Capicura Partners – Outlook 2nd Quarter 2023

March 30, 2023

Banking crisis has a disinflationary effect

- ***Tighter credit conditions due to banking crisis leads to economic slowdown***
- ***US Federal Reserve may refrain from further rate hikes but monitors data closely***
- ***Market again too optimistic about first rate cuts - likely to be disappointed***
- ***Probability of recession increased - inflation remains a problem - equity market valuations too high***
- ***Hold on to cautious asset allocation***

Investor focus on the debate of "hard, soft or no landing", which had dominated much of the first quarter, was shifted overnight by the closure of Silicon Valley Bank and the problems among other US regional banks. As the financial crisis 2008 lingers at the back of many investors' mind, it is understandable that nervousness is elevated. The fear of a financial crisis 2.0, which was further fanned by the emergency rescue of Credit Suisse and thus found its way to Europe, seems to be on everyones mind. Although banks are better capitalized for regulatory reasons since the financial crisis 2008 and the capital ratios of many institutions are even higher than required, this is currently not helping much. When confidence in an institute wanes, a bank run can quickly arise, even if its capital- and liquidity ratios are sufficient. Moreover, large US and European banks are not only very different in their business models, but are also more strictly regulated than "smaller" US regional banks, including Silicon Valley Bank (lower capital- and no liquidity requirements, no stress tests, etc.).

«Investors must try not to lose their heads»

Today, bank runs happen silently and more subtle. Huge sums are shifted between banks at the "speed of light" via online banking tools and on the push of a button. Pictures of bank runs where savers form a long queue in front of a bank are definitely to be found in history books.

In addition, social media channels can turn into catalysts of bad worrisome news. The crisis of confidence will probably continue for a while and further measures on the part of central banks and finance ministries cannot be ruled out. However, investors are well advised to keep a cool head and not overreact.

«Tighter credit conditions could imply rate hikes of up to 100bp»

We expect the rapid and sharp interest rate hikes of the past twelve months and the current bank confidence crisis to further tighten credit conditions on both sides of the Atlantic (see Fig. 1).

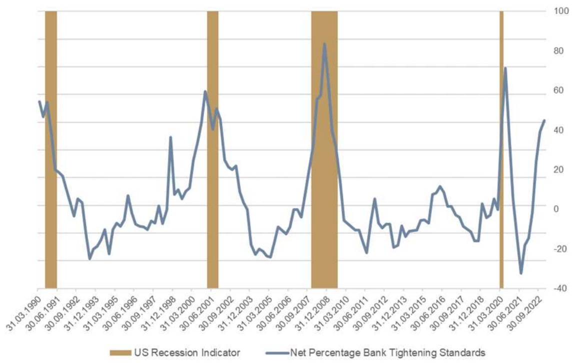

Fig. 1) *Net percentage of domestic U.S. banks tightening their standards for commercial/industrial loans to large and medium-sized businesses. Data: Bloomberg / FRED St. Louis FED / Chart Capicura Partners*

Tighter credit conditions can be compared to an interest rate hike and slow economic growth and have a disinflationary effect. The "impact" of such tightening is difficult to quantify but could be equivalent to an implied rate hike of between 25 and 100bp. The US central bank will therefore be cautious when it comes to further rate hikes and make them more data-dependent (focus on labor market and inflation figures). However, the FED is stuck between a rock and a hard place. It should continue to fight inflation (raise interest rates and continue to reduce the central bank balance sheet) and at the same time is confronted with problems in the banking sector. The latter must not, or should not, get out of hand.

Capicura Partners AG | Dreikönigstrasse 55 | 8002 Zürich | T +41 58 680 12 20 | info@capicura.ch | capicura.ch

What is increasing however, is the probability of a US recession towards the end of 2023. A recession has been "predicted" by the inverse yield curve for some time now (difference 10y/2y Treasury yields).

