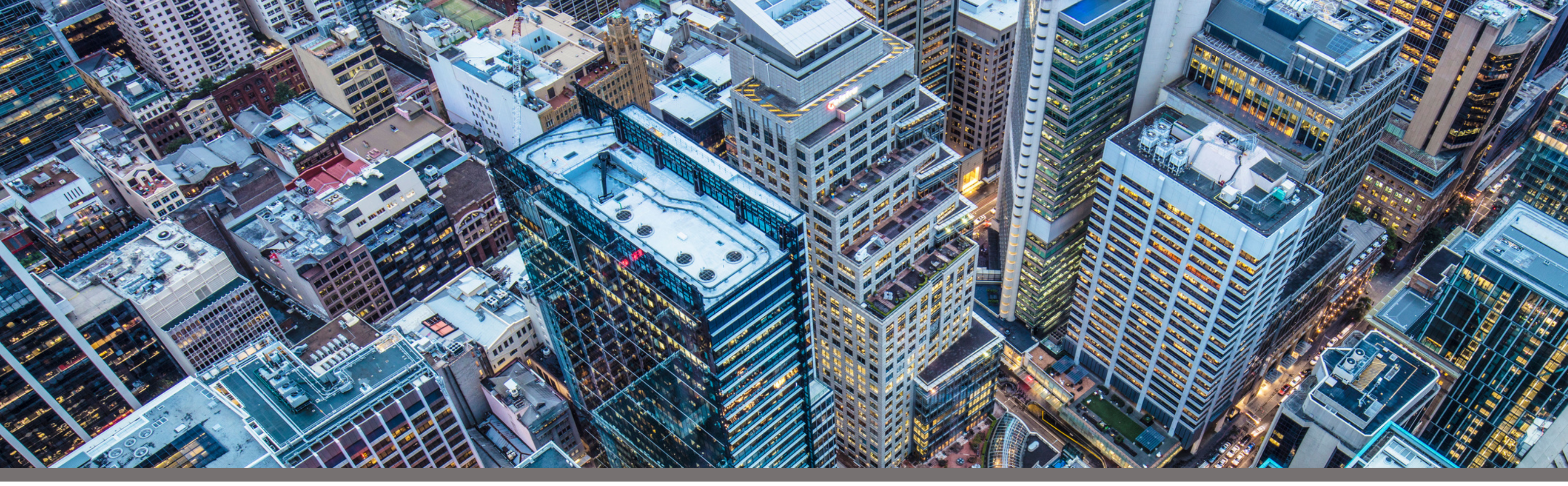


FOUNDED IN	EMPLOYEES	LOCATED IN	ASSETS DIRECTLY UNDER MANAGEMENT	ASSETS INDIRECTLY UNDER MANAGEMENT
1988	**70+**	**10+** COUNTRIES	**US$2.6** BILLION	**US$24.0** BILLION

ICM Monthly Review

June 2022

Market Review

The clear skies of spring may be well and truly upon us, but financial markets remain under grey clouds. Volatility remains high, and markets will continue to be turbulent until the U.S. Federal Reserve or inflation buckles. The resolution of that uncertainty will be the catalyst for a market turnaround.

There was a slight reprieve for U.S. stocks during May, with the S&P 500 flat for the month. However, May's return masked the intra-month volatility, similar to April. As of May 19th, the S&P 500 was down 5.6% month-to-date and 18.2% year-to-date, continuing to flirt with bear market territory.

The S&P 500 declined sharply in the middle of the month after Walmart and Target, two prominent American retailers, missed earnings estimates despite both companies seeing an increase in revenue. Higher fuel, freight, and labour costs, coupled with an inability to pass rising costs on to customers, meant earnings declined. The earnings miss for Target meant the share price plummeted by more than 22%, while Walmart declined by 11.4%, its worst one-day loss since 1987[1].

The S&P 500 energy sector resumed its role as the top-performing sector, rising by 15% during the month, and was the only thing standing between a fourth negative month for the S&P 500 in 2022.

The war in Ukraine continues to weigh on sentiment in Europe, with no sign of a straightforward resolution. As a result, the Eurostoxx 50 declined by 0.5% during the month and was down 11.8% year-to-date to the end of May.

