GLOBEINVEST
CAPITAL MANAGEMENT INC.

INVESTMENT NOTES

MARCH 2023

UPCOMING 2023 BNN SHOWS

Christine: April 18 @ 12 pm

Christine: May 17 @ 12 pm

Christine: June 13 @12 pm

Equity markets managed to overcome the upheaval in the U.S. financial system and post positive returns in the first quarter of the year. Technology stocks led with the NASDAQ Composite up 16.8%, rebounding from their dismal performance last year and reflecting expectations the interest rate tightening cycle is near the end. Energy and bank stocks were the laggards in the first quarter.

Financial conditions have tightened considerably following the U.S. banking crisis in early March. The aftershocks have yet to be fully felt and this adds to the anxiety permeating through financial markets, with investors trying to anticipate the path of U.S. Federal Reserve rate movements.

Tightening Cycles and Financial Stress

The pace of interest rate increases by central banks around the world, which started in March 2022, is the fastest on record. Layered on top of these short-term rate hikes, the Fed began a program of quantitative tightening in June 2022 to combat high inflation, which ramped up much faster than the prior cycle. History shows that when the Fed is raising interest rates, an unexpected shock (such as a financial crisis) can trigger a recession. The latest Fed tightening cycle may very well have caused something to break in the financial system, in the form of the Silicon Valley Bank (SVB) collapse (chart 1). As noted by strategist Ed Yardeni, past banking crises triggered by Fed tightening coincided with peaks in the federal funds rate (chart 2).

The tightening cycle for central banks is nearing the end. The Bank of Canada is on hold and the Fed has softened its stance from “ongoing rate increases” to “some additional policy firming”, albeit the Fed does not project rate cuts this year. The Fed, however, does acknowledge the events in the banking system are likely to result in tighter credit conditions for households and businesses, which would in turn affect economic outcomes. The Fed’s policy decisions will increasingly be more dependent on incoming economic data.

Financial Contagion

The failure of the two regional banks, SVB and Signature Bank (SB) is not a repeat of the 2007/2009 Global Financial Crisis (GFC). The core issue that led to SVB’s failure was a mismatch between its cost and lifespan of its deposits versus the yield and duration of its assets. This mismatch was brought to light by the environment of rapidly rising interest rates combined with a largely uninsured depositor base. This is very different from the GFC which centered around bad sub-prime mortgages and the U.S. housing crash.

To summarize, SVB had invested a large portion of its cash or assets (received from its depositors) in long-term U.S Treasury bonds when interest rates were very low. When rates moved up over the past year, bond prices fell; however, if the bonds were held to maturity, their full value would have been received. SVB’s depositor base (considered liabilities of the bank) was very concentrated in technology related sectors, consisting mainly of venture capitalists, private equity, and technology start-ups who can withdraw their accounts on demand. As the technology industry hit a downturn last year, many of SVB’s clients were drawing down their accounts. SVB had insufficient liquid reserves to fund the withdrawals and was forced sell bonds at a loss. This weakened its capital base and forced them to seek additional equity capital, which sent an alarming message to both their investors and depositors. The former rushed to sell their stock and the latter rushed to get their money out thereby creating a “run on the bank”.

Similarly, SB had a largely uninsured and concentrated depositor base, focused on the cryptocurrency industry, as well as substantial long-term bond holdings. Financial contagion took hold following SVB’s failure on March 10th, and a “run” on SB ensued, leading to federal regulators taking control of SB on March 12th.

The Federal Reserve, Federal Deposit Insurance Corporation (FDIC) and U.S. Treasury moved quickly to stop any runs on other banks, as deposits began to move out of other regional banks too. On the afternoon of March 12th, the government departments announced all deposits (both insured and uninsured) at SVB and SB were protected, and created a new facility, the Bank Term Funding Program (BTFP) to provide liquidity by allowing banks to get loans of up to one year in length. The BTFP eliminates the need by banks to sell their assets at a loss to fund their depositors' needs. So far, the actions taken by the Fed and FDIC has contained the crisis.

