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INVESTMENT COUNSEL LTD.

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Investment Commentary

Table one below shows the price performance of the S&P/TSX index and the S&P 500 index over the periods indicated. The TSX experienced very little price performance in the first quarter of 2023. The performance was largely impacted by a decline in bank shares and weak performance of the oil and gas sector. The S&P 500 index performed better because the heavily weighted technology subindex had strong performance during the quarter. Over the last year both indices declined by approximately the same amount.

There was a substantial increase in S&P 500 index over the last three years. There was a slightly smaller gain for the S&P/TSX index during the same period. The reason for the dramatic gains was that three years ago was the bottom of the COVID-induced sell-off of the markets. Therefore, the performance is not as impressive as it appears.

Table 1

Price Performance of the S&P 500 index and the S&P/TSX index

% Change

	S&P/TSX	S&P 500 index
Q1 2023	2.6	7.8
One Year	(8.4)	(8.5)
Three Years	58	75.9

Source: Factset

As table two indicates, the sell-off in the financial service stocks was a significant factor in the weakness in both markets during the first quarter of 2023 and for the last twelve months. The financial stocks, and in particular the U.S. regional bank stocks, have now declined to a level that, barring a complete financial crisis, represent good value.

Table 2

Performance of Various Banking Sector Indices – Total Return

	% Change	
	Three Months	One Year
Canadian Banks	(1.5)	(16.1)
U.S. Financials	(13.8)	(26.4)
U.S. Regional Banks	(24.5)	(37.6)

Source: RBC Capital Markets, iShares

The Inflation Rate Remains the Key Driver of Interest Rates

Inflation is falling. The end of alarmingly high inflation appears to be imminent. Inflation peaked in June of 2022 when the all-items CPI reached a level of nine per cent. Since then it has fallen more or less steadily. In the first two months of 2023, the CPI was 6.4 per cent and 6.0 per cent, respectively. Excluding the volatile food and energy categories, the CPI was 5.6 per cent and 5.5 per cent in January and February. While this is progress, inflation is still running well above the Federal Reserve Board's target level of two per cent. The key issue is how does it fall back to two per cent from its current level?

There are three components of inflation, goods, shelter, and other services that were largely responsible for the run-up in inflation in 2021 and early 2022. Prices for manufactured goods surged in 2021 as consumer spending, fuelled by low interest rates, government stimulus and pandemic-driven savings collided with backed-up supply chains.

Strong demand for houses and apartments from low interest rates and remote working caused shelter costs to contribute more than half of December's 5.7 per cent core inflation. Shelter inflation is forecast to fall from a high of 8.1 per cent in March of 2023 to 5.3 per cent by December.

Core service costs are largely driven by labour costs. Hourly pay for private sector workers rose at an annual rate of 4.6 per cent in the three months through January, compared with an average rate of 3.3 per cent in 2018 and 2019, according to the Wall Street Journal. Although wage growth has shown signs of decelerating recently, it remains at levels that make it difficult for the Federal Reserve Board to reach its inflation target.

The U.S. Banking System Avoids a Full-Blown Crisis – What are the Implications for Further Interest Rate Increases?

On Sunday March 12th, regulators approved plans to backstop depositors and financial institutions associated with Silicon Valley Bank (SVB) and Signature Bank. The measures, which include guaranteeing all deposits of the banks, were announced jointly by the Treasury Department, the Federal Reserve Board, and the Federal Deposit Insurance Corporation. The steps did not constitute a bailout, because stock and bondholders of SVB and Signature bank are not being protected.

The Federal Reserve Board also announced that it would make additional funding available to all banks through a new "Bank Term Funding Program".

SVB had $209 billion in assets at the time it failed. It was the sixteenth largest bank in the U.S. It was also the largest bank failure in the U.S. since Washington Mutual failed in 2008. At the time, Washington Mutual had $307 billion in assets.

Signature Bank had $118 billion in assets at the time it failed.

The failures of SVB and Signature Bank are the highest profile failures of the Federal Reserve Board's campaign to slow the economy and bring inflation down. The Federal Reserve Board has raised interest rates by 4.5 per cent over the last year and there are indications more increases are likely. At the Federal Open Market Committee meeting on March 21-22, the federal funds rate was increased to 4.75 per cent. The Federal Reserve Board also forecasted one more increase in the federal funds rate. The 25 basis point increase was at the low end of what was expected, and the prospect of only one more increase was a positive surprise. This position was taken by the Federal Reserve Board because it believed credit conditions will tighten throughout the banking system as a result of the failures of SVB and Signature Bank. The result should be a natural slowing of the U.S. economy.

