FPWM
TAILORED FINANCIAL SOLUTIONS

QUARTER 2 2023

Investment Strategy Committee Tactical Asset Allocation Views & Commentary

Tactical positions relate to the strategic allocations for our five risk rated portfolio benchmarks which power our investment process. They are expressed as in the key below.

- - Strong Underweight	- Underweight	N Neutral	+ Overweight	+ + Strong Overweight

Please contact us if you require further information.

ASSET CLASS	TACTICAL POSITION	COMMENTARY
Global Government Bond	+ +	We move strong overweight as we are now closer to the peak in rates. Strains in the banking sector, falling inflation and signs of peaking labour market conditions should allow the Federal reserve to step back from tightening in the next few months. Fed risks a deep recession if QT continues
Investment Grade Bond	N	Credit spreads have widened to more attractive levels, especially in the banking sector. We prefer to stay neutral here until the dust settles and we are more confident that spreads have stabilised. European bonds are more attractive, but we are wary due to recent stresses in banking system
High Yield Bond	-	We remain underweight for similar reasons as for investment grade. Credit spreads have widened to more attractive levels, but we prefer to wait for now as we have not seen a default cycle. Europe offers better value and upside vs US, but we prefer to stay patient for the moment
Emerging Market Bonds	- -	Any deterioration in sentiment and strength in the US dollar tends to be negative for emerging market assets, we move to strong underweight and stay patient until valuations suggest we are well paid to take the risk. China reopening may create a short term effect, but we doubt its longevity
UK Equity	N	We maintain exposure as UK has serious headwinds and uncertain leadership which has hit Sterling. Recession in the UK seems inevitable, and a continuation of responsible fiscal policy is essential if UK plc is to emerge stronger from the slowdown. We remain neutral on valuation grounds
Developed Market Equity	+ +	US valuations are now fairer after the recent correction and economic dynamism means small overweight in basket. In Europe sentiment is less positive and valuations are not particularly attractive. Japanese valuations are fair, Asia may get short term stimulus from China re-opening
Emerging Market Equity	-	We remain underweight as the combination of persistent inflation in the US and financial stress may, in the short term, put upward pressure on the US dollar and the asset class. A strong USD hurts EM Equities as performance vs Developed markets tends to be inversely correlated with USD.
Commodities	N	We expect performance to moderate across the Commodity complex if recession plays out and demand slows, but OPEC+ cut should support oil prices. Base metals outlook will depend on DM economies avoiding a sharp downturn. US corn acreage likely to increase to fill Ukraine supply gap
UK Commercial Property	- -	Industrial, warehousing and logistics favoured, with portfolio balance key as capital values fall across the market. Retail and offices remain under pressure which may continue until the economy recovers. Any Sterling weakness may prompt international investors return, which may be positive
Absolute Return	+ +	We continue to rely on this allocation to provide diversification, reduce portfolio volatility and provide downside protection. The combination of market neutral and macro strategies diversifies risk exposure, despite challenging market behaviour. We expect macro strategies to rebound
Cash	+ +	We maintain our cash weighting as market uncertainties and the future outlook for economic growth, interest rates, quantitative tightening, and market weakness suggests further volatility, before markets stabilise. Cash now gives a good yield as well as optionality if the market weakens

Please Note: The views expressed are those of the Investment Strategy Committee. They should not be taken as a personal recommendation to invest or refrain from investing.
Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements.

LOOKING BACK…

Global equities gained in Q1 **(FTSE World Index +6.82%)**, despite the collapse of Silicon Valley Bank (SVB) and Credit Suisse's malaise, which caused a sell-off in bank shares. Markets rose on receding recession worries, better inflation numbers and hopes of easier monetary policy and a Fed pivot. Growth stocks outperformed as government bond yields fell, while the falls in bank shares hit Value stocks, which underperformed over the quarter.

The short sharp sell down that followed the collapse of Silicon Valley Bank (SVB) didn't stop US Equity markets from rising strongly over the quarter **(S&P 500 +7.03 %)**. The collapse of SVB, followed shortly by Credit Suisse, caused falls in March before recovering to finish the quarter higher as investors concluded that the systemic risk was minimal. The Federal Reserve (Fed) raised rates twice, pushing borrowing costs to the highest point since 2007. Inflation – as measured by the core personal consumption expenditure (PCE) index – climbed less than expected in March, leading to speculation that further rate hikes will be limited. Other economic data suggested the US continued to grow in the first quarter and the labour market remained resilient. In February, average hourly earnings rose by just 0.2% month on month, and 4.6% year on year, which shows that wage pressures are gradually decelerating. The energy and healthcare sectors lagged over the quarter. Tech stocks made some of the strongest gains.