Late in the month, E.U. leaders agreed to a watered-down ban on Russian oil imports, with oil imports via pipelines excluded from the ban to appease Hungary. This, the sixth E.U. sanctions package, was the most difficult to negotiate yet, and likely could lead to some disquiet amongst member states as countries with access to Russian pipelines continue to benefit from cheap Russian fuel, which trades at a c. 20% discount to Brent Crude[2]. Gas imports from Russia remain exempted from sanctions. Surging energy prices will continue to weigh on the European economy. As a result, the risk of inflation and pressure on the European Central Bank to raise rates remains elevated.

From a market perspective, the bright spot remains the U.K., with the FTSE 100 rising by 0.8% during the month. The FTSE 100 is one of the few positive stock market indices year-to-date, up 3.0%, primarily driven by its significant energy component.

Emerging market equities increased by 0.6% in May, with significant gains for Brazil, 3.2%, and more modest gains for China, 1.5%, driving a positive monthly return for the index.

Shanghai remained in lockdown for much of May, although a gradual re-opening through June provided some positivity for markets. Nonetheless, it will be difficult for the Chinese Communist Party to thread the needle of zero tolerance for Covid with continued economic growth over the coming months.

In Brazil, the central bank increased interest rates to 12.75%. As recently as February 2021, the Brazilian Federal Funds Rate, or Selic rate, was as low as 2%. Against the backdrop of rapidly increasing interest rates, a strengthening dollar and slowing global economic growth, the Brazilian stock market has been remarkably robust, up by 6.2% year-to-date to the end of May.

At the short end of the yield curve, interest rates increased marginally on the certainty that the U.S. Federal Reserve would raise rates in June and July. However, further out the yield curve, there was a welcome reprieve in rates, with the U.S. three year treasury yield declining for the first time since July 2021 and U.S. five and ten year treasury yields declining for only the second time since July 2021. The decline in yields meant a small gain of 0.2% for the U.S. Treasury Index, measured by the Barclays U.S. Aggregate Government Index.

In Europe, the Barclays Euro Aggregate Government Index declined, losing 1.8% in May, as the threat of war-induced inflation continues to point towards higher rates in the medium term.

Corporate bonds continued to perform well, with gains for both the U.S High Yield and U.S. Investment Grade indices, with slightly wider credit spreads being more than offset by lower rates.

As reflected by the Bloomberg Commodity Price Index, Commodities continued to march higher in May, rising by 1.5% in the month, for a total gain of 32.7% year-to-date, primarily driven by oil prices increasing by 12.3% and gas prices rising by 12.4%. Outside of energy and grain prices, most other commodity prices declined during the month[3].

Outlook

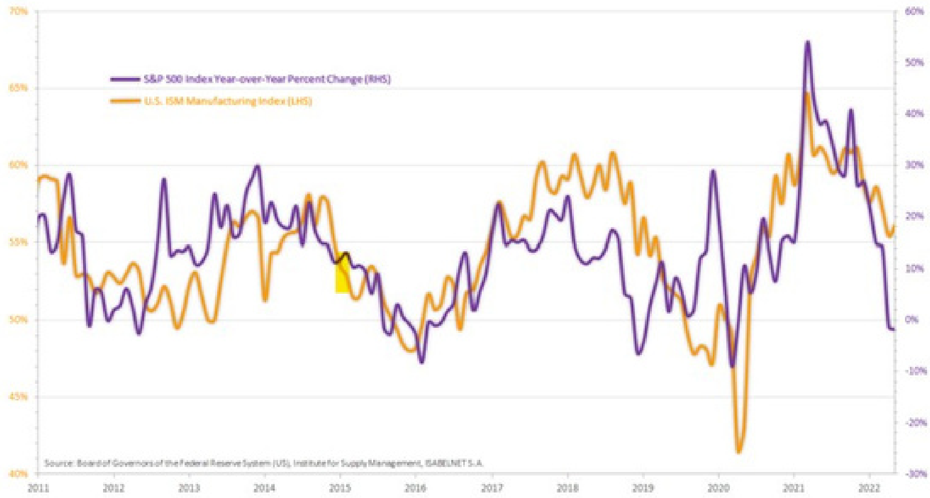
The Merriam-Webster dictionary defines anticipation as the action or state of looking forward to some occurrence. It can be argued that markets are always in a state of anticipation, pricing, at any point, how the distilled wisdom of the investment masses see the future development of economic growth or inflation and their associated impact on corporate earnings. Given the investment cognoscenti must navigate significant turning points in the market, this leads to heightened market sensitivity to new information, which can offer up early clues as to the direction and momentum of economic fundamentals. As investors, once we ascertain where fundamentals are likely pointing, we must then deduce how the investment markets will adjust to reflect these new fundamentals. We are now at one of those critical junctures, namely, will the inevitable monetary tightening needed by the Federal Reserve Bank to tame inflation force the U.S. economy into recession and, if so, how will the market price that risk?

