



Wealth
Management US

Quarterly report

Q1 2023 market review



| Forward-looking
for generations

Contents

- 4 Q1 2023 summary
- 6 Macro summary
- 8 Fixed income
- 12 Equities
- 15 Key market data



Cover image

Bauer brothers, Hortus Botanicus, detail from
"Lilium," 1776/1804

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The big news event of the first quarter came in March when the collapse of Silicon Valley Bank (SVB) highlighted the problems and dangers of aggressive rate hikes.

Sanjay Rijhsinghani, Chief Investment Officer LGT Wealth Management

Q1 2023 summary

Over the course of the first quarter, strong global economic and labour data ensured that the Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of England (BoE) all maintained their restrictive policy, announcing two interest rate hikes each. However, despite this hawkish stance, the quarter saw both bonds and equities* eke out low-to-mid-single digit gains.

*(as measured by the MSCI All Country World Index and the Global Corporate Bond Index respectively)

At a glance

- Bonds and equities made a positive start to the year.
- Central banks continued to raise rates.
- Inflation remains elevated with resilient labour markets.
- Bank failures may force a pause in the hiking cycle.
- Dollar weakens, lifting most other currencies.

Macro summary

The first quarter of the year was not without volatility and market moving events. After data pointed towards a softening of prices in January markets, both fixed income and equities started the year strongly in the hope that the end of the tightening cycle was in sight. However, surprisingly strong growth and labour data in February (with the falling of natural gas prices helping Europe, and the re-opening of China post-COVID providing a boost) put aside any hope that central banks were done with their tightening. The strong labour market pointed to unemployment rates moving below their pre-pandemic levels for many of the world economies. As a result, the broad message that price pressures remain too high continues to be the core focus of major central banks. The market had to reassess where rates would peak and push back any hope that rates may be cut on the back of a recession.

Strong economic data was not restricted to just the Western economies. China's re-opening post the abandonment of their 'zero-COVID policy' resulted in a strong pick-up in activity, helping not only the domestic economy, but also boosting growth in Europe and Asia. However, geopolitical tensions between China and the West continue to impact investor sentiment in the region.

It would be naïve of us to think that one of the fastest and most aggressive rate hiking cycles in history would not result in some 'casualties'. Whilst we saw a dramatic fall in the prices of all cryptocurrencies, the big news event of the first quarter came in March when the collapse of Silicon Valley Bank (SVB) highlighted the dangers of aggressive rate hikes. Whilst the problems at SVB were unlike those witnessed during the banking crisis of 2007/08, there were concerns surrounding contagion. Fortunately, swift central bank action across the developed markets ensured the problem was contained, with all deposit holders being guaranteed access to their money.

SVB was not the only high-profile banking failure during March. We also saw the collapse of the 167-year-old Swiss banking giant Credit Suisse. Its problems have been well-flagged for a few years. Once again, the Swiss National Bank was quick to take action and calm markets by 'orchestrating' a takeover of Credit Suisse by UBS. However, this came at the expense of subordinated bondholders who were wiped out in the process.



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Looking forward, the recent woes in the banking sector will leave central banks with a tough decision on their pace of rate rises. There is every reason to believe that banks will now impose tighter capital conditions, which may equate to a further percentage point of rate hikes as lending standards are increased. As a result, we may be coming to the end of this tightening cycle, with maybe one more rate rise in May before we see a pause by central banks.

Whilst every cycle is different, and this one more so because of the pandemic, we do expect to see the impact of higher rates in coming quarters. The 'lag' can at times be long and, with some 14 months since the first-rate hike, we expect economic activity and pricing pressures to abate towards the end of this year.

Fixed income

In many ways, the old adage attributed to Mark Twain that “History does not repeat itself, but it often rhymes” feels rather appropriate this quarter. The inflationary backdrop that followed the pandemic led to many investors seeking historical comparisons.

Looking back to history

The pandemic goods boom is sometimes compared to the economic repurposing that occurred in the periods surrounding the Second World War. While this historical comparison may be useful in helping us understand the higher goods prices we faced, one could question the validity of this claim given that society has broadly moved away from goods (car, home improvements) towards services (restaurants, holidays, etc.)

The various energy crises that the world faced in the 1970s pushed inflation higher for a prolonged period. The acute crisis was driven by geopolitical events pushing raw energy costs higher. As the population experienced interest rate rises as a result, and their real incomes squeezed, this led to more industrial action by unions and a wage price spiral. Given this backdrop, central banks pushed bank rates up into double digit territory to quell demand and bring the economy into better balance. This resulted in the deepest yield curve inversion in history i.e. short-dated government bond yields reached higher than longer-dated yields, causing havoc to the US banking system and ultimately culminating in the Savings and Loan (S&L) crisis.