The regional banks have accessed the Fed credit facilities and their usage will be monitored to assess the level of stress in the banking system. Unlike the GFC when large financial institutions were at risk, the biggest U.S. banks have benefitted from the flight-to-safety mindset. According to Federal Reserve data, the 25 biggest U.S. banks gained $120 billion in deposits in the days after SVB collapsed and all the banks below that level lost $108 billion over the same period. Fund flows into money market funds have also been elevated.

Our investments in U.S. banks have always been and will continue to be focused on the large megabanks with strong liquidity and capital ratios. Post the GFC, the regulatory oversight and capital requirements became more stringent on the largest banks as they were deemed "too big to fail", whereas the midsize banks were not. The larger banks are also subject to an annual stress test by the Federal Reserve to assess their ability to withstand market turmoil and to determine the amount of shareholder payouts allowed, in the form of dividends and share buybacks.

The fallout of the banking debacle will mean tougher rules for regional banks as well. Financial conditions have tightened considerably flowing the demise of SVB and SB. Lending activity will slow as banks tighten credit standards and shore up their balance sheets, increasing cash on hand. For the overall banking industry, margins will narrow due to increased funding costs to retain and attract new deposits. It remains to be seen if a credit crunch materializes to drive the U.S. economy into a recession.

Canadian Banks

Compared to all the recent drama within the U.S. banking system, the Canadian banking system seems quite dull – which is one of the reasons we are comfortable owning domestic banks for the long-term. For starters, the Canadian system is very concentrated, dominated by just six institutions. These banks have a much more diversified depositor base than any regional U.S. bank, with each Canadian bank boasting a broad base of clients coast-to-coast. Unlike SVB and its overexposure to emerging technology companies, this makes concurrent withdrawals resulting in a "run" extremely unlikely. Additionally, the Canadian industry is much more regulated, and thus, conservative. Incidentally, this also helped the banks here escape the GFC largely unscathed.

Forced Merger

Turning our attention to the Swiss banks, the situation with Credit Suisse was not quite as dire as it was with SVB or SB. There was no "run". In fact, it looked like the bank had ample assets to pay off all its liabilities. But it was very close: on Friday, March 17th, the company's stock price implied that its assets were worth 1.5% more than its liabilities (for a rough comparison, RBC's ratio is more than ten-times higher). Apparently, that was too close for comfort for Swiss regulators, who forced UBS Group to acquire Credit Suisse that weekend, even though the bank could have possibly continued to carry on as normal. In fact, regulators were so keen to see the merger go through that the government changed the laws to prevent Credit Suisse shareholders from voting on, and possibly vetoing, the deal.

Economic Indicators

The leading indicators we track continue to signal a recession on the horizon. We are loathe to say, "this time it is different", nonetheless, we note that many events over the past few years have been atypical. Historically accurate, the Conference Board Leading Economic Index (LEI) anticipates turning points in the business cycle by about 12 months. The LEI includes 10 components covering labour market conditions, consumer behaviour, manufacturing activity and financial conditions. The LEI peaked in February 2022 and has slipped for the 11th straight month. The six-month average change of -0.6% remains below the recession threshold of -0.4% (chart 3).

Conclusion

Financial markets have been concerned about a pending recession for some time. It has yet to materialize. The recent decline in short-term and long-term bond yields following the banking crisis signals both slower inflation and economic growth is ahead. Annual inflation continues to ease and further deceleration is expected due to elevated base year comparisons.

Economic cycles are inevitable and the companies you own are equipped to withstand them. They have also been preparing for an economic slowdown and will attempt to take advantage of market dislocations to increase their competitive positioning within their respective industries. Our focus remains on building wealth for our clients over the long-term.

