Economic & Market Round-up (March / Q1 2023)

Summary: It was a positive quarter all round, with equities and bonds across most regions delivering a positive return. Equities were bolstered by resilient economies, particularly within the service industries, falling energy prices, and falling bond yields (boosting growth-related stocks, for example technology and communication services). Both Germany and China posted strong growth, thereby boosting equity returns in these areas. From a sector point of view, Energy, Financials and Healthcare were negative. Bond yields fell (prices rose) on the back of a potential slowing of interest rate rises, with some predicting we're nearing the peak, and a move to lower risk assets given the turmoil in the banking sector.

Interest rates & inflation

- The latest inflation print for the UK came in at 10.4% (February, 2023), up from 10.1% in January, thereby causing the Monetary Policy Committee (MPC) of the Bank of England (BoE) to increase the base rate by 0.25% to 4.25%. Central banks target an inflation rate of 2% and have reiterated many times that their main aim is to reduce inflation. The yields on both the 10-year and 2-year gilt (UK government bond) have fallen from their highs this year, thereby indicating that markets expect the path of interest rates to be nearing their peak.
- Europe and the US also increased their interest rates (3% and 5% respectively). All three central banks indicated that further rate hikes may be necessary should inflation persist. Nevertheless, with energy prices expected to continue to fall, the expectation is that inflation will fall considerably as we move into the summer.
- The recent issues with some regional US banks were connected to interest rate rises. Specially, the issues SVB (Silicon Valley Bank) were mainly related to cash reserves being invested into long-dated government bonds, which have a greater sensitivity to interest rate risk (as rate rise, the price of these bonds fall).

Key takeaway: issues in the banking sector have concentrated the minds of central banks, which may impact their future interest rate pathway. Nevertheless, this did not stop all three aforementioned central banks to increase rates in their latest decisions. This could indicate two things: (1) they are confident that the current issues with banks are specific in nature and do not constitute a broader issue, and (2) they remain focused on bringing inflation down. Services inflation remains sticky and unemployment remain at record lows, thereby indicating rates may continue to increase, or at least remain elevated.

Financials: Opportunity or Risk?

What a month for financials! With the collapse of SVB (Silicon Valley Bank) and Signature Bank, as well as the rescue deals for Credit Suisse, the banking sector experienced heightened volatility to say the least, with the index (MSCI ACWI/Banking) down as much as 13% in March alone. As it currently stands, issues with these banks are specific in nature and we do not think there will be a broader issue throughout the financial sector.

Financials continues to be one of our favoured assets classes, being one of the highest-ranking sectors based on our valuation-driven analysis. Our investment case for global financials remains strong, attributed to high expected return based on our fair value analysis, relative valuations remaining attractive, the resilience to a severely adverse recession (evidenced through stress testing), improving margins (benefits from higher interest rates), robust balance sheets and record low non-performing assets (bad loans). Overall, global financials remain one of our overweight positions in portfolios, although we did reduce this slightly in the most recent portfolios changes, in line with our reduction in UK equities (financial services represents 19% within the FTSE 100).

Specifically, Financials represent around 11% within GBP Moderate portfolios (based on Golden Copy 60 exposure). Although the sector has experienced heightened volatility in recent weeks, the major market moves have been concentrated to a handful of banks, which we have immaterial exposure to across the portfolios (less than 0.1% exposure in any one of the aforementioned banks).

Why is this not another financial crisis?
Banks are in a much better financial position compared to 2008:

- Qualifying assets for capital ratios were tightened post 2008.
- Capital requirements are a lot higher than they were in 2008.
- Liquidity regulation, including central bank support in terms of cash reserve funds, have increased.

Key takeaway: although this is a moving piece, as of today, we view Financials positively, and retain our sector exposure within client portfolios. Our analysis demonstrates the strength of the sector overall, and we view the current issues are specific in nature and should not extend to the wider industry. Our extensive analysis on valuation highlights to us that this sector is relatively cheap, and there could be further upside, which we haven't incorporated into our assumptions, for example, if net interest margins do increase with interest rates. Together, this provides us with a wide margin of safety, meaning that potential downside risk is reduced and our return expectations are more favourable.

Performance

2023 has started in sharp contrast to 2022 with positive return from both stocks and bonds, albeit driven by a select few areas. The diverse nature of our portfolio has allowed us to deliver strong relative and absolute returns.

