March Madness

Though October has long been regarded as the most treacherous month for stock investors, it may be time for March to claim that dubious title. So far in this young millennium, the vernal equinox has coincided with the popping of the dot-com bubble, the final market plunge of the Great Financial Crisis, the covid crash, and now a burst of bank failures. As it stands, we might all be better off if the investing calendar comprised only 11 months!

Whereas investors, strategists, and commentators were recently rapt by soaring inflation and surging interest rates, focus quickly shifted to the financial system in Q1, as Silicon Valley Bank (SVB) met a swift demise near the end of the quarter and its much larger global cousin, Credit Suisse, was forced into the arms of its compatriot and erstwhile competitor, UBS. These were and are significant events, with implications for the economy, monetary policy, financial regulation, and equity and debt markets. In this note, we won't expound on the reasons for the failures or the policy responses that followed – *enough pixels have been laid down in that pursuit already* – but will instead attempt to answer some of the questions that might have come to mind as you think about your portfolio and family wealth in light of recent news. As always, we'll be short on prediction and long on perspective, as we try to fill in some of the pertinent gaps.

How will the bank failures impact the broad economy?

It's not hard to find confident answers to this question in the financial press but, frankly, it's impossible to know for sure. Most useful is to look at what was dominating economic thought beforehand and then consider how new developments might alter the established consensus view. As we all know, central bankers had embarked on a program of rapid policy rate increases over the past year in a full-throttled attempt to tame the steep rise in inflation and, though CPI had begun to recede, it was widely believed that monetary tightening had not yet reached its conclusion.

The collapse of SVB and the emergent struggles of other "regional" banks in the US, however, have the potential to alter the trajectories of both the economy and monetary policy. Though regional banks are not individually large, their collective clout is significant: according to Bank Credit Analyst, for example, banks with less than $250bn in assets account for 45% of consumer, 50% of commercial and industrial, and nearly 60% of residential real estate lending in the US. Suddenly, though, these institutions are looking over their shoulders, concerned not only about the stickiness of their deposit bases but also with the type and quality of the loans they make; in fact, it has been estimated that the credit contraction likely to follow could impose the tightening equivalent of as much as 1.5% in US Fed rate hikes. When this endogenous constriction is combined with other inputs (such as the continuing decline in commodity prices and the recent downturn in shelter costs), we may find that inflation and interest rates are soon retreating faster than earlier predicted. Of course from an equity perspective, the valuation boost potentially provided by lower rates will have to be balanced against the chance

that earnings growth will be harder to come by, and so selectivity within portfolios should become even more important in the months ahead.

Could current conditions balloon into a scenario resembling 2008/09?

The backdrop to this financial event is markedly different from that which preceded the Great Financial Crisis (GFC), not least of which are the lessons that policy makers now carry from that calamitous episode. This experience undoubtedly contributed to the swiftness with which deposits were guaranteed at SVB and the urgency assigned to packaging out Credit Suisse and its sprawling empire. As well, prior to the GFC, significant debt had accumulated in the private sector as individuals and families levered themselves to an historic degree in order to join the real estate boom. Now, however, household balance sheets in the US are about as strong as they've been since the Second World War, greatly reducing the risk that fissures in the financial system will spill over to the all-important consumer, as they did in 2008/09. Even though monetary authorities are now working from a much more constrained position than they were a decade and a half ago, having to thread the needle of maintaining the fight against inflation while keeping the financial system sufficiently liquified, we perceive the odds of a GFC-like scenario to be fairly low.

