“The quality will remain long after the price is forgotten”. – Henry Royce

In Roman times the Ides of March marked the deadline for debts to be settled, however it appeared this year that settlement date was brought forward by five days as Silicon Valley Bank collapsed on liquidity concerns, sending the financial markets into turmoil as fears of a Lehman style crisis escalated. While the previous financial crisis may have been down to mortgage portfolios being repackaged and sold at higher credit ratings to unknowing investors, this latest run on the banks was the first caused by social media, as Twitter and WhatsApp feeds told investors to pull their money from SVB which combined with ease of digital banking started the domino effect in record time.

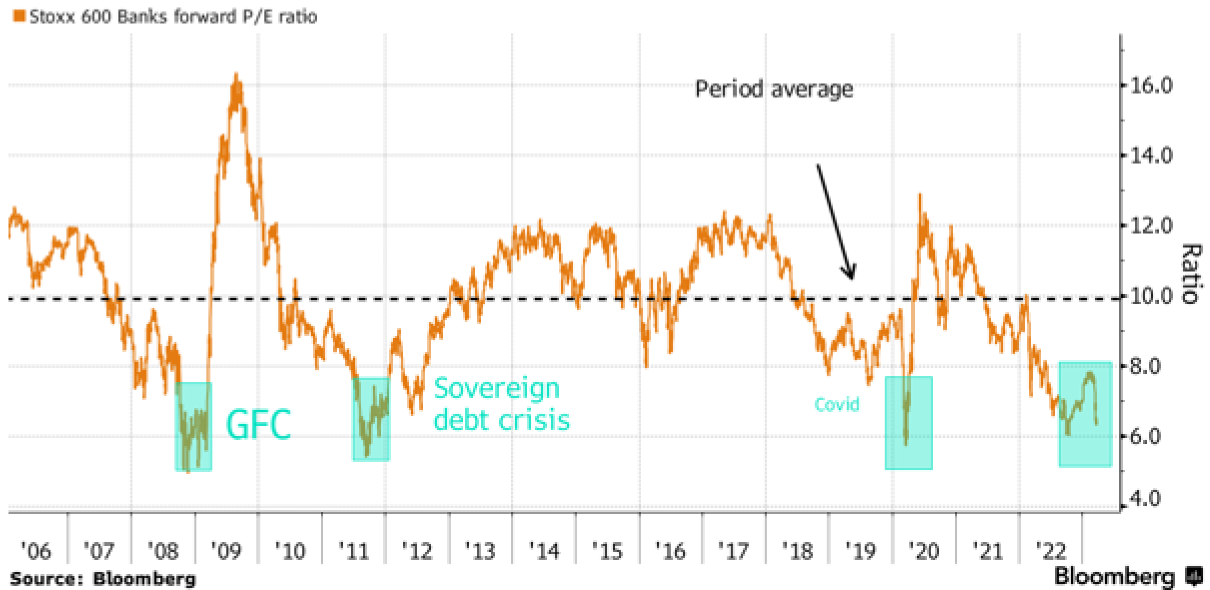
European Banks had been outperforming their US counterparts for almost six months.

Source: Bloomberg

The largest scalp was Credit Suisse, whose problems started many years before SVB’s problems came to light settled, as the Swiss authorities decided it was time to put it out of its misery. After a ruling that send shudders down the CoCo market, Credit Suisse ended its 167-year history, merging into UBS to create a single Swiss MegaCap bank. These moves along with coordinated central bank liquidity measures and rescue package initiatives led by the US banks such as JP Morgan Chase, stemmed the tide and a run on the banking system for the time being.

