Global Strategy Weekly

It is time to have some long-term vision

Albert Edwards
+44 20 7762 5890
albert.edwards@sgcib.com

Investor perceptions of the future are heavily influenced by current circumstances – aka extrapolation. But things have a habit of turning out radically different from mainstream forecasts, don't they? Back in 1996, my non-consensus Ice Age call was that deflation would trigger a secular change in financial market relationships, with equities de-rating relative to government bonds. So where might we be heading now?

- Journalists often refer to me as a market "veteran". That's a polite way of saying that I'm so old that I've seen a lot of economic cycles first hand. And the funny thing is as I get older, I can remember them even more vividly!

- Rummaging around my collection of charts, I came up with the one below on public sector fiscal deficits and updated it with the very latest OECD forecasts (as of this week, link). Given the current circumstances, who would believe that the US is the only one of the 'Big-3' to have run a budget surplus in any one year (in 2000) for the last 30 years (see chart below).

- Those of us already working at the coal face back then will recall a totally different mindset to now, with President Bill Clinton showing great deference to the 'bond vigilantes'. **Back in 2001, commentators were expecting the US Treasury market to totally disappear and wondering about what they would have to use as a 'risk-free' benchmark rate.** That might sound ludicrous to those of you who were not around at the time, but it is true. And it all certainly turned out rather differently.

- Just how wrong can forecasters be when caught up in the grip of prevailing groupthink? A 2013 Business Insider article cited the Congressional Budget Office (CBO) 2001 forecasts as an example; "*in 2001, the CBO projected that the total Clinton surplus of about $280 billion would balloon to $5.9 trillion worth of cumulative **surpluses** through 2011, when in reality the accumulated **deficits** reached $6 trillion at the end of that time period.*" – link.

- We're not picking on the CBO; their latest projections of President Trump's Big Beautiful Bill adding $2.4tn to the US debt by 2034 should not be ignored – link. Rather I want to highlight more generally how 'groupthink' can turn out to be very wrong. In particular, we test the prevailing view among equity investors in recent years that there is no real alternative to US equities because of its heavy exposure to the tech sector.

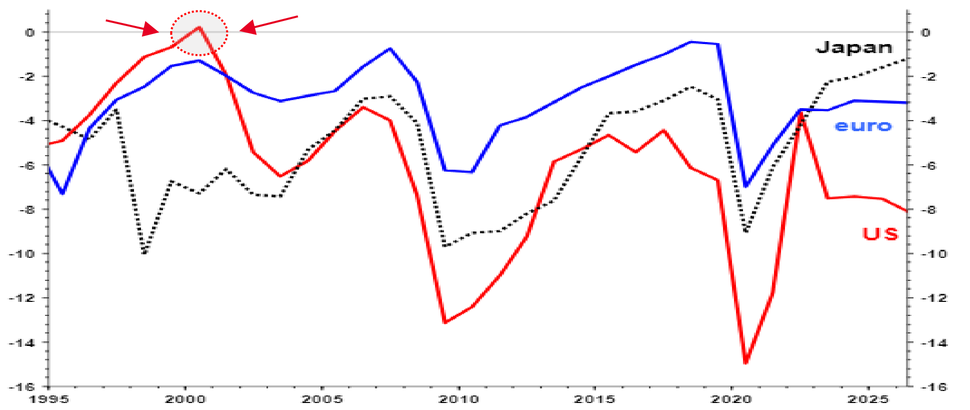
Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

Global Strategy 'Team'
Albert Edwards
(44) 20 7762 5890
albert.edwards@sgcib.com

Once upon a time the US actually ran a budget surplus! (Government net lending as % GDP)

