News from the Investment Committee

Q2 2023

DYNAMIC PLANNER

News from the Dynamic Planner Investment Committee – April 2023

The Investment Committee (IC) met on Thursday 27th April and reflected on the wider financial sector frailties following the fall-out of the Silicon Valley and First Republic Bank collapses in the US. In Europe, the dramatic loss of confidence in Credit Suisse led to a deposit run-off at digitally enabled speed and a total wipe-out of its statutory capital reserves, held in specialist bonds called Contingent Convertibles or 'Cocos'.

These events are symptomatic of the sharp increase in interest rates, shrinking central bank balance sheets and the receding tide of global liquidity that had flooded the financial system for much of the past decade. For those financial institutions that have relied too much on cheap liquidity by taking on too much leverage and aggressively mismatching their balance sheets, times will be challenging given their magnified exposure to bond duration risk. Should confidence in the banking system weaken further, this could result in contagion risks in other financial markets, particularly the leveraged pension funds. However, it was acknowledged that the major global banks are more robust than in the lead-up to the GFC, with global regulators requiring much greater capital and liquidity buffers.

Despite the financial challenges faced from higher interest rates, growth has been more resilient than expected. Aided by a decline in energy prices, with a mild winter in the northern hemisphere helping to reduce demand for natural gas, growth appears to have picked up in early 2023. Alongside the rapid reopening of the Chinese economy following the lifting of Covid restrictions, global growth has been more resilient than expected this year.

The IC also discussed the stickiness of underlying inflation being higher than expected at this stage of the economic cycle, indicating a broad-based ability for companies to both pass on higher input costs and maintain (or even expand) margins. Wage growth across the major economies remains quite elevated, as a result of extremely tight labour markets. This is partly reflecting robust levels of demand, but also reduced labour supply, an issue which is particularly impacting the UK economy. In the US productivity growth has lagged wage increases and this seriously questions the level of stretched P/E ratios in the US, should inflation remain higher for longer and when/if it reverts to the Fed's original 2% target anytime soon. And the shape of the (inverted) bond yield curve traditionally has been a consistent signal of impending recession, so markets will continue to ponder with why it would be different this time?

The economic and financial market uncertainty created by recent events in the banking system is expected to leave central banks more watchful in the coming months over recession risks. That means that the rapid rate hiking cycles that have been running for a year or more may be paused, or even be coming to an end this year. Another global systemic risk is the US national debt already hitting its current ceiling of $31 trillion in January and the possibility of the government defaulting on its obligations, by as soon as 1st June. We can expect further political brinksmanship between the Biden administration and the Republican controlled House of Representatives, with the latter aiming to extract spending cuts and other policy concessions from the White House.

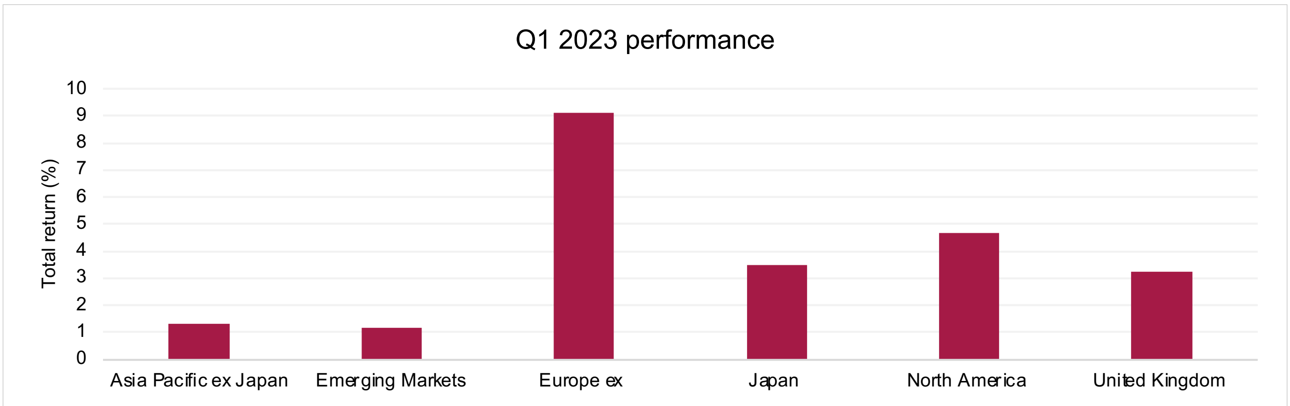
Despite the ongoing financial and geo-political volatility perturbing global market sentiment, the Dynamic Planner model continues to remain focused on the analysis of long-term trends which are expected to impact a wide range of financial instruments. The process of quarterly assumption setting is designed to avoid the over-emphasis of short-term transitory signals whilst remaining alert to strategic drivers of change. For this quarter, the IC approved only minimal changes for the Q2 2023 capital market assumptions, with the efficient frontier curve shifting marginally downwards and to the right for the lower to mid-risk benchmarks from the previous quarter's position.

