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Reflections & Insights

"I have the coolest banking job in the entire world. I get to work with companies that change the world."

– GREG BECKER, CHIEF EXECUTIVE OFFICER, SVB

It is a year since interest rates started to rise substantially around the developed world. It is hard to overstate the amount of ink spilt since trying to determine whether or when such rises would stop and whether or when there would be an effect on the global economy, with declining activity and falling inflation. Pretty much all of this ink has been wasted. Interest cycles work with long, unpredictable lags because adapting to new conditions takes time, for individuals and companies. As yet, most developed economies, but especially the US, are still doing OK.

Apart from the general reduction in value triggered by a rise in rates, the first things to be badly affected by the cycle were assets that have what is known in the jargon as 'long duration'. These assets have expected

returns that start in the distant future, or where no fundamental underpinning exists. The obvious candidates were crypto assets and unprofitable companies with only blue skies in their prospectuses.

In the past quarter, a second set of victims has been undone. Banks, again. Although there has been a rush to draw comparisons with the Great Financial Crisis, the crash of Silicon Valley Bank (SVB) et al. is more akin to an old-fashioned bank run. SVB was not insolvent but had short-term liquidity issues when its customers started to lose confidence in it. Its balance sheet was invested in longer-dated instruments, which fell disproportionately in value when interest rates rose. When depositors wanted their money back, it was forced to liquidate those holdings and realise losses, so exacerbating the loss of confidence. It has been said that it is irrational to start a bank run but rational to join it when it's started. That is, in effect, what happened.

Credit Suisse was on an altogether grander scale, and its forced takeover by UBS is the culmination of many years of mistakes and strategic failures. Again, though, the change in the monetary weather launched the crisis.

In both these cases, depositors were protected, and action was taken to stabilise things quickly and effectively. There will no doubt be plenty of legal action over who bore the losses – in the case of Credit Suisse, the outcome was quite controversial – but the fact is, that a liquidity issue was not allowed to develop into anything more serious. By the same token, there are plenty of economic puritans out

there who bemoan the bailing out of depositors on the grounds that moral hazard has been suspended, which is bad for the process of creative destruction underpinning capitalism. To these, failing to punish depositors means no penalty for taking on extra risk. Whatever your position, though, a repeat of 2008 looks extremely unlikely. Nevertheless, the effect of all this is to tighten credit conditions and increase the likelihood of a slowdown towards the end of this year. It may influence the course of interest rates by lessening the need for large increases to slow activity.

High interest rates causing havoc

Are there more shoes to drop as the slow ratchet of higher interest rates works its havoc? Almost certainly. Higher interest costs will affect anybody with high borrowings. Distortions in balance sheet management caused by a very long period of almost zero rates affect several industries. Raising equity capital has become more difficult, and the banking unravelling will tighten credit conditions, making borrowing more difficult. Industries that relied on the magic money tree to stay afloat will find the next few quarters much more difficult. This is already visible in how activist investors force loss-making tech businesses to focus on the bottom line. In biotech, companies with promising pipelines have had easy access to capital and were able to finance their development in-house. From now, some will be forced to sell out to big pharma companies who have become very reliant on these minnows for new drugs. Commercial real estate is highly leveraged and adjusting to post-pandemic working patterns.

The point of all this is to illustrate that a significant movement in the interest rate cycle mandates adjustment but that the adjustment takes a long time. Inflation will begin to fall as some of the supply chain issues, which caused such vicious price rises, are resolved, but price pressures are not going away. Indeed, businesses with relatively inelastic demand for their products have ratcheted prices and are contributing to the inflation excess. Surprisingly, there has not been a consumer or regulatory backlash, as the increases to consumers often exceed changes in input prices, a conclusion visible in the fact that corporate profit margins in the consumer sector have continued to expand. It is also worth noting that the only real beneficiaries of high inflation are indebted governments – the real value of their liabilities is falling quickly, even if the cost of servicing new debt is rising.

