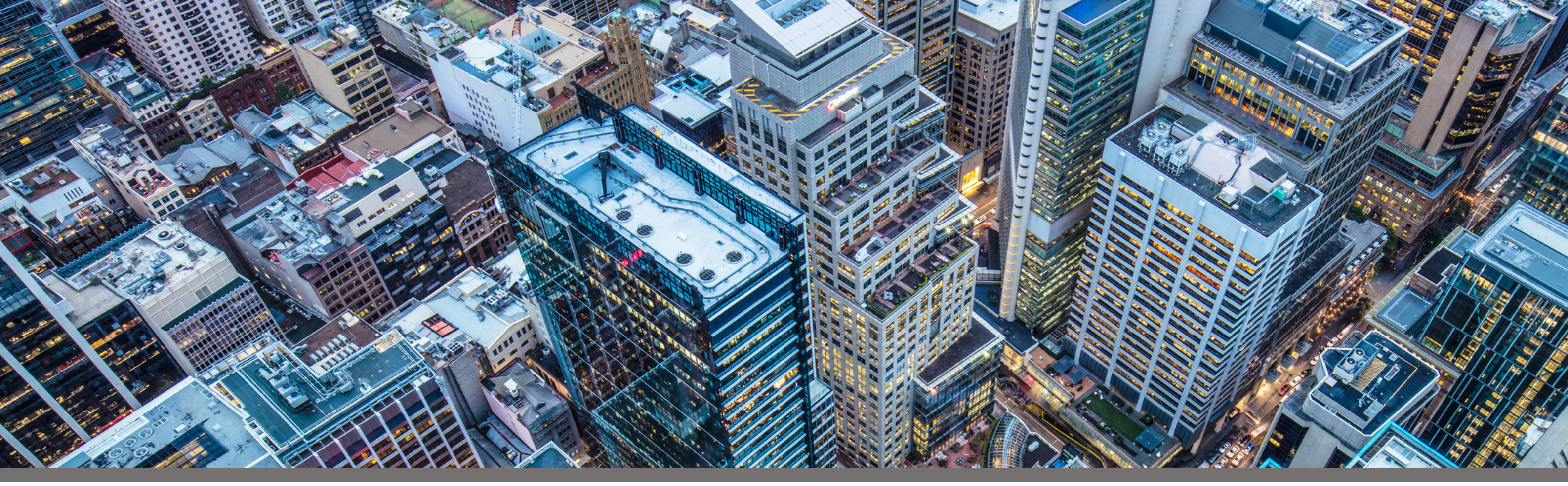


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.9** BILLION	**US$21.5** BILLION

ICM Monthly Outlook

DECEMBER 2022

Market Review

In November, the S&P 500 index continued to rally, finishing up 5.4% adding to 8.0% gains from October, the first back-to-back monthly gains on the index since August 2021. The S&P 500 index remains in correction territory year-to-date, down 14.4%. The gains in November were all the more impressive given the extremely hawkish speech by US Federal Reserve Chairman Jerome Powell at the Federal Reserve Open Market Committee ("FOMC") meeting press conference early in the month where the FOMC decided to raise rates by a further 0.75% to 3.75%. It was clear from Powell's speech that the US Federal Reserve remains resolute in its fight against inflation, with Powell stating, "we have some ground left to cover and cover it we will" (1).

Against the backdrop of a hawkish US Federal Reserve, thankfully, inflation provided a welcome reprieve. Inflation numbers for October, released in November, showed inflation slowing to 7.7% for the 12 months ended October 2022, coming in below the consensus estimate of 8.0% and a significant reduction from the peak of 9.1% in June.

Leading indicators continue to point towards a weakening economy, with the ISM Manufacturing Purchasing Managers Index decreasing to 49.0 in November. The unemployment rate remains low at 3.7%, although there are signs that the market could be weakening as jobless claims have increased in recent weeks. Continuing jobless claims have been rising since May and now stand at 1.6 million persons, up from 1.3 million in May this year.

