SoundCapital™

Posted 3/22/2023 by Christian Luchsinger

SoundInsight N°4

01 Interest rate expectations drop massively

02 Financial sector needs government support

03 Inflation expectations reflect lower future growth

04 Defensive positioning remains

Crisis of confidence

The financial sector is flashing a clear warning signal. Higher interest rates are leaving the first cracks in an obviously fragile banking system. The consequences could turn out to be a paradigm shift in terms of monetary policy.

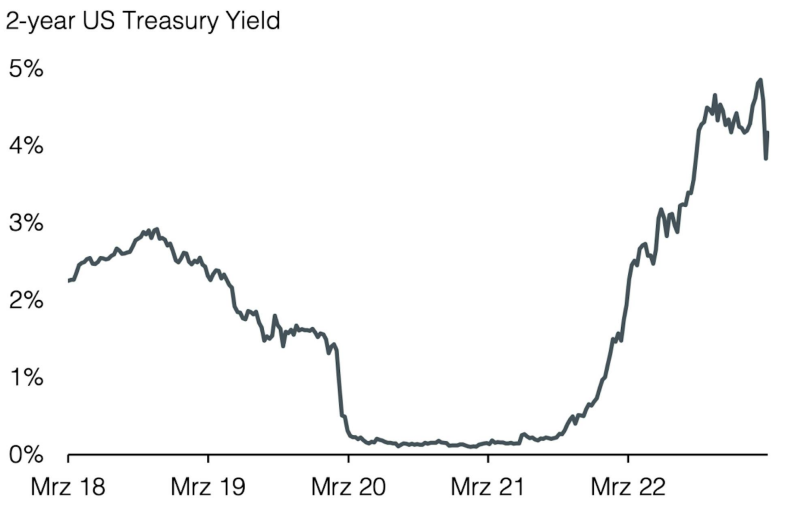
A little more than a week ago, the content of this Sound Invest would have been quite different. Almost all macroeconomic data exceeded analysts' expectations and pointed to continued persistent inflation. Hence, the interest rate expectations derived from the FED and ECB monetary policy were subsequently adjusted sharply upward by the market. At the beginning of March, the expected US key interest rate for the end of the year reached 5.75%, a level unseen for more than 20 years.

Then events came to a head: Apparently flawed risk management at Silicon Valley Bank (SVB) led to the second largest bank failure in US history. Although relatively unknown outside the US, SVB was one of the 20 largest US commercial banks, with total assets of USD 209 billion. Nearly half of US venture capital technology and healthcare companies were doing business with SVB. Continuously rising interest rates put pressure on the value of risk capital invested in bonds, triggering a crisis of confidence, followed by a bank run. Within 48 hours, depositors got bailed out by the FDIC (Federal Deposit Insurance Corporation), with all creditors' deposits (including uninsured) of more than USD 150 billion guaranteed by the government. At the same time, two other institutions, Silvergate and Signature Bank, became insolvent and their deposits were also immediately guaranteed by the FDIC in the same manner.

The drastic situation put the entire regional banking sector in the USA under massive pressure and did not stop at the large US financial institutions, as their stocks also suffered heavy losses. From a European perspective, the events were already eclipsed in the following week. With Credit Suisse, a globally far more relevant institution got under pressure. While a "too big to fail" institution like CS is subject to much stricter capital and liquidity requirements, a collapse in its share price and a sharp rise in its credit default swaps, coupled with increasing international political pressure, forced the Swiss financial market regulator to smooth the waters with a forced takeover by rival UBS. In the transaction, the SNB granted a total of CHF 200 billion in additional liquidity guarantees and the Swiss Confederation issued a loss guarantee totaling CHF 9 billion. On top of that, the conversion of subordinated CS bonds created an additional CHF 16 billion in core capital. With the Swiss Confederation, one of the world's most solvent sovereigns intervened and, in our view, created the important basis for a lasting calm in the market. However, the fact that this crisis of confidence was only solved with government support is unlikely to help investor sentiment.

