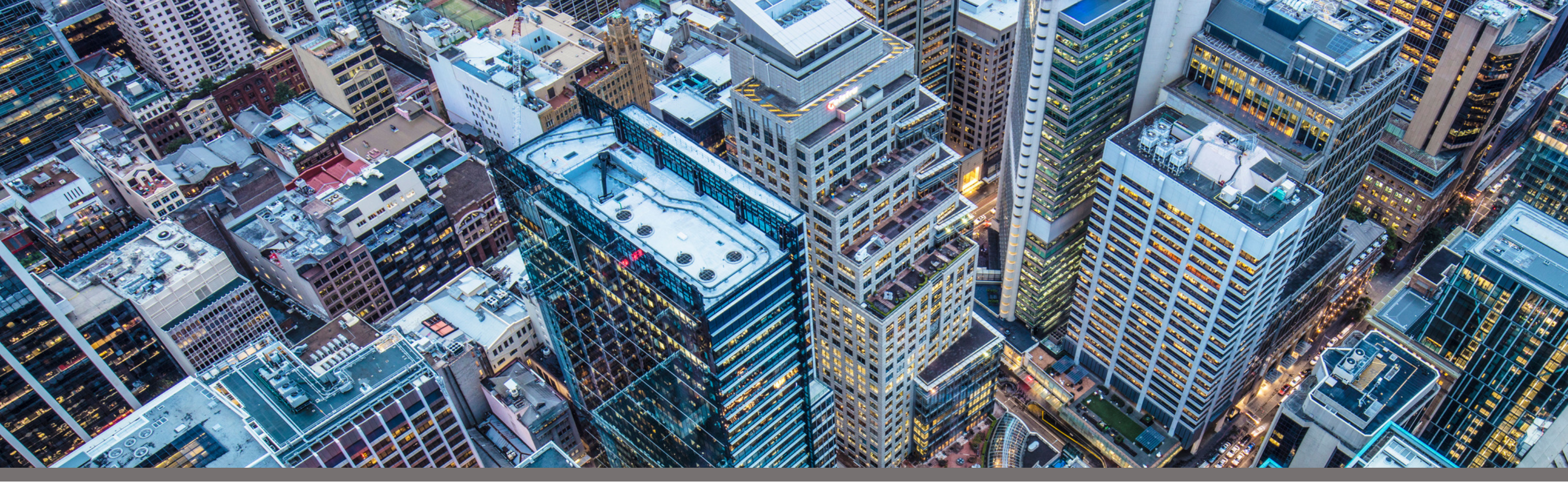


FOUNDED IN
1988

EMPLOYEES
80+

LOCATED IN
10+
COUNTRIES

ASSETS DIRECTLY UNDER MANAGEMENT
US$2.1
BILLION

ASSETS INDIRECTLY UNDER MANAGEMENT
US$22.1
BILLION

ICM

ICM Monthly Outlook

SEPTEMBER 2022

Market Review

During August, the S&P 500 finished down by more than 4% for the month, as markets continued their Jekyll and Hyde routine. The S&P 500 began the month by rising 4.2% before tumbling by 8.1% as markets reacted to a surprisingly hawkish speech from U.S. Federal Reserve Chairman Jerome Powell at Jackson Hole.

In August, inflation numbers released for the 12 months ended July 2022 showed that the annual inflation rate had slowed more than expected to 8.5% in July from a 40-year high of 9.1% hit in June, and below market forecasts of 8.7%. Consumer prices in the U.S. were unchanged in July from June 2022, after rising at a 17-year high rate of 1.3% in the previous month. Core inflation, which excludes energy and food, was 5.9% for the 12 months ended July.

Chairman Powell's statement at the end of the Jackson Hole Summit surprised markets despite evidence of slowing inflation, with the S&P500 falling more than 3% that day alone. While Powell reiterated some comforting points about the U.S. Federal Reserve taking a data-dependent stance, in his short 8-minute address, he also had some comments that spooked markets. Powell stressed the strength of the underlying economy and dismissed the lower inflation readings for July as "[falling] far short of what the committee will need to see before we are confident that inflation is moving down". He said restoring price stability will likely require maintaining a restrictive policy stance for some time and warned that the historical record cautions strongly against prematurely loosening policy. Markets are now pricing an 81% chance that the U.S. Federal Reserve will go for a 75bps hike in September.

