FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.6** BILLION	**US$9.4** BILLION

ICM Monthly Outlook

AUGUST 2024

Market Review

US short-term interest rates, measured by US three-month treasuries, broke out in late July, falling to 5.28%. They had been range-bound between 5.33% - 5.46% for the previous twelve months. This trend continued after the end of the month, with rates falling as low as 5.18%.

US one-year treasuries yielded 4.74% at the end of July, down from 5.11% the previous month. This is not the first time that US one-year treasuries have fallen rapidly in this cycle. Previously, rates declined significantly in March 2023 and January 2024, but increased again when a softening of economic data and rapid inflation cooling failed to materialise.

Further out the yield curve, US interest rates declined too, with US 10-year treasuries falling by 37bps to 4.03% from 4.40%, and US 30-year treasuries falling by 26bps to 4.30% from 4.56%.

The yield curve remains inverted, with US two-year treasuries, 4.26%, continuing to yield more than US 10-year treasuries, 4.03%. The yield curve inversion has been rapidly falling from more than 100bps a year ago, to 50bps in June, to 23bps at the end of July and almost zero in early August. As a reminder, a yield curve inversion has historically been an excellent predictor of a recession. The recent yield curve inversion is the largest since 1980 and has lasted longer than any inversion in history.

As measured by the Bloomberg US Treasury Index, US Treasury bond prices increased by 2.2% during the month and are now up 1.3% this year.

Having cut interest rates in June, the European Central Bank (ECB) opted to hold rates steady in July and said that September remained wide open. Unsurprisingly, short-term rates remained steady, with the German three-month treasuries yielding 3.32% at the end of the month, similar to the yield at the beginning of the month.

Like the US, the yield on longer-dated eurobonds had sharp declines, with the yield curve largely flattening but for the nearest maturities.

As measured by the Bloomberg Euro Government Index, European Government bonds increased by 2.2% in July and are up 0.3% in 2024.

The Euro strengthened against the US Dollar for only the second time this year, increasing by 1.1%. The significant currency move was the Japanese Yen, as it surged by 7.3% in July. We highlighted early this year that the Yen had lost one-third of its value against the US Dollar since the end of 2020. The Yen rebound in July reflected an increase in Japanese rates bouncing firmly out of negative territory, coupled with a decline in US rates.

Market Review continued

The S&P 500 increased by 1.1% in July, hitting a new all-time high. Interestingly, tech and communications, considered interest rate-sensitive sectors, were significant underperformers in the month, losing 2.1% and 4.2%, respectively. The Nasdaq lost 0.8% in July.

In July, European Equities, as measured by the Eurostoxx, fell by 0.4%. Year to date, European Equities are now trailing US Equities with returns of 7.8% versus 15.8% for the S&P 500. UK Equities, as measured by the FTSE 100 Index, increased by 2.5%.

The Japanese Nikkei remains one of the top-performing indices this year, up 16.8%, despite a fall of 1.1% during the month. A hawkish-sounding Bank of Japan spooked markets in early August, sending the Yen soaring and the Nikkei tumbling with an expectation of higher future Yen interest rates.

Emerging Market Equities, as measured by the MSCI Emerging Market Equity Index, increased by 0.8%. As measured by the Hong Kong Hang Seng Index, Chinese equities were down 2.1%.

As measured by the Bloomberg Commodity Index, commodities fell by 4.5% on growth concerns, with oil declining by 6.6%, natural gas by 21.7%, and copper by 4.9%. Gold continued to hit new all-time highs, rising by 5.2% to USD 2,447.6 per ounce.

In July, spreads in US investment-grade corporate bonds remained flat at 96bps. As measured by the ICE Bank of America US Corporate Index, US Investment-Grade Corporate Bonds rallied by 2.4%, mainly driven by falling rates.

Spreads in US high-yield bonds widened from 321bps to 325bps during the month. Like investment-grade bonds, US high-yield bonds benefitted from declining interest rates during the month.

Market Outlook

For some time now, we have been bullish on the outlook for risk assets, a view that has primarily played out. Since January 2023, high-yield bonds are up 18.8%, global equities have returned 41.8%, the S&P 500 47.3%, US Tech 95.6%, and Bitcoin a massive 257.5%.

Firmly held views can often fall victim to confirmation bias, the tendency to interpret new information in such a way as to confirm existing beliefs. We have enough humility to realise that we are not immune.

After such a strong rally, now seems like an ideal time to revisit our bullish thesis on risk assets.

