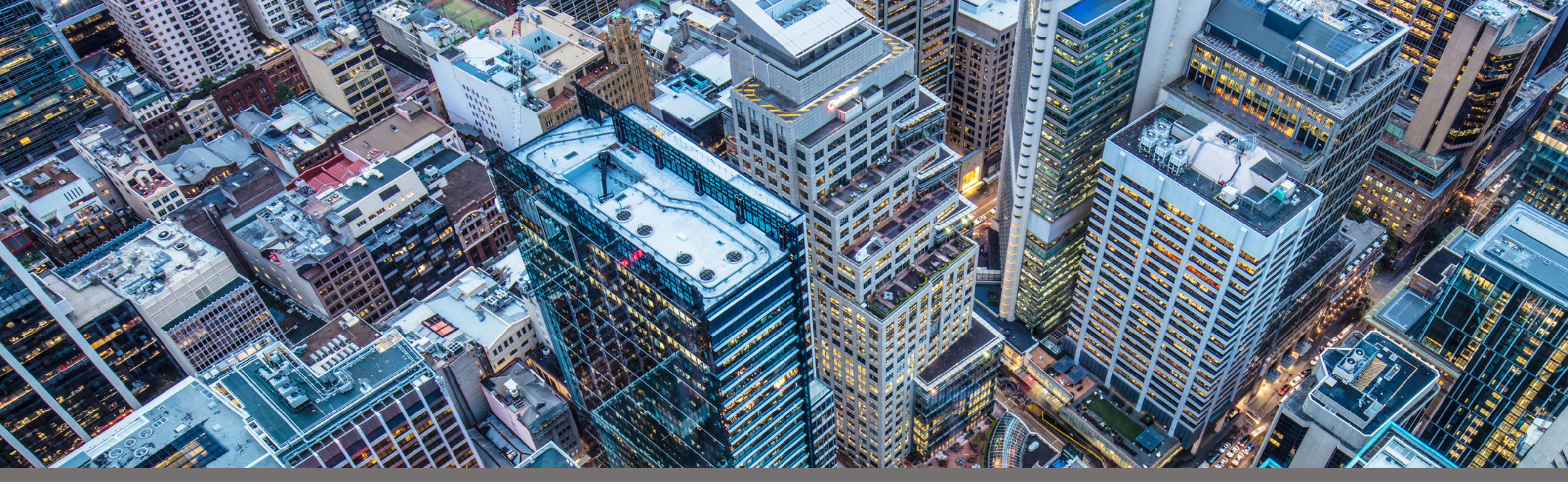


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.8** BILLION	**US$22.2** BILLION

ICM Monthly Outlook

MARCH 2023

Market Review

After a solid start to the year, the S&P 500 gave back some of its early gains, losing 2.6% in February but remains in positive territory year-to-date, up 3.4%. Declining inflation, coupled with a softening tone at the Fed, pushed markets higher in January. The market increasingly priced in a Goldilocks scenario where inflation would decrease without the need for significantly higher interest rates.

In February, economic data came in significantly higher than expected. Counter-intuitively, strong economic news is weighing on markets, as it increases the probability that inflation becomes more embedded and therefore heaps more pressure on the US Federal Reserve to continue on its rate hiking path.

In January, the US created 517k jobs versus 223k in December and a consensus estimate of 185k. US Job Openings remain extremely high at 10.8 million job openings, with c. two job openings for every unemployed person in the US.

Later in the month, inflation data came in hotter than expected at 6.4% year-on-year versus an expectation of 6.2%.

Furthermore, US consumer spending increased by 1.8% month-on-month versus a 1.2% estimate. The increase in consumer spending came off the back of monthly declines in November and December. It was the highest reading since the US economy reopened in the aftermath of Covid lockdowns. With credit card debt continuing to increase in the US, it remains to be seen how long the US consumer can remain resilient, particularly in light of rising interest rates.

US Manufacturing PMI, which had been declining since late 2021, increased in January to 47.7 from 47.4 in December, indicating economic contraction but at a slower pace. In addition, the gap between new orders and inventories, a leading indicator for future PMI readings, narrowed further as new orders picked up to 47.5 in February from 42.5 in January, and inventories decreasing to 50.1 from 50.2.

