

Presentation to 'AAI Los Angeles Chapter' June Meeting:



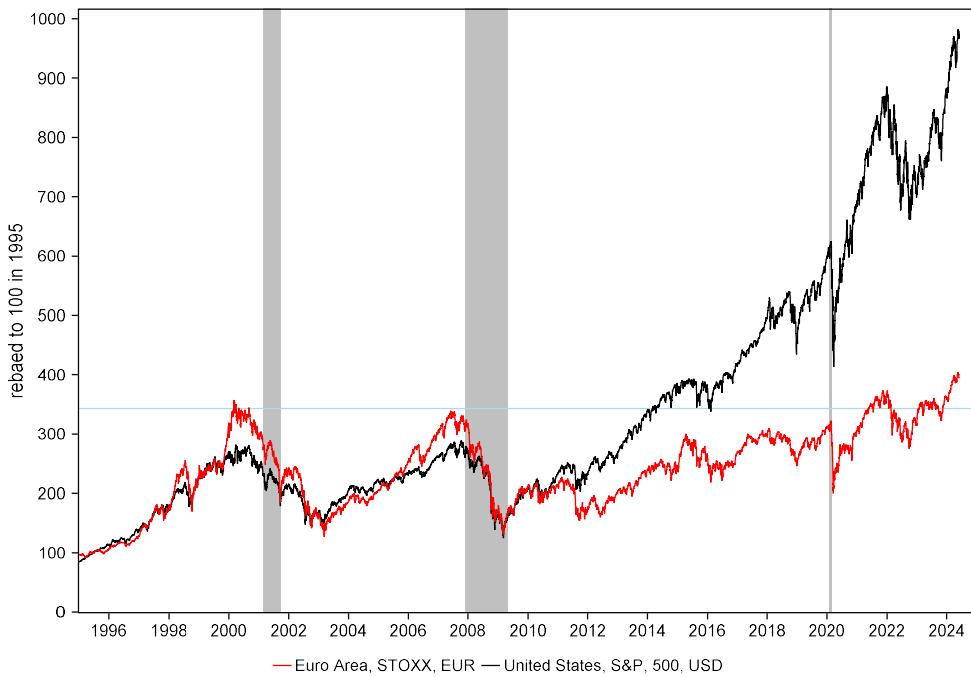
Rotate, Rotate, Rotate!

a.k.a. Why the magnificent seven won't dominate forever and what's coming next (for investors)?

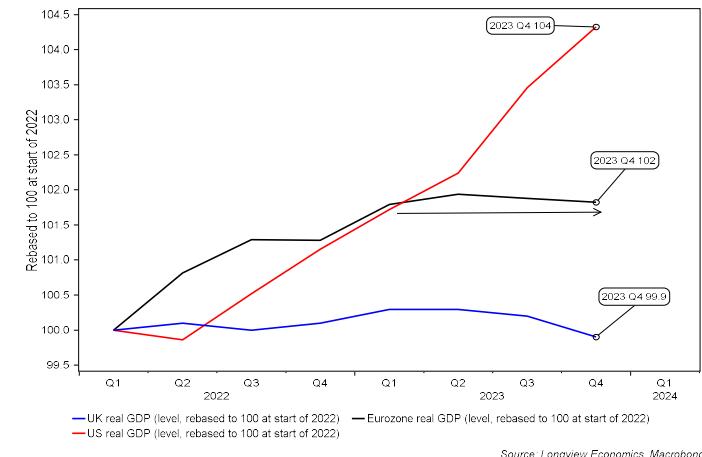
Chris Watling, Global Economist & Chief Market Strategist,
Longview Economics, June 2024

GDP, Stock Market & Earnings Compared – Exceptional US performance

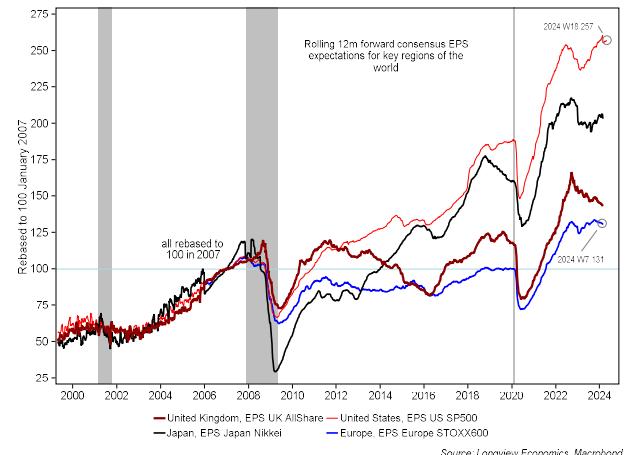
US & European equity markets (rebased to 100 in 1995)



US, UK & EZ real GDP level (rebased to 100 at start of 2022)

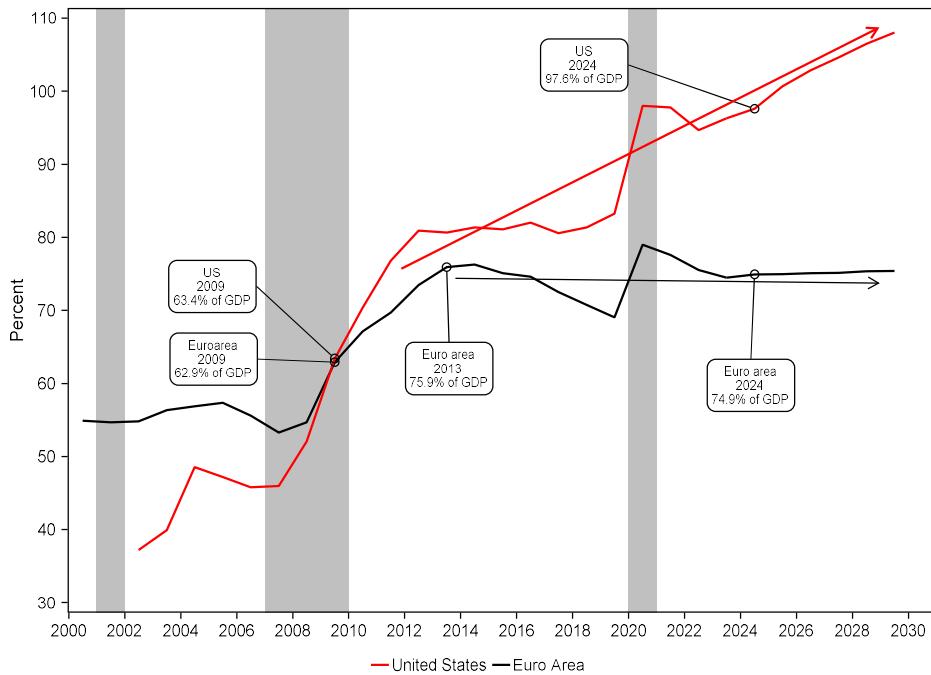


Consensus rolling 12m forward EPS – for key global regions/markets

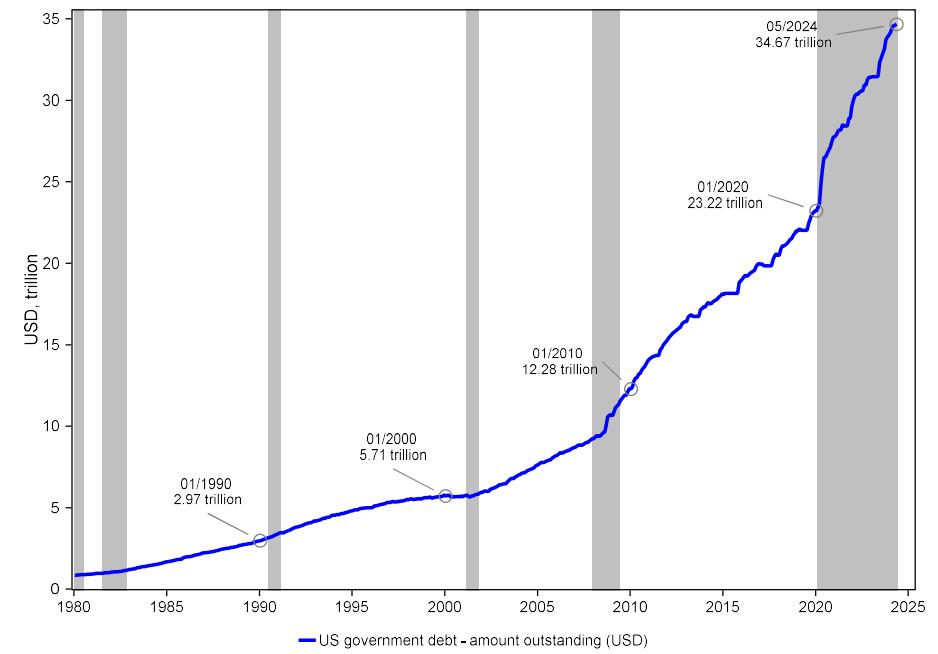


US Earnings → have been helped by US ‘Fiscal Laxity’

US & EZ net government debt (relative to GDP, %)

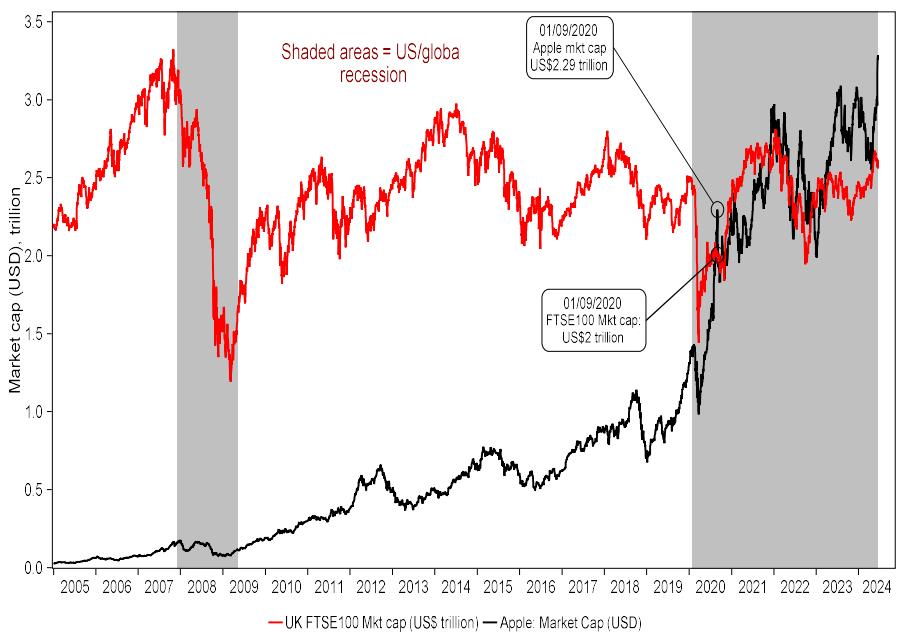


US outstanding government debt (\$tn)

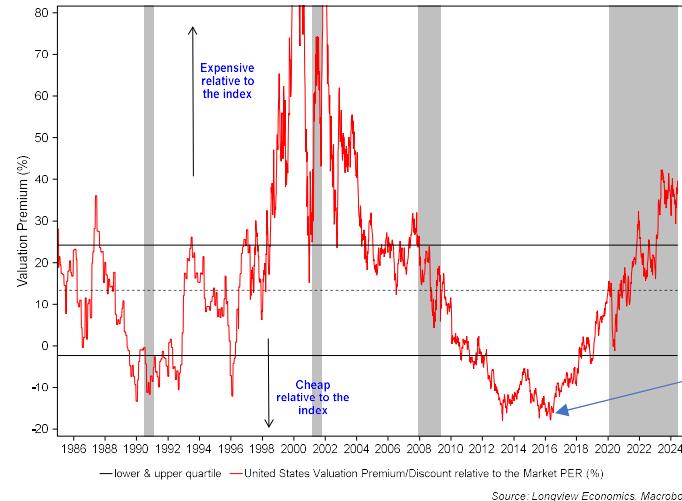


Last 5 - 10 years -> All about Tech/growth stocks

Apple's Market cap vs. the UK's FTSE100's market cap



US Tech PER rel. to US Equity Market



Tech was cheap in 2013/15 (rel. to mkt) – now expensive

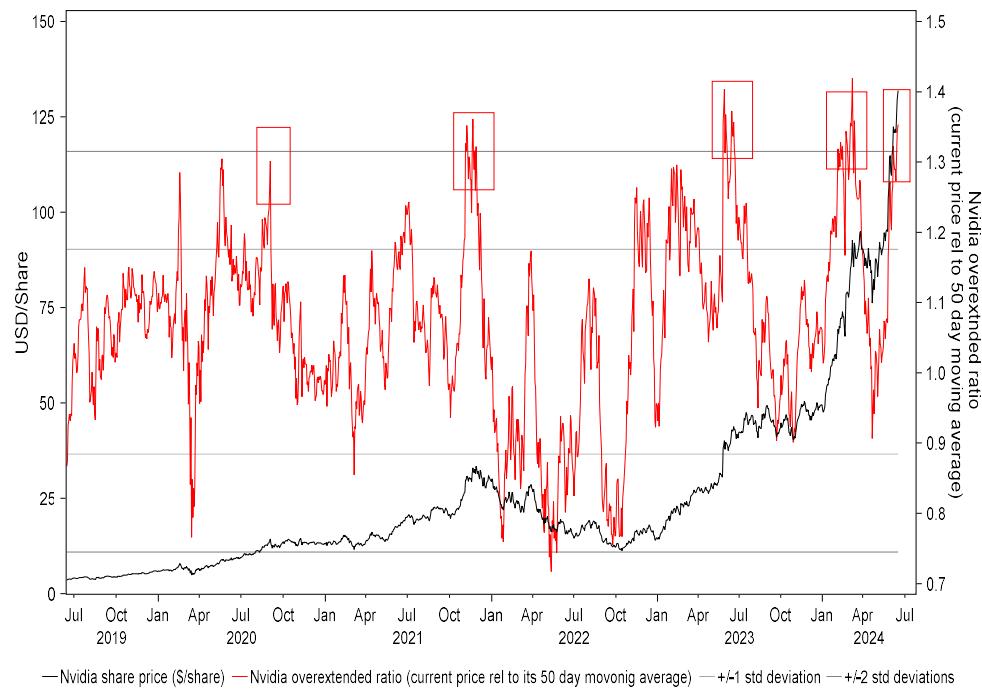
FAAMGs + NVIDIA & Tesla (market cap) as % of global market cap



