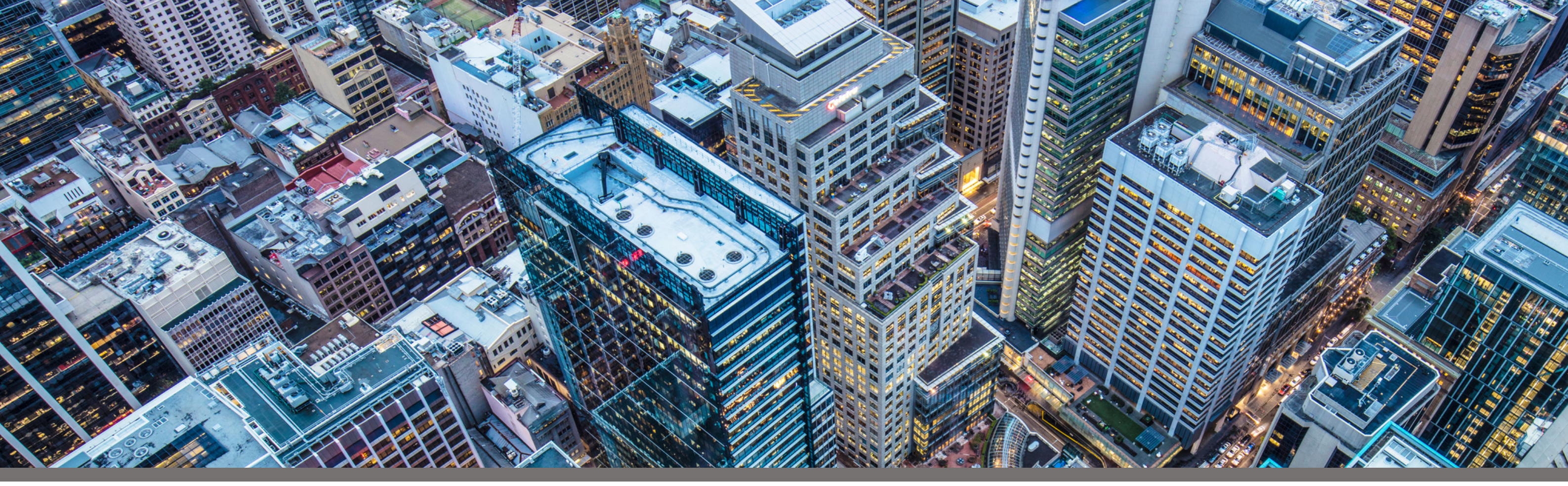


| FOUNDED IN | EMPLOYEES | LOCATED IN | ASSETS DIRECTLY UNDER MANAGEMENT | ASSETS INDIRECTLY UNDER MANAGEMENT |
|---|---|---|---|---|
| **1988** | **70+** | **10+** COUNTRIES | **US$2.1** BILLION | **US$22.1** BILLION |

# ICM Monthly Outlook

AUGUST 2022

## Market Review

In Q2 2022 the U.S. technically entered recession with two consecutive quarters of GDP contraction, as GDP fell by 0.9% in Q2, following a 1.6% contraction in Q1. The contraction in Q2 was primarily driven by declining inventories, as businesses which had stocked up on goods due to supply chain issues last year moved to reduce the inventory they held. This followed Q1 contraction, driven by declining inventories and a large trade deficit. The astute reader will note that declining inventories and trade deficits are a production issue (the "P" in GDP), and not a consumption issue.

Inflation continued to soar in August, with annual inflation of 9.1% in the 12 months to the end of June 2022, the highest reading since 1981. Several factors are pointing towards softening inflation. Gas prices have fallen from a high of more than USD 5 per gallon to almost USD 4 per gallon today[(1)]. U.S. mortgage rates have been falling too, and in July, they fell below 5% for the first time since April[(2)].

As expected, in July the U.S. Federal Reserve raised rates by a further 75bps. With Fed Funds Rate now at 2.5%, interest rates are at their highest since the Global Financial Crisis. Not only are interest rates high in comparison to recent history, but the speed of the increase has also been rapid. Consider the last interest rate hiking cycle: the U.S Federal Reserve began increasing rates from 0% in December 2015, and did not reach 2.5% until December 2018. The U.S Federal Reserve have increased by the same amount in just five months between March and July this year. The U.S. Federal Reserve has not raised rates at such a pace since the 1980s.

