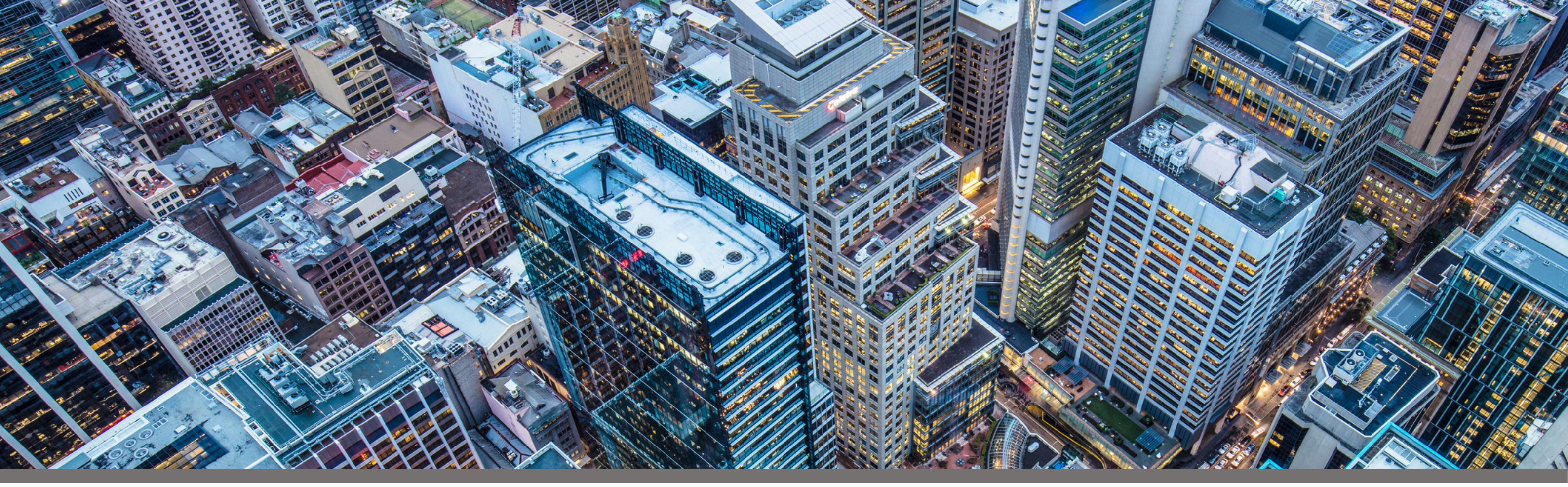

FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**80+**	**10+** COUNTRIES	**US$1.9** BILLION	**US$24.5** BILLION

ICM Monthly Outlook

MAY 2024

Market Review

US short-term interest rates, as measured by US three-month treasuries, yielded 5.39% at the end of April, up from 5.36% at the end of March. US three-month treasuries have been range-bound between 5.33% and 5.46% since the US Federal Reserve last increased interest rates to 5.25% - 5.50% in July 2023. By historical standards, US short-term interest rates offer incredible value, with the highest prevailing rates since the beginning of this century. In fact, you need to go back to the 1980s to find a time when short-term risk-free rates were at the levels they are today. Adjusting for inflation, rates remain attractive at c.2.0%, a post-GFC high and about average in the 30 years prior to the GFC.

At the end of April, the US yield curve implied only a 55% chance of a rate cut by September and suggested only one rate cut in 2024. At the beginning of the year, the prevailing yields on US treasuries implied six rate cuts in 2024.

As inflation remains stubbornly high and the labour market continues to prove resilient to higher rates, the market raised its expectations for future interest rates. The yield on the US 10-year treasuries was 4.68% at the end of April, up from 4.20% at the beginning of the month and 3.88% at the beginning of the year.

Increasing longer-end interest rates resulted in US Treasury bonds, as measured by the Barclays US Aggregate Government Index, falling by 2.3% in April. US Treasury bonds are down 3.3% so far this year.

Yields have turned sharply higher due to a renewed uptick in inflation over the past few months. In April, US Personal Consumption Expenditures (PCE) inflation came in with prices 2.7% higher than twelve months earlier. This was up from 2.5% the previous month and is the highest PCE inflation reading since November 2023.

Core PCE inflation (inflation excluding food and energy price changes) continues to be on a downward trajectory, coming in at 2.8% for the twelve months ending 31 March 2024. Since September 2022, Core PCE has been getting progressively lower every month but one.

