MONTHLY MARKET
Commentary

Albemarle STREET PARTNERS

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It's a crazy little thing called rates

2023 has got off to a bumper start with both bonds and equities rallying. The decline in inflation appears to have lifted the gloom in markets and investors have started to shift away from an ultra-defensive stance.

While we're not quite out of the woods yet with regards to risk assets, bonds should continue to benefit from falling inflation. The inflation backdrop in the UK is not as rosy but is likely to follow the rest of the developed world with a lag.

Central banks, led by the Federal Reserve, have delivered a quick and robust response to inflation pressures. The sharpest increase in policy rates in living memory have impacted economic activity and prices for goods and commodities are down meaningfully versus last year.

Tight labour markets and the lags in wage negotiations will cause services inflation to linger a while longer. Despite this, we expect the US Federal Reserve to hike rates once more before pausing. The European Central Bank and the Bank of England are further behind in their inflation response and may need to take additional steps before stopping.

Another one bites the dust

The May Day Bank Holiday saw the demise of yet another west coast bank. First Republic, a regional bank with a $170 billion loan book, was put into administration over the weekend and its assets were sold to JP Morgan by US regulators. While First Republic had been teetering ever since Silicon Valley Bank's failure, management's inability to muster sufficient support creates a worrying omen for whoever is next weakest in the queue.

These events are often framed in isolation, without due care given to broader financial backdrop. Financial conditions are tight and will tighten further as regional banks limit lending. There are meaningful implications for debt financed assets such as commercial property.

No escape from reality

We pay considerable attention to the macro backdrop when building client portfolios. The direction of inflation and bond yields are key inputs in our investment decisions. We are, however, just as mindful of what companies are reporting.

With 53% of US market constituents having reported first quarter results, 79% have posted better than expected earnings (according to FactSet – 28.04.2023). Overall earnings are down 3.7% with consumer discretionary and communication services seeing the largest improvement in their earnings trends. At the halfway mark, margins appear to have stabilised, after falling for most of 2022. Energy remains the sector with the largest improvement in margins versus the 5-year trend. Revenue growth for the broader market has slowed from double digit growth to 2.9%. Materials companies are seeing high single digit declines in revenues which is a stark contrast to consumer discretionary companies, which are still benefitting from robust post COVID demand for leisure and hospitality.

Companies, at least the larger ones we care most about, appear to be doing a good job of navigating the slowing economy. While we have expressed our reservations about analyst forecasts in the past, incoming earnings have surprised to the upside.

Conclusion

There are moments in markets when asset prices fail to follow the prevailing narrative. We are aware of tight monetary conditions, bank failures and the slowdown in the real economy. Yet despite these warning signs, markets have displayed remarkable resilience. Waiting for the worst to pass is an exercise in self-discipline. It is important to remain focused to data and avoid nihilistic tendencies that build during bear phases. Expected returns are higher than they were last year. Inflation is waning, and central banks are about to call time on policy tightening. Recessionary risks are rising, yet margins appear to be stabilising.