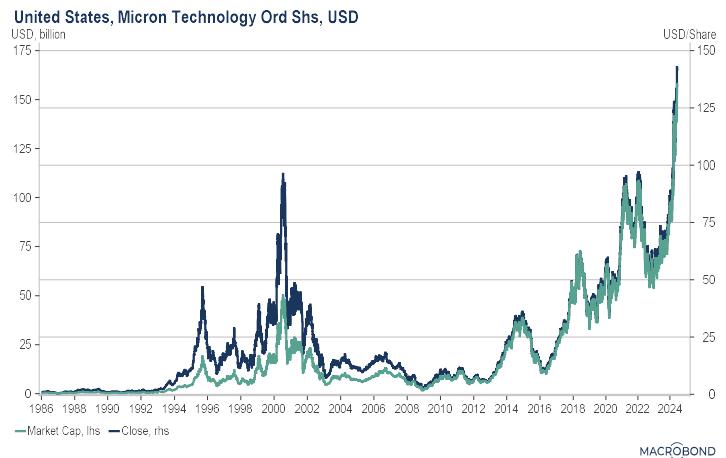
7 stocks now account for ~1/5th of the total market cap of the global stock market

Last 2 years (specifically) -> All about AI

Nvidia shown with an 'over-extendedness' indicator

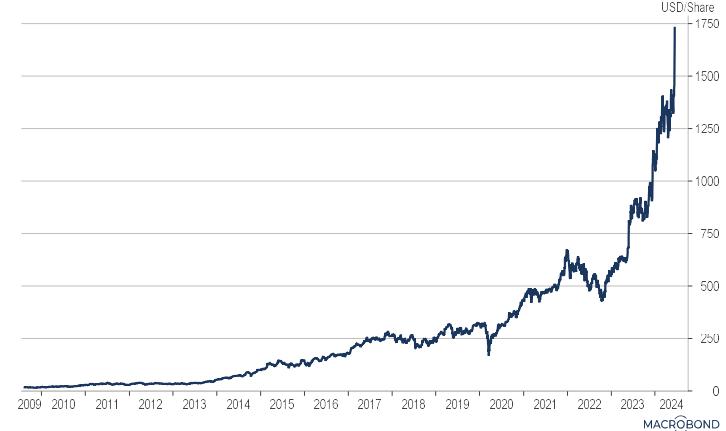


Micron (\$/share)



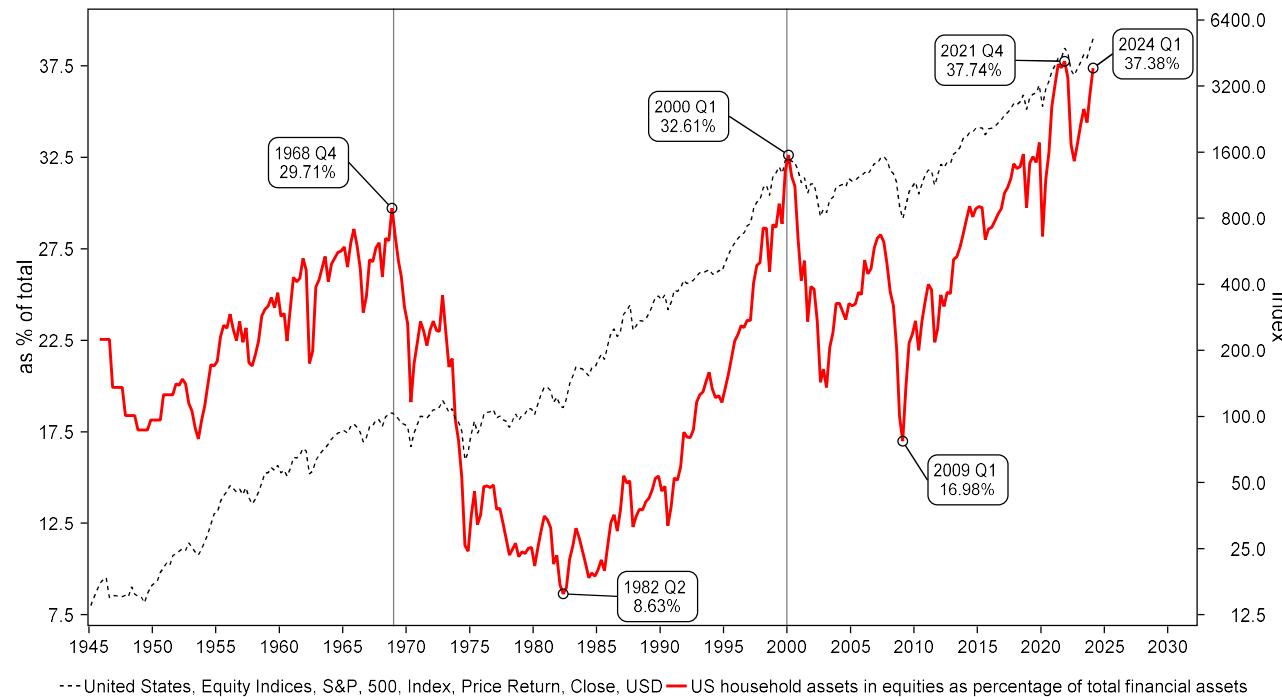
Broadcom – competitor to Nvidia

United States, Broadcom Ord Shs, Close, USD



Households: Over-ownership of Equities - All in! Even though bond yields are now high

US household equity ownership as % of total financial assets





Theme:

“The Great Global Sector Leadership Switch”

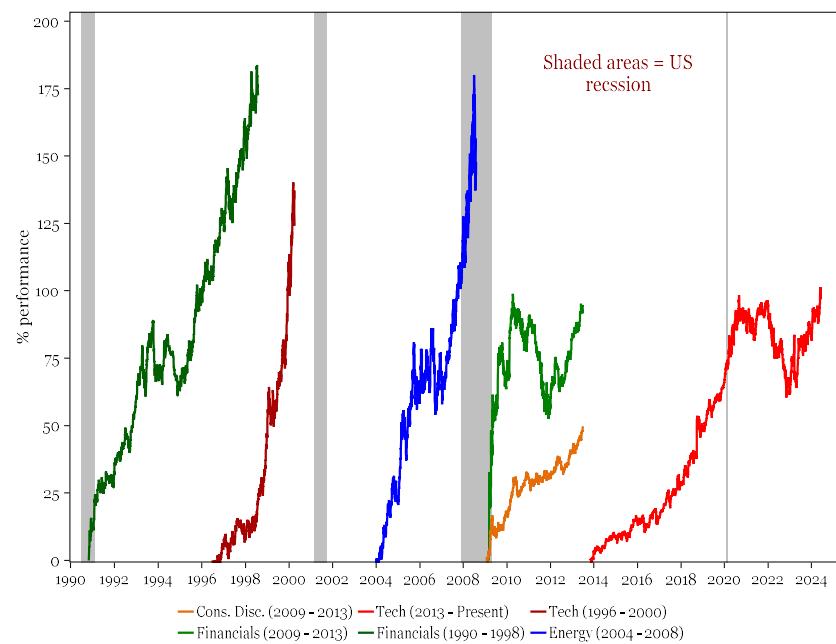
1. Markets Have Fashions (the history)
2. The big picture global macro themes for the next 2 – 5 years (the driver)
3. The message of (relative) valuation (the back-up)

1. Markets Have Fashions

Rotation of Global Sector Leadership 1990s through to present

| Period/Bull market | Macro theme | Leadership |
|--------------------|---|--|
| Late 1990s | Productivity miracle/new technologies | TMT |
| Noughties | CSC/rise of China – housing booms/end of 18 year land cycle | Banks, materials & energy |
| Post GFC - 2015 | Hunt for Yield | Yielding/income plays – healthcare/staples |
| 2015 – 2020/21 | Scarcity of growth/deflation fears (low bond yields) | Tech/Growth & concept stocks |
| 2022/3 - ? | Normalisation of policy/US & western consumer strength/final years of an 18 year land cycle (+ CSC) | New Leadership - ?? |

(some of the) S&P500 sector leadership
(% performance of leading sectors)



Long cycle of Leadership – changing
-> driven by overarching global macro theme

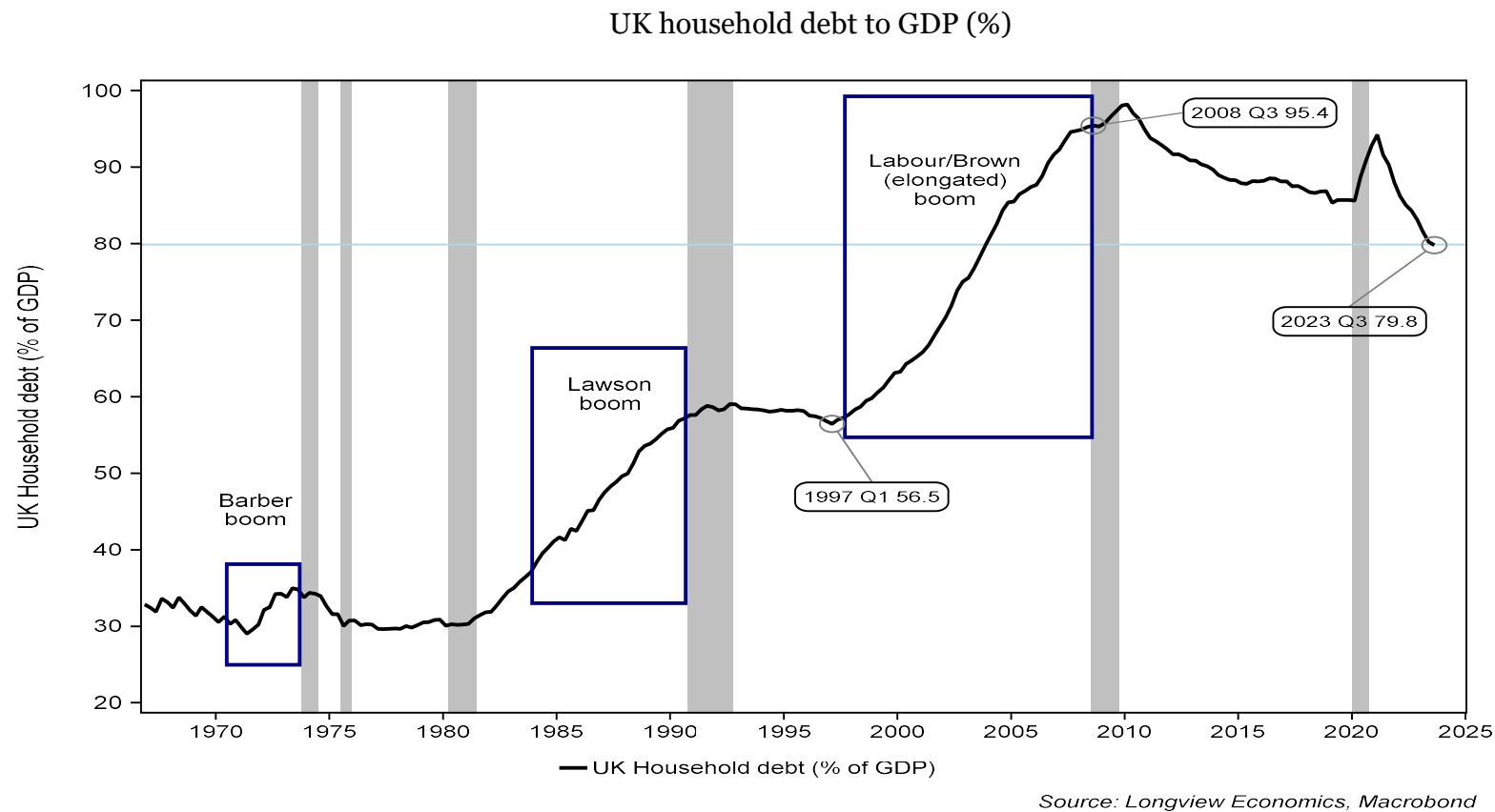
Source: Longview Economics, Macrobond

2. The Changing Global Macro Theme

Western Consumer
& Housing Boom



The Boom Thesis



Western Household Balance sheets Credit Booms Brewing (UK, US)

