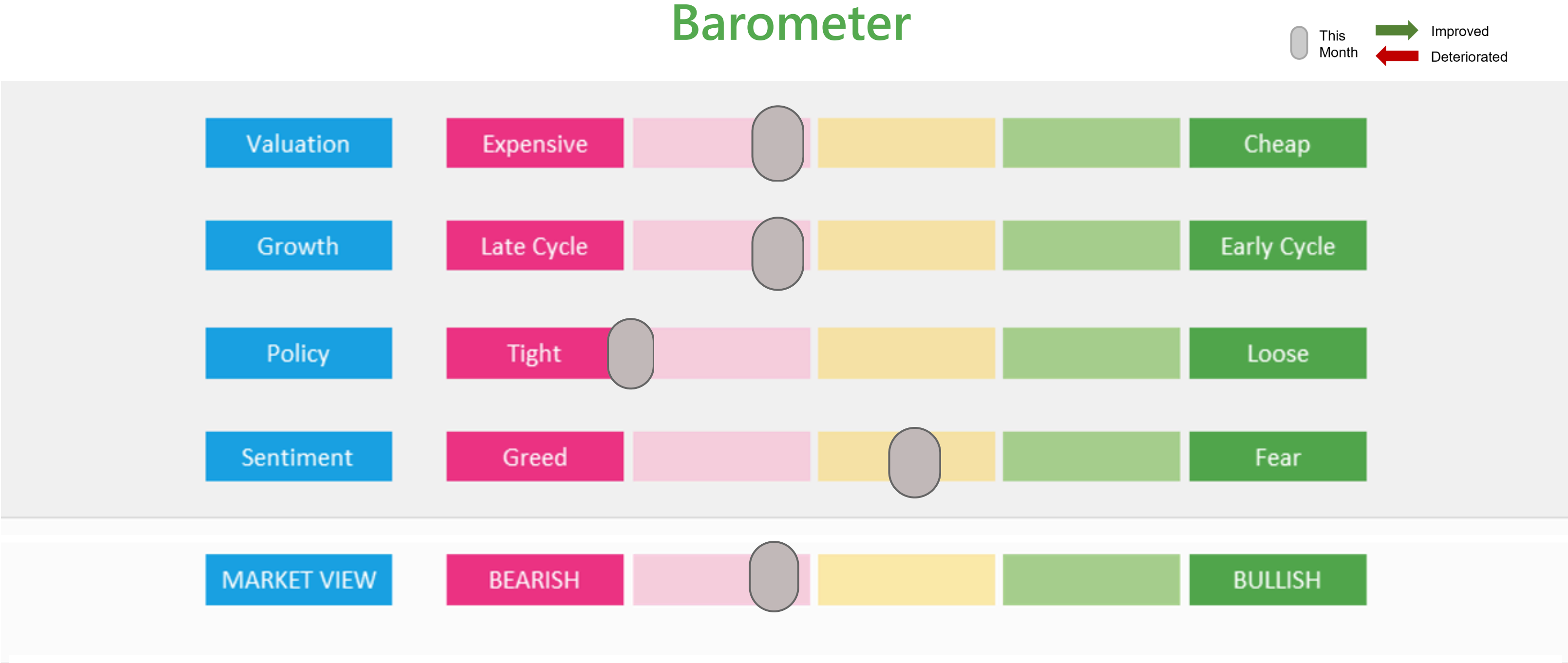
JULY 2024

CCLA GOOD INVESTMENT

Market Barometer

Barometer



Keep on Trucking

Our barometer says market fundamentals are solid.

Leading indicators are inching higher with the Global PMI indicating solid expansion in Services and modest expansion in Manufacturing.

Broken record time, but the forward earnings integer is growing everywhere, and at a low teens annual rate in the key US equity market. Colleagues point out that the equal-weighted indices are also seeing earnings expansion, so the love is being shared.

Meanwhile interest rate expectations have stabilised (rather than as we have had so far this year, pricing <u>out</u> further rate cuts). The ECB finally cut interest rates for the first time in this cycle, and this after the Bank of Japan ended QE. The Fed tapered QE, halving the monthly rate of purchase. **All of this is good news for risk assets as it betokens normalisation**.

In our Charts of the Month we note that:

- **The UK tax burden has risen to 37% of GDP**, a post WW2 high, and we ruminate about whether post general election the new government will be able to grow investment / productivity and therefore GDP, and keep the tax take down, or opt to raise the tax take further. If it's the former, UK assets should do very well.
- **The stock-bond correlation** says we are still in an inflationary regime
- **Expectations for Fed funds** over the longer term are still too low, we think
- **Bond yields have broken decisively out** of their 1982-2020 range and should now structurally remain higher for longer

We continue to believe the outlook for risk assets is good.

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Contents

TOP OF MIND

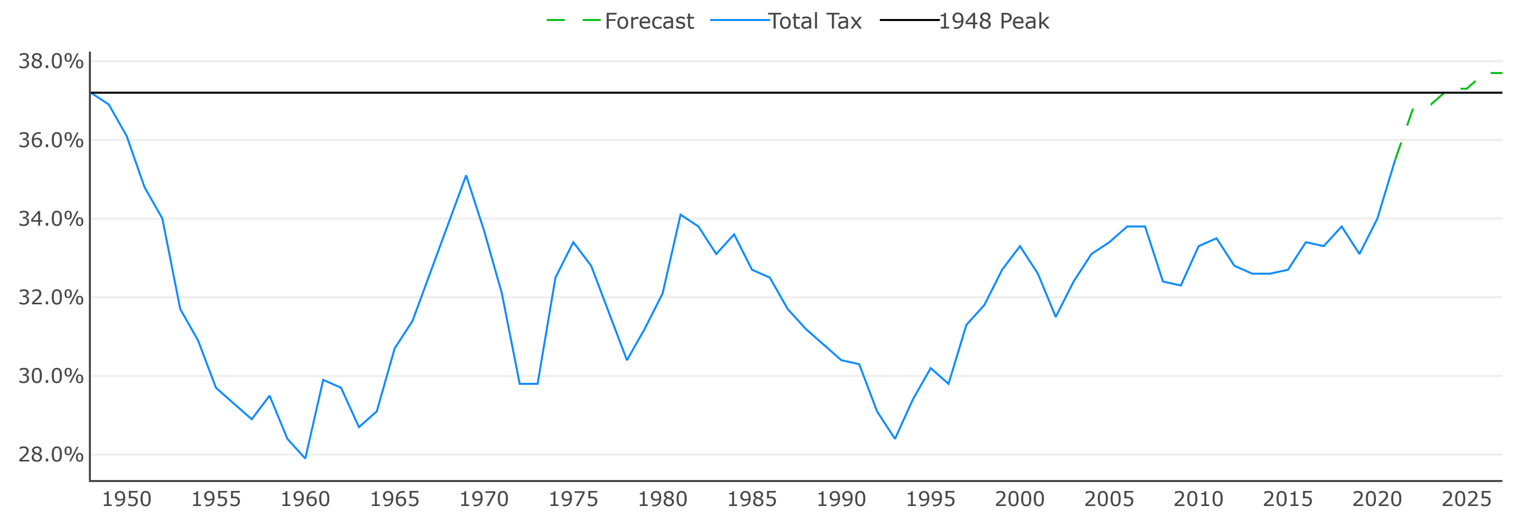
CCLA

Charts of the Month (1of 4)

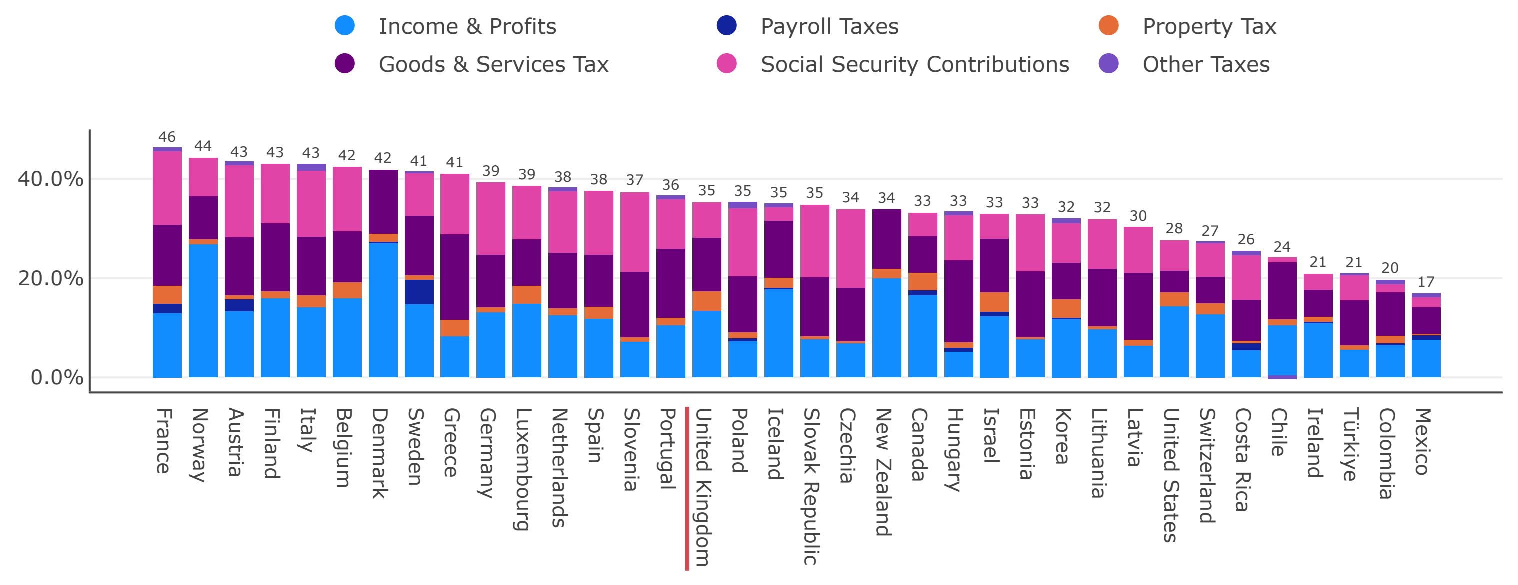
The UK tax burden is the highest in living memory, at 37% of GDP in 2023, according to the Office of Budget Responsibility (top chart). A recent Nuffield Foundation / Resolution Foundation paper* pointed out that the tax take has risen in the first two fiscal events in seven of the last eight new governments. So we should assume they go up now too.

How far the tax burden rises will depend on how successful the next government is in stimulating investment, therefore productivity, and therefore growth. Absent faster nominal GDP growth, the UK might choose to go the way of continental Europe and raise the tax burden even higher. The lower chart shows that our continental cousins have, in many cases, much higher tax burdens than we do in the UK. **Our 37% of GDP tax take compares with 40-46% in all of France, Norway, Austria, Finland, Italy, Belgium, Denmark, Sweden and Greece, and 39% in Germany**.

