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Equity strategy and market outlook

MARCH 2023

Published by Edison Investment Research

Global perspectives: Storm in AT1-cup?

- **2023's rally in global equities has proved unsustainable in the face of cracks in the US banking system.** The weakest link in the financial system during this period of tighter monetary policy has been uncovered. However, the collapse of Silicon Valley Bank (SVB) seems a special case of mismanagement rather than a harbinger of a systemic crisis in the banking system. While Credit Suisse has been forced into the arms of UBS, error-prone management featured more strongly in the market dynamics than actual capital ratios.
- **While all banks are subject to the risk of depositor flight, the situation is not at all similar to that of 2008.** There is at this time no evidence of widespread hidden losses embedded deep in the banking system. A decade of post-crisis regulation means that Tier 1 capital ratios for systemically important banks are close to double those prevailing at the time of the financial crisis.
- **Central banks are adopting the correct approach of isolating the problem banks and providing liquidity against good collateral.** In hindsight, SVB's collapse may be seen as triggering the peak in US interest rates, which are now expected to fall by 140bp by the end of 2024 from current levels. Long-term bond yields have shifted lower, which, if sustained, will provide valuation relief to asset prices. This faux banking crisis may yet come to be seen as the perfect storm in a teacup, as it shifts medium-term expectations for US interest rates lower.
- **Global consensus earnings estimates for 2023 have continued on a downtrend over the past month.** Subdued single-digit earnings forecasts for major markets are unlikely to induce investors to aggressively jump back into global equities, leaving a brief rebound rather than a sustained rally our base case.
- **We maintain a neutral outlook on both global equities and global bonds.** Global equity valuations at a little above their long-term averages at a time of cyclically low earnings growth offer little directional guidance in an environment of banking stress, even in the absence of a full-blown systemic crisis..

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Banking crisis: This is not 2008

The aphorism that in every period of monetary tightening, something in the financial plumbing will break has been confirmed in 2023. March has been a harrowing period for investors, as psychological echoes of the 2008 financial crisis at times drowned out rational analysis. Investors observed the failure of SVB, followed by bank runs out of the US regional banking system. The US Federal Reserve raced to backstop liquidity within the system by allowing swaps of held-to-maturity bonds at face rather than market value.

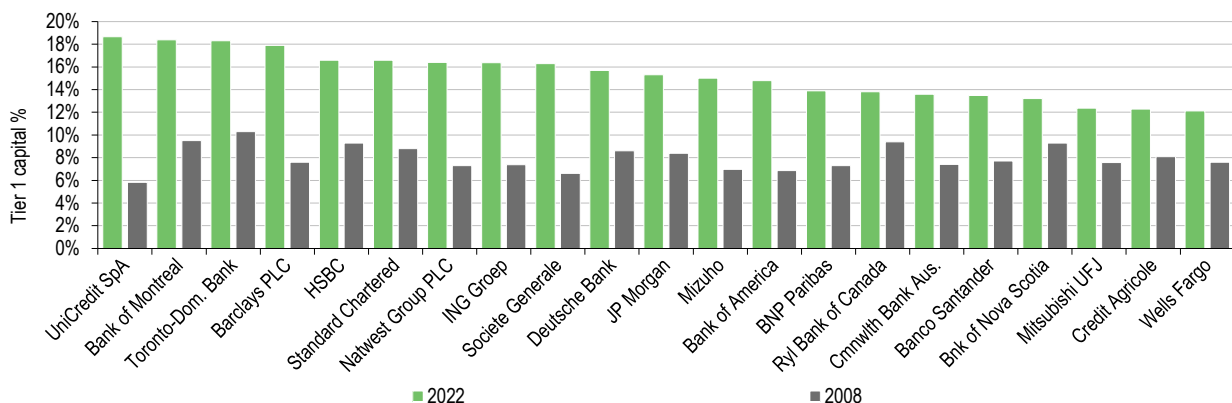
Large US banks attempted to shore up confidence in regional banks by placing deposits at First Republic Bank to offset panicking customer withdrawals. Then, risk aversion spread to Europe where Credit Suisse was hastily driven into the arms of UBS, in what was deemed by the Swiss authorities to be a viability event. This controversially incurred a write-down of CHF16bn of additional tier 1 (AT1) debt securities, while leaving equity investors with significant potential value in the merged entity. Swiss regulators may have saved Credit Suisse, but at the cost of wrecking a €250bn market in bank debt securities.

As in 2008, regulators, central banks and governments were involved in initiatives that had imperatively to be concluded 'before markets opened on Monday'. Most recently, Deutsche Bank was a further victim of a speculative attack as according to reports a US\$5m credit default swap trade sparked a sell-off in the company's debt triggering a share price fall of a further 15%, an all-time low and risking further depositor flight.

During this market panic there has been a generous overlay of the 2008 financial crisis narrative, which in our view obscures key differences between then and now. Mismanagement appears to have played a significant role in the demise of SVB, as the concentration of depositors in a single economic sector suggested that liquidity had to be especially carefully managed. Instead, management chose to boost profits by investing in long-dated securities at record low yields, which suffered significant losses as interest rates increased.