The recent rally in the S&P 500 index reflects the market view that economic conditions are weakening and inflation is slowing, providing the US Federal Reserve with cover to slow down the rate with which they have been raising interest rates.

While inflation in the US appears to be abating, there was no such relief in Europe or the U.K., where inflation hit fresh highs of 11.5% and 11.1%, respectively. In Europe, inflation is almost three times its pre-2022 record, 4.0% in 2008. In the U.K., inflation is higher than at any time since the early 1990s. The European Central Bank ("ECB") and Bank of England ("BoE") both raised rates by 0.75% during the month, bringing their base rates to 2.0% and 3.0%, respectively.

Despite increasing inflation and base interest rates, European equities, as measured by the Eurostoxx 50 index, increased by 9.6% in November, while UK equities, as measured by the FTSE 100 index, increased by 6.7%.

In November, US interest rates tumbled. Other than for the very shortest maturities, over which US Federal Reserve policy exerts the most influence, interest rates across the curve were down by 0.44% on average. Interest rates had not declined so rapidly in a month since March 2020, when they tumbled by 0.5% on average as the global economy shut down. The US Treasury Index, measured by the Barclays US Aggregate Government Index, rallied 2.7% on declining rates.

Market Review continued

Corporate bonds had a superb month, benefiting from lower rates and tightening spreads. Investment Grade credit, as measured by the ICE Bank of America US corporate index, had its best month since April 2020, rising by almost 5.0%, while High-Yield Credit, as measured by the ICE Bank of America high-yield index, rose by 1.9%.

Market Outlook

Just like winter storms, not all recessions are similar. Depending on their particular characteristics, the impact and aftereffects of these storms can be very different. Our regular readers will know that, since early summer, we have been predicting a significant growth slowdown and a recession to hit the US and other major global trading blocs, such as Europe and the UK, in late 2022 and the first half of 2023.

While an event-driven or systemic-led recession, such as the banking crisis in 2008, can be particularly nasty, an inflationary-led recession can arguably be less damaging and less protracted. It could also be argued that tighter monetary policies sparked by higher inflation can be cathartic by helping to excise some of the more frothy or unsustainable aspects of a given economy, allowing it to rebuild at a later stage on a much more assured footing.

The chances of a mild and relatively short recession are improving

Since the beginning of the Federal Reserve's monetary tightening action, the US economy, particularly the manufacturing side of its economy, has been slowing down, albeit from strong levels of activity earlier in the year. As we move forward in time and as economic data emerges, we are starting to get a better insight and understanding into the type of recession the US is likely to face over the coming months and its implications for risk asset prices.

The ISM Purchasing Manager Index is an excellent measure of the point-in-time strength of the US business cycle and, therefore, a good indicator of whether the US is sinking into a recession. For many months we have been calling for this indicator to fall below 50, indicating that the US manufacturing economy has slipped into a contractionary rather than expansionary environment. As we write, this indicator has just been released and indicates a measure of 49.0 for November, down from a high of 63.7 as recently as last March. This suggests that the manufacturing side of the US economy continues to slow and is just starting to tip over into a period of contraction. While we expect this negative momentum to continue and this measure to drop further, we concede that its decline has been slower than expected, indicating greater signs of resilience in the US economy.

Consumer spending is also holding up well, supported by a surprisingly robust labour market which similarly has performed better than our expectations. Initial jobless claims have remained remarkably steady and do not suggest a rapid deterioration in the employment market. Indeed, recent Non-Farm Payroll reports suggest that while the number of monthly new job hires is falling, the US economy continues to add a healthy level of jobs every month, albeit not at the breakneck speed of 2021. The JOLTS survey, a report which measures the number of available jobs, reported 10.3m openings in early November, which is falling and down from its peak in March of nearly 12m. However, it is still considerably higher than the c.7m job openings reported in 2019 before the pandemic. Hence the level of job openings may need to fall further to dampen wage inflation pressures. Overall, the US jobs market is cooling but only gradually. While US unemployment is likely to rise from here, creating a recessionary environment, given the strength we have seen in the jobs market to date, we do not expect unemployment to increase dramatically.