Currently the market is pricing four more 25bps increases through the rest of 2022, bringing the Fed Fund Rate back to 3.5%. After that, the market expects the U.S. Federal Reserve to pivot and begin easing monetary policy. Despite the fact the U.S. is in a recession, the U.S. labour market remains robust. In July, the U.S. economy added 528k jobs, the most since February. U.S. unemployment is now 3.5%, its lowest since February 2020.

In July, U.S. Equities bounced back with gusto, rising by 9.1% during the month after a horrific Q2 where the S&P 500 fell by 16.4%. While the U.S. Federal Reserve continues to increase short-term interest rates, rates at the longer end of the curve fell during the month, and this lower long-term interest rate is supportive of higher equity prices. The technology sector rebounded strongly in July, rising by 13.5% and recouping much of the 20.5% losses from Q2 2022. The consumer discretionary sector, having been the worst performing sector through the first half of 2022, was the best performing sector in July, rising by almost 20%. It remains to be seen if the worst of the market decline is behind us, and volatility certainly looks set to remain high for a period. However, we believe that a market rally over the next 12 months outweighs the probability of further significant declines.

## Market Review continued

In July, European equities rallied. The EuroStoxx 50, Europe's blue-chip index, increased by 7.3% during July, despite Europe's first increase in interest rates in over a decade.

In July, the European Central Bank ("ECB") raised interest rates by 0.5%, taking the deposit rate from negative 0.5% to 0%, as inflation in the Eurozone continues to rise, hitting 8.9% in the twelve months to July 2022. However, given Europe's reliance on the import of Russian energy, the outlook for European Inflation remains more muddied. Moreover, it will continue to be that way while the war in Ukraine persists.

In July, U.K. equities, measured by the FTSE 100, increased by 3.5%. Despite the underperformance of the FTSE in July, relative to the U.S. and Europe, the FTSE remains one of the best performing indices in 2022.

In July, emerging market equities declined by 0.3% per the MSCI Emerging Market equity index. Despite positive performance from India, Brazil, Taiwan and South Korea, the index finished the month negative as Chinese equities, which make up c.30% of the index, were down 7.8% for the month.

As discussed above, the U.S. Federal Reserve continued to increase interest rates, raising rates by 0.75% in July. However, the U.S. Treasury Index, measured by the Barclays U.S. Aggregate Government Index, increased by 1.6% in July, primarily driven by decreasing interest rates in the longer end of the curve, as rates from 3 years to 30 years all fell in July.

In Europe, the Barclays Euro Aggregate Government Index gained 4.1% in July. However, European government bonds have lost 8.6% in 2022 so far.

Corporate bonds rallied in July, with the U.S. high yield bond index increasing by 6.0% and the U.S. investment-grade bond index increasing by 2.9%. Corporate bond spreads have doubled since the start of the year.

Commodities, as reflected by the Bloomberg Commodity Price Index, renewed their upward trajectory in July, increasing by 4.3% during the month. While oil declined by 4.2% during the month, natural gas rallied, rising by more than 50% and driving the index higher due to its weighting as the third largest holding.

## Market Outlook

As investors, we know uncertainty creates price volatility. When we have more than one possible investment outcome, we get greater price volatility as the market tries to price in the probability of these various outcomes and the implications for markets. One way of dealing with this uncertainty is to adjust your investment timeframe. Generally, if we consider complex questions over a longer timeframe, we can narrow the number of probable outcomes and sometimes almost eliminate the uncertainty. For example, no one can be certain whether equity markets might go up or down tomorrow, but if we look out ten years, it is virtually certain that equity markets will be higher. So, let's begin by asking ourselves what we know for certain about the current cycle.

**Investment uncertainty decreases when we look out over more extended periods**

Let's look over a longer timeframe of the next 12-18 months. We know with a high probability that inflation will gradually normalise and fall back to appreciably lower levels, if not quite back to pre-covid levels. We also know the Federal Reserve will eventually stop rising rates. After they stop raising rates, we know it is very likely they will at some point begin cutting rates again, even if they have to raise them again before cutting. Suppose we can make these assertions with a very high level of confidence or certainty. In that case, it becomes a more straightforward question of the timeframe as to when inflation falls, growth falls, and the Federal Reserve stops raising rates and eventually moves to cut rates. We also know with a very high level of certainty that if the Federal Reserve stops raising rates and eventually begins to cut rates to stimulate the economy, the equity market and other risk assets will rally. We have already seen a glimpse of this. At the July Federal Open Market Committee meeting, Chairman Powell announced that while the committee anticipated ongoing increases in the Federal Funds rate would likely be appropriate, the pace of those increases would depend on the incoming economic data and the evolving outlook for the economy. This softening in stance, and acknowledgement that it would be appropriate to slow the pace of rate increases to assess how cumulative policy adjustments are affecting the economy and inflation, was enough to send the Nasdaq over 4% higher on the day.