Despite March being a difficult month for our multi-asset portfolios, with mainly only lower risk portfolios outperforming the relevant ARC benchmark, the full quarter was much better. In Q1 2023, all risk profiles across all ranges outperformed the relevant ARC benchmark. In addition, our Active portfolio range passed its 10-year anniversary, and with it, outperformed across all risk profiles compared to the relevant ARC benchmark. Medium to Longer term performance (3, 5 and 7 years, where applicable) remains strong across the range, with all but the majority of the lowest risk profiles outperforming.

The Morningstar Multi–Asset Funds performed well in Q1 2023, delivering a positive absolute return (2.1%, 1.8% and 1.7% for the MAF40, MAF60 and MAF80 respectively). One-year numbers continue to compare favorably against the peer group at 38th, 25th and 8th percentile for the MAF40, MAF60 and MAF80 respectively (the IA Mixed 20-60% Shares peer group for MAF40 and the IA Mixed 40-85% Shares peer group for MAF60 and MAF60). Since inception (30/11/2020) the funds have returned -0.26%, 7.37% and 14.37% (MA40, MA60 and MA80).

Outlook

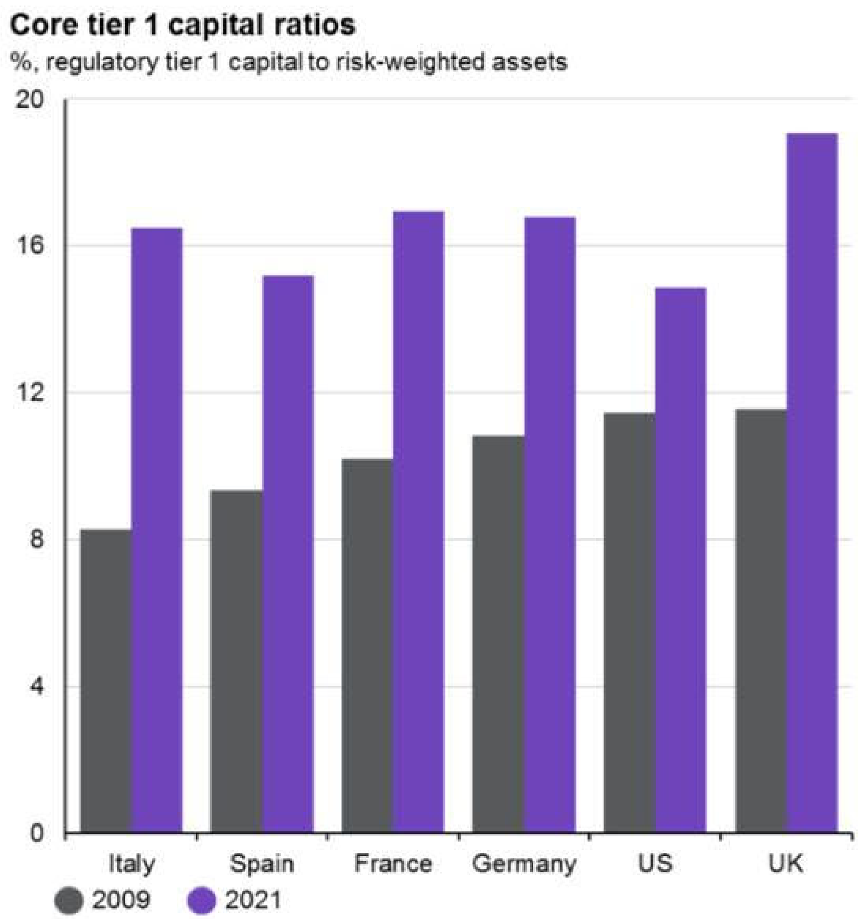
Investors have endured a challenging and highly volatile market environment over the past few years. With a global pandemic like we've never seen before, inflation rates we've not experienced in over 40 years, interest rates at their highest point since before the financial crisis, banking troubles and heightened geo-political risks, including the invasion of Ukraine and western tensions with China, it's no wonder markets are floundering.

With the market backdrop looking very uncertain, it's more important than ever that we remain disciplined to our investment approach, seeking assets trading below their fair value, balancing both opportunities and risks.

Chart of the month

Despite the turmoil in the banking sector, balance sheets are in a much better state than pre GFC.

Since the global financial crisis, core tier 1 capital ratios have increased across developed market economies. As a result, banks in these economies have a much larger capital buffer, bolstering their ability to withstand financial distress.



Source: Left: IMF, Refinitiv Datastream, J.P. Morgan Asset Management. Core tier 1 ratios are a measure of banks' financial strength, comparing core tier 1 capital (equity capital and disclosed reserves) against total risk-weighted assets.