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[INTRODUCTION]

Staci West: Welcome back to the 'Investing on the go' podcast brought to you by FundCalibre. Darius and Juliet are here once again to offer their opinions on the first quarter of 2023 — from the banking crisis to political football, it's been a busy start to the year.

Sam Slator (SS): I'm Sam Slator from FundCalibre, and today I've been joined by Darius McDermott and Juliet Schooling Latter to talk about what's been going on in the first quarter of 2023. So, this could be a long one, guys, it's been a busy three months!

[INTERVIEW]

SS: Perhaps we'll start with the home market and the FTSE 100. It reached an all-time high of over 8,000 points in the first three months. It's come down a bit since then. So, maybe we could talk about why it was so strong at the start of the year and perhaps why it's come off a little bit now?

Juliet Schooling Latter (JSL): Yeah, well, I mean, what you have to realise about the FTSE 100 is that it's not really representative of the UK economy. It's done well for a few reasons: it contains some energy giants such as Shell and BP, which have outperformed due to the increase in energy costs, post the invasion of Ukraine. Shell, I think is up over 60% since the start of 2022. And also, the FTSE 100 is quite global looking, with 75% of its revenues coming from overseas. So, with the pound quite weak, the overseas earnings are worth more in sterling.

Darius McDermott (DD): Yeah, I mean the FTSE, as Jules says, 75% of its earnings comes from overseas. But even though it reached a record high at a sort of an index level, it wasn't massively expensive on a valuation metric. So, for instance, the price to earnings ratio [PE ratio] is probably the most common used. And even though the index at an index level was at a record high, actually, because of the earnings of some of those big companies, the PE ratio itself was actually lower than it has been at other peaks. So, it wasn't expensive, even though it was at a record high, which does sound a little odd and confusing to understand.

As you rightly say, January was a very strong month for markets as sort of the gloom of 2022 looked behind us, and that sort of rate rises looked to be nearing an end. Then February was a very poor month. All global markets, including the FTSE [100], which had got to sort of 8,000, went back to 7,200. So, that's quite a big fall and [it] has now subsequently rebounded into sort of the mid 7,500 type of range. So, yes, it was an odd one where the index looked at a record level, yet actually in aggregate, it wasn't a very expensive index.

SS: And the thing that's been hitting the headlines in the last week or so, has been banks. We started off with a few problems in the US, so, perhaps we'll start there as well. We had Silicon Valley Bank [SVB] that had to be rescued, basically was bought out by, or at least the UK arm was bought out by HSBC. There's been a couple of other niche banks over there that have had problems. What's happened in the US?

JSL: Well, SVB was rather a sort of you know, a niche bank which focused on tech. So, I think that's a sort of special situation as it were. It was… mindful of the global financial crisis [that] there was a sort of concerted effort to sort the situation out quickly, but the US is slightly different in that it has these sort of smaller regional banks as well as some of the big banks. But SVB was based around the tech industry.

DD: And I would not claim - full disclosure - to be a banking analyst, but there were two things broadly that went wrong. Firstly, a lot of the collateral that they held in the bank, was held in long duration US government bonds, and what did you not want to own in 2020? [It] was long duration bonds. So, that was part one of the problem. Part two, as Juliet's already alluded to, the banks make money by taking deposits in from savers and lending that money to companies, to grow. And the technology sector had a tough year, particularly unlisted technology companies, and their requirement for funding became greater. So, they were lending to companies in a niche industry or a very big industry - it was once niche - at the same time, those companies were getting into difficulty and their collateral was going down because it was held in long duration bonds. So, very specific.

There has been some contagion in other US banks, which are already having to be rescued at the time of recording. First Republic Bank is another - again, it's not a major bank - but shares are down hugely in the last two weeks. And, as you say, there is two sides to this, that's the US side and the US Treasury with their own other committees decide which banks they will and won't rescue. And they're trying to stop this contagion where one bank goes and then a number of other banks go. So, it is actually quite uncertain at the moment, and I suspect we are reasonably early into this banking story. Whether it's as bad as the financial crisis, I can only hope not, but I suspect we may not have heard the last of it.

