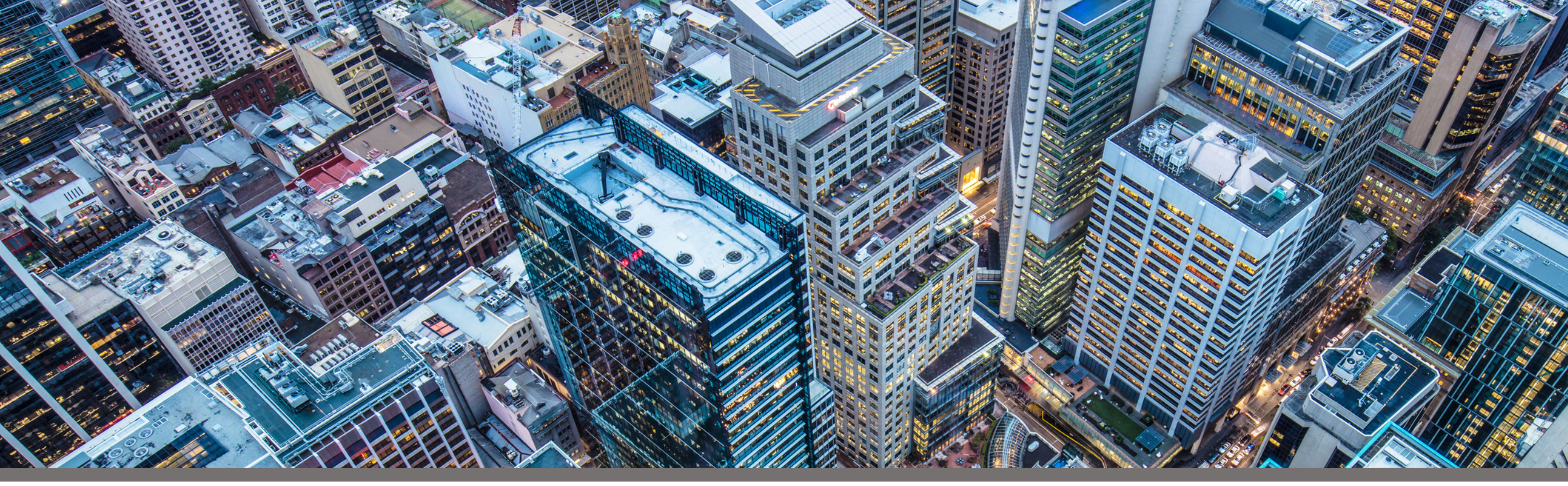


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.8** BILLION	**US$22.5** BILLION

ICM

ICM Monthly Outlook

JULY 2023

Market Review

It’s half-time in 2023, and fortune has favoured the brave thus far, despite the unyielding chatter of economic slowdown.

Investors enjoyed a stellar six months if they stayed invested, albeit many will likely be recouping losses from 2022. Investors who doubled down on or got involved in big tech in Q4 2022 have enjoyed phenomenal returns. Equity markets atop the leaderboard. Year to date, the NASDAQ is +32%, and the S&P is +16%; very respectable. In June alone, the Nasdaq and the S&P increased by 6.6% and 6.47%, respectively.

The strong performance in the first half of 2023 will be remembered mainly for the dominance of US large-cap tech companies. US large-cap tech companies dominate the major indices, hence the indices’ strong performance. The best performing companies are those that investors perceive will benefit most from advances in Artificial Intelligence, including Facebook, Amazon, Apple, Nvidia, and Google. For example, in June, Nvidia, one of the world’s largest manufacturers of microprocessors used in artificial intelligence, beat analysts’ sales predictions by more than 50% and subsequently became the world’s sixth USD 1 trillion market capitalisation company. Morgan Stanley’s analysts revised Microsoft’s market capitalisation target to USD 3 trillion from USD 2.5 trillion based on Artificial Intelligence efficiencies.

