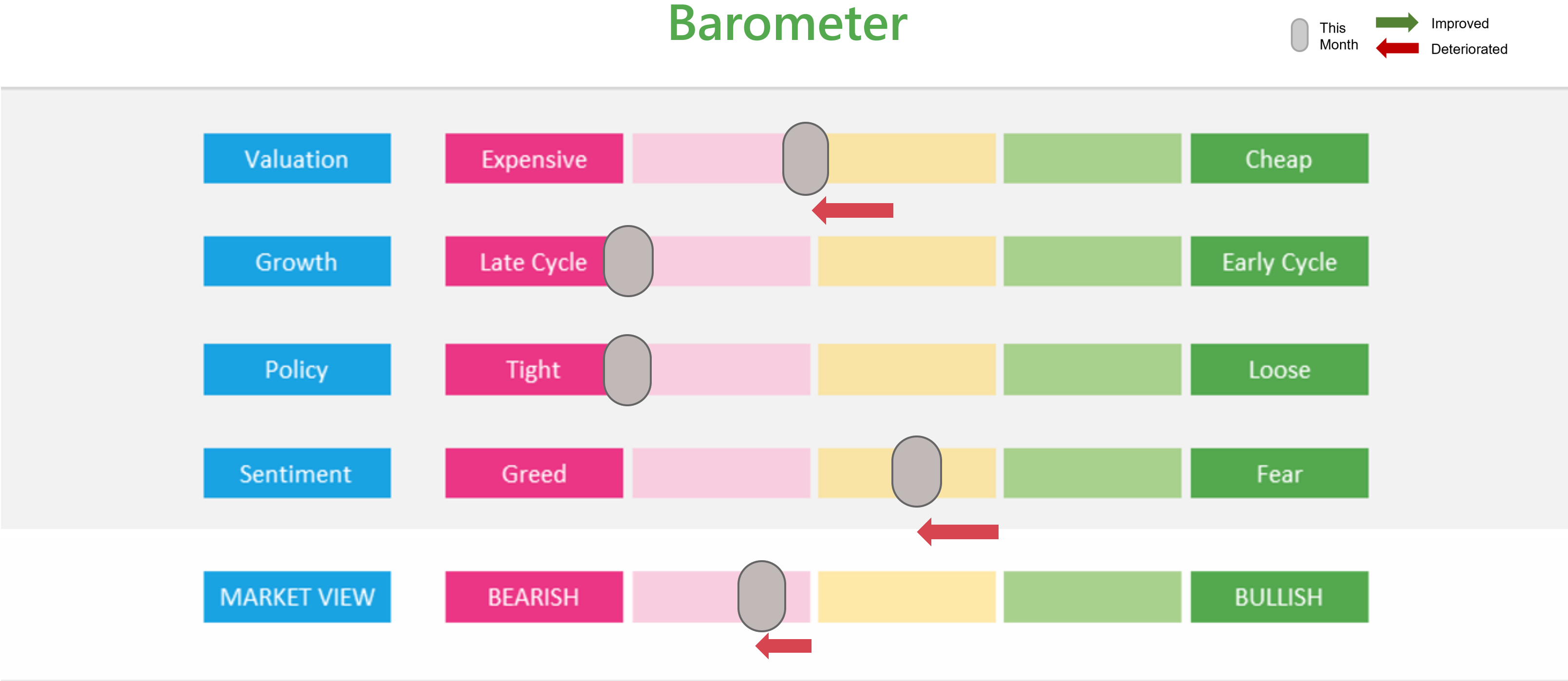
Market Barometer

JANUARY 2024

Barometer



Powell confirms the tightening is over

The December FOMC meeting to all intents and purposes declared an end to the massive policy tightening of '22-23. Fed Chair Jay Powell said that "we have moved very fast" to contain inflation and highlighted that the Board was satisfied that inflation has so far fallen without unemployment rising, possibly because of a supply shock in the labour market, with strong gains in labour force participation and strong net immigration.

Bond yields typically fall by 100bps in the 12 months following the last hike in a tightening cycle. The last hike was on 26 July 2023 and bond yields are at the same level now as they were then. This could presage further bond market strength following the rally of the last two months.

In line with this relief from the tightening cycle, market sentiment has continued to recover as markets have rallied, which dampens our expectations for future gains. Real forward returns from US equity in particular is now down to around 3% (off a starting Shiller PE of 30, thus an earnings yield of just over 3%). While other equity markets still offer reasonable value, in our eyes, forward returns are inevitably lower than they were.

Bond markets can rally further in the case of recession, but in a soft landing we would expect them to earn their coupon but not much more. 10 year index linked gilts yield 0.05% at time of writing, so there's thin gruel if we avoid recession.

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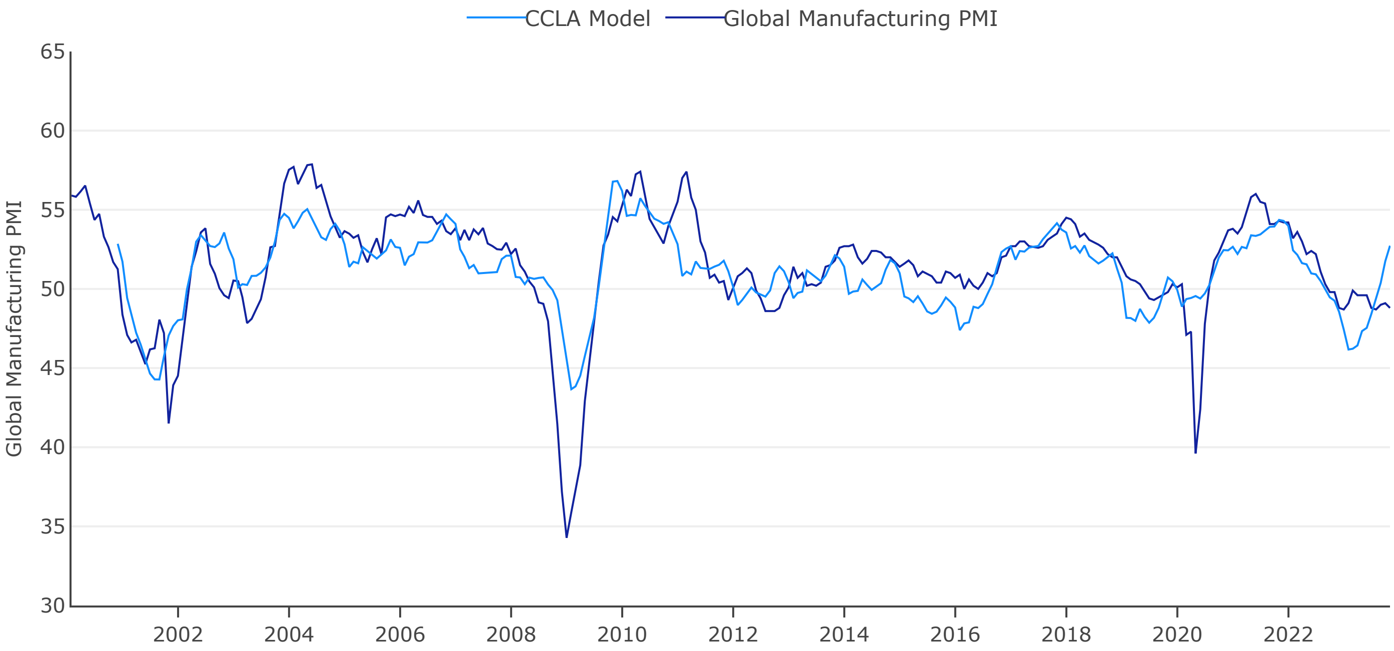
Charts of the Month

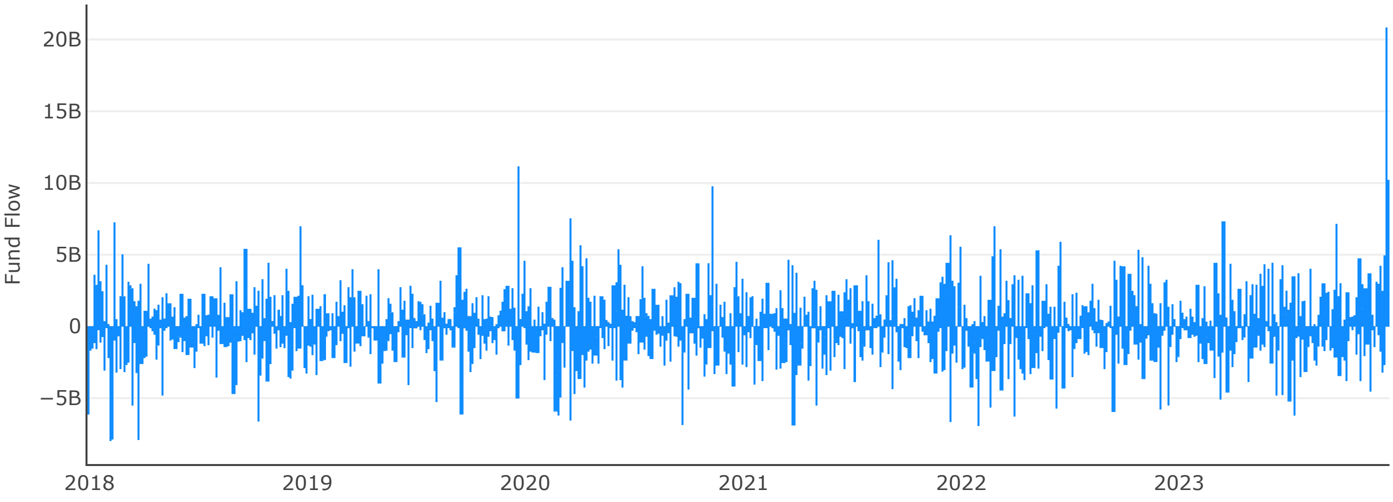
Could the global manufacturing cycle be bottoming out? Typically, manufacturing cycles are said to be 18 months up and 18 months down. This downturn has so far lasted 30 months, having peaked in May 2021, so it is overdue a recovery. We have rebuilt here a model first published by Deutsche Bank using Asian and Chilean (copper) export data as a lead on the global manufacturing PMI. You could have a situation where the US consumer finally fades just as a new manufacturing cycle begins. If the US consumer fades, all bets for the global economy are off - recession would follow.

The fund flows into the S&P 500 ETF have been immense in recent weeks. Are retail flows turning back to equity?

