



FOUNDED IN

1988

EMPLOYEES

80+

LOCATED IN

10+
COUNTRIES

ASSETS DIRECTLY
UNDER MANAGEMENT

US\$1.9
BILLION

ASSETS INDIRECTLY
UNDER MANAGEMENT

US\$21.5
BILLION



ICM Monthly Outlook

NOVEMBER 2022

Market Review

In October, the S&P 500 rallied, finishing up 8%. However, the October rally was halted in early November after the U.S. Federal Reserve meeting, where a further 75bps increase in interest rates was confirmed as expected by the market. The market initially rallied, buoyed by new wording suggesting that the U.S. Federal Reserve was softening its stance. However, it sold off after many hawkish comments from Chairperson Powell in his post-meeting press conference.

U.S. ISM Manufacturing Purchasing Managers' Index ("PMI") continues to trend down, hitting 50.2 in October from 50.9 in September and a peak of more than 60 in November 2021. A PMI reading above 50 indicates that the manufacturing economy is generally expanding, while a PMI reading below 50 indicates that it is generally contracting. The ISM Prices Index is a component of the U.S. Manufacturing PMI. In October, the U.S. ISM Prices Index registered 46.6 versus 51.7 in September, indicating raw materials prices decreased for the first time in 28 months, marking a new low in the collapse of raw material prices from 87.1 in March this year⁽¹⁾.

The U.S. labour market added 261k jobs in October, 61k more than estimates but lower than the 315k jobs created in September⁽²⁾. October was the weakest month for job creation since December 2020. Unemployment increased in the month to 3.7%. Job openings surprised to the upside in September, with an increase of 400k jobs after falling by 1 million in August, one of the sharpest declines on record⁽³⁾. While the labour market remains strong at an aggregate level, cracks are beginning to appear. Earlier this month, Facebook parent, Meta, announced it was shedding 13% of its workforce or 11,000 jobs⁽⁴⁾. Twitter have laid-off half of their staff, 3,700 employees⁽⁵⁾. Microsoft let go of 1,000 workers, less than 1% of its staff⁽⁶⁾. Uber competitor, Lyft, cut its headcount by 13%, laying off 700 employees⁽⁷⁾. Online payment giant, Stripe, cut 14% of its staff, or 1,100 employees⁽⁸⁾. Amazon has paused any new corporate hiring⁽⁹⁾.

U.S. inflation for September, released in October, showed that U.S. headline inflation had increased by 0.4% month-on-month and 8.2% year-on-year. U.S. inflation for the past three months was 0.5% or 2.0% annualised. Three-month inflation has only been lower once since June 2020. The problem now appears that inflation has shifted away from food and energy and is being driven more by items such as shelter, transport, and medical care, or what the U.S. Federal Reserve call core inflation. U.S. core inflation increased by 0.6% month-on-month and by 6.6% year-on-year. U.S. core inflation for the past three months was 1.5% or 6.2% annualised⁽¹⁰⁾.

U.S inflation data for October, released at the time of writing, showed headline inflation slowing to 7.7%, its slowest pace of increase since January, and core inflation slowing to 6.3%⁽¹¹⁾. Initially, at least, there has been a strong positive reaction from the market. Perhaps the turning point in the battle against inflation? We prefer to see it as the beginning of the end, there will be blips, but we have begun the descent.

Market Review continued

The U.K. government was forced into an embarrassing U-turn on fiscal policy, which first resulted in the Chancellor of the Exchequer, Kwasi Kwarteng, losing his job and ultimately culminated with Prime Minister, Liz Truss, having to resign. As a result, Truss takes up the mantle as the shortest-serving U.K. Prime Minister ever. So far, the change of government seems to have settled currency and equity markets in the U.K.

European equity markets rallied in October, increasing by 9%. For the moment, it looks like Europe will keep the lights on this winter, and the near term looks stable, albeit there is a long road ahead for Europe to wean itself off Russian oil and gas.

