Core Global/Core International Equity Strategies

NCM Monthly Commentary for April 2023

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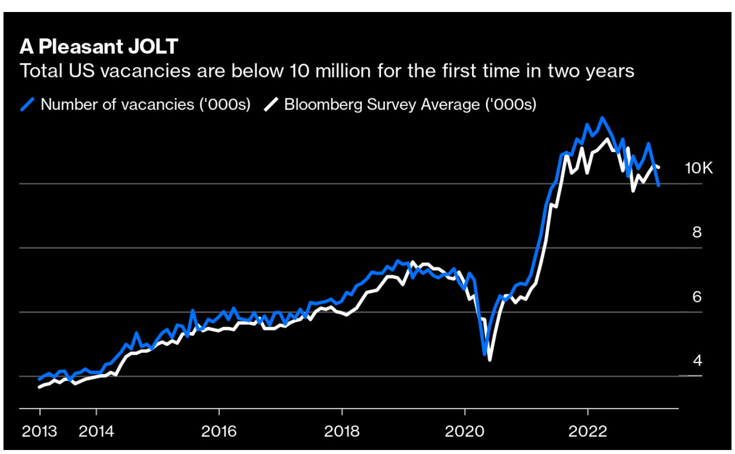
First Quarter 2023 Review

After a challenging year in 2022, global equity markets generated positive returns during the first quarter of 2023 with all major geographic regions in the green. The S&P 500 was up 7%, the STOXX Europe 600 index climbed by 7.8%, the Nikkei 225 increased by 7.5%, and the Emerging Markets collectively generated a positive return of 4%. Some of the factors driving these returns include falling inflation, better than expected economic data in the U.S. and Europe, as well as enthusiasm related to the reopening of China's economy.

Inflation

In terms of inflation, the headline figures continue to fall in both Europe and the United States. In Europe, preliminary readings showed that Eurozone headline inflation fell to 6.9% during the month of March, down from 8.5% in February. In the U.S., the consumer price index increased by 6% from a year earlier, a decline from 6.4% in January and down from the 40-year high of 9.1% in June of 2022.

CHART 1



Source: Bloomberg

In addition to falling inflation, the recent JOLTS figure (Job Openings and Labor Turnover Survey) was also encouraging. The JOLTS data has been highlighted as a key metric by U.S. Federal Reserve Chairman, Jerome Powell. The job market has been very strong for quite some time with roughly two job openings for each unemployed person. The most recent JOLTS data showed that the number of official job vacancies in the US dropped below 10 million for the first time since May 2021 as seen in Chart 1.

In terms of vacancies for each unemployed person, that number is now down to 1.67 vacancies per job seeker. The gap between job openings and the unemployed, which has been cited as a critical factor by Jerome Powell has fallen by approximately 20%.

CHART 2

Source: Bloomberg

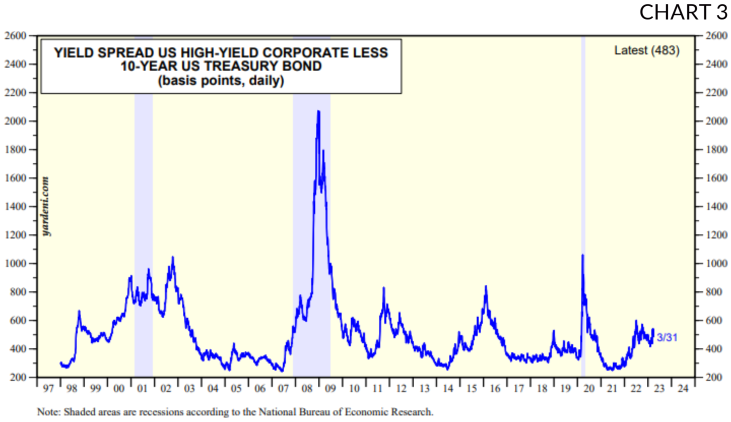
The ongoing easing in inflation and the smaller gap between job openings and the unemployed leads us to believe that we are nearing the end of the interest rate cycle. In addition to these factors, the recent dislocation in the U.S. regional bank sector is another factor that leads us to believe that we are nearing the end of the hiking cycle. The recent events in the banking sector will likely cause tighter lending conditions. If banks do restrict lending in the coming months, there is a very high likelihood that it will slow the economy. This should provide yet another catalyst for inflation to keep easing. Having said that, the probability of a recession has increased in the aftermath of the recent events in the U.S. banking sector.

