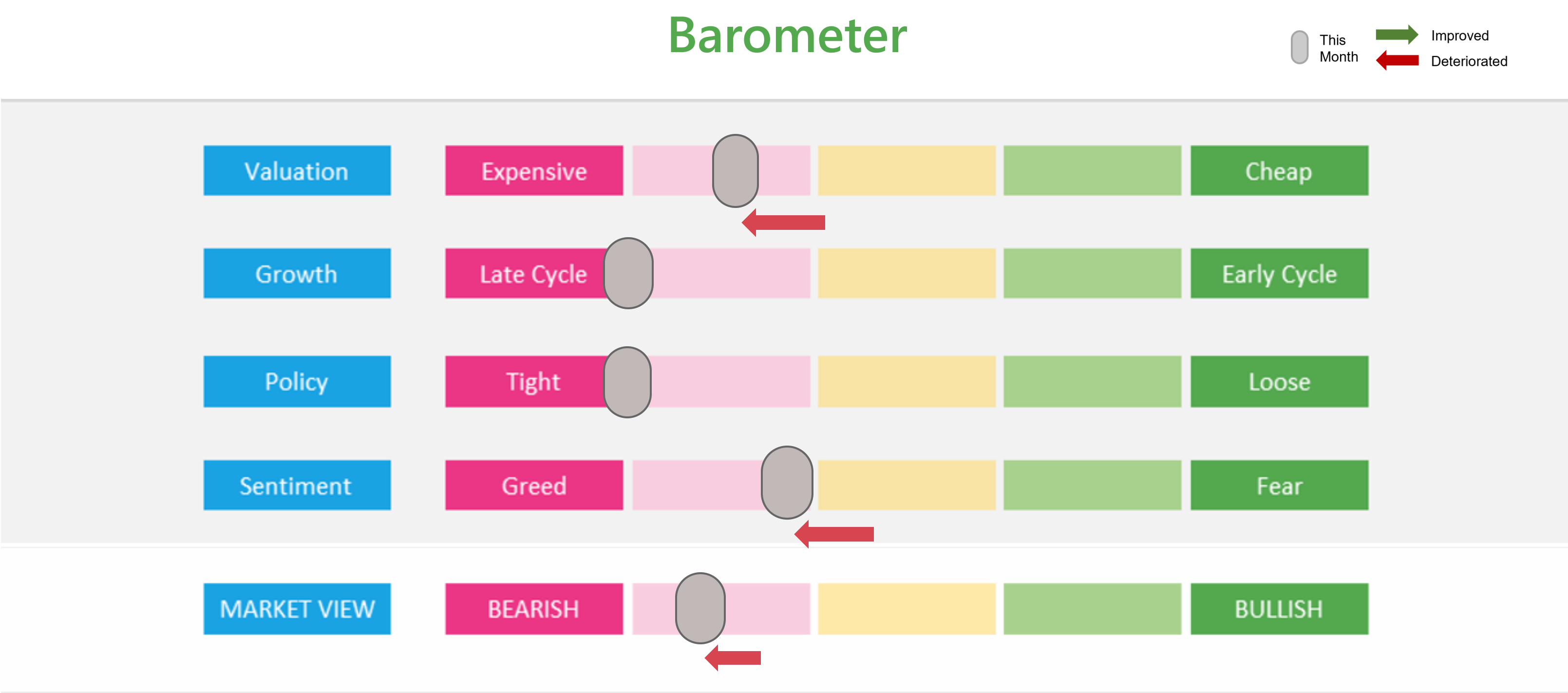
FEBRUARY 2024

CCLA
GOOD INVESTMENT

Market Barometer



The PE Re-Rating is Becoming Stretched

Equity markets have re-rated. The rally of Q4 has seen the S&P500 re-rate from 17x to over 20x price/earnings multiple. Against this, trailing earnings have stopped falling and forward earnings estimates continue to rise.

The bull case is that the multiple goes back to its 22.5x high of late 2020 and forward earnings estimates continue to rise, in which case **the S&P500 could rise another 20%**.

The bear case is that we have a recession, the PE falls back to its 16x long run average and earnings fall 10%, in which case **the S&P500 could fall 30%**.

The risk-reward is deteriorating, that much we can say!

We highlight two Charts of the Month. The first shows that the **excess demand for labour is moderating**. Until now this has been a market positive, as it entailed slowing wage growth and thus slowing inflation. If it continues to moderate further it would entail rising unemployment and then recession. We are closely watching.

The second shows the components of S&P500 return over time. **Last year's rally was almost completely driven by PE re-rating**. Now, earnings will have to take over to drive markets higher. If we continue to avoid recession that could happen. But **it's becoming a tighter call**.

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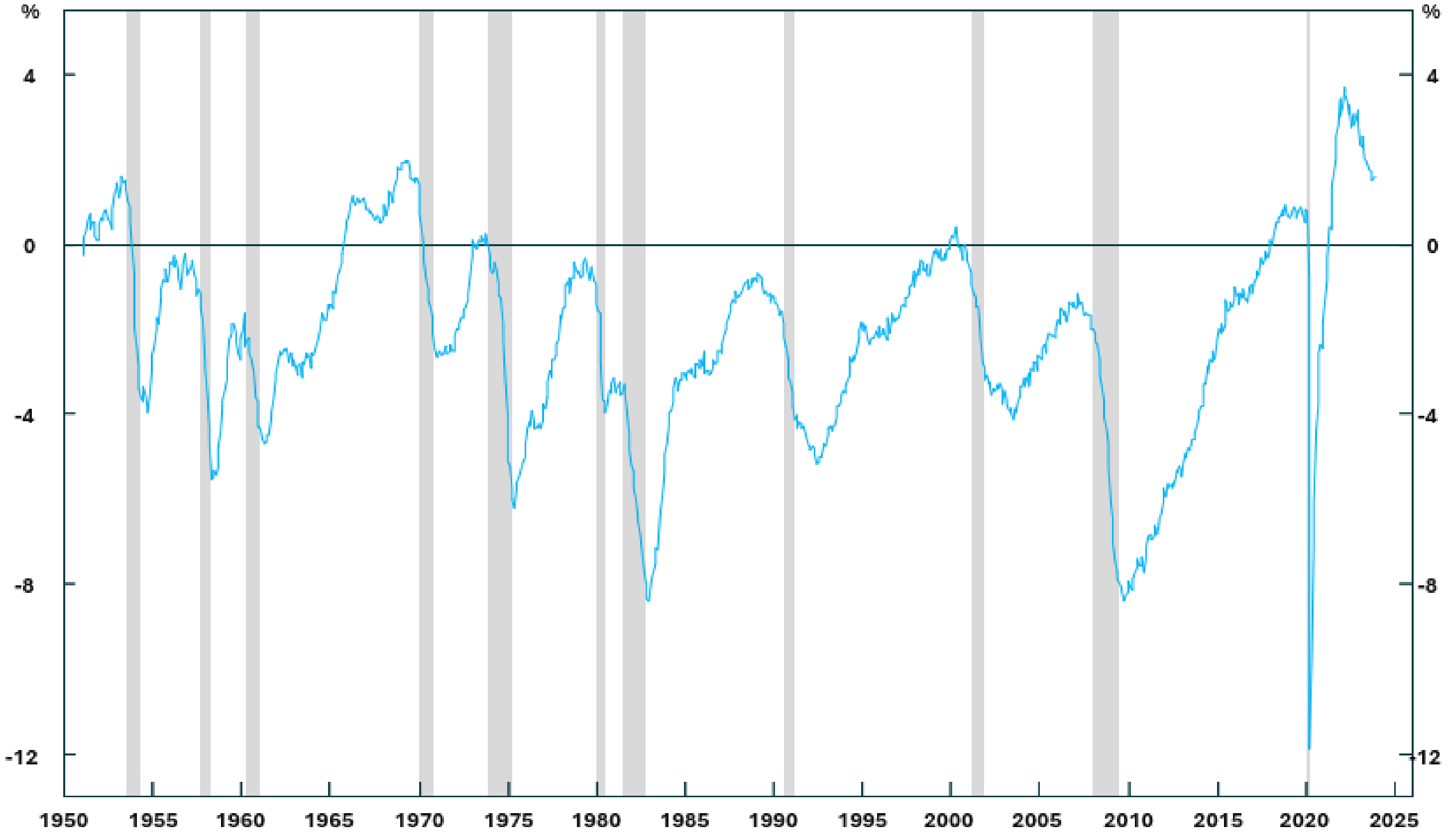
Contents

Charts of the Month

This month we feature two charts published by independent research boutiques that we think do a good job of explaining current market conditions. This chart is from Peter Berezin at BCA (Bank Credit Analyst) in Montreal. It shows total demand for labour in the US (employed people plus unfilled job vacancies) minus the working age population, as a percentage of the working age population. It shows two things. First, that there is currently excess demand vs supply of labour. Second, this is very rare in history. The result is that as demand for labour has fallen in the last two years unusually the unemployment rate has not gone up, but instead wage inflation has slowed. Peter calls it the "immaculate disinflation".

What comes next may not be so immaculate. At some point, possibly soon, **if demand for labour continues to fall** the unemployment rate will finally go up, and we will be in a vicious cycle of rising unemployment > falling demand > unemployment up further > recession. **The alternative is the much anticipated soft landing**, where demand for labour re-accelerates and averts recession for a few more years. You can see on the chart that this is what happened in 1967-1969 when President Lyndon Johnson unleashed fiscal stimulus via infrastructure spending in what he called The Big Society. We will be watching this chart very closely.

