THOUGHTS ON THE MARKET

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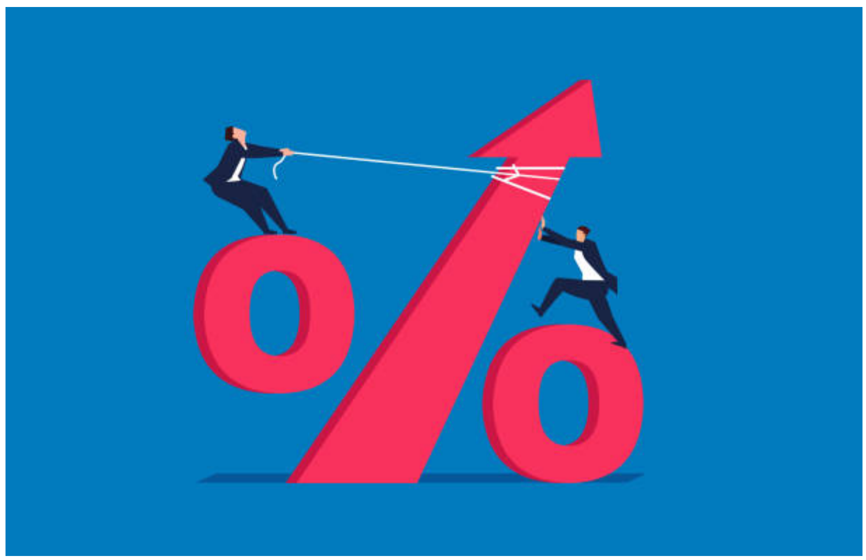

The Fed and Unintended Consequences

"Clearly there are always unintended consequences of any legislative or regulatory act that's taken in the heat of battle."

- Richard Grasso, Retired Chairman, NYSE

The U.S. Federal Reserve (Fed) and its Chairman Jerome Powell have had a very difficult time over the last three years. When Covid struck, the Fed added over $3 trillion to their Treasury holdings to provide liquidity to a struggling global economy. They were then faced with the challenge of the highest inflation level since the 1980's. This led the Fed into the most aggressive interest rate increase cycle in history, after a decade of near zero interest rates. Recently, we had the failure of two U.S. banks, Silicon Valley Bank and Signature Bank of New York, when the Fed had to take quick action to guarantee bank balances and access to those funds in order to help stabilize confidence in the U.S. banking industry. This month, we will review the consequences of the Fed's interest rate policy, whether intended or not, and try to best determine our investment path moving forward.

We begin with some historical perspective. The U.S. began tracking long term interest rates in 1873. The rate was 6% at the time and trending lower. The rate did not again reach that level until 1973. The years 1973-1999 were the only time in U.S. history when long interest rates went above 6%. The Fed had forecasted to come close to that rate again during this current interest rate cycle but two bank failures have caused enough uncertainty to trigger worry of a ripple effect causing another 2008 financial crisis. U.S. regional banks such as First Republic and even the international giant Credit Suisse saw their share prices fall dramatically, with Credit Suisse being forced to merge with Union Bank of Switzerland by Swiss regulators. Poor management caused these banks to fail but some fingers are being pointed at the Fed for raising interest rates so quickly and stressing the global financial system. We want to point out here that the global banking system is in far better condition than 2008 and there is no danger of a similar situation at this time.

Another unintended consequence has been historic volatility in the U.S. Treasury bond market. The 2 year bond has fluctuated from a high of 5.04% prior to the Silicon Valley collapse, to a low of 3.75% to currently sitting at 3.96%, down from 4.42% last month. The 10 year bond has been more stable and is at 3.49%, down from 3.62% last month. Yields moved dramatically lower across the maturity spectrum as the market saw the Fed was on the horns of a dilemma: do they continue their fight against inflation by continuing to raise rates and draw money out of the banking system or is restoring confidence in the banking system the new priority? The answer is they are attempting to do both. In the most watched Fed meeting since 2008, Chairman Powell raised interest rates a further 25 basis points but definitely softened his rhetoric around future rates hikes. In fact, his forecast saw rates declining in both 2024 and 2025. His primary focus is remaining on inflation but he did say that future rate increases would be data dependent versus definite planned increases. In his discussion around the bank failures, one reason Powell cited for less Fed intervention was he expected banks to be more reluctant to lend as they will want to protect capital reserves. This will certainly be true for the smaller U.S. regional banks as many of these firms saw their share prices fall as much as 90%. This decrease in lending is expected to further slow the economy and thereby ease inflation.

