STONEWOOD
WEALTH MANAGEMENT

Monthly Investment update
March 2023

Investment Insights

Q1 2023 Overview

Table 1: Asset Class Performance Table (performance data for Q1 2023)

Asset Class	1 Month	YTD	1 Year	3 Years	5 Years
UK Equity	-2.47%	3.55%	5.39%	14.26%	15.23%
Global Equity	1.00%	4.53%	-0.93%	16.02%	19.69%
DM Equity	1.01%	4.95%	-0.48%	17.08%	21.66%
EM Equity	0.92%	1.20%	-4.48%	8.33%	4.94%
Global Property	-4.84%	-1.10%	-14.20%	10.03%	-4.41%
Global Bonds	1.01%	0.21%	-2.10%	-3.34%	0.87%
UK Gilts	3.03%	2.25%	-17.17%	-9.59%	9.46%
EM Bonds	-0.72%	-0.53%	0.25%	0.41%	-2.13%
Oil	-3.62%	-7.82%	-8.87%	41.41%	-28.14%
Gold	5.36%	5.18%	7.20%	6.04%	22.72%
Commodities	-2.29%	-7.93%	-6.81%	20.95%	-28.48%
IA Mixed Investment 40-85% Shares	-0.86%	2.21%	-4.66%	8.32%	9.27%
IA Mixed Investment 20-60% Shares	-0.61%	1.57%	-5.03%	5.09%	6.54%
IA Mixed Investment 0-35% Shares	0.24%	1.63%	-5.85%	1.92%	6.79%

Source: Factset, 31 March 2023, Returns in GBP

The first quarter of 2023 is now behind us.

It has been an eventful three months with a lot to digest for investors. The year started on a positive note with bond and equity markets rallying until early February. Following the previous year of negative returns and heightened uncertainty, this was welcomed by those concerned that last year's returns would continue into 2023.

The optimism from January was short-lived and February saw a shift in expectations as inflation did not slow as rapidly as anticipated. The market quickly repriced the probability of more interest rate hikes and expectations of a higher terminal rate.

March brought its own set of surprises which have rippled through markets. The month started with the unravelling of Silicon Valley Bank. The sudden and swift run on bank deposits which ultimately led to the collapse of the bank and quickly became a US regional banking sector problem as deposit outflows were experienced by most regional and large banks.

The sequence of events and measures implemented by regulators and Central Banks seemingly has greatly reduced the possibility of systematic contagion. This is good news for investors because a systematic breakdown of the banking sector would negatively impact the broader economy and capital markets.

While some calm has returned in the broader US and global banking sector it has not been without incident. Silicon Valley Bank, Silvergate Bank and Signature Bank have collapsed, and the beleaguered Swiss banking giant Credit Suisse was forced into a merger (a de facto bail out) with their largest Swiss competitor UBS over the course of a weekend to avoid the possibility of default.

Equity markets ended March in positive territory except for UK equities. Year to date equity markets have surprised many by being in positive territory across all regions that we monitor.

Bond markets have also been mostly positive in the first quarter, with Gilts being an outperformer relative to other global bonds. Global bonds have repriced positively during March with interest rate expectations declining following the banking sector volatility.

The bond market is pricing in a decline in interest rates during 2023 and into 2024 after expecting increases in interest rates just a month ago. The change in expectations is premised on tightening credit conditions due to the banking sector developments. As credit conditions tighten, growth and inflation are expected to contract, and central banks are expected to need to stimulate global markets with interest rate cuts.

Having duration in your bond portfolio (i.e. longer dated bonds) has been rewarded in this last month.

Commodities have been mixed. Oil prices are down almost 9% on a one-year basis and are reflective of economic growth concerns. Gold on the other hand has had a very strong start to the year. Gold has actually behaved in a more typical safe-haven fashion performing very well during the month of March as markets exhibited concerns around the banking system and with the drop in the value of the US Dollar.

Gold miners, which continue to be the way we express our exposure to physical gold prices, have outperformed the underlying metal price and have been a strong contributor to our relative performance year-to-date.

Overall investors have enjoyed a reasonably good start to the year if we use the IA Mixed Investment Indices as a benchmark for UK investors.

Short-term relief does not necessarily mean good times ahead.

