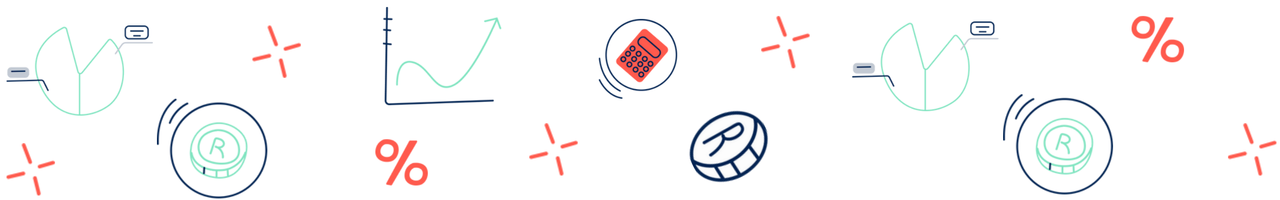
Truffle Asset Management

Economic Commentary
Q1 2023



Global Banking sector under strain

Market volatility continued to run high into March, this time precipitated by a mini yet significant crisis in the banking sector. The failure of two mid-tier US banks (Silicon Valley Bank and Signature Bank), closely followed by Swiss authorities organising the UBS takeover of struggling Credit Suisse brought investor panic and concerns around financial market stability. An immediate market sell-off was subsequently tempered as Central Banks including the US Fed indicated some willingness to provide support to any banks experiencing a deposit run and/or expressed their confidence in the current resilience of major financial systems.

The magnitude and speed of rate hikes have placed a strain on those banks with concentrated deposit books and weaker or smaller balance sheets. In our view, the likelihood of further issues for the sector differs across regions and is dependent on the regional regulatory environment and accounting practice. Banks themselves will also take appropriate precautionary measures to avoid collapse.

US: slowly, slowing down

US banks are more at risk in the current environment with data indicating an outflow from fixed deposits and into money market funds as savers seek higher interest rates and better security. Smaller banks are at even higher risk and worryingly represent a sizable 70% of US commercial real estate funding. As with interest rate hikes, the impact of banks' consequently tightening credit standards to protect capital and strengthen balance sheets will lead to a more restrictive growth environment. Significant US industries such as real estate and private equity which are heavily reliant on cheap credit will continue to come under pressure.

Falling job openings in the US are an additional sign of an economic slowdown ahead, even though the PMI remains in expansionary territory.

From a company earnings perspective, although estimates in the US have come down, they are still high relative to history. The significant tightening of credit conditions and a higher earnings base indicates a significant risk of meaningful earnings downgrades in the US. The chart below highlights this risk showing falling Earnings Per Share (EPS) following a tightening of banking funding to the Commercial and Industrial (C&I) sector.

Europe: supported by regulatory strength and lower gas prices

We expect market pressures on the banking sector in Europe to be less damaging than in the US given a more robust regulatory environment and strong liquidity ratios across European banking institutions. Average liquidity coverage ratios are at 150% vs. the 100% minimum requirement. Swiss regulation is different, and Credit Suisse had known weaknesses in their business model.

Growth in Europe is proving to be resilient despite another 50bps rate hike by the European Central Bank (ECB) in March. Economic data in Europe is still positive and benefitting from lower gas prices and the ECB now expects higher growth and lower inflation this year in their economic projections. It is evident higher rates are yet to impact the economy.

China: propping up global growth?

The surprise opening of the Chinese economy in the fourth quarter of last year continues to support economic growth, however, there is little evidence of increased fixed capital formation which suggests the current growth is more consumer-led. Regulatory easing is also important for sustainable growth and the newly announced Alibaba restructure provides a good indicator of less regulatory pressure in the tech sector. Also positive for China is the continued recovery of consumption and travel, the latter providing support for tourism in other regions including SA.

South Africa: needing power and confidence

The SA economy continues to face significant headwinds. A larger than expected 50bps rate hike implemented in March provided additional pressure on an economy already expected to generate flattish growth for 2023. The current outperformance of oil prices relative to metal prices will place pressure on SA's trade account while SARS potentially missing its Budget target does not bode well for the SA Budget deficit.

The ongoing electricity crisis is not without challenges and while there has been some progress to resolve the issues, much needed implementation of policy to allow for increased privatization of energy supply and generation still appears slow-moving. The Government withdrew the State of Disaster however, there is concern that National Treasury will re-implement an already reversed decision to exempt Eskom from disclosing "Irregular expenditure and fruitless and wasteful expenditure" that occurred during the financial year.

Loadshedding pressures will likely persist for the rest of the year along with low consumer and business confidence. The FNB / BER Consumer Confidence Index for the first quarter of 2023, unfortunately, dropped to its lowest quarterly level since 1993, indicating severe concerns from consumers around SA's economic prospects. Self-provision of renewable energy sources by both consumers and businesses will hopefully improve the outlook for 2024.

Outlook: aggressive cross currents

The risk of a US recession is increasing. We think the impact on US earnings will likely overwhelm slightly lower bond rates and rates should not fall meaningfully at the long end of the curve. The S&P500 was up 7,5% over the first quarter of 2023 supported by strong returns from growth stocks. We believe valuations are too high and therefore expect underperformance of the index from here.

The negative impact of a US credit contraction and sustained higher rates will likely place pressure on the European economy. European stock markets may well underperform as a result, despite current reasonable valuation levels.

The risks to asset prices in the current environment are both complex and significant. The impact of sustained high inflation and high interest rates in major economies is beginning to show. The reopening of China should provide some support to commodities suffering lower demand levels in developed economies while certain cyclical sectors like luxury should be partially protected from a global recession given their exposure to recovering Chinese consumption. Chinese companies exposed directly to the consumer, like Tencent, should also fare better than developed market assets.

Given an overall constrained growth environment, we would expect defensive sectors to perform better on a relative basis. Despite continued market uncertainty, we remain focused on identifying appropriate investment opportunities across all funds while staying committed to our investment philosophy and process.

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Morningstar Award was awarded to Truffle Asset Management (Pty) Ltd on 23 March 2022 and 22 March 2023. Full details and basis of the award are available on request..

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