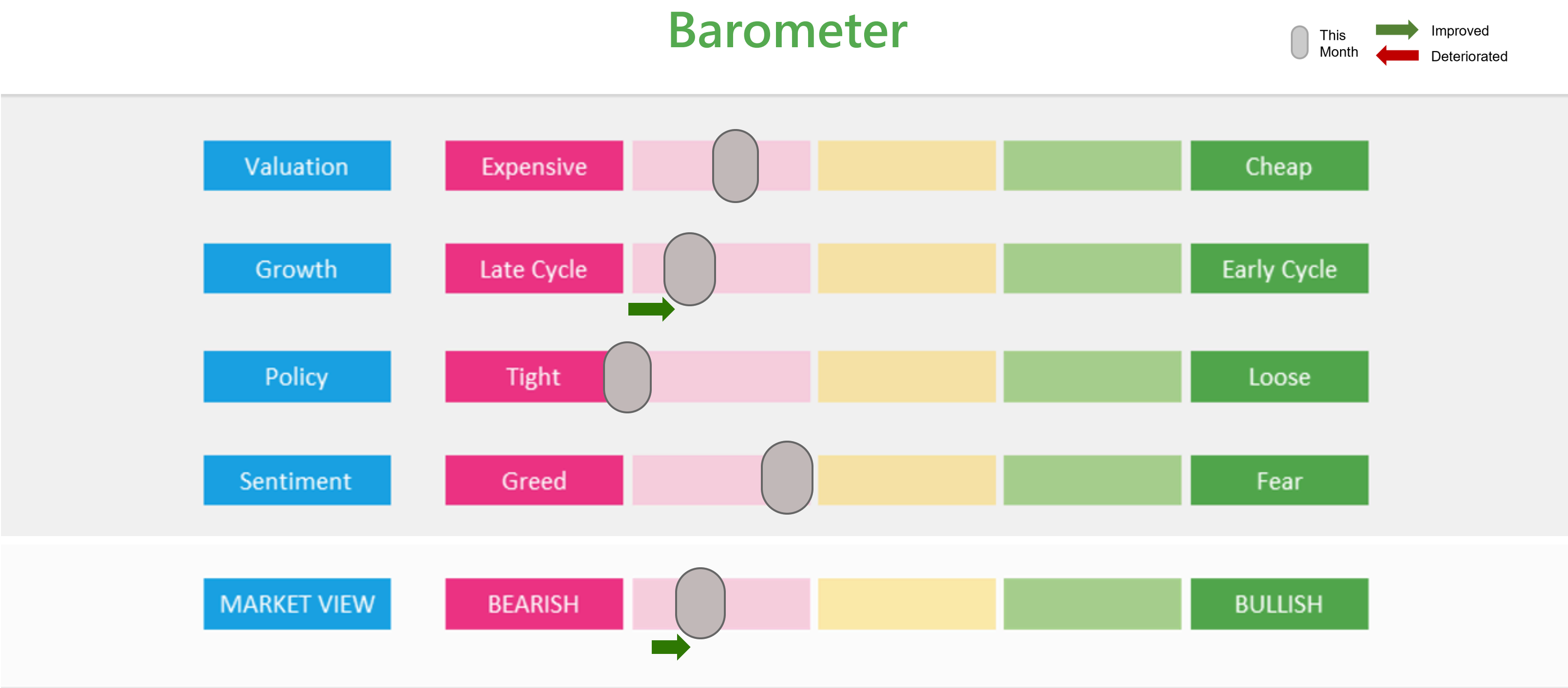
MARCH 2024

CCLA
GOOD INVESTMENT

Market Barometer



Leading Indicators are Ticking Up

We pointed out last month that equity market valuations are becoming stretched, specifically in the US. But, while monitoring that, we continue to repeat our mantra that **bull markets run from recession to recession**, and equities generally peak only a matter of months before the onset of recession.

Which is why it's so important to watch the leading and current activity indicators. And the **PMIs (both Mfg and Services) have gone up** over the last couple of months, moving out of the recession zone they've been in or near.

Our Charts of the Month reiterate this point. **Consumer incomes are growing solidly**, especially in the US, as the labour market remains firm and wages continue to grow ~4% annual rate. **Capex is also showing signs of life**.

We look at the US Information Technology sector's valuation for signs of a bubble in our second Chart of the Month.

The PE ratio is high-ish (for the market's leading sector) at 29x but we should be aware that that is precisely half the multiple that prevailed at the peak of the TMT bubble of 2000 (58x).

We would not chase these stocks, but there has to be at least a chance that a bubble inflates, especially if the Fed cuts interest rates while earnings momentum remains strong and there's no recession in the immediate offing.

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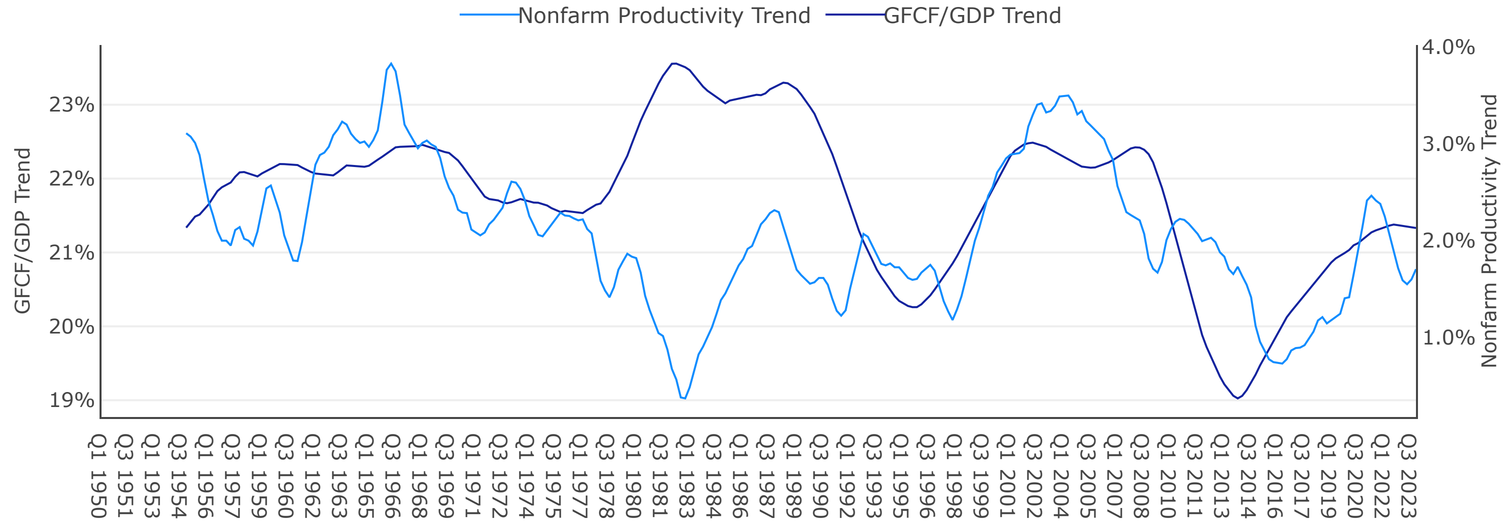
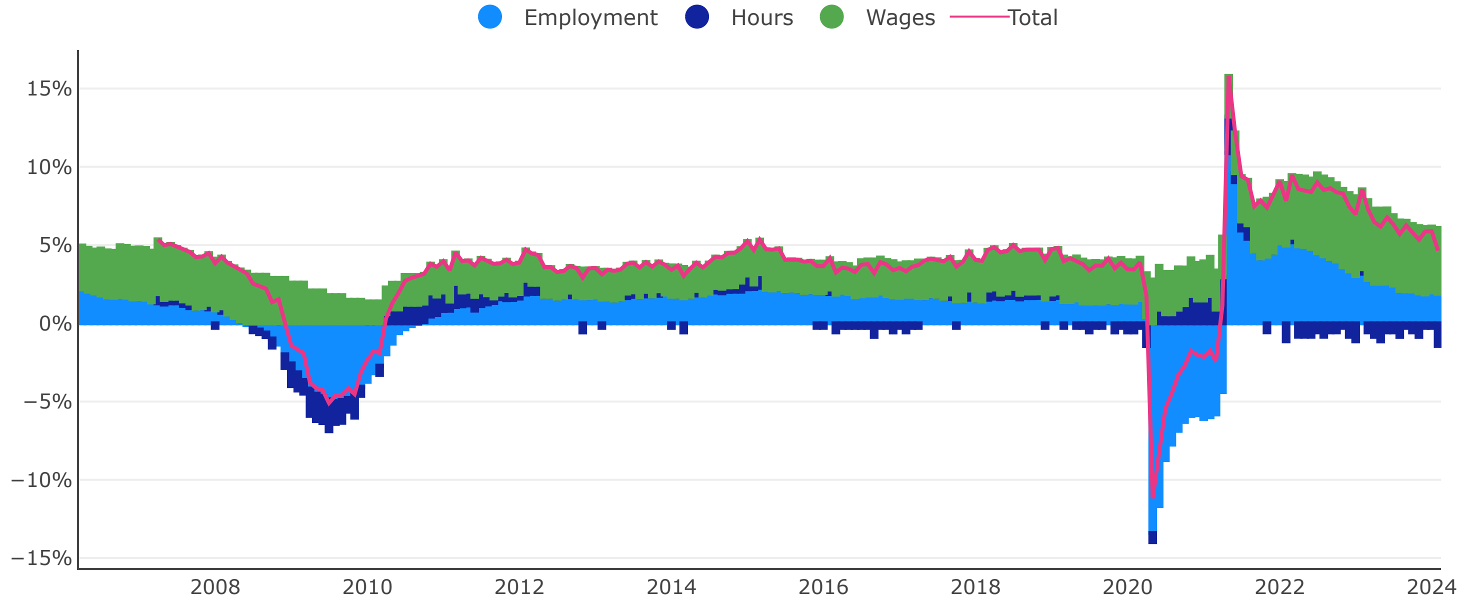
Charts of the Month

Lest we be accused of being too cautious on the US economy (still thinking there's *risk* of recession later this year / early next year), we highlight two critical economic drivers that are holding up very well. The top chart shows that **gross fixed capital formation has picked up** in the last five years and relates this to trend productivity growth, which has also inflected higher. The recovery in capex is driven by two sectors - shale oil production and onshore manufacturing. Joe Biden's Inflation Reduction Act could extend this further. The bottom chart shows that the combination of **strong wage and employment growth has turbocharged consumer income growth**. Until and unless we see a downturn in this, which drives the 68% of US GDP that is personal consumption, there won't be recession.

