Verus Wealth Notes – Q1 2023

A Tough Quarter for the Bears

In our Wealth Notes newsletter that you received in January, we suggested to you that we were more optimistic than most, but most importantly, volatility was here to stay! We said the bottom line was that patience would be the key for investors in 2023, especially in the early stages of the new year. For those who are able to withstand the volatility, they should be rewarded with solid gains in 2023. That is exactly what has unfolded so far in the first quarter of 2023.

Monthly and Quarterly Returns of the Major Markets

	January	February	March	1st Quarter
Dow Jones	2.83%	-4.19%	1.89%	0.38%
S&P 500	6.18%	-2.61%	3.51%	7.03%
NASDAQ	10.68%	-1.11%	6.69%	16.77%
Russell 2000	9.69%	-1.81%	-4.98%	2.34%
S&P/TSX	7.13%	-2.63%	-0.60%	3.69%

Source: Verus Financial

The chart above clearly highlights that the NASDAQ has been a clear winner. The NASDAQ had its best quarter since December 2020. Many market pundits are still singing the same song, that the volatility will ultimately produce a substantial recession, believing this will form the final stages of the current bear market. They also believe this will inflict considerable losses and eventually be followed by a new bull market, led by a fresh group of stocks that will offer tremendous profit opportunities. The following chart clearly illustrates that so far, they have been dead wrong!

NASDAQ VS. The Dow – Q1 2023 Return

NASDAQ		Dow Jones	
Adobe	14.38%	3M	-14.17%
Amazon	20.36%	Chevron Corp	-6.22%
Google	16.39%	Coca-Cola Company	-1.46%
Meta (Facebook)	69.91%	Home Depot	-6.58%
Microsoft	20.34%	IBM	-7.39%
Netflix	17.13%	Johnson & Johnson	-13.01%
Salesforce	48.23%	JPMorgan Chase	-3.56%
Shopify	32.18%	Procter & Gamble	-1.90%
Tesla	91.91%	Walmart	2.68%

Source: Verus Financial

The chart above clearly illustrates that so many analysts got it wrong on their call for investors to shift to big value companies, which are major components of the Dow. In Canada, the S&P/TSX didn't fare well, as bank and energy stocks underperformed in the first quarter of 2023.

The Bears are still out in full force, sticking with their predictions of doom and gloom. Morgan Stanley's top strategist, Michael Wilson, who is among the most predominant bearish voices on US equities, warns the rally and tech stocks that exceeded 20% isn't sustainable and that the sector will return to new lows. He believes that the S&P 500 could drop 26% in the coming months.

Bank and Energy Company Returns for Q1 2023

Company	Return
Royal Bank	0.95%
Toronto-Dominion Bank	-7.67%
Bank of Montreal	-3.28%
Suncor	1.65%
Enbridge	-3.38%
TC Pipelines	-1.37%

Source: Verus Financial

Just recently, Toronto-Dominion became the largest bank in the world, with short positions amounting to 3.7 billion.

Our proactive move of recently decreasing your Canadian component and adding increased weightings to the US and Europe certainly worked in our favour. In the first quarter of this year our Verus US Focus Growth mandate was up 14.07%, and our Verus International Growth mandate was up 14.91%.

Investors continue to digest hawkish commentary as Powell's opening statement before the US House of Representatives Financial Service Committee was identical to the one he gave before the Senate. Fed Chairman Jerome Powell made it clear in March that the central bank is prepared to react to signs of economic strength by continuing to be vigilant with respect to interest rate increases. While the bond market is pricing in further increases, the pace of increases has become more modest, potentially signalling that we may be near the end of the tightening cycle. North American equity markets reacted in typical fashion by selling off, although year to date, returns are still very constructive, based on all the elements that the markets have faced.

In Canada, for the first time in a year, the Bank of Canada (BoC) opted not to raise interest rates. Weaker household and business activity resulted in a directional improvement in inflation numbers (CPI), justifying the BoC pause. An additional contributing factor is the weakness in the Canadian dollar and its impact on both imports and exports. However, like the Feds, the BoC has expressed that it is also prepared to raise rates if any circumstances change.

