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

SEPTEMBER 2023

Market Review

In August, we saw a number of movements: the S&P 500 fell by 1.6% thanks to rallying into the end of the month, having been down by almost 5% at one stage during August; interest rates were a significant driver of equity market movements; and, global interest rates hit their highest level since the Global Financial Crisis ("GFC") in 2008.

In mid-August, the yield on US 30-year treasuries hit 4.45% from 4.01% at the beginning of the month before retreating to 4.21%. Furthermore, minutes released from the US Federal Reserve meeting in July showed officials continued to believe that the inflation fight is not over and that more restrictive monetary policy may be required. While ratings agency Fitch downgraded the US government's debt, citing unsustainable debt and deficit trajectories as well as political dysfunction, this does not appear to have been the main driver of the increase in yields during the month, as markets brushed past the downgrade for at least a week before yields started increasing.

August was perhaps a gentle reminder that while inflation has declined significantly from highs, there is still some work to be done, and the US Federal Reserve continue to signal that they are intent on doing it. All eyes will be on the US Federal Reserve later in September to see any potential rate increase and where the rates are likely heading through the end of 2023 and into 2024.

The US Conference Board Leading Economic Index continues to point towards economic contraction and is signalling a short and shallow recession in the Q4 2023 to Q1 2024 period. The Conference Board Leading Economic Index has a strong track record in predicting recessions. It has been indicating a forthcoming US recession since mid-2022.

ISM Manufacturing Purchasers Manager Index ("PMI") read 47.6 in August, up from its lows 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. ISM Service PMI continues to point to strength in the US Services sector, with a reading of 54.5 in August.

Somewhat under the radar until recently, energy prices are rising again. In August, oil prices increased by 1.5% and natural gas prices increased by 5.1%. They are up 19.5% and 22.2% respectively, over the past three months. After month end, Brent prices soared past USD 90 per barrel after Saudi Arabia announced it would continue its 1 million barrel a day output cut until the end of this year. The Saudis first announced it would unilaterally cut production by 1 million barrels per day in June, at that point for July only. Prices have been steadily rising from just over USD 70 per barrel since. Continued oil price increases could yet begin to exert upward pressure on inflation numbers and thus pressure on the US Federal Reserve to resume aggressive monetary tightening.

Like the US, European stocks also fell in August, with the Eurostoxx 50 falling by 3.8%. Similar to the US, inflation and interest rates are weighing on risk assets. However, Europe also grapples with war and a potentially significant

Market Review continued

economic contraction. In early September, the European Commission downgraded predictions for economic growth to 0.8% for 2023 from 1.0% forecasted in May this year. Paolo Gentiloni, the European Commissioner for the economy, stated that “Economic activity stalled in the second quarter, and survey indicators point to further weakening in the coming months.” With inflation in Europe running at 5.3%, the European Central Bank is in an increasingly difficult position of having to raise rates in a weakening economy.

In the UK, the FTSE 100 fell by 2.5%. Like in Europe, growth continues to be anaemic, and inflation continues to run at 6.8% despite a sharp decline in recent months. The Bank of England continues to tread a path fraught with danger in its battle against inflation.

In August, as measured by the MSCI Emerging Market equity index, emerging markets declined by 6.0%. Chinese equities fell sharply, losing 6.2% in August to leave the index down 4.4% this year, an abysmal performance against the backdrop of a full re-opening of the Chinese economy for the first time since the Covid outbreak. China continues to grapple with the fallout from its property market slump, which is stifling economic growth and mounting further pressure on debt-laden developers. The Chinese Communist Party (“CCP”) has introduced measures to ease the situation, including liquidity support for developers, lowering restrictions on home purchases and cutting interest rates. However, it remains a core aim of CCP chairman, Chairman Xi, that China moves away from debt-fuelled growth dependent on real estate. So far, actions by the CCP have been met with a lukewarm reception by markets. In August, the Chinese Renminbi fell to its lowest level in 16 years against the dollar.

