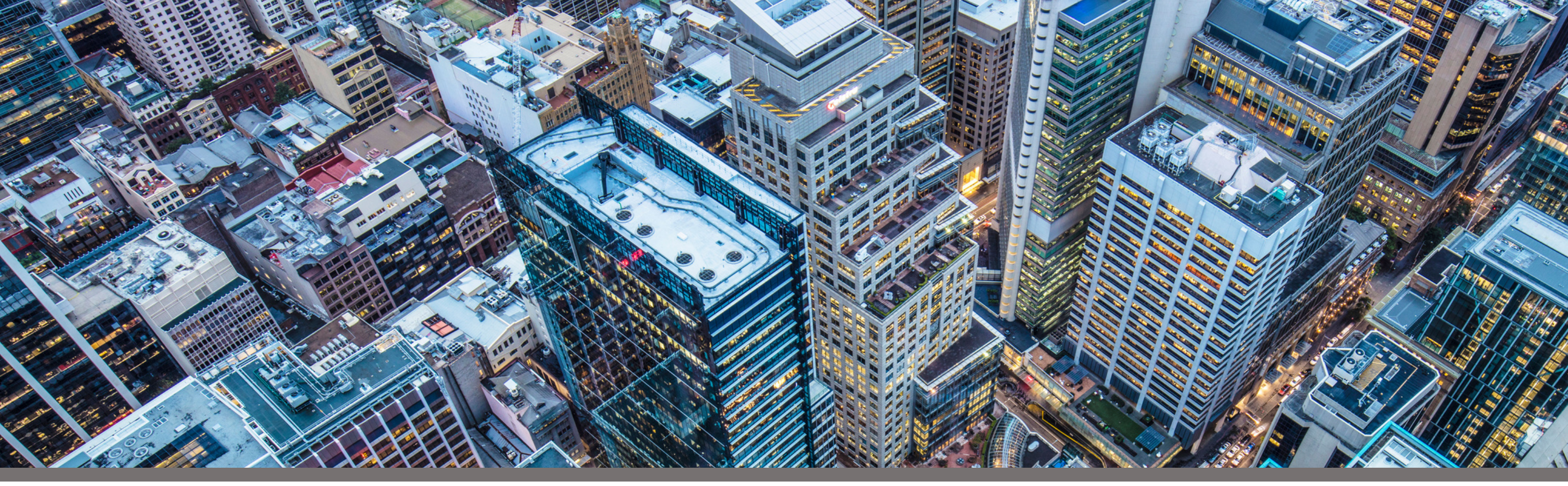


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.8** BILLION	**US$22.5** BILLION

ICM

ICM Monthly Outlook

JUNE 2023

Market Review

In the US, the headlines were dominated by discussions around the debt ceiling. The debt ceiling is the maximum amount of money the US can borrow by issuing bonds. Once the ceiling is reached, the Treasury Department must resort to extraordinary measures to meet spending obligations. The debt ceiling was last negotiated in December 2021, when it was increased by USD 2.5 trillion to USD 31.4 trillion. In January 2023, the US officially hit the debt ceiling of USD 31.4 trillion and has since been relying on "extraordinary measures" to avoid default. In early May 2023, Treasury Secretary Janet Yellen said that if a deal was not reached to increase the debt ceiling limit by June 1, the government would be forced to prioritise payments and could end up defaulting on debt if interest and capital repayments on bonds were not prioritised. A default by the US would result in untold volatility in capital markets. Yet, markets remained largely sanguine about the prospect, likely reflecting the likelihood that a deal would be struck. And so it was, after much political bluster and posturing, that Republicans and Democrats agreed to suspend the debt ceiling through to 2025. This was the 78th time the debt ceiling had been raised, extended, or revised since 1960.

The debt ceiling impasse comes up regularly with varying degrees of seriousness. Still, the outcome always ends up the same, a last-minute deal in which everyone claims to be the architect and victor. Markets know this. Ultimately, the S&P 500 shrugged off the risk of a US default and increased by 0.2% during the month.

In our opinion, the US Debt to GDP of c. 123% is of greater concern. US debt to GDP is now larger than Portugal, Italy, Ireland, and Spain and only marginally lower than Greece, the five countries infamously known as the PIIGS less than a decade ago.[1] Furthermore, the US Budget deficit, is running at USD 1.1 trillion for the six months ending March 2023. The budget deficit is lower than it was in 2020 (USD 1.9 trillion) and 2021 (USD 2.1 trillion) but is significantly higher than it was in 2022 (USD 400 million).

