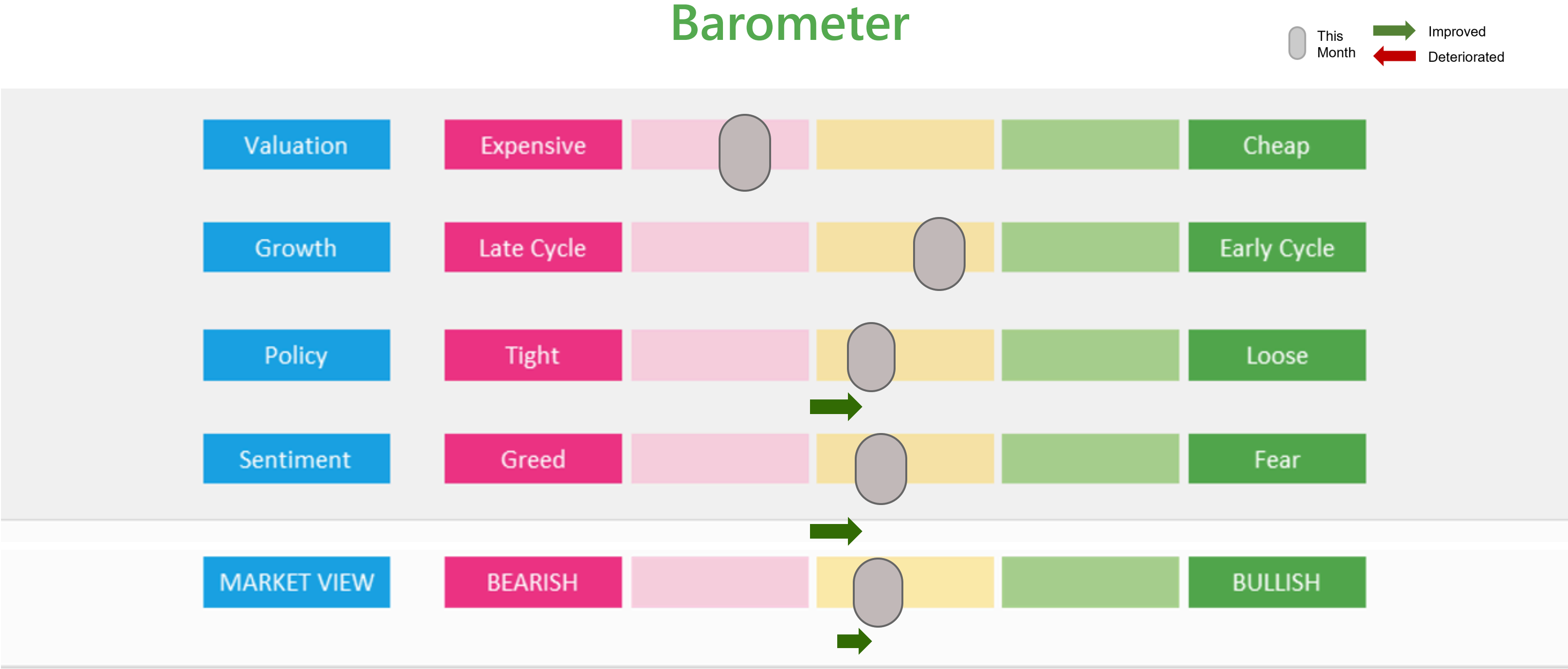
DECEMBER 2024

CCLA
GOOD INVESTMENT

Market Barometer

Barometer



He's back

- **Trump will extend the TCJA (Tax Cuts and Jobs Act, 2017) tax cuts,** further cut corporate income tax, de-regulate especially in energy and financial services, possibly reduce government inefficiency and probably encourage M&A.
- **This more than offsets the upside risks to inflation** in the near term (6-12 months), in our view. In his last administration it took two years for piece-by-piece tariff hikes to brew into a full-blown trade war.This time it could happen more quickly than that, but it might not end that way at all. Trump is transactional.
- So what we know is we'll get tax cuts, and what we wait to see is whether the tariff hikes develop very negatively or are more background music but not the main focus. Either is possible, we think.
- **Meanwhile global economic activity remains well underpinned**, at least in the dominant Service sector.

In our Charts of the Month we examine some of the risks around inflation with Trump 47:

- **The "chart that saved Donald Trump's life"** looks at illegal immigration into the US. We consider the impact a new crack-down might have on wages
- We look at various outcomes for the **US deficit** and the inflationary impact - perhaps up to +0.5%
- **Re-accelerating inflation** could shift the regime from Disinflation to Reflation, but that's still not a bad environment for risk assets per our Fire & Ice frame-work ...
- ... and **M&A might now take off**, supporting animal spirits

We are acutely aware of stretched equity valuation in the US equity market, but for now **remain risk on**.

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Contents

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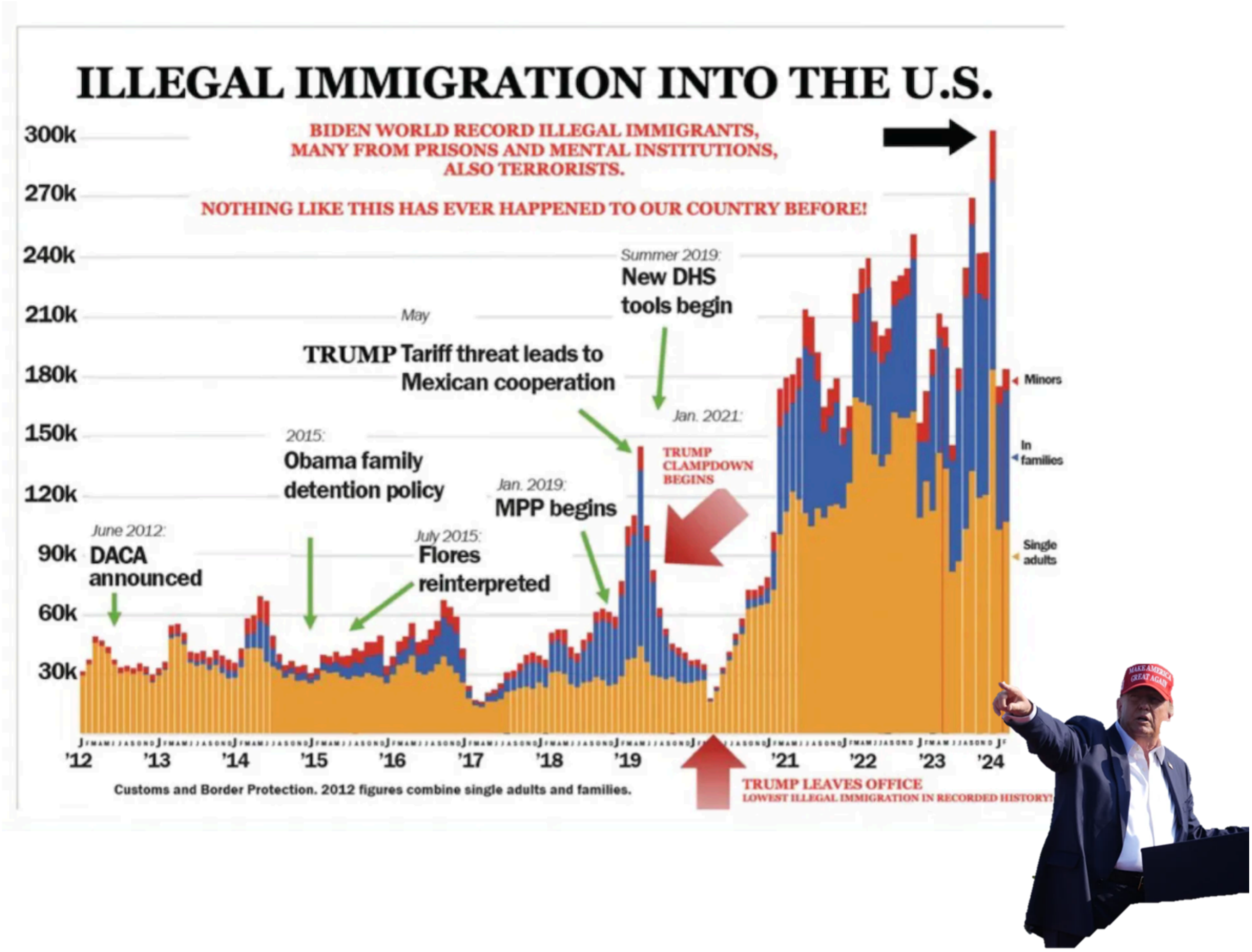
Charts of the Month (1 of 4)

The "chart that saved Donald Trump's life" tracks illegal immigration into the US. At his stump speech in Butler, Pennsylvania, on 13 July 2024, he turned to look at it at the moment that shots were fired. Trump has said that he "will sleep with that chart for the rest of my life".

Many analysts attribute his subsequent election victory to two factors – immigration and inflation. While it is unlikely that he will be able to enact his promise to deport 20 million "illegals", we do expect he will push back hard on immigration. This would have knock-on consequences, supporting wage inflation. Average hourly earnings growth has decelerated from 6% to 4% over the last two years, still well above the 2-3% range prevailing pre-pandemic. If it stays at 4% or even accelerates from 4%, overall US PCE inflation unlikely to settle at the current 2.0-2.5% level, making substantial further Fed rate cuts unlikely.

We would not be surprised if we had already had the last rate cut in this mini-easing cycle, or if a cut at the 18 December meeting were the last.



Note | The chart is reproduced directly as presented by the Trump campaign team, including the team's own annotations

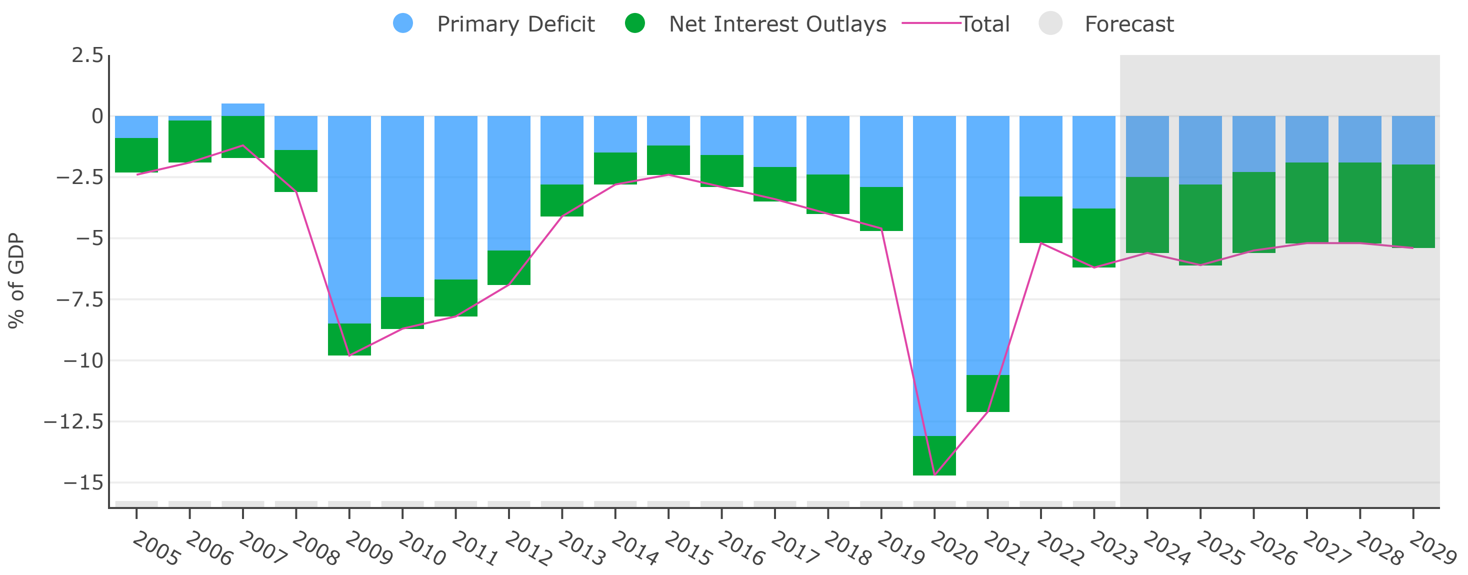
Sources | Washington Post: 'A look at Trump's misleading, inaccurate graph of U.S. immigration': 23 May 2024

