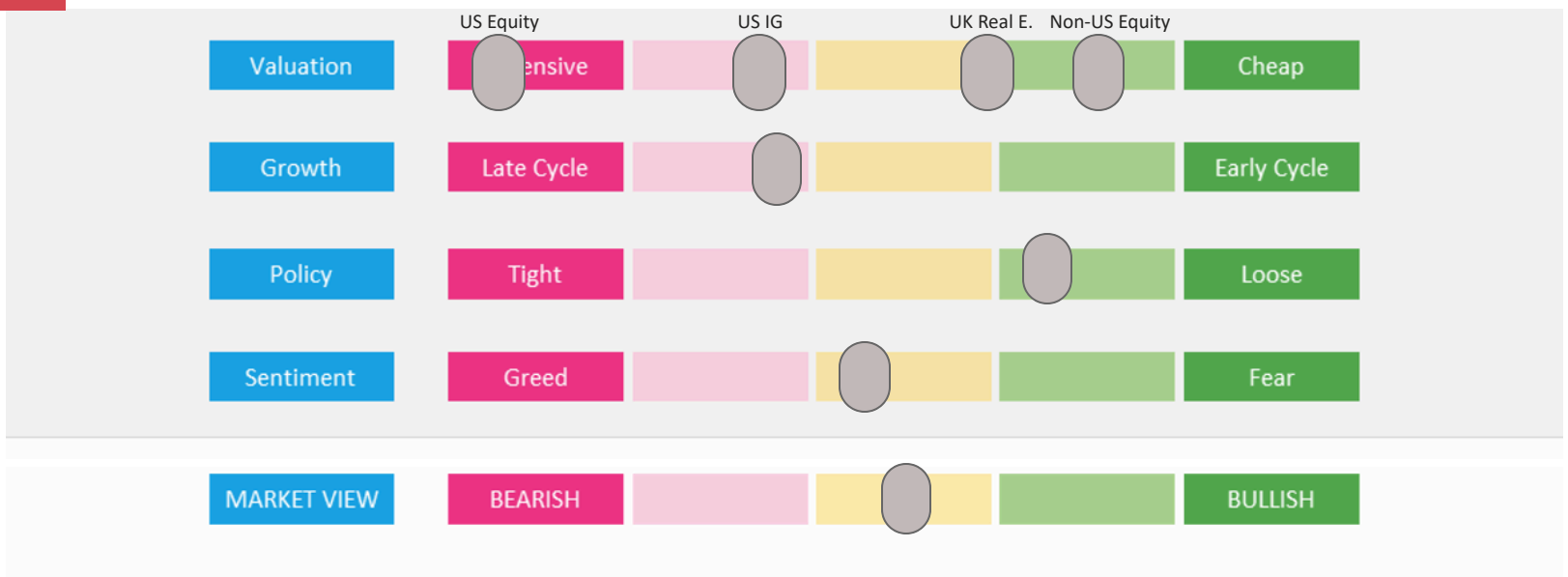


Christmas Market Barometer

Barometer

 This Month
  Improved
  Deteriorated



Our Twelve Charts of Christmas

US equity is very expensive, within 10-15% of all time high valuations depending on the measure. However, rising earnings, positive estimate revisions and still-abundant market liquidity are powerful supports. And as we illustrate above, valuation outside the US equity market is hardly egregious and in some cases good value.

It's been very much a pro-risk market over the last two years. We show that the riskiest equity market strategies (leverage, volatility, loss-making tech stocks) have been the stand-out winners, while Value and Quality, those bastions of conservatism, have badly lagged.

This has meant a gross de-rating of Quality equity, from (admittedly) quite stretched levels a year ago.

We ask the \$2trn question - will AI capex pay out?

Our basic maths suggests it will be a stretch for the hyper-scalers to sustain currently high CFROI, but we acknowledge the momentum.

Elsewhere we look at:

- What happens if the US re-values its gold reserves.
- How surprisingly few rate cuts are priced in.
- The likely transition from QT back to mild QE.
- What it would take for the US equity market to cede leadership.
- How President Trump's tanking approval ratings may play out.
- And we present our Capital Market Assumptions.

Finally, **we wish you a very Merry Christmas!**

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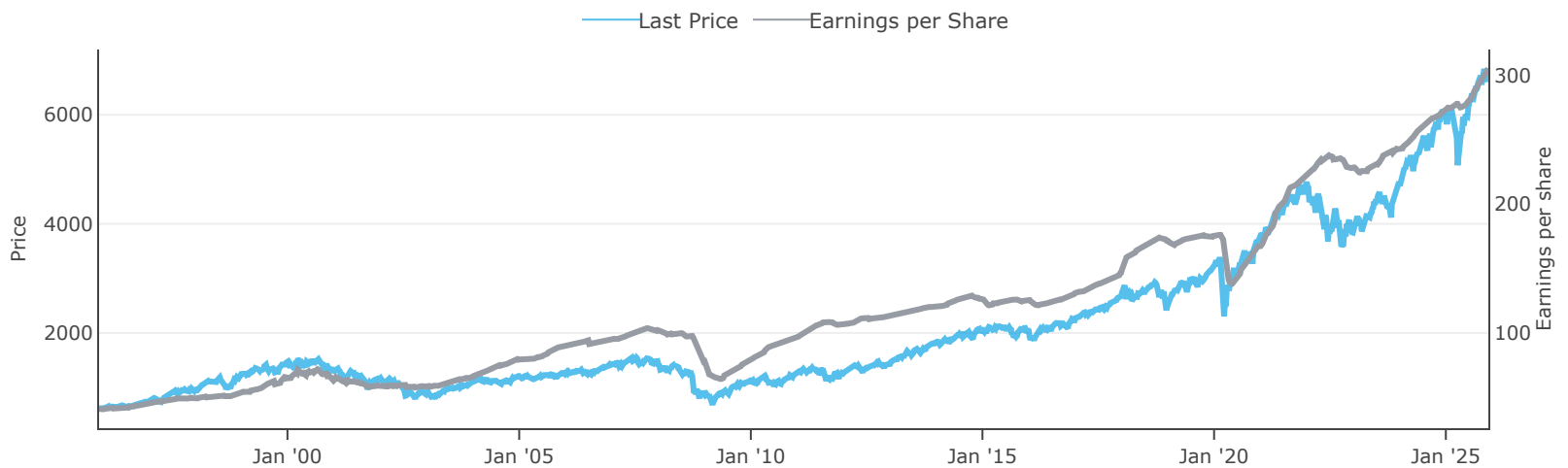
The First Chart of Christmas

Keeping it simple, earnings drive the stock market and earnings are going up. So near-term risk markets still seem very well supported by the fundamentals.

