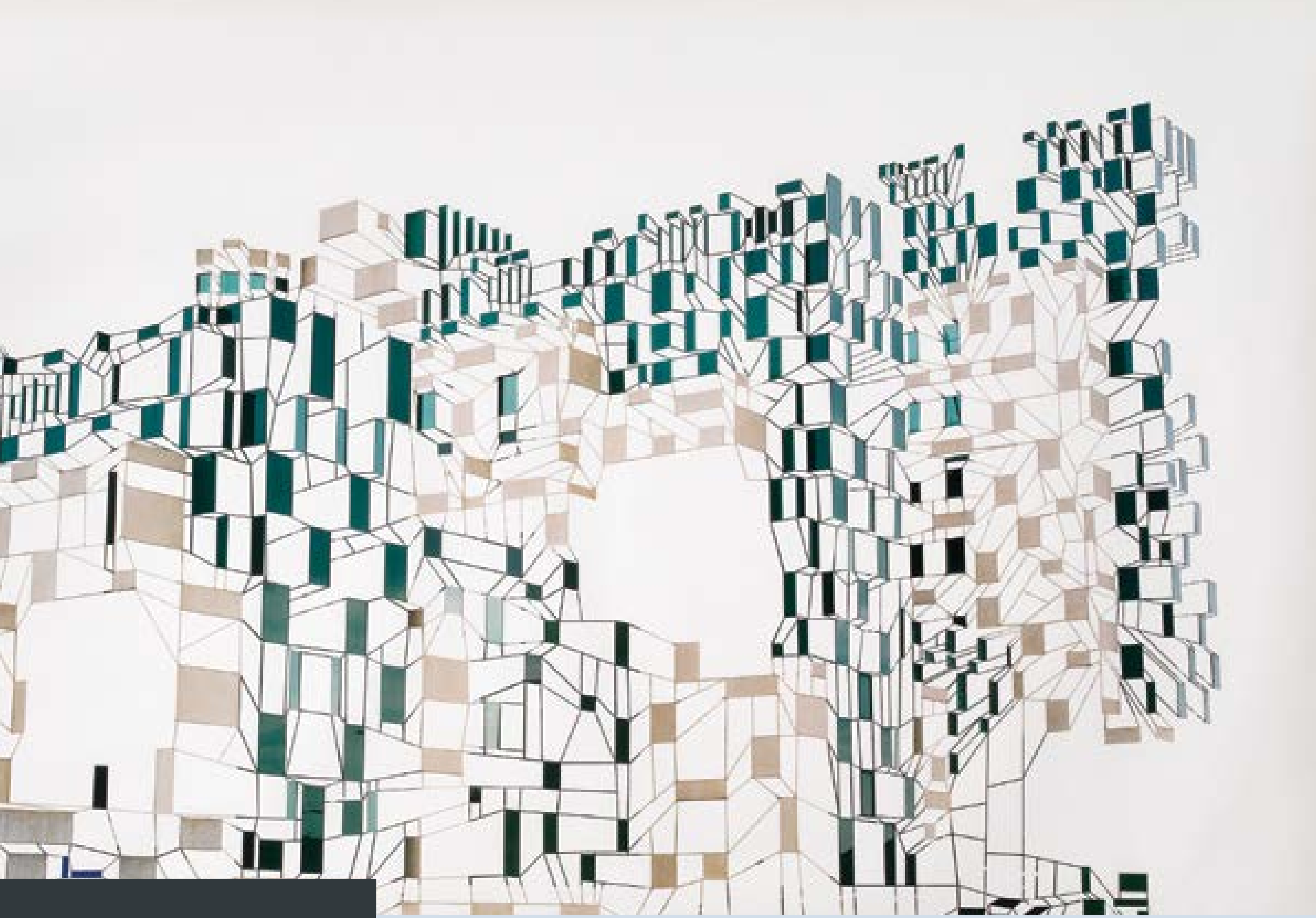
OBSERVATION

2nd QUARTER 2023



POWER POWELL!

Banking Crisis and political theatre over the debt ceiling will be in focus Q2/Q3-2023!

