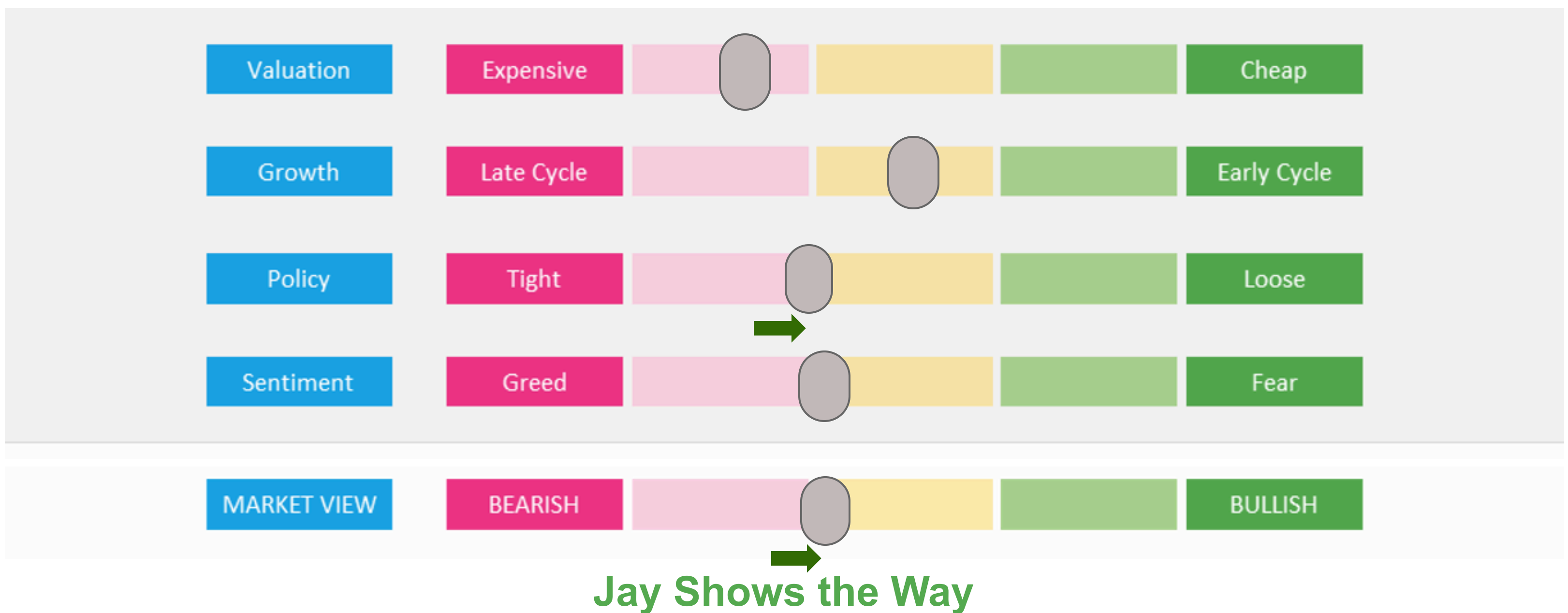
OCTOBER 2024

CCLA
GOOD INVESTMENT

Market Barometer



Jay Shows the Way

- **And they're off.** The Fed signalled that it meant business by cutting 50bps rather than 25bps. As a first move in a new rate-cutting cycle that itself was an interesting statement of intent. The fact that there was a dissenting vote was also indicative of just how much Chairman Jay Powell wanted 50bps when he could have had unanimous agreement on 25bps.
- **What do they know that we don't?** Well, lots, obviously, but we don't think the sinister interpretation is necessarily the correct one - and the market has taken the 50bps as an unambiguous positive too.
- **It's not that there are no clouds on the horizon.** We are paid to be paranoid. Risks centre on 1) the US labour market, with the unemployment rate rising and that at risk of becoming self-reinforcing. Jay Powell cited this as the main reason to cut rates. 2) the US housing market, where affordability is low, homebuilder confidence is low, transaction levels are low. **BUT - earnings estimates are resolutely rising, lead indicators still point to expansion, inflation is under control and rates are falling.**

In our Charts of the Month:

- **We look at the R Star**, also known as the natural real rate of interest. We think that recent estimates of the R Star have been too low. This matters because policymakers take some account of it as a measure of the "fair" interest rate. The Fed thinks neutral real rates are below 1% too, so they might take rates down to that level even absent a recession, which could turbo-charge risk assets.
- Even if R Star estimates have been correct, interest rates have been far too low for a very long time, but are now on the tight side, so should be cut anyway.
- **Pandemic excess savings have been spent**, and M2 money / GDP has also normalised. There is no longer a cushion under domestic consumption
- **Who will win the US election?** We don't know, but one market indicator is leaning towards Kamala. That would mean no tax cut extension.

We remain risk on.

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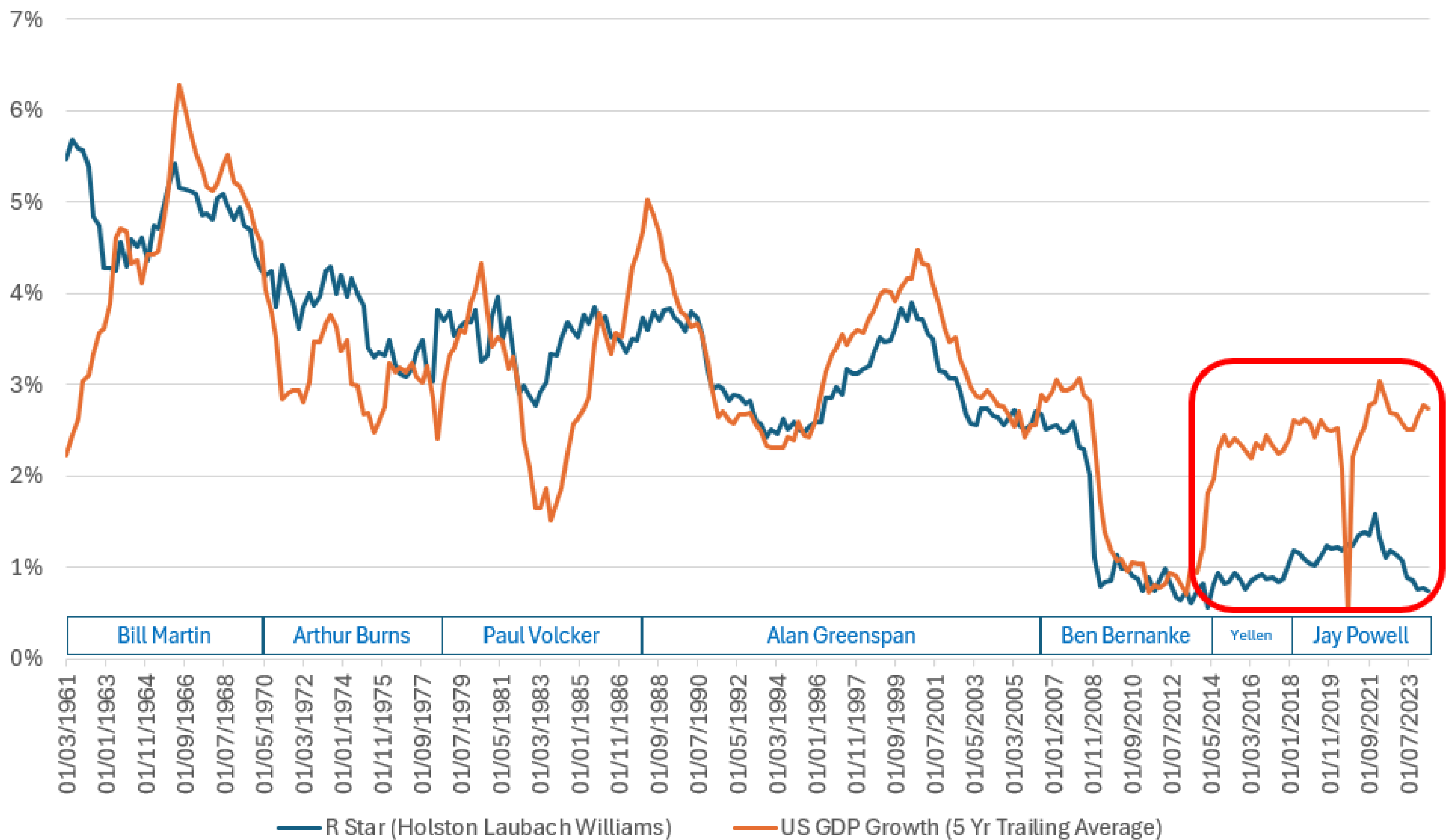
Charts of the Month (1 of 4)

Theory says that the natural interest rate should be close to the trend growth rate of an economy. The natural rate can be defined as the real interest rate that equilibrates between saving and investment, and so keeps output growth at trend without engendering inflation. These days economists refer to it as the "R Star". The idea of a natural rate was first proposed by the Danish economist Knut Wicksell in 1898. He wrote in "Interest and Prices" that the "*natural rate is roughly the same thing as the real [rate of return] of business*". GDP is the growth of gross value added i.e. the rate of return. Ergo, according to Wicksell, the natural interest rate should be around the growth rate. And indeed, as we show below, economists' estimates of the natural rate have been very close to the average growth rate... until recently (see red box below).

This raises the question of whether we have recently been under-estimating trend / potential growth.

We have been Under-Estimating Potential Growth



Sources | CCLA, Bloomberg. Federal Reserve Bank of New York, Bureau of Economic Analysis. All data as at Sep 2024.

