INVESTMENT ENVIRONMENT

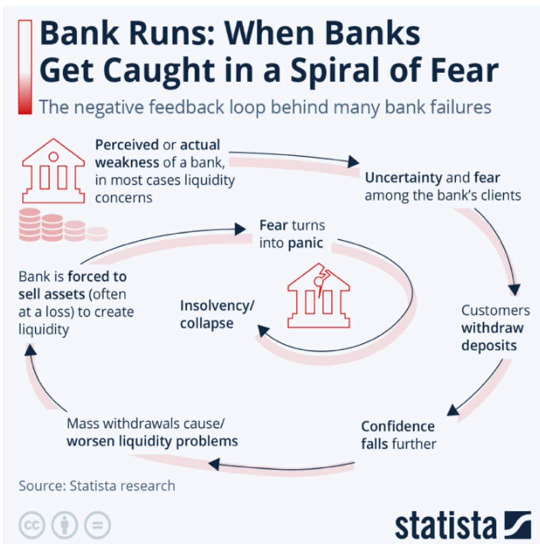
DOUGLAS INVESTMENTS

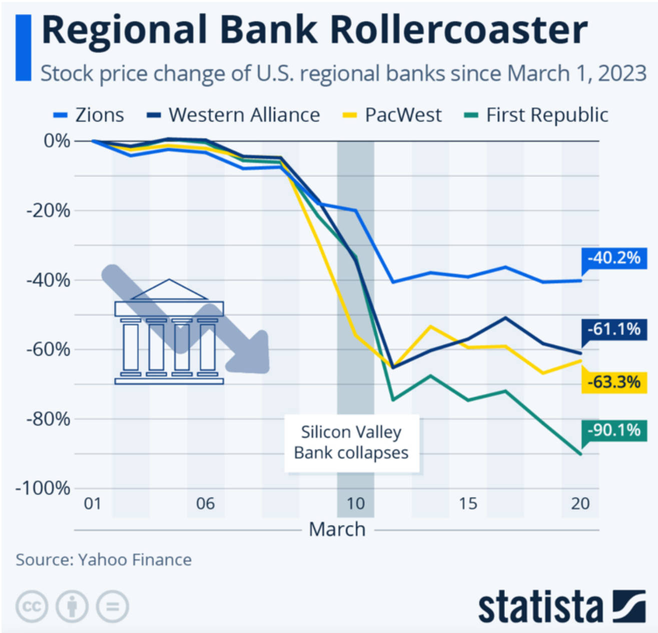
Introduction

March saw one of the biggest shifts in macro focus as the market moved from inflation focus to financial stability. This was largely driven by concerns of a liquidity crisis amongst the regional banks in the US with contagion effects spilling into Europe. Markets experienced significant volatility in equities and even more extreme moves in bonds as rate expectations changed based on the shift in focus. Despite this, the ECB increased rates by 50bps, which was in line with what was previously communicated. The market expectations for the Fed changed daily with expectations ranging from a pause to a 50bps hike. Ultimately the Fed increased by 25bps, which was well received by markets. In the UK the BOE moved in line with expectations and hiked by 25bps. This was based on a more upbeat outlook for the UK's sluggish economy while still acknowledging the risks posed by turmoil among global banks. Inflation forecasting in the US is improving with market expectations and the actual data very closely aligned with fewer surprises and it continues to cool off. However, the rate of slowdown is not as rapid as it was at the start of the year and core inflation is potentially proving sticky, as we have previously written about, but the market is primarily focused on the concerns in the banking sector. The war in Ukraine continues with Putin committing to persisting until Russia has achieved its goal. The geopolitical tensions continue with President Xi Jinping spending 3 days in Russia discussing various topics but also looking to play peacemaker in the war in Ukraine. On the other hand, Japanese Prime Minister Fumio Kishida visited Kyiv and showed strong support to Ukraine. Locally load shedding continues to have a negative impact on the economy with a number of companies citing margin pressure due to significant load shedding costs. South Africa's GDP shrunk 1.3% in the fourth quarter of 2022 as the impact of load shedding was truly felt by the economy as a whole. Earlier this week, the Reserve Bank raised interest rates by 50 bp (25 was expected) sighting sticky inflation. This caused the ZAR to appreciate against the USD as the interest rate differential widened marginally. The political environment remains volatile with the EFF staging a National Shutdown on Monday 20 March which attracted significant media coverage although it was ultimately largely ineffective. President Ramaphosa finally implemented his cabinet reshuffle with limited surprises but a clear move to surround himself with allies. South Africa now has a minister responsible for electricity with Kgosientso Ramokgopa appointed to the role with the focus of bringing load shedding to an end. Inflation in South Africa reaccelerated to 7% in February from 6.9% in January largely driven by food.