Global Manufacturing vs Key Exporting Countries



SPY US ETF Fund Flows $



Sources | Bloomberg. CCLA Model uses 3m/3m growth rates for exports made by Taiwan, Korea's semi-conductors, and Chile; followed by a 12-month smoothing
All data as at Dec 2023

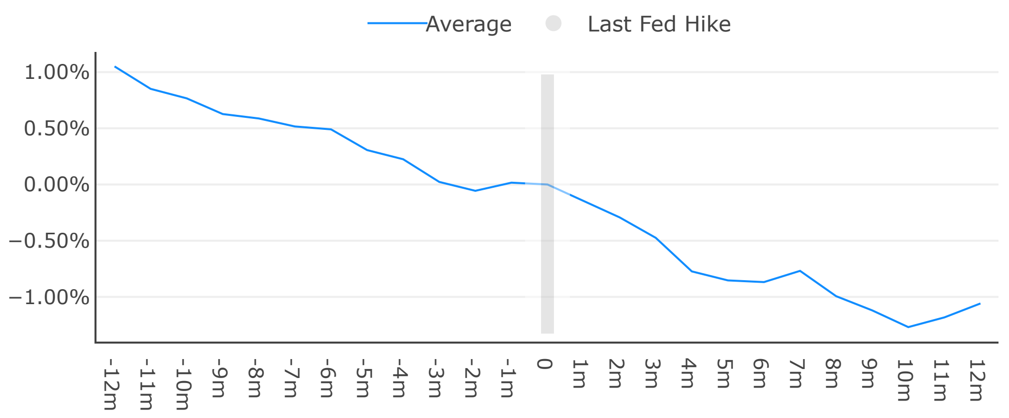
Charts of the Month

What usually happens to bond yields around the last interest rate hike in a cycle? The table shows the change in US 10 year bond yield 1 to 12 months after the last hike in the last eight tightening cycles. Very clearly, the end of hiking cycle is very good news for government bonds. **On average the bond yield falls ~100bps over the year following** the last hike. This time around, the last hike may have happened on 26 July 2023. Since then bond yields rose then fell, and at the time of writing (just before Christmas 2023) are almost exactly where they were back in July. So if the precedent of the last eight cycles holds this time too, **we could expect another 100bps lower bond yields from here.**

10Y US Treasury Yield Move Around Last Fed Hike

Period	Aug 1984	Sep 1987	Feb 1989	Feb 1995	Mar 1997	May 2000	Jun 2006
				Final Rate Hike			
1m	-0.3%	-0.4%	0.3%	-0.3%	0.2%	-0.4%	-0.3%
2m	-0.7%	-0.6%	0.3%	-0.5%	-0.0%	-0.3%	-0.5%
3m	-1.0%	-0.5%	0.1%	-0.6%	-0.3%	-0.7%	-0.7%
4m	-1.2%	-0.8%	-0.7%	-1.5%	-0.6%	-0.7%	-0.5%
5m	-1.2%	-1.1%	-0.9%	-1.5%	-0.4%	-0.7%	-0.7%
6m	-1.2%	-0.9%	-1.0%	-1.2%	-0.7%	-0.7%	-0.6%
7m	-0.7%	-0.5%	-0.8%	-1.3%	-0.6%	-1.1%	-0.4%
8m	-1.4%	-0.2%	-0.8%	-1.5%	-0.9%	-1.3%	-0.6%
9m	-2.0%	-0.4%	-1.0%	-1.6%	-1.0%	-1.4%	-0.6%
10m	-2.6%	-0.2%	-1.1%	-1.8%	-1.2%	-1.5%	-0.6%
11m	-2.5%	0.0%	-1.0%	-2.0%	-1.3%	-1.3%	-0.4%
12m	-2.5%	-0.4%	-0.4%	-2.1%	-1.1%	-1.0%	-0.1%

Average and Median 10Y Yield Change



Sources | Bloomberg. All data as at Dec 2023

VALUATION

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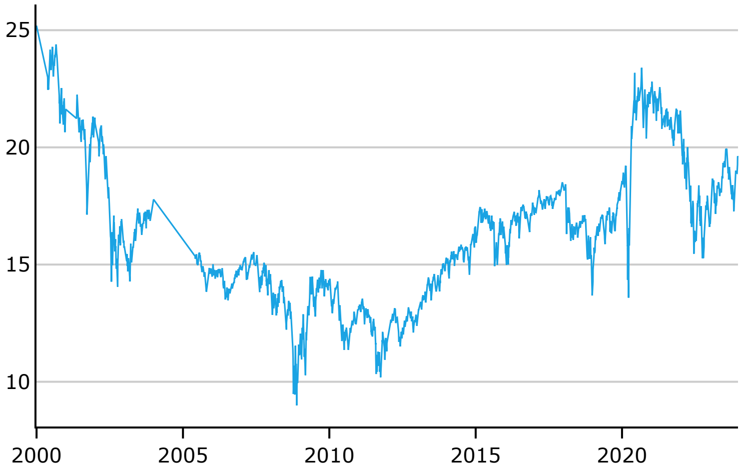
Equity | USA

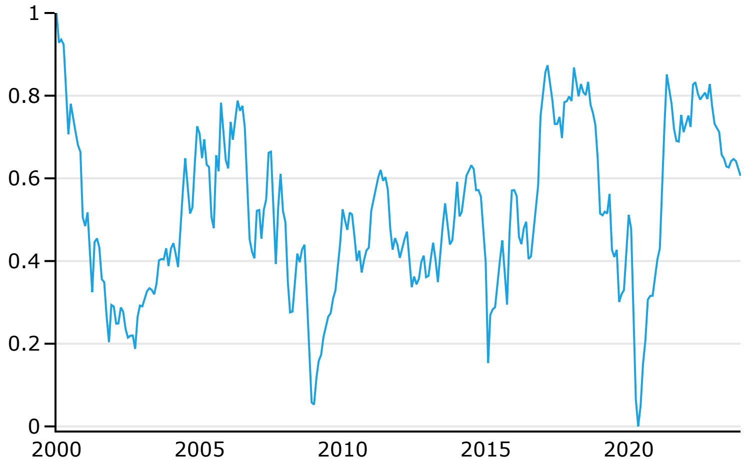
The US equity market has re-rated sharply in the last two months, from 17x to 20x consensus forward earnings (top left chart). This leaves the spot valuation nearly 20% above its 16.2x average of the last thirty years. It's interesting to note that there is a large valuation dispersion between the so-called Magnificent Seven (Apple, Microsoft, Amazon, NVIDIA, Alphabet, Tesla and Meta) and the rest of the US stock market. Those seven stocks are now 27% of the MSCI USA and trade on a forward PE of 27.8x. The equal-weighted S&P 500 trades on a PE of 16.5x. 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 1.2%. Both methods point to meagre excess returns over bonds.

S&P 500 Valuations

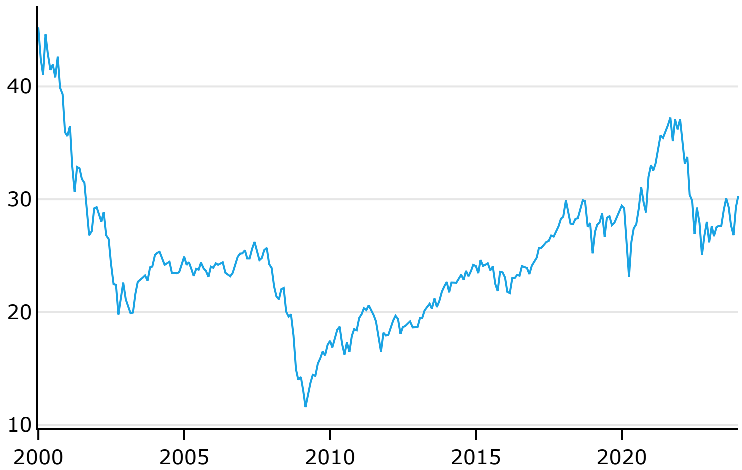
S&P 500 Forward PE



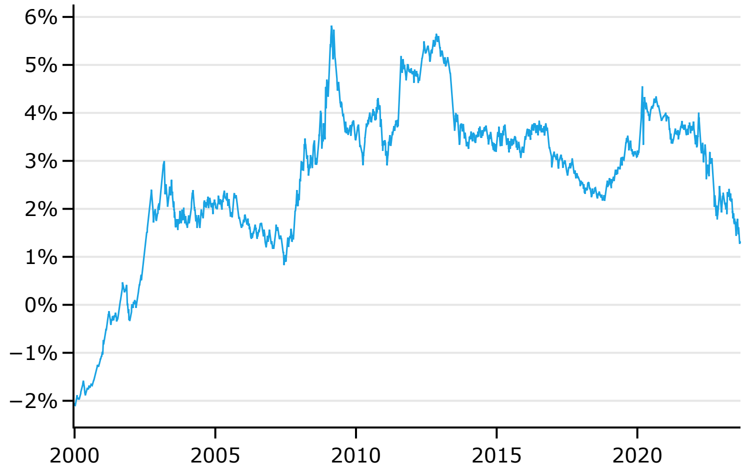
Composite Value Indicator Model



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.

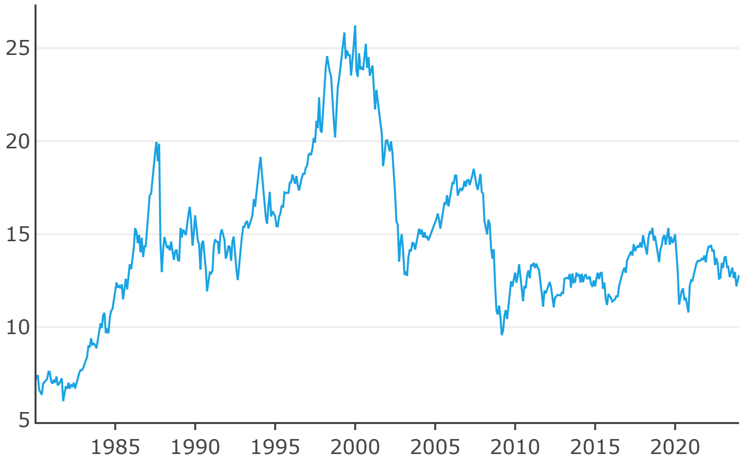
Sources | S&P 500 PE: Bloomberg, CVI Model: CCLA, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of Dec 2023

Equity | Regional

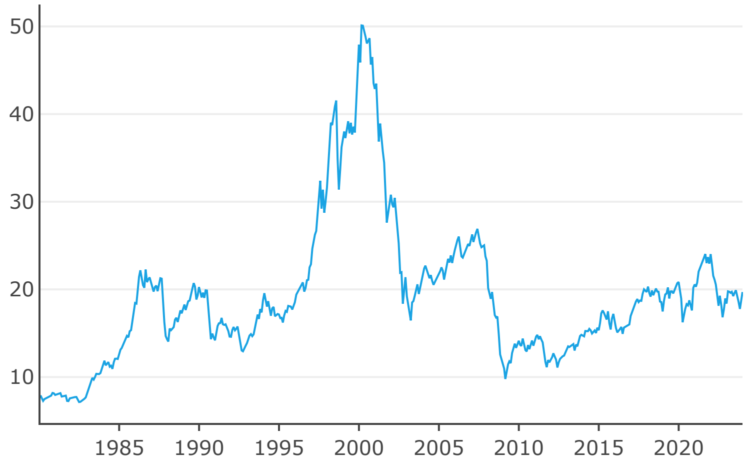
Outside the US (which is 69% of MSCI World), equity markets continue to look reasonable value (UK, Europe-ex-UK) or outright cheap (Japan, EM). The de-rating of last year is notable everywhere. The UK Shiller PE of 12.8 gives an earnings yield of just under 8%, which is a good approximation of expected forward real returns. On the same basis, Europe ex-UK PE of 19.7 gives a 5% forward real return. Asia and Japan look similarly good value to us.