In August, European government bonds, as measured by the Barclays Euro Aggregate Government Index, increased by 0.3%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, decreased by 0.6%.

Investment Grade credit, as measured by the ICE Bank of America US Corporate index, decreased by 0.7% and High-Yield credit, as measured by the ICE Bank of America high-yield index, increased by 0.3% during the month.

Market Outlook

After running hot for a couple of years, the US economy continues to decompress slowly like a kettle taken off the boil.

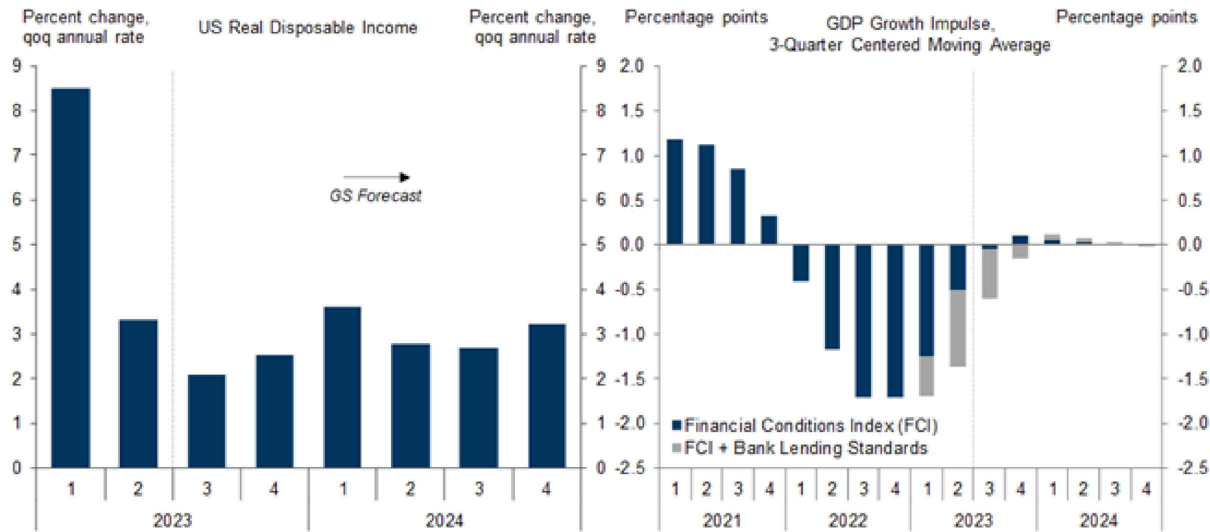
While inflation is falling and the job market is declining, it is all happening relatively slowly. Economic momentum is declining, but this weakness does not appear to be accelerating, which is good news if we hope to avoid a meaningful recession. Indeed, this slowing momentum, engineered by tighter Federal Reserve policy, has the economy on a glide path to a soft landing and a targeted inflation rate of around 2%.

A US economic soft landing is increasingly likely with manufacturing activity at an inflection point

We believe the probability of the US falling into recession is receding, and even if we have a recession, our view is that it will not be a deep or long-lasting recession. Of course, GDP growth will slow and will be weak for a few more quarters, but it is increasingly likely that GDP growth will post positive rather than negative quarterly numbers over the coming year.

Market Outlook continued

US Real Income Growth Reaccelerating; Monetary Policy Drag Fading



Source: Goldman Sachs Investment Research

According to Goldman Sachs, as shown in the chart, US real disposable income looks to reaccelerate in 2024 due to continued solid job growth and rising real wages bolstered by falling inflation. This should cushion any negative GDP momentum. Furthermore, the Goldman Sachs Financial Conditions index has already inflected. It has been showing better momentum since earlier this year, meaning that financial conditions no longer have the same negative drag on economic growth as last year. Going forward, this negative drag on GDP growth from financial conditions will likely be replaced with positive contributions to GDP growth.

