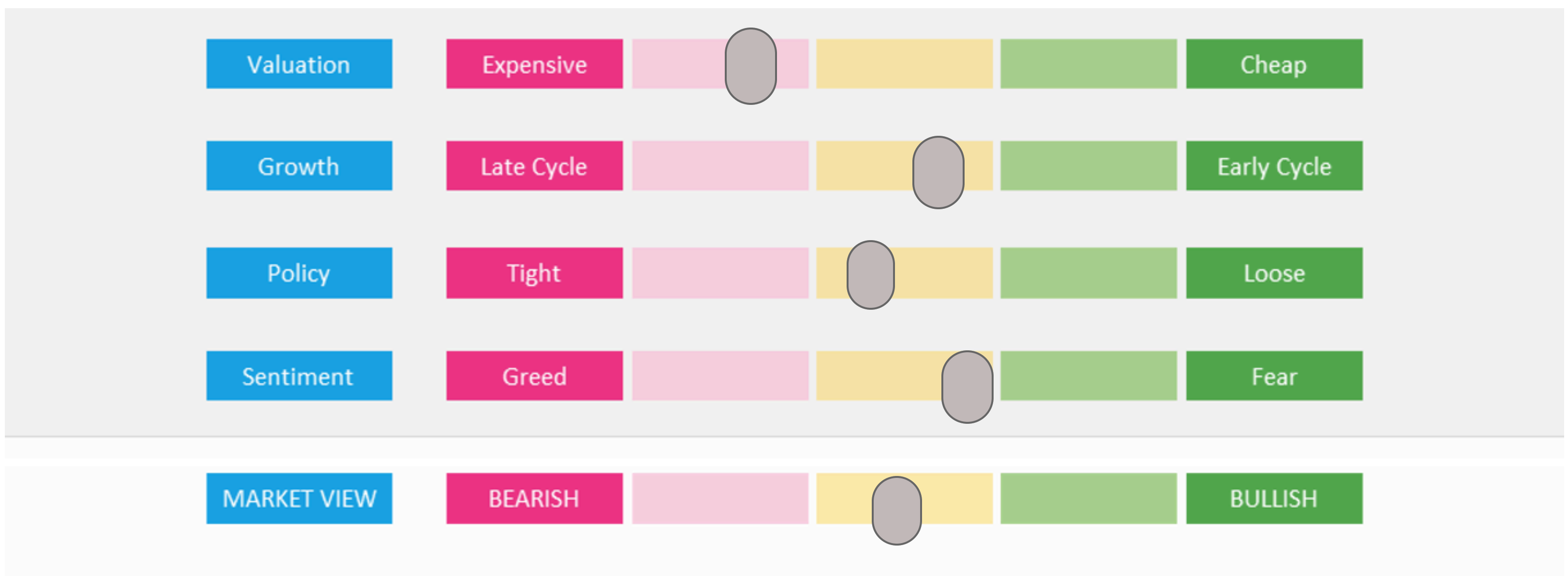
MARCH 2025

CCLA
GOOD INVESTMENT

Market Barometer

Barometer



Tax Tailwind, Tariff Headwind

- **Our operating assumption is that Trump is good for equities in the first instance.**
- **Tax cuts will come**, courtesy of new Treasury Secretary Scott Bessent prioritising the extension of the 2017 Tax Cuts & Jobs Act.
- **Elon Musk is working hard to cut the deficit** - hopefully not enough to cause a recession though.
- **Tariffs will probably also be enacted**, but it remains to be seen how pervasive they will be. At worst they risk tipping US trade partners into recession, but there does seem to be room for negotiation with this most transactional of Presidents. It feels premature to position for a major trade war that might not happen.

In our **Charts of the Month** we look at:

- **The extraordinary level of market concentration** that has arisen in the US stock market - shades of the TMT bubble.
- **The elevated level of Tech sector valuation** - also shades of the TMT bubble, but early in its inflation.
- **Using Free Cash Flow yield** to value equity markets, which is yet another indication that there remains very good value outside the US from a top-down point of view, and not a lot of value in the US.
- **A Mar-a-Lago Accord** - we ask could Trump attempt to devalue the US dollar? We think unlikely now, but after the tariff situation is resolved not impossible.

The top-down market call is getting harder. Last year was easier: growth up, inflation and interest rates down = market up. Our checklist of market risks now is 1) waning earnings momentum 2) trade war 3) fiscal crisis 4) accelerating inflation. We don’t have a fiscal crisis but there are shades of the other three. That said, for now, **we remain risk on**.

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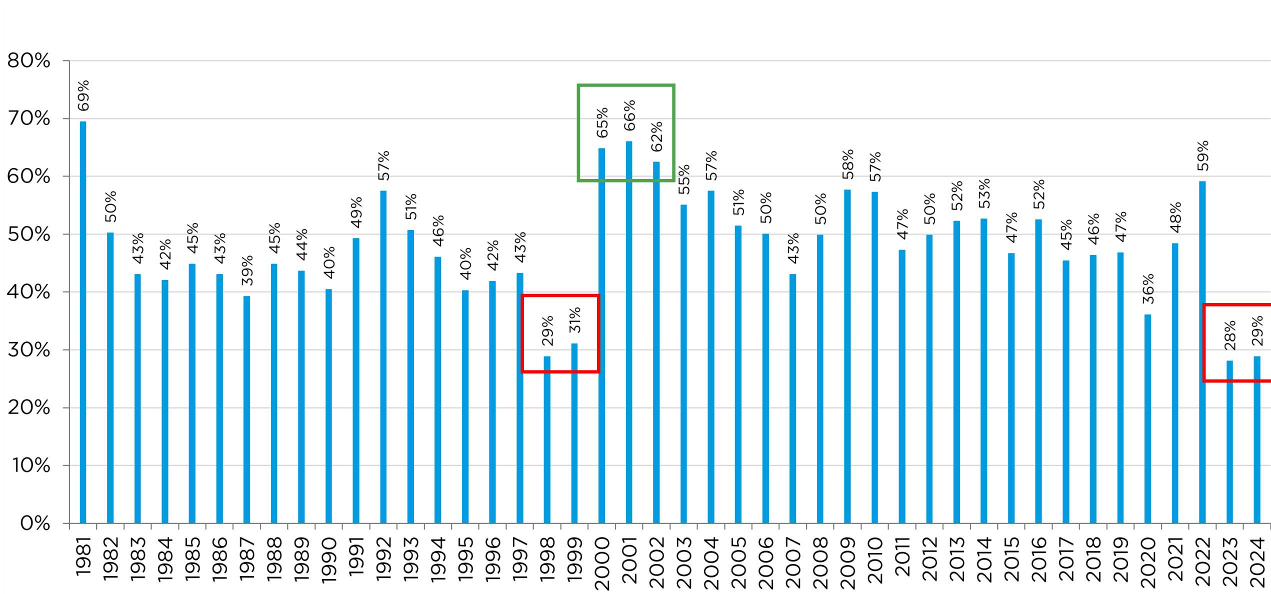
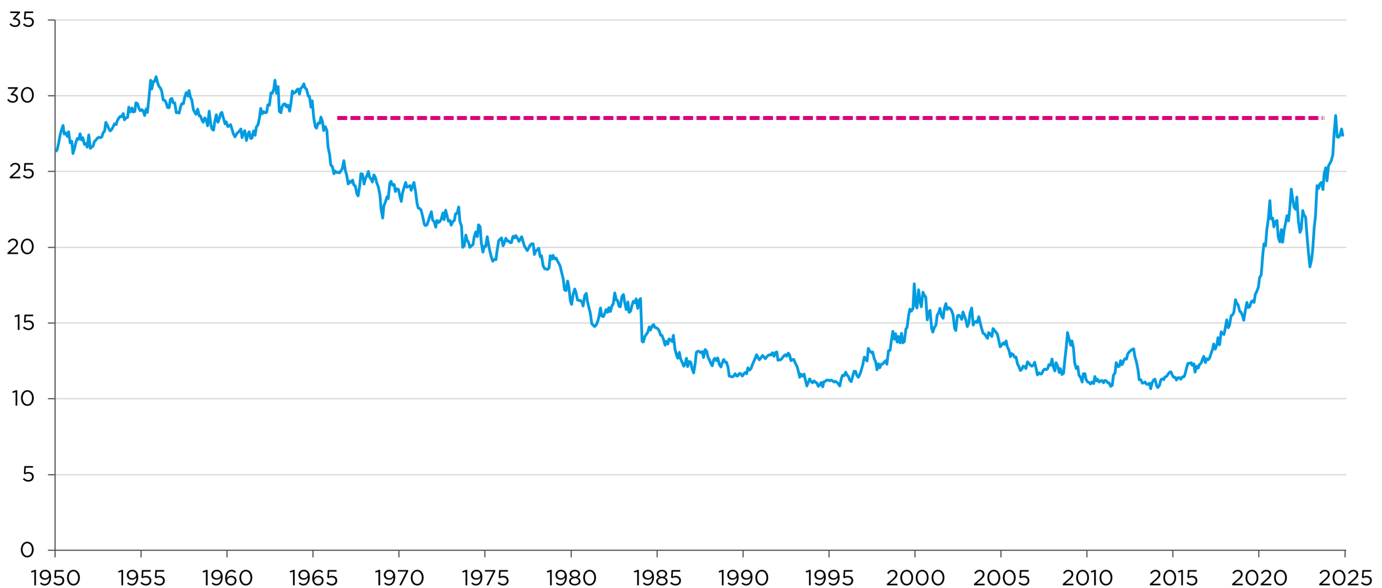
Charts of the Month (1 of 4)

Concentrated market leadership with few stocks outperforming. The bar chart shows that the proportion of S&P500 constituents that have outperformed the S&P500 in the last couple of years has been unusually small. This concentration of leadership has happened only once before in our professional lifetime, and that was during the inflation of the TMT bubble during 1998 and 1999. When the bubble burst, the index heavyweights underperformed and that allowed a broad swathe of non-TMT stocks to outperform for several years, producing a target-rich environment for stock pickers. This is not a time to go passive or to hug the benchmark. Similarly, the lower chart shows that index market cap has not been this concentrated in the (knowingly selected) seven largest stocks since the 1960s, when the index was dominated by the Nifty Fifty consumer electronics stocks, which went on to have a torrid and structural de-rating during the 1970s.

Percentage of S&P500 Stocks that have Outperformed the S&P500 (Rolling 12 Months)



Share of US Equity Market Capitalisation from the Largest Seven Stocks



Sources | Top chart: CCLA, Bloomberg as at 31 December 2024. Bottom chart: Empirical Research Partners. Last data point 30 November 2024.

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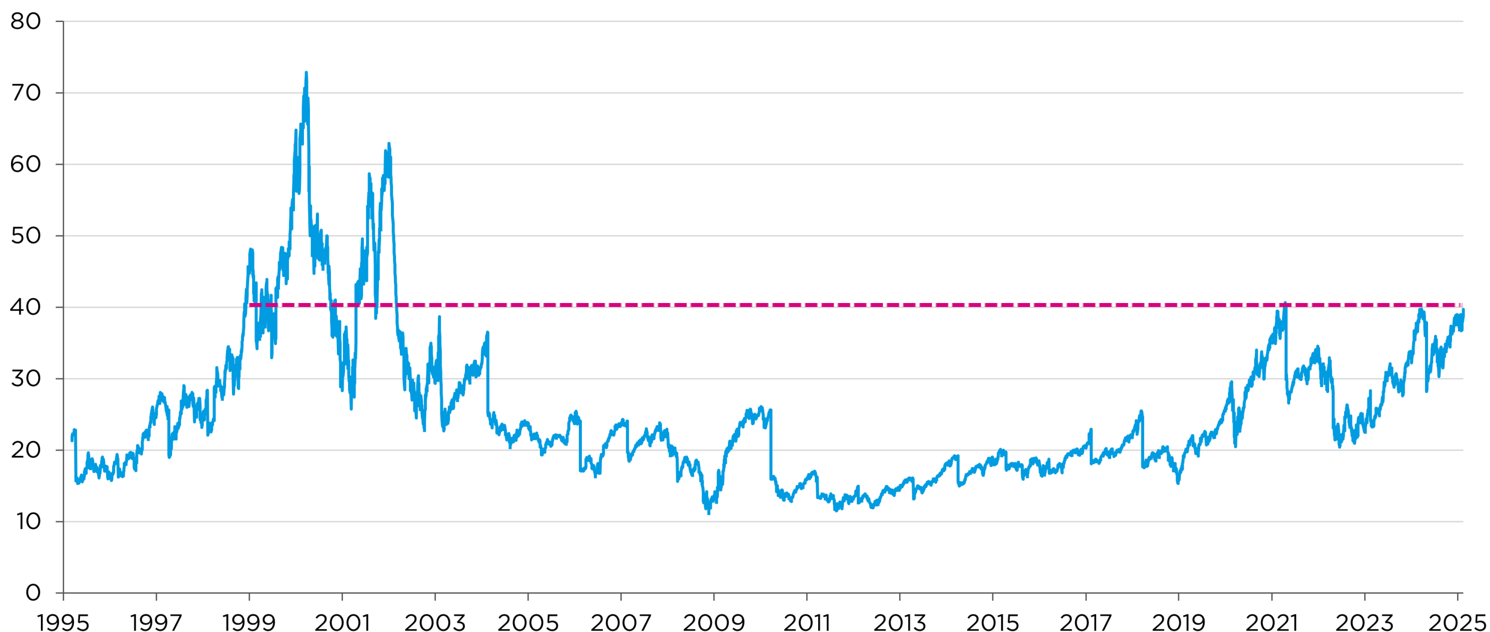
Charts of the Month (2 of 4)

Bubble watch. This concentration of market leadership has led to a structural re-rating of several sectors but none more than the global IT sector, which now sits on 40x consensus forward earnings, a level it reached (on the way up) in March 1999. At the peak of the TMT bubble a year later in March 2000 the group reached a now scarcely credible 73x PE. It then proceeded to fall by 83% over the ensuing three years.

