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March 2023
Quarter in Review

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THE POLICY SEESAW: BANKING CRISIS TIPS TO LOOSENING

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Global asset markets were volatile in Q1 amid rising economic headwinds and uncertainty around the trajectory of monetary policy. Despite this, both equities and fixed-income markets rallied over the period. At the start of the year, there was optimism for a global 'soft landing' – i.e. an economic slowdown but no recession. These attitudes were supported by generally resilient economic data and expectations of a boost from China's reopening. As a result, risk assets posted strong gains in January. In February, however, this gave way to concerns around overheating amid sticky inflation, and central banks indicated that monetary policy may need to be tightened further and faster than previously anticipated. This rhetoric reached its peak in early March, when US Federal Reserve (Fed) Chair Powell gave his testimony to Congress, which coincided with the peak in the US Treasury (UST) two-year yield of over 5.0%. The banking crisis hit later that week and turned the outlook for monetary policy on its head.

Banking crisis

As the collapse of Silicon Valley Bank (SVB) unfolded, the authorities acted quickly and decisively to guarantee deposits and the Fed launched a one-year funding scheme to shore up confidence and liquidity in the banking system. This sent a signal to investors that regulators and central banks were willing to aid the sector in times of distress. Nevertheless, concerns that the collapse could lead to financial instability and a sharp slowdown were a concern for the Fed. As a result, it hiked by only 25 basis points (bps) at its March meeting rather than the 50bps expected prior to the SVB crisis; Chair Powell struck a somewhat cautious tone and implied that financial stability was imperative.

Contagion in Europe

The week after the SVB failure, the banking sector crisis spread to Europe. Credit Suisse faced funding problems, which culminated in a takeover by UBS, seemingly forced through by Swiss authorities. There were then concerns over Deutsche Bank, but these abated given the company's improved financial position compared to a few years ago.

ECB policy

Despite the banking crises, the European Central Bank (ECB) stuck to its guidance and hiked its deposit rate by 50bps to 3.0%; the central bank has said that it expects inflation "to remain too high for too long." Headline consumer prices for the eurozone rose by 6.9% year-on-year in March, while core prices accelerated from 5.6% in February to a new historical high of 5.7%. ECB President Lagarde said the central bank would be in data-dependent mode and would not provide forward guidance for its next policy move. The ECB also addressed concerns around potential contagion to eurozone banks from the latest "market tensions", saying that it "stands ready to respond as necessary to preserve price stability and financial stability in the euro area".

Bond market volatility

These developments pushed down the UST two-year yield to as low as 3.76% – a 129bps fall in the space of just two weeks. Long-end yields fell, but not by nearly as much; this led to a steepening of the yield curve. The spread between two- and 10-year USTs rose from a low of -107bps to -58bps at the end of March. There was a similar pattern in the eurozone, with German two-year Bund yields falling from a peak of 3.33% to a low of 2.36%, while the two-year/10-year spread more than halved from -70bps to -25bps.

CHARTS OF THE QUARTER

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 31 March 2023.

Bonds – German 10-year yield

Source: ILIM, Bloomberg. Data is accurate as at 31 March 2023.

MARKET ROUND-UP

Equities

Global equities, as represented by the MSCI All Country World Index (ACWI) rose by 7.2% (5.5% in euro terms) in Q1.

European ex UK equities outperformed, rising 10.5% (10.2% in euros) as the eurozone avoided the recession many investors had been fearing at the end of last year. The 36.1% fall in the gas price to below pre-Ukraine war levels helped boost production and sentiment across Europe, supporting equity markets.

US equities rose 7.7% (5.8% in euros) as economic news flow improved compared to the slow momentum evident at the end of 2022, while expectations for the level of the fed funds rate at year end fell towards the end of the quarter.

Pacific Basin equities lagged, rising 3.1% (0.4% in euros), with Hong Kong equities down -1.9% on profit taking following the strong gains late last year on the announcement of the reopening of the Chinese economy.

The UK also lagged, rising 3.2% (4.2% in euros), partly due to energy stocks which were impacted by the fall in the oil price during the quarter.

Bonds

Global bonds rose during the quarter. Expectations of an imminent peak in central bank policy rates, continued easing of inflation (even if at a slower pace than initially expected) and renewed growth concerns linked to the banking crisis all contributed to lower bond yields. The US 10 yield fell from 3.87% at the end of December to 3.47% at quarter-end.

The ICE BofA 5+ Year Euro Government bond index was up by 2.7%. The German 10-year yield was volatile, rising to its highest level since 2011 at 2.77%, with core inflation reaching new highs and investor expectations for the peak in the ECB deposit rate rising to 4.0%. Yields fell with the emergence of the banking crisis and resultant growth fears, and the German 10-year yield fell to a low of 1.92% as investors began to discount fewer ECB rate hikes. As fears of contagion from the banking crisis began to ease, yields rose into quarter-end with the German 10-year yield ending March at 2.29%.

Meanwhile, peripheral eurozone bond spreads narrowed. Italian 10-year spreads over the equivalent German bunds fell by 33 basis points (bps) to 1.80% as the coalition government proved to be more moderate than feared prior to its formation. Spreads for Spanish government bonds fell by 8bps to 1.01%. The moves were aided by a more favourable economic backdrop as the eurozone was expected to avoid a recession while economic data for both Italy and Spain generally surprised to the upside.