UK Tax Burden Over Time as % of GDP



Global Tax Burden as % of GDP 2023



* resolutionfoundation.org/publications/hiding-in-plain-sight/

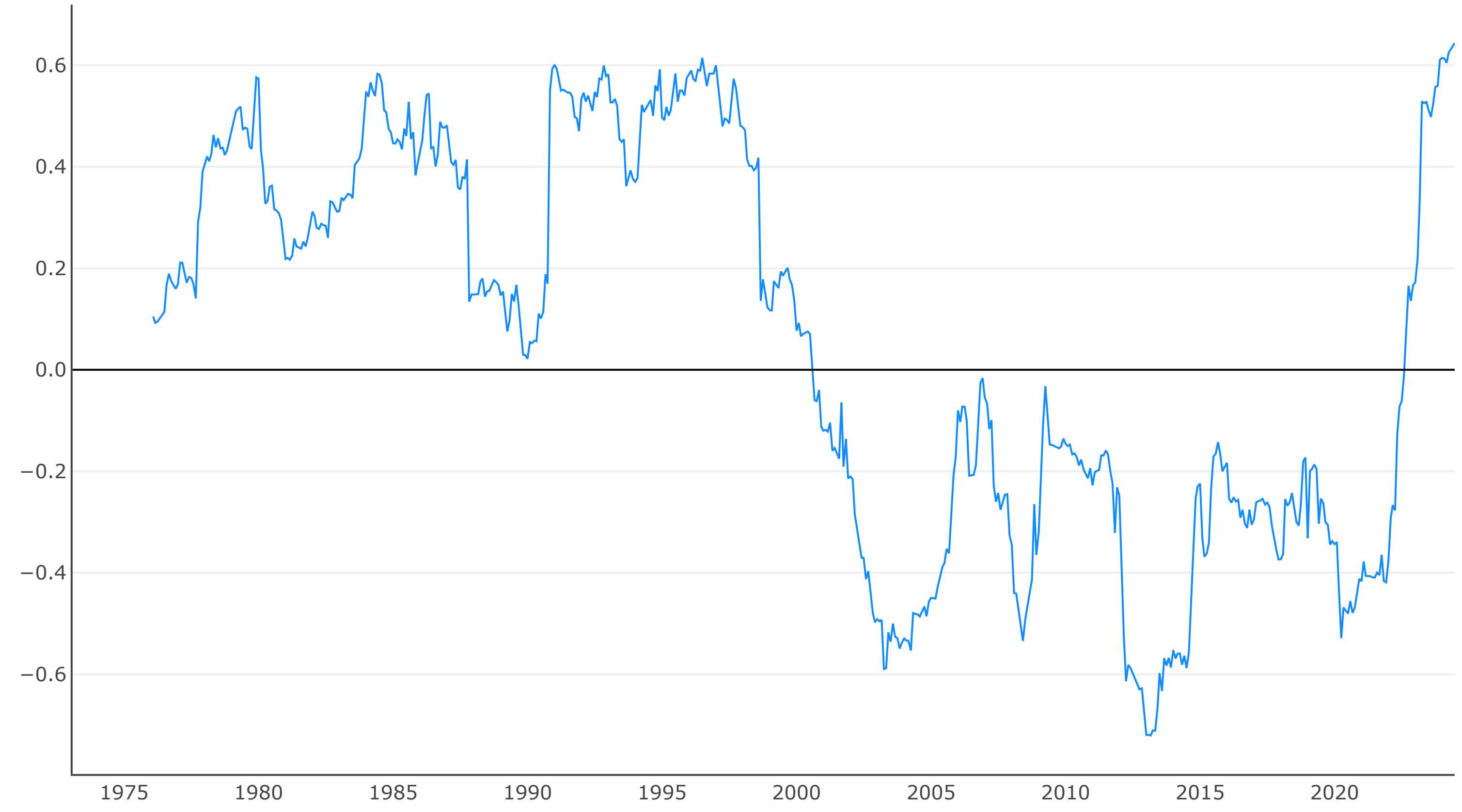
Sources | UK Tax Burden: OBR data as at Aug 2023. Global Tax Burden: OECD Revenue Statistics 2023, CCLA.

CCLA

Charts of the Month (2 of 4)

Back to the old world. The chart shows the correlation between changes in US bond prices and changes in US equity prices - the so-called stock-bond correlation. Over the long run the correlation is determined by the level of inflation. When inflation is well above zero, both equities and bonds react negatively to higher inflation and positively to lower inflation, so they are positively correlated. Over the last 20 years though, the dominant market fear has been one of deflation, not inflation - a consequence of low growth and "secular stagnation". In such a world, equities react negatively to (even) lower inflation because they lose pricing power, whereas bonds react positively because there will be less inflation eating away the real value of their fixed income coupons. So the two asset classes are negatively correlated. **Why does this matter? Because we can get a read on what kind of world we are in from observing the stock-bond correlation. The market still fears inflation, not deflation.** (If Trump is elected and is inflationary it would be bad for stocks and bonds).

US Stock Bond Correlation



Sources | Bloomberg, CCLA, data as at June 2024. US Stock Bond Correlation chart uses MSCI USA Total Return Index vs. Bloomberg US Treasury Total Return Index, over a 3 year trailing window with monthly periodicity

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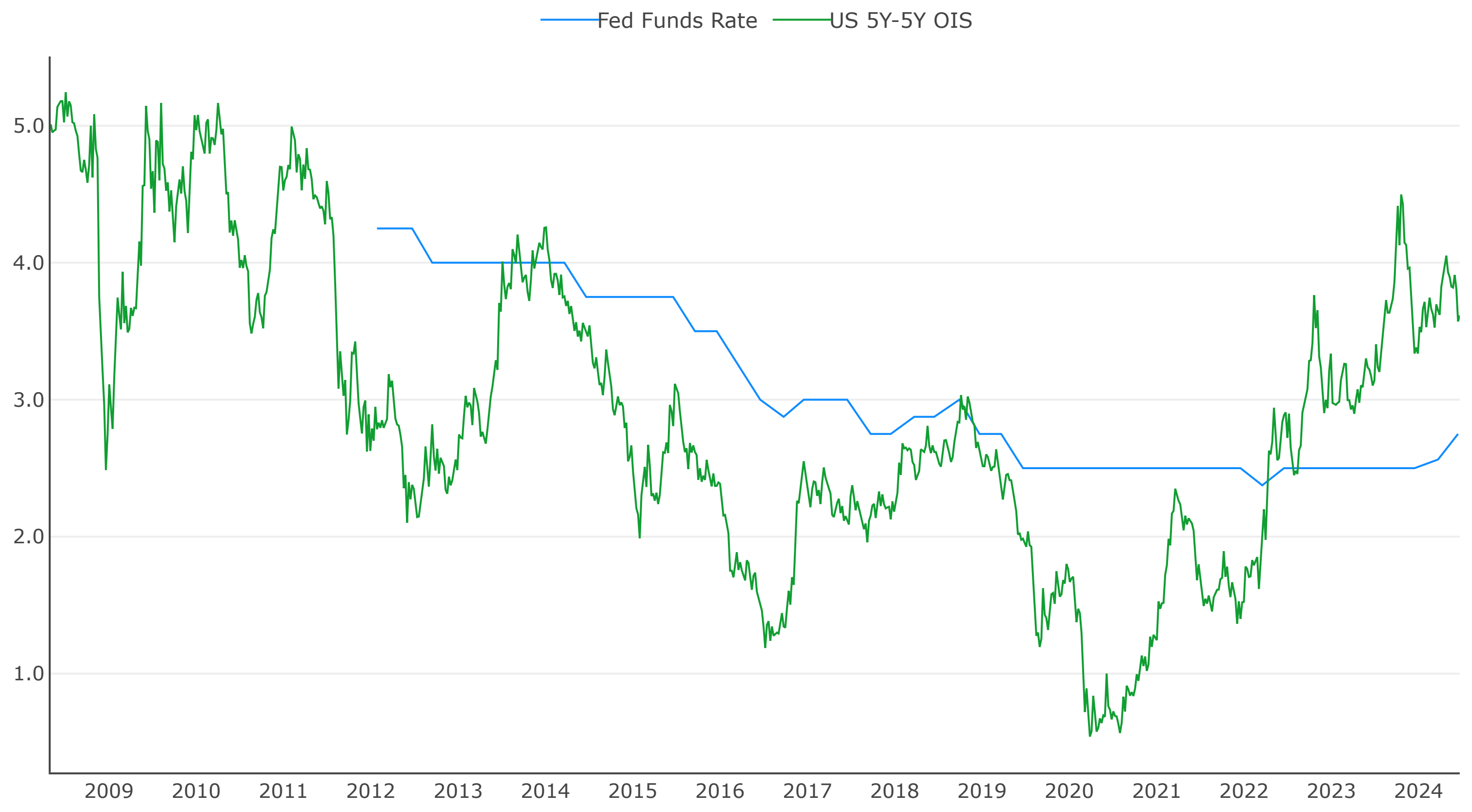
Charts of the Month (3 of 4)

We continue to emphasise that the Fed's own long term interest rate forecast is too low! This can have a bearing on bond yields, meaning that there is probably less downside to yields in a recession than most currently think. We showed the so-called Dot Plot (Fed policymakers' own guess of the long term path of the policy interest rate) last month. Here the blue line is the timeseries of that central guess of the long term neutral rate. In green we show the "5 year 5 year" - the market's guess of the five year average Fed funds rate, five years forward. What this shows is that between the GFC and the pandemic, the market thought the Fed was too bullish on future growth and inflation, expecting both to normalise. Now, the Fed is too bullish on rates, thinking that they can remain lower for longer. **This should eventually put upward pressure on bond yields...but not until after the next recession, we think.**

Market's Neutral Rate Expectation vs. The Fed's

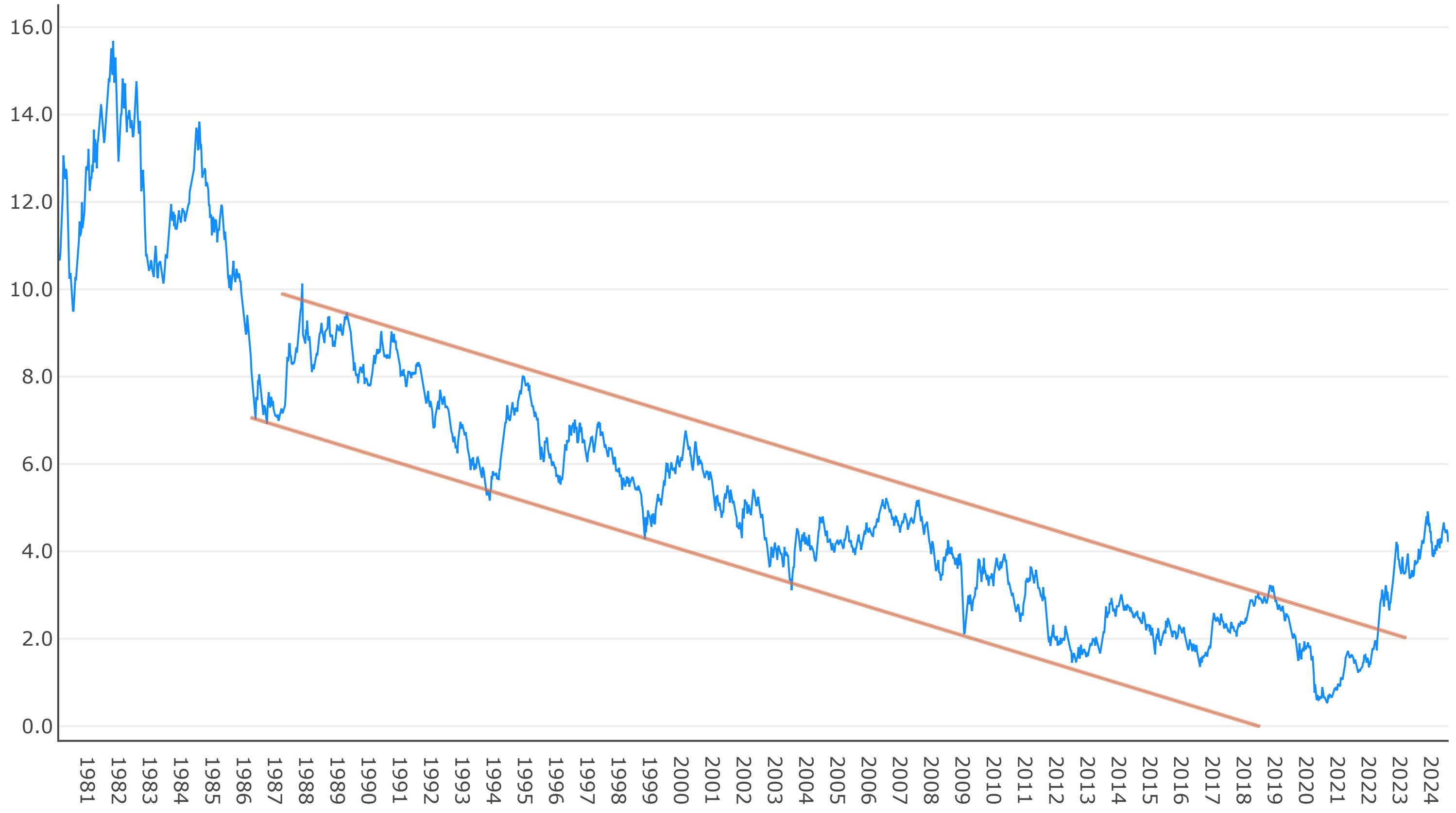


Sources | CCLA, Bloomberg. Data as at June 2024

Charts of the Month (4 of 4)

Breakout! This chart is a good illustration of the riot that has taken place in the bond market since the pandemic. As our old Morgan Stanley colleague Gerard Minack has pointed out, the secular bond bull market of 1982-2020 was characterised by successively lower lows in bond yields, and lower highs. What he (and we) now expect is a series of higher lows and higher highs. Few would look at the chart and think that bond yields urgently need to go higher now - quite the reverse, they probably have more downside risk than upside risk, i.e. bonds are increasingly "buyable". Especially in the case of recession. However, as our chart on the previous page showed, **it is not hard to imagine structurally higher interest rates over the coming decade than the prior decade**.

