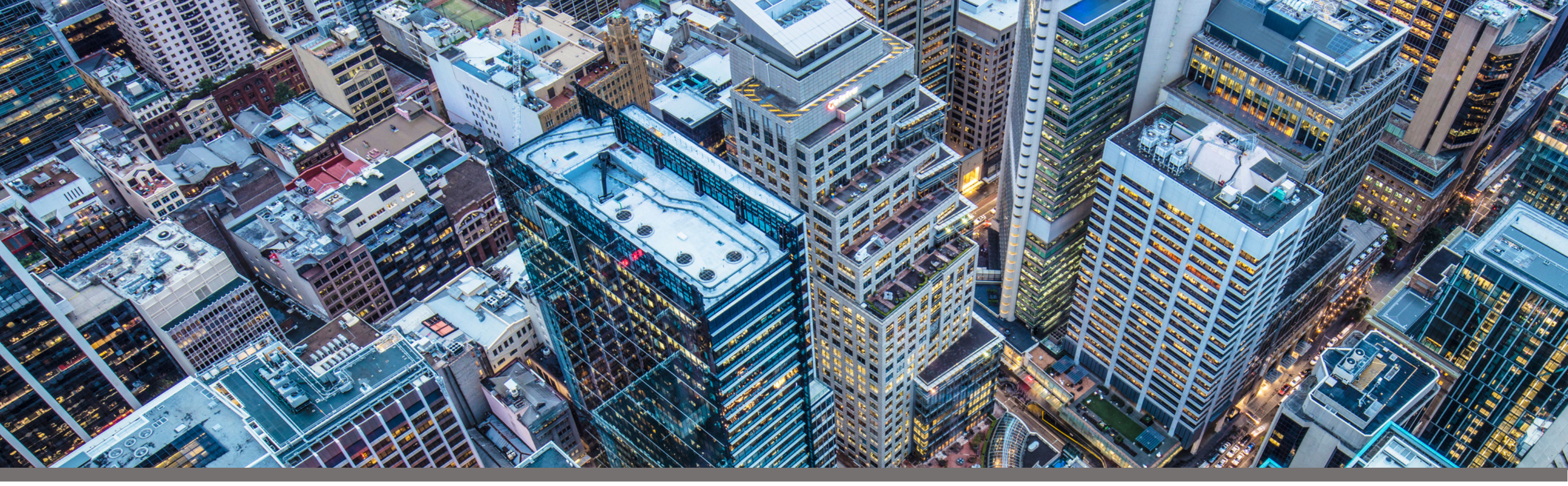


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.7** BILLION	**US$21.5** BILLION

ICM Monthly Outlook

NOVEMBER 2023

Market Review

The S&P 500 fell by 2.1% in October, its third consecutive monthly decline, and it has fallen by 8.3% since July. Year to date, the S&P 500 has increased by 10.7%. The S&P 500 continues to fall despite the US Federal Reserve holding rates steady over its past two meetings, in November and September. This was the third meeting in the last four where the US Federal Reserve has decided to leave rates unchanged. Since May 2023, the Federal Reserve has raised rates by only 0.25%. Obviously, short-term interest rates are not to blame for the most recent sell-off.

However, while the US Federal Reserve has held fire at the short end of the curve, the longer end of the curve has been rapidly increasing since July this year. For instance, US 10-year treasuries increased to 4.93% from 3.96% between July and October, having moved very little in the previous nine months. Furthermore, US 30-year treasuries increased to 5.10% from 3.86% between July and October, having fallen to 3.86% from 4.16% over the previous nine months. While the US Federal Reserve base rates will often bag the headlines, it is these longer-term rates off which all other major asset classes, including equities, are priced.

As we have said before, the impact of rising rates on equities is well known. The higher the interest rate on the risk-free asset, i.e. US Treasuries, the higher the return risky assets, like equities, must provide to attract capital. Roughly speaking, for every 1% increase in long-term rates, the equity price must adjust by c. 10%, so the equity market also returns an additional 1%. Given that long-term US rates increased by c. 1% over the past three months, it's unsurprising to see the S&P 500 decline of c. 10% to reflect the new higher interest rate environment.

The rate increase at the long end of the curve coincided with a slight but notable increase in inflation readings. In July, inflation data released for June showed inflation running at 3.0%, its lowest level since early April 2021. Since then, headline inflation has steadily risen, hitting 3.7% for the twelve months ending September 2023.