With the economy heating up, the market has increased the likelihood that rates will go higher for longer. As a result US interest rates, which had declined in January, climbed higher in February. US two-year treasuries increased by 0.60% to 4.81% in February from 4.21% in January, US ten-year treasuries increased by 0.41% to 3.92% from 3.51%, and US 30-year treasuries increased by 0.28% to 3.92% from 3.63%. The yield curve remains deeply inverted, with the premium for investing in ten-year treasuries versus two-year treasuries now negative 0.89%, the most negative it has been since the early 1980s.

In Europe, the Eurostoxx increased by 1.8% and is up 11.7% so far in 2023. The Eurostoxx has outperformed the S&P 500 by more than 20% over the past eight months. A combination of good planning and a mild winter meant

Market Review continued

that Europe has largely escaped the winter relatively unscathed. The price of natural gas in Europe, which had peaked last June at EUR 320 per Mega Watt Hour, finished February at less than EUR 50 per Mega Watt Hour, broadly in line with the price pre the Russian invasion of Ukraine. While gas prices remain high relative to their historical norm, they are no longer at levels threatening a deep and prolonged recession in Europe.

In the UK, the FTSE rose 1.3% in January and is up 5.6% year-to-date. UK GDP increased by 0.3% in January, beating expectations for a 0.1% increase. However, UK GDP remains the only G7 economy that has not yet recovered to pre-pandemic levels.

The UK's largest energy producer, Harbour Energy, complained that the UK government's windfall tax on energy companies has all but wiped out profits. In 2022, Harbour Energy made a net profit of USD 8 million after paying a one-off non-cash deferred tax charge of USD 1.5 billion. Harbour Energy has said it will refocus its investment programme elsewhere and has cancelled two UK developments as well as announced potential job cuts. The wisdom of such a government policy at a time when energy security is so high on the agenda remains to be seen.

The UK is also continuing to grapple with strikes and potential strikes across a range of areas, from doctors and nurses to rail staff.

In January, emerging markets, as measured by the MSCI Emerging Market equity index, fell by 7.6%, giving back much of January's gains. The sell-off in February was broad-based, with major index components China, Brazil and India all suffering losses.

European government bonds, as measured by Barclays Euro Aggregate Government, fell by 2.3% for the month, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, fell by 2.3%.

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, fell by 1.3% and 2.9%, respectively. The decrease in both corporate bond indices reflected increasing rates rather than widening spreads, as spreads remained relatively static during the month. Since peaking last July at almost 600bps, high yield spreads have since tightened to c. 400bps, while investment grade spreads have tightened from 160bps to 130bps.

Market Outlook

More information does not necessarily equal less uncertainty. February was a classic month where more new economic information only served to create more questions and drive further economic uncertainty. In recent months we had asserted that the risk of a deep US recession was receding and, indeed, there was a rising probability that a recession could be avoided altogether. This was predicated on a stronger-than-expected US labour market and an easing of restrictive financial conditions, which, having peaked in November 2022, were becoming less of a break on growth with every passing month.

At the start of the year, markets began to price in better inflation data, a downshift in the pace of Federal Reserve hikes and a slightly better growth outlook. In February, a blockbuster US jobs report, where 517k jobs were added to the US economy in January, coupled with a hotter-than-expected CPI inflation report, not only confirmed this improving economic growth outlook but also raised the spectre that the Federal Reserve was once again falling behind the curve and might have to raise rates further and keep them pinned higher for longer. Fears of more hawkish monetary policy materially upset the previous market narrative of a slowing economy, steady disinflation and a Federal Reserve close to the end of its tightening cycle.

Given the renewed fear that the US economy is too strong for inflation to come down and that the Federal Reserve may have to become more hawkish again, the bond market was relatively quick to price out the interest rate cuts that had previously been priced in for later this year. Indeed, we saw a further inversion of the yield curve as short-dated yields rose faster than longer-dated yields. As a result, growth equities that rallied strongly during January sold off in February, while cyclical-oriented equities performed stronger as they will likely benefit from better-than-expected economic strength.