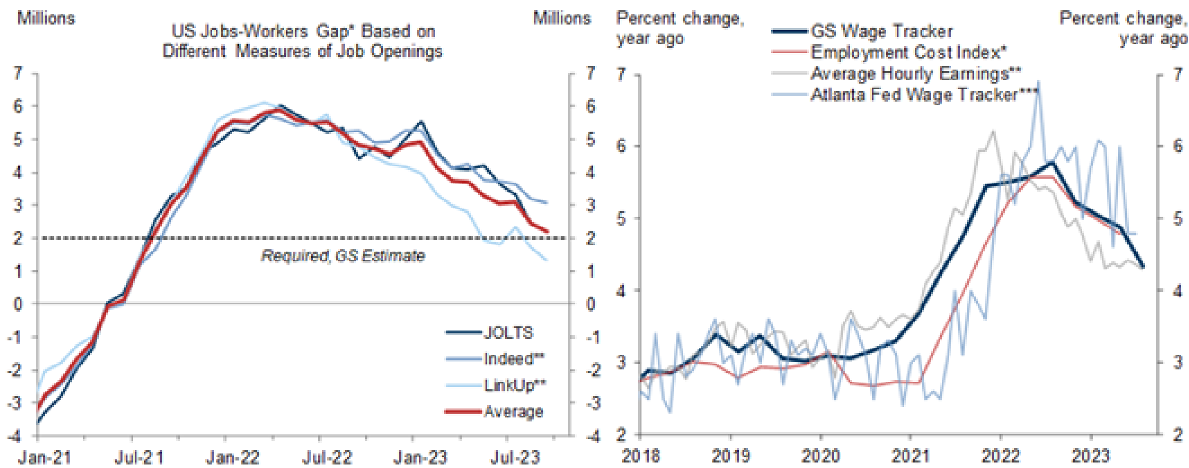
Indeed, looking at the GMI Financial Conditions index, which measures financial conditions on an annual rate of change basis, it is evident that a strong correlation exists between it and the US ISM Manufacturing Index with a 9-month lead. The GMI Financial Conditions index bottomed late last year and has improved ever since. This leading correlation tells us that the US ISM Manufacturing Index, our proxy for the US business cycle, is likely to be bottoming around now and that US manufacturing activity should start to improve over the coming months and quarters. At first, this monthly improvement in activity will be small. The index will still register as weak, reporting less than 50, but it should be less weak than in previous months. However, as we move through the first half of 2024, the ISM index should move back above 50, and manufacturing activity should begin growing again.

US ISM Manufacturing Index versus GMI Financial Conditions Index (YoY%) – 9 Month Lead

Source: Global Macro Investors

The US Labour Market is showing increasingly more evidence of a slowdown
Recent data from the US labour market continues to point to signs of a gradual rebalancing from one that was very tight and overheating to one that is now on its way back to a more normalised state, synonymous with an economy growing at a more consistent and sustainable pace.