Fast forward to today and it's entirely plausible that this group could double again this year. It's also equally possible that it could halve, in this fund manager's view. Investors of a conservative bent would do well to reflect on this unusually wide array of possible outcomes. We should add that valuation dispersion is currently around average, meaning that there remains a reasonable opportunity set within the IT sector to pick outperforming stocks, we think.



Sources | CCLA, Bloomberg. All data as at Feb 2025

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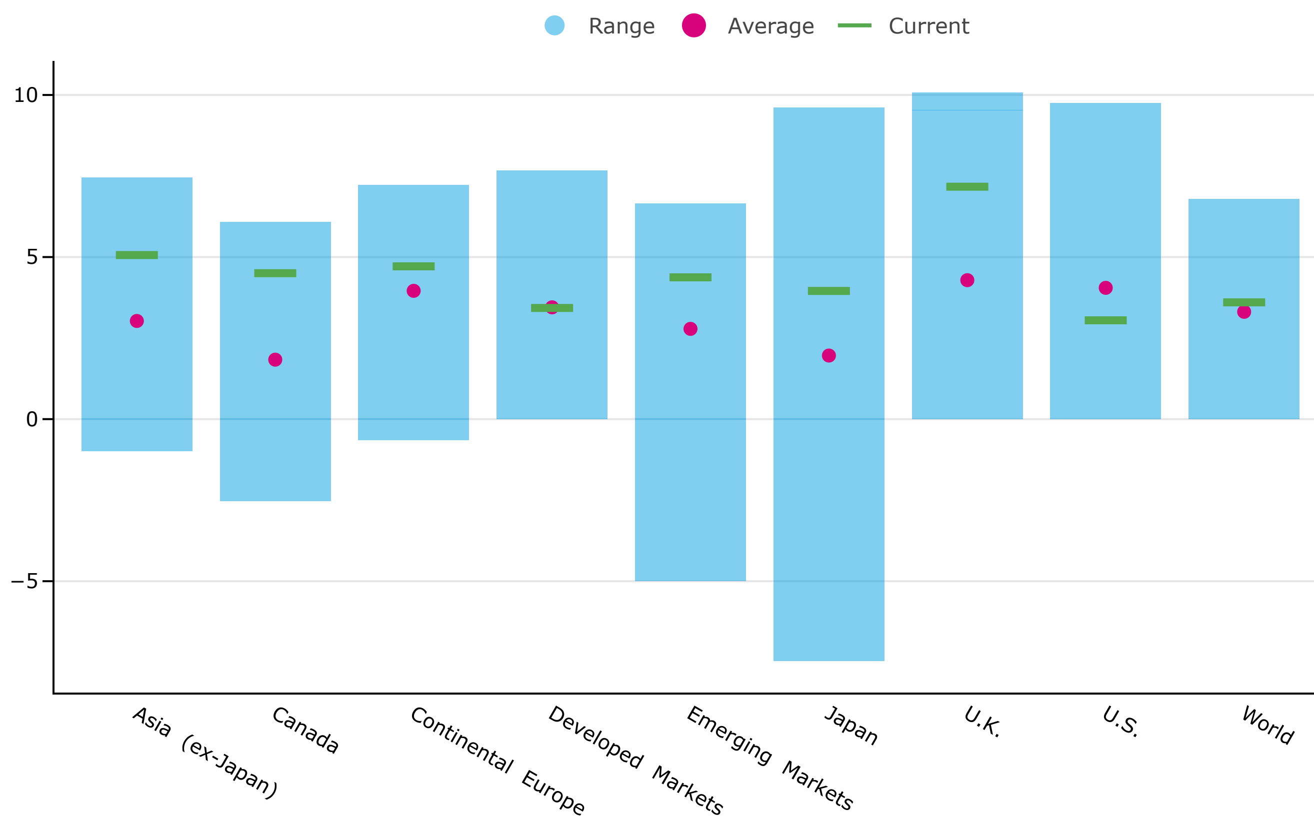
Charts of the Month (3 of 4)

Another way of looking at equity market valuation - Free Cash Flow Yield. Our approach to assessing forward equity market returns is to invert the price earnings ratio to get an earnings yield and then assume partial reversion to mean by blending long run average with spot earnings. This is the approach adopted by Nobel laureate Robert Shiller, among others, and is generally considered robust. However, earnings is not cash flow, and cash is king. So it is at least interesting to look at Free Cash Flow yield as a cross-check on our earnings based projections.

Data from Empirical Research, a quant strategy research house we subscribe to, shows that FCF based yields support the idea that **returns outside the US equity market can be good to very good over coming years** from this starting point. FCF yield is lowest in the US, as expected, at 3.1%, and the US is the only region with current yield lower than its long run average (which has been 4.1% going back to 1986).

FCF yields around 5% are attractive and available in Asia and Continental Europe. The UK is standout cheap on this measure with a FCF yield of 7.2%.



Sources | Empirical Research Partners Analysis, CCLA as at Feb 2025.
Notes | Capitalisation-weighted data, excluding financials. Emerging Markets since 1992

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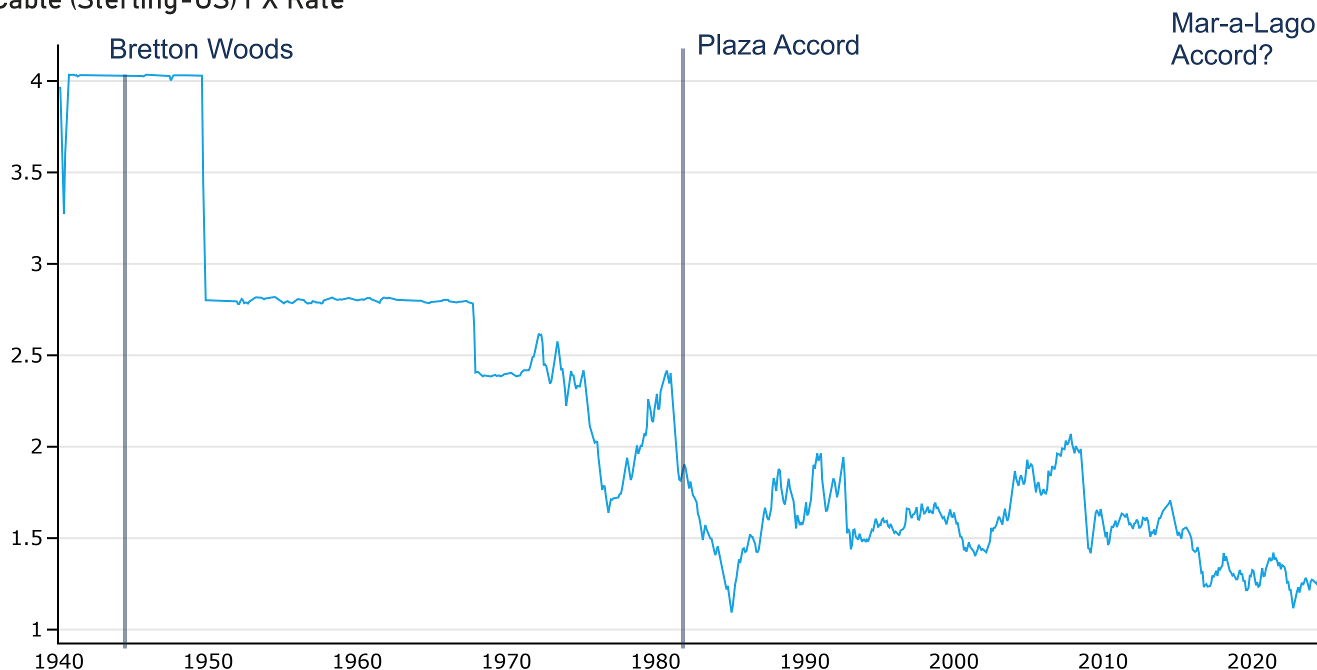
TOP OF MIND

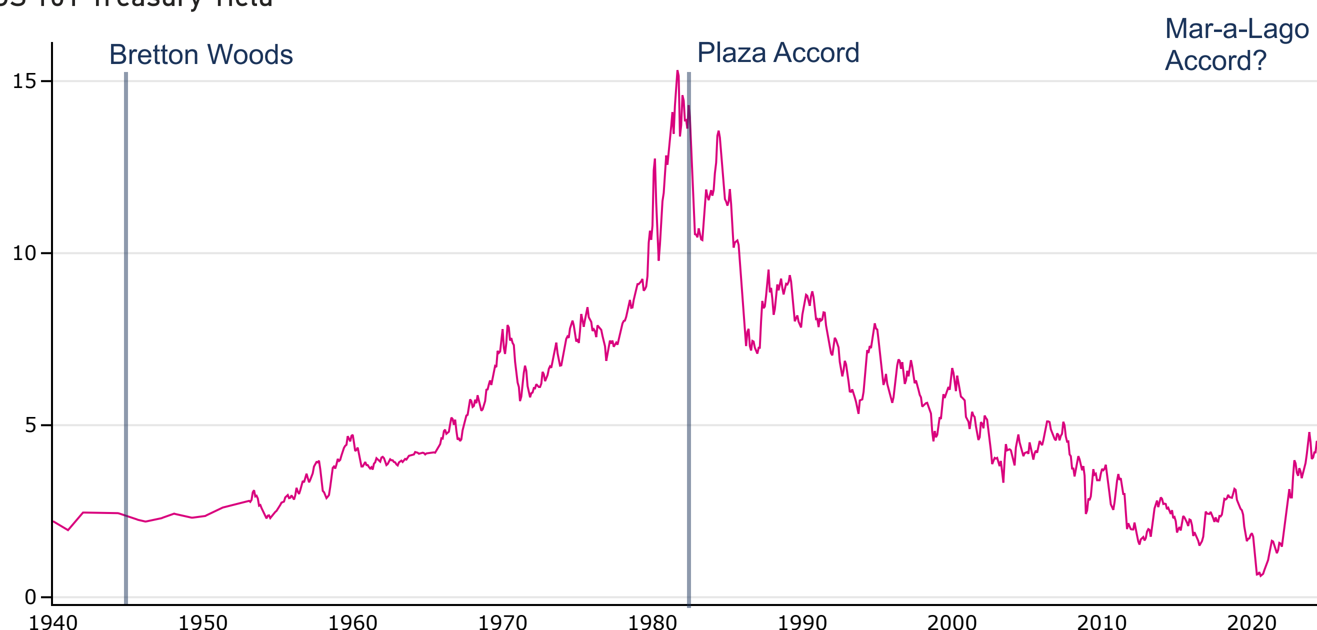
Charts of the Month (4 of 4)

One risk we are watching carefully - could Trump devalue the dollar? There is increasing market talk of a "Mar-a-Lago Accord". The name is a reference to the 1985 Plaza Accord where the G7 agreed to intervene in currency markets to weaken the dollar. A November 2024 paper by Stephen Miran (see source below) is influential in this debate because he is likely to be Trump's pick as Chairman of the Council of Economic Advisers. The paper suggests that dollar overvaluation is driven by excess and persistent demand for USD reserve assets as trade surplus countries re-cycle dollar receipts into treasuries. Tariffs are one way of making surplus countries finance the trade deficit. Lowering US defence spending while non-US countries increase theirs is another. For our part we acknowledge that the USD is overvalued and that there has been a free-rider problem. The phasing, as the paper points out, would be tariffs first, dollar devaluation second. **For now, though, we have strong US nominal GDP and higher-for-longer rates. Both are dollar supportive.**

Cable (Sterling-US) FX Rate



US 10Y Treasury Yield



Stephen Miran paper available at https://www.hudsonbaycapital.com

Sources | CCLA, Morgan Stanley, Bloomberg as at Feb 2025

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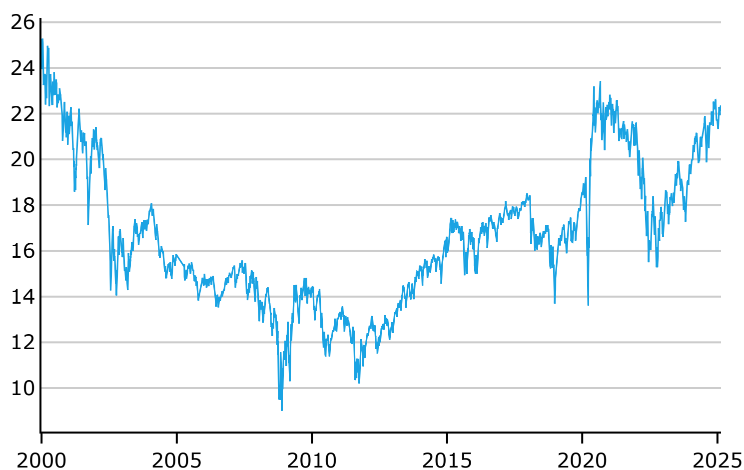
Equity | USA

Forward P/E is still stretched at ~22x, 2025 EPS growth estimates have risen to ~14% and institutional investor equity positioning is near highs ~55% -not far from the ~60% peak in 2000*.

