Concentrated Global Growth

Market Overview

The notable fact about the first quarter was the robust global equity market performance outside of the financials sector. Much of the volatility was introduced in the last month of the quarter, as the government rescue of Silicon Valley Bank (SVB) deposit holders led to fears about broader contagion across the banking system and investors' growing concern about Credit Suisse led to its acquisition by UBS with guarantees from the Swiss government.

By the end of the quarter, the immediate volatility had subsided, but investor concerns were higher around whether something was finally breaking after a rapid series of central bank rate hikes. It's worth recalling that the first quarter started on a fairly positive note, with many strong economic news stories in January helping markets to rebound after a challenging 2022. For instance, European natural gas prices fell by 24% over January, which helped to allay fears about a potential recession. That was echoed among various sentiment indicators, with consumer confidence rising to its highest level in months. Meanwhile in China, the economy's reopening continued and restrictions were eased, boosting hopes that global growth would be lifted more broadly. This brighter macro outlook meant that plenty of assets began the year very strongly.

By March, however, concerns about the banking sector drove investors to shift their focus from inflation and interest rates (which had dictated market moves in January and February) to the stability of the global financial system, leading to meaningful volatility in financial markets. So, what happened to SVB and Credit Suisse, and is there more turmoil to come?

For SVB, decisions made around asset-liability management ultimately weakened its balance sheet, and the company's financial position deteriorated further as its highly concentrated customer set within the venture capital ecosystem collectively drew down cash balances as funding inflows slowed. When the bank attempted to shore up its balance sheet through a capital rise, the same customers withdrew their money "en masse" as fear of a bank run took hold within the community, driven by an unwinding of depositor confidence.

In the case of Credit Suisse, the bank had been unprofitable for a number of years as a result of credit decisions such as Greensill and Archegos Capital Management, a finance firm and a hedge fund, respectively. The loss of investor confidence in Credit Suisse was accelerated by an unfortunately timed admission from the bank that it had found material weaknesses in financial reporting processes—leading to UBS and the Swiss government stepping in to put in place an acquisition of the bank.

From what we can see today, we believe that these were isolated and idiosyncratic incidents. Although there may be more casualties among smaller and weaker financial institutions, as confidence remains fragile, the overall health of the global banking system remains robust. On the other hand, one of the second-order effects of recent events will be more cautious lending from banks, leading to lower credit availability and further tightening of financial conditions. The net effect will be a tougher economic environment in the months ahead of us.

Portfolio Performance

The first quarter of 2023 saw the Concentrated Global Growth Portfolio increase in absolute terms but, both gross and net of fees, lagged the MSCI World Index's return of 7.7%. (All returns in US-dollar terms.) Although the year started strongly with a return to risk assets, the spectre of higher rates and a banking crisis took some of the shine off equity performance. Sector performance has diverged meaningfully in the MSCI World, with technology, communication services and consumer discretionary all posting strong double-digit returns for the quarter. Unsurprisingly, financials was among the weaker sectors for the quarter, joined by healthcare and energy. On a regional basis, quarterly returns in Europe were better than in the US, although performance gains did not extend into March, as mega-cap technology companies

staged a strong monthly rally. Part of the market's reaction to the turmoil in March was a flight to safety in large tech names, which hurt our relative performance given our underweight to big tech.

During the quarter, the biggest detractors from absolute performance were Charles Schwab, Recruit Holdings and Abbott Laboratories. Schwab, the US financial-services provider, has been caught up in the recent financial sector difficulties because of its bank, which holds client cash deposits and is matched by a substantial bond portfolio. Unlike the troubled banks mentioned above, Schwab sees client cash deposit drawdowns not because of a loss of confidence in the bank, but because of client reallocations to equities, bonds, money market funds and CDs seeing higher returns than they can find in bank interest rates. This happens every cycle, and Schwab anticipated the move but likely underestimated the magnitude—partly a result of the speed and ultimate level of the Fed hiking cycle.

The meaningful decline in Schwab's share price reflects the market's concern that if all of Schwab's client deposits ($503 billion) were moved to higher-return assets, how would Schwab fund it, and what would the earnings impact be? The market is playing a "what if" game, with the potential outcome being its tangible equity facing elimination if the company was forced to sell its entire bond portfolio today. But that is not the reality. Schwab has 34 million client accounts, and those customers don't move all together at the same time. The company has seen clients move to higher-yielding vehicles for some time, so we are likely later in the game than most assume. There are multiple funding sources (Federal Home Loan Banks, CDs and the new Bank Term Funding Program), so Schwab shouldn't have to liquidate its bond portfolio. Schwab's portfolio throws off income each year to fund withdrawals. Finally, clients continue to bring assets to the company, and based on disclosures through mid-March, inflows have accelerated. So, we think the reaction is overdone.