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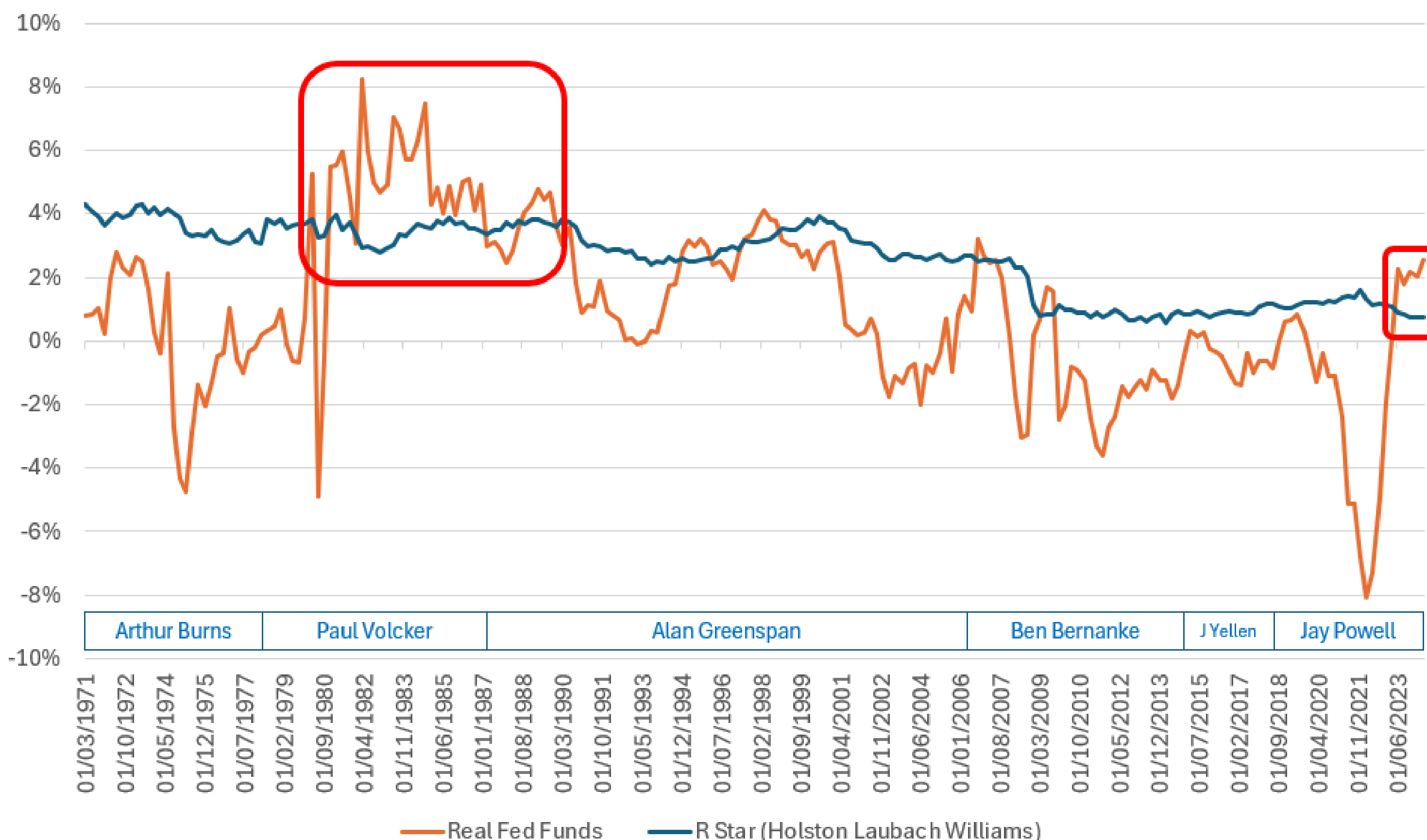
Charts of the Month (2 of 4)

Even if the R Star estimate is too low, real interest rates have been even lower. According to Wicksell, the money real interest rate (orange line below) should be on average similar to the natural real interest rate (blue line below) for an economy to be in equilibrium. To the extent that they are not, we can say that monetary policy is either tight or loose. On that reading, Paul Volcker is the only Fed Chairman in the last 50 years to have conducted a tight monetary policy for any period of time (large red box below). It also points to the fact that monetary policy is currently tight (small red box below), indicating that Jay Powell and colleagues are right to be contemplating substantial cuts to interest rates regardless of whether the economy slows or not, now that inflation has come under control. **One thought, though, is that *if* the R Star estimate is currently too low *and* the Fed believes that estimate, there is a good chance that the Fed will cut interest rates more than is necessary, which could turbo-charge risk assets in the event of a soft landing for the economy.**

Interest Rates have been Too Low for a Long Time



Sources | CCLA, Bloomberg. Federal Reserve Bank of New York, Federal Reserve. All data as at Sept 2024

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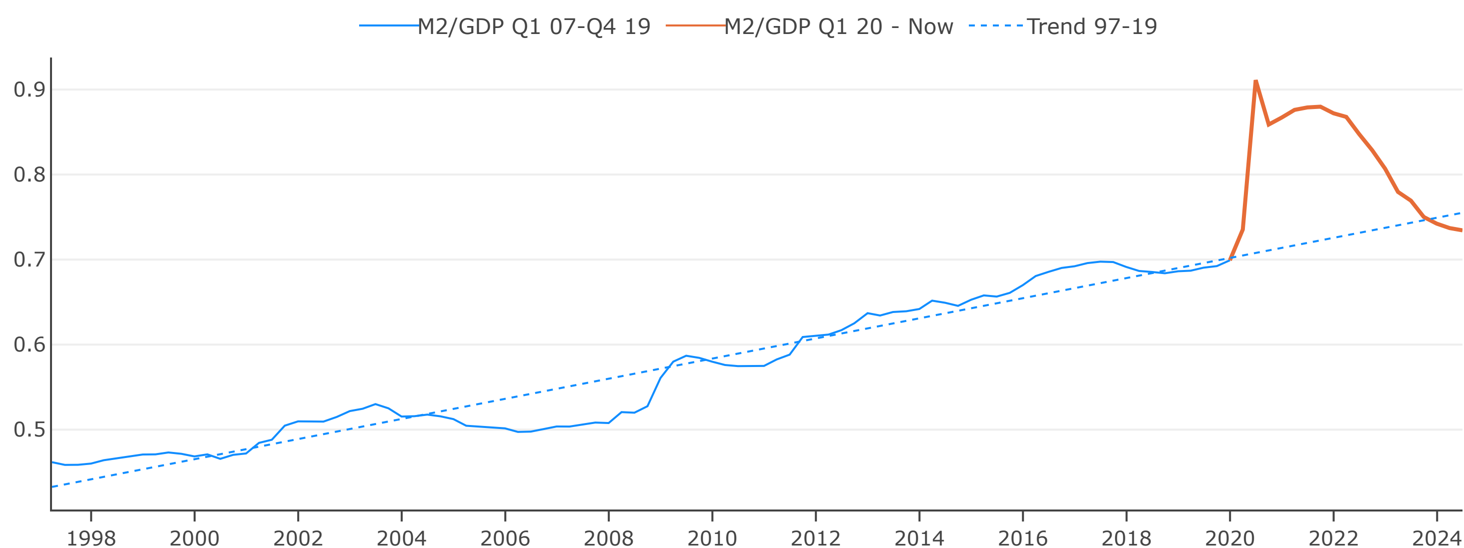
Charts of the Month (3 of 4)

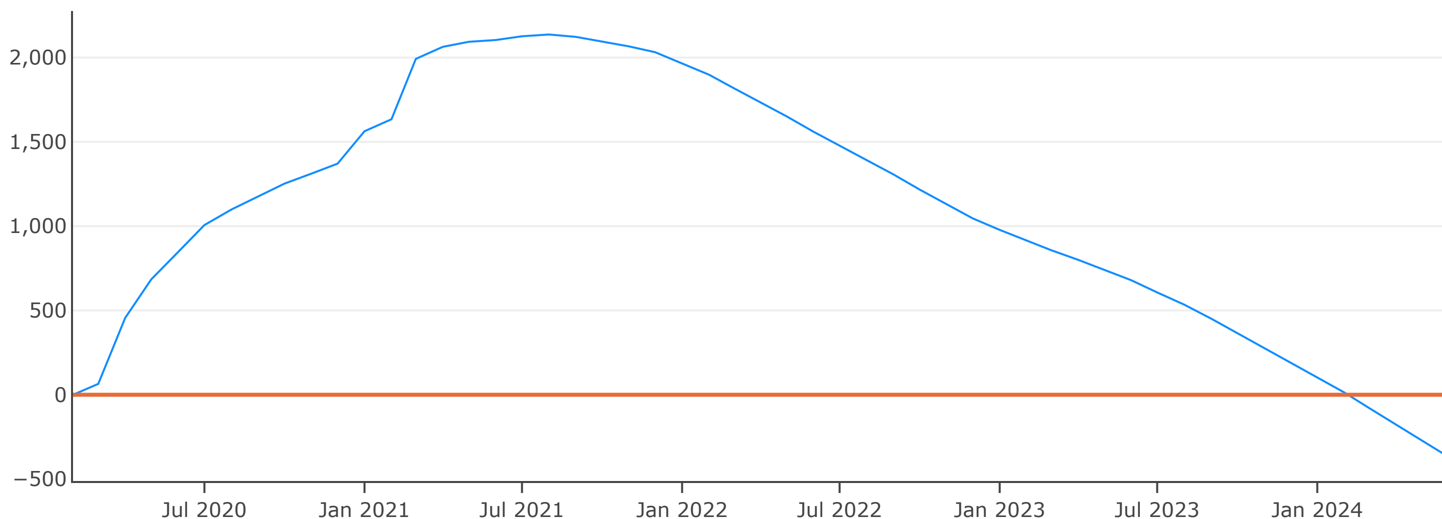
In many ways, the US economy has normalised after the excesses of the pandemic. The clearest way to see this is through the lens of the money supply (top chart below). In response to the crisis, central banks printed money while GDP shrank, resulting in the ratio of M2 money / GDP ballooning in early 2020. This itself resulted in inflation taking off. With the advent of tight monetary policy in reaction to that inflation, the money/GDP ratio then started to normalise, and is now back to its pre-pandemic trend line. Similarly the excess consumer savings accumulated during the pandemic (by people not being able to spend their incomes / stimulus cheques) have now been spent (bottom right chart).

In short, there is no more cushion for domestic consumption from excess savings / money.

US Money Supply Growth



US Cumulative Aggregate Excess Savings $tr



Sources | CCLA, Bloomberg. Data as at Sept 2024. US Cum. Agg. Excess Savings: Federal Reserve Bank of San Francisco as at June 2024

TOP OF MIND

Charts of the Month (4 of 4)

The US Presidential election is "in the margin of error" / "too close to call" / "we have no idea". However, one way of observing what the market seems to be pricing in is to look at how stocks that would benefit from a Democrat win (renewable energy stocks, healthcare, infrastructure spending) are performing relative to those that would benefit from a Republican win (de-regulation beneficiaries, oil, gas and steel stocks, construction and security stocks). Goldman Sachs has constructed baskets of these two cohorts. **The equity market is leaning more towards a Democrat win, for now.**

Sources | Bloomberg. Data as at Sept 2024

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Equity | USA

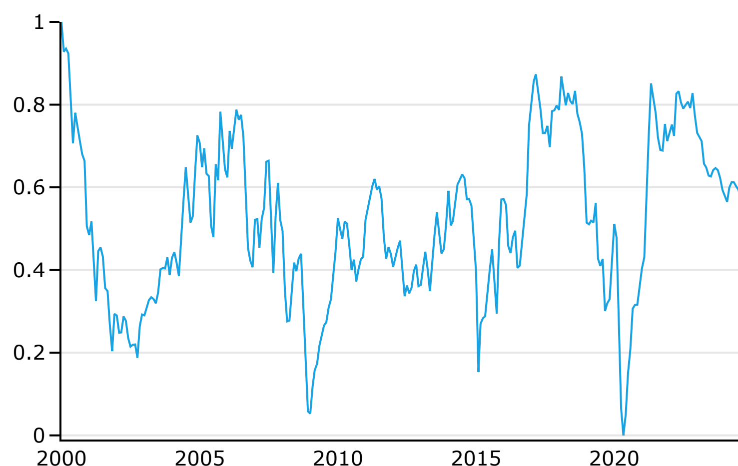
Having declined over 4% during the first week of September, the market's pessimism exhausted after the jobs report. Since then, the S&P 500's rally has been very closely correlated with the growing expectation of a 50bps cut at the FOMC meeting. The index is up over 1.5% on the month and 21% YTD, at the time of writing*.

