

A note from Dan

Are falling banks a game-changer for central banks?

March 2023



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If a week is a long time in politics, in the investment world, a year can represent the end of an era, and the start of a new one.

Two i's — inflation, and interest rates — have upended investment markets over the past 12 months, ending the post-GFC period where ultra-low interest rates, stubbornly low inflation, unusually low bond yields (high bond prices), and steep share market valuations, seemed so set.

Wind the clock back to the start of 2022; official interest rates in many countries were around all-time lows and expectations for inflation were just starting to climb out from basement levels. Bonds offered little in the way of income, or protection, in the event of rising inflation.

Fast forward to this year and things are very different.

Cavalier risk-taking comes undone

First up, investors with memories of the GFC may be feeling a case of déjà vu on the back of news of the collapse of three American banks — Silvergate Capital, Signature Bank and Silicon Valley Bank (SVB) — associated with industries towards the riskier end of the spectrum.

Silvergate Capital, and Signature Bank were seen very much as banks for cryptocurrency companies, while SVB had venture capital companies, as well as crypto startups, as customers.

What they have in common is that they all came of age in an ultra-low interest rate world and have gone under as interest rates have shot up over the past year.

This brings to mind Warren Buffet's line: "Only when the tide goes out do you discover who's been swimming naked."

It may be possible, for a while at least, to get away with a cavalier attitude to risk when interest rates in the US and many countries were around zero, but it does catch up with you when monetary policy tightens pushing interest rates higher and thus knocking asset values, in the process.



It is worth noting that in previous high inflation episodes, like the late 1970's and early 1980's, **P/E ratios were significantly lower.**

Companies' balance sheet strength is especially important in times like now, and the downfalls of Silvergate Capital, Signature Bank, and SVB are unlikely to be the last. Most recently, in a move brokered by the Swiss government to restore confidence in the Swiss banking system, Credit Suisse entered into a merger agreement to be absorbed by local rival UBS.

To head off a potential contagion effect, the US federal government has stepped in to guarantee Signature Bank and SVB deposits.

These events have put policymakers in a tough spot.

Some financial markets participants appear to think that the chances of the US Federal Reserve ending its rate rising cycle, earlier than expected, have gone up.

However, it was unusually low interest rates that enabled the likes of SVB, Signature Bank, and Silvergate Bank to emerge in the first place, and pausing the rate rising cycle would most likely incubate more problems.

With the US unemployment rate close to a 50-year low¹ — suggesting that despite a series of interest rate rises, the American economy has positive momentum — a loss of nerve by the US Federal Reserve by backtracking from its rate hiking trend could entrench high American and global inflation.

US inflation rose 6% year-on-year in February,² well above the around 2% figure targeted by the US Federal Reserve (the Fed), as well as many other central banks. Inflation is central banks' *Public Enemy No 1* with the Fed's recent decision to hike America's official cash rate³ appearing to confirm this.

Changing sources of inflation

While inflation remains far too high, the sources of inflation have changed.

Global supply chains are no longer overwhelmed by surging demand for goods, nor disrupted by COVID-19.

Think back to the first half of last year; there were stories of strong demand for everything from furniture to games consoles. Demand for these items and other goods has cooled.

Remember the global microchip shortage that was frustrating so many industries last year? That too has eased.

The oil price today is lower than before Russia's invasion of Ukraine.

So, why is inflation proving to be so sticky?