USA Gross Fixed Capital Formation & Productivity Growth (5 Year Average)



US Aggregate Household Earnings Growth YoY%



Sources | USA GFCF & Productivity: Bloomberg and CCLA; USA Agg. Household Earnings Growth: Bureau of Labour Statistics. All data as at Feb 2024

TOP OF MIND

CCLA

Charts of the Month

Impossible things. As the Red Queen tells Alice in Through the Looking Glass, "Why, sometimes I have believed as many as six impossible things before breakfast." Many alarm bells have sounded now that the US Information Technology sector's weight in the MSCI USA index is 30%, almost back to its 2000 TMT bubble high of 33%, and the top 10 stocks are 75% of US equity market cap, above the 2000 peak share and in line with the all time peak of 1929. Is it possible to believe that they can inflate further?

Bubble? What bubble? Well, for one thing, the PE ratio of the US IT sector (29x) is nowhere near as extended as it was in the TMT bubble (58x) - shown in the chart below. In fact, it's exactly half of its bubble peak. Second, IT and the Magnificent Seven now are far more cash generative than they were in 2000. We may not love the valuation (we are half benchmark weight in the Magnificent Seven) but this may have further to run.

MSCI USA Information Tech. Index 12-Months Forward Price / Earnings

Sources | Bloomberg, CCLA. All data as at Feb 2024. Note | The line in the chart flatlines in the early 2000s when index earnings go negative - Bloomberg smooths the data.

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VALUATION

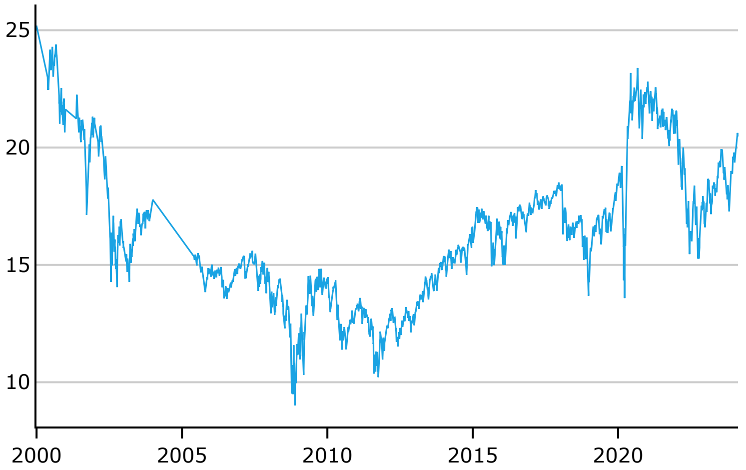
Equity | USA

The US equity market has re-rated sharply in the last four months, from 17x to almost 21x consensus forward earnings (top left chart). This leaves the spot valuation nearly 27% 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 4.3% now.

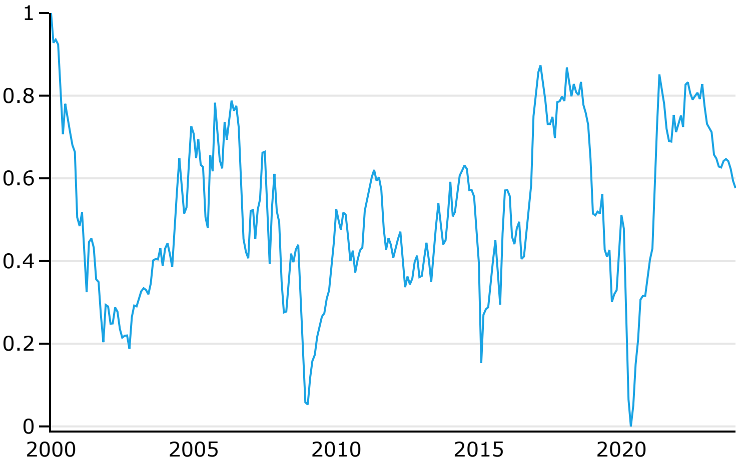
The CAPE (Cyclically Adjusted PE) is 32x. A shorthand for future real expected return is the CAPE earnings yield, indicating that US equity may not be expected to return much more than 3% annualised over coming years.

S&P 500 Valuations

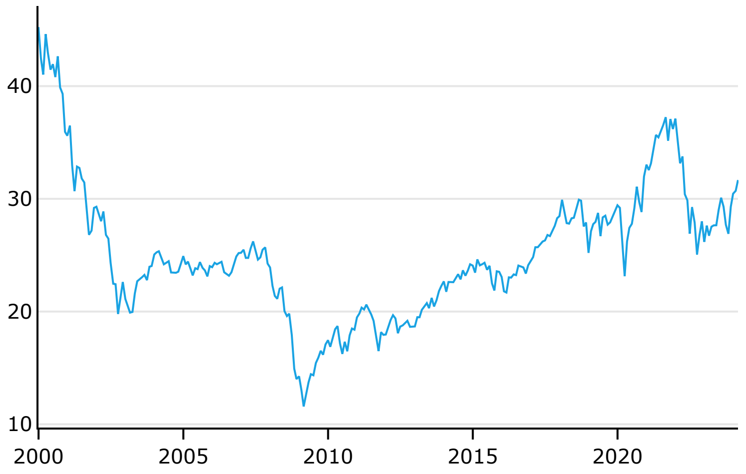
S&P 500 Forward PE



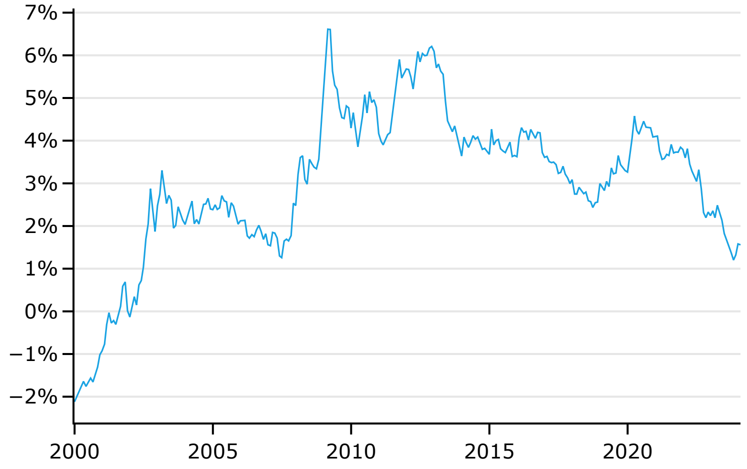
Composite Value Indicator Model



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 Feb 2024

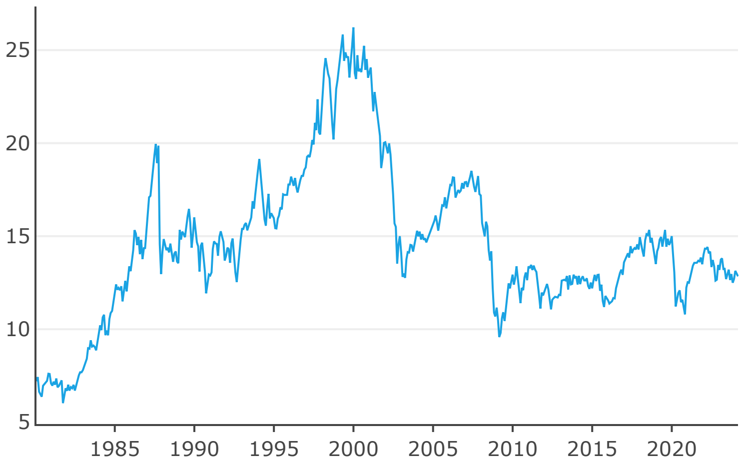
VALUATION

Equity | Regional

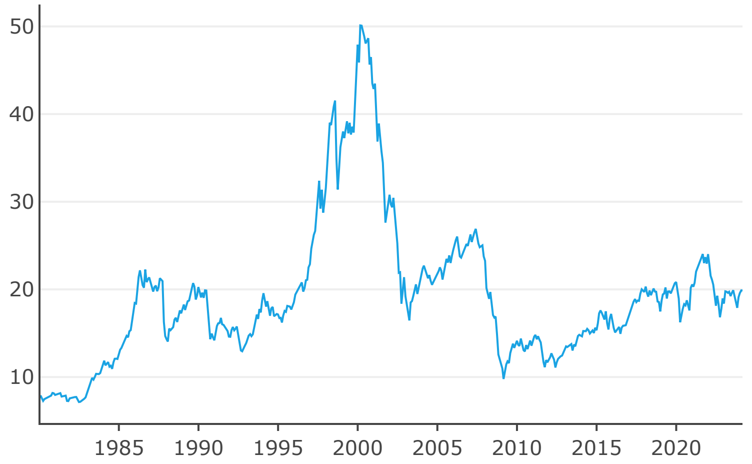
Outside the US (which is 69% of MSCI World), equity markets continue to look reasonable value (UK, Europe-ex-UK) or outright cheap (Japan, EM). The de-rating of last year is notable everywhere. The UK Shiller PE of 12.8 gives an earnings yield of just under 8%, which is a good approximation of expected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