Goldilocks explained
We all know the story about Goldilocks, the three bears, and the girl who liked the porridge, the chair, and the bed that were “just right.” Those familiar with financial markets have their version of Goldilocks or “just right” economic conditions. There can be some variation, but generally, they include good or accelerating economic growth coupled with slower inflation (disinflation).

Inflation explained
Let's start with inflation. Inflation is the general increase in the price of goods and services in an economy. A little bit of inflation is good. It encourages consumers and businesses to purchase today rather than wait and pay more tomorrow. It is also much better than deflation, the general decrease in the price of goods and services in an economy, which leads to a delay in purchasing decisions and a rapid decline in economic activity.

High or unpredictable inflation is also bad, as businesses and consumers struggle to make long-term financial decisions because prices change rapidly and erratically. For this reason, central banks usually target low but positive inflation, generally c.2.0%, aiming to provide consumers and businesses with predictable operating conditions.

Furthermore, central banks will rectify high inflation by raising interest rates. While this helps slow inflation, it also makes borrowing more expensive. Higher interest rates lead to reduced consumer spending, lower business investment, and a potential economic slowdown or recession.

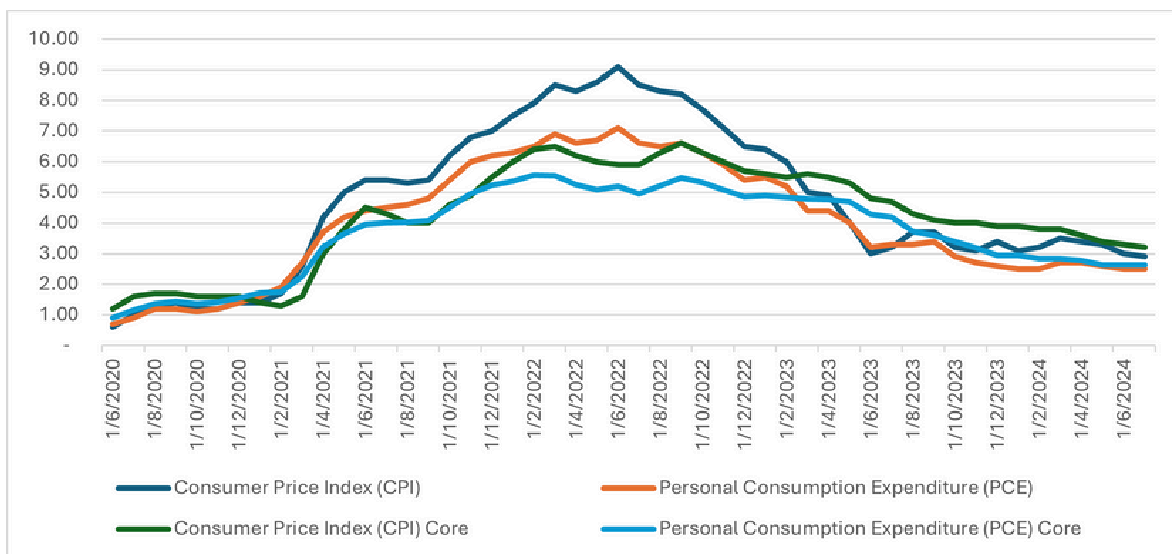
The Goldilocks economic scenario ideally involves inflation close to 2.0% but can also include inflation above 2.0% but decelerating towards 2.0% (disinflation).

Maybe a final point to explain before diving into the data is that inflation is different for everyone. A retiree will experience inflation differently than, say, a student. A parent with college-going children will experience inflation differently from a young single professional. This is why inflation can often seem like a spaghetti alphabet of names from CPI to PPI to PCE. It can include regular, core and super-core. Frequently, people will exclude items to fit their narrative; see the Biden administration in 2021 when they said that inflation was driven by the increase in the cost of used cars and would be temporary. It is not just politicians who misread inflation; the US Federal Reserve, responsible for controlling it, misread inflation for most of 2021 when they insisted it was temporary.

Inflation, the big picture

So, let's step back and identify the wood from the trees. Regardless of which measure we use, inflation is clearly slowing and is getting extremely close to the Federal Reserve's target of 2.0%. Rather than getting caught up in the details of month-to-month inflation moves, let's see inflation for what it is ... low, falling, stable, close to targets, and offering businesses and consumers a degree of certainty about the future economic environment.

Core US CPI / PCE Inflation



Source: ICM, Bloomberg

Furthermore, the Federal Open Market Committee (FOMC) estimates inflation to be 2.8% in 12 months. The Cleveland Fed predicts inflation of 2.3% in 12 months. Treasury Inflation-Protected Securities (TIPS) market pricing shows inflation at 2.3% in five years. Truflation, a blockchain measure of inflation that tracks over one million items, is running at 1.7%.

