SIGMA
PRIVATE OFFICE

Q1 2023 QUARTERLY REVIEW AND OUTLOOK

MARKET REVIEW & OUTLOOK

2023 got off to a positive start after a tumultuous year in financial markets in 2022. Global equity markets rallied in January with the Nasdaq posting its best start to the year in two decades. Strong gains across the board were driven by improving investor sentiment as inflation moderated, the labour market showed continued signs of strength and economic data seemed to suggest a soft, or even no-landing, scenario could transpire. Other factors contributing to the rebound in investor sentiment included the China reopening, a softer dollar, further easing of supply chains restraints, declining energy prices and a lower bar for corporate earnings.

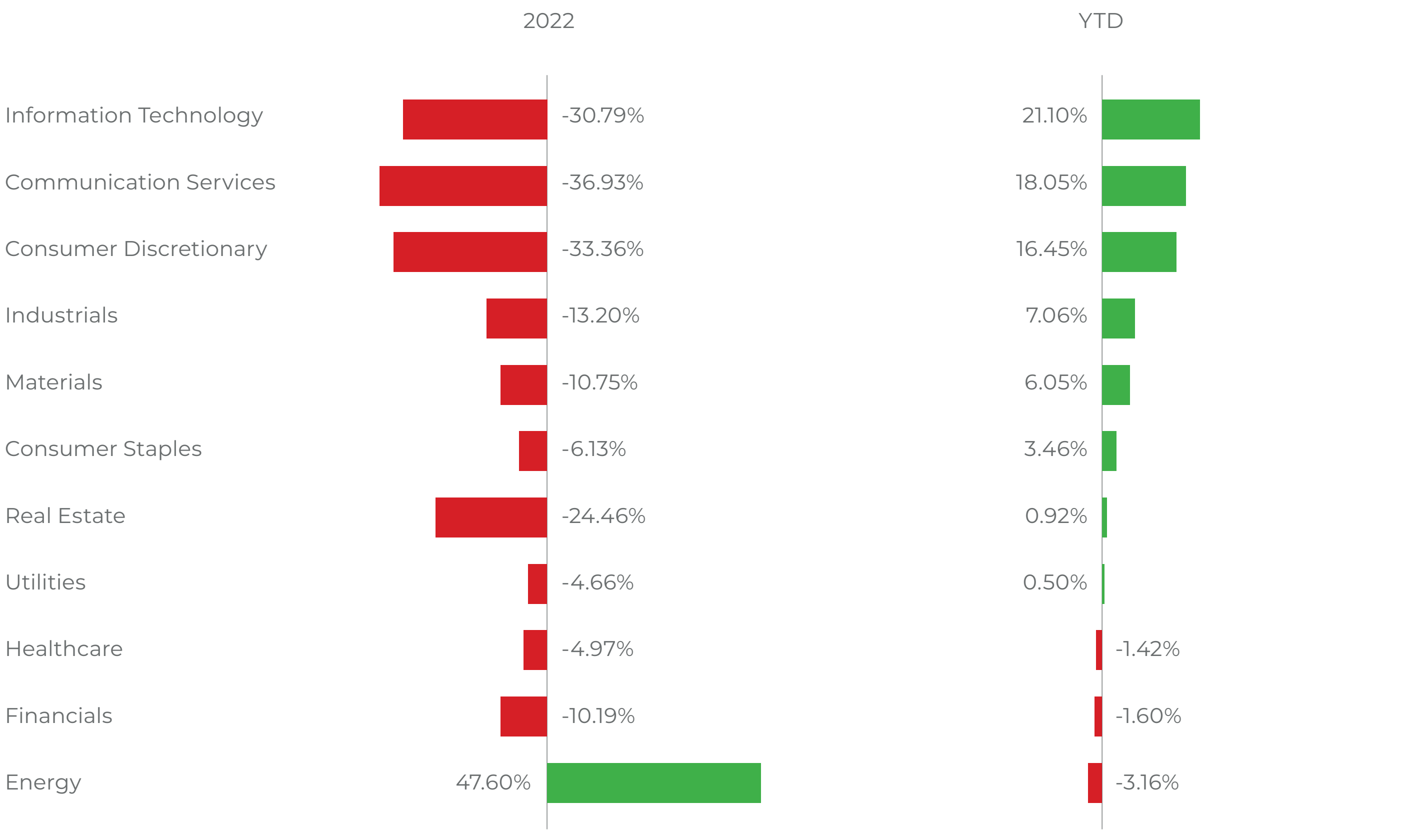
The remainder of the quarter unfortunately painted a slightly more uncertain picture. US equity markets pulled back in February and early March as employment data came in much stronger than expected and inflation, although seemingly on a downward trajectory, proved sticky. European equity markets on the other hand, were steadfast throughout February, as a mild winter helped avert the much-feared energy crisis and improving economic data led to calls even Europe could avoid a sure-fire recession.

