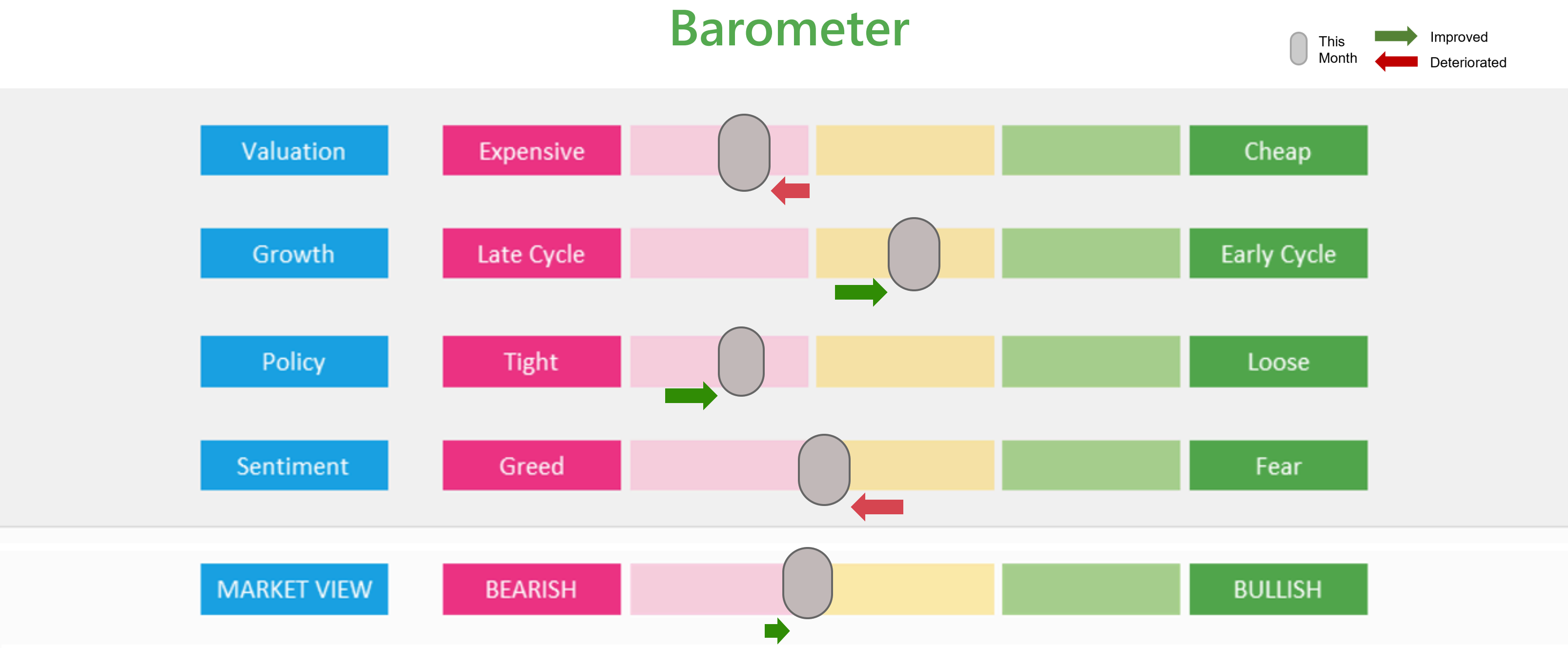
AUGUST 2024

Market Barometer



Market fundamentals remain solid, underpinned by:

- **Earnings growth at a 10% annual rate** both in Q2 reported (so far with half of companies having reported as we go to press), and in the forward earnings estimate. We cannot overstate how critical this is. If we followed one indicator only it would be earnings.
- **Inflation continuing to trend lower**, back towards central bank target. US CPI ex Food and Energy has slowed from 6.5% to 3.3% in a straight(ish) line since its peak in Sept 2022. **We are still in a Disinflation** regime - the best inflation quadrant for both equities and bonds in our Fire & Ice framework.
- **Sentiment that has improved** but is still not at extremes that would warrant caution.

Risks we are watching:

- **Unemployment** inching higher. Consumers starting to **downtrade. Trump and inflation risk.**

In our Charts of the Month:

- We set out our **Fire & Ice framework** for inflation, which determines the asset market regime.
- We are still in **Disinflation** regime, which is very positive for risk assets.
- We show why we are such **fans of the Shiller PE** as a lead indicator of forward market returns over the long term (but not in the short term).
- We look at performance breadth and show that this year and last have been two of **the worst environments for stock pickers** as so few stocks have outperformed.
- We look at the US yield curve (again) as it un-inverts.

We continue to believe the outlook for risk assets is good.

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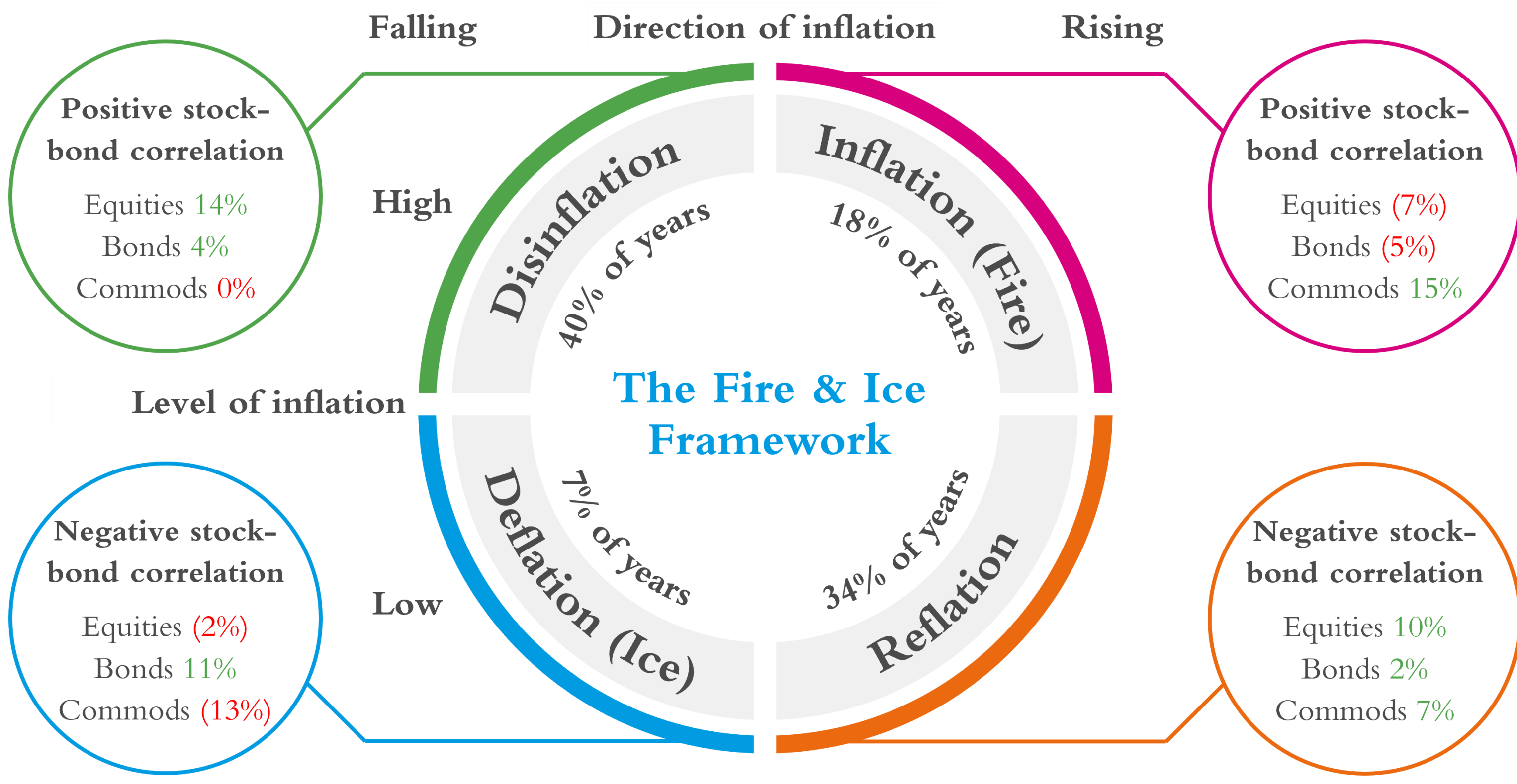
Charts of the Month (1 of 4)

Fire & Ice. Since the late 1990s we have used a framework for asset class returns that we call Fire & Ice (after the poem by Robert Frost, quoted by our late mentor Barton Biggs at Morgan Stanley - see below). The framework asserts that asset class returns are critically dependent on the **level** and **direction** of inflation. Empirically we have found this to be the case. Take the last four years to illustrate. **1)** The pandemic was a **Deflation (Ice)** shock. The regime was "Ice" (bottom left quadrant below). Stocks fell on a projected lack of demand and weak pricing power. Bonds rallied as the real value of their fixed coupons rose. **2)** Massive fiscal stimulus caused **Reflation** (bottom right). Asset prices reversed course. Equities rallied on recovering pricing power, bonds sold off. Then **3)** the stimulus was overdone, M2 money stock soared, and **Inflation (Fire)** ensued. Paper asset prices all fell as markets priced in surging inflation eroding real returns. Eventually **4)** inflation peaked as central banks tightened policy, and the **Disinflation** regime began, boosting paper asset prices. **We are still in the Disinflation regime, one of the reasons that both equities and (some) bonds have been performing well.**

Asset Class Real Annualised Total Returns in each Fire & Ice Quadrant (1928-2024)



Fire & Ice

Some say the world will end in fire,
Some say in ice.
From what I've tasted of desire
I hold with those who favour fire.
But if it had to perish twice,
I think I know enough of hate
To say that for destruction ice
Is also great
And would suffice.

By Robert Frost

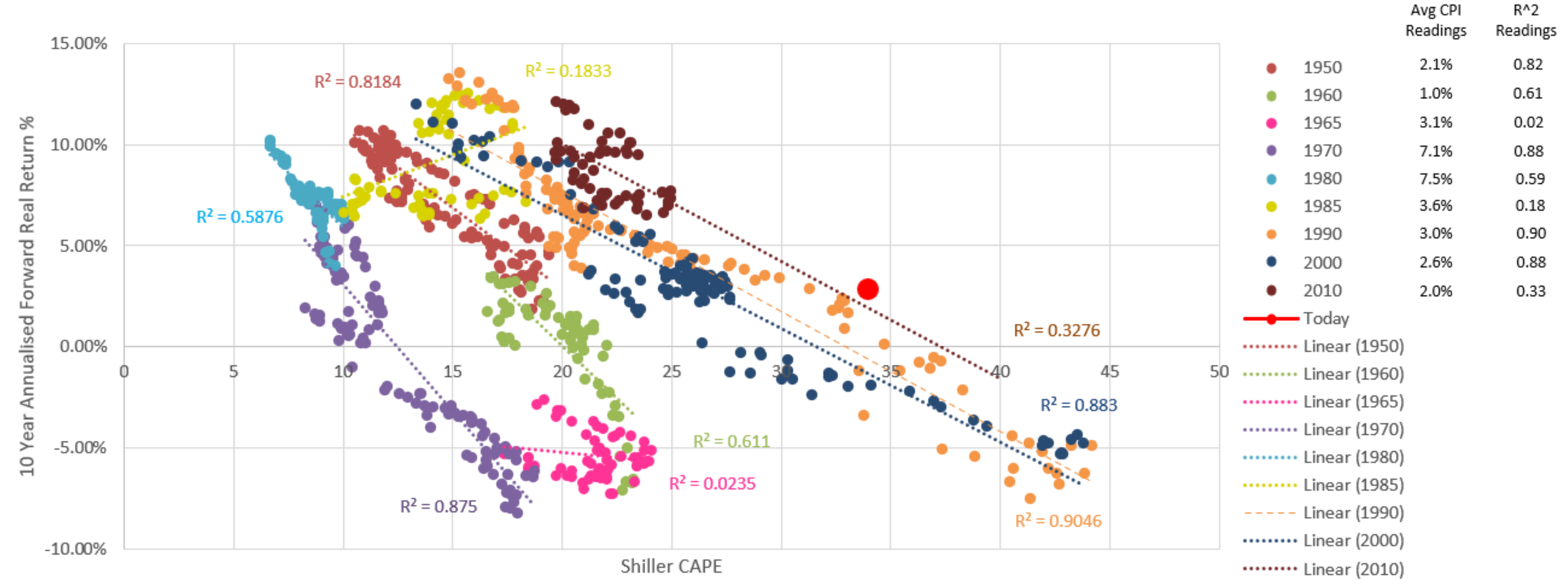
Sources | CCLA, Bloomberg. Data as at July 2024