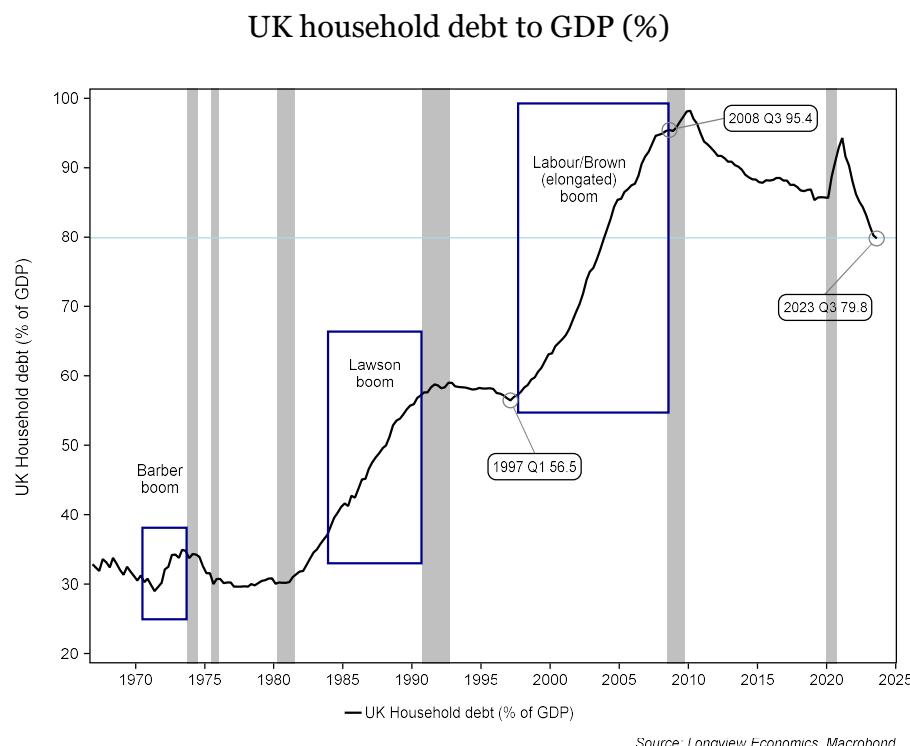
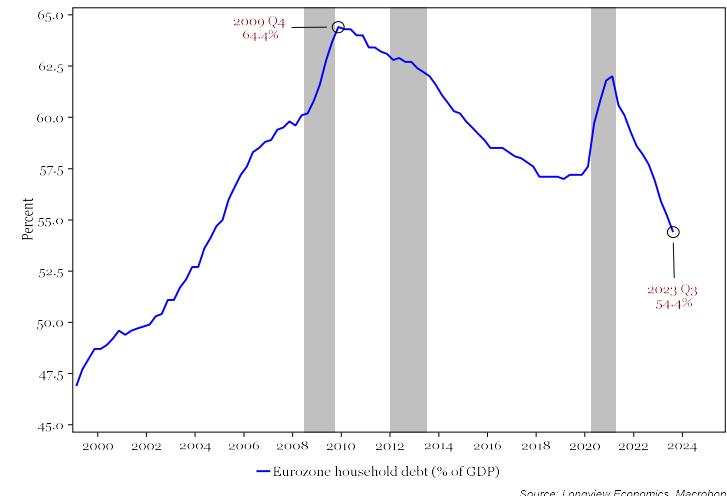
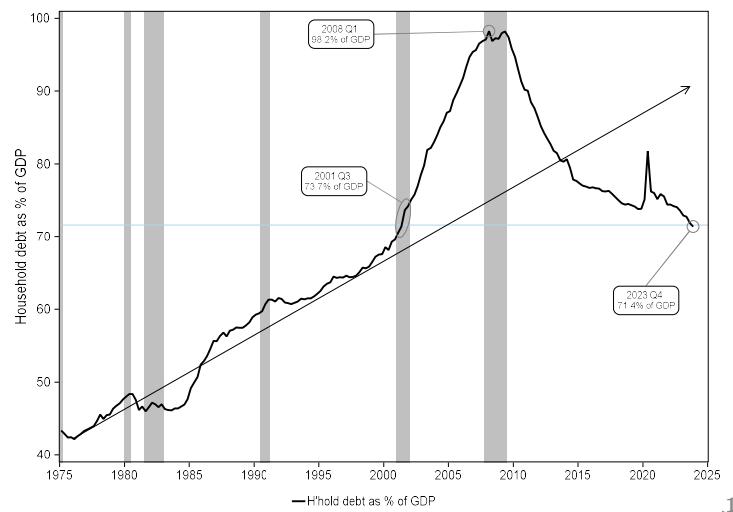


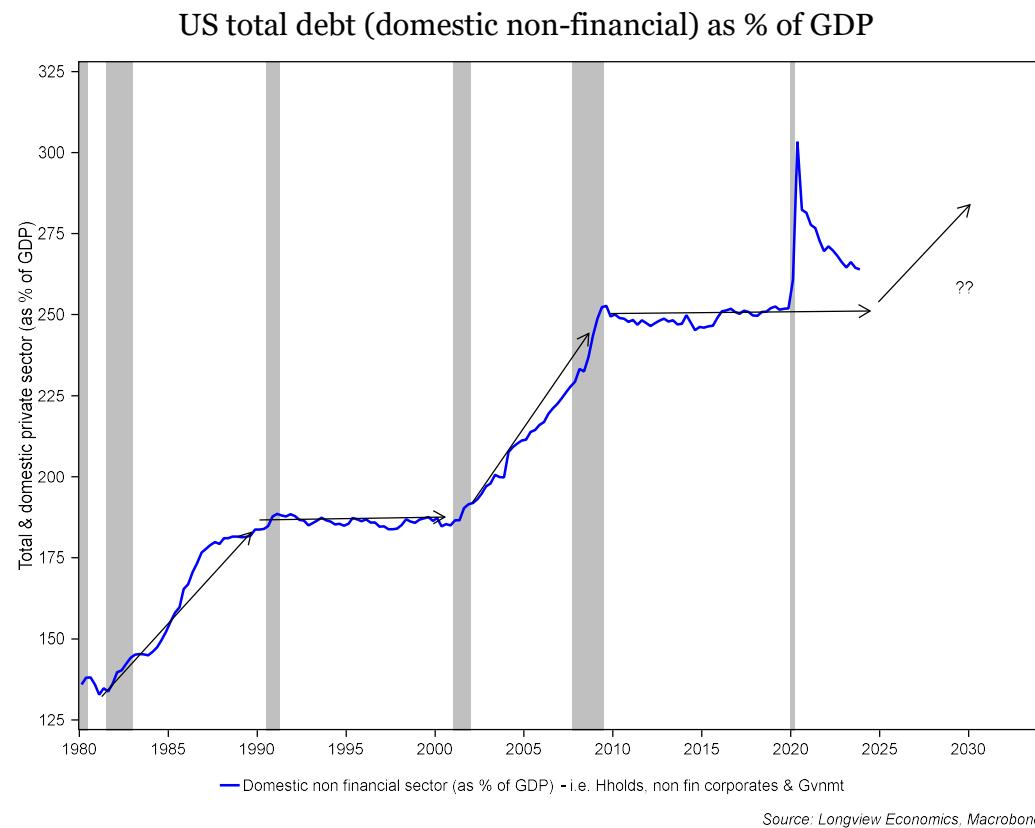
Fig 11: Eurozone household debt to GDP (%)



US Household debt to GDP (%)



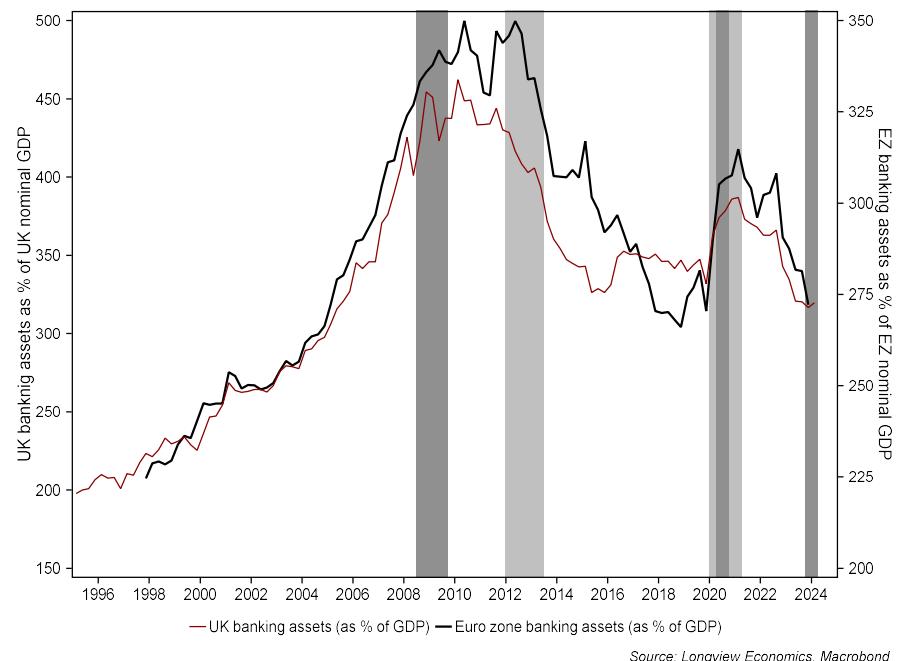
US Phases of Leveraging (interspersed with phases of flatlining)



i.e.
corporate,
government
and
household
sector

Western Banking Systems -> Capital Up/Leverage Down

FIG 5a: Tier I capital ratio vs. common Tier 1 ratio (% of risk weighted assets)



European banks have been repairing their balance sheets and their capital buffers, particularly in the 8 – 10 years after the GFC. Rate cuts, in our view, will therefore be a key trigger for a renewed phase of strong bank lending/consumer re-leveraging. This will mean stronger economic and earnings growth outcome in Europe over the next 1 – 4 years (i.e. compared to recent years).

US banks – risk weighted assets as % of total assets

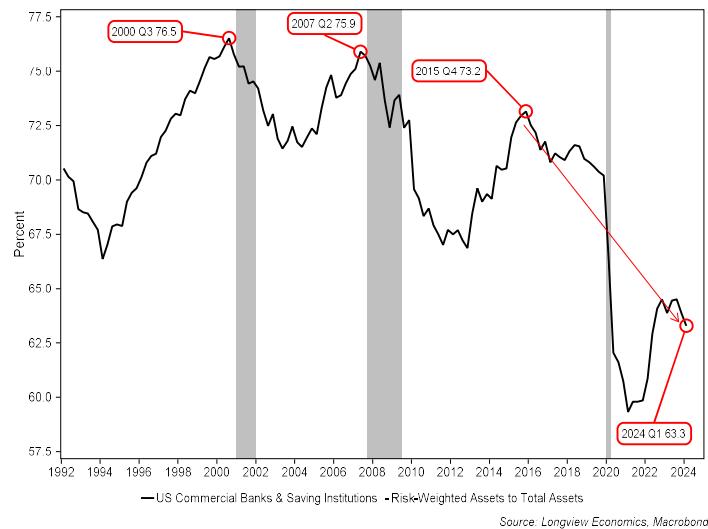
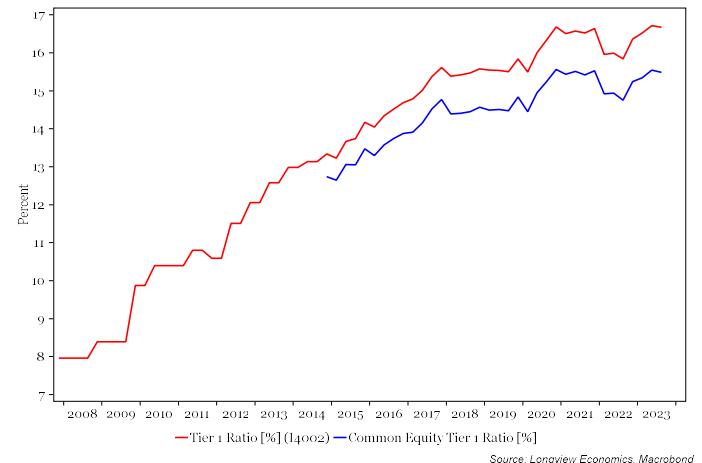
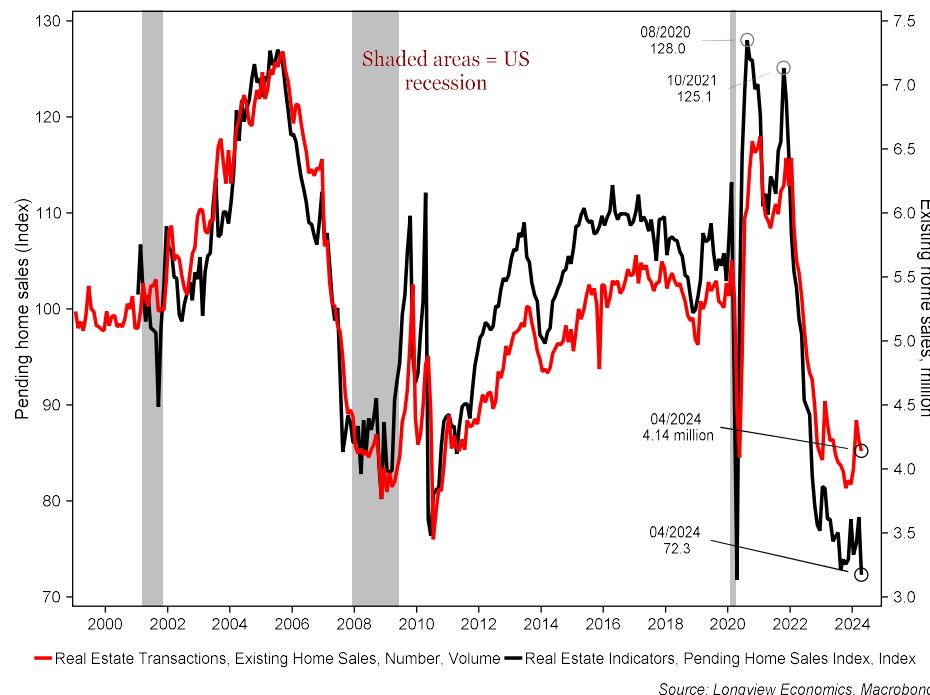


FIG 5: Eurozone & UK banking assets (as % of GDP)



Western Housing Activity – Depressed BUT if you cut rates....