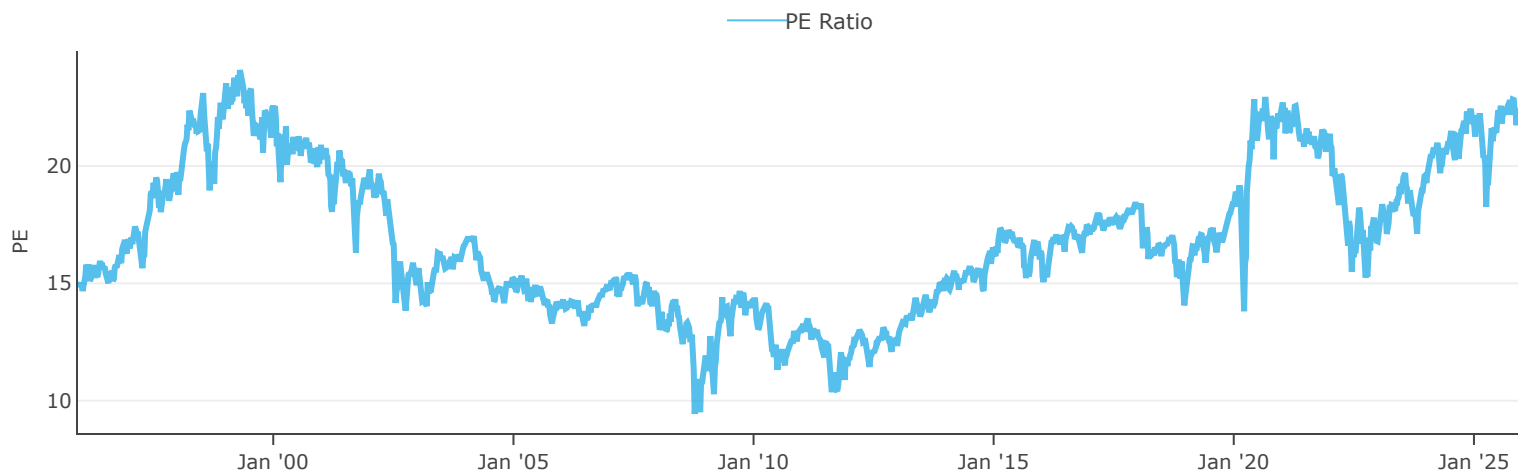
Against this, **market valuation (in the US equity market) is very extended.** A Shiller PE of 38 and a forward PE of 22 are each only 10-15% off the all time high valuations achieved in 1999-2000.

Simple conclusion - **the next market correction is going to be closer to -50% than the usual -25%,** we guess. But it's hard for a market to correct when supported by strong earnings and strong liquidity.