Eurozone shares led developed markets Q1 **(FTSE World Europe ex UK +9.41%)** despite the Credit Suisse malaise, led by the information technology, consumer discretionary and communication services sectors. Laggards were real estate and energy. Financials whipsawed in March after the failure of US Silicon Valley Bank and the subsequent purchase of struggling Credit Suisse by UBS in a deal brokered by the Swiss government, Credit Suisse's problems were seen as being contained and financials ended up over the quarter. The European Central Bank raised interest rates by 50 basis points in both February and March. Consumer price inflation fell to 6.9% from 8.5% in February. While core inflation (excluding food and energy costs) rose marginally to 5.7% from 5.6%. The service sector powered the Markit flash purchasing managers' index to a 10-month high of 54.1 in March, while the manufacturing index was below 50, showing mixed signals about the direction of the Eurozone economy. The French government's plans to raise the retirement age created protests across the country and President Macron narrowly survived a no-confidence vote over the issue.

UK equities rose over the quarter **(FTSE All Share +2.03 %)** amid hopes that central banks might be in a position to 'pivot', cutting interest rates in late 2023. The consumer discretionary sector outperformed, reflecting a very strong recovery in many domestically focused areas which bounced back on evidence the UK economy had been resilient during the energy crisis. Q4 GDP data surprised in that, contrary to expectations, the UK economy had not contracted in Q4 2022, dodging a technical recession by avoiding two consecutive quarters of decline. Nevertheless, the Bank of England (BoE) said it still expected the country to enter recession later in 2023, albeit a shallower one than predicted in November 2022, as wholesale energy prices have fallen considerably as the European energy crisis has abated. The BoE's Monetary Policy Committee voted to continue to raising interest rates as inflation remained the main concern. Inflation proved stronger than expected, in part due to the resilience of the domestic economy. The Nationwide House Price Index reported a -3.1% fall in the year to March 2023, down from -1.1% in the 12 months to February.

Japanese stocks rose strongly in Q1 **(TSE TOPIX +5.91%)** following the surprise adjustment to the yield curve control policy, which was announced in mid-December, although outgoing governor Kuroda left policy unchanged at the January policy meeting. The policy was intended to keep short term yields low for corporate borrowers, without harming long term yields held by pension funds and life insurers. The bands were relaxed in December and had come under some market pressure due to inflation rising. Quarterly earnings results were mixed as exporters struggled due to Yen appreciation, and a tech sector slowdown. In common with other markets, SVB's collapse, and the bailout of Credit Suisse affected market sentiment, but the market rebounded toward the end of the month. Yen weakness supported cyclical stocks. The Tokyo Stock Exchange's expected guidance for companies with a price-to-book ratio below 1 to boost corporate value attracted global attention, especially for companies announcing enhanced shareholder remuneration.

Asia ex Japan equities lagged the World index in Q4 **(FTSE Asia Pacific ex Japan +3.55 %)** with strong gains by Taiwan, Singapore and South Korea offset by weaker performances by Hong Kong, India and Malaysia. Chinese shares rose strongly early in the quarter as Beijing loosened its Covid-19 restrictions. Supportive property market measures and a loosening of the regulatory crackdown on China's technology companies also bolstered investor sentiment. Fears of a global recession weakened investor sentiment towards the region in February, with Thailand, Malaysia and South Korea experiencing sharp falls as investors took profits following a strong performance in January on investor optimism sparked by China's reopening. March saw equities rise again, with all index markets achieving a positive performance as fears following the collapse of Silicon Valley Bank eased.

Emerging markets had a relatively poor quarter, **(FTSE Emerging +2.01%)** despite renewed optimism about EM after the re-opening of China's economy. February and March saw an escalation in US-China tensions and a widespread loss of confidence in US and European banks as well as higher US rates which tend to negatively impact Emerging economies. The Czech Republic was the leading market and Mexico also outperformed due to improving economic data. China was ahead of the index, although the shooting down of a Chinese high altitude balloon in US airspace was a negative. South Africa, Poland and Thailand all lagged the index, with South Africa continuing to suffer from the electricity crisis. Brazil was down in dollar terms against a backdrop of softening economic data and anti-government riots that damaged government buildings in January. India generated negative returns amid allegations of fraud and share price manipulation at a major conglomerate early in the quarter.

