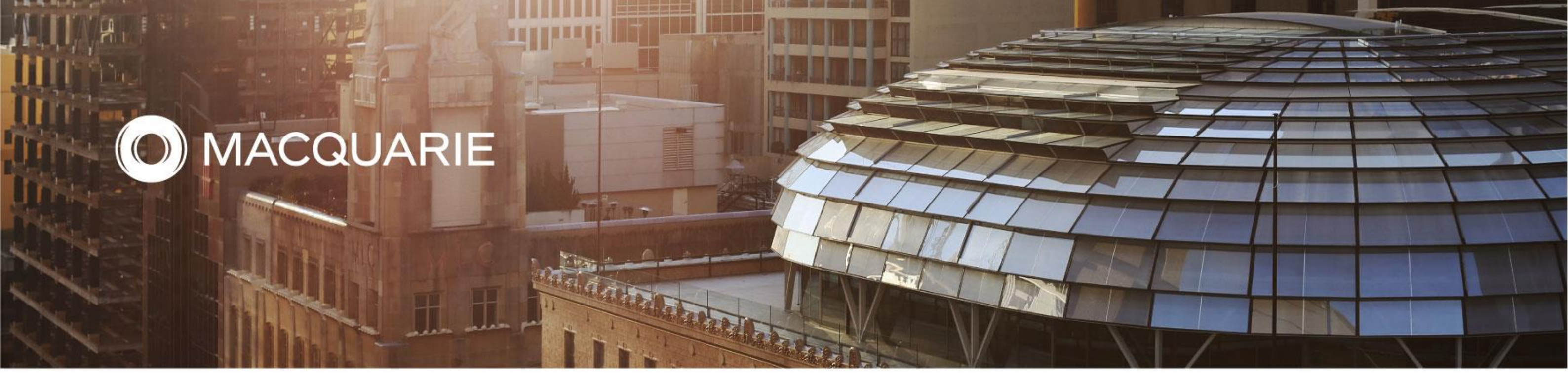


Investment Strategy Update #136

A Q&A on recent financial sector developments

In this note we provide answers to five investor key questions after the failure of a section of US banks and European financial institutions.

1. *Is this a crisis of confidence or a broader system issue?*
2. *To what extent does this impact Australia?*
3. *What are the risks to economic growth and financial markets?*
4. *What are the possible solutions?*
5. *What does this mean for investment portfolios?*

1. Is this a crisis of confidence or a broader system issue?

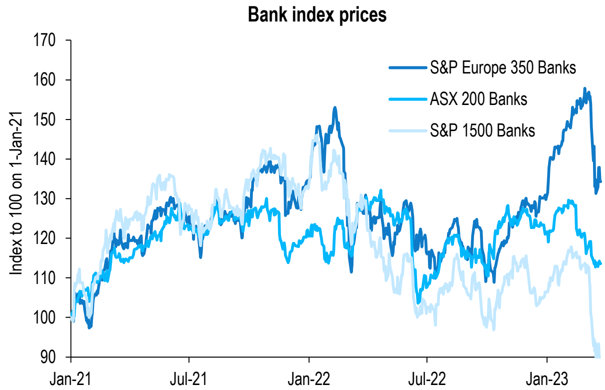
Answer: At this stage, a crisis of confidence leading to a tightening in credit conditions and not a broader system credit crunch. The Fed (and global policy makers) have the tools to deal with liquidity issues and have quickly shown their willingness to do so via multiple initiatives such as swap lines, term funding, discount window, deposit guarantees and private sector contributions. However, the scale and pace of policy tightening make it likely that there may be additional pressure points as well as longer term drag from higher borrowing costs and less lending.

- On March 10th, Silicon Valley Bank (SVB), the 16th largest bank by assets, failed due to run on deposits. It was the largest bank failure since the 2008 financial crisis. This was quickly followed by Signature Bank (SBNY) and First Republic Bank (FRC). A few days later, Credit Suisse (CSGN) was absorbed by UBS (UBS) in an emergency style takeover that was reminiscent of what occurred during the GFC.

