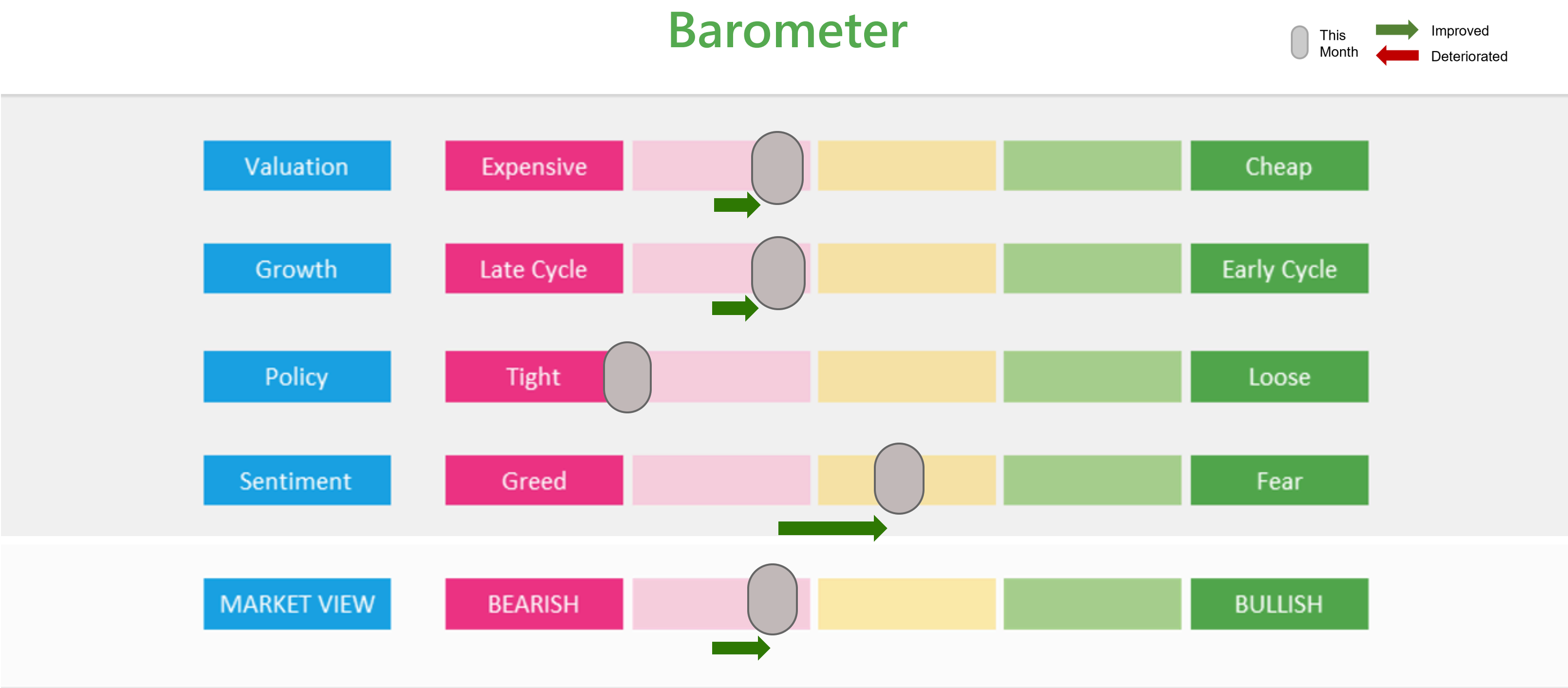
MAY 2024

CCLA
GOOD INVESTMENT

Market Barometer



Nominal Growth Remains Strong

Our barometer says market fundamentals are improving.

Valuations are still somewhat stretched but became a little less stretched last month. Leading indicators improved, broadening out from Services to Manufacturing expansion. With inflation still sticky, the good news is that nominal growth has remained strong, which in turn has supported nominal EPS. And sentiment moved back to neutral from having been somewhat stretched in the last few months.

It's true that policy remains on the tight side after 500+ bps of rate hikes and with central bank balance sheets generally contracting, but this is offset by consensus earnings estimates which continue to rise at a >10% annualised clip, in the US at least.

To try and engage our readers we have expanded our Charts of the Month from initially one page to four pages, so that every month there is topical new content in addition to the regular run through our key indicators.

This month we look at:

- US unemployment and the Sahm rule, a recession indicator that is not yet indicating recession
- The components of US inflation and the need for Services inflation to slow down
- Bank reserve growth as a liquidity indicator and coincident indicator for the stock market
- Earnings estimates as a driver for the stock market

We conclude that earnings still have the whip hand and we keep risk on.

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Contents

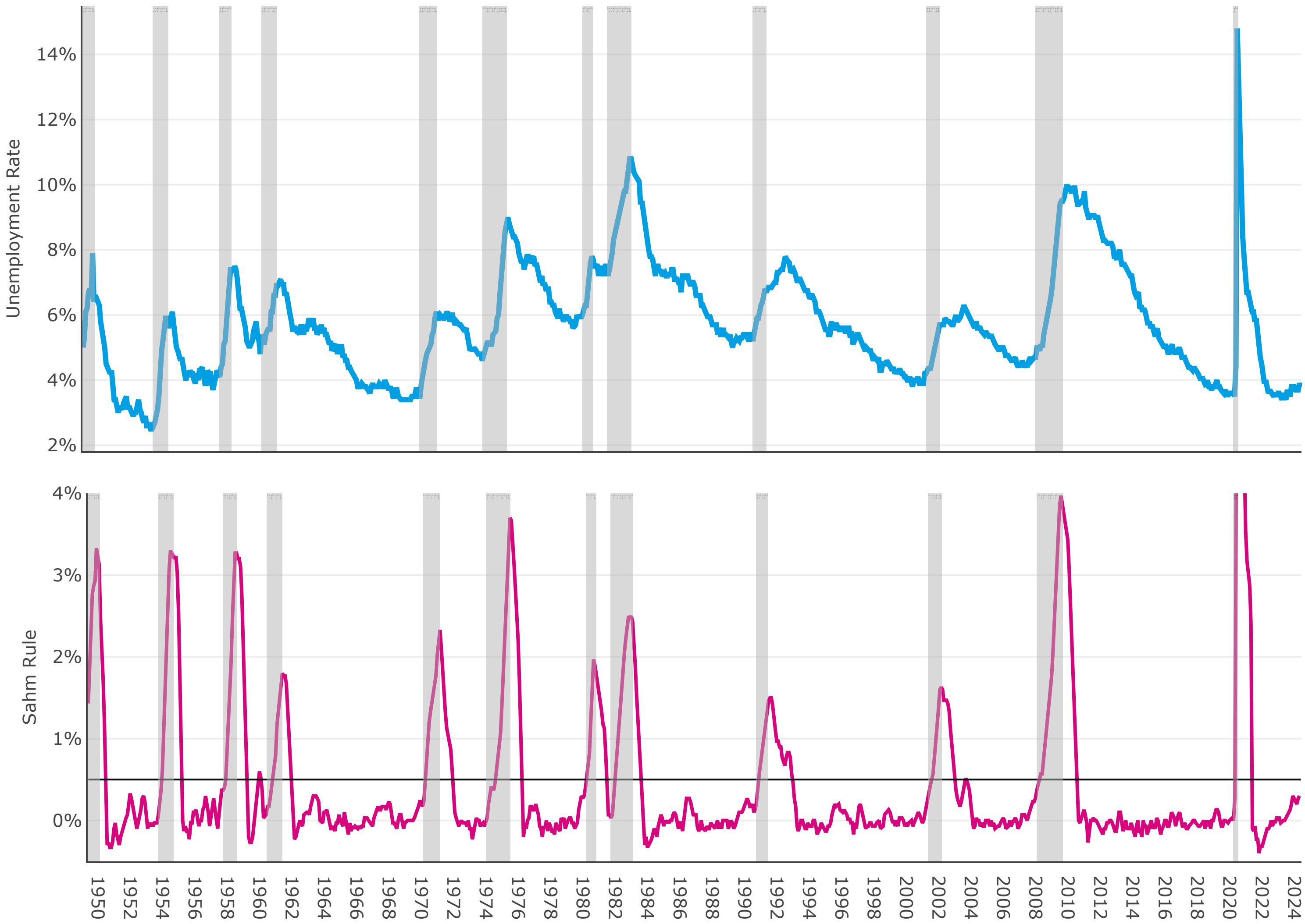
TOP OF MIND

Charts of the Month

Unemployment doesn't go sideways for long - it usually falls gradually or shoots higher (see upper panel). That's because when it starts to go up, demand falls, bringing more layoffs in its wake, and it rapidly becomes a vicious circle. The US economist Claudia Sahm developed a rule based on this observation. When the (three month average of the) unemployment rate has risen just 0.5% points off the most recent (rolling three month) low in the unemployment rate, the Sahm Rule is triggered, and a recession starts (see lower panel).

The Sahm rule has not triggered yet, to be very clear - the indicator is 0.3% points off its low, not 0.5% - and we have been here before mid-cycle and then recovered (in 1963, 1967, 1987, 1995). It's something we are watching as yet another recession indicator that's not flashing yet but is possibly getting closer.

USA Unemployment vs. Sahm Rule



Sources | Bloomberg, Stayathomemacro.substack.com, CCLA. Sahm Rule was developed by Dr. Claudia Sahm. Methodology used is based on her Substack blog post. Data as at April 2024. Grey shading signifies recessions as per NBER. Sahm Rule graph has been cut at 4%

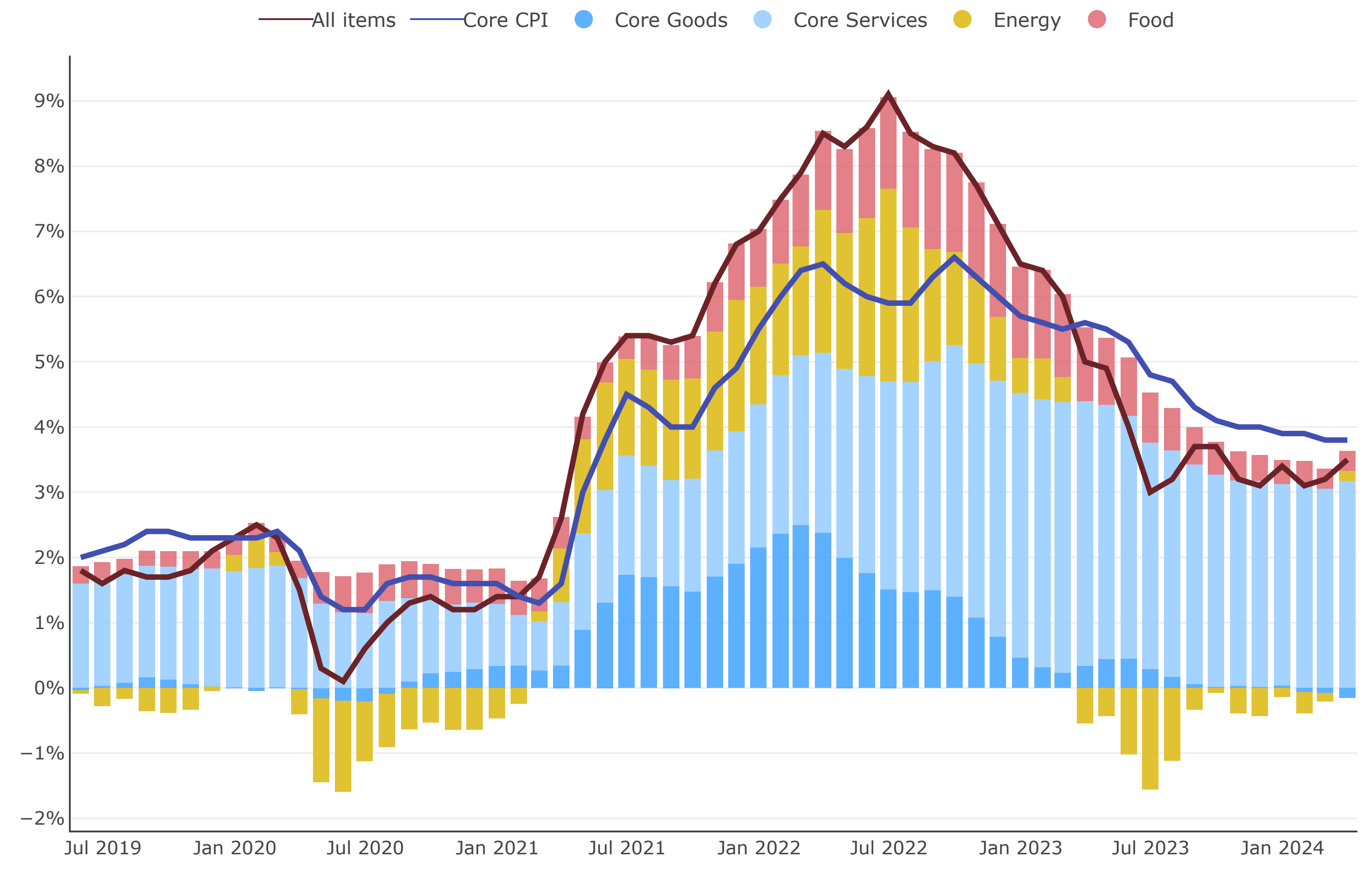
TOP OF MIND

Charts of the Month

Inflation is proving stickier than most expected. The chart shows that traded goods inflation has dissipated. Between them, Food, Energy and Core Goods have gone from causing 6% points of the 9% peak annual inflation in June 2022, to just 0.3% points of the latest 3.5% inflation reading.

