STONEHAGE FLEMING

GLOBAL EQUITY PERSPECTIVES 6 JANUARY 2025

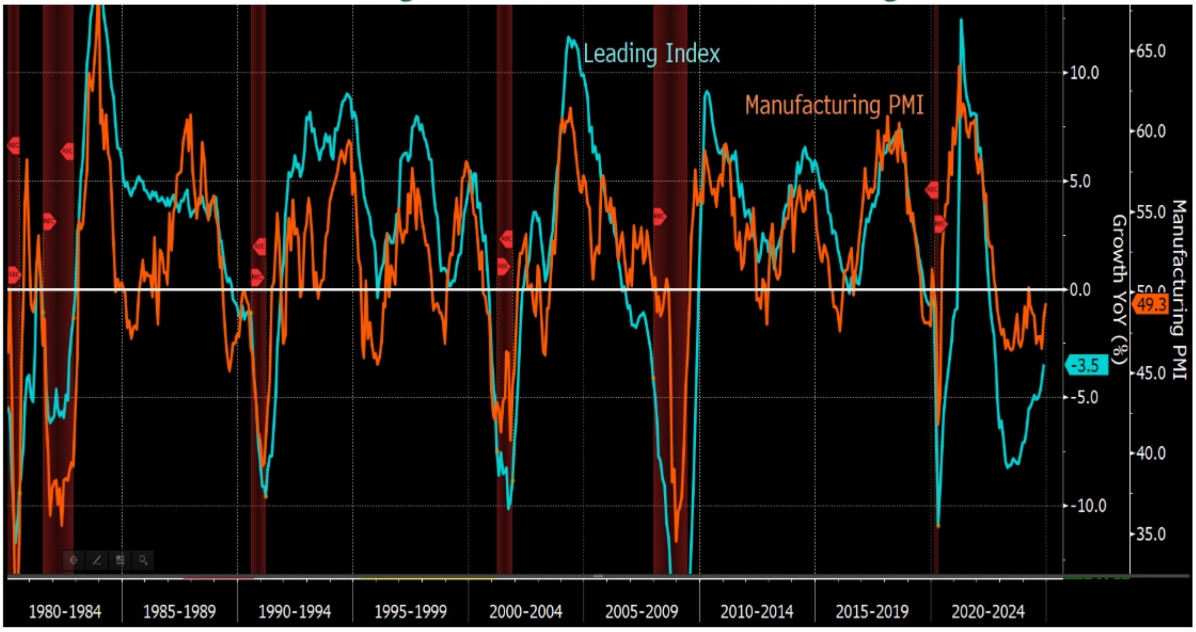
"The true sign of intelligence is not knowledge but imagination."

Albert Einstein

1. US FUNDAMENTALS

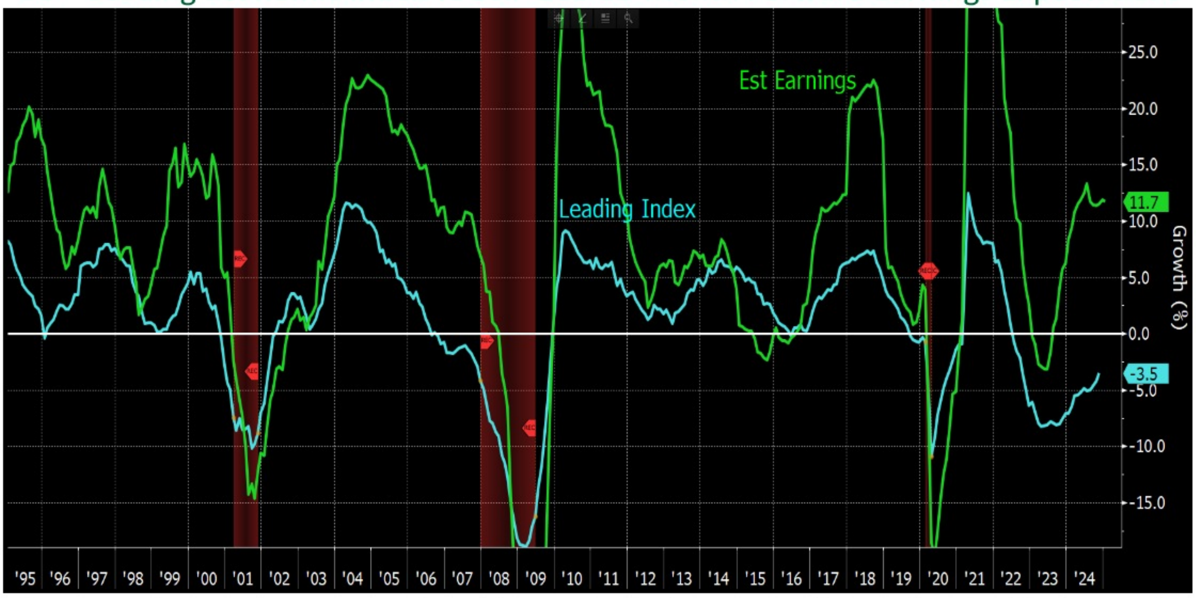
At the beginning of a new year, we consider the basic investing fundamentals:

