INVESTMENT UPDATE & OUTLOOK

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PPM Investment Update & Outlook

Developed stock markets had a robust rally in January, but most of their year-to-date gains have been erased due to a resurgence in recession fears and anxieties surrounding the stability of the financial system after the collapse of certain regional U.S. banks. There were huge market swings in the US banking sector during Q1 that showed similarities to 2008 and led to parts of the yield curve to invert as increased volatility led to outflows until some clarity emerged. The Fed and FDIC took quick action to avoid contagion and market panic and thereby prevented a potentially sharp slowing of the US economy. February and March saw some market weakness due to the strength of employment in the US and sticky inflation data. The Nasdaq did, however, post its best start in over 20 years, showing that investors have seen the easing of the Fed rhetoric as a positive sign after recent market events. Overall, a good start to the year thus far despite having seen a run on some US banks, a forced bank merger in Europe and a rapid rise in interest rates.

Figure 1 - Source Bloomberg. March 2023

During Q1, the S&P rose 7.5%, with inflows into technology stocks, moderating inflation expectations, and a repricing of rate rises, indicating that we may be closer to the end of the hiking cycle, leading to a rotation back into growth. The outperformance of the top 10 names in the S&P gave investors comfort that sentiment towards the technology sector is still bullish and inflows back into the US mega caps meant they were the outperformers during Q1.
On the other hand, value names in Q1 underperformed versus tech/growth due to the weakness in regional bank losses within their fixed income portfolios but the Nasdaq has now rallied over 20% off the low, a technical signal for a bull market, but we are now waiting for the earnings cycle to confirm this.

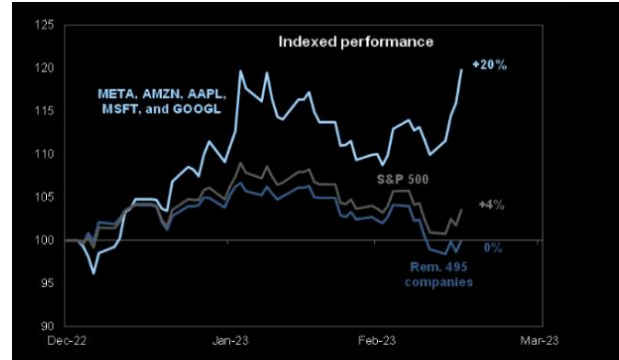

Figure 2- Source Refinitiv. March 2023

As mentioned above the rally in the US large caps means that the 40 companies in the Dax combined are worth less than Apple or Microsoft, and only slightly more than Google parent Alphabet.

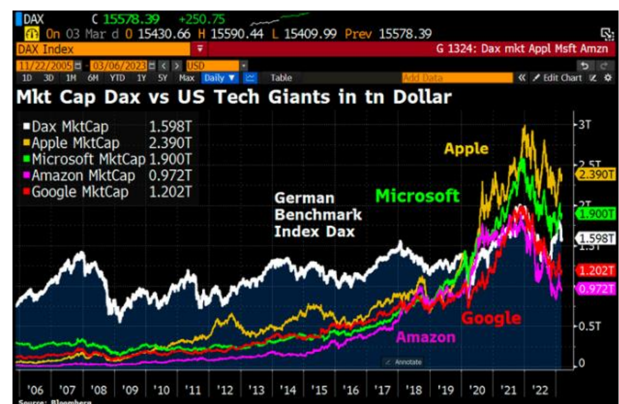

Figure 3 - Source Bloomberg. March 2023

The FTSE was flat during this quarter, having reached a new all-time high in February – led by significant inflows, M&A and the commodity recovery on a China reopening. Other indices also had a strong finish to Q1- the MSCI World Index +7.88%, Nasdaq 16.8% (a reverse of last year when growth underperformed value), Dax +12.25% & CAC +13.11%. European markets recovered as energy prices eased, China reopening taking shape and economic data surprising to the upside. Overall equity markets were pleased to see inflation moderating, weaker dollar, supply chains reopening, strong labour market, low expectations for corporate earnings and positive economic data.

