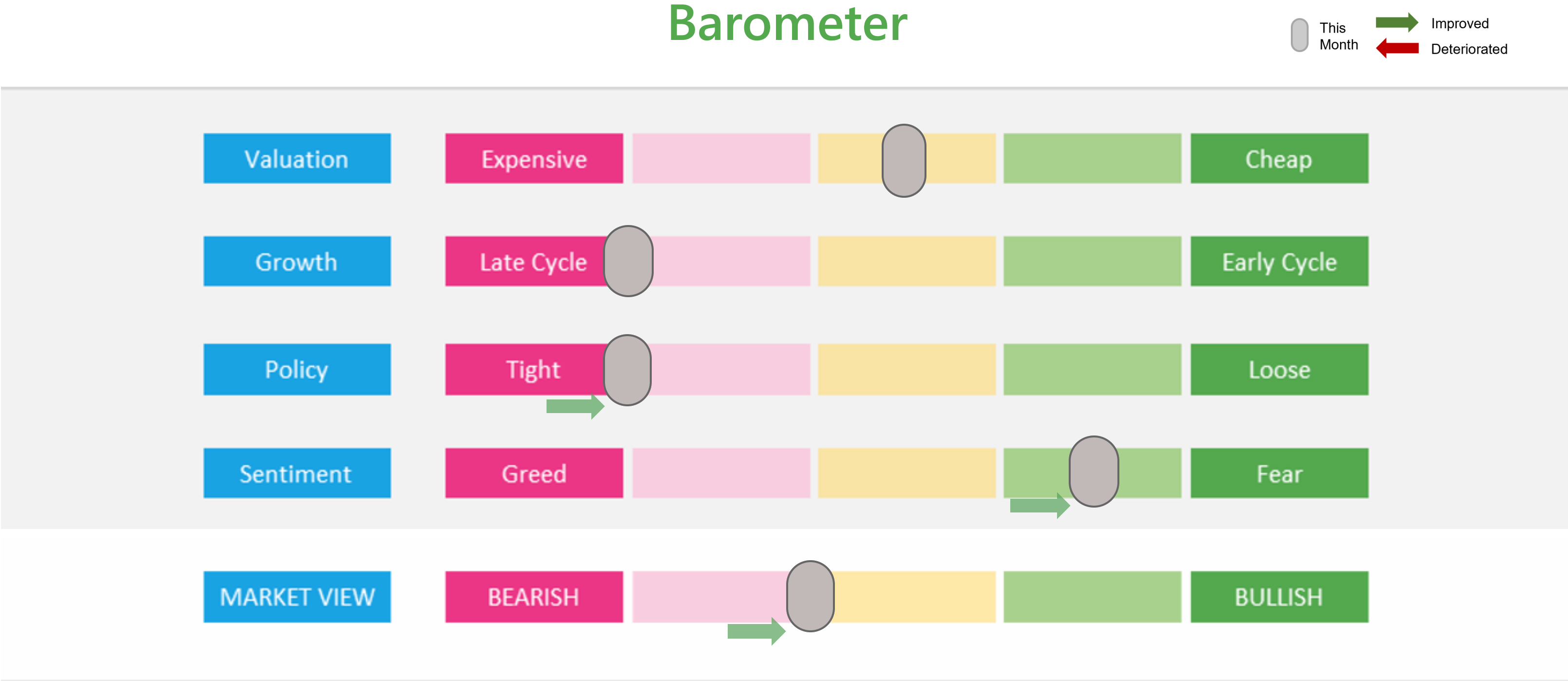
NOVEMBER 2023

# Market Barometer

## Barometer




## On the plateau of Table Mountain (aka at Peak Rates)

Bank of England chief economist Huw Pill refers to the Bank's approach to interest rates as resembling **Table Mountain, not the Matterhorn**.

Table Mountain is wide and flat where the Matterhorn is high and steep. The indication is that **we should not expect interest rates to move very much** (up or down) from the current 5.25% as inflation is squeezed from the system.

Federal Reserve chairman **Jay Powell made similar comments** at the 1 November FOMC meeting, saying that "supply and demand conditions continue to come into better balance," which the market took to mean that we may already be past the last rate hike in this cycle.

**Bond markets have been responding positively to these developments**, which has also helped equity markets given the strongly positive correlation between stocks and bonds. We highlight this in our new Charts of the Month page (p3).

**Earnings season has been progressing reasonably well** with forward earnings estimates continuing to be revised higher.

Leading indicators are not signalling the all clear on the recession front, but current activity means **we remain close to normal (but still slightly below average) levels of risk appetite.**

# Contents

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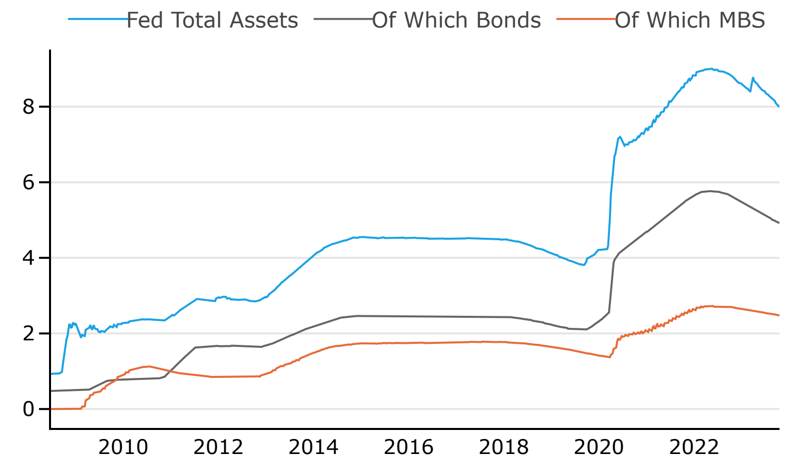
TOP OF MIND

# Charts of the Month

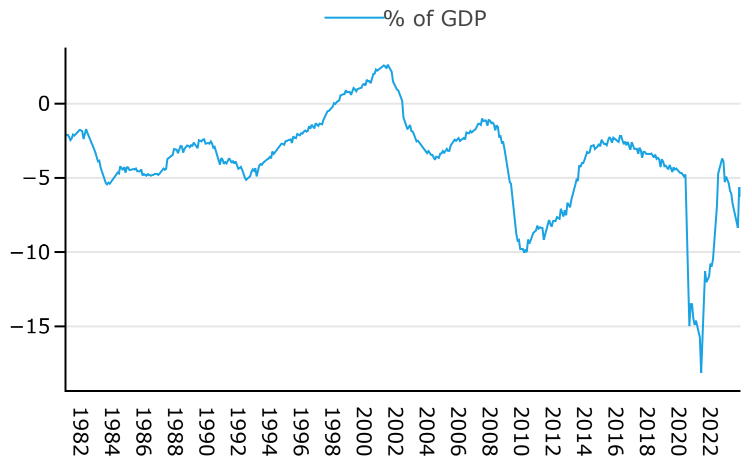
**The concept of "fiscal dominance" is coming to the fore**. The US deficit is an eye-catching 6% of GDP at the peak of an economic cycle, with full employment, while as the top right chart shows, in the 1980s and 1990s it reached 5% only in the depths of recession. So there is going to be an abundant supply of US treasuries (and UK gilts). Demand for reserve assets is also constrained by central banks allowing their bond portfolios to roll off. Top left shows this effect in the US, with the US treasury bond portfolio having fallen by $800bn since June last year. This spooked bond markets in Q3.

**Lower bond prices also now mean lower equity prices** - in a reversal of the prevailing trend for the last twenty years. This change in the stock bond correlation has come about as inflation expectations have risen, and is unlikely to reverse unless we go back to worrying about deflation - something we do not think is likely.

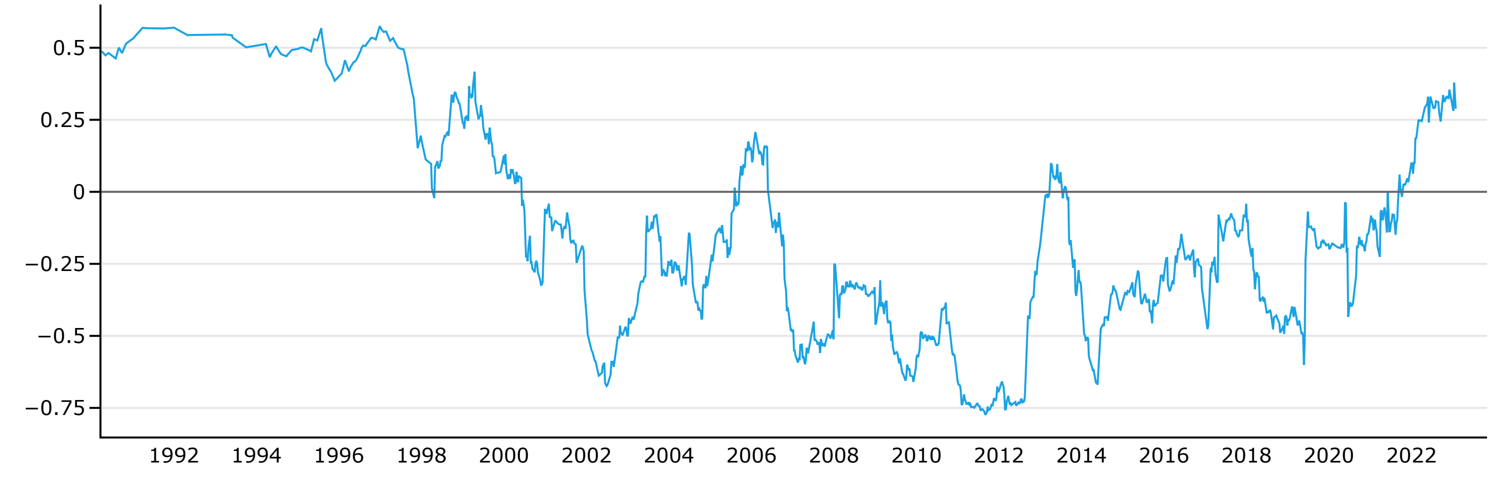
Fed Reserve Balance Sheet Assets ($trn)




US Federal Surplus/(Deficit) as % of GDP




Stock-Bond Correlation




Sources | Fed Reserve Balance Sheet, and Surplus/Deficit graphs: US Treasury, Stock-Bond Correlation: Bloomberg. All data as at Nov 2023

Note | Stock-Bond Correlation chart shows the rolling 52 week trailing correlation of weekly changes in S&P 500 index and the Bloomberg US treasury index.

