WATTERSON
FINANCIAL PLANNING

Market Update

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SQUARE MILE
INVESTMENT SERVICES

Macro Backdrop

The balancing act being performed by central banks between taming inflation and avoiding recession got even harder in March as a new fault line emerged in the banking sector. The crises at Silicon Valley Bank and Credit Suisse were idiosyncratic and largely self-inflicted – the former had been without a Chief Risk Officer for most of 2022 whilst pursuing a highly risky investment strategy and the latter had lurched from one well-publicised disaster or scandal to another in recent years. Bank runs occur when depositors lose confidence that their money is safe. However, the banking system as a whole is substantially more robust than it was before 2008's financial crisis.

Thanks to a mild winter and tumbling gas prices, easing of supply chain pressures and year-on-year base effects, we expect headline rates of inflation to continue to decline. Despite February's unexpected blip, Prime Minister Sunak's pledge to halve the inflation rate by the end of 2023 is still very achievable. 'Core' inflation, though, which excludes energy and food, is proving much stickier. In the US, the headline inflation rate has dropped from a peak of 9.1% in June last year to 6.0% but core inflation has fallen only from 5.9% to 5.5%.

This is in no small part because labour markets, consumer spending and economic growth have so far remained surprisingly resilient even as interest rates have soared from 0.1% to 4.25% in the UK and from 0.25% to 5% in the US in little more than a year. Unemployment rates continue to be close to 50-year lows in both the UK and the US. Wage growth, though, in real (after inflation) terms is currently still negative and this is prolonging the cost-of-living squeeze.

It is almost inevitable that there will be further casualties as a result of the abrupt withdrawal of the punchbowl of abundant and ultra-cheap debt from which governments, companies and investors had been binging for more than a decade. We can only speculate as to where the next fracture might occur, but central banks might be forced to put financial and economic stability first and let up in their fight to crush inflation.

Bond Markets

After a torrid 2022, bond markets delivered welcome gains to investors in the first quarter of 2023, but only after subjecting them to another white-knuckle rollercoaster ride. Up by almost 5% at the beginning of February, the UK government gilt market (excluding index-linked gilts) slumped to be down by 1.5% a month later before rallying strongly to finish the quarter with a gain of just over 2%.

During January bond markets powered ahead as falling inflation stoked optimism that peaks in interest rates would be lower than previously thought and that an economic 'soft landing' could be achieved. However, a blockbuster US jobs report in February coupled with stronger-than-expected economic data and fresh warnings from central banks that the battle against inflation had not yet been won reversed all of January's gains and more. Bond markets rallied once again, though, in March as the failure of several banks rekindled fears of recession due to tighter credit conditions. This revived hopes that central banks would be cutting interest rates before the end of the year.

The outlook for bond markets looks finely balanced. If recent problems in the banking sector are a cause or precursor of economic troubles ahead, then bond yields could fall (and bond prices therefore rise) further. If, however, the financial squall blows over and the narrative returns to the fight against inflation then bond yields might be too low and prices vulnerable to a setback. Compared to a year ago, though, investors in bonds are now at least being paid a reasonable rate of return just to own them.

Equity Markets

Mirroring the performance of bonds and for the same reasons, stock markets got off to a barnstorming start to the year, global stock market indices rising in January by more than 6% and the UK market up by 4.5%. In February, rising bond yields presented a headwind for growth stocks (and therefore US shares in particular) but the more 'old economy' UK stock market inched higher.

All major stock markets, though, fell sharply at the beginning of March as the failure of Silicon Valley Bank and rescue of Credit Suisse evoked memories of 2008, prompting a wave of risk aversion amongst investors. With its heavy weighting in banks, returns from the UK equity market at its low point were negative year-to-date. However, swift action by the authorities and the absence of contagion meant that investor confidence was quickly restored. Over the quarter as a whole, global equities were up by more than 7% in local currency terms and UK equities by just over 3%.

Although the immediate danger to financial stability seems to have been contained, we expect volatility to be an ongoing feature of stock markets in 2023. The battle between inflation and economic growth is ongoing and, although share valuations are generally much lower than they were, they are still not compellingly cheap. The outlook for corporate profits also remains uncertain. As we noted three months ago, though, it is quite possible for corporate profits to grow in a recession. This is because economic growth is measured in real terms after inflation but corporate profits can be boosted by inflation if margins are maintained.

We expect stock selection to be important in 2023. Companies most at risk are those which will need to refinance high levels of debt on their balance sheets. In contrast, companies with dominant market positions, and hence pricing power, are best placed not only to raise prices at least in line with inflation but also to weather any forthcoming economic downturn. We continue to emphasise both characteristics in portfolios which use actively managed funds.

Currencies

Compared to bonds and stocks, currency markets were relatively calm in the first quarter of 2023. Sterling was the strongest major currency, appreciating by almost 3% against the dollar and by just under 1% against the euro. In times of crisis money floods usually into the dollar. The weaker trend in the US currency so far in 2023 therefore suggests that investors remain fairly sanguine about the overall backdrop and are not fearful that recent stresses in the banking sector are set to snowball. As a reminder, exposure to foreign currencies in the portfolios we manage comes mainly from investments in overseas equity markets. Foreign currency exposure in the bond funds we use is generally hedged back into sterling.

Alternative Investments

Gold also followed the track in bond markets (the metal performs best when interest rates in real terms are falling) and benefited additionally from its safe haven status as confidence in banks was jolted. Over the quarter, the price of gold was up by almost 8% in US dollars and by 5% in sterling terms. The problems in the banking sector unsurprisingly also sparked a renewed flurry of interest in cryptocurrencies, the price of bitcoin rising by a staggering 72% in dollar terms in the first three months of 2023. Despite this gain, bitcoin is still almost 60% below its November 2021 peak. Given the lack of regulation, cryptocurrencies remain a speculative asset class which is unsuitable for use in the portfolios we manage. Yet another quarter has passed without the FCA pronouncing how it will resolve the mismatches in both the liquidity and the valuation frequency of daily dealing funds and the bricks-and-mortar properties in which they invest. The daily dealing UK property fund sector therefore remains in limbo.

As always, funds in the absolute return sector produced a wide range of returns ranging from a gain of almost 8% to a loss of nearly 6% in the quarter. This only underlines the disparate range of strategies, objectives and risk profiles in the sector. In 2022, returns ranged from +30% to -20%! Despite higher yields making bonds more attractive than they were, we continue to believe that absolute return funds can provide an uncorrelated stream of returns and therefore have an important role to play in diversified portfolios which use actively managed funds. The selection and combination of complementary funds, though, is critical to success in any allocation to the sector.

All data has been sourced from FE fundinfo, Refinitiv and Square Mile.

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