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A crowning moment and a new regime?

It has been a surprisingly resilient start to the year – all things considered.

While last quarter we noted that the football World Cup had essentially "saved" the UK GDP for the fourth quarter by preventing it from slipping into recession, this quarter we had the Coronation of King Charles III which provided its own boost. A series of May bank holidays and Britannia on display certainly sparked a sense of well-being and consumer confidence in the UK, but it remains to be seen if this will be enough to offset the many headwinds the economy is facing as we approach mid-year.

These headwinds include not only the now-familiar concern of persistently high inflation and rising interest rates, but also some exogenous threats, such as the incipient regional bank crisis in the US. This stock market seems impervious to all of these though, as markets have remained strong throughout the year and remarkably forgiving to disappointing earnings.

If there is a new regime that is starting to form now it would be one characterized by a slight but distinct downward shift in inflation, discussions of (some) central banks pausing in their rate hikes and the widescale "wait and see" around artificial intelligence and the kind of disruption that it is likely to unleash.

In the UK inflation is proving slower to tame than in other economies but (as detailed below) it does look like the steam being let out of energy prices will be key to leading the rate to buckle. The 25 bps May rate hike, in which the Bank of England hiked rates for the 12th time in a row brought the base rate to 4.5%. The 10-year gilt price also proved to be weak too. As the Bank of England has continued to sell bonds into the market demand has not exactly been abundant and this is placing further pressure on bond prices.

So overall the UK is facing a bit of a mixed picture as the bond crisis of September/October is still leaving an element of fragility in the system. The Prime Minister and the Bank of England sounded optimistic notes in recent weeks about inflation as well as revenue growth and consumer confidence. The country skirted the banking crisis experienced by regional banks in the US, but the gilt crisis should be a reminder that crises often arise where we least expect them.

As we approach the end of the first half of the year, it does not feel like a time for complacency. 2022 was tough, and 2023 so far is a bit of a mystery. Onwards!

Key Developments since the last quarterly update:

- **Inflation continues to lose some steam –** This is particularly the case in the US, although in the UK it may be more in the eye of the beholder (Bank of England) than in the number so far.
- **Are we there yet on interest rates?** All central banks seem to be converging around the potential end to the current rate hiking cycle. The Fed settled on a second 25 bps rate rise in May despite a frazzled financial sector, while the ECB and the Bank of England both did the same although the ECB was more resolute about "not pausing".
- **Employment is now not so frothy –** Slowly but surely the job market seems to be showing signs of normalizing with fewer job vacancies and employment increasing slightly to 3.9%. In the US too, the data showed fewer job openings, an uptick in layoffs and higher unemployment claims – although it should be noted that all of these changes are modest. While this would not normally be good news, as an indicator of more muted economic activity it might signal the end to restrictive monetary policy.
- **Echoes of 2008 in the US regional banking crisis.** The brisk Spring blew wind blew in another chilling factor in the US with the swift and consecutive failure of a string of regional banks. Triggered by liquidity and not solvency problems, the flight of depositors from banks such as SVB, Signature Bank and First Republic Bank was evidence of the alarming speed of a modern-day bank run. This time JP Morgan was drafted as the system's saviour but it remains to be seen what would be done if the problem became truly systemic.
- **Artificial Intelligence gets real.** As discussed later, artificial intelligence has become the new Blockchain when it comes to a buzz word that excites investors around any company, not only tech, and users and analysts alike have been obsessed with the potential for services such as ChatGPT and Bard to transform how work is done. This may be behind some of the positive reception that large-cap stocks have received in recent months.