S&P500 Index Price and forward EPS



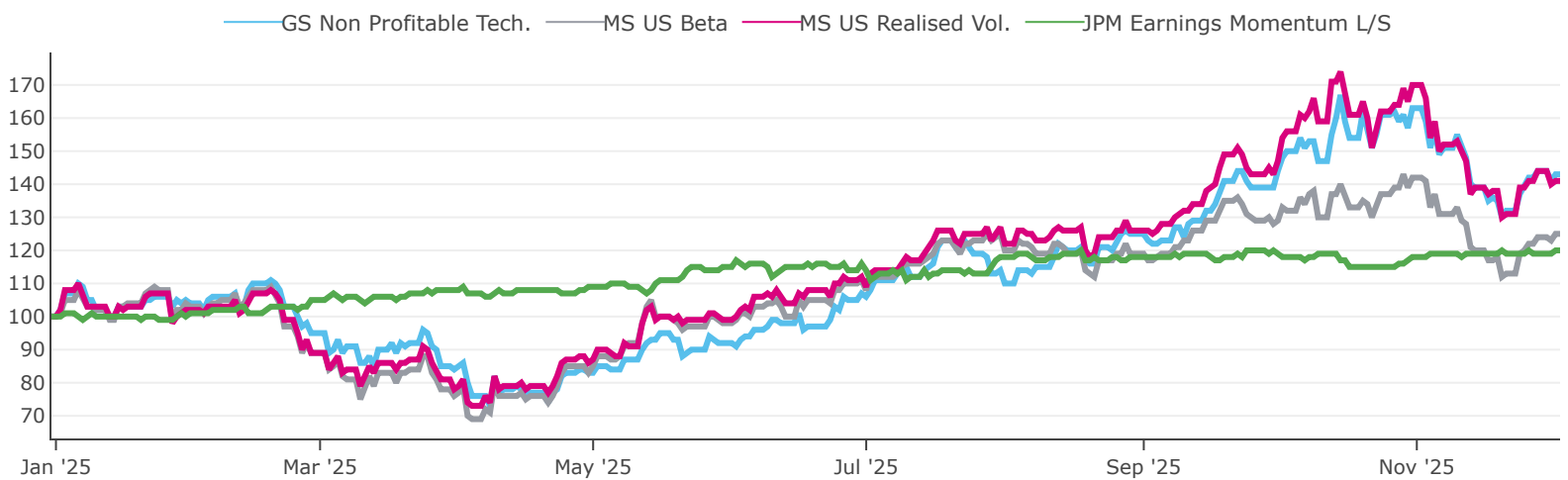
S&P500 Index PE Ratio



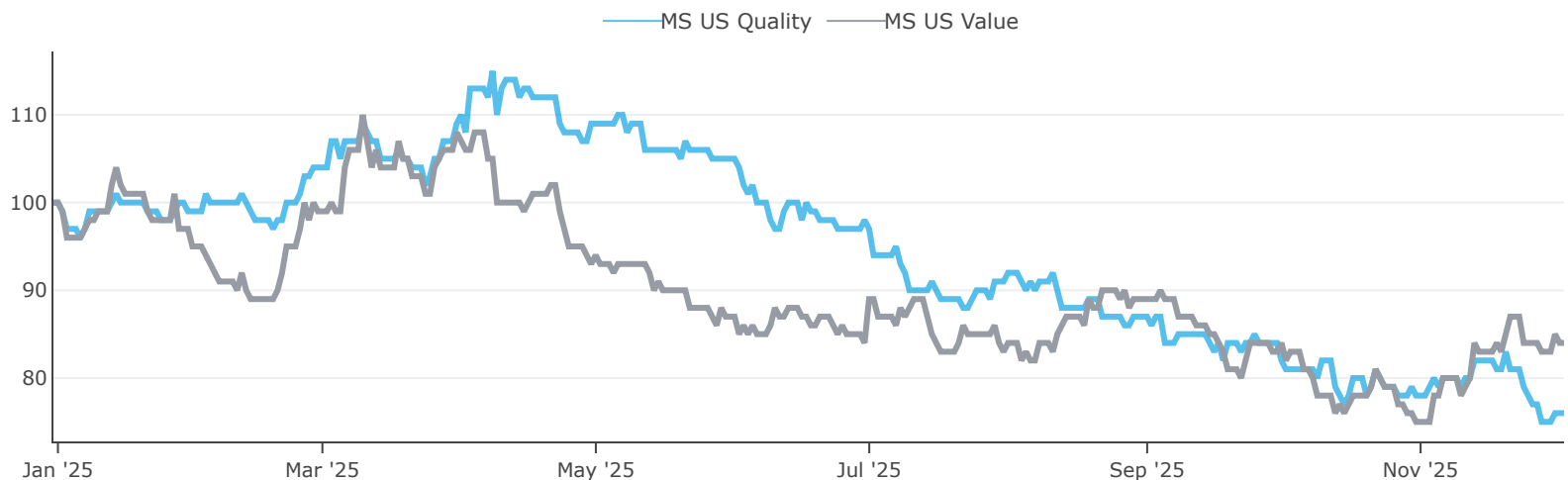
The Second Chart of Christmas

Expanding risk appetite. The charts illustrate just how "risk-on" the market has felt since the tariff-induced lows of early April. Since then, a strategy that is long highly volatile stocks and short very low vol stocks has rocketed, returning over 100% between April and October, before settling down in November, but may well be going again now. Goldman Sachs has a "non profitable" tech stocks basket - a euphemism for "loss-making" - which has performed very similarly to the high volatility long short basket. Solidly plugging away, up "only" 20% is the long-short earnings momentum basket. Conversely, Quality and Value have been the two worst strategies. **So it's been a strongly "risk-on" market, dominated by retail investors and day traders.**

Style factor winners YTD



Style factor losers YTD



The Third Chart of Christmas

The de-rating of Quality has very much been the story of the last 18 months. Over the last 10 years or so the Quality PE premium expanded from 5% (versus the PE of MSCI World) to, at peak June last year, 30%. It has now fallen to 14% (top chart). Within that, US Quality is still at a 24% premium to the world (lower chart) while ex-US Quality is under 10% (not shown).

What's the right "Quality premium"? Clearly Quality stocks should trade at some premium to the world. To the extent that they no longer de-rate relative to the world, and to the extent they continue to sustain a higher CFROI than the world, **mathematically they should outperform.**

MSCI World Quality PE vs MSCI World PE (Premium)



MSCI Quality PE relative to MSCI World PE (Premium)



The Fourth Chart of Christmas

The \$2 trillion question - will the AI capex be a profitable investment? The five publicly listed "hyper-scalers" (which are competing to provide the dominant large language models and inference engines) currently generate \$1.59 trillion of revenue off a capital base of \$1.66 trillion (see table), giving an asset turn of 96%. They currently envisage cumulative capex over the next five years of \$2.1 trillion. If we assume their margins are similar in monetising their AI investment as they are in their existing businesses, that means **they will have to generate \$2 trillion of incremental revenues annually from the new capex** (96% of \$2.1 trillion).

How likely is this? Some people have pointed out that the most successful software roll-out of all time is Office 365 from Microsoft. Office 365 had revenues last year of \$94bn. So **the hyper-scalers will have to generate the equivalent of 21 Office 365s in order to maintain their current profitability.**

Alternatively we could compare them to the five largest subscription entertainment channels today. Between them Netflix, Amazon Prime Video, HBO Max, Disney+ and Tencent Video have 909m subscribers globally, which we estimate generate annual revenues of \$115bn. If the hyper-scalers can gain 909m unique subscribers they would need to be charging them \$2,200 each per year / \$180 per month to generate their \$2 trillion. How much would you pay for your AI license?

What will market shares be in AI? A comparison with the internet search (browser) market may be helpful. After launch in 1998, Google's market share in search got to 60% by the end of 1999, and has been around 90% for the last five years. Is it reasonable to expect that there is only one winner in the provision of monetisable large language models? Or, how likely is it that all five hyper-scalers "win" in AI? And what will happen to the capex plans of the AI losers when they realise they are not going to win?

For now, though, our (and everybody else's) channel checks in the AI supply chain confirm that it is still in accelerating ramp-up mode. Capex estimates are only being revised up, even from these lofty levels.

