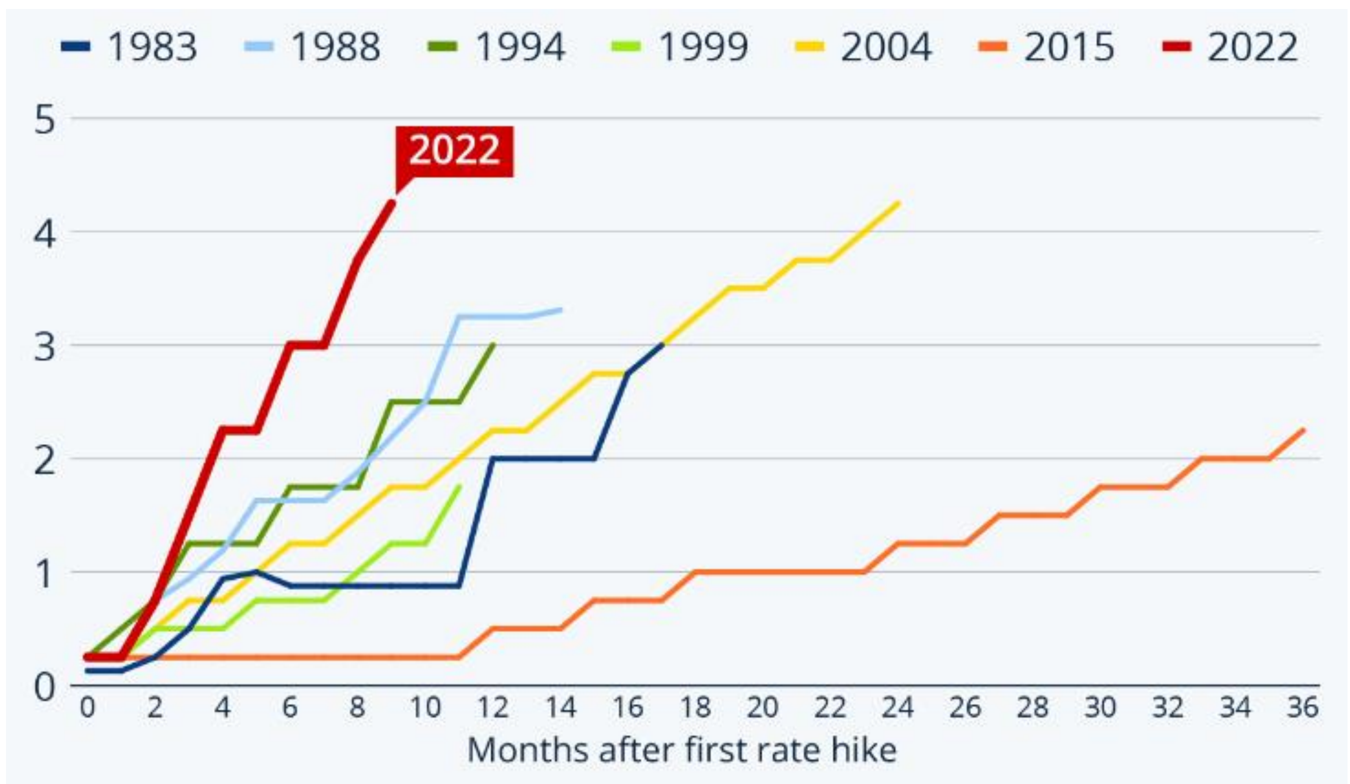
Shard Capital

QUARTERLY INSIGHTS – Q1 2023

Given that for the best part of 14 years investors had effectively had their “hands held” by central banks, it is understandable that the events of 2022 should have affected confidence quite so badly. Coming off very extreme valuation levels both bonds and equities were clearly ripe for a correction, and 2022 duly obliged.

