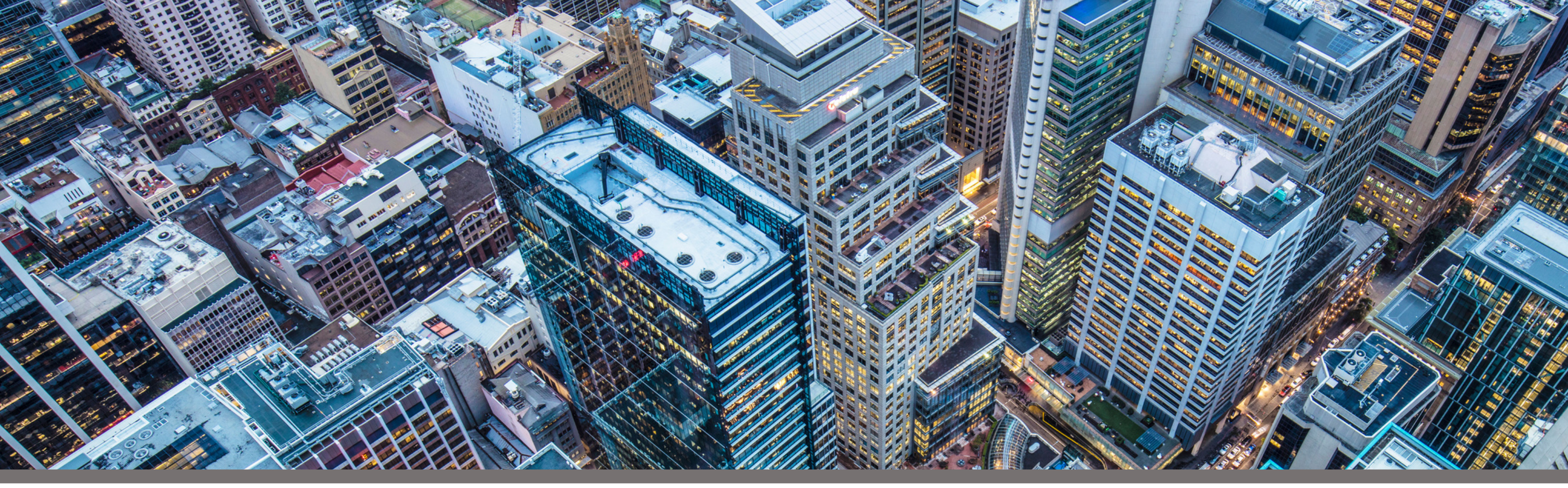

FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**70+**	**10+** COUNTRIES	**US$2.8** BILLION	**US$24.1** BILLION

ICM Monthly Review

MAY 2022

Market Review

April was a month to forget for many investors as stocks and bonds continued to tumble in unison.

The S&P 500 fell by 8.8% in April and is now down by 13.3% in 2022. The S&P 500 sell-off was indiscriminate with all sectors declining except for consumer staples. Even the energy sector, a rare highlight in 2022, fell by 1.6% during the month, although it remains up 35.4% year-to-date.

The tech-heavy Nasdaq declined by 13.3% in April and is firmly in bear market territory, down by 21.2% in 2022 and 23.2% from its all-time high on 19 November 2021. Many of the stock market darlings of the Covid era have reversed course at speed, especially those thematic technology names that benefited from the stay-work from home economy.

On April 20th, Netflix's share price fell by 35% when it reported that platform users declined by 200k during the first quarter. While this is a rounding error relative to its 222 million worldwide users, it is the first time Netflix has reported declining user numbers in a decade.

So far, it seems valuation compression, rather than earnings disappointments, has driven the sell-off in U.S. equities. Continued economic growth will be critical to continued earnings growth, particularly with inflation putting pressure on costs.

Emerging market equities fell by 6.1% in April and are now down by 13.2% in 2022, broadly in line with the S&P 500. China accounts for almost a third of the emerging market indices. In April, Chinese equities fell by 4.9% and have now declined by 18.7% in 2022. Furthermore, the losses in 2022 follow a decline in the Shanghai 300 index by 5.2% in the prior year.

South Korea and Taiwanese equities also declined, falling by 3.1% and 6.2%, respectively, and are now down by 10.9% and 8.9%, respectively, so far this year.

