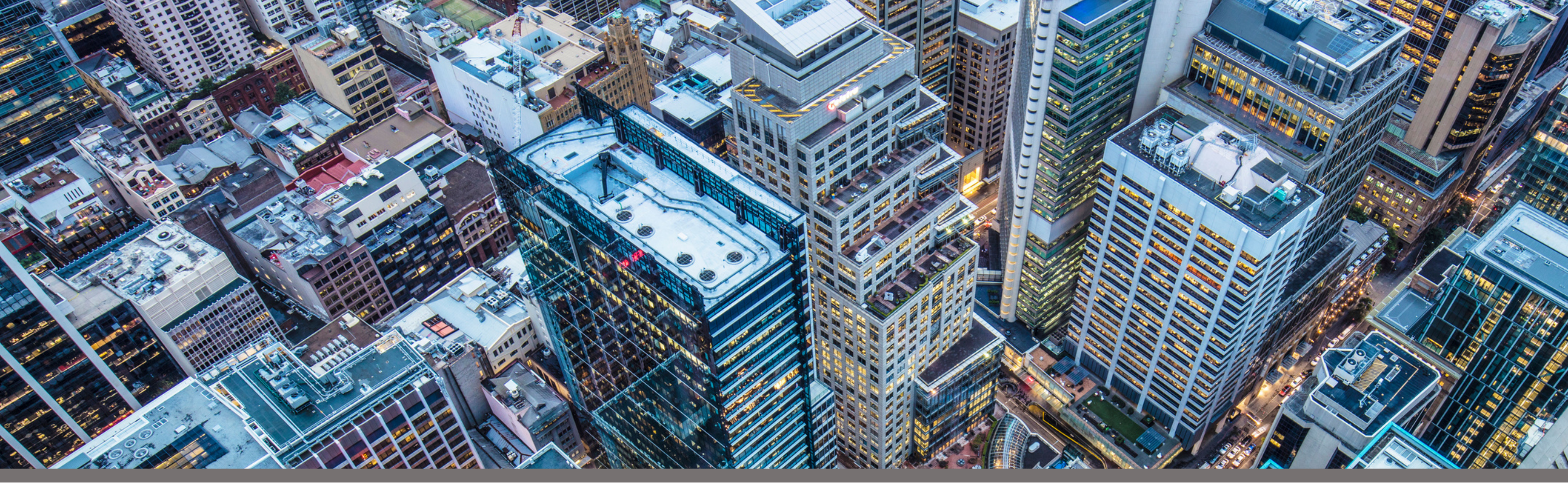


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.7** BILLION	**US$21.5** BILLION

ICM Monthly Outlook

DECEMBER 2023

Market Review

In November, interest rates tumbled across the major economies as investors increasingly expected that inflation has been conquered by central banks. In the US, rates for ten-year treasuries fell by 60bps to 4.33%; in Germany, rates fell by 36bps to 2.13%; in the UK, rates fell by 34bps to 4.17%; while in Japan, rates fell by 28bps to 0.67%. In the US, inflation is now running at 3.2%; in Europe, inflation is running at 2.4%; in the UK, where inflation turned much later, inflation has fallen to 4.6%; and in Japan, inflation is running at 3.3%.

While inflation has continued to fall, labour markets have proven remarkably robust, with unemployment in all major economies close to record lows and well below levels traditionally associated with a recession.

Falling inflation and the prospect of strong consumer demand sent equity markets soaring in November. During the month, the S&P 500 returned 9.1%, its best monthly in more than a year and more than regaining the losses from a three-month losing streak before November. Year to date, the S&P 500 has returned by 20.8%. The Nasdaq returned 10.8% in November and has now returned 37.0% so far this year; the Eurostoxx returned 8.1% in November and has now returned 19.3% so far this year; while the FTSE 100 returned 2.3% in November and has now returned 3.7% so far this year. From a sector perspective, pro-cyclical sectors performed well, such as Technology, Financials and Consumer Discretionary, while Consumer Staples and Energy underperformed.

It was unsurprising to see energy stocks retreat in November, with oil prices falling by 5.2%, adding to the 8.3% decline in October. The cost of a barrel of Brent Oil was USD 82.83 at the end of November and has since fallen further, trading at c. USD 75 at the time of writing. Despite production cuts announced by Opec+, oil prices are being weighed down by a combination of higher US output and declining demand.

While OPEC+ have committed to voluntary cuts of more than 2 million barrels of oil a day, less than half is currently allocated to individual states, with the rest to be announced in due course. The uncertainty around who will cut and when seems to have added to the sense that tensions are rising between members of the oil group. Meanwhile, figures released last week showed that US oil output reached an all-time high of 13.2 million barrels of oil a day in September. The ability of the US to fill any gap left by OPEC+ production cuts, particularly with demand forecast to soften next year, looks likely to keep a lid on energy prices in the short term, which is expected to ease inflationary pressures further.

Against the backdrop of falling inflation and easing inflationary pressures, investors have been increasingly pricing in a rate cut in the coming months. Mid-December sees all three major Western central banks, the US Federal Reserve, the European Central Bank and the Bank of England, hold their final meetings of 2023. Investors will be watching closely for cues as to when or under what conditions interest rate cuts will likely be forthcoming.