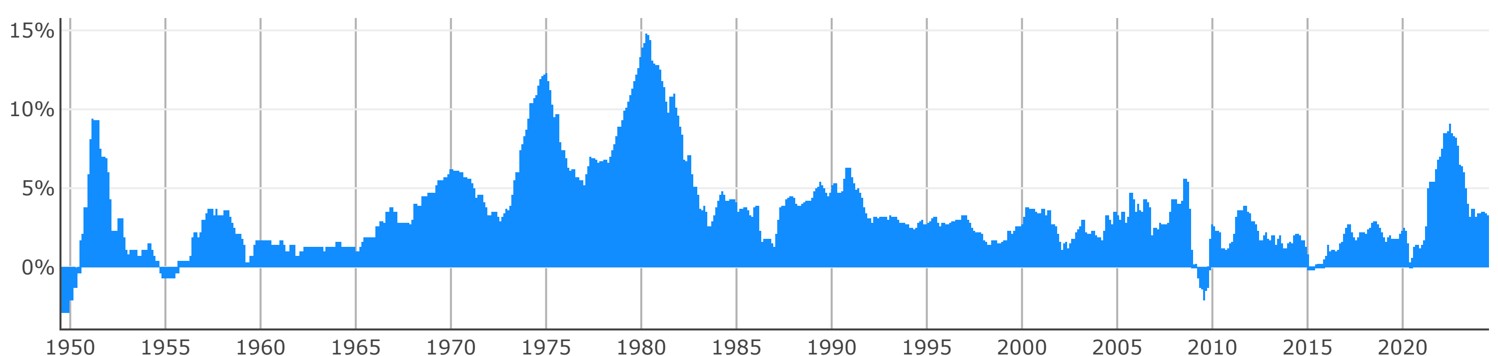
TOP OF MIND

Charts of the Month (2of 4)

We use Shiller PE to estimate future market return. Should we? Each dot is a monthly observation of 1) the Shiller PE ratio for the S&P500 (on the horizontal axis) and 2) the subsequent 10 year real total return of the S&P 500 (on the vertical axis). The dots are coloured by decade or half decade. We also show lines of best fit for each period. **This makes three main points. First, that starting valuation does a very good job of explaining forward returns** in most (but not all) decades. The r2 measures explanatory power. We can say that the Shiller PE explains >80% of return in the 1950s, 1970s, 1990s and 2000s, and ~60% of return in the 1965-70 and 1980-85 periods. So in 50 of 70 years it does a stellar job. It's only in the 1965-70, 1985-90 and 2010-14 periods that is has not worked. **The second point is that with the Shiller PE now at 34x, forward real returns have historically ranged between +3% and -3%.** We are assuming +3% (see the red dot) in line with the current decade average line of best fit. We also acknowledge that Shiller PE does a POOR job of explaining returns over shorter (1-7 year) horizons. **The third point - higher inflation periods give lower / negative real returns** (see the purple and pink clusters, being the 1970s and 1965-70 when inflation was high and rising.

S&P 500 - Shiller PE (x-axis) vs Subsequent 10 Year Real Annualised Total Return (y-axis)





Sources | Bloomberg, CCLA as at July 2024

TOP OF MIND

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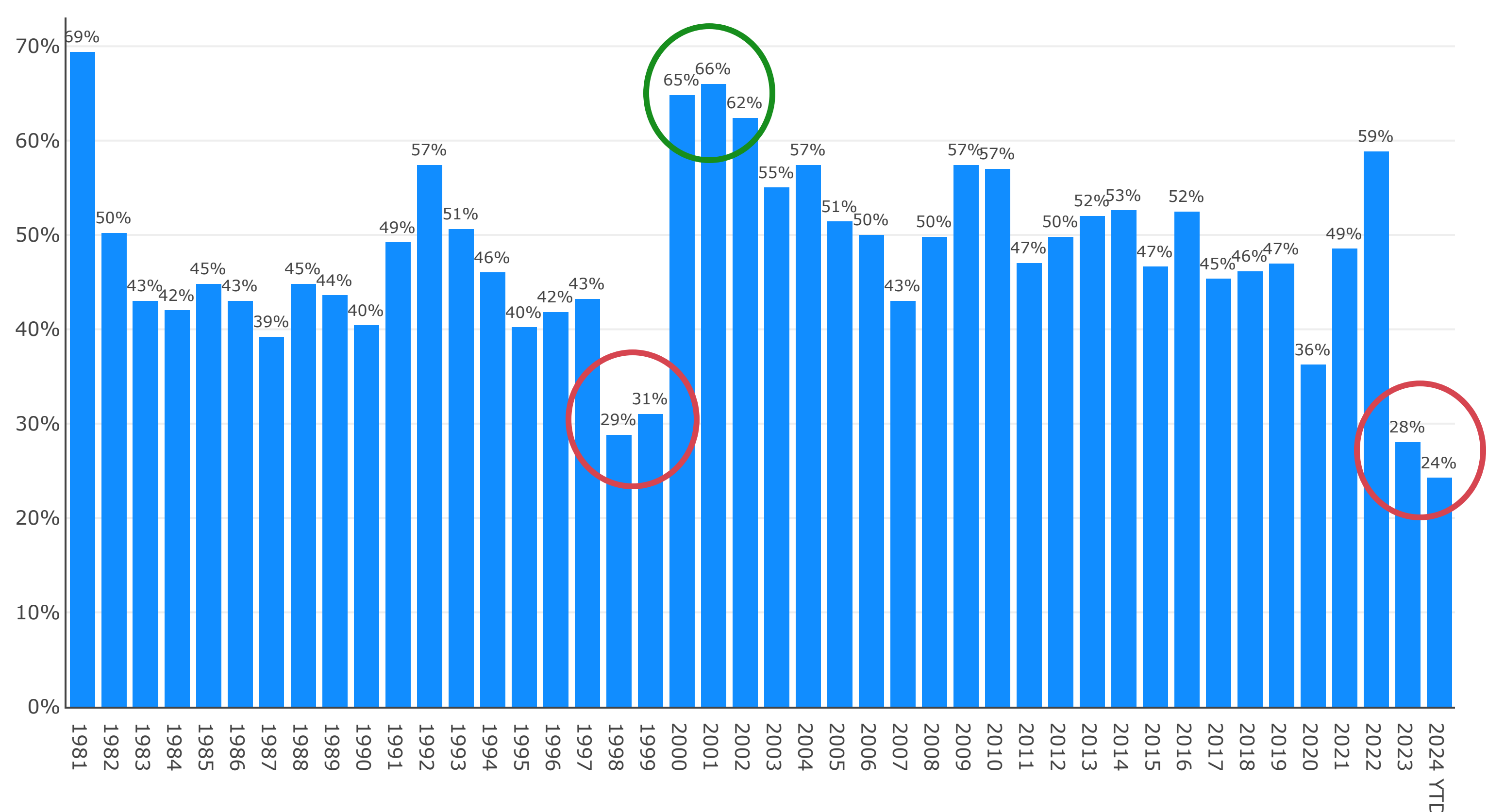
Charts of the Month (3 of 4)

Market leadership has been extraordinarily narrow. The chart below illustrates that just 24% of stocks have outperformed the S&P 500 index this year, after just 28% outperformed last year. In the last 45 years 2023 and 2024 so far have had the narrowest market leadership. This time around it's happening because the Magnificent Seven (Apple, Amazon, Alphabet, Microsoft, Meta, Nvidia, Tesla) are the seven largest weightings in the index (at 29% in total) and have hugely outperformed. Last time it happened was in 1998-99, the so-called TMT bubble, when large caps such as Microsoft, Cisco, Intel, Lucent, IBM and AOL doubled or trebled, before round-tripping back down to earth.

It follows that there has been a commensurately **narrow opportunity set for stock pickers,** and this is borne out in the data. According to an AJ Bell report, **only 26% of Global equity funds outperformed the benchmark** in the first half of 2024. The consolation could be that the opportunity set expands in coming years. After the lean years (for stock-pickers) of 1998-99, the following years were three of the best ever for breadth, with 62-66% of stocks outperforming in each year.



Sources | Bloomberg, CCLA, data as at July 2024.

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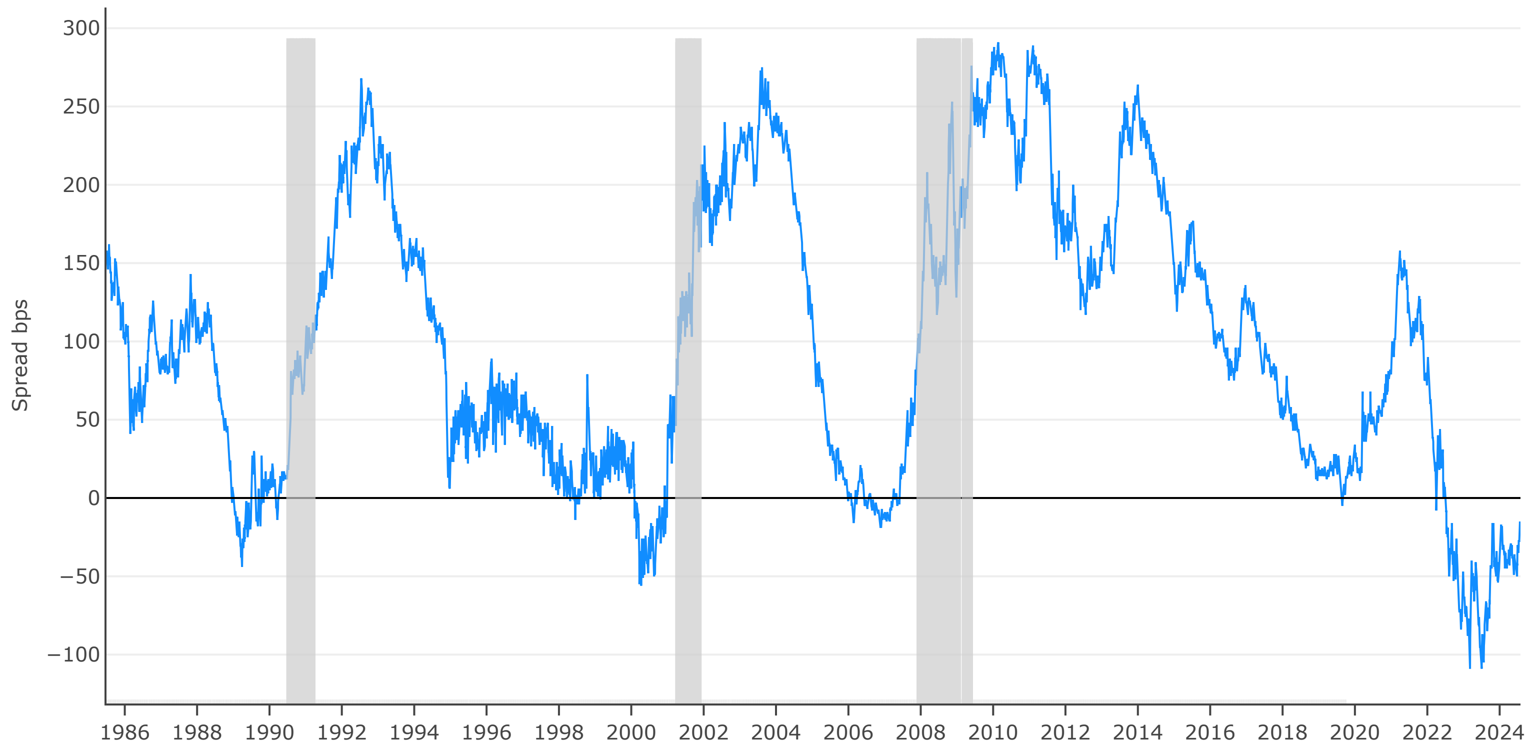
Charts of the Month (4 of 4)

Beware the de-inversion Below we show the slope of the US yield curve, defined as the 10 year bond yield minus the 2 year bond yield. The curve has been inverted (negatively sloped) for now two years, since first inverting in July 2022. This is the longest curve inversion without a recession in over 70 years. But it is now de-inverting / re-steepening, and the UK curve last week actually de-inverted, i.e. UK 10s now yield more than UK 2s. **Is this a positive for markets? Not usually.** What normally happens after an inversion is the 2 year bond yield starts to fall as markets price in a rate-cutting cycle, normally in response to a weaker economy. What we can say today is that markets are pricing in a rate-cutting cycle, but so far it looks more to be taking out tight policy than introducing very loose policy. But as we can see from the chart, **if we got a major steepening in the yield curve it would most likely indicate recession**.