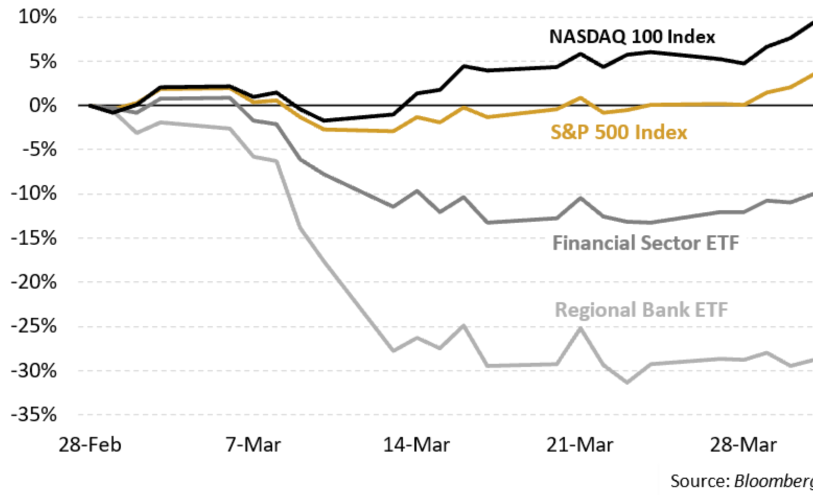
If US banks are under pressure, what does that mean for Canadian lenders?

Despite the many similarities between the Canadian and US economies, our banking systems are notably different. As mentioned above, the problems now surfacing in the US are linked to its large cohort of regional banks, a subset which doesn't exist to any great extent in Canada (in fact, there are more banks registered in the state of North Dakota than there are in our entire country!). Though we tend to think of banking as built on a foundation of money, it's really all about confidence and when that confidence begins to erode, almost no amount of money can stop an accelerating spiral. If anything, the current issues in the US reveal why a fractional reserve banking system is fraught with risk in a country with more than 4000 lenders. Because the majority of funds deposited to banks are lent out or invested – *and not available for immediate and simultaneous withdrawal* – it's important that institutions carry large, broad, and heterogeneous depositor bases. When a bank is linked to a narrow group of industries in a concentrated geographical area (as SVB was with the tech sector in Silicon Valley), the odds of a large portion of the client base acting in the same way at the same time are amplified. This structural difference, combined with the Canadian banking industry's balance sheet strength and its reputation for conservative capital management, greatly reduces the chance that our lenders would find themselves in a similar bind to that now being felt south of the border.

How have markets and DM portfolios fared through this challenging stretch?

When bad things happen, it's common for investor risk appetites to disappear and capital to take off on a "flight to safety". Ordinarily, this has meant an exodus out of stocks and into government bonds *(and heavy bidding did push treasury yields down significantly during March)*, as well as a shift within equity markets toward sectors which have traditionally been regarded as less volatile. This has meant that more prosaic groups, such as utilities and consumer staples, have tended to fare relatively well in times of stress, while tech and other "long duration" assets have typically suffered. Running counter to

this trusty playbook, however, the S&P 500 not only *gained* ground this March, but its rise was emphatically led by big technology (the accompanying chart compares the recent performance of the NASDAQ 100, the S&P 500, and two of the sub-groups most affected by the banking crisis).



This behaviour gives rise to at least two observations. First, if stocks can rally in the face of two major bank failures and yet another Fed rate hike implemented in the midst of this turmoil, perhaps underlying market strength is greater than widely believed. And second, with senior technology names attracting capital in a moment of financial anxiety, it could be that the group has graduated up the asset class hierarchy to a more mature position.

A clue as to why investors might favour large tech companies when quality is at a premium can be found on their balance sheets, which are often cash rich and debt light. These characteristics not only provide staying power in a climate of economic uncertainty and shelter from the cost of rising rates, they also offer a high degree of capital flexibility when opportunities arise. Microsoft, for example, is set to complete its acquisition of gaming giant, Activision Blizzard, once final regulatory approval is received. Instead of taking on pricey debt or issuing equity to fund the purchase, however, Microsoft will pay the entire $68.7bn tab with cash – *and this outflow will deplete barely two thirds of the company's accumulated stockpile*.

DM's main equity mandates posted strong absolute and relative results in the first quarter of 2023, helped both by the sectors we have historically avoided and by significant gains in several of our core positions. Our bond allocations also recovered significant lost ground over the past three months, as interest rates continued to recede from the heights of last fall and credit spreads remained relatively benign, especially when the banking difficulties described above are considered. As we've learned through crises large and small over our multi-decade history, general distress can provide some of the best investment opportunities, while personal panic almost always leads to financial peril. As stewards of your wealth, we'll continue to seek out the former while helping you to evade the latter.