As measured by the MSCI Emerging Market equity index, emerging market equities failed to participate in the equity market rally in October, declining by 2.0%. In a common theme this year, Brazil rallied during the month on the back of congressional election results, which largely voted for market-friendly parties. The elections were seen as a positive by markets despite the election of a devout socialist, Luiz Inácio Lula da Silva, as President. Brazilian equities are up 12.2% this year. Chinese equities continue to weigh on emerging markets and likely will do so until the government relaxes its zero Covid policy.

U.S. rates lurched higher during the month. If you feel that you have read this before, it's because you have. This is the ninth month, of ten this year, that interest rates have increased. Unfortunately, Chairperson Powell's press conference did little to ease concern over how high rates will go. However, some solace is that the pace of increase in rates for longer-dated treasuries appears to have slowed. Nonetheless, the U.S. Treasury Index, measured by the Barclays U.S. Aggregate Government Index, is now down almost 15% year-to-date⁽¹²⁾.

While it is still early days, inflation numbers released as we write have positively impacted rates. For example, U.S. ten-year treasuries have fallen by 23bps to 3.85%, and U.S. two-year treasuries have fallen by 26bps to 4.3%. Corporate bonds were a mixed bag in the month, with the U.S. high-yield bond index increasing by 2.8% and the U.S. investment-grade bond index decreasing by 1.1%.

Market Outlook

Most of us enjoy a nicely paced movie with a fresh storyline and a few twists and turns to keep us guessing. Even if a movie is a rehash of recognisable plotlines and has a predictable ending, a well-directed film with a good pace and likeable characters can still be enjoyable. Observing the Federal Reserve combat inflation with its aggressive interest rate hikes and the resulting economic slowdown emerging over the last several months has been comparable to watching a below-average movie with a relatively predictable plotline and the pace of a sloth. It is harder to watch because we know the main protagonists and their capabilities. We know how the main characters are likely to act in certain situations and what the consequences of those different actions are likely to be. Hence the room for a few surprising twists and turns is somewhat limited, and, in our opinion it is only a matter of time before the final predictable act comes into view. We believe the centrepiece of this final act will be a U.S. recession where demand destruction, caused by rapidly applied and restrictive levels of financial conditions, conclusively defeats inflation. The Federal Reserve will respond by going on pause indefinitely, leading to a rally in the price of risk assets generally. There is a possibility that the Federal Reserve feels compelled to restart hiking at some point in Q1 2023 or early Q2 2023 as financial conditions ease too quickly for its liking. Still, if it happens, we believe it will be a short and final bout of Federal Reserve tightening before the recession bites hard and forces the Federal Reserve to start easing again later in 2023.

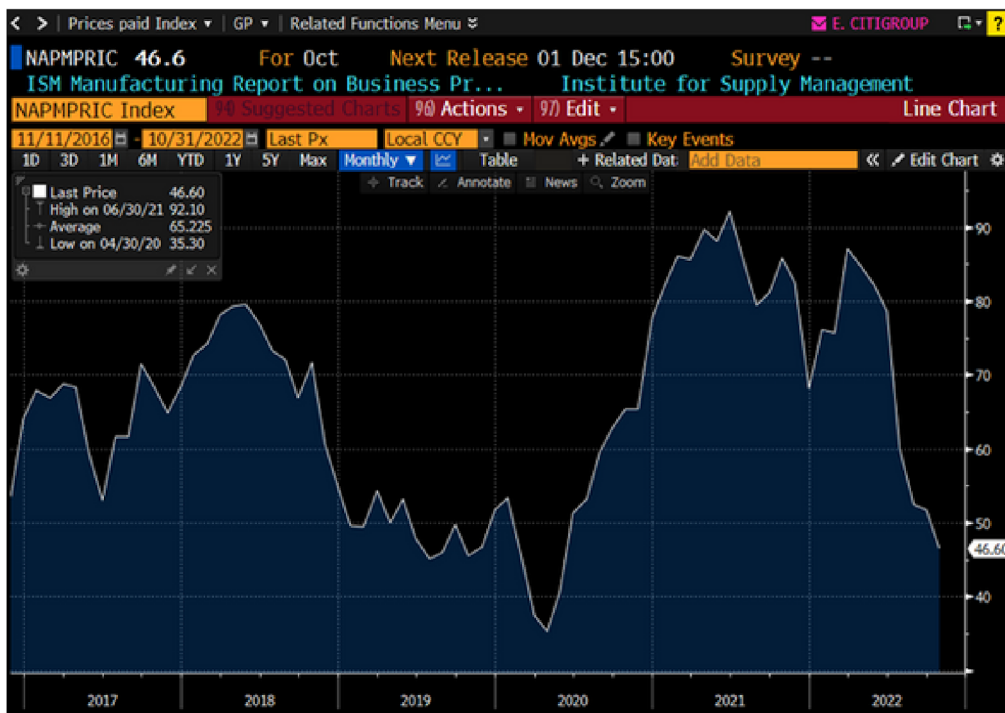
The uncertainty facing markets today is less than in 2008 and 2020

