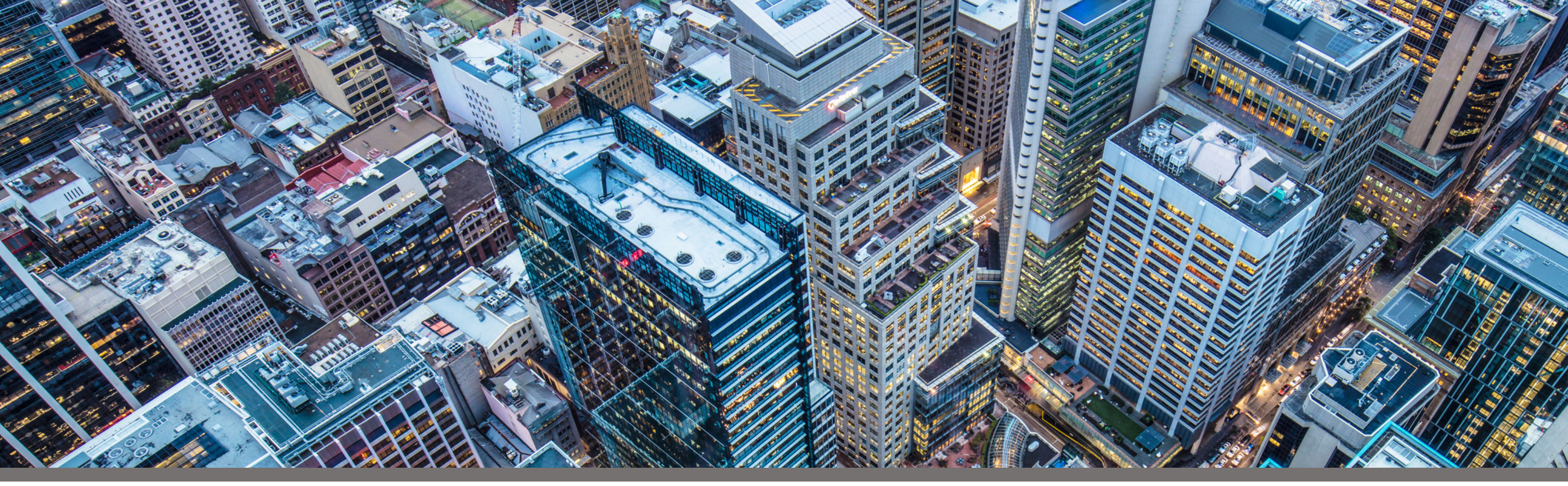


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.8** BILLION	**US$22.9** BILLION

ICM Monthly Outlook

AUGUST 2023

Market Review

Equity markets continued to march higher in July. The S&P 500 was up another 3.2% in July, and the total return for the index is now 20.6% in 2023. There were very few market commentators advocating for this back in December.

Facebook, Amazon, Tesla, Apple, Nvidia, Microsoft and Google, which make up c. 25% of the S&P 500, were responsible for about two-thirds of the S&P 500's returns in the first seven months of the year.

After a brief pause in June, July saw a resumption of interest rate increases by the Federal Open Market Committee. The latest 25bps hike lifted the federal funds rate to a new target range of 5.25% to 5.5%. The federal funds rate is now at its highest level in 22 years.

In the press conference following the decision, Federal Reserve Chairman Jerome Powell refused to be drawn on the likely path of interest rates and was keen to emphasise that the future direction of interest rates was likely to be data-dependent. It is easy to forget how far we have come. Still, one quote from Powell's recent press conference, "We have covered a lot of ground and the full effects of our tightening have yet to be felt", stands in contrast to a quote from last November "We have some ground left to cover and cover it we will".

We continue to believe that the heavy lifting is done and that the next significant move in the federal fund's rates is more likely to be down rather than up. Economic data continues to soften, providing cover for the US Federal Reserve to relent in this rate-rising cycle.

In July, US Non-Farm Payrolls showed 187k jobs created versus an expectation of 200k. In addition, US Non-Farm Payrolls for May and June were revised down. US Job Openings continued to fall, hitting 9.6 million jobs in July, its lowest level since early 2021 and down from a peak of 12 million jobs in March 2022.