Recent developments show that central banks have reached their monetary goal or might have already exceeded it. Generally, banking crises are followed by stricter lending standards and a lower risk appetite among companies and investors. In the US, SMEs are likely to be hit hardest, as they are most dependent on lending from regional banks. US small businesses account for nearly two-thirds of jobs in America, so the reduced availability of credit is likely to lead to an increase in unemployment. While there will be a lag before these effects reach the economy, inflationary pressures are likely to ease as a result. This is clearly reflected in market developments: the Fed's expected key interest rate at year-end fell from 5.5% to 4% last week. Not surprisingly, US inflation expectations for the next 12 months fell to 2.4%.

We see our current positioning confirmed and maintain a defensive allocation. We remain overweight government bonds across our fixed income allocation. In our view, rising credit spreads do not yet represent a buying opportunity for lower quality bonds. In equities, we remain underweight due to depressed risk premiums and favor defensive markets and investment styles such as Switzerland and high-dividend quality stocks.



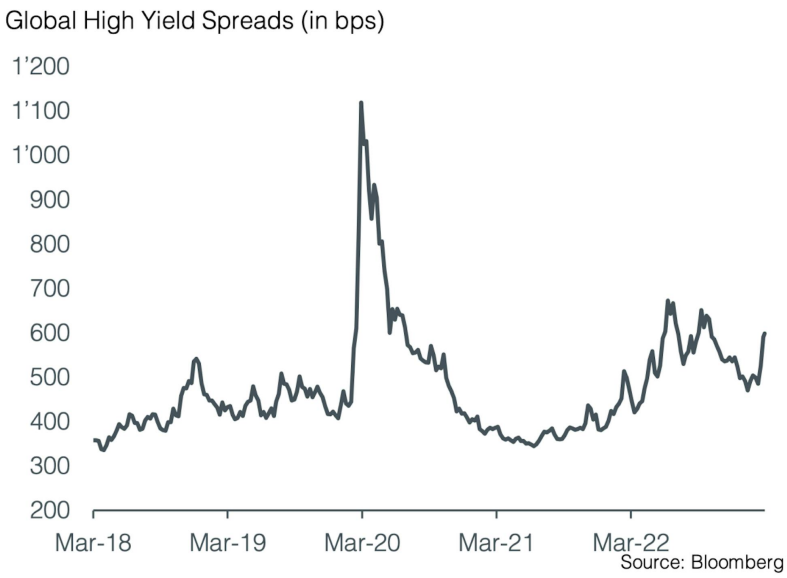
Source: Bloomberg

Yields

Central bank policy is being put to the test by the current uncertainty in the financial sector. Interest rate expectations for the coming months have been massively revised downwards, especially in the US, with interest rate cuts now expected at the end of the year instead of increases. In addition, interest rate volatility has once again risen massively, as complete calm has not yet returned despite government intervention. However, interest rate levels remain attractive for the time being. From our point of view, it has been confirmed in recent days that high-quality bonds again offer not only a decent yield but also a positive diversification effect during stressed markets.



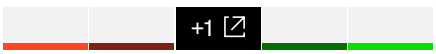
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Source: Bloomberg