Unlike the mortgage and banking crisis of 2008 and the Covid-induced crash of 2020, the Federal Reserve and other central banks engineered this bear market and inevitable economic recession. Central Banks are acting in response to the threat of runaway inflation, the genesis of which can be found in the ultra-easy monetary policy used to counteract the most harmful effects of the global pandemic. In the bear markets of 2008 and 2020, the largest uncertainties or imponderables were highly opaque in equal measure. In 2008, we had poor visibility on the location of bad loans in the banking system. Hence, we had to cope with high levels of bank balance sheet fragility and the indefinite knock-on impact that would have on credit and new lending. In 2020, we did not know how long our economies would need to stay closed and whether any vaccine, whenever forthcoming, would be effective. We were only able to overcome these uncertainties with time. It took time and a considerable amount of due diligence

Market Outlook continued

before we could distinguish between strong banks and those in trouble. It took time and massive scientific advancement before we knew whether a vaccination program would allow us to open up our economies. In contrast, in this bear market we already know that inflation, arguably our most significant uncertainty in current markets, is falling and that its decline will likely accelerate next year. Hence, we argue that the level of uncertainty and complexity around today's largest imponderable facing markets is nowhere near as uncertain as those facing us during the last major bear markets.

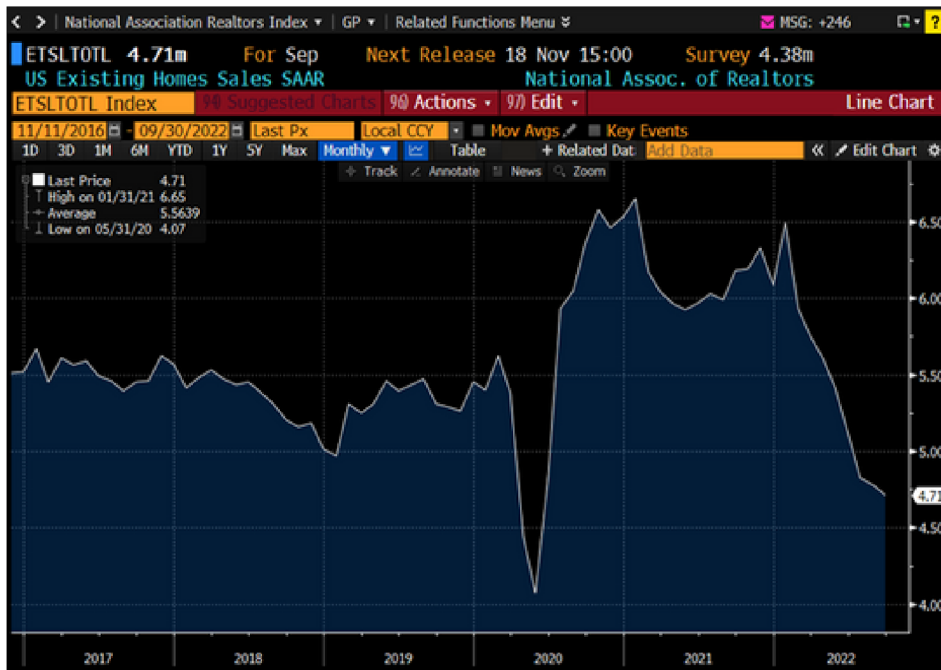
ISM Manufacturing PMI Index – Price Paid Subcomponent