The positive start to the first quarter of 2023 seems to be at odds with the news flow and a lot of the economic data we are keeping a close eye on.

The banking sector volatility experienced during March is not necessarily a story that is fully behind us.

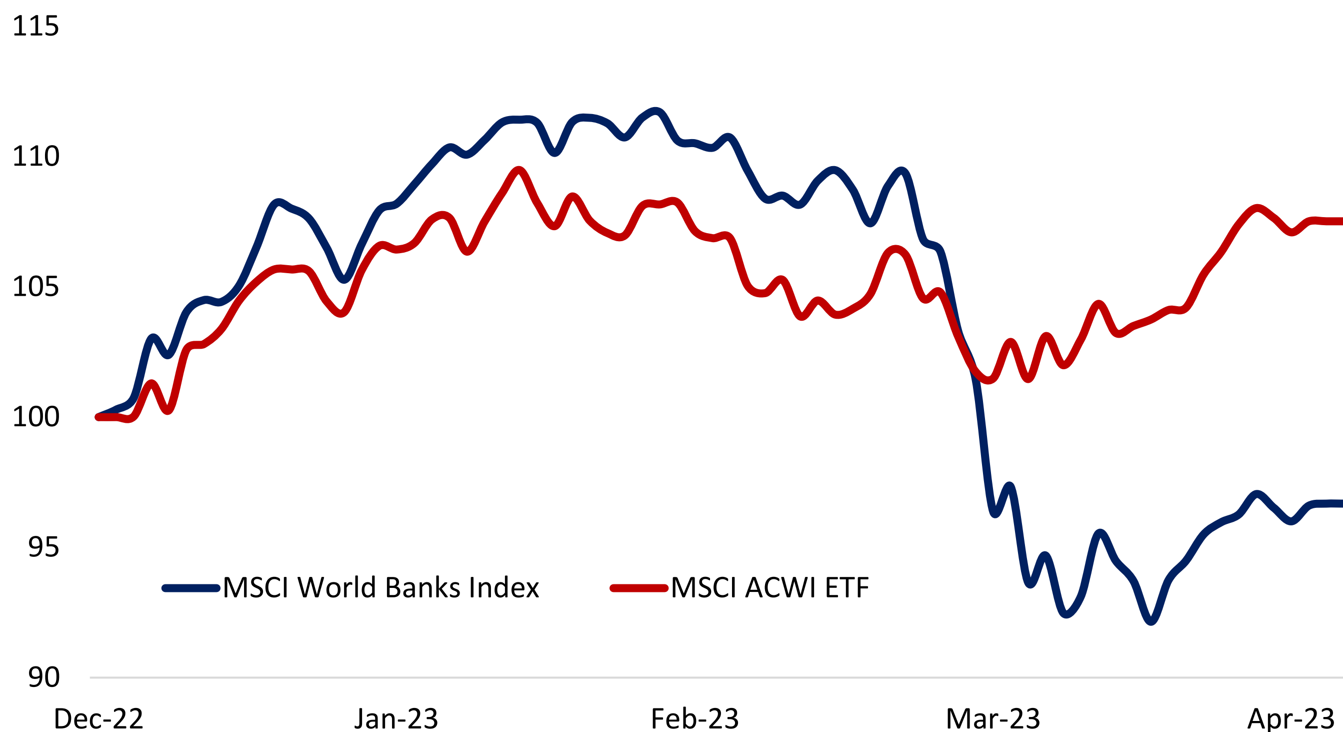
The sharp increase in interest rates from the beginning of 2022 to date has created a major problem for bank balance sheets and solvency. Banks tend to own a lot of long-duration bonds and when interest rates increase as quickly as they have, they have experienced a large negative mark-to-market loss that needs to be realized on the asset side of their balance sheets.

Banks in theory should manage this interest rate risk actively and many have, but a few have clearly not, and the knock-on effect is evidenced by what we have seen in the last month or so.

The other issue banks face is that for the first time in many years investors now have a feasible alternative to short-term bank deposits. They can invest in short term Treasuries/Gilts and earn more than they earn on their cash deposits with their bank. By owning Treasuries/Gilts they also face no deposit risk. This has led to continued deposit outflows, albeit more slowly than in the first few weeks of March.