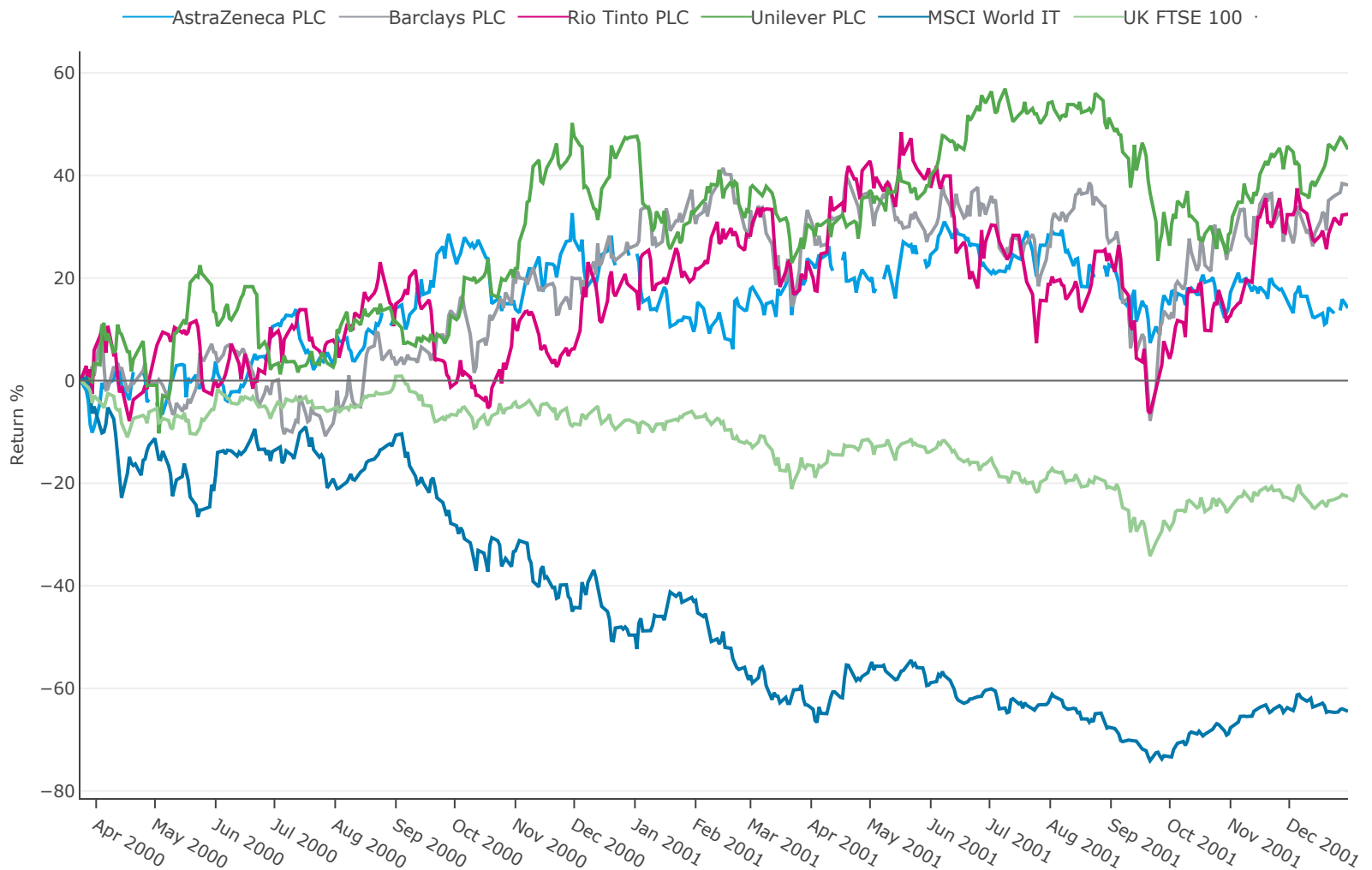
FINANCIAL METRICS OF THE FIVE HYPERSCALERS

Bloomberg Consensus Estimates (2025, \$ billion)	MSFT	ORCL	GOOG	META	AMZN	TOTAL
Revenue	282	57	342	198	711	1590
EBIT	128	19	131	82	81	441
EBIT Margin	45%	32%	38%	41%	11%	28%
Total Assets	619	168	450	276	625	2138
Current Liabilities	141	33	89	34	179	476
Invested Capital	478	135	361	242	446	1662
Asset Turn (Revenue/Capital)	59%	42%	95%	82%	159%	96%
Return on Invested Capital (ROIC)	27%	14%	36%	34%	18%	27%

The Fifth Chart of Christmas

The unwind of the TMT bubble during 2000-2001 is enlightening. Stocks that had been overlooked during the bubble's inflation 1996-1999 in many cases performed well in absolute as well as relative terms during its deflation. Thus, per below, while the FTSE 100 fell 30% and MSCI World IT fell 75% peak to trough in 2000-2001, various big name old world stock actually rose. A range of Healthcare, Bank, Mining and Consumer Staples stocks were up 20-50% while the new world stocks collapsed. We do see the differences between then and now, namely that valuations today within the AI sector are not anywhere near as stretched as the TMT stocks were; and they are still cash generative despite the ramp in capex; and conversely the non-AI stocks are not as cheap as the old world stocks were in 2000. (Our concern is more with the earnings of the AI stocks). But the point still stands, we think. **Even if the stock market corrects sharply, some or many overlooked Quality stocks should still perform well.**

Some stocks go up when the market goes down

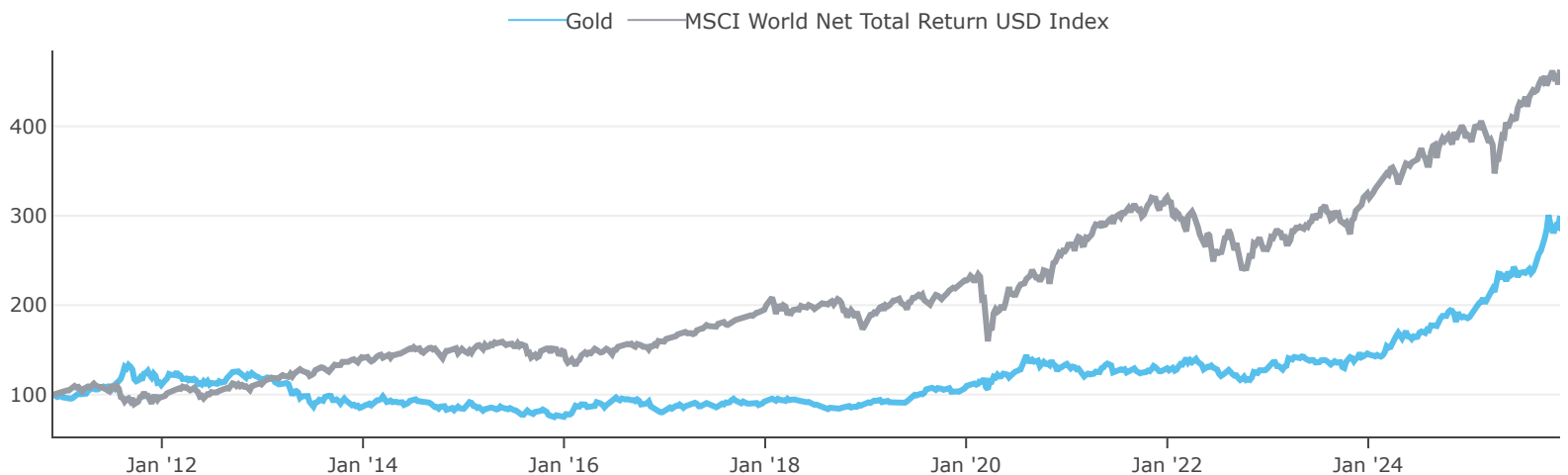


The Sixth Chart of Christmas

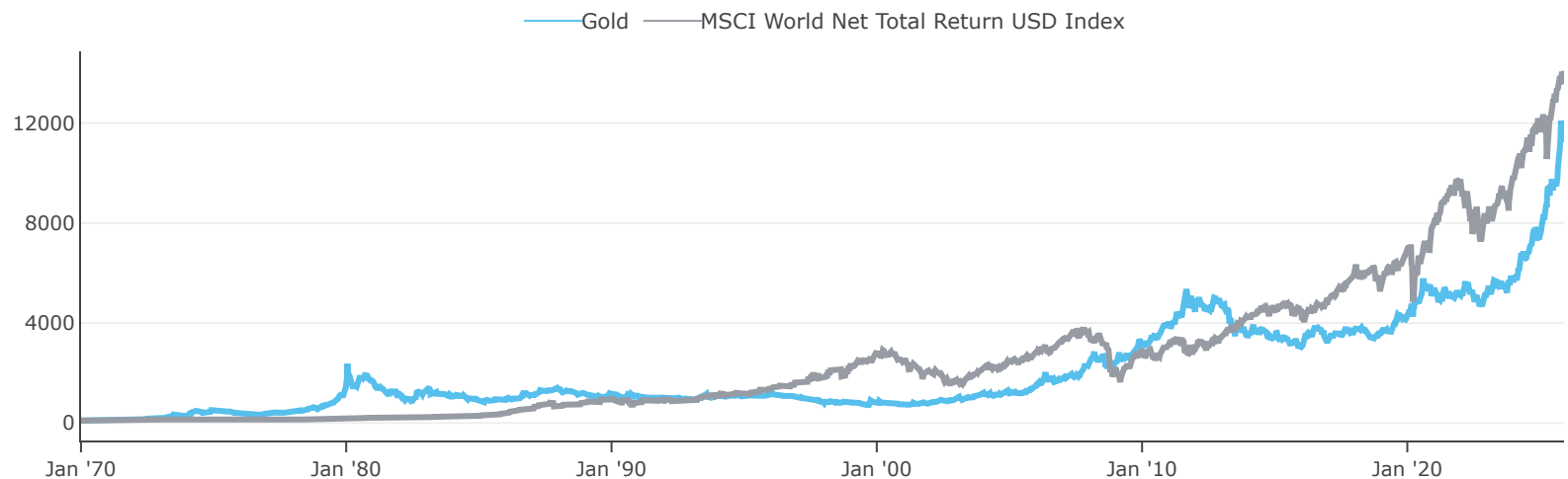
Gold has been catching up with equities again. Even if equities retain their total return performance lead over gold on a 15 year view (top chart), the degree of catch up over a 55 year view (from the beginning of the 1970s and the end of the US gold standard in 1971) is remarkable. Another 17% outperformance by gold and it will have caught up with equities again on the 55 year view.

