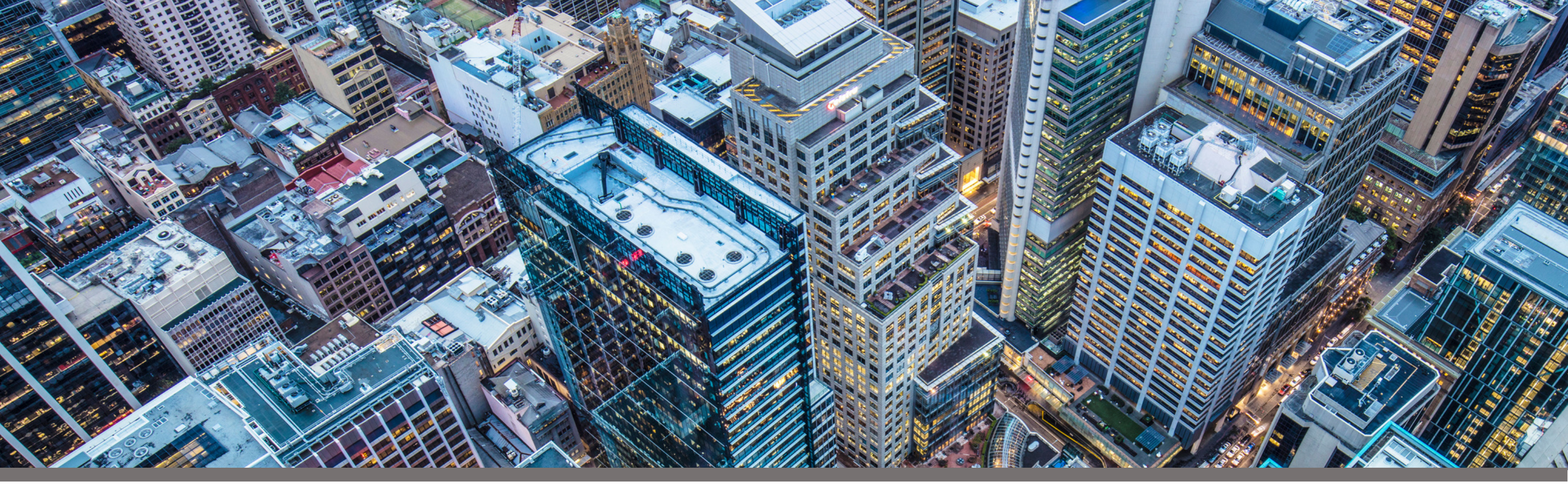


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.8** BILLION	**US$22.9** BILLION

ICM Monthly Outlook

OCTOBER 2023

Market Review

The US Federal Reserve held rates steady in September. This was the second meeting in the last three where the US Federal Reserve has decided to leave rates unchanged. Having raised rates by 5.0% in the 14 months to May 2023, the Federal Reserve has increased rates by only 0.25% over the five months since. Officials at the Fed continue to issue warnings that the inflation fight is not over and higher interest rates are forthcoming. However, our read is that increases in the Federal funds rate will be extremely limited in scale relative to what we have seen so far. In September, US three-month treasuries increased by just 0.01%.

Of more concern now are yields at the longer end of the curve. During September, US three-year treasuries increased by 0.24%, US 10-year treasuries increased by 0.46%, and the US 30-year treasuries increased by 0.49%.

The yield curve inverted in October 2022, as the yield on US three-month treasuries rose above the yield on US 10-year treasuries. In the months following, the yield curve became ever more inverted as the yield on US three-month treasuries rose to 5.38% in May 2023 from 4.06% in October 2022. Over the same period, the yield on 10-year treasuries fell to 3.64% from 4.05%. This divergence reflected the market view that while the US Federal Reserve would continue to increase rates at the short end of the curve, longer-term rates would fall as inflation came under control and the economy potentially fell into a recession.

