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Debt Ceiling Stand-off and Growth Runways



IN THIS ISSUE

- Novo Nordisk Update
- Vietnam Market Review
- Navigating the Storm – Understanding the US Debt Ceiling
- Back to Banking

DEBT CEILING STAND-OFF AND GROWTH RUNWAYS

ALASTAIR POWER | INVESTMENT RESEARCH MANAGER

IN THIS ISSUE



STOCK FOCUS

Novo Nordisk Update

[READ THE ARTICLE](#)



INSIGHT

Vietnam Market Review

[READ THE ARTICLE](#)



TOPIC OF THE MONTH

Navigating the Storm – Understanding the US Debt Ceiling

[READ THE ARTICLE](#)

Back to Banking

[READ THE ARTICLE](#)

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RISK WARNING

Investments and income arising from them can fall as well as rise in value. Past performance and forecasts are not reliable indicators of future results and performance. There is an extra risk of losing money when shares are bought in some smaller companies. Redmayne Bentley has taken steps to ensure the accuracy of the information provided.

As we progress towards the halfway point of 2023, financial markets look to have calmed somewhat following a volatile first quarter. Inflation remains a key topic with the UK figures heightened despite previous expectations of a fast reversal towards the 2% target figure. Western central banks continued their interest rate increases, the latest of which are expected to be the last in both the UK and US, and recent economic data remains robust with the UK avoiding a recession. Issues within the banking sector remain, as we will explore later, while corporate profitability is yet to slide in a broad sense.

Having settled somewhat in the wake of the Silicon Valley Bank (SVB) collapse, the US banking sector experienced further turmoil as First Republic became the latest victim, taken over by JP Morgan following the flight of nearly US\$100bn of deposits. Jamie Dimon, CEO of JP Morgan, recently declared this part of the US banking crisis over and that everyone can relax for breath. Potentially calming words from an industry leader, but we must remember that First Republic is the third bank to be taken over by US regulators since March. Larger banks coming in to rescue their smaller counterparts indicates stability within the banking system, but in the longer run it could spell issues with a handful of names in a dominant position.

Away from the banking sector, currency markets are being watched with interest as the US Dollar continues its slide downwards against its peers. Having risen sharply in the last two years, the Dollar's recent weakness is partly linked to concerns surrounding the US debt ceiling, the maximum amount the US Government can borrow to meet its liabilities. Decided by Congress, an agreement to raise the current ceiling level from US\$31.4tn remains unachieved. Without a resolution, the risk of default looms, with the US Government expected to run out of cash in early June; a scary headline but ultimately overblown as we explore later.

European equities have been one of the strongest performing markets in the year-to-date, easily surpassing other major developed and emerging markets. Some of this comes from the low base at the back end of 2022 which caused energy concerns, but it's easily forgotten that continental Europe plays host to some of the finest companies on the planet with significant exposures to the global economy, particularly Asia. Meeting a European equity fund manager without Novo Nordisk as a top position is fast becoming a rarity. This is not just in relation to its core insulin business but also due to the development of its Wegovy weight management product which is becoming difficult to ignore as we later outline in the Stock Focus article of this issue.

Another interesting growth story flying under the radar comes from the frontier market of Vietnam, Asia's emerging economic champion. Now the 15th largest country by population, its economy continues to advance with GDP growth of 6.5% projected by the Asian Development Bank for 2023. From a high level, the future is extremely positive with the country having an average age of 32.5 years and a population with high levels of literacy and internet use alongside a rapidly increasing urbanisation rate. Buying directly into this growth is challenging with nuances such as ownership limits for foreign investors, but access is enabled through a number of Vietnam-focused investment trusts such as Vietnam Holding Ltd or Vietnam Enterprise Investment Ltd.

STOCK FOCUS

NOVO NORDISK UPDATE

OSCAR SHEEHAN | INVESTMENT EXECUTIVE



Several months ago, I wrote a piece on Novo Nordisk, the Danish pharma company that has seen its share price grow by almost 58.48% over the last year. At the time, the company was already popular among fund managers operating in the space. Professional and retail investors alike have continued to lap up the company's shares and you would be hard pressed to find a European collective vehicle without it in their top ten holdings. Given the company's extended run, we believe it is a story worth revisiting.