As often said in this letter, the US Federal Reserve was wrong when inflation took off in earnest in 2021. They will unlikely risk being wrong again, particularly if it means being seen as more tolerant of inflation.

October saw continued resilience of the US economy with a blockbuster jobs report, robust retail sales data and a blowout GDP print of 4.9% annualised for the third quarter.

However, other economic data continues to weaken. In a surprise to markets, the ISM Manufacturing Purchasers Manager Index ("PMI") fell to 46.7 in October, versus 49 in September and an expectation of 49. As a reminder, a PMI reading of greater than 50 indicates growth, while a reading of less than 50 indicates contraction. The PMI had been improving over the previous few months and looked set to move into expansionary territory.

Market Review continued

In September, existing home sales fell to a new cycle low of 3.96 million annualised. Only twice in the past 25 years have existing home sales fallen as low, most recently during the COVID-19 pandemic and before that in the aftermath of the Global Financial Crisis in 2008. High interest rates are certainly impacting housing activity as mortgages to buy these homes become increasingly difficult to service. So far, US house prices have fallen from a median asking price of USD 480k in Q4 2022, to USD 430k in Q3 2023.

In October, unemployment ticked up to 3.9%, up from 3.5% in July.

There is certainly enough evidence to point to a softening of economic conditions and, thus, a softening in inflation data. The recent uptick in inflation, to us anyway, feels more like a temporary blip rather than a new trend. We believe that inflation will head lower again in the coming months.

In Europe, too, inflation has been falling. In October, the Eurozone inflation fell more than 1% to 2.9% from 4.3% in September and 5.3% in August. The European Central Bank ("ECB") ended an unprecedented series of ten consecutive rate increases with a pause in October, holding its base rate at 4.0%. ECB president Christine Lagarde suggested that any rate cuts or softening in stance is likely some way off.

With continued dependence on foreign-produced energy, energy prices remain a huge risk in Europe. The latest conflict in Gaza will do little to ease concerns, particularly if other Middle Eastern countries get drawn into the conflict.

European stocks continue to follow their US counterparts, falling 2.6% in October, versus negative 2.1% for the S&P 500; falling 8.9% for the past three months, versus negative 8.3% for the S&P 500; and up 10.4% year-to-date, versus 10.7% for the S&P 500.

In the UK, the FTSE 100 fell by 3.7% in October and is now up 1.4% year-to-date.

In October, emerging markets, as measured by the MSCI Emerging Market equity index, fell by 3.3% and have now declined by 12.5% over the past three months in a relatively substantial and broad-based sell-off.

In October, European government bonds, as measured by the Barclays Euro Aggregate Government Index, decreased by 0.4%, while US Treasury bonds, measured by the Barclays US Aggregate Government Index, decreased by 1.2%.

Investment Grade credit, as measured by the ICE Bank of America US Corporate index, decreased by 1.8% and high-yield credit, as measured by the ICE Bank of America high-yield index, decreased by 1.2% during the month.

Market Outlook

Storm clouds gather, and gentle breezes become gusting winds. Hauling in the sail and setting down anchor is suddenly a tempting option. Yet this decision will come at a cost. Greeting loved ones and the enjoyment of home comforts will have to wait.

Like sailing a yacht, every investment decision comes with consequences. Deciding not to take a risk can avoid the cost of making a financial loss but will come at the opportunity cost of losing out on a potentially profitable opportunity. The investment manager's skill is to weigh these explicit and implicit risks or costs and decide which option offers the best, probability-weighted, expected outcome. There are no free shots, unlike the usual commentators in the business news media who offer an opinion one week only to offer a very different view the following week, seemingly free of consequences. Beware of any investment advice given without obvious skin in the game.

The talking heads would have you believe, this time around, that bonds are crashing as yields surge, equities are overvalued, and economic peril lies ahead. Jamie Dimon, the CEO of JPM Morgan, who continues to get his calls wrong, is now warning us that geopolitical tensions could fuel inflation, especially as trends such as rising oil and commodity prices, the transition to clean energy, and the restructuring of global trade all threaten to push up prices. "I don't think inflation will keep coming down," he said. "It may not, and therefore rates may go higher."

