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

JANUARY 2023

Market Review

2022 was a challenging year. Inflation, rates, war and a looming recession, weighed heavily on markets. In December, the S&P 500 fell by 5.9%, the eighth time in 2022 that the Index moved by more than 5% month-on-month.

For 2022, the S&P 500 declined by 19.4%, just short of bear market territory, despite earnings increasing by c. 4%. In December, value stocks again outperformed growth stocks, with the ninth monthly outperformance in 2022. Growth stocks declined by more than 30%, while value stocks fell by just 7.4%, reflecting both the worsening growth outlook and the impact of higher rates on companies with the bulk of their earnings in the distant future. The Forward Price Earnings Ratio ("Forward P/E Ratio") for the S&P 500 fell from more than 21 times at the beginning of the year to 16.5 times at the end of 2022.

The decline in fixed income left investors with no port in the storm. With rising interest rates, long-duration assets experienced significant price declines. The PIMCO 25+ Year Zero Coupon U.S. Treasury Index Exchange-Traded Fund (ZROZ) is the longest-duration bond exchange-traded fund ("ETF") available in the market, with a maturity of longer than 25 years and a coupon rate of zero. It fell by c. 40% in 2022 despite being invested exclusively in "safe-haven" treasuries.

There was some relief from rising rates towards the end of 2022. Between September 2022 and December 2022, interest rates across the curve, except very short end three month Treasuries, were broadly flat. Over the same period, equities rallied, with the S&P 500 rising by 7.5%.

The impact of rising rates on equities is well known. The higher the interest rate on the risk-free asset, i.e. U.S. Treasuries, the higher the return risky assets, like equities, must provide to attract capital. Roughly speaking, for every 1% increase in long-term rates, the equity price must adjust by c. 10%, so the equity market also returns an additional 1%. Given that long-term U.S. rates increased by c. 2% during the year, the S&P 500 decline of 20% reflects the new higher interest rate environment, and the stabilisation of long-term rates in the fourth quarter coincided with an equity market rally. In 2023, we expect rates to continue to be a significant driver of equity markets, albeit we see that lower rates will be supportive of risk assets. The big unknown in 2023 is the length and depth of a potential U.S. recession and the potential impact on corporate earnings, which we discuss in our outlook.

In the U.S., inflation has continued to fall from its peak of 9.1% in June 2022, with a reading of 7.1% in November. Inflation in the Eurozone, which peaked in October 2022 at 10.6%, fell to 9.2% in December.

Market Review continued

Leading economic indicators, such as the ISM Manufacturing Purchasing Managers Index ("ISM PMI"), continue to point to future weakness, with the ISM PMI falling to 48.4 in December from 49.0 in November. Any reading below 50 indicates an expectation of economic contraction.

In December, emerging markets, as measured by the MSCI Emerging Market equity index, fell by 4.1% despite an increase for the index's largest component, Chinese equities. Emerging market equities finished 2022 down by 22.4%. In December, the Chinese Communist Party further relaxed its zero Covid policy. While the spread of Covid since reopening has hampered economic activity, China, like the rest of the world, will likely see a significant increase in economic activity as people embrace their newfound freedom.

As we noted above, 2022 left no hiding place for investors. One of the hardest hit asset classes was European government bonds, as measured by Barclays Euro Aggregate Government, which fell by 18.5% for the year. The U.S. Treasury bonds, measured by the Barclays U.S. Aggregate Government Index, fell by 12.5% in 2022. Investment Grade credit, as measured by the ICE Bank of America U.S. corporate index, and High-Yield credit, as measured by the ICE Bank of America high-yield index, fared comparatively well, only falling by 15.4% and 11.2%, respectively. As we said above for equities, we believe that interest rates will be supportive, or at least not destructive, for risk assets such as corporate bonds in 2023. However, recession and the path of earnings will also play a major role in determining returns.

