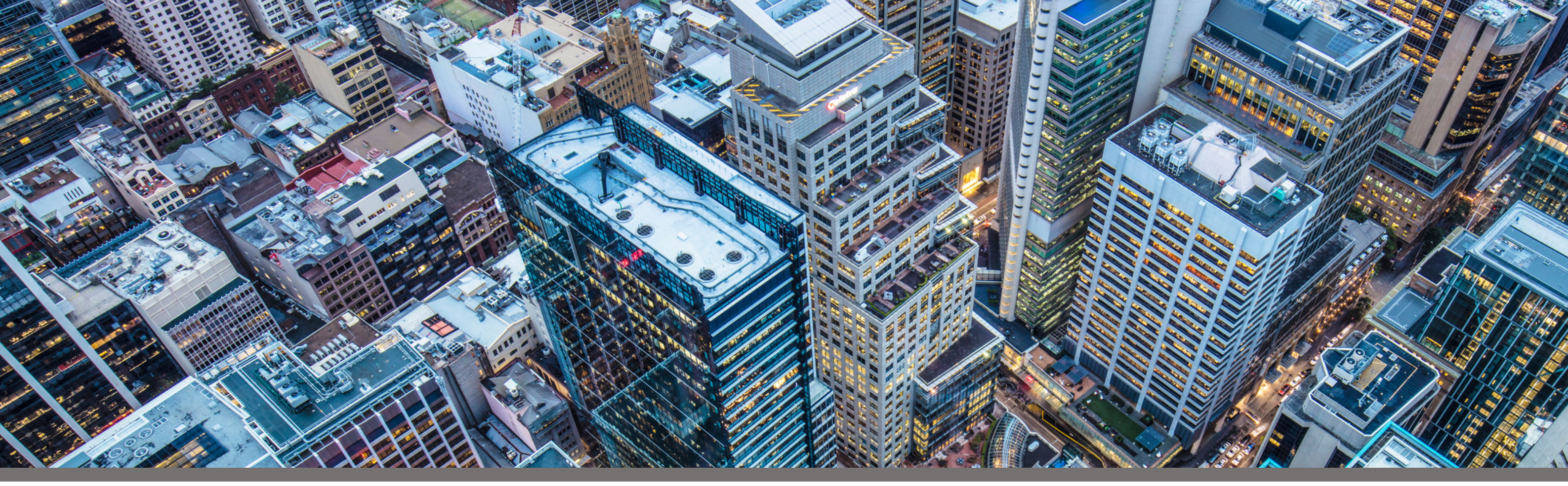


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.8** BILLION	**US$22.5** BILLION

ICM Monthly Outlook

MAY 2023

Market Review

Over the last weekend of April, US regulators orchestrated a takeover of First Republic Bank by JPMorgan Chase, after it became apparent that First Republic would be unable to stem the outflow of deposits that had seen its deposit base shrink by USD 100 billion during Q1 2023. Despite the risks, the US Federal Reserve continued on its rate-rising path on 3 May, raising rates to 5.25%.

Equity markets have so far largely shrugged off the issues in the US banking system, with the S&P 500 increasing by 1.5% in April and 8.6% in 2023. Having fallen by close to 10% in March, the S&P Financials sector bounced back in April, increasing by 3.0%. So far in 2023, the big winners at a sector level have been Technology up 22%, Consumer Discretionary up 14.6% and Communications up 24.5%. All three sectors have benefitted from lower rates, given their tilt towards higher growth and expected earnings accumulating further into the future.

Inflation has continued to move in the right direction. Headline US inflation fell to 5.0% in March, helped by a decline in energy prices of 6.4% over the past 12 months. Over the past nine months, headline inflation has been running at 2.4% or 3.2% annualised. Unfortunately, core inflation, which strips volatile energy and food inflation, is now running higher than headline inflation and remains stubbornly high at 5.6%. Like headline inflation, core inflation is also heading in the right direction but more slowly. Shelter, which makes up 35% of the headline inflation index and close to half of the core inflation index, remains the significant driver of inflation, increasing by 8.2% over the past 12 months. However, as we have pointed out in previous letters, shelter costs tend to act with a lag, and we expect shelters' contribution to inflation to fall in the coming months.

