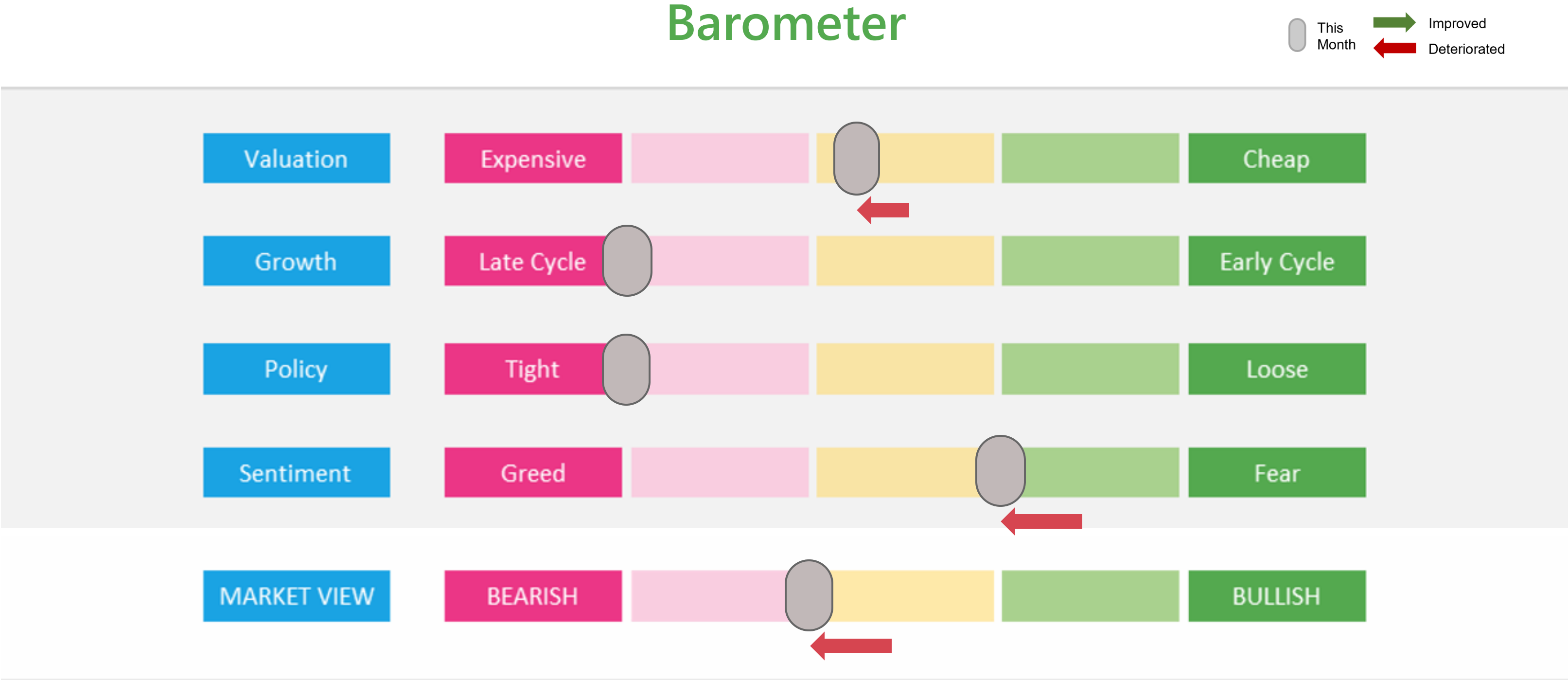
DECEMBER 2023

Market Barometer

Barometer



Sprinting for the Finishing Line

The last month has been an "everything rally" with MSCI World equity up 6%, Gilts up 3%, non Gilts up 3%, Listed Private Equity up 12%, and Infrastructure up 6%.

Well not quite everything was up. Levered loans (whose returns depend on short term interest rates) were down as expectations for rate cuts started to be priced in; and commodities continued their dismal year, losing 4% on the month and now down 14% for the year to date.

Market buoyancy was driven by two cuts being priced in for the Fed next year on the back of a dovish November FOMC meeting. This has been less the case for the UK's MPC, though 2024 rate expectations are still on their lows for the last six months.

In our charts of the month we hold Rishi Sunak to account on his pledge to halve inflation this year. While headline inflation has indeed halved from 10% to 5% since he made the pledge in January, core inflation is almost exactly unchanged and still high at 5.7%. The UK has made less progress than the US on taming inflation.

US earnings have once again led the world, with Q3 EPS up 3% year over year where elsewhere earnings fell.

Broadly, inflation is decelerating, global earnings estimates are roughly flat, we are at peak interest rates and there's no immediate recession warning from high-frequency leading indicators.

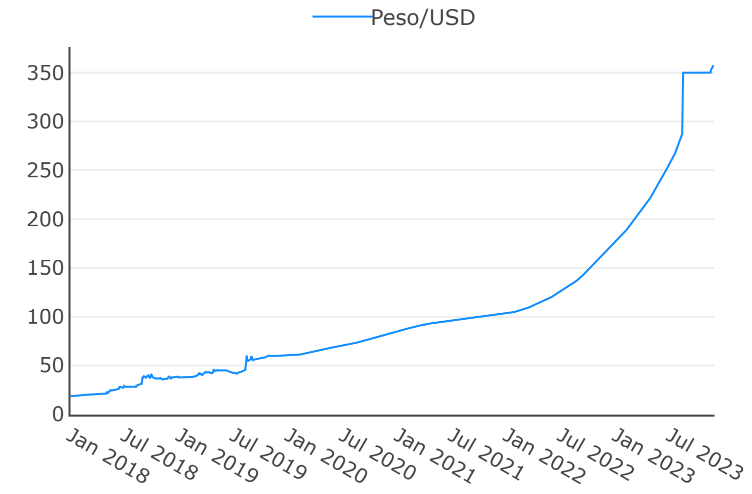
Contents

Charts of the Month

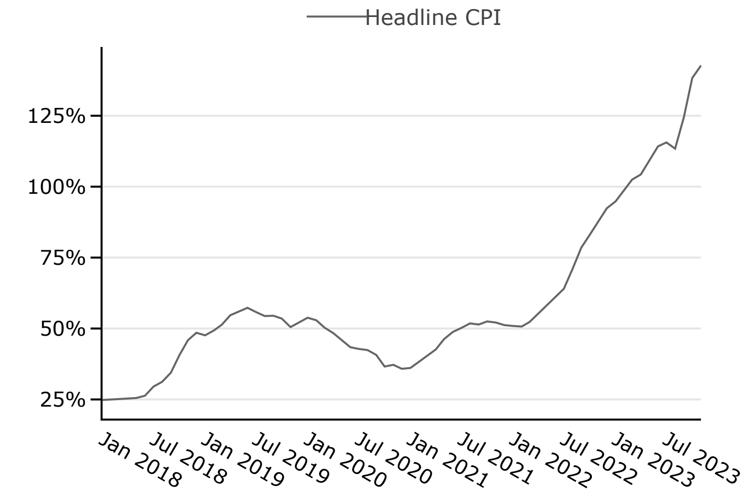
Normally we would tend to ignore politics when constructing portfolios (because of the low signal to noise ratio). But extreme events can teach us a lot. The big lesson is that if you lose control of inflation you lose control of your currency. Argentinian CPI is currently running at a staggering 143% annual rate, which has resulted in the purchasing power of the currency falling by a factor of nine over the last several years. The unofficial exchange rate is nearer 1,000 peso to the dollar. All of which is an extreme way of saying that the UK government's battle with inflation is very important.

Has Rishi Sunak kept his promise to halve inflation this year? On the headline CPI, absolutely, it has fallen from 10.1% when he made the "pledge" in January, to 4.6% in the October reading. However, core inflation remains stubbornly high at 5.7%, having been 5.8% in January. As we pointed out last month, we are on the Bank of England's "Table Mountain" for interest rates - higher for longer, until and unless a recession intervenes.

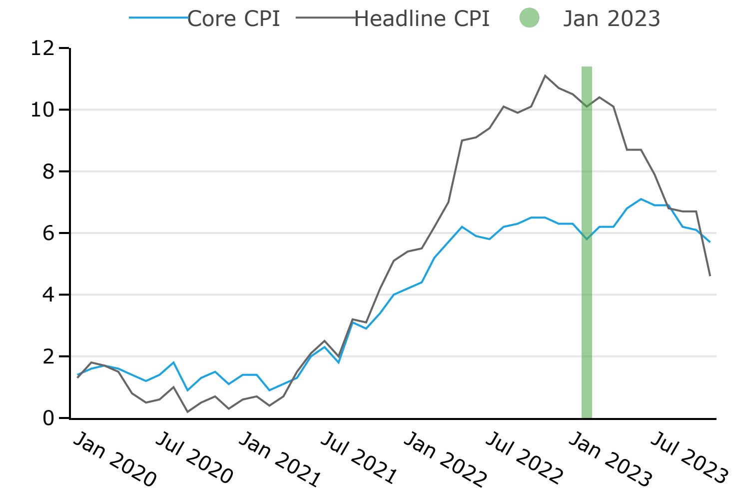
Argentinan Peso



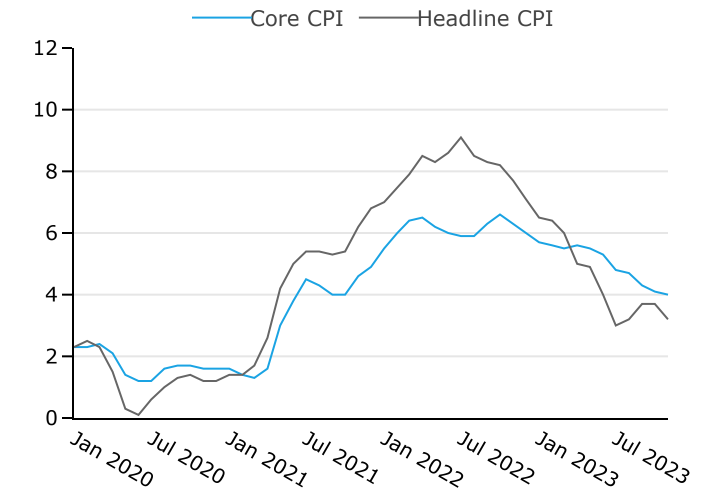
Argentina CPI (% YoY)



United Kingdom Inflation



United States Inflation



Sources | Bloomberg. All data as at Nov 2023

CCLA

Charts of the Month

The US stock market has outperformed the world once again this year, for the 13th year in the last 14 years. It's been driven by a combination of valuation re-rating versus the world and by better earnings growth than the rest of the world. These tables show that this resilient earnings trend continued in Q3. US earnings grew 2.6% year over year in the quarter, compared to a 13.7% decline in EAFE (Europe, Asia, Far East, which includes everything in MSCI World that is not North America). The detail shows that the largest declines happened in cyclical sectors such as Materials, Industrials and Energy, which are much heavier weights ex US than in the US market. Earnings fell in all three DM regions - the UK, Europe ex UK and Japan.