U.S. Market Overview

The U.S. equity market is already pricing in a significant economic slowdown given the recent tightening in monetary conditions engineered by the U.S. Federal Reserve Bank. Market pricing is set by new information being digested at the margin. As a discounting mechanism, the market is always pricing in new information. Hence the rate of change in fundamental economic data is more important in determining market prices than the absolute level of economic data.

The Purchasing Managers' Index (PMI), calculated by the Institute of Supply Management, is a leading indicator of the health of the U.S. economy. It is a diffusion index, meaning that any reading above 50 indicates economic expansion; below 50 indicates economic contraction. From the following graph[4], if we compare the year over year rate of change in the S&P 500 index to the PMI index over past economic cycles, we note that the S&P index tends to lead reported levels on the U.S. PMI over time. The recent rapid fall in the S&P 500 index suggests that a much weaker future PMI trajectory with a reading of 50 or below is all but inevitable. Therefore economic recession is a growing probability.

Purchasing Managers' Index (PMI), Institute of Supply Management[4]

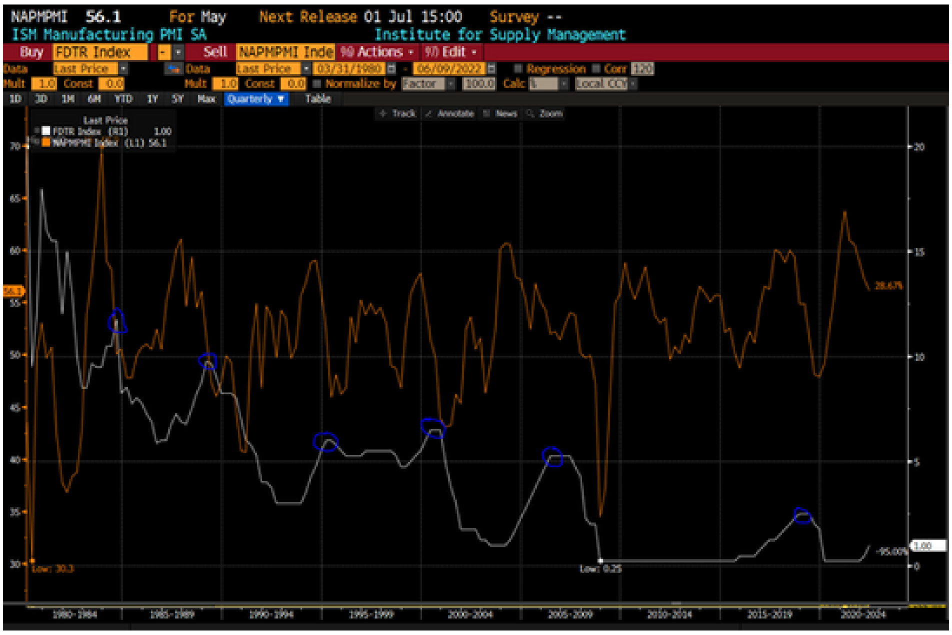


Given that a PMI of below 50 is typically synonymous with a recession, we could argue that the stock market has already priced a recession, with the recession's depth and length the only question remaining.

