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OUT OF THE ORDINARY

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Market commentary

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Overview

Since the Covid pandemic hit more than three years ago, almost every month seems to have been packed with incidents or market moves that have necessitated commentary in their own right. March was no exception. It appears that bankruptcies in the US banking sector are like buses. There had been none since 2018 and then three arrived in the space of five days. A week later, in Switzerland, Credit Suisse had to be rescued by UBS, and there were even rumours circulating about the viability of Germany's Deutsche Bank. Suffice to say at this point that the worst of the alarm is behind us for now, and we shall delve into some of the specifics later in this commentary.

The first quarter of 2023 broke into three distinct parts. Importantly, though, the aggregate effect for balanced portfolio investors was positive, which comes as a relief following the travails of last year. January set markets on a better path, with both equities and bonds prospering. The mood was supported by a growing conviction that Europe, thanks to a mild winter, would not fall into a deep recession, as had been feared. Energy prices fell sharply from their peaks as supply shortages failed to materialise. China also offered hope for increased consumer demand and less disruption to supply chains following the abrupt ending of its zero-Covid policy. US consumers continued to spend the savings that they had built up during the pandemic. And even the UK reported that it had avoided falling into a recession in the final quarter of 2022.

But the mood turned less positive in February and into early March. Bad news not materialising had provided fuel for a relief rally, but too much good news was unwelcome. As economic data releases consistently beat expectations, hopes for a "goldilocks" outcome, in which moderate growth would persist while allowing inflation to subside, took a hit. Fears grew that central banks would need to keep interest rates "higher for longer", and that was very much the message that US Federal Reserve chairman Jerome Powell delivered in his testimony to Congress on Tuesday 7 March. Bond yields rose alongside peak interest rate expectations; equities struggled to fend off the combined effects of a rising discount rate and the threat of a future recession if central banks continued to tighten monetary policy until "something broke".

And within 24 hours, something did start to break, which set markets on a new trajectory. That something was Silicon Valley Bank (SVB), then the sixteenth largest in the United States as measured by its loan book. The biggest problem faced by SVB was not that it had made loans that were going bad, which one might think of as the typical root cause of a failing bank. It was the fact that it could not fulfil demands from clients to withdraw cash deposits without crystalising losses in its investment portfolio.

Owing to the breakneck speed of growth in its deposit base in the four preceding years – growth that was annualising at a heady rate of forty percent – the bank had decided to invest a good portion of those funds into government bonds and mortgage-backed securities, two asset classes deemed by regulators to bear minimal risk, at least from a solvency perspective. Misguidedly, as it turned out, the bank's managers attempted to squeeze some extra juice out of these bonds by investing in longer maturities which offered a bit more income in a world where yield was hard to come by. Remember that around $18 trillion of investment grade debt globally had a negative yield-to-maturity in mid-2021.

When yields rose in the face of rising inflation and higher central bank policy rates, these bonds lost value. Even then, though, accounting rules allowing the bonds to be classified as "held to maturity" meant that no loss needed to be recognised. That only happened when deposit balances fell to a level at which SVB was forced to sell some its investments and convert them into hard cash. Events can unfold very quickly once people get even the slightest inkling that a bank's viability is at risk. SVB tried to raise new equity, but it became clear that this would be a short-term solution at best. There were a lot more uncrystallised losses in its portfolio and the pace of deposit withdrawal was accelerating. There was no alternative other than for the Federal Deposit Insurance Corporation (FDIC) to declare SVB bankrupt.

As if there were not enough problems already, the bankruptcy order revealed that around 95% of SVB's deposits were greater than the FDIC's $250,000 ceiling for guaranteeing deposits. Even if the bank's finances could be run down in an orderly fashion, depositors, many of whom were immature companies entirely dependent upon those deposits to fund daily operations, could end up in financial difficulties. It might have taken weeks, months or even years for cash to be distributed. This forced the FDIC to guarantee all of SVB's deposits over the following weekend.