Novo Nordisk is part of a cohort of large European companies that, despite being domiciled in Europe, generate a large portion of their revenue from overseas markets. Wegovy, its weight loss drug, has had approval in the US for quite some time and demand has been high. Another main driver of the company's continued success has been the approval of Wegovy in both the UK and Europe for widespread use. While competitors have started investing in obesity treatment, Novo Nordisk's head start and the market dominance of Wegovy may make it hard to catch. As with any company operating in the sector, there are questions about whether new drugs will be

approved, but the potential pipeline appears robust and strong cash flow has allowed the company to continue to reinvest in its future. The company may have experienced some reputational damage in the UK and its shares are trading at a historically high level, but this could be perceived as a reflection of the strength of its underlying products.

Previously, we discussed the concern of obesity in the western world. The potential size of the market and the lack of any real competition is what has fuelled the growth of Wegovy and Novo Nordisk over the past couple of years. However, things are changing and competitors are starting to emerge. Wegovy has proven so popular that demand is outstripping supply in the US. While in one sense this is excellent for Novo Nordisk, it has also created an opportunity for competitors to enter the market. There are many notable threats to the firm's market dominance as things stand but, to highlight a couple, Mounjaro (a drug from the same family developed

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by Eli Lilly) and Amgen 133 (a potentially effective drug developed by Amgen that is still in early-stage trials) could both become a serious threat. Mounjaro is already approved for use to treat diabetes and manufacturers hope it will gain approval as an obesity treatment in the US in the near future. Amgen 133 might be some distance from gaining approval, but early study results indicate that it could help patients lose 15% of their body weight in just 85 days. The bottleneck in the production of Wegovy provides an opportunity for these companies to gain market share if they can position themselves correctly. In the UK, this opportunity may be marginally more pronounced as Novo Nordisk has recently been suspended from the Association of British Pharmaceutical Companies for

failing to disclose that it had sponsored weight management training courses for healthcare professionals. Two further audits have been ordered on the firm's marketing practices. This poses a real threat to the company beyond just a tarnished reputation and could create an opportunity for a rival with an effective product if they are seen as having a 'cleaner' ethical background.

On a more positive note, approval is hard to come by in pharmaceuticals and, with this in mind, Wegovy has recently had two boosts to its potential sales. The drug has been approved centrally in both Europe and the United Kingdom for widespread treatment of obesity. There is some advantage to being first movers as it often takes new drugs years of testing to gain approval in these markets. This allows Novo Nordisk time to advertise its drug, build relationships with healthcare practitioners and patients and further solidify its market leading position. This makes it increasingly difficult for competitors to disrupt its position. Wegovy sales may have missed their Q1 target but still climbed over 346% year-on-year. It only gained central approval late in the quarter and, as such, the company expects growth in the future. Despite the missed target, Novo Nordisk revised its sales and operating growth target up to 28%-34%.

Last year, we highlighted that there was a degree of concentration risk associated with the company as 70% of its revenue is generated from one single drug. The purchase of Forma Therapeutics towards the end of 2022 remains its most prominent recent addition. Its pipeline now consists of several new drugs for the treatment of a wide range of conditions from cardiovascular disease and rare blood disorders to Alzheimer's and Sickle Cell disease. There are also upgrades to the Semaglutide drug that underpins its current generation of diabetes and weight loss treatments. The company is still heavily tilted towards the obesity and weight loss market and this does present a risk that must be considered when analysing it.

All in all, the major revelation for Novo Nordisk over the past few months has been the long-awaited European and UK central government approval. The floodgates have opened for obesity treatment in these markets and currently no other company has the same level of regulatory approval. The question going forward is whether Novo Nordisk's growth can withstand the competition that is starting to emerge. The company is currently trading with a price-to-earnings ratio of over 30 which, in the current environment, feels eye wateringly high. The company's future will ultimately depend on its ability to produce better and more cost-effective treatments than its rivals and, while it has enjoyed an early mover's advantage, this is inherently difficult to predict. ■

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INSIGHT



VIETNAM MARKET REVIEW

STEPHEN DONE | INVESTMENT RESEARCH



Vietnam, located in Southeast Asia, is a captivating country with a rich history, diverse culture, and breathtaking natural landscapes. In recent years, the country has emerged as one of the world's fastest-growing market economies and has attracted significant foreign investment. With favourable population demographics and a strategic geographical position, Vietnam offers an interesting market for both domestic and international business.

Economic performance in recent decades has been steady and impressive, averaging 5.5% GDP growth annually since 1990, showing resilience in the face of global challenges. This has resulted in robust GDP growth in recent years, with 8% year-on-year GDP growth in 2022, among the highest in the world for the period. This growth has been driven by multiple factors including a booming manufacturing sector, rising domestic consumption, and increasing foreign investment. The country also possesses a stable macroeconomic environment, with current inflation levels of 3.2% significantly lower than many other countries.

