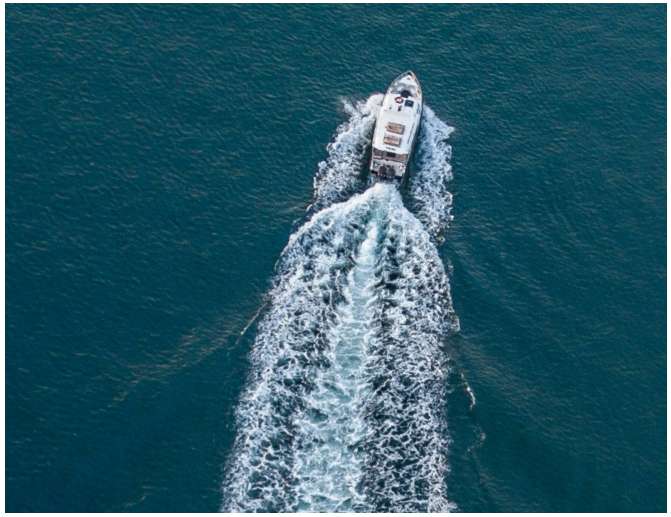
Close Brothers
Asset Management

# Investor Insights

Staying the course: Diversification is key

# In this edition of Investor Insights we cover



## Staying the course

Diversification remains a key pillar of our investment approach.

## Energy prices

Energy and the re-opening of China are contributing to a better outlook.

## ChatGPT

The phenomenal growth and investment opportunities of ChatGPT.

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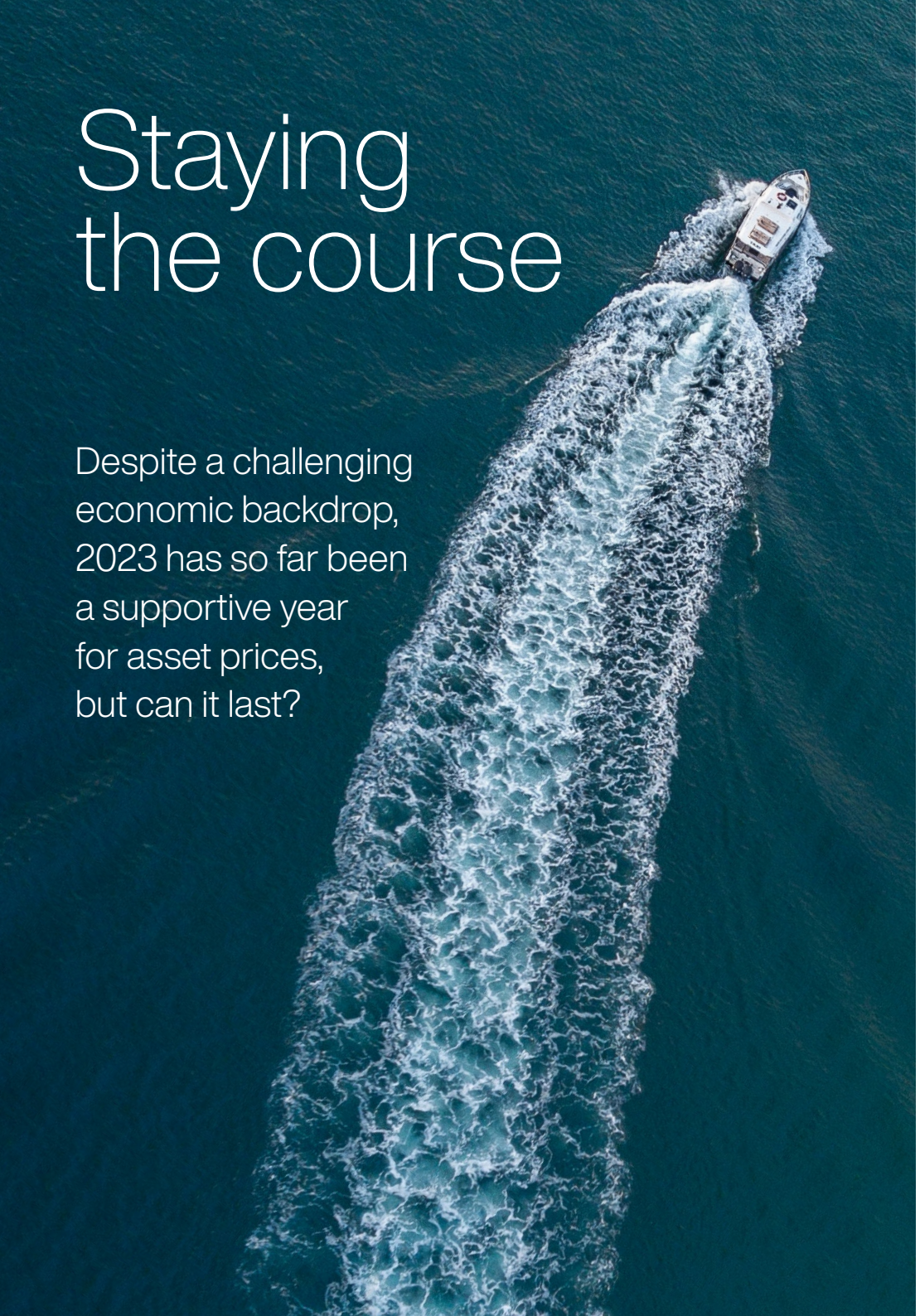
# Staying the course

