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First Quarter 2023

Markets had an extremely strong start to the year in January, though this faded and reversed slightly in February and March as concerns about growth and the banking sector came to the fore. Nonetheless, such was the positive performance in the first few weeks that most equity indices recorded comfortably positive performance for the quarter. In GBP terms, the US S&P 500 and the MSCI World indices gained around +5% in Q1, driven predominantly by large technology companies which rebounded after their underperformance in 2022. The UK and emerging markets lagged this move, with the FTSE 100 appreciating by +2.4% and the MSCI EM index adding +1.5% in Sterling terms – in the case of the latter, excitement over China's post-lockdown reopening fizzled out quite quickly. Regionally, the strongest performance came in the Eurozone where the Eurostoxx 50 gained +13.1% despite a weak period in March; stocks in this region are under-owned and tend to be sensitive to the economic cycle, while passing through the winter with the energy crisis less acute than feared was a relief. Bond markets also posted healthy gains in January and for Q1 as a whole were generally up by 2%-3%.

Driving this positive start to the year was more evidence of inflation declining – albeit gradually – adding to hopes that central banks, notably the US Federal Reserve (Fed), would be able to cease raising rates in the near future. To generalise, goods inflation has subsided significantly but services inflation still looks sticky and too high for comfort. Economic data otherwise has generally been robust, though there have been some signs of a weakening trend towards the end of the quarter. Western labour markets remain tight and this has helped to support consumer spending. Taking prices and activity data together, central banks have persisted with rate hikes and anti-inflation rhetoric, aiming to get on top of this even if it results in economic weakness later in the year or into 2024.

Concerns over banks dominated the news flow in March, resulting in a high level of volatility in bond markets but relatively little reaction for most equities outside the financial sector. Early in the month, the relatively little-known Silicon Valley Bank (SVB) ran into sudden difficulties and required liquidity support from the Fed in an attempt to prevent wider issues. SVB was arguably uniquely exposed to rising interest rates, which affected the health of its loans to technology firms and made it difficult to retain deposits; crucially, its capital buffers were made up of US Treasuries, which had declined in value, and therefore when sold to meet deposit outflows large losses were crystallised. There are some concerns that other regional banks in the US could be affected by a lack of depositor confidence, but the Fed's support seems to have reduced this risk for now. Regional banks are key lenders and it would be a blow to economic growth were they to retrench in their lending activity, but this seems likely to at least some extent.

While not in any way linked directly to the SVB situation, the issue of deposit flight hit Credit Suisse – it has been struggling for profitability over recent years and was in the midst of a complicated turnaround plan. Clients were unwilling to wait for this and outflows accelerated to the point where the future of the business was suddenly imperilled. Cajoled by the Swiss government and central bank, UBS took over Credit Suisse and this brought a great deal of stability to the situation from an external perspective.

Equity markets have been sanguine despite these developments, exhibiting low volatility apart from in bank stocks. However, bond markets were very turbulent with yields moving by unusually large amounts in both

January and March as investors reappraised the path of Fed rate hikes, which are now expected to peak at a lower level than previously expected due to the likely economic impact of US bank lending being curtailed.

Outlook

Our previous quarterly commentary highlighted that bonds had become more attractive due to yield levels and the potential for capital gains if rates started falling, and in January we added to our fixed income weighting for risk profiles where this was appropriate. We have become increasingly cautious during the quarter, which supports this higher allocation to safer assets, as we are unsure that the global economy can continue to show the same level of resilience to higher interest rates it has displayed so far. We are only seeing cracks of weakness so far, but would not be surprised if these developed further. This need not necessarily be negative for riskier assets such as equities, as if bond yields fall or central banks start to pause or lower interest rates then this can be very supportive for stocks, particularly those in certain sectors such as technology or healthcare. The path to lower rates is unlikely to be straightforward, however. Even if inflation moderates, it may well settle at higher levels than central banks will be comfortable with given that rising prices have become psychologically-embedded for consumers and businesses. We are reviewing our equity weighting and composition to ensure it is appropriate in the current environment.

We continue to favour emerging markets in Asia for their growth potential and relatively attractive equity valuations, while they could also benefit from the powerful tailwind of a weakening US dollar if the Fed starts to reverse course on interest rates later this year. Elsewhere, March was a reminder that some areas that are cheap, such as European bank stocks, can become cheaper still if they face a persistently unfavourable business environment – in this case, high levels of regulation and now a pressure to raise deposit rates to retain customers. Interestingly, European banks appear a solid investment in the bond space for similar reasons; their capital ratios are healthy, they seem diligently regulated and they are viewed by governments as akin to a utility. These factors assure repayment of coupons on bonds but do not promise the levels of profitability that would excite shareholders.

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