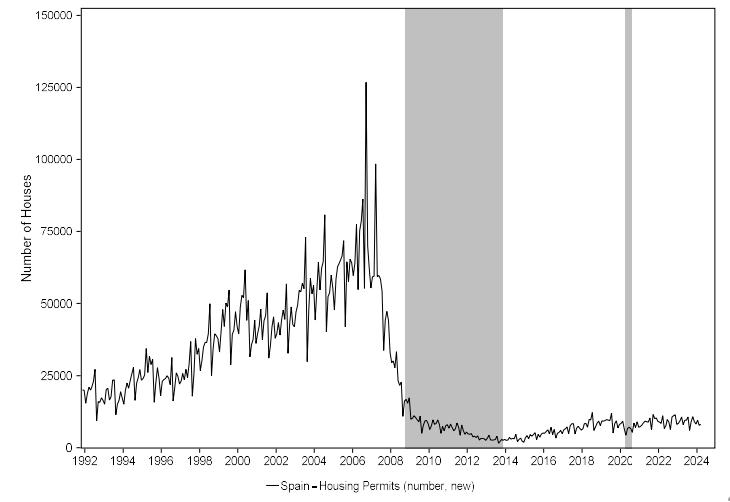
US existing home sales (number) vs. pending home sales (index)



UK net mortgage lending (£bn, monthly)

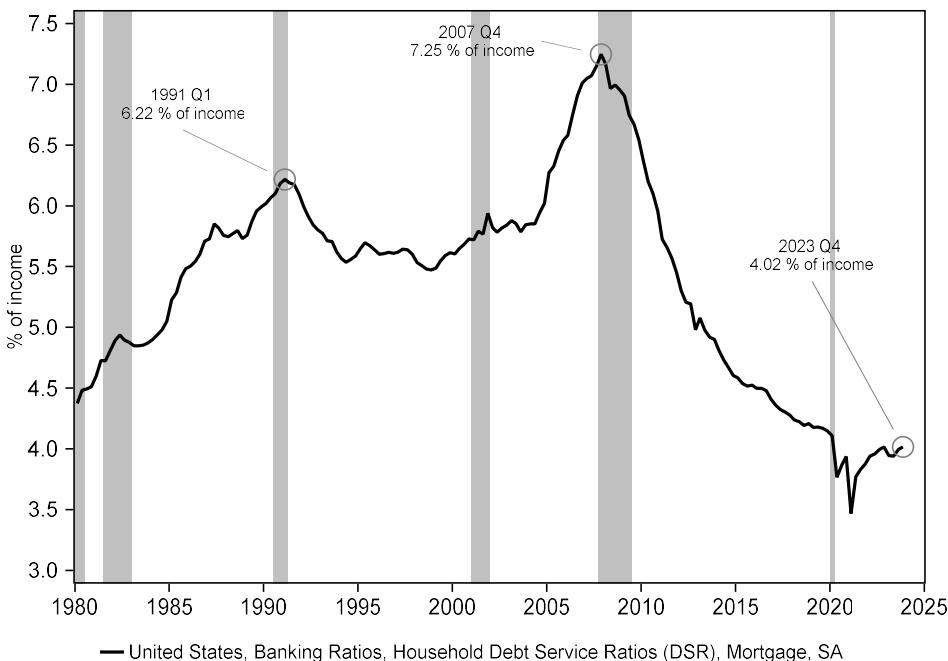


Spanish building permits



Affordability -> Debt service ratios good

US households – mortgage debt service ratio (as % of income)



Source: Longview Economics, Macrobond

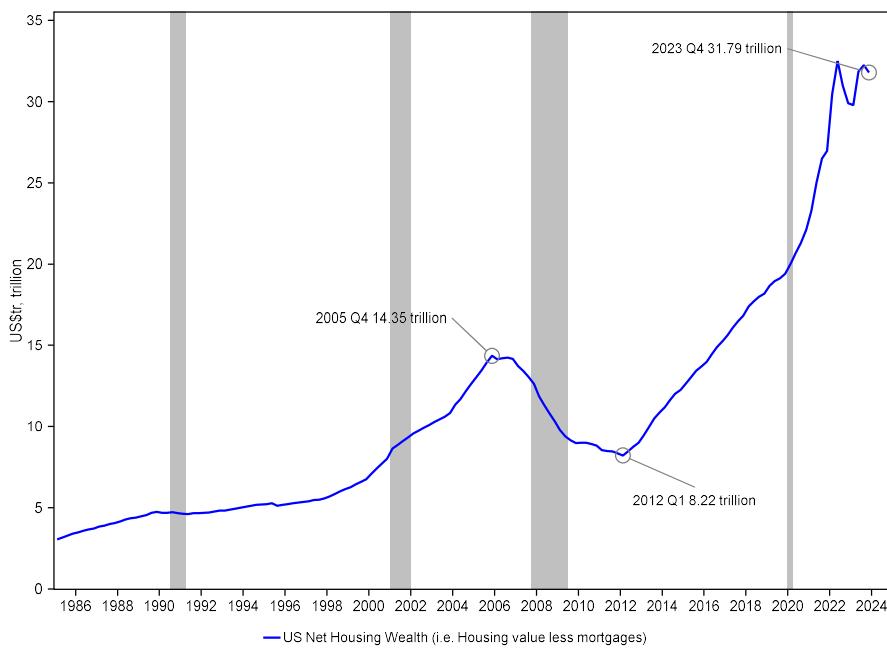
UK households – mortgage debt service costs (as % of GDP)



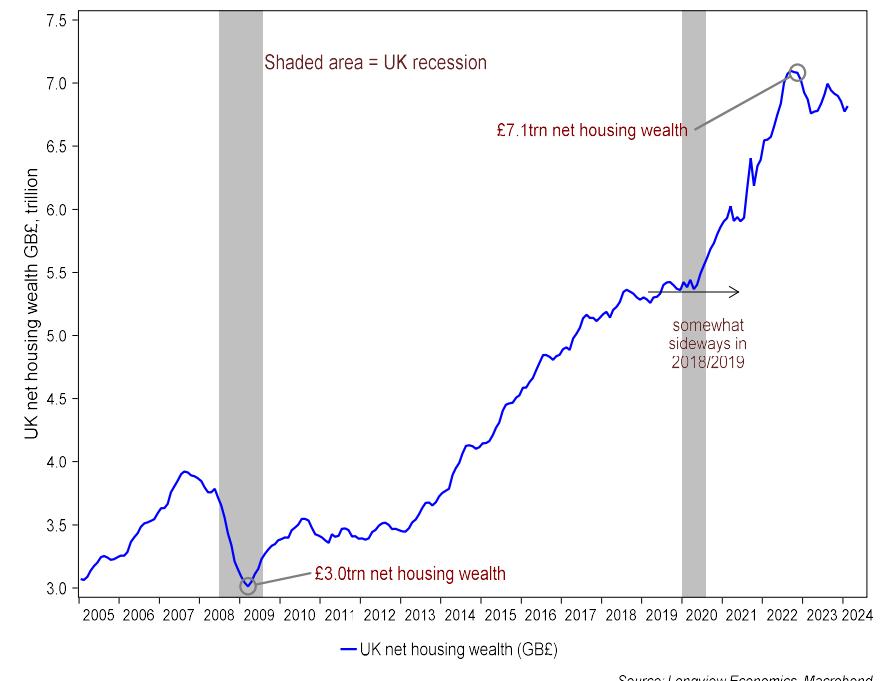
Source: Longview Economics, Macrobond

High level of Western Housing Wealth

US households' net housing equity
(net of mortgage debt), US\$tn

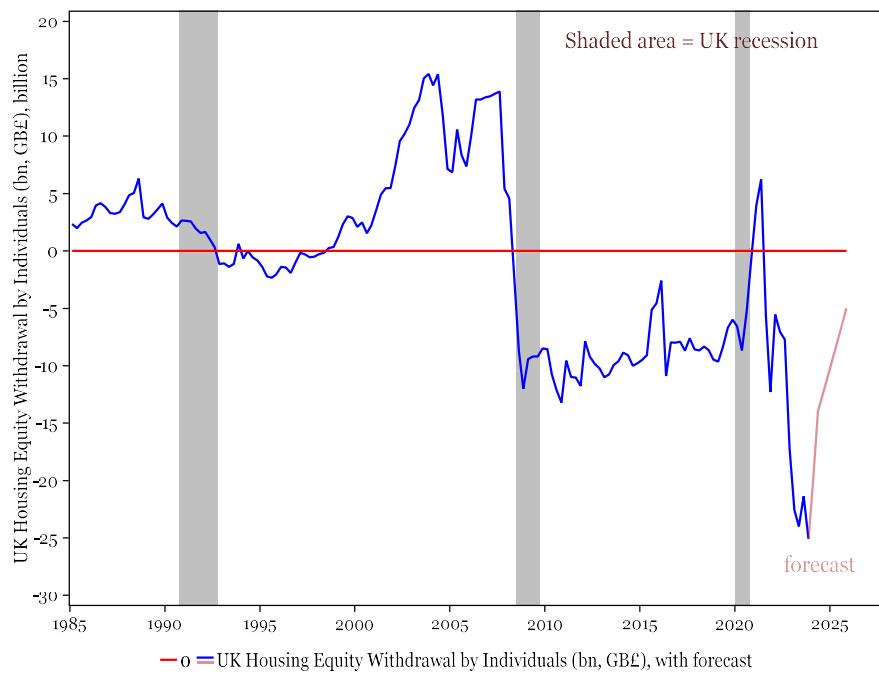


UK net housing wealth (GB£, tn)

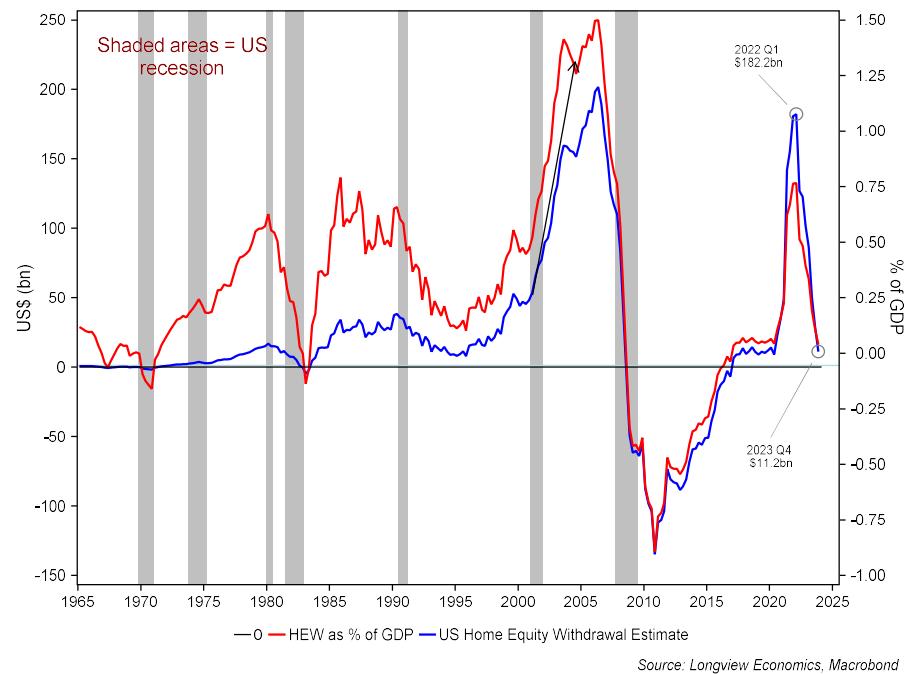


HEW should turn positive (coming quarters)

UK Housing Equity Withdrawal (GB£, bn), with 2024 & '25 forecasts



US Home equity withdrawal (US\$b & as % of GDP)



A New Cycle is Dawning

Powerful Combination of Factors Coming Together

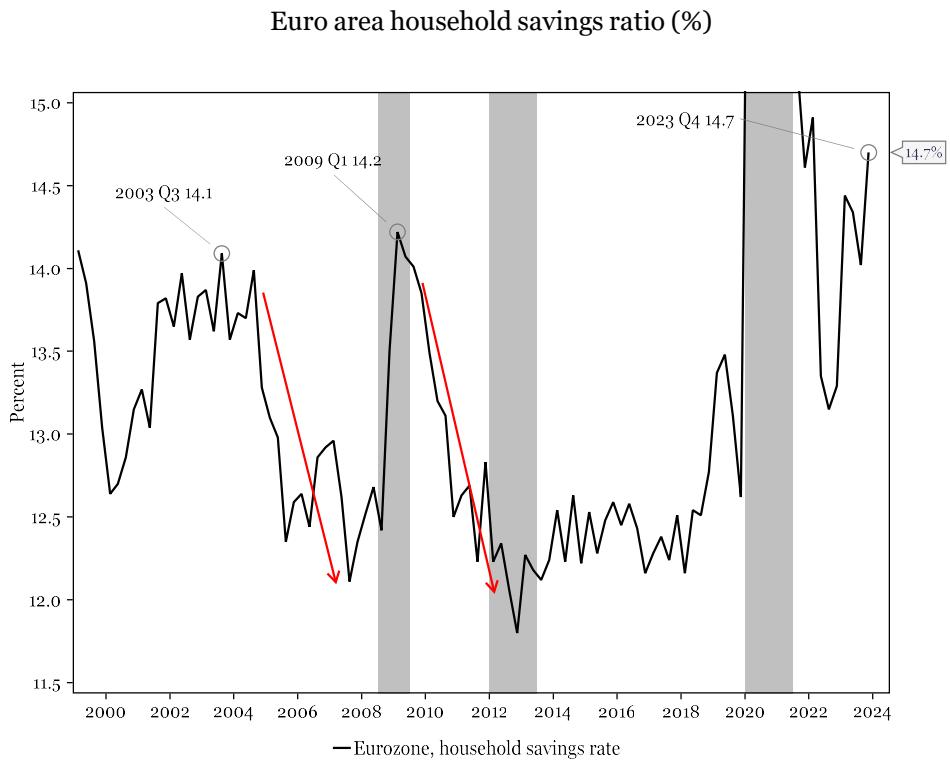
It's a common theme, though, in the US, across much of Southern Europe and in the UK.