Market Review continued

As noted, while the labour market remains robust and wage pressures continue, it is likely that central banks will remain on guard against any secondary round of inflation driven by labour, which can be harder to control once embedded.

In November, Moodys, the last of the major credit rating agencies to maintain a AAA rating for the US Sovereign, changed its outlook on US Sovereign Debt from stable to negative to reflect higher debt-servicing costs and increasing political polarisation. In the short term, the move means little. As seen from the downward movement in interest rates, the market largely ignored the issue. However, the increasingly negative view of the US Sovereign from those paid to assess creditworthiness must be a negative in the long term.

The ISM Manufacturing Purchasers Manager Index ("PMI") remained at 46.7 in November. As a reminder, a PMI reading of greater than 50 indicates growth, while a reading of less than 50 indicates an economic contraction. In October, existing home sales continued to fall, reaching an annualised rate of 3.79 million versus 3.96 million in September. Only twice in the past 25 years have existing home sales fallen as low, most recently during the COVID-19 pandemic and before that in the aftermath of the Global Financial Crisis in 2008.

In November, emerging markets, as measured by the MSCI Emerging Market equity index, increased by 7.8%, primarily driven by exceptional performance by Brazilian and South Korean equities. Emerging markets continue to trail other major equities markets this year, up just 5.2% year-to-date.

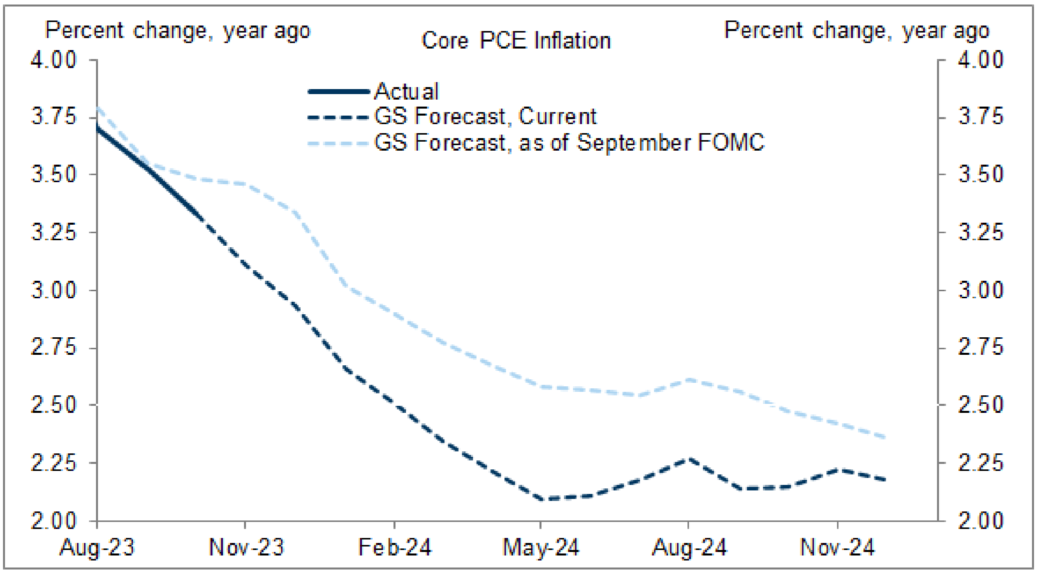
In November, European government bonds, as measured by the Barclays Euro Aggregate Government Index, increased by 3.0%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, increased by 3.5%.

Investment Grade credit, as measured by the ICE Bank of America US Corporate index, increased by 5.6% and High-Yield credit, as measured by the ICE Bank of America high-yield index, increased by 4.5% during the month.

Market Outlook

As we draw toward the end of another eventful investing year, evidence suggests that the fog of uncertainty around the course of inflation has finally cleared. Of course, some voices will continue to argue that inflation will remain sticky and that the last mile of disinflation will be the hardest. Yet, regular readers of this letter will know we have never subscribed to this dubious theory.