Despite a challenging economic backdrop, 2023 has so far been a supportive year for asset prices, but can it last?



**A strong start**

Providing a welcome respite from the turmoil of 2022, asset performance has been broadly favourable so far this year, with both equities and bonds higher at the end of the first quarter than at the start of the year. While a number of factors have likely contributed to this stronger performance one driver stands out - the movement in bond yields.

If we look at the performance of the global equity index over 2022, the trough seen in September 2022 coincides with the peak in the US government bond yield. This reflects the fact that, even whilst central banks were still tightening monetary policy, markets were beginning to price in an end to monetary tightening.

While a number of factors have likely contributed to this stronger performance one driver stands out - the movement in bond yields.

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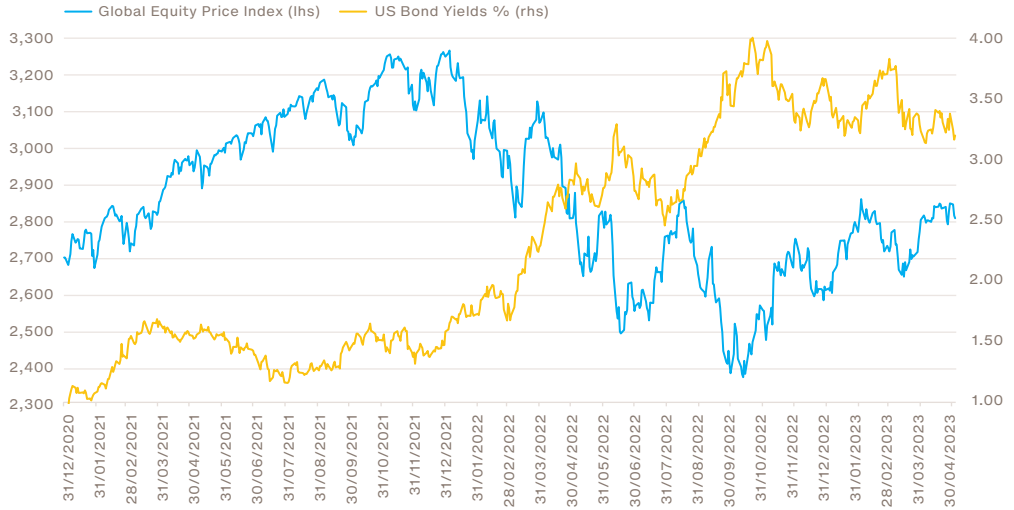
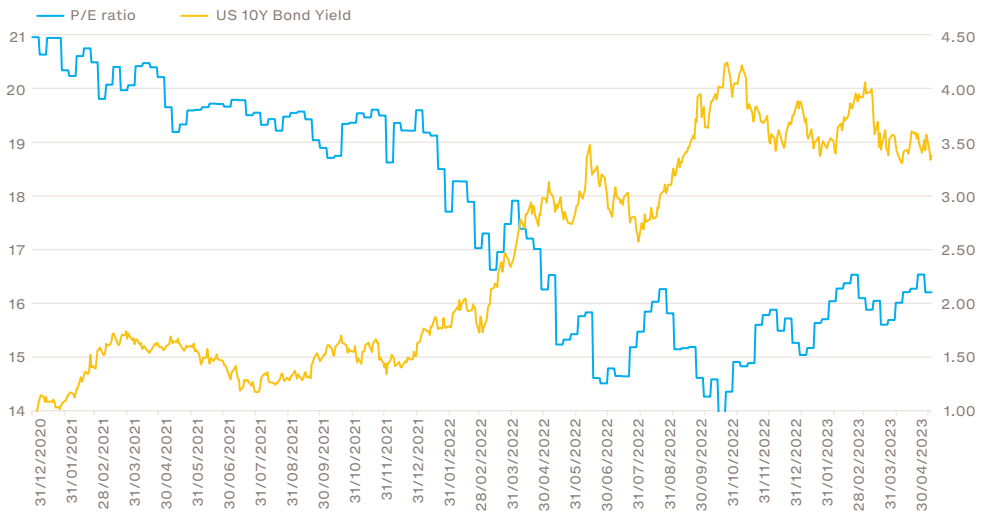
**Global Equities vs US Government Bond Yields**