Christine Poole, MBA, CFA
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CHART 1: US Yield Curve & Financial Crises (basis points, weekly)
- Yardeni

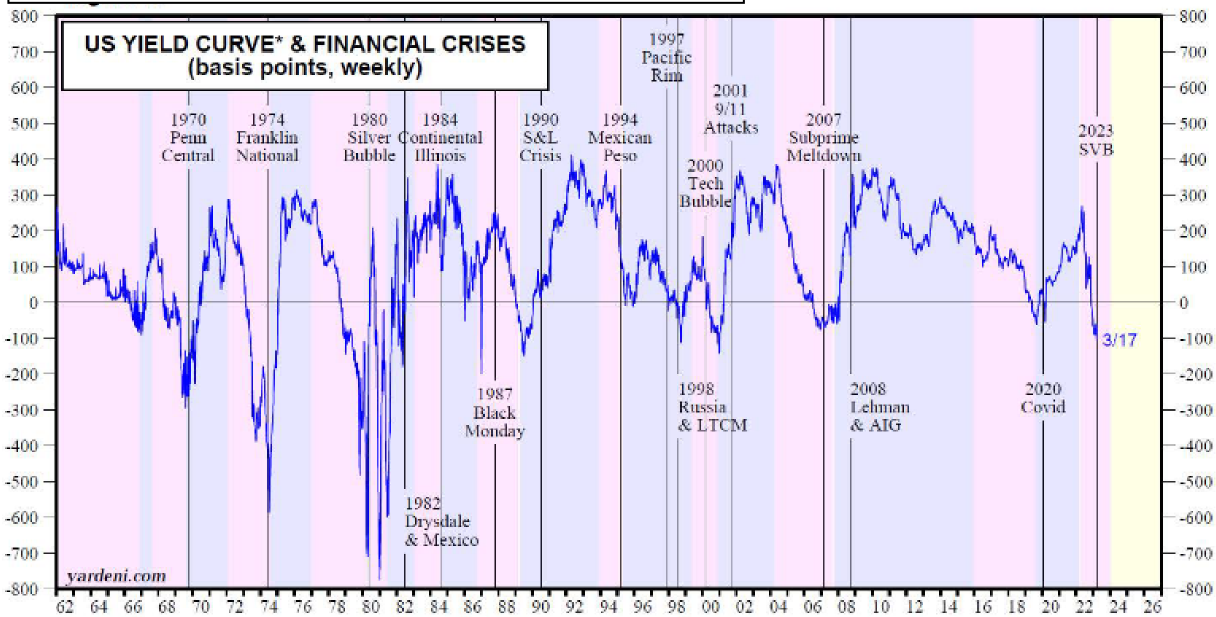


CHART 2: Federal Funds Rate & Financial Crises
- Yardeni

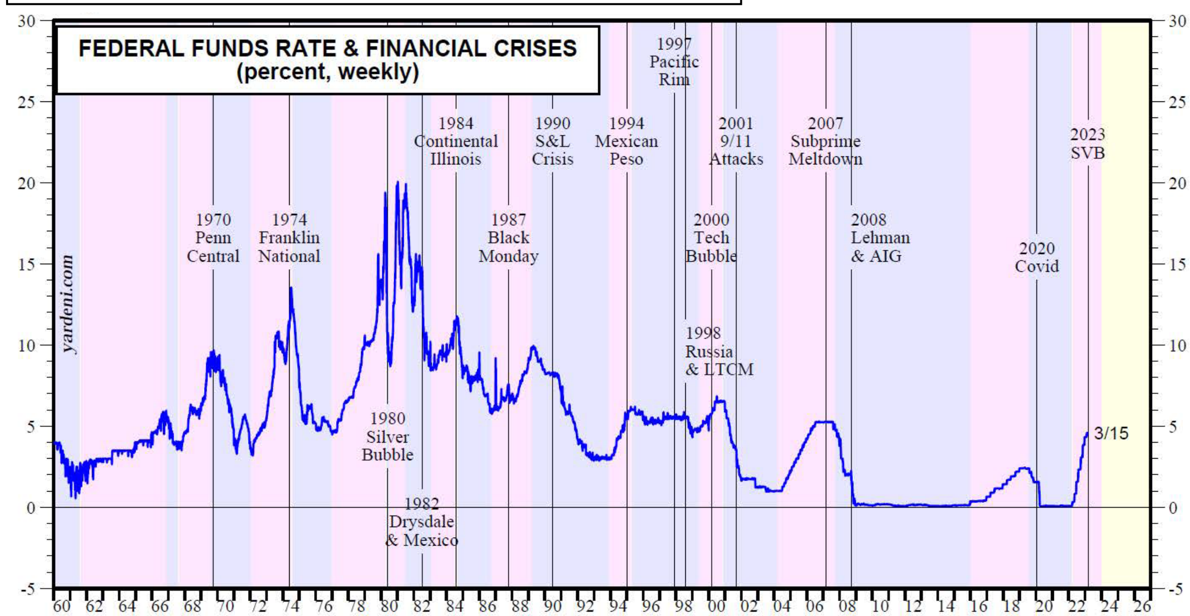
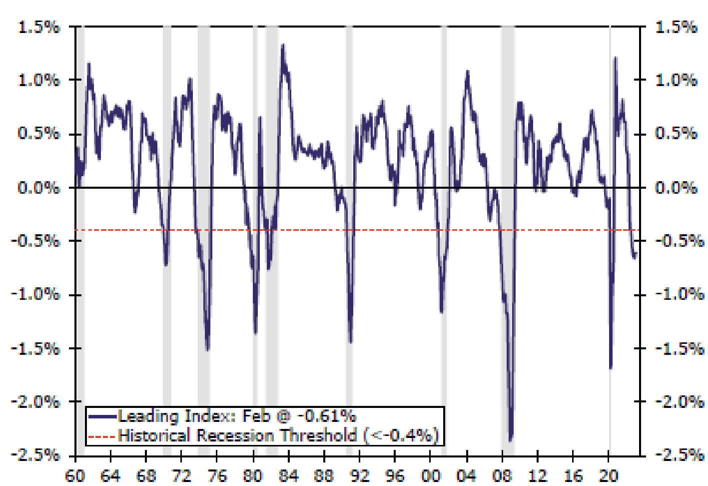