Not only did the market have to contend with higher inflation, a more hawkish Federal Reserve and the prospect of higher rates, but this was compounded with disappointing GDP numbers. In Q1, US GDP grew at an annualised rate of 1.6%, well below the 3.4% posted for Q4 2023 and missing estimates of 2.5%.

Against the backdrop outlined above, it was unsurprising to see the S&P 500 retreat in the month, falling by 4.2% in the month (4.1% after accounting for dividends). The major detractors in the month were rate-sensitive sectors, tech down 5.5% and real estate down 8.6%.

Market Review continued

In Europe, the European Central Bank ("ECB") base rate remains at 4.0%. The yield on three-month German government bonds is largely unchanged from last month at 3.62%, reflecting the premium for investing in Europe's most economically secure economy and the likelihood that the ECB will cut rates in the coming months. The market continues to expect two to three rate cuts this year, with the first one coming as soon as next month. With April's inflation reading of 2.4% and inflation continuing to decline, there is less pressure on the ECB to maintain restrictive policy. The Swiss and Swedish central banks have already cut interest rates.

The yield on longer-dated German government bonds increased by c.30bps across the curve. Higher yields mean that European Government bonds, as measured by the Barclays Euro Aggregate Government Index, fell by 1.4% in April and are now down 2.0% so far this year.

Once again, despite an increase in yields, the Euro fell by 1.2% against the US Dollar, as yields increased even further in the US. One concern for the ECB has to be the increasing likelihood of imported inflation if it cuts rates before the Federal Reserve.

In April, European Equities, as measured by the Eurostoxx, fell by 3.2% (2.3% after accounting for dividends). While much is written about the S&P 500 and the Magnificent Seven, or the FANG or latest 'in vogue' acronym, the Eurostoxx has matched the S&P500 every step of the way in the aftermath of the pandemic in 2020. Over the past four years, the Eurostoxx has returned 90.6% versus 84.1% for the S&P 500.

In early May, the Bank of England held UK interest rates at 5.25%. Two members of the Monetary Policy Committee, including the Deputy Governor, voted to lower rates. The Governor of the Bank of England, Andrew Bailey, indicated that a cut in interest rates may come as soon as next month.

The yield on longer-dated UK government bonds increased by c.40bps across the curve to yield an average of c.4.4%. The UK yield curve remains inverted.

In April, UK Equities, as measured by the FTSE 100 Index, increased by 2.4% (2.7% after accounting for dividends), hitting a new all-time high in the process. Despite outperformance in April, the FTSE has significantly underperformed its European and US peers over the past twelve months.

In April, Emerging Market Equities, as measured by the MSCI Emerging Market Equity Index, outperformed developed markets, falling by 0.2%. China rebounded hard in April, with the Hong Kong Hang Seng Index up 7.4%. Chinese equities continue to be one of the worst-performing equity markets. Despite April's gains, over the past twelve months Chinese equities trail Brazilian Equities by more than 16%, Indian Equities by more than 30% and Taiwanese Equities by more than 40%.

In April, Commodities, as measured by the Bloomberg Commodity Index, increased by 2.7%.

Oil gains were modest during the month, up just 0.4%. In April, Israel and Iran ceased the charade of a proxy war with direct attacks on each other. True, the attacks were well broadcast and did little damage in either case, but they are indicative of escalation. Mounting tensions in the Middle East mean that the risk to oil prices is to the upside.

In April, the price of copper exceeded USD 10,000 per tonne for the first time since 2022, indicating hopes for a recovery in demand, which was partly driven by the clean-energy sector.

In April, spreads in US investment-grade corporate bonds tightened from 94bps to 91bps. Despite tighter spreads, US Investment-Grade Corporate Bonds, as measured by the ICE Bank of America US Corporate Index, fell by 2.3%. As discussed previously, US rates increased by c.50bps during the month, significantly overwhelming the positive price effect from a tightening of spreads.

Spreads in US high-yield bonds widened from 315bps to 318bps during the month. In April, US high-yield bonds, as measured by the ICE Bank of America High-Yield Index, fell by 1.0%. US high-yield bonds outperformed US investment-grade corporate bonds due to their higher run-rate income and less exposure to higher rates due to the shorter maturity of the underlying bonds in the index.

