

INVESTMENT NOTE

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ROCKS AND HARD PLACES



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OLD MUTUAL MULTI-MANAGERS

The Federal Reserve, America's central bank, was born out of a crisis. The banking panic of 1907 was the biggest US financial crisis up to that point, and only ended when John Pierpoint Morgan, founder of the eponymous bank, pulled together rival bankers to stabilise things. It worked, but also illustrated the need for a central bank to step in as lender of last resort when individual banks or the system as a whole need liquidity and stability. The Fed was therefore set up in 1913 as a system of regional reserve banks, with the New York branch taking the lead in financial market interventions.

We are again experiencing such a moment of panic. Authorities on both sides of the Atlantic had to step in and calm markets and support banks. Success so far has been mixed, with renewed fears resurfacing on Friday, this time over the future of Deutsche Bank.

Panic or not, central banks are also still raising interest rates to combat stubbornly high inflation. Normally, fighting banking crises involves rate cuts. But this is a very different world and inflation remains a priority. Central banks are caught between a rock and a hard place.

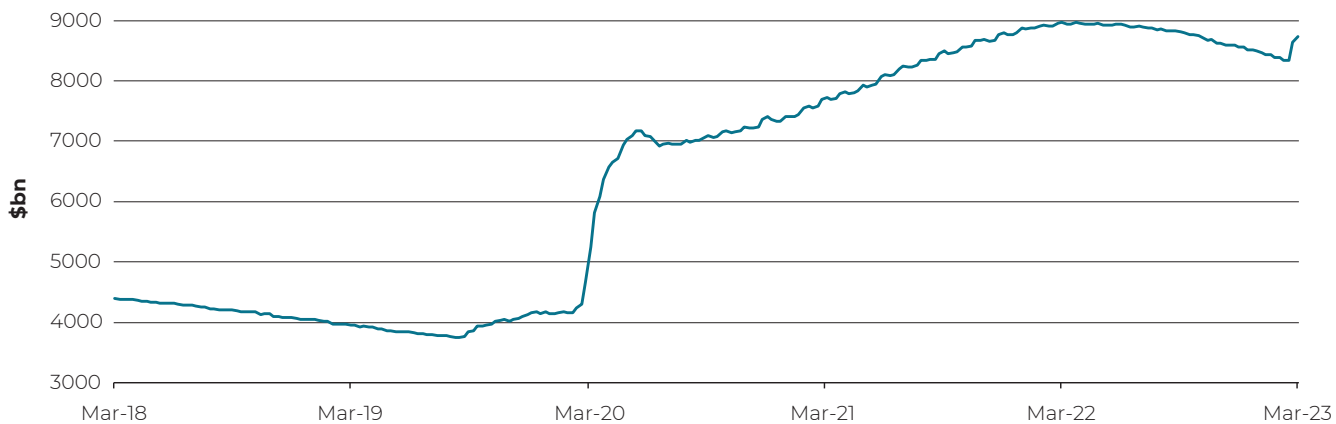
Moreover, not hiking might also have reinforced panic if investors worried that central banks were worried. A surprisingly large element of effective policymaking is psychological. This makes it hard to forecast, since policymakers are not just mechanically moving things up and down.

The Fed therefore raised its policy rate by 25 basis points last week, taking the range of the federal funds rate to 4.75% to 5%. Little over a year ago, this range was only 0% to 0.25%. At the same time, it has lent out more than \$160 billion this month to banks through its existing discount window and new term funding program. This has offset the previous five months of quantitative tightening, the process whereby the Fed was allowing its balance sheet, swollen from years of bond buying, to shrink. As with any bank, loans made by a central bank are assets on its balance sheet, along with the securities purchased.