S&P 500 Q3 Earnings

Sector (BICS)	Reported	Sales Surprise	Earnings Surprise	Sales Growth	Earnings Growth
All Securities	471 / 500	1.0%	7.5%	1.7%	2.6%
Communications	22 / 22	0.7%	14.5%	6.0%	44.3%
Consumer Discretionary	48 / 52	1.1%	12.1%	8.8%	38.4%
Consumer Staples	31 / 38	0.4%	5.9%	4.0%	5.5%
Energy	26 / 26	2.0%	-0.4%	-17.1%	-36.3%
Financials	59 / 59	1.7%	10.2%	5.4%	16.7%
Health Care	61 / 64	1.7%	3.8%	6.2%	-20.3%
Industrials	66 / 71	0.8%	6.8%	2.3%	8.4%
Information Technology	69 / 79	0.8%	7.8%	0.6%	4.6%
Materials	29 / 29	0.0%	5.3%	-10.3%	-20.1%
Real Estate	30 / 30	3.3%	3.5%	6.2%	2.9%
Utilities	30 / 30	-6.0%	2.3%	-5.7%	9.3%

MSCI EAFE Q3 Earnings

Sector (BICS)	Reported	Sales Surprise	Earnings Surprise	Sales Growth	Earnings Growth
All Securities	564 / 606	-1.4%	-1.3%	-4.4%	-13.7%
Communications	38 / 39	0.4%	-77.6%	-1.8%	-85.8%
Consumer Discretionary	64 / 69	2.2%	14.1%	10.1%	52.6%
Consumer Staples	51 / 54	-0.5%	3.7%	-3.2%	-8.4%
Energy	16 / 17	-4.9%	0.0%	-22.0%	-41.9%
Financials	73 / 86	10.2%	13.9%	5.3%	31.6%
Health Care	49 / 50	-1.7%	-1.2%	-1.9%	-1.0%
Industrials	114 / 120	0.2%	-2.1%	-1.1%	-36.4%
Information Technology	59 / 60	-0.3%	3.1%	0.5%	-12.7%
Materials	61 / 64	-2.9%	-5.3%	-11.6%	-40.7%
Real Estate	17 / 23	-1.6%	-6.6%	3.2%	7.4%
Utilities	22 / 24	-31.1%	-8.2%	-31.2%	31.2%

Sources | Bloomberg. All data as at Nov 2023

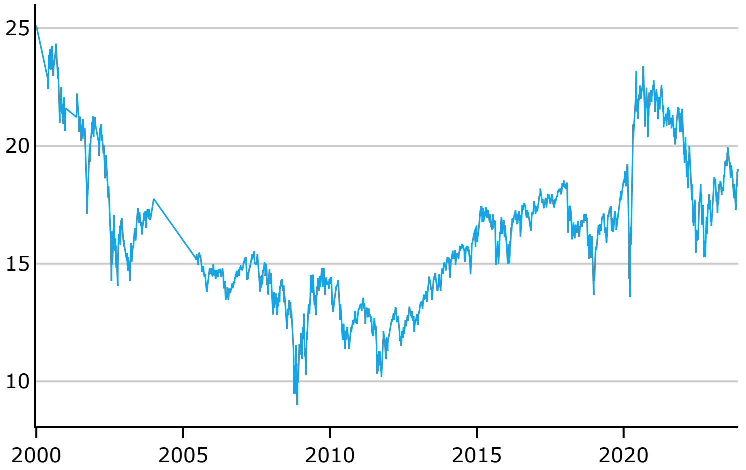
VALUATION

Equity | USA

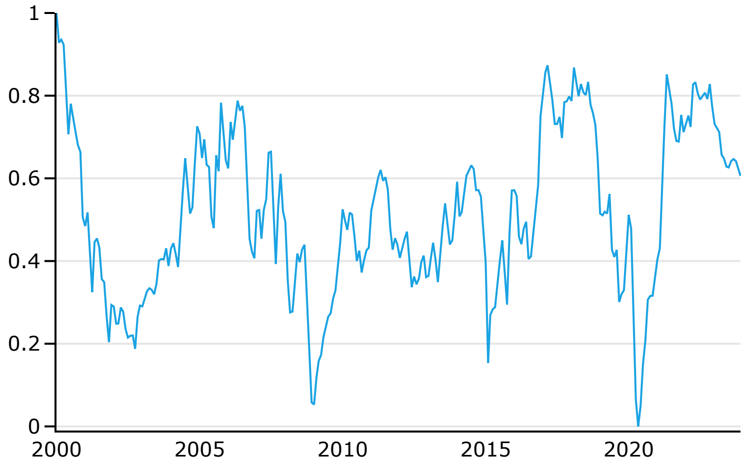
US equity market is undoubtedly still expensive, though it's fairly concentrated in the Magnificent Seven. Spot PE (top left) valuation is 19x, still above its 16.2x average since 1990. It's interesting to note that there is a large valuation dispersion between the so-called Magnificent Seven (Apple, Microsoft, Amazon, NVIDIA, Alphabet, Tesla and Meta) and the rest of the US stock market. Those seven stocks are now 28% of the S&P 500 and trade on a forward PE of 27x. The equal-weighted S&P 500 trades on a PE of 15.6x. Conclusion - the overvaluation of the S&P is concentrated in relatively few names. The way we calculate the Equity Risk Premium (Shiller earnings yield less real bond yield) the ERP is a lowly 1.3%. The way others calculate it (consensus forward earnings yield less nominal bond yield) it is 1.0%. Both methods point to meagre excess returns over bonds.

S&P 500 Valuations

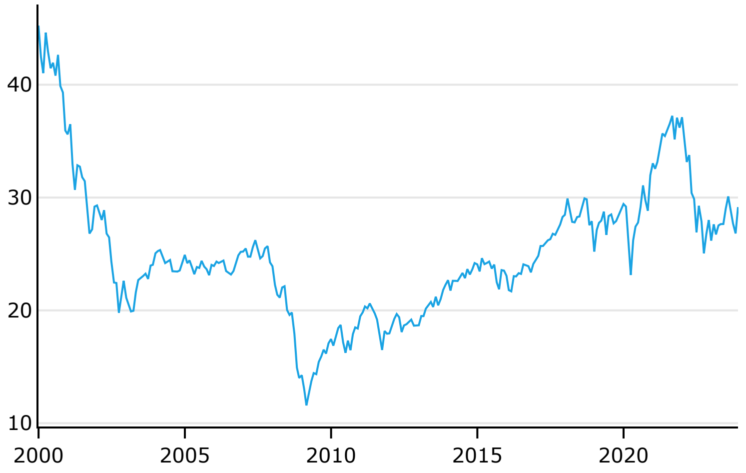
S&P 500 Forward PE



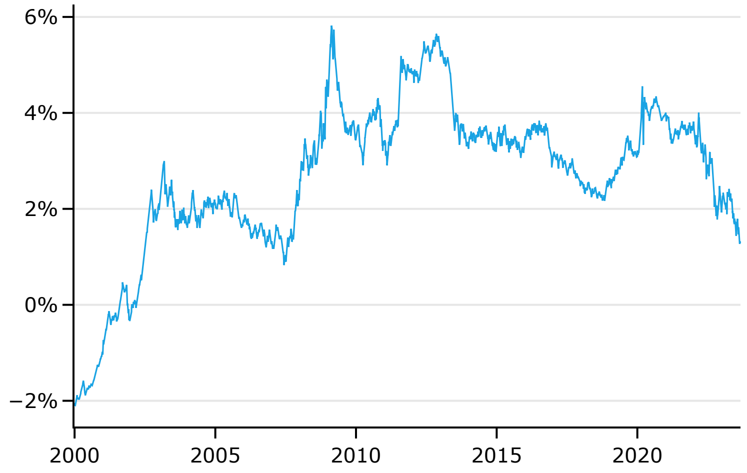
Composite Value Indicator Model



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 Nov 2023

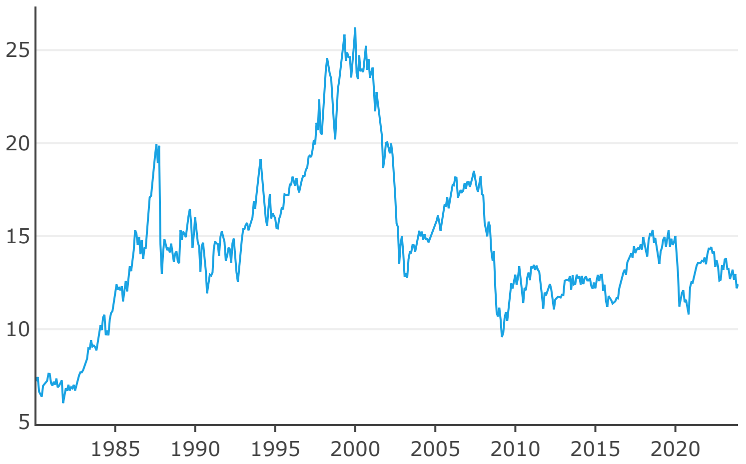
VALUATION

Equity | Regional

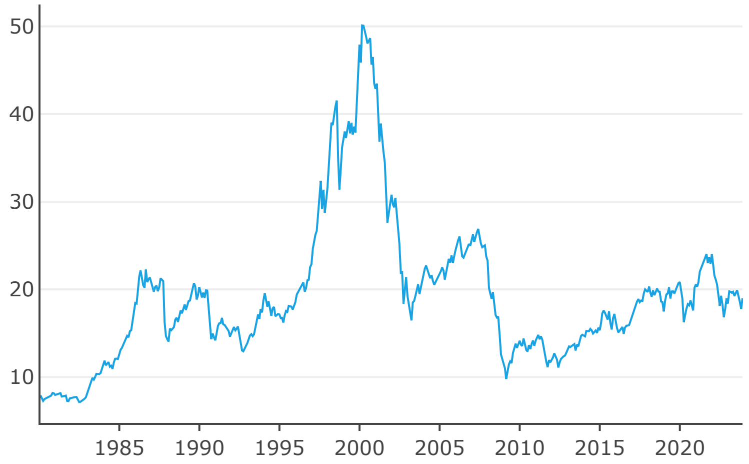
Outside the US (which is 69% of MSCI World), equity markets look either very reasonable value (UK, Europe-ex-UK) or outright cheap (Japan, EM). The de-rating of last year is notable everywhere. The UK Shiller PE of 12.4 gives an earnings yield of 8%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 18.9 gives a 5.3% forward real return. Asia and Japan look similarly good value to us.