But humans, being the emotional creatures that we are, tend to see the start of a New Year as a “good” reason (excuse) to be optimistic and any number of narratives are usually put forward to help justify this more positive outlook. This year the bullish narrative was predicated on the argument that, having raised interest rates during 2022 at the fastest pace in recent history (see below), the Federal Reserve in the US was therefore most probably close to ending this cycle of rate rises and might even start cutting rates by year end. Investors persuaded themselves that this prognosis was very credible and as a result January saw a very sharp rally in most risk assets, with those shares/sectors which had suffered most in 2022 being those that benefited most during the first few weeks.



Source: *Federal Reserve*

However, sentiment is an inevitably fickle companion and so it proved to be by February where it only took a couple of economic indicators to be released which suggested that inflationary pressures were not abating as quickly as wished for, together with an increasingly hawkish rhetoric from the Fed, to cause investors to quickly move from a "the Fed will pivot soon" narrative to a "the Fed will keep rates higher for longer" narrative !

As a result, February saw a very broad sell-off as investors began to react to US Treasury yields that rose sharply over the month, in one of the most dramatic moves seen in recent years.

US Treasuries Volatility at Short End

Source: *Bloomberg*

This new, more pragmatic outlook, which saw interest rates moving higher than had originally been anticipated, seemed to have established itself as the preferred narrative as we headed into March, but, as so often happens, the thesis of "higher rates for longer but with only a mild recession at the end", was turned abruptly on its head by an event which occurred on the 6th March which very quickly threw the entire outlook for the year into a sharply new perspective.

Silicon Valley Bank (SVB) focused, as the name suggests, on providing banking services to the Technology industry that had grown up in Northern California over the preceding 40 years, (the bank was established in October 1983). It had a particular reputation for helping early-stage start-up companies in the sector. Over the years, along with the tech industry generally, the bank prospered. Its demise came, not from injudicious lending, but rather (very ironically) from taking client deposits (mainly short-term in nature) and effectively lending these deposits to the US Government (through exposure to long-term US Treasury and Agency Bonds). So, it was not credit risk that did for SVB, but rather interest rate risk (duration).

As the Fed raised rates very sharply (as noted above) so the value of the bonds SVB had invested in fell sharply as a result, creating mark-to-market losses on these bonds. Ordinarily that would not have been a problem, but as the impact of higher interest rates began to be felt within the broader US economy, so many of the tech companies started asking for their deposits back in order to finance day-to-day operations. As withdrawals mounted so SVB was forced to sell US Treasury bonds (at a loss) to meet demands for cash. As losses mounted so the bank decided to try and raise capital through a rights issue........and that's when confidence in the bank began to fade very quickly. These days, in an era where electronic banking, with associated Apps, gives clients instant access to their money it takes, literally, only minutes to withdraw funds from banks, thus making the risk of bank-runs much more systemically dangerous than they have ever been before.

The upshot of this very 21st Century "bank run" was that the Treasury and FDIC were forced to step-in and effectively close SVB (whilst guaranteeing all depositors). Despite their swift action (some might even say because of it) confidence in smaller regional banks in the US has been significantly affected and over the week ending 15th March up to $119 Billion of deposits moved out of smaller regional banks, with the bulk of this money going into either Money Market funds and/or much larger, systemically important, banks like JP Morgan or Citigroup.

In Europe confidence was likewise impacted by the eventual failure of Credit Suisse which was effectively forced into the arms of UBS, due to its inability to raise required funding to remain solvent.

As a result of the foregoing, the swings in sentiment witnessed during Q1 have been, to put it mildly, dramatic. The S&P500 rose 10% over a four week period from January to February, then promptly fell 7.8% from Feb to mid-March, before rallying towards month-end to finish the Quarter up 7% in aggregate.......quite a ride......but nothing compared to the volatility in the bond markets where the yield on 2 Year US Treasuries (bearing in mind this is meant to be a low risk part of the bond curve) rose 24% from mid-January to early March (from 4.08% to 5.07%) when yields dropped dramatically post SVB from 5.07% to 3.89% in the space of 6 days, before stabilising by month end at a yield of 4.02%. As we said, that is quite some volatility in what is generally seen as a "low risk" investment!