Market Outlook continued

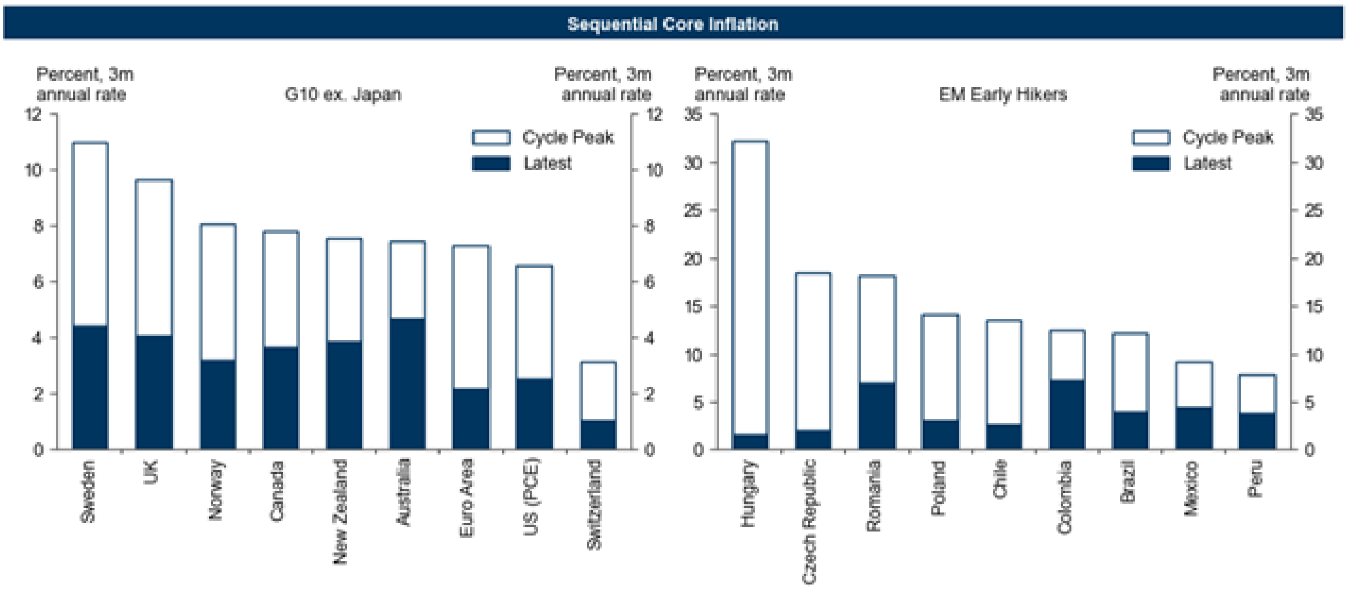
He isn't the only Wall Street boss worried about the economic outlook. Citi CEO Jane Fraser recently told CNBC that she was seeing "cracks" appear as consumer demand softens, especially among poorer Americans struggling to navigate higher prices and steeper borrowing costs.[1]

In our opinion, this is all day-to-day fluster and noise. Substantively, little has changed over the last several months. The US economy is in the middle of a monetary policy-induced slowdown. Inflation pressure built up from waves upon waves of excessive fiscal spending is slowly reducing. As we have said for several months now, we are moving into an environment of stable to rising growth, falling inflation, improving financial conditions, and increasing liquidity. The remainder of this year and next year will be a supportive environment for risk-taking, and brave investors will be rewarded. Do not be persuaded by the talking heads to put down anchor or change course. It may turn out to be a costly decision if you do.

Inflation will continue to fall over the coming 12 months
US monetary policy tightening is likely over even though the Federal Reserve will say they will hike further if the data warrants it. We think the data will not provide the ground for more rate hikes.

Inflation has been falling across many of the largest economies globally. Goldman Sachs estimates that since the end of 2022, sequential core inflation in this group of economies has fallen from 6% to 3% sequentially. Central banks have, therefore, achieved more than three-quarters of the adjustment needed to get inflation back to their targets. More likely than not, core inflation should fall below 3% by the end of 2024.