US Job-Workers Gap

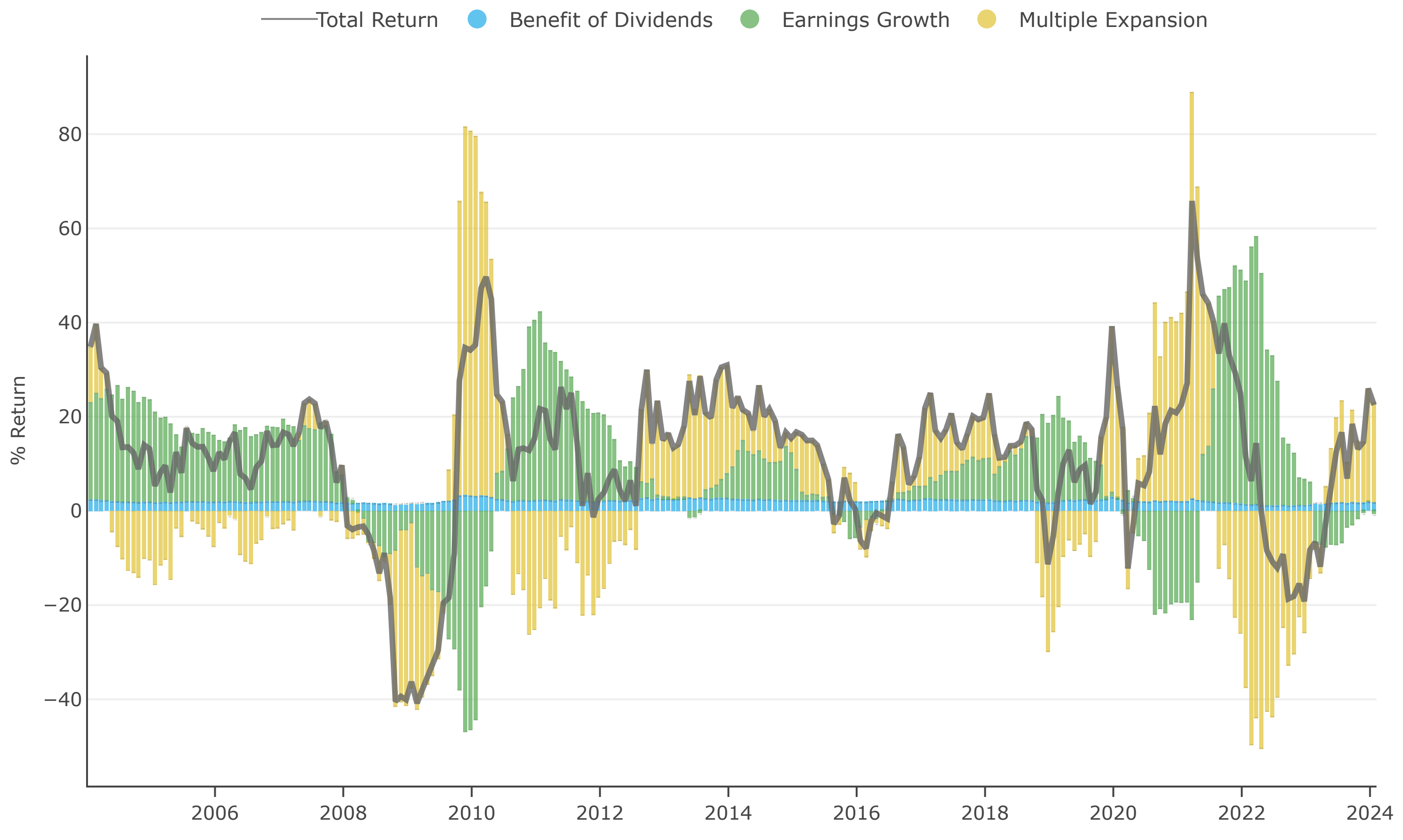


Sources | BCA Research. Jobs-workers gap is the difference between labor demand (sum of job openings and civilian employment) and labor supply (civilian labor force) as a percent of the labor supply. Historical job openings data are extended using the composite help-wanted index estimated in Regis Barnichon, "building a composite help-wanted index", economics letters volume 109, issue 3, (December 2010). Job openings since June 2022 are based on BLS JOLTS job openings and estimates using indeed job postings index. Note: shaded areas denote NBER-designated recessions. All data as at Jan 2024

Charts of the Month

The second chart of the month is from Nick Nelson at ASR (Absolute Strategy Research), and shows the trailing 12 month **total return of the S&P500 broken into its three principal components** - EPS growth, dividend yield and change in PE multiple. It's a nice way to visualise what's been driving this market bust then boom of the last three years particularly. What we see is that nearly all of the S&P's return of the last 12 months has been attributable to a rising PE ratio while earnings have been about flat year over year. **For the market to make more progress now would require earnings to start growing again**, as further PE re-rating from this starting point looks a stretch, as we discuss on the next page.

S&P 500 Total Return Breakdown



Sources | ASR, LSEG Datastream. All data as at Jan 2024

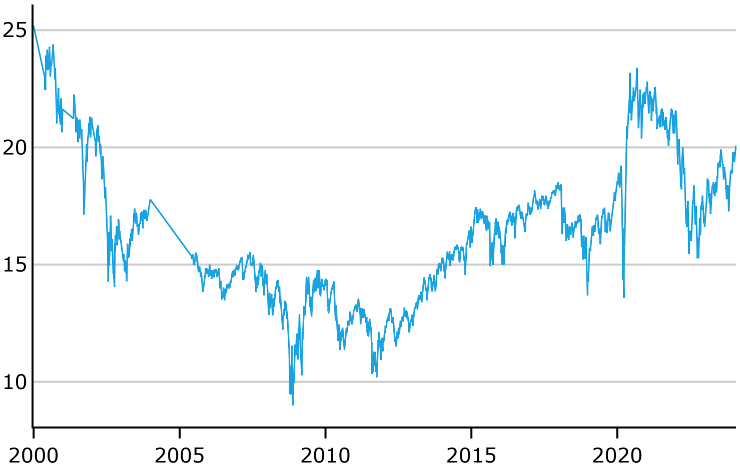
Equity | USA

The US equity market has re-rated sharply in the last three months, from 17x to 20x consensus forward earnings (top left chart). This leaves the spot valuation nearly 25% above its 16x average of the last thirty years. **For the PE multiple to continue to re-rate back to its 22.5x high of 2020 would take a large rally in bond yields or a bout of what Alan Greenspan called Irrational Exuberance**. Note that the US 10 year yielded 0.5% in 2020 vs 4% now.

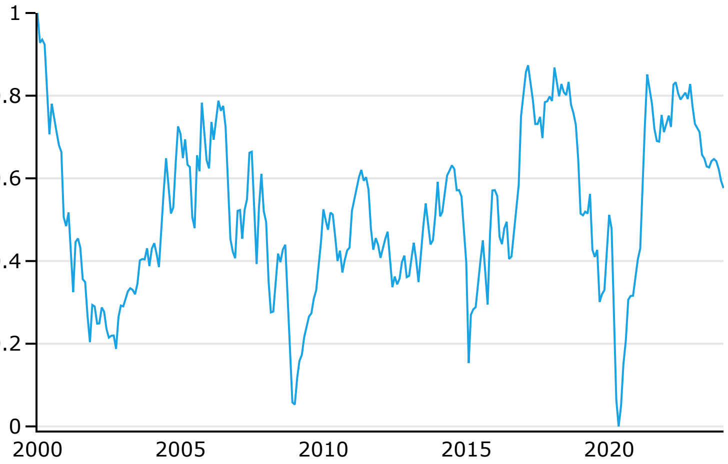
The bull case is PE goes to 22.5x and earnings are up 10% for **S&P500 up 20%**. **The bear case is** the PE falls back to its long run average of 16x and earnings fall 10% in a recession for **S&P500 down 30%**. Risk reward is tilted negatively.

S&P 500 Valuations

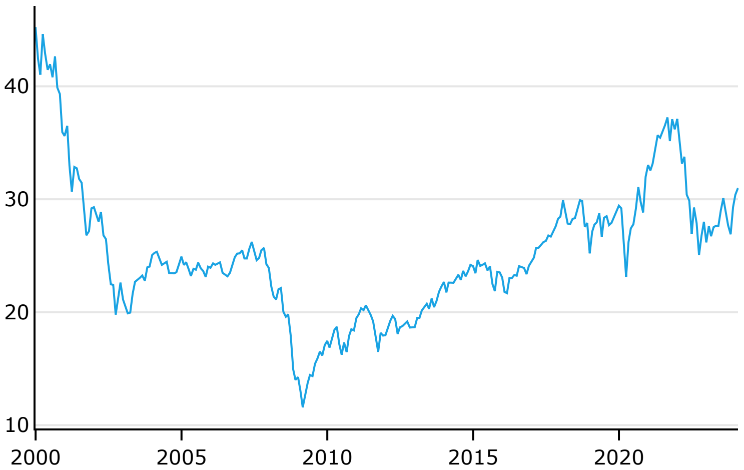
S&P 500 Forward PE



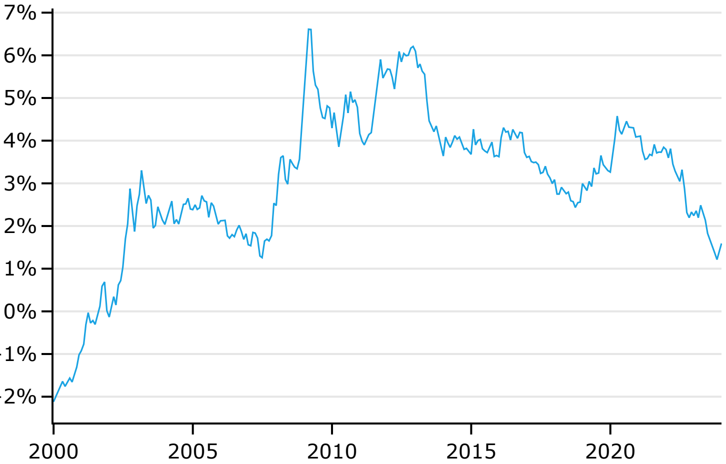
Composite Value Indicator Model



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.

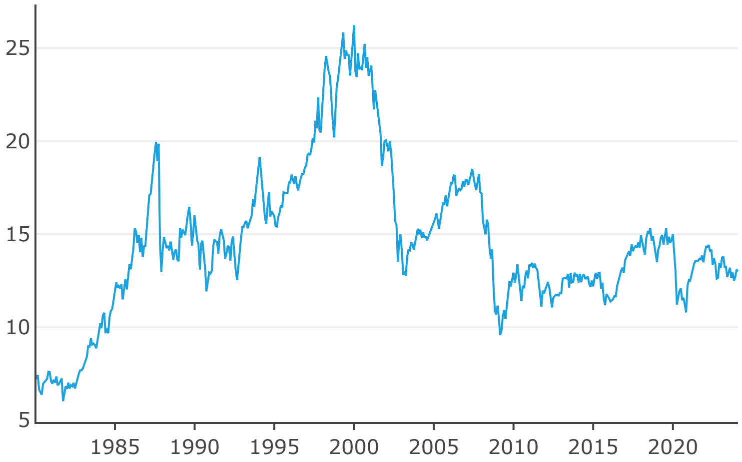
Sources | S&P 500 PE: Bloomberg, CVI Model: CCLA, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of Jan 2024

