OUT OF THE ORDINARY

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Market commentary

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Overview

Financial markets have been on a rollercoaster ride for much of the past three years, with major events developing almost every month. The rollercoaster finally encountered a fairly flat section during April, with market indices and bond yields displaying minimal change. The ever-industrious number-crunchers at Deutsche Bank reported that only five out of 38 non-currency asset classes that they track moved by more than 3% in either direction, the least volatile outcome since before the outbreak of Covid.

That's not to say, however, that nothing was going on. The eerie calm in major indices has at times seemed unnerving. Investors could be forgiven for wondering if this quiet patch represents a "pause that refreshes" or a "calm before the storm". While the major cyclical themes running through markets continue to revolve around inflation, monetary policy, and the risks of recession and downgrades to corporate earnings, there are currently three very specific areas of focus: the US regional banking system; the US debt ceiling negotiations; and the first quarter earnings season.

Will banking regulations become tighter?

If it had been suggested two months ago that three sizeable regional US banks and the second largest bank in Switzerland would have to be rescued following a run on their deposits, few people would have predicted that global equities would be higher now than at the beginning of March according to the MSCI World Index. It reflects well upon the rapid response of regulators and central banks, which provided liquidity and the effective guarantee of deposits. Lessons were learned during the Great Financial Crisis (GFC). Even so, the same bodies could also be blamed for helping to create the mess in the first place. Regulatory standards were loosened during Donald Trump's presidency and persistently loose monetary policy encouraged inappropriate risks to be taken. We have probably not seen the last casualties of the current tightening of monetary policy.

There is already talk of stricter banking regulations. Even if this causes some short-term pain, it could be construed as a good thing in the longer term if it prevents the build-up of the sort of excesses that might trigger a deeper financial crisis. It has consistently been our opinion that the tighter regulation and stronger capital demands made of banks in the aftermath of the GFC, as well as those lessons learned by central banks concerning the need to guarantee liquidity to the financial system, meant that a re-run of 2008 was a low probability event. We adhere to that view. Even so, it is fair to say that the speed at which deposits can be withdrawn from banks these days at the touch of a button is a source of concern, and it would not be surprising to see higher deposit insurance levels introduced in response (the current levels are £85,000 in the UK, $250,000 in the US, and €100,000 in Europe). We should also point out that accounting conventions and balance sheet structures in the UK and Europe are more conservative and present less risk of similar problems developing. The same is true for the larger US banks deemed to be amongst the "Global Systemically Important Financial Institutions".

But it is impossible to ignore the stress amongst the regional US banks and the knock-on effects that this might have. Although, according to a study by IBISWorld, there is a registered bank for every day of the year in the UK, the reality is that the market is dominated by the "Big Four" (and many of those registered banks have just a few branches limited to representing the interests of foreign nationals). In contrast, and at the latest count, the US has no fewer than 4,270 banks, of which 4,255 have less than the $250bn of assets that would make them subject to more stringent regulation and stress testing. These banks are the lifeblood of many local communities, providing 38% of all loans. Their biggest share, a whopping 67% (according to data provided by Nomura), is in Commercial Real Estate (CRE) lending.

CRE is already under pressure. Valuations took a big hit last year when discount rates went up and office vacancies remain elevated as remote working practices adopted during Covid have not been fully reversed. There are around $1 trillion of CRE loans maturing between now and the end of 2024 and these will have to be refinanced. Not only will the interest rate payable be higher (in all likelihood), but the willingness to provide new loans will be lower if regional banks' profitability is undermined by a squeeze on deposit margins (as they pay up to retain deposits) and by a tighter regulatory regime. If there is any silver lining, it is that this refinancing should play out over an extended period rather than delivering a sudden shock. Even so, everyone will be watching to see whether this turns from what is currently largely a problem of liquidity (which central banks are better equipped to deal with) to one of solvency.

What might happen to the US debt ceiling?

Congressional squabbles over the US government's debt ceiling are becoming a hardy perennial. This year's flowering will unfold over the coming months and threatens to present another unwelcome influence for markets, that of a default on debt repayments. We have been here on several occasions in the past, and because the debt ceiling is denominated in nominal dollars, the higher inflation background has accelerated the latest episode. Almost all external observers agree that the debt ceiling, although seemingly sensible on the surface in that it might restrain profligate "pork barrel" spending, is a nonsense. But unless Congress agrees to scrap it, the theatre will continue on a regular basis. It makes for ugly, if compelling, politics. With a highly divisive partisan background and a split Congress, as it is currently, the probability of some sort of accident is not immaterial.