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Current Macro Snapshot

Doom Loops and Wage Spirals

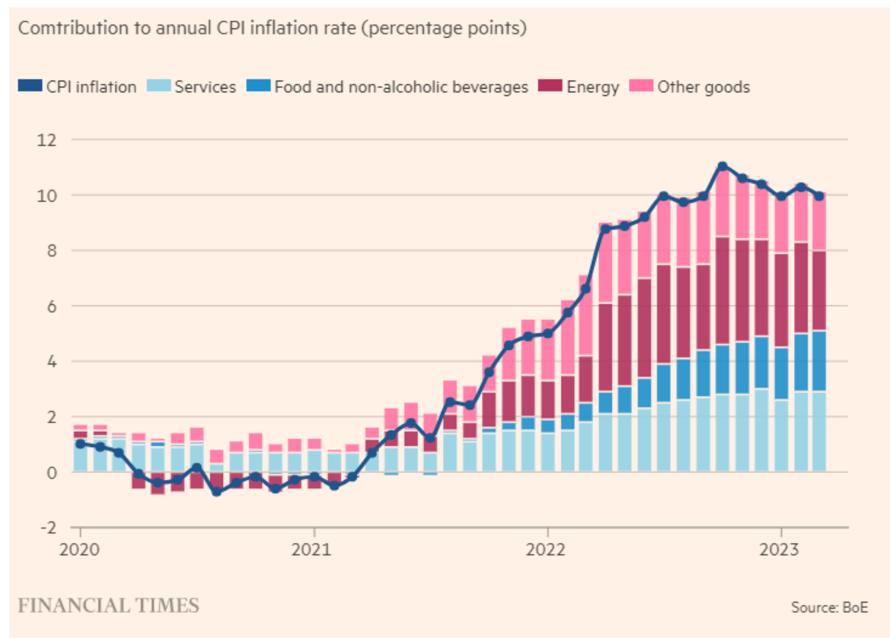
The last use of the term "doom loop" was around the time of the pension fund/gilt crisis of September/October 2022 when a wide-scale loss of confidence in the UK government led to a collapse of demand for UK gilts, which was then exacerbated by forced selling by the holders of those gilts as they sought to reduce leverage levels. This precipitated a *doom loop* of dropping bond prices necessitating further sales and so the doom loop took effect. As noted earlier, the hangover from the end of last year has introduced some volatility in this sector, once the most mundane of mundane areas.

It seems that the hangover from September/October is still having a lingering effect. It was reported that the Bank of England actually made a profit on purchasing gilts at rock bottom prices in the Autumn when it was a rescue agent and subsequently selling them back to the market once prices had rallied. Fair game, as it does take the heat out of the suggestion that taxpayers paid for the bailout if the process led to a profit for the bank.

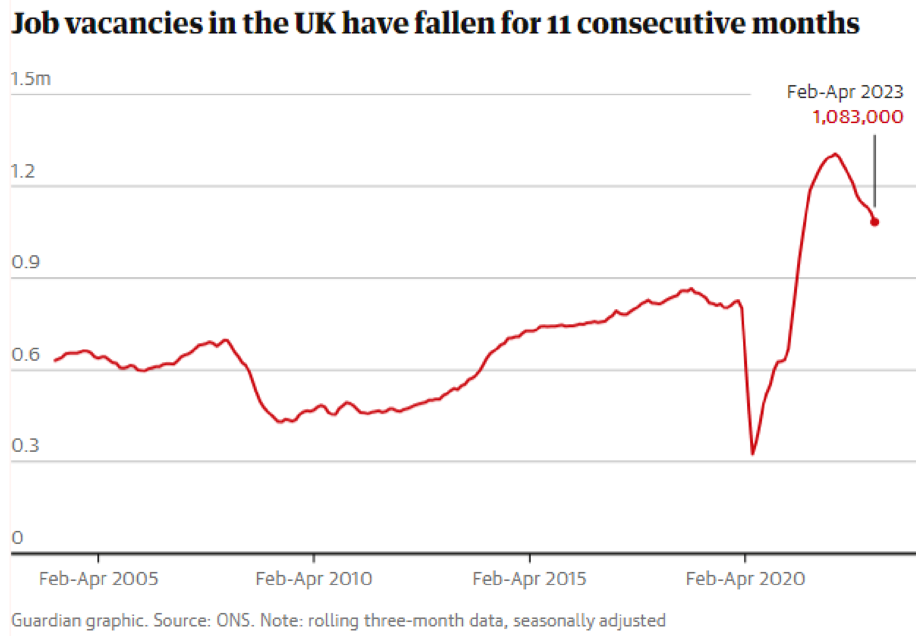
On the other hand, it remains committed to reducing its substantial gilt portfolio (suggested to amount to over £800 billion) by 10% per annum, by both failing to replace maturing debt but also by selling into the market. This comes at a time when the gilt market demand remains fragile and it is therefore somewhat possible that another downdraft in gilt prices is possible. With leverage levels much reduced and collateral buffers more robust today, it is unlikely that this downward price pressure will kick off a doom loop but this market remains one to watch.