Despite the cross-asset valuation dropping to the 52nd percentile (top right), equity risk premium (bottom right) still looks rich at 1.2%. Similarly on an absolute measure, the CAPE (cyclically adjusted PE) still stands near recent highs at ~35x, creating an earnings yield and forward real expected return close to 3% annualised.

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. *MTD from 30 Aug 24 to 24 Sept 24.

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

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VALUATION

Equity | Regional

Outside the US we continue to see better top-down market value. In the UK, **attractive valuations, improved political clarity, and high dividend yields in a declining Gilt yield market, with a low beta to MSCI World, continue to make for interesting prospects.**

Shiller CAPEs highlight UK as 13.6x with an earnings yield (and expected forward real returns) over 7%, with Europe and Japan around 20x and ~5%, and EM 12x and ~8% respectively.

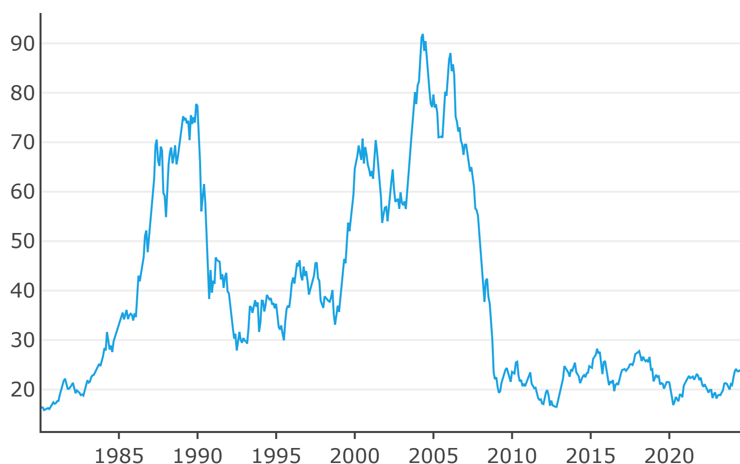
Europe

UK | Shiller P/E

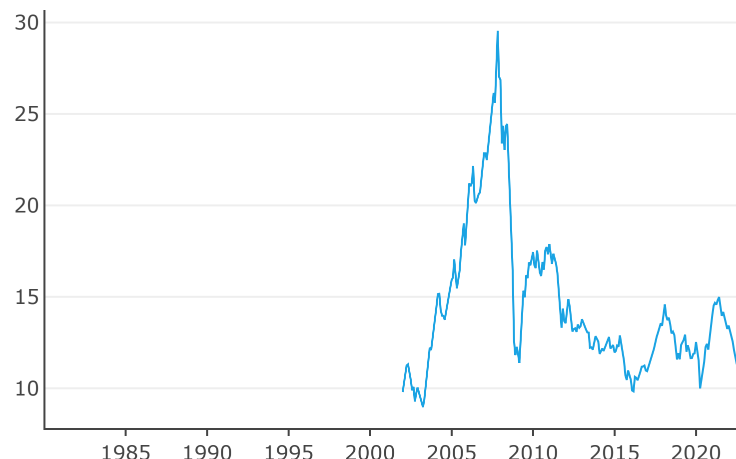
Europe (Ex-UK) | Shiller P/E

Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



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

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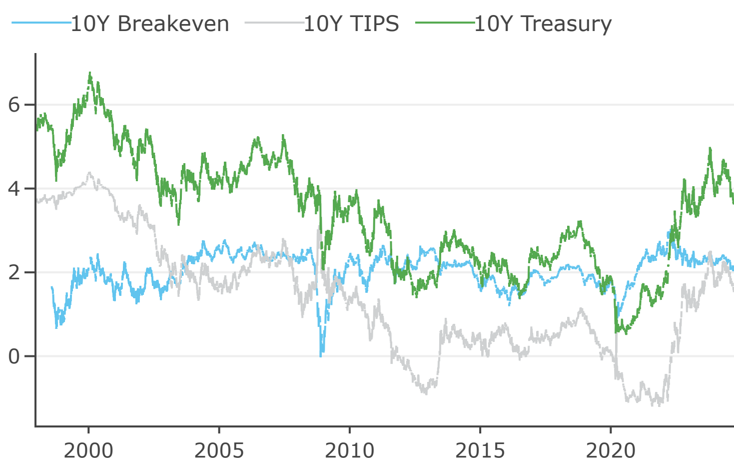
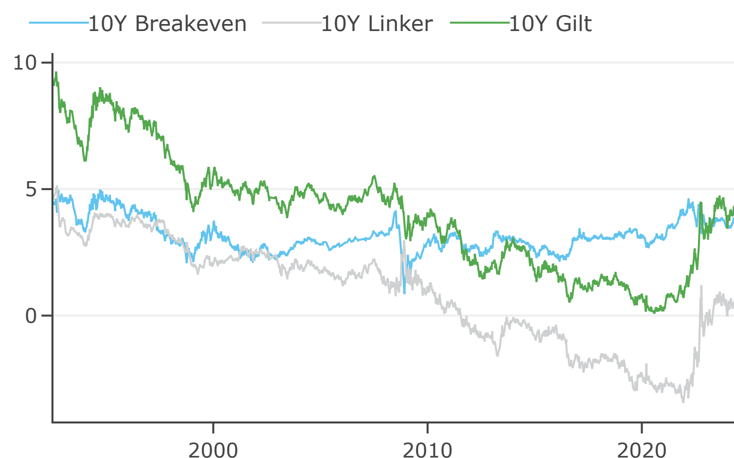
Bonds

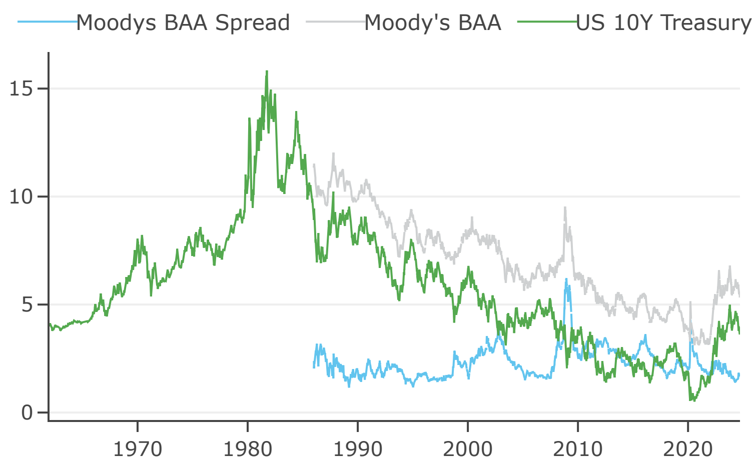
UK and US sovereign bond yields have continued to fall since their May peaks, creating the first consistent bullish environment for bond holders since Q3 last year. 10Y UK and US Treasuries (UST) fell 42bps and 95bps respectively, leaving the UK with a higher yield than US. Worth noting, almost three-quarters of the fall in UST is due to a repricing of the US inflation-linked bonds, i.e. a reduction in long-term growth expectations for the US, now at a 2024 low of 1.5%.

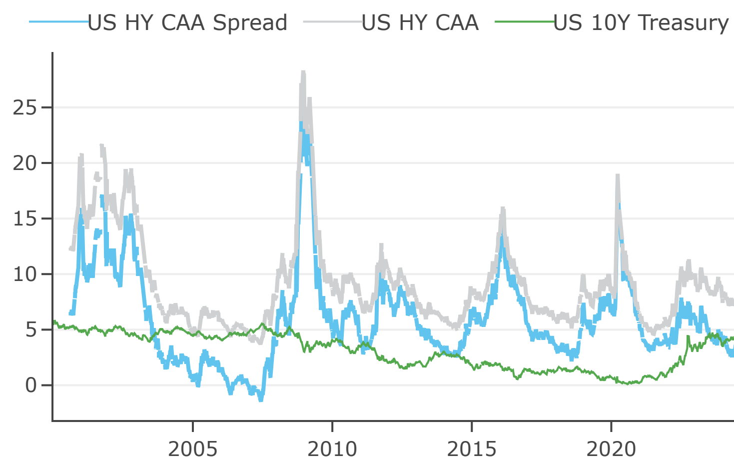
Corporate US BBB yield fell 20 bps MTD, closely following the fall of Sept Fed Fund Rate expectations. **After stripping 2.5% for expected inflation, IG real yields of 2.8% still look reasonably attractive.**

Global Government & Corporate Yields









Sources | Bloomberg as at Sept 2024

Alternatives

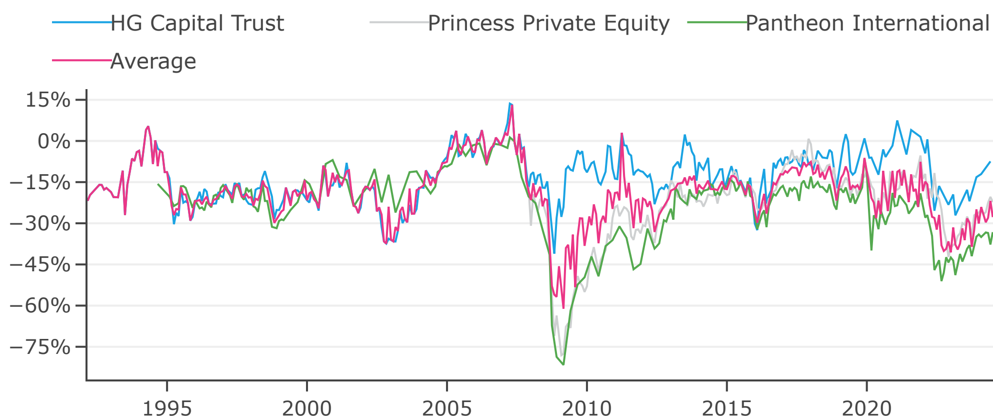
Industry reports peg dry powder in the Alternatives asset class at a very large $4.5trillion*, with over two-thirds coming from Buyout, Credit and Infrastructure market funds. Given the subdued activity in 1H24, there is a growing urge to transact, especially with the potential for US rate cuts on the horizon.

