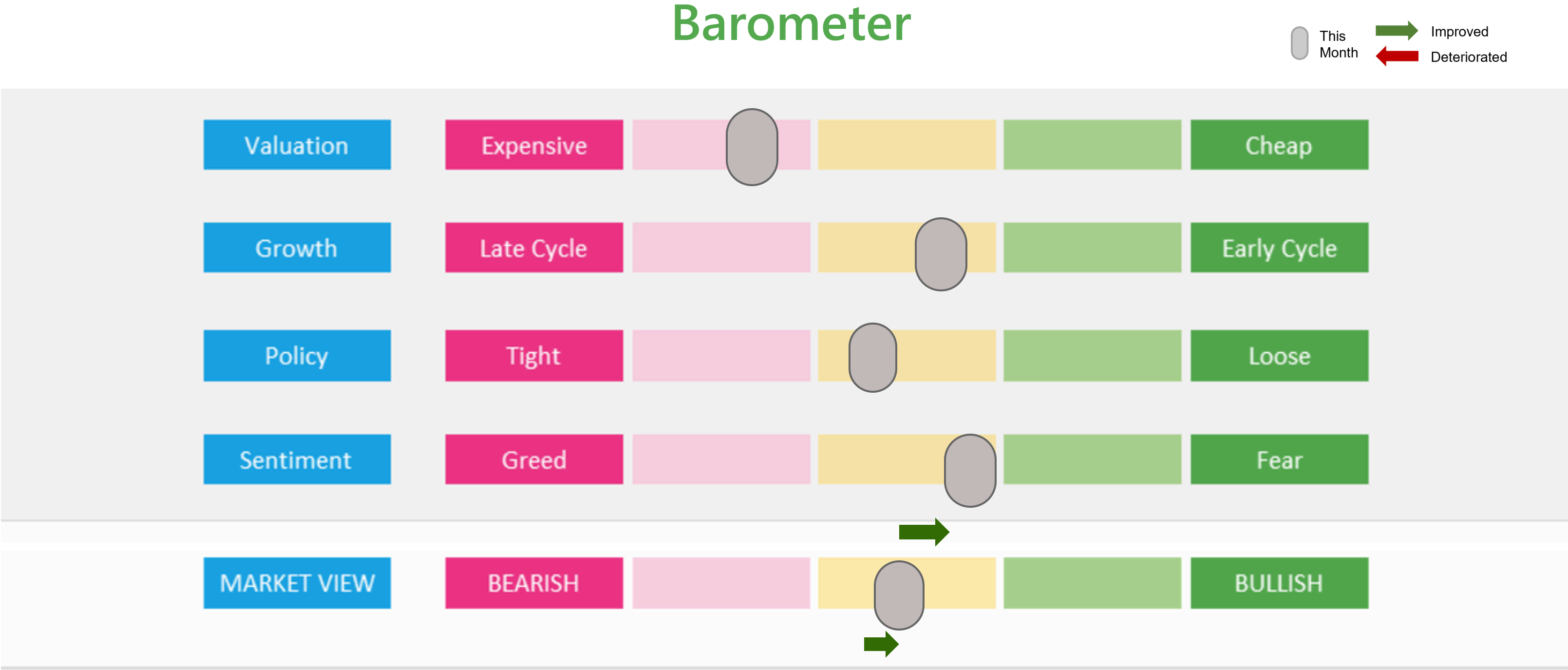
FEBRUARY 2025

Market Barometer

Barometer



Trump Bump

- **The market reaction to the election of Donald Trump has been effusive.** MSCI World is up 9% since 5 November given the pro-growth (but potentially inflationary) bias of the new President.
- **The question is one of phasing**. We are operating on the assumption that the market will price in the good news on tax cuts and market-friendly deregulation first, then worry about inflation and / or trade war second.
- **Tax cuts first...**new Treasury Secretary, Scott Bessent has set out his priorities as extending the Tax Cuts & Jobs Act (2017) tax cuts beyond the end of this year, and targeting 3,3,3 (3% growth, 3% deficit, 3 mbpd increased oil production). That's bullish.
- **... then a trade war?** However, on the day of his inauguration, (20 January), the President issued a memorandum which ordered federal agencies to review trade policy, and he has warned that he could impose tariffs on China and others ahead of those agencies' 1 April reporting deadline.

In our Charts of the Month we examine:

- The rise in **animal spirits** post the US election
- How **extended momentum** has become
- The tidal **wave of liquidity** supporting markets

We also differentiate Rachel Reeves from Liz Truss! So far so good for the gilt market, despite a wobble in early January.

We **remain risk on**.

Contents

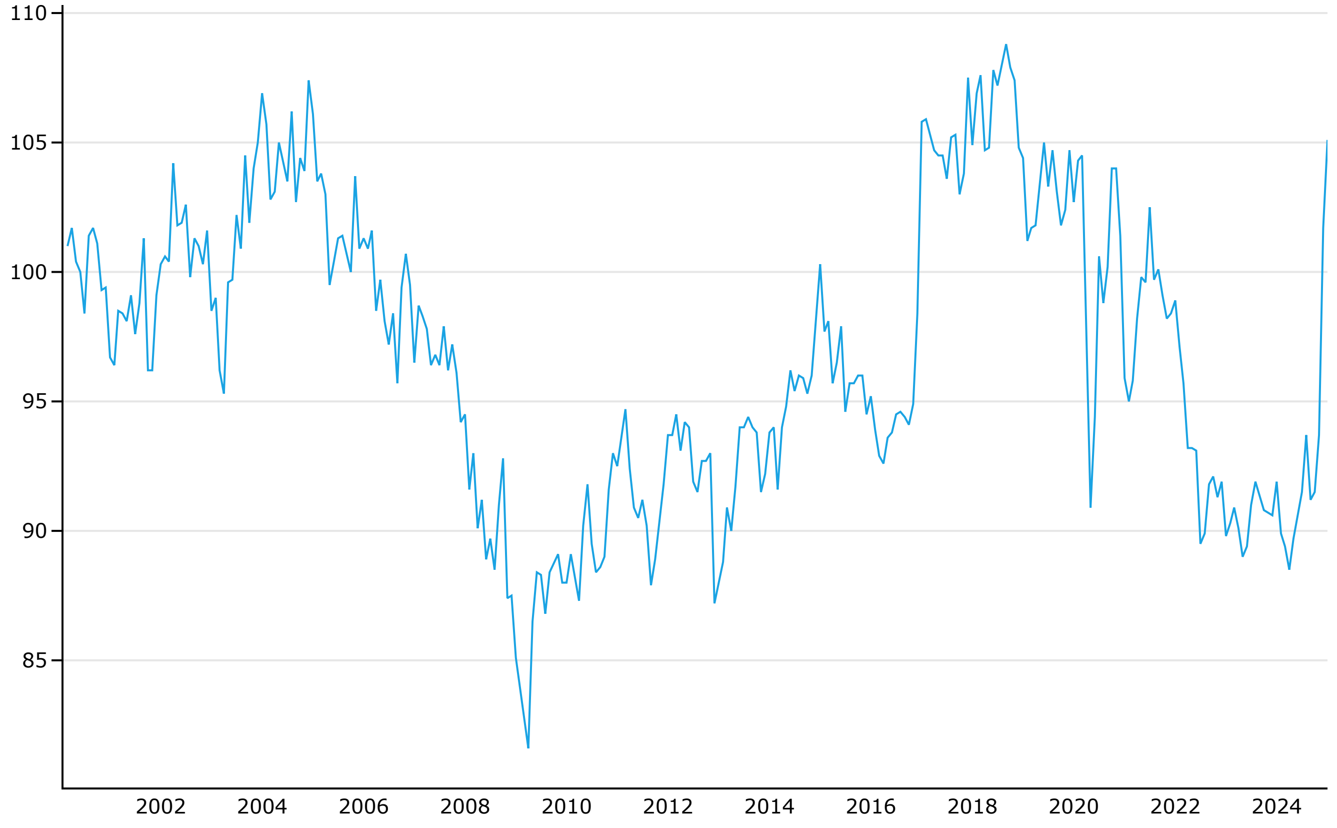
Charts of the Month (1 of 4)

The "Trump effect" appears to be lifting animal spirits. The National Federation of Independent Business survey of small business optimism has moved sharply higher since the November election. Scott Bessent has been confirmed by the US Senate as Treasury Secretary, and promised in his confirmation hearing that he would aim to curtail the budget deficit while cutting tax and renewing the Tax Cuts and Jobs Act of 2017.

Meanwhile President Trump issued a memorandum on the day of his inauguration which ordered federal agencies to review US trade policy, with particular focus on China-US trade. **They are expected to report their findings by 1 April**, and President Trump has also indicated that he will raise tariffs on Canada, Mexico and Panama, possibly earlier than that date, even as early as 1 February.

While the market remains sanguine on trade for now, **it seems pretty clear to us that the new administration intends to confront US trade partners on tariffs soon.** We will keep a sharp eye on this.

US Small Business Sentiment Index



Sources | National Federation of Independent Business Bloomberg, CCLA as at Jan 2025.

CCLA

Charts of the Month (2 of 4)

Momentum is extended. The chart shows the notional return to a Morgan Stanley strategy that is long the 15% of US stocks with the strongest 12 month price momentum, and short the reverse. Inflection points in this series often accompany market peaks and troughs. The red circles coincide with major market peaks in 2000, 2008 and 2022, and the secular troughs in 2003 and 2020.

This move in price momentum is unusually broad and has been accompanied by positive earnings momentum, according to Empirical Research. This is actually still a supportive sign, but again, **vigilance for any loss of earnings momentum is critical.**

Morgan Stanley US Momentum Long Short Basket return

Sources | CCLA, Morgan Stanley, Bloomberg as at Jan 2025

CCLA

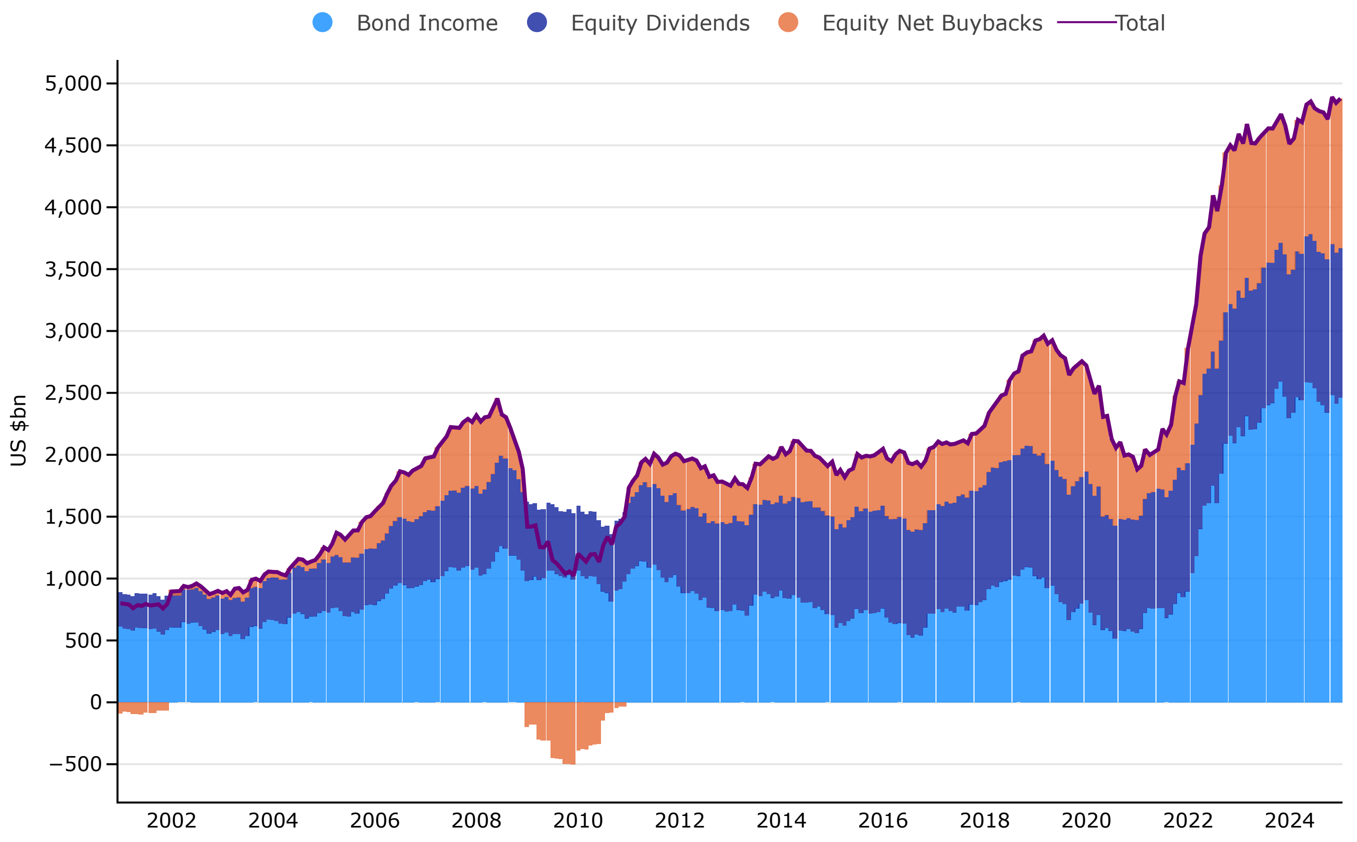
Charts of the Month (3 of 4)

Global liquidity remains abundant. When interest rates rise, the cost of capital goes up, and the rate hiking cycle of 2022-23 definitely had that effect. A higher cost of capital had to be absorbed into the valuation of all asset classes and this resulted in an equity, bond and real estate bear market, all at the same time.

