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Monthly Market Newsletter

GLOVISTA INVESTMENTS

Glovista Global Perspectives

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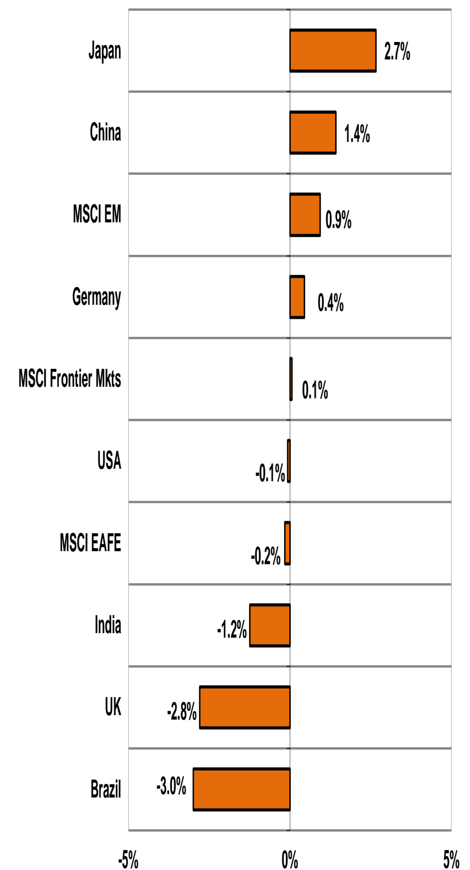
US Regional Banking Sector Crisis Fuels Rally in Long Duration Assets and Sell-Off in US$ and Low-Quality Factor; Glovista Sustains Overweight Bond Duration and Underweight Equities Allocation

The month of March has witnessed traumatic developments in the US banking sector, finding its epicenter in the unfolding of the second and third largest banking sector bankruptcies in US history, entailing the collapse of SVB and Signature Bank. Such developments translated into one of the largest monthly percentage declines in the US Banking Sector index in recorded history (Figure 1). The anatomy behind such bankruptcies has been well documented and attributed to a number of factors, including:

- the affected banks' outsized share of uninsured deposits as a percentage of total deposits;
- a severe duration mismatch of the affected banks' asset and liability exposures, a dominant share of which was not suitably hedged for the outsized interest rate moves that have unfolded since the beginning of 2022, and;
- the US banking regulatory framework's inadequate coverage of risks conditioning the small and regional banking sector space, particularly via the government's 2018 decision to waive the space from the application of Dodd-Frank regulations applicable to large banking sector institutions.

As long-time students of financial and economic history, we consider the seeds of the current US regional banking sector crisis to have been laid over the past several quarters, in the form of the largest succession of US policy interest rate hikes seen in decades, leading to the deepest bond market sell-off in over half a century. That regulatory policy mistakes were at a play, in the form of the third factor listed above, is but a typical sign of the complacency that characterizes government policy stances following long periods of stability that fuel a strong appetite for less regulation even in cases where it is arguably most justified.

Country-wise Monthly Performance in USD terms (Mar 2023)*



Source: MSCI & Bloomberg

**As of March 28th, 2023*

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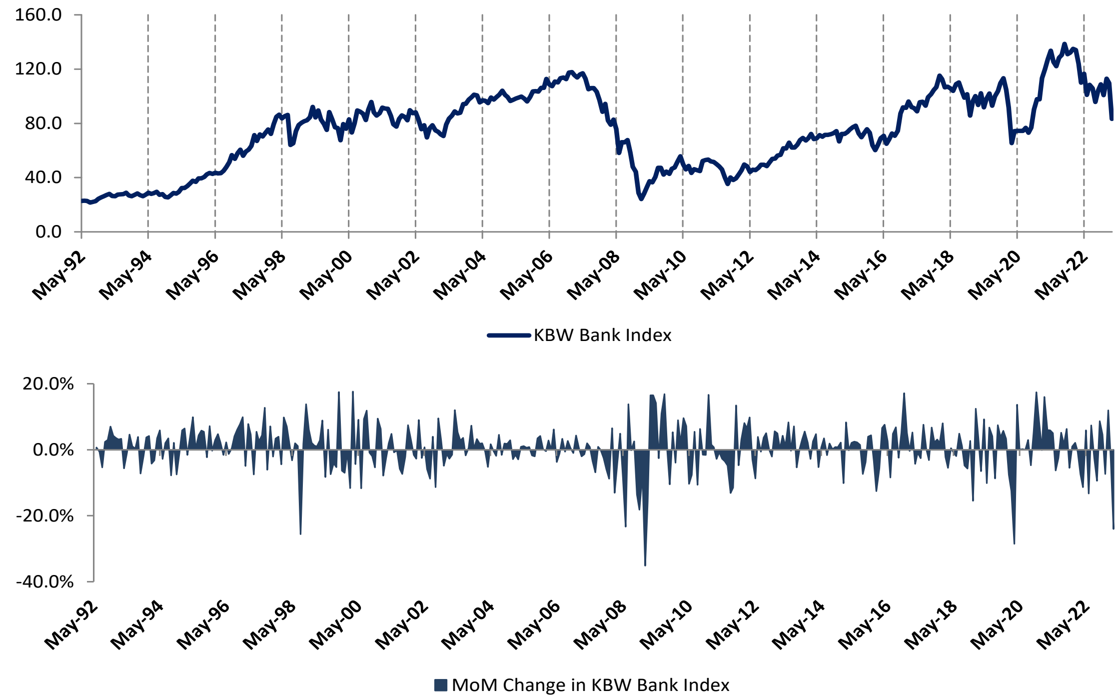
S&P500 Monthly Sector Performance – Mar MTD 2023*		
Sectors	% Change	FY1 PE Ratio
Energy	-2.91%	9.9
Materials	-4.81%	16.9
Industrials	-2.36%	18.7
Cons Disc	-2.37%	23.0
Cons Stap	2.06%	20.2
Technology	5.82%	25.0
Healthcare	0.14%	17.1
Financials	-11.82%	12.9
Utilities	1.95%	17.6
Telecom	6.52%	15.8
Real Estate	-7.47%	33.5
S&P500	0.03%	18.1