The MSCI World ended the quarter up 7.88% whilst the S&P500, up 7.02% over the quarter, lagged European Indices with the DAX up 12.25% and CAC up 13.11%. In the UK, the FTSE traded largely flat over the quarter principally due to its overweight to energy and financials. The Nasdaq was the standout performer, up 16.78% over the quarter, with financial pundits calling mega cap growth stocks the new "safe haven trade" amid global uncertainty. This paints a contrasting picture from last year, where growth stocks significantly underperformed on concerns around rising interest rates, as seen in Chart 1.

In our past market outlooks, we have been proponents for quality growth stocks to outperform in the rebound, so their recent performance doesn't come as a surprise to us. Looking ahead, we expect high quality growth stocks to lead the market higher as investors favour their healthy balance sheets, low debt levels, non-cyclicality of earnings and high cash flow generating capabilities in a world where the cost of capital has become significantly higher.

CHART 1

MSCI WORLD SECTOR RETURNS

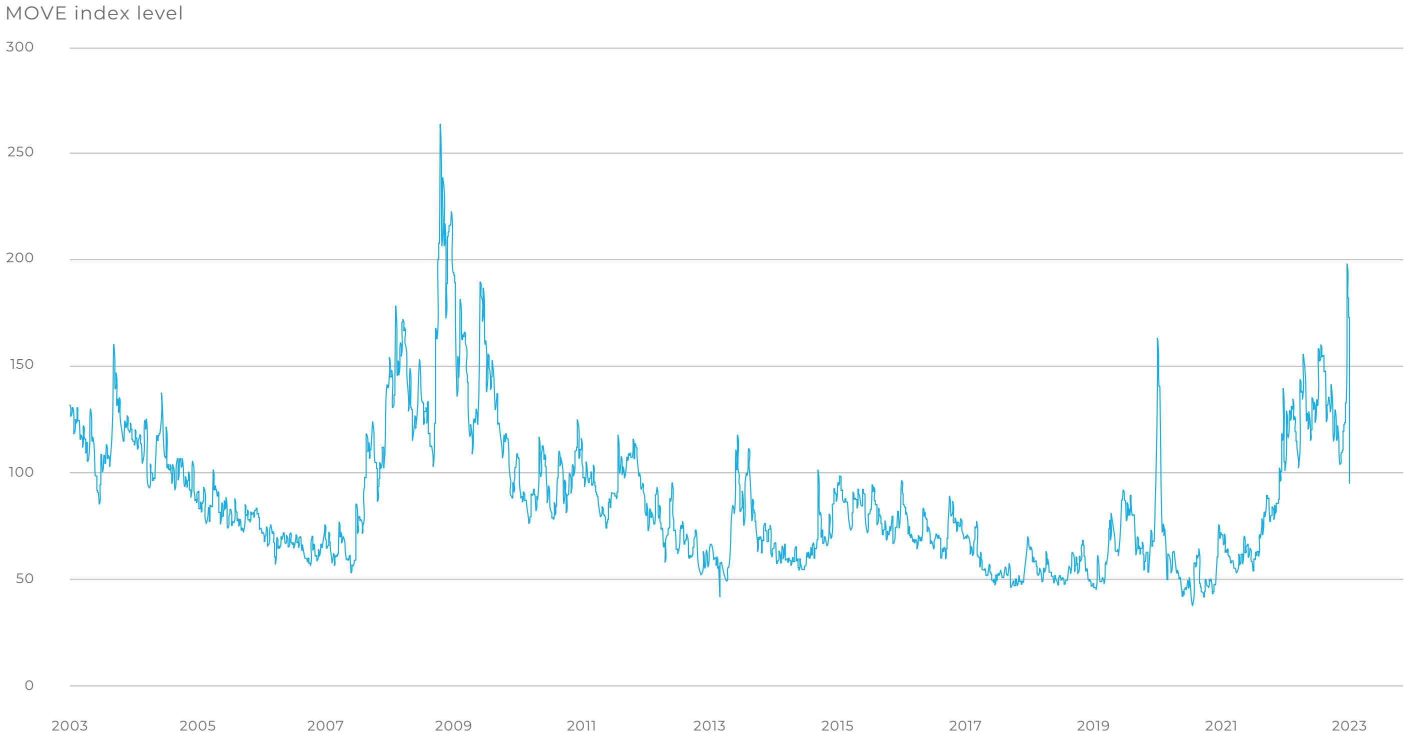


Source: MSCI, data as of 31/03/2023

Perhaps a more telling story of global uncertainty played out in the bond market. Following its worst year on record, the Bloomberg Global Aggregate Bond Index got off to its best ever start of the year in 2023 as higher yields and lower inflation spurred huge inflows. However, bond market volatility spiked and hit its highest level since 2008 (Chart 2) as yo-yoing expectations for Central Bank policy paths resulted in significant rate repricing.

A bullish start to the year brought the 10 Year US Treasury Yield down to 3.37% from 3.88%. Despite a relatively dovish decision by the FOMC to hike rates by 25bps on February 1st, yields quickly reversed on the back of a much higher than anticipated non-farm payrolls print which showed 517,000 jobs were added in the US in January. The 10 Year Yield pushed back above 4%, hitting