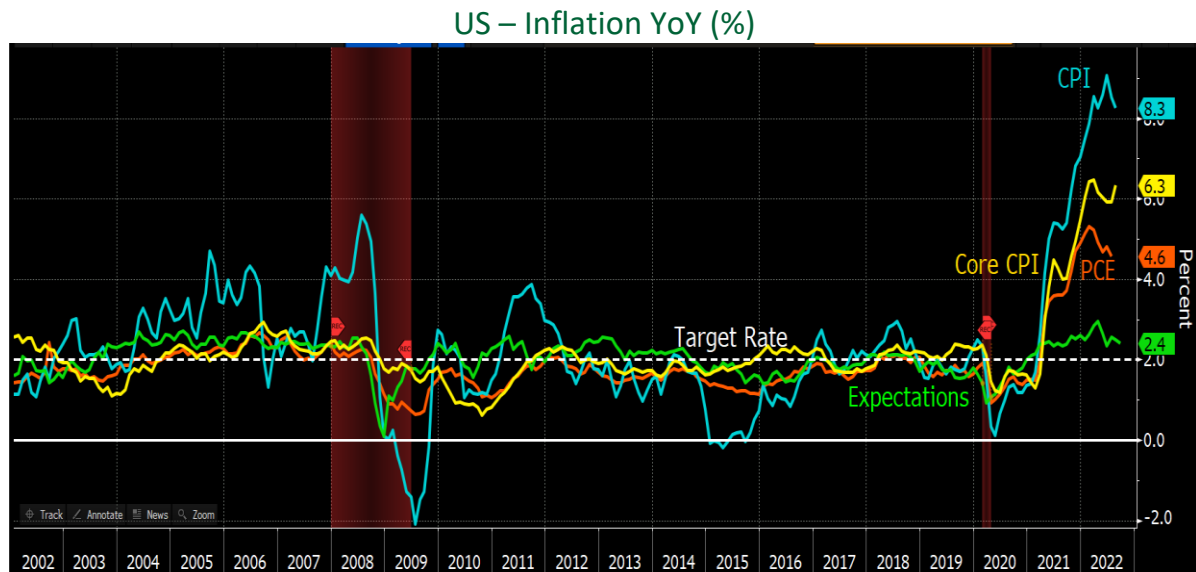


"Wise to resolve, and patient to perform."

