CURMI & PARTNERS

April 27th, 2023

Monthly Strategy Update

The month in summary:

In last month's report we focused on how the narrative had shifted away from growth concerns at the start of the year back to inflation concerns. Chair Powell's testimony on 8th March fuelled concerns around inflation. The US curve inverted further, as the 10-year US Treasury rose to 4.0% (up from a low for the year of 3.4% on 12/01), whilst the 2-year US Treasury rose to 5.1% (a 100bp rise from 12/01). The hawkish tone adopted by Chair Powell during his testimony led to a re-pricing higher of the peak FED fund rate. Credit and equity investors were insensitive to the rise in yields. On balance, the developments early in March were in-line with our expectations.

Yet, we did not anticipate the collapse of Silicon Valley Bank ("SVIB") in the US and Credit Suisse ("CS") in Europe that unsettled investor confidence in the global banking system. So far, we believe that these banking issues are idiosyncratic in nature, as we will describe in more detail below. Yet the impact on financial markets was significant. The direct impact on the economy is expected to be minimal, mainly through a tightening in lending standards. We expect banks to focus on asset quality and on managing their loans to deposits ratio, to avoid suffering the same fate as SVB. This tightening in lending conditions could replace additional monetary policy tightening by the FED, and inadvertently help in the fight against inflation as it weighs on aggregate demand.

A sector which may be exposed to tightening of lending standards is commercial real estate ("CRE") as US banks are an important source of liquidity for the sector. CRE loans account for roughly 16.5% of US bank loans. For smaller banks, CRE loans account for around 33% of total loans. Real estate was already under pressure from higher funding costs, and lower liquidity could add to the pressure, in our opinion.

On balance, the message from the markets is conflicting. Rates are pricing-in a recession and rate cuts in 2023. The US 10-year yield fell 52bp from 08/03 to 3.5% by the end of March. The yield curve has steepened during the period as the big move seen in the US 2-year yield following Powell's testimony reversed. On the other hand, risky assets recovered strongly as global equities ended the month with a total return of 3.2% which suggests that equity investors remain relatively unconcerned.

Sovereign		
	MoM bp	YTD bp
US 10-year yield	41	5
DE 10-year yield	37	8
UK 10-year yield	49	15
Credit		
LCL Total returns	MoM %	YTD %
EUR IG	-1.3%	0.7%
EUR HY	0.1%	3.3%
USD IG	-2.7%	0.7%
USD HY	-1.1%	2.5%
GBP IG	-2.6%	1.4%
GBP HY	1.1%	4.4%
Equities		
LCL Total returns	MoM %	YTD %
Global	-2.4%	4.6%
S&P 500	-2.4%	3.7%
Nasdaq 100	-1.0%	9.6%
STOXX 600	1.9%	8.7%
DAX	1.6%	10.4%
CAC	2.6%	12.4%
FTSE 100	1.8%	6.2%
Emerging markets	-6.5%	0.9%
EM ASIA	-6.8%	0.8%
EM LATAM	-6.2%	3.1%
EM EMEA	-4.3%	-2.1%
Currencies		
Total return	MoM %	YTD %
EURUSD	-2.6%	-1.2%
EURCHF	0.1%	0.7%
GBPEUR	0.2%	0.7%
GBPUSD	-2.4%	-0.5%
Commodities		
Total return	MoM %	YTD %
Oil WTI	-2.7%	-4.3%
Oil Brent	-2.0%	-2.1%
Natural Gas	2.3%	-38.6%
Gold	-5.3%	0.2%
Copper	-2.8%	7.0%
Iron Ore	1.6%	3.7%
Lumber	-23.1%	7.8%

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Macro-economic views

In last month's report we highlighted the positive macro-economic developments and the impact these are having on macro-economic expectations. We mentioned the faster re-opening of the Chinese economy and the warmer than expected weather in Europe and discussed how these should set-off some of the negative impact on aggregate demand from higher funding costs. On balance, the global economy was in a better place at the end of February compared to the start of the year. Yet, the situation has changed during March following the collapse of SVIB, Signature Bank ("SB") and Credit Suisse.

We believe that it is too early to gauge the impact of the uptick in banking sector stress over the past month. The expectation is for lending standards to tighten over the coming months, which could weigh on economic growth. Yet we stress that forecasting this is very complex, which makes current forecasts slightly less reliable. More data is required to assess the impact of the SVIB, SB and CS collapse.

On the other hand, the data coming out of China remains supportive with 5.3% consensus growth expected in 2023. This represents a significant acceleration from the 3.0% recorded last year. Growth in 1Q23 of 4.5% YoY beat expectations (4.0%). Yet, similar to what is happening in Developed economies, the recovery has been largely driven by the Services sector. Though data published so far has been encouraging.

Finally, although we were concerned with the rising inflationary pressures at the end of February, the data coming out over March seem to support the view that we have seen the worst of inflation globally. There are still some divergences, with Europe still reporting rising core inflation, though we see less scope for aggressive tightening across developed economies given the recent economic data published by the countries we follow.

Exhibit 1 – Consensus real GDP growth and inflation expectations

Developed economies economic growth for 2023 has been revised higher over the past month but inflation expectations remain unchanged

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting								
Real GDP, YoY%	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F (new)*	*FY22F*	*FY23F*	*FY24F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*FY22F*	*FY23F*	*FY24F*
United States*	1.3	0.2	-0.5	0.3	1.0	1.6	1.8	2.1	1.0	1.0	1.2	0.8	-0.3	-0.4	-0.5	-0.2	0.0	0.5	-0.2
Japan*	1.4	1.3	1.1	1.0	1.1	1.2	1.2	1.0	1.1	1.2	0.5	0.3	0.2	-0.1	0.1	0.0	-0.3	-0.2	0.2
Germany	-0.1	0.0	-0.2	0.4	0.9	1.1	1.3	1.8	0.0	1.1	0.3	0.5	0.4	0.3	-0.1	-0.2	-0.1	0.4	-0.2
France	0.7	0.3	0.4	0.4	0.9	1.0	1.2	2.6	0.5	1.0	0.3	0.4	0.5	0.1	0.1	-0.2	0.1	0.2	-0.2
Italy	1.1	0.2	0.0	0.4	0.8	1.0	1.0	3.7	0.5	0.9	0.3	0.5	0.5	0.4	0.1	0.0	-0.1	0.4	-0.1
Spain	2.5	0.6	0.9	1.0	1.3	1.7	1.9	5.5	1.3	1.5	0.8	0.2	0.3	-0.1	-0.3	-0.2	0.0	0.3	-0.4
Eurozone	1.1	0.4	0.3	0.6	0.9	1.2	1.3	3.5	0.5	1.2	0.7	0.6	0.6	0.2	-0.1	-0.1	0.2	0.5	-0.1
UK	-0.2	-0.6	-0.5	-0.3	0.1	0.6	0.9	4.3	-0.4	0.8	0.5	0.6	0.7	0.6	0.2	-0.2	0.2	0.5	-0.1
Developed Economies	1.2	0.3	0.0	0.5	1.1	1.5	1.7	2.8	0.8	1.3	0.8	0.5	0.0	-0.2	-0.2	-0.1	0.1	0.3	-0.1
China	3.4	7.3	4.9	5.8	5.2	5.0	4.9	3.0	5.3	5.0	0.8	0.4	0.1	-0.1	-0.2	-0.1	0.0	0.2	0.0
Emerging Economies	2.7	5.4	4.0	4.7	4.5	4.5	4.5	3.7	4.2	4.4	0.5	0.3	0.0	-0.2	-0.1	0.0	0.6	0.1	0.0
Global								3.4	2.4	2.8							0.0	0.3	-0.1