In July, US Consumer Price Inflation ("CPI") increased to 3.2% year-on-year, up from 3.0% in June but below estimates of 3.3%. Annualised Inflation for the last three months fell to 2.0%, right on the US Federal Reserves inflation target and the first time three-month inflation has been on target since November 2020.

While CPI inflation is trending towards the target, Core CPI, which strips out volatile food and energy components, remains stubbornly high at 4.7%, its lowest reading since October 2021 and down from 4.8% in June. Shelter, which makes up almost half of the Core CPI Index, was up 7.7% in the year to the end of July, effectively meaning that it contributed the vast majority of all core inflation in the period. As we have often said, the shelter component of inflation tends to come through with a lag. As of July 2023, the US asking rents have increased by just 0.3%.[1] We expect that this slowing in the increase in rents will be reflected in Shelter inflation in the coming months.

Market Review continued

In July, the Brent oil price rose by 14.2%, its largest monthly gain since December 2021. At the end of July, the price of Brent was USD 85.56 per barrel, its highest price since April this year. After a sharp increase in price in June, natural gas prices fell by 5.9% in July. Natural gas prices are c. 70% lower than they were this time last year. A sharp rise in energy prices kicking off a second round of inflationary pressure remains a risk if a periphery one.

In recent days, Germany's gas storage operators group, INES, warned that Germany could face severe gas shortages until early 2027 if it does not add more fuel infrastructure. In the short term, Germany is reasonably well positioned for the coming winter, with 90% of gas storage facilities filled already.

In late July, the ECB continued to raise rates, with a quarter-point increase to 3.75%, bringing rates to their highest level in more than 20 years. While inflation in Europe continues to be higher than in the US, it is following the same downward trajectory with a couple of months lag, reflecting the ECBs initial slower start in increasing rates.

The European stock market continues to shrug off higher rates, decreasing growth and geopolitical risks, increasing by 1.8% in July and now returning more than 21% this year.

In the UK, the FTSE remains a laggard, increasing by 5.5% this year, well behind other major equity markets and giving up most of its outperformance from 2022. UK inflation fell sharply in July, falling to 7.9%. In the previous month, inflation was 8.7%, prompting the Bank of England into a surprise 50 basis point rate. The latest inflation numbers will come as a welcome relief in the UK, where the market at one point was pricing 6.25% interest rates by the end of 2023.

In July, as measured by the MSCI Emerging Market Index, emerging markets increased by 6.0% and are now up by 10.7% year-to-date, driven by Brazil, South Korea and Taiwan. Equity market returns remain subdued in China as it grapples with the prospect of deflation, as consumer prices fell by 0.3% in July. So far, Chinese Communist Party rhetoric on stimulus has not been matched with action.

In July, European government bonds, as measured by Barclays Euro Aggregate Government Index, decreased by 0.2%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, decreased by 0.4%.

Investment Grade credit, as measured by the ICE Bank of America US Corporate index, increased by 0.4% and High-Yield credit, as measured by the ICE Bank of America high-yield index, increased by 1.4% during the month.

Market Outlook

Imagine driving a car in reverse gear along a mountainous, cliffside road while only looking out the rear-view mirror. Now imagine it's not the rear-view mirror but rather a video of the rear-view mirror, which is already three months old. It's a ridiculous scenario, yet this is how Elon Musk colourfully described how the Federal Reserve manages US interest rate policy.

While the primary purpose of this hyperbole is presumably to garner a few laughs, it does contain a number of truths which perhaps explains why the Federal Reserve seems so out of touch with the current pulse of the business cycle. Firstly, it is true that the Federal Reserve is focused on backwards-looking rather than forward-looking indicators. Its dual mandate is focused on inflation and jobs data which are lagging indicators. Hence these variables only respond to a slowing economy months after the slowdown has started and only bottom months after the economy has bottomed. They are certainly not what you could describe as pre-emptive of a slowing economy. Secondly, when the data used in those indicators arrives, it already tends to be several months old, which again militates against effective decision-making by the Federal Reserve.

This probably helps explain why the Federal Reserve believed it was justified to go with a further rate hike in July after a pause in June despite the fact that inflation is falling quickly and there are signs that many parts of the economy are already in recession, such as manufacturing and housing. It is focused on lagging data and makes its decisions based on this data. In contrast, it is unwilling to be led by or respond to pre-emptive data such as the US ISM Manufacturing index.