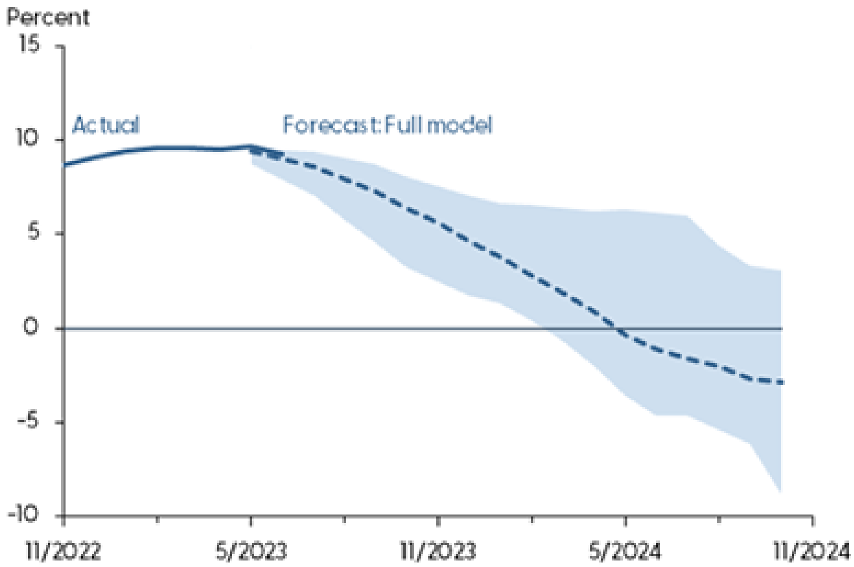
Annualised Percentage Change in Core Inflation Across Major Global Economies



Source: Goldman Sachs Global Investment Research, Haver Analytics

We believe US inflation will continue to fall despite what is commonly reported in the media and the recent elevated level of US government yields. As previously explained, shelter-related inflation is a lagging economic data point and typically only starts to be reflected in the reporting many quarters after rents and house prices have started falling in the real economy. The shelter component is a massive part of the overall US inflation basket, and its contribution to falling inflation or disinflation will only increase in the coming months. Indeed, as seen in the chart, the San Francisco Federal Reserve Bank has forecasted that year-over-year shelter inflation could continue to slow through late 2024 and may even turn negative by mid-2024.[2] If this happens, it would be the most severe contraction in shelter inflation since the global financial crisis of 2007-09.[3] If this prediction transpires, given that shelter is approximately 30% of the overall US CPI basket, it will significantly contribute to bringing overall inflation further down.

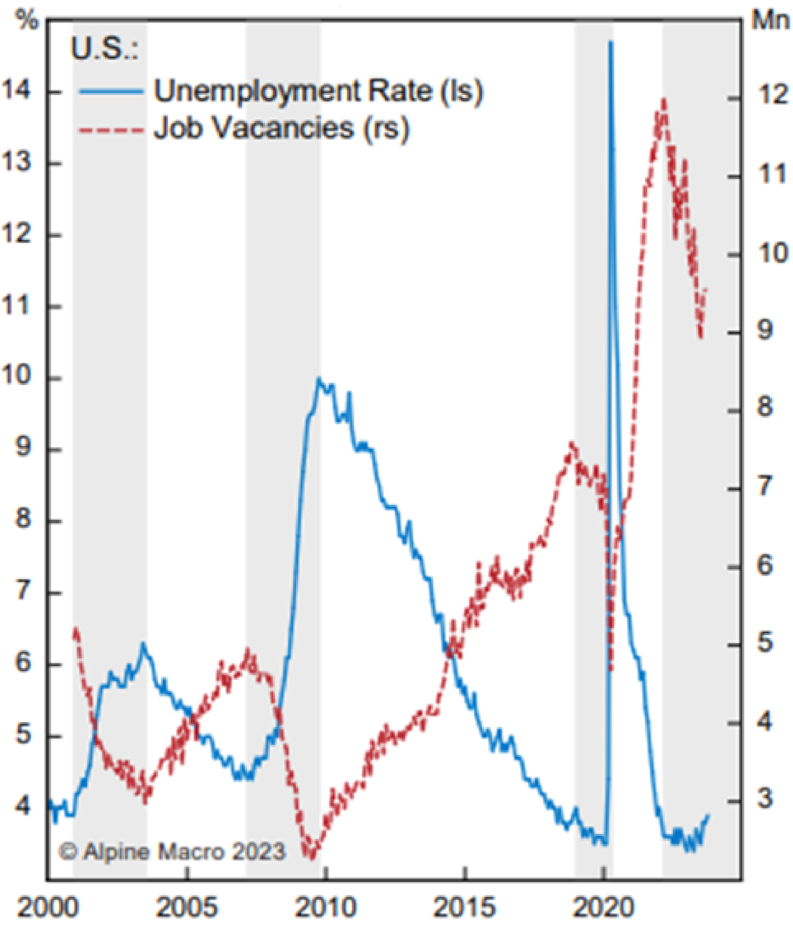
Forecast of Year over Year % US Shelter Inflation