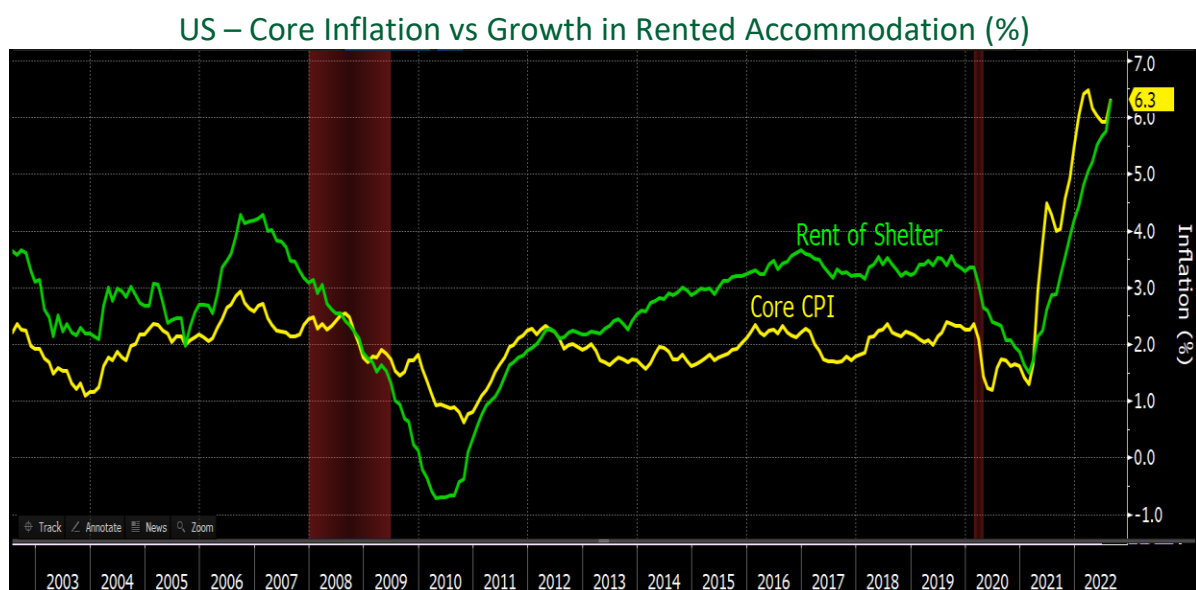
Homer

1. US INFLATION

The August US CPI (Consumer Price Index) headline inflation number dropped another 0.2% to 8.3%:



The market expected a larger drop (to 8.1%), but it is comforting to see that the energy and food effects over and above the core inflation effects are becoming less of an issue, with the supply chain effects following from the Pandemic continuing to diminish. Importantly, ten-year Inflation Expectations (the green line in the chart above) continues in a downward trend. Unfortunately, the core inflation reading (the yellow line) increased, implying some stickiness in the system.



A key contributor to core inflation is the cost of rented accommodation. This cost is increasing sharply, currently at +6.3%, supported by low unemployment levels and relatively low interest rates. We believe these conditions may worsen over the coming months.

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

2. INTEREST RATES

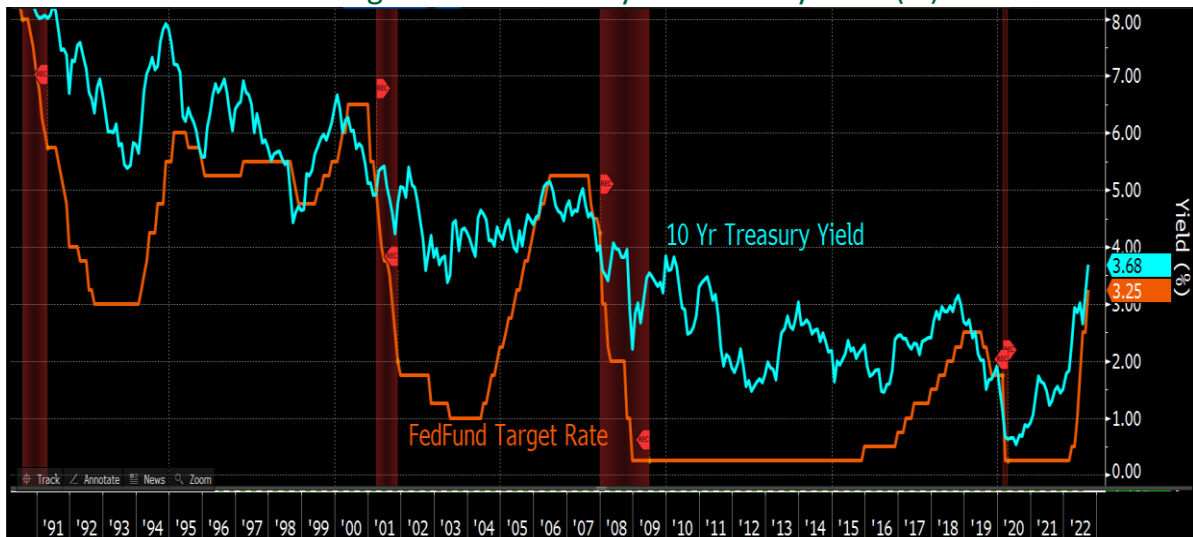
The Fed (Federal Reserve) has made it clear with its most recent meeting that it remains on an aggressive tightening path to contain inflation. This has caused some of the current volatility in the capital markets. The general expectation is for another 0.75% increase in their target rate at their next meeting at the beginning of November.

Fed Target Rate vs Target Rate Futures (%)



Market expectations are currently for a target rate of slightly above 4% at the end of the year, with around another half percent over 2023 (the green and yellow lines in the above chart). This seems somewhat optimistic (low) for us, but overall, it is clear the market does not expect further strong Fed action beyond their last meeting in December this year.