The problem has been the light blue bars, Core Services inflation, which is driven by wages, and which has contributed 3-3.5% points to the headline inflation rate every month for the last six. As we saw on the previous page, the US labour market is slowly starting to loosen with a gently rising unemployment rate. Our expectation is that inflation will resume its downwards progress later this year. This is necessary in order for there to be rate cuts.

US Headline CPI Components



Sources | Bloomberg, CCLA. Data as at April 2024

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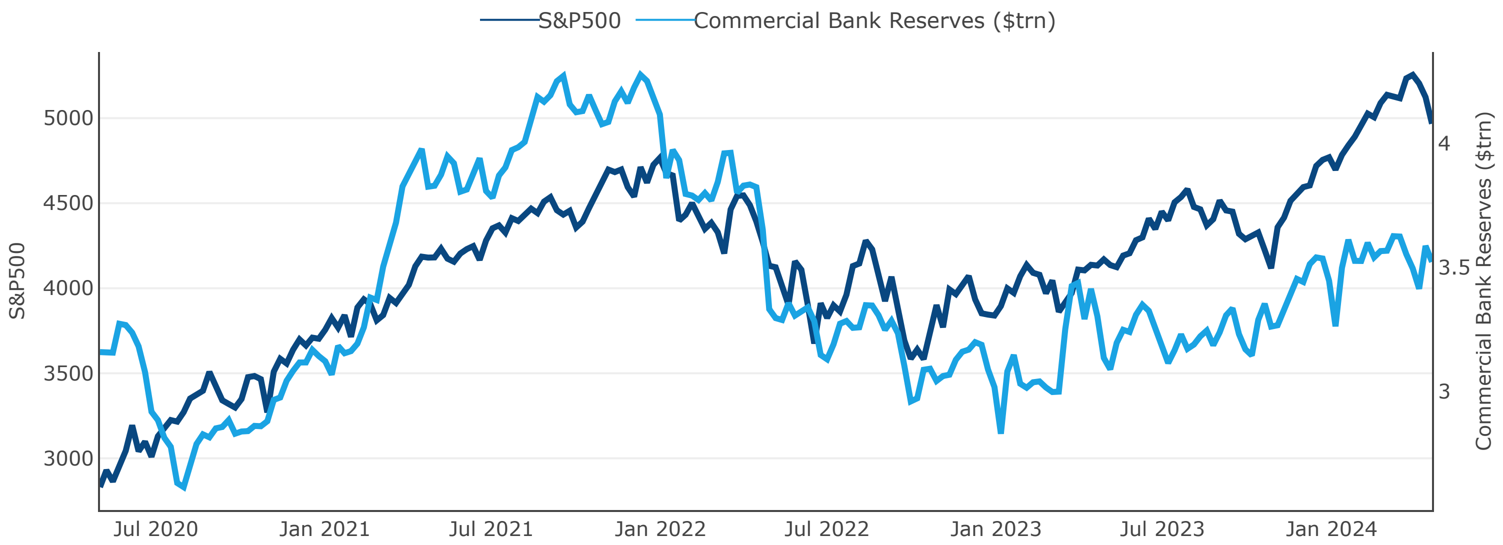
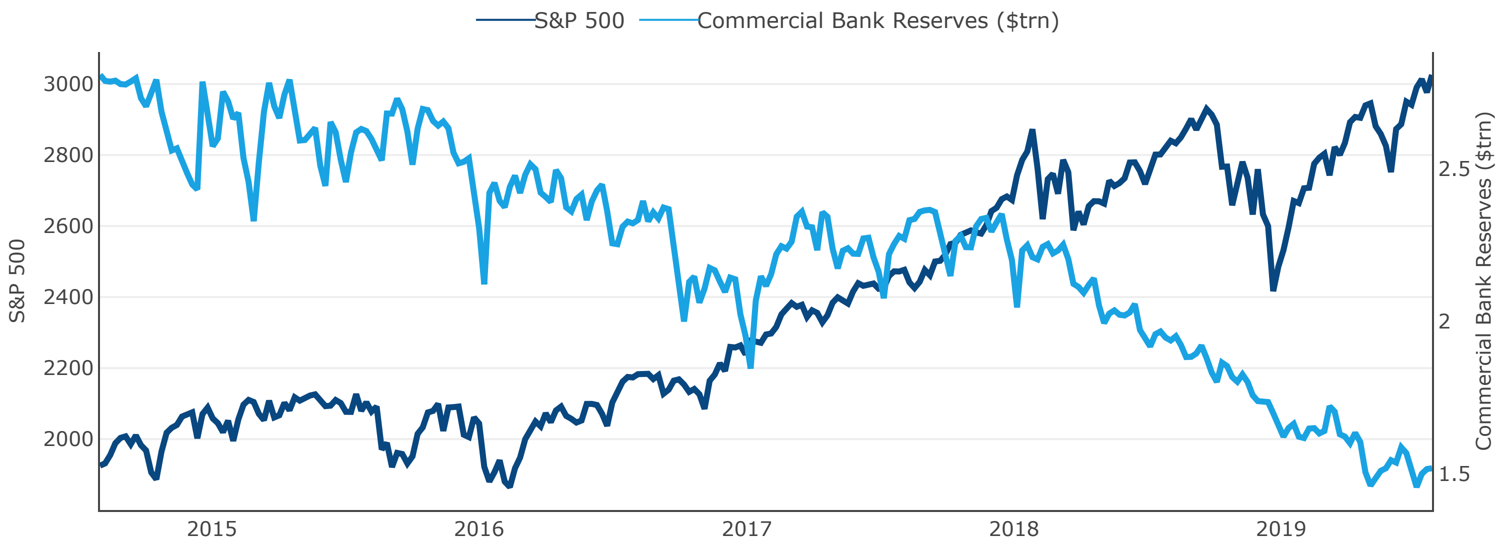
Charts of the Month

Are bank reserves driving the stock market? It is tempting to think that the upper chart below "explains" S&P 500 index performance. There's been a tight fit between changes in the stock of commercial bank reserves at the central bank and changes in direction of the stock market in the last few years, as the chart shows. However, if we take this relationship back to the five years preceding this, the relationship not only disappears but inverts. But for now, with bank balance sheets somewhat constrained, it's worth watching bank reserves. Since late 2022, the Fed has been able to drain excess liquidity by allowing Reverse Repo to drain but that can't go on for long as repo balances have fallen from $2.7trn to $0.8trn. After this the only way to keep the balance sheet shrinking will be via bank reserves. Again, worth watching.

Are Bank Reserves Driving S&P 500?



Trend From 2014

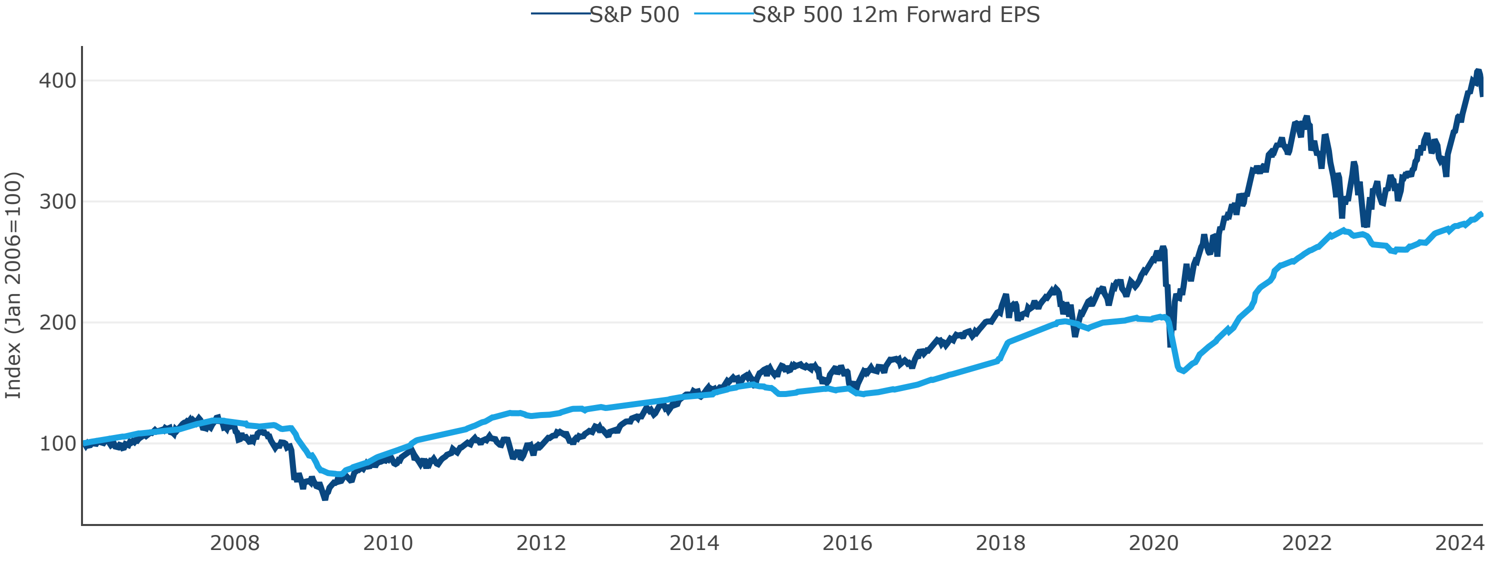


Sources | CCLA, Bloomberg. Data as at April 2024

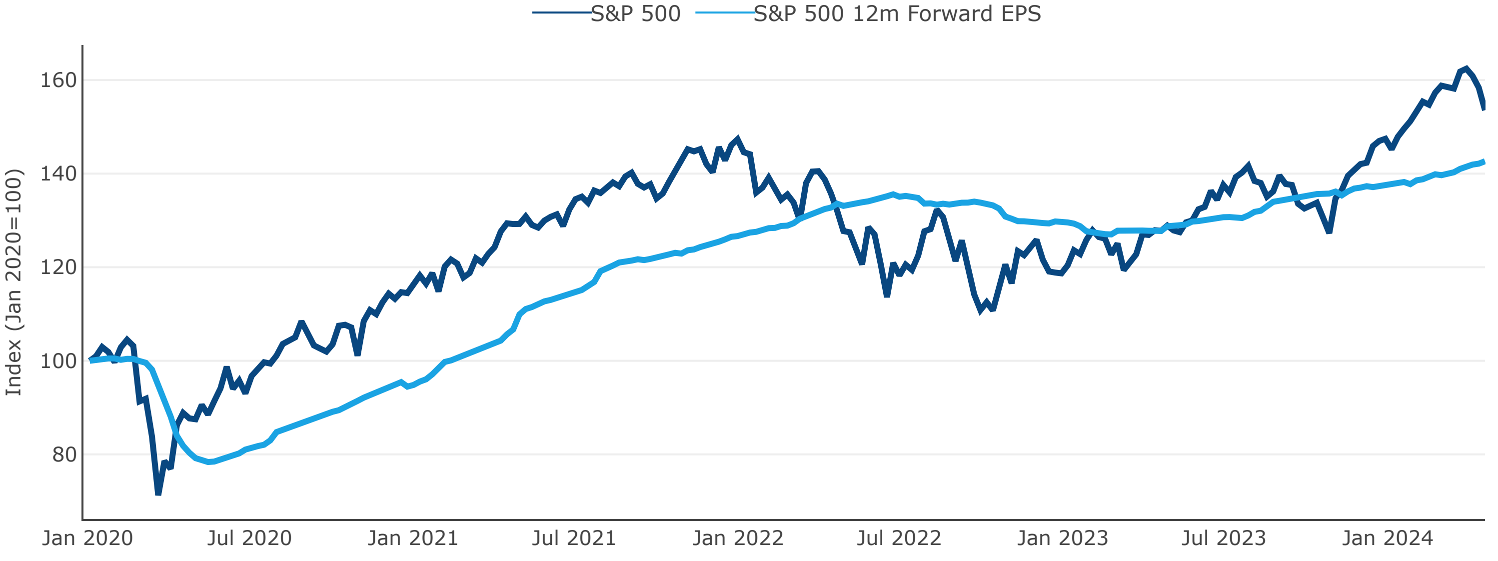
Charts of the Month

Keeping it simple - earnings always drive the stock market. And the good news is that S&P500 earnings are going up. Since the Feb 2022 low in the 12m forward EPS estimate (light blue line, upper chart below), it has risen at a nearly 13% annual rate. One may object that this is all driven by the Magnificent Seven, where estimates have risen at a 50% annual rate. But **if you take out the things that have gone up in any index, what's left will have gone down**, i.e. it was ever thus. Furthermore, in the current and prior earnings seasons, 8 out of 11 sectors saw year-on-year EPS growth - it's just been Materials, Energy and Healthcare that have seen EPS declines. This to us is a sign of a healthy market.

