State of Play

Four seasons

30 March 2023

Since the pandemic struck just over three years ago, investors have experienced extraordinary highs and lows. Most, I am sure, were hoping that the start to 2023 would bring more certainty and less volatility. Sadly, it feels like we have seen all four seasons in a busy first quarter where the ghosts of our financial past have reappeared. Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play before a short Easter break.

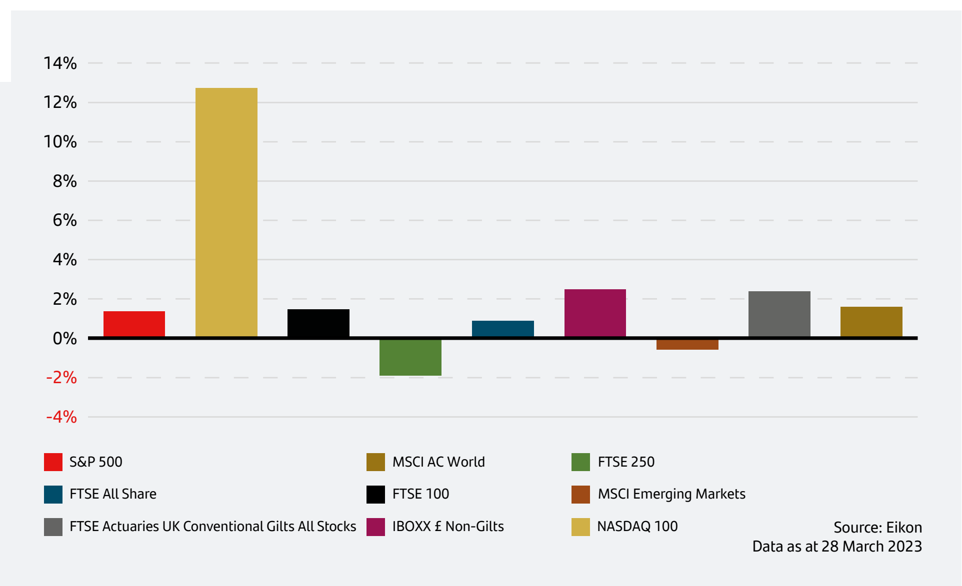
Key highlights from this week's State of Play

- January hopes for a brighter future
- February reality check
- March's ghost of financial past
- Outlook

January – initial hopes of a brighter future

Despite the sobering economic outlook, investment markets made a bright start to 2023. Even after the central banks raised interest rates towards the end of the month, it was anticipated, and markets took this in their stride, seeing light at the end of the tunnel as all major indices rose. In January, virtually all asset classes made positive returns, with the technology-dominated NASDAQ in the US gaining 10%, closely followed by both Chinese and European shares at 8% and 7% respectively.[1] The UK stock market has continued the modest returns of last year by gaining just over 4% in January. Whilst bonds have lagged shares, all major bond assets made positive ground with UK Corporate Bonds delivering over 4% returns including income.[1] This was in line with the much improved outlook for bonds after the aggressive normalisation of rates delivered by central banks throughout 2022.

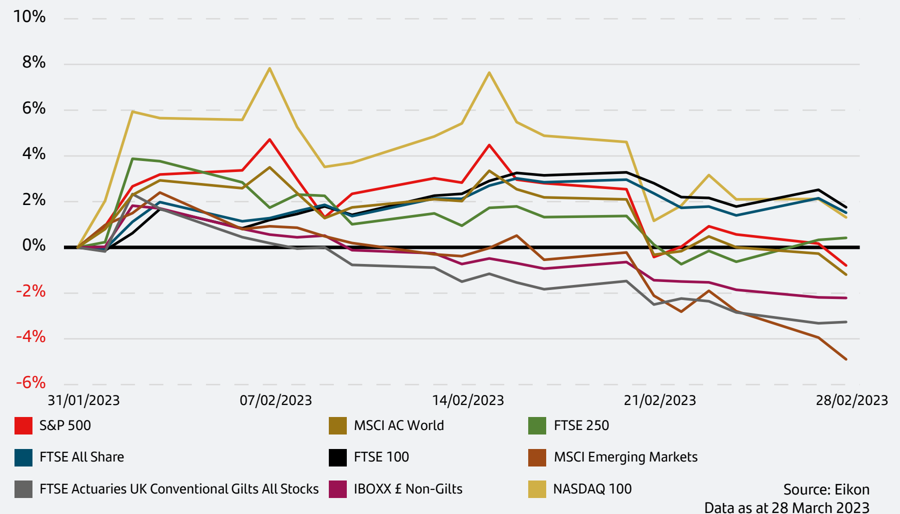
Investment total returns for the first quarter of 2023



