



CARTLIDGE MORLAND
INDIVIDUAL WEALTH MANAGEMENT

INVESTMENT COMMENTARY



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BANKING ISSUES

Financial markets unexpectedly entered a period of continuing volatility within a fortnight of our previous bulletin. Our mood then was one of cautious optimism – and it remains so – for all the panic recent events in the banking sector have caused.

No bank will survive a period in which depositors lose confidence and collectively demand repayment of their deposits at short notice. This is because banks lend funds deposited for the longer term and rarely hold sufficient in cash/readily realisable securities to redeem a large portion of their deposit base in a matter of days.

The modern financial system has several coping mechanisms. Banks have been forced to erect far more stringent capital/liquidity buffers than applied prior to the Great Financial Crisis fifteen years ago. The amount of capital held has to be commensurate with perceived balance sheet risks too. The natural 'safety valve' is overnight inter-bank lending, whereby the banks lend one another money to cover shorter term liquidity issues. Ultimately, one of the essential functions of the central banks such as the Bank of England (BoE), the European Central Bank (ECB), the US Federal Reserve (Fed) and the Bank of Japan is to act as 'lenders of last resort' to their domestic financial systems, and in practice to the global banking system too.

Recent weeks have shown the system described working in practice, with the depositors of Signature Bank and Silicon Valley Bank (SVB) in the US having their entire deposits guaranteed by the US Federal Deposit Insurance Corporation (FDIC), which was established in 1933 to assure depositors and to avert runs on banks arising resulting from rumour or lapses in confidence. Borrowers from the banks concerned have been supported and banking services maintained. The BoE played its part by negotiating and encouraging a rescue of SVB's far smaller UK operation by HSBC, whilst the US bank closed in an orderly manner supervised by the US authorities. Neither bank was considered systemically important so these problems were viewed largely as ones for the US to resolve.



Within days, the Swiss banking giant, Credit Suisse, met the same fate and it **was** one of the 30 global banks systemically important to the international financial system. In discussion with and under pressure from other central banks, the Swiss National Bank orchestrated and eased a takeover of Credit Suisse by Union Bank of Switzerland (UBS). Once again depositors kept all their money, loans by Credit Suisse are unaffected and customers retain access to banking services.

This ability of the central banks to defend the integrity of the banking system and recent demonstration of their willingness are all immensely reassuring. However, there are still losers whose fate financial markets cannot ignore. Shareholder interests (the equity interest) in SVB have almost certainly been wiped out. The Swiss ruthlessly and swiftly amended the preferential order of interests to allow equity holders in Credit Suisse some value to their holdings, whilst allowing some of the bondholders' interests (which should have taken precedence) nothing. This has caused considerable unrest and disquiet amongst bondholders – for all the US, European Union and the British central banks have condemned the approach the Swiss have taken and reassured markets the same would not apply in their jurisdictions.

Despite years of mismanagement, Credit Suisse maintained a strong balance sheet, so markets consider any major bank might be destroyed almost overnight by similar lack of confidence on the part of depositors. This is sobering and attention has turned to the apparently weaker European banks and to the substantial network of regional banks across the US. The FDIC is reluctant to extend protection to unlimited deposits for fear of encouraging recklessness amongst banks' management. Treasury Secretary, Janet Yellen, now views the latter as essential to maintain confidence but lacks the power to push such a radical measure through Congress without winning some support from highly sceptical Republicans. There is some danger of credit to businesses being withdrawn, just as the Fed moves closer to engineering the mild recession it desires as a means of curbing inflation.

The picture described is one of considerable uncertainty in the global banking sector presently. Although the international regulators have confidence in the strengths of the sector and emphasise there are no parallels with the state of the major banks prior to the GFC, confidence has been hit. There are signs of considerable caution in the interbank lending market most obviously in the pricing of the credit default swaps which support it. At the very least, a high degree of coordinated fire-fighting by the central banks may become necessary to provide the reassurance markets now require.

