OVERBERG MARKET REPORT

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Global Report

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Bank crisis implications

Social media tweets and immediate cell phone-activated deposit withdrawals meant banks collapsed quickly without warning. Silicon Valley Bank (SVB) fell on the 10th of March, soon followed by Signature Bank. By the weekend, the contagion spread to Europe leading to the rescue and forced takeover of Credit Suisse. Nerves are still frayed. Another US regional bank, First Republic was taken over by a consortium of peers after its share price spiralled. However, authorities have moved rapidly to prevent a full-blown financial crisis.

Without hesitation, the Federal Reserve issued a guarantee to cover all the deposits of SVB. In addition, it created a $25 billion new lending facility, the Bank Term Funding Programme, to provide liquidity to regional banks in need. Banks would provide collateral in the form of US Treasury bonds, but the bonds would be valued at par value, not at the forced selling price that led to SVB's collapse. In Switzerland, the Swiss National Bank provided a $53 billion credit line to Credit Suisse prior to arranging its takeover by Union Bank of Switzerland (UBS).

Should we be worried? Banks themselves are in infinitely better shape than they were in the 2008/09 Global Financial Crisis. Bank fundamentals have improved steadily over the past 15 years, guided by rigorous stress tests and more conservative internal controls. They are much better capitalised and have liquid balance sheets. Moreover, the debt servicing capacity of households and businesses is healthy, keeping non-performing loans at historically low levels. Households and businesses in the US and Europe have steadily deleveraged their balance sheets since the Global Financial Crisis and household savings are still well above pre-pandemic levels following the boost from Covid-19 relief transfers. Even if non-performing loans do rise, banks would manage as the industry's reserve coverage ratio is at its highest in 40 years, capital ratios are sound and loan-to-deposit ratios are very low. According to stress tests, the systemic "too big to fail banks" are in good health.

In this cycle, bank failures have been idiosyncratic, caused by poor management rather than systemic imbalances. Banks have failed due to inadequate management of interest rate risk rather than rising credit risk, which would be far more serious. SVB's failure was due to losses incurred on its US Treasury bond portfolio rather than credit defaults. Capital Economics Group Chief Economist, Neil Shearing concluded on the 20th of March, "As things stand, we think that bank lending will contract in most advanced economies but that the feedback loop through rising credit risk (and a system-wide crisis) will be avoided."

What are the implications for economic growth? Prior to the SVB failure, bank loan growth in the year to early March registered a robust 10.8%. Lending standards may tighten causing loan growth to decelerate, which would affect mortgage extensions, durable goods spending and business investment, but solid bank capital adequacy and reserve ratios should limit the impact. Economic

activity was on a rising trajectory prior to the bank failures so could accommodate a slowdown without resulting in a recession. Global growth has rebounded in the first quarter of the year, likely to show a sizeable lift from the 0.2% quarter-on-quarter contraction in Q4 2022. The OECD predicts 0.5% quarter-on-quarter global growth in Q1. The global composite purchasing managers' index increased sharply from 49.7 in January to 52.1 in February rising above the neutral 50-threshold for the first time since July last year, with gains recorded across most major economies. Forward-looking survey components indicate further improvement ahead. In the US, with households sitting on an amassed savings base exceeding $3 trillion, the outlook for consumer spending, which comprises over two-thirds of GDP, still looks strong. The crisis among small and mid-sized regional banks will undoubtedly slow growth but a recession remains unlikely. Goldman Sachs has raised its estimate of the probability of a US recession only slightly from 25% to 35%.

Bank failures are on par for the course during interest rate tightening cycles. The good news is that they tend to mark the end of rate cycles. The Fed, ECB and Bank of England were not deterred from hiking rates further in their post-SVB policy meetings. Even the Swiss National Bank, which one might have most expected to pause following the demise of Credit Suisse, hiked its benchmark rate by a full 50 basis points from 1.0% to 1.5%. Indeed, it raised its Swiss GDP growth forecast for 2023 from 0.5% to 1.0%, despite the domestic banking crisis. However, central banks will be led by the Fed in damping down their recent hawkish tone. The end of the rate hiking cycle is now in plain view. The softening in credit extension will help to bring inflation down and the threat to financial stability will raise policy makers' concerns about over-tightening.

At the Fed policy meeting on the 22nd of March, Chair Jay Powell said, "We're looking at what's happening among the banks and asking, is there going to be some tightening in credit conditions, and we're thinking about that as effectively doing the same thing that rate hikes do… in a way that substitutes for rate hikes." In some respects, the bank crisis is doing the Fed's job for it. The large transfer of funds from bank deposits into money market funds, amounting to $120 billion over one week, is equivalent by some estimates to a 50-75 basis point hike in the fed funds rate. Yet, despite tighter credit conditions the Fed cut its GDP forecasts for 2023 and 2024 only slightly from 0.5% to 0.4% and from 1.6% to 1.2%, respectively. Fed funds futures point to a much lower trajectory for the benchmark interest rate. Currently at 4.75%-5.0%, the Fed funds rate had been projected two weeks ago to rise as high as 5.7% by mid-year. It is now projected to drop to 3.8% by year-end.