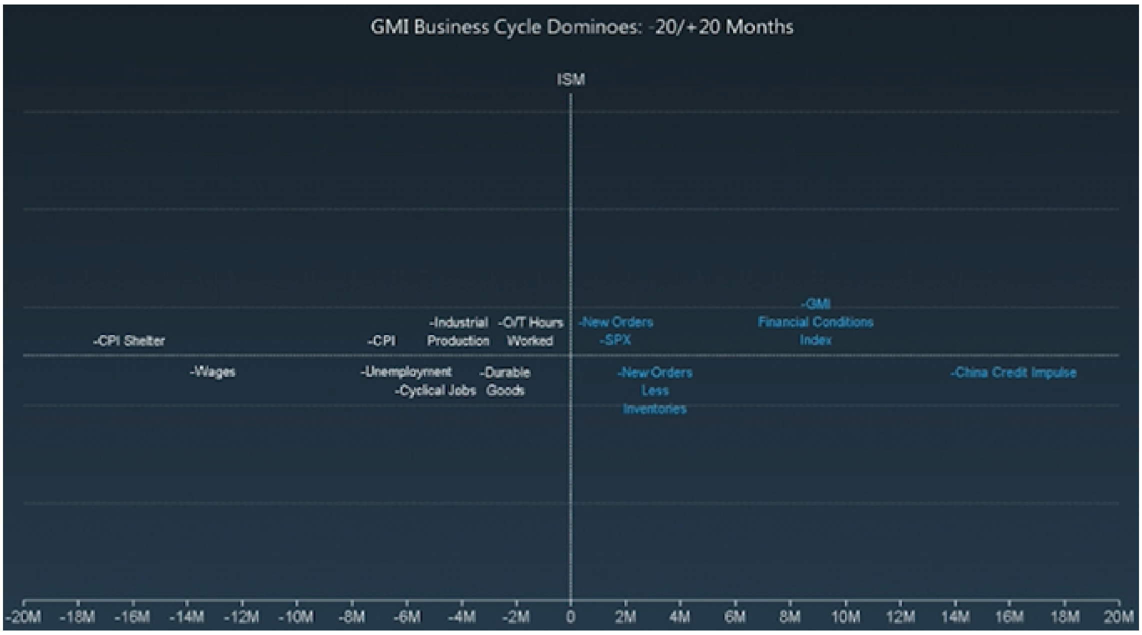
Market Outlook continued

As we mentioned previously, there was undoubtedly tremendous psychological pressure on the Federal Reserve committee to avoid making another mistake concerning inflation policy such that nothing has been left to chance in the fight to rid the US economy of inflation. The Federal Reserve Committee have stated on many occasions that they would rather err on the side of doing too much tightening than doing too little and seeing inflation embed itself for many more years to come. Given its focus on lagging data and labouring under the unconscious bias of wishing to avoid making another mistake on inflation, we believe that time will show that the Federal Reserve has indeed tightened too much.

Inflation will continue to fall, including core Inflation

We think inflation will continue to fall precipitously and will not prove to be sticky. The business cycle chart below shows that it is normal to expect that inflation will not reach its low until at least 6-9 months after the business cycle bottom, and wage inflation is further back at about a year after the business cycle low. We expect we are only reaching the low of the US business cycle, as measured by the ISM index, around this month or next.

Business Cycle and Lead/Lagging Indicators



Source: GMI Macro Advisors

Indeed, the US Producer Price Index (PPI), which measures the cost of input for manufacturing companies, tends to lead CPI inflation by several months. The PPI Final demand index for June came in at 0.1% on an annual basis. Hence US producer price inflation has officially collapsed to zero on a year-over-year basis.

As we can see in the next table, this index is an excellent lead indicator for CPI inflation on a year-over-year basis and argues that annual CPI inflation will fall close to zero in the coming months.