S&P 500 and consensus 12 month forward EPS estimate



Trend from 2020



Sources | CCLA, Bloomberg. Data as at April 2024

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Equity | USA

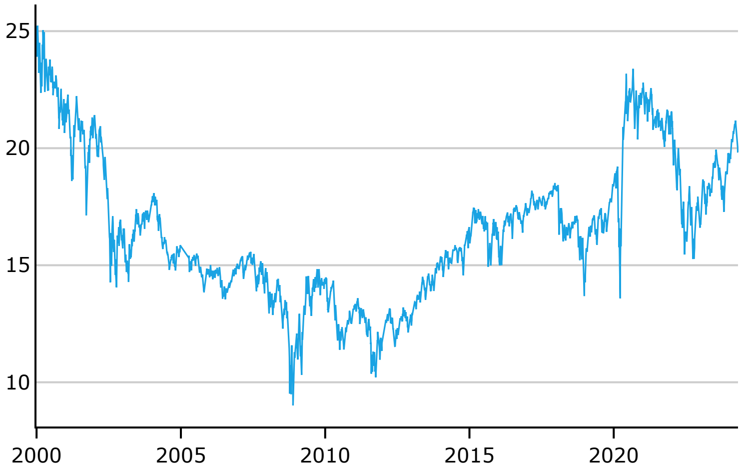
The US equity market ticked lower this month after having sharply re-rated in the prior five months. This leaves the spot PE valuation at 20x, still 25% above its 16x average of the last thirty years.

The CAPE (Cyclically Adjusted PE) has also ticked lower, to 30.8x. 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.

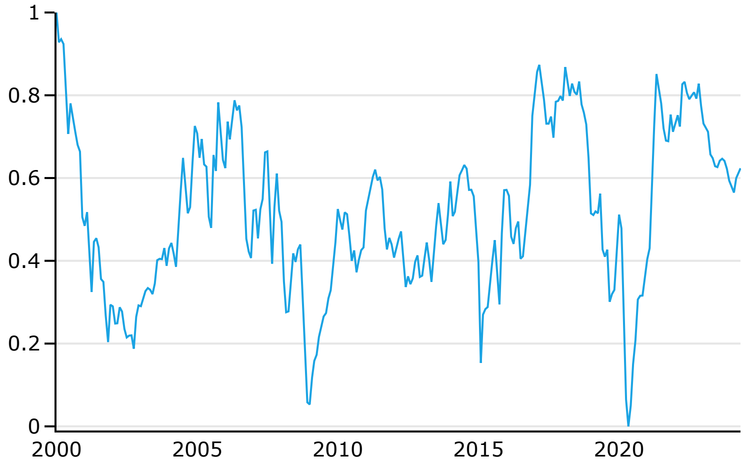
Cross asset valuations are in the 60th percentile, ie equity is a little extended but not dramatically so - on our Composite Value Indicator (top right). But absolute valuations are full in the US at least.

S&P 500 Valuations

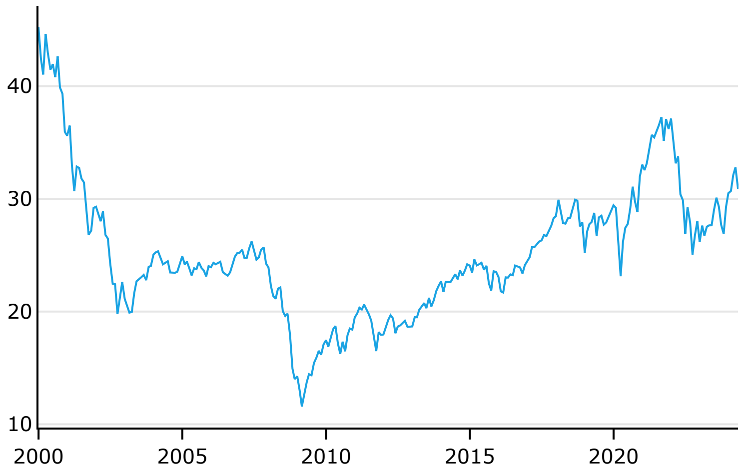
S&P 500 Forward PE



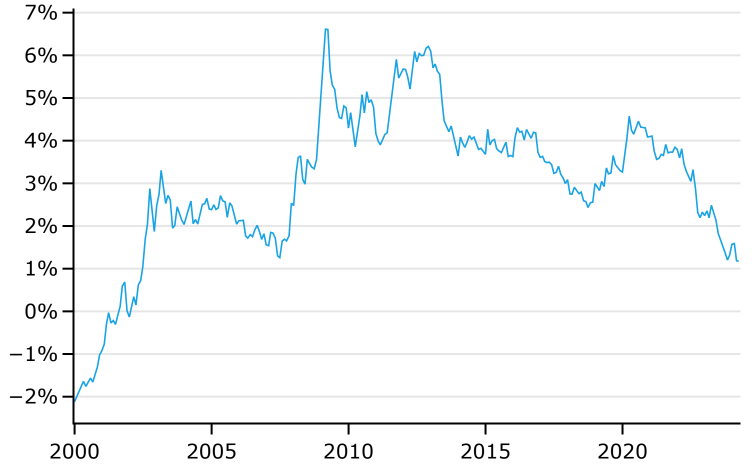
Composite Value Indicator Model



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, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of April 2024

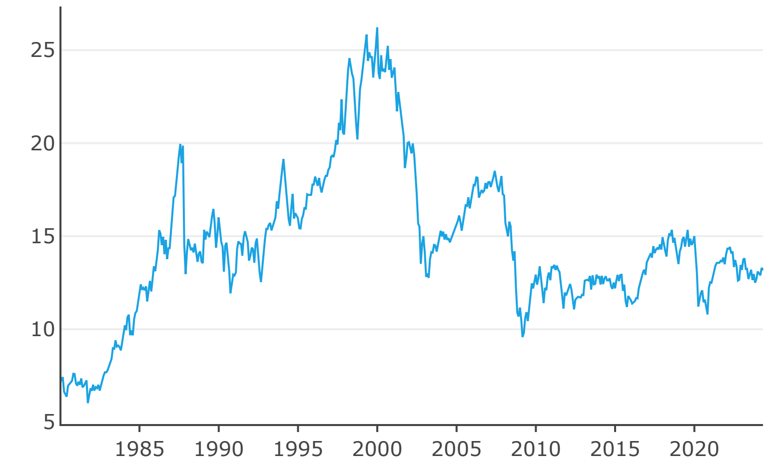
VALUATION

Equity | Regional

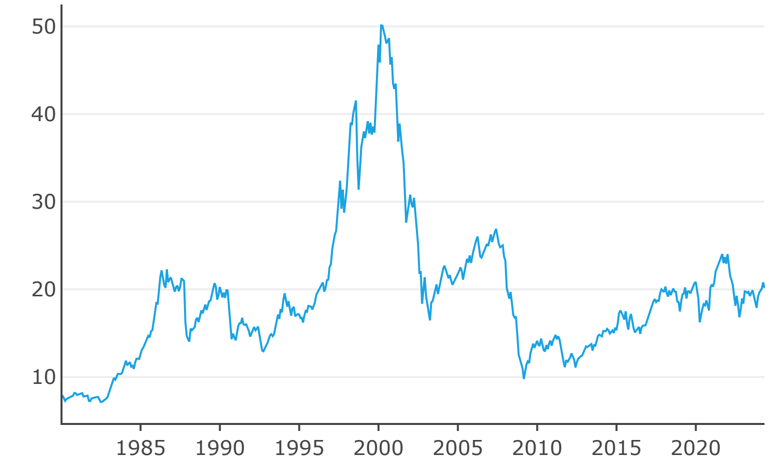
Outside the US (which is 69% of MSCI World), equity markets continue to look reasonable value (UK, Europe-ex-UK) or outright cheap (Japan, EM). The de-rating of last year is notable everywhere. The UK Shiller PE of 13.2 gives an earnings yield of just over 7.5%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 20.2 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

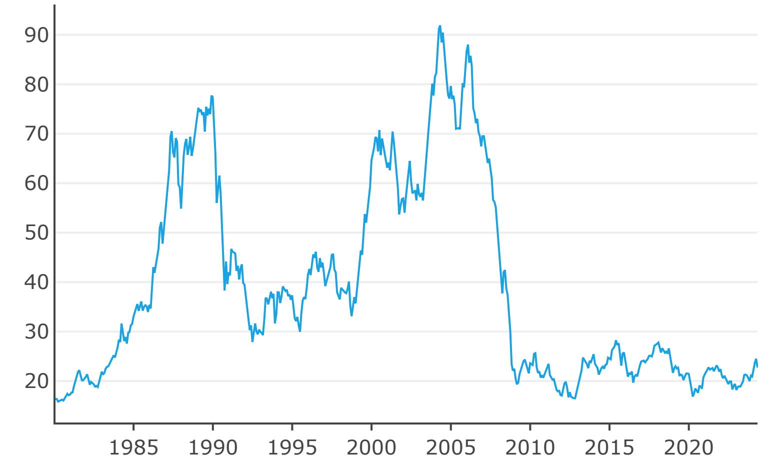


Europe (Ex-UK) | Shiller P/E

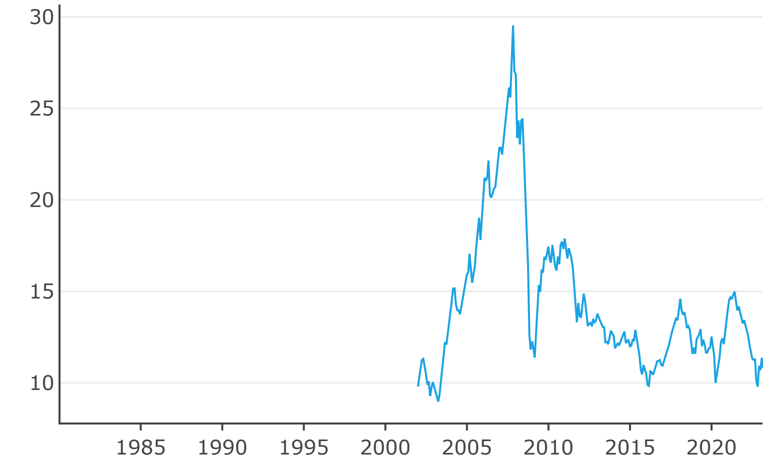


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



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

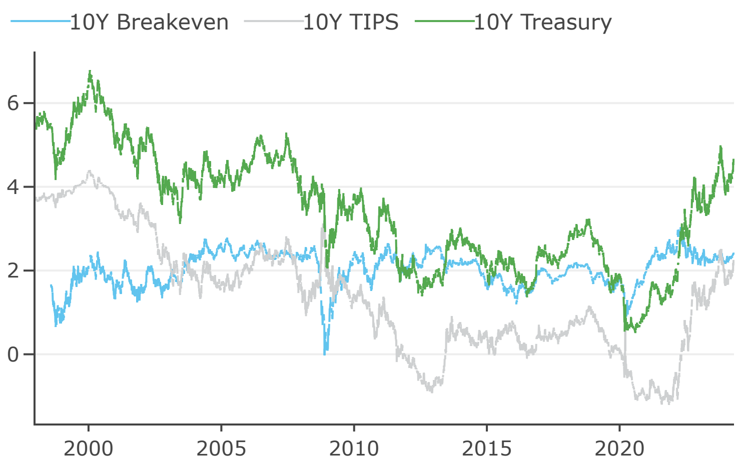
Bonds

Bond markets have given back some of their gains from the "everything rally" of November and December. Since the start of the year, the iBoxx Sterling Gilt index is down 4.3% (albeit 6% above the October-lows), iBoxx Sterling AA (IG) is down c.2.3% and iBoxx Sterling HY is up almost 2.6%.