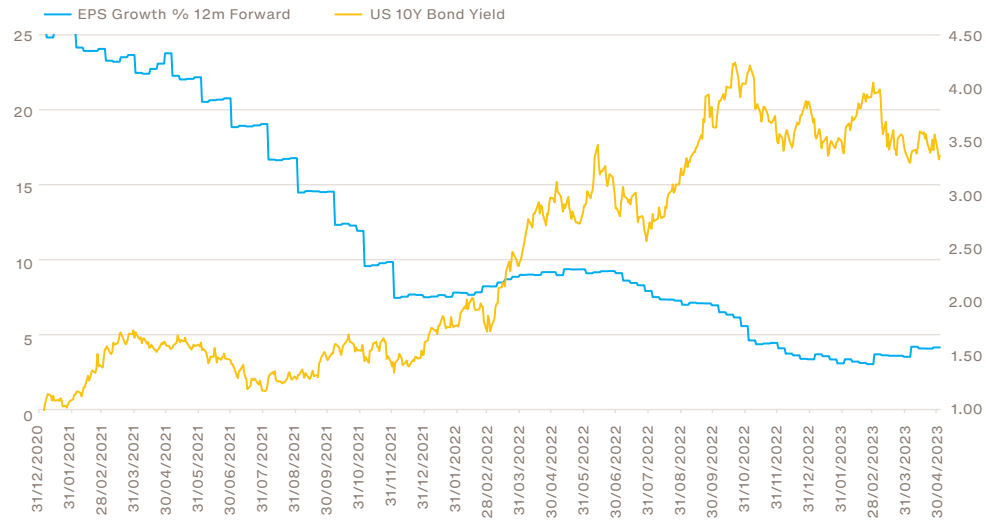

Source: Bloomberg Finance L.P. and DataStream

**World PE rations vs US Bond Yield**




Source: Bloomberg Finance L.P. and DataStream

**World EPS growth vs US Bond Yield**




Source: Bloomberg Finance L.P. and DataStream

The reasons why this supported the bond market are clear – the price of issued bonds moves in opposition to the direction of future interest rate expectations. It is for this reason that bonds suffered so much in 2022, when interest rate expectations were rising.

Most bonds pay a fixed interest rate that becomes more attractive if interest rates fall, driving up demand and the price of the bond.

If interest rates increase, investors will no longer prefer the lower fixed interest rate paid by a bond, resulting in a decline in its price.

However, interest rates also had a big impact on equities, as we have seen. One way of illustrating this is to look at the relationship between bond yields and the multiple that investors are willing to pay for future earnings – the price-to-earnings ratio. Bond yields are used to calculate the present value of future earnings so the higher interest rates are, the lower that multiple is likely to be. This means that higher bond yields, and thus lower bond prices, also translate to lower equity prices.