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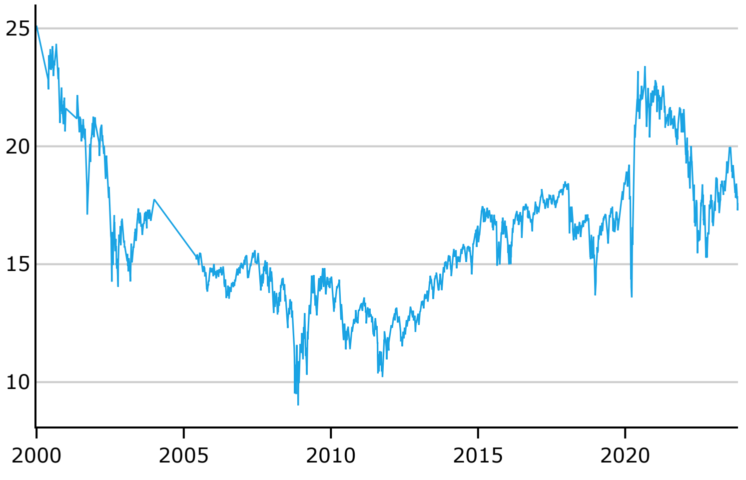
# Equity | USA

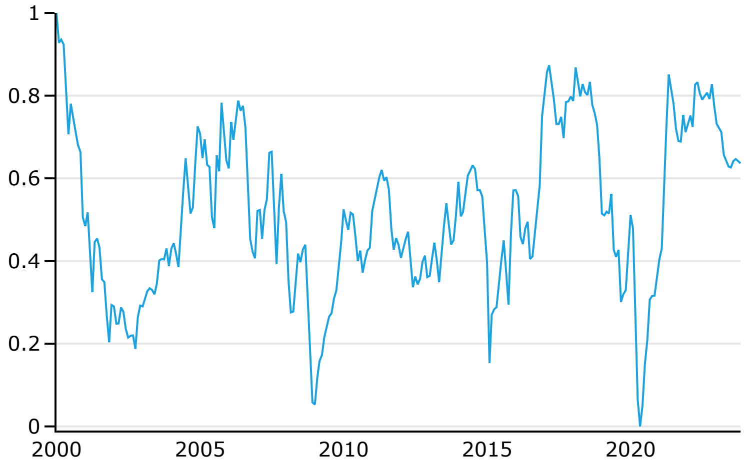
**US equity market has been correcting its overvaluation.** In the last three months the US forward PE (top left chart) has de-rated from 20x to 17.3x, with the US market correcting 6% while earnings estimates have continued to grind higher. This means the spot valuation is still above its 16.2x average since 1990 but is increasingly reasonable if earnings continue to hold up. It's interesting to note that there is a large valuation dispersion between the so-called Magnificent Seven (Apple, Microsoft, Amazon, NVIDIA, Alphabet, Tesla and Meta) and the rest of the US stock market. Those seven stocks are 27% of the S&P 500 and trade on a forward PE of 26x. The equal-weighted S&P 500 trades on a PE of 14.8x. Conclusion - the overvaluation of the S&P is concentrated in relatively few names.

## S&P 500 Valuations

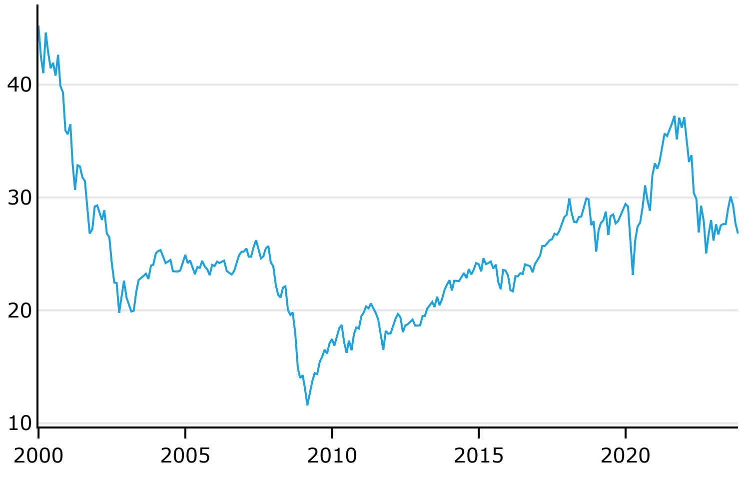
S&P 500 Forward PE



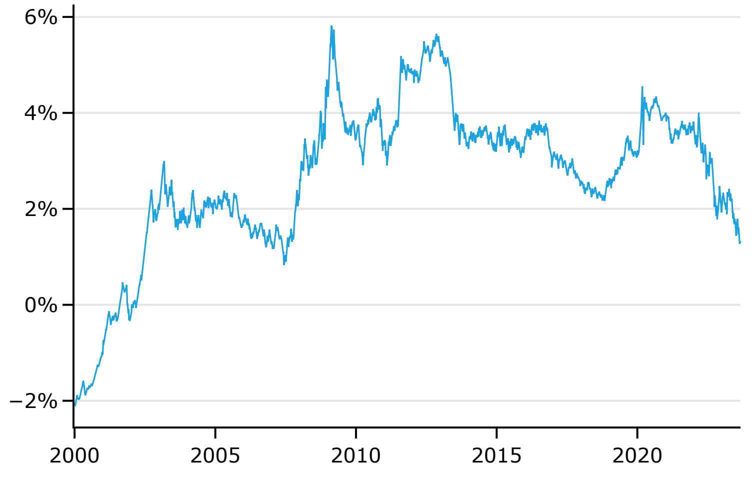

Composite Value Indicator Model




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.

Sources | S&P 500 PE: Bloomberg, CVI Model: CCLA, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of Nov 2023

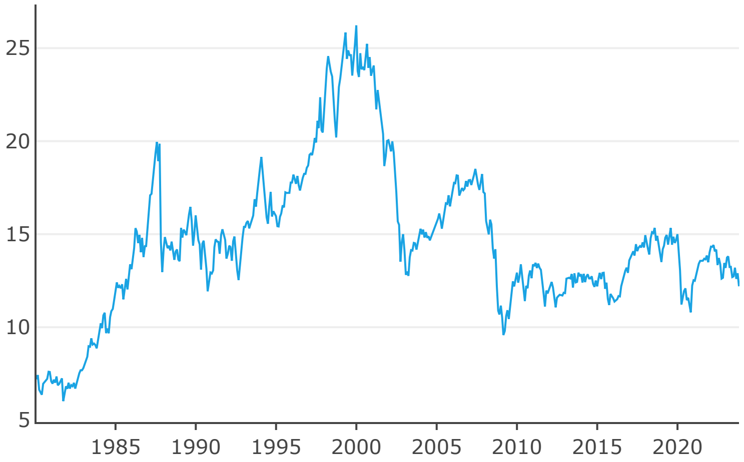
VALUATION

# Equity | Regional

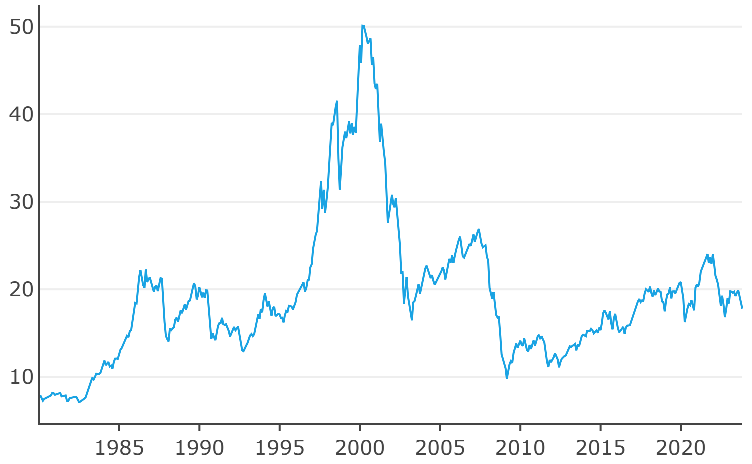
**Outside of the US, (which is 67% of MSCI World), equity markets look either very reasonable value (UK, Europe-ex-UK) or outright cheap (Japan, EM).** The de-rating of last year is notable everywhere. The UK Shiller PE of 12.2 gives an earnings yield of 8%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 17.8 gives a 5.6% forward real return. Asia and Japan look similarly good value to us.

## Europe

UK | Shiller P/E

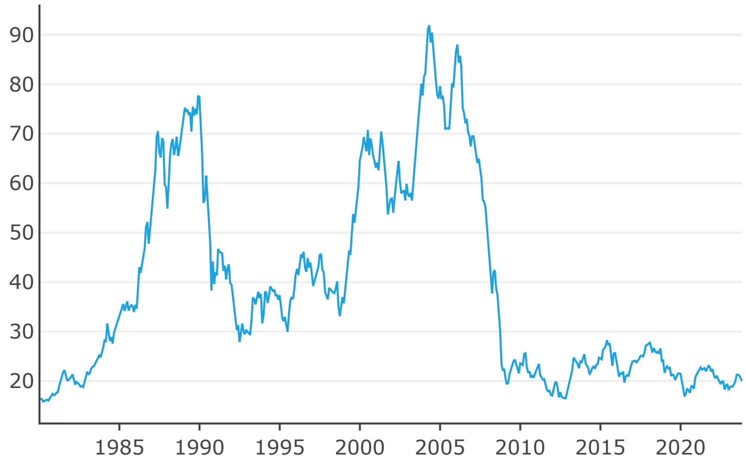



Europe (Ex-UK) | Shiller P/E

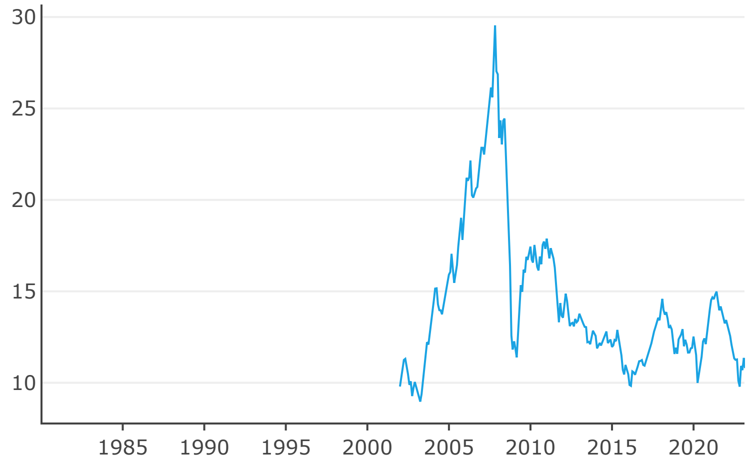



## Asia & Emerging Markets

Japan | Shiller P/E




EM | Shiller P/E




Sources | Shiller P/Es: Morgan Stanley as of Nov 2023

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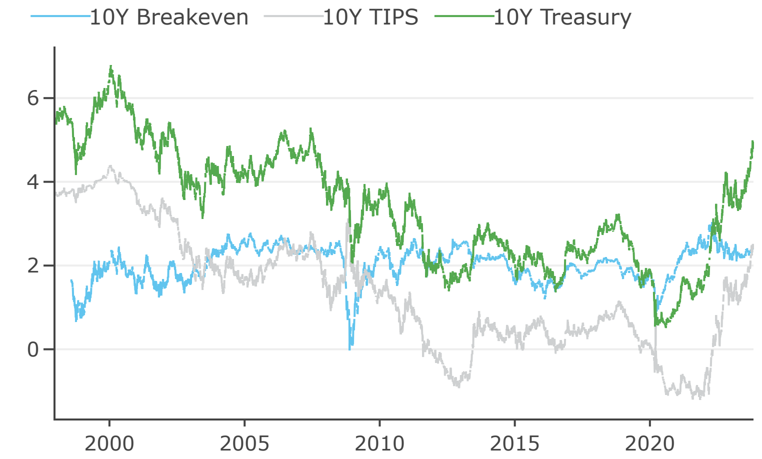
# Bonds