Figure 4 - Source Bloomberg. March 2023

The overall market rally between mid-October and February has raised questions about whether the economy is still in a recessionary state and if this trajectory can be sustained. The rally can be attributed to three main factors: the reopening of China's economy after the COVID pandemic, Europe's relief from high energy prices, and the conversion of order backlogs into economic activity as supply chains operate more smoothly. While the economy has grown, the underlying demand has weakened, resulting in an estimated increase in the US GDP from a negative 2% rate in mid-2022 to a positive 2.5% rate in Q1 2023.

Despite recent market declines, current valuations suggest that investors still believe an economic "hard landing" can be averted, if the Federal Reserve and other central banks continue to implement a monetary policy that strikes the right balance. Before the recent instability in the banking sector, inflation was the main concern for both central banks and markets. However, the recent market volatility may cause policymakers to choose a more cautious approach to interest rate increases than they would have based solely on recent data showing strong consumption and persistent price pressures.

Figure 5 - Source Refinitiv. March 2023

Certain parts of the market have relied on low rates for too long and are now having to adapt to the new norm and preserve cashflow, deal with the spike in the cost of borrowing and manage duration risk – all of which have brough a significant rerating to many sectors and erosion of lofty premium valuations. With a sharp rise in interest rates and a shrinking of central bank balance sheets, the surging tide of global liquidity that has inundated the financial system for much of the past decade is now receding. This will prove to be a challenging time for those who have overextended themselves with excessive leverage, over-reliance on cheap and easy liquidity, and over-exposure to duration in its broadest sense.

Some business models will no longer be viable, particularly those with scant cash flow generation and an overabundance of promises of future returns. Since the zenith of equity markets in 2021, valuations for these companies have plummeted, leading to some notable failures. We have already witnessed a bank run in the United States, along with the collapse of three medium-sized banks that were closely tied to more speculative parts of the economy. With some valuations having been adjusted over 60% downwards it has led to some significant value opportunities.

Q1 reporting consensus expectations have been scaled back significantly over the last few months, meaning that scope for upside surprises should be higher given the low hurdle rate. With some US large caps such as Apple (AAPL) and Amazon (AMZN) up more than 20%. Tesla (TSLA) and Meta Platforms (META) have gained more than 60% in 2023 means they were seen as a defensive buy this quarter. For the S&P, earnings estimates have been scaled back from +7% year on year (yoy) to -7% yoy and in Europe yoy growth expectations stand at -9%. Even in the US and Europe median stock earnings per share (EPS) growth projection are below 0 – allowing some buffer when the earnings season starts.

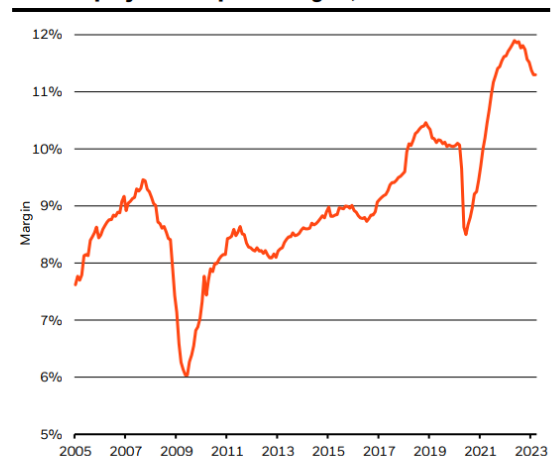

Figure 6- Source Blackrock. March 2023

We think it's important to explain the issues with the banking sector in the US & the UBS / CS forced merger

as it has a wider implication for Central Bank action and market stability. Both led to some weakness and a wider spill into other asset classes, but this was short-lived as the Fed and other banks added immediate liquidity to ensure there was not mass panic and widespread selling. Although there was a quick policy reaction to avoid contagion from the failure of SVB and Signature Bank, it was still the second and third-largest commercial bank failure in US history.

