



# The Sandler Quarterly



Wealth Management  
Dominion Securities

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## Positive markets climb a wall of worry in Q1

### KEY INSIGHTS

- Equity markets gain ground in the first quarter
- Canada pauses on interest rate hikes, The Fed gets closer to doing the same
- The bond market begins to anticipate lower rates
- Investors relax following banking sector stress in March
- Inflation continues to cool while the economy and jobs numbers remain resilient

Since bottoming last October, markets have posted positive returns in the fourth quarter of 2022 and the first quarter of 2023 (see *Figure 1* below). Many clients are pleasantly surprised to hear that portfolios are off to a good start this year given the negative news headlines around the banking sector and continued talk of an oncoming recession. As the old saying goes – markets climb a wall of worry.

While markets are, on average, higher year to date, there has been a remarkable divergence of performance within the

various industry sectors. Many of the areas of strength this year were areas of weakness last year. Technology and communication services, for example, were the big losers last year but are leading the charge this year with returns in excess of 20%. Healthcare, financials and energy have displayed the opposite trends, being relative outperformers in 2022 only to lag so far in 2023.

These trends reinforce two key concepts central to our investment methodology; diversification and regular rebalancing.



Figure 1: S&P500 Jan 1<sup>st</sup>, 2022 – Mar 31<sup>st</sup>, 2023 (Source: FactSet)

# Quarterly Review

Q1 2023

## Diversification

We all know intuitively that diversification makes sense from a risk management perspective. It is at times like this however that its importance and value become apparent. As evidenced above, volatile markets do not treat all sectors and asset classes equally. Attempting to time the market and choose which sectors to be invested in at any given point is next to impossible and is typically a great lesson in humility.

We believe that all our investments will perform very well over the next 5 to 10 years (or else why would we own them), but we really cannot predict which will do well in the next 5 to 10 months. Particularly at such an uncertain time for the economy and markets.

If the economy enters recession this year as predicted by RBC, then our investments in utilities, telecom and healthcare will outperform. On the other hand, if we avoid recession or have a brief shallow recession, then we should see technology, industrials and materials shine. If we look beyond this year and instead focus on 2028 for example, all our equity investments are expected to provide attractive, positive returns in the form of growth over time and regular dividends in the meantime. Different sectors will lead the charge at different times, but all should win in the long run.

Being diversified also allows us to execute on another tenet of our investment discipline – rebalancing.

## Rebalancing

As mentioned above, different investments perform at different times. Because we own a broad selection of sectors and asset classes, our portfolio holdings constantly drift away from their ideal targets. The winners this quarter grow in size relative to their weaker counterparts. This gives us the opportunity to trim back those that have done well and redeploy the proceeds to others that have become cheaper.

A recent real-life example of this would be Apple and CVS Healthcare. In March we trimmed our Apple position back down to target weight as it had gained over 20% from the beginning of the year. CVS, on the other hand was down ~20% year to date and we were able to use the Apple proceeds to buy more of it at an attractive price.

Repeated regularly over many years, this disciplined rebalancing process has been shown to add value and enhance returns. By its nature, it has us selling into strength

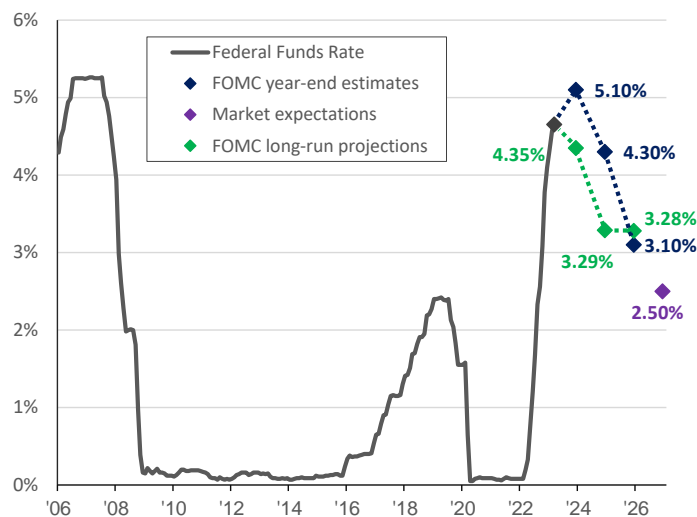
and buying great businesses at lower prices. We like to say that we are contrarian - not by nature, but by process.