As anticipated, the Federal Open Market Committee did not increase interest rates in June 2023, referred to as a hawkish pause by investors. The Federal Reserve Bank was buying time to assess the impact of its previous hikes. Remember, in March and April, the Federal Reserve hiked in the face of mounting pressure to pause due to a nascent banking crisis in the US, which may still play out.

By the end of June, the Federal Reserve Bank and other Central Bankers warned investors that they may not be finished in the current rate cycle yet. At the Central Banker policy forum in Sintra, Portugal, in June, Chairman Powell commented that additional hikes were likely and that restrictive policy was needed for some time. Since Chairman Powell's comments, investors expect another 25 basis point interest rate hike at July’s meeting due to robust economic data.

Noteworthy in June was the surprisingly higher rate of inflation in the UK and the Bank of England’s surprise 50 basis point rate hike immediately afterwards, outside of its regular meeting schedule. Year on year, UK CPI increased to 8.7% versus the consensus expectation of 8.4% for May. Year on year, core CPI rose to 7.1% versus the consensus expectation of 6.8%. Core CPI excludes energy, food, alcohol & tobacco. Following the Bank of England’s hike, the entire UK Gilt curve was above the US curve. For example, the UK 10-year gilt yields 4.5%, the US 10-year treasury yields 3.97%, and the German 10-year yields 2.5%.

Market Review continued

The USD and GBP yield curves remain inverted. An inverted yield curve is a predictor of a recession, typically. In the first week of July, the US yield curve was the most inverted it has been in recent history.

In June, the Brent oil price rose by 3.08%, while the gas price rose 23%, albeit from a low base. At the end of June, the gas price was 48% lower than this time last year, 71% lower than its peak in August 2022.

The second-half performance of 2023 will depend on how long economic growth stays stronger than expected, how long employment remains at its current record lows and if inflation falls more than expected. Despite strong growth from some sectors, the lag effect of higher rates will impact the economy.

Numerous times in the past decade, we warned about the opportunity cost of sitting on the sidelines waiting for something bad to happen. In the first half of 2023, investors who stayed on the sideline anticipating deeper value will be hard-pressed to catch up this year.

Market Outlook

Sentiment and emotion are powerful human forces that pervade and influence human behaviour in myriad settings including frequently determining the direction and state of capital markets. That should be no surprise, given that the flows of capital within these markets are equally likely to be determined by investors acting on emotion and feeling rather than cool calculation and rational decision-making.

Investor sentiment at the end of 2022 was very much marked by a sense of foreboding that the weakness experienced in equity markets during the course of 2022 was not yet over and that the tentative rally in share prices, that had been enjoyed since October 2023, was at material risk of being upended as we moved through the early months of 2023. This sense of investor fear was predicated on the concern that as the economy weakened, corporate earnings would be severely curtailed and negative earnings revisions would be reported during the first half of 2023.

Earnings have proved more resilient than investors expected

According to FactSet, while US Corporate earnings were down c. -2.2% for Q1 2023, this compared to an expected earnings decline estimate of -6.7% earlier in the quarter. The number of companies reporting positive EPS surprises and the magnitude of these earnings surprises came in above their 10-year averages.[1] Clearly, investors' fears were not realised. Corporate earnings resilience surpassed expectations. Rather than being the pin that burst the nascent stock market recovery, better-than-expected corporate earnings served as the relief catalyst that propelled the stock market higher. The Nasdaq, with its technology and growth focus, posted a return of over 31%, its best return in the first half of a year since 1983. The broader S&P index also has a smashing start to the year with a return of 16%. Indeed, it is clear from the price performance of these two indices that as investors' worst fears around earnings do not materialise and as investors perceive that the Federal Reserve is winning its battle with inflation while not killing the economy, the more optimistic they have become with time.