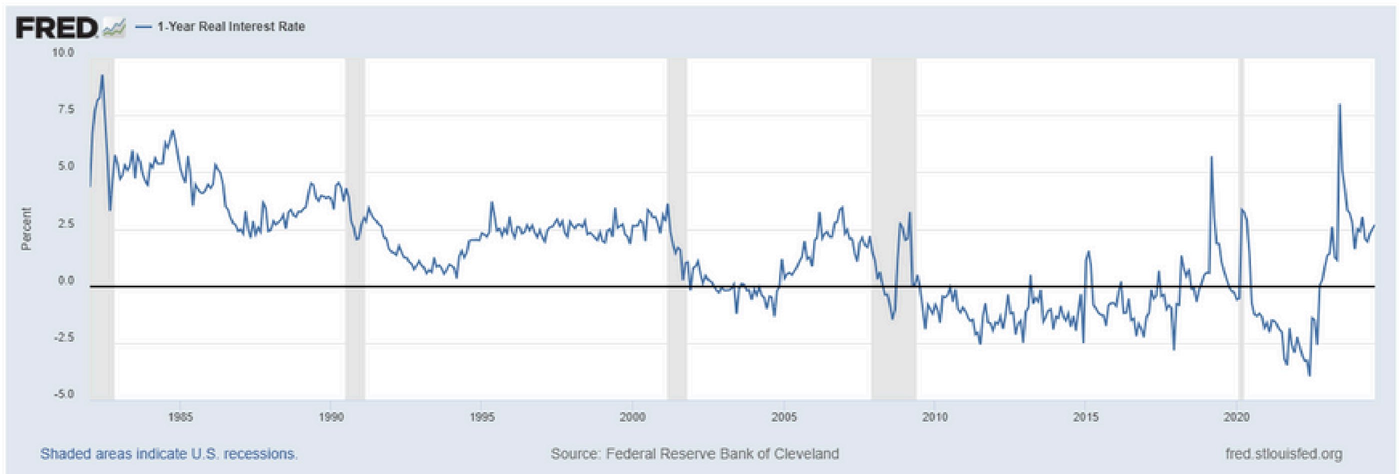
We believe falling inflation has supported risk assets and will continue to do so.

How will the inflation rate feed into interest rates

Despite the clear disinflationary trend, the US Federal Reserve has remained steadfast in its hesitancy to reduce interest rates. Having moved too slowly in 2021 to increase interest rates, they do not wish to be caught out again in reducing rates too quickly or ultimately too deeply, despite the evidence that they have sufficient scope to do so. They are now running the risk of being too restrictive for too long.

The Federal Funds rate, at 5.5%, remains way in excess of the inflation rate. Real interest rates, the prevailing short-term interest rate minus the current inflation rate, remain incredibly high by recent historical standards.

Real Interest Rates



Source: St Louis Federal Reserve

In his testimony to Congress in July, US Federal Reserve Chairman Jerome Powell outlined that a weaker labour market was now as much a risk as higher inflation, drawing attention to the US Federal Reserve's dual mandate of curbing inflation whilst maintaining full employment. Powell commented that "the labour market appears to be fully back in balance" and "[that the job market was no longer] a source of broad inflationary pressures for the economy".

In June, the Federal Reserve published its summary of economic projections, which disclosed the following median expectations for year-end 2024: unemployment of 4.0%, PCE Inflation of 2.6%, Core PCE Inflation of 2.8% and Federal Funds rate of 5.1% (indicating a little more than a single 25bps cut between June and December 2024).[1]

Since then, unemployment has increased to 4.3%, PCE Inflation has fallen to 2.5%, and Core PCE Inflation has fallen to 2.6%. Against this backdrop, it seems highly unlikely that the year-end target of 5.1% for the Federal Funds rate will remain intact. In fact, there is potential for as many as two cuts (or 50bps of cuts) in September as the Federal Reserve tries to pre-empt some expected economic weakening and get some of its heavy lifting done ahead of the US Presidential election.

As of mid-August, futures markets are already pricing in four cuts (100bps) in 2024 and another four more in 2025. For risky assets to get a material boost from declining interest rates, the fall will likely need to be sharper or deeper than the market has already priced. Despite this, we see the risk here as slightly skewed to interest rate cuts coming faster than expected (have rates ever come down any other way?) and limited risk of rates remaining at current levels.