A multitude of factors contributed to the downfall of SVB. The majority of SVB's customers were technology and venture capital (VC) firms (growth names). To attract new clients, SVB provided comparatively higher deposit rates than many larger peers. To finance these higher rates, SVB invested in longer-term, higher-yield bonds when it had excess cash. However, this strategy was not hedged (a classic asset liability mismatch – triggered by an increase in rates and leverage) and, when the Federal Reserve began raising interest rates aggressively, the VC market experienced significant volatility. The value of many of the bonds that SVB had purchased declined significantly (bond values typically decrease as interest rates rise), resulting in substantial investment losses- which led the bank to announce it lost $1.8 billion in asset sales, then trying to raise capital leading to a 60% fall in the share price resulting in the FDIC putting the bank into receivership. On March 27th, it was announced that First Citizens Bank would acquire SVB from the FDIC. The Fed & FDIC designated SVB as a systemic risk to the financial system and reassured customers that their deposits were secure. The spike in volatility in bond markets was severe, and the yields on the 2-year UST dropped 102 basis points in the days after the closure. Furthermore, the Federal Reserve implemented the Bank Term Funding Program (BTFP), which acted as a source of liquidity to enable other banks to meet deposit outflows without having to sell securities at a loss, thus preventing similar liquidity crises from occurring.

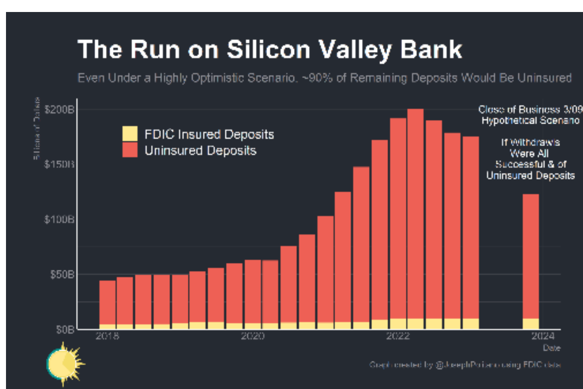

Figure 7- Source Apricitas Economics. March 2023

In Europe, Credit Suisse's, one of the 30 so-called Global Systemically Important Banks (G-SIB), decline was not unexpected given the challenges the bank had been facing, including operating losses, management changes, accounting irregularities, and asset outflows. The recent scandals involving Archegos Capital and Greenhill Capital added to the bank's troubles, resulting in significant regulatory fines and a sharp rise in credit default swap (CDS) prices over a year ago. When Credit Suisse failed to secure enough support from its largest shareholder, the Saudis, UBS stepped in and announced its acquisition of the bank, with support from the Swiss National Bank. As part of the deal, the bank's riskiest bonds, known as AT1s, were completely written off, placing them below common equity on the credit hierarchy. But what was more interesting was the adjustment of the capital stack – the forced merger of UBS and Credit Suisse raised concerns about the legality of the creditor hierarchy. The Swiss National Bank's (SNB) deviation from Basel III conventions, prioritising common equity holders over AT1 bondholders, caused investors to worry that other European banks might adopt a similar strategy. To prevent a widespread selloff, regulators in the UK and Europe quickly moved to reaffirm the seniority of AT1 bonds over common equity but the $260bn AT1 market suffered huge losses and a liquidity freeze.

Had Credit Suisse not been sold to UBS, it would have gone bankrupt next trading day, causing global a financial crisis, SNB's Schlegel said. With the merger agreed upon – "best among bad solutions"– financial stability concerns won't keep SNB from raising interest rates.

Figure 8 - Source Bloomberg. March 2023

Despite these challenges, we anticipate that European equities will perform well due to their exposure to China's fast-growing economy, drop in energy prices and attractive valuations. In addition, we see potential buying opportunities in sectors with low valuations and positive correlations with interest

rates, such as energy and materials, as well as small-cap stocks.

There is still some political risk attached as Macron urged European strategic autonomy amid US-China tension: emphasising the need for Europe to develop capabilities that would enable EU to become world's 3rd superpower. The greatest risk, Macron said, is that Europe gets caught up in crises that are not ours.