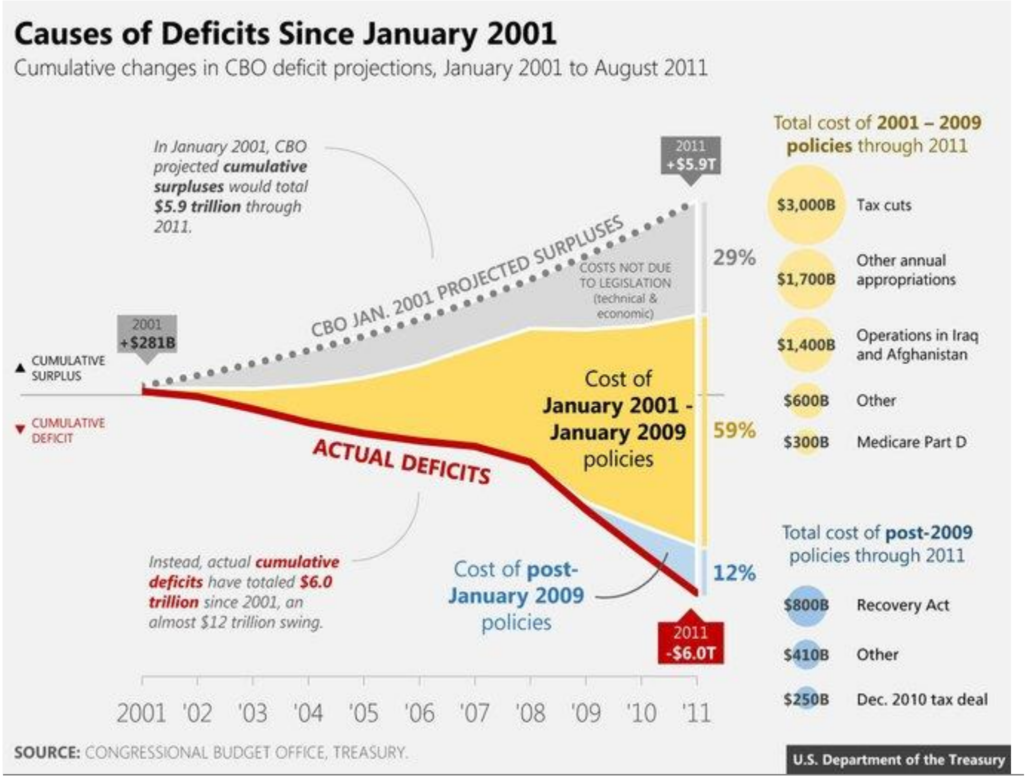


Source: Datastream, OECD

Back in 2013, Business Insider (BI) highlighted the chart below posted on Twitter by the US Treasury (link) noting that *"This chart (below) paints a pretty poor picture of the CBO's forecasting abilities, which account for well over half of the missing surplus. While the 'other annual appropriations' category could use a little clarity, this chart also hits the nail on the head when it comes to identifying the major deficit drivers:* ***An extremely large tax cut that failed to pay for itself, two wars on the nation's credit card, an unfunded expansion of an entitlement program, and general overspending turned what could've been a cushy surplus into a huge deficit."***

If only back in 2013 the author could have conceived what was coming down the tracks in terms of budget over-runs. They would never have believed it could happen. But it did. That is why on these pages we like to think and say the unthinkable.

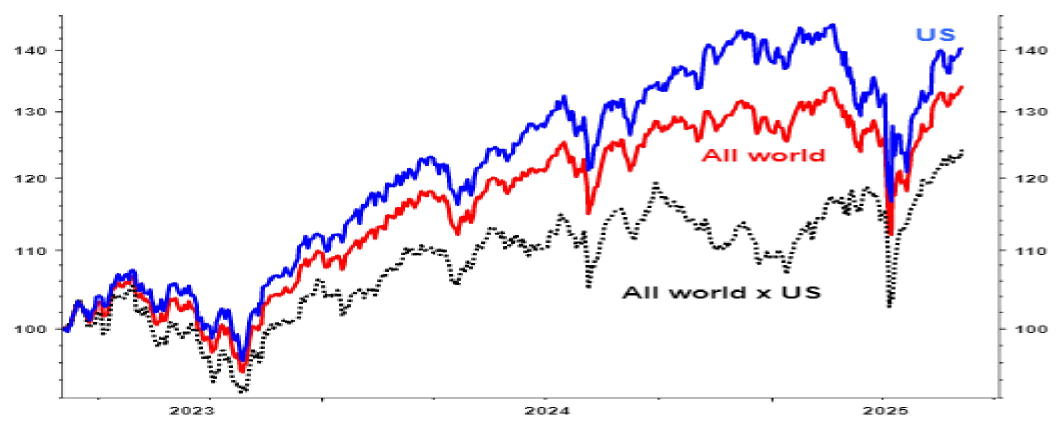
The CBO projection of US budget surpluses forever was the prevailing thinking at that time



Source: Business Insider 2013

So let's take a look at equities, especially as the MSCI all World Index, which just hit an all-time high yesterday (red line below). This has been driven higher by non-US markets in recent weeks, while the US index is still noticeably shy of its February all-time high.