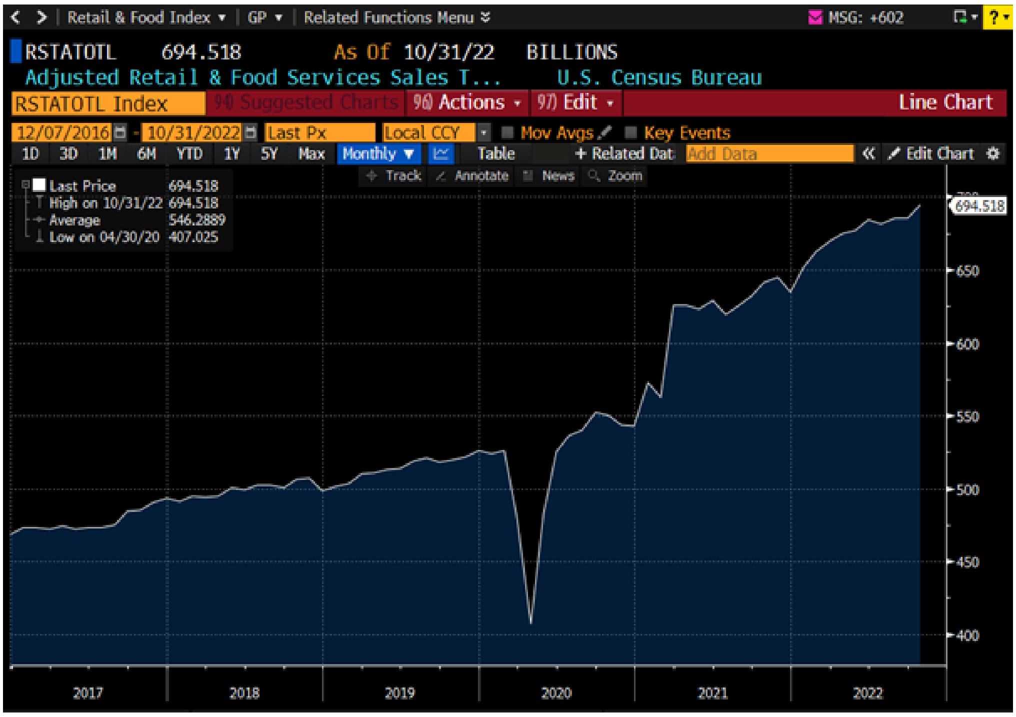
While the US housing market is facing significant pressure with current interest rate levels, mortgage holders are relatively well protected as the majority of US mortgages are long-term and fixed. Clearly, house prices and rents are likely to fall further, but given that the system is not highly leveraged on this occasion, we do not expect a full-blown housing crisis.

Considering the strength of the US jobs market, it is probably not altogether surprising to see that US retail sales are holding up well. Indeed, given inflation, retail sales may continue to hold up well on a nominal basis even though they may be flat or fall on an inflation-adjusted or real basis. If retail sales remain strong, then corporate revenues on a top-line basis should also perform well. Those corporations with pricing power will do fine, while those with less pricing power will see margins crimped and earnings fall. This is the key question for next year and will likely determine the path of equity prices. It is very likely that corporate earnings will fall next year. If earnings come off harder than expected, we could see pressure on equity prices, especially if negative earnings revisions are reported in Q1 and Q2 of next year. On the contrary, if spending stays strong and corporates can pass on the

Market Outlook continued

increase in costs, then equity prices may remain resilient and indeed rally during the course of the year as it becomes increasingly likely that the Federal Reserve is winning its battle with inflation, allowing it to possibly cut interest rates towards the end of 2023 and into the early part of 2024.

