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B Capital Commentary and Outlook Update 2Q 2023

"An argument is made that there are just too many question marks about the near future; wouldn't it be better to wait until things clear up a bit? You know the prose: "Maintain buying reserves until current uncertainties are resolved," etc. Before reaching for that crutch, face up to two unpleasant facts: The future is never clear, and you pay a very high price for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."

Warren Buffet

2023 has started with a rally after a dismal 2022 for financial markets faced by sharply higher inflation and interest rate rises. Despite initial volatility caused by the collapse of Silicon Valley Bank (SVB), which caused significant volatility in bank shares, global equities managed to gain in Q1 and today we are looking to reach and then pass through the high at the start of last year. Developed markets were particularly buoyed by receding recession worries.

In the US, investor optimism led to a rise in stocks, despite the short-lived market turbulence caused by the collapse of SVB in March. The Federal Reserve (Fed) raised rates twice during the quarter, and inflation is cooling, leading to expectations that the hiking cycle could shortly come to an end. Tech stocks made some of the strongest gains, while the energy and healthcare sectors lagged the most over the quarter.

Eurozone shares also gained during Q1, despite volatility in the banking sector. The information technology, consumer discretionary, and communication services sectors led the gains, while real estate and energy lagged. The European Central Bank raised interest rates twice in February and March, while Eurozone inflation declined to a one-year low in March. The Markit flash purchasing managers’ index reached a 10-month high of 54.1 in March, although growth was powered by the service sector with the manufacturing index below 50.

UK equities rose over the quarter, with economically sensitive areas outperforming. Industrials and consumer discretionary sectors performed well, reflecting a strong recovery in many domestically focused areas. The latest quarterly GDP data revealed that the UK economy had not contracted in Q4 2022, contrary to consensus expectations. As a result, the economy dodged a technical recession. The Bank of England (BoE) still expects the country to fall into a recession later in 2023, but the recession is expected to be shallower than the BoE had been predicting.

Japanese stocks also rose strongly in Q1, with the Topix up 7.2% in yen terms. Quarterly earnings results were mixed, with exporters having a difficult time due to yen appreciation during Q4 2022, and a slowdown in production mainly affecting technology sectors. In March, the market was dragged down by concerns over the collapse of SVB and the bailout of Credit Suisse by UBS, severely hitting Japanese financial stocks. However, the market rebounded toward the end of the month, supported by yen weakness.

In fixed income, government bond yields fell during Q1, leading to a rise in prices. Growth stocks outperformed value in the quarter, but only after substantial declines the year before.

As we enter into the second quarter of the year, there has been much discussion surrounding the recent banking turmoil and its potential impact on the global economy. While there is no doubt that this uncertainty may cause some short-term pain, there is reason to believe that the world economy's unusual resilience will continue.

Before the recent chaos, evidence suggested that global GDP was increasing at an annualized rate of 3%, with job markets on fire in rich countries. As of now, there is scant evidence of a shift in "real-time" data towards slower growth. Various high-frequency measures, such as the "current-activity indicator" produced by Goldman Sachs, have remained steady, and purchasing-manager indices showed a slight improvement in March. Weekly measures of GDP produced by the OECD are also holding up.

UBS tracks global GDP growth as priced by financial markets, which currently indicates growth of 3.4%, versus 3.7% before Silicon Valley Bank (SVB) collapsed. While it is still early days, there is reason to think recent turmoil will have less impact than many fear.

The two main worries for economists are uncertainty and credit. While a leap in uncertainty can trim annual GDP growth by 0.5 percentage points, the impact is unlikely to be that significant unless the turmoil continues. Ipsos found that American consumer confidence grew a bit from early to mid-March, and the "uncertainty index" derived from analysis of newspapers by Stanford University is drifting back down. German business sentiment even improved in March.

However, the worry of credit is more significant. If firms cannot get their hands on finance, they cannot grow as quickly. After the fall of SVB, capital markets froze, causing consternation. Fewer people noticed when the market picked up. Although spreads on corporate bonds rose a little after the collapse of SVB, they too have fallen back in recent weeks. Companies may have briefly held off issuing new debt to check that the coast was clear but issuance rebounded again recently. Overall, it seems likely that despite the SVB panic, March 2023 will turn out to be a relatively average month for corporate-debt issuance.