Its ingredients are essentially as follows:

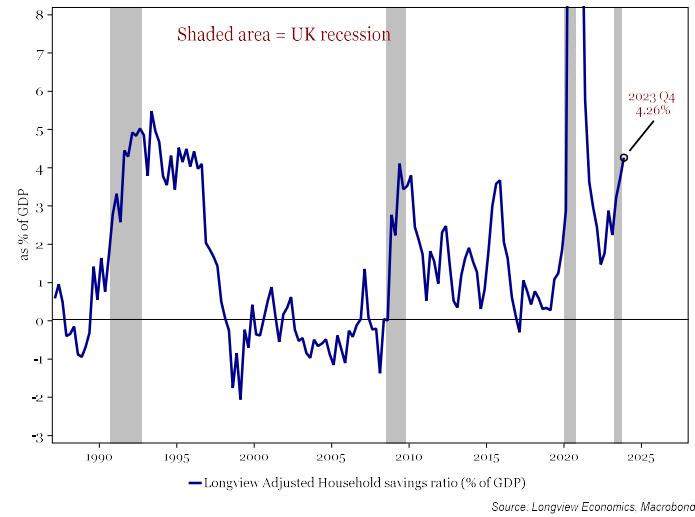
- **High levels of bank capital** and banks which want to lend money;
- **Households** which have **held back from borrowing** because of high interest rates – and have **high levels of housing equity**;
- **Households** which have also **deleveraged** their balance sheets over the past 15 years (post GFC), and now have relatively low household debt to GDP levels (compared to high developed debt to GDP countries, e.g. Australia, New Zealand);
- **Housing market activity is depressed.** BUT should pick up in response to rate cuts (as they happen).
- Countries where **inflation is falling**, money is tight and growth is/will be soft. As such, inflation should hit its target soon (and in many cases go below target – e.g. see our analysis on why UK inflation will probably hit 0% – 1% in the next 6 – 12 months, available [HERE](#));
- As such, those countries' central banks will be cutting policy rates soon (and most likely several times).

Added to that mix, the aforementioned countries also generally have structurally strong corporate sectors (e.g. see the US & EZ corporate sector cashflow charts). And in many instances, equity markets are attractively priced (i.e. with low PE ratios – NB not the US large cap market).

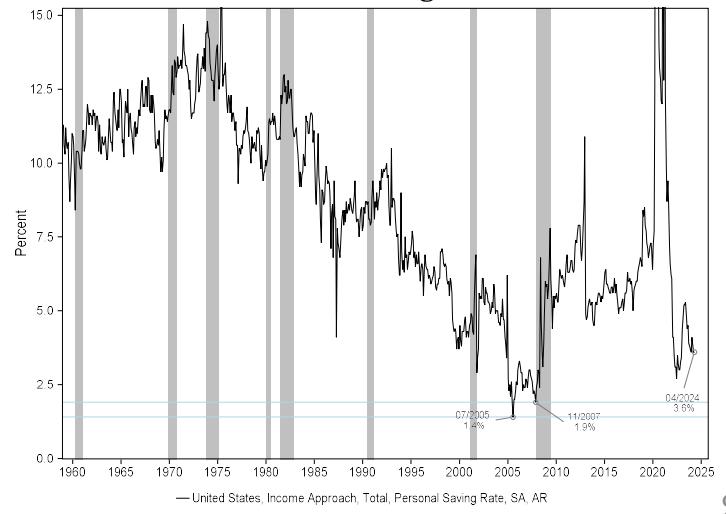
Household Sector: America vs. Europe/UK



UK adjusted household savings ratio (as % of GDP)

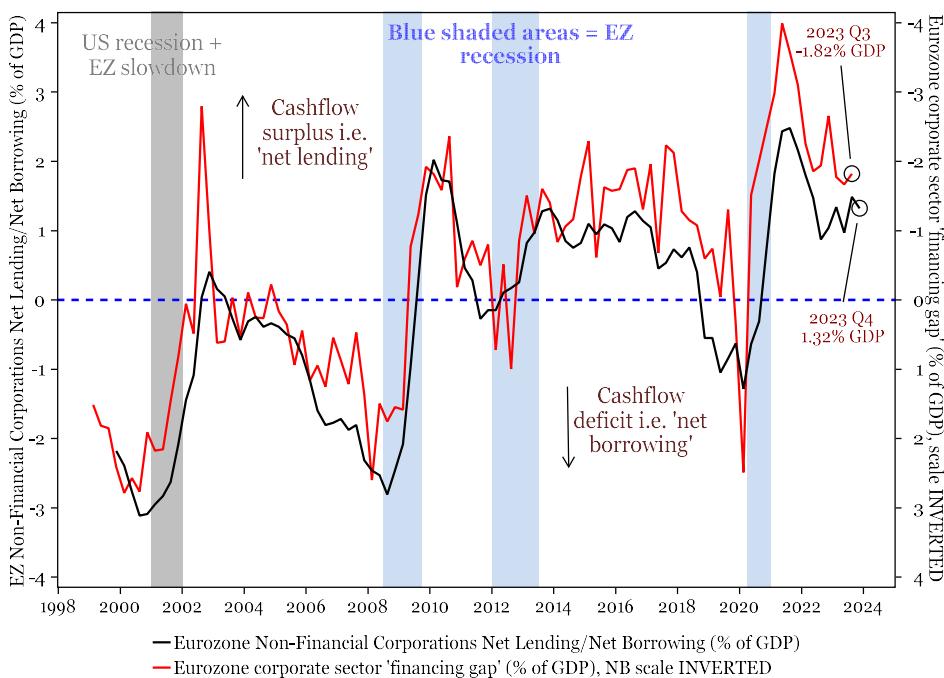


US household savings ratio (%)

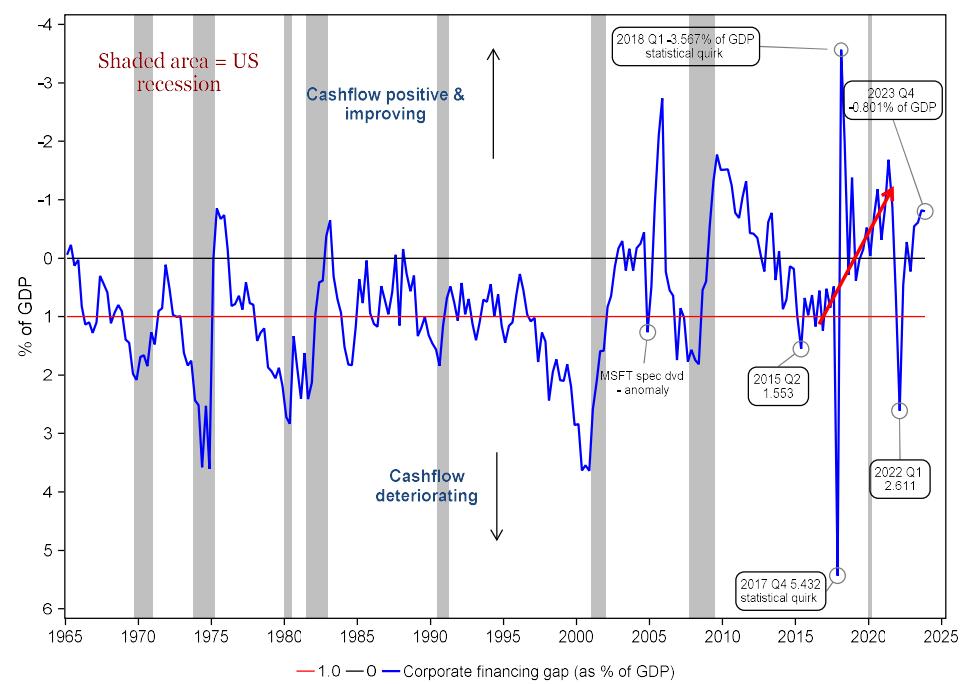


Corporate Sectors: America vs. Europe

Euro zone corporate sector free cashflow (as % of GDP)

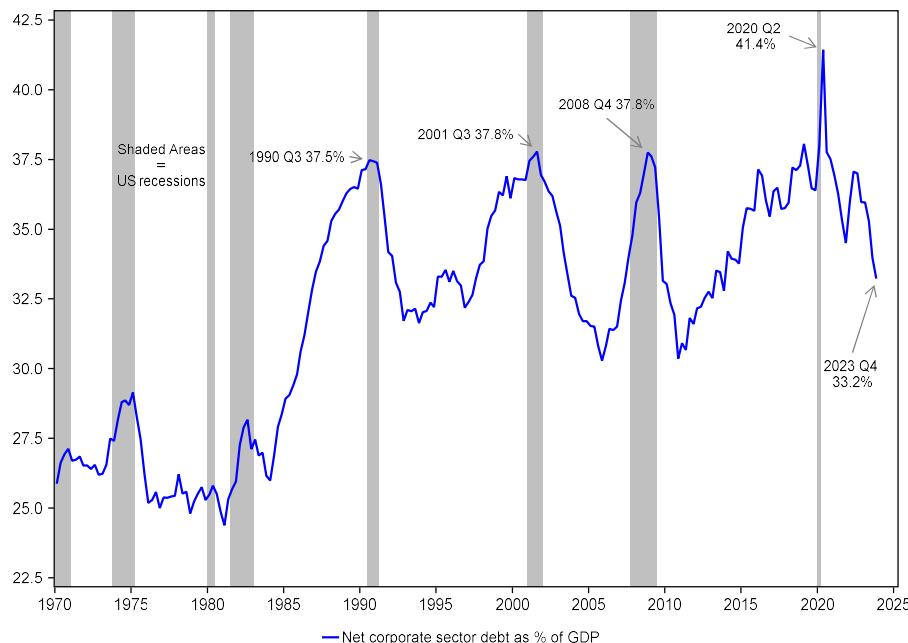


US corporate sector financing gap (% of GDP)

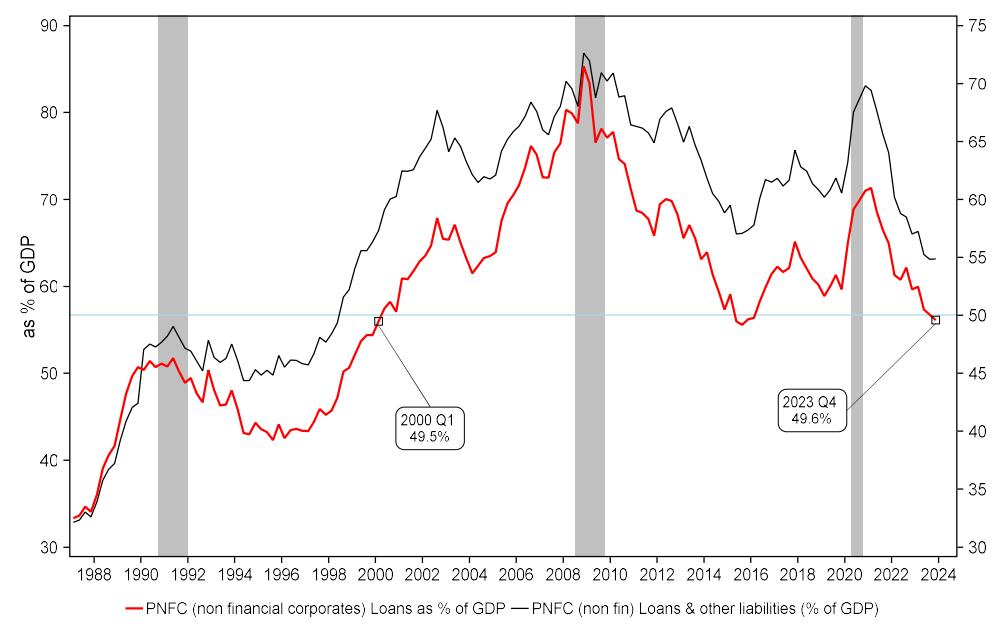


Western Corporate sectors

US corporate sector debt net of cash and cash equivalents (% of GDP)