Fed Target Rate vs Us 10-year Treasury Yield (%)



With the recent sharp increase of the US Treasury Yield, it is already back at 2010 levels. Before the Credit Crisis, the Fed Target rate peaked at 5%, with the Treasury Yield staying below that level since 2002. Apart from a short period during the Credit Crisis, inflation has stayed below 5% over all this period.

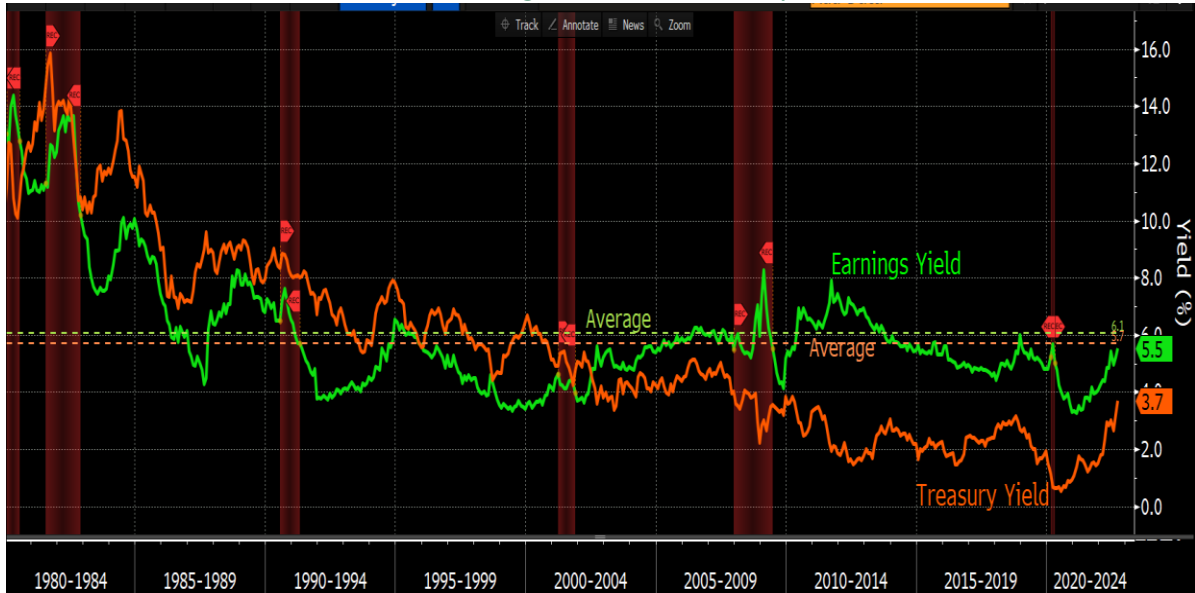
Of course, going forward, all these issues are directly related to how 'sticky' Inflation stays above 5% (or so). Neither the Fed Target Rate futures, nor the implied 10-year inflation expectations on the previous page, imply a prolonged period of very high inflation. On this simplistic basis, we can expect US interest rates to increase further, but not materially so. It is our impression, though, that the era of sub-3% US Treasury Yields may be over for a while.



3. EQUITY RISK PREMIUM

The new interest rate environment has unsettled many investors, with fears that share valuation multiples may adjust materially lower for higher interest rates. The best way to consider this aspect is through an Equity Risk Premium (ERP) study.

S&P 500 – Earnings Yield vs Treasury Yield (%)



The current Earnings Yield (EY) of 5.5% is close to its long-term average of 6.1%. Against that, the current Treasury Yield (TY) of 3.7% is much lower than its own long-term average of 5.7%. Importantly, before the new millennium EY exceeded TY most of the time. With the lower interest rate environment with lower economic growth and especially following the Credit Crisis and the Pandemic, the reverse happened with EY exceeding TY.

S&P 500 – Equity Risk Premium (%)



As many now believe (including ourselves), we are entering a new environment of higher interest rates. Logically, the main question is how much higher. As we touched on in par. 2, we do not yet see evidence of it moving materially higher than currently (also seeing a continuing pedestrian economic outlook).