CHART 3: Leading economic Index (Six-Month Average of Monthly Change)
- The Conference Board and Wells Fargo Economics



RECENT BNN SHOWS

Christine: March 21, 2023

Christine: February 17, 2023

Christine: January 18, 2023

Christine: December 16, 2022

Christine: November 18, 2022

Christine: October 18, 2022

Christine: September 20, 2022

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GLOBEINVEST CAPITAL MANAGEMENT INC.

MARCH 31, 2023 STATISTICAL SUMMARY

STOCK MARKETS	QTD	1 YEAR
S&P TSX COMPOSITE TOTAL RETURN (CAD)	4.6 %	-5.2 %
S&P 500 TOTAL RETURN (CAD)	7.2 %	-0.2 %
S&P 500 TOTAL RETURN (USD)	7.5 %	-7.7 %
DJIA TOTAL RETURN (USD)	0.9 %	-2.0 %
NASDAQ COMPOSITE PRICE RETURN (USD)	16.8 %	-14.1 %
MSCI WORLD INDEX PRICE RETURN (CAD)	7.0 %	-1.1 %
MSCI WORLD INDEX PRICE RETURN (USD)	7.3 %	-8.6 %
CANADIAN UNIVERSE BOND INDEX	2.9 %	-2.0 %

COMMODITIES	QTD	YTD
GOLD	9.2 %	2.8 %
SILVER	1.8 %	-3.3 %
COPPER	7.9 %	-13.2 %
NATURAL GAS (NYMEX)	-50.5 %	-60.7 %
WTI	-5.7 %	-24.5 %
BRENT	-8.5 %	-25.4 %

TREASURY BONDS	03/31/23	12/31/22	03/31/22
2 YEAR (CAD)	3.74 %	4.06 %	2.27 %
2 YEAR (US)	4.06 %	4.41 %	2.28 %
5 YEAR (CAD)	3.02 %	3.41 %	2.39 %
5 YEAR (US)	3.60 %	3.99 %	2.42 %
10 YEAR (CAD)	2.90 %	3.30 %	2.40 %
10 YEAR (US)	3.48 %	3.88 %	2.32 %
30 YEAR (CAD)	3.02 %	3.28 %	2.37 %
30 YEAR (US)	3.81 %	3.97 %	2.44 %
CPI (CAD)	5.20 %	6.30 %	6.70 %
CORE CPI (CAD)	4.80 %	5.30 %	5.50 %
CPI (US)	6.00 %	6.50 %	8.50 %
CORE CPI (US)	5.50 %	5.70 %	6.50 %