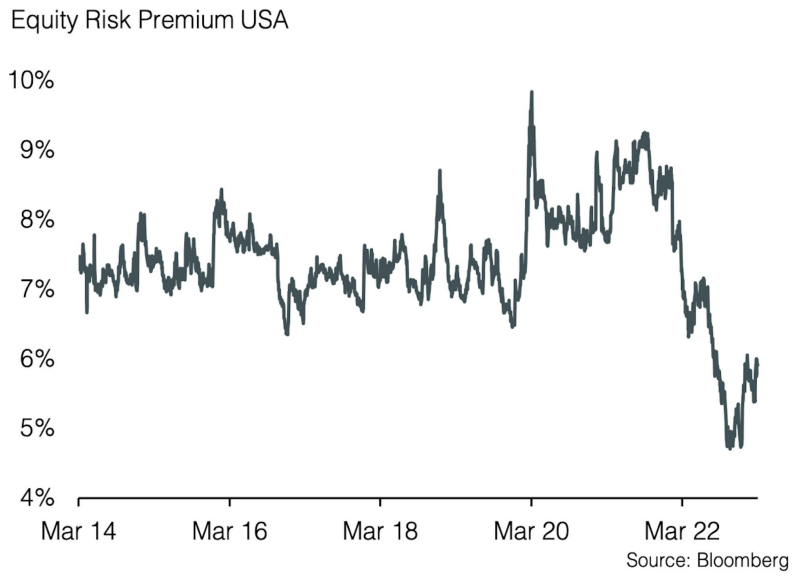
Spreads

Credit spreads have jumped significantly due to stress in the banking sector. Nevertheless, we do not yet see attractive valuations by historical standards. In the wake of uncertain economic developments, spreads are likely to rise, especially for lower credit ratings. We maintain our preference for high quality and avoid high-yield corporate bonds.



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Equity Risk Premium

Lower interest rates, lower share prices and declining inflation expectations have had a slightly positive impact on risk premiums. Nevertheless, they currently remain at an unattractive level.



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Manufacturing PMI

	Jun 21	Jul 21	Aug 21	Sep 21	Oct 21	Nov 21	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23
Global	55.5	55.4	54.1	54.1	54.2	54.2	54.3	53.2	53.7	52.9	52.3	52.3	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	50.0
USA S&P Global	62.1	63.4	61.1	60.7	58.4	58.3	57.7	55.5	57.3	58.8	59.2	57.0	52.7	52.2	51.5	52.0	50.4	47.7	46.2	46.9	47.3
USA ISM	61.1	60.0	59.6	60.7	60.4	60.8	58.6	57.6	58.4	57.0	55.9	56.1	53.1	52.7	52.9	51.0	50.0	49.0	48.4	47.4	47.7
Europe	63.4	62.8	61.4	58.6	58.3	58.4	58.0	58.7	58.2	56.5	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5
Germany	65.1	65.9	62.6	58.4	57.8	57.4	57.4	59.8	58.4	56.9	54.6	54.8	52.0	49.3	49.1	47.8	45.1	46.2	47.1	47.3	46.3
United Kingdom	63.9	60.4	60.3	57.1	57.8	58.1	57.9	57.3	58.0	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3
France	59.0	58.0	57.5	55.0	53.6	55.9	55.6	55.5	57.2	54.7	55.7	54.6	51.4	49.5	50.6	47.7	47.2	48.3	49.2	50.5	47.4
Italy	62.2	60.3	60.9	59.7	61.1	62.8	62.0	58.3	58.3	55.8	54.5	51.9	50.9	48.5	48.0	48.3	46.5	48.4	48.5	50.4	52.0
Spain	60.4	59.0	59.5	58.1	57.4	57.1	56.2	56.2	56.9	54.2	53.3	53.8	52.6	48.7	49.9	49.0	44.7	45.7	46.4	48.4	50.7
Sweden	65.7	65.0	60.5	64.7	64.3	63.2	61.3	62.0	57.6	56.7	54.6	54.5	53.0	52.1	49.6	49.0	46.7	46.0	46.0	47.0	47.0
Switzerland	67.1	70.0	67.3	67.4	66.3	64.1	64.5	63.7	62.7	63.3	61.6	59.8	59.1	58.0	56.7	56.8	55.4	54.4	54.5	49.3	48.9
China Local	50.9	50.4	50.1	49.6	49.2	50.1	50.3	50.1	50.2	49.5	47.4	49.6	50.2	49.0	49.4	50.1	49.2	48.0	47.0	50.1	52.6
China Caixin	51.3	50.3	49.2	50.0	50.6	49.9	50.9	49.1	50.4	48.1	46.0	48.1	51.7	50.4	49.5	48.1	49.2	49.4	49.0	49.2	51.6
Japan	52.4	53.0	52.7	51.5	53.2	54.5	54.3	55.4	52.7	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0	48.9	48.9	47.7

Description: The Purchasing Managers' Index (PMI) is a forward-looking economic indicator based on company surveys. A value above 50 indicates an improving economic environment, whereas a value below 50 indicates a worsening environment.

