Macro tailwinds persist + what to use as early warning indicators

- Our leading indicators for growth, liquidity, and policy remain supportive of the 6-month forward outlook for risk assets. The incremental positive since last month is that our Eurozone and China growth leading indicators have risen further.
- While the macro backdrop remains good, many asset classes have low embedded risk premia and high valuations relative to history. We flag two early warning signs to indicate when high valuation assets are vulnerable: A) the VP Correction Signal and B) any signs of bear steepening, especially in response to further Fed cuts.
- Our N. American semiconductor capital cycle score remains healthy and better than tech hardware and software. Scores are also much better than European/Asian semis.

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Contents

This monthly Macro Snapshot report blends the output from VP's key Tactical (1-3m), Cyclical (6-12m) and Structural (2-3y+) models.

Please visit the Asset Allocation summary for all our views across asset classes and time horizons and our Desert Island Chart Collection for our top asset allocation charts.

"Risk-on" tailwinds persist, potential for equity rally to broaden out

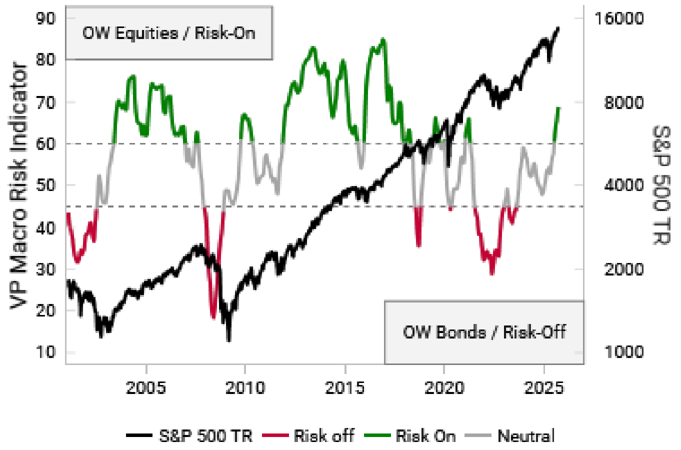
Our Macro Risk Indicator remains in "risk-on" territory (top 2 charts) as our leading indicators for liquidity, growth and policy remain supportive of the 6m-forward outlook for risk assets.

The incremental positive since last month is that our Eurozone and China growth leading indicators have recovered further, while our US growth leading indicator remains resilient (bottom left chart).

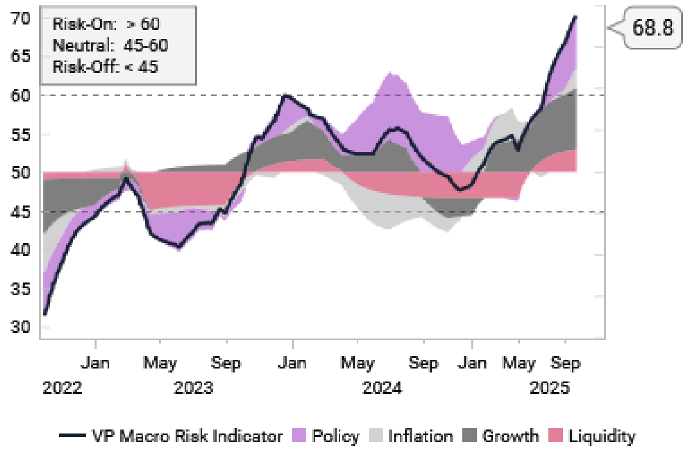
The vast majority of central banks across the world are still easing policy in sync (link), while global excess liquidity remains positive (link).

It is notable that the correlation between the S&P 500 and the equal-weighted S&P 500 has fallen dramatically (bottom right chart). Historically, sharp drops in correlation have been indicative of changing investor behavior and the potential for equal-weighted indices to outperform. Such a broadening out of the equity market rally would be consistent with the risk-on macro backdrop.

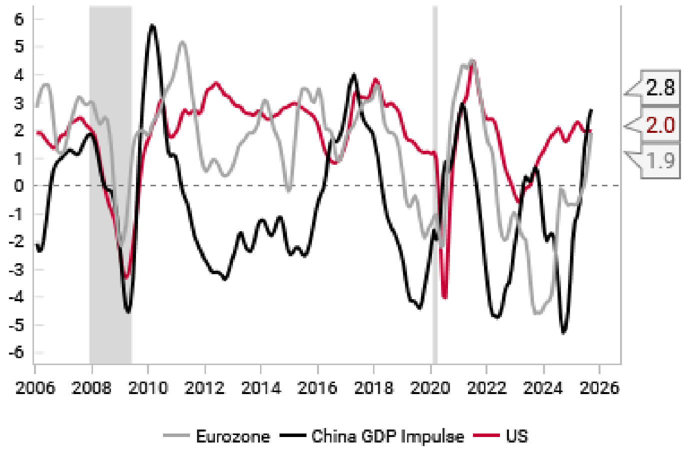
Asset Allocation: VP Macro Risk Indicator



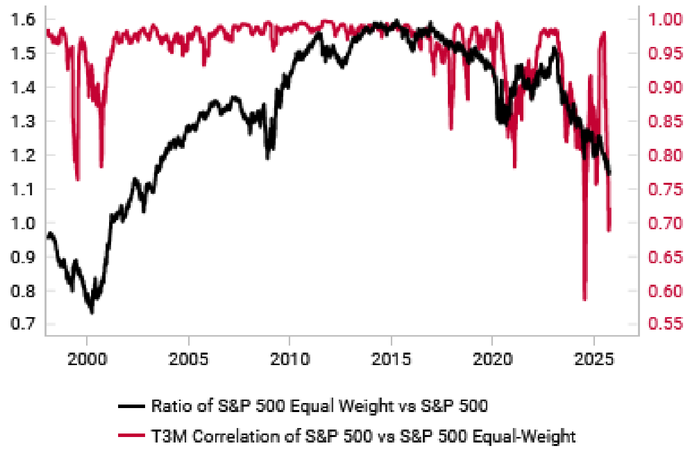
Asset Allocation: VP Macro Risk Indicator



