The Porretta Group

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Wealth Management
Dominion Securities

Mark Porretta, CIM
Senior Portfolio Manager &
Wealth Advisor
mark.porretta@rbc.com
905-764-5258

Theresa Bruno
Associate Wealth Advisor
theresa.bruno@rbc.com
905-764-1345

Eric Hoey
Associate Investment Advisor
eric.hoey@rbc.com
905-764-5847

Christopher Hoang
Associate
christopher.hoang@rbc.com
905-764-5263

The Porretta Group of RBC Dominion Securities

260 East Beaver Creek Rd.
Suite 500
Richmond Hill, ON
L4B 3M3

www.markporretta.com

Quarterly Update

Markets have a keen ability to sift through information and react quickly. Following a difficult year for equity and fixed income markets, we have experienced quite the opposite in the first quarter of this year. Markets started off strong after inflation continued to move downward, and the interest rate cycle looks to be nearing the end. Unfortunately, while we hope for uneventful quarters, it rarely happens that way. This quarter we got something else: bank collapses. While the sticker shock of this brings ill-feelings of 2008, this situation is not the same.

This time it's different

Financial turmoil inevitably awakens memories of 2008–09 and the global financial crisis. We believe strongly that the recent events in the U.S. financial system are not the early stages of a 2008 repeat; 15 years ago, we had a banking crisis, whereas, today we have a crisis at a few banks.

In 2008, banks had a genuine problem. Assets they had carried on their books were worth less (and in some cases worthless) because of extremely lax loan standards that resulted in widespread loan defaults. That created a hole in the banks' capital and some banks were likely technically insolvent; if we added up all the money they would ever receive from their investments, the amount would have been insufficient to pay all the money that the bank owed.

Today's issue is not that the expected money from banks' assets will never be received. Many of the assets with the steepest price declines are U.S. Treasuries that we, and all market participants that we are aware of, fully expect to be repaid on time and in full. The issue today is that more depositors than normal are demanding their cash, driven by fear of bank failure. It's a classic bank run that deposit insurance is supposed to help us avoid.

There are two ways to deal with a bank run. One is to calm depositors' fears and discourage them from removing money. Much of the money being withdrawn isn't leaving the banking system overall, but moving from a few small banks to larger ones. This is not ideal for the long-term health of a competitive banking system, but it is a far cry from 2008's global financial instability. It is also why we think this is a crisis for some banks but not for the banking system.

The other way to deal with a bank run is to find new money for the bank to use.

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In large part, that's already happened. The U.S. Federal Reserve's (the Fed's) new lending facility allows banks to use central bank financing to replace depositor money for certain U.S. Treasury and mortgage bonds. Critically, the Fed allows the banks to fund the bonds at the face value of the investment, meaning that, in most cases, this is a near seamless transition for depositor funding amounts.

The 2008–09 global financial crisis was a critical, if not the critical, financial event of the century to date. It's understandable that investors remain scarred by the event and that any word of bank failures brings fears. But we believe the underlying causes of the current market upheaval are both less substantial for the banking system and more easily controlled by existing central bank and regulatory mechanisms.

Nobody rings a bell

In the U.S., the job of officially determining the start and end of recessions (and expansions) goes to the National Bureau of Economic Research, a private, nonprofit, nonpartisan organization. Its objective is accuracy, not speed. On average, it has made the call about a year after the event. So, there can be a long stretch where debate continues to rage about whether the U.S. economy is or is not in recession without "a referee" making the call.

And the same goes for recoveries from recession. The global financial crisis and the accompanying recession ended in Q2 2009, but it was 2012 before most consumers and many businesses came around to accepting that.

While one waits for the referee's call, the yield curve has proven to be a useful timing tool. One of the yield curve's great strengths as a leading indicator, in our view, is that it works equally well in both directions. Inversion happens on average about 11 months before the recession starts, while normalization (i.e., short-term interest rates fall back below long-term rates) occurs about 11 months before the economy pulls out of recession.

Figure 1

Historical U.S. market performance when Fed policy shifts

Before and after the final rate hike in a Fed tightening cycle: Downside risk right before the Fed pauses, but typically strong gains afterwards

S&P 500 performance	Before final rate hike			After final rate hike		
Final Fed rate hike	6 months	3 months	1 month	1 month	3 months	6 months
Median 1970 – 1979	-1.0%	-2.5%	-4.5%	2.6%	-4.4%	2.8%
Median 1980 – 1989	9.0%	7.3%	-0.5%	1.2%	1.4%	8.0%
Median 1990 – 2018	2.4%	2.3%	1.0%	0.6%	7.2%	13.3%
Median since 1970	**2.9%**	**0.5%**	**-0.7%**	**1.0%**	**1.7%**	**5.9%**

Source - RBC Capital Markets U.S. Equity Strategy, Bloomberg; periods of positive performance shaded in green, periods with negative performance shaded in red

At the epicentre of recent turmoil was a handful of U.S. regional banks uniquely exposed to the numerous impacts of a high-interest-rate environment. Market volatility subsided enough over the course of March to give Federal Reserve policymakers sufficient confidence to push forward with another 25-basis-point rate hike, bringing the top of the target range to 5.00%. But, whereas markets had been expecting the Fed to continue hiking towards 6.00% this year, rate cuts toward 4.25% are now the base case. Inflation in North America remains elevated but continues to trend in the right direction. This could give the Federal Reserve additional cover to take a cautious approach, or even to pause and assess the impact of rate hikes to this point — something the Bank of Canada has already stated it plans to do.

What are we doing?

As expected, the banking crisis in the United Stated and Europe has been the centrefold of people's attention for the last quarter. While there are bank collapses on a yearly basis, this event seemed to receive more media attention than most. For a lot of people, this felt like 2008. But as noted above, this situation was vastly different. On our end, we took this as an opportunity to add to well capitalized, large financial institutions on both sides of the border that we believed were receiving undue collateral damage from SVB and Credit Suisse.

In the last few quarterlies, we have been adamant on two things needing to happen before we put more capital to work: inflation moving lower and nearing the end of the rate hike cycle. We believe we are close on both fronts. As we near peaking inflation and interest rate hikes, we believe this will present an opportune time to be adding to equites (see Figure 1). We have been well positioned with larger than normal cash balances, where we are now able to be opportunistic and re-investing back into companies with higher yields and/or reduced valuations.

On the fixed income front of the portfolio, we have made the changes in late 2022 to lock in the fixed income portion over the next five years. Since then, rates across the curve have moved downward, thus giving us near the absolute best rates available. As this portion has primarily invested in Guaranteed Investment Certificates (GICs) and short duration, high quality bonds, this will act as a great ballast against any further volatility in our portfolio.

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