Gold is up because government debt is up, in our view. There are broadly four ways out of a debt trap: 1) a surge in productivity, 2) an unanticipated surge in inflation, 3) devaluation or 4) default. Barring AI delivering on its productivity promise we can for the time being probably dismiss the productivity surge. **Any of the other three options is good for gold.**

Gold vs Equity (last 15 years)



Gold vs Equity (last 55 years)



The Seventh Chart of Christmas

What happens if the US re-values its gold reserves? The upper table (below) summarises the Fed's \$7trn balance sheet. Amazingly, the gold reserves are held at a valuation of \$11bn! The US has 8,133 tons of gold which is 261m ounces - which it values at \$42 / oz when the prevailing market price now is over \$4000. So the \$11bn book value is actually currently worth \$1,100bn. The lower table shows the impact on the Fed's balance sheet if gold were revalued. Both sides of the balance sheet go up by \$1,089bn. The line item on the Liabilities side that would be credited is the US Treasury General Account, aka the government's bank account at the Fed. So Scott Bessent would suddenly have \$1trn to dispose of however he (and Donald Trump) wanted, as long as the Congress approved it. If you were Donald Trump, and you weren't sure you would still have control of the House of Representatives after November 2026's mid-term elections, you'd do this before then.

What might they spend it on? Choices, choices. They might save it, using it to seed a Sovereign Wealth Fund. They might not, though. They might invest it in Infrastructure. They might distribute some in one-off payments to support Americans through an ongoing cost of living crisis. Or it might be a mix of all three. What we can be fairly sure of is that some of the proceeds would be used to support the economy in what remains a very tough labour market. **IF they revalue. Which they might not.**

Fed Balance Sheet (*as is, 26 Nov 2025*)

Assets (\$bns) "Factors Supplying Reserve Funds"		Liabilities (\$bns) "Factors Absorbing Reserve Funds"	
US Treasury Securities	4,191	Currency in Circulation	2,423
Mortgage-Backed Securities	2,063	Reverse Repo Balances	328
Mark to Market on Securities	203	Reserve Balances of Banks	2,896
Gold stock	11	US Treasury General Account	903
Other (FX assets, SDRs, Currency)	134	Other	52
TOTAL ASSETS	6,602	TOTAL LIABILITIES	6,602

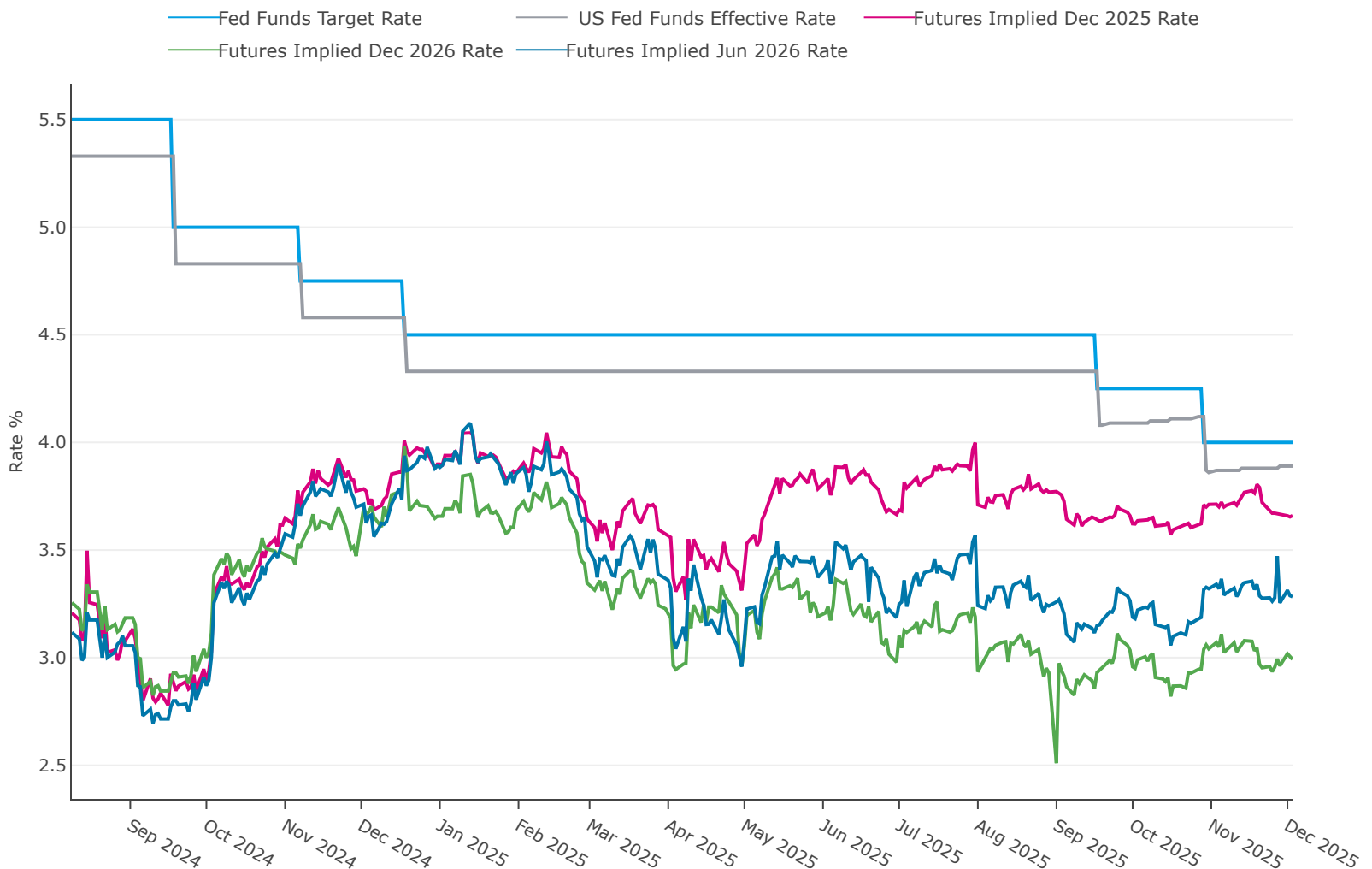
Fed Balance Sheet (*after Gold Revaluation*)