As the chart below shows the best performance over the Quarter was seen in asset classes that did worst in 2022, (Bitcoin was down 64% and the Nasdaq fell 33% in 2022), whereas conversely those that did well in 2022 (the Bloomberg Commodity Index rose 13.6%) saw losses over Q1.

Source: *Bloomberg*

Looking ahead for 2023

The extraordinary moves seen at the short end of the US Treasury curve are very relevant in shaping our outlook for the year ahead, as they vividly reflect the extreme dispersion in investor sentiment as regards the likely trajectory for the Federal Reserve's interest rates policy for the rest of 2023, and therefore, by extension, the likely trajectory for the US economy for the year as well. Investors are becoming increasingly aware of the "Trilemma" the Fed now faces as it tries to <u>simultaneously</u> reconcile three seemingly contradictory problems namely, how do they: tackle persistently inflationary pressures, whilst stabilising the banking system, without at the same time causing a sharp recession in the US. The answer to this very real conundrum will decide how the US economy, and therefore markets, are likely to fare over the rest of this year.

Some significant observations

- The collapse of SVB and related impact on confidence in regional banks is a major game changer for the US economy and therefore for markets
- Deposits draining from regional banks together with tighter lending standards will likely see reduced levels of lending to small and mid-cap businesses
- According to the Small Business Association (SBA) between 1995 and 2020 small businesses accounted for 62% of all jobs in the US
- The same report found that small businesses account for about 44% of US GDP
- Despite the foregoing the Fed has publicly stated that getting inflation under control is of greater importance than avoiding a recession
- As we have already begun to see, in a grossly leveraged world higher interest rates inevitably expose weaker businesses
- If the Fed is true to its word, then it is likely that the US will experience a more protracted recession than is currently being priced in by equity markets
- Two "systems" at the heart of all economies namely, Banking and Fiat Currency, both rely on **Confidence** to prosper. Over the last few years Confidence is one thing that has become increasingly short in supply.
- When **Confidence** is in short supply is when **Gold** (and now its digital cousin Bitcoin) both thrive.
- For now, confidence in the US$ remains reasonably well supported, but we are increasingly looking to reduce exposure as the Fed nears the end of this interest rate tightening cycle
- Central banks and politicians have managed to shore up confidence in both the banking system and fiat currencies, but investors know that with fiscal stimulus effectively off the table the only option open to them in the event of any future crises is effectively <u>more</u> money printing. As with any government that prints excessively……at some point investor patience and confidence are both exhausted.
- We therefore continue to favour more defensive positioning with overweight exposure to Gold
- That said, with risk aversion currently so high and with correspondingly high levels of cash in portfolios, we recognise that it would not take much in the way of positive news to see risk assets rally sharply
- Any hint from the Fed that they are at or close to terminal rates of interest will therefore likely lead to a short-term rally in risk assets, which we believe should be seen as an opportunity to further reduce risk exposure.
- These same essential issues also face the EU and UK, namely trying to get inflation under control without damaging the banking system and/or causing a recession. Unfortunately, they both also only have limited and blunt tools to try and tackle these issues.

The situation which confronts the Fed, and many of the other major central banks in the world, is unprecedented. This is because monetary policies that took interest rates to the lowest level ever experienced in history were always bound to encourage the recklessly excessive use of leverage to either finance consumption and/or just to speculate. For the best part of 15 years negative real rates of interest effectively forced investors to take more and more risk or suffer financial repression by seeing cash deposits eroded by inflation (small though it might have been) in real terms.

Central bank monetary "policies" seemed to have been predicated on the illogical and dangerous assumption that interest rates would never have to rise again.......otherwise how did they think that a whole generation addicted to free money would be able to cope when the "free money tree" was eventually cut down ?

As has been well documented the twin effects of the Covid re-opening and the Russian invasion of Ukraine unleashed an inflationary shock on the world that would have been hard to handle even if interest rates had been anywhere close to normalised, but with interest rates at all-time lows central banks were forced to raise interest rates at the fastest pace seen for over fifty years.......forced upon a global economy that had never been so deeply indebted.

Again, you don't need to be an economics professor to work out that in that situation something is very likely to break.