US – Leading Economic Index vs Manufacturing PMI



Both the Leading Economic Index and Manufacturing PMI indices are in negative territory but are in the process of recovering well. Such trends are constructive for risk assets.

US – Leading Economic Index vs S&P 500 12-Month Forward Earnings Expectations



S&P 500 Index Earnings expectations (the green line) are strongly correlated with the Leading Economic Index. It is also following the latter's current trend. The current expectation of +12% growth in earnings reflects a "no recession" scenario and a positive picture for business fundamentals.

2. RECESSION RISK

We guard against potential investor complacency and take cognisance of the following:

US – High Yield Curve vs Yield Curve (%)

The High Yield Curve is almost one standard deviation below average, reflecting high investor confidence (the orange line). Whilst not at an extreme level, it deserves close monitoring. The Yield Curve has made a strong recovery off a low base into positive territory. Such a trend has historically often been followed by a recession.

US – Adrian Crump & Moench 10-Year Term Premium (%)

The above term premium of various maturities is by implication a more complex version of the Yield Curve. It has historically provided similar recession warnings as the Yield Curve by spiking shortly before the next recession. The current trend is therefore not comforting.

The US economy has been resilient since the Pandemic, supported by, amongst others, low interest rates. We, therefore, stay alert to such warning signals. Continuing positive employment and consumption data currently keep us constructive.

3. FED POSITION

Following the Pandemic there were material reservations amongst many investors whether the Federal Reserve (Fed) could continue to support the economy.

US – Fed Balance Sheet vs GDP (%)

In our view the Fed has been hugely successful, shrinking its balance sheet with little adverse effects on the economy. In absolute terms they have shrunk the balance by almost a quarter since its peak in 2022. Relative to GDP, they have shrunk the balance sheet by a third – from over 35% to 24%. This level is below the pre-Pandemic peak. The Fed is in a less stressed financial position than what many expected.

The following chart reflects the Money Supply picture:

