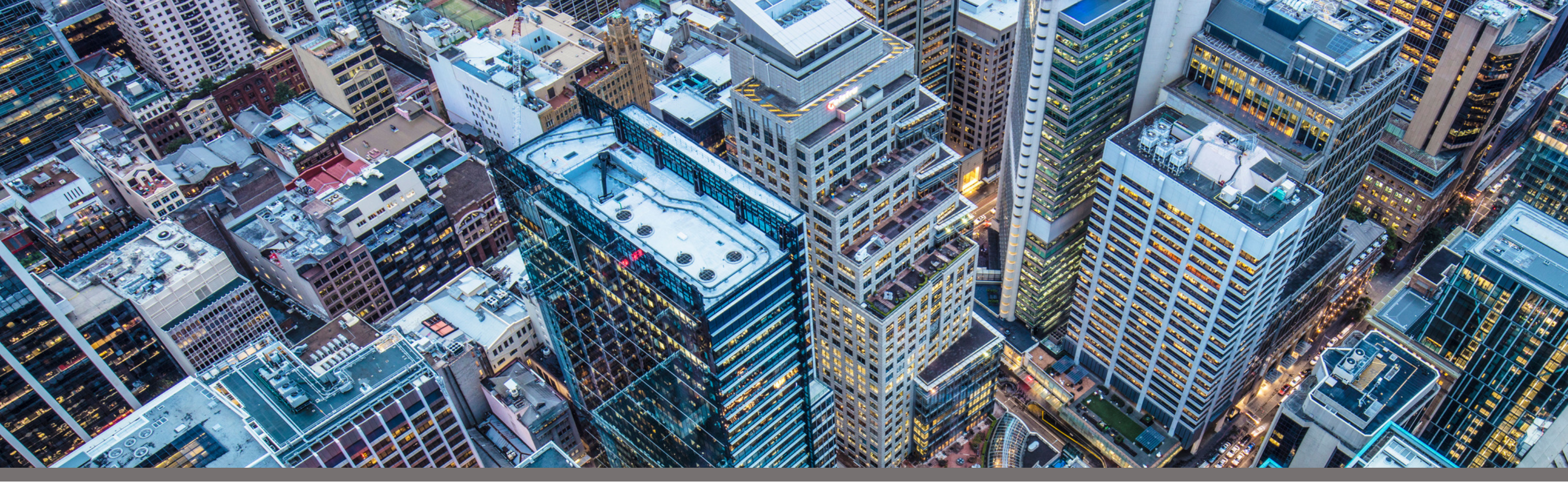


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.8** BILLION	**US$22.2** BILLION

ICM Monthly Outlook

APRIL 2023

Market Review

Markets were shaken early in the month with the collapse of Silicon Valley Bank ("SVB"), a regional bank in San Francisco offering services specifically designed to meet the needs of the tech industry in Silicon Valley. At the time of failure, SVB had USD 209 billion in deposits. The failure of SVB was the second largest ever for a US bank. SVB initially saw deposits flee as depositors moved money out of the bank and into higher-yielding money market accounts that took advantage of the significant yield advantage on short-dated government securities. As the deposits fled, SVB was forced to sell down its holding of US government securities that it had purchased when interest rates were significantly lower. As a result, SVB was carrying considerable unrealised losses on these bonds. Once deposits started to leave SVB, it had to sell its government bonds and recognise the losses on these bonds, which diminished its capital base. Once this became clear, depositors began to question the solvency of SVB, and a classic bank run ensued. With the contagion that followed the collapse of SVB, New York-based Signature Bank also failed, and US authorities were required to step in to insure deposits and organise an orderly wind-down of both banks. However, European banks were not left unscathed. UBS was forcibly required by its regulator to acquire Credit Suisse to prevent a potential collapse as confidence amongst depositors ebbed.