VP G3 Growth Leading Indicators, 3mma



S&P 500 vs S&P 500 Equal Weight correlation is falling



Source: S&P Global, Refinitiv, Macrobond, and Variant Perception

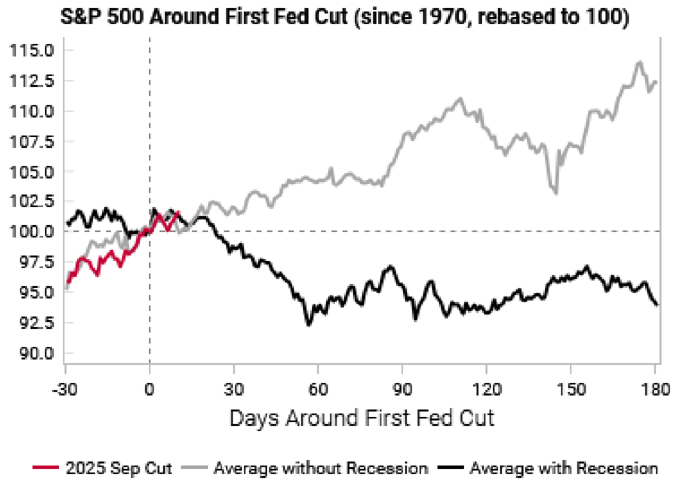
Tracking “no recession” Fed easing cycles so far

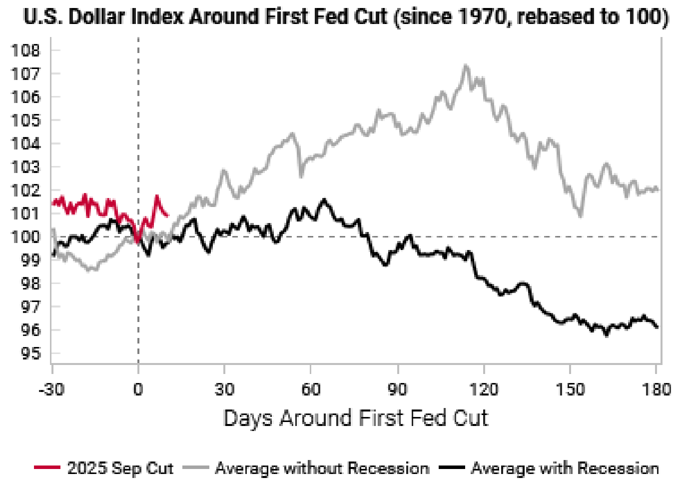
The Fed cut by 25 bp in September as widely anticipated, which we flagged as a “buy the rumor, sell the fact” (link) event that would likely mark the low in yields and the US dollar for the year.

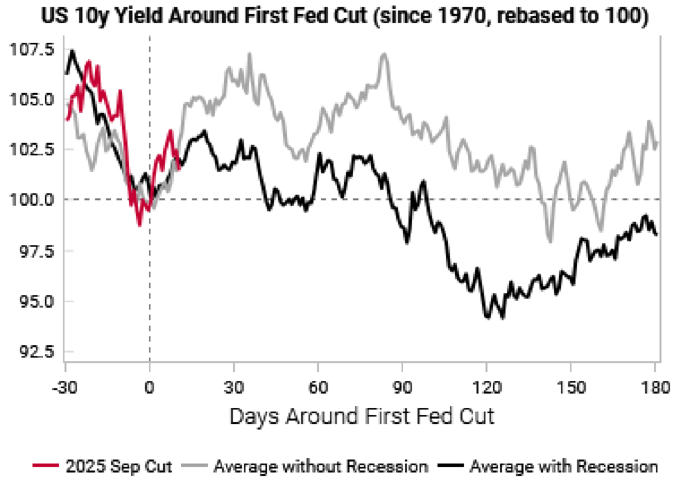
Asset price behavior after the first Fed cut depends heavily on if a recession materializes or not. Today, our leading indicators do not foresee a recession, which means the most comparable analogs are the “no recession” Fed cuts in 1984, 1995, and 2024 (link).

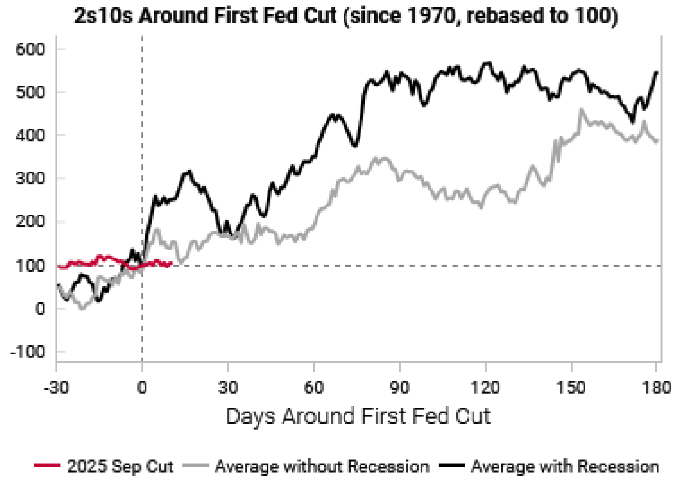
Since the September 17th rate cut, asset price behavior has been mostly in line with historical “no recession” cuts. The S&P remains resilient (top left chart), the US dollar has bounced a little (top right chart), and US 10y yields are off the lows (bottom left chart).

So far the yield curve has not reacted (bottom right chart), which is more similar to “no recession” Fed easing cycles. Recessionary Fed easing cycles tend to see much more dramatic yield curve steepening.









Source: S&P Global, Refinitiv, Macrobond, and Variant Perception

Inflation remains above target, but leading indicators are rolling over

The balance of inflation data is mixed. We interpret this to mean that the Fed's room to act is constrained. It will be hard for the Fed to justify multiple cuts next year, but the data also does not suggest a renewed hiking cycle.