February reality check

After such a bruising 2022, January came as a light relief for investors as all asset classes made a strong recovery. The question for market participants was whether this momentum would endure longer than the previous relief rallies seen throughout last year. This is where investors see a buying opportunity after a sharp fall in asset prices and invest, pushing values back up until poor economic news bursts the bubble and values begin to fall once more. This rhythm has been maintained throughout the last 18 months, making life very difficult for retail investors as sustained volatility makes life very uncomfortable and triggers strong emotions. For some, these emotions become too strong and they react.

February market performance



Source: Eikon
Data as at 28 March 2023

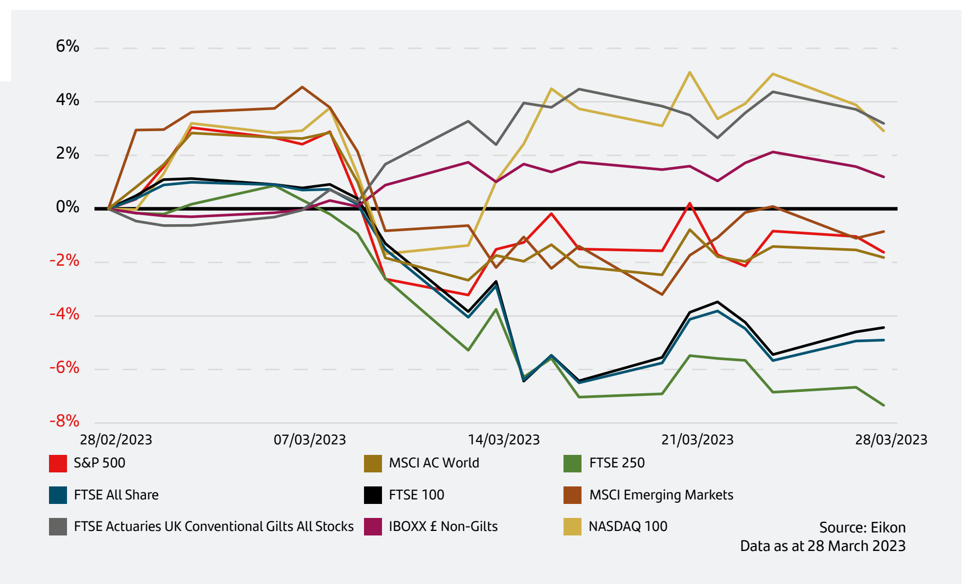
So, why did investors become nervous in February? Fresh jobs data in the US shocked markets as the US economy added over half a million jobs in January, nearly three times the level forecast as the unemployment rate fell to 3.4%.[2] This, coupled with stronger retail sales than anticipated and core inflation remaining stubborn, triggered investor concerns about the central bank's future response. In the January Federal Reserve (Fed) meeting, Jerome Powell, the Chairman, commented that the task of tackling inflation was not yet complete and that they were prepared to go higher on rates if necessary to see the job through. As you can imagine, the data showed the US economy is still very strong, and with a tight labour market and wage settlements still elevated, market participants realise this may lead to a larger rate increase in March than was initially priced in.