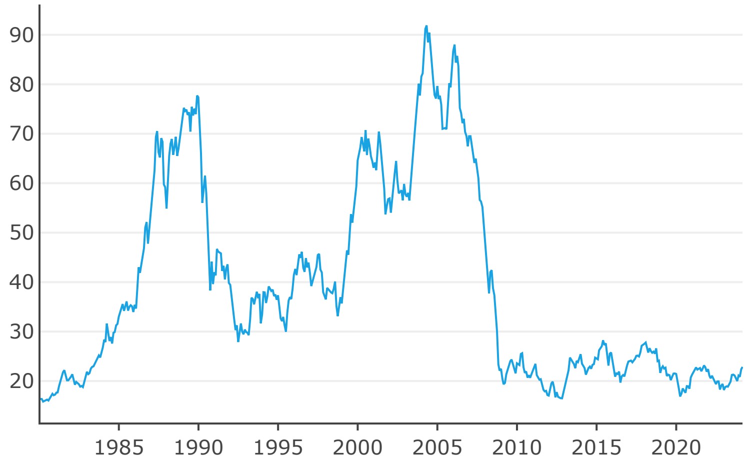


Europe (Ex-UK) | Shiller P/E

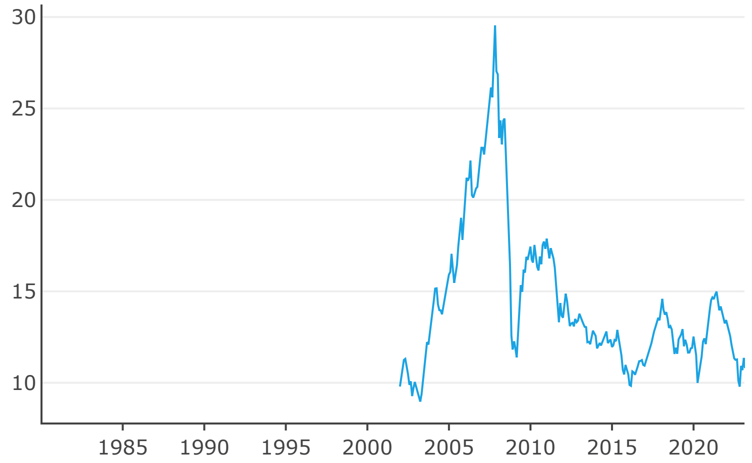


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



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

VALUATION

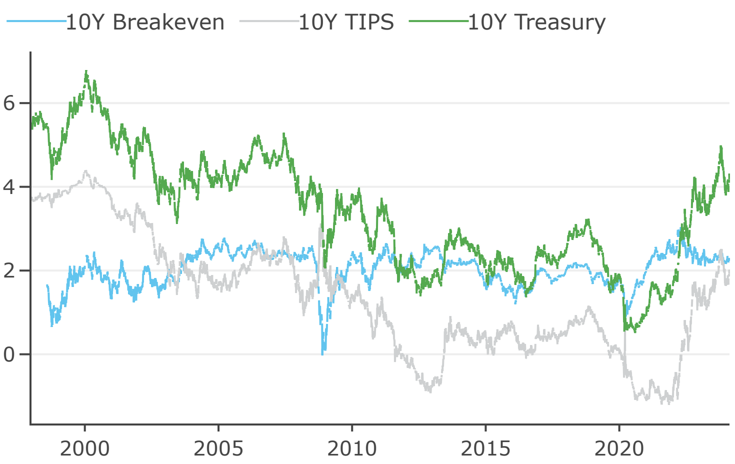
Bonds

Bond markets have given back some of their gains from the "everything rally" of November and December. Since the start of the year, the iBoxx Sterling Gilt index is down 4% (albeit 6% above the October-lows), IG is down 2% and HY is flat.

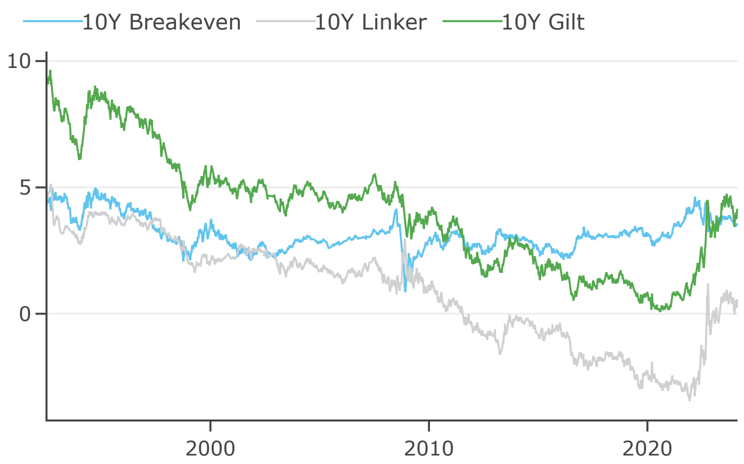
Corporate US BBB yields are still 5.83%, which stripping out 2.5% expected inflation, yields above 3.3% real expected total return, **which to our eyes remains reasonably attractive**.

Global Government & Corporate Yields

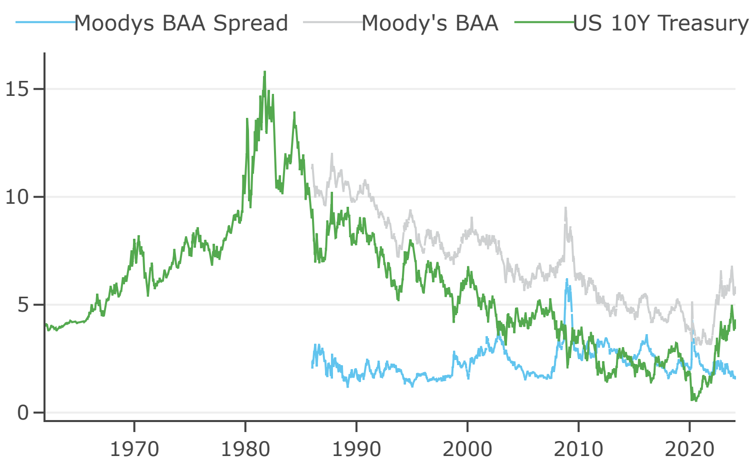
US 10 Year Treasury Yields



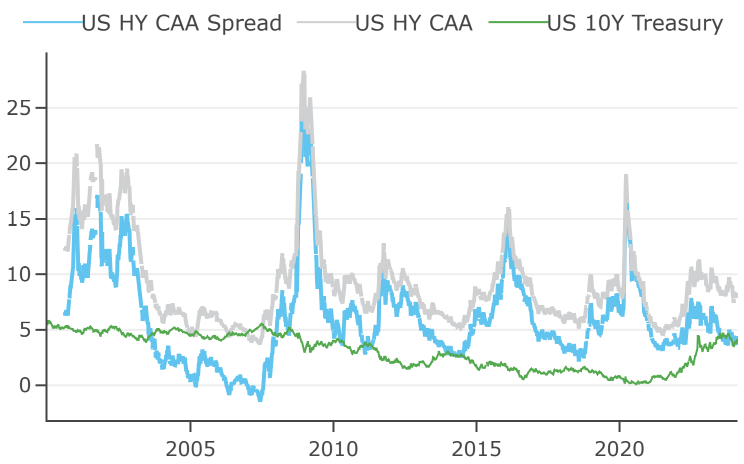
UK 10 Year Gilt Yields



US Corporate Investment Grade Yield



US Corporate High Yield



Sources | Bloomberg as at Feb 2024

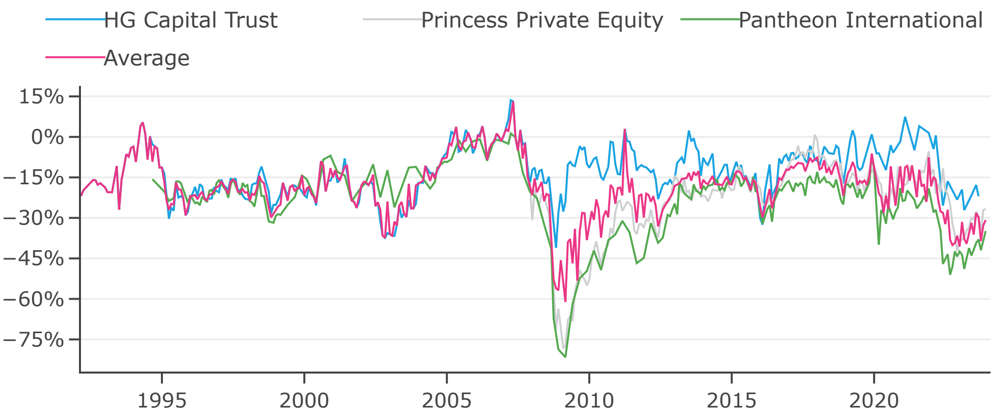
Alternatives

The IRR on Core Private Infrastructure now offers over 2.7% 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