Dislocation in the banking sector

A discussion of the first quarter cannot be complete without a discussion of the bank failures in the United States. While we don't want to minimize what's occurred in the banking sector, we believe the circumstances are quite different compared to what happened during the Great Financial Crisis. The dislocation that occurred during the Great Financial Crisis in 2008-09 was caused by a system wide deterioration in credit across numerous asset classes including real estate, credit cards, and autos. In addition to a deterioration in credit, there was widespread belief that several of the largest banks in the world were about to fail. As we all know, the failure of the banking system was averted in 2008 due to several measures that were taken by governments and central banks around the world.

Although concerns remain about the health of the overall banking system today, we would like to highlight some of the differences between 2008 and the backdrop that exists today. First and foremost, banks are significantly better capitalized today due to regulatory changes that occurred in the aftermath of the Financial Crisis. Second, credit trends have deteriorated from abnormally low levels but are nowhere near levels that were reached during the Financial Crisis. When there is fear about credit worthiness in the markets, it gets reflected in the bond market through credit spreads. As seen in Chart 3, the spread between high yield corporate bonds and the 10-year U.S. Treasury Bond remains well below other periods of market stress including the Technology Bubble (early 2000's), Financial Crisis (2008-2009), and the COVID pandemic (2020).

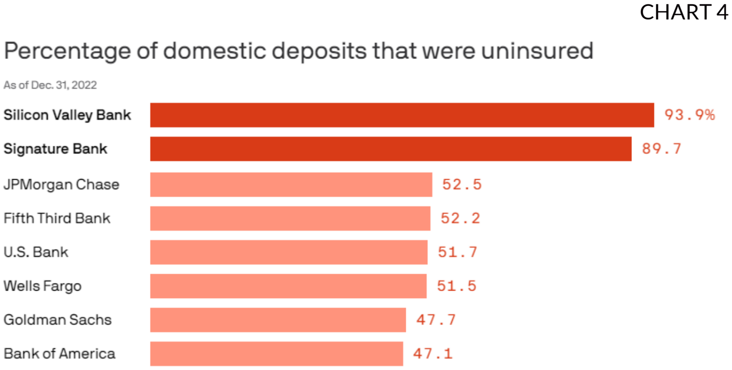
CHART 3



Source: Bank of America Merrill Lynch and Federal Reserve Board.

Another point of difference that should be emphasized is the high level of uninured deposits at two of the banks that recently failed in the United States. As seen in Chart 4, both Signature Bank and Silicon Valley Bank had approximately 90% of their deposits uninsured. This compares with many of the largest banks which have levels closer to 50%. The implication of this is that the foreclosed banks became vulnerable when comments started surfacing on Twitter. Several executives in the financial services industry have described the recent events as a social media generated bank run.

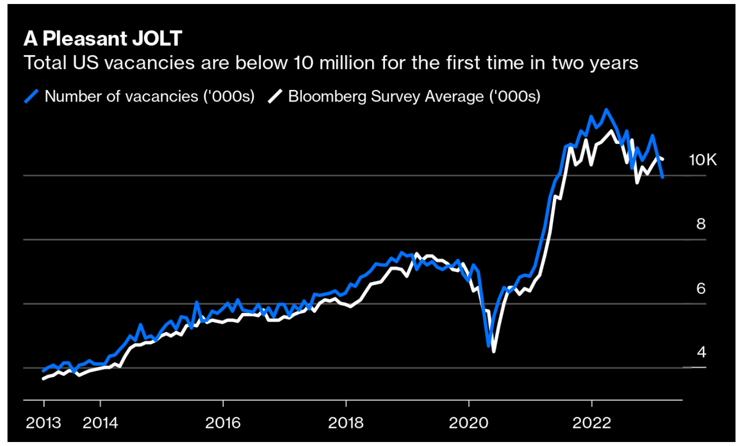
CHART 4



Data: S&P Global Market Intelligence; Chart: Axios Visuals

A few comments about Credit Suisse seems appropriate given that the bank is in the process of being absorbed by UBS. In a nutshell, Credit Suisse is a bank that has been on the decline for the last 15 years as seen in Chart 5. From what we can tell, the regulators in Switzerland likely reached a breaking point and ultimately decided that a takeover of Credit Suisse by UBS would be in the best interest of the Swiss banking system.