US – M2 Money Supply vs S&P 500

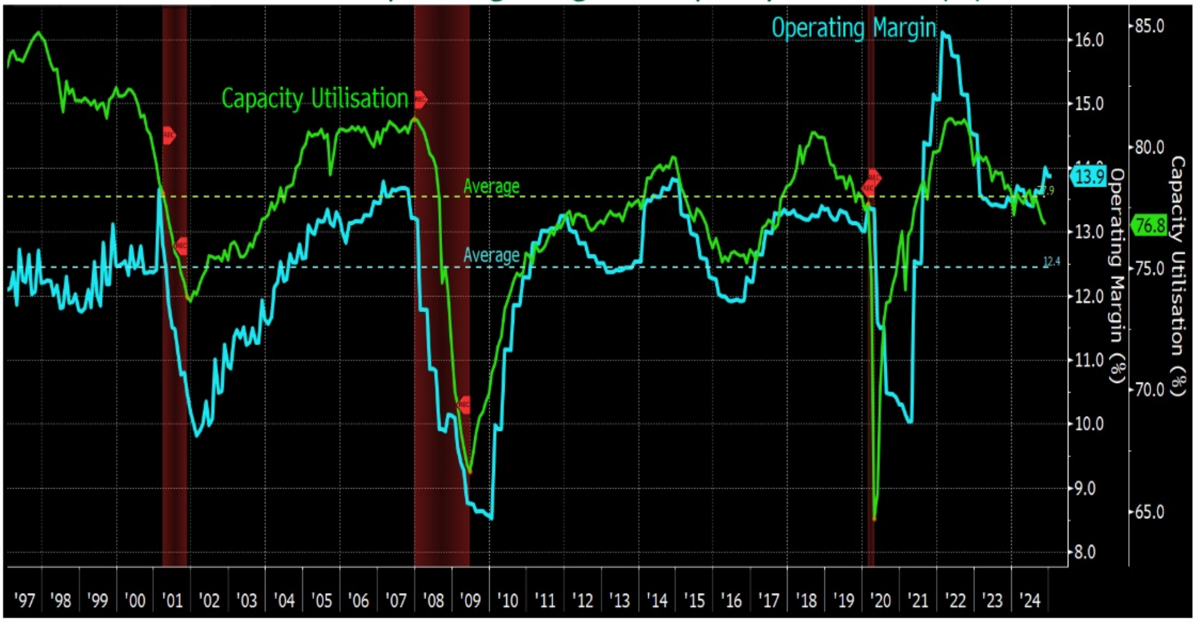
US Money Supply contracted as the Fed started shrinking its balance sheet in 2022. It is currently recovering well, growing at +3.7%. Whilst this level is historically relatively low, the positive trend is important to bear in mind. Growing Money Supply has historically been positive for share prices. Broad credit injection into the economy (as a percentage of GDP) has also recovered well and has completed two positive quarters (not on the chart).

Overall, we believe the Fed has been successful in improving its own financial position after the Pandemic and can continue to support the economy as may become necessary.

4. COMPANY MARGINS

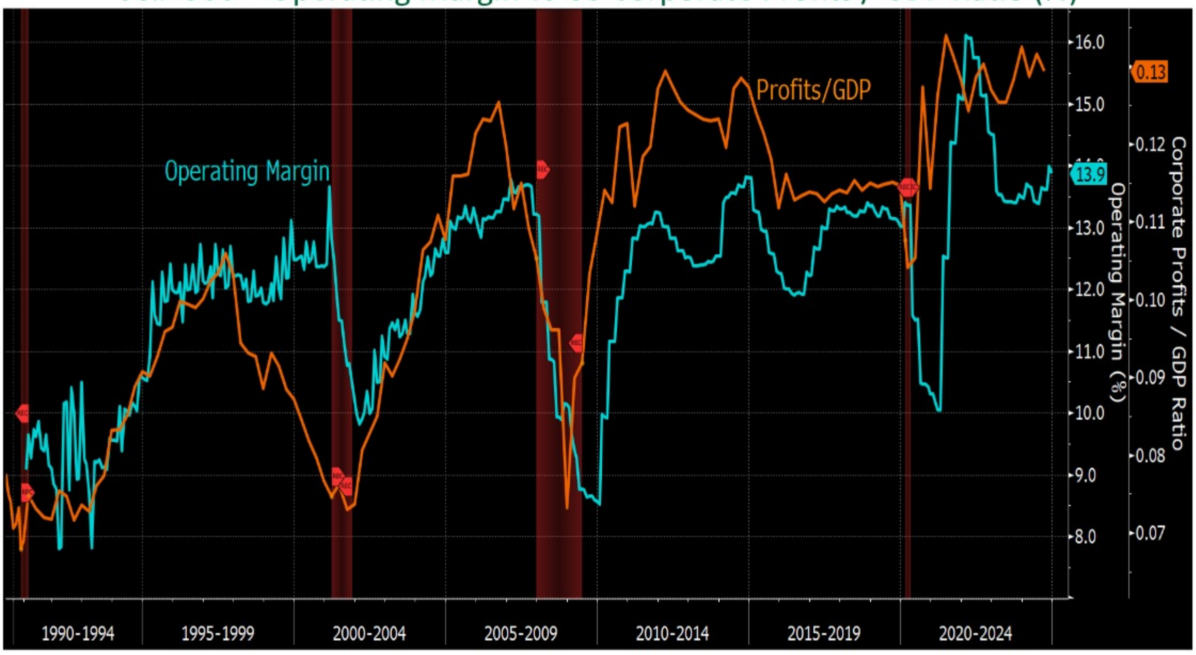
In order to understand the potential for further earnings growth, it is logically important to consider the current level of Operating Margin.