Since the end of May, we have witnessed a rapid increase in the longer-term rates, with the yield on US 10-year treasuries increasing to 4.57%. The yield curve, which had been inverted by 1.75% at its most inverted, is now inverted just 0.87%. We expect the yield curve to normalise over the coming months, with longer-term lending earning a premium over shorter-term lending. As Fed governor Chris Waller rightly pointed out, "financial markets are tightening up, and they are going to do some of the work for us".

Not surprisingly, given the increase in interest rates, the S&P 500 fell by 4.8% in September. The S&P 500 fell 3.3% during Q3 2023, its first negative quarter since Q3 2022, but remained up 13.1% in 2023.

For the 12 months ended September 2023, headline inflation was 3.7%, the same rate of increase from the previous month. This is up from a low of 3.0% in June 2023. However, core inflation continues to fall to new lows, hitting 4.1% in September, its sixth monthly decline and its lowest reading since 2021.

ISM Manufacturing Purchasers Manager Index ("PMI") read 49 in September, up from 47.6 in August and its low of 46 in June. As a reminder, a PMI reading of greater than 50 indicates growth, while a reading of less than 50 indicates contraction.

In last month's letter, we highlighted the recent increase in energy prices. Energy prices continued to increase in September, with oil up 9.7% and natural gas up 5.8%.

Market Review continued

European stocks also fell in September, with the Eurostoxx 50 falling by 2.8%. Europe outperformed the US by 2% in September but remains neck and neck year to date.

In the UK, the FTSE 100 increased by 2.4%, primarily driven by energy stocks but also by financials.

In September, emerging markets, as measured by the MSCI Emerging Market Equity Index, declined by 3.1%. Year to date, emerging market equities are flat, with significant gains in Brazil, India, Taiwan and India being offset by a substantial decline in Chinese equities so far this year.

In September, European government bonds, as measured by the Barclays Euro Aggregate Government Index, decreased by 2.1%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, decreased by 2.5%.

Investment Grade credit, as measured by the ICE Bank of America US Corporate index, decreased by 2.4% and High-Yield credit, as measured by the ICE Bank of America high-yield index, decreased by 1.2% during the month.

Market Outlook

JK Galbraith, the famous economist, once said, "The only function of economic forecasting is to make astrology look good". Indeed, the one certainty about forecasting is that it will give you plenty to be humble about. It is fair to say that the ongoing strength of the US economy since the Federal Reserve embarked on its programme of tighter monetary policy has been underestimated by most market participants.

Given we have experienced the most aggressive and rapid tightening of US monetary policy in four decades,[1] we would have expected more significant economic weakness by now. Of course, we can speculate as to why this has not happened. Economic demand has undoubtedly been supported by an unprecedented level of US Government fiscal stimulus, initially through the pandemic stimulus payments and more recently through the triad of the Inflation Reduction Act, the CHIPS Act and the Green Act. Consumer demand has certainly exceeded expectations. Consumer demand has probably been supported by excess savings built up from pandemic supports and extended by continued job market strength. The job market continues to benefit from the significant fiscal spending under the government spending programmes.

With the two arms of government policy, fiscal and monetary, working in opposite directions, economic activity is slowing but not by as much as might have been expected using historical forecasting models. Having raised the Federal Funds rate by 525 basis points in less than two years, this aggressive tightening has led to monetary conditions now being restrictive, probably even very restrictive, which is evidentially putting downward pressure on economic activity, hiring, and inflation. Yet such is the implied boost from fiscal spending, economic demand, and consumer spending is softening but at a slower rate than ordinarily expected. So, while the key goals of the Federal Reserve remain on target with inflation coming down and the labour market coming more into balance, the economy is not as weak as anticipated, and unemployment is not ratcheting up as quickly as predicted.

