FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.7** BILLION	**US$21.5** BILLION

ICM Monthly Outlook

JANUARY 2024

Market Review

On 31 December 2021, the S&P 500 reached an all-time month-end high of 4,766. It has taken exactly two years to the day to reach a new all-time month-end high. On 31 December 2023, the S&P 500 hit a new month-end peak of 4,770, a measly 0.08% gain.[1] Those who have been on a desert island for the past two years may be forgiven for thinking that the past two years have been largely uneventful times for markets. Regular readers will know it has been anything but.

2022 was abysmal for financial markets. For example, the S&P 500 declined by 19.4%. ICM Limited approached 2023 cautiously optimistic for a good year for financial markets based on our view that inflation would fall, interest rates would decline, and that the benefit of lower rates would more than compensate for a recession-induced decline in earnings. In simple terms, we felt the sell-off from 2022 was overdone, and equities looked cheap based on the fundamentals.

We may not have been so optimistic if we had foreseen bank failures on both sides of the Atlantic, long-term interest rates ending the year at almost the same level that they started the year, a US sovereign downgrade, heightened geopolitical tensions between the US and China, continued war in Ukraine, and a fresh outbreak of war in the Middle East.

And yet, as is so often the case, the market marched higher, with the S&P 500 increasing by 24.2%[2] and within a whisker of an all-time high. As has tended to be the case in recent years, returns on the S&P 500 were dominated by a few of the largest holdings. The Magnificent Seven[3] increased 104% during the year and contributed more than 60% of the S&P's total return. At a sector level, technology was the stand-out sector, returning 58%, with communications close behind, returning 56%. Only the energy and utility sectors - the only positive S&P sectors in 2022 - had a negative year.

The early part of the year was dominated by the narrative around recession, with the debate being on when, how deep and for how long, rather than if. The spate of banking failures in spring, including the Swiss behemoth Credit Suisse, increased fears that a banking crisis would accompany and intensify any recession. Notwithstanding the banking turmoil, the US Federal Reserve ("the Fed") was unperturbed. While the Fed increased available liquidity to all banks, orchestrated banking takeovers, and ensured an orderly wind-down of banks in trouble, it was unrelenting in its fight against inflation, increasing interest rates in the aftermath of the banking turmoil in March, May, and July, which, in addition to the rate increase in February brought the total for the year to four.

The Fed's efforts would largely be rewarded by June when US CPI inflation fell to 3.0%, and despite the Fed having held rates steady since, it was only in December that the Fed tentatively accepted that the battle against inflation had been largely won, with Fed Chairman, Jerome Powell, indicating that cuts in the cost of borrowing was coming

Market Review continued

"into view". Policymakers are now forecasting three rate cuts in 2024, although this is significantly less than the six that the market is currently pricing in.

Having peaked at 9.0% in 2022, US inflation was running at 3.4% as we exited 2023, up from 3.1% in November but still significantly down from its heights. Around the world, inflation rates tumbled, too, falling from 8.8% to 2.9% in the Eurozone, 10.5% to 3.9% in the UK, 6.3% to 3.1% in Canada, and 4.3% to 2.8% in Japan.

In equity markets, the S&P 500 was far from the only show in town. The Nasdaq increased by 44.7%, the Eurostoxx increased by 23.1%, and the Japanese Nikkei increased by 28.3%. The Japanese Nikkei hit a 33-year high in early 2024.

In November, emerging markets, as measured by the MSCI Emerging Market equity index, increased by 3.6%, bringing the total return to the year to 9.0%. Most emerging markets saw strong positive performance. For example, Brazilian equities increased by 22.3%, Indian equities increased by 22.0% equities, Taiwanese equities increased by 31.3%, and South Korean equities increased by 24.1%. The underperformance of Chinese equities, which comprised one-third of the index and were down 10% for the year, held back emerging market equities.