Europe

UK | Shiller P/E

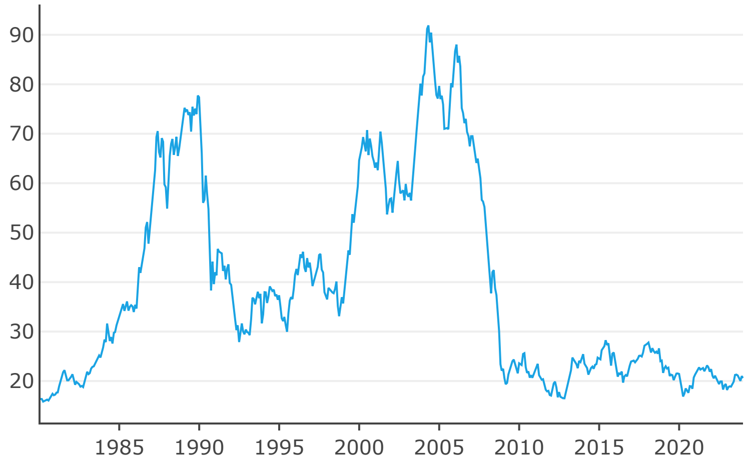


Europe (Ex-UK) | Shiller P/E

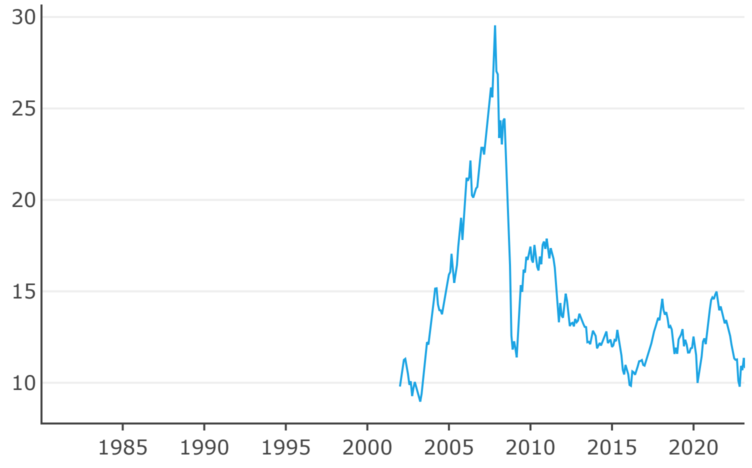


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



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

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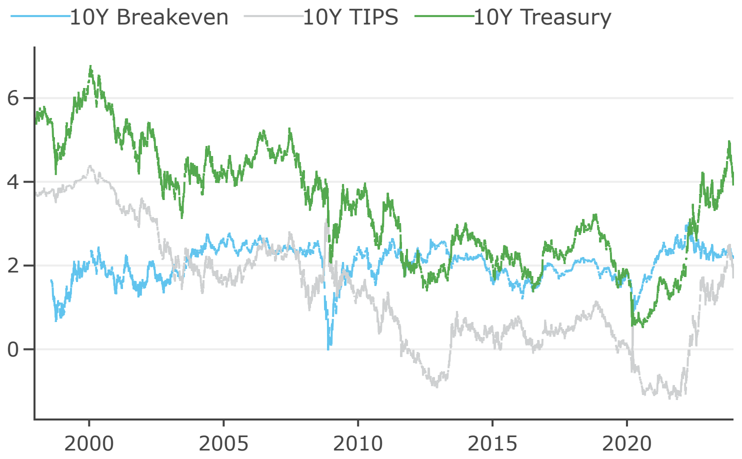
Bonds

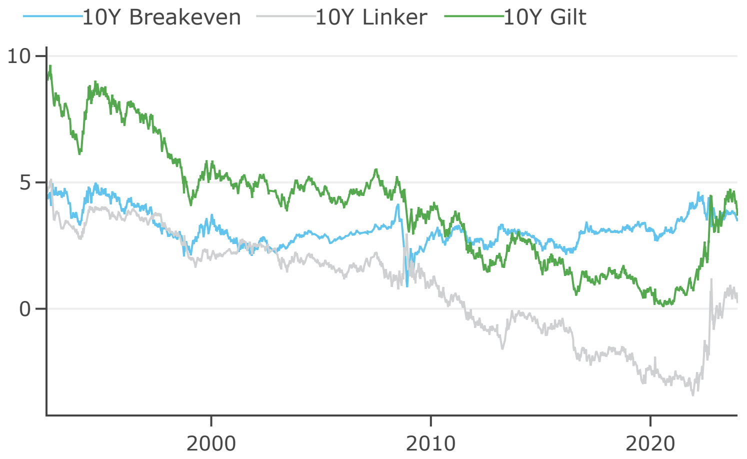
Bond markets have rallied across the board during the "everything rally" of November and December. Since the mid-October lows in Gilts, the Gilts index is up 10%, IG is up 8% and HY up 4%. Within the government bond market, the rally has been led by a falling real bond yield, but breakeven inflation has also fallen.

Global Government & Corporate Yields

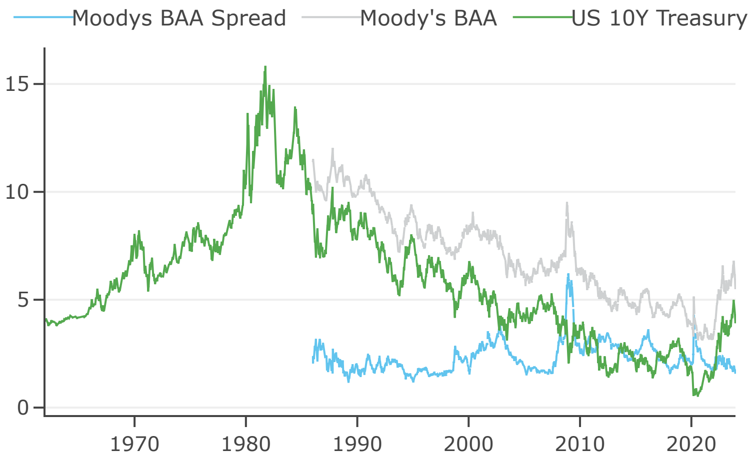
US 10 Year Treasury Yields



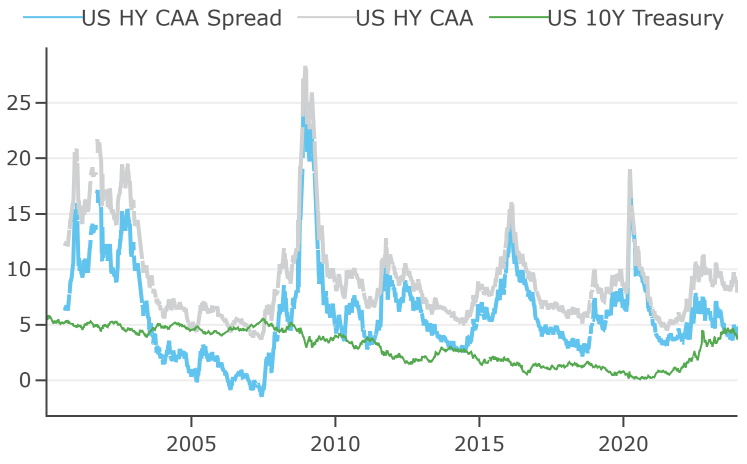
UK 10 Year Gilt Yields



US Corporate Investment Grade Yield



US Corporate High Yield



Sources | Bloomberg as at Dec 2023

V A L U A T I O N

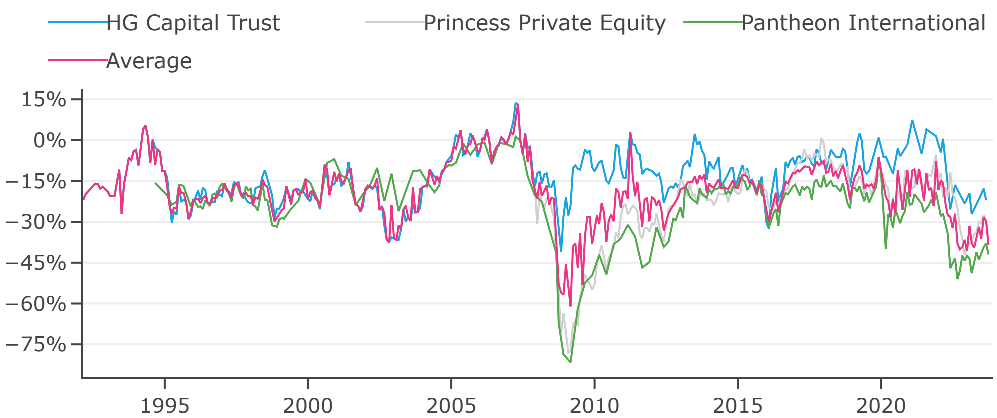
Alternatives

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 35-42% discounts** to the underlying NAVs which we think is an opportunity. **Levered Loan yields have risen from 5% to over 9%.**