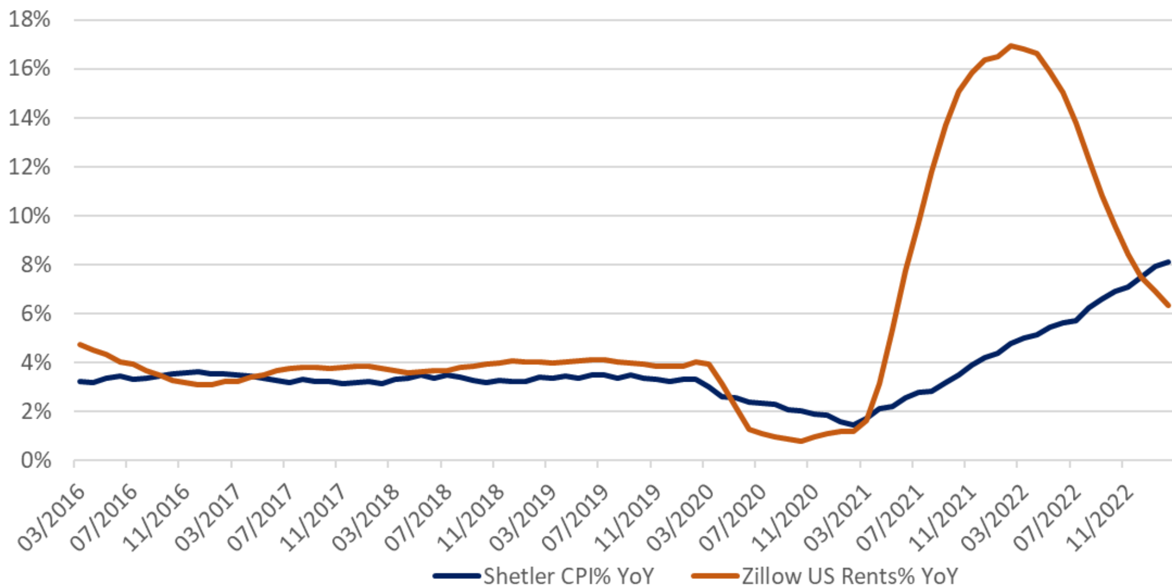
The contagion concerns saw financial institutions worldwide fall in value in short order, as investors sought to fire first and ask questions later as latent memories of the 2008/09 financial crisis still loom large in many investors’ minds. The big difference to 2008 is that the problems that banks have run into this time is a liquidity one rather than a solvency one 15 years ago. Since the GFC authorities have greater tools at their disposal to deal with liquidity issues quickly, and these have already been on display. The effect, however, of the run on SVB, Signature Bank and large scale withdrawals from other regional banks may be that banks become less willing to make new loans, especially in higher-risk sectors such as Real Estate, where the regional banks are already over-exposed. As the chart below shows sentiment and valuations in the European banking sector is already close to the GFC lows, and those with memories of 2009 will remember how quickly the valuations reverted once the Geithner/Obama financial stability plan was enacted.

European Banks P/E ratios close to previous crises lows.



Shifting focus to inflation, which remains stubbornly high, predominantly due to shelter (housing rents) and wages. Unfortunately, CPI and RPI numbers are backward looking so the Central Banks are likely to keep on raising rates well after inflation starts to fall; even if the issues in the banking sector had them temper the scale of their hikes this month. Shelter has the biggest weight in the inflation reading and accounts for over 34% of CPI, predominantly coming from a 7.5% weighting for rent of primary residences and 25.4% for owners' equivalent rent of private housing.

Rental Inflation and the CPI measure of Shelter are very different.



Source: TIM/Bloomberg/Zillow

While homes sales have picked up lately, they are well off the levels seen in 2020-21. Mortgage applications which should be a good indicator of future home sale, however, continue to fall and most recent reading of the average price of housing dropped for the first time since 2011, all of which suggests that the shelter reading is out of kilter with real world experiences.