Assets (\$bns) "Factors Supplying Reserve Funds"		Liabilities (\$bns) "Factors Absorbing Reserve Funds"	
US Treasury Securities	4,191	Currency in Circulation	2,423
Mortgage-Backed Securities	2,063	Reverse Repo Balances	328
Mark to Market on Securities	203	Reserve Balances of Banks	2,896
Gold stock	1,100	US Treasury General Account	1,992
Other (FX assets, SDRs, Currency)	134	Other	52
TOTAL ASSETS	7,691	TOTAL LIABILITIES	7,691

The Eighth Chart of Christmas

It's a little surprising that so few rate cuts are priced in, given the likely change of leadership at the Federal Reserve. Rates have already been cut from 5.5% to 3.75%. Not that we think the US economy needs rate cuts, despite the weak labour market. The Fed publishes FOMC members' own projections of the long run (i.e. neutral) Fed funds rate. Currently they think 3.0% is neutral. The futures market expects the interest rate to be exactly that neutral rate by the end of next year (see chart). But in a weakening economy, with a new Fed chair, mid-term elections in a year's time and a Fed that's more focussed on the labour market than stubbornly above target inflation, **the risk must be that interest rates are cut more than the market currently expects to below neutral.**

Probability of Fed Rate Cuts

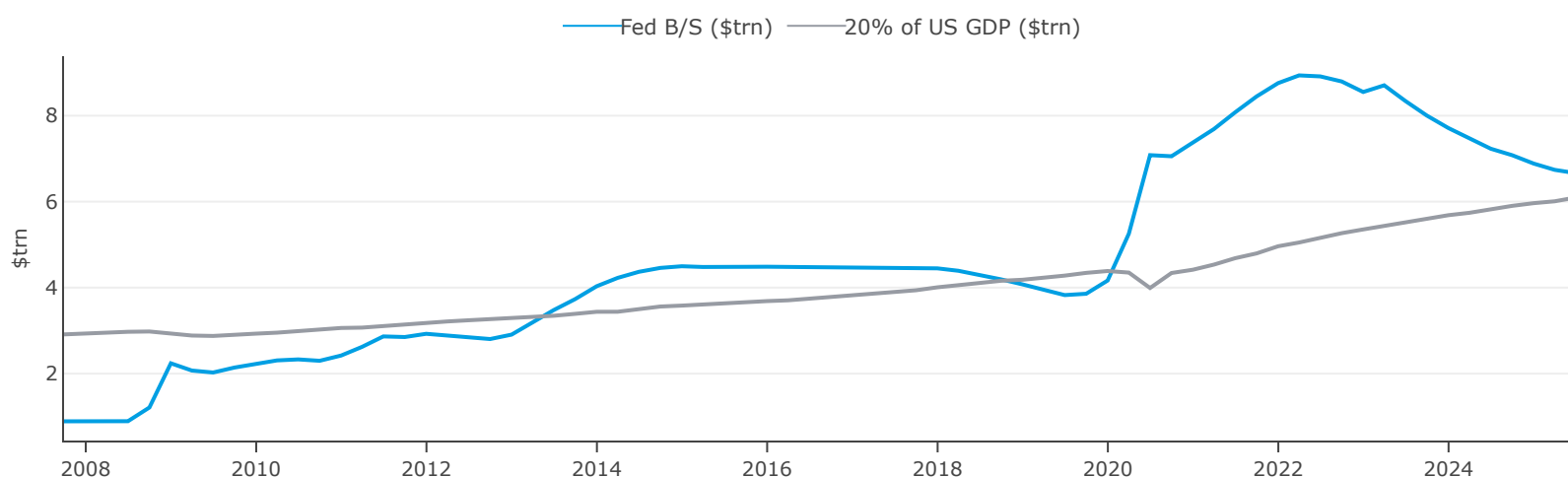


The Ninth Chart of Christmas

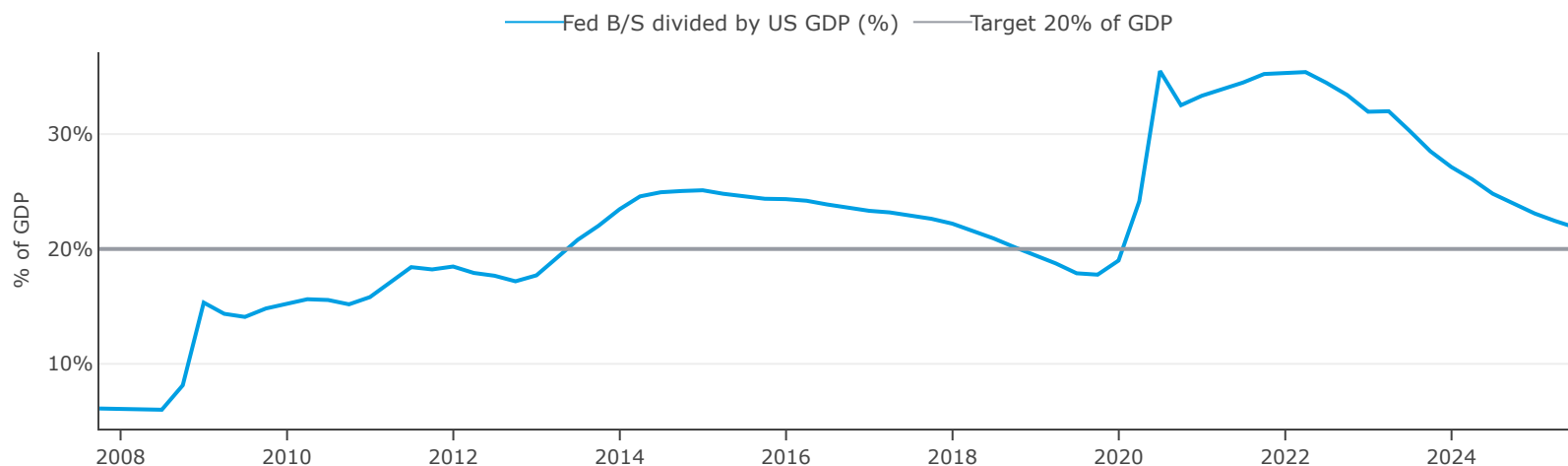
QT is dead. Long live QE. A very important phase transition occurred during Q4 2025 as regards to the Fed's balance sheet. At the October meeting the Fed announced it would stop shrinking the balance sheet from December 2025 by reinvesting the proceeds of matured bonds. At the December meeting it announced new standing reverse repo operations for T-bills which could end up expanding its balance sheet.