Market Outlook continued

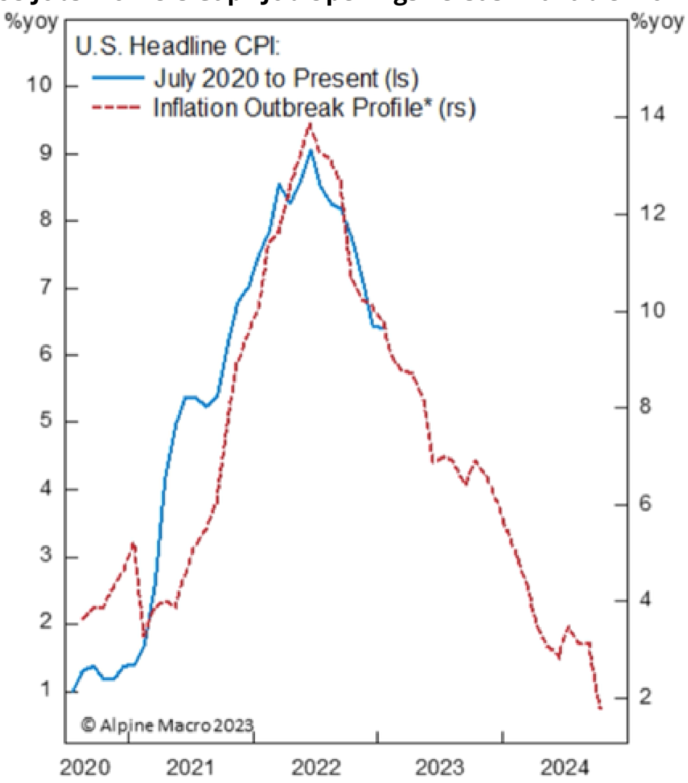
The key question facing markets right now is whether this rise in yields and sell-off in equities, especially growth-orientated stocks, is just a one-off adjustment to reflect the fact that markets became too complacent and priced in too much inflation relief too quickly? Or does this reflect a more fundamental hawkish shift in Federal Reserve policy, where it is forced to embark on a renewed campaign of setting more restrictive financial conditions? Clearly, the next set of jobs and inflation data will probably determine whether the Federal Reserve believes faster tightening is warranted.

Our central case view is that we will likely see a middle or more benign path. While economic growth is doing better than expected, especially outside the US, it is also probably true that the disinflation trend is still intact, with previously rising shelter costs due to hit an inflexion point and likely to start falling soon. Therefore, the threshold for the Federal Reserve to accelerate its pace of tightening from 25bps to 50bps is high. Increasing the rate of change could also undermine confidence in the Federal Reserve, suggesting that they had miscalculated yet again. Of course, if we have further robust labour or inflation data, the Federal Reserve could opt to increase the pace of those hikes once again.

The disinflationary trend is still intact

We believe the trend of disinflation that we have seen over the last several quarters is still intact. Month-to-month changes can be notoriously volatile, so we should allow for occasional volatility. It is important to remember that disinflation is not a linear process. While history tells us that inflation does not fall in a straight line, it does tell us that it tends to fall as rapidly as it rises, mirroring itself. The chart below compares the current inflation trend against the average pattern of several inflation breakouts historically. It finds that our recent experience maps very closely the rise and fall of previous inflation paths. This gives us significant comfort that the disinflation trend is still intact.

US Jobs Workers Gap - Job Openings versus Available Workers



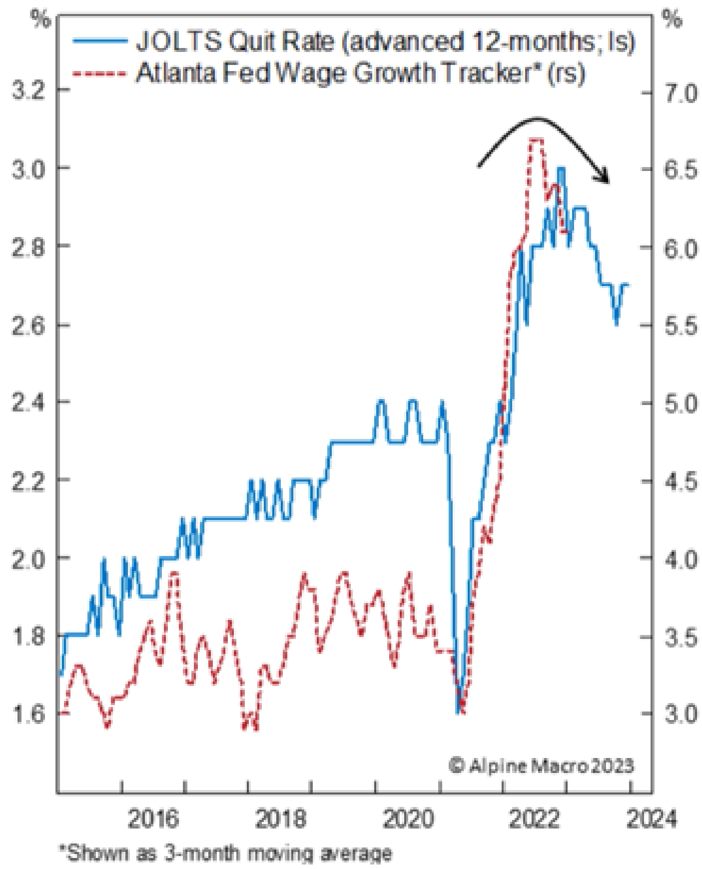
*Average of 5 major inflation outbreaks from the 1940s through the 1980s