In summary, 2022 was a dreadful year across asset classes, and we expect that very few portfolios exited the year unscathed. However, we would like to highlight a few points that hopefully bring some solace going into 2023. Government Bonds which have offered so little return for so long, are now paying significant income. Ten-year U.S. Treasuries now yield 3.875%, the highest rate in over a decade. Even ten-year German Bunds are paying 2.5%, having paid less than 1.0%, and sometimes even a negative yield, for the better part of a decade. Furthermore, the S&P 500 is almost 20% cheaper in a year where earnings grew by c. 4%. So for long-term investors focused on cash flow, the bang for the buck is significantly better coming into 2023 than it was in 2022.

Market Outlook

As we enter 2023, there is probably no more significant determinant on markets and the economic path ahead than that of U.S. inflation and the Federal Reserve's response to it with a view to bringing inflation back down to its longer-term target of 2%. We have a rather unusual situation where economic data is deteriorating, with U.S. manufacturing on the precipice of a recession, and yet we still have a seemingly very hawkish Federal Reserve. At this point in the business cycle, historically, the Federal Reserve would typically be about to start cutting interest rates if it had not already begun.

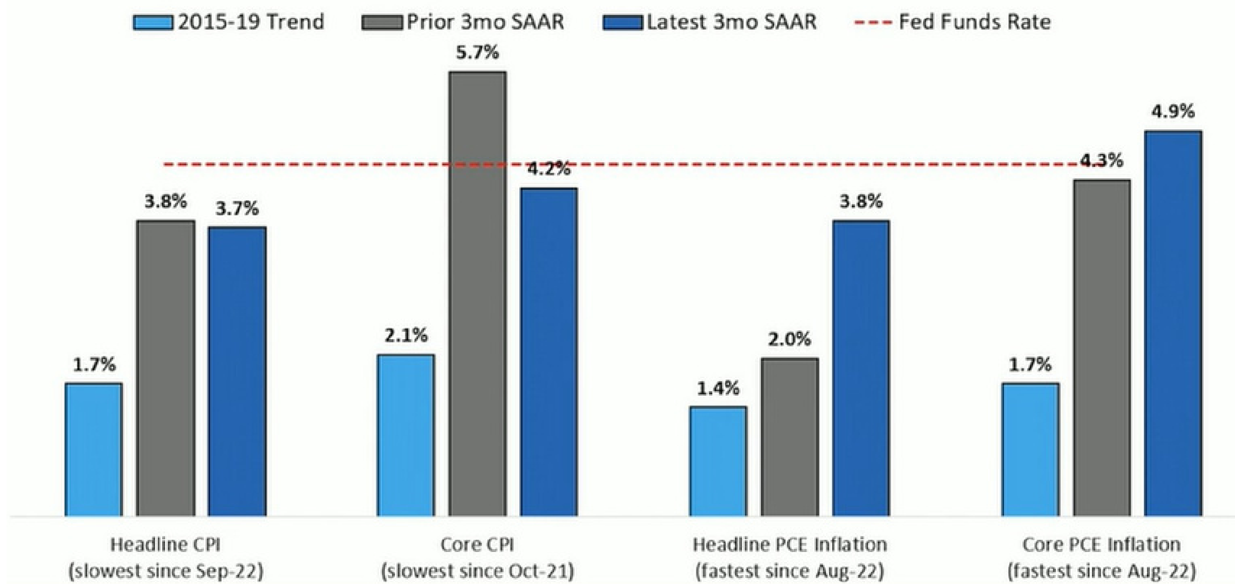
The last US CPI report in December showed that annual inflation has now fallen to a run rate of 7.1% year over year, with core inflation falling to 6.0%. While the readings were better than expected, they are still at very elevated levels and higher than where the Federal Reserve, as recently as September, expected inflation to be at year-end 2022. Hence the Federal Reserve is still laser-focused on keeping financial conditions sufficiently restrictive to return inflation to its 2% target.