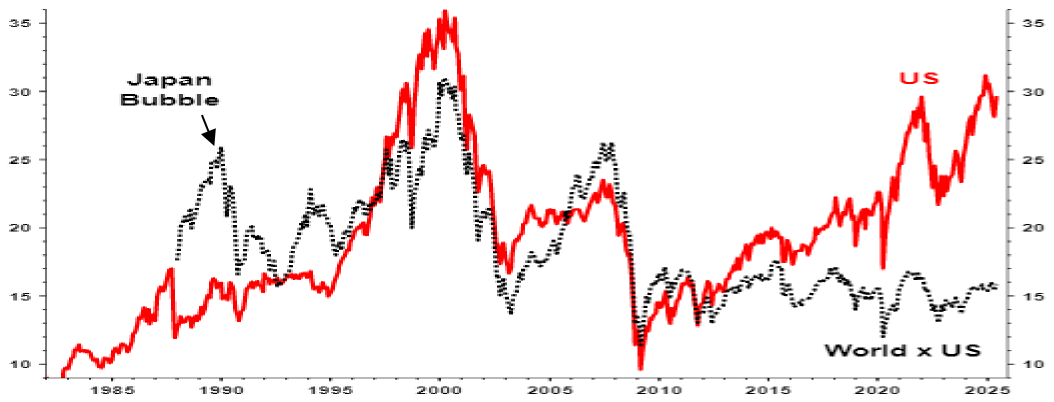
MSCI All World equity index has just hit an all-time high



Source: Datastream

Equity strategists are apparently only now beginning to question the idea of 'American exceptionalism' in terms of equity investing. It has truly been an incredible period of outperformance, which has widened the gap in US valuations with the rest of the world equity markets to unprecedented levels.

Price/trend earnings (similar to the Shiller P/E or cyclically adjusted P/E – aka CAPE)



Source: Datastream

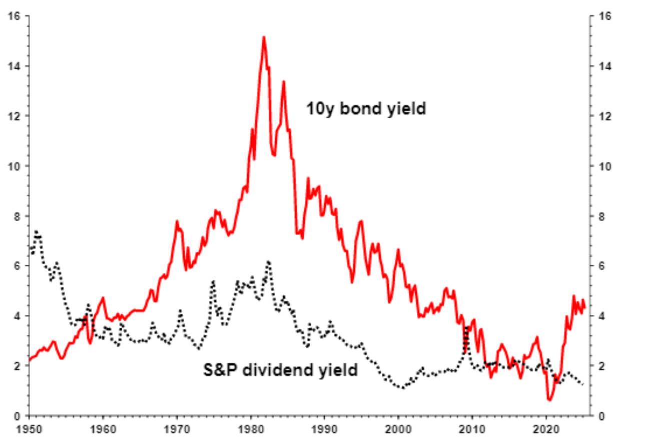
The problem with US nose-bleed high equity valuations is that the mood music of the bond market has changed but the market doesn't seem to have noticed. Equity yields remain very low (dotted line below uses CAPE) despite the bond yield leap-frogging the equity yield.

In the US, the bond yield has leapt above the equity earnings yield (using CAPE)

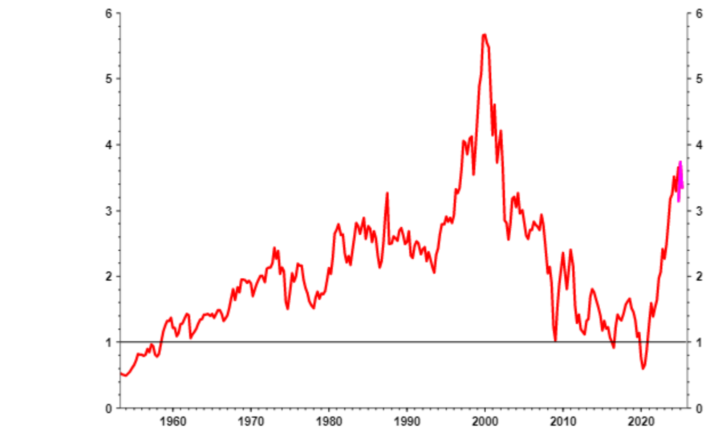
Source: Datastream

Do you remember that back in 2020 Robert Shiller unexpectedly justified a high CAPE because of low bond yields? (link). I wonder what he is saying now.

US bond and dividend yields



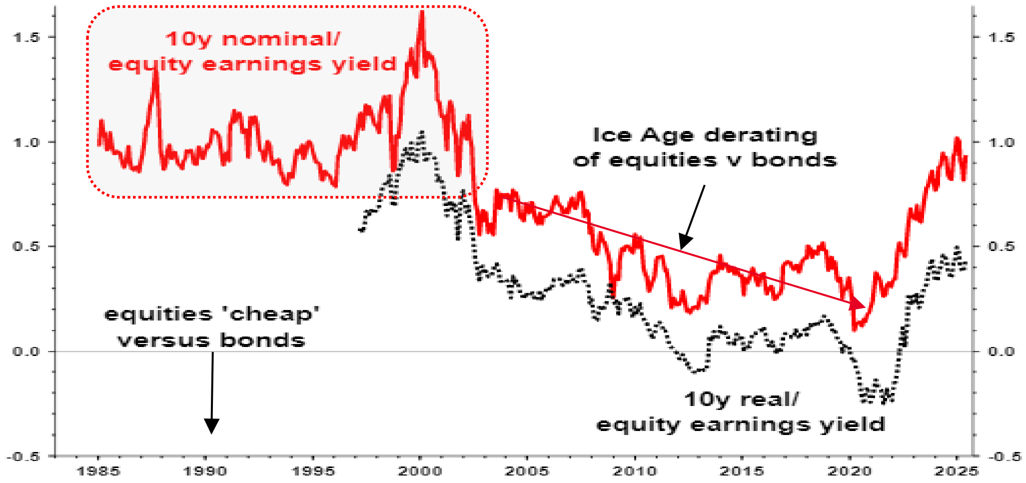
US bond yield/trailing earnings yield ratio



