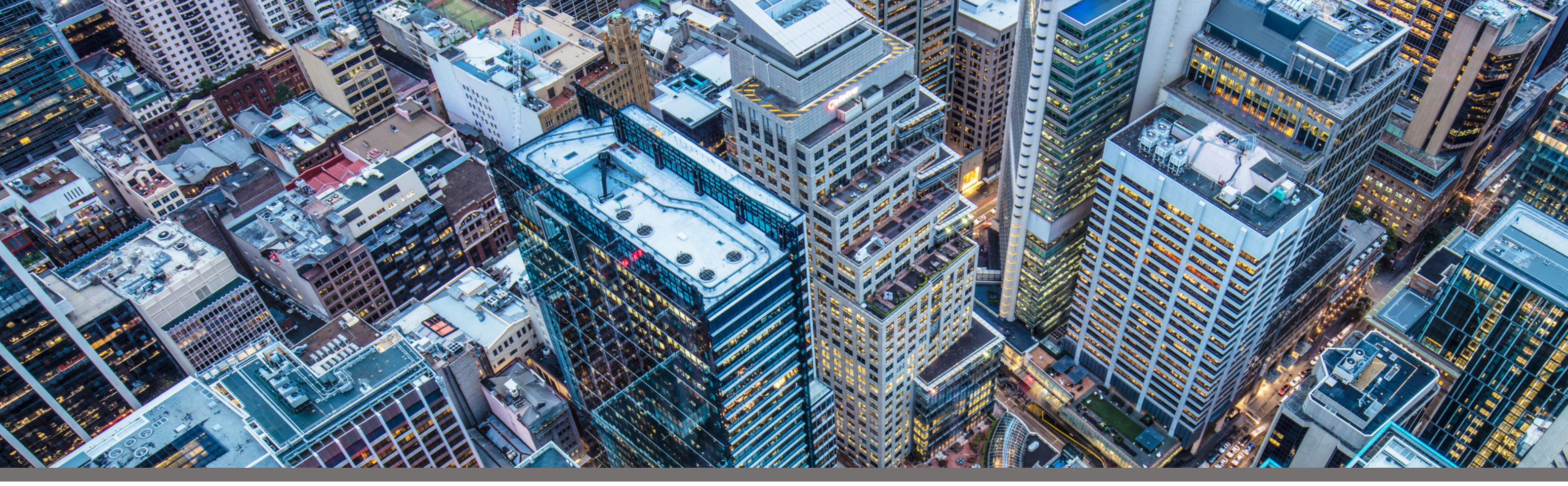


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**70+**	**10+** COUNTRIES	**US$2.6** BILLION	**US$24.0** BILLION

ICM Monthly Review

July 2022

Market Review

In June, U.S. equities continued their trend lower. The S&P index declined 8.4% during June. The S&P 500 was down 20.6% in H1 2022, its worst first half of the year since 1970[1]. The S&P 500 and the NASDAQ are both in a bear market now.

The S&P's sell-off in June was broad-based. All eleven sectors produced a negative return in June. The energy sector of the S&P 500 declined by 17% versus a positive 15% in May. Year-to-date, the energy sector has returned c. 30.4%. By comparison, the tech sector declined by 9.4% to give a year-to-date return of negative 30.2%.