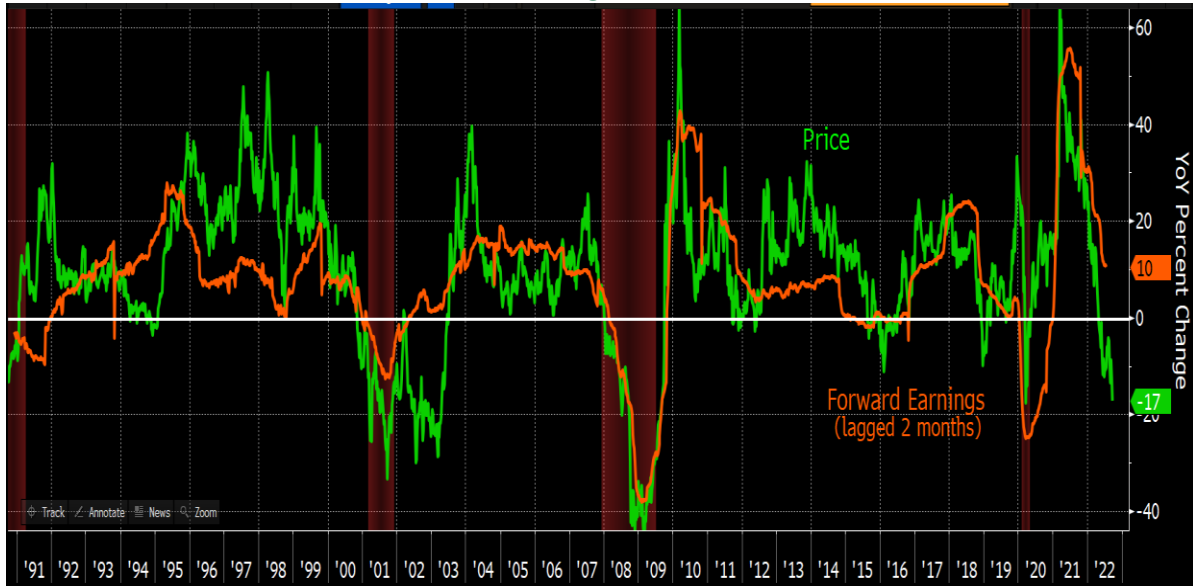
The ERP is currently 1.5% higher than its long-term average. We would not make a case for it moving back to negative numbers (the EY getting lower than the TY), but the 1990s can be a guide that current Equity valuations are not materially out of line in this context. Overall, we do think strong earnings growth and fair PEG (Price/Earnings to Growth) ratios remain critical.



4. US EARNINGS

Investors currently must caution against incorrect perceptions about the US company earnings outlook. Many are of the opinion that index earnings expectations are unrealistically high and that there is major risk for disappointment.

S&P 500 – Forward Earnings vs Price Index Growth (%)



As reflected in the above chart, there is logically a strong correlation between the forward earnings growth and share prices. The current gap between the S&P 500 index growth (-17%) and forward earnings growth (+10%) is very wide. Many will conclude from this chart that share prices reflect a major collapse in earnings is still on its way.

S&P Energy Index – Forwards Earnings Per Share (\$)