«Market expects first US interest rate cuts as early as June – it could well be disappointed»

We rule out the possibility that the FED will cut interest rates as early as June, as expected by the market. So on this point we are sticking to the FED rhetoric (see blue dotted line in Fig. 2). In our view, interest rates will only be adjusted downward if the banking crisis spreads further or a recession becomes unavoidable towards the end of the year (supported by weakening macro data and disappointing corporate earnings reports). The market is thus likely to be disappointed once again by the Federal Reserve's expected interest rate path (see Fig. 2 for the development of interest rate expectations).

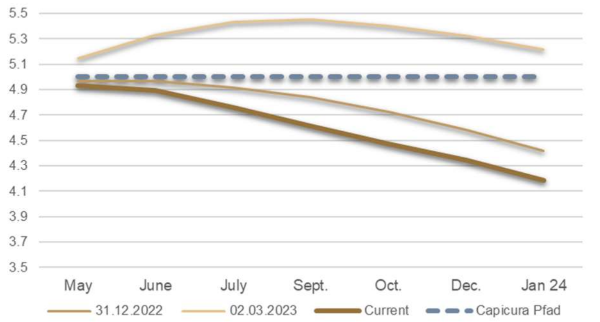

Fig. 2) *Development of interest rate expectations since the end of 2022 (FED Fund Futures). Data Bloomberg, Chart Capicura Partners*

The market expects a further 25bp interest rate hike in Switzerland and an additional 50bp in Europe. But in Europe, the current uncertainties within the banking sector could well mean that the peak in interest rates is near. The narrowing interest rate differential vis-a-vis the USD should provide tailwind for the EUR and limit the upside potential for the Greenback.

«The US government bond market is under great stress»

The world's largest bond market, the market for US government bonds (Treasuries), is under great stress. This is indicated by the MOVE index (see Fig. 3, beige line). The MOVE index measures volatility in the Treasury market and is the counterpart to the VIX (S&P500 volatility index).

Like the VIX, the MOVE index is considered a fear barometer and can be viewed as a contra indicator. We have reached levels in recent days which are rarely observed and even above the COVID highs. This means that many investors are fleeing to safe havens such as US government bonds. However, this can also be an indication that the longer dated yields are overshooting to the downside, creating upside potential for interest rates on the long end of the curve should the dark clouds clear over the banking sector.

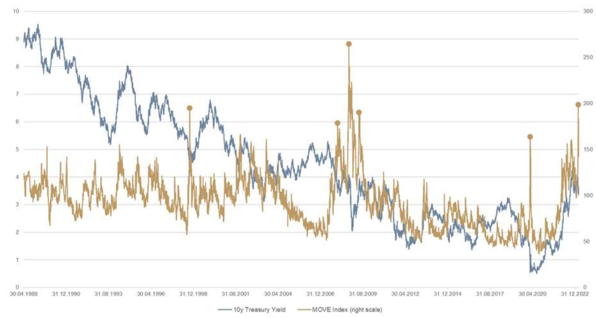

Fig. 3) *Merrill Lynch MOVE Index. Implied volatility for US government bonds, Data Bloomberg / Chart Capicura Partners*

«Increased recession probabilities limit upside for stock markets»

The threat of a recession combined with increased inflation (stagflation), make the still "rich" valued equity markets (especially the USA with P/E ratios for the S&P500 of 18x 2023, 16.4x 2024) vulnerable to corrections. For this reason, we maintain our cautious positioning. We continue to see good investment opportunities in the bond market, which is why this asset class accounts for around 25% in a balanced portfolio. The liquidity cushion gives us the possibility to take advantage of opportunities (also within equity markets if available). In the alternative space, we focus on Gold, REITs (Real Estate Investment Trusts) and Hedge Funds.

Asset Allocation	
Cash	*15%*
Fixed Income	*25%*
Equities	*40%*
Alternative Investments	*20%*

Fig. 4) *Suggested asset allocation for a Balanced Portfolio in Q2 2023*