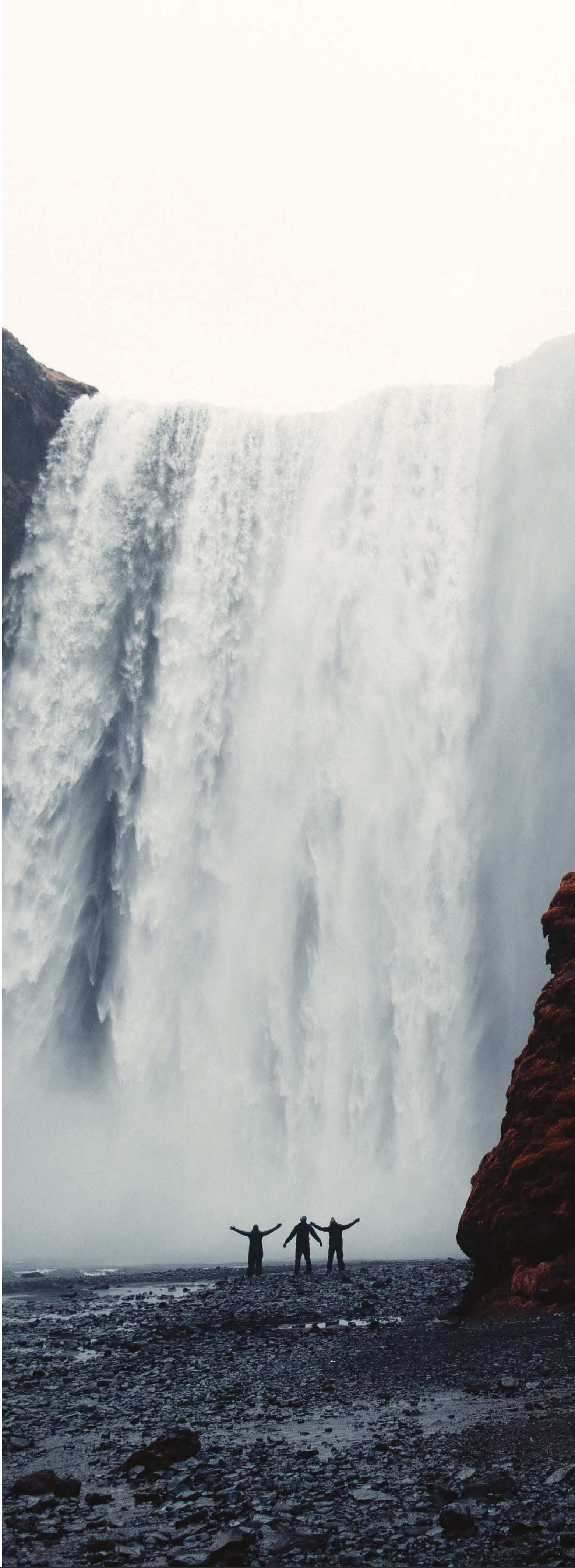
Market Update

Q1 2023 in review

Financial markets entered the year focusing on one major risk: would the US, as the world's largest economy, experience a soft or hard economic landing, and what this would mean for the rest of the global economy?

As the saying goes, 'there are decades where nothing happens, and there are weeks where decades happen'. During this past quarter it has certainly felt appropriate to use such a phrase as a lot of noise was inflicted on financial markets in the first part of 2023. The quarter started in a positive tone, with the re-emergence of China and Chinese tourists in particular supporting global markets. However, it ended with financial woes, with a regional US banking crisis and the takeover of Credit Suisse by UBS in Europe.



Market Summary
Q1 2023

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Q1 Economic Review

The quarter started well in terms of economic growth, following the faster-than-expected China reopening at the end of January, and the IMF subsequently raising its previous economic growth forecast from 2.9% to 3.1% for 2023, as well as seeing an expected continued fall in global inflation.

Despite being dubbed the most forecasted recession in history by commentators, we saw a raft of strong economic data prints, notably in the US. Non-farm payrolls showed that 517,000 jobs were added to the US labour market in January. This exceeded the 187,000 jobs estimated, and while welcome news economically (as it reduced the likelihood of a recession), it reversed the phrase that has dominated markets in recent years, as we entered a "good news is bad news" scenario. That is, good news economically is interpreted as bad news for markets, as whilst the upwards pressure on inflation remains strong, this in turn adds pressure on central banks to continue raising interest rates and leaves the threat of persistent inflation on the table.

Unemployment in the US is running at 3.4% (the lowest level since 1969), and a tight labour market combined with strong retail sales data and a strong US consumer, suggests any recession is expected to be short and shallow (or a 'soft landing' scenario). Coming into the year, the median forecast across sell-side institutions, for a US recession over the next 12 months, was 65%. This then reduced somewhat on the back of strong economic data, but increased again due to the speedy demise of Silicon Valley Bank and other US regional mid-tier banks.