SVB, Signature Bank and Credit Suisse all had their own individual issues that played a role in their downfall. However, interest rate increases at an unprecedented pace and a contraction of the money supply on a scale unseen in living memory are causing significant disturbances to the financial system. We had previously noted these stresses as far back as last September when the UK government had to step in to save the pension system, and the Japanese Central Bank had to intervene to support the Japanese Yen. Until there is a change in US monetary policy, we expect these periodic bouts of financial stress to continue.

Due to the banking sector instability, markets began to price in a potential Federal Reserve pivot, with rates across the board tumbling during March. US 2-year treasuries decreased by 0.75% to 4.06% in March from 4.81% in January, US 10-year treasuries decreased by 0.45% to 3.47% from 3.92%, and US 30-year treasuries decreased by 0.27% to 3.65% from 3.92%. Moreover, inflation continues to decline, running at 6.0% for the 12 months ending February versus 6.4% for the 12 months ending January and 9.1% for the 12 months ending June 2022. As a result, the market began to bet that the US Federal Reserve will relent rather than risk a full-blown financial crisis. Despite the banking instability, the S&P 500 posted a 3.5% gain and has now increased by 7.0% year-to-date. The Nasdaq and S&P 500 Tech Indices saw the most significant gains at 6.7% and 10.9%, respectively, as these indices would benefit most from easing monetary conditions.

In March, the US created 236k jobs, bringing the total jobs created for the first quarter of 2023 to c. 1 million. While the jobs market remains robust, the economic outlook continues to worsen. In March, the ISM US Purchasing Managers Manufacturing Index ("ISM") fell to a new cycle low of 46.3 versus 47.7 the previous month and 65 less than two years ago. The ISM continues to point to rapidly decreasing economic activity on the manufacturing side of the economy.

Market Review continued

In Europe, the Eurostoxx increased by 1.8% and is up 13.7% in 2023. The Eurostoxx is up more than 10% over the past twelve months, a remarkable performance against the backdrop of inflation and war in Europe. Equities in Europe are undoubtedly being buoyed by the continued decline in natural gas prices which have fallen by 50% so far this year.

In the UK, the FTSE fell by 3.1% in March. The FTSE, which benefitted in 2022 from its relative overweight to energy, suffered in March, partially from its energy overweight, but predominantly from its banking overweight, with the sector selling off hard in the aftermath of the UBS takeover of Credit Suisse.

In March, emerging markets, as measured by the MSCI Emerging Market equity index, generated positive returns, increasing by 3.2%, driven by a good month for Chinese equities. Chinese equities are currently benefitting from increased economic activity on the back of abandoning its zero covid policy late last year, inflation running at c. 1%, and easing monetary conditions. Two of 2022's standout performers, Brazil and India, have lagged in the early months of 2023.

European government bonds, as measured by Barclays Euro Aggregate Government Index, increased by 2.5% during the first quarter of 2023, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, increased by 3.0%.

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 2.6% and 1.1%, respectively. Rates continue to drive returns on credit more so than spreads. While spreads widened during the month, this was more than offset by a decrease in rates.

Market Outlook

A tipping point has been reached. Almost a year to the day after the Federal Reserve embarked on a new cycle of higher interest rates and tighter monetary policy, the most aggressive in US economic history, two US regional banks and a Swiss national champion bank have failed. While poor management decisions are the reason for the failure of Silicon Valley Bank ("SVB"), its demise was directly due to massive unrealised losses that built up rapidly in its US Government bond portfolio due to the rapid rise in interest rates over the previous twelve months. This immediate loss of confidence in the bank led to a deposit run not just at SVB but across smaller regional US banking institutions. The Federal Reserve was forced into pumping significant liquidity into the banking system to replace those deposits being withdrawn at a breath-taking pace. SVB was seized and taken into receivership by the FDIC. Less than a week later, another US bank, Signature Bank, was suddenly in trouble as depositors withdrew unsustainably large sums of money as contagion continued to spread. Again, the FDIC was forced to step in and take the bank into receivership to calm markets and boost perceived financial stability within the banking sector. The following weekend Credit Suisse, a Swiss national champion and very large, systemically important bank, appeared to be on the brink of collapse and was forced by its regulator into a shotgun takeover by UBS to stem the real and imminent danger of further banking failures, not just in Switzerland but potentially Europe and elsewhere. The most aggressive pace of interest rate hikes ever overseen by a US Federal Reserve was probably always going to break something, and, in that sense, it delivered in spades.

