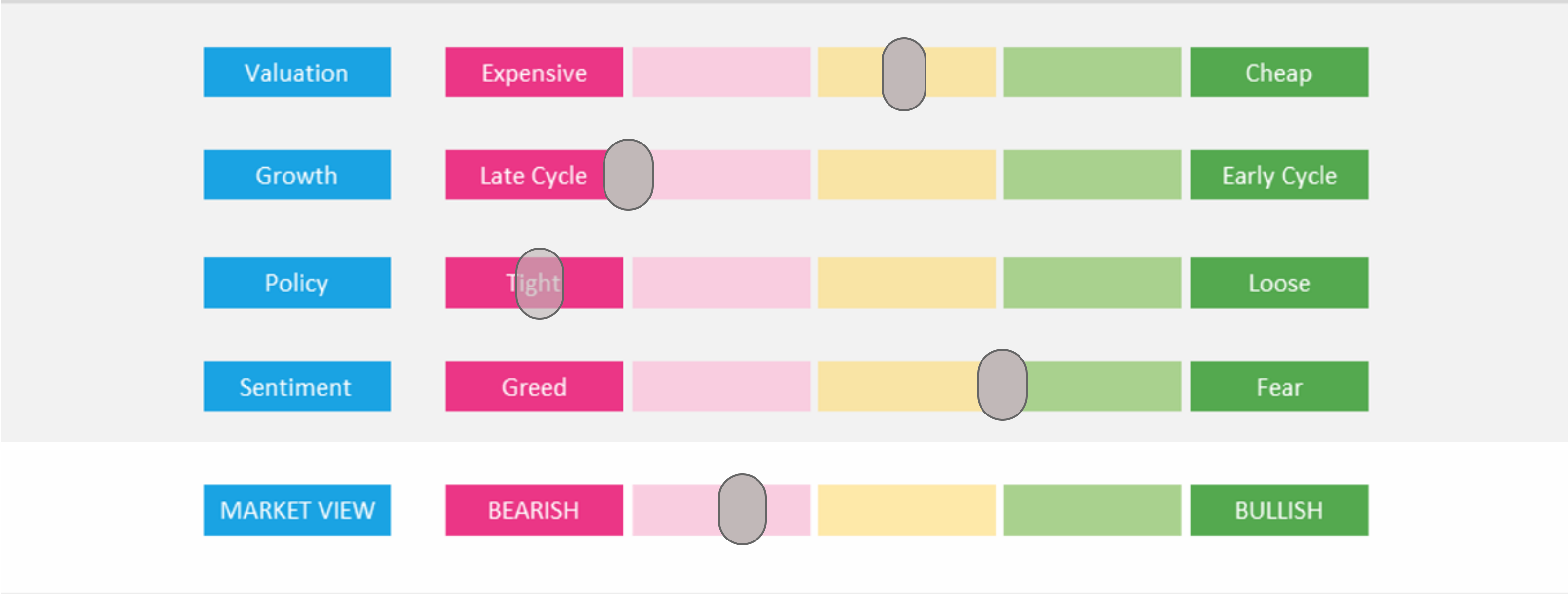
OCTOBER 2023

Market Barometer

Barometer

This Month
Improved
Deteriorated



Higher for Longer

The US stock market has started to de-rate, with the forward PE falling from 20 to 18 over the last few months.

The culprit isn't earnings, which are still well supported on a trailing basis and rising on a forward basis. It's the discount rate. We reiterate last month's conclusion that **real bond yields are approaching levels where they may be attractive to those fearing an inflation resurgence**.

Leading indicators of the Services sector continue to roll over.

This should allow central banks to go on hold soon, led by the Fed, but **higher for longer is the mantra** that we think will hold until and unless the labour market cracks.

Investor sentiment is no longer cautious, and is close to average levels, we find.

The cycle continues to mature and unemployment (a lagging measure of the cycle) is starting to tick up.

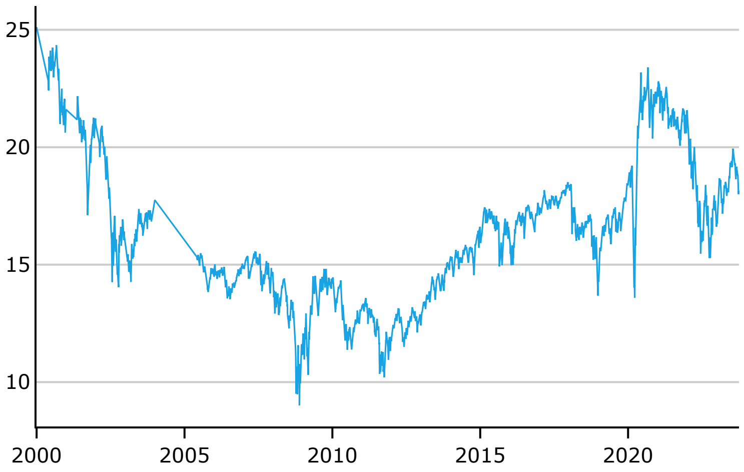
Contents

Equity | USA

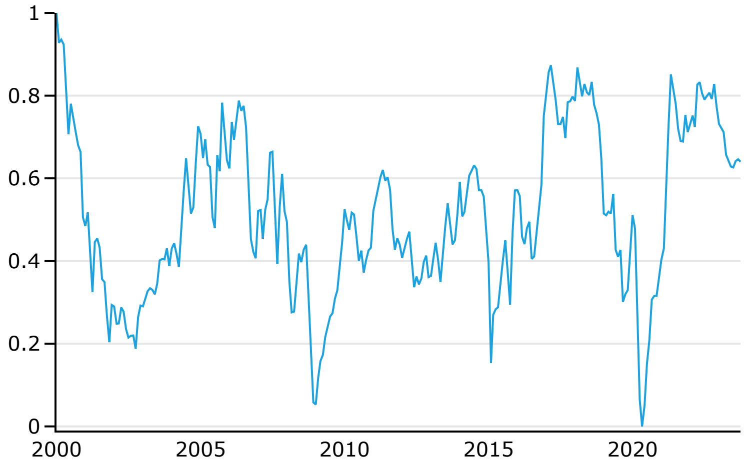
US equity market valuation is falling on near-term forecasts. In the last three months the US forward PE (top left chart) has de-rated from 20x to 18x, with the US market correcting 7% while earnings estimates have continued to grind higher. This means the spot valuation is still above its 16.2x average 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 30x. The other 493 S&P 500 stocks trade on a forward PE of 13.4x. Similarly, the equal-weighted S&P 500 trades on a PE of 14.6x. Conclusion - the overvaluation of the S&P is concentrated in a few names.

S&P 500 Valuations

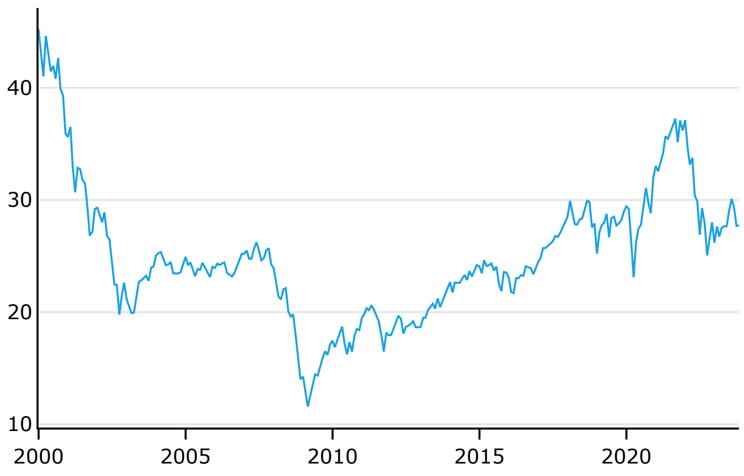
S&P 500 PE



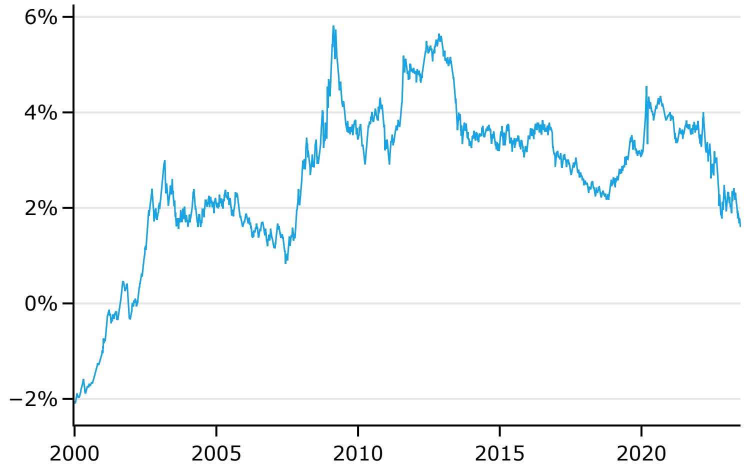
Composite Value Indicator Model



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.