Q1 at a glance

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However, it ended with financial woes, with a regional US banking crisis and the takeover of Credit Suisse by UBS in Europe.

Government bond prices rose in March (with yields coming down), as investors moved towards safe-haven assets following the turmoil in the banking sector.

The factor that gave the best return was Growth, with Value and Momentum the laggards over the first three months of the year.

This was a positive, but volatile quarter for growth assets; with speedy policymaker responses providing reassurance to markets.

Following the protests from the Chinese populace towards the end of 2022, and as rumours started to emerge about the removal of zero-covid policy in China, the Hang Seng index rallied by around 50% between October to January, while the CSI increased by around 20%.

Further, the MSCI Emerging Markets index (of which China now accounts for roughly 30%), rallied by around 15% over the same period.

On the back of the recent banking turmoil, the questions for us and our portfolios are twofold: 1) 'what exposure do we have either directly or indirectly'; and 2) 'is there risk of contagion which could affect our fundamental investment thesis?'. The answer to the direct exposure questions is a resounding no, while on the indirect exposures it ranges between negligible to non-existent. The S&P 500 indices- of which our US HSBC American equity tracker funds index fund is linked to - has exposures of 0.05% to SVB and 0.07% to First Republic, for example. Although this is deemed immaterial exposure, and the mid-tier banks involved are, by definition, not systemically important institutions that pose systemic risk. The bigger concern is a knock-on impact on confidence generally and reduced lending to the corporate sector from banks; particularly from small regional banks which account for a large percentage of commercial loans.

A bank run is no longer likely epitomised by people queuing outside a branch waiting to withdraw deposits, as with Northern Rock in 2007. Instead, with significantly higher levels of online banking penetration in the digital age (think social media and banking apps), deposits can now be withdrawn with alarming speed. Although, given the speedy response from policymakers, we believe confidence in the financial system is restored with there being little to no systemic risk financially.

Investec Bank in their latest Global Economic Overview forecast that global growth will slow by 0.1% to 2.6%. This modest drag on growth is as a direct result of tighter lending from banks, particularly mid- tier banks. This is tempered however by the fact that banks had already began the process of tightening lending coming into the quarter, as they anticipated an economic slowdown in 2023.

On equity markets, recent research shows that the UK stock market is trading at the largest discount to the S&P 500 in over a decade. The current starting point of equity valuations is a large predictor of future returns. We believe that the market truism that those businesses which lead into a bear market will rarely lead out holds true. This therefore favours our UK equity bias in portfolios, given the starting point on valuations and historical precedence.

In Fixed Interest, it was a rollercoaster of a quarter for the short-end of the government yield curve (bonds with 2 year maturity in particular), which largely reflects the likely path of central bank interest rates. The UK 2-year government bond yield increased from around 3.4% at the beginning of January, on the back of stronger economic data, to just over 4% in February. It then pulled back dramatically following SVBs collapse, to around 3.4% at the end of the quarter. This reflected lower inflation expectations and the reduced likelihood of a 'higher for longer' interest rate environment prevailing. It is not surprising then that a measure of volatility in the US Treasury market (the MOVE Index) reached its highest level since 2008.

Markets continue to climb the wall of worry. It is too early to tell whether the recent banking stresses will induce a more severe 'credit crunch', and thus bring forward a US and global recession. However, even if the banking crisis is coming to an end, another issue looms on the horizon: negotiations about the ceiling on issuing US debt. Projections of government revenues suggest the Treasury bank account will hit empty during July. Since 1960 however, the US government has overcome the US debt ceiling on 78 occasions; thus, history tells us that the consequences of not 'muddling through' are too severe, with some resolution inevitably being found.

There is always a reason not to invest, but the most important decision is to get invested and stay invested, maintaining a long-term balanced portfolio, and making adjustments based on changes to the fundamental investment thesis, not short-term market views.

The one certainty in markets is volatility, and market participants should remember in such times that long-term investing is rewarded and controlling emotions is imperative.

Summary

This was a positive, but volatile quarter for growth assets.

While these policymaker responses raise possible questions around engendering ‘moral hazard’ in markets (i.e. banks will be encouraged to take risks in the knowledge that the state has their back), it provides reassurance to markets and reduces the risk of continued wide-scale depositor outflows and therefore instils confidence.

Despite this banking noise dominating the current news headlines, the key focus is still very much on seeing continued falls in the levels of both headline and core (stripping out the volatile food and energy components) inflation and the ability of key economies to avoid a painful recession.

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