HIGGINS INVESTMENT GROUP INC.

May Market Analysis

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The Markets

	May	Change in Month	Year –To-Date
S&P TSX	19572	−5.2%	1.0%
S&P 500	4179	0.3%	8.9%
Dow 30	32908	-3.5%	−0.7%
Oil	$68.09	−11.3%	−15.2%
Gold	$1982	−0.9%	9.8%

Markets were generally weaker, unless you were in a select group of large capitalization technology stocks. The broad equity markets declined on fears of a looming recession. The primary concern was the risk of a slowing Chinese economy. A second worry was the uncertainty regarding the US debt ceiling. Investors were concerned what would happen if there was not a deal and the US ending up defaulting on maturing debt and investors were concerned that even if there were a deal, that it would decrease government spending and slow the economy. What used to be the primary concern, but is now just one of the many investor fears, is the risk of a recession caused by the year of rising interest rates. Even the Federal Reserve states it wants to see weaker numbers before it can first stop raising rates and consider lowering them.

The technology sector was the only TSX sector with a positive return in the month. Technology stocks dominate the major US indexes so were able to keep the US indexes in positive territory for the year and month. Fears that China's economy was slowing and that the Federal Reserve was still trying to slow the US economy led investors to dump economically sensitive stocks. Commodity price weakness caused the Energy, Gold and Mining sectors to include losses greater that 8% in the month. As we will discuss in more detail in our commentary, the Banking sector suffered losses of more than 6% in May. In the US when the market is up but most stocks are down, it is said the market has bad breadth, breadth not breath. In Canada it was very clear most stocks were down in the month.

Reflection

You can bank on it

In our last commentary, we focused on the crisis in US regional banking. This month we look at the 5 major Canadian banks and the major US banks.

The other day we saw a market technician on a business television show, one of those people that look at price charts to get a sense of the future direction of the market. The analyst indicated he expected a stock to rise if it crossed a certain price point, if not, it would drop. When questioned he said his charts led him to believe a stock would decline but that it was not a prediction but he would prepare to sell if factors changed. The same can be said about the banks. First a little accounting lesson.

When a company, or person, who has borrowed from a bank defaults or declares bankruptcy, the bank might not be able to collect on the loan or mortgage. In short, the bank will lose money on the loan. Lenders know every borrower will not repay their loan so they charge everyone higher interest rates to ensure they will still make a profit on their portfolio of loans. You would think that the banks would show lower income or even a loss when the portfolio has several defaults. However, that is not how the banks account for the loss. The banks review their loan portfolio on a regular basis and based on their review, they estimate how much they might lose on the outstanding loans. They record the estimate as an expense in the year of the review. The other side of the expense is a provision they hold on the balance sheet; this is known as creating a reserve against bad debts. When the debt eventually is written off it goes against the provision on the balance sheet and has no impact on income.

Given that brief accounting lesson, we can look at the bank earnings differently. The banks have provisions for loans they know are bad and have provisions for loans that may go bad. When Covid impacted the world, the banks and everyone could see companies laying off workers to protect the workers and due to government requirements. At first blush it looked like companies would permanently close and people would not have the cash to meet their loan payments. With 20/20 hindsight we know that governments crated an alphabet full of program acronyms that provided funds to businesses and individuals. If we look at the Toronto Dominion bank, we see their earnings dropped in the early years of Covid and rose after vaccines became common place, the change in earnings was mostly due to changes in provisions. The table below is a real eye opener. You can see the TD bank increased their provision for performing loans, payments still being made by the borrower, from less than $400 million to over $7 BILLION as Covid began. As we mentioned earlier, this is an account provision and not realized losses on the portfolio. As the world exited the depths of Covid the banks realized they had been too conservative. The banks lowered their provisions and recorded an increase in income of more that $1.5 Billion in 2021. They continued to record lower provisions in 2022.

Year	Provision for performing loans in MILLIONs
2019	$399
2020	$7276
2021	$(1533)
2022	$(370)

Fast forward to 2023. The central bank raised rates by more that 4% over the past twelve months and this put pressure on those that borrowed with variable rate debt. Higher interest costs led some to sell their properties and kept new buyers on the sidelines as they could no longer afford to carry a mortgage. Home prices declined. The banks looked at lower home prices combined with borrowers that could not afford higher payments and they began to increase their provisions. Most economist forecast a recession that will lead to job losses and more missed payments. So far this year TD has increased its provisions by

almost $1.3 Billion compared to $100 million for the same period last year. A recession WILL negatively impact the economy and lead to job losses and business closures both of which are bad for the banks.

