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Monthly View as at 31 March 2023

Bank failures dominate March headlines

The first quarter of 2023 has seen multiple plot lines drive the investment narrative. The market mood has fluctuated between apprehension and optimism. In the first weeks of the year recession fears dominated, which then evolved to optimism that central banks could achieve a soft landing followed by suggestion of "no landing" in mid-February/early March. The markets were then disrupted by the emergence of a potential bank crisis in March. As March concluded, fears of a collapse of the banking system receded.

The failure of banks in Europe and the United States has rightfully been the central focus of investors given the implications of their demise. Although the bank failures on both sides of the Atlantic occurred concurrently in time, the failures are largely coincidental. Credit Suisse qualified as a globally significant financial institution with over SFR 500 billion of assets. The bank had been in financial difficulties for several years as a result of inadequate risk controls, trading losses and capital outflows. The inability of a large Saudi Arabian shareholder to contribute further capital triggered a liquidity crisis, an intervention by the Swiss National Bank and ultimately the acquisition of Credit Suisse by its peer UBS.

In the United States Silicon Valley Bank (SVB) and Signature Bank also suffered failures. In the case of SVB, the asset and liability mismatch arose from the bank being deposit rich and an investor in US Government Treasury bonds that declined in market value as interest rates rapidly rose. US financial authorities acted quickly and decisively to close the banks and protect depositors. Bank failure in North America is not unusual and although SVB is reasonably large it is not systemically important. The greater concern has perhaps been the risk of contagion spreading to other financial institutions, were the fear of failure to snowball. Although the issues in the banking market appear to be contained there will still be reverberations arising from these events. It seems likely that a flight to safety has taken place, favouring the large unquestionably strong money centre banks, and thus smaller regional banks will find it more difficult to secure capital. This and increased regulatory scrutiny will limit the availability of credit and potentially slow the US economy. The injection of funds also appears to offset the quantitative tightening undertaken by the Federal Reserve to dampen demand. Some estimates suggest that half of the quantitative easing to date has been offset. The impact on inflation and therefore the interest rate outlook is uncertain at present. A reduction in credit availability will reduce demand but the provision of financial support increases money supply. It seems likely that central bankers will distinguish their financial stability objectives from combating inflation in this instance and in the near term continue to apply interest rate pressure to quell inflation.

Inflation appears to have peaked and investor debate has shifted to the rapidity with which inflation will fall. Competing schools of thought exist. One has it that the bank failures are symptomatic of the success of monetary policy and that central banks expect to "break things" in the financial system to gain inflation traction. Other economic indicators such as housing prices and construction volumes are falling, with economies on the brink if not already in recession. These circumstances will require central banks to pivot and rapidly reduce policy interest rates. The contrary school of thought considers inflation to be more persistent with wage/price effects conspiring to hold inflation up. While labour markets remain tight, workers will be able to win a larger share of capital to preserve real purchasing power. Although inflation is decelerating, proponents of the sticky inflation thesis believe central banks will keep interest rates elevated until such time that inflation has returned to target or is convincingly on track to achieve this outlook. This approach gives central banks dry powder to respond if a significant deterioration in economic conditions were to occur.

Flight to safety generates fixed interest gains

In the current conditions the bank failures have not been sufficient to sway central banks away from increasing base rates. The Federal Reserve increased its base rate by 0.25% to 5.00%. The European Central Bank hiked 0.5% to 3% and the Swiss National Bank, despite the Credit Suisse failure, lifted its rate by 0.5% to 1.5%. The less strident Reserve Bank of Australia also saw fit to increase its Official Cash Rate by 0.25% to 3.6% although with softened guidance.

While the bias in short-term policy rates has remained upward, longer-term market interest rates have been more volatile and contrasted with policy rates. Government bond yields in the United States, Australia and New Zealand all reduced. The fall in rates occurred across the yield curve and ranged between 0.4% and 0.5%. The fall in government bond rates reflects the flight to safety by bond investors. US and New Zealand yield curves remain inverted whereas that of Australia is positively sloping but only by 0.5%. As such it appears that bond investors remain pessimistic as to the near-term outlook. Inverted yield curves are thought to be a precursor to recessions but do not in themselves indicate timing.

Typically, a steepening of the curve is observable prior to a recession becoming evident. Corporate bond yields are above those of government bonds but have also retreated over March. Income levels remain attractive relative to the recent past and the fall in yield has resulted in capital gains.