U.S. Inflation is falling quickly at the margin

The good news is that indications show that U.S. inflation has peaked. Let's look at the average inflation readings for the last three months that ended November on an annualised basis (rather than examining inflation on a year-over-year change). We can see that inflation is falling rapidly at the margin. Interestingly the following chart by '42 Macro' shows that annualised measures of inflation, both the Consumer Price index (CPI) and Personal Consumption Expenditures (PCE), continue to fall at pace[(1)]. Core CPI is now running at around 4%, and downward momentum strongly implies it is likely to fall further. January's inflation data will likely continue to show evidence of declining inflation momentum. Indeed, the monthly pace of CPI inflation could be flat or negative while the core CPI print could annualise near the Fed's 2% price target.

Market Outlook continued

Seasonally Adjusted 3 Month Annualised US Inflation (CPI and PCE)



Source: 42 Macro

It is interesting to note that these measures of annual inflation are now below the Fed Funds rate. As we have mentioned, the Federal Reserve will likely want to see the inflation rate fall below its Fed Funds rate. Historically this measure has been an appropriate yardstick to gauge the level of the Fed Funds rate required to contain inflation over time. This relationship broke down in 2021 when inflation started to rise rapidly in anything but a transitory manner. Now that this yardstick is back in place, it will lead the Federal Reserve committee the reassurance they need that they have done enough to permanently quell inflation and protect the long-term reputation of its members. It is undoubtedly a signal the Federal Reserve will interpret as confirming that its Fed Funds rate is close to being sufficiently restrictive to bring inflation back down to 2% on a sustained basis.

Edging very close to a Federal Reserve pause

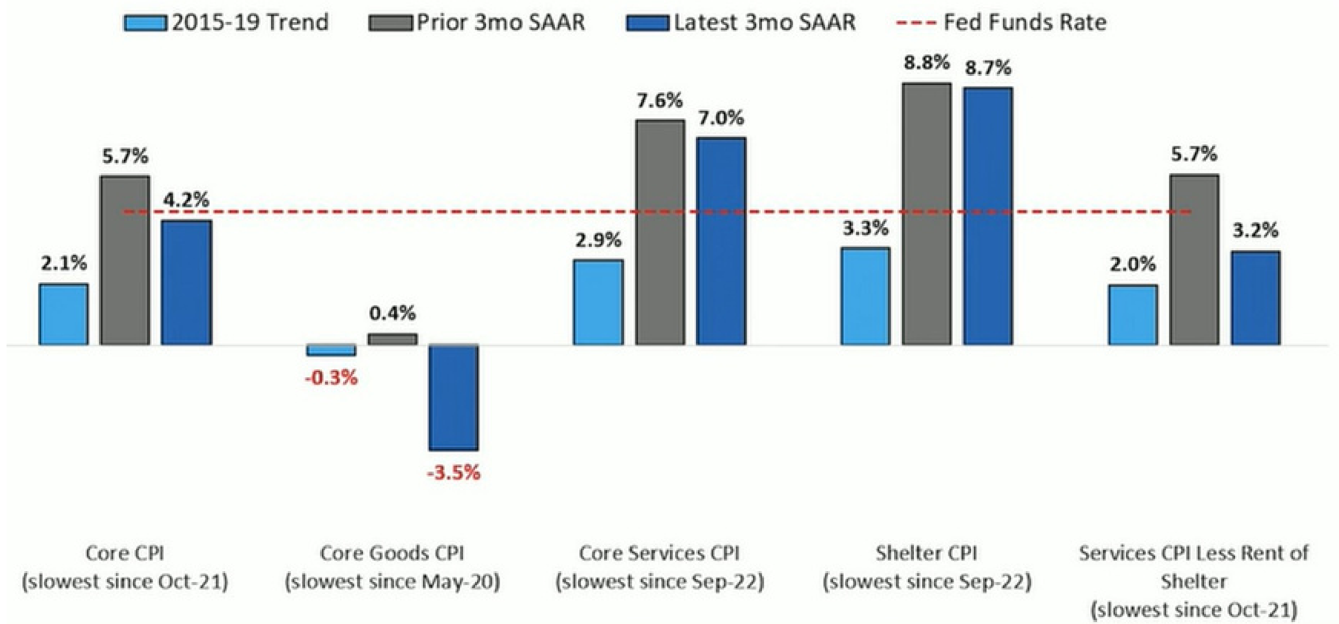
The Federal Reserve has indicated that while it believes its monetary policy is restrictive, it still needs to be sufficiently restrictive. The Federal Reserve's dot plot from December 2022, which asks each FOMC Committee member to opine where the Fed Funds rate is likely to be at different points in time, shows the median rate at the end of 2023 at 5.1%. There is substantial unanimity around this median rate prediction, which suggests that committee members have a solid consensus that we will see another three rate hikes of 25bps each during 2023 needed to bring the current rate up to that level. In contrast, pricing in the bond market suggests that the Fed funds rate could easily top out just below 5% requiring only two more rate hikes this year in February and March.