	Consensus Forecast, % QoQ							Consensus Forecast, % YoY			Revisions since last meeting							
Consumer prices, YoY !	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*1Q24F*	*2Q24F*	*3Q24F (New)*	*FY22F*	*FY23F*	*FY24F*	*4Q22F*	*1Q23F*	*2Q23F*	*3Q23F*	*4Q23F*	*FY22F*	*FY23F*	*FY24F*
United States	5.9	4.3	3.8	3.4	3.0	2.7	2.5	8.0	4.3	2.6	0.0	0.3	0.5	0.7	0.5	0.0	0.5	0.1
Japan	3.4	2.7	2.1	1.7	1.5	1.2	1.3	2.5	2.3	1.2	0.0	0.5	0.3	0.4	0.5	0.0	0.3	0.1
Germany	8.8	6.7	5.6	3.6	3.0	2.6	2.4	8.6	6.2	2.6	0.0	-0.6	-0.8	-0.5	-0.3	0.0	-0.4	-0.3
France	7.0	5.7	5.1	3.9	2.6	2.1	2.0	5.9	5.4	2.6	0.0	0.3	0.2	0.3	0.3	0.0	0.3	0.3
Italy	9.6	8.4	6.5	2.3	2.4	2.4	2.3	8.7	6.5	2.4	0.0	-0.5	0.0	-0.4	-0.4	0.0	0.0	0.4
Spain	5.0	3.8	3.1	3.7	3.1	3.0	2.0	8.3	4.1	2.6	0.0	0.0	-0.3	-0.2	0.1	0.0	-0.1	0.1
Eurozone	8.0	6.2	4.7	3.1	2.8	2.5	2.3	8.4	5.6	2.4	0.0	-0.4	-0.4	-0.2	-0.3	0.0	-0.3	0.1
UK	9.8	7.2	5.4	3.6	3.1	2.1	2.2	9.1	6.5	2.4	0.0	-0.3	-0.8	-1.1	-0.6	0.0	-0.5	-0.1
Developed Economies	7.8	5.8	4.9	4.1	3.6	3.2	2.9	8.6	5.5	3.0	0.0	0.5	0.3	0.3	0.4	0.1	0.3	0.1
China	1.3	2.0	2.2	2.7	2.7	2.3	2.0	2.0	2.3	2.3	0.0	-1.0	-0.2	0.0	0.2	0.0	0.0	0.1
Emerging Economies	5.8	5.2	5.2	5.4	5.2	4.6	4.1	6.3	5.9	4.6	0.0	-0.5	-0.2	0.0	0.2	1.2	0.1	0.3
Global								8.7	5.6	3.6						-0.1	0.4	0.1

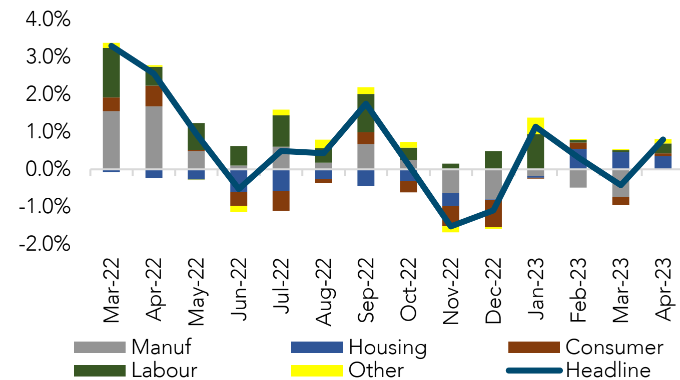
Source: Bloomberg (Note: QoQ figures for the US and Japan are QoQ SAAR, Shaded areas indicate Actuals)

United States

Growth: Goldman Sachs' Current Activity Indicator ("CAI") stood at -0.4% in March, down from +0.3% in February but has since bounced back to positive territory to +0.8% so far in April (Exhibit 2). The deterioration in March was primarily driven by Manufacturing and Consumer CAI, possibly impacted by the negative sentiment following the collapse of SVIB and SB. Both measures have improved in April which could imply that the impact was short-lived. Despite the apparent slowdown in activity during March, the Atlanta FED GDP estimate has remained fairly stable at +2.5%, down from +2.6% forecasted on 08/03 (Exhibit 3). The economic data released in the US remained supportive for most of the month, with 3.5% growth being forecasted by 23/03 but was 1% lower by 18/04 as new data released was taken into consideration.

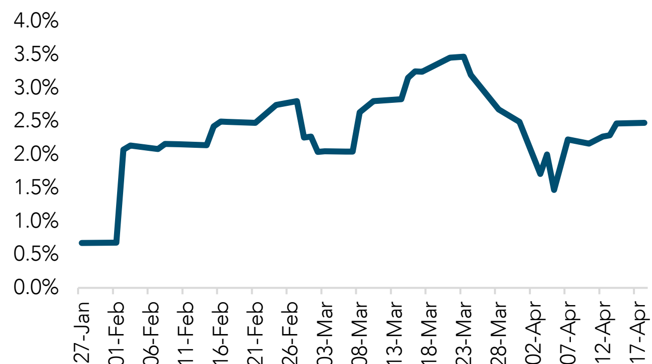
Inflation: February inflation pressures moderated slightly as the Core PCE price index accelerated by 4.6% (Exhibit 4). Inflation concerns had creeped back into investors' mind following the release of the January PCE which saw the first acceleration in price increases since September 2022. These concerns were made worse following Chair Powell's testimony which focused on the need for more rate hikes in 2023 to get inflation under control. Yet developments since then have been quite positive on the inflation front. The job-workers gap, a key indicator of wage pressure, moderated last month to 4.1 million, down from 4.6 million. Yet, the Atlanta FED wage tracker increased to 6.4%, the highest since November 2022.

Exhibit 2 – US Current Activity Indicator
Headline CAI continued to deteriorate during March but has bounced back to positive territory in April



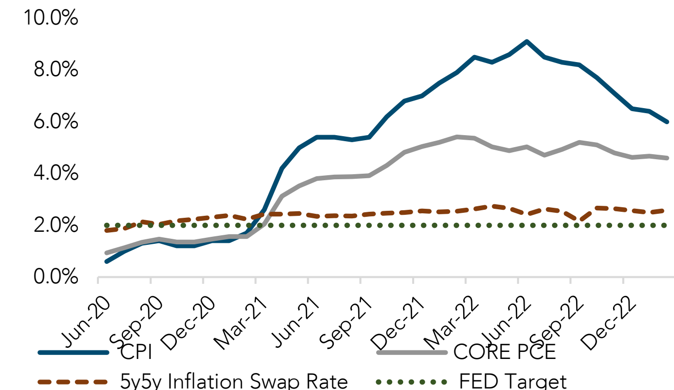
Source: Goldman Sachs

Exhibit 3 – Atlanta FED GDP estimate
The Atlanta FED growth forecast for 1Q23 peaked at 3.5% on 23/03 but has since come down to 2.5% on 18/04