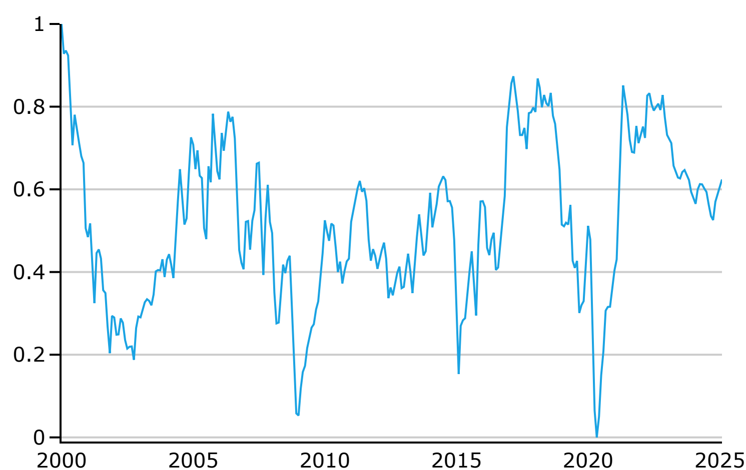
Despite the optimism and goldilocks pricing, volatility is playing a role throughout the earnings season. According to JP Morgan research, US stocks with earning beats are *underperforming* on the day, meanwhile, stocks that miss estimates are being penalised in line with historical averages**. This speaks to the frothy nature of the current market.

S&P 500 Valuations

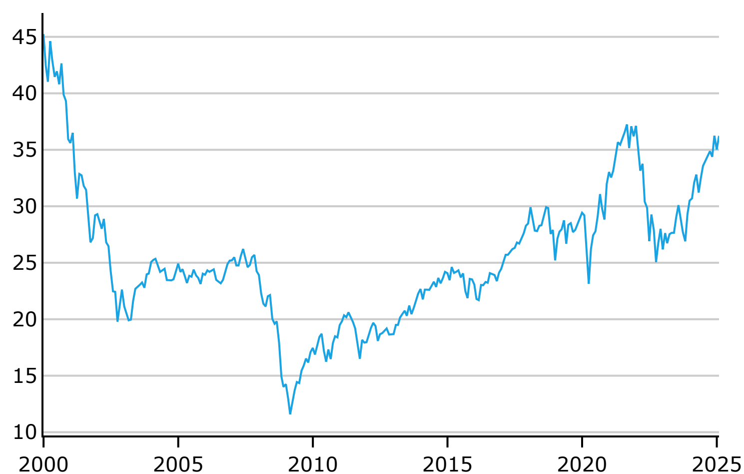
S&P 500 Forward PE



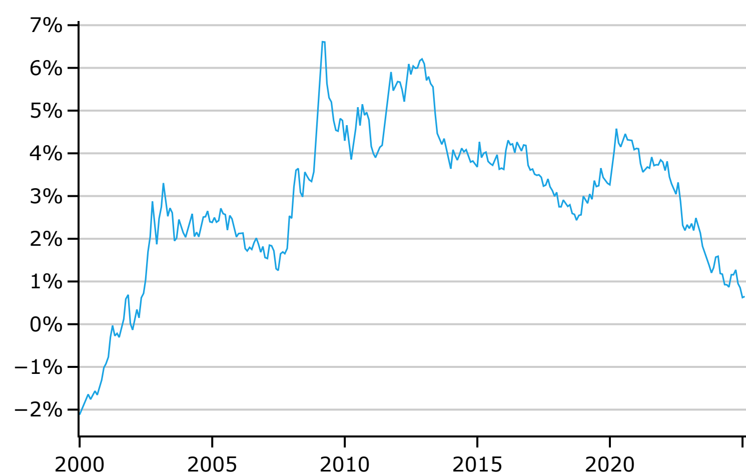
Composite Value Indicator Model



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. *State Street: Country Chartbook 12 Feb 25. **JP Morgan Equity Strategy:Q4 Earning Season Tracker 14 Feb 25.

Sources | S&P 500 PE: Bloomberg as at Feb 2025. CVI Model: CCLA as of Feb 2025, Shiller PE/CAPE: Morgan Stanley, Equity Risk Premium: CCLA as of Feb 2025

VALUATION

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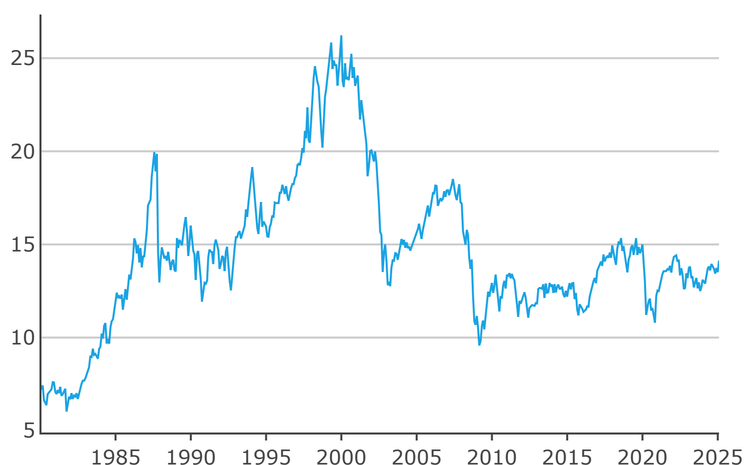
Equity | Regional

Despite ending 2024 on a relatively sombre note, Europe Ex-UK has surged ahead in 2025 with YTD returns exceeding 10%*. Interestingly, from a macro perspective, little has changed: Eurozone trend GDP growth estimates remain weak, geopolitical uncertainty continues to cloud major economies like Germany and France, and despite multiple rounds of stimulus, China's economy has yet to show significant recovery. Furthermore, the EU faces high risks of tariffs from the US.

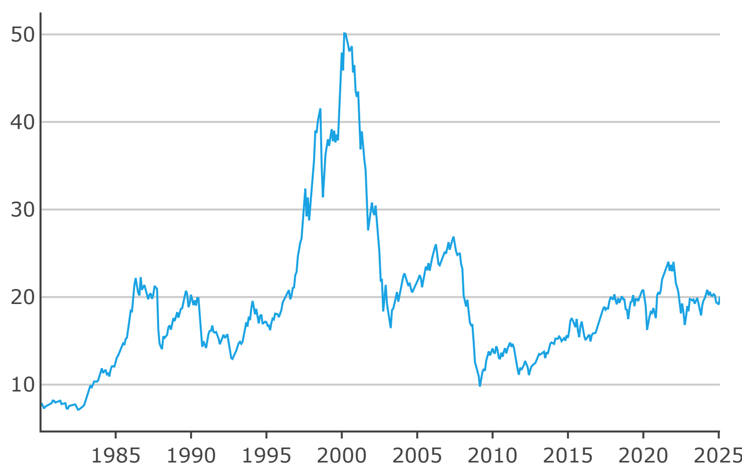
So, what explains this strong performance? Key drivers include relatively cheap starting valuations, falling interest rates, and the potential for a peace-deal between Ukraine and Russia, coupled with prospects of higher defence spending. Earnings revisions have stabilised too, with 2025 EPS growth now expected ~8%. Sectors such as Communication Services, Consumer Discretionary, and Finance have driven most of the returns.

Europe

UK | Shiller P/E

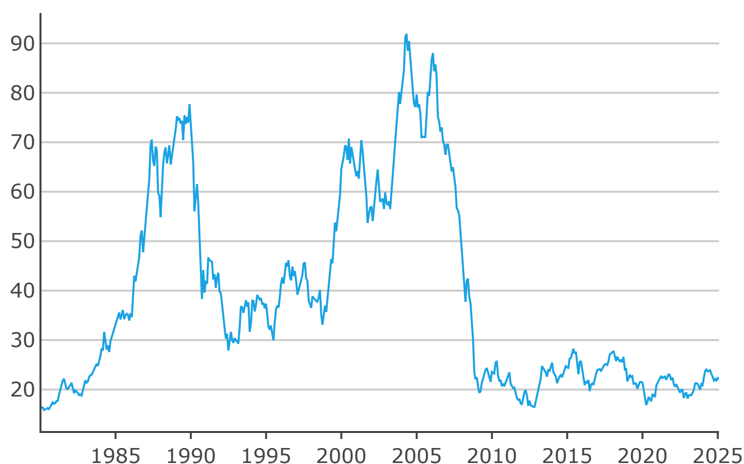


Europe (Ex-UK) | Shiller P/E

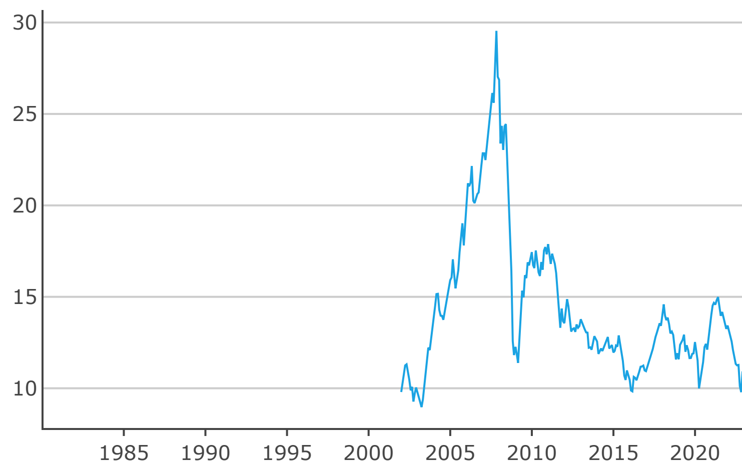


Asia & Emerging Markets

Japan | Shiller P/E



EM | Shiller P/E



Sources | Shiller P/Es: Morgan Stanley as of Jan 2025. Shiller P/E is calculated as today's price divided by the real average earnings of the last 10 years. *MXEUG 17 Feb 2025.

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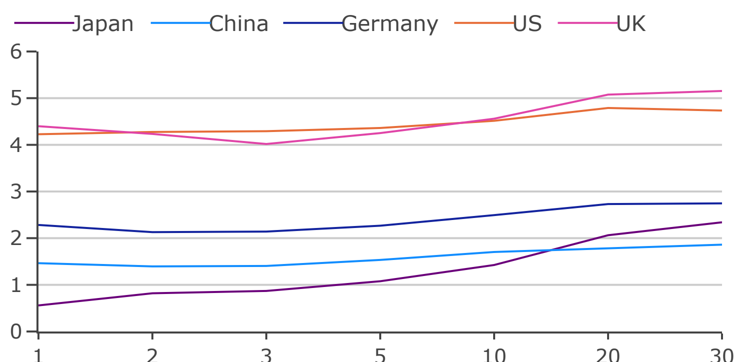
Bonds - Sovereigns

Continuing with Europe, fiscal management remains a significant hurdle for Germany and France, albeit in different ways. In Germany, the ‘debt brake’ *legally* restricts borrowing to 0.35% of GDP annually, limiting government spending and leading to deteriorating public services and infrastructure over the years. The upcoming German election is set to focus heavily on loosening the 'debt brake' to increase fiscal support. **Consequently, German Bunds have experienced a 7bps-15bps rise across the curve since January**.

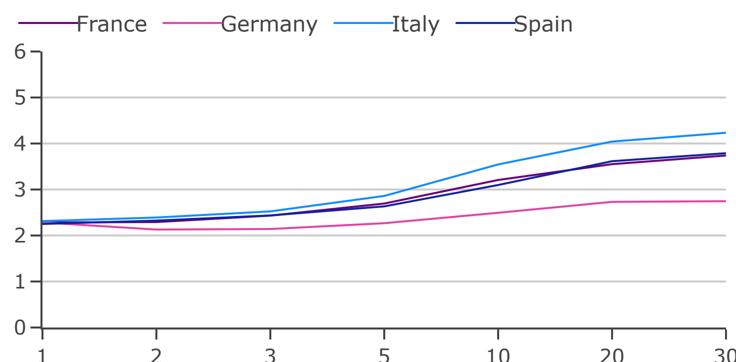
Meanwhile, France’s deficit, although significant at ~6%*, is self-governed, creating a parliamentary tug-of-war and multiple unsuccessful budgets. Ultimately, Article 49.3 was invoked in February to pass the budget without a full vote. **The political risk was priced in throughout last year, meaning there was no real change to OATs year-to-date.**

Global Government Yields

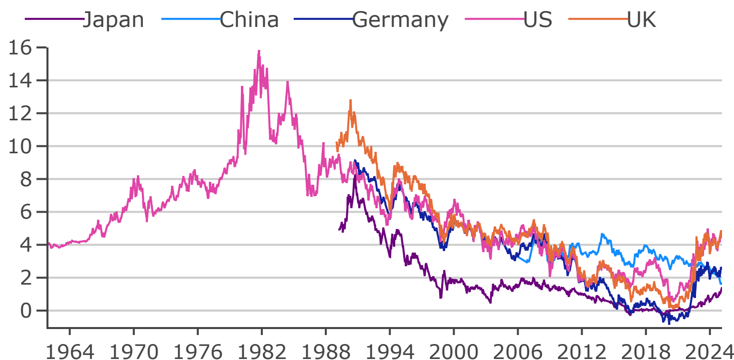
Global Treasury Yield Curves (Term vs %)



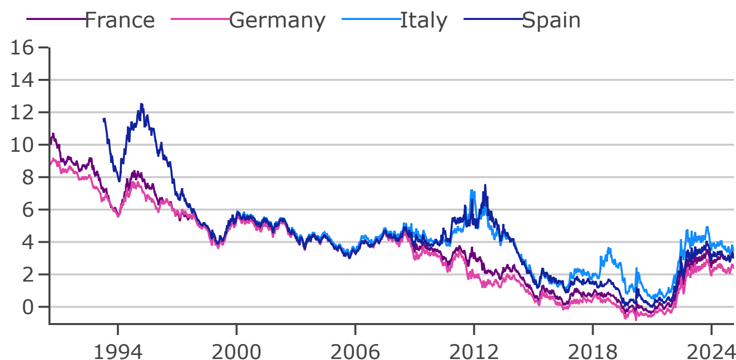
European Treasury Yield Curves (Term vs %)



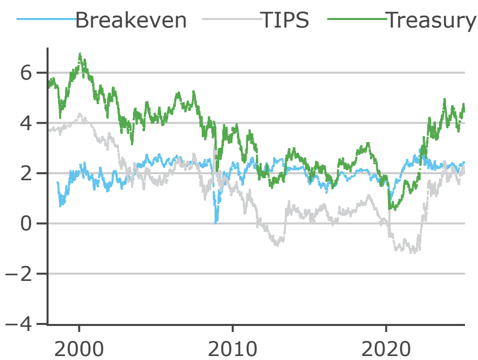
Global 10Y Yields %



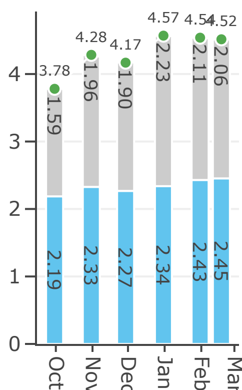
European 10Y Yields %



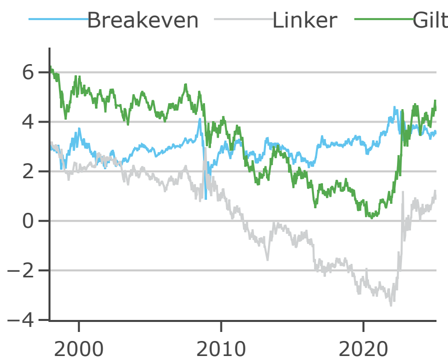
US 10Y Yields Breakdown %



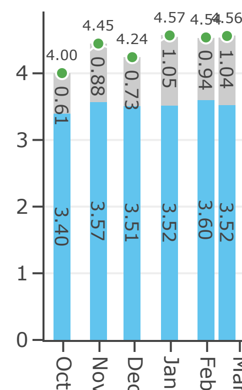
Last 6 Months



UK 10Y Yields Breakdown %



Last 6 Months



Sources | CCLA, Bloomberg as at Feb 2025.

