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SNOWGUM QUARTERLY

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INTRO

It seems we are nearing the end of the interest rate tightening cycle, with the RBA keeping things on hold, the Fed having slowed its rate of tightening, and the RBNZ expected to have put through their final super-sized rate hike.

Widespread weakness can be seen in the US banking sector. A deposit rate paradox has emerged, where raising deposit rates leads to a reduction in net interest margins, causing banks to operate at a loss. While leaving deposit rates near zero increases the likelihood that depositors withdraw their capital.

The rapidly changed interest rate environment now rewards a more traditional mix of bonds and equities, which deliver diversified return characteristics for the first time in some years.

WHAT'S INSIDE THIS QUARTERLY:

KEY STATS

- Cash rate may be stabilising, presently 3.60%
- Unemployment in Australia is 3.50%
- Inflation is 6.80%

ECONOMIC UPDATE

Inflation

Monetary policy works with long and variable lags so Central Banks are meant to "*take away the punchbowl just as the party gets going*". Monetary policy should pre-empt economic conditions to accommodate the lagged transmission of changed settings.

The punchbowl was left out too long in 2021. Central Banks have fought hard to recover credibility as inflation managers. Credibility is a prerequisite to taming inflation as inflation expectations can be self-fulfilling.

We've seen the fastest tightening cycle in history through 2022 and into 2023. Central Bank messaging indicates an increased reliance on incoming data, having lost their Nostradamus nerve. In relying more heavily on incoming data, Central Banks have become more backwards looking than they used to be or perhaps should be.

Looking ahead, credit conditions have deteriorated, consumer confidence is weak, GDP is slowing, supply side factors have stabilised, frailties appear to be spreading in banking and a large volume of rate rises continue feeding into the economy in varied and lagged ways.

Cracks are also emerging in commercial property. Central Banks look to have done enough.

Some good news - The five-year break-even inflation [1] in the US as of March is 2.1%p.a. This is the markets prediction of average inflation over the next five years. US inflation is presently at 6.04% and Australia's inflation surprised lower at 6.8% (expectation were for 7.2%).

The breakeven rate signals US inflation may undershoot Fed targets at some point in the next few years. Market consensus aside, there remains remarkably divergent views on the pathway of inflation, with lingering concerns it will reignite, while others (as indicated by market consensus) think it will come down rapidly.

Employment

Despite the economic weakness, the labour market remains resilient, with unemployment near 60-year lows. The strong labour market starting point should insulate advanced economies from a deep recession, should a recession eventuate at all.

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[1] Break-even inflation is the difference between the nominal yield on a fixed-rate investment and the real yield (fixed spread) on an inflation-linked investment of similar maturity and credit quality.

Interest rates
Professional forecasters' models are often poorly equipped to deal with inflection points in economic cycles. The market is pricing interest rates at or near the top of their cycle, and interest rates are expected to fall later this year.

However, professional forecasters expect more sustained rate tightening and have generally been slower to adjust rate forecasts.

US Banking Crisis
The banking sector challenges emerging in 2023 are different from those in 2008. Unlike the Australian banking market, where roughly 90% of bank assets are long-term variable (floating) rate loans, in the United States, banking assets have large weightings to long-term fixed-rate loans. More than 50% of these loans were refinanced or originated from 2020 onwards, locking in record-low pandemic-era interest rates. With a large portion of US banking assets generating income between 2.5-3.5%, there is little scope for banks to pay depositors more than a 1% interest rate. US mortgage holders have no incentive to refinance, and depositors' incentives to withdraw capital grow with each rate rise.

The deposit rate paradox
If a US bank raises its deposit rate, its net interest margins shrink, and the bank risks running at a loss. If a US bank leaves deposit rates near zero, the likelihood depositors withdraw capital increases.

The second scenario played out for Silicon Valley Bank (SVB).
Faced with only bad options, most banks have sat on their hands praying depositors won’t redeem capital.

It is implausible that:

- Long dated asset deteriorations are limited to a small number of banks.
- Post GFC regulation, which has strengthened the banking sector’s capital position, alters the deposit rate paradox.