Rate cuts could also boost the Infrastructure market. Dividends make up a high proportion of the market's total returns, lending it bond-like characteristics. **We believe Infrastructure should perform well in a rate-cutting cycle.**

Global Valuations

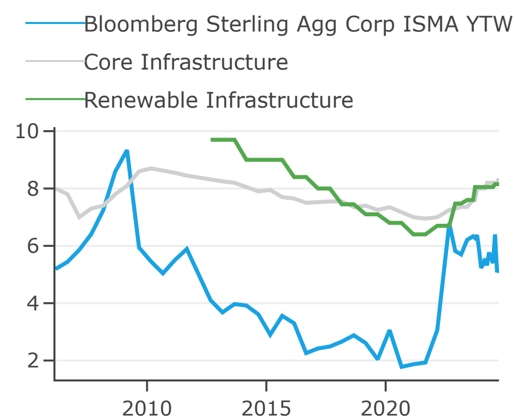
Listed Private Equity

Discount To NAVs



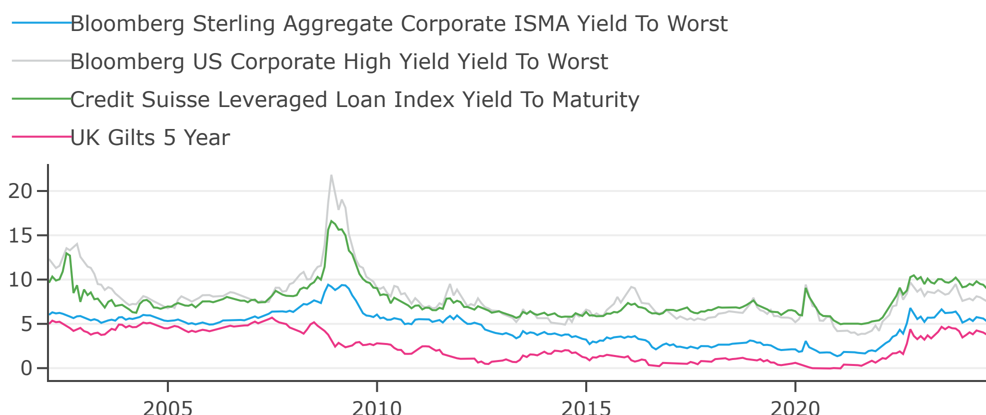
Infrastructure

Infrastructure Discount Rates vs Bond…



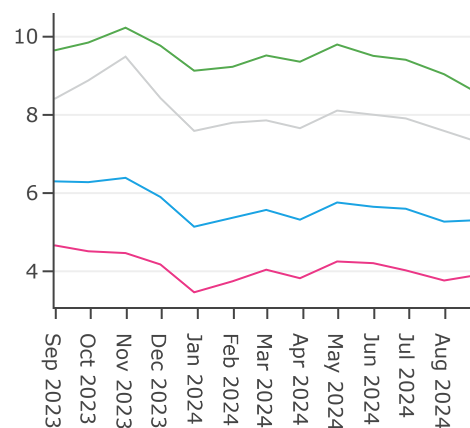
Contractual Income

Income Yields



Last 12 Months

Income Yields



Sources | Infrastructure: CCLA, Bloomberg; Property: MSCI UK Monthly Property Index, Bloomberg; Private Equity: Bain Global Private Equity Report, Bloomberg, Pitchbook; Contractual Income: Bloomberg, Pitchbook. As of Aug 2024. *Morgan Stanley: How Private Equity is Spending its $4.5tr Cash Pile, 16 July 2024

VALUATION

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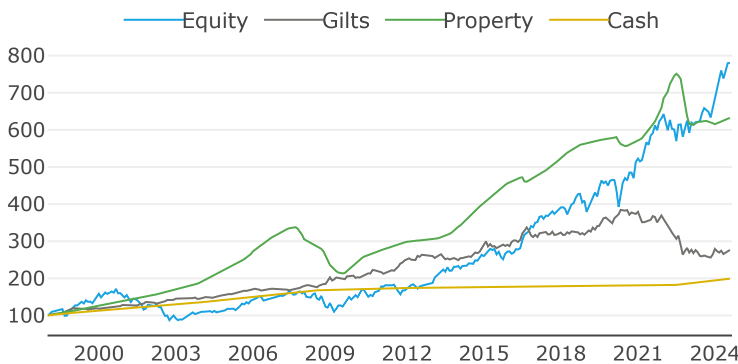
Property

UK commercial property yields and capital values have stabilised in recent months. According to MSCI, transaction volumes across Europe look to be in a "recovery phase" with the UK likely to rebound faster. This can be seen through several UK listed real estate investors raising equity to go after relatively cheap opportunities. **On the other hand, given most purchases are financed, the start of the Bank of England's cutting cycle could also add fuel to this growing demand.**

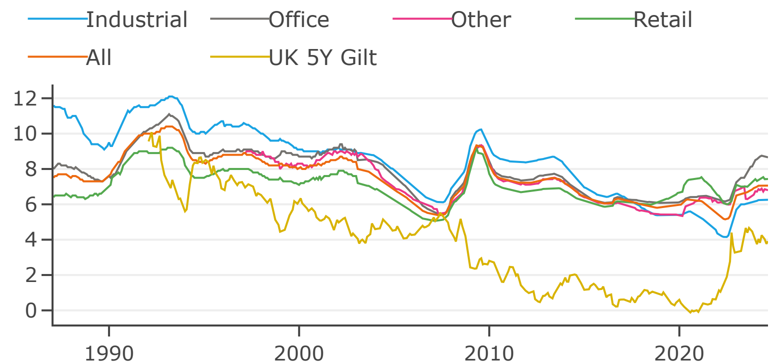
Within the context of CPI + 4%, current equivalent yields look attractive at 7% on average. Worth also noting, real returns to Property have tended to average around the starting Equivalent Yield (middle left chart). **This bodes well for forward returns from here.**

UK Commercial Property Market

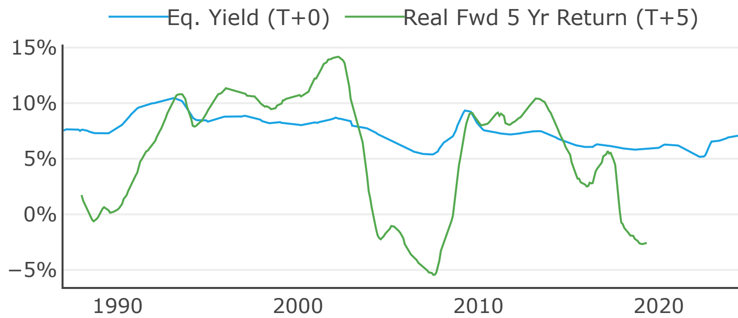
25 Years Of Return 1998=100



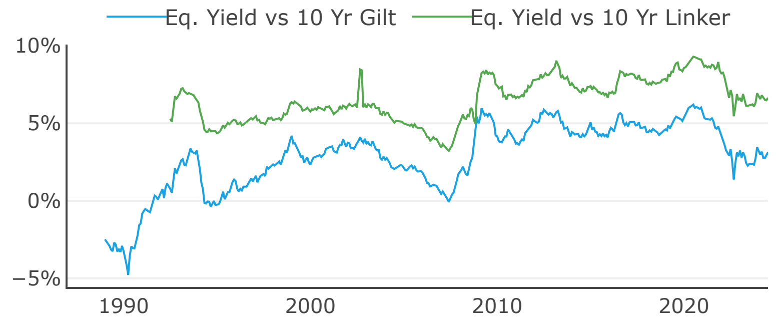
Equivalent Yields vs Gilt Yields %



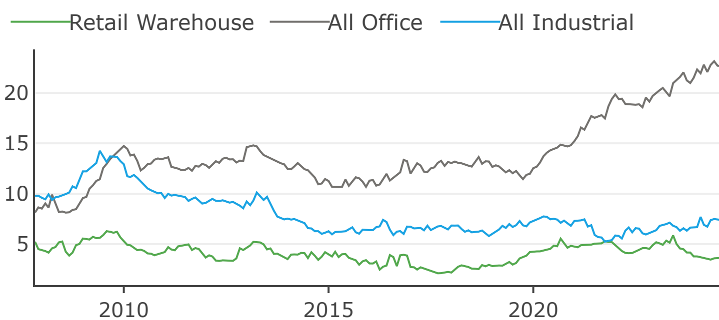
MSCI UK All Property Monthly TR Index %



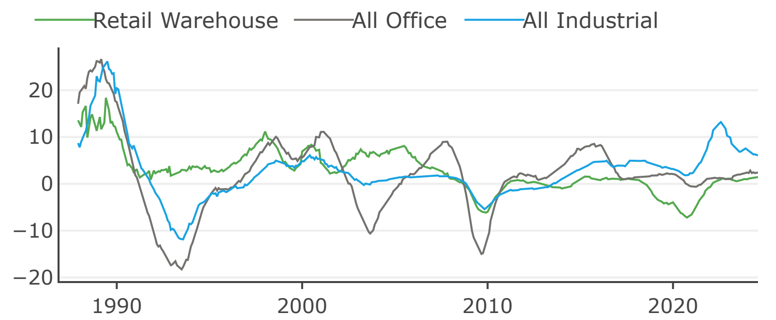
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



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

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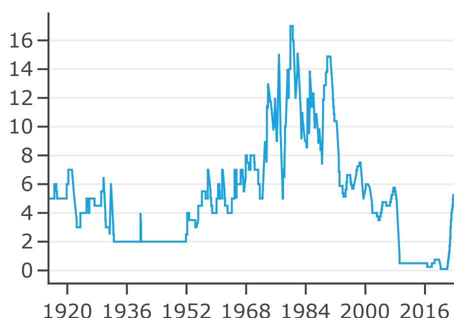
Cash

Is the UK economy heading for a recession? If we judge the UK through three lenses: 1) Corporate earnings: FTSE 250's latest half-year season shows healthy EPS growth at 10%. 2) Labour market: Cooling, but remains stable. Total hours worked typically fall before a recession, but are currently on the rise. 3) Consumption: Weak!