a year to date high of 4.08% on March 3rd as Federal Reserve Chairman Jerome Powell took a much more hawkish stance in his testimony to Congress when stating "the ultimate level of interest rates (terminal rate) is likely to be higher than previously anticipated." The move higher in rate expectations was short lived, terminal rates pulled back in the aftermath of the banking sector fallout and the 10 Year yield ended the quarter back at 3.48%. Bond yields in Europe followed the same volatile trajectory as in the US.

CHART 2
BOND MARKET VOLATILITY HIGHEST SINCE 2008



Source: Yahoo Finance, data from 12/11/02 to 27/03/23

By far the biggest ball to drop this quarter was the fallout that ensued in the banking sector. The failure of Silicon Valley Bank and Signature Bank marked the second and third largest commercial bank failures in US history. This was shortly followed by UBS's historic "purchase" of the troubled Swiss institution Credit Suisse. Understandably, this resulted in tremendous fears around the (in)stability of the global financial system, with many parallels being drawn to 2008. However, we believe the situation is more nuanced than the mainstream media portrays and therefore warrants a more in-depth analysis which you will find later in this Market Review.

Clearly volatility has spiked across all asset classes since early 2022 and given the uncertainty around future paths for global economies, we believe volatility is here to stay for the foreseeable future. At times like these it is therefore important to recall what volatility is. Howard Marks, a famous American investor, once said "volatility is, at best, an indicator of the presence of risk. But volatility is not risk." As we've written about in the past, volatility is part of your investment journey and your tolerance for handling volatility has already been accounted for in your asset allocation. Riding out volatility is therefore key to achieving your long run return objective. It does not put it at risk.