Core US PCE Inflation Outlook



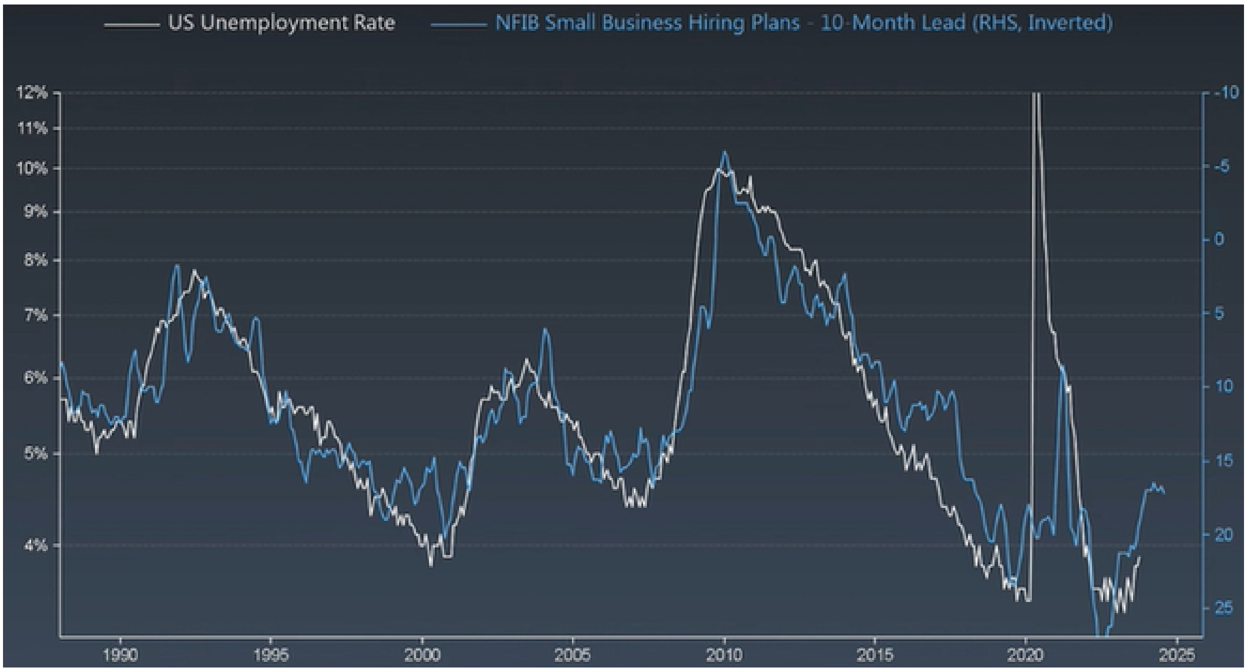
Source: Goldman Sachs Global Investment Research

Market Outlook continued

The latest readings from monthly US core PCE, the Federal Reserve's preferred measure of inflation, indicate that core inflation has slowed from a 4% annualised rate in 1H 2023, to 1.9% in 2H 2023. Hence, inflation is already at or near 2%, which aligns with the Federal Reserve's long-run target inflation rate. Furthermore, we know that the reported shelter component of the US inflation gauge lags the actual reading in the real economy by about 12-18 months. Hence, this significant index component will continue to put formidable downward pressure on inflation readings as we advance on a month-on-month basis for most of 2024. In addition, producer prices, which generally lead consumer prices by several months, have utterly collapsed in recent months, not just in the US but most major global economies, especially in the EU, where they have recently witnessed negative year-on-year price changes.

This fall in core US inflation is also aided by continued rebalancing in the US labour market. As the National Federation of Independent Business (NFIB) reported, small business hiring plans suggest that the US labour market will continue to soften conditions with the unemployment rate increasing to 4.5%. We expect this to happen given that the US Labour market lags the business cycle by at least 12-18 months. Hence, even though the business cycle may be bottoming, we can still expect US labour market conditions to soften even as the business cycle and manufacturing activity bounce back.

US Unemployment Rate versus NFIB Small Business Hiring Plans - (10 Month Lead Inverted)



Source: Global Macro Investor

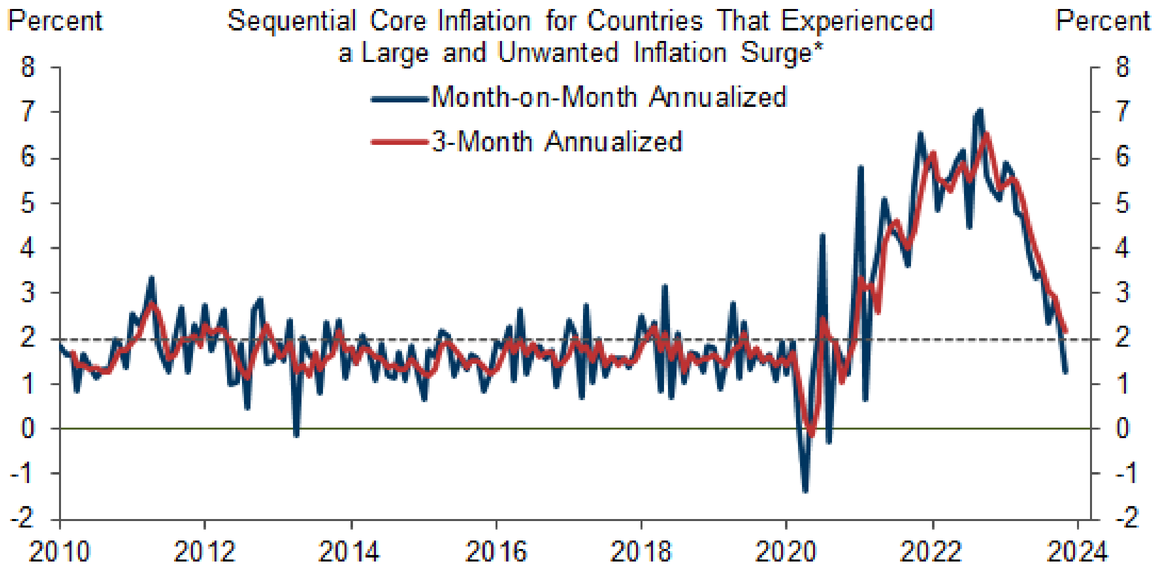
Given the faster return to the Federal Reserve's inflation target and our belief that the US labour market will continue to soften, we expect that the Federal Reserve will start cutting rates earlier than previously believed by the market. While the Federal Reserve will want to see further evidence of disinflation to be confident that inflation is moving down sustainably towards its goal, we believe the Federal Reserve Committee will soon conclude that current rates are overly restrictive and, therefore, no longer consistent with an environment where core inflation is at or close to its long-term target of 2%. At the most recent December Policy Press Conference, Chairman Powell signalled this by saying the Federal Reserve would reduce monetary restrictions on the economy well before core inflation hits 2%. This would be done for fear of overshooting and having monetary constraints weigh too heavily on economic activity.