However, **the flip-side of higher rates is higher cash production from financial assets**. The chart below is reproduced from data provided by Soc Gen's quant team. In the zero interest rate period between the GFC and the pandemic, global financial assets produced cash flows back to investors of around $2trn per year, but after the rate hikes this has more than doubled to nearly $5trn per year.

We should not under-estimate how supportive this liquidity is for risk assets at the moment.

US $ Annual Cash Flows from Global Bond and Developed Equity Markets



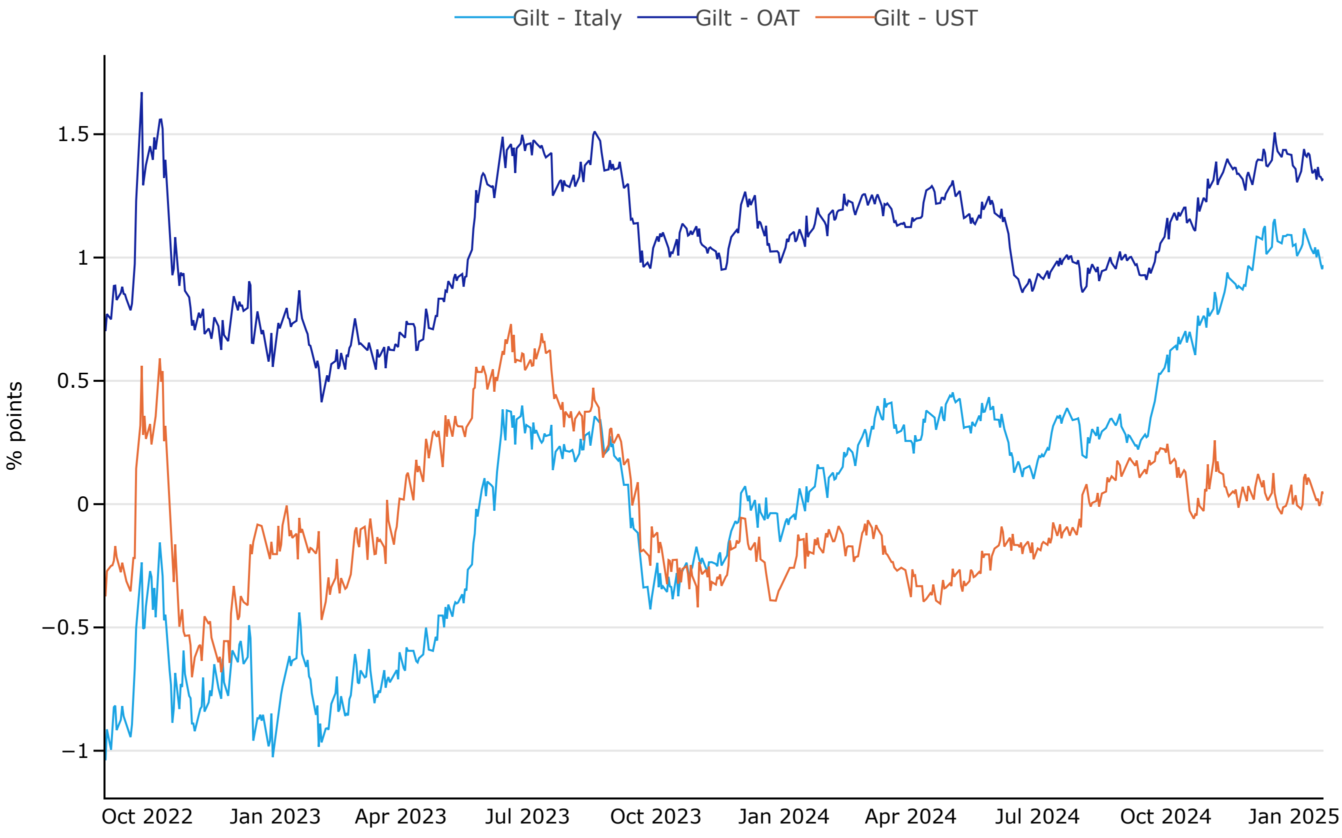
Sources | Soc Gen Strategy Estimates. Data as at Jan 2025

CCLA

Charts of the Month (4 of 4)

Keir Starmer is not Liz Truss and Rachel Reeves is not Kwasi Kwarteng. There was some concern in early January that the new government was at risk of losing control of the gilt market, and gilt spreads over US treasuries widened for a short period. However, as the chart shows, since mid January those spreads have narrowed again as Rachel Reeves re-confirmed that she would always prioritise the fiscal rule, which was "iron-clad". Despite all the doubters we are encouraged by much of what the Starmer government has done. It had to establish its fiscal credentials so had to raise tax from somewhere given the over-riding desire to increase government investment. Now there is a declared intent to enable supply-side reform, with Starmer even invoking the spirit of Thatcherism, and calling for the rowing back of red tape and regulation. Unheard of for a Labour government. **In our view, and much against the consensus, we'd say "so far, so good".**

10 Year Government Bond Yileds (Since Liz Truss)



Sources | CCLA, Bloomberg. All data as at Jan 2025

CCLA

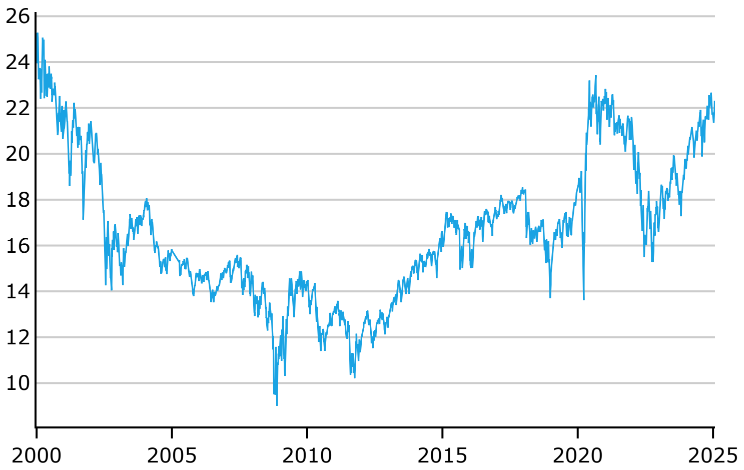
Equity | USA

2024 was another 20%+ year for the S&P 500. While it is fair to say the S&P 493's total return of 17% pales in comparison to the Magnificent 7's (M7) 48%, it is worth noting that since 1874 the market's modal annual return falls within a 10%-20% range. With that in mind, the less-loved 493 actually had a very *normal* performance. The current forward P/E sits at 22x, almost at the all-time high of 25x. Another 20% year would push the forward multiple into that all-time high territory*.

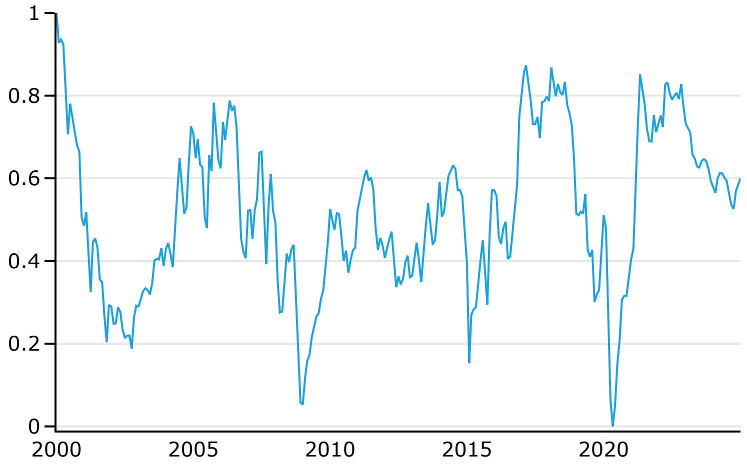
While this is not impossible, it is certainly not straightforward. The conditions that spurred market performance during the 2016 administration are different to now. **Current valuations, bond yields and federal deficits are significantly higher, even investor positioning is stretched. Not to mention the headwinds to hyper-scalers from the new DeepSeek R1 model. These factors can limit performance ahead.**

S&P 500 Valuations

S&P 500 Forward PE

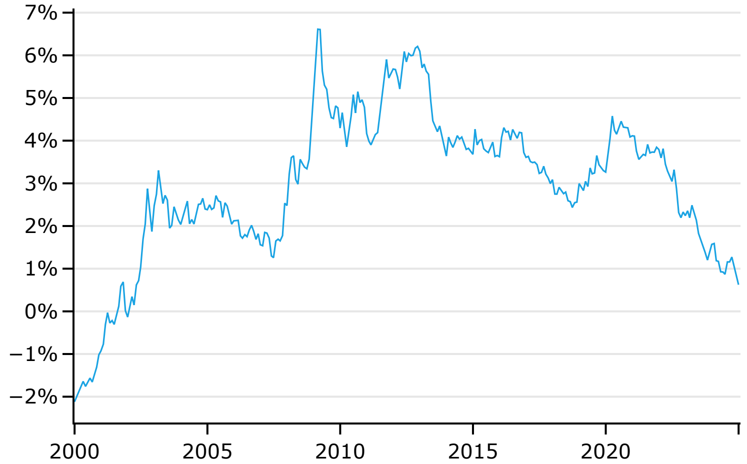


Composite Value Indicator Model



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. *Assuming no change to earnings expectations. Sources | S&P 500 PE: Bloomberg as at Jan 2025. CVI Model: CCLA as of Jan 2025, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of Jan 2025

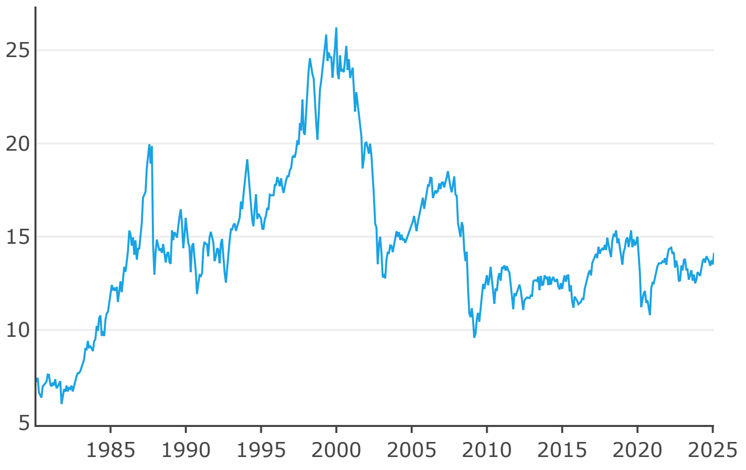
Equity | Regional

Regional equities remain attractively valued in relative terms, but dollar strength remains a key concern, especially for Emerging Markets. For the Eurozone, current forward EPS growth of 8% is significantly lower than the US's 15%, but in line with the zone's poor GDP growth expectations. **The UK continues to be an edge case, at low valuations and not much exposure to US tariffs it offers a defensive tilt with strong dividend yields, unfortunately however, not much prospect of earnings growth at 6%.**

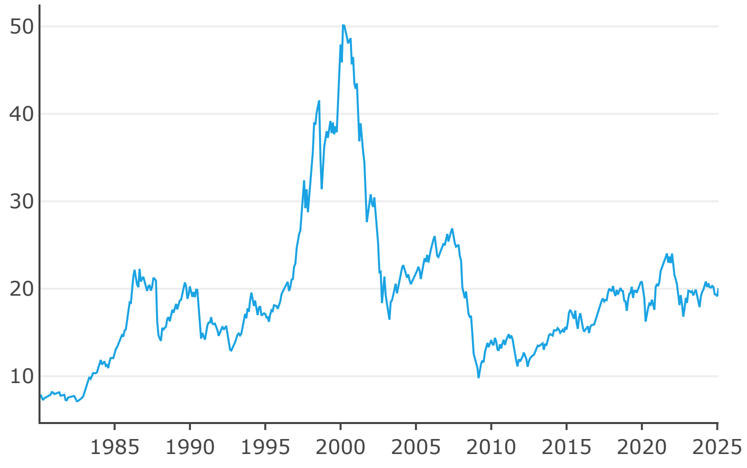
Shiller CAPEs are: UK at ~14x with an earnings yield (and expected forward real returns) over 7%, with Europe and Japan around 20x and ~5%, and EM around 12x and ~8% respectively.