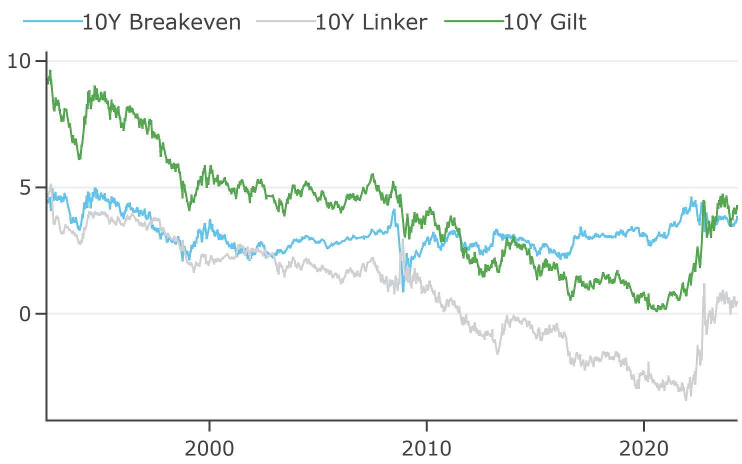
Corporate US BBB yields are still around 6.1%, which stripping out 2.5% expected inflation yields above 3.6% real expected total return, **which to our eyes remains reasonably attractive**.

Global Government & Corporate Yields

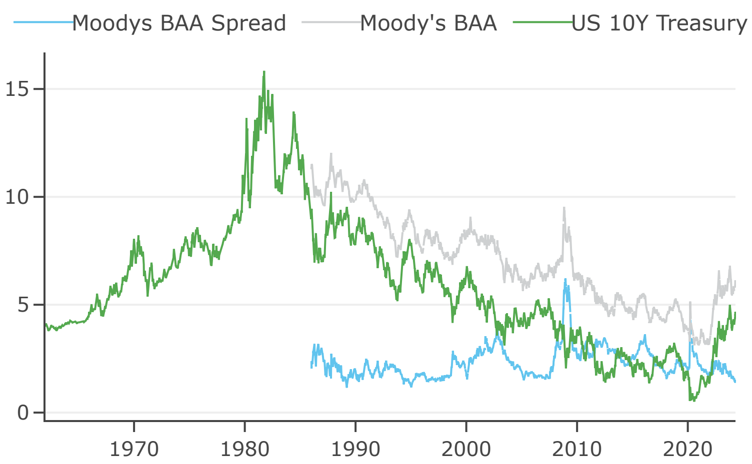
US 10 Year Treasury Yields



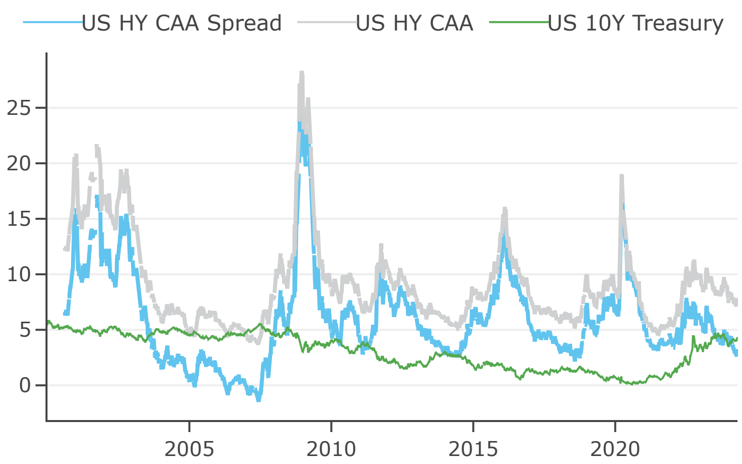
UK 10 Year Gilt Yields



US Corporate Investment Grade Yield



US Corporate High Yield



Sources | Bloomberg as at April 2024

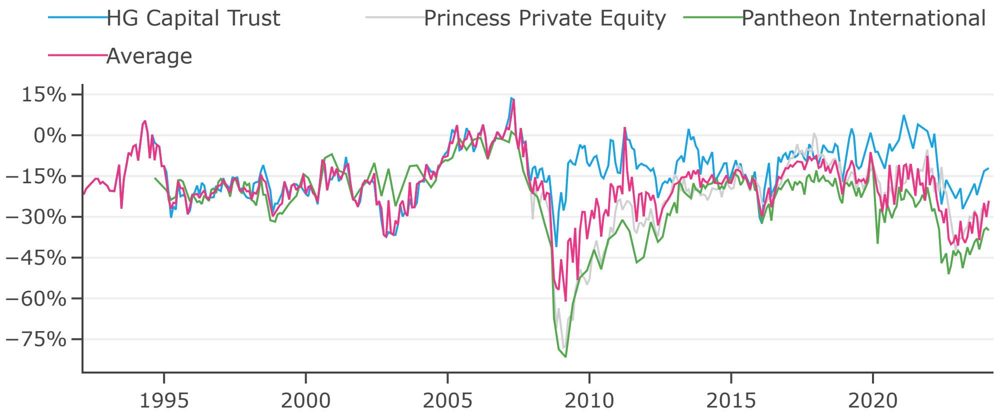
Alternatives

The IRR on Core Private Infrastructure now offers 2.9% return spread over IG corporate bonds, which is becoming more interesting after a much tighter spread over the last two years. Listed Infrastructure trades at 10-35% discounts to net asset value (NAV), which is somewhat more interesting, especially where managers can add value via development. After strong performance last year, Private Equity multiples are no longer at a large discount to public equity, but the discounts to the underlying NAVs remain wide if less than they were (top left chart). **Levered Loan yields have risen from 5% to over 9% but are at risk of falling in a rate cutting environment**.

Global Valuations

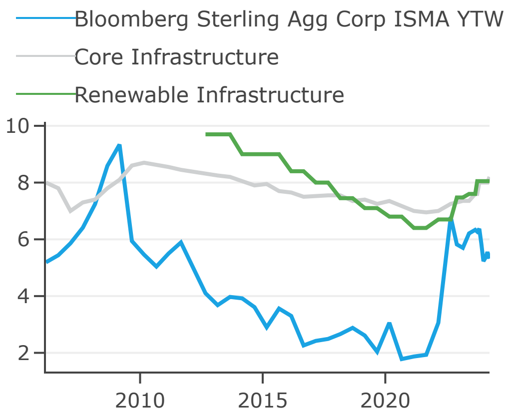
Listed Private Equity

Discount To NAVs



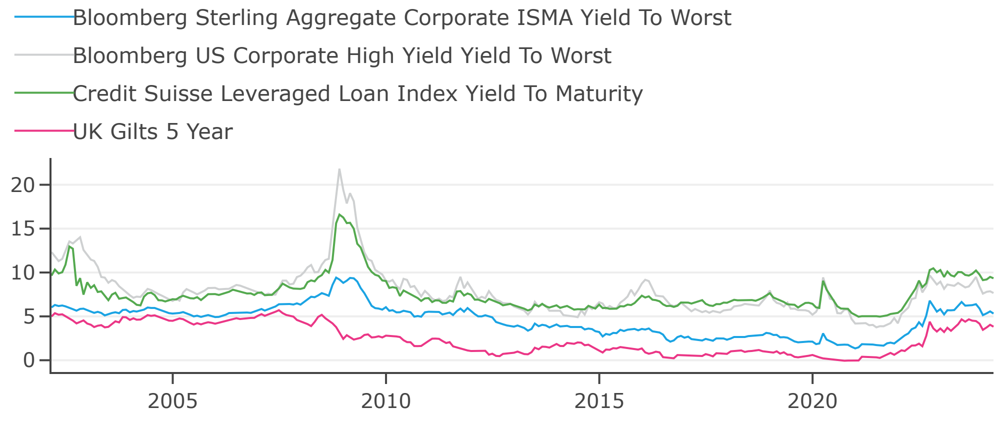
Infrastructure

Infrastructure Discount Rates vs Bond Yields



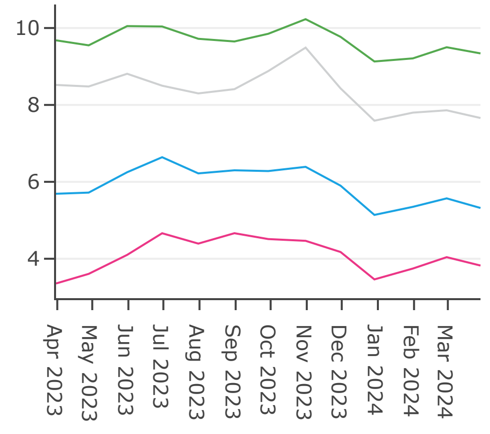
Contractual Income

Income Yields



Last 12 Months

Income Yields



Sources | Infrastructure: CCLA, Bloomberg; Property: MSCI UK Monthly Property Index, Bloomberg; Private Equity: Bain Global Private Equity Report, Bloomberg, Pitchbook; Contractual Income: Bloomberg, Pitchbook. As of April 2024

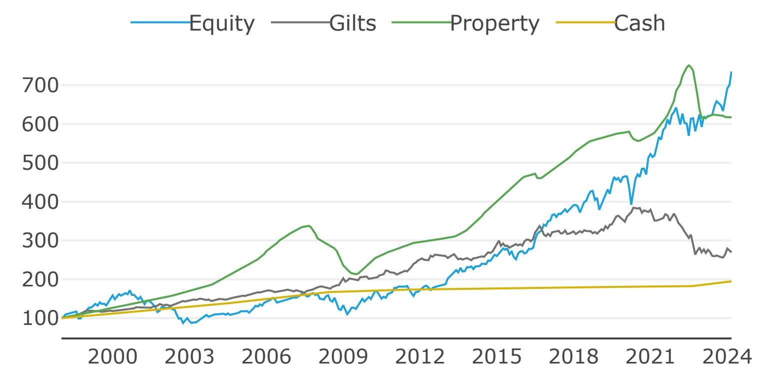
Property

The UK Commercial Property market offers good yields, (7.0% Equivalent Yield on average), within the context of the commonly targeted CPI+4% returns at a portfolio level. NAVs appear to have stopped falling, having declined 21% 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.