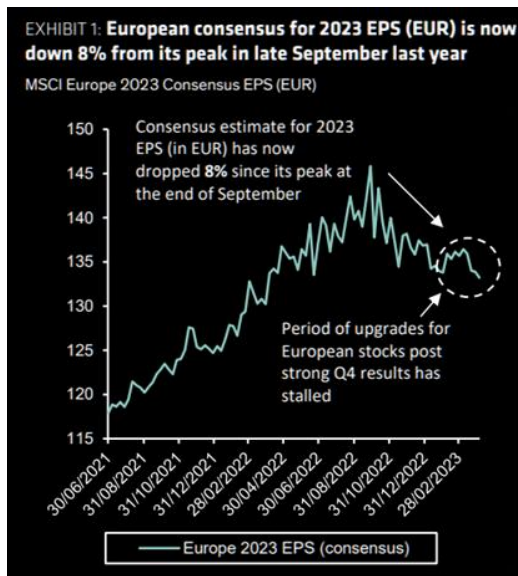

Figure 9- Source Bernstein. March 2023

The UK market has continued to be one of the best-performing global markets and offers the highest dividend yield in the developed market space. The FTSE rallied from 6650 to above 8000 during the last 6 months as global investors saw this as a significant opportunity to increase exposure in this previously under-owned region. In addition, given the years of underperformance in the UK market, the recent rally in banks, commodities, and ongoing M&A, the UK continues to perform strongly and has made a new all-time high. With plenty of tailwinds, a strong dividend yield, risk reduction, and a stronger outlook, we see scope for the UK to be one of the best-performing markets this year. In Q1 there has been a number of M&A deals, namely, Dechra Pharma, Kape, THG (in play), Network International, Sureserve, Industrial REIT, Wood Group & Hyve. Outside of this there are many that are subject to bid speculation – across the whole market cap spectrum. The UK market is not immune to global corporate pressures as domestically listed companies issued 75 profit warnings in the first quarter of 2023, with 22% coming from the technology or telecommunications sectors, according to EY-Parthenon. This was the highest level for the first quarter since 2020 and that 35% cited contract delays or cancellations as uncertainty has delayed decision making and hit discretionary spending.

On the other hand, the US market outlook is heavily influenced by the Fed's guidance and the dollar's outlook. The Federal Reserve has set a clear goal to bring US inflation back to 2%, which may lead to a further tightening of monetary policy. However, the Fed's monetary policy tightening cycle is likely coming to an end, which is good news for US equity investors. Despite this, the market may show little direction during the 'high for longer' interest rate phase until inflation has significantly decreased, and rate cuts can be priced in. It is forecasted that US economic growth will slow down to below 1% throughout most of 2023, resulting in lower sales volumes and margin compression for corporations. As a result, analysts predict slightly negative earnings growth for 2023, with a decline of -4.4% expected in the first half of the year. In the short term, there may be further consolidation for US equities reflecting the downgrade in earnings expectations. To navigate this, investors are focusing on quality stocks across the US market, not just in financials and IT. Although the recent turmoil in the US banking and IT sectors is unlikely to lead to a credit or systemic banking crisis, it may impact economic confidence and activity – however as yet we have not seen evidence of this post the regional bank news.

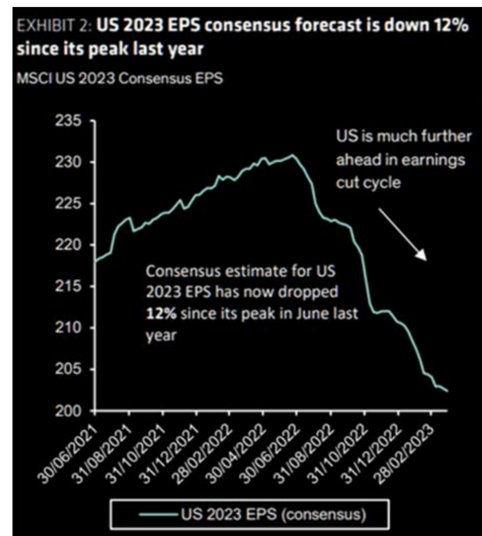

Figure 10- Source Bernstein. March 2023

As China reopens its economy following its post-zero-COVID policy, economic momentum in China and the wider Asia region is expected to pick up speed, potentially alleviating concerns about slowing growth in the US and Europe. This could have a positive impact on stock markets in the region, particularly for European companies with significant exposure to the rest of the world, including Asia.