In 2023, European government bonds, as measured by the Barclays Euro Aggregate Government Index, increased by 7.1%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, increased by 5.7%. For the first time in many years, much of the return on sovereigns was through coupon income, with only marginal returns coming through falling rates. The opportunity for coming coupon income remains, with long-term US bonds yielding c. 4%.

Investment Grade credit, as measured by the ICE Bank of America US Corporate index, increased by 8.4% and High-Yield credit, as measured by the ICE Bank of America high-yield index, increased by 13.5% during the month.

Market Outlook

Omne trium perfectum. This trio of Latin words, in principle, suggests that all good things come in threes. We believe it is a very apt description of where we find ourselves in the current investment cycle at the beginning of 2024. Even though 2023 was a strong year for returns across many asset classes, we believe 2024 will see a continuation of this strength, and it is more likely than not to last into 2025, making for possibly another two years of strong returns.

The premise underlying this constructive view can be distilled down to a simple fact - we are now in a new cycle of easier monetary policy where all good things for risk assets tend to follow. Such a cycle takes time to run its course fully, implying that market conditions will probably be supportive for risk asset markets for all of 2024 and most, if not all, of 2025. According to Alpine Macro research, the average price gain in US stocks in the two years following a bear market is about 60%. So far, the S&P 500 index has risen 32% from its 2022 lows, which supports the view that more price gains can be expected this year.

This time last year, the consensus was that high US inflation had been caused by an overheating economy created by consumers celebrating their newly won mobility post the pandemic. The commonly held view was that this runaway inflation could only be cured by a monetary policy-induced recession. However, over the course of 2023, this thesis was summarily disproven as inflation came down without the need for a recession or a material increase in unemployment. This suggests that the inflation surge we experienced had much more to do with supply-side challenges and disruptions around the pandemic and much less with an overheating economy. Tighter monetary policy was required so that price increase effects did not get embedded in longer term inflation expectations which could have set off a more extended period of above target inflation. The drag on growth from tighter monetary policy was offset by positive factors such as the gradual improvement in commodity and labour supply chains and the rebound in service demand as people became more comfortable with closer face-to-face interaction. These counter-opposing forces resulted in an unusual outcome in 2023, where we enjoyed falling inflation with better-than-expected growth without a significant unemployment spike. This phenomenon is more cheekily known as the immaculate disinflation.