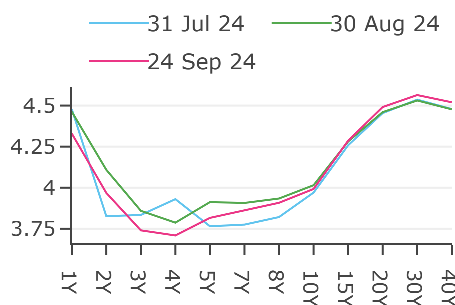
Household savings rose in the lead up to the last six recessions including last year's technical recession. It typically takes 10 quarters (~2.5 years) before consumers favour spending again. In the current cycle, confidence remains low and savings are still climbing, raising concerns for another growth scare. We expect the 10th quarter to kick in next summer. **With rates expected to be closer to 4%, inflation near 2% and unemployment around 4.5%; the rosier backdrop next year could give rise to confidence and spending in time to avoid another slowdown.**

UK Sterling Market

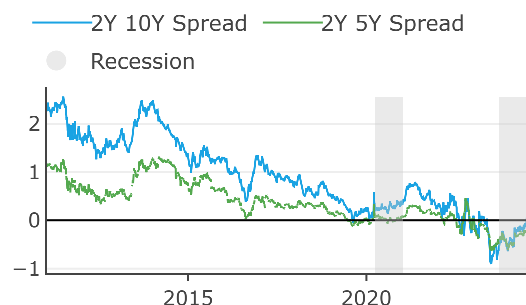
Official Bank Rate



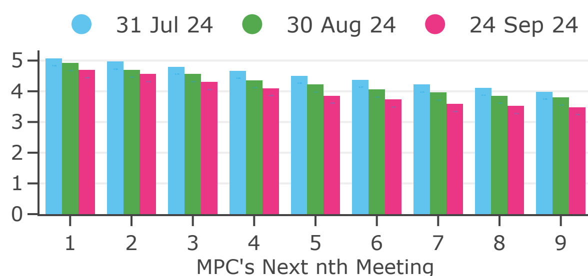
UK Gilt Curve



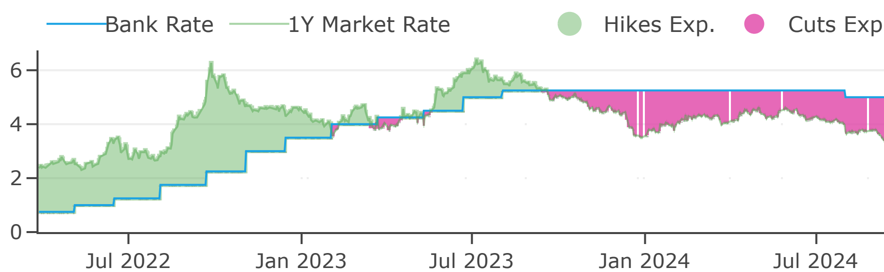
Gilt Spreads



Rate Expectations For Future MPC Meetings



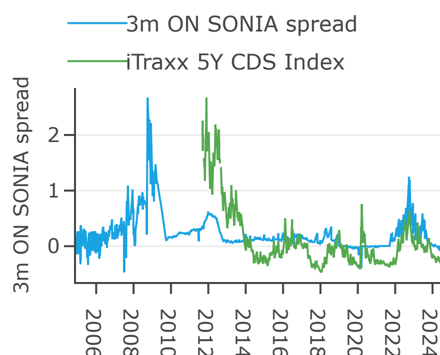
1Y Forward Market Rate Expectations



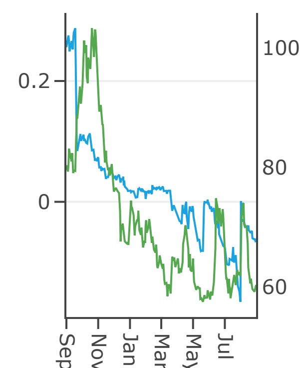
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2024					
	Mar…	April	May	June	July	August
RPI	4.30	3.30	3.00	2.90	3.60	3.50
CPI	3.20	2.30	2.00	2.00	2.20	2.20
CPI Core	4.20	3.90	3.50	3.50	3.30	3.60
CPI Services	6.00	5.90	5.70	5.70	5.20	5.60
CPI Goods	0.80	-0.80	-1.30	-1.40	-0.60	-0.90
Priv. Wages	5.90	5.90	5.00	5.00	4.90	

Market Stress



Last 12 Months



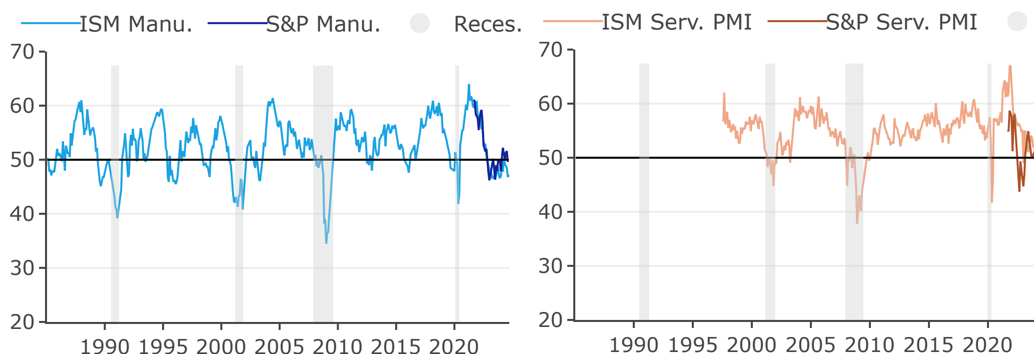
Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, at least +/- 2 standard deviations away scores as red. Bloomberg for all charts, as of Sept 2024
2 Break-evens at 3.4% minus 1% CCLA CPI conversion estimate; 1.3% BoE 2026 real GDP growth estimate.

Global PMIs

We have included both S&P Global and ISM PMI readings for the US. Both surveys are a collection of responses from varying sets of US corporations and therefore the respective results may vary. **We do not have a preferred survey, rather the combination helps give us a holistic understanding of the economy.**

US Manufacturing continues to weaken across backlogs, new orders and importantly, employment. However, Services which represents over 70% of US corporate output, is showing the exact opposite and remains strong despite recent fluctuations. **The UK continues to outperform the G7 with strong readings across all industries.**

United States



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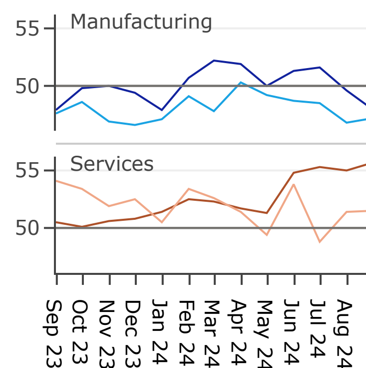
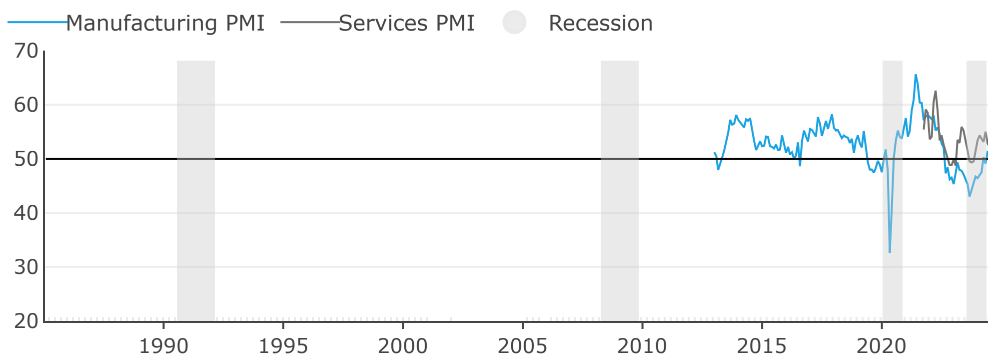


United Kingdom



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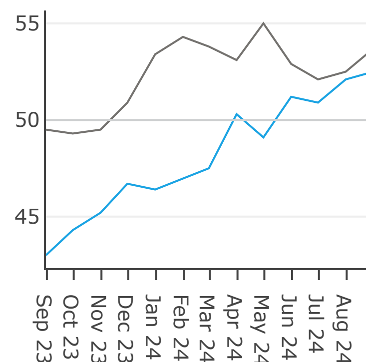
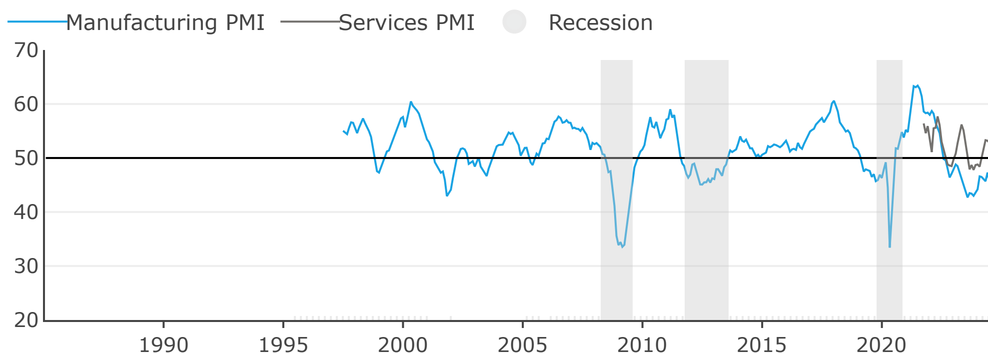


Eurozone



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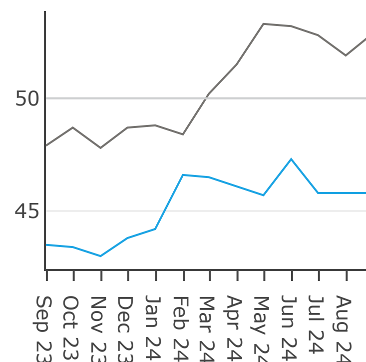

Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Aug 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

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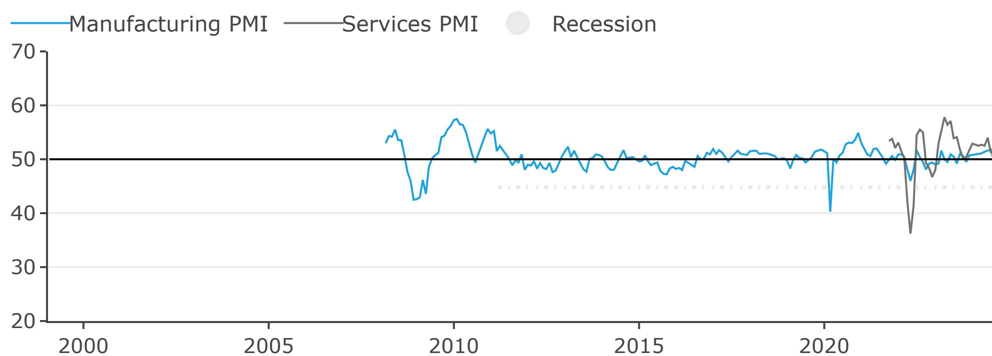
Global PMIs

Global Manufacturing PMI fell below 50 for the first time this year in July and worsened in August. Surveys suggest companies remained reluctant to hire additional staff while cost and cash flow were top of mind. There were cut backs in purchasing activity too, as a result of contraction in new orders. None of this bodes well for global growth.