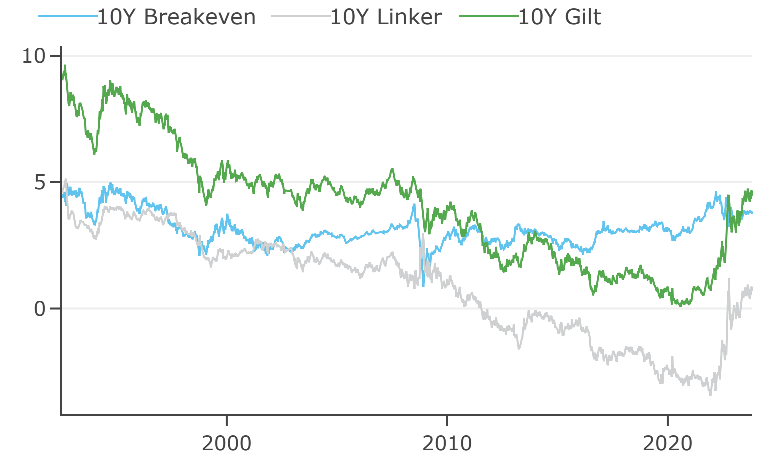
**All of the back up in bond yields in the last two years has come from rising real yields**. Breakeven inflation is hovering around our view of fair too, with the 10 year US breakeven implying 2.4% 10 year average US CPI. Investors who fear a resurgence of inflation may consider owning index linked bonds now. Separately, HY bonds have wiped some of their gains made earlier this year; yields rose from 8% in Sept to 9.6% in the latest reading. This has been on the back of rising Treasury yields and not spreads. **It may take a recession, though, for duration to be rewarded**, even if spreads would widen.

## Global Government & Corporate Yields

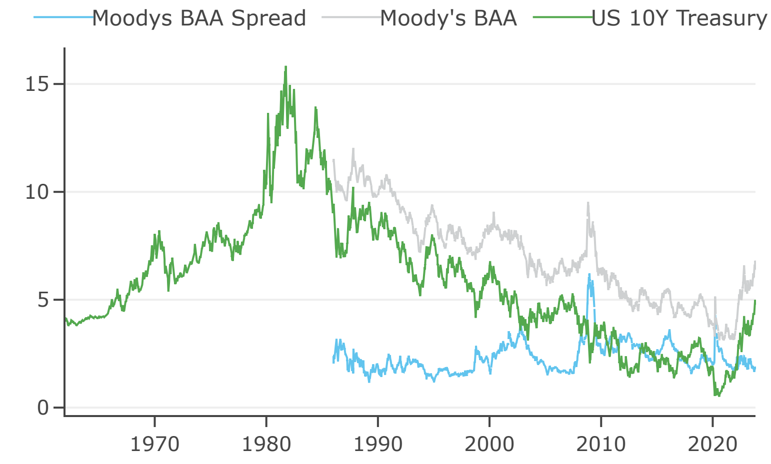
### US 10 Year Treasury Yields



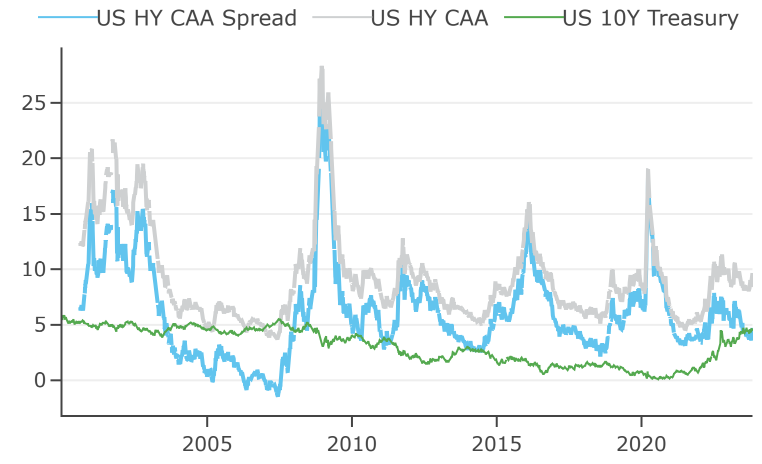

### UK 10 Year Gilt Yields




### US Corporate Investment Grade Yield




### US Corporate High Yield




Sources | Bloomberg as at Nov 2023

VALUATION

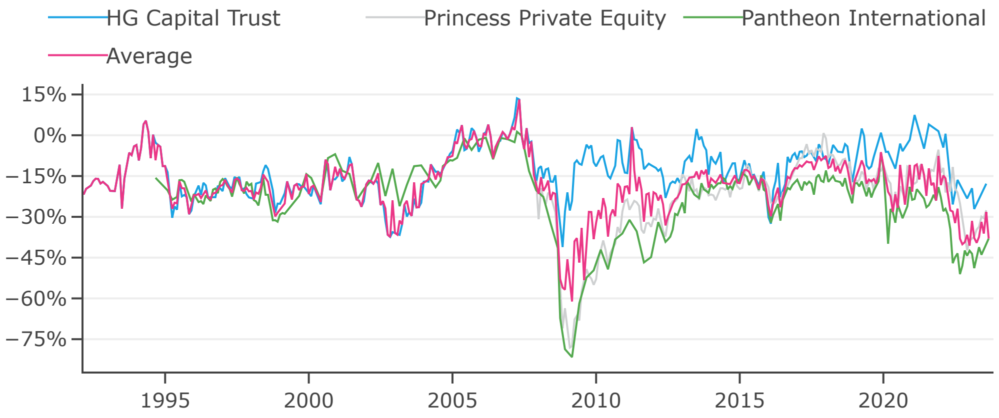
# Alternatives

**The IRR on Core Private Infrastructure now offers close to 1.30% return spread over IG corporate bonds.** On its own this makes it a less compelling investment opportunity as an asset class. Listed Infrastructure trades at 10-15% discounts to net asset value (NAV), which is somewhat more interesting, especially where managers can add value via development. Similarly, Private Equity multiples are no longer at a large discount to public equity, although **Listed PE now trades at 17-40% discounts** to the underlying NAVs which we think is an opportunity. **Levered Loan yields have risen from 5% to almost 10%**.

## Global Valuations

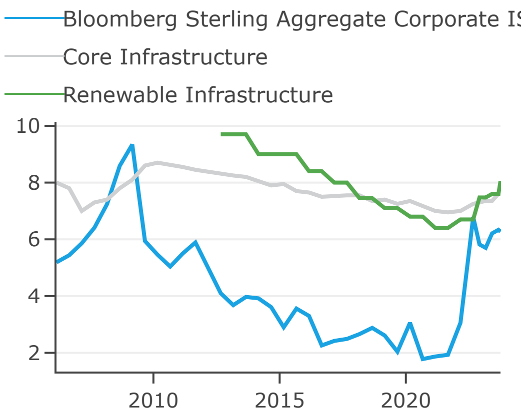
### Listed Private Equity

Discount To NAVs



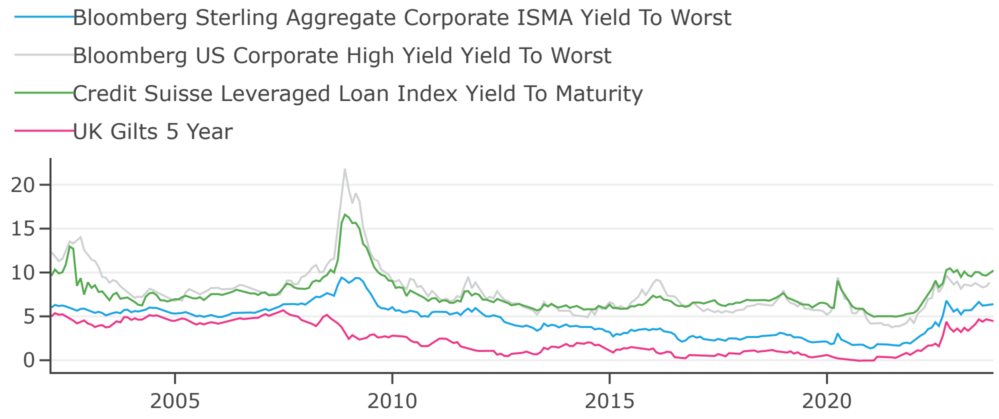

### Infrastructure

Infrastructure Discount Rates vs Bond Yields



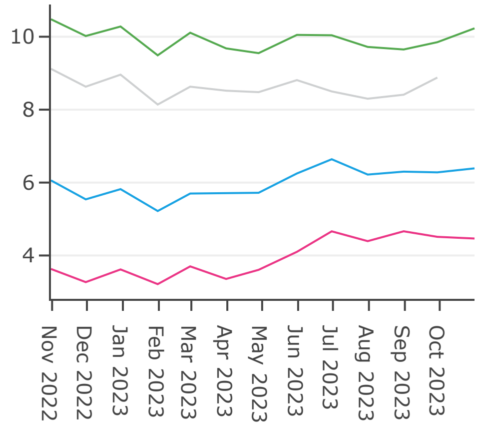

### Contractual Income

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 Nov 2023

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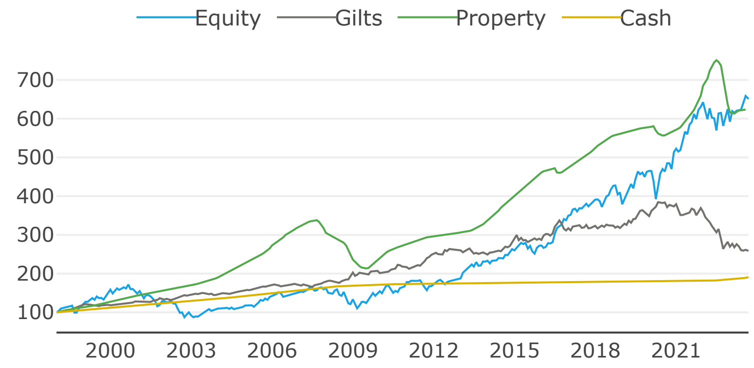
# Property

**The UK Commercial Property market offers reasonable yields,** (6.7% 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.

