

"The energy of the mind is the essence of life."

Aristotle

1. BOND MARKET

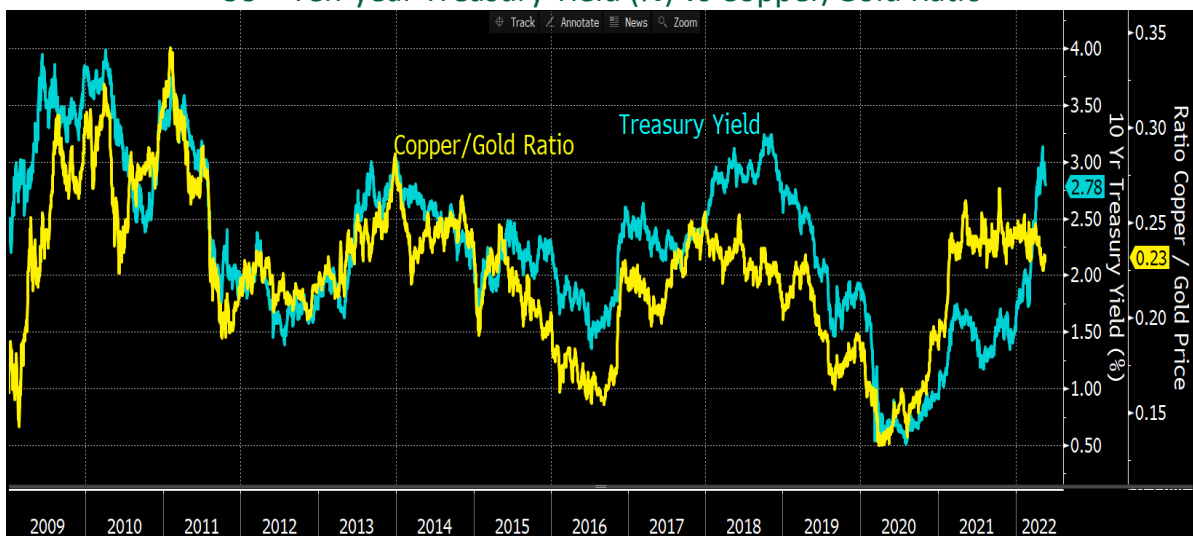
The exceptionally liquid US bond market is a good barometer of the fundamental economic backdrop.

US – Ten-year Treasury Yield vs Inflation Expectations (%)



With the current high US inflation levels and the central bank tightening, the Treasury yield this year has increased from 1.5% to a peak of over 3.1%. This level corresponds with peak levels over the past ten years. It has since receded to 2.8%. Ten-year inflation expectations followed a similar track, currently at 2.6%, above peak levels over the same period, but strikingly also receding. It seems that the US bond market has found a solid footing for the moment and is less volatile than what many had feared.