So far, the robust jobs market in the U.S. has provided Powell and the U.S. Federal Reserve with cover to continue on the restrictive monetary policy path. In July, the U.S. created 526k new jobs versus an expectation of 250k. While the labour market remains strong, other areas show signs of economic weakness. New home sales declined to 511k in July, having been as high as 900k as recently as January, and new home starts declined to 1.4m in July from 1.9m in April[1]. Housing is a crucial driver of investment, employment, and consumption (especially white goods). Even before rates began to increase, housing was already suffering from rising building costs and excess supply. Mortgage rates, which had been easing in July, grew to almost 6% in August.

On the back of the U.S. Federal Reserve policy of tightening financial conditions, the U.S. Dollar ("USD") has been akin to a steamroller crushing everything in its wake. In recent days, the USD has reached its strongest level against the British Pound since 1985 and its strongest against the Japanese Yen in 24 years. So far in 2022, the USD has appreciated by 15% against a basket of six of its peers. Moreover, the USD has reached parity with the Euro for the first time since the early days of the Euro. The unparalleled appreciation of the USD, coupled with rampant inflation, is forcing the previously perma-dovish European Central Bank ("ECB") to start raising rates at pace. In early

Market Review continued

September, the ECB raised rates by 75bps. The only other time the ECB raised rates by this amount was in January 1999, when the ECB implemented a 75bps rate increase to smooth the Euro's launch.

Inflation in the E.U. is currently running at 9.8%, primarily driven by an increase in energy costs. While there are reasons to believe inflation may begin to wane in the U.S., there is no such comfort in Europe. In the opening days of September, Russia cut off gas supplies to Europe from the Nordstream 1 pipeline for three days of maintenance. Russia subsequently announced that it would cut off gas supplies indefinitely due to a lack of vital components that the Russians could not source under the current sanctions imposed by Europe. Russian President Vladimir Putin later downplayed technical problems and stated that the Nordstream pipeline would not be restarted until E.U. lifted sanctions. Before the shutdown, Germany was ahead of its target to fill gas storage facilities across the country, which were just over 83% when the shutdown occurred versus a target of 85% by October.

German reliance on coal as an energy source has increased significantly this year. So far in 2022, almost a third of German energy is being generated from coal. Unfortunately, coal releases twice as much carbon per unit of energy as natural gas and 60 times more carbon per energy unit than nuclear power[(2)]. The Russian Invasion of Ukraine is certainly doing nothing to help the climate crisis and government efforts to reduce carbon emissions.

Against this backdrop, it was unsurprising to see the Eurostoxx fall by 5.1% during the month. In the U.K., the FTSE 100 fell by 1.9% and remains an outlier in 2022, with only a marginal fall year-to-date versus significant declines for most other major equity markets.

In August, emerging market equities declined by 1.3% per the MSCI Emerging Market equity index. In a repeat of last month, Chinese equities, which make up c. 30% of the index, once again acted as a drag on the index and more than offset positive performance from Brazil, India, Indonesia and Malaysia.

After a reprieve in July, U.S. rates began to trend higher again in August, with rates rising by c. 60bps across the U.S. Treasury Curve up to 10 years and by 30bps for U.S. 30-year treasury bonds. As a result, the U.S. Treasury Index, measured by the Barclays U.S. Aggregate Government Index, fell by 2.5% in August and is now down 10% year-to-date.

In Europe, the Barclays Euro Aggregate Government Index lost 5.2% in August, with European Government bonds now down 13.4% for the year[(3)].

Corporate bonds also fell in August, with the U.S. high yield bond index decreasing by 2.4% and the U.S. investment-grade bond index decreasing by 2.7%. Oddly enough given the strength of the USD, Commodities threaded water, increasing by 0.1% during the month, as reflected by the Bloomberg Commodity Price Index.

Market Outlook

As an active manager, our overriding goal is to beat the market return. Indeed, the holy grail is to beat the market return but with less price volatility than the market. In other words, to achieve superior risk-adjusted returns. However, you are unlikely to beat the market return if your portfolio is largely in consensus with the market in terms of both its design and nature. Hence to beat the market consistently, you typically need to have a non-consensus view more often than not, and when you adopt such a view, you need to be proven right more often than not. Clearly, as a manager, you won't be right all the time. Still, good managers distinguish themselves from average or poor managers by regularly having non-consensus views and being proven right more often than not.