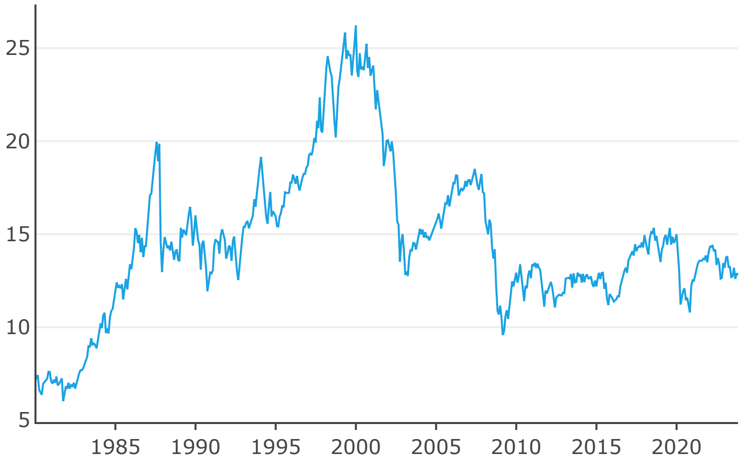
Sources | S&P 500 PE: Bloomberg, CVI Model: CCLA, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of Oct 2023

Equity | Regional

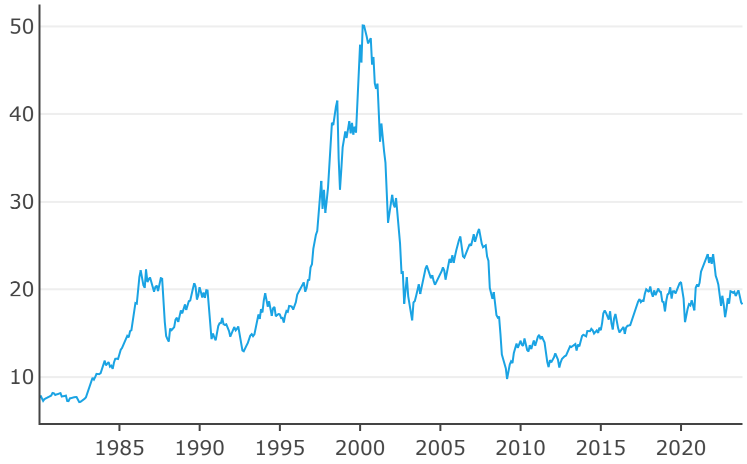
Outside of the US, (which is 67% of MSCI World), equity markets look either very reasonable value (UK, Europe-ex-UK) or outright cheap (Japan, EM). The de-rating of last year is notable everywhere. The UK Shiller PE of 12.9 gives an earnings yield of 8%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 18.5 gives a 5.4% forward real return. Asia and Japan look similarly good value to us.

Europe

UK | Shiller P/E

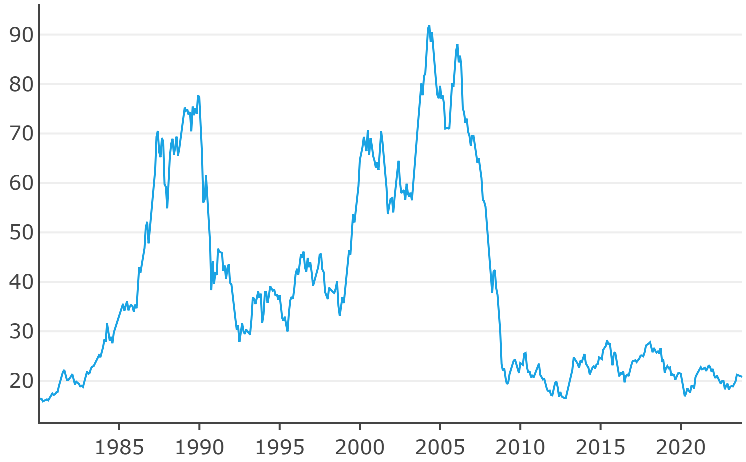


Europe (Ex-UK) | Shiller P/E

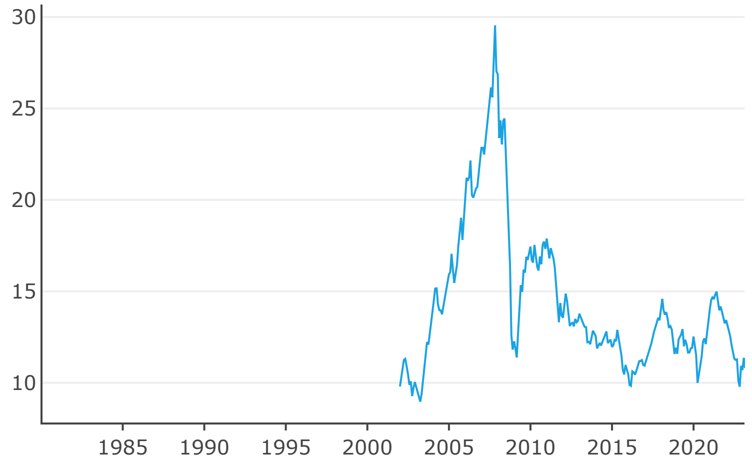


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



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

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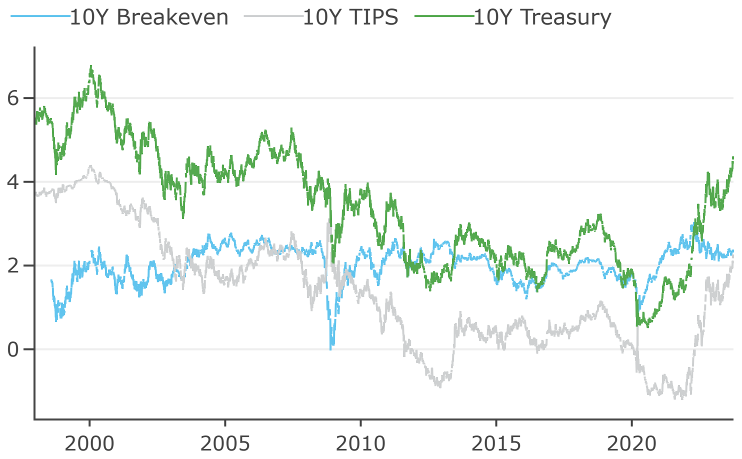
VALUATION

Bonds

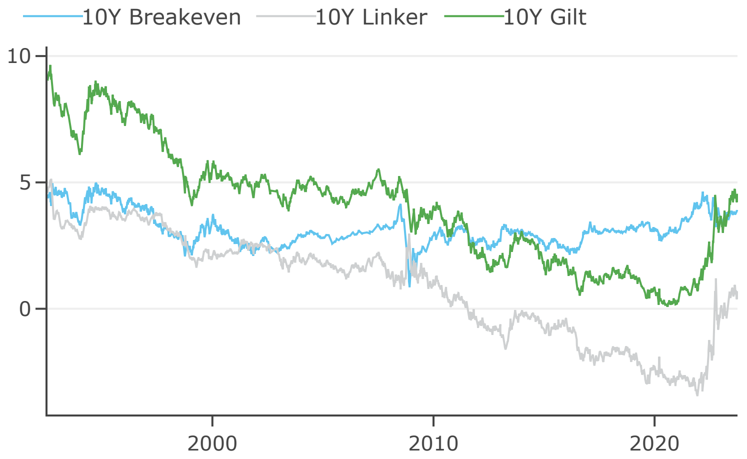
The bond bear market is running full speed ahead. The market focus has shifted to the US fiscal deficit, which at 8% of GDP is at a truly remarkable level for an economy at almost full employment. The top two charts show quite clearly that all of the back up in bond yields in the last two years (i.e. since September 2021) 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, it is remarkable how well high yield has traded, with HY yields falling from over 10% to 8.5% in the last twelve months. **It may take a recession, though, for duration to be rewarded**, even if spreads would widen.