US 10 Year Yield



Sources | Bloomberg. Data as at June 2024

Equity | USA

The US equity market ticked higher this month, continuing to expand on its 14% year to date return. Current levels imply spot PE valuation at 21x, still 31% above its 16x average of the last thirty years.

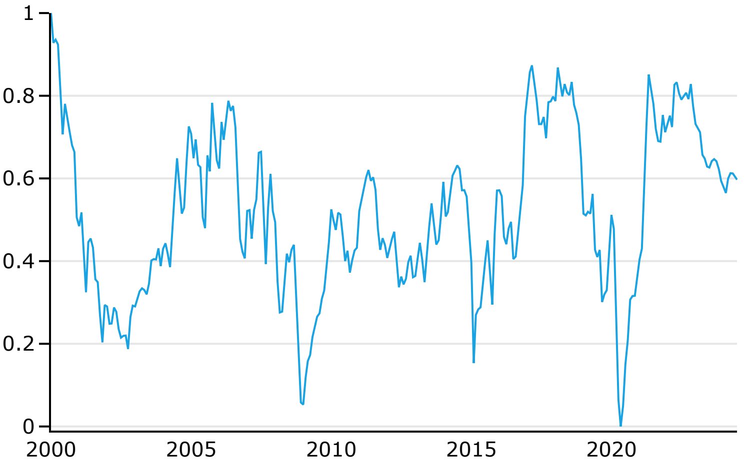
The CAPE (Cyclically Adjusted PE) has also ticked higher, to 33.6x. A shorthand for future real expected return is the CAPE earnings yield, indicating that US equity may not be expected to return much more than 3% annualised over coming years.

Despite cross asset valuations dropping to the 60th percentile (top right), it would still suggest equities are a little extended but not dramatically so. But absolute valuations are full in the US at least.

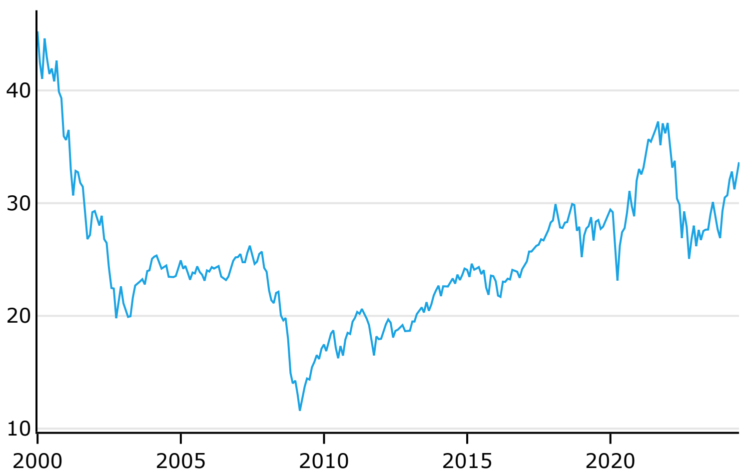
S&P 500 Valuations

S&P 500 Forward PE

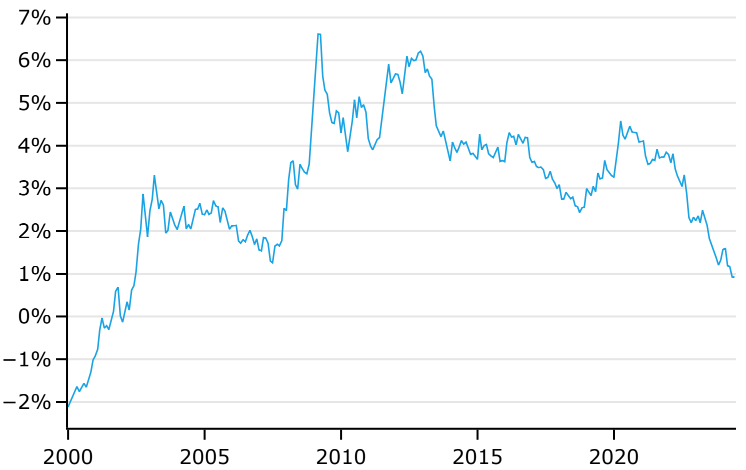
Composite Value Indicator Model



CAPE / Shiller P/E



S&P 500 Equity Risk Premium



Note | Composite Value Indicator was built at Morgan Stanley in 1997 and is published with permission. It is an aggregate of seven equity yields adjusted for bond yield, T bills yield and inflation, and is expressed here in its percentile range. The CAPE / Shiller PE is today's price divided by the average earnings of the last 10 years. The Equity Risk Premium is calculated as the Shiller earnings yield minus the real bond yield.

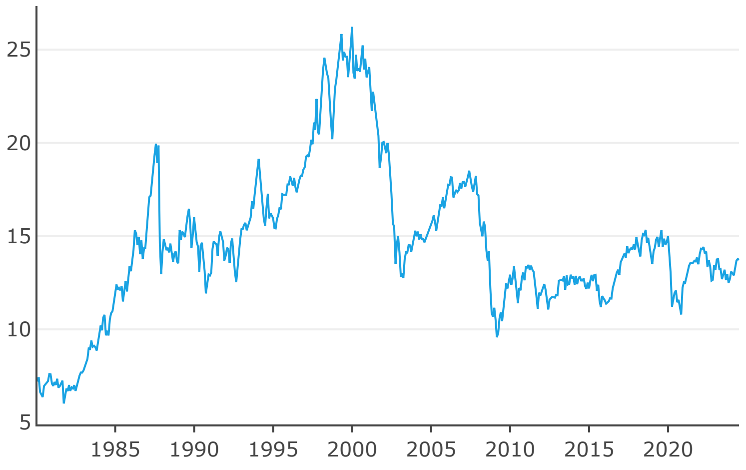
Sources | S&P 500 PE: Bloomberg, CVI Model: CCLA as of June 2024, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of June 2024

Equity | Regional

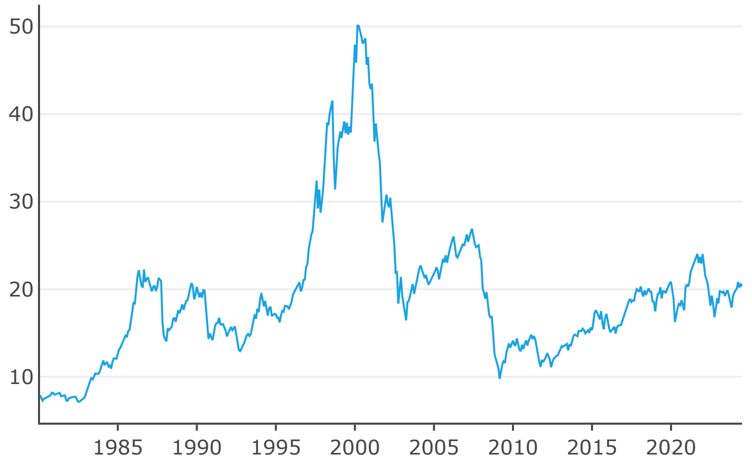
Outside the US (which is 69% of MSCI World), equity markets continue to look reasonable value (UK, Europe-ex-UK, Japan) or outright cheap (EM). The de-rating of last year is notable everywhere. The UK Shiller PE of 13.7 gives an earnings yield of just over 7%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 20.3 gives almost a 5% forward real return. Asia and Japan look similarly good value to us, the latter despite its strong recent performance.

Europe

UK | Shiller P/E

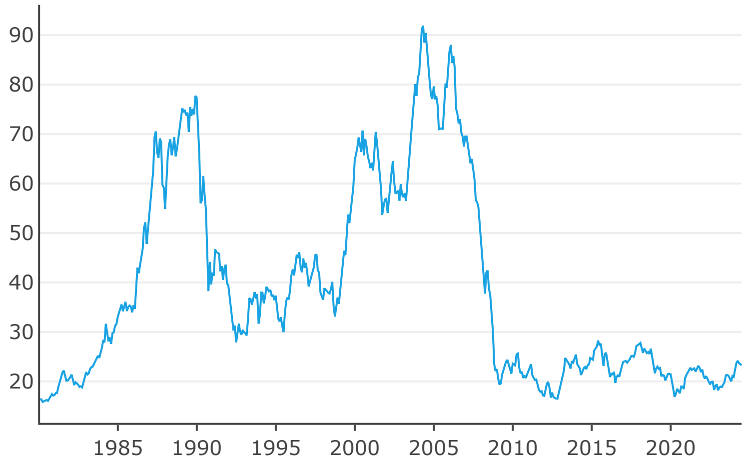


Europe (Ex-UK) | Shiller P/E

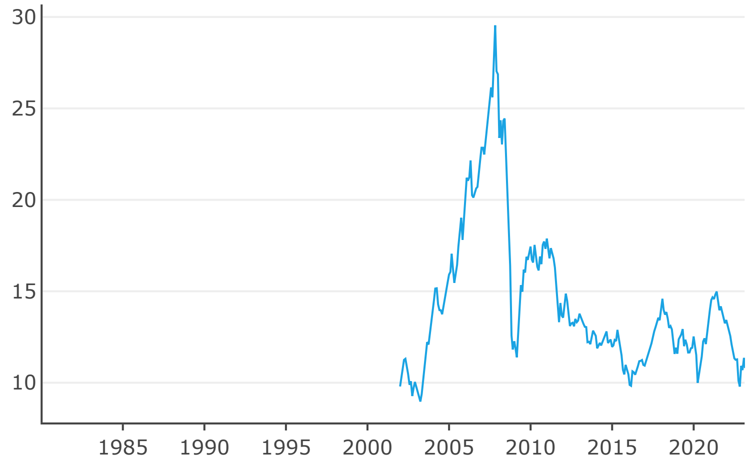


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



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

VALUATION

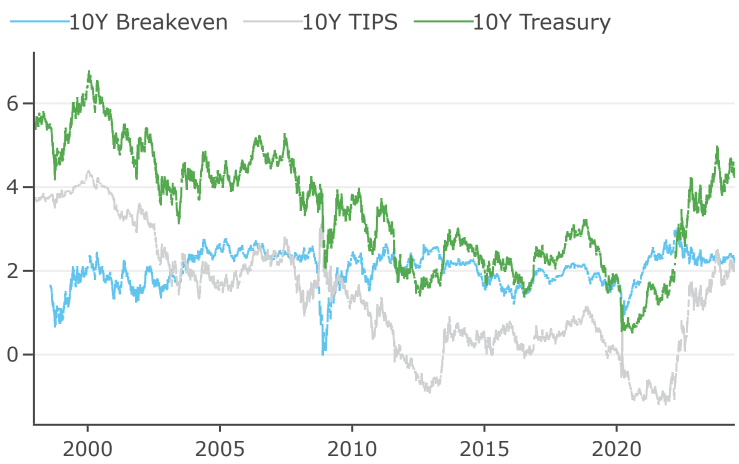
Bonds

US and UK 10Y Government bonds continue their slow decline in yields. Given the recent stability in breakeven rates, both regions are now pricing in inflation-linked bonds close to 2% and 0.6% respectively. A good indicator of market's expectation for long-term real GDP growth rates, and in our view looks to be at fair value. **This means we are currently indifferent between nominals and linkers.**

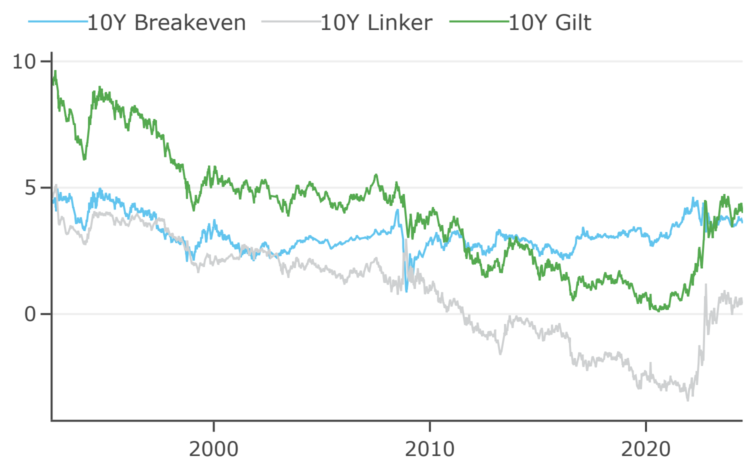
Corporate US BBB yields are still around 5.8%, which, stripping out 2.5% expected inflation, yields above 3.3% real expected total return, **which to our eyes remains reasonably attractive**.