WEALTH

CHART 1: FEDERAL RESERVE ASSETS

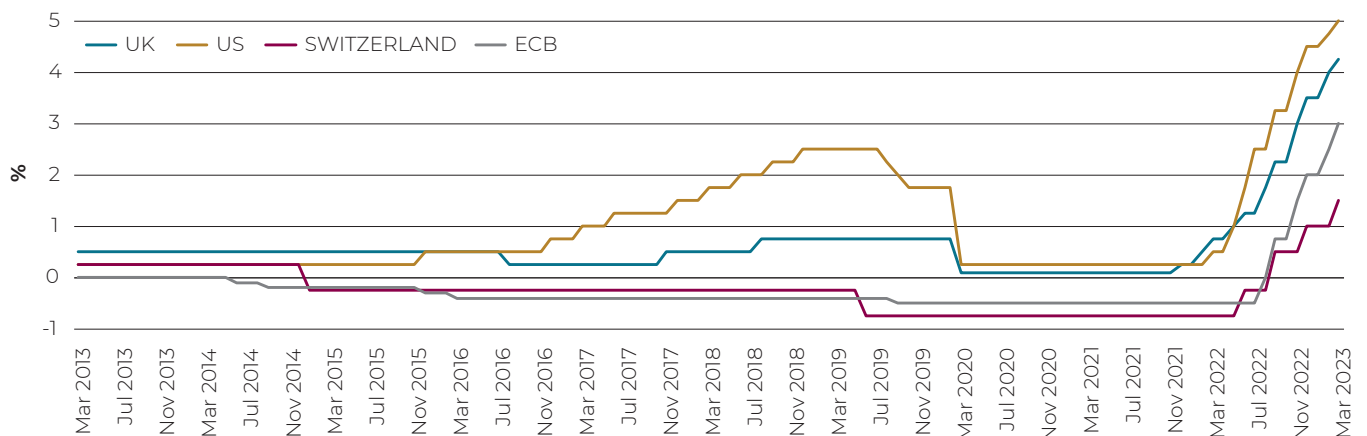


Source: US Federal Reserve

The Bank of England (BoE) also hiked rates last week, shortly after new data showed that inflation surprisingly jumped to 10.4% in February. The Swiss National Bank, fresh from

orchestrating the sale of Credit Suisse to UBS, hiked rates by 50 basis points to 1.5%

CHART 2: POLICY INTEREST RATES, %



Source: Refinitiv Datastream

Notably, the Fed and BoE dropped guidance for future rate increases, as the European Central Bank did the prior week. From now on, decisions will be made on a meeting-by-meeting basis depending on the incoming data and how the economic outlook evolves.

The reason is that the stress in the banking sector adds a new dimension to an already uncertain situation. While some economists have produced estimates that show the banking panic will shave between 0.5% and 1.5% off US economic growth this year, Fed Chair Jerome Powell was at pains to reiterate that no-one really knows yet how it will play out. However, it does imply a possible end to the hiking cycle.

RATES IMPACT

One thing is clear. Higher interest rates are taking a toll, just not where they were expected to.

Before the collapse of Silicon Valley Bank, it appeared that the rapid interest rate increases of the past 14 months had

little discernible impact on economic activity outside a few pockets. Indeed, at the start of the year, it seemed as if economic growth was accelerating on both sides of the Atlantic (and of course in China, where Covid restrictions

were scrapped) with low unemployment and solid growth in consumer spending. March's S&P Global Purchasing Managers' indices, released on Friday, were all solidly in positive territory across the major economies.

There were three possible explanations for this. Firstly, the economies of Europe and the US were able to absorb much higher interest rates than previously thought. In economic jargon, this implied that the neutral real rate of interest, or r^* , is much higher than previously believed.

The second explanation is that the distortions of the pandemic that caused the surge in inflation also rendered economies less vulnerable to higher rates. In other words, while higher rates would normally sink the economy, this is a special case.

The third and more realistic explanation is not that this time is different, but simply that there hasn't been enough time. Interest rates have historically impacted economic activity and inflation with a lag of a year or more, and therefore the impact is still coming.

We now know that a big part of the impact has showed up – somewhat unexpectedly – in the banking sector. More specifically, in certain parts of the banking sector, notably smaller, regional banks in the US. Just because they are smaller, doesn't mean they are insignificant. Smaller banks (defined as those outside the 25 biggest institutions) account for a substantial slice of lending, particularly into the commercial real estate market. This market has already faced pressures from the impact of Covid on the office sector and e-commerce on shopping centres.

One concern is that banks will refuse to roll over some loans to real estate firms, causing them to go under. There is an old bankers' saying that "a rolling loan gathers no loss". If loans are extended, everyone can pretend that things are

fine. But when the loan is called, there is a collision with reality. Either the borrower repays but risks floundering, or the borrower defaults and the bank takes the hit. One way out has historically been for banks to package and sell mortgages to investors, but this market for commercial mortgage-backed securities has been extremely soft for several months, limiting the ability for banks to move loans off their books.