Europe

UK | Shiller P/E

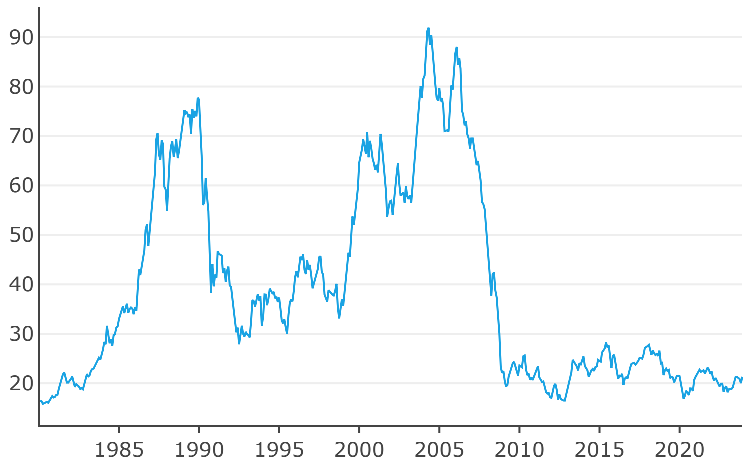


Europe (Ex-UK) | Shiller P/E

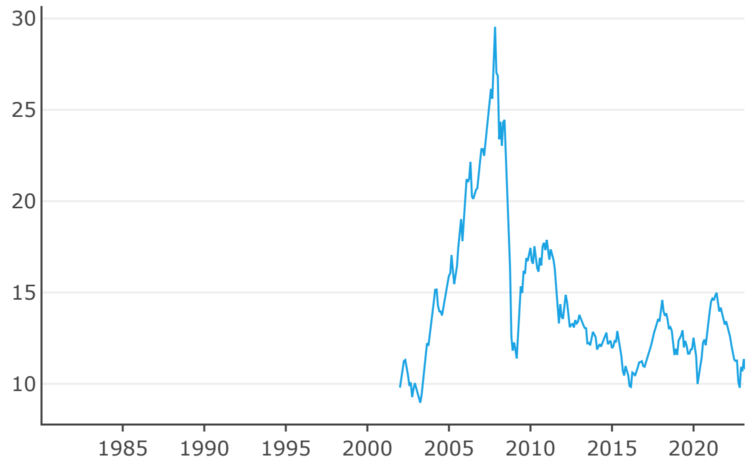


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



Sources | Shiller P/Es: Morgan Stanley as of Nov 2023. Shiller P/E is calculated as today's price divided by the average earnings of the last 10 years.

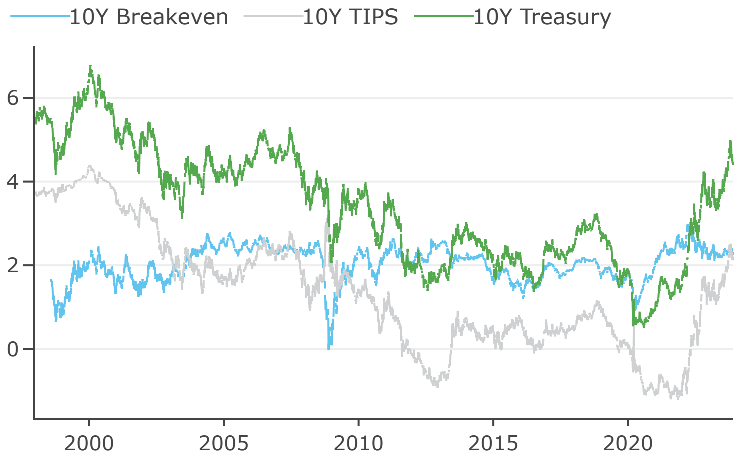
VALUATION

Bonds

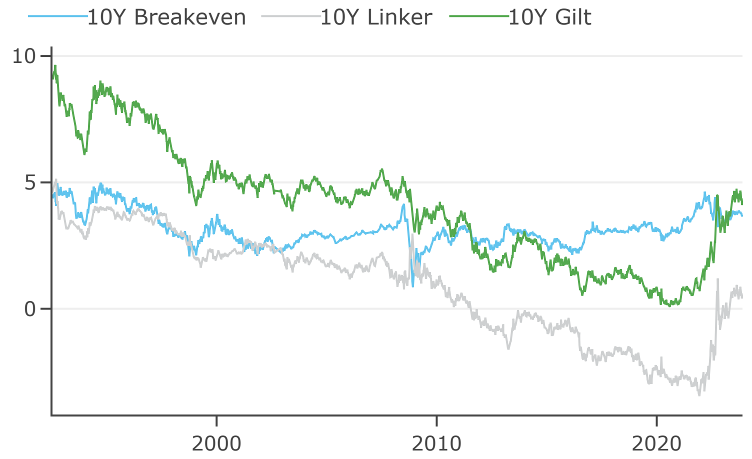
All of the back up in bond yields in the last two years has come from rising real yields. Breakeven inflation is hovering around our view of fair too, with the 10 year US breakeven implying 2.2% 10 year average US CPI. Investors who fear a resurgence of inflation may consider owning index linked bonds now. Separately, HY bonds have re-couped losses made in Sept-Oct and are back at YTD highs. **It may take a recession, though, for duration to be rewarded**, even if spreads would widen.