US Producer Price Index (1 Month lead) versus US CPI Inflation YoY%

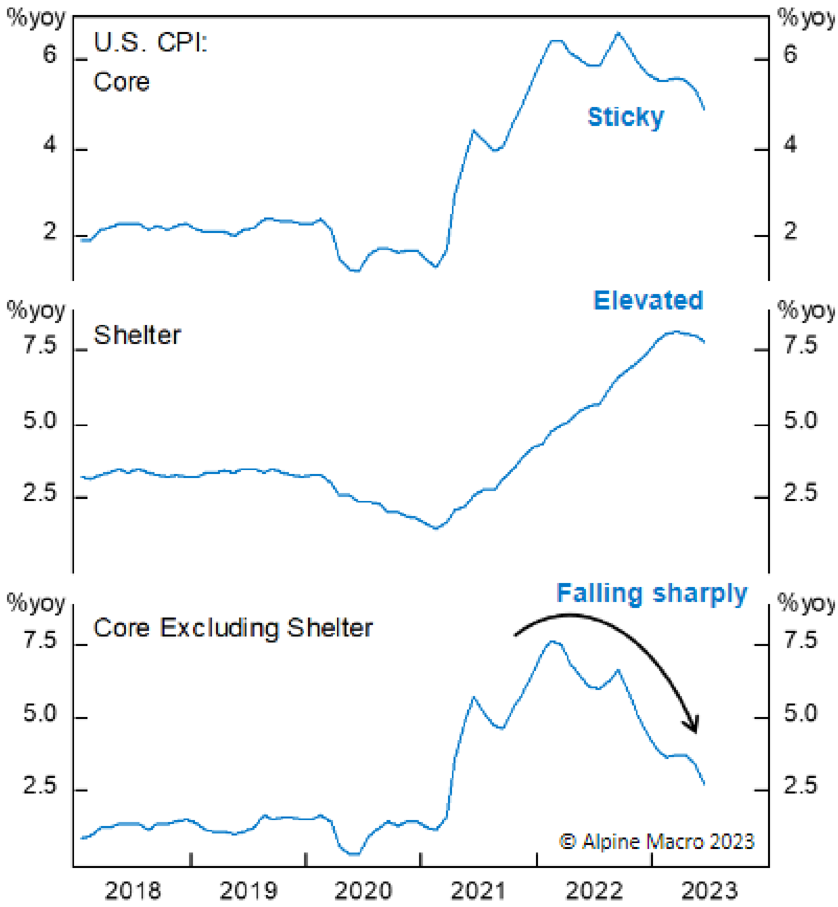
Source: GMI Macro Advisors

Inflation and core inflation will continue to fall as unemployment begins to pick up. We know this because the business cycle tells us it will happen sequentially, just as it has always done before. The business cycle pattern repeats itself.

The US Labour market continues to show signs of easing. The JOLTS report from June, which shows the ratio of job openings to unemployed workers, continues to report a falling surplus of available job openings. The US Quits report continues to fall, suggesting workers are more reluctant to quit their jobs, reflecting less confidence amongst them about regaining employment elsewhere.

Furthermore, when we examine core CPI more closely, we can see that the shelter components of core inflation remain elevated. In fact, according to Alpine Macro in the chart, if one strips out the Shelter component from core CPI, core CPI ex-shelter inflation has already fallen to 2.5% on an annual basis reflecting recent falls in average hourly earnings. This is very close to the Federal Reserve target of 2%. Yet we know shelter inflation is already falling in the real economy, with house prices and rents falling considerably over the last year. Given the well-recognised delays in official calculation methods, it is only a matter of time before the housing components of the core CPI index begin to reflect these declines fully.

US Core CPI Inflation versus US Core CPI Inflation ex Shelter



Source: Alpine Macro

Our business cycle analysis tells us that we should expect inflation to continue to cool and that the labour market will loosen as unemployment increases. We also know that historically, a 0.5% increase in the US unemployment rate is almost always associated with a recession. Indeed, the "Sahm Rule" rule states that if the three-month moving average of the national unemployment rate increases by 0.5% or more from its lowest value in the last year, it typically signals the beginning of a recession.[2]