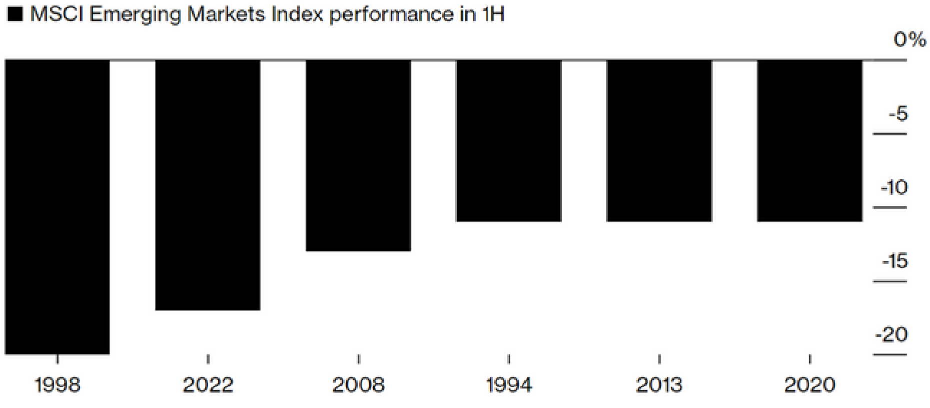
The U.S. consumer appears to be reeling in spending, especially on nonessential goods. The consumer discretionary sector of the S&P 500 declined by 10.7%. Retail sales fell by 0.4% in May[2], and regrettably, April's and March's retail sales numbers were revised down. We are not surprised by the decline in consumer discretionary spending as the expense of essential items increases. You may remember that last month, we referred to Walmart's CFO saying that consumer spending was evolving toward low-margin consumables and away from higher-margin apparel and electronics[3]. The consumer staples sector of the S&P 500 fell by only 2.7%.

There are signs of weakening activity in the housing market, with home sales falling from 6.5 million in the 12 months to the end of January, to 5.4 million in the 12 months to the end of May [4]. Moreover, we expect home sales will continue to slow given that house prices have increased by 40% since the beginning of 2020 and mortgage rates have almost doubled over the past year from 3% to 6%[5].

In June, European equities declined sharply. The EuroStoxx 50, Europe's blue-chip index, fell 8.8% during the month. The EuroStoxx 50 was down 19.6% in H1 2022.

Investors are increasingly concerned about the risk of recession in Europe (and globally) and how long it may last. In addition, rising food and energy prices are driving inflation higher across Europe and threatening economic growth. In June:
- Spanish inflation was 10.2%, surprisingly higher than expected and its highest since 1985[6].
- Belgian CPI was 9.7%, up 0.7% from the previous month and higher than expected[7].
- German inflation was the outlier, declining by 0.3% to 7.6% year on year[8]. However, German CPI fell in May thanks to government subsidies for energy prices that took effect at the start of May. Germany's CPI would likely have been higher than expected without the energy tax rebate.

In June, emerging market equities declined by 6% per the MSCI Emerging Market equity index. Chinese equities, which make up c. 30% of the index, were up 2.1%. Still, negative returns in Taiwan (-11.8%), India (-5.2%), South Korea (-13.2%) and Brazil (-11.5%) dragged the emerging market equity index into negative territory. The MSCI Emerging market index declined 17.9% in H1 2022.



Source: Bloomberg
Note: 2022 performance denotes yearly performance through June 27.

As expected, the U.S. Federal Reserve increased rates in June, opting for a 75bps increase. The most recent increase took the Federal fund rate to 1.75%. The market is pricing that the U.S. Federal Reserve will increase rates by another 75bps at their meeting in July. The median Federal Reserve board member expects rates to rise to 3.8% next year.

After a reprieve in rates in May, rates went higher again in June. The U.S. three, five, and ten-year treasuries now yield c. 3%, marginally higher than at the end of April. Despite Federal Reserve members indicating higher rates next year, the rate of change in medium-term yields appears to have slowed.

The increase in yields meant a loss of 1.6% for the U.S. Treasury Index, as measured by the Barclays U.S. Aggregate Government Index. In Europe, the Barclays Euro Aggregate Government Index declined, losing 2.3% in June. European government bonds have lost 12.3% in 2022 so far.

Reminiscent of the European Sovereign Debt Crisis ten years ago, spreads on sovereign bonds of southern European countries increased sharply in June. For example, the yield on Italian government bonds moved to more than 4% during June, and the spread between Italian government bonds and German government bonds widened to 2.4%. Given Italy's debt to GDP, fiscal deficit and growth profile, they simply cannot service debt at a rate of more than 4% without a significant government austerity programme. The move in yields in the periphery forced the European Central Bank to hold an emergency meeting to consider additional tools to stabilise bond yields.