S&P 500 – Operating Margin vs Capacity Utilisation (%)



Capacity Utilisation peaked in 2022 and has been since been drifting lower and is now slightly below average (the green line). Operating Margins followed a similar trend (the blue line), but have recently picked up again. There is therefore currently a disconnect between the two series.

S&P 500 – Operating Margin vs US Corporate Profits / GDP Ratio (%)



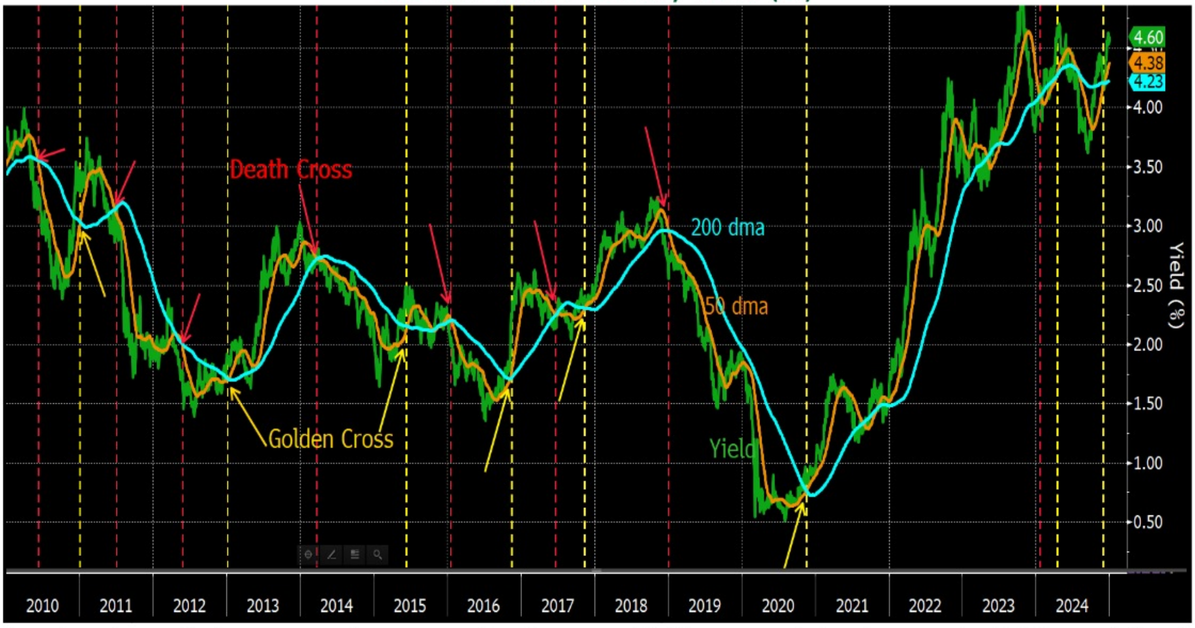
Operating Margins logically also have a close correlation with overall profits as a ratio of GDP. Despite the current Operating Margin being well below its historic high, the Profit Ratio is close to a peak level. This reflects the high productivity level in corporate America.