Europe

UK | Shiller P/E

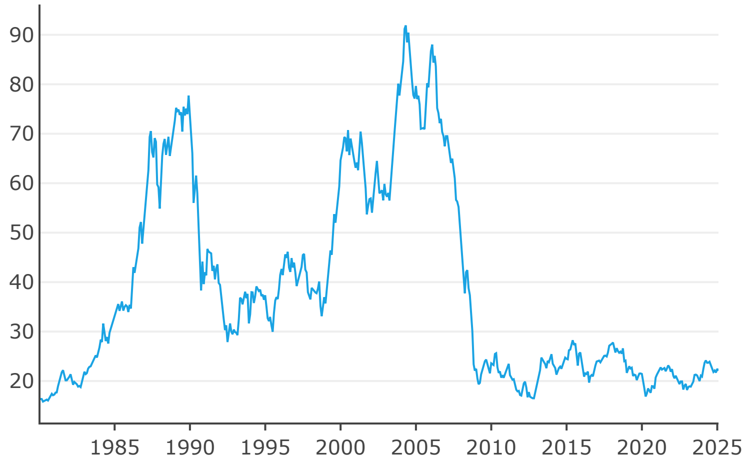


Europe (Ex-UK) | Shiller P/E

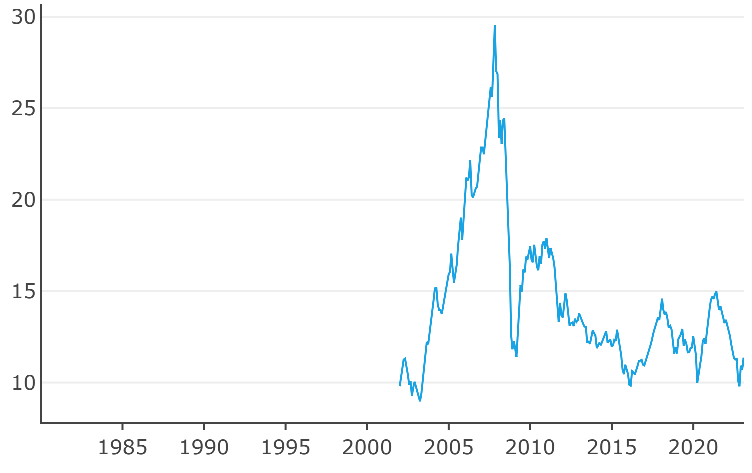


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



Sources | Shiller P/Es: Morgan Stanley as of Jan 2025. Shiller P/E is calculated as today's price divided by the real average earnings of the last 10 years.

VALUATION

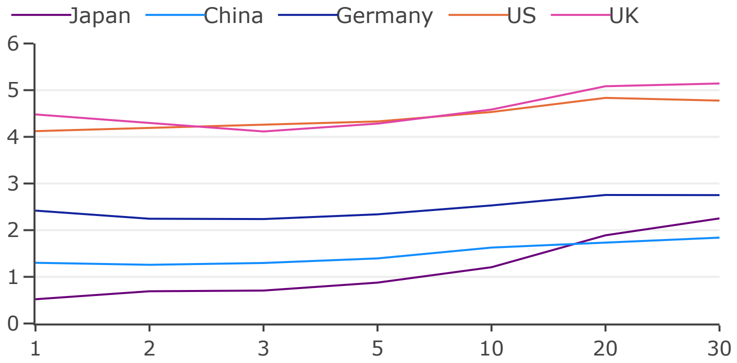
Bonds - Sovereigns

The rise in UK bond yields seems driven by external factors, particularly the US, rather than UK fundamentals. US 10Y Treasury yields rose 22bps to 4.79% from 1-14 January 2025, largely due to the rise in inflation-linked bond yields, reflecting growth expectations from Donald Trump's policies. Similarly, UK 10Y Gilts increased by approximately 30bps to 4.89% with linkers attributing to most of the rise, although without a corresponding growth catalyst in the UK.

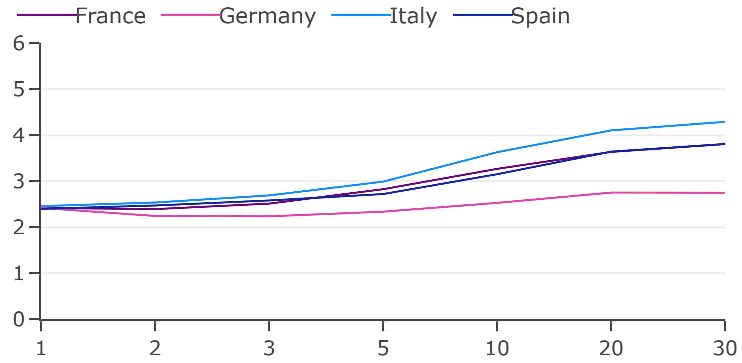
This spike, nonetheless, approached yields that raised concerns about UK public finances and led to a drop in the Cable rate. However, both US and UK government bonds and the FX rate has since recovered almost entirely.

Global Government Yields

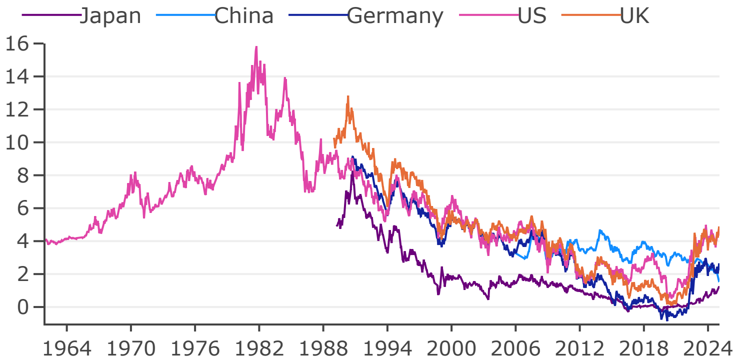
Global Treasury Yield Curves (Term vs %)



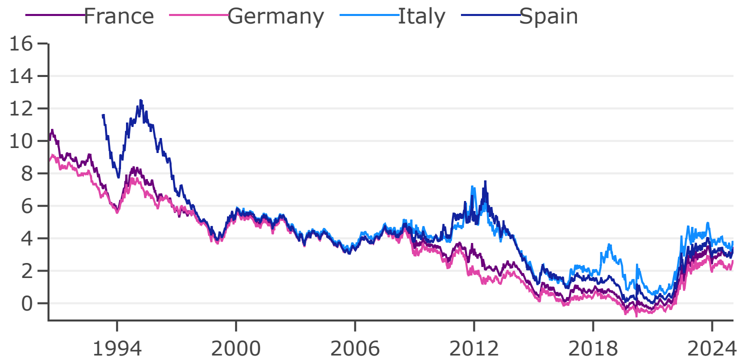
European Treasury Yield Curves (Term vs %)



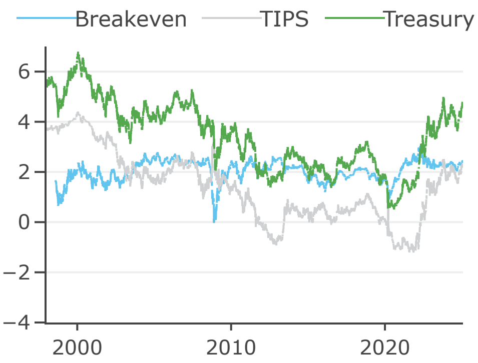
Global 10Y Yields %



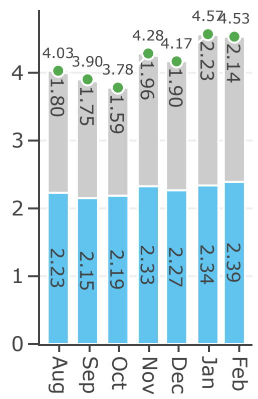
European 10Y Yields %



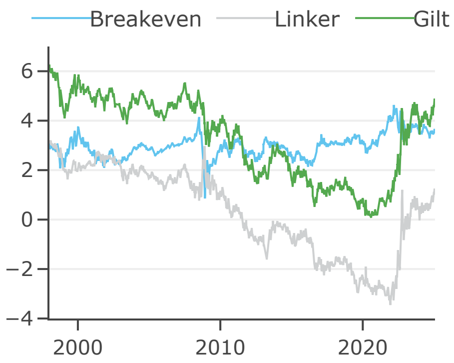
US 10Y Yields Breakdown %



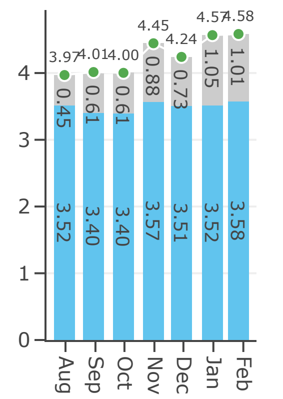
Last 6 Months



UK 10Y Yields Breakdown %



Last 6 Months



Sources | CCLA, Bloomberg as at Jan 2025.

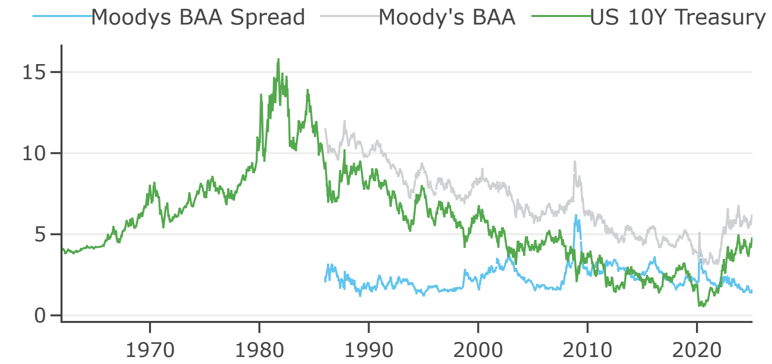
Bonds - Credit

December was a weak month for both IG and HY. iBoxx HY currently offers a yield just shy of 5%*, while leveraged loans are touching 8%*.