Equity | Regional

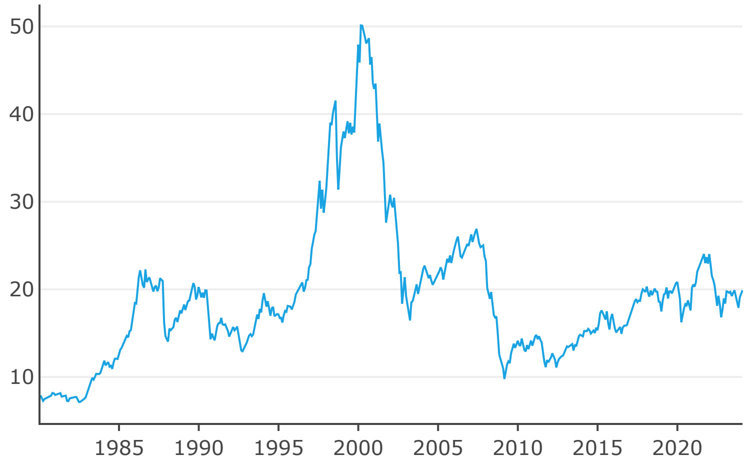
Outside the US (which is 69% of MSCI World), equity markets continue to look reasonable value (UK, Europe-ex-UK) or outright cheap (Japan, EM). The de-rating of last year is notable everywhere. The UK Shiller PE of 12.8 gives an earnings yield of just under 8%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 19.7 gives 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

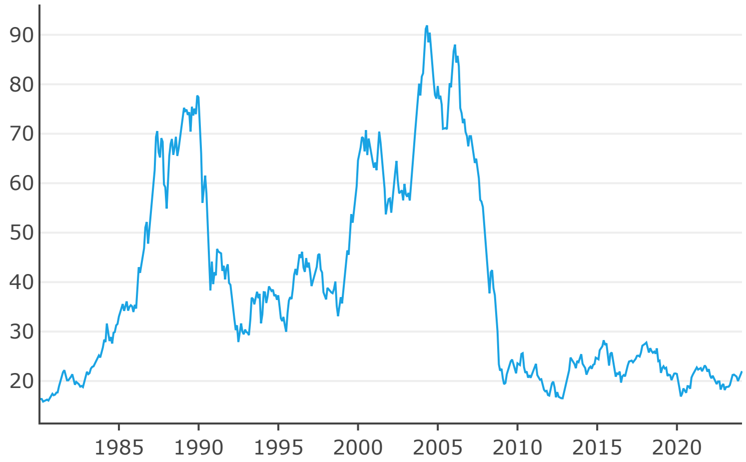


Europe (Ex-UK) | Shiller P/E

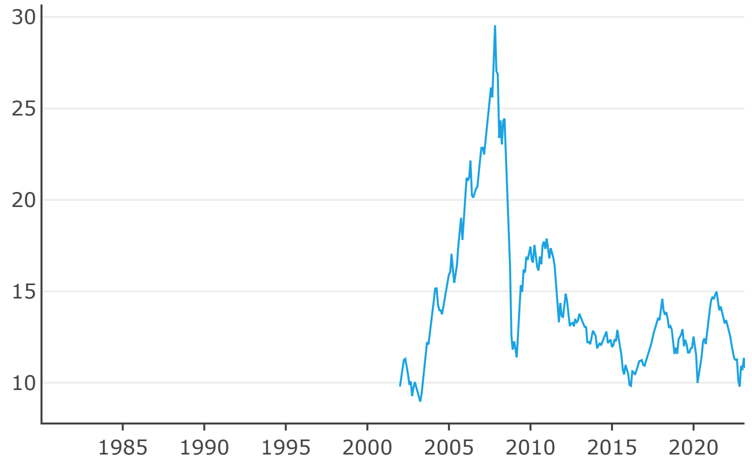


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



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

VALUATION

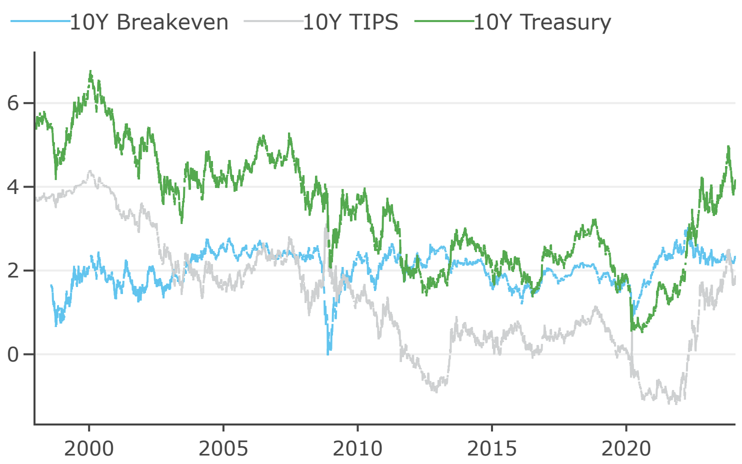
Bonds

Bond markets have given back some of their gains from the "everything rally" of November and December. Since the start of the year, the Bloomberg Sterling Gilt index is down 4% (albeit 6% above the October-lows), IG is down 1% and HY is flat.

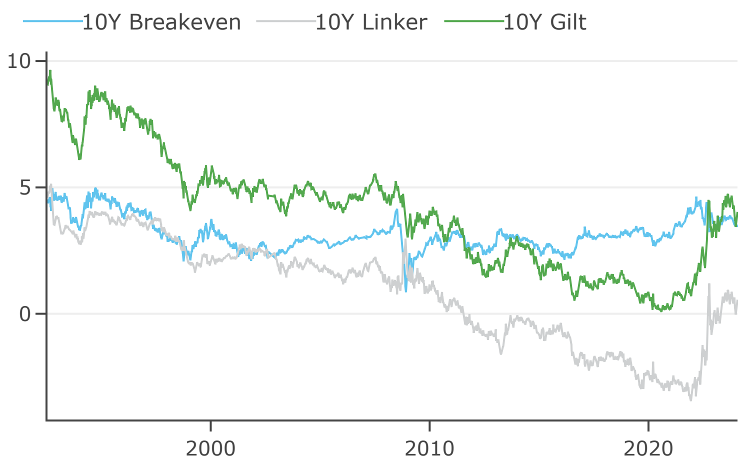
Corporate US BBB yields are still 5.4%, which stripping out 2.5% expected inflation yields nearly 3% real expected total return, **which to our eyes remains reasonably attractive**.

Global Government & Corporate Yields

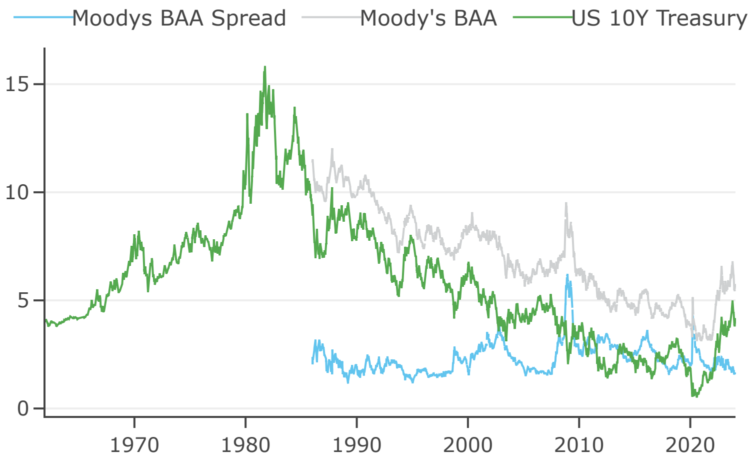
US 10 Year Treasury Yields



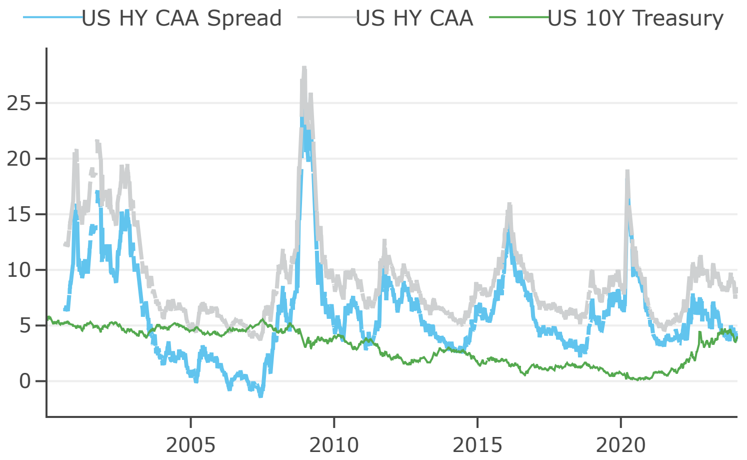
UK 10 Year Gilt Yields



US Corporate Investment Grade Yield



US Corporate High Yield



Sources | Bloomberg as at Jan 2024

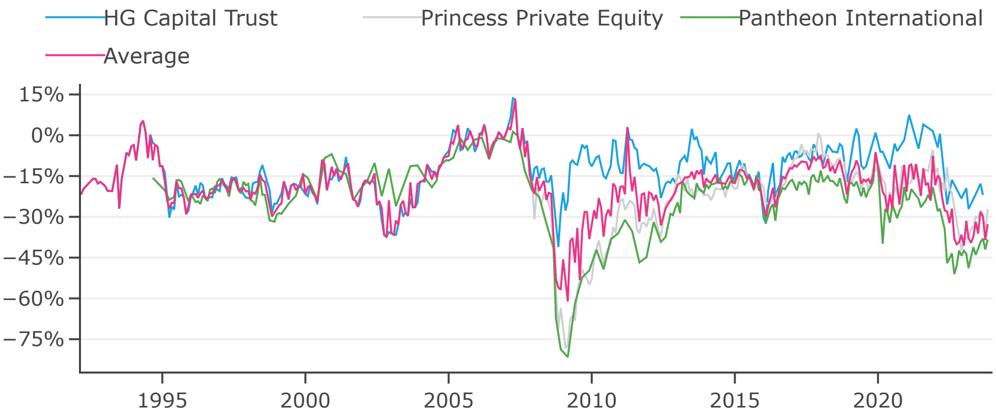
Alternatives

The IRR on Core Private Infrastructure now offers 2.75% return spread over IG corporate bonds, which is becoming more interesting after a much tighter spread over the last two years. Listed Infrastructure trades at 10-50% discounts to net asset value (NAV), which is somewhat more interesting, especially where managers can add value via development. After strong performance last year, Private Equity multiples are no longer at a large discount to public equity, but the discounts to the underlying NAVs remain wide if less than they were (top left chart). **Levered Loan yields have risen from 5% to over 9% but are at risk of falling in a rate cutting environment**.