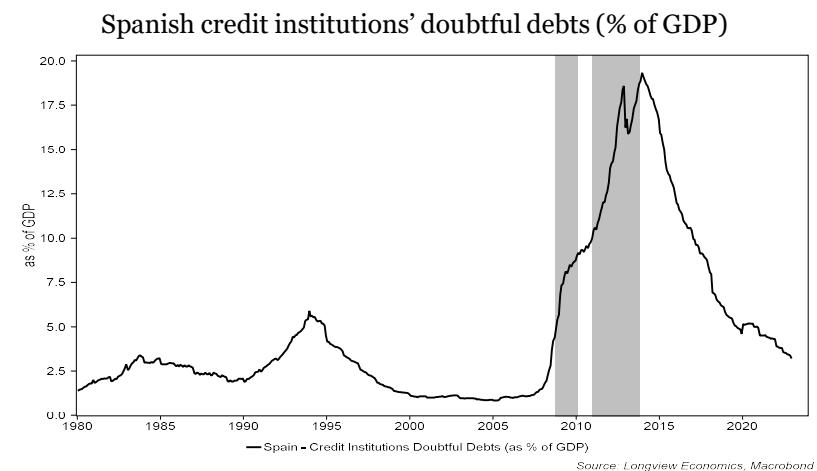
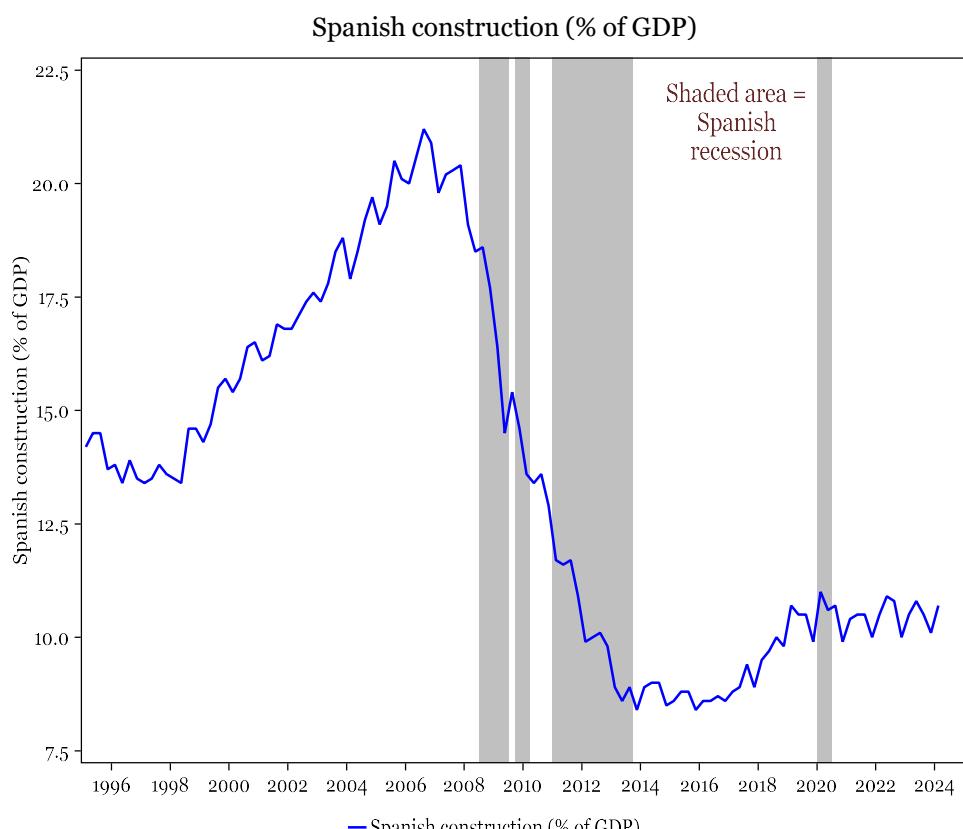


UK Private sector corporates loans/liabilities as % of GDP

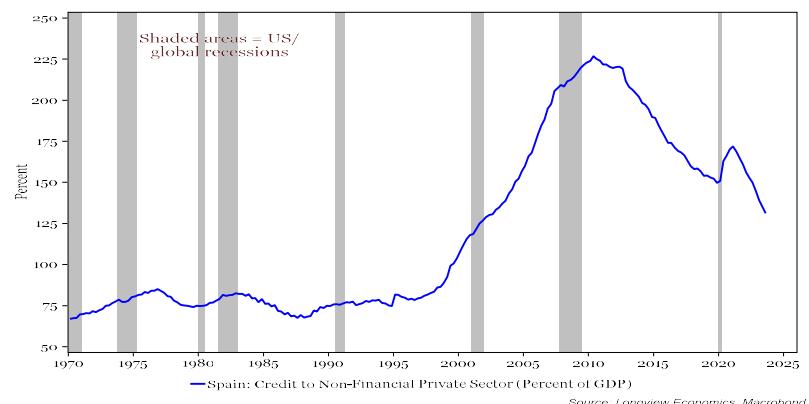


Leadership Switch within Europe → from North to South!, e.g. Spain

Structural imbalances in the Spanish economy have unwound.



Spain: Credit to Non-Financial Private Sector (% of GDP)



3. Relative valuation

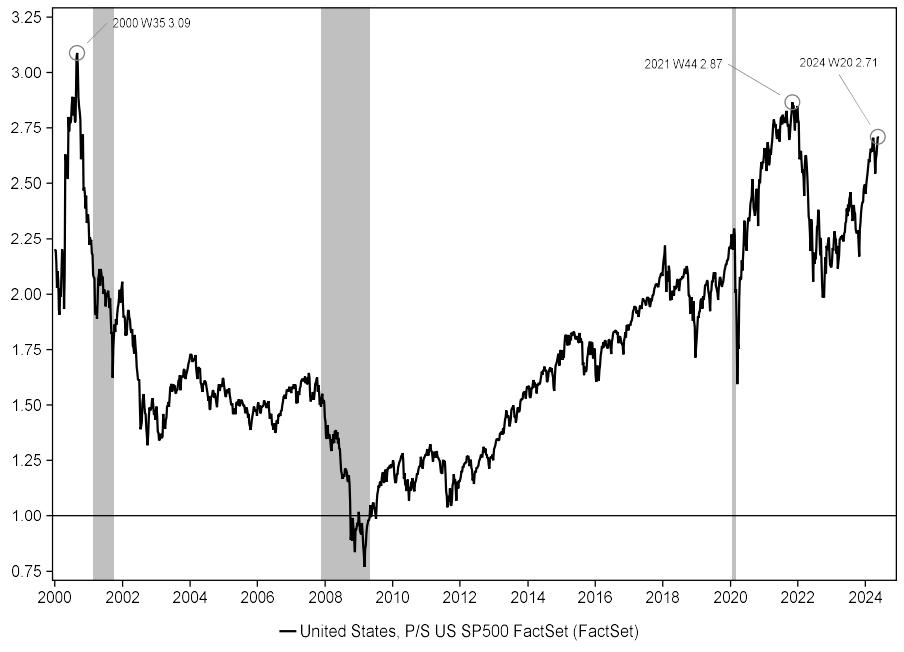
US (large cap)
Valuation Risk ->
High

(timing, as always, is the challenge)

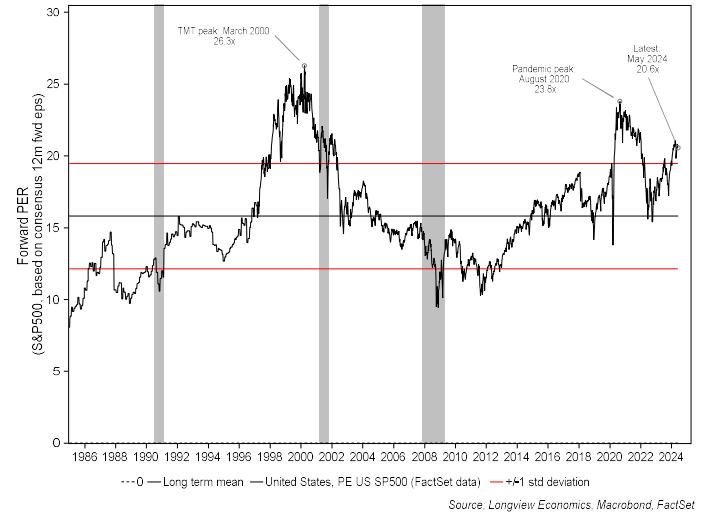


Rich US Valuations

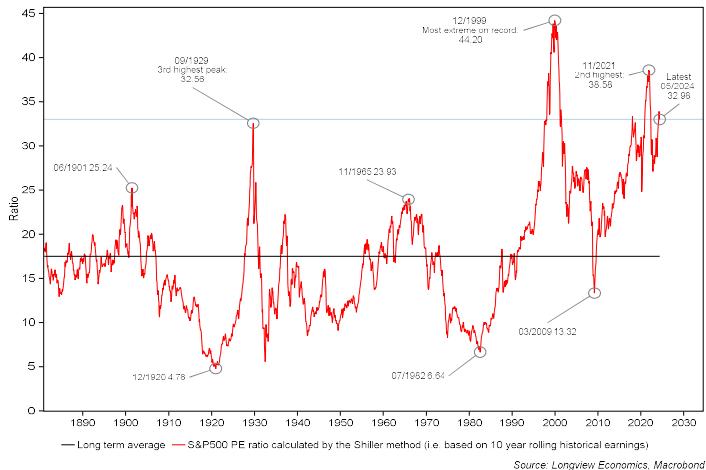
US S&P500 market capitalization to sales ratio
(multiple)



S&P500 forward PE ratio (based on 12m fwd consensus EPS)



Shiller PE ratio



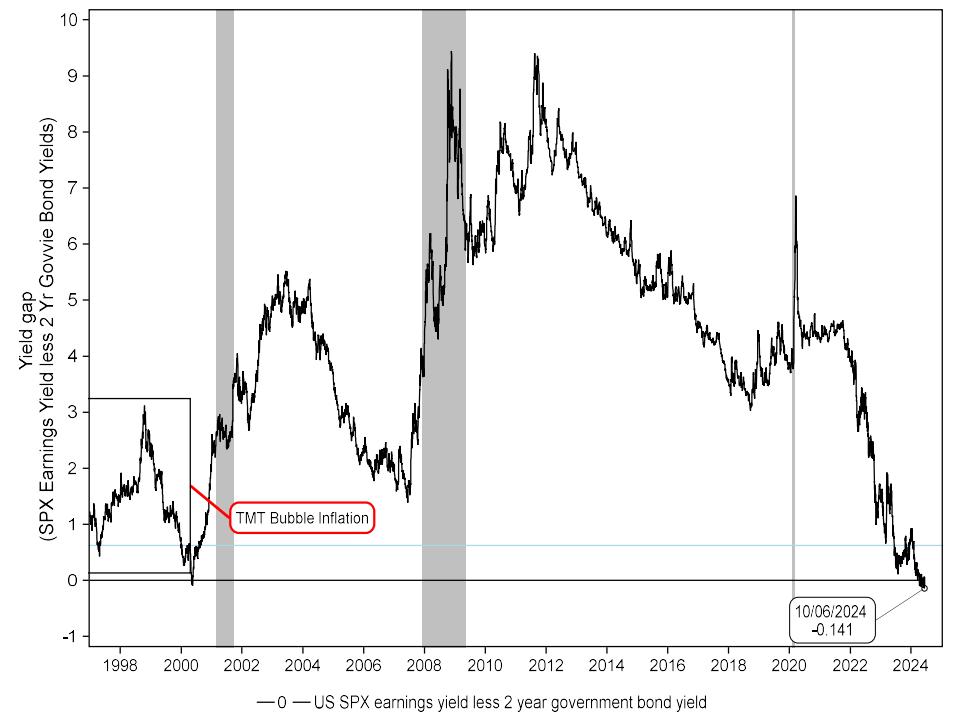
US Equities

Also, expensive rel to bonds/yield

US Equity Risk Premium (Earnings yield less real bond yield, %)



US S&P500 Earnings yield (inverse of PER) less 2 year bond yield (pp)



++ Almost All US Sector -> Expensive

Table 1: Sector standalone and relative PE ratios (with data scored as percentiles)

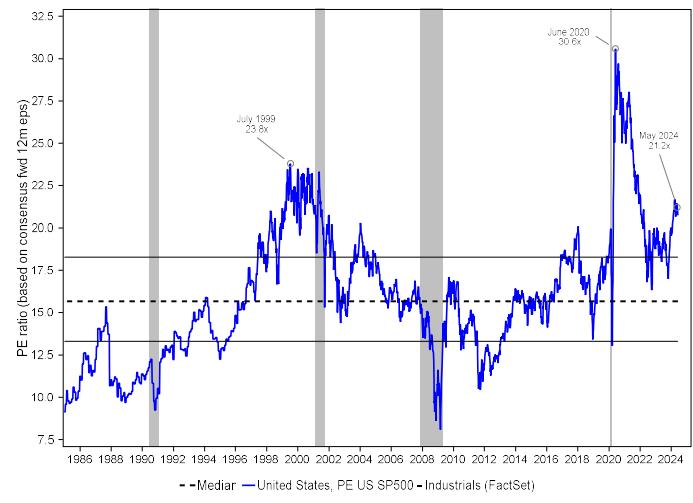
| S&P 500 Sector | vs. Index | Data since | fwd PE ratio (x) | vs. own history | vs. | | | | | | | | | | |
|---------------------------|--------------|---------------|---------------------|--------------------|---|----|----|----|----|----|----|----|----|----|----|
| | | | | | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 |
| 1. Energy | 5 | 31/12/1984 | 12.1 | 33 | | 2 | 6 | 9 | 12 | 11 | 11 | 4 | 18 | 13 | 45 |
| 2. Materials | 63 | 31/12/1984 | 20.3 | 94 | 99 | 60 | 55 | 88 | 79 | 86 | 19 | 84 | 62 | 87 | |
| 3. Industrials | 59 | 31/12/1984 | 21.2 | 91 | 96 | 40 | 51 | 87 | 77 | 85 | 15 | 84 | 61 | 89 | |
| 4. Consumer Discretionary | 53 | 31/12/1984 | 24.2 | 83 | 92 | 45 | 49 | 79 | 67 | 76 | 27 | 80 | 67 | 81 | |
| 5. Consumer Staples | 11 | 31/12/1984 | 20.5 | 81 | 90 | 12 | 13 | 21 | | 30 | 31 | 9 | 57 | 36 | 86 |
| 6. Healthcare | 24 | 31/12/1984 | 19.4 | 85 | 90 | 21 | 23 | 33 | 70 | | 44 | 9 | 61 | 48 | 85 |
| 7. Financials | 9 | 31/12/1984 | 15.2 | 83 | 90 | 14 | 15 | 24 | 69 | 56 | | 12 | 69 | 38 | 85 |
| 8. IT | 87 | 31/12/1984 | 28.6 | 91 | 97 | 81 | 85 | 73 | 91 | 91 | 88 | | 92 | 78 | 87 |
| 9. Communications | 17 | 31/12/1984 | 18.9 | 72 | 83 | 16 | 16 | 20 | 43 | 39 | 31 | 8 | | 22 | 76 |
| 10. Utilities | 44 | 31/12/1984 | 17.3 | 86 | 88 | 38 | 39 | 33 | 64 | 52 | 62 | 22 | 78 | | 96 |
| 11. Real Estate | 11 | 27/12/1999 | 16.5 | 26 | 57 | 13 | 11 | 19 | 14 | 15 | 15 | 13 | 24 | 4 | |
| Index | | 31/12/1984 | 20.7 | 86 | 96 | 37 | 41 | 47 | 89 | 76 | 91 | 13 | 83 | 56 | 89 |

Data up to: 20/5/2024

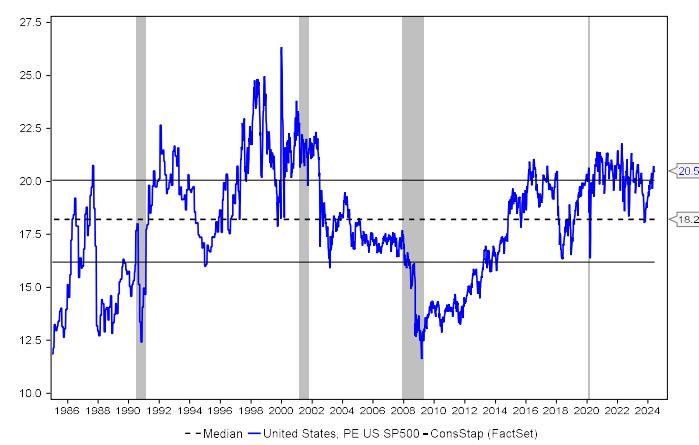
These tables should be read as the row header relative to the column header. Cells/Rows shaded red are more expensive on a percentile basis relative to history, while those shaded green are cheap on that relative basis.