Small and Mid-Size U.S. Banks Are at Risk – Canadian Banks Are Not at Risk

The failure of Silicon Valley Bank was caused primarily because it had a mismatch between what it was earning on its assets and what it was paying on deposits. Two years ago, the bank purchased large quantities of very low-yielding government bonds. As interest rates rose, depositors received higher interest than what the government bonds were yielding. Also, as interest rates increased, the price of bonds declined. Furthermore, Silicon Valley Bank had primarily corporate accounts. Therefore, when the corporations decided to take their deposits out of SVB, they did so in large quantities. The bank then had to sell bonds at a loss to meet the withdrawals. This combination of factors led to the collapse of SVB.

In response to the sudden collapse of SVB, the FDIC has now insured all deposits at the bank.

Canadian banks do not have anywhere near the same mismatch between their deposits and their loans or bond portfolios. Additionally, Canadian banks are well diversified with many revenue and profit sources.

The Implications for the U.S. Banking System – More Regulation and Consolidation

The dramatic and material intervention by the U.S. federal regulators could trigger tougher capital requirements and liquidity rules for all banks. This will amount to a reversing of some steps taken during the Trump administration to ease restrictions on smaller banks. The easing of restrictions had advantaged regional banks relative to the largest banks in that they had lower capital requirements and lighter regulation. If the situation changes, industry consolidation may be inevitable. At present, the U.S. has more than 4,000 banks. By comparison, the U.K. and Canada are dominated by just six banks.

Commercial Real Estate Debt – The Next Area of Problem Loans

With the banking industry in some turmoil there is an increasing concern about commercial real estate debt, particularly loans backed by office buildings. In February of 2023 Columbia Property Trust, which owned 19 office buildings in New York, San Francisco, Washington, and other cities, defaulted on $1.7 billion in debt on seven of its buildings. High interest rates and a glut of vacant space spawned by remote and hybrid work strategies are upending one of the most stable investments of the commercial property world. For the first time even with the job growth of the last two years vacancies have soared as businesses adopted hybrid and remote workplace strategies. The relationship between job growth and demand for space is fractured.

Commercial property valuations are in decline as a result of the factors mentioned above. Owners with floating rate mortgages have to pay more in debt service costs reducing their cash flows.

This year is important for commercial property debt because a record amount of commercial mortgages (more than $270 billion) are due to expire in 2023, according to the data firm Trepp, Inc. Further, at the median U.S. bank commercial real estate loans account for 38 per cent of loan holdings, according to analysis by KBW Research. The only saving grace is that banks have lent more conservatively since the 2008 financial crisis. A lower loan to value ratio since 2008 ensures that even if buildings suffer a loss in value they are still worth more than their mortgages.

The Reopening of the Chinese Economy

In May of 2022, Shanghai was locked down completely as a result of an outbreak of the Omicron variant of COVID. By October 28, cities across the country were in lockdown. In response to widespread protests, China began loosening its COVID-19 restrictions on December 7th of 2022. By January 8th of 2023 it had lifted them altogether. In addition to relaxing COVID restrictions, China is opening up on policy more broadly. The regulatory crackdown on large technology companies was largely waned. Further, the government has signalled more support for property sector and its financing needs.

The most important factor to watch is consumer spending.

Although it is early days, China has begun the year with strong growth. The February PMI (Purchasing Managers' Index) reached 52.6, its highest level since 2012, according to the Wall Street Journal. The key items to watch now are housing and employment. If the labour market recovery continues to broaden out from industry and construction to services, it raises the prospect of very strong growth in 2023.

Summary and Assessment:

There is increasing evidence that the U.S. economy is slowing. The Purchasing Managers' Index declined steadily from April of 2022 to December of 2022. This is a leading indicator of economic activity. Further, the yield curve is significantly inverted. Six month treasury bills are yielding 4.8 per cent while 10 year treasury bills are yielding 3.4 per cent. This situation indicates the expectation that inflation will remain high.

In our opinion, the federal funds rate is close to a peak level. Investors will likely perceive only one further increase in the federal funds rate positively, and that could occur in May of this year at the next Federal Open Market Committee meeting. It is worth noting that the Federal Reserve Board has raised interest rates seventeen times, beginning in December of 2015 when the federal funds rate was 0.25 per cent.

Consequently, in the absence of a full-blown banking crisis or a severe recession, the markets in both Canada and the U.S. are at levels where they represent good value in my opinion. This is particularly the case for bank stocks in Canada and the U.S.

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