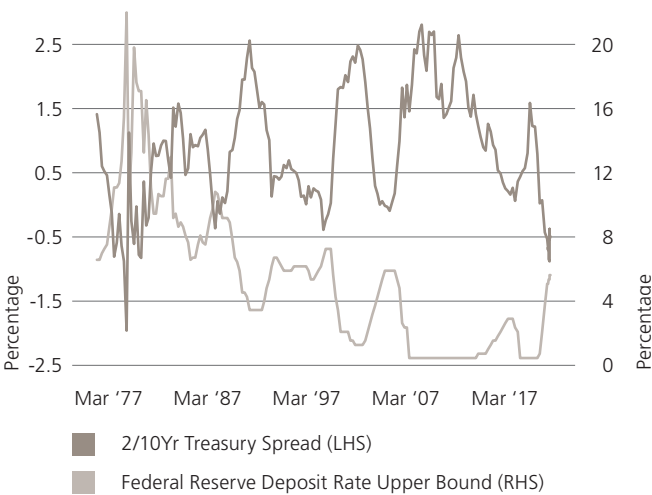
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As the economy showed signs of resilience, we saw investors price in more rate hikes by central banks.

Jeremy Sterngold, Deputy CIO LGT Wealth Management

Same script, different cast?

The events that unfolded over the last quarter bear a striking similarity to those of the 1970-80s. As the economy showed signs of resilience, we saw investors price in more rate hikes by central banks. This was further amplified by signs that inflation may remain stickier than previously anticipated. As a result, the yield inversion moved to its most pronounced level since that period in the early 1980s, when the S&L crisis was starting to unfold.

Yield curve as expressed by the spread between 2yr and 10yr treasuries



Source: Bloomberg, LGT Wealth Management

Banking woes

Back to the present day, it was the combination of the yield inversion and the swift rate hiking cycle that ultimately led to the demise of SVB.

SVB faced a cash crunch while having far too many of its assets invested in interest rate sensitive securities, leading capital to quickly dry up. This spooked investors who feared that bank assets marked as “held to maturity” might be hiding the fact that they could technically be insolvent. The authorities were quick to intervene and protected depositors, but more regionally focused banks in the US now face higher costs and an increasing regulatory burden as result.

Concerned depositors quickly reassessed other banks that might be prone to such failures. Given the tarnished reputation of Credit Suisse (CS), its depositors gave the bank no time to see its restructuring plan through and continued to pull funds at a swift pace. As a result, the Swiss authorities felt obliged to intervene, forcing a shotgun style wedding with UBS. This also left a sour taste for deeply subordinated bondholders in CS, as they were wiped out and saw equity holders prioritised ahead of them. This controversial decision has increased broader financing costs for the banking sector.

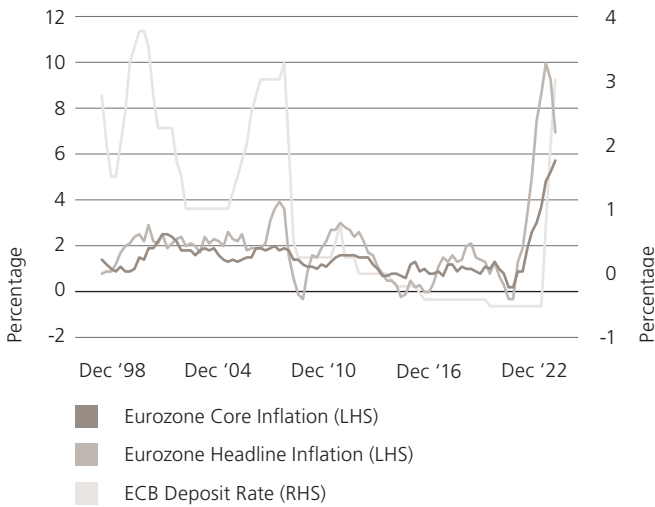


Central bank activity

Prior to these bank failures, lending surveys across the US and the Eurozone already showed a tightening in standards. Given that financial conditions are arguably much tighter in the wake of recent events, central banks are likely to become more reactive to incoming data than sticking to a pre-set course. Even though the major central banks did hike, with the ECB, Fed and BoE raising rates by 0.5%, 0.25% and 0.25% respectively, their tone was much softer. This shows that they are not only waiting to see the size of the impact these bank failures had, but also that they are wary of stoking the flames further by quickly changing tack.

For the ECB, the problem is more acute as core inflationary pressures in the Eurozone continue to rise to record levels, despite cooling headline pressures. However, by quickly abandoning negative interest rates and moving rates to levels last seen in 2008, it is having a pronounced impact on both residential and commercial real estate prices. Of all the central banks, the balance between price stability and financial stability is the most challenging for the ECB. In terms of the Fed and BoE, we are likely to see either modest increases or even a pausing of the hiking cycle. Given that inflation remains well above target, the bar to cut rates later this year remains relatively high so far.