Inflation will not be helped by the surprise production cut by Saudi Arabia in early April. The Saudis, UAE, and Iraq committed to cutting more than one million barrels of oil per day starting in May.[1] As a result, the oil price rallied from USD 80 per barrel to USD 85 per barrel in the aftermath of the announcement, although it had fallen back to USD 80 per barrel by the end of April. Despite this news, the oil price has declined by c. 40% since the beginning of the year.

In Europe, the Eurostoxx increased by 1.0% and continues to outperform US equities in 2023, up 14.9% versus 8.6% for the S&P 500. However, growth continues to be anaemic in Europe, with GDP for the first quarter showing that the economy grew by just 0.1% versus 0.0% for the last quarter of 2022. Looking forward, PMI data for the Eurozone continues to trend higher. However, the disparity in outlook continues between the services sector at 56.2 and the manufacturing sector at 45.8, the widest in over a decade. A PMI reading above 50 indicates expansion, while a reading below 50 indicates contraction.

In early May, the ECB raised rates by 0.25% to 3.25%. ECB president Christine Lagarde, reminiscent of U.S Federal Reserve Chairman Jerome Powell in 2022, sent the ominous message, "We know that we have more ground to cover." Regardless, the slowdown in the pace of increase from 50bps to 25bps was welcome, and the drop in loan

Market Review continued

demand in the EU suggests that previous rate increases are beginning to restrict economic activity.

In the UK, the FTSE index increased by 3.1% in April and is now up 5.6% year-to-date. Inflation in the UK remains above 10%, and core inflation crept higher in March. Coupled with strong wage data, pressure remains high on the Bank of England to continue increasing interest rates.

In March, emerging markets, as measured by the MSCI Emerging Market equity index, fell by 0.8% and is now up 3.2% year-to-date. So far in 2023, strong returns in Taiwan and South Korea are offset by poor returns for Brazil and India, while Chinese equities are flat for the year.

In April, European government bonds, as measured by Barclays Euro Aggregate Government Index, decreased by 0.1%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, increased by 0.5%. Investment Grade credit, as measured by the ICE Bank of America US Corporate index, and High-Yield credit, as measured by the ICE Bank of America high-yield index, increased by 0.8% and 1.0%, respectively.

Market Outlook

Human emotions run deep. Humans are naturally disposed to think subjectively, yet we must learn to think objectively. As investors and market participants, our emotions have a profound impact on our thoughts, behaviours and decision-making processes. Moreover, our emotions can lead to unconscious bias in our decision-making as a direct result of our past experiences. At times of market extremes, these biases can have a more pronounced effect on the behaviour of the market and its participants and key decision-makers. We believe we are in such a period now.

We first raised this risk as it pertains to the Federal Reserve nearly a year ago. We said that, given the Federal Reserve had made a policy error believing rising inflation would prove transitory, there was now a greater risk that in order to protect their reputational legacies, the committee members, including Chairperson Powell, would more than likely overcompensate by raising rates too high to ensure that they would not fail for a second time to curtail inflation, regardless of the economic consequences. Chairperson Powell has admitted on many occasions that they would rather force the economy into a 'slowdown' and resuscitate it at a later stage than let inflation get embedded. In our opinion, this overcompensation bias is happening now. The March and possibly May rate hikes will prove to be a mistake. Despite a US banking crisis and clear evidence of disinflation, the Federal Reserve has continued to blindly push ahead with hikes. It seems only the failure of four US banks and the potential threat of more to come has forced the Federal Reserve to even consider changing its stance, from one where further interest rates increases may be appropriate, to one where future interest rate decisions will now only be determined by the incoming economic data. This is not quite the same as saying that they have paused, yet the market has chosen to interpret it more or less in this way.

