# State of Play

## Potential Peak?

**4 May 2023**

**Last week, First Republic Bank became the latest casualty of the rapid rise in interest rates in the US. As expected, the Federal Reserve increased rates by 0.25%, but is this the pause many commentators have been anticipating? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.**

**Key highlights from this week's State of Play**

- First Republic Bank rescued
- Latest US earnings round up
- Federal Reserve rate rise
- Outlook

# First Republic Bank – JPMorgan to the rescue

A few short weeks ago, Silicon Valley Bank (SVB) announced to the market that it had been forced to sell some long-dated bonds at a significant loss due to a lack of capital following high levels of depositor withdrawals. What followed was the fastest run on a bank in history, enabled by technology and fuelled by social media and 24-hour news. The banking turmoil that followed provided a stark reminder of the global financial crisis that unfolded 15 years earlier. A crisis of confidence triggered fears that others would follow soon after, until the Federal Reserve stepped in with a swift resolution to calm investor nerves.

One of the main reasons for SVB's failure, beyond a poor business model and depositor concentration, was the sharp normalisation of interest rates by the central bank in response to rising prices. On the one hand, banks benefit from higher interest rates as they are able to widen the gap between the rate they charge borrowers and the rate they pay savers. However, such a sharp rise in interest rates also prompts savers to move their cash from one bank to another to secure higher interest payments. After SVB collapsed, Credit Suisse, the troubled Swiss bank, also had to be saved by securing a deal with its great rival, UBS, to avoid further panic. This fall in confidence amongst depositors saw a huge movement of savings from small and regional banks to much larger institutions or into money market funds with asset managers.[1]

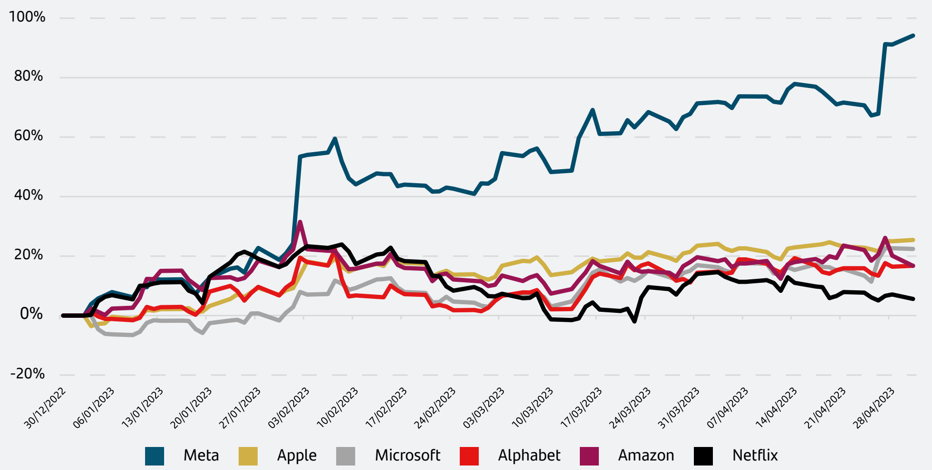
Last Friday witnessed the latest casualty, First Republic Bank in California. Regulators stepped in to seize the bank from operating, leading to a rushed deal over the weekend with JPMorgan to buy what was left before the market opened in the US on Monday (1 May).[1] While US bank shares did fall slightly when the bell rang to open the new trading week, when compared to the crisis in March, investors seemed to take the latest failure in their stride. However, despite the calm, many experts have since been very vocal about the impact of the events in March and the potential knock-on effect on the availability of credit over the next few months. They argue that large banks will become more cautious by accumulating more savings from smaller banks as depositors choose well-known names over the rates that might be available, combined with restricting lending to businesses and individuals. I am fairly certain this developing situation may influence the Federal Reserve Open Market Committee on future rate decisions for the remainder of this year, mindful that banks tightening lending criteria could lead to a credit crunch if they continue to raise rates beyond what is required to tame inflation.