Source: Datastream

The secular de-rating of the bond/equity earnings yield ratio (aka as the 'Fed Model') was a key component of the Ice Age. The ratio had been stable around 1.0 from 1982, but we predicted that this seemingly stable relationship would trend lower. Of course, as the equity yield is a 'real' variable, we should compare it with real, rather than nominal bond yields as below. It tells the same story.

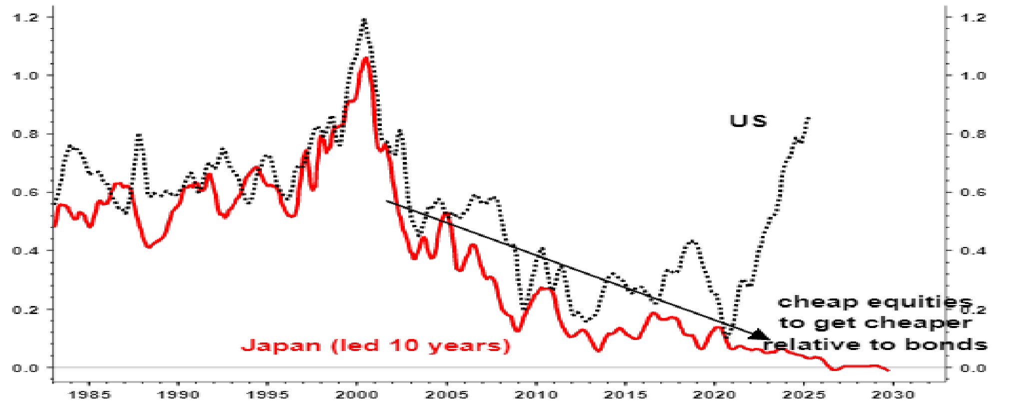
The Fed Model of bond/equity yield ratio began to trend lower in 2000 due to The Ice Age



Source: Datastream

The chart below shows how Japan was ahead of the US in terms of secular de-rating of equities vs bonds – until the US ratio exploded higher after the 2020 pandemic (note same scale for both series).

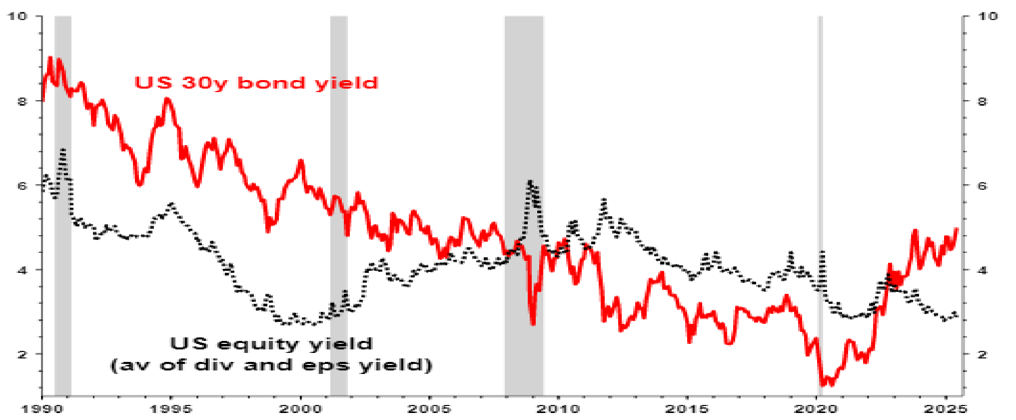
Bond/trailing MSCI cashflow yield ratio (Japan led de-rating by 10 years until recently)



Source: Datastream

Looking at the chart below really does ram home how US equities have ignored rising bond yields.