With the improving outlook for inflation and interest rates, the US treasury bond yield curve has become considerably less inverted. Prior to the SVB collapse 10-year Treasury bonds were yielding 85 basis points less than 2-year bonds. The yield gap has since narrowed to 40 basis points. There has been a constructive decline in 10-year yields, but 2-year yields have dropped even more sharply as markets sniff the onset of Fed rate cuts. This is good news for financial markets, with a recent surge in central bank liquidity providing the added impetus. The Fed's balance sheet was gained by a massive $300 billion in the aftermath of the SVB collapse, a rate of liquidity expansion not seen since March 2020, at the onset of the Covid-19 pandemic. More liquidity expansion is predicted, which should feed through to higher financial asset prices.

According to independent research company MRB Partners, "The global economy didn't need any help, but just received lower borrowing rates, a reversal (for now) of some of the paper losses on government bonds, lower energy prices and a near certainty that the Fed et al will not deliver a monetary knock-out blow for the foreseeable future."

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WEEKLY REPORT

Local Report

Robert Wantenaar

Managing market fluctuations

History is written in permanent ink, it is unchangeable. Our actions today will have no effect on the record books. History, however, has a way of repeating itself, so if we study it, we realize that through 152 years of history in financial markets there have been multiple bear markets and crashes but each time, the market has recovered. Investors who hold through times of uncertainty are always rewarded.

The past three weeks have been scary, to say the least. With the latest reported figures, there seems to be no slowing in interest rate hikes. Until inflationary pressures subside, this upward trend will continue. The continued positive job data certainly do not assist the cause for halting the increases in interest rates or look at tapering off from these elevated levels.

Silicon Valley Bank's (SVB's) collapse and potential liquidity issues have added fuel to the fire and sent global stocks into a downward spiral. The event wiped out $465 billion in just 3 days, prompting the government to intervene by underpinning the depositors' funds and halting trading, in doing so, trying to ensure they do not face a bank run. With these types of events being circulated as headline news, it is not surprising that investors are cautious or concerned. By the "persuasion of pessimism," we are attracted to bad news. When directly compared against each other, losses loom larger than gains. We treat threats as far more urgent than opportunities as a mode of survival, which is why progress happens slower than setbacks. We are intrigued and persuaded by it. It is how we thrive and continuously, we believe that the outcome will be different but it's always the same. History has proved this.

We should not allow our decisions of today to be persuaded by current market conditions and affect the long-term outlook of investment portfolios. Our biggest asset, after all, is time! Especially in terms of investing. So many people allow their immediate pain to influence decisions that could last generations. We need to understand that what goes up, will come down but the inverse is also true. Looking at global stock market data between January 1971 and July 2022, if you had randomly picked one day during this period and had chosen to invest for just 24 hours, you would have had a 52.4% chance of making gains — similar odds to the toss of a coin. Long-term investing dramatically increases your chances of returns. Just weeks more in the market can make a considerable difference. If you had invested your money for an unspecified quarter (trading days only) during that same 50-year period, your chances of making a profit increased to 65.6%. Investing for any one year would have generated a positive return 72.8% of the time while investing for 10 years increased your chances to 94.2%. As ex-Bridgewater capital CEO, and billionaire Ray Dalio, has said, "Cash is trash, continuous balancing of portfolios is vital."

As active portfolio managers, Overberg Asset Management is continuously rebalancing portfolios to ensure we optimize the growth available in the market. When equities fall out of favour, we ensure we have greater exposure to hedges against this. Take US Treasury yields as an example, currently at 16-year highs. In a 14-month period, yields have moved from 1.54% to 4.78%. Two years ago, they were just 0.12%. A 60/40 portfolio of US stocks/bonds are currently in a 14-month drawdown, 14%

below its all-time high. This is now the longest drawdown for a 60/40 portfolio since the great financial crisis (37 months) and before that the aftermath of the dot-com bubble (43 months). How long will this one last? It is impossible to say… According to research analyst Charlie Bilello, “The halcyon era of hitting new all-time highs on a weekly basis is over. Replaced by the reality that risky investments carry risk, lengthy periods can pass before hitting all-time highs. That is the price of admission, without which there would be no higher reward.” Experience in the market will teach you an invaluable lesson. The greater the return, the more volatile the performance.

BOTTOM LINE: In times of market turmoil, do not lose sight of your financial objectives and deviate from your long-term plan. Play the long game. Markets will fluctuate but this should not deter continued investment nor encourage a knee-jerk decision to pull out of the market. The best time to deploy capital is when things are going down. The Price Earnings Ratio of the JSE All Share Index is below 11x, (10.87x on Friday) indicating that shares are trading at low prices – there is little downside. Right now, it is an excellent time to start nibbling at shares. Warren Buffett once said, “Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it.” Always have a trusted financial advisor at your side. You are welcome to contact one of Overberg’s experienced consultants to guide you through these uncertain times.

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