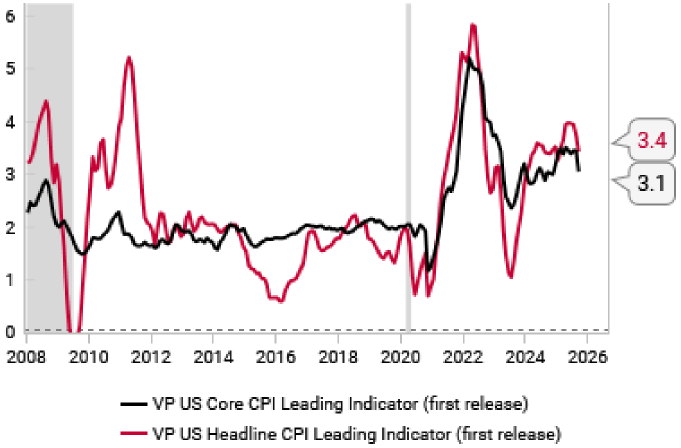
Our US inflation leading indicators for both core and headline CPI have rolled over, but the 6m-forward point estimates remain above the Fed's inflation target at >3% annualized (top left chart).

Alongside our US growth LEI running at 2% annualized, this implies >5% nominal GDP. This is a healthy rate of growth that would normally **NOT** warrant the market to price in another 4 Fed cuts over the next year and a terminal rate of 3% by 4Q26.

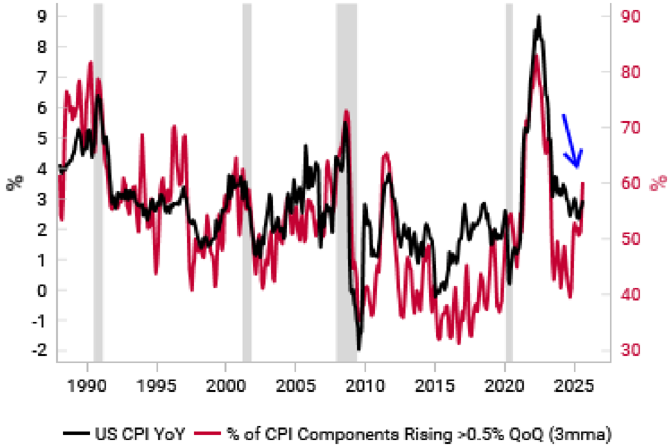
It should also be noted that reported inflation breadth has ticked up again to its highest level since 2021 (top right chart). Inflation surprises are also starting to mean-revert higher from very negative levels amid the first signs of tariff pass-through we highlighted last month (link, bottom left chart).

To track potential second wave risk next year, we are watching the "higher prices" sub-component of the ISM surveys (bottom right chart). So far, intentions to raise prices have been rolling over, implying second wave risks have not materialized yet.

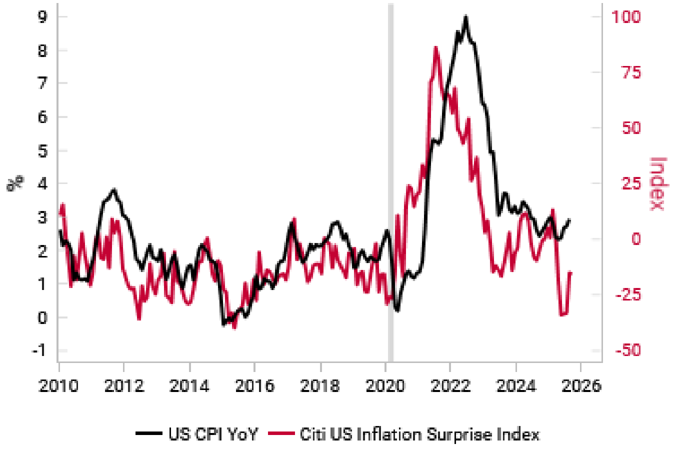
VP US Inflation Leading Indicators - Unsmoothed



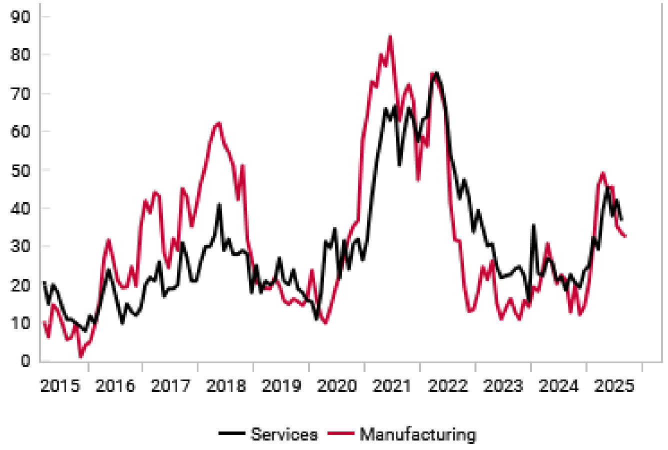
% of US CPI Components Rising >0.5% QoQ



US Headline CPI vs US Inflation Surprise Index



ISM Prices Sub-Components: Higher ONLY



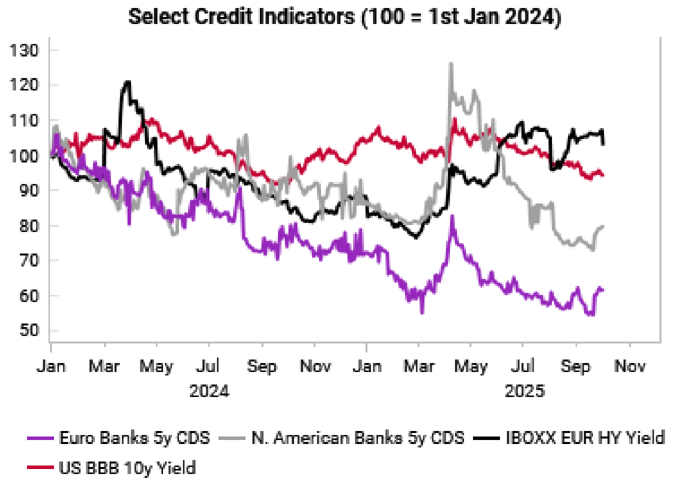
Keep calm, watch VP Correction Signal / bear steepening for warning signs