Previous quarter market overview

Equities

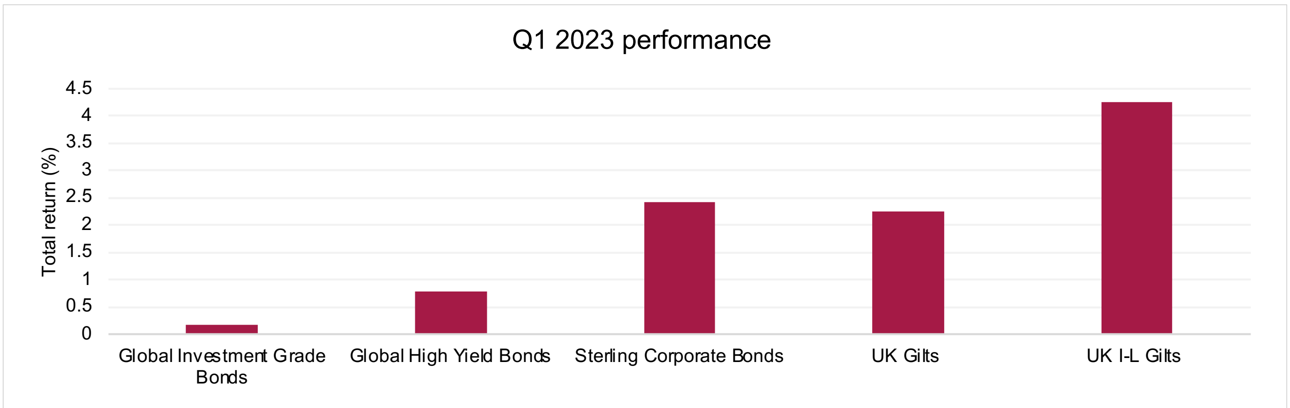
Despite March witnessing the collapse of Silicon Valley Bank in the US and a dramatic loss of confidence in Credit Suisse which was subsequently rescued by UBS, global equities enjoyed strong gains during the quarter. Such surprising optimism was buoyed by receding recession worries in developed markets as commodity prices fell and lingering concerns of wider systemic risks in the financial sector being shrugged off, given the greater resilience of the major global banks post the GFC of 2007/8.

In an expression of confidence, the US Fed raised interest rates by 25 basis points in both February and March to their highest level since 2007. Over the quarter, further tightening was made by the ECB and the Bank of England to tackle stubbornly high and persistent inflation. There was also a sense of renewed optimism about emerging markets, given the re-opening of China's economy, albeit tempered by re-escalating US-China tensions.