The damage to banks will prove more consequential. Since the start of March, global banks' share prices have tumbled by more than 10%. Research suggests falling share prices tend to hit loan growth. Banks may also cut lending if they see deposit outflows or need to raise capital because investors doubt their safety. This could cut global growth from 3% to 2.5%.

Yet despite the recent US banking turmoil, there are forces working in the other direction. One is the rebound of China, with economists expecting the world's second-largest economy to grow by over 7% year on year in the second quarter of the year. Supply-chain bottlenecks have mostly eased, and energy prices have fallen. It is unlikely that the recent banking turmoil will push the world economy over the edge, but there is no doubt that it may cause some short-term pain.

At the midpoint of the Q1 2023 earnings season, S&P 500 companies were reporting better-than-expected earnings, with both the number of companies reporting positive earnings per share (EPS) surprises and the magnitude of these surprises above their 10-year averages. However, as predicted last year the Index is still reporting a year-over-year decline in earnings for the second consecutive quarter. Of the companies that have reported results for Q1 2023, 79% have reported EPS above estimates, which is above the 5-year and 10-year averages. Companies are reporting earnings that are 6.9% above estimates, which is above the 10-year average but below the 5-year average.

The blended earnings decline for the first quarter is -3.7% today, compared to -6.3% last week and -6.7% at the end of Q1. Positive earnings surprises from multiple sectors contributed to the decrease in the overall earnings decline, with Information Technology, Consumer Discretionary, Energy, Industrials, and Communication Services sectors leading the way. Five sectors report year-over-year earnings growth, with Consumer Discretionary and Industrials leading, while six sectors report a year-over-year earnings decline, led by Materials and Health Care.

In terms of revenues, 74% of S&P 500 companies have reported actual revenues above estimates, which is above the 5-year and 10-year averages. Companies are reporting revenues that are 2.1% above estimates, above the 5-year and 10-year averages. The blended revenue growth rate for the first quarter is 2.9% today, compared to 2.1% last week and 1.9% at the end of Q1. Positive revenue surprises from multiple sectors contributed to the increase in the overall revenue growth rate, with Consumer Discretionary, Industrials, Energy, and Health Care sectors leading the way.

Looking ahead, analysts still expect earnings growth for the second half of 2023. For Q2 2023, analysts are projecting an earnings decline of -5.0%. For Q3 2023 and Q4 2023, analysts are projecting earnings growth of 1.7% and 8.8%, respectively. For all of CY 2023, analysts predict earnings growth of 1.2%, with earnings picking up into 2024. The forward 12-month P/E ratio is 18.1, which is below the 5-year average but above the 10-year average, in other words it's neither cheap nor expensive to own stocks and looking out to next year should be the focus.

To understand why a brightening economic outlook could catch many professional investors off guard, we can start by looking at how they are currently positioned. According to Bank of America's monthly survey of global fund managers in April, they are almost record-breakingly bearish. This is reflected in their investment choices, as they have loaded up on bonds to a degree not seen since March 2009, pushing yields down. Additionally, nearly two-thirds of them believe that the Fed will cut rates in the final quarter of this year or the first quarter of next year. They are also avoiding the stocks of financial firms more than they have since the first COVID-19 lockdowns. Their top crowded trades are "long big tech stocks" and "short US banks".

However, if the economy were to strengthen and interest rates were to remain high, every one of these positions would be knocked. Rising long-term yields would cause bond prices to fall, and bets on the Fed cutting rates would be ruined. While banks' bond portfolios would suffer, steady growth and an upward-sloping yield curve would boost their lending margins and help their shares recover. Without rate cuts, big tech firms would lose access to cheap borrowing, and higher yields on bonds would make the uncertain promise of future revenues less attractive by comparison. Although their immediate earnings prospects might improve, their valuations are already sky-high, so their potential for benefitting would be limited.