Chart 1 below highlights the underperformance of global banking stocks which commenced in March relative to global equity markets. This was more acute in the US with the US regional banks underperforming by around 25% vs the 11.5% underperformance of global banks.

Chart 1: Global Bank Stocks vs. Global Equity Markets



Source: FactSet, Q1 2023, Index prices in USD

The effects will take some time to play out but there is a chain of events that this withdrawal of deposits creates. In order to incentivize clients to keep deposits with the bank they will have to offer higher deposit rates. By increasing deposit rates bank profitability is negatively impacted.

Without an increase in deposits, banks will have less ability to lend to borrowers.

The second order effect of these deposit outflows is that banks will have less appetite to lend and where they do have appetite to lend, the cost of that borrowing will need to be higher to match the banks increased cost of capital.

This means it will be more difficult to get a loan from a bank and if you can get a loan, it will cost you a lot more.

Ipso facto there will be less borrowing taking place throughout global economies.

What has been of interest is how investment markets appear to be digesting the above. It seems that investors are more focused on the increased possibility of a recession and the response that they have become accustomed to during the past few recessionary episodes. The playbook of the last 22 years has been that every time there is a slowdown in growth, central banks have cut interest rates to stimulate growth via increased money supply and lower cost of capital. This has been consistent and the correct action to take has been to own growth assets during these easing episodes.

This may explain the recent rally in equity markets during the month of March, which has been especially evident in the more cyclical and technology orientated businesses which have been some of the best performers' YTD.

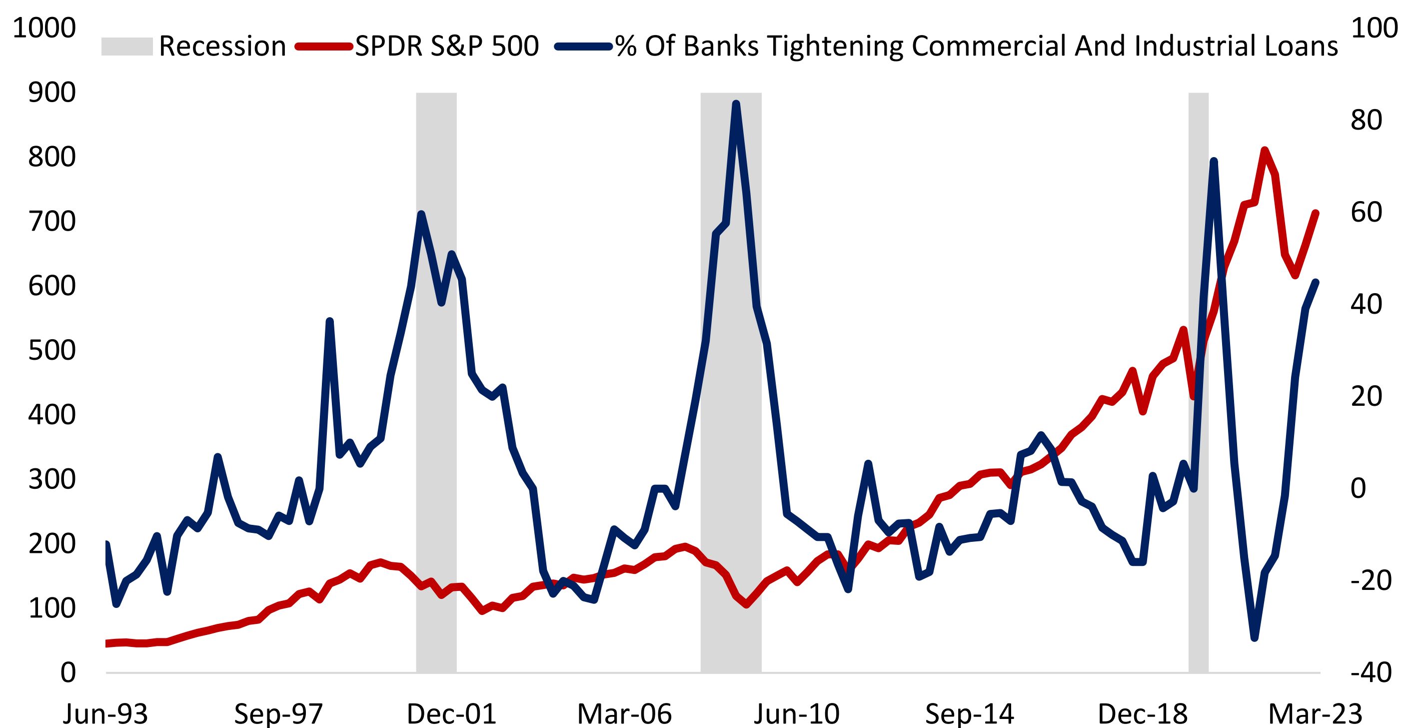
More value and quality orientated businesses have been shunned in favour of their higher growth counterparts, again in line with the playbook of the last two decades.