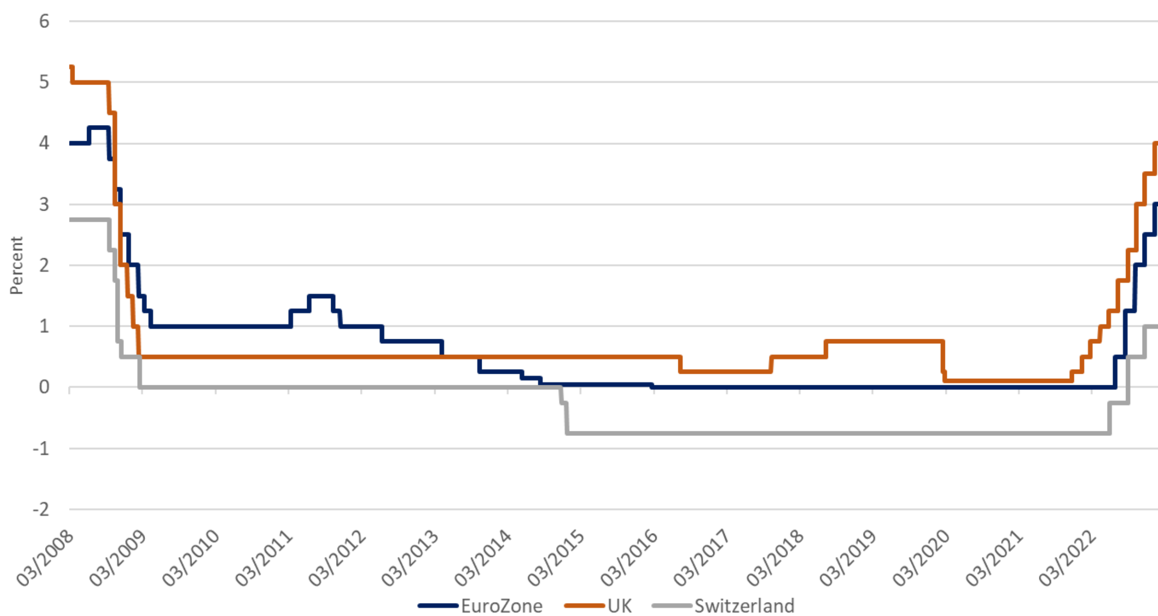
Value of investments can fall as well as rise and you may not get back the amount you have invested

US median house prices fell for the first time in over a decade.

Source: TIM/Bloomberg

The US Federal Reserve were not alone in deciding to raise rates despite the fallout from the banking sector. The European, British who are still looking at inflation running at 8.5% and 10.4% respectively and even the Swiss, who see inflation of 3.4% as excessive, put through their own increases during the month.

The Europeans follow the Fed's lead.



Source:TIM/BOE/ECB/SNB

The VT Tyndall Global Select Fund B Acc (GBP) fell by 0.71% as the fallout from the trials and tribulations of the banking sector and the actions of central bankers to combat inflation proved to be a brake on the upward trajectory of markets experience in January and February. The Fund has risen by 3.74% in the year-to-date.

Value of investments can fall as well as rise and you may not get back the amount you have invested

Fund Activity and News

For investors who follow the Fund's sector weightings they will notice a large shift from Investment Technology into Financials, we assure you that this has not been an active decision, but a reclassification of payment companies by MSCI from the former to the later when it underwent its sector review earlier in the month.

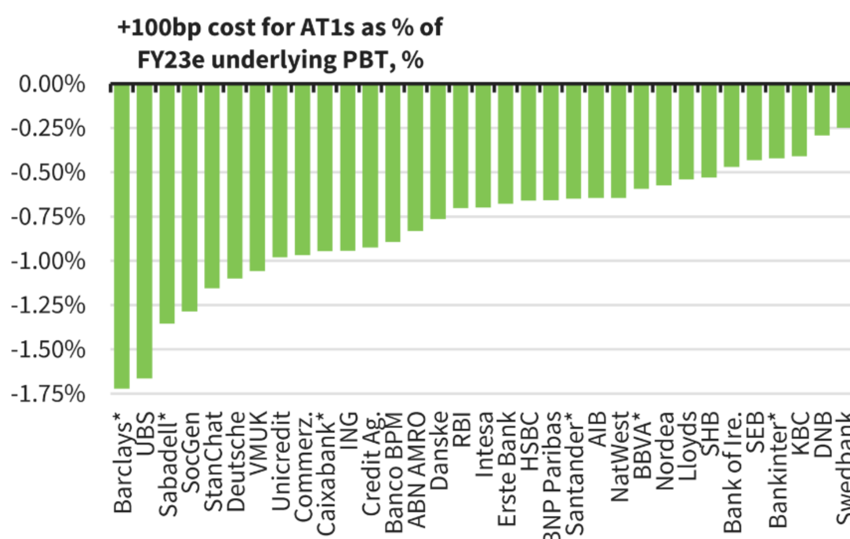
During the month, however, we switched our position in UBS into Heineken.