The current offer on the table from the Republican Party is to raise the debt ceiling by $1.5 trillion or to suspend it until March 2024, whichever comes first. But there are strings attached, not least ones that require the Democrats to make big cuts to federal spending budgets. Unsurprisingly, President Biden is not in favour of such retrenchment. Neither will it have escaped your attention that the whole thing could blow up again just a few months before next year's Presidential election if the Republicans' offer is taken up. For now, the government is able to utilise "special measures" to keep the administration running. This involves things such as borrowing from federal pension funds. The timing of the so-called "X-date" when the money runs out will be largely subject to the amount of non-withheld tax that can be raked in during the current tax payment season. The first signs on this front were ominous. The market's default position is that negotiations will go to the brink, as usual, but that pragmatism will prevail, with the Republicans being the ones who will have to give ground. But the dysfunction in Washington cannot be underestimated, and this is another reason for our continued cautious stance.

What effect has company reporting season had on the markets?

Finally, in this section, a word on the first quarter company reporting season. Once again, earnings have held up remarkably well in aggregate. One bright spot has been the ability of many companies to sustain prices in line with, or higher than, inflation. This phenomenon has been especially visible amongst sellers of many essential goods (if one believes that sugary drinks, snacks, and chocolate count as essentials alongside soap, detergent, and prepared foods). A representative sample of six Consumer Staples with global reach (Nestlé, Mondelez, Procter & Gamble, PepsiCo, Coca-Cola and Unilever) reported average year-on-year revenue growth of 12%, made up entirely of price increases. Indeed, volumes were, on average, marginally lower. Accusations of "greedflation" abound, but investors are happy to pay up for this pricing power for now, with the group producing an average capital return of 6.6% so far this year, with all of that coming since early March when the banking problems started. That's a sure sign of investors taking defensive positions.

Markets – US

We commented last month on the narrow leadership of the US equity market, with a handful of shares contributing the lion's share of the gains. To some degree that was justified during the reporting season, with the likes of Apple, Microsoft, Alphabet and Meta Platforms all delivering pleasing numbers. However, the positive capital returns (+6.5% year-to-date) that this has generated for the widely referenced S&P 500 Index and for the more technology-driven NASDAQ 100 Index (+19.1%) continues to mask a greater malaise elsewhere. For example, the Russell 2000 Index, which is comprised of companies 1001 to 3000 in terms of market capitalisation, has fallen 1.3% owing to worries about an imminent slowdown. The worst performing sector is Energy (-9.7%), as oil and gas prices have continued to fall back. Financials are the second worst (-6.7%), but even that does not reveal the extent of damage sustained by the Banks sector amidst the ongoing turmoil in the regional banks. The KBW Regional Bank Index is down 28.5%. (Bloomberg market data to COB 3/5/23)

UK

The FTSE 100 Index was a standout performer in 2022 thanks to the predominance of the large cap Energy companies which benefitted enormously from a high oil price. That has not been the case in 2023, and the index is a laggard amongst global peers, gaining just 4.5% year-to-date. Elsewhere in this commentary we note the influence of certain types of company in driving local markets higher, but the UK's gains have been remarkably diverse in their nature. In terms of index points, the FTSE's rise has amounted to 341. The top 10 contributors to that (adding up to 307 index points) are all very different: HSBC (Bank – 77 points), AstraZeneca (Pharmaceuticals – 43), Unilever (Consumer Staples – 32), Flutter (Gambling – 30), Reckitt Benckiser (Household Goods – 24), National Grid (Electricity Distribution – 21), BAE Systems (Defence – 21), RELX (Information Services – 21), Rolls Royce (Aerospace – 19), and London Stock Exchange (Financial Services – 19). That diversity could make the gains achieved by the index a bit more sustainable should sentiment turn for the worse.