One side effect of higher inflation/interest rates has been lower bond prices, which virtually all Cartledge Morland clients would have witnessed in the fixed interest exposure of their portfolios last year. Consider the damage to personal balance sheets amongst private investors. It is now estimated that UK defined benefits pension schemes alone have lost in excess of £500bn on their bond holdings. Lower bond valuations weaken balance sheets and banks hold vast bond portfolios. Yields/income from bonds have increased as a result of the rotation described which potentially improves pension scheme solvency and profit margins in banking. It is indeed an ill wind that blows no good and as we have said previously, the normalisation of the bond markets is necessary, but it is a **very** painful process. A degree of quantitative easing by a different name seems quite likely as a mild anaesthetic but the central banks are likely to be grudging with it as it could stoke inflation once again.



OVERVIEW

Having made a strong start to the year, following signs that inflation levels were moderating and the reopening of the Chinese economy following pandemic related lockdowns, equity markets have struggled over the past few weeks. Rapidly rising interest rates in the US took their toll on more specialised regional banks, SVB and Signature Bank. SVB held huge amounts of long-dated Treasury holdings which made significant losses due to their sensitivity to interest rates moves. Depositors withdrew billions of dollars over a very short period of time. In Europe, Credit Suisse one of the key banks of the global financial system, which had suffered reputational damage over a number of years was sold to its Swiss rival, UBS, for \$3.8bn – a 99% fall from its 2007 value. The catalyst for its downfall was the Saudi National Bank announcing that it would not provide further support. Whilst the reasons for the difficulties of the US and European banks were different ultimately it was the depositors' loss of trust in them that led to their failure.

The uncertainty arising from these bank failures led to volatility in equity markets, particularly in the financials sector. European and UK equity markets have been impacted in particular due to their significant exposure to banks. However, the larger systemically important banks are in strong financial shape due to more diverse sources of funding, matching liabilities and assets efficiently, as well as robust regulation. The smaller US regional banks (ie less than \$200 bn in size) do not have to abide by such strict rules as their larger counterparts. Banks across Europe and Asia have to comply with onerous regulation. Coordinated swift action by the main central banks to provide dollar liquidity to financial institutions did calm jitters in financial markets. Additionally, the FDIC moved to guarantee the deposits held in SVB and Signature Bank.