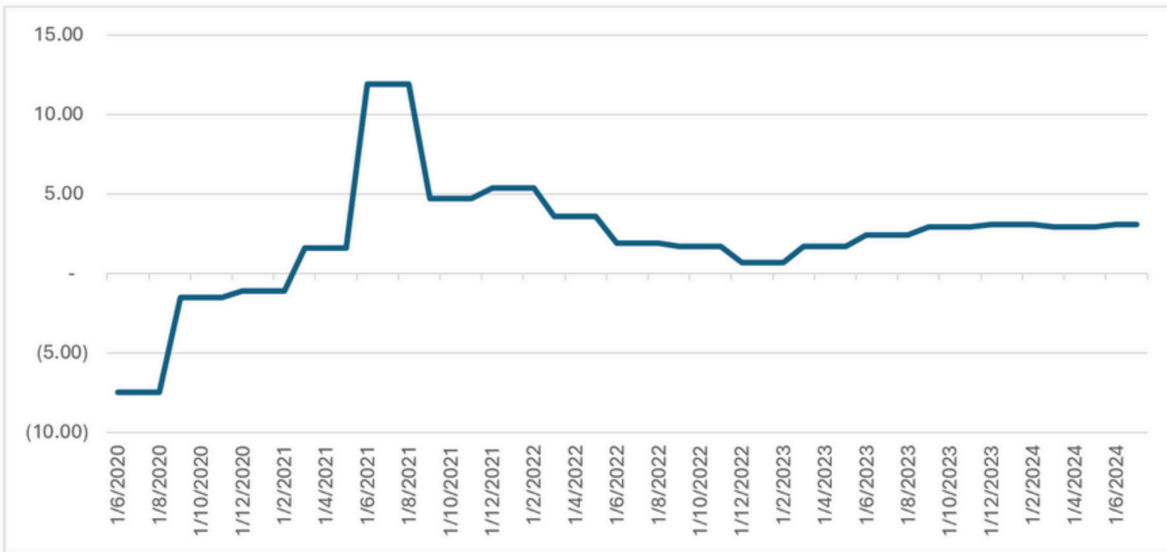
Therefore, like inflation, we see interest rates as supportive for risky assets over the medium term.

However, falling inflation and interest rates are just one side of the equation. Accelerating economic growth is also required to foster Goldilocks-like economic conditions.

Economic growth, the big picture

Post-COVID growth peaked at 11.9% in Q2 2021. Growth then slowed, without ever contracting, until Q4 2022, when it expanded by just 0.7% over the previous twelve months. Since then, economic growth has been growing at an increasingly faster pace, and it has grown by 3.1% for the 12 months ending Q2 2024.

US Real GDP Growth 2020-2024



Source: ICM, Bloomberg

The trend shows increasingly faster growth, although acceleration has slowed over the past several quarters. The critical question is whether the economy has turned and whether we should expect slower growth or even a recession. In terms you have probably heard before in the media, this is framed as the "soft landing" versus the "hard Landing" debate.