As we can see from the chart above left, the peak in interest rates coincided with a trough in the amount investors were willing to pay for future earnings.

If we look at those earnings themselves, we see that, in aggregate, earnings growth expectations haven't changed a great deal since the autumn of last year. This suggests that bond yields have had an important role in the equity recovery seen so far in 2023 and are likely to remain important in the months ahead.

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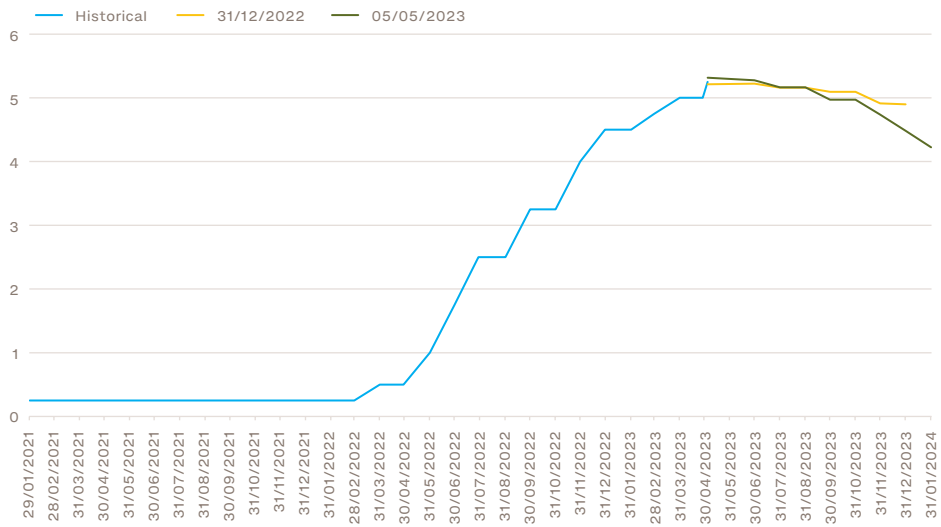
The path of interest rates has evolved broadly as expected.

**Are we there yet?**
Given the importance of bond yields and monetary policy for asset prices, when can we expect monetary tightening to end? Since the end of last year, futures prices have indicated that market participants anticipate the US Federal Reserve to end monetary tightening this year, and as soon as this summer. Since then, the path of interest rates has evolved broadly as expected, with the policy rate marginally higher today than forecast in December, and rates now expected to decline more sharply than previously anticipated.

**Future Market Indication of Interest Rate Expectations %**




Source: Bloomberg Finance L.P.

# Banking crisis

In March 2023, a banking crisis emerged in the US and saw the collapse of a number of banks. The crisis appears to have been contained within the US - mainly because European and UK banks have far tighter restrictions.

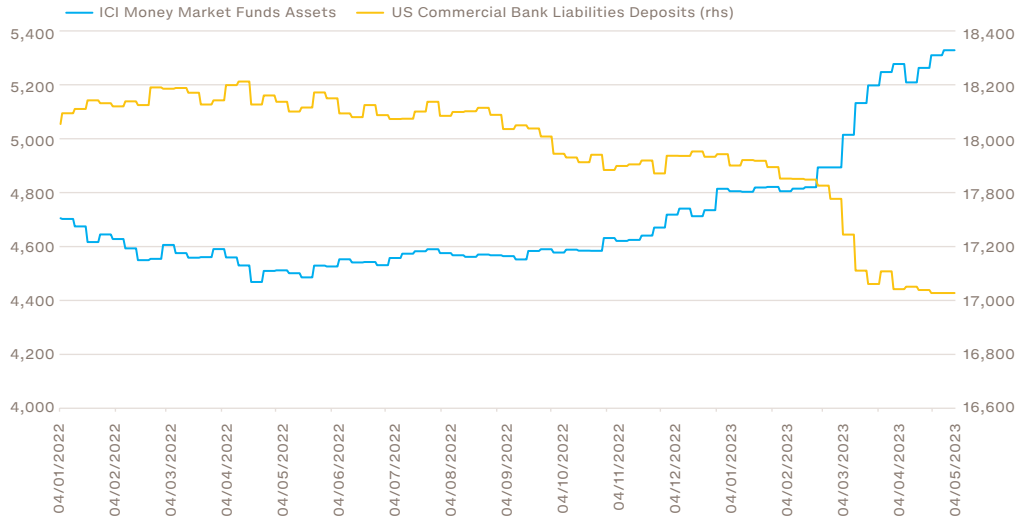
The first shoe to drop was the failure of Silicon Valley Bank (SVB), a commercial bank with clients predominantly in the tech sector. The bank's difficulties were started by a fall in bank deposits. To fund these deposit withdrawals, SVB had to sell assets. However, lower loan demand meant that the bank had invested much of its assets in government bonds, which had fallen in value since interest rates began to rise. The bank sold these bonds, realising losses. Eventually, the bank had to recapitalise, sparking wider concern.