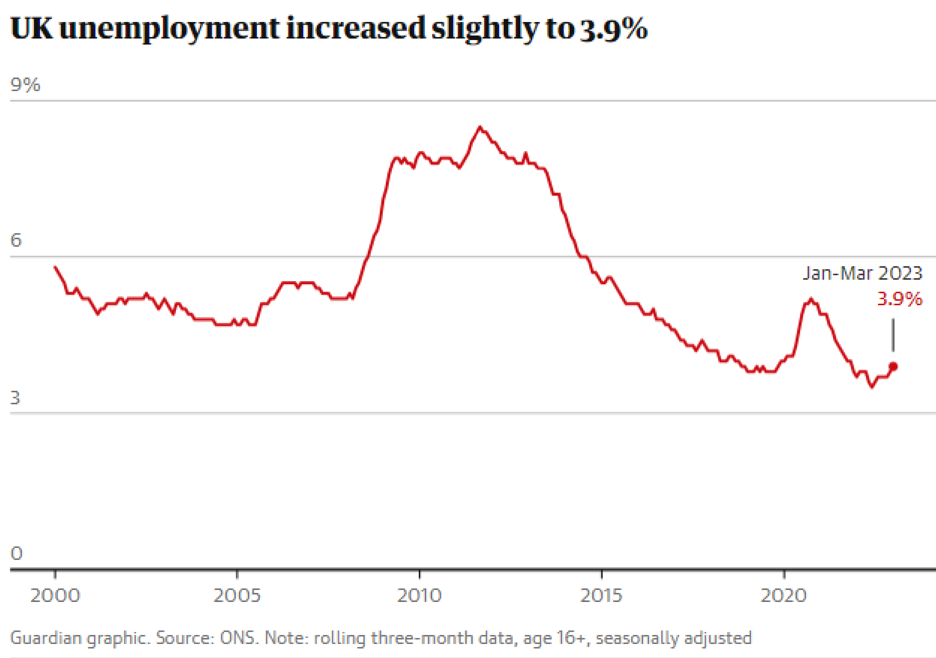
From loops to spirals, and the Bank of England recently admitted that it was facing a UK wage-price spiral as the governor reiterated the pledge to get inflation back to 2%. This was what the bank deemed a "second round" of price rises – and the shift from the initial hikes in prices of energy and food to services and wage increases. In the fixed income section below we show the Bank's expectations for the inflation rate to moderate in 2024 and beyond, and indeed some moderation has already gone into effect in the US as the chart below demonstrates:

Looking at the blue line (which includes food and energy) we can see that much of the drop in prices has come from energy, which is a pattern that is repeating in the UK:



Recession forecasting is still continuing but it is remarkably vague as to the nature of the coming recession as well as its start date. As noted above, the UK has skirted negative GDP growth through a series of exogenous events that have boosted spending, and in the US too the tight employment situation and high levels of cash on hand at money market funds suggests that spending could remain supported for some time to come. The charts below show some of the shifts in UK employment numbers. Will this recession be all bark and no bite?