Market Review continued

As the market has increasingly priced in that policy rates have peaked for this cycle, risk assets have performed well, with equities moving to all-time highs and credit spreads approaching their cycle tights. If this process reverses, we can expect to see spreads widening.

Investor appetite for corporate bonds remains extremely strong. In Q1, corporate borrowers issued USD 606 billion of bonds, up 40% from the same period in 2023 and the highest total since 1990.[1] In the week ending 10 May, high-yield companies issued USD 14 billion in debt, the highest since 2021, and investment-grade companies issued USD 57 billion.[2]

Market Outlook

Investors, commentators, and journalists remain fixated on inflation and, ultimately, its impact on monetary policy. For nearly a year, writers are like a broken record, parsing the same data with the same rhetoric, looking for the first hint of the elusive pivot by the Federal Reserve. As far as the Federal Reserve's Chairman is concerned, there's no hurry to cut rates.

Recently, Federal Reserve Chairman Powell reiterated his edifying message that the Federal Reserve is winning the war on inflation, and we are in the final mile now. Overall, Powell's tone recently is being interpreted as dovish. He gave short shrift to the notion of further rate hikes in this cycle, and all expectations are for a downward move next; it's just a matter of when.

Powell bought time for the Federal Reserve by acknowledging that the final mile is taking longer than expected and acknowledged the "lack of further progress" on inflation in 2024 thus far. Arguably, patience is the Federal Reserve's core message.

In addition, other Federal Reserve officials said in unison that the current interest rate is sufficiently restrictive to reel in inflation. It is merely a question of timing, and they are in no rush. Therefore, we believe the earliest for a cut will be September. While some commentators are sticking with their prediction of a rate cut in July, we do not expect July, barring a ruinous shock to the economy that we can't envisage.

Bloomberg's interest rate predictor attributes a less than 30% probability of a 25-basis point rate cut in July. The odds of a cut in September are up to about 80% versus 55% on the 30th of April. As a reminder, as recently as December 2023, the market predicted four cuts (25 basis points each) by July 2024.

Inflation is heading in the right direction

While the most recent inflation data was encouraging, it is probably not enough to convince Federal Reserve officials to cut earlier than September. We believe the Federal Reserve will want to be sure that inflation is on a sustainable path lower. To quote Shakespeare's play, Macbeth, they will want to "make assurance doubly sure." The Federal Reserve would rather wait an extra month than cut too soon just to re-hike if inflation increased again, which is possible, although not our central case.

While welcome, the continuing downward inflation trend does not warrant a rush to cut rates.

The Federal Reserve Banks committee members' recent public speeches reinforce the adage of "don't fight the Fed." Several Federal Reserve committee members went on record recently saying they would hold for longer. For example, on 6th May, New York Federal Reserve president John Williams said that "policy is in a very good place, and [the Federal Reserve] has the time to collect more [data], so steady as she goes." On 7th May, the Minneapolis Federal Reserve president, Neel Kashkari, said that he believes rates will likely need to be held at current levels for an "extended period." Finally, on May 9th, Boston Federal Reserve president Susan Collins said that "it will take longer than previously thought" to bring inflation down. Collins believes that slower economic growth will be needed to bring down demand and, therefore, inflation.[3] Ultimately, they all believe the Federal Reserve will reign in inflation to 2% or very close, and we agree. It's just not there yet.

Kashkari went one further to say that a hike may be necessary if inflation stalls near 3%. "I think it's much more likely we would just sit here for longer than we expect, or the public expects right now until we see what effect our monetary policy is having."[4]

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We believe these members would oppose a rate cut in July. In addition, the Federal Reserve Bank does not want to over-stimulate the US economy unnecessarily by cutting rates.

While the core consumer price index, which excludes food and energy costs, climbed 0.3% from March and was lower than expected, the annualised core inflation number cooled to the slowest pace in three years to 3.6% in April versus 3.8% for March, year on year. That said, the last three and six-month annualised figures are still above 4%, consistently above the Federal Reserve's 2% target, which is the key reason why we believe the Federal Reserve is extolling patience.

Service inflation remains the sticky wicket that needs to fall. With April inflation in line with expectations and consumer confidence dipping, the inference is that services inflation will cool in the coming months, ultimately releasing pressure on the Federal Reserve to hold rates stable.