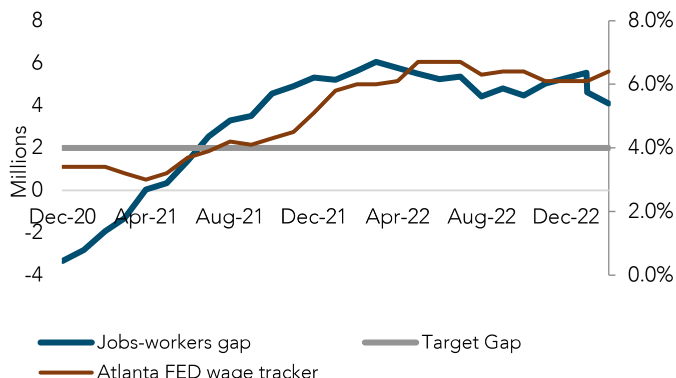
Source: Atlanta FED

Exhibit 4 – US Inflation rate
Core inflation accelerated by 4.6% YoY in February, slightly below the January increase of 4.7%



Source: Bloomberg

Exhibit 5 – Job-workers gap (LHS) and Atlanta FED wage tracker (RHS)
The jobs-workers gap declined further last month to 4.1 million though the Atlanta FED wage tracker rose to 6.4%



Source: FRED, Atlanta FED

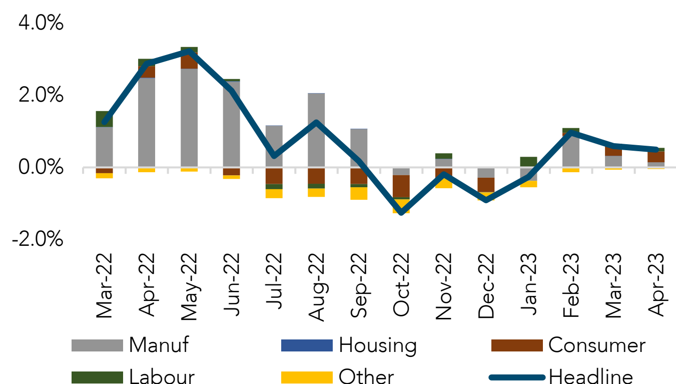
Europe

Growth: The Euro Area Headline Current Activity Indicator ("CAI") decreased to 0.5 in March from the prior 0.9 (Exhibit 6). The decrease of 0.4 was mainly driven by a decline in the Manufacturing CAI of 0.6 (from 0.9 to 0.3 in March) and in the Labour CAI of 0.06 (from 0.13 to 0.07 in March). These declines were however offset by the increase in Consumer CAI of 0.2 (from 0.05 to 0.24 in March) and in the Other CAI component of 0.06 (from -0.13 to -0.07 in March). Despite the seemingly weaker activity, the Euro-area Composite PMI rose to 53.7 (Exhibit 7), the highest reading since May 2022 driven by the Services sector (55.0 from 52.7) whilst Manufacturing deteriorated further (47.3 from 48.5). Notwithstanding the weakness seen in the Manufacturing sector, Industrial Production in the Euro-area accelerated 2.0% YoY in February from 1.0% in January (Exhibit 8). Production grew in most sectors, but growth was fastest in motor vehicles (5.5% MoM) and chemicals & pharmaceuticals (3.2% MoM).

Inflation: Headline inflation in Europe came in at 6.9% in March, which represents a sharp drop from February's increase of 8.5% (Exhibit 9). Food inflation remained elevated whilst energy inflation was mixed across sub-components. At the core level, strong seasonal effects drove Euro Area inflation in March of 5.7% (up from 5.6% in February) which continues to point to more ECB tightening over the near term.

Exhibit 6 – EU Current Activity Indicator

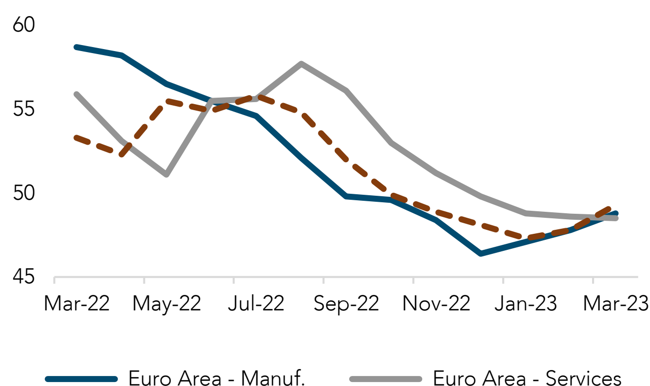
Economic activity in the Euro-area has been deteriorating since February though is still in positive territory



Source: Goldman Sachs

Exhibit 7 – EU PMIs

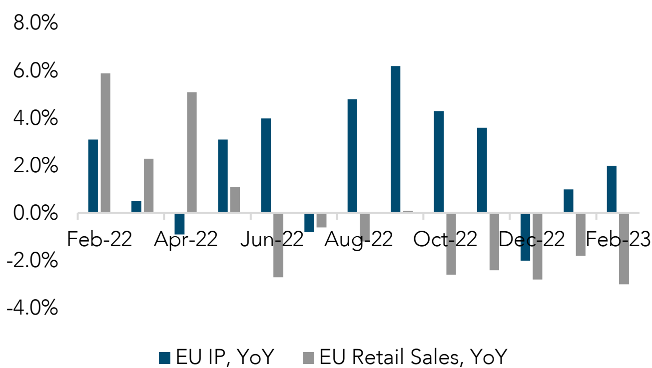
The Composite PMI for the Euro-area rose to 53.7, the highest since May 2022



Source: Bloomberg

Exhibit 8 – EU Industrial Production

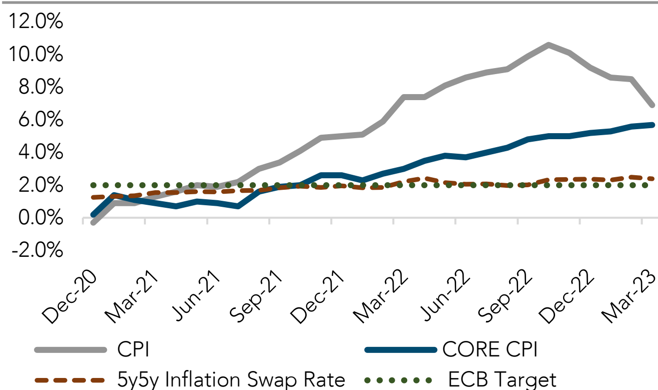
Industrial production accelerated 2.0% in February, accelerating from +1.0% in January though retail sales continued to weaken



Source: Bloomberg

Exhibit 9 – EU Inflation rate

Core inflation increased again in March which suggests more ECB tightening over the near term