Source: Alpine Macro

Early signs of US Labour Market Slowdown

The Federal Reserve has been clear in recent times that its focus regarding its battle against inflation is in the area of non-housing related services or predominantly the wages sector of the economy. It wants to see evidence of sustained downward pricing pressure in core services and wages. Despite the current strength of the US Labour market, we know it tends to lag a slowdown in the real economy. Consistent with this view is mounting evidence of a turn and a coming weakness in the labour market. While the absolute level of job openings remains historically high, the level of job openings is no longer growing on a year-over-year basis. It looks most likely to contract going forward. In addition, the jobs quit rate is now falling. This rate historically rises in times of plentiful jobs reflecting employee confidence that if they quit, they will be able to find employment relatively quickly. As seen in the next chart, this quit rate measure tends to lead wage growth by about 12 months, and a falling quit rate suggests that labour conditions are weakening.

Early signs of US Labour Market Slowdown

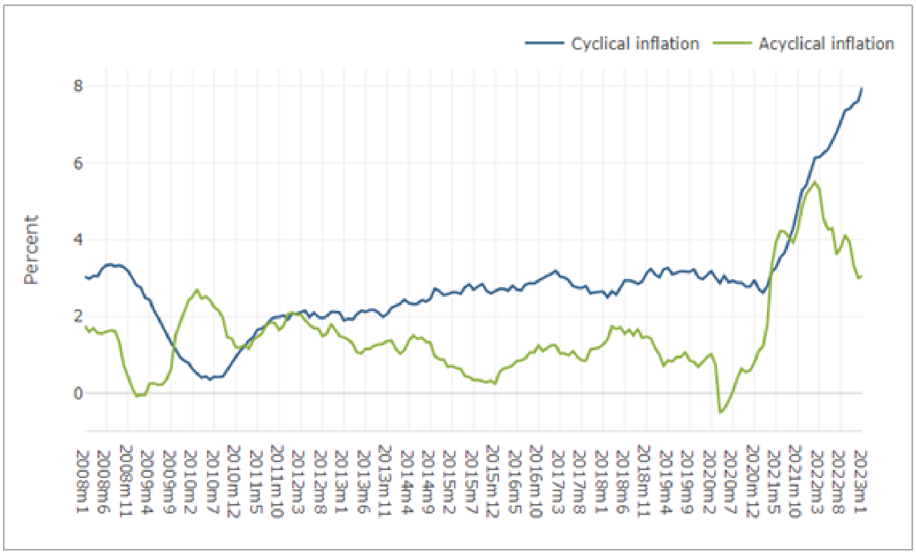


Source: Alpine Macro

Early signs of US Labour Market Slowdown

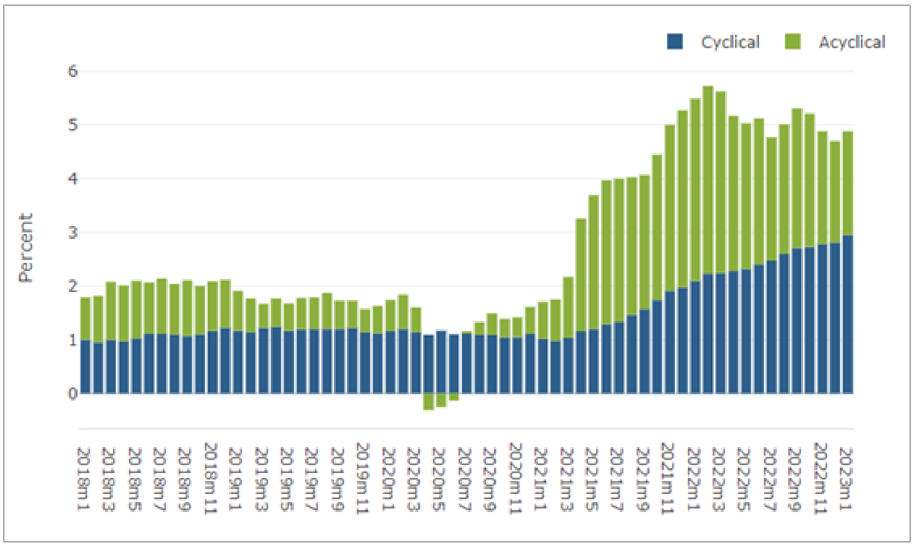
The Federal Reserve Bank of San Francisco has done some interesting analysis on core inflation using the Federal Reserve's preferred measure known as the PCE (Personal Consumption Expenditures) price index. The PCE tracks the change in prices of a particular basket of goods and services purchased by consumers throughout the economy. The bank has divided the categories of core PCE inflation into cyclical and acyclical components. Cyclical components include those categories where prices tend to be more sensitive to overall economic conditions. Acyclical components include those categories that are more sensitive to industry-specific factors and not due to general economic conditions. The following charts below show the cyclical and acyclical core PCE inflation series and the contribution of each measure to overall core PCE inflation over time.

Cyclical and Acyclical Core PCE Inflation (yoy)



Source: Federal Reserve Bank of San Francisco

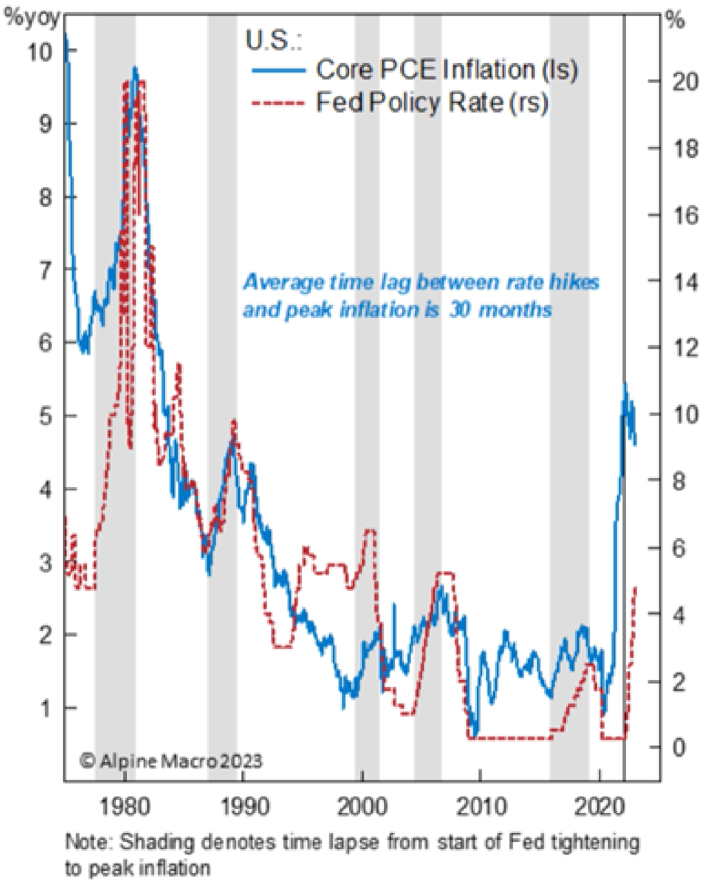
Cyclical and Acyclical Contributions to Core PCE Inflation (yoy)