Notes | * 2024 budget deficit.

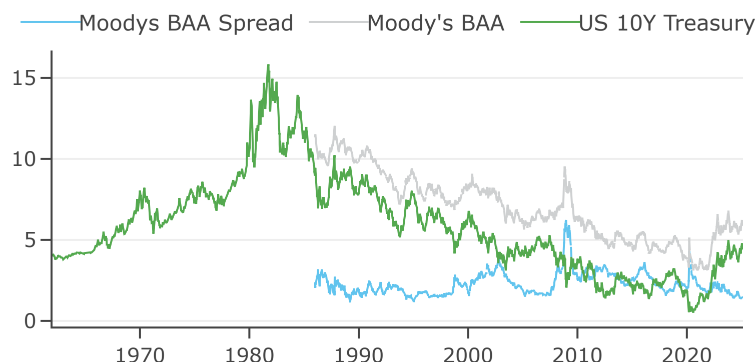
Bonds - Credit

High-yield spreads have stayed at multi-year lows of 2.6%, yielding about 7%, yet this conceals some underlying issues. Recent CPI figures have led the Fed to adopt a more cautious approach, lowering expectations for rate cuts this year. This has kept floating rate products like leveraged loans and high-yield credit in favour.

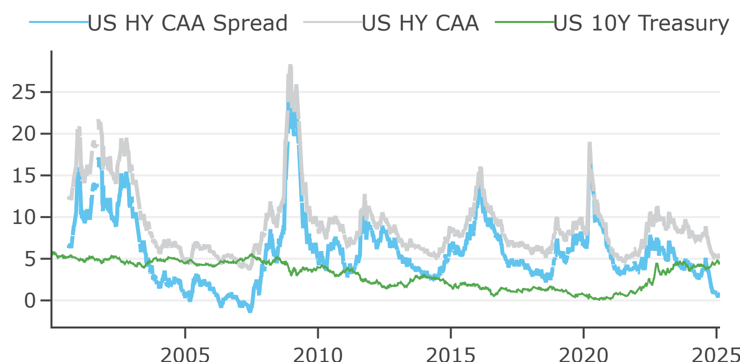
However, capital is not equally available across the market. **Lower-quality issuers, especially those in the bottom decile, are struggling to attract investors.** The CCC segment is particularly distressed, with default rates hitting 32% by par and 19% by issuer, mainly due to cash flow pressures from higher interest rates. Since mid-2024, CCC-rated issuers have seen a net migration of -25% (upgrades vs. downgrades) compared to just -2.7% for B-rated issuers*. **Although higher-rated HY issuers are faring better, we believe the spreads remain too tight and are not looking to extend our position in this space.**

Global Credit Yields

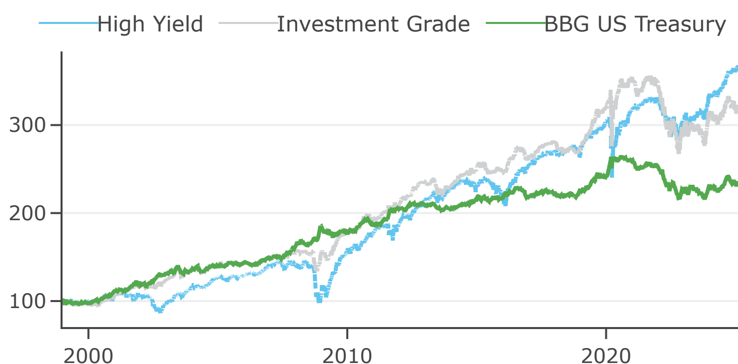
US Corporate Investment Grade Yield %



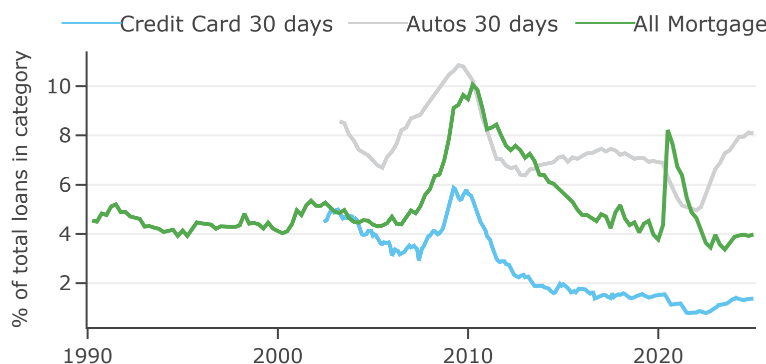
US Corporate Investment Grade Yield %



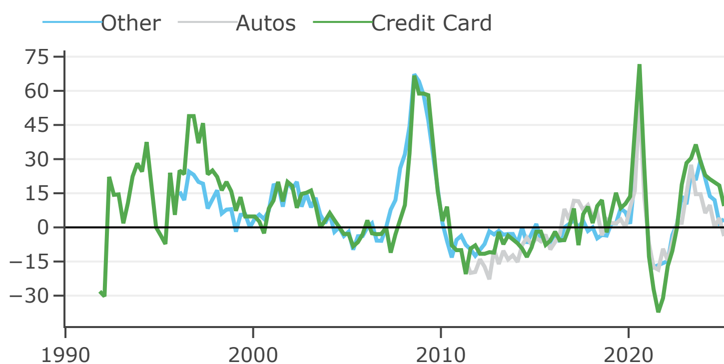
US Tr. vs IBoxx IG and HY Total Return $ (100= 31 Dec '98)



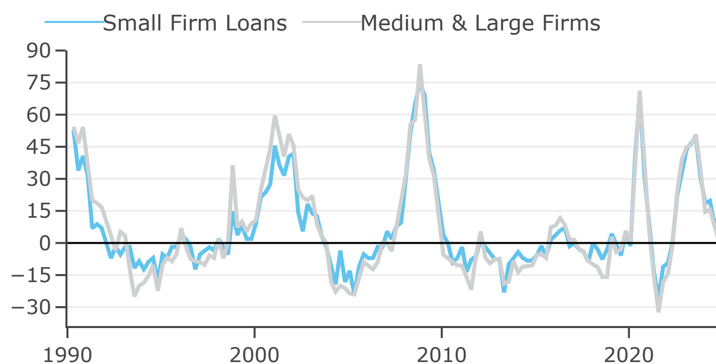
US Delinquencies %



Net % of Banks Tightening Consumers Credit Conditions



Net % of Banks Tightening C&I Credit Conditions



Sources | Federal Reserve, Senior Loans Officers Survey, CCLA, Bloomberg as at Feb 2025.*Figures taken from Bank of America: Collateral Thinking: Time to bu
hooks? 13 Feb 25.

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Alternatives

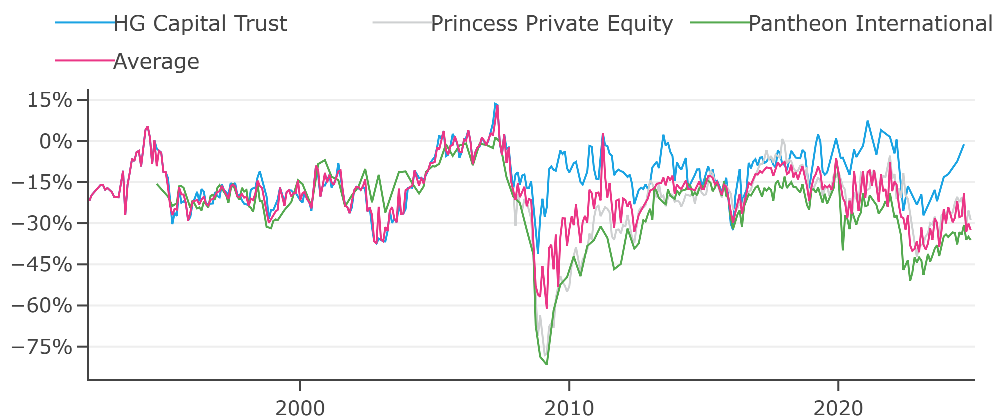
The private equity (PE) market has shown a modest return of +6.4% between Q1-Q3 '24, in contrast to the more robust +22% from the S&P 500 and +11% from the Russell 2000, over the same period. Nonetheless, analysts are increasingly optimistic about the outlook for PE, particularly in the US, due to favourable regulations, strong consumer demand, healthy corporate balance sheets, and the potential for central bank interest rate cuts.

However, challenges persist. The gap between capital calls and distributions remains a concern, compounded by the fact that older assets have not been fully repriced. Policy risks, including tariffs and immigration, add headwinds to the interest rate path. But, despite these hurdles, Q4 2024 saw an uptick in company acquisitions, which could provide a boost to distributions. **Newer PE funds are performing better, primarily due to their reduced reliance on debt and the lower valuations of new investments, which have returned to pre-pandemic levels.**

Global Valuations

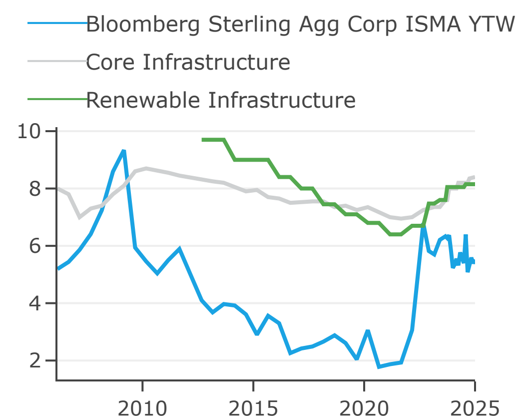
Listed Private Equity

Discount To NAVs



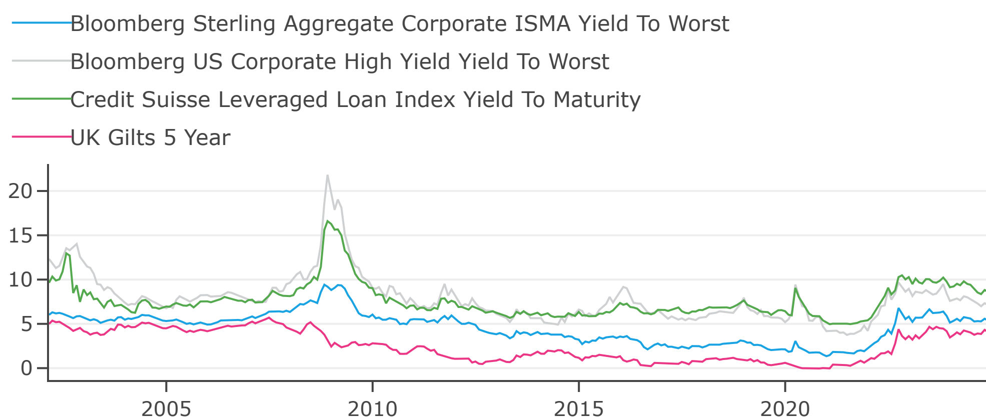
Infrastructure

Infrastructure Discount Rates vs Bond Y…



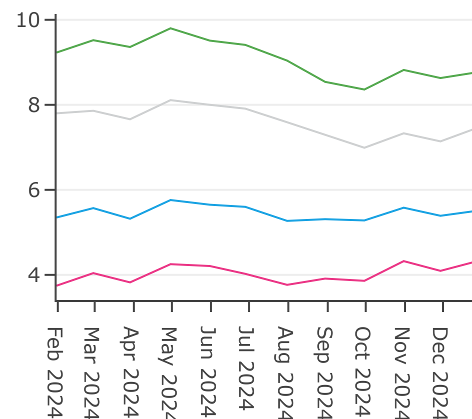
Contractual Income

Income Yields



Last 12 Months

Income Yields



Sources | Infrastructure: CCLA, Bloomberg; Bloomberg; Private Equity: Bain Global Private Equity Report, Bloomberg, Pitchbook; Contractual Income: Bloomberg, Pitchbook. As of Feb 2025. JP Morgan: Alternatives Investment Outlook & Strategy 6 Feb 25, used as source for the commentary.

