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FUND MANAGER QUARTERLY REPORT

Q1 2023 Fund Manager Report

Three Rate Rises and a Bank's Funeral

By Wayne Bishop

Now we see who's swimming naked.

We apologise for the mental images this title may have invoked, but it's an old City saying that "when the tide goes out, we can see who's swimming naked", and in the first instance, this has been a number of banks. Whilst Credit Suisse was a very slow train crash and resolved by the Swiss National Bank, Silicon Valley Bank was the result of obvious (and under-supervised) poor balance sheet management. The issue itself is not systemic to the banking system but one that caught its supervisors off guard. Being non-systemic, this is not a repeat of 2008, but caution is required given the way forward will not be same, as there will be no way out through monetary easing this time.

Years of easy money, through almost zero interest rates and oversupply of money have left a number of banks in a vulnerable situation. In the financial crisis of 2008, money supply from major central banks tripled but had no effect on inflation as the velocity of money collapsed. The relationship between money supply and inflation (the Fisher Equation) is twofold (not one-fold as often reported): the quantity of money, multiplied by the velocity of money, will equate to the price level. In 2008, the banking system was in crisis and one cancelled out the other, meaning we saw almost no inflation in the years following the global financial crisis. The main market concerns from that period were sovereign debt levels (2013) and the taper tantrum (2018) when, as the velocity of money started to rise, the central banks began to reduce the supply of money.

The Pandemic led to a reversal of this tightening of monetary policy, a lowering of interest rates, and an increase in money supply. However, this time, the velocity of money recovered far more quicky and, added to this, all economies experienced cost push inflation as supply chain issues, safety concerns, economic redundancy and later on a war induced energy crisis, all led to a sudden and sharp increase in inflation. This led to interest rate increases.

There are plenty of opinions as to whether interest rates have gone too far too fast or not far and fast enough, something we need not delve into right now. However, at the same time central banks have again been draining money out of the system, and with less money which is more expensive to obtain, capital discipline is back. On a positive note, and we have seen some leading economists comment on this, we expect this will lead to a sharper pull back in inflation, even if further down the line in late 2023.

This means the capital that is available to the market is more demanding in terms of the quality and return of investments. Ideas that were viable in 2020 are no longer attractive, and the market is now adjusting. What the banking sector is experiencing now, and banking is naturally very capital sensitive, is expected to follow through to other sectors. Starting with those sectors that are either cost of capital sensitive (real estate, capital goods) or highly discretionary items.

For markets, this means risks and concerns move from the systematic macro-economic issues such as interest rates and economic growth, to unsystematic issues such as those companies (or countries in the case of bonds), who are “swimming naked” and those who have better balance sheets.

The noise these issues create (in terms of news flow and headlines etc.) will only add to the already high volume of pessimism out there. The change that began with the pandemic, and later the war in Ukraine, is now beginning to really impact business and investment decisions for the future, and whether we call it creative destruction or any other name, this change is now affecting markets. From an Impact and ESG perspective, some of these changes are overdue. After under performing for nearly two years, some of the key investment areas are coming back to life and we detail some of this below.

Fixed income

The super long bull market in fixed income (starting in the mid-1990s) finally came to an end in spectacular style in 2022. Like “the boy who cried Wolf”, over the years, its ending had been foretold a number of times but to no avail, but the fierce response by Central Banks and some unbelievable political madness meant the fall was faster and harder than expected.

In hindsight, we began re-investing in fixed income a little too soon, before Liz Truss, but now we are just above our neutral levels across portfolios. Going forward, we expect fixed income to be calmer, witnessing smaller yield curve gyrations as inflation and interest rate expectations adjust in a more moderate fashion. With economic stresses, we expect quality to remain a key issue going forward and therefore still favour higher quality paper. The issuance of green bonds has given us access to some higher quality paper; however, we remain vigilant in our screening of these bonds to avoid greenwash.

With interest rates and yields now at more respectable levels, fixed income and cash have once again become investable asset classes. Although real returns are still negative when set against the current very high levels of inflation, market expectations remain that inflation will fall back towards 4% in the short to medium term and therefore a return to real yields is possible. Concerns about the supply of paper as governments continue to issue bonds to finance high levels of debt, whilst central banks are no longer large buyers, is a key reason we favour higher quality debt. We do see the supply concerns being largely mitigated by the fact that demand for fixed income has returned, now there is a real “risk free” return.

Infrastructure and Property

As a consequence of fixed income now offering lower risk returns of 4% or more, this has had a negative impact on both infrastructure and real estate investments. Hitherto, these had been the main beneficiaries of low bond yields. Although returns of 5-6% and normally index linked are appealing, the exposure to debt (however hedged it may be) and relative risk to fixed income has made this sector less appealing as a lower risk investment.

