FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.9** BILLION	**US$21.5** BILLION

ICM Monthly Outlook

OCTOBER 2022

Market Review

In September, the S&P 500 finished down by more than 9% as markets continued to grind lower. Unfavourable inflation numbers coming straight on the back of U.S. Federal Reserve Chairman Jerome Powell's hawkish Jackson Hole address means that markets need to wait at least another month for a pivot in U.S. monetary policy.

Inflation numbers for August, released in September, showed that U.S. inflation had risen at a relatively modest 0.1%. As with anything, the devil is in the detail. U.S. inflation included a 5.0% decrease in energy costs. Shelter costs, which comprise c. 33% of the Consumer Price Index ("CPI") and more than 40% of the Core CPI, offset the decrease in energy costs, increasing by 0.7% month-on-month. Core CPI, which strips out volatile items such as food and energy, increased by 0.6% month-on-month, primarily driven by the increase in shelter costs. The Federal Reserve refers to Core CPI more than Headline CPI. Before August, year-on-year Core CPI had been falling since March 2022. The market was caught off guard by the hotter-than-expected Core CPI number, with the S&P 500 finishing down by 4.3% on the day of the release[(1)].

U.S. Manufacturing Purchasing Managers' Index ("PMI") continues to trend down, hitting 50.9 in September, indicating that the economy continues to expand but now at a much slower pace. The reading was the lowest since June 2020, amidst the Covid pandemic[(2)].

The U.S. labour market continues to show strength, adding 263k jobs in September and bringing unemployment to a new low of 3.5%. That said, jobs growth has been cooling, with the U.S. economy creating fewer jobs than in August (315k), and far fewer than in July (537k). Job openings, have also been decreasing, falling by 1m in August, one of the sharpest declines on record, and bringing the ratio of job openings to unemployed persons down from 2:1 to 1.7:1.

While the signs of a slowing economy are evident, the U.S. Federal Reserve has been bolstered in its fight against inflation with the economy and job market holding up relatively well. As a result, the market continues to discount equities further as the prospect of higher rates for a more extended period becomes more likely.

So far the impact of higher U.S. rates has been most apparent in the USD's strength. The strengthening of the USD over the past year has been spectacular. For example, in May 2021, one USD would buy 0.7 GBP. Today one USD will buy 0.9 GBP, and during September the exchange rate went as high as 0.95 GBP after the U.K. government announced a series of fiscal measures, including tax cuts that resulted in an expansionary budget with significant amounts of unfunded spending.

A series of economic heavy-hitters, from the IMF to the U.S. Treasury Secretary, condemned the U.K.s mini-budget as fiscally irresponsible. The budget was also out of step with the Bank of England's monetary policy, which had

Market Review continued

been tightening in recent months to stave off inflation. The sharp increase in interest rates caught some major institutional investors, particularly pension funds, off guard. Moreover, it resulted in the Bank of England needing to step in to provide liquidity at the very time they had focused on reducing liquidity to fight inflation. Ultimately the U.K. government were forced into an embarrassing U-turn. The FTSE ended the month down 5.4%.

Not to be left out by the drama, Europe's energy woes were compounded during the month, firstly by Russia's complete shutdown of the Nordstream gas pipeline and then by a series of explosions on both Nordstream pipelines. Any hope that Russia would soften its stance and help Europe meet its energy needs this winter is now gone. The Eurostoxx fell 5.7% in September and is now down 23% year-to-date.

The situation in Europe was not helped by the OPEC plus decision in early October to cut production by c. 2m barrels a day, or 2% of global supply. Having declined by 20% over the previous two months, oil prices rallied in the announcement's aftermath.

In September, emerging market equities declined by 11.5% per the MSCI Emerging Market equity index. Emerging market equities are now down by more than 30% in 2022. Even before the rally in Brazil in early October, on the back of a positive election result, Brazil provided a rare bright spot and is down only 0.8% year-to-date to the end of September.