We agree with the market assessment that only two further rate hikes will be forthcoming. Despite the Federal Reserve's concerns about continued strength in the labour market and the possibility that financial conditions might start to loosen too quickly, we predicate our view on the marked slowing in inflation in recent months combined with the recent ISM Purchasing Manager Index reading for December at 48, indicating that U.S. manufacturing has entered a recession. This weaker data combination will likely convince the FOMC members that conditions are sufficiently restrictive to return inflation to its 2% target. The markets and Federal Reserve policymakers believe we are close to peak rates on a six-month view. Of course, there is a risk that consumer spending remains more robust for longer. Therefore, the Federal Reserve could feel compelled to march rates even higher than currently expected, but that is not our central case expectation. Furthermore, we have always maintained that once the Federal Reserve goes on hold, they will likely not feel the requirement to increase rates again in the current cycle.

The path toward Federal Reserve rate cuts

So as the question around the terminal rate level becomes less contentious, the debate is now moving on to how long we will need to stay at this terminal level before the Federal Reserve feels ready to cut. We know the Federal Reserve will only cut rates once it believes inflation is on track to fall to its 2% target in a sustained manner. To gauge when this might occur, it is helpful to break inflation down into three broad buckets: goods, housing-related services or shelter and, finally, non-shelter-related services.