# US earnings round-up

Despite the US economy slowing to an annualised rate of 1.1% based on the data released last week, the latest earnings round from most of the major players in the US market has beaten expectations. Last week, Microsoft, Alphabet (owner of Google), META Platforms (formerly Facebook) and Amazon all beat market expectations, although the devil was certainly in the detail. As an example, Microsoft's cloud computing business, Azure, grew 16% to $22.1 billion at the same time revenue from personal computing fell 9% to $13.3 billion. America's largest technology companies have been quick to identify efficiencies and reduce costs, cutting tens of thousands of jobs in response to concerns about the prospects for the US economy.

Given the volatility since the start of the year, it would be all too easy for investors to think these giants have underperformed. However, on closer inspection, not only have they beaten market expectations on revenues and earnings, but their share prices have also risen across the board, with META Platforms being the star performer. The chart below shows the 'FAANG's, as they are sometimes referred to. Ranging from 5.6% for Netflix to a whopping 94% for META. Despite the banking crisis in March, most of the major banks in the US also beat forecasts, benefiting from higher interest rates and a flood of depositor cash from smaller banks on their balance sheets.

## FAANGs performance year to date

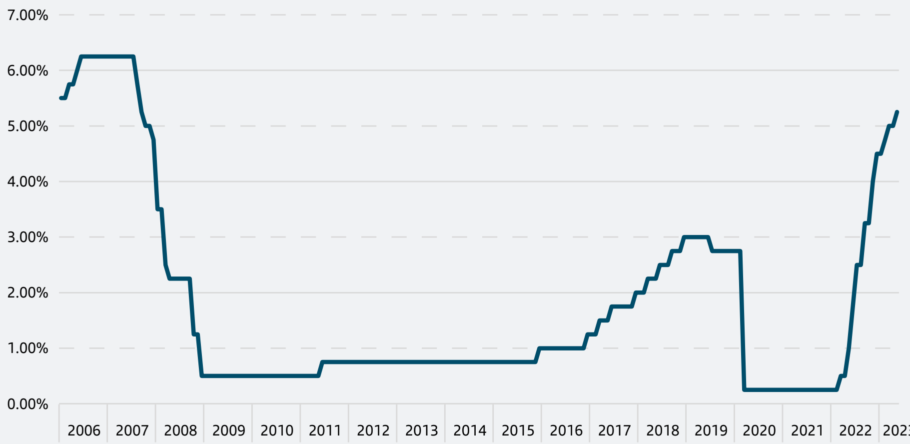



Source: Eikon
Data as at 1 May 2023

## Is it time to press the pause button?

As expected, the Federal Open Market Committee met to discuss interest rates and the prospects for the US economy, concluding on a 0.25% rise in rates and importantly, signalling a change in their forward guidance and language. The most recent economic data shows the US economy is slowing and headline inflation is falling. However, after the banking crisis, the central bank is mindful of the potential risks to the financial system and tightening credit conditions, where banks are beginning to restrict lending. In addition, core inflation, which excludes energy and food prices, is stubbornly high, and the latest earnings season demonstrates how resilient the US economy remains despite such a sharp rise in rates over the last 18 months. While job openings were lower than forecast, showing the jobs market is cooling down, concerns remain that higher wage settlements continue to feed into demand, making the task of taming inflation harder.[2]

### US Federal Reserve interest rates




Source: Federal Reserve
Data as at 4 May 2023

The Federal Reserve Chair, Jerome Powell, said in the subsequent press announcement, "We will closely monitor incoming information and assess the implications for monetary policy. In determining the extent to which additional policing firming may be appropriate to return inflation to 2% over time, the committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. In light of these uncertain headwinds, along with the monetary policy restraint we put in place, our future policy actions will depend on how events unfold."[3]

Oddly enough, the only silver lining that will help the Federal Reserve press the pause button now is the tightening credit conditions triggered by the banking crisis. Banks hoarding cash and restricting lending have a similar effect as rising interest rates. In the months ahead, tighter credit conditions will place a drag on economic demand, which in many respects does some of the heavy lifting for the central bank. It remains to be seen whether they choose to pause at the next rate meeting in mid-June.

## The value of seeking guidance and advice

It is important to seek advice and guidance from a professional financial adviser who can help to explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it is important to allocate time to review this to ensure this remains on track and appropriate for your needs.

**Learn more!**

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing **here**.

Note: Data as at 4 May 2023.

[1] Financial Times, 1 May 2023
[2] Investing.com, 2 May 2023
[3] Federal Reserve, 3 May 2023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