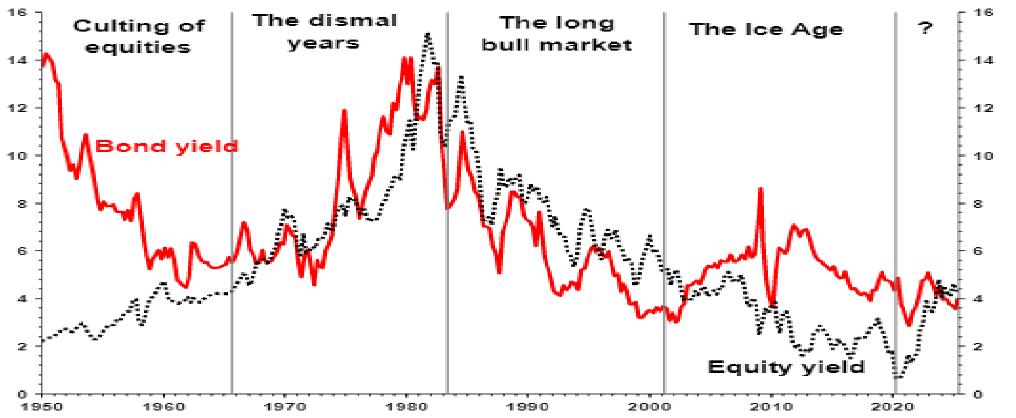
How long can US equities ignore this secular shift in bond yields (same scale for both lines)



Source: Datastream

Below is the Ice Age chart that I often used to highlight the different secular investment phases. We are in a new period where I (and other former deflationists) believe bond yields are rising on a secular basis. The Ice Age is not just sleeping, it is dead. Fiscal dysentery has seen to that.

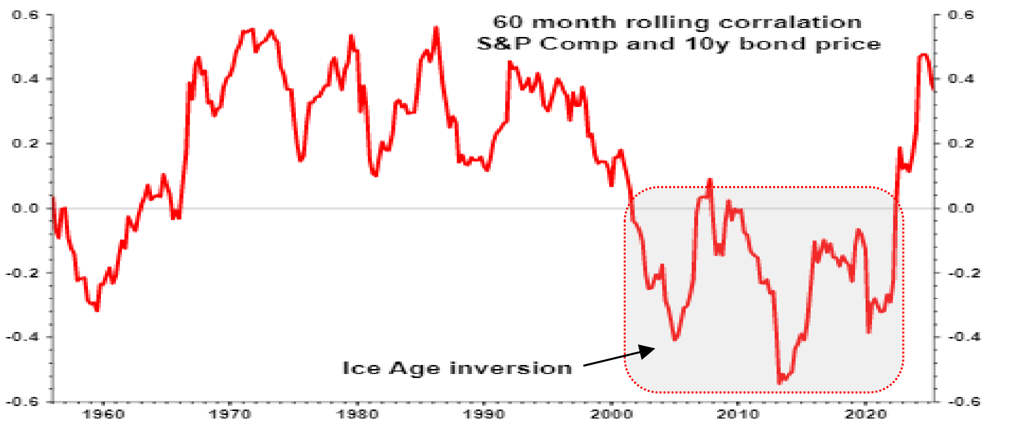
US 10y yield and equity yield (average of dividend and trailing earnings yield)



Source: Datastream

We predicted way back in 1996 that a key part of the unfolding Ice Age would be a flip from a positive correlation between bonds and equities to a negative one as the secular derating of equities vs bonds ensued – like Japan. Another key indication that The Ice Age thesis is dead and we have moved beyond that phase is that the correlation has flipped back to positive. **So rising bond yields are definitely not good news for equities – although the US equity market is yet to wake up to this!**

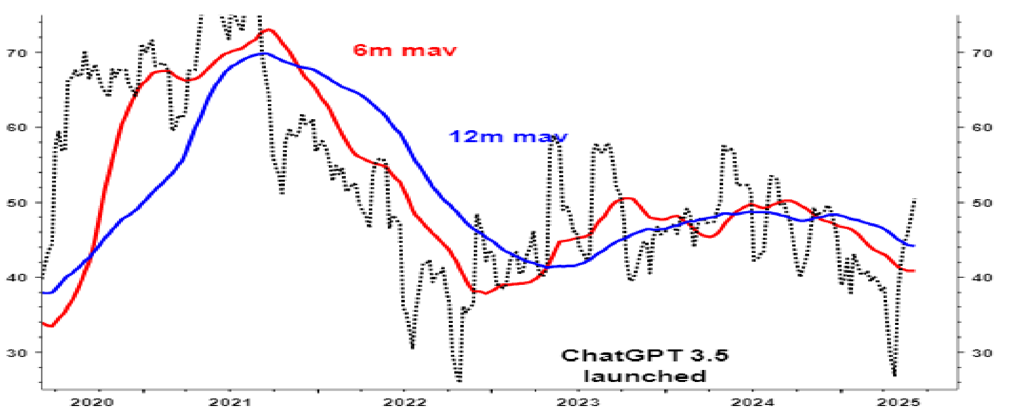
Rolling 6 year correlation between US 10y bond and equity prices



Source: Datastream

So much for long term; what about the near term? Analysts' optimism has bounced higher.