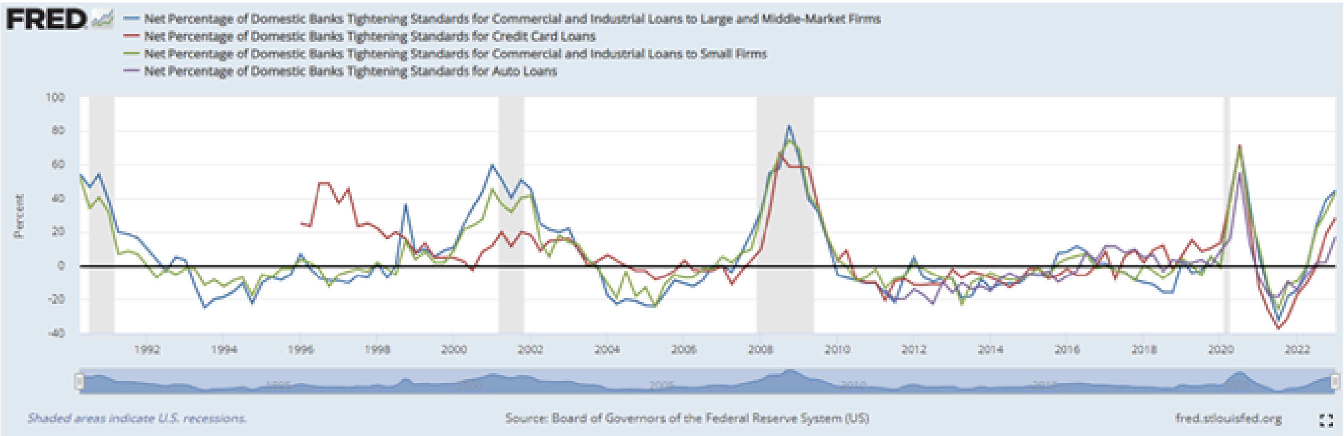
Signs of stress in the financial system herald the end of the Federal Reserve tightening cycle
While bond markets are pricing in one final interest hike by the Federal Reserve in May, we believe that the current cycle of interest rate hikes should already be at an end. Tightening cycles typically end with stresses starting to appear in the financial system. The Federal Reserve manages monetary policy in response to the economic indicators of inflation and unemployment, which tend to lag the business cycle, so when stresses appear, it is often a signal that they have gone far enough and, typically, too far already.

If the Federal Reserve pushes ahead with one further final interest rate hike in May, it will likely be remembered as a mistake. While the swift response of the relevant banking authorities to the imminent threat of contagion seems, at least for the time being, to have calmed the situation, the trauma experienced, especially amongst US regional banks, is likely to have longer lasting effects and severe ramifications for the current business cycle. The immediate response by regional US banks will be to shore up deposits, boost standby liquidity and cut back on lending.

Market Outlook continued

US Bank lending standards which, as seen in the chart, were already rising in response to recession concerns and the risk of higher corporate defaults, will increase even faster. Marginal business loan applications will be refused. Company plans for investment, and expansion will now be severely curtailed. ICM guesstimates that the recent banking instability will have the same retardant impact on US economic growth, equivalent to further rate hikes in the region of 50bps to 100bps.