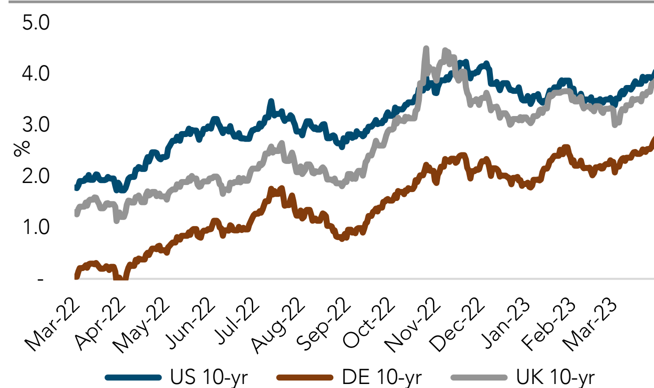


Source: Bloomberg

Rates

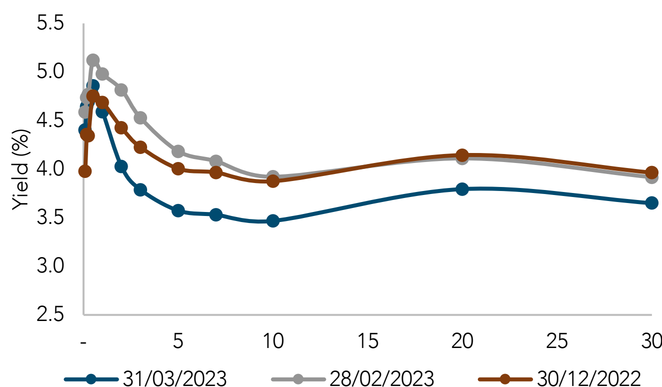
The collapse of two US regional banks and troubles at CS led to a surge in volatility within the rates market during March. The MOVE index (a measure of volatility in rates) surged to 199 on 15/03, well ahead of the 5-year average (76) as investors reduced exposure to riskier asset classes and ploughed into sovereign paper. Since then, the MOVE index has moderated to around 121, which is still elevated but somewhat in-line with levels considered to be normal during periods of uncertainty over central bank action. Therefore, we expect this high volatility in rates to persist for longer, especially given the divergence in views that are currently driving markets.

Exhibit 10 - 10-year nominal bond yield for the US, Germany and UK
February saw a reversal of the shift downwards in yields seen in January as inflation concerns returned



Source: Bloomberg

Exhibit 11 – US Yield Curve
The U.S. sovereign yield curve continued to invert during January to levels not seen since the 1980s



Source: Bloomberg

United States

In the US, the main talking points in March was the collapse of both SVIB and SB, concerns around contagion and the FED's response to the banking crisis. Consequently, the yield on the 10-year U.S. Treasury declined by circa 45bp to close at the 3.5% level. Regulators responded promptly as the Treasury Secretary Yellen noted that all depositors, both insured and uninsured, will be made whole under the systemic risk exception. In addition, the FED announced the creation of the Bank Term Funding Program ("BTFP"), which allows banks to borrow against securities (such as treasuries) at par. This means that banks do not need to sell securities at a loss to fund deposit outflows.

Amid all this uncertainty, the FED hiked rates by a further 25bp during its March meeting, pushing the Federal Funds Rate to 4.75% - 5.00%. The 2-year Treasury Yield rose 25bp in the first 8 days of March to 5.1% following Chair Powell's testimony to Congress. It then plummeted 130bp to 3.8% by 26/03 as investors priced-in rate cuts in 2H23 to fight the impact from the tightening in financial conditions. Since then, the 2-year has moved again above 4%, closing at 4.3% by 19/04. This has led to a further inversion in the 2s10s by 52bp during March as the 2-year yield declined 80bp whilst the 10-year yield declined by 45bp over the 1-month period to 31/03. Going forward, the market is pricing-in another rate hike at the next meeting, but with c.55bp of rate cuts expected in 2H23. We believe that rate cuts in 2023 are unlikely in view of the high inflation.

Europe

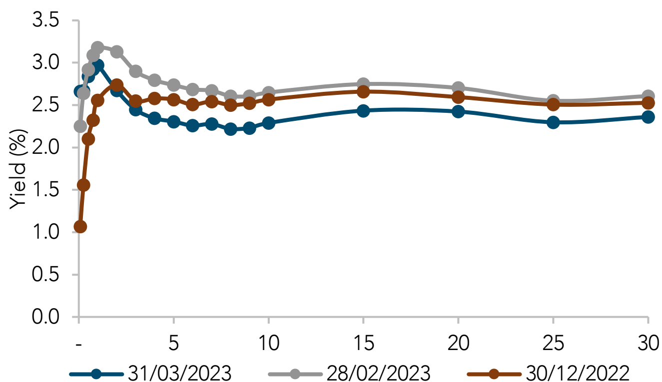
EUR rates declined in March but were less impacted than US rates, possibly as a result of the higher inflation in the region and the additional tightening required to bring inflation down to target. While the banking crisis began in the US, it quickly unfolded in Europe with Credit Suisse and its eventual acquisition by UBS. While the banking crisis did not affect any banks operating in the Euro Area, barring some slight speculation on Deutsche Bank which was swiftly quelled by the German Government, investors still sought safety in Government bonds. In fact, the yield on the Bund declined to 2.3% by the end of March which represented a decline of circa 36bp in yield MoM.

Since the end of March, rates in the Euro Area have slowly reverted back to the levels seen before the collapse of SVIB. The yield on the German 10-year paper is at 2.5% at the time of writing (17/04) which is roughly at the same level seen before the collapse of the two U.S. regional banks. As banking sector concerns continue to recede, we expect the market to shift their attention to the upcoming ECB meeting on 04/05.

Ahead of next month's ECB meeting, the market is pricing a 33% probability of a 50bp rate hike. On balance, given that core inflation is still rising and is already at a high level, the probability of a 50bp rate hike is higher than 33%. This could lead to some volatility in EUR rates as we approach the meeting date. The ECB's hiking cycle started much later than the US and it is likely that it will end later too. The warmer than expected weather could potentially have delayed price moderation, as it boosted demand. The ECB has always communicated its priority of fighting inflation before anything else and we believe that this stance is unlikely to change unless something breaks.

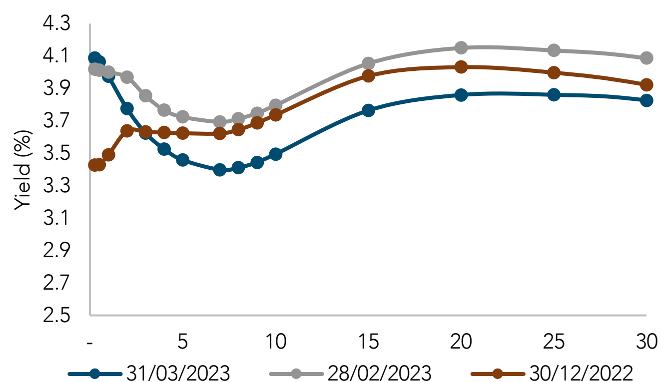
Despite the UK not being impacted by the banking crisis, the yield on the UK Gilt declined by circa 34bp to 3.5% as the market adopted a negative risk sentiment with investors flocking to sovereigns for safety. Furthermore, during the month, the yield curve flattened as the spread differential between the 2s10s tightened by circa 9bp, contrary to the movement seen in both the US and Germany. In March, the BoE hiked by a further 25bp to 4.25%, which was in line with expectations, given the high level of inflation which unexpectedly edged higher to 10.4% in March from 10.1%, which was also higher than expectations of 9.7%.

