QUARTERLY INVESTMENT LETTER

Q1 2023

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

"It's close to impossible to apply brakes to the economy without breaking something."
Niall Ferguson, Bloomberg, 19 March 2023

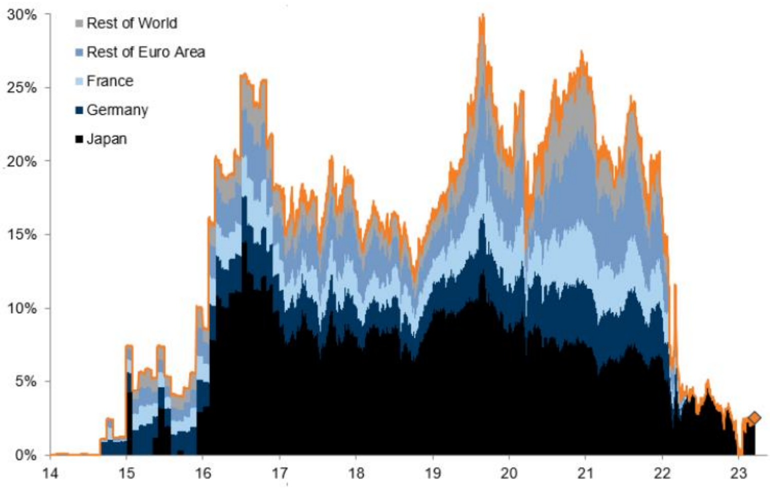
EXECUTIVE SUMMARY

- Aggressive monetary policy tightening in the past year has exposed the fragility of a small number of US regional banks and raised concerns around financial sector contagion
- Whilst Credit Suisse has long been beleaguered for unrelated reasons, it too became the focus of investor fear, resulting in Swiss National Bank support and a takeover by rival UBS within less than one week
- Action by the US authorities has been swift, covering uninsured deposits and providing a liquidity backstop where necessary, preventing a collapse in confidence that characterised the Global Financial Crisis of 2008
- These events are likely to weigh on US economic growth, restraining lending activity by small-medium sized banks and curtailing consumers' propensity to spend, however this comes with a silver lining – lower inflation and less pressure on the Federal Reserve to raise interest rates further
- In Europe and the UK, the situation is not dissimilar; growth momentum has been building, underpinning inflation 'stickiness', but tighter credit conditions should mean an earlier end to rate hikes than otherwise
- China's rapid reopening from zero-covid policies has kick-started consumer activity, yet broader geopolitical and macro headwinds have weighed on emerging market returns – we remain cautious towards the region
- Renewed questions of financial stability have not derailed our investment outlook, which is characterised by a period of slowing growth and falling inflation as opposed to outright recession, but do imply heightened volatility in equity and bond markets as the situation unfolds
- The big picture supports selective engagement with risk assets, differentiating from the broad market to capture valuation and earnings growth disparities. We are pursuing this through a range of high quality active managers, and leaning into specific themes, namely healthcare, value and smaller companies. The outcome is a well balanced portfolio of investment ideas which we retain high conviction in for the long term.

INTRODUCTION

The failure of Silicon Valley Bank (SVB) and Signature Bank in the US, shortly followed by solvency concerns and the rapid UBS takeover of Credit Suisse, serve as stark reminders of the shifting macro dynamics at play. Only 18 months ago a quarter of all outstanding government debt was yielding less than zero. The cost of capital has been increased by an unprecedented magnitude in a very short space of time (chart 1[1]), and as Niall Ferguson references in the above quote, such a shift in market conditions exposes fragilities.

Chart 1: 25% of global bonds had a negative yield in late 2021



With investor confidence shaken and developments ongoing, this early publication of our Quarterly Investment Letter provides an initial assessment on financial sector stresses and implications for the investment outlook.

A GLOBAL FINANCIAL CRISIS IN THE MAKING?

Comparisons with the 2008 financial crisis are unsurprising, with bank contagion risk gripping global investment markets.

> Whilst we are duly humble in our ability to predict the course of events in the weeks ahead, there are good reasons to consider a comparable crisis of financial confidence to be unlikely.