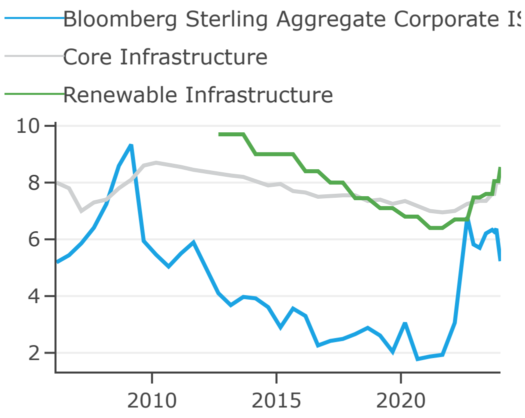
Listed Private Equity

Discount To NAVs



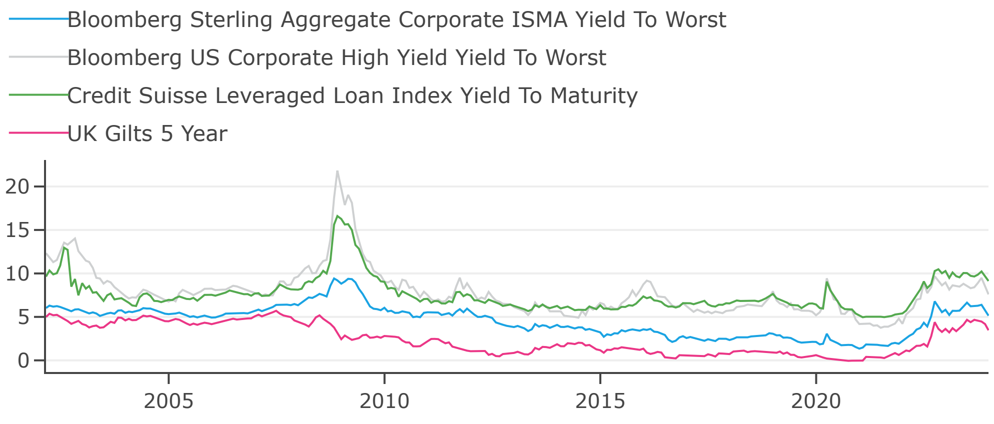
Infrastructure

Infrastructure Discount Rates vs Bond Yields



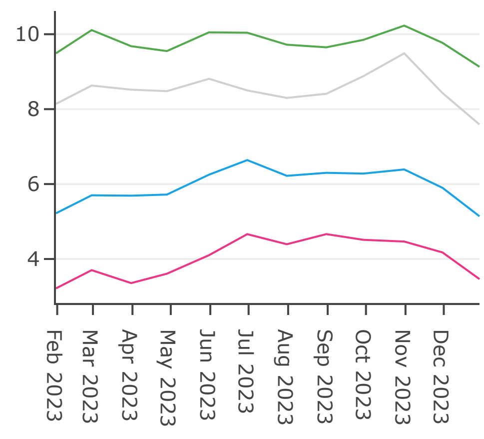
Contractual Income

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 Feb 2024

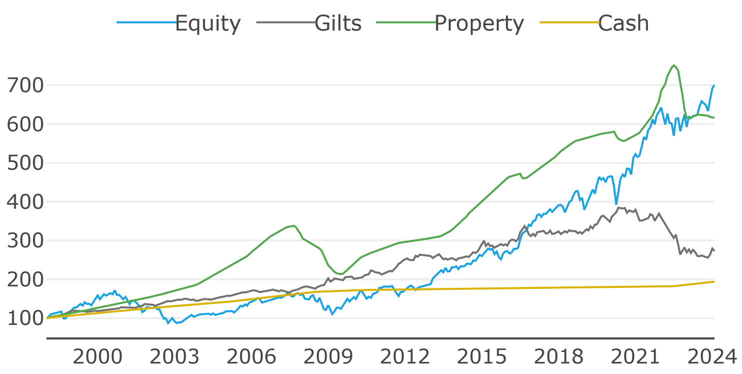
Property

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% in 2022 and been flat 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.

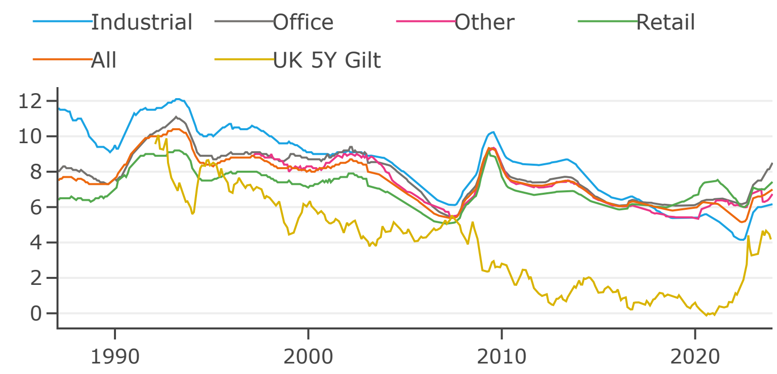
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

UK Commercial Property Market

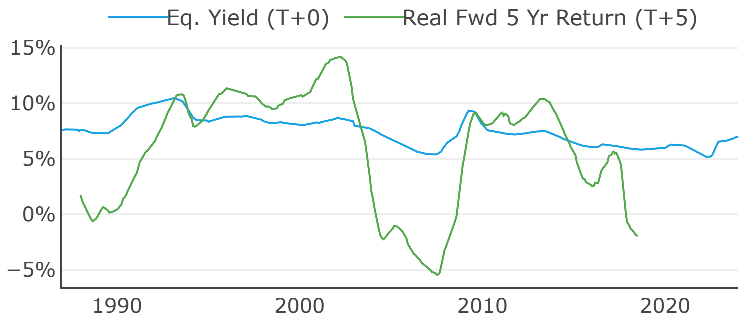
25 Years Of Return 1998=100



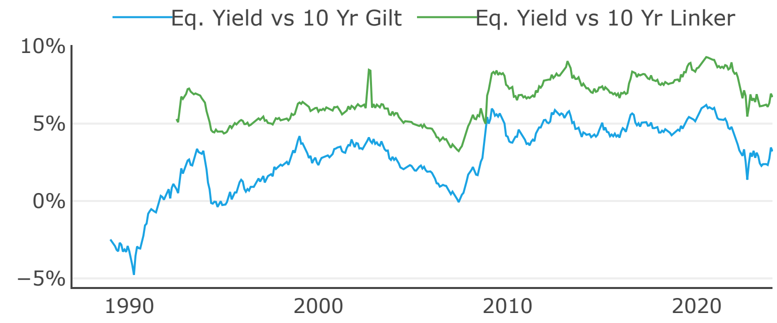
Equivalent Yields vs Gilt Yields %



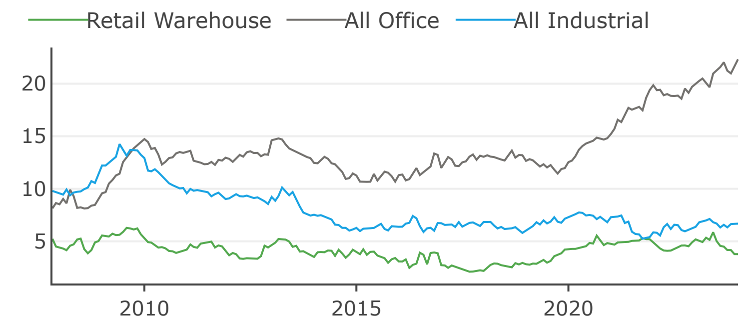
MSCI UK All Property Monthly TR Index %



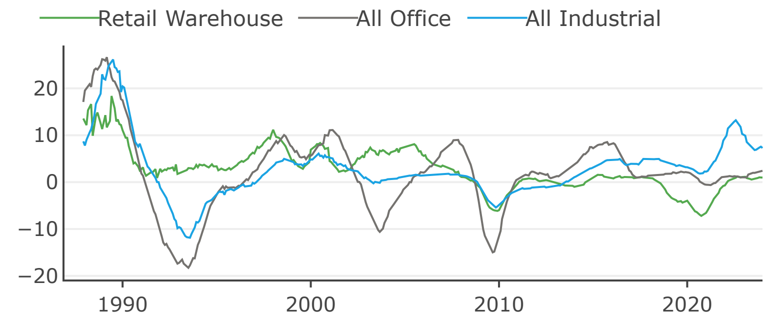
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



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

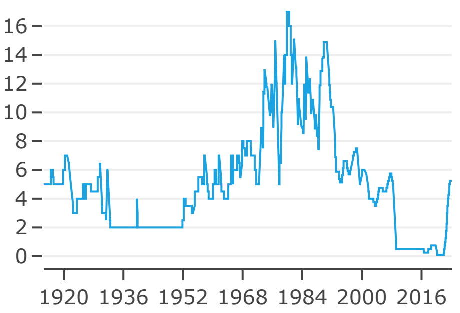
Cash

In its February MPC meeting, **the BoE finally moved away from discussing how high interest rates could go**, instead focussing on 'how long do we have to maintain this stance', essentially suggesting the end of their tightening cycle. This shift in sentiment is important as it puts the BoE back in line with other major central banks and sets up the question of the first rate cut.

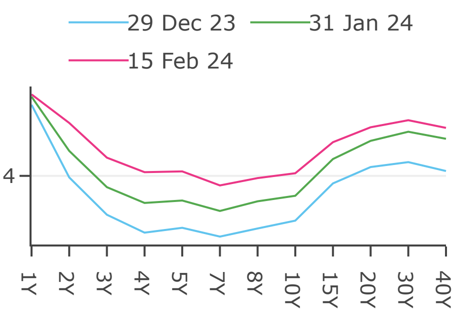
Although **no one can predict exactly when the first cut will be**, our view is that certain conditions must be met. Firstly, headline CPI needs to be closer to 3%; secondly, private wage growth needs to be closer to 3.5%; finally, unemployment needs to be closer to the Bank’s Non Accelerating Inflation Rate of Unemployment (NAIRU) 4.5-5%. These conditions are unlikely to take place until Q3/Q4 ’24.

UK Sterling Market

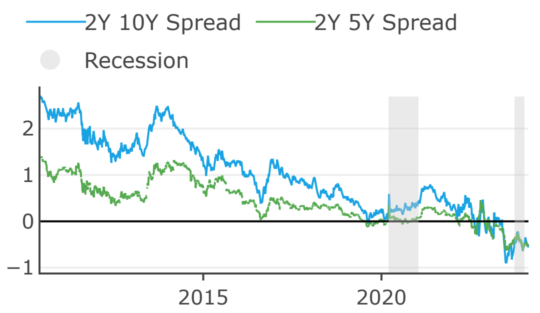
Official Bank Rate



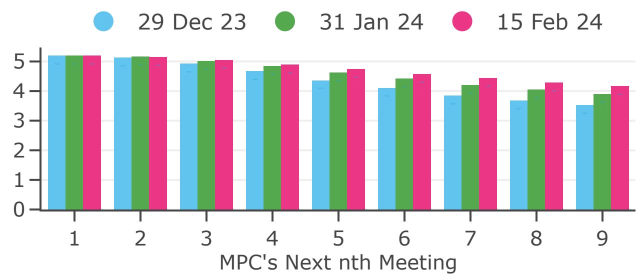
UK Gilt Curve



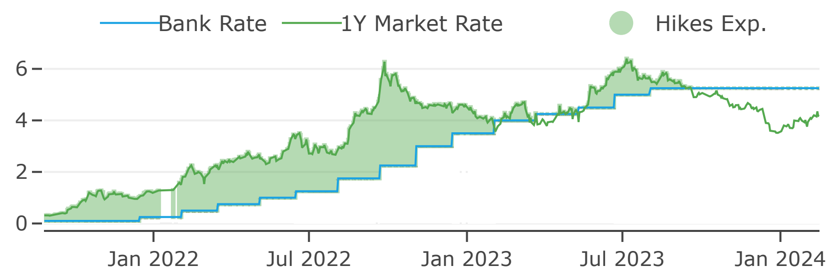
Gilt Spreads



Rate Expectations For Future MPC Meetings



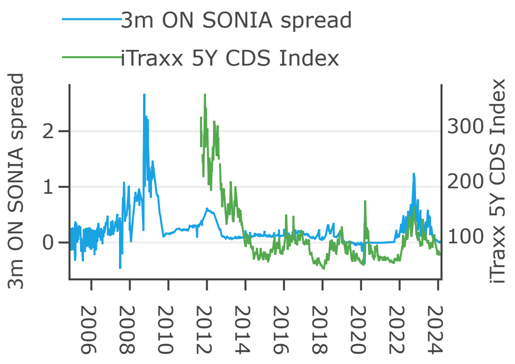
1Y Forward Rate Expectations



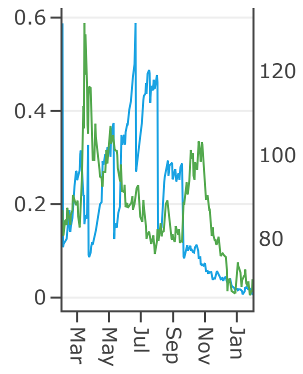
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2023					2024
	Aug...	Sep...	Oct...	Nov...	Dec...	Jan...
RPI	9.10	8.90	6.10	5.30	5.20	4.90
CPI	6.70	6.70	4.60	3.90	4.00	4.00
CPI Core	6.20	6.10	5.70	5.10	5.10	5.10
CPI Services	6.80	6.90	6.60	6.30	6.40	6.50
CPI Goods	6.30	6.20	2.90	2.00	1.90	1.80