Source: Bloomberg

U.S. rents are also starting to crack, with October marking the second consecutive month-over-month decline. Many forecasters suggest that rents may fall in 2023 rather than simply slow down⁽¹³⁾. Declining rents are not altogether surprising given the significant slowdown we have witnessed in the U.S. housing market. U.S. house prices fell in September for the third month in a row and look set to continue falling as existing home sales continue to plummet. Like declining rents, we are not surprised by declining house prices, with the average 30-year U.S. mortgage rate now firmly over 7%.

U.S. Existing Home Sales

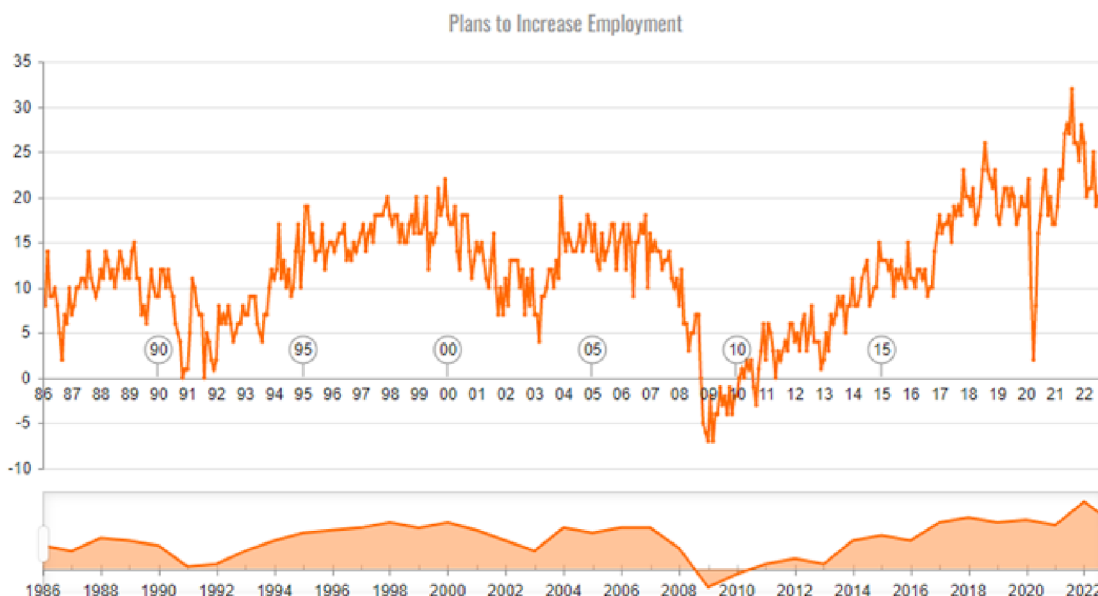


Source: Bloomberg

Of course, the Federal Reserve knows that these components of the overall U.S inflation basket are decreasing. Instead, it is mainly concerned about wage and services inflation, which can become more embedded and challenging to control. We believe we are seeing early signs of weakness in the U.S. labour market, and this weakness will soon become more entrenched, with unemployment starting to rise as we move into next year.

The National Federal of Independent Business (NFIB) hiring index, which measures the intention of small businesses to hire over the next three months, is now in a falling pattern and is more than likely to continue moving down⁽¹⁴⁾.