US Jobs Workers Gap - Job Openings versus Available Workers



Source: Alpine Macro

The chart, produced by the Federal Reserve Bank of St. Louis, captures the net percentage of US banks rising or reducing their lending standards over previous economic cycles, including the current cycle. The current rate of change in tightening standards compared to the pace experienced in previous US recessions is very similar. Historically, when bank lending or credit availability turns rapidly lower, it has acted as a severe break on economic momentum and typically heralds a new recession. Now consider that the data in the chart was last updated in early February, well before the recent banking crisis, which only serves to materially exacerbate the pre-existing trend of tightening credit and increasing demand destruction. Indeed, it has been reported that US bank lending contracted by the most on record in the last two weeks of March[1]. Commercial bank lending dropped nearly $105 billion in the two weeks that ended March 29th, 2023, the most in Federal Reserve data back to 1973. As we have previously argued, this tightening of credit will hasten the onset of a recession, after which demand destruction will ensure further disinflation.

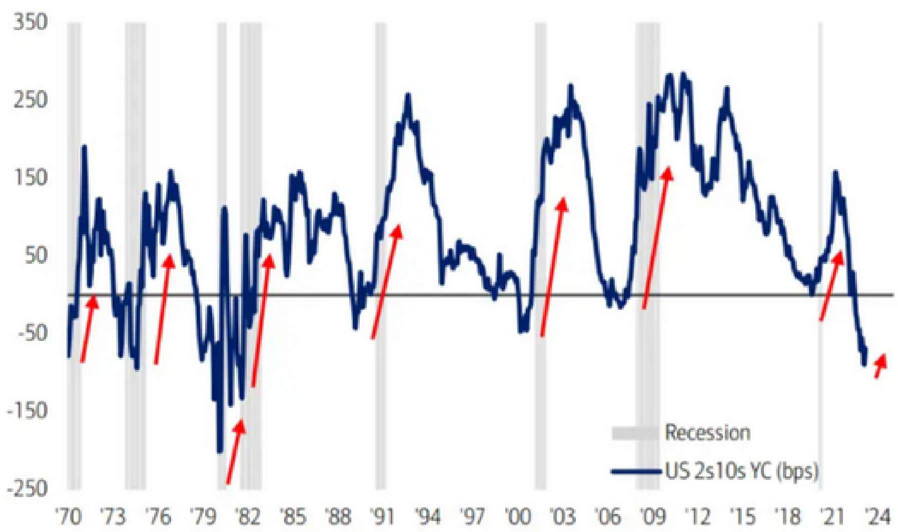
A steepening yield curve is a sign of imminent recession

Last month we discussed that the totality of wisdom contained in bond market pricing and the yield curve shape is considered one of the best predictors of an economy's future health. While an inverted yield is synonymous with a looming recession, as it signals that short rates are too high to sustain economic expansion, it does not pinpoint when a tipping point is reached and when a recession is likely to start.

Early signs of US labour market slowdown

The Federal Reserve has been clear in recent times that its focus regarding its battle against inflation is in the area of non-housing related services or predominantly the wages sector of the economy. It wants to see evidence of sustained downward pricing pressure in core services and wages. Despite the current strength of the US labour market, we know it tends to lag a slowdown in the real economy. Consistent with this view is mounting evidence of a turn and a coming weakness in the labour market. While the absolute level of job openings remains historically high, the level of job openings is no longer growing on a year-over-year basis. It looks most likely to contract going forward. In addition, the jobs quit rate is now falling. This rate historically rises in times of plentiful jobs reflecting employee confidence that if they quit, they will be able to find employment relatively quickly. As seen in the next chart, this quit rate measure tends to lead wage growth by about 12 months, and a falling quit rate suggests that labour conditions are weakening.