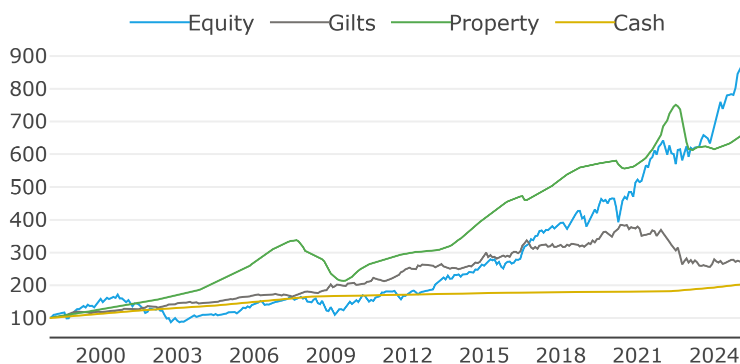
Property

2025 continues the trends of 2024. All-property equivalent yields hover around 7%, mainly driven by rental growth, while property yields fluctuate with the bond market. The rise in UK 10Y Gilts has pressured property yields in January, but a quick recovery following the CPI reading suggests the damage is unlikely to be long lasting. UK property market saw an annual total return of 6.9%, with Residential continuing to outperform at 10%, and Industrials close behind.

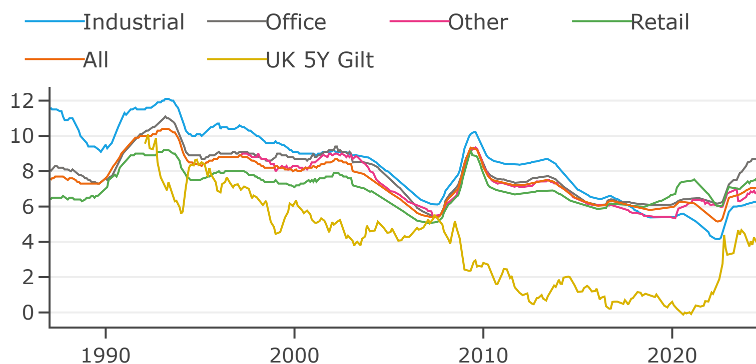
Looking ahead, prospects are positive. Credit conditions for commercial real estate continue easing, the Bank of England cut rates in February, and vacancy rates appear stable. The all-property equivalent yield remains attractive at ~4.5% real*. However, potential risks include subdued growth impacting rental yields and further spill-over effects from the US into UK bond markets.

UK Commercial Property Market

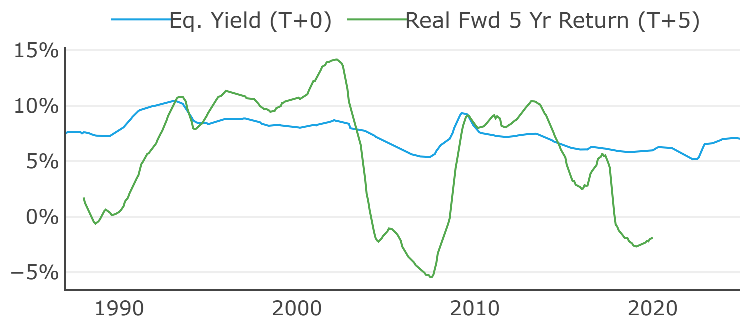
25 Years Of Return 1998=100



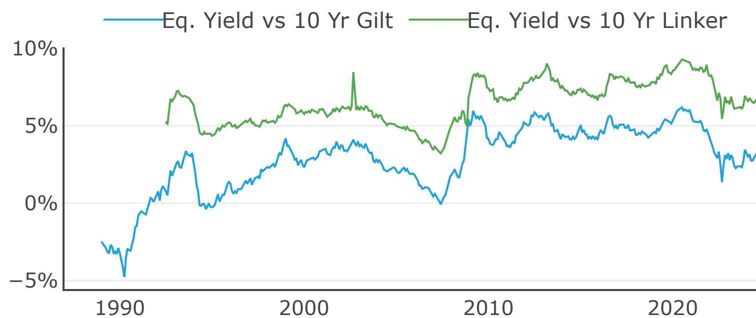
Equivalent Yields vs Gilt Yields %



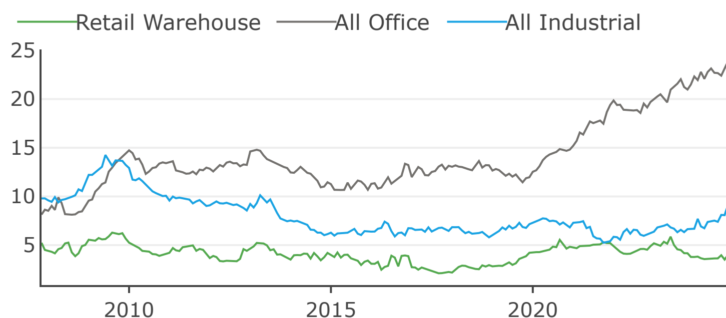
MSCI UK All Property Monthly TR Index %



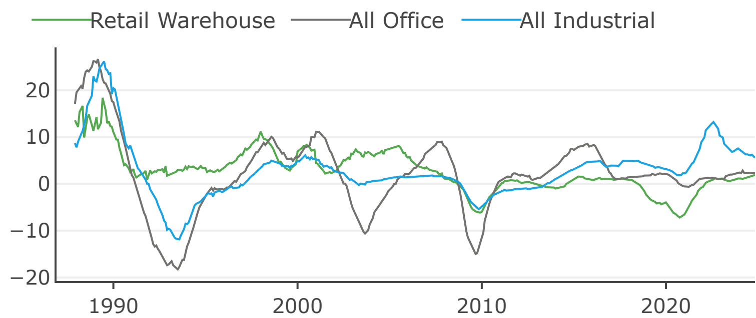
MSCI UK All Property Index - Equivalent Yield Spreads



Vacancy Rate %



Nominal Rental Value YoY Growth %



Sources | Equivalent Yields, Vacancy Rate, and Nominal Rental Value charts: MSCI UK Monthly Property Index as at Jan 2025. 25 Years of Return, All Property Monthly TR Index as at Jan 2025. *All property equivalent yield (7%) - inflation expectation (2.5%).

VALUATION

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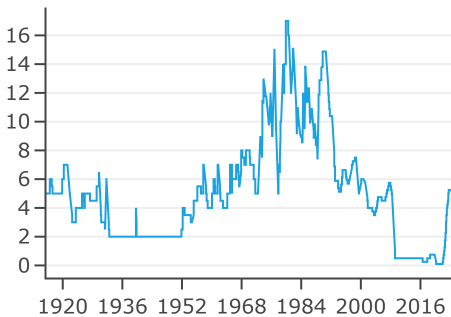
Cash

The UK has a monetary rate on par with the USA but a growth rate mirroring Europe. This is creating unnecessary restrictiveness. The latest CPI reading at 3% and ONS private sector wage inflation at 6.2% have cemented the BoE's concerns about wages fuelling sticky services inflation. However, concerns about wage inflation need to be considered with firms' pricing power – which at present is waning due to low consumer confidence, a rise in effective mortgage rates ~4%, and high saving rates. The introduction of NICs has further dampened business sentiment, increasing overheads and risking layoffs. The ability of firms to continue driving up wages is limited.

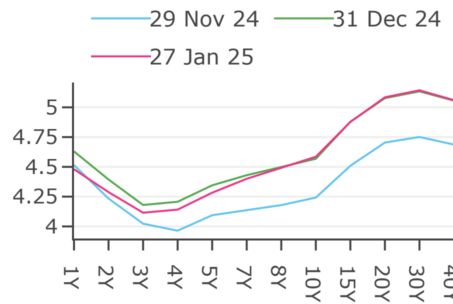
Separately, since 2H '24, expenditure indicators show slowing industry output, low consumption, and low business investment. Government spending did the heavy lifting in Q4 '24 and remains a key growth contributor, but even that is at risk amid shrinking headroom. **The BoE must avoid excessive restrictiveness that could tip the UK into recession.**

UK Sterling Market

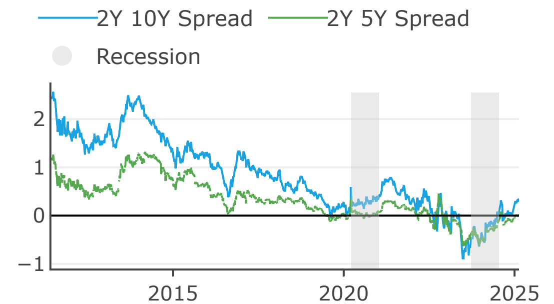
Official Bank Rate



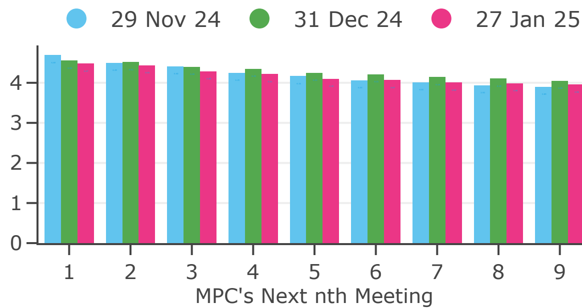
UK Gilt Curve



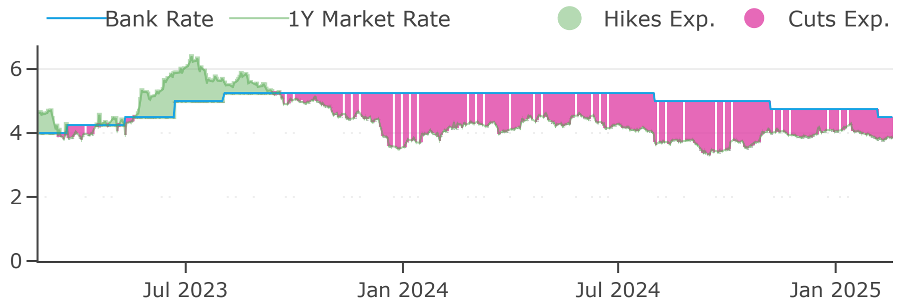
Gilt Spreads



Rate Expectations For Future MPC Meetings



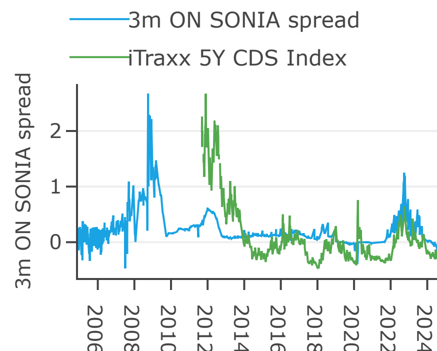
1Y Forward Market Rate Expectations



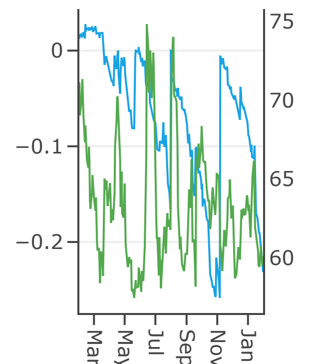
Inflation Readings YoY% | Colour by 10Y Z-Score*

Year	2024					2025
	Au…	Sep…	Oct…	No…	Dec…	Jan…
RPI	3.50	2.70	3.40	3.60	3.50	3.60
CPI	2.20	1.70	2.30	2.60	2.50	3.00
CPI Core	3.60	3.20	3.30	3.50	3.20	3.70
CPI Services	5.60	4.90	5.00	5.00	4.40	5.00
CPI Goods	-0.90	-1.40	-0.30	0.40	0.70	1.00
Priv. Wages	4.60	5.10	6.70	5.90	6.10	

Market Stress



Last 12 Months



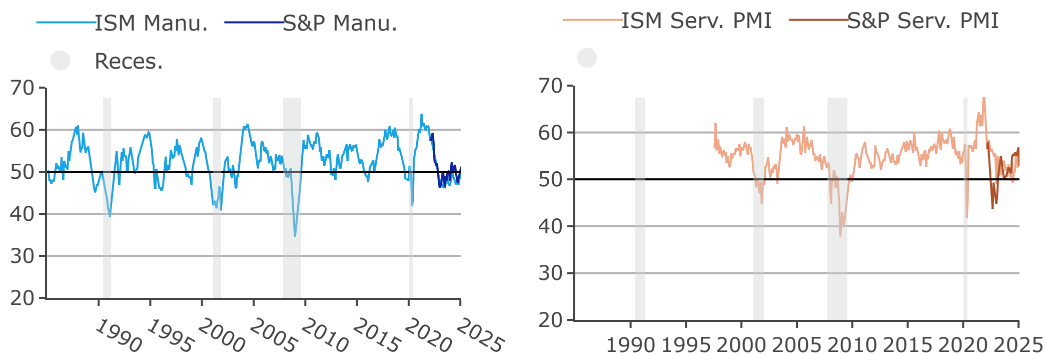
Sources | ITraxx CDS is the Markit iTraxx Europe Senior Financial Index, comprising 30 equally weighted credit default swaps on IG European entities. *10 year z-score applied on each series, coloured using gradient with score of 0 as green, at least +/- 2 standard deviations away scores as red. Bloomberg for all charts, as of Feb 2025.

Global PMIs

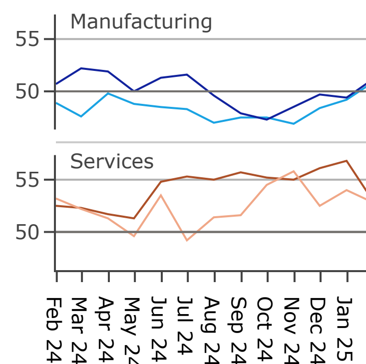
Manufacturing surprised positively with January's reading (released in February), entering expansion territory. Panellists highlighted increases in production, new orders, and employment. This, coupled with the rise in small business optimism, continues to bolster the US economy. Services also maintained their growth, with a PMI just under 53, reflecting ongoing expansion.