JSL: I mean, the thing is that banks since the financial crisis are, you know, on the whole, they're better regulated, more stable businesses. But they're so dependent upon confidence. So, you know, if depositors get nervous about the solvency of a bank, then they start to withdraw their money, and what happens is they then bring about the insolvency that they were concerned about. So, you know, confidence is key here.

DD: Yeah, that's absolutely right, that's absolutely right. You know, people start taking their money out [and] you end up with a vicious circle, you know, you end up actually making the bank insolvent. So yeah, confidence is absolutely key in the banking sector.

SS: Yeah, I think that's something that was echoed by the manager of the M&G Global Macro Bond fund. He said that, what's happening in the US - and we'll move on in a minute to what's happening in Europe - are very different stories, but actually the one thing they have in common is they've knocked confidence among investors. So, moving then on to Europe, we've had problems with Credit Suisse, so perhaps we can talk about what's happened there?

DD: And so, as Juliet said in the last part, banks are now better capitalised and better regulated. So, what does that mean? So, firstly, the capital: if a bank lends a pound, it needs to keep about 15 to 20p of cash on its balance sheet. And it's depending obviously on what that cash looks like, because there's cash and there's near cash - very short-dated high quality government bonds. And the regulators in Europe have insisted that not only do they have more capital, so that if there is a run on the bank or a lack of confidence, they've got plenty of money to back them up, but that it is held in higher quality assets, if you like. What happened in the financial crisis was it was held in what was thought to be high quality assets. They packaged mortgages and things like that, that had AAA ratings. But when you have a housing crisis then, you know, mortgages don't look so rock solid. So, that is a fact that banks are better capitalised and better regulated.

With Credit Suisse - again, I do not claim to be an expert, but have done a moderate amount of reading and listening around this - is they've had a number of issues and that's led to them being fined. And they were certainly, in the last year or so, if you had to pick a European bank that looked like it could have an issue, Credit Suisse was pretty much at the top of that list. So, as that contagion from the US spread and confidence, the first line of target was Credit Suisse in Europe and confidence dwindled, depositors took their money out and for all intents and purposes, the Swiss have had to bail them out and have, let's just say offered the hand of marriage of Credit Suisse to UBS, while saying there's a nice dowry for doing so, to try and get some stability. And I appreciate that. I'm trying to keep this as jargon free and basic as possible. And normally what happens in circumstances like this, is the equity holders are the first to suffer, and then the bond holders suffer depending on how senior your debt is.

Now, there's a new type of bond which was introduced post the financial crisis called AT1s or Cocos [contingent convertibles]. And these were there to put a buffer really between the equity and the bond holder. And what happened with the Swiss regulator over Sunday evening [Sunday, 19th March 2023] as we record of this week was actually, the Swiss regulator decided that those bonds would be wiped out *before* the equity, which was unexpected and did cause substantial instability in markets, [in the] early part of this week as we record.

So, then the European regulator came out and said that that wouldn't happen in European banks, and that caused some stability. So, it has led to instability and as Juliet widely pointed in the last bit, it's about confidence. If you think where your money is, your bank's going bust, you go to the cash point, you get as much of it out or you know, … [so] that's what the European and Swiss [central banks] have tried again to stop this contagion in Europe, localise it in Switzerland and put … I mean, Credit Suisse was a huge bank. It's a huge establishment, and they've slightly had, or UBS have slightly had, have been, as we say, encouraged to buy to all intents and purposes, Credit Suisse, to stop that huge financial institution actually going bust.

SS: And amongst all that, we did have a little bit of good news, which came with the Chancellor's budget, at least in terms of pensions. So, perhaps you could just outline that for listeners, please?

JSL: The Budget seems a long time ago, doesn't it, since we've had such a turbulent week since then? Yeah. so well, I mean, one thing about the budget was that they were talking about inflation was due to fall to 2.9% this year. But we've, since then, had an unexpected sort of jump in February to 10.4%. So, that will be interesting to see what happens with regards to interest rates going forward. But yeah, we have really low workforce participation in the over fifties. So, this is largely as a result of the [pensions] Lifetime Allowance, which was introduced in 2006. So, it is just causing all sorts of issues, most importantly, the fact that all the senior doctors were retiring and high court judges and things. So, it's fantastic that the government's now

scrapped the Lifetime Allowance, which is good news. And they've increased the annual allowance from 40,000 to 60,000 [£]. So, it's good news for anyone who may require medical treatment, but also good news for those saving for pensions!