These are all more indications that the Fed won't countenance any squeeze in interbank liquidity and that **the Fed put is back in full force.**

Fed Balance Sheet vs "Optimal" Fed Balance Sheet (\$trn)



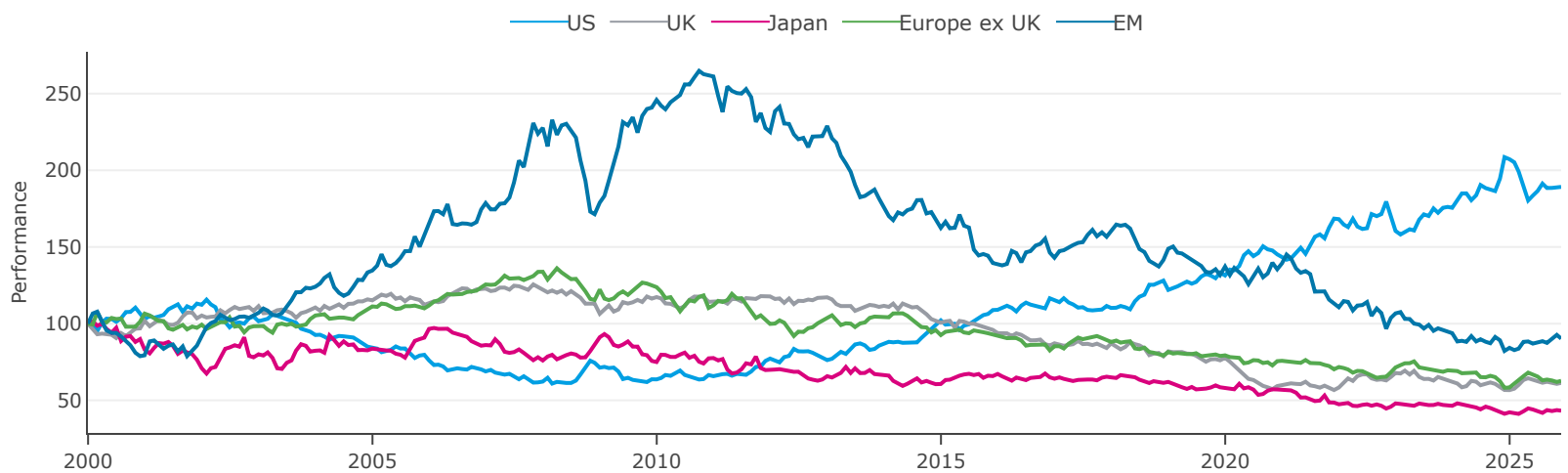
Fed Balance Sheet as % of GDP



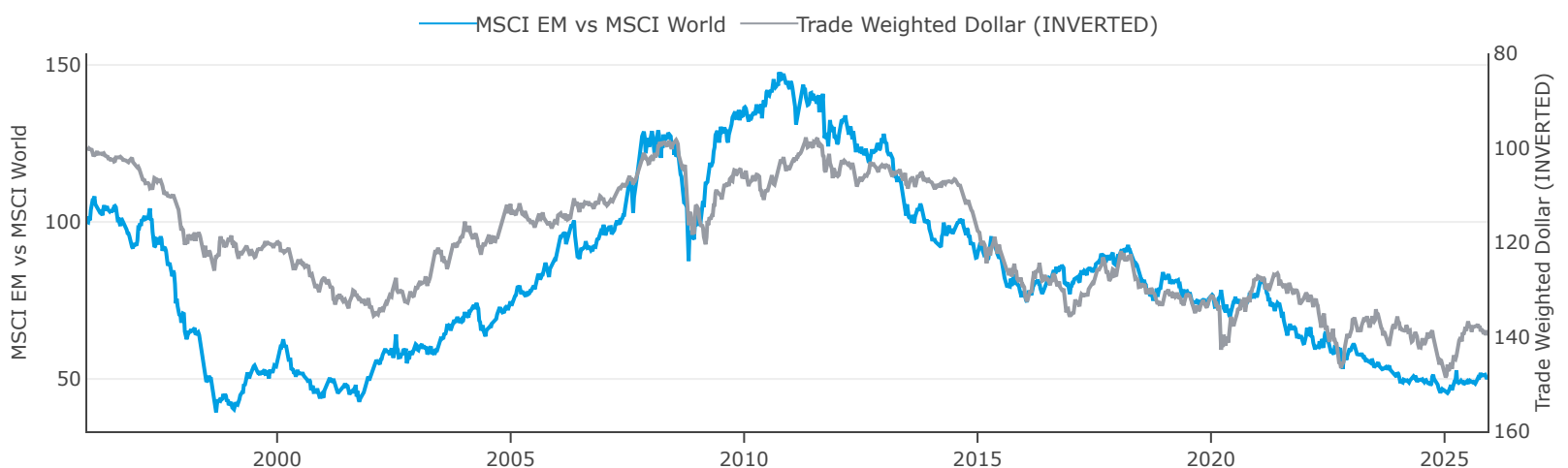
The Tenth Chart of Christmas

The first decade of the millennium was China's, but it's been all America since 2010. It's very hard to see this US market leadership transitioning elsewhere unless the AI theme loses momentum, or Europe and China really do succeed in stimulating their domestic economies enough to wake from their slumber. So often in Europe and the UK it's been a case of good plans falling down in the implementation. Thus, Rachel Reeves has failed to reform welfare, improve NHS productivity and kick-start a domestic capital investment surge. Similarly, Friedrich Merz's Germany coalition is getting bogged down in domestic welfare spending rather than reforming it. And France has if anything overtaken (undertaken?) the UK as the political basket-case of Europe. **We should probably accept that the US market will continue to lead the world until and unless the AI theme falters.** As the lower chart shows, EM outperformance requires the dollar to fall.

Regional Performance Relative to MSCI World (all in \$ terms, 12/99=100)