However, it is important to note that this scenario is not the most likely outcome. The Fed predicts that rates will eventually settle at around 2.5%, and investors and pundits who predict ongoing hawkishness are few and far between. Tightening monetary policy has already caused global markets to plummet, Britain to face a sovereign-debt crisis, and America to experience banking turmoil. The idea of a thriving economy even as rates stay high or rise further seems unlikely.

Yet, even if the economy were to slow down, tight monetary policy alone could harm investors. Inflation remains a concern, and Fed Chairman Jerome Powell is determined not to repeat the mistakes of the 1970s by giving up the fight against rising prices too early. Moreover, central banks are not the only ones who influence interest rates. As American politicians argue over the debt ceiling, the risk of a sovereign default triggered by a miscalculation grows, sending borrowing costs spiralling by accident. Although this may seem like a remote risk, it is precisely these types of pain trades that often catch investors off guard.

	2022	2023	2024
World Output	3.4	2.8	3.0
Advanced Economies	2.7	1.3	1.4
United States	2.1	1.6	1.1
Euro Area	3.5	0.8	1.4
Germany	1.8	-0.1	1.1
France	2.6	0.7	1.3
Italy	3.7	0.7	0.8
Spain	5.5	1.5	2.0
Japan	1.1	1.3	1.0
United Kingdom	4.0	-0.3	1.0
Canada	3.4	1.5	1.5
Other Advanced Economies	2.6	1.8	2.2
Emerging Market and Developing Economies	4.0	3.9	4.2
Emerging and Developing Asia	4.4	5.3	5.1
China	3.0	5.2	4.5
India	6.8	5.9	6.3
Emerging and Developing Europe	0.8	1.2	2.5
Russia	-2.1	0.7	1.3
Latin America and the Caribbean	4.0	1.6	2.2
Brazil	2.9	0.9	1.5
Mexico	3.1	1.8	1.6
Middle East and Central Asia	5.3	2.9	3.5
Saudi Arabia	8.7	3.1	3.1
Sub-Saharan Africa	3.9	3.6	4.2
Nigeria	3.3	3.2	3.0
South Africa	2.0	0.1	1.8
Emerging Market and Middle-Income Economies	3.9	3.9	4.0
Low-Income Developing Countries	5.0	4.7	5.4

Fig 1: World Economic Outlook Projections
***Source - IMF, April 2023**

We remain cautiously optimistic about the world economy where we see the rich world slow more, and the emerging world achieve much better growth. According to our current projection, the global growth rate is expected to decrease from 3.4% in 2022 to 2.8% in 2023, and then increase to 3.0% in 2024. The slowdown in growth will be more pronounced in advanced economies, which are expected to experience a decline from 2.7% in 2022 to 1.3% in 2023. However, in a possible alternative scenario where the financial sector undergoes more stress, global growth is expected to fall to around 2.5% in 2023, with advanced economies experiencing a growth rate of less than 1%. While headline inflation is projected to decline from 8.7% in 2022 towards around 5.0% in 2023 due to lower commodity prices, core inflation may well decrease at a slower pace. In most cases, inflation is not expected to return to nearer target levels until 2025.

For these reasons we have maintained a focus on quality companies in the developed world to protect dividend cover, and added allocations to EM equities including China and EM credit in our core models. We are finally seeing the merits of precious metals shine through as the US dollar loses some ground after a burst of strength last year, and peak rates come into view. Typically, gold is favoured when a banking crisis occurs, and combined with some slowing of the economy and inflation worries there may be room for it to head higher above $2'000 an ounce. We expect markets to look further forward to 2024 and beyond, giving some opportunity for PE expansion from here, but there is no doubt that this more bullish stage for equities will be bumpy. This is especially the case with growth and tech stocks which have performed well this year but can turn on a dime if inflation (and therefore interest rates) expectations turn higher. We think keeping a balance between the growth plays and defensive sectors including some fixed income and precious metals exposure will provide a positive return this year, but with so many variables there is less certainty. Things may turn out a bit better than the rather crowded market consensus expects.

Lorne Baring
Managing Director