INVESTMENT UPDATE

APRIL 2023

FOR PROFESSIONAL INVESTORS ONLY

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At the beginning of the month Federal Reserve board chairman Jerome Powell was sufficiently unhappy with progress the Fed was making in bringing down inflation to consider raising the banks benchmark interest rate even faster and even higher and keeping it there for longer than had originally been anticipated. A few weeks later a small bank in Silicon Valley, badly managed, inadequately supervised and audited, could not meet its depositors' demands for cash prompting the government to shut it down.

To quote Warren Buffet, "one thing we learn from history, is that people don't learn from history." Amongst fears of a global financial crisis reawakened from 2008 we saw Credit Suisse swiftly dispatched and rehoused. By the end of March, the market is pricing in a series of rate cuts before the year end. As ever, we will seek to unpack this swirl of data in the update that follows.

Sharp rises in interest rates are taking their toll on the banking sector. So-called smaller banks in America determined by assets sub $250 billion are not subject to the same regulatory regime as systematically important larger banks nor are they subject to the same regime as banks within the Eurozone. Accounting regulation for sub $250bn banks simply allowed for assets whose values were lower due to market conditions to remain on the balance sheet at full value – fine until their disposal is demanded to meet deposit redemptions.

The ability for account holders to effectively drain a bank of its deposits in double quick time and simply by the click of a mouse should not be underestimated, effectively requiring banks to sell their reserve asset base to meet frenzied demand for the return of customer deposits. These reserve assets (Treasuries and Mortgage-Backed Securities) had seen their realisable values fall courtesy of higher interest rate policies. Events surrounding the demise of Silicon Valley Bank and Signature Bank in the United States unfolded quickly and this coupled with bad management and a complete absence of internal risk controls gave rise to some alarming headline news.

The Federal Reserve chose to intervene and has provided sufficient liquidity to avoid a knock-on repeat of the saga – so they say. Please note, this is not quantitative easing. Meanwhile elsewhere in the world, the long troubled and unprofitable Credit Suisse succumbed to pressure and is now under UBS ownership, having been sold under direction of the Swiss National Bank at a knockdown price. The scenarios described create a moral hazard for central banks as pictorially shown below – where central banks are effectively forced to bail out incompetence.

We do not see the 2023 banking crisis as systematically invasive at the point of writing, and therefore not the same as 2008-9.

Source: *www.economicshelp.org*

The negative credit impulse created by the banking collateral crisis is disinflationary and will deliver a knock-on dampener to economic growth. In the US, the Federal Reserve has raised interest rates by 4.75% in just under a year – an unprecedented pace. Headline inflation has dropped from a recent peak of 9.1% to 6.0%, according to the US Labour Department and should continue to decline as year-on-year comparisons for food and energy prices become less demanding. What is left thereafter is profit margin inflation where firms have used the monetary phenomenon to expand their own margins.

As last month, the labour market remains tight but there are signs of lay-offs increasing and this figure expanding further will probably mark the pyrrhic victory over the inflation dragon, at least in the United States. A suite of credible leading indicators remain adamant a technical recession is on the cards and our house view aligns here.

Perhaps surprisingly, equity markets have not been dislodged from their 8-month range-bound trading pattern by the unfolding banking sector collateral crisis, nor an additional 0.25% hike in interest rates. Earnings are trending lower, albeit still at pre-Covid levels and are in our opinion likely to impact equity values as they trough later this year, probably post the first rate cut by the Federal Reserve. Assuming we are correct, this will mark the point at which we will adjust portfolios to a risk-on status. The chart below shows market implied forward expectation for US interest rate policy.

US Treasury yields have begun to trend lower, standing now at a shade above 3.5% for the 10-year stock, down from over 4% but structurally higher than 2.46% 12-months ago. We will participate in the higher duration quality fixed income opportunity, avoiding high yield riskiness, when we are more confident of trajectory, perhaps not too far distant.