US Retail Sales



Source: Bloomberg

In short, the economic data so far tells us that while a recession is still likely, it could be shaping up to be a relatively mild recession. Given the labour market's strength, we may even achieve a soft landing where we avoid a recession altogether. Based on the rapid pace of Federal Reserve tightening, our instinct is to say that a recession is probably unavoidable. Cyclical indicators, which have historically been very accurate and are based on the rate of change in economic variables rather than an absolute level, also suggest that a recession is unavoidable. Yet economic data, while weakening, is not signalling a sharp collapse in activity. Of course, the Federal Reserve could still crater the economy if it does not pause or slow down its aggressive pace of tightening. It is vitally important to allow some time to pass to further assess the impact of previous rate increases on the economy, which we know take time to work their way through, with their effects typically only presenting themselves on a lagged basis of several months. The Federal Reserve is aware of this and has recently stated this as a concern. Hence it is almost certain the Federal Reserve will soon pause its interest rate hikes, possibly as early as December, most likely after January. The question is then whether this pause will evolve into a permanent pause.

Returning to our leading indicators of the ISM Manufacturing Index and the US business cycle, we can see in the next graph that they have already bottomed and are trending upwards again. This suggests to us that this recession or slowdown will not be protracted. The GMI Financial Conditions Index, which is historically tightly correlated with the ISM index on a lagged basis, has bottomed out and is recovering. It suggests that the US business cycle will bottom out around the spring of 2023, with a potential recovery taking place throughout the summer and into the autumn period[2].

ISM Manufacturing Purchasing Managers Index versus GMI Financial Conditions Index

Source: Global Macro Investors

Furthermore, the Chinese Credit impulse, which historically leads the US manufacturing cycle, has been on a definite upswing for many months as the authorities look to reprime their economy. This leading indicator also suggests that US manufacturing will continue to weaken but bottom out sometime around the end of Q1 or early part of Q2 2023[3]. As we know, the Chinese have started to re-stimulate their economy by permitting higher credit and money supply growth. More recently, they have announced plans to slowly abandon their highly restrictive Covid policies.

ISM Manufacturing Purchasing Managers Index versus China Credit Impulse

Source: Global Macro Investors

The ISM Manufacturing Index is not only an important indicator of US economic vitality but historically has also been very accurate in predicting the end of a given tightening cycle. Without fail, the Federal Reserve has historically always either paused its tightening policy or, indeed, cut interest rates when this indicator has fallen below 50. Clearly, the Federal Reserve's actions are impacting the economy significantly as we are now close to the point where they have always paused.

Will a pause by Federal Reserve ultimately turn into a permanent end of its tightening cycle
In trying to answer the question of whether this pause will ultimately turn out to be permanent, we probably need to look more closely at the path of future inflation, as this is the critical target for the Federal Reserve. Inflation was trending dangerously higher but is now trending lower due to the Federal Reserve's tightening actions. The inflation basket is broadly composing goods and services, shelter and wages. Goods inflation has now largely come to a standstill and, in some categories, is in outright deflation. Services are still increasing but are slowing. Shelter works with a lag effect, but real rents are now in marked decline as per the recent survey from Apartment List below and will eventually lead to a fall in official shelter inflation next year[4].

MoM Change in National Rent Index (2018 - Present)

Source: Apartment List Rent Estimates

Wages are still increasing, with average hourly earnings up 5.1% in November on an annual basis. While this is less than the 7.7% annual US CPI inflation rate in October, the Federal Reserve will be keen to get this number down to its long-term average of 2-3%. We don't think inflation will be as sticky as some other commentators say, but if there is going to be a source of resistance, it is likely to come from the labour market as wage demands remain firm.

The Truflation index, a real-time, on-chain entity tracking the price data of more than 10 million items across the US economy, indicates that inflation is falling and falling fast[5]. It suggests that real-world inflation in the US has steadily declined from a peak of 12% in late March to just over 6% in early December and is showing no signs of bottoming yet.