Global Government & Corporate Yields

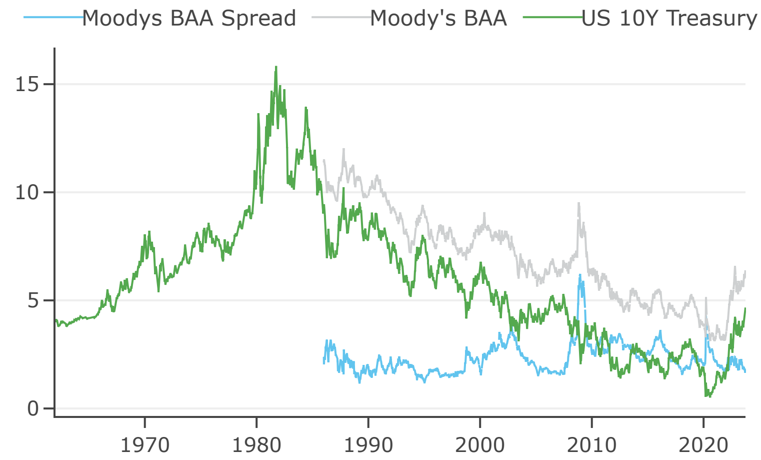
US 10 Year Treasury Yields



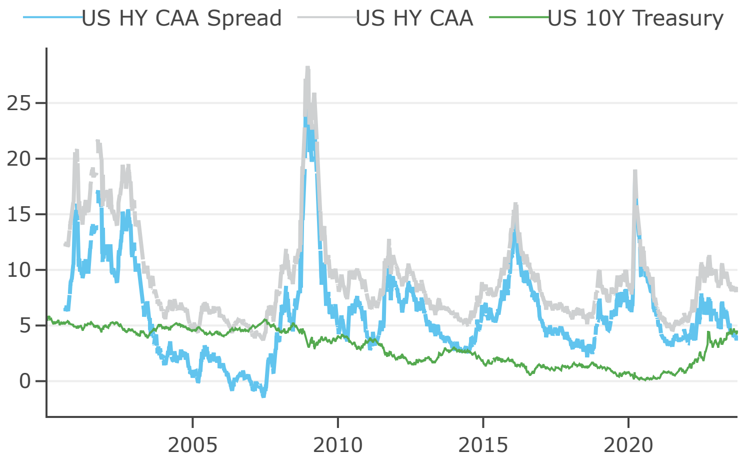
UK 10 Year Gilt Yields



US Corporate Investment Grade Yield



US Corporate High Yield



Sources | Bloomberg as at Oct 2023

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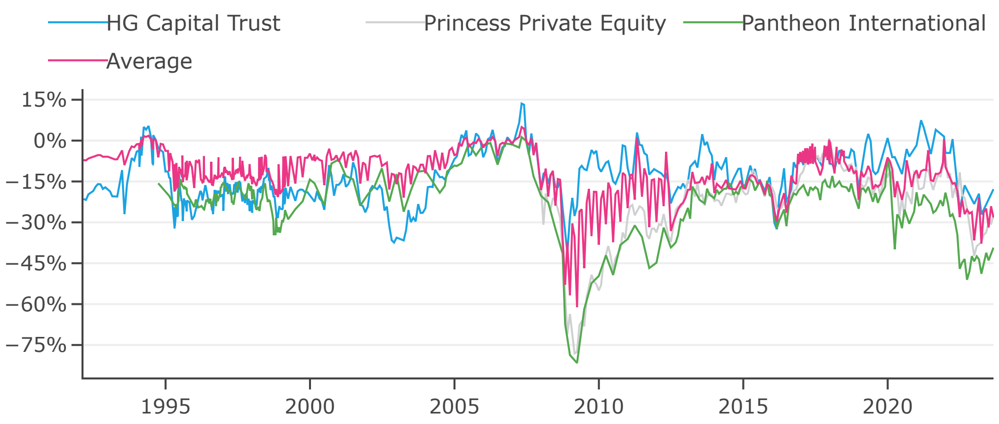
Alternatives

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

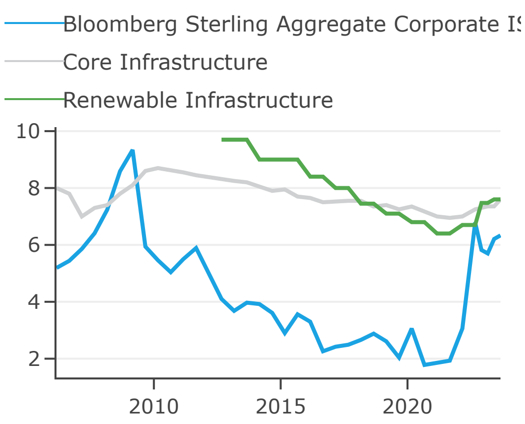
Listed Private Equity

Discount To NAVs



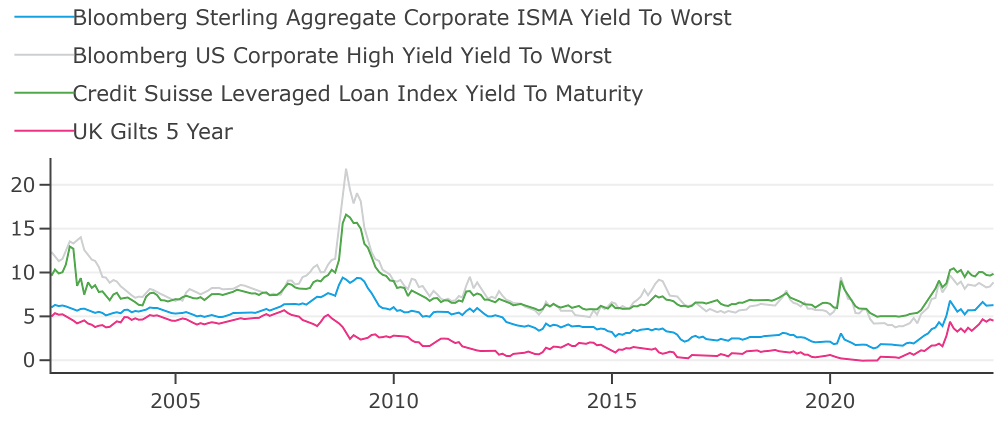
Infrastructure

Infrastructure Discount Rates vs Bond Yields



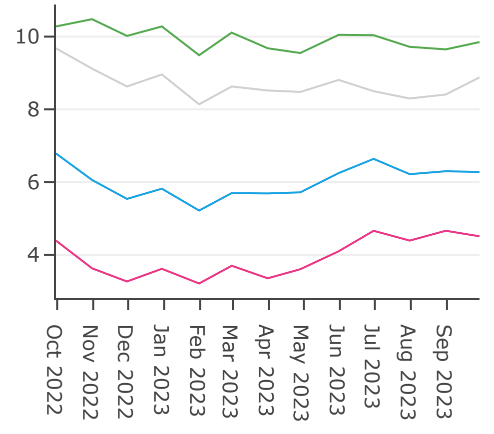
Contractual Income

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 Oct 2023

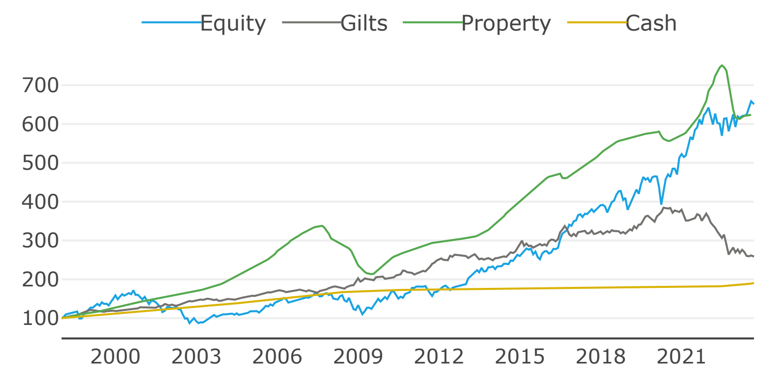
Property

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.

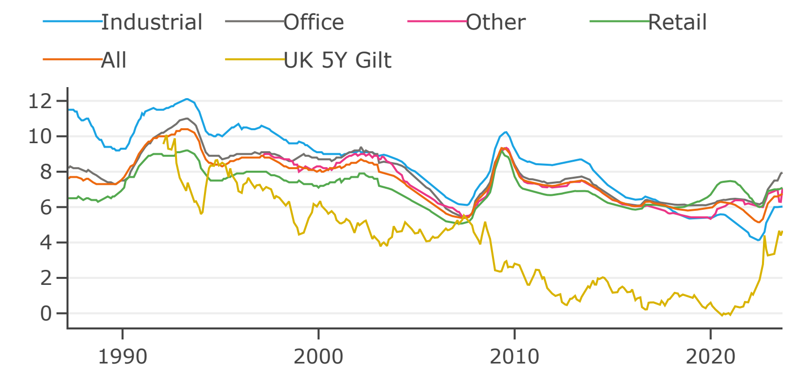
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

UK Commercial Property Market

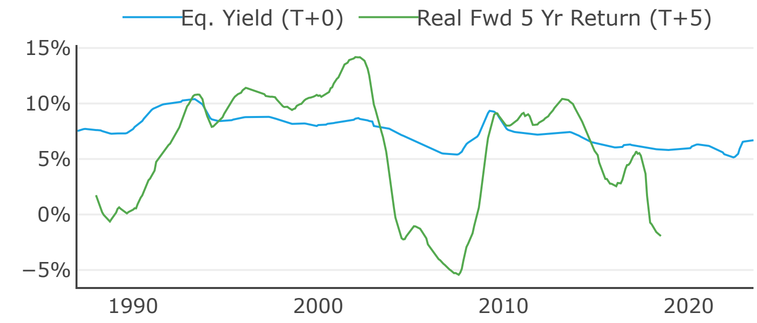
25 Years Of Return 1998=100



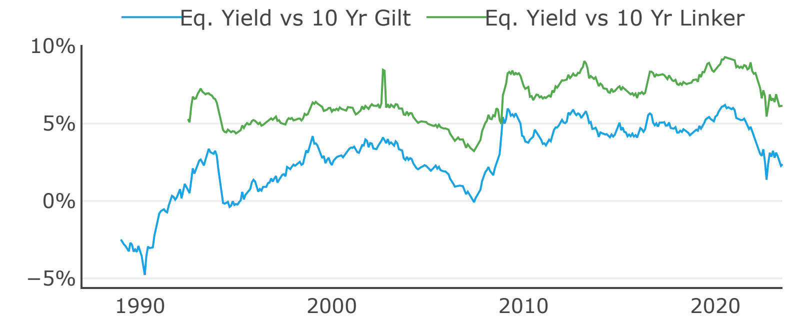
Equivalent Yields vs Gilt Yields %



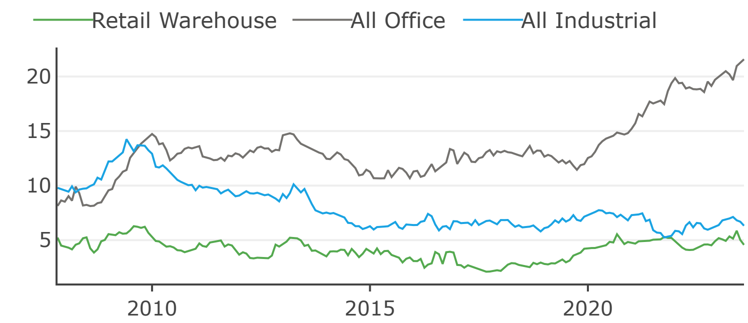
MSCI UK All Property Monthly TR Index %



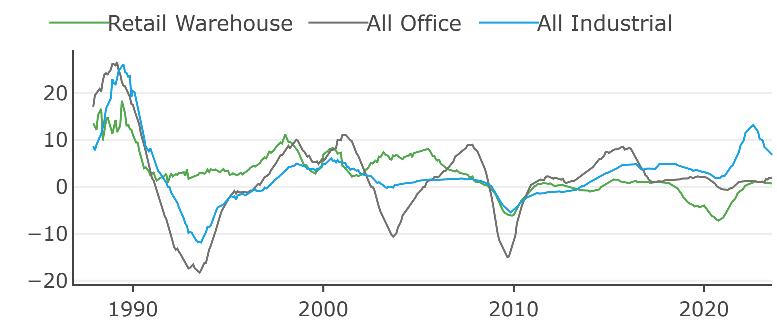
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



Sources | All charts: MSCI UK Monthly Property Index as at Sep 2023. Other Balance Property Fund Index is a short-hand name of 'MSCI/AREF UK Other Balanced Open-Ended Quarterly Property Fund Index', which is the COIF Property Fund's performance benchmark.