Bonds

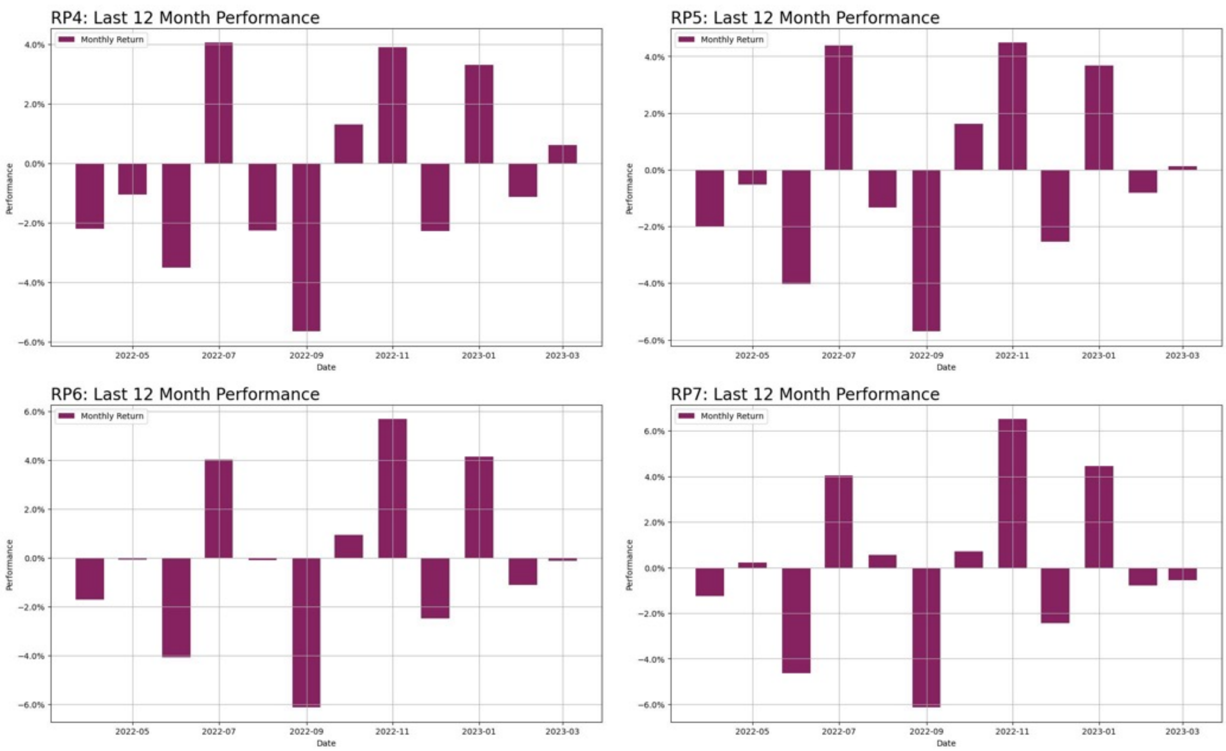
Central banks continued with their interest rate hikes against a volatile market backdrop with widening credit spreads. The US banking collapses in mid-March prompted a sharp rally in government bond markets, discounting the possibility of an earlier pause, or even an end to the hiking cycle. While there were signs that previous rate hikes were already biting (particularly in housing markets), their full impact on the broader economy is yet to be seen and concerns still linger over persistently high inflation data in both the US and Europe.



Review of the benchmark allocation performance

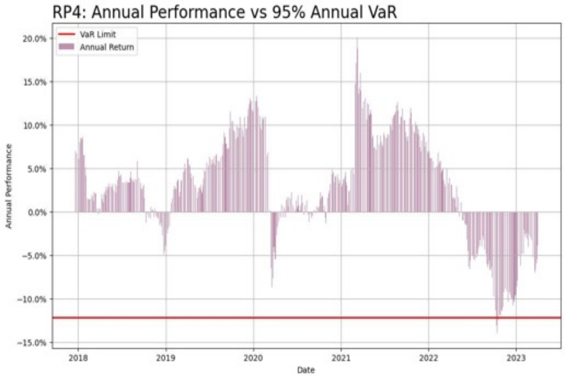
The charts below show the monthly discrete returns over the last 12 months and following the previous quarter's issues with the UK gilts market, we can see that outcomes have been consistent during the March market turmoil from a risk/reward perspective.

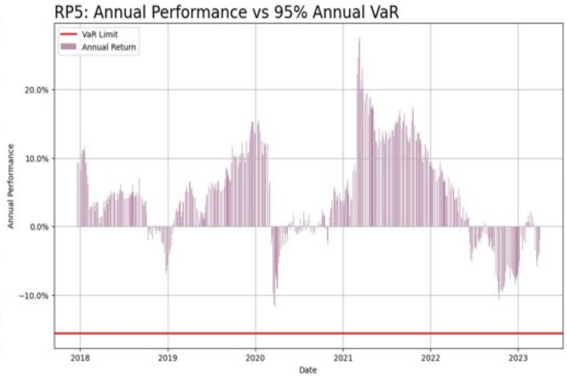
Monthly observed returns over last 12 months