TOP OF MIND

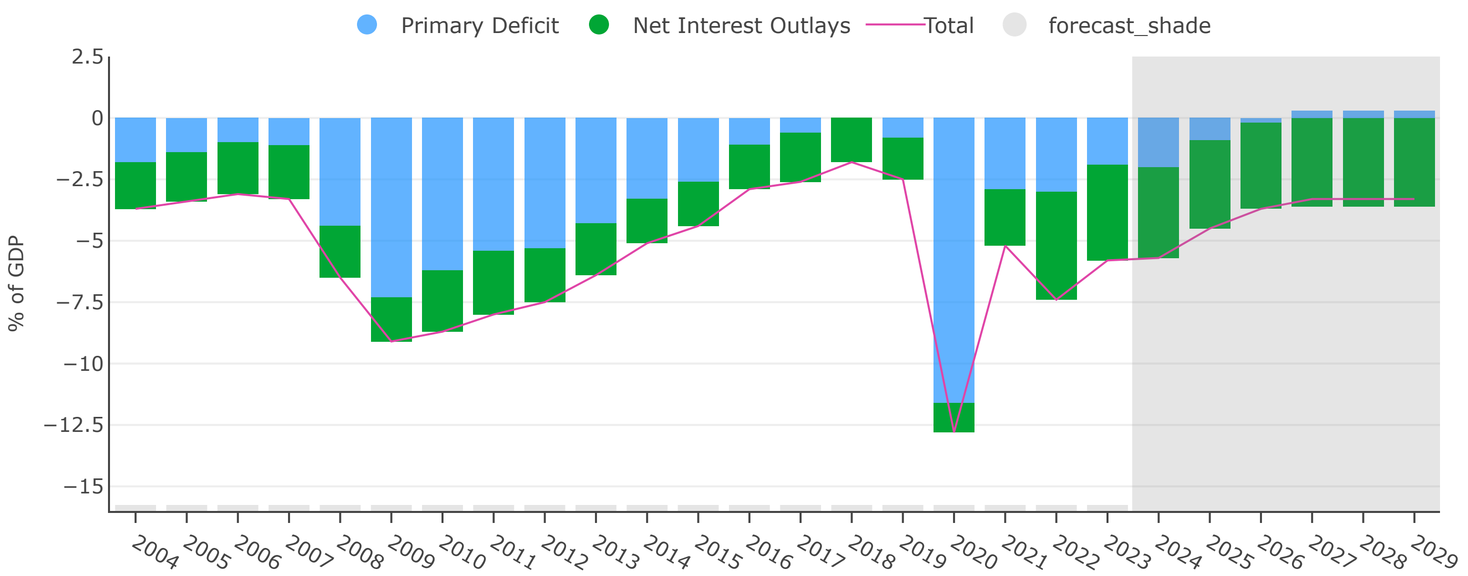
Charts of the Month (2 of 4)

Are deficits inflationary? Luckily we don't have the space in these capsule comments to delve too deeply into this vexed question. However, a recent paper* by researchers at the LSE estimates an inflation multiplier of 0.18% on price level for a 1% of GDP deficit shock. The current Congressional Budget Office (CBO) estimates a 2025 deficit 6.1%, marginally wider than the 2024 estimate of 5.6%. However, if all the Trump campaign policies were enacted the deficit could balloon to 9%, per the CBO. Using the LSE multiplier that would mean the Trump **deficit effect could add 0.5% to inflation**.

US: Components of Fiscal Deficit



UK: Components of Fiscal Deficit



*Hazell, J and Hobler, S, (2024), Do Deficits Cause Inflation? A High Frequency Narrative Approach, London School of Economics white paper

Sources | CCLA, CBO as at March 2024, OBR as at October 2024, Morgan Stanley.

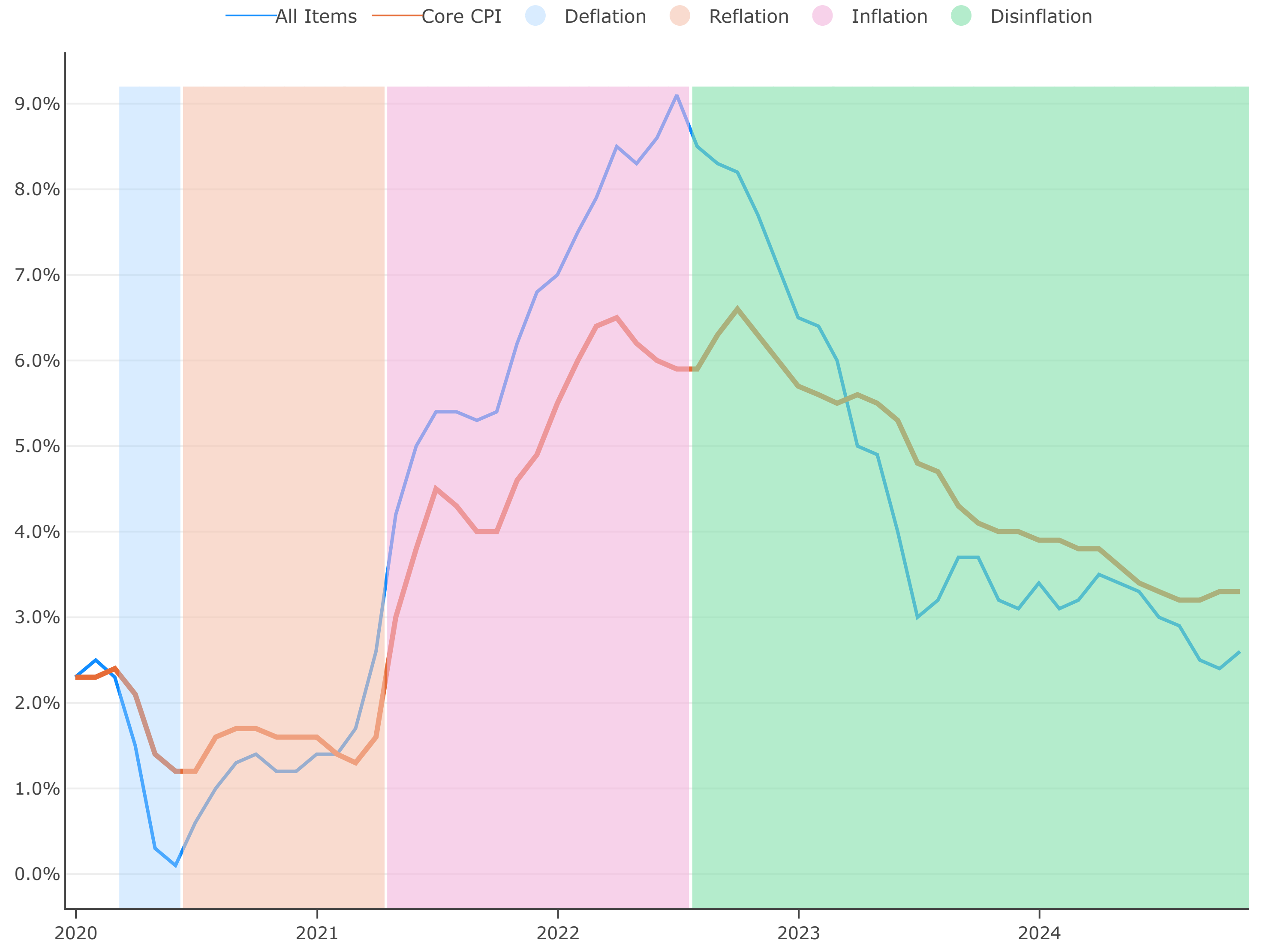
Charts of the Month (3 of 4)

The inflation regime is about to change from disinflation to reflation, we think. According to our ***Fire & Ice*** framework we have been in a disinflation regime (high and falling inflation) since June 2022, which is typically strongly supportive of risk asset returns. If inflation stops decelerating and re-accelerates we will move into a reflation regime (low and rising inflation).

Reflation is supportive of risk assets too. Based on history (1928-2020) the annualised real total return of US equities during reflation regimes has been +10% and it's been on average +7% for commodities. Bonds have lagged at +2%, on average.

The risk comes when headline inflation accelerates through 4-5%, starting a new inflation regime. That is what the bears fear, but it's unlikely to happen in the next six months, we think.

USA Headline and Core Inflation



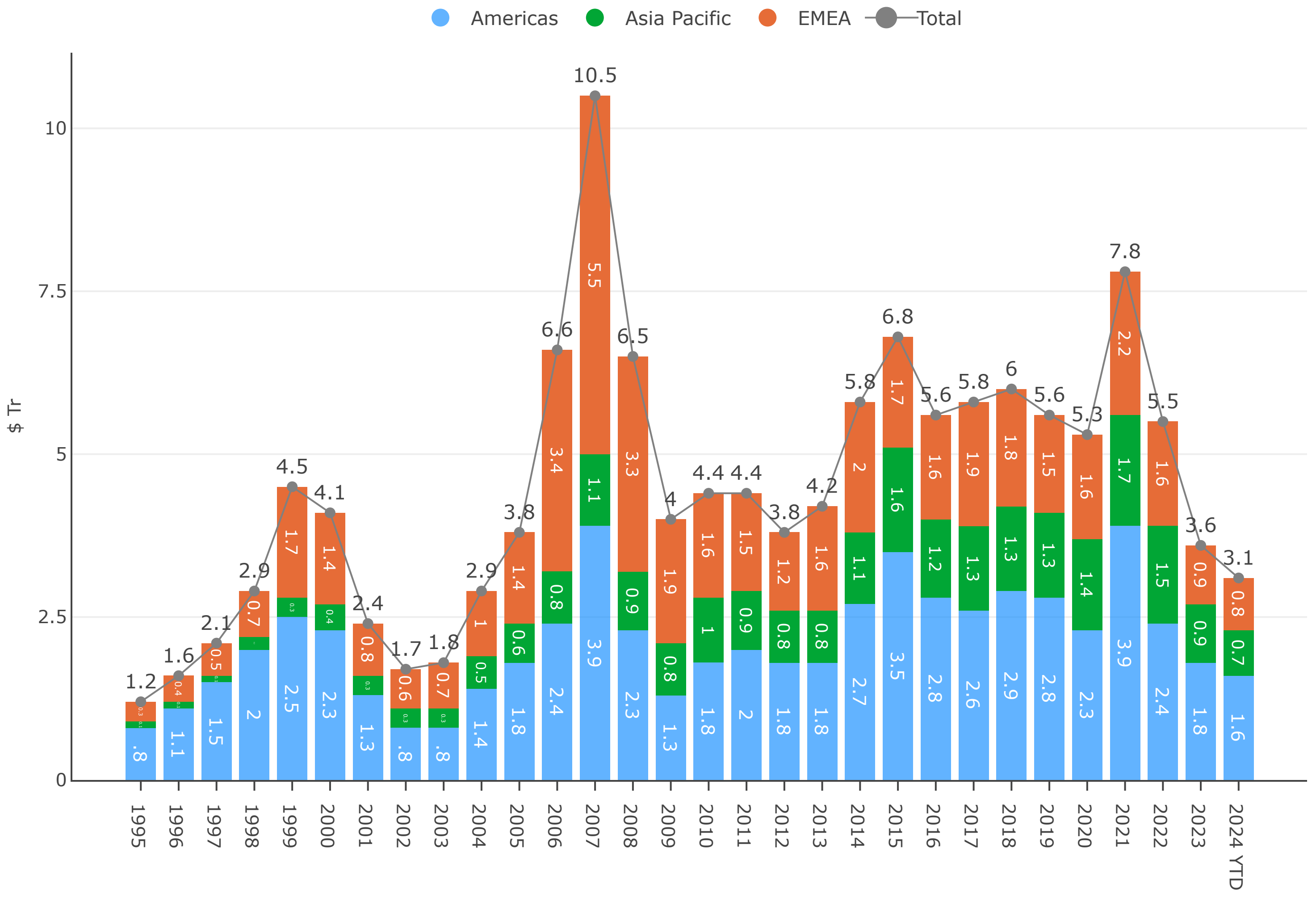
Sources | Bureau of Labour Statistics, Bloomberg. Data as at Nov 2024

Charts of the Month (4 of 4)

The coming M&A boom. It is an unusual feature of this market cycle that with stock market indices at all time highs, Mergers & Acquisitions (M&A) volumes are at cycle lows. Indeed, activity in 2023 and 2024 compared to GDP is at a 30 year low, according to Morgan Stanley. The proximate cause of this stagnation in the normally buzzing world of M&A bankers is the change in interest rates of the last three years. The incoming US administration is likely to deregulate in two particular areas - energy and financial services.

This should have a positive impact on "animal spirits" and provide support to stretched valuations.

Announced M&A Volume by Region ($Tr)



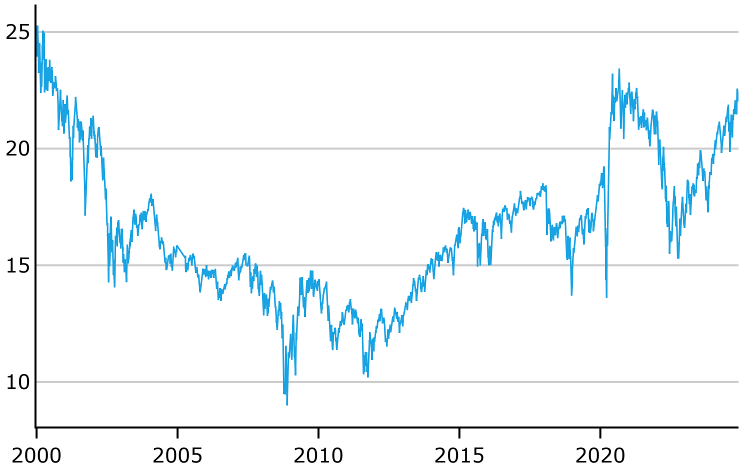
Sources | CCLA, Morgan Stanley. All data as at Nov 2024.

Equity | USA

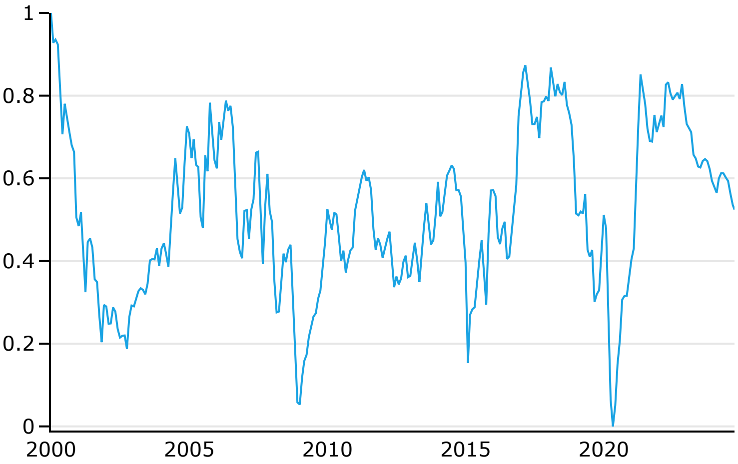
Despite the cross-asset valuation dropping to the 52nd percentile (top right) as inflation has eased, the equity risk premium (bottom right) still looks thin at ~1.3%. On an absolute measure, the CAPE (cyclically adjusted PE) stands near recent highs at ~35x, creating an earnings yield and forward real expected return close to 3% annualised.

