Serber Speaking

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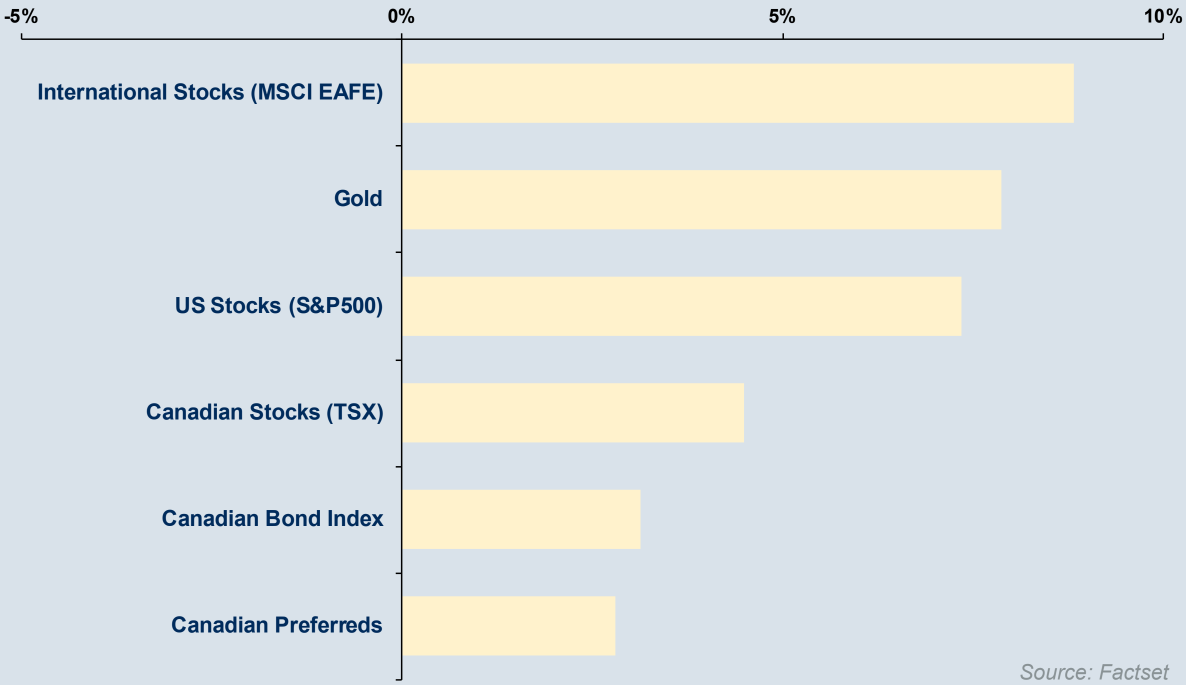
Commentary for the quarter ended March 31, 2023

When Bad News Could Be Good News

The positive returns in Q4 2022 continued in the first quarter of 2023. As seen on the chart below, the main benchmarks we track were all positive for the last quarter -- despite the scary news in early March of the failures of Silicon Valley Bank in California and Credit Suisse in Switzerland.

Performance by Asset Class: January 1 to March 31, 2023 (in Canadian $)



In what may seem like perverse logic, the bank failures could act as positive news for stocks. Here's the logic: Central banks, such as the US Fed, are determined to slow down the economy in order to reduce inflation. The main way they to do this is by continually raising interest rates until aggregate demand begins to recede, bringing down the upward pressure on prices and thereby reducing inflation.

After its February 1 meeting, the Fed announced a 0.5 percentage-point increase in its trend-setting Fed Funds rate to 4.75 percent and noted that "ongoing increases in interest rates *will* be appropriate..." Contrast this with its recent March 22 meeting, two weeks after the Silicon Valley Bank failure, at which it raised the rate by only 25 basis points and adjusted its wording to state that "some additional policy firming *may* be appropriate."

While this may seem like a minor distinction, it amounts to a major change in policy. Essentially, it means that the campaign of aggressive interest rate hikes, which began in March of 2022, is coming to an end.

Most economists, including those at the Fed, believe that the stress on the banking system related to the failure of SVB and other banks will lead to a slowdown in lending activity. This has the effect of lowering aggregate demand in the economy - exactly what the Fed is trying to achieve. Since a contraction in bank lending will now do some of the heavy lifting, the Fed will not need to raise rates as high as they previously thought.

Indeed, at the beginning of March the yield on two-year US government bonds was about five percent. At the end of March, it was four percent, indicating the drop in expectations of how high the Fed would need to raise rates. Lower interest rates are good news for stocks, other factors holding constant. Prior to the SVB failure, the NASDAQ index of high-tech stocks (which are very sensitive to interest rates) was at about 12,000. On March 31, it closed at 13,200 -- a 10-percent gain. As long as the banking mini-crisis does not morph into a full-blown financial crisis, it may indeed turn out that SVB's collapse, while disastrous for many of its stakeholders, was beneficial for the stock market in general.