Global Government & Corporate Yields

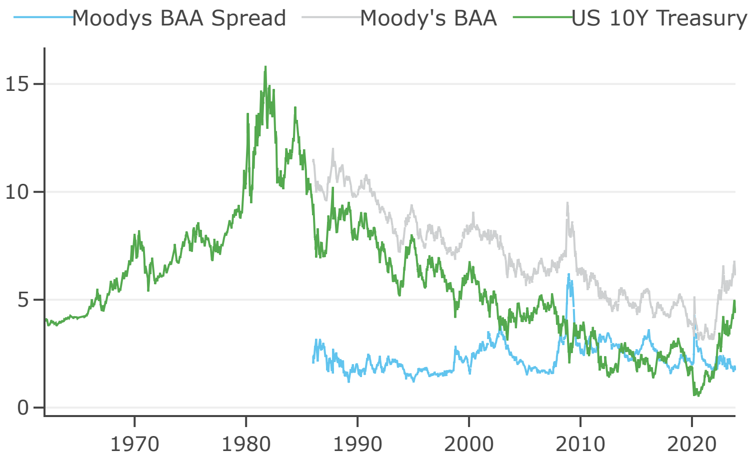
US 10 Year Treasury Yields



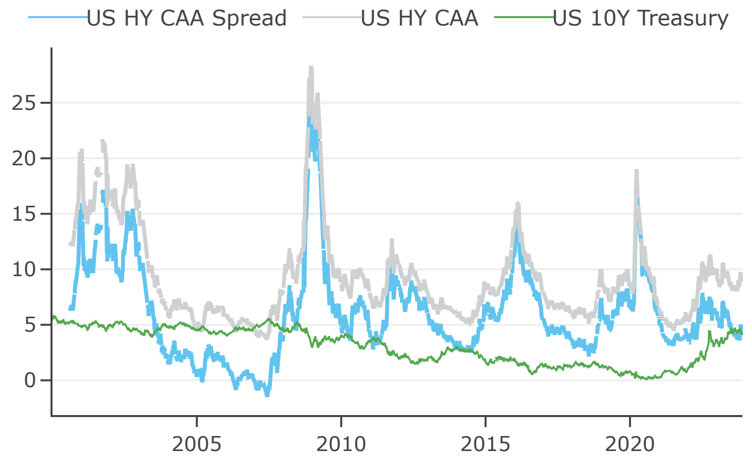
UK 10 Year Gilt Yields



US Corporate Investment Grade Yield



US Corporate High Yield



Sources | Bloomberg as at Nov 2023

VALUATION

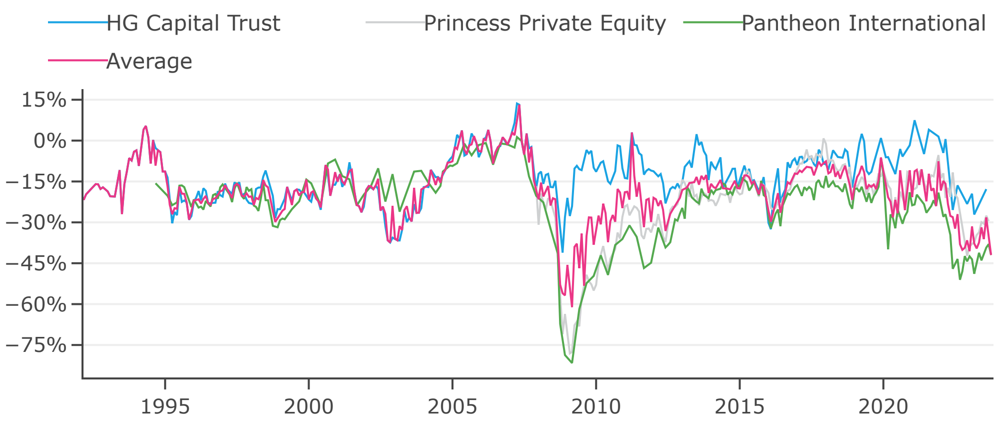
Alternatives

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

Global Valuations

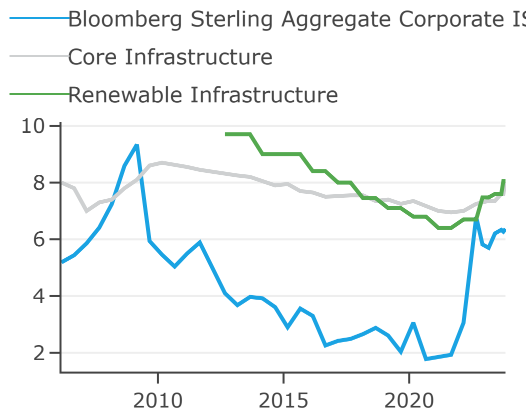
Listed Private Equity

Discount To NAVs



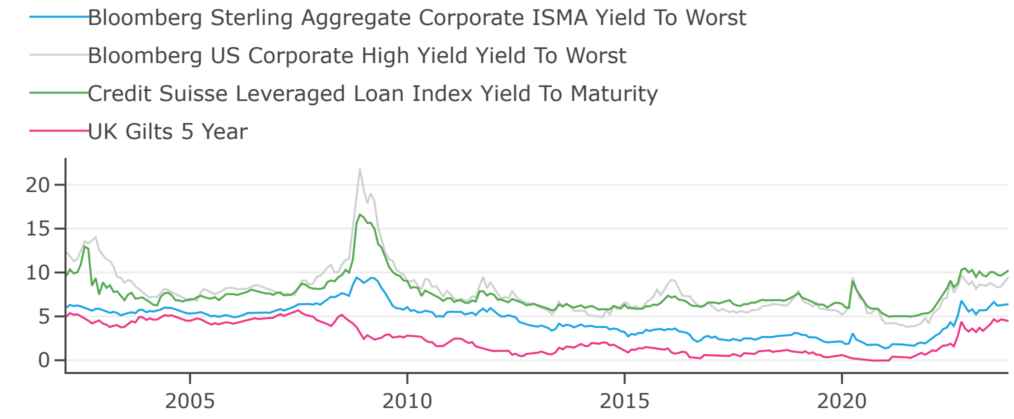
Infrastructure

Infrastructure Discount Rates vs Bond Yields



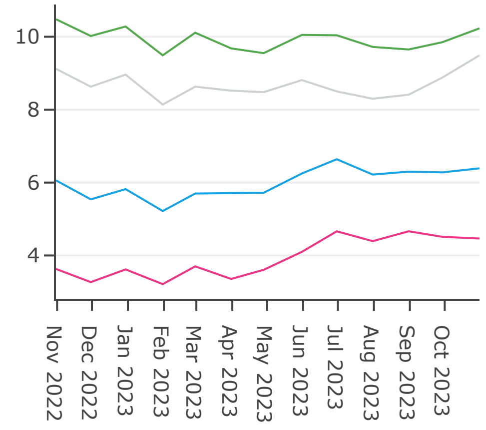
Contractual Income

Income Yields



Last 12 Months

Income Yields



Sources | Infrastructure: CCLA, Bloomberg; Property: MSCI UK Monthly Property Index, Bloomberg; Private Equity: Bain Global Private Equity Report, Bloomberg, Pitchbook; Contractual Income: Bloomberg, Pitchbook. As of Nov 2023

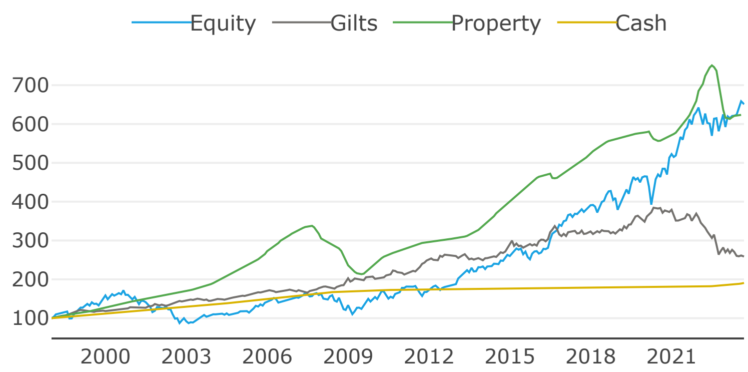
Property

The UK Commercial Property market offers reasonable yields, (6.9% Equivalent Yield on average), within the context of the commonly targeted CPI+4% returns at a portfolio level. NAVs appear to have stopped falling, having declined 21% last year. Our Property team characterises the market as "orderly", but with a "buyer's strike" as investors wait to see the full impact of the 14 hikes in Bank Rate that we have already had.

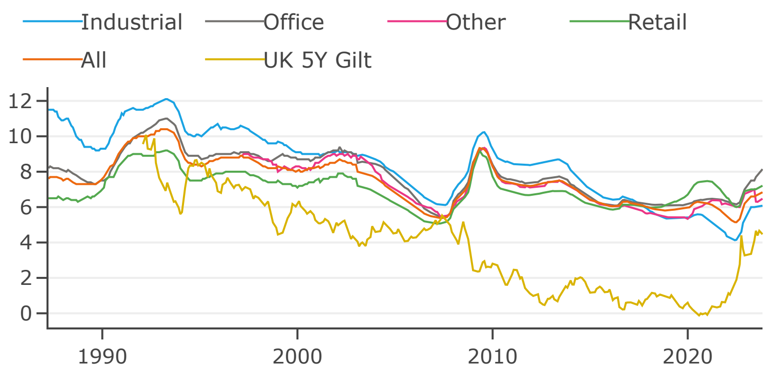
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

UK Commercial Property Market

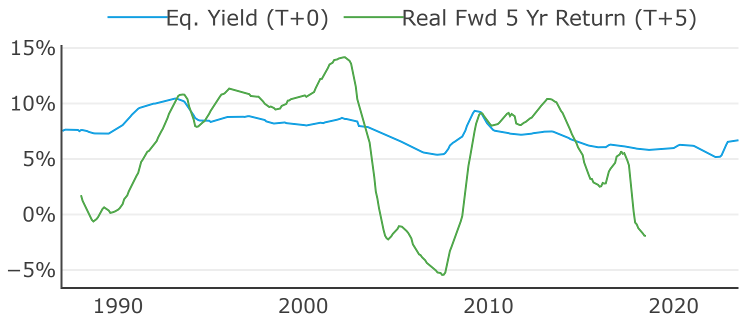
25 Years Of Return 1998=100



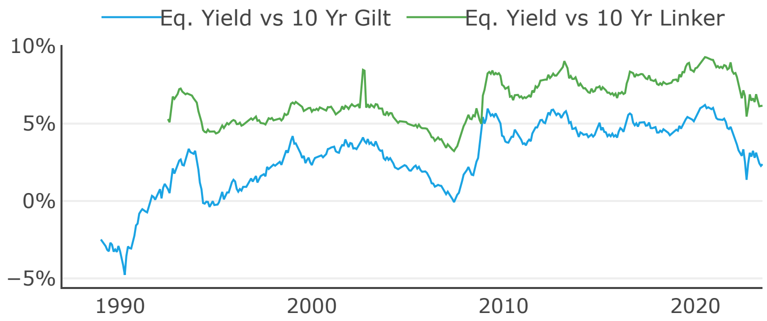
Equivalent Yields vs Gilt Yields %



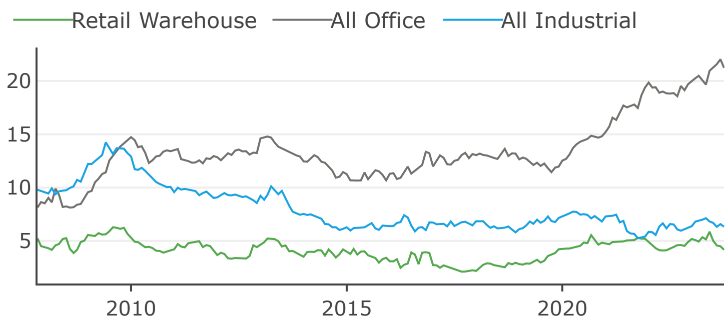
MSCI UK All Property Monthly TR Index %



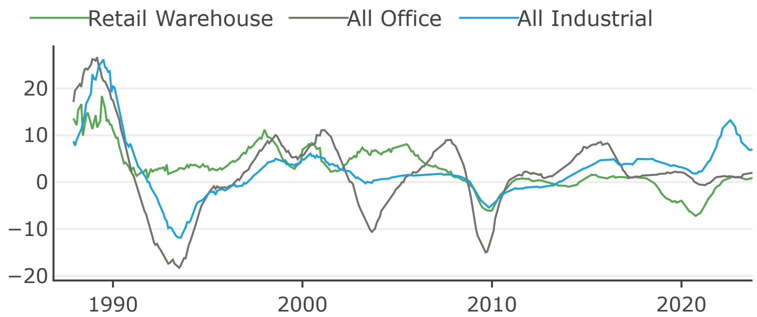
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



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

CCLA

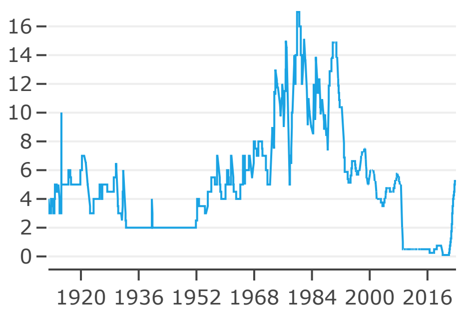
Cash

The BoE held rates at 5.25% for a third consecutive meeting, likely entering the flat-lands of their "table-top" mountain. The markets, however, don't see this lasting too long, having already priced in at least two 25bps rate-cuts in 2024. This may seem premature given the stickiness in wages and core services. Even the BoE's two-year-forward inflation forecast suggests inflation goes below target only by Nov 2025. Having said that, underlying drivers to wages are cooling - albeit very slowly.

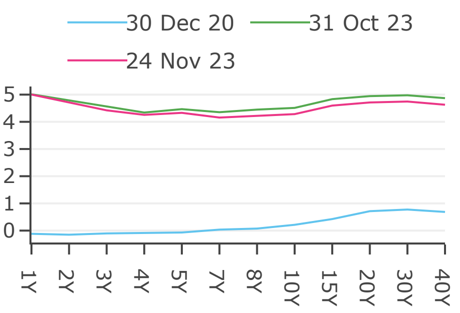
As we envisaged, October's CPI reading came in considerably lower, thanks to the energy base-effects. However, it is too soon to make a call on cuts unless it seems recession is imminent.

UK Sterling Market

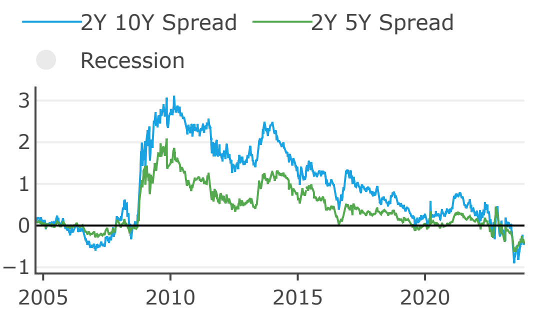
Official Bank Rate



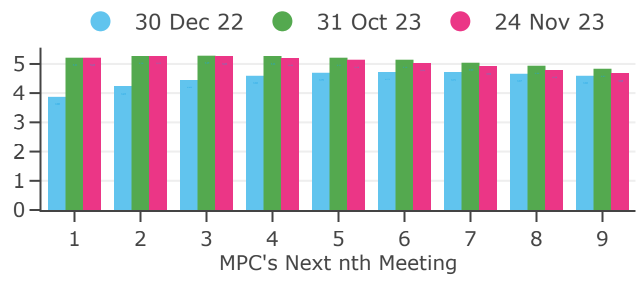
UK Gilt Curve



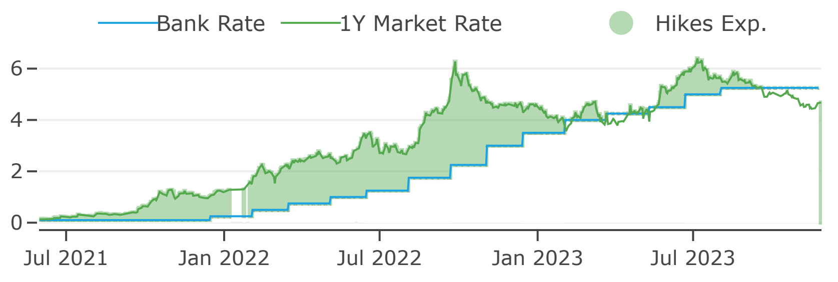
Gilt Spreads



Rate Expectations For Future MPC Meetings



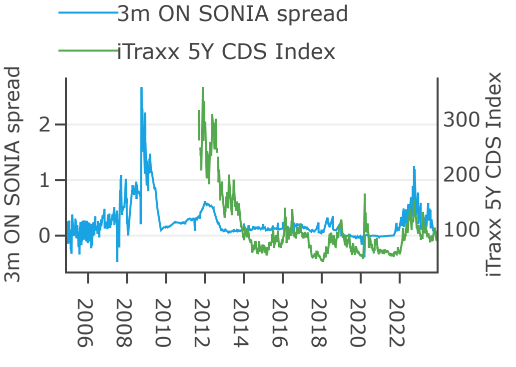
Further Tightening Expected



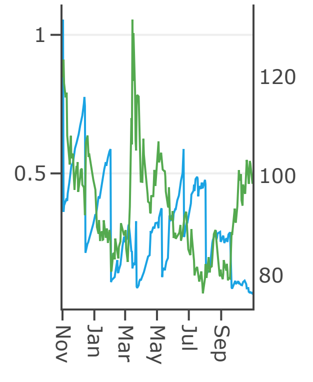
Inflation Readings YoY% | Colour by 10Y Z-Score*