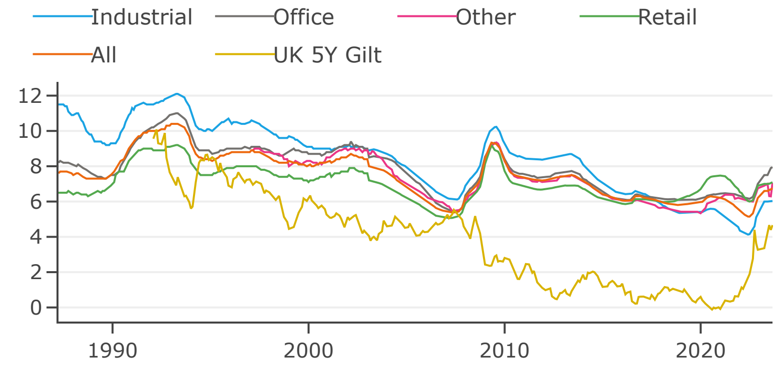
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

## UK Commercial Property Market

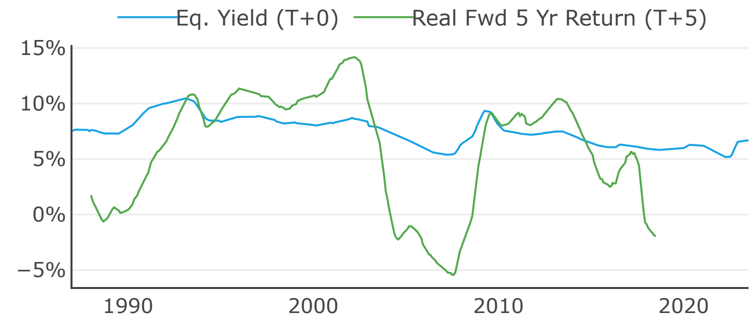
### 25 Years Of Return 1998=100



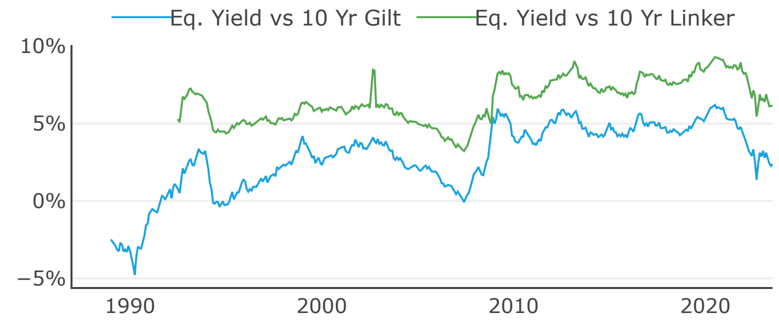

### Equivalent Yields vs Gilt Yields %



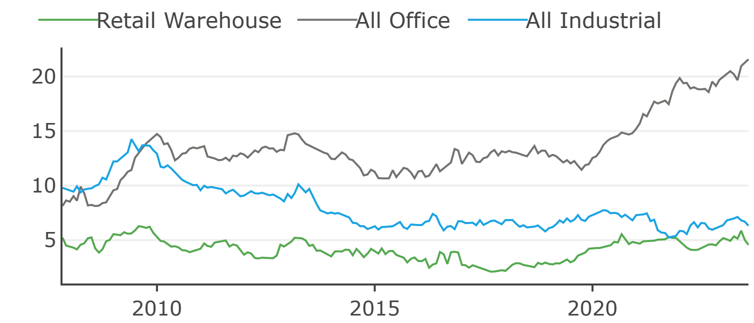

### MSCI UK All Property Monthly TR Index %



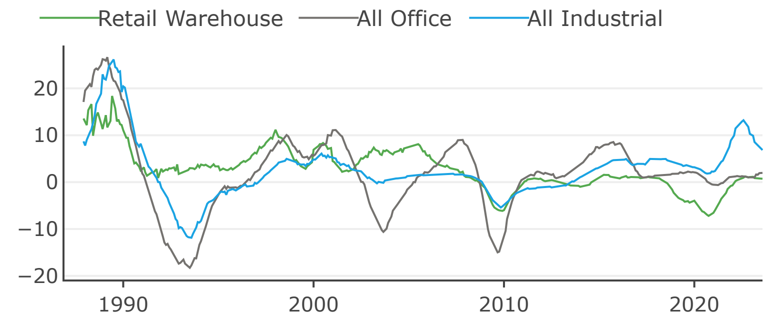

### MSCI UK All Property Index - Equivalent Yield Spreads




### Vacancy Rate %




### Nominal Rental Value YoY Growth %




Sources | Equivalent Yields, Vacancy Rate, and Nominal Rental Value charts: MSCI UK Monthly Property Index as at Nov 2023. 25 Years of Return, All Property Monthly TR Index, and UK All Property Index - Equivalent Yield Spreads: CCLA as at July 2023

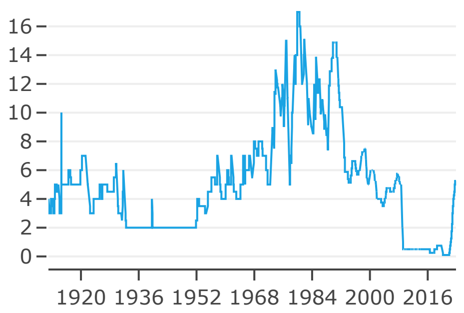
# Cash

**The BoE held rates at 5.25% for a second consecutive meeting**, likely entering the flat-lands of their "table-top" mountain. The markets, however, don't see this lasting too long, having already priced in at least two 25bps rate-cuts in 2024. This may seem premature given the stickiness in wages and new upside-risks to oil, but underlying drivers to wages are cooling and energy prices are significantly lower than last October's Ofgem cap. Even the BoE's two-year-forward inflation forecast suggests inflation below target by Nov 2025.

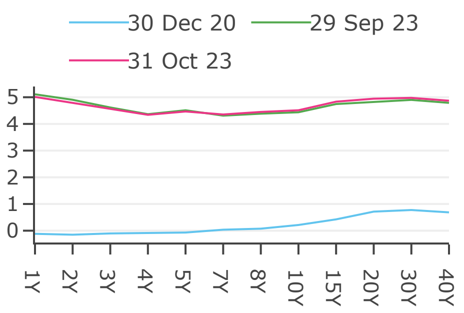
**We believe October's CPI reading should show a considerable drop, further raising the bar for any more tightening.** However, it is too soon to make a call on cuts unless it seems recession is imminent.

## UK Sterling Market

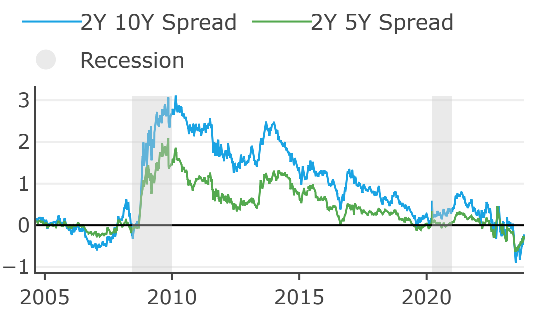
### Official Bank Rate



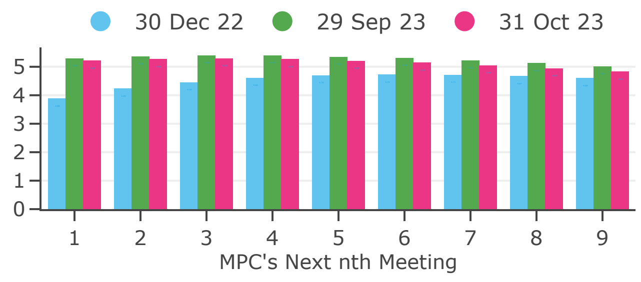

### UK Gilt Curve



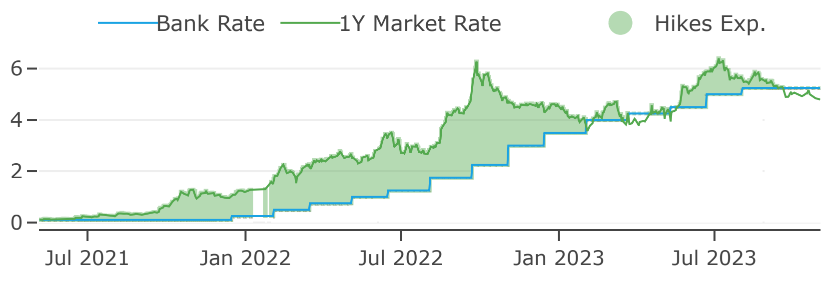

### Gilt Spreads




### Rate Expectations For Future MPC Meetings



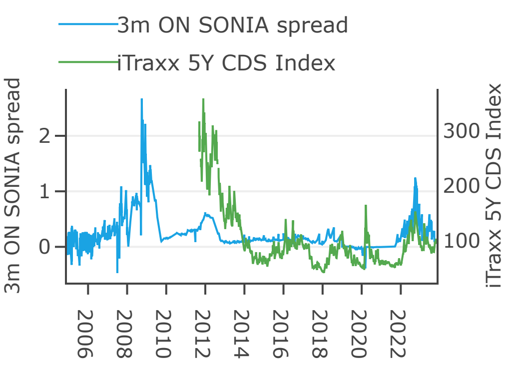

### Further Tightening Expected



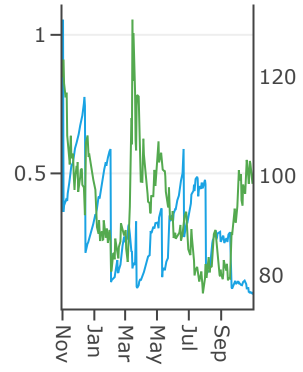

### Inflation Readings YoY% | Colour by 10Y Z-Score*

| | May | June | July | August | September |
|---|---|---|---|---|---|
| RPI | 11.30 | 10.70 | 9.00 | 9.10 | 8.90 |
| CPI | 8.70 | 7.90 | 6.80 | 6.70 | 6.70 |
| CPI Core | 7.10 | 6.90 | 6.90 | 6.20 | 6.10 |
| CPI Services | 7.40 | 7.20 | 7.40 | 6.80 | 6.90 |
| CPI Goods | 9.70 | 8.50 | 6.10 | 6.30 | 6.20 |