Market participants are eagerly awaiting the end of the current interest rate hiking cycle hoping that the Federal Open Market Committee (FOMC) deems it enough to have reached a peak following its 10th consecutive hike in May 2023. "Let's bend Powell before he breaks more" was the outcry in March 2023 following the distress in the US regional banking sector on the back of higher and tighter financial conditions. Markets might say they did indeed succeed to bend Powell enough for the FOMC to end any pre-commitment to rate hikes and slow down with the rate hike figures. Powell's life as a chairman has not been the easiest since he was appointed to the office by then President Trump compared to the 15 prior chairmen of the FED. During his first year it was the trade war with China that weighed heavily on financial markets, and with Donald Trump urging the FED to cut rates, which he finally did very gradually by mid-2019.

Then in 2020, Covid-19 accelerated rate cuts before inflation started to reappear at the end of 2021 eventually creating the situation markets are in today.

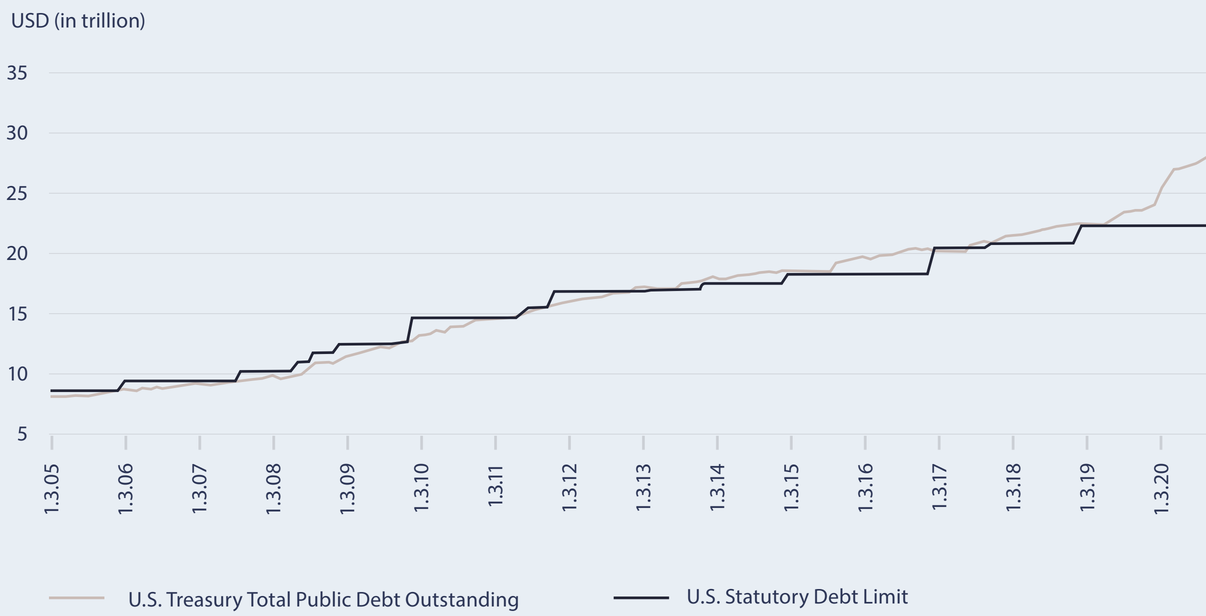
While the dis-inflation slowly but steadily continues its downward trend, Jerome Powell needs to show toughness and courage these days. As if the banking turmoil was not enough, another recurrent event is again starting to gain traction on financial markets that could have further economic implications: the debt ceiling is approaching! This limit is the total amount of money that the United States government is authorized to borrow in order to meet its existing legal obligations, including social security and medicare benefits, military salaries, interest on the national debt, tax refunds, and other payments. The below graph shows the evolution of the US Debt ceiling and its respective increases since 1980, sitting at the current target of USD 31.38 trillion. Some might rate the talks of negotiating a new debt limit as purely symbolic, or a way for democrats and republicans to demonstrate fiscal responsibility. One could almost argue that the notion of US debt limit introduced in 1917 was intended for US political parties to fight and gain concessions from the other party. Yet, the debt ceiling talks rarely end off in structural spending cuts or raising taxes.