Continued

There were a number of factors that made this bank particularly vulnerable. SVB was offering little or no interest on deposits, at a time when higher interest rates meant attractive interest rates were available elsewhere. The bank's clients were mainly in the technology sector. This resulted in a sector downturn hitting the bank harder and news of the trouble at the bank spreading quickly. Many of these clients also each had a large amount of cash deposited at the bank, above the amount protected by the US deposit insurance scheme. This meant that, rationally, corporate clients were right to pull deposits. The bank's risk management was also clearly lacking, with no risk officer in place for eight months. Furthermore, as a smaller US bank, SVB was subject to less stringent controls than its larger peers, and at the same time was less able to fund deposit flight.

While some of these factors were idiosyncratic to SVB, others have a broader application, as we have seen from failures elsewhere in the US banking sector. Smaller US banks continue to face pressure, and investors continue to shift deposits out of small banks and into large banks and money market funds, seeking higher yield and greater surety. Even for banks with more diversified customer bases, in the age of social media, the queue to withdraw deposits forms quickly and invisibly.

**US Assets $bn**




Source: Bloomberg Finance L.P

The crisis in the US's smaller banking sector is clearly not over, with more names facing difficulty. However, individually, these banks are a small share of the total US banking sector, which is less consolidated than many other markets. Crucially, no US large bank has run into trouble, and large US banks face tighter capital rules.

Banks judged to be "Global Systematically Important Banks" face higher rules still, and the interdependence of bank funding has fallen in the wake of the Global Financial Crisis, with interbank lending having fallen by two thirds. It is also significant that, with the exception of Credit Suisse, which had a long and chequered history of controversies, the crisis appears to have been contained within the US. This is in part because European and UK banks have far tighter restrictions.

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While the banking crisis continues, there are likely consequences:

**Lower profitability**
Customers with deposits above the US deposit insurance limit, currently $250,000, are at risk of loss. Greater awareness of this has likely led to a surge in customers moving money around, and in bank withdrawals. It seems likely that US regulators may seek to assuage these concerns by raising the limit for the deposit insurance scheme. This scheme needs to be funded, and the levy on banks would likely increase. A higher threshold also risks "moral hazard", and bank regulations would likely tighten to prevent this. Tighter regulation would also likely hinder profitability, as it would likely further limit the amount of risk banks are able to take.