¹ *US hiring boom continued in February with 311,000 added jobs.* Dominic Rushe 11 March 2023, <https://www.theguardian.com/business/2023/mar/10/us-jobs-report-february-2023>

² *US consumer prices rise 6% at tricky time for Fed amid Silicon Valley Bank fallout.* Colby Smith 14 March 2023, <https://www.ft.com/content/5fe8394f-9a4c-4dad-81c4-9d5c0adae542>

³ *Federal Reserve issues FOMC statement.* Board of the Governors of the Federal Reserve System press release 22 March 2023, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230322a.htm>



The main source of inflation now is in service industries, which are more exposed to labour costs. In the US, Britain, Canada, and New Zealand, for example, wage growth is still higher than is consistent with central banks' 2% inflation targets.⁴

This should not be a surprise given strong labour markets. Six of the G7 group of big rich countries enjoy an employment rate at or close to the lowest seen this century.⁵

It is hard to see how underlying inflation can meaningfully ease while labour markets stay so tight. The upshot is that households, businesses, and investors are probably going to have to navigate further interest rate rises and accompanying complications and hardships.

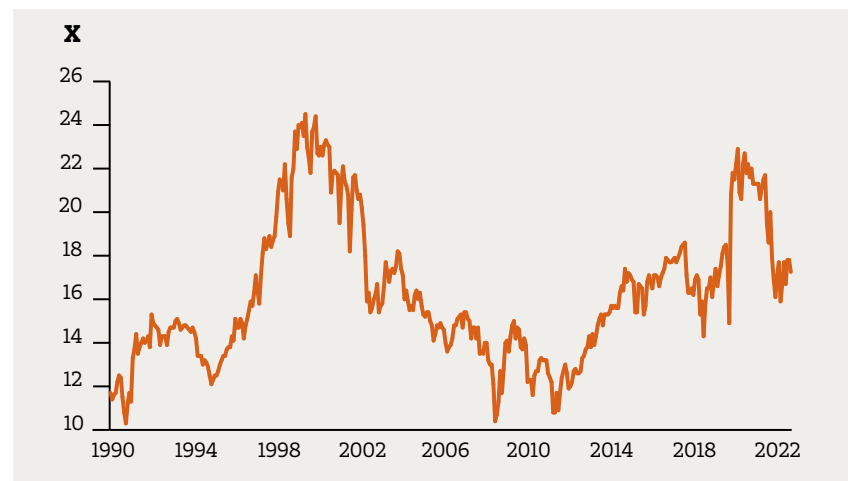
Share markets still not cheap

While the events of recent weeks have dominated media headlines, what's transpired in the US share market, the S&P 500, this year, has been instructive.

Valuations, as measured by the forward price-to-earnings ratios⁶ (P/E ratio), have fallen by a similar degree to what occurred with the bursting of the tech bubble in 2000. Another observation is the S&P 500 P/E ratio started 2023 at around 17 (**Chart 1**), suggesting that US shares are neither cheap or expensive, if we use the average multiple of the past 30 years as the 'fair value' yardstick.

More recently, the forward 12-month P/E ratio for the S&P 500 was around 17.8 (**Chart 1**). This P/E ratio was below the 5-year average (18.5) but above the 10-year average (17.3).⁷

Chart 1: US S&P 500 P/E ratios have fallen, but still not cheap
Forward price-to-earnings ratio



As of 17 March 2023

Source: IBES

- ⁴ *Still aloft. Inflation will be harder to bring down than markets think.* The Economist. February 18th – 24th 2023.
- ⁵ *Unemployment Rates, OECD - Updated: February 2023.* <https://www.oecd.org/newsroom/unemployment-rates-oecd-update-february-2023.htm>
- ⁶ The Forward Price-to-Earnings or Forward P/E Ratio divides the current share price of a company by the estimated future ('forward') earnings per share (EPS) of that company. It is a way of gauging the expensiveness or cheapness of a company or share market.
- ⁷ *FactSet Earnings Insight*, John Butters, 16 March 2023 [https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_031623.pdf#:~:text=For%20CY%202023%2C%20analysts%20are,and%20revenue%20growth%20of%202.1%25.&text=Year%20Average%20\(17.3\)-,The%20forward%2012%2Dmonth%20P%2FE%20ratio%20for%20the%20S%26P,10%2Dyear%20average%20of%2017.3.](https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_031623.pdf#:~:text=For%20CY%202023%2C%20analysts%20are,and%20revenue%20growth%20of%202.1%25.&text=Year%20Average%20(17.3)-,The%20forward%2012%2Dmonth%20P%2FE%20ratio%20for%20the%20S%26P,10%2Dyear%20average%20of%2017.3.)