VALUATION

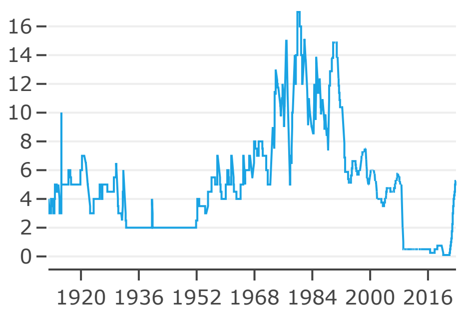
Cash

The BoE's higher-for-longer stance and the ripple effects in the US Treasury market triggered a sell-off in Gilts in early October, helping to reverse some of the 2s-10s inversion. However, the spread still remains negative (a historical harbinger for an economic downturn). Core and Services inflation fell, but the latest private-sector wage growth remains above 8%, and continues to pose a headwind to the disinflation story.

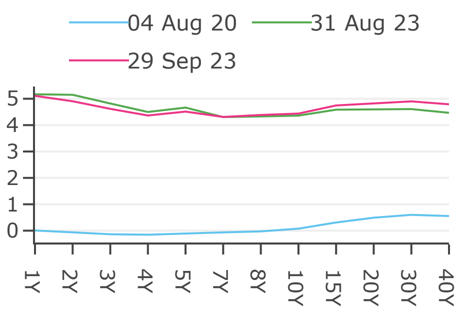
We believe we are still in the final phase of the tightening cycle, where UK rates are likely to peak close to where they are now, with a resurgence of inflation remaining the upside risk.

UK Sterling Market

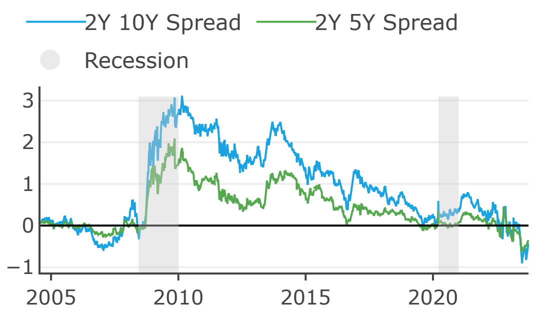
Official Bank Rate



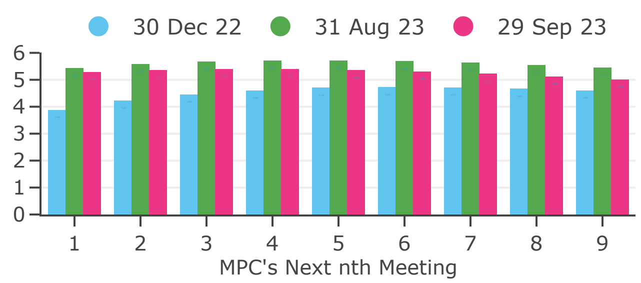
UK Gilt Curve



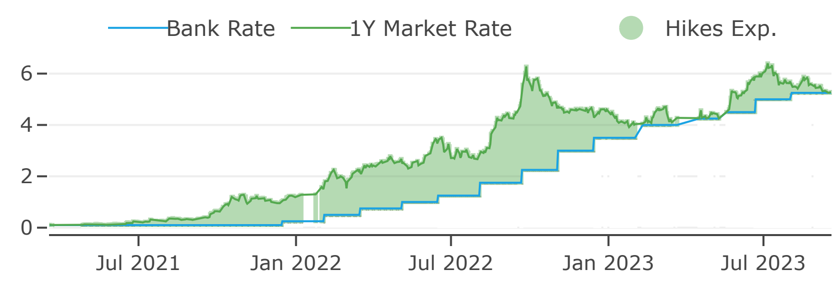
Gilt Spreads



Rate Expectations For Future MPC Meetings



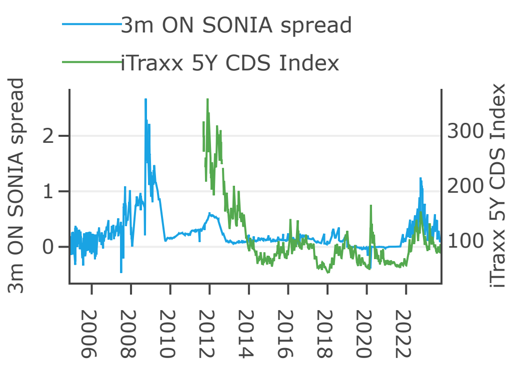
Further Tightening Expected



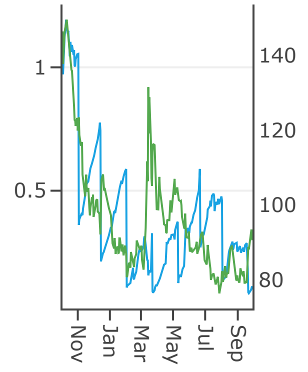
Inflation Readings YoY% | Colour by 10Y Z-Score*

	April	May	June	July	August
RPI	11.40	11.30	10.70	9.00	9.10
CPI	8.70	8.70	7.90	6.80	6.70
CPI Core	6.80	7.10	6.90	6.90	6.20
CPI Services	6.90	7.40	7.20	7.40	6.80
CPI Goods	10.00	9.70	8.50	6.10	6.30

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 Oct 2023

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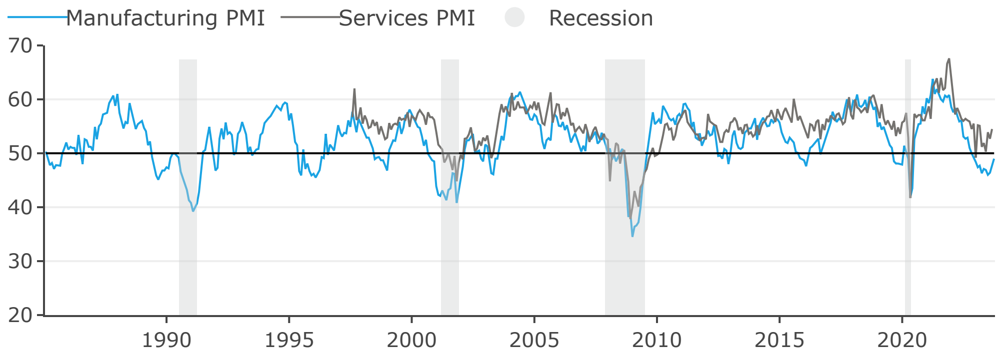
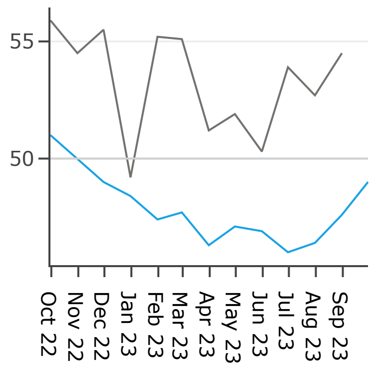
Global PMIs

The recovery in Services PMIs from the first half of the year is starting to roll over. While the Manufacturing PMIs have been at recession levels, **Services PMIs are now starting to roll over, or enter recessionary levels - note especially the UK and Eurozone**. It will be interesting to watch developments here now that the majority of pandemic-era excess savings (income that could not be spent during lockdowns) is finally running out. Job creation is slowing in the US, (non farm payrolls growth has slowed), and wage inflation is also slowing. These are the seeds of recession, but that recession still seems a way off.