DD: Yeah, I mean, with respect to financial services and helping people save for their long-term goals, which is, I suspect what we are all trying to do, the one thing I think is really annoying about pensions, is this uncertainty. They become a political football, and the government of the day can either make pensions less attractive or more attractive, because pensions generally on the way in you earn tax relief, and that is actually a cost to government. And the lifetime cap on pensions was, as Juliette says, causing some people to leave work because it just was actually costing them, you know, there was a tax burden that they hadn't been able to reduce by pension contributions. So, I suspect it is actually a very good thing.

What I worry about is the next government changing it again, you know, it's, as I say, it's a bit of a political football and the opposition party have already said that they think it's, you know, only [for] the really rich. Well, actually, if you work in and have a final salary because you work for government in one capacity, whether it's a teacher, doctor, nurses, firemen, you know, you can actually, if you work your whole career, you actually do build up a very generous pension pot. And, to my mind, it's not, you know, removing a tax burden just to the rich. It's removing a tax burden to lots of hardworking people who work for government. So, you know, if you are a senior teacher and you've worked for over 40 years in education and not been paid particularly well, compared to the private sector, one of your perks is this golden pension. So, removing that upper cap doesn't just help doctors or maybe higher earners, it actually, you know, potentially offers incentive to many other sectors as well. And I think, again, I'm not a banking analyst, I'm not a pensions expert either, but, you know, some of these things just get wildly thrown around, and I'm worried that pensions is a political football - as I say, the opposition have already threatened to undo some of this lifetime allowance.

So yeah, it's still confusing, but broadly, it's good for those who want to save in pensions for their long-term savings, knowing that if they are fortunate enough and hardworking enough and invest enough, that actually their pensions won't be capped and taxed very heavily over that certain Lifetime Allowance.

SS: And then very briefly, let's have a quick look, a bit more detail of what's done well and what hasn't in the last three months. The best sector's been technology. Now, we did an event with the managers of Sanlam Global Artificial Intelligence and AXA Framlington Global Technology fund a couple of weeks ago. And they were actually really excited about the long-term prospects and the fact that because technology had obviously had a sell-off in the last year or so, there were some good valuations there for some of the stocks. But shorter-term, do you think it's just been a relief rally? Is there too much uncertainty in the world for tech at the moment, or what are your thoughts?

DD: So, for me, this is all about interest rates and whether interest rates are going to go up more or less than the market itself expects. Back in the early noughties and late nineties, we had something called a tech boom. It was a bit of a revolution, tech was just beginning, and lots of these companies weren't profitable. Now the big tech companies make more money than even my co-commentator here could spend on handbags, if she tried her hardest! They're huge cash generation companies and they then have this long duration view on those cash returns. And when interest rates go up, long duration assets do badly whether it's a bond or in lots of cases, equity. So, there was a substantial sell-off in technology companies last year because of this relationship between their long duration cash flows and rising rates.

At time of recording, the US put rates up a quarter percent last night [22 March 2023] because, whilst inflation is still a threat, there's this concern about [a] banking crisis. So, it's that direction of rate rises, which is whipsawing all over the place with other factors like the banking crisis, like this persistent inflation that Juliet touched on, at a very high inflation point in the UK, when we might have expected it to be gently going down. So, there are a number of actually quite complex macro factors at play. And that rally where people actually thought rates were going to stop going up and potentially come down, it was a factor in the outperformance of technology. Also in uncertainty, which we definitely have an uncertain macroeconomic picture, these technology companies have rock solid balance sheets, huge cash flow earnings and actually could look quite defensive assets as well. So, a number of things going on there.

JSL: Yeah, I mean, you know, valuations were quite stretched coming out of the pandemic because technology was a big winner from that, but it came off I think 25% last year. And yeah, they rallied this year, but I think they're still down about 18% from their peak.