Global Valuations

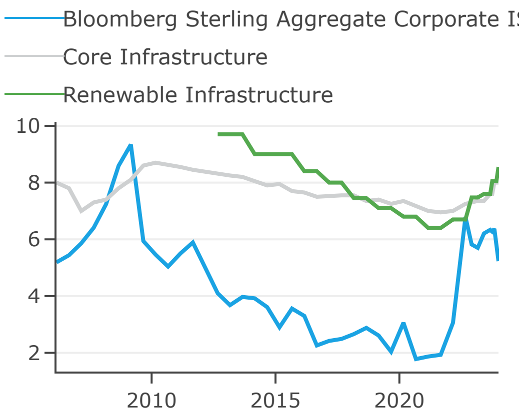
Listed Private Equity

Discount To NAVs



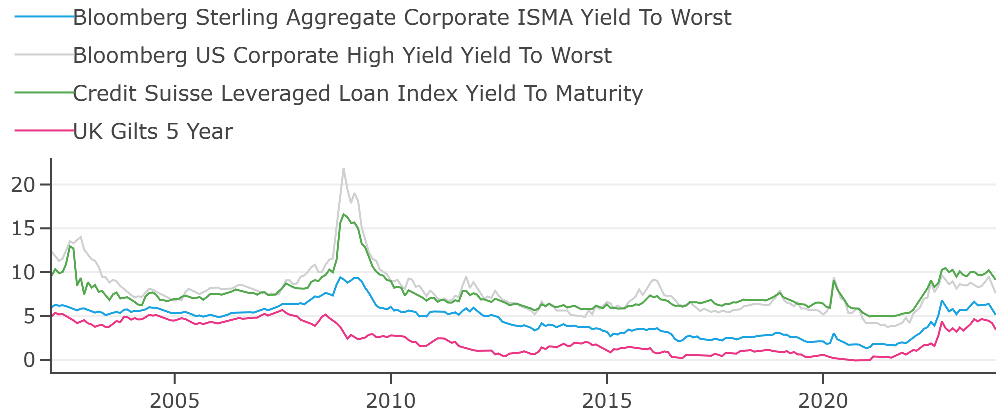
Infrastructure

Infrastructure Discount Rates vs Bond Yields



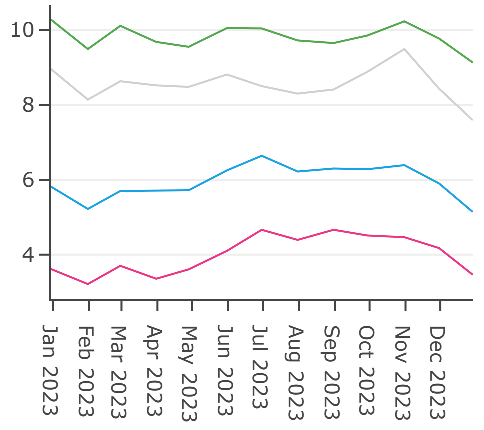
Contractual Income

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 Jan 2024

VALUATION

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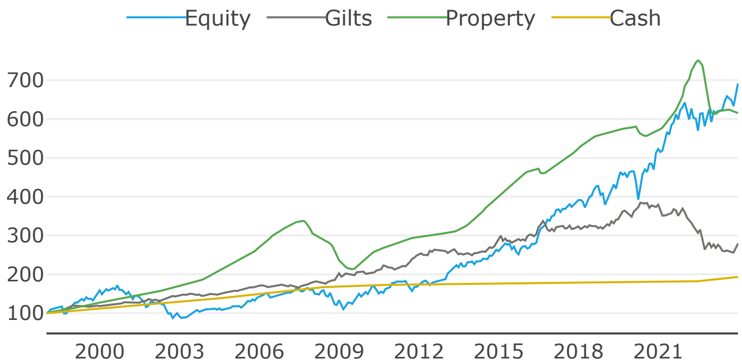
Property

The UK Commercial Property market offers good yields, (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% last year. Our Property team characterises the market as "orderly", but with a "buyer's strike" as investors wait to see the full impact of the 14 hikes in Bank Rate that we have already had.

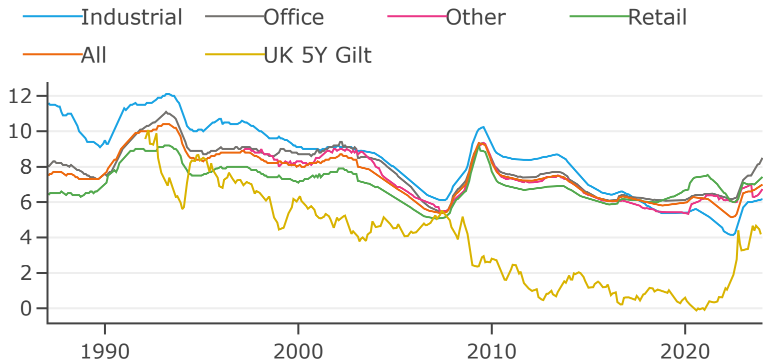
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

UK Commercial Property Market

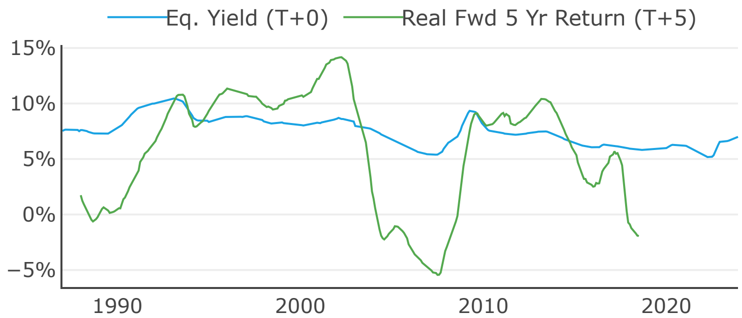
25 Years Of Return 1998=100



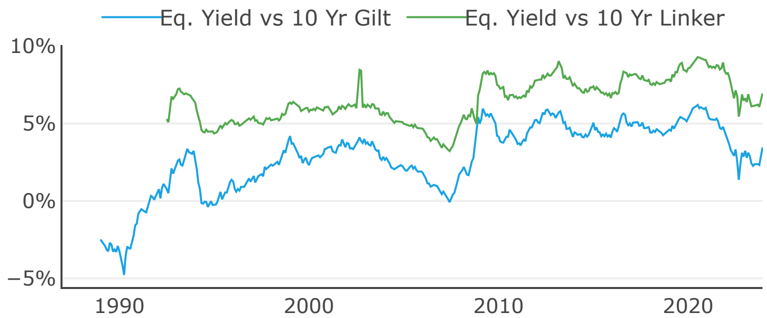
Equivalent Yields vs Gilt Yields %



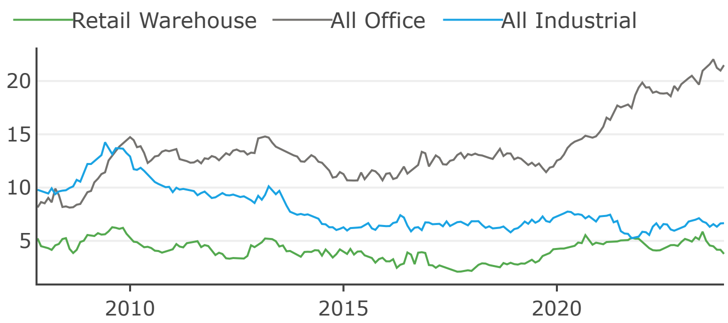
MSCI UK All Property Monthly TR Index %



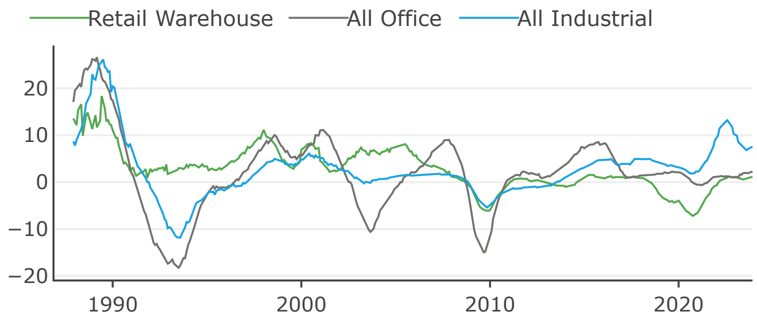
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



Sources | Equivalent Yields, Vacancy Rate, and Nominal Rental Value charts: MSCI UK Monthly Property Index as at Jan 2024. 25 Years of Return, All Property Monthly TR Index as at Dec 2023

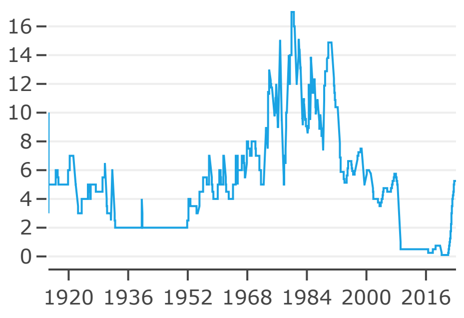
Cash

The Bank of England has shied away from a dovish tone of late, **going against the tide of other major central banks.** Despite this, the market has continued to take into account the lower readings in Headline CPI, and Private Sector Wage growth (compared to the BoE's forecasts) as a positive sign towards loosening policy. **Currently pricing in four rate cuts in 2024 starting in May.** It must be noted, however, market one-year rate expectations are seldom perfect.

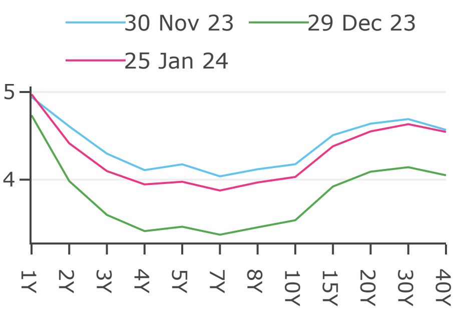
Nonetheless, we could expect these recent economic readings to shift the Bank away from their December hawkish commentary "further tightening… would be required if there were evidence", to a stance closer to, leaving rates as they are for the time being. **Risks to cuts include, fiscal easing in March's Budget, and sustained wage inflation above 3.5%**.

