Quarterly Investment*Update*

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Banking stress brings a mild recession closer

But reality has yet to set in for equity valuations, especially in the US

If you just looked at a chart of global stock prices, you probably wouldn't know that we have had high-profile bank failures. At the time of writing, the global equity benchmark was more or less unchanged compared with the end of February and the end of December. As we set out in our recent Investment*Update* on banking stress, we don't believe that these are the foreshocks to a systemic crisis, but it is hard to argue that they won't lead to lending conditions getting even tougher. We were already seeing constriction before this panic set in. Further belt tightening will raise the already high probability of a US and global recession, though we continue to believe it would be a mild one.

Even before the travails of Silicon Valley Bank (SVB) or Credit Suisse, global equity valuations were too high relative to what the historic, tight relationship with inflation-adjusted (real) bond yields suggests they should be. To put it another way, the better the real yield available from safer assets like bonds the less investors are willing to pay for potential future returns from riskier equities. And the current disconnect in valuations remains despite the recent fall back in yields.

With the downgrades to earnings forecasts that we believe are likely to come through, price-earnings multiples would need to rise just to keep stock prices level, which is difficult to see. Already earnings are falling, sales growth is slowing, profit margins (the amount of profit for each unit of sales) are shrinking, manufacturing confidence is negative, longer-dated bond yields are below shorter-dated yields (signalling a recession is expected), bank lending conditions are tightening sharply, and unemployment is at historically low levels. In the past, when all of those conditions have been met markets have been in for a rough ride.

As we set out in December's Investment*Update*, we have a checklist of adjustments we need to observe before we position for a new bull market. We expect the global recession to be relatively shallow (in short because there are no egregious imbalances that need to unwind), and insofar as recent banking stress may have brought forward the start of that recession (a sharper pull-back in new loans) there is perhaps now more hope that we will start checking off that list before the end of the year. But we're not there yet and we're keeping our seatbelts tightly fastened.

Europe: cold front approaching

Many of Europe's leading economic indicators are firmly pointing towards recession. But the purchasing managers' index (PMI) of service-sector confidence has unexpectedly improved, and is not far off 'boom' territory. The equivalent survey of manufacturers fell to 47.1 (above 50 is consistent with rising profits), missing the consensus expectations of a rise back to 49. Such bifurcating trends can be hard to interpret, but there are two points worth making: first, the manufacturing series has a much stronger relationship with the profits underlying stock markets. Second, this may just reflect the usual order of things as we head into recession: weakness first appears in housing and residential construction, then capital expenditure and banking, and then consumer spending and jobs bring up the rear. If the services PMI reflects the latter then that may not really give us much comfort about where we're going to be in six months' time. Surveys of financial market professionals, such as the ZEW and Sentix, back-tracked earlier in March, before Credit Suisse's forced merger with UBS. The bottom line is that the lagged effects of last year's rate rises are yet to come through. In Europe, rates didn't start increasing until July and it takes at least 12 months for most of the impact of a rate hike to take effect.

In Europe as a whole, the banking system is much more resilient than in the US, where the large global banks are resilient thanks to regulation, but the rest of the banks aren't. This adds a more complex dimension, which is itself a weakness, that Europe doesn't have.

Among the key differences are that European banks with more than €30 billion of deposits must hold sufficient high-quality liquid assets to handle liquidity needs during a 30-day period of stress. They are also subject to 'net stable funding' rules requiring them to lock in funding over a 12-month horizon. The European Central Bank (ECB) enforces strict policies on managing interest-rate risk (the lack of which could be said to be the downfall of SVB), asking banks to regularly stress-test their balance sheets for sharp changes in interest rates. And the ECB's financial stability review last November showed banks' increasing use of interest swaps (derivatives that allow counterparties to exchange a fixed stream of interest payments for floating payments, or vice versa) as a tool to manage risk.