Rather, for an investor, risk when properly defined is one of two things: 1) the permanent loss of capital and 2) any decision that moves you further away from achieving your stated investment objectives. In the history of the stock market, risk as per the first definition, has never occurred for the diversified long-term investor. Ironically however, in an attempt to avoid the first definition of risk, typically during periods of heightened market volatility, investors often succumb to "prudence" by reducing equity exposure or market timing. Knowingly, or unknowingly, decreasing the probability of attaining their investment objectives. Amidst the volatility, we therefore emphasize the importance of diversification, investing in quality assets and staying disciplined to your long-term financial plan.

THE BANKING SECTOR TURMOIL IN PERSPECTIVE

The stability of the global financial system was thrown into the limelight with the near simultaneous collapses of Silicon Valley Bank, Silvergate Bank and Signature Bank in the US in early March. Investor angst also spread to Europe with the demise of Credit Suisse, a 167-year-old institution.

It seems the first cracks in the global financial system have started to appear as some of the unintended consequences of significantly higher interest rates become apparent. However, it is too soon to make any hasty conclusions on the future state of the banking system and a more in-depth look suggests the risk of contagion is not as great as currently feared given the soundness and resilience of the global banking sector, particularly the large systemically important banks.

THE CAUSE?

To fully understand the cause of the recent bank collapses it's worth first understanding how banks work. Simply put, a bank borrows money from its depositors in the short term to lend out money over the longer term (in the form of mortgages, loans etc). Since the 2008 Financial Crisis, regulatory requirements have forced banks to be much better capitalised to ensure they can always meet short term cash withdrawals, preventing a traditional bank run.

So what went wrong with SVB? On March 8th, SVB's management announced that they expected the pace of deposit withdrawals to accelerate and announced a plan to raise capital to increase their liquidity. SVB's stock price fell over 60% on March 9th, exacerbating worries about the bank's solvency and triggering a run on the bank as depositors headed for the door. Unable to raise capital and facing increasing withdrawal requests, SVB was forced to sell their long-dated US Treasuries, trading at significant losses (the S&P US government bond index was down 10.83% in 2022). SVB was deemed insolvent, and the FDIC (Federal Deposit Insurance Corporation) put the bank into receivership. On March 27th, it was announced that First Citizens Bank would acquire SVB from the FDIC.

> *"At a basic level, SVB management failed badly. They grew the bank very quickly. They exposed the bank to significant liquidity and interest rate risk and didn't hedge that risk."*
>
> – ***Jerome Powell***
> *FOMC Press Conference, 22nd March 2023*

As for Credit Suisse, their downfall perhaps wasn't a total surprise given the Swiss bank had been plagued by operating losses, management changes, accounting irregularities and asset outflows. Recent scandals like Archegos Capital and Greenhill Capital had cost the bank billions in regulatory fines and credit default swaps (CDS) had started drastically rising over a year ago. After failing to garner sufficient support from the Saudis, their largest shareholder, UBS (supported by the Swiss National Bank) announced it would acquire Credit Suisse. A key part of the deal said that Credit Suisse's riskiest bonds, known as AT1s would be entirely wiped out, placing AT1s below common equity on the credit hierarchy.

THE INTERVENTION?