Corporate bonds sold off like most other financial assets in June. As a result, U.S. high yield bond spreads increased to 579 basis points from 454 basis points at the start of June. In addition, U.S. investment-grade bond spreads increased to 100 basis points from 80 at the beginning of June. Corporate bond spreads have now roughly doubled since the start of the year.

Not even commodities, as reflected by the Bloomberg Commodity Price Index, could shelter the storm in June, falling by about 10% in the month.

Market Outlook

"The dilemma is that if one does not risk anything, one risks even more"
Erica Jong, American novelist and satirist.

Some of the hardest decisions in life are those defined by dilemmic choices. The U.S. Federal Reserve Bank, joined by a plethora of other central banks across the globe, are now deciding whether they should risk crashing their economies through tighter monetary policy, or allow inflation to possibly reek even greater economic havoc over time if left unchecked. This choice has been primarily forced on central banks by the inexorable rise of demand-pull inflation and exacerbated by supply-push inflation, the origins of which both are found in the global pandemic.

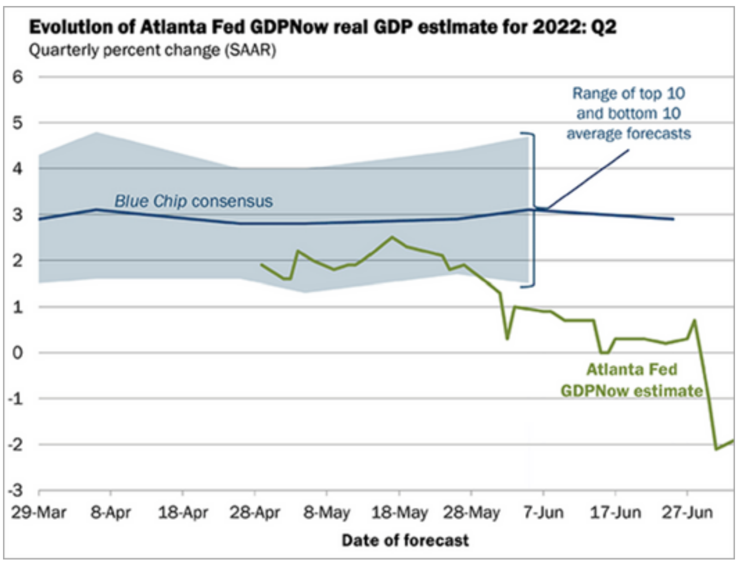
The forced closure of economies during the pandemic resulted in massive supply-side disruption, while ensuing government stimulus and pent-up consumer demand led to a resurgent desire and ability to spend once restrictions were lifted. These huge swings in economic activity and the monetary and fiscal responses to the pandemic have now destabilised the previous steady economic equilibrium that central banks had largely achieved during the last decade. The current challenge for global policymakers is to contain, control and finally curtail these consequent economic waves and reverberations. Given the amplitude of these economic waves are much greater than usual, the central bank response required to counterbalance and contain these forces also needs to be greater. Hence the absolute margin of error naturally increases with the result that central banks are unlikely to engineer economic soft landings. Indeed, the probability of a Federal Reserve induced U.S. recession seems to grow more unavoidable by the day.

Growing risk of a U.S. growth shock

The challenge above explains the very hawkish behaviour of the Federal Reserve and its commitment to lowering future inflation through tighter monetary policy. For these reasons, we believe a recession in the U.S. is virtually assured. Indeed, we are already witnessing a synchronised global economic slowdown, and we believe economic data will get much worse over the coming months. Our read of leading economic indicators suggests that the U.S. and other economies will experience a growth shock. As previously argued, we believe the rate of change in monetary conditions is key to understanding the impact such actions will have on the real economy and fundamental economic data. Economic participants have time to adapt and change predictably and calmly if the tightening is slow and gradual. If the change is abrupt and rapid, uncertainty becomes too great and economic participants simply move to the sidelines and decide to do very little. This behaviour change can happen suddenly and underpins our view of an upcoming growth shock. Decisions around consumption and capital expenditures are justifiably deferred or, worse, abandoned until uncertainty abates and normality is restored. We have now entered this phase. The consequences of this will become apparent in the months ahead.