UK Sterling Market

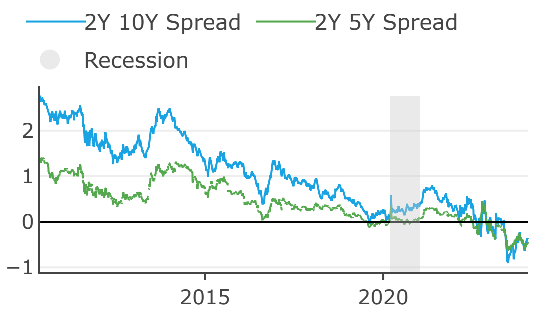
Official Bank Rate



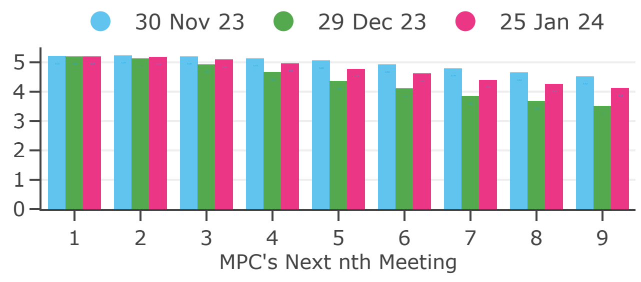
UK Gilt Curve



Gilt Spreads



Rate Expectations For Future MPC Meetings

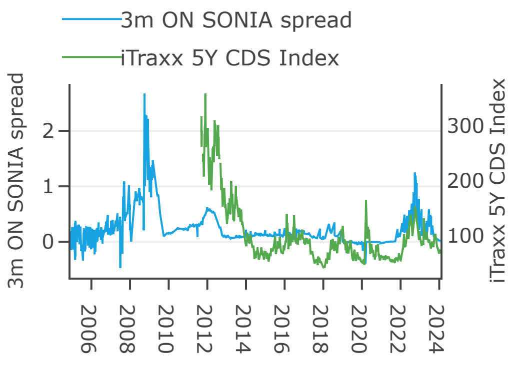


Further Tightening Expected

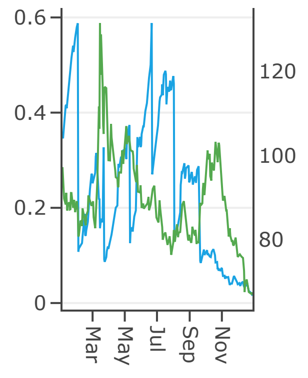
Inflation Readings YoY% | Colour by 10Y Z-Score*

	Aug...	Sept...	Oct...	Nov...	De...
RPI	9.10	8.90	6.10	5.30	5.20
CPI	6.70	6.70	4.60	3.90	4.00
CPI Core	6.20	6.10	5.70	5.10	5.10
CPI Services	6.80	6.90	6.60	6.30	6.40
CPI Goods	6.30	6.20	2.90	2.00	1.90

Market Stress



Last 12 Months



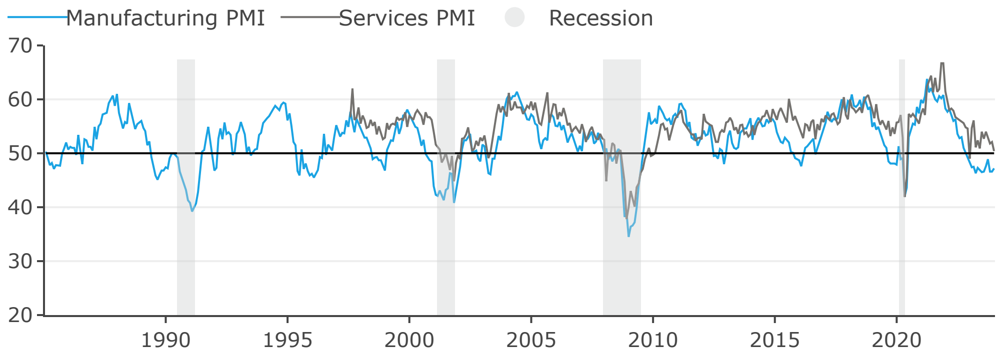
Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, at least +/- 2 standard deviations away scores as red.
Bloomberg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

Global PMIs

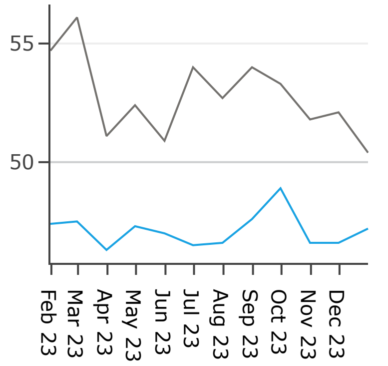
US GDP registered a still buoyant 3.3% real growth in Q4, after nearly 5% in Q3. Personal consumption remained the primary growth driver, adding 1.9% points to the total. Most economists expect growth to slow back to the 2% rate that prevailed in the first half of the year - but **they do not expect a recession.** The purchasing managers' surveys in the US continue to validate that expectation, holding above the recession threshold.

The UK's lead indicators are taking on a rosier hue, with an ongoing recovery particularly in Services. **Europe continues to bump along the bottom.**

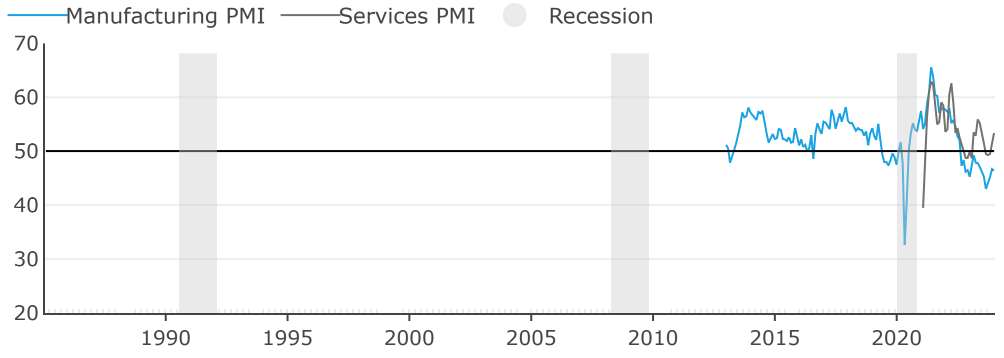
United States



Last 12 Months



United Kingdom



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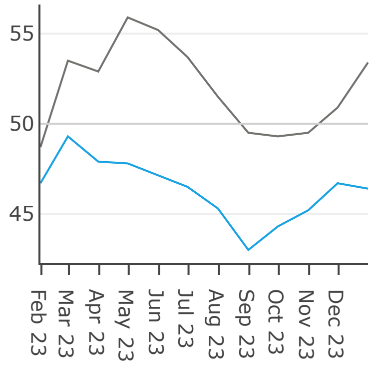
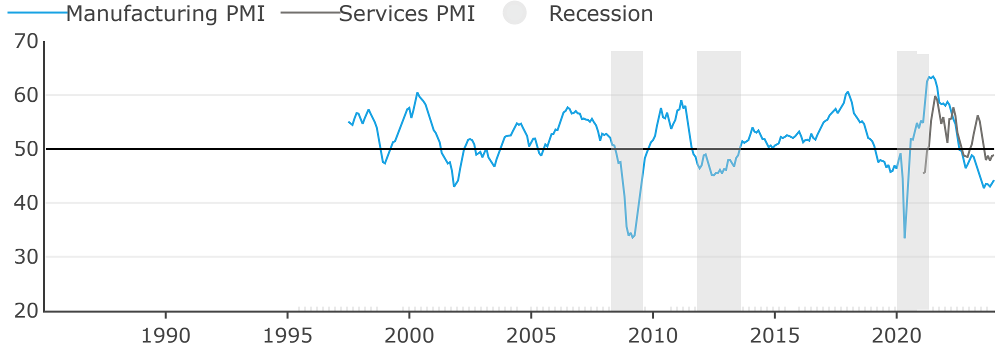
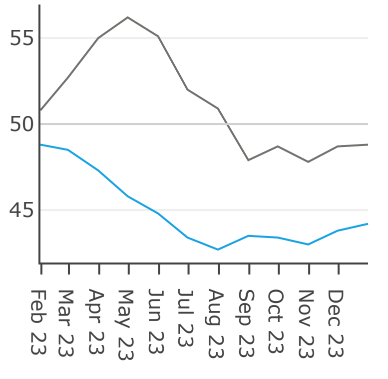


Eurozone



Last 12 Months



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

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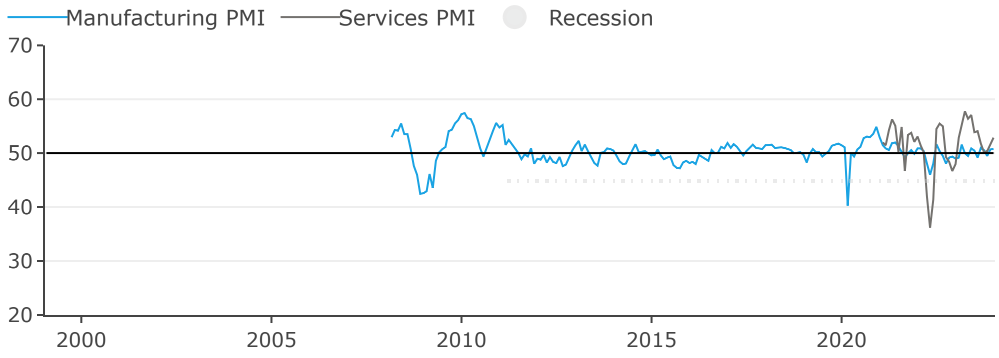
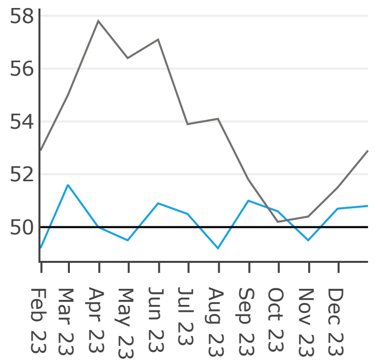
Global PMIs

Global leading indicators therefore continue to hold up with Services still stronger than Manufacturing (bottom right chart).

