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March Market Analysis

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The Markets

	March	Change in Month	Year –To-Date
S&P TSX	20100	−0.6%	3.7%
S&P 500	4109	3.5%	7.0%
Dow 30	33274	1.9%	1.4%
Oil	$75.67	−1.3%	−5.8%
Gold	$1986	8.3%	10.0%

The market rose in the face of uncertainty. This month was historic as two US banks closed due to a fear of a run-on deposits. Markets originally collapsed, then the government announced they would back all the deposits at the California technology bank, Silicon Valley Bank. The head of the Treasury indicated the US would cover all deposits, not just those that were insured. The market breathed a sigh of relief. Things were so dire there was talk the Federal Reserve might have to lower rates rather than increase them. The possibility of lower rates caused the markets to rally as the explanation for the weakness last year was that interest rates had to increase to put the inflation genie back in the bottle.

Uncertainty led to a rally in the price of gold. If the banks might close then gold serves it role as a safe haven. Gold's 8% increase led to a double digit increase in the price of the Gold stocks on the TSX. Not all commodities benefited from the uncertainty as the price of Oil fell. Investors believed that a recession might lower demand for oil and as such demand for Oil company shares. Needless to say bank shares dropped by more than 6%, only the marijuana stocks did worse. Fears of an economic slow down put pressure on the Real Estate sector.

The previous two paragraphs were my explanation of the recent market movements. The next paragraph is what ChatGPT, an AI system, had to say. It seems to specialize in vague explanations and even incudes a reference to Covid as a market mover. I might have another month or two before I am replaced by Artificial Intelligence. (To be honest I used the free version that does not provide updated information)

The S&P/TSX Composite Index, which measures the performance of the Canadian equity market, experienced a significant amount of volatility last month. There were several factors contributing to this volatility, including concerns over rising inflation and interest rates, uncertainty around the ongoing COVID-19 pandemic and its impact on the economy, and geopolitical tensions. Additionally, there were several high-profile earnings reports and corporate announcements that caused individual stocks to fluctuate. All of these factors combined to create a highly uncertain and volatile market environment, with sudden swings in the index occurring on a daily basis. Investors were left grappling with uncertainty and attempting to navigate the market's volatility in order to make informed investment decisions.

Reflection

Is your money safe?

We spent less time this month looking at broad economic statistics as the only real story was the risk of a financial contagion similar to the Lehman crises in 2008/2009. They say that history does not repeat but it rhymes. This glib phase means that events will not occur exactly has they did in history but history is still a good guide. I looked at the commentary for last March and it warned about the risks of an inverted yield curve. Unfortunately, the risk that impacted the market was rising interest rates.

A year ago, investors worried that an inverted yield curve might lead to a recession. A yield inversion is when the 10-year bond has a lower yield than a 3-month term note. (In 2022 the 2-year yield was higher than the yield on the 10-year bond) Many believe this is a harbinger of a recession. Interest is the cost of money; higher interest rates mean more of your money goes to pay interest and less is available for spending or saving. Typically, short-term interest rates are lower than long-term rates. It seems logical that there is greater risk the longer you have to wait to be paid so you demand a higher interest rate. Companies that borrow are willing to pay more for long-term debt to lock in their cost and take away financing risk. When short-term rates are higher than long-term rates it is an indicator that something is wrong.

After the economic collapse in 2008 Central banks purchased government debt, known as Quantitative Easing, to inject liquidity. The central banks began removing some of this stimulus in 2018 and we saw the stock markets weaken. When Covid hit the world Central banks took drastic measures. They dropped interest rates to near zero. They dramatically expanded their balance sheets by purchasing government debt.

The actions by the Central Banks combined with supply chain issues led to an increase in prices of almost everything. Home prices spiked, commodity prices rose and the cost of living to the average person rose. At first the banks stated the bout of inflation was transitory and they did nothing. Once they realized the inflation genie was out of the bottle and they had to try to get things back under control. The Central Banks took drastic action. The US Federal Reserve increased rates 7 meetings in a row. They began to shrink the size of their balance sheet.

As you would expect people began to anticipate a recession. What they did not expect was a banking crisis. Home prices in major cities, like Toronto, fell 20%. This created some concern but investors felt they could look through the near-term problems. As discussed earlier the inverted yield curve gave investors a reason to pause as an inverted curve often precedes a recession.