- Markets reacted quickly to this flow of news. Policy makers (including the Federal Reserve, the FDIC and Swiss National Bank) provided markets with large amounts of liquidity at the discount window, emergency loans, deposit guarantees and provisions for future loses. In addition, regulators brokered a deal whereby several US financial institutions provided a substantial cash infusion for FRC. Policymakers showed they have the tools and a willingness to deploy them as needed to preserve financial stability.

- While these events unfolded at breakneck speed, the trigger – higher inflation driving a rapid increase in interest rates and a dramatic withdrawal of favourable liquidity conditions - has been building for some time.

US and European bank stocks under pressure - Australia less affected

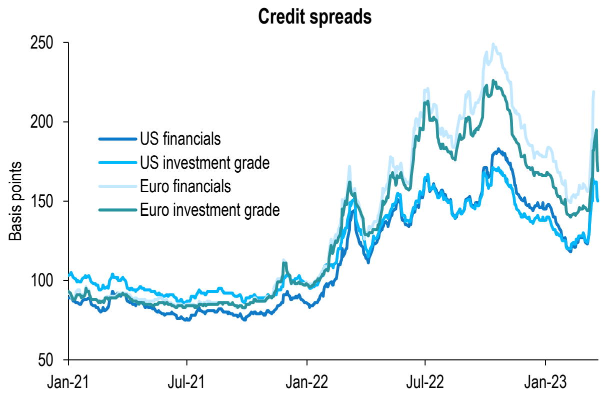


Source: Refinitiv, MWM Research, March 2023

- Poor management decisions made several US banks more vulnerable than others. For example, SVB's decision to concentrate its deposits in tech venture capital and invest heavily in treasuries made it vulnerable to higher interest rates.

- The result of the bank stress was a spike in credit spreads, a sharp decline in equities (predominantly across the financial sector), a significant decline in bond yields and a sharp reversal in expectations for future interest rate increases.

US and European credit spreads spike



Source: Refinitiv, MWM Research, March 2023

- Rapid tightening in monetary policy often has unintended consequences and these have come to the surface. It appears that we are dealing with a crisis of confidence rather than a broader system problem in the financial sector.

- Maintaining confidence is key to minimising the damage and the response from regulators has been swift.

- While credit conditions have tightened, the financial sector continues to function. Businesses and households have access to capital even if it is at a higher price. In addition, central banks have the firepower to do more if needed and the willingness of the banking system to protect itself is also a positive vis-à-vis during the GFC where this was not possible (self-preservation was the goal).

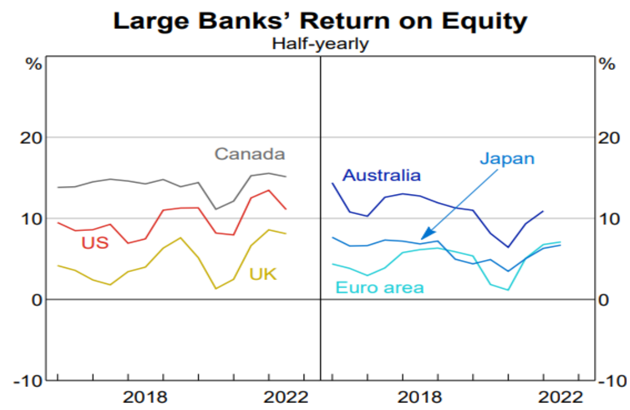
2. Is Australia immune from global financial sector risks?

Answer: Not immune, but better placed than some countries due to stringent regulation, a robust banking system that is unlikely to suffer from the same concerns that drove a deposit run in the US as well as a credible central bank. From an economic perspective, Australia will suffer from a global tightening in lending conditions, but domestic fundamentals remain solid.

