Quarterly Report | March 2023

Lucerne
Alternative
Investments
Fund

March 2023 Quarterly Report

The Lucerne Alternative Investments Fund (LAIF) is expected to have a positive 0.06% return for March, resulting in a quarterly performance of 0.37%. Private Equity, Global Long Short, and US Healthcare and Consumer Discretionary Long Short investments were among the top performing investment strategies for the quarter. While Systematic Trend Following and Convertibles were the biggest detractors in the quarter.

Since its inception five years ago, LAIF has achieved a 9.02% pa return, exceeding its RBA cash rate plus 6% over a market cycle benchmark. It has achieved this with approximately half the volatility of equity markets thus not only diversifying and mitigating risk but in the wild swings of the last 18 months, preserving capital.

The markets experienced a tumultuous and volatile quarter with substantial bond market swings, multiple banks collapses, and significant equity market volatility. Despite this, the markets shrugged off the apparent concerns as the S&P 500 returned 7.03%, and the ASX200 Accum was up 2.26%. We worry about the concentration of returns in the S&P 500. For example, the technology sector, which suffered large drawdowns in 2022, witnessed a significant surge of 22% in the quarter, with Nvidia (+90%), Meta (+76%), and Tesla (+68%) leading the charge. Additionally, the consumer services sector, boosted by the strong performance of Apple (+27%) and Microsoft (+22%), increased by 21%. As a result, we are uneasy that these select few companies are heavily influencing the overall index performance.

We note that several of our previous theses presented in past posts are coming to fruition. The apprehensions surrounding global banking and the potential for contagion, along with the looming threat of a ticking time bomb in commercial real estate, lead us to question the viability of this equity market rally.

Furthermore, we feel uneasy about the discrepancy between the signals from the bond markets, which are indicating an economic downturn and recession, and the equity markets, which appear to disregard these warnings.

While bond yields drifted steadily higher through the quarter, they reversed dramatically and ended at 30-year lows in March as stronger than expected US macro data (including CPI, PPI, retail sales and labour data) that central banks could pause their rate increase and potentially commence cutting rates by the end of 2023. This is not something we expect to unfold as terminal rates are likely to be higher than present to tame inflation, which is the central banks only objective .

This quarterly report delves into the quarter's events and provides our view of the current market volatility.

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A look back at Q1:

- The US Federal Reserve (Fed) continued its pursuit of controlling inflation. As a result, the Fed cash rate increased by 50 basis points for the quarter.
- Reserve Bank of Australia (RBA) increased the cash rate by 25 basis points each in February and March, thereby increasing the cash rate by 50 basis points for the quarter and marking 10 consecutive rate hikes for a total of 3.60% increase in this time.
- Bank failures in the US sent shockwaves through financial markets in March.
- The venture capital and private equity valuations continue to be supported, but the start-up ecosystem has been disrupted and capital available for both is on watch.
- Tighter credit conditions may create a headwind for the economy, making close monitoring of the situation essential across industries and regions.
- Calls for a pause in interest rate hikes echo louder because of a potential contagion effect on the economy due to bank failures.
- FOMC meeting minutes changed to a dovish tone in February for the first time since the rate raising cycle in the wake of the banking turmoil.
- The persistence of high global inflation remained although the decrease in oil prices and the alleviation of supply chain pressures have contributed to its recent softening.
- Services inflation remained high, supported by robust demand and rapid wage growth.

Another policy error in the making?

In retrospect, it is essential to acknowledge that monetary policy is subject to considerable time lags. Historically, unemployment tends to be at its lowest point just before a recession. However, several leading indicators, such as durable goods orders, commodity prices and freight rates suggest a decline in inflation.

The US Federal Reserve ("Fed") has a range of financial stability measures at its disposal. Still, it is limited to using interest rates to tackle macroeconomic inflation (as discussed in previous posts). The Fed believes it can simultaneously achieve financial stability and hike rates, although this remains to be seen. So far, to be fair to them, that is what they are doing. But whether they can achieve this and balance macro and financial stability in the upcoming months will be the key. (We sense it is unlikely).

Notably, markets are influenced by the dispersion between actual results and anticipated outcomes. There is a significant divergence between market expectations and the Federal Open Market Committee (FOMC) messaging. Despite Fed Chairman Powell's announcement that there would be no rate cuts this year, futures markets forecast four rate cuts in 2023, beginning as early as June. If one believes the old maxim "don't fight the Fed", then now is the time to stay away from bonds.