The UK stock market made small gains and Europe remained just in the black, but all other asset classes fell. Despite China fully reopening, the strength of the dollar saw Emerging Markets fall nearly 6% and a sharp rise in bond yields saw a reverse of the strong bond performance in January with UK Gilts falling 3%. Most other classes were just on the negative side, having been on a bumpy ride throughout the month.[2]

March's ghost of financial past

The first ten days of March began without alarm as market participants awaited updates on inflation and other macro-economic data. The idea being that this would confirm to them that central banks would continue on their tightening path, albeit much closer to the peak of rate rises where most could at least breathe a sigh of relief and look back down the hill we had just climbed, waiting for the inevitable descent. However, once news broke of Silicon Valley Bank's (SVB) cash troubles, the ghost of our financial past reared its ugly head. On Thursday 9 March, SVB clients withdrew $42 billion in just one day as technology assisted the fastest bank run in history.[3] The Federal Reserve went into crisis mode, protecting investors' money and providing much needed liquidity as the banking sector started to suffer caused by shear panic.

March market performance



Source: Eikon
Data as at 28 March 2023

The collapse of SVB Bank in the US was primarily driven by the rapid reverse of loose financial conditions and low interest rates. The knock-on effects of firstly SVB and then the troubles at Credit Suisse, saved by a bailout by UBS and the Swiss Central Bank, have spread a wider fear of a potential credit crunch.

Outlook

So, what is a credit crunch and why are market participants so fearful? If we go back in time to the Global Financial Crisis in 2008, while the initial trigger was caused by poor mortgage loans being wrongly risk rated by banks and financial organisations, the primary reason for such radical central bank intervention was the lack of available credit. All modern economies rely on the fluid movement of money from savings to lending. If individuals and businesses cannot borrow money because banks become risk averse to lending, the economy grinds to a halt. People lose their jobs and businesses fail. It is why such vast sums of new money were essentially created by central banks to buy debt from banks and replace this with cash so banks could start lending once again.

Fast forward to 2023 and the reason investors are so nervous is because of the implications of a loss of confidence in the banking sector. Whilst lessons were learned from the financial crisis and banks now carry large quantities of capital in case of crisis, this doesn't stop volatility and the fear of being the next cab on the rank when one of the large brands needs saving from going bust. The SVB collapse is arguably an isolated case given their business model. However, SVB is not the only bank that carries large losses on bond assets because of the sharp rise in interest rates. Normalisation of monetary policy has prompted sharp rises in bond yields, leading to losses, especially for longer-dated government bonds. All the time a bank can hold these investments to maturity, the implications of holding these losses are limited.

However, the crunch is caused when banks react to market fear and hunker down by collecting more cash deposits and restricting lending or stopping new lending altogether. This has created a nervous marketplace where wild swings in bank share prices lead to a wider market sell-off and bond yields swing violently during the trading day. Regardless of this uncertainty, central banks still carry the weight of high inflation pressure and will not want to pause until they are certain the job of bringing this down has been completed. This brings me to why investors probably feel more uncertain now than just a few weeks ago.

If banks restrict lending, this limits the ability of economies to grow, and the longer-term impact could be severe. Central banks have wanted to cool economic demand by increasing interest rates. However, it is difficult for them to be certain whether the recent banking crisis will lead to a slowdown in the months ahead making any further rate rises unnecessary. Also, as I have explained in previous updates, rate rises take many months to take effect, and often central banks have raised rates in the past well beyond the point where they needed, prompting longer and deeper recessions.

Market participants are now busy trying to evaluate whether last week's rate rises will be the last. If they are, then in some ways this will be a relief for many, but for others, this simply means the central banks have recognised the wider risk of an economic slowdown as lending becomes less readily available. Navigating this narrow path for policymakers is fraught with danger and the propensity to make mistakes is much higher. For investors, it is a reminder that one key principle of investing is time horizon. If you simply look at market movements, either daily or weekly, the graph can look terrifying at times like now. However, when you pull back over many years or even decades, while today seems like a disaster, it is just a point on a longer investment journey that always rewards patience above all else, provided you have diversified your portfolio appropriately.

Asset Management

The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 28 March 2023.

[1] FE Analytics, 27 March 2023
[2] Investing.com, 27 March 2023
[3] CNBC, 10 March 2023

Important Information

For retail distribution.

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