Source: San Francisco Federal Reserve Bank

We have been predicting that the US labour market will continue to soften and report weakening numbers over time. The most recent jobs report did not disappoint. The slowdown in private payroll growth, a loss in manufacturing jobs and a higher unemployment rate are all signs of broadening weakness in the labour market.

US Job Vacancies versus US Unemployment Rate



Source: Alpine Macro

Significantly, job vacancies have been contracting since last September. This has played an important role in pushing down wage inflation in the recent past and will continue to do so. As seen in the chart, historically, a drop in the job vacancy rate usually leads to a meaningful rise in unemployment about 8-12 months later. This suggests that by mid-2024, the US unemployment rate is set to rise towards 4.5-5%, or even higher than this if the US economy falls into a recession.

As unemployment rises, this will undoubtedly lead to falling wage growth and, in turn, lower services-related inflation, a key focus for the Federal Reserve. With falling shelter inflation, this will have a noticeable impact on core PCE inflation, pushing it further down as we progress through 2024.

A slowing economy will also reflect falling demand, synonymous with less money chasing goods and services. Furthermore, as per the chart, 2-year inflation expectations are now anchored at levels consistent with inflation running at sustainable levels of about 2%, which aligns with the Federal Reserve's target. This is a crucial point. If consumers believe inflation will be lower in the future, or they have a sense that a recession is just around the corner, or both, then it is likely they will curb their spending either because they believe there is a chance that those desired goods or services might be cheaper in the future or because they are fearful about their income prospects and their ability to afford such goods and services. This scenario is now most likely one facing US consumers.

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

Source: Bloomberg

In our view, the Federal Reserve will likely keep short-term interest rates high if the incoming economic data indicates that the economy is running with an inherent inflation bias. If the financial data suggests inflation is on a sustainable and consistent path of about or towards 2%, then the Federal Reserve is likely to start cutting interest rates. This probably means that core inflation will need to be closer to 3% before we can expect a first-rate cut. Interest rate cuts will come eventually as unemployment will continue to drift higher with interest rates currently pinned so high. Given that the labour market operates on a lagged basis to the business cycle, it is clear that US labour market softness is set to continue for at least another year.

The business cycle is turning; manufacturing activity will pick up in 2024

We have shown before that the business or manufacturing cycle is led by financial conditions, which is a composite measure of the change in interest rates, the US dollar and equity markets. While economic conditions did become tighter for a short period through September and early October, they have, in the main, been easing since late last year. Typically, given the strong positive correlation, albeit with a lag of 6-12 months, between these two variables, when we see an easing in financial conditions, the manufacturing cycle tends to improve. Since financial conditions have been easing for most of the past year, this signals that, even if we slip into a recession in the coming months, it won't be long-lasting or deep and erosive. Corroborating this assertion, we can see that the ISM Manufacturing Index, which essentially reflects a point-in-time measure of the health of the manufacturing sector, is no longer falling precipitously, which it has been doing since it peaked in March 2021. Hence, manufacturing activity will pick up as more into 2024. Many of the headwinds affecting the sector in recent years, such as the energy crisis, inventory destocking and disproportional consumer spending on services rather than manufactured goods, post-COVID, are now fading.

US ISM Manufacturing Index

Source: Bloomberg

We also believe that an environment where real disposable income is increasing as headline inflation falls and a relatively strong labour market should support consumption and prevent a meaningful recession from getting a grip on the consumer.

Forget the noise; keep focused on the fundamentals

When managing assets, we manage to what we believe will be the most likely economic and market-related scenarios in the near to medium term. We do not manage to more extreme events with a lower probability of occurrence. In this context, specific scenarios which various commentators in the media are now suggesting might happen, such as a severe recession or stubborn inflation leading to runaway bond yields, are plausible but, in our view, are unlikely. Listening and acting upon these views without doing your own research will come with consequences. Do your research, form a considered view and stay the course!

