Bessette Wealth Management of RBC Dominion Securities

The Good

The year has started off on strong footing. Inflation, having reached a peak in June, has been falling ever since with the U.S. down to 5% and Canada down to 4.3% on a year-over-year basis. Europe avoided what looked to be an assured recession, buoyed by low natural gas prices due to a warmer than normal winter which acted as a stimulus to the economy. In China, the abandoning of their Zero-Covid policy to end 2022 has resulted in a strong re-opening with GDP growth anticipated to be 5%. Closer to home, the U.S. consumer remains resilient with mid-single digits retail sales growth and low unemployment continuing to be at levels not seen since 1969. Even the heavily indebted Canadian consumer does not show strong signs of cracking to date due in part to accommodative bank mortgage flexibility.

The stronger than anticipated economic performance around the world, combined with soft commodity prices (save for recent oil price strength) and falling inflation have led to strong asset price performance. For the first quarter, global stocks gained 7.9%, outpacing Canada's main stock market return of 4.6%. From the lows of mid-October through the time of this writing, global stocks have returned 21% driven by robust developed markets performance in places like Europe and Japan with the EAFE index up over 30%. Bond prices appear to have bottomed as well, with the Canada Bond Universe up 4.9% from mid-October through today. As we have highlighted in prior letters, negative price performance of the magnitude we witnessed in 2022 almost always underwrites significant upside price performance within a reasonably short window thereafter.

The Bad

The North American and global economies do continue to face challenges. The investment community still anticipates a recession, albeit at a lower chance than recent expectations with consensus now down to a roughly 60% probability. Most of the economic criteria we track are pointing to end of cycle or recession already underway.

Despite the tepid economic outlook, unemployment continues to remain at extremely low levels and wage growth remains above long-term averages. Nearly a third of federal workers in Canada are now on strike, demanding higher wages to offset elevated inflation and we have seen similar negotiations globally in both the private and public sector. So while inflation falls, there continues to be inflationary headwinds on the labor side of the equation as we move through early 2023.

Further exacerbating inflationary pressures is an abrupt oil supply cut by the OPEC cartel. The surprise announcement in mid-March led to prices going from a one year-low of $67/bbl to over $80/bbl, a nearly 25% gain in under one month.

Despite headline inflation falling to the mid-single digits, we continue to see challenges to get to the U.S. Federal Reserve's target of 2%. We believe the Central Banks are willing to accept economic weakness rather than continued elevated inflation. So while the market expects interest rate cuts by the U.S. in July and in Canada by October, we believe only a recession of some significance by this time could lead to such an outcome.

And The Ugly

Increasing the chance of this very recession outcome is stress in the banking sector. In early March we saw the first major banking failures since the Great Financial Crisis. Two smaller regional U.S. banks, Silicon Valley Bank and Signature Bank, experienced a loss of confidence by depositors and a resulting

traditional bank run at this time. Creating yet more crisis-like headlines was the shotgun marriage of Switzerland banks UBS and Credit Suisse.

Silicon Valley Bank and Signature Bank shared in common a very high percentage of total deposits being uninsured above the U.S. $250,000 limit. Both banks had suffered losses on their bond portfolios from higher interest rates, wiping out on paper its regulatory capital. In normal circumstances, these bond losses would only be on paper. Unfortunately, a significant portion of the client base was found in the non-profitable tech community, and were withdrawing cash deposits to fund operations which resulted in bonds being sold at a loss prior to maturity. Depositors, fearing there was not enough asset value to cover their uninsured deposits, withdrew more than the bank could fund on short notice. Due no doubt in part to the lessons of the past banking crisis, the U.S. government provided full insurance for all deposits at failed lenders while the U.S. Federal Reserve quickly created extraordinary liquidity to ensure the financial system continued to work as per normal times.

In the case of Credit Suisse, years of non-profitability, restructurings and strategic missteps led to its failure. We acknowledge the headlines read a lot like difficult times 15 years ago, but we side on the conclusions of the market that the recent isolated failures are unlikely to lead to a wider global banking problem, with the largest banks globally adhering to entirely different and more stringent capital requirements than U.S. regional banks, Canada's included.

We See Multiple Roads Forward and Are Positioning Portfolios for the Uncertainty

The economic climate has been better than expected to start the year, with the market having previously anticipated imminent recession by mid-2023. That outlook has improved, pushing out any expected timelines.

We believe now there is less certainty as to what comes next. We believe the chances of a recession may have in fact increased with recent banking issues, as lenders are likely to be more risk averse and lend less to their customers. The lower loan growth could possibly lead to self-fulfilling economic weakness as we head into the second half of 2023.

Positively, economic weakness should continue to help depress inflationary pressures and we may in fact see a more accommodative monetary environment in the near future which has a positive impact on many asset prices including bonds.

As always, the timing and magnitude of challenges are unknown in advance so we will continue to position client portfolios for multiple economic and financial markets moving forward. We believe we are back to a stock and bond pickers market, where not all asset classes or individual securities are likely to experience a rising tide. We can therefore easily envision a multi-year era where a lot of value is created through differentiated investment expertise alongside process driven investment decision making.

Entering 2022 Bessette Wealth Management was as conservatively positioned as it had been in a long time. We are most, as always, concerned with risk mitigation and protecting to the downside. Beginning in August, we began a steady migration to tilt to more offensive areas of the market, not knowing exactly when the bottom would be. We continued this strategy in the first quarter of 2023, knowing we would be too early to catch the bottom, just right on some adjustments and inevitably late on others. Our focus as we continue through the year is to continue to mitigate difficult downside markets while still positioning to capture upside and keep pace as economic and market conditions improve.

Bessette Wealth Management

® / ™ Trademark(s) of Royal Bank of Canada. Used under licence.