Quarterly Newsletter / Spring 2023

Lacomp plc is an independent investment management company providing portfolio management services to private investors worldwide.

After a dismal 2022 when virtually all asset classes and indices fell heavily, the markets seemed to be progressing steadily during the first quarter, having mostly shrugged off the concerns over the ongoing conflict in Ukraine and the increasingly heated nature of Sino-American relations.

The VIX (the 'worry index') had fallen back as confidence returned and all, so it looked, seemed well. Markets had returned to a more 'normal' pattern of muted ups and downs but with the broad trend moving into positive territory.

However, things changed rapidly when problems arose at Silicon Valley Bank (SVB). SVB was little known outside of California where it played a key role in providing banking facilities to start-ups and early-stage companies, particularly in the tech sector. It suffered a 'perfect storm' as the value of its Treasury investments fell with rising interest rates at the same time as venture capitalists lost their appetite for investment in the sector.

Business customers turned to the bank for cash and a panic ensued as it became clear that the bank would have to sell assets at a loss in order to meet the cash calls. The deposit protection in the US is capped at a generous $250,000 (compared to the UK's £85,000) but 95% of the bank's deposits exceeded this limit. With most of its business devoted to corporate clients, SVB was severely exposed to such a panic.

Emotion typically trumped reality – SVB in fact had plentiful assets to meet its liabilities provided they were held to maturity – and an old - fashioned bank run ensued. The shares in SVB fell 60% on 9th March, triggering fears of a broader malaise in US regional banks. On 18th March a consortium of larger US banks stepped in to support another bank, First Republic, also headquartered in California, and Treasury Secretary Yelland was moved to express full confidence in the resilience of the banking system. Many former football managers and government ministers know what that usually means!

Indeed, for a while it looked like the problem might be spreading farther afield and into other, better-known banks, particularly as Credit Suisse (CS) was forced to draw down options from the Swiss National Bank after the major Saudi shareholder declined to provide funding beyond its self-imposed 10% stake limit. CS clearly was in trouble, and as contagion threatened, trading in shares in some major European banks was temporarily suspended.

In the end, the Swiss National Bank and the Swiss financial regulators intervened, brokering a deal – behind closed doors! – that saw CS being sold at a knock-down price to its major Swiss rival, UBS.

CS shareholders – petrodollar investors like the Saudis and Qataris alongside other shareholders - were furious, but not as much as the holders of what are termed Additional Tier 1 bonds. AT1s, a form of convertible bonds, were created after the 2008 financial crisis in an effort to bolster banks' safety buffers. When a business fails, it is normal for shareholders to take the biggest hit, and bondholders expect to get some of their investment back. In this case, even though it was legally questionable, the AT1 holders were wiped out. Their loss amounted to some 17 billion dollars! This in itself spooked the market, considering the total AT1 market at the time amounted to a staggering 275 billion dollars, and AT1 holders everywhere worried whether the same could happen to them.

For a while, the spectre of 2008 haunted market sentiment but, at least for the present, things appear to have stabilised and an international banking crisis averted.

Over the last 15 years or so, UBS and CS became very different banks. UBS decided to remain conservative in its approach to banking whereas CS chose to become more and more involved in investment banking. Some ill-fated investment risks and poor decisions resulted in spectacular losses. When Archegos Capital Management went bust two years ago, CS was the biggest loser, to the tune of 5.5 billion dollars! CS was also involved in Greensill's insolvency with a rumoured loss of around 3 billion dollars. Another mismanaged investment and fraud scandal in Mozambique lost serious money, and about ten years ago CS ended up paying billions in fines for helping foreign nationals evade taxes in their home country. Then there were several scandals involving top management figures, and CS was also accused of misleading the authorities and of 'material weaknesses' in its financial reporting.

Not only have we witnessed the failure of a 167-year-old national institution – CS had lost over 90% of its value in the ten years before its 'merger' with UBS – but it has also shredded Switzerland's reputation as a bastion of institutional discretion, orderliness and reliability.

Meantime, the war in Ukraine rages on, above all in the Eastern area. It is difficult to know where everyone is at, given that real information is sparse and too many 'expert' commentators from all corners of the world blur the picture. There was plenty of talk of an imminent counter-offensive by the Ukrainians, but leaked Pentagon assessments and other documents, apparently shared with friends in an online gaming chat room by Jack Teixeira, a 21-year-old member of the Massachusetts Air National Guard, have cast doubts on that.

When we first heard about the leaked documents, and before we learned about its source, we wondered whether it might be misinformation, disinformation, or propaganda? Things are never crystal clear in military conflicts.

What we do know is that continued support from Western nations is helping Ukraine, including at long last from Germany as well. On the other hand, Russia is getting help from China, Iran, North Korea, Syria, India and even Egypt, plus another five or six minor players.

We hear about a falling out of the Wagner group, heavily engaged in the Bakhmut area, and the Kremlin leadership. Putin's former chef and Wagner mercenary group leader Prigozhin is accusing Moscow of starving his fighting force of both vehicles and ammunition. Thousands of soldiers from both sides have lost their lives in the battle for supremacy in Bakhmut, a town of relatively little strategic importance.