S&P 500 Valuations

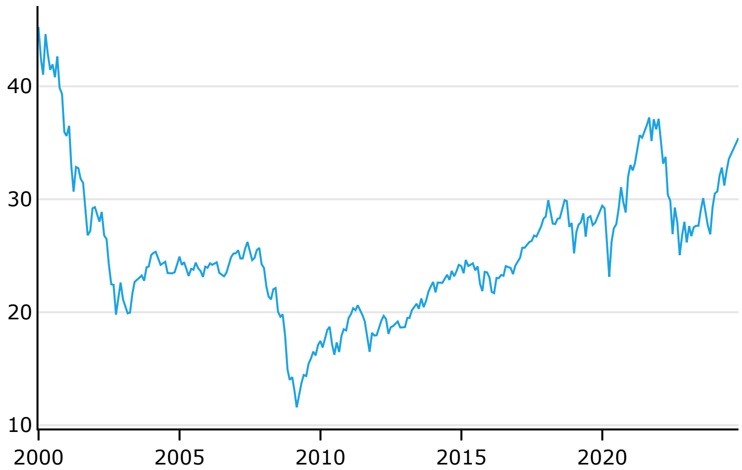
S&P 500 Forward PE



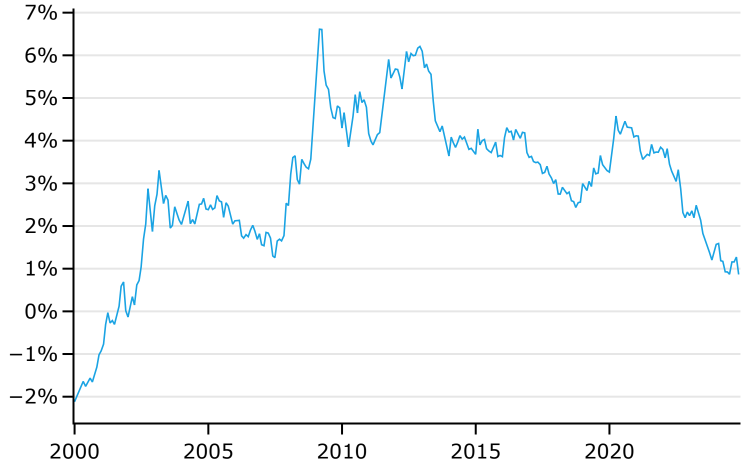
Composite Value Indicator Model



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. *YTD to 23 Oct 2024. **10 Jul 24 to 24 Oct 24 using UBS Ex-Mag-7 vs UBS Mag-7 indexed at 100. Sources | S&P 500 PE: Bloomberg as at Nov 2024. CVI Model: CCLA as of Nov 2024, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of Nov 2024

VALUATION

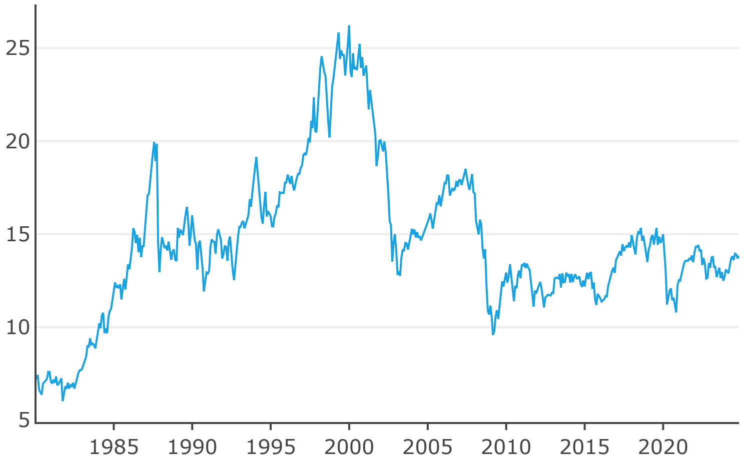
Equity | Regional

A major debate for ex-US regions is circled around the potential impact of Trump's tariffs. For MSCI Europe (ex-UK) it is estimated that 26% of weighted revenues are exposed to the US. However, only ~6% of goods are likely applicable to tariffs and ~3% highly applicable to tariffs*. **At a 10% tariff, it would imply a potential ~-1ppt impact on EPS growth for 2025*. Unfortunately, Europe has another problem - China. Their slowdown is expected to knock off ~2ppts in 2025 European earnings estimates*.**

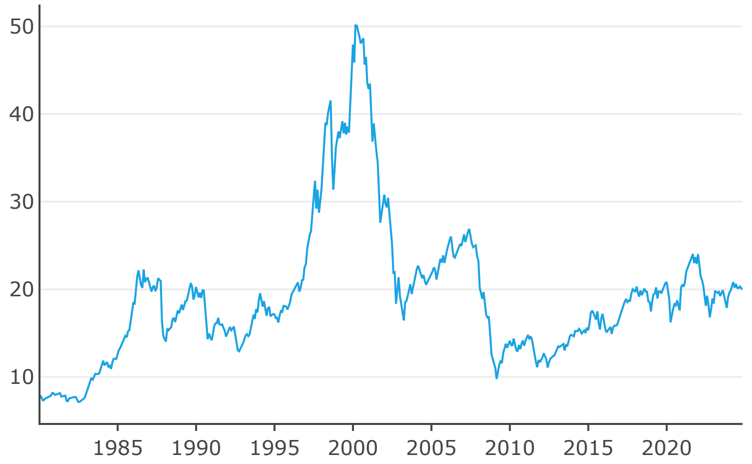
Shiller CAPEs highlight UK as 13.8x with an earnings yield (and expected forward real returns) over 7%, with Europe and Japan around 20x and ~5%, and EM around 12x and ~8% respectively.

Europe

UK | Shiller P/E

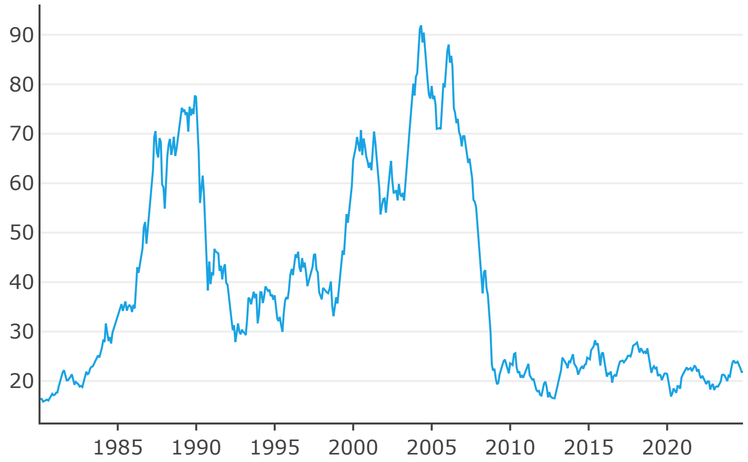


Europe (Ex-UK) | Shiller P/E

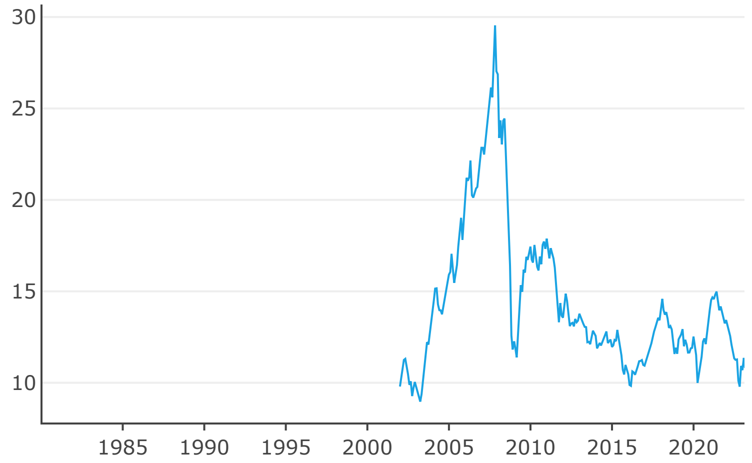


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



Sources | Shiller P/Es: Morgan Stanley as of Nov 2024. Shiller P/E is calculated as today's price divided by the real average earnings of the last 10 years.*Morgan Stanley: 'Looking through The Fog' 17 Nov 2024.

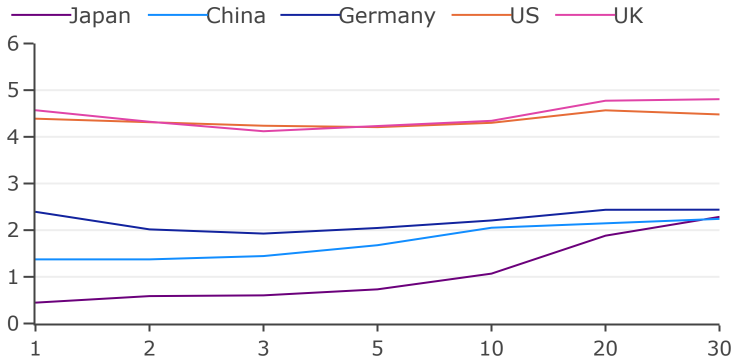
Bonds - Sovereigns

Tariffs – inflationary. Tighter immigration – inflationary. Fiscal loosening – inflationary. The growth aspect of Trump's policies are debatable, however, there is a clear consensus that they are inflationary. This was not lost on the bond market, **the long end saw significant re-pricing in yields, 10Y, 15Y, 20Y all up between 55-65bps and the 10Y testing the 4.5% level.**

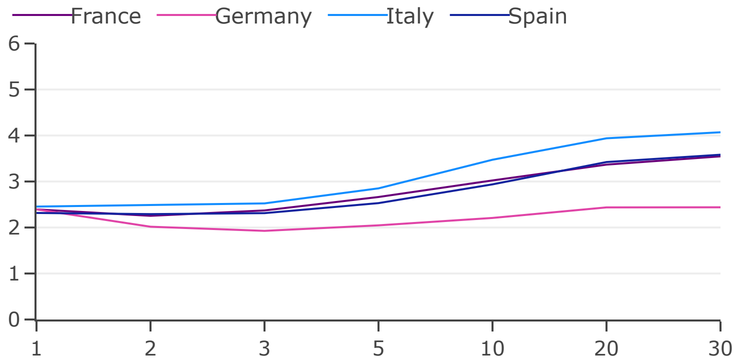
We are conscious that the trailing 3-year stock-bond correlation remains positive and thus we could see a bond rally into the year end if stocks rally as we expect. However, **given a potential change in inflation regime our preference is shifting towards short duration and inflation-linked bonds.**

Global Government Yields

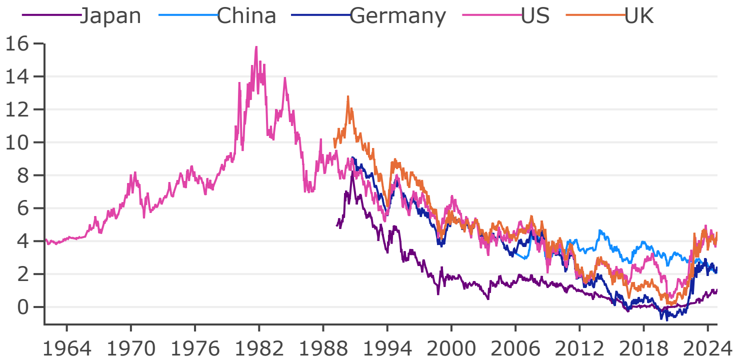
Global Treasury Yield Curves (Term vs %)



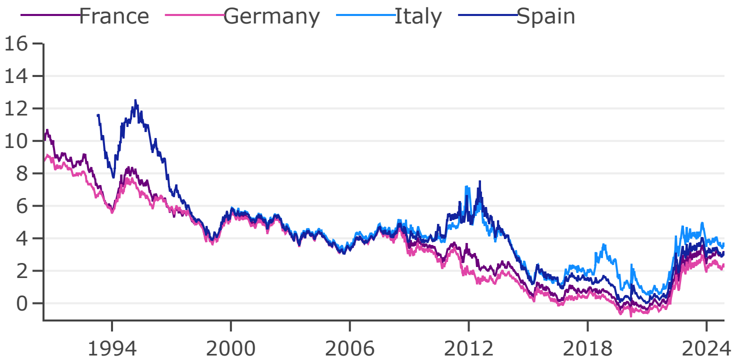
European Treasury Yield Curves (Term vs %)



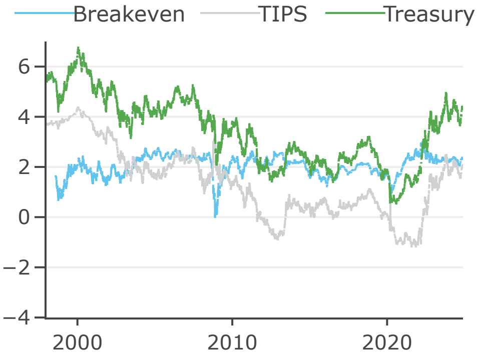
Global 10Y Yields %



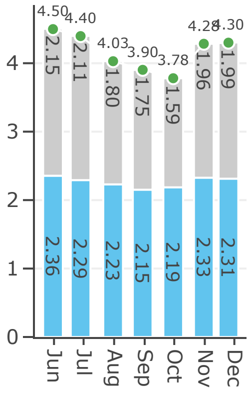
European 10Y Yields %



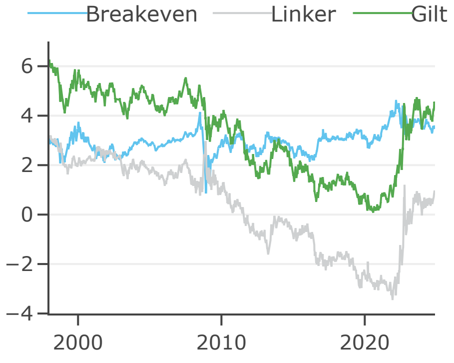
US 10Y Yields Breakdown %



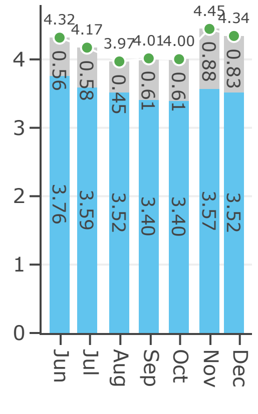
Last 6 Months



UK 10Y Yields Breakdown %



Last 6 Months



Sources | CCLA, Bloomberg as at Nov 2024.