Exhibit 12 – German 10-year yield curve
German 10-year yields rose 37bp during February, reversing the fall seen in January. Yields are up 8bp YTD



Source: Bloomberg

Exhibit 13 – UK 10-year yield curve
The 10-year Gilt yield rose by c.49bp during February though unlike other countries/regions, the yield curve flattened



Source: Bloomberg

Credit

Following the banking sector anxiety, the focus for bond investors remains on the macro-economic impact from the tightening of lending standards, as systemic fears have subsided. Besides a pullback in core retail spending in March and a slowdown in industrial freight and housing activity, evidence so far suggests resilience in consumer services and a minor impact in layoffs. In fact, within the USD HY market, cyclicals have outperformed defensives in the aftermath of SVIB failure. This resilience can also be seen within CCC-rated debt.

On a YTD basis, around $26.1 billion of USD-denominated bonds were upgraded from HY to IG vs. just $14.8 billion of fallen angels. Despite the favourable picture painted by these figures, the overall trend has been towards more downgrades than upgrades. With the exception of BB and CCC rated bonds, downgrades have outpaced upgrades across all of the other ratings. However, the trend in the EUR market remains more positive as upgrades are still outpacing downgrades. The YTD rating migration supports our preference for EUR over USD paper.

Credit spreads widened substantially in March following the collapse of two U.S. regional banks and the buyout of Credit Suisse by UBS in Europe. While the crisis did lead to wider spreads, specifically within the financial sector, analysts continue to see scope of credit spreads to tighten further from here. Although the risk of a weakening economy could weigh on the credit market (mainly through downgrades and higher defaults), given the current higher yield environment, investors could find it much easier to reduce their risk exposure, leading to outflows from riskier asset classes like Equities and HY credit into IG. This in turn partly explains our preference for IG over HY.

According to S&P, the default rate in the U.S. is set to rise to 4.0% by the end of 2023 with the figures set to reach 3.25 % in Europe during the same period. There were a total of 14 defaults in March as the global default tally rose to 37 this year which is a tie with 2016 as being the highest YTD rally since 2009.

Exhibit 14 – Spread movements and total returns for Investment Grade and High Yield credit

Total Returns indices	MoM Δ	YTD Δ
USD IG	2.8%	3.5%
USD HY	1.1%	3.6%
AAA	4.4%	5.0%
AA	3.5%	3.9%
A	2.7%	3.3%
BBB	2.7%	3.6%
BB	2.0%	3.4%
B	0.7%	3.5%
CCC	-1.4%	5.0%

Total Returns indices	MoM Δ	YTD Δ
EUR IG	1.0%	1.8%
EUR HY	-0.4%	2.9%
AAA	1.0%	0.0%
AA	1.4%	1.3%
A	1.2%	1.6%
BBB	0.8%	2.0%
BB	0.0%	2.4%
B	-0.1%	3.5%
CCC	-4.3%	1.7%

Total Returns indices	MoM Δ	YTD Δ
GBP IG	1.0%	2.5%
GBP HY	-0.7%	3.7%
AAA	1.4%	1.0%
AA	1.3%	1.8%
A	1.2%	2.6%
BBB	0.8%	2.5%
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Spread Movements	MoM Δ	YTD Δ
USD IG	14.15	8.12
USD HY	42.75	-13.78
AAA	-4.47	-1.58
AA	0.96	0.71
A	14.75	9.18
BBB	16.09	8.35
BB	15.74	-12.27
B	43.59	-24.54
CCC	83.19	-34.42

Spread Movements	MoM Δ	YTD Δ
EUR IG	21.80	2.12
EUR HY	62.72	-15.26
AAA	26.09	46.65
AA	14.86	11.52
A	17.60	6.26
BBB	26.59	-1.87
BB	52.62	-0.30
B	56.88	-47.13
CCC	185.96	110.42

Spread Movements	MoM Δ	YTD Δ
GBP IG	21.42	-2.99
GBP HY	75.38	-50.08
AAA	16.23	9.13
AA	16.97	8.98
A	18.72	-2.51
BBB	24.32	-4.25
BB	N/a	N/a
B	N/a	N/a
CCC	N/a	N/a

Source: Bloomberg

Equity

March was a very volatile month for equity markets that kicked-off with Chair Powell's testimony to Congress. During his testimony, Powell reiterated his message of higher and potentially faster rate hikes during the upcoming meetings. Chair Powell's hawkish comments during the testimony which ended on 8th March led to a re-pricing of the peak rate to 5.5% by the July meeting, up from 5.0% at the start of the year. Also, no rate cut was being priced-in post the meeting. This followed the higher-than-expected PCE print at the end of February. The narrative has now shifted completely to inflation concerns.

Exhibit 15 – S&P 500, STOXX 600 and US Real yield (RHS)

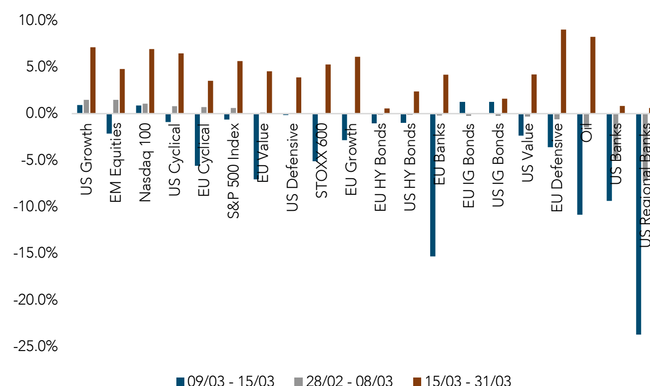
The negative correlation between rates and US equities held during a volatile March

Source: Bloomberg

Performance rebased from 31 December 2021

Exhibit 16 – Total return in local currency terms

Sell-off in equities was primarily concentrated in specific areas of the market, with EU banks and oil recovering strongly to month end



Source: Bloomberg

Inflation concerns weighed on performance for US equities primarily due to their larger tilt to Growth when compared to European equities. In the two weeks (24/02 to 09/03) that followed the release of the January PCE (24/02) which included Chair Powell's testimony (08/03), the S&P 500 lost 2.2% as the real yield rose 40bp in a month to 1.7% on 8th March. We have highlighted the negative correlation between equities and the real yield before, though the improving economic backdrop had weakened such a relationship (Exhibit 15). In contrast, European investors were less concerned as the STOXX 600 index lost just 0.4% during the same period.

Yet, the backdrop changed significantly in two days as a result of an uptick in banking sector stress. The swift collapse of Silicon Valley Bank (10/03) and Signature Bank (12/03) raised concerns over banking stress contagion. These concerns were later exasperated by news that the situation at Credit Suisse was deteriorating, leading to UBS acquiring the stricken bank. The anxiety around the health of the banking sector and the rising risk of contagion led to a re-pricing downwards of the peak Fed fund rate to 4.8% on 15/03, with c.105bp of rate cuts expected in 2H23. There was a quick response from policymakers which in the end helped to calm down markets.

The initial equity market reaction to the collapse of SVIB was understandably negative. European equities suffered the most given their higher value tilt, losing 5.1% over the next 5 days ending on 15th March (Exhibit 16). European Value and Cyclical strategies were also under pressure, losing 7.1% and 5.6% respectively over the same period. European banks lost 15.3% as fears of contagion mounted, compared to US banks losing 9.4% over the same period. Given the tilt towards growth, US stocks delivered a positive return of 0.9% over the same 5 days.