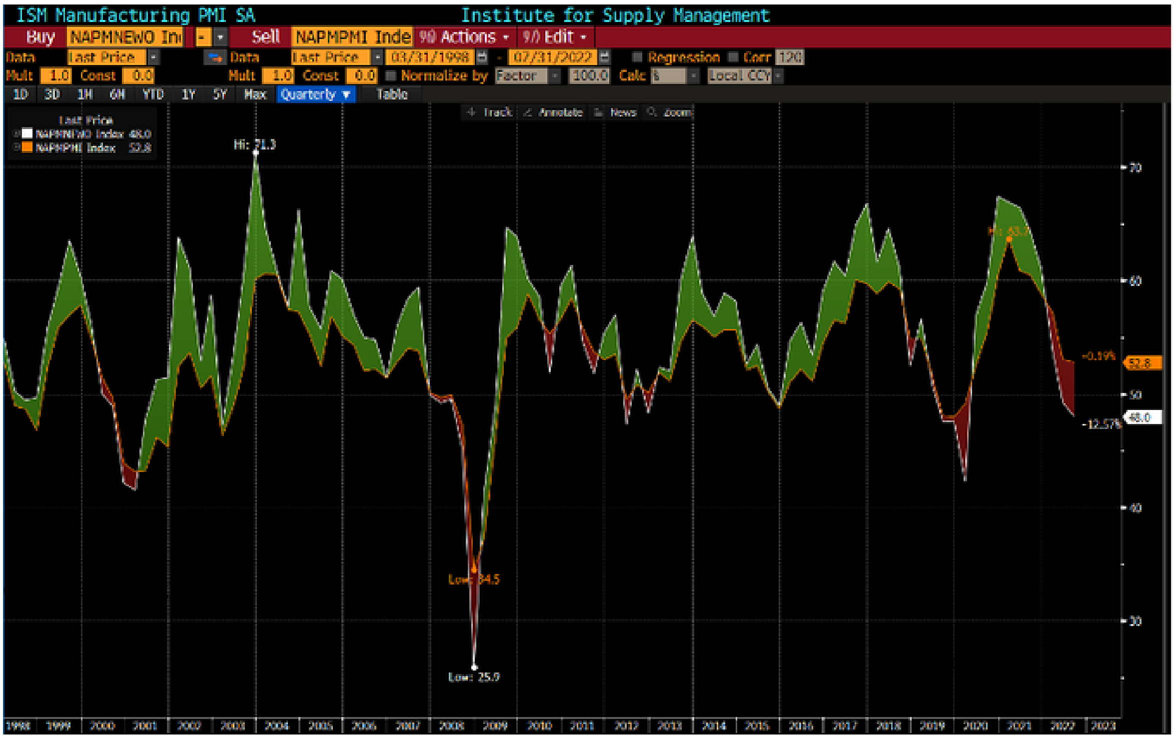
## Market Outlook continued

So, when is the Federal Reserve likely to stop raising rates, or at least pause, so they have the time and space to assess the impact on the economy of their recent tighter monetary policy measures? We believe the Federal Reserve will feel duty bound to stop raising rates, if only for a short period, to assess the impact on the economy once they believe the data shows the economy is headed towards a recession. Historically this has always been when a key forward leading economic indicator known as the Purchasing Manager Index (US PMI) has fallen to 50 or below.

### A US recession has arrived

When we look at the recent US PMI report for July below, we can see that the most recent reading was 52.8. The New Orders component, which typically leads the overall index reading, has fallen below the crucial line of 50 with a reading of 48, implying new business orders are in contractionary mode compared to recent months. As we can see from the table below, a lower New Orders number is likely to lead to a lower overall Index reading in the coming months.