Services on the other hand continued to expand strongly, posting above 50 readings across employment, new business and future activity. **At present, Services are maintaining the buoyancy of the global cycle.**

China



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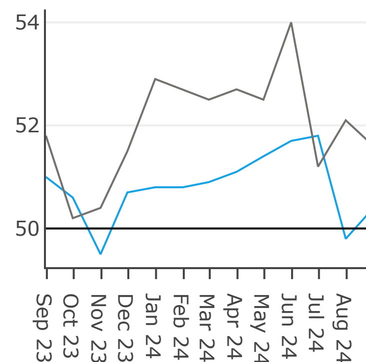
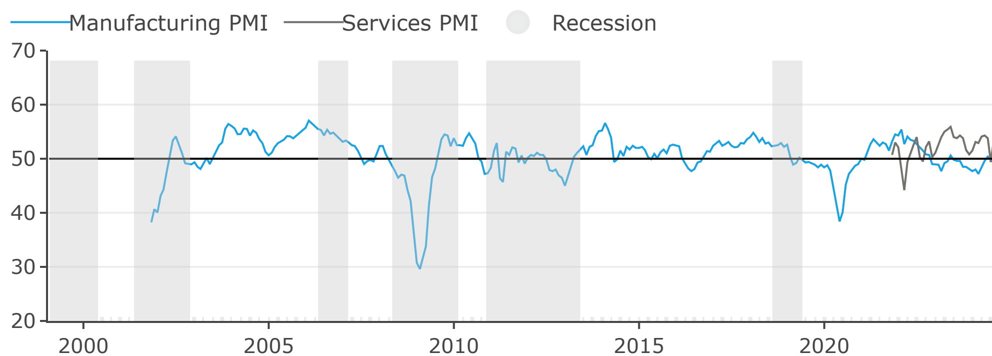


Japan



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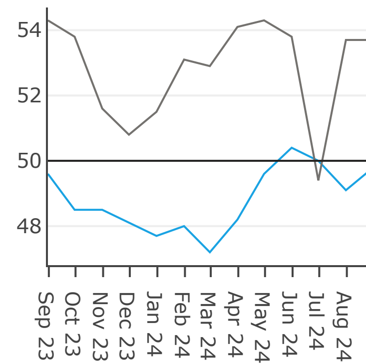
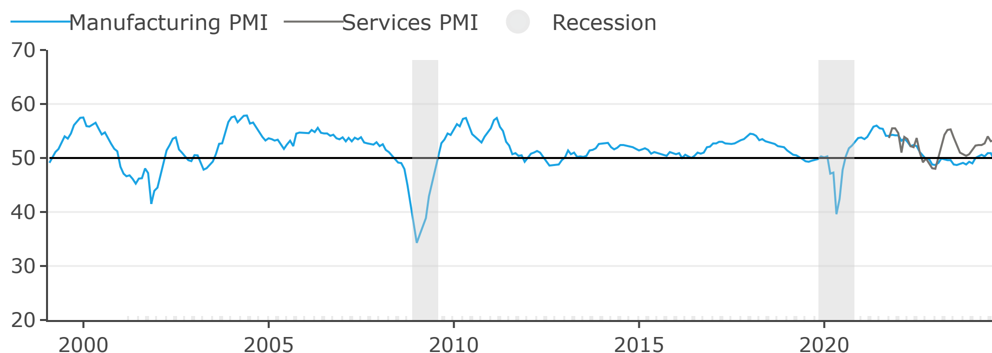


Global



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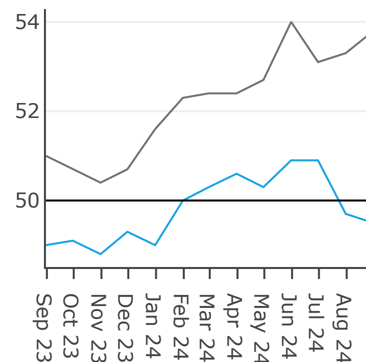

Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Sept 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

GROWTH

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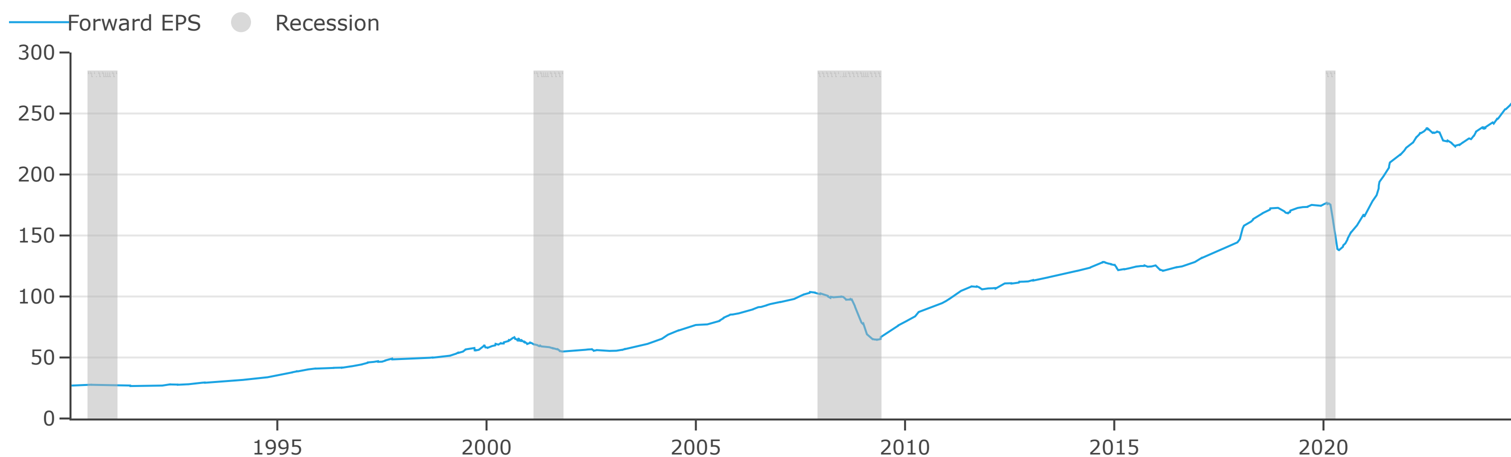
Earnings

Consensus forward earnings estimates continue to recover (top chart) while trailing earnings are just starting to grow again. S&P 500 for Q2 show top line growth of 5% with EPS growth a little over 10% - both solid readings and in line with the 20-year pre-pandemic average. On a sector level, 9/11 sectors have shown positive earnings growth, with Materials and Industrials being the two laggards.

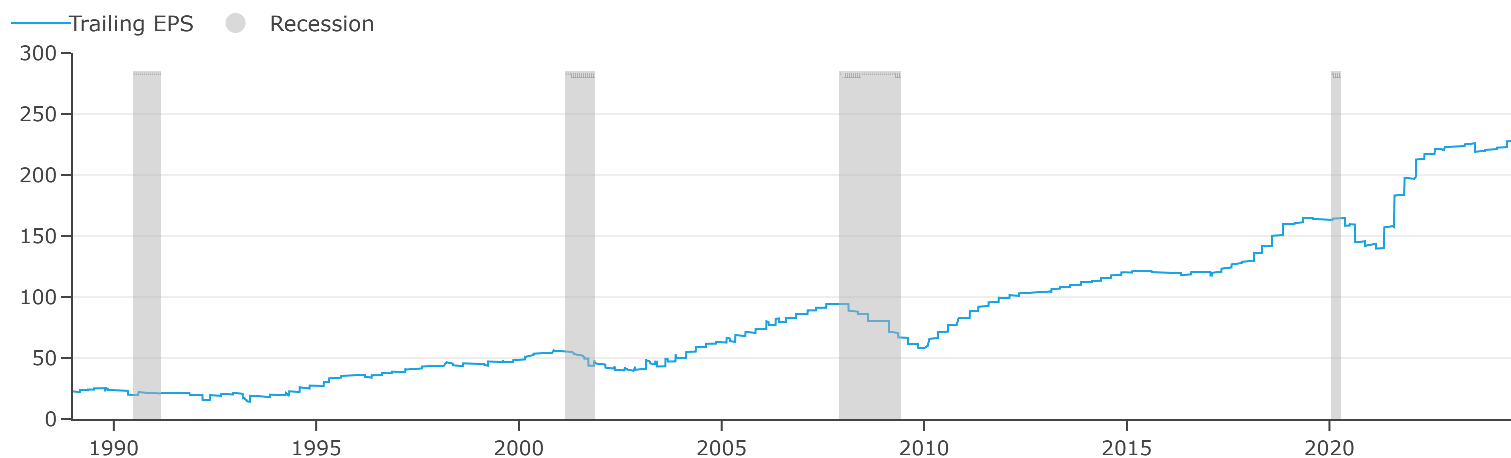
We continue to believe that earnings are in position to take over from PE re-rating in driving the market higher. A softening **US consumer remains an active risk, and we continue to monitor signs of fragility moving from low-income households into more middle-and-high-income households.**

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 Sept 2024

GROWTH

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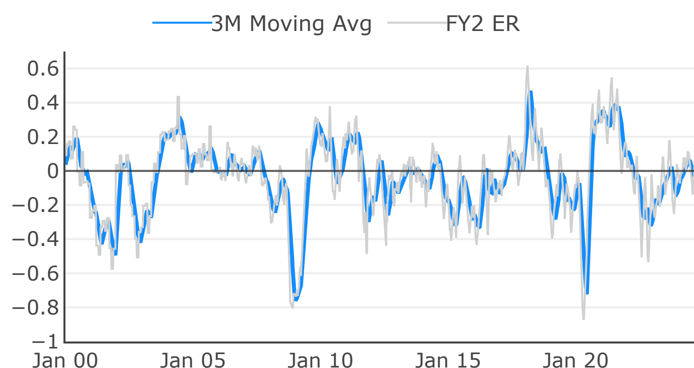
Earnings

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.

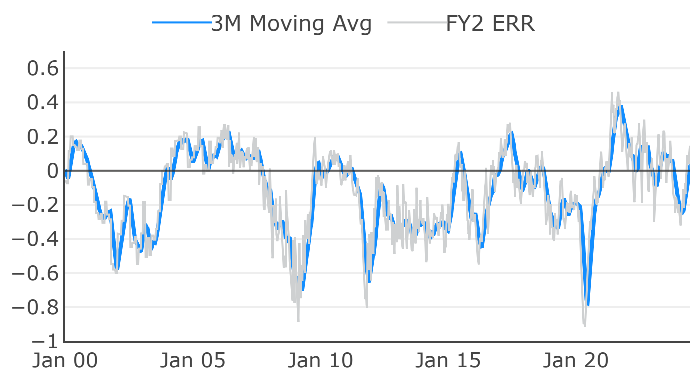
The overall assessment is that earnings breadth is ticking up, with the U.S. now joining Japan in having positive net earnings breadth. This speaks to a broadening out of earnings support from just the Magnificent Seven.