European investment grade (IG) corporate bonds rose by 1.4% in Q1 amid a general downshift in bond yields. IG yields fell marginally, by 4bps to 4.17% and spreads widened slightly, by 2bps to 166bps. Global high yield bonds rallied, with yields falling by 37bps to 7.61% and spreads narrowing by 19bps to 395bps amid expectations that key central bank rates were close to the cyclical peak.

Emerging market (EM) local debt performed the best within fixed income in Q1, rising by 3.8%. Yields fell by 30bps to 6.62%. EM hard debt rose 1.2% as yields fell by 9bps to 7.71% and was likely aided by a weaker US dollar, with the MSCI Emerging Markets Currency index rising by 1.9% in Q1.

Currencies and commodities

The US dollar index (DXY) exhibited weakness during Q1, falling by 1.0%. This was likely aided by improved global growth prospects, with the global composite PMI in February rising into expansionary territory for the first time since July. The euro rose against the US dollar, up from 1.0705 at the end of 2022 to 1.0839 by the end of March, aided by expectations that the Fed was closer to the peak in its tightening cycle compared to the ECB.

Commodities fell -4.9% (-6.6% in euros), impacted by the prospect of demand destruction amid tighter credit conditions caused by the banking crises. While the Chinese economy recovered strongly following its full reopening in January, activity levels and growth failed to meet some of the more optimistic forecasts and this also contributed to softer commodity prices. Brent crude oil fell by 7.1% in Q1 to $79.8/barrel. European gas prices fell -36.1% as the European winter was relatively mild, enabling gas storage levels to remain significantly above expected levels as Europe succeeded in diversifying gas supplies away from Russia.

Meanwhile, gold rallied by 8.0%, aided by the potential for lower interest rates, US dollar weakness and lower US real yields in Q1. Despite Chinese growth failing to meet some of the more optimistic expectations, metals were generally firmer as they benefited directly from the improvement in growth and increased infrastructure spend. Copper rose 7.5% while aluminium was up a more modest 1.4%. Wheat fell -12.6% as the Black Sean Grain Initiative remained operational with grain supplies from Ukraine still entering the global market.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	QTD Return (%)	YTD Return (%)	2022 Return (%)
MSCI Ireland	19.5	19.5	-21.1
MSCI United Kingdom	4.2	4.2	1.4
MSCI Europe ex UK	10.2	10.2	-11.9
MSCI North America	5.7	5.7	-13.8
MSCI Japan	4.5	4.5	-10.8
MSCI EM (Emerging Markets)	2.2	2.2	-14.5
MSCI AC World	5.5	5.5	-12.6

10-Year Yields	Yield Last Month (%)	2022 Yield (%)	2021 Yield (%)
US	3.47	3.87	1.51
Germany	2.29	2.57	-0.18
UK	3.49	3.67	0.97
Japan	0.35	0.42	0.07
Ireland	2.75	3.13	0.24
Italy	4.09	4.70	1.17
Greece	4.22	4.62	1.34
Portugal	3.12	3.59	0.47
Spain	3.30	3.66	0.57

FX Rates	End last month	2022 Rates	2021 Rates
US dollar per euro	1.08	1.07	1.14
British pound per euro	0.88	0.89	0.84
US dollar per British pound	1.23	1.21	1.35

Commodities (USD)	QTD Return (%)	YTD Return (%)	2022 Return (%)
Oil (Brent)	-7.1	-7.1	10.5
Gold (Oz)	8.0	8.0	-0.3
S&P Goldman Sachs Commodity Index	-4.9	-4.9	26.0

Source: ILIM, Bloomberg. Data is accurate as at 1 April 2023.

THE ILIM VIEW – LOOKING AHEAD

Global equities have proven resilient in the face of mounting headwinds, from lacklustre earnings to continued monetary tightening and banking crises. However, in our view, the asset class has yet to price in an adverse economic scenario like a recession, so volatility is set to remain elevated. This relates especially to the fallout from the banking crises and the resultant impact on sentiment and credit creation. Moreover, while inflation has decelerated from six months ago, price pressures remain elevated and tighter credit conditions would likely crimp demand, resulting in pressure on corporate earnings and margins. Even if central banks were to ease into the slowdown, equity markets have typically fallen during previous periods of monetary easing.

This has usually been due to the reason behind the monetary easing: namely, recessionary conditions. In the event of such a scenario, valuations still do not look attractive: the 12-month forward P/E for the MSCI USA is 18.5x against a long-term average of 17.1x. Equities outside the US offer better value. Europe ex-UK equities trade at a multiple of 12.4x against a long-term average of 13.2x, while emerging markets are better value versus global peers. On balance, we believe there could be a better entry point for equities later this year.

THE MONTH AHEAD

APRIL

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
				7 US Unemployment Rate (Mar) US Non Farm Payrolls (Mar)
		12 US Inflation Rate YoY (Mar) US FOMC Minutes	13 GB GDP MoM (Feb)	14 US Retail Sales MoM (Mar)
	18 GB Unemployment Rate (Feb)	19 GB Inflation Rate YoY (Mar)		
				28 JP BoJ Interest Rate Decision FR Inflation Rate YoY Prel (Apr) EA GDP Growth Rate YoY Flash (Q1) DE Inflation Rate YoY Prel (Apr)

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Figures referenced herein have been sourced from ILIM and Bloomberg. Forecast figures have been prepared by ILIM based on reasonable assumptions, internal data and data sourced from Bloomberg.

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