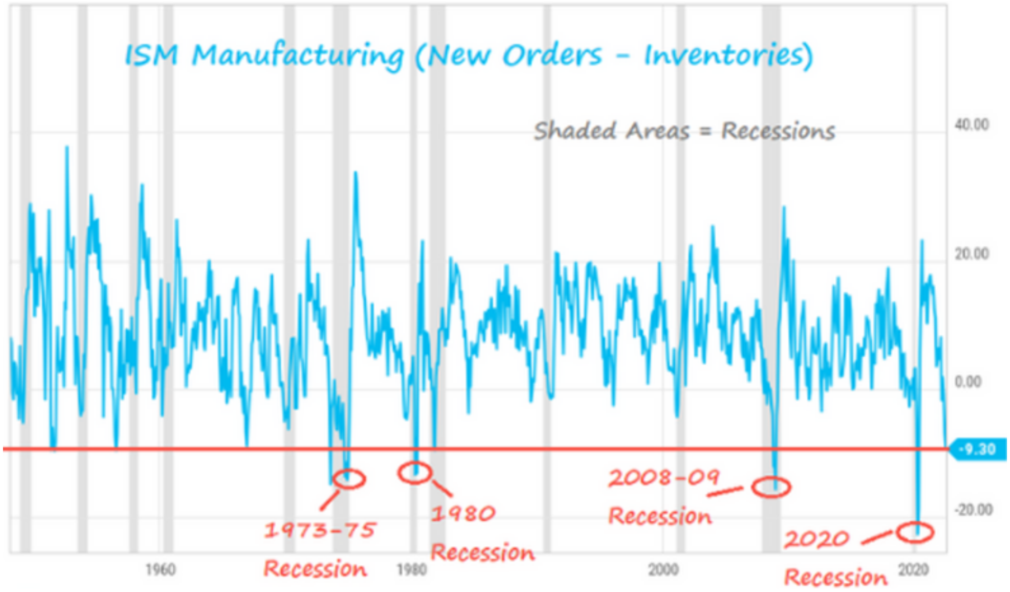
**ISM Manufacturing PMI SA**




Source: Bloomberg

Even more enlightening as a leading indicator is when we compare the difference between the New Orders and the Inventories component reading of the Purchasing Managers Index as in the next table[3]. Elevated inventories and sharply falling new orders are significant indicators of future economic weakness. We can see that the U.S. economy was already in recession the last time the spread was so negative. Furthermore, we can observe from the table that few U.S. recessions in the previous 50 years saw such significant weakness in this measure. The data shows that a sharp and potentially deep recession, if not already arrived, is imminent. Hence, we think the Federal Reserve will feel compelled to slow down and pause its current rate hiking schedule in the next few months.

**US ISM Manufacturing New Orders Index - US ISM Manufacturing Inventories Index**




Source: Compound @CharlieBilello, Aug 1 2022

**The Federal Reserve will soon relent**

Unless the economic data between now and September, when the committee meets again, is extremely weak, our best guesstimate as to when this pause might come in is October or November. We believe the Federal Reserve will relent, if only temporarily, to allow some time to assess whether further rate hikes are warranted. We believe the likelihood of this action is even higher given the unprecedented speed of the previous rate hikes and the risk that the potential drag from this cumulative tightening is yet to be fully absorbed by the real economy. The Federal Reserve will need time to monitor and ascertain the impact of these past hikes on the real economy. We assert that if the economic data at that point is weak enough, heralding a possible deeper recession, the Federal Reserve will be forced to pause.

The employment market is still strong, and there are signs of wage inflation, which will still cause the Federal Reserve concern. Indeed, many observers say that a strong jobs market gives the Federal Reserve cover to keep increasing interest rates. While this may be true to some extent, we do not believe this cover lasts for much longer for the reasons already described above and also because the jobs market is a lagging indicator or a best a coincident indicator. If we examine other areas of the unemployment market which are more forward-looking, we can see early signs of weakness. The monthly Job Openings and Labor Turnover ("JOLTS") have been falling since March. The weekly Initial Jobless Claims reports have also been increasing steadily since March. Businesses in interest rate-sensitive sectors such as housing, finance, technology and retail are laying off workers.

