MERRION INVESTMENT MANAGERS | CANTOR Fitzgerald

Strategy & Outlook

MARKET UPDATE

MAY 2023

Q1

Global equities were virtually unchanged on the month in euro terms in April (-0.1%), a bounce in the euro (+1.7% against the US dollar) disguising slightly better returns (US equities +1.2%, European equities +1.6%, Japanese equities +2.7%). This apparent lack of volatility disguised some negative undertones within the market, defensive sectors such as consumer staples and healthcare rallying by circa 2% and more cyclical sectors such as consumer discretionary and materials falling by 2% or more. Throughout the month however, ominous signs in the US banking industry continued to surface, deposit outflows and hidden losses on hold to maturity assets raising significant concerns about profitability for banks in general and viability for regional banks in particular. The month ended in spectacular fashion, the failure of First Republic Bank over-taking Silicon Valley Bank as the second largest ever US bank failure. Despite 3 US bank failures in the space of 6 weeks, Federal Reserve officials continue to insist that the US banking system is “sound and resilient”.

From a macro perspective, the turmoil in the US banking sector is highly concerning. Credit conditions were already poor before any of these problems surfaced, as the rapid rise in interest rates served to curtail demand for credit whilst simultaneously severely tightening credit availability. It is highly likely that credit conditions have tightened significantly since, acting as a further (potentially significant) headwind to growth. Despite this, central banks seem determined to continue raising interest rates to supress inflation, despite clear evidence that peak inflation is behind us and that the aggressive interest rate rises in western economies are only starting to bite a re-leveraging consumer just as excess savings from the pandemic are rapidly disappearing.

Another potentially catastrophic event in the form of the US debt ceiling looms ever closer. Treasury Secretary Janet Yellen announced that the US government may be “unable to continue to satisfy all of the government’s obligations by early June, and potentially as early as June 1”, absent some move on the debt limit by Congress. The earlier date (late July / early August had been seen as most likely) is due to weaker than expected federal tax receipts in April, which in turn raises questions about how strong the economy truly is.

Outlook

All of the above raises significant concern in our view and creates the conditions for a volatile summer period. It seems clear that interest rates in the US are too restrictive or have certainly moved into restrictive territory far too quickly without due consideration of the lags inherent in monetary policy and the impact such moves could have on the banking system and its ability to provide credit to a modern economy. The ECB has not raised rates by as much as Federal Reserve but has kept pace with them since they did begin raising rates last summer, as has the Bank of England.

The US debt ceiling debate, with such a fractious political situation, raises concerns even further, particularly as time is apparently so short. It took 15 attempts for Republicans to elect a speaker of the House. The risk of an accident has risen dramatically. Of course, it is still possible to avoid a scenario where the US defaults on its obligations, and that remains the base case for the market consensus. But the risk is not zero.

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Positioning and Outlook

As noted previously, we began the year with a very positive outlook for asset markets. Recession was fully expected but not guaranteed. We expected inflation to continue to recede. The end was in sight for the current rate hike cycle. China was reopening fast. The consumer faced significant headwinds, but policy-driven investment spending would drive economic activity.

However, the risks we outlined at the beginning of the year have increased, in some cases dramatically. Central bank policy error may have already happened. Risks around US property and the US consumer have increased. A new source of concern has appeared in the shape of the US banking sector, which in turn has dramatically increased the risk of recession a risk which we thought was overstated at the beginning of the year. Meanwhile, the risk of structural inflation has dissipated, but central banks seem unaware of this, continuing to tighten policy and sounding hawkish in the face of banking sector turmoil.

We reduced growth asset exposure in the funds towards a more neutral stance over the course of March, and reduced exposure further over the course of April towards the lower end of the asset allocation range. This raised cash in the defensive side of the funds, which we have invested in European Treasury bills, where yields north of 3% are now a very attractive alternative for what could be a very volatile summer. Given the potential volatility in markets ahead and the low price of index option protection, we have a higher-than-normal level of protection in place.

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