Eurozone Core Inflation vs Headline vs ECB deposit rate going back to 1998



Source: Bloomberg, LGT Wealth Management

Corporate bonds started the quarter on a strong footing, but saw credit spreads reverse as the banking woes unfolded. Subordinated debt faced the most material repricing in the aftermath of bailing in CS Additional Tier One debt holders. However, towards the end of quarter, subordinated bonds recovered as both the European Banking Authority and the BoE came out criticising the Swiss decision to prioritise equity holders over bond holders.



Equities

International Equities

Most equity markets started the year on a positive note, before running out of steam late February/early March and then catching a second wind over the last few weeks of the quarter. After a torrid time throughout much of 2022, growth stocks did far better than their value counterparts in the first quarter of 2023. The technology-heavy Nasdaq Index in the US was able to rise 20%. However, to put this into context, it remains 20% below the peak it reached in November 2021.

The S&P 500 in the US was up 7% with the consumer discretionary sector leading the way (up 16%) as online shopping giant Amazon rose 23%, adding \$200bn to its market capitalisation. It was, however, very much not a case of a rising tide lifting all boats. The S&P financials sector fell 6% despite solid earnings and little pick up in reserving for non-performing loans. This suggests bank management did not see many signs of economic weakness. Instead, three US banks falling into bankruptcy in short order took the whole sector down. Investors worried whether the world’s first bank run in the era of social media would feed into others, and whether this would affect the Fed’s tightening path. The defensive consumers staples sector was flat, even with such uncertainty, as quarterly earnings showed double digit price increases driving volumes down pretty much across the board.

Over in Europe, the French CAC Index beat the German Dax Index with a 13% return, vs. 12%. Handbags trumped cars with Louis Vuitton Moët Hennessy (LVMH) up nearly a quarter compared to ‘just’ 15% for Mercedes-Benz.

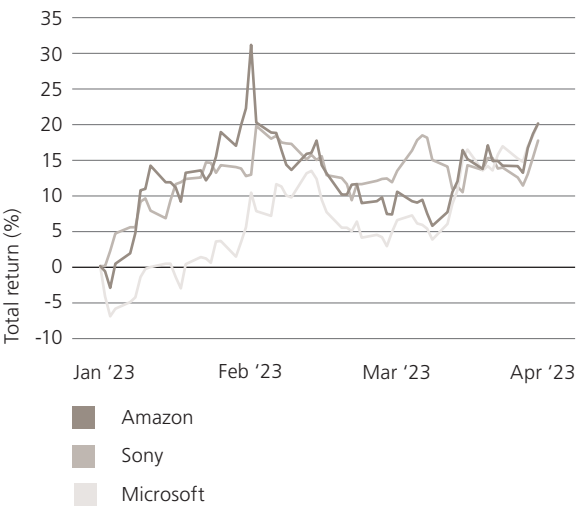
The Japanese Topix Index for once kept pace with the US by rising 7%, driven of course by the electrical appliances sector which was up 16%. Indeed, one-time Walkman maker Sony joined another 1980s

bellwether, Microsoft, in putting a fifth on its market cap.

It was something of a surprise that even after dismantling its zero-COVID strategy overnight in Q1, China didn’t lead the way amongst equity markets. Though 6% and 5% returns for the Shanghai and Shenzhen stock markets are certainly not to be sniffed at. The fact that Credit Suisse’s demise didn’t stop the Swiss market index rising 4% reflects how much it had already fallen (its market cap was only CHF11bn at the start of 2023) and that there are plenty of other world class Swiss companies around. Plus, its ‘saviour’ UBS, rose 12%.

The MSCI emerging markets only adding 4% shows that it is not always a truism that they do well when it’s ‘risk on’.

Amazon, Sony and Microsoft quarter to date performance



Source: Bloomberg, LGT Wealth Management

UK Equities

The FTSE 100 Index managed to deliver a total return of 3.6% over the first quarter of 2023. However, the journey was far from smooth. Initially, the gain was prompted by renewed optimism on the outlook for the global economy. However, as financial sector woes took centre stage, the FTSE gave up some of its gains witnessed in January and February.