It is, however, dangerous to downplay the effects that a political stalemate, a non-agreement of a new debt ceiling, could have as non-essential services would need to be shut down.

As Janet Yellen outlined in her recent letter to congress: "We have learned from past debt limit impasses that waiting until the last minute to suspend or increase the debt limit can cause serious harm to business and consumer confidence, raise short-term borrowing costs for taxpayers, and negatively impact the credit rating of the United States." 2018 saw two government shutdowns with the last one occurring in December 2018 and which resulted in a forced lay-off of 380'000 workers with an additional 420'000 required to work without known payment dates. It lasted 35 days and was the longest in US history. The S&P 500 returned +10.43% in the same period and the volatility index VIX went from a peak of 35 at the beginning of the shutdown to 17 with an average level of 22. This also demonstrates the resilience and strong conviction of investors that a solution on debt ceilings must eventually take place.

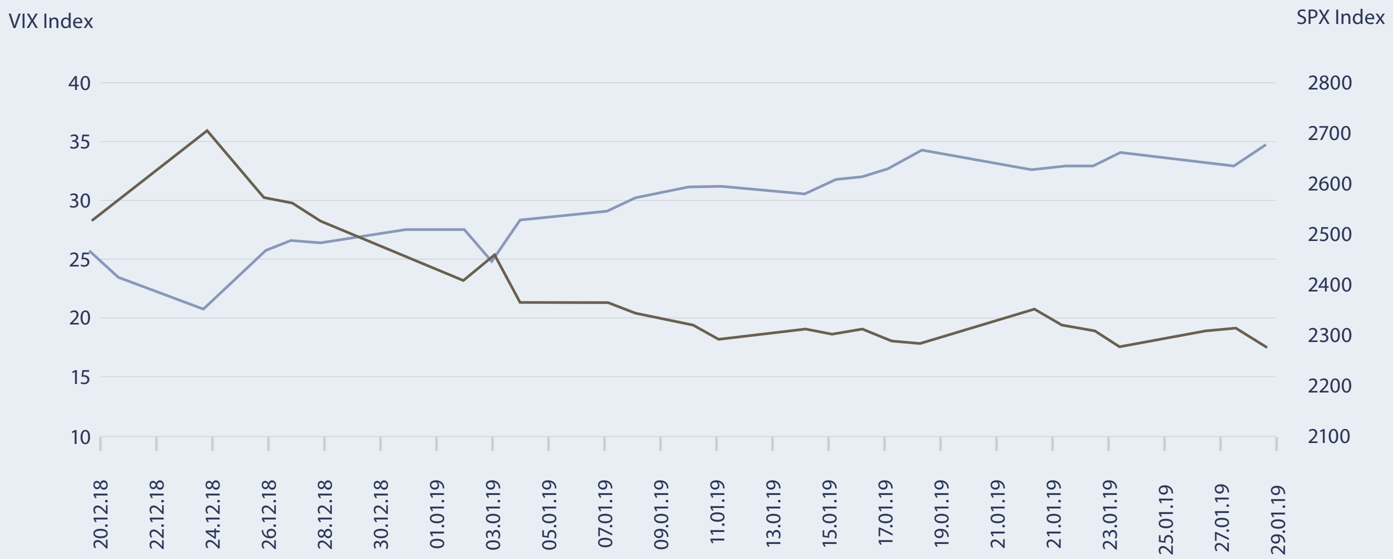
The "what if"question over possible stalemate implications is leaving a mark on the premiums paid on US treasuries. It is surely not surprising that premiums on insuring US defaults are rising with nervousness in the market increasing as well. The 1Y cost at 150 bps has never been this high. We share the view that the current political setup with the republicans having a slight majority in the congress along with democrat Joe Biden could lay ground for extended talks, but an extended shutdown period of US governmental services is rather unlikely. Since 1960, Congress has acted 78 separate times to permanently raise, temporarily extend, or revise the definition of the debt limit – 49 times under Republican presidents and 29 times under Democratic presidents. Coming back to Jerome Powell and his most recent woe of a new debt limit:

Total US outstanding debt vs. debt limit



Source: Bloomberg

S&P 500 Performance & Volatility index during longest US shut-down



Source: Bloomberg

the FED is more of a witness than a main character for the debt ceiling talks.

