Quarterly Investment Update

April 2023

Hammond Raggett & Company Ltd
7th Floor The Lexicon, Mount Street
Manchester, M2 5NT
0161 834 2222
enquiries@hammondraggett.co.uk

General Economic Overview – To End Quarter 1 2023

In an unexpected turnaround from the general mood of 2022, the first quarter of the year started quite brightly for risk assets. Sentiment during 2022 was focussed on inflation expectations and the actions and rhetoric of central banks to combat it. Towards the end of the year focus shifted to the likelihood of recession and was this one of the factors that increased investors' expectations of rate cuts as we entered 2023. During January, sentiment was more positive as investors went back into risk assets believing that the rate tightening cycle was close to its peak and that by the end of the year we would see a pause, if not the beginning of a rate cutting cycle. By the end of January core equity markets had risen by around 6-8% (source FE Feb 2023) and yields had fallen. In February this confidence was challenged by the hawkish language of firstly the Fed, then the ECB and Bank of England, all indicating that the battle against inflation was very much still on, and that the data coming through supported a tougher stance, as employment figures and economic growth levels remained robust. In the US, employment numbers surprised on the upside in both January and February which reinforced the chances of a rate increase in March, although more recent events, influenced by the banking turmoil, brought the likelihood of this into question. By the end of the quarter all major central banks had chosen to raise rates.

Overall economic data across the globe was more positive than had been predicted, and even the UK saw positive GDP numbers in January of 0.3% (source ONS) when a negative number had been expected. This has been a stumbling block for many central banks in bringing down inflation over the last six months as, even with both quantitative tightening and interest rate increases, inflation has remained stubborn. There are differences across sectors with goods inflation certainly trending lower, but services inflation has stayed high. Any possible recession may be more sector specific rather than affecting the aggregate economy of each country. The level of uncertainty that has surrounded the potential path of rates has been responsible for much of the volatility in bond markets and this has of course been exacerbated by the recent problems in the US banking sector.

The focus of the financial markets in the last weeks of March has clearly been the fall out of the collapse of the Silicon Valley Bank and the contagion across the banking sector. Whilst the real problems are concentrated in US regional banks, it doesn't take much for these events to start to undermine the entire global banking sector. Timely interventions by the US, UK and European authorities have reduced the threat of wider contagion, ensuring that the overall banking system is still robust. Details aside, the current problems are very different to 2008 with systemic banks in the developed markets under tighter rules and well capitalised. There are always weak links however, and the problems with Credit Suisse were highlighted, forcing a takeover by UBS.

This raises the question of how this uncertainty will affect the interest rate policy of central banks in the coming months. Will the problems result in a tightening of credit conditions and increase the pressure on company finances, especially for the private equity market which tends to be more highly leveraged? Central bank support for the banking sector can be seen as a separate action to the battle against inflation, allowing the Fed and ECB to continue on a similar path, but they have to consider the evolving economic conditions as well. This perhaps highlights that rate rises over the past year have prompted the first cracks in the financial system, putting central banks in the difficult position of having to deal with the conflicting objectives of managing inflation and maintaining financial stability.

The events of March suggest that a recession is more likely during 2023 with tightening credit conditions hampering global growth potential.

Equity Markets Overview

The first quarter had seen continued levels of volatility in risk assets but, perhaps surprisingly, volatility has been higher in bond markets. In contrast to 2022, the year started with all the major equity markets up with some areas, such the US tech index (Nasdaq), rising over 10% in January alone. The initial confidence from investors was founded on the belief that the interest rate cycle was closer to pausing rises, or even cutting them, than had first been thought. This confidence seemed to ignore the words of central banks which remained cautious as data suggested that inflation, although falling, was still stubbornly high. In February the rally ran out of steam and harsher rhetoric from the Fed meant risk assets fell back, the momentum eased for the time being. Growth stocks recovered most in this period as a lower terminal rate reflect well on the DCF calculations that future profits are evaluated on, which is positive for such stocks. An additional boost for the global economy was the reversing of the zero Covid policy in China which was seen as a huge positive for Asian economies and for the rest of the world. This enthusiasm faded towards the end of the quarter with growth not improving as fast as some had thought it might. European equities were one of the strongest beneficiaries as it became apparent that the winter has not been as harsh as anticipated and the use of gas much lower, keeping the economy in a healthier position. The UK market was split with the FTSE 100 stocks maintaining a decent capital performance but mid and small cap stocks struggling much more.