There have been many wild weeks in the history of finance, but few in recent memory, quite like the ones we saw in March of this year. As jitters rapidly spread about the health of the banking sector from the US to Europe, a concern that had barely registered for most investors just days earlier spooked the markets. There were sudden moves in prices for bank stocks, corporate debt and commodities, but nowhere was the chaos more acute than in the $24 trillion market for US treasuries.

Yields on two-year US Treasuries sank more than half a percentage point on Monday, March 27th, 2023. The very next day, the two-year note soared over a quarter of a point, and then on Wednesday, tumbled as investors frantically recalibrated how much more, if at all, the Federal Reserve would raise interest rates. The price swings were so violent right through to the close of trading on the Friday. These swings topped those triggered by the collapse of Lehman Brothers, 9/11, the bursting of the dot.com bubble and the emerging market crisis of the 1990s.

As the chart below depicts, the 2-year yield on US Treasuries traded in a range of more than 150 basis points or 1.5%. At its March lows, the 2-year rate traded around 3.55%. It also rose as high as 5.08%.

The collapse of Silicon Valley Bank (SVB) added more volatility and uncertainty to markets worldwide. SVB was founded in 1983 and was the 16th largest US bank before its demise. They specialized in financing and banking for venture capital-backed startup companies which were mostly in the technology sector. Venture capital firms did business there as well, including many tech executives.

SVB saw a huge influx of deposits from 2020 through early 2022. Deposits reached $198 billion on March 31, 2020, from $74 billion in June 2020.

SVP's mistake was investing in longer-term mortgage securities with more than 10 years to maturity rather than shorter-maturity treasuries or mortgage issues maturing in less than five years. This led to an asset/liability mismatch.

This collapse clearly highlights the dangers of aggressive central bank hikes. As interest rates rose sharply and the bond market cratered in 2022 (bond prices move inversely to yields), SVB's bond portfolio took a huge hit. This episode highlights the dangers caused by rapid monetary tightening.

On March 13, 2023, SVB Financial Group sold a bond portfolio worth $21 billion to Goldman Sachs Group. Inc. This transaction resulted in SVB booking a $1.8 billion loss, which was the transaction that set the wheels in motion for their ultimate failure.

Only days before a panic drove Silicon Valley Bank into a collapse in less than 48 hours, banking analysts remained widely optimistic about the company. Half of the two-dozen analysts who were tracking the company were still advising investors to buy the stock, according to data compiled by Bloomberg. One analyst forecasted the share price would nearly double to $500 in a year. Even some, who saw the toxic mix that would later sink the bank stock, maintained their hold ratings, which is a neutral stance that amounts to sitting on the sidelines.

Just like regulators and investors, the streets' analysts were caught off guard by a Twitter-age bank run that shook global markets, shining a spotlight yet again on a prickly issue that Wall Street has wrestled with for decades: the almost constant, rosy analysis produced by many of its research divisions. It bodes the question yet again, are the analysts writing these research reports for corporate finance or for the best interest of investors?

On Thursday, March 16, 2020, the four biggest US banks lost $52 billion in market value. PacWest Bancorp fell 25%, Frist Republic Bank lost 17%, Charles Schwab Corp. fell 13%, while US Bancorp lost 7%. America's biggest bank, JP Morgan, Chase & Company, fell 5.4%.

We at Verus Financial firmly believe this current situation bears “LITTLE RESEMBLANCE” to the bank failures during the financial crisis in 2008.

There will, however, be continued fallout. Much greater financial due diligence and scrutiny will become the order of the day. Although Charles Schwab is being swept up in the wave of recent financial meltdowns, it makes little sense. The firm, a half-century mainstay in the brokerage business, isn't over, exposed to crypto, startups or venture capital. Fewer than 20% of Schwab's depositors exceed the FDIC's $250,000 insurance cap, compared with about 90% at the now-defunct Silicon Valley Bank. With 34 million accounts, an army of financial advisors and more than $7 trillion of assets, it towers over regional institutions.