Nasdaq versus S&P 500 versus Russell 2000 Index % Returns YTD

Source: Bloomberg

Market Outlook continued

We are in the early stages of a new equity bull market
This price performance on the broader indices suggest to us that we are in the early stages of a new bull market and that the market low or bottom of the previous bear market is now behind us. While the equity market recovery has been led by the growthier element of the market, especially large-cap technology names, the market breadth is widening as more names and sectors bounce off their lows from last year. As can be seen in the chart, even the Russell 2000, which represents the US small-cap stock market index or smaller publicly listed companies in the US, has started to perform in June after trading largely sideways for most of the year.

This surprising equity market strength is clearly welcome and bodes well for continued equity market strength in the second half of 2023. According to CFRA Research, the average return for the second half of any given year since WWII is about 4.5%, and the same period usually sees positive returns 70% of the time. However, when you have a first-half gain of more than 10%, the average return in the second half has averaged greater than 8% and been positive more than 82% of the time. Hence it seems more likely than not that we will see positive returns continue over the second half of 2023 and less likely that we see a material fall back in prices by year-end. Furthermore, when the first half has been positive, then typically the best-performing sectors in the first half continue to outperform in the second half more than 60% of the time. In this instance, those sectors are communication services, consumer discretionary and information technology.

In addition to corporate earnings being more resilient than expected, another support to market sentiment this year has probably been the perception that the Federal Reserve is close to the end of its tightening cycle. Indeed, the Federal Reserve announced its first pause in the tightening cycle in June. While it believes financial conditions are now restrictive, the Federal Reserve is still undecided in terms of whether they are sufficiently restrictive to bring inflation back down to its 2% target or whether they need to tighten further. In light of the 500bps of cumulative tightening already implemented, the uncertain lags by which monetary policy affects the economy and the potential headwinds caused by the tightening of credit conditions, such as bank failures, the Federal Reserve believes it was prudent to pause and to allow time to gauge the impact of these effects on the U.S economy.

Despite evidence inflation is falling, the Federal Reserve is still not convinced the job is done
Recent utterances from Chairperson Powell suggest that Federal Reserve is not yet convinced that conditions are sufficiently tight enough to ensure it will reach its inflation target.

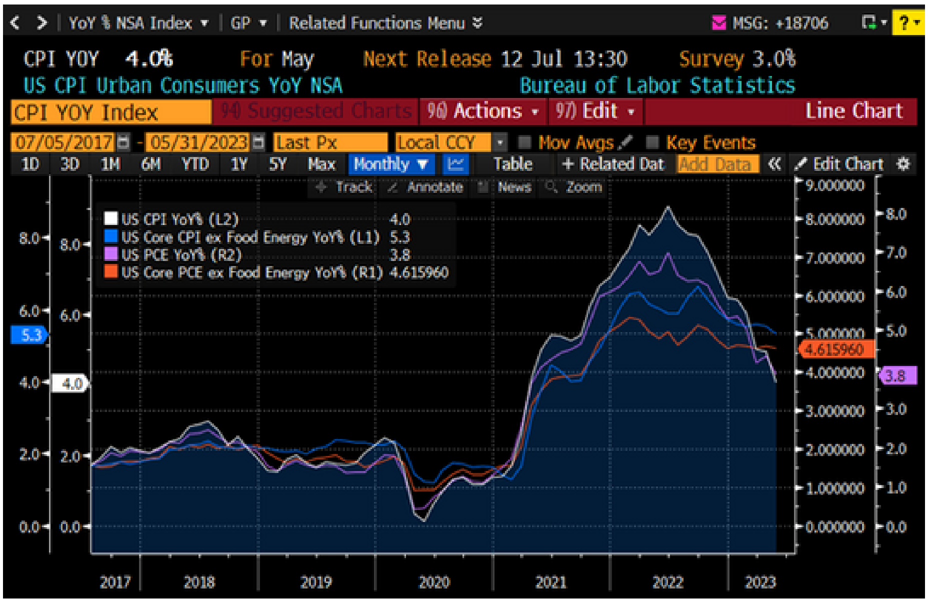
It believes that the US Labour market is still too strong which is driving real wage gains which in turn pushes personal incomes higher which drives more spending and consumption finally leading again to even more demand for labour.