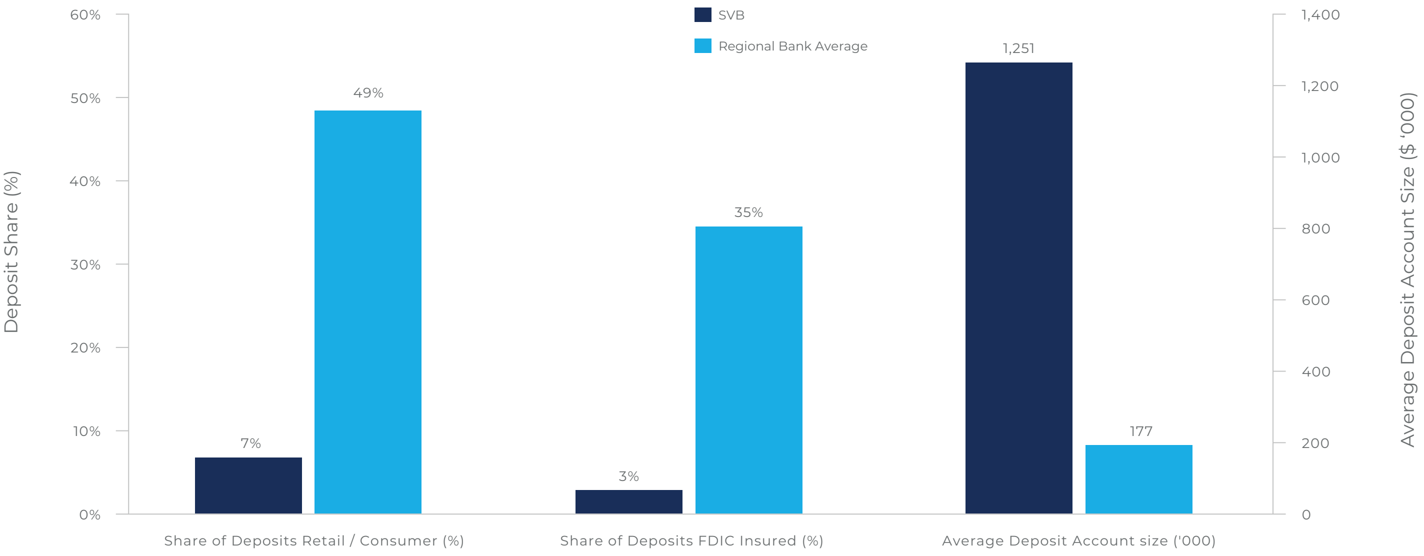
Fearing the risk of contagion, The Federal Reserve and FDIC intervened to prevent a widescale bank run on other US financial institutions. They declared SVB a systemic risk to the financial system and declared all customer deposits safe in the hope of restoring security. In addition, The Federal Reserve introduced the Bank Term Funding Program (BTFP); a liquidity source that would eliminate the need for banks to sell high quality securities at a loss to meet deposit outflows, thus preventing other similar liquidity crises.

In Europe, the Swiss National Bank's decision to put common equity holders ahead of AT1 bondholders, a reversal of conventions stated in Basel III, prompted a wave of worry other European banks could follow a similar approach. UK and European regulators moved quick to support the seniority of AT1 bonds over common equity to stem the selloff.

CONTAGION IN THE BANKING SECTOR?

While the developments in the banking sector are indeed worrying and will require close oversight, we think the collapse of SVB was largely down to idiosyncratic vulnerabilities and poor risk management. Firstly, SVBs customer base, dominated by private equity and venture capitalist firms (in 2021 they boasted over 50% of US VC backed tech start-ups were customers) was inherently riskier than the broader banking industry's depositors which are predominantly much stickier retail customers. As a result, the average deposit account size at SVB were significantly larger and only 3% of deposits were FDIC insured (less than $250k) as shown by Goldman Sachs research in Chart 3, making the bank much more vulnerable to a bank run.