Market Outlook continued

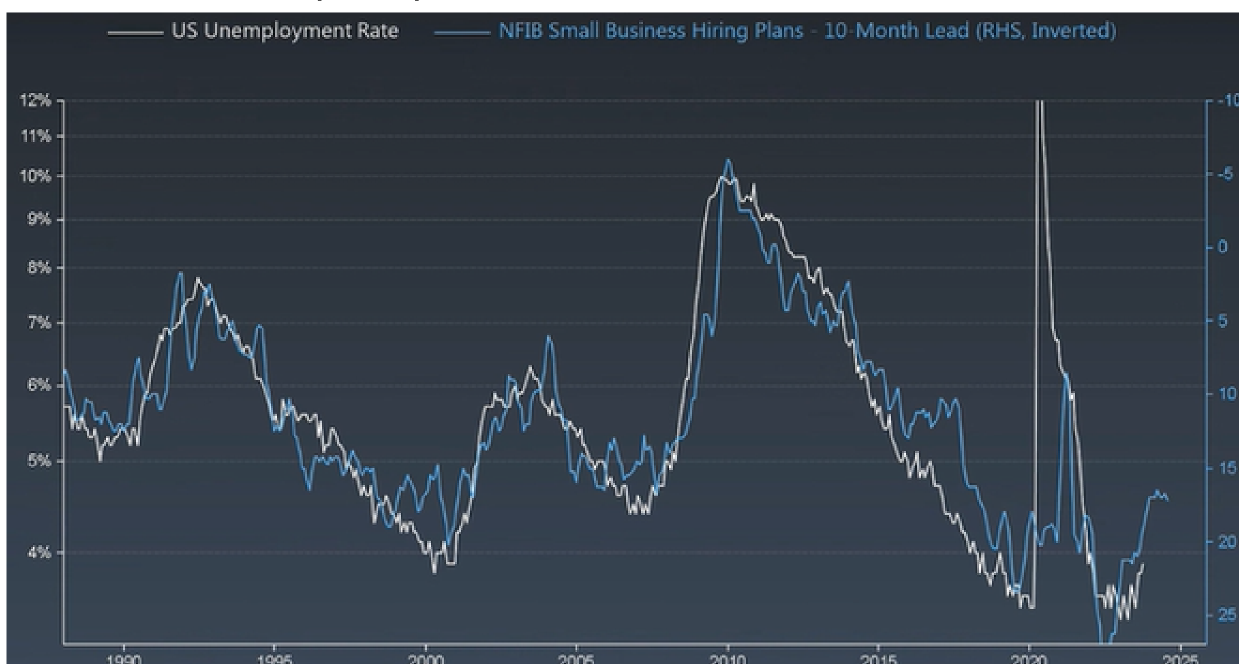
Indeed, it is remarkable how well the global and US economies fared in 2023 despite tighter monetary policy. Goldman Sachs now estimates that global GDP will have grown 2.7% in 2023, with the US increasing 2.4%, a full 2% points above the consensus forecast of a year ago. This level of dynamism in the economy has supported the US labour market, yet it has still managed to cool down, and those forces that were pushing wage inflation higher at an ever-increasing rate have abated. Nominal wage growth has slowed meaningfully, and while not back to the 3.5% year-over-year growth rate, which would be consistent with the Federal Reserve's inflation target of 2% inflation, it does seem to be reverting steadily where it is currently at about 4.3% quarterly annualised. When combined with inflation expectations that are well anchored, this suggests that the Federal Reserve has succeeded in preventing inflation from getting embedded and leading to undesired second-round effects.

US interest rate cuts are coming

Going forward, an easier monetary policy will be facilitated by a further continuation of the disinflation cycle. The overriding aim of the Federal Reserve is to bring inflation down to its long-term target of 2%, as measured by its favoured inflation indicator, the Personal Consumption Expenditures (PCE) index. Once the Federal Reserve is convinced that inflation is on a sustainable course to this longer-term target, it will no longer be incentivised to keep monetary policy overly restrictive and to run the risk of an unnecessary and unwanted slowdown. A slowdown will create more unemployment, which is incongruous with the Federal Reserve's second mandate, maximising employment. Leaving rates pegged unnecessarily high for longer, even though there is sufficient evidence to show that core inflation is back on a consistent course to 2%, would run the risk of creating another policy error. This view was reflected in the Federal Reserve committee meeting minutes from December. Hence, there does appear to be a growing sentiment amongst the committee members that interest rates do not need to be held at restrictive levels once they believe that inflation is on a sustainable path to 2%. This is more dovish than we would have been thinking a few months ago and is very different from the Federal Reserve simply stating that rate cuts will only first happen when its 2% inflation target has been met.

We can see from the chart that the core PCE index, the Federal Reserve's preferred measure of inflation, continues to fall. Indeed, when we measure it on a 6-month annualised basis, we can see it is already back at the Federal Reserve's target of 2%. This is probably the single biggest argument underpinning a decision to start cutting interest rates, probably as soon as March.