Last month we stated that it was all but inevitable to expect the U.S. Purchasing Managers' Index (PMI), a leading indicator of the health of the U.S. economy, to show a much weaker trajectory going forward with a reading of 50 or below, indicating a contracting economy. We discussed the possibility of the Federal Reserve relenting on its current interest rate tightening path, as has historically always been the case, once this index reached or sank below 50. The latest reading on this index for June, published last week, came in at 53 from 56.1 in the previous month and compared to 54.5 expected. Our level of conviction is increasing that this measure will fall well below 50 in the coming months and could drop to around 40 by year-end if the Federal Reserve does not relent.

Already a measure produced by the Atlanta Federal Reserve, which tracks economic data in real-time and adjusts continuously, sees U.S. Q2 GDP contracting by 2.1%[9]. As more monthly data becomes available, this GDPNow forecast[10] generally becomes more accurate. Coupled with the U.S. Q1 GDP's decline of 1.6%, this would imply that the U.S. is already in a technical recession. If this is true, we are experiencing a relatively rare event where the Federal Reserve is tightening aggressively through higher interest rates and quantitatively tightening when the economy is already in recession. This does not bode well. It inevitably points to an accelerating slowdown and a growth shock. In contrast to previous cycles, where inflation was not the primary concern, it is likely the Federal Reserve would already be on hold or about to do so.



As previously argued, we believe the Federal Reserve is absolutely committed to taming inflation and ensuring it returns to more comfortable levels. We believe the current Federal Reserve committee is under immense pressure to uphold the bank's reputation and protect its professional legacies. Hence, in our view, having now been found to be wrong in their belief that inflation was merely transitory, the committee members probably believe that they are unlikely to get a second chance to quell inflation. Suppose they relent too soon, and inflation turns upwards from a higher base. In that case, the credibility of the Federal Reserve will be tarnished, and their reputations will be shattered. Hence, we believe the committee will only relent once they think inflation is truly conquered or the economy is too weak to withstand another rate hike.

Therefore, on balance, we conclude that the Federal Reserve will most likely make the same policy mistakes of the past by over-tightening, resulting in a cratering U.S. economy.

A sharp but relatively short-lived U.S. recession ahead

We believe that the most likely shaped recession facing the U.S is sharp and possibly deep but relatively short-lived, so something resembling a V-shaped recession. We believe this because the Federal Reserve intends to conquer inflation by pushing down hard on aggregate economic demand. The aggressive and rapid nature of the interest rate hikes increases the probability that demand reduction will be abrupt and sudden rather than long and gradual. Once the Federal Reserve relents and as inflations start to wane, real incomes should rise accordingly, allowing consumption and the economy to recover more quickly. Moreover, we don't see any significant imbalances in the U.S. economy today, such as an unemployment crisis or banking system implosion. Without such imbalances in the economy acting to keep it pinned in a more protracted downturn, the economy will likely rebuild and rebound relatively quickly. Despite this engineered slowdown, the fundamentals of the U.S. economy remain sound. They will likely support a more robust and quicker recovery once the Federal Reserve relents and no longer stands in the way of recovery.