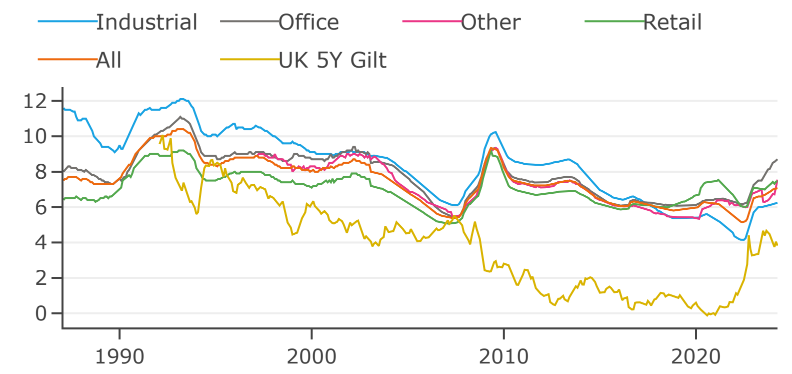
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

UK Commercial Property Market

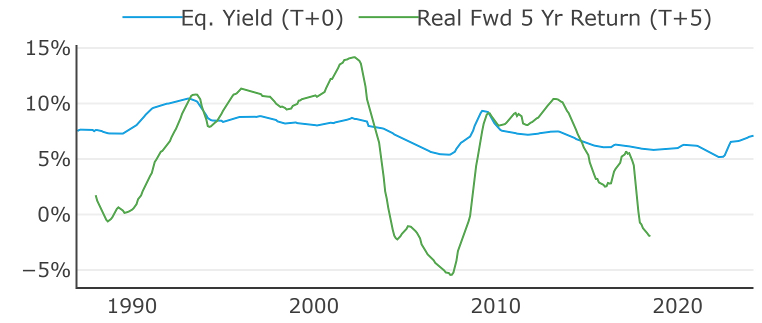
25 Years Of Return 1998=100



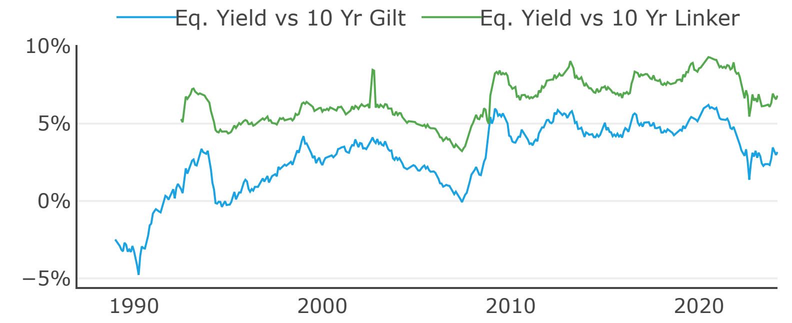
Equivalent Yields vs Gilt Yields %



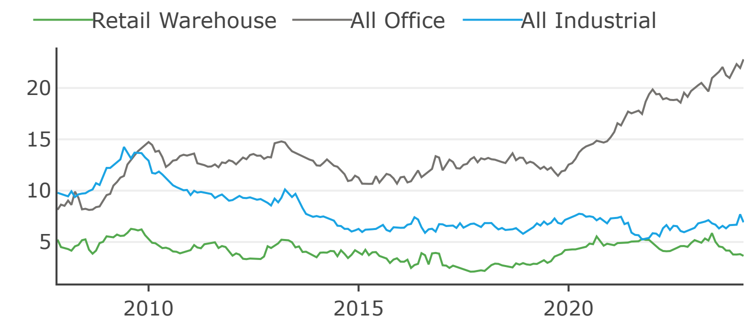
MSCI UK All Property Monthly TR Index %



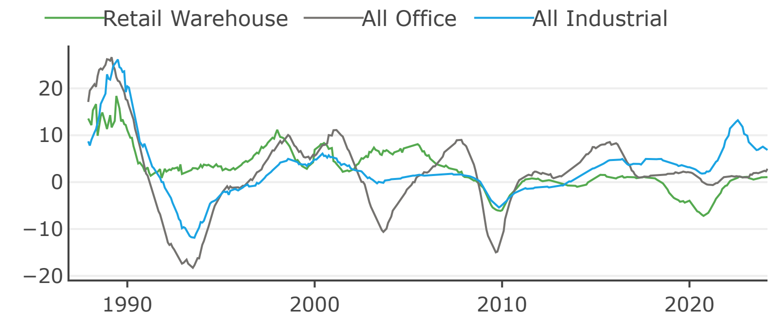
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



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

VALUATION

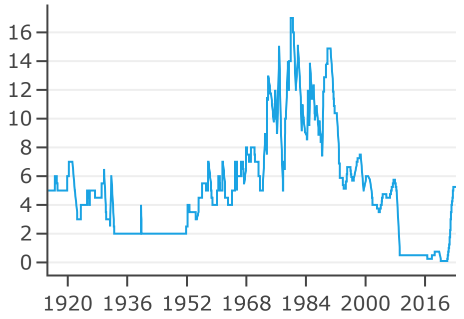
Cash

Global markets operate with a level of interconnectedness. Hence when the US Headline CPI reading for March showed an unexpected 30bps increase, it caused a stir in the US rates market, with ripple effects felt in the UK. For instance, **10Y Gilts are up at 4.3% (at time of writing), their highest level so far this year.**

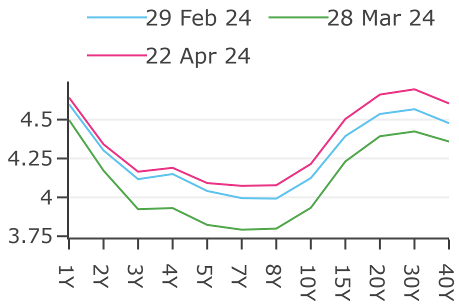
Turning to UK inflation, the UK has largely exhausted the benefit of falling Goods prices, meaning that any further deceleration in headline inflation will have to come from Services inflation - a tougher ask. Nonetheless, we could see some relief on the back of softening wage growth during H2 '24, which could be enough to produce Headline readings of around 2%. **We will be monitoring the MPC's tone in May's MPC meeting for hints of a Q3 cut.**

UK Sterling Market

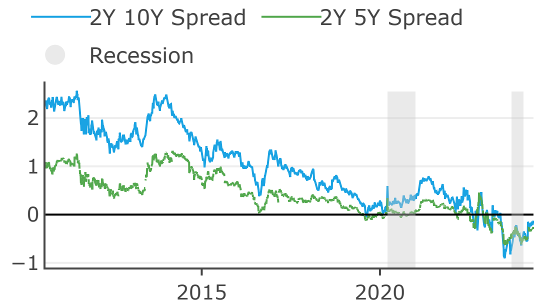
Official Bank Rate



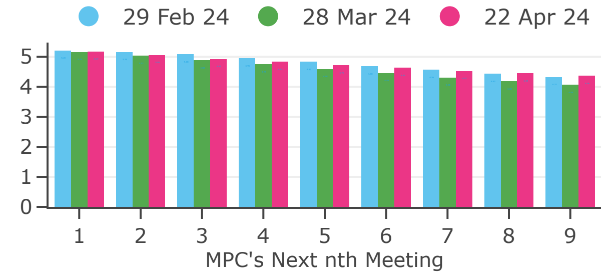
UK Gilt Curve



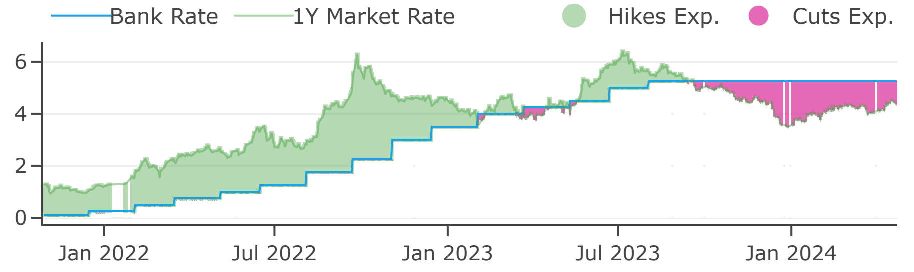
Gilt Spreads



Rate Expectations For Future MPC Meetings



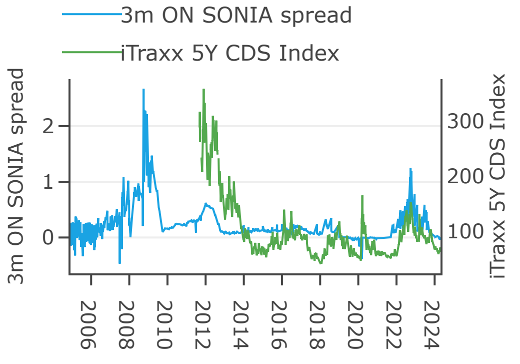
1Y Forward Market Rate Expectations



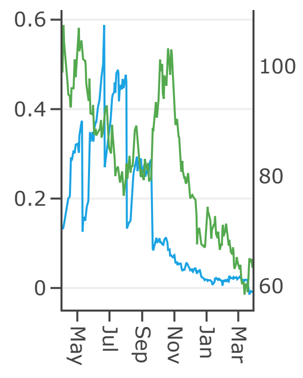
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2023			2024		
	Oct...	Nov...	Dec...	Jan...	Feb...	Mar...
RPI	6.10	5.30	5.20	4.90	4.50	4.30
CPI	4.60	3.90	4.00	4.00	3.40	3.20
CPI Core	5.70	5.10	5.10	5.10	4.50	4.20
CPI Services	6.60	6.30	6.40	6.50	6.10	6.00
CPI Goods	2.90	2.00	1.90	1.80	1.10	0.80
Priv. Wages	6.20	6.30	6.20	5.90	5.90	

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 April 2024

GROWTH

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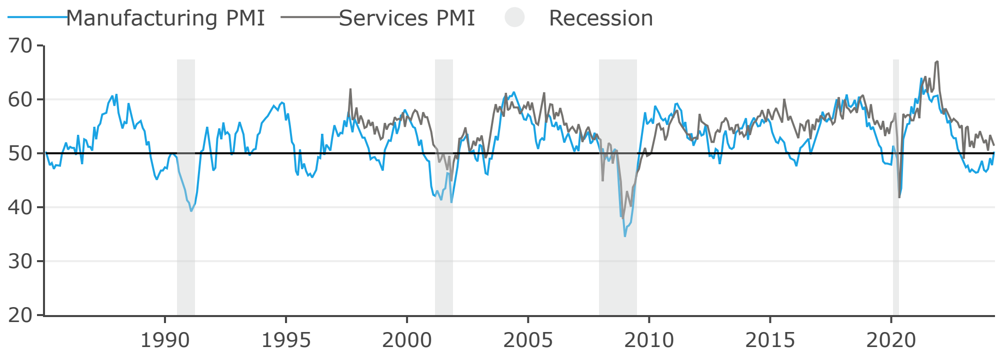
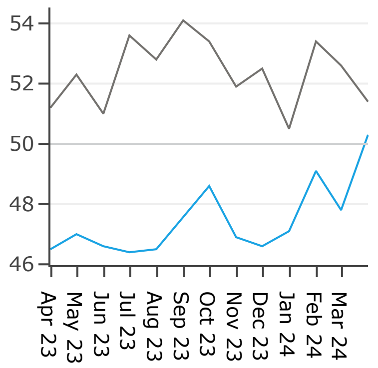
Global PMIs

Leading indicators are holding up in aggregate around the world. The key US Services PMI remains solidly in the 50-55 range that it has been in for the last year, continuing to indicate solid expansion of the 70% of the US economy that it represents. And the US Manufacturing PMI has broken above 50 for the first time in over a year. Eurozone Services PMI is now solidly above 50 too. **For now there is no sign of recession from these fast moving indicators**.