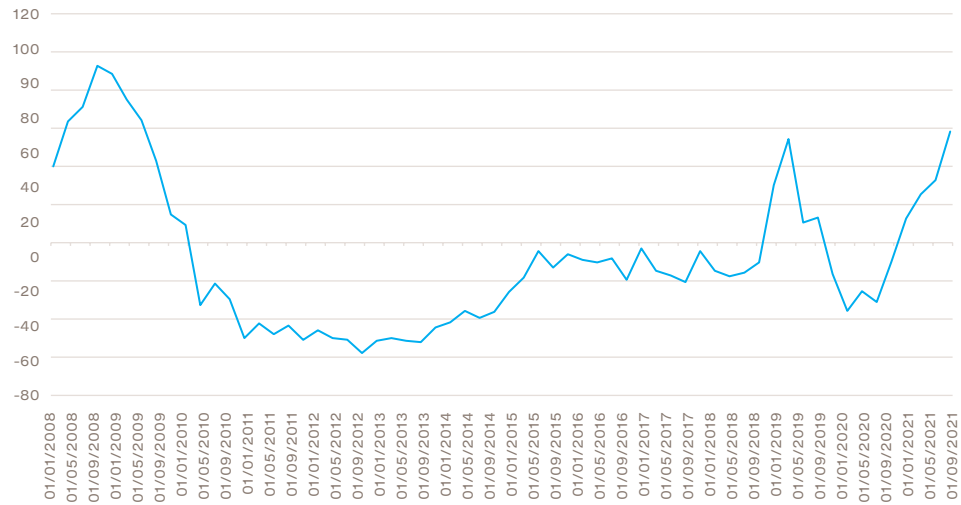
**Consolidation**
The crisis has already led to some consolidation, with large US banks acquiring smaller banks facing difficulties. Stress faced by smaller banks is expected to result in broader consolidation in the sector.

The crisis appears to have been contained within the US. This is in part because European and UK banks have far tighter restrictions.

**Tighter credit growth**
Greater stress on the banking system is expected to result in tighter credit growth. We have early evidence of this in business and loan officer surveys but it is not yet clear how long the period of stress will last or how pronounced the hit to credit growth will be. Nonetheless, credit growth is expected to slow faster than previously expected, and this is likely to weigh on GDP growth.

**Monetary policy implications**
The tightening of credit conditions acts on the economy in much the same way as an interest rate rise does. This combination of slower growth and tighter credit conditions is likely to mean that, compared to the counterfactual, the US Federal Reserve is likely to tighten monetary policy by less.

**Fed Senior Officer's Survey - Net % of Domestic Respondents Increasing Spreads of Loan Rate over Banks' Cost**




Source: Bloomberg Finance L.P.

# Positive surprises

Since the start of the year, GDP forecasts have been revised higher. This reflects the fact that activity has broadly been stronger than expected. Two drivers have been standout contributors to a better outlook - energy and China re-opening.

**Energy**
The sharp fall in energy prices has led to upward GDP revisions, especially in the UK, Europe and Asia, regions that are significant net importers of gas. It is also helping to pull down inflation in these regions.

The decline in gas prices is, in part, due to a mild winter in Northern Europe. After Russia invaded Ukraine, European countries embarked upon a programme of measures to reduce reliance on Russian gas. This involved filling up gas storage ahead of the colder winter months, and putting in place alternative supply sources such as imported liquefied natural gas (LNG), as well as taking measures to reduce energy consumption.

Combined with a mild winter, these steps have helped to reduce European gas demand, pushing down prices. Gas prices are now expected to remain lower for the rest of the year, with single-digit unit pricing (£/€) possible in Europe. Looking ahead to winter 2023, high storage levels are expected to mitigate demand stress, with even a total halt to Russian pipeline flows expected to be manageable.

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The sharp fall in energy prices has led to upward GDP revisions, especially in the UK.

**China reopens**
At the end of 2022, Beijing officials relaxed China's strict "zero-Covid" social restrictions. The relaxation of controls makes it possible for China to enjoy a recovery in GDP growth in 2023, with many forecasts at or close to 6%. A recovery could also boost demand elsewhere, with tourism and luxury goods expected to benefit.

So far, the recovery has evolved ahead of expectations, with Q1 growth rebounded more strongly than anticipated. However, once the sugar-rush of the initial easing is over, consumption may be constrained by weaker household balance sheets and weaker consumer confidence. Youth unemployment is high in China, which could undermine the ability and willingness of consumers to spend.

Unlike previous recoveries, the rebound is expected to be concentrated in the services sector. While policy makers have made pledges to support the economic recovery, they seem less willing to bolster growth by turning on the spending taps. At the recent Politburo meeting, officials confirmed that monetary and fiscal policy would be supportive, but local government borrowing would remain under scrutiny. The housing sector is also likely to get less support, with officials reintroducing their credo that "housing is for living in, not for speculation."

