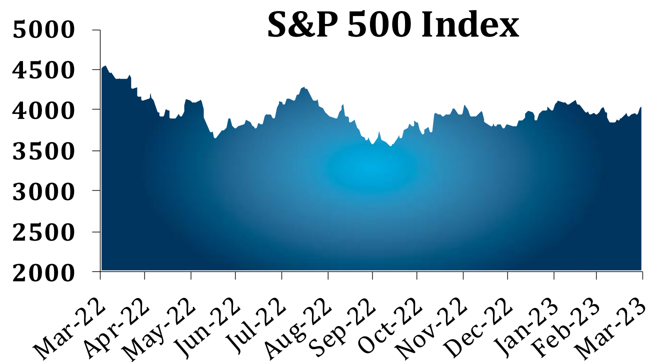
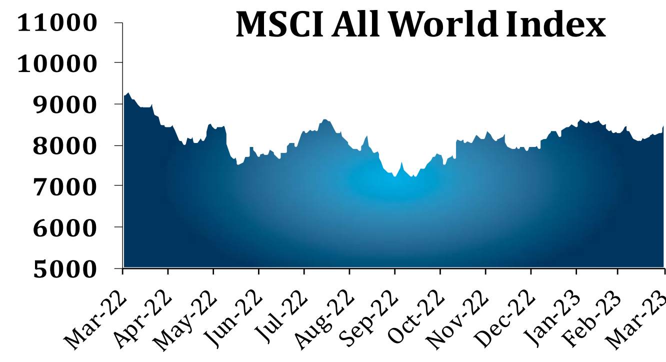
Stock Market Analysis

Look Forward





In our March 21st Market Update, we gave our views on the market volatility caused by central banks' war against inflation. Sharply rising interest rates have stressed the banking system. The central bankers' activities have been similar to fighting wildfires where containment is the main objective. Since we sent out that report, the ECB, SNB, BOE and the U.S. Fed have continued to raise bank rates in order to cool off their economies. At the same time, they are targeting "hot spots" in the banking system to limit the potential spread to the overall economy. Unfortunately, like wildfires, periods of rising interest rates can have unpredictable outcomes, and understanding operational parameters is difficult. More details of the bank crisis can be found in our fixed income report.

The market volatility may be difficult to navigate in the short-term, but it will create interesting opportunities for patient long-term investors. The problems in the banking sector will likely accelerate the well-anticipated economic slowdown, as banks will be forced to reduce lending. We also anticipate that inflation will take longer than expected to return to central bank target levels. With elevated economic, political and economic risk, market forecasting is as much social science as quantitative analysis. For these reasons, we decided to lower the risk in the equity portfolio by taking profits in some of the portfolio winners and reducing our exposure to the energy sector to market weight. With that being said, we believe the current Fed tightening cycle is near its peak, and lower interest rates going forward should become a tailwind for equities. Revenue growth and profit margins will be challenged for economically sensitive sectors until we get through the downturn. We believe that it is important to identify companies with experienced management teams, resilient business models and strong fundamentals in this period.

Anchor Investment Management Ltd. is Licensed to Conduct Investment Business by the Bermuda Monetary Authority

Stock Market Analysis

We often point out that the stock market is a forward-looking mechanism. Despite the turbulence in the banking sector and economic uncertainty, shares have performed well since last year's capitulation. The MSCI All Country World has rebounded 18% from its October 2022 low. The index would need to rebound another 18% to return to its 2021 high, and we continue to find plenty of value in the market. The MSCI All Country World benchmark rose 7.3% in the first quarter, with similar gains in the S&P 500 and EAFE international indices. After lagging last year, primarily due to rising interest rates, technology shares led the market gains in the quarter, with the NASDAQ Composite Index jumping 17%.

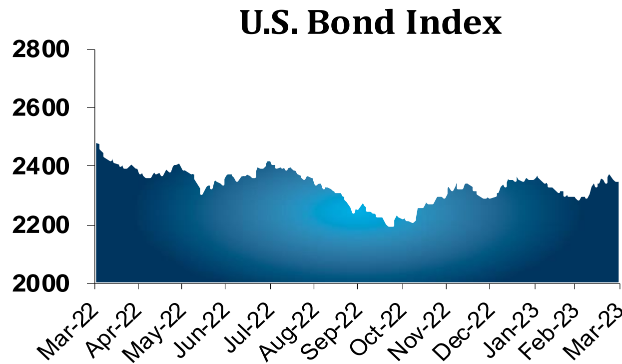
The Anchor Equity Portfolio Composite returned 7.8% in the first quarter compared to 7.3% for the MSCI All Country World Net Total Return benchmark. Despite the 2022 selloff, the portfolio has produced a +17.5% annualized return over the past three years compared to +15.5% for the MSCI All Country World Net Total Return benchmark.

