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QUARTERLY INVESTEMENT REVIEW

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"Like watching a mad donkey thrashing around in a field,
bouncing off all the fences."
Bank of America on markets in 2023.

The first quarter was eventful. After the extremely difficult experience for both bonds and equities in 2022, markets started 2023 steadily. As a sign of interest rates normalising on 4th January for the first time since 2010 the Bloomberg index of negative yielding securities disappeared. They had peaked at $18.38 trillion in December 2020. During January and February the market fluctuated between concerns that the abrupt tightening of liquidity last year would lead to a recession, and the announcement of strong corporate results. However, in March a banking crisis erupted that has seen the demise of two American banks, Silicon Valley and Signature, and one Swiss bank, Credit Suisse. Banking crises are inherently disruptive, but this one puts the Federal Reserve and other Central Banks in a particularly difficult position. With inflation not yet under control, they need to keep interest rates high but this has put pressure on the weak points of the financial system, which need interest rate cuts. Further tightening could lead to more failures. The situation seems to require two opposing interest rate responses, a higher one for inflation and a lower one for stressed banks.

The bank collapses revived memories of 2008, but it is clear that this situation is different. The 2008 crisis affected the whole system, whereas today it is focused on individual banks with specific issues. This crisis is less a test of the banking system and more a test of how the authorities handle the bail out. Silicon Bank, which focused on loans to technology companies, had invested its deposits in long dated US government bonds. As interest rates rose last year their value fell, and the resulting losses unnerved customers and triggered a bank run. The extraordinary feature of the collapse was its speed, $42 billion of deposits were withdrawn on a Friday and over the weekend the Fed moved swiftly to guarantee all its deposits. It was unlikely that they would have allowed a bank to collapse for owning US Treasury bonds, but in a digital age nerves were frayed by the realisation that bank deposits are on a hair trigger. In a confidence crisis like this markets tend to look for the weakest link and test it, and Credit Suisse was such a target, as it has suffered a series of well publicised losses in recent years. It was forced to merge with UBS, in a somewhat controversial action by the Swiss regulator and government. This is not the same as the Lehmans collapse, individually these situations are not systemic, but together with events such as the LDI crisis in the UK last September and the Adani implosion in India, they drain confidence and raise concerns about what the next collapse will be. It suggests that parts of the plumbing are not quite right in the financial system. This is being exposed after fifteen years of ultra-low interest rates and the consequent misallocation of capital. To the extent that excesses are being squeezed out it is healthy, but it is uncomfortable to see the stresses revealed, and fears have risen that the economy may be heading into recession. Another marked difference to 2008, is that today inflation is much higher, at a time when global debt has vastly increased. This debt is predicted to rise further because of increasing defence budgets, and costs associated with relocating supply chains from Asia, and the green transition. On top of that there is now a war, which threatens supply shocks from Russia and China.

The course of inflation will be the critical determinant of markets for the next year. Inflation has changed from being generated by bottle necks caused by the pandemic to being driven by wage growth. If the economy is headed for recession then it is a highly unusual one given the strength of the labour market. But inflation has also been stimulated by a relative lack of capital expenditure. Apart from technology it is difficult to find spending excesses in any sector. In fact, much of the capital expenditure that has taken place has been connected to improvements in environmental standards rather than to increase capacity. Most of all inflation has been generated by the astounding fiscal and monetary stimuli that arose in response to the Covid pandemic. As some of this stimulus wears off inflation is expected to reduce, but the number of strikes and union demands on wages show that wage pressures remain powerful. Many workers have suffered falling real wages over a period of twenty years largely as a result of China entering the WTO. This with inflation bounding upwards means there is plenty of scope for wage pressures to continue. Meanwhile a helpful factor in inflation is that the warm winter has contained energy prices. Europe and the UK spent three times on energy in 2022 compared to 2020, including $780 billion of subsidies. Oil supply and demand is roughly in balance at present, but if demand rises or supply falls for any reason then energy prices could take off adding further to inflationary pressures. Something that illustrates this and shows the impossible position that energy companies find themselves in is encapsulated by being told by President Biden to increase production to ease the pressure on energy prices, whilst simultaneously being criticised for not curbing production for environmental reasons. How inflation evolves from here will have a significant impact on markets.