Now the 15th most populous country globally with a population size of over one hundred million, its demographics are attractive. It has a median age of 32.5 years, which is among the youngest in the continent, a 98% literacy rate, the second highest among investible frontier market countries, and high internet use, all of which are complimentary to future economic growth. The growth in population has seen the country witness rapid urbanisation in recent years, with the current 38% urbanisation rate expected to increase as people move from rural to urban areas in search of improved economic opportunities. The country also boasts the fastest growing middle class population in the region, driving growth in domestic consumption levels. With these factors leading to increased spending, expectations are for continued growth in areas such as retail, automotive, real estate, and hospitality.

Vietnam has a large number of workers aged between 16 and 54, allowing it to benefit from relatively lower manufacturing costs when compared to areas such as Chinese coastal provinces, where manufacturing wages have been rising rapidly over the past decade due to the decrease in the

size of the working demographic. Despite this, Vietnam is also experiencing growth in the number of over-65s with improvements in healthcare resulting in a continued rising life expectancy to the current 75 years, the second highest life expectancy in Southeast Asia, which is expected to be a drag on per capita growth between 2020 and 2050.

A key component of the strong performance of the Vietnamese economy in recent years is the growing manufacturing sector. Vietnam has become a key manufacturing hub, particularly for electronics, clothing, and footwear. The Vietnamese Government's initiatives to attract foreign investment, coupled with favourable labour costs, make the manufacturing sector highly attractive for businesses seeking cost-effective production. Vietnam has also benefited from its strategic location, which allows it to serve as a gateway to the rest of Southeast Asia and major global markets. The country is also a key beneficiary of the diversification in global manufacturing supply chains that are moving away from China towards competitive Southeast Asian countries. In 2022, Vietnam's goods exports rose by 10.6%, however, the economic slowdown in the US and EU, which together account for 42% of Vietnam's total goods exports, has resulted in predictions of significant weakening in exports in the upcoming period.

In addition to its strong economic performance, Vietnam has also made significant progress in improving its political and regulatory environment. The country has worked to reduce corruption and improve the rule of law, alongside implementing reforms aimed at improving the business environment through simplification of administrative procedures that reduce the friction on foreign companies investing and conducting business in Vietnam. These efforts have helped to attract foreign investment, particularly from countries like Japan, South Korea, and China. The Vietnamese Government has also offered tax incentives, developed industrial zones, and promoted public-private partnerships in order to enhance its attractiveness to its investors. Foreign direct investment in the country has actually created 27% of the country's GDP in the previous 30 years, accounted for 70% of the export turnover and contributed 17% to the Government state budget.

Vietnam is also set to benefit from its growing network of free trade agreements. Since 2015, it has been a member of The Association of Southeast Asian Nations (ASEAN), which aims to move toward greater economic and community integration on a number of fronts. Vietnam already has benefited considerably from the ASEAN Free Trade Agreement (AFTA), which has substantially removed tariffs on trade between ASEAN member countries since 2010. Another important trade deal that took place in 2020 was the EU-Vietnam Free Trade Agreement (EVFTA). The EVFTA is an important boost to Vietnam's export sector, with 99% of bilateral tariffs scheduled to be eliminated over the next seven years, as well as significant reduction of non-tariff trade barriers. These trade agreements will look to strengthen Vietnam's competitiveness as an exporting hub, while attracting further foreign direct investment.

However, as with many emerging markets, Vietnam does not come without its challenges and risks. This includes an infrastructure gap within the country and, despite significant investments in recent years, Vietnam still lags behind other countries in the region, particularly in areas such as transport and energy. The Government estimated that by 2030, US\$133bn of new power infrastructure spending is required, including US\$96bn for power plants and US\$37bn to expand the power grid, in order to facilitate further growth within the economy.

Another challenge for the country is, despite its large and young labour force, employers often express concerns about the growing skills gap, indicating that there is a mismatch between the skills possessed by the workforce and the skills required by businesses. Improving the skills of Vietnam's labour force is essential for the country's economic competitiveness, industry upgrading, technological advancements and attractiveness to foreign businesses. By investing in skills development, Vietnam can enhance productivity, foster innovation, and ensure sustainable economic growth for decades to come.



Vietnam is also vulnerable to environmental risks, such as climate change regulation and natural disaster incidents that can negatively impact economic development over the long term. The country's Government recently started to place increased emphasis on sustainability and green initiatives which will drive investment in renewable energy and environmentally friendly practices and will aim to mitigate this risk. The country has immense potential for renewable energy, particularly solar and wind power and the Government aims to increase the share of renewable energy in the country's total energy consumption in coming years.