Seasonally Adjusted 3 Month Annualised US Inflation by Bucket

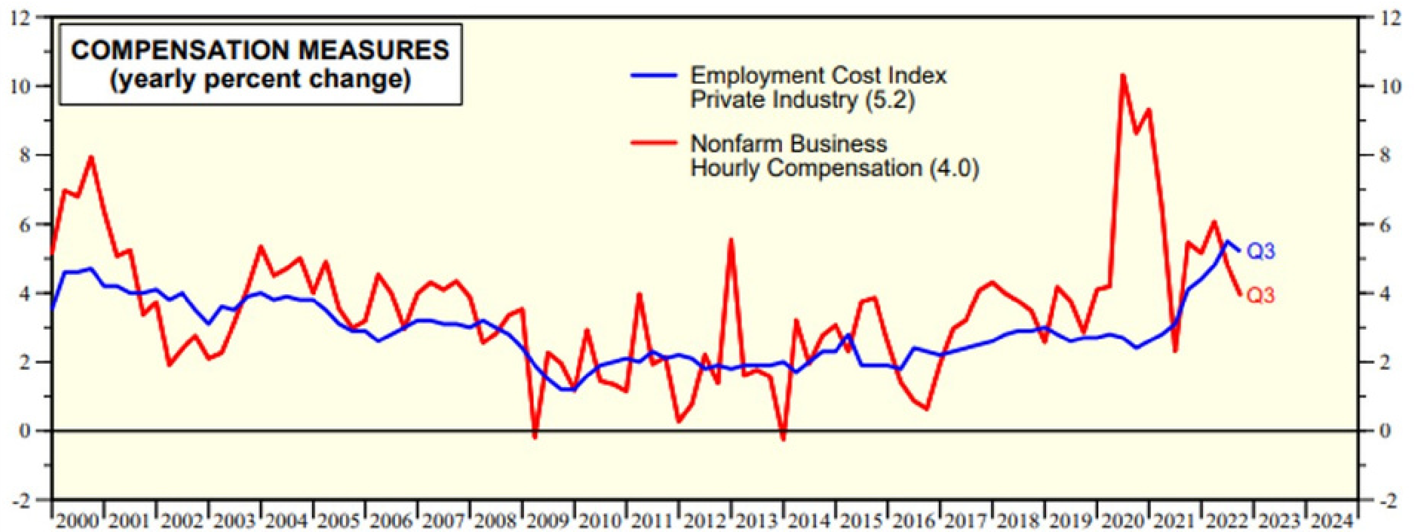


Source: 42 Macro

The table above has helpfully done this for us and then annualised the latest 3-month averages to calculate current running inflation in each bucket. Goods inflation has been dis-inflating quickly and has turned outright deflationary in recent months. Shelter CPI is now beginning to turn from very high levels, and as we work through the first half of 2023, this momentum will only increase. We know this because this measure lags actual shelter inflation by several months, and we know that 'real-time' rents and house prices in many parts of the US are already in decline. This will soon show up in the CPI measurements. Finally, non-housing related core services, which account for about 55% of the PCE core inflation index, are primarily a labour market function. This is the component that most concerns the Federal Reserve at this juncture, as the other two broad buckets are currently deflationary or will invariably begin recording increasing disinflation. The Federal Reserve believes the labour market is extremely strong and is still displaying unusually elevated levels of bargaining power and strong job growth despite the level of interest rates already pushed through. It believes that the vacancy level is still too high, symptomatic of an imbalance in the market between supply and demand of labour caused by many factors related to the pandemic. In their view, wage increases are still running at a level inconsistent with a 2% inflation target, even allowing for standard productivity increases of 1-1.5% over time. As a result, the Federal Reserve is concerned that this element of inflation will take a substantial period to get down. At the same time, we recognise this concern, the table above shows that inflation in the services ex-shelter bucket has turned and appears to be coming down on a last 3-month average annualised basis.

Furthermore, if we look at the US private sector employment cost index and average hourly earnings in the chart below, we can see that a turn in general wage inflation does appear to be happening[2].

U.S. Employment Cost Index & Non-Farm Business Hourly Compensation



(4)

Source: Yardeni Research, Inc

Despite this positive momentum, general wage inflation is likely one of the critical factors determining the length of time the Federal Reserve deems it necessary to maintain interest rates at the terminal level before cutting again.Currently, the Federal Reserve believes wage inflation will remain stubborn, resulting in it having to hold interest rate policy at a restrictive level for a sustained period and probably into 2024. Indeed, no members of the FOMC see the Federal Reserve cutting interest rates in 2023. The Federal Reserve is reconciled with the fact that it will probably take a recession or a sustained period of below-trend growth and some softening of labour market conditions to moderate demand and get wage inflation down to a level more in line with its target. Indeed, in their most recent Summary of Economic Projections report, the Federal Reserve sees the unemployment rate reaching 4.6% by the end of 2023. They believe this level will be consistent with a 3.5% wage growth level, which, allowing for annual productivity gains, would be consistent with a 2% inflation rate. The bad news is that to get unemployment up to this range from its current level of 3.5%, history tells us that a recession is almost certainly needed. According to Alpine Macro research, their study shows that, over the last 70 years of U.S. economic history, every time the unemployment rate increases by 1/3rd of 1 per cent, a recession has followed[(3)].