The analogy has been used many times before, but that does not make it any less relevant today. What we are effectively facing today are economies that are so highly addicted to low interest rates that attempting to get them to "kick the habit" risks some very harmful withdrawal symptoms and economic damage. Handling this process would be tough enough under "normal" geopolitical conditions, but with geopolitical tensions currently high, this will make the task of weaning the patient(s) back to health so much harder.

Since the end of World War Two the world has evolved under the hegemonic supervision of the USA which has been, and still remains, the pre-eminent military and economic global superpower. Over this period the supremacy of the US$ as the global reserve currency has not been questioned, and the fact that oil (and all other commodities) are priced by reference to the US$ is what caused the French famously described this state of affairs as an "exorbitant privilege" enjoyed by the US.

But things are changing. Slowly, sometimes imperceptibly, but changing nonetheless. Partly this is as a response to the USA's practice of (increasingly) weaponizing the US$, a short-sighted and ultimately counterproductive policy, but also partly in response to a natural reassessment of the international order.

China has always played a "long game". Starting with Deng Xiaoping's reforms starting in the late 70's China's path to prosperity has been remarkable. Their admittance to the WTO in 2001 accelerated the drive for economic reform and expansion and it is calculated that over the last 40 years over 770 million Chinese citizens have been lifted out of poverty, taking China from an essentially agrarian economy (which still could not feed all its citizens) to an industrial powerhouse in record time.

With increased economic power comes increased military power and it was always inevitable that, at some stage, China would begin to challenge America's economic and military supremacy more actively. That time is now upon us. Taking advantage of the increased hostility between the US and Russia as a result of the war in Ukraine, and also in order to try and get more economies and commodities away from relying solely on the US$ for trade, China has been steadily building a new trade "block" or alliance with Russia, India, Pakistan, four central Asian nations and now, very importantly, with Saudi Arabia, which has recently been admitted to the Shanghai Cooperation Organisation (SCO) as a dialogue partner, with a view to joining as a full member in due course.

An immediate example of the economic and political shift towards China is the recent news that OPEC is to cut back on oil production by 1 million barrels a day until the end of the year. It is

probably no coincidence that it follows so closely upon President Xi's recent visit to Saudi Arabia. At a time when the West is desperately trying to get inflation back under control (and with President Biden due to contest an election next year) this highly political move is clear evidence of the increasing divide between "east and west" as attitudes harden, and countries increasingly begin to "take sides".

These may be early days, and the US$ is under no immediate threat of losing its reserve currency status, but the direction of travel is clear and inexorable. Already China and Saudi Arabia have traded and settled oil purchases in Chinese Renminbi and more commodities are being discussed for future trading and settling "off the US$ standard".

At this stage it is worth briefly mentioning Japan and the very large surplus in Net Foreign Assets which the country runs. Japanese investors have, for a very long time, effectively helped finance deficits for countries in the West, most particularly the US. This has meant that whenever market stresses appeared Japanese investors (quite reasonably) repatriated their money back to Japan. This meant (means) that the Yen has always been seen as a "risk-off" currency during times of market dislocation. Over recent years the policy adopted by the BOJ and MOF to peg 10 Year JGB yields close to zero has led to more prolonged Yen weakness, but as inflation slowly returns to Japan (finally) so the pressure grows to either abandon the policy of targeting specific yields on 10 Year JGB or at least widen the band considerably. In either situation the Yen would likely move swiftly higher. We therefore believe that the Yen currently offers cheap optionality as form of hedge within portfolios in the event that market stresses do indeed rise later this year.