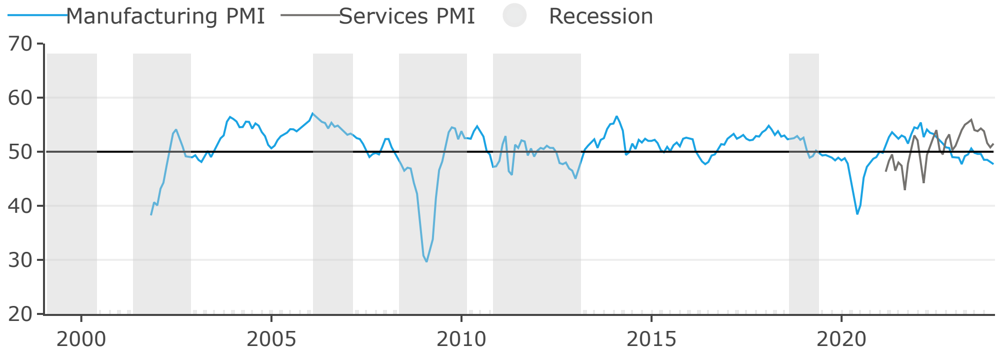
China



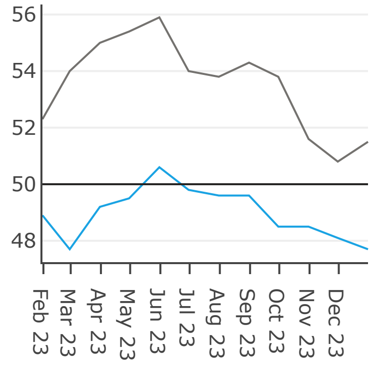
Last 12 Months



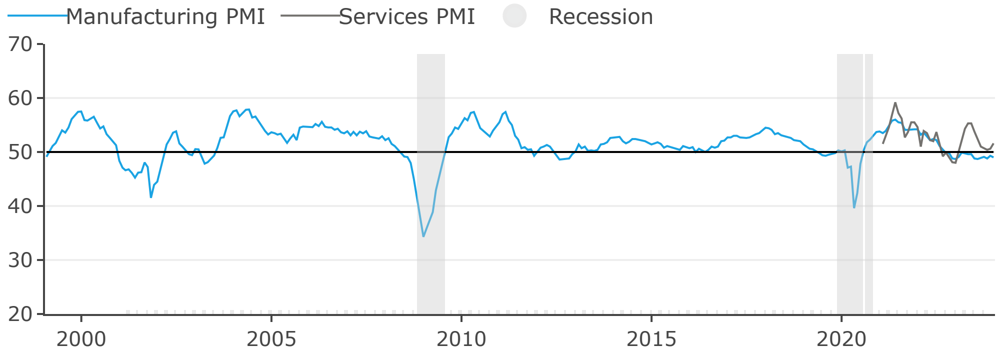
Japan



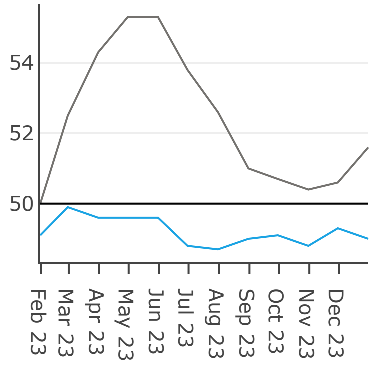
Last 12 Months



Global



Last 12 Months



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

GROWTH

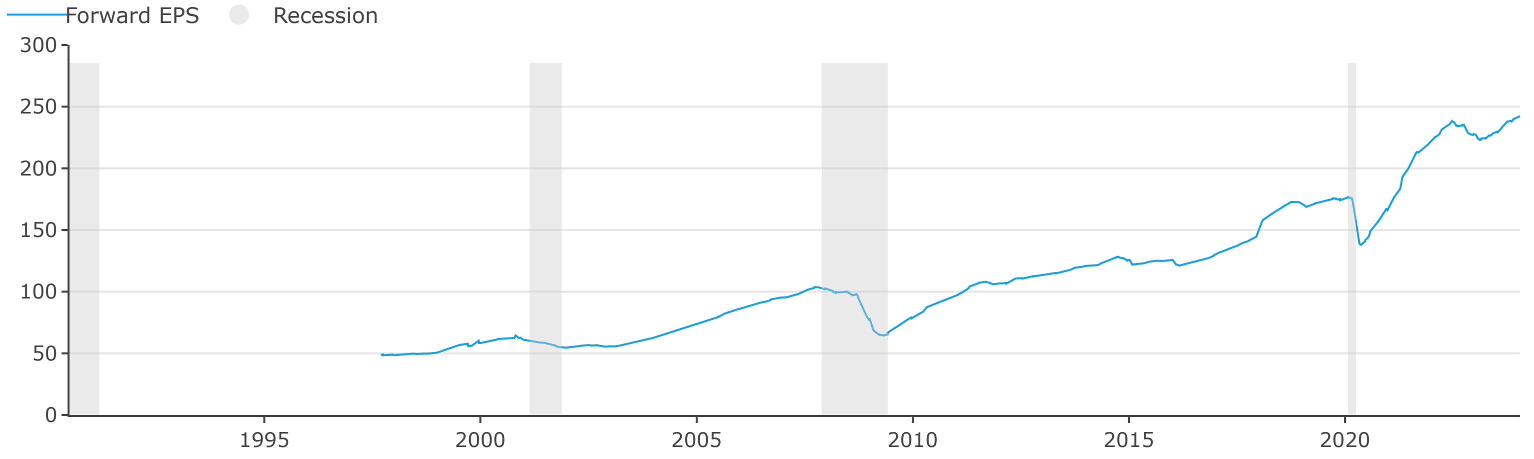
Earnings

Consensus forward earnings estimates continue to recover while trailing earnings start flattening. Net net, this is a positive outcome compared to expectations of a recession-induced earnings fall.

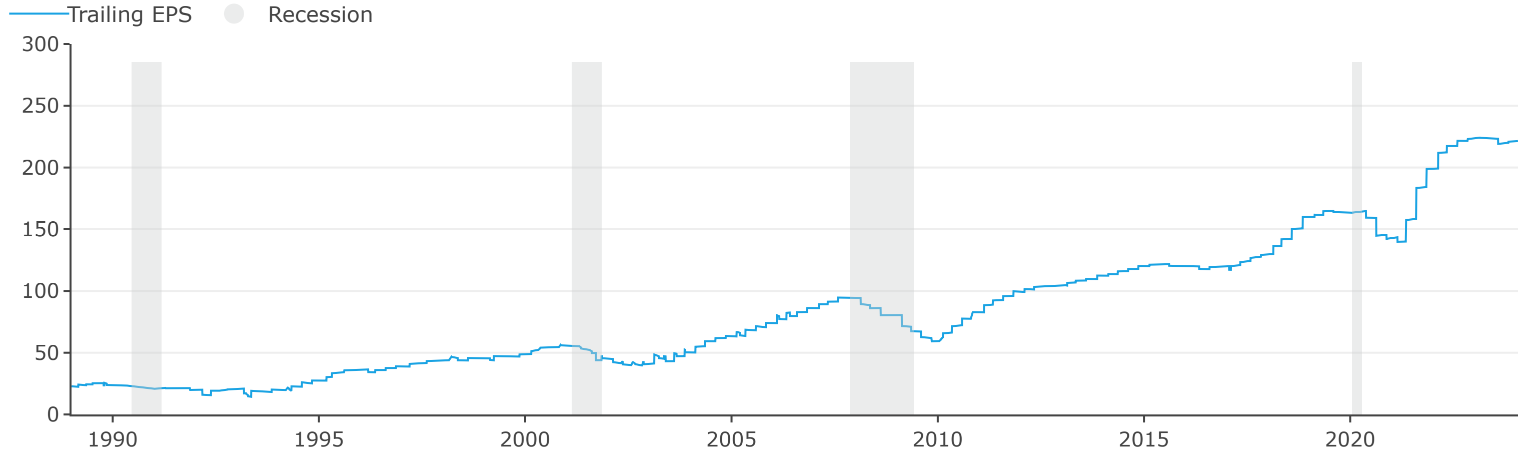
Q4 earnings season is just getting underway as we write, but with 143/500 S&P500 stocks having reported the average beat vs consensus is 1% at the sales level and 8% at the EPS level. As the top chart shows 12 month forward earnings estimates continue to trend higher. **For now at least, earnings could 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 Jan 2024

GROWTH

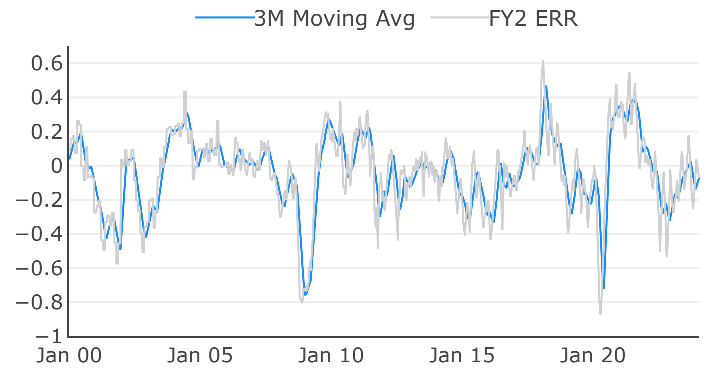
Earnings

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.

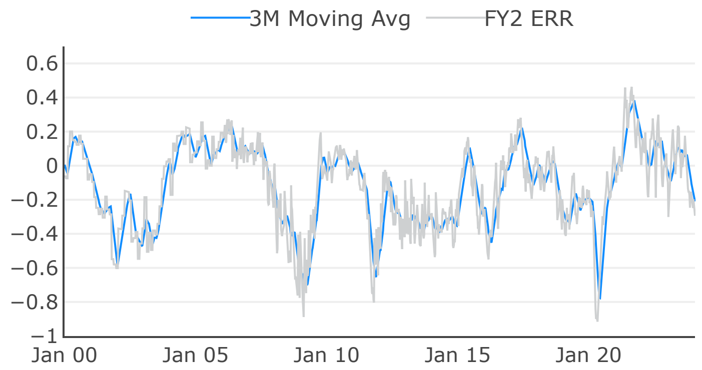
The overall assessment is that earnings breadth is ticking up in the US (though there are still more downgrades than upgrades)**; and Japan stands out as the only major market with positive net earnings breadth.**