Source: Longview Economics, Macrobond

US industrials – forward PE ratio (1985 to present)



US consumer staples – forward PE ratio (1985 to present)



Digging into those sectors.... Rich Large Cap Val'ns

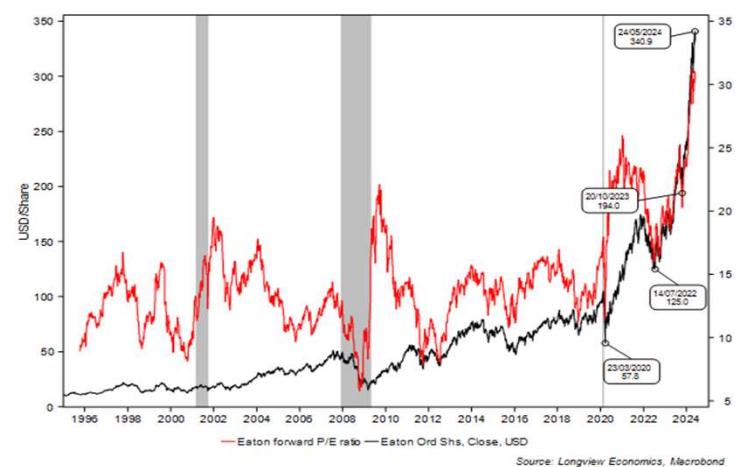
Top 20 stocks by size (market cap) in the S&P500
industrials sector

| Top 20 stocks (by market cap) | 2024 EPS estimate | 1m change in 2024 EPS estimate | No of estimates | Fwd PE (x) | Fwd D/Y (%) | Fwd P/S (x) | Price chg (1m) | Price chg (12m) | Mk Cap (\$bn) |
|-------------------------------------|-------------------|--------------------------------|-----------------|------------|-------------|-------------|----------------|-----------------|---------------|
| GE Aerospace | 4.0 | DOWN -0.4% | 14 | 30.4 | 0.6 | 4.7 | -0.5% | 100% | 179.1 |
| Caterpillar Inc. | 21.7 | UP 0.2% | 23 | 15.3 | 1.7 | 2.4 | -3.3% | 60% | 165.4 |
| RTX Corporation | 5.4 | UNCH 0.0% | 21 | 18.3 | 2.4 | 1.7 | 2.1% | 12% | 139.0 |
| Union Pacific Corporation | 11.3 | UP 0.4% | 25 | 18.9 | 2.4 | 5.4 | -6.3% | 17% | 137.8 |
| Uber Technologies, Inc. | 0.8 | DOWN -34.0% | 30 | 47.5 | 0.0 | 2.9 | -3.7% | 69% | 135.7 |
| Eaton Corp. Plc | 10.5 | UP 2.0% | 19 | 30.3 | 1.1 | 5.2 | 2.0% | 82% | 133.1 |
| Honeywell International Inc. | 10.0 | UNCH 0.0% | 21 | 19.1 | 2.3 | 3.3 | 1.7% | 2% | 120.3 |
| Lockheed Martin Corporation | 26.3 | UP 0.4% | 19 | 16.7 | 2.9 | 1.5 | -3.2% | 1% | 108.6 |
| Boeing Company | -0.7 | DOWN 138.1% | 22 | 94.1 | 0.0 | 1.2 | -1.1% | -16% | 105.4 |
| Deere & Company | 33.1 | DOWN -1.0% | 22 | 14.5 | 1.6 | 2.3 | -9.0% | 2% | 101.6 |
| Automatic Data Processing, Inc. | 8.7 | UP 0.2% | 18 | 24.2 | 2.4 | 4.9 | -1.6% | 13% | 98.3 |
| United Parcel Service, Inc. Class B | 8.2 | UP 0.0% | 26 | 15.1 | 4.9 | 1.2 | -9.5% | -22% | 98.0 |
| Waste Management, Inc. | 7.4 | UP 0.7% | 20 | 20.7 | 1.5 | 3.7 | -3.8% | 27% | 81.9 |
| General Dynamics Corporation | 14.6 | UNCH 0.0% | 23 | 19.2 | 2.0 | 1.7 | 2.0% | 43% | 80.5 |
| TransDigm Group Incorporated | 27.6 | UP 1.2% | 22 | 35.7 | 0.9 | 8.8 | 4.3% | 66% | 73.4 |
| Trane Technologies plc | 10.5 | UP 2.7% | 22 | 29.4 | 1.0 | 3.7 | 7.0% | 93% | 72.9 |
| Illinois Tool Works Inc. | 10.4 | UP 2.5% | 17 | 22.2 | 2.4 | 4.2 | -5.7% | 4% | 70.1 |
| Cintas Corporation | 14.1 | UP 0.0% | 17 | 40.6 | 0.8 | 6.6 | -0.3% | 42% | 67.3 |
| Parker-Hannifin Corporation | 23.2 | UP 0.8% | 18 | 19.9 | 1.2 | 3.2 | -5.6% | 57% | 67.3 |
| Northrop Grumman Corp. | 24.8 | UNCH 0.0% | 21 | 17.2 | 1.8 | 1.6 | -8.2% | 2% | 66.1 |

GE Aerospace share price (US\$/share) and market cap to sales ratio



Eaton share price and forward PE ratio



Concentration Risk

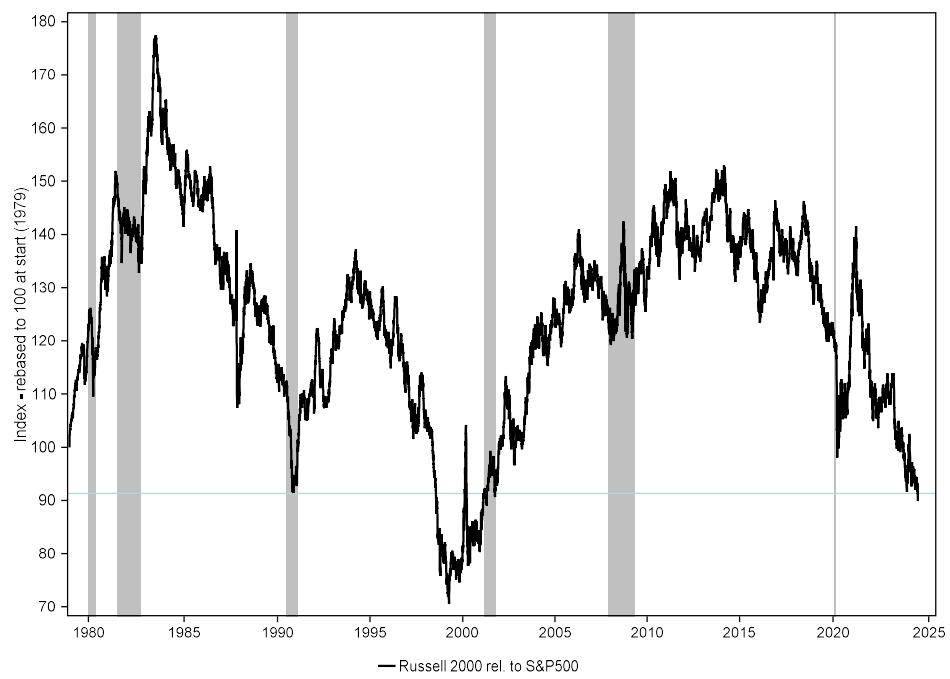
Concentration Risk – in a handful of mega cap stocks
(The new Nifty- Fifty or equivalent)



Source: Daily Shot, BofA/Deutsche

Concentration of **top 10 % of stocks** by market cap
(US market, 1926 – present)

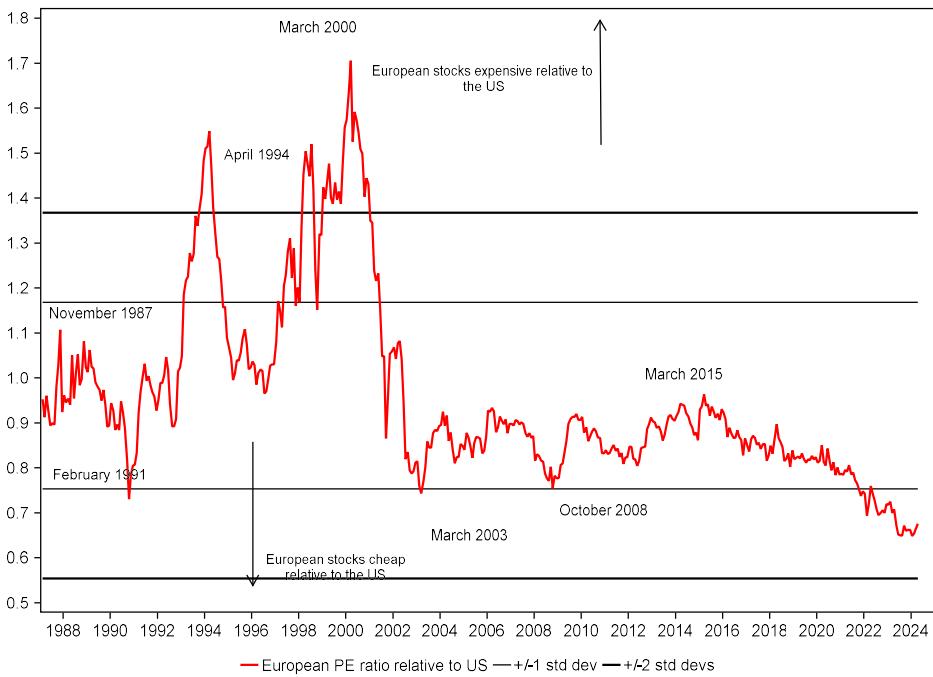
Russell 2000 rel to S&P500



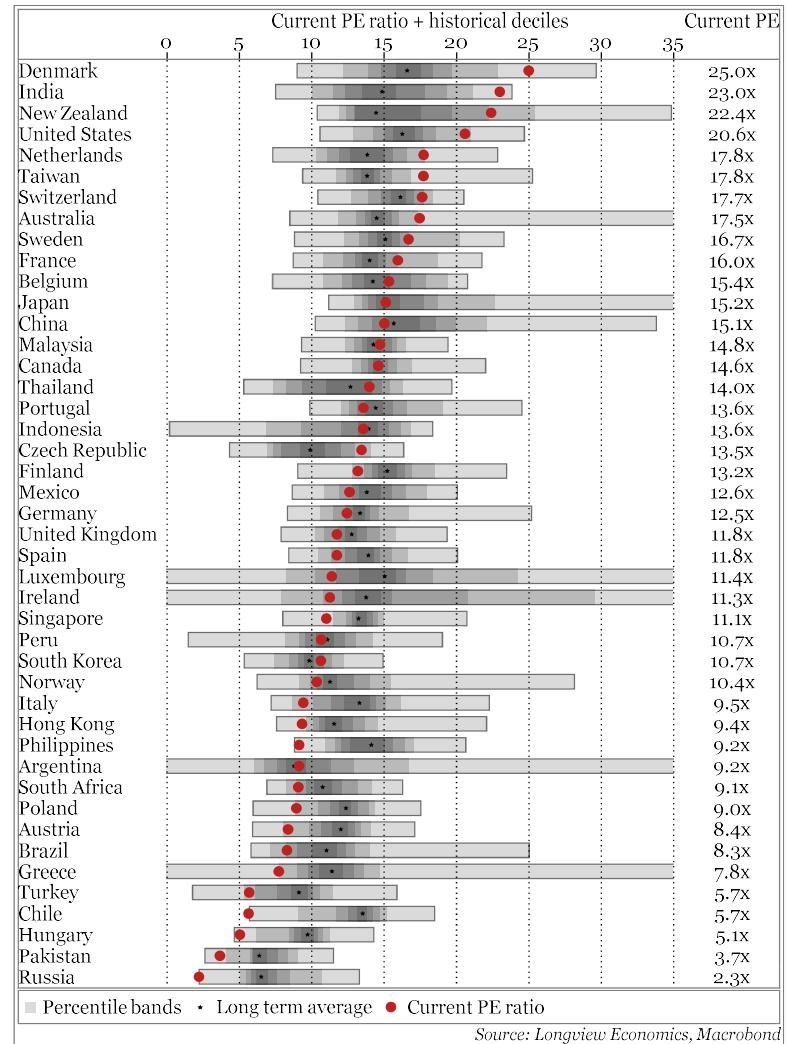
Source: Longview Economics, Macrobond

Cheap Markets -> Elsewhere

PE ratio – Europe relative to the US (both based on forward 12m rolling consensus EPS)