### Market Stress




### Last 12 Months



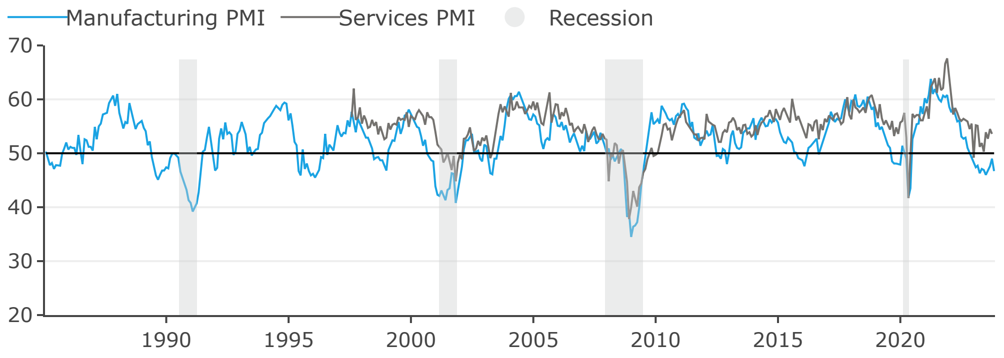

Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, highest and lowest scores as red. Bloomberg for all charts, as of Nov 2023

GROWTH

# Global PMIs

**US GDP registered a scarcely credible 4.9% real growth in Q3**, driven mainly by 3.3% growth in real private consumption and with an assist from government investment and inventory build. 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, even if the Manufacturing PMI for October unexpectedly relapsed (blue line, top right chart). **Eurozone activity, however, does look very weak**, with Services drifting lower towards the already recessionary Manufacturing. **The UK is just about holding on!**

United States

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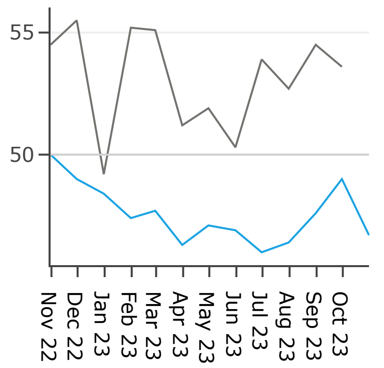
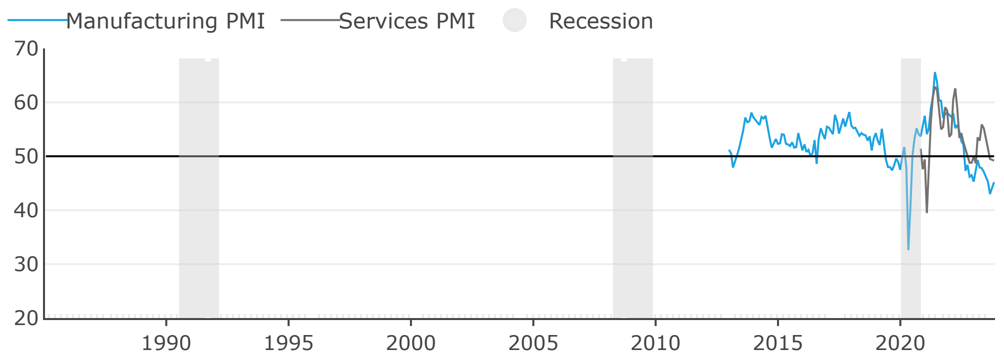



United Kingdom

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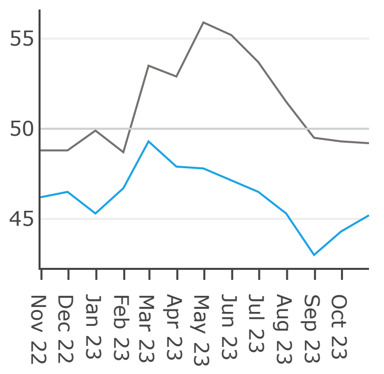
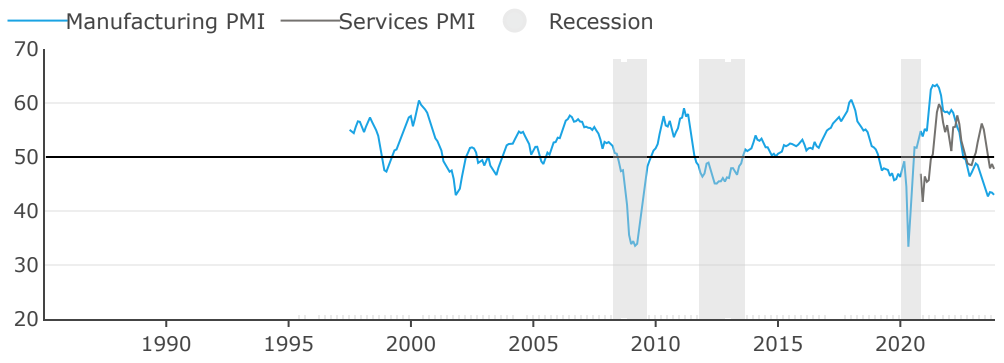



Eurozone

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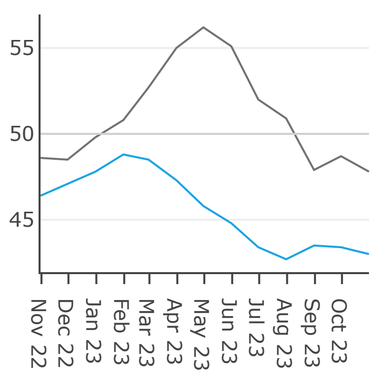


Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Nov 2023. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

GROWTH

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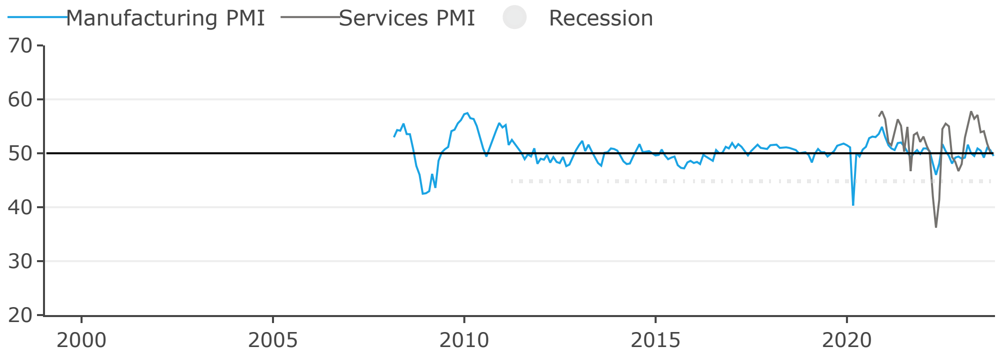
# Global PMIs

**China and Japan leading indicators are around the 50 expansion/contraction threshold,** but current activity is also OK if not stellar. Japan GDP is growing just below a 2% annual rate.

**Global leading indicators therefore continue to hold up with Services still stronger than Manufacturing.**

China

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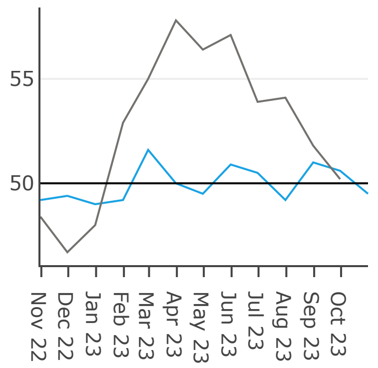
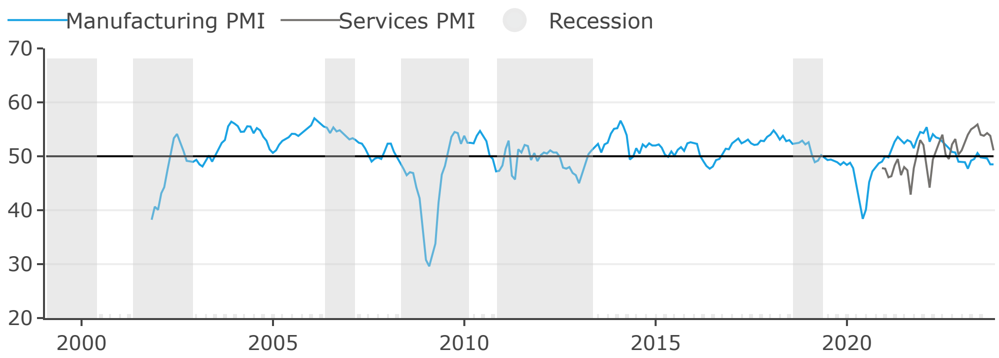
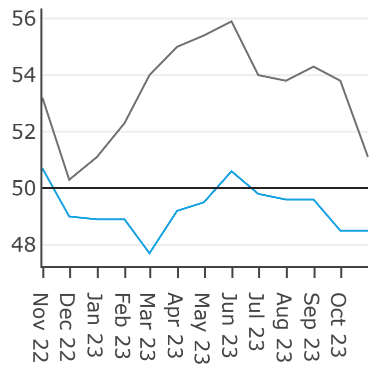


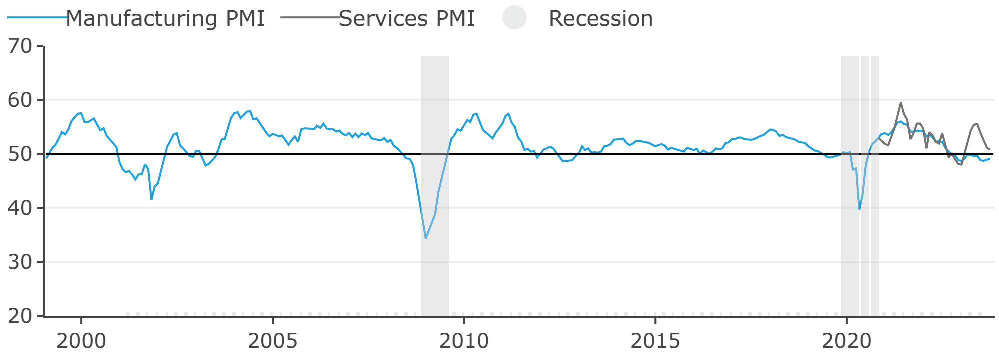

Japan




Last 12 Months




Global

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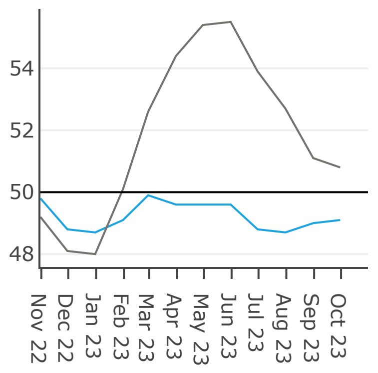



Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Nov 2023. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

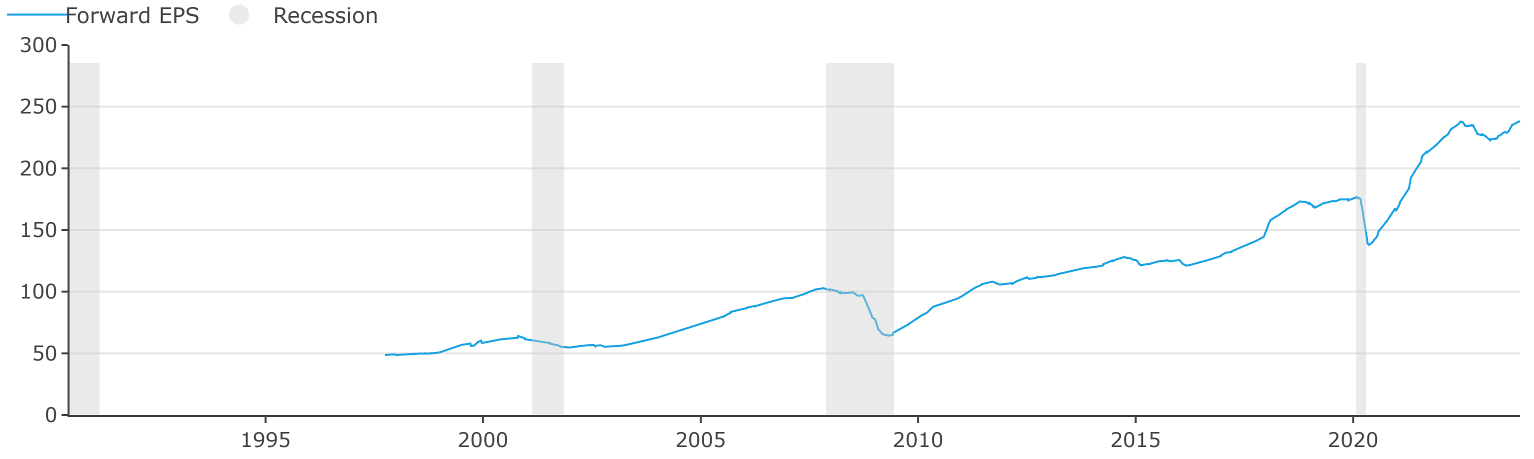
# Earnings

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

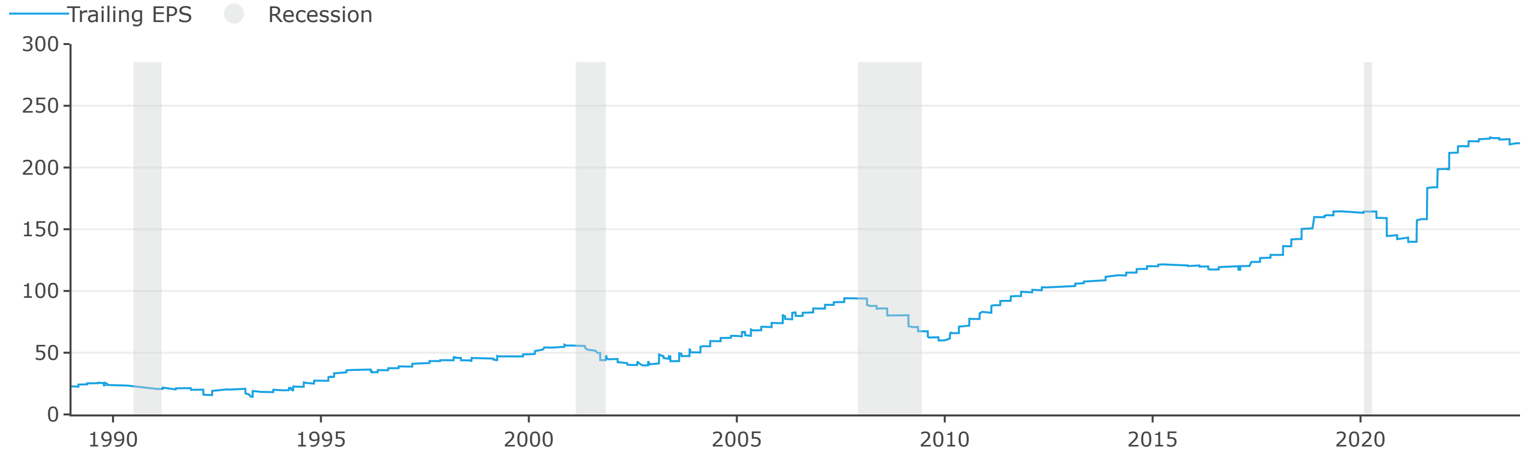
It's also worth noting that **Q3 earnings season has shown EPS flat to slightly growing again on a year over year basis**, having contracted in the prior four quarters.

## S&P 500

### Bloomberg Est. EPS




### 12M Trailing EPS




Sources | S&P500 12M Forward EPS using Bloomberg BF transformation, 12M Trailing EPS from Bloomberg as at Nov 2023

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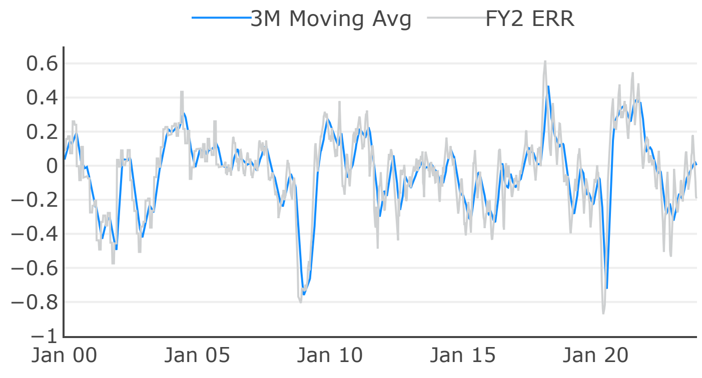
# Earnings

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.

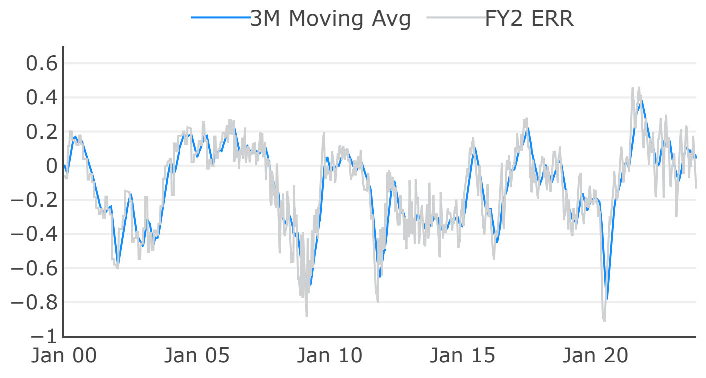
**The overall assessment is that earnings breadth has recovered in the US and Japan particularly**. Analysts are usually too optimistic at the start of the year, so modest downgrades do not prevent equity markets going up.

