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20 YEARS ANNIVERSARY

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MARKET COMMENTARY

Market Comment 21st March 2023

Coming out of the easing of COVID 19 measures in early 2022, there were no warning signs of impending failure at Silicon Valley Bank, in fact they were still benefiting from an influx of new depositors as investment poured into the tech industry throughout the pandemic.

Funds from venture capitals and tech startups contributed to the growth of the bank's assets to $90 billion by the end of 2022. The bank had used deposits to buy long-term treasuries and mortgage-backed securities – a seemingly safe investment.

However, a $42 billion bank run (where depositors demand back their deposits) caused a forced sale of the bank's assets in an attempt to meet these demands. Whilst attempts to raise capital through the issuance of shares failed, the end was inevitable, forcing regulators to close them down on Friday 17th March 2023 and protect depositors' money.

Whilst most banks allocate a portion of depositors funds into assets such as government debt, the percentage of depositor's funds held in these now loss-making deposits at SVB was high. Whilst not a massive issue if held to maturity, SVB could benefit from small bank rules in the US and not have to mark their investments to market. The run on the bank meant they were forced sellers and begun realising these losses.

The sudden collapse of SVB also sparked a $10 billion run on deposits at Signature bank, leading to the third-largest bank failure in US history. Many other regional banks came under pressure and the situation caused market sentiment to sour, with banks across the globe coming under pressure over concerns this could trigger similar bank runs.

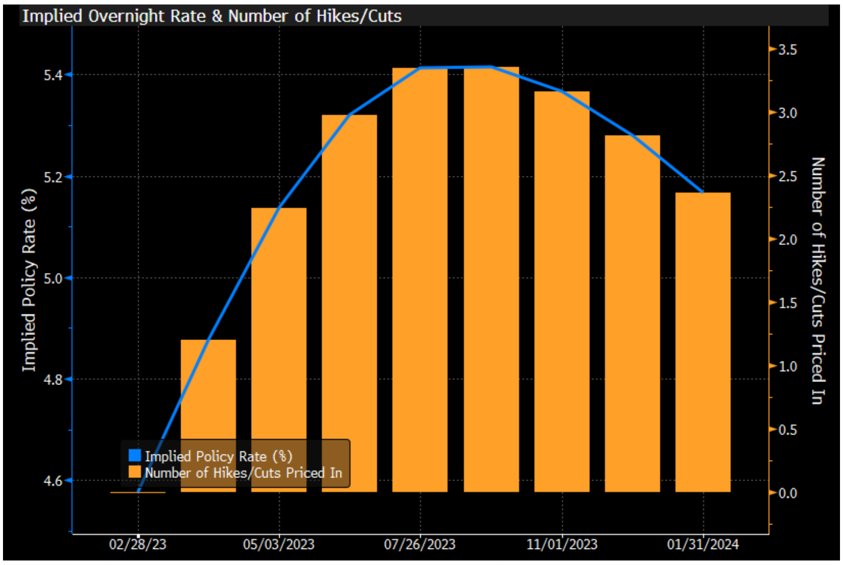
Portfolios had no exposure to SVB or Signature Bank, and given portfolios have limited to no exposure to traditional or challenger bank equity, they were somewhat shielded from the gyrations in the banking sector, although the souring in general market sentiment did see a wider sell off in equity markets. Our lower allocation to equities and higher cash levels has benefited investors in recent weeks, with equity markets on a downward trend since the beginning of February 2023.

Just as the spotlight was on the financial sector, on Tuesday 14th March 2023, Credit Suisse released an announcement stating it had found material weaknesses in its financial reporting processes for 2021 and 2022, that may have resulted in misstatements of financial results. These weaknesses state lack of effective oversight and risk assessment that could identify financial misstatements. Contagion fears grew on the back of the Credit Suisse announcement, although it is important to note that Credit Suisse's struggles has been an ongoing saga, with its share price already down over 60% prior to this announcement (1 year return to March 23).

What caught investors off guard here is the treatment of AT1 bond holders of Credit Suisse, who saw their bonds valued at zero, rather than convert to equity, whilst this was not out of the ordinary, equity holders of Credit Suisse on this occasion ranked higher, sparking a wider sell off in other AT1 debt. Legal action on this is already underway.

