WARNER MATTHEWS
ASSET MANAGEMENT

# Newsletter – Second Quarter 2023

## Tired of saying "We Live in Interesting Times…"

I am leaning on a piece of research I came across during the month to help explain in simple terms what we have witnessed in the banking sector (thanks to John Mauldin). Let us take Silicon Valley Bank (SVB) as our example: - when you deposit money into a bank, you are in effect lending the bank that cash and your deposit appears as a liability on the bank's balance sheet. The bank in turn will lend that deposit onto someone else hoping to make a profit between the cost of funds (the interest it pays to the depositor) and the interest it receives on the loans it makes. These loans are the backbone of an economy – from small business loans, to mortgages, credit cards and auto loans to name a few, but the bank also loans the government by purchasing securities (Treasuries and Gilts). They don't yield as much but are much lower risk (but not zero risk).

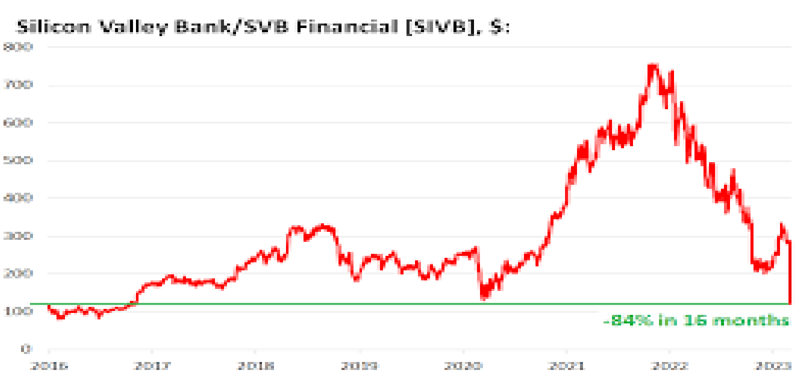
The issue with SVB was one of duration risk – their deposit base (which was made up of tech entrepreneurs) can demand the cash at any time, whereas the bank is not always able to call in its loans. In normal times, depositors will leave their deposits in place, but that's not always a given. Depositors in SVB were a narrow set of firms that had benefited from an era of cheap money. This source of funding was "parked" at SVB until required for investment in expansion or working capital needs. When these depositors decided they no longer trusted SVB with their deposits, SVB were unable to furnish all their requests. Why you may ask? Because SVB had invested a bulk of these deposits into bonds and mortgage backed securities when rates were close to zero. Fast forward a year or two, when interest rates had spiked (and bond values have fallen) the book of loans that SVB hoped to make a profit on were now sitting on significant losses. The decision to sell some of these loans at a loss precipitated a panic amongst the financial community which in turn created a classic run on the bank. As a result, the regulator (FDIC) had to jump in and backstop all deposits to avoid more turmoil.

Hope Springs Eternal

Seems apt given the cherry blossom is in full bloom and, despite the current set of unprecedented events, the phrase in an Alexander Pope poem from 1734 is as relevant today as it was almost 300 years ago!

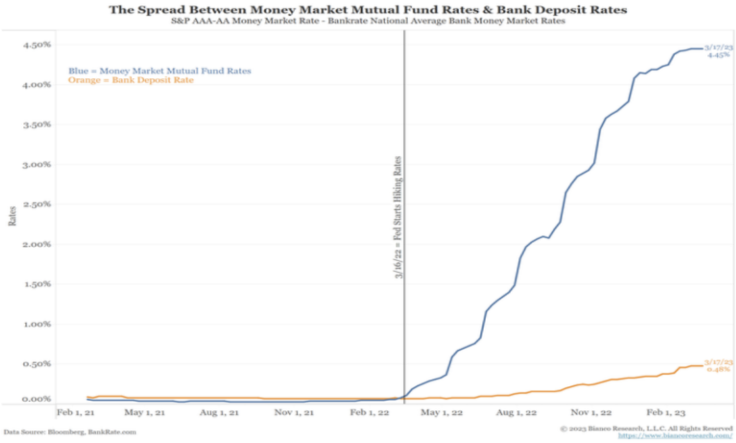
With that in mind, I searched the internet for songs with Spring in their title and only 3 emerged………settling on anything Spring related the options were more plentiful but more unusual in this scribes' views, so to play it safe I opted for a timeless classic which warms even the coldest of hearts….Here Comes The Sun by the Beatles