Since the default of First Republic in early May, which we covered at length in last month's letter, the banking sector has largely rallied. PacWest Bancorp and Western Alliance Bancorporation, the two banks seen as next at risk after the First Republic rescue, have increased by 2-3 times since the rescue. We are not sure we have heard the last of this story yet, although the outflow of deposits from the US banking system appears to have stabilised for now.

The US Federal Reserve hiked interest rates by 25 basis points in May 2023, its tenth consecutive meeting in which it raised interest rates. At the press conference following the meeting, US Federal Reserve Chairman Jerome Powell stated, "We're no longer saying that we anticipate" additional rate increases, further adding that any further action will be "driven by incoming data". Cracks in the united front of the Federal Reserve are appearing, with several Federal Reserve Regional Presidents arguing for a wait-and-see approach. In contrast, others argue that further increases are warranted based on the data and could act as an insurance policy in the fight against inflation. Regardless of the outcome, it would appear that the bulk of the heavy lifting has been done.

Market Review continued

While inflation remains above the US Federal Reserve's 2% target, it continued to decline in April, falling to 4.9%. The annual rate of inflation has been falling every month since June 2022. We expect this trend to continue.

The US Labour market continues to be an anomaly, with the US adding 300k jobs in April and a further 340k jobs in May. Non-Farm Payrolls have delivered more jobs than estimates every month since March 2022. On a more positive note for inflation, average hourly earnings continue to grow at a slower rate, falling to 4.3% in May, having been as high as 6.0% in early 2022.The strength of the labour market has driven investors to revise expectations of rates in the longer term. In the aftermath of the US Federal Reserve meeting in early May, the market was pricing a 75bps cut by year-end. By the end of May, this had been scaled back to an expectation of just 25bps by year-end.

The continued decline in the price of oil to c. USD 70 per barrel should be supportive of lower inflation in the future. Oil prices are down 40% over the past year and are trading at levels last seen in late 2021.

In Europe, the Eurostoxx fell by 3.2%, the third month in a row it has trailed US Equities, although it has outperformed US Equities by 10% over the past year. Numbers released in June by Eurostat showed that the European Union fell into a mild recession, but symbolically important, recession in Q1 2023, with a contraction of 0.1% in that quarter following a similar contraction in Q4 2022. So far, the ECB seem undeterred and set to continue on its rate-rising path. We have read some significant financial publications discussing the great divergence between US and EU rates, but we remain unconvinced. The EU started hiking rates shortly after the US and is likely to continue hiking for slightly longer, save for a crisis, where the ECB will closely follow any rate cuts by the Fed.

In the UK, the FTSE increased by 5.4% in May and is now down 2.1% year-to-date. The UK equity market is energy-heavy, and the significant decline in energy prices is weighing on energy companies' profitability and share prices. The UK is not being helped by stubbornly high inflation, rising wages, labour shortages and industrial strike action across industries, including nurses, civil servants, rail workers and airport staff.

In May, emerging markets, as measured by the MSCI Emerging Market equity index, fell by 2.4% and is now up flat year-to-date. In May, positive returns in Brazil, India and Taiwan were offset by declines in China.

In May, European government bonds, as measured by Barclays Euro Aggregate Government Index, increased by 0.4%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, decreased by 1.2%. Investment Grade credit, as measured by the ICE Bank of America US Corporate index, and High-Yield credit, as measured by the ICE Bank of America high-yield index, both declined by 1.3% during the month.

Market Outlook

Momentum is a measure of an object's motion and is determined by its mass and velocity. It essentially describes how difficult it is to stop or change the motion of an object. Let's assume that the US economy is an ocean liner, and that the Federal Reserve's monetary policy and level of interest rates is the force that is applied to slow or quicken the speed of this enormous ship. Even if the engines of the ocean liner are put into full reverse, its momentum, at first, will still push it forward. Of course, it will begin to slow, but it will take time for the entity to come to a complete standstill and even longer to move into reverse. Similarly, if the ship's engines are slowly brought back to neutral and then into forward, it will take time for the ocean liner to build up speed and forward momentum again. The US economy works similarly with monetary policy and the level of interest rates as the engines that build or reduce momentum across the economy. This explains why the US economy, and certain components of that economy, such as the jobs market, can seem initially to defy the economic brakes applied by the Federal Reserve. Yet, it is inevitable that if the brakes are left applied, the economy will come to a complete standstill and, indeed, most likely will go into reverse if not lifted.