	June	July	August	Sept...	October
RPI	10.70	9.00	9.10	8.90	6.10
CPI	7.90	6.80	6.70	6.70	4.60
CPI Core	6.90	6.90	6.20	6.10	5.70
CPI Services	7.20	7.40	6.80	6.90	6.60
CPI Goods	8.50	6.10	6.30	6.20	2.90

Market Stress



Last 12 Months

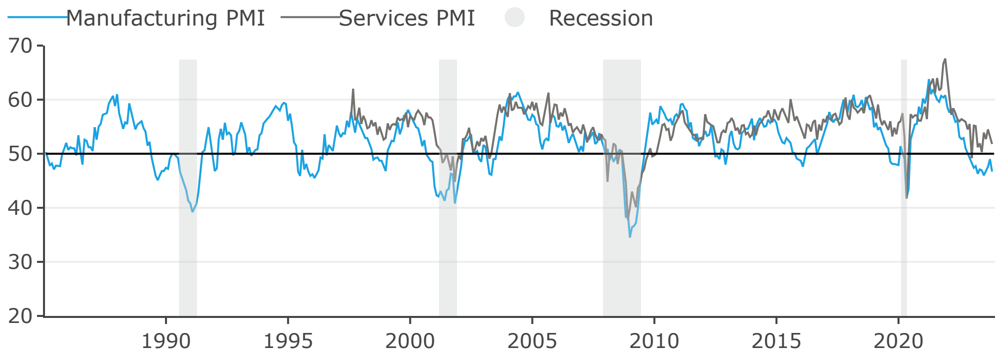


Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, highest and lowest scores as red. Bloomberg for all charts,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

Global PMIs

US GDP registered a scarcely credible 5.2% real growth in Q3, driven mainly by 3.6% growth in real private consumption and with an assist from government investment and inventory build. Most economists expect growth to slow back to the 2% rate that prevailed in the first half of the year - but **they do not expect a recession.** The purchasing managers' surveys in the US continue to validate that expectation, holding above the recession threshold, even if the Manufacturing PMI for October unexpectedly relapsed (blue line, top right chart). **Eurozone activity, however, does look very weak**, with Services drifting lower towards the already recessionary Manufacturing. **The UK is just about holding on!**

United States



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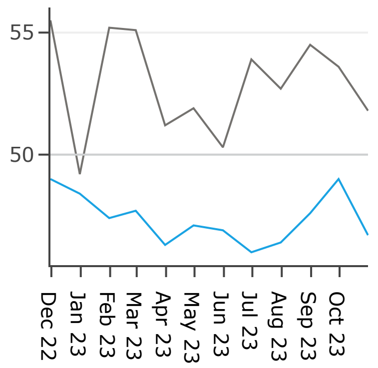
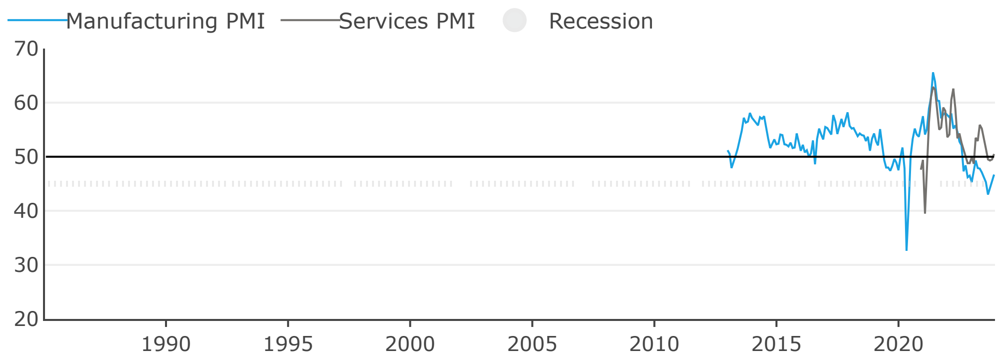


United Kingdom



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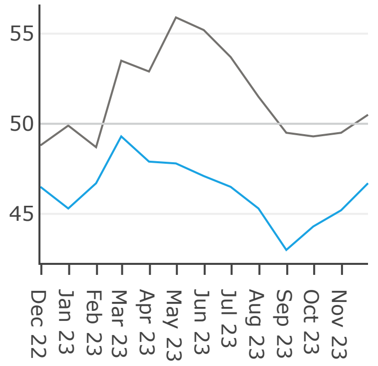
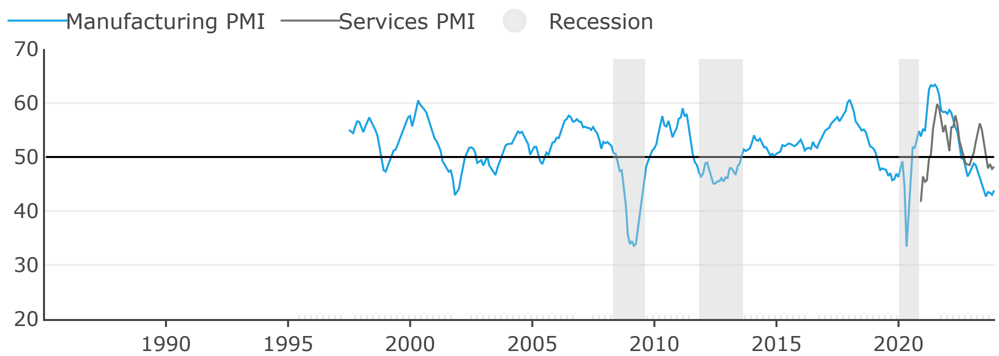


Eurozone



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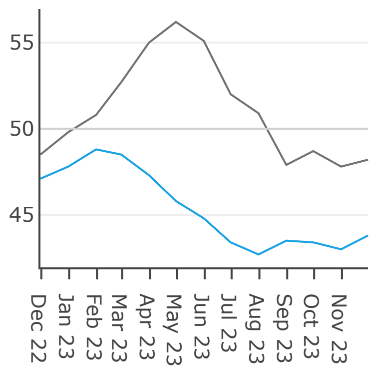


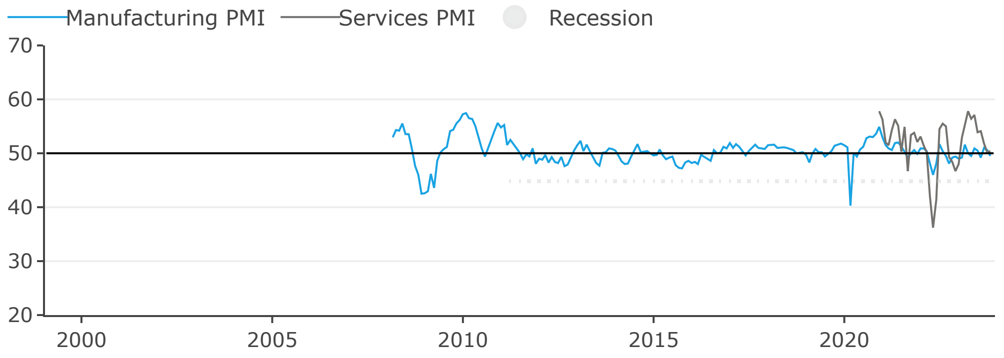
Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Nov 2023. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

Global PMIs

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

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

China



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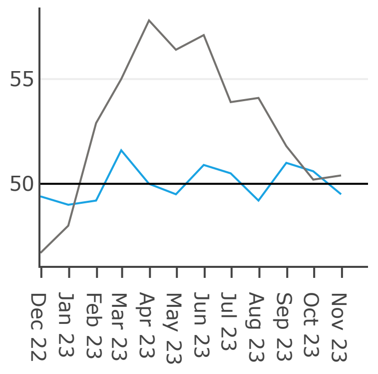
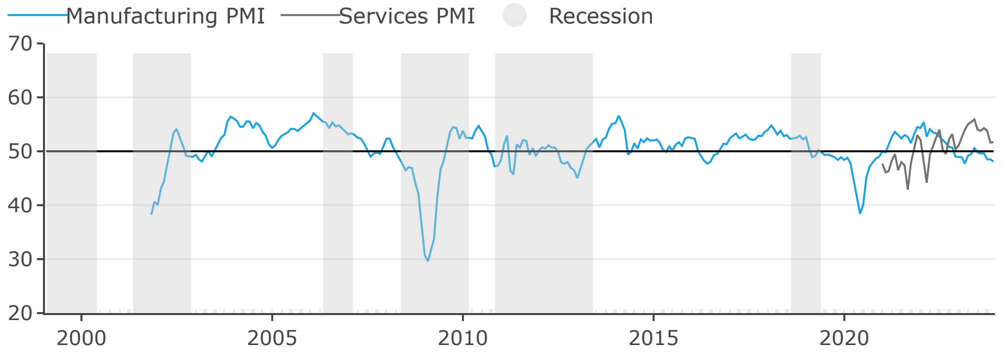
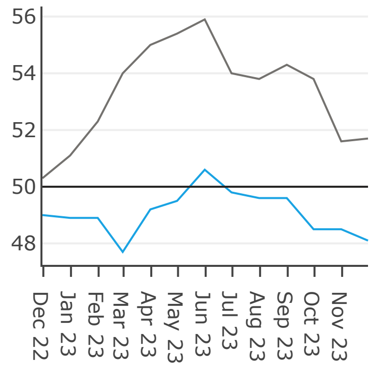