**Silicon Valley Bank share price collapse – the rise and fall**




Did the regulators fail to address this issue? The stress tests created by the regulator (that are applied to banks to see how they are managed) were still using interest rates that were well below the current rate, so it bore no relationship to today's backdrop. Additionally, the level of insured vs uninsured deposits had grown exponentially, in SVB's case uninsured deposits equated to 94% of total deposits, so SVB's management and the regulator appeared to overlook the fragility in their deposit profile.

## How to find a safe home....

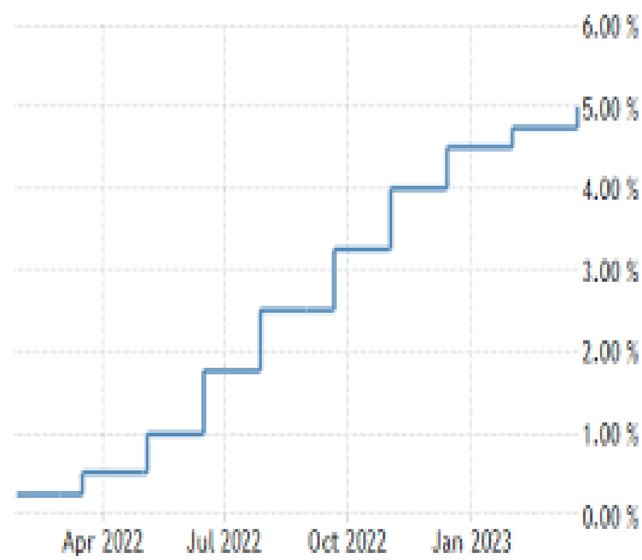



In this environment, depositors went searching for safe havens, and the prime beneficiary were a particular type of low-risk bond funds – Money Market funds. These funds hold a basket of safe, short-term bonds issued by governments and companies that mature within 12 months. They typically offer higher rates of interest (see the chart below which shows the difference between money market fund yields and bank deposit rates). However, they are not risk-free, so the values of these funds can fall and investors need to consider liquidity risk. This occurred during Covid-19 when investors tried to redeem their money market investments, but the managers of these funds were unable to meet these requests as they were unable to liquidate the underlying holdings in such an unusual environment. Gold was another asset that proved its mettle during the last quarter, posting solid gains. Although things have subsequently calmed down, the issue of higher interest rates is that it increases the probability that borrowers are unable to meet their repayment schedule or roll over their loans once they mature. This may be a prevailing issue in 2023.

## THE RISKS OF RISING RATES INTO A SLOWDOWN

Central banks are continuing with the auto-pilot rake hikes each month, despite the persistency of inflation. Even with the fragility of the banking system coming to light, Central Bank heads are now hostage to previous communications that inflation must be tamed at all costs. If western economies are heading for recession, could it have been an avoidable situation? From a technical perspective short-term Government bond yields are still higher than their long-term counterparts, that is unusual. In 2011, the then head of the European Central Bank, Claude Trichet, hiked rates twice in quick succession just as the European bloc was enjoying a nascent recovery from the Global Financial Crisis. These rate hikes created a Euro centric sovereign debt crisis which pushed the European Union's recovery further out. Is it therefore time for Central Banks to have more confidence in doing less if the situation demands it – public opinion appears to suggest so.

US FED FUNDS RATE





## SHRINKAGE
## IN ALL ASPECTS ASIDE FROM MY WAISTLINE...

I couldn't help but notice not only the price increase in my children's Easter Eggs, but also the tell-tale signs that the Eggs had shrunk. This observation was backed up by an article I read about "shrinkflation", where the price of a product rises whilst the product shrinks in size. The article highlighted that the cost of a Cadbury's Dairy Milk Chocolate Buttons Egg had risen 25% year-on-year, yet the weight had reduced almost 25%. This is good for investors in consumer staples companies that have pricing power and innovative profit margin dark art manoeuvres, but less good on the consumer. Even with the shrinkage in the amount of chocolate, it doesn't appear to have positively impacted my waistline...