VALUATION

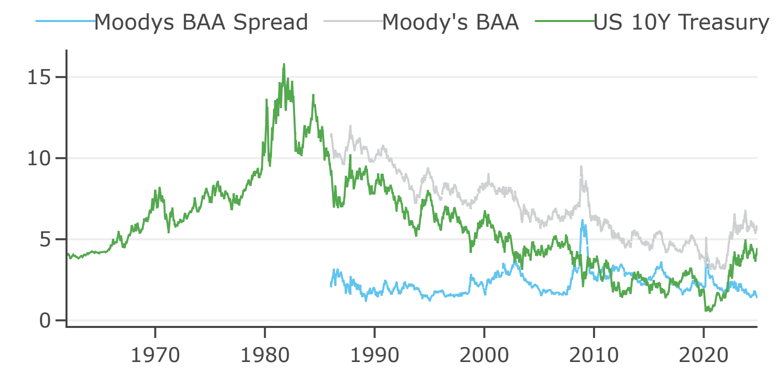
Bonds - Credit

One major concern in the US high-yield (HY) market is the risk of re-financing into rates that are much higher than the pandemic period. Especially since **almost a third of the Russell 3000 companies with listed interest expense were unable to cover interest costs over the past year*.** Yet, spreads fell further after the US election result and remain at multi-decade lows.

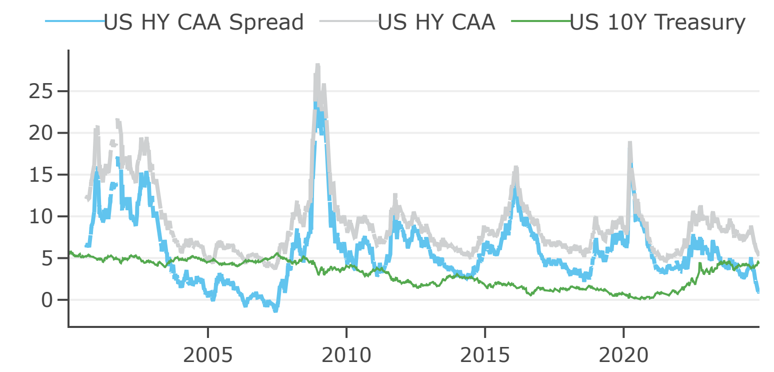
Why? With c.80% of debt maturing between 2027 and 2031**, this significantly reduces refinancing pressure and gives time for rates to fall further. Consequently, **the shortage of available on-the-run securities is still met with strong demand to deploy capital creating a technical imbalance** and significantly tightening spreads over the last few years. We believe HY is not attractive presently.

Global Credit Yields

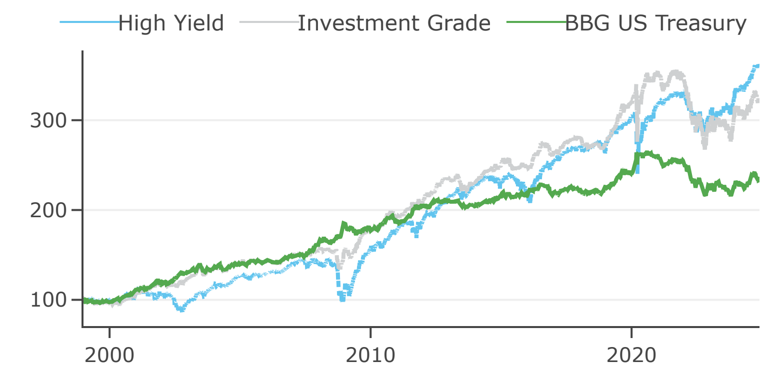
US Corporate Investment Grade Yield %



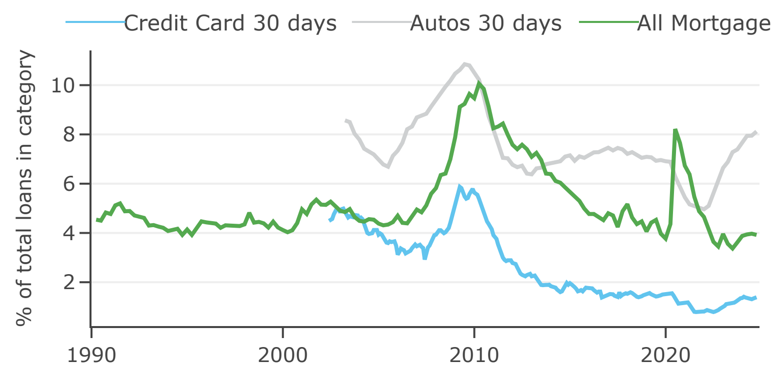
US Corporate Investment Grade Yield %



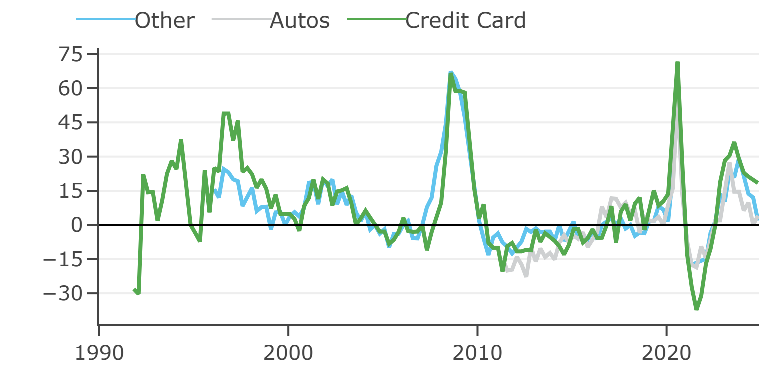
US Tr. vs IBoxx IG and HY Total Return $ (100= 31 Dec '98)



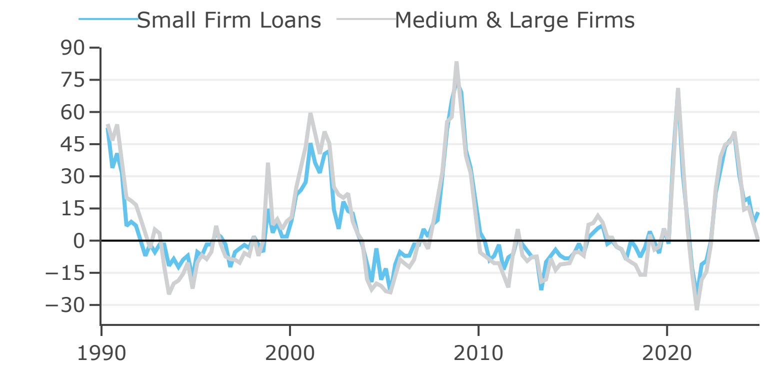
US Delinquencies %



Net % of Banks Tightening Consumers Credit Conditions



Net % of Banks Tightening C&I Credit Conditions



Sources | Federal Reserve, Senior Loans Officers Survey, CCLA, Bloomberg as at Nov 2024. C&I: Commercial and Industrial. *Bloomberg: 'Credit Is at Risk of Repricing...' 10 Nov. 2024 , **Bloomberg US HY index

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Alternatives

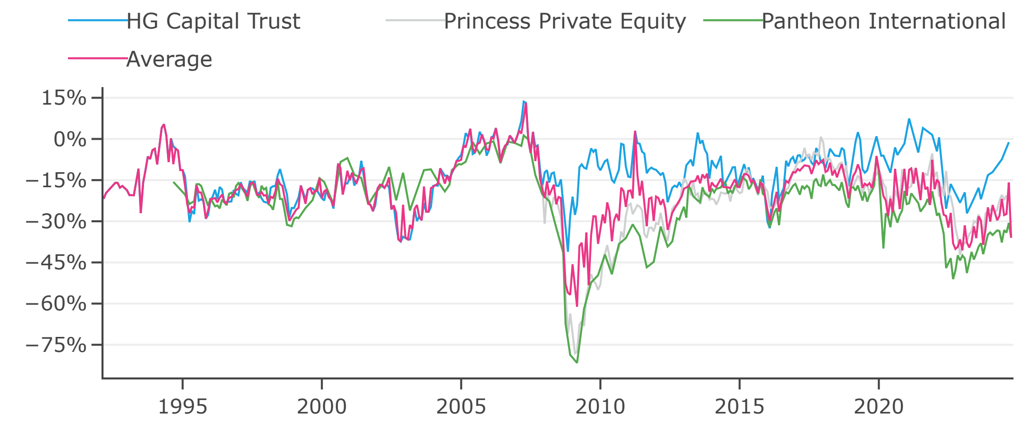
It's not often that market supply-and-demand forces find themselves on the cusp of an ideal economic backdrop. **Yet, this balance may be emerging for M&A.** We've talked previously about the difficulties this market has faced in recent years, **2025/2026 could bring in more tailwinds.**

Firstly, with the US poised for a soft-landing, the stock market at record highs, and favourable de-regulation on the horizon, the backdrop is setting nicely. While demand for deal-making has been building, GPs are under significant pressure to deploy their long-held dry power and revigorate their aging portfolios. Supply factors aren't far off either; investment banks are highlighting companies open to inorganic expansion and synergies, especially given the technological advancements made in AI, robotics and cybersecurity. **Granted, regulatory policies still need to be approved and rates are still too high. But both these headwinds are likely to fade over 2025/2026.**

Global Valuations

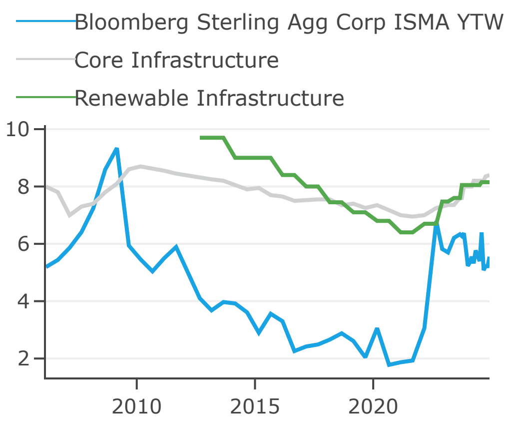
Listed Private Equity

Discount To NAVs



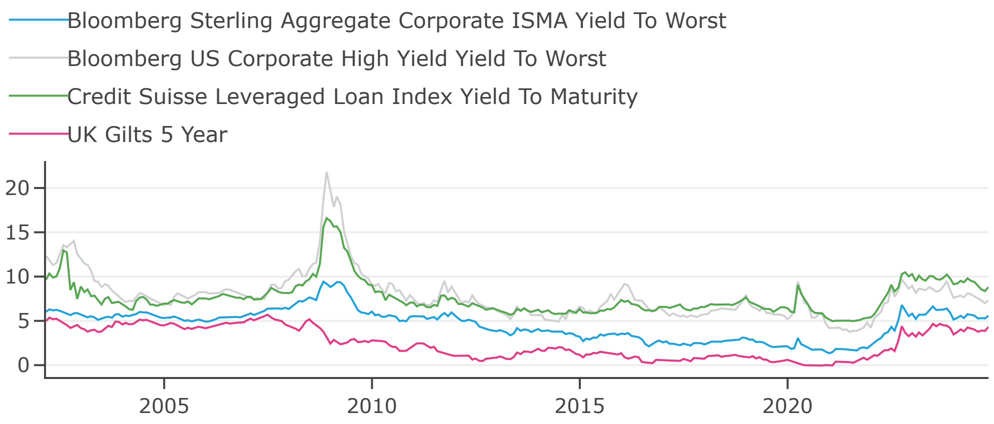
Infrastructure

Infrastructure Discount Rates vs Bond…



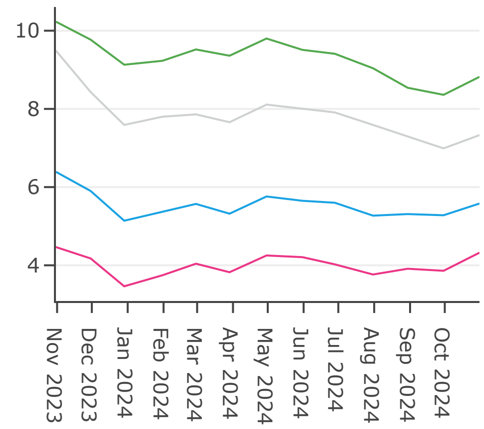
Contractual Income

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 Oct 2024. *Bank of America: Evolution into a lower rate environment. 27 Sept 2024