The speed of monetary policy tightening by the Federal Reserve bank has been relatively rapid. It has achieved this by adopting a very hawkish tone, which has spurred the market into pricing in higher future interest rates and, therefore, tighter credit or borrowing conditions. As a result, the U.S. Government bond market has seen one of the fastest, if not the fastest repricing in history, where market interest rates have doubled in a matter of months, with the U.S. three year treasury yield increasing to 2.75% today from under 0.5% last November. All forms of borrowing are priced off the treasury yield curve. For example, long-term U.S. mortgage rates have nearly doubled from under 3% to over 5% during the same period. Increasing mortgage rates pushes monthly interest repayments beyond the realms of affordability for many house buyers, which will lead to a downturn in demand for new and existing homes and all the goods and services that accompany a new home purchase or trade up. The speed of the interest repricing will make the change even more painful as the fall in housing activity will be abrupt, leaving many businesses floundering will little time to adjust, causing economic damage.

Last month we expanded on our rationale for why we believe the U.S. Federal Reserve will pivot later this year, with our best guesstimate in September or October 2022. We said last month that we believe that inflation is inextricably linked to demand, and inflation will inevitably fall as tighter monetary conditions squeeze out demand. As demand falls, we expect inflation to fall soon afterwards as less money is chasing a relatively fixed supply of goods and services. Once inflation has turned, and the Federal Reserve is convinced that inflation is beaten, it will likely stop tightening monetary conditions.

Let's look at previous economic cycles using the PMI index as our proxy for the business cycle. Over the last 40 years, shown in the graph below, it is notable that every time the PMI index has approached or fallen to 50 during a monetary tightening phase, the Federal Reserve has always stopped tightening. This is an intuitive assertion. Why would the Federal Reserve Bank feel comfortable tightening once a recession is all but assured?



Hence, we think this time will be no different. We expect, despite the challenging inflation outlook and the question of the Federal Reserve's credibility, that it is likely to signal a halt to the current tightening path once the PMI approaches or falls below 50. By extrapolating from this graph and given that we believe the slowdown is accelerating, we think the PMI index could be close to 50 by September or October this year, setting us up for a pivot or cessation in tightening. Another interesting observation from this chart is that every tightening episode by the Federal Reserve has ended at a lower absolute level than the previous economic cycle. Is this a coincidence, or is it, as we suggested last month, a function of long term trends in U.S. demographics and technology, culminating in slower trend growth, lower demand and higher technology and production efficiencies over time.

Unease with inflation continues

Conceptually, breaking inflation down into components may help us better understand how inflation will likely behave going forward. Let's start by assuming that long term trend inflation is about 2%. Anything above this number we will call excess inflation. Given U.S. inflation is currently running at 8.2%, excess inflation is now around 6% and has been caused by 1) a mixture of short to medium term supply bottlenecks and longer-term underinvestment in upstream commodity production capacity, and 2) excess demand. Assuming that each component accounts for roughly 50% of this excess inflation, inflation should start to fall as consumer demand begins to cool and supply bottlenecks are resolved. Furthermore, higher commodity prices and/or curtailed consumer spending will likely solve commodity production and supply issues through demand destruction in the short term or higher investment spending over the longer term. Indeed, there is plenty of evidence already suggesting that consumer demand for durable goods is declining, such as retail inventories at historically high levels and large U.S. retail corporations such as Target announcing plans to discount their stock as consumers shun more discretionary or durable items such as white goods and electronics in favour of necessities such as groceries and office clothes.

Interestingly, despite higher costs generally, U.S. consumer spending has stayed relatively resilient and is changing in nature rather than simply entering a firm declining cycle. This is because consumers are in reasonably good shape, having paid down debt and built-up excess savings during the pandemic. Indeed, while the U.S. personal savings rate fell to a low of 4.4%[5] in April, the lowest since September 2008, the consumer's balance sheet is in much better shape than before the pandemic. Wells Fargo estimates that U.S consumers amassed some US$2.3 trillion of excess savings over and above what they would have been expected to have saved in line with pre-pandemic savings trends[6]. This savings reserve probably explains why consumer spending is holding up better than expected, given the tightening in financial conditions experienced so far this year.

Furthermore, let us suppose U.S. consumers have more savings and are generally now relatively less indebted. In that case, they likely have a greater desire for and access to borrowing than at similar points in previous cycles. Indeed, given that consumer demand makes up over 70% of US GDP, we could expect that the U.S. economy might stay stronger for longer. If we go into recession, such a recession could be relatively short-lived.