Global Earnings Revisions Ratios

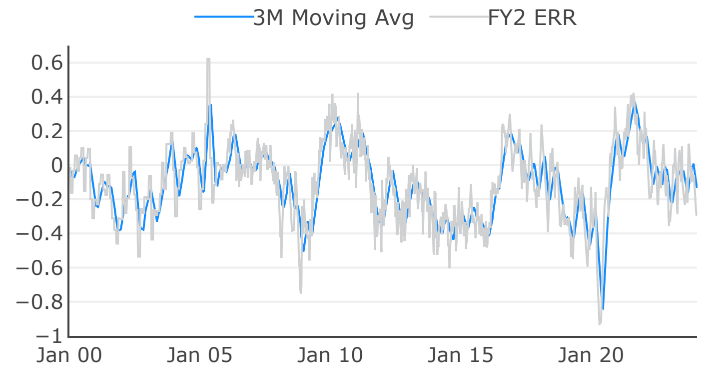
USA



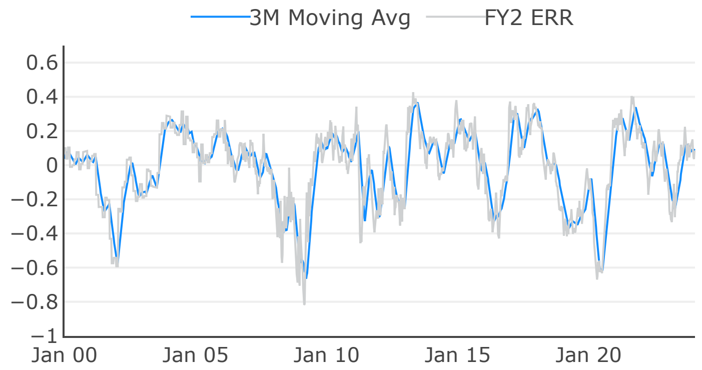
Eurozone



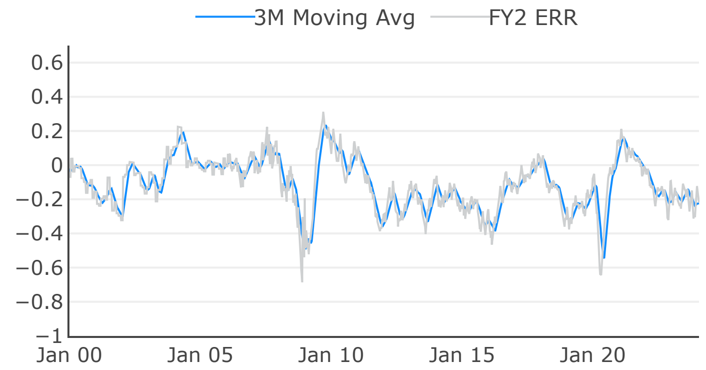
UK



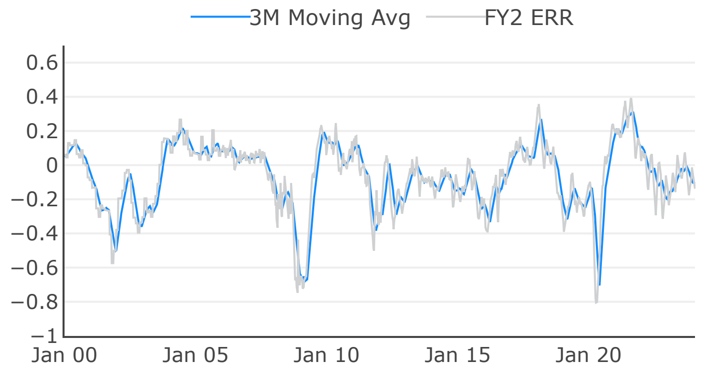
Japan



Emerging Markets



World



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

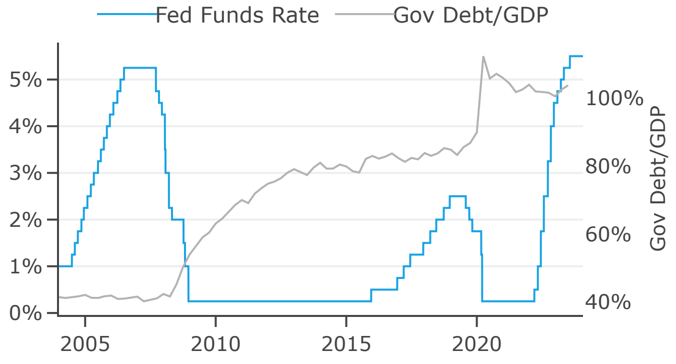
POLICY

Interest Rates

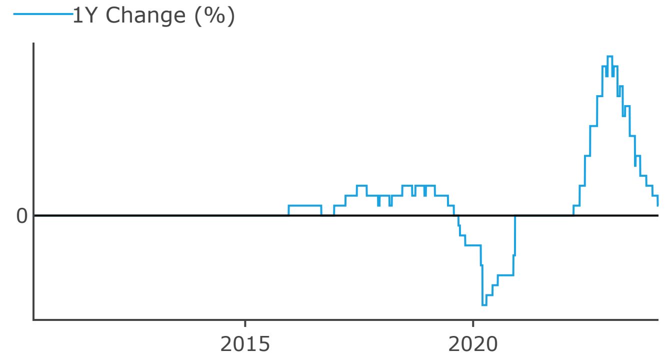
We noted last month that the December FOMC meeting had all but confirmed the US tightening cycle was over. Now, we would point out the middle chart on the left hand side - because inflation has decelerated so quickly, **the REAL Fed Funds rate (nominal interest rate less CPI) is rising**. Our view is that with Fed Funds at 5.5% and inflation coming back towards 2% (currently 4%), the real interest rate will only rise. If growth slows as economist consensus expects, at least some rate cuts will be required. If growth slows a lot, our Fed watching counterparts don't rule out 6x25 cuts, one at each scheduled meeting between May and December.

China cut its RRR (required reserve ratio for banks) from 10.5% to 10%. **No major central bank is hiking any more.**

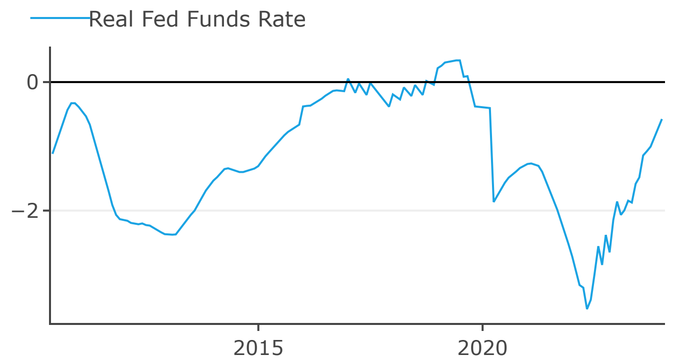
Fed Funds Rate



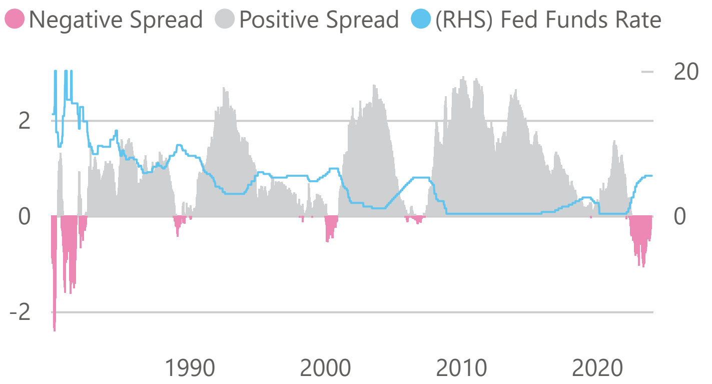
Change in Fed Funds Rate



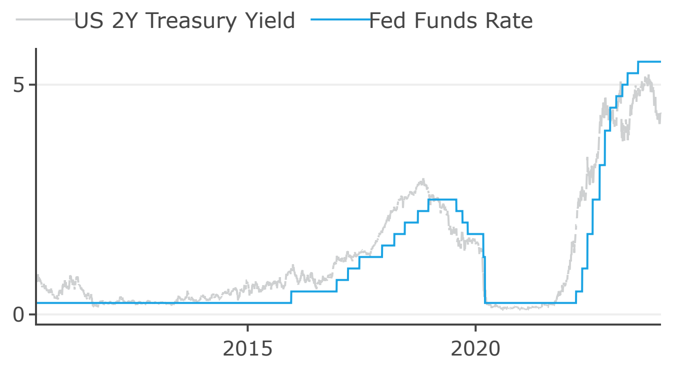
Real Fed Funds Rate (Using 2Y MA CPI)



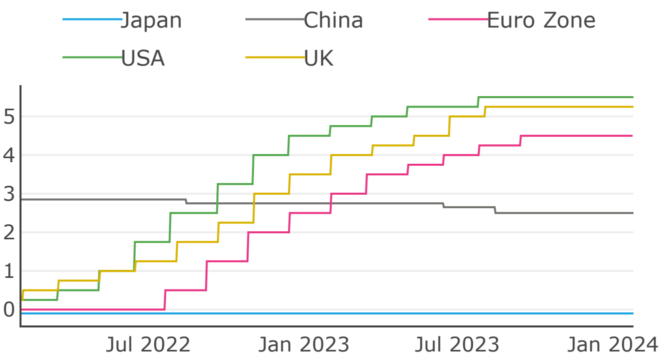
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Jan 2024

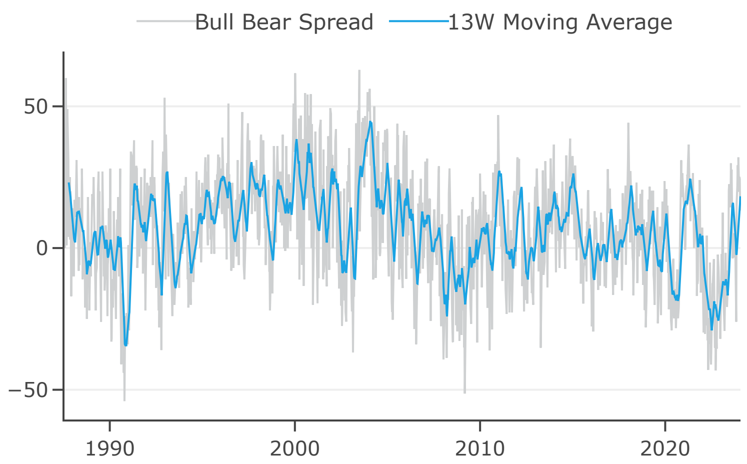
Sentiment

The Harnett Bull & Bear Indicator has moved from Extreme Bearish sentiment (which is bullish for the market!) in October 2022 **to now just beyond neutral** (the current reading is 6/10). In other words, while we have been able to say that institutions and individuals were not taking enough risk over the last couple of years, we can no longer say that.

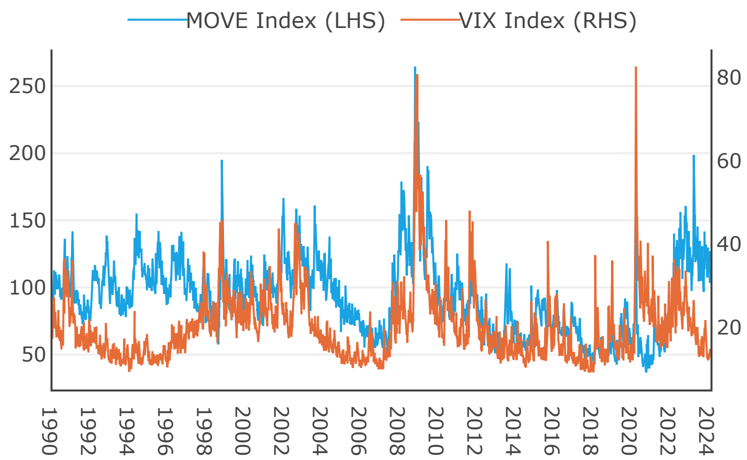
Drivers of the normalisation in sentiment, according to Michael Hartnett, include "strong inflows to HY bonds, better credit market technicals and a big improvement in equity market breadth". Similarly, Bull Bear spread from the American Association of Individual Investors (AAII), (top left) shows **individual US investors are now net bullish equities**, and the VIX index of implied volatility for the S&P500 is back to its lows.