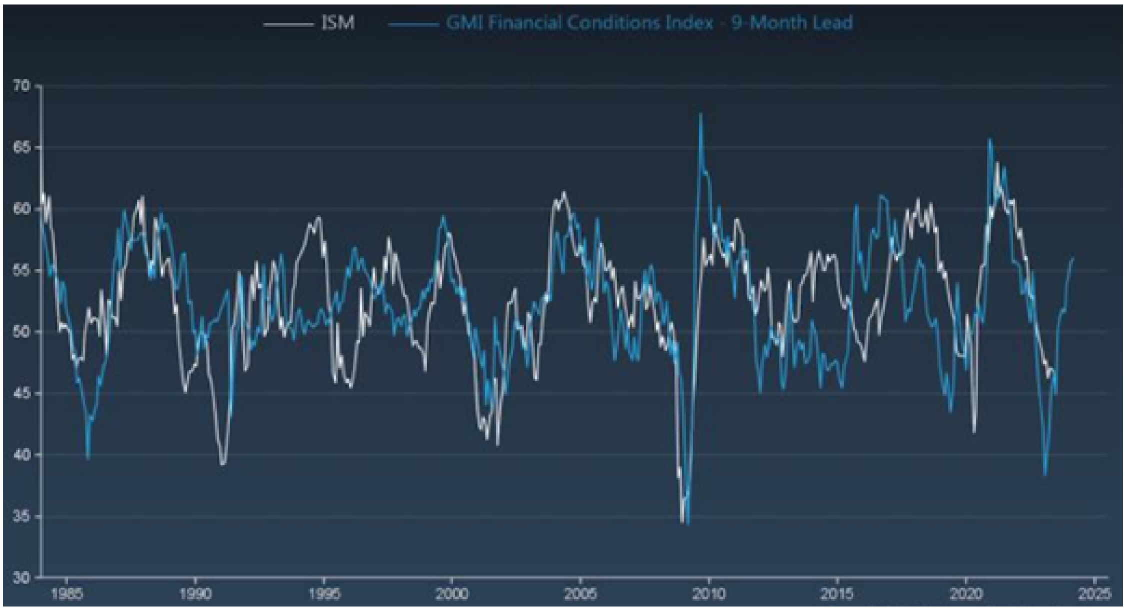
A resilient labour market raises the probability that the US will avoid a recession
Although we expect more weakness in the US labour market, it has to be acknowledged that it has been much more resilient than we would have expected, given the weakness in other parts of the economy. As we posited many months back, this unexpected strength probably has to do with the aftereffects of the pandemic and its specific impact on the labour market. Due to the number of worker deaths and those who decided to leave the labour market prematurely, now known as the 'Great Resignation', the workforce was left more structurally short of labour in the post-pandemic period compared to the scenario had the pandemic not occurred. This led to tightness in worker availability, and hence employers have shown a reluctance to lay off workers, knowing the difficulty of finding them when previously looking to hire. This explanation fits with the data from recent JOLTS reports, which have not only consistently shown a large surplus of job openings to available workers but also are reporting less hiring activity rather than rising layoff activity. This speaks to a labour market that is cooling rather than one that is in decline, which raises the probability of a soft landing and the avoidance of recession.

While we still believe that the US will eventually slip into a recession, our level of confidence in that view is falling. Furthermore, our confidence is increasing that if we ultimately do have a recession, it will not be deep or long-lasting. Large parts of the economy are already in recession, such as the manufacturing and housing sectors, yet other areas of the economy, such as services, travel and hospitality continue to show strength, albeit these areas have been weakening in recent months. We think these sectors will continue to slow, and we may get an overall recession. If we don't, so many historically reliable indicators will have been wrong, which suggests that pandemic-born stimulus packages still have a bearing on the strength of the overall economy.

While there is a myriad of reasons why we believe any US recession/slowdown will not be deep or long-lasting, probably the most important reason is that when we look at the forward indicators of the current business cycle, the signalling from these leading indicators has already turned positive.

As we have shown before, the GMI Financial conditions index shows a strong correlation to the US ISM Manufacturing Index with a 9-month lead. As we can see in the chart, this index has already bottomed and has begun moving higher. This signals that the US ISM Manufacturing Index, our proxy for the US business cycle, will probably bottom out in the coming months and start to swing upwards. This will herald a pickup in US manufacturing from the probable lows coming this fall.