U.S. rates lurched higher during the month. The hawkish tone taken by U.S. Federal Reserve Chairman Jerome Powell at Jackson Hole, coupled with unfavourable inflation numbers and robust economic data, gave the market little reason to believe a pivot is imminent. The premium for investing in longer-dated treasuries has turned deeply negative, with U.S. ten-year treasuries yielding almost 50bps less than U.S. two-year treasuries. This is the most negative the spread between the two has been in the past 20 years. The U.S. Treasury Index, measured by the Barclays U.S. Aggregate Government Index, is now down 13% year-to-date. In Europe, the Barclays Euro Aggregate Government Index has lost 16.7% this year[3].

Corporate bonds also fell in September, with the U.S. high-yield bond index decreasing by 4.0% and the U.S. investment-grade bond index decreasing by 5.3%.

Market Outlook

Any knowledgeable sailor will tell you that the first thing you need to do to ascertain where you are going is to know your current location and where you have been.

Since April of this year, we have been convinced that the global economy has entered a synchronised slowdown and that, ultimately, this will take the sting out of inflation and pressure off higher prices. Subsequent economic data has only reinforced this view. By June, we spoke of an impending future growth shock that would be visited upon the U.S. economy, which would ultimately force the Federal Reserve to relent later this year with additional interest rate hikes. Counterintuitively, we believed this rapid slowdown would ultimately prove supportive for the prices of risk assets such as long-maturity treasury bonds, equities, and higher-quality corporate bonds as it would herald a relief rally on the premise that the cycle of tighter monetary policy would end.

The Federal Reserve will go on hold soon (most likely this year)
It should therefore come as no surprise to the reader that we stick by our view and are now even more convinced that our view will prove correct. We believe that economic conditions are now close to a point where the Federal Reserve will soon have little choice but to go on hold indefinitely with its interest rate policy. We believe markets, through October and November, will anticipate this coming signalling by the Federal Reserve, leading to a strong rally in risk asset prices into the end of this year. Indeed, we believe that the long end of the U.S. Government bond curve, which the Federal Reserve does not peg, will start to rally from recent highs as the market begins to price in the economic slowdown and rapidly falling longer-term inflation expectations. Indeed, it is interesting to note in the next graph, that equity markets, despite exhibiting plenty of volatility given the uncertainty, have not put in

Market Outlook continued

material new lows since June, when we first posited the idea that a rapidly weakening economy would eventually quieten the Federal Reserve and lead to a rally in markets. This price action suggests that the equity markets have priced in a recession but are not yet ready to rally in a sustainable way until the Federal Reserve starts to signal that it is close or closer to the end of its aggressive tightening cycle.

Nasdaq and S&P 500 Indices

Source: Bloomberg

The market is already signalling that it believes the Federal Reserve has won the battle on inflation with future inflation expectations having fallen back to long-term equilibrium levels. The table below shows that five-year forward inflation levels are close to the 2% range.

US Federal Reserve Five-Year Five-Year Forward Inflation Expectation Rate Index

Source: Bloomberg

In our view, there are many reasons why the Federal Reserve will relent with interest rate increases soon; therefore, we will address the most critical points below.

The U.S. is unlikely to avoid recession

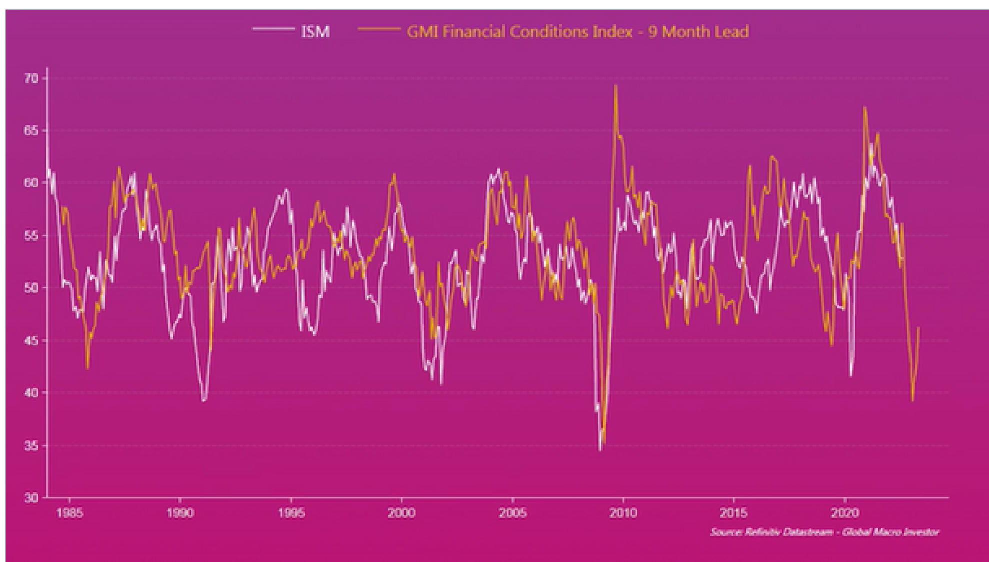
Many leading economic indicators are telling us that the U.S. is already in or on the cusp of recession. For example, the U.S. Regional Manufacturing Survey below, which tends to lead the overall U.S. ISM Manufacturing index ("ISM"), is pointing to an ISM reading of well below 50 in the coming months, which is firmly in recession.