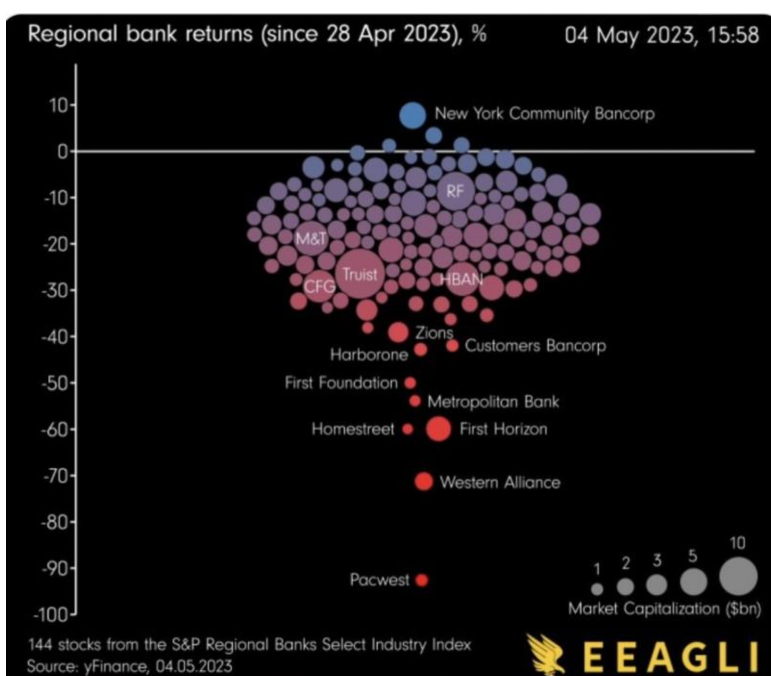


A New-Fashioned Bank Run

The past few months have been a tumultuous one for US regional banks, and the spectre of the demise of Silicon Valley Bank, which was seized by US regulators over the course of a dramatic weekend revealed some of the collateral damage that the stark rate rise cycle has wrought. Among the many notable aspects of that case are the perils of concentration in a customer base, the speed with which modern online banking allows a flight of depositors to occur, and the damage that a rising rate cycle can do to so-called risk-free instruments. While different in nature to the crisis of 2008, which was mainly due to defaults and poor credits, this crisis arose on the lower-risk side of the portfolio – the short-term government bonds used to support deposits.

The speed of regulatory intervention mirrored the no-nonsense approach that we had also seen with the Bank of England intervention in late September. This was repeated again in Europe with the forced merger between UBS and Credit Suisse, which some commentators compared to a shotgun marriage. While this type of action provides a floor under institutional failure – for now – it does beg the question as to how much of a safety net can be provided ultimately – and whether even the printers of money will reach their limits in terms of propping up failing institutions.

The chart below shows the stark loss of confidence in the regional banking sector in the US, and the way that the sector acted as a group despite some meaningful differences in customer composition. The lesson here is that no institution was deemed immune from contagion effects of loss of trust and confidence. The key difference between US and UK markets is the lack of fragmentation in this manner in the UK. With the banking sector here dominated by a far smaller number of large banks there does not seem to be the same danger or fragility.

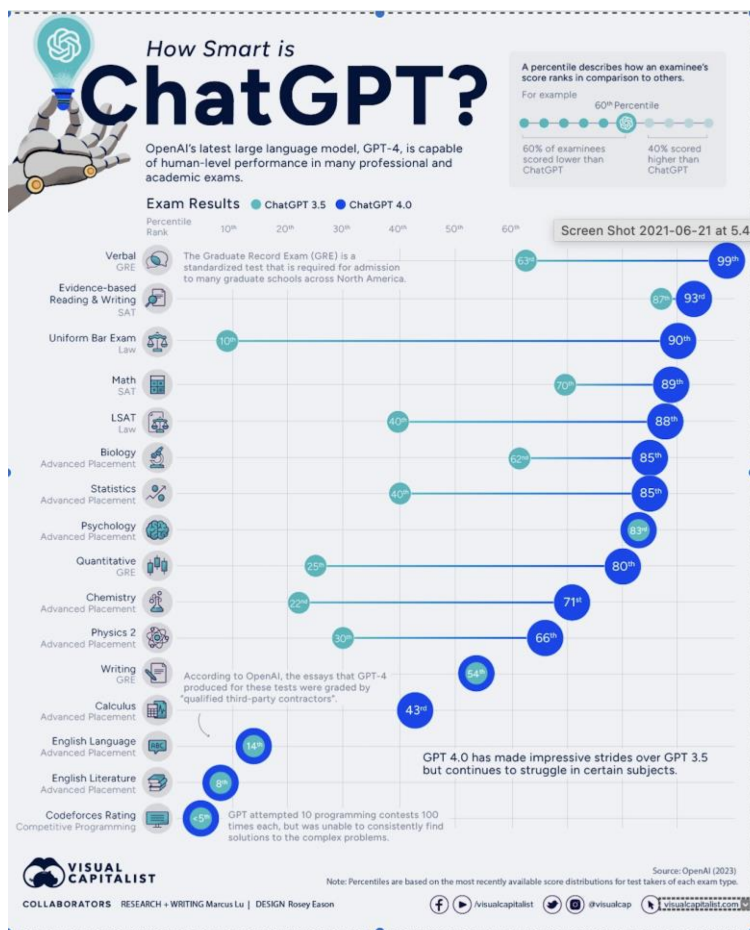


There are also some indications that despite the swift movement of funds out of banks in response to a fear about the safety of deposits that not all trust in the financial system has been lost. Instead it seems to have been dispersed – as funds left banks they flowed into money market funds, gold and even Bitcoin. Equities too saw inflows over the year to date, which did contribute to some of the strong equity market performance, and inflows into emerging markets were particularly strong.