- Australia should be relatively well insulated from global financial sector turmoil although it may not escape unharmed if this was to develop into a sustained decline in confidence. In this situation, tightening financial conditions and declining capital availability means the recession we expect may be deeper and possibly more prolonged.

- Australian banks are profitable, well-capitalised, and have good asset quality. The financial sector is also strongly regulated, and the RBA has good credibility. There are also significant differences in Australian banks' balance sheets, compared to the banks that failed in the US. Macquarie sees very little risk of similar liquidity issues as seen in the US. According to the RBA, Australian banks are as profitable as the large US banks and more profitable than European, Japanese or UK banks.

Australian banks as profitable as large US banks

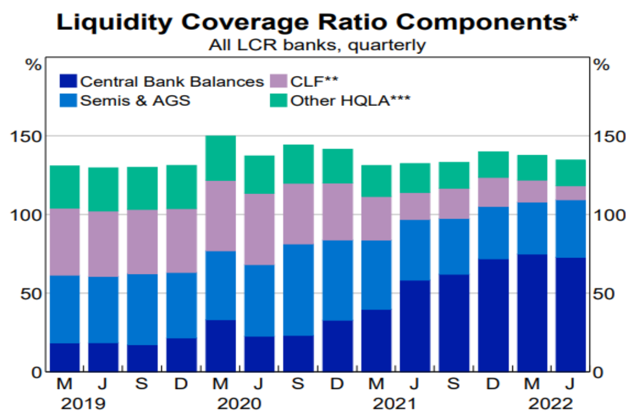


Source: RBA, October 2022

- Australian banks generally lend out the majority of their deposits, do not invest these in bonds and hold a large proportion of liquid assets that are marked to market (semi-annually), which is unlikely to mean capital positions are at risk.

- Obviously, a crisis of confidence that drives broader financial sector concerns will cause funding markets to be impacted and credit spreads to widen but a higher cost of capital is quite different from a lack of liquidity, which is not what has occurred to date. Data from the RBA shows the Australian banks liquidity coverage ratio (banks' ability to meet cash outflows in periods of stress) is well above regulatory requirements, with most cash balances at the RBA.

Australian banks have ample liquidity coverage



Source: RBA, October 2022.

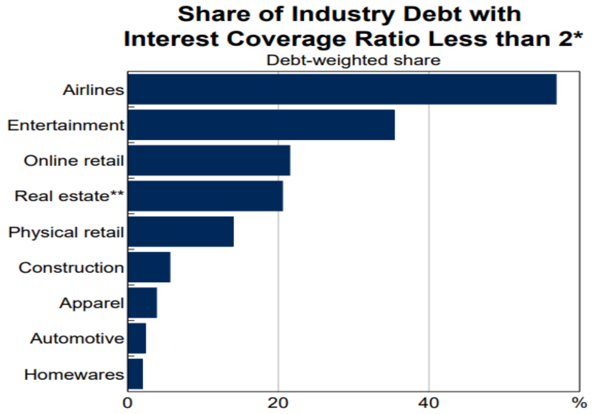
* LCR is decomposed into HQLA relative to net cash outflows. ** Refers to eligible amount for LCR calculation. *** Includes HQLA type 2, coins and notes, RBNZ securities and other.

- Ultimately a prolonged widening in credit spreads will impact bank capital positions and potentially trading income performance and earnings. We continue to think this would be modest if problems are contained and located in the US/Europe.

- Lastly, US sector issues are likely to impact some early-stage companies' viability, and banks may have direct or indirect credit exposures. Macquarie believe the Australian majors are not well represented in this space and do not expect to see significant losses.

- While the financial system is likely to be resilient to the current hit to confidence from the banking issues in Europe, there are some vulnerabilities worth highlighting. Industries that bore the brunt of the pandemic (airlines, retail, hospitality, tourism etc) had barely begun their recovery when they were hit with cost pressures and higher interest rates. According to the RBA, airlines, entertainment on-line retail and real estate (particularly office) are more interest rate sensitive than others.