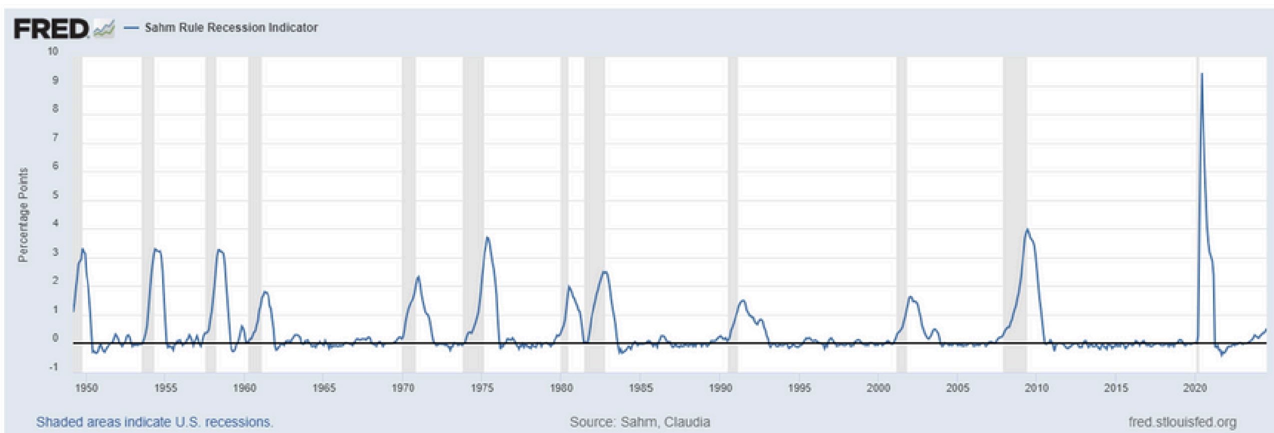
Employment data

We touched on unemployment, explaining that the softening in the labour market was good for lower interest rates, and it is. However, like the story with the three bears, economic data can be neither too hot nor too cold for risk assets to rally. Put another way, while bad news has been good news as inflation has fallen and the likelihood of rate cuts has increased, eventually, bad news, if there is simply too much of it, will become plain old bad news.

The recent unemployment rate increases to 4.3% have been appreciably higher than the estimated 4.0% that the Federal Reserve had forecast just a month earlier for year-end 2024. Furthermore, the increase in unemployment breached the Sahm rule when it hit 0.5. As many may know, recessions are not known in real-time and are generally only determined after the fact. Claudia Sahm developed the Sahm rule as a measure that could flag recessions in real-time, allowing policymakers and financial market participants to react accordingly. The Sahm rule has flagged every recession correctly since the 1950s. It indicates a recession when the average unemployment rate over the previous three months is more than 0.5% higher than the minimum unemployment over the last twelve months. This indicates that the unemployment rate is accelerating faster and that worse is likely to come.

However, an increase in the size of the jobs market, rather than an outright loss of jobs, seems to be driving the Sahm rule breach.

Sahm Rule Recession Indicator



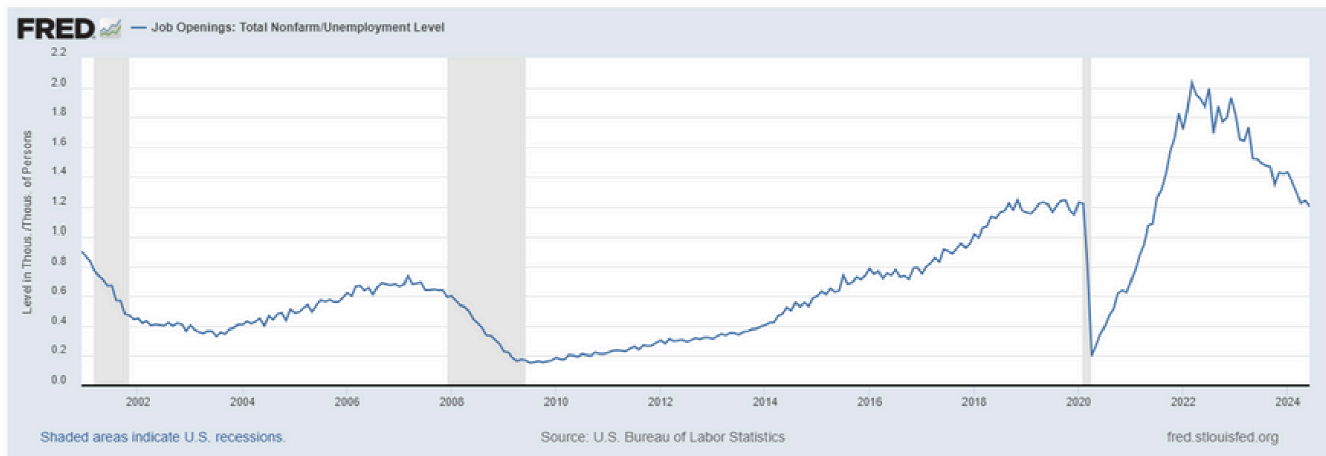
Source: St Louis Federal Reserve

Other employment data has also shown a weakening. Initial jobless claims have been gradually creeping higher in 2024. The most recent 26-week average shows 223k initial claims per week versus an average of 211k in March. Continuing claims, too, have recently seen an uptick. Having risen from 1.3 million in June 2022 to 1.8 million in August 2023, continuing claims plateaued here until May 2024 but have recently risen to approach 1.9 million.

In addition, the ratio of job openings to unemployed persons has declined. Having peaked at 2.0 (two job openings for every unemployed person), it has gradually fallen over the past few years, hitting 1.2 in June 2024, more or less in line with the number before the pandemic.

Like the Sahm Rule, this points to a gentle weakening of economic growth and merits caution rather than outright panic.