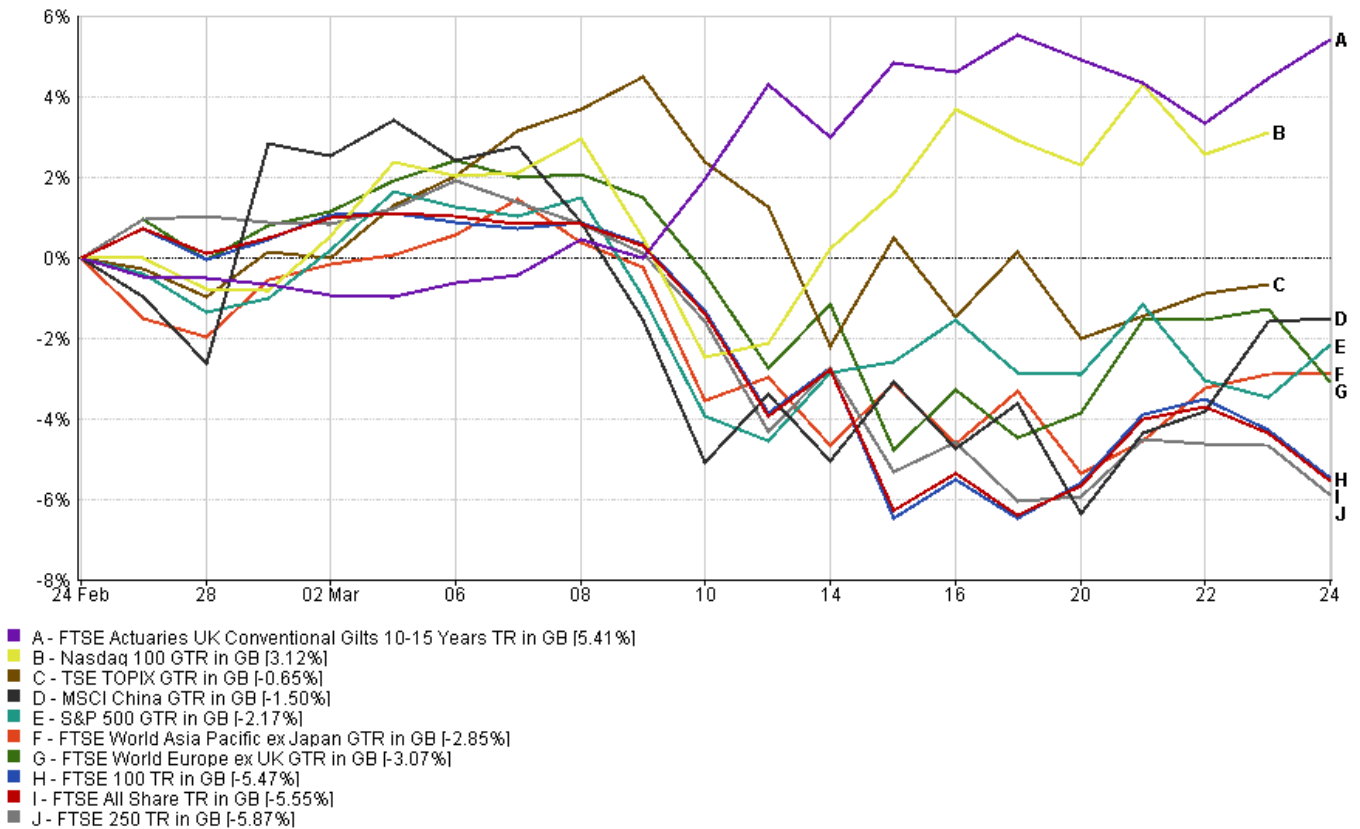


If the speed of monetary tightening has caused these cracks in the banking system, will the central banks pause the interest rate hiking cycle or even start to cut rates? The central banks have to consider their dual remits of providing price stability as well as financial stability. The recent round of central bank meetings indicate that controlling inflation is still the priority with inflation running way above most major central banks' 2% target levels. In the US, the jobs market remains strong with US employers adding 311000 jobs in February. However, wage growth was slightly lower than expected so adding a little less pressure to inflation. US inflation rose by 6.0% pa in February slowing from 6.4% pa in January so it appears that tighter monetary policy is having an impact although inflation is 'sticky'. At its latest meeting, the Fed raised its main rate by 0.25% to a range of 4.75-5.00%. The Fed may now need to take less action as regional banks, which account for about 50% of all US lending, may have to tighten their lending criteria to protect their balance sheets which in turn would slow economic growth. Markets are pricing in another 0.25% rise in May and then cuts later in the year. The prospect of the current interest rate hiking cycle peaking has been beneficial to the share prices of growth companies, for example technology companies, the future earnings of which are valued on interest rates.

The Monetary Policy Committee (MPC) of the BoE increased Bank Rate by 0.25% at its latest meeting to 4.25%. The hike came after UK consumer price inflation (CPI) rose unexpectedly to 10.4% pa in February up from 10.1% pa in January. The MPC pointed to an improved outlook for Gross Domestic Product (GDP) which rose by 0.3% in January following a 0.5% contraction in December. The services sector provided support through education, transport, storage and human health activities. Recent statistics show increasing economic activity in the UK and stronger than expected retail sales so indicating possible economic growth over the first quarter of 2023. (A change from the contraction predicted by the BoE at its February meeting). The policies announced in the recent Budget should increase GDP further over the coming years. The MPC also expects inflation to fall steeply despite the surprise recent uptick; wholesale gas futures and oil prices have fallen which should temper inflation levels during the year. Additionally, nominal wage growth seems to have weakened and according to the BoE is likely to fall through the year.