US 2yr/10yr Yield Curve v US Recessions



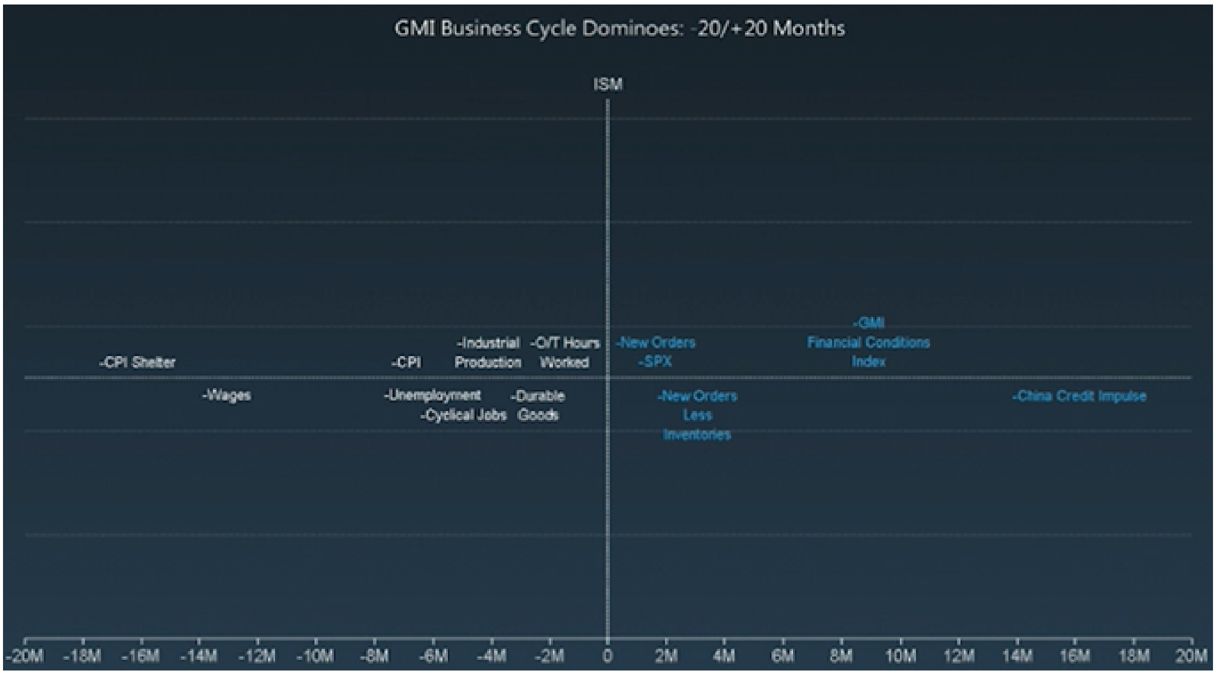
Source: Bank of America Global Investment Strategy

There is a better indicator which typically tells us when a recession is usually starting, and this is when the yield curve, as measured by the spread between the 2-year and 10-year Treasury bond yield, begins to quickly re-steepen. As seen in the chart produced by Bank of America, the US yield curve always tends to re-steepen again just before the economy falls into recession. This trigger accurately heralds the beginning of a recession and is usually caused by shorter-term bond yields falling faster than longer-term bond yields. This is a classic bull market steepening of the yield curve driven by the bond market anticipating that the Federal Reserve will soon be forced to cut interest rates once the lagging indicators, on which it relies, eventually, turn more negative about the health of the economy and reflect what the bond market has already deciphered from leading indicators. Since the recent banking crisis, the US yield curve has seen a dramatic re-steepening. As we write, the 2-year Treasury note yield has fallen by 100bps while the 10-year note has fallen by 60bps over the last month. The 2-10 year curve was inverted in early March by 92bps. One month later, in early April, the curve is much less inverted by only 52bps. Due to an oncoming economic slowdown which we believe is now inevitable, the curve should continue to steepen, with the 2-year note eventually yielding much less than the 10-year note over the coming quarters. Ironically, the harder the Federal Reserve continues to push with higher interest rates now, the more likely this is to steepen the yield curve further. Such actions would also cause more economic damage and ensure a deeper and longer-lasting recession than is probably necessary to get inflation back to its long-run target of 2%. It follows that the deeper and longer the recession, the more likely the need for even more future interest rate cuts.