Sources | Bloomberg. Data as at July 2024

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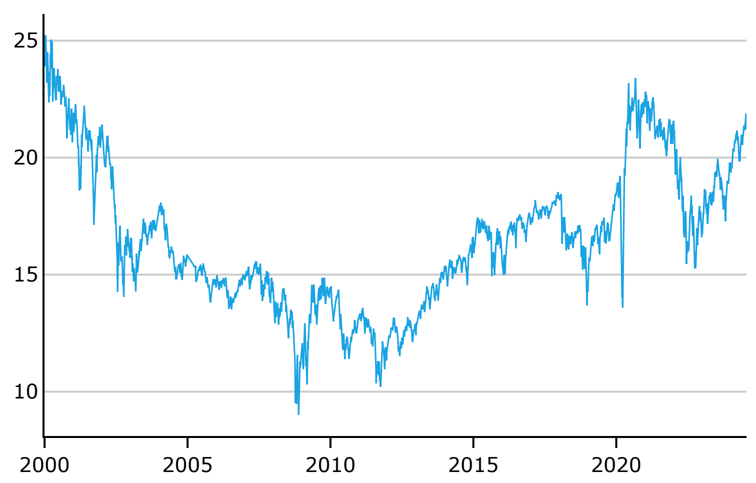
Equity | USA

Despite a mid-month wobble, the US equity market continued to expand on its 17.5% year-to-date return. Current levels imply spot PE valuation at 21x, still 31% above its 16x average of the last thirty years.

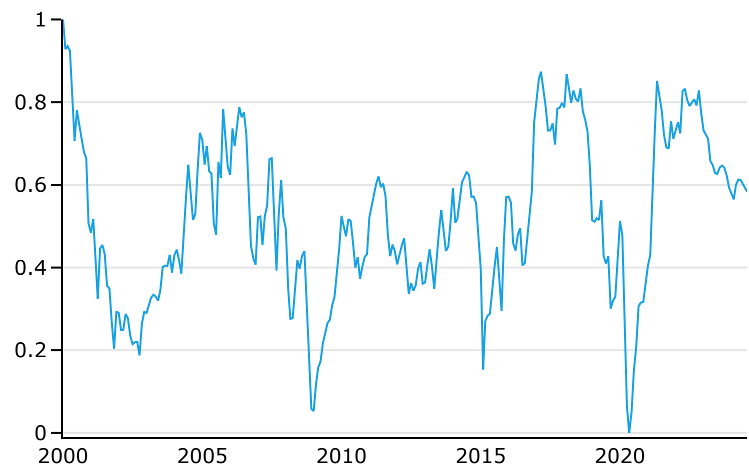
The CAPE (Cyclically Adjusted PE) has also ticked higher, to 34x. A shorthand for future real expected return is the CAPE earnings yield, indicating that US equity may not be expected to return much more than 3% annualised over coming years. **Despite cross asset valuations dropping to the 58th percentile (top right)**, it would still suggest equities are a little extended but not dramatically so. But absolute valuations are full in the US at least.

S&P 500 Valuations

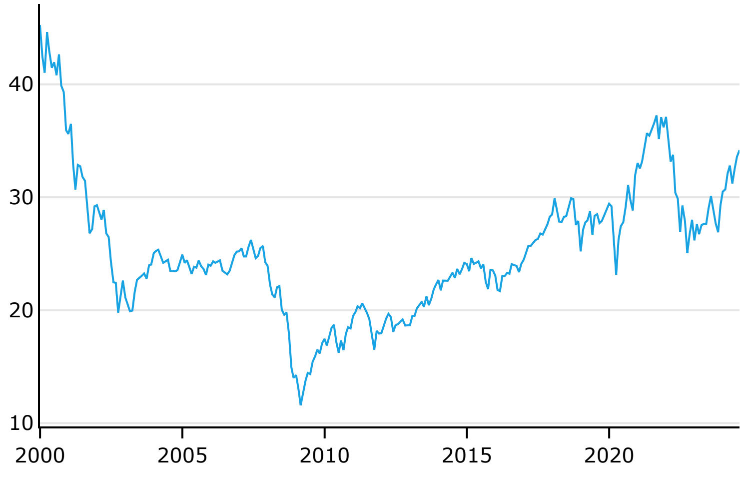
S&P 500 Forward PE



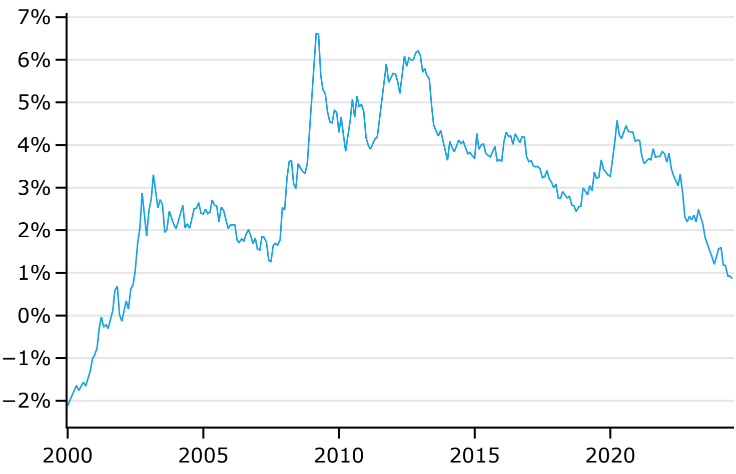
Composite Value Indicator Model



CAPE / Shiller P/E



S&P 500 Equity Risk Premium



Note | Composite Value Indicator was built at Morgan Stanley in 1997 and is published with permission. It is an aggregate of seven equity yields adjusted for bond yield, T bills yield and inflation, and is expressed here in its percentile range. The CAPE / Shiller PE is today's price divided by the average earnings of the last 10 years. The Equity Risk Premium is calculated as the Shiller earnings yield minus the real bond yield.

Sources | S&P 500 PE: Bloomberg, CVI Model: CCLA as of July 2024, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of July 2024

VALUATION

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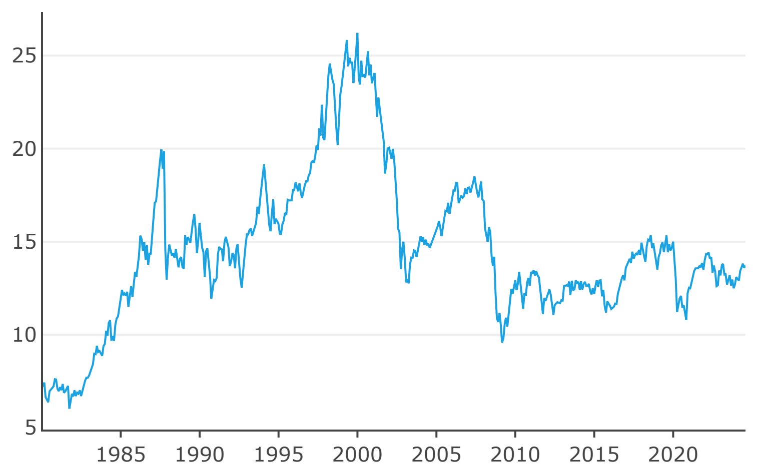
Equity | Regional

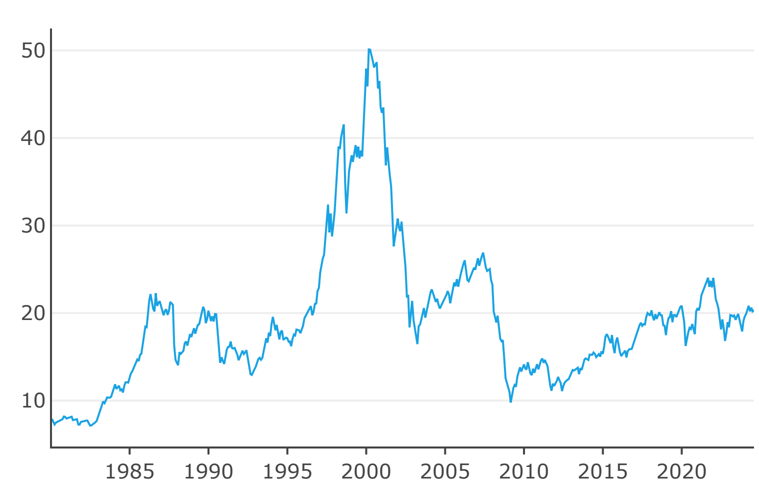
Outside the US, equity markets continue to look reasonable value (UK, Europe-ex-UK, Japan) or outright cheap (EM), despite recent re-rating. The UK Shiller PE of 13.7 gives an earnings yield of just over 7%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 20.3 gives almost a 5% forward real return. Asia and Japan look similarly good value to us, the latter despite its strong recent performance.

Europe

UK | Shiller P/E

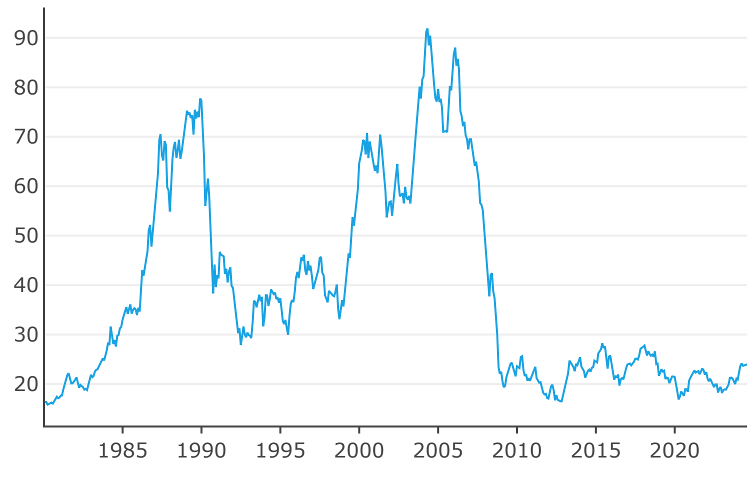


Europe (Ex-UK) | Shiller P/E

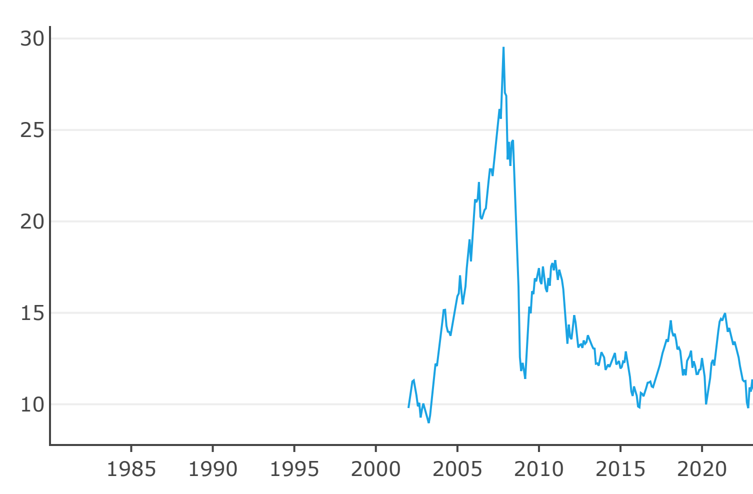


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



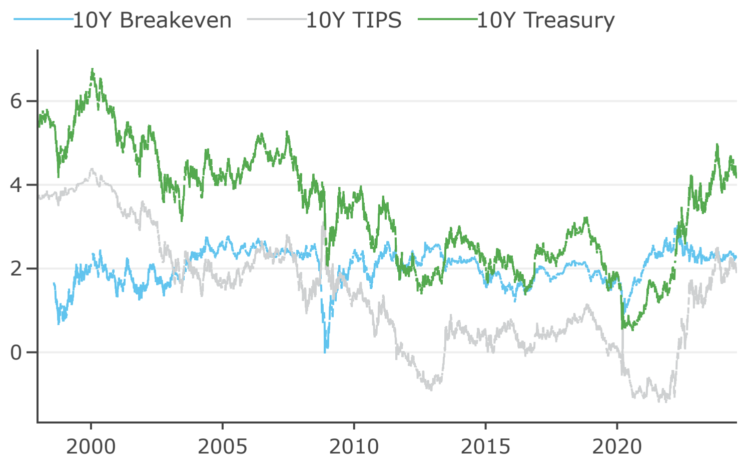
Sources | Shiller P/Es: Morgan Stanley as of July 2024. Shiller P/E is calculated as today's price divided by the real average earnings of the last 10 years.