Standalone **broad index*** PE ratios – various country indices
(based on rolling 12m forward EPS)

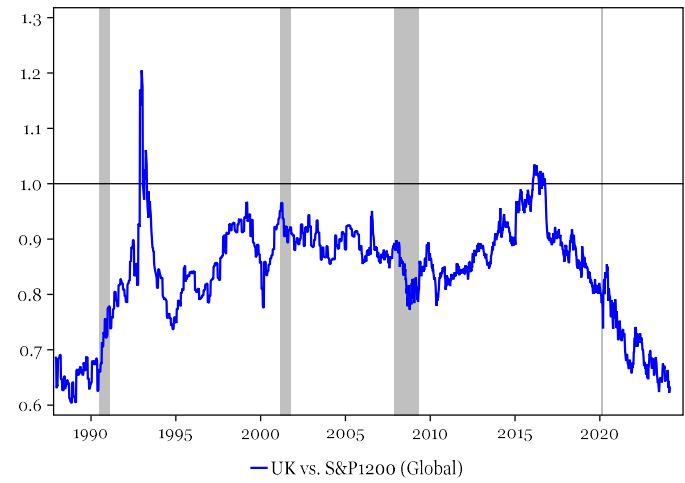


Cheap UK Valuations

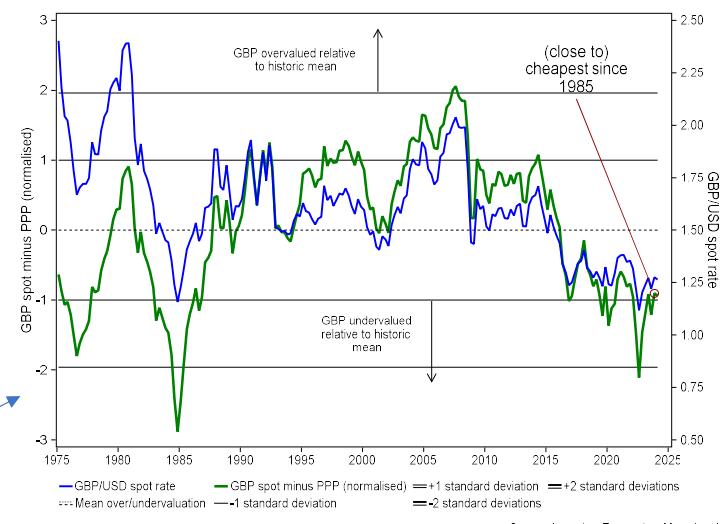
UK's FTSE100 PER (based on fwd consensus EPS)



UK FTSE100 vs S&P1200 global index – rel performance



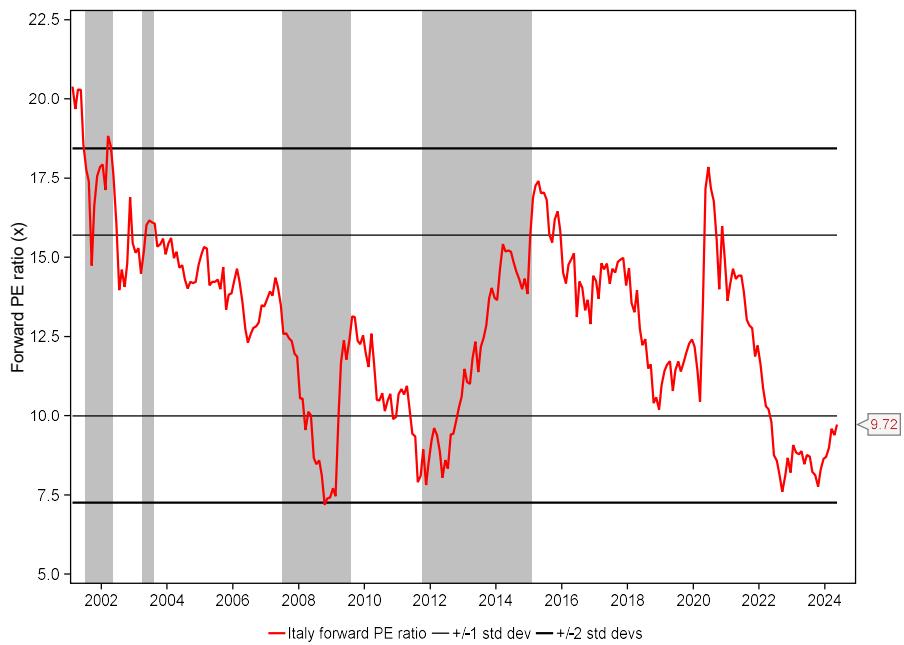
UK GB£ - valuation



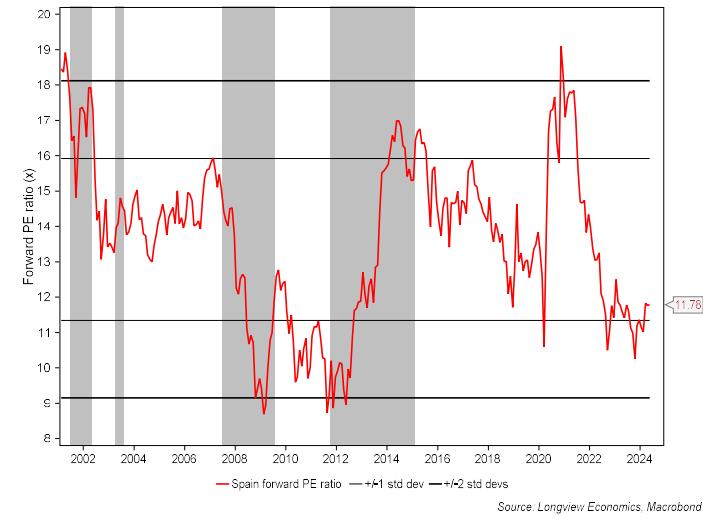
GB£/US\$ spot rate vs. GB£ relative to PPP (shown with std dev bands)

Cf. Spain & Italy

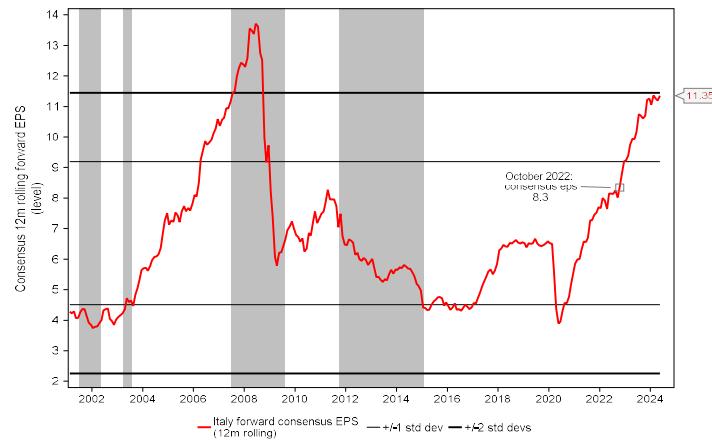
Italian forward PE ratio (based on rolling 12m fwd consensus EPS)



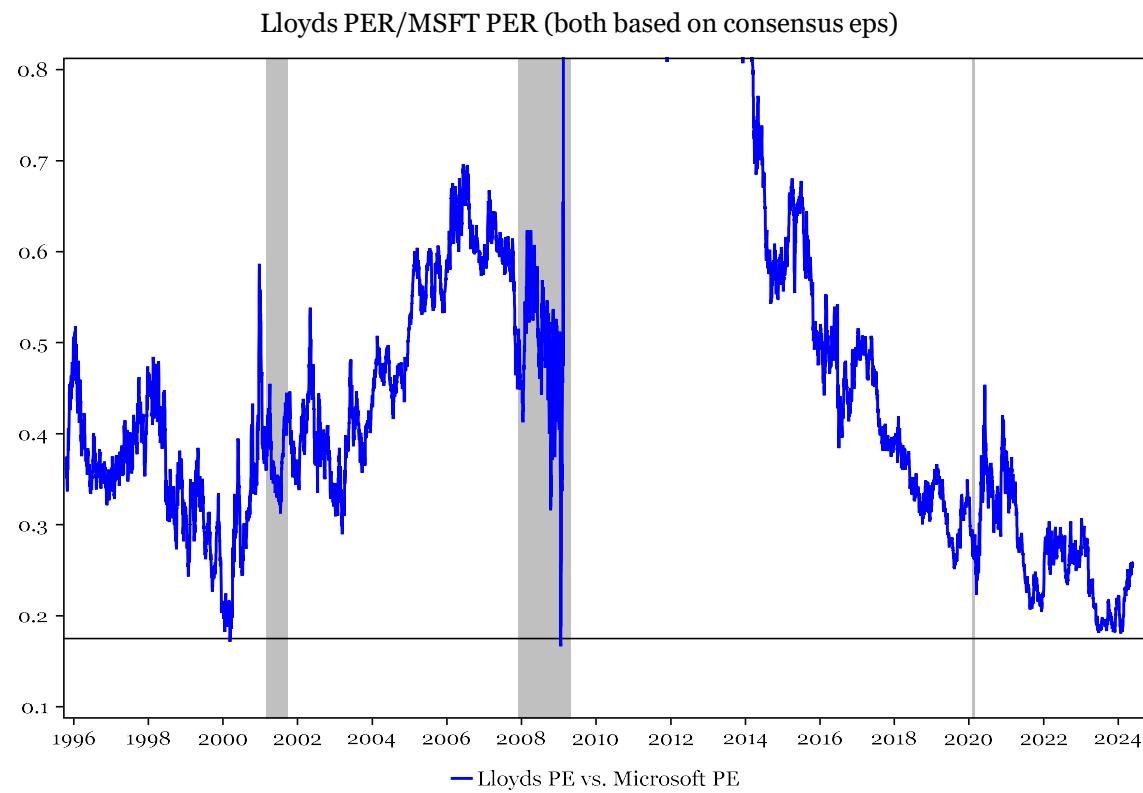
Spanish forward PE ratio (based on rolling 12m fwd consensus EPS)



Italian stock market earnings (consensus, rolling 12m forward, level)

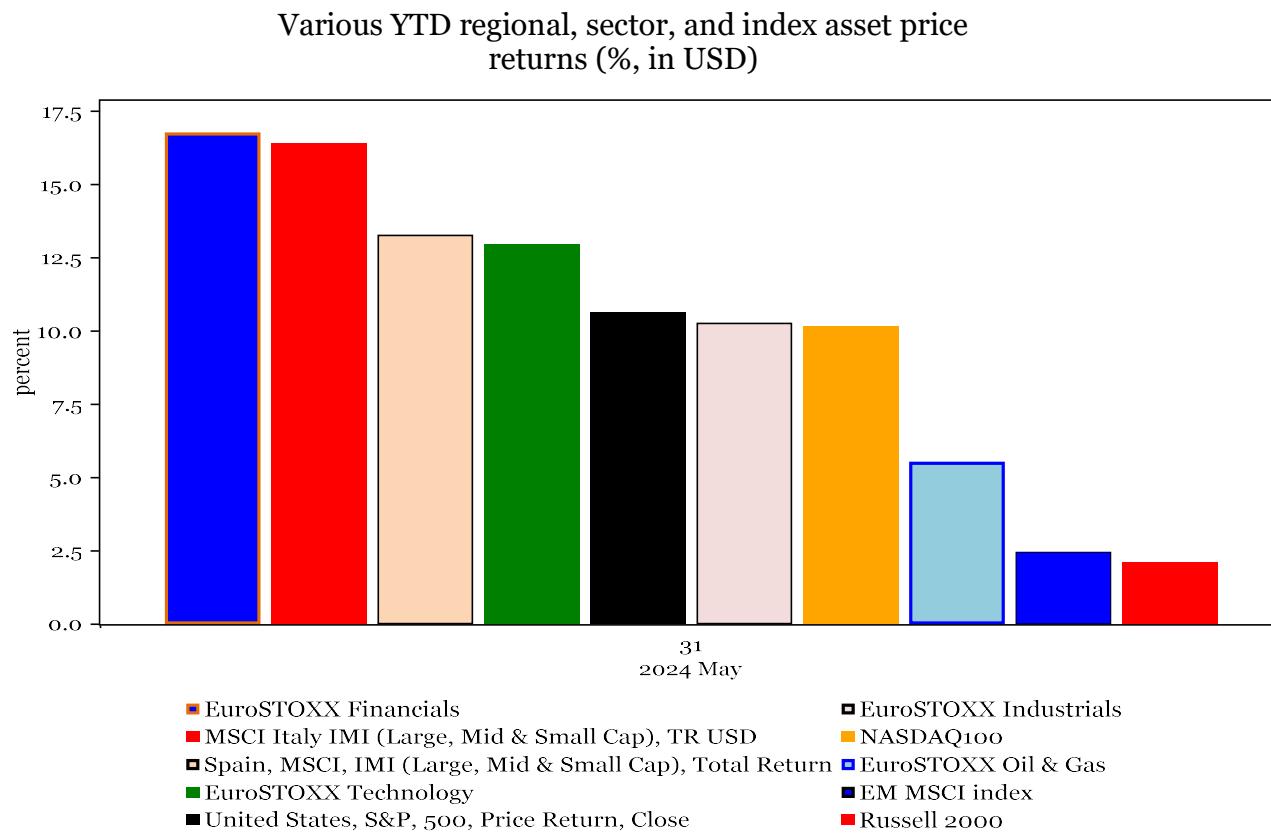


UK Lloyds Bank vs MSFT (fwd consensus based PER)



Source: Longview Economics, Macrobond

Global Performance - Various (YTD)



Source: Longview Economics, Macrobond

Conclusion





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