US Inflation Rate

Source: Truflation

The Federal Reserve committee is likely to want to see the inflation rate fall below the level of its own Federal Funds rate. This will probably give them the assurance that they have done enough to permanently quell inflation and protect the committee's long-term reputation. The US Treasury yield curve between 3 months and ten years is now over 130bps inverted, one of the most inverted curves in history, which tells us how tight the Federal Reserve is keeping rates at the front end. The market believes both the intent and determination of the Federal Reserve to bring inflation down. Hence, long-term inflation expectations have now fallen back in line with longer-term averages, such as 2.2% on the 5-year inflation breakeven rate. It is clear that headline inflation will continue to fall and may even fall faster than expected, down towards 4% by the end of Q1 2023. This should allow the Federal Reserve to pause indefinitely as the economy slows and inflation falls steadily. This should be positive for risk sentiment, supporting the potential for stronger capital markets during Q1 and Q2 of next year.

However, there is a material risk to this argument, which emanates from the recent turn in financial conditions. As we saw earlier, restrictive impulses from tightening financial conditions measured across multiple financial variables are receding and will become positive tailwinds over time. Hence the US economy will, in the coming months, benefit from unambiguously positive growth impulses spurring more demand and economic growth. For example, inflation will be falling, so real incomes will be rising, boosting consumer spending power. This could hamper the Federal Reserve's ability to rebalance the labour market to bring wage inflation under control, which in turn could force the Federal Reserve to raise rates again in March or May.

Price Implications of a milder and less protracted recession

Given that we now have a better insight into the type of recession we are facing and the most likely path of further rate increases by the Federal Reserve, we need to consider their implications for the prices of risk assets.

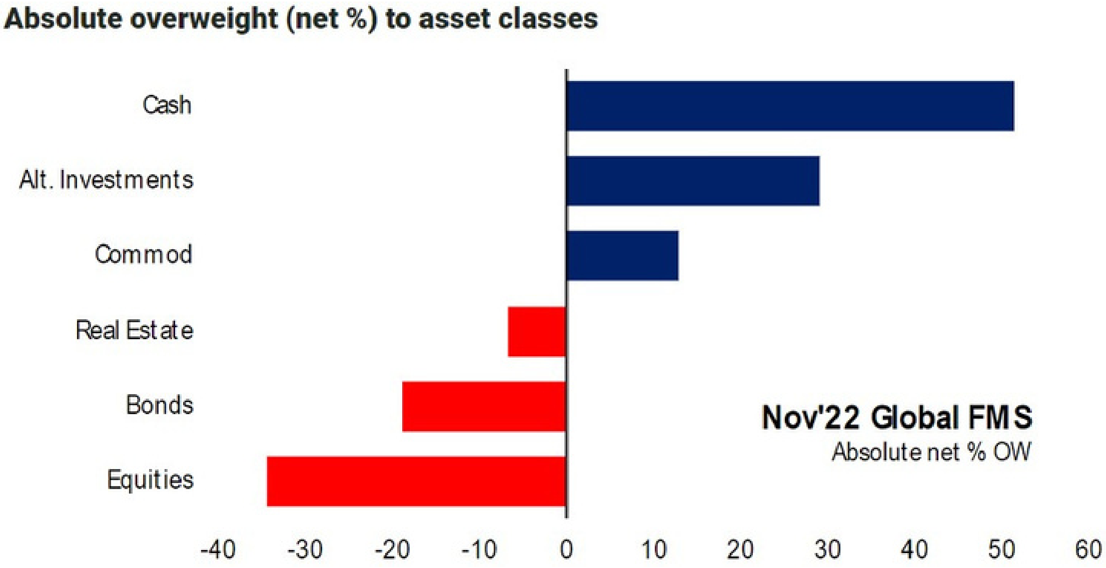
Clearly, a soft landing or a milder and shorter recession carries a better prognosis for a shallower correction and quicker recovery in prices than a deeper and more protracted recession. While the price falls already seen in equity markets throughout 2022, in anticipation of the Federal Reserve's induced slowdown, need to be considered, there is still potential for additional price pressure for risk assets triggered by negative corporate earnings revisions coming through in Q1 and Q2 of 2023. We have already seen evidence of this negative earnings revision momentum, with the percentage of analysts reducing earnings estimates in Q4 2002 well above average. This momentum will likely continue, and we will probably see more negative earnings revisions early next year.