Regional US banks under severe stress will further weigh on economic growth

In our view, it is pretty shocking that the Federal Reserve is not more circumspect in its decision-making at this time, given what is happening to its financial system, especially as the roots of the current US banking crisis can be found in its own monetary policy. The scale and pace of aggressive rate rises of recent times have blown a hole in the high-quality liquid assets that banks are ironically required by regulation to carry to protect their standing in times of stress. Additionally, five hundred basis points of interest rate rises have led to an exodus of regional bank deposits to higher-yielding money market funds. The choice for regional US banks is stark, either raise deposit rates and destroy profitability or keep deposit rates low and lose your deposits.

Simultaneously, as their liquidity and profitability are threatened, a slowing US economy will lead to rising bad debts and credit losses, eroding their balance sheet strength. A hamstrung regional banking sector will not supply credit to an economy if it is worried about its own fragility and the negative existential consequences of getting it wrong. From senior management to the board, emotions will have a more pronounced effect on critical decisions. Fear will now drive executive decision-making, and ever more conservative behaviour will be adopted. Regional and smaller-sized banks will hoard liquidity and slow down lending, possibly abruptly. With the flow of credit slowing, or indeed stopping to key sectors of the economy such as small business, a particular focus for regional banks, US economic growth will slow.

Market Outlook continued

As consumers become more concerned about the stability of the banking sector and their own welfare amidst an economic slowdown, they will demand less credit, save more and spend less. The greater the perceived instability of the financial sector and uncertainty around the economic outlook, the greater the emotional response to protecting their financial well-being by demanding less credit and spending less. Again, emotions run deep.

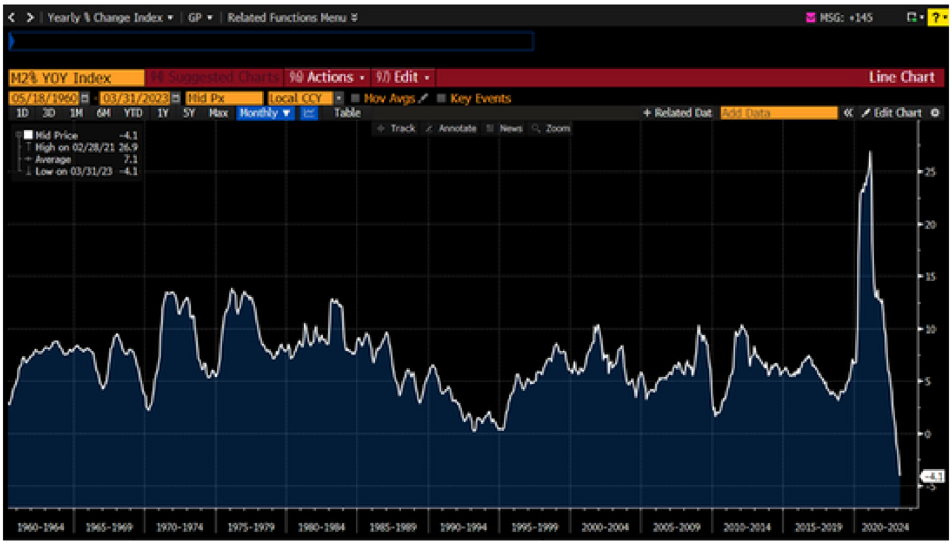
All of these trends are happening now and are probably accelerating. The April Senior Loan Officer Opinion Survey revealed that loan officers at US banks have continued to tighten corporate lending standards in Q1 2023, with the proportion of banks tightening terms on loans for medium and large businesses rising to 46%, up from 44.8% in the previous quarter. However, the report also showed much weaker demand for credit, with the proportion of banks reporting stronger demand for commercial and industrial loans dropping by 55.6% in Q1, marking the sharpest decline since 2009 during the global financial crisis.[2]