**Monetary policy implications**
While we still expect global growth to be weaker in 2023 than 2022, forecasts have been revised up significantly. These positive surprises explain, in part, why monetary policy makers have continued to tighten for longer than some anticipated.

**Past the inflation peak**
While 2022 was characterised by rising inflation, with supply chain problems, labour market changes and Russia's invasion of Ukraine all conspiring to push prices higher, we expect inflation to be falling in most developed market economies in 2023. This is for a number of reasons. Because prices rose significantly in 2022, if prices remain stable, or even rise by a smaller percentage, inflation will be slowing. Energy and food prices have also eased further. Food prices have been stronger than anticipated, due to poor harvests, but Futures prices suggest these should fall too.

We expect inflation to be falling in most developed market economies in 2023.

One source of continued concern has been the tightness in labour markets and the strength of wage growth. However, in the US and the UK there is early evidence of the labour market beginning to weaken. Weaker inflation is expected to bring down wage growth, with workers seeking lower pay increases. Already-executed monetary tightening is also expected to weigh on the economy in coming quarters, which could create more slack in the economy, and thus the labour market.

**Monetary policy implications**
Less inflationary pressure relieves the pressure on central bankers to continue tightening. However, in the second half of the year, when the "easy wins" from base effects and falling prices are in the rear view mirror, labour trends are likely to come into greater focus, as they may have a greater influence on inflation, as it approaches target.

# Risks remain

While the outlook for 2023 is looking brighter, risks remain, both for the economy and for financial markets.

**Banking crisis**
The banking crisis is not over and, as such, it remains a risk. Furthermore, the degree of tightening already executed is significant and monetary policy acts upon the economy with long and variable lags. These lags are, generally liken to lengthen, given changes to the structure of the financial system since the Global Financial Crisis. For example, the share of UK households that have a fixed rate mortgage has increased to more than 80% and a greater share of home owners are fixing for longer. This diminishes the immediate “cash flow” impact of a rate rise.

**Interest rates**
While we expect an end to monetary tightening in the main developed markets in coming months, risks remain further out. Futures markets are currently pricing in not only an end to rate hikes in the US in 2023, but also rate cuts in the second half of the year. However, the Federal Reserve’s Open Markets Committee instead expects rates to remain flat in the second half of the year. If growth is stronger than expected, or only a shallow recession materialises, there is a risk that the market will be disappointed in its expectation of rate cuts. This could trigger declines in both bonds and equities.

**Manufacturing**
While business surveys point to a healthy services sector, it is clear that conditions have deteriorated in the manufacturing sector. This may reflect weaker demand for goods, as consumers prioritise spending on experiences, as well as easing supply chain pressures. Many firms also have full inventories, having stocked up on goods in the face of supply challenges. However, destocking and weaker demand are expected to translate to weaker orders, and manufacturing does tend to lead the broader economy.

# The rise of ChatGPT

Since ChatGPT was launched at the end of 2022, it has attracted a staggering 100 million users, which is the fastest ever user uptake for a new application. To put that into context, it took Meta (previously Facebook) four and a half years to hit that mile stone and it took Twitter five years. But what exactly is ChatGPT and why has it generated so much interest?

CBAM's Senior Investment Specialist, Tom Santa-Olalla met with Jakub Dubaniewicz, Senior Equity Analyst to discuss the growth of ChatGPT.

**Tom Santa-Olalla (TSO):** We've seen a phenomenal surge with ChatGPT and there has been a lot of media coverage, but what exactly is it and where did it come from?

**Jakub Dubaniewicz (JD):** It was developed by a Silicon Valley startup called OpenAI but it's now backed by Microsoft. It's basically a chatbot – an online conversation tool – that has been trained by an Artificial Intelligence (AI) algorithm.

It's been designed to mimic human conversation and interaction. So unlike Google, which is a search engine designed to provide a list of links when you ask a question, ChatGPT provides a single answer in a more human-like way which you can interact with.

**TSO:** So AI is key here and although most people have heard of it, they may struggle to neatly define it. How do you define AI?

**JD:** In very basic terms it is machines performing tasks usually associated with intelligent beings. We're actually surrounded by AI in our day-to-day lives, sometimes without even realising – Siri, Alexa, Google Home, Netflix or social media recommendations – all of these are driven by AI.