China's economy grew 4.5% in Q1 2023, the fastest in a year and at a quicker pace than expected as the end of Covid Zero gave way to stronger consumer spending and factory output.

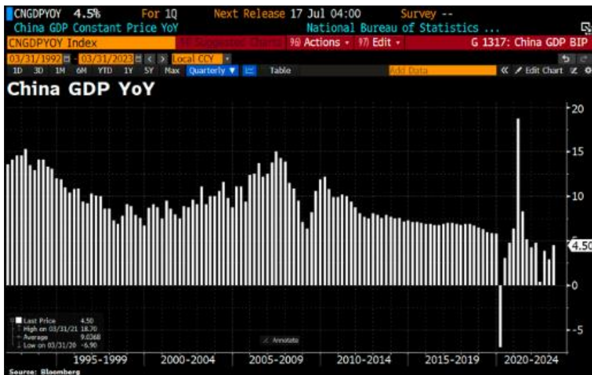

Figure 11- Source Bloomberg. March 2023

We see numerous opportunities in Asia as the region benefits from increased intra-regional trade and the reopening of the Chinese economy. We anticipate solid growth as pent-up demand is unleashed. The pre-COVID economy demonstrated the power of the Chinese and Asian consumer on the local and global economy, with noticeable effects on financial markets. In terms of sector selection, we have become less defensive in our approach within the Asian region. While we do not expect the technology sector to lead the markets as equities rebound, we do anticipate demand to reach a bottom soon, potentially lifting economic activity and market returns in the region.

The strong rally of emerging market (EM) equities that started in Q4 2022 continued into Q1 2023. However, with developed markets (DMs) beginning to price in "higher rates for longer" in February, EM equities began to face headwinds from tighter financial conditions in DMs and fading risk appetite among foreign investors. The escalating tensions between Beijing and Washington, which primarily affected Chinese equities, also impacted Asian and global EM indices due to their significant exposure to Chinese stocks. We do not anticipate EM equities to diverge significantly from global equity trends, particularly during times of global risk-off sentiment as recently experienced. However, there are market-specific fundamental differences within the EM universe that offer opportunities for relative outperformance.

Additionally, the reopening of China has also boosted sentiment in the EM & EM credit segment, with anticipated lower default rates and a favourable supply outlook. Although the current yield presents a lucrative carry opportunity, potential for further improvement seems limited as spreads have already improved significantly. Export volume data suggest trade growth remained negative in early 2023, and this slump is primarily a demand-led problem – weakening import growth in DM, especially - that has had second-order effects on supply chains as vendors (in tech particularly) accelerate their inventory depletion in expectation of weak demand growth.

Fixed Income (FI) also posted a large recovery, having suffered one of the worst years in history – simply due to higher yields and lower inflation leading to significant inflows. After experiencing a sell-off last year the U.S. Aggregate Bond Index is +4.0% in Q1, which has been supported by the Federal Reserve, in response to both cooling inflation and bank worries. At this juncture bonds remain attractive relative to valuations over the past ten years and will likely remain so barring an unexpected rise in inflation.

Yields across a variety of bonds, including government securities and high-yield bonds, are higher than they have been in the past two decades. While considering price, our focus is on inflation, the Federal Reserve, and on commentary around an impending recession. We believe that despite inflationary forces, inflation has peaked but consumers will continue to face upward pricing pressure (wages, mortgages, and consumer spending).

Despite this, we do not believe that the Federal Reserve will quickly engage in easing. Instead, we think central bankers will take lessons from the 1970s to ensure that they suppress inflation. The downside to this strict approach is that it could lead to a higher possibility of a recession. However, if investors seek the perceived safety of the asset class, a recession could have a positive effect on bond prices. Bonds continue to offer attractive carry opportunities and we feel more confident about their returns in 2023. As such, we have been adding to FI as it is our asset class of predilection for the time being, on a risk-adjusted basis.