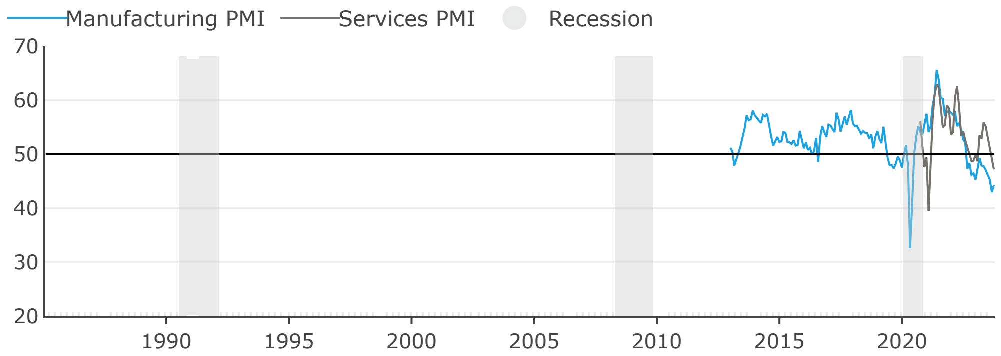
United States



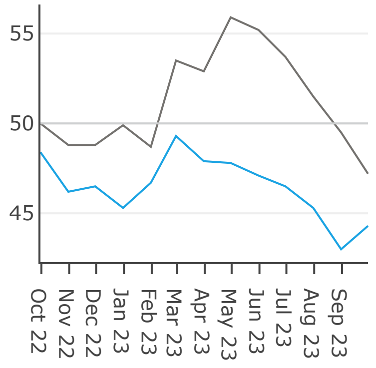
Last 12 Months



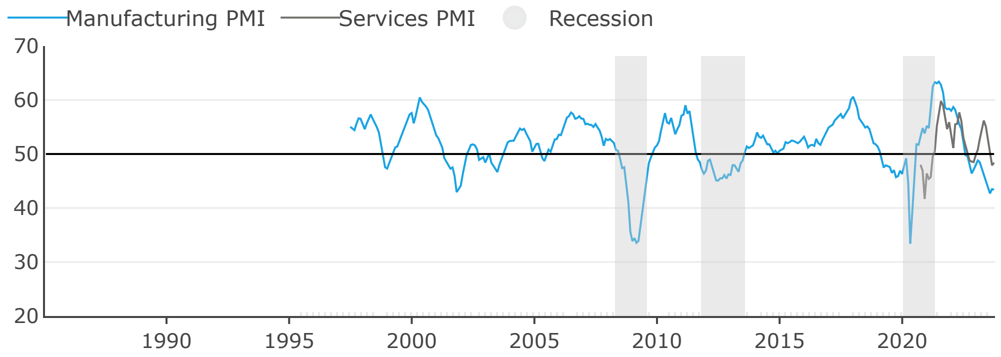
United Kingdom



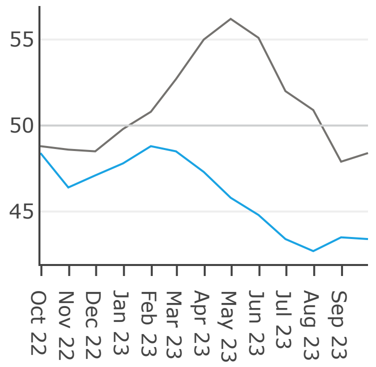
Last 12 Months



Eurozone



Last 12 Months

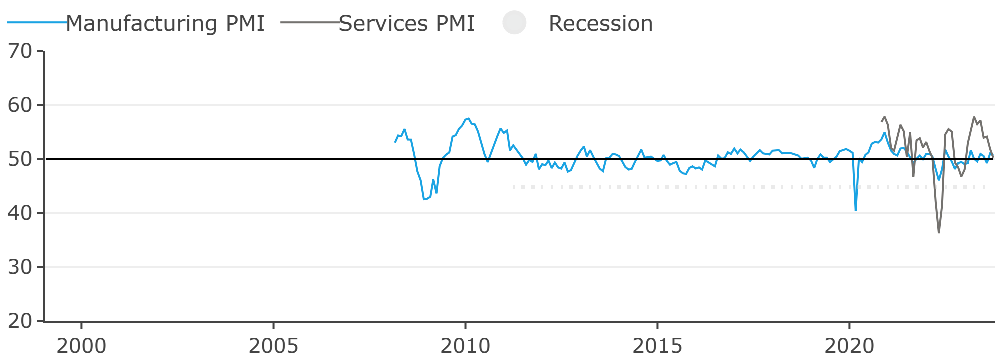


Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Oct 2023. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

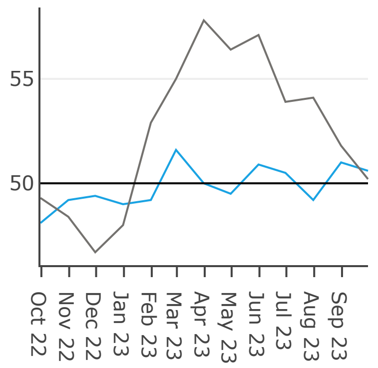
Global PMIs

The Global PMIs (bottom right chart on this page) are rolling over at high levels (Services) or still reporting recessionary levels (Manufacturing). As discussed on the previous page we must watch Services very closely now that excess savings are exhausted or close to exhausted.