Anaemic growth, perhaps

Putting all this together, the most likely trajectory for the balance of this year is that interest rate pressure remains modestly upwards, a tendency which may be mitigated a little by the banking problems. By the end of this year, growth may be anaemic in most developed economies and inflation will continue to fall, although maybe not into the 2% area which Central Banks regard as ideal. The likelihood of a crushing recession is low. Balance sheets are very strong across the piece and labour markets, in most places, are very robust, with some structural shortages. This combination should allow real incomes to recover next year. As far as markets are concerned, the anticipation of an interest rate pivot (falling rates) and the disappointment that it is further away will continue to create market volatility in a world where not much may happen, end to end.

What is more interesting is what lies beyond the unfolding of the current interest rate cycle.

Free capital freely available?

Most market participants expect this cycle to give way to one that resembles the last – low-interest rates and low growth. This is, of course, a wonderful environment for equity prices because valuations can skyrocket, and capital is both free and freely available. While nothing is certain, it is at least worth considering the alternative. First, demographic trends (an increasingly older population, fewer younger people) are likely to embed some of the labour shortages we see today when some reshoring is taking place. Second, economic policies (in the US) have become more explicitly protectionist, partly due to deteriorating geopolitics and domestic political pressure. The EU will likely be forced to respond. Third, climate change will require investment in both public and private spheres in ways that will crowd out other forms of investment.

This means that growth could be higher than in the past decade as investment shares of GDP rise. That leads to the conclusion that interest rates could be more normal than they have been since the Great Financial Crisis. For most of the post-war period, they have averaged around 250 basis points above inflation. So, if inflation drops but is stickier than in the recent past and settles in the 3% area, that would point to interest rates of around 5% over the next cycle. At the same time, labour market trends suggest that the labour share of the economy might increase – it has been a one-way downward march since

1980, which will, of course, compress corporate margins. All in all, this makes for a more volatile and complex global economic setup. Geopolitics remains uncomfortable, which has unpredictable effects on commodity pricing and energy costs. This is not what the market expects.

The other factor which needs to be taken into account is productivity. It is generally understood that productivity has declined since the 1970s across the developed world. This followed a long period of growth caused by the adoption of the internal combustion engine (in the early 19th century) and the massive growth in communications. It is perhaps surprising that the arrival of computers and the internet did very little to disrupt the trend. The evangelists of the new order believe that artificial intelligence (AI) could be as effective in boosting productivity as the introduction of the technologies of the 1920s. It is outside the scope of this review to opine on this as it needs to be clarified how the technology will develop. In any event, all it may do is generate a wave of white-collar redundancies. Perhaps the world can do with fewer lawyers. Or maybe fewer market commentators....

At this juncture, we turned to ChatGPT to weigh in with its infinite wisdom, asking: "Will AI improve economic productivity?" ChatGPT's answer (partial): 'Yes, AI has the potential to improve economic productivity. AI can automate many routine and repetitive tasks, freeing up human workers to focus on higher-level tasks that require critical thinking and problem-solving skills... Additionally, AI can help streamline supply chain management, reduce waste and improve overall economic efficiency....'

On the other hand, in answer to the question 'When will the Fed pivot?' It responded: 'I'm sorry, as an AI language model, I cannot predict the future events or actions of the Federal Reserve. Their decisions are based on various economic indicators and data, which are subject to change in real-time.' Well, that's a relief, and not that we know either.

Interesting enough, but where does that leave an investor?

As explained, 2023 may be a year where markets generate plenty of wheel spin but don't go anywhere much. If economic activity slows towards the end of the year and inflation falls toward the target zone, optimism about a rebound in activity during 2024 will likely provide a decent foundation for markets to advance. This is largely what markets expect, and this rather optimistic outlook is priced in. If the alternative scenario outlined above is even partially correct, that advance will be relatively modest as a lowering of interest rates of the expected magnitude fail to materialise. As described, corporate profits may face some headwinds, so interest rates will be the main determinant of how far markets can advance. This is a scenario where longer-term investors can start to add risk on setbacks and consider that market leadership may shift towards areas that benefit from the things we are confident will happen in the years ahead – that is to say green tech and artificial intelligence.

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