However, there are signs of a deceleration. While the economy is growing, the combined manufacturing and services PMI indicates an annualized GDP growth rate of 1.6% for January, compared to 2.4% in the fourth quarter of 2024.

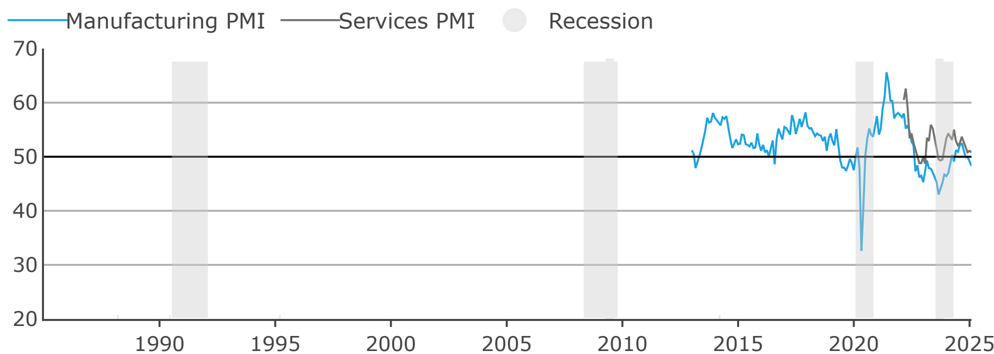
United States



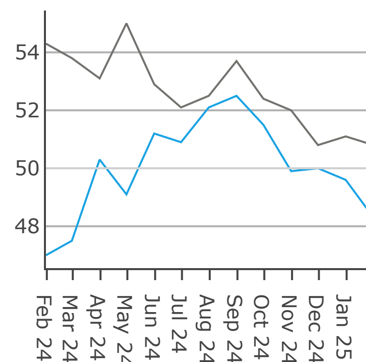
Last 12 Months



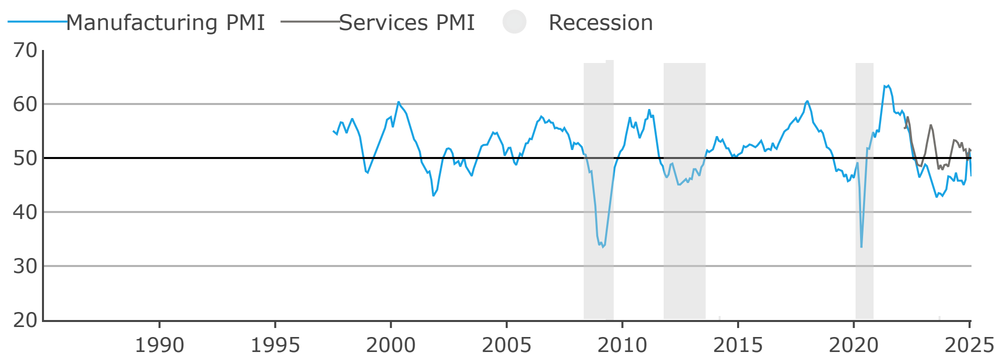
United Kingdom



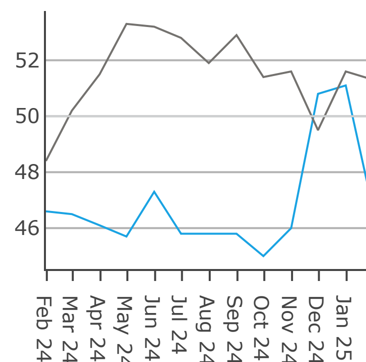
Last 12 Months



Eurozone



Last 12 Months



Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Feb 2025. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP

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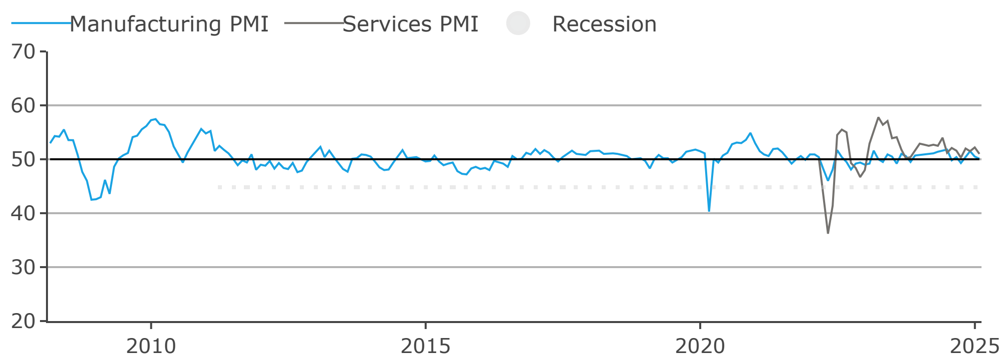
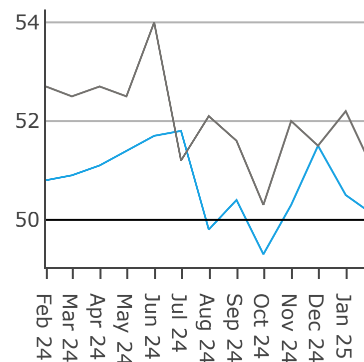
Global PMIs

The Japanese manufacturing sector faced its seventh consecutive month of decline in January 2025, Manufacturing PMI falling to 48.7 from 49.6 in December. This marks the steepest deterioration in ten months, driven by significant reductions in production and new orders. Despite continued hiring and optimism about an eventual demand recovery, business confidence dropped to its lowest in over two years and concerns were raised regarding the timing of any such improvement*.

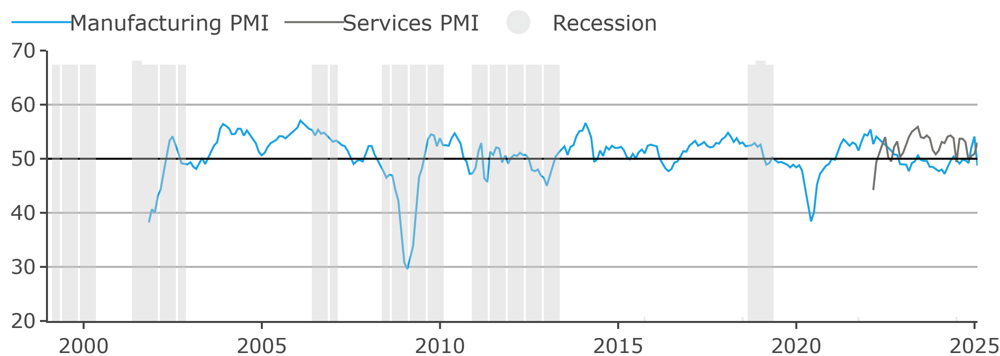
China



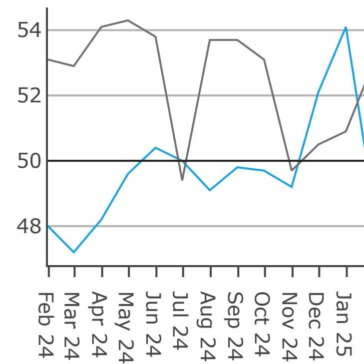
Last 12 Months



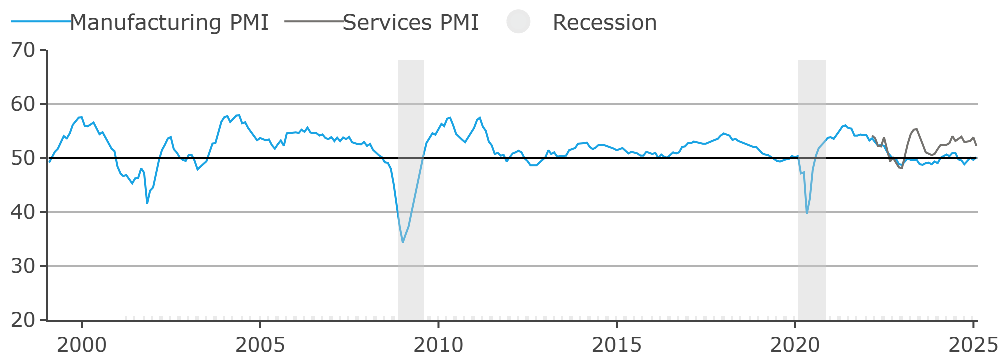
Japan



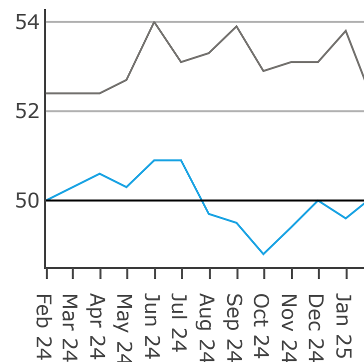
Last 12 Months



Global



Last 12 Months



Sources | US Services and Manufacturing: ISM; All other countries including global: S&P Global as of Feb 2025. Recession defined as two consecutive negative quarters of GDP, recession ends with two consecutive positive quarters in GDP. *www.pmi.spglobal.com Japan Manufacturing PMI news release 3 Feb 2025.

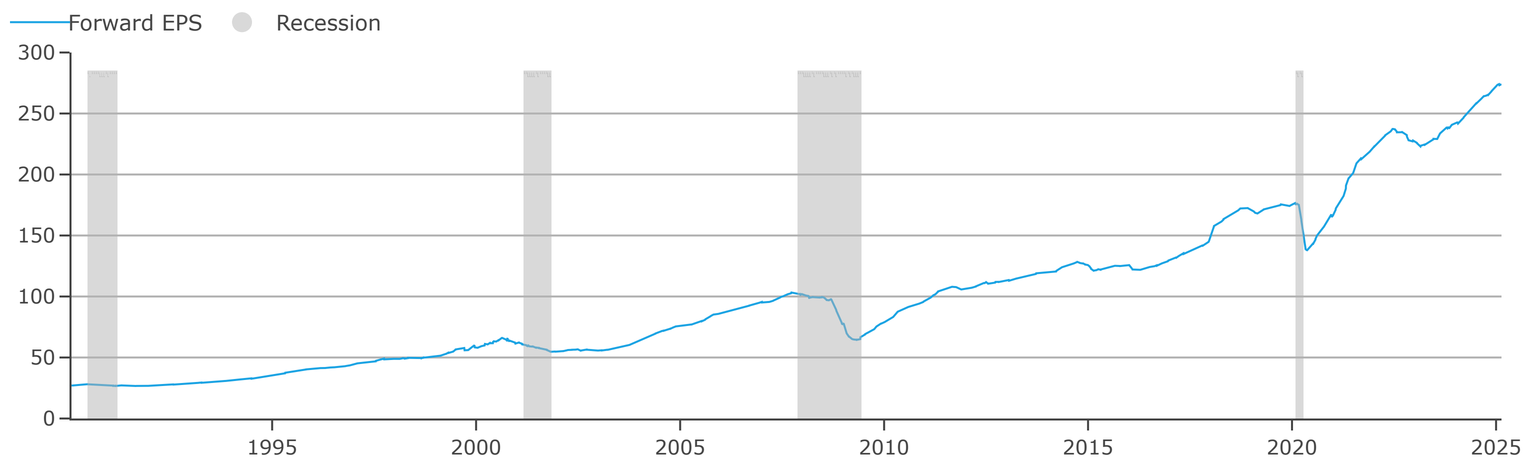
Earnings

The latest earnings season highlights that the US exceptionalism story is far from over. Over ¾ of the S&P 500 companies have reported by the time of writing*, 75% of which beat earnings with an average surprise of ~6%, resulting in another season of double-digit EPS growth (~10%). Sales saw a milder performance with 5% top line growth, nonetheless, still comfortably sitting above the 2001-2021 average of 3.8%.

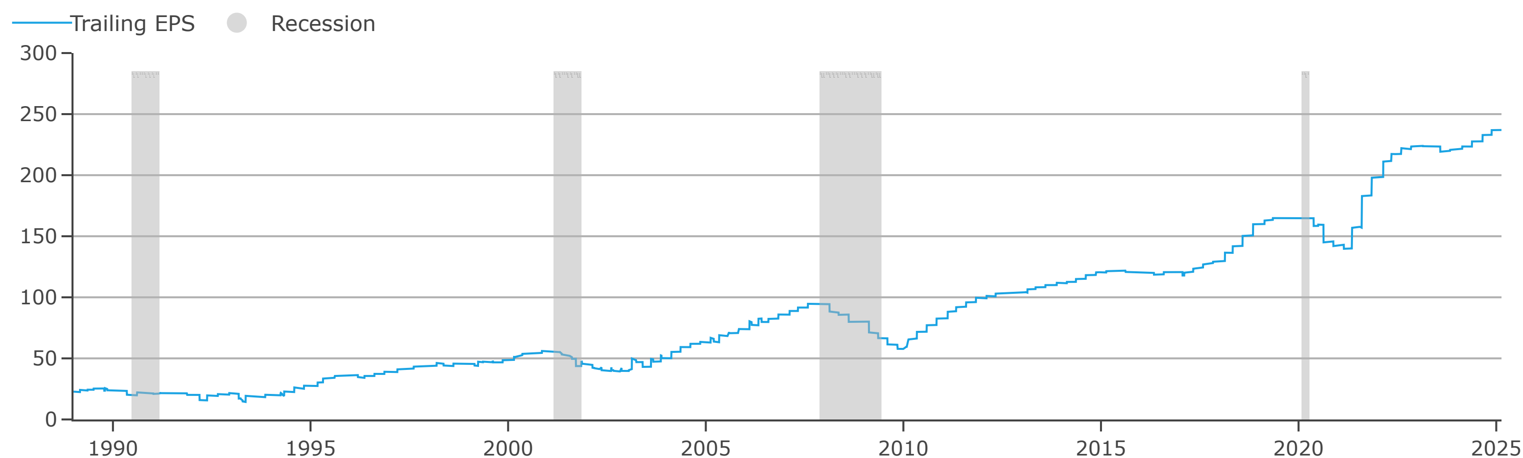
8/11 sectors have seen earnings growth so far with Discretionary, Healthcare, Financial and Real Estate leading the way. Discretionary in particular saw a whopping 30% EPS growth. Restaurants, Travel, Lodgings, Casinos are all experiencing resilient spending trends. **This trend coupled with a soft performance in Staples continues to support the case for strength in the US consumer.**

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 Feb 2025. *17 Feb 2025.

