

Hymans Robertson Investment Services (HRIS)

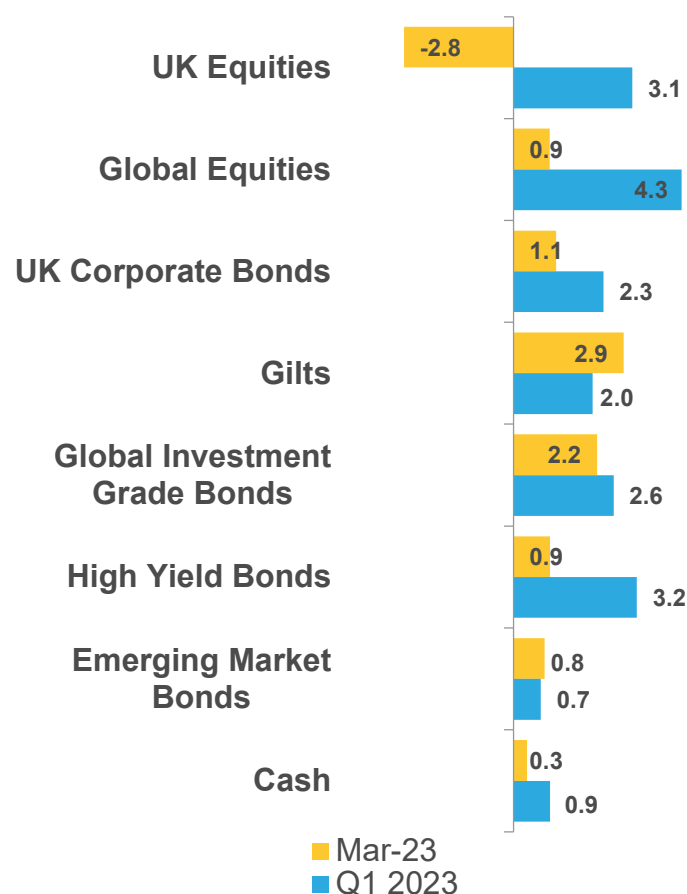
Market Digest

Q1 2023

Quarterly Highlights

- All the main asset classes generated positive returns over the quarter, with equities and higher yielding bonds being the best performers.
- Global equities outperformed UK equities, due to the UK being impacted more by the stresses witnessed in the banking sector in March.
- UK CPI inflation unexpectedly rose from 10.1% to 10.4% in February. Falls are expected to resume over the following months. Over the quarter, the Bank of England (BoE) raised rates by 0.75%, across two meetings, to 4.25%.

Asset class returns (%)



Market summary

- The start of the year brought positivity to markets, with emerging evidence that inflation had peaked in many major economies, bringing greater expectations that central banks would begin to slow down their interest rate hiking programmes. The end of the quarter saw focus turn to the banking sector. Fragility spread first from the US, with the collapse of Silicon Valley Bank, and then to Europe as Credit Suisse was bought out by its Swiss rival, UBS. The takeover restored some calm to the financial sector and meant central banks continued to raise interest rates in March, albeit only by 0.25% in the case of the Federal Reserve and the Bank of England.
- Our model portfolios are typically invested in a combination of the asset classes shown in the chart. Despite the stresses seen in the banking sector, global equities generated a positive performance over the period. UK equities had a poor March, owing to the large exposure to banks, and therefore underperformed the global market.
- Bonds rose over the month and quarter, as expectations that we were reaching the peak in interest rates pushed down bond yields (bond prices rise as yields fall). High Yield Bonds benefitted from credit spreads falling i.e. the difference between yields on High Yield and government bonds fell.
- At a portfolio level over Q1, all asset classes contributed to positive performance. The riskier assets, such as equities, performed well in January as investor confidence grew. The bonds in the portfolio performed better in March when investors favoured the safety of government debt during the period of banking stress.

Outlook and topical market themes

- The economic outlook for the UK is improving, although remains challenging. The OBR no longer expects a recession during 2023 and expects headline inflation to drop to 2.9% by the end of 2023.
- Although investor confidence has somewhat returned to the banking sector, the impact of any tightening of bank lending on the economy is still to be determined. One positive to emerge is that it could mean central banks won't have to lift interest rates as high to get inflation under control.

UK gets an economic upgrade

After a series of gloomy economic growth forecasts over Q4 2022, this year has seen a number of upgrades to the outlook. First, the Bank of England upgraded their forecast in February, although still expected a recession. In March, as part of the budget, the OBR¹ set out their latest forecast which stated they no longer expect the UK economy to enter recession this year, as defined by two consecutive quarters of negative GDP growth (growth for the full year is still forecast to be -0.2% due to a large single-quarter contraction in Q1 23). The OBR points to a large fall in wholesale gas prices and a lower peak in interest rates as driving the improvement. Despite the improvement in the economic outlook, the UK stock market underperformed the global market in Q1, although it still posted a healthy positive return. This highlights that the market may still be focusing more on the inflationary issue rather than the growth outlook. Although the OBR expects a sharp drop in headline inflation to 2.9% by the end of 2023, the most recent data release showed an unexpected rise in inflation and highlights the test the Bank of England still has in reaching its 2% target in the near term.

Fragility returns to the banking sector

The impact of higher interest rates is starting to feed through to various parts of the economy. In March, the impact on the banking sector became apparent, leading to a handful of bank failures on both sides of the Atlantic (see our notes on [SVB](#) and [Credit Suisse](#)). Although investor confidence has returned somewhat following the Credit Suisse takeover, the impact of any tightening of bank lending on the economy is still to be determined. One positive to emerge is that it could mean central banks won't have to lift interest rates as high to get inflation under control. We've seen this being reflected in bond markets as investors have reverted to an expectation of interest rate cuts in the US before the end of the year.

Chart of the month

Core tier 1 capital ratios
%, regulatory tier 1 capital to risk-weighted assets



Source: JPMorgan Asset Management

The global banking system has been put under serious stress for the first time since the 2008 Global Financial Crisis but so far there has been no systemic risk. Has the new regulatory regime worked?

The chart shows the average bank core tier 1 capital ratio, effectively the degree of losses the banking sector can sustain on their assets without threatening viability. This illustrates how the post-2008 regulatory framework has improved the stability of the banking system by ensuring it can withstand greater losses, especially in Europe. This gives us confidence that we are unlikely to see a repeat of 2008.



Jack Richards
Investment Manager

¹ The Office for Budget Responsibility (OBR) is a non-departmental public body funded by the UK Treasury, that the UK government established to provide independent economic forecasts and independent analysis of the public finances.

Risk warning

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