This is already happening. In April, the Bureau for Economic Analysis first reported that US GDP growth was only 1.1% in Q1 2023, which was subsequently revised to 1.3% in late May.[2] Nonetheless, this was down significantly from a growth rate of 2.6% in Q4 2023. Compared to the fourth quarter, the deceleration in real GDP primarily reflected a downturn in inventory investment and a slowdown in business investment. These movements were partly offset by an acceleration in consumer spending, an upturn in exports, and a smaller decrease in housing

Market Outlook continued

investment. Given that consumption or consumer spending is about 70% of the US economy, the economy is likely to weaken further as consumer spending is crimped. Continued elevated inflation, higher interest rates and a faltering global economy are collectively expected to limit US consumers' ability to spend this year. Real consumer spending is forecast to drop at a 0.5% annualised rate in the second and third quarters of 2023, the first back-to-back quarterly decline since early 2020.[3]

Slowing US growth and lower inflation expectations will keep the disinflation narrative intact
We believe that slowing growth will ensure that the disinflation narrative remains firmly intact. We do not believe inflation will prove to be sticky. We believe inflation and disinflation are ultimately caused by the velocity of money circulating in the economy, which is a function of the money supply, people's expectations of the future inflation level and their propensity to spend. If there is little propensity to spend, then, regardless of the amount of the money supply, inflation will remain benign as the velocity or turnover of money in the economy is low as fewer people are willing to spend their money to chase goods and services. Hence, if people feel less confident about their future wealth or expect inflation to remain low, they will be in no hurry to spend and consume their money today. Alternatively, suppose people have high future inflation expectations, meaning they believe the price of goods and services will be higher in the future. In that case, they are likely to be more inclined to want to spend their money today and therefore, the velocity of money in the economy will increase, chasing goods and services and leading to higher prices.

The causes of the current inflation cycle are now essentially gone. The roots of the current cycle can be traced back to the response by the Federal Reserve and the US Treasury to the global pandemic and its negative impact on consumer demand. In August 2020, in a departure from the previous policy, the Federal Reserve embarked on a new policy of average inflation targeting, where it adopted a strategy of achieving an inflation rate that would average 2% over time rather than targeting a 2% inflation rate at a given point in time.[4] Whilst it sounded like a subtle change, it was not. By targeting an average inflation rate of 2% over time, it implied the Federal Reserve would be comfortable in allowing the economy to run hot and at higher levels of inflation if it was deemed appropriate. This had the almost immediate effect of sending inflation expectations higher which was the Federal Reserve's intent. It wanted to avoid falling into a morass of low inflation expectations, sluggish economic growth and ineffective policy tools such as negative interest rate management. In simple terms, the Federal Reserve decided it would engineer higher inflation in the future by forcing inflation expectations higher. In other words, if people believed the Federal Reserve was going to be slower to increase rates to control demand and was going to be more willing to tolerate inflation running at higher levels than 2%, then the chances were that higher inflation would occur, and hence inflation expectations moved higher. In hindsight, we know that the Federal Reserve probably underestimated the additional impact that stimulus checks would have on inflation due to the additional increase in the money supply. In addition, it completely underestimated the extent that cost increases due to supply-side bottlenecks and disruptions would have on inflation. Of course, it cannot be blamed for the spike in commodity prices caused by the outbreak of war in Ukraine.

Turning back to the current day, these factors are now removed. The Federal Reserve has embarked on one of the most aggressive monetary tightening episodes in history, combining rapid interest rate increases with sustained quantitative tightening. US Government stimulus programs have ceased, and supply chain disruptions are now largely resolved, with freight costs in many parts of the world almost back to pre-pandemic levels.[5] The shock impact on commodity prices from the outbreak of war in Ukraine has also significantly receded.

Given that the forces driving inflation higher from 2020 onwards are now absent, it is no surprise that future inflation expectations have normalised and have more or less fallen back to pre-pandemic levels. The chart shows the bond market's expectation of where the US annual inflation rate will be in 5 years, suggesting it will be in the area of 2.17%, in line with the Federal Reserve's target of 2%. The 1-year and 2-year equivalent for inflation expectations are currently at 1.96% and 2.13%, respectively, suggesting that inflation is very much under control and the current disinflationary process will lead us back to normalised levels of inflation where the Federal Reserve will be happy to reduce interest rates once more.