Market Implications

We remain constructive on developed world equity markets in the medium to longer term, and our conviction is buoyed by the strength witnessed in these markets in recent weeks. Equity markets are appealing, in our view, because we anticipate they will be viewed as attractive in many different plausible future scenarios. If, for example, economic weakness continues in the US, this is likely to hasten an acceptance by the Federal Reserve that they have done enough to permanently tame inflation, which would probably bring forward the timing of possible rate cuts. In our opinion, equities would rally on the announcement of a beginning in the interest rate cutting/easing of the monetary policy cycle. In contrast, if the economy remains resilient and shows signs of a rebound, particularly in manufacturing, early next year, this should also support equities as it bolsters expectations around more robust consumer spending and growing corporate earnings. As we have said for a couple of months, we believe we are in the early stages of an equity bull market, which will be supported by an economic environment of rising growth, peak interest rates and falling inflation. Hence, volatility should be welcomed as an opportunity to buy equities, particularly growth equities, as we believe they will post good returns into 2024 and possibly further into 2025. Of course, uncertainties still need to be resolved, such as sticker inflation, the threat of higher yields and geopolitical concerns, but we believe they will be resolved or fade in importance as we move forward.

Government bond yields offer value at current levels. While yields may go higher if inflation remains stickier and the Federal Reserve feels compelled to remain on hold for much longer than the market expects, we believe that, on balance, inflation will continue to fall. Yields will naturally gravitate lower over the next year or two. While one waits for this scenario to play out, investing in Treasury bonds today pays a handsome running yield. They are also a hedge against recession risks should we be wrong and any possible US downturn turn out deeper than we currently expect.

While credit spreads are trading inside their average spread over the last two decades, they are closer to the average spread than their tightest levels. In contrast, to spread valuation, the all-in yield offered by both investment and high-yield credits is comparable to some of the most attractive points over the last two decades. Hence, we believe investment-grade bonds, as well as higher-quality high-yield bonds, will perform very well over the next couple of years. An environment that supports equity prices should also support higher-quality corporate bond spreads as we expect earnings to grow and interest rates to fall, increasing debt affordability. Of course, this environment could become more challenging for highly leveraged, lower-rated, high-yield bond issuers as debt service costs will remain much higher for much longer. Despite this, there will still be a myriad of attractive opportunities in this space for the foreseeable future, which makes us convinced that strong returns are ahead of us, especially for better-rated issuers.

We maintain our medium to longer-term bearish stance on the US dollar. This view is predicated on the US dollar's tendency to underperform in an environment characterised by improving growth but slowing inflation. We also expect US inflation to slow, which should mean the end of the Federal Reserve rate hiking cycle. Even though we are bearish on the US dollar, we do not expect material weakness as we believe the US economy will outperform other major global economies over the next several years, supporting relative US dollar valuations.

Supported by the likelihood of a weaker US dollar environment over the medium to longer term, we believe returns on emerging market equity and debt will be strong for the foreseeable future. While we expect the Chinese economy will benefit from further policy stimulus as we enter 2024, it is clear that China has a host of longer-term challenges around foreign policy, regulatory oversight and demographic decline that will hamper its longer-term growth rate if left unaddressed. Nonetheless, other emerging market countries will benefit from the global upswing in manufacturing activity that we anticipate happening as we move through 2024 and into 2025.

In synchrony with our expectation that we will see an improving global upswing in manufacturing activity over the next 18 months, we expect increasing demand for commodities, especially metals, combined with genuine supply constraints and disruptions to lead to higher commodity prices in the medium term.

Gavin Blessing

16 November, 2023

Source Data: ICM, Bloomberg as of October 31st, 2023

[1] https://www.businessinsider.com/us-economic-outlook-jpmorgan-dimon-government-spending-geopolitics-russia-ukraine-2023-10?r=US&IR=T

[2] https://nationalmortgageprofessional.com/news/san-francisco-fed-forecasts-shelter-inflation-slowdown-amid-rising-interest-rates

[3] https://www.frbsf.org/economic-research/publications/economic-letter/2023/august/where-is-shelter-inflation-headed/