In conclusion, Vietnam's economic performance in recent years has been remarkable, characterised by strong growth, foreign direct investment inflows, export expansion, and development in key sectors. Over the medium-term economic outlook, a large number of positive growth drivers are creating favourable tailwinds and will continue to underpin the rapid growth of Vietnam's economy. While challenges remain, the Government's policies, openness to change and ongoing efforts to address them suggest a positive outlook for Vietnam's economic future. ■

TOPIC OF THE MONTH



NAVIGATING THE STORM – UNDERSTANDING THE US DEBT CEILING

JAMES EADES | INVESTMENT RESEARCH



Step into the realm of American politics and you'll find a contentious and often bewildering subject known as the United States debt ceiling. Established in 1917 as part of the Second Liberty Bond Act during World War I, the debt ceiling sets a legal cap on US Government borrowing in order to meet financial obligations. Fast forward 106

years and this fiscal mechanism seems to have become a political battleground, where politicians have leveraged its purpose to advance their agendas, igniting intense partisan debates on whether to raise, lower, or eliminate the ceiling altogether.

At present, the debt ceiling stands at a staggering US\$31.4tn, 177% higher than at the end of 2008. Interestingly, since 1960 Congress has raised it 78 times, which would suggest that increasing the ceiling has become routine practice. But why has it been raised so frequently? In essence, the Government faces a delicate balancing act between trying to fulfil its fiscal responsibilities while supporting the needs of the nation. In recent years we've witnessed steeper increases in the debt ceiling than ever before. This is partly due to the fact that interest rates have remained extremely low over the last decade, in comparison to historic levels. Therefore, over a sustained period the US Government has had access to significantly cheaper debt than in previous decades which has enabled it to comfortably load up on more debt. However, as interest rates have surged over the last 18 months, things have become slightly more challenging for the Government in terms of debt servicing and the fiscal budget. The country also exhibits an increasingly polarised political environment where both Republicans and Democrats are at odds over who should take responsibility over the current situation.

In recent weeks, US Treasury Secretary Janet Yellen issued a warning on the matter, stating that the Treasury, the world's largest borrower, could hit the so-called 'X-date', when the US would default or be unable to meet its full spending obligations, as soon as June 1st. Emphasising the mere threat of default could unleash chaos within financial markets, sending shockwaves through the entire US economy and exacerbating concerns of an already looming recession – the rhetoric feels gloomy. Despite these warnings, the latest meeting between President Joe Biden and House Speaker Kevin McCarthy produced minimal progress towards a solution. The Republicans, however, have introduced a bill that included reasonable spending changes relating to the debt ceiling, but the inclusion of various policies unrelated to the spending debate has made negotiations challenging, indicating a potential debt ceiling stand-off.

Many have argued that the Treasury could avoid a complete default by prioritising payments on debt obligations to creditors at a delayed date at the expense of discretionary spending such as education and transportation. This is known as a technical default but while it may be advantageous to creditors the consequence of this could be a direct hit to economic activity and financial market sentiment. Even so, determining who gets paid first is a difficult and very political task. For example, postponing or reducing the funding of social programs to prioritise obligations to large institutions is unlikely to go down well with voters. Many also argue that this would go against the 14th amendment of the US Constitution, which states: the “validity of the public debt of the United States... shall not be questioned”. While it acts as a cornerstone for the rights of all citizens and ensures equal treatment, Janet Yellen downplayed the idea of leaning on the amendment, saying any attempt to invoke it would spark a constitutional crisis.

A default may be avoided purely because such a catastrophic event would be the worst possible outcome, not just for markets and the economy, but also politically. More than 70% of Americans support avoiding a default even if there are no

spending cuts which would suggest that a default would not be an economical or political winner, which politicians have realised. It is likely that the decision will be one of a last-minute bipartisan compromise in which they choose to raise or suspend the debt ceiling with a possibility of spending cutbacks.

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One thing that hasn't gone unnoticed as a result of such debate and uncertainty are the implications on financial markets. Considering a current backdrop of already-tightening credit conditions and volatile markets, short duration Treasury Bills with maturities after the X-date have seen upward yield movements. You can now purchase one-month Treasury Bills with a yield of close to 5.4% as investors are requiring greater returns for the default risks attached, considerably higher than the rate returned a year ago. Money market funds that predominantly hold short-dated US Treasuries may also be impacted. If sentiment around US debt weakens there is a possibility that shareholders could withdraw their capital very quickly, resulting in an extraction of liquidity out of these funds with a possibility that managers will have to sell off assets at a loss. It is important to note that these funds have had months to pare down their Treasury holdings, replacing them with other high-quality, short-term debt from issuers other than the Treasury.