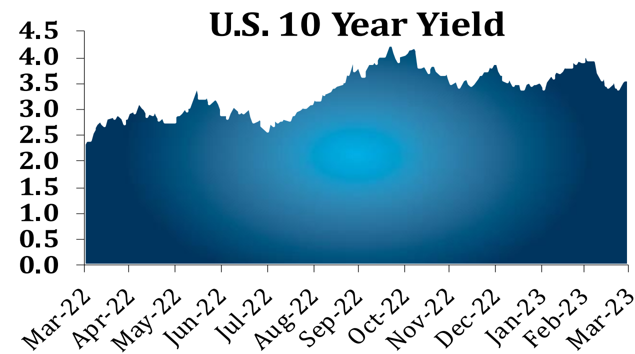
The Anchor High-Quality Income Portfolio held up much better than the major global stock indices during the 2022 market selloff, falling only 0.6% compared to -2.9% for the SG Global Quality Income benchmark and -17.4% for the MSCI All Country World Net Total Return benchmark. The HQ Composite returned 2.5% in the first quarter compared to 4.8% for the SG Global Quality Income benchmark. The portfolio has produced an annualized return over the past three years of +14.6% compared to +11.6% for the benchmark. *

**Performance is based on Anchor composite portfolios after transaction and administration costs and management fees. Past performance does not guarantee future returns*

Fixed Income Analysis

March Madness!





The big news in March and the first quarter was the banking stress that erupted in mid-March. It led to a flight to safety environment with treasury rates falling across the curve. The 10-year treasury declined 0.45% to 3.47%, while the 2-year fell 0.79% to 4.02%. The Fed raised the fed funds rate to 5% (upper limit) on March 22nd, though Powell was cautious of the future path given the uncertainties surrounding financial stability given the banking sector stress. The market is pricing rate cuts before year-end, which is at odds with FOMC expectations of holding the fed funds rate steady as per the DOT plot. Although spread widening was led by the banks and high yield market, the overall market is still not showing widespread credit stress. Instead of waffling on about fed fund futures, inflation, and the labor market, we thought we would offer some insight into the recent banking stress.

Investor focus on U.S. banks began with KeyCorp commenting on deposit pressures from clients in its Q4 earnings call. This was followed by the voluntary liquidation of Silvergate Capital on March 8th, and the forced closures of Silicon Valley Bank (SVB) on March 10th and then Signature Bank on March 12th. Banking stress then made its way across the Atlantic Ocean to Credit Suisse (CS). All of these banks fell victim to bank runs, whereby deposit outflows forced the banks to liquidate securities and, in some cases, crystallized large unrealized losses to meet the outflows. Below are some takeaways from the banking stress in March.

Bank regulation: The topic of bank regulation is firmly back on the radar. U.S. regional banks are not subject to the same regulatory requirements (liquidity coverage ratio, stress testing) as “systemically important” banks (those with assets >$250 billion). As such, these less regulated banks have more bandwidth for less robust risk management (SVB is a prime example). Additionally, in times of stress the depositors/clients of these less regulated banks tend to seek the relative safety of the “too big to fail”, systemically important banks. Being more exposed to depositor flight combined with less risk management oversight is a bad marriage. This is likely going to change through stricter regulation of regional banks.

Fixed Income Analysis

Unintended consequence of the Fed's monetary tightening: Over the last twelve months the Fed has raised the fed funds rate from 0.25% to 5%. This led to one of the worst years of bond market performance on record in 2022. The impact of this move in interest rates is especially evident in bank's held-to-maturity (HTM) investment portfolios. HTM is an accounting treatment whereby unrealized losses on securities do not flow to the income statement or impact bank's capital ratios. In return for this accounting treatment banks must hold the securities until maturity. U.S. bank HTM portfolios typically consist of some combination of treasuries and agency mortgage-backed securities (MBS). Given the large move higher in treasury rates and mortgage rates over the past year, securities purchased in 2020 and 2021 have significant unrealized losses. This is especially true for MBS. When mortgage rates rise, prepayments slow thereby increasing the duration (interest rate sensitivity) of these securities. This does not mean that banks are insolvent or are hiding losses. Treasuries and agency MBS are U.S. government guaranteed securities. The losses are temporary and will reverse if the securities are allowed to mature (or if interest rates fall materially). SVB had a very large HTM portfolio loaded with securities purchased in 2020 and 2021 when interest rates were much lower.

Bank Deposits: U.S. bank deposit rates had barely risen while the fed funds rate had risen to 5% in just 12 months. Part of the reason for this is the banks' deposit rates are anchored to the loan rates and yields in their HTM portfolios which do not change quickly. As a result, U.S. banks have seen deposits leaving to money market funds, which are higher-rated and pay 4%-5% depending on the investor class. The Federal Deposit Insurance Corporation (FDIC) only guarantees deposits up to $250k. In the event of a bank failure, deposits over $250k are (supposed to be) treated as unsecured creditors. Going forward, banks will have to pay up for deposits, from a more informed and nervous deposit base, which will squeeze their net interest margins.