The concept of second-order thinking is closely linked to having non-consensus views. As Howard Marks explained in his brilliant book *The Most Important Thing*, first-level thinking is simplistic, superficial and linear. All the first-level thinker needs is an opinion about the future, such as if the inflation outlook is higher. Therefore interest rates must go up, and stocks will go down. Second-level thinking is deeper and more complex. It is thinking in terms of interactions and consequences through time. So, asking the question, what will happen to economic spending and the economy's strength if inflation goes up and interest rates need to go up? If the economy weakens, what will happen then?

Market Outlook continued

Our non-consensus view

For some months, we have adopted a non-consensus view. We believe the U.S. and global economy will weaken quickly, vanquishing the Federal Reserve's latitude to hike interest rates aggressively. In our opinion, it is only a matter of a few months before significant economic weakness forces the Federal Reserve to go on hold indefinitely. As capital market transactions slow and liquidity worsens, the Federal Reserve will be compelled to stop quantitative tightening. We believe risk markets are likely to rally strongly on such an outcome because the Federal Reserve is no longer acting as a break on economic growth and liquidity. Furthermore, suppose a soft landing is not achieved, and the economic slowdown is deeper than expected. In that case, the market is also likely to see this as a reason to rally as it increases the probability that the Federal Reserve will loosen monetary conditions again through interest rate cutting or renewed quantitative easing to boost economic activity.

It is generally accepted that the Federal Reserve was mistaken not to tighten earlier in this economic cycle. As a result, inflation expectations became unanchored, and together with supply side shocks such as the war in Ukraine, the U.S. inflation rate accelerated to the upside. A high level of inflation is not conducive to healthy and sustainable economic growth. The Federal Reserve is fully aware of the risks of high inflation and, therefore, the importance of re-anchoring inflation expectations lower once again. They may have been slow to act initially, thinking that higher inflation would be transitory. Still, now that they have realised that inflation expectations have become unanchored, they are tightening conditions with almost unparalleled aggressiveness. Interestingly, while five-year forward inflation expectations increased, they did not do so aggressively. This cannot be said for three-year forward inflation expectations, which, as seen in the chart below, have become very unanchored but have been brought back down due to the Federal Reserve's aggressive action.

ISM Manufacturing PMI SA

Source: Bloomberg

To gain control of inflation once more, the Federal Reserve has to get interest rates up to a level considered to be restrictive and not accommodative to economic growth. They know that their aggressive interest rate policy will curb inflation, but it will likely come at the price of crimping economic growth. Their challenge is an almost impossible balancing act. Raise rates too slowly, and inflation remains unfettered. But, on the other hand, raise too quickly and bury the economy. We believe the Federal Reserve has made the best of a poor choice. They have gone aggressively, knowing that this choice at least gives a high probability of taming inflation. Moreover, it will get them to the point of interest rate neutrality or higher, where interest rates can be cut to stimulate activity if needed. Of course, this choice runs a higher risk of hurting the economy, but that is the trade-off. Having opted for the more aggressive strategy, we believe the Federal Reserve's main challenge now is that they run out of time for more hikes, given the accelerating pace of the economic slowdown. In our opinion, the brakes of monetary policy are being slammed so hard that the U.S. economy will likely come unstuck, forcing the Federal Reserve to cease raising rates or run the risk of a deeper, more protracted recession.

Our theory also explains why the Federal Reserve continues to sound hawkish or jawbone at every opportunity. They want to keep financial conditions in capital markets as restrictive as possible for as long as possible because this increases the probability of taming inflation expectations and achieving price stability. Hence it was no surprise to see Federal Reserve Chairman Powell reiterating, at Jackson Hole in late August, that it was their unswerving goal to moderate demand to align it with supply better as this is key to managing inflation expectations and achieving price stability. He has committed to keeping conditions restrictive until, in their opinion, the job is done. This message was designed to caution markets and keep them on guard. If markets rally too soon and financial conditions become easier, the Federal Reserve's ability to dampen down inflation expectations is less effective. Our view is that this tactic by the Federal Reserve will become less effective relatively soon, as it becomes more apparent in the data that inflation has peaked and that economic data shows a worsening economy and a clear-cut recession.