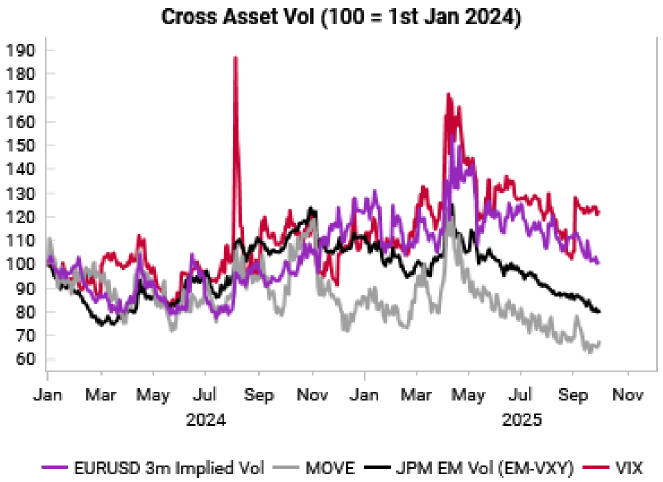
Relative to history, many asset classes have lower embedded risk premia today, even while the macro backdrop remains good. **We essentially have a "valuation" problem in many assets, but not necessarily a "macro" problem.**

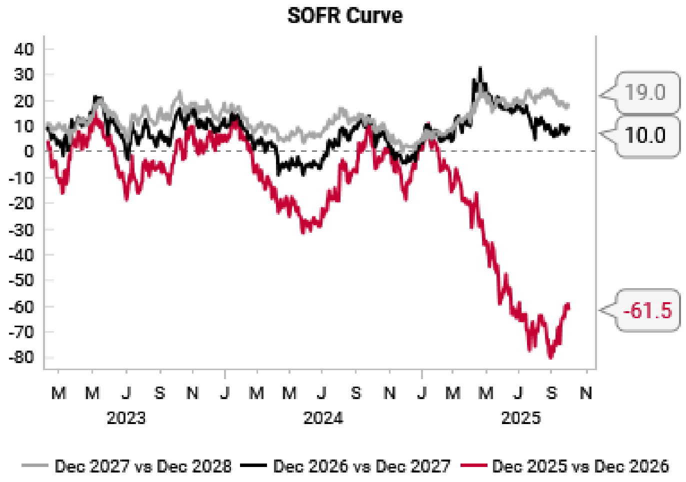
We reconcile this tension by being explicit in using two early warning signs to indicate when high valuation assets are vulnerable: A) the VP Correction Signal ([link]) and B) any signs of bear steepening, especially in response to further Fed cuts.

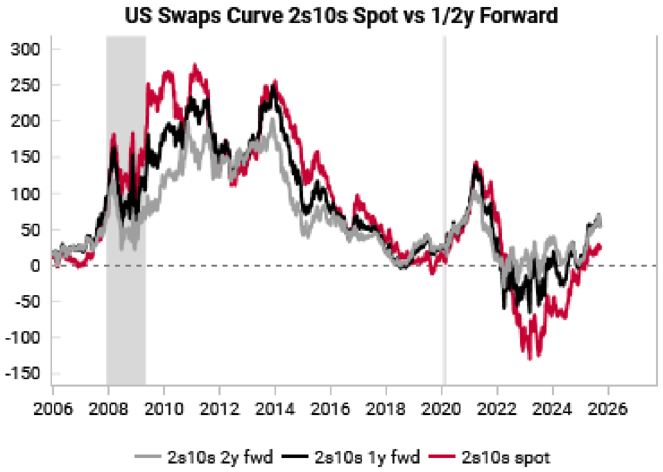
The VP Correction Signal tracks when various credit spreads and cross-asset volatility are deteriorating at the same time (top two charts). The key is not the magnitude, but the breadth of deterioration. The top two charts show a selection of the inputs. If implied volatility rises across all asset classes, alongside widening spreads, that would be a signpost of broad de-risking behavior, necessitating portfolio hedges.

The SOFR curve is also now struggling to discount a lower terminal policy rate, with the Dec 2026-2027 and Dec 2027-2028 parts of the curve still pricing hikes (bottom left chart). The risk is that the Trump-inspired Fed tries to cut even more than the curve is pricing, driving a bear-steepening and questions about the Fed's credibility. We are not there yet, but that's what we are watching (bottom right chart).









Source: S&P Global, Refinitiv, Macrobond, and Variant Perception

Semis still capital scarce vs tech hardware/software, US better than Europe/Asia

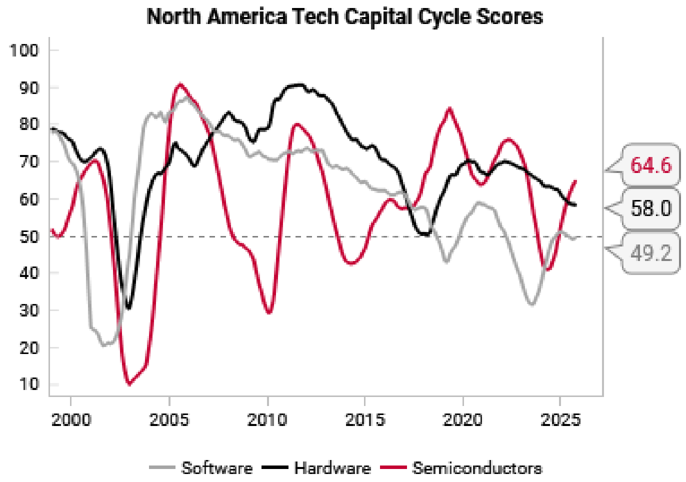
We are open to the narratives around long-term over-investment in AI and the historical analogs to the dot-com fiber build-out or 19th century railways. The difficulty is that these narratives are not timing devices.