Global Government & Corporate Yields

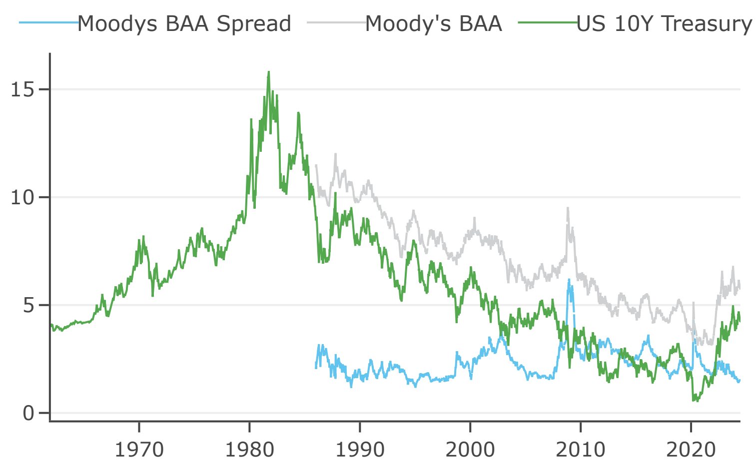
US 10 Year Treasury Yields



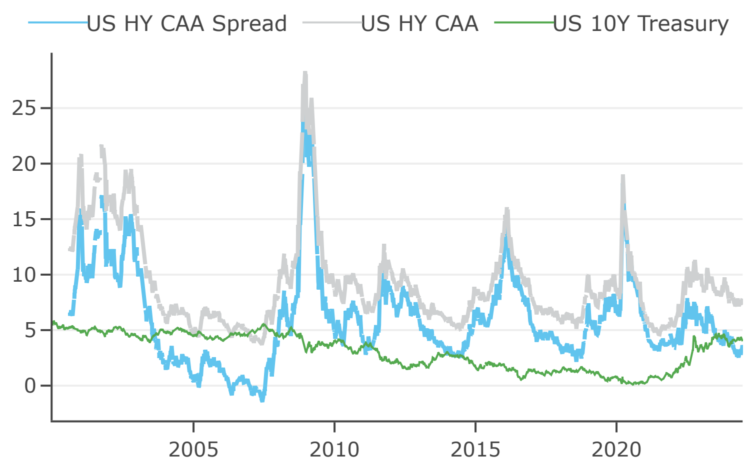
UK 10 Year Gilt Yields



US Corporate Investment Grade Yield



US Corporate High Yield



Sources | Bloomberg as at June 2024

Alternatives

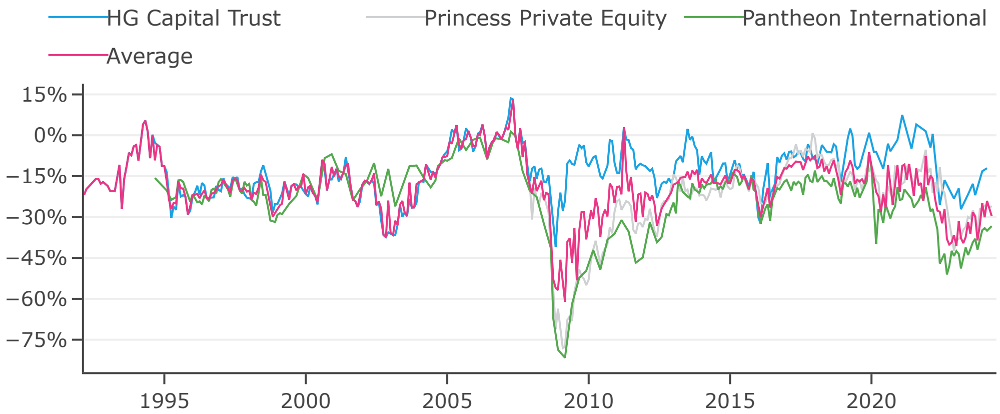
The IRR on Core Private Infrastructure now offers 2.4% return spread over IG corporate bonds, which is still interesting after a much tighter spread over the last two years. Listed Infrastructure continues to trade at 10-35% discounts to net asset value (NAV), which is somewhat more interesting, especially where managers can add value via development. Private Equity discounts to NAV remain wide (top left chart).

The recent surge in investor demand for Levered Loans benefitted some pockets of the market, creating small discounts on yields. However, **on aggregate Leverage Loan yields stay at over 9% with a rate cutting-cycle remaining as the main risk.**

Global Valuations

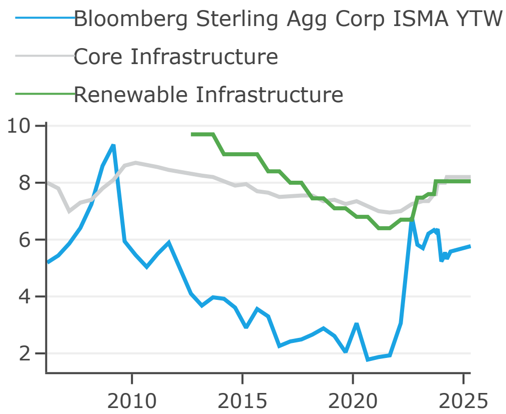
Listed Private Equity

Discount To NAVs



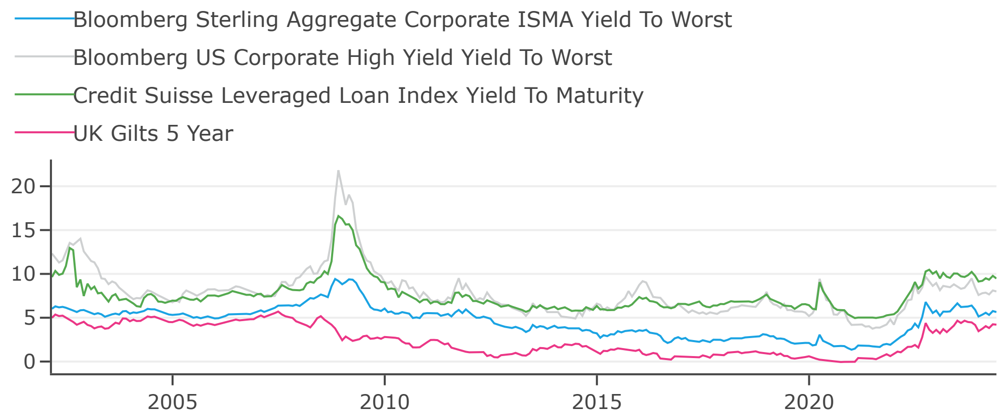
Infrastructure

Infrastructure Discount Rates vs Bond Yields



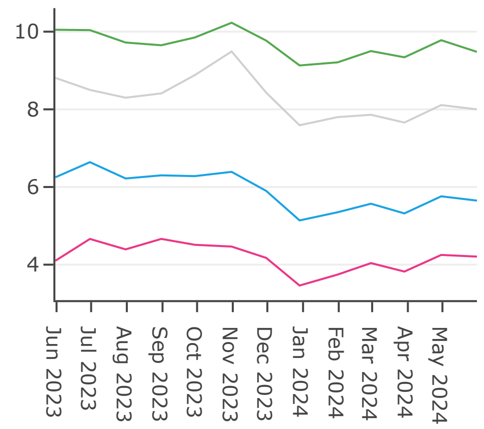
Contractual Income

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 June 2024

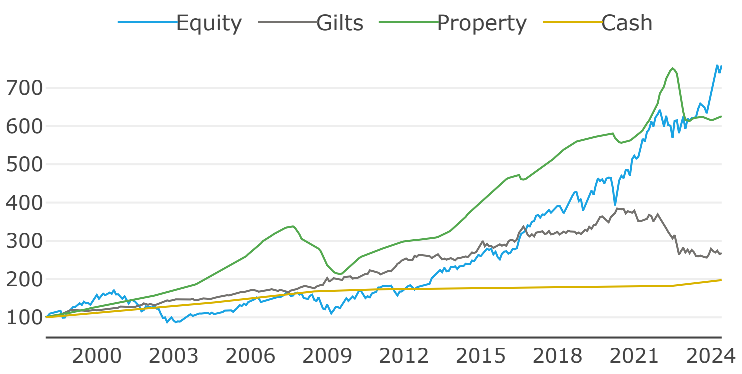
Property

The UK Commercial Property market offers good yields, (c.7.0% Equivalent Yield on average), within the context of the commonly targeted CPI+4% returns at a portfolio level. NAVs appear to have stopped falling, having declined 21% last year. Our Property team characterises the market as "orderly", but with buying and selling activity bumping along the bottom as investors wait to see the full impact of the 14 hikes in Bank Rate that we have already had.

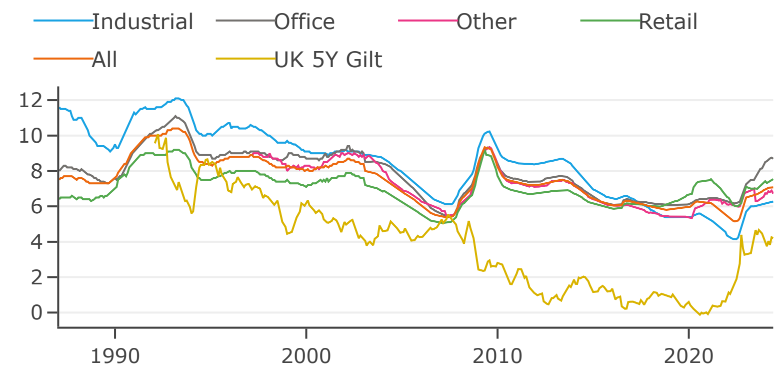
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

