Brewin Dolphin

Q1 2023: Quarterly Review

5 April 2023

At the end of the first quarter of the year, Guy Foster, our Chief Strategist, looks back at the events that have shaped the markets over the past three months.

The first quarter of 2023 began with gains for equity markets. Technology shares performed particularly well, partly because sentiment towards the sector had become extremely depressed after a year of poor returns.

Technology shares have a long, anticipated trajectory of profits, which makes them appealing to investors. However, this appeal can sometimes be more than reflected in high share prices. Even profitable sectors can reach valuations that make it hard for shares to keep rising, or leave them vulnerable to falls. Technology's long runway of prospective profits means that the sector is particularly sensitive to changes in expected long-term interest rates. If expected interest rates rise, this could have a negative impact on the perceived value of that stream of profits.

Lower interest rate expectations have been good for bonds. Like technology stocks, bonds suffered severely from the unexpectedly steep trajectory of interest rate increases during 2022. Even during the final weeks of the quarter, bonds were being buffeted by changing expectations for the economy.

Retail therapy

As the new year began, forecasts were very downbeat for growth around the world, and particularly in the UK. However, it has become clear that economies are more resilient than most people thought. We can only speculate as to the source of this resilience, although the savings that consumers built up during lockdown have clearly been a factor. This enabled many to maintain their standards of living despite steep increases in costs.

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Wages also increased although, on average, by less than prices. However, the confidence that consumers found in labour markets, many of which now offer multiple open positions for those currently unemployed, kept them spending. Another tailwind came from the oil price, which reached its peak in June and has been declining ever since. Falling oil prices mean falling expenses for households and businesses. The most immediate impact is lower fuel costs for transport. As an input into most goods production, falling energy bills reduce the upward pressure on other goods too.

Passing the peak

The decline in energy prices certainly helped to engender a sense of inflation having passed its peak. The oil price fell around 10% over the quarter, while European wholesale gas prices halved. Prices have not been definitively tamed though. In the US, core inflation, which strips out the effect of falling energy prices, accelerated during the first few months of the year. In other regions, it is harder to tell how price trends are evolving, as the data tend to be quite volatile from month to month.

Falling oil prices have less impact on consumers or inflation in Europe, where its impact is dulled by generally

higher levels of fuel duty. In most regions, though, the driver of inflation that worries policymakers the most is wage inflation. Policymakers fear that a high ratio of job vacancies to unemployed will empower candidates to demand higher wages, which companies will then recoup through higher prices, emboldening workers to demand yet higher wages, causing both wages and prices to chase each other higher.

The evidential improvement in the economy, therefore, saw interest rate expectations begin to really pick up during February, with growing concerns that the labour market remained tight despite the extremely steep increases in interest rates suffered during 2022.

Banking on rate rises

The outlook for interest rates changed quite dramatically in March as the impact of higher rates made itself felt in unexpected quarters.

One consequence of rising interest rates is that assets such as bonds, which pay a fixed amount of annual income, fall in price (bond yields and prices are inversely related). If interest rates are 5%, newly issued bonds will need to yield 5% to attract buyers. That means bonds that were issued when interest rates were 1% must fall in price until they, too, yield the market rate.

Most banks lend out the money they have received as deposits to achieve an 'interest margin' – the difference between the interest they pay to depositors and the interest they receive from borrowers. This had been one of the most popular sectors to invest in during 2023 as banks began to earn higher interest rates from the loans they made, but were slow to offer much interest to their own depositors.

Trouble in the valley

In 2021, Silicon Valley Bank (SVB) saw an unprecedented increase in its deposits at a time when interest rates were very low. The bank invested these deposits in high-quality bonds but it had to buy quite long-dated bonds, paying slightly higher yields, in order to earn a reasonable margin. As interest rates rose, the value of those bonds fell.

These price falls would have been gradually recouped over the life of the bonds. But unfortunately for SVB, whose customers include many high-spending technology start-ups, the deposits used to buy the bonds were being withdrawn. This forced SVB to sell the bonds, thereby crystallising a loss. To ease the situation, the Federal Reserve offered loans against the face value of the bonds. That meant depositors could withdraw

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their money from the bank without imperilling those who stayed put. Such a response helps to reduce the risk of a run on the bank, where depositors feel it is rational to be among the first to leave because they expect the bank to ultimately run out of money.

With the Federal Reserve's new loan programme, any other banks who found themselves in a similar position would be able to extricate themselves, at a cost. For SVB, however, it was too late and the bank entered receivership (eventually being sold out of receivership to a peer). Depositors were protected throughout.

Over the following week, investors were nervous about banks and settled on Credit Suisse as another potentially weak specimen. SVB, as one of hundreds of small US regional banks, was unusual in being able to take excessive interest rate risk. Large banks have been subject to regulation which controls their risk exposure. However, regulation cannot prevent banks from making losses altogether and, after few difficult years, Credit Suisse embarked on a multi-year expensive restructuring which would involve suffering more losses before a phoenix-like recovery. Long-suffering Credit Suisse investors capitulated, taking their lead from the Saudi National Bank, which had been an anchor investor in the Swiss lender. With the share price falling and banking anxiety rising, Credit Suisse's depositors continued to shift assets away from the bank, while other institutions seemed reluctant to deal with it. Over the following weekend, Swiss regulators arranged a sale of the bank to Swiss rival UBS.

Heroes to zeroes

After beginning the quarter in an apparently profitable position, banks ended the quarter among the worst performers. In part, that reflected a reappraisal of the risks of the sector, but an additional factor was that the banking turmoil is assumed to have limited the extent to which interest rates can now rise.

The interaction between interest rates and banks and vice versa remains a point of conjecture. Undoubtedly, the speed with which interest rates rose contributed to SVB's demise. But will banks be less willing to lend after the crisis? There was already evidence of tighter lending standards, which reflected concerns over a recession.

These standards may have increased, but it has been the outflow of deposits, rather than defaults on loans, that has been the cause of the problems. Meanwhile, the fall in interest rate expectations has meant the cost of providing mortgages has declined. This comes at a time when signs of life are returning to residential property markets. Wage increases, mortgage rate declines and the desire among employers to see staff back in the office are all resulting in rising demand for housing.

The events of the last few weeks will remind many of the financial crisis 15 years ago. Measures have been taken to ensure that while badly run banks can still cost their shareholders dearly, they are now safer institutions for depositors and for the businesses who rely on a resilient banking system. In the US, which has an extensive system of smaller regional banks, failures are not uncommon but generally pass off without harm to depositors and, in doing so, serve as a reminder that carelessness in banking has dire consequences.

> Worry is the interest paid by those who borrow trouble.
> George Washington

Guy Foster, Chief Strategist

Guy leads RBC Brewin Dolphin's Investment Solutions team working to align our investment capabilities with the needs of clients. He also provides recommendations on tactical investment strategy to our investment managers and strategic recommendations to the group's Asset Allocation Committee. Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. He frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of RBC Brewin Dolphin.

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