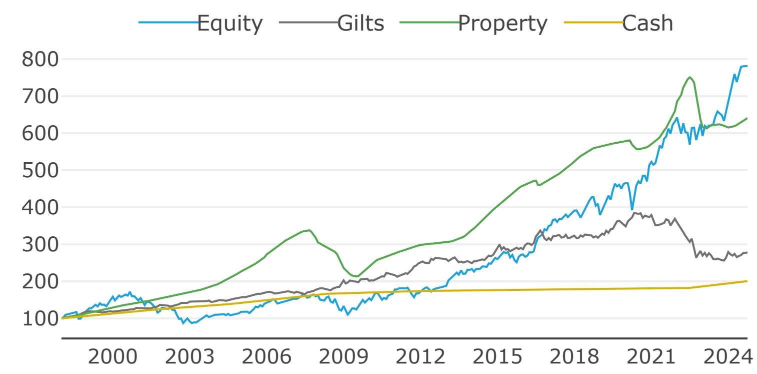
Property

The emergence of artificial intelligence (AI) has created a surge in demand for data centres. From established tech firms to VC-backed start-ups with AI-centred business models, this surge has been a key driver in the significantly low vacancy rates across the major regions of Frankfurt, London, Amsterdam, Paris and Dublin (FLAP-D). London would historically be around 20%, it is currently below 10%, with prime data centre regions like Slough at 5%. **Restrictions in available land, power, labour and materials related challenges have kept a lid on supply across UK and EU – only adding to the imbalance and putting upward pressure onto rents.** Yields across the regions fall between 5-6% on average.*

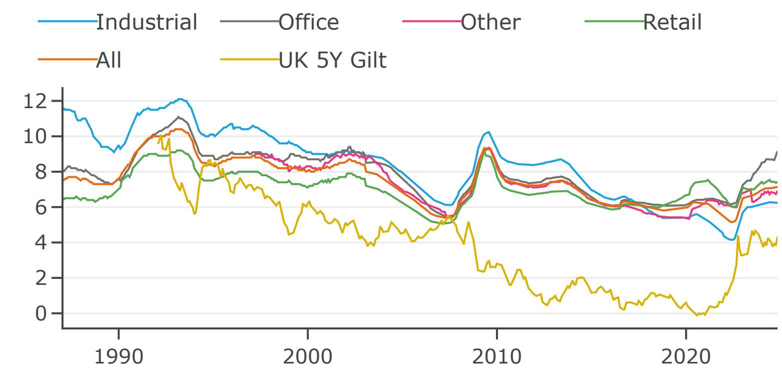
Within the context of CPI + 4%, current equivalent yields across all property look attractive at 7% on average. Worth also noting, real returns to Property have tended to average around the starting Equivalent Yield (middle left chart). **This bodes well for forward returns from here.**

UK Commercial Property Market

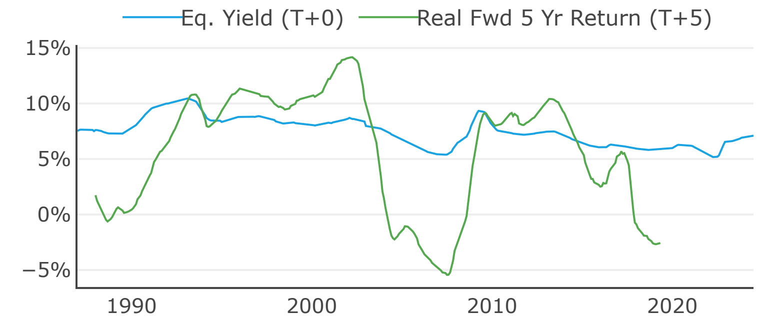
25 Years Of Return 1998=100



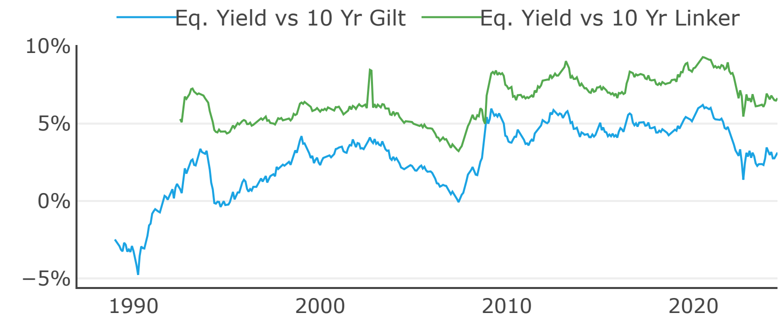
Equivalent Yields vs Gilt Yields %



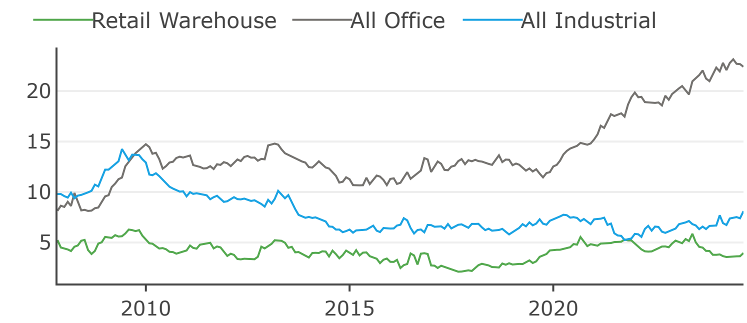
MSCI UK All Property Monthly TR Index %



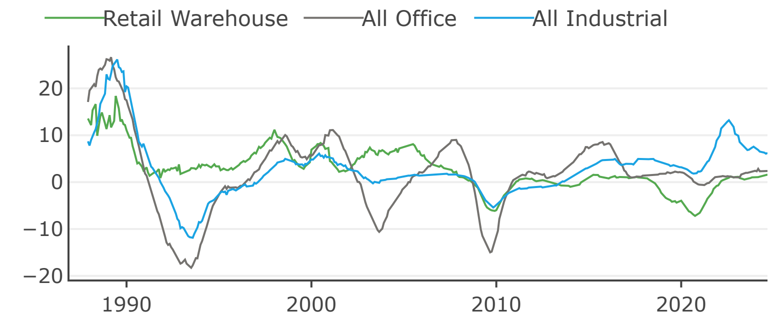
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



Sources | Equivalent Yields, Vacancy Rate, and Nominal Rental Value charts: MSCI UK Monthly Property Index as at Nov 2024. 25 Years of Return, All Property Monthly TR Index as at Oct 2024. *Savills; 'Investors increasing focus on data capitalisation' May 2024.

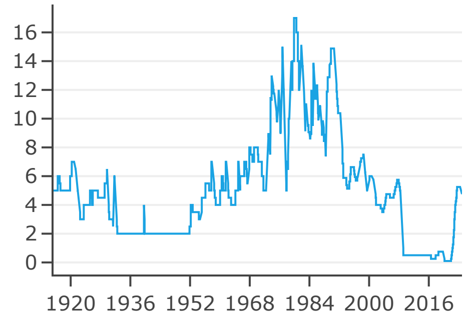
Cash

Now that the UK Budget and US election are behind us, the UK government needs to shift its focus towards trade as a catalyst for UK's economic growth. This includes not only international trade but strengthening domestic trade too. November's Mansion House speech was a good starting point in this regard.

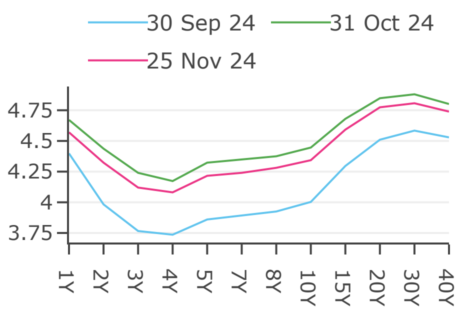
On domestic trade, the Chancellor emphasised the existing levels of regulation, particularly on financial services, had "gone too far". She also highlighted that the FCA/PRA will now consider growth and international competitiveness as part of their remit. On the international front, despite Brexit, the EU remains the UK's largest exporting market - accounting for 47% of trade, with the US as the next largest market with 15%. **Given potential for US tariffs ahead, it becomes even more important for the government to maintain good relations with the EU if it wants to achieve its growth agenda**.

UK Sterling Market

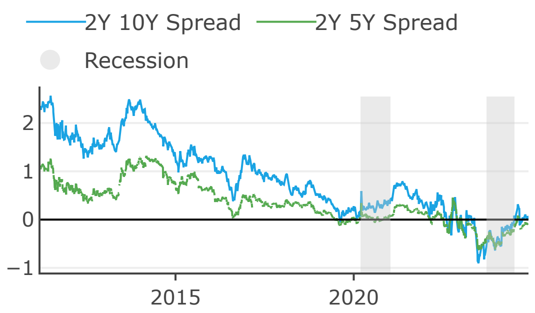
Official Bank Rate



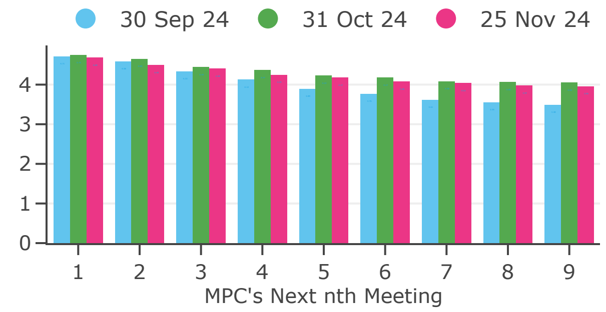
UK Gilt Curve



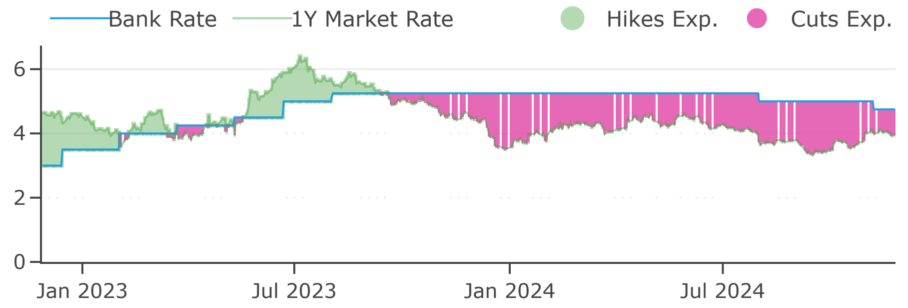
Gilt Spreads



Rate Expectations For Future MPC Meetings



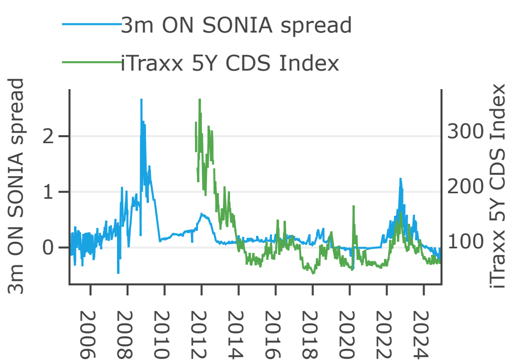
1Y Forward Market Rate Expectations



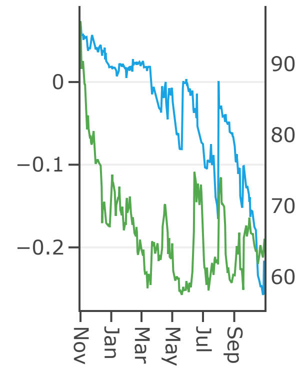
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2024					
	May	June	July	August	Sep…	Oct…
RPI	3.00	2.90	3.60	3.50	2.70	3.40
CPI	2.00	2.00	2.20	2.20	1.70	2.30
CPI Core	3.50	3.50	3.30	3.60	3.20	3.30
CPI Services	5.70	5.70	5.20	5.60	4.90	5.00
CPI Goods	-1.30	-1.40	-0.60	-0.90	-1.40	-0.30
Priv. Wages	5.00	5.00	4.90	4.60	4.90	

Market Stress



Last 12 Months

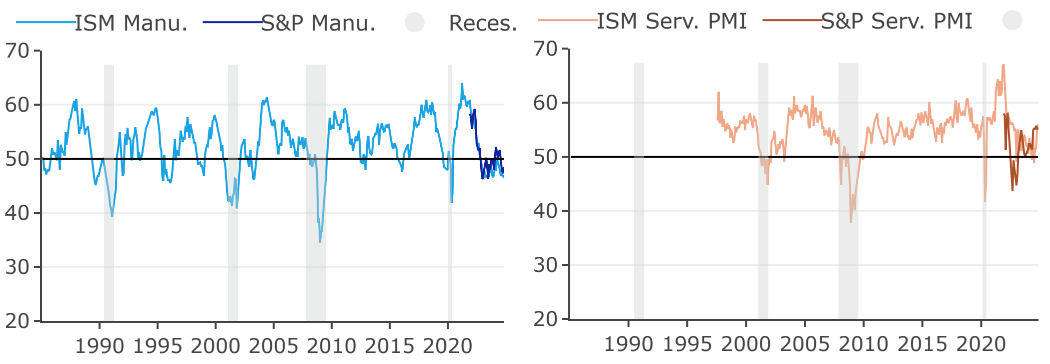


Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, at least +/- 2 standard deviations away scores as red. Bloomberg for all charts, as of Nov 2024. *21 Aug: 5Y Break-evens at 3.4% minus 1% CCLA CPI conversion estimate; 1.3% BoE 2026 real GDP growth estimate.