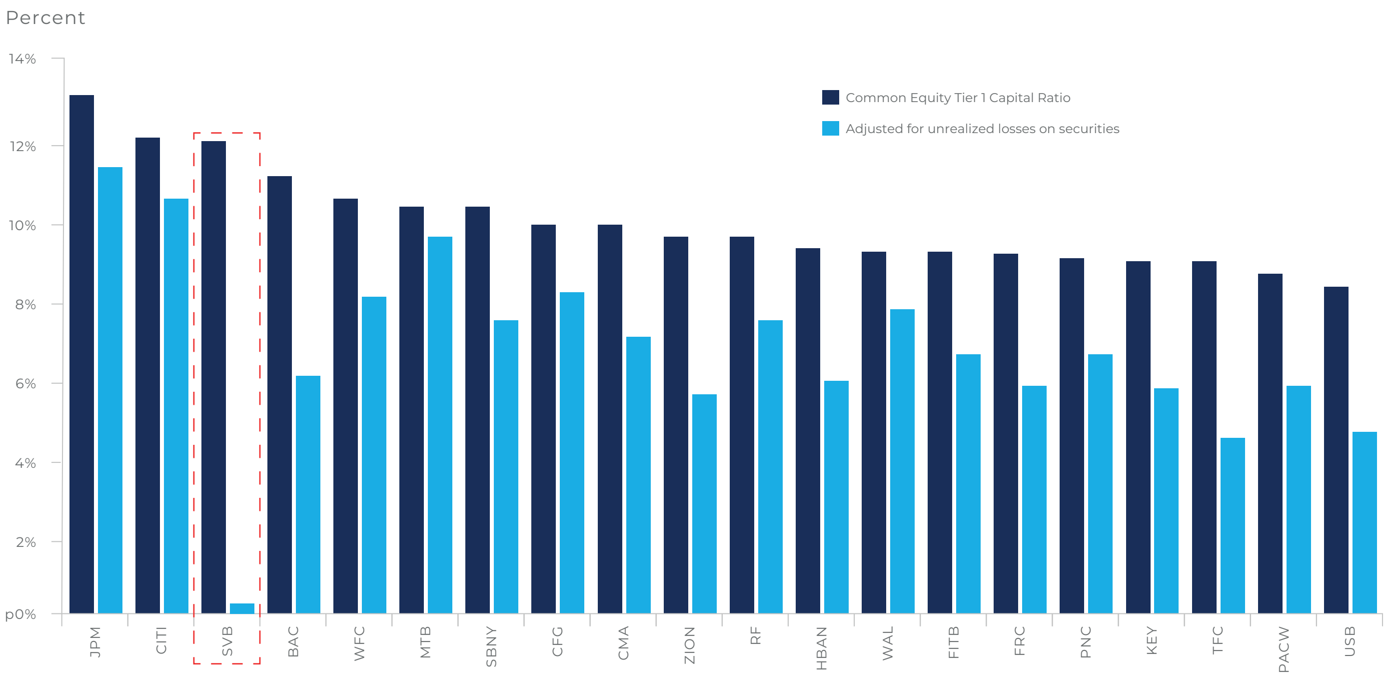
CHART 3
DEPOSIT CHARACTERISTICS OF SVB RELATIVE TO OTHER LARGE REGIONAL BANKS



Source: Investment Strategy Group, Bloomberg, Goldman Sachs Global Investment Research.
Regional Bank Average is an Average of 15 large regional banks.

Secondly, SVB's rapid rise in deposits, which far exceeded its loan growth, meant large excess liquidity was invested into US Treasuries. As shown in Chart 4, SVB had the second-best Tier 1 Capital Ratio in the US, however given most of these bonds were bought in 2020 and 2021 at lower yields, the rapid rise in interest rates in 2022 left SVB extremely vulnerable to mark-to-market losses which totally wiped out their Common Equity Tier 1 Capital.