We continue to focus on quality corporate credit, mostly in Global and EM Investment Grade (IG) markets and at the "belly" of the yield curves for US, European and UK IG (i.e. 5-7 years – medium duration).

Figure 12- Source Goldman Sachs. March 2023

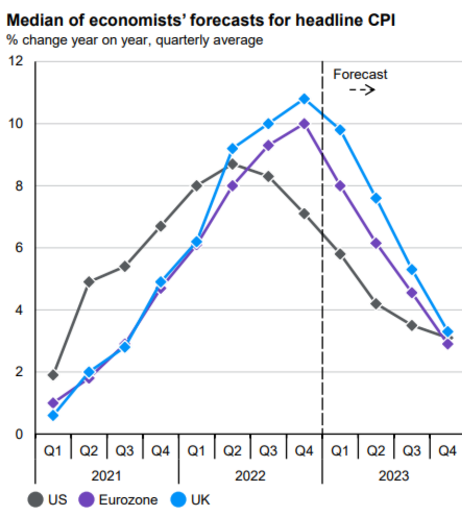

Figure 13- Source JP Morgan. March 2023

For the FI market, global inflation prints, from a sticky start have started to ease. US March PPI fell 0.5% MoM, below estimate of 0%, in another sign that US inflation may have peaked.

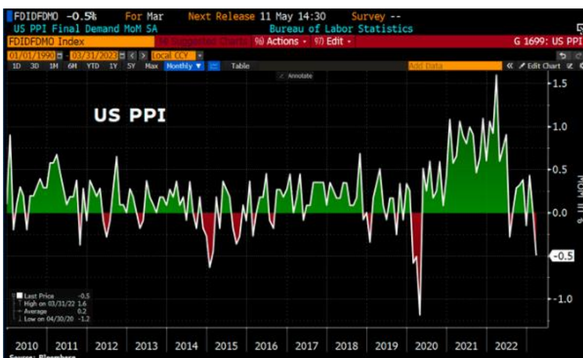

Figure 14- Source Bloomberg. March 2023

Commodities, including oil, are expected to remain high, with the potential for recovery in Chinese demand and OPEC+ providing a floor. U.S. production is not expected to significantly increase, and the end of the drawdown from U.S. strategic petroleum reserves is expected to provide further tailwinds. A small decline in Russian supply is also likely to support tight oil supply/demand. The demand for copper is expected to recover with strong demand from grid and renewable installation in China, as indicated by a major Chinese state-owned grid operator and the National Energy Administration's targets. The quota for Chinese local government special bond issuance (used to fund infrastructure projects) is also expected to remain high, but the positive picture will take some time to translate into physical demand. Although gold prices fell significantly in February, they are expected to remain strong due to the likelihood of G10 central banks and the Fed reaching their terminal rates by mid-year and continued strong demand from central banks.

The Billion-Dollar Dilemma: Gold or Bitcoin? Gold drops <2k while Bitcoin hits year-to-date high as it breaks $30k. With dollar weakness gold has seen a resurgence in Q1, as has silver. Silver has rallied 13.6% since mid-March and Q2 should be supportive as many of the fundamental drivers of the bull market have yet to fully play out (we still see further downside in the dollar, rates, and upside in investor interest in precious metals is likely over the coming months).

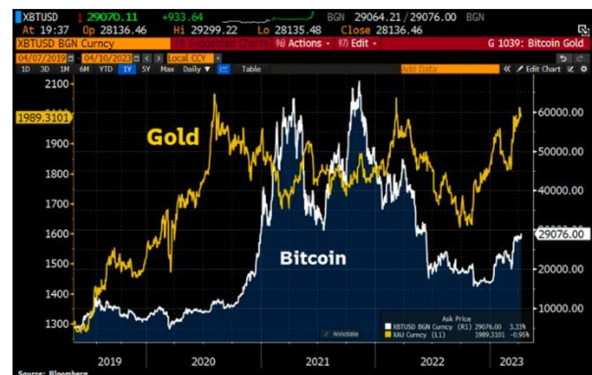

Figure 15- Source Bloomberg. March 2023

Key risks for H2.