No US recession? Think again

At the end of 2022, surveys said that a very large proportion of institutional

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Look forward

investors believed that the US would enter recession in 2023. The same surveys early this year suggested that many had rethought this position. We have not. Even the shortest estimate among recent academic studies that look at how long it takes for rate hikes to hit the real economy would suggest that we have only just passed the stage where most of the impact of the US Federal Reserve's (Fed's) *first* quarter-point hike back in March is being felt. And there's another 4.5% of rate hikes still to be felt after that…and counting. Since the second half of last year we've seen much tighter bank lending conditions. The lag between tighter lending standards and slower growth in lending runs at around 12-to-15 months. The tightening in bank credit conditions is consistent with a huge 10% contraction in commercial and industrial loans into the end of this year. The 1.0% monthly contraction in US durable goods orders in February indicated that business appetite for investing in new equipment was weakening even before the banking turmoil arose. The inflation-adjusted money supply is already falling at a pace of 8%, and that's before the broader slowdown in lending – commercial bank money creation – really kicks in. The growth of real money supply is one of the best leading indicators of recession and it has never been this negative since 1959, as far back as records go.

What about all that savings and low unemployment?

The pushback on our recession view tends to focus on the strength of the labour market and the pandemic-related growth in savings. Employment and unemployment are lagging indicators. They always look great a few months before recession. In the last four economic cycles, the unemployment rate held steady for almost two years after growth turned south before beginning its ascent. We're also a bit nervous about trusting the US employment data at present. They are collected by surveying firms, but response rates have fallen dramatically: to just 44% in December from 60% in January 2020 in one key survey and to only 30% from 60% in another. These survey-derived numbers are at odds with data from national recruitment firms, such as Indeed and ZipRecruiter, who report that new job listings are falling rapidly. It's also worth noting that not all recessions involve big labour market shakeouts. Since the start of the 1970s, only about 15% of recessions in the G7 (the seven largest developed economies) have coincided with falling employment, according to Oxford Economics.

Those excess savings built up during the pandemic, which have been exhausted in Europe after adjusting for inflation but are still very sizeable in the US, are the main source of upside risk. But the US savings *rate* has been rising since September when the pandemic support programs ended. In other words, in aggregate, households aren't drawing down on their savings anymore. Another reason why savings were accrued was because of loan moratoria and forbearance, particularly on student loans. These are ending and interest payments are set to resume (and then some) this year. As an indication of how much they may need to rise, personal interest payments have been some $100bn below trend.

Why the Fed's balance sheet matters

In our mid-March Investment*Update* we discussed the increase in the size of the Fed's balance sheet and what it can tell us about banking stress. One week on, it increased again. However, this was due largely to the loans extended to the Federal Deposit Insurance Corporation so that it has the funds to bail out the previously uninsured depositors at the failed banks that the government then subsequently insured. More importantly, the central bank's primary lending to commercial banks was lower than the previous week, falling back to $110bn from $153bn. That's very positive news, though tempered by the fact that banks also borrowed an extra $40bn under the emergency Bank Term Funding Program, which could suggest ongoing trouble in the broader system (although, we suspect this this could just be knock-on trouble at US regional lender First Republic, whose problems are well known – something to monitor). All in all this latest Fed balance sheet release was a pleasing one. Especially when we combine that with fading markers of broader financial stress, such as the cost of short-term corporate borrowing (commercial paper) or the rates at which banks lend to each other.

The Fed also publishes an aggregation of commercial banks' assets and liabilities, albeit with a two-week lag. Pleasingly, small banks had c.$100bn more cash on hand on the Wednesday following SVB's failure compared with the previous week. There were $120bn of deposit outflows but this was offset by $250bn of borrowing, mainly from the Fed, to build precautionary war chests. We will be very interested to see the following week's data (we'll publish an update in the online version of this note).

China past its prime

Chinese growth will bounce back this year but not to the extent that it could rescue the rest of the world from recession, in our opinion. Beijing has confirmed a GDP growth target of 5%, and planned stimulus of just 3.3% of GDP, down from 9.5% of GDP in 2022. At the annual National People's Congress in March, we noted a profound emphasis on quality not quantity. Consumption is recovering after 2022's lockdowns, but it's falling short of the more bullish estimates from economists and analysts, while consumer confidence surveys are still coming in weak. Perhaps that shouldn't be a surprise when you consider the wealth effect from last year's outright contraction in net household wealth, the first in at least two decades, alongside subdued wage growth.