Job Openings to Unemployed Persons

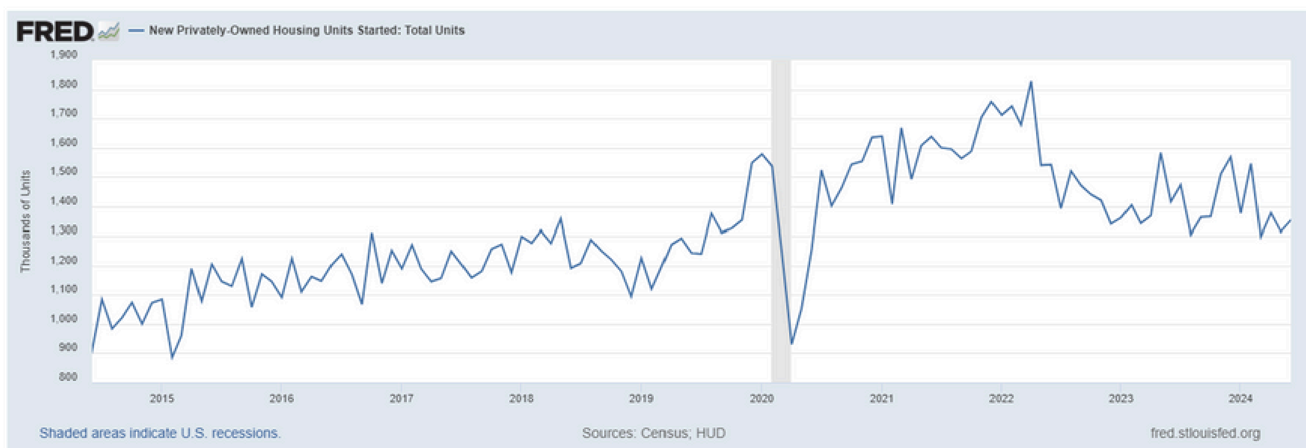


Source: St Louis Federal Reserve

Other leading indicators

Housing starts in the US have continued to decline, with July's running at an annualised rate of 1.2 million, down from more than 1.8 million in April 2022. While the data is weakening, it is still very much aligned with economic expansion rather than recession.

US Housing Starts

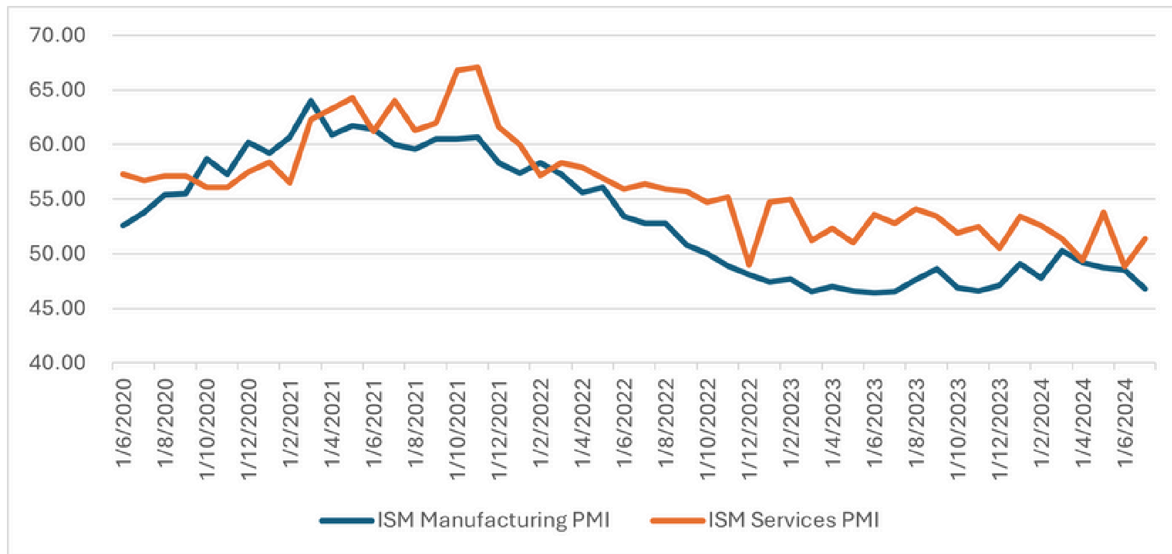


Source: St Louis Federal Reserve

The ISM Manufacturing Purchasing Managers Index (PMI) has also been pointing towards a weakening in economic conditions, falling to 46.8 in July. A reading above 50 means that there are more purchasing managers with a positive outlook than a negative outlook, while a reading below 50 means that there are more managers with a negative outlook than a positive outlook. July's reading of 46.8 would imply a negative outlook for the manufacturing sector.