UK

Like many developed economies the UK remained reasonably robust over the first few months of the year. It was thought that we would have a negative GDP number in January, but recent ONS data shows the economy grew by 0.3% year on year. A stronger than expected consumer was mainly responsible, with the service economy continuing to recover well, especially with the return of premier league football after the break for the World Cup. There were other more negative signs as manufacturing output registered a 0.4% month on month drop (consensus +0.2%,). Construction output also fell by 1.7% month on month (source Capital Economics) after stagnating in December, perhaps partly due to an unusually wet January. This suggests that there was probably some underlying weakness as a result of the high inflation and high interest rates. Overall, the better than expected growth could free up some cash for the Chancellor for his autumn budget as long as the recent banking crisis does not impact on growth later in the year, as credit restrictions tighten.

The UK was not as affected by the problems created in US regional banks, but the fall out clearly crossed into Europe. The capital adequacy rules in the UK and Europe are stricter than in the US and it was clear that there were not the same issues regarding uninsured deposits, but the government still had to step in to make sure Silicon Valley Bank in the UK was taken over by a major institution, in this case HSBC.

The budget this quarter was the first since the disastrous mini budget in September last year. It was called a 'budget for growth' but it mostly focused on policies to help people back into work based on childcare and pensions. UK productivity falls short of many developed nations and needs work to help improve growth prospects. As has been the case over several quarters in the last year, the small and mid-cap area of the UK stock market has underperformed whilst the larger cap energy focused companies have continued to outperform. This not only reflects the fact that energy and commodities have benefitted from supply constraints, but also that the UK domestic economy has struggled.

US

The performance of the US stock market has been quite strong year to date, thanks in the main to the enthusiastic start to the year when investors felt inflation had peaked and interest rates would come down sooner than expected. This was tempered as we moved through the quarter as central banks worked hard to curb the bull run with more hawkish sentiment. Other data has continued to suggest the economy remains robust – the employment data surprised in January and February with high new hires data. More recently the focus has centred on the regional banking crisis which has been covered extensively in the financial press and, as we write, is still affecting banking stocks across the globe, making markets generally more volatile. US regional banks have less strict financial conditions applied to them than the larger systemic banks, and this has meant they have come under a lot more pressure in the current challenging period.

The current problems started with the Silicon Valley Bank which collapsed because of investor withdrawals combined with a poor risk hedging strategy and the US authorities had to step in and protect deposits to prevent further contagion. Some of the larger US banks have also come together to support another bank, First Republic, as it suffered similar concerns. There are around 4000 regional banks in the US and so they are an important part of the banking infrastructure of the country. The stabilisation of this sector is vital to the US economy, and the tightening of credit conditions that may well follow these events could act as a further brake on the US economy and help the Fed to reach its goal of reducing inflation. In March, the Fed increased interest rates by a further 0.25% as it has chosen to separate the fight against inflation from the banking problem. Their recent statements acknowledged the potential impact of the banking turmoil, noting that ’recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation‘. Despite a more pessimistic assessment of recent inflation – which was described as ’elevated‘ rather than having ’eased‘ – the statement hints that the end of the tightening cycle is approaching. These recent events may speed up the process of lowering inflation but may also have other unintended consequences.

Europe

The European story has been an improving one over the last six months as investors readjusted their thinking after a mild winter. The fact that the weather has played such an important part following the supply side constraints created by the invasion of Ukraine emphasises how uncertain the future of economic growth looked in mid-2022. Whilst this has improved confidence in core European industries, manufacturing PMIs have actually started to fall slightly as recent problems in the banking sector have knocked some of the shine off future growth prospects. The failure of Credit Suisse and the takeover by UBS has stemmed the tide of falling share prices in banks, but investors remain wary of the sector. The European banking sector is actually stronger and better capitalised than the US regional equivalents but it has still come under pressure in the recent confidence crisis. Other factors that are challenging Europe include the French battles over pension reform and the continued threat from supply issues caused by the war in Ukraine. We have even seen rail workers in Germany strike over pay, as in the UK. Defence spending in central Europe may offer some specific opportunities, as will the drive to shift the reliance on Russian gas and increase the supply from renewables.