NFIB Survey - Plans to Increase employment over the next three months

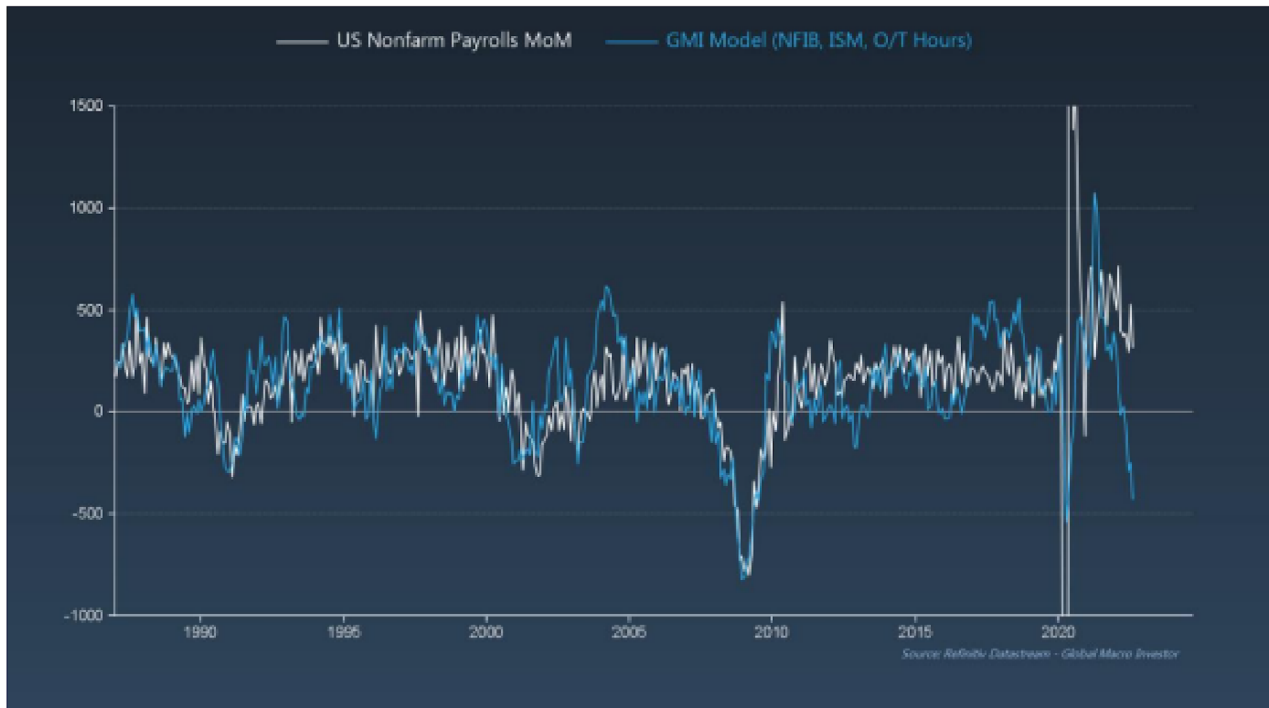


Source: NFIB

The ADP U.S. National Employment report, whilst still showing positive changes in monthly U.S. private sector payrolls, is slowing in its rate of increase, with the three-month moving average in October now at 205,000 monthly job adds compared to 391,000 back in Q1 2022.

Indeed, investment research firm Global Macro Investors (GMI) has leading indicator models suggesting that U.S. Non-Farm payrolls will soon turn negative in the coming months. This is all consistent with a slowing economy, as the employment market is usually the last to see a material downswing in activity.

ISM Manufacturing PMI Index vs Inverted U.S. 30 Year Mortgage Rate YOY% Change (18 Month Lead)



Source: Global Macro Investor

We believe it is only a matter of time before the majority of the components of the U.S. inflation basket show readings of slowing inflation year over year (i.e. disinflation) or outright deflation such as certain commodities and other goods prices.

It is also worth considering the impact of base effects in measuring the year-on-year inflation number. The concept is that high year-over-year percentage gains make similar increases harder to reach the following year. We can show this by looking at the U.S. CPI Inflation index (seasonally adjusted) and extrapolating the month-on-month percentage changes over time. For example, looking at the last three months of inflation changes up to the end of September, the average monthly change is 0.16%. If we assume conservatively that average monthly inflation will be 0.25% for the coming twelve months, annual inflation will fall gradually but considerably over the course of 2023.