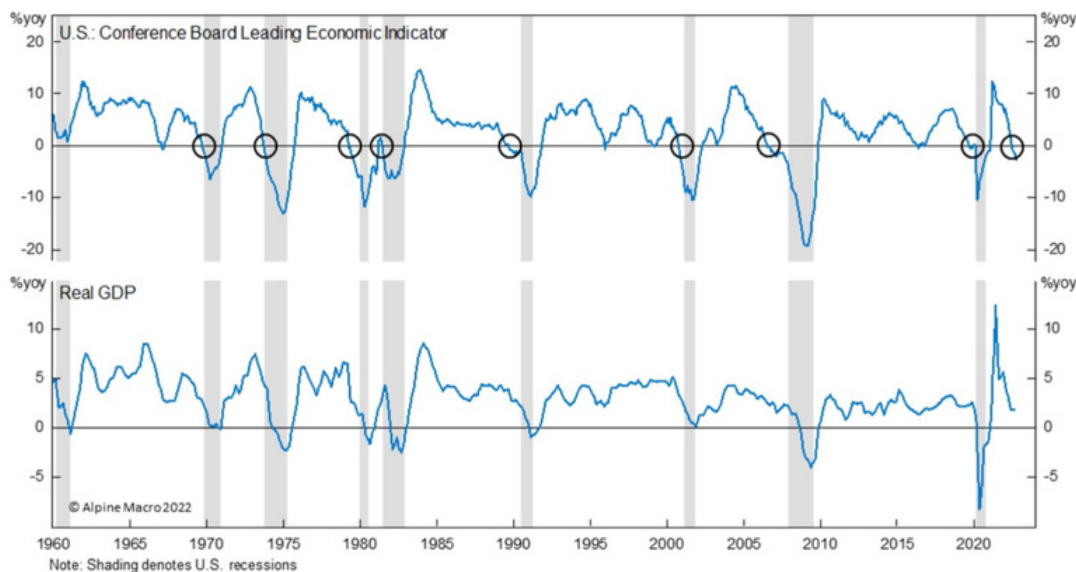
We anticipate the Federal Reserve will begin cutting rates once they are convinced that inflation is sustainably moving down to the 2% target. This implies they will be willing to cut rates once they believe it is all but assured that falling momentum would bring inflation down to this target. For this to occur, we need the number of job openings to fall and unemployment to rise. Typically a broad-based economic recession would achieve this. Still, given the apparent tightness in U.S labour markets underpinning consumption, it is not guaranteed that we will get such a recession anytime soon. The latest Job Openings and Labour Turnover Survey (JOLTS) data, which measures the number of job vacancies, showed that in November, there were 10.45 million open jobs and only six million unemployed workers. It is logical to conclude that the unemployment rate has remained low because there are approximately 1.7 vacancies for every unemployed person. Before the pandemic, the ratio was closer to 1.25. The Federal Reserve wants this ratio to return to its pre-pandemic balance before considering cutting.

U.S. Job Opening versus U.S. Unemployed Workers

Source: Bloomberg

It is clear that, in addition to slightly higher unemployment, we also need to see personal spending soften, which is the most significant component of the economy. Falling spending and a weakening jobs market is usually synonymous with a recession. As we know, most leading economic indicators are now pointing towards recession. Moreover, the best internal market indicator of a future recession is also present in the form of an inverted yield curve.

U.S. Job Opening versus U.S. Unemployed Workers



Source: AlpineMacro

As we can see above, the US Conference Board Leading economic indicator has an excellent track record in predicting recessions ahead of time. This indicator is a broad-based measure of 10 underlying economic variables that tend to move before changes in the overall economy. Historically, a recession has followed every time the broad measure has gone negative year-over-year. Counterintuitively this is good news. To satisfy the Federal Reserve's prerequisite for a cut in rates, we need below-trend growth and some softening of labour market conditions or, in other words, a recession. A recession might be bad news for corporate earnings and general corporate creditworthiness. Still, it will allow the Federal Reserve to feel comfortable that inflation is on a sustained path lower. This will herald a new economic reset where interest rates can be lowered to a point where the economy can eventually revert to a steady equilibrium of trend growth without runaway inflation. This indicator has turned negative since September 2022, and typically we would not have to wait more than several quarters before we enter recession territory after this tipping point. However, there is a complication this time around. As the job