ISM Manufacturing PMI Index vs GMI U.S. Regional Manufacturing Survey Composite

Source: Global Macro Investor

The Global Macro Investors (GMI) financial conditions index, a weighted index of the rate of change in interest rates, the U.S. dollar and commodities, leads the US ISM manufacturing survey. It is again pointing much lower in coming months. Indeed, it suggests the U.S. real economy will go substantially weaker from here but bottom out around the end of Q1 2023. The fact that this indicator is pointing to a bottom in the real economy early next year is favourable for equity markets as they tend to look forward and discount a recovery in the economy, usually months before the actual economy bottoms.

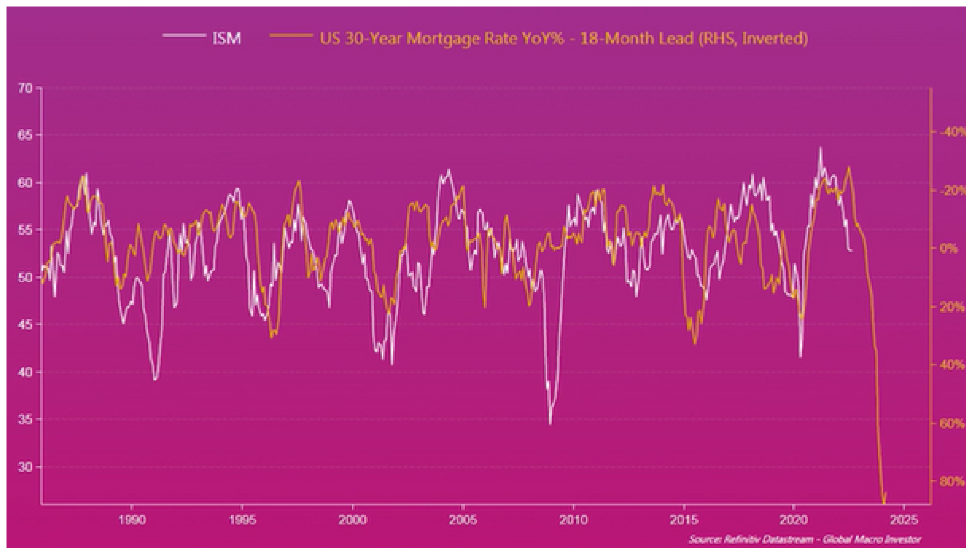
ISM Manufacturing PMI Index vs GMI Financial Conditions Index (9 Month Lead)



Source: Global Macro Investor

If we map the U.S. ISM against the rate of change in the 30-year U.S. Mortgage rate as a proxy for the health of individual consumers, it also suggests a coming collapse in the ISM after the fastest repricing in U.S. mortgage rates in history. With mortgage rates now topping 7%, housing affordability has evaporated and with-it housing demand. In August, Moody's expected a U.S. house price decline of 0%-5%. Less than two months later, they expect a 15%-20% housing price decline assuming a recession hits[4]. This feels scarily like housing market crash territory, if we are to be frank.

ISM Manufacturing PMI Index vs Inverted U.S. 30 Year Mortgage Rate YOY% Change (18 Month Lead)



Source: Global Macro Investor

The broader economic ramifications of a U.S. housing market crash are obvious. Along with significant pressure on all those ancillary industries that support the housing market, this rapid move in mortgage rates will hammer the disposable income of mortgage holders on adjustable-rate mortgages and is likely to bring put the brakes on demand for new mortgages and new housing.