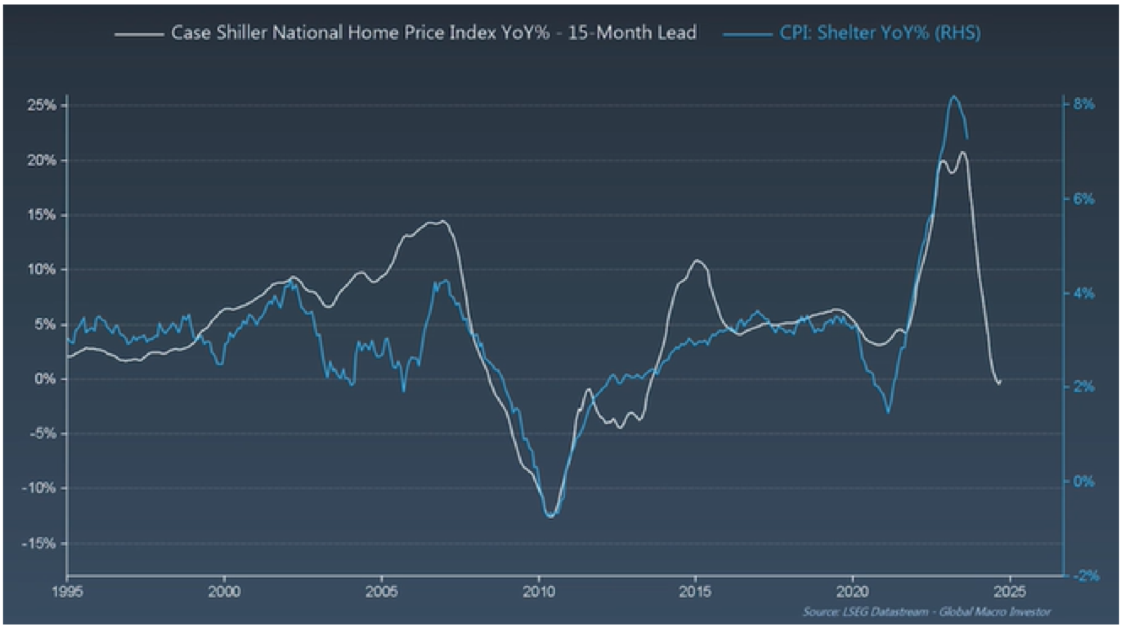
This is probably new territory for the Federal Reserve. It is trying to decipher an apparent dichotomy where the economy is experiencing falling inflation, yet there is still decent economic growth and a relatively robust labour market. Whilst inflation is falling, core PCE (Personal Consumption Expenditures) prices still rose 3.5% over the year to August. Excluding the volatile food and energy categories, core PCE prices rose 3.9% over the same period. Given that the Federal Reserve is unquestionably committed to bringing inflation down to its 2% goal over time, it is now becoming more evident that the committee is going to want to remain on hold for a much more extended time unless something within the financial sector of the economy breaks (i.e. more bank failures) or the labour market or economic demand falters abruptly and significantly from here. Given the underlying strength in the economy and the natural inflation bias that this supports, the Federal Reserve's instinct will be to stay at current high rates for longer.

While the Federal Reserve could decide that a further rate hike in November is justified, we believe such a move is unlikely based on the incoming economic data. This is because we believe the Federal Reserve is correct in its view that monetary policy is already sufficiently restrictive to bring inflation down over time. We will continue to see this happen as we move through the end of this year and most of next year.

Market Outlook continued

Shelter costs, the largest component of reported inflation, is only now starting to rollover

