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Principal Equities

Principal Asset Management℠

Equity market recap

FIRST QUARTER 2023

Notable themes

- **New era bank runs –** two notable bank failures in the U.S. unleashed a wave of deposit outflows from other regional lenders, while the government aided merger of Switzerland's two largest banks further rattled investor confidence.
- **Flight to liquidity –** investors piled into money market funds, short-term Treasuries, and blue-chip growth stocks, foreshadowing ongoing pressures for rate-sensitive commercial real estate, private equity, and venture capital.
- **Balancing act –** tightening credit conditions call into question the ability of central banks to maintain their prior hawkish intentions.

Building on their late 2022 rebound, a wide majority of global equity markets posted solid gains during the first quarter of 2023. For much of the period, monetary policy continued to dominate investor attention, in the hope that moderating inflation, slower economic growth and an easing of U.S. dollar strength could contribute to a less hawkish stance by the Federal Reserve and other major central banks worldwide. Indeed, consensus expectations shifted in favor of a "soft landing" scenario, with growing expectations that the magnitude and pace of further interest rate hikes would soon moderate.

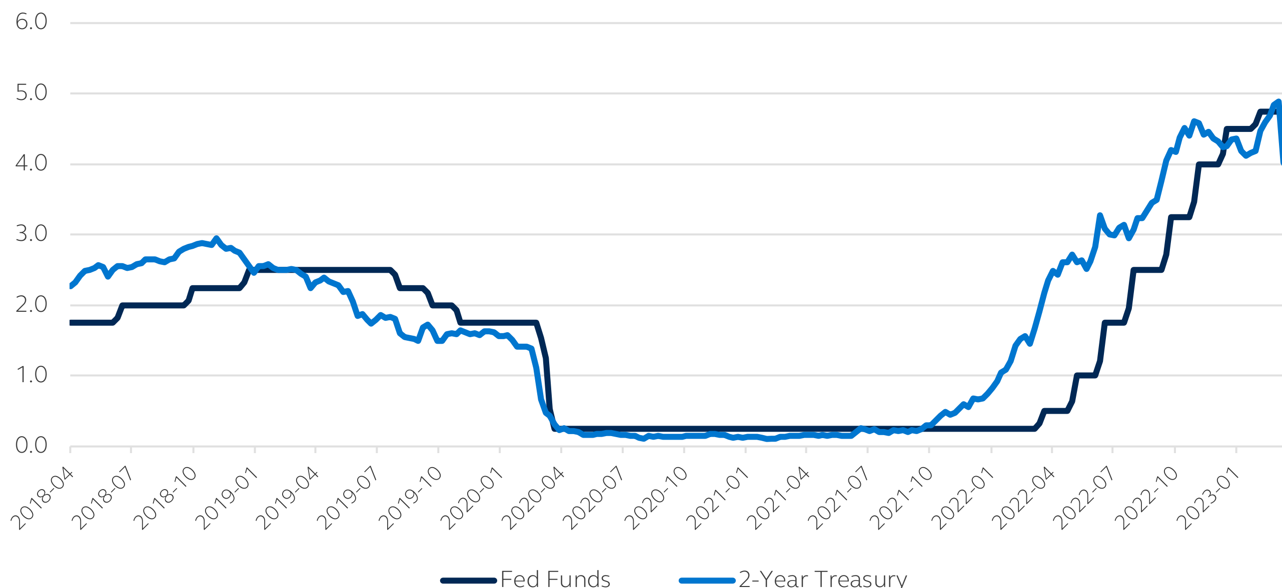
That encouraging backdrop abruptly changed in early March, as a fresh wave of volatility gripped capital markets. The initial tremors emanated from the obscure crypto-focused Silvergate Capital, which voluntarily liquidated after several months of client outflows. This was initially attributed to the broader strains in cryptocurrency markets following the FTX scandal. However, the very same week, Silicon Valley Bank (SVB Financial), a previously fast-growing lender that catered to private equity clients, announced an unexpected recapitalization plan that sent its depositors fleeing in mass, and within 48 hours, was seized by the FDIC, ending the bank's 40-year-run. The following week, New York based Signature Bank, which also focused on cryptocurrency lending, met the same fate. SVB and Signature marked the second and third largest commercial bank failures in U.S. history.

Contagion fears quickly spread across regional banks, especially among those with large books of uninsured deposits (>250,000), most notable First Republic, which narrowly averted failure thanks to deposit transfers from a consortium of large lenders. The following weekend, regulators, in conjunction with the Fed and U.S. Treasury, swiftly approved plans to backstop SVB and Signature depositors, and with the establishment of a new emergency credit facility with the Fed to provide loans up to one year for institutions affected by the bank failures. These events also rattled financial

> "Only when the tide goes out do you discover whose been swimming naked"
>
> **Warren Buffett**

institutions abroad, especially long-beleaguered Credit Suisse, where a long string of client withdrawals and votes of non-confidence by its major shareholders rapidly faced the brink of collapse. This led to an emergency intervention by the Swiss National Bank and UBS, culminating in the arranged merger of the country's two largest banking and wealth management institutions.