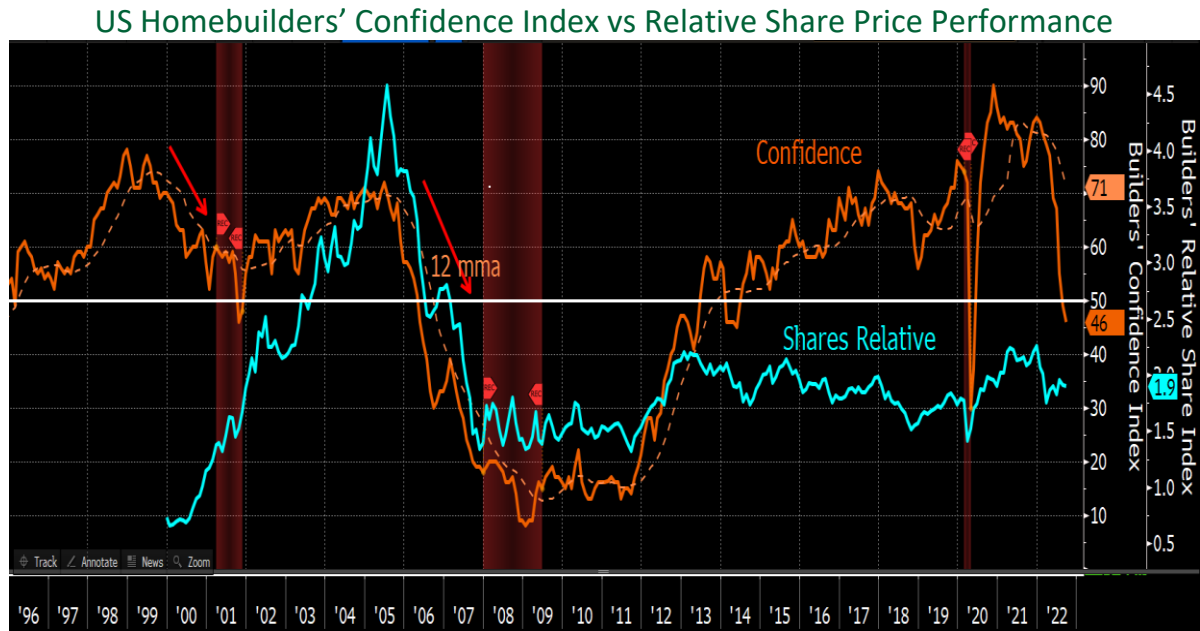
Earnings expectations for the Energy sector is rising at a steep level. It is currently almost a third higher than its previous record, when the oil price was \$140 in 2008, +160% higher than its level before the Pandemic and +216% higher than a year ago. With other sectors' earnings outlooks relatively uninspiring, these growth numbers have quite an effect on overall index earnings numbers - to the tune of contributing c6% to overall earnings growth.

On this basis, the S&P 500 earnings growth reduces to +4% from the +10% in the top chart. This gap with share prices (that include the strong Energy share prices) in the chart still seems somewhat wide, with the result that investors should caution against potential earnings disappointments. Contrary to this, those companies that keep delivering may be rewarded against weak expectations.