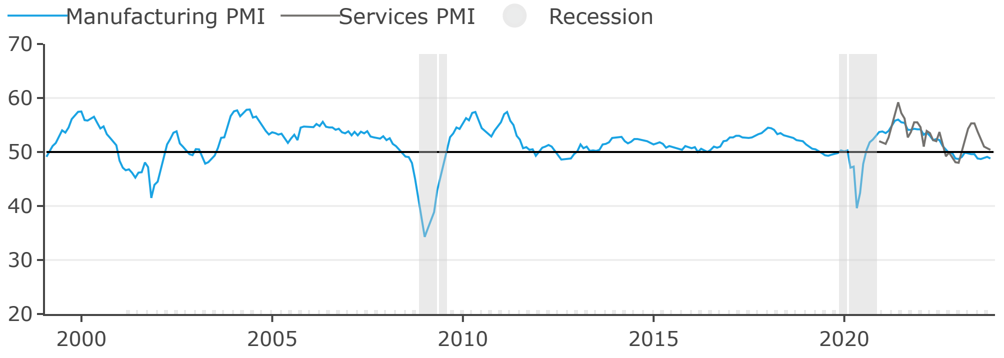
Japan



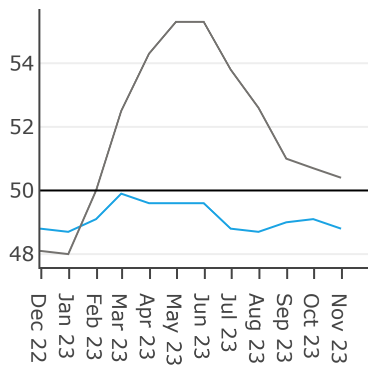
Last 12 Months



Global



Last 12 Months



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

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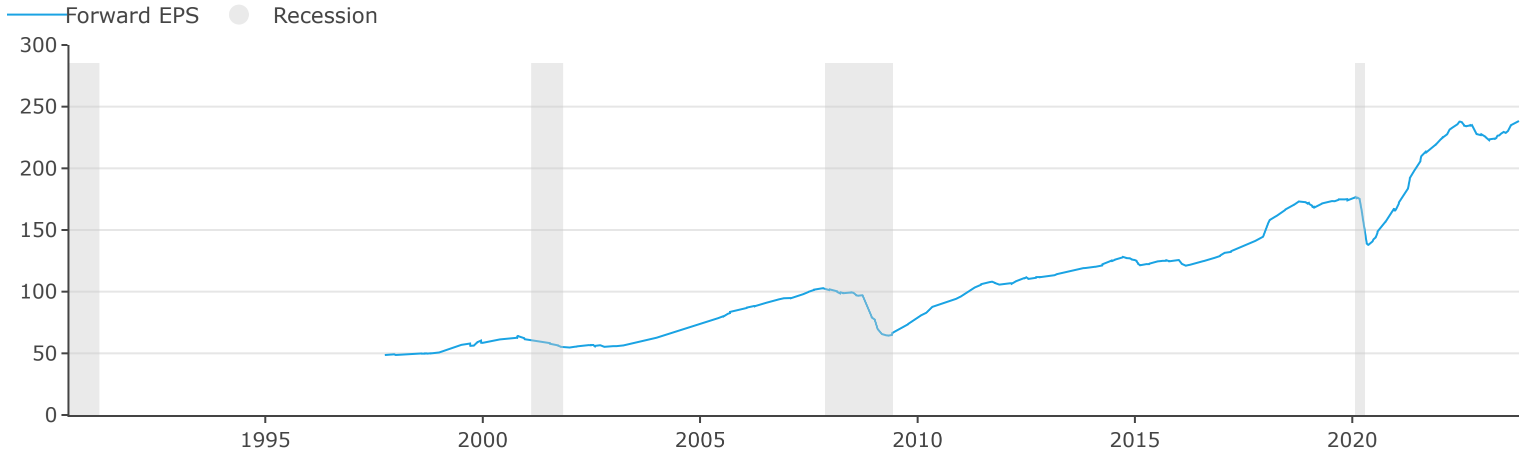
Earnings

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

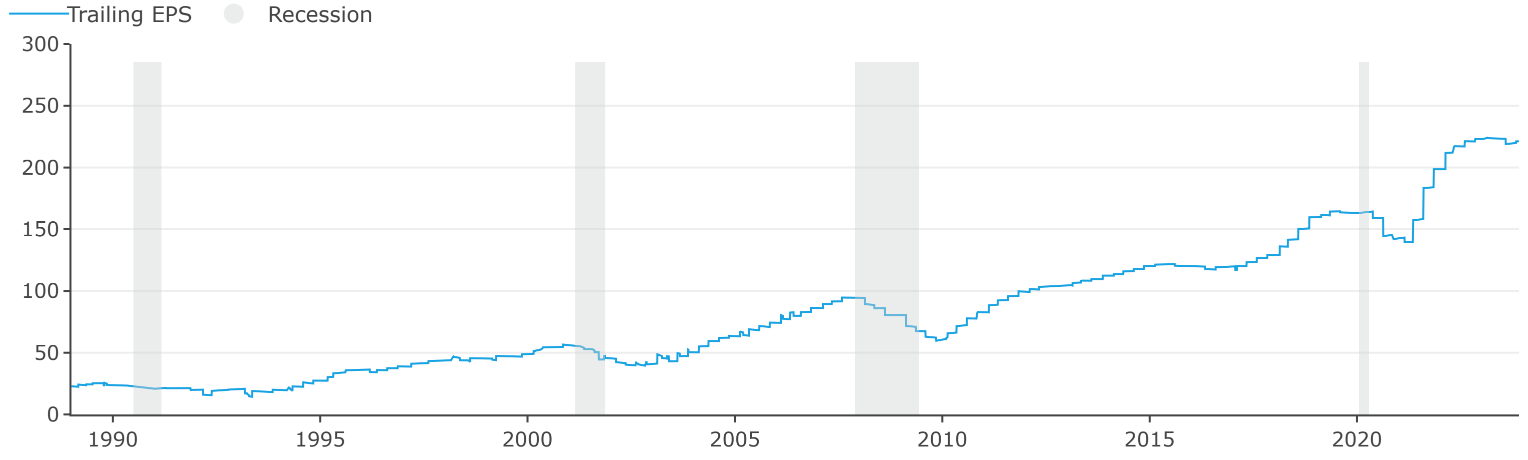
It's also worth noting that **Q3 earnings season has shown EPS flat, to slightly growing again, on a year over year basis**, having contracted in the prior four quarters.

S&P 500

Bloomberg Est. EPS



12M Trailing EPS



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

GROWTH

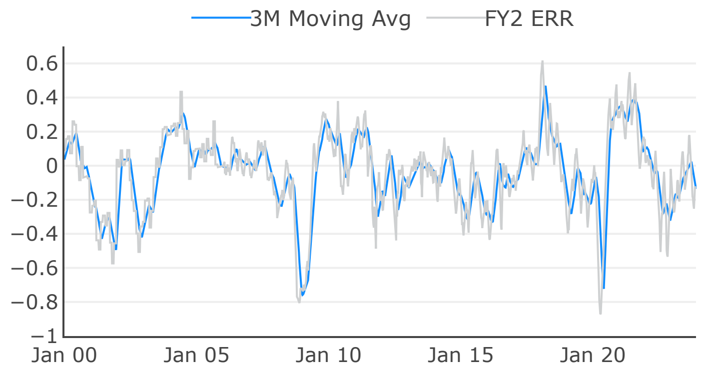
Earnings

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.

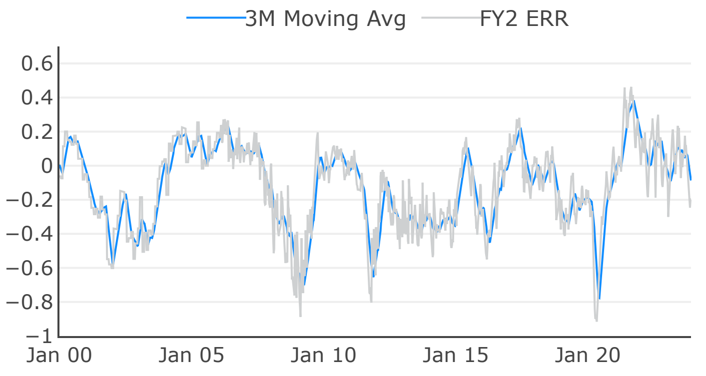
The overall assessment is that earnings breadth had recovered in the US, but dropped to -14% in the latest reading. Japan on the other hand, continues to see recovery. Worth noting, analysts are usually too optimistic at the start of the year, so modest downgrades do not prevent equity markets going up.