Back to the Future with ChatGPT

As discussed below mentions of artificial intelligence and its disruptive potential have animated equity markets over the year to date and charts like that below reveal the starkness of the potential change. Disruptions in how work will be produced and who will be needed to deliver it remain in the zone of

speculation, and we are bound to read quite a bit more about the impact of these advances in months and years to come.



Sterling rides high

Sterling has benefited from the stronger than expected performance of the UK economy as well as the absence of much drama on the political front. The GBP has been well supported and has gained ground against the US dollar over the year to date – but only by 3% due to some volatility. This is notable as so much of the fund's assets are held in dollars. Any dollar weakening will erode the returns from dollar-denominated assets.

Individual Asset Class Performance.

- Equities
- Fixed income
- Other asset classes

The chart below shows recent performance in main equity indices (at May 26, 2023)

Equity Index	Year to date (May 26, 2023)	1 year
FTSE 100	2.35%	0.55%
S&P 500	9.53%	1.14%
Nasdaq	23.97%	6.96%
Dax (Europe)	14.8%	10.52%
Hang Seng	-5.23%	-6.81%
Shanghai Comp	3.99%	2.63%

Equities: A Mixed Bag of Earnings; Punishment is Gentle

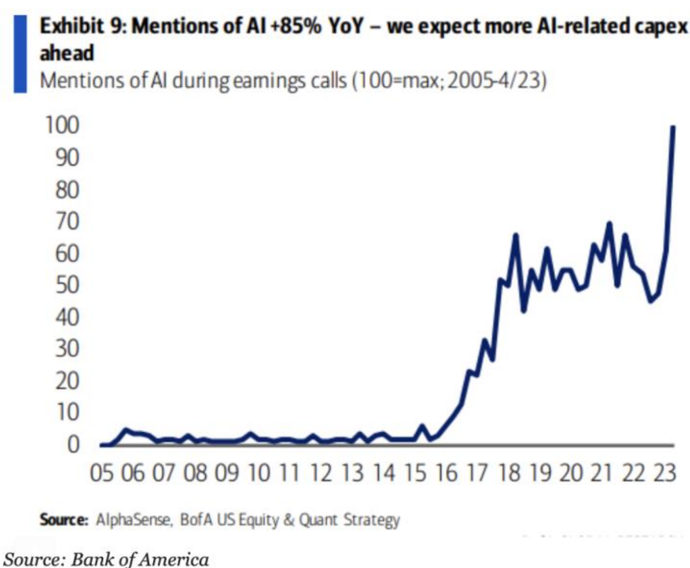
The sub-title of this section is identical to last quarter's as the message is identical. Earnings were widely "talked down" and as a result surprised on the upside. Companies cautioned about slowing demand and a more conservative consumer, but still demonstrated pricing power and robust demand. The message of streamlining, flattening and discipline sent by cuts to headcount were widely celebrated as they have been all year.

Markets have remained strong and in positive territory this year, despite the downturn caused by the US regional banking crisis. Again, it has been the tech-heavy Nasdaq leading the charge, with the S&P still in very respectable territory but non-US stocks more challenged, with the exception of Europe. Resilience in Europe and the emergence from the energy angst that characterized last winter

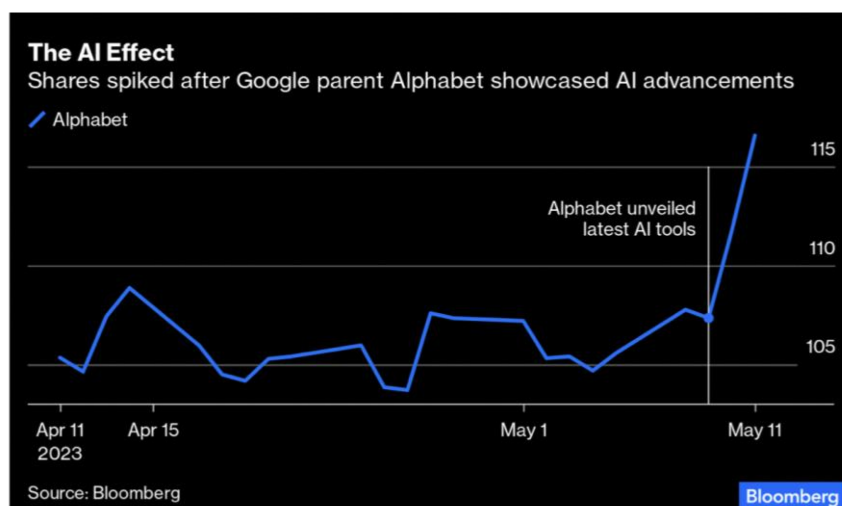
has driven investment across the region, while the UK market has been disappointingly weak against a backdrop of stronger than expected economic activity

Investors were instead interested in a different kind of newsflow – the promise of artificial intelligence and who the new power brokers might be set off another buying frenzy.