Unemployment and wage Inflation significantly lag the business cycle

At ICM, we believe understanding the business cycle and knowing where we are in the business cycle at any given time is paramount for understanding the likely pattern of future economic indicators. We can think of the business cycle as a chain of possible events that share a causal relationship, similar to a domino effect. Our friends at GMI Macro Advisors have estimated where along the business cycle timeline these key indicators sit relative to the ISM US Purchasing Managers Manufacturing Index ("ISM"). In other words, the chart below shows us when these key economic variables tend to inflect (top or bottom out) relative to the ISM index. So, for example, the China Credit Impulse is a lead indicator of the ISM and tends to lead by about 17 months. Similarly, the GMI Financial Conditions Index tends to lead the ISM by about nine months. Turning to those indicators that lag the ISM, we see industrial production tends to bottom out about six months after the ISM has turned, whereas unemployment and CPI only bottom out about 8-9 months after the ISM.

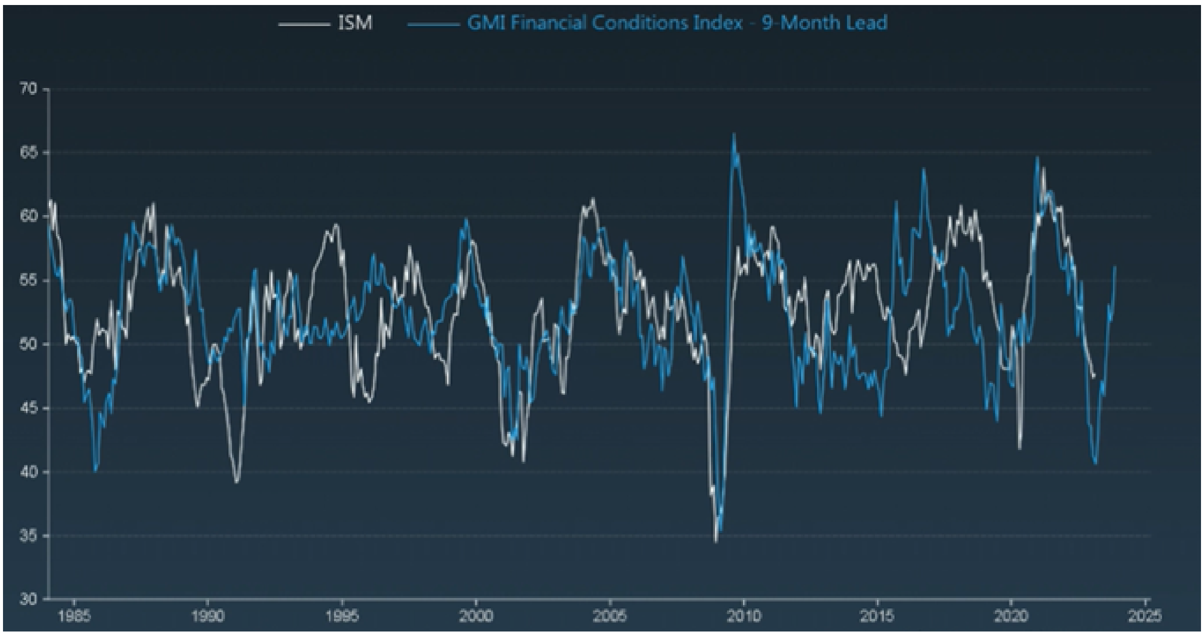
Business Cycle and Lead/Lagging Indicators



Source: GMI Macro Advisors

Given that we now know where key economic variables tend to inflect along a timeline relative to the ISM index, it is important to deduce where the ISM is in terms of its cycle. Using lead indicators, such as the GMI Financial Conditions Index, we can approximate the future evolution of the ISM index as shown in the second chart by Global Macro Advisors. The rate of change in the Financial Conditions Index tends to lead the rate of change in the ISM by about nine months showing a very close correlation. As we have previously discussed in this letter, the Financial Conditions Index bottomed late last year around October/November and has risen strongly since then. This suggests that the ISM will bottom around June of this year.