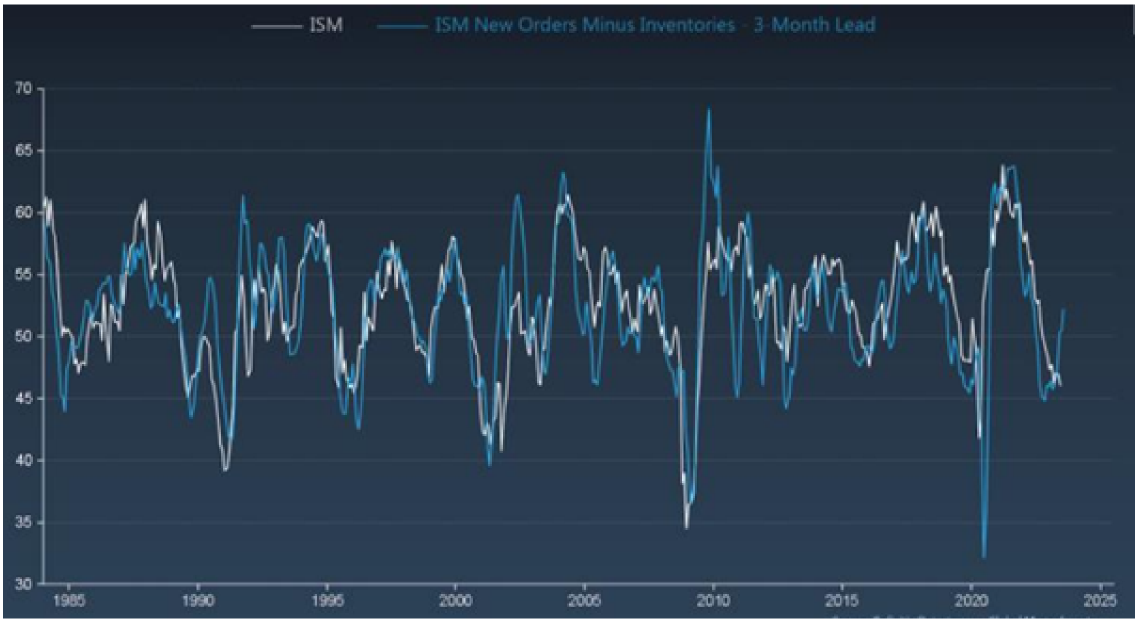
US ISM Manufacturing Index versus GMI Financial Conditions Index (YoY%) – 9 Month Lead



Source: Global Macro Investors

This signal is also confirmed by most forward-looking components of the ISM Manufacturing Index. As we can see in the chart, the ISM New Orders and Inventories components have turned positive and embarked on an improving trend. This suggests the turn in the overall ISM Manufacturing Index, and hence the business cycle is very close.

US ISM Manufacturing Index versus ISM New Orders Minus Inventories (YoY%) – 3 Month Lead



Source: Global Macro Investors

A recession can still occur even after the business cycle has turned

It is important to note that a turn in the business cycle does not mean that a recession cannot occur in the next couple of quarters, as many components of the economy operate on a lagged basis. However, assuming this trend is maintained, which so far the signals show to be accurate, then the likelihood of a long or deep recession does appear to be receding.

Furthermore, even if we see the economy starting to bottom late this year and into next year, we still expect the Federal Reserve will cut interest rates. This is because inflation and unemployment, its dual mandate, will continue to soften well into 2024 and possibly even into 2025. Hence the Federal Reserve cannot simply ignore its current restrictive monetary policy stance when inflation falls below trend or when unemployment is higher than it could otherwise be under its maximum employment mandate. Hence it is very likely that we will see an easing of monetary policy as we go through the course of 2024, which will be supportive of risk assets in general.

Market Implications

We believe the medium to long-term outlook for equities and other risk assets, in general, is improving. We say this because forward-looking data, which the equity markets focus on in contrast to the Federal Reserve, tells us that we are moving from an environment of falling growth and falling inflation to one of rising growth and falling inflation. It is the Goldilocks scenario. The threat of recession is receding, and with it, the risk of the worst possible ravages a recession can have on consumer spending and corporate earnings. The negative tail-end risk of recession is gradually replaced with the growing probability of a future where consumers can continue to spend supported by a growing economy. This is unambiguously good for risk assets such as equities, corporate bonds and commodities. This, together with investor positioning, which was bearish in nature, explains the recent strong performance by global equity markets as investors realised the implications of better-than-expected economic data and scrambled to add exposure.