Commentary from the US Federal Reserve suggests that official interest rates will keep rising until inflation is brought under control.



Six of the G7 group of big rich countries enjoy an **employment rate at or close to the lowest seen this century.**

So, despite having already fallen at an unprecedented speed, the US P/E ratio could fall further from here. It is worth noting that in previous high inflation episodes, like the late 1970's and early 1980's, P/E ratios were significantly lower, down into the single digits!

That said, the starting level of P/Es then was significantly lower than this current episode. A share market at 'fair value' does not, in isolation, lend itself to strong views on whether to increase (or decrease) allocations. This makes it necessary to move on to the other component of share valuations – earnings – to gauge the attractiveness, or otherwise, of share markets.

Though US earnings expectations have come down since the start of the year, investors are still expecting modest positive earnings growth for the S&P 500 in 2023, and a strong earnings pickup in 2024 (**Chart 2**).

Given the amount of economic uncertainty, it's arguable that current earnings expectations are vulnerable. Moreover, it may take a meaningful recession to drive the earnings outlook lower, and with that push the US P/E ratio into 'cheap' territory, because at this moment, it's not.

Chart 2: Earnings forecasts seem vulnerable

S&P 500 index consensus earnings forecasts

	Earnings per share (EPS)	Year-on-year change %
2020	139.76 (actual)	-14.2
2021	208.53 (actual)	49.2
2022	218.39 (estimate)	4.7
Q1	54.83 (actual)	11.6
Q2	57.95 (actual)	9.9
Q3	56.05 (actual)	4.0
Q4	53.23 (estimate)	-1.5
2023	221.63 (estimate)	1.5
Q1	50.84 (estimate)	-7.3
Q2	54.59 (estimate)	-5.8
Q3	57.29 (estimate)	2.4
Q4	58.77 (estimate)	10.4
2024	248.83 (estimate)	12.1

As of 20 March 2023

Historical earnings and growth rates are frozen when the reporting periods are complete. Annual EPS is calculated independently of quarterly EPS, and may not equal quarterly sum due to estimate coverage and index constituent changes.

Source: Yardeni Research, Inc. and I/B/E/S data by Refinitiv. <https://www.yardeni.com/pub/yriearningsforecast.pdf>

Whatever happens next, a degree of market turbulence is likely. There are no short-cuts or magic bullets to get through this.



A unified investment team leveraging a powerful common engine

As ever, our investment team is sticking by investment principles — chiefly diversification across many dimensions — that have proved themselves over decades.

Our unified investment team was created by bringing together the investment teams of IOOF, MLC, and ANZ Pensions & Investments. Though our investment professionals' corporate origins vary, our commonalities are far greater, and this has enabled us to come together to form a single team around a shared sense of purpose.

We have thoughtfully come together to create an investment capability of uncommon depth and breadth to meet our clients' dynamic needs. We have a unified-culture and single investment team leveraging a powerful common engine supporting decisions.

Leveraging our scale for clients' benefit

As we have come together, we are progressively uncovering ways to harness the benefits of our scale and solutions.

Our size means we have become even more important to the investment managers whose strategies feature in our portfolios.

We have greater buying power with the managers we select for our investment building blocks, which gives us access to ever-more sophisticated alternative investment strategies, and sought-after private assets.

Our size means managers are willing to create bespoke investment solutions for our portfolios, while our enviable resourcing means we can widen the scope of our research to identify the best investment managers across the world.

I'm confident that our investment team's collective experience, and knowledge, coupled with sticking by time-tested values, can enable us to successfully steer portfolios, we manage for our clients, through what may lie ahead.

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