Most Vulnerable or Niche Banks Failed: The U.S. banks that have liquidated or been forced to close have been niche players with underlying characteristics that made them most susceptible to a bank run. Tech venture capital portfolio companies dominated SVB's client/deposit base. The bank's balance sheet grew aggressively in 2020-21 due to lofty tech company valuations. These companies went from being flush with cash in 2021 to bleeding cash in 2022-23. Approximately 90% of SVB's deposits were non-FDIC guaranteed – depositors had a huge incentive to pull these deposits as the SVB headlines worsened. Additionally, SVB's investment securities accounted for 55% of total assets, much higher than peers. Three-quarters of the securities were classified as HTM. As deposits flowed out of the bank, SVB was forced to liquidate billions of HTM securities, thereby crystalizing unrealized losses and negatively impacting capital ratios. Silvergate and Signature Bank were the largest crypto-friendly banks, both of whom were under the eye of regulators (Silvergate was under investigation by the Department of Justice). With regards to Credit Suisse (CS), the bank was in the early innings of a large restructuring after years of management blunders.

Anchor Investment Management Ltd. is Licensed to Conduct Investment Business by the Bermuda Monetary Authority

Fixed Income Analysis

In 4Q22, CS lost ~30% of total deposits. When investor/client fears spread to Europe, CS was the bank with the greatest taint of uncertainty. Its demise moved incredibly quickly, ramping Wednesday, March 15th, and ending on Sunday, March 19th, with the announcement that UBS would acquire them.

Quick, coordinated action by the authorities: The Fed, Federal Deposit Insurance Corporation (FDIC), and Treasury Department issued a joint statement guaranteeing all deposits of the failed banks (not just FDIC insured deposits, >$250k), and the FDIC would offer bank's 1-year collateralized loans valuing the collateral (HTM securities) at par. Additionally, collateral for discount window borrowing, where banks can borrow from the Fed (up to 3 months), was also given par value. These collateral valuations increased bank's liquidity. The deposit guarantee was intended to slow deposit flight from smaller banks and reduce any contagion effect from those depositors taking large haircuts on their bank deposits. In the case of Credit Suisse (CS), the Swiss government, Swiss National Bank, and Swiss bank regulator pressed UBS into agreeing to acquire CS over the weekend (18th and 19th). It's clear that there is no appetite from authorities to let banking stress in the most vulnerable banks snowball into a widespread banking crisis.

Depositors Made-whole, Losses Imposed on Security Holders: Losses will be imposed on equity holders and unsecured bond investors of the three U.S. banks. The CS/UBS deal is an odd outcome. Equity holders will get $3.25 billion worth of UBS shares, while EUR17 billion of CS's additional tier 1 (AT1) capital securities were completely wiped out. Equity holders are subordinated to tier 1 capital in the capital structure. As such, they should not receive proceeds if AT1 debt holders are wiped out. However, due to language in Swiss banking regulation, the Swiss regulator was able to write down the AT1 capital since CS received extraordinary government support. Unsurprisingly, AT1 capital securities of EU banks reacted negatively to this, with credit spreads selling off in these securities.

At the time of writing the coordinated action of the authorities has largely worked to calm market fears. We have no way of knowing if this will last, especially if the U.S. economy enters a recession. Regional and community banks are most at risk, given the potential deposit flight. Additionally, commercial real estate loans are largely concentrated in these banks. Even before the banking stress in March, banks were tightening lending standards, as per the Fed's Senior Loan Officer Survey on Bank Lending Practices. Banks are likely to continue the belt tightening which will only further restrict credit availability. Our fixed income portfolio's only own systemically important, too-big-to-fail U.S. banks, who are best positioned to weather a banking storm should one occur. We also note that March 2023 is a great example of why we hold a core position in treasuries.

Fixed Income Analysis

Disclaimer

This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. Past performance is no guarantee of future results. The opinions expressed may change as subsequent conditions vary. The information and opinions contained in this material are derived from proprietary and nonproprietary sources deemed by the authors to be reliable, are not necessarily all-inclusive and are not guaranteed as to accuracy. There is no guarantee that any forecasts made will be correct. Reliance upon information in this material is at the sole discretion of the reader. Investment involves risks. Readers should consult their financial advisors prior to any investment decision. Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Sources may include MSCI, Bloomberg, and S&P Global. Information contain within is private and confidential and for the sole use of clients of Anchor Investment Management Ltd. (“AIM”). AIM respects the intellectual property rights of others. If you see a copyright or trademark of yours which is being infringed, you may notify AIM at info@anchor.bm. We will contact you to obtain details of your claim.