JPY vs USD

Source: *Bloomberg*

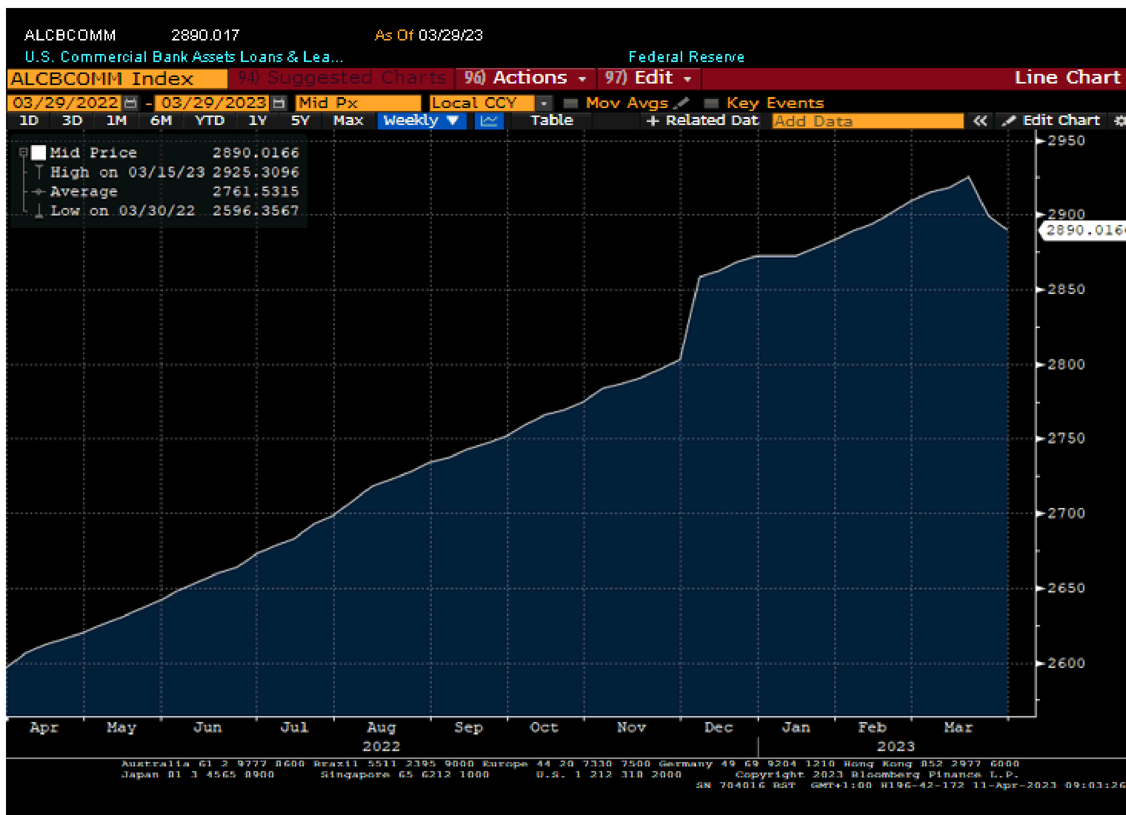
But back to the Fed and the outlook for interest rates in the US.

Given that the Fed has frequently stated that fighting inflation is its primary "mission", the news that OPEC is going to cut back on Oil production is not exactly what they were hoping to hear, and is therefore likely to prove yet another reason for the Fed to maintain its hawkish attitude towards rates over the next couple of months, whilst it collates and aggregates the myriad economic inputs that will help it determine how effective their policies have been so far in achieving the "price stability" part of their mandate.

The elections in 2024 are also likely to be of relevance to the Fed though in fairness unlikely to be a huge influence at this stage. Their main concern will be to try and avoid accusations from either party that they, in some way, influenced the outcome. To that end it will be in their interest to "front-load" rate rises now so that they have room to start easing sooner rather than later. This thinking favours the Fed hiking by another 25bps (probably for the last time in this cycle) at the FOMC meeting on the 3rd May, taking Fed Funds rate to 5% / 5.25% range.

Whilst coming from a different base and facing different challenges it is worth noting that 5.25% was where the Fed got to in June 2006 and which was enough to negatively impact US house prices such that sub-prime and Alt-A mortgages began to quickly lose value, eventually impacting a couple of hedge funds in July 2007. In broad terms this in turn started the dominoes falling culminating with the Lehman default in September 2008.