Investors long hoping for an upward-sloping yield curve based on a falling front end are feeling more optimistic about their strategy. Last December, after Chairman Powell said rate cuts were coming into view, investors started to position for rate cuts sooner rather than later. That trade idea proved premature, as strong-than-expected inflation data and better non-farm payroll data supplanted the previous downward trends, to the dismay of most.

The most recent inflation data renews investors' confidence that the Federal Reserve's cuts are back on the horizon. Investors are increasingly confident about the prospect of a steeper yield curve.

According to the US Bureau of Labor Statistics (BLS), housing costs are the biggest component of core inflation. Powell said in his May speech that this has been a bit of a puzzle. Policymakers have for some time now expected this figure to stabilise. But he said that the lags between newly signed leases and shelter costs in the CPI have been longer than expected.

In his May speech, Chairman Powell and the Federal Reserve still forecast that overall inflation will continue to fall in 2024. However, Powell acknowledged that the Federal Reserve's confidence was lower than before due to recent upside surprises.

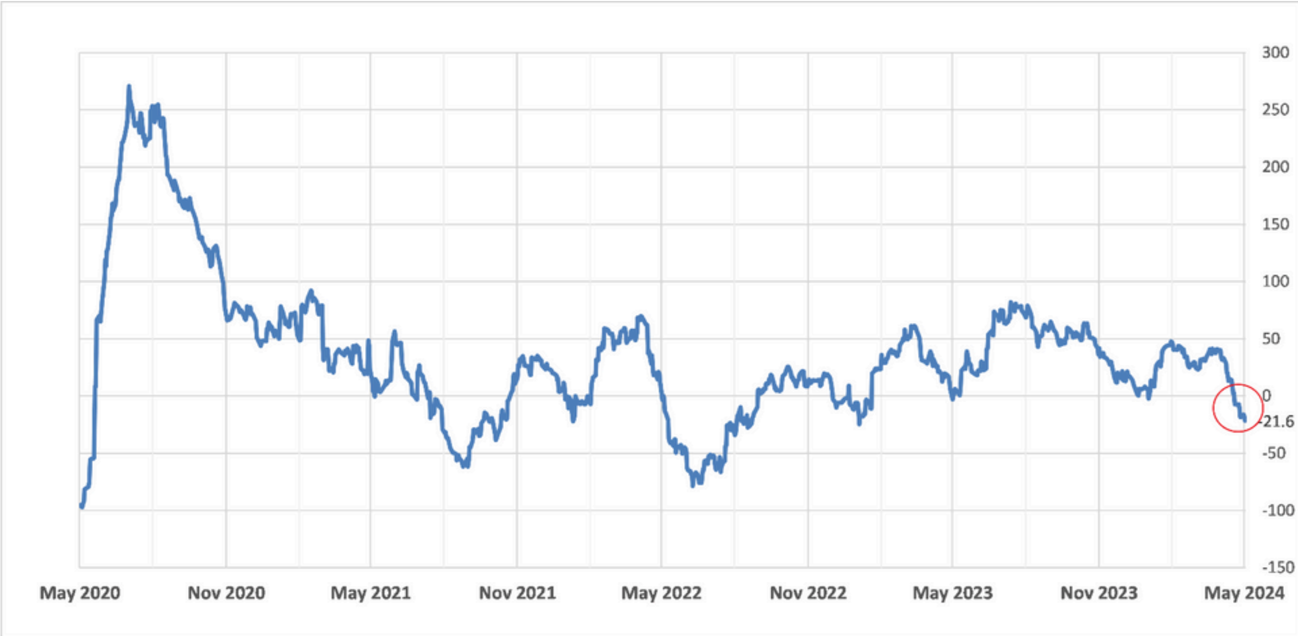
Powell's confidence in declining inflation is premised on the Federal Reserve viewing recent inflation upticks as a mere bump in the road. Powell explained that "there are a number of places in the economy where there are lag structures built into the inflation process." Powell expressed continued confidence in what we see as disinflation in shelter, as rent growth falls significantly, and supply-side and supply-chain bottlenecks continue to improve.

Surprise indices and sentiment surveys

Surprise indices flag data from surveys long before it comes through in the hard data, such as labour market figures. Previously, survey data has been a real-time indicator of an inflection point, which the hard data lags. The last few months' economic data surprised on the upside, such as the higher-than-expected inflation and stronger-than-expected non-farm payrolls.