Source: Federal Reserve Bank of San Francisco

Interestingly both charts clearly show that all of the disinflation that we have seen to date has come from the resolution of supply-side disruptions, presumably caused by the pandemic or caused by unique supply constraints within specific industry sectors such as energy. The charts suggest that disinflation from categories more sensitive to slowing demand, and higher interest rates, have not yet started in earnest. However, the rate of increase does appear to be slowing. This work is corroborated by analysis by Alpine Macro, where they examined the last several inflation cycles and found a typical time lag of about 30 months between when the Federal Reserve starts to raise rates to combat inflation and when inflation subsequently peaked. With regard to the current cycle, we know that inflation has already topped out since late last year, around the same time that the Federal Reserve embarked on its rate-hiking process. This is unusual and not consistent with previous inflation cycles. This raises the question of how inflation can have peaked so quickly, given that the Federal Reserve has just begun to tighten. Granted, the Federal Reserve's current hiking cycle has been one of the fastest on record, so we would expect the impact on inflation to come sooner, but this still does not explain the absence of a lag between the beginning of the hiking cycle and a peak in inflation. The chart below shows previous inflation cycles, and the grey bars reflect the time lag that has always occurred except for the current cycle.

Federal Reserve Cycles and Inflation Response



Source: Alpine Macro

The most likely answer to this conundrum is that most of the disinflation we have experienced to date has probably come from the resolution of supply-side pandemic disruptions, which would be consistent with the conclusion of the Federal Reserve Bank of San Francisco. However, this implies that we are still to largely benefit from disinflation trends yet to emerge from the cyclical and economically sensitive side of the economy, such as shelter and wages.

The bond market is telling us that a recession is coming, which will kill inflation

The totality of wisdom contained in bond market pricing and the shape of the yield curve is considered one of the best predictors of inflation and the economy's future health. The US yield curve has been inverted for many months, where short-dated interest rates are considerably higher than longer-dated rates. This phenomenon is a high probability harbinger of a coming recession. The greater the inversion, the more likely a recession. A deeply inverted yield curve signals that short rates are too high to sustain economic expansion. Since early February, the yield curve has further inverted, with 2-year Treasury rates above 5% while 10-year Treasury rates are below 4%. Having lower interest rates further out in time tells us that the bond market believes that due to the Federal Reserve's intervention to raise short-end rates to stem inflation will likely cause a significant slowdown or recession. In effect, intentional demand destruction will dampen inflation.

We can also observe where the bond market expects the level of expected inflation to be at different points in time. Despite the recent stronger economic data, particularly related to the US job market, the expected inflation rate, one year from now, is still much lower than it is today at just over 3%, even though it has moved up from as low as 2% in early February. Interestingly, the expected inflation rate three years from now has only marginally moved higher from about 2.3% to about 2.5% and remains in line with the Federal Reserve's target. The bond market is therefore telling us that the Federal Reserve will complete its job of taming inflation, and we will get considerably more disinflation over the next 18 months. It also tells us that despite enjoying a still robust labour market today, we are likely to get a recession during that period. Given the excellent historical track record of the bond market in prognosticating future economic conditions, it is probably unwise to have a view very different from the one just outlined.

The strong US labour market is testing Federal Reserve's patience

Given the strength of the US labour market and the recent US senate testimony in March by Chairman Powell, where he reiterated that there is little sign of disinflation in the category of core services, excluding housing, the risk has increased that the Federal Reserve may increase the pace of rate hikes. The Chairman stated that stronger-than-expected economic data suggests that the ultimate level of interest rates is likely to be higher than anticipated. Furthermore, he said that if future stronger data indicates that faster tightening is warranted, they will be prepared to increase the pace of rate hikes. This would be a U-turn for the bank after recently bringing increments down to 25bps and in contrast to the Chairman's statement last October, which stated that the pace of interest rate increases was now much less important than how high interest rates go and how long they remain at that final terminal level. This behaviour indicates that the Federal Reserve is under considerable pressure to get inflation down as quickly as possible. As it becomes more impatient and nervous about the course of inflation, it increases the probability of a policy error through overtightening, which increases the likelihood of a recession. This is what the highly inverted yield curve is already signalling to us.

We believe that while financial conditions have been improving and the labour market has been showing strong signs of resilience, it is still more likely that we will see a recession in the US later this year or next year. Clearly, the Federal is in a pitched battle with the labour market, euphemistically saying that there will be "some softening in labour market conditions". In reality, the Federal Reserve would like to see enough weakness in the labour market to bring wage growth under control. Yet history tells us that for this to happen, it will take a sizeable uptick in unemployment which has virtually always been synonymous with a recession. Hence the Federal Reserve is prepared to sacrifice jobs at the altar of inflation. This is its unspoken goal. If the Federal Reserve becomes more hawkish because it is concerned that disinflation has stalled, it will stop financial conditions from improving, which they have been doing in recent months.