US Equity Indicators

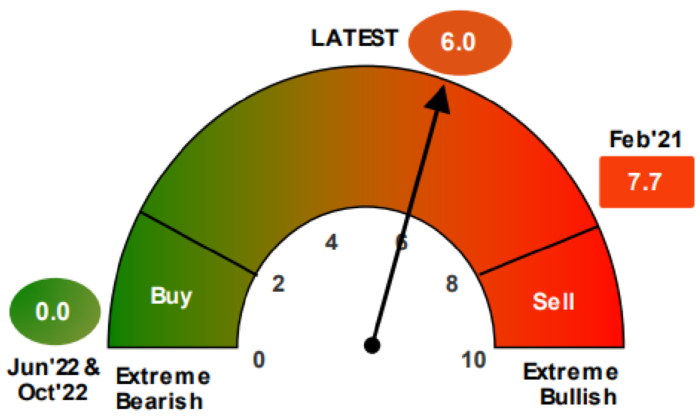
AAII Bull Bear Spread



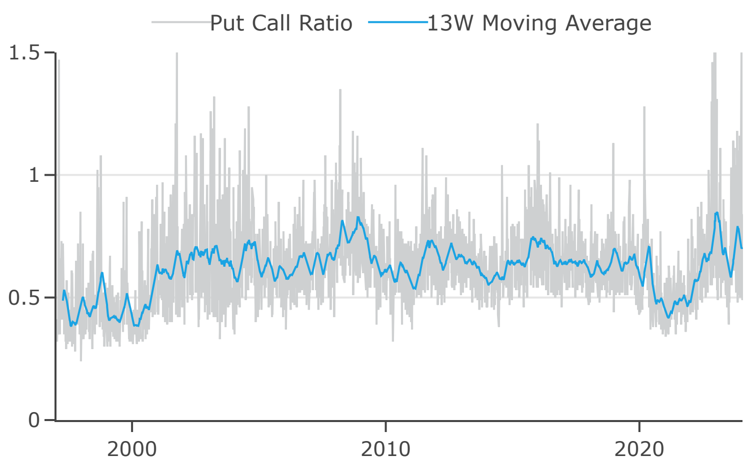
Equity vs. Bond Sentiment



Hartnett Bull & Bear Indicator



Equity Put Call Ratio



Sources | Bull Bear Spread, Vix and Equity Put Call Ratio: Bloomberg, Hartnett: kind permission from Bank of America, as of Jan 2024

SENTIMENT

CCLA

Fund Flows

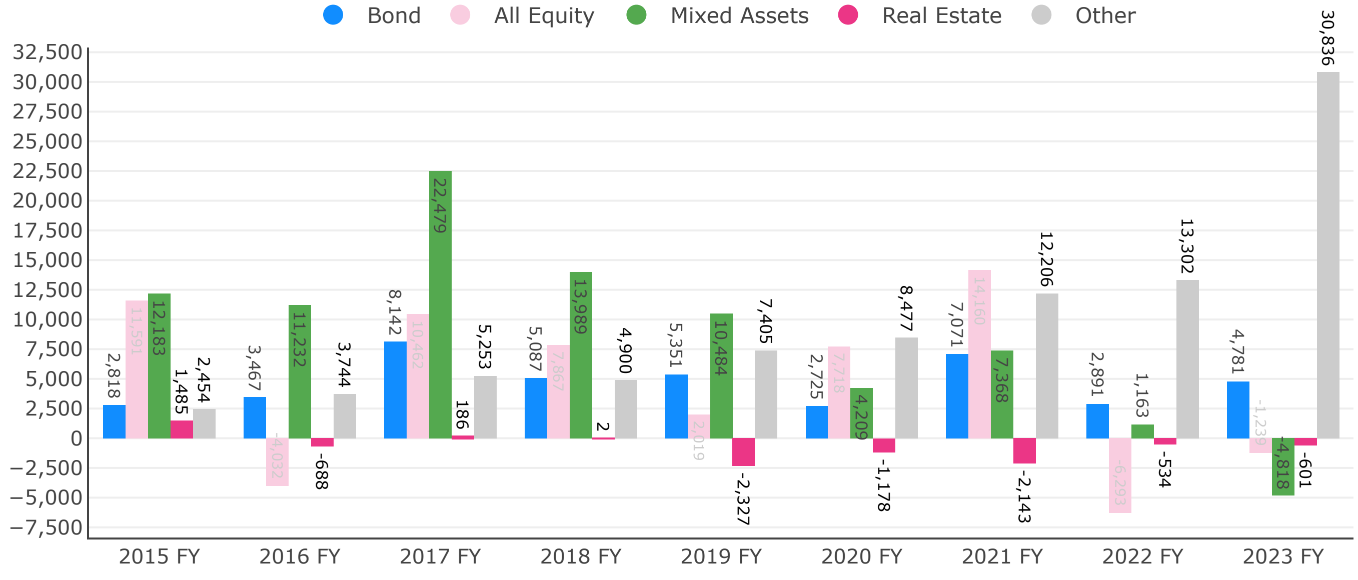
This page captures UK investment fund flows only, as a measure of how optimistic or pessimistic sentiment has become.

There has been an extraordinary inflow into cash (shown here as "Money Markets") and out of Equity and Mixed Asset funds. Bond flows are modest but do show inflow. In short, flows have shown investors repositioning defensively. This is bullish at the margin for forward returns to risk assets, as a contra-indicator.

UK Investor Sentiment

Net Fund Flows by Asset Class £m

Date	Bond	All Equity	Mixed Assets	Real Estate	Other (inc. MM)	Money Market (MM)	Total Net Flows
2022 Q1	-506	-1,261	1,148	-284	5,158	44	4,256
2022 Q2	534	-672	1,247	61	2,238	-111	3,408
2022 Q3	1,197	-4,701	-287	-85	2,545	423	-1,331
2022 Q4	1,666	341	-945	-226	3,361	310	4,198
2023 Q1	2,747	258	397	-93	5,966	456	9,275
2023 Q2	1,684	447	-190	-148	7,274	1256	9,066
2023 Q3	-111	-2,384	-1,407	-184	8,728	1265	4,642
2023 Q4	460	441	-3,618	-176	8,868	1405	5,976



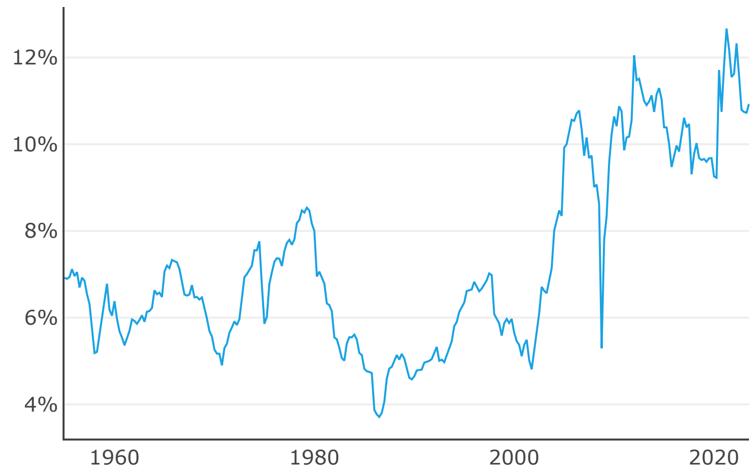
Sources | All charts: Calastone Fund Flow Index as at Jan 2024. Fund Flow data measures UK investor sentiment, showing the net flow of capital to and from open-ended investment funds.

The Big Picture

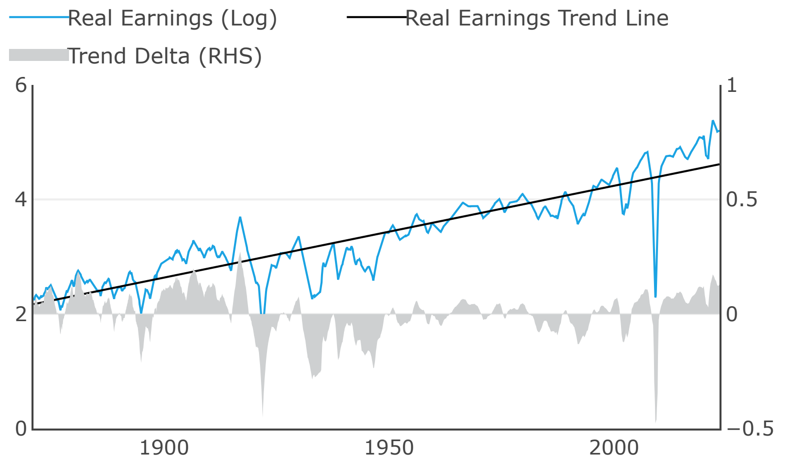
Here we highlight some longer-term imbalances that, **should** they correct, would have have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. It's corollary (not shown)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

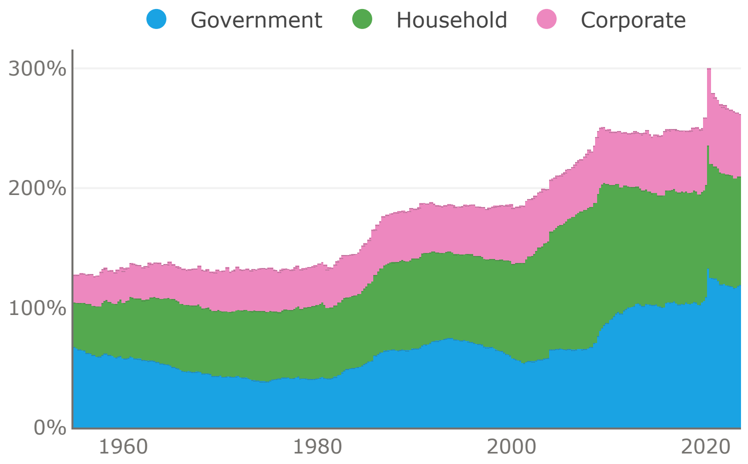
Profit Share of GDP



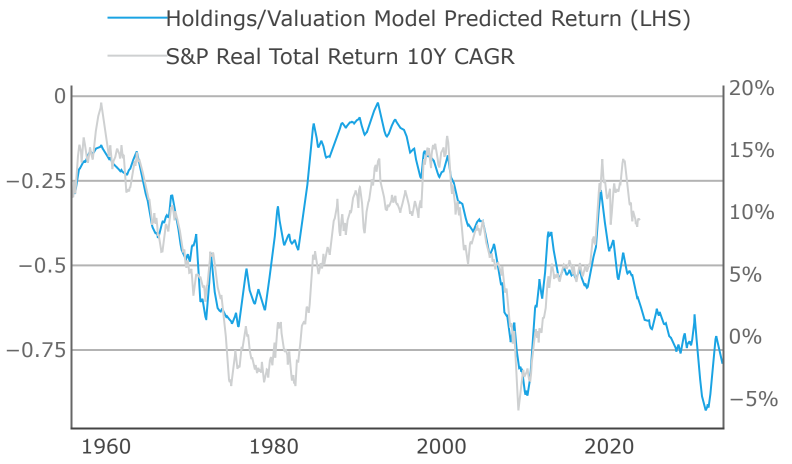
Earnings Deviation From Trend



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 as at Jan 2024.

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