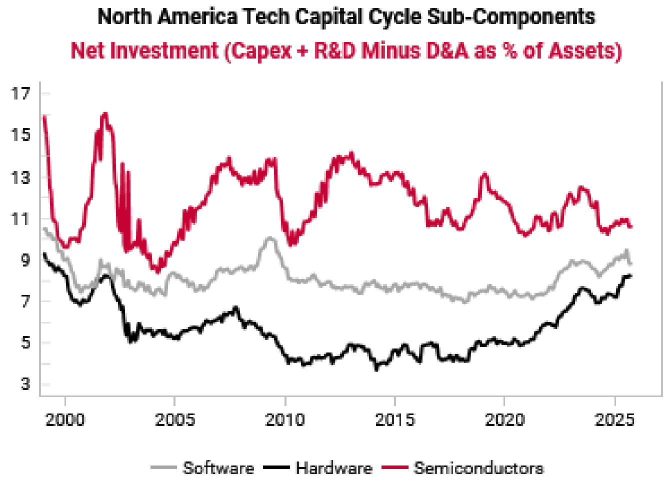
We prefer to rely on our capital cycle scores for a tangible data-driven way to assess how the AI industry is evolving.

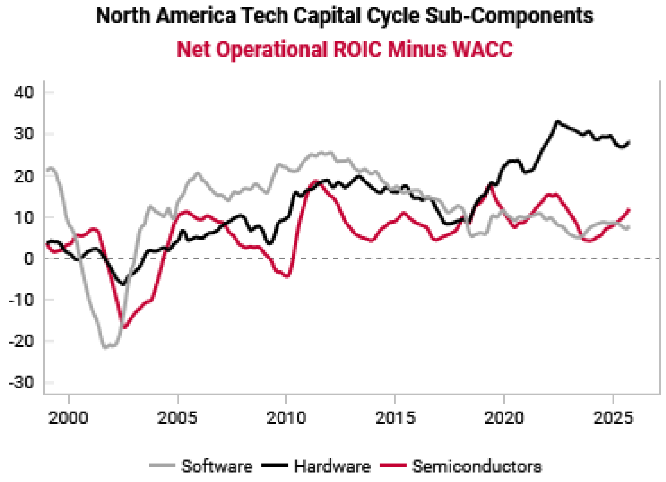
Today, our Capital Cycle scores are high and improving for North American semiconductors, while the scores for hardware and software are trending lower (top left chart).

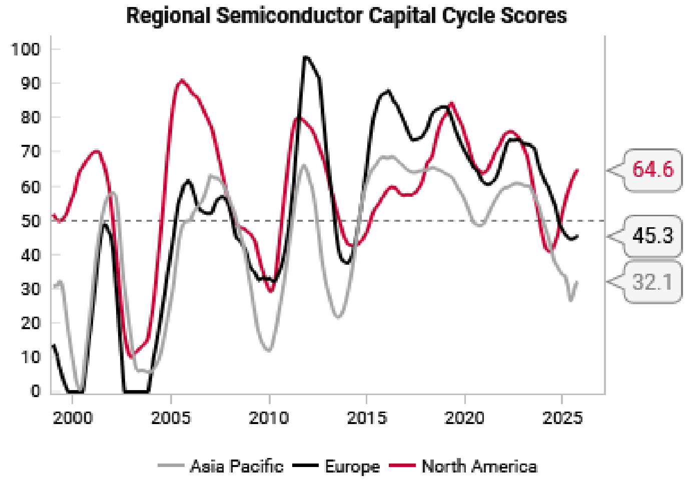
Over the past few years, we have seen a much more dramatic rise in software and hardware company net expenditures on capex and R&D, compared with relatively steady semi expenditures (top right chart). At the same time, semiconductor operational ROIC has been improving while tech hardware operation ROIC is trending lower from high levels (bottom left chart).

There is also a notable regional divergence. North American semiconductors are much more capital scarce than the European and Asian semi companies (bottom right chart).









Source: S&P Global, Refinitiv, Macrobond, and Variant Perception

Earnings optimism elevated, macro tailwinds for EM, small caps

Our US EPS leading indicator ticked down this month to 7.5% annualized growth (top left chart). This is below consensus forecasts of 11.7% for 1Q26 and 13.8% for calendar year 2026 (see Factset Earnings Insight, link), suggesting earnings expectations are now too optimistic.

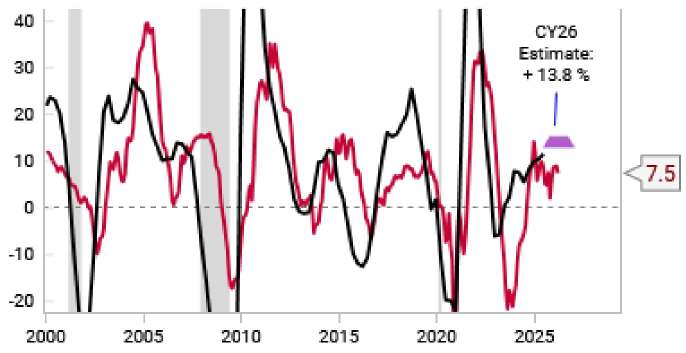
Earnings estimate revisions remain positive, but the momentum is also peaking (top right chart).

With our Macro Risk Indicator still suggesting to overweight equities, we think it is more prudent to prioritize equity exposure in select US sectors and EM equities that have a higher margin of safety.

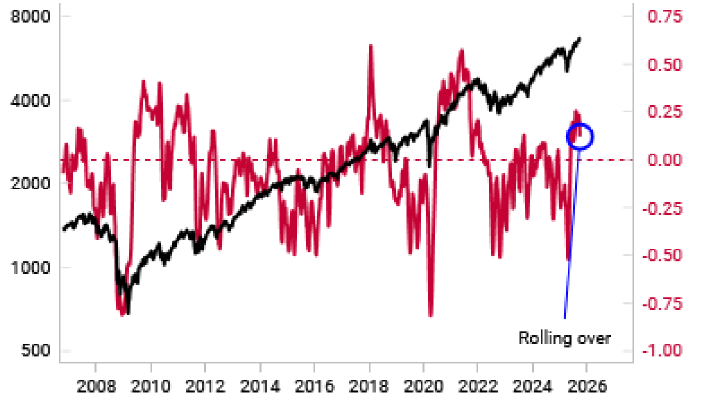
Within US sectors, our Asset Allocation Engine prefers energy, technology and consumer staples. We also note that macro tailwinds suggest an improved outlook for small caps with a fruitful period coming up for active stock selection within small caps (bottom left chart, and see our recent Note).