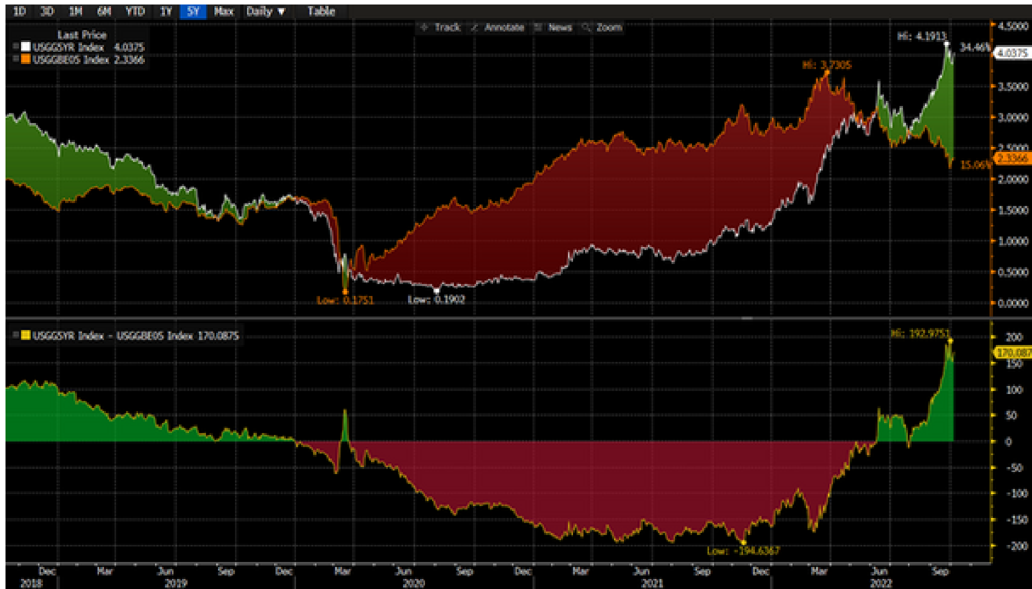
A rapid rise in real interest rates will kill marginal consumer demand

Real interest rates in the U.S. are now rising rapidly as inflation expectations begin to fall. Yet nominal rates are still increasing as economic growth continues to slow! This is never a healthy concoction. The U.S. has witnessed a rapid tightening in monetary conditions as real 5-year Treasury yields have risen by about 4% in less than a year. This is both a substantial and rapid tightening in financial conditions. In the last three months alone, the U.S. has seen real yields rise by 2%. This increase in rates is both odd and worrying when one considers that U.S. economic growth is falling, inflation has peaked, and leading indicators suggest that a sharp recession is pretty much guaranteed. Moreover, it indicates that quantitative tightening (i.e. the Federal Reserve selling bonds from its balance sheet) is possibly causing a decoupling of bond yields from inflation and growth. When one considers that the total public and private debt in the U.S. economy has mushroomed from USD 55tn in 2008 to USD 88tn in 2021[5], the speed and quantum of the increase in real interest rates is almost certain to inflict huge pressure on the economy and soon. ICM estimates that a 4% increase in real rates equates to USD 3.5tn in additional annual interest servicing burden, which is about 15% of U.S. annual GDP. This interest burden will undoubtedly shock the U.S. economy in the coming months. The table below shows the spreads between the current five-year nominal Treasury yield and the expected five-year inflation rate to arrive at the real interest rate. The five-year real interest rate has gone from negative 2% at the beginning of 2022 to nearly positive 2% today. This move in real interest rates is likely to kill off marginal demand as disposable income is squeezed.

ICM Monthly Outlook

OCTOBER 2022

U.S. Five-Year Treasury Rate vs U.S. Five-Year Inflation Break Rate



Source: Bloomberg

Disinflation will become the new market narrative in 2023

Despite some concerns in the market that inflation will remain sticky, in our opinion, inflation has definitively peaked and is set to fall sharply. Many leading indicators, ranging from commodity indices to central bank liquidity measures, point to significantly falling inflation as measured by the CPI over the coming months. In addition, a broadly dispersed survey of small businesses in the U.S. conducted by the National Federation of Independent Business also reports lower prices and points to a lower CPI reading in the coming months as can be seen in the graph below.