US ISM Manufacturing Index versus GMI Financial Conditions Index (year-on-year)



Source: GMI Macro Advisors

Suppose we expect the ISM index to bottom around June. In that case, we can infer from our previous timeline chart that US unemployment should not peak until about 8-9 months after that, suggesting it will not top out until the early months of 2024. Interestingly the timeline chart also points to the fact that wages and shelter-related CPI, which lag to a considerable degree, will only bottom out in the summer of 2024. Hence, it is more likely that wages and shelter-related inflation are probably not so much sticky but rather just very lagging, meaning that they do slow but take much longer to do so compared with headline inflation.

Despite lagging the business cycle by an inordinately long time, unemployment and wage inflation are vital indicators of focus for the Federal Reserve and other central banks. This probably explains why monetary policy is typically slow to tighten and slow to loosen when it is obvious the more sensible course of action would be to move more pre-emptively. This lag effect is the key rationale for our assertion above that the Federal Reserve had probably done enough to quell inflation before the banking crisis. To continue to tighten, after the recent banking crisis and the deleterious effects we know this will have on credit flow within the economy, the Federal Reserve risks making yet another policy error just as it did by not moving earlier at the beginning of this cycle.

While the US Labour market has been robust, there is evidence that jobs are becoming less plentiful and wage pressure is subsiding. According to US small business advocate NIFB, the National Federation of Independent Business, the hiring plans of small businesses in the US are falling such that it points to unemployment rising by about 1% over the next year. Furthermore, according to Refinitiv Datastream, the percentage of US Industries reporting negative growth in job openings on a year-over-year basis is now around 75%, which is very high historically and invariably means that job losses are on the way. It is just a matter of time. Indeed, it is likely that monthly US Non-Farm Payroll reports will flip negative in the coming months, which, given the labour market strength we have seen since the pandemic recovery, could still have the capacity to shock capital markets when it happens even though it is pretty predictable based on data from leading indicators.

Implications for Markets

Given the recent weakening in US economic data, the banking crisis and the re-steepening of the yield curve, we believe it is very likely that the US economy is probably entering a recession or, better said, a period of very low or no economic growth at present. Despite this, given that longer-term leading economic indicators have mostly turned positive, we do not think this recessionary period will be overly deep or long-lasting. As we have previously argued, we believe this period of significant credit tightening will continue to ensure that the process of disinflation will remain intact for the foreseeable future. It is important to reiterate that we will continue to see disinflation long after the US economy bottoms, given the lagged nature of many of the components within the inflation index.

In our view, the outlook for equities is more complicated in the short to medium term while it grows more constructive towards the end of the year and into next year. We believe that the strong rally in equities since the beginning of the year, confounding many investors, has been driven by falling inflation, a relatively robust consumer, and a belief that the end of the Federal Reserve's tightening cycle is drawing to a conclusion. Clearly, this information justifies a higher market multiple, and the equity markets have been right to price it in, but it does raise the bar for further equity gains over the summer months. As we have suggested before, we believe that the Federal Reserve will continue to cramp down hard on inflation driven, as much by legacy and reputational reasons, as by the belief that it is easier for them to correct an economic slowdown caused by overtightening than doing too little now and having to battle higher and more deeply embedded inflation expectations in the future. Hence, it is more than likely that the Federal Reserve will mistakenly increase interest rates by another 25bps in May and may reserve the right to go again if inflation does not come down quickly enough for its liking. Indeed, with the Federal Funds interest rate at 5.25% and core inflation trending at less than 4% and falling fast, the economy will have to deal with real interest rates of 1-2%, which could prove to be very restrictive, especially if bank lending completely dries up. Furthermore, the Federal Reserve is likely to promote a narrative during the summer that it is prepared to keep rates higher for longer to ensure all vestiges of inflation are purged. Despite a cooling economy, this narrative will likely spur greater equity market volatility over the summer, especially as the economic data continues to portray a weakening economy and corporate margins compress due to rising costs and little or no top-line revenue growth. This uncertainty will increase nervousness amongst investors and corporate leaders, especially as, we expect, labour market data turns decidedly negative and job losses begin to mount. Furthermore, all of this uncertainty has to play out over the summer and early autumn, which is seasonally a less supportive time for equity risk.