US Labour Market Rebalancing; Wage Growth Continues to Slow

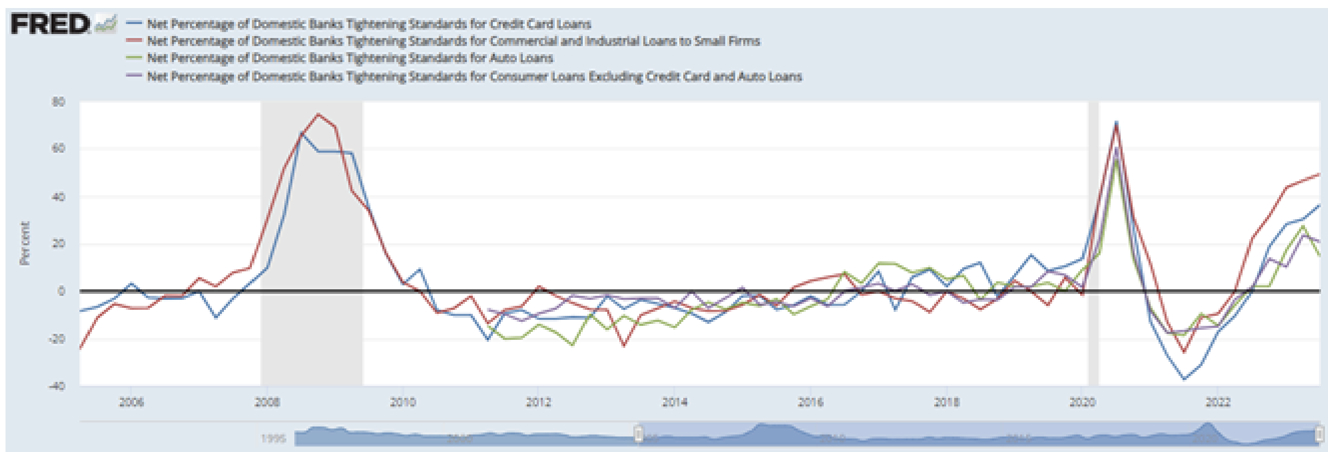


Source: Goldman Sachs Investment Research, Haver Analytics, Linkup, Indeed

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. The chart on the right shows this is already happening, with wage growth falling from a peak last year. We believe this momentum is likely to continue. Indeed, as we asserted last month, based on previous business cycles, wage inflation typically decelerates up to a year after the business cycle low as measured by the US ISM index. Given we are only seeing the low in this index about now, this implies we should expect to see much more wage-price deceleration over the coming months and quarters.

Another contributor to falling inflationary pressures is expected to be softer consumer spending. According to research from the Federal Reserve Bank of San Francisco, cumulative excess savings built up by US households during the pandemic will probably be exhausted during Q3 2023. It seems these excess savings are part of why the US economy has remained so resilient this year despite the most aggressive cycle of interest-rate increases experienced in several decades.[1]

Net Percentage of US Domestic Banks Tightening Lending Standards



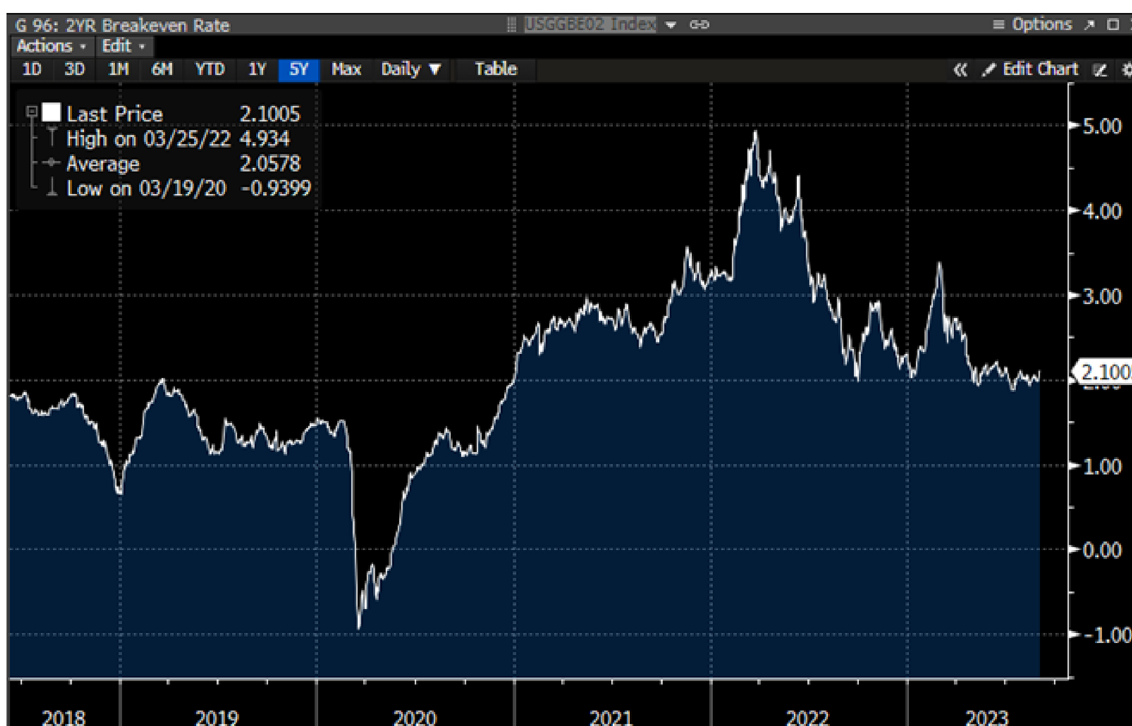
Source: Federal Reserve Bank of St. Louis