Case Shiller US Home Price Index (YoY%) – 15 Month Lead versus CPI Shelter YoY%



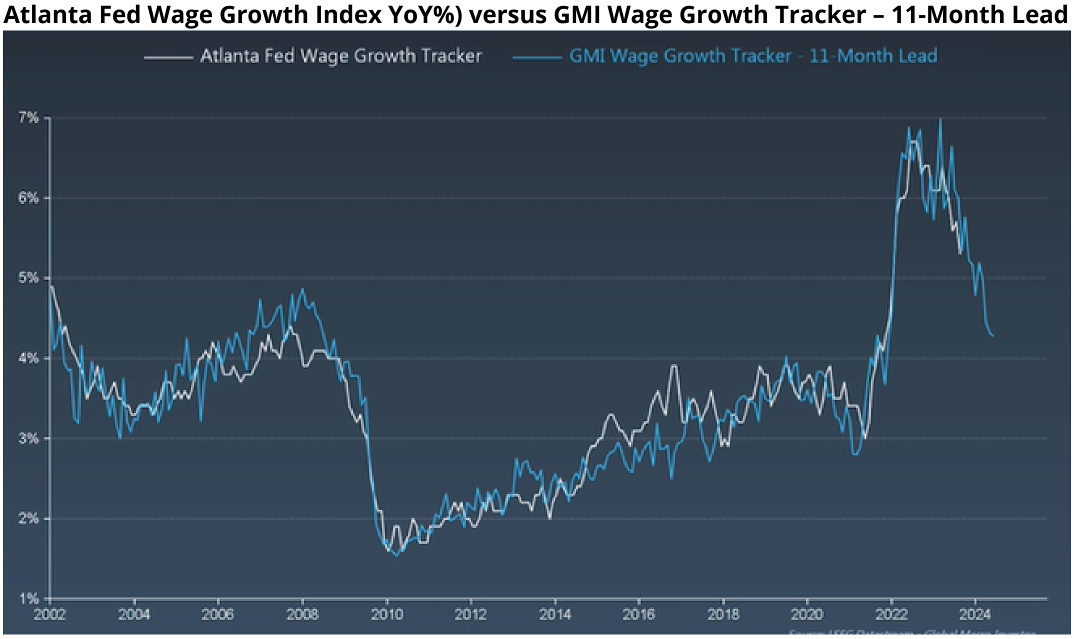
Source: Global Macro Investor

As the largest single component of core Consumer Price Inflation (CPI), comprising 40% of the core CPI measure, shelter costs or rents are only now beginning to turn, as seen in the chart above. Given how this data is collected and reported by the Bureau of Labor Statistics, this component of core CPI significantly lags the actual, on-the-ground, observable inflation rate. This component will continue to make substantial downward contributions to core CPI inflation well into 2024 and even into 2025.

Wages and Salary Costs lag the business cycle and have much further to fall

Like rents, wage and salary costs take time to show up in inflation numbers. As the chart illustrates, leading indicators suggest that wage costs will continue to fall as we move into 2024 and possibly beyond. The most recent jobs report for September confirmed that the labour market rebalancing is happening. While hiring momentum is strong, the average hourly earnings fell further to 4.2% annually and 3.4% on a last 3-month annualised basis. This level is very close to compatible with the Federal Reserve's 2% inflation target, given the assumed annual productivity growth of around 1.5%.

Atlanta Fed Wage Growth Index YoY%) versus GMI Wage Growth Tracker – 11-Month Lead