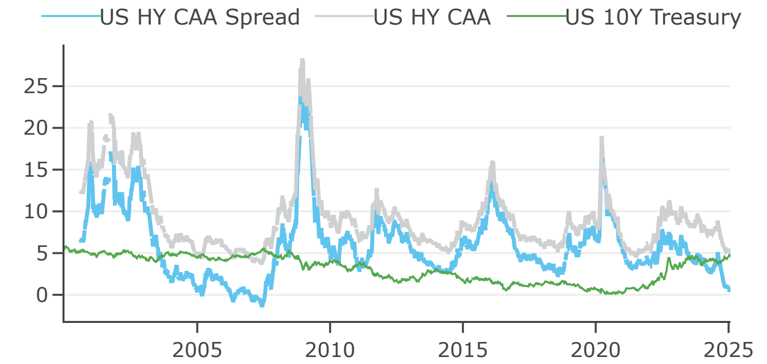
Given the tightness of spreads and limited rate cuts priced in, HY doesn't offer much upside compared to leveraged loans. Loans are in a very strong position. BoA expects defaults having to rise to 8% (currently ~4.5%*) or prices to fall to $96 (a $1 fall*) for loans to underperform HY. Loans do bring their own headwinds, however. **If the Fed Funds Rate stays at the 4% handle it would require lower-quality businesses with floaters to generate over 10% in earnings growth to avoid downgrades/defaults**.**

Global Credit Yields

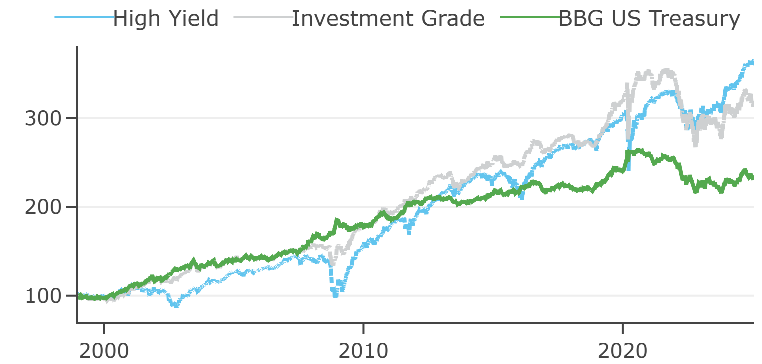
US Corporate Investment Grade Yield %



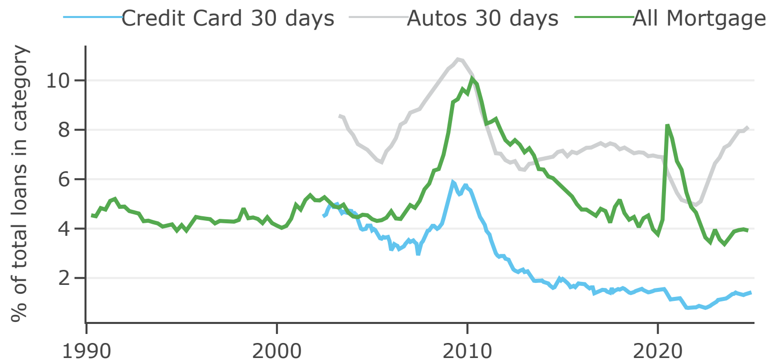
US Corporate Investment Grade Yield %



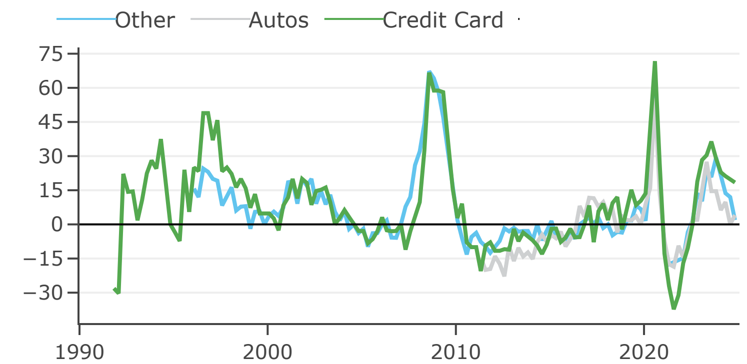
US Tr. vs IBoxx IG and HY Total Return $ (100= 31 Dec '98)



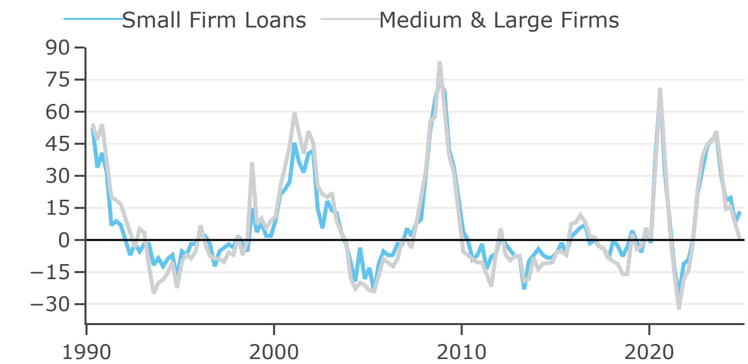
US Delinquencies %



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. BoA: Bank of America. *21 January 2025. **BoA: 'Rate Cuts Over - next for Credit?' 13 January 2025.

Alternatives

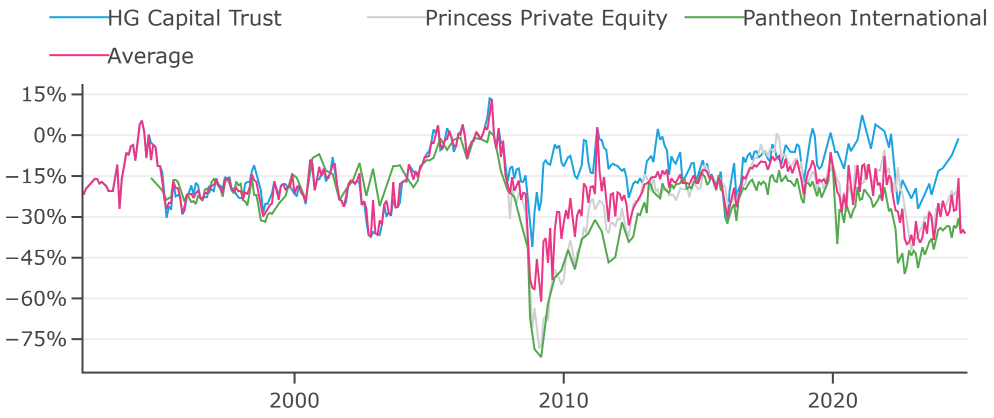
To drill, or not to drill, that is the question. **Despite Trump's encouraging catchphrase, his desire to increase U.S. oil supply to lower oil prices is at odds with the need for industry management to approve such costly projects**. According to a survey by the Kansas City Federal Reserve, firms reported that WTI oil prices need to average $62 for drilling to be profitable, and $84 for a substantial increase in drilling to occur*. Currently, prices are at $74, with projections for the next three years remaining around this level. Despite this, the drilling expectations index rose from -3 to 13 in the fourth quarter, with 60% of firms planning to increase capital expenditure in 2025.

It is worth noting that while Trump's executive order has opened Alaska for drilling, it remains a very expensive, difficult, and risky area to explore, despite its attractive estimated 3.2 billion** barrels of oil reserves. We do not expect firms to rush into drilling there just yet.

Global Valuations

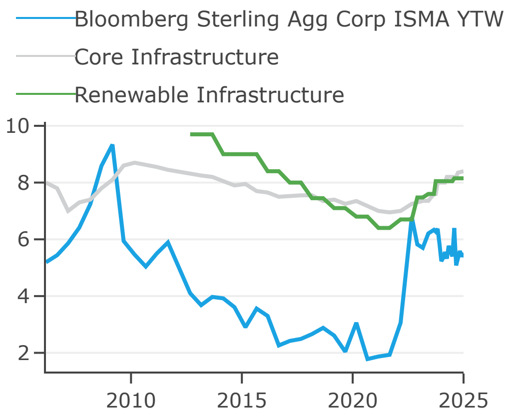
Listed Private Equity

Discount To NAVs



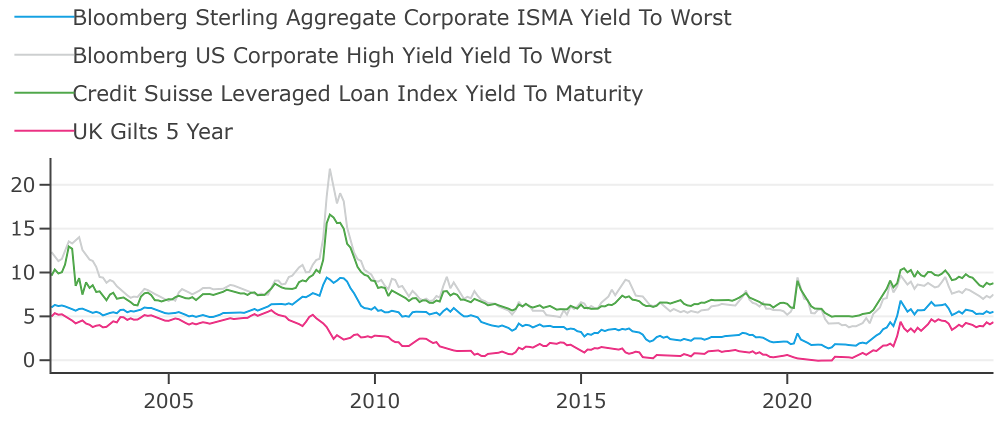
Infrastructure

Infrastructure Discount Rates vs Bond…



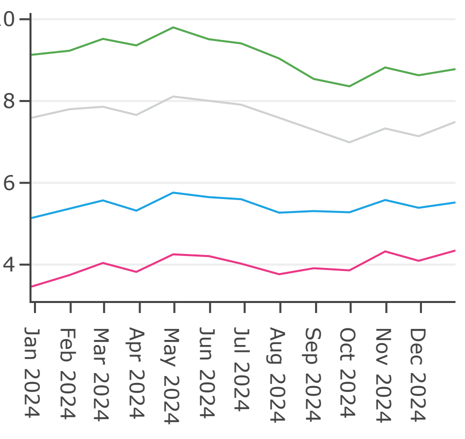
Contractual Income

Income Yields



Last 12 Months

Income Yields



Sources | Infrastructure: CCLA, Bloomberg; Bloomberg; Private Equity: Bain Global Private Equity Report, Bloomberg, Pitchbook; Contractual Income: Bloomberg, Pitchbook. As of Jan 2025. *Kansas City Fed: Tenth District Energy Activity Fell at a Steady Pace 10 Jan 2025. **US Energy Information Administration: Alaska Profile 2022.

VALUATION

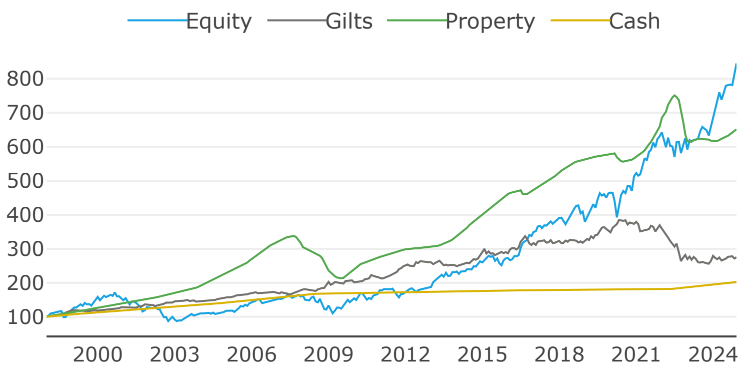
Property

2025 continues the trends of 2024. All-property equivalent yields hover around 7%, mainly driven by rental growth, while property yields fluctuate with the bond market. The rise in UK 10Y Gilts has pressured property yields in January, but a quick recovery following the CPI reading suggests the damage is unlikely to be long lasting. UK property market saw an annual total return of 6.9%, with Residential continuing to outperform at 10%, and Industrials close behind.

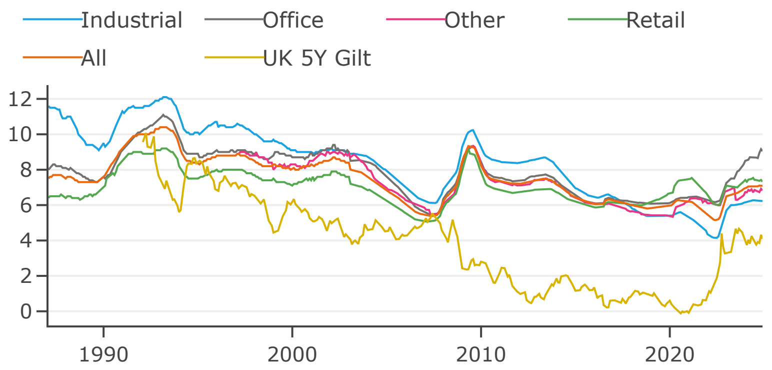
Looking ahead, prospects are positive. Credit conditions for commercial real estate continue easing, the Bank of England is expected to cut rates in February, and vacancy rates appear stable. The all-property equivalent yield remains attractive at ~4.5% real*. However, potential risks include subdued growth impacting rental yields and further spill-over effects from the US into UK bond markets.