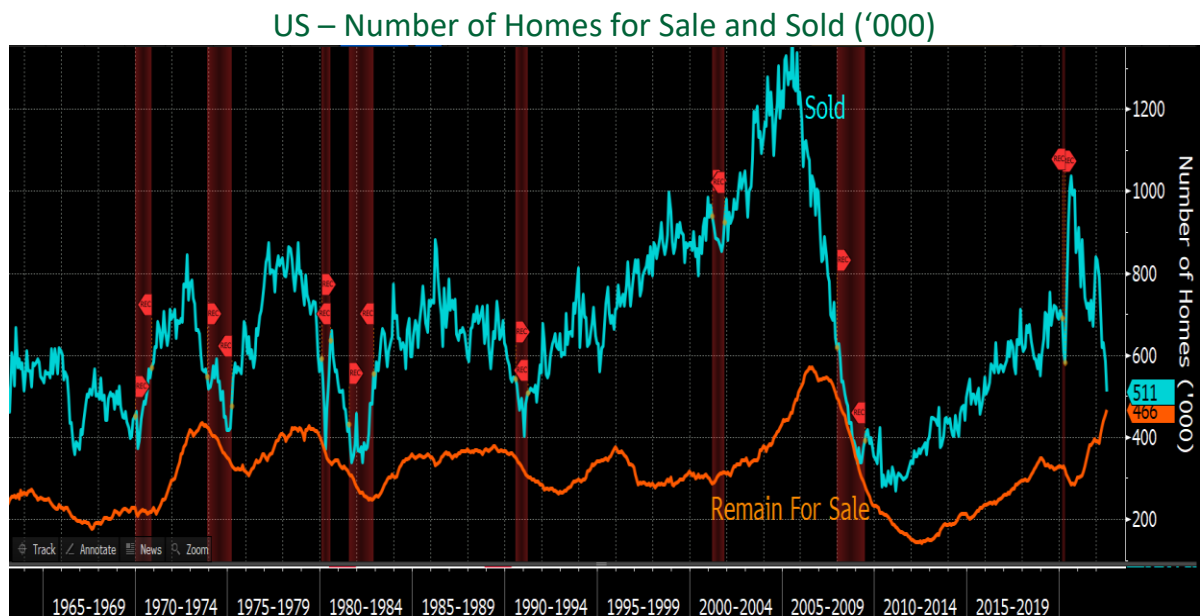


5. US HOMEBUILDERS

The US Homebuilders' Confidence index is a good leading economic indicator:



After a strong run since the Credit Crisis (barring the Pandemic period) the index has taken a severe downturn this year and is currently in destructive territory for the first time in eight years (the orange line). The sector has had a sideways performance over all of this period and has underperformed this year.



The number of homes sold is currently dropping sharply, while the number of homes remaining unsold is rising sharply. The latter is now approaching the former.

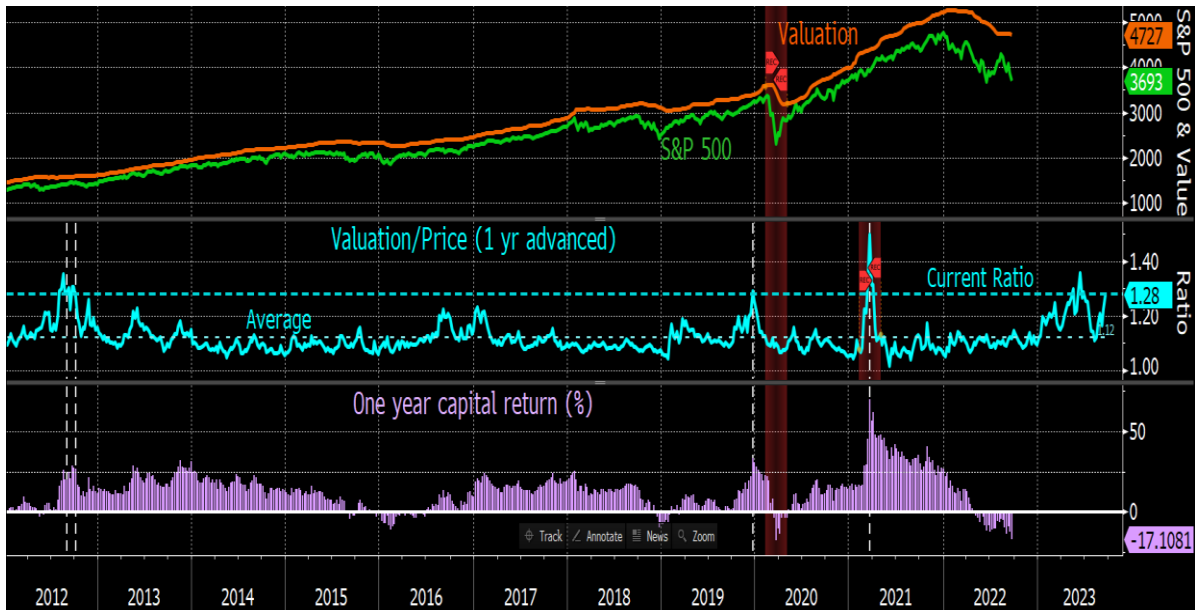
Whilst the above is very basic information, we believe it is quite fundamental to US consumer confidence and as an economic barometer. Rising interest rates are going to affect this sector further. On the positive side, this may also imply lower rent inflation, but only much later.