The point is these things take time to unravel. The Fed are clearly aware of the lagged effect of interest rates, and this is likely to steer them on the side of caution after the May meeting. Having started lifting rates in March last year (0.25% up to 0.50%) and having reached 5% at the March meeting this year it is likely that at this stage the sharp rise in rates will begin to prove challenging for many high yield or leveraged loans that will be coming due for refixing over the summer months, particularly in the area of Commercial Property where there is quite high exposure at smaller regional US banks.



Source: *Blooberg*

We mentioned above that the collapse of SVB (and Signature) bank was likely to be a "game changer" for the small and mid-cap sector of the US. This is not because the banks actually failed but rather because of the way they failed. These bank failures highlighted the dramatic effect which technological advances have had on the banking industry.

Without dissecting the "modus operandi" of Fractional Reserve Banking (FRB) in any detail, the critical point is that if, with the technology we have today, depositors can remove their money from a bank in a matter of minutes (if not seconds), then the whole basis of confidence which underpins how FRB works and which is essential in order to ensure the proper functioning of any bank , is rendered instantly obsolete and instead becomes the Achilles Heel of the whole system…….not something we have ever had to face before but which goes to the very heart of how our global financial system works.

Whilst in theory at least all banks should be equal, the truth is that larger banks are inevitably more equal than others. This is not only because they have a much more broadly diversified depositor base but also because of the not insignificant fact that they are SIFI (Systemically Important Financial Institutions), and therefore deemed "too big to fail".

If money is seen as the "blood" which carries much needed oxygen through the financial system, and banks are seen as the heart(s) that pumps this money through the system then, following the SVB debacle, it must be prudent to operate on the basis that from now on the risk of myocardial infarctions for smaller banks is much more probable than it was before……..and let's not forget these are the banks that provide such critical support to "Middle America"…….or used to anyway……

How this story evolves is anyone's guess, but it is certainly clear that the way banks operate and are regulated in the future, how we interact with them and the concept of free banking, will all likely have to be seriously reconsidered. The Pandora's Box of FRB has now been opened and it will be impossible to assume that banking can ever operate as it previously did given the shocking evidence we now have as to the extremely fragile nature of deposit bases at these institutions.

What does this mean for portfolios?

As we mentioned we have been cautiously positioned for some time given that we know that during a period when central banks are raising interest rates it takes time for these effects to work through the system and for "cracks" to begin to appear. The first of those cracks has dramatically appeared and so now it is a case of waiting for further evidence to emerge as to where the excessive use of leverage was most egregious…….it was ever thus.

Many sectors and businesses have already been marked down sharply in anticipation of the inevitable day of reckoning finally arriving. These include but are not restricted to: Private Equity, Venture Capital, Commercial Property and Investment Trusts. The "good" news is that very often during periods of market stress and dislocation, in a general rush for the exits, many assets become quite clearly oversold and so it pays to hold cash and or near cash within portfolios in order to be able to profit from these opportunities as and when they arise.

This approach requires patience because the exact timing of these events is, by definition, impossible to predict precisely and as a result "performance drag" often occurs. For those that judge performance on a monthly or quarterly basis this can be frustrating, but when assessing performance over a longer time frame patience is most usually rewarded.

As an example of our current thinking / positioning across all our risk models we have a significant allocation to Alternatives and within this, reflecting our comments above, we have significant weighting to Gold, alongside other positions which further help to decorrelate risks within portfolios. In Fixed Income our entire allocation is to Government Bonds, be they Developed Markets or Emerging Markets as, at present, we don't believe spreads on Corporate Credit compensate

adequately for the increasing recession and potential systemic risks we see on the horizon. Within our Equities allocation we have an overweight exposure (directly or indirectly) to China as we feel it is one of the few major markets which is priced reasonably at present and where both the central bank and the Government have begun to indicate that they are willing to ensure that the economy is offered adequate assistance as the country opens-up from the Covid lockdown.

In summary we think that, in general, markets have probably got slightly ahead of themselves as we enter the second quarter, but recognise that this misplaced optimism may endure for longer than might be advisable given the high levels of cash held by investors and which we referred to earlier.

CONTACT US

For further information on any of our services, or if you would like to arrange a meeting with an investment manager to see how we can work with you, please get in touch.

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