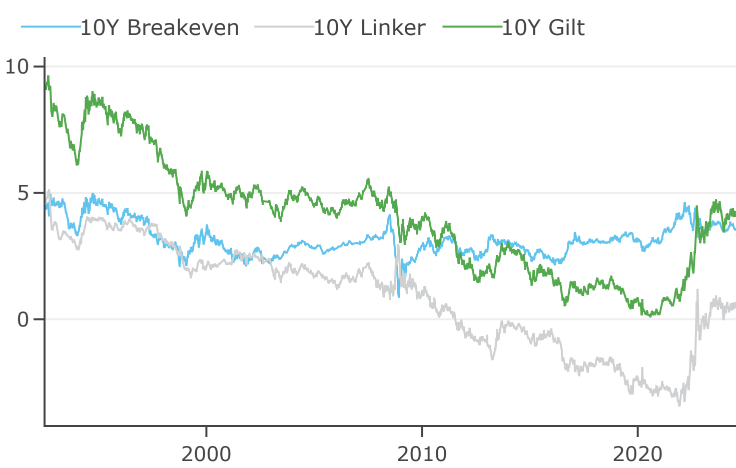
Bonds

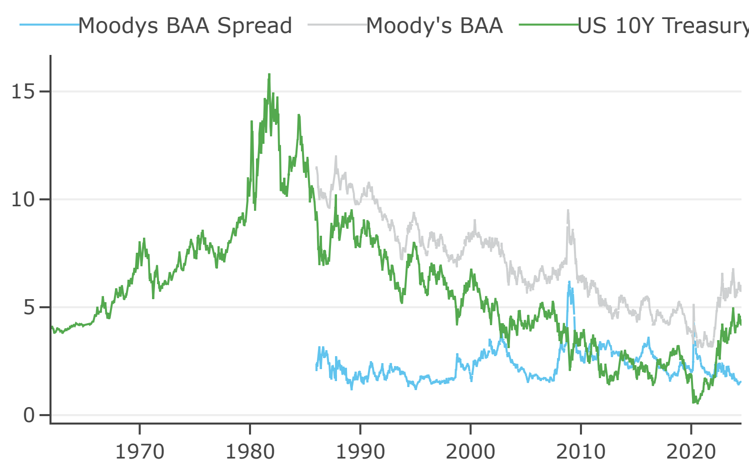
US and UK 10Y Government bonds have been trading sideways. Given the recent stability in breakeven rates, both regions are now pricing in inflation-linked bonds close to 1.9% and 0.5% respectively. A good indicator of market's expectation for long-term real GDP growth rates, and in our view looks to be at fair value. **This means we are remain indifferent between nominals and linkers.**

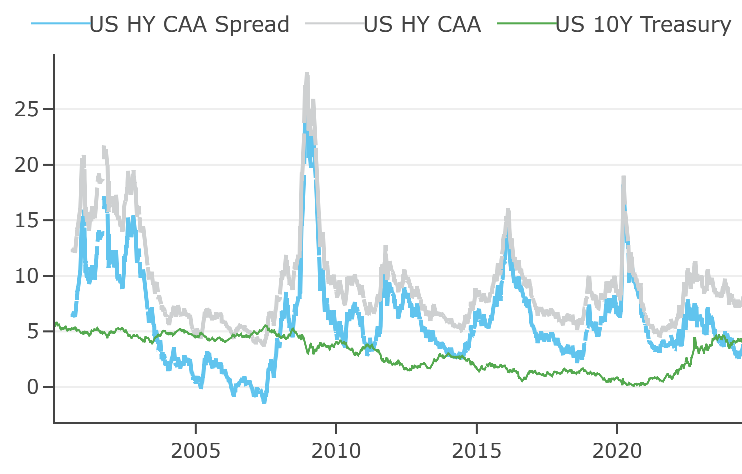
Corporate US BBB yields are still around 5.8%, which, stripping out 2.5% expected inflation, yields above 3.3% real expected total return, **which to our eyes remains reasonably attractive**.

Global Government & Corporate Yields









Sources | Bloomberg as at July 2024

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Alternatives

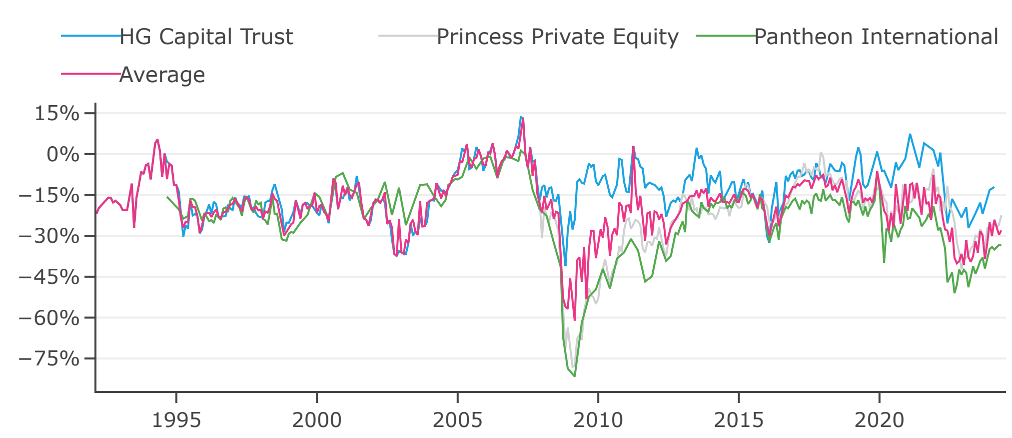
The IRR on Core Private Infrastructure now offers 2.8% return spread over IG corporate bonds, which is still interesting after a much tighter spread over the last two years. Listed Infrastructure continues to trade at 10-35% discounts to net asset value (NAV), which is somewhat more interesting, especially where managers can add value via development. Private Equity discounts to NAV remain wide (top left chart).

The recent surge in investor demand for Levered Loans benefitted some pockets of the market, creating small discounts on yields. However, **on aggregate Leverage Loan yields stay at over 9% with a rate cutting-cycle remaining as the main risk.**

Global Valuations

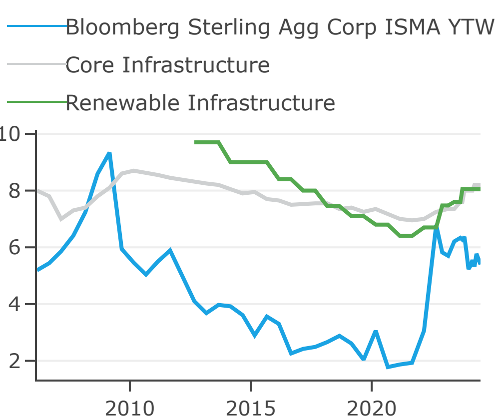
Listed Private Equity

Discount To NAVs



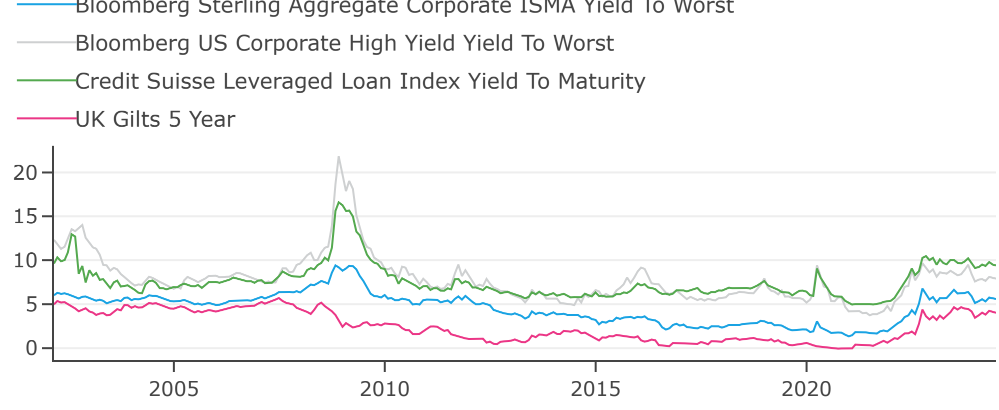
Infrastructure

Infrastructure Discount Rates vs Bond Yields



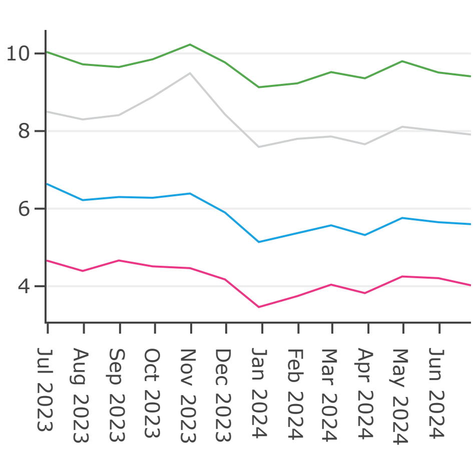
Contractual Income

Income Yields



Last 12 Months

Income Yields



Sources | Infrastructure: CCLA, Bloomberg; Property: MSCI UK Monthly Property Index, Bloomberg; Private Equity: Bain Global Private Equity Report, Bloomberg, Pitchbook; Contractual Income: Bloomberg, Pitchbook. As of July 2024

VALUATION

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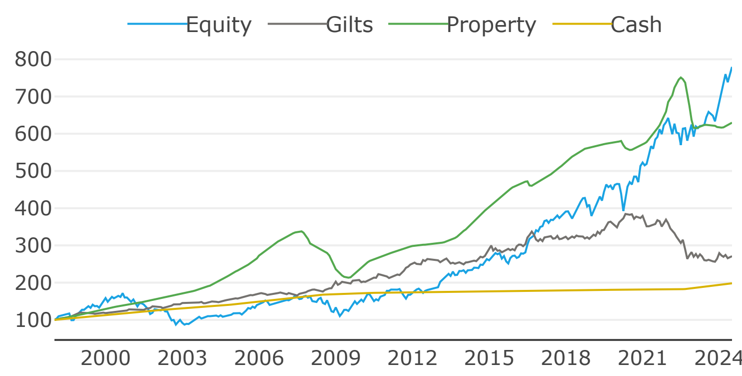
Property

The UK Commercial Property market offers good yields, (c.7.0% Equivalent Yield on average), within the context of the commonly targeted CPI+4% returns at a portfolio level. NAVs appear to have stopped falling, having declined 21% in 2022. Underlying physical transaction volumes are bumping along the bottom but have not started to recover. Meanwhile, there ongoing outflows from open-ended property funds are reported.

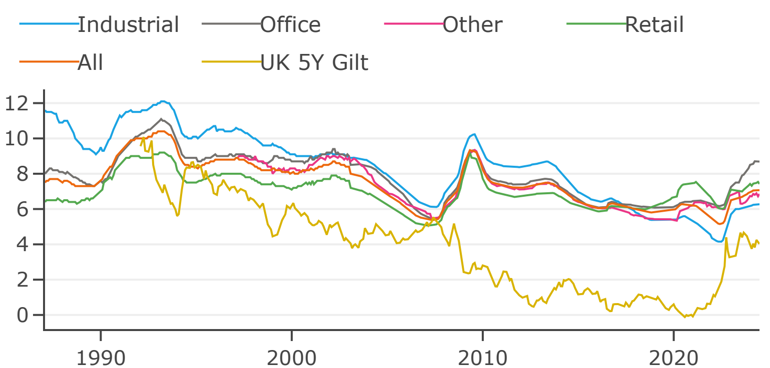
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle left chart). **This bodes well for forward returns from here**.