As the Silicon Valley Bank issues came to light the Fund slightly reduced our position in JP Morgan, albeit that we see JP Morgan as one of the beneficiaries from the liquidity issues in the US regional banks as deposits are likely to flow to the large US banks. We also reduced our position in UBS earlier in the month as its share price reached 15-year highs and close to the level it underwent a rights issue back in 2008.

While the deal brokered by the Swiss authorities and UBS to consign Credit Suisse to the history books should give UBS the opportunity to finally push into the Ultra High Net Worth community in the US, which they have struggled with to-date, and increase its existing dominance is Asia and Switzerland, the deal comes with significant execution risks.

Having successfully closed all but its essential investment banking operations ten years ago, they will have to come to a decision what to do with Credit Suisse's failing investment banking arm. We expect that in the long-term UBS will align the investment bank to the operations that it still participates in and cut the parts that are deemed non-core. As seen when UBS went through this process, it is not a straightforward procedure, and comes with significant costs attached to it.

The purchase terms of 1 UBS share for every 22.48 Credit Suisse shares (the equivalent of CHF 0.76 per share) was a reduction of over 53% on the previous week's close, however it does dilute existing shareholders as it comes alongside a suspension of its buyback plan. The surprise decision to cancel Credit Suisse's additional tier 1 capital (AT1), also known as CoCos, is an unusual move as normally shareholders would de first in line to absorb losses and bond holders thereafter; effectively CHF 16 billion of notes were deemed to be worthless overnight. This move will undoubtedly lead to increase in credit spreads in UBS, which would be an unwelcome consequence, thus increase the cost of debt for the combined enterprise. UBS has $12.8m of AT1 bonds, which account for 28.3% of their Core Equity Tier 1 ratio, which compares a bank's capital against its assets, the highest percentage of any European bank, albeit that Barclays and HSBC have a larger number of AT1 bonds.



Source: Barclays

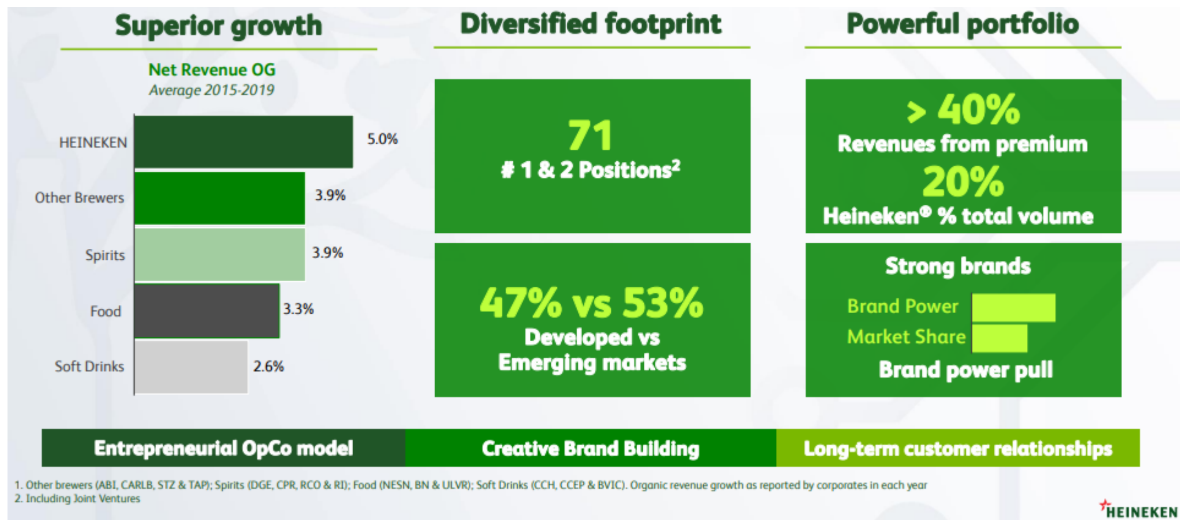
Another unusual move in the acquisition was that in the attempts by the combined Swiss authorities to draw a line under the risks falling out from Credit Suisse's demise, UBS shareholders we denied the right to vote on the deal, in order to complete the deal before the market open after the weekend. This therefore brings into question whether UBS's management continue to work in the best interests of shareholders. The management estimate that the deal will bring annual run-rate cost reductions of more than CHF 8 billion by 2027, and to be EPS accretive by that date. It remains to be seen whether the reputational damage to Credit Suisse results in investors leaving and conducting their business with other investment banks who have less restructuring underway, thus pushing the timeline for EPS accretion further to the right. Furthermore, many of the key 'rainmakers' will undoubtedly be courted by other banks as the merger gets underway, which may lead to increased asset outflows.