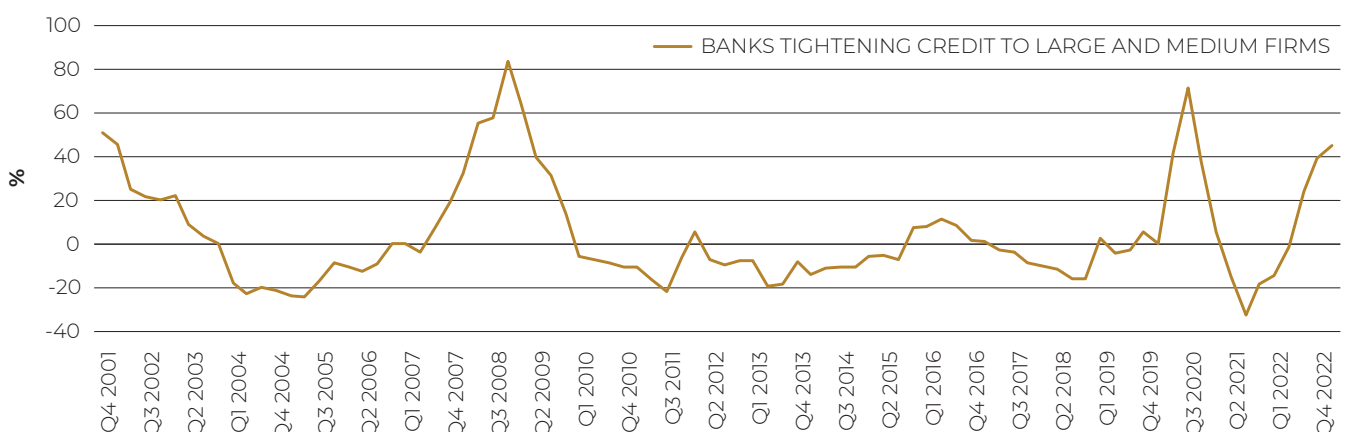
Either way, there is likely to be a contraction in bank lending into this sector, as well as others. Banks are already charging more for mortgages, with the spread of both commercial and residential mortgages over government bonds widening.

Some banks are also being squeezed from the liability side of the balance sheet. Even before this latest episode, banks were losing deposits due to competition from higher yielding products (such as money market funds). When interest rates rise, banks are slow to raise the interest rates they pay on deposits, but quick to raise the rates they charge on loans. This allows them to earn a spread and explains why banks generally benefit from a rising interest rates environment.

Taking deposits is not just a line of business for banks, it is an important, usually cheap, source of funding. A deposit is effectively a loan to a bank. Smaller banks will probably be forced to pay higher interest rates to retain deposits that are now leaving for money market funds and larger (safer) banks. The higher cost of funding could further weigh on lending into the real economy.

Both the Fed and the ECB regularly survey banks to enquire about lending activity and in both cases, banks tightened lending standards in the fourth quarter, before the current episode. When the latest surveys are released, they are likely to show further caution on the part of banks.

CHART 3: US FEDERAL RESERVE LOAN OFFICER SURVEY



Source: Refinitiv Datastream

The combination of higher interest rates, widening spreads on loans and tighter bank lending standards is likely to put pressure on economic activity. This is what central banks needed to cool inflation, and they remain committed to doing so.

THE PLOT THICKENS

The Fed's own quarterly "dot plot", a summary of projections of officials from the various regional reserve banks, suggests that the peak is near. The median dot on the plot points to rates ending 2023 at 5.1%, more or less where we are now. The projection is unchanged from December.