We believe the likelihood of further unwelcome economic surprises is diminishing for the first time in a while based on the following graphs. Since the start of May, the surprise indices for the United States have fallen into negative territory for the first time since January 2023. The Citi Economic Surprise Indices measure data surprises relative to market expectations. A positive reading means data releases are stronger than expected, and a negative reading means data releases have been worse than expected. Bloomberg's Economic Surprise Index has also fallen into negative territory.

Citi Economic Surprise Index



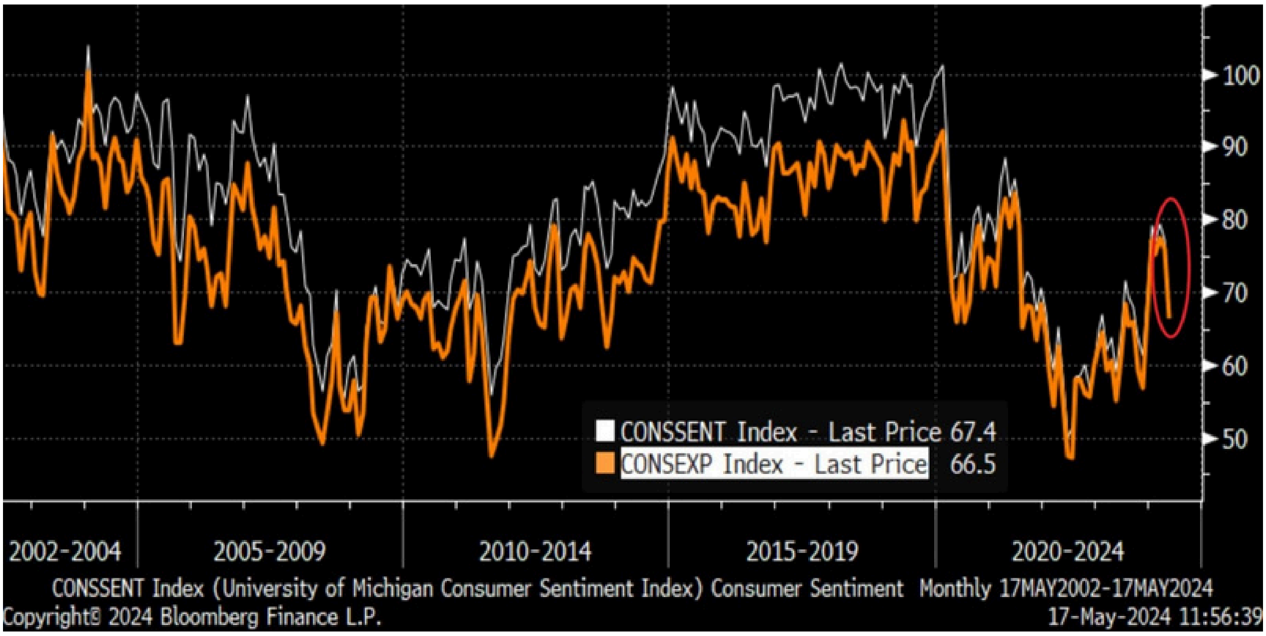
Source: Bloomberg

Bloomberg's Economic Surprise Monitor

Source: Bloomberg

Notwithstanding the fact that the US economy has been far more resilient than expected for the past two years, these indices suggest that the economy is slowing due to the Federal Reserve's restrictive monetary policy. That said, given recent history, we would be loath to base all our decisions on this one metric, and the curve-steepening (lower front-end) won't happen based on soft data.

The University of Michigan Consumer Sentiment Index



Source: Bloomberg:

The University of Michigan Consumer Sentiment Index also suggests that US consumers are rowing back. In April 2024, the Sentiment index had its sharpest fall since August 2021, falling to 67.4 from 77.2 (-13%) versus the consensus estimate of 76.2. Sentiment deteriorated across age, income, and education levels, with western states exhibiting a particularly steep drop. Consumers expressed worries about inflation and interest rates, which is understandable given the media's recent commentary about sticky inflation and higher-for-longer interest rates. We suspect that the increase in gasoline prices in April also weighed on consumer sentiment. Thankfully, crude oil prices have fallen since the start of May and should provide succour for consumers going forward, assuming the oil price stays around its current price, in which case the drop in consumer confidence will be short-lived.