Given the above, we could see the first interest rate cut as early as March 2024 if inflation readings continue to track lower and the labour market shows a healthy rebalancing between the demand and supply of jobs. Recently, Christopher Waller, a member of the Federal Reserve's board of Governors, suggested as much when commenting, "[if after] several more months…we feel confident that inflation is really down and, on its way, you could then start lowering the policy rate just because inflation is lower."[1] It is probably just a function of time before this becomes the majority view of all of those on the Federal Reserve Monetary Committee. We expect the Federal Reserve to adopt a measured pace of cuts at first and respond as appropriate to the incoming economic data as we move through next year. The Federal Reserve is trying to strike a balance between growth and inflation. Cutting too early runs the risk of not banishing inflation fully and then having to keep rates elevated for longer. Cutting too late sees the risk of losing out on a soft landing and eventually cutting rates much more deeply in a recessionary environment.

Either way, we believe rate cuts are coming soon. We consider a recovering economy is not incompatible with rate cuts as we think the decision to cut will be driven by falling inflation and not necessarily the rate of future economic growth, which we expect to evolve at moderate, rather than runaway, levels. Furthermore, we believe current technological trends in AI adoption, robotics and computer processing power are primed to boost labour productivity and contribute meaningfully to disinflation over a longer timeframe.

This steady decline in core inflation is not just happening in the US; it is broadly mirrored across many major economies of the world, reflecting a synchronised move in disinflation. Indeed, Isabel Schnabel, one of the ECB's most hawkish members, was quoted recently as saying, "….. importantly, underlying inflation, which has proven more stubborn, is now also falling more quickly than we had expected. This is quite remarkable." [2]

G10 Core Inflation Back at Target



*GDP-weighted average of G10 economies (ex. Japan) plus EM early hikers. The EM early hikers are Brazil, Chile, Colombia, Czechia, Hungary, Mexico, Peru, Poland, and Romania. Data SA by GS when official SA not available. Unreleased values estimated using the average change in the mom rate for released countries.

Source: Goldman Sachs Global Investment Research

All of this strongly suggests that 2024 will be hallmarked by cuts in interest rates across many major economies, not least those that were early in the rate hiking process, such as Brazil. Indeed, a Federal Reserve biased towards easing will make the job of emerging market central banks that smidgen easier when optimising their own interest rate and exchange rate policy.

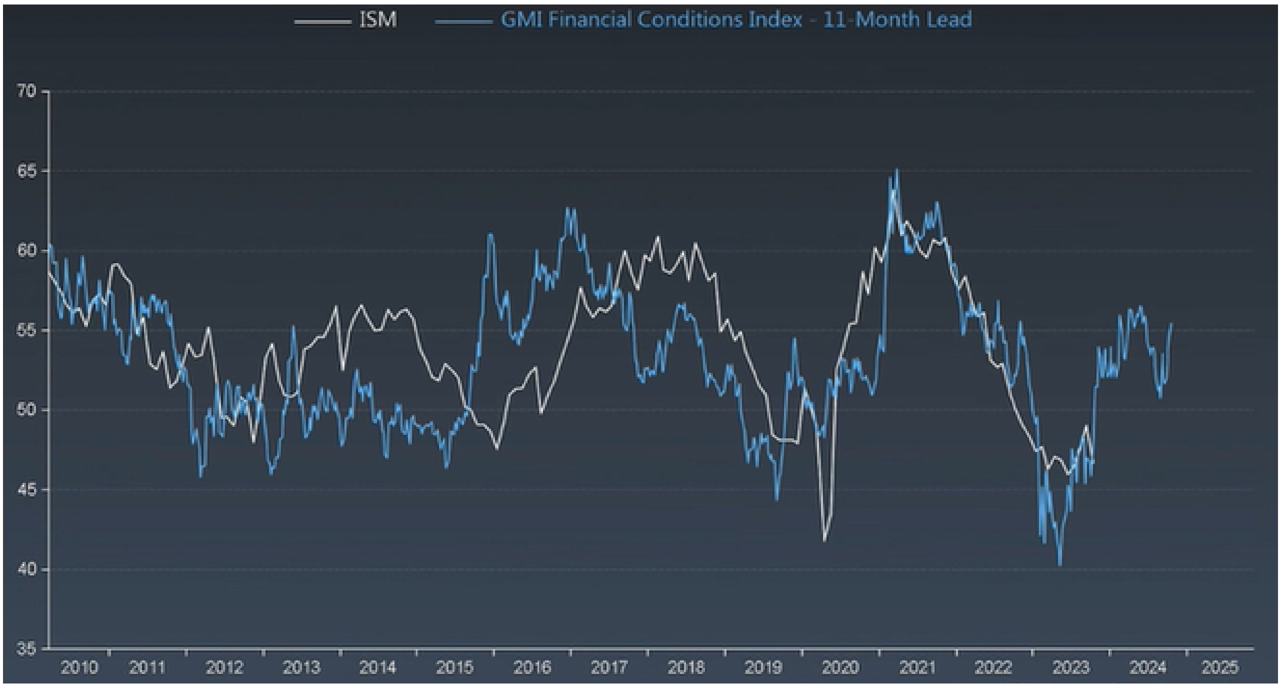
We expect that one of the most interesting debates of 2024 will be whether an improvement in financial conditions leading to an improving economy over time will eventually hinder the Federal Reserve from cutting interest rates to a level deemed to be the neutral long-term Federal Funds rate. This is the level of short-term interest rates where it is believed that economic activity is neither being stimulated nor restricted by interest rate policy. A neutral interest rate level today is about 2.5-3.0%. We expect that inflation will remain relatively benign even as the economy rebounds in 2024, and this will allow the Federal Reserve to continue to reduce interest rates in late 2024 and throughout 2025, albeit at a more gradual pace than at first. In our view, there is every possibility that the Federal Reserve will be able to bring its Federal Funds rate down to this neutral rate by 2025/2026.