We believe the effective utilisation of technology explains some of this high productivity, and the diversion from historic norms. It is also clear that analysts must ensure they understand the potential and the durability of these levels of productivity.

5. US INTEREST RATES

Capital markets are very conscious of US interest rates staying higher for longer than many previously expected.

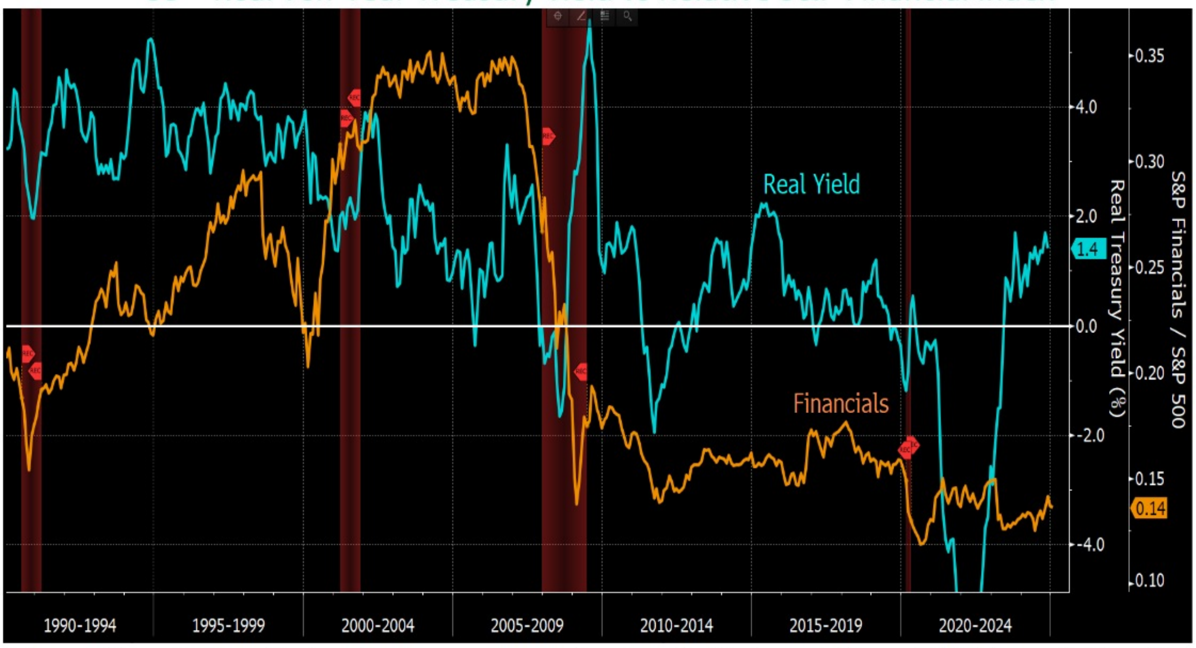
US Ten-Year Treasury Yield (%)



Despite three Fed rate cuts last year, the Treasury Yield currently is close to its 2023 peak level. Technically it has recently had a Golden Cross event (indicated with the yellow vertical broken line) with its 200-day moving average making an upwards turn. General perception is that US trade tariff uncertainties are one of the main reasons and therefore may keep rates high for a while.

Persistent high rates can have many capital market implications. The following is one of those.

US – Real Ten-Year Treasury Yield vs Relative S&P Financial Index



It is a striking feature that real rates are currently close to their post Financial Crisis peak (the blue line). This implies a US economic environment that has made a strong recovery. Should this real yield trend persist, it will imply a strong financial sector and investors may focus more on the sector. The orange line presents the sector's relative performance. It shows strong outperformance up to the Financial Crisis, which was a period of high real rates.

6. VALUATIONS

The following chart reflects valuations on both a historic and forward basis:

S&P 500 Historic and Forward P/E Ratios

We value the forward valuation metric more than the historic one. At a level of 22 times, it is currently as elevated as the 2020/2021 peak level, but not yet at the 1999 level.