As the charts below slow the mention of AI soared in the last few months as it became a new buzzword, not unlike Bitcoin or Blockchain was some years ago. Even a behemoth like Google could be boosted by the promise of AI advancements:



Source: Bank of America



But tech has been a favourite all year, as the chart below shows, and the concentration of the US stock market is now becoming a repeating pattern. If we focus on the Big 7 and the Big 5 stocks, it is clear

that these have exceeded the indices all year, while if those Big 7 stocks are stripped out of the S&P the performance is actually negative year to date.

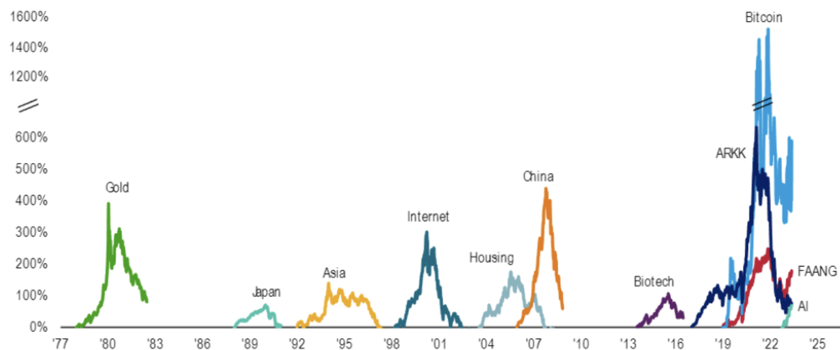
Big 7, Big 5, NASDAQ, S&P, and S&P ex Big 7 year-to-date.

This concentration can lead to more volatility when a sector comes in and out of favour and can often make it more challenging for active managers to outperform their indices. This is an area that we will continue to discuss with Border to Coast given the importance of our equity allocation to the growth component of the portfolio.

Whether artificial intelligence proves to be a bubble remains to be seen, and as the chart below shows it would only be the latest in a series of bubbles that the market has digested over the past five decades.

Chart 2: Artificial Intelligence a "baby bubble" for now

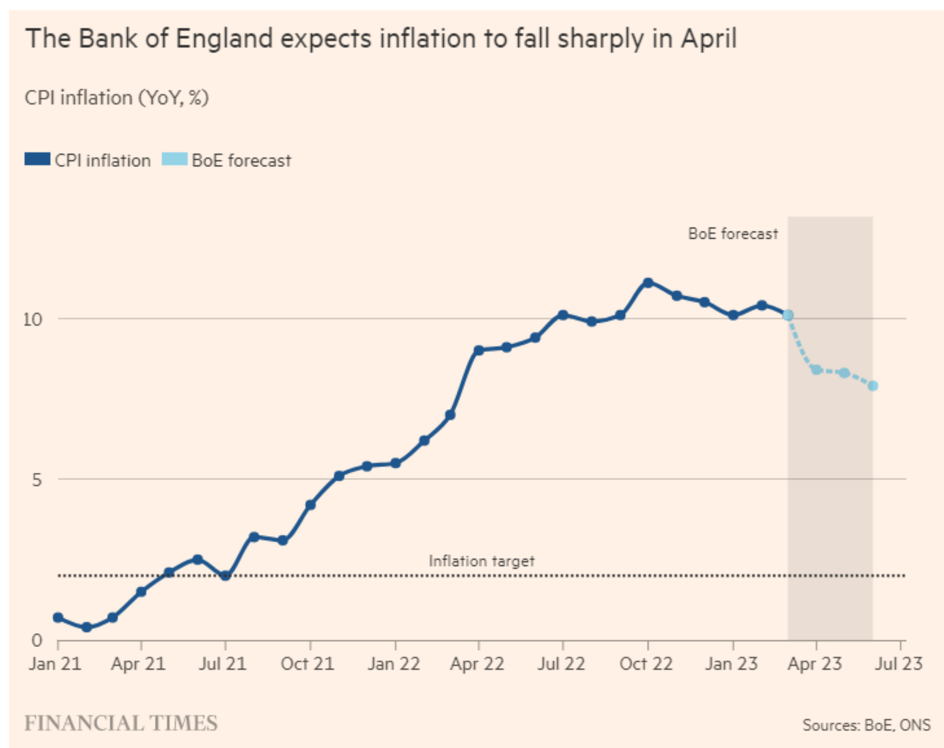
History of asset bubbles



Source: BofA Global Investment Strategy, Bloomberg (AI = NVDA + MSFT)