UK Commercial Property Market

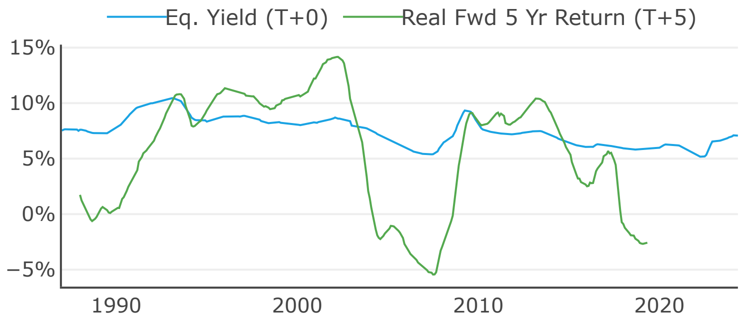
25 Years Of Return 1998=100



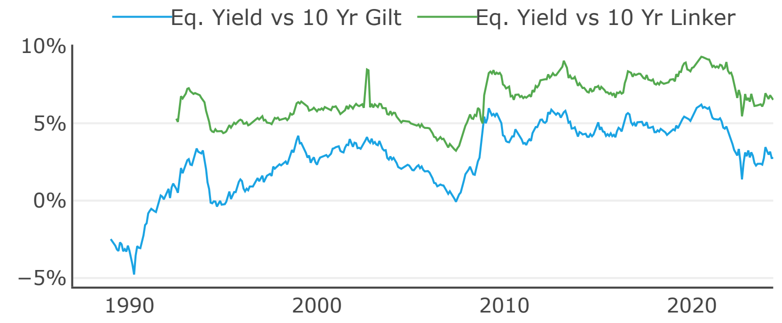
Equivalent Yields vs Gilt Yields %



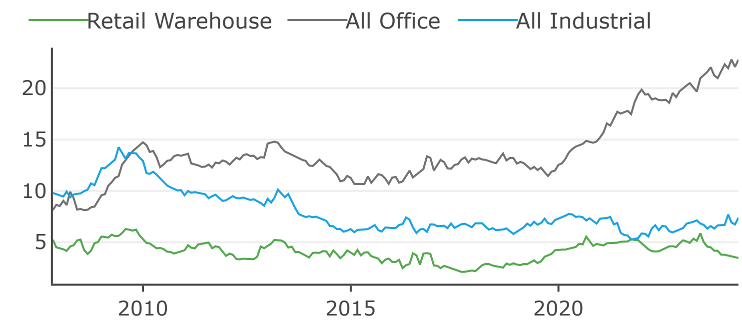
MSCI UK All Property Monthly TR Index %



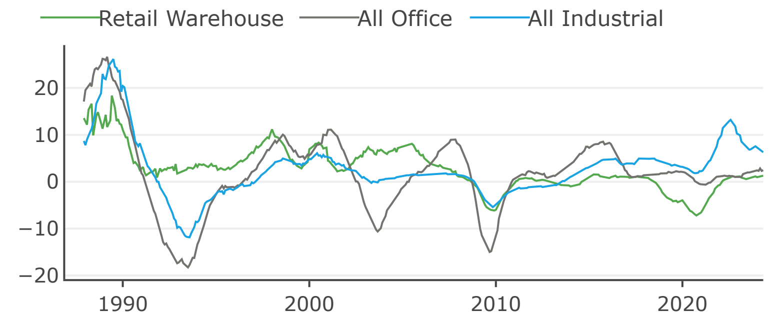
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



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

VALUATION

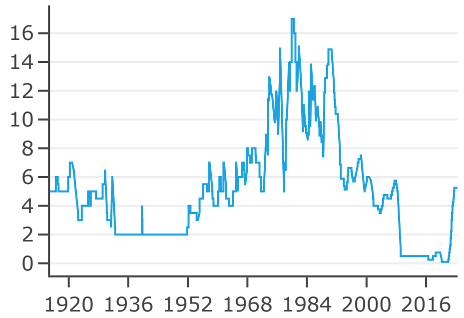
Cash

Our expectation of a Q3 rate cut is becoming the prominent view in the market. Traders are now pricing in a 65% chance of a 25bps drop in the August meeting, up from 36% at the start of June. Given inflation at 2% and the labour market showing signs of cooling, reasons to maintain higher rates are fading.

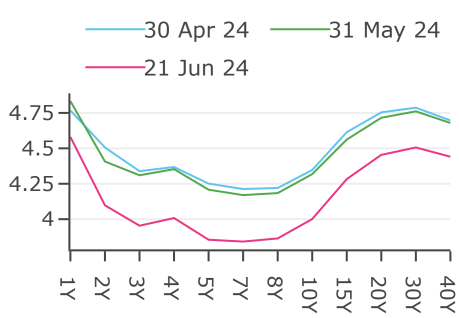
Having said that, the hawkish narrative has not totally disappeared. The fall to 2% headline CPI was largely courtesy of continued Goods disinflation compensating for sticky Services. Unemployment has ticked up to 4.4%, but wages remain sticky at above 5%. Composite PMI has dropped, but remains in the expansionary zone. So yes, the economy looks to be softening and relieving some monetary pressure makes sense, **but we should not expect significant rate cuts at this stage unless the economy falls off a cliff.**

UK Sterling Market

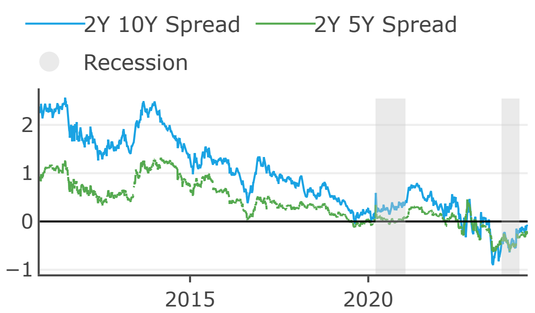
Official Bank Rate



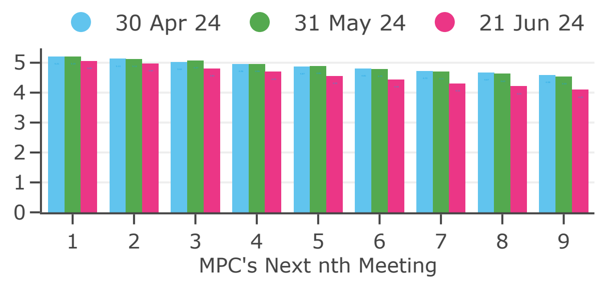
UK Gilt Curve



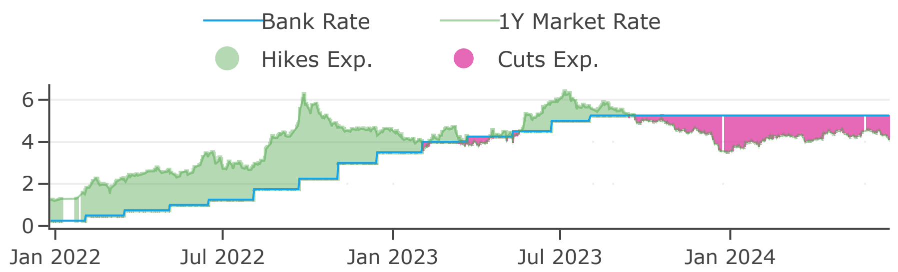
Gilt Spreads



Rate Expectations For Future MPC Meetings



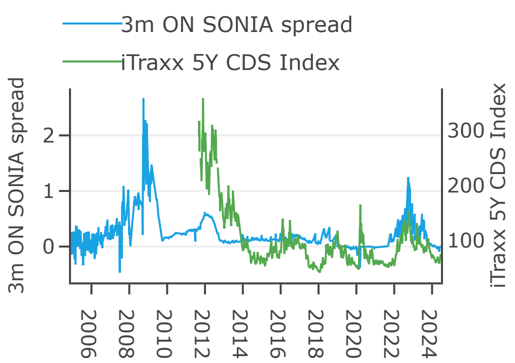
1Y Forward Market Rate Expectations



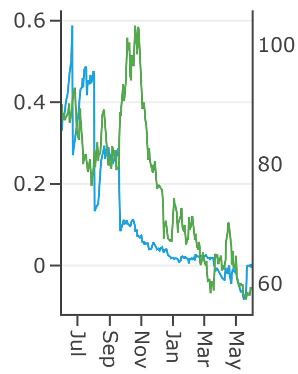
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2023	2024				
	Dec...	Jan...	Feb...	Mar...	April	May
RPI	5.20	4.90	4.50	4.30	3.30	3.00
CPI	4.00	4.00	3.40	3.20	2.30	2.00
CPI Core	5.10	5.10	4.50	4.20	3.90	3.50
CPI Services	6.40	6.50	6.10	6.00	5.90	5.70
CPI Goods	1.90	1.80	1.10	0.80	-0.80	-1.30
Priv. Wages	6.20	5.90	5.80	5.90	5.70	

Market Stress



Last 12 Months

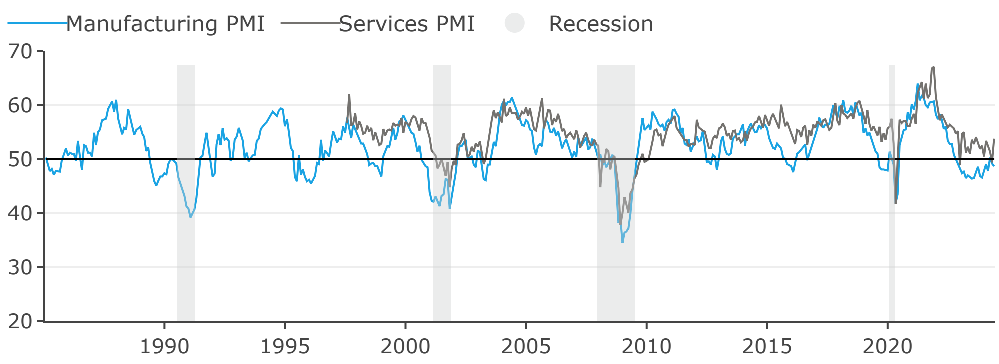


Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, at least +/- 2 standard deviations away scores as red.
Bloomberg for all charts, as of June 2024

Global PMIs

Leading indicators continue to hold up in aggregate around the world. The key US Services PMI dropped below the 50 line for the first time in 28 months in April's reading, however, since quickly recovering to a strong 53 level in the May reading. Continuing to struggle, the US Manufacturing PMI fell again into contraction for two consecutive months with the latest reading. On the other hand, Eurozone Services PMI is now solidly above 50. **For now there is no immediate sign of a recession**.

United States



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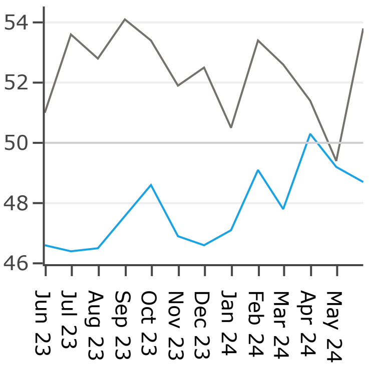
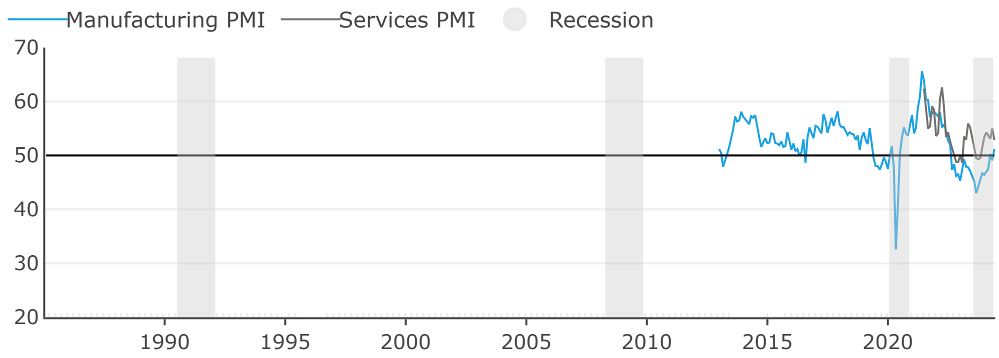


United Kingdom



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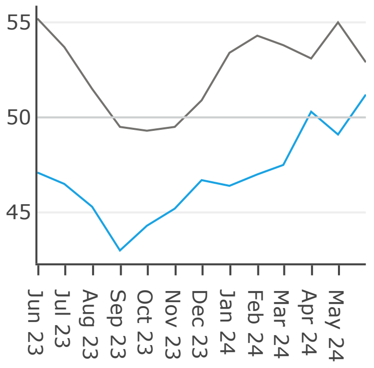
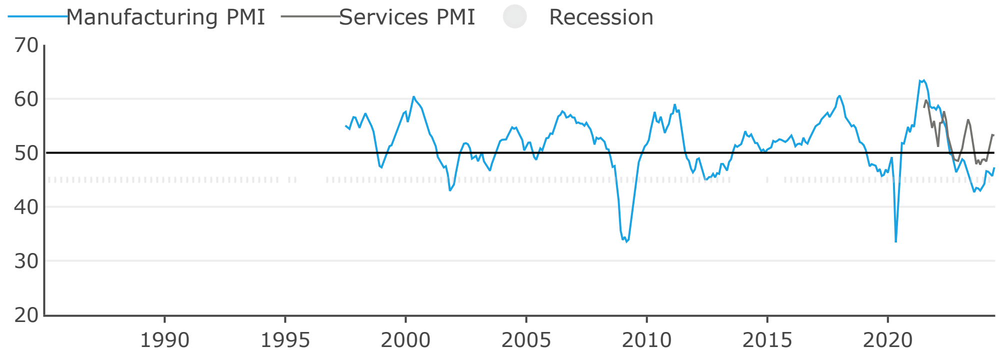