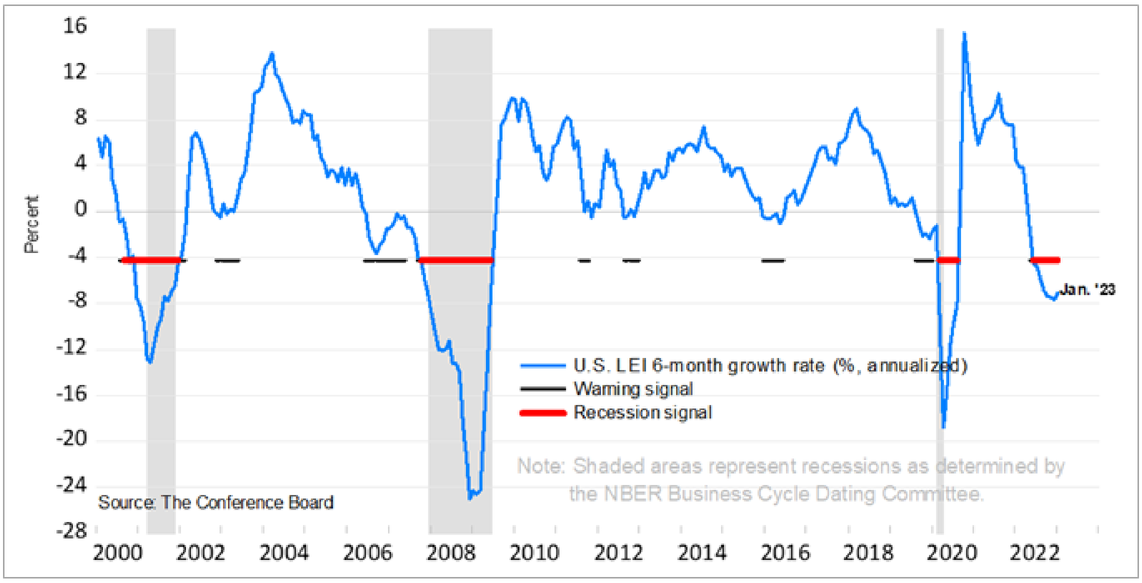
Higher real interest rates will test the US economy

As inflation falls and nominal interest rates increase, the US economy has to run under the burden of higher real interest rates (nominal rates adjusted for inflation). Even if growth is better abroad, such as in China, this is probably not enough to stop the US economy from slipping into recession under very high real interest rates. With US real interest rates at over 2% and heading towards 3%, the highest they have been since the 2008 Global Financial Crisis, the economy is unlikely to remain unscathed for any persistent period. Therefore, we think longer-term equilibrium real interest rates need to be structurally lower going forward than at any previous point in US history. Our reasoning is twofold: Firstly, US trend economic growth, the sum of labour force growth and labour productivity growth, is now lower than before the pandemic, given that US labour force growth has fallen. Secondly, the total amount of debt carried by the Government, corporates and individuals is much higher than at any point in history.

Our central case is still a recession

It is essential to realise that a determined Federal Reserve is always very likely to win and achieve its goals. Its firepower is almost limitless. They can continue to push rates higher to get inflation back down to their 2% target. The real question is how much pain this will inflict on the real economy in the process. If the Federal Reserve accelerates the pace of rate hikes again, it is more likely that greater pain will be visited on the real economy, and the probability of recession will increase. A recession is still very likely even if it continues along its current slower path. The US Conference Board's composite index of leading economic indicators firmly signals a recession in the next 12 months.

US Conference Board Leading Economic Indicator



The chart above shows the duration, depth, and diffusion of a downward movement in the leading economic indicators. Duration refers to how long-lasting a decline in the index is, and depth denotes how significant the decline is. Duration and depth are measured by the rate of change of the index over the last six months. Diffusion is a measure of how widespread the decline is (i.e., the diffusion index of the LEI ranges from 0 to 100 and numbers below 50 indicate most of the components are weakening). When the diffusion index falls below the threshold of 50 (denoted by the black dotted line in the chart), and simultaneously when the decline in the index over the most recent six-month period falls below a historically relevant threshold of -4.2%, the index then signals a coming recession as it is doing now. It has accurately predicted all of the most recent US recessions.