Extrapolation of the US CPI Inflation Index into next year

Date	Index Value	MoM	YoY
7/31/2023	304.26	0.25%	3.0%
6/30/2023	303.51	0.25%	2.8%
5/31/2023	302.75	0.25%	3.9%
4/30/2023	301.99	0.25%	4.6%
3/31/2023	301.24	0.25%	4.7%
2/28/2023	300.49	0.25%	5.7%
1/31/2023	299.74	0.25%	6.3%
12/31/2022	298.99	0.25%	6.7%
11/30/2022	298.25	0.25%	7.1%
10/31/2022	297.50	0.25%	7.6%
9/30/2022	296.76	0.39%	8.2%
8/31/2022	295.62	0.12%	8.2%
7/31/2022	295.27	-0.02%	8.5%

Source: Empire Financial Research

This is the likely course of inflation next year. Believing that inflation will remain high next year requires a belief that labour costs will explode higher or that we will see even more disruptions to energy and food supply chains due to the ongoing war in Ukraine or some other exogenous factor.

As we have said before, we believe the narrative in 2023 will turn to one of significant disinflation. This is the very fulcrum of our argument as it makes, in our opinion, the Federal Reserve's subsequent actions more predictable.

The Federal Reserve is setting the scene for an 'indefinite' pause

The last Federal Reserve meeting on November 2nd was more hawkish than general market expectations and certainly our own view. At first, the statement was well received by the market as new language suggested that Federal Reserve was preparing the ground to allow for a slowdown or pause in the pace of its tightening to date. The new language said, "In determining the pace of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments". However, the market was subsequently disappointed in the post-meeting press conference where Chairperson Powell made three points very clear. Firstly, in their view, it is clear that ongoing increases in the Fed Funds rate will be appropriate. Secondly, the level of the terminal rate or 'peak' Fed Funds rate is still very uncertain and likely to be higher than the expectation at their last meeting in September. And finally, the Fed Funds rate will likely have to remain at a restrictive level for some time to ensure that they achieve their goal of price stability.

Based on the change in the statement language and in the discussions that followed, it is our view that the Federal Reserve is becoming more concerned about the potential adverse lag effects on the economy from the rapid pace of interest rate increases to date. We believe this new language is an implicit acknowledgement by the Federal Reserve that more time is needed to ascertain these effects fully. Hence, it is clear that the Federal Reserve committee now wants to move slower moving forward. At the same time, in our opinion, they do not wish to sound dovish as they believe that we are not yet at a level of rates that is sufficiently restrictive to bring about long-term price stability. By sounding hawkish on the terminal rate, it stops financial conditions from easing too rapidly, which might otherwise occur if markets felt the new language was very dovish. Hence Chairperson Powell explicitly told us that the pace of interest rate increases is now much less important than how high interest rates go and how long they remain at that final terminal level. The Federal Reserve knows the risk of overtightening is lower if it moves further into restrictive territory more gradually. A slower approach affords them more optionality in the case of unexpectedly weak or stronger economic data. Moreover, it reduces the risk of financial instability should the market be concerned that the Federal Reserve is not listening to rising pressures in some parts of the market.

Given the strong returns for equity markets in October, it probably should not have come as a surprise that Chairperson Powell would read from the same playbook that he and other members of the Federal Reserve committee have used since late last year. That is, they want to remain sounding more hawkish than the market expects so that financial conditions remain as tight as possible for the time being.

Despite Chairperson Powell's overall hawkish tone, we believe the Federal Reserve is setting the scene to allow them to move more slowly or halt their rate hiking exercise. Halting would allow time and space to fully understand the lagged effects of previous rate increases on the economy. However, by warning that this stance is less important now than the level of the final terminal rate or for how long rates will remain at that final level, he is attempting to remain hawkish so that financial conditions do not suddenly become easier when the job of conquering inflation is possibly not complete. Given the weakness that we see ahead for the economy in terms of leading economic indicators, coupled with a backdrop of falling inflation over the coming months, we think it is unlikely that the Federal Reserve will need to restart raising rates after pausing. We believe the economic data will worsen and be too weak to justify a further round of interest rate hikes. We also believe that the capital markets will eventually come to this conclusion sending the prices of most risk assets higher over time and, arguably more importantly, sending the U.S. Dollar lower. Indeed, as we have been saying for some months now, given the anticipatory nature of markets, we expect the market will start to rally when it believes the Federal Reserve is close to deciding to go on pause indefinitely. We expect this to happen imminently. Hence, we are constructive on equities, both developed and emerging markets, higher quality bonds and other long-duration assets.