In the case of Credit Suisse, the bank has suffered numerous scandals in recent years, potentially indicative of a squeeze on profitability in the core business, which was being offset by increasingly risky client-based activities. The lack of investor confidence in its proposed restructuring plan spilled over into an existential crisis when its recent anchor investor declined to offer further support and depositor flight took hold. Regulators and well-remunerated bank employees may wish to reflect on the fact that if there is no long-term attraction for bank sector shareholders, depositors will be next out of the door.

Exhibit 1: Capitalisation ratios of large global banks significantly enhanced compared to 2008



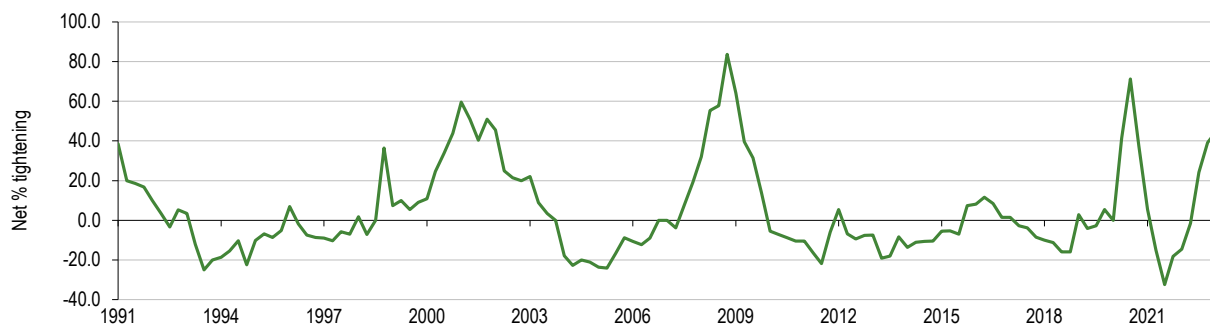
Source: Refinitiv

However, in terms of the banking system, rather than specific corporate entities, the level of capitalisation is a world apart from that prevailing in the run-up to the financial crisis of 2008. Bank tier 1 capital ratios (of loss absorbing capital to risk-weighted assets) are in the mid-teens, or close to double their level prior to 2008, Exhibit 1. Furthermore, there is not at this stage the perception of widespread hidden losses within the banking system, which would rapidly erode these capital buffers. We would certainly concede that in the event of a recession there may be, for example, commercial property exposures that may prove troublesome for profitability for certain banks, but that still does not necessarily represent a systemic risk for the entire banks sector.

It appears that short-term interest rates have now risen to the point that there is a rush for money-market funds, which are seeing record inflows, and out of the banking system. This disintermediation of the banking system as money is directed away from deposits and into government securities will in turn have a contractionary effect on credit availability, if sustained.

We concur with the view recently expressed by US Fed Chair Jerome Powell that it represents a significant extra level of monetary tightening. We note that even before the recent volatility within the banking sector, the US Fed's loan officer survey in January, Exhibit 2, suggests that bank credit conditions have tightened to recessionary levels.

Exhibit 2: US bank credit availability restrictive even before recent bank volatility

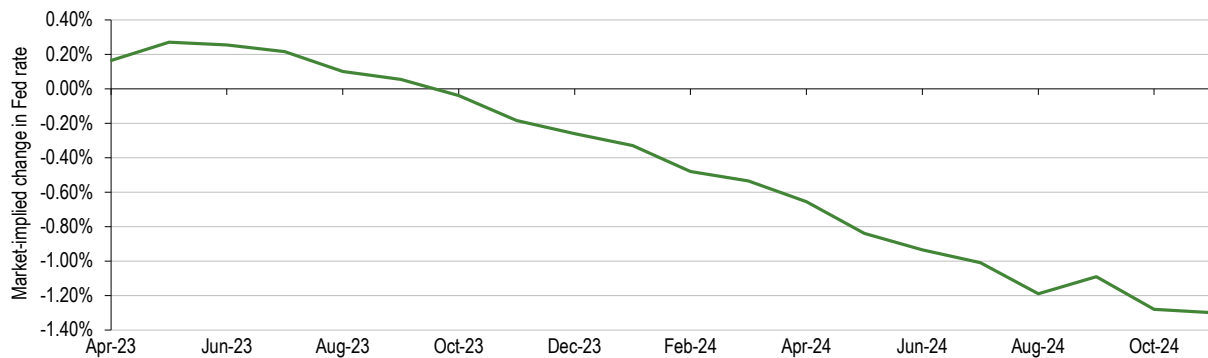


Source: Board of Governors of the US Federal Reserve

Peak in US policy rates to ease valuation pressure

As the market panic in respect of the banking sector eases, we believe investors will become more focused on the likely slowing of the US economy in a tougher market for credit, but also recognise the peak in US policy rates has been reached. US interest rate futures are now discounting a 140bp decline in US interest rates from current levels and the US Treasury yield curve has shifted meaningfully lower at all maturities. This is likely to ease the pressure on bank funding, as alternatives to deposits become proportionately less attractive in terms of income.