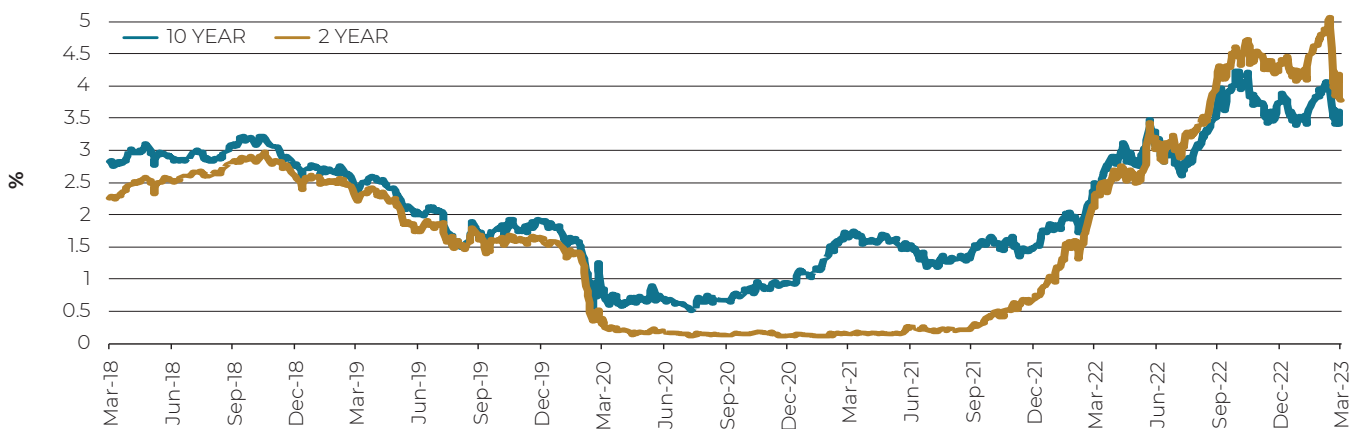
However, money markets are pricing in cuts, with fed funds futures pricing in a rate of 4% by the end of the year, a full percentage point lower than today. This should not necessarily be seen as good news. If the Fed starts cutting, it is more likely to be due to a recession than a gentle decline in inflation.

However, the fog of uncertainty probably means a more cautious approach in the months ahead as central banks, the Fed in particular, try to disentangle the various effects of banking stress on credit, growth and inflation.

Where does it leave other markets? The policy-sensitive two-year Treasury yield now trades at 3.8%, the lowest level since September and down from a peak of 5% just a few weeks ago.

The 10-year yield is also significantly lower at 3.5%. The fact that shorter-dated yields are above long-dated yields is known as an inversion of the yield curve. This has historically preceded a recession, though the lag between inversion and recession has differed from cycle to cycle. For now, as mentioned, growth is still solid.

CHART 4: US TREASURY YIELDS, %



Source: Refinitiv Datastream

Meanwhile, despite a broad sell-off in global equities (not just banks), forward price: earnings multiples have not moved materially since bottom-up earnings forecasts have been revised lower in line with a softer economic outlook. The US market still looks on the expensive side, while markets

outside the US look fairly priced. The equity market does seem somewhat at odds with the bond market, pricing in a softer landing than what bonds are pointing to. Unfortunately, no one can predict the future. All we can do is ensure that our funds are diversified and leaning into the value on offer.

IMPORTANT REMINDERS

The events of the past few weeks serve to remind us of a few important points. Firstly, though banks are a lot safer now compared to before the 2008 Global Financial Crisis, there are always risks since the business model is inherently risky. This episode is likely to lead to renewed regulatory scrutiny and so it should. Unlike most other firms, say retailers or construction companies, bank failures can cause stress in the wider economy and financial markets. If a retailer folds, its competitors can step in and gain market share. If a bank goes under, its competitors are at risk of contagion.

Secondly, when interest rates rise far and fast, there will be an impact, but not necessarily where you thought it would be. It is naïve to think otherwise. Thirdly, in the short term it is surprises that move markets. Until very recently, Silicon

Valley Bank (SVB) was on very few people's radar screens. It is not that SVB, First Republic, Credit Suisse or Deutsche Bank were hiding things from investors Steinhoff-style. The numbers were there for all to see. But the world is awash in data, and short on attention spans. As a general rule, the things we read about are not the things to worry about most. If known risks materialise, it will not shock anyone.

Finally, because markets are moved by surprises, timing is extremely difficult to get right consistently. It is natural for investors to be anxious amid all the current uncertainties but jumping in and out of the market tends to do more harm than good. One thing we do know is that over the long run, these surprises and shock episodes matter little for the asset class as prices follow earnings higher. Therefore, what matters most is being in the market.