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 Feb 2024

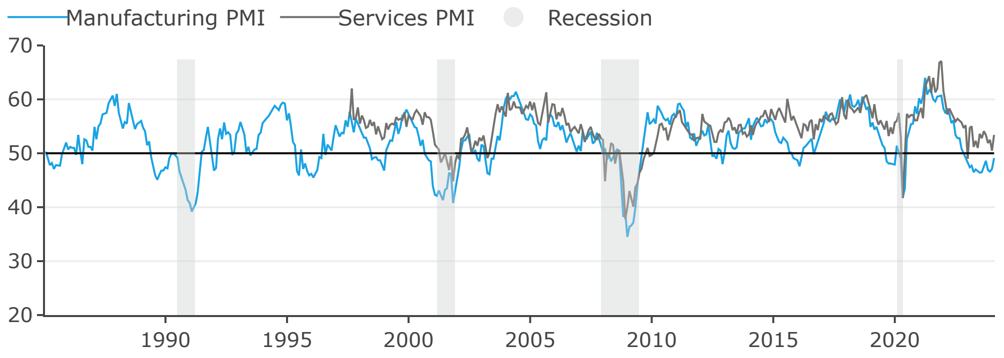
GROWTH

Global PMIs

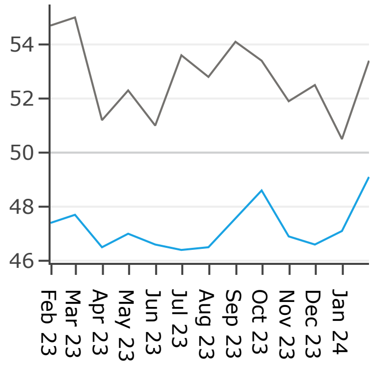
Leading indicators turned up in January, almost across the board. The top right chart shows US Services PMI (in grey) is at levels consistent with solid expansion, but that **Manufacturing PMI is also booting up** towards 50 and away from the recession threshold of 45.

It's a similar story in the UK where Manufacturing is emerging from recession while Services continues its two month recovery **- the technical recession of H2 23 notwithstanding**. Even **Eurozone Manufacturing is showing a pulse**.

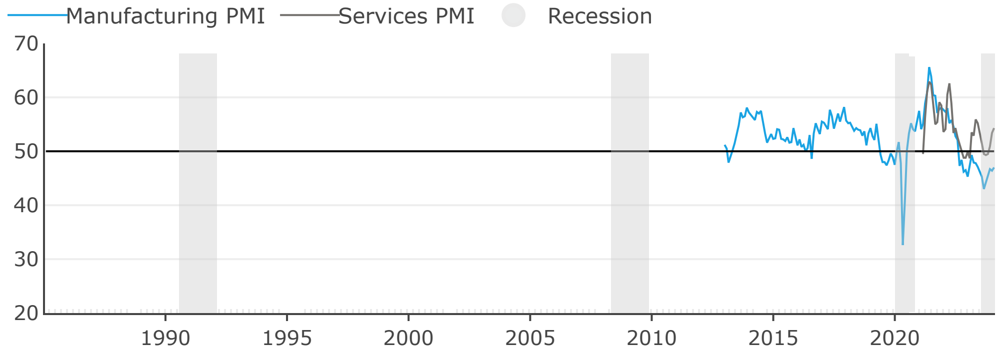
United States



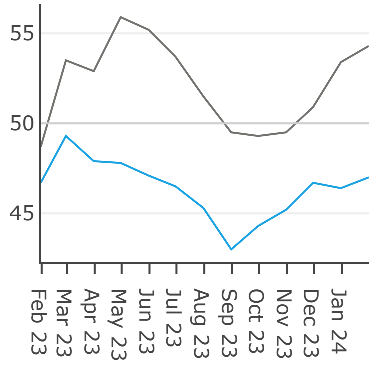
Last 12 Months



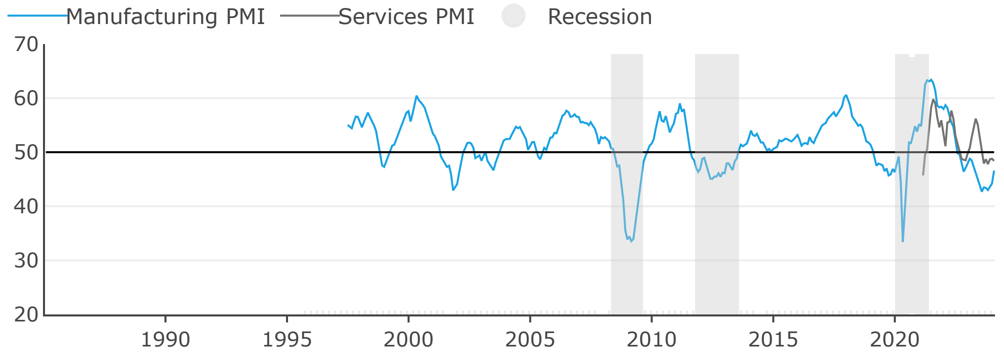
United Kingdom



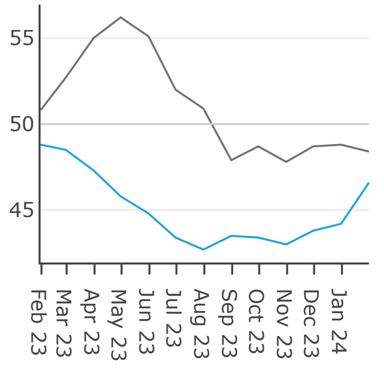
Last 12 Months



Eurozone



Last 12 Months

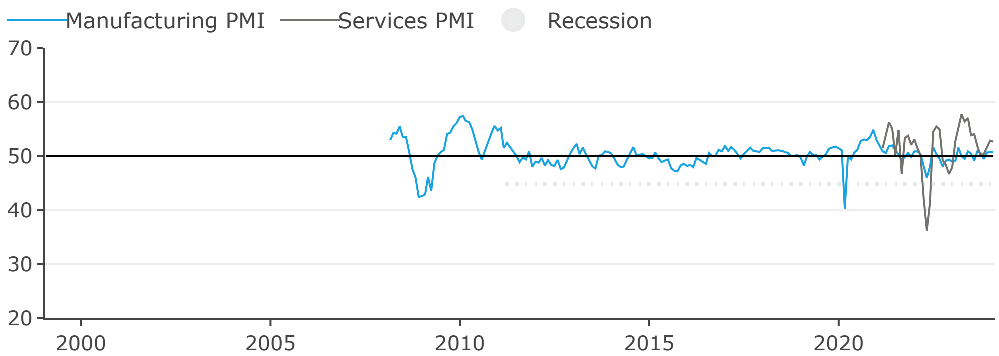


Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Feb 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

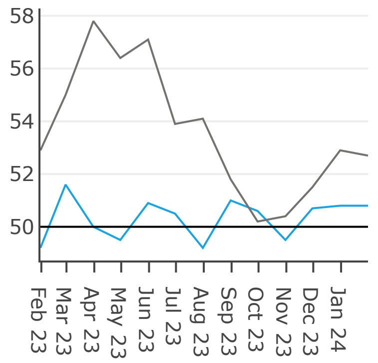
Global PMIs

Global leading indicators therefore continue to hold up with Services still stronger than Manufacturing (bottom right chart) despite its recent recovery to a neutral 50 reading.