A recession is all but assured

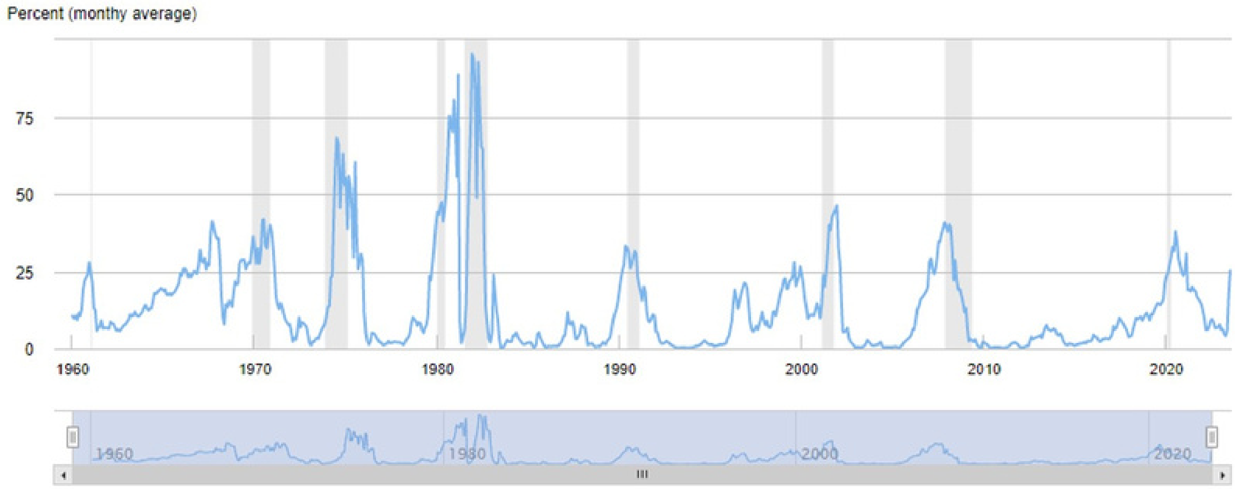
As evidence supporting this opinion, the Conference Board of U.S. leading Economic Indicators declined for a fifth consecutive month in July, suggesting U.S. recession risks are rising soon. Consumer pessimism, equity market volatility, slowing labour markets, housing and construction markets, and manufacturing new orders all suggest that economic weakness will intensify and spread more broadly throughout the U.S. economy. The Conference Board projects the U.S. economy will not expand in the third quarter and could tip into a recession by the end of the year or early 2023.

US LEI continues to point to a decline in near-term economic activity

Source: Conference Board of U.S. leading Economic Indicators

We have another chart following, which the New York Federal Reserve produces. The model uses the slope of the yield curve, or "term spread", to calculate the probability of a recession in the U.S. twelve months ahead. As one can see, when this model hits a reading of 25, it is rarely wrong to predict a U.S. recession within the next 12 months.

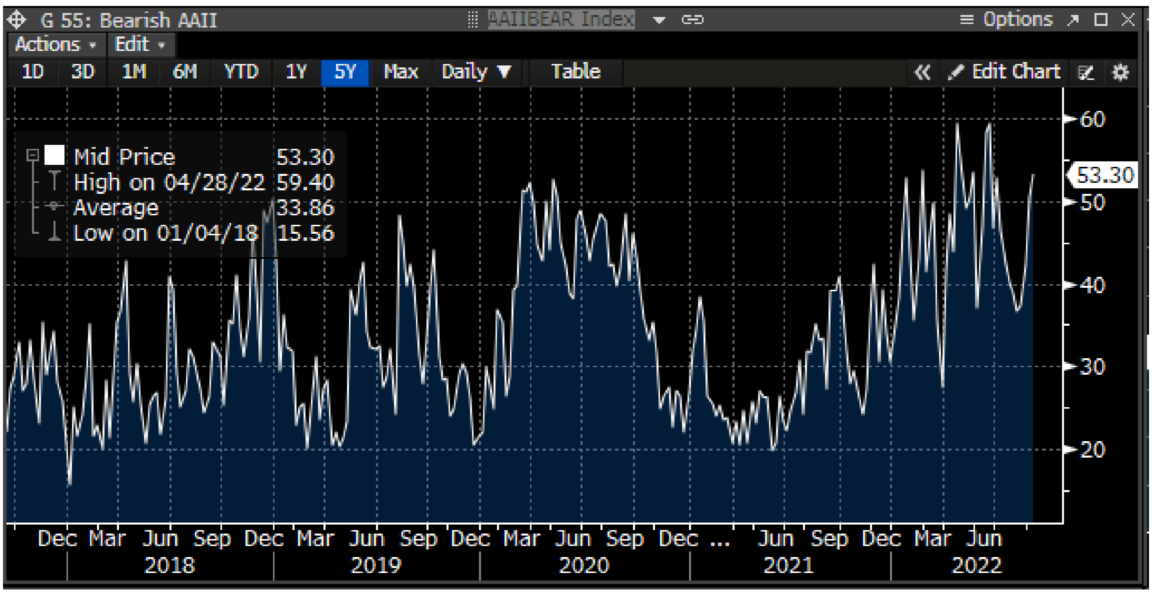
Probability of US Recession, Twelve Months Ahead of Term Spread Ratings