UK Commercial Property Market

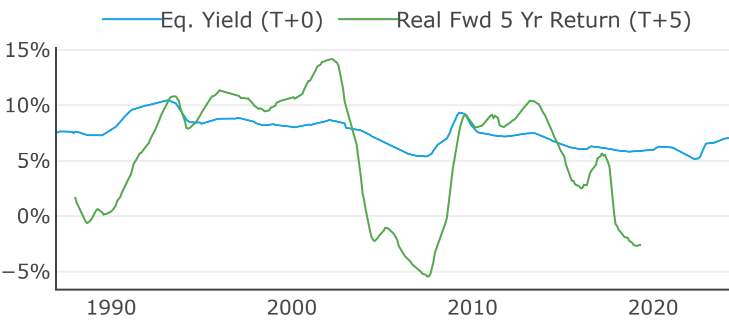
25 Years Of Return 1998=100



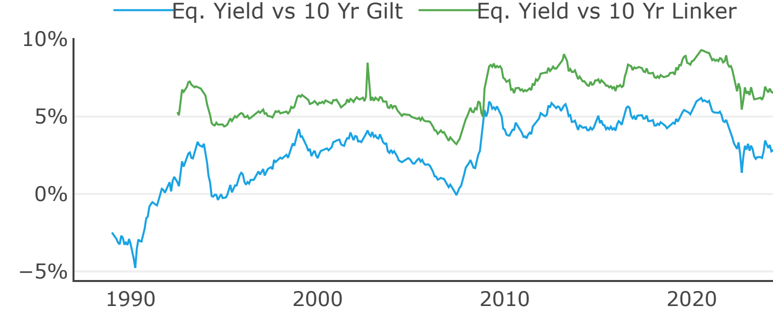
Equivalent Yields vs Gilt Yields %



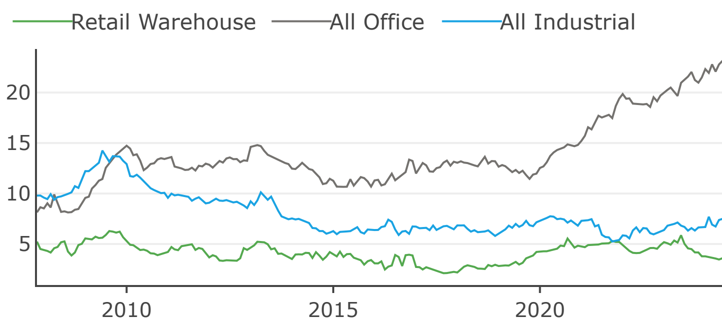
MSCI UK All Property Monthly TR Index %



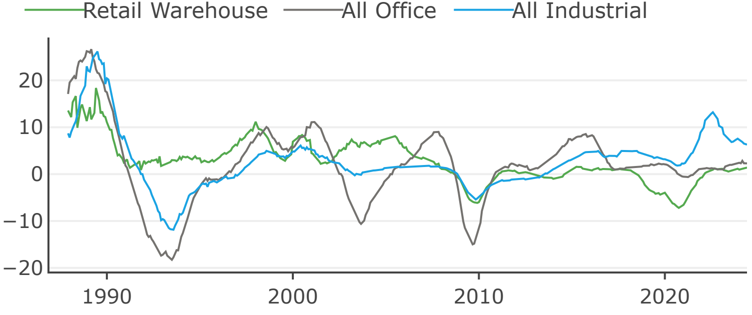
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



Sources | Equivalent Yields, Vacancy Rate, and Nominal Rental Value charts: MSCI UK Monthly Property Index as at July 2024. 25 Years of Return, All Property Monthly TR Index as at June 2024

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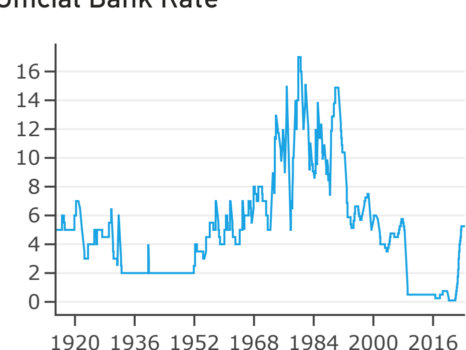
Cash

The UK 2Y-10Y spread has un-inverted (normalised) for the first time since May 2023. An inversion of the sovereign yield curve is usually considered an ominous sign, a historic harbinger to a recession. However, the recession tends to start after the normalisation of the yield curve, which, as of 9 July, became the case for the UK Gilt curve.

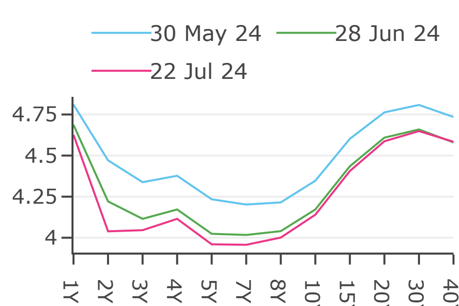
The fate of the UK economy is not set, however. The flash PMIs for both services and manufacturing industries are performing strongly with businesses optimistic about future orders, inflation and interest rates. Speaking of the latter two, **with no immediate sign of danger to the economy, the markets price in a 60% chance of a 25bps rate cut in Aug.**

UK Sterling Market

Official Bank Rate

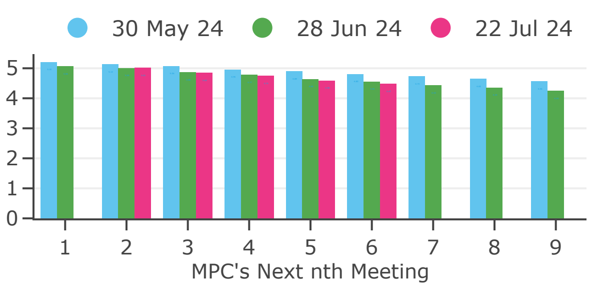


UK Gilt Curve

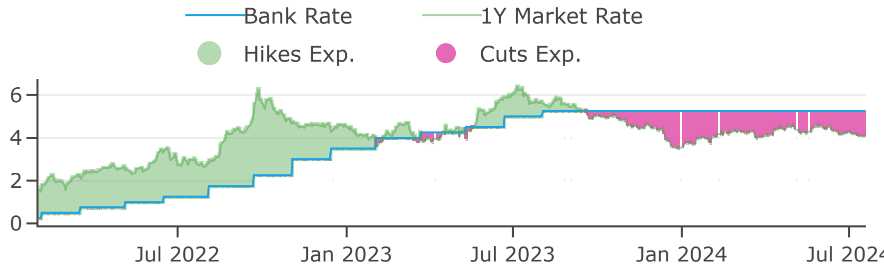


Gilt Spreads

Rate Expectations For Future MPC Meetings



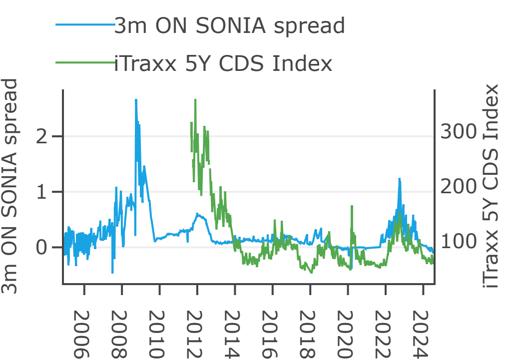
1Y Forward Market Rate Expectations



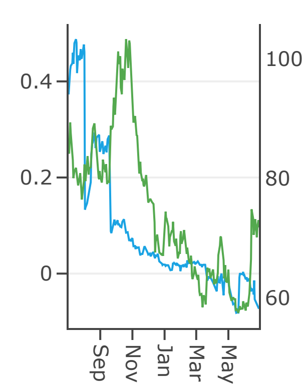
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2024				
	Feb...	Mar...	April	May	June
RPI	4.50	4.30	3.30	3.00	2.90
CPI	3.40	3.20	2.30	2.00	2.00
CPI Core	4.50	4.20	3.90	3.50	3.50
CPI Services	6.10	6.00	5.90	5.70	5.70
CPI Goods	1.10	0.80	-0.80	-1.30	-1.40
Priv. Wages	5.80	5.90	5.90	4.90	

Market Stress



Last 12 Months



Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, at least +/- 2 standard deviations away scores as red.
Bloomberg for all charts, as of July 2024

GROWTH

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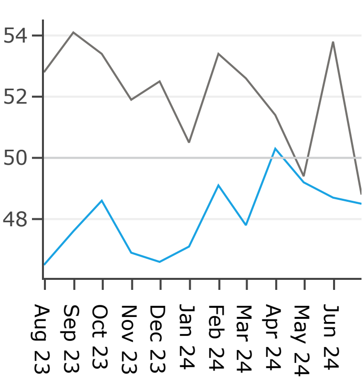
Global PMIs

Despite poor US readings, leading indicators continue to hold up in aggregate around the world. The key US Services PMI for June dropped below the 50 line, making it the second contraction in the last three months. Lower business activity, weaker new orders and continued slow down in employment all played a role. Manufacturing did not fair any better. US Manufacturing PMI fell again into contraction for the third consecutive month. On the other hand, Eurozone Services PMI is now solidly above 50. **For now there is no immediate sign of a recession**.

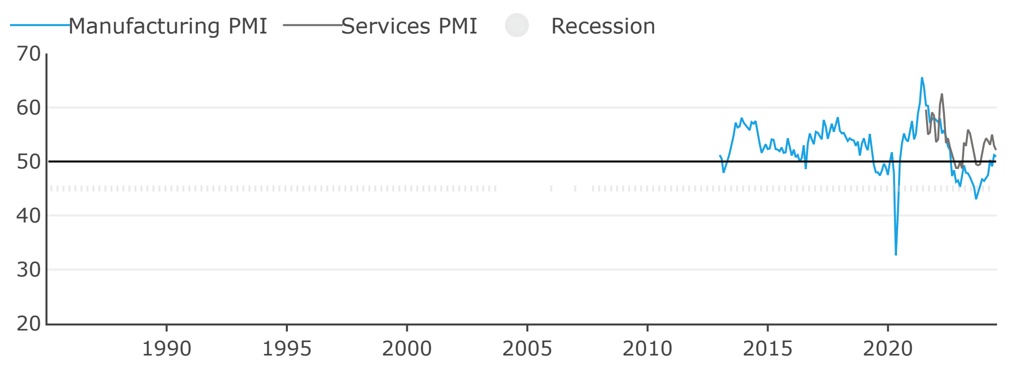
United States

Manufacturing PMI
Services PMI
Recession
70
60
50
40
30
20
1990
1995
2000
2005
2010
2015
2020

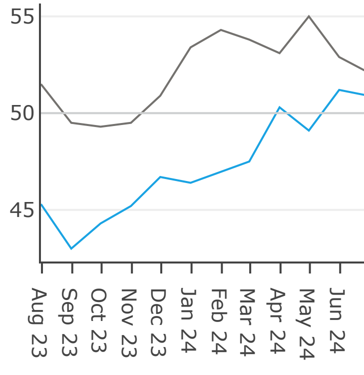
Last 12 Months



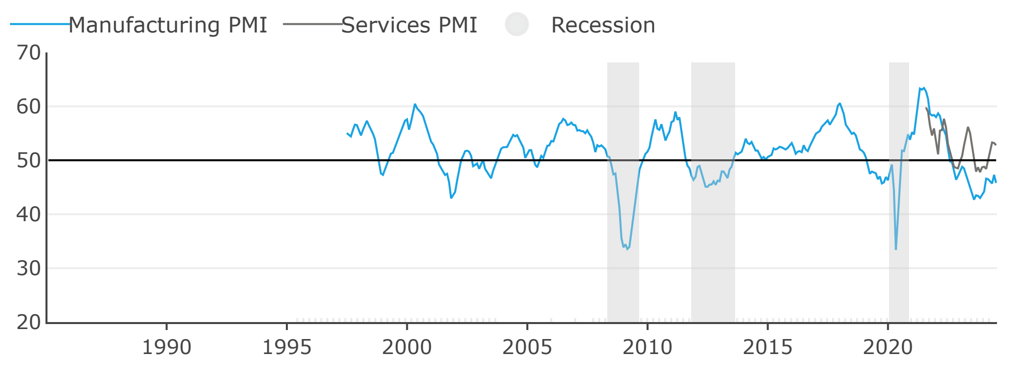
United Kingdom



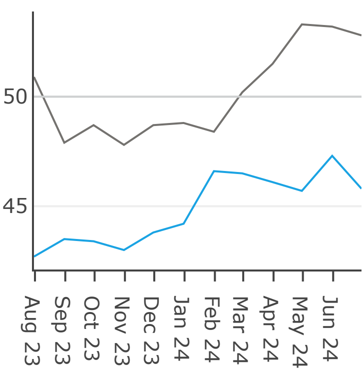
Last 12 Months



Eurozone



Last 12 Months



Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of July 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

GROWTH

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Global PMIs

Both the Global Services and Manufacturing PMIs remain above 50 (bottom right chart), indicating that the Manufacturing recession is over and that there is no imminent recession risk. This can change quickly, but for now, growth is supported.