DD: Yeah, I think the NASDAQ was down 30% in 2022 versus the broader S&P of around 20%. And sometimes valuation matters. These companies kept going, ignoring what valuation metrics they were on. [As] Juliet says, a lot of technology companies were pandemic winners, and they just got expensive, and then, coupled with the valuation and the interest rate outlook, saw them, you know, come down to more reasonable valuations.

SS: The other sectors that have done really well have been Europe - both large cap and small cap. What's been good about Europe at the start of the year?

JSL: Quite simply, it was oversold. I think there was a lot of fear surrounding how Europe would cope with gas supplies under threat and higher oil and gas prices, but the winter's been sort of relatively mild, they've managed to store quite a lot of gas and so I think, you know, the market's just sort of breathing a bit of a sigh of relief now. And European companies are, I think are having quite a strong earnings season.

SS: Corporate and strategic bonds have actually done pretty well, or they had until we had the Credit Suisse issues anyway. Given what's happening, are you still confident about bonds, if interest rates might have to go up a bit more or what are your thoughts there?

DD: Well, I think whatever we know - or don't know, more to the point! - about the future rates, we're definitely near the end of the rate-rising cycle, rather than the beginning, which is exactly where we were this time last year, which is why bonds did so badly. And the actual starting yields on bonds are now attractive again, they're even attractive versus cash rates, they're attractive versus dividend yields, so you're actually getting paid something via the coupons, to hold bonds. So, you know, back when I started, you know, that was the main part of the bond return, was your coupon and coupons got to a such a very low level. Now they're much more attractive with rates definitely near at the end of the cycle rather than the beginning. I think we can be fairly positive on corporate bonds as an asset.

SS: And the areas that struggled have been healthcare, Indian equities and commodities. What's gone wrong for those areas?

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JSL: I think it's quite simply they've done well and [are] having a pullback. I'm a long-term fan of India and it had done very well and was looking expensive, so I think investors have been taking profits. But you know, I still like it for the long term.

DD: Yeah, I mean, commodities were very strong last year, as was India. And, you know, valuations got expensive. I'm slightly surprised at healthcare; healthcare is normally a sector that does well in uncertain times and I'd be fairly confident that if we continue in this very uncertain economic background, that healthcare should be a sector that will outperform.

SS: So, it's been a bit of a mixed bag. We've got what, a few days left now until the end of the tax year? So, there'll be a few last-minute investors thinking, should I or shouldn't I sort of add a bit more to my pensions, use my ISA allowance? Where are you guys putting your ISA money this year?

JSL: Well, I quite like Japan at the moment where corporates have got quite strong balance sheets and there's a sort of, there's a turnaround going on there in corporate governance. And do you know, I'm <laugh> I tend to be a bit of contrarian, so I, you know, I was just looking at valuations and looking at UK smaller companies, so I think as a long-term bet, they're just so oversold and so unloved at the moment that, you know, that hopefully they will have a turnaround eventually.

DD: Yeah, I mean for my ISA, pretty much all of my personal ISA savings are all in our own funds that we advise on. One area outside of that, that I have been adding to is gold. Gold is actually at a record high. Normally I tried to buy things when they're, like Juliet said, out of favour and cheap. But I have been increasing my gold weighting with the Ninety One Gold equity fund [Ninety One Global Gold] and the Jupiter Gold & Silver fund have been an area that I've been topping up into, in this uncertain world, may not make a huge amount of money on those purchases…

Like Juliette, I also like UK smaller companies. I like things that have had a bad time. We, as a team, have always liked smaller companies over the long term, but in difficult markets, they tend to underperform, they get cheaper then over the next decade, as economies recover, they tend to be the place to be. So, for me, it's been a little bit of addition in gold and a bit of smaller companies.

SS: Thank you. Well, we've covered a lot of ground there, I think. I think we'd probably all quite like a quieter quarter for the next one. But thank you very much and if you would like to find out more about our views, please go to FundCalibre.com. And don't forget to subscribe to the 'Investing on the go' podcast.

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