market remains strong, given the excess of jobs over the available supply of workers, wages and personal consumption are rising. So, while it is still more than likely that we will enter recession territory in Q2 or Q3 this year, it must be acknowledged that the U.S. could skirt a broad-based recession and experience weak growth instead.

The critical scenario requirement for rate cuts
It is this combination of a slow or contracting economy, a weakening labour market and weaker consumer demand that the Federal Reserve Committee members will be looking for before they entertain cutting rates. With the Federal Reserve playing hardball, stating they will stay the course until price stability is restored, we may be in for an extended period where rates are pinned at the terminal rate. It will depend on the job market's strength and personal consumption. Suppose the jobs market weakens more quickly, and we slip into recession. In that case, the Federal Reserve can presumably start cutting rates earlier than expected in the early to middle second half of 2023. On the other hand, if the jobs markets remain solid and the US avoids a classic recession, rate cuts may not come until late in 2023 or 2024. We can say with more certainty that, based on history, when the Federal Reserve starts to cut, it is likely to cut rates quickly. Indeed, we could see 2-3% of rate cuts within nine months.

The inevitability of rate cuts
We believe the Federal Reserve will inevitably begin cutting late this year or in 2024. We believe this because inflation is likely to fall substantially, and therefore, real interest rates will rise to problematic levels if nominal interest rates are not eventually cut. Moreover, given the debt accumulated over the last several decades by successive governments, private entities, and individuals, it is doubtful that the U.S. or the global economy can thrive with high levels of both nominal and real levels of interest. As a result, we estimate that the long-term sustainable level of real interest rates is likely to be around 0-1%, much lower than our estimate for real interest rates by the end of this year and next year if nominal interest rates are not cut.

Of course, the path to the Federal Reserve's first rate cut could be frustrated and possibly elongated by several factors. As discussed above, if the U.S. economy avoids a recession, this will delay the time to a first cut. Other risks that could arrest the pace of falling inflation are a rapid easing in financial conditions, such as improving equity markets or a weaker dollar, and the reopening of China bolstered by stimulative economic and monetary policy, which have already started in earnest. There is also the small matter of FOMC members' reputations. After believing the beginning of this inflationary upswing was purely transitory, they certainly do not wish to compound their first error with a second by cutting too early only to see inflation rise again. This bias will probably push the Federal Reserve to an extreme in ensuring they have done enough to kill inflation. Hence, they are likely to wait longer before cutting than they should. Nonetheless, if any of these risks materialise, it will probably only delay the first rate cut by several months, pushing cuts into 2024.

Now that we have laid out our best view of the bigger economic picture for 2023 and how it might play out with its associated risks, let's investigate its implication for markets.

Implications for markets
2023 will be a good year for risk assets in general. It will be a positive year overall for investor returns despite plenty of expected volatility as markets grapple with the uncertainty around weakening U.S. economic data and stubborn U.S. wage inflation. In simple terms, both developed and emerging equity markets will be broadly higher, most government bond yields significantly lower and corporate bond spreads, notably higher quality issuers, on balance tighter. We also suspect the U.S. Dollar will trend downwards, subject to the occasional rallies when uncertainty arises around stubborn U.S. wage inflation and other geopolitical risks.

Equities should benefit from lower inflation and lower yields over time. With the U.S. economy gradually resetting to a more sustainable growth footing and reduced uncertainty around interest rate policy, the longer-term corporate earnings outlook should be positive. Of course, in the interim, as the economy transitions to trend growth and moderate inflation, markets and corporations will have to cope with the adjustments of a temporary rise in unemployment and a fall in consumption demand leading to the possibility of lower earnings. Hence, we recognise the potential volatility caused by the counter-prevailing forces of falling earnings in the short term but more stable and assured earnings growth in the longer term.