**Inflation will be quelled and deflationary forces might begin to surprise**

There is an argument in markets that the Federal funds rate is only now back to the bank's long-term neutral interest rate policy range of 2.5% - 3% and that this is not high enough to quell inflation. We believe this logic is misguided. A more critical point in determining the trajectory for the business cycle, the level of growth or weakness in the economy, and ultimately the level of demand-pull inflation, is the rate of change in tightening financial conditions. The shock effect, if you will. If the real economy is subject to a rapid tightening in financial and monetary conditions, it will have less time to adjust, and the negative economic impact is more severe. As we have described before, in a world of rapidly tightening financial conditions and more significant resultant uncertainty, business spending decisions, for example, are not simply adjusted downwards, they are deferred, or worse, abandoned. Hence growth can collapse very quickly and with it demand. Ultimately, if demand falls and there is less money chasing goods and services, those items' prices will also decrease. Of course, supply-side or cost-push inflation will continue to be an issue, but ultimately, if you lower demand, lower inflation will follow over time, which is what the Federal Reserve will accomplish. There is even a chance that we see may see some deflationary forces at work in the US next year due to falling commodity prices from peak, a strong US dollar and the possibility of a liquidation cycle where China manufacturers, fearful of a reduction in US consumption, may start discounting their manufactured good prices.

We are very mindful of supply-side or cost-push inflation. As far back as August 2020, the ICM team talked publicly about the concept of the great reflation. While higher inflation was being engineered by Federal Reserve in its desire to raise inflation expectations, we said that supply-side inflation would become more pronounced over time as the shortage of upstream CAPEX investment in much-needed commodities came into effect. Today, we cannot be surprised by the ever-tightening supply of raw materials as it was primarily caused by a mixture of poor government policy and incentives, and a failure or inability by corporations to invest in upstream resource development over the last decade. Whilst this will mean that commodity prices are likely to remain elevated for many years to come, it does not mean that inflation will keep rising at higher levels. On the contrary, a higher but steadier level of commodity prices is likely enough to bring on more supply without leading to excessive year-on-year inflation.

**Structurally higher supply side inflation in coming years**

That said, there is likely to be somewhat structurally higher supply side inflation for at least the next several years. This is primarily due to the impact of Covid and the war in Ukraine on global supply chains which has cemented a recognition by western governments and corporations that they can no longer afford to rely extensively on the eastern trading partners for their supply of strategic goods and commodities. The response by China to Covid with its zero-tolerance plan and propensity to abruptly and indefinitely shut down factories at a moment's notice has shown the West that the country has become an unreliable business partner in a complex global supply chain. Furthermore, the war in Ukraine and growing tensions over Taiwan have highlighted how disagreements between nation-states can be highly disruptive to supply chains. These events have exposed the rising risk of geopolitics in a world where growing nations in the East seem intent on asserting their economic and political power and influence over others, especially those from the West. This has led to Western companies starting to re-shore formerly outsourced operations at home or closer to home, where this risk of disruption is significantly reduced.

An example is the U.S. Chips and Science Act, passed in both houses of Congress. This act creates incentives for domestic semi-conductors manufacturing and scientific research. It aims to prevent companies that received funding from expanding their microchip manufacturing in China or other countries of concern. This deglobalisation effort will increase costs into the future as new capital expenditure is required to build these new supply chains and manufacturing plants.

**Interest rates will fall initially in recession and then rebound and settle at slightly higher rates than pre-covid levels**

While we expected inflation to fall and fall soon, we expect it to remain at higher levels for some time. As explained above, supply-side inflation is inevitable, but this component, along with demand-pull inflation, will come down to more manageable levels. Overall, we expect inflation to come down to at least 4% in the medium term but only gradually fall lower after that. This implies that interest rates are likely to find an equilibrium level higher than they were before Covid but at a level that is still manageable for the global economy to grow while high enough to keep inflation under control. We sense that interest rates will probably settle, in the longer term, around 2.5% for short rates and slightly higher at about 3% for long rates. Of course, rates will likely collapse once more as we fall into recession in the U.S. and Europe over the next 3-6 months. Still, we expect them to rebound to these higher levels as we enjoy a more sustainable recovery with inflation kept at bay.

**A great buying opportunity is in the offing**

Given our view on the economy's direction over the next six months and our anticipated view of the Federal Reserve response, including the ECB and other central banks, we believe there is a significant opportunity for investors at this point. We believe the opportunity in Government bonds right now and the growing opportunity in corporate bonds and developed world equities is probably one of the best buying opportunities of the last decade, bettered only by the value offered amidst the investor-led panic and capitulation of the March 2020 and the Covid induced economic recession.