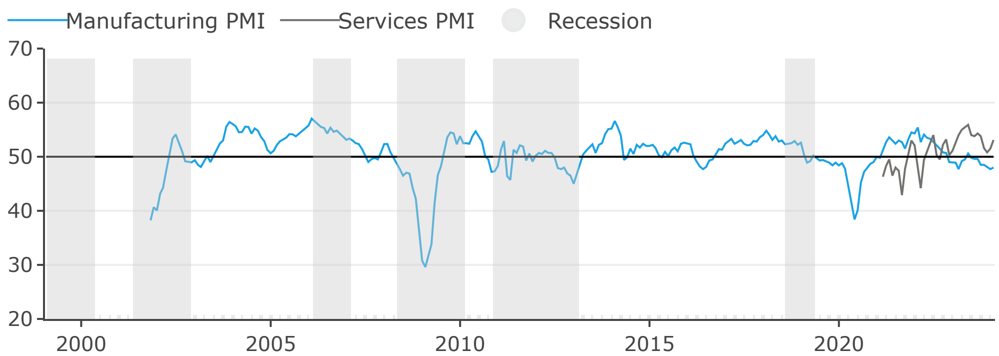
China



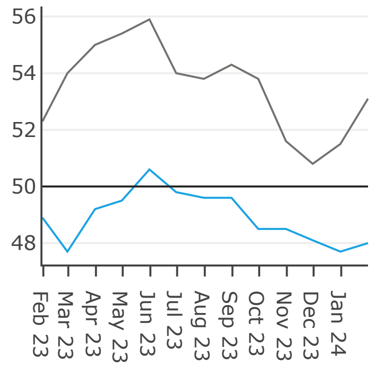
Last 12 Months



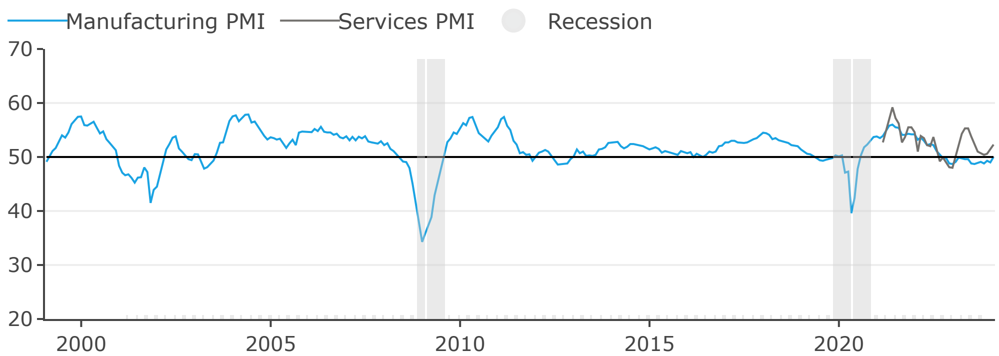
Japan



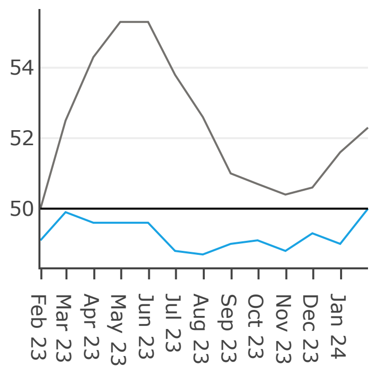
Last 12 Months



Global



Last 12 Months



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

Earnings

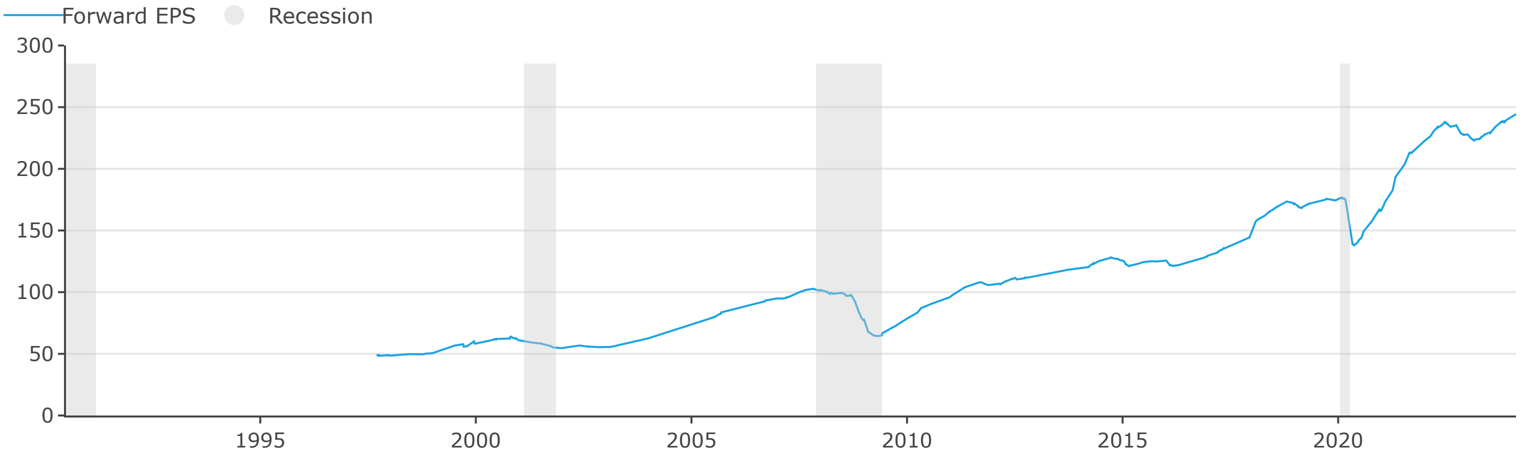
Consensus forward earnings estimates continue to recover while trailing earnings continue to flatline**.**

Q4 earnings season has been rather strong for the S&P500. With 93% of companies now having reported, EPS are looking to end up around 7% year-over-year for the quarter. Only three sectors have down earnings year-over-year - Energy and Materials on lower commodity prices (not surprising given the manufacturing recession and de-stocking), and Healthcare (where the pandemic pulled forward earnings which are now in an air pocket). Elsewhere strength is observed across IT but also in Consumer Discretionary segments such as Leisure and Retail.

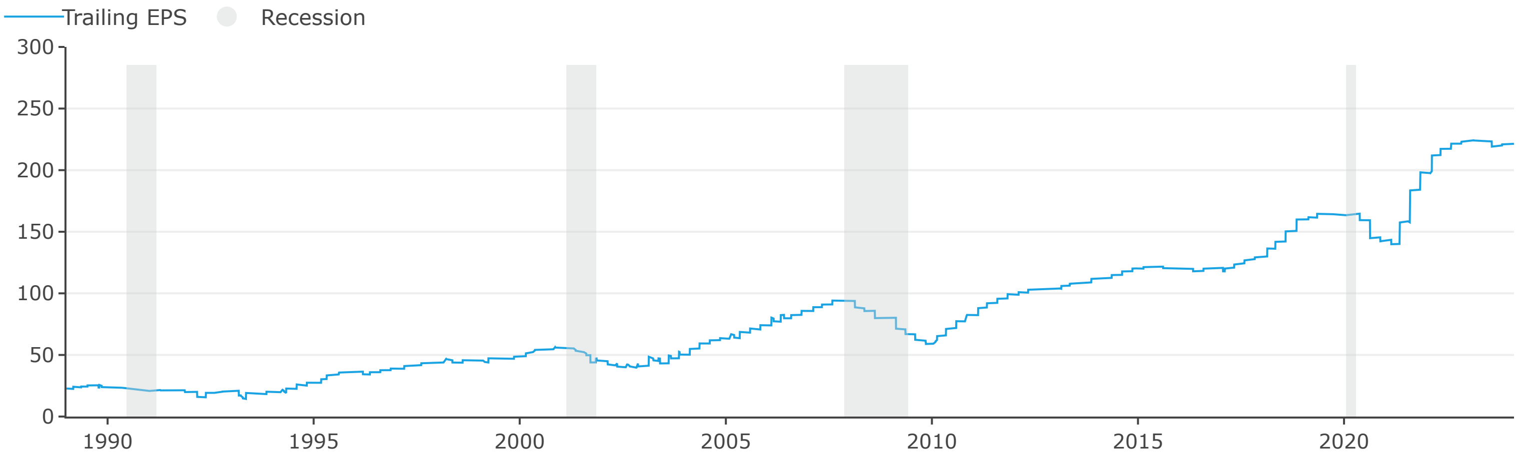
For now at least, earnings could be in position to take over from PE re-rating in driving the market higher, although clearly a recession would change that.

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 Feb 2024

GROWTH

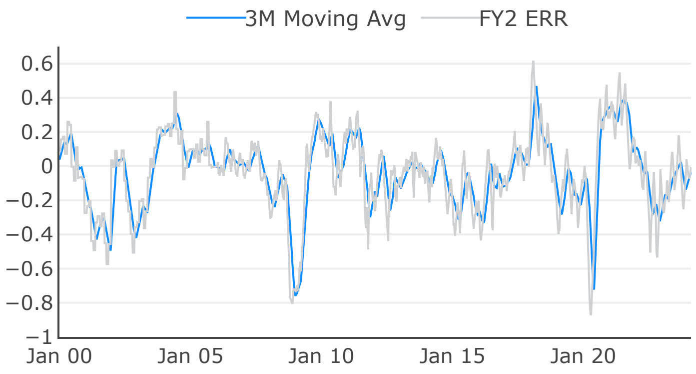
Earnings

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.

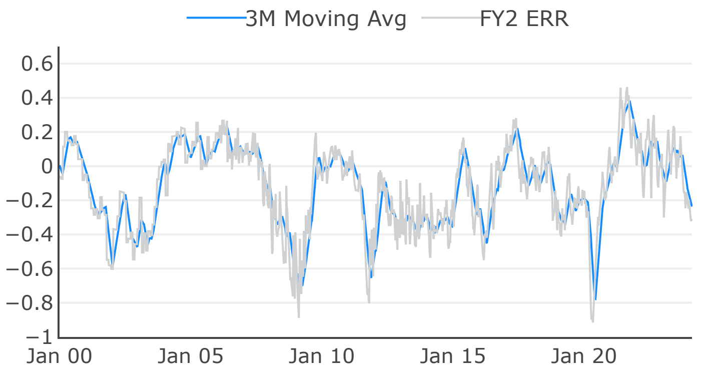
The overall assessment is that earnings breadth is ticking up in the US (though there are still more downgrades than upgrades), **and Japan stands out as the only major market with positive net earnings breadth.**