## Interest Rates

It's not only equity markets that have been volatile recently. Fixed income markets have also been on a wild ride. As you are aware, interest rates rose rapidly last year as central bankers aggressively increased rates. Recently however we have seen longer term yields falling in anticipation of future rate cuts. Central bankers can control short term interest rates with their policy actions, but longer-term yields are set by investors in the market.

At this point in time, the market (all investors combined) is betting that we will see central banks cut rates in the back half of this year (see *Figure 2*). We got a little ahead of this trend last year when we extended our average bond maturity by adding some longer dated bonds.

Similar to our comments above regarding diversification in equity sectors, it is important to diversify a portfolio's fixed income holdings. It would be easy to concentrate all of our bonds into short term GIC's at 5% right now, but in doing so we would be exposed to a risk known as reinvestment risk. This happens when an entire bond portfolio matures in a time of lower rates and is forced to accept those prevailing low rates. By owning an array of maturities it is possible to guard against reinvestment risk. This concept is well explained in the article [Why go long when short-term bonds yield more?](#)



*Figure 2: Fed funds rate expectations (Source: Bloomberg, FactSet, Federal Reserve, JPMorgan)*

# Quarterly Review

Q1 2023

## Recession Watch

RBC continues to call for recession in the second half of this year. This would explain why the market is pricing in lower interest rates before year end. Continued low unemployment numbers however do not suggest recession at the moment. We will monitor the employment numbers closely for signs of deterioration. Chief Investment Strategist, Jim Allworth's Recession Scorecard (see *Figure 3* below) shows three of seven indicators in recessionary territory. This recent article, [A US recession moves closer](#), expands on where each of the seven indicators currently stand. Stay tuned for regular updates as these indicators evolve.

Indicator	Status		
	Expansionary	Neutral	Recessionary
Yield curve (10-year to 1-year Treasuries)			✓
Unemployment claims	✓		
Unemployment rate	✓		
Conference Board Leading Economic Index			✓
Free cash flow of non-financial corporate business	✓		
ISM New Orders minus Inventories			✓
Fed funds rate vs. nominal GDP growth	✓		

*Figure 3: US recession scorecard (Source: RBC Wealth Management)*

## Banking Sector Woes

You have likely read about troubles in the banking sector during March. While these developments are concerning to be sure, they are not indicative of issues within the broader banking system at this time. The article that follows, [A crisis for a few banks is not a banking crisis](#), puts the recent events in context and compares them to problems in the past.

2023 is likely to keep us on our toes, but with a solid start under our belt and a disciplined plan to handle volatile markets, we feel well-positioned as we look ahead. Enjoy the spring weather and please keep in touch - we are all back to the office and only too happy to have visitors drop in.



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	Q1	1 Year
<b>Indices</b>		
<b>S&amp;P/TSX</b>	3.69%	-8.18%
<b>Dow Jones</b>	0.38%	-4.05%
<b>S&amp;P 500</b>	7.03%	-9.29%
<b>Nasdaq</b>	16.77%	-14.05%
<b>Euro Stoxx</b>	13.74%	10.57%
<b>Japan Nikkei</b>	-2.61%	0.79%
<b>India Sensex</b>	-3.04%	0.72%
<b>VIX (Volatility)</b>	-13.71%	-9.05%

<b>Commodities</b>		
<b>Gold</b>	7.96%	1.64%
<b>Silver</b>	0.60%	-2.80%
<b>Copper</b>	7.64%	-13.16%
<b>Oil</b>	-5.72%	-24.54%
<b>Natural Gas</b>	-40.34%	-61.75%

<b>Currency</b>		
<b>CAD</b>	0.27%	-7.47%
<b>EUR</b>	1.25%	-2.06%
<b>JPY</b>	-1.31%	-8.40%
<b>AUD</b>	-1.88%	-10.65%
<b>GBP</b>	2.10%	-6.10%

Values as of March 31<sup>st</sup>, 2023

# A crisis for a few banks is not a banking crisis



March 24, 2023

Global Portfolio Advisory Committee

It's understandable that investors remain scarred by memories of 2008–09 and that any word of bank failures brings fears. But several factors distinguish the current turmoil from the banking system crisis of 2008–09. We discuss the drivers of U.S. policymakers' current approach to today's stress, and the risks for investors in U.S. banks.