But the FOMC's total of 10 rate hikes have contributed to the US debt ceiling to be reached sooner than many would have hoped for. As per the monthly statement of the US treasury department: net interest represented USD 67 billion in March 2023. Annualizing the latest monthly figure would put the US's net debt financing costs alone to a ratio of 16% of its total fiscal revenues forecast for 2023. And the burden is rising as maturing bonds are issued at higher interest rates thanks to the FOMC's rate hikes.

So political pressure could again weigh on Powell's shoulders which in turn might further ignite rate cut hopes for the second half of the year.

Switching from the debt ceiling to the US banking sector, the pressure has been on with customers moving their cash balances into money market (MM) instruments. Not only would they diversify away from the balance sheet risk of their bank, but also generate more revenues as interest earned through short-term MM products often are more appealing than interest on plain deposit.

Regulators seizing First Republic bank and selling client assets to JPMorgan Chase & Co reminded investors that unlike the Credit Suisse takeover by UBS, shareholders can in fact get zero.

In a transaction where both, creditors and shareholders of First Republic Bank took the brunt, client assets were sold, not the bank itself.

This marks the third large bank closure in the US in 2023 already with the smaller losing credibility even more so than the big banks. Surely, blame can be found in higher interest rates that eventually led to these massive outflows over credibility and balance sheet issues.

But it is still too early to tell if we are at a structural behaviour change in banking clients or if this will eventually end up as a cyclical phenomenon.

The debt-ceiling talks could have some short-term impact and spark volatility not only in equities but also in the treasury market. In the meantime, however, we join Janet Yellen by "respectfully urging Congress to protect the full faith and credit of the United States by acting as soon as possible".

IT'S A BALANCING ACT

The impacts of inflation and rates on equity valuations.

According to the International Monetary Fund (IMF), global inflation is expected to fall from 8.8% in 2022 to 6.6% in 2023 and 4.3% in 2024, still above pre-pandemic levels of about 3.5%. Outlook remains tilted to the downside, but this scenario is being challenged. While rising food and energy prices accounted for much of the inflation we saw in 2022, core inflation, which excludes food and energy, is now also a major driving factor in high inflation rates globally. It includes ripple effects slowly trickling down into numerous industries and trends in the labor market, such as the availability of jobs and rising wages. While inflation is slowly coming down, it is stickier than previously expected.