What resolves this for Schwab? We believe that rates and time are the keys. As the economy slows and the Fed either stops raising rates or maybe even lowers rates, the bond portfolio losses will likely lessen. Likewise, with rates stabilizing, there is not an incremental incentive to pull more cash from the bank and place it elsewhere. Time should be Schwab's friend, as its bond portfolio will mature at par (or full value) given that the firm is invested largely in government securities and not taking on credit risk. This means the mark-to-market portfolio losses ultimately go away and the equity impairment fear is erased. Time also helps Schwab on the asset gathering side, as the company has historically grown client assets around 6% annually, which should stabilize the bank cash outflow fear as some new assets will likely go to the bank. Lastly, time should allow Schwab to build incremental equity capital, which provides a further buffer should the company have to liquidate some of its bond portfolio for an unforeseen reason. Unfortunately, neither rates nor time will happen tomorrow. Although we believe that perception will be dramatically different this summer, we will likely have to endure concerns until then. Of course, further aggressive rate hikes by the Fed would exacerbate the current stress.

One final note on earnings: as Schwab borrows from some of the funding sources mentioned above, the firm carries a higher interest rate than the underlying bond portfolio, and therefore incurs a negative rate spread, which hurts short-term earnings. So, the more cash that leaves the bank over the next few months, the worse near-term earnings will be. This doesn't affect the long-term earnings potential, but creates near-term uncertainty that no one can model with precision—hence the continued weakness in the stock.

Turning to other detractors within the quarter, Recruit Holdings is based in Japan and provides online staffing resources, including the website Indeed. Third-quarter results missed against profit expectations and fears of a longer slowdown in the jobs market has weighed on the stock. Abbott Laboratories is a diversified US healthcare company that faced further fallout from last year's infant formula recall, as it was revealed that the Federal Trade Commission has submitted a civil investigative demand to the company.

The biggest contributors to absolute performance during the quarter were Microsoft, ASML and SAP. US software giant Microsoft has benefited recently from the flight to large-cap tech, as well as gathering market excitement around artificial intelligence and its potential to power far more effective software solutions for customers. Dutch company ASML produces vital semiconductor manufacturing equipment and is a clear beneficiary of a more benign global growth environment, particularly in China. SAP, a German company that provides enterprise resource planning software, is in the midst of a strategic pivot to selling its services through cloud computing, rather than through traditional licenses. We believe that we are fast approaching the financial payoff for this and the company is guiding to an imminent return to double-digit profit growth.

Portfolio Changes

In terms of position changes in the Portfolio, we added Chinese internet media company Tencent during the quarter. We had previously sold this stock because of increasing concerns about the Chinese regulatory environment, but after a steep decline in price and a strong games pipeline, it now offers a much better risk/reward and exposure to the China reopening story. We made one further Portfolio change in our Japanese exposure, selling our position in Recruit Holdings because of longer-term concerns that the job market will begin to slow. We replaced this holding with Keyence, which develops and manufactures sensors and measuring instruments for factory automation. We think Keyence is well positioned to supply these niche products and solutions quickly and reliably despite industry and supply chain challenges, which should continue to mean solid financial reporting.

Outlook

It has been a busy month for Portfolio team members as they headed to China, Paris and Milan for company visits and to get a better sense of what is happening on the ground. In China, we visited Hainan, a duty-free island undergoing strong commercial development, which is backed by supportive central government policy to develop a local free-trade zone. There, we observed robust domestic reopening in action, with certain consumer categories (such as skincare) being particularly sought after. We also sensed a rosier consumer mood compared with Western economies, supported by a benign inflationary environment and pent-up savings. Our trip confirmed our view that China, which is behind the rest of the world in their reopening journey, will likely be one of the scarce sources of growth this year.

As we wrote earlier in this commentary, recent events in the banking sector should lead to tighter financial conditions overall, edging us closer to the point where the economy cools enough to slow down inflation. As we move progressively toward that pivot point, we expect economic conditions will become increasingly difficult. Correspondingly, we have tilted the Portfolio more defensively in preparation for the months ahead. The good news is once we get there, the central banks will have room to pause interest-rate hikes, thus providing a firmer anchor to long-term bonds yields, and by extension the valuation of all other asset classes, including equities. From that point onward, markets will likely refocus on the “E” (earnings) instead of “P/E,” and our Portfolio should be well positioned for outperformance given a differentiated earnings growth profile.

Please don’t hesitate to reach out should you have questions about your account or our views.

Kind regards,

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Please refer to the following legal disclosures.

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