Macro Environment

Banks are largely institutions based on trust. People and businesses need to feel certain that their money held at the bank is safe and that they can get access to it when needed. When this trust breaks down, the system can fall apart very quickly. The Statista image on the right reflects how this can spiral into a crisis. During March we saw this unfold in both the US and Europe, starting with the collapse of Silicon Valley Bank (**SVB**) in the US. As depositors became concerned about SVB they started pulling their deposits which forced SVB to sell assets that they planned to hold to maturity in order to meet the liquidity requirement of the deposits being withdrawn. These assets that were meant to be held to maturity resulted in a significant loss, which ultimately wiped out the equity of the bank and pushed it into insolvency. The compounding effect of depositors losing faith in a bank and pulling their deposits has a fast and significant knock-on effect.





As the market lost faith in SVB the knock-on effect to other regional banks was significant as outlined by the Statista chart on the left. A steep sell off was experienced in the share price and depositors started to move their deposits to 'more secure' banks such as the Bank of America which saw an increase of about USD15bn in a few days. Regulators needed to get involved with the Fed, Treasury and FDIC guaranteeing deposits even above the insured level of USD250 000 in order to try and calm markets. The contagion spread to Europe with Credit Suisse experiencing significant stress and ultimately a government brokered deal resulted in UBS purchasing Credit Suisse for CHF3bn. This is again in an effort to shore up confidence in the banking system and comes with a number of terms and conditions but looks like ultimately a good deal for UBS.

The banking concerns have had a knock-on effect to the macro environment as the market anticipates the banking strain having a material impact on central bank hiking policy. However, central banks operated swiftly and managed to restore calm. In general, banks capitalization is solid, and deficiencies are limited; therefore, the likelihood of a systemic crisis seems remote. While there is some restoration of normality, the expectation is that central banks need to slow rate hikes, and less than previously thought, as the past hikes are already putting strain on the system. It is anticipated that financial conditions will tighten as a result of the banking concerns, as a more cautious lending approach is adapted. These conditions will naturally slow growth for banks, and the economy as a whole, which is part of the reason that market expectations for rates have dropped off so significantly. Before the concerns about the banking system, the expectations were for a terminal rate that could even get above 6% but that has come down significantly to around 5%. However, it is important to note that inflation remains prevalent and potentially stickier than anticipated and therefore we do not anticipate rate cuts until 2024.

So far 2023 has provided interesting phases of macroeconomic focus which have been well summarised by Bloomberg *(Bloomberg, 5 things to start your day Americas edition, 22 March 2023)* as follows:

- Recession fears (first few weeks of January)
- Soft-landing optimism (late January through mid-February)
- The "No Landing"/reheating consensus (mid-February - early March)
- Fears of a bank crisis in the US and Europe (early March to yesterday)
- Modest optimism that the banking crisis is contained to a few idiosyncratic institutions (yesterday)

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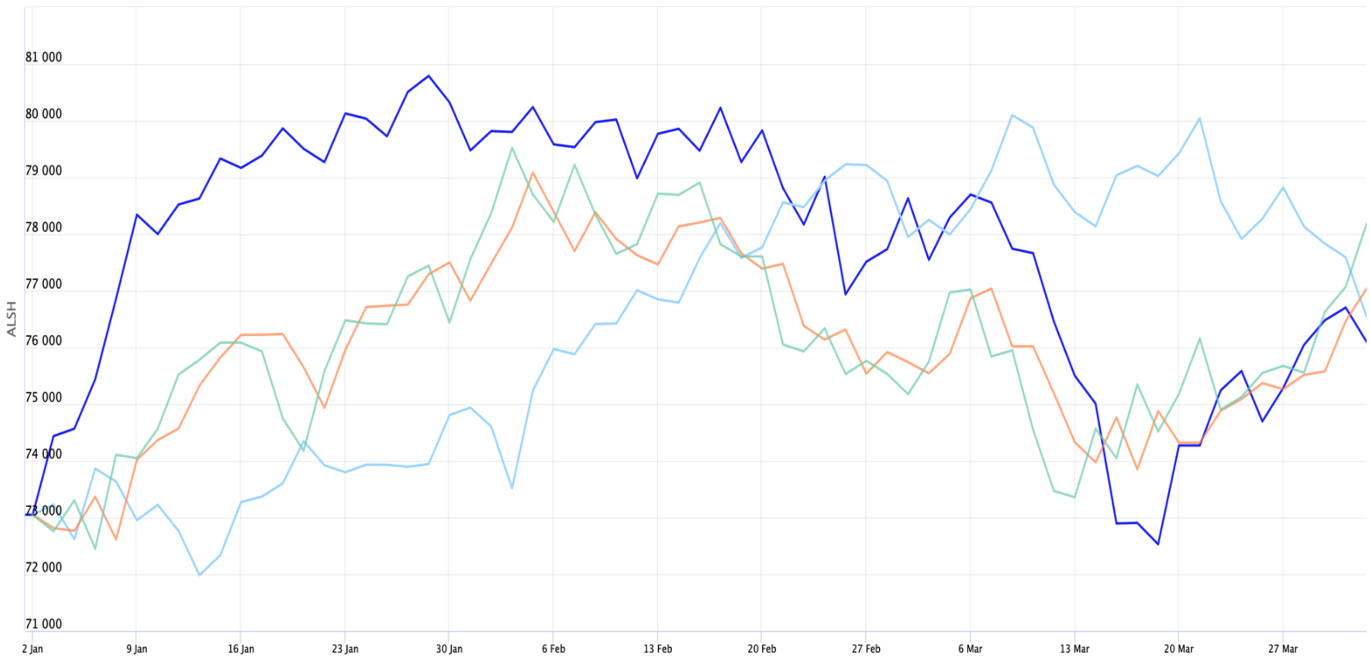
Asset Allocation