Some banks bought into the concept of lower for longer. This was the mantra that the Central Banks would leave rates low longer than many expected to avoid a recession. Borrowers and some banks began to view low rates as enticing as another shot of heroin to an addict. One bank in particular took advantage of taking low-cost deposits and placed them in long term bonds. This allowed the bank to lock in a profit of the difference between the bond interest and the almost zero interest paid on the deposits. Earnings were good.

There was one problem, the price of a bond fluctuates in the opposite direction of interest rates. Rising interest rates led to a decrease in the value of the bonds held by the bank. Not a problem for the bank as they did not expect to have to sell the bonds. However….

Silicon Valley Bank was a bank focused on the technology sector. During the growth phase deposits came in and they were placed as loans to technology companies. Demand for loans declined as the tech sector began to layoff employees and fewer companies needed bridge financing prior to going public. Higher interest rates moved some investors from technology companies to other investments. SVB still had the deposits but did not have loan demand so they placed the funds in long bonds. As described above, higher interest rates over the course of a year drove the value of their portfolio lower. But… Some depositors began look at the situation and decided to move their funds to other banks or even cryptocurrencies. Once word got out more depositors asked for their cash. To pay the depositors SVB had to sell the bonds at a loss. This meant the bank was losing money. The rest is history.

In previous commentaries we described the banks as being part of a con game. The term con game or con artist is short for confidence. The trickster has to gain your confidence before taking advantage of you. The banks rely on the confidence of their depositors to keep in business. Once investors lost confidence in SVB they wanted their money back. Just like the movie It's a Wonderful Life, the bank does not sit with cash in the vault, it is lent out and if everyone wants their money, they can't until the bank makes every borrower repay their loans. In the movie the savings and loan had a few dollars left. In the real world with money able to move with a click, things happen much faster. SVB closed on a Friday and the government announce ALL deposits would be insured not just the ones up to the $250,000 limit. If you know your deposit is covered by the government then you have confidence in your bank, so the con continues.

People are smarter than they are given credit for. They began to look at all regional banks as risky and did not want to have more in a bank than they knew they had insurance. This lack of confidence could have brought down healthy banks that did not have liquidity to meet the cash demands. The government said they would cover ALL deposits at banks. This restored confidence and prevented a cascading series of bank failures similar to the savings and loan crisis in the 80s.

Fears about the banking sector drove some depositors to purchase government securities. The yield on the 2-year US Treasury bond declined by three quarters of a percent. This decline in bond yields occurred while the Central Bank put through another quarter of a percent rate increase. This drained some deposits from the banking sector.

If you remember back at the beginning of this section, we mentioned that a recession typically follows an inverted year curve and that it often occurs 12 to 18 months later. The yield curve inverted 12 months ago. Note an inverted curve is viewed as a sign of coming problems, not a cause of problems. As deposits moved from the banking sector to government debt, this decreased the funds available to fund mortgages or loans to new businesses. Lower loan activity will have a more direct impact on the economy than another quarter of a percent in the Federal Funds rate. We NEED people to have confidence in the banking sector.

I harken back to 2007/2008 when the Citi-bank CEO indicated that his bank had to keep up with aggressive lending as his competitors were, or in his words “as long as the music is playing, you have to get up and dance”.

Asset Mix: We expect the equity markets to be volatile but provide positive returns over the coming year.

Summary

" Does the recent flattening of the yield curve portend recession? Not necessarily …on the other hand..” St. Louis Federal Reserve.

This month we discussed the repercussions of one bank failure in the United States. Banking is a con game, meaning it relies on the confidence of the depositors. If people lose confidence in one bank this can create a run and, as we saw with SVB, a bank closure. The US has literally thousands of small banks that could not withstand significant withdrawals. Canada on the other hand has a handful of large well capitalized banks. We all have 20/20 hindsight. I can tell you why a bank collapsed but I cannot forecast which one will be next or if there will be a next one. The government made sure they injected an equal dose of liquidity and confidence to the banking sector.

Have we changed our outlook? Yes and No. We still focus on companies that pay dividends that can withstand short term problems. I look back to March 2009 when the Bank of Montreal’s price declined to the point where its dividend yield was 10%. I purchased shares of BMO. I look at the Canadian banks and believe their earnings may decline due to provisions for weaker loans. I am starting to think the Canadian banks with yields approaching 6% are becoming attractive for investors that can handle near term volatility. I do not know when the markets will begin to rally but I think there are attractive investment opportunities available today.

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