Firstly, SVB and Signature Bank are not indicative of the broader US banking sector. SVB catered almost entirely to the corporate sector, specifically tech-sector start-ups and venture capitalists. This depositor base proved extremely flighty as concerns around balance sheet health grew – a consequence of experiencing rapidly climbing deposit costs while their Treasury bond portfolio suffered steep declines in value. Signature Bank was also a 'boutique' serving primarily corporate clients, with 20% of deposits in crypto related assets. Ultimately, the fragility of their business models tell us little about the health of the banking system at large.

The situation surrounding Credit Suisse is quite different, yet the turmoil that engulfed the lender is linked to SVB's demise. Investor uncertainty spread from US regional banks and was absorbed by Credit Suisse, where a reputational and profitability challenge quickly become an existential threat. The Swiss National Bank provided very substantial liquidity support, creating a platform for UBS to acquire their long term rival and begin a restructuring process.

The response from central banks, both in the US and Switzerland, has been swift and decisive. Having covered all uninsured deposits at failed regional banks, the US FDIC[2] has sent a signal that it considers any bank larger than this to be systemically important. Furthermore, banks have been provided with a mechanism to avoid realising losses

[1] Source: Goldman Sachs, March 2023.
[2] Federal Deposit Insurance Corporation

on Treasury bonds through the Bank Term Funding Program (BTFP), should they require funding.

Importantly, policy makers and regulators have a playbook for mitigating banking sector contagion risk, and the signs are that appropriate measures will be taken. However, only time will tell whether confidence can be sustained or whether the shaky foundations of other institutions are revealed.

THE IMPACT ON GLOBAL GROWTH

Before the failure of Silicon Valley Bank on the 10th March, economic growth had been remarkably resilient despite widespread recession fears. We noted in our 2023 Investment Outlook how "*we believe a soft landing, characterised by growth slowing but avoiding a 'broad-based weakening', is fairly likely, yet under-appreciated*".

The evidence so far has been broadly supportive of this case. US consumers have been spending more, benefiting from rising real incomes (chart 2[3]) and an abundance of job vacancies, while the reopening of China (chart 3[2]) introduced a source of activity that had been virtually dormant for almost three years. In turn, European businesses saw order volumes recover sharply, and recession fears were lifted as the natural gas price plummeted from post Ukraine invasion levels.

Chart 2: US real incomes are no longer declining

% change, 6 months (annualised), 3 month moving average

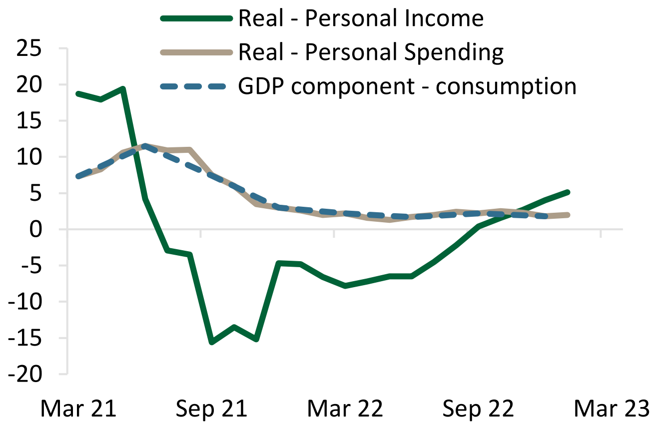


Chart 3: China reopening will support global activity

Purchasing Managers Index, 3m moving average

As a result, inflation has remained uncomfortably sticky, motivating central bankers to stay the course on monetary tightening. As recently as 7th March, Fed Chair Jerome Powell stated that "the ultimate level of interest rates is likely to be higher than previously anticipated". The primary concern of investors recently has been that growth may prove *too* good, reaccelerating on the back of the above tailwinds, and stoking another wave of high inflation. Interest rates would need to be 'higher for longer', pushing up borrowing costs for the real economy.

> Whilst a package of strong economic data this year may justify higher interest rates, concerns surrounding financial stability changes the calculus for the Federal Reserve.