Core US Personal Consumption Expenditure (PCE) Inflation



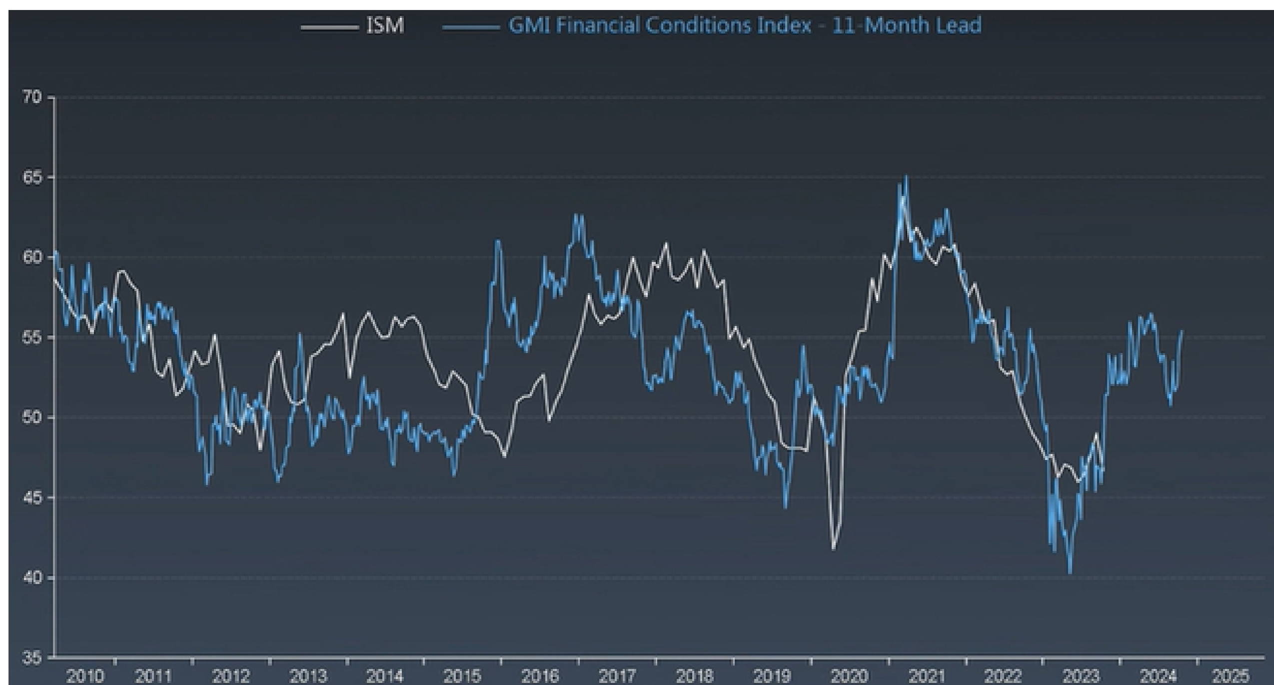
Source: Goldman Sachs Global Investment Research

In our opinion, the Federal Reserve will start cutting interest rates before inflation hits its target of 2% because it believes the target will be hit and that keeping interest rates pegged restrictively higher a moment longer would only increase the risk of unnecessary economic hardship and fallout. The Federal Reserve will base its decision on a series of economic data points, trends and indicators rather than one single reading. Hence, isolated readings that suggest disinflation may be stalling (or indeed inflation may be rising) and which support an argument that interest rate cuts are not coming should be treated with caution. At least until such time, if ever, such reports are reinforced with increasing frequency. Until then, we believe the disinflationary trend is still very much intact and will soon herald multiple rounds of rate-cutting by the Federal Reserve throughout 2024. We expect more disinflation pressures from various areas, such as shelter and core goods, where shortages pushed prices far above trend and above current production costs, boosting margins. We believe increasing competition will cut these higher margins through increased price discounting. We also believe the US labour market will continue to rebalance as the jobs-to-available workers gap trends further down.

A US economic recovery is only months away

Far from fearing a deep recession, as we have been saying for the past several months, we believe that leading economic indicators have been pointing to an upturn in the business or manufacturing cycle. The US ISM Manufacturing index is a great gauge of whether the manufacturing base of an economy is expanding or contracting at a given moment in time. From the chart below, we can see that this measure is currently less than 50, which indicates the manufacturing economy is still in contraction, but a recent improvement in financial conditions throughout most of 2023 is indicating that an improving ISM or increasing manufacturing activity lies in front of us.