S&P analyst optimism (analysts' EPS upgrades as % of all estimate changes for S&P 500)



Source: Datastream

Although analysts' optimism has recovered on the TACO hypothesis (link), a downtrend has been evident for a long while now, way ahead of the recent tariff turmoil. US Tech overall is just not delivering high profits in the way optimists had hoped, and this is weighing on the wider market.

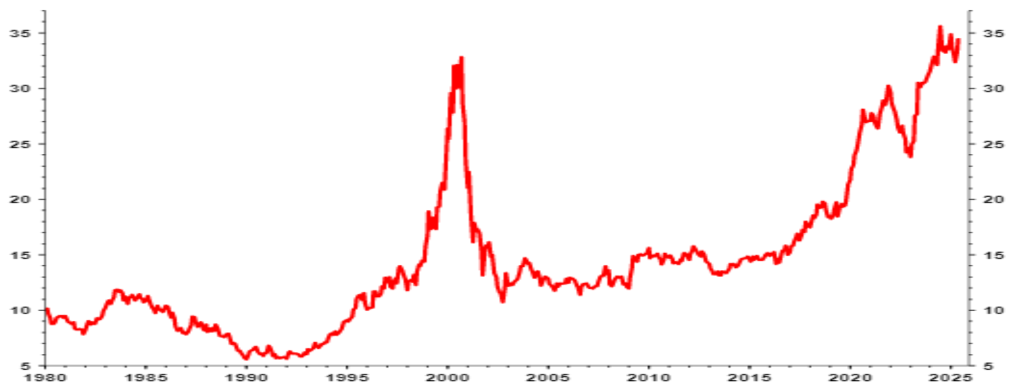
US analysts' optimism on the tech heavy Nasdaq 100 has been slip-sliding for quite a while now

v

Source: Datastream

In addition to faltering earning momentum, the aforementioned secular bear market for bonds is not good news for growth sectors like Tech. This wouldn't matter so much if US Tech were not dominating the overall US indices in a way never seen before, even at the height of the 2000 tech bubble.

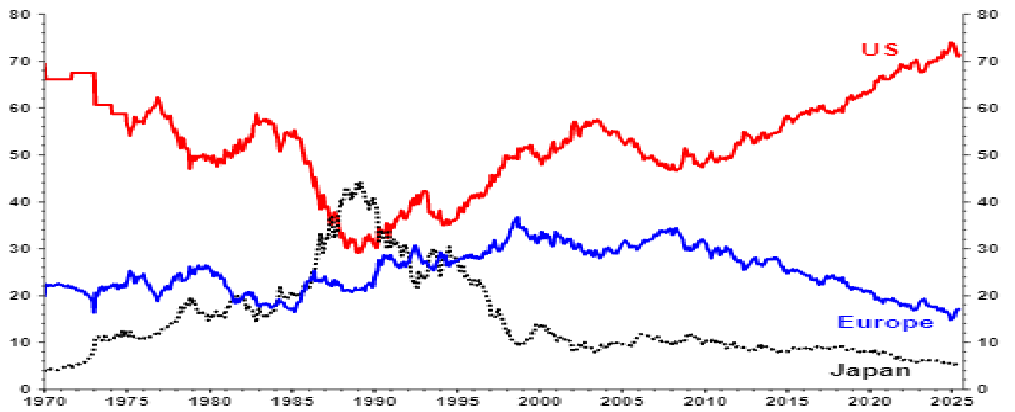
US Tech is still some 35% of overall US market cap – (and that excludes many M7 stocks!)



Source: Datastream

The mention of 2000 brings me full circle to bold predictions (that may turn out wrong of course). Given my own track record, there are very few things I feel certain predicting. But one of them is that the trend that took US equity market cap to three quarters of the MSCI world Index will reverse, just as it did from 1970 to 1988 when the US fell from 70% of world market cap to less than 30%. A return to at least post GFC levels of c.50% seems plausible to me. **It's a Brave New World.**

US share of MSCI World Index hit 75% recently. Is the long march down to 50% about to start?



Source: Datastream

ANALYST CERTIFICATION

Each author of this research report listed on the cover hereby certifies that the views expressed in the research report accurately reflect his or her personal views, including views about subject securities or issuers mentioned in the report, if any. No part of his or her compensation was, is or will be related, directly or indirectly to the specific recommendations or views expressed in this report.

The analyst(s) who author research are employed by SG and its affiliates in locations, including but not limited to, Paris, London, New York, Hong Kong, Tokyo, Bangalore, Frankfurt, Madrid, Milan, Geneva, Seoul, Warsaw and Casablanca.