Global Shares

The year-to-date strength of the US share markets continued in March despite the uncertainty caused by bank failures and the potential for recession. Investors have a renewed appetite for large technology companies. In part this will reflect revised expectations as to the interest rate outlook then adjusting cost of capital assessments but will also stem from the operational improvements being made. Reductions in head count remain a feature of technology companies and when these cuts are announced share prices have generally reacted favourably. Meta for example has announced a further round of 10, 000 layoffs.

The S&P 500 and Dow Jones Industrial average also provided positive gains, but these indices have not been as strong as the technology-orientated NASDAQ 100. Unsurprisingly banks broadly, but regional banks in particular, were a source of weakness in March. The commercial real estate sector continues to be a concern as vacancy levels remain high post COVID and the sector's traditional high debt levels make it vulnerable to higher interest rates. The March quarter reporting season will commence shortly and S&P 500 earnings are expected to be challenged, with a 6.4% slide projected.

Like the United States the performance of China's stock indices has varied. Post COVID recovery continues to gain momentum and the work out in the property market continues with the Evergrande Group reconstruction reaching resolution. A change in the mainland's investment climate may be signalled by the announcement of a restructuring by Alibaba which will see the conglomerate split into six divisions and potentially separated from the parent company.

Australian Share Market

A substantial proportion of the Australian share market is comprised of financials. The strength of the Australian banking sector is unquestionable, but the sector still caught a cold from the global effect of the Northern Hemisphere banks. Competition in the Australian mortgage market is intensifying and there are signs that the tailwind from expanding net interest margins may have peaked. Materials comprise 24.5% of the ASX 200 index and made ground in March. Australia's energy commodities oil, coal, LNG and lithium were weaker in March, but base and precious metals held up better. Raw material inputs which enable development of the renewable energy sector continue to garner support from investors.

New Zealand Share Market

The New Zealand share market was essentially flat in March, with gains in large capitalisation stocks offsetting falls in smaller capitalisation and property shares. Large capitalisation companies Ebos and Spark contributed the most to index performance. The month saw a marked diversion between the returns of dairy companies Fonterra Shareholders Fund (FSF) and Synlait Milk. A2 milk was also impacted by Synlait's weakness. FSF announced a much-improved profit and a return of capital from the sale of its Chilean business whereas Synlait revised down earnings guidance in response to cost increases. FSF lifted 12% and Synlait fell 36%. The Pushpay takeover offer was revised after being initially rebuffed and this stock rose 9% as a deal was concluded. The impact of cost inflation and more subdued consumer demand was evident in the Warehouse's half year result and the stock declined 30%.

Summary

As confidence around the stability of US banking sector grows the focus of global financial markets will likely return to inflation and anticipated central bank actions, as was the case earlier in the year. Although inflation is expected to moderate over 2023, central banks will be reluctant to pivot their policy stance until there is clear evidence inflation is falling to within their target bands. Therefore, while central banks are expected to pause raising interest rates soon, a cut in interest appears some time away. This dynamic, along with an expected softening of economic data, supports our bias toward an overweight to income assets currently. Global interest rates continue to reward investors and fixed income plays a diversifying role in a portfolio, as highlighted by recent market movements.

An easing of inflation pressures and an ending of central bank interest rate increases would be supportive for global share markets. Against this backdrop, the slowing of economic activity provides a headwind for corporate profitability. As a result, we continue to monitor market conditions to assess the ongoing appropriateness of portfolio positioning. Focusing on your long-term goals while acknowledging that in the short-term, returns may be volatile, should reward investors.

Indices for Key Markets

As at 31 March 2023	1 Month	3 Months	1 Year	3 Years p.a.	5 Years p.a.
S&P/NZX 50 Index	0.2%	3.9%	7.8%	-1.0%	7.4%
S&P/ASX 200 Accumulation Index (AUD)	-0.2%	3.5%	13.2%	0.1%	16.5%
MSCI ACWI Index (Local Currency)	2.4%	7.0%	14.9%	-5.6%	15.8%
MSCI ACWI Index (NZD)	2.0%	8.8%	5.9%	2.4%	13.3%
S&P/NZX 90 Day bank bill Total Return	0.4%	1.1%	2.1%	3.2%	1.3%

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