Fixed Income markets started the year on a more positive note and Government bond yields fell over Q1 **(FTSE World BIG Domestic Sovereign +2.91%).** The year started amid positive sentiment on the growth outlook as energy costs fell and China reopened, but this was balanced by concerns that inflation was proving sticky, as core inflation measures ticked higher once more. Central banks continued with their interest rate hikes, though some adjusted their stance, becoming more nuanced in their language. The collapse of Silicon Valley Bank dwarfed inflation concerns prompting a sharp rally in government bonds, as fears of a banking crisis meant markets went from pricing in rate hikes to discounting sizeable rate cuts in some markets. The US 10-year yield fell from 3.92% to 3.47%, with the two-year going from 4.82% to 4.03%. Germany's 10-year yield decreased from 2.65% to 2.29%. The UK 10-year yield fell from 3.71% to 3.49% and two-year decreased from 4.07% to 3.44%.

Due to the bank scares corporate bond markets have been volatile with widening credit spreads. Investment Grade bonds saw some volatility **(Bloomberg Global Aggregate – Corporates +3.46%**) but outperformed government bonds, as did High Yield **(Bloomberg Global High Yield +3.15%)** despite poor performance from the banking sector. Emerging market bonds also enjoyed a positive quarter as USD weakened **(JPM GBI-EM Global Composite +3.61%)** along with hopes of Fed easing.

After a stellar 2022 for commodities, The S&P GSCI Index fell in Q1, **(Bloomberg Commodity -6.37%)**. Energy and livestock were the worst-performing constituents, while precious metals and industrial metals achieved price gains. Within the energy components, prices for natural gas, gas oil and heating oil were all sharply lower. In precious metals, gold achieved a robust price gain amid banking fears, while silver achieved a more modest price appreciation. In industrial metals, nickel was sharply lower, while declines in the price of lead were more muted. Copper and aluminium prices both advanced in the quarter.

UK Commercial Property marginally weakened **(FE UK Property Proxy-0.82%).** For both the commercial and residential property markets the high level of economic uncertainty and evidence that prices are correcting have encouraged a 'wait-and-see' attitude among real estate investors. Across the markets there are reports of a mismatch between buyer and seller expectations on pricing. In commercial property, the MSCI Market Rental Growth Index for offices rose by 0.19% in February, but the sector fell over the quarter in capital value terms. This trend was mirrored in Industrials where rental grew in January and February (MSCI industrial rental +1.01%), but capital values fell a similar amount. Retail capital values continued to decline falling more than 1% over the quarter.

In Currencies, Sterling was the standout performer vs other majors over Q1 2023, strengthening against all major currencies, with **USD -2.02%**, **JPY -3.31%** and **EUR-0.57%**. A strong Sterling reduces the return for investments denominated in foreign currencies over the period.

Please Note: All quoted returns are on a price basis in local currency terms.

LOOKING FORWARD…

"Whenever the Fed hits the brakes, someone goes through the windshield," - **Michael Feroli**

While this part of the commentary looks to the future, we can't brush over the fact that in March we saw the second and third-largest bank failures in US history with Silicon Valley Bank (SVB) and Signature Bank, and in Europe UBS took over troubled Credit Suisse. Authorities responded swiftly to stabilise these situations, and while we don't think that this is another Lehman moment, it can't be disregarded.

When you deposit money in a bank account, you aren't simply giving it to the bank for safekeeping. You are lending your cash to the bank, and your deposit appears as a liability on the bank's balance sheet. In simple terms, the bank borrows money from you then lends it to someone else. If all goes well, the bank profits from the difference between the interest it pays you as depositor and interest received on the loans it makes to businesses and private individuals. Banks also loan money to the government by purchasing government securities (Treasuries in the US, Gilts in the UK). They don't yield as much as their mainstream lending operations, but are lower risk and good to hold on the balance sheet to meet solvency requirements, most of the time…Running a bank is a balancing act because the assets (loans) and liabilities (deposits) have different maturities. People can demand their cash any time, but the bank can't call in its loans, at least not quickly. This creates a liquidity mismatch, which works 99.99% of the time as most people leave their balances in place and the liquidity mismatch is not a problem.

