2023 Q1 INVESTMENT REVIEW

Summary

- European stock markets rebound strongly on lower energy costs.
- Banking sector capital strength questioned following US bank failures.
- Bank interest rate rises hitting a ceiling and unlikely to fall quickly.

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- The information is provided in good faith and is believed to be accurate, but as some data is provided by third parties this can not be guaranteed.
- Past returns should not be seen as predictors of future returns.

A broadly positive start to markets this quarter, despite it being a game of two halves.

Optimism that inflation has peaked gave way to banking sector concerns after the failure of a few US banks. This raised the question of whether we might be heading back to a 2008 crisis, although this is seen as unlikely.

European stocks rebounded strongly as overseas market demand grew and energy costs fell significantly.

European stock market prices are also seen as relatively good value, especially against the US.

Global inflation is falling rapidly but the UK is more stubborn, in part due to additional trade barriers following Brexit and a smaller workforce. These resistant forces are not going away anytime soon, but price rises will continue to slow.

The International Monetary Fund (IMF) forecasts global growth slowing sharply this year and potentially more so if banking conditions tighten further because of an unwillingness to lend to consumers and businesses.

Liquidity conditions in markets may well become more of a focus point, especially in less tradable assets such as commercial property or private equity in the months ahead.

Market Data
(GBP)

Asset Class	Index	Q1 2023
European Shares	Euro STOXX 50	13.1%
Gold	S&P GSCI Gold Spot	5.2%
World Shares	FTSE World ex UK	4.9%
North America Shares	S&P 500	4.4%
Japanese Shares	TSE Topix	3.2%
UK Shares	FTSE All Share	3.1%
Corporate Bonds	Bloomberg Sterling Aggregate Corporate	2.5%
UK Gilts	Bloomberg Sterling Gilts	2.2%
Asia Pacific Shares	MSCI AC Asia Pacific ex Japan	1.3%
Emerging Market Shares	MSCI Emerging Markets	1.1%
UK Commercial Property	FE UK Property Proxy	-0.8%
Hedge Funds	HFRX Global Hedge Fund	-2.7%
Commodities	S&P GSCI Commodities	-7.5%

Performance Data: FE Analytics in GBP to 31/3/2023

Q1 Review

Investors experienced a broadly positive start to 2023, albeit growing optimism from falling inflation data was offset by concerns over the health of the banking sector.

European stock markets in particular rebounded strongly, with the EURO STOXX 50 rising +13.1% far outpacing other markets. French luxury conglomerate LVMH (Moet Hennessy Louis Vuitton) a listing within the index became the first European company valued above $500bn making owner Bernard Arnault the world's wealthiest person.

The luxury sector has shown significant growth over the past decade and little concern for the cost of living crisis. The delayed re-opening of the Chinese economy post-pandemic has also released pent-up consumer demand that has buoyed the sector.

More broadly, Europe has managed to avoid a prolonged energy crisis that for a time appeared as an existential threat for many companies. Previous stockpiling of Liquified Natural Gas (LNG), warmer weather and general industrial demand restraint has reduced the cost of European gas by over 80% since the peak price last summer.

This has had a significant impact on earnings expectations and therefore the value attached to companies by investors, leading to an overall strong market.

Inflation globally has now peaked as expected with US 12 month rolling CPI for example falling to +5% in March from +6.5% in December. In the UK however, the situation is nuanced with annual inflation barely falling to +10.1% in March from +10.5% in December, though the reduction is expected to accelerate quickly and catch down.

Although energy and transportation costs have fallen, this has been offset by leisure (restaurants) and food (in particular bread and cereals) where prices increased +19.2% over 12 months in March, the highest for 45 years according to the ONS. Rising labour costs, poor harvests and additional trade barriers following Brexit are seemingly to blame.

UK inflation remains the highest of the main G7 nations due to its specific challenges as shown in the ONS chart below. This has implications for the base interest rate set by the Bank of England, which is due to rise again from 4.25% to 4.5% on 11th May.

Source: Consumer price inflation from the Office for National Statistics, and Harmonised Index of Consumer Prices (HICP) from Eurostat

Banking sector confidence started to erode this quarter as smaller regional banks in the US namely Silicon Valley, Signature and most recently First Republic experienced a loss of depositor trust that eventually became fatal. The result was that each needed to be propped up by other stronger banks to avoid any contagion in the financial system.

Banks run on a fractional reserve basis i.e. not every saver could have their deposit returned at the same time because funds are lent out to borrowers and are committed. The amount that is held available for repayment is typically invested in liquid and risk-free investments such as government debt. Due to rising rates, the value of this government debt fell, meaning the capital position of the banks weakened. With this loss of confidence, savers started to withdraw their money making the situation unrecoverable.

Government bonds were always thought of as risk-free until suddenly they were not. Thinking back to the calamitous 'mini-budget' last year there was a period when government debt was unsellable simply because the volume overwhelmed the market and pricing became uncertain. This risk was not foreseen.

Perhaps the most notable event though was the takeover of Credit Suisse, which was forcibly acquired by UBS at the insistence of the Swiss government over a weekend. The 166-year-old bank had been involved in a number of scandals over recent years and suffered large financial losses within its markets division, such that depositor confidence evaporated, leading to the rescue.