Exhibit 3: US interest rate futures now discount 140bp of easing by December 2024



Source: Refinitiv

For asset markets, the key risk a month ago was ever-increasing interest rates as unseasonably warm weather on both sides of the Atlantic boosted economic growth and gave central bank policymakers no reason to hesitate in jawboning market rates higher and increasing policy rates with relative impunity, even as monetary policy operates with a significant lag on economic activity and consequently inflation.

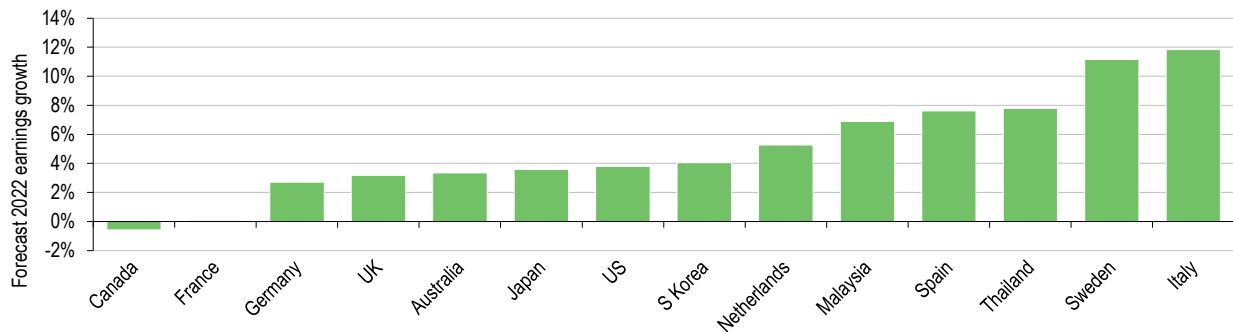
Despite protestations to the contrary, given recent events we expect policymakers to be acutely aware of the risks to financial stability of significant further increases in policy rates at this time. Bank depositors have effectively given notice that they will no longer 'look through' mark-to-market losses on held-to-maturity bank security portfolios. In terms of the economic cycle, we expect inflationary pressure to continue to decline during 2023, as a result of prior policy tightening and still fading impacts on the supply chain from COVID-19.

The positive impact of this mini-crisis in the banking sector has been, in our view, to hasten the peak in US policy rates. We now believe 10-year government bond yields in Europe and the US are unlikely to rise significantly from current levels, which should underpin equity markets by easing the valuation pressure seen over the prior 12 months on sectors particularly geared to discount rates, such as utilities. For real estate, however, investors will have to carefully tease apart the offsetting impact of the reduced availability of funding and rising vacancy rates from lower economic growth.

Earnings estimates stuck on a downward track

Even if US interest rates may have peaked, 2023 earnings forecasts remain on a downward track, which is set to accelerate given the recent stresses in the banking system. The declines are evident at a global level and are widely spread across sectors. Furthermore, most major markets are offering a sub-10% rate of earnings growth for the full year, which seems unlikely to persuade marginal equity investors to come off the sidelines and aggressively chase the equity market.

This modest consensus earnings growth forecast is, however, consistent with the below-trend level of developed market GDP growth expected by central bank policymakers. Such a low rate of earnings growth continues to offer precious little scope for forward P/E multiple compression from expanding earnings over the course of the year.

Exhibit 4: Global consensus earnings forecasts subdued for 2023


Source: Refinitiv, Edison Investment Research calculations. Note: Equal-weighted global revisions index.

Conclusion

The recent banking mini-crisis is a reminder that accidents happen when monetary policy is tightened as the weakest links in the financial chain are tested. The good news is that the world banking system is amply capitalised to absorb the current shocks and is in a very different position to when the first financial institutions failed or required rescue in 2007 and 2008.

In addition, the question of financial stability represents a new constraint on the rate at which monetary policy can or should be tightened. With a tougher environment for credit provision ahead, we believe we are at least close to the peak in US interest rates and, if so, long-term government bond yields are unlikely to rise significantly further from current levels. This should ease pressure on global valuations, especially in non-cyclical sectors such as utilities, pharma or technology where earnings are less at risk from declining economic activity.

While there has been a rapid release of upward pressure on US short-term interest rates, the recent banking mini-crisis represents a reality check in an environment where earnings growth is subdued and above-target inflation is yet to be defeated.

Global equity valuations at a little above their long-term averages offer little directional guidance at a time of cyclically low earnings growth in an environment of banking stress, even in the absence of a full-blown systemic crisis. We maintain neutral outlooks on both global equities and global bonds, at least until we are able to discern a stronger directional signal, either in terms of earnings momentum or valuations.

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