Signs of inflation peaking

There are already signs that inflation has peaked. While U.S. CPI no longer seems to be accelerating, the Federal Reserve's more closely watched measure of inflation, the PCE Core Deflator, has been falling steadily since February from 5.4% to 4.70% in May. Noticeably many commodity prices such as Copper, Zinc and Aluminium are all off about 20% since their March/April highs. Spot WTI oil is about 15% lower from its recent peak too. Meanwhile, U.S. inventories remain very high, which is likely to translate into discounting pressure on retailers who will be eager to get products moved on so that new seasonal stock can be bought in. The Bond market is also signalling that the Federal Reserve will be able to break the back of inflation and has brought down its own implied forecast for U.S. inflation five years from now. This gauge, known as the five breakeven inflation rate, measures the difference between the real yield of the inflation-linked 5-year maturity curve and the yield of the closest nominal Treasury maturity. The measure of future inflation has fallen from 3.7% in March to 2.5% in late June. Finally, consumers are feeling the pinch from higher inflation. Not only has U.S. consumer confidence turned very weak, but also the savings rate in the U.S. has fallen significantly from highs of 30% in 2020 to closer to 5% today. This is a sign that consumers' ability to spend is starting to become stretched and would suggest that consumption or demand for goods and services is likely to weaken over time.

It is our contention, based on a historical equity market analysis of previous corrections, that if we were to avoid a recession, the equity markets, having fallen about 20-25% to date, would now be in the region of market low and would most likely be forming a bottoming process. However, if we have a recession, which is now very much our central case, then further equity and credit market weakness will depend on the recession's length and depth. Suppose we have a sharp and long-lasting recession. In that case, equity and credit markets are likely to move lower to reflect the probability of a material fall in future consumption leading to a material hit in corporate earnings and rising defaults. If the recession is sharp but expected to be relatively short-lived, then the negative impact on equity and credit markets will likely be less.

Figuring out the market bottom

Remember, bull markets are born out of recessions; typically, the market bottoms 3-6 months ahead of the economy. Hence the best time to put money to work will be over the coming months. There have already been several signs of capitulation in the market, signalling a bottom or being somewhere close to a bottom. For example, in mid-June, the S&P 500 index showed extreme weakness. In five of the seven sessions through Thursday, June 16th, at least 9 in 10 S&P 500 stocks dropped, a record run of widespread losses[11]. We believe equity and credit markets will likely go lower as the economic data materially weakens and negative corporate earnings revisions come through, especially in the upcoming earnings reporting season. Market rallies before this time should probably be sold. The smartest action is anticipating when the Federal Reserve is likely to relent. We believe the Federal Reserve is likely to relent in September or October of this year, primarily because we anticipate that most major economic indicators will confirm that the U.S. economy will be in recession. The market will almost certainly react to this action, which is the single most plausible reason for forming a market bottom.

We have to recognise that central banks are now a very large and influential player in the investment markets, and this is unlikely to change anytime soon. Over the last several decades, the global central banks have built an organised and coordinated armoury of policy tools that they can use to maintain price stability and maximise employment. They fully intend to manipulate the economic cycle to achieve their mandated aims. When exogenous shocks deflect their economies away from their comfortable growth equilibriums or achieving their policy targets, central banks will use these monetary toolkits to create the optimal economic conditions to achieve their targets. So, in simple terms, once inflation is tamed through higher interest policy, the Federal Reserve's attention will quickly shift back to job creation by creating the economic growth conditions to achieve its aims. This implies that the Federal Reserve will not only relent with rate hikes once the U.S. economy enters a recession but is also likely to eventually start stimulating and easing again if it deems it necessary to achieve its dual mandate of maximum employment. We aim to allocate the capital in our funds according to our anticipation of how these economic patterns and policy responses will unfold over time.

Gavin Blessing, 8 July 2022

Source Data: ICM, Bloomberg; as of 30 June 2022.

[1] https://www.barrons.com/articles/stock-market-sp500-1970-outlook-51656620380
[2] https://www.logisticsmgmt.com/article/u.s._retail_sales_see_slight_may_decline
[3] CNBC - https://www.cnbc.com/2022/05/18/target-tgt-q1-2022-earnings.html
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[5] https://am.jpmorgan.com/gb/en/asset-management/adv/insights/market-insights/market-updates/monthly-market-review/
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[10] https://www.atlantafed.org/cqer/research/gdpnow
[11] https://www.bloomberg.com/news/articles/2022-06-17/in-prevalence-of-selling-this-is-a-market-rout-without-equal

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