## Global Earnings Revisions Ratios

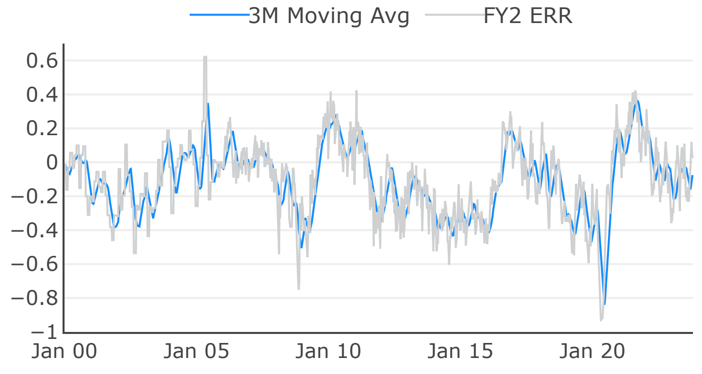
### USA



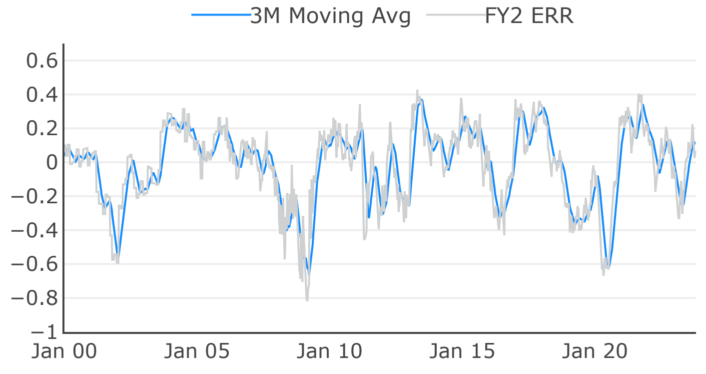

### Eurozone



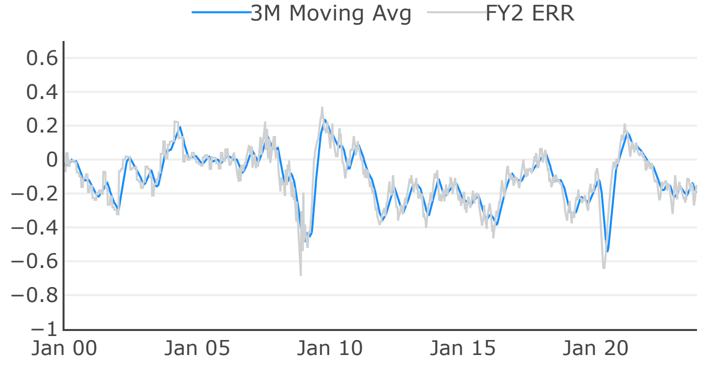

### UK



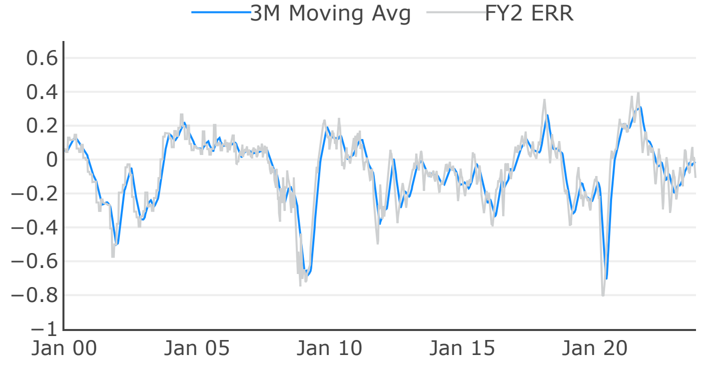

### Japan




### Emerging Markets




### World

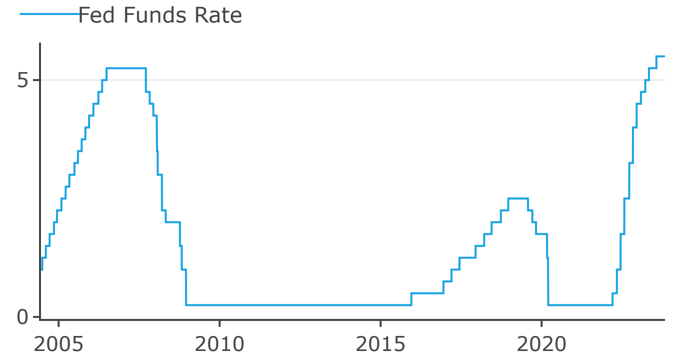



Sources | JP Morgan, the MSCI index has been used for each respective region, as at Nov 2023.

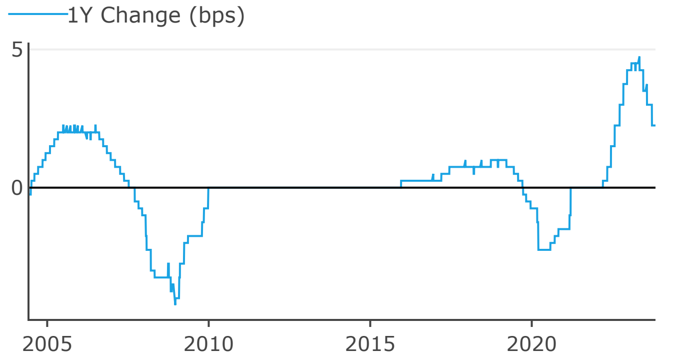
# Interest Rates

**The fastest interest rate hiking cycle since the Volcker era is probably close to, or at, an end.** (Paul Volcker was Chairman of the Board of Governors of the Federal Reserve from 1979-1987, and is famous for taming inflation by aggressive interest rate hikes). At least that is the message from the bottom left chart which compares current interest rate with the expected path over the next two years. 2Y yields are 5.09% as of 30 Oct, compared to Fed Funds rate at 5.5%.

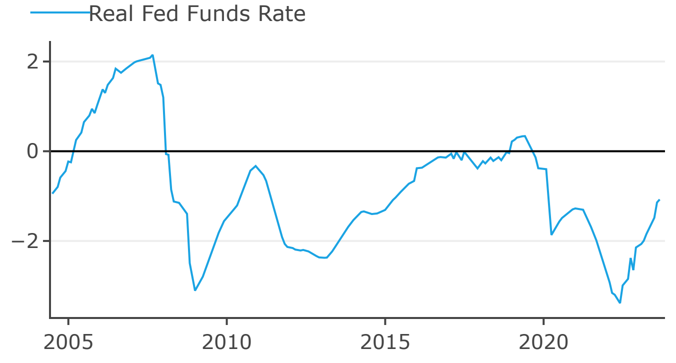
### Fed Funds Rate



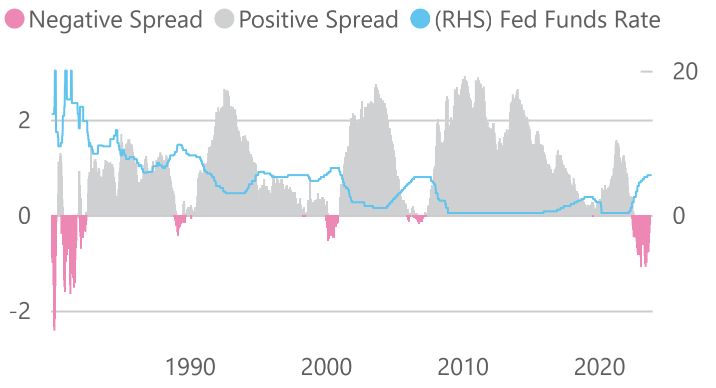

### Change in Fed Funds Rate



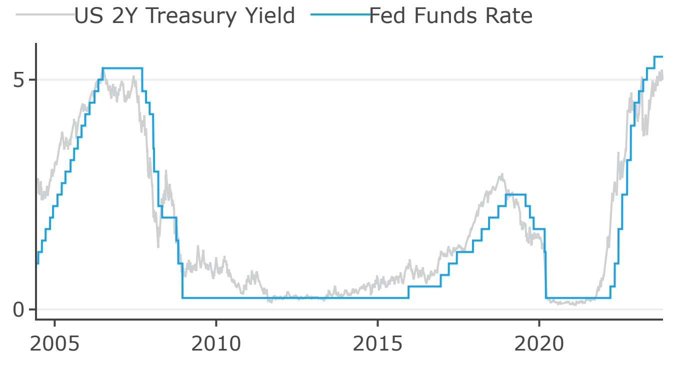

### Real Fed Funds Rate (Using 2Y MA CPI)



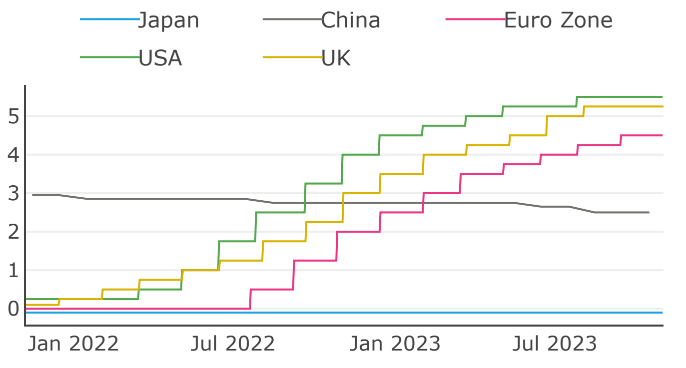

### Fed Funds Rate vs 2s10s Curve




### Fed Funds Rate vs 2Y Treasury




### Global Comparison



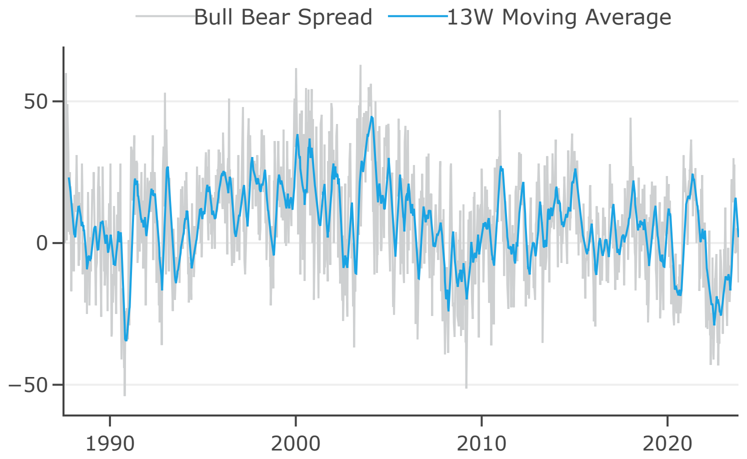

Sources | Bloomberg for all charts, as of Nov 2023

# Sentiment

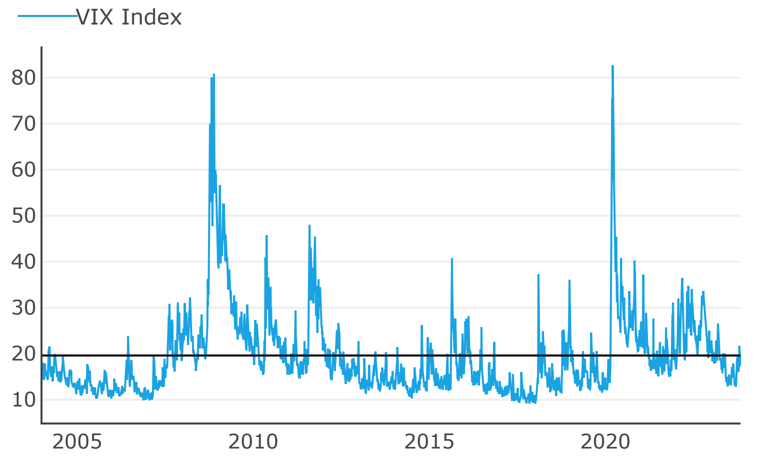
This page is a weather vane for market sentiment. **Investors have become more cautious again.** The American Association of Individual Investors, (Bulls minus Bears), is good to watch as it's so volatile, therefore captures the mood swings of Mr Market. The three month (13-week) moving average is relatively flat, with a reading of 2.05. Put-call is around average and VIX at a sanguine 17.3 (v.s. a long term average of 19.6). Bank of America strategist, Michael Hartnett's, Bull-Bear indicator uses all of these and more to come up with a single reading, which has fallen back towards extreme bearish sentiment, with a 1.5 / 10 reading. Separately, Morgan Stanley Prime Brokerage reports that hedge fund net leverage is falling, denoting caution.