US – Ten-year Treasury Yield (%) vs Copper/Gold Ratio

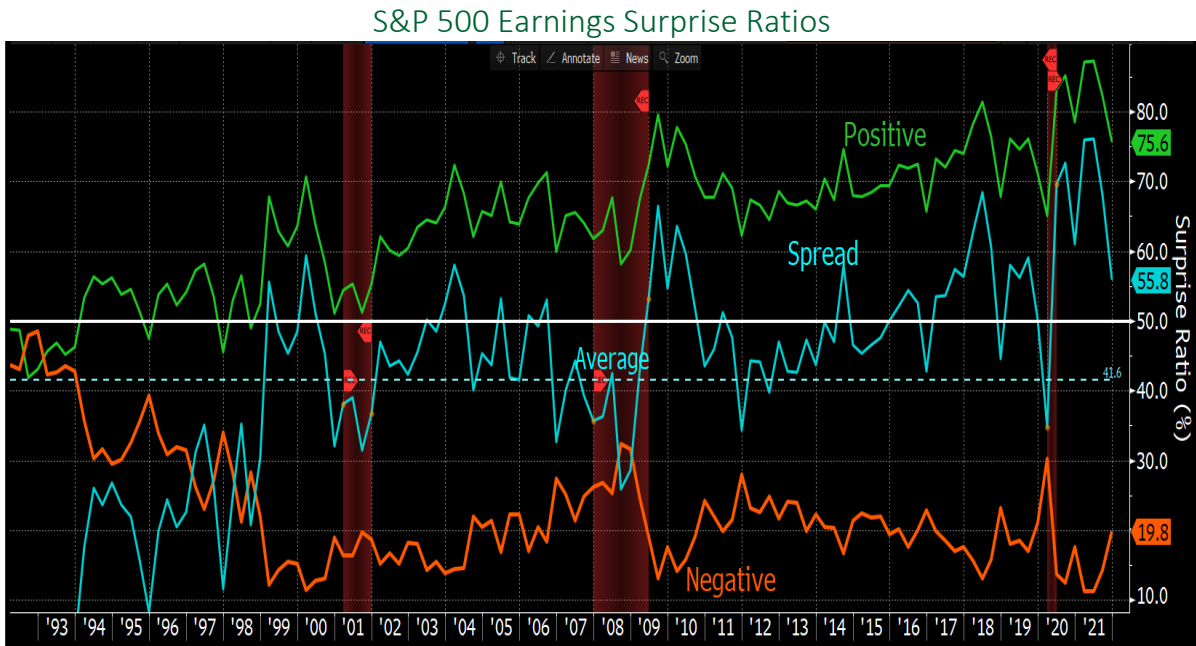


The preceding statement is supported also by the above chart comparing the Treasury Yield with the Copper/Gold ratio. The relationship between the two series has remained relatively intact, with the Treasury Yield recently receding along with the Copper/Gold ratio. It therefore seems that longer duration bond yields continue to be driven by economic fundamentals rather than being dominated by inflation scares alone.

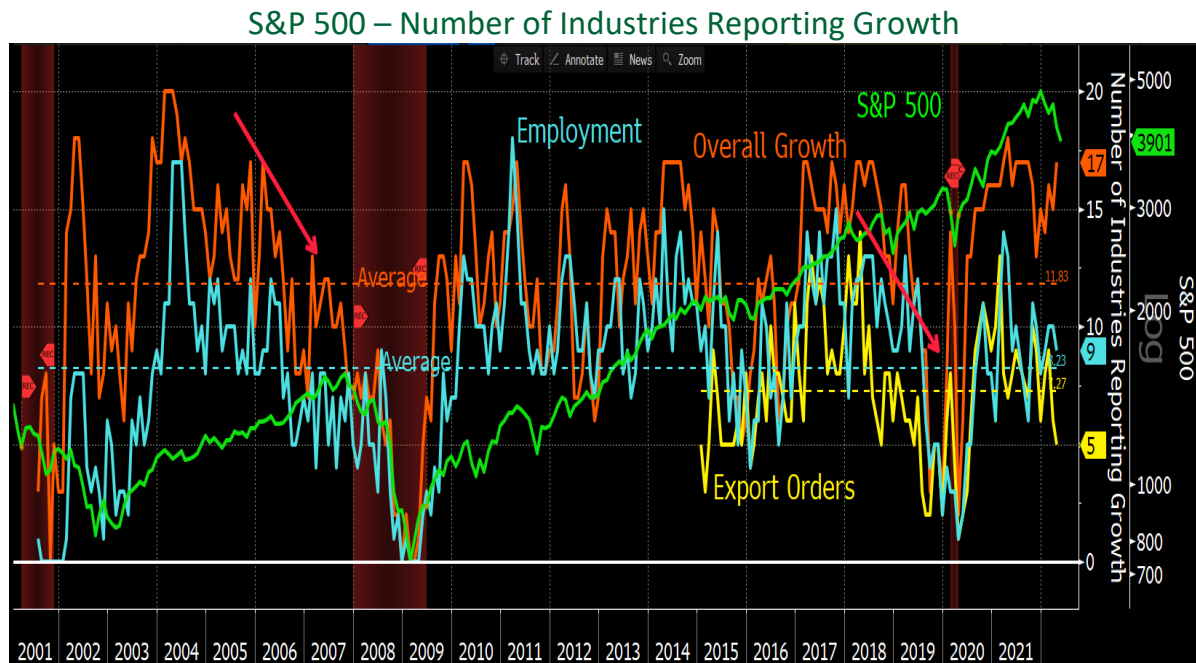
Source: Bloomberg & Stonehage Fleming Investment Management Limited. May 2022. **Past performance is not a guide to future performance.**

2. US REPORTING SEASON

The US reporting season is almost done with 95% of the S&P 500 companies having already reported.