While Brazil equities tumbled by 10.1% in April, it remains one of the few positive performing equity indices in 2022, up 2.9%., helped by its large exposure to materials and energy.

Diversified investors seeking solace in fixed income were left disappointed too. It's difficult to think of a comparable period where fixed income has offered so little protection from a sharp decline in equities. In April, the Barclays U.S. Aggregate Government Bond Index fell by 3.1% and is now down by 8.5% in 2022, while the Barclays Euro Aggregate Government Bond Index fell by 3.8% and is now down by 8.9% this year. In April, Corporate bonds also fell, with declines of -5.0% and -3.6% for the U.S. investment-grade and high-yield indices, respectively and declines of -12.3% and -8.0% for the U.S. investment-grade and high-yield indices, respectively.

Market Review continued

While the annual inflation rate in the U.S. rose to 8.5% in March 2022, the most recent economic data suggests the rate of increase for inflation is slowing with core inflation ex food and energy showing a 0.3% monthly increase, which was down from 0.5% in February.

There was continued upward momentum across commodities, with the Bloomberg Commodity Price Index rising by 4.1% in the month, resulting in a total gain of 30.7% year-to-date. In April, oil prices increased by 1.3% and are up by 40.6% year-to-date. Meanwhile, some notable metal prices eased with nickel, copper and aluminium prices falling by 1%, 5.8% and 12.6%, respectively

In Q1 2022, U.S. GDP contracted by 1.4% versus forecasts of a positive 1.1% and an increase of 6.9% during the fourth quarter of 2021. Declining inventories, decreased government spending and a widening trade deficit caused the decline in GDP in the first quarter. In the fourth quarter of 2021, inventories added 4.9% to headline growth. In the first quarter of 2022, the natural cycle of reducing an inventory build-up began, and businesses decreased inventory investment. The decline in inventory contributed to a GDP contraction of 0.9%. Furthermore, U.S. government spending fell by 2.7% in the first quarter. In addition, the U.S trade deficit widened to a record USD 290 billion from the previous record of USD 230 billion in the fourth quarter of 2021.

Job growth in the U.S remains robust, with 1.7 million jobs created during the first quarter and the unemployment rate falling to 3.6%. Wage growth increased by 5.6% through to the end of March 2022. Job vacancies, at 11 million, remain elevated relative to their pre-pandemic level of c. 8 million.

Outlook

It is no exaggeration to say that we are currently going through an incredibly complex and uncertain macroeconomic environment which has arguably been created by fiscal and monetary policy responses to a confluence of exogenous shocks in recent years, namely the global pandemic and more recently war in Ukraine. All investors are focused on inflation and grappling with the incredulity of how we have encountered inflation the likes of which has not been seen in fifty years since the 1970s, especially given the ever-present disinflationary forces of technology and demographics, which we have detailed in the past. Unlike the 1970s, where inflation was caused by the combination of a simultaneous supply and demand shock, we believe that inflation today has been largely caused by several supply-side pressures, namely, the quick and sudden re-opening of western economies after the pandemic, an overreliance on just-in-time supply management practices and a decade long chronic underinvestment in upstream production capacity for commodities such as oil and copper. These pressures have only been exacerbated by the recent outbreak of war in Ukraine and the resultant fall in its exports of commodities and from sanctions imposed on Russian sourced commodities.

We believe we are close to or at peak inflation and associated fears around inflation. The rate of change in commodities-based inflation is slowing and this will soon become apparent in U.S. CPI reports, if not already. Indeed, U.S. core inflation ex. food and energy has already turned lower, and we expect this trend to continue in coming months. Despite recent Covid related shutdowns in China, there is a plethora of evidence in the U.S. suggesting that supply chain pressures have significantly eased and may soon be behind us. Railcar loadings(1) in the U.S. are down year over year, suggesting truck transportation capacity is normalising. The U.S. Cass Freight Index(2), which measures the number of intra-continental freight shipments across North America for everything from raw materials to finished goods, points to a levelling out of U.S. freight activity with little if any year-on-year growth. The Freightos Baltic Global Container index, which rose rapidly from 2020 onwards and peaked at $11,000 in September 2021, is now falling having registered $8,955 in April 2022. Not only do these readings tell us that the rate of change behind supply-side inflation is now falling, they also act as lead indicators for GDP growth in the U.S., suggesting that growth is headed lower and potentially quite quickly.