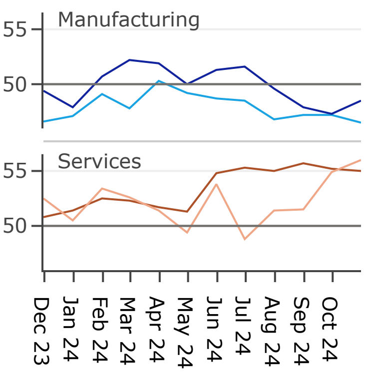
Global PMIs

US Services continued its trend of expansionary services business activity, with a strong set of new orders (the highest reading since April 2022) despite a continued scale-back of staffing. **Manufacturing everywhere remains weak.**

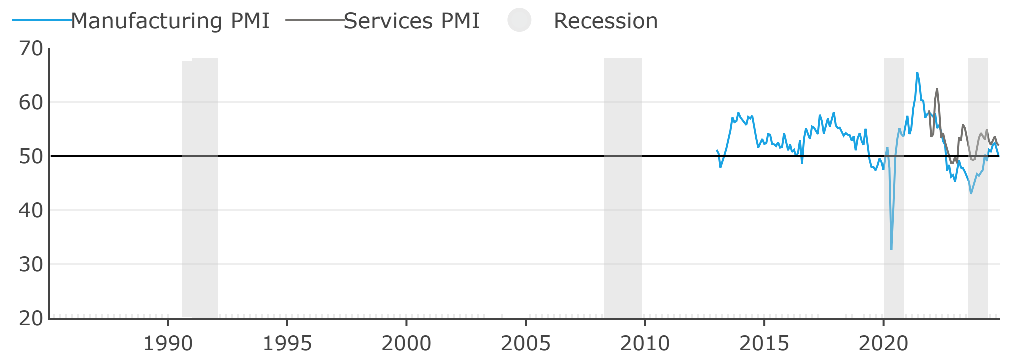
United States



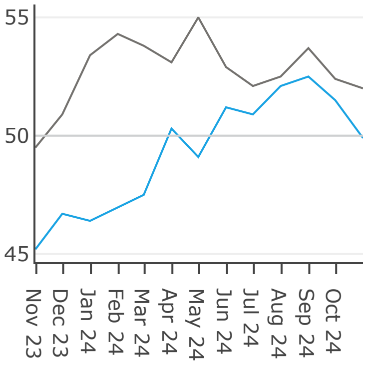
Last 12 Months



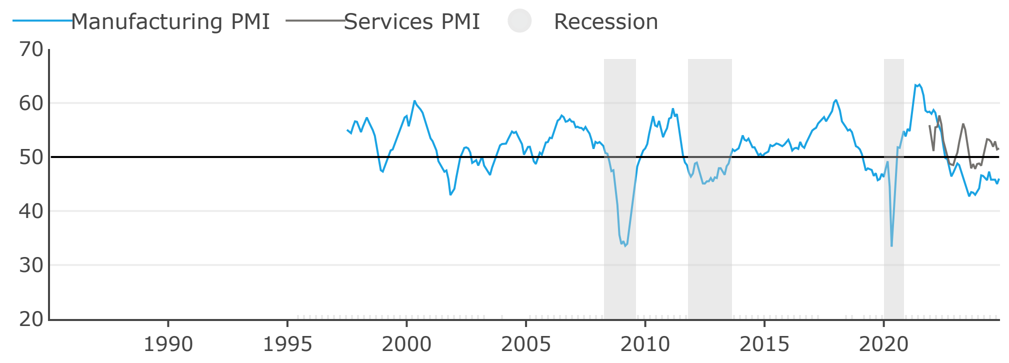
United Kingdom



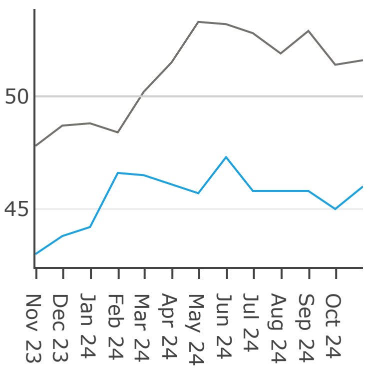
Last 12 Months



Eurozone



Last 12 Months

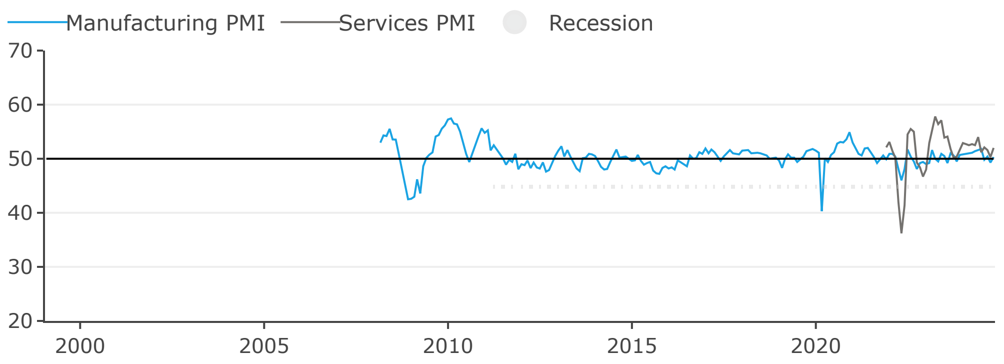


Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Nov 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

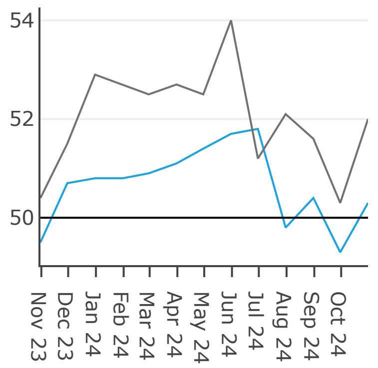
Global PMIs

The global activity story remains - Services strong, Manufacturing weak. China Manufacturing has not really broken out of its despondency.

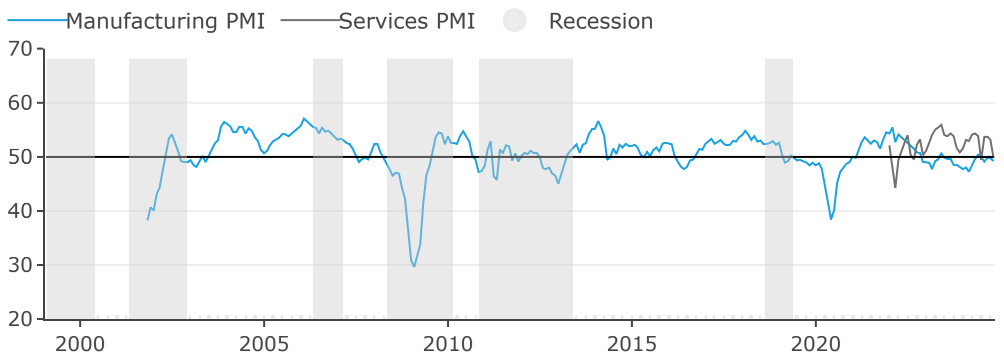
China



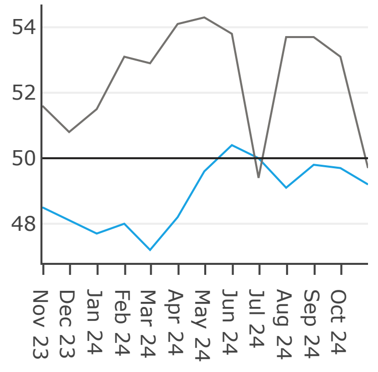
Last 12 Months



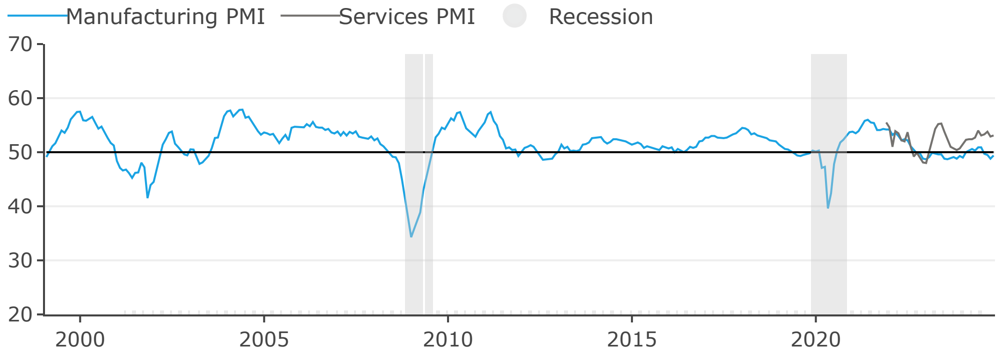
Japan



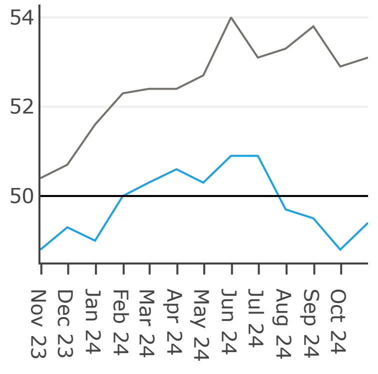
Last 12 Months



Global



Last 12 Months



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

GROWTH

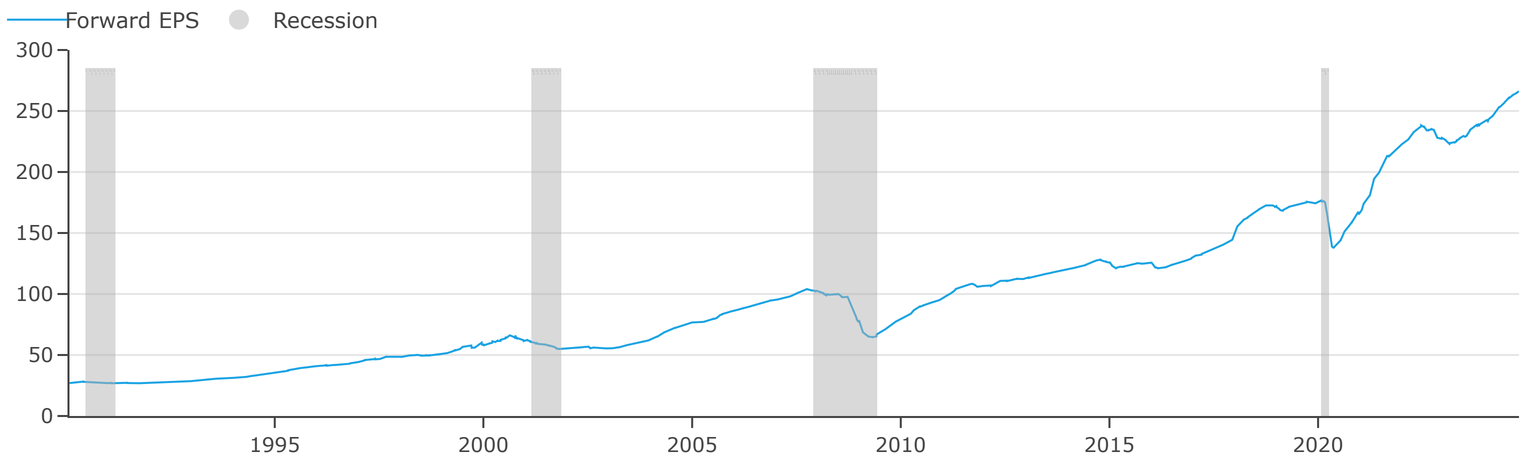
Earnings

Almost 95% of US companies have reported their Q3 earnings at the time of writing. **8/11 sectors continued to show positive sales and earnings growth**, with the usual suspects: Materials, Industrials and Energy lagging behind. Overall S&P 500 sales and earnings growth has been ~5% and ~8% respectively. **Although earnings growth is slower than last quarter, both metrics remain broadly in line with pre-pandemic 20 year averages.**

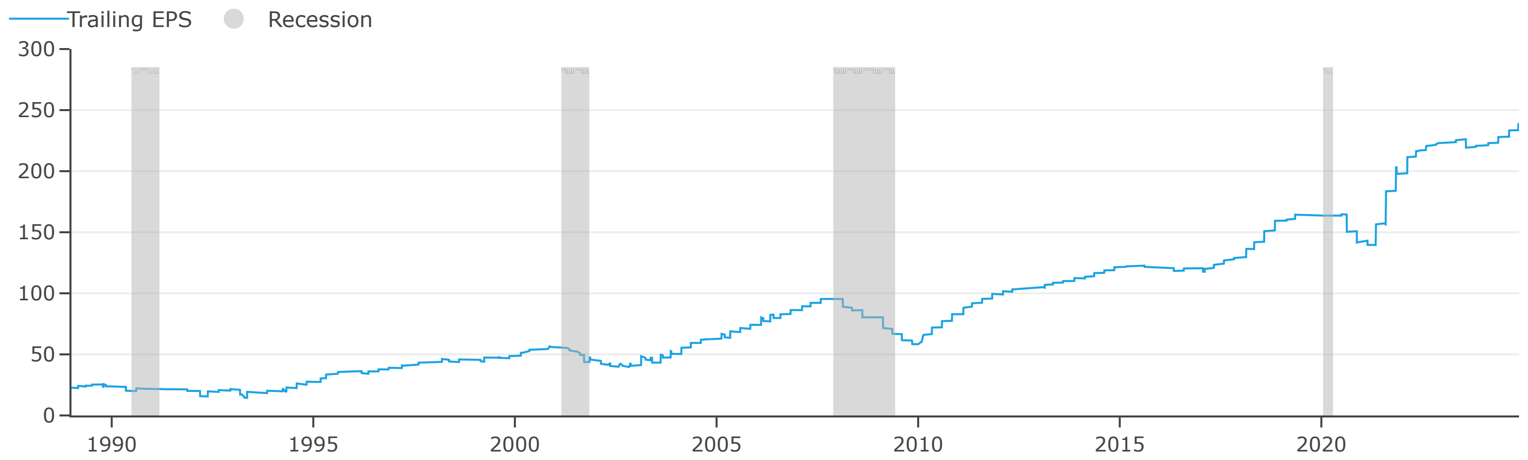
Mag-7 earnings growth has slowed over the year, even Q3 expectations were almost half of Q2. Nonetheless, the **Mag-7 continued their trend and comfortably beat expectations for the 7th straight quarter. S&P-493 also delivered a beat with EPS growth of 1.9% against 1.4%.**

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 Nov 2024. *JP Morgan Flows & Liquidity: current US equity positioning by asset managers and leveraged funds are above 2 standard deviations from the 2012-2024 average.