We remain more cautious than some appear to be and will take you through elements of our thesis that we are focusing on in light of recent developments. In our view, this builds on our thesis which remains intact from late 2021.

Our core thesis is to remain underweight equities going into a period of slowing growth. We expect markets will have to reprice overall equity valuations with credit conditions continuing to deteriorate.

Chart 2 below shows a 30-year history of credit conditions as per bank loan officers survey data against the performance of equity markets, as measured by the S&P 500 Index. In previous episodes of tighter loan conditions, equity markets tended to drop while in two of the last three recessions credit conditions only started to ease materially after the recession was over.

Chart 2: Bank Lending Conditions vs Equity Markets



Source: FactSet, June 1993-March 2023, Quarterly Data, USD

If we then assess how central banks have responded, these also tend to coincide with credit availability and conditions. This is exhibited clearly in Chart 3 below.

Again, looking at the long-term relationship, central banks tend to start cutting interest rates only after the economy has entered recession and only after equity markets have already started to experience drawdowns. We are yet to enter a recession according to the traditional definition and many still do not expect there not to be a recession during 2023.

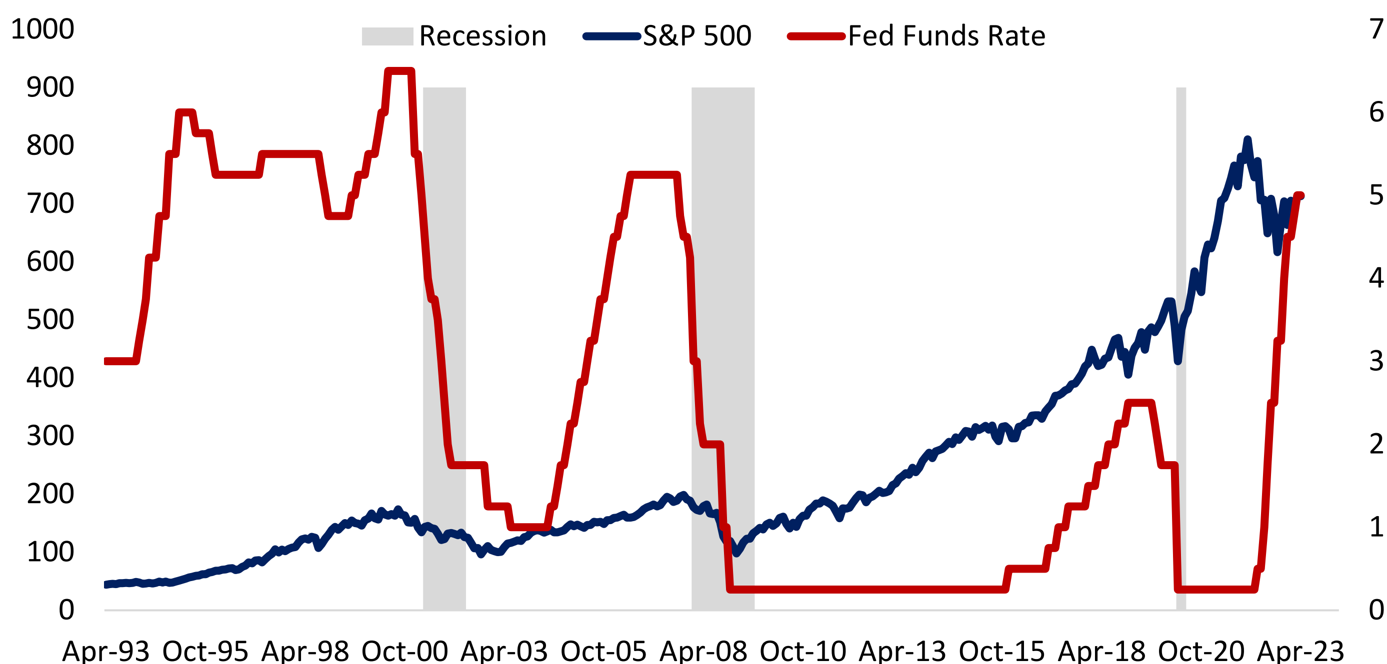
If the central bank is content on hiking rates further this year and making credit conditions tighter while simultaneously banks are tightening lending conditions, then we are led to believe that equity markets are likely vulnerable to further corrections.