6. VALUATION

We touched on the S&P current multiple valuation in par. 2. The following discussion reflects the consensus bottom-up valuations of the S&P 500 constituents, consolidated into the valuation of the S&P 500 index:

S&P 500 – Index vs Consensus Valuation

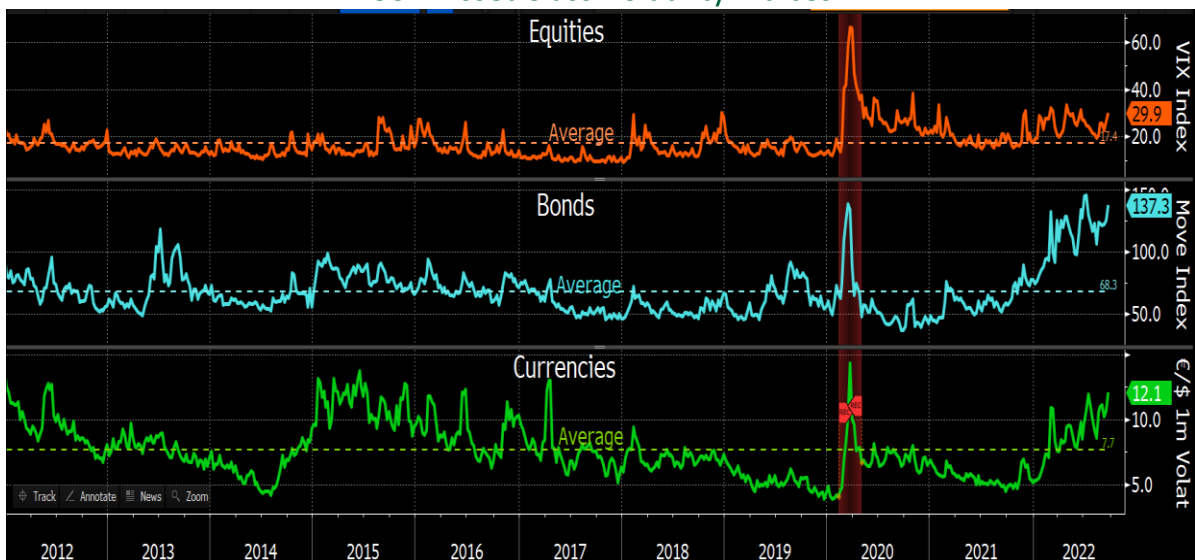


The top section of the above chart shows the Index price value (green line) along with the consensus valuation (orange line). The middle chart (blue line) reflects the ratio of Valuation/Price. It has been advanced one year. The lower chart reflects the one-year capital appreciation of the Index.

Considering the middle chart, the current ratio is 1.28, reflecting +28% potential upside. The horizontal line shows that such a level of upside, or more, has only occurred in 2011, 2018, and 2020 over the past decade. Along with that, as the vertical lines on the bottom chart indicate, all those occasions delivered over 20% returns over the following year.