To a great extent, SVB's problems were peculiar to itself. The same could be said of another bank that failed, Signature Bank of New York, which had a similar duration

mismatch between its liabilities (deposits) and its assets (loans and investments), although a quite different client base. The third US bank to fail, Silvergate, was very specifically affected by the turmoil in the cryptocurrency industry. But, as some are wont to ask, when does a run of idiosyncratic problems develop into a systemic one?

That question became even more pertinent a week later, when Credit Suisse (CS) had to be rescued after a similar "run on the bank". Again, this looks like a very specific situation. CS had been accident-prone for years, with a record of run-ins with financial regulators. Its wealth management business had been underperforming and its investment banking arm persistently failed to match up to the big beasts on Wall Street. Even so, while its demise was not exactly a surprise, it was a shock.

How were the markets affected?

Unsurprisingly, all of this had a profound effect on markets, the biggest of which was to trigger a massive shift in interest rate expectations and bond yields. The simple narrative was that pressure on the banking system could create a vicious cycle of weaker profits, tighter lending standards, tricky refinancing of existing loans and, ultimately, rising bad debts. The commercial real estate sector was seen as especially vulnerable to rising defaults on loans, particularly as more than two-thirds of lending to this industry originates from US regional banks, amongst whose number SVB and Sovereign used to be counted. Such an economic setback would force the Fed to cut interest rates much sooner and from a lower level than previously threatened.

To put this into context, the yield on US 2-year Treasury Bonds, which is a good lead indicator for the Fed Funds rate, dropped from 5.07% to a low of 3.76% in just a few days. Indeed, its initial three-day move from over 5% to just below 4% was the most extreme shift seen since the equity market crash of October 1987, surpassing moves seen even during the Great Financial Crisis. No doubt some of this move was exaggerated by the amount of money that had been betting on higher rates which needed to be taken off the table quickly.

If we look at this through the slightly different lens of interest rate futures, the peak US Fed Funds rate projected by the market was 5.69% following Mr Powell's congressional testimony, and it ended the month at 4.95% (having been as low as 4.75% in the interim). Perhaps more remarkably, the market also went from having given up on any notion of interest rate cuts before the end of this year to pricing in a rapid reduction. The January 2024 interest rate future fell from a peak of 5.43% to a trough of 3.69%, before settling at 4.15% at the end of March.

There were similar patterns in rates futures markets in the UK and in Europe, although not as extreme. But in the midst of the turmoil, the central banks made it clear that they were not in panic mode and that they still had a very close eye on inflation risks. Thus, the European Central Bank raised its deposit rate by 0.5% in March to 3%, while the Fed and the Bank of England proceeded with quarter-point increases to 5% and 4.25% respectively. Investors remain in two minds about whether to view this as a vote of confidence in the economy or the last knockings of a catastrophic policy error, although they seem to be veering towards the latter conclusion.

This overview section has been taken up with a much deeper dive than we might normally consider appropriate for this commentary. However, we consider it important that clients understand the scale and complexity of some the events that have recently taken place. In the next sections we will further consider how these influences have played out in markets. One final point to make is that had not four banks got into difficulties during March, it is quite conceivable that investors would be worse off now than they would otherwise have been. That speaks to the positive influence of lower interest rates on financial assets, especially those that are exposed to steady growth trends and generating decent profits, notably the large cap US technology companies.

Markets – US

2023 has witnessed a renaissance in the fortunes of large cap Technology shares, to such an extent that they have acquired yet another new descriptive acronym to reflect the latest list of favourites – MAGMAN. In order of capital gain during the first quarter: Nvidia (+90%), Meta Platforms (+76%), Apple (+27%); Amazon (+23%), Microsoft (+20%), Alphabet/Google (+17%). These are against an S&P500 Index return of 7%, of which this group contributed around a half. There are a few reasons for this surge, some technical, some more fundamental. There was great clearing out of positions towards the end of 2022, with year-end tax loss harvesting a key driver of that. There was also a meaningful amount of money betting on further declines. When these did not materialise, the positions had to be reversed, creating a short squeeze. Optimism about generative artificial intelligence has also been a strong propellant, with Nvidia supplying the chips for the computing power and the likes of Microsoft, Alphabet and Apple increasingly embedding it into enhancements of their existing services. Microsoft and Amazon provide the cloud-based computing power and data storage facilities. Meta is in the AI mix, while also benefitting from a less aggressive (and profitless) pursuit of domination of the metaverse. Latterly, falling bond yields have added icing to this multi-layered cake by boosting discount rate-based valuations.