Hence the Federal Reserve is now probably of the view that the labour markets are too tight relative to it achieving its disinflation goal especially as it pertains to core non-shelter related services.

It is now likely that the Federal Reserve will go with another rate hike at the end of July. The Federal Reserve has been true to its word this cycle. They said they will 'keep going until the job is done'. It is very clear that this is not lip service.

Despite the manufacturing side of the economy clearly being in a recession and historically being a good enough reason to stop hiking rates in the past, the Federal Reserve Committee really mean business and would rather err on the side of caution and do too much tightening rather than do too little.

US Consumer Price Index (CPI) YoY% versus Core CPI YoY%

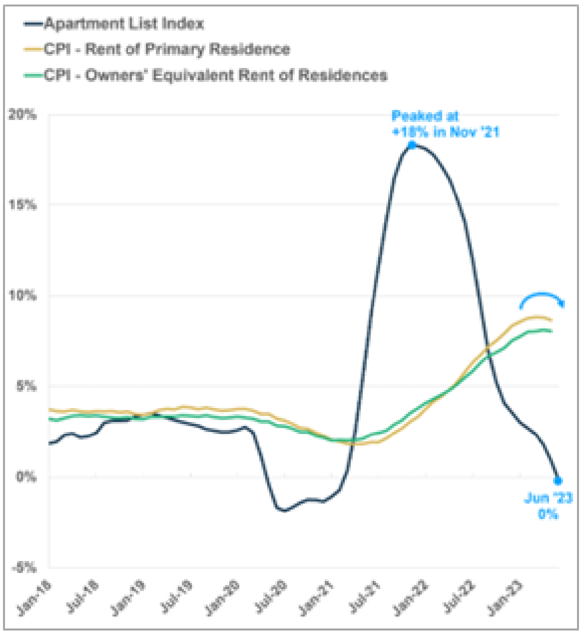


Source: Bloomberg

Clearly, the core measures of both these indices are falling more slowly and appear sticky, but we are of the view that these measures will also fall. It is only a matter of time before the disinflation process which started in the goods and materials sector, where we have witnessed prices rising more slowly or falling outright, works its way through to the other major components of inflation, namely, the housing and shelter related sectors of the economy and finally the labour and wages market.

In the next chart we can see that the rate of change in apartment rental asking prices has fallen considerably over the past year and given the lag effects when it comes to measuring this slowdown, the official CPI index is now only know starting to reflect the reality on the ground which is that the peak pressure rental market asking prices has now passed and rents are flattening out since the latter part of last year. Hence this slowing momentum in shelter related inflation should continue to be recognised by the official indices for the rest of this year and into next year.

Private v Official Rental Price changes (Year over Year%)



Source: Carson Investment Research, Federal Reserve Bank of St. Louis

We also know the labour market is typically the last sector of the economy to correct as we go into a recession and/or major slowdown. An economic slowdown generally leads to a slowdown in the labour market as unemployment begins to rise and demand for labour falls. Hence wage pressures eventually subside but not immediately as companies initially try to hold to their workers but as time passes and the slowdown takes a greater grip, employers are forced to relent and shed workers.

Core inflation will continue to fall
According to Goldman Sachs, the impact of the Federal Reserve tightening and the ensuing economic slowdown is already having an observable impact on US labour market rebalancing. Their measure of the jobs-workers gap, which calculates the number of jobs available compared to the number of workers available to fill those jobs, has roughly halved, and sequential growth in average hourly earnings has already slowed to the 4% pace which is necessary to bring medium-term inflation back into the Federal Reserve's comfort zone.