Fed Funds Target vs 2 Year Treasury Yield (%)



As of 31 March 2023. Source: FactSet

As the quarter drew to a close, volatility subsided considerably, underpinning further gains in equity markets, and relative stability in credit markets. This underscores the observation that each of the failed institutions had idiosyncratic asset-liability risk management failures rather than deteriorating loan books. As such, the market took relative comfort in the decision by the Fed to raise its benchmark target range by 0.25%, with an upper bound of 5.0%. The accompanying Federal Open Market Committee members' "dot plot" showed a peak Fed funds rate of 5.1%, indicating the Fed believes they are nearing the end of their tightening cycle. The banking sector problems clearly impacted the Fed's rate expectations. Fed Chair, Jerome Powell, emphasized that their statement language had changed from "ongoing increases in the target range will be appropriate" to "some additional policy firming may be appropriate". Inflation continues to be far too elevated, but has slowed, and the labor market still too tight but, increasingly, it seems that tightening credit conditions may do the Fed's job for them.

In additional signs of containment, performance of the broader financial services sector was relatively muted. Despite declines of than 20% among the U.S. regional bank sub-sector, the broader S&P 500 financial sector declined just over 5%, while non-U.S. financial stocks posted modest gains. Meanwhile, technology, communications, and consumer discretionary stocks all enjoyed spirited double-digit rallies during the quarter. Indeed, these were among the hardest hit sectors in 2022, but conversely have been the biggest beneficiaries of moderating inflation (including lower oil prices) and lower long-term interest rates (including home mortgages). The strength in technology stocks was

exemplified by semi-conductor shares which rerated higher despite weaker earnings. Gains in the discretionary sector were particularly robust among luxury and higher-end athleisure retailers.

As the aforementioned sector leaders and laggards suggest, it was a wonderful quarter for high quality, large cap growth stocks, while more challenging for value and small cap styles. As measured by the Russell indexes, the largest 200 U.S. stocks gained 8.7% while the smallest 2000 posted a 2.7% advance. Among U.S. Large Caps, the Russell 1000 Growth posted a 14.4% return, while its Value counterpart eked out a mere 1.0% gain. Among non-U.S. stocks, style differentials were much more muted but still skewed in favor of growth and large caps.

With hopes of keeping contagion risks at bay, equity markets proved to be resilient. The MSCI All Country World Index posted a 7.3% gross total return for the quarter, comparable to the 7.5% showing by the S&P 500. The MSCI Emerging Market Index lagged global peers, but was still up by 3.9%, led by the technology heavy Taiwanese and Korean markets. MSCI EAFE posted a gain of 8.6% led by strength in continental Europe. U.S. investors with exposure to international markets also benefitted from a further weakening of the U.S. dollar against most major currencies, especially the Euro and British Pound. It was the second consecutive quarter of outperformance by Europe, underscoring how overly bearish prior expectations had become.

The accompanying table summarizes regional and global sector aggregate performance on a USD basis, gross of cross-border tax withholding.

	3 months	12 months
MSCI World Index	**7.88%**	**-6.54%**
North America	7.58%	-8.66%
Europe	10.74%	2.03%
Pacific	4.84%	-5.73%
MSCI Emerging Markets Index	**3.96%**	**-10.70%**
China	4.71%	-4.73%
Asia Ex China	4.88%	-12.44%
Latin America	3.93%	-11.05%
EEMEA	-1.07%	-17.84%
MSCI All Country World Index	**7.44%**	**-6.96%**
Communication Services	17.24%	-15.26%
Consumer Discretionary	14.27%	-11.82%
Consumer Staples	3.49%	1.22%
Energy	-2.86%	7.56%
Financials	-1.32%	-10.16%
Health Care	-1.54%	-3.67%
Industrials	6.90%	-0.76%
Materials	5.43%	-8.92%
Real Estate	0.72%	-19.12%
Technology	20.52%	-7.19%
Utilities	-0.48%	-5.66%

Sources: MSCI, Standard and Poor's in USD. As of 31 March 2023.

Looking ahead

Previous rate hikes coupled with recent financial turmoil have put the Federal Reserve in a more dovish state. Attaining pricing stability through further tightening of financial conditions remains key but that tightening doesn't necessarily need to come from Fed rate hikes, and instead, could come from credit conditions as banks tighten lending standards. Regarding the recent strains on regional banks, we believe the worst is behind us and several positive factors, supportive of equities, remain in place, noted below:

- Decelerating inflation, albeit still elevated
- The Federal Reserve pivoting to a more dovish path
- Improving supply chains
- Peak dollar – 6-month low
- Supportive valuations

These all contributed to healthy gains to start the year with expectation for further opportunities in the year ahead though there will be bumps along the way.