Eurozone



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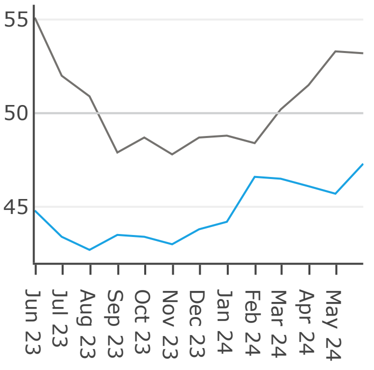
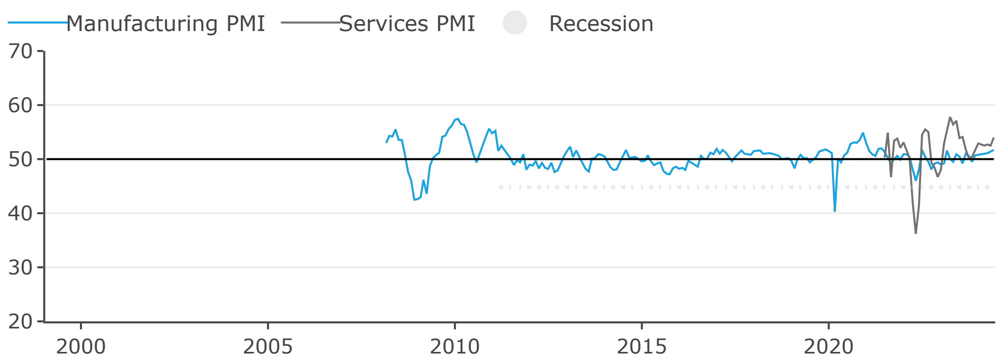


Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of June 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

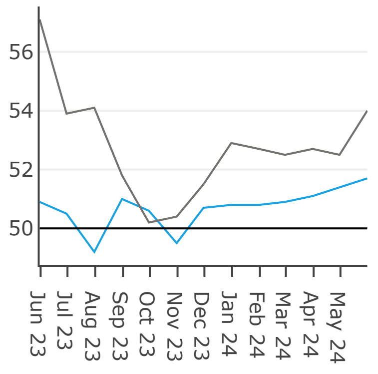
Global PMIs

Both the Global Services and (more recently) Manufacturing PMIs are above 50 (bottom right chart), indicating that the Manufacturing recession is likely over and that there is no imminent recession risk. This can change quickly, but for now, growth is supported.

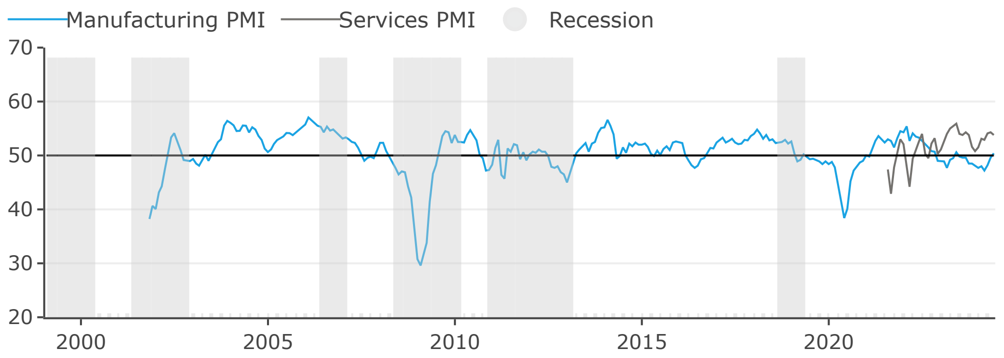
China



Last 12 Months



Japan



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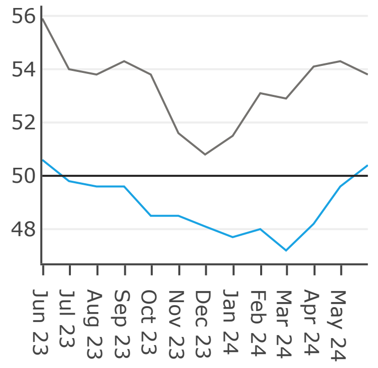
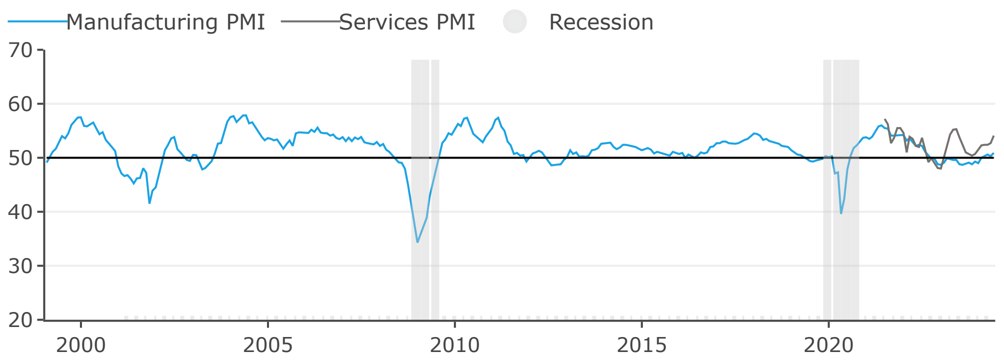
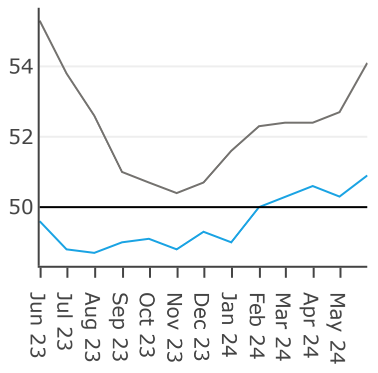


Global



Last 12 Months



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

GROWTH

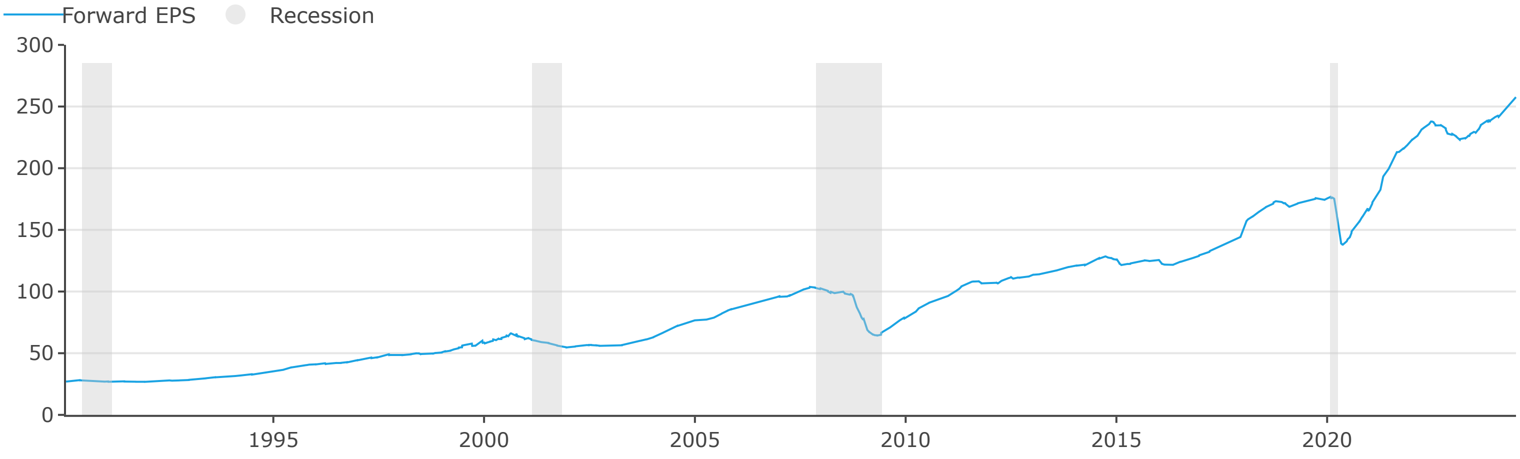
Earnings

Consensus forward earnings estimates continue to recover (top chart) while trailing earnings are just starting to grow again (if you squint at the bottom chart you can just about see it!)

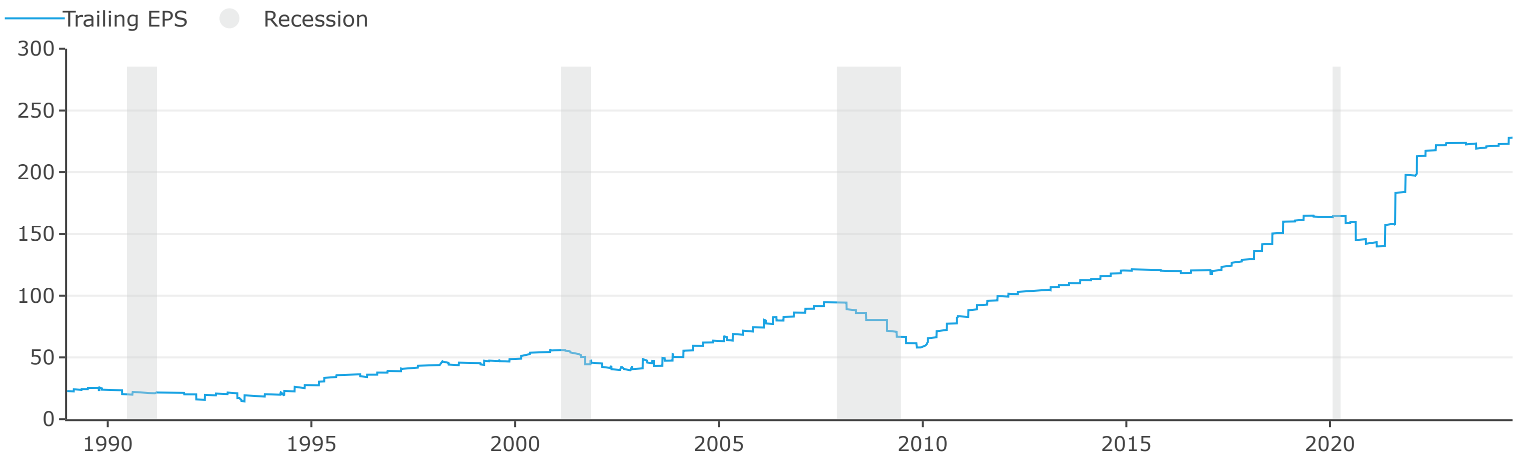
We reiterate that earnings could be in position to take over from PE re-rating in driving the market higher, although clearly a recession would change that.

S&P 500

Bloomberg Est. EPS



12M Trailing EPS



Sources | S&P500 12M Forward EPS using Bloomberg BF transformation, 12M Trailing EPS from Bloomberg as at June 2024

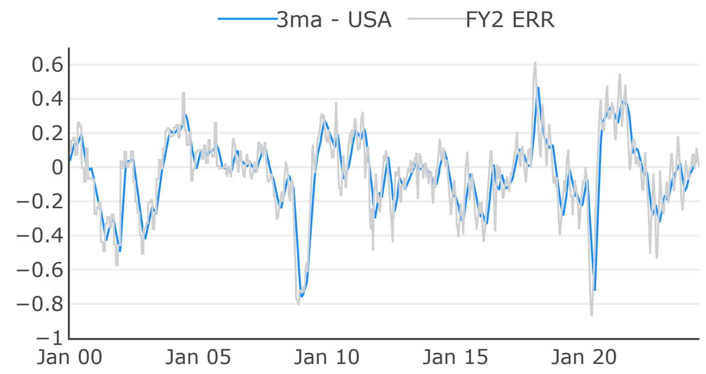
Earnings

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.