Global Earnings Revisions Ratios

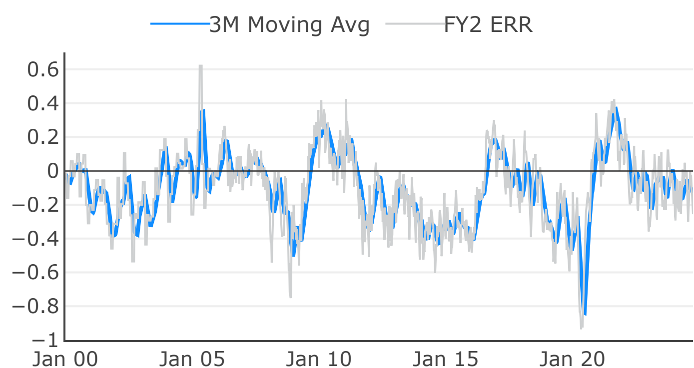
USA



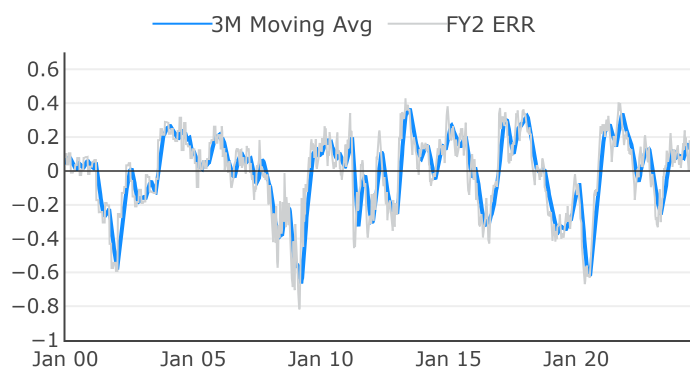
Eurozone



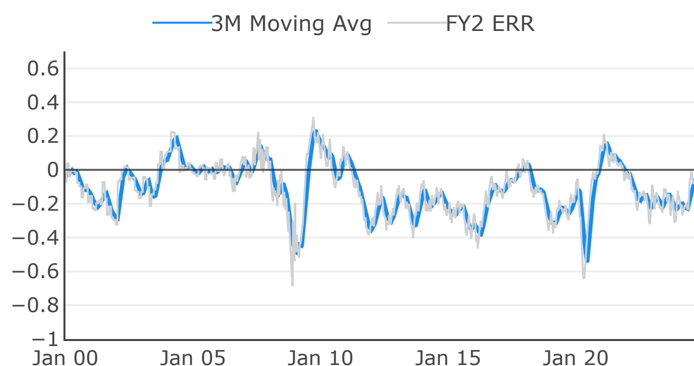
UK



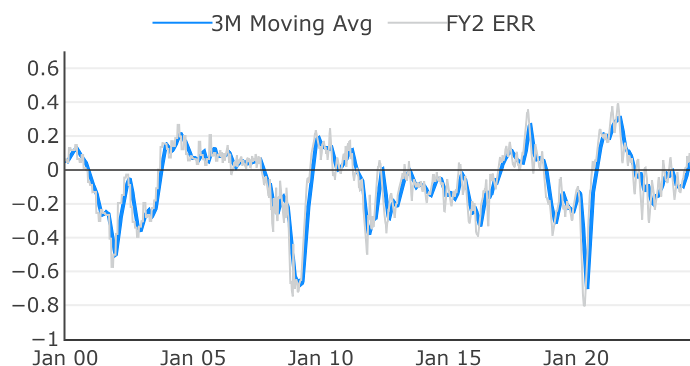
Japan



Emerging Markets



World



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

POLICY

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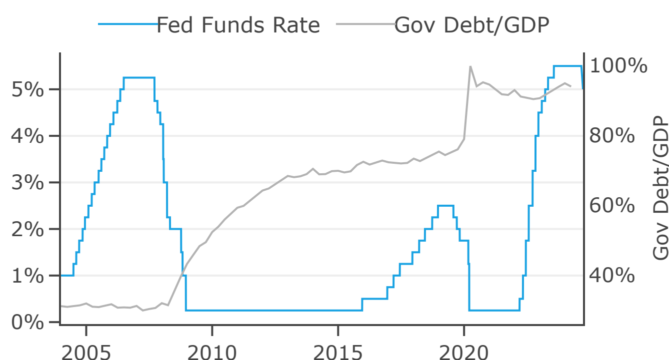
Interest Rates

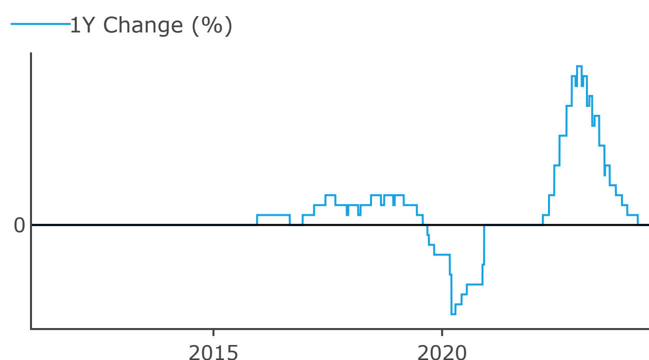
"The time has come for policy to adjust", "We do not seek or welcome further cooling in labour market conditions". These comments by Jay Powell at the Jackson Hole Symposium have made it clear that labour-stability is the new focus.

The job vacancy rate has dropped to 4.9%, nearing Fed Governor Waller's critical 4.5% threshold; the unemployment rate has triggered the Sahm rule; and small businesses, which are responsible for the majority of US hiring, are experiencing significant deterioration in earnings - NFIB Actual Earnings Changes are now at 2010 levels. **These factors highlight weakness in the labour market and could go some way to explaining why the Fed chose to start with a 50bps cut rather than a 25bps.**

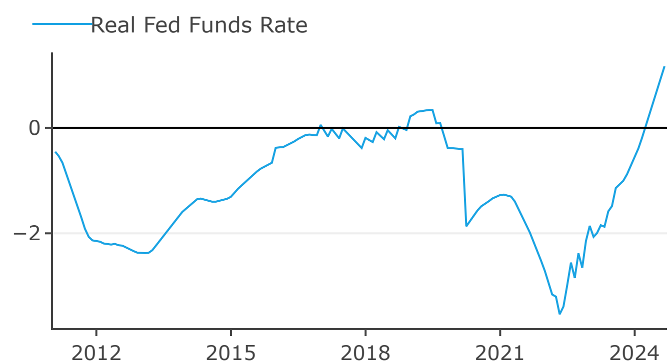
Fed Funds Rate



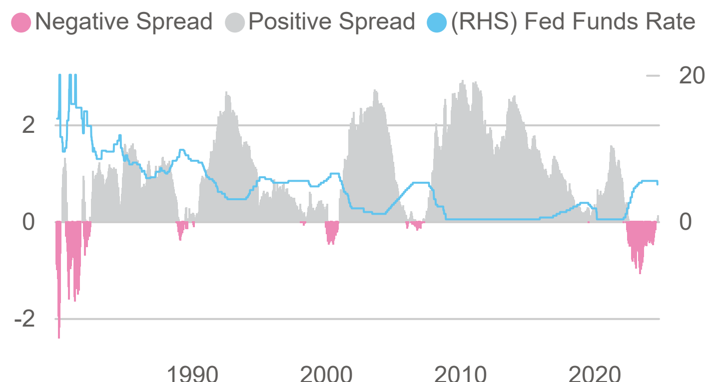
Change in Fed Funds Rate



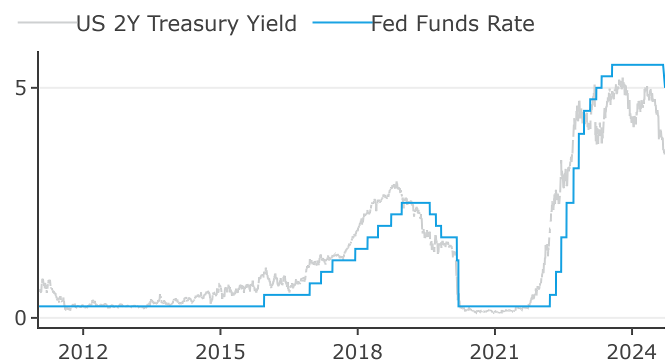
Real Fed Funds Rate (Using 2Y MA CPI)



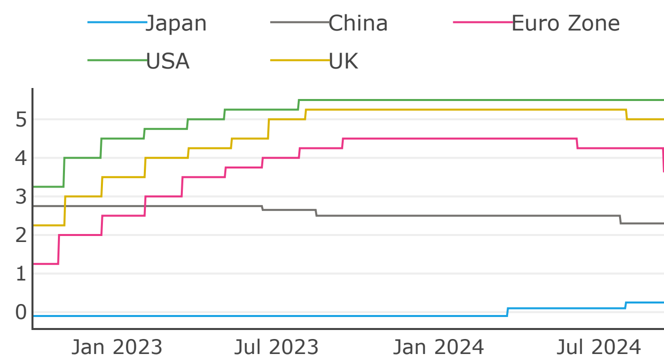
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Sept 2024

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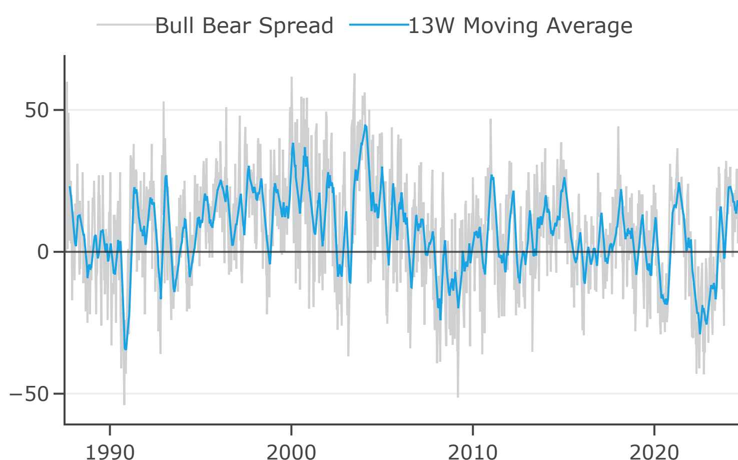
Sentiment

The Dollar-Yen carry-trade unwind did create some short, but intense, selling pressure at the start of August. **This lead the VIX to spike to levels above 40, similar to the likes of the COVID period in June 2020.** The panic lasted just a few days before the VIX normalised back towards its <20 levels.