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 and today we have a crisis at a few banks. This distinction is critical for investors, in our view.

We see the relative paucity of new measures by U.S. policymakers to date as a reflection of the ultimate manageability of today's issues. But we also believe it could mark a potentially unwise attempt to assign losses between depositors and investors, a move that we see as fraught with potential unintended consequences.

## Banking basics

Banking at its core is a relatively simple business. Depositors give an institution savings, and banks invest those savings. Sometimes banks buy existing investments such as U.S. Treasury bonds, and sometimes banks create their own investments by making loans. As long as the bank's investments return more in interest and principal than it owes depositors, the bank is in good shape. Since some borrowers don't pay and some bonds go bad, banks also have money from their owners, referred to as either capital or equity, to cover those losses.

One complication for banks is that depositors can, by and large, withdraw their money at any time, but banks don't always have the same luxury. Borrowers can't be forced to repay a mortgage on demand and bond prices may have temporarily declined. To allow for this, banks always try to keep plenty of cash on hand to meet depositor withdrawals, but they cannot keep it all in cash or they

would not have a way of generating the cash flow to pay interest or dividends to investors.

## Past problems

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.

Fixing this type of permanent drop in future income requires capital. Capital is risky, and as a result it's expensive, even in good times. In 2008–09, banks needed someone to replenish money that had already been lost, and that is a particularly difficult request. Ultimately, the government had to step in and provide assistance.

## The easy part

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 the existence of the deposit insurance is supposed to avoid.

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For important disclosures and author's contact information, see [page 3](#).

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There are two ways to deal with a bank run. One is to calm depositors' fears and discourage them from removing money. To a certain extent, that has worked. 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. To a large part, that's already happened. The Federal Reserve'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; it's more expensive, but it's there.

The existing Fed mechanism doesn't work for all types of bank investments. Commercial and individual loans are not homogenous risks like government bonds. But the central bank has plenty of experience in crafting joint solutions for these types of assets with the U.S. Treasury Department, where the Fed provides financing to non-government assets and Treasury absorbs any realized credit losses. Historically, these arrangements have worked to the Fed's and the government's advantage.

Turmoil in European banks could add to the pressure on certain U.S. financial institutions and potentially raise the stakes for the Fed and Treasury. But with asset quality sound and with our view that major European banks are likely to continue to perform on their obligations, we think this remains a problem well within the capacity of the U.S. government.

### **Moral hazard**

Since the current problem should be relatively easy to solve, the obvious question is why have policymakers failed to act more decisively.

We see three reasons. First, existing legal authority to act is murky, at best. The Federal Deposit Insurance Corporation (FDIC) has wide powers to resolve banks in receivership, but absent congressional action it is relatively hamstrung in preventive moves. Second, because the overall system is not in crisis—as noted, large banks have seen deposit inflows—there is less immediate pressure on regulators to push the limits of their authority. Finally, and we believe somewhat hazardously, policymakers, in our view, are willing to see bank failures in part to combat potential moral hazards created by the 2008 bailouts. We think they are using this episode to reinforce that investors in banks—buyers of bonds, preferred shares, and stocks—are at risk if a bank fails.

While this is not necessarily a bad message to send, it is a different message than investors had perhaps believed after 2008. In 2008, we think that investors largely—and reasonably—concluded that investments made in sound financial institutions would be respected in a resolution if the bank later fell as part of an external risk event. A full government guarantee may not have been thought likely, but given the highly regulated nature of the institutions and the key role banks play in the economy, some consideration for investors may have been expected.

We are worried that policymakers may get what they seem to wish for: a sudden repricing of the risks in investing in bank bonds and stocks. If that were to occur, it could make it difficult for some banks—particularly smaller institutions—to borrow sufficient money in the public markets at economically viable rates to support their current levels of lending, let alone the type of loan growth companies have come to rely on. The impacts would likely be felt across the economy but would be especially detrimental for small businesses that rely on local lenders.

For investors, we think it is key to remember that the primary support for any investment is the fundamental underlying business and, broadly speaking, we believe the U.S. banking system's fundamentals remain solid. Even if the goalposts have moved from 2008 on the impact to investors in the case of default, that change does not directly impact investors in institutions that remain in operation. To state it plainly, we think that will be the case for the overwhelming majority of U.S. banks.

### **Not the end**

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.

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As of December 31, 2022

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			Count	Percent
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