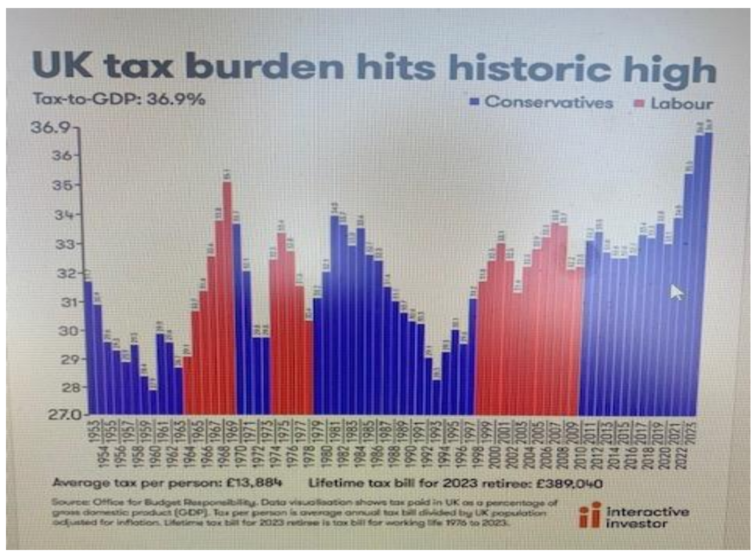
## DOLLAR DOMINATION AT RISK?

Given all the hoopla surrounding the global banking system, a largely unnoticed geo-political event took place last month which may have serious implications.  Iran and Saudi Arabia held their first high level talks in over 7 years, brokered by Chinese officials, to restore diplomatic relations. The two countries had vied for dominance in the Middle East and had been on opposing sides of the civil wars in Yemen and Syria. The negotiations were seen as a diplomatic coup for Xi Jingping, the Chinese leader, as well as a blow to the US influence in the Middle East. Will this be seen as a precursor for a change in the US dollar's status as the world's reserve currency?

There are already plans in the making to create alternatives; in South America they are working on a common currency (Sur). The Chinese have been imposing their influence across Asia and beyond, and the first non-US dollar oil contract occurred when China purchased oil out of Dubai earlier this year. That said, it is undeniable that the US dollar remains unrivalled. There is $2 trillion in notes in circulation outside the US. In many countries, the US dollar usage far outweighs the local currency. Almost 40% of the world's debt is issued in dollars. This means the US is often the lender of last resort. During the pandemic, the US Fed ensured that dollars were readily available for other Central Banks, thus tempering a volatile situation in financial markets. Most importantly, around 40% of global trade is invoiced in the greenback. Put simply, there just isn't the scope for a replacement - maybe one day the younger generation will be able to usurp the US dollar with a crypto currency or something of similar ilk, but for now this seems like a pipe dream.

## GENERATIONAL SHIFTS IN INCOME …

I often discuss with my father what it was like growing up in post-war England. He vividly recalls rationing and the lack of food items which we consider necessities in today's world. His generation were, however, the ones that benefited from the extraordinary house price inflation. Average house prices have increased almost 6-fold since the 1950s, and pockets in the South East have seen even more dramatic. Average incomes have also risen sharply, up over 366%. However, the average tax paid has risen even more sharply, up almost 500% since 1953. Tax take as a percentage of average income now sits at 41%, up from 32% in 1953. As you can see from the chart, tax as a percentage of GDP has now risen to all-time highs, and anyone thinking that the Conservative Party are the Party of low taxes will have to think again!




So how to make sense of the dialogue with my father? It is clear that rising salaries and low house prices in the 1950s and 1960s meant there was a boom in home ownership. Fast forward to today and home ownership is fast becoming out of reach to Generation Z. Coupled with rising tax rates and interest rates and stagnating wages, the gap between those that have (assets such as homes and investments) and those that don't, may become a societal issue that cannot be ignored.