The Federal Reserve would have us believe, and indeed Chairperson Powell stated at the recent May press conference, that conditions in the US banking sector have broadly improved since early March and that the US banking system is sound and resilient. This might be true for large, systemically important US banks. Still, it rings hollow when applied to the regional and smaller banking sector, which is of utmost importance for lending to small and mid-sized US companies, the backbone of the US economy. Incredibly, such claims are being made amidst the fourth US bank failure in less than three months, with the latest, First Republic Bank, being the largest to date. The Federal Reserve is downplaying the seriousness of the situation to bolster confidence in the system. On the announcement of First Republic's Q1 results on April 24th, when it disclosed that it had lost 41% of its deposits over the quarter, with deposits falling from $176 billion to $104 billion, it was patently clear the bank has little chance of an independent future and needed to be rescued, especially when $30 billion of the $104 billion came in the form of deposits from a coalition of the largest US banks including JPMorgan and Citigroup.

The recent bank failures of Silicon Valley Bank, Signature Bank and now First Republic Bank are three of the largest four US bank failures ever, with these three banks comprising total assets of USD 532 billion.[3] Even though this accounts for just 2.3% of total US banking system assets of USD 23 trillion, worries are beginning to mount. In broad terms, these USD 23 trillion of total assets are funded from three primary sources, equity of 2.3 trillion, debt of 2.5 trillion and deposits of 17.2 trillion. Over the past twelve months, deposits held at US commercial banks have shrunk by nearly USD 1 trillion.[4] That is not deposits leaving one US bank for another, but deposits leaving the US commercial banking system entirely, with most of this seemingly going to money market funds to enjoy much higher yields and arguably greater security.

As we have described above, current monetary policy, including quantitative tightening, is the root cause of this deposit flight affecting US regional and small banks. Not only are deposits leaving the banking sector in search of higher yields in money market funds, quantitative tightening and tighter credit policy mean that reserves are being drained from the banking system through other channels. Hence the US economy is experiencing the quickest annual decline in the supply of money, as measured by M2 money supply (the total of all cash, deposits, savings accounts and retail money market funds in circulation) in decades, as shown in the chart. This does not augur well for the health of the US economy.

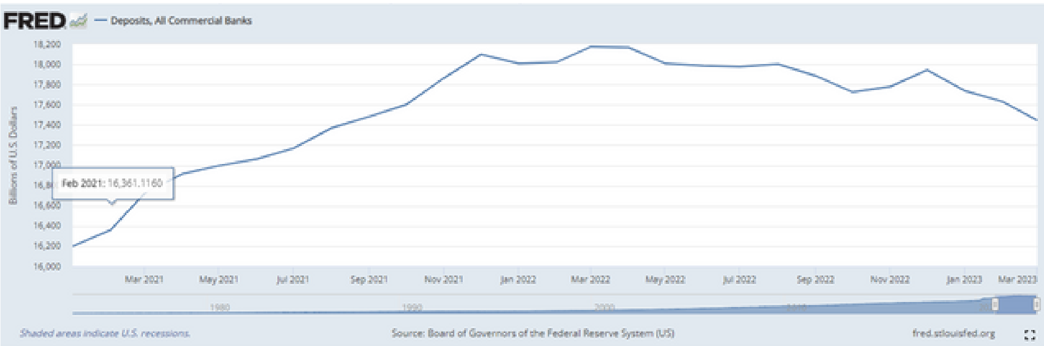
US M2 Money Supply – Year over Year % Change



Source: Bloomberg

As the Federal Reserve shrinks its balance sheet and banks tighten their lending standards and cut back on lending, this reduces the supply of money in the economy, which in turn puts a squeeze on deposits and credit availability. We can see the impact of these actions on deposits across all commercial banks in the chart produced by the Federal Reserve Bank of St. Louis.

US Bank Deposits, All Commercial Banks



Source: Federal Reserve Bank of Saint Louis (FRED)

The rapid decline in deposits across all banks is noteworthy. Still, the situation is even worse for regional banks, given that we know that the largest, systemically important U.S banks have seen their deposits increase over the period as depositors have sought to move large deposits over $250,000, which do not benefit from a US government guarantee to the perceived safety of larger institutions.