Higher inflation will reduce the value of bonds and growth stocks. If interest rates rise it will make servicing debt harder which will affect highly indebted entities. A Deutsche Bank research estimated that 20% of US companies have debt servicing costs higher than their profits in 2022. The vast injections of cash into the system during Covid and low interest rates allowed more competition in many sectors, but this is starting to reverse. This will help profits for the survivors. Less fashionable 'old world' stocks have been shunned over the last decade and have been forced to operate conservatively. This sets them up for a period of excess returns. There have been significant rationalisation in many industries, for example, European short haul flights capacity is down 10% since Covid and is now witnessing strong pent up demand as people are able to travel again. The US has dominated returns over the past decade but this may be changing. Much is made of the slowdown in China's growth but their economy was $5 trillion in 2008 and now it is $18 trillion. A 3% growth rate creates the same GDP expansion that 10% growth created then. The MSCI Asean index has fallen by a quarter over the last decade, despite the fact that many countries in the region, such as Indonesia, Vietnam, and the Philippines have grown at an average rate of 5% per year. As a result, there are some very cheap valuations there and in Hong Kong. One of the best positioned markets is Japan. Shareholder returns have reached new highs thanks to ongoing cost-cutting and an emphasis on profitability and cashflow improvements. Activism and Private Equity related deals have reached new highs. There is a collective effort and sense of urgency to improve shareholder returns. This pressure is coming from the Tokyo Stock Exchange and domestic asset managers, as part of the government effort to improve stock market returns for the ageing population. Valuations are low, companies have strong balance sheets so benefit from higher interest rates, and foreign investor positioning is low. Japanese real wages have been flat for three decades. At today's exchange rate Japanese workers in all sectors are chronically underpaid relative to their G7 counterparts. A permanent increase in wages would boost consumer confidence, domestic consumption and credit growth.

Another feature of the quarter was the emergence of AI (Artificial Intelligence) into the mainstream in the shape of Chat GPT from Microsoft and then Bard from Google. AI is simply advanced computing. The concept has been around for some time (Elon Musk was a co-founder of the parent company of ChatGPT) but it is now showing results, and significant efficiencies. Computer programs that used to take two weeks are being completed in two hours. Other applications include real-time translation, drug development, and controlling power grids to aid more efficient energy consumption. These efficiencies will create more profit. In the next couple of decades AI will become as powerful as the internet. Not having it will be the same as a business not having a website today. It will be a platform change in the economy and the ripple effect will create multiple opportunities. The question will be which companies will benefit and which will suffer. Goldman Sachs have estimated that three hundred million jobs may go as a result of AI. A working man is paid for cleaning a room, but he will no longer pay for having his Will written if he can get it for free. Capital has always kept labour suppressed, but now, for the first time, white collar workers are threatened. Only specialist workers will be protected.

The restless action of the market is indicative of the changes underway. There is a lot of uncertainty, but it is clear that the bacchanalia of 2020-21 is over. Companies without profits or weak business models or balance sheets will find life far tougher in this higher interest rate environment. For the strong companies a 5% interest rate regime may prove better than the 1% one that has endured for so long, as a lot of competition will be removed. The dislocations created by inflation and new technologies will make for great medium and long term investment opportunities for those who can withstand the volatility. In the short term much will be depend on inflation, and particularly on energy prices. Fossil fuels are so pervasive in the economy that another price surge would be damaging. With regard to currencies there are signs that the difference of growth between the US and the other major economies may be narrowing. Together with the US banking issues that may well mean that the exceptional strength of the US dollar will lessen.