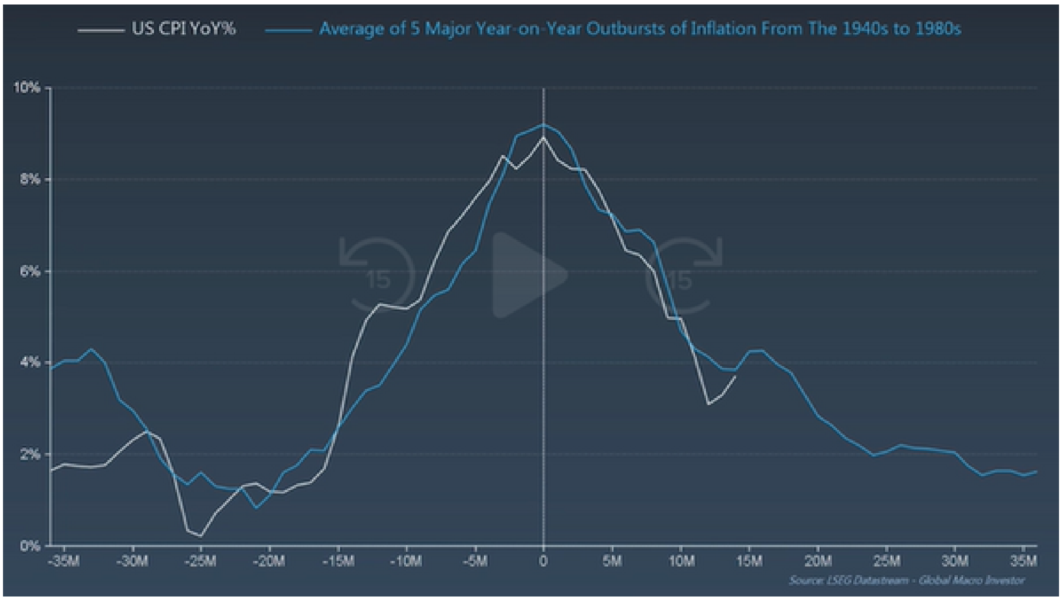


Source: Global Macro Investors

The recent pickup in headline US inflation does not herald the end of this disinflationary cycle
Surprisingly, strong economic growth this far into a period of aggressive monetary tightening is probably not the only concern for the Federal Reserve. While headline inflation had been decelerating for over a year, it has recently started to turn up again, even though core inflation continues to fall. This has caused some market participants to worry that the inflation problem has not yet been resolved and that the Federal Reserve might have to continue hiking. This is probably part of the recent spike in longer-dated Treasury bond yields and the bear steepening in the yield curve we witnessed in late September and early October.

As we have consistently said, headline and core inflation will continue to fall. Indeed, we think it is expected to see a bounce in headline CPI around this stage of the slowdown/recovery. The next chart shows the current path of US inflation since its peak last year. It compares current inflation to the average inflation timeline experienced by five different instances of major US inflation breakouts from the past.

US CPI YoY% versus Average US Inflation Breakout Timelines



Source: Global Macro Investor

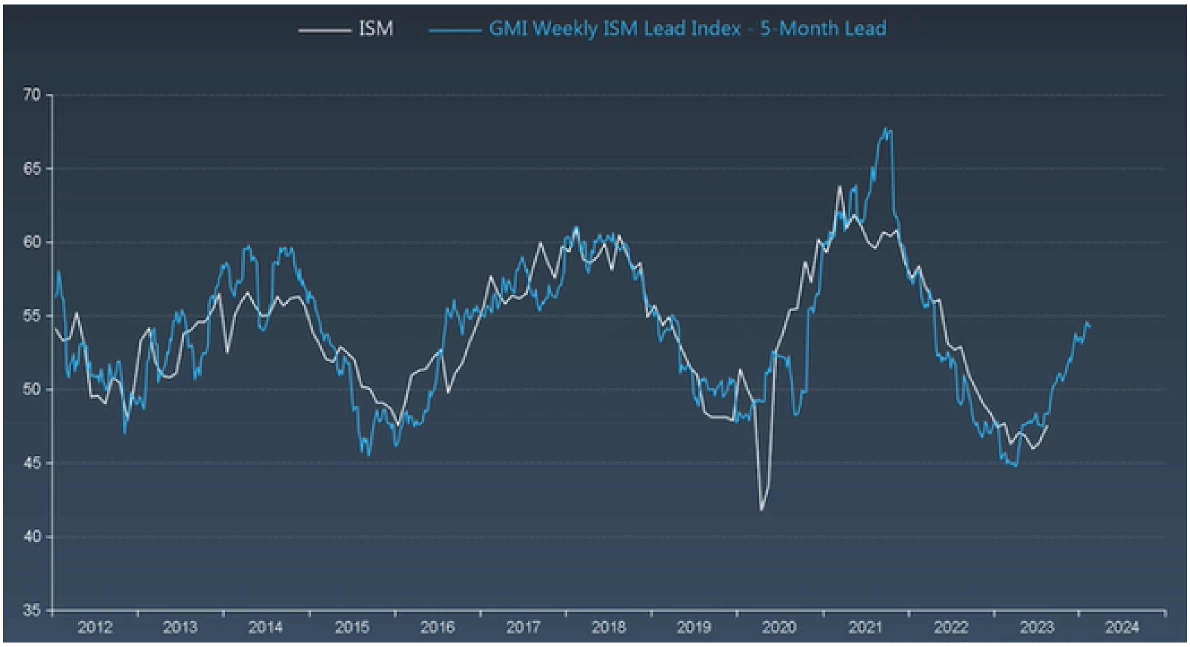
The chart on the left above shows the surplus of US job openings over the number of available workers, using several measures, including the JOLTS report. It clearly shows that the excess supply of job openings is now materially lower since the beginning of the year and much more in line with historical averages or pre-pandemic levels. In theory, this should relieve pressure on wage inflation and cool the overall labour market as it becomes more balanced.

