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Quarterly Commentary Q1 2023

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The disappointing underperformance in the first quarter of 2023 is attributable, almost entirely, to the air pocket which hit capital markets in March with the bank run on Silicon Valley Bank as well as a small number of other challenged institutions (notably Credit Suisse). A critical issue is whether the current banking “crisis” is systemic, or alternatively an isolated event, and therefore more of a storm in a tea cup. The background context to all of this is a change in policy setting on both the fiscal and monetary fronts, as authorities around the world try to row back some of their remarkable monetary indulgence that occurred during the Covid period of 2020-2022. This has ushered in a period of Government spending restraint (relative to the Covid era) and tighter money. Because investors are expressing confidence that this period will be relatively short in duration and that the policies will be successful, i.e. constrain inflation and lead to reduced interest rates, there has been renewed interest in growth stocks and a retreat from cyclicals and especially financials. Paradoxically therefore policy tightening is producing lower not higher interest rates, and increased investor expectations of a recession. For value investors (most value stocks are to a degree cyclical) this has been a painful combination, resulting in a performance double whammy at the hands of Mr Market in the form of dampened earnings expectations to which a lower rating is applied. Uncertainty at present is at very high levels but not it would seem about confidence in the competence of Central Bankers, belief in the inevitability (or desirability) of lower interest rates and high probability of imminent recession this year. At Hosking Partners we have serious doubts regarding all three of these market convictions.

The heart of Q1 underperformance lies not in the portfolio’s underweight to the USA, although that is what the attribution analysis appears to show. The broader US index performance matched that of the ACWI benchmark, despite (or because of) the fact that it is American macro-economic data points which dominate the investor discourse globally. As already mentioned, investors interpreted the Federal Reserve’s sequential raising of interest rates as “bullish”, i.e. bringing forward the inflection points both in inflation and the interest rate trend. It was the stock market rotation associated with this view which adversely affected portfolio returns on a mark-to-market basis, with financial stocks lagging and growth stocks recovering, especially in the technology-related sectors.

The IT sector actually rose around 21% in US dollar terms in the three months, well ahead of the c. 7% benchmark return (US dollar terms). With the portfolio's exposure materially below the benchmark weighting of the industry as at quarter end, this was a major aspect of the portfolio's overall underperformance. Meanwhile, in the Financials sector, there was a literal inversion of the IT sector's experience. The portfolio is overweight to Financials and they underperformed significantly. In summary, the overweight to Financials and underweight to IT, considered together, produced well over 100% of the portfolio's relative underperformance.

Elsewhere however there were encouraging signs as to how some portfolio bets are likely to evolve. In Japan for example, where purchases have been made over the last 12 months, an edict has emanated from the Tokyo Stock Exchange (TSE). This is that all modestly valued companies should provide plans to their shareholders about how they will achieve an upward revaluation, specifically a premium to book value (as a first step). Given that 40% of Japanese firms' shares presently trade below book value (the result of massive overcapitalization) there are plenty of targets for the TSE, and value investors, to aim at! The likely initiatives will centre around share buybacks to improve return on equity. These are already running at record highs and seem bound to accelerate further. It is hard to imagine a clearer clarion call for a significant shift to value investment outperformance in Japan. Also in Emerging Markets, additions were made in the quarter to the portfolio's exposure to Sri Lanka which last year became engulfed in a financial crisis. This has now been stabilized thanks to loan agreements and economic reforms agreed by the country with the IMF and other creditors such as India and China. The scene is set for a multi-year recovery that will benefit equity valuations significantly. The economic upturn will probably be led by tourism which has had four shaky years consecutively. This year two million tourists are expected to arrive in Sri Lanka, still a huge discount to the 27 million visitors expected in Thailand. With the portfolio having a ten-year holding period on average, we are always on the look-out for investment opportunities which have an extended runway but high potential pay-offs.

In contrast several of the portfolio's other bets had a more limited impact. The overweight exposure to Emerging Markets was only slightly negative, and the outlook here remains positive relative to Developed Markets. The overweight to the Materials sector was a negative due to investors' fears about imminent recession but this was more than offset by underweight to Healthcare which continued to struggle relative to the benchmark. At the stock-picking level individual contributions, positive and negative conformed to the patterns highlighted above. Of the ten greatest share price 'attribution' losses, four were Financials, and no fewer than five were IT underweights.

On the basis that capital markets have an enduring capacity to act as investors least expect, it is worth revisiting the current paradox between high overall levels of uncertainty and investors' conviction in certain outcomes. Firstly, there has been investor conviction that recession is imminent, hence the underperformance of cyclical shares and sectors. In support of this contention is the weakness in the monetary aggregates underpinned by varying degrees of commitment to quantitative tightening. The question is whether this is offset by the low level of real interest rates and the fact that the world economy has considerable bounceback potential as a result of Covid-affected activity in the years from 2020-2022. The degree to which the March (still evolving) banking crisis has resolved this question cannot yet be determined and will depend partly on whether the (bizarre) business strategies of the Silicon Valley Bank were indicative of systemic or idiosyncratic failure.

A second conviction was highlighted during the current quarter in the use by commentators of the phrase 'the Fed pivot', which held that recent macro-economic data justified a near-term peak in the interest rate cycle. Clearly there is a link here to the earlier recession thesis, the only problem being that there is, as yet, no sign of recession and little indication thus far that inflation has peaked. Underpinning both convictions is a remarkable confidence in the competence of actual bankers and that low interest rates are the outcome to be wished for. In the UK there is a special insight into the dissonance inherent in this thought in that the present Governor of the Bank of England blames the

country's 11% inflation rate (which is more than 5x the targeted level) on everyone except his institution's monetary policies of the last five years.

Perhaps just as probable is a counter-thesis to the consensus which, as a result, could well prove to be wrong on all three counts. We would suggest that it is still plausible to advocate that central banks are "behind the curve", that inflation will remain stubbornly above target and that interest rates will continue to be raised, possibly after a near-term plateau. In addition, developed economies may remain resiliently immune to the expected recession as Covid recovery offsets any dampening effects of higher nominal interest rates. Germane to whether the thesis or counter-thesis is the more probable is the emergent March banking "crisis". It seems difficult to argue that Silicon Valley Bank was an exemplar for the wider banking sector any more than Credit Suisse was a role model for investment-bank managers – which does not rule out the possibility (or likelihood) of further "accidents" down the road which nevertheless prove to be non-systemic. There is, of course, the delicious irony that the Achilles heel of the banks is now the safer securities (government bonds) they were forced to buy by the regulators, and not (so far at least) risky loans to over-excited private sector borrowers. In any event, the authorities have acted (or overreacted) as if the crisis is systemic (removal of the deposit issuance cap etc.) which must reduce the probability of that outcome.

Thus, it is far too soon, in the opinion of Hosking Partners, and on the basis of one month of relative stock market moves, to conclude that a widely diversified portfolio of undervalued and underowned securities is an inappropriate or unwise portfolio, even in the light of the first quarter's performance. The likelihood is that the world economy continues to exhibit signs of life even in a context of higher interest rates, that concerns about the banking system subside and that the global equity portfolio described herein more than recovers the relative performance ground that was lost in the present quarter.

If this note reads as a little frustrated, that would reflect the mood of the writer. It is not a pleasant emotion but it does recall feelings as we neared the end of the TMT bubble and navigated various ‘false dawns’. The game of snakes and ladders we played for those months gave way to a period for the capital cycle investor which would fit under the ‘halcyon’ heading. Spring is an exciting time….

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