Global Earnings Revisions Ratios

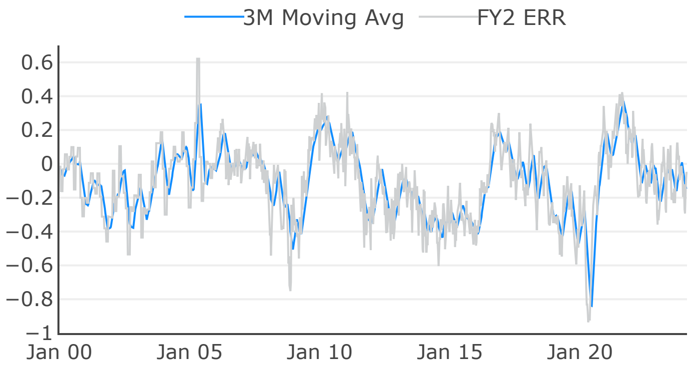
USA



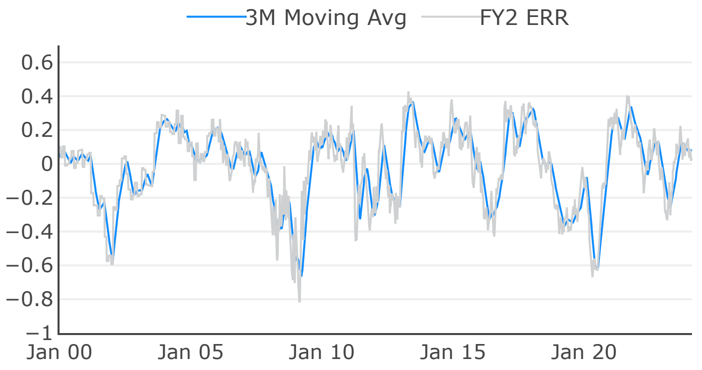
Eurozone



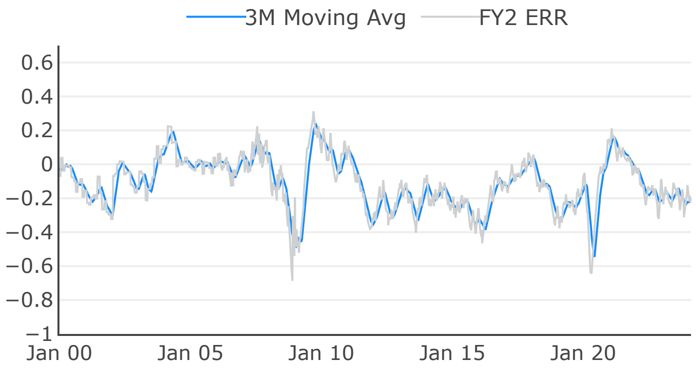
UK



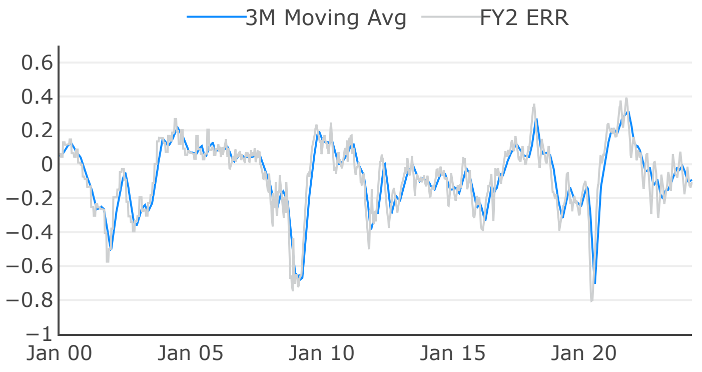
Japan



Emerging Markets



World



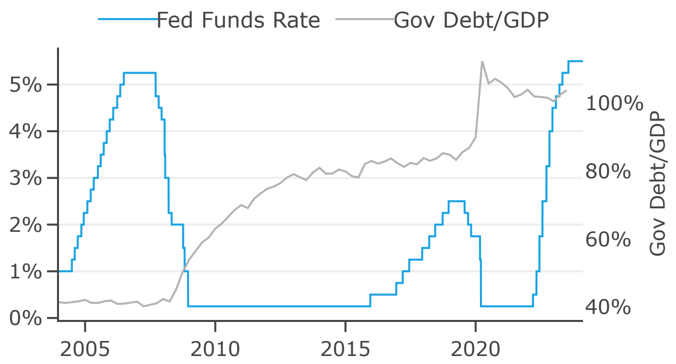
Sources | Eikon, the MSCI index has been used for each respective region, as at Feb 2024.

Interest Rates

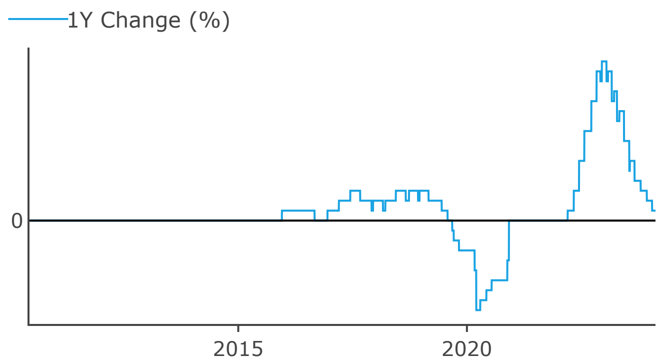
The December FOMC meeting had all but confirmed the US tightening cycle was over. Now, we would point out the middle chart on the left hand side - because inflation has decelerated so quickly, **the REAL Fed Funds rate (nominal interest rate less CPI) is rising**. Our view is that with Fed Funds at 5.5% and inflation coming back towards 2% (currently 3.1%), 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 3x25 cuts, almost one at each scheduled meeting between July and December.

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

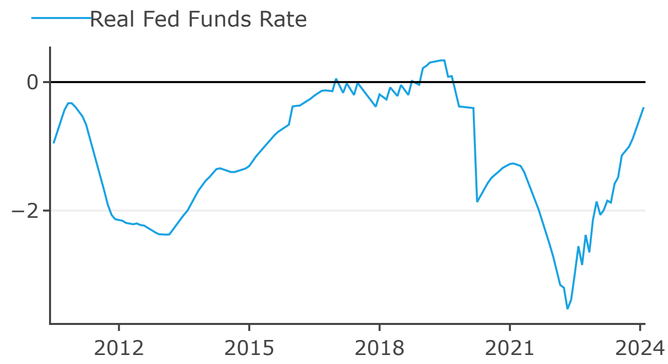
Fed Funds Rate



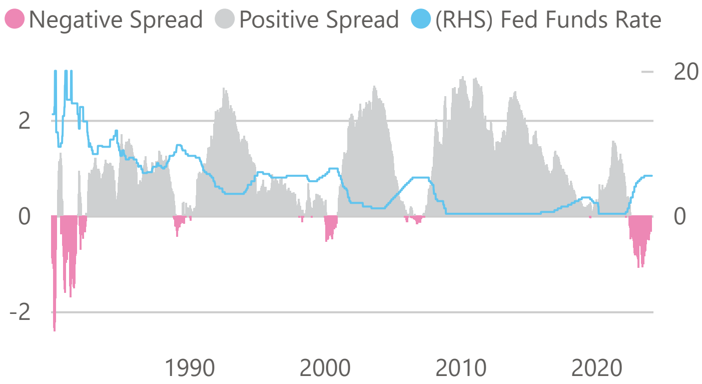
Change in Fed Funds Rate



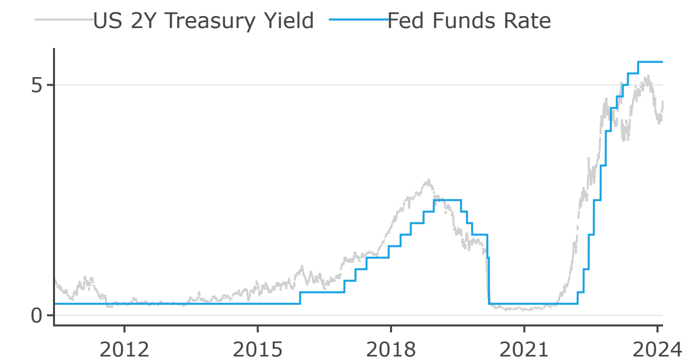
Real Fed Funds Rate (Using 2Y MA CPI)



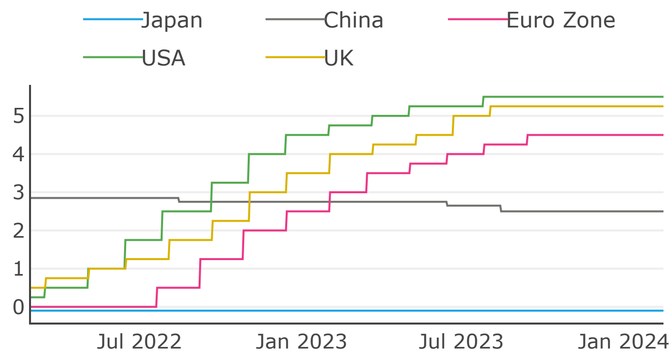
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Feb 2024

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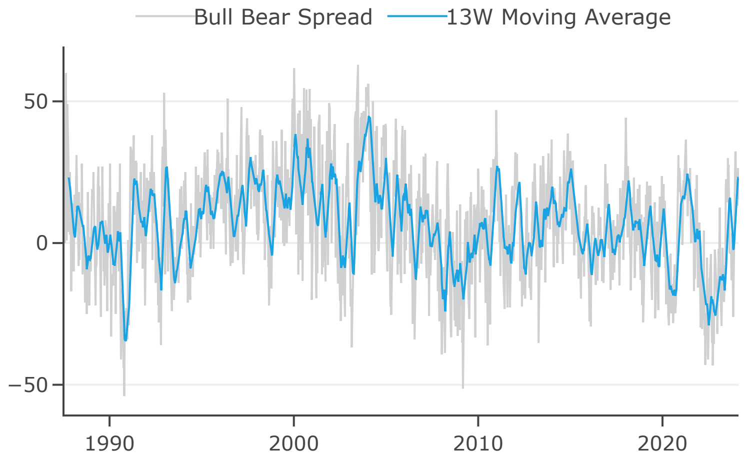
Sentiment

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 6.6/10). 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.