NFIB U.S. Small Business Survey (1 month lead) vs U.S. CPI YoY% Change

Source: Global Macro Investor

The ISM New Orders component also continues to worsen. When coupled with increasing inventories and falling consumer demand, this will likely quicken the pace of inventory liquidations and disinflation. In our opinion, the surprise of 1H 2023 could be that inflation comes down faster than expected and the rate of disinflation becomes the new narrative. This should be very supportive for markets.

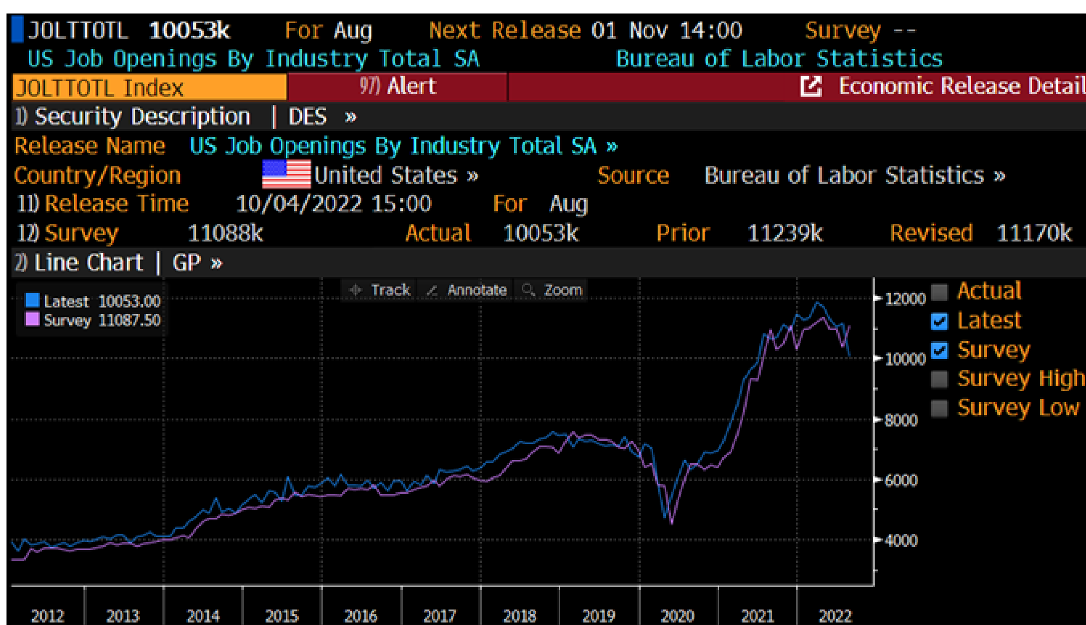
Falling liquidity is leading to dysfunctional markets

Another reason why the Federal Reserve will soon relent is that the flow of liquidity in the financial system has significantly reduced, leading to dysfunctional and disorderly financial markets across the globe. Monetary policy uncertainty is leading to greater volatility in the financial markets, which has impaired price discovery. When investors perceive a higher risk of price volatility associated with certain assets, they become less sure about how to price that risk. When investors grow unsure, their default action is to adopt a wait-and-see approach deferring any decision to invest. As a result, global credit markets have been practically shut for over a month, so regular corporate refinancings are no longer happening on the scale needed to avoid a future credit crunch. Furthermore, negative market news can magnify market movements in such environments, which can also severely affect the global economy's health over time. A classic example of this market nervousness was the outsized adverse reaction to U.K. Gilt yields and the steep drop in Sterling on the recent budget announcement by the new U.K. Conservative party leadership.

