CS INVESTMENT
MANAGERS

VIEW FROM THE SQUARE

March 2023

Après la deluge

Only days ago, it seemed we would be discussing just how high Jerome Powell, head of the US Federal Reserve, might feel obliged to raise interest rates; now after the banking crisis in California there is some debate about whether they will be raised again. In the meantime, the ripple from Silicon Valley Bank (SVB) failure in California, which rapidly became worthless beyond rescue, has brought tension to global markets with sharp falls, particularly in financial stocks.

The banking model is based on confidence as deposits are usually short term in nature. To make a profit, bank lending customarily is based on longer dated duration of investment-largely on investments that have little immediate liquidity. When confidence drops, alarm can spread quickly and, where questions already exist, this is quickly expressed in sharp share price falls. In this case, the already vulnerable Credit Suisse bank in Europe has come under heavy pressure and investors worry that contagion will spread further.

In a quite different way, the UK experienced an earlier crisis in which Liability Driven Investments (LDI) created a crisis through leveraged positions which hadn't been stress tested given the prolonged low interest rate environment. In both the SVB and LDI situations, an overreliance on the assumption that interest rates would remain low caused severe problems when conditions changed. One major lesson appears to have been learned since the 2008/9 crisis; sanitise the problem as quickly as possible and prevent contagion as much as possible. Effectively this means printing money with a likely outcome of reducing interest rate pressure but at the same time stoking inflationary pressures in the medium term.

We will be discussing the situation with fund managers we respect and are hopeful that this fire can be doused. While the operating structure of banks can create vulnerability, the UK banking system has taken major steps to strengthen balance sheets and clear up mis-selling issues. UK and US authorities are acting quickly and the crisis may have accelerated the peak of the interest rate cycle. However, inflation has not been brought back under full control despite UK Budget forecast of a drop below 3% by year end.

In these circumstances, with the US$ potentially weakening after this initial flight to safety subsides, we remain positive about the prospects for commodities as the Asian economies stimulate gradual global growth again. There is still a good deal of developed economy consumer liquidity around. With tight labour markets and at least a reduction in the pace of interest rate increases global growth looks set to return.

For investors we should know by the new fiscal year (April 6th) whether panic can be avoided but at present we are looking for the beneficiaries of this financial turbulence rather than the victims. However, with the increasing amount of leverage now in markets, events can change quickly. Please feel free to contact us as we plot a way through current volatility.

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