We can observe that around 12-15 months after the peak in inflation, it is common to experience a bounce in inflation, which can last for several months before the significant downward trajectory in inflation typically recommences. On deeper analysis, this phenomenon is caused by faster moving and smaller weighted components of CPI, such as commodities, where, about now, prices start to pick up in anticipation of the turn in the business cycle reflecting the probability of increasing future demand. This has the effect of temporarily boosting the overall CPI number. However, the slower-moving, heavier-weighted components of inflation, namely shelter and the passthrough of wages, will continue to exert downward pressure on CPI. Eventually these components will reassert themselves as the faster-moving commodity price components start to decelerate once more. Hence, reported CPI typically rolls over again, and the disinflationary trend continues, as seen in the chart. These lag effects of inflation explain why central banks only tend to start cutting interest rates 18 months to 2 years after a recession or business cycle low and not earlier.

While we are convinced that inflation will continue to fall, we think the Federal Reserve will hold policy at a restrictive level until they are confident that inflation is moving down sustainably toward its objective of 2% inflation. This confidence will be based on the totality of the incoming economic data and the consistency and sustainability of the trend pointing towards achieving its objective. The Federal Reserve is no longer given to taking anything for granted. This lesson has been learnt. It wants clear evidence that its objective will be met and that the battle to restore price stability is won before it starts to ease its policy stance.

The business cycle is turning and will begin to improve over the coming year
As we pointed out last month, we believe the business cycle, as measured by the US ISM Manufacturing Index, seems to have bottomed and is now on an improving trajectory. Whilst this index is not yet measuring over 50, the point at which the manufacturing economy is considered to be expanding, it does indicate the economy is rebounding off its lows and that manufacturing activity is starting to pick up. Indeed, when we look at the forward-looking indicators of this index, it does suggest that the U.S ISM index is set to gain a reading of 50 and above in the coming months.

US ISM Manufacturing Index versus GMI Weekly ISM Lead Index (YoY%) – 5 Month Lead