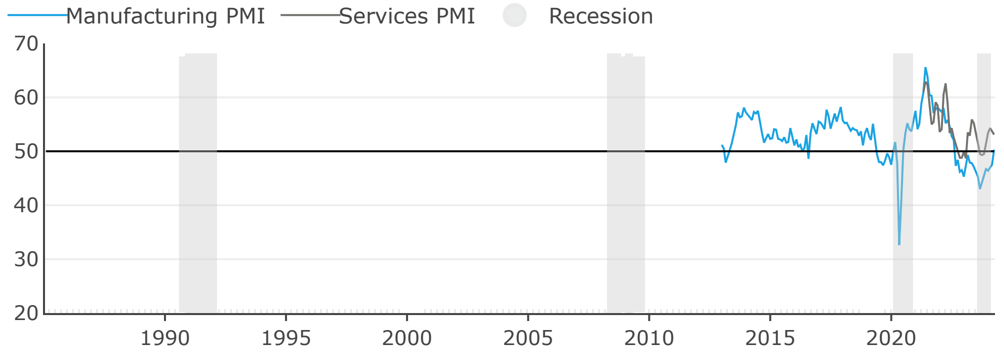
United States



Last 12 Months



United Kingdom



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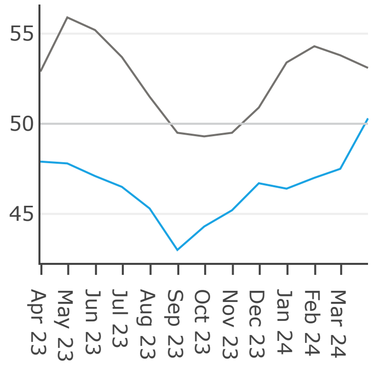
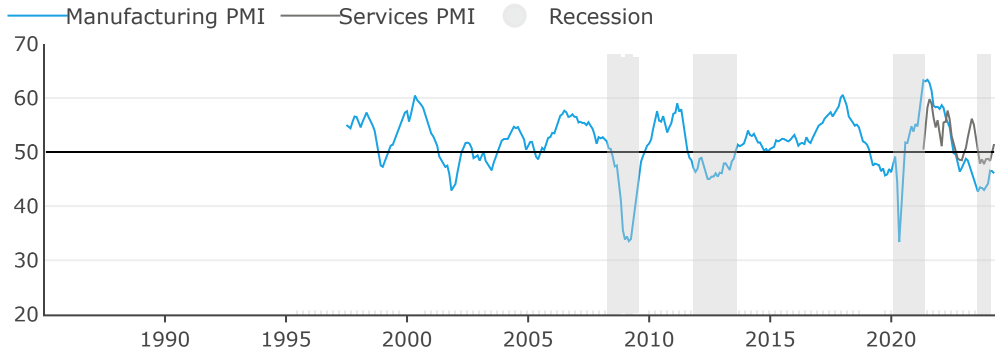


Eurozone



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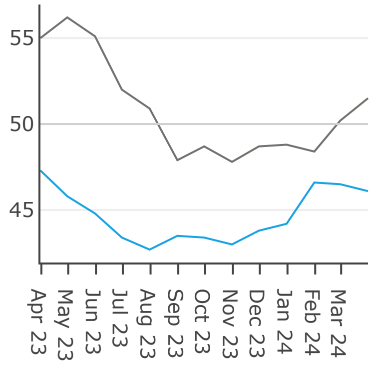


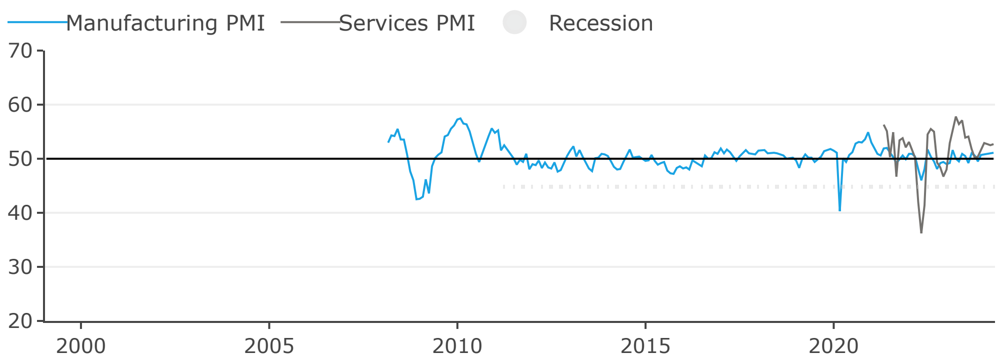
Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of April 2024. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

GROWTH

Global PMIs

Both the Global Services and (now) 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



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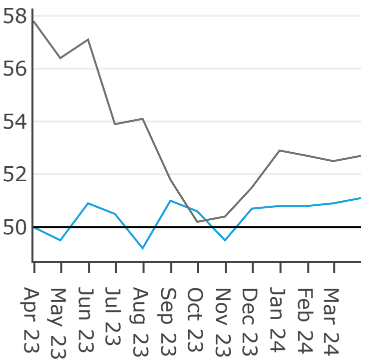
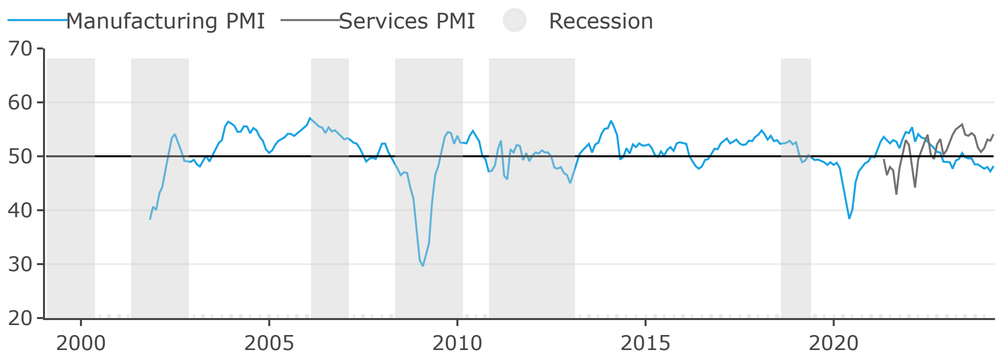


Japan



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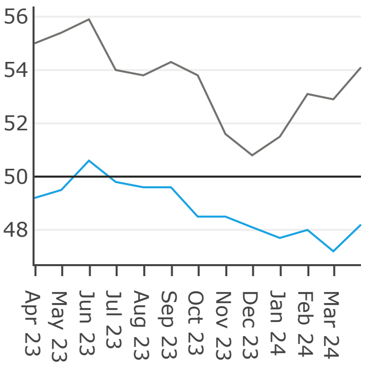
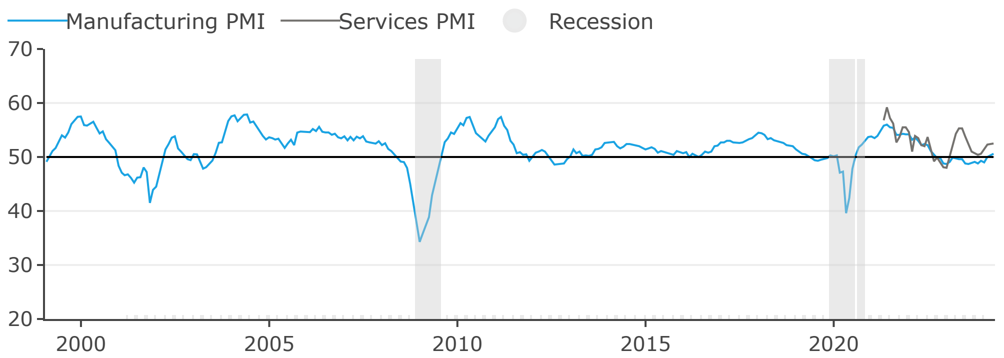
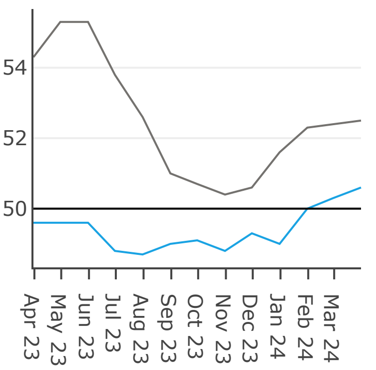


Global



Last 12 Months



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

GROWTH

CCLA

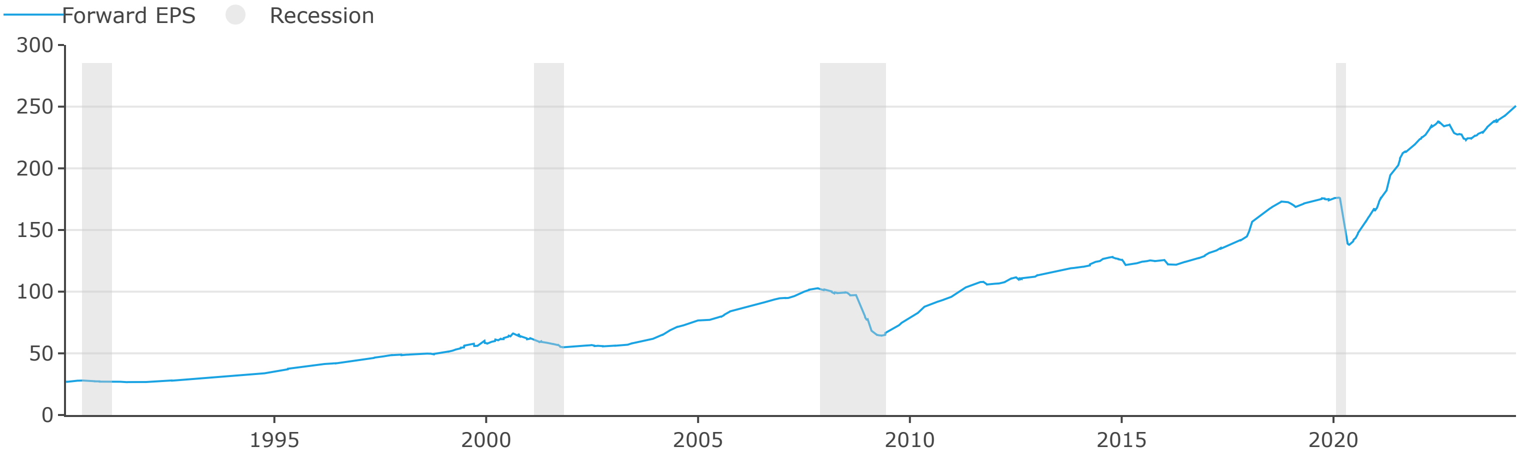
Earnings

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!)

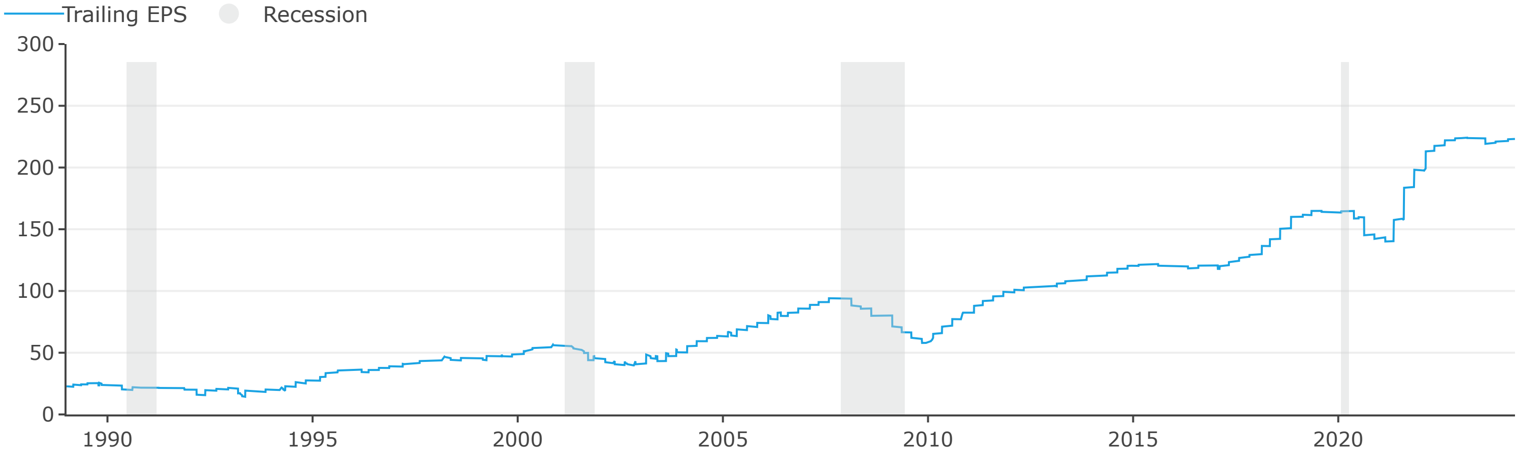
We reiterate that earnings could be in position to take over from PE re-rating in driving the market higher, although clearly a recession would change that.

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 April 2024

GROWTH

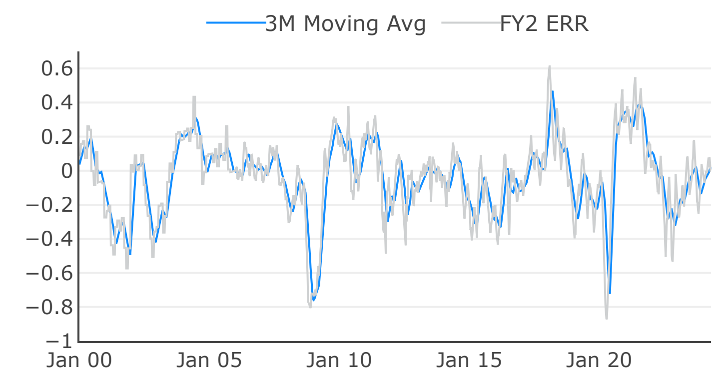
Earnings

These charts show the breadth of earnings revisions, i.e. # upgrades minus # downgrades / total estimates, so it is a directional measure showing how widespread upgrades or downgrades are. Historically, troughs in revisions breadth have been excellent times to add risk.