US ISM Manufacturing Index versus Financial Conditions (11-Month Lead)



Source: Global Macro Investor

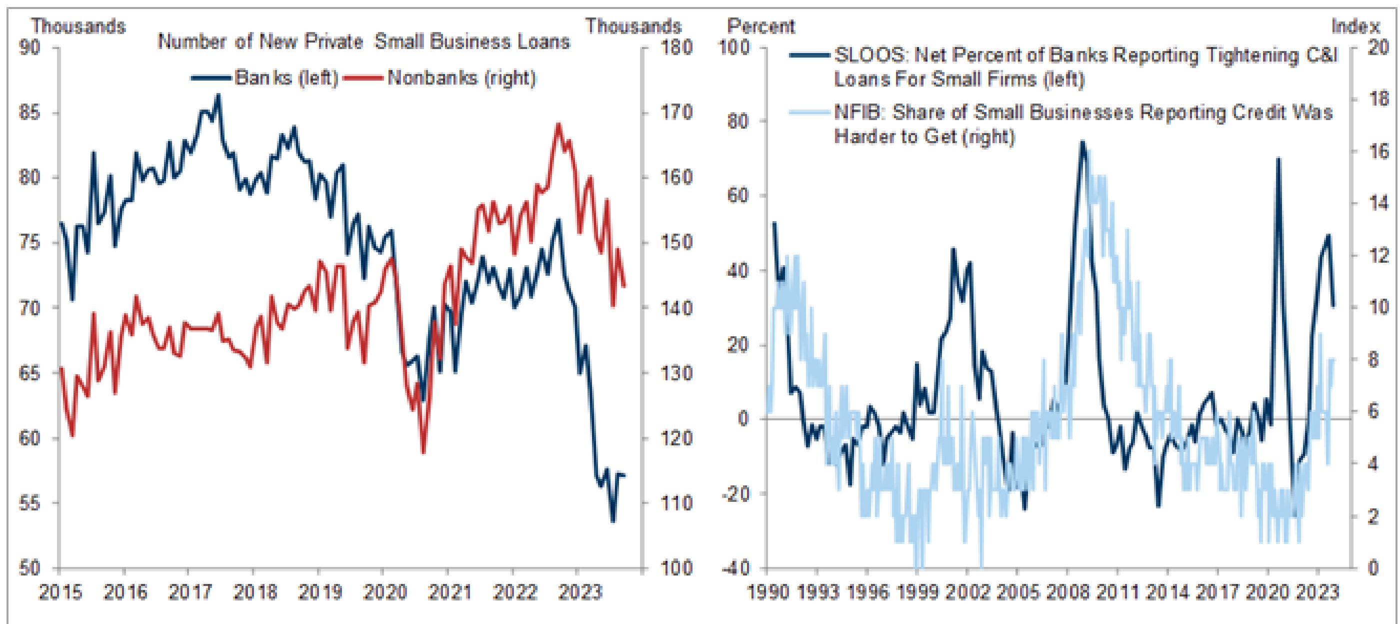
We believe the growth path highlighted in this chart above will be accurate again and that economic growth will rebound and rise steadily throughout 2024. There are several reasons for our optimism.

We expect consumer spending to remain robust as inflation falls and the labour market remains healthy, with unemployment remaining historically low. Even though wage growth is falling, it is still growing around 4% on a year-on-year basis. Hence, allowing for inflation, we should see real disposable income continuing to grow at around 2%, which will be ideal for supporting consumption and GDP growth of at least 2%. Consumption is now on a more normalised and sustainable footing going forward as the exogenous impacts of pandemic effects and fiscal responses ebb away.

Financial conditions have also improved and will probably continue to trend better, as we can see in the chart, and this should be supportive of economic growth through an improving manufacturing outlook. Recent headwinds that exerted downward pressure on industrial activity, such as the inventory destocking cycle, post-pandemic catch-up spending on services, and the recent energy crisis, are all easing, which should boost the sector.