CHART 4
IMPACT OF UNREALIZED SECURITIES LOSSES ON CAPITAL RATIOS



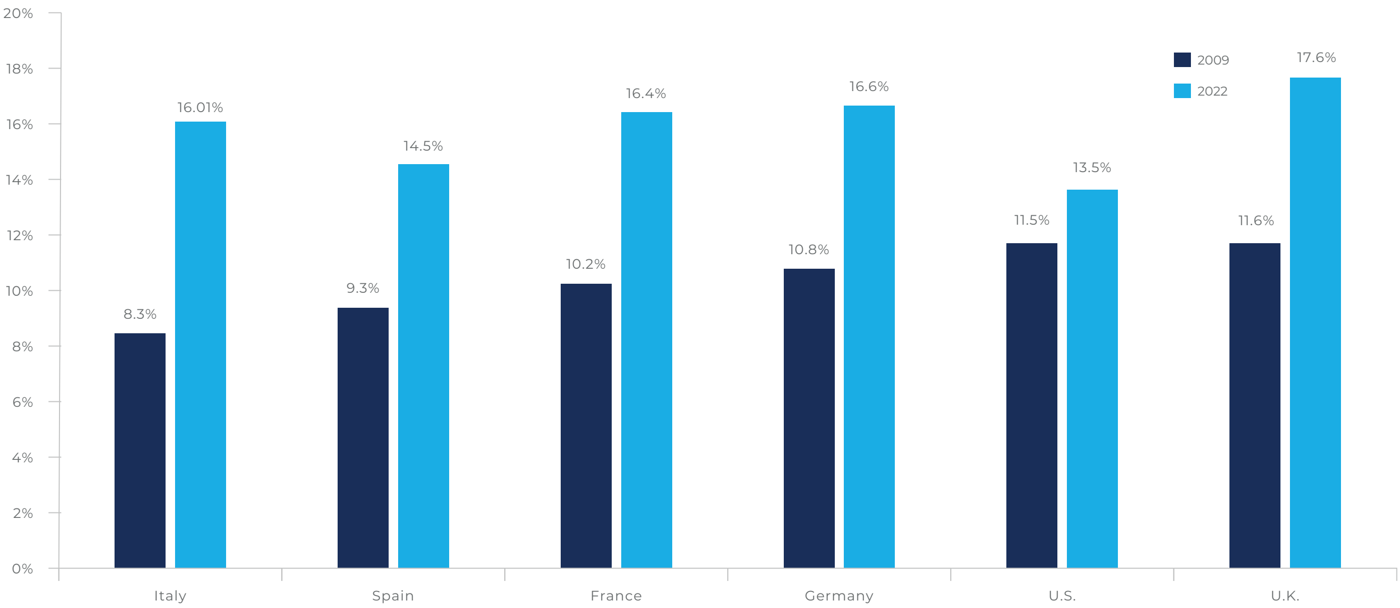
Source: JPMorgan Asset Management, Q4 2022

Notably, such losses represent a much smaller portion of capital at other US banks where interest rate risks are typically hedged, and securities held within Tier 1 Capital are more widely diversified. A lack of awareness, or active choice to ignore the above factors suggests significant failures in risk management by SVB and highlights some of the vulnerabilities of riskier banks.

However, we shouldn't extrapolate this to the wider banking sector which today is much healthier than prior to the Global Financial Crisis. Banks hold fewer riskier assets on their balance sheets and are far better capitalized, with Tier 1 Capital Ratios in the US and Europe much higher than they were in 2009, as shown in Chart 5.

CHART 5
FINANCIAL SECTOR IS WELL CAPITALIZED

Regulatory Tier 1 Capital to risk-weighted assets, %



Source: IMF, data as of 30/06/2022

Contagion in Europe also seems to be largely under control for now given European CDS has not widened all that much, as seen during the European Sovereign Debt Crisis. The outlier is Deutsche Bank which has faced selling pressures and a widening CDS spread, however this seems more down to general market anxiety rather than fundamental problems at the bank.

THE RISKS?

The banking system relies on confidence. The recent fallouts have dented that confidence and we continue to see depositors moving funds from regional banks to large banks or switching into money market funds and short dated bonds. While this could result in more regional bank failures, with all eyes on First Republic Bank, we believe the policy responses should be sufficient to stem contagion risks. However, the cost of credit has risen, and lending standards have tightened further, potentially dampening loan growth from here. While this likely helps lower inflation it also risks reducing business fixed investment, consumer spending and global economic growth.

Central Banks are now tasked with balancing their fight against inflation whilst maintaining financial stability. Both the Federal Reserve and the ECB proceeded with their decisions to hike interest rates at their March meetings signalling their continued confidence in their economies and banking systems. Importantly, the banking system's main concern today is not one of credit quality, like in 2008. Rather it is a potential liquidity issue, if faced with a bank run, stemming from losses on high quality bond portfolios. As such we are of the view that the problem is manageable as Central Banks have clearly expanded their policy toolkit and shown their willingness and ability to act quickly to restore confidence.

Global markets and economies are constantly evolving, and we will keep a watchful eye on behalf of our clients. We look forward to updating you on the developments next quarter.

Thank you for taking time to read our Market Review.
Sigma Investment Committee