US 5-Year Forward Inflation Expectations

Source: Bloomberg

With inflation expectations having fallen back to normalised levels, we expect the velocity of money will also slow as people's propensity to spend falls, which will further ensure that the current disinflation process remains intact. Falling demand cures inflation. It has always done so in history, and we expect it will do so again. Despite having to listen to stories that inflation is sticky and not falling as quickly as expected, when we look at a real-time indicator of inflation in the US economy, we see inflation coming down quickly and relatively consistently over the last year. We expect this process to continue.

Realtime U.S Headline Inflation

Source: truflation.com)

Given that monetary policy is now restrictive, arguably very restrictive, this brake on growth is creating significant negative momentum. Just like our ocean liner above, this falling momentum will continue to exert negative downward pressure on the US economy and will eventually push the economy into outright recession, assuming no corrective action is taken. The US regional banking crisis and the resultant reduction in the flow of credit will only exacerbate this slowing momentum.

Once inflation is beaten, the Federal Reserve will begin to boost liquidity once more

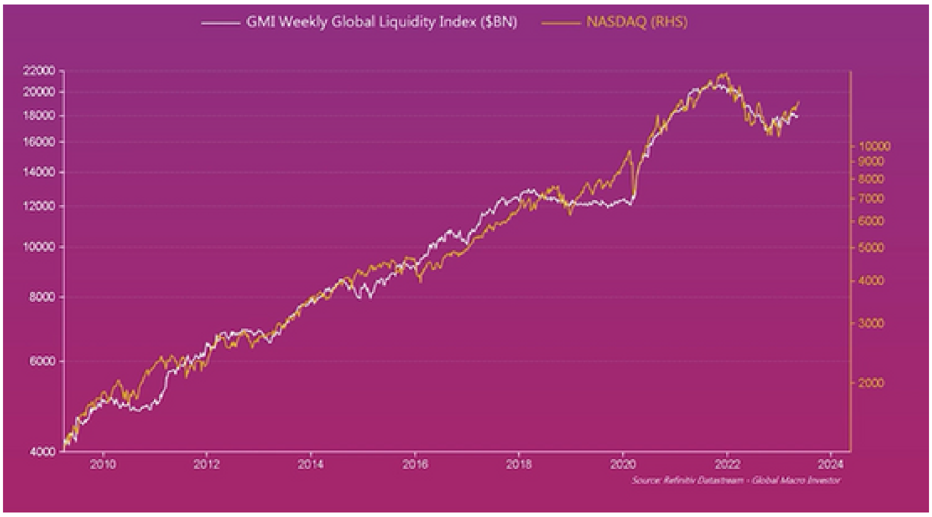
Hence, we believe the Federal Reserve will eventually have to remove this brake on economic growth by not only pausing but actually loosening monetary policy and cutting interest rates once again. This is only a matter of when, not if, it happens. Our best guestimate is probably early next year. Still, it could happen earlier if consumer demand in the economy plummets, leading to continued disinflation and a conviction by the Federal Reserve that it has beaten inflation. We know the Federal Reserve believes its credibility is in question as it was very late in recognising that this current cycle of inflation was anything but transitory. This reluctance to get it wrong twice so publicly has probably resulted in the Federal Reserve's unwillingness to start easing policy until it sees the slowdown in the reported numbers through rising unemployment and weaker growth numbers. Historically the Federal Reserve has pre-empted a coming recession by relying on leading indicators of the economy, such as weaker ISM Purchasing

Manager reports. On this occasion, it seems to be disregarding this ‘soft’ indicator type data. It is not ready to relent until it sees ‘hard’ data evidence of rising unemployment and falling wage inflation. It is leaving it very late in the day to remove the brakes and alleviate this negative momentum on the economy. Hence the risk is now higher that a recession could be deeper than it might have been had the Federal Reserve acted sooner to soften the economic landing.