Global Earnings Revisions Ratios

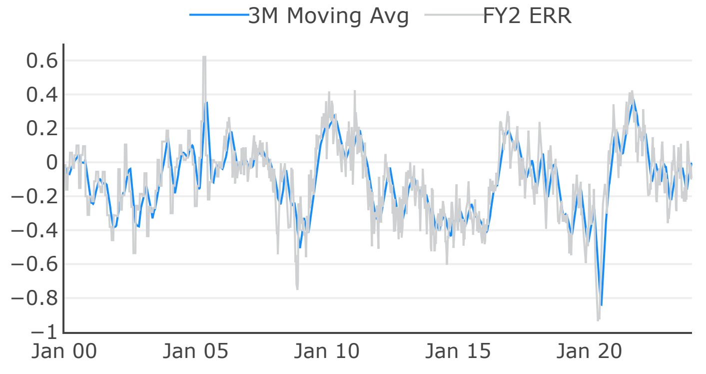
USA



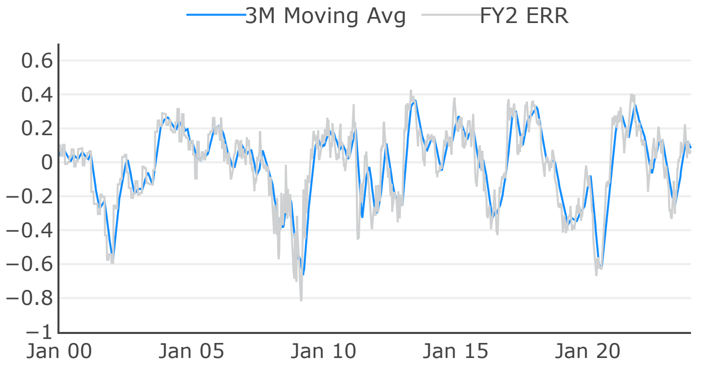
Eurozone



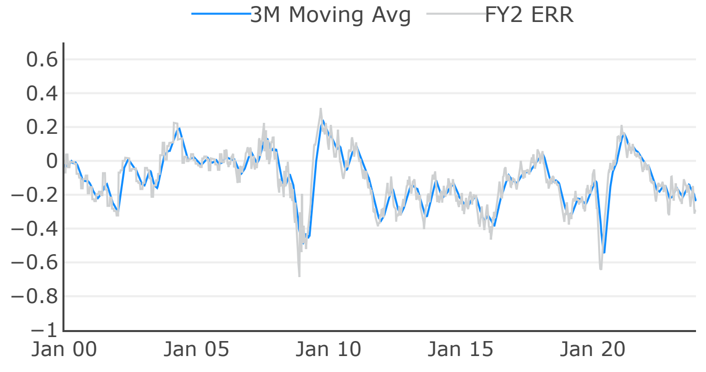
UK



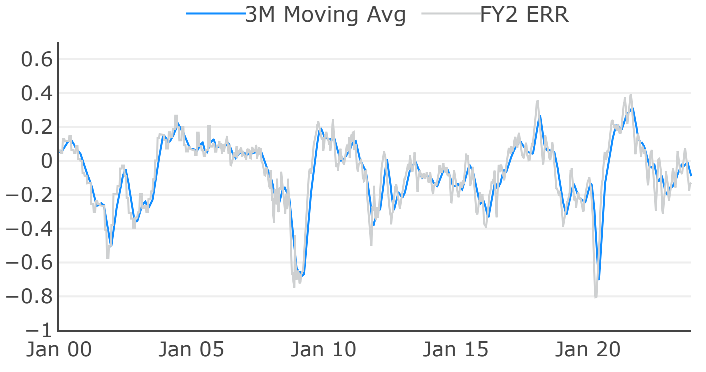
Japan



Emerging Markets



World



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

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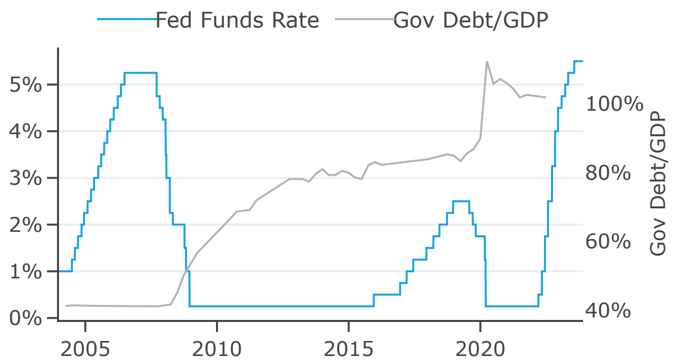
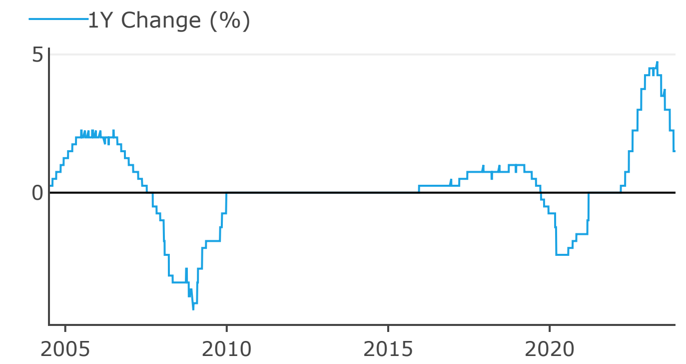
Interest Rates

The fastest interest rate hiking cycle since the Volcker era is probably close to, or at, an end. (Paul Volcker was Chairman of the Board of Governors of the Federal Reserve from 1979-1987, and is famous for taming inflation by aggressive interest rate hikes). At least that is the message from the bottom left chart which compares current interest rate with the expected path over the next two years. It was also the message of Fed Chairman Jay Powell at the November FOMC when he pointed out that supply and demand factors were "coming into balance". 2Y yields are 4.95% as of 24 Nov, compared to Fed Funds rate at 5.5%.

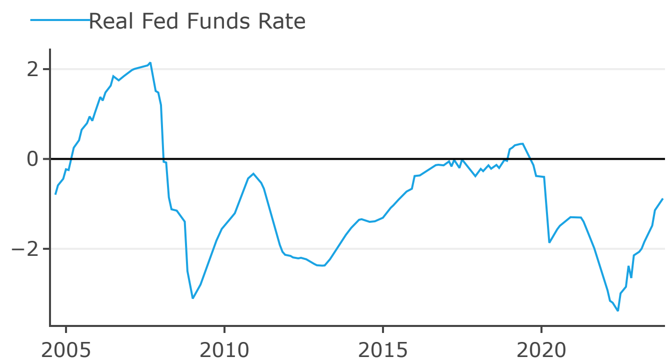
Fed Funds Rate



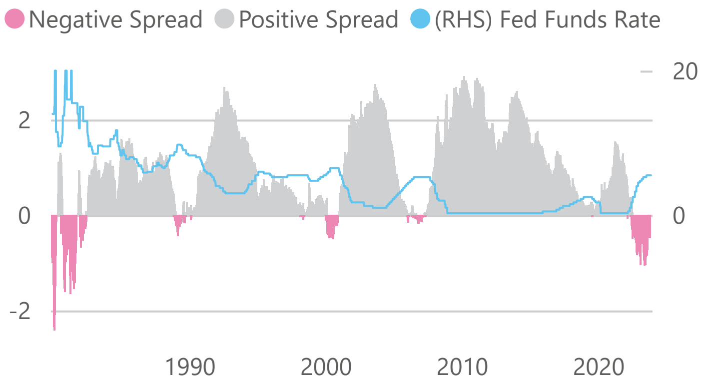
Change in Fed Funds Rate



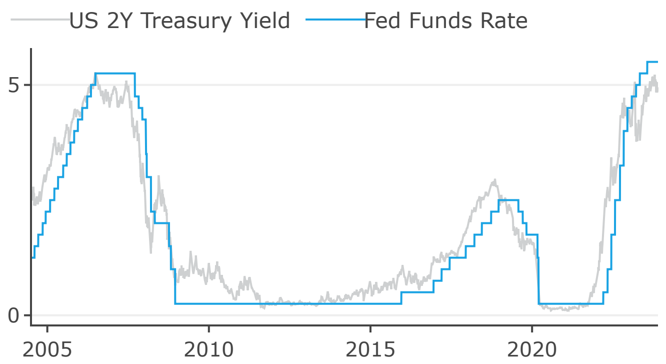
Real Fed Funds Rate (Using 2Y MA CPI)



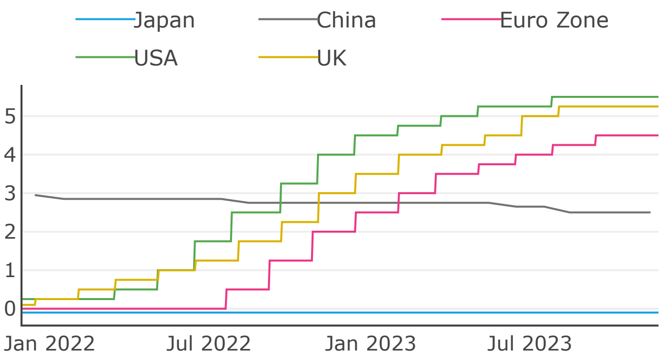
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



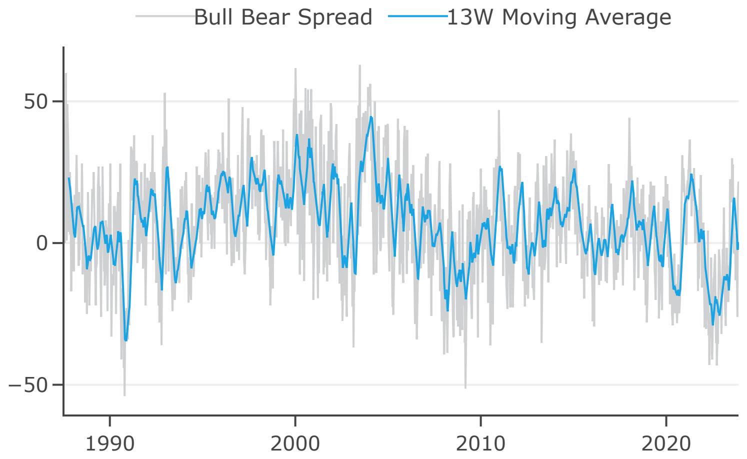
Sources | Bloomberg for all charts, as of Nov 2023

Sentiment

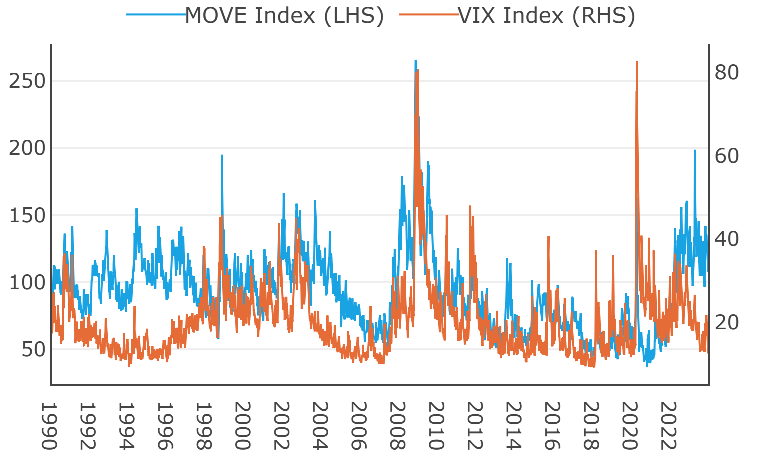
This page is a weather vane for market sentiment. **Investor sentiment is not stretched**. The American Association of Individual Investors, (Bulls minus Bears), is good to watch as it's so volatile, therefore captures the mood swings of Mr Market. The three month (13-week) moving average is relatively flat, with a reading of 0. Put-call is around average and VIX at a sanguine 12.4 (v.s. a long term average of 19.6). **The top right chart show a very interesting divergence between bond risk as measured by the MOVE index - which is high - vs low equity implied risk as measured by the VIX**. This suggests to us that there's further upside in bonds as implied volatility settles down, if it settles down, which it should if inflation continues to abate. BAML's Bull & Bear Indicator has nudged higher but from low levels - it's still bullish.