The risk element for property has become more manifest in the last quarter. Whilst our portfolios have avoided office and retail exposure, two areas we considered at risk in the post-pandemic world, specific issues with the Home REIT remain unresolved with issues being worked through. To a large extent, these risks are already reflected in the share prices of our more socially focussed property investments as they are all closed-ended investments. This means the share price and value of the investment reflects supply and demand, rather than a formulaic Net Asset Value of the underlying properties. We still believe there are issues in the broader commercial property space as debt and arrears are being addressed that will act as a headwind for the sector. In the longer term, we see the depressed prices in more socially motivated property investments as a buying opportunity.

Likewise, in infrastructure, all the portfolio investments in this area are focussed on owning either renewable energy assets such as wind farms, solar parks, AD plants or battery parks that have a genuine and high impact on the environment. These assets are a core element in portfolios and have lagged the broader market in the last 18 months, especially compared to oil and gas over the same short period. We feel the war related oil boost has had its day, and that the longer-term trend in favour of renewable energy and real assets will resume. As longer-term investors, and seeking to maintain a high positive environmental impact, we plan to stick with these investments. Likewise, the small addition of forestry to the portfolios was mildly positive in the first quarter.

Equities

The first quarter of 2023 saw global ESG leaders once again outperform global equities by almost 1%. High Impact investments however underperformed by a large margin on the quarter.

Renewable Energy was a swing factor, underperforming the main market. In fact, a leading global clean energy index actually returned negative 2.67% in sterling terms, despite wider markets returning high single digits.

As we mentioned in the conclusion of our December 2022 report, we felt the last quarter of 2022 was pivotal for ESG and Impact investments as the world exited the trio of shocks experienced in 2022 (War, inflation and rapid monetary tightening).

Overall, there was a slight reduction to renewable energy equity exposure in the period. We used weakness to add to both wind turbine makers and some support companies but sold the investment in Orsted, a leading wind farm developer. There are a number of interesting investment opportunities but timing is important, as growth investments this depends on interest rate expectations, political support, input costs and valuation grounds. In the long term, we see a strong future for the sector and the pace of change has been heightened by both a global desire not to be over exposed to fossil fuels again, and for governments to see green industries established in their countries.

The International Energy Agency has reported that government spending based on today's policy settings would raise global clean energy investment by over $2 trillion annually by 2030. The EU's RePowerEU deal and the United States' Inflation Reduction Act are two examples of the support behind this sector.

Some of the best performing investments over the last quarter have been in electrification, where in some cases new investments such as ABB have performed well. We also saw elements of a recovery in some of the riskier investments in this area, in particular around EV charging and battery technology.

Healthcare, both physical and mental, remains a sector in recovery in the post-pandemic world. The focus of portfolios is around efficiency, AI and technology. Demand for healthcare remains on a strong upward trend in both the developing and developed world, but in both cases, it comes at a high cost as expectations rise. This is forcing efficiency and new technology to detect health problems sooner, which has a high social as well as financial benefit. At the end of the quarter, we added to Spire healthcare where ethics allow, wanting to increase our exposure to the sector.

The outlook for equities remains uncertain. Although global equity markets have rallied this year, the rally has been narrow in that a minority of the stocks have made most of the gains. We are about to enter reporting season for the first quarter of 2023 and the management comments and outlooks will be closely scrutinised. In traditional fashion, expectations have been managed lower ahead of the reporting period, but we expect any weakness or strength to be jumped on by the markets. As both debt and equity capital will be more expensive and harder to come by, we expect companies needing capital to have a harder time.

Conclusion

As markets get to grips with the dynamics of more demanding capital, we expect a higher level of unsystematic risk. We see more stability in quality fixed income as the interest rate and tightening panic ease and focus moves to quality. Infrastructure and property have borne the brunt of a reallocation of capital, which has led to flat performance over the quarter, but we see this as a mid-term nadir. The social and environmental impact as well as the more stable outlook means we still consider these attractive investments.

As we mentioned in the last quarter, we feel equities have pivoted and the outlook for the next few months is mixed. In general terms there is a focus on the steepness of the path for interest rates, inflation and growth dynamics, and in unsystematic terms by company specifics and a return to more traditional metrics such as quality of earnings and balance sheet risks.

As the reflation and war trades wear off, fundamentals and future growth prospects are once again pointing to global solutions, and in all areas, valuations are more realistic and opportunities are increasing. As a result, portfolios are risk adjusted with higher levels of fixed income and infrastructure than the market to provide income, and a growth focus in equity investments as opportunities present themselves.

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