Equities recovered strongly in the second half of March as both European and US equities rallied c. 5% to month end. Growth strategies outperformed Value, given the expectation of a loosening in monetary policy whilst Defensives outperformed cyclicals given the higher probability of a recession. Overall, we saw no news supporting this rally, other than some indications that the banking stress could be contained. Equities are now back to YTD highs despite a much more challenging backdrop and higher uncertainty.

In terms of our investment themes for the first half of 2023, we preferred European equities with a higher tilt to Value and Cyclical names compared to the benchmark index. Following the uptick in bank stress and the potential repercussions on global economic growth, we made slight adjustments to our views. We believe that the rally late in March that continued so far in April is unwarranted given the high levels of uncertainty. Whilst we acknowledge that the potential for contagion has largely receded, the risk of an economic slowdown have increased. We do not believe that the higher risk is being fairly priced by the market.

We maintain our preference for European equities over US despite the outperformance of the former on a YTD basis. In our opinion, Europe's valuation discount to the US is unwarranted in the current environment. We note that the STOXX 600 constituents have changed significantly over the past 20 years, with the current top-10 able to generate much higher top-line growth than in the past when the index was dominated by companies operating in mature industries.

Cyclicals outperformed during February despite the uptick in rates volatility which generally favours exposure to Defensives. Current economic growth optimism has accelerated sharply YTD, and economic data needs to surprise to the upside over the coming weeks in order to sustain the current levels of growth optimism. We believe that stock selection will be critical, as cyclicals valuation is historically high against a backdrop of high macro-economic uncertainty. We would avoid having a large tilt either side of both strategies.

We continue to believe that investors will prefer stocks trading on low valuations and that focus on high returns to shareholders. At the other end of the spectrum, Value strategies tend to underperform during periods of economic weakness. Again, we now recommend a balanced exposure to Value vs Growth.

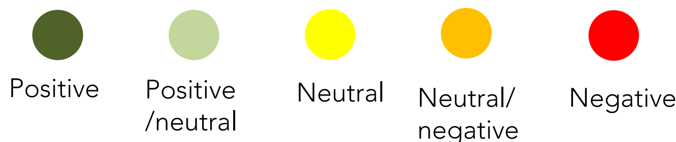
Exhibit 17 – Valuations – Developed markets

Valuations have expanded since the end of February despite the uptick in banking sector stress

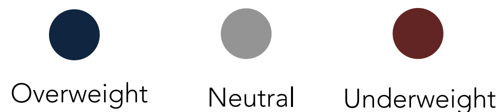
Historical Data	SPX	SXXP	SX5E	DAX	CAC	FTSE100	FTSE250
Current Forward PE ratio (FPE)	17.0x	12.3x	11.9x	10.7x	12.2x	10.5x	10.5x
Forward PE ratio (31/12/2022)	16.8x	11.9x	11.3x	10.5x	11.3x	10.0x	11.1x
10 Year data							
Highest	22.1x	17.5x	18.0x	15.7x	18.2x	15.4x	17.9x
Highest (date)	31/12/2020	29/12/2020	29/12/2020	28/12/2020	04/12/2020	02/12/2015	29/12/2020
Lowest	12.2x	10.0x	9.0x	8.4x	9.1x	8.4x	8.3x
Lowest (date)	23/03/2020	18/03/2020	18/03/2020	18/03/2020	18/03/2020	03/10/2022	23/03/2020
Median	16.0x	13.7x	12.8x	12.1x	13.3x	12.8x	13.7x
95th percentile	20.4x	16.0x	16.3x	14.5x	15.9x	14.9x	15.2x
5th percentile	13.7x	11.5x	11.0x	10.7x	10.9x	9.9x	10.8x
Historical rank (since 2006)							
Percentile	83.6%	43.6%	49.6%	31.5%	44.7%	28.6%	22.2%
Current FPE, % above/ (below) 10-YR median	6.1%	-9.9%	-6.8%	-11.6%	-8.2%	-18.1%	-23.5%
Current FPE, % above/ (below) Dec 22	1.1%	4.0%	5.6%	2.5%	8.2%	4.6%	-5.6%
GS Forecast index level							

Source: Bloomberg

Key – Our view



Key – Allocation



Asset Class			Positioning
Developed Market Sovereign Bonds			We prefer to remain on the sidelines for the time being given the current elevated volatility within the rates market. Rates have come down significantly over the past month as investors are pricing-in rate cuts in the second half of the year. However, we believe that central banks are unlikely to cut rates given where inflation is at. Core inflation is moderating in the US but is still well above the FED's target. As for Europe, core inflation is still rising primarily driven by food inflation. We would expect rates to rise slightly and hover around current high levels assuming the base case scenario of a soft landing materialises. We would re-assess our position if the macro-economic outlook deteriorates meaningfully, increasing the probability of a hard landing.
Investment Grade Corporate Bonds			We expect spreads to contract further in the coming months driven by outflows out of riskier asset classes into IG. We note that the IG space is now offering attractive yields to investors following the aggressive tightening by central banks over the past months. This should provide investors with a more compelling argument to reduce their risk exposure, especially when considering the high uncertainty around the macro-economic backdrop. Cumulative flows in IG funds have been positive on a YTD basis and we expect this to persist over the coming months. Also, when taking into consideration our view on DM Sovereign bonds, we prefer to have a slightly shorter-duration compared to the benchmark.
High Yield Corporate Bonds			We downgraded our allocation on HY to Neutral from Overweight during March given the macro-economic outlook. Similar to the IG space, the asset class is providing investors with much higher yields to compensate for the higher risk. Yet, given the uncertainty around economic growth we opted to reduce exposure to the sector. Our view is supported by the rising default rate which we expect will get worse if the base case (soft landing) materialises. Also, we believe that the combination of higher funding costs (as a result of the higher interest rates) and tighter lending conditions could result in liquidity issues for companies that are under stress. Within the sector we continue to prefer issuers that generate high cash flows combined with a strong balance sheet as we believe their earnings will be less susceptible to higher finance and input costs. Similar to IG, we prefer to have slightly shorter-duration compared to the benchmark.
Developed Market Equities			Despite the rising uncertainty, equity markets have generated double-digit returns on a YTD basis. Although we acknowledge that developments early in the year were positive for the global macro-economic outlook, we note that a lot of the good news had already been priced-in. The uptick in banking sector stress and the possibility for tightening in lending standards increases the uncertainty. Yet, investors seem to be focusing on the possibility of the FED cutting rates in 2H23, the return of the FED pivot that has worked so well for investors in the past. We believe that central banks are unlikely to cut rates given the high inflation levels and if they do cut rates, then it is likely that the macro-economic backdrop has deteriorated materially, which would be negative for equity markets. The current returns so far in 2023 are not consistent with a recession and we would expect equities to re-price lower should that risk increase.
Emerging Market Equities			In our opinion Emerging market equities performance could be boosted by China's commitment to re-open its economy at a faster rate than previously expected at the start of the year. The China growth story should also be beneficial for commodity exporting regions like Latin America. We note that EM equities are negatively impacted by the strength in the US Dollar and inflation news flow due to the high level of US Dollar denominated debt issued by EM countries. Finally, we see rising political risk as a potential headwind for EM equities, with tensions between US and China rising in recent months.