Continued

**TSO:** So why has ChatGPT captured people's imagination and had such growth in such a short period of time?

**JD:** I think it's because it's interactive. It feels more personal and it can answer a vast amount of questions or perform text-based tasks. Chatbots were originally designed to meet basic customer service needs but with ChatGPT you get so much more – from writing essays, drafting business plans or even planning your holiday.

**TSO:** So potentially a really helpful tool. What are the key benefits?

**JD:** For businesses it's a huge productivity and efficiency boost. AI can automate repetitive tasks, improve engagement and unlike standard chatbots, it can manage complex queries with accuracy - and because of the language processing algorithms, it responds in a more human-like way, making it more personalised.

If you need it to write your essay or email, create a presentation or illustration, not only will it create a draft, but you can then modify the content in an interactive way.

**TSO:** It's always a question that pops up with discussion AI, but what does this mean for jobs – are we about to see people being replaced by AI?

**JD:** AI can automate a wide range of tasks but I think it impacts the tasks, not necessarily the job itself. Plus the work force always adapts to technological developments. AI allows people to spend more time on higher value-add tasks - people will still be needed. And of course what a chatbot doesn't have is emotion – well not yet!

**TSO:** What about the downsides, are there any risks?

**JD:** With any AI driven tool, it's only as good as the data behind it. AI responses can often sound impressive, but the problem is that AI can't distinguish fact from fiction or good from bad. It simply predicts the most likely answer based on the data it's been trained on.

**TSO:** The UK Government blocked TikTok from its network and there are impartiality concerns about Twitter in the pre-musk era. Are there any privacy or security concerns?

**JD:** There are potential privacy issues. ChatGPT is still in infancy stage and a lot needs to be considered. Users will need to be made aware of what happens to the information and data they feed into the chatbot. People may not be happy with their information being used for language training models for instance. Some of this may require regulatory input of government intervention. As with the case with tech development, only time will tell.

**TSO:** For investors, what is the investment opportunity here?

**JD:** As I mentioned, OpenAI has been backed by Microsoft, but other large tech companies such as Meta, Google, Amazon have been very active in the AI arena for many years because of its widespread capabilities – such as scanning for cyber threats, targeting adverts or driverless cars.

Many sectors could benefit from this technology, especially companies with access to large amounts of data – so there are huge opportunities.

Let's not forget that in a gold rush, you can also make money from selling the picks and shovels. As AI grows, more computer power, servers, data centres for example, are needed to help power it. Companies involved in cloud computing and the manufacturing of advanced semiconductor chips all stand to benefit here so there are lots of potential opportunities for investors.

**TSO:** Good to hear and one we'll continue to watch closely.

# Investment implications

We expect 2023 to bring both opportunities and challenges for investors. In terms of opportunities, falling inflation and an end to the current monetary policy tightening cycle should offer relief to asset prices across equities and bonds. Bonds could also benefit from the more pessimistic outlook for global growth. However, a weaker growth environment is likely to translate to weaker corporate earnings growth.

Even though the monetary policy landscape is becoming more supportive for equities, the outlook for earnings could continue to weigh on those sectors where forecasts will be cut most. For this reason, we have a neutral stance on equities, and we are keeping a close eye on valuations. Within equities, we favour regions with better growth prospects, with Asia and emerging markets expected to enjoy stronger growth and a boost from China reopening.

With regard to bonds, we have become more constructive on the asset class overall and we now see greater value in selective opportunities, though yields have pulled back since the autumn.

Diversification remains a key pillar of our investment approach and alternatives continue to play an important role in portfolio construction. Recent volatility has been broad reaching and we continue to prioritise securities with low cross-asset correlation, and attractive inflation-hedging characteristics.

As ever, we continue to focus on the long term prospects of businesses, favouring quality companies at attractive prices. We expect moments of volatility to continue to offer opportunities for the selective investor to identify good businesses at attractive prices that have declined in tandem with the broader market.

Diversification remains a key pillar of our investment approach and alternatives continue to play an important role.

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