Despite the talk of a possible recession in the US, our optimism around a healthy recovery in US economic activity during 2024 continues to grow. Importantly, we do not expect nor desire to see runaway growth as this would not be supportive of a more sustainable evolution of the next upswing in the business cycle and financial market returns.

We know that the US business cycle, as measured by the US ISM Manufacturing index, is currently in contraction and has been for quite a while, unlike services activity, which has remained relatively resilient during 2023. We expect manufacturing activity to pick up in the coming months as leading indicators of the US business cycle point in this direction.

We note the strong correlation between current financial conditions and an 11-month lead compared to the ISM Manufacturing Index. This tells us that there is a high probability that the ISM index is currently bottoming and will improve as we move into and through 2024. Given the resilience of US services and labour markets, this augurs well for an improving US economy in 2024, where the threat of a meaningful recession or entrenched slowdown should be avoided.

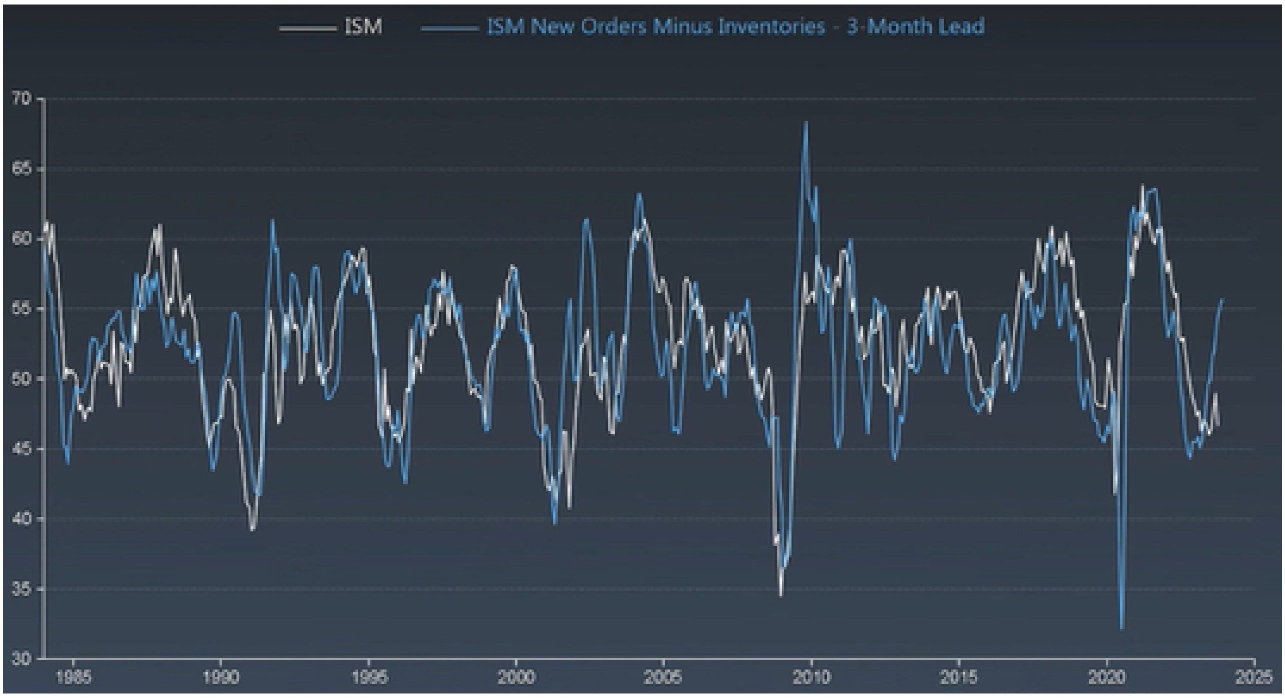
US ISM Manufacturing Index versus Financial Conditions (11-Month Lead)



Source: Global Macro Investor

Further corroboration of this comes in the shape of the ISM New Orders' less Inventories component compared to the overall ISM Index. This subcomponent always tends to lead the overall trend of the ISM index. This indicator now points to a reading of over 50 in the coming months, which signals expansion rather than contraction in manufacturing activity. It suggests that we might see the ISM back at 55 by the end of 2024, which would be synonymous with a healthy growth rate in manufacturing activity.