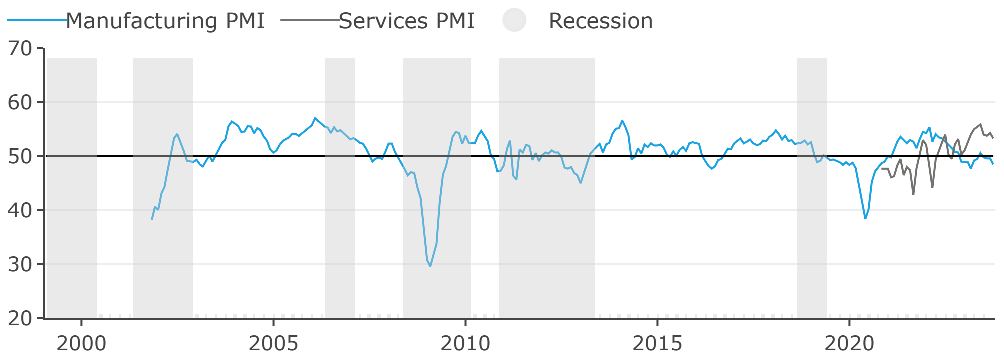
China



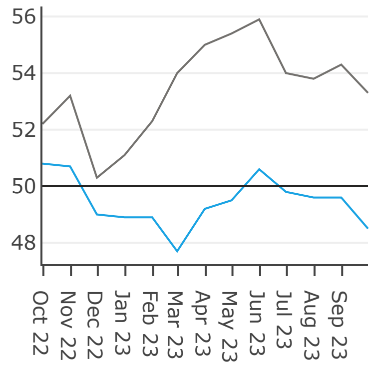
Last 12 Months



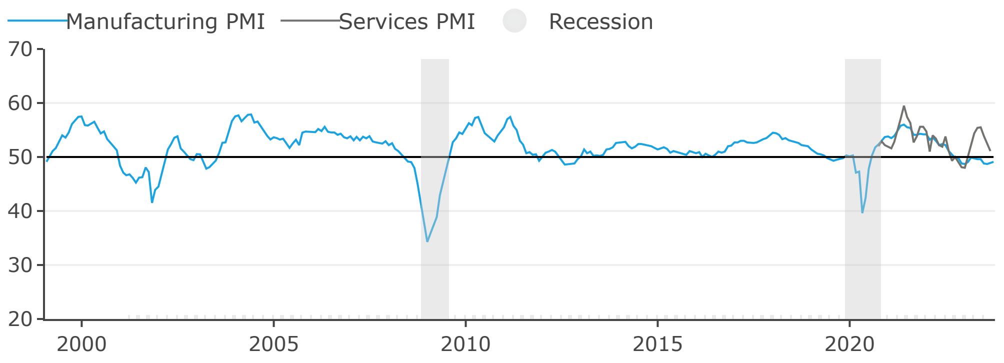
Japan



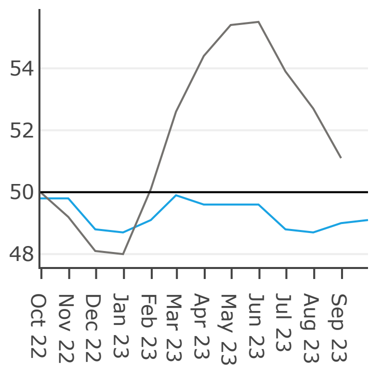
Last 12 Months



Global



Last 12 Months



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

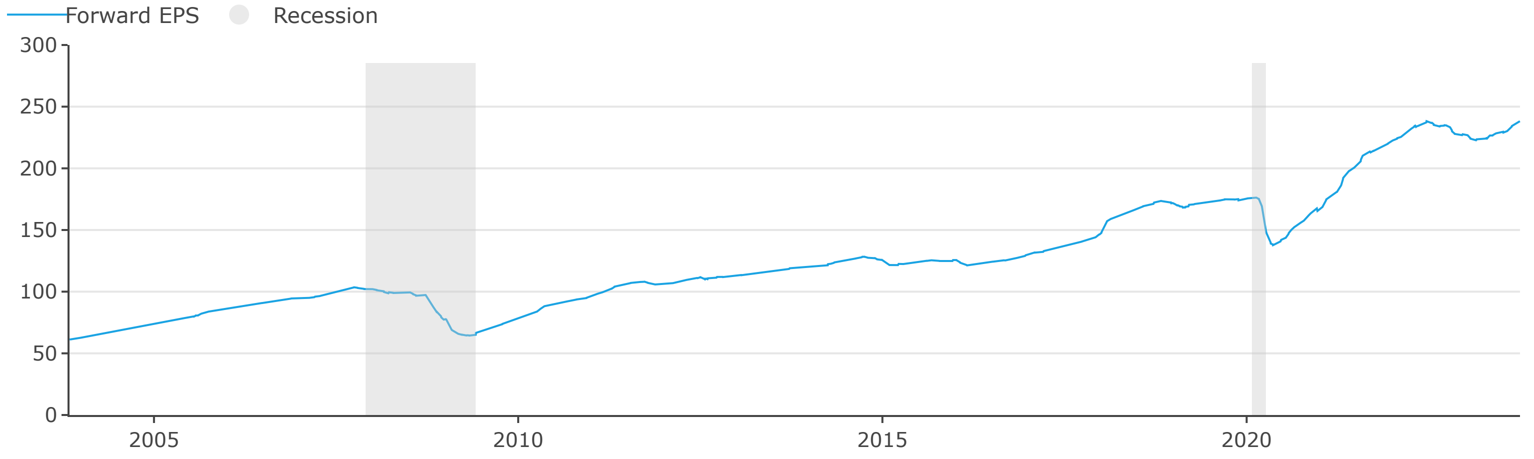
GROWTH

Earnings

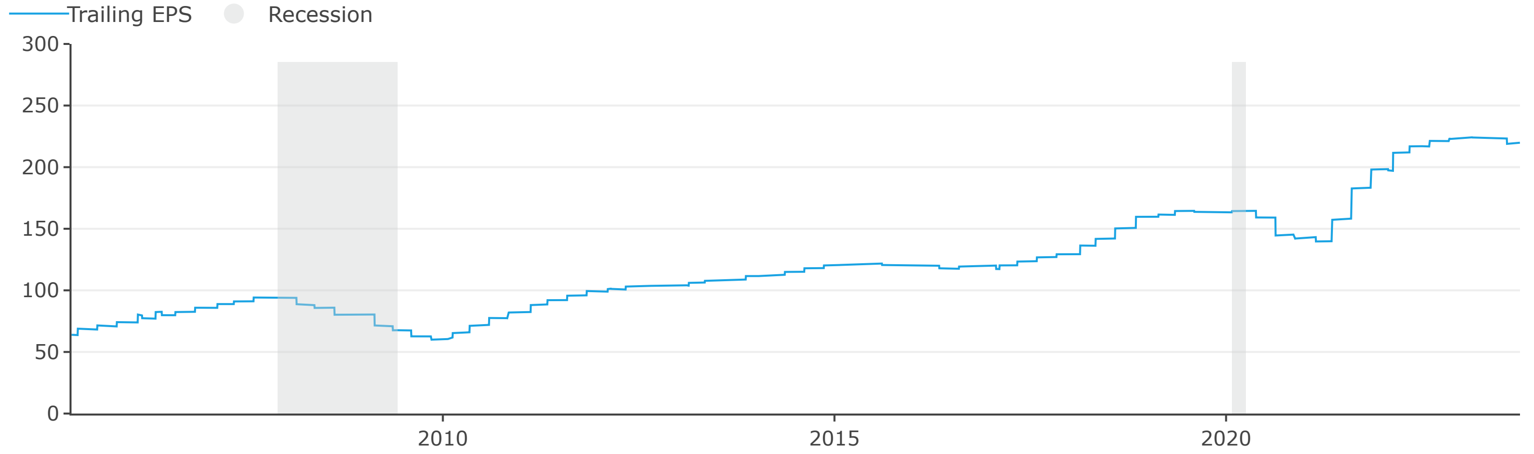
Consensus forward earnings estimates continue to recover while trailing earnings start flattening. Net net, this is a positive outcome compared to expectations of a recession-induced earnings fall.

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 Oct 2023

GROWTH

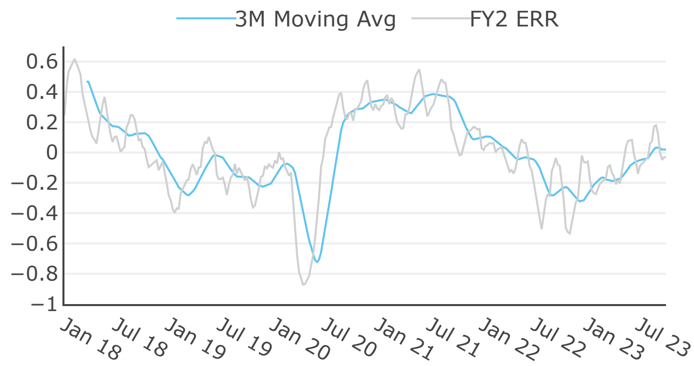
Earnings

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 - see Dec 2018 and Mar 2020 for recent examples.

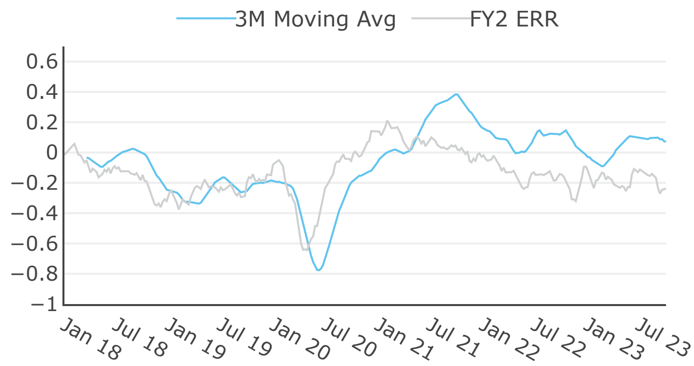
The overall assessment is that earnings breadth has stabilised at a modest rate of downgrade in all regions. Note that modest downgrade momentum is the normal state of affairs in all markets. Analysts are usually too optimistic at the start of the year, so modest downgrades do not prevent equity markets going up.

Global Earnings Revisions Ratios

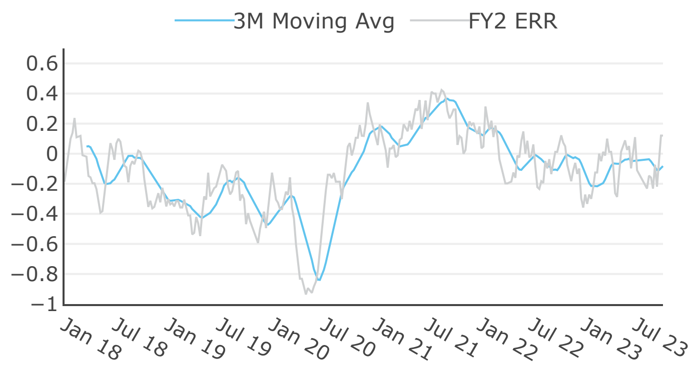
USA



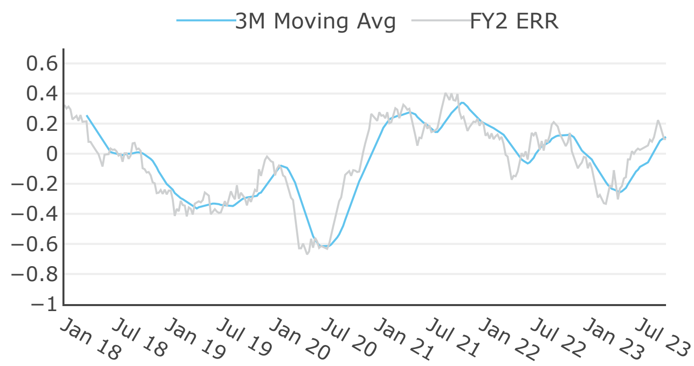
Eurozone



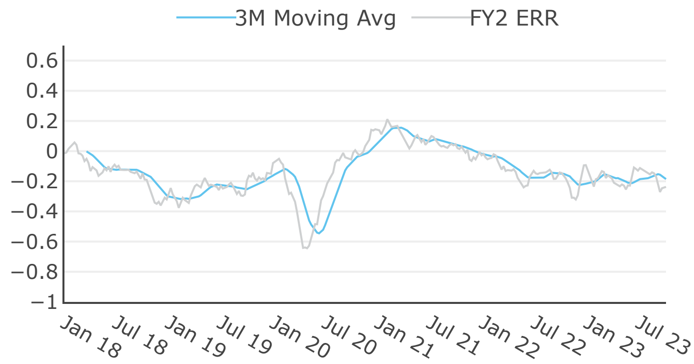
UK



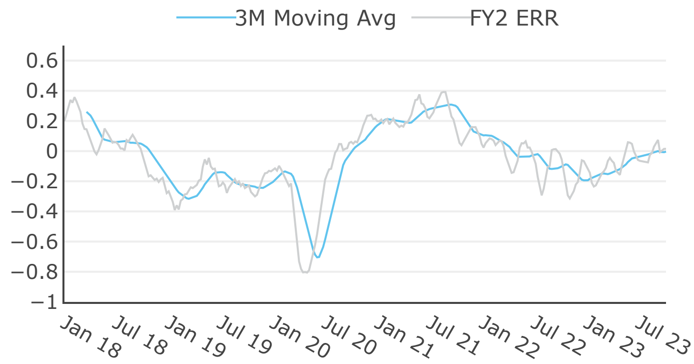
Japan



Emerging Markets



World

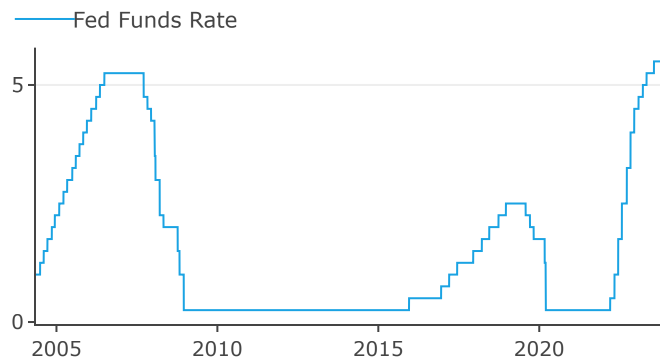


Sources | JP Morgan, the MSCI index has been used for each respective region, as at Oct 2023.