The ISM Services PMI improved to 51.4 from 48.8 in June, indicating a slightly positive economic outlook for services purchasing managers.

ISM PMI



Source: ICM, Bloomberg

While the economy is slowing down, it is slowing in an orderly fashion. Even the leading indicators pointing to a slowdown come with caveats. For instance, the ISM themselves state, "A Manufacturing PMI above 42.5 per cent, over a period of time, generally indicates an expansion of the overall economy." The breach in the Sahm rule outlined above appears to be driven more by new job market entrants rather than any significant pickup in layoffs.

Economic growth, like inflation and interest rates, continues to support risk assets. Therefore, in our opinion, we remain in a Goldilocks-like environment, even if our conviction has weakened somewhat.

Valuations and market implications

We started this month's letter by reviewing the performance of risk assets since January 2023. As a reminder, High-Yield bonds are up 18.8%, Global Equities have returned 41.8%, the S&P 500 47.3%, US Tech 95.6%, and Bitcoin is up 257.5%. We did not arbitrarily pick January 2023 as a starting point. Since January 2023, markets have been buoyed by the twin tailwinds of increasing growth and slowing inflation, or in other words, the Goldilocks period.

While we continue to believe that we are in the Goldilocks period, we recognise that it is maturing and could be in its later stages. Therefore, we remain vigilant to risk, particularly overpaying for assets.

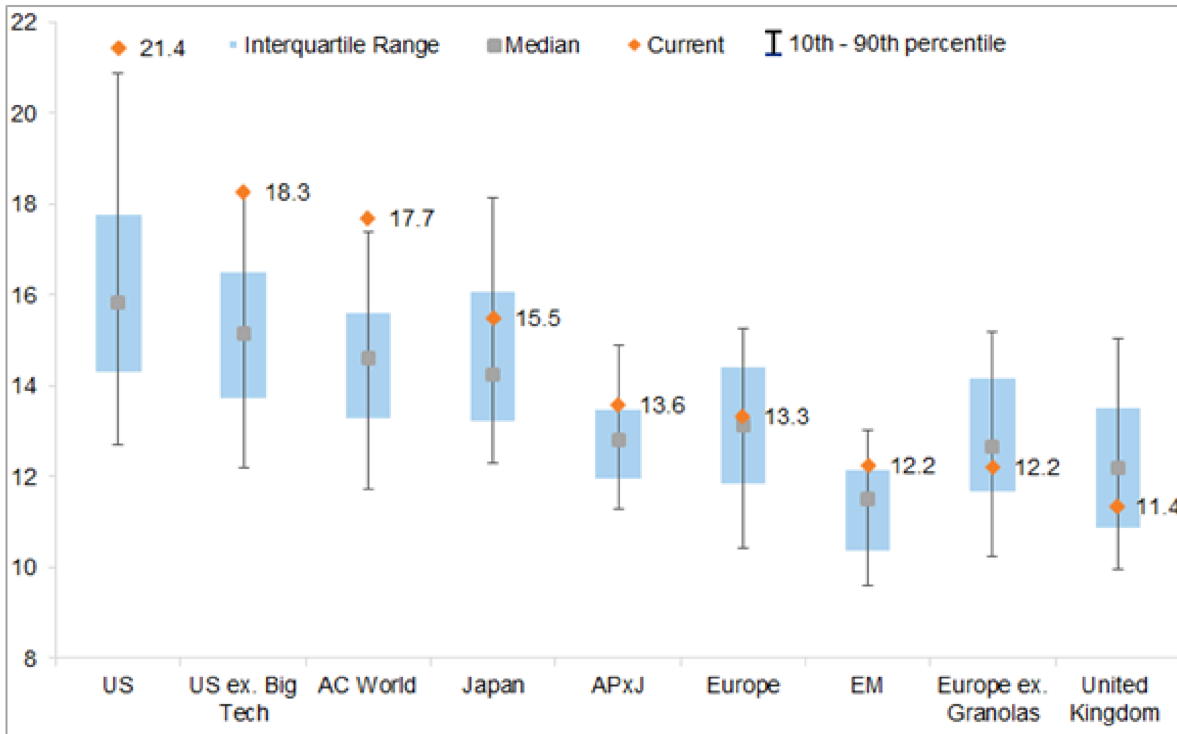
US Equities currently trade at a multiple of 21.4x forward earnings.[2] Relative to history, this is at the extreme end of the range and well above the 90th percentile of forward price-earnings ratios for US Equities. Furthermore, the forward price-earnings ratio is based on earnings that are c.12% higher than today's earnings. Anything less than 12% earnings growth over the next twelve months will disappoint and make today's valuations look even more extreme. Public equities can outstrip overall economic growth for a time, but there are limits.