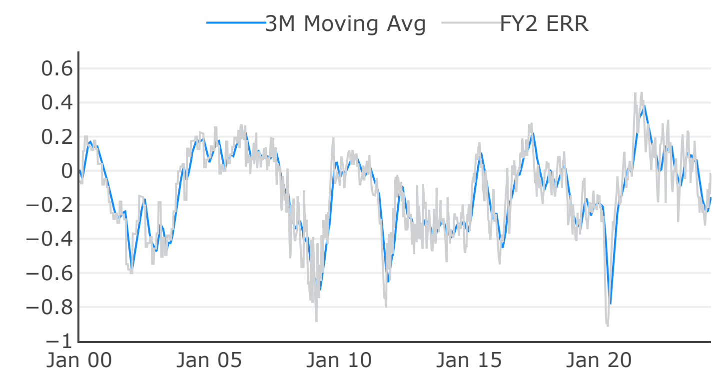
The overall assessment is that earnings breadth is ticking up in with the US now joining Japan in having positive net earnings breadth. This speaks to a broadening out of earnings support from just the Magnificent Seven.

Global Earnings Revisions Ratios

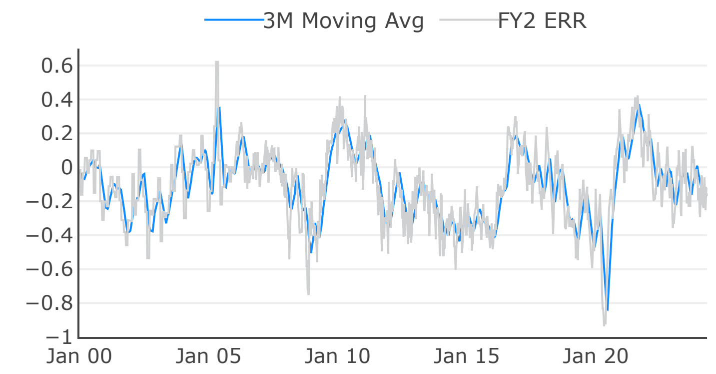
USA



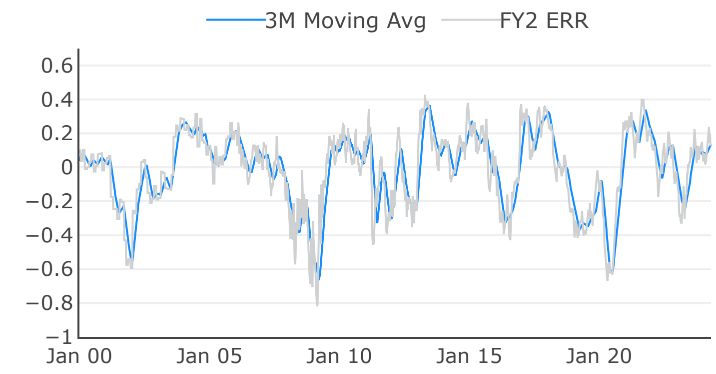
Eurozone



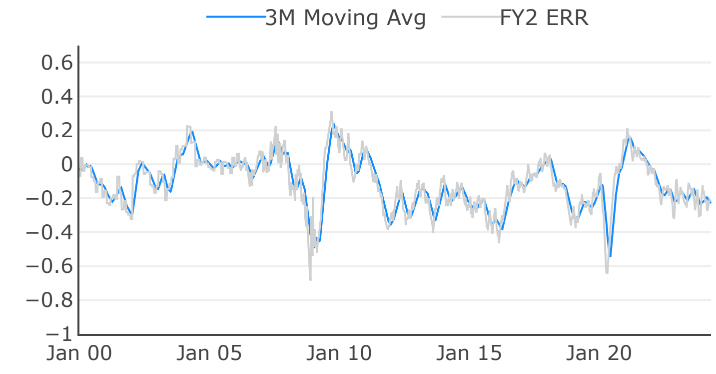
UK



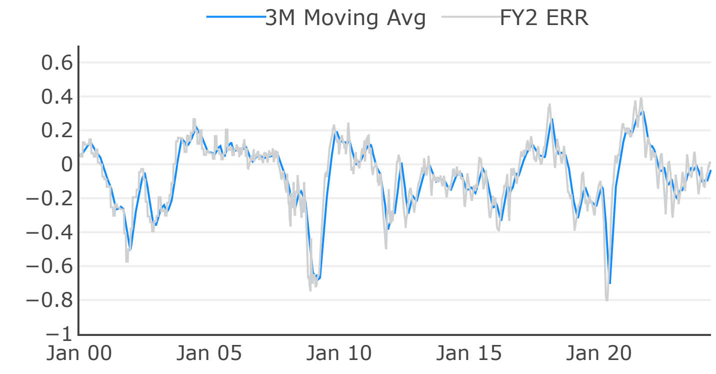
Japan



Emerging Markets



World



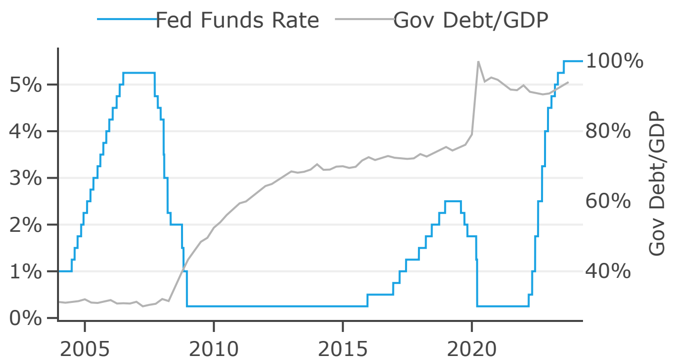
Sources | Eikon, the MSCI index has been used for each respective region, as at April 2024.

POLICY

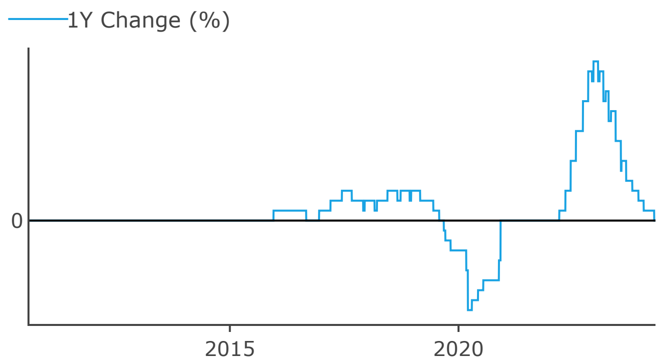
Interest Rates

After last month's excitement of a first Japanese rate hike in 17 years, **sticky inflation has pushed the US two year bond yield back up to 5%,** from just above 4% earlier this year. 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**.

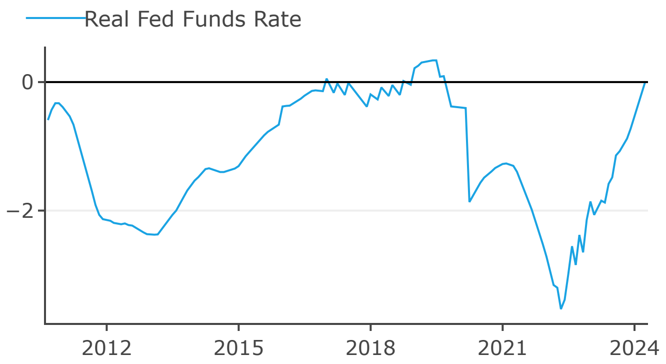
Fed Funds Rate



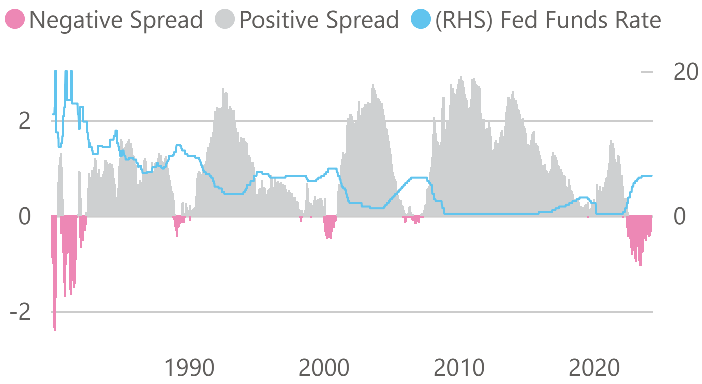
Change in Fed Funds Rate



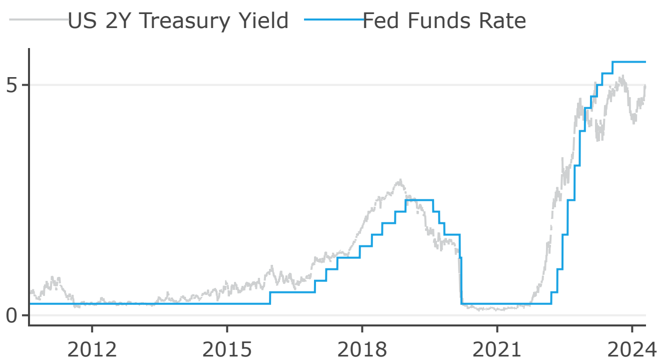
Real Fed Funds Rate (Using 2Y MA CPI)



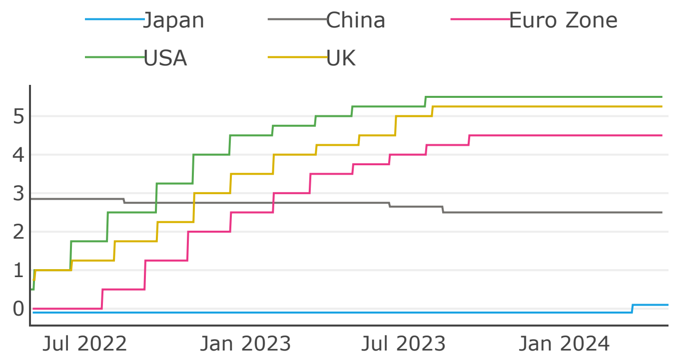
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



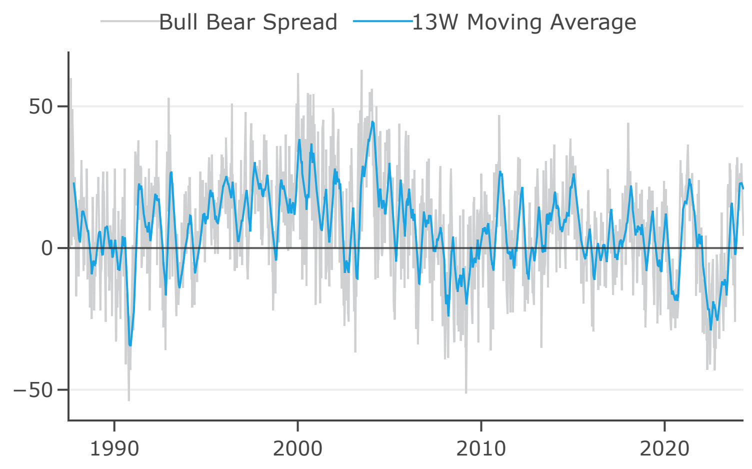
Sources | Bloomberg for all charts, as of April 2024

Sentiment

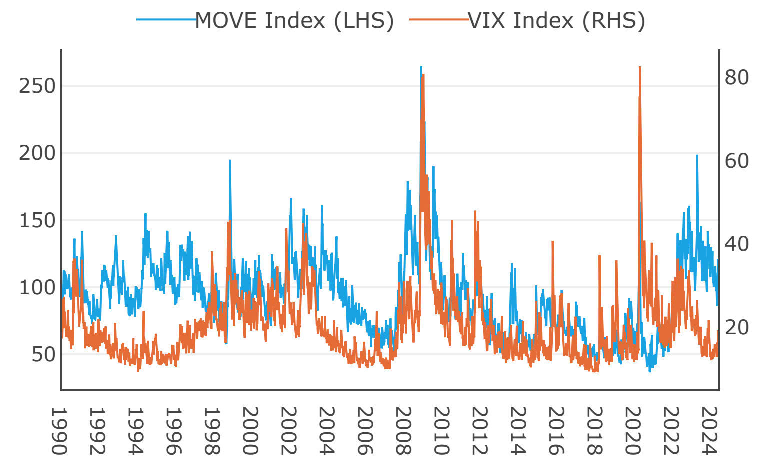
The Hartnett Bull & Bear Indicator has moved from Extreme Bearish sentiment (which is bullish for the market!) in October 2022 **to now bang on neutral** (the current reading is 5/10). In other words, sentiment is neither extended nor washed out, and is therefore unlikely to be a catalyst one way or another.