The risks of a US regional banking credit crunch have significantly receded
Our concern last year over the regional US banking system, where a rapid rise in interest rates had threatened to destabilise the whole sector through an erosion of profit margins, a hit to balance sheet reserves and a flight of deposits, has been contained remarkably well. Hence, we are now becoming more confident that the risk of a severe credit crunch has been averted. We, therefore, do not expect any significant tightening of credit from current levels. Whilst bank lending standards did increase, banks have not pulled back on lending as much as feared. Indeed, non-bank lenders cut back on lending far less than the regional banks and filled many of the lending gaps left where regional banks decided to exit.

US Bank Lending Credit Surveys



Source: Accutrend, Federal Reserve, National Federation of Independent Businesses, Goldman Sachs Investment Research

Any asset price volatility caused by strong US economic growth will prove temporary
Whilst we view the potential for better-than-expected economic growth as a positive within our overall investment framework, it could be a double-edged sword. If growth rises to the upside, this could delay the start of interest rate cutting by the Federal Reserve or certainly slow down the pace at which it is inclined to cut interest rates. Such an outcome would disappoint markets and lead to increased market volatility. While we believe stronger growth will ultimately lead to higher prices for risk assets in the medium to longer term, as it should translate into stronger corporate earnings over time, in the short term, it could lead to more uncertainty around the timing of rate cuts and the general thrust of easier monetary policy. That said, we believe this volatility and any resulting price weakness will be temporary as greater economic activity should ultimately mean greater corporate profitability and higher equity prices.

Given the Federal Reserve's concern about leaving interest rates too restrictive for too long, especially with inflation firmly on the way to its target level, we expect it will start cutting soon, and we still believe that March is the most likely date for the first rate cut, although it could be pushed to May. We expect a number of rate cuts in quick succession could follow the first-rate cut. This rate cutting path could become more complicated after the first several cuts, and it will probably depend on how the economy develops as we move through 2024 and whether inflation reaches its target level of 2%.

Our best estimate for the neutral Federal Funds rate is about 2.5%-3%. This is the level of short-term interest rates where it is believed that economic activity is neither being stimulated nor restricted by interest rate policy. So, this implies that the Federal Reserve will cut by up to 300bps over the next couple of years as long as inflation stays on target and certainly does not spike higher as the economy gains momentum next year. We expect this can be achieved.

The Federal Reserve is also likely to taper the current pace of its balance sheet runoff in 1H 2024, which is earlier than expected. Currently, the Federal Reserve is shrinking its balance sheet by $60 billion a month in the case of US Treasuries and $35 billion a month in the case of mortgage-backed securities.[4] This decision will be driven by a desire not to overshoot with respect to reducing liquidity in the financial system and making credit conditions too tight in the broader economy. Furthermore, slowing the pace of runoff will allow more time to smooth the distribution of reserves across

banks, avoiding the risk of instability. In other words, banks, especially smaller banks, who need reserves are more likely to be able to get them or hold on to them in an orderly way. This is important and supports our viewpoint that global liquidity will increase through 2024 and into 2025.

Market Implications

We have held the view since October 2022 that we are in the early stages of a multi-year equity bull market, which is supported by an environment of recovering economic growth, disinflation and easier monetary policy. We are now ready to say that 2024 will be the year that this bull market grows up.

Of course, we have had a strong US equity market price run in recent months, and it is quite likely that prices will recede over the coming weeks and possibly months, but we are very confident in our call that US equity markets will still rise over the course of this year and into 2025. It is clear that plenty of optimism has already been priced into equities, but this is probably justified given the constructive economic outlook. Indeed, there is room for economic growth to surprise on the upside in 2024. Corporate profits will grow throughout 2024, supported by robust consumer spending and better-than-expected economic growth. We see a great alignment of positive forces that will exert upward pressure on equity prices and all risk assets in 2024 and 2025, and it is this rare coalescing of forces that makes us highly confident in our prediction. Given that the Nasdaq and the S&P 500 rose 35% and 24%, respectively, we may not see these returns being beaten again this year. Nonetheless, we expect very strong absolute returns in 2024. The rationale for our confidence is summarised as follows: we expect growth momentum in the US economy to gradually recover, disinflation to continue, and the monetary policy to start easing. Furthermore, we expect financial conditions to continue to improve and central bank global liquidity to continue increasing since it inflected in late 2022.