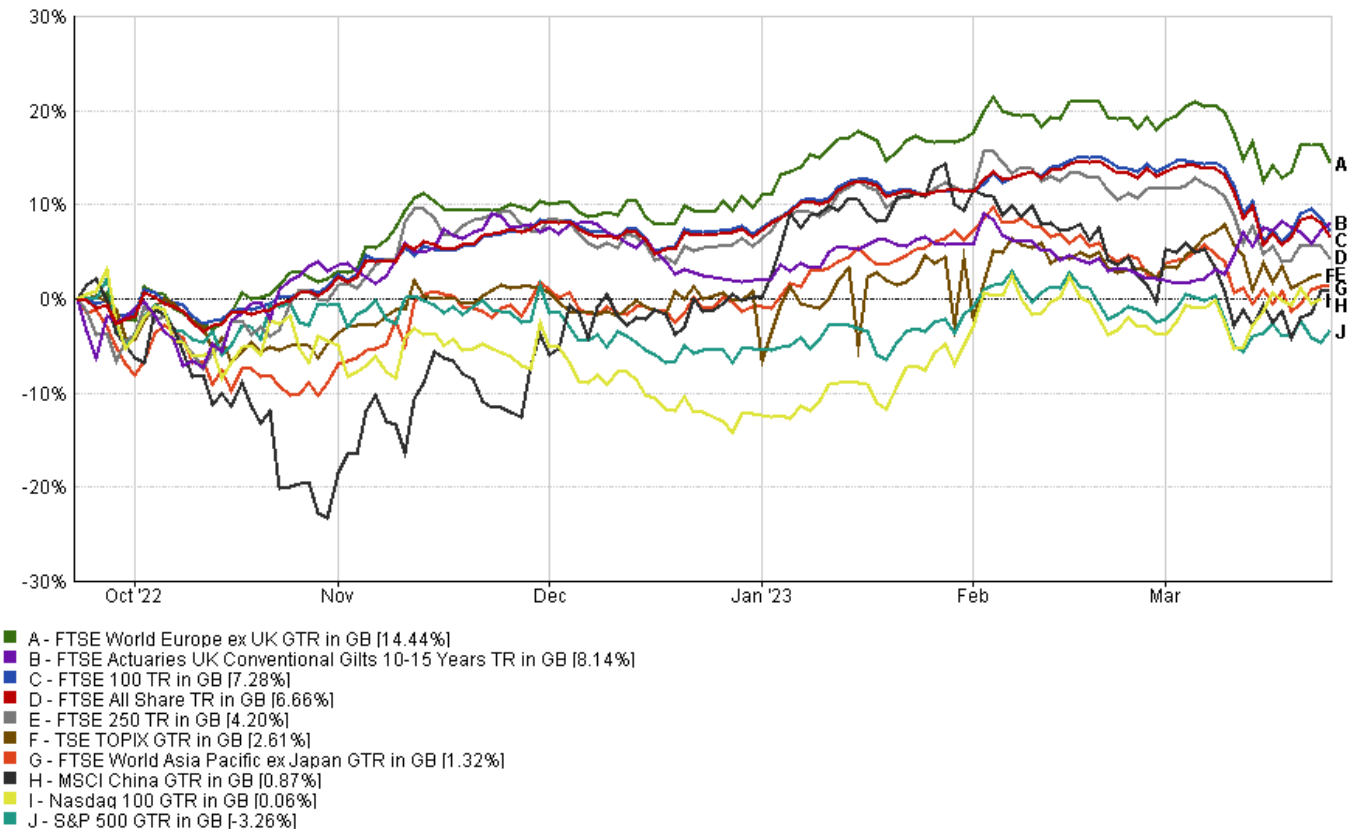
The European Central Bank (ECB) also continued to increase interest rates in the midst of the turmoil surrounding Credit Suisse. Its deposit rate was increased by 0.5% to 3.0%. However, the ECB did alter its stance by moving away from its commitment to keep "raising interest rates significantly at a steady pace" indicating that they were uncertain of how much further they would be able to increase interest rates. Inflation remains above target at 8.5% pa in February. However, the ECB revised its quarterly inflation forecast for this year down by 1.0% to 5.3% pa and for next year from 3.4% pa to 2.9% pa in 2024 as energy prices fall.