## US Equity Indicators

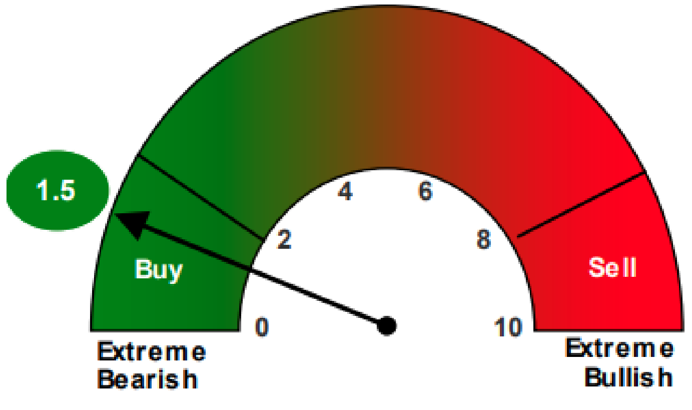
### Bull Bear Spread



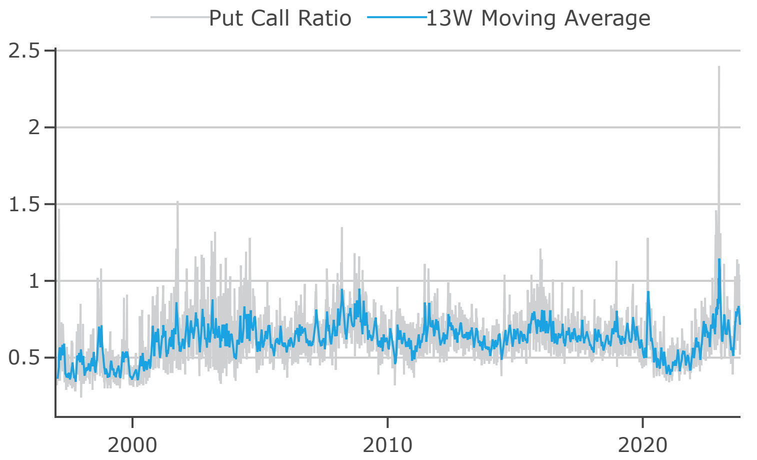

### VIX




### 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 Nov 2023

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# Fund Flows

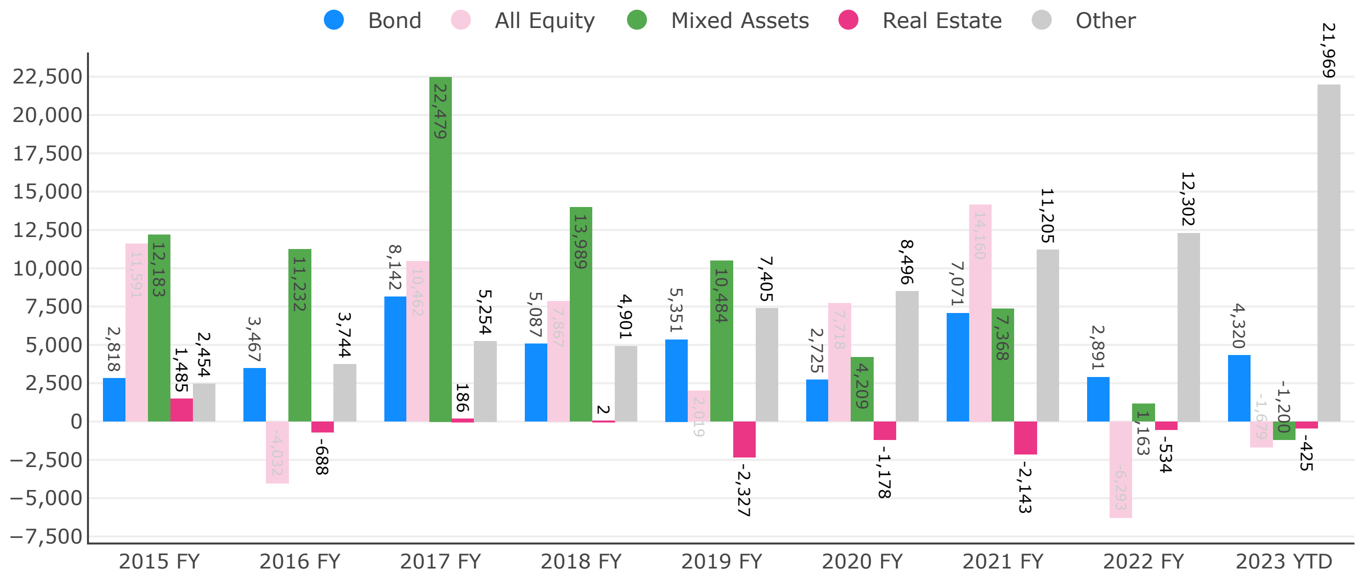
This page captures UK investment fund flows, as a measure of how optimistic or pessimistic sentiment has become.

The message from flows is that **investors are still cautious, with large inflows into Bond funds (until this quarter) and especially "Other"** (mainly money market) funds.

## UK Investor Sentiment

Net Fund Flows by Asset Class £m

| Date | Bond | All Equity | Mixed Assets | Real Estate | Other | Total Net Flows |
|---|---|---|---|---|---|---|
| 2022 Q1 | -506 | -1,261 | 1,148 | -284 | 5,158 | 4,256 |
| 2022 Q2 | 534 | -672 | 1,247 | 61 | 1,238 | 2,408 |
| 2022 Q3 | 1,197 | -4,701 | -287 | -85 | 2,545 | -1,331 |
| 2022 Q4 | 1,666 | 341 | -945 | -226 | 3,361 | 4,198 |
| 2023 Q1 | 2,747 | 258 | 397 | -93 | 5,966 | 9,275 |
| 2023 Q2 | 1,684 | 447 | -190 | -148 | 7,274 | 9,066 |
| 2023 07 | 347 | -983 | -82 | -66 | 2,600 | 1,817 |
| 2023 08 | -330 | -1,195 | -281 | -121 | 3,322 | 1,395 |
| 2023 09 | -128 | -206 | -1,044 | 3 | 2,807 | 1,431 |




Sources | All charts: Calastone Fund Flow Index as at Nov 2023. Fund Flow data measures UK investor sentiment, showing the net flow of capital to and from open-ended investment funds.

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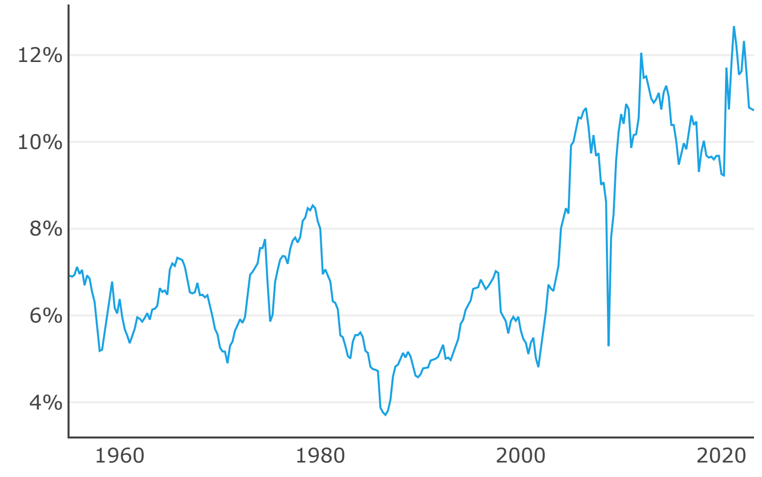
# The Big Picture

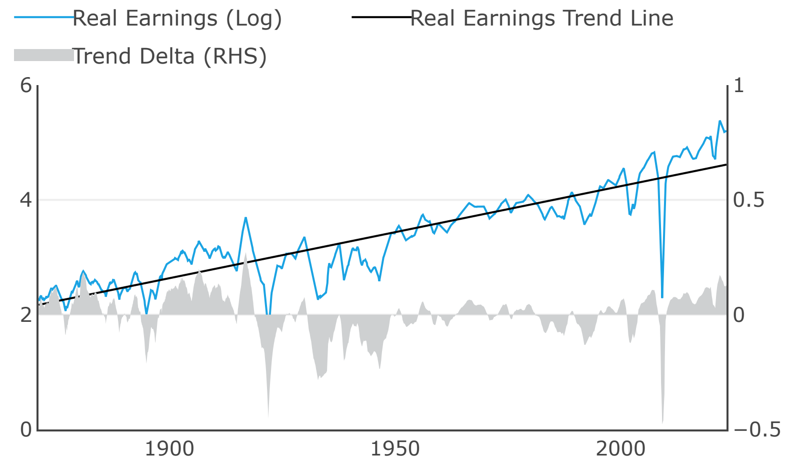
Here we highlight some longer term imbalances that, **should** they correct, would have have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. It's corollary (not shown)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

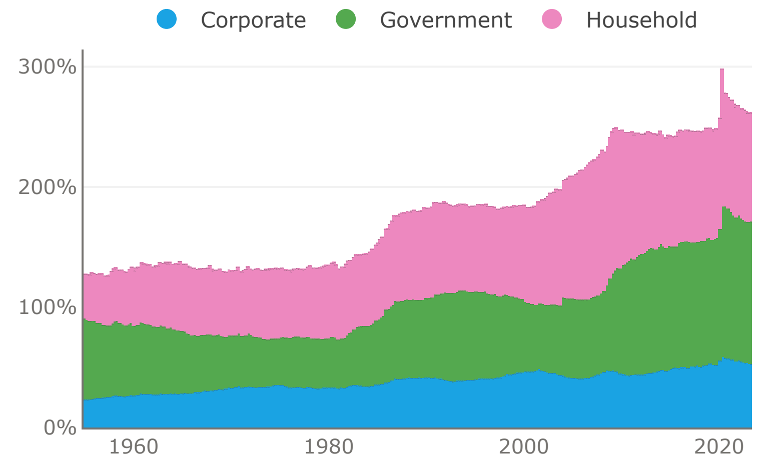
### Profit Share of GDP



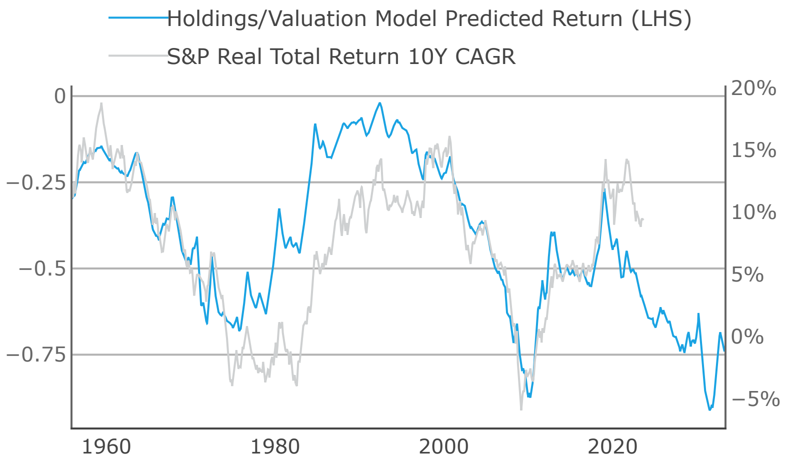

### Earnings Deviation From Trend




### 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 Nov 2023

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