The fallout from the recent U.S. bank failures and acquisition of Credit Suisse by UBS in Europe have put a spotlight on the industry and potential underlying impacts from swift monetary tightening polices. The ongoing challenges facing banks in the U.S. is funding (liquidity) and capital. Broadly speaking, the challenges facing most banks presently are that savings deposit rates/yields are too low compared to other alternatives that customers have for low-risk yield such as Treasuries, money market securities, high yield savings, etc. This has driven depositors to pull funds and capture yield through alternative means and thus driving banks to move securities being used as reserves for loans that were previously deemed as "held-to-maturity" to the "available-for-sale" accounting classification which then triggers an immediate revaluing of their portfolio of held-to-maturity to market prices.

Rising rates have revalued fixed income securities such as Treasuries and lower risk bonds substantially lower. The revaluation of these securities lower most significantly impacted banks that deal in the higher growth areas of the market such as private equity, venture capital, and innovative companies as those depositors were pulling funds amid needs for cash/capital. Most traditional mainstream banks, those that are not high growth, appear to be sufficiently capitalized and have multiple sources for funding. This is not to say that margin pressure won't be severe in the coming quarters; it will be, and there will be a battle to retain deposits. This was well known going into 2023, and Silvergate (SI), and SIVB have now brought the issue front and center; driven by their own company specific strategies.

Nevertheless, as interest rates remain somewhat elevated, the weaker banks will be more vulnerable, particularly when subject to lighter regulation as in the U.S. We continue to monitor, but do not believe this is a systemic problem, but rather cases of severely mismatched assets and liabilities and failures of risk management. Moving forward there will be greater scrutiny of deposit bases and flows, and wholesale funding costs.

The Federal Reserve's latest inflation gauge showed a rise of 0.3%, but less than the expected 0.4% as energy prices trended lower. In Europe, we are seeing similar trends as the March consumer prices

of 6.9%, year-over-year, was the lowest in a year and down from the 8.5% in the previous month. Similar to the U.S., energy was the key element to the reduction though food remain elevated. More recently, home prices have also jumped following deterioration over the past two months. The fight for pricing stability is far from over but the trend remains positive, and the expectation is for less central bank intervention ahead. (However, OPEC's surprise announced oil production cut in April throws yet another wrinkle into central bank's inflation fight.)

Over the long-term, inflation is going to be pushed higher by near-shoring initiatives. The war in Ukraine and escalating geopolitics elsewhere has many countries reassessing their supply chains and trading partners. Investments are ratcheting up for more domesticated production, semis, food, and energy, while aligning with trusted countries. This will also drive long-term structural change opportunities.

Following synchronized tightening, we are beginning to see diverging rate paths amid differentiating economic and inflation backdrops. The Bank of Canada hiked its key interest rate to its highest level in 15 years but became the first major central bank fighting global inflation to say it would likely hold off on further increases for now. The Federal Reserve is on a similar path given the recent fragility in the financial market.

On the other hand, the European region does remain on a path for more rate hikes to come. As future rate hikes have already been affirmed, the European Central Bank (ECB) has removed any doubt of its commitment to the price stability mandate. Economic uncertainty remains abound for the region, and policymakers must surmount a complex balancing act between weaker growth, persistent inflation, and external international shocks. Positively though, growth has held up well and recession risks have moved to a "shallower" scenario.

China is on a new path of slower growth that will be more domestically led. With leader Xi Jinping securing his third term and surrounding himself with more loyalists, expect less reform. Geopolitical conflicts remain heightened causing ongoing challenges for supply chains, while both China and its major trading partners are simultaneously looking to become more independent on energy and food sourcing. This is evident in China as land gets converted to more food sourcing regardless of prior commitments. Positively, the region has relaxed its zero-COVID policy measures, which is supportive of improving near-term growth, and improvements in relative valuations.

We believe we are in the midst of a generational change in global trade flows, as the West reduces its reliance on China and Russia. The U.S., Japan, and Europe should all experience expanding manufacturing bases. As the re-shoring trend accelerates and duplication in global supply chains increases, it will be a net benefit to global companies with the expertise in the capital equipment that will be needed to drive a manufacturing renaissance outside China.

2022 was a challenging year. 2023 may present similar challenges as persistently restrictive monetary policy and the likely resulting recession will weigh on the broad equity market outlook, though our expectation is that much of this has already been priced in. Rates and inflation are stabilizing, and attractive global equity valuations set the stage for opportunities ahead.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility.

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MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The index covers approximately 85% of the free float-adjusted market capitalization in each country. Information regarding the comparison to the MSCI World Index is available upon request.

MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets. The index covers approximately 85% of the free float-adjusted market capitalization in each country. Information regarding the comparison to the MSCI Emerging Markets Index is available upon request.

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