Outside of the US, the liquidity backdrop still favors EM over DM equities, with Brazil our top pick (bottom right chart).

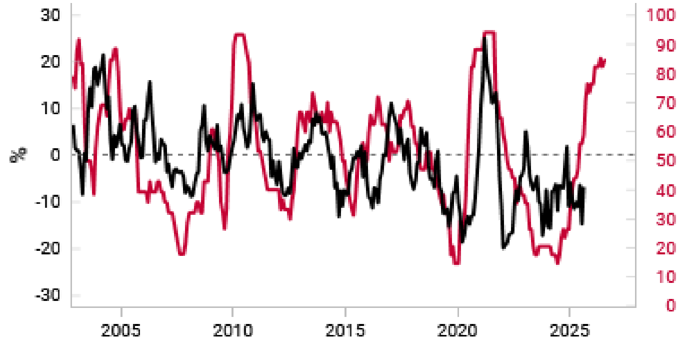
VP US EPS Leading Indicator (6 Month Lead) - Unsmoothed



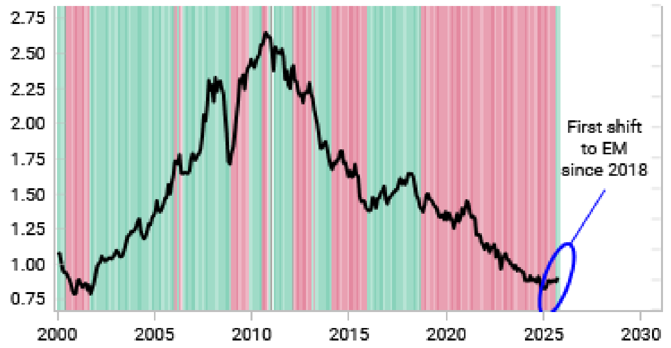
S&P 500 vs US Earnings Estimate Revisions



VP Business Cycle Financing Index Leads Small Cap Relative Outperformance vs Large Cap By 12 Months



EM Regime Indicator vs MSCI EM/DM Ratio (Inputs: EM vs DM Real M1, Global Excess Liquidity)



Source: S&P Global, Refinitiv, Macrobond, and Variant Perception

Yields trading near low end of fair value range, moderately biased upwards

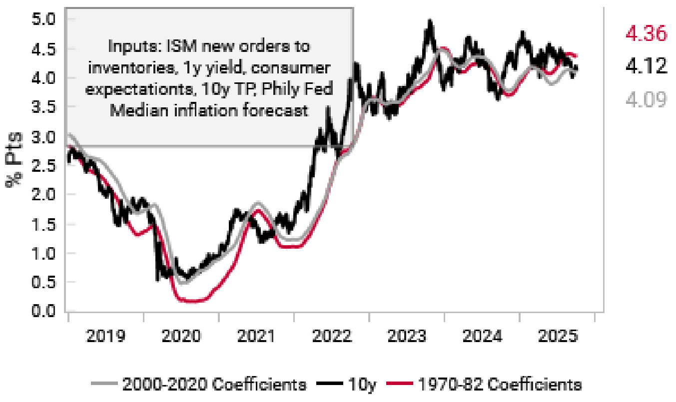
The recent fall in 10-year US yields puts them near the lower end of our fair value estimates (top left chart) while the rolling total return from 10y USTs is also in the middle of its long-trend (top right chart).

Our estimate of R* - the real short-term neutral rate - is still at 1.4%, which is also where the 5y5y real OIS is trading (bottom left chart). We use the 5y5y real OIS as a proxy for the market-implied R*. Again this shows yields are not wildly mispriced.

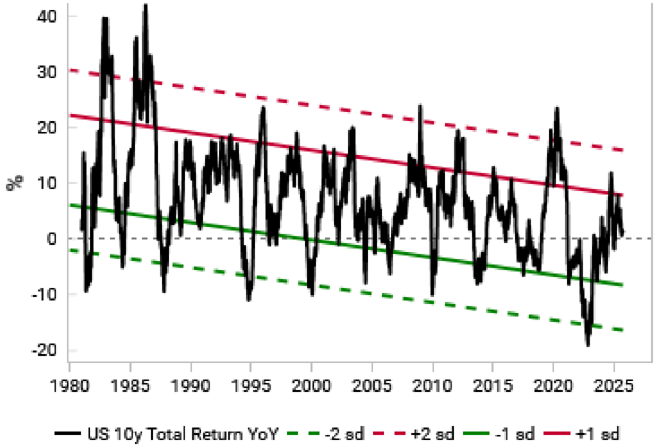
The 2s5s10s butterfly is starting to tick up. When this is low and negative, we interpret that to mean the market is discounting a Fed easing cycle that restores growth, whereas when this is high, it's a sign the market is worrying about a Fed hiking cycle that slows the economy. We used this in January to warn of a yield peak (link). Today the bottoming in the 2s5s10s can be interpreted as saying the market has already priced in peak easing.

There isn't much room for short-term rate expectations to fall further absent a recession given the SOFR-implied rate of ~3.0% by 4Q26. Our R* estimate plus inflation of ~3% suggests the nominal neutral policy rate is near 4.5%. **The risk is the Fed cuts lead to accelerating growth and inflation in 2026, implying we should retain a moderate bias towards yields higher.**

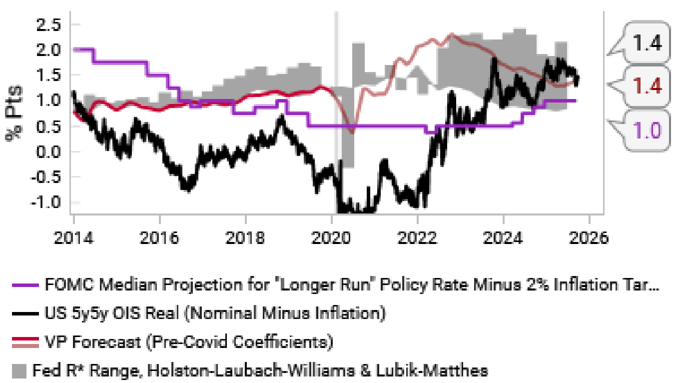
US 10y Yield Fair Value Model (using only long-dated inputs)
Fitted to Either 1970-82 or 2000-20