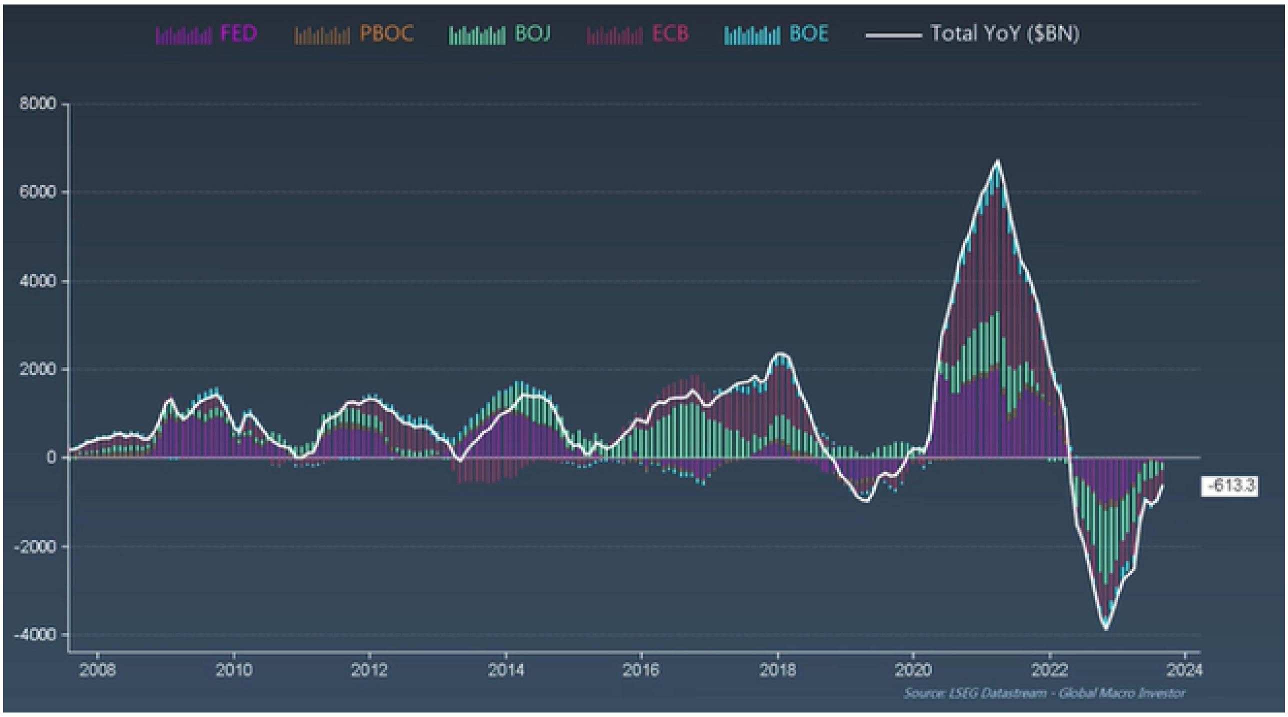


Source: Global Macro Investor

We believe any further slowdown or looming recession will be short-lived, barring some calamitous events in financial markets or the financial sector. We also suggest that this potential future inflexion in economic growth has caused U.S Treasury yields to spike higher as the bond markets reassess the implications for the Federal Reserve's ability to contain inflation and the need for yet higher interest rates. It is also why we believe the Federal Reserve is not likely to ease interest rates significantly until inflation is observed to be back, firmly and sustainably, in the 2% target range. This might take longer than the mid-summer 2024 time point that the market has currently priced in.

We have previously discussed global liquidity's importance in determining asset price direction. Generally, as liquidity increases, risk asset prices tend to do well as more dollars and other fiat currencies are available to chase assets. The opposite is also true. There has been a lot of discussion in recent times suggesting that falling levels of absolute liquidity could put pressure on asset prices, with the Federal Reserve pursuing its policy of quantitative tightening. We see this differently. We believe the rate of change in liquidity is more important than the absolute quantum for determining the price of assets.

Global Central Bank Liquidity YoY Rate of Change USD Billions



Source: Global Macro Investor

The chart shows us what has been happening to global central bank liquidity in recent times, and it points to the fact that liquidity has been improving on a rate of change basis even though it is still negative year on year on an absolute basis. The chart shows us that global liquidity, when observed on a rate of change basis, bottomed around the beginning of Q4 2022 and continues to improve on a year-to-date basis. Indeed, equity and risk asset markets generally bottomed around the same time. Interestingly, the chart also suggests that if we remain on the current trajectory, global central bank liquidity is likely to expand again on a net absolute basis as we move into 2024 and, most likely, in 2025.

Our fundamental view would align with this suggestion. We know that global economies, in general, are slowing mainly due to restrictive monetary policy. We also believe Western world inflation will revert to a targeted long-term rate of 2%. Furthermore, we do not subscribe to the view that Western world economies can indefinitely grow at their recent trend growth rate with current high-interest rates and continued quantitative tightening. It seems to us that the ECB and the Federal Reserve are probably already at the end of their rate-hiking schedule. Hence, we can see a path over the next 12 - 18 months where Western world central bank liquidity increases once more, joining the Japanese and Chinese central banks that have already started to loosen monetary policy. Therefore, global liquidity will be a fundamental support to risk asset prices throughout 2024 and 2025. Of course, global liquidity could come back much more quickly if something breaks within the financial sector or markets. In this scenario, we expect the Federal Reserve and other central banks to intervene to calm markets and avoid a deflationary spiral driven by fear and uncertainty. Hence, we believe the balance of probability is weighted very firmly in our favour of increasing, not decreasing, global liquidity even in different and contrasting scenarios.