Looking forward, we expect that inflation, particularly wage and core services inflation excluding shelter, will show enough evidence of decline that the Federal Reserve will be satisfied that its monetary policy is sufficiently restrictive and no further tightening is warranted. Soon afterwards, the price for conquering inflation is likely to become apparent, with US GDP growth likely to prove very weak, most probably negative in the form of recession. This is not a satisfactory steady state outcome for the Federal Reserve as unemployment will rise in this scenario. Given that the Federal Reserve’s dual mandate is also to create the right economic conditions to maximise employment, it will eventually start to loosen monetary policy by cutting interest rates and, most likely, engaging in renewed quantitative easing or balance sheet expansion to spur economic growth. In our view, this will lead to an increase in money supply and net liquidity later this year and during the course of next year and possibly in 2025. This, in turn, is likely to kick start the beginning of another business cycle with a recovery in leading economic indicators such as the ISM and, as we have seen in recent times, an increase in asset prices. We believe risk asset prices will rise because they are directly correlated to the size of the money supply and central bank balance sheets. All things being equal, as more US dollars and other fiat currencies are printed, the value of risk assets expressed in US dollar terms must increase. Essentially if more US dollars and other fiat currencies are outstanding, then regardless of whether they remain on bank balance sheets as reserves or find their way into the real economy through credit lending, the value of each unit of fiat currency has been reduced and therefore the value of other relatively scarce assets, namely stock, commodities and crypto, expressed in fiat terms such as US dollar, must increase. Let’s look at some of the evidence for this.

Global liquidity is highly correlated with risk assets such as stocks
Let's look at We can review the growth in total global liquidity (or simply fiat money supply) and compare its growth over the last 15 years with the Nasdaq index since the Great Financial Recession, and observe that the correlation is staggering. Indeed, GMI has performed a regression analysis to calculate the correlation between the weekly moves in these two indices, and the result is a staggering 97%. This implies that weekly movements in global liquidity can explain 97% of the weekly moves on the Nasdaq. There are also strong correlations between global liquidity and the S&P and Cryptocurrencies, essentially all relatively scarce risk assets.

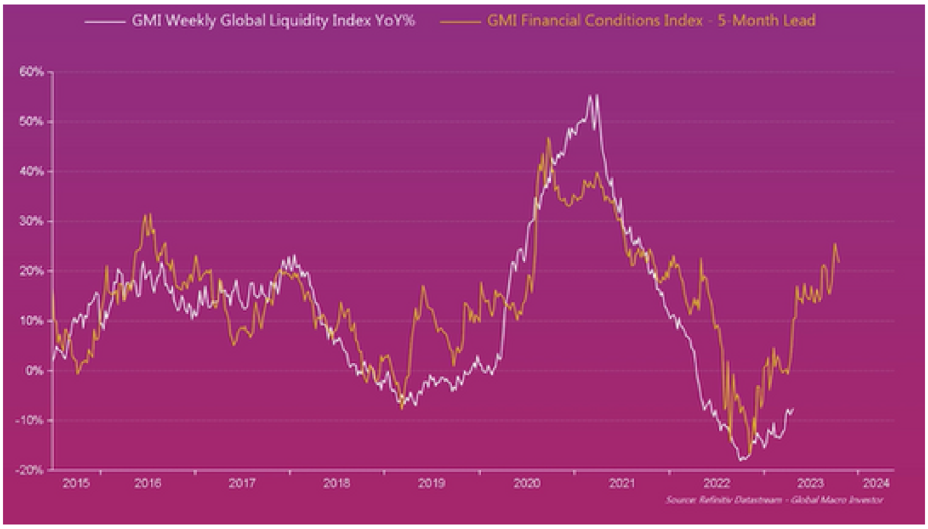
GMI Weekly Global Liquidity Index versus Nasdaq Index



Source: Global Macro Investor (GMI)

This then begs the question of where liquidity is likely to go. Again, GMI has attempted to answer this question by identifying a strong leading relationship between their GMI Financial Conditions Index and global liquidity, as seen in the following chart.

GMI Weekly Global Liquidity Index YoY% versus GMI Financial Conditions Index Y0Y%



Source: Global Macro Investor (GMI)

As we can see, the correlation or relationship between both variables is strong. The GMI Financial Conditions Index, which is a weighted average of the rate of change in the price of many vital variables such as the US dollar, commodities and yields, leads global liquidity by about five months. We can see that global liquidity has turned already, having bottomed late last year, with Japan and China already easing monetary policy. We expect that as the US economy bottoms later this summer/autumn, the Federal Reserve will also begin to ease monetary policy, effectively adding to this improving global liquidity momentum. Therefore, despite the potential for occasional bouts of volatility and falling risk asset prices, we see the prices of stocks and corporate bonds rising in the back end of 2023 and throughout 2024 and, most likely, into 2025.