This is supported by a closer look at the data. Since 1993 there have been five noticeable hiking cycles. Three of these cycles have preceded a recession. One of these cycles is currently underway and therefore we cannot use the data yet.

But in 2 of the three previous cycles that ended in a recession ('01 and '08) the equity market only bottomed out well after interest rates had already started to be cut or reached their low point in the cycle.

If we extrapolate this out to today it is therefore possible that equity markets have further downside from here as we are still in an environment of contracting liquidity and availability of credit. It would likely require central banks to start cutting rates aggressively for more than one month or quarter for us the see the turning point for a new bull market to commence. This can be seen in the chart below as well.

Chart 3: Fed Funds Rate and Equity Market Performance



Source: Factset, April 1993 to April 2023, Monthly, USD

In a review of the last 30 years of quarterly data, there have been three recognised recessions observed. In each of these recessions we have seen that credit conditions tend to tighten prior to and not after each recession commences. This is logical in that the tightening of conditions leads to less economic activity, resulting in a recession.

Table 1 Equity Market Performance and Credit Tightening Cycles:

Total Number of Quarters	120
Number of Recessions	3
Number Negative Quarters	32
Number of Tightening Periods	23
Drawdown Avg during Tightening and Recession	-24%
Current Drawdown	-12%

Source: Factset, (Quarterly Data, June 1993- March 2023, S&P 500 and US Bank Loan Survey Data)

In each recession we have seen the equity market contract by an average of 24% while lending conditions are still tightening.

Lending conditions tend to loosen prior to the end of the recession, which is in line with the idea that central banks and therefore commercial banks will make credit available to stimulate economies out of a recession. (The recession in 2020 is difficult to learn much from as it only lasted a quarter)

If the past is any indicator of what lies ahead, it would lead us to believe that with credit conditions deteriorating a recession is increasingly likely, if not inevitable. This tightening cycle may be more pronounced than some previous cycles due to the banking sector stress and the further impact that may have.

This could mean a deeper or more drawn-out recession.

Another factor making things more complex is that for much of the last 30 years central banks have not been fighting inflation and recession simultaneously. If inflation remains above target it becomes very challenging for central banks to cut rates aggressively. Put differently, if central banks cut rates while inflation remains above target it is likely we will see a resurgence in inflation in time.

Central banks are fighting the battle on two fronts, namely inflation and growth. The implication may mean that buying risk assets in advance of rate cut expectations may not yield the same results as it has historically.

In our view this means that there is an asymmetric downside risk in higher growth assets and our preference remains to be on the lower end of equity allocations for our respective investment mandates.

Within our equity allocations, we continue to favour equity assets that exhibit the following:

I. Attractive valuation characteristics both on an absolute and relative basis.
II. A preference for equity exposures with a quality focus, where debt levels are manageable and cashflow generation is strong and consistent through various market cycles.

Summary

Our investment outlook has not changed meaningfully in the last few months. The rally experienced in January in our view was not based on fundamentals and the drawdown experienced in February seemed to be a realization of that. The banking sector volatility and concerns around future credit availability is in line with our base case of a recession materializing.

We remain underweight equity relative to our longer-term strategic mid-points and have benefitted from the inclusion of diversifiers during the quarter.

With bonds markets now starting to price in rate cuts as opposed to hikes during the remainder of 2023 we believe that there may be the opportunity to rotate some of our fixed income and take profits in a few areas.

We remain positive about fixed income in general and think the current environment is better for fixed income investors than it has been for much of the last 15 years. Bond volatility does remain elevated and there may be short-term moves in prices. Our preference is not to chase yields for yields sake, this strategy should reduce some of this price volatility and reduce the default risks in the portfolio.