Given that we have already seen a significant and meaningful decline in equity valuations in 2022, together with our view that any slowdown in spending is likely to be shallow and short rather than deep and extended, it would suggest that conditions are ripe for higher equity gains over time. This is especially true when the market will soon experience less hawkish and possibly more accommodative monetary policy over the next 12-18 months. From a technical perspective, investor positioning is still very short and bearish coming into 2023, which is positive for markets if we get any good news. This suggests that we could see a strong start for capital markets in the first few months of the year as inflation cools and consensus forms that the Federal Reserve is close to pausing its rate-hiking cycle. Of course, we could see lower earnings revisions, but if this is already priced in and investors are positioned this way, we could see an anti-consensus rally in markets. Inflation peaks tend to coincide with equity market bottoms and better-performing markets.

As inflation falls during the year and as pressure relents on the Federal Reserve to keep conditions restrictive, we are likely to see lower longer-term bond yields, which will be positive for government and high-quality corporate bonds. Suppose the economic slowdown is not so deep and not so long. In that case, corporate credit quality, which will go weaker, should be able to avoid the worst and remain relatively robust, allowing for relatively stable and slightly tighter spreads from current levels. While credit spreads generally do not look overly attractive, there are still many individual bond opportunities within the market, especially when the potential for strong total returns is high, given the likely combination of falling yields and tightening spreads.

Since last October, we expect the weakening trend in the U.S. Dollar will likely continue. The DXY, or dollar index, is now trading below its 50-week moving average, suggesting that this trend will stay intact, albeit with plenty of volatility. Moreover, the relative yield advantage over other currencies, which the U.S. Dollar enjoyed for the last year or more, will soon near a peak as the Federal Reserve starts to loosen monetary policy as its battle with inflation nears an end well ahead of other major regions, such as the UK or the Eurozone. This will lend itself to a weaker U.S. Dollar over time but will be positive for all other risk assets, not emerging market equities. As inflation falls and interest rates come down, real yields will eventually fail too. This will be unambiguously good for Gold and commodities, which a reopening Chinese economy will also support.

In summary, while we can make a case for positive performances across most risk assets in 2023, there still needs to be more certainty, not least the risk of lower earnings revisions and a hawkish Federal Reserve wanting to exert as much pressure as possible on stubborn wage inflation. On balance, the Federal Reserve will win out, but it may require that interest rates be pegged at higher interest rates for longer, especially as financial conditions continue to ease.

We suspect we could see better-than-expected performance across risk assets in the first half of the year, followed by weakness in the third quarter as markets price in a more elongated cycle before the Federal Reserve is willing to start cutting rates. However, falling to low inflation, lower longer-term bond yields, improving economic growth outlook, and the potential for renewed monetary stimulus late in 2023 and into 2024 should provide the foundation stone for a continued and broad rally across risk assets again towards the end of 2023 and into 2024.

Gavin Blessing

11 January 2023

Source Data: ICM, Bloomberg, Trading View; as of 31 December, 2022.

[1] https://42macro.com/

[2] https://www.yardeni.com/

[3] https://alpinemacro.com/

Risk Warning

This document is intended solely for use by professional investors and advisors. Opinions expressed whether in general or both on the performance of individual securities or funds and in a wider economic context represents the view of the fund manager at the time of preparation and may be subject to change without notice. This document may refer to past performance which is not a guide to current or future results. All statements in this document, other than statements of past performance and historical fact, are "forward-looking statements". Forward-looking statements do not guarantee future performances. This document should not be interpreted as giving investment advice or an investment recommendation. It is produced solely for information purposes only and may not be copied or distributed without expressed permission. The information in the title banner is as at 30 September, 2022. Issued and approved by ICM Limited.