Fixed Income/Spotlight: Where do banks go from here

The Bank of England has now made its 12th consecutive rate hike bringing the UK base rate to 4.5% although there are some indications that the bank will shortly pause its activity based on its expectations that inflation will shortly start to fall – see chart below:

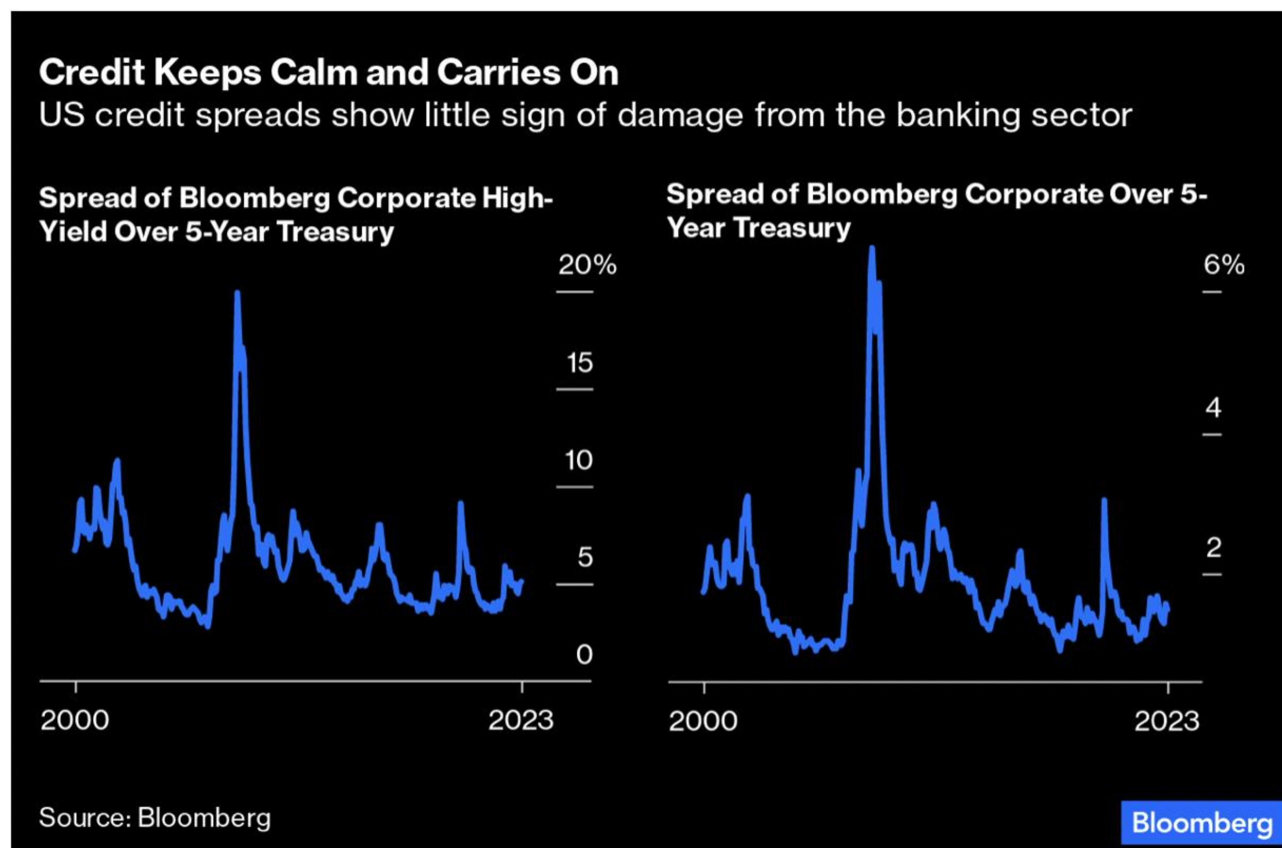


Now that some dust has settled following the gilts and pension crisis of late 2022 it is clear that the UK gilts market is still not quite behaving normally. We noted above the current bond selling program in place and the fact that this is not necessarily being matched by adequate demand leading to the gilts to trade at higher yields as they fall in price. For a buyer, therefore, there are good yields available on relatively low-risk government bonds and this is mirrored across the rest of the fixed income complex. Bonds are interesting again, in short, and this is reflected in our asset allocation shift to include more mainstream fixed income.