Outlook continued

These supply chain challenges, sparked by Covid related shutdowns, led to a behavioural change in U.S. manufacturers during the pandemic where they sought to build up inventories in order to ensure they had goods to sell or supplies to ensure continuous production. This build-up in inventories contributed to an increase in GDP growth through 2020 and 2021. If demand now starts to wane, for which we are seeing evidence, then it is likely that these inventories will start to be liquidated which implies a further drag on GDP growth and a fall in future ISM index readings. Hence, we expect ISM indicators to start falling and therefore GDP growth to decline over the coming months. We expect inflation to follow suit by rolling over soon and starting to fall steadily thereafter, reflecting declining demand and the need for inventory liquidation. Indeed, as we see it, the risk of inflation could be to the downside, as it comes off harder than most investors now believe, primarily due to a mix of easing supply side pressures and a rise in demand destruction due to falling real incomes and higher commodity prices.

We believe that inflation is inextricably linked to demand in general. If demand falls, we expect inflation to follow soon after as there is less money chasing a relatively fixed supply of goods and services. The recent increase in inflation, oil prices and mortgage rates are similar to a tax on consumers and this will undoubtedly act as a brake on their consumption patterns. This notional tax is reducing their net disposable income that would otherwise be spent on discretionary goods and explains why the University of Michigan Consumer Sentiment Index is in the doldrums and why we have seen slowing core retail sales in the U.S., especially in e-commerce. Of course, average annual incomes have increased but they have lagged inflation, therefore the working consumer is somewhat but not fully insulated from inflation. In sharp contrast, non-working consumers, such as retirees, are witnessing a massive fall in their real incomes as their pension payments are broadly fixed. This fall in general consumer demand is happening now and it is just a question of how deep and how fast it happens. As with inflation, the risk is probably that economic growth slows faster than is currently expected and as growth falls it will drag inflation expectations down with it.

Corporate profitability is unquestionably going to be hurt by virtue of the nexus of slowing consumer demand and increasing producer input prices. Again, the rate of change in producer prices suggest a lower economic growth rate as their margins are squeezed allowing only a lower level of spending in the general economy. Not surprisingly, given the rapid increase in market interest rates, combined with falling equity markets and rising risk premia, the year-on-year change in the Goldman Sachs Financial Conditions Index is pointing to lower future U.S. ISM readings.

As we look to other economic regions of the globe, we see more weakness suggesting evidence of a synchronised global slowdown. The Chinese economy has been slowing down for some time partly induced by Government policy in the areas of construction and financial sector regulation. Worryingly China's Credit Impulse index has fallen significantly since March 2021 and is still falling, although the rate of change has slowed. Covid related shutdowns are hampering any Chinese Government stimulus initiatives. Given that China is a large part of global GDP, this index is a good leading indicator for the US ISM index and points to stalling growth, if not outright recession, in the U.S. by the end of this year or early next year. Europe is facing similar problems to the U.S. but is starting from a weaker base and now has to grapple with all the economic challenges posed by war on its doorstep, not least possible energy usage restrictions as their economies try to move away from a dependence on Russian energy. Forward looking economic indicators across these regions are looking weak.

If we needed confirmation of a trajectory of weakening U.S. and global growth over the next several quarters, look no further than the recent performance of the U.S. dollar examined on a trade-weighted basis. The DXY index is a measure of U.S. dollar strength against all other global currencies, and it is highly correlated with the business cycle, because the U.S. dollar, as the global reserve currency, is the denominator of the value of all global goods and services. Therefore, as the absolute value of this basket of goods and services declines, the value of the U.S. dollar must go up and vice versa. The sharp increase in the DXY index that we have seen from the beginning of April also tells us to expect a sharp slowdown in U.S. and global Purchasing Managers' Indices coming into the summer.

Outlook continued

Hence, when we distil it all down, we expect the market narrative to change in the coming months from one focused on inflation to one more focused on a U.S. and global growth slowdown. In this scenario, inflation is likely to fall simultaneously with lower growth pushing the Federal Reserve initially to go on hold while referring to weakening economic data and outlook and then eventually possibly having to re-adopt a more stimulative stance.