UK Commercial Property Market

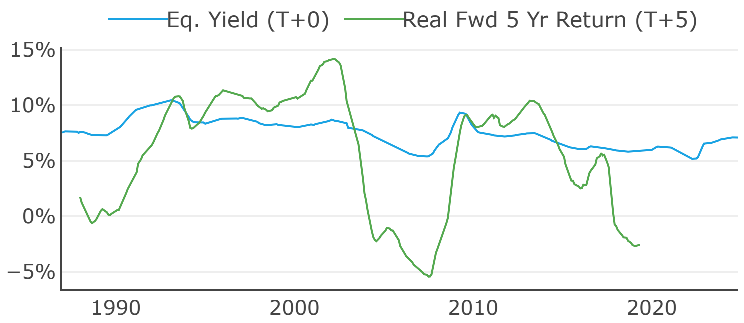
25 Years Of Return 1998=100



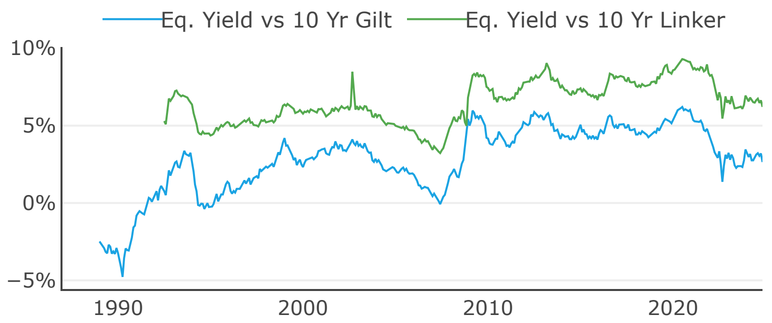
Equivalent Yields vs Gilt Yields %



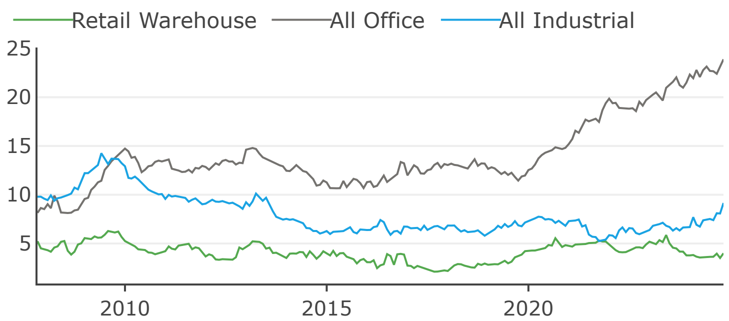
MSCI UK All Property Monthly TR Index %



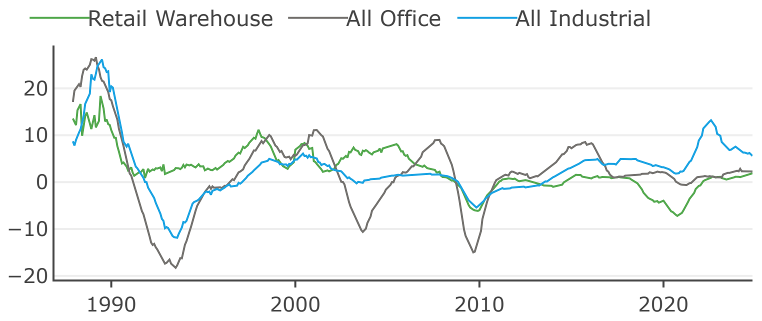
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



Sources | Equivalent Yields, Vacancy Rate, and Nominal Rental Value charts: MSCI UK Monthly Property Index as at Dec 2024. 25 Years of Return, All Property Monthly TR Index as at Nov 2024. *All property equivalent yield (7%) - inflation expectation (2.5%).

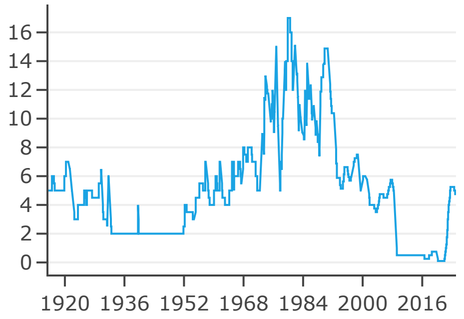
Cash

The UK gilt issuance has garnered attention, especially post-October's Budget. With rising Treasury spending, UK gilt issuance is anticipated to be around £300bn for the current and next fiscal year, marking the second-largest issuance since 2008, second only to the pandemic.

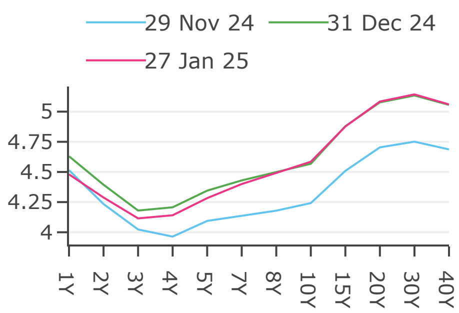
Despite a deep average gilt cover-ratio over the past two decades and even stronger cover over the past year, there is speculation of falling demand. The DMO's 2025 GEMM and Gilt investor meeting highlights "strong support…for a reduction in the duration of conventional gilt issuance in 2025/2026 relative to the current year". Some attendees cited declining structural demand from pension funds as a driver for this recommendation. Although, worth noting, the last 30-year, 39-year and 49-year issuances have all been comfortably ~3x cover. **Based on the minutes, we may see more short/mid-term issuance from April.**

UK Sterling Market

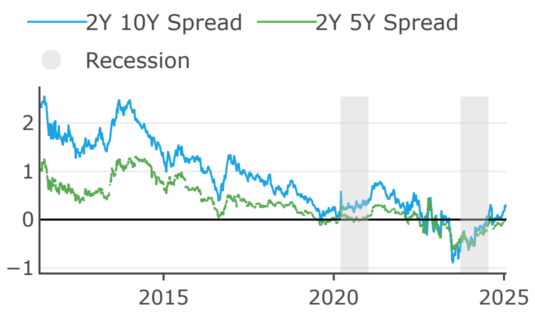
Official Bank Rate



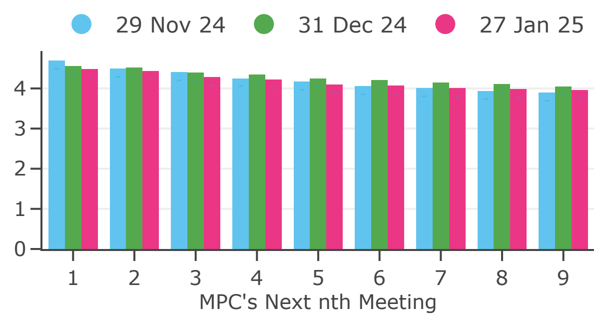
UK Gilt Curve



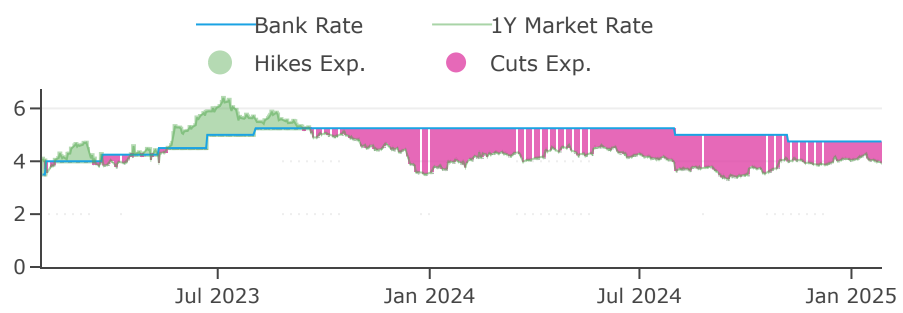
Gilt Spreads



Rate Expectations For Future MPC Meetings



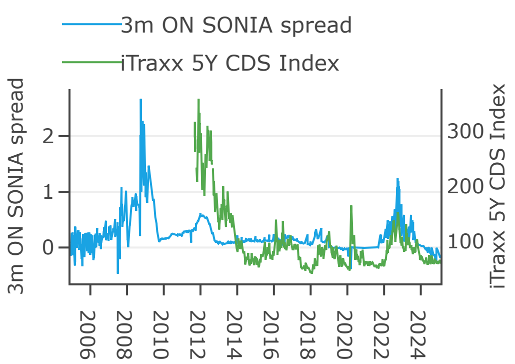
1Y Forward Market Rate Expectations



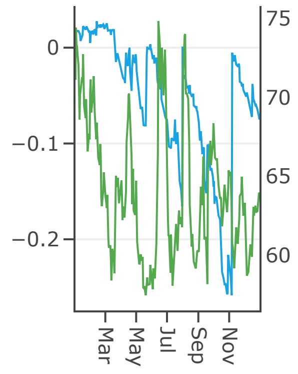
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2024					
	July	Aug…	Sep…	Oct…	No…	Dec…
RPI	3.60	3.50	2.70	3.40	3.60	3.50
CPI	2.20	2.20	1.70	2.30	2.60	2.50
CPI Core	3.30	3.60	3.20	3.30	3.50	3.20
CPI Services	5.20	5.60	4.90	5.00	5.00	4.40
CPI Goods	-0.60	-0.90	-1.40	-0.30	0.40	0.70
Priv. Wages	4.90	4.60	5.10	6.70	6.10	

Market Stress



Last 12 Months



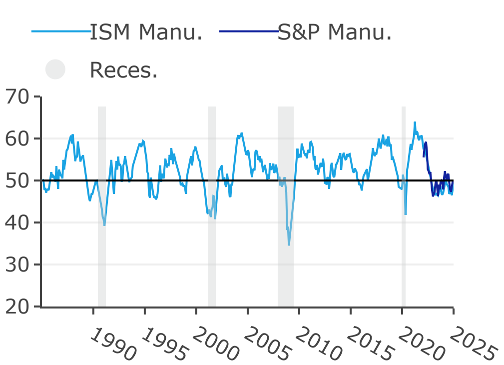
Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, at least +/- 2 standard deviations away scores as red. Bloomberg for all charts, as of Jan 2025.

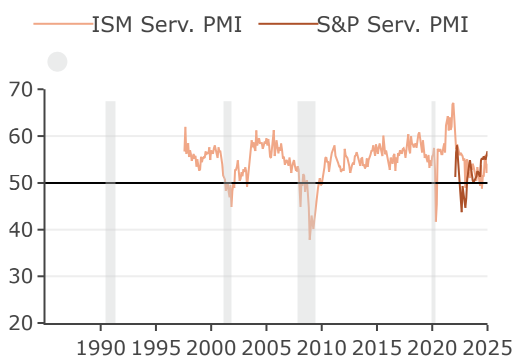
Global PMIs

The US economy continued its pattern in December 2024. The Services sector saw a rise in business activity, with the S&P Global Services Index increasing to 56.8 from 56.1 in November. New orders expanded at their fastest rate since March 2022, leading to accumulated backlogs and a marginal increase in employment (the first in five months). Business confidence reached an 18-month high, **with 44% of firms expressing optimism for the year ahead.**

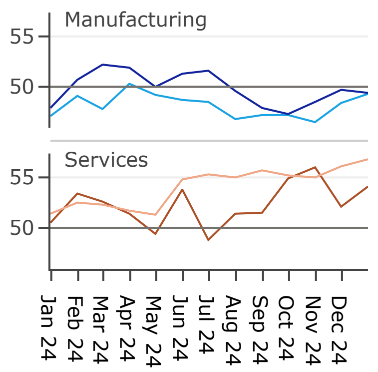
Conversely, the **Manufacturing sector faced challenges,** with the S&P Global Index falling to 49.4 from 49.7 in November, **marking the fifth consecutive month of declining production.**

United States

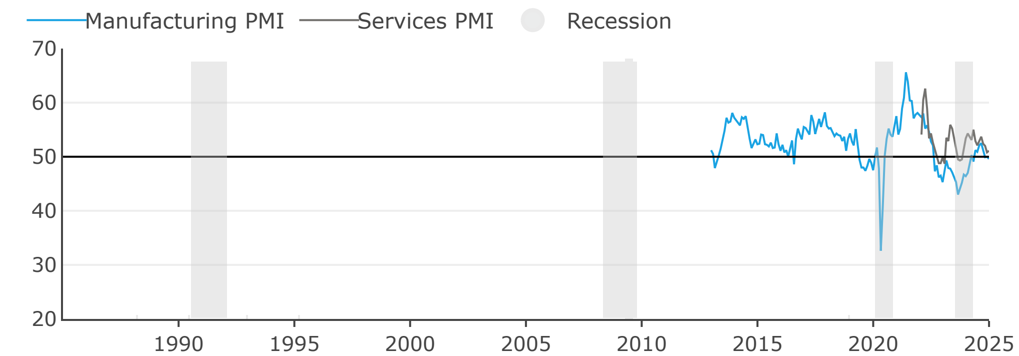




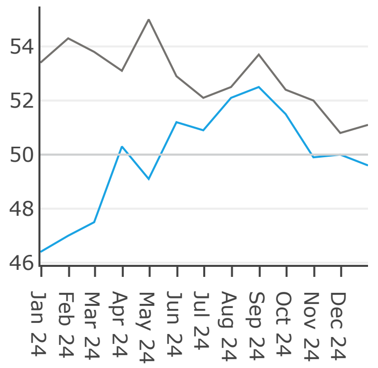
Last 12 Months



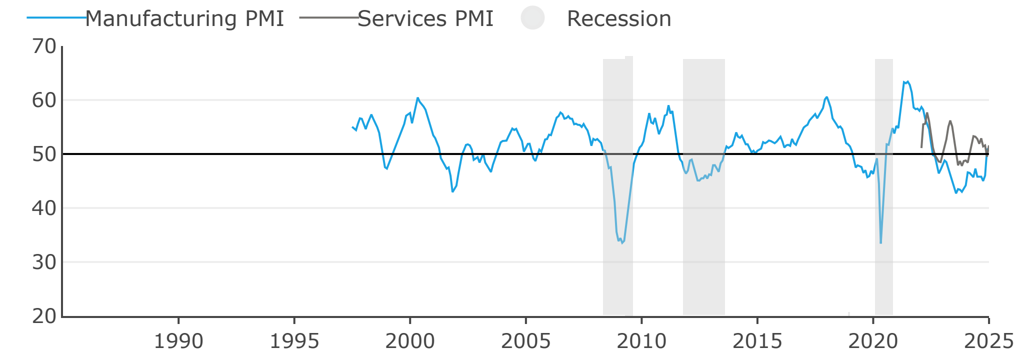
United Kingdom



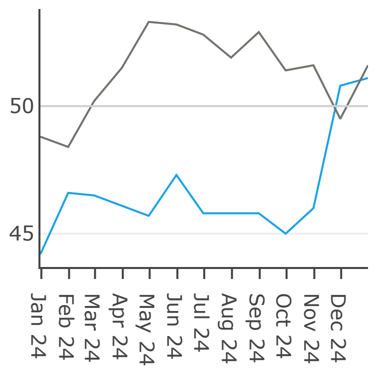
Last 12 Months



Eurozone



Last 12 Months



Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Jan 2025. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