Europe

Continental European markets have been led higher this year by France's CAC 40 Index (+15%). This is somewhat at odds, perhaps, with media coverage of widespread protests in the country against President Macron's proposed changes to the pensions system. But it reminds us that in many markets it is international, not domestic, factors that drive share prices. The largest company in the CAC 40, accounting for a fifth of its market capitalisation, is LVMH (Moet Hennessy Louis Vuitton). This purveyor of luxury goods has seen its shares rise almost 30% this year thanks to a surge in demand from Chinese customers celebrating the end of harsh restrictions on their movement during the zero-Covid policy era. LVMH also achieved the distinction of becoming the first European-listed company to top half a trillion dollars in terms of market capitalisation. Its founder, Chairman and CEO, Bernard Arnault, controls almost half of the company, by virtue of which he is now reported to be the world's richest person. Demand for luxury goods has also been reflected in the performances of Hermes International (+37%) and Kering (+20%), whose brand portfolio includes such famous names as Gucci, Cartier and Saint Laurent. Along with another winner from the trend for more conspicuous consumption in Asia, L'Oreal (+31%), these companies account for a massive 41% of the CAC 40. No wonder President Macron embarked on a charm offensive during his recent state visit to China!

Emerging Markets

We have recently met with several strategists and fund managers who cover and invest in Emerging Markets. And while we are aware that they might have a vested interest in being positive on the asset class, it is hard to ignore the almost uniform opinion that good value is on offer. Even the most consistently negative strategist that we have encountered is now willing to say that EM is "in the very last stages of underperformance". The EM complex has faced numerous challenges in recent years, not least of which has been the consistent strength of the US dollar. EM equities tend to be negatively correlated with the dollar owing to liquidity flows and the cost of capital – money flowing towards the US moves away from EM and a stronger dollar increases liabilities when translated into local currencies. Rising dollar interest rates and globally pervasive inflation have also forced EM countries to raise their own interest rates. But there is a widespread feeling that inflation rates have peaked and that US interest rates are about to reach the highest point for this cycle. The dollar also looks expensive on a variety of measures. Peak inflation, peak rates and peak dollar should create a positive inflection point for EM. At the same time, relative valuations are attractive, and more than one manager has pointed out to us that valuation spreads within countries and sectors are very high, leading to outperformance opportunities for active managers. One area of pushback on any enthusiasm for EM is the nature of China's relationship with Taiwan, and we are acutely aware that this is a risky situation, to say the least. We do not think that it is in China's best interests to proceed with an invasion of Taiwan along the lines of Russia's invasion of Ukraine. There are very strong trade ties between the two countries, not least involving Taiwan's globally dominant position in the production of semi-conductors. The key date we should look forward to is January 13 2024. This might well be the day of the most important presidential election of next year, rather than the one in the United States the following November. The current President of Taiwan, Tsai Ing-wen, is friendly towards the West. It remains to be seen whether she remains in power.

Fixed Income

The Bloomberg Global Aggregate Index of all investment grade debt flat-lined during April, which provided welcome respite following the volatility of March. UK Gilts were a relatively poor performer, with the 10-year yield rising from 3.49% to 3.73% owing to persistently strong consumer price data. The good news for investors, though, is that the asset class now offers decent income, even if not high enough to keep pace with current inflation. The situation is even more attractive for higher rate domestic taxpayers. With coupons on Gilts maturing in the next few years being exceptionally low (because they were issued during the period of near-zero interest rates), the yields to maturity of more than 4% available on short-dated Gilts will accrue with minimal tax liability, as Gilts are not subject to Capital Gains Tax. This makes them a viable alternative to bank savings accounts or Money Market Funds, and there is no need to worry about deposit insurance limits.

UK Gilts have delivered a total return of -2.1% over the last three months and -15.3% over the last year. Index-Linked Gilts returned -2.9% and -25.3% over the same respective periods. Emerging Market sovereign bonds produced a total return of -3.1% in sterling over the three months to end April (-0.8% over 12m). Global High Yield bonds delivered -2.4% (+0.6% over 12m) in sterling.

Conclusion and Outlook

If patience is a virtue, then we feel extremely virtuous for remaining patient. Whether our patience pays off remains to be seen. It has been our opinion for some time that the regularly referenced “long and variable lags” of monetary policy transmission would eventually make themselves felt in real economic activity. There are signs of this happening in the banking and real estate sectors, as written about earlier in the commentary. But it’s fair to say that “excess” savings built up during the pandemic, shifting spending patterns (with the preference moving towards services and away from goods), and the persistent foibles of supply chains and inventory management are all conspiring to make this economic cycle far from straightforward to read. We choose to stick to higher quality companies with strong balance sheets which will not only enable them to weather a storm but also to capitalise on competitors’ weaknesses – note, for example, how strong banks can benefit from industry consolidation by taking on the assets and loans of failed banks on favourable terms. We continue to await a more opportune moment to increase the risk tolerance in portfolios.

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