Concerns about corporate earnings pressure to be outweighed by the relief of the end of monetary tightening

Of course, if the economic data goes weaker, further pressurising corporate earnings, this could exert downward pressure on asset prices and certainly keep volatility high. Still, over time we believe this pressure will be offset by the knowledge that the monetary tightening cycle is at or close to an end and that we are likely moving towards a new cycle of gradual monetary easing. We do not underestimate the resolve of the Federal Reserve to use its tools to complete the job of attaining price stability and safeguarding its reputation. There is no doubt in our minds that a terminal Fed Funds level of over 4% is simply too high to be sustained in the medium to long term. Hence, we believe that the Federal Reserve, having accomplished its victory over inflation, will then look to gradually ease monetary policy over time in the pursuit of its second mandate of maximising employment.

Hence, we expect that by the end of 2023 and into 2024, the Federal Reserve will likely start moving the Fed Funds rate back down again towards neutral territory of around 2.5% or lower, depending on economic conditions. According to Goldman Sachs research, looking back at data since 1960, the median time between the final rate increase by the Federal Reserve and before it starts to cut interest rates again has been 6.5 months.

Of course, there is a risk that financial conditions start to ease before inflation is conquered. This is what most likely concerns the Federal Reserve. Forward-looking measures of economic conditions show the restrictive impulse is set to peak in late Q4 2022 and Q1 2023. Beyond this timeframe, this tightening impulse will likely start to fade as the rate of change in tighter financial conditions begins to lessen or even reverse. If this happens too early and inflation has not fallen quickly enough, the Federal Reserve might feel compelled to implement one last bout of tightening. If this happens, risk asset prices will no doubt come under further pressure for another period. We believe this scenario is less likely to occur for the reasons given above. Nonetheless, we think that as we go through the course of 2023, it will become clear that inflation is quelled. This will clear the path to a final terminal rate and, eventually, to lower interest rates.

It is worth noting that inflation-driven bear markets tend to see a smaller downside in the 25-35% range, unlike bear markets driven by credit crises etc. Hence looking at U.S. stock markets returns on a year-to-date basis, one could argue that we are in the right neighbourhood and don't need to see a much deeper sell-off from the lows reached in early October.

Just in case our readers have not yet figured out that we are bullish on most equity markets, it is worth pointing out some seasonal work by the Carson group that shows that both six months and twelve months after a mid-term election, U.S. stocks have never been lower. This observation ties nicely with our long-held assertion that we would see a strong rally in risk assets towards the end of this year and into 2023. Our view is unchanged. Given the current shockingly poor sentiment in markets and highly risk-averse positioning with many investors overweight

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cash, we believe the prices of assets are well poised for a strong rebound and may have completed their bottoming process for this cycle. We will finish by repeating the concluding sentence from last month's letter, as our message is the same, save a growing level of conviction. Given inflation has peaked, bad economic news is heavily discounted by way of lower asset prices, and investor sentiment is extremely bearish, we believe rigorous, research-based investments in quality stock and corporate bonds made today at current prices will emerge as great positive asymmetric trades over the coming year.

Gavin Blessing

11 November 2022

Source Data: ICM, Bloomberg, Trading View; as of 30 October, 2022.

[1] <https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/october/>

[2] <https://www.bls.gov/news.release/empsit.nr0.htm>

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[4] <https://www.forbes.com/sites/brianbushard/2022/11/09/meta-lays-off-11000-employees-here-are-the-biggest-us-layoffs-this-year/?sh=32923a4c1002>

[5] <https://fortune.com/2022/11/09/facebook-twitter-layoffs-irresponsible-innovation/>

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[13] <https://www.businessinsider.in/policy/economy/news/rents-are-starting-to-fall-across-the-us-and-theyre-set-to-drop-even-more-in-2023/articleshow/95143024.cms>

[14] <http://www.nfib-sbet.org/indicators/>

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