US reporting standards allow banks to value long-dated fixed income assets at face value, but as deposit redemptions force the sale of these assets, banks must accept market value, which is often a discount to face value. This means that current US bank balance sheets inaccurately represent a bank's capital position, and the market value of US commercial banks' balance sheets may be significantly weaker than reported.

As Martin Wolfe alluded to in the FT/AFR [1], “*according to the US Federal Reserve, on March 8, the difference between the book value of the assets and debt liabilities of US commercial banks was $US2.137 trillion… a recent paper suggests that market-to-market losses [on long dated assets is] already around $US[1.7]-2.0 trillion*”.

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[1] Credit Suisse-UBS takeover: Four ways to fix the bank problem (afr.com)

If a real crisis emerges, regulatory intervention will follow. Possibilities are:

1. Short term
   - The US Fed would be forced to do a U-turn on interest rates. This would lift the value of long-dated assets and provide a poorer set of alternative investments for depositors.
   - Draw down on emergency lending tools the US Fed has at its disposal to lend into the banking sector to overcome 'liquidity' challenges… as it would likely be described.
2. Longer term –
   - Cap the ratio of fixed rate loans relative to variable rate loans across the market. This is a macro-prudential lever that better insulates a bank's net-interest margin throughout rate cycles.

Although a retrospective change might be politically untenable, addressing future issuance will greatly improve US banking system stability.

Of the above options, the bond market looks to be pricing in something like option 1a - a capitulation in the Fed Funds rate. The market is not pricing in a return to ultra-low rates. Market positioning is at odds with projections released in conjunction with the FOMC meeting in March. Not a single FOMC member expects rate cuts in 2023.

An aside - Australia is a good example of a banking market largely immune to the deposit paradox. The unusually large percentage of variable rate loans (even most fixed loans will revert in a short period of time to variable loans) means bank net interest margins are always reasonably stable and profitable.

In times of monetary induced tightening, correlating to heightened banking liquidity risks, depositors are induced to raise saving levels, correlating to a strengthening in banking balance sheets when needed most! The Aussies do banking well, or continue to be lucky. It also makes the RBA's job easier, as we discussed in a paper some time back titled amplification of transmission.

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INVESTMENT UPDATE

We took advantage of low-risk opportunities in late January and early February to add fixed income exposures to many portfolios. This was achieved through a range of fixed income fund managers, with a larger allocation to Australian fixed income assets.

Our positioning is expected to be beneficial in case of inflation surprising on the downside, as well as providing portfolio insurance if Central Banks fail to execute a soft-landing. Jerome Powell's recent comments suggest a lack of confidence in this scenario, stating that "*I think that pathway still exists and you know, we're certainly trying to find it*."

To fund this portfolio insurance, we moved some capital out of infrastructure and retained floating rate credit exposures, as yields remain attractive. While there is a risk of inflation increasing, we believe this is less likely, and central banks will be successful in fighting inflation.

We have retained direct positions in Woodside, QBE, IAG, and others, while exiting some banking exposures. Although Australian banks are largely immune to offshore challenges, they could be impacted by broader sector deterioration.

We believe that Woodside remains attractive, with natural gas being the most obvious intermediate transitional energy source to support the long-term renewable energy transition.

Microsoft, which we view as possibly the best large business in the world, remains attractive despite not being cheap. The next phase of 'co-piloted' productivity tools will further entrench the company's importance to global commerce.

As a result of the investment changes being made and the emergence of a more traditional blend of stocks and bonds for the first time in some years, portfolios are a little more defensive in appearance. This has been made possible by the diversification of bonds and equities and reasonable returns in fixed income, which has not been seen for a number of years!

The indigestion suffered by growth stocks, fixed income, and most liquid assets broadly in 2022 is likely to translate into a stomach-ache for private assets in 2023. Many private assets (such as commercial property) have avoided registering a fall in asset prices, at least on paper.

However gravity can only be defied for so long.

Matt Vickers