Airlines and entertainment are more leveraged



Source: RBA, October 2022

* Sample consists of public and private companies in Canada, Japan, New Zealand, the United Kingdom, the United States and 18 developed European countries. Interest coverage ratio is calculated as earnings before interest, tax, depreciation and amortisation divided by interest expense. Data are for the six-months-ended 30 June 2022. ** Real estate companies include real estate operating and development companies, real estate services and REITs.

3. What are the risks for financial markets versus economic growth?

Answer: Declining risk appetite widens credit spreads and increases the cost of debt. If there is enough stress, credit markets can freeze and prevent businesses from rolling over or issuing debt. Nonetheless, spread widening has already occurred and will likely increase further given the large increase in interest rates and a rising risk of recession.

- Concerns around the banking system are being transmitted to financial markets and the real economy via two channels. First, via falling confidence and rising uncertainty; and second via a tightening in financial conditions through the price and the availability of capital.

- Falling bond yields have provided some offset to a higher price for credit but they also reflect a lack of confidence about the outlook. Deposit outflow from the collapse in confidence forces affected banks to slow credit growth, and this has flow-on effects to spending and economic growth.

- Higher credit costs (spreads) and a reduced supply of credit (via tighter lending standards) work their way into the real economy by slowing demand (investment and spending) with flow-on effects to hiring and wages growth. Against a backdrop where policy tightening was already slowing growth in many major economies such as the US and Australia, the widening in spreads that have come with the current banking sentiment add additional downward momentum.

- Weaker demand further hurts margins that were already falling from cost pressures and it drives earnings down further. The sell-off in equities reflects these concerns.

- The tightening in credit conditions may only be temporary if policy makers are successful in restoring confidence and have little economic consequences. They can have large economic consequences without good policy intervention or if they remain at elevated levels for long periods of time.

- Changes in monetary policy on the other hand are calculated and tend to be more permanent. Central banks continuing to tighten policy must allow for the impact of tighter credit conditions in their policy calculations. At the March FOMC, Fed Chair Powell said that recent developments had probably done some of the Fed's work and interest rates need not rise much further now.

4. What are the possible solutions?

Answer: Regulators are dealing with a series of idiosyncratic risks rather than broader system risk and they have adopted a three-pronged approach that appears to be working. 1) Providing stressed banks with access to liquidity offsets the impact on their balance sheet from withdrawal of deposits. 2) The FDIC also plays a key role in supporting confidence by extending deposit insurance to affected banks even though their deposits weren't insured prior to coming under stress. 3) Facilitating distressed business sales to stronger institutions allowing the private sector to resolve its own issues. If recent developments were to escalate, then interest rate cuts would come likely be the next move.

- The trigger for these recent developments are higher interest rates and tightening liquidity. However, this situation occurred because several poorly designed business models were not robust in the face of higher rates and tighter liquidity. Nearly all institutions will survive, but the problem is that the relatively small number that fail have the potential to damage confidence in the broader financial system and that has large negative economic consequences. Regulators have more tools to deploy if financial stability is threatened again.

- This is a delicate issue and leaves policymakers in a difficult position. Up until now they have been raising interest rates to achieve their goal of price stability, and prior to the past few weeks it was clear more work needed to be done. However, the same policymakers also need to maintain financial stability and sometimes it's not possible to achieve both goals at once.

- At this stage, policy is trying to do just that. On one hand, it is trying to protect confidence by providing liquidity to whichever financial institutions need it and facilitating the private sector to support itself. On the other hand, monetary policy is kept tight in pursuit of price stability.

- Confidence can be fragile, but over the past few days the three-pronged approach seems to be working. However, if the financial system experiences another wave of stress then central banks will need to make tough decisions. In this instance, preserving financial stability becomes more important than achieving price stability and interest rates may be cut.