Without a doubt, some of these inflation pressures will take longer to resolve themselves, especially if we can avoid a sharp and deep recession in the U.S. Relatively high levels of demand and more ingrained supply constraint issues will keep certain commodity prices pinned higher, such as crops and possibly oil. Still, even in this case, the rate of change in inflation should start to fall as commodity prices stop their advance and merely stay high.

Estimating the Federal Reserve response

We recognise that the U.S. Federal Reserves credibility is on the line. Chairperson Powell and other committee members must feel under enormous pressure to ensure that, having failed to contain inflation, they take no chances whatsoever in ensuring that they have killed off inflation before relenting on their current path of monetary tightening. It is a question of legacy. Does this Federal Reserve committee want to always bear the infamy as the committee who got inflation wrong by calling it 'transitory'? They have been given a chance to put the record book right. This suggests they will take every reasonable opportunity to stamp out inflation before pivoting. As described above, we believe the Fed will relent only when the economy is cratering on the edge of a recession. Simultaneously the bond market should be rallying with yields falling, signalling to the Federal Reserve that a recession is nigh and that excess inflation is largely beaten, at least inflation of the type that can be controlled directly by monetary policy. We expect that the Federal Reserve will take its cue from the bond market that the battle against inflation has been won and will only then relent.

Of course, there is the matter of quantitative tightening to consider. Indeed if the Federal Reserve has embarked on a path of reducing its balance sheet, this will lead to technical selling pressure in the bond markets leading to an automatic rise in yields. However, we are reluctant to make this rather obvious conclusion for several reasons. Firstly, the looming risk of recession and especially of the Federal Reserve bank tightening into a worsening economic environment will compel investors to seek out and buy safe-haven assets such as high-quality government bonds. Secondly, during past episodes of quantitative tightening by the Federal Reserve, yields have fallen not increased. The reason for this phenomenon is probably to do with crowding out and quality effects. During previous episodes of quantitative easing, where the Federal Reserve bought high-quality Government bonds to drive down yields artificially, creating what is known as financial 'repression', institutional investors were crowded out and pushed further down the credit quality curve in the search for yield. With quantitative tightening, this action goes into reverse, with private investors tempted to sell their lower-quality bonds in favour of buying higher-quality bonds at more normalised yields. Hence, quantitative tightening and selling of high-quality bonds by the Federal Reserve is met with strong buying from institutional investors. This serves to prevent yields from rising and, when coupled with increasing concerns about slowing economic conditions, can drive bond yields lower.

In a similar vein to the bond market, we think the equity market, in anticipation of a turn in policy, is likely to rally a month or two before the Federal Reserve pivots. History tells us that equity markets tend to rally once it is believed that the Federal Reserve has tamed inflation. Ironically, we may soon reach a point where an ultra-hawkish Federal Reserve hastens an equity market rally if the market is convinced that the Federal Reserve will kill off inflation, thereby reducing uncertainty around the direction of inflation in the medium to longer term. But, of course, in the short term, as uncertainty remains high and growth comes under increasing pressure, it is likely that we stay in risk-off mode with equities remaining highly volatile and with the potential for some more outright declines between now and the fall.

This then begs the question of whether the Federal Reserve's medicine could kill the economy? This is a very plausible risk. On balance, we favour a scenario where the economy slows significantly and either skirts a recession or slips into a recession but rebounds soon afterwards. We believe if a recession hits, it is likely to be short-lived for several reasons. Firstly, one needs to recognise the relative strength of the U.S. consumer embodied by a high level of historical savings and a relatively robust labour market. Secondly, once the Federal Reserve Bank believes its battle with inflation has been won, it is likely to quickly turn its attention to the second of its dual mandates: to support maximum sustainable employment. Hence if unemployment is starting to rise due to recessionary pressures, it probably will not be long before the Federal Reserve feels compelled to begin priming the economy and potentially loosen monetary policy.