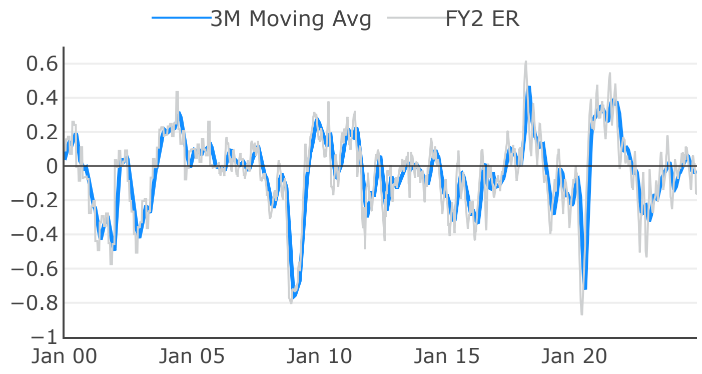
Earnings

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.

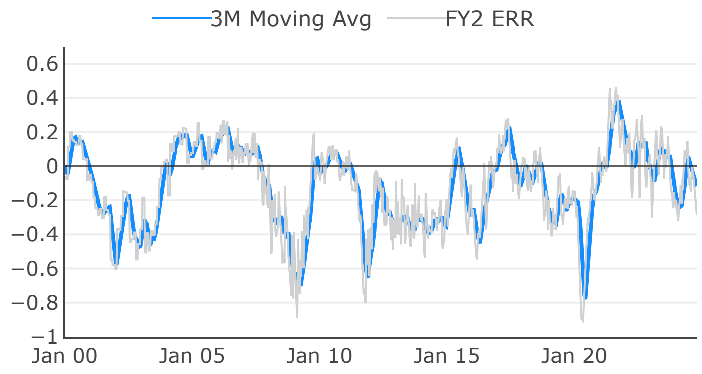
Earnings revisions breadth has deteriorated (but very mildly) over the last few months. However, **revisions are very seasonal and the current change is very much in line with the last 25+ years of average monthly trend revision.** The US was not alone as the UK and EU also faced negative revisions. However, Japan stood out positively driven in part by the strength of their Banking sector.

Global Earnings Revisions Ratios

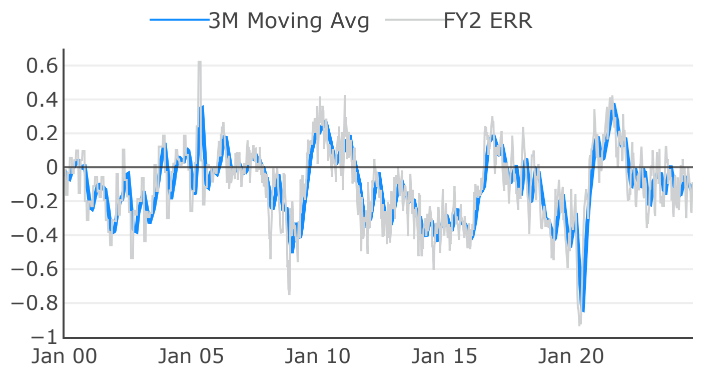
USA



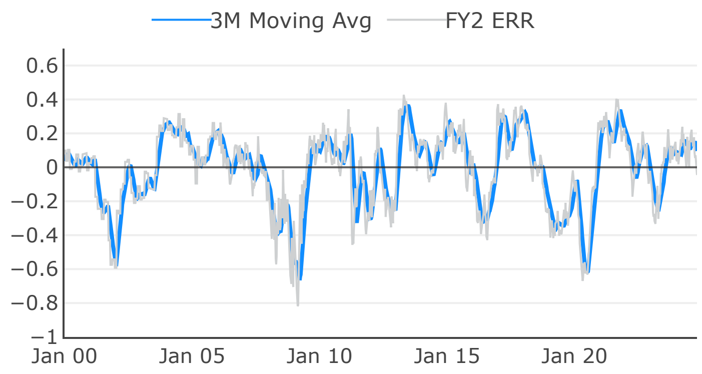
Eurozone



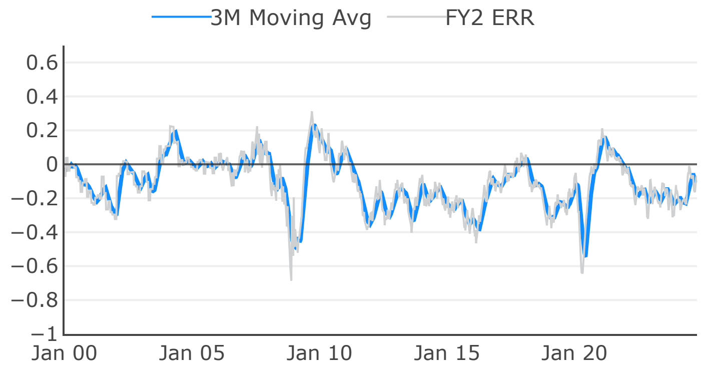
UK



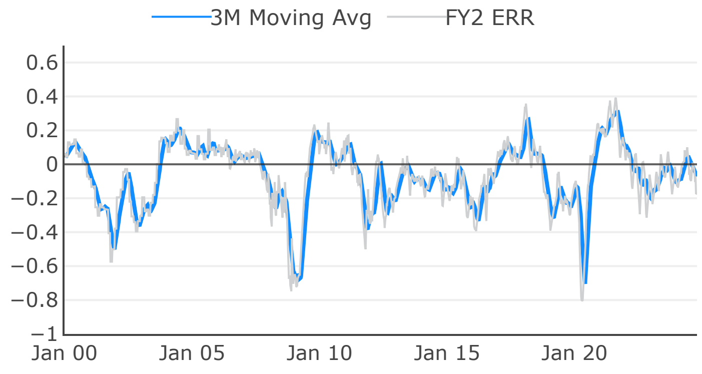
Japan



Emerging Markets



World



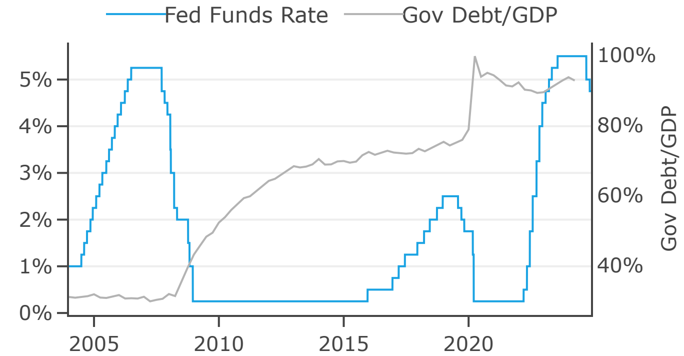
Sources | Eikon, the MSCI index has been used for each respective region, as at Nov 2024.

Interest Rates

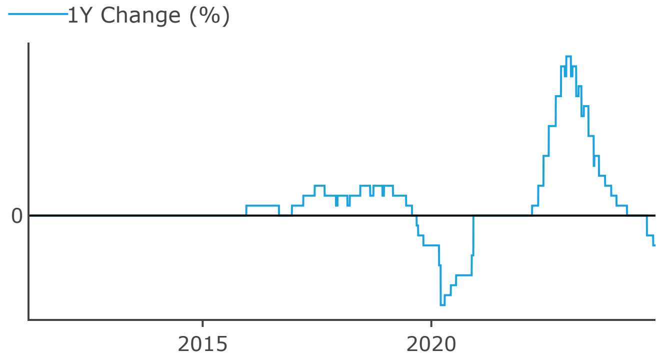
As expected, the November FOMC meeting brought a 25bps rate cut, bringing US Fed Funds Rate to 4.5-4.75. The minutes, released at the end of November, highlight the FOMC officials show support for "gradually" reducing rates given the strength of the economy and labour market. Despite this and a higher than expected CPI print (2.6%), **markets expect another 25bps cut in December before Donald Trump's return to office.**

Given Trump is fiscally loose, **it is worth reiterating that 33% of all US government debt is to mature over the next 12 months.** The re-issuance will be expensive. The effective rate of all US marketable debt is ~3.4% - much lower than the current 3-month T-Bill rate of ~4.4%*.

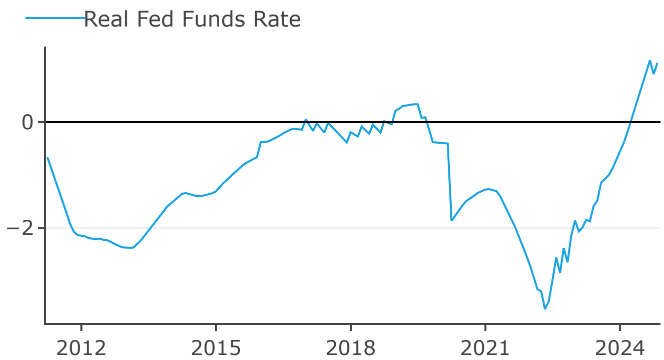
Fed Funds Rate



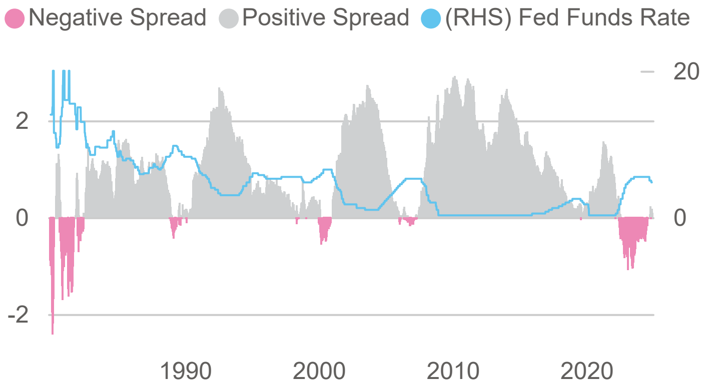
Change in Fed Funds Rate



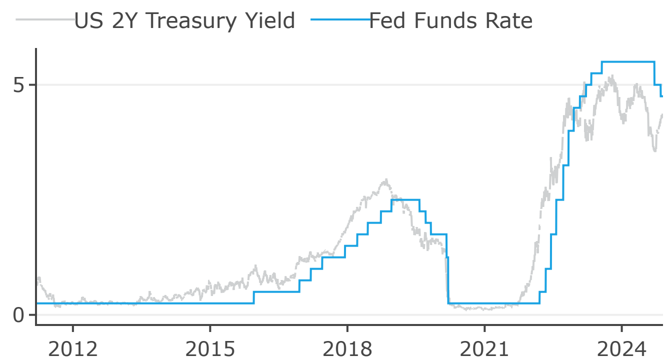
Real Fed Funds Rate (Using 2Y MA CPI)



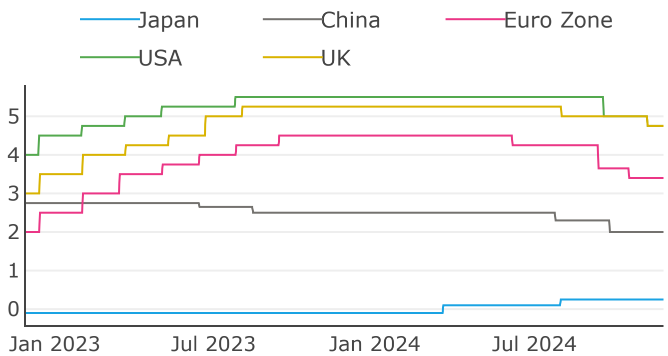
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Nov 2024. * as at 27 November.

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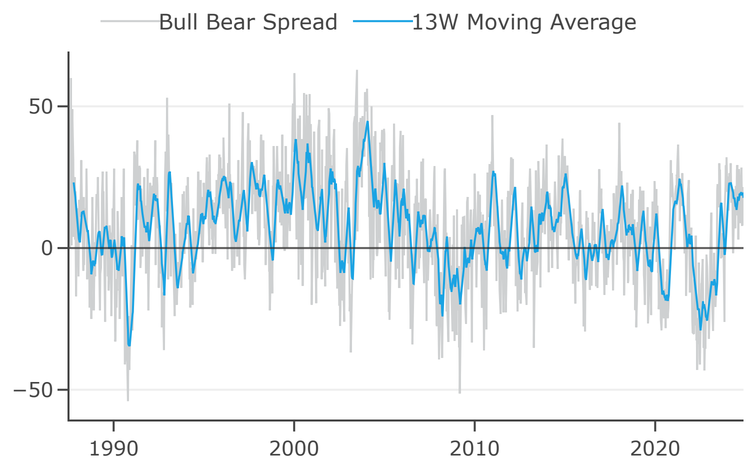
Sentiment

The Dollar-Yen carry-trade unwind created short, but intense, selling pressure at the start of August. **This lead the VIX to spike to levels above 40, similar to the likes of the COVID period in June 2020.** The panic lasted just a few days before the VIX normalised back towards its <20 levels and has remained around those levels since.