- If there is no more stress and inflation remains problematic, then monetary policy would need to remain tight and interest rates may even need to rise a little further. This is the latest messaging from the Fed.

- The tipping point for cutting rates is when the loss of financial stability has large downside economic consequences as we saw during the GFC. It is also possible that the situation in regional banking system tightens the supply of credit and this impacts the economy. Data, particularly labour market data, over the next couple of months will be critical in this assessment.

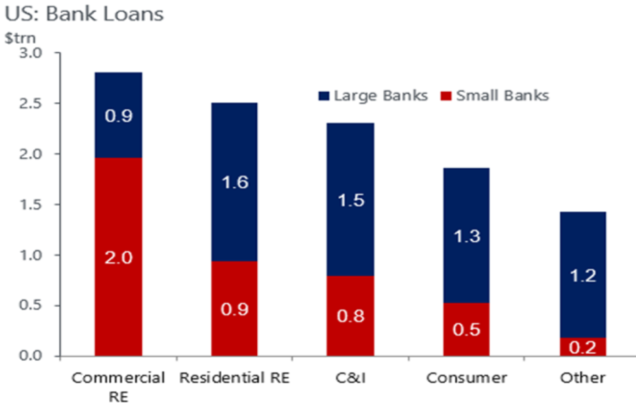
5. What does it mean for investments & portfolio positioning?

Answer: These recent developments do not change our view that a recession is coming, and our portfolios are already positioned for this. Credit conditions have tightened, and this may have bought forward the start of the recession although this is still uncertain. It may also have added to the depth of the contraction, but it's too early to estimate the damage. Without a large catalyst, confidence is likely to remain fragile and asset prices will be extremely volatile. Bonds should act as a solid growth hedge, but equities are vulnerable to growth weakness. Private markets are sitting on mark to market downgrades in asset values and selective hedge funds are at risk of being caught out on the wrong side of macro moves.

- Prior to these developments, we expected the global economy to head into recession in H2. China was one of the few bright spots, with the reopening progressing better-than-expected. The current situation may change the timing of the start of the recession, the magnitude of its depth or its duration, but a recession is still expected, and this doesn't change our current defensive portfolio position.

- Nonetheless, we have seen the first sign of a large crack from 12 months of tightening policy, and this has the potential to bring forward the start of the recession. The rise in interest rates thus far has created a housing downturn and there have been signs consumer spending has slowed. Manufacturing is also contracting, but the labour market remains tight and wage pressures are persisting in the world's major economies.

Smaller US banks have a large exposure to commercial property



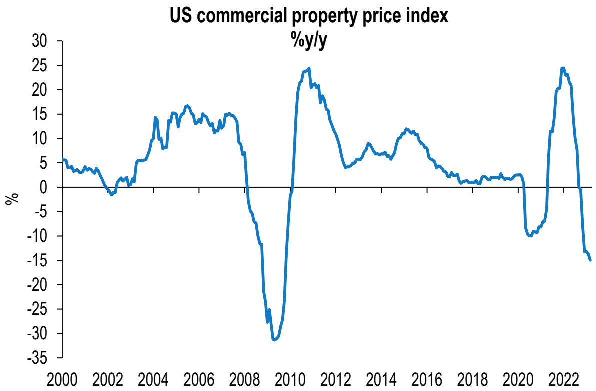
Source: Oxford Economics, Haver Analytics, March 2023

- While market attention has shifted from the inflation fight to financial stability, it is still too early to say whether interest rates have peaked. Furthermore, there is no sign yet that earnings have bottomed, or rates cannot tick higher from current levels. We retain our underweight position in equities, given the clear downside potential attached to our recession call.

- Financials remain under pressure from the regional banking stress in the US. More broadly, the impact of central bank tightening will be most concentrated on assets (financial or physical) with duration. The problems with US regional banks may not be over yet, with around 45% of their lending extended to commercial property which is trading on very optimistic cap rates of around 3% which is not sustainable.