The scoreboard says it has been a good quarter for investors with equity, bonds and gold all in positive territory. We have benefitted from these positive directional changes but remain cautious in our tactical positioning. Our portfolios remain well diversified, this reduces vulnerability to drawdowns in any one part of the market.

It certainly is a case of treading cautiously when we believe the conditions are not conducive to taking outsized risk positions.

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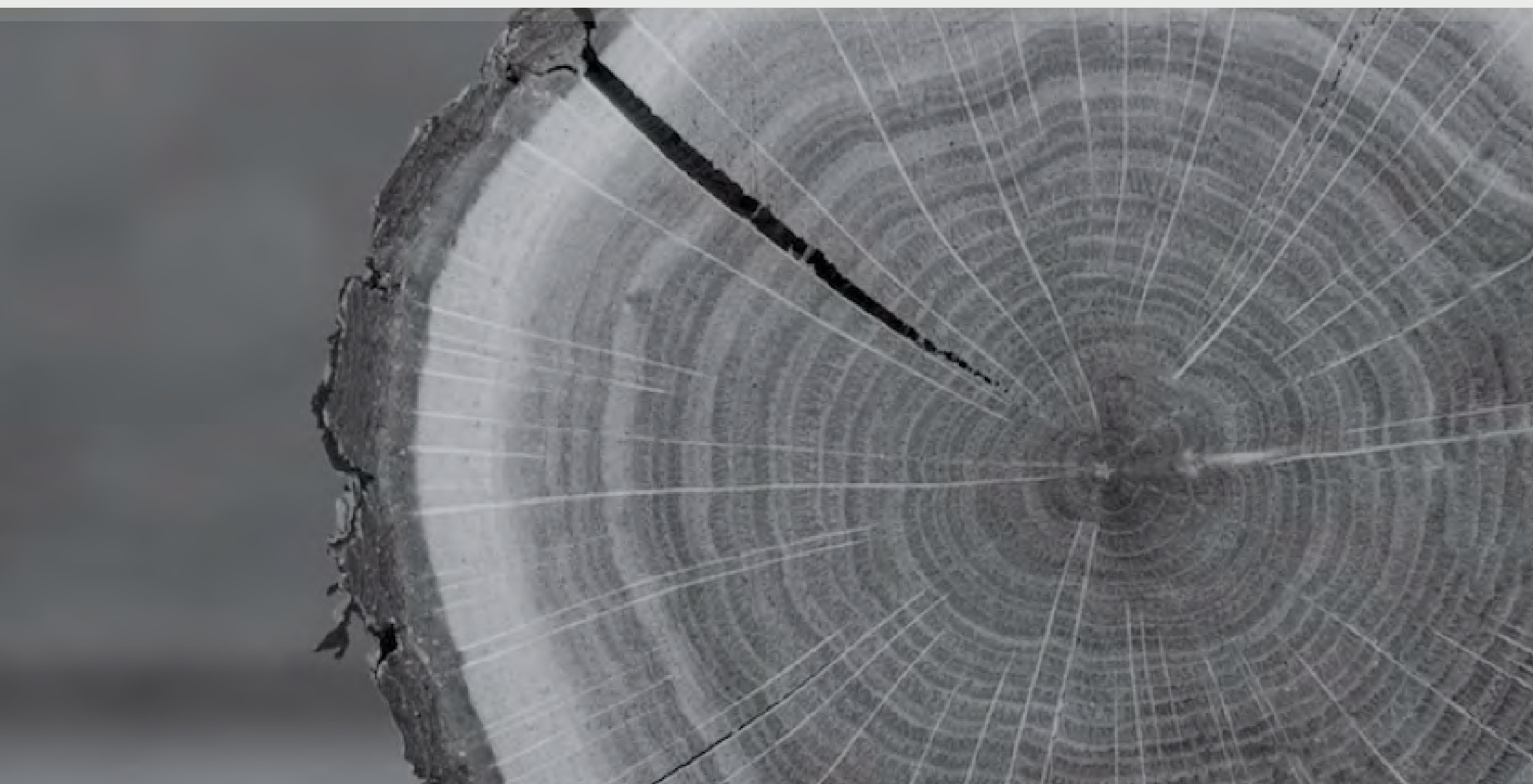

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