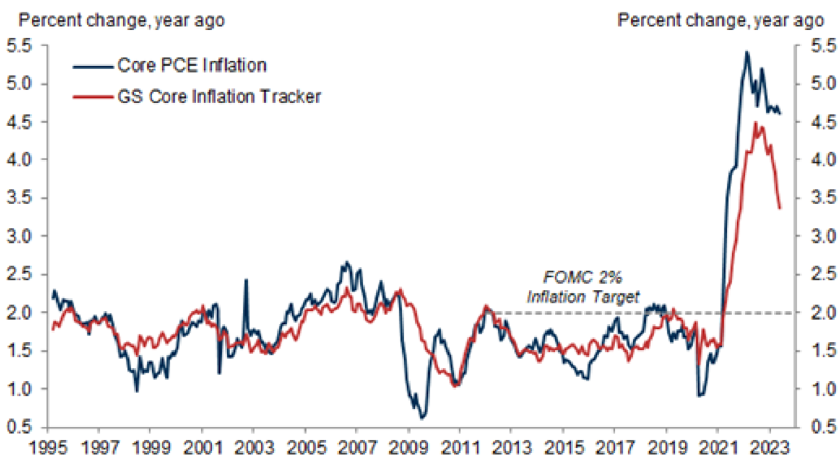
Remember the Federal Reserve has previously stated that wage growth of 3.5% or below is consistent with their long-term inflation target of 2% as they allow a 1.5% offset for annual worker productivity growth.

More broadly, a measure which Goldman Sachs uses to extract the underlying trend in core inflation, known as their Core Inflation Tracker, is now consistent with a trend pace of core inflation 3.4%.

As the chart shows, this suggests that we will see further renewed declines in reported core inflation this summer and later this year, driven by the aforementioned rebalancing of the labour market, slowing shelter costs and recent falls in used car auction prices.

This has led Goldman Sachs to lower their December 2023 core PCE forecast by two-tenths to 3.5% (from 3.7% previously). Their forecast for December 2024 is unchanged at 2.4%.

Core US Personal Consumption Expenditure (PCE) Inflation



Source: Goldman Sachs Global Investment Research

The U.S economy is still more than likely to enter a recession later this year
While consumer spending remains relatively robust, buoyed by a strong labour market, the US economy is still slowing and, on the balance of probability, should fall into a recession. As can be seen in the chart by the US Conference Board, the index of leading economic indicators is firmly pointing towards recession.

The US Leading Indicator Index has declined in each of the last fourteen months and continues to point to weaker economic activity ahead. This indicator historically is a very good indicator of an approaching recession. While the Conference Board recently revised their Q2 GDP forecast from negative to slight growth, they project that the US economy will contract over the Q3 2023 to Q1 2024 period due to "continued tightness in monetary policy and lower government spending."

The Conference Board Leading Economic Index

Source: The Conference Board

As demand ebbs due to the restrictive nature of monetary conditions within the economy, it is our view that the disinflation process will continue regardless of whether the Federal Reserve feels compelled to move again.

In our view, the evidence suggests that monetary conditions and the cumulative effects of past tightening have still not been fully felt and are already sufficiently restrictive to slow consumer demand, eventually bringing inflation back down to the 2% target level.

Any further increases in interest rates, in our view, are most likely not needed and will only serve to damage the economy unduly which will only be clear in the fullness of time.

The aftereffects of the banking instability from March will still only be felt in the months ahead when credit lending is likely to be curtailed further.

Indeed, the Federal Reserve has explicitly recognised this risk and cited it as one of the reasons for pausing a further rate hike in June.

While the acute pressures facing US regional banks earlier this year may have receded, the root cause behind their challenges has not changed. Their response to these challenges will result in reduced lending and credit flow within the economy.

The situation facing the commercial real estate market is only likely to worsen as portfolios are required to be marked to market leading to significant impairment losses. These markdowns and the knock-on implications for refinancing requirements, coupled with residual concerns over bank liquidity and profitability, could lead to further banking instability later in the year, like what was witnessed in the first quarter. Such a scenario would only serve to exert further downward pressure on economic growth.