Source: New York Federal Reserve

The consensus view held by most market participants today is that the Federal Reserve will continue to raise rates until the inflation rate is markedly lower than current rates, leaving no doubt that the war on inflation is won. They argue that the U.S. consumer and the labour markets are especially strong, causing inflation to be more embedded through demands for higher wages and salaries, thereby perpetuating the ever-rising prices for goods and services. This strength means that the Federal Reserve will have to hike interest rates much higher than current levels before demand slows to the point where inflation is tamed. This consequent fall in consumption demand is likely to lead to an economic slowdown or recession, leading to a decline in corporate profitability and hence a further collapse in equity prices. They point to history, which suggests that the U.S. stock market only tends to bottom a few months before the economy bottoms. The consensus view is that we are still far from an economic bottom and are still many months away from an equity market bottom. It says the U.S. economy will not bottom until at least the second half of 2023, implying that the earliest U.S. stock markets can bottom is a few months before this or around Q2 of next year. This explains why most investors remain bearish and why sentiment indicators in the market, such as the ASCII Bear Market indicator, remain extremely bearish:

ASCII Bear Market indicator



Source: Bloomberg, AAII index

Why the current market consensus view is wrong

We completely disagree with this consensus view. In our opinion, the consensus view has the hallmarks of first-order thinking.

The consensus view regarding the timing of the equity market bottom would be far more plausible if the Federal Reserve were running to the rescue of the U.S. economy after a slowdown that had been caused by an exogenous shock, or where the economy had naturally entered a contractionary period due to the end of a particular credit cycle. In these circumstances, the Federal Reserve would cut rates and loosen monetary policy to shield the economy from the worst ravages of a recession. Equity markets tend to rally as the Federal Reserve intervenes, as such a move usually heralds a turn or bottom in the economic cycle a few months later.

In our view, present-day market circumstances are very different. In contrast, the cause of the current economic downturn and weakness in capital markets is very different. It is a direct consequence of the concerted effort by the Federal Reserve to tighten and restrict liquidity to lower economic activity and bring down inflation. If credit liquidity is restricted, marginal funding decisions and marginal economic projects are cancelled, thereby reducing overall economic activity and demand. This lowering of demand eventually kills inflation as it better aligns supply with demand. However, as it is typically only a matter of time before the tightening of liquidity brings an economic slowdown, the Federal Reserve can only intervene in this manner for a limited period. As the economy eventually slips into recession, the Federal Reserve will be forced to relent with tightening. More often than not, they will be required to bolster the economy again, at some point later, by engaging in renewed stimulus.

We believe we will see a sustained market rally once the Federal Reserve signals that it is no longer prepared to raise rates due to the mounting evidence of economic weakness. We believe recent hawkish comments by the Fed Chairman at Jackson Hole were a concerted effort to keep monetary conditions as tight as possible for as long as possible. The Federal Reserve committee knows full well that once markets rally, liquidity conditions will begin to loosen. Given the professional reputations of Federal Reserve committee members are at stake, they want to maximise the probability that the current inflation pulse is sufficiently curtailed or exhausted before we reach the point at which all negative news and risks are fully discounted in markets or, better said, a market bottom or base is formed upon which equity markets can start to rally. Despite the possibility that the market may rally once the Federal Reserve relents with further rate increases, given its desire to re-anchor inflation expectations, the Federal Reserve is likely to keep rates high for as long as possible. Only severe economic weakness will likely force them to cut rates next year. Otherwise, they may stay on hold for quite some time.