As we said last month, we are in the early stages of a new multi-year equity bull market. We believe that developed world equities and risk assets, in general, will continue to do well during the remainder of 2023 and into 2024, buoyed by a myriad of positive factors. Improving financial conditions, falling inflation, peak interest rates and soon to be recognised, improving economic growth will help to underpin equity valuations. Furthermore, the expected easing of monetary policy by the US, and possibly also China, will help sustain this bullish momentum through the course of 2024 and into 2025. This viewpoint is also supported by investor positioning, which shows that many fund managers are still underweight equities. The recent Bank of America Survey shows that about 20% of global fund managers are still net short equities, albeit this has dropped from over 50% net short at the beginning of the year as they have gradually become less bearish.[3]

Of course, we could get volatility in the nearer term caused by seasonal factors, interest rate volatility, profit taking amongst stretched valuations and disappointment around the timing of Federal Reserve rate cuts in 2024. Hence, we remain cautious in the short term, but given our medium to longer-term views, we suggest any significant weakness or corrections in the near term should be bought.

We continue to remain constructive on US government bond yields at current levels. We believe the disinflation process has much more to go and that the notion of sticky inflation is erroneous. With rates in restrictive territory and demand reduced, inflation will continue to fall. The impact of cumulative past rate hikes is yet to be fully felt. With short-end rates around 5% and longer bond yields above 4%, real rates are becoming very high at about 2%. This level of real rates has historically caused economic activity to slow significantly and, in our view, given that the quantum of debt outstanding across the US economy is now higher than ever,[4] it will become an unsustainable burden if rates do not fall gradually. While fiscal expansion and increasing bond supply are negative factors for US bond prices, we believe that real yields should decrease over time as ongoing disinflation clears the path for a new monetary easing cycle. One could also argue that interest rates have been kept artificially high because the Federal Reserve has pushed short-term rates too high, given that it would rather risk economic recession than see inflation survive. As we know, it is focused on lagging rather than leading economic indicators. Hence the market perceives Federal Reserve action as being late on everything – late to raise rates in 2021 and, therefore, probably late to cut rates in 2023/24. This is likely to result in all rates staying higher for longer than they ordinarily would or should.

We maintain our bearish stance on the US dollar. The US business cycle is ahead of other countries and economic regions, so we should begin to see the interest rate differential narrow between the US dollar and other currencies, such as the Euro, which is bearish for US dollar strength. Furthermore, the US dollar tends to underperform in an environment where we have improving growth but slowing inflation and only tends to recover and outperform towards the end of such cycles where growth is peaking, and inflation is rising. This is a long way off yet; hence we believe we are in for an extended period of sustained US dollar weakness.

We are becoming increasingly bullish on emerging market equity and debt as it looks like it could break out in a world of US dollar weakness. While Chinese economic activity has recently been poor, we expect more stimulus in due course, particularly around the property market, which should be favourable for economic growth in the region. Again, we would be cautious in the short term for similar reasons given about developed world equities. However, we expect emerging market equity and debt to have a period of strong returns starting later this year and extending right through 2024.

Our view on commodity prices is relatively unchanged from previous months. While prices have been weak due to concerns over the global economic slowdown, we expect improving economic growth out of Asia, especially around decarbonisation and growing capital expenditure on green energy and renewable infrastructure, to bolster pricing. For example, copper demand is already up 11% year over year in 1H 2023, making it one of the strongest starts to a year since the supercycle years in the early 2000s. We expect demand from Western economies to pick up later this year or next year, supported by a rebound in economic growth and the easing of respective monetary policy, which should underpin commodity prices in the medium to longer term

Gavin Blessing
11 August, 2023

Source Data: ICM, Bloomberg as of 31 July, 2023.
[1] https://www.redfin.com/news/redfin-rental-report-july-2023/
[2] https://www.reuters.com/article/us-usa-fed-sahm/sahm-rule-enters-fed-lexicon-as-fast-real-time-recession-flag-idUSKBN1WJ12J
[3] https://www.hedgefundtips.com/july-2023-bank-of-america-global-fund-manager-survey-results-summary/
[4] https://www.statista.com/statistics/1083150/total-us-debt-across-all-sectors/

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34 Bermudiana Road | PO Box HM 1748 | Hamilton HM GX | Bermuda
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