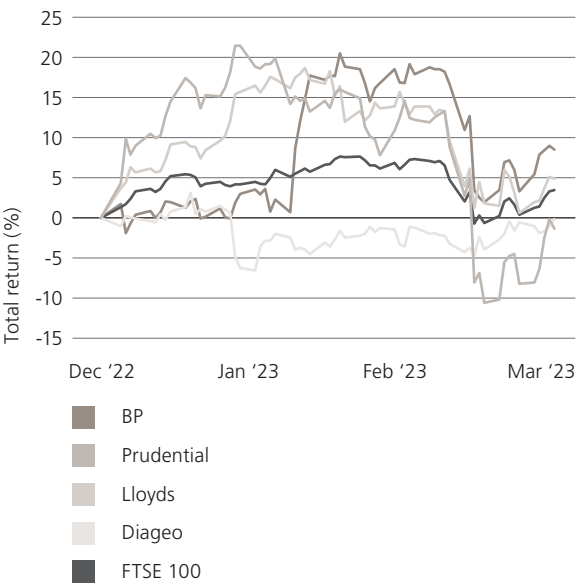
The global and cyclical nature of the FTSE meant that it was particularly susceptible to changes in global risk appetite. The high components of banking and financial services in the index saw it fall out of favour given investor nervousness following the revelation of solvency problems at SVB in the US and Credit Suisse in Switzerland. This impacted financial stocks such as Prudential, Phoenix and Lloyds Bank. However, there was a small relief rally in such names as the quarter came to a close. Nonetheless, despite a positive total return, it lagged the broader global index.

London-listed stocks have been unloved by the all-important global investors since the Brexit vote in mid-2016. The extent of the valuation discount to leading stock markets (like the US) increases the probability that businesses located outside of the UK could be attracted to the acquisition opportunities afforded by the combination of share price weakness, and the longer-term decline in the pound. There was no related surge in takeover activity over the course of the quarter, but we remain of the view that investors should be alert to the possibility that lowly rated UK sector leaders will be subject to predatory interest. The recent strength in the pound may have its roots in positive political developments on key issues. These include the Northern Ireland breakthrough and progress on industrial action.

In more general terms, we remain highly selective, and continue to place emphasis on the FTSE 100

Index rather than the more domestically orientated FTSE 250 mid-cap Index. Over the last 18 months, the BoE’s Monetary Policy Committee (MPC) has delivered the fastest rise in UK interest rates since the early 1980s. A mild winter may have eased some of the UK’s energy bill concerns, but there is little doubt that the spending power of UK-based consumers has been curtailed by mortgage rate rises and squeezed real incomes. This reinforces our preference for more global orientated businesses and our caution towards UK retail.

Total return of BP, Prudential, Lloyds, Diageo and FTSE 100 Index



Source: Bloomberg, LGT Wealth Management



Key market data

Key market data (as at 31 March 2023)

Asset class	Level	1m %	3m %	6m %	1y %	3y %	5y %	YTD %
Equity indices (total return) *								
FTSE All-Share (GBP)	4158	-3.41	2.03	10.48	-0.71	33.80	6.77	2.03
S&P 500 (USD)	4109	3.51	7.03	14.61	-9.29	58.99	55.60	7.03
Euro Stoxx 50 (EUR)	4315	1.81	13.74	30.04	10.57	54.83	28.37	13.74
Nikkei 225 (JPY)	28041	2.17	7.46	8.11	0.79	48.23	30.70	7.46
MSCI World (USD)	2174	2.56	7.58	15.73	-4.98	61.36	57.39	7.58
MSCI AC Asia Pacific ex Japan (USD)	612	2.43	4.52	13.42	-3.70	31.47	16.69	4.52
MSCI Emerging Markets (USD)	59416	2.20	3.84	10.76	-6.23	30.18	12.08	3.84
10 year bond yields **								
UK	3.49	-0.34	-0.18	-0.60	1.88	3.13	2.14	-0.18
US	3.47	-0.45	-0.40	-0.36	1.13	2.80	0.73	-0.40
Germany	2.29	-0.36	-0.28	0.18	1.74	2.76	1.79	-0.28
Japan	0.35	-0.16	-0.07	0.11	0.13	0.33	0.30	-0.07
Commodities (USD)								
Gold	1969	7.14	8.20	18.44	1.02	24.35	48.85	8.20
Oil	79.77	-5.38	-2.84	-10.23	-26.08	250.79	13.52	-2.84
Currency								
GBP-USD	1.24	2.13	2.79	10.76	-6.09	-0.28	-11.86	2.79
GBP-EUR	1.14	-0.31	0.97	-0.12	-3.83	0.71	-0.22	0.97
EUR-USD	1.09	2.45	1.80	10.90	-2.35	-0.98	-11.66	1.80
USD-JPY	133.09	-2.29	0.87	-8.05	9.65	23.28	25.14	0.87

Source: Bloomberg, ICE, London Stock Exchange, MSCI, Standard & Poor's, Stoxx Tokyo Stock Exchange

* Performance is given on total return indices, but the levels are for the main indices.

** Displayed as absolute changes in yields, rather than percentages.

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Despite central banks all maintaining their restrictive policies, announcing two interest rate hikes each, the quarter saw both bonds and equities eke out low-to-mid-single digit gains.

Sanjay Rijhsinghani, Chief Investment Officer LGT Wealth Management

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