Market Implications

Contrary to consensus market opinion at the time, we stated in our monthly letter last December that we expected 2023 would be a good year for risk assets in general. We suggested that "we could see a strong start for capital markets in the first few months of the year as inflation cools and consensus forms that the Federal Reserve is close to pausing its rate-hiking cycle. Of course, we could see lower earnings revisions, but if this is already priced in and investors are positioned this way, we could see an anti-consensus rally in markets. Inflation peaks tend to coincide with equity market bottoms and better-performing markets."

Clearly, we are pleased with our call given how equity markets have performed in the first six months of the year.

We remain constructive on risk assets such as equities and corporate bonds for the remainder of 2023 and especially as we go into 2024, given our view that the global liquidity cycle which has already started to turn.

We expect this turn in global liquidity to be further boosted by the Federal Reserve Bank, by mid next year at the latest, as it is ultimately forced to reduce interest rates and bolster the money supply in order to resuscitate a weakening US economy battling the forces of negative economic momentum.

However, we maintain our view that in the short term to medium term, it is better to adopt a more cautious view on US equities and risk assets in general. This cautious view is driven by a belief that those higher valuations, recently attained, could be challenged by waning corporate earnings, falling consumption and growing uncertainty around the trajectory of inflation.

Indeed, market volatility could easily rise if the perception increases that an impatient Federal Reserve will stop at nothing to get inflation down quickly regardless of the longer-term damage it could cause the economy. These factors, combined with traditional seasonal weakness, lead us to be believe that equities and other risk asset prices might retrace temporarily from what we believe are relatively overbought levels.

We remain constructive on government bond yields at current levels. We believe it is only a matter of time before inflation is back consistent with the Federal Reserve target of 2% yet we think economic momentum will end up much weaker as a result of achieving this goal especially if the Federal Reserve does not remain patient and instead continues to rachet interest rates even higher. Hence, we are very likely to be a position by early next year where the US economy is weaker, possibly in recession, and where inflation is close to target but where interest rates are unsustainably high. While the short end might see further increases in yields as the Federal Reserve tightens even further, we believe the longer part of the curve offers very good value with 10- and 30-year Treasury yields over 4%. It is hard to envisage these longer-term yields going much higher from current levels before falling back down. We view any short-term backup in yields as good longer-term buying opportunities.

Although we remain bearish on the US dollar in the medium term, we could see a rally at times during the summer and autumn caused by a growing realisation that the Federal Reserve is unwilling to cut rates as quickly as priced in by the market or just in response to the possibility of weaker equity markets.

Similar to our view on developed world markets and supported by our longer-term bearish view on the US dollar, we remain cautiously constructive on emerging market equity and debt, especially in Asia, as the money supply in this region continues to improve. We would view the region as a relative outperformer versus the US and European markets. In the short term to medium term, we believe risk-off sentiment could dominate for the same reasons given earlier for developed markets and hence we would adopt a more defensive tone for the next several months. However, we do expect emerging market equity and debt to have a period of strong returns starting later this year and extending right through the course of 2024.

While Commodity prices have been in the shadows this year given the global economic slowdown and weaker-than-expected demand from China, we do expect improving economic growth out of Asia to provide some support to prices despite economic concerns around demand from the US and Europe. We expect western economies to eventually bottom later this year or next year with a rebound in 2024 supported by the easing of respective monetary policy. Our central case expectation is for any US recession to be relatively mild and short-lived. Rising demand from Asia coupled with an expected upturn in US and European economic activity in early 2024 should underpin commodity prices in the medium to longer term.

Gavin Blessing
7 July, 2023

Source Data: ICM, Bloomberg as of 30 June, 2023.
[1] https://insight.factset.com/sp-500-earnings-season-update-may-5-2023