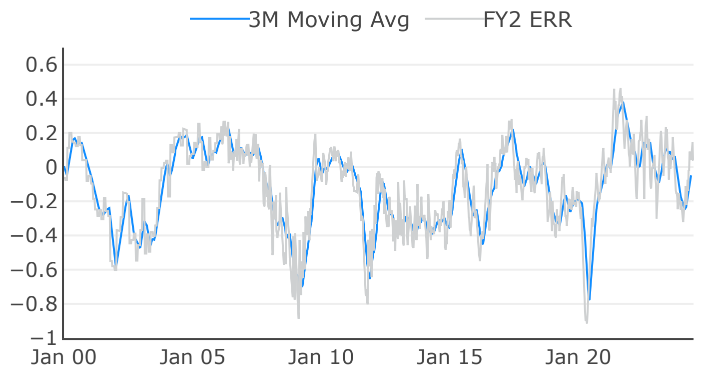
The overall assessment is that earnings breadth is ticking up, with the US now joining Japan in having positive net earnings breadth. This speaks to a broadening out of earnings support from just the Magnificent Seven.

Global Earnings Revisions Ratios

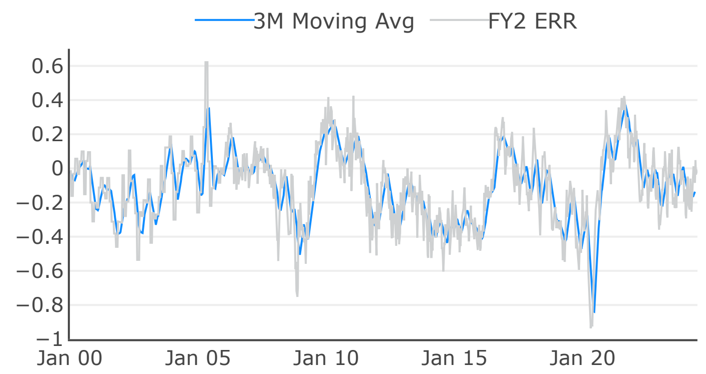
USA



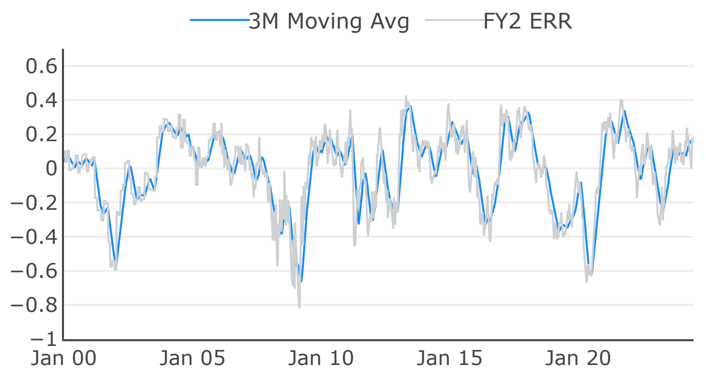
Eurozone



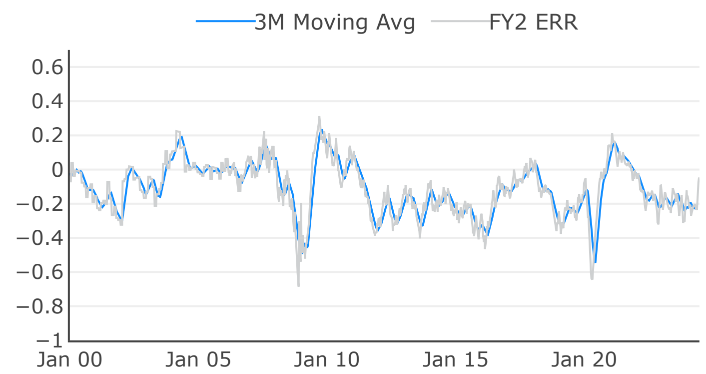
UK



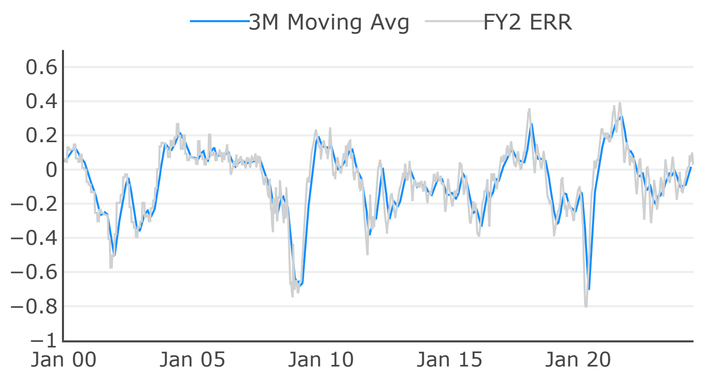
Japan



Emerging Markets



World



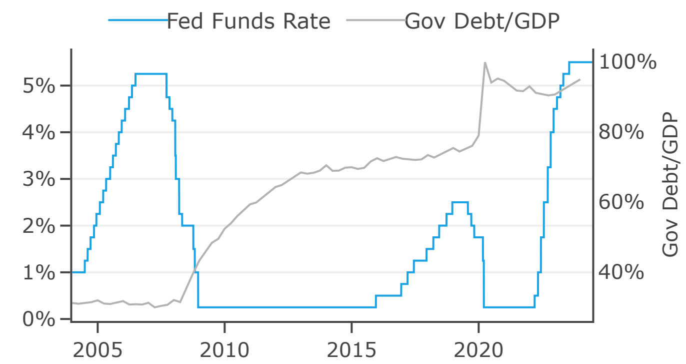
Sources | Eikon, the MSCI index has been used for each respective region, as at June 2024.

POLICY

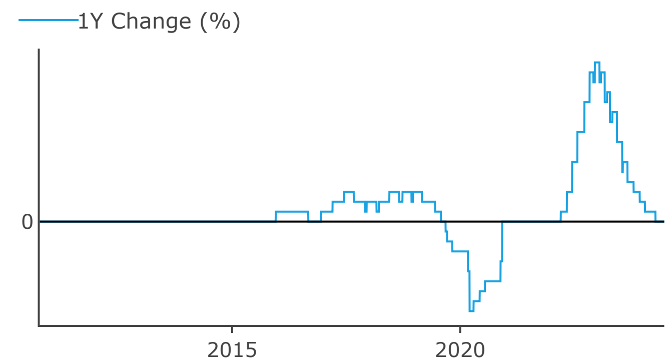
Interest Rates

Despite US inflation remaining sticky at above the 3% level for 12 months now, US two year bonds have fallen over 15bps over the same period, now yielding ~4.7%. The seven rate cuts that were pencilled in for 2024 have dwindled to just two now expected. **To the extent that this is a reflection of a strong nominal growth rate which supports index earnings, this does not have to be a very negative indicator for the stock market**.

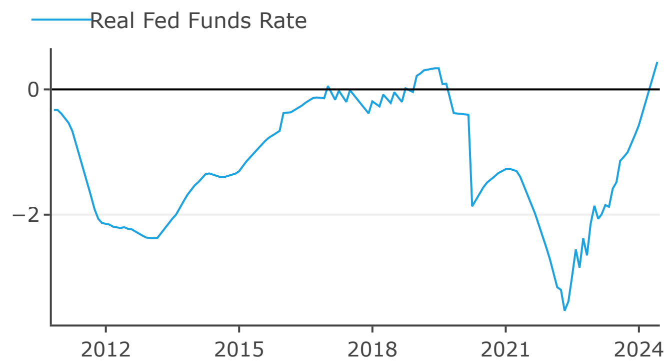
Fed Funds Rate



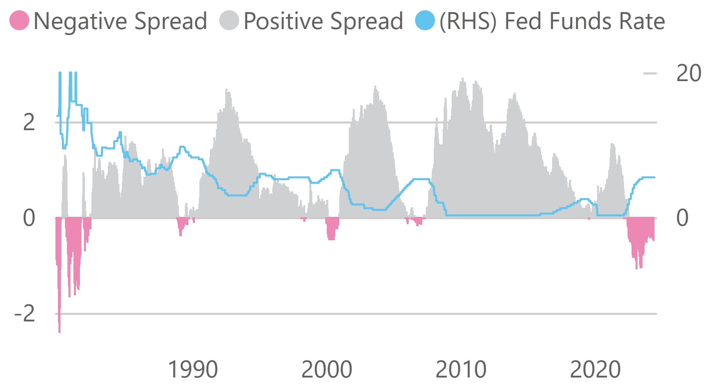
Change in Fed Funds Rate



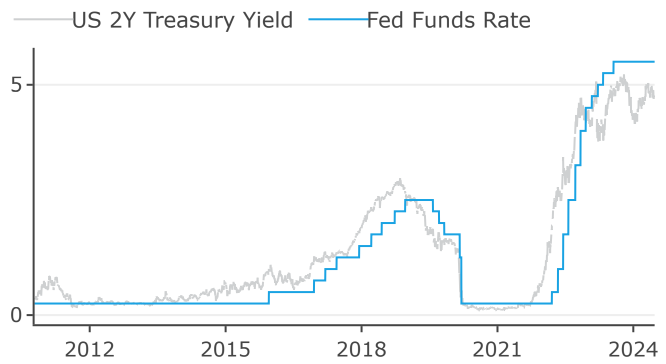
Real Fed Funds Rate (Using 2Y MA CPI)



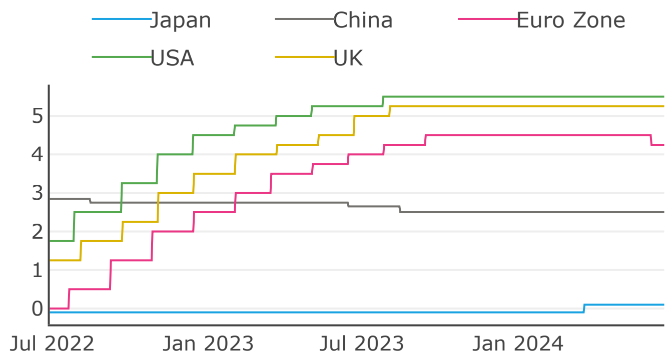
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



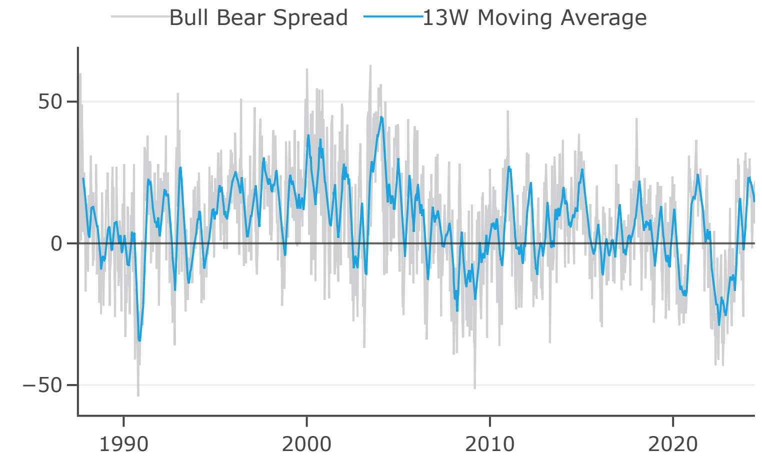
Sources | Bloomberg for all charts, as of June 2024

Sentiment

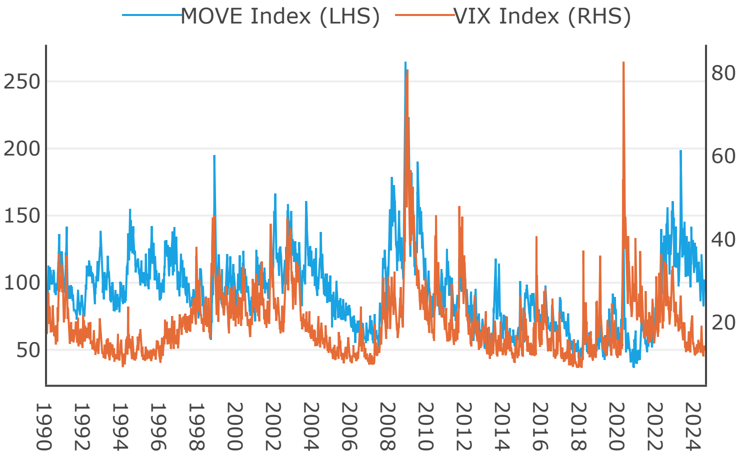
The BAML Hartnett Bull & Bear Indicator has moved from Extreme Bearish sentiment (which is bullish for the market!) in October 2022 **to now slightly above neutral** (the current reading is 6.1/10). In other words, sentiment is neither too extended nor washed out, and is therefore unlikely to be a catalyst one way or another.