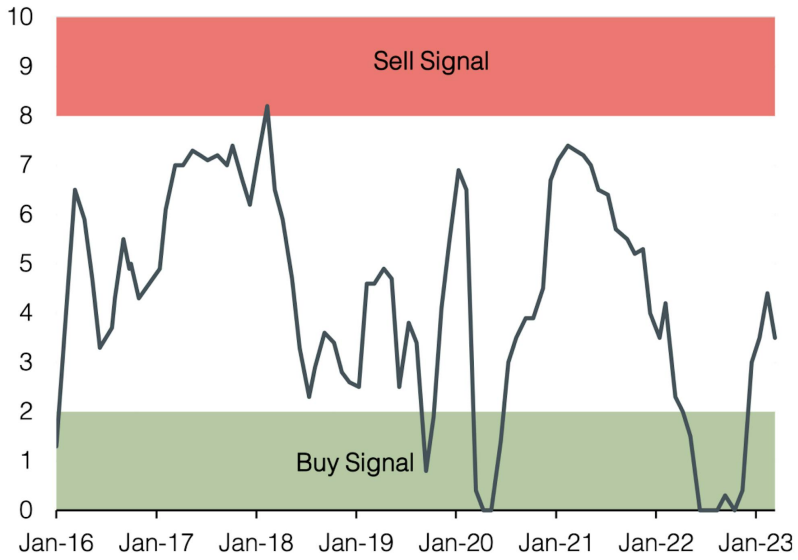
Leading Indicators

Leading indicators have improved again over the past month. In particular, the jump in China's purchasing managers' indices points to improved sentiment in one of the most important economic areas. Both the manufacturing and service sector have improved. Currently, the indicator remains at a neutral level, but is clearly moving in the direction of a positive assessment.



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Risk-Index

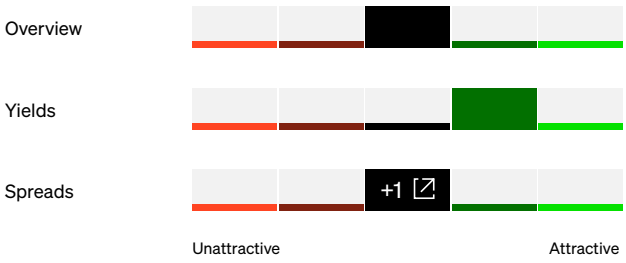
It can hardly come as a surprise that investors' appetite for risk has declined. However, there has been no panic; we are, however, noticing an increasingly defensive positioning in bonds. The risk positioning is surprisingly resilient in equities, where no major outflows were recorded despite higher volatility. Overall, the risk index continues to give a neutral signal.



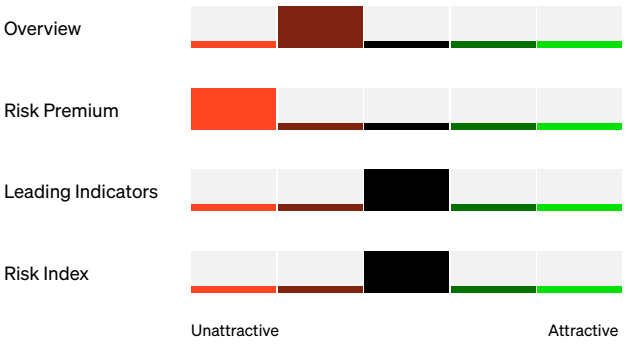
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Bonds



Equities



Appendix

Sound Invest is the central tool for our investment allocation. We use it to systematically and consistently assess the aspects that are relevant to the development of the financial markets. As a result, our clients can rely on a rational and anti-cyclical implementation of our investment decisions.

- **Focusing on the essentials** Interest rate level, risk premium, valuation, economic development, investor sentiment and positioning. These are the decisive factors for success on the financial markets, especially in turbulent times when the temptation to react irrationally to the headlines is particularly strong.
- **Comparability over time and place**
  The factors mentioned above are equally relevant for all markets and at all times. This is the result of a strict «backtesting» process that continues into the future.
- **Cumulating our investment experience**
  Our strength lies in the many years of experience of our partners and principals. It is precisely this experience that we summarize and make it applicable with Sound Invest.
- **Transparency**
  Thanks to our monthly publication, our clients always know where we stand in the investment cycle and how we expect the financial markets to develop.

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