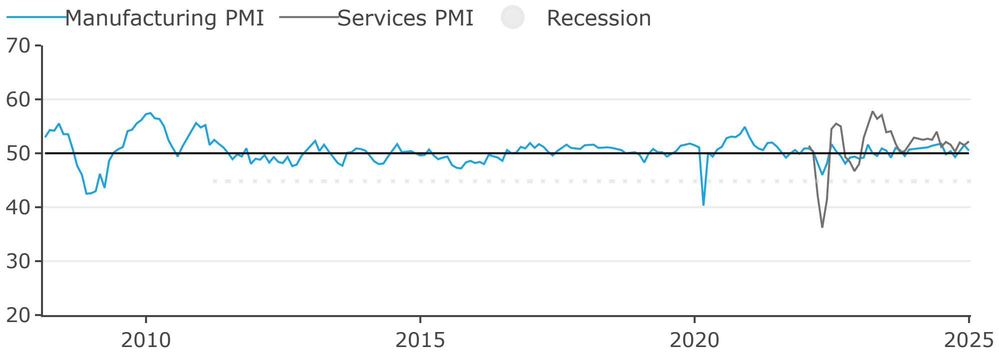
GROWTH

CCLA

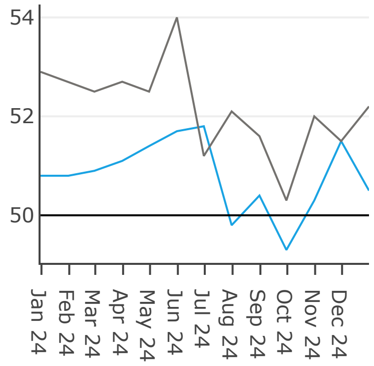
Global PMIs

The global activity story remains - Services strong, Manufacturing weak. China Manufacturing showed a spark of life in December as businesses placed last-minute orders before Trump was inaugurated. This contributed to almost $1tr of surplus for the year 2024 and supported the annual real GDP growth figure of 5.4%, beating the 5% target. This may have been just a surge and we wait to see the impact of Trump's policies on China.

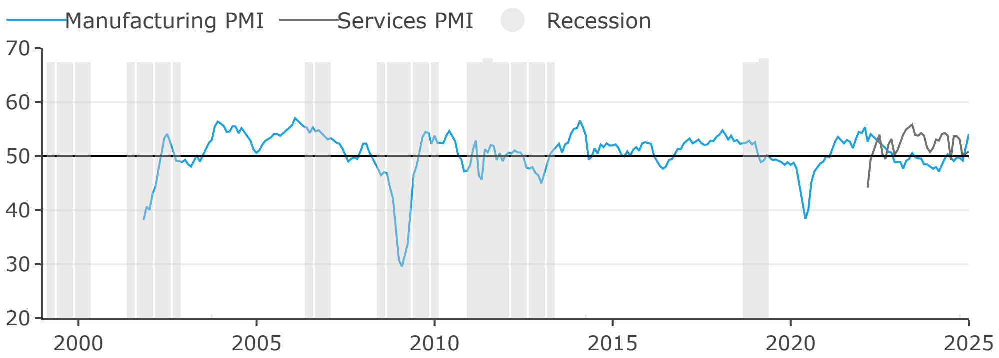
China



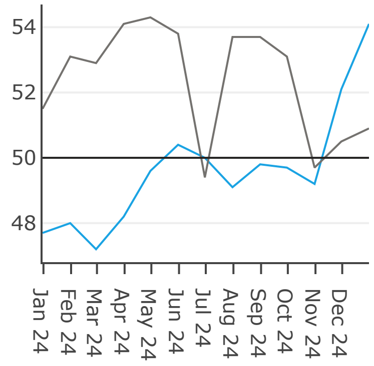
Last 12 Months



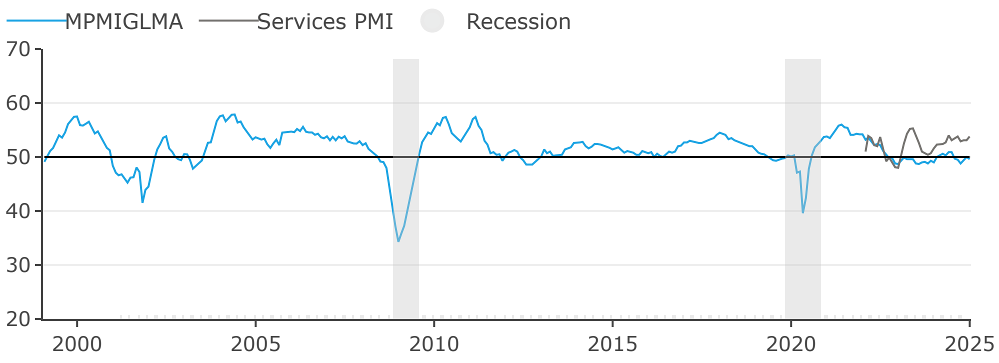
Japan



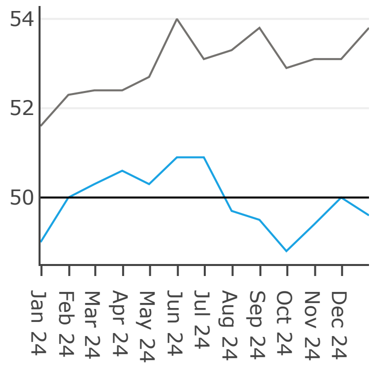
Last 12 Months



Global



Last 12 Months



Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Jan 2025. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

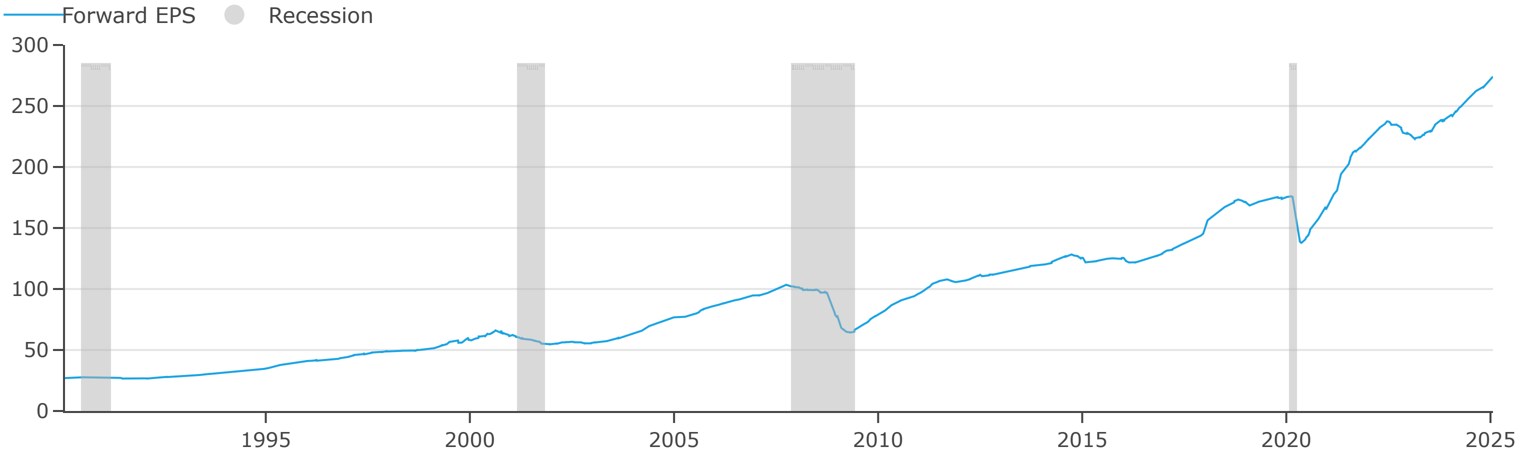
Earnings

Many commentators project a challenging year for the M7 amid the market broadening. But this seemed unlikely for most of January, especially given the S&P 500, M7 and 493 were expecting EPS growth of ~15%, ~30% and ~13% respectively. With such a significant lead in forward EPS growth and positive EPS revisions, it was hard to see a tough year ahead for the M7. However, news from the Chinese AI start-up, DeepSeek, changed the narrative. **DeepSeek's R1 AI model outperformed ChatGPT (and others) in capability benchmarking, while costing 27x less to train than ChatGPT. This raises doubts in the investment case across the AI supply chain, and may hurt the order pipeline for the tech giants.**

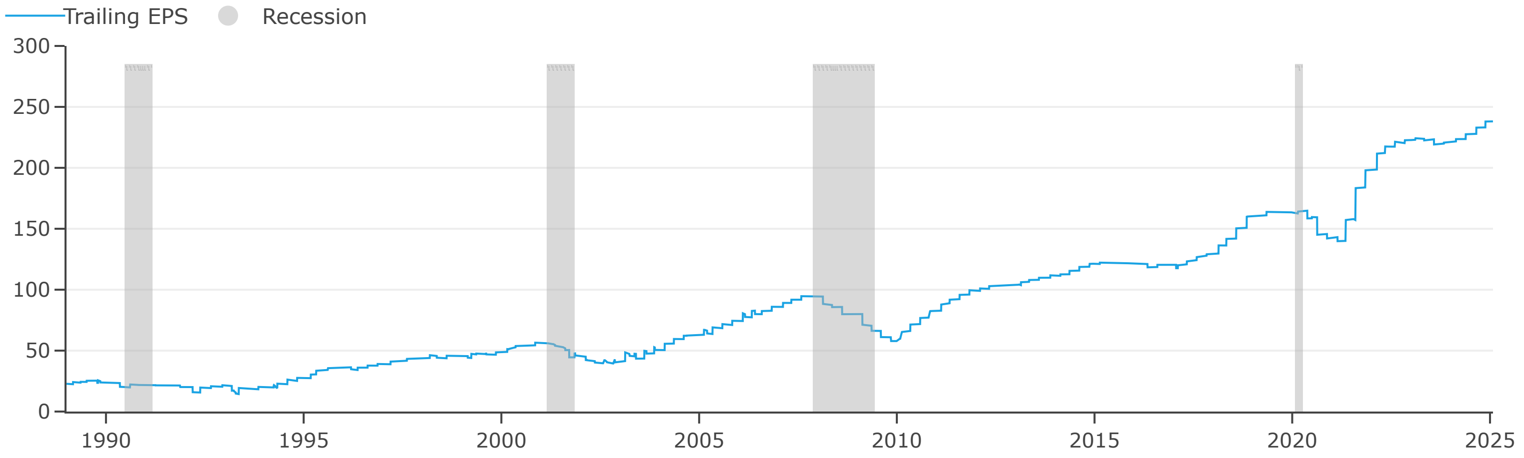
Given the stretched fundamentals of the US market (see page 8), we expect the market to be more sensitive to misses this year, creating more downside risk.

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 2025.