Crisis and Confidence

To establish confidence in the market, the Fed raised interest rates by a lower than usual 25 basis points in March. This decision reflected Chairman Powell's and his team's confidence in managing the economy. As a result, they also stated there would be no interest rate cuts in the current year. However, given the recent crisis in regional US banks and the potential for contagion, Powell may be forced to concede and become cautious.

The Fed is currently in a challenging position, given the liquidity trap they find themselves in. High inflation combined with the potential collapse of banks has eroded the Fed's confidence in raising rates to combat inflation. If the failure of banks were to occur, it would not be limited to just one region. Still, it could cripple the global economy, leading to a recession. The domino effect and economic downturn are intricately linked to confidence, which makes this situation even more precarious for the Fed.

The Risks of Cutting Rates Prematurely

Over the past year, we have consistently maintained that interest rates would rise for a more extended period than the consensus estimates. Still, we also acknowledge that interest rates will eventually decrease again.

However it is crucial to note that an adverse economic event, such as a severe recession, will serve as the impetus for this eventual decline in interest rates and will have significant implications for investors. In addition, recently, there has been a growing consensus that the Fed will implement substantial rate cuts later this year in response to banking sector issues, as reflected in the 2-year Treasury yields.

To those who desire lower interest rates without first addressing the issue of inflation, we caution you to be mindful of what they wish for. History has shown that it is better to brace for a certain degree of short-term economic difficulty to prevent even more significant harm in the future, whether Western societies are determined to tackle the significant problems associated with interest rates, inflation and debt without deferring them and letting them intensify over time.

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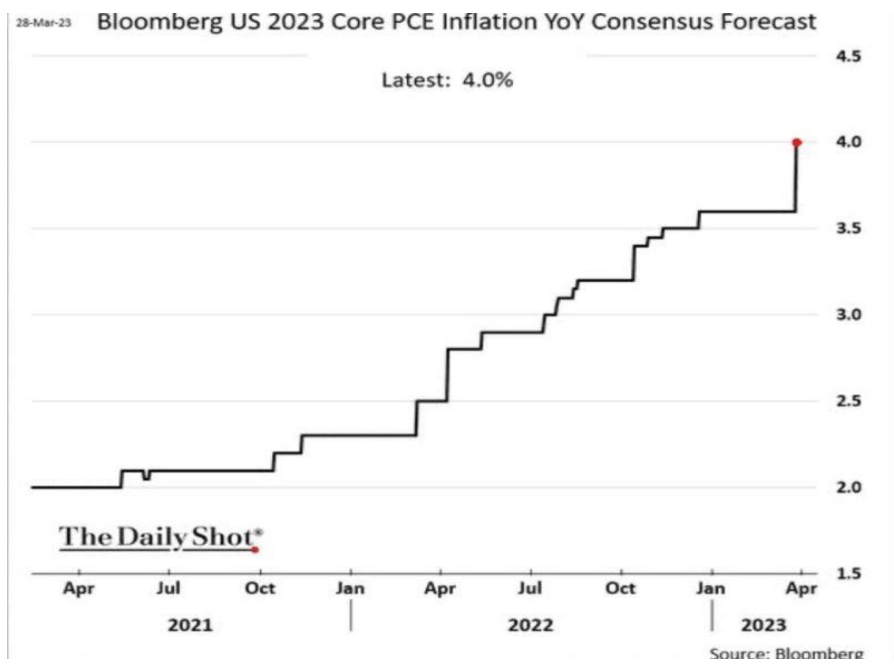

(Exhibit 1)

The chart presented above illustrates the consensus forecast for 2023 US PCE inflation, which has experienced a significant and alarming increase over the past month, suggesting that much work must be done to curb inflation. If the consensus prediction is correct, it may require several more interest rate hikes instead of cuts in the future. In our opinion, inflation takes precedence over banking turmoil, and we anticipate this trend to persist for an extended period.

Analysing Credit Suisse and Silicon Valley Bank: Understanding the Key Differences in Risk Exposure

SVB's downfall was primarily attributed to their prioritisation of net interest income (NII) over the economic value of equity (EVE), resulting in poor liquidity management and inadequate risk controls. As a result, this was a liquidity issue rather than a solvency issue.

Unlike SVB, Credit Suisse operates under the European Banking Authority's (EBA) regulatory oversight, which mandates using non-parallel shocks to evaluate the economic value of equity (EVE). These shocks enable banks to gauge potential net gains or losses in response to interest rate fluctuations It offers an additional layer of protection against interest rate changes.

However, it is crucial to acknowledge that Credit Suisse faces challenges that are not linked to asset and liability management. In the past, the bank has faced considerable reputational damage due to allegations of poor investment choices, money laundering, and other controversies.