The simple truth is that the current Federal Reserve monetary policy is inconsistent with a healthy and vibrant banking system. Not only have higher rates punctured a hole in the balance sheet of regional banks, but the rapid rise in short-term rates and inverted yield curve has also destroyed bank profitability and threatens to break bank liquidity. Regional banks will now be forced to fire-sell assets to raise liquidity to meet withdrawals and repay emergency and short-term borrowing facilities provided by the authorities, which were never designed or permitted to function as long-term funding tools. If that was not enough, the demand destruction, a slowing economy, and higher unemployment that the Federal Reserve impatiently wishes to bring about in order to curb inflation will wreak further havoc on regional bank balance sheets through higher loan defaults over the coming years. Moreover, the details of the recent Federal Deposit Insurance Corporation (FDIC) deal with JP Morgan to rescue First Republic Bank have hardly inspired confidence in the collateral values supporting its liabilities, given that JP Morgan benefits from an 80% loss-sharing agreement on all mortgage and commercial loans. As to whether we have seen the worst of this US banking crisis, no one can be sure, but there is still a sizeable risk that there could be more failures and certainly more negative consequences for the US economy, given the regional bank's vital role in providing credit to US business and industry. Indeed, the picture painted by equity markets for the regional banking sector in the US is not pretty and certainly does not inspire confidence that the crisis facing the sector is over. As demonstrated by the US Regional Bank's ETF performance in the chart, equity market pricing indicates that uncertainty remains very high.

IShares US Regional Banks ETF Share Price Performance

Source: Bloomberg

Raising the US debt ceiling could exacerbate deposit flight and lead to tighter liquidity conditions

Whilst a US political deadlock over an agreement to raise the permissible US Government debt ceiling creates general economic uncertainty, it is likely only a matter of when and not if an agreement is reached. The US Government needs to be able to pay its commitments as they fall due and avoid a default. More concerning is the fact that the US Treasury has been forced to run down its stock of reserves, such as the Treasury General account at the Federal Reserve, as it has not been able to issue more debt in recent times given it is already up against the debt limit. Once the debt ceiling limit is raised, it will inevitably lead to the US Treasury issuing more debt into the market, which will have the impact of draining liquidity from the capital markets. Furthermore, if it chooses, in part, to issue T-Bills instead of longer duration notes and bonds, this could exert even more pressure on bank deposits as they move out of the banking system into T-Bills, offering greater security and higher yield.

A combination of further quantitative tightening from the Federal Reserve, as it looks to reduce its balance sheet, combined with the US Treasury wishing to replenish its stock of dollar reserves with new unfettered issuance, is likely to lead to tighter liquidity conditions later this summer which is not supportive for equity and capital market valuations.

Unemployment is now turning higher, and wage disinflation will follow

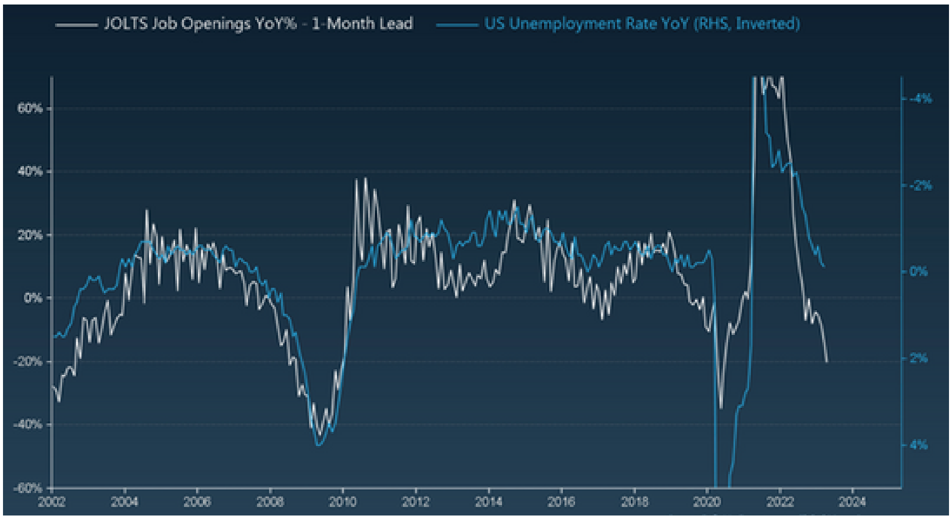
Turning to the likely course of key economic data in the coming months, we expect readings to continue to soften, particularly in those key areas watched by the Federal Reserve, namely unemployment and inflation in non-shelter related services or predominantly the wages sector of the economy. As we discussed in last month's letter, much of this key data operates with a significant time lag. Hence, the effects of higher rates and more restrictive financial conditions take time to work through the economy, but they inevitably do come. We expect the jobs market to continue to weaken over the coming months as we know that unemployment would not be expected to peak until about nine months after the bottom in the ISM US Purchasing Managers Manufacturing Index ("ISM"), which we use as a meaningful proxy for the business cycle. We expect the ISM will bottom soon, probably in the current quarter, so this implies we will see continued weakness in jobs-related data for the remainder of this year. In addition, evidence of a slowing jobs market continues to emerge, with the recent US Jobs Opening (JOLTS) survey continuing to point towards falling vacancy levels as jobs become less plentiful.