While the economy sits anxiously in Congress' hands, it remains to be seen whether lawmakers can reach an agreement in time to prevent Americans from experiencing the first default in the country's history. One thing that the debt ceiling does bring is another opportunity for global investors to reconsider their portfolio allocations across asset classes and regions. Bonds still provide compelling income and protection. For those sitting on excess cash, debt ceiling turbulence could be a good thing to watch for a potential entry point into financial markets. ■

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BACK TO BANKING

ALASTAIR POWER | INVESTMENT RESEARCH MANAGER

In our last issue we covered the path to collapse of the previously unknown Silicon Valley Bank. At the time, UK bank shares were down sharply, erasing the returns of early 2023 and Credit Suisse teetered on the edge with significant deposit outflows while markets were nervous and asset price performance reflected the concerns. To highlight the fear surrounding Credit Suisse, several emails from bond traders found their way into inboxes offering the bank's bonds at deeply discounted prices, one of which in a rare moment of humour from a bond desk came with the title "One for the brave". The article concluded with expectations of issues being centred around individual names as opposed to a system-wide problem. Since publishing that issue in March, developments within the sector have included the snap takeover of Credit Suisse by fellow Swiss banking giant UBS and the more recent closure of First Republic Bank, the third and largest regional US bank failure in little over two months. A system-wide issue continues to feel unlikely considering the strength displayed by the larger names in the space.

Credit Suisse's takeover by UBS in March caused some controversy, in part due to the equity holders having no say in the takeover, but mostly with regards to the wiping out of some US\$17bn of regulatory debt as part of the deal. Additional Tier One (AT1s) bonds are likely to be unknown to many retail investors, but they quickly hit the headlines as part of the takeover. Introduced to the banking sector post financial crisis as a regulatory capital buffer, they sit just above common equity in the capital structure of the bank. If the bank's shares are assigned zero value, these bonds convert to equity and protect the more senior bonds higher in the capital stack. As part of the UBS takeover, Swiss regulators enabled the cancellation of these AT1s, causing some US\$17bn of losses in what has been a controversial process. Regulatory bonds of UK banks took a nosedive as contagion fears spread; Natwest's 5.125% Perpetuals fell from near £91 to c.£74 in a matter of days and are yet to fully recover the lost ground. UK and European regulators quickly stepped in to assure the market they would not repeat the actions of Swiss regulators, but this failed to calm the market with the financial sector of bond markets experiencing further volatility. In the run up to its final annual general meeting, Credit Suisse's earnings report highlighted CHF61bn of outflows in the first quarter alone, a significant figure for a bank already battling with internal control issues and the fallout of events linked to firms such as Greensill and Archegos. Clearly the bank was under

considerable strain and the decision to cancel the debt from the takeover deal was required to get it over the line and prevent further concerns.

Post takeover of Credit Suisse, banking share and bond prices partly recovered in a period of relative calm. Concerns seemed to ease until the May 1st announcement of First Republic bank being taken over by the Federal Insurance Deposit Corporation (FIDC), making it the third regional US bank closure since March and the second largest in US history having been valued at US\$20bn at the beginning of April. JP Morgan stepped in to take over, with CEO Jamie Dimon announcing in the aftermath that the near-term problems look to be over, with any knock-on effects yet to be seen. These second order effects are likely to play out through tighter credit lending conditions. In Europe this is already beginning to be seen with the ECB Credit Conditions survey highlighting more banks tightening their lending than easing. In the US, The April Senior Loan Officer Opinion Survey reported on tighter lending standards in all areas from household to enterprise lending. Tighter lending conditions generally result in fewer loans being written and, as a result, a slowing of economic activity.

While nerves remain within the sector, many banks are quietly showing signs of strength. Both UniCredit and Deutsche Bank signalled positively with the early redemption of some of their bond issues, and other larger names such as Barclays continue to show a solid financial position. At the end of 2022, the bank had loans to customers of £399bn against deposits of £526bn and a cash liquidity pooling in the region of £370bn that would enable it to cover nearly half of the deposit base. Clearly the larger banks in the sector are displaying significant strength in relation to some of the smaller regional US banks which have been experiencing issues.

Recent events in the sector have clearly caused some alarm, but we retain our positive outlook, seeing the issues confined to individual names as opposed to what is considered a robust system, at least for the larger players. Knock-on effects remain to be seen and, as such, we continue to watch developments with interest. ■

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