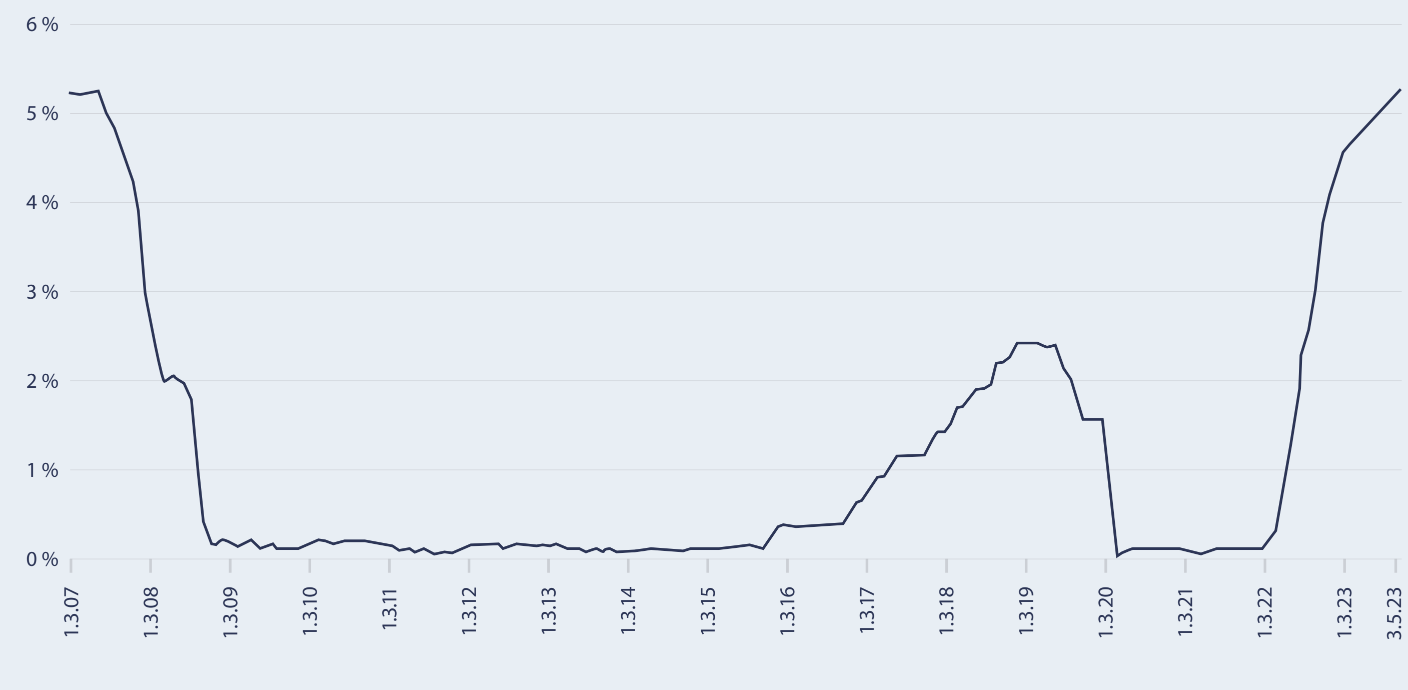
Inflation and rates' impact on equity valuations are interlinked.

Higher inflation can have a negative impact on equity valuations as it brings lower P/E multiples due to slower economic growth, lower quality profits, and higher interest rates. Likewise, lower inflation brings higher P/E multiples because it brings faster growth, less inflated profits, and lower interest rates. On the flipside, higher interest rates mean that borrowing costs for companies will increase, which should lower corporate earnings. It will also mean that future earnings will be worth less in today's currency unit. Additionally, higher rates should slow loan demand, leading to a slower growing economy.

These expectations led to the 2022 bear market.

Central banks have increased reference rates by an unprecedented level of both magnitude and speed. With colossal stocks of public debt, countries are incentivized to sustain some level of inflation in order for

FED Rate development



Source: Federal Reserve Bank of New York real rates to remain negative (and thus naturally reduce the debt load).

With rates getting close to expected inflation rates, are we at this tipping point?

The commonly used term for the current status-quo, notably concerning the Fed's rather advanced rate hike process, is that of "hawkish pause". It refers to the time when a central bank may not be raising interest rates from this juncture, but still signaling that it is ready to do so if necessary, while waiting for the policy effects to impact the economy.
Its effects on equity markets can vary. If investors were expecting interest rate cuts and the central bank delivers a more hawkish message, it could provide a near-term negative surprise for equities. However, if the hawkish pause is seen as a sign that the central bank is ready to act to control inflation and support economic growth, it could have a positive effect on equity markets.If it is perceived as a first step towards an upcoming drop in rates, this can lead to a strong market rally.

With multivariable factors impacting inflation and rates, we maintain a rather neutral equity positioning, both in terms of weight, being close to our mid-point, and in terms of positioning, currently favoring low cyclical industrials.

We have also reduced our exposure to financials and healthcare, while adding a more growth-oriented exposure to anticipate getting closer than expected to this coveted "tipping point".