Over three quarters of the companies reported better than expected earnings, with less than 20% of them reporting worse than expected earnings. The spread between these two numbers (the blue line in the above chart) is well above average.



Seventeen of twenty industries reported overall growth – an elevated number compared to historical experiences. Only five experienced export growth – a low number historically. The US export market is weaker than usual, with the strong Dollar also hampering these activities.

It seems that Corporate US has been well on track operationally over the first quarter. Seeing the message in lower recent bond yields, we should not expect the above positive picture to continue in the second quarter. That said, there are no clear signals yet of a materially deteriorating US economy.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. May 2022. **Past performance is not a guide to future performance.**



3. VALUATIONS

The stock market is not always driven by valuations, but with the current volatile conditions valuation is clearly in the spotlight from a risk perspective. We consider a few charts in this context:

S&P 500 – P/E Ratio and Forward P/E Ratio



Both the historic and forward P/E ratios in the above chart have dropped materially to marginally below their respective long-term averages. As an indication of the de-rating the market has already undergone, the latter is down -36% since its peak just over a year ago. On this absolute basis, it seems most portion of the derating is done. However, it is unlikely investors will be able to, anytime soon, look forward to a positive turn in ratings and instead will need to rely on operational growth in their businesses for positive equity returns.

S&P 500 – Forward earnings Yield vs Treasury Yield (%)



The Earnings Yield in the above chart is currently at 5.8%, close to its 20-year average (as concluded on the previous chart). The ten-year Treasury yield is currently 2.8%, leaving a spread of 3.0% between the two values. This spread is close to its 20-year average, leaving equity valuations fairly valued on a relative basis.

Even though Treasuries are currently stable, we should prepare for a further increase in yields. This brings us back to the important point of the need for good organic business growth to compensate for the potential of rising interest rates. From a risk perspective, therefore, sharply rising rates can be a threat to equity returns.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. May 2022. **Past performance is not a guide to future performance.**



S&P 500 – Index vs Consensus Valuation



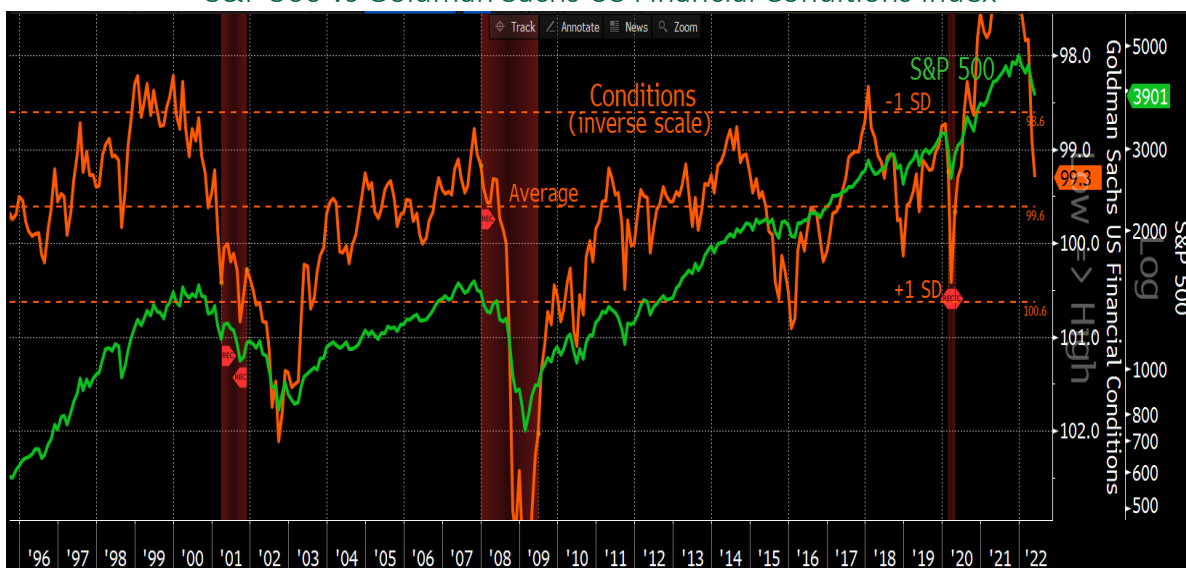
The orange line above reflects the analyst consensus valuations of all the S&P 500 index constituents, consolidated into the index valuation. The blue line in the second chart above reflects the upside valuation on this basis (this chart is advanced for one year). The purple bars in the bottom chart reflects the one-year capital returns on the corresponding valuations.