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However it is the investment losses of Credit Suisse that can be differentiated from the mismanagement issues that impacted Silicon Valley Bank, as the former was primarily exposed to credit risk. In contrast, the latter's difficulties mainly stemmed from interest rate risk (leading to liquidity risk).

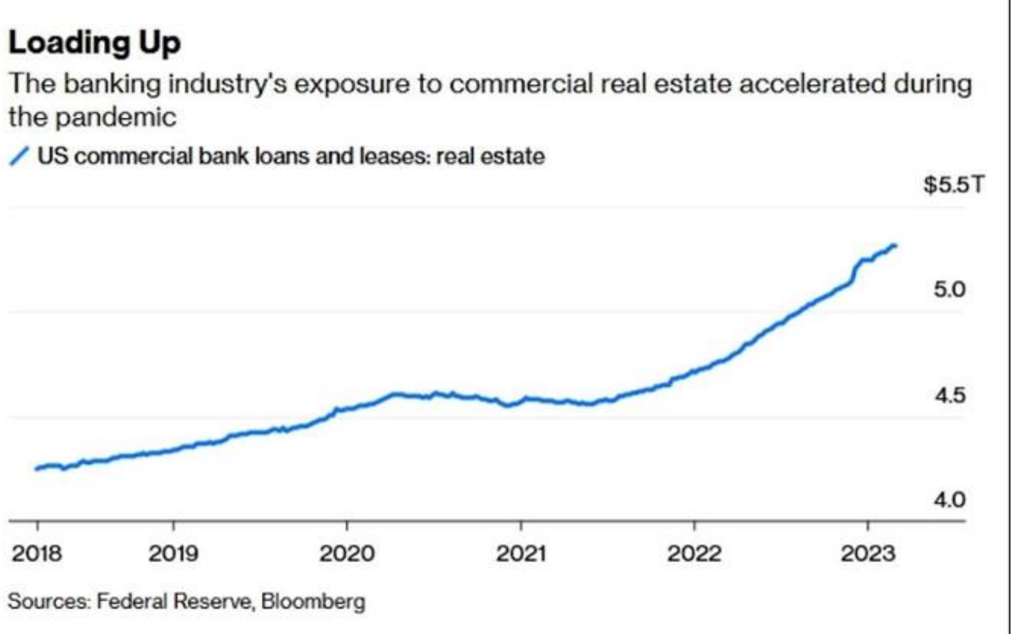
Although both banks have experienced difficulties during the same period, it is vital to acknowledge that Credit Suisse's challenges occurred over a lengthy period of poor risk management combined with an inability to manage their diverse business and are unique and should not be interpreted as a sign of broader systemic problems within the banking sector. Nevertheless, the global debate on the risks of high-yielding hybrid instruments was ignited by the write-off of Credit Suisse's $17 billion worth of Additional Tier 1 (AT1) capital Contingent Convertibles (CoCos) bonds.

It is worth highlighting that regulators across the globe have different approaches to dealing with hybrid instruments that share characteristics of both bonds and equities. For example, in Switzerland, authorities chose to write off the entire portfolio of AT1 capital CoCos to enhance financial market stability. In contrast, regulators in the UK and EU have confirmed that Common Equity instruments are responsible for absorbing losses first. As a result, the Banks must write down AT1 bonds (CoCos) only after their complete exhaustion.

More Pain in the Horizon?

What happened with SVB was a minor issue compared to the more powerful time bomb looming on bank balance sheets. We observe that the US banking industry increased its exposure to Commercial Real Estate (CRE) heading into the pandemic.

(Exhibit 2)