We expect that UBS share price will remain very volatile in the coming months and believe that despite various risks being underwritten by the Swiss National Bank (and effectively the Swiss taxpayer, to whom it would cost CHF 12,500 each if drawn upon in full), the execution risks are difficult to quantify, and given that the combined company no longer passes our "do I understand the company in its entirety?" screen, we sold our remaining position. The subsequent replacing of the Dutch CEO, Ralph Hammers with the previous Swiss CEO, Sergio Ermotti, was a surprise, however it was under his tenure that the bank started to cut its old investment bank, so perhaps it may be proven to be a prudent move.

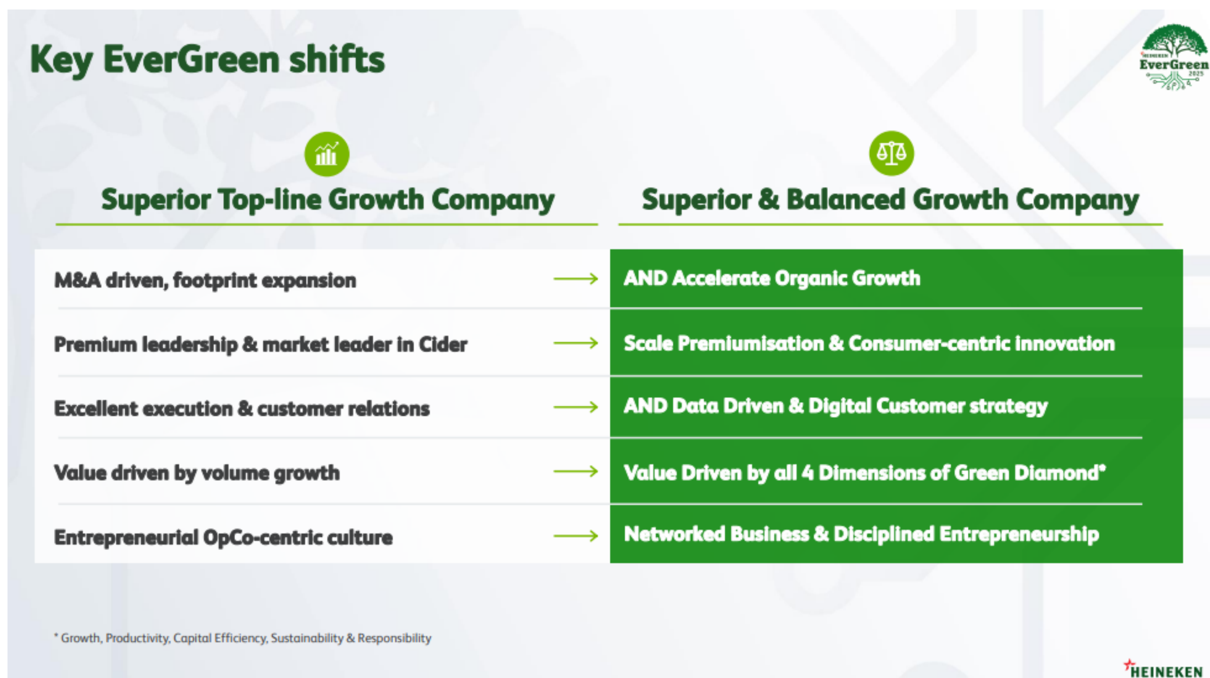
<u>UBS resorts to recruiting its old CEO for the Transition</u>

We also invested in Heineken Holding to take over UBS's place in the Fund.