Where is Putin at in all this? To date, his army has failed. According to information from Russia, trains carrying T55 tanks, taken out of storage, are heading to the front line. If this is true, it shows that Putin really is getting desperate. These tanks were built seventy years ago and by now are thoroughly outdated. Their armour wouldn't even stop a bullet fired from a modern rifle, and their armament is wholly inadequate against the armour of more modern tanks.

So, is Putin getting desperate? Let us remind ourselves that one of the main reasons for his 'special military operation' was to stop NATO encroaching on his motherland. And what has he achieved? Finland, who share a border with Russia of over 800 miles, now have joined NATO. In addition, Finland has a formidable army which, in the event of a war and mobilisation, would be bigger than the UK's army. It also is incredibly well equipped.

Finland joining NATO has more than doubled the length of previous borders of other NATO countries (Poland, Norway, Latvia, Lithuania, and Estonia) with Russia, and that is why we think a somewhat unhinged Putin, surrounded by yes men who are unlikely or too scared to tell him the truth, could become really dangerous. Let us hope that he retains a degree of sanity.

Here in the UK, as indeed around the globe, people continue to struggle with the high cost of living. So much for the so-called 'transitory inflation'! So many other forecasts were also completely wrong – we wrote about them in our last Newsletter. Bank of England Governor Andrew Bailey gives us reasons and excuses. Anything and anybody but himself and the BoE Monetary Policy Committee. He suggested businesses increasing their prices should consider the effects on inflation as "higher inflation really benefits nobody." Oh really? Does it not occur to him that maybe a business – be it a pub, a restaurant, a retail shop, or a service provider – has to do so to survive? He also blamed higher inflation on people retiring too early as this pushes up wages to replace them. Really? He even told trade unionists to moderate their wage demands, all done for the greater good of the nation…

It is up to the BoE to control inflation, not price setters, early retirees or trade unions!

Many years ago, we warned that the Quantitative Easing (QE) could have a nasty sting in its tail, namely inflation. QE was introduced in the UK in 2009 after the financial crisis and was designed to avoid or at least mitigate a recession at a time when inflation was very low or even negative. It was a new way of dealing with the problems, replacing traditional monetary policy which was proving ineffective at the time. Most economists agree that a small amount of inflation is good for the economy, and a healthy target in that respect is around 2%. Indeed, that is the target the BoE sets itself.

Where the BoE probably went wrong in the first place was to print far too much money and for too long, 'printing money' being a euphemism for QE. Secondly, it kept interest rates too low for too long, and thirdly, when there were clear signs that inflation was on the up, it did nothing and kept monetary policy very loose, again for far too long.

Immediately after the December 2019 UK general election and as a bit of a surprise as it had not been in the Tories' manifesto, Boris Johnson announced that he was planning radical changes to the civil service. Among other things, his suggestions included replacing permanent secretaries with political appointees, closing, or merging departments, and making it easier to hire and fire civil servants. These measures had the fingerprints of his special adviser Dominic Cummings all over it. Cummings had long argued that the civil service was bloated, wasteful and often not delivering, or even obstructing, ministers' agendas.

In the event, Covid intervened, and these plans were put on the back burner. However, we were reminded of those post-election plans when Dominic Raab's resigned at the end of last week as deputy prime minister and justice secretary. He said he would do so if the allegations against him were proven to be correct. Yes, after five months of investigation, Adam Tolly KC's report did find him 'intimidating' and 'aggressive' on a couple of occasions. But does that make Dominic Raab a tyrant or merely a very demanding boss?

Let's face it, the civil service is far from perfect. The DVLA, the Passport Office and the Probate Registry are woefully slow in dealing with applications. Not surprising when one learns that about half the civil servants are still working from home – three years after Covid started.

Housekeeping

UK-resident clients will be aware of the changes to Capital Gains Tax announced by Chancellor Jeremy Hunt last November. The annual tax-free allowance for CGT reduced from £12,300 to £6,000 on 6th April 2023, and will be further cut to £3,000 in April 2024. In the same Budget Mr. Hunt announced a halving of the tax-free allowance for dividends from £2,000 down to £1,000 on 6th April, and that it will be halved again to £500 next April. These changes do not affect portfolios held within ISAs and Pensions.

We have always sought to keep clients' tax bills down however, where previously it was possible to manage some taxable investment portfolios (e.g. General Investment Accounts) to keep realised capital gains within the annual allowance, in future this will be nigh-impossible to achieve without our management of your portfolios, and thus potential future investment performance, being impaired.

Fortunately, where gains are realised in excess of the allowance the Capital Gains Tax rates are unchanged: 10% for basic rate tax payers (20% if higher rate) on investment gains in excess of the CGT allowance, 18%/28% for gains on residential property – but not of course your main residence.

This means for investment portfolios that potential CGT charges will be relatively modest, half the rate charged on earned income. And don't forget that to have a CGT liability means that you've made and crystallised capital profits.

And finally …

An update to our 'back office' software means these April valuations will be the last produced in the current format. Our next reporting pack in July will look a little different, and we thought we should prepare you for the change in good time!

Bagshot 26th April 2023

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