Hence, we are now adopting a more cautious approach towards equities over the next few quarters. We expect equities will broadly succumb to a downward bias with plenty of volatility. However, towards the end of the year, we think it will be time to become more bullish again as the economy will have bottomed, corporate earnings will be closer to growing again, and inflation will be much lower, allowing the Federal Reserve to start potentially cutting interest rates to spur growth. We think spreads are broadly fairly valued, but the uncertainty described above will likely weigh on sentiment and could push spreads wider over the summer. As we believe the recession will be relatively mild, we think higher-quality credit spreads will hold in somewhat better and outperform lower-quality credits, which are likely to struggle disproportionately more with a higher interest rate burden, greater refinancing risk and margin erosion.

Despite the recent move higher in treasury bond prices, reflecting a rapid fall in government yields after the banking instability in the US, we continue to like treasury bonds on a medium to longer-term basis. We are now in a curve-steepening environment. As we enter an economic slowdown where demand destruction will quell inflation, it is rational that the treasury curve, especially the front end, should price in lower interest rates over time as the Federal Reserve will eventually cut its lending rates to encourage growth. Whilst we think yields right across the curve will ultimately fall, we believe the most attractive part of the curve is the 5-7 year maturity area. We believe these maturities will benefit hugely from falling yields, yet if inflation remains stubborn, they are less exposed than longer-dated issues.

The US dollar has been in a weakening pattern since last November when it became apparent that the Federal Reserve was winning its battle on core inflation. This weakness has followed through as it grew ever more likely that the Federal Reserve will likely cease raising rates and pivot at some point later this year or early next year. Furthermore, there are signs of a gradual global growth recovery led by China and other emerging countries, which will put further downward pressure on the US dollar. We expect the US dollar could rally at certain points during the summer on stock market uncertainty. Still, we believe it will continue to weaken over the long term, especially when the Federal Reserve starts to ease later this year or early next year.

As we previously noted, the Chinese economy is improving, benefiting from an upswing in credit and liquidity support from its central authorities and its delayed reopening from Covid. Other countries in the region will no doubt benefit from this recovery. Furthermore, economic data from many smaller and emerging countries point to an early turnaround in growth prospects, where economies are recovering again, although from a low base. This augurs well for future global growth and ultimately growing commodity demand into 2024 and beyond. Given a weaker US dollar, early signs of economic recovery and solid demand for commodities, we expect emerging market equities and bonds to perform well later this year and into 2024. However, they are unlikely to be left unscathed this summer, given our view on the near-term outlook for developed market equities.

Finally, it probably should go without saying that we are bullish on Gold. The precious metal tends to do very well in environments where real yields are falling and supports for the US dollar are weaker. As we get through the current economic uncertainty of the summer and it becomes more apparent that inflation is falling and that rates need to fall even faster, this combination should prove irresistible to gold buyers.

Gavin Blessing

13 April 2023

Source Data: ICM, Bloomberg as of 31 March, 2023.

[1] https://www.bloomberg.com/news/articles/2023-04-07/us-bank-lending-declines-sharply-for-a-second-straight-week#xj4y7vzkg?leadSource=uverify%20wall

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