We remain comfortable with our current asset allocation as the market remains volatile with some steep sell offs and rallies so important to remain in the market but with a cautious approach. The Technology sector has benefitted from the banking concerns as several investors shifted funds into big tech, which has seen a decent rally. Our bond positions have benefitted from the drop off in yield and continue to play an important role in portfolios. Structured products continue to add income to the portfolios with some downside protection. We are continuing with our cautious allocation in the current market volatility and are also aware of the next round of earnings starting in mid-April, which will provide further insights into the effect of the rate hikes on the economy as well as companies performance and expected margin pressure. As we have previously communicated, we anticipate volatility to remain for the first half of 2023 and it is important to remain invested to catch the market rallies although we maintain our view that there is pressure in the system and hence we remain with our cautious approach.

Market Performance

March saw discrepancies in the market with offshore equities improving while local equities suffered a decline. Globally the MSCI World was up 1.71%. The S&P500 ended the month up 4%. The JSE was down 3.22% in March. The chart below depicts the market movements for the year to date with the blue line showing the JSE all share up 4.18% and the light blue line showing the ZAR/USD exchange rate recovering a bit in March but still declining YTD by 4.78%, the orange line showing the MSCI World up 5.46% and the green line showing the S&P500 up 7.03%.



Equities

There was significant volatility in the equity markets during March as markets digested hawkish comments at the start of the month by central bankers followed by a shift into financial stability concerns. Earnings season was largely finished so macro factors were the focus of markets and banks specifically saw very large swings with drops of up to 70% being experienced. As the market settled there was also a significant recovery in most banks. Further job cuts from Meta and Amazon reflected the continued cost saving focus that several companies are taking. As we move into April the focus will shift to earnings with the banks starting on 14 April which will provide insights into any further pressures in the system.

Valuations are currently a bit stretched especially considering anticipated earnings pressure. The focus on bank stability has disrupted the rhetoric around a possible recession; however, as earnings start to come through, we anticipate the recession conversation picking up. There are pockets of opportunities as certain stocks get oversold during negative sentiment but our general view on equities is to remain patient for attractive entry points based on fundamental analysis of earnings. In the local market, the risk off sentiment has hurt the JSE and load shedding has impacted poor results; however, resources have staged a recovery. The environment remains uncertain, and equities don't like uncertainty, so we need to try look through this cycle and make decisions with a long- term view, which is how we have constructed portfolios and the basis on which we are making any changes.

Bonds

Bonds in portfolios have benefitted from the drop in yield (bond's price move inversely to the yield). It has been a very volatile month for bonds with significant moves as the banking concerns have driven yield in both directions depending on the news flow. We remain focused on the shorter end of the curve as the sensitivity to rate changes increases the longer the maturity of the bond. Our view remains to hold these bonds to maturity as the yield is attractive especially considering the current view that rate cuts could even take place in this calendar year.

Conclusion

The first quarter of 2023 has been filled with mixed sentiment as the strong start to the year has faced recent headwinds. Overall portfolios have been well positioned and our cautiously optimistic approach has been sensible as some positive sentiment has driven strong rallies but important not to chase these runs as the market is moving quickly and you can get caught on the wrong side. We anticipate the second quarter of 2023 continuing in this trend and it will be important to take advantage of attractive valuation opportunities but recognizing that there are still significant economic headwinds and we are not in a bull market. As always the team is available should you wish to discuss portfolio positioning and any of our thoughts on the above.