Tighter credit conditions are starting to bite

Tighter credit conditions should dampen demand and further ease inflationary pressures in the economy. As can be seen in the chart, bank credit or lending conditions are now tightening for most segments of consumer and small firms' credit across the US economy. Delinquency rates for credit cards and auto loans are now back up to or surpassing levels that prevailed when the pandemic began, although mortgage delinquencies remain low. US credit card balances rose by $45 billion in Q2 2023, rising past $1 trillion for the first time in the New York Federal Reserve survey's history, indicating that consumer spending is probably no longer enjoying the same robust platform as it has done for the last couple of years and could quickly begin to soften later this year and into next year.[2]

By observing key variables within the US bond markets, we can benefit from the distilled wisdom of where investors expect inflation to be in several years. The difference in the yield between inflation-protected bonds and nominal bonds of the same maturity is known as the break-even rate or the level of expected inflation in the future. The chart shows the 2-year expected inflation rate development over the last five years. Interestingly, the bond market believes inflation will be just over 2% in about two years from now.

US 2-Year Inflation Expectations



Source: Bloomberg

While investor inflation expectations are not back to pre-pandemic lows of around 1.5%, which was unusually low at the time, an expectation of 2% is precisely in line with the Federal Reserve's inflation target of 2%. Hence, this tells us that the Federal Reserve's creditability in the marketplace is very high and that the bond market believes it will be able to control inflation in the future and is on course to achieve its inflation target.

Lower inflation expectations will lead actual inflation lower

The market and, ultimately, the consumer must believe in the Federal Reserve's creditability and ability to control inflation. We believe the level of inflation expectations is a key determinant of the actual or realised level of inflation over time. In our opinion, inflation is a function not just of the available money supply in an economy but also of the velocity of money or the turnover of money in the economy. More money in the economy, turning over more quickly, and chasing a relatively limited supply of goods and services usually leads to higher inflation, especially in the short to medium term. The inflation expectations of consumers have a direct bearing on the velocity of money. If consumers have high inflation expectations, they will naturally fear that the goods and services they wish to consume in the future will be too expensive to buy, so they typically choose to consume those goods and services now. Therefore, they pull forward their consumption of goods and services from the future and consume them in the present. This causes demand and the velocity of money to spike as they chase more goods and services today.

When future inflation expectations fall, consumers become less fearful about their future spending power, become less inclined to consume today and are quite willing to push their consumption into the future, leading to a lower velocity of money and lower inflation levels. Indeed, if consumers expect outright lower prices in the future or deflation, they typically stop spending in the short term and save instead, which usually heralds a demand-led recession.

Given that inflation expectations are now back at more normalised levels, it suggests that US consumption will slow. In turn, inflation will return to more normalised trend levels, in line with the Federal Reserve's target. Indeed, we can see consumption and inflation slowing in other parts of the world where, for example, Germany has now registered its third consecutive quarter of negative growth,[3] and China has recently suffered from falling demand and deflation. While the US economy is relatively closed, US economic growth will be impacted by weaker Chinese growth and imported goods deflation as producers cut pricing to reduce inventories.[4]

