

Quarterly Commentary, March 31, 2023

Global equities have started the 2023 year rising in the first quarter in all major regions, though the rally is notably narrow. There were two key developments in the first quarter – the public launch of ChatGPT, a software platform that makes certain artificial intelligence (AI) capabilities available to the public and businesses, and a banking crisis that started in the U.S. and then spread to Europe. On the economic front, there continued to be low unemployment, solid personal income growth and a softening of inflation across the developed world. In local currency terms, 8 of the 11 industry sectors rose, with the Information Technology (+21.0%), Communication Services (+17.9%) and Consumer Discretionary (+16.1%) sectors performing the best. Falls were led by the Energy sector (–3.8%), Financials (–1.9%) and Health Care (–1.9%) as commodity prices fell and a banking crisis saw several banks fail and major steps taken by regulators to avert deepening instability.

The U.S. Federal Reserve raised the cash target rate a further 50bp to a 4.75% to 5% target range in two 25bp increments, slowing its pace of increase. Having raised interest rates by 450bp since the start of this tightening cycle a year ago, the impact on slowing inflation and slowing economic growth is starting to become more apparent, though recent data on U.S. economic growth has remained resilient and ahead of expectations. One clear sign that the sharp move higher in interest rates has consequences was the collapse of California-based Silicon Valley Bank after a run on its deposits led to its inability to meet the liquidity needed. The crisis escalated across other smaller U.S. banks and then to Credit Suisse in Europe before the regulators' responses finally worked to avert a systemic crisis. To do this, they provided liquidity to banks on generous terms and galvanized major banks to intervene to help reduce stress in the system.

Japan has a new Bank of Japan Governor, Kazuo Ueda, and his policy decisions, particularly the shift away from Yield Curve Control, will be closely watched, given the implications for global money flows. China continues its committed, albeit chaotic, reopening and cut the Reserve Requirement Ratio for its banks in March to help with efforts to revitalize economic growth. Geopolitical tensions between China and the U.S. were again evident during the quarter, including the cancelling of a visit by the U.S. Secretary of State to Beijing and the coordinated widening of restrictions on the export of advanced semiconductor machinery to China.

The portfolio rose during the March quarter. The largest contributors were the holdings in ASML, Microsoft and LVMH, which all rose in the quarter. ASML is well positioned as semiconductor needs expand globally, and its lithography equipment remains in high demand. Microsoft also performed well as ChatGPT, an artificial intelligence chatbot, was released by OpenAI and Microsoft increased its ownership of the company and added AI to several products including Bing. This evidenced the ability of Microsoft to commercialize AI in a way investors had not been able to visualize before and added to our thesis on the large addressable markets that Microsoft remains well positioned to win. LVMH performed well as its exposure to the reopening of Asia, especially China, gained momentum and the benefit for LVMH sales was assessed.

The largest detractor in the quarter was U.S. Bancorp (USB), which fell over the quarter, first as fears of a banking industry collapse fueled panic and then as the assessment of a deterioration in the earnings outlook weighed on the sector. As the fifth-largest U.S. bank, USB is well positioned as further industry consolidation seems likely and looks undervalued post the sector-wide sell-off. The other larger detractors were all among our more defensive holdings; United Health Group on no particular news, and Eversource Energy, which struggled alongside the Utilities sector as the rise in real rates weighed during the quarter.

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It certainly appears that markets have ‘climbed the wall of worry’ during 1Q2023 though it is fair to reflect that the overall indices’ strengths have been heavily influenced by a few stocks. As the banking crisis broke in March, we were reminded that we have been on crisis watch for some months now; history tells us that significant and rapid monetary policy tightening tends to break things. We would anticipate the tightening to be almost complete (perhaps one last 25bp for the Federal Reserve?). We believe inflation will continue to be the core focus as central banks work to bring inflation down to target levels and we will need to continue to see lower inflation datapoints over 2023 if Central Bank rate rises are to pause.

A systemic crisis in banking has been averted but it seems plausible, if not probable, that further breakages may lie ahead. Analysis of insurance company holdings and commercial real estate, refinancing risks on maturing debt as well as those more exposed to a contraction of lending, especially by smaller banks, will be ongoing. There will be increased regulation of banks in the U.S., and it is likely credit growth has been impaired by the events of recent weeks, laying the case for less economic growth in the months ahead. The risk that these pressures may ultimately translate into an economic recession in many parts of the world is elevated but the depth of the slowdown remains unclear.

Labour markets are lagging indicators and so unhelpful for gauging progress on wage inflation. It is notable that layoffs in the U.S. have picked up and are spreading much further afield than the large numbers being reported for many technology companies. Where surveys collect data on inflation expectations, such as by the University of Michigan, we note that these remain anchored as consumers anticipate current high inflation will fall. Annualized, the month-on-month increase in core PCE inflation data for February is at 3.7%, suggesting improvement in headline figures will continue.

On another positive note, the recent difficulties for financials and progress on inflation likely bias the risks to the long end of the yield curve, or 10-year government bond yields, to stay in the recent range, and below 4% in the U.S. This is a positive for the valuations of longer-duration investments, especially those with strong cash flows and high returns on capital. The backdrop against which we find ourselves once again feels like one in which the MFG Asset Management strategy is advantaged. We believe our process leads us to highly advantaged companies that are balanced within the portfolio between those with strong secular growth tailwinds and those with low economic sensitivity and resilience.

Index movements and stock contributors/detractors are based in local currency terms unless stated otherwise. U.S. GDP statistics come from the U.S. Department of Commerce, while U.S. employment and inflation statistics are published by the U.S. Department of Labour. EU economic statistics come from Eurostat. UK statistics are released by the Office for National Statistics.

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