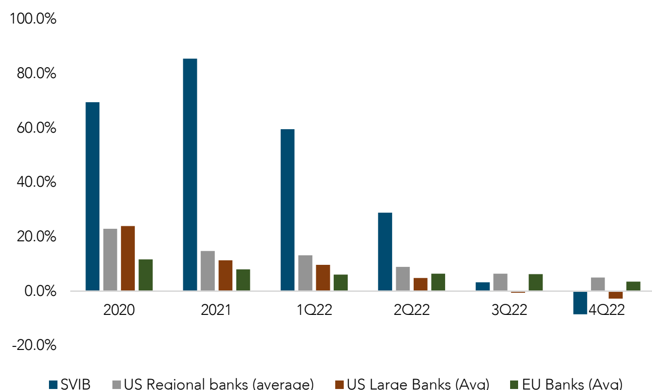
Appendix 1 – SVIB and Credit Suisse Collapse

A key concern for investors is whether banking stress can be contained. We believe that a better understanding of the SVIB collapse will provide investors with some peace of mind. We think that what happened was idiosyncratic in nature, primarily explained by unique circumstances at both SVIB and Credit Suisse. At this stage we think that comparisons with the global financial crisis of 2008 are unwarranted. Other US and European Banks are well capitalised and have appropriate levels of liquidity.

SVIB's deposit growth outpaced that of the industry over the past 2 years. Despite the uncertain economic backdrop, SVIB reported deposit growth of 229% in the 27 months to 31st March 2022 (Exhibit 18). This compares with average deposit growth for US regional banks of 43% during the same period and 48% for US large banks. Furthermore, the average deposit growth for European banks amounted to 24%. Furthermore, SVIB had had a fairly unique deposit base with very few retail clients and a high proportion of its deposits above the $250,000 level and uninsured by the FDIC. Additionally, roughly 60% of its deposits were with the technology and health care & life sciences sector, and an additional 12% with private equity and venture capital firms.

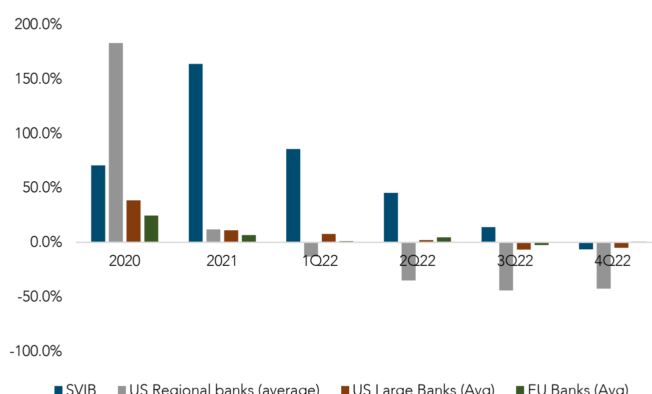
High levels of liquidity is problematic when the fed funds rate was close to zero. Therefore, the bank invested this excess liquidity into US Treasuries and securities issued by government-sponsored enterprises (c.93% of the fixed income portfolio). Over the 27 month period, the investment portfolio ballooned to $97billion or 347%, with held-to-maturity ("HTM") investments accounting for 88% of this growth (Exhibit 19). Investments accounted for 57% of total assets (vs an average of 5% for regional banks) and 780% of equity (vs. 32% for the sector). HTM investments do not affect capital or income as no fair value revaluation is required. Yet, it exposes the bank to significant duration risk as the FED started to hike rates aggressively in 2022. Tightening of monetary policy impacted SVIB in two ways: (1) unrealised losses in its investment portfolio (Bank reported unrealised losses of $15.2 billion on its HTM portfolio); (2) Higher risk free rates weighed on IPOs and public markets which led to liquidity shortfalls for early/speculative stage companies (SVIB had a high exposure to these companies unlike other banks).

Exhibit 18 – YoY growth in deposits
Despite the uncertain economic backdrop in 2020, SVIB deposit growth outpaced the sector's deposit growth



Source: Bloomberg

Exhibit 19 – YoY growth in investments portfolio
The low FED funds rate led to SVIB investing excess liquidity in US Treasury and other similar fixed-rate instruments

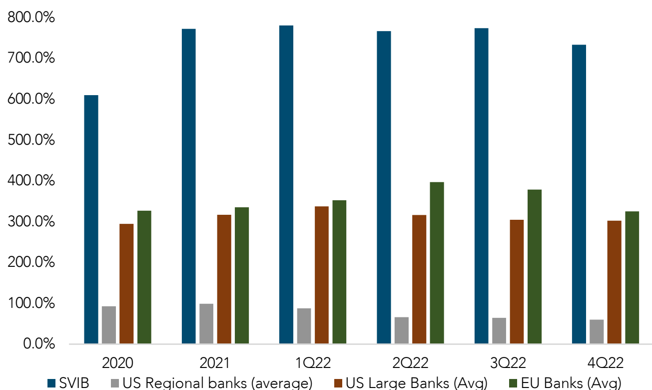


Source: Bloomberg

Over the 9 months to 31 December 2022, deposits at SVIB fell 12.6%, whilst investments fell 6% during the same period. In contrast, the average deposit growth for US regional banks was -0.6% compared with a decline in investments portfolios of 42% on average. Deposit outflows continued in 1Q23, with a further 5% in the first two months of 2023. In March, SVIB lowered its outlook for 2023, and announced that it sold $21billion of US Treasury and agency securities from its AFS portfolio with the intention of investing the proceeds in short-duration US Treasuries. This transaction was supposed to add $450million to net income for the year, but in fact resulted in an after-tax loss of $1.8 billion. In order to boost capital following this unexpected large hit, the Bank announced its intention to raise $2.3 billion in common equity or similar instruments which was expected to be priced after a day of marketing. However, the combination of guidance downgrade and a large loss on sale of securities, coupled with a large percentage of deposits not insured by the FDIC, a large proportion of investments held at HTM and the closing of Silvergate spooked investors. The capital raise never happened and SVIB suffered 25% deposit withdrawals in one day which effectively sealed the fate of the bank.

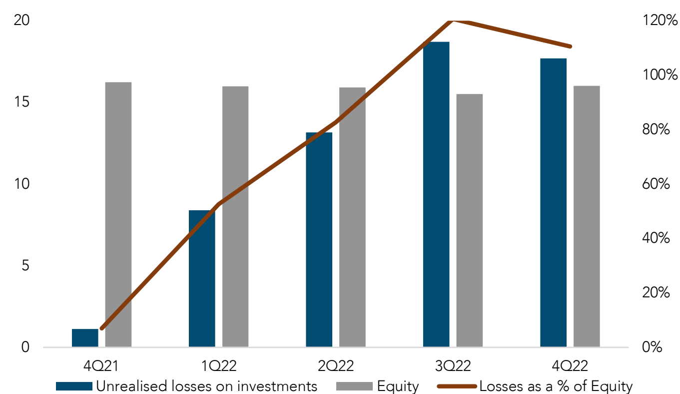
Credit Suisse ("CS") has suffered from poor profitability and governance issues for many years. These included a criminal conviction for allowing drug dealers to launder money in Bulgaria, entanglement in a Mozambique corruption case, a spying scandal and its association with Lex Greensill and Archegos Capital. A new strategic plan was announced on 27 October 2022, which highlighted management's intention to focus more on wealth management and less on investment banking. This came alongside a capital increase of CHF4billion to restore CS's CET1 to 14% by end 2022. Many fed up clients decided to move money out of CS with deposit outflows of CHF138billion in 4Q22. The announcement from its largest shareholder, Saudi National Bank, that it would not inject any fresh capital in the bank reportedly led to deposit outflows of up to CHF10billion per day. CS was eventually acquired by UBS.