Still betting against the crowd

As I've mentioned in both of my last two newsletters, investor sentiment has been quite negative, and this continues to be the case. The American Association of Individual Investors has been surveying its members regularly for 36 years. Over that period, bullish sentiment has been about seven percentage points higher than bearish sentiment, on average. But as of last week, the bears exceeded the bulls by 23 points. Because investor sentiment generally reflects what's in the rear-view mirror, it tends to be a poor predictor, and even a contrary indicator, of what is coming down the road.

The combination of lower expectations for interest rates, the negative general sentiment and the likelihood that corporate profits will remain solid this year, or even surprise on the upside, leads to the expectation that equities should continue to have a positive year, building on the gains seen in Q1.

That said, it is still quite possible that, as 2024 approaches, the outlook will become clouded as the effects of the dramatic rise in interest rates over the past year are increasingly felt. If so, it will be appropriate to take a more defensive posture in portfolios sometime later this year. Stay tuned.

Will SVB-like failures hasten the move to digital currency?

The failure of Silicon Valley Bank highlights the Achilles heel of the modern financial system – bank deposits. While depositors assume that they can withdraw all their money any time, this is only true if they don't. A deposit is a loan to the bank. While banks hold cash reserves to allow for normal levels of withdrawals, no bank has enough reserves to withstand a majority of depositors demanding their money back. If depositors begin to worry that a bank's assets are losing value and that there may not be enough to pay them, it becomes a race to get your money out first - the classic bank run. As we saw with SVB - one of the 25 largest US banks - this can put a bank out of business in 48 hours. Given the risk that a banking panic can spread like wildfire, the authorities created a firebreak by, among other things, extending deposit insurance to cover all SVB deposits, regardless of size.

But a different solution may be headed our way. It's known as CBDC, which stands for Central Bank Digital Currency. What does this mean? Think of it this way: The cash you have in your wallet is issued by your country's central bank and is a liability of that central bank, backed by the government. A bank deposit is more convenient because it is electronic, but is a liability of that particular bank, which is subject to failure. What if you could have electronic cash, with all the convenience it entails, as a liability of the central bank? It would eliminate the risk of losing money if your bank turns out to be the next SVB, potentially rendering obsolete the concept of "deposit insurance." All the world's major central banks are actively looking into the idea of CBDCs right now. If your money is an electronic liability of the central bank, it is not only safe but you can also move it around - down the block or around the world - in seconds, without having to deal with any bank. Which begs the question: in a CBDC world, what exactly will be the role of banks? That said, many observers are not comfortable with the idea of the central bank having a record of everyone's financial transactions. Either way, I believe that as this decade progresses CBDC will increasingly become a topic of interest, controversy and financial-system transformation.

From the Planning Notebook

Introducing the First Home Savings Account (FHSA)

The FHSA is a new registered account available to help Canadians save up to $40,000 on a tax-free basis toward the purchase of a home. The FHSA combines features of an RRSP and a TFSA. We expect to be able to open FHSA accounts starting later this month. Here are the key things to know:

Like an RRSP, contributions made to an FHSA are tax-deductible. Like a TFSA, withdrawals made (to purchase a home) will not be taxable. Unlike the RRSP Home Buyers' Plan (HBP), the funds withdrawn from an FHSA do not need to be paid back.

Individuals will be able to contribute up to $8,000 per year, with a lifetime limit of $40,000. Unused room can be carried over to the next year.

FHSAs can only be opened by residents of Canada who are 18 years of age and who are considered "first-time homebuyers," defined as those who have not owned a home in which they lived at any time during the calendar year in which the account is opened, or at any time in the preceding four calendar years. It is up to clients to certify eligibility by signing the application form, as there is no duty imposed on issuers to ensure compliance.

Contribution room starts accruing after an FHSA is opened for the first time, unlike TFSA contribution room that begins to accumulate starting at age 18, whether you've opened a TFSA account or not. The FHSA can stay open for a maximum of 15 years, or until December 31 in the year the account holder turns 71.

If the funds are withdrawn to buy a qualifying home in Canada, none of the principal or accumulated income will be taxed. There is almost no downside—if a qualifying home purchase is not made, the full amount of principal and accumulated income can be rolled over on a tax-free basis into the plan holder's RRSP.

There are generally two groups who would potentially benefit from opening and funding an FHSA -- younger people who are saving to buy a home or anyone who currently rents and has been renting for the past five years or more.

If you have any questions about FHSAs, or any other matter, please reach out to me at david.serber@rbc.com

Note: Please check with a qualified tax adviser before acting on any ideas expressed above.

Until next time, best regards,

David Serber

If you would like to discuss your personal situation please feel free to contact me. Also, feel free to forward this copy of ***Serber Speaking*** to anyone you think would find it of interest.