In the table below, Global Macro Insider (GMI) has calculated their proprietary financial conditions index, which historically leads the US ISM PMI by about nine months[4]. It is pointing sharply downwards, suggesting that the US PMI will fall below 45 in the next several months and below 40 by early next year, suggesting a sharp U.S. recession is coming. Interestingly the indicator has turned and is starting to move higher again, suggesting that the U.S. economy will bottom in about eight months, so about March of 2023. Equity markets typically bottom 3-6 months before the real economy bottoms, suggesting the equity market bottom is nearby. Equity markets also tend to bottom when inflation peaks, which is about now in our view.

**Global Macro Insider Financial Conditions Index (9 Month Lead) - US ISM Manufacturing PMI**


Source: www.globalmacroinvestor.com

Furthermore, the strategists at GMI have attempted to show the relative value of different asset classes compared to the business cycle as measured by the ISM PMI based on the rate of change on a year-over-year basis. For example, the table shows that the current pricing on the Nasdaq is synonymous historically with a PMI reading of 42, or a U.S. economy in deep recession. In other words, the Nasdaq is already pricing in a deep recession at current trading levels. It suggests that the S&P is not as cheap and is only currently pricing in a mild recession. The market which stands out as cheap is Government bonds or risk yields. It suggests yields are currently trading at levels equivalent to the US PMI reading of 65 or a very robust economy. Clearly, this is wrong. Risk-free yields should be much lower in line with an economy falling quickly into recession. This is why we have been saying for some months now that bonds, especially Government bonds, look very attractive and that the top in bond yields is most likely a done deal.

**Long-term market technicals suggest we are close to a significant inflexion point**

At ICM, we are primarily fundamental-based, bottom-up investors. Still, we observe macro trends and market technicals to understand when markets may be approaching or at significant inflexion points. The table below examines the price movement of the S&P 500 over the last 20 years.

The histogram below the price chart is called the MACD indicator and tracks price momentum over time in markets and has a strong record of capturing trend changes in price over time. If we look at this indicator on a monthly timeframe to eliminate daily market noise, we can see that we are now at a possible major inflexion point in the market. The size of bars in the histogram measures the change in price momentum from one month to the next, and as the bars turn from red to pink and then to green over time, it indicates that positive price momentum is increasing. It is interesting to note when and how many times we received this signal over the last 20 years. We counted seven times, and generally, all of them were fantastic entry points on the S&P. Of course, the signal can roll over as it did in August 2001, but the reliability of this indicator is notably high given the longer timeframe over which we are making the observation.

**S&P 500 Index**


Source: www.tradingview.com

The indicator further down in the bottom third is called the Stochastic RSI. This measure also tracks price momentum compared to recent averages and indicates when a market is heavily oversold or overbought. Again, this reliable indicator tells us that the market is very oversold on a monthly basis and is likely to enjoy a rebound over the coming months.

In our opinion, a sharp but relatively short-lived recession is coming. The best way to think about it is to imagine it as a growth shock. Even though large parts of the economy remain in good shape, we believe the Federal Reserve will be forced to at least to pause its current tightening posture in the face of these rapidly slowing economic indicators. This pause will lead to a market rally in yields and higher prices for risk assets more broadly. Inflation will show that it has peaked and is set to fall over time. Economic uncertainty will start to wane but only slowly. The

Federal Reserve will probably conclude that it has done enough to quell inflation but may be reluctant to start cutting rates until it is certain that excessive inflation is conquered for the foreseeable future. If economic weakness becomes more entrenched, they may cut rates.

Alternatively, they may do nothing and go on hold indefinitely, believing that the economy can recover and grow sustainably with interest rates around the neutral range without triggering excessive inflation. Either way, these paths point to a rally in risk assets reflecting an environment where oversold risk assets can retrace prices back to levels considered more in line with fair value levels and where valuations can reflect the benefit of future sustainable economic growth free from the threat of runaway inflation. Embrace the big monthly picture, don't get lost in the daily detail.

**Gavin Blessing**
10 August 2022

Source Data: ICM, Bloomberg, Trading View; as of 31 July 2022.
(1) https://www.npr.org/2022/08/06/1115440553/gas-prices-oil-inflation-cost-of-living?t=1659952233336
(2) https://www.nbcnews.com/business/real-estate/us-mortgage-rates-drop-below-5-percent-first-time-in-months-rcna41535
(3) https://twitter.com/charliebilello/status/1554117824876105728?ref_src=twsrc%5Etfw
(4) https://www.globalmacroinvestor.com/