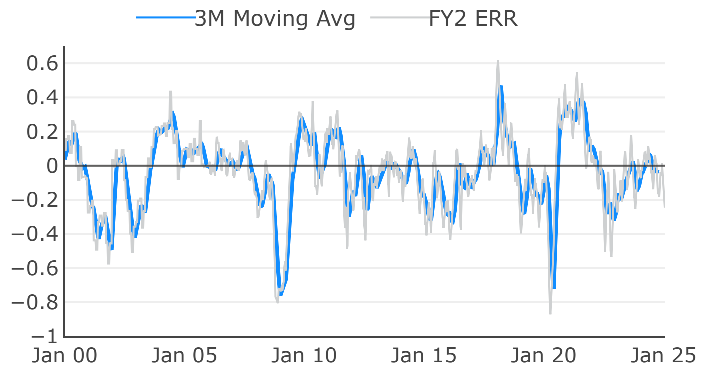
Earnings

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.

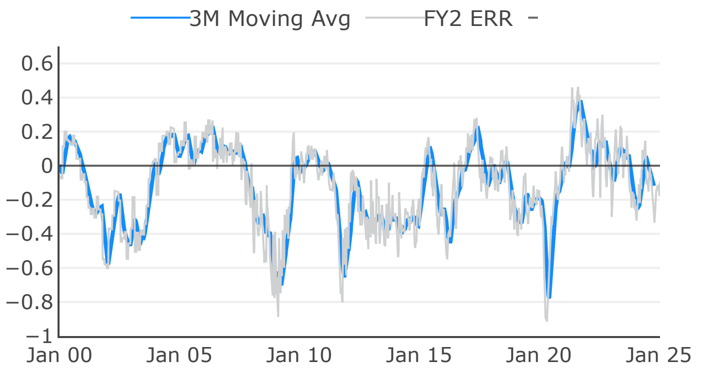
Earnings revisions breadth has deteriorated (but very mildly) over the last few months. However, **revisions are very seasonal and the current change is very much in line with the last 25+ years of average monthly trend revision.** The US was not alone as the UK and EU also faced negative revisions.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

Global Earnings Revisions Ratios

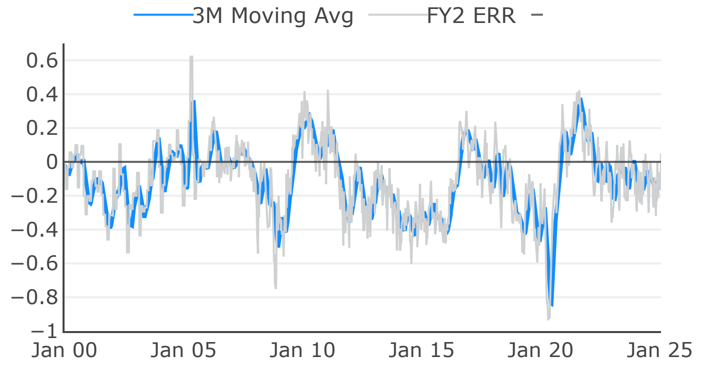
USA



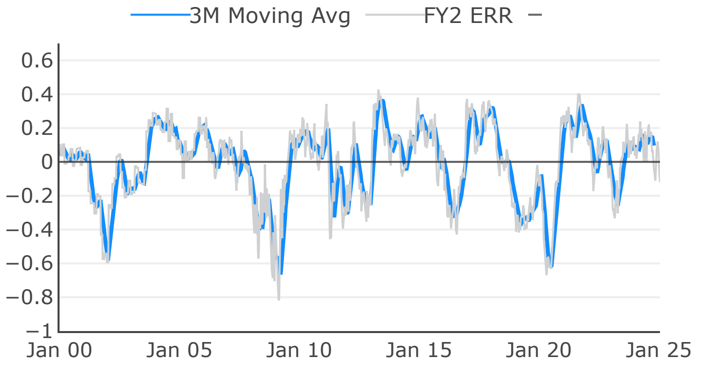
Eurozone



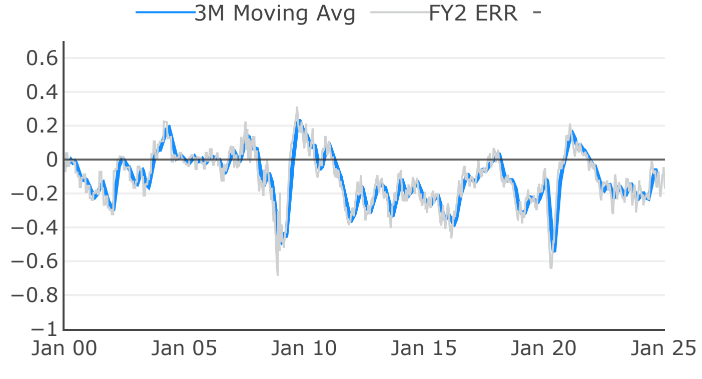
UK



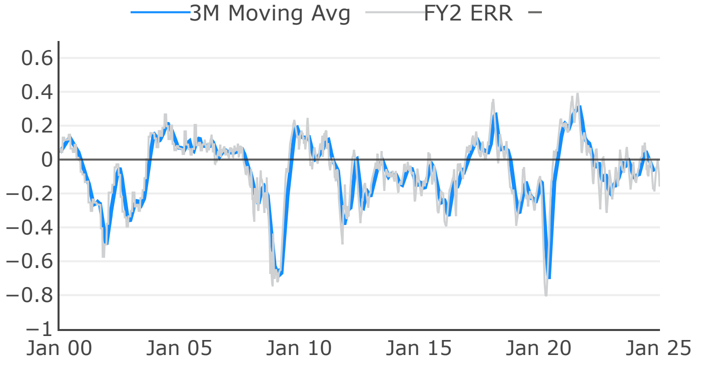
Japan



Emerging Markets



World



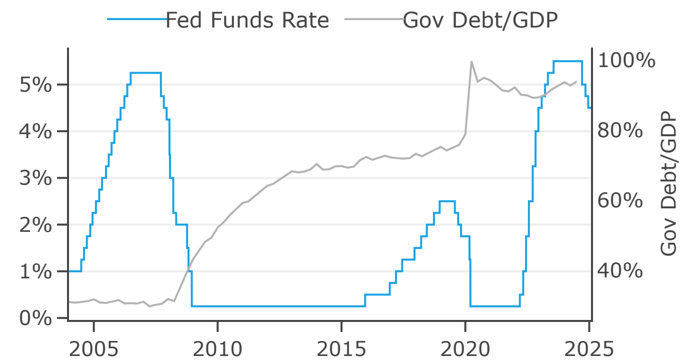
Sources | Eikon, the MSCI index has been used for each respective region, as at Jan 2025.

Interest Rates

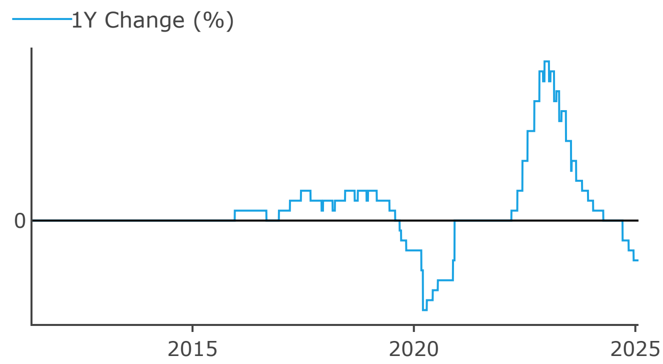
As expected, the December FOMC meeting brought a 25bps rate cut, bringing US Fed Funds Rate to 4.25-4.50. However, the cut was met with a much more hawkish tone from the Chair. "We're in a good place, but I think from here it's a new phase and we're going to be cautious about further cuts". Powell highlighted the concerns about inflation remaining sticky, particularly shelter. **Markets have repriced, now only expecting one 25bps rate cut in 2025.**

Worth noting, as per the Real Fed Funds Rate chart, current policy is considered restrictive by ~1%. A 25bps cut later in the year is likely to still maintain overall restrictiveness.

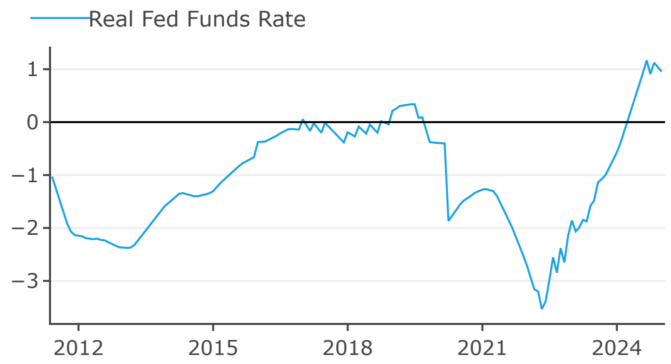
Fed Funds Rate



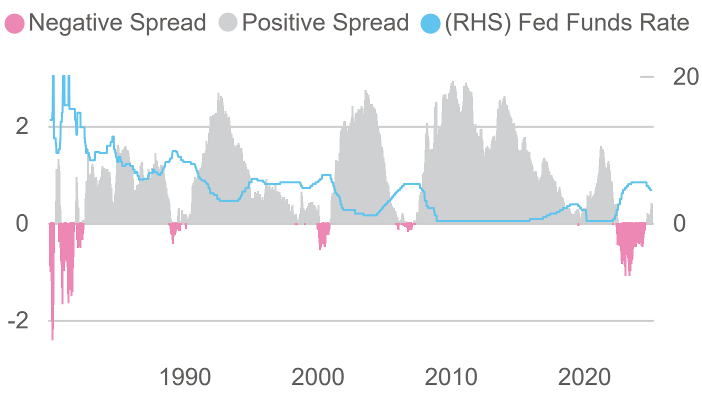
Change in Fed Funds Rate



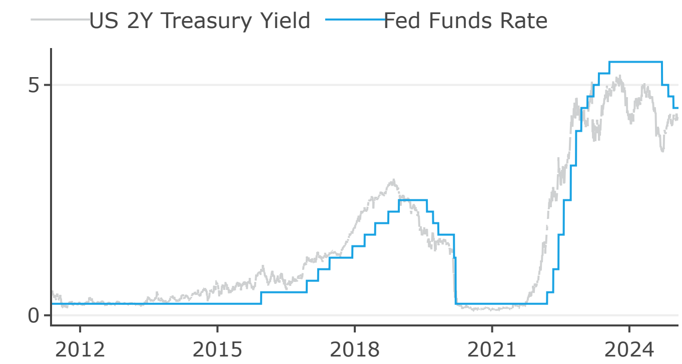
Real Fed Funds Rate (Using 2Y MA CPI)



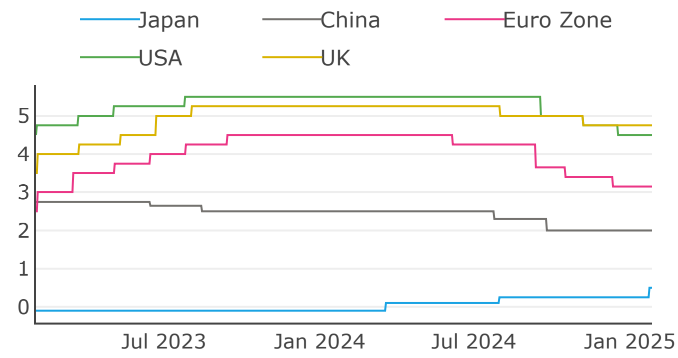
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Jan 2025.

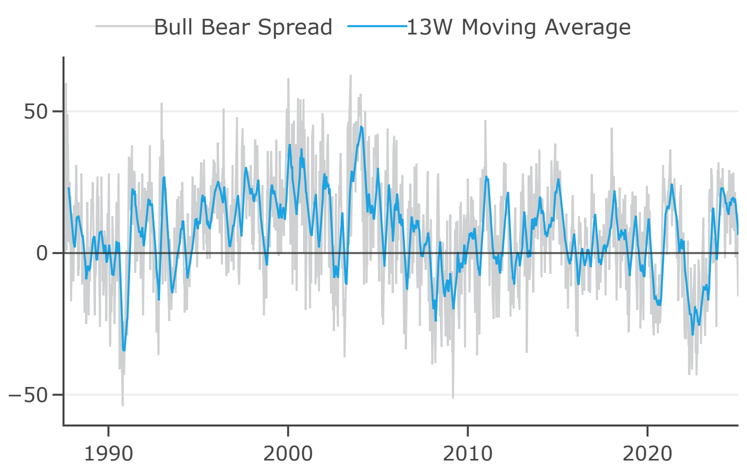
SENTIMENT

Sentiment

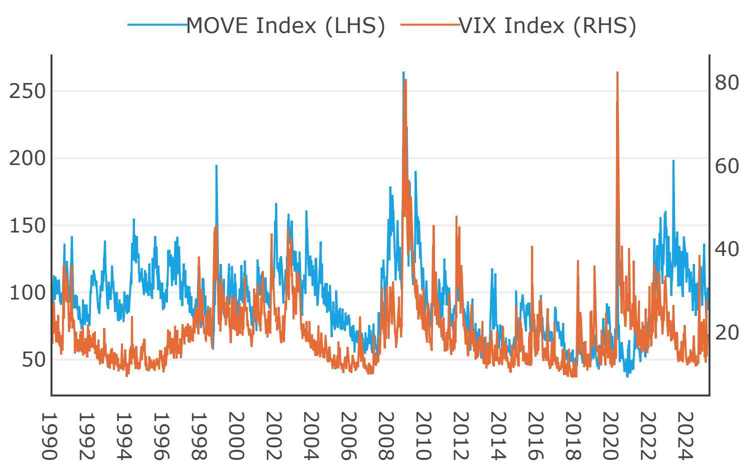
The BAML Hartnett Bull & Bear Indicator has moved further into the bearish territory (which is good for forward returns). Now at 4.0 vs last month at 5.4.