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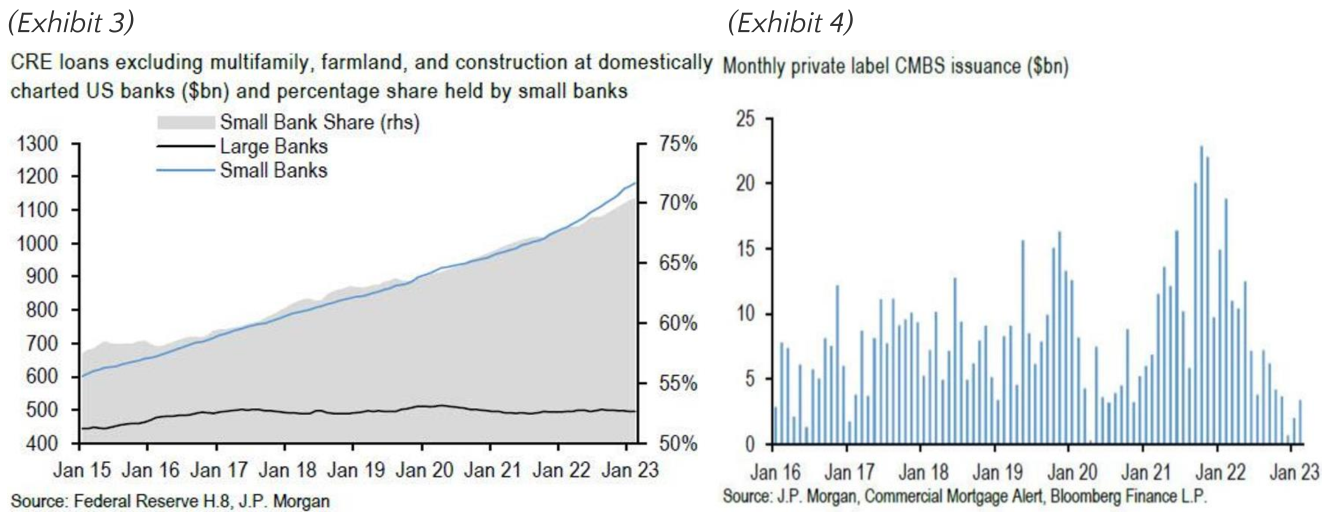
According to the Wall Street Journal, a record $270 billion worth of commercial mortgages are set to expire in the US this year. Banks with less than $250 billion in assets hold most of these loans. It is worth noting that SVB's downfall was initiated by a $1.8 billion loss from its bond portfolio.

The potential losses from CRE loans that enter into default could be more significant. During their February meeting, the Fed expressed concern for small banks holding these commercial loans. It singled out the risk to smaller banks and their CRE exposure.

It's understandable why 2023 poses a challenge. Small banks in the US have the majority share of commercial real estate (CRE) loans, accounting for around 70% of the total amount (Exhibit 3), including commercial mortgage-backed securities. Commercial loans typically have shorter terms and variable interest rates than residential mortgages. The combination of rising interest rates and decreasing demand will likely result in declining CRE prices in 2023.

(Exhibit 3) *(Exhibit 4)*



As the issuance of commercial mortgage-backed securities decreases (Exhibit 4), there is a possibility of a decline in the demand for commercial real estate. In addition, due to the difficulty in obtaining credit, there may be further price drops in the market.

There are two significant concerns for banks:

1. The increase in defaults
2. The possibility of collapsing prices

In both situations, banks may experience a significant decline in the value of their commercial debt portfolios. Moreover, these issues may also compound each other: lower prices could lead to more defaults, as borrowers cannot meet their obligations.

The decrease in commercial mortgage-backed securities issuance implies that banks are becoming more cautious and restrictive in lending practices. Indicating their concern about the future outlook of the CRE market and the liquidity of their current debt portfolios.

Furthermore, it is uncertain how severe the credit crunch will be as banks attempt to strengthen their financial positions and weather the ongoing credit turmoil. As a result, the lending market may become even more restricted in the near future.

Even in the absence of a banking crisis, it is likely that lending will become more stringent. This tighter lending environment could lead to decreased productivity, reducing revenues for companies and individuals.

A decline in revenue could lead to a reduction in income, ultimately resulting in lower tax revenue for the government.

Conclusion

During the company reporting season in Australia, there was a higher than usual occurrence of earnings misses and beats, highlighting the significant level of forecasting uncertainty throughout the market. As a result, the outlook statements made by companies were generally cautious, with central themes including uncertainty surrounding future demand for companies exposed to the consumer and housing sectors. Another significant issue was the shift in focus from labour availability to labour costs, particularly for wage inflation.

Given the prevailing market conditions, LAIF believes the upcoming US reporting season will reflect similar trends.

The markets are expected to remain volatile due to concerns surrounding the banking system and the implementation of aggressive monetary policy. Unless there is a shift in central bank policies, economic growth will likely decline, putting pressure on corporate earnings. One lesson from observing the market's expectations for forward interest rates is that these expectations can change rapidly.

Portfolio Movements

Lucerne Alternative Investments Fund continues to achieve uncorrelated and differentiated returns to equity and bond markets. To adapt to the current market, the Investment Committee has decreased investments in strategies predicted to have high market beta and increased the allocation in Global and Australian Long/Short, Volatility Arbitrage and Decarbonisation strategies.

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If you, or someone you know, would like to talk with us, please do not hesitate to contact us at laif@lucernepartners.com to arrange a call. Again, thank you for your interest in LAIF, and we wish you safe investing for the quarter ahead.

The Lucerne Alternative Investments Fund
April 2023

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