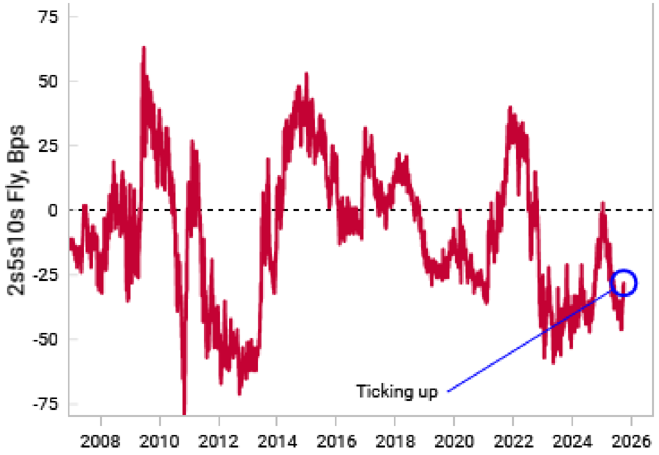
10y US Treasury Total Return YoY (Relative to 10 Year Trend)



US Neutral Rate R* vs VP Estimate vs 5y5y Real OIS
Neutral rate = real short-term interest rate expected to prevail when an economy is at full strength and inflation is stable



US Treasury 2yr-5yr-10yr Butterfly



Source: S&P Global, Refinitiv, Macrobond, and Variant Perception

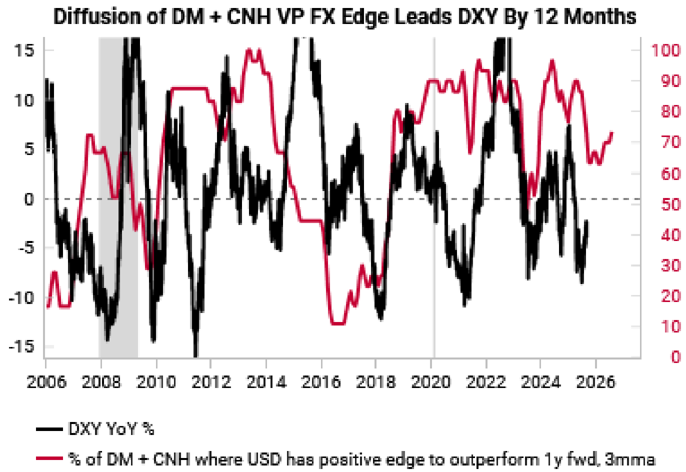
Cyclical FX Edge model still points to USD rebound

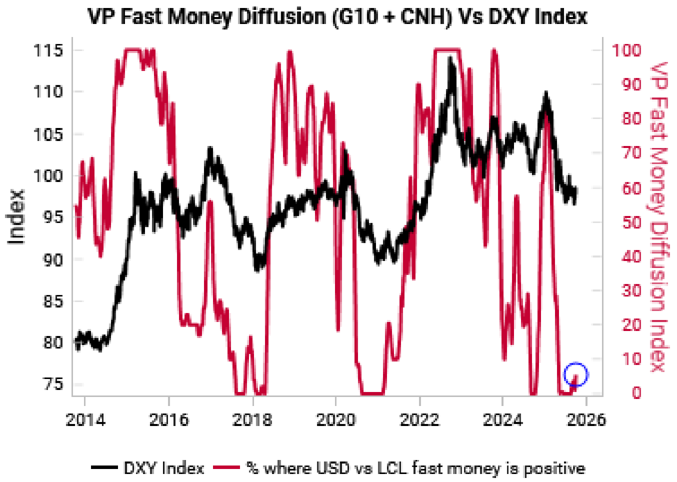
Our cyclical and tactical indicators still point to a rebound in the USD now that the Fed easing cycle has been fully discounted.

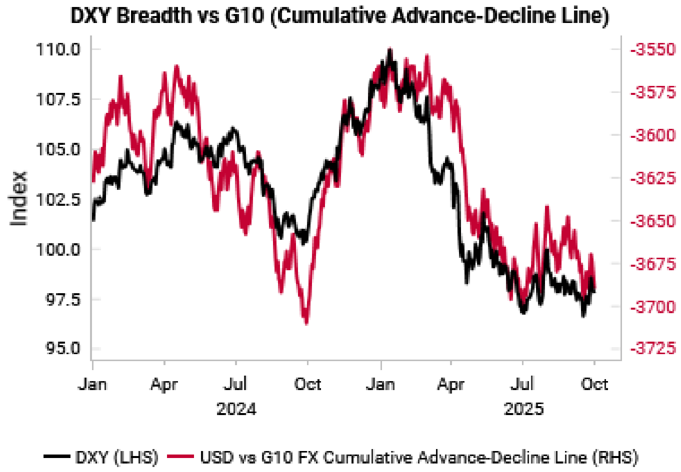
On a cyclical basis, our fundamentals-based FX edge model shows the USD has a positive expected 1-year total return against most G10 currencies (top left chart).

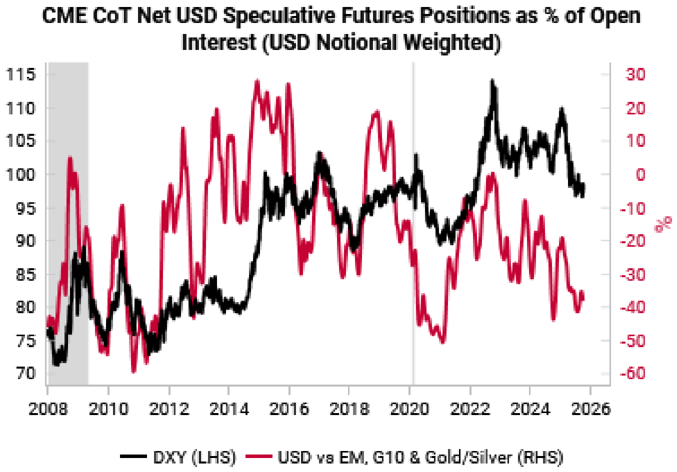
Meanwhile, most tactical indicators we monitor suggest the dollar is bottoming out. Our Fast Money diffusion index – a measure of speculative activity – has risen from 0%, which has marked the start of dollar rebounds over the past decade (top right chart). To add to this, breadth against G10 currencies has stabilized and short positioning against the dollar remains stretched (bottom two charts).