- Rate Hike Cycle – the market has priced in peak rates and now revolve around how long until rate cuts.
- Inflation – globally inflation prints have started to moderate allowing central banks some relief from hiking. In essence the pivot to easing.
- China – stronger economic data has started to filter into other global markets.
- Russia / Ukraine – we do expect some resolution.
- Growth Expectations - have been guiding higher.

Central banks are currently facing challenges in determining the correct policy approach, especially given persistent inflation, and worsening financial conditions. To address these issues, there are three questions regarding monetary policy that need to be answered: how much of an impact will policy tightening have, how quickly will this impact materialise, and can existing policy structures manage the process?

While many factors suggest that central banks should keep policy tight to reduce stubbornly high core inflation, it is recognised that the impact of monetary policy tightening may be less effective than in previous financial cycles. The strong labour markets and the lingering effects of pandemic fiscal stimulus may also delay the impact of policy tightening. There are also technical questions about future changes to policy approaches and structures that still need to be addressed. Economic history shows that the real economy experiences the most severe negative effects after interest rates have already increased. However, it is plausible that the markets have already responded to the higher rates and their potential outcomes.

Despite these challenges, central banks are expected to prevail, and inflation is projected to fall over the next year, although it will remain above target levels. The forecast for the Fed and ECB policy rates is to reach "terminal" levels soon. Recent market expectations of Fed rate cuts in the second half of 2023 due to regional banking distress in the U.S. and concerns about market liquidity appear overblown. There is no systemic risk given the decisive response of the Fed and the robust measures implemented in the Eurozone following past financial crises. A significant reset in valuations has provided one of the most attractive entry points for stocks and bonds in over 10 years.

However, financial markets may remain cautious even under the assumption that the rate cycle can be managed, as the potential for higher yields could keep riskier corporate bond assets under scrutiny. Equities are also likely to experience modest gains over the next 12 months, as higher interest rates and falling corporate earnings expectations weigh them down. Investors are aware that there are less alternatives to equities as an asset class given the compression of the risk-free rate compared to six months ago. The yield on the 10-year UST note means that investors are receiving lower returns on their investments in relatively safer assets than they would have in the past. As a result, some investors may choose to diversify their portfolios and allocate some of their funds to alternative asset classes such as real estate, commodities, or bonds with higher yields or dividend-paying stocks.

Consensus expectations are for S&P 500 earnings to trough in 1Q23. Things will only get better from here.

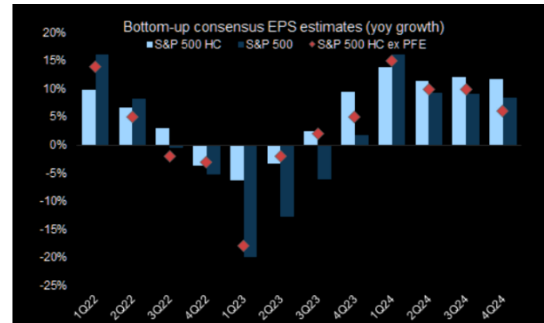

Figure 16- Source Factset. March 2023

In addition to policy risks, geopolitical risks remain a significant concern, and recent corporate earnings results suggest that many firms are reaching their limit in boosting revenues and profits, as falling real wages moderate volumes and pricing power. Ultimately, consumers will play a vital role in the future of the economy as the lack of infrastructure should boost demand this year higher incomes increase demand that is under capacity (as the economy continues to reopen and Covid habits revert to norm). Consumer led Infrastructure investment will result in a boost in economic growth. Persistently high inflation and changes in monetary policy expectations, such as unexpected rate cuts, may lead to short-term volatility in both bond and equity markets. Therefore, it is important to manage portfolios with caution and diligence as part of our asset allocation process. Our preference leans towards two types of assets - those that can safeguard portfolios against a significant economic downturn and those whose prices already account for such an outcome.

IMPORTANT INFORMATION

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