Market Implications

Despite short-term volatility, we remain constructive on developed world equity markets in the medium to longer term. We believe the outlook for equities and other risk assets, in general, is improving. Forward indicators of the business cycle point to an improving economic outlook as we move through 2024 and into 2025, and this should further benefit corporate earnings. Of course, there are plenty of risks in the short term, such as the factors driving the recent spike in bond yields, the threat of a US Government shutdown, or a stronger US dollar. Still, looking further out, we believe we are in the early stages of an equity bull market, which will be supported by an economic environment of rising growth, peak interest rates and falling inflation. Hence, we believe any current weakness should be bought as, by and large, this volatility is caused by uncertainty over short-term issues that are likely to be resolved.

We understand why the yields on US government bond yields recently spiked higher. This is a classic bear steepening of the yield curve where short-end yields are pegged to the Federal Funds rate, but long-end yields move higher driven by stronger economic growth and the uncertainty and implications this has for interest rate policy and getting inflation down (i.e. higher and/or higher for longer interest rates). Of course, there are also concerns about the pressure on yields that might be caused by the significant amount of expected supply yet to come from the US Treasury. There are growing fears around debt sustainability at current interest rate levels and concerns about who will be the marginal buyer of US Treasuries given, for now at least, that foreign central banks and domestic US banks are not buyers. Whilst this uncertainty is increasing volatility and driving yields higher in the short term, we do not believe we are at the point where concerns over debt sustainability become the primary driver of yields. Instead, we believe Treasury yields offer value at current levels. However, volatility will remain until we get greater clarity on these issues. In the longer term, these issues will likely resolve themselves in a way that will result in lower yields and higher Treasury bond prices.

We believe investment-grade bonds will perform well over the medium to longer term. We expect yields will fall over this timeframe, which will lift the price of higher-quality corporate bonds. An environment that supports equity prices should also support investment-grade bond spreads as we expect earnings to grow and interest rates to fall, increasing debt affordability. In contrast, the near-term environment could be challenging for more highly leveraged, lower-rated high-yield bond issuers. Undoubtedly, debt service costs will remain much higher for much longer compared to recent times. This could become more problematic for high-yield issuers operating at the lower end of the credit rating spectrum.

Despite its recent rally, we maintain our medium to longer-term bearish stance on the US dollar. This view is predicated on the US dollar's tendency to underperform in an environment characterised by improving growth but slowing inflation. We also expect US inflation to slow, which should mean the end of the Federal Reserve rate hiking cycle. Further out, the narrative will gradually move to a discussion about when the Federal Reserve will make its first interest rate cut, which could put pressure on the US dollar. We expect rate cuts in the US before Europe, leading to a weaker USD into and throughout 2024.

In line with our weaker US dollar view over the medium to longer term, we have a constructive view on emerging market equity and debt. We expect Chinese economic activity to increase as we enter 2024, driven by an improving export environment, a rebuild in inventories and more government-backed stimulus.

We believe we are at that point in the business cycle where we should see increasing demand for commodities, especially metals. As global economic activity begins to pick up as we move through 2024, commodity prices should rise, reflecting increasing demand. Furthermore, we expect copper and those metals associated with green energy and renewable infrastructure to benefit from an ever-increasing investment in decarbonisation.

Gavin Blessing

13 October, 2023

Source Data: ICM, Bloomberg as of September 30th, 2023

[1] https://www.statista.com/chart/28437/interest-rate-hikes-in-past-tightening-cycles/
[2] https://www.whitehouse.gov/cea/written-materials/2021/09/09/housing-prices-and-inflation/