Furthermore, while we believe in artificial intelligence's potential to lead to massive productivity gains and drive growth, in the short term, we think its utility may be overstated. According to Demand Sage, monthly website visits to ChatGPT have fallen from 1.8 billion in April, to 260 million in June 2024.[3]

We remain positive on US Equities overall, but our conviction is decreasing based on valuations. While growth stocks are richly valued, other areas of the market, such as small caps, cyclical, and value stocks, have more convincing upside, especially as the Federal Reserve embarks on a journey of monetary policy easing over the next several quarters and possibly years.

Other major equity markets are more reasonably valued relative to the US and its history. However, the growth outlook is lower outside of the US. Still, we remain more positively disposed to Equity markets of developed countries outside of the US on the basis that there is more pessimism priced in, and so more margin of safety if growth slows more than we currently expect.

12-month Forward Price Earnings Multiples versus last 20 years

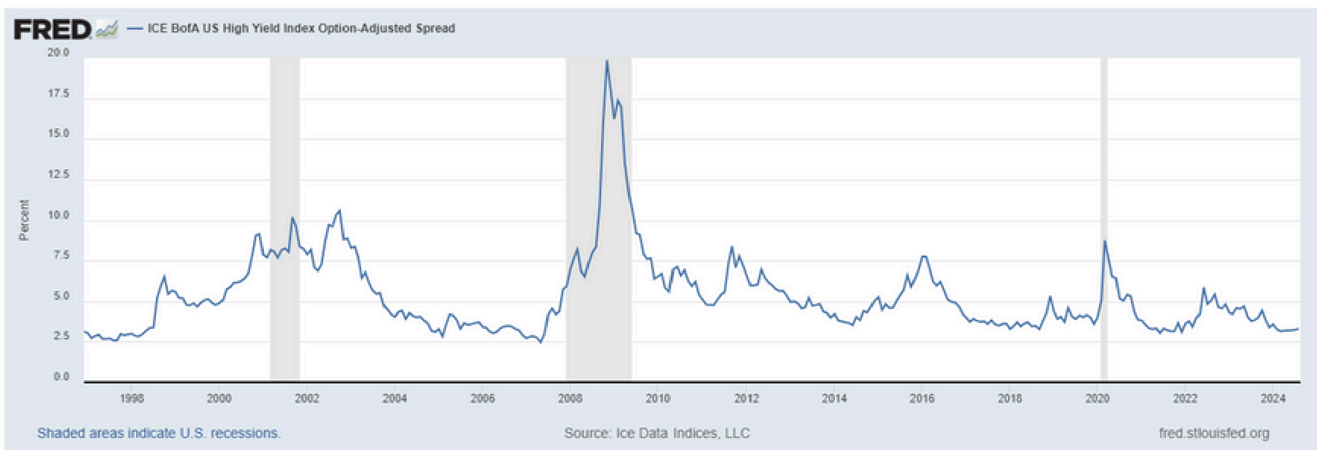


Source: Goldman Sachs Global Investment Research

We continue to like emerging market equities on a valuation basis.

Other risk assets, too, remain expensive relative to historic levels. For instance, High-Yield credit spreads, the additional yield pick-up that investors receive above treasuries for investing in lower-rated companies, were trading at 325bps at the end of July, i.e. extremely tight relative to history. That said, we believe shorter maturity or duration corporates are attractive as overall yields are generous relative to history and relative to their fundamental credit risk in the short to medium term.

US High Yield Credit Spreads



Source: St Louis Federal Reserve

As noted previously, real rates have rarely been so lucrative for investors, and we are happy to overweight short-term sovereign debt here.

We are also happy to overweight at the longer end of the yield curve, although less so than at the shorter end, as the yield curve is likely to shift from its inverted shape today to a more normal upward-sloping one through a bull steepening, where short-end rates are pulled down by interest rate cuts.

Against the backdrop of slower growth, we see some downside to the oil price, although, as we have previously pointed out, given the supply constraints, we believe this is limited.

Ben Hannigan
19 August, 2024

Source Data: ICM, Bloomberg as of 31 July, 2024.

1. https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20240612.pdf
2. Goldman Sachs - Global Equity Views
3. https://www.demandsage.com/chatgpt-statistics/#:~:text=Top%20ChatGPT%20Statistics,are%20from%20the%20United%20States.

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