(The lurch down in the June readings for Services PMIs in China and Japan seem to have been statistical quirks, and the Japanese reading for July is reported to have recovered to 54.)

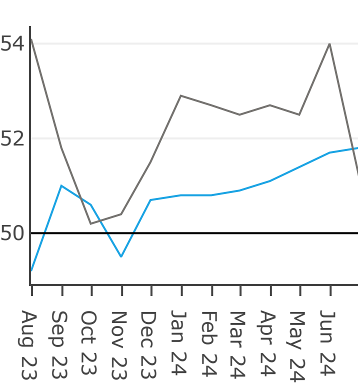
China

Manufacturing PMI Services PMI Recession

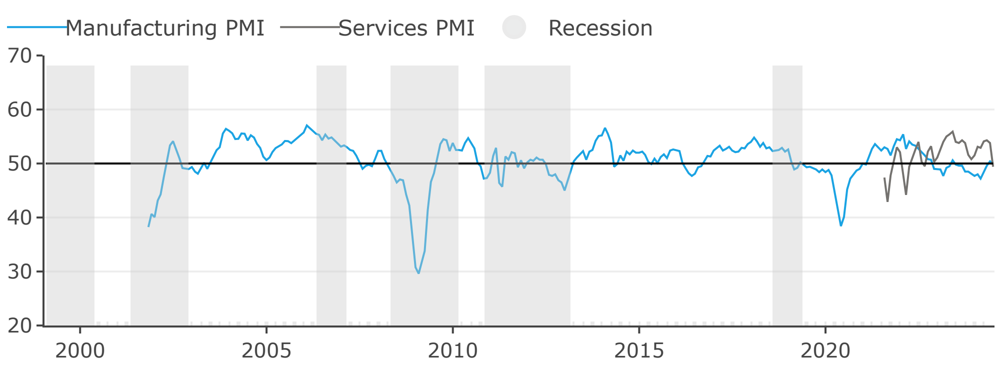
70 60 50 40 30 20

2000 2005 2010 2015 2020

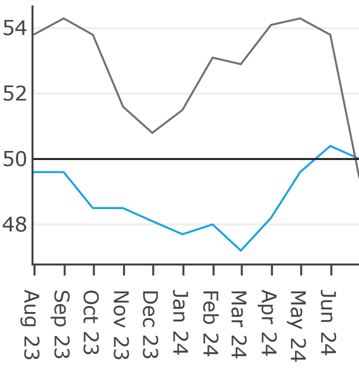
Last 12 Months



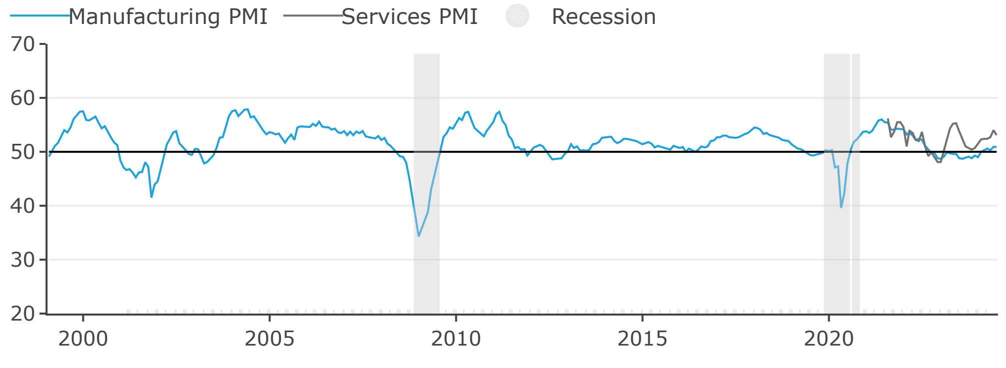
Japan



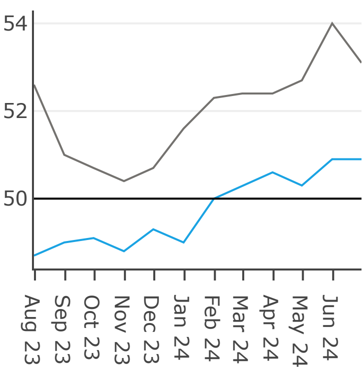
Last 12 Months



Global



Last 12 Months



Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of July 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

GROWTH

CCLA

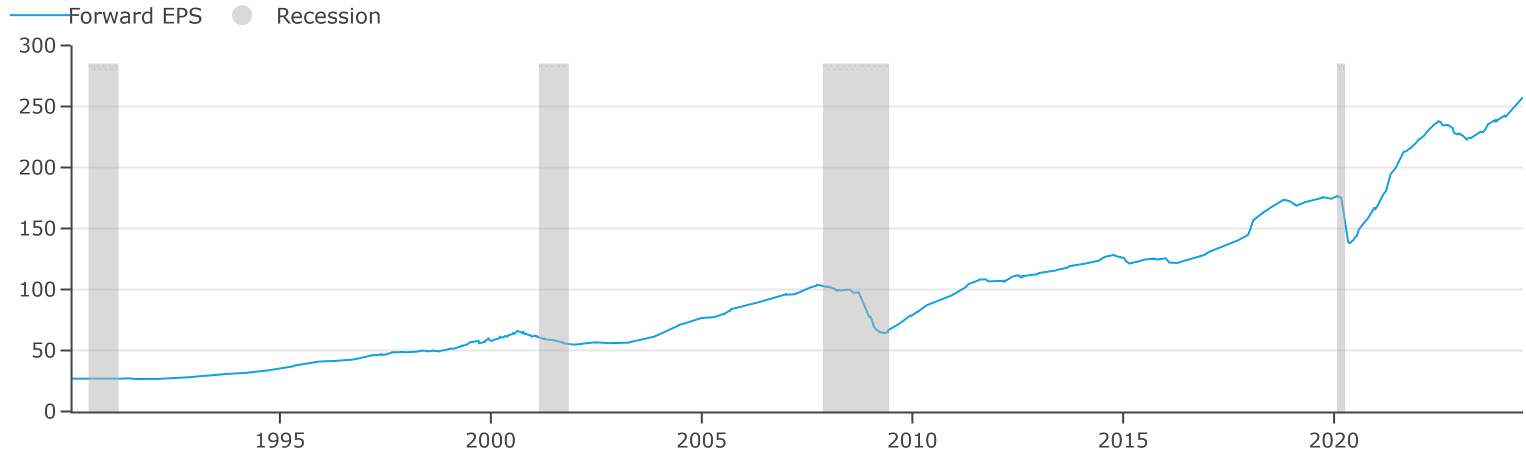
Earnings

Consensus forward earnings estimates continue to recover (top chart) while trailing earnings are just starting to grow again. With half of S&P500 companies having reported for Q2 earnings as we go to press, year over year EPS have grown 10% and results on average beat estimates by 4% points - both solid readings.

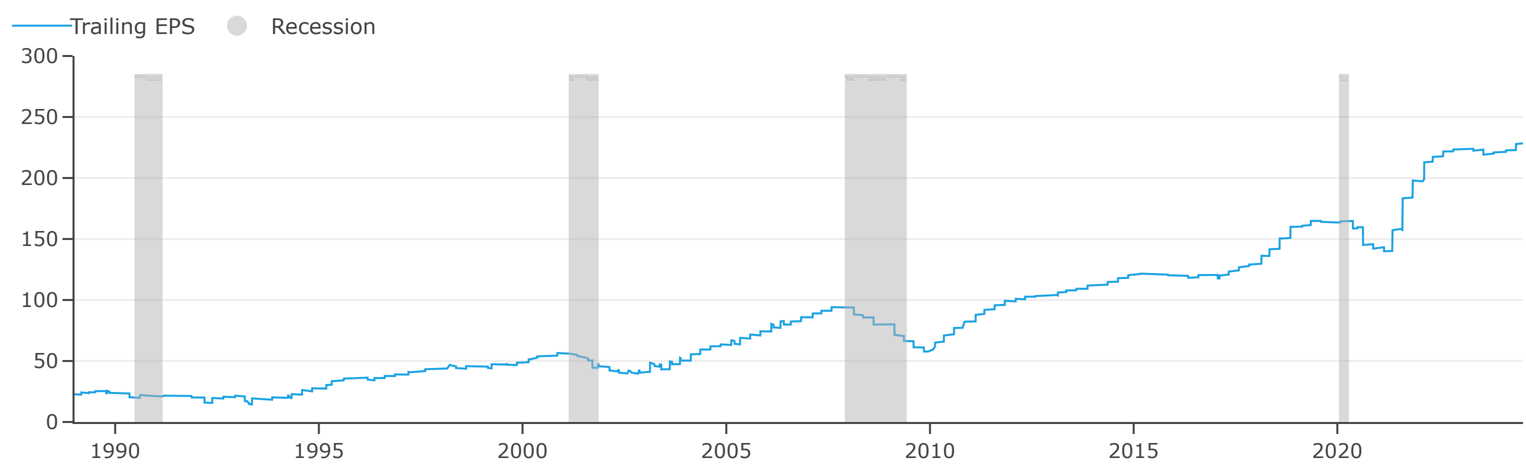
We reiterate that earnings could be in position to take over from PE re-rating in driving the market higher, although clearly a recession would change that.

S&P 500

Bloomberg Est. EPS



12M Trailing EPS



Sources | S&P500 12M Forward EPS using Bloomberg BF transformation, 12M Trailing EPS from Bloomberg as at July 2024

GROWTH

CCLA

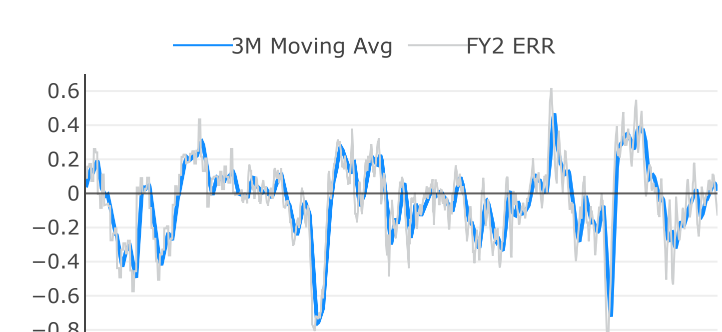
Earnings

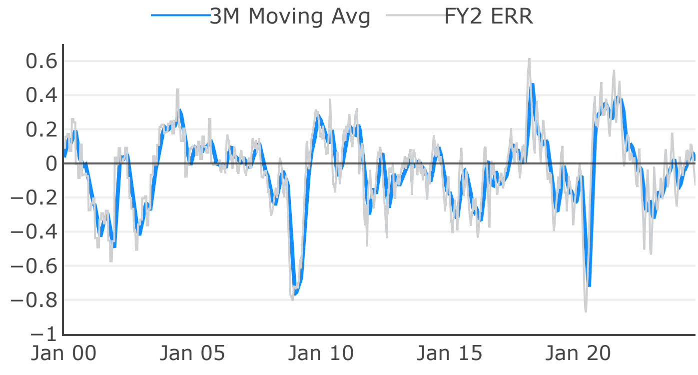
These charts show the breadth of earnings revisions, i.e. # upgrades minus # downgrades / total estimates, so it is a directional measure showing how widespread upgrades or downgrades are. Historically, troughs in revisions breadth have been excellent times to add risk.

The overall assessment is that earnings breadth is ticking up, with the US now joining Japan in having positive net earnings breadth. This speaks to a broadening out of earnings support from just the Magnificent Seven.