CHART 5



Source: Bloomberg

To wrap up our views on banking, we believe the current situation will be contained. We think Citigroup's Chief Executive Officer, Jane Fraser, does a good job of describing the current state of affairs and we tend to agree with her assessment. "We're talking about a few banks," Fraser said. "This is not something that is spread across the entire banking system. This isn't like it was last time. This is not a credit crisis. This is a situation where a few banks have some problems and it's better to make sure we nip that in the bud."

Portfolio Review

As far changes in our portfolios, we have increased our weight in the Technology sector. The sector came under significant selling pressure in 2022 and valuations have become more reasonable. During the first quarter we re-initiated a position in Meta Platforms. We had previously owned the company but sold our entire Meta position back in February of 2022 when Mark Zuckerberg gave specific guidance on how much money the company was going to spend on the Metaverse. At that time, it became clear to us that the company was willing to spend with reckless abandon so we exited our holding. After we sold it, the stock fell by 70%. Fast forward 1 year later, and the company announced a strategic pivot in terms of its capital allocation. To be specific, Mark Zuckerberg announced that 2023 was going to be the year of efficiency. The company announced that it was slashing costs and that it was going to reduce its headcount in a significant way. A few weeks ago, Meta announced that it would cut 10,000 jobs, and this is happening just four months after it said it was letting go 11,000 employees. We believe the increased focus on efficiency will have a very positive impact on the company's earnings in the years ahead.

In addition to the tailwinds from its cost reduction efforts, Meta also has a potential opportunity should Tik Tok get banned in the United States. This could be a significant windfall for Meta given that TikTok has become a very large business. It has been estimated that Americans spent 53 billion hours on TikTok last year. According to eMarketer, Tik Tok is expected to generate $14.2 billion in revenue in 2023, which is up 43% from last year and a tenfold increase since 2020. This implies that the company will generate more revenue in 2023 than Snapchat, Pinterest, and Twitter combined. It's suffice to say that if Tik Tok is banned in the U.S., it should represent a very large opportunity for Meta Platforms. In addition to the potential Tik Tok opportunity, we also believe that Meta will be a beneficiary from the boom in artificial intelligence that will play out in the years ahead.

Outlook

We remain cautiously optimistic in our outlook for 2023. Given last year's significant decline, stocks are trading at more reasonable valuations. In addition, inflation measures have been falling and the red hot job market is finally showing signs of cooling. When combining these developments with what's happened in the banking sector, we believe that central banks are nearing the end of their interest rate hiking cycle.

One of the key risks to our outlook is the potential fallout from the dislocation that has occurred in the banking sector. One of the consequences from recent events is that lending standards have tightened and this is very likely to create a drag on economic growth. If the economic drag is too big, the economy will fall into a recession. However, if a recession does materialize, we believe it will be a milder garden variety type recession. We have held this view for some time now. Our rationale for saying this is that global banks have robust levels of capital while corporates and consumers are significantly less exposed to credit risk and leverage risk than they have been historically. In the United States, debt servicing ratios are near multi-decade lows and 90% of U.S. mortgages are fixed, far below levels seen during previous tightening cycles. Similar to consumers, U.S. corporates have shifted a large portion of their debt to fixed rate debt. One last point. Contrary to last year, the U.S. Federal Reserve Bank now has room to manoeuvre given how much it has raised interest rates in the last year. In other words, if the economy slows too quickly, they can cut interest rates. And that's exactly what the bond market is saying with approximately 3 interest rate cuts projected over the next 9 months. For all these reasons, we believe that any recession that unfolds should be shallow one as opposed to a deep, prolonged recession.

We remain confident in the long-term outlook for our portfolio holdings given their robust free cash flow generation and their strong balance sheets. These are the types of companies that are best positioned to weather the storm should we be headed for a recession.

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