CONFLICTS OF INTEREST

This research contains the views, opinions and recommendations of Societe Generale (SG) credit research analysts and/or strategists. To the extent that this research contains trade ideas based on macro views of economic market conditions or relative value, it may differ from the fundamental credit opinions and recommendations contained in credit sector or company research reports and from the views and opinions of other departments of SG and its affiliates. Credit research analysts and/or strategists routinely consult with SG sales and trading desk personnel regarding market information including, but not limited to, pricing, spread levels and trading activity of a specific fixed income security or financial instrument, sector or other asset class. Trading desks may trade, or have traded, as principal on the basis of the research analyst(s) views and reports.

As a general matter, SG and/or its affiliates normally make a market and trade as principal in fixed income securities discussed in research reports. SG has mandatory research policies and procedures that are reasonably designed to (i) ensure that purported facts in research reports are based on reliable information and (ii) to prevent improper selective or tiered dissemination of research reports. In addition, research analysts receive compensation based, in part, on the quality and accuracy of their analysis, client feedback, competitive factors and SG's total revenues including revenues from sales and trading and investment banking.

IMPORTANT NOTICE: Sections of this publication that are contributed by non-independent analysts should not be construed as investment research as such have not been prepared in accordance with legal requirements designed to promote the independence of investment research. Therefore, even if such sections contain a research recommendation, such sections should be treated as a marketing communication and not as investment research. SG is required to have policies in place to manage the conflicts which may arise in the production of its research, including preventing dealing ahead of investment research.

IMPORTANT DISCLAIMER: The information herein is not intended to be an offer to buy or sell, or a solicitation of an offer to buy or sell, any securities or security-based swaps and has been obtained from, or is based upon, sources believed to be reliable but is not guaranteed as to accuracy or completeness. Material contained in this report satisfies the regulatory provisions concerning independent investment research as defined in MiFID. Information concerning conflicts of interest and SG's management of such conflicts is contained in the SG's Policies for Managing Conflicts of Interests in Connection with Investment Research which is available at https://insight-public.sgmarkets.com/compliance/equity or https://insight-public.sgmarkets.com/compliance/credit SG does, from time to time, deal, trade in, profit from, hold, act as market-makers or advisers, brokers or bankers in relation to the securities, or derivatives thereof, of persons, firms or entities mentioned in this document and may be represented on the board of such persons, firms or entities. SG does, from time to time, act as a principal trader in equities or debt securities that may be referred to in this report and may hold equity or debt securities positions or related derivatives. Employees of SG, or individuals connected to them, may from time to time have a position in or hold any of the investments or related investments mentioned in this document. SG is under no obligation to disclose or take account of this document when advising or dealing with or on behalf of customers. The views of SG reflected in this document may change without notice. In addition, SG may issue other reports that are inconsistent with, and reach different conclusions from, the information presented in this report and is under no obligation to ensure that such other reports are brought to the attention of any recipient of this report. To the maximum extent possible at law, SG does not accept any liability whatsoever arising from the use of the material or information contained herein. This research document is not intended for use by or targeted to retail customers. Should a retail customer obtain a copy of this report he/she should not base his/her investment decisions solely on the basis of this document and must seek independent financial advice.

The financial instruments discussed in this report may not be suitable for all investors and investors must make their own informed decisions and seek their own advice regarding the appropriateness of investing in financial instruments or implementing strategies discussed herein. The value of securities and financial instruments is subject to currency exchange rate fluctuation that may have a positive or negative effect on the price of such securities or financial instruments, and investors in securities such as ADRs effectively assume this risk. SG does not provide any tax advice. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized. Investments in general, and derivatives in particular, involve numerous risks, including, among others, market, counterparty default and liquidity risk. Trading in options involves additional risks and is not suitable for all investors. An option may become worthless by its expiration date, as it is a depreciating asset. Option ownership could result in significant loss or gain, especially for options of unhedged positions. Prior to buying or selling an option, investors must review the "Characteristics and Risks of Standardized Options" at http://www.optionsclearing.com/about/publications/character-risks.jsp. or from your SG representative. Analysis of option trading strategies does not consider the cost of commissions. Supporting documentation for options trading strategies is available upon request.

Notice to French Investors: This publication is issued in France by or through Societe Generale ("SG") which is authorised and supervised by the Autorité de Contrôle Prudentiel et de Résolution (ACPR) and regulated by the Autorité des Marchés Financiers (AMF).

Notice to U.K. Investors: Societe Generale is a French credit institution (bank) authorised by the Autorité de Contrôle Prudentiel (the French Prudential Control Authority) and the Prudential Regulation Authority and subject to limited regulation by the Financial Conduct Authority and Prudential Regulation Authority. Details about the extent of our authorisation and regulation by the Prudential Regulation Authority, and regulation by the Financial Conduct Authority are available from us on request.