US Equity Indicators

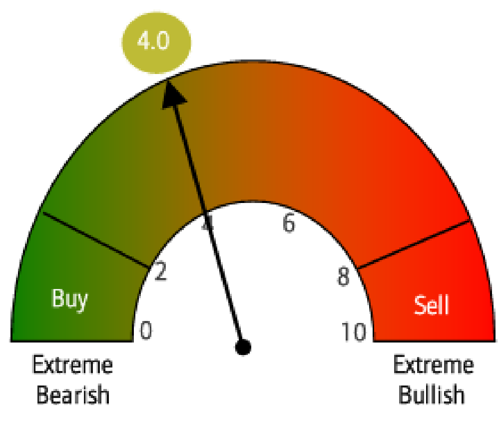
AAII Bull Bear Spread



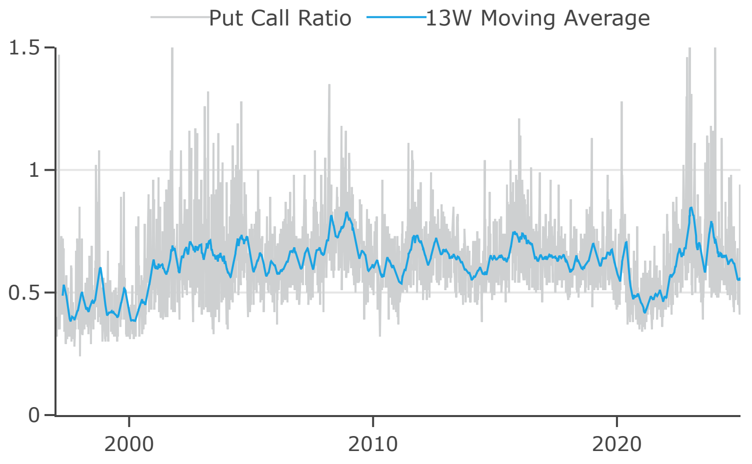
Equity vs. Bond Sentiment



Michael Hartnett's Bull & Bear Indicator (BAML)



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 Jan 2025

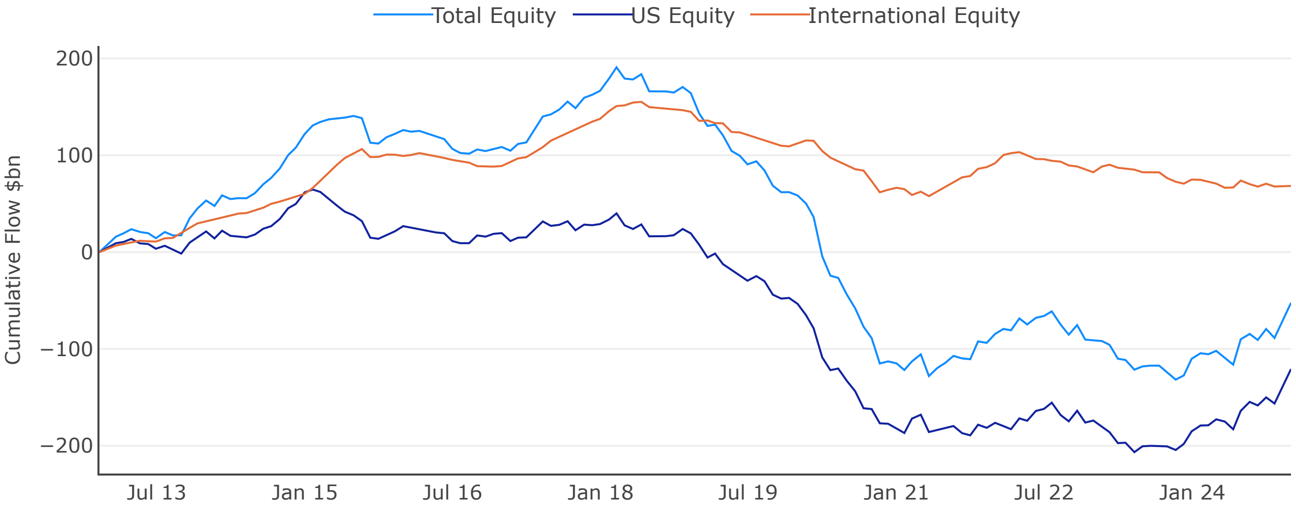
Fund Flows

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.

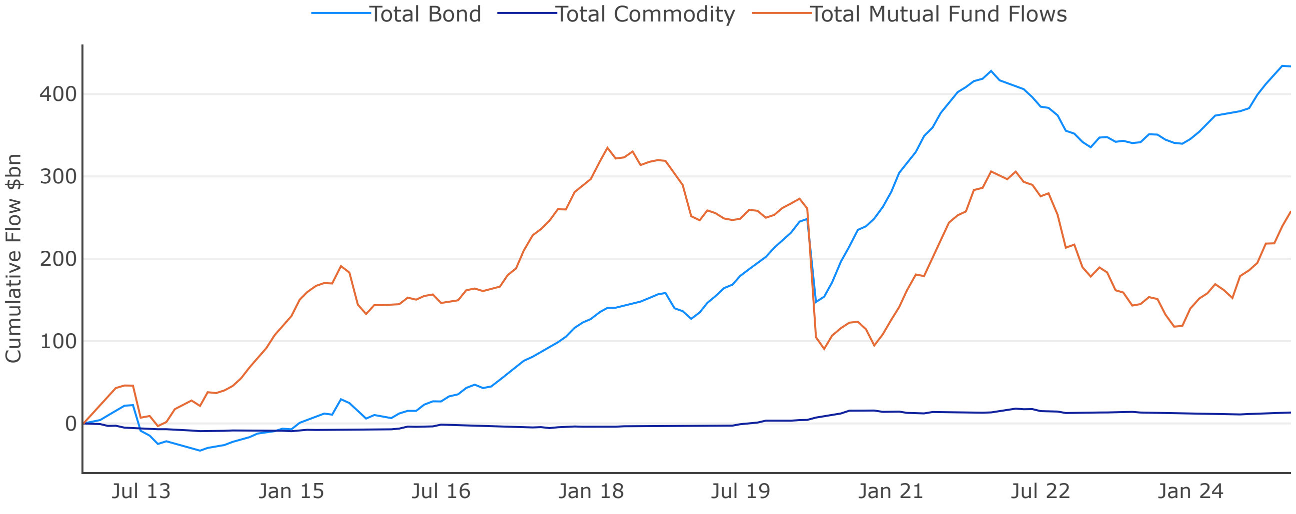
The message in these data points continues to be that there is little enthusiasm for actively managed funds even if the outflows from equity funds have stopped.

US Mutual Fund Flows

Equity Markets Cumulative $bn



Non-Equity Markets Cumulative $bn



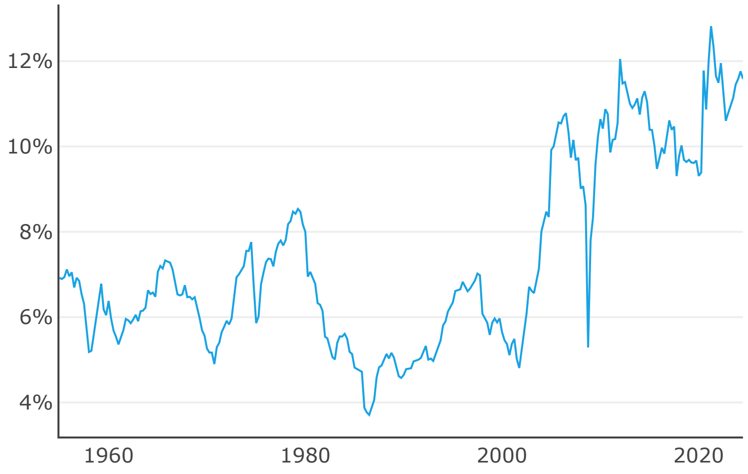
Sources | All charts: Bloomberg ICI fund flow data. Data as at Jan 2025

The Big Picture

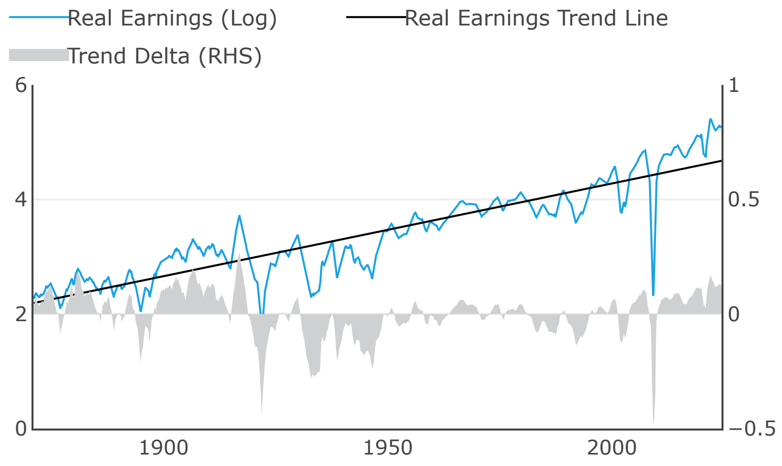
Here we highlight some longer-term imbalances that, **should** they correct, would have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. Its corollary (not shown) is that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

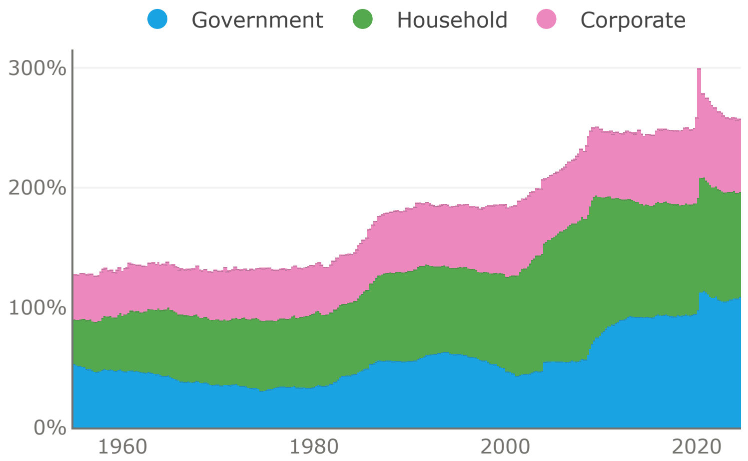
Profit Share of GDP



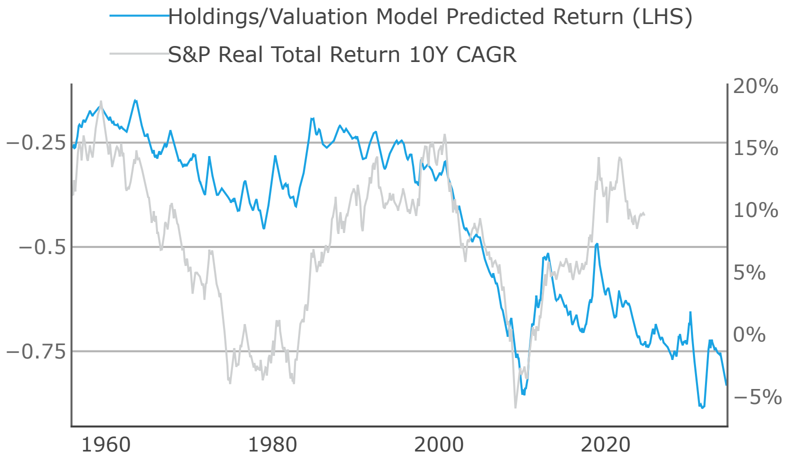
Earnings Deviation From Trend



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 Jan 2025.

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