The Federal Reserve rate hiking cycle is probably over

Falling government or fiscal stimulus, slowing wage growth and tightening credit conditions should make the Federal Reserve Committee more comfortable with their current policy stance over time and point to the probability that they will not need to raise interest rates any further in September or November. The Federal Reserve is no longer giving forward guidance on interest rates. It has made it abundantly clear that further interest rate decisions will ultimately depend on the economic data. Despite their restrictive policy stance, with real interest rates above 2% and evidence of a slowing economy, we sense that the Federal Reserve Committee still believes an underlying inflation bias exists. Our view is that the economic data will continue to soften, which we think will provide enough evidence in the data that no more interest rate increases are required to bring inflation back to its 2% target. Hence, as we go through the last quarter of this year, we think it will gradually become apparent to the market that the Federal Reserve rate hiking cycle is paused for good and, therefore over, which should support market sentiment. This view is further supported by the fact that the Federal Reserve will likely continue with its balance sheet reduction plans even if it decides that no further interest hikes are required. This balance sheet flexibility will give the Federal Reserve the confidence and latitude to make this decision.

Market Implications

We have been arguing for several months that, as investors, we should adopt a more cautious market positioning given that equity markets, in general, could see pricing weakness driven by seasonal factors, profit-taking amongst stretched valuations and disappointment around the timing of Federal Reserve rate cuts being pushed out further into 2024. In contrast, we believe the medium to longer-term outlook for equities and other risk assets, in general, is improving, and indeed, we believe we are in the early stages of a new multi-year equity bull market that began when a bottom was achieved in October 2022.

Equity markets are anticipatory. Forward indicators of the business cycle point to an improving economic outlook as we move through 2024 and into 2025. This improvement in sentiment is likely to be supported further by an easing of monetary policy as the Federal Reserve calculates that real rates are too restrictive and inconsistent with its full employment mandate. We believe this equity bull market has been and will continue to be supported by an economic environment of rising growth, peak interest rates and falling inflation. Hence, we believe the recent weakness in August and September are corrections that should be bought.

We remain constructive on US government bond yields at current levels as we believe bond yields are either at or close to the top of their range for the current cycle. We do not believe the structure of the US economy has changed so radically post the pandemic and its attendant emergency policy responses such that it can cope with the current level of real interest rates are now about 2%, which is a full 3% higher (i.e. from negative 1% to positive 2%) than they were for more than a decade before the pandemic struck. Given that the accumulated amount of US debt in both the private and public sectors is now higher than at any time before in history, it is not clear to us how the US economy will be able to sustain the financing cost of this burden without other productive sectors of the economy being squeezed in terms of investment capital and growth.[5] Bond prices will benefit from falling inflation and weakening unemployment over time. Of course, the Federal Reserve will likely be slow to cut interest rates, which may delay a fall in government bond yields until later in 2024. Still, we certainly believe the direction of travel will be lower, not higher, yields over the medium to longer term.

Despite its recent rally, we maintain our medium to longer-term bearish stance on the US dollar. This view is predicated on the fact that the US dollar tends to underperform in an environment with improving growth but slowing inflation. We also expect US inflation to slow along with US growth, 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 will improve as we go into 2024, driven by the end of its recent destocking cycle, an export improvement and more government-backed stimulus.

We expect commodity prices to remain broadly subdued in the short term due to concerns over the global economic slowdown. However, we expect global economic activity to pick up next year. As such, commodity prices should reflect this increasing demand with higher prices, especially given the supply constraints around many commodities, most notably copper. We also expect copper and those metals associated with green energy and renewable infrastructure to benefit from an ever-increasing investment in decarbonisation. A weaker US dollar environment and falling interest rates should also be supportive.

Gavin Blessing
11 September, 2023

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

[1] https://fortune.com/2023/08/16/americans-savings-nearly-depleted-sf-fed-study/
[2] https://www.msn.com/en-us/money/personalfinance/credit-card-car-loan-delinquencies-surpass-pre-pandemic-levels/ar-AA1fiDHi
[3] https://www.forbes.com/sites/simonconstable/2023/08/28/germanys-epic-recession-continues-economy-still-cant-catch-a-break/?sh=40b6b0812bd2
[4] https://www.ft.com/content/7586a7a5-94e0-412c-abd2-66832ed486d9
[5] https://www.statista.com/statistics/1083150/total-us-debt-across-all-sectors/

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