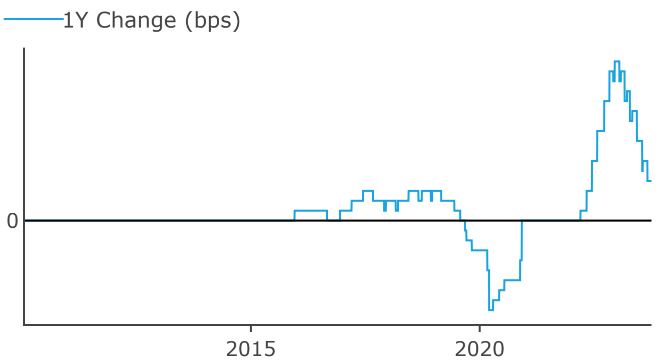
Interest Rates

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 5.11% as of 28 Sep, compared to Fed Funds rate at 5.5%.

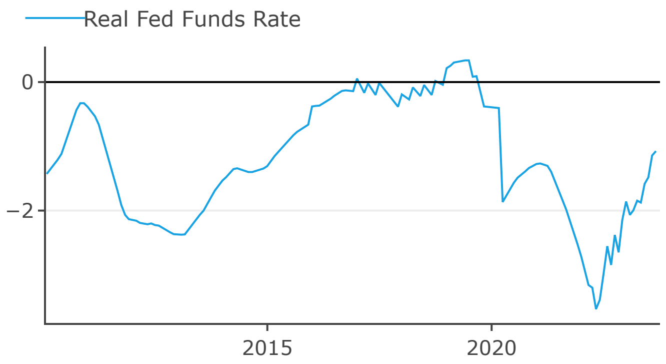
Fed Funds Rate



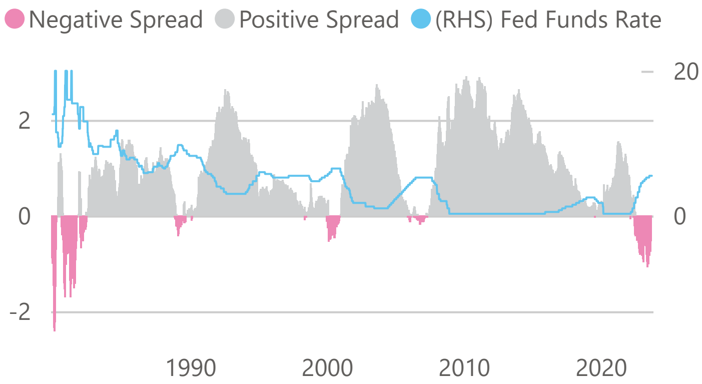
Change in Fed Funds Rate



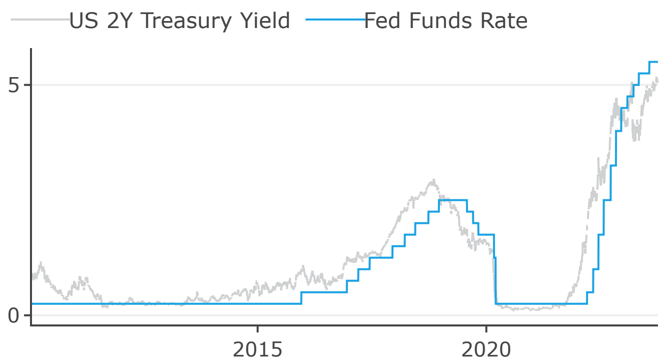
Real Fed Funds Rate (Using 2Y MA CPI)



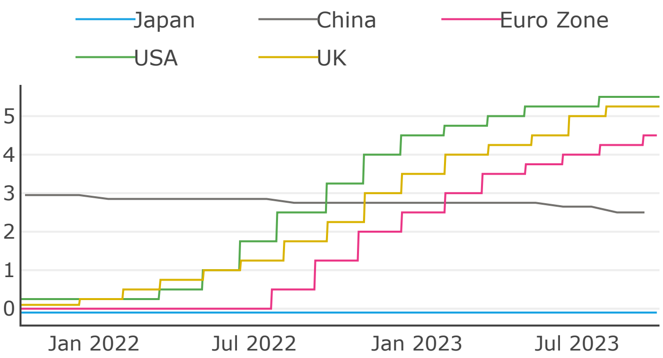
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Oct 2023

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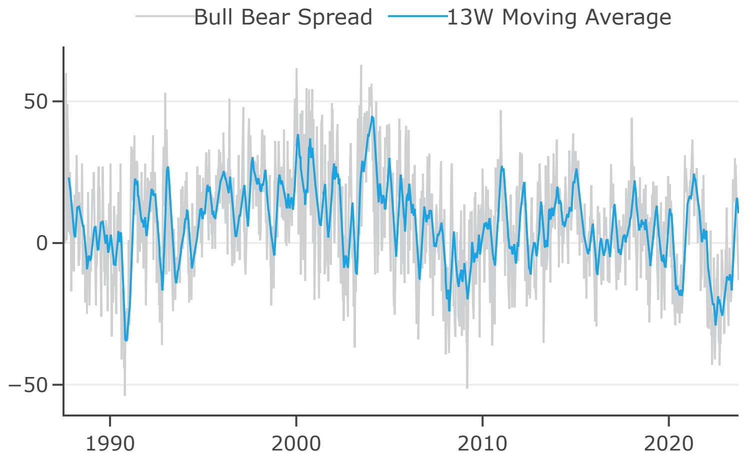
Sentiment

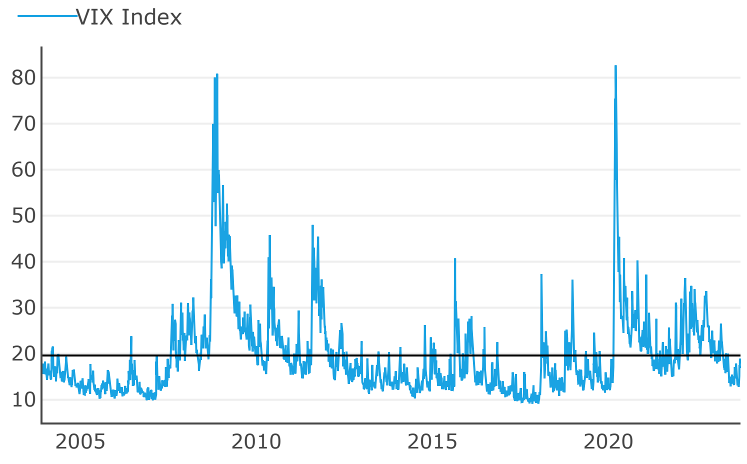
This page is a weather vane for market sentiment. **Investors are becoming less cautious**. The American Association of Individual Investors, (Bulls minus Bears), is good to watch as it's so volatile, therefore captures the mood swings of Mr Market. The three month (13-week) moving average is no longer depressed, with a reading of 10.5. Put-call is around average and VIX at a sanguine 17.9 (v.s. a long term average of 21). 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 to 3.0 / 10, i.e. still denoting reasonably cautious investors. Separately, MS Prime Brokerage reports that hedge fund net leverage is falling, denoting caution.