Global Valuations

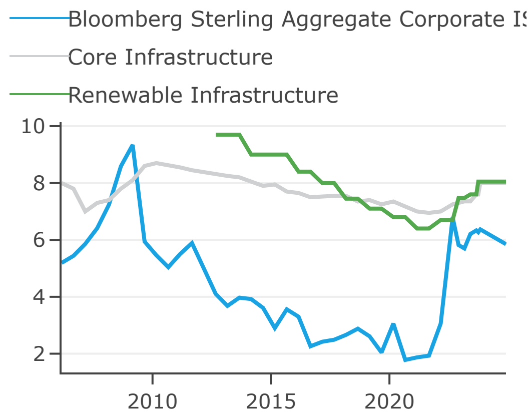
Listed Private Equity

Discount To NAVs



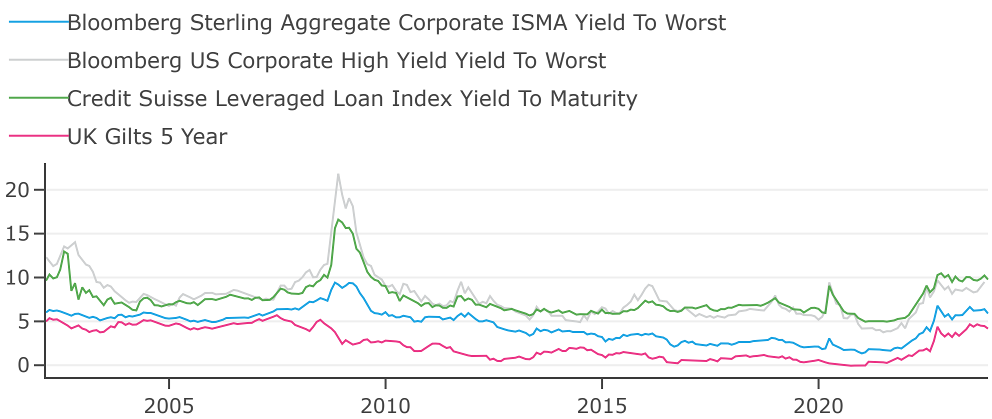
Infrastructure

Infrastructure Discount Rates vs Bond Yields



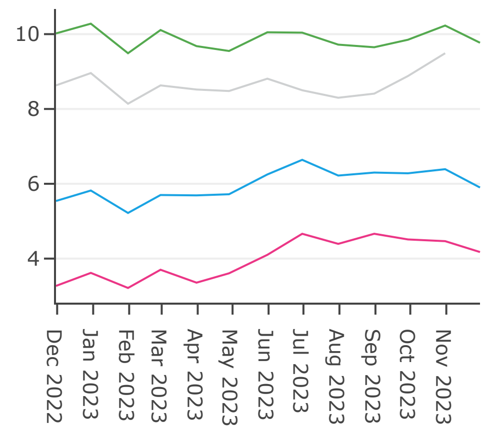
Contractual Income

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 Dec 2023

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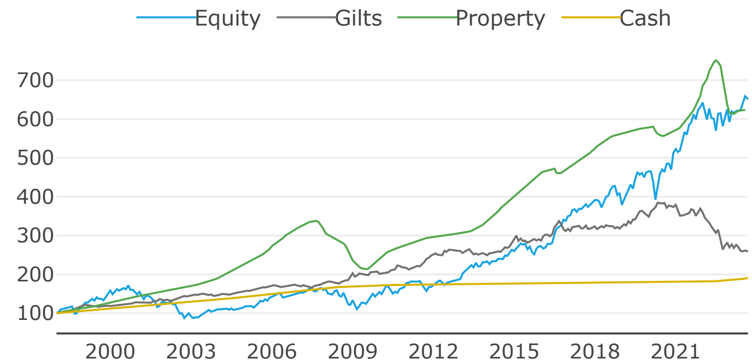
Property

The UK Commercial Property market offers reasonable yields, (6.8% 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.

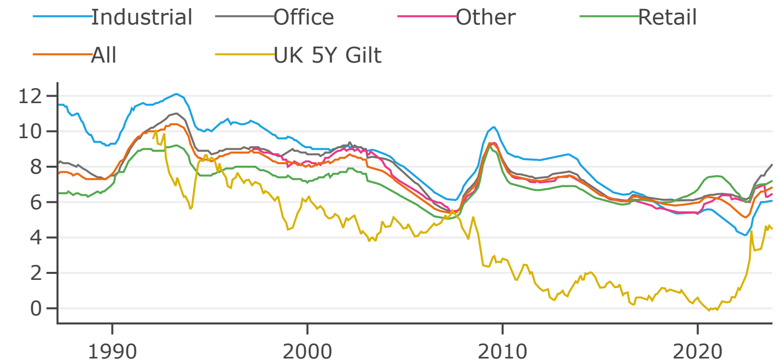
We show that UK Commercial Property has generated similar returns to global equity over the last 25 years (top left chart). Further, that outside of correction phases (one of which we have just been through) **real returns to Property have tended to average around the starting Equivalent Yield** (middle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

UK Commercial Property Market

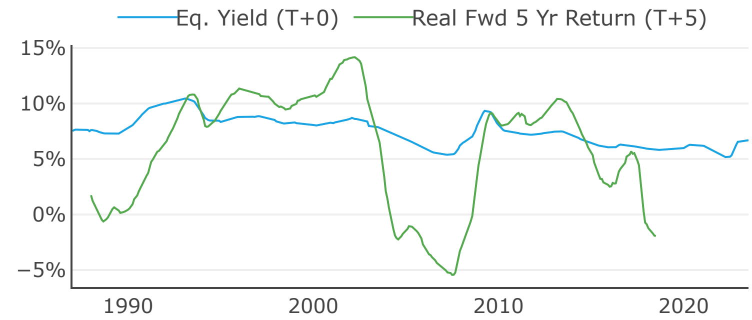
25 Years Of Return 1998=100



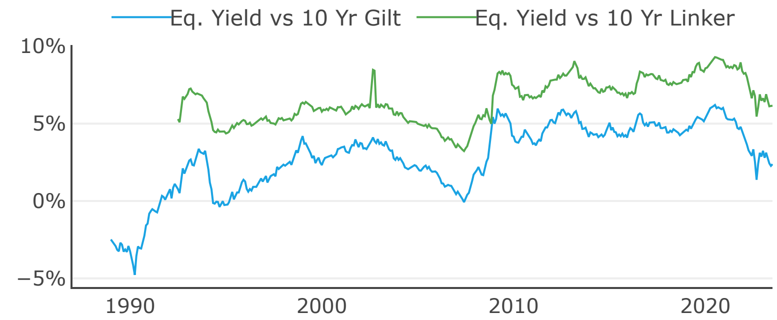
Equivalent Yields vs Gilt Yields %



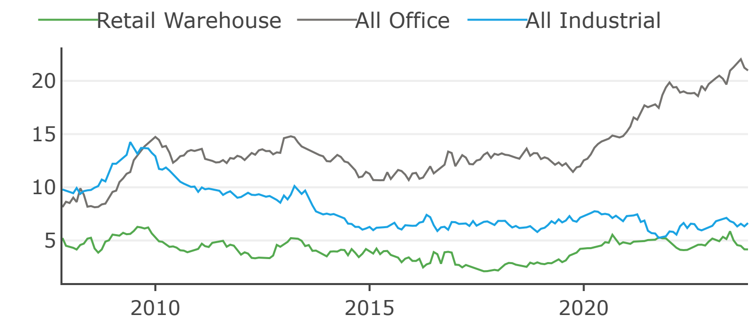
MSCI UK All Property Monthly TR Index %



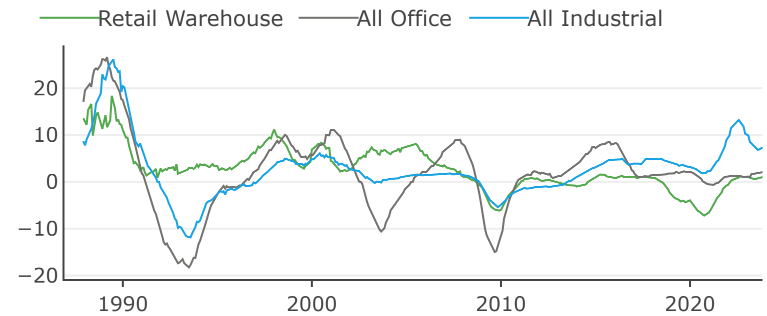
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



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

VALUATION

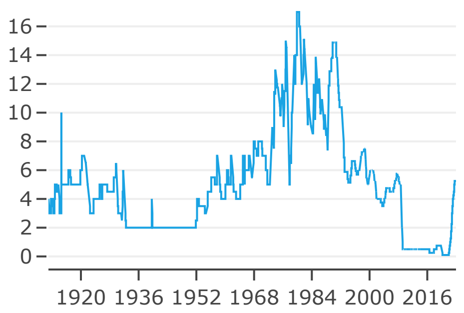
Cash

The BoE held rates at 5.25% for a third consecutive meeting. Reading between the lines, our expectation is that the Bank is likely in the flat-lands of their "table-top" mountain. The markets, however, don't see this lasting too long having already priced in four 25bps rate-cuts in 2024. The sentiment seems to be driven by a combination of looser labour data, falling headline CPI and a potential dovish pivot by other developed central banks. Worth noting however, private sector wage growth is still 6.4%, double where we would expect for an overall 2% headline inflation target.