The consensus valuation currently shows a +30% upside, with its broken horizontal blue line showing that such a level of upside (or more) has occurred only three time before over the past ten years. Those occasions have rendered one-year capital returns of +25% or more (see the vertical white lines and the corresponding purple bars). From a fundamental value perspective, therefore, the stock market seems to be attractively valued.

4. FINANCIAL CONDITIONS

Goldman Sachs offers a valuable Financial Conditions index. It considers no-risk interest rates, equity valuations, credit spreads and exchange rates as they impact on GDP. The index is reflected in the following chart:

S&P 500 vs Goldman Sachs US Financial Conditions Index



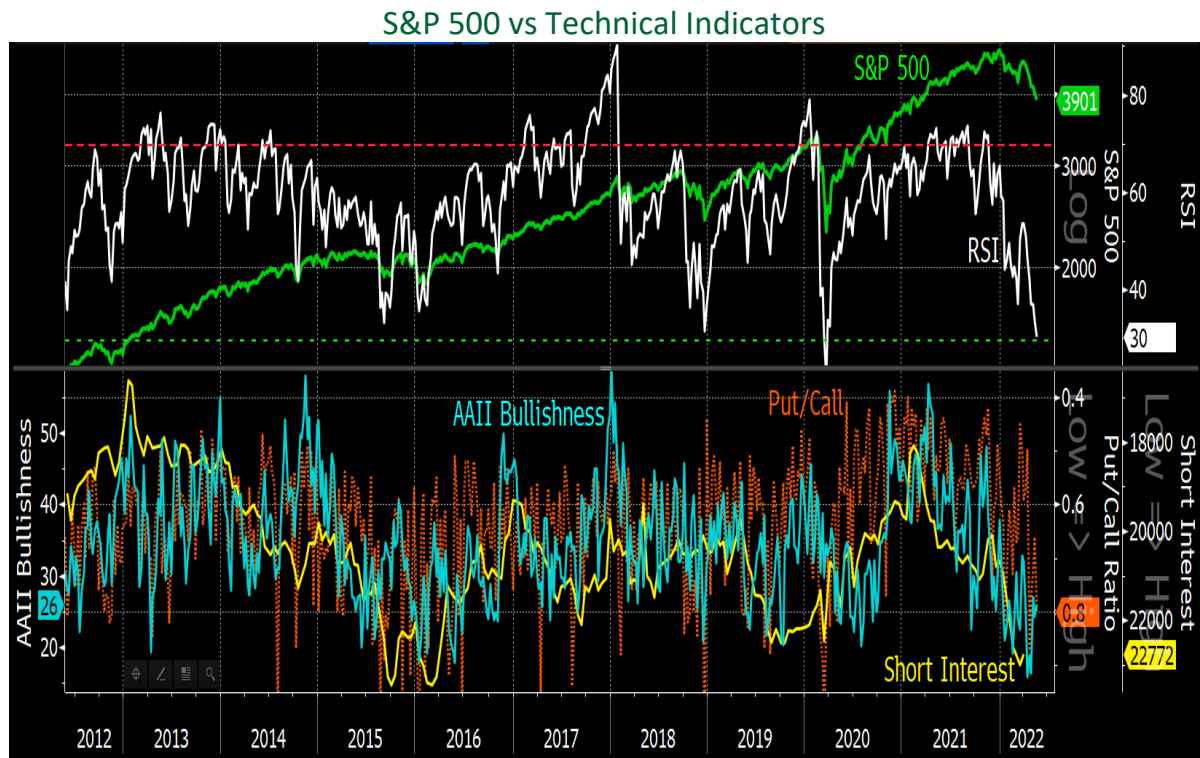
The index has a good correlation with the stock market, and is a valuable tool to identify entry or exit points. It is currently approaching its long-term average, with a neutral message currently.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. May 2022. **Past performance is not a guide to future performance.**



5. TECHNICAL PICTURE

The following chart reflects several technical indicators:



The top half of the chart reflects the S&P 500 index with its RSI overbought/oversold indicator. The latter is currently on a 30-digit reading which is the second most attractive reading over the past ten years.