US Equity Indicators

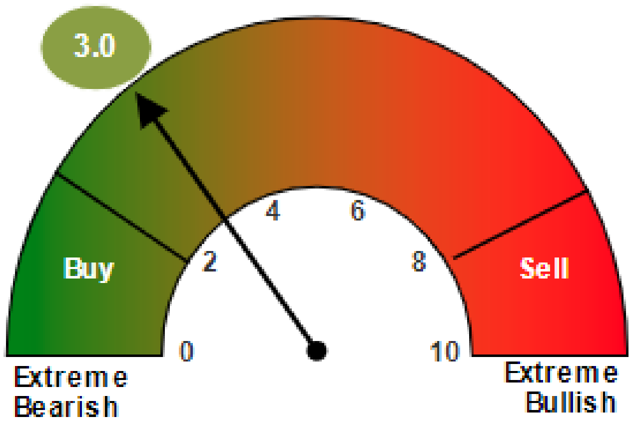
Bull Bear Spread



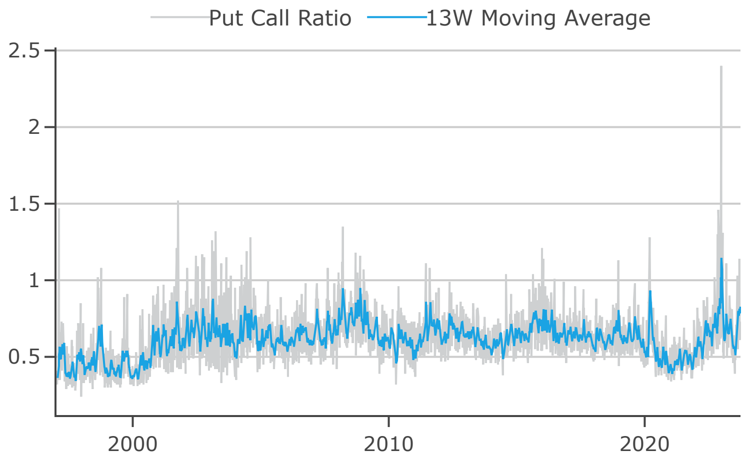
VIX



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 Oct 2023

Fund Flows

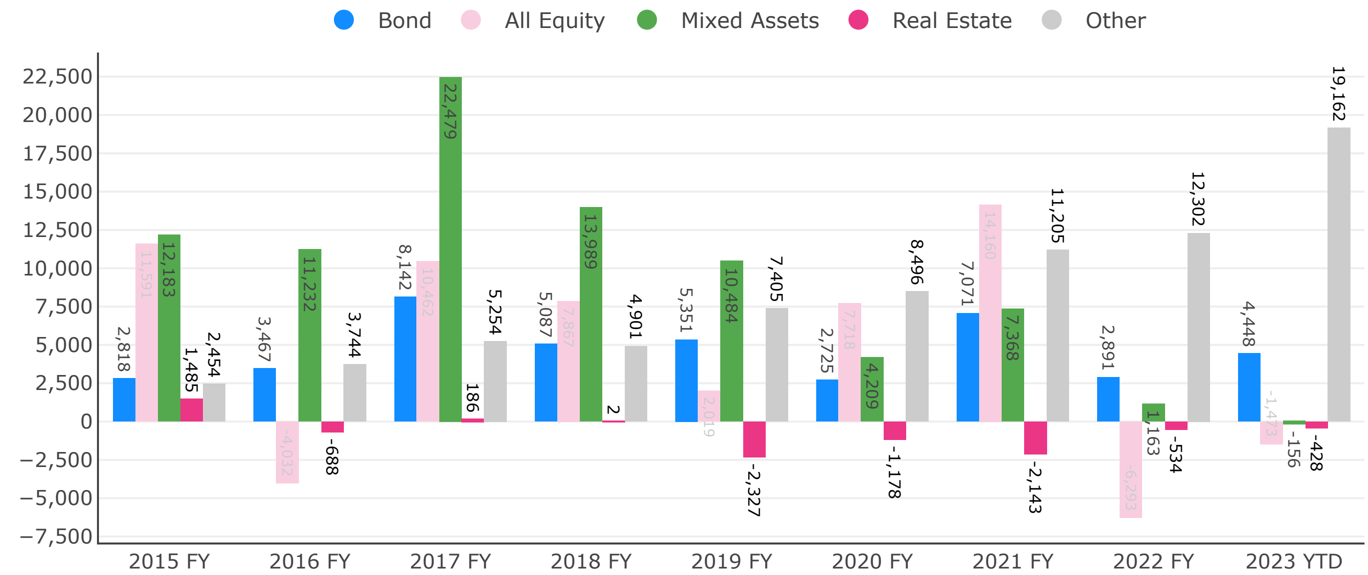
This page captures UK investment fund flows, as a measure of how optimistic or pessimistic sentiment has become. The message from flows is that **investors are still cautious, with large inflows into Bond funds and "Other"** (i.e. money market) funds. While marginal outflows YTD in risk assets such as Equity or Real Estate.

It is also notable that within the Equity category ESG Funds continue to dominate inflows.

UK Investor Sentiment

Net Fund Flows by Asset Class £m

Date	Bond	All Equity	Index-Tracked Equity	Active Equity	ESG Equity	Non ESG Equity	Mixed Assets	Real Estate	Other	Total Net Flows
2021 Q1	2,538	3,889	1,226	2,663	2,903	986	1,313	-1,004	2,428	9,163
2021 Q2	2,112	6,278	2,039	4,239	2,177	4,101	2,288	-741	2,337	12,274
2021 Q3	1,125	2,602	646	1,956	2,860	-258	1,625	-255	2,460	8,557
2022 Q1	-506	-1,261	-1,151	-110	1,316	-2,577	1,148	-284	5,158	4,256
2022 Q2	534	-672	-1,445	774	1,980	-2,652	1,247	61	1,238	2,408
2022 Q3	1,197	-4,701	-1,214	-3,487	187	-4,888	-287	-85	2,545	-1,331
2022 Q4	1,666	341	-666	1,008	3,194	-2,853	-945	-226	3,361	4,198
2023 Q1	2,747	258	610	-352	744	-486	397	-93	5,966	9,275
2023 Q2	1,684	447	2,731	-2,284	-90	537	-190	-148	7,274	9,066



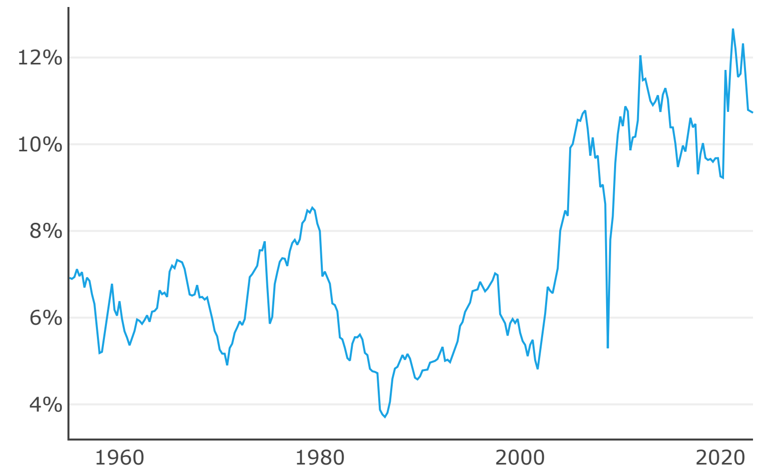
Sources | All charts: Calastone Fund Flow Index as at Oct 2023. Fund Flow data measures UK investor sentiment, showing the net flow of capital to and from open-ended investment funds.

The Big Picture

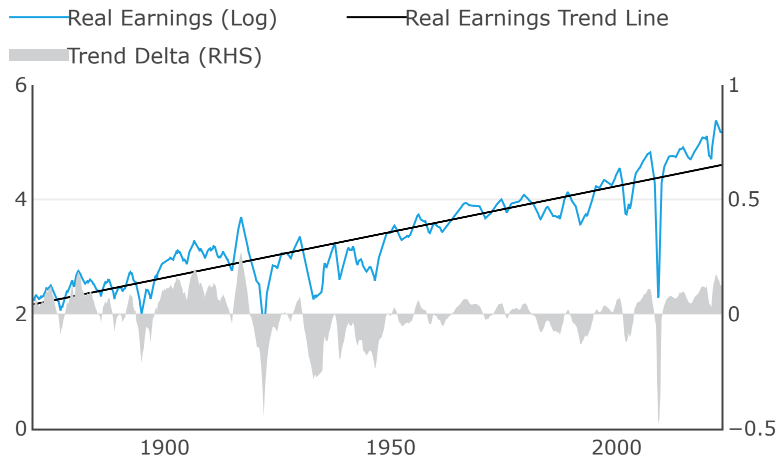
Here we highlight some longer term imbalances that, **should** they correct, would have have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. It's corollary (not shown) is that the wage share is at the lowest level it has been in almost as long. Allied to this, the top right chart shows that earnings are as far above their long run trend 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

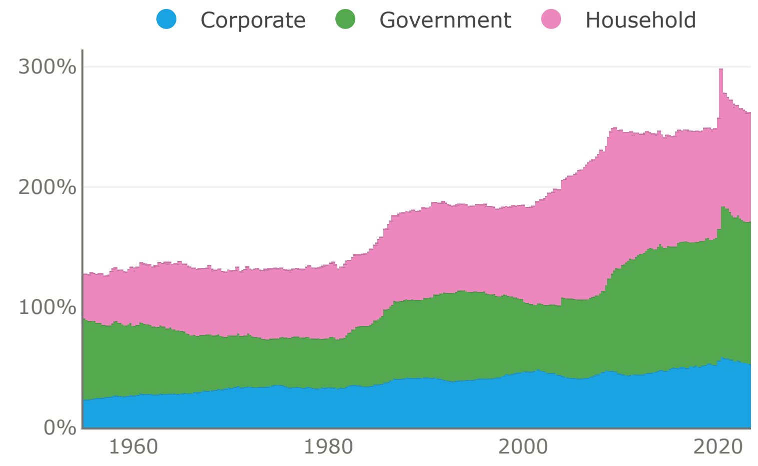
Profit Share of GDP



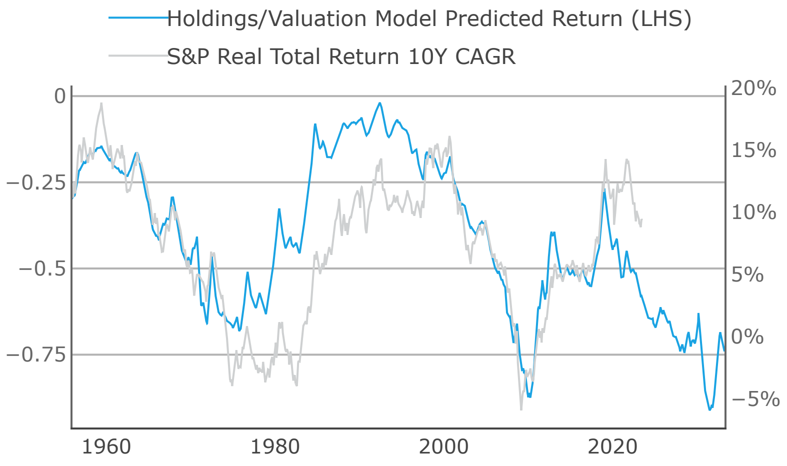
Earnings Deviation From Trend



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 Oct 2023

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