Commodity market supply disruption

Of course, there are many geopolitical risks currently present, not least the war in Ukraine, which has resulted in higher energy prices, particularly higher oil prices. If we do slip into a recession, oil prices will fall due to lower demand, which would be positive for the inflation story. However, this scenario is far from assured. Global oil production capacity is tight, which may mean that oil prices stay elevated for longer. Indeed, the recently announced E.U. embargo on Russian oil could be problematic in the fight to control inflation later this year and next year. Suppose Russia cannot find alternative buyers for the 2.4m barrels of oil per day that it now sells to the E.U. In that case, a significant amount of this production will have to be shut in as Russia does not have substantial storage capacity. This is problematic for Russia and the rest of the world as many of its oil wells are based in eastern Russia and operate under very extreme climatic conditions in the permafrost. There is a significant risk that once these wells are shut-in, they will be damaged permanently and will no longer be economically viable to be brought back online later. Hence, a large chunk of this Russian production could be lost forever. The risk of higher oil prices is very much present in the short-to-medium term despite a declining global economy. If oil prices continue to spike from current levels, it will guarantee the U.S, and possibly the rest of the world, a recession. Yet even if we are fortunate enough to avoid such a scenario, we believe higher oil prices will likely remain an unwelcome companion to any recovery scenario of the global economy over the next several years. If uncertainty around long term oil prices as a result of misguided political and populist energy policies constraints investment in upstream oil and gas production, oil prices will likely remain higher for longer.

USD

We mentioned last month the importance of the USD and its relationship to the business cycle. Historically the U.S. dollar tends to strengthen as we enter and go through a period of declining global trade and business activity. The rationale is that as international trade declines, the U.S. tends to import fewer goods and services and hence exports fewer U.S. dollars abroad in exchange. Therefore, foreign U.S. dollar deposits become more scarce just as higher U.S. interest rates typically require foreign borrowers to demand more U.S. dollars to service their debt obligations. A stronger USD is negative for the pricing of all risk assets, given it is the denominator in which all other assets are valued. Simple maths suggests the price of these assets, valued in U.S. dollars, should fall as the U.S. dollar strengthens. We had a helpful reprieve since the middle of May, with the U.S. dollar falling in strength against other currencies as measured by the DXY index. This probably explains the recent rally in global equities and commodities since that time. Despite the recent weakness in the DXY, it is perhaps still too early to call a cyclical turn in the U.S. dollar. That said, if the market increasingly believes that inflation is tamed or the Federal Reserve is sure to tame it in the coming months, we might see the beginning of a declining cycle in U.S. dollar strength. A weaker U.S. dollar would support most risk assets, including global equities, emerging markets and commodities.

We believe we are closer to the end than the beginning of the current market challenges of increasing inflation, the antidotal medicine of Federal Reserve tightening and the threat of induced recession. Of course, the natural uncertainty raised by these factors is set to remain with us for a while longer. Still, we believe as we move through the summer months, this uncertainty around inflation and Federal Reserve policy will probably abate, leading to plenty of opportunity for the intelligent investor.

Gavin Blessing, 9 June 2022

Source Data: ICM, Bloomberg; as of 31 May 2022.
[1] Financial Times - https://www.ft.com/content/6bd41174-6f7c-4152-9fa0-4a11f2a0ed05
[2] Financial Times - https://www.ft.com/content/acc55aee-1b63-4f23-b52d-41fe661b0714
[3] World Bank - https://thedocs.worldbank.org/en/doc/5d903e848db1d1b83e0ec8f744e55570-0350012021/related/CMO-Pink-Sheet-June-2022.pdf
[4] https://www.isabelnet.com/ism-manufacturing-index-vs-sp-500-index/
[5] https://finance.yahoo.com/news/us-savings-rate-hits-lowest-level-since-2008-144126366.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAGebmf0sDQDjf_LnMrVO_SYv8Ts2n9CHTr6fa0JbMl91DNhPp3s5aTjmc9NNBaWjT8bWZdQwg0h3CqsEg8-3xKw9xAgM3LXWS5aE0-F0af1lT-ZitlgRn1IyuKN71w3t0BifVt-b8o2ia0i4vkdiBdyDrt3vJeAtx9uujrsVICZ5
[6] https://finance.yahoo.com/news/us-savings-rate-hits-lowest-level-since-2008-144126366.html?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAGebmf0sDQDjf_LnMrVO_SYv8Ts2n9CHTr6fa0JbMl91DNhPp3s5aTjmc9NNBaWjT8bWZdQwg0h3CqsEg8-3xKw9xAgM3LXWS5aE0-F0af1lT-ZitlgRn1IyuKN71w3t0BifVt-b8o2ia0i4vkdiBdyDrt3vJeAtx9uujrsVICZ5

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