US ISM Manufacturing Index versus New Orders minus Inventories (3 Month Lead)



Source: Global Macro Investor

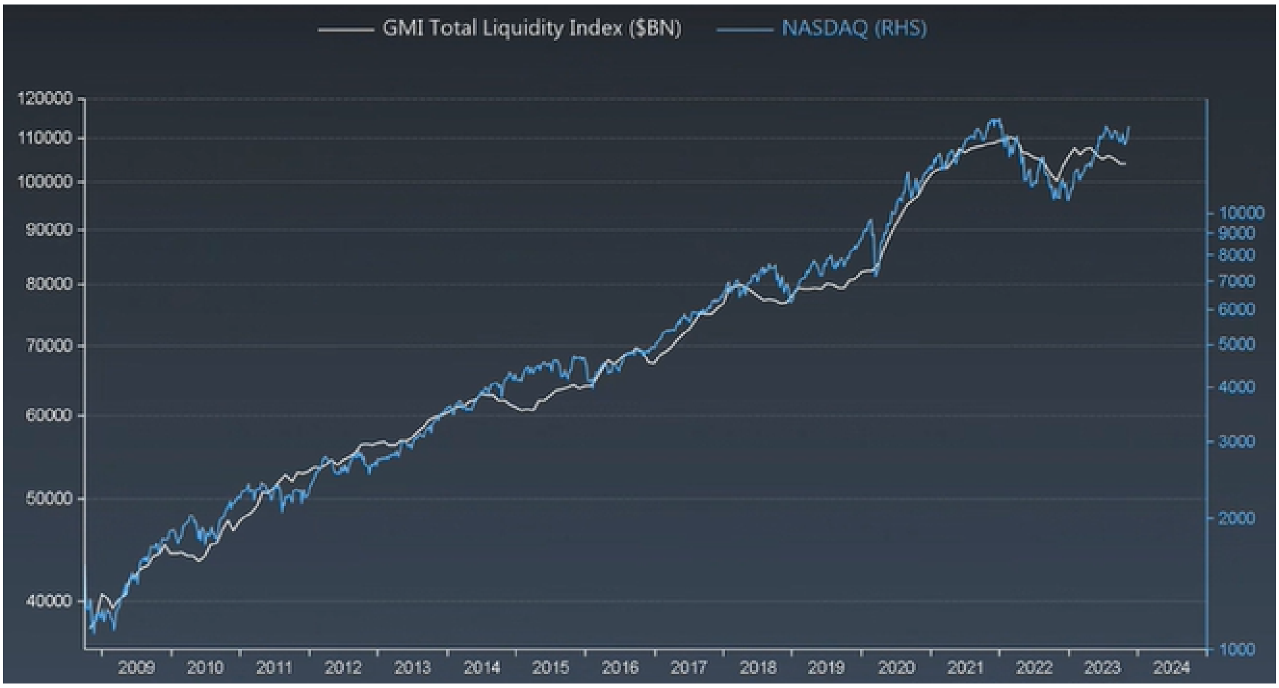
So, in terms of the business cycle, this suggests that we are now on the cusp of a new US cycle where we expect to enjoy recovering growth, continued disinflation and more balanced labour markets. This suggests an environment similar to a Goldilocks-type economy where conditions are 'just right', typically characterised by a combination of low inflation, low unemployment and steady economic growth.

It could be argued that we are entering a period in 2024 where conditions could be described as better than Goldilocks. Where 2024 might differ is that we are likely to see continued disinflation or an outright fall in inflation and not just steady or low inflation. This potential "Goldilocks Plus" environment could scarcely be better for the prices of risk assets to flourish. Of course, some asset classes and/or sectors will outperform others, and different sectors may perform relatively better than other sectors at different points in the cycle. Still, in the environment we have just described, we expect all risk assets to have their day at some point. We could imagine that growth equities will do better initially as investors look forward, pricing in future growth expectations and lower interest rates. However, as we move through the cycle where the economy starts to expand again with actual growth and natural end demand increasing, we should expect small-cap companies and commodity markets such as metal and energy-related prices to accelerate.

So, as we look forward to 2024, we see an improving US economy and an inflection into easier monetary policy. And yet, that is not all. We also see an improving trend in financial conditions closely followed by a rising trend in global liquidity.

As we have often pointed out, liquidity is a key driver of asset prices, especially over the most recent decades. We have noted before the close correlation between global liquidity and, for example, the Nasdaq index. As global liquidity goes, so goes the value of asset prices, especially growth stocks. If we know the direction of global liquidity, we have a great chance of knowing the direction of stocks and other risky assets.