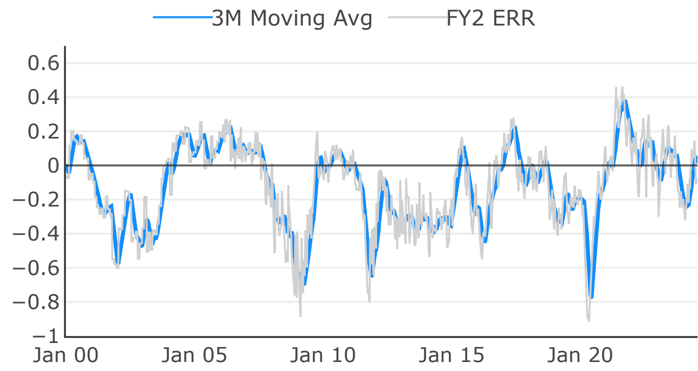
Global Earnings Revisions Ratios

USA

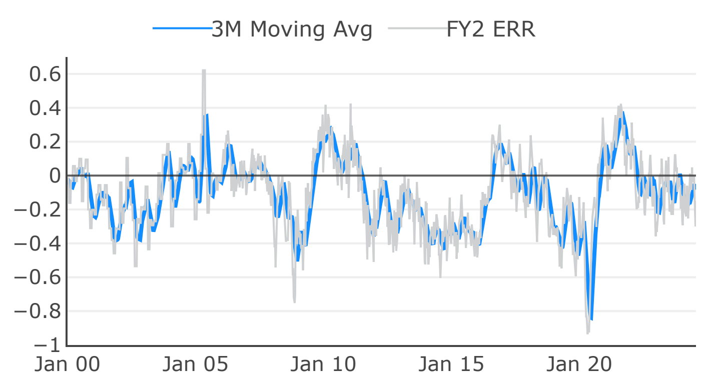




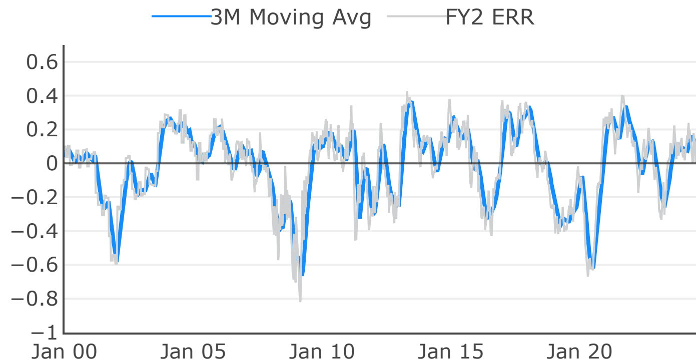
Eurozone



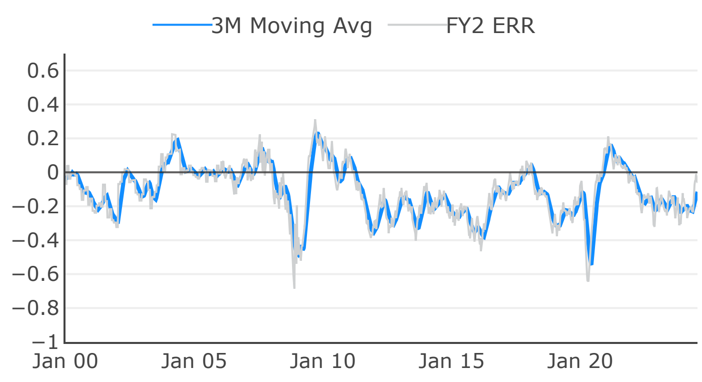
UK



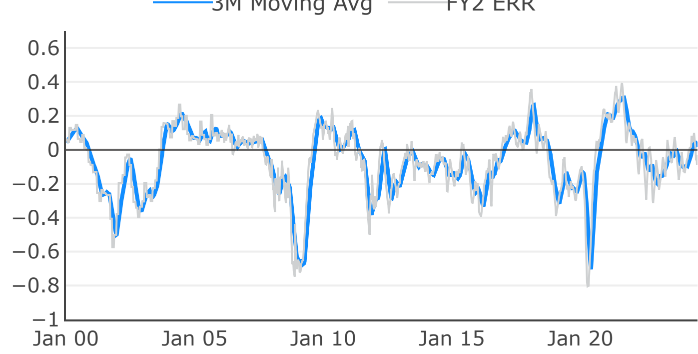
Japan



Emerging Markets



World



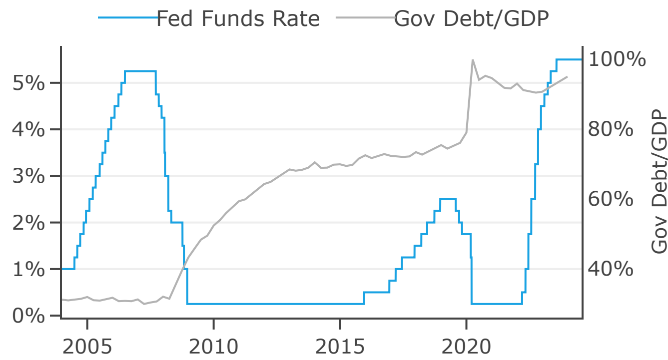
Sources | Eikon, the MSCI index has been used for each respective region, as at July 2024.

POLICY

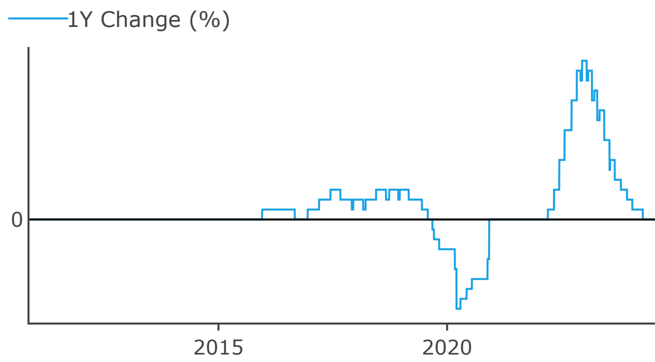
Interest Rates

Despite US inflation remaining sticky at around the 3% level for 12 months now, US two year bonds have fallen over 34bps over the same period, now yielding ~4.5%. The seven rate cuts that were pencilled in for 2024 have dwindled to just two now expected. **To the extent that this is a reflection of a strong nominal growth rate which supports index earnings, this does not have to be a very negative indicator for the stock market**.

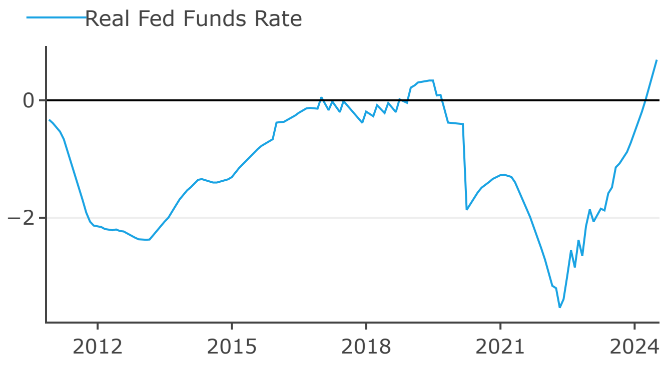
Fed Funds Rate



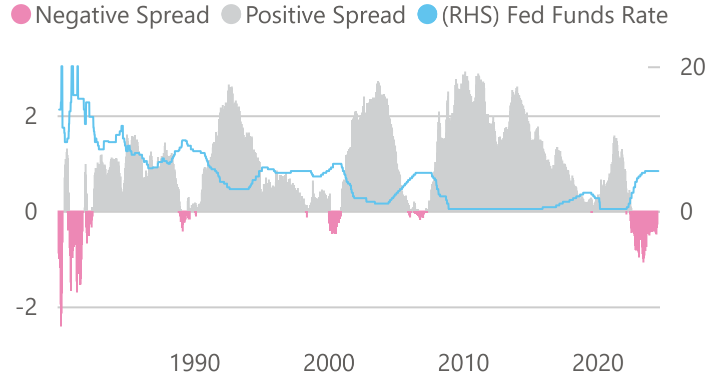
Change in Fed Funds Rate



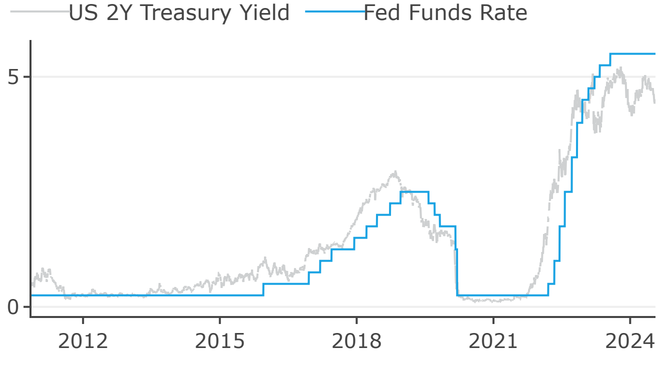
Real Fed Funds Rate (Using 2Y MA CPI)



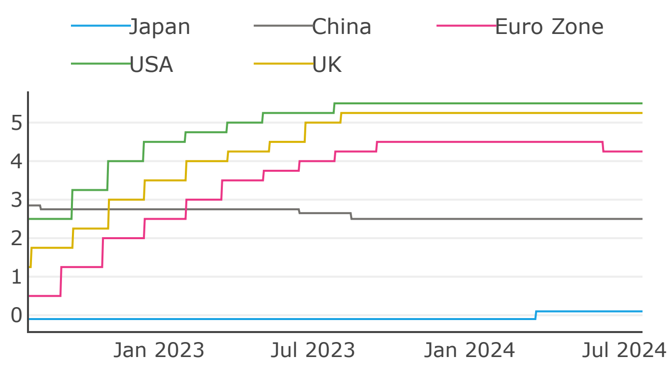
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of July 2024

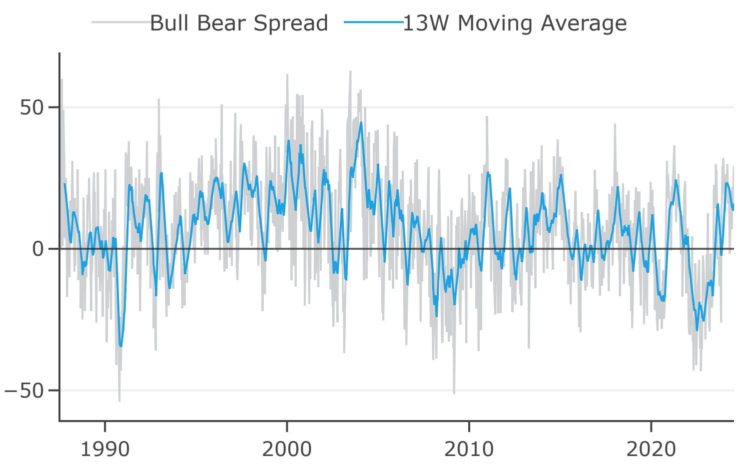
SENTIMENT

Sentiment

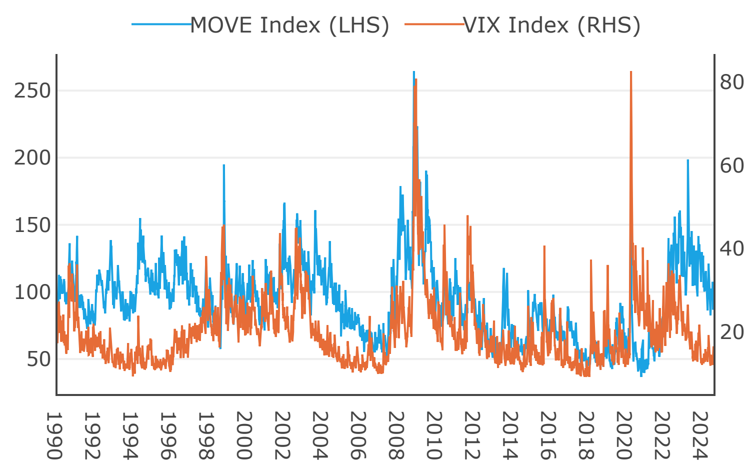
The BAML Hartnett Bull & Bear Indicator has moved from Extreme Bearish sentiment (which is bullish for the market!) in October 2022 **to now above neutral** (the current reading is 6.5/10). In other words, sentiment is edging towards the bullish side, but has not reached extreme levels yet.