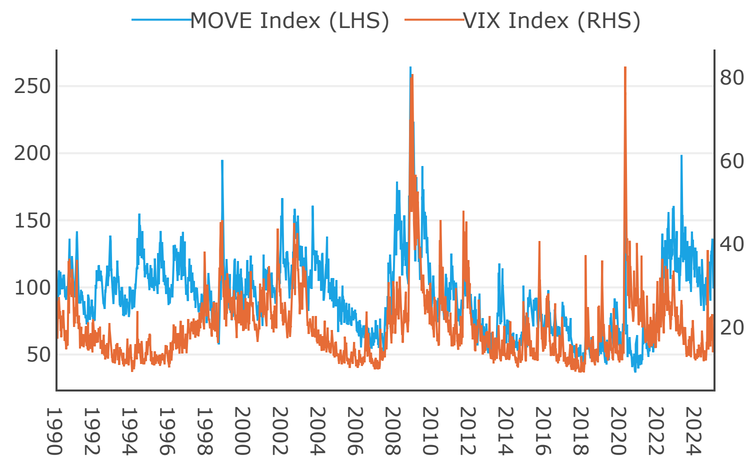
The BAML Hartnett Bull & Bear Indicator has moved from Extreme Bearish sentiment (which is bullish for the market!) in October 2022 and 2023 **to now mildly bullish** (the current reading is 5.4/10).

US Equity Indicators

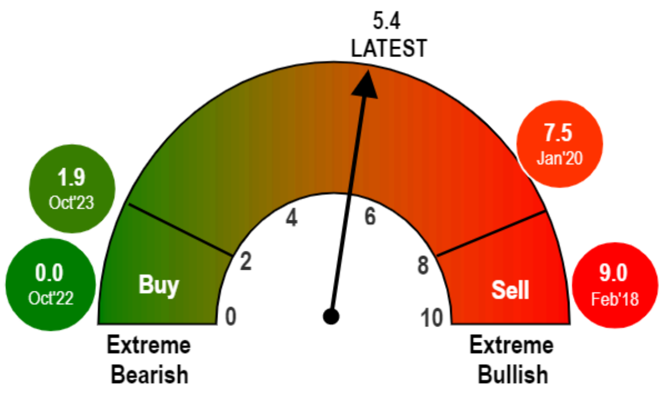
AAII Bull Bear Spread



Equity vs. Bond Sentiment

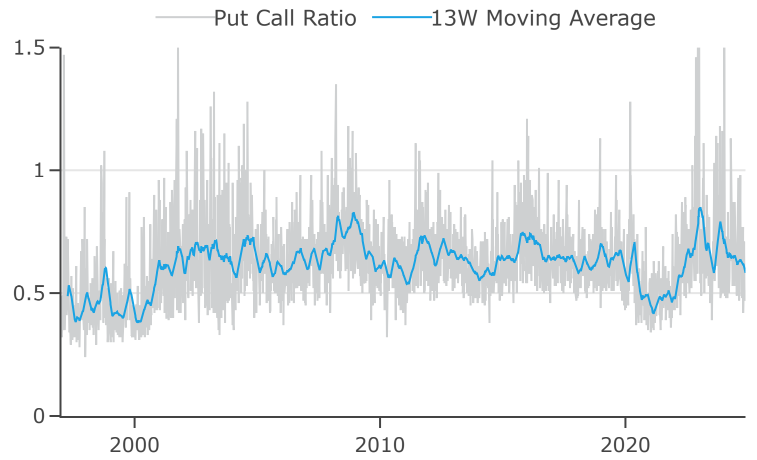


Michael Hartnett's Bull & Bear Indicator (BAML)



Source: BofA Global Investment Strategy

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 Nov 2024

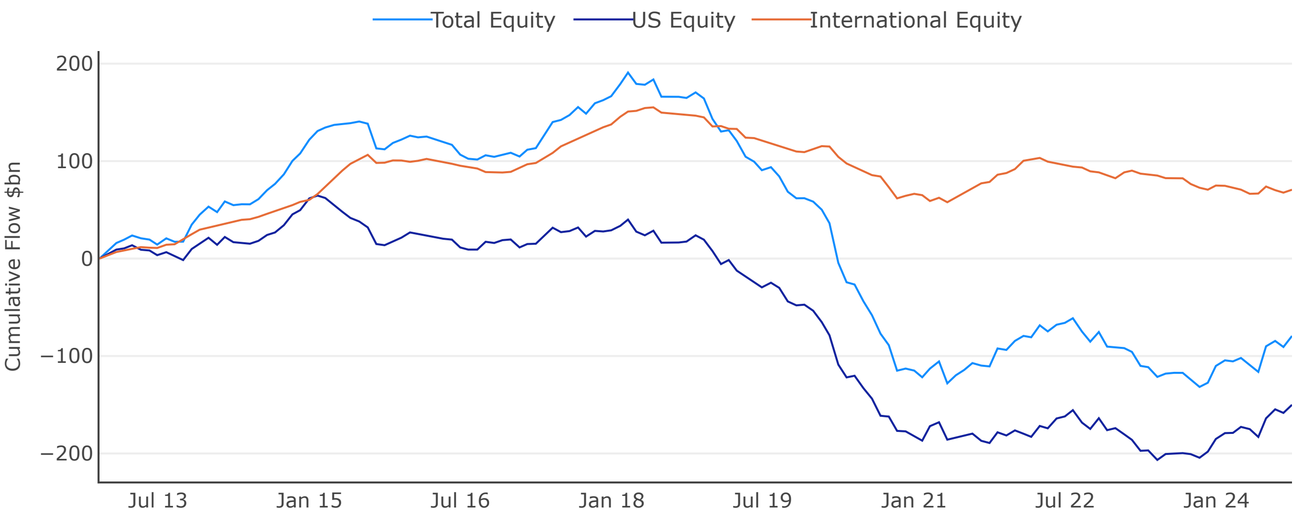
Fund Flows

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.

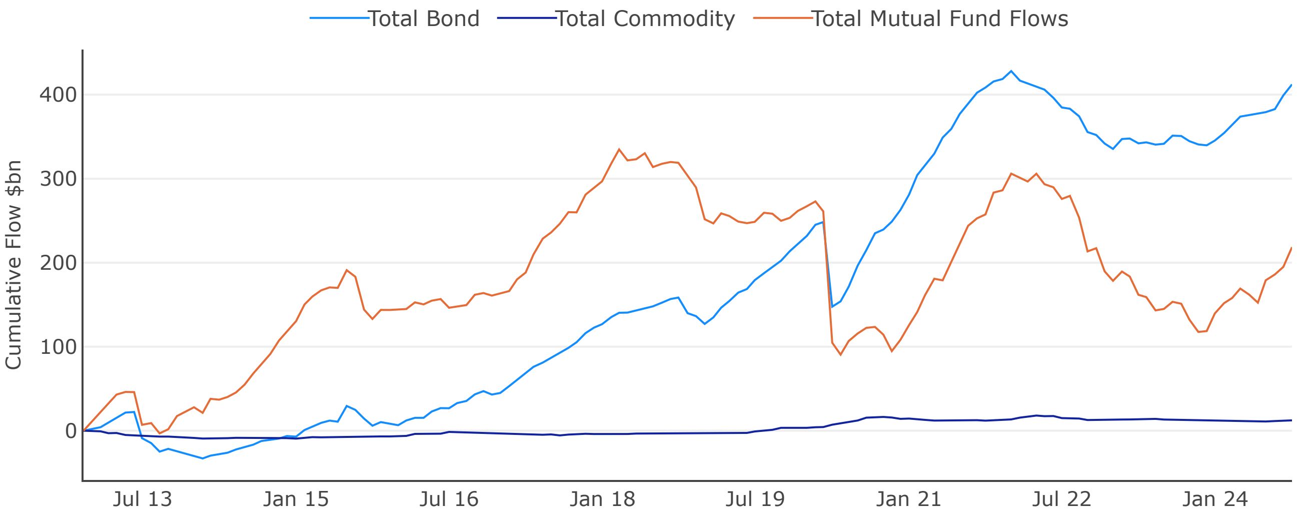
The message in these data points continues to be that there is little enthusiasm for actively managed funds even if the outflows from equity funds have stopped.

US Mutual Fund Flows

Equity Markets Cumulative $bn



Non-Equity Markets Cumulative $bn



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

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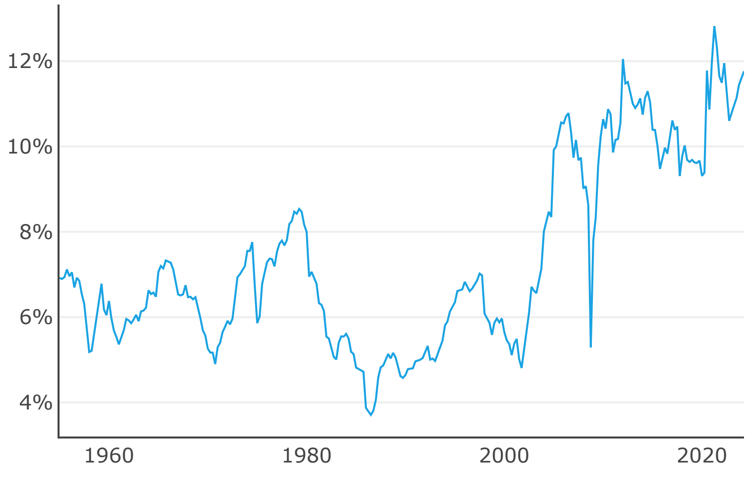
The Big Picture

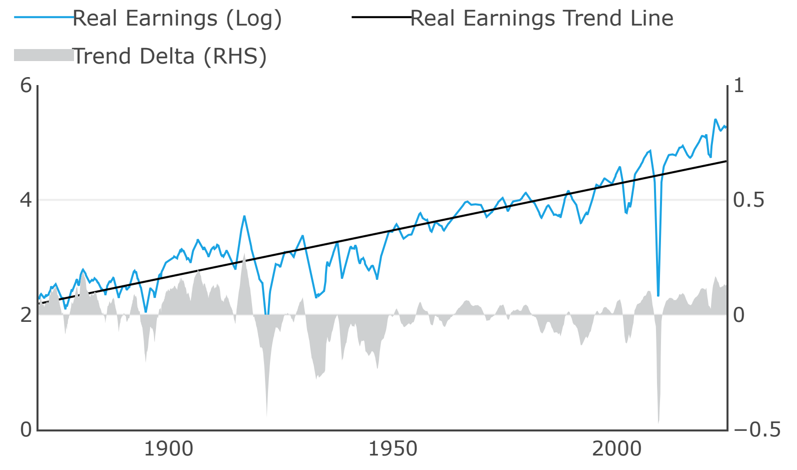
Here we highlight some longer-term imbalances that, **should** they correct, would have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. Its corollary (not shown) is that 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

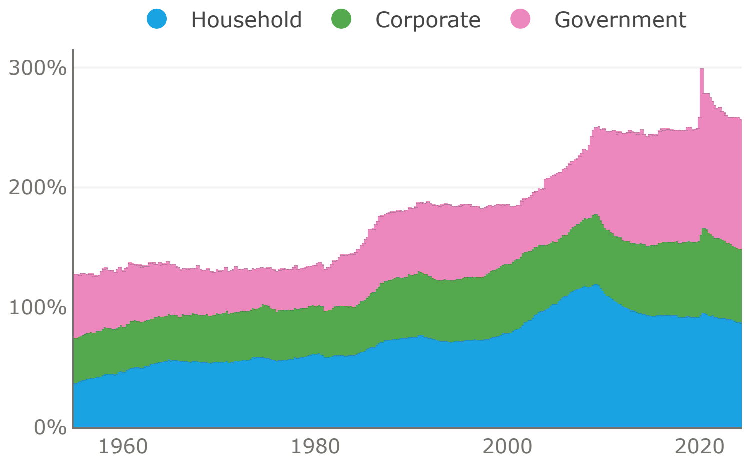
Profit Share of GDP



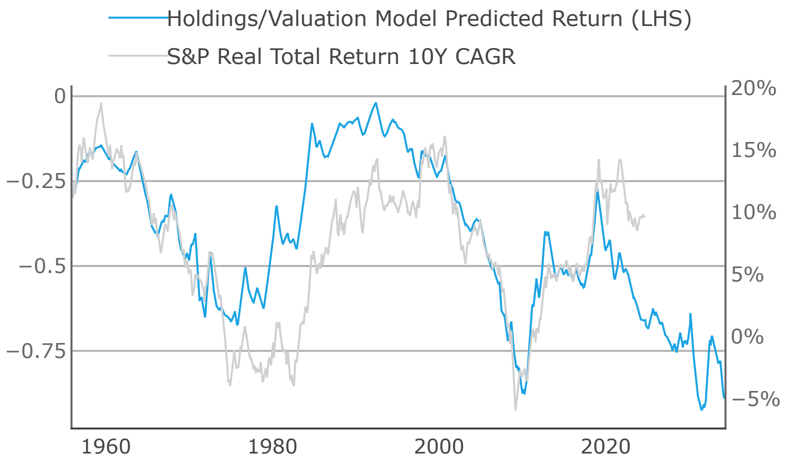
Earnings Deviation From Trend



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 Nov 2024.

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