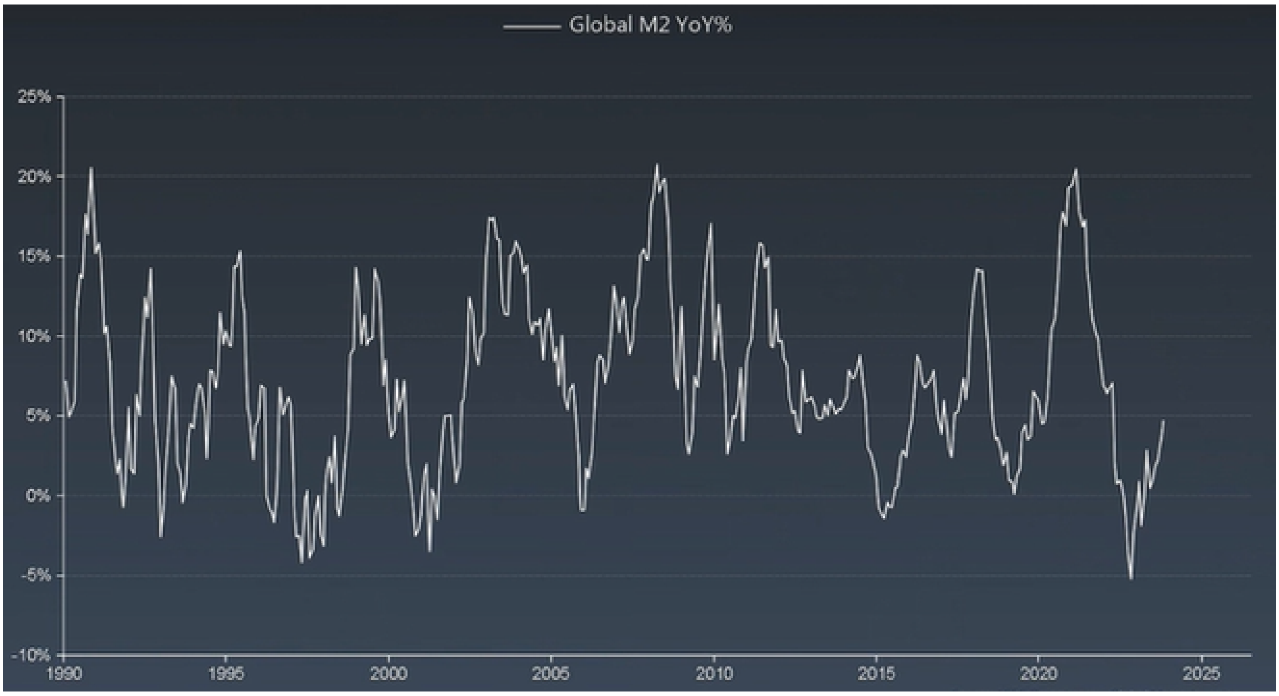
GMI Total Global Liquidity Index versus Nasdaq



Source: Global Macro Investor

If we examine the rate of change in Global liquidity, as denoted by M2 money supply, we can see that this measure of global liquidity bottomed and has been rising since the end of 2022. Is it purely a coincidence that this is precisely when the Nasdaq and S&P 500 bottomed, too?

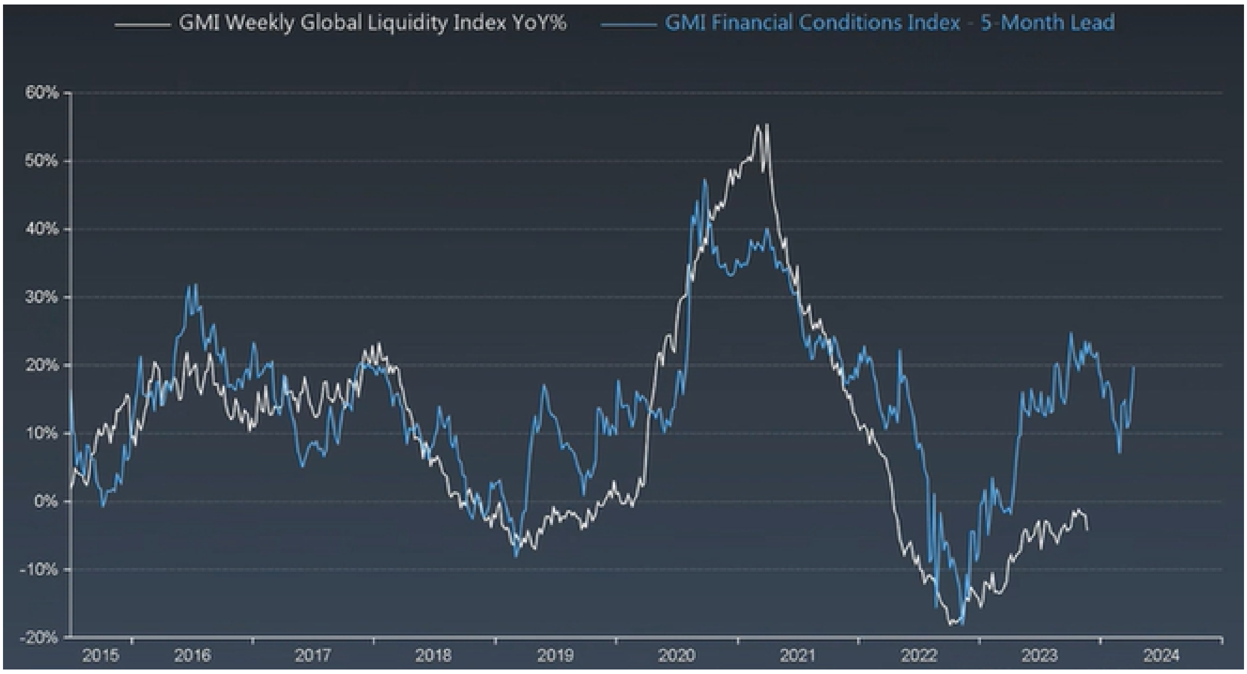
GMI Total Global Liquidity Index versus Nasdaq