Inflation in the region is at 6.9% down from 8.5% in February (source FT March 2023) but still remains a focus for the ECB. Although they predict that inflation will decline substantially this year, they are not being complacent as core inflation, which strips out energy and food prices, is at 5.7%, slightly up on the previous month, with wages increasing at a record pace in Q4 2022. The ECB have therefore forged ahead with rate rises, protecting the longer-term view that combating inflation remains the chief focus of monetary policy and that the banking issues can be separated. The two recent rate increases have been 0.5%, accompanied by language that suggests these will not be the last, unless data suggests otherwise. Recent data from Spain and Germany shows that headline inflation numbers have dropped significantly in March, mainly because of energy prices falling which offers some encouragement for the policymakers.

Asia & Emerging Markets

While there have been some concerns about the banking sector and fluctuations in the US currency, emerging country banks remain better capitalised than their developed market counterparts, and historically a weaker US dollar has coincided with better returns from emerging market equities. A strengthening US currency over part of the first quarter was a temporary headwind to emerging markets, as some countries are financed with US$ debt and imports of energy, materials and food are all effectively priced in the US currency. Emerging markets are also further into their monetary tightening phase than Western counterparts, with China in particular in a different stage of its economic cycle and policy being eased.

China has ended its zero Covid Policy and is indicating support for the areas of the economy hardest hit, including the property market, and is increasing fiscal and monetary stimulus. While the rebound from the economic slowdown in China may not be rapid, there are positive signs of expansion in services activity, and the government remains committed to increasing fiscal support for the economy and reducing taxes on small companies.

Following the SARS outbreak in 2003, Chinese consumer confidence took time to recover. Whilst the property market is stabilising, a rapid rebound in prices would not be consistent with the common prosperity framework shaping Chinese economic development and there are signs that the manufacturing sector is suffering from the global economic slowdown. On a positive note, China's services activity is now expanding at its fastest rate in 12 years and the government is committed to increasing fiscal support for the economy and reducing taxes on small companies.

India, with its large domestic market, improving infrastructure, and attractive tax and labour reforms, offers investors an excellent long-term investment opportunity. The country has a strong rule of law as the world's largest democracy and is investing heavily in its infrastructure, with robust levels of new road construction and private sector investment improving airports, gas and power distribution, renewable energy, and the railway system. The introduction of new insolvency and bankruptcy rules has helped the write-off of non-performing loans, and the private sector banks are well placed to capitalise on the growth of the economy.

In Latin America, there are concerns about the future economic policies of the Lula administration in Brazil, although the country should benefit from its abundance of certain resource assets. Mexico is well placed to attract inward investment, and some countries in the Middle East, including the UAE, are continuing to benefit from the inflows of foreign investor money due to their increasing popularity as safe haven states in the emerging world.

Overall, emerging markets offer a favourable long-term story and should be supported by their relatively low valuations compared to developed markets. With the monetary tightening cycle further advanced in these countries, the long-term investment case for the region remains intact. Levels of economic growth relative to the developed world should be stronger over the next five years, as inflation is less elevated than in the West and there remains abundant sources of relatively cheap supplies of labour, especially in non-China Asian countries such as India, Indonesia, and Vietnam.

Japan

The rate of consumer inflation slowed in Japan, with the core consumer price index rising 3.1% year on year in February, down from January's 4.2%, which was the highest in over four decades. The contribution from energy fell notably due to government electricity subsidies to cushion the impact of price pressures. Amid calls for further stimulus, a government panel endorsed plans to add more than JPY 2 trillion to existing inflation relief measures, in response to the rise in energy prices as well as to support low-income households. Japan has not managed to avoid the contagion concerns in banking, with banking shares enduring a significant sell off and falling more than their counterparts in the US and Europe. Japanese banks fell 17% in March (source FT March 2023) whereas US banks fell 6% over the same period. Japan, like the US, has a strong regional banking structure which has generally been in decline but whose deposits account for half the country's cash. These large cash Page 5 deposits have also been invested in US Treasuries which is similar to SVB in the US. Higher interest rates in Japan could put more stress into the system although the banks in Japan have higher liquidity standards than in the US.