Our preferred expressions for a tactical dollar bounce are long USDKRW ([link]) and short EURUSD ([link]). Our FX Edge model triggered a buy signal on USDKRW last month, while we think the EUR can weaken further as the policy divergence implied by SOFR and Euribor markets narrows ([link]).







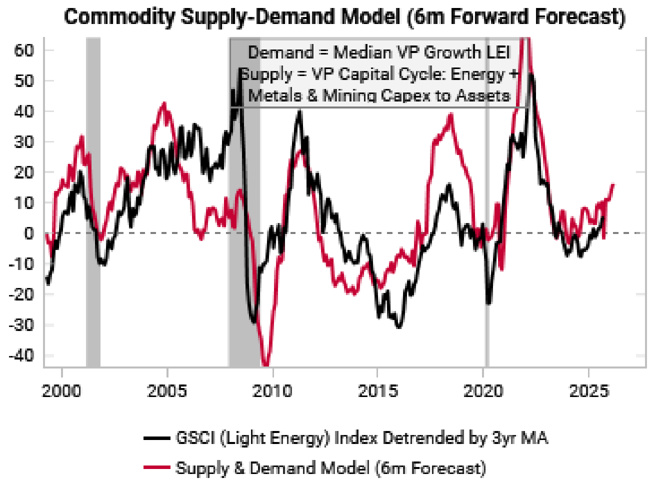


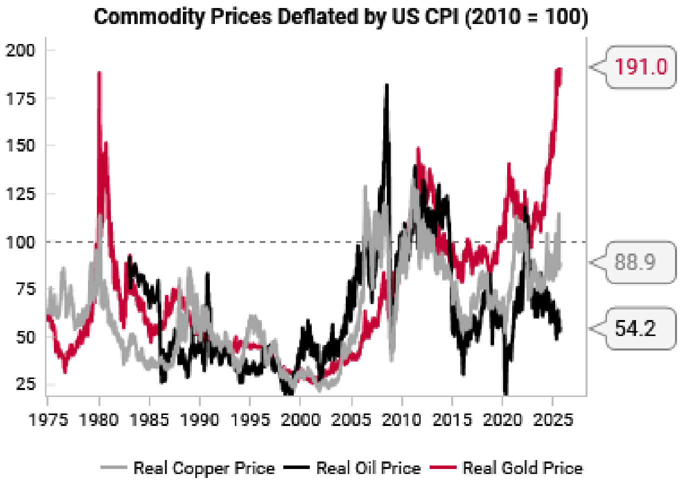
Commodity outlook improving, energy and metals cheap in gold terms

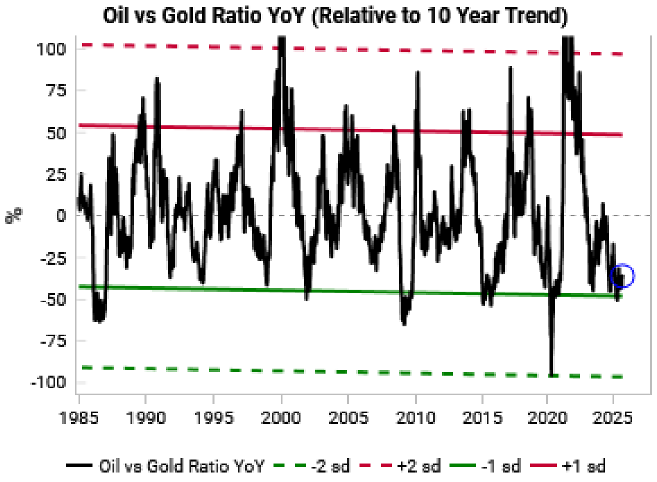
Our commodity supply-demand imbalance model continues point to higher prices over the next 6 months (top left chart). This is against a structurally bullish geopolitical backdrop of inelastic, politically-driven demand and concentrated supply chains that are increasingly weaponized in a multi-polar world.

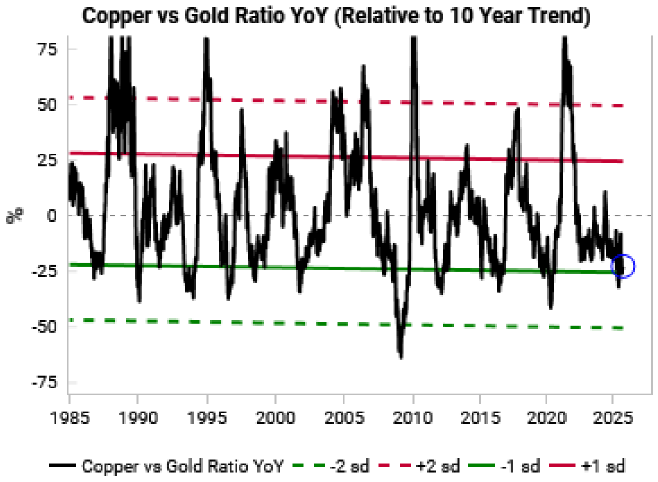
In real terms (i.e. deflated by CPI), copper and oil remain well below their highs and have potential to catch up to gold (top right chart). Both commodities' relative performance to gold is near multi-decade lows (bottom two charts). These have generally marked turning points in relative performance and point to gains for both oil and copper.

In absolute terms, gold continues to benefit from structural tailwinds and should remain a core real asset holding. In July, we highlighted that the gold-silver ratio implied catch up potential for silver (link). Today, after a blistering rally, silver has triggered an LPPL bubble exhaustion sell signal (link), suggesting to take profits.









Source: S&P Global, Refinitiv, Macrobond, and Variant Perception

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