Rapid inflation will not return for the foreseeable future

In contrast to rising asset prices driven by increasing liquidity, we do not expect inflation to rise significantly once it has bottomed. This probably sounds counterintuitive. Surely if money supply and liquidity are growing, and asset prices are increasing, we will get inflation. We don't think so. Instead, we expect inflation to remain relatively benign and in line with the Federal Reserve's average target of around 2% for at least the first two years of the next business cycle, which will most likely start later this year as the economy bottoms out. We are of this opinion because we believe inflation expectations will remain low. Hence people's propensity to spend, and therefore the turnover of money in the economy, will stay at moderate levels. In contrast, asset prices will rise for a different reason, namely because their value in fiat or US dollar terms will increase as more fiat currencies and US dollars are printed. This happened during the 'tens' decade before the pandemic, and we expect it to occur again. Since the Great Financial Crisis, central banks are all working off the same playbook. When their economies go into reverse, central banks boost the money supply through different forms of quantitative easing. Until this pattern of behaviour by central banks stops, the cycle we have seen before is most likely to happen again.

Market Implications

Last month we explained that, in the short to medium term, we had adopted a more cautious view on equities and risk assets in general. This was predicated on several reasons, not least the solid performance we have seen for global equities so far this year and a recognition that seasonally the summer months could challenge these higher valuations, especially in the context of a slowing economy, falling consumption and uncertainty around inflation and the Federal Reserve's reaction to this uncertainty. It is quite logical to expect that before we get to the point where the Federal Reserve relents and starts to ease monetary policy, we will probably need to experience a further build-up of stress or fear in the financial markets, or further weakness in the economy and the jobs market. At the very least, rising uncertainty and worry about these factors alone are probably enough to cause volatility to increase and asset prices to retrace somewhat. As we look further out toward the end of the year and into 2024, we are very constructive for the reasons we explained above and based on the turn in the global liquidity cycle, which has already started and which we expect to be boosted by the Federal Reserve, later this year, as it is ultimately forced to reduce interest rates and increase liquidity to resuscitate a weakening economy battling the forces of negative economic momentum.

We remain cautious toward equities and corporate bond spreads for now. Near-term liquidity issues due to the renewed issuance of bonds by the US Treasury may draw liquidity from the markets compounding the tightening conditions already being experienced from quantitative tightening. We also expect to see more economic weakness, especially concerning the jobs markets. This could spark some profit-taking in the short to medium term. Markets could also be upset by a refusal by the Federal Reserve to relent with further hikes or a delay to easing policy given its headstrong determination to break inflation regardless of the impact on the US economy.

We remain constructive on government bonds at current levels. We repeat; current yield levels are not sustainable over the longer term. With inflation falling quickly, real interest rates are marching higher. The US economy will not be able to withstand these higher rates indefinitely. High interest rates have already slowed the economy significantly and will continue to do so if left unaltered. The vast majority of leading indicators are currently pointing towards recession. The interest burden on the economy, when including Government and private debt, is too great and will ensure negative GDP growth over time if not reduced. We view any short-term backup in yields as good longer-term buying opportunities, with the intermediate part of the maturity curve offering the most appeal on a risk/reward basis.

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.

Given our belief in the power of the liquidity cycle, as explained above, we remain cautiously constructive on emerging market equity and debt, especially in Asia, as the money supply in this region continues to improve. Hence, we would view the region as a relative outperformer versus the US and European markets. If the Chinese recovery falters, we believe the authorities will rush to its support with further liquidity injections and easing of monetary policy tools, which will support asset prices in the region.

Commodity prices should be supported by improving economic growth out of Asia despite economic concerns around demand from the US and Europe. We expect Western economies to bottom later this year and to mount a recovery into 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. As the US business cycle begins to turn, together with Europe on a more lagged basis, growth prospects should improve significantly as we move into and through 2024, supporting commodity prices.

Gavin Blessing
9 June, 2023

Source Data: ICM, Bloomberg as of 31 May, 2023.

[1] https://www.ft.com/content/8f671cc5-2e9e-4ad5-ab0a-61b8f4048619
[2]https://www.washingtonpost.com/business/2023/04/27/gdp-2023-q1-economy/
[3] https://www.bankofthewest.com/Wealth-Management/insights/articles/economic-report/a-strong-start-to-consumer-spending-in-2023
[4] https://www.cnbc.com/2020/08/27/powell-announces-new-fed-approach-to-inflation-that-could-keep-rates-lower-for-longer.html
[5] https://www.freightos.com/freight-resources/shipping-delays-and-cost-increases/

ICM Limited | Head Office
34 Bermudiana Road | PO Box HM 1748 | Hamilton HM GX | Bermuda
www.icm.limited