7. TECHNICAL PICTURE

US – Asset Class Volatility Indices

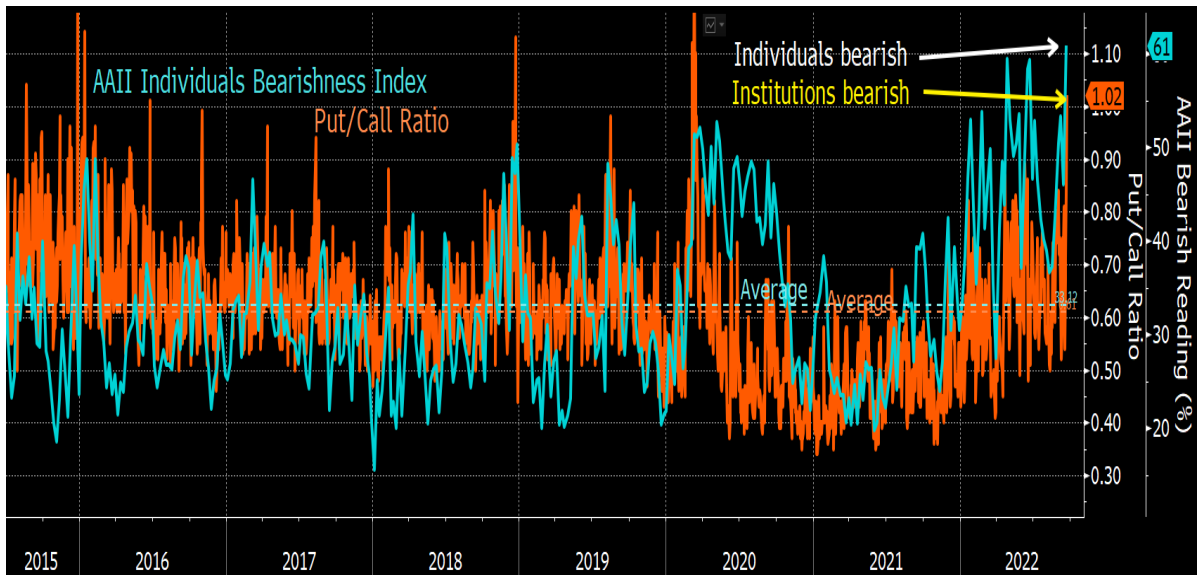


Volatility for all of Equities, Bonds and Currencies have picked up sharply. It is particularly the case in Bonds and Currencies and creates material uncertainties for investors.

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

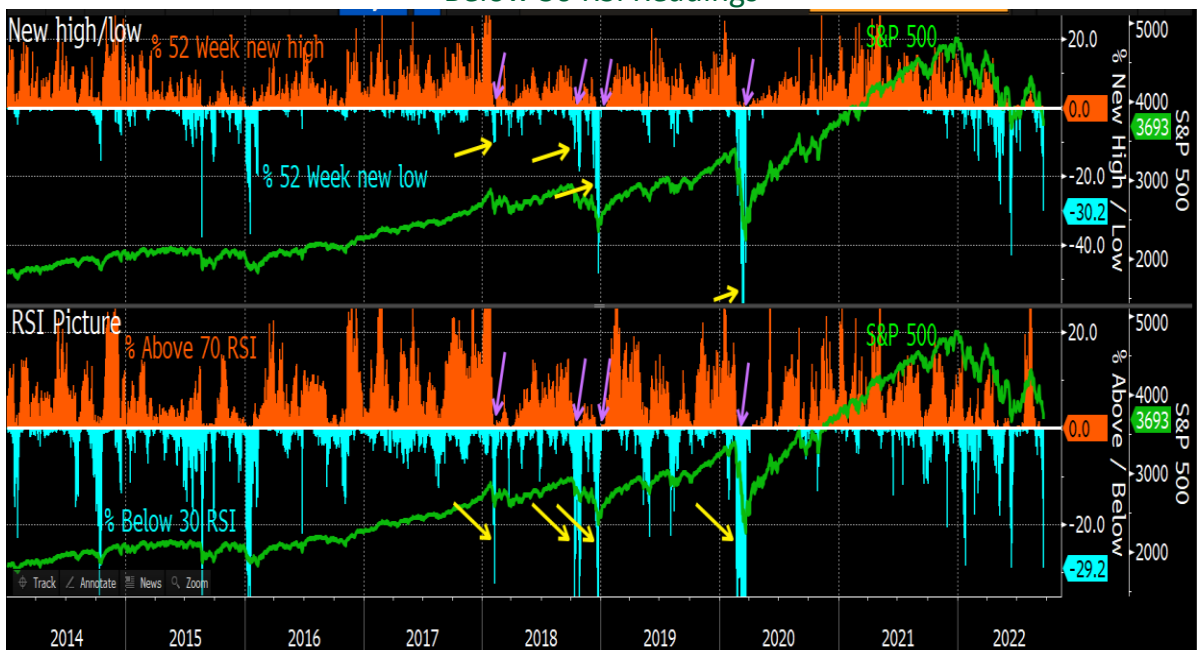


S&P 500 Put/Call Ratio & AII Bearishness Ratio



Both the indices reflecting individual and institutional investor sentiment in the above chart currently reflect extreme bearishness. Historically, such bearishness rather indicated buying opportunities on the logical condition that there were not particular fundamental changes lying ahead.

S&P 500 - % of Constituents at 52-week New Highs or New Lows, and Above 70 or Below 30 RSI Readings



No S&P 500 members are currently trading at new highs (top chart) or above 70 RSI readings (bottom chart), while 30% are trading at new lows (top chart) and 29% below 30 RSI readings (bottom chart). These levels have historically indicated technical buying opportunities.

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



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