Exhibit 20 – Investments as a % of total equity
The size of SVIB's investment portfolio was around 7x its total equity which is well ahead of other US regional banks and bigger banks



Source: Bloomberg

Exhibit 21 – SVIB unrealised losses on the investment portfolio
The FED's aggressive tightening led to significant losses in SVIB's fixed income portfolio, with the losses exceeding equity in 3Q22



Source: Bloomberg

Appendix 2 – Potential repercussions from SVIB and CS

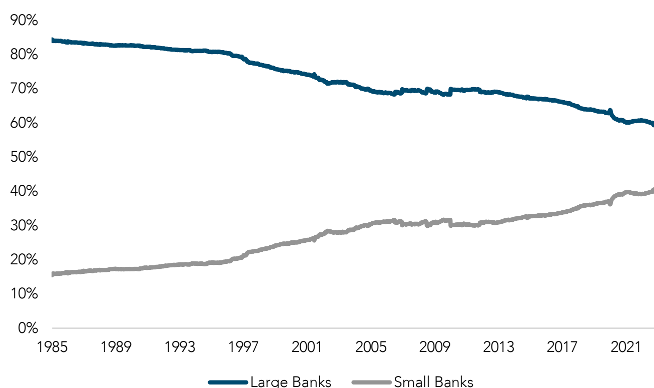
The role of the banking sector to drive economic growth cannot be downplayed. Barclays note that banks account for roughly 33% of total credit in the US and 55% in Europe. This implies that any significant tightening in lending standards could have a significant impact on economic growth going forward in our opinion. This view is supported by the growth in the role of regional banks within the US. Today, US regional banks account for roughly 40% of the bank loans in the US compared to 16% in 1985 (Exhibit 22).

The level of tightening in lending standards is very difficult to forecast, as US Regional banks may opt to reduce their lending to maintain a loans to deposit buffer in case of an uptick in deposit outflow. Yet, we note that the loans to deposit ratio screens as low compared to history (Exhibit 23). Assuming deposit outflows stabilise, we view this as a very likely outcome, with banks looking to grow their loan book without adding too much risk. Yet, lending conditions could still be impacted if banks remain concerned about deposit outflows, as this would probably be mitigated by higher cost of credit.

Regional banks have a significant exposure to areas of the economy that are currently under stress from higher financing costs. Small and medium sized banks, defined as those banks with assets not exceeding $250billion, account for 80% of commercial real estate loans ("CRE") held by US banks (Exhibit 24). The aggressive tightening of monetary policy by the FED over the past year has exerted pressure on CRE prices. Barclays estimate that US banks are the largest holders of CRE debt (42%). As noted, Regional banks are very active within the CRE space, with the risk that the sector will be hit by a liquidity crunch as lending standards are tightened. The FED stress-tests commercial mortgages portfolios held by banks with more than $100 billion in total assets, and the results indicate that capital levels are sufficient to absorb credit losses even in the severe case. However, credit quality in the space could deteriorate as loans mature during a period of high financing costs. The worst-case scenario would be a spike in bankruptcies in the sector that could have severe repercussions for the economy.

Exhibit 22 - Share of Bank credit

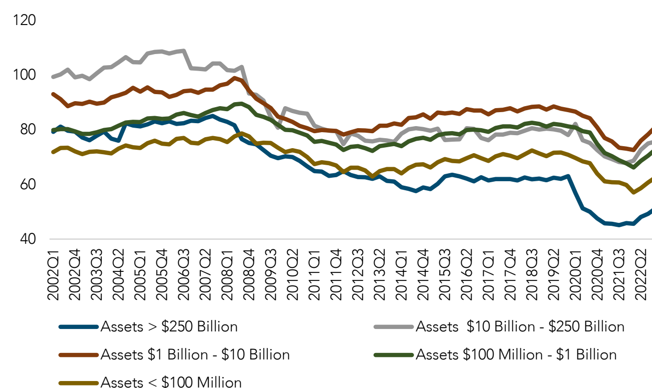
Smaller US banks have grown significantly over the years, accounting for roughly 40% of bank loans in 2023, from 16% in 1985



Source: FRED

Exhibit 23 – Loans to deposit ratio for US banks by asset size

Loans to deposits ratio are still at historically low levels which could provide some buffer for banks to support



Source: Federal Deposit Insurance Corporation

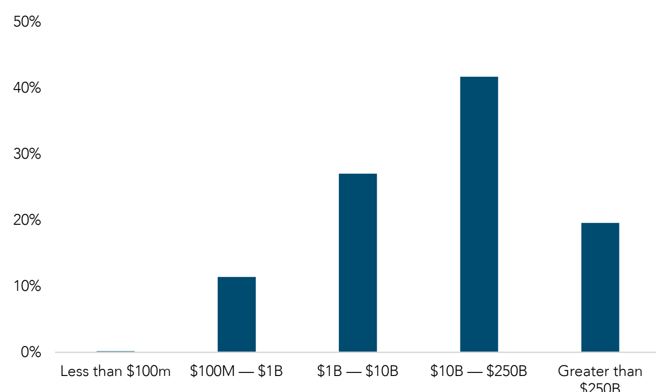
The events at Credit Suisse could lead to a higher cost of funding for banks in the future. A key discussion point for investors following the merger of UBS and CS was the full write-down of AT1 capital to zero (around $17billion) despite paying equity holders CHF3billion. A full write-down of the AT1 investment is allowed in the event of a contingency event, which depends, in part, on the calculation of the CET1 ratio. Yet, the decision not to respect the creditor hierarchy principal has led to investors re-evaluating the risk profile of the asset class leading to a higher required return.

Although regulators have come out to calm investors, reiterating their commitment that the AT1 holders would be given preference to equity holders, as per creditor hierarchy principals, we believe that the conditions for investors have changed. The YTW on European Banks AT1 instruments peaked at around 15.4% on 20/03, an increase of 574bp in a week, but has since retreated to around 10.9% (Exhibit 26). This is still above the median since the start of the year of 9.1%. We still expect investors to demand a higher return for such instruments in the future, which could put off some issuers in the future.

We see this as a risk for Banks with a higher proportion of AT1 funding. According to Barclays, AT1 capital accounts for 0.9% of total funding amongst European banks. CS had the highest percentage of AT1 capital relative to total funding (as at 3Q22) at just over 3.5%, followed by UBS at just over 2.0%. Other European banks are less reliant on AT1, which should make any impact from higher required return manageable. There has also been a widening in CDS spreads for European banks, and it is likely that this will persist for longer (Exhibit 21). By contrast, we note that AT1 investments have been very profitable for investors and have been particularly useful for yield pick-up during a period characterised by very low rates.

Exhibit 25 – Commercial Real Estate Lending by Bank Size

Small and Medium-sized Banks (defined as those with assets of $250b or lower) account for 80% of total CRE lending



Source: Federal Deposit Insurance Corporation

Exhibit 26 – European Banks AT1 Yield to Worst

The required return for AT1 instruments seems to have peaked at around 15% on 20/03, but has since come down to around 11%

Source: FRED

Disclaimer

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