US Equity Indicators

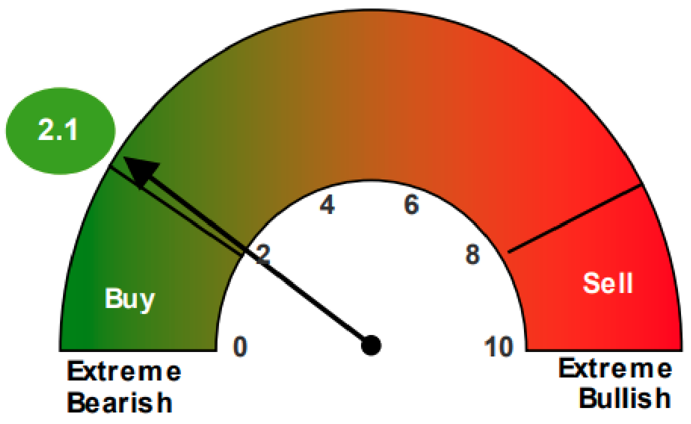
Bull Bear Spread



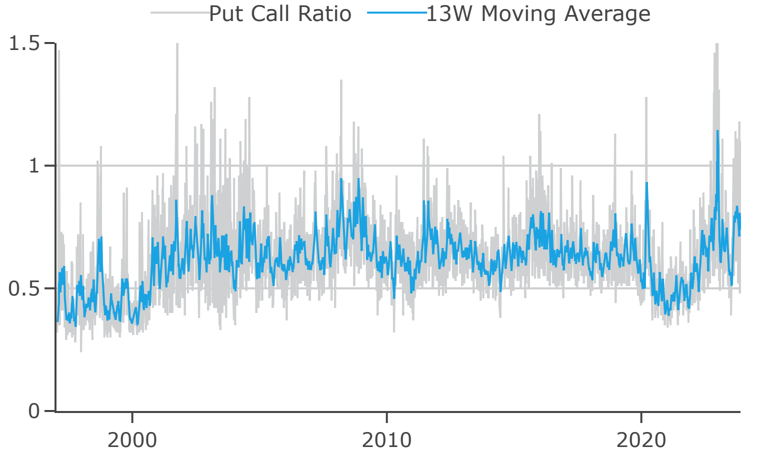
Equity vs. Bond Sentiment



Hartnett Bull & Bear Indicator



Equity Put Call Ratio



Sources | Bull Bear Spread, Vix and Equity Put Call Ratio: Bloomberg, Hartnett: kind permission from Bank of America, as of Nov 2023

Fund Flows

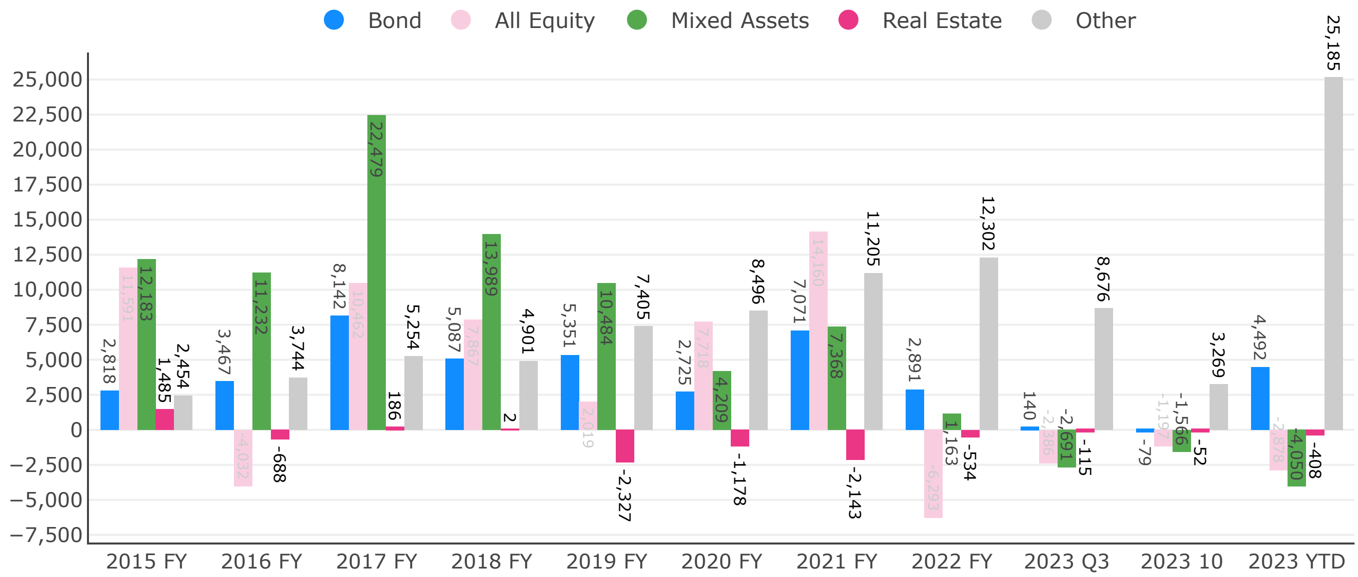
This page captures UK investment fund flows, as a measure of how optimistic or pessimistic sentiment has become.

There has been an extraordinary inflow into cash (shown here as "Other") and out of Equity and Mixed Asset funds. Bond flows are modest but do show inflow. In short, flows have shown investors repositioning defensively. This is bullish at the margin for forward returns to risk assets, as a contra-indicator.

UK Investor Sentiment

Net Fund Flows by Asset Class £m

Date	Bond	All Equity	Mixed Assets	Real Estate	Other	Total Net Flows
2022 Q2	534	-672	1,247	61	1,238	2,408
2022 Q3	1,197	-4,701	-287	-85	2,545	-1,331
2023 10	-79	-1,197	-1,566	-52	3,269	376
2022 Q4	1,666	341	-945	-226	3,361	4,198
2022 Q1	-506	-1,261	1,148	-284	5,158	4,256
2023 Q1	2,747	258	397	-93	5,966	9,275
2023 Q2	1,684	447	-190	-148	7,274	9,066
2023 Q3	140	-2,386	-2,691	-115	8,676	3,624



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

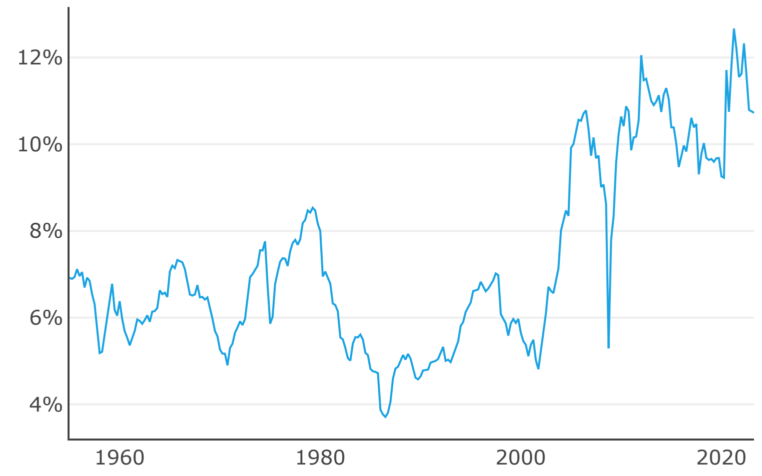
OTHER OBSERVATIONS

The Big Picture

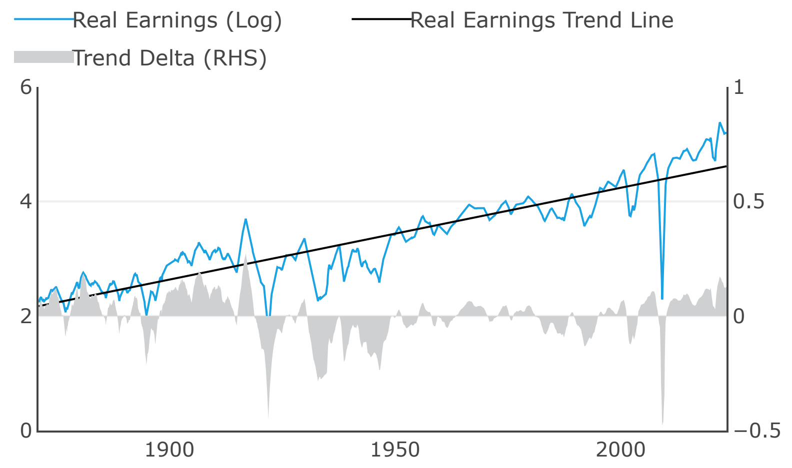
Here we highlight some longer term imbalances that, **should** they correct, would have have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. It's corollary (not shown)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

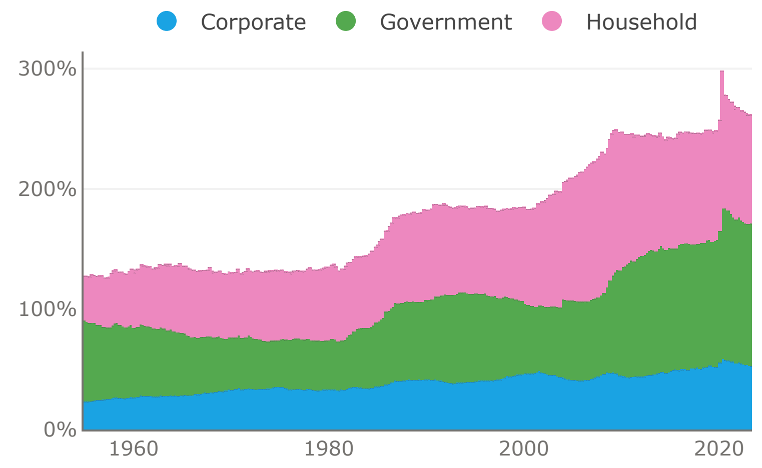
Profit Share of GDP



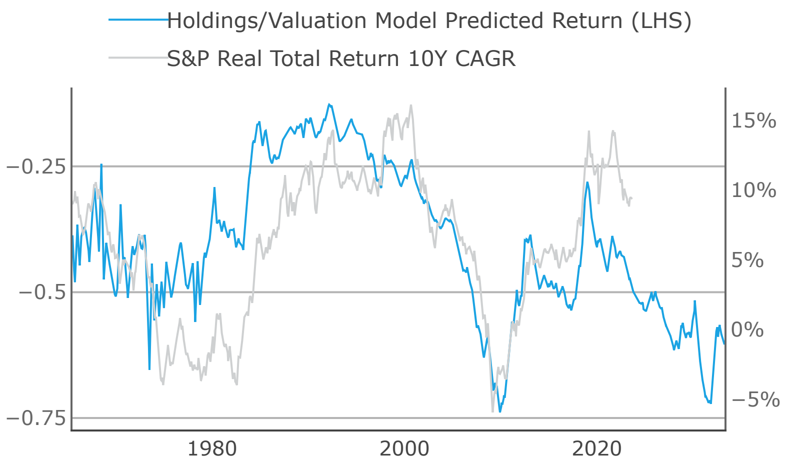
Earnings Deviation From Trend



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 as at Nov 2023.

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