ONE MONTH STERLING INVESTMENT MARKET TOTAL RETURNS



24/02/2023 - 24/03/2023 Data from FE fundinfo2023

SIX MONTH STERLING INVESTMENT MARKET TOTAL RETURNS



23/09/2022 - 24/03/2023 Data from FE fundinfo2023



The CM Investment Commentary is compiled by Angela Cooper, Managing Director of Cartledge Morland's Investment Services team.

Angela runs the firms' investment management propositions, with over 30 years' experience in investment research working for investment companies, leading UK national IFAs and wealth managers. Angela graduated from the London School of Economics and is a Chartered Insurance Practitioner.

OUR VIEW

Problems in the financial system always cause major concern to investors many of whom witnessed the stresses in the global financial system during the GFC of 2008. There remains the worry that the turmoil in the banking sector will continue as the actions of the central banks in continuing to raise rates might increase or expose new weaknesses in the banking sector. On the face of it, the environment in which European banks operate has improved dramatically as interest rates have risen, net interest margins have improved whilst credit defaults remain relatively low. The current stresses in the banking system are reminiscent of 2008 but the background is vastly different. In the prelude to the GFC, the banks were experiencing credit losses on US mortgages with credit quality deteriorating rapidly. High levels of debt and inadequate regulation added to the toxic mix. Fifteen years later, balance sheets are stronger and regulation more robust. The smaller US regional banks had a less onerous monitoring system but this is likely to change in the wake of the SVB and Signature Bank failures. Credit Suisse was very well capitalised – in fact it did not need a bail-out in the GFC whilst UBS did. It was the deterioration in Credit Suisse's reputation over time which weakened it. The problems leading to the collapse of these banks are largely idiosyncratic rather than systemic, but the central banks have moved quickly to ensure that there is sufficient liquidity in the markets to reassure depositors, borrowers and investors. They have learnt lessons from the GFC and appear ready to support the global financial system as necessary.

We believe that the interest rate hiking cycle is nearing its peak. The steep increase in rates over the last year coupled with tighter lending as a result of the recent uncertainty surrounding banks will see economic growth in the major economies flat-line or perhaps contract this year. Wage growth and inflation levels over the next few months will be crucial for central banks and investors alike. There is the distinct possibility of one further round of rate rises if inflation remains stubbornly above target. It seems unlikely that central banks will cut interest rates in the very near future despite the turbulence in the banking sector. Any such action could lead to inflation returning with a vengeance in the next few years.

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OUR VIEW Continued

Markets had risen strongly in the latter part of 2022/early 2023 based particularly on the view that inflation had peaked, would fall back towards target across the developed economies during 2023 and that an end to interest rate hiking cycle was in sight. The only two factors that have changed are (a) US inflation appearing more stubborn than anticipated due to continued strength in the US economy and (b) the turmoil caused in the banking system by recent bank failures.

Over the recent market turmoil, we have seen lower risk assets, such as gilts, perform as expected with investors seeking safety in government backed bonds, high quality corporate bonds and cash. After the dislocation in the fixed interest markets over 2022, it is reassuring to see these traditional lower risk asset classes provide downside protection when equity markets are volatile. We continue to maintain fully diversified portfolios with longer term investment horizons.

**If you have any queries please do not hesitate to contact
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