Aggressive monetary tightening by the Federal Reserve is also playing havoc with global trade and the global business cycle. The USD is the world's reserve currency, with approximately 80% of the world's trade invoiced in U.S. dollars[6] yet the U.S. economy only accounts for about 16% of Global GDP[7]. Therefore, there is always a strong demand for U.S. dollars, but this demand is further increased when U.S. dollar interest rates are increasing as foreign debtor nations need to find more U.S. dollars to service their debts. At the same time, a recession and slowdown in global trade typically leads to falling U.S. trade imports and therefore a lower amount of U.S. dollars available abroad to satisfy demand leading to even more U.S. dollar strength. If U.S. dollars become less available, international trade begins to fall apart, leading to a slowdown in the global business cycle. This contributes to the idea of a synchronised global slowdown where suddenly tighter monetary policy pushes a weakening global economy over the edge and into recession.

Of course, the U.S. Jobs market is the last area of strength, but this will soon give way as signs mount that it is cooling. It is significant that the U.S. lost 1m potential jobs in August alone as per the reduction in the Jobs Openings report below. This is likely to continue as the jobs market weakens further, making the Federal Reserve think twice about the pace of its interest rate increases.

U.S. Job Openings & Labor Turnover Survey (JOLTS)



Source: Bloomberg

The Federal Reserve is about to make another blunder

The Federal Reserve is on course to make another massive blunder. Their first error was letting inflation take hold without attempting to chasten it early by making some pre-emptive interest rate increases last year in the mistaken belief that inflation would be transitory. It would be unfair to say the Federal Reserve committee should have predicted the Ukraine war and its impact on energy and food commodity prices. Still, maybe they could have allowed for supply-side constraints in their modelling and not been so quick to dismiss the rising price pressure as

transient. Now in their haste to salvage their tarnished reputations and compensate for their late about-turn, they are tightening monetary policy so aggressively, we might even argue recklessly, that the propensity for error in having too tight conditions is much higher than it ought to be. Little apparent concern or consideration is being given to the speed at which they are tightening, as no time is allowed between hikes to assess the impact of past increases on the broader economy. The analogy is akin to driving a car at high speed through a packed underground car parking lot and expecting not to crash into any other cars or walls. Only a miracle will avoid a very unwelcome but predictable outcome of a hard landing. It is clear from recent communiques that the Federal Reserve has opted to err on the side of too much rather than too little tightening.

Of course, having a too-tight monetary policy is not sustainable long term if we are to deal with the total global debt burden, which is now approaching USD 300tn[8]. While we must not have runaway inflation, the global economy requires an element of financial repression, where monetary policy remains on the loose side of neutral, to solve the world's total debt problem. We simply have too much debt across the major nations of the globe. Realistically, this will not be solved by global Governments paying down their debt over time given political demands. Neither will a financial Armageddon be allowed to take place, leading to a collapse of the global financial system where all debt would be ultimately rightsized to a level that will enable a new start. Instead, the most probable and sensible solution, in the long term, is to allow inflation to grow at levels above the general level of interest rates, thereby inflating our debt away. Hence, the Federal Reserve knows it will ultimately have to relent and loosen monetary policy once again.

We mentioned at the beginning of this outlook section that we believe markets are going through a process of bottoming. As a team we are always focused on finding great positive asymmetric trades where there is more upside than downside risk. Given inflation has peaked, bad economic news is heavily discounted by way of lower asset prices and investor sentiment is extremely bearish, we believe rigorous research-based investments made today at current prices will emerge as great positive asymmetric trades over the coming year.

Gavin Blessing
7 October 2022

Source Data: ICM, Bloomberg, Trading View; as of 30 September, 2022.

[1] https://www.ft.com/content/dd0ffcb8-ccf4-4a6d-8306-72854888090e
[2] https://www.ismworld.org/globalassets/pub/research-and-surveys/rob/pmi/rob202210pmi.pdf
[3] https://am.jpmorgan.com/gb/en/asset-management/adv/insights/market-insights/market-updates/monthly-market-review/
[4] https://fortune.com/2022/10/05/housing-markets-at-risk-of-25-to-30-percent-home-price-crash-moodys/
[5] https://www.statista.com/statistics/1083150/total-us-debt-across-all-sectors/
[6] https://fortune.com/2022/10/05/housing-markets-at-risk-of-25-to-30-percent-home-price-crash-moodys/
[7] https://www.statista.com/statistics/270267/united-states-share-of-global-gross-domestic-product-gdp/
[8] https://www.iif.com/Key-Topics/Debt/Monitors

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