UK

UK equities, having prospered last year thanks to a weaker pound and the earnings boost from energy stocks, are finding the going a bit heavier this year, at least relative to other regions. Even so, the flagship FTSE 100 Index finally breached the 8,000 level in February before abruptly giving up all of its gains for the year when the problems arose in the banking sector, in large part because fears about global economic weakness put downward pressure on the energy and mining sectors. It must be emphasised, though, that none of the UK's banks were deemed to be at risk. Indeed, HSBC turned out to be an opportunistic buyer of SVB's UK arm. The Spring Budget was another chance for Chancellor Jeremy Hunt to rebuild the government's reptation for fiscal and economic competence, which was largely achieved. One pleasant surprise for UK savers was the abolition of the cap on the lifetime allowance for personal pension assets, although the Labour Party has pledged to reverse that decision should it prevail at the next General Election, which must take place by January 2025 at the latest.

Europe

Europe's banking sector was more badly caught up in the mini crisis that developed in March, falling by almost 20%. There were certainly profits to be taken because the sector had risen by more than 60% from its lows of last summer. Higher interest rates delivered by the ECB promised a meaningful expansion in profitability, and the receding threat of a deep recession on the Continent had also bolstered confidence. As we head into the second quarter of the year, the ECB is the central bank that sounds the most hawkish in its policy pronouncements, with core inflation proving to be stickier than it would like. It rose from 5.6% in February to 5.7% in March, which represented a new high for this cycle.

Emerging Markets

Chinese equities enjoyed a strong run between November and January as investors decided they were investible after all. A key driver of sentiment was the decision to abandon the zero-Covid policy. There were also supportive announcements concerning the country's troublesome real estate sector as well as liquidity injections into the economy. February and March have been more about consolidating those gains as we await clearer signs of recovery in the official data. The Communist Party's attitude towards the important technology sector has been another factor affecting sentiment. A recent decision to split Alibaba, a company that provides a broad range of online services, into six separate units suggested some softening of a two-year long crackdown on the industry and a more productive approach to unlocking value in the sector. Emerging Markets in aggregate continue to offer good relative value and structural growth opportunities. We continue to expect the peak of the US inflation and interest rate cycles to confirm the peak of the dollar bull cycle, and this should be supportive to EMs based on past experience.

Fixed Income

Global bonds, as measured by the Bloomberg Global Aggregate Index have had a rollercoaster ride so far in 2023, although at least ended up with a positive return of 3.5%. January's performance was the best since the index's inception in 1990, while February's was the worst. March was more constructive as investors sought safe havens from the banking sector crisis and future interest rate cuts were priced in. While the yields available are not as juicy as they were a month ago, they remain considerably higher than anything that had been available for the past decade and government bonds now offer a decent vehicle for short term cash management as well as portfolio diversification.

UK Gilts have delivered a total return of +2.05% over the last three months and -16.7% over the last year. Index-Linked Gilts returned +4.1% and -27.16% over the same respective periods. Emerging Market sovereign bonds produced a total return of -0.68% in sterling over the three months to end March (-0.7% over 12m). Global High Yield bonds delivered +0.35% (+1.67% over 12m) in sterling.

Conclusion and Outlook

We continue to maintain our stance of waiting for a more opportune moment to increase equity risk allocations. While some market participants believe that the problems in the banking sector will prove to have marked the low point in sentiment this year, we view them more as proof that last year's monetary policy tightening is beginning to have a deeper economic impact. And while we agree that this will eventually force central banks to start to loosen policy, which will provide support to financial assets, we would prefer to have greater clarity around the depth of the cuts to corporate earnings that we believe are inevitable. Thus, we continue to believe that now is not the time to be extremely defensive either, given that we are approaching the end of the monetary policy tightening cycle. During the next few months, we are likely to continue to experience choppy markets as we navigate the turning point.

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