Given all the recent indicators, inflation will fall, most likely without a recession, justifying a fall in front-end bond yields and a fall in longer-end yields by less. In such an environment, bond investors will find value in longer-duration bonds, as opposed to the current defensive short-duration bias of many. Bad news will be good news for bond and equity markets as rates fall and liquidity increases.

Despite several Federal Reserve members playing down the market's expectation for a rate cut in 2024, our base case remains that the Federal Reserve Bank will cut at least once in Q3 or Q4 2024.

Will history repeat itself?

If the Federal Reserve does not cut rates by year-end, markets will enter an entirely new realm: their longest period on hold at the end of a tightening cycle for over sixty years. Already, it has been ten months since the Federal Reserve stopped hiking on July 31st, 2023. According to JP Morgan, the previous record in the past sixty years was from July 2006 to September 2007 (fourteen months), just before the Global Financial Crisis (GFC) in late 2007 and 2008. We certainly do not draw any parallels between the current economic outlook and the period before the financial crisis in ’07 and ’08.

The GFC was triggered by the collapse of financial institutions due to a self-induced credit crisis facilitated by light touch regulation. Regulators learnt a hard lesson, and the days of “casino banking” are long gone. Today, the banking sector is fundamentally more robust than in 2007, with far stronger regulation and the economy/consumer is far more resilient.

While many economists suggested/assumed tighter family balance sheets would result in reduced consumer spending from higher rates, it hasn’t significantly transpired. Until recently, consumer confidence remained strong and has been a key driver of economic growth. Strong employment remains crucial to strong consumption and continued consumer confidence. Plenty of consumers locked in cheap mortgages at rock-bottom rates during the pandemic. Rules around affordability have saved stretched borrowers from themselves. While history does repeat itself, we believe the Federal Reserve can manage the economy with “Powell Puts” when this lengthy spell of higher interest rates has worked its way through the economy, which will eventually slow down. We believe the first hard number for weakness will come in the jobs market. The Federal Reserve has plenty of spare capacity to take further remedial action when necessary. It's the old adage that bad news is good news for investors, who'll benefit from a lower discount rate when rates fall.

Comparing 2006 and now feels foolish to us. Yes, interest rates are high, the jobs market is tight, the Federal Reserve is on hold, and there are potential asset bubbles. Nor are we naive enough to suggest that excessive risk-taking will never return in some corner of the market. However, at present, we do not believe that any significant asset bubbles exist to the extent that they could jeopardise the economy in a similar way that banks and subprime mortgages did during the GFC. We are still watchful for the commercial real estate sector, but we don't believe it could wreak system havoc akin to 2008 when global governments were ultimately required to bail out their banks.

Of course, there are always unknown unknowns, such as COVID-19, that could sideswipe the market. The private credit market is an area that has the potential to cause problems. Private credit providers are increasingly stepping into banks' shoes, especially for high-risk assets. For instance, private credit providers are set to provide more than $11 billion to help Intel build a manufacturing facility. The same private equity firm is lending to distressed corporates to buy back their distressed debt. It begs the question of how private equity is funding such enormous investments.

A significant difference between this time and 2007 is that consumers' debt servicing is considerably lower than in 2007, even though base rates are similar: 5.5% today versus 5.25% in 2007. US households' total debt-service ratios are broadly flat compared to the past ten years. It isn't a case of freeing up cash for consumers, but one in which higher rates didn't add a significant additional burden to the majority of consumers, as they had locked in lower long-term interest rates when rock bottom rates prevailed, such as in the aftermath of the COVID-19 outbreak.

Market implications

We continue to predict that risk assets will continue to rally in the current environment. The assurance that the next rate move will be downward encourages greater global liquidity to flow into risk assets. A good example of this was the recent rally in Bitcoin as inflation expectations recalibrated lower and the probability of interest rate cuts increased. Thanks to improving financial conditions, we remain constructive on most asset classes. It's blue skies ahead for the time being.

Conor Spencer

20 May, 2024

Source Data: ICM, Bloomberg as of 30 April, 2024.

[1] https://www.ft.com/content/2b16f721-007d-4148-b4b7-bca15d054bed

[2] https://www.ft.com/content/6e5c5657-b50c-4da2-a82c-20e991b87b5f

[3] "The recent data lead me to believe this will take more time than previously thought," Collins said in a speech at the Sloan School of Management at the Massachusetts Institute of Technology. "There is no pre-set path for policy."

[4] Kashkari said at the Milken Institute conference in Los Angeles.