The recent action witnessed by U.S. bond yields has been remarkable. The speed of the sell-off in bond yields is without parallel in modern times. We have arguably never seen a sell-off of this magnitude in such a short period of time and certainly never seen as momentous a sell-off in relative terms where the rate on the 10-year Treasury bond increased from 1.51% to 3% by the end of April. This is now close to the previous cycle interest rate high in 2018. When we consider this fact, in the context of leading economic data pointing to significant economic weakness ahead, it suggests that we are probably close to a peak in interest rates for this cycle. Science tells us that for every action we should expect an equal and opposite reaction. While it may not be an exact equation, I believe it is sensible to think this can and will happen in markets too. When we get this magnitude of monetary tightening in such a short period of time, then it becomes more likely that we are going to see an accelerated downside in economic growth. Interestingly when we look back at previous peaks in the U.S. 10-year Treasury bond interest rate cycle over the last 20 years, each peak is lower than the previous peak which further indicates to us that long term demographic and technology trends combined with higher amounts of total debt in the economy are leading to structurally lower inflation and therefore lower equilibrium interest rates over time. Suggesting that we might have structurally lower interest rates in the U.S. for years to come is not an unreasonable assertion given what has happened in Japan and Europe in recent decades. So, if we are right about U.S. interest rates being close to their peak for this cycle, this then suggests we could experience a very short and sharp interest rate cycle.

The implication of our discussion above, in our opinion, is bullish for bonds. Based on where we believe economic fundamentals are already trending and the implications of rapidly tightening financial conditions, it suggests we are close to a peak in market interest rates. In addition, when we consider investor positioning, where most investors are still short bonds believing that inflation and bond yields are sure to continue marching higher, the probability of a surprising major bond rally is rapidly increasing. As we know, to make strong returns in the market one needs to have an anti-consensus view and to be ultimately right. We think this is one of these great situations if you are a bond investor.

The outlook for equities may be more volatile but we think equities can also perform in the months to come. This view is predicated on the emergence of a significant economic slowdown followed by steadily falling inflation. In this scenario, which we believe is increasingly likely, the U.S. Federal Reserve Bank may pivot. We have long held the belief that the U.S. Federal Reserve Bank will not have to raise rates by as much as the market has priced in. Our conviction in this view grows by the day. Since the Federal Reserve changed its Inflation target from a pin-point target of 2% to an average through the cycle inflation target of 2%, in August 2020, we have been of the view that the Federal Reserve sees the market perception of its intended action as important a tool as the action itself. Using this tactic, it engineered a rise in inflation expectations in less than 18 months, something it failed to achieve in the previous decade. Hence, we expect the Federal Reserve is using a similar tactic to fight current inflation by sounding very hawkish in the expectation that the market will tighten financial conditions even more quickly, hopefully leading to an earlier taming of inflation. If we are right and an economic slowdown soon emerges, with a concurrent fall in inflation, then a change in signalling by the Federal Reserve is likely to lead to a significant rally in equities and most other risk assets. Indeed, depending on the steepness of the slowdown, the Federal Reserve could even resort to more stimulus yet again which would further ignite equities. We note that equities historically tend to do very well in the time period after inflation tops out and starts falling. We expect this to start happening over the summer months and into the latter part of the year.

The outlook for commodities, particularly base metals, is probably most constructive of all. Despite the run-up in prices that we have seen in recent times, near term fundamentals remain strong and could arguably trump fears of a global slowdown. Chronic underinvestment in upstream production capacity, low stock levels, ESG demand factors and geopolitics all point towards increasing demand and tight supply. Of course, a global slowdown might mean prices temporarily fall, especially in the case of oil, buffeted more by market sentiment than a long-lasting fall in demand. And while China caught an economic chill earlier than the west, commodities demand will be supported as Chinese stimulus and activity begins to kick in soon.

Outlook continued

Given emerging markets are very tied to the commodity cycle, the outlook for these markets is constructive too especially with a slowdown in the U.S. economy very much in sight. While a strong USD has hurt emerging market returns over the last six months this could be about to change soon, should we see a weaker U.S. dollar, as the Federal Reserve is forced to change course and at least call a cessation to its current tightening agenda. The beginning of a weakening U.S. dollar cycle should bring much relief to many markets, not least emerging markets and commodities.

Gavin Blessing
12th May 2022

Source Data: ICM, Bloomberg; as of 31st March 2022.
(1) Yardeni Research – https://www.yardeni.com › pub › ecoindrailcar
(2) https://www.cassinfo.com/freight-audit-payment/cass-transportation-indexes/cass-freight-index

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