As we have said, equity markets historically tend to rally soon after inflation peaks. While the inflation data appears sticky, it seems it has peaked. Headline CPI has fallen for the last three consecutive months, and three-month moving average annualised inflation is falling quickly. Year-over-year inflation comparisons will likely decrease and improve as we go through the latter part of the year. Except for energy, most commodity prices are now down year-over-year. According to the most recent PMI Manufacturing report in August, the Supplier Deliveries survey reported that only 19.6% of panellists said deliveries slowed over the previous month. This compares with levels closer to 50% during Q4 of 2021 and suggests many of the supply chain bottlenecks and price spikes caused by the pandemic are finally starting to clear[(4)].

U.S. Consumption will weaken

When looking at the U.S. consumer, we note that consumption has held up relatively well. This is primarily due to a strong labour market which to some degree is shielding the working consumer from run-away inflation and reduced purchasing power. Furthermore, consumers had built up quite a lot of savings during the pandemic, which again absorbed much of the pain of higher prices. However, more recently, borrowing on credit cards has significantly increased, which suggests that the benefit of those past savings is falling[(5)]. More and more consumers are borrowing to fuel spending, which never makes for a good ending.

In addition, we need to consider the significant negative wealth effect that has occurred this year due to declining asset values. A report by the Federal Reserve estimates that Americans' collective wealth has fallen by more than $6.2tn from a record $150tn at the end of 2021, primarily due to a collapse in equity valuations[(6)]. Considering that U.S. GDP is about $21tn per annum, this wealth effect shock equates to about 30% of U.S. GDP. This is likely to affect consumption over the coming months negatively. Those relatively wealthy consumers who have lost some wealth will likely cut back on spending on higher-priced items. Of course, those with little savings are already being hammered by inflation and will have to adjust consumption accordingly.

Of course, we must acknowledge that the U.S. labour market is still strong. While the economy is slowing on the manufacturing and housing side, consumption, supported by the working population, is more than 69% of U.S. GDP [7]. Hence it is odd to be talking about a recession when unemployment is so low at 3.7% and jobless claims, while off their lows, are not yet rising rapidly. Nonetheless, we still believe that the U.S. labour market will eventually crack as business activity slows and employers become more cautious. Furthermore, given the employment market is a lagging indicator, we are reluctant to believe that the labour market will save the U.S. economy and protect it from recession.

Who can afford much higher interest rates

Let's play devil's advocate and assume that the labour market stays strong and the U.S. economy somehow avoids further weakness. Now let's also consider the Federal Reserve in their wisdom, believe we need even more rate hikes into restrictive territory, remembering that we are already at the long-term neutral rate, in the Federal Reserve's opinion, of 2.25-2.5%. If we see another 75bps hike in September 2022, this will bring us to 3-3.25%. We believe that much higher rates – certainly beyond 4% - will become very problematic for the Federal Reserve and the U.S. Government. This is because the sheer expense to the national exchequer quickly becomes unsustainable given the U.S. national debt, which is now over $30tn [8]. Given these debt levels, an incremental increase of 1% in interest rates adds $300bn of annual expense to the government budget. This is almost half the U.S. Defence budget at $700bn or the Medicare budget at $650bn. Considering the cumulative rate rises this year and those which are almost certainly coming later this month, we are looking at an annual expense increase of $900bn, which is mindboggling. This expense will either be added to the national debt, making the situation worse in future years or will be financed through higher taxes or cuts in expenditure. It should be clear to all that much greater hikes from here are neither politically feasible nor mathematically sustainable.

Gavin Blessing
14 September 2022

Source Data: ICM, Bloomberg, Trading View; as of 31 August 2022.

[1] https://tradingeconomics.com/united-states/housing-starts
[2] https://www.ft.com/content/9d3c8af8-ae00-4dc5-9e85-579681450c9c
[3] https://am.jpmorgan.com/gb/en/asset-management/adv/insights/market-insights/market-updates/monthly-market-review/
[4] https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/august/
[5] https://www.washingtonpost.com/business/2022/08/02/credit-card-debt-inflation/
[6] https://www.reuters.com/markets/us/us-household-wealth-falls-again-second-quarter-fed-says-2022-09-09/
[7] https://ycharts.com/indicators/personal_consumption_gdp#:~:text=Basic%20Info,month%20and%2069.49%25%20last%20year
[8] https://www.forbes.com/advisor/personal-finance/u-s-national-debt-surpasses-30-trillion-what-this-means-for-you/

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