US Equity Indicators

AAII Bull Bear Spread



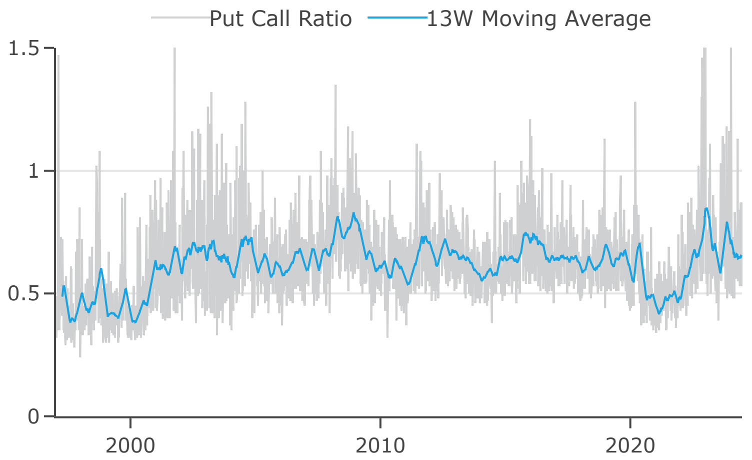
Equity vs. Bond Sentiment



Michael Hartnett's Bull & Bear Indicator (BAML)

Rises to 6.1 from 6.0

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 June 2024

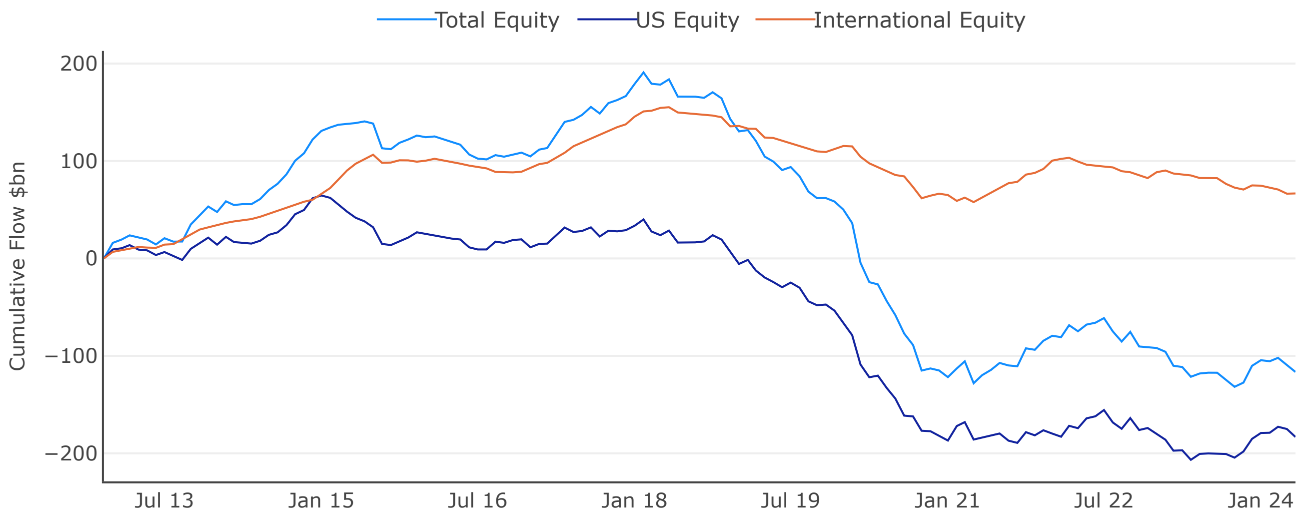
Fund Flows

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.

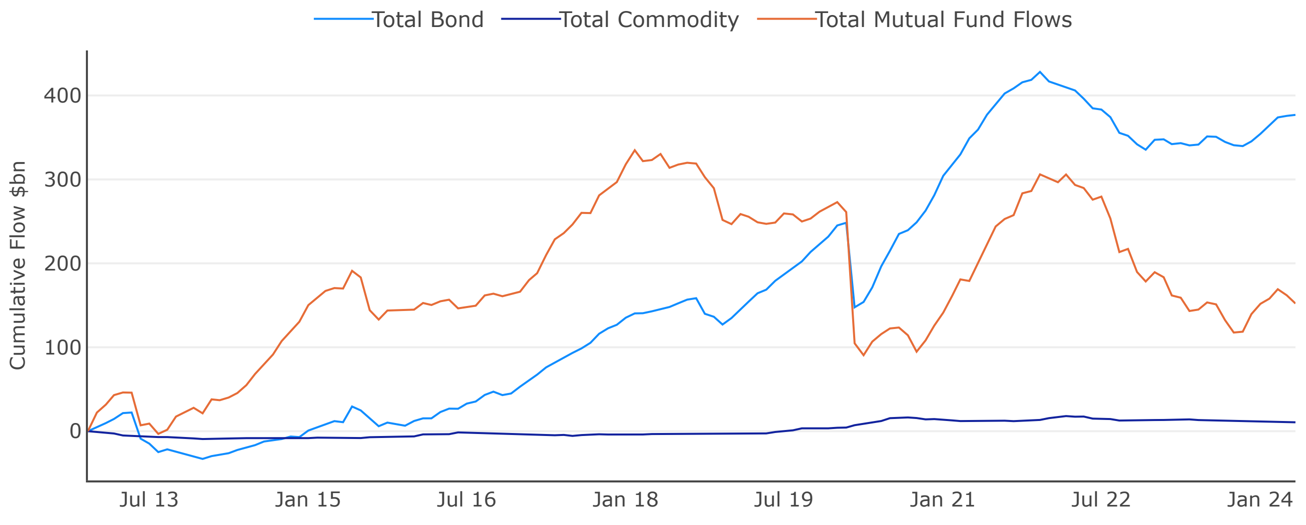
The message in these data points continues to be that there is little enthusiasm for actively managed funds even if the outflows from equity funds have stopped.

US Mutual Fund Flows

Equity Markets Cumulative $bn



Non-Equity Markets Cumulative $bn



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

OTHER OBSERVATIONS

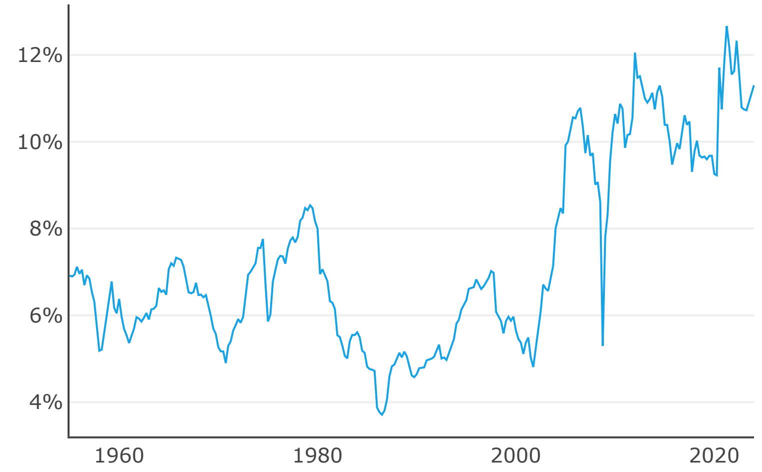
CCLA

The Big Picture

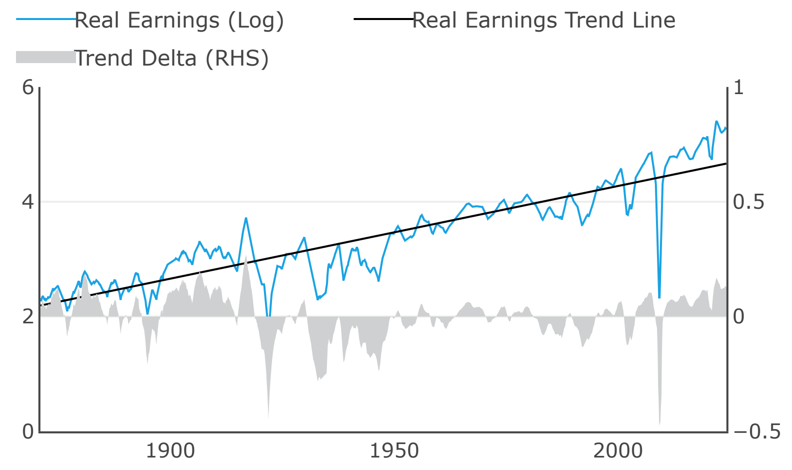
Here we highlight some longer-term imbalances that, **should** they correct, would have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. Its corollary (not shown) is that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

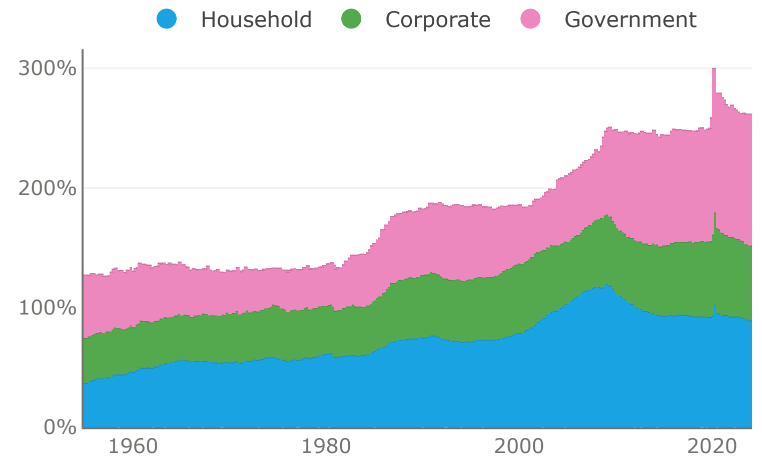
Profit Share of GDP



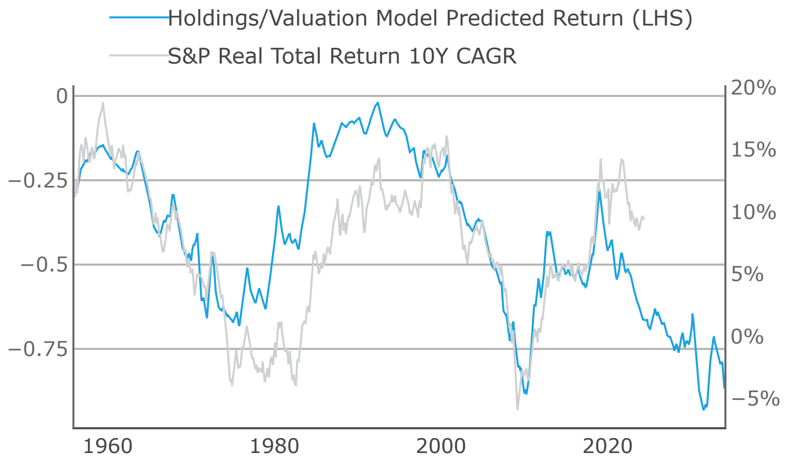
Earnings Deviation From Trend



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 June 2024.

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