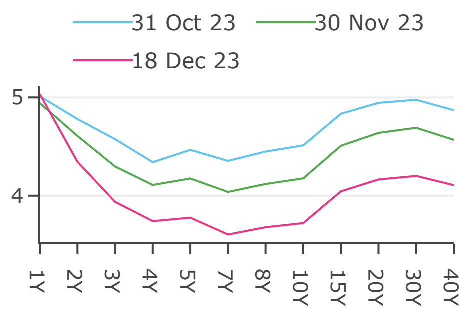
1Y forward-looking real rates are positive 2% (1Y B/E vs 1Y SONIA) and can be considered restrictive for the economy. **We need to see this feed into more Core disinflation before we can start thinking of rate cuts.**

UK Sterling Market

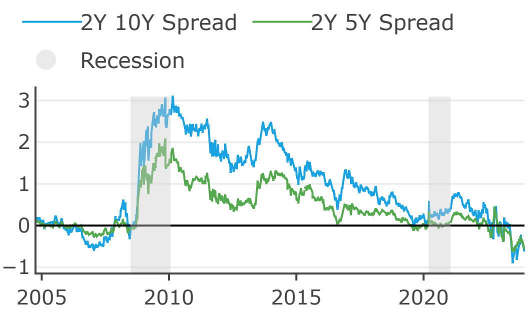
Official Bank Rate



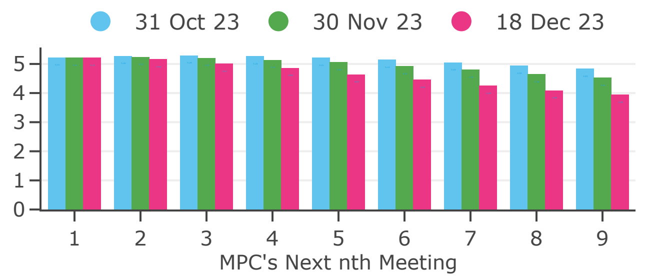
UK Gilt Curve



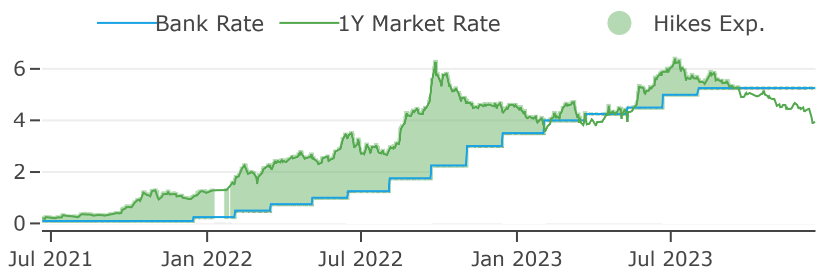
Gilt Spreads



Rate Expectations For Future MPC Meetings



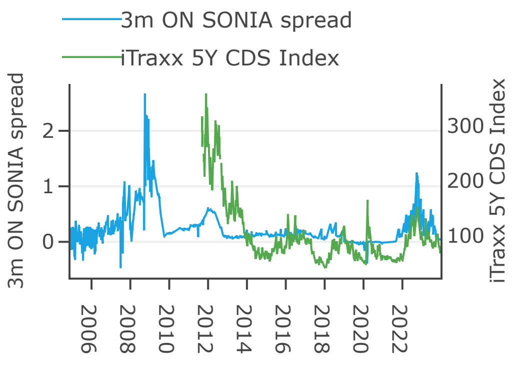
Further Tightening Expected



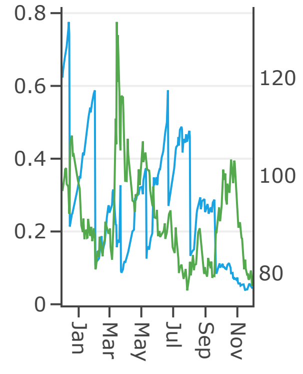
Inflation Readings YoY% | Colour by 10Y Z-Score*

	June	July	Aug...	Sept...	Oct...	Nov...
RPI	10.70	9.00	9.10	8.90	6.10	5.30
CPI	7.90	6.80	6.70	6.70	4.60	3.90
CPI Core	6.90	6.90	6.20	6.10	5.70	5.10
CPI Services	7.20	7.40	6.80	6.90	6.60	6.30
CPI Goods	8.50	6.10	6.30	6.20	2.90	2.00

Market Stress



Last 12 Months



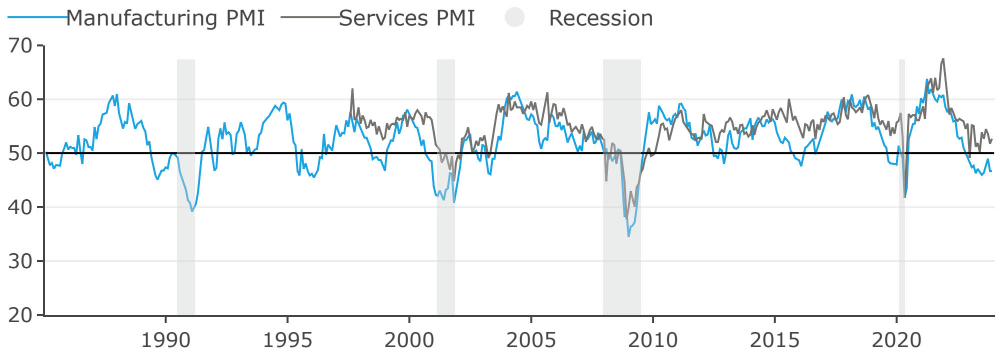
Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, highest and lowest scores as red. Bloomberg for all charts,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

Could Eurozone activity be bottoming out? If global manufacturing is troughing out that would be supportive.

United States



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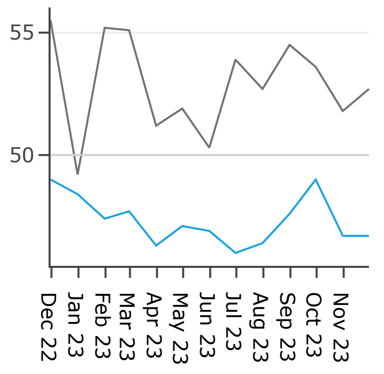
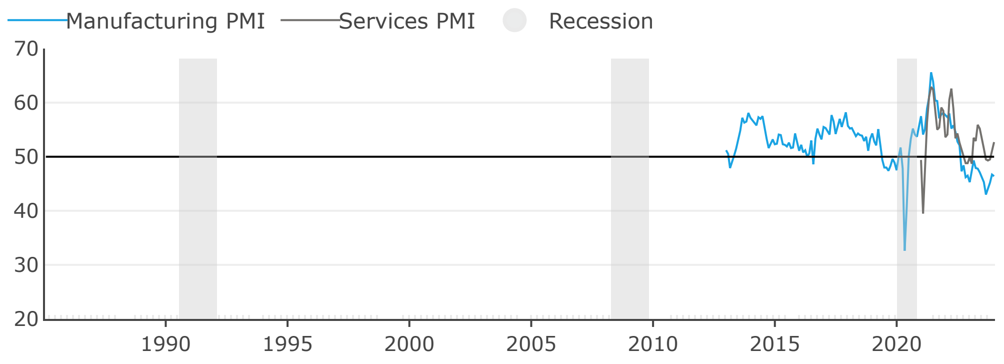


United Kingdom



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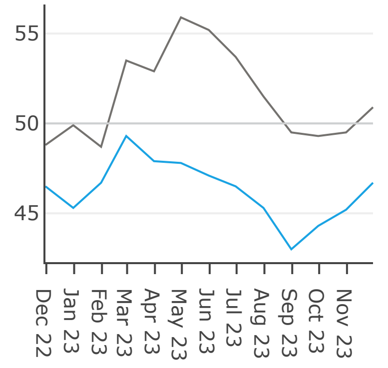
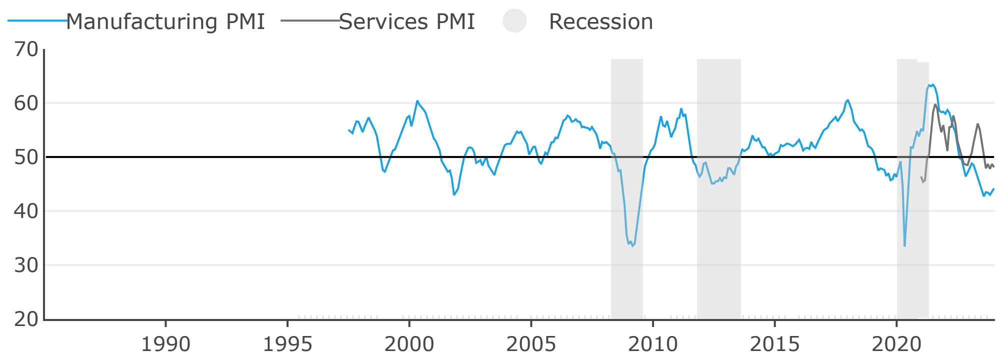


Eurozone



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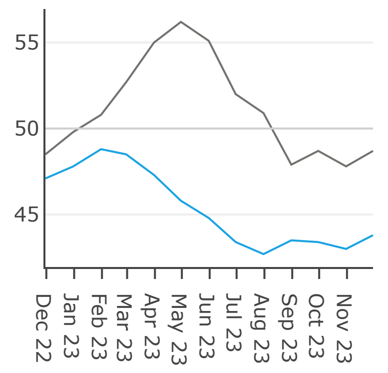


Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Dec 2023. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

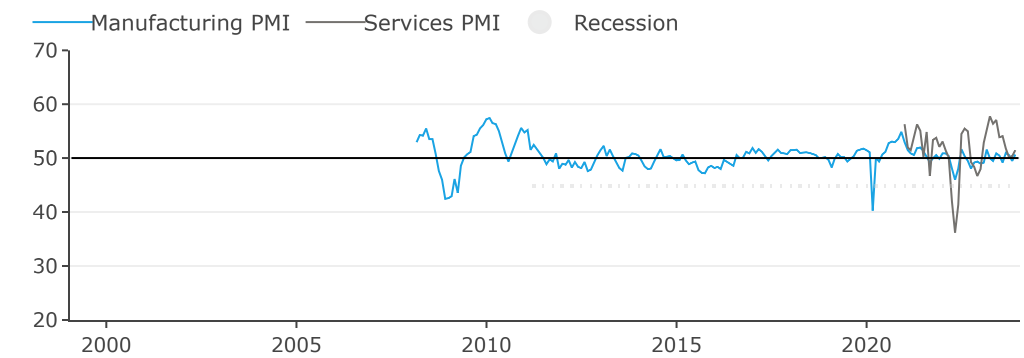
GROWTH

Global PMIs

China and Japan Services 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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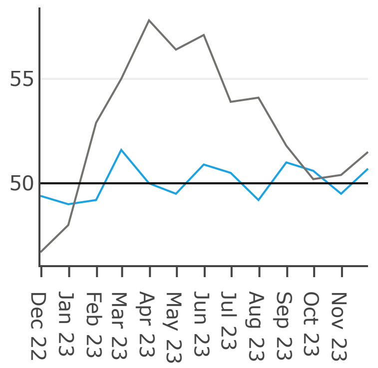
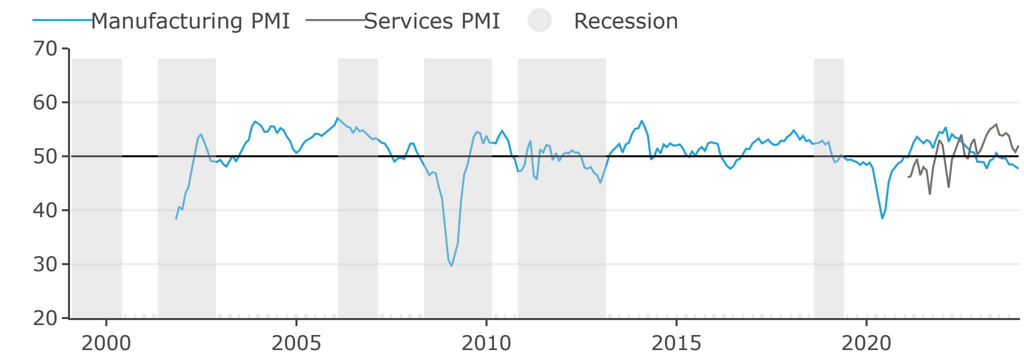