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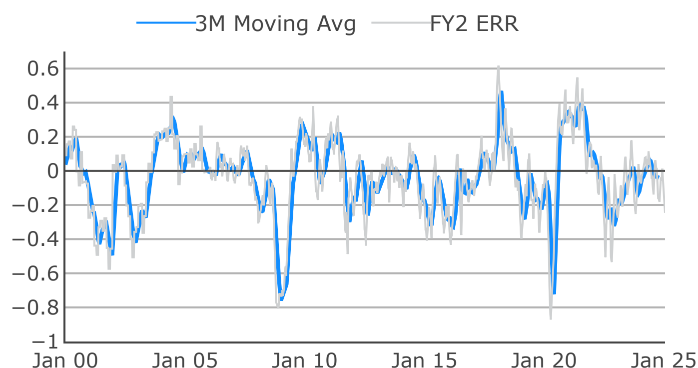
Earnings

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

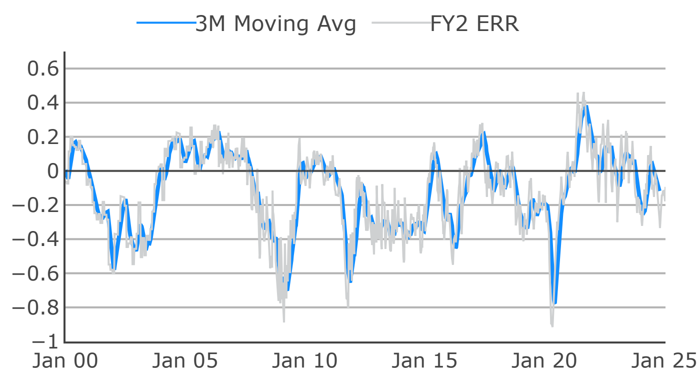
Earnings revisions breadth has deteriorated (but very mildly) over the last few months. However, **revisions are very seasonal and the current change is very much in line with the last 25+ years of average monthly trend revision.** The US was not alone as the UK and EU also faced negative revisions. However, Japan stood out positively driven in part by the strength of their Banking sector.

Global Earnings Revisions Ratios

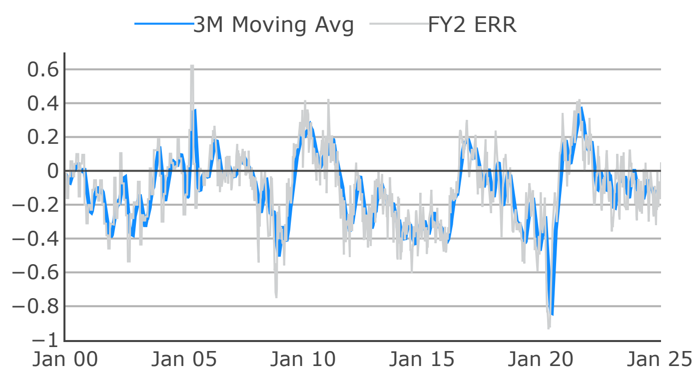
USA



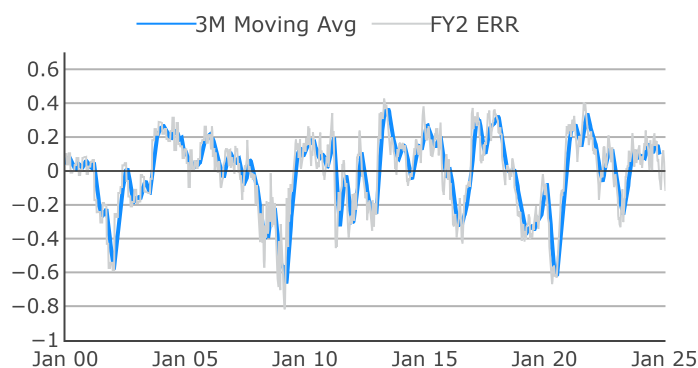
Eurozone



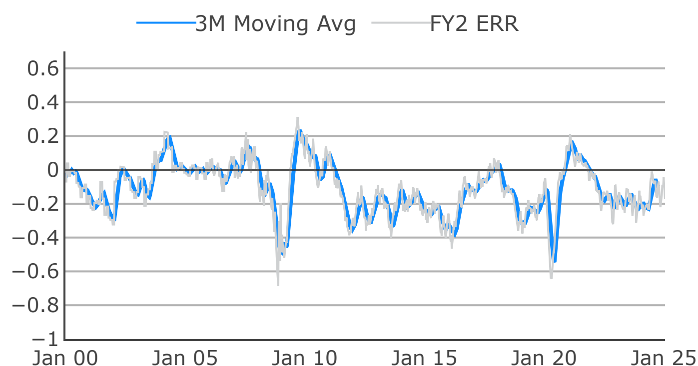
UK



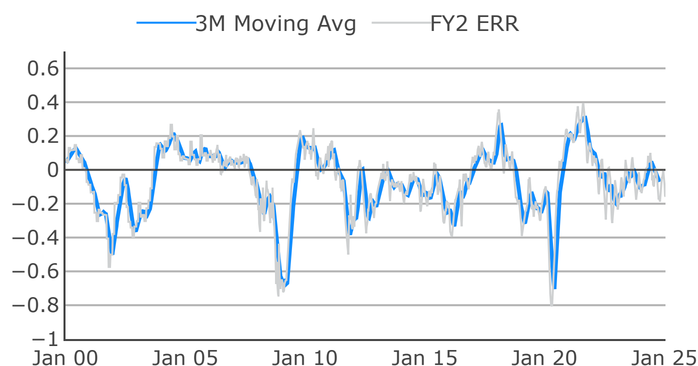
Japan



Emerging Markets



World



Sources | Eikon, the MSCI index has been used for each respective region, as at Feb 2025.

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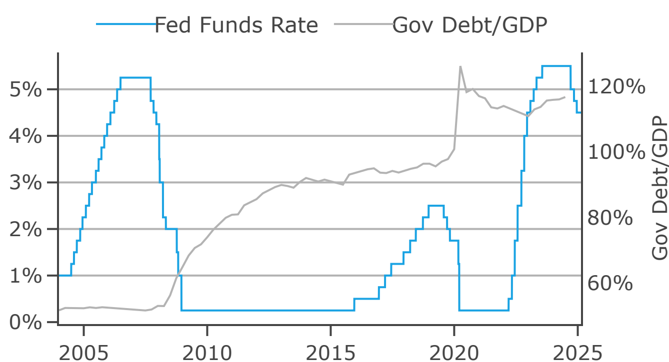
Interest Rates

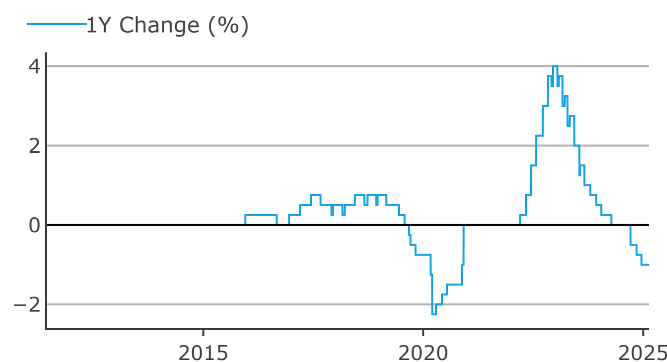
Market tensions rise as China retaliates with 10-15% tariffs on $14bn of US goods, targeting agricultural equipment, vehicles, LNG, and oil. In addition, China restricts rare earth exports to the US, impacting industries reliant on Tungsten and other crucial metals, such as defence manufacturers. US Trade Representative's findings on China's phase one trade deal compliance will be reported on 1 April, potentially escalating tensions further.

Meanwhile, the US imposes 25% tariffs on all steel and aluminium imports. Although the intention is to benefit domestic manufacturers, it should be noted that under a similar regime in 2018 steel prices initially rose, having knock-on effects on steel-using manufactures and directly costing 75k job losses*. **These policies are inflationary (at least initially), which explains the Fed's recent hawkish comments.**

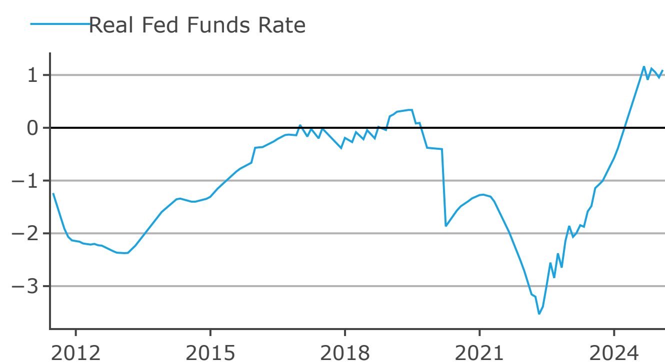
Fed Funds Rate



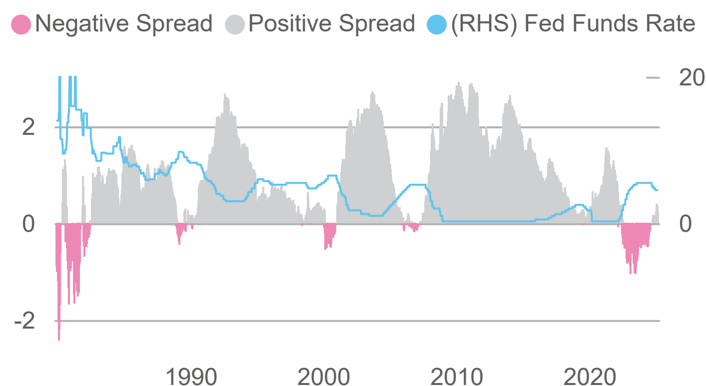
Change in Fed Funds Rate



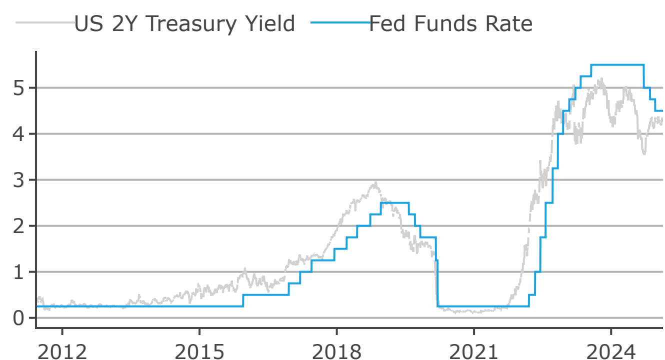
Real Fed Funds Rate (Using 2Y MA CPI)



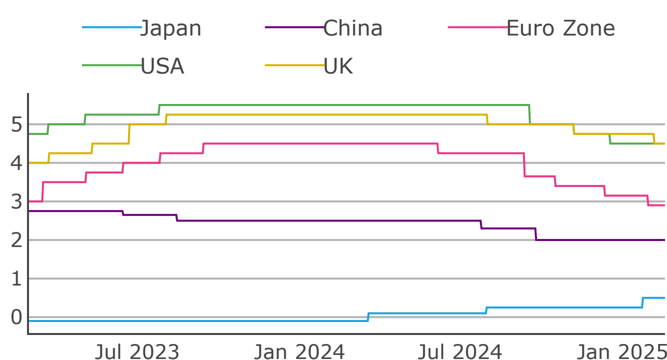
Fed Funds Rate vs 2s10s Curve



Fed Funds Rate vs 2Y Treasury



Global Comparison



Sources | Bloomberg for all charts, as of Feb 2025. *Council On Foreign Relations: 'What Trump's Aluminium and Steel Tariffs Will Mean, in Six Charts' 14 Feb 2025.

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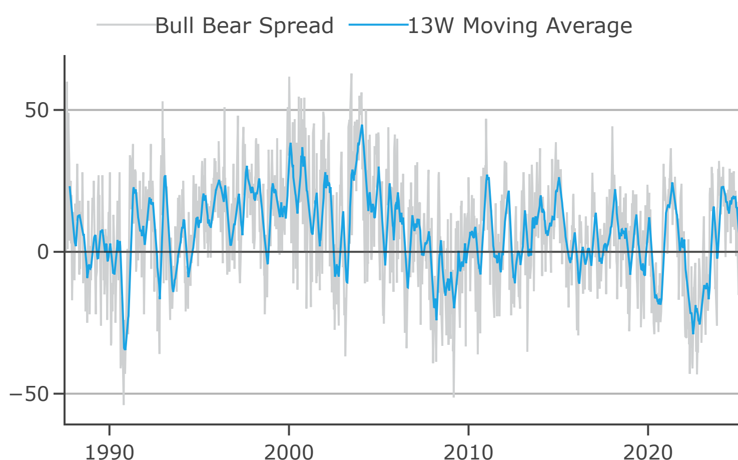
Sentiment

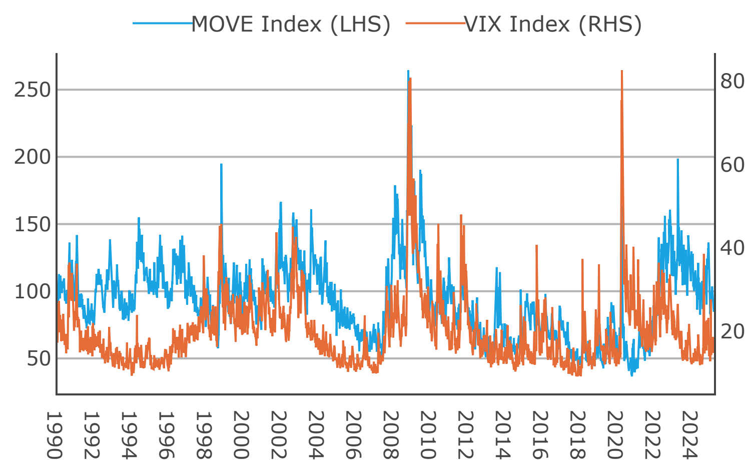
The BAML Hartnett Bull & Bear Indicator has increased towards neutral territory (which remains good for forward returns). Now at 4.8 vs last month at 4.0. The increase can be attributed to improvement in the equity market breadth, increased bond flows and even more equity allocation in long-only positioning.