As noted in the previous review, the change of leadership at the Bank of Japan (BoJ) could result in some further moves in the Yield Curve Control (YCC) policy. In its recent meeting, the Bank of Japan acknowledged that in view of recent price rises, there are calls to revise its accommodative monetary policy. However, it noted that it considers the risk from hasty policy change to be more significant than the risk from delaying a change. It needs to carefully consider and discuss whether to revise policy, since revisions affect financial markets and a wide range of economic entities. A more relaxed YCC policy would be received well, and allowing bond yields to move higher would also be attractive as it would be a small step towards normalising monetary policy. In contrast, changing the policy rate would mark a dramatic shift in monetary policy after seven years of negative rates and is unlikely to happen in the short term.

Fixed Interest

The first few months of the year have seen improving conditions for bond holders as the prevailing view was that inflation was at, or near to, its peak and that interest rate rises could be paused by the end of 2023. During this period yields fell, and investors had a more optimistic outlook on corporate debt. As the quarter progressed, sentiment moved more negatively as central banks distanced themselves from these views, becoming more hawkish in defence of their strategies, which was to continue to raise rates as inflation was not falling enough to consider pausing or cutting rates.

Because of these changing views, volatility in fixed interest markets has been quite significant in recent months and this was highlighted by what happened in the latter weeks of March as investors in the US became nervous about their banking system. A run on one of the regional banks meant global bank valuations came under considerable stress and in the US the Federal Deposit Insurance Corporation (FDIC) had to step in to protect customer deposits and reassure investors after the collapse of Silicon Valley Bank. Several key factors led to SVB's demise and relate to its unique business model. European banks were not as exposed and several broader factors that contributed to SVB's stress aren't as prevalent in Europe as they are in the US. Investors may argue that SVB severely mis-managed its interest rate risk and this could occur at any bank, but the confluence of factors that combined to bring down the 16th largest bank in the US is simply hard to find at any decent-sized diversified lender on either side of the pond and, importantly, it doesn't appear that in Europe any large banks have worryingly large exposures to SVB.

Investors have seen a period of heightened volatility, with US ten-year yields falling over 50ps in a day which is largely unheard of in government bond markets outside of crisis moments like the GFC. The falls and rises in these assets only happen in periods of instability and have occurred all across the rate curve. One of the consequences of the fear in markets has been the take up of money market funds in the US with over $286 bn deposited in these funds in March (source EFPR March 2023) mainly in prime funds invested in short term government debt. The flight to safety has been a feature of recent market activity with US government debt in high demand and a cause of yields falling. In high yield spreads have widened to take account of the riskier environment but to date market default rates remain relatively low.

The prospects for a fixed interest investor appear to be more positive as we move through 2023 given the consensus belief that interest rates have travelled the majority of their likely path upwards. Any problems with inflation remaining high might mean we have to reset this view but at the moment yields look more likely to fall than rise by the end of the year.

Alternative Assets

Overall global commodity prices fell in the first quarter of 2023 with energy prices at the heart of this. In energy, oil was one of the key fallers alongside thermal coal. Oil prices have seen higher levels of volatility as Russia indicated it would cut production from February whilst at the same time China's reopening demand was seen as a boost for prices. This was partly offset by recessionary fears as central banks pursued hawkish policies and the US government indicated it would release more of its strategic oil reserve. Natural gas prices also fell as the weather was better than anticipated in both the US and Europe. This has had a positive effect in reducing inflationary pressures in both regions. Key base metals including aluminium, copper and nickel all saw prices decline as demand optimism relating to China's reopening faded, the only exception being gold which benefitted from global uncertainty around the banking problems in the US. Agricultural prices rose again in February, largely on supply concerns.