The bottom half of the chart reflects the following:

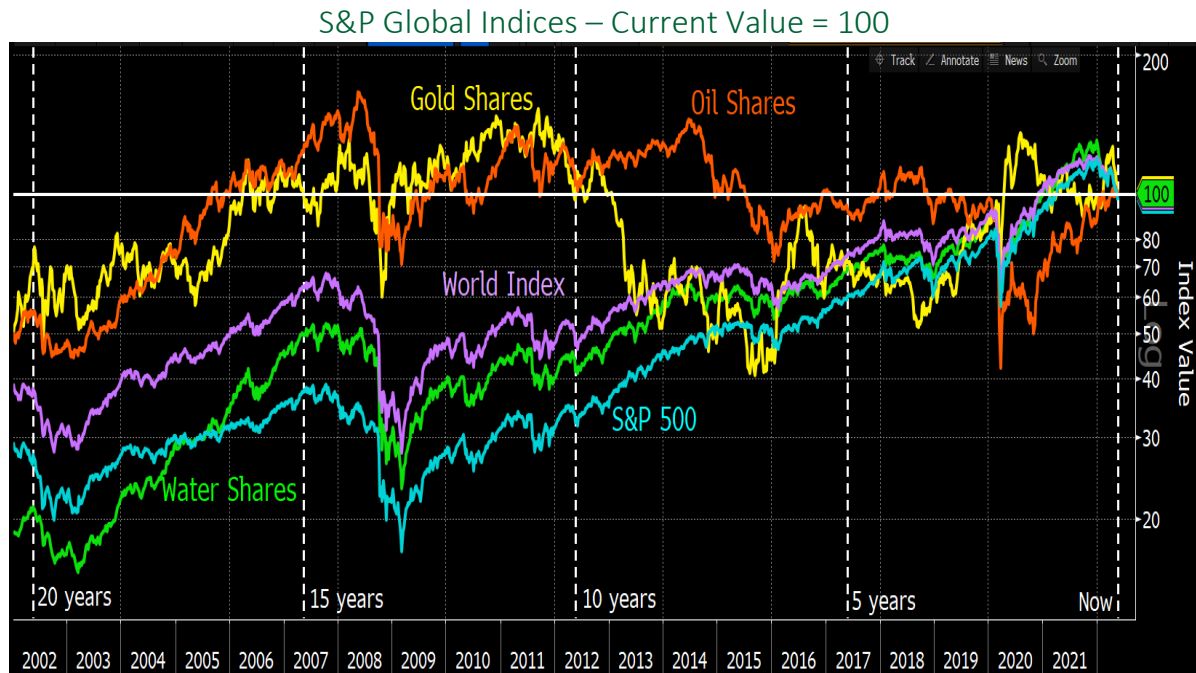
- AAII Bullishness index (individual investors, blue line)
The current reading of 26 is very low. Such readings have historically indicated good entry points.
- Put/Call ratio (institutional market, orange line, inverse scale)
The current reading of 0.8 is elevated. Such readings have historically indicated good entry points.
- Short Interest (hedge market, yellow line, inverse scale)
The current reading is close to ten-year record levels. Such levels have historically indicated good entry points.

The market is technically quite oversold. It seems to already discount a potentially weakening fundamental outlook to quite some extent. The stable bond market reflects the same message, as touched on earlier.



6. RELATIVE PERFORMANCE

The current volatile market circumstances prompted us to consider the long-term relative performance of a few indices:



We index Gold, Oil and Water Share Indices along with the MSCI World and S&P 500 indices over twenty years to their current respective values. It only reflects their capital values. The charts show how much one historically had to pay to earn an index value of 100 today. It produces interesting results:

- The S&P 500 index has done the best most of the time.
- Water shares also did well, beating the S&P 500 over seventeen years or longer.
- Oil shares have done particularly well since the Pandemic, but over five, ten and fifteen years delivered little capital value growth.
- Gold shares have offered buying opportunities at times, but delivered little growth over ten or fifteen years.
- Oil and Gold shares have, historically, offered better trading opportunities, while the S&P 500 and the World Index and Water shares have been better buy-to-hold candidates.

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