The market is pricing in the strong possibility that another smaller bank could fall despite the Chairman's assurances that the flow of deposits between banks has stabilized. The smaller banks will have to pay higher rates to attract deposits, which will reduce their profitability and further slow their recovery. In this scenario, the large banks such as JP Morgan benefit as people look for a safer haven for their funds.

Here are what we believe are some possible outcomes from these recent events: 1) U.S. bank lending will slow down even further from the combination of higher rates and regional banks rebuilding their balance sheets. 2) This will likely lead to a slowdown in U.S. Gross Domestic Product and possibly a short and shallow recession. Our outlook is for low growth U.S. GDP as we do not see how unemployment goes much lower given the number of people retiring. 3) Over $500 billion has moved from regional banks to money market funds and larger banks. We believe the Fed would again protect deposits but we only see full public confidence restored once interest rates begin to fall again. 4) As we move through 2023 and into the U.S. Presidential campaign in 2024, both the state of the economy and the level of interest rates will be focal points of debate. The investigation into the bank failures may also cause the Biden administration some trouble if the Fed was found to be too lax in its regulation. Interest rates will also be of concern in any Canadian election as there approximately $137 billion in variable rate mortgages just between CIBC and Royal Bank where homeowners are now only paying interest due to rate increases, yet another consequence of Fed policy that Canada had to follow. That is potentially a lot of unhappy voters on both sides of the border.

Given all the side effects of the Fed's battle against inflation, the stock market has been fairly choppy but relatively flat overall. In Canada, we have seen weakness in banks, particularly TD and Bank of Montreal as they are both currently involved in takeovers of U.S. banks. However, Canadian banks are in a much stronger position than their U.S. counterparts due to homeowner equity, stricter lending standards and much better capital positions which can withstand potential write-offs. Energy stocks have also been under pressure as crude oil prices fell below $70 per barrel. These companies remain highly profitable and we are maintaining positions for the dividend income, call premiums and a likely increase in oil prices back above $70 once recession fears ease.

The reaction of the U.S. bond market to recent events has also been informative. Prior to the failure of Silicon Valley, the 2 yr yield peaked over 5% and the spread between the 2 yr and 10 yr bonds widened to over 100 basis points and highlighted the market's fear that the Fed was going to cause a recession. That spread has now narrowed to 47 basis points as the markets have priced in that the Fed is now likely closer to the end of rate increases than previously expected. Though the bond market and the Fed disagree on the timing, both are forecasting future interest rate cuts, which is definitely a positive.

Coming in April, the U.S. first quarter earnings reports will be closely watched both for actual earnings and any changes in future forecasts. Despite rising interest rates last year, most companies in the S&P 500 fared well, as many are self funded from sales and not directly affected by interest rates. The U.S. banks will likely have to take higher loan loss provisions to be extra cautious but we are otherwise optimistic that the trend of recent quarters will continue to be positive. The U.S. Consumer Price Index, the Core Personal Consumption Index and unemployment data will all be closely tracked and market sentiment will continue to improve as inflation falls.

We remain defensive in our portfolios with a focus on market leading companies with strong cash flows and balance sheets. We continue to emphasize cash flow generation through dividends and call premiums while seeking to keep overall portfolio volatility at a minimum.

The Fed has been faced with a variety of extreme challenges which have led to both positive and negative results. We will continue to adjust to market conditions as the Fed does and while inflation remains stubborn, we are encouraged that the trend is heading in the right direction. Until next month, stay well.

As always, questions, comments, concerns and feedback are always welcome.

Yours truly,
Trevor, Walter and the Cooper Wealth Management team