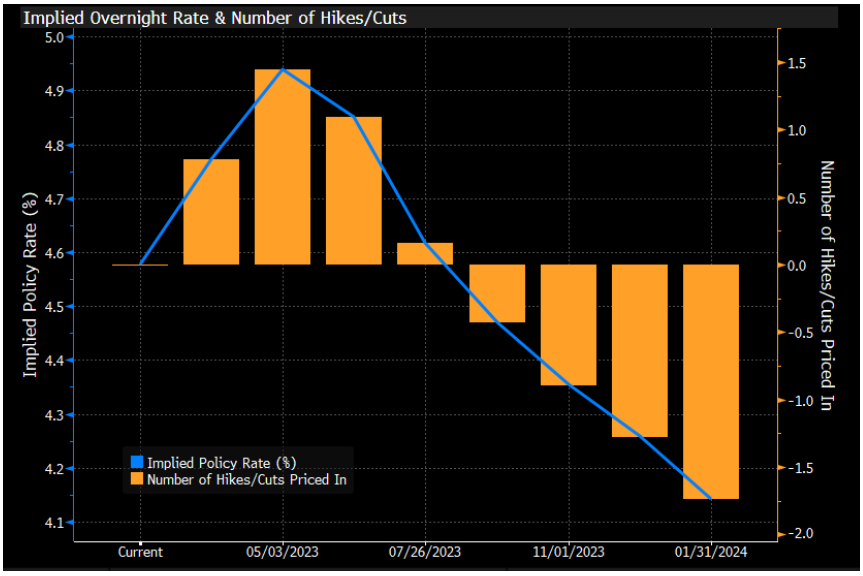
Last year we improved the credit quality of debt within portfolios, favouring shorter dated gilts (where applicable) and higher rated corporate bonds, which have subsequently rallied on safe haven flows. The increased concerns of contagion and deterioration in confidence has raised the prospects of a hard landing, fuelled by a tightening in credit conditions resulting in lower business and consumer spending. As a result, markets have re-priced interest rate expectations, forgetting the inflation fight that policy makers have been on for the last year.

The graph below represents the implied overnight bank rate for the United States at the end of February 2023. At that time, markets were pricing peak rates in Q4 2023 at circa 5.4%, leading to a period of rate cuts at a more pedestrian pace into 2024:



(Source: Bloomberg)

Three weeks later, 21st March 2023, markets have priced in a different scenario, with peak rates now expected in May, with more aggressive rate cuts being priced in from that point:



(Source: Bloomberg)

As mentioned, the near-term beneficiary has been safe haven assets, with quality fixed income rallying, particularly longer duration assets given the repricing highlighted above. Whilst we have been at the shorter end in terms of duration, we are comfortable in our current positioning given inflation has shown signs of stickiness, and the labour market is yet to show alarming signs of cracking (note UK inflation for February surprised to the upside: CPI posting 10.4% when 9.9% was expected, whilst core inflation also unexpectedly moved higher).

We head into a number of key central bank policy decisions this week, including the Federal Reserve (Wednesday) and the Bank of England (Thursday), which remain our main focus in the immediate term.

With regards to banking, an important point to note is the different scenario most global banks find themselves in versus the distress of the 2008 financial crisis, with greater capital held on balance sheets to weather the storm of economic downturns and credit quality souring. Corporate balance sheets are in a much stronger position, whilst consumers have benefited from having higher savings levels as a result of the covid crisis (albeit this have been tapped into given the cost-of-living crisis). Given this, we feel the repricing of some banks in recent weeks has been overdone, and in bespoke portfolios, we have used some weakness to add to some UK bank names where ethics allow.

Looking ahead, whether its Q2 or Q4, it was becoming clearer that peak rates were in sight as we started 2023, which is beneficial for equities, particularly higher growth focused investments which would benefit from a move lower in the discount rate. As mentioned, we have had a cautious stance over the last six months, with our equity allocation remaining near the lower end of the range for each risk profile. Inevitably, this means the next move will be an increase in exposure, although given the uncertainty we find ourselves in, the investment committee have voiced limited desire to be making widespread changes in the near term and will be led by central bank policy comments.

Demand for goods and services of impact focussed companies has remained strong, and we have seen evidence of this in the recent reporting period. Given the scenario we find ourselves in, the importance will be quality of earnings and balance sheet strength, but also targeting geographies with the legislative support for a just transition.

Legislation such as the US Inflation Reduction Act, or the EU's RePower EU has provided stimulus support at an unprecedented level which will help drive capital towards key impact areas. The latest UN climate report, released earlier this week, highlighted the need to act now on the climate crisis or face irrevocable damage as we head towards global warming in excess of 1.5 degrees. Reaching targets will require huge amounts of investment in energy, transport and industry which are key focusses of portfolios. One of the key investment focuses we are excited about in the coming years is renewable energy, and you can find our recent report on the sector by clicking here.

As a business our investments have always had a genuine Impact and ESG focus. For the last 18 months sticking to our own and our clients' own ethical values has been painful, as armaments, fossil fuels, banks and tobacco have been the best performing sectors that could have cushioned some of the wider market decline. We are now seeing some of this unwind as markets again focus of a future where growth will be in addressing many social and environmental issues as corporate and consumer behaviour changes.

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Company & Contact Information

Website: www.kingandshaxsonethical.co.uk

Email: ethical@kasl.co.uk

Phone Number: +44 (0)20 7426 5960

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