*as of Mar 28th 2023

Figure 1. US Regional Banking Sector Crisis Fuels the Fourth largest Percentage Monthly Decline in History for the KBW US Banking Sector Index



Source: Bloomberg

The immediate global market ramifications from the ongoing US regional banking sector crisis include the following:

- **US$ sell-off and lower government bond yields:** In general, episodes of banking sector stress carry adverse effects on economic activity via the resulting contraction of credit conditions stemming from weakened banking sector balance sheets. At the present juncture of softening economic growth – owing to the lagged effects from the massive interest rate hikes implemented during 2022 as well as the fast-approaching complete depletion of US households' savings built up during the pandemic era via massive federal government transfer programs – the ongoing banking sector stress will likely reinforce the deceleration of US economic activity. As a result, it is reasonable to expect bond yields and the US Dollar to decline on the back of current US banking sector problems. In fact, such dynamics have been at play these past several weeks, with the US Dollar weakening by 3.06% and the 10-year US Treasury bond posting a sharp 42 basis points decline since March 8th of this year.

- **Rally in long-duration assets:** The reduction of long-term bond yields and a weaker US Dollar both support the relative revaluation of long duration asset prices. In that regard, it is not surprising that technology and other growth sector stocks, along with long duration fixed income, have solidly outperformed these past several weeks.

- **Low quality factor underperformance/sell-off:** The resulting weakening of US economic growth expectations from the onset of regional banking sector concerns has led to the strong underperformance of low-quality factor across major asset groups. For example, over the past few weeks (Since March 8th), US high yield bond spreads have widened by 67 basis points versus 10 year US Treasurys.

- **Commodity price declines:** Understandably, the adverse effect exerted by current US banking sector difficulties on US and global economic growth expectations have been accompanied by a considerable decline in commodity prices. For example, since March 1st, front-month contract prices for crude have declined by 5%.

The fast-paced nature of the US regional banking sector's implosion during the month of March led our investment team to respond promptly in implementing three rebalancing actions across our managed portfolios: cutting out our entire US value sector allocations – as those sectors are dominated by financial and energy sector stocks; further reducing our overall equity allocations, and; increasing our bond portfolio duration considerably, particularly to US Treasurys and high-grade US corporates. The nature of such rebalancing actions reflected our expectation the crisis would extend beyond a few days and carry a number of macro and financial implications outlined above.

As we look ahead, we expect the pace of US economic activity to decelerate further, now reinforced by the lagged effects from the tightening of credit conditions following the SVB and Signature Bank implosions. We continue to view such deceleration to be exerted by the lagged effects from the monumental policy rate hikes of 2022 as well as the depletion of US household savings fueled by pandemic era transfers from the US federal government. Against such a macro backdrop, we expect to sustain underweight equity, industrial commodity and US Dollar currency allocations while keeping overweight allocations to fixed income. Moreover, at the factor level we expect to sustain our overweight high quality, underweight cyclical allocations.

Emerging Market Perspectives

EM Equities Sharply Outperform Developed Peers in March, as US Banking Crisis and Eurozone Bank Sector Concerns Solidify EM Economic Growth and Currency Outperformance Outlook

The US regional banking sector crisis along with Eurozone banking sector concerns have resulted in a resumption of US$ weakness and increased prospects of US and Eurozone economic growth deceleration versus emerging market economies. In contrast to the composition of the emerging market equity index benchmarks during the 1980s and 1990s, in which macroeconomic balance sheet vulnerable countries and commodity sector stocks dominated benchmark weightings, today emerging market equity index benchmarks (e.g. MSCI Emerging Markets index) are dominated by robust macroeconomic balance sheet country constituents (e.g. South Korea, China, Taiwan, India) and domestic economy oriented companies (e.g. financials, consumer discretionary, information technology).

The above-mentioned distinction between today's emerging market equity index composition – at the country and sector levels – and those prevailing during the 1980s and 1990s are important for investors to take under consideration. Today's emerging market corporates' stronger financial position and vastly lower sensitivity to demand conditions in the developed economies strongly suggest EM companies' revenue and earnings growth outlook on a relative basis has strengthened considerably further following the current banking sector dislocations in the US and Europe.

As we look ahead, within our emerging markets strategy, we continue to favor overweight allocations to north Asia and selected Latin American markets, funded with underweight allocations to South Africa, Central Europe and select South East Asian markets.

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