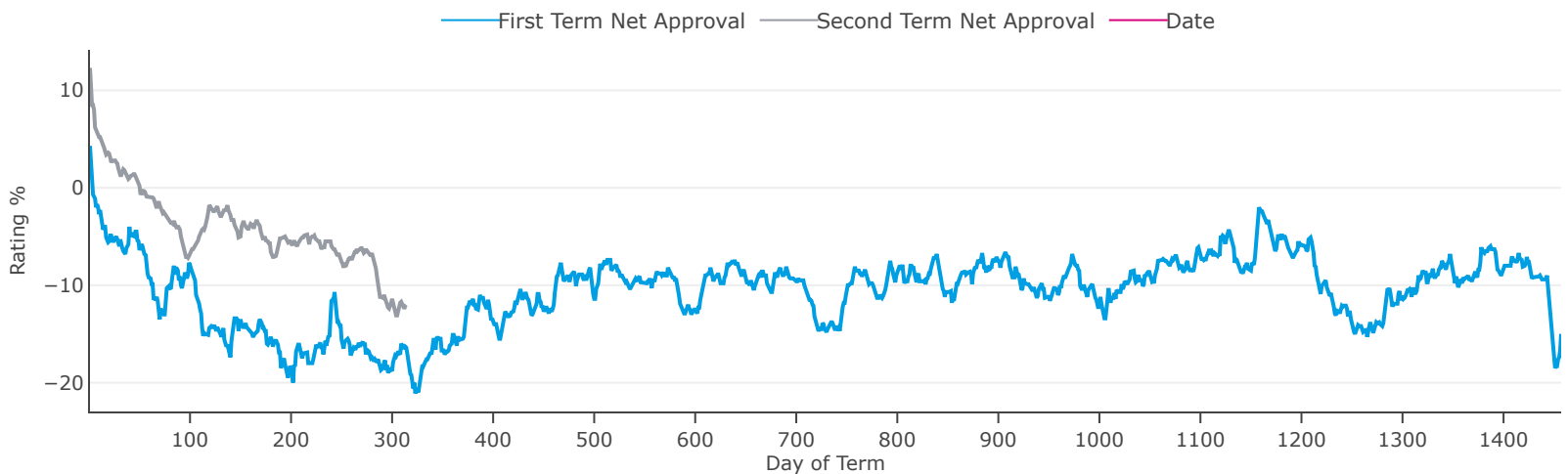
Emerging Market Equity Outperforms when The US Dollar Falls



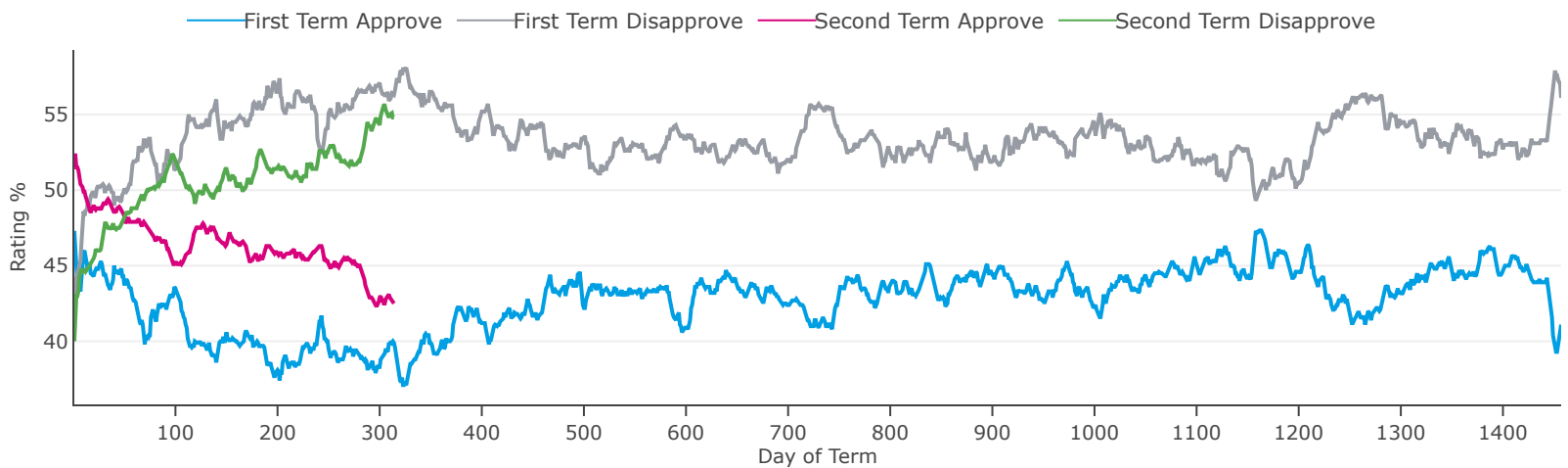
The Eleventh Chart of Christmas

President Trump's approval ratings are tanking, although as the top chart shows it's not as bad as it was in his first term, when his net approval went from +10% to -20% in his first 200 days. Back then his numbers recovered when the Tax Cuts & Jobs Act was signed into law, cutting taxes for most Americans. It's unclear what rabbit he can pull out of the hat now and given that the OBBBA plus the tariffs add up to net cuts in post tax income for 90% of Americans. The mid-term elections in November 2026 will be a potential watershed moment, as the Republicans could (likely) lose control of the House of Representatives. It is very likely that the administration will throw everything they have at supporting the US economy in advance of November. **Expect plenty of liquidity via a spend down of the Treasury General Account, and ramped up pressure on the Fed to ease.**

President Donald Trump Approval and Disapproval Ratings (by Day of Term,



President Donald Trump Approval and Disapproval Ratings (by Day of Term, %)



The Twelfth Chart of Christmas

And finally... we set out our capital market assumptions for equity and sovereign bonds. We present two approaches to forecasting equity market returns but highlight that we actually use the average of the Shiller earnings yield and the spot earnings yield.

Our expected real annualised total return for global equity is 3.5%, around half the level that has been delivered over the last decade. For bonds, gilts offer the highest return in developed markets but still well short of our target investment objective of CPI+4% net.

Global Equities

Total Return	US	Europe ex UK	UK	Japan	Emerging Markets	ACWI	World
Building Block Method (Real)	3.0%	5.5%	6.6%	3.2%	6.9%	3.6%	3.3%
Avg Shiller CAPE & Spot PE Method (Real)	3.5%	5.7%	7.0%	4.9%	7.1%	4.0%	3.8%
Average Real Return	3.2%	5.6%	6.8%	4.1%	7.0%	3.8%	3.5%
Inflation Expectation	2.5%	2.0%	2.5%	1.5%	3.5%	2.3%	2.2%
Average Nominal Return	5.7%	7.6%	9.3%	5.6%	10.5%	6.1%	5.7%

Fixed Income - Sovereigns

Inputs	US	Europe ex UK	UK	Japan	Emerging Markets
Trend Real Growth	2.0%	1.4%	1.5%	0.7%	3.8%
Term Premium	0.5%	0.5%	0.5%	0.5%	1.0%
Fair Real Yield	2.5%	1.9%	2.0%	1.2%	4.8%
Inflation Expectation	2.5%	2.0%	2.5%	1.5%	3.5%
Fair Nominal Yield	5.0%	3.9%	4.5%	2.7%	8.3%
Yield Now	4.11%	2.67%	4.39%	1.67%	2.59%
Bond Price (FV Yield)	£100.00	£100.00	£100.00	£100.00	£100.00
Bond Price (Yield Now)	£107.18	£110.67	£100.48	£109.41	£149.32
Pull To Par Annualised Return	-0.7%	-1.0%	0.0%	-0.9%	-3.9%
Total Nominal Return	4.3%	2.9%	4.4%	1.8%	4.3%

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