US Equity Indicators

AAII Bull Bear Spread

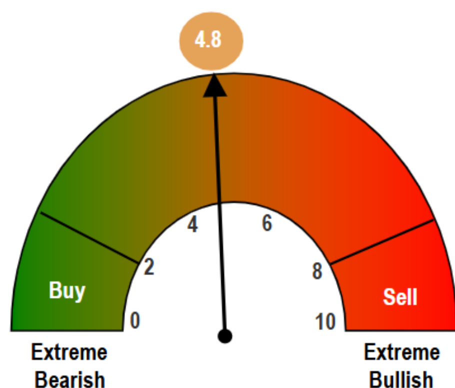


Equity vs. Bond Sentiment

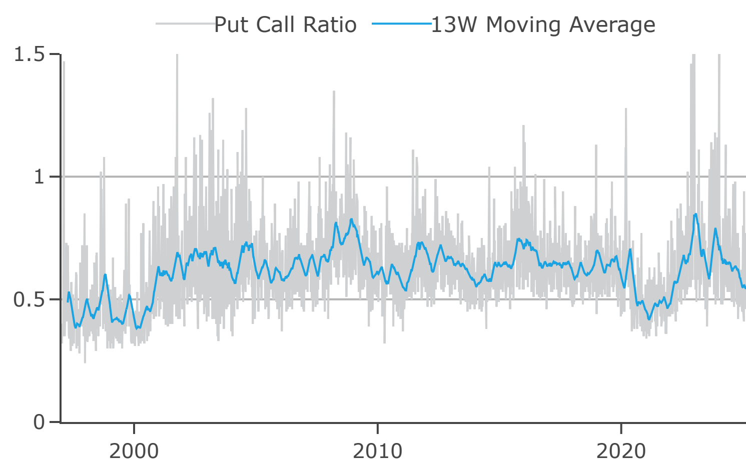


Michael Hartnett's Bull & Bear Indicator (BAML)

Up to 4.8 from 4.3



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 Feb 2025

SENTIMENT

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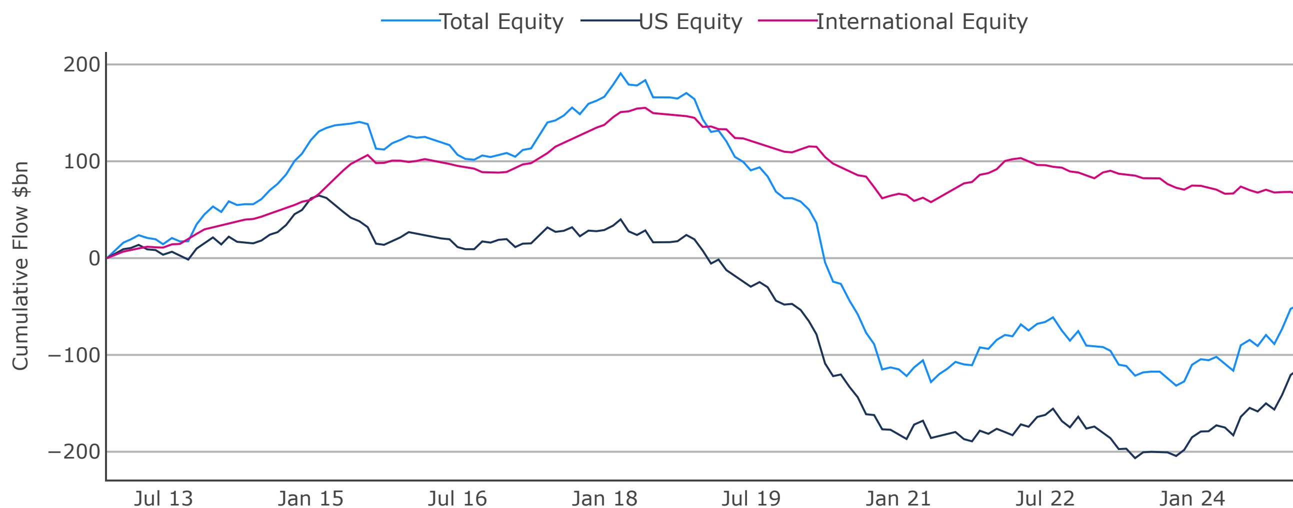
Fund Flows

This page captures US mutual fund flows as reported by the US Investment Company Institute, and flows are shown here as a cumulative total by adding successive months' flows. This excludes ETFs / passive and is therefore only for active flows. In later months we plan to add passive flows to get a feel for how fund liquidity is affecting markets.

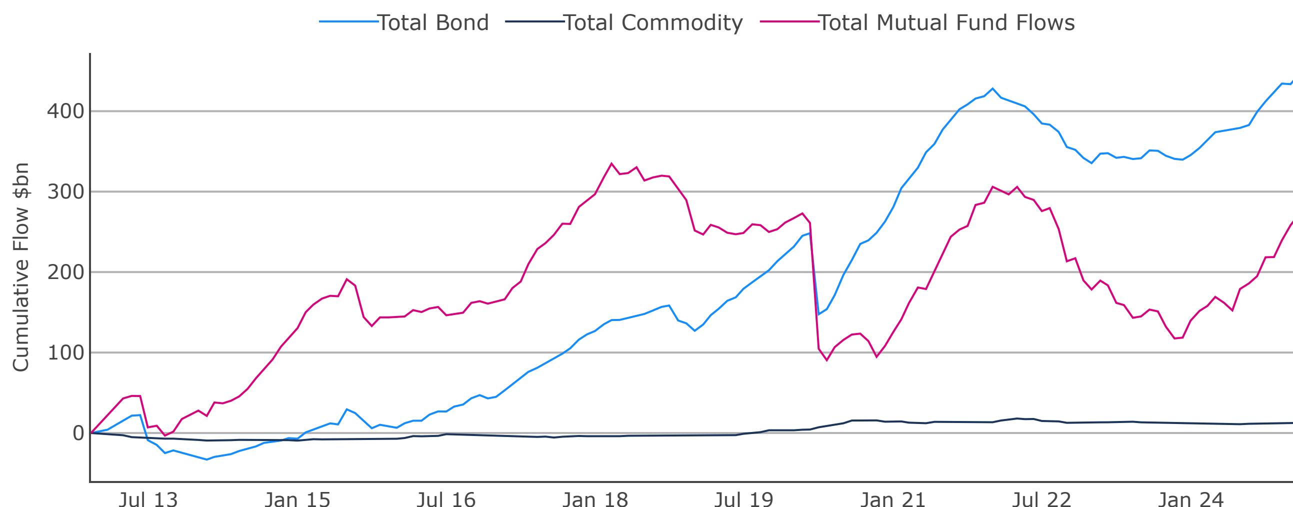
The message in these data points continues to be that there is little enthusiasm for actively managed funds even if the outflows from equity funds have stopped.

US Mutual Fund Flows

Equity Markets Cumulative $bn



Non-Equity Markets Cumulative $bn



Sources | All charts: Bloomberg ICI fund flow data. Data as at Feb 2025

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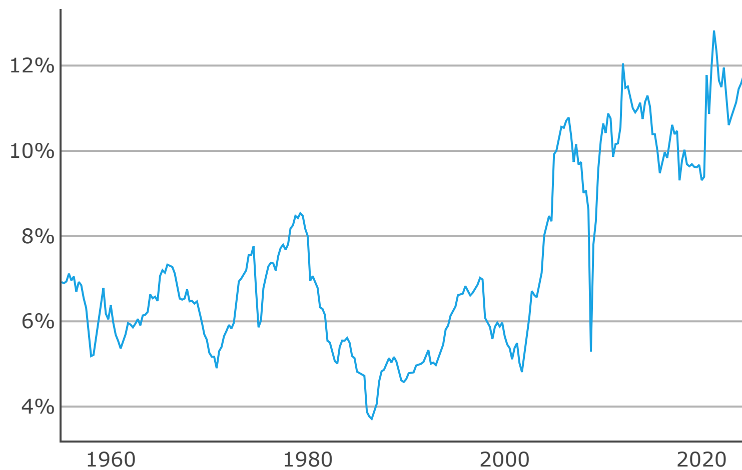
The Big Picture

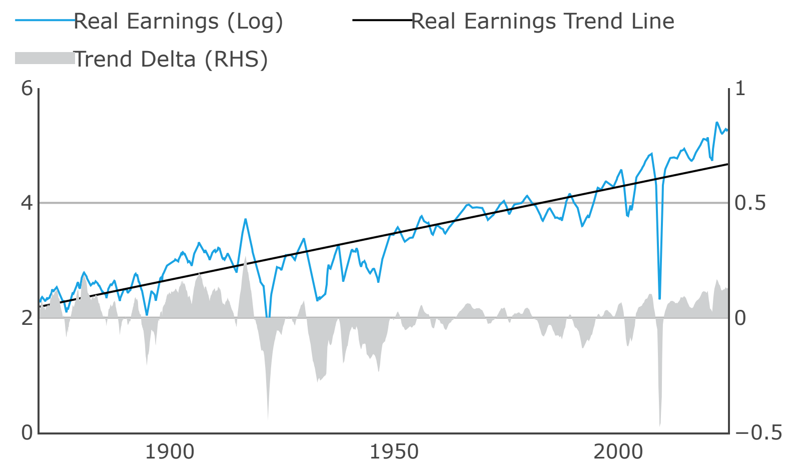
Here we highlight some longer-term imbalances that, **should** they correct, would have an outsized impact on risk asset returns. We don't make predictions but we do watch these. US corporate profit is just off the highest share of GDP that it has ever been since 1929. Its corollary (not shown) is that the wage share is at the lowest level it has been in almost as long. Allied to this, the top right chart shows that earnings are as far above their long run trend in absolute terms as they have also been since 1929. Domestic non-financial debt is also extremely elevated. All of this suggests that if old relationships hold and we get mean reversion, forward 10 year returns could be much lower than suggested by the ERPs.

Long Term Inbalances

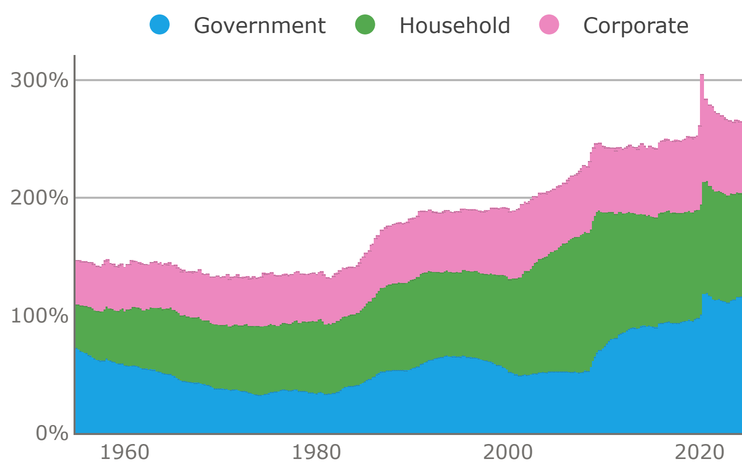
Profit Share of GDP



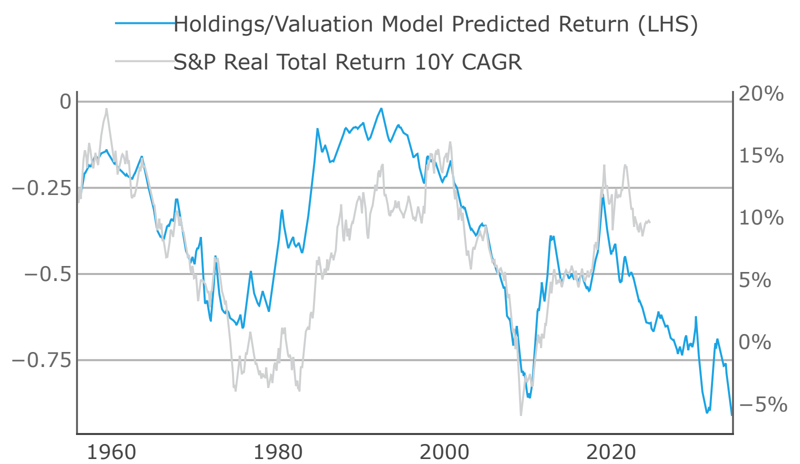
Earnings Deviation From Trend



Non Financial Debt as Share of GDP



S&P 500 10Y Forward Returns



Sources | Profit Share of GDP, and Non Financial Debt as Share of GDP: Federal Reserve Economic Data (FRED); Earnings Deviation From Trend: CCLA using Shiller CAPE data from Yale.edu; S&P 500 10Y Forward Returns: Holdings/Valuation Model uses three inputs: Tobin's Q, Shiller CAPE and Household Equity Holdings to predict 10Y forward returns. All data refreshed as at Jan 2025.

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