US Equity Indicators

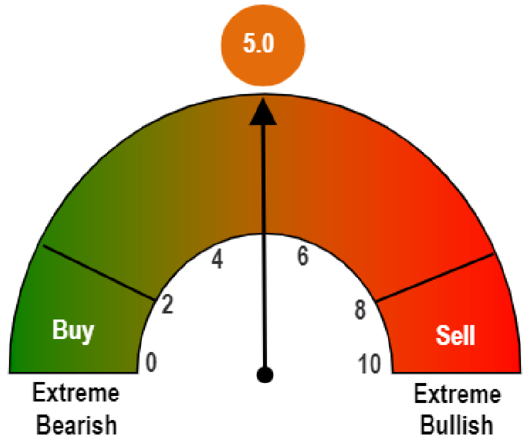
AAII Bull Bear Spread



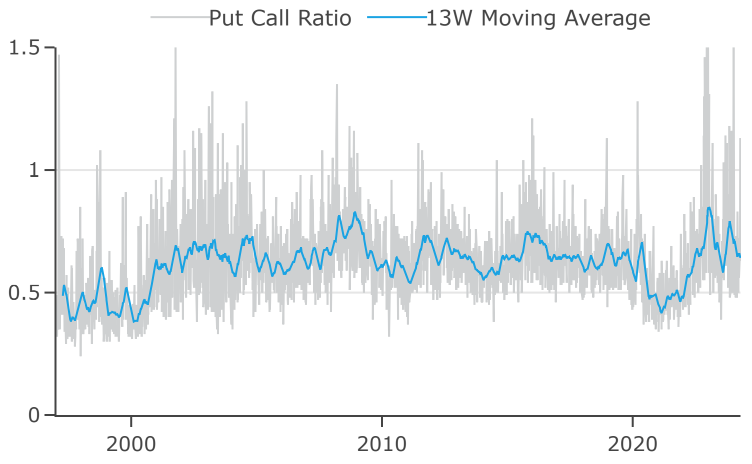
Equity vs. Bond Sentiment



Michael Hartnett's Bull & Bear Indicator (BAML)



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 April 2024

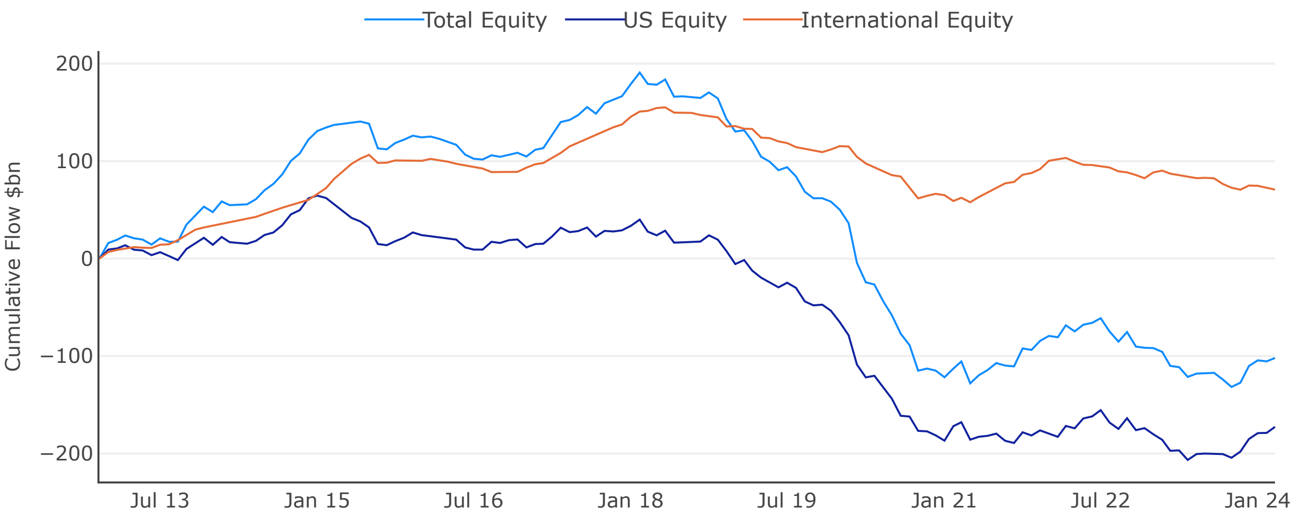
Fund Flows

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.

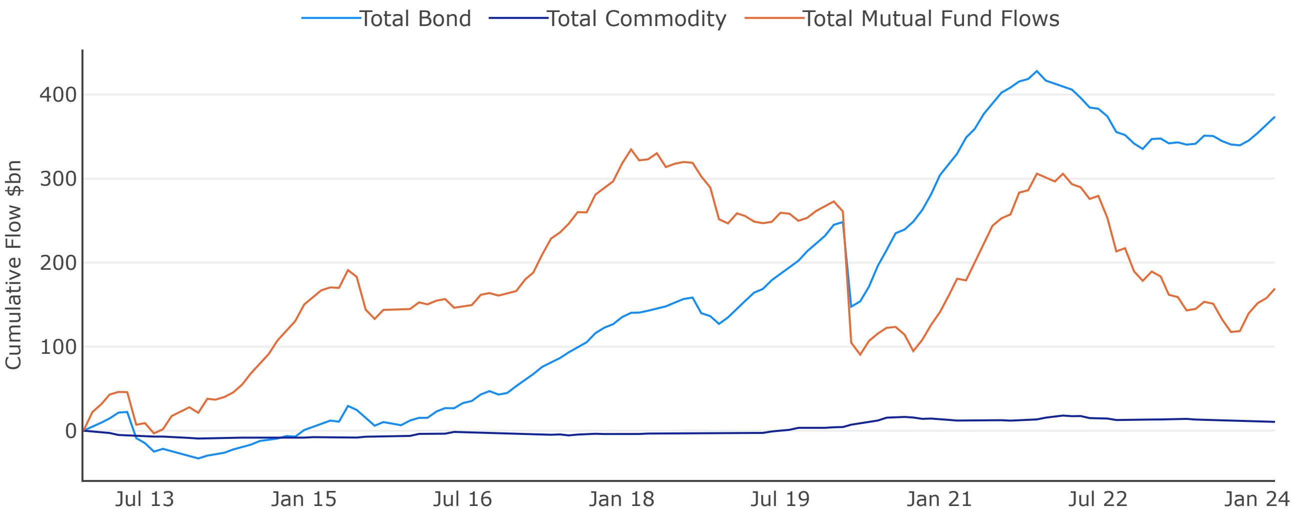
The message in these data points continues to be that there is little enthusiasm for actively managed funds even if the outflows from equity funds have stopped.

US Mutual Fund Flows

Equity Markets Cumulative $bn



Non-Equity Markets Cumulative $bn



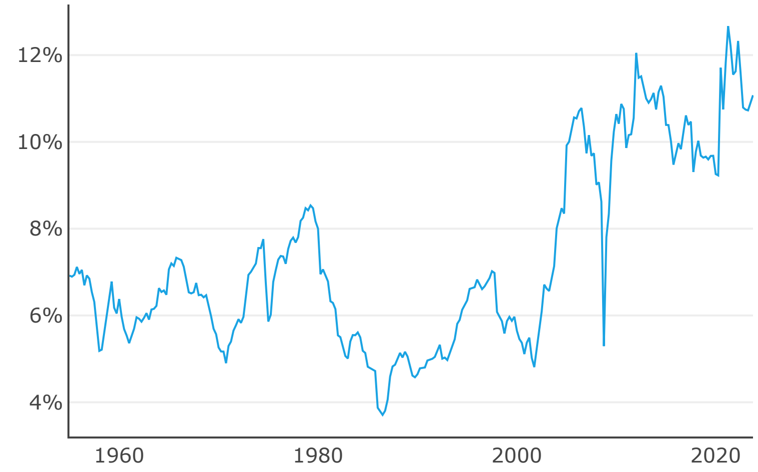
Sources | All charts: Bloomberg ICI fund flow data. Data as at April 2024

The Big Picture

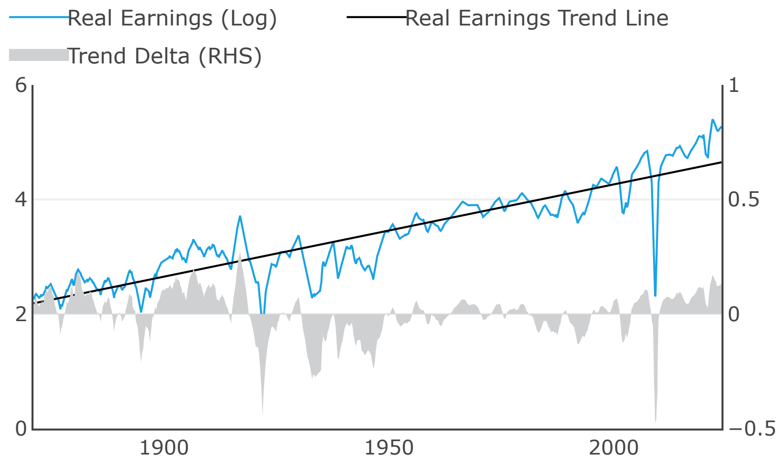
Here we highlight some longer-term imbalances that, **should** they correct, would have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. Its corollary (not shown) is that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

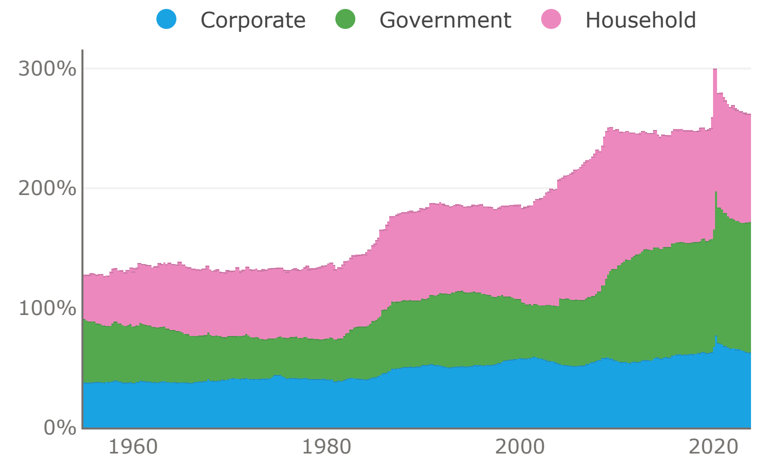
Profit Share of GDP



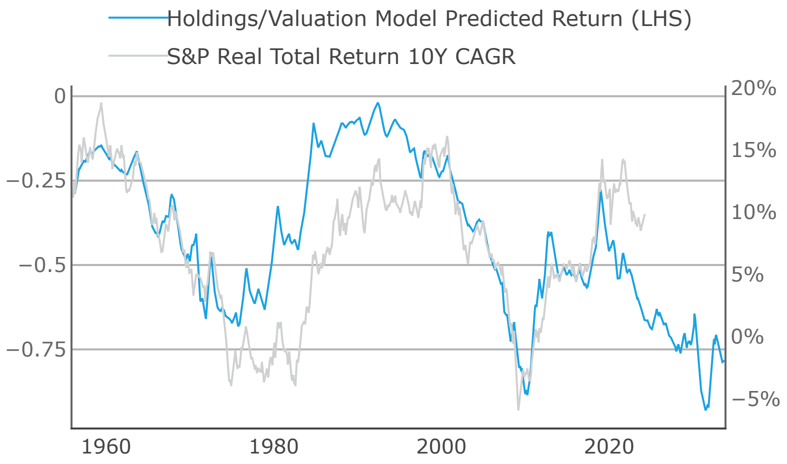
Earnings Deviation From Trend



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 April 2024.

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