Two things made SVB particularly vulnerable. Firstly, its depositors were highly concentrated, with over 90% of deposits from corporates and over 50% of deposits coming from early-stage technology companies. Second, SVB had a particularly large pile of longer-term Treasury and mortgage-backed securities bought when deposits ballooned in 2020–2021, but before the Fed started raising interest rates in early 2022… When interest rates rise the market value of bonds falls, which is not a problem if you hold the bonds to maturity. However, it can be a big problem if you need to sell them before they mature. When deposit outflows spiked, the liquidity mismatch hit and these bonds then had to be sold to generate cash, realising losses from the interest rate rises in the process. This rapidly turned a liquidity problem into a solvency problem and SVB failed.

In the US post the GFC, midsize banks are not subjected to the same scrutiny as large banks, but even if they were, it is unlikely that stress testing them in the same way as the larger banks would have prevented failure. Why? Because the tests asked the wrong questions, failing to test the scenarios that led to SVB's failure—large and rapid increases in interest rates.

Incredibly, 94% of SVB's deposits were above the $250,000 FDIC coverage limit, and therefore uninsured. Nor is it just the case with SVB. Even much larger banks can have more uninsured than insured deposits. At a $250,000 limit, US banks had $10.5 trillion in uninsured deposits as of mid-2022, and only $7.4 trillion insured. In the SVB scenario, regulators used a "systemic risk" emergency clause to cover otherwise uninsured deposits. FDIC was able to do this without breaking its own finances because SVB had good assets in its Treasury portfolio. They were just illiquid.

It is important to remember that the Fed is also a bank regulator working alongside other agencies to ensure stability in both individual banks and the banking system as a whole. Their actions/inactions paved the way for SVB's failure by regulating for the past not the future. After 2008, Congress passed the Dodd-Frank Act which was intended to prevent another GFC or subprime mortgage crisis. The Act focussed on reducing bank credit risk, and encouraged banks to hold more Treasury securities, which in theory have no credit risk, yet conveniently ignoring the interest rate risk of holding those bonds. To make it worse, banks could treat long-term Treasuries differently without marking those assets to market against their capital base, instead valuing them at their maturity value.

So, when the Fed started to drastically increase rates in 2022, they as a bank regulator were creating the very adverse scenario that led to the collapse of SVB. Fed Chairman Jerome Powell and other FOMC members are sounding quite hawkish, leading to expectations of further hikes, but he must also be mindful of the effect on smaller US banks. At the same time, not raising rates risks letting inflation start climbing again. The FOMC are between a rock and a hard place, but only have themselves to blame.

The Fed's new Bank Term Funding Program allows banks with unrealised losses in their Treasury securities to pledge them as collateral and get cash from the Fed, providing liquidity for those who gorged on T-bonds but didn't hedge the risks. This will likely solve the immediate problem, (although there still may be some problems at small banks lower down the food chain) but is patently unfair to the prudent banks as the Fed is essentially rewarding unwise risk-taking. Continuing the post GFC theme of Moral Hazard.

In Europe, the issues facing Credit Suisse were not new as the bank's stock price had fallen by almost 80% from its 2021 peak. Credit Suisse then had problems with its financial reporting process, and a major shareholder suggested it would not be willing to increase its stake any further. This, combined with an already stressed environment for banking shares, created a renewed wave of selling pressure on the stock, leading to the UBS take over. Markets broadly welcomed the swift action taken by policymakers and regulators, and improvements in the institutional architecture of the eurozone over the past 10 years mean a low risk of another sovereign debt crisis.

In an ironic twist, it seems that the banking problems may actually help the Fed and the ECB, bringing the required slowdown closer without further tightening from the central bank. Further tightening is now likely to come from an additional source as banks reduce credit availability, with some estimates suggesting it will be equivalent to the Fed hiking an additional 150 basis points. This would justify the recent FOMC economic projections of a 5.1% peak rate this year, or one more quarter-point hike.

There are multiple signs of an impending recession which would be deflationary and help the Fed achieve its inflation target. Indeed, the New York Fed's yield curve recession probability is the highest since 1980. 1982 was the last "intentional" recession and also one of the deepest, as Fed Chairman Volker drove the US economy into recession to break inflation. We are not suggesting that 2023 is the same, but it does seem to rhyme. Chairman Powell and the other members of the FOMC will not admit this, but, if necessary, they are willing to drive the US into recession to once again to stop damaging inflation. Unlike in the 70s and 80s, the Fed can only directly influence half of the CPI directly through policy and it is the half that it can't influence that has fallen to date. Service sector inflation needs to fall, and a credit crunch should give the Fed the disinflationary recession it desires. As the US household savings rate falls and post pandemic pent up demand becomes exhausted, we believe a US recession may be a reality as soon as the second half of 2023.