US Equity Indicators

AAII Bull Bear Spread

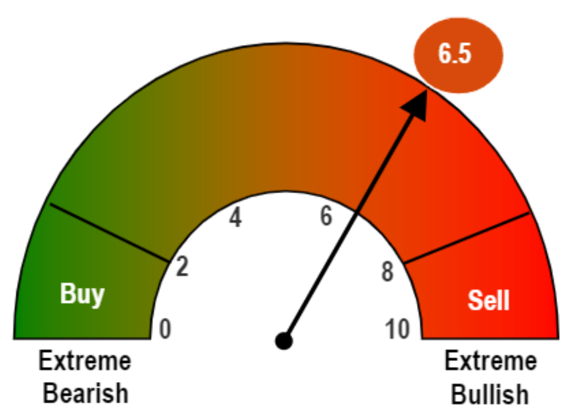


Equity vs. Bond Sentiment

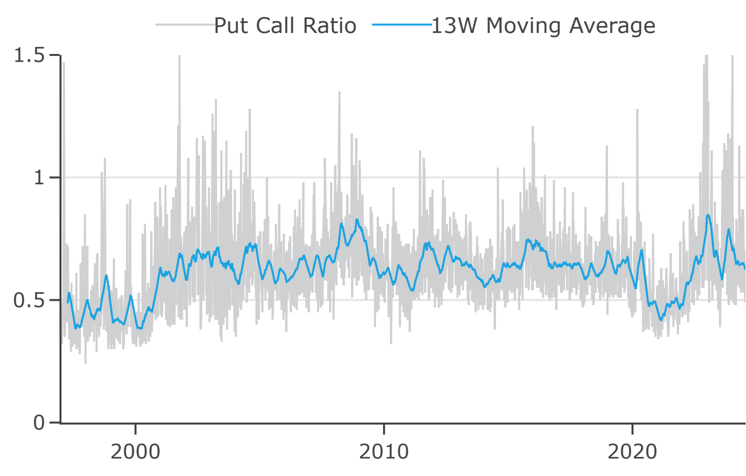


Michael Hartnett's Bull & Bear Indicator (BAML)

Rises to 6.5 from 6.3



Equity Put Call Ratio



Sources | Bull Bear Spread, Vix and Equity Put Call Ratio: Bloomberg. Michael Hartnett's Bull & Bear indicator by kind permission from Bank of America, as of July 2024

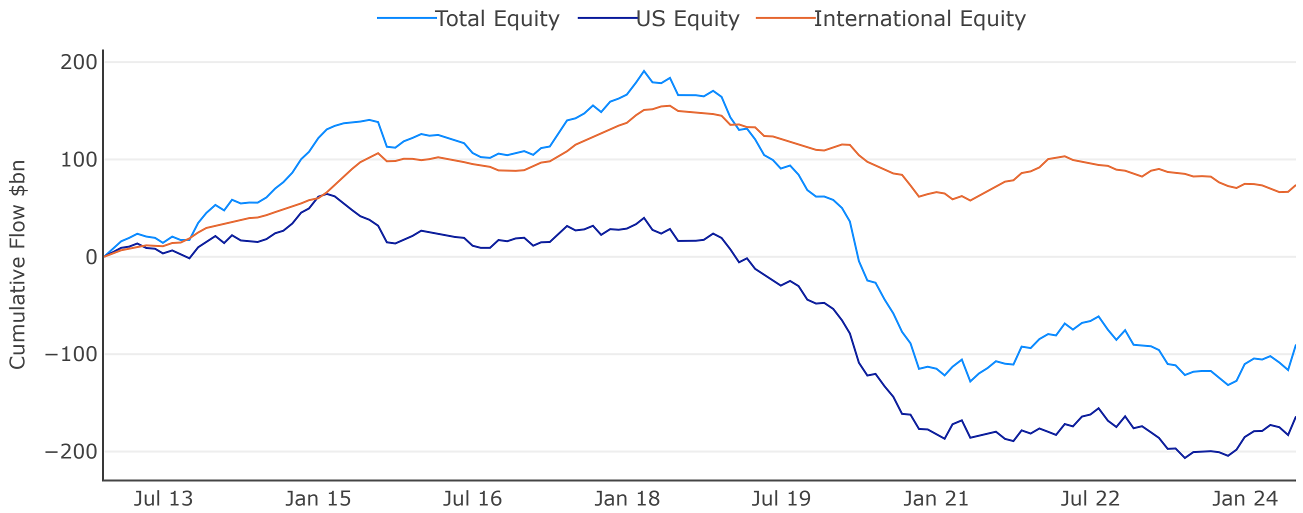
Fund Flows

This page captures US mutual fund flows as reported by the US Investment Company Institute, and flows are shown here as a cumulative total by adding successive months' flows. This excludes ETFs / passive and is therefore only for active flows. In later months we plan to add passive flows to get a feel for how fund liquidity is affecting markets.

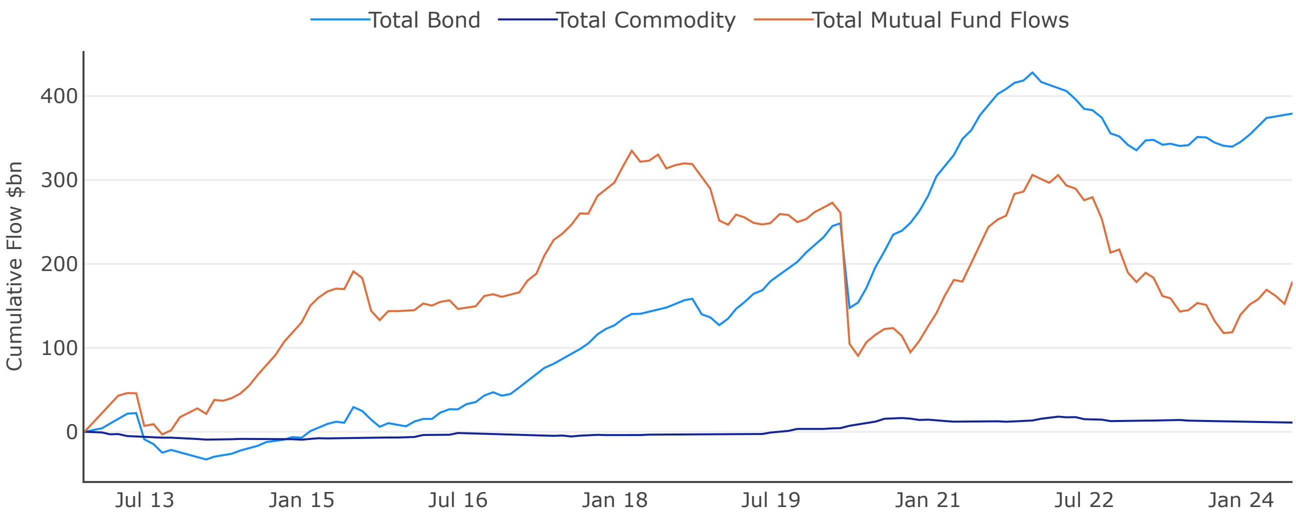
The message in these data points continues to be that there is little enthusiasm for actively managed funds even if the outflows from equity funds have stopped.

US Mutual Fund Flows

Equity Markets Cumulative $bn



Non-Equity Markets Cumulative $bn



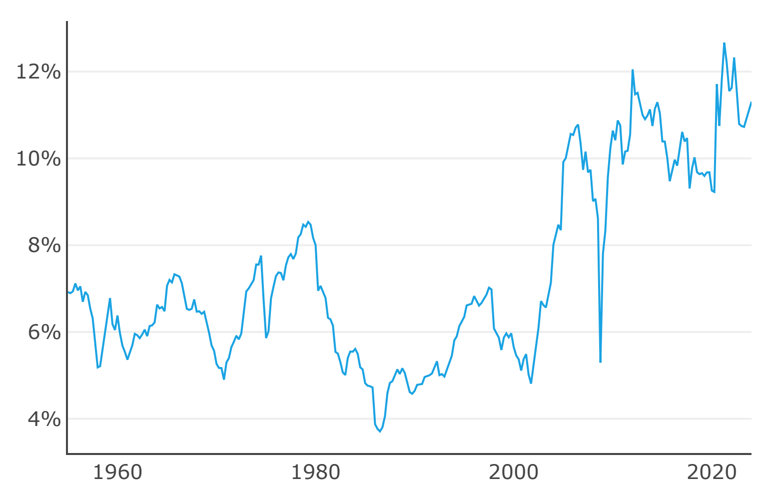
Sources | All charts: Bloomberg ICI fund flow data. Data as at July 2024

The Big Picture

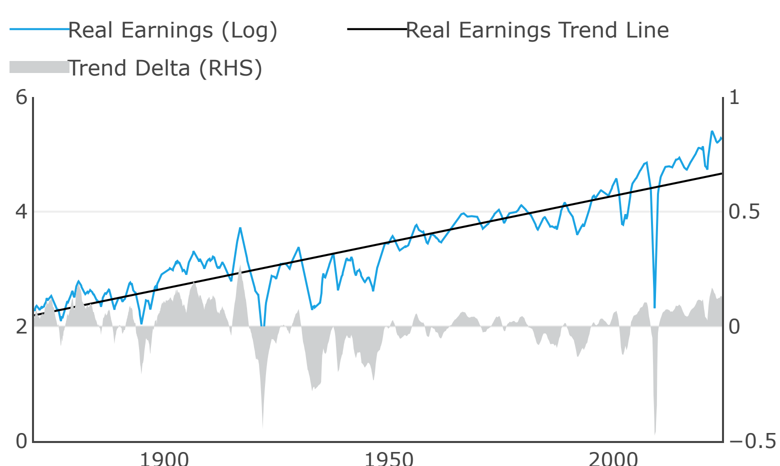
Here we highlight some longer-term imbalances that, **should** they correct, would have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. Its corollary (not shown) is that the wage share is at the lowest level it has been in almost as long. Allied to this, the top right chart shows that earnings are as far above their long run trend in absolute terms as they have also been since 1929. Domestic non-financial debt is also extremely elevated. All of this suggests that if old relationships hold and we get mean reversion, forward 10 year returns could be much lower than suggested by the ERPs.

Long Term Inbalances

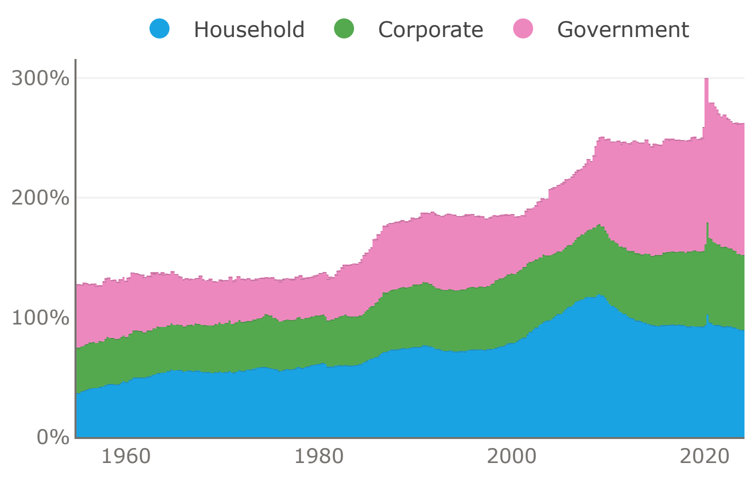
Profit Share of GDP



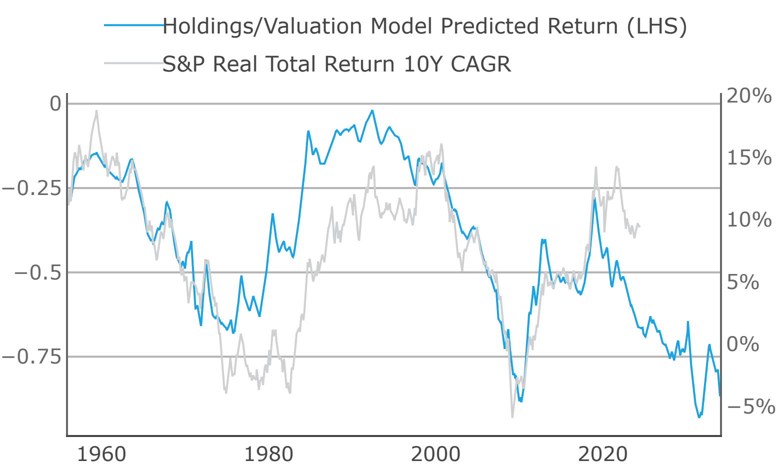
Earnings Deviation From Trend



Non Financial Debt as Share of GDP



S&P 500 10Y Forward Returns



Sources | Profit Share of GDP, and Non Financial Debt as Share of GDP: Federal Reserve Economic Data (FRED); Earnings Deviation From Trend: CCLA using Shiller CAPE data from Yale.edu; S&P 500 10Y Forward Returns: Holdings/Valuation Model uses three inputs: Tobin's Q, Shiller CAPE and Household Equity Holdings to predict 10Y forward returns. All data refreshed as at July 2024.

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