Japan



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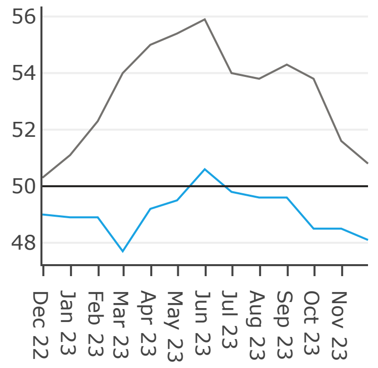
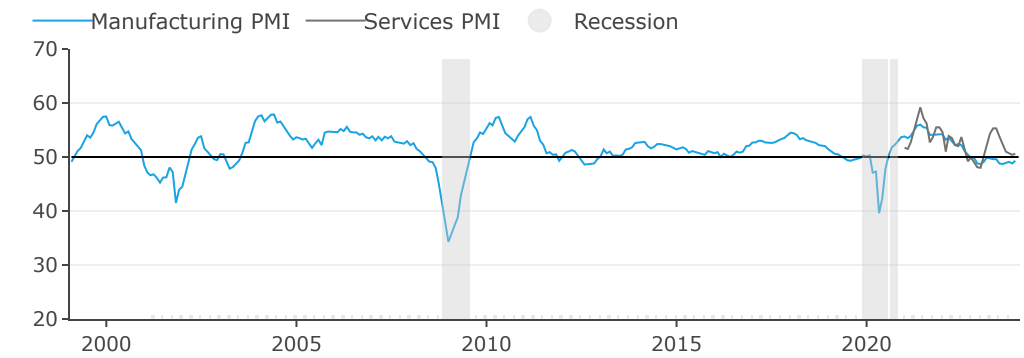
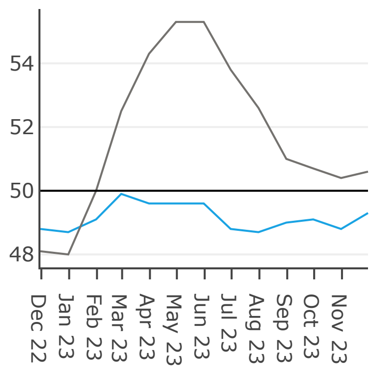


Global



Last 12 Months



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

GROWTH

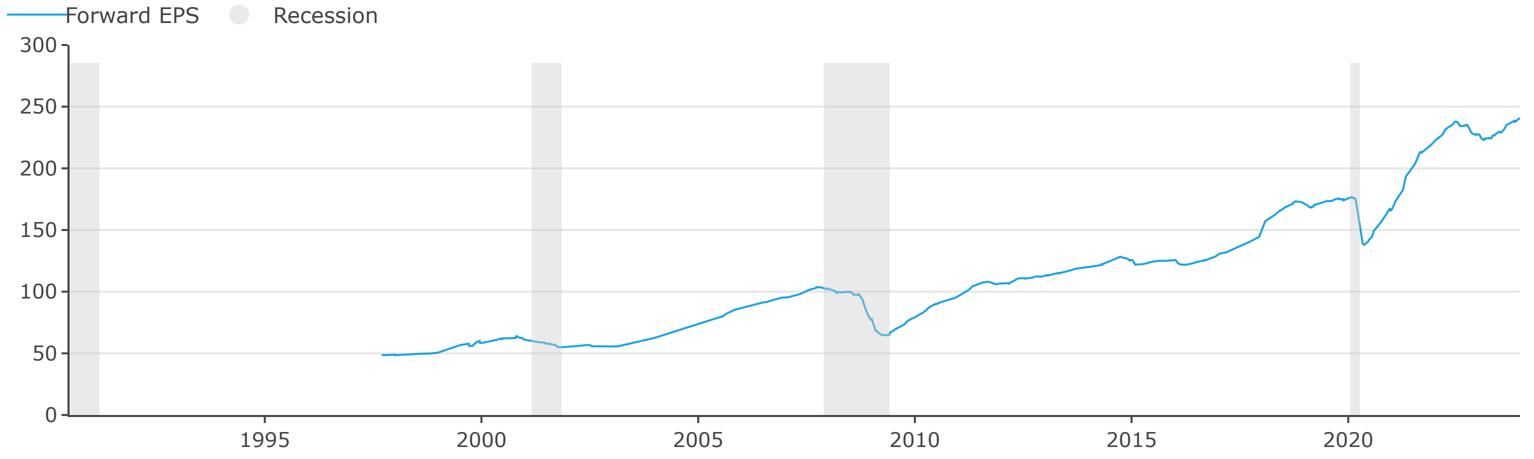
Earnings

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

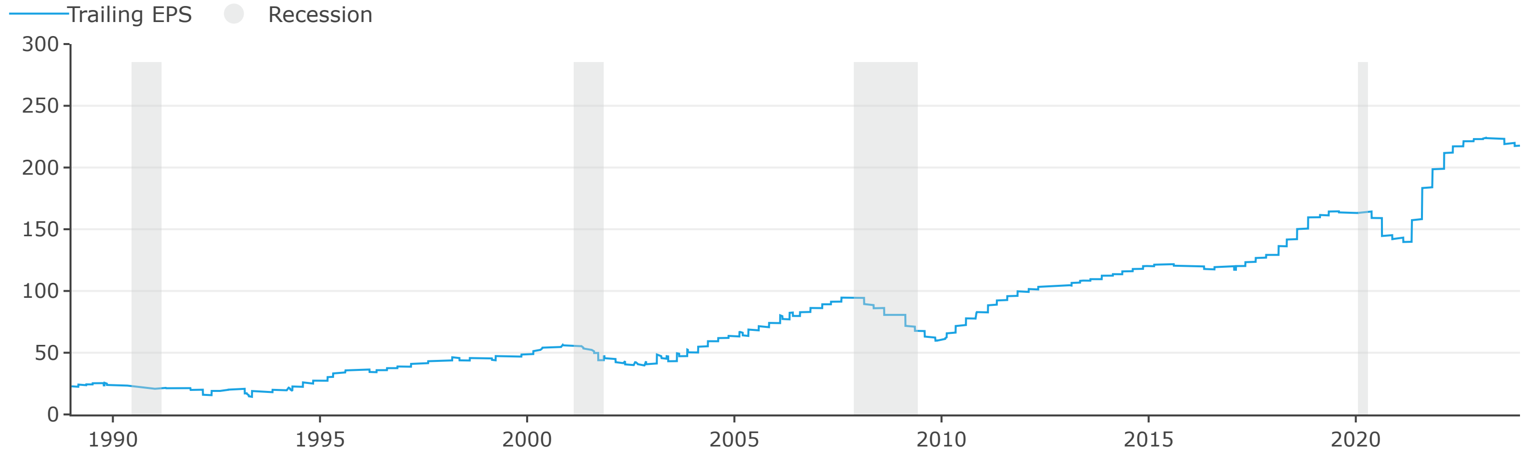
It's also worth noting that **Q3 earnings season saw EPS growth of 5% on a year over year basis**, after three quarters of falling year-on-year growth.

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 Dec 2023

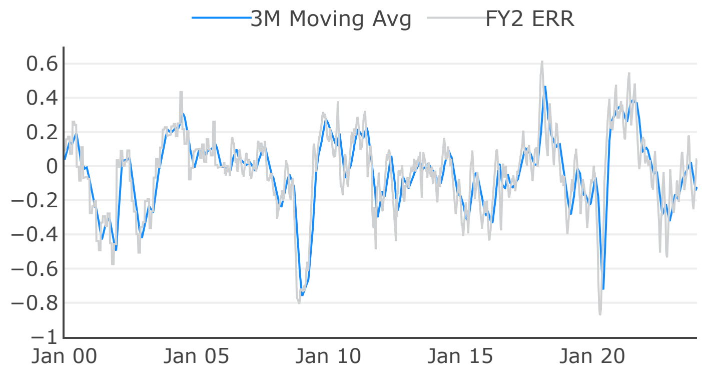
Earnings

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.

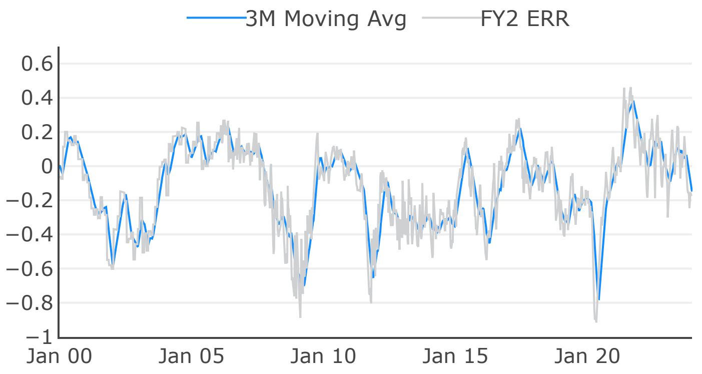
The overall assessment is that earnings breadth is almost exactly zero, i.e. there are an equal number of upgrades and downgrades. **In short, earnings are benign.**