When you purchase a stock you hope the price will rise. Generally rising earnings lead to higher stock prices. If you expect a recession, you expect lower earnings. Therefore, stock prices decline. Companies pay dividends from their earnings and, generally, increase their dividend when they expect to pay the higher dividend with rising earnings. The 5 major Canadian banks reported lower earnings than last year primarily due to changes in provisions. Despite the decline in earnings, most of the big 5 banks increased their dividends this quarter. They are unlikely to increase their dividend if they expect to have a sustained decrease to their earnings. The banks were signaling that they believe good times are around the corner.

Canadian banks stocks are down double digits from their price at the beginning of the year. One explanation is they are down due to the prospect of lower earnings. The second factor leading to a decline in Canadian banks was weakness in the US banking sector. Some investors extrapolate the problems in the US to the operations of the Canadian banks. This is likely a mistake there are thousands of banks in the US and only a few large banks in Canada.

In the US, two regional banks closed or were swallowed up by a larger bank with the assistance of the US government. Once the prospect of losing your nest egg at the local bank became a possibility people decided it was time to move their funds to other places. With the ability to transfer funds quickly on the internet, a bank can quickly run out of liquidity. Essentially this is what happened to Silicon Valley Bank. Rumours, or facts, got out that SVB had to sell portions of its investment portfolio at a loss meaning its capital cushion had began to shrink. Several technology companies used SVB for their banking including for processing payroll. The companies would have to put the funds in the bank before paying their employees. This would be millions of dollars with only $250,000 insured. Treasurers tried to limit their exposure to the bank and as a result the bank closed on Friday and was taken over by one of the big New York based banks. To avoid a run on all regional banks some government officials indicated the full balances at this bank would be covered by the takeover and the government guaranteeing the purchasing bank that they would not suffer losses beyond an agreed amount. The same officials implied a similar protection would be offered to other banks. This prevented a run out of these banks.

The problems at 2 banks led to a dramatic decrease in the prices many regional banks. TD was in the process of acquiring a US regional bank but was having issues with the regulators. TD decided it was prudent to pay a fee to the other bank and walk away from all the issues. Other Canadian banks have operations in the US and this led some to put a lower value on these operations. The brokerage firm Schwab transfers excess funds in its client accounts and places them in a related bank to earn extra income. Investors decided they could take their funds and invest them in insured deposits or government debt. The run on the smaller banks hastened the loss of deposits at Schwab as investors did not like having their funds at a bank. In the past year deposits at Schwab fell by 30%. These issues caused some to rethink their investments in banks in general.

The big money centre banks such as Citibank and JP Morgan also had significant price declines. This despite the fact these are the banks the government called to absorb the other regional banks, with a guarantee. Companies moved their deposits from small regional banks to the larger safer money centre banks, yet investors still sold the shares of the big banks.

If you are patient, you may have a good opportunity to own good assets at a discount and get paid handsomely to wait. At the depths of Covid, due to a decrease in the price of TD stock it yielded more than 5%. At the beginning of 2022 the bank had a yield of 3.2% as the price had increased, TD's dividend had grown from $1.99 to $2.42 over that period. TD now has a yield of 4.6% and has a dividend of $2.70. The yield is close to the level at the depths of the uncertainty of Covid. The dividend has grown by 35% over the past few years. The bank is paying the stockholder more than they are paying the people who buy GICs and the banks have a history of increasing their dividend. If you had bought TD in 2020 and held it to today your yield on your original purchase price would be (2.7/37.5=) 7.7%. This does not take account of the increase in the price over that period. There are no guarantees in the stock market but if you want a 10% return on your investment, the 4.6%dividend means you only need the bank to have a 5.4% annual price appreciation. I think that is possible over a few years after we exit the predicted recession. I cannot pick the bottom of the market but it seems reasonable to buy the banks or to purchase them once we know the extent of any recession.

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

Summary

" Prepare, don't predict." A market technical analyst

Many investors are concerned about lower bank earnings but they might be fooled by accounting and not reality. Bank earnings are significantly lower this year than for the same period last year. Bank stocks, as you would expect are down in sympathy with the lower earnings. But much of the change is caused by increase accounting provisions for potential loan losses. In other words, the banks are preparing for a recession but not predicting one. Even if the economy does go into a recession later this year or next year the banks will have reported the lower income due to their provisioning so far this year. Do you buy the banks or wait, that is the question.

What are we doing? We continue to like dividend paying stocks, especially those with a history of increasing their dividends. We have neither sold or purchased banks in the past few months. Their earnings are lower but they increased their dividends. The income you earn on a new purchase grew in dollar terms and percentage. A lower stock price makes the yield on the stock higher in percentage terms. We are likely to add to the banks but we might wait until there is greater clarity before adding. I would rather pay more and know the risks are much less. We have not changed our approach.

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