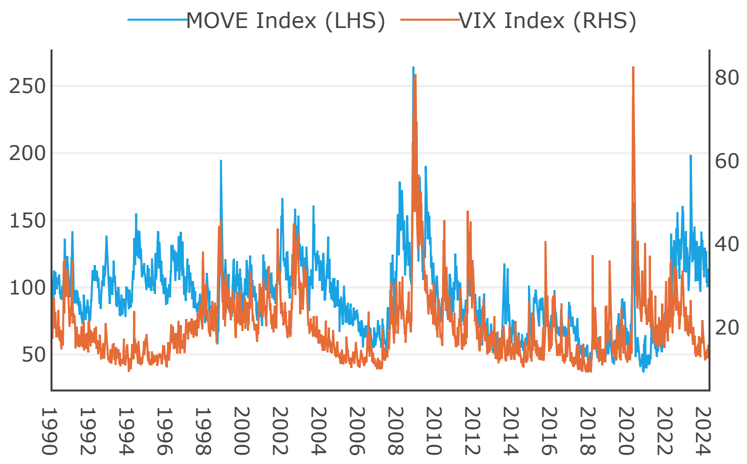
Drivers of the normalisation in sentiment, according to Michael Hartnett, include, "strong inflows to HY bonds, better credit market technicals and a big improvement in equity market breadth." Similarly, Bull Bear spread from the American Association of Individual Investors (AAII), (top left) shows **individual 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

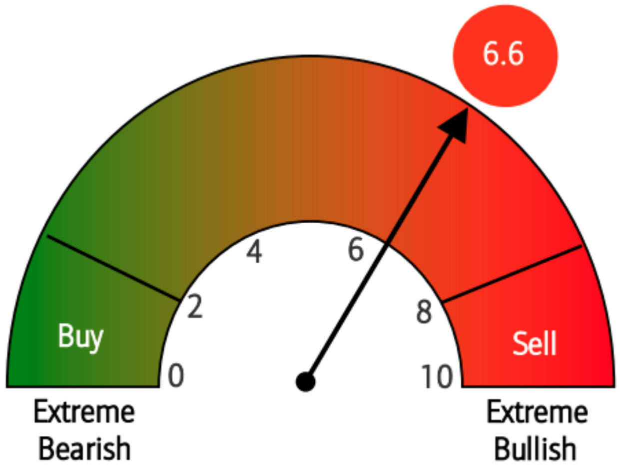
AAII Bull Bear Spread



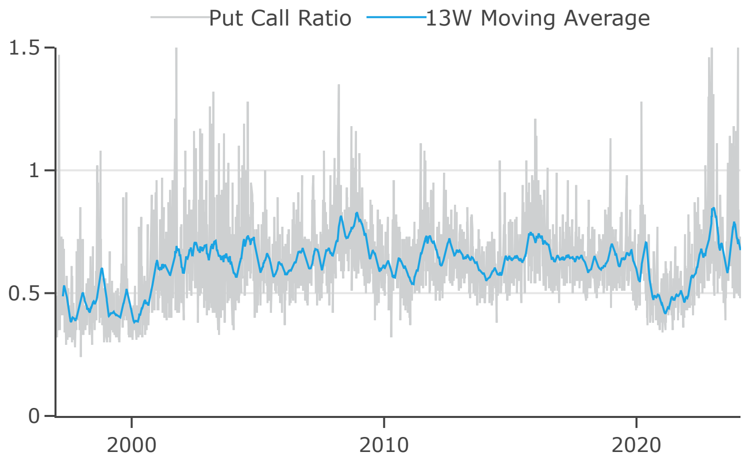
Equity vs. Bond Sentiment



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 Feb 2024

Fund Flows

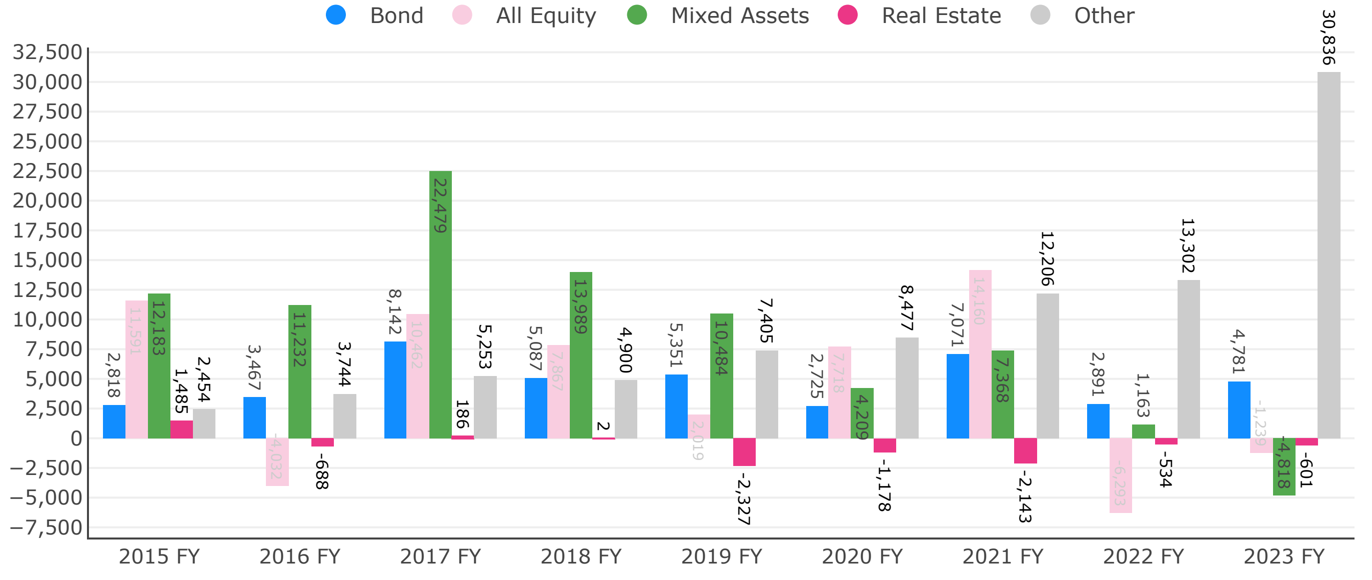
This page captures UK investment fund flows only, as a measure of how optimistic or pessimistic sentiment has become.

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.

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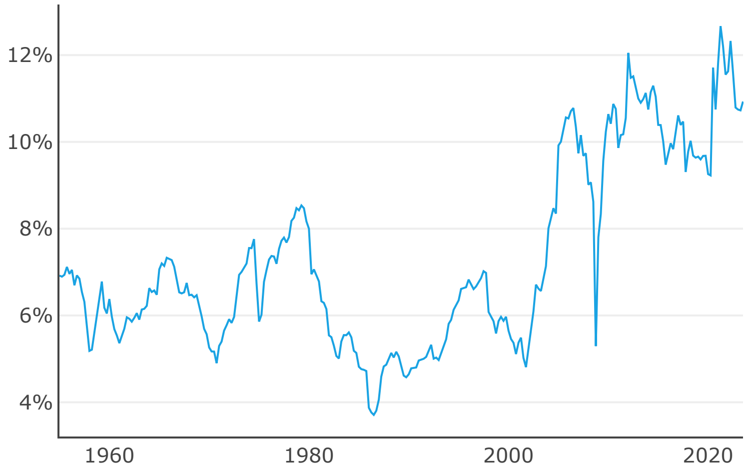
The Big Picture

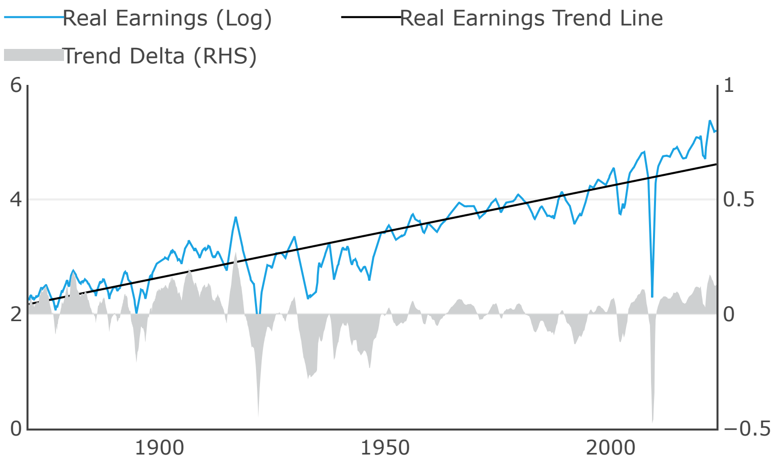
Here we highlight some longer-term imbalances that, **should** they correct, would have have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. It's corollary (not shown)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

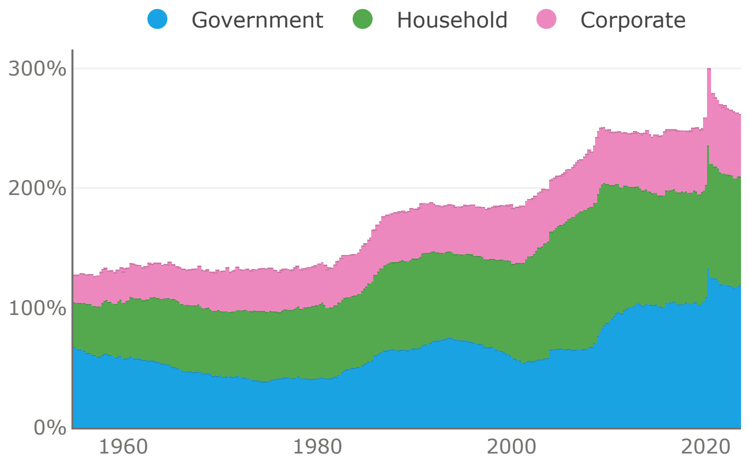
Profit Share of GDP



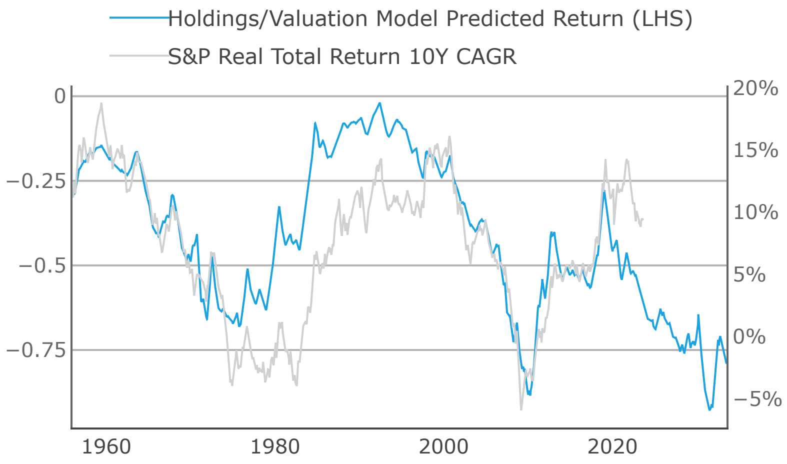
Earnings Deviation From Trend



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 Feb 2024.

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