CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

May 2023

Mixed Signals

The US Federal Open Market Committee has a huge influence on equity and bond markets, not just with their interest rate adjustments, but with the commentary from the Chairman, Jerome Powell. Wall Street constantly tries to second guess the longer term impact of the immediate pronouncement and Wednesday's update by Powell was a case in point. To make matters more difficult, news of another US bank in trouble emerged before he finished his speech.

Mr Powell's remarks seemed to be in line with recent expectations, that immediate interest rates would rise by 0.25% and that might just mark the peak of the interest rate cycle. Bond rates have been falling since last October, largely on the basis of the Fed's firm approach to using steady increases in short term interest rates to bring inflation under control.

The meaning of words is critical and according to the market, at some point during his speech, Jerome Powell seemed to have hinted that while he had a tight grip on inflation and had perhaps done enough, other third-party actions might dilute these efforts. This created the impression that he might have to look at further interest rate rises as employment levels and profit margins are still high. The market then faced the paradox that such increase(s), while hurting corporate profits and thereby equities, might actually lower longer term interest rates by taking the eventual action that would finally impact more fully on inflation-and so bond prices rose while equities fell.

This interpretation emerged just about the time that PacWest Bancorp "was reviewing its strategic options" and reminded a gently rallying regional bank market that conditions remained fragile. The highest priority for the US Fed is to preserve confidence in the US banking system. The source of this trouble can be traced back to the Trump era, where regulations were relaxed on all but the five largest US banks. The liberated majority in many cases set out on a major expansion that left many vulnerable to a sharp rise in interest rates, with less than secure deposit foundations.

The market impression that seems to be developing is that, as the full effects of liquidity tightening may not be felt for some months, and further interest rate increases may be constrained below that required to fully control inflation. This suggests that we should keep a close eye on inflation beneficiaries.

The reduction in bond yields is now filtering into other income generating assets, and a UK logistics landlord suggested that trading was developing at yields below 5%. Equities could find traction if inflation subsides to 5%. However, as major currencies are devalued and real bond yields hover near negative territory; the most logical beneficiary is Gold where, with some trepidation, we have been increasing allocations.

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W.Forsyth, Executive Chairman and CIO

43 Charlotte Square
Edinburgh EH2 4HQ

T. 0131 624 7709
investments@csmanagers.com

www.csmanagers.com