Strategy & Outlook

MARKET UPDATE

APRIL 2023

Q1

Global equities had a strong start to the year, rising by more than 8% in euro terms in the first six weeks. A rapid China reopening, no energy crisis in Europe, falling inflation in the US and expectations of a slowdown / end to the Federal Reserve's hiking cycle meant recession fears (which had been very much to the fore in Q4 22) gave way to "soft landing" hopes. Strong data in January however saw these hopes fade, to be replaced with more overheating worries, a single month's data becoming a focus for Fed officials not helped by huge revisions to previously released data. Central Banks however are clearly latching on to anything they can to enable a hawkish steer, buoyed by the continued strong activity data which showed that nothing had broken yet from their actions, and rate expectations spiked dramatically during February.

There are consequences though from such an aggressive monetary policy campaign, and eventually a tipping point was reached, the drain of deposits from the US banking system leading to the collapse of Silicon Valley Bank, the second biggest ever bank failure in the US, quickly followed by Signature Bank in New York. This placed severe pressure on other regional banks, raising the threat of a major liquidity crisis, forcing the Federal Reserve to come up with yet another type of emergency lending program. The fallout forced Credit Suisse into the arms of UBS, with large guarantees for UBS from the Swiss state.

The fluid narrative therefore continues – in the space of one quarter, we have moved from recession to soft landing to overheating to banking crisis. None of this stopped central banks from raising short term interest rates over the quarter – the Fed by 50 basis points, the BoE by 75 and the ECB by 100. Global Equities finished the quarter up 5.7% in euro terms.

Outlook

There are a number of implications for the banking sector and the macroeconomic environment from the collapse of Silicon Valley Bank. Scrutiny is being placed on regional banks, their liquidity positions, and the value of their equity. The actions from authorities should in theory provide comfort to depositors, but in the modern age, there is no need to queue to remove deposits, and why take the risk? The authorities have not guaranteed all deposits – just the deposits of failed banks. The liquidity backstops should be sufficient that deposit removal can be covered by banks without realising losses on their assets, but this will not be cost-free, and the profitability of these banks will be questioned.

The fallout also raises questions about the path of monetary policy from here. The aggressive interest rate campaign by the Fed (with the ECB trying hard to follow) has finally broken something. Will the Fed continue with rate hikes and risk further contagion in the banking system? Will the ECB proceed with its planned path for rate hikes? Markets have moved rapidly to price out a substantial part of the rate hikes that had been priced between now and summer, with rate cuts in the US before year-end being priced in again. A tightening of credit provision from the banking sector seems inevitable, which is both a headwind for growth and a disinflationary impulse, reducing the need for policy tightening from central banks.

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Positioning and Outlook

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 risk of policy error (if it hasn't already happened) from Central Banks has risen over the last three months. The Fed, ECB and Bank of England forged ahead with further rate rises even as the banking crisis was unfolding, when the reasonable course of action (particularly for the Federal Reserve) would have been to do nothing and wait and see how the banking crisis played out over the following few weeks (a course of action which would have zero impact on medium term inflation).

The funds were at the top end of their asset allocation range for much of the first quarter and had a very strong quarter in absolute and relative terms. Active positions in FX (dollar hedging), bonds (overweight peripheral Europe and long-dated US treasuries) and equities (long-standing overweight positions in US semi-conductors and European industrials, as well as the tactical decision to materially increase FANG and EM exposure earlier in Q4 22 on a record collapse in their share prices) all contributed strongly to performance. Over the course of the quarter, we materially reduced our holdings in Emerging market assets, in particular Chinese listed equities which had rallied materially, investing the proceeds in more attractive opportunities elsewhere. On the defensive side of the portfolios, we used the sell-off in longer dated bonds in February to add duration, a position we reversed after bonds rallied in March. We also invested some cash in short dated European treasury bills, where yields are now becoming attractive as ECB rate expectations rise.

Over the course of March, as the risk of central bank policy error increased and the banking crisis unfolded, we reduced exposure to banks (where we had a small overweight in European banks) and industrials. We invested most of the proceeds of these sales in high quality defensive stocks which had underperformed / derated significantly year to date. Given the volatility in markets, we have also been very active with index put options within the alternative fund (a key component of the multi asset funds), and we have also had a higher than normal level of protection in place over the last month. This has served the funds well, reducing volatility significantly.

WARNING: Past performance is not a reliable guide to future performance.

WARNING: The value of your investment may go down as well as up.

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