Total US Job Openings (JOLTS Survey)

Source: JOLTS Survey, GMI

As the following chart demonstrates, the rate of change in the JOLTS survey is closely correlated with the change in unemployment. Given that the JOLTS Survey has now fallen by 20% year over year, we should start to see a noticeable increase in the unemployment rate during the rest of this year, indeed piercing through 4% and heading towards 5% into 2024.

JOLTS Job Openings YoY% versus US Unemployment YoY%



Source: JOLTS Survey, GMI

In addition to the fall in job openings, most leading employment indicators are pointing lower too. For example, the weekly jobless claims numbers are steadily rising. In addition, small and medium-sized businesses report that their hiring intentions have been drastically lowered while the voluntary job quit rate is falling.

As the jobs market softens and the unemployment rate rises, we expect to see declining wage growth and non-shelter-related service inflation. Historically wage growth tends to top out around the same time as we reach peak employment. However, once unemployment starts to drift upwards, we usually see momentum build in wage disinflation. As shown in the chart below, the trend in core non-shelter-related services inflation peaked last September at over 6% and is trending down and should continue to fall. For example, the April reading was just over 5%, and the last 3-month annualised reading is coming in at just over 4%. If this trend continues down, which we believe it will, then it should be enough to keep the Federal Reserve on pause given that they now have said that further interest rates decision will be based on the data, which is probably the most important data variable that they are watching.

US Bloomberg CPI Core Services less Housing YoY%

Source: Bloomberg

Market Implications

We believe the Federal Reserve is in a bind. On the one hand, it wants to foster tighter credit conditions to bring about demand destruction, which will curb inflation. Furthermore, it wishes to maintain this position for as long as possible so that the chances of inflation rebuilding again within this business cycle are remote. On the other hand, its monetary policy has created higher short-term rates, an inverted yield curve and growing credit problems in commercial real estate which have undermined both the profitability and stability of US regional banks and, therefore, their ability and desire to keep providing a healthy flow of credit to the economy. While this banking crisis may appear localised to just regional US Banks, the sector is a hugely important conduit for lending into corporate America, with Goldman Sachs estimating that its accounts for about 80% of all commercial real estate loans, 60% of residential real estate loans and half of the commercial and industrial loans.[5] In our view, this banking crisis is unlikely to end as long as the policy choices that caused it to happen in the first instance remain unchanged. To date, the institutions of State have just dealt with the symptoms of the problem, through hurried bank rescue deals, without curing the problem. We believe it is inevitable that the Federal Reserve will eventually have to loosen its grip on the flow of credit for fear that too much damage will be caused to the economy, as current conditions are too restrictive and unsustainable.