Global Earnings Revisions Ratios

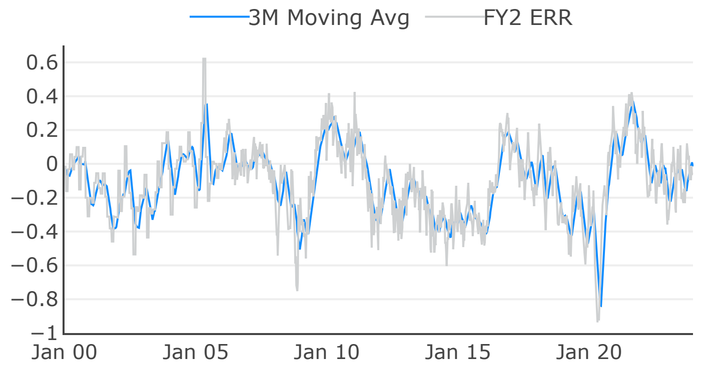
USA



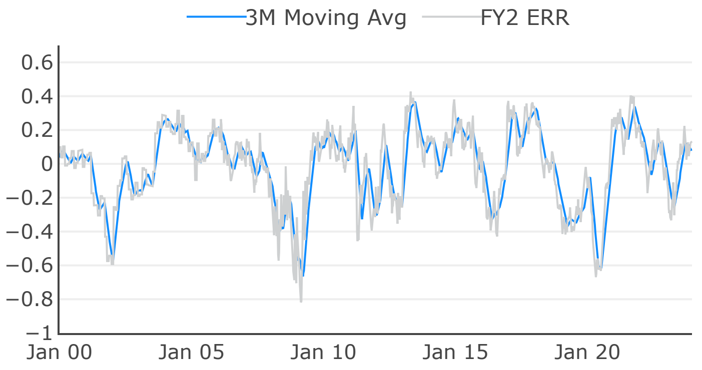
Eurozone



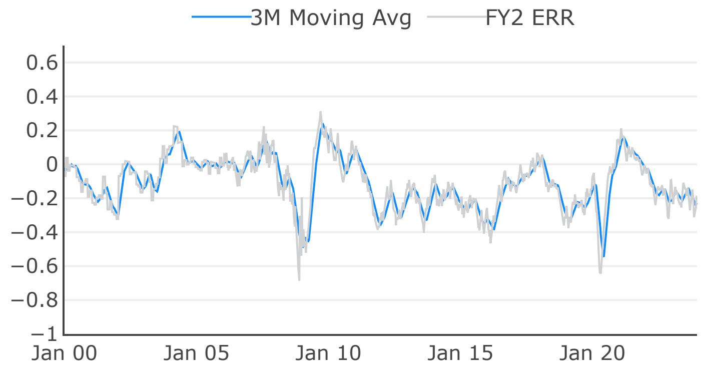
UK



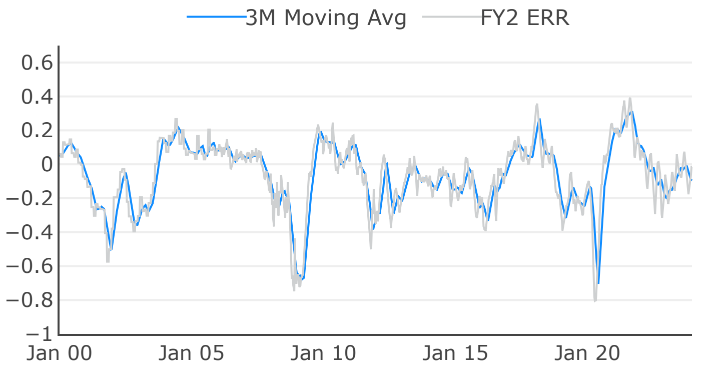
Japan



Emerging Markets



World



Sources | Eikon, the MSCI index has been used for each respective region, as at Dec 2023.

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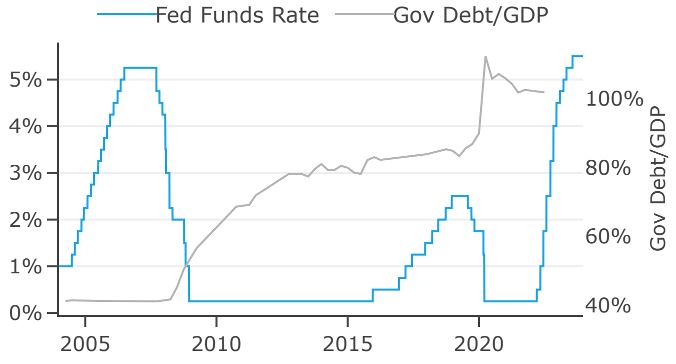
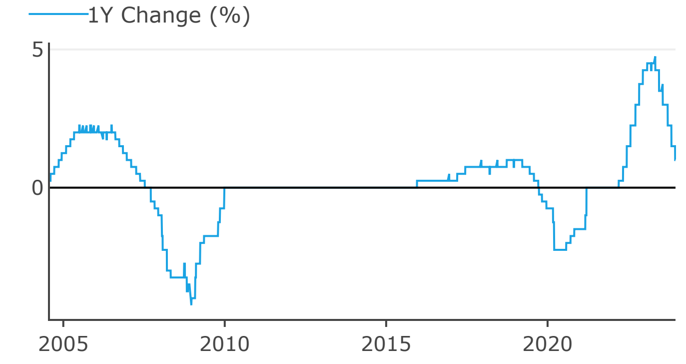
Interest Rates

The December FOMC (Federal Open Markets Committee) meeting all but confirmed that the hiking cycle has ended. Fed Chairman Jay Powell pointed out that risks of over/under doing it are "back into a better balance" and "back to the point where both mandates are important"; followed by a forecast of 75bps cuts in 2024. 2Y yields are 4.45% as of 18 Dec, compared to Fed Funds rate at 5.5%

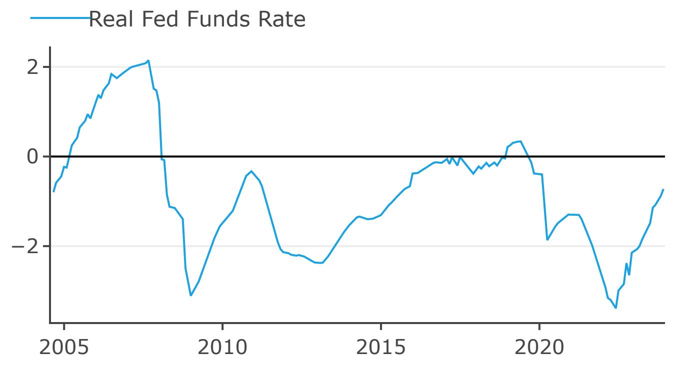
Fed Funds Rate



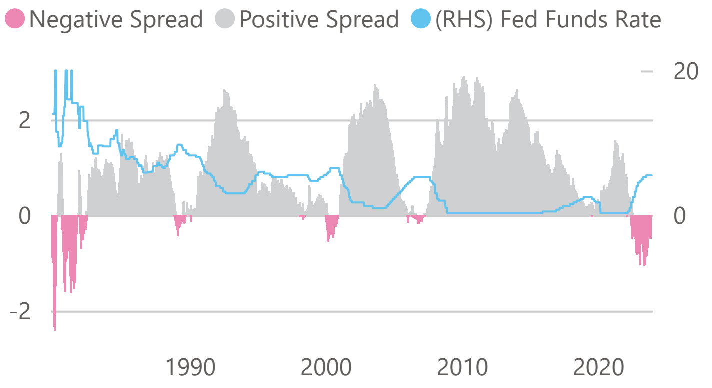
Change in Fed Funds Rate



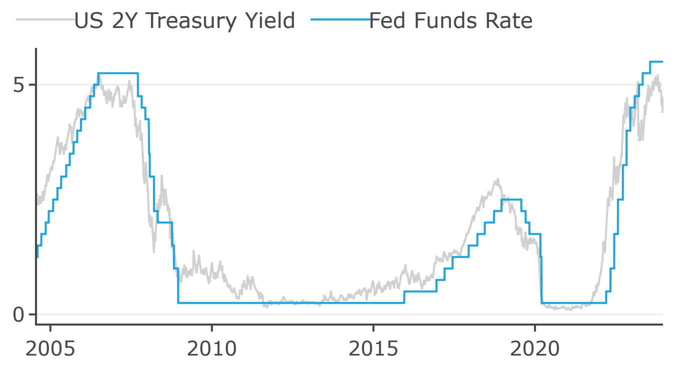
Real Fed Funds Rate (Using 2Y MA CPI)



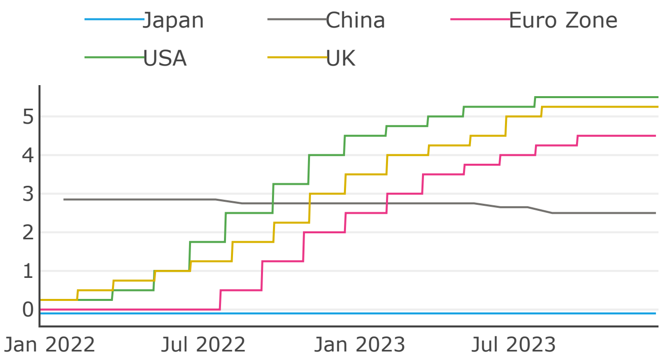
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Dec 2023

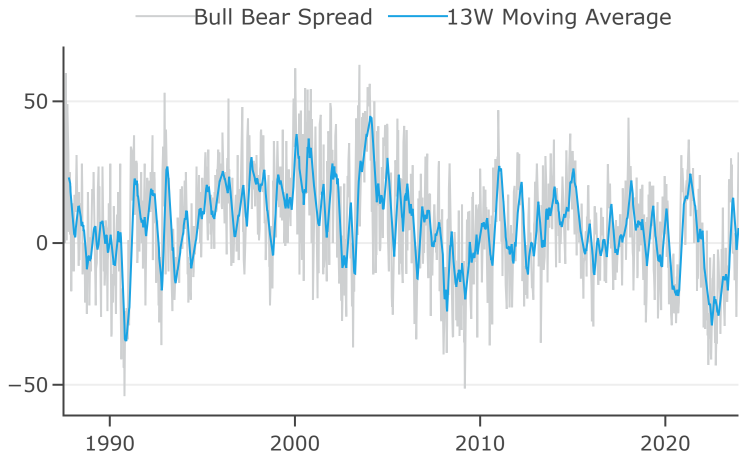
Sentiment

The Harnett Bull & Bear Indicator has moved from Extreme Bearish sentiment (which is bullish for the market!) in October 2022 **to now almost exactly neutral** (which would be a reading of 5/10). In other words, while we have been able to say that institutions and individuals were not taking enough risk over the last couple of years, we can no longer say that.