It is not unreasonable to see this current level as more justifiable than the levels of 1999 because there are many more high-quality businesses causing the current high valuations than the case was in 1999, both from a profitability, cash generation and outlook point of view.

S&P 500 – Forward Equity Risk Premium (%)

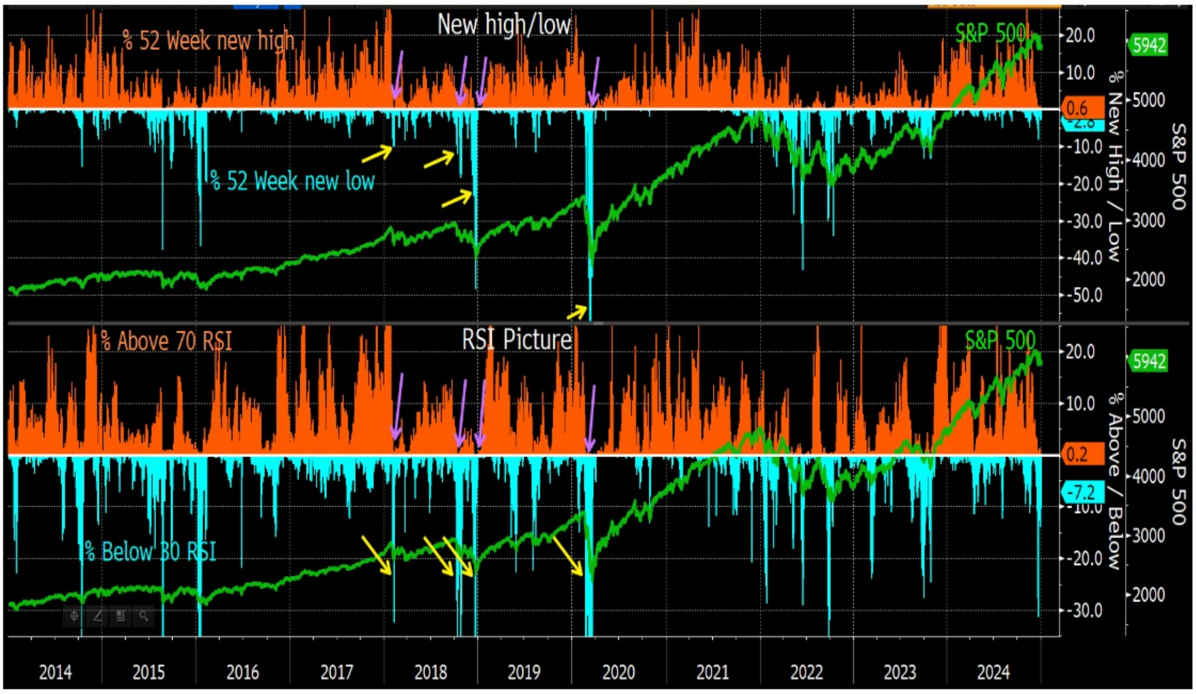
The Equity Risk Premium (the difference between the Earnings and Treasury Yields, the blue line) is currently in negative territory, the first time in 22 years. Whilst this implies an expensive equity valuation compared to bonds, this premium was lower (even more expensive) in 1999. This reflects the same message as depicted above.

All said, equity valuations are stretched. The new US administration has little room for error, especially on the inflation and trade fronts. The stock market is banking on positive outcomes on both of these factors.

7. TECHNICAL PICTURE

The weak December made the S&P 500 technical picture less overbought than some may perceive:

S&P 500 – Percentage of Constituents at New Highs/Lows and Above 70 RSI / Below 30 RSI



Only 0.6% of constituents are at new lows and only 0.2% are above their respective 70 RSI levels (respectively the top and bottom charts). Against this, 2.8% are at new lows and 7.2% are below their 30 RSI levels, reflecting a somewhat more oversold than overbought market. On this overall basis, there is currently little froth in the market.

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RISK DISCLOSURE

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