Notice to Swiss Investors: This document is provided in Switzerland by or through Societe Generale Paris, Zürich Branch, and is provided only to qualified investors as defined in article 10 of the Swiss Collective Investment Scheme Act ("CISA") and related provisions of the Collective Investment Scheme Ordinance and in strict compliance with applicable Swiss law and regulations. The products mentioned in this document may not be suitable for all types of investors. This document is based on the Directives on the Independence of Financial Research issued by the Swiss Bankers Association (SBA) in January 2008.

Notice to Polish Investors: this document has been issued in Poland by Societe Generale S.A. Oddzial w Polsce ("the Branch") with its registered office in Warsaw (Poland) at 111 Marszałkowska St. The Branch is supervised by the Polish Financial Supervision Authority and the French "Autorité de Contrôle Prudentiel". This report is addressed to financial institutions only, as defined in the Act on trading in financial instruments. The Branch certifies that this document has been elaborated with due diligence and care.

Notice to U.S. Investors: For purposes of SEC Rule 15a-6, SG Americas Securities LLC ("SGAS") takes responsibility for this research report. This report is intended for institutional investors only. Any U.S. person wishing to discuss this report or effect transactions in any security discussed herein should do so with or through SGAS, a U.S. registered broker-dealer and futures commission merchant (FCM). SGAS is a member of FINRA, NYSE and NFA. Its registered address at 245 Park Avenue, New York, NY, 10167. (212)-278-6000.

Notice to Canadian Investors: This document is for information purposes only and is intended for use by Permitted Clients, as defined under National Instrument 31-103, Accredited Investors, as defined under National Instrument 45-106, Accredited Counterparties as defined under the Derivatives Act (Québec) and "Qualified Parties" as defined under the ASC, BCSC, SFSC and NBSC Orders

Notice to Singapore Investors: This document is provided in Singapore by or through Societe Generale ("SG"), Singapore Branch and is provided only to accredited investors, expert investors and institutional investors, as defined in Section 4A of the Securities and Futures Act, Cap. 289. Recipients of this document are to contact Societe Generale, Singapore Branch in respect of any matters arising from, or in connection with, the document. If you are an accredited investor or expert investor, please be informed that in SG's dealings with you, SG is relying on the following exemptions to the Financial Advisers Act, Cap. 110 ("FAA"): (1) the exemption in Regulation 33 of the Financial Advisers Regulations ("FAR"), which exempts SG from complying with Section 25 of the FAA on disclosure of product information to clients; (2) the exemption set out in Regulation 34 of the FAR, which exempts SG from complying with Section 27 of the FAA on recommendations; and (3) the exemption set out in Regulation 35 of the FAR, which exempts SG from complying with Section 36 of the FAA on disclosure of certain interests in securities.

Notice to Hong Kong Investors: This report is distributed or circulated in Hong Kong only to "professional investors" as defined in the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) ("SFO"). Any such professional investor wishing to discuss this report or take any action in connection with it should contact SG Securities (HK) Limited. This report does not constitute a solicitation or an offer of securities or an invitation to the public within the meaning of the SFO.

Notice to Japanese Investors: This publication is distributed in Japan by Societe Generale Securities Japan Limited, which is regulated by the Financial Services Agency of Japan. This document is intended only for the Specified Investors, as defined by the Financial Instruments and Exchange Law in Japan and only for those people to whom it is sent directly by Societe Generale Securities Japan Limited, and under no circumstances should it be forwarded to any third party. The products mentioned in this report may not be eligible for sale in Japan and they may not be suitable for all types of investors.

Notice to Korean Investors: This report is distributed in Korea by SG Securities Korea Co., Ltd which is regulated by the Financial Supervisory Service and the Financial Services Commission.

For Documents distributed In Australia by SG Securities (HK) Limited - Notice to Australian Investors: This document is distributed by SG Securities (HK) Limited, a Registered Foreign Company and Foreign Financial Services Provider in Australia (ARBN 126058688) that is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 ("Act"). SG Securities (HK) Limited is regulated by the Securities and Futures Commission under Hong Kong laws, which differ from Australian laws. The information contained in this document is only directed to recipients who are wholesale clients as defined under the Act.

For Documents Distributed in Australia by SG Sydney Branch - Notice to Australian investors: This document is distributed by Société Générale (ABN 71 092 516 286). Société Générale holds an AFSL no. 511956 issued under the Corporations Act 2001 (Cth) ("Act"). Société Générale is a foreign Authorised Deposit-Taking Institution under the Banking Act 1959 (Cth) and any products described in this document which are issued by Société Générale do not form deposits or other funds of Société Générale. No entity described in this document (aside from Société Générale) is an