Heineken has evolved under the leadership of Dolf van den Brink and has an industry leading premium portfolio, balanced with local champions, as well as a global network that is evenly weighted across the continents. In zero alcohol beer, which is growing at almost 8.5% per annum, Heineken is the clear global leader with Heineken 0.0 capturing 75% of the category growth between 2017-22, the company is now widening its zero-alcohol initiative across its leading brands worldwide and should continue to capture the lion's share of the category growth.

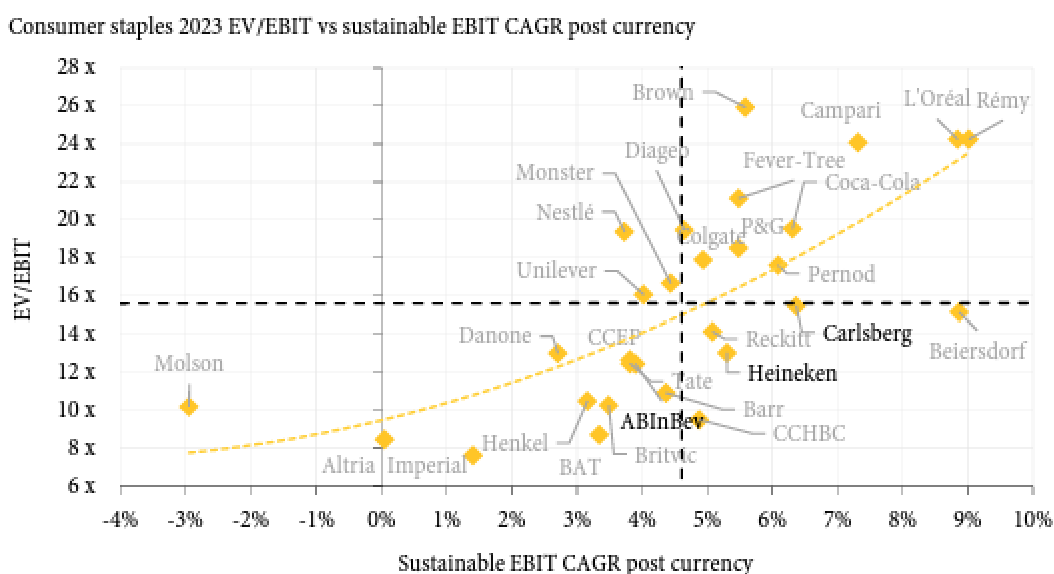


The leadership team of Heineken is very experienced with a long-term focus on both growth and profitability through premiumisation and efficiency savings. The executive team have an average tenure of over 15 years, and the CEO has worked at Heineken for 24 years. The management has recently launched the 'EverGreen' plan instilling a culture of greater productivity which has not been optimised thus far.



2022 was a year of significant cost pressures, but these are now abating and operating leverage should return, allowing margins and profitability to recover and surpass previous levels. Heineken also offers improving returns, a good track record of making opportunistic acquisitions and an increasingly efficient balance sheet, where it is committed to a long-term target of less than 2.5x net debt/EBITDA.

In valuation terms the company trades at a discount of almost 20% to the European staples sector versus a historic discount of 4%, despite a better growth record than the other food and beverage companies up to the pandemic, and we expect that they can regain this record now that lockdown anomalies are in the rear-view mirror. The holding company, in which the Fund invests, trades at a discount to the primary listing, of which it owns 50.4%, and the Heineken and Hoyer families own 53.7% of the holding company.



Source: Redburn, FactSet

Richard Scrope, Fund Manager, VT Global Select Fund, 31st March 2023
Data source (unless otherwise stated): Bloomberg.

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