MEETING PROBABILITIES														
MEETING DATE	**200-225**	**225-250**	**250-275**	**275-300**	**300-325**	**325-350**	**350-375**	**375-400**	**400-425**	**425-450**	**450-475**	**475-500**	**500-525**	**525-550**
5/3/2023							0.0%	0.0%	0.0%	0.0%	0.0%	51.5%	48.5%	0.0%
6/14/2023		0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	48.3%	48.7%	3.0%
7/26/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	21.6%	48.5%	28.3%	1.6%
9/20/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	12.5%	37.2%	36.8%	12.8%	0.7%
11/1/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	7.0%	26.4%	37.0%	23.3%	6.0%	0.3%
12/13/2023	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	4.3%	19.0%	32.9%	28.5%	12.6%	2.5%	0.1%
1/31/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	2.8%	13.9%	28.0%	30.1%	18.2%	6.0%	0.9%	0.0%
3/20/2024	0.0%	0.0%	0.0%	0.0%	0.0%	2.0%	10.8%	24.1%	29.5%	21.5%	9.4%	2.4%	0.3%	0.0%
5/1/2024	0.0%	0.0%	0.0%	0.0%	2.1%	10.8%	24.1%	29.5%	21.5%	9.4%	2.4%	0.3%	0.0%	0.0%
6/19/2024	0.0%	0.0%	0.0%	0.9%	5.9%	16.7%	26.5%	25.9%	16.1%	6.3%	1.4%	0.2%	0.0%	0.0%
7/31/2024	0.0%	0.0%	0.7%	4.5%	13.6%	23.7%	26.1%	18.9%	9.1%	2.8%	0.5%	0.1%	0.0%	0.0%
9/25/2024	0.2%	2.0%	7.7%	17.1%	24.5%	23.6%	15.5%	6.9%	2.0%	0.4%	0.0%	0.0%	0.0%	0.0%

Source: *Fedwatch, As at 29 March 2023*

UK interest rates rose as expected in line with those in America but are way lower than prevailing headline and even core inflation. As we can all attest, food prices continue galloping higher despite weakening wholesale prices – profit margin inflation is undoubtedly in play here. The banking skew apparent in UK equity markets saw the rally sharply curtailed during March. Weaker energy prices in the form of natural gas and oil have helped all markets and Europe remains a particular beneficiary.

The knock-on impact to year-on-year inflation data will pull headline figures lower. Eurozone countries continue to see overall weakening GDP growth, although the notable outlier being Ireland who artificially benefits (and raises GDP for the Eurozone bloc overall) from those branded global mega firms who choose to locate a head office there for tax reasons. The European Central Bank raised rates 0.5% despite banking pressures and speculation circled Deutsche Bank, but it remains unmoved at the point of writing.

The positive glow of the Chinese economic reopening continues to benefit Asian markets and those larger trading partners. There is no recession or slowdown in Asia. Anyone who has recently visited will no doubt vouch for the vibrancy and optimism evident across the region.

Mr Kazuo Ueda, Governor-elect at the Bank of Japan will no doubt make incremental progress to reduce yield curve control from the date of his arrival in office – until then a dignified calm, as one might expect.

The peace dividend enjoyed during the 1990s and 2000s and resulting economic expansion was hard won. The intersection of deglobalisation, a pandemic and the resurgence of inflation has reintroduced geopolitical tensions. Investors rightly expect their investment managers to take these matters squarely into account and the breadth of age and experience here at Alpha Beta Partners is a key differentiator in this regard. Geopolitics is one of our 4 key areas of focus. A modern-day cold war is building, and battles are unlikely to be kinetic but will be technology led. The weaponisation of food and energy, for example, can create more economic damage than a traditional battle or border skirmish. Impacts to portfolio valuations are inexorably linked – we remain focused in this regard, of course.

Portfolios have benefited from the rotation to China, and those economies at lower valuations buoyed by renewed economic growth. As set out above, we are poised ready to secure opportunities in quality fixed income securities and to re-engage more meaningfully with equities when the growth story resumes. Meanwhile, now is not the time for heroics and we are paid to wait with attractive yields available from money market funds and other institutionally sourced cash vehicles. Our Risk First approach is proving highly appropriate as the impacts of sharply higher interest rates shakes economies with some collateral damage, yet we simultaneously seek to benefit from unaffected regions at more attractive valuations.

Written by the Alpha Beta Partners Investment Team

All sources Bloomberg unless otherwise listed.

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The Five Diamond rating awarded on Alpha Beta's Core portfolio range.