Source: Global Macro Investor

So, global liquidity has been improving on a rate-of-change basis since the end of 2022, and it has recently turned positive on a year-over-year basis. Interestingly, the chart shows that the GMI Financial Conditions Index is a good lead indicator of global liquidity. This strongly suggests that global liquidity will continue to rise over the coming months. Hence, if global liquidity continues to improve over the course of 2024, it is a bullish indicator for all risk assets, including corporate bond spreads.

GMI Weekly Global Liquidity Index versus GMI Financial Conditions Index (3 Month Lead)



Source: Global Macro Investor

Market Implications
We continue to reiterate our belief that we are in the early stages of an equity bull market, which will be supported by an economic environment of recovering economic growth, disinflation and falling interest rates. Rising global liquidity over the next 12-18 months will further support the price of risk assets. This will provide a strong bid, initially for higher growth assets and sectors but eventually permeating into more cyclical and value sectors as the economic recovery becomes more established and broader-based. We believe consumer spending, and hence corporate earnings, will stay relatively strong, boosted by low levels of unemployment and a gently improving economy. Therefore, any volatility in inflation or geopolitical concerns leading to a price retracement should be welcomed as an opportunity to buy.

Government bond yields still offer value at current levels. Inflation will continue to fall, allowing the Federal Reserve to cut multiple times during 2024 and 2025. Hence, yields should continue to naturally gravitate lower over the next year or two, and we expect 10-year yields to fall closer to 3% over time. While waiting for yields to fall, Treasury bonds will also pay a handsome running yield, increasing the probability of a solid return over the next several years. Treasury bonds have had their worst back-to-back annual return in decades. 2024 is unlikely to be another negative year.

Corporate bond valuations will perform well in the medium term as we expect interest rates to fall and corporate earnings to grow during 2024, thereby increasing debt affordability. Whilst corporate spread valuations have rallied strongly over the last year, the all-in yield offered by both investment and high-yield credits remains very attractive.

After being bearish on the US dollar for more than a year, we are becoming less so. The US dollar has a strong tendency to underperform in an environment characterised by improving growth and slowing inflation. Hence, it would be wrong to ignore this fact. However, we believe the US economy will outperform other major global economies over the next several years, supporting relative US dollar valuations. Indeed, the EU seems to be slipping back into recession, and Eurozone inflation is falling quickly. While the probability of US rate cuts has been brought forward in recent months, this phenomenon is happening even more rapidly in the EU and the UK.

We are increasingly excited by the prospects for emerging market assets in 2024 and beyond. In an environment where we see increasing levels of global liquidity, a benign US dollar and rising demand for essential production inputs such as commodities, we are bullish on emerging market equity and debt returns in 2024. It is noteworthy how well the economic fundamentals of most emerging market countries have performed over the last two years during severe and aggressive monetary tightening by the US Federal Reserve. As emerging market central banks now start to ease monetary policy in response to falling inflation and a weaker US dollar, we should see these economies in a position to take full advantage of the global upswing in manufacturing activity that we anticipate will happen later in 2024 and into 2025. Investor pessimism towards China has become very high. While justified, we could see China outperform as it continues to ramp up monetary easing measures to revitalise its economy. President Xi's recent and understated visit to the US, his first in six years, to meet with President Biden probably points to a renewed desire to improve relations with the West, prioritising the need to bolster Chinese trade and its economy over other longer-term geopolitical aims.[3]

In line with our expectation that we will see a global upswing in manufacturing activity over the next 18 months, together with higher levels of global liquidity, we expect commodities prices to rise gradually over the year. Price rises could be exaggerated in specific cases where the dearth of investment in production capacity over many years could lead to future supply disruption.

Gavin Blessing
18 December, 2023

Source Data: ICM, Bloomberg as of November 30th, 2023.
[1] https://apnews.com/article/inflation-interest-rates-economy-federal-reserve-growth-fa6c5ed8992041e2bd8e0d5276337daa
[2] https://www.irishexaminer.com/business/economy/arid-41283769.html
[3] https://www.reuters.com/world/us/veiled-swipe-china-blinken-tells-apec-us-believes-free-region-2023-11-14/

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