- In US commercial property, gearing is relatively conservative, but falling asset prices have the potential to cause this to deteriorate rapidly. The vacancy rate for US office property is at its highest level in 20 years. On the demand side, net absorption turned negative in 2H22, with demand likely to weaken further as the unemployment rate rises. According to Green Street Commercial property research, office property capital values are already 15% below their early 2022 peak. Most commercial property debt in the US is not provided by the banks but issued by companies themselves into capital markets, or by mortgages and loans provided by non-banks, therefore reducing the transparency of potential problems from the regulators and markets.

US commercial property prices down 15% from peak

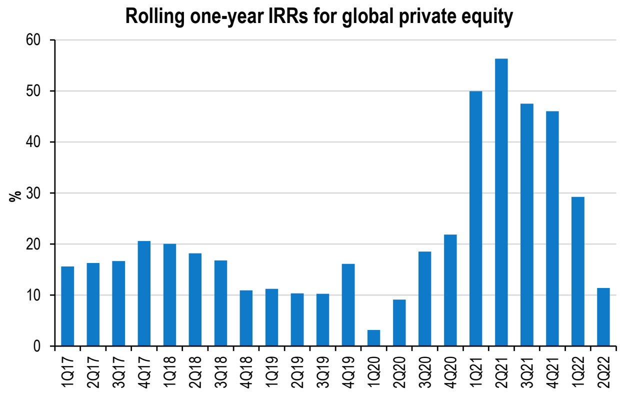


Source: Green Street, March 2023

- In **equities,** we favour a style-neutral approach to portfolio construction with a quality overlay and we think this is still appropriate. If the Fed was seriously contemplating cutting rates, then we may be tempted to favour growth / small caps over value / large caps, but its too early to position for this.

- During the past year, **alternative assets** proved resilient to higher interest rates and listed market volatility when the two major asset classes (equities and sovereign bonds) are volatile. We still like hedge fund strategies and private debt over private equity. But there are rising risks to these strategies as asset values are written down, capital allocation is more discriminatory and as the risk of getting caught out on the wrong side of macro shifts rises. For now, private debt still offers floating rate returns in a rising interest rate environment, while private equity returns will continue to decline, as the rise in interest rates eventually flows through to the valuation of private assets.

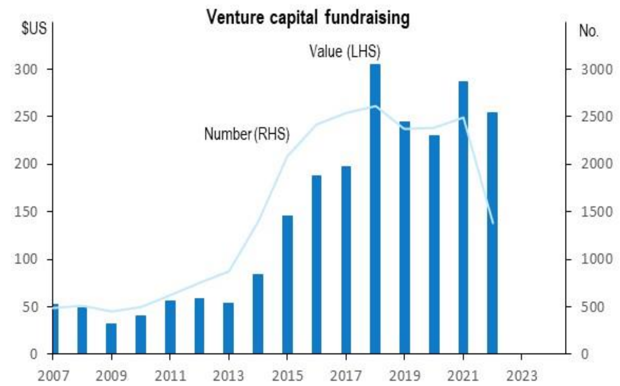
Private equity returns have fallen sharply



Source: Pitchbook, MWM Research, March 2023

- Venture capital (VC) also relies upon low cost of funding and easy access to capital. Last year's increase in interest rates put downward pressure on valuations and tightened available funding and the banking crisis has added to these pressures. The value of global VC deals to fall from $U181bn to $US66bn. The problem when a crisis of confidence occurs is that investors want to exit their higher risk positions such as those in VC. It is likely that the VC suffers from the inability to exit due to falling valuations as well as less liquidity.

The VC boom is well and truly over, but there is still more downside risk



Source: Pitchbook, MWM Research, March 2023

Macquarie WM Investment Strategy Team

Investment Strategy Update #136 finalised on 27 March 2023.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return