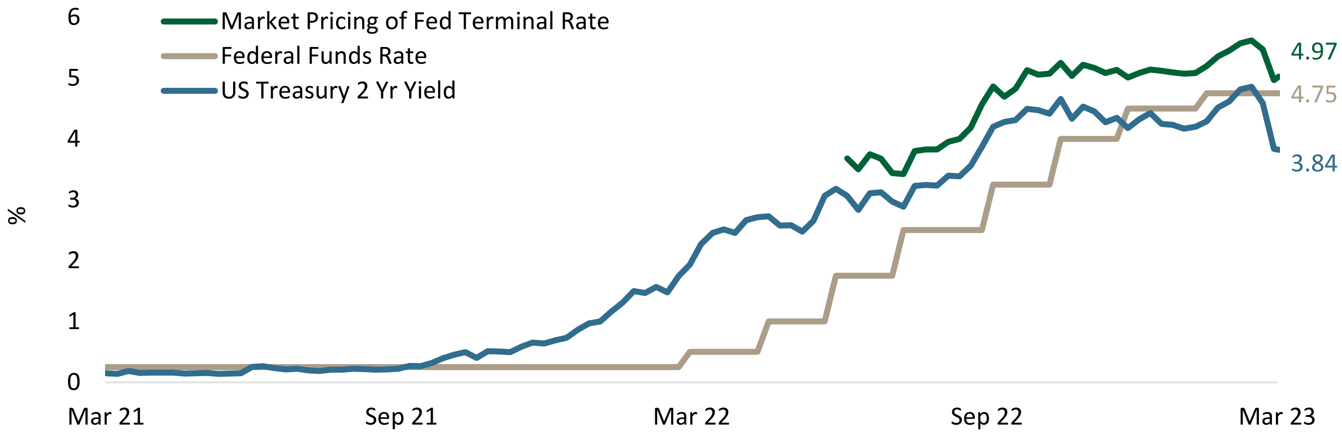
Recent events are likely to weigh on US economic growth by restraining lending activity by small-medium sized banks, who support a meaningful proportion of businesses. Capital expenditure plans may suffer, and hiring intentions may be pared back, curtailing consumers' propensity to spend. It is likely that part of the Federal Reserve's objective will be implemented by the regional banking community. That is, to tighten conditions and slow growth, reducing inflationary pressures.

The central bank will also be acutely aware that, should they push borrowing costs much higher, other unintended consequences may occur, as the real economy adjusts to the end of zero-interest rate policies. This means that the

[3] Source: Bloomberg, February 2023

terminal, or peak rate of interest, should be lower than it otherwise would have been. Market pricing of the terminal rate has adjusted down to c. 5% from c. 5.7% in early March (chart 4[4]).

Chart 4: Bank stress has reduced the need for higher interest rates



The situation in Europe is not dissimilar; growth has been better than expected so far this year, underpinning inflation 'stickiness'. Despite meeting only a day after Credit Suisse came under siege, the European Central Bank reaffirmed their commitment to the inflation fight and raised interest rates by 0.5%. However, in contrast to prior statements, they did not mention future rate hikes, preferring a more flexible approach.

The UK economy has also started the year better than expected, reporting 0.3% GDP growth for January (following a 0.5% contraction in December). Improved public finances allowed for meaningful fiscal loosening in the Spring Budget, totalling c. 0.8% of UK GDP in each of the next three years. As a result, a 2023 recession now appears less likely. However, with the financial sector representing a large share of UK GDP and the impact of 2008 still fresh in the memory, the Bank of England are likely to tread carefully when it comes to further rate hikes.

Overall, the events of recent weeks will undoubtably act as a drag on global growth in the months to come. Yet when we consider the economic momentum coming into this year, and the prospect of supportive action by policy makers, a full derailment of the global economy, or serious financial crisis, remains unlikely.

INVESTMENT STRATEGY

The events of mid-March, with financial stability back under the microscope, represent a new chapter in the highly disrupted economic cycle that began three years ago. Following years of ultra-loose monetary policy, and extreme liquidity support in 2020-21, the macro-landscape is normalising, and specific weaknesses are being revealed.

> The big picture supports selective engagement with risk assets. Equity and bond markets continue to react with a high degree of sensitivity, and we are staying close to developments and retaining flexibility and discipline in our investment process.

Importantly, earnings expectations for the coming year are approximately zero for the US equity market, posing two important conclusions. Firstly, positive surprises are within reach, should financial stress remain controlled, inflation fall and growth hold up, as we expect. Secondly, investing in a differentiated manner to the broad market index is paramount. We are pursuing this through a range of high quality active managers, and leaning into specific themes and sectors, namely healthcare, value and smaller companies. The outcome is a well balanced portfolio of investment ideas which we retain high conviction in for the remainder of this year and beyond.

SFIM Investment Committee
20 March 2023

[4] Source: Bloomberg, 20 March 2023.

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