THE PONV BUTTON

AT1 hybrids in a "post-PONV-Credit-Suisse" (PPCS) world

There was an outcry amongst bond investors lately with the Swiss Financial Regulator FINMA deciding that the emergency ordinance on additional liquidity assistance and the granting of federal default guarantees by the Swiss National Bank to help a distressed Credit Suisse would qualify as a PONV (point of nonviability event). Following the introduction of AT1 instruments after the 2008 Global Financial Crisis (GFC), the case of Credit Suisse not only marked the first example of a systemically important bank undergoing an "event" that would lead to a write-off of its subordinated, AT1, or contingent convertible bonds ("CoCos"), but it sparked global attention as equity holders of Credit Suisse got off a better foot than the junior bondholders. The general understanding was that AT1's could get converted into equity shares once certain thresholds of capital ratio requirements are met and would trigger this. However, beware of the covenants! To the surprise of many (but not all), the Swiss AT1's typically have a feature which is usually not found in other AT1 markets: the inclusion of an automatic, permanent write-down of principal to zero on a "viability event". And it is this specific feature on all AT1 bonds of Credit Suisse that made it possible for equity shareholders to be treated favourably over the AT1 bondholders. To avoid unnecessary volatility in the European AT1 bond market, the ECB as well as the BOE rushed aside with supporting statements reminding investors that common equity instruments are to be the first ones to absorb losses and only after they have been depleted would the financial regulator require subordinated bonds to be written down.

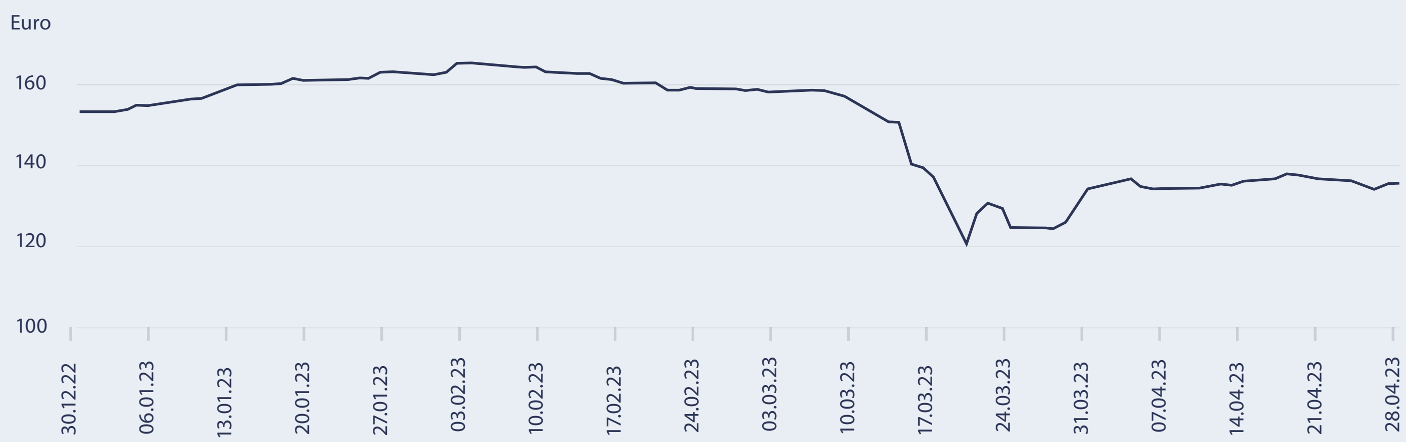
Investors are now confronted with two main questions: what are the longer-term implications for the AT1 bond market and is the current drawdown an appealing opportunity to buy into this segment?

Without surprise, current times seems to be challenging and tricky for the AT1 bond market. As these instruments typically have a perpetual feature along with call dates (the issuer typically has the right to redeem the bonds at par on certain dates), the standard way to value attractiveness of these instruments was the yield to call, with the assumption that these bonds would indeed be called by the issuing banks. However, if they do not get called then the standard way of valuing makes less sense and investors should rather consider the simple yield which unfortunately does not include the pull to par. So even though some yield metrics would look very attractive, others would do less.

The current backdrop on the segment could take some time to find some comfort with all the potential ramifications of holding AT1 hybrids in a riskier operating environment.

As a result, new issuance could be more expensive and more vulnerable to sentiment. But it is also in times where dislocations are existing that could present appealing opportunities, just like the European market for collateralized loan obligations back in March 2020. Eventually AT1 CoCos will remain a key part of banks' capital structure as these instruments still fulfil the role they were designed to perform. It is only a matter of time until new issues emerge and find appetite amongst the riskier bond investors again.

iBoxx Contingent Convertible Liquid Developed Europe AT1 TRI (EUR Hedged)



Source: Bloomberg

ACTION

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