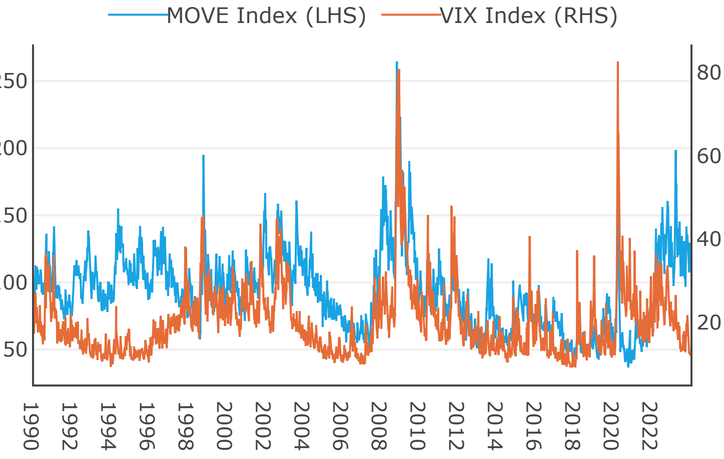
Drivers of the normalisation in sentiment, according to Michael Hartnett, include "strong inflows to HY bonds, better credit market technicals and a big improvement in equity market breadth".

US Equity Indicators

Bull Bear Spread

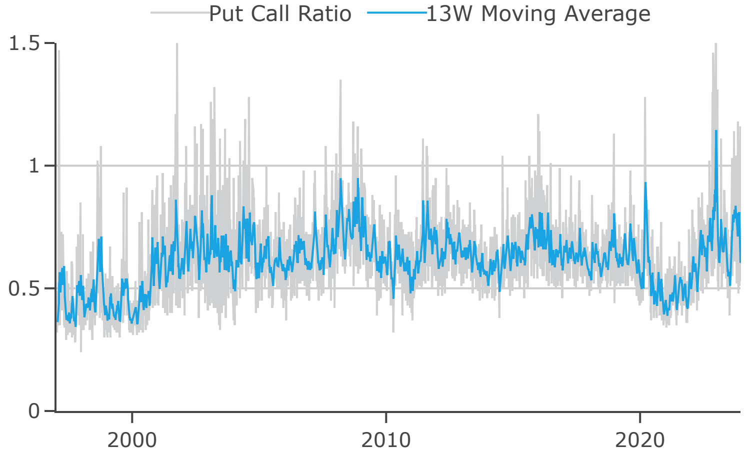


Equity vs. Bond Sentiment



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 Dec 2023

Fund Flows

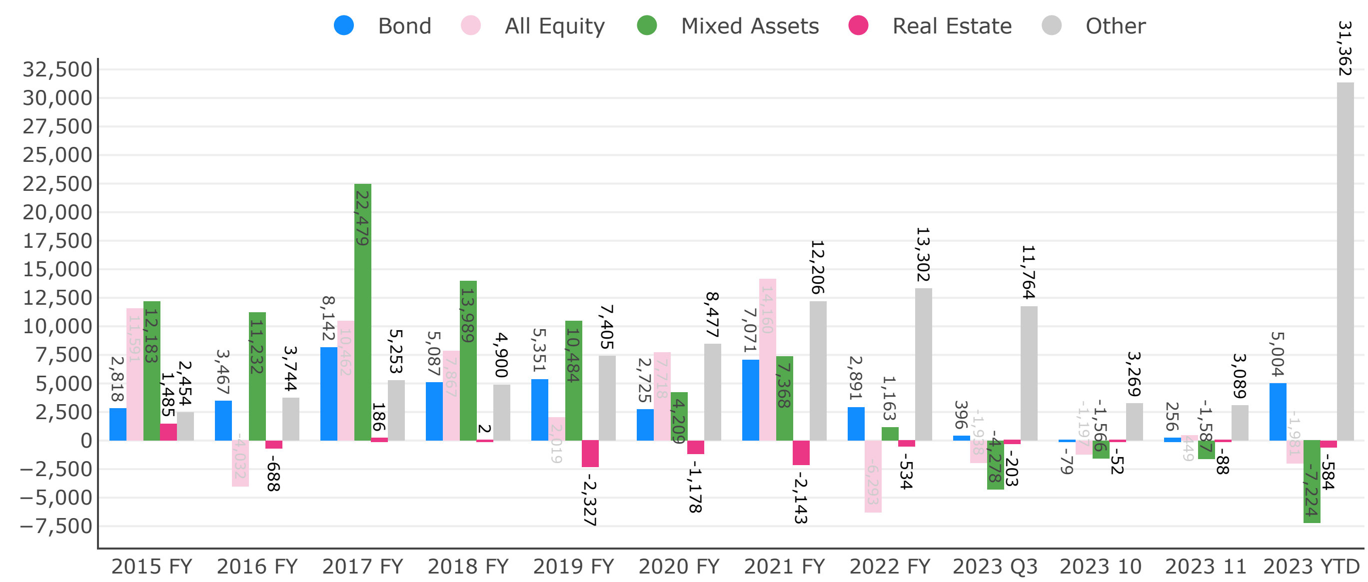
This page captures UK investment fund flows only, as a measure of how optimistic or pessimistic sentiment has become.

There has been an extraordinary inflow into cash (shown here as "Money Markets") 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 (inc. MM)	Money Market (MM)	Total Net Flows
2022 Q1	-506	-1,261	1,148	-284	5,158	44	4,256
2022 Q2	534	-672	1,247	61	2,238	-111	3,408
2022 Q3	1,197	-4,701	-287	-85	2,545	423	-1,331
2022 Q4	1,666	341	-945	-226	3,361	310	4,198
2023 Q1	2,747	258	397	-93	5,966	456	9,275
2023 Q2	1,684	447	-190	-148	7,274	1256	9,066
2023 Q3	396	-1,938	-4,278	-203	11,764	1703	5,742
2023 10	-79	-1,197	-1,566	-52	3,269	586	376
2023 11	256	449	-1,587	-88	3,089	525	2,119



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

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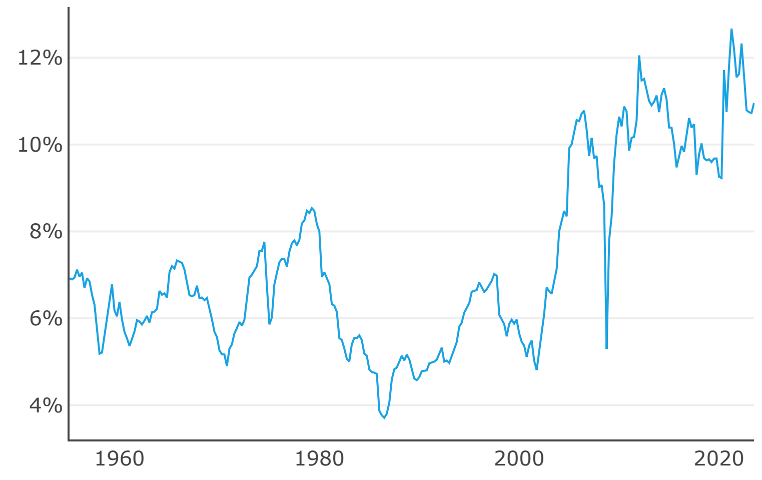
The Big Picture

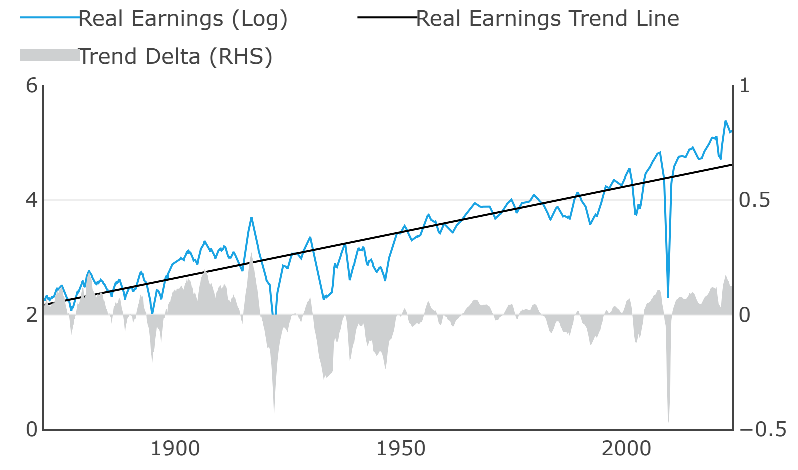
Here we highlight some longer-term imbalances that, **should** they correct, would have have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. It's corollary (not shown)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

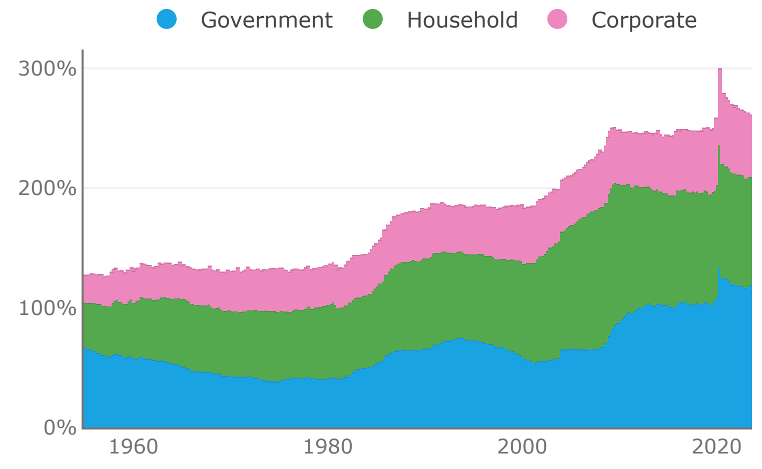
Profit Share of GDP



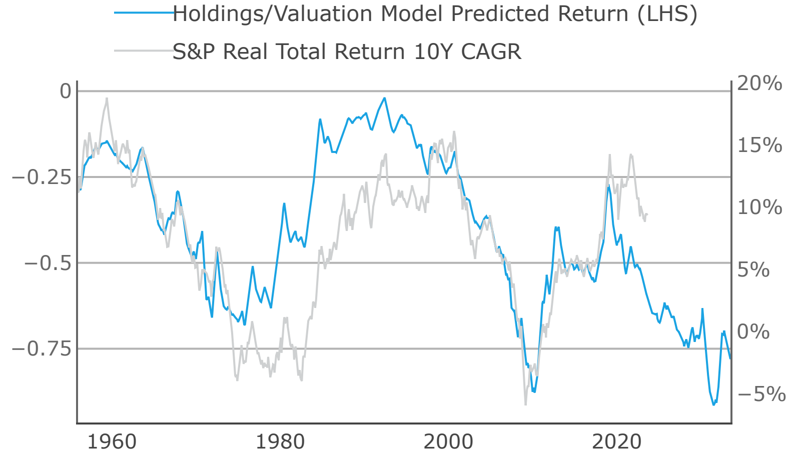
Earnings Deviation From Trend



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 Dec 2023.

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