China is not without its own banking problems either. Banks have used a combination of accounting tricks and securitisation to conceal bad loans. But it's an open secret, because it hasn't prevented rising bad debt from weighing on bank profitability. This is especially true among regional banks, which have seen their return on assets fall to just 0.5%, from 1.5% less than a

decade ago. Even before last year's downturn, 289 regional banks (out of a total of c.4,000) were considered 'high-risk' by the People's Bank of China. This will constrain the rebound in the very important property sector. Most loans are from state-owned banks and many are to state-owned enterprises, so a banking crisis in any normal sense is almost impossible. The government just moves money from the left pocket to the right pocket – it has deep enough pockets. But it will constrain credit creation for some time. As our head of asset allocation Oliver Jones sets out in a forthcoming report, the Chinese economy faces many other structural headwinds that look likely to persist over the long term.

Does everybody hate the UK?

The UK economy has been stronger than expected in early 2023, but unfortunately we still expect a recession. The better start to 2023 and the large easing in energy price pressures mean that we do now think the UK recession will be milder than we previously thought. But we expect the lagging effects of the Bank of England's rate increases to dent growth by more than the latest official estimates from the Office for Budget Responsibility (OBR) suggest. By the end of March, the financing costs of about 40% of UK households with mortgages will have increased – and by more than £1,200 a year for about half of this group (about 1.5 million households). The UK also faces fiscal tightening (especially income tax thresholds not moving with inflation), banks tightening lending standards, and negative wealth effects from lower property values. We do not believe that people will reduce their savings to fund consumption in the way that the OBR suggests.

Added to these woes there has been a spate of recent media speculation that the UK stock market is in terminal decline, though we think reports of the death of the UK market are greatly exaggerated. Arm, the chipmaker, recently announced that it will list in the US rather than the UK, and building materials supplier CRH also plans to move its listing to the US. This has contributed to concerns in the media that the UK stock market is in long-term decline. Since the early 20th century stock exchanges *attracted* companies by having the most stringent rules. A race to the top if you like. This was because companies could signal governance-related virtuousness by listing on gold standard exchanges, something that became particularly important in the wake of the Wall Street Crash of the 1920s. It is perhaps a sorry reflection on how the 'Governance' in Environmental, Social & Governance (ESG) analysis seems to be being overlooked, even as ESG itself has dramatically gained in importance in recent years. Finally, the large returns that used to be associated with newly listed companies are rarer because companies are staying private for longer. IPOs are often more about founders and earlier backers exiting their investments than they are about raising capital for fast-growing companies by broadening ownership. For sure, international diversification is crucial: we are global investors. However, the UK stock market remains an important part of our portfolios. Indeed, its above average exposure to defensive sectors such as consumer staples and healthcare, alongside its above average exposure to commodities, makes it uniquely attractive right now. So too does its cheap valuation. Despite its large outperformance last year, the gap between UK market valuations and the rest of the world's is still near multi-decade highs. And this holds true when factoring out variations in sector composition and long-term growth expectations.

The UK market is still one of the largest and most liquid equity markets in the world. It just doesn't match the US as a source of capital – no one does. Yet in 2020 (the latest data we have available), the proportion of UK shares held by overseas investors increased to a record high, at 56%.

Life on the high seas

Navigating mild recessions is a normal part of investing. They rarely hold back equity returns for long. Quality and defensiveness are the two factors we're favouring. Measures of quality we look for are sector-beating returns on investment, high and stable profit margins and easily manageable levels of debt and interest payments. Indeed, the ability of companies to cover their interest payments has suddenly become a top-performing factor in March amid tightening lending conditions. In terms of defensiveness, we look for low volatility in share prices relative to the overall market and earnings with a low sensitivity to the business cycle.

Corporate bonds are also looking attractive relative to equities, although they are in high demand and we can't get our hands on as many as we'd like. For the first time since before the global financial crisis, the yield on higher-quality investment grade corporate bonds is meaningfully higher than the equivalent equity yield (annualised returns divided by price). Corporate bonds often outperform equities after the Fed raises rates for the last time in a tightening cycle, regardless of the outcome for the economy. Equities need an improving growth outlook to outperform – in 2001 and 2007 the beneficial impact of the first rate cut was overwhelmed by deteriorating growth. For sure, bond yields are sensitive to the business cycle too, but they are two-thirds less sensitive than equity valuations. We believe US corporate bonds are too expensive (yields are too low), but the yield gap between European corporate bonds and safer government debt is wide relative to history and looks more attractive.

We continue to believe it makes sense to stay invested in equities, and assets like corporate bonds which have some 'equity-like' risk, though with a defensive bias – keeping our seatbelts securely fastened as we expect more turbulence ahead. We'll keep you posted as we pass the milestones toward a new bull market.

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