These forces should exert positive pressure on risk asset prices, especially in a US Presidential election year. It will likely take a significant, unexpected exogenous event, such as a major geopolitical flashpoint, to deflect this “Goldilocks Plus” type cycle off its course. Any price weakness on volatility or uncertainty should be bought. In terms of how we see the year unfolding, we would expect weakness in the early part of the year, strength returning in the spring and to early summer, traditional weakness reappearing in early autumn, and strength returning once more for Q4 2024.

A word of warning is that risk assets are generally not priced to recessionary levels. Hence, if we are wrong, and the US economy does slip into a more meaningful slowdown or recession, this would lead to more weakness in equities, especially cyclicals and credit. Even then, we would expect risk assets to recover quickly as we imagine the response of the Federal Reserve would be to hasten its rate-cutting exercise and boost liquidity, which would support asset prices in short order.

Government bond yields still offer value at current levels. If inflation continues to fall, we believe yields will naturally gravitate lower over the next year or two. We could imagine 10-year US Treasury yields falling closer to 3-3.5% over time.

Whilst corporate bond valuations are not cheap, they are not getting cheaper during this bull phase of the market. Hence, we expect spreads will stay relatively tight for at least another 18 months, if not longer. This will be driven by lower interest rates, improving earnings, and increasing debt affordability. Overall, the return of higher yields over the last two years means that corporate bonds will deliver strong returns for the foreseeable future as we expect a high running yield or coupon will be combined with capital appreciation from falling yields over time.

We have become less bearish on the US dollar and have become relatively neutral. The US dollar has a strong tendency to underperform in an environment characterised by improving growth and slowing inflation, and this rule has proven to be a great guide to performance in the past. However, on a relative basis, the growth outlook for the US economy is improving much more quickly than for other economic regions, such as the Eurozone, leading to stronger relative strength and support.

We expect emerging market assets to continue to do well in 2024 and beyond. In an environment where we should see increasing levels of global liquidity, a benign US dollar and rising demand for essential production inputs such as commodities, it is hard not to be constructive on the outlook for this sector. Furthermore, when you consider that stock valuations in many countries are historically cheap, such as in Latin America, it makes one believe that we might be on the cusp of a mini golden age for emerging markets in general. The impediments that stood in the way of relative outperformance versus developed world markets over the last decade have finally started to fall away. Given the improvement in emerging market fundamentals, we believe the occasion is set for emerging market valuations to return, especially if we have a strong commodity pricing cycle.

We believe we will see an upswing in global manufacturing activity over the next 18 months, which should boost commodity demand. When taken together with depressed inventories and chronic underinvestment in production capacity over the last decade, we expect commodities prices will need to rise gradually over the year.

Overall, there are plenty of sources for possible surprises. For example, listed amongst these could be the further escalation of existing or new geopolitical events, the US economy retracing and slipping back into a more meaningful recession or inflation spiking back up. In all of these instances, risk asset prices will fall in the short term as the uncertainty is priced in. For the reasons we have explained above, we would see all of these events, if they occur, as opportunities to buy the market at lower prices as we believe, ultimately, that large financial forces are at work that are coalescing and will inexorably push up risk asset prices over the course of 2024 and most, if not all of 2025.

Gavin Blessing
18 January, 2024

Source Data: ICM, Bloomberg as of 31 December,, 2023.
[1] While the price return was 0.08%, the total return inclusive of dividends was 3.37%.
[2] The total return inclusive of dividends was 26.3%.
[3] The magnificent seven are Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, Meta
[4] https://www.reuters.com/markets/us/feds-waller-balance-sheet-tapering-could-slow-this-year-2024-01-16/

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