US equities have enjoyed a good rally year to date by pricing in the fact that the Federal Reserve has now paused in all but name, with further interest rate increases very unlikely. However, the Federal Reserve is still walking an economic tightrope between keeping conditions restrictive enough in order to battle inflation versus the need to ease conditions to reduce stress in the regional banking system and other parts of the economy, such as residential and commercial real estate. Of course, it is only a matter of time before further weaknesses or stresses in the economy or financial system emerge, compelling the Federal Reserve to act. It is important to remember that the Federal Reserve is a reaction agent. It typically reacts rather than pre-empts. Therefore, before we get to the point where the Federal Reserve relents and starts to ease monetary policy, we will probably need to experience a further build-up of stress or fear in the financial markets or a significant acceleration in the coming economic downturn. Failing this, is it likely, that for the very same reasons the US economy is now having to endure the highest real interest rates since 2007, the Federal Reserve will likely keep short-term interest rates pinned at current levels for as long as is reasonably possible. Hence, we face the risk that interest rate cuts do not come down as quickly as has been priced into markets which will cause the market to be disappointed. Alternatively, keeping rates too high for too long could cause more damage to the real economy or, worse, breakage in the financial system which could also cause markets to decline. Either way, given current equity and credit valuations, it seems most sensible to us to play from the sidelines, meaning reducing risk with a view to buying the market and individual stock or bond opportunities on any significant pullbacks.

Our cautious approach toward equities and corporate bond spreads is also a function of the sizeable inflexion in US liquidity that we anticipate after a higher US debt limited limit is finally approved by Congress. In addition, renewed issuance of bonds by the US Treasury will draw liquidity from the markets compounding the tightening conditions already being experienced from quantitative tightening. This draining of liquidity will undoubtedly put technical pressure on asset prices.

We remain constructive on government bonds. Simply said, current yield levels are not sustainable over the longer term. The cost of servicing US Government debt alone at current rates, never mind all the debt in the economy owed by corporates and individuals, will stifle economic growth. It is only a matter of time before rates need to come down once more. The only question is whether it will be an orderly and gradual exercise in line with slowing economic growth and disinflation or a rapid fall in rates due to a systemic crisis and/or a collapse in economic growth. While there is a risk that the Federal Reserve does not start cutting interest rates as early as the market currently expects in September, we still view any short-term backup in yields as good longer-term buying opportunities, with the intermediate part of the maturity curve offering most appeal on a risk/reward basis.

While we remain bearish on the US dollar in the medium term, we could see a rally at times during the summer and autumn caused by a growing realisation that the Federal Reserve is unwilling to cut rates as quickly as priced in by the market or just in response to the possibility of weaker equity markets and tighter US liquidity.

We remain cautiously constructive on emerging market equity and debt, especially in Asia, as the money supply in this region continues to improve. Hence, we would view the region as a relative outperformer versus the US and European markets. However, possible heightened US market volatility and tighter US dollar liquidity conditions could cause periods of weakness to emerge in this asset class too. In addition, while the Chinese recovery appears patchy, given reports of weaker-than-expected consumer spending, especially regarding property and big-ticket items, the authorities will likely continue to prime the economy by supporting consumption.

Commodity prices should be supported by improving economic growth out of Asia despite economic concerns around demand from the US and Europe. While Western economies currently have their challenges, our central case expectation is for any recession to be relatively mild and short-lived. Hence global growth prospects should improve significantly towards the back end of 2023 and into 2024, supporting commodity prices.

Gavin Blessing

12 May, 2023

Source Data: ICM, Bloomberg as of 30 April, 2023.

[1] https://www.npr.org/2023/04/03/1167824124/saudi-arabia-oil-production-cuts-gas-prices-energy-markets
[2] https://www.federalreserve.gov/data/sloos/sloos-202304.htm
[3] https://www.nytimes.com/interactive/2023/business/bank-failures-svb-first-republic-signature.html
[4] https://www.federalreserve.gov/releases/h8/20230428/
[5] https://www.ft.com/content/945f754b-6323-4ad1-8b8c-76ef8d2e0a6a

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