With valuations in commercial property still highly stretched and rental growth likely to slow as economies fall into recession it's possible that capital values will fall further in 2023. While the 4.5% decline forecast at the all-property level (source Capital Economics 2023) would be less severe than in 2022, this would take the peak-to-trough fall to almost 20%. That would be the second sharpest correction on record and a slightly more pessimistic view than the previous outlook from Capital Economics. Offices are expected to fare worst, while stronger rental growth will support industrial, and retail will benefit from smaller yield gains. Favourable structural shifts underline the view that industrial should also outperform further ahead, with total returns predicted to be 6.8% p.a. over 2023-27 (source Capital Economics 2023). Retail returns are expected to sit in the middle at around 5.7% p.a., while offices will trail at 5.3% p.a. It is expected that elevated mortgage rates will result in at least a 12% price correction in the UK before the market stabilises in 2024. In the US, Capital Economics expect 2023 will be the weakest year for home sales in a decade. As high mortgage rates continue to weigh on demand, they also predict that prices will fall by about 8% to their low point in mid-2023.

Summary

The surprisingly positive start to the year was superseded by the US banking problems towards the end of March which in turn led to the eventual takeover of Credit Suisse by UBS. The chain of events which led to this were not predictable and resulted in a period of equity market instability, especially in the banking sector. The final positioning of markets for the quarter was positive with gains made in January still holding, despite the banking problems in the US and the greater threat of recession. There were also differences in sector returns within regions such as the US, for example the Nasdaq returned a positive 15.05% whilst the Dow Jones Industrial index was only marginally positive. Investors have certainly been spooked by the events in the banking sector and have headed for quality and more defensive names, although it is interesting to note that in the US this includes some of the large tech companies which have powered the recovery in the Nasdaq during the quarter.

In the broader global economy, the focus for most governments has been on curbing inflation whilst avoiding a recession that cuts too deeply. The cost-of-living crisis is still at the forefront of investors' minds with inflation in food much higher than in other areas – in the UK it was as high as 17% in February (source ONS March 2023). The US Fed is very aware of the differences between the broader inflation numbers and core inflation, which was up slightly in February, and have maintained a stance that suggests rate rises will continue until this battle has been won. In other areas the concerns over recession have increased in importance as data has started to indicate a downturn in business levels. The likelihood of a recession has also increased following the banking crisis as credit tightening looks more likely to hit business and personal lending. This may ultimately result in falling inflation but could also escalate the possibility of a harder recession.

The most positive views in the regions suggest that Asia and emerging markets offer the potential for stronger returns given the valuation opportunities and the potential support of the Chinese government. The UK has seen a very binary level of returns with the larger cap FTSE 100 companies delivering good relative numbers whilst mid and small cap companies have struggled much more. A major structural change for UK investment managers over recent years has been that global portfolios now tend to allocate far less to the UK than in the past which is a factor in the fall in fund flows to UK open ended and closed ended funds. Investors may have to accept that the UK stock market is no longer the most significant part of a portfolio on a more permanent basis. This may also lead to more volatile portfolios as currency fluctuations become increasingly important. We maintain the view that this is not the time to switch out of risk assets as long as you have a longer term horizon, but to be patient, perhaps with an eye to total return rather than just capital values as these will fluctuate more in times of uncertainty. We have moved into a period of slower economic growth and possible recession but timing when to be in and out of risk assets will always be difficult and more often than not will result in negative outcomes.

Important Notes

The summary of recent economic and investment markets news and any comments in relation to the outlook for such are not intended to take the place of individual independent investment advice. This document contains a generalised commentary only and individuals should not take investment decisions based solely on its content. We strongly recommend seeking individual independent financial advice before making any investment decision. The views expressed in this document may differ from advice provided on an individual basis.

Past performance is not a guide to the future. The value of investments and the income from them can and does go down as well as up. Whilst investments are designed to return more than the sum invested, in the form of capital appreciation, income or a combination of the two, it is important to note that even over long investment time frames it is possible that an investor may get back less than originally invested.

Hammond Raggett & Company Limited
7th Floor, The Lexicon
Mount Street
Manchester
M2 5NT

Telephone: 0161 834 2222
Email: enquiries@hammondraggett.co.uk

Visit our Website: www.hammondraggett.co.uk