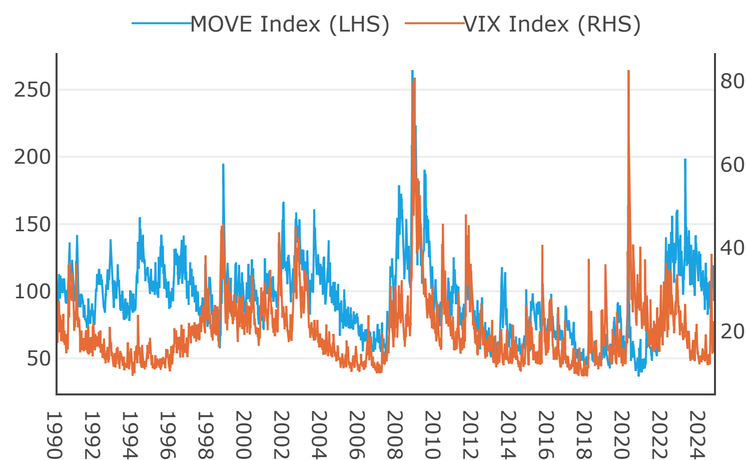
The BAML Hartnett Bull & Bear Indicator has moved from Extreme Bearish sentiment (which is bullish for the market!) in October 2022 **to now above neutral** (the current reading is 5.2/10). Given last month's reading of 6.1, **it seems sentiment is flip-flopping in undecisive territory rather building towards extreme levels.**

US Equity Indicators

AAII Bull Bear Spread

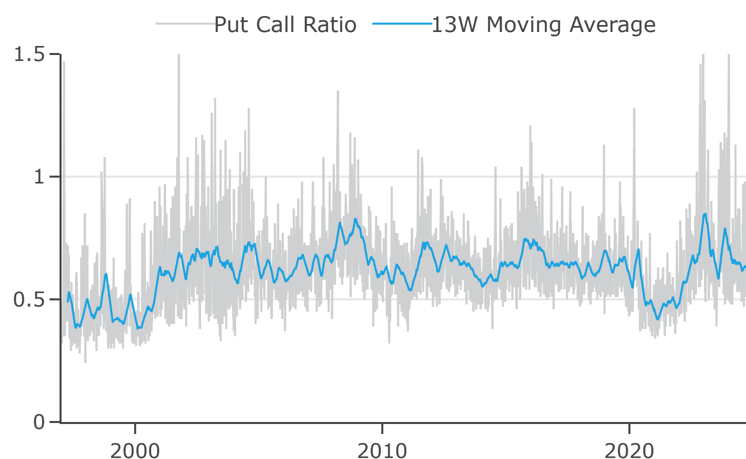


Equity vs. Bond Sentiment



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 Sept 2024

SENTIMENT

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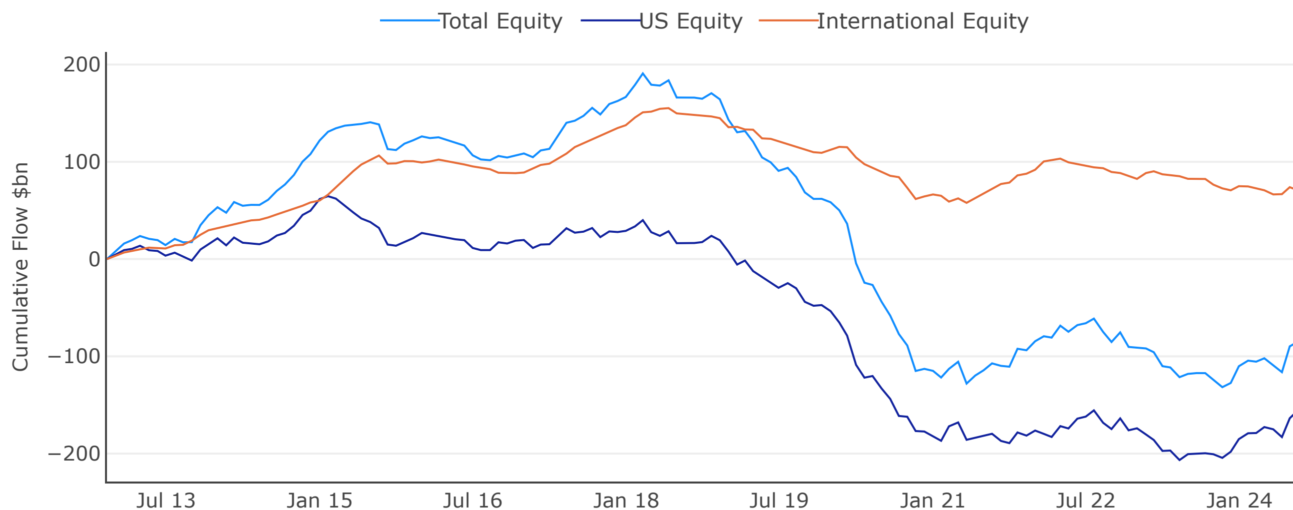
Fund Flows

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.

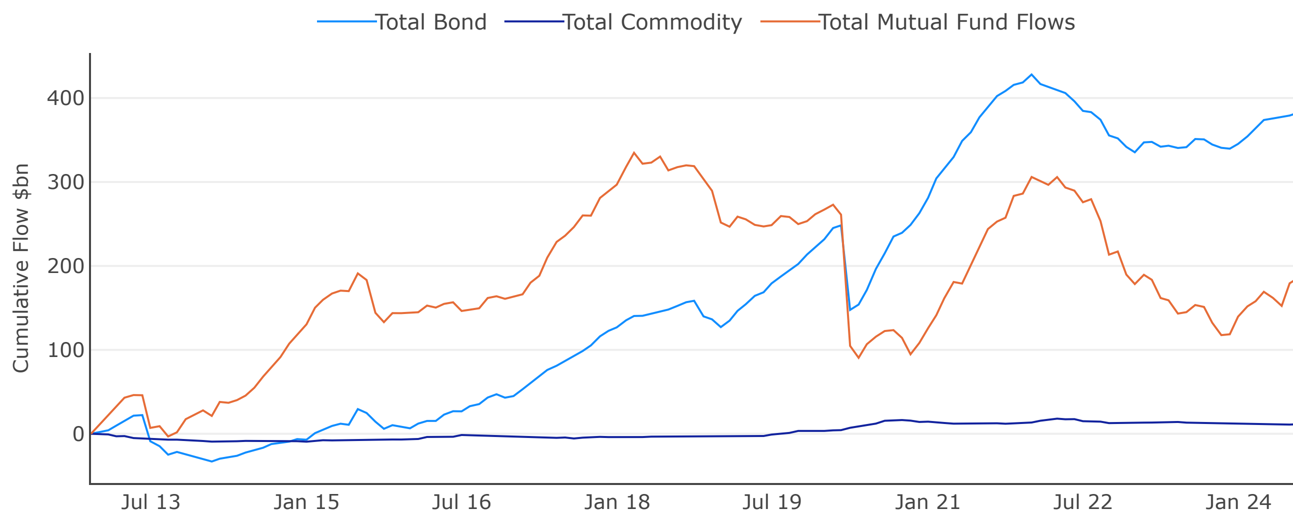
The message in these data points continues to be that there is little enthusiasm for actively managed funds even if the outflows from equity funds have stopped.

US Mutual Fund Flows

Equity Markets Cumulative $bn



Non-Equity Markets Cumulative $bn



Sources | All charts: Bloomberg ICI fund flow data. Data as at Sept 2024

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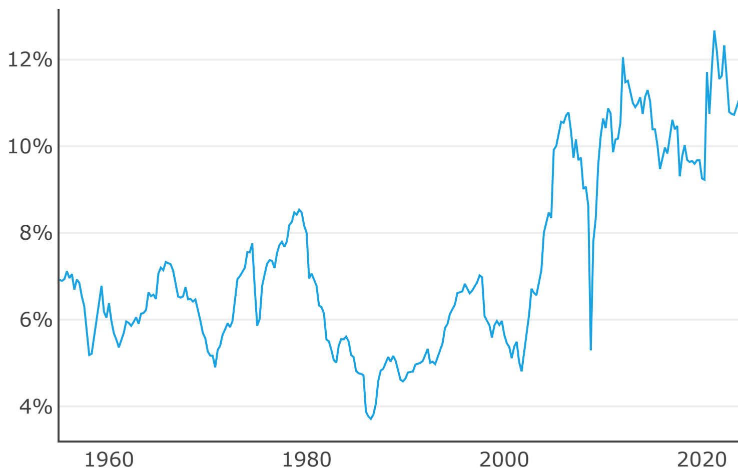
The Big Picture

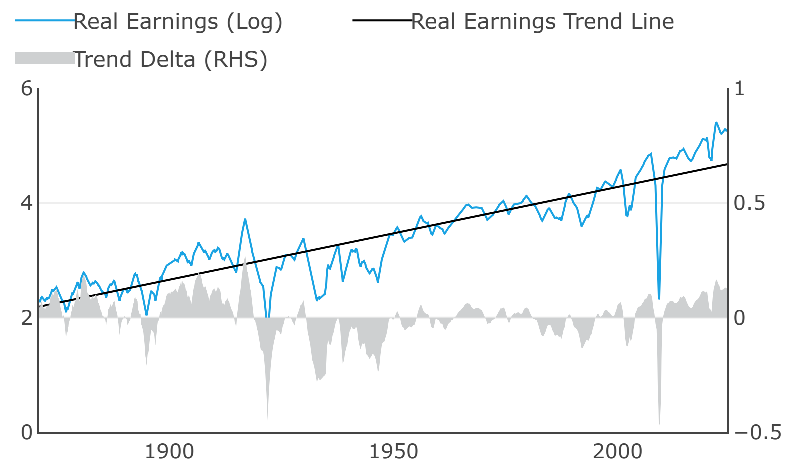
Here we highlight some longer-term imbalances that, **should** they correct, would have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. Its corollary (not shown) is that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

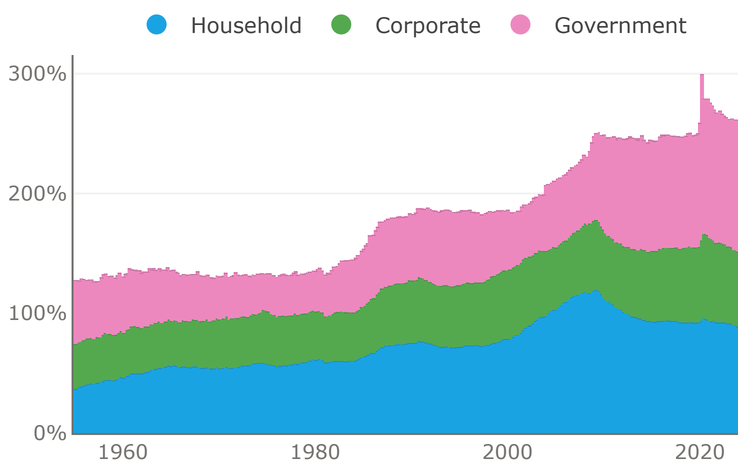
Profit Share of GDP



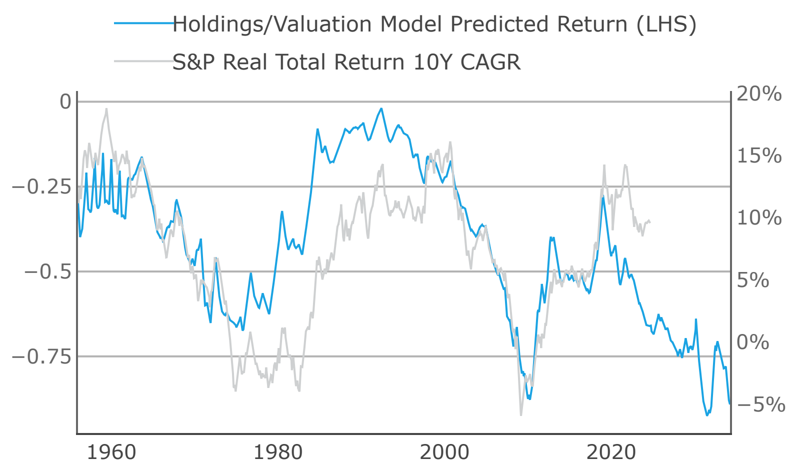
Earnings Deviation From Trend



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 Sept 2024.

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