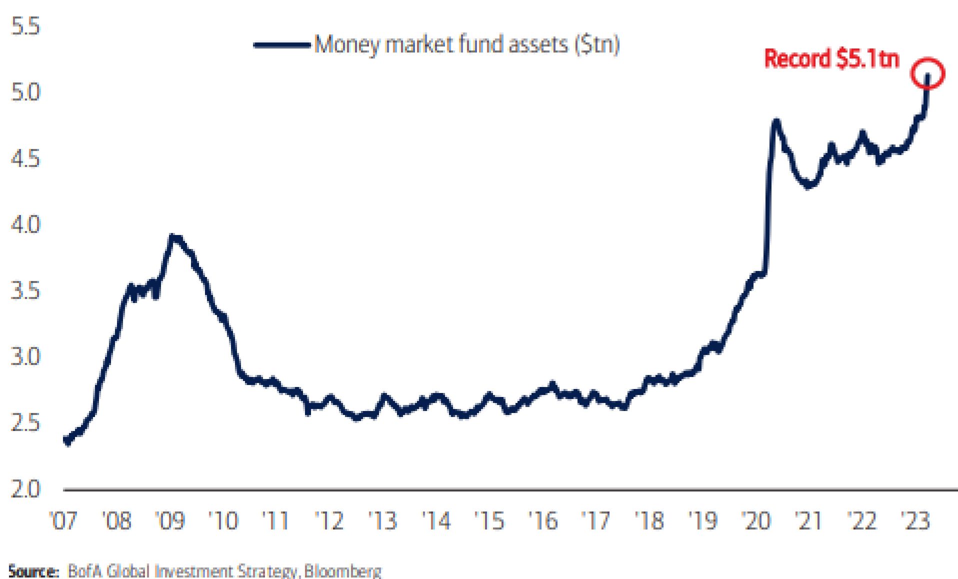
Despite all this, there are some questions. Investors are starting to unearth some risks that have been hiding in plain sight. Unrealized losses on a balance sheet loaded with long-dated bonds ballooned to more than $29 billion last year. At the same time, higher interest rates are encouraging customers to move their cash out of the very accounts that underpin Schwab's business. Schwab shares have lost more than a quarter of their value since March 8, 2023. It's all another indication that the US Federal Reserve's effort to arrest inflation has caught the financial world asleep at the switch, napping on the reality of what the Fed hikes can do to damage a long-duration bond portfolio.

The economic data renaissance combined with the threat of financial sector instability leaves central banks with difficult choices. High inflation means more rate hikes are likely, but worries about financial stability argue for moving cautiously.

The following chart clearly depicts and is yet another example of why the consensus view is usually wrong. Investors have been massively overweight cash and underweight US equities.

Source: BofA Global Research

I will leave you with one final thought, which shows the massive inflows into money market mutual funds, which now sits at an astounding 5.1 trillion. Where do you think all this money is going to go when interest rates eventually move back down? Opportunity knocking!



Verus Financial

Yours in Investing Strategies,

Ken Gordon, PFP, CDFA, CFDS
Senior Wealth Advisor
Tel: 604-235-2919
ken.gordon@nbc.ca
Nominated as one of Canada's Top Wealth Advisors 2021
Globe and Mail in partnership with SHOOK Research

Cody Gordon, CFA, CIM
Potfolio Manager & Wealth Advisor
Tel: 604-235-2918
cody.gordon@nbc.ca

Disclaimer

National Bank Financial - Wealth Management (NBFWM) is a division of National Bank Financial Inc. (NBF), as well as a trademark owned by National Bank of Canada (NBC) that is used under license by NBF. NBF is a member of the Investment Industry Regulatory Organization of Canada (IIROC) and the Canadian Investor Protection Fund (CIPF), and is a wholly-owned subsidiary of NBC, a public company listed on the Toronto Stock Exchange (TSX: NA).The particulars contained herein were obtained from sources we believe to be reliable, but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein. The opinions expressed do not necessarily reflect those of NBF. The information contained herein has been prepared by Ken Gordon, an investment advisor at NBF. The opinions expressed do not necessarily reflect those of NBF.