But what about the rest of the lending environment? There is little doubt that in the US a new wave of scrutiny and regulation will choke off some credit provision by regional banks. A tighter, more prudent, attitude to credit is the normal response to a crisis such as this, and normally it is private credit that steps into the breach in such an instance. The private credit environment has been expanding rapidly on a global basis, and as an example it now represents over 18% of credit markets in the US – up from 4% in 2000. Some analysts estimate that the size of the market that is currently represented by bank lending that could be addressed by private credit to be as large as $40 trillion, while currently

private credit marks only $2 trillion[1]. Clearly this area has a huge runway for growth, and it may dull the otherwise normal effect of a credit crisis.

As the charts below show private credit has been quite resilient in recent weeks, despite the backdrop of the regional banking crisis.



Other asset classes:

No other shoe has dropped in private markets despite many market commentators listening for its sound. Private equity valuations have not been notably marked down in pace with public markets over 2022 (they do lag by at least one or two quarters), but pricing in the secondary market has changed somewhat. While in the past "choice" private equity assets might yield no discount or even a premium when being sold in the secondary market it seems that 75-80% of NAV is the current pricing range. This reflects the deep uncertainty surrounding valuations today. The fund-raising environment has changed significantly since 2021 presenting interesting opportunities for LPs wishing to gain exposure to top managers.

[1] Source: Apollo Global Management, Inc.

Outlook . . A New Regime?

It seems we have reached the end of our "new inflationary regime" narrative, although our days of high inflation are by no means over. It is just that markets have looked around the corner, looked at the trend, and are listening to the experts, and have started to believe the promise. And as night follows day, talk of inflation is followed by talk of interest rate pathways and, as inflation buckles, so too will rates – or so the story goes.

The truth is that we really don't know the path that monetary policy will take – whether the focus will be on inflation only as it has been to date, or whether financial stability will dominate if central banks are faced with a choice. When the Bank of England had this decision in September 2022 it intervened as a purchaser of government bonds – it did not slow its rate rise trajectory but it did something expansionary nonetheless.

Earlier this year the US Fed had a similar choice as some commentators expected them to pause interest rate hikes in light of the prevailing banking crisis. They did not, but did pursue only a more modest 25 bps hike.

But what we do know is that institutions are "locked and loaded" figuratively speaking to step in when there is a crisis, and this places some floor of comfort under markets today. It won't protect investment returns from slipping from the acceptable to the mediocre, but it may provide some safety net against total loss.

In coming months we will be watching in particular:

- **Landing the Inflation Plane.** This has not changed since last quarter – although we are now in descent mode – or about to enter it. Watching how inflation works its way through the economy, through labour and through consumer pricing will be critical in the months ahead as Covid-savings start to finally run dry.

- **Are US Regional Banks a Canary in the Coal Mine?** After J.P. Morgan acquired First Republic Bank following an intense weekend of negotiations, its CEO, Jamie Dimon, sought to reassure the market that all was now well in the US financial sector. There was no need to worry and calm had been restored. This seemed overly simplistic after a dramatic few days that had revealed the pace at which confidence and trust could evaporate and exactly what a modern day bank run actually looks like. Investors and customers remain jittery and it is quite

possible that another spark could trigger another meltdown. In this area we would rather see a summer of no news to restore some calm to a rather frazzled area.

- **UK Bond Jitters.** At the time of writing the divisive political standoff over the debt ceiling in the US looks likely to be resolved and the can kicked down the road for two years at least. The climate of uncertainty over recent weeks a bit of a trip up for market performance, so the resulting resolution led to a boost. In the UK, it seems this risk-off mood was somewhat contagious as Sterling weakened and bonds sold off in the very same week as the US was experiencing this uncertainty. The fact that bond yields almost returned to post mini-budget levels was somewhat chilling and led to all kinds of prognostication around the future path of the Bank of England. Suffice to say that the experience of both the US and the UK in the past month has shown how easily and quickly developed markets can start to behave as emerging markets might have. This is an area we will have to watch closely in the second half of the year.

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May 29, 2023