Implications for markets

While we generally remain constructive on the outlook for risk assets for the year as a whole, we believe the risk of a policy error by the Federal Reserve, and hence a policy-induced recession, has increased over the course of the last month. Clearly, the Federal Reserve is becoming less patient and under immense pressure to bring inflation down as rapidly as possible. Hence, we think the risk is considerable that higher real rates will erode confidence in the real economy and destroy end demand. Moreover, despite having raised rates far more aggressively than in previous cycles, the Federal Reserve seem to be almost despairing that they have not yet seen a softening of labour market conditions in response, even though there is a strong argument that this tightness has been caused by the aftereffects of the pandemic where a significant segment of workers decided not to return to the labour force.

If the Federal Reserve chooses to accelerate its efforts to push interest rates to a higher-end terminal rate and at a faster pace than previously indicated, then this would risk doing further damage to consumer demand and, ultimately, corporate earnings, which would be unambiguously bad for equity prices.

That said, we continue to believe that the disinflation cycle is still intact and suggest we need more time for previous rate hikes to have their effect. As we see more evidence of disinflation, this should be positive for market sentiment and equity prices. In our view, a key determinant of equity market prices this year will be the nature of any forthcoming recession. If it turns out shallower than expected, this should also be positive for equities as the earnings impact should not be as great. On the other hand, if a recession is deeper and longer, this would most likely lead to lower equities over the course of this year. Acting as a counterweight to lower equity prices, resulting from concerns over recession and earnings, will be the response of the Federal Reserve to evidence of a recession. The end of the tightening cycle and confirmation of a final terminal rate, not to mention the probability of eventual rate cuts once inflation is on a sustained path towards the target rate of 2%, should also boost equities.

For now, we remain constructive on equities in the short term based on the possibility of a relief rally, given recent exaggerated concerns about stalling disinflation. However, we expect that markets will more acutely feel the uncertainty we have just discussed during the summer months leading to greater volatility. Nevertheless, we think greater clarity around the economy and the Federal Reserve's response will be better known towards the end of the year, lending support to equities at that point.

Our view on interest rates is relatively more straightforward. We believe market yields or interest rates are close to peak levels. Given that a slowdown or recession is virtually certain, we do not believe current market interest rate levels are sustainable over the longer term. Real interest rates will be too high for the US and European economies to bear longer term. Hence we have a longer-term constructive view on rates. Of course, rates could go higher in the short to medium term, although we think we are already very close to the higher end of the longer-term range. Consequently, we find government bond yields attractive at current levels and should be bought at times like now when concerns about persistent inflation pervade the market. Whilst corporate bond spreads are trading just inside their 10-year averages and hence look somewhat expensive, the all-in expected return over time from a combination of run-rate interest income, potential yield declines, and spread compression looks very compelling against most potential economic backdrops, with the exception of the worst recessionary scenarios.

China's reopening, supported by plenty of Government-led stimulus, is positive for the broader global economy and could shield the US and European economies from the worst effects of a policy-induced slowdown. Demand for commodities will be boosted, but price action is likely to remain muted while the US and European economies labour under higher real rates and slide towards possible recession.

The US dollar may benefit from the recent uncertainty around the path of interest tightening in the US Ultimately, we think disinflation will continue, and yields will fall, putting pressure on the USD over the longer term. Emerging market equities and bonds can perform if and when greater certainty on the US disinflation process emerges but may underperform otherwise.

While we expect positive returns from equity and credit markets over the year, we believe above-average levels of uncertainty will keep volatility unusually high. While we could see a relief rally in the coming weeks, we do expect to see periods of general weakness ahead over the next few quarters as US markets try to fully gauge whether there is enough momentum in the disinflationary process to bring its economy along a gradual path to the Federal Reserve's inflation target of 2% and the extent of any economic slowdown required to get us there. As we move through to the back of the year, we expect greater certainty on these issues to emerge. This clarity, combined with the knowledge that the tightening cycle is behind us, can lead to an environment where risk assets can once again perform strongly.

Gavin Blessing

10 March 2023

Source Data: ICM, Bloomberg as of 28 February, 2023.