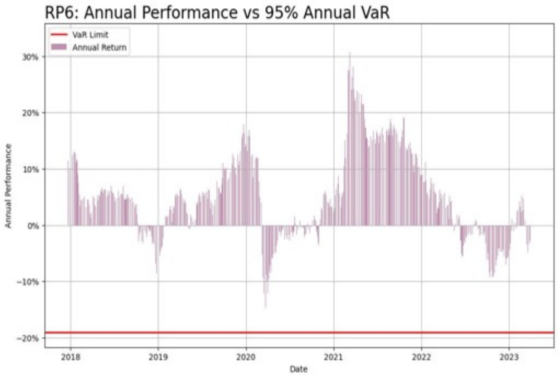


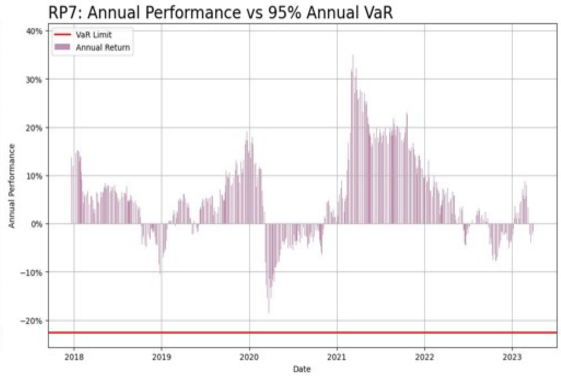
Annual Value-at-Risk analysis

The charts below show the rolling annual returns calculated each day over the last 5-year period vs. their 95% VaR limit (the red horizontal lines). In September 2022, Risk profile 4 experienced falls in excess of its expected VaR limit, reflecting the extreme level of volatility endured in both Sterling and Sterling denominated debt.

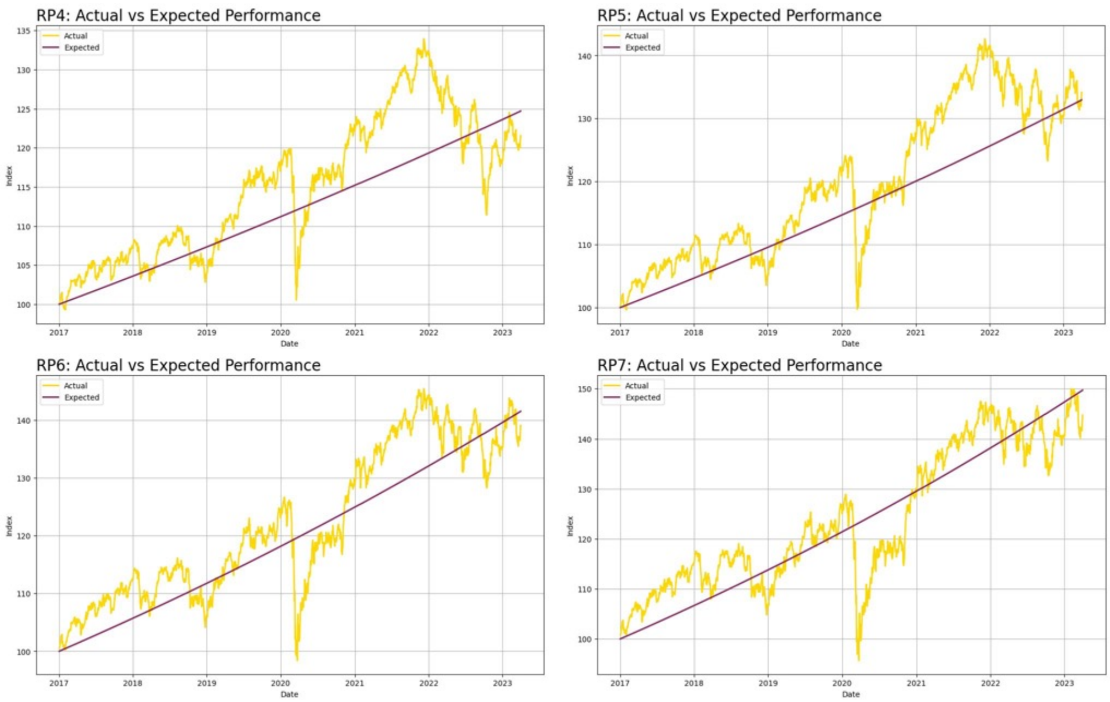








The charts below show the observed benchmark returns compared to their expected return forecasts set 5 years previously (as depicted by the purple trend line). As can be seen the long-term trends have been reasonably consistent when viewed from both an ex-post and ex-ante perspective.



Dynamic Planner Investment Committee

May 2023

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