Some may counter by saying that the Fed has already eased monetary conditions through stimulus to support the banking system, but they would be wrong. There can be no doubting that the Fed has supplied more liquidity, if it hadn't, banks would have failed, and funding costs soared. No Central Bank will let deposits be destroyed if they can help it as it undermines confidence which affects the economy. But it is important to understand that the Fed's injections of liquidity were passive; they were responding to the demand for settlement cash from the troubled banks and not to stimulate the economy, much like the early iterations of QE, where the liquidity injections stayed at bank level and didn't make it into the broader economy providing no stimulus. This sterile action has some similarities with the surge of deposits into Money Market Funds (MMF) in the US, and more Fed unintended consequences…

As a result of the Fed's badly calibrated response to the Pandemic there has been a flood of cash into Money Market Funds to the extent that the MMF have more Assets Under Management (AUM) than there are cash assets available for them to invest in. MMFs must invest their funds in instruments of high quality and short maturity. Previously, they might purchase Treasury Bills from investors and as a result returned the money to the financial system aiding liquidity, but this is no longer the case. Currently US MMF stand at around $5.5 trillion with around $3 trillion of available Treasury Bills to buy. So, what does a MMF do with the extra funds? They use the Fed's Reverse Repo (RRP) facility, which allows MMFs to access a return of currently 4.8% on an overnight facility with the Fed – a remunerative and almost riskless transaction for the MMFs. But use of the RRP is "sterile" in terms of the market effect, an unhealthy development with largely negative implications for the US financial system and economy going forward. The move to Money Market Funds has had a significant effect on the banks' deposit bases and ability to lend, which our economist Andrew Hunt believes has vastly outweighed the impact of QT on the banks. The Fed has incentivized MMFs to deal with them at the expense of other private entities. Its interventions have led the US economy to rely on the Fed for its normal operations as a money market maker of first resort, rather than a traditional lender of last resort during financial crises. This development could, over time, undermine the efficiency and robustness of the US market economy, reducing the efficient flow of money through the banking system, which is essential for the proper functioning of a market economy. This effect on the money supply is important to monitor.

US Money supply has fallen 7.65% (3m annualised) or $430.17bn. Within that number base money (reflecting the flood to MMFs) was actually up $124.58bn, but more importantly for the economy, commercial money (money created through debt issued by commercial banks) was down a stunning $554.75bn. This mirrors the big drop in Q4 2008 following the Lehman collapse in September 2008, and in 2020 the 3 months to mid-June. In times of banking sector stress, banks tend to stop lending. The scale of monetary decline we are now starting to see is the worst since the Great Depression and comes at a time when credit conditions are the tightest since 2009 and the early stages of the Pandemic. We don't know whether they can see it, but how much more does the Fed need to do? We are potentially at a key inflection point and the next actions/inactions may be key to the length and depth of the US recession.

Coming back to the Moral Hazard issue, which has been supporting imprudent risk taking for longer than we care to remember. The World was saved from numerous crises and firms as well as depositors were saved to the extent that Moral Hazard became a tradeable feature of markets. Entities took more and more risk knowing that if all else failed, the Fed would step in to save the day. Recently, (because of SVB and Signature?) Chairman Powell seems to be saying no more. It is an inevitable part of any path towards a resumption of a more "old normal", which we would welcome. We hope for a return to a more "real" investment environment where balance sheets, leverage and the quality and profitability of businesses became more central to their valuations than interest rates. Call me a Dinosaur, but we can but hope…

In February markets priced in interest rates "higher for longer", bond yields rose, and equities fell. We could see some more volatility over the next quarter caused by uncertainty about the trajectory of inflation and interest rates, but on a more positive note, lower equity valuations vs the beginning of 2022 may mean that markets are less vulnerable to risks, including a recession, earning downgrades or higher interest rates. The decline in gas prices and reopening of China are supportive of markets at current levels, even if rates are not cut as soon as might have been expected in January.

It is also important to remember that markets are forward looking, so if inflation does continue to fall it could drive central banks to end their monetary tightening and cut rates, providing relief to bonds and possibly equities. Diversification, active asset allocation and manager selection can build stronger portfolios, especially now fixed income markets have regained their traditional characteristics within a balanced portfolio - offering income and providing a good potential hedge against recession risks.

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