EQUITIES - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Global	MSCI World	US\$	2 693.0	1.39%	-0.81%	3.46%	-11.44%
United States	S&P 500	US\$	3 971.0	1.38%	0.03%	3.41%	-12.15%
Europe	MSCI Europe	US\$	1 813.0	2.08%	-2.84%	4.68%	-4.38%
Britain	FTSE 100	US\$	9 060.0	1.39%	-4.33%	0.50%	-8.01%
Germany	DAX	US\$	1 428.0	2.07%	-1.45%	9.84%	-1.45%
Japan	Nikkei 225	US\$	209.5	1.06%	4.00%	5.27%	-8.80%
Emerging Markets	MSCI Emerging Markets	US\$	972.0	2.10%	0.83%	1.67%	-14.51%
Brazil	MSCI Brazil	US\$	1 310.0	-2.53%	-7.09%	-10.21%	-30.58%
China	MSCI China	US\$	65.4	2.93%	2.14%	2.31%	-9.81%
India	MSCI India	US\$	703.7	-0.73%	-1.16%	-8.73%	-12.90%
South Africa	MSCI South Africa	US\$	401.0	4.43%	-0.99%	-4.75%	-26.29%

EQUITIES - SOUTH AFRICA (TOTAL RETURN UNLESS INDICATED OTHERWISE)

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Share (Capital Only)	All Share (Capital Index)	Rand	74 695.0	2.99%	-3.91%	2.25%	0.46%
All Share	All Share (Total Return)	Rand	12 770.0	3.16%	-3.33%	2.95%	4.48%
JSE Capped SWIX	Capped SWIX (Total Return)	Rand	30 920.9	2.71%	-3.80%	0.52%	-0.28%
TOP 40/Large Caps	Top 40	Rand	11 745.0	3.43%	-2.91%	3.97%	6.01%
Mid Caps	Mid Cap	Rand	19 350.0	0.77%	-5.94%	-2.56%	-4.64%
Small Companies	Small Cap	Rand	28 987.0	1.11%	-4.30%	-1.33%	5.70%
Resources	Resource 20	Rand	5 324.1	2.63%	-0.27%	-7.32%	-18.59%
Industrials	Industrial 25	Rand	21 366.0	4.84%	-2.09%	12.85%	30.51%
Financials	Financial 15	Rand	10 362.0	0.47%	-8.28%	-2.24%	-6.49%
Listed Property	SA Listed Property	Rand	1 592.3	-0.75%	-4.25%	-5.89%	-1.77%

FIXED INTEREST - GLOBAL

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
IBOXX Global Government S&P Overall (USD Unhedged)		US\$	79.5	0.72%	4.14%	3.28%	-9.84%

FIXED INTEREST - SOUTH AFRICA

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
All Bond	BESA ALBI	Rand	879.1	0.42%	0.43%	2.51%	5.55%
Government Bonds	BESA GOVI	Rand	866.5	0.43%	0.43%	2.49%	5.49%
Inflation Linked Bonds	BESA CILI	Rand	328.6	0.78%	1.26%	0.74%	4.59%
Cash	STEFI Composite	Rand	515.6	0.14%	0.47%	1.63%	5.90%

COMMODITIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
Brent Crude Oil	Brent Crude ICE	US\$	75.0	2.77%	-9.65%	-12.80%	-36.98%
Gold	Gold Spot	US\$	1 979.0	-0.50%	9.28%	8.50%	1.80%
Platinum	Platinum Spot	US\$	977.0	0.10%	2.41%	-8.95%	-4.22%

CURRENCIES

DESCRIPTION	INDEX	CURRENCY	INDEX VALUE	WEEK	MONTH-TO-DATE	YEAR-TO-DATE	1 YEAR
ZAR/Dollar	ZAR/USD	Rand	18.17	1.60%	1.04%	-6.27%	-20.09%
ZAR/Pound	ZAR/GBP	Rand	22.23	1.03%	-0.72%	-7.38%	-13.86%
ZAR/Euro	ZAR/EUR	Rand	19.55	0.61%	-0.67%	-6.81%	-18.32%
Dollar/Euro	USD/EUR	US\$	1.08	-0.93%	-2.04%	-0.93%	1.85%
Dollar/Pound	USD/GBP	US\$	1.22	-0.43%	-1.91%	-1.10%	7.90%
Dollar/Yen	USD/JPY	US\$	0.01	-0.86%	-4.05%	-0.30%	6.82%

Source: I-Net, figures as at 24 March 2023

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WEALTH

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