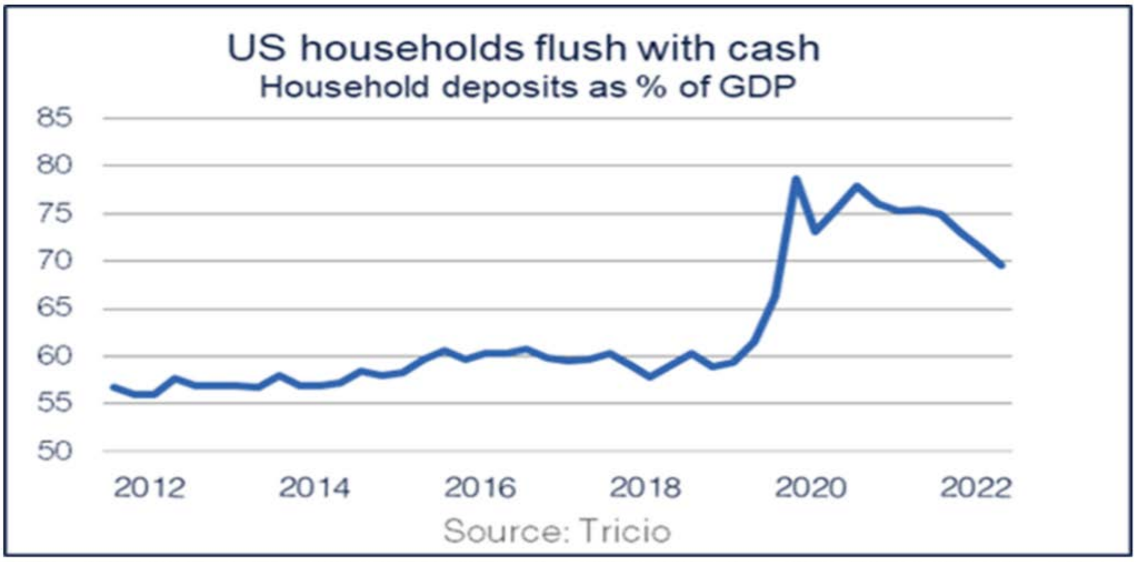
Shockingly to markets, the Swiss government changed legislation to allow the takeover, including wiping out the value of some bondholders whilst paying cash to shareholders (albeit crystallising an -87% 12-month loss) contrary to the accepted rules of the investment game, where shareholders are the ones who take the first bath.

These events show yet again that investors should plan not only for what they know might happen but also have a buffer for what they don't know is coming around the corner.

The International Monetary Fund (IMF) World Economic Outlook report in April forecasted advanced economy growth slowing from 2.7% in 2022 to 1.3% this year, or perhaps even lower if financial sector stress increases. It also stated that inflation would unlikely return to bank targets until 2025 in most cases.

In our January review, we highlighted the state of the important US economy as a barometer through a leading economic activity index, which was displaying clear signs of a forthcoming recession. That indicator has weakened further such that a recession is now highly likely based on previous periods.

As highlighted below by our economic consultants Tricio, the fact a recession has not yet occurred is due to the strength of US consumer spending, given strong household finances from pandemic-related savings. However, this picture is weakening and will surely not hold back the tide especially if banking credit conditions tighten further.



This provides some guidance for stock markets, though entirely not guaranteed, as it is rare markets do not suffer a further fall in value during a recession, despite falling in the lead-up also. This can be rationalised by the negative sentiment that develops and the question of 'could this get any worse', which always creeps into investors' minds no matter individual risk tolerances. Human emotion does not change, but behaviour does not have to follow and good financial advice can help.

What investors have got used to over the years (decades in fact) is that bad news can be good news, meaning when economic difficulty comes about, central banks lend a hand and ease interest rates and employ other mechanisms (quantitative easing) to support markets. The difference this time, if the IMF is to be believed, is that inflation will remain above target for a couple of years and tie the central banks hands behind their backs.

I read recently a quote from former US Federal Reserve governor Paul Volcker regarding inflation:

"Everybody likes to get rid of inflation... (but) inflation isn't that bad compared to the alternatives".

This is to say if interest rate rises bring about the desired recession to reduce inflation, the risk is that inflation becomes a secondary problem to the recession itself. This is when central banks may take the view that some inflation is tolerable and the pressure to help may be too much. Markets are predicting that interest rates will come down slightly and at least not go any higher from here. On the latter point we think that is a safe bet, but don't expect rate cuts anytime soon.

The fact many commenters are saying the recent US banking situation is not a repeat of the financial crisis of 2008 may well be accurate, but risks missing another point. Credit conditions have tightened and debt has become more expensive, which increases the need to have more cash available, be it funds tied up in normally liquid government debt or less readily realisable assets such as property or alternatives.

We think this may well translate into increased volatility over the next 12 months in asset prices as selling pressure takes effect. This is already being seen in commercial property for example, where property value write-downs are starting to be seen. The sector has not yet adopted methods preventing private investors from selling their holdings daily, despite the underlying asset class potentially taking months to turn into cash, hence why the 'gating' of funds could be seen again.

None of this should be of concern to those who have secured secure surplus income or have planned in advance their cash requirements because in such a market environment there would be simply no need to react. We continually assess our client's income and capital needs as part of our planning.

We have also been looking at our asset allocation in the face of the new investment landscape but, for now, we have made no changes to our longer-term allocation. We are mindful that if markets do come under pressure this year we are best placed to focus on quality even at the expense of returns. It seems a more defensive mindset may be appropriate in the shorter term, which includes re-balancing portfolios and phasing any new investment money.

If you have any questions regarding our investment strategy please contact your adviser who will be happy to discuss further.

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