As a counter to this argument, we believe a signalling by the Federal Reserve that it is edging ever closer to the end of its tightening cycle will be supportive for capital markets. If the Federal Reserve goes on pause in December or early in the new year and inflation continues to trend down, this could buoy sentiment and prices. However, this positive environment for risk assets could be abruptly shaken if the Federal Reserve believes it cannot go on pause or must restart its rate hikes in May in order to rebalance labour markets. The Federal Reserve will ultimately win its battle with inflation regardless of whether it comes earlier or later than the market expects.

Examining market technicals, we note that they remain supportive for future equity and corporate bond prices. Sentiment remains very poor towards risk assets, so any improvement could be supportive for prices over time.

Similarly, investor positioning is currently very bearish, as found below in the recent survey by Bank of America. It points to a significant overweight to cash and underweight to equities and bonds amongst US institutional fund managers[6].

Global Fund Manager Positioning Survey



Source: Bank of America Global Fund Manager Survey

The recent declining price trend in the US Dollar is yet to be affirmed

The US Dollar has been trending weaker since mid-October. Given that it is the denominator of global value, this has been good for the prices of all other risk assets, especially emerging market equities. Looking below at its performance over the last ten years on a trade-weighted basis, we can see that the US Dollar still appears relatively expensive. At some point, it is likely to mean revert and trend back down towards its longer-term average. Whether we are on that path yet is still uncertain in our minds. We might well be, but it hangs in the balance. We have still not fallen below some of the key weekly moving averages to confirm that we are in a newly affirmed downtrend. Therefore, US Dollar price action tells us that it is simply too early to know whether a new downtrend has begun or whether a final rally could yet occur. As before, the answer to this question probably comes down to the relative strength of the US labour market over the coming months and whether the Federal Reserve believes it has done enough or whether it believes it must go further by bringing its Fed Funds rate up to 5% and above. A renewed move higher in the US Dollar in the new year would be bad news for most other asset classes.

US Inflation Rate

Source: Bloomberg

In summary, while we can make the case for positive performances across most risk assets in 1H 2023, there is still much uncertainty, not least the risk of lower earnings revisions pressuring sentiment and prices in the short term. Therefore, at the very least, we should continue to expect plenty of market volatility during this period.

The prognosis becomes decidedly brighter as we look further out to 2H 2023 and 2024. The Federal Reserve is very likely to have stamped out any pockets of stubborn inflationary resistance by the middle of next year. Earnings revisions will be largely behind us. Financial conditions will likely be supportive and act as a favourable tailwind to the economy. Falling to low inflation, lower longer-term bond yields, recovering economic growth, and the potential for renewed monetary stimulus should provide the foundation stone for a broad rally across risk assets, including developed and emerging market equities, corporate bonds and commodities.

Gavin Blessing
12 December 2022

Source Data: ICM, Bloomberg, Trading View; as of 30 November, 2022.
[1] https://www.wsj.com/articles/transcript-fed-chief-powells-postmeeting-press-conference-11667422099?tpl=cb
[2] https://www.globalmacroinvestor.com/
[3] https://www.globalmacroinvestor.com/
[4] https://www.apartmentlist.com/research/national-rent-data
[5] https://truflation.com/
[6] https://business.bofa.com/en-us/content/market-strategies-insights.html