PRIVATE CLIENT SOLUTIONS

April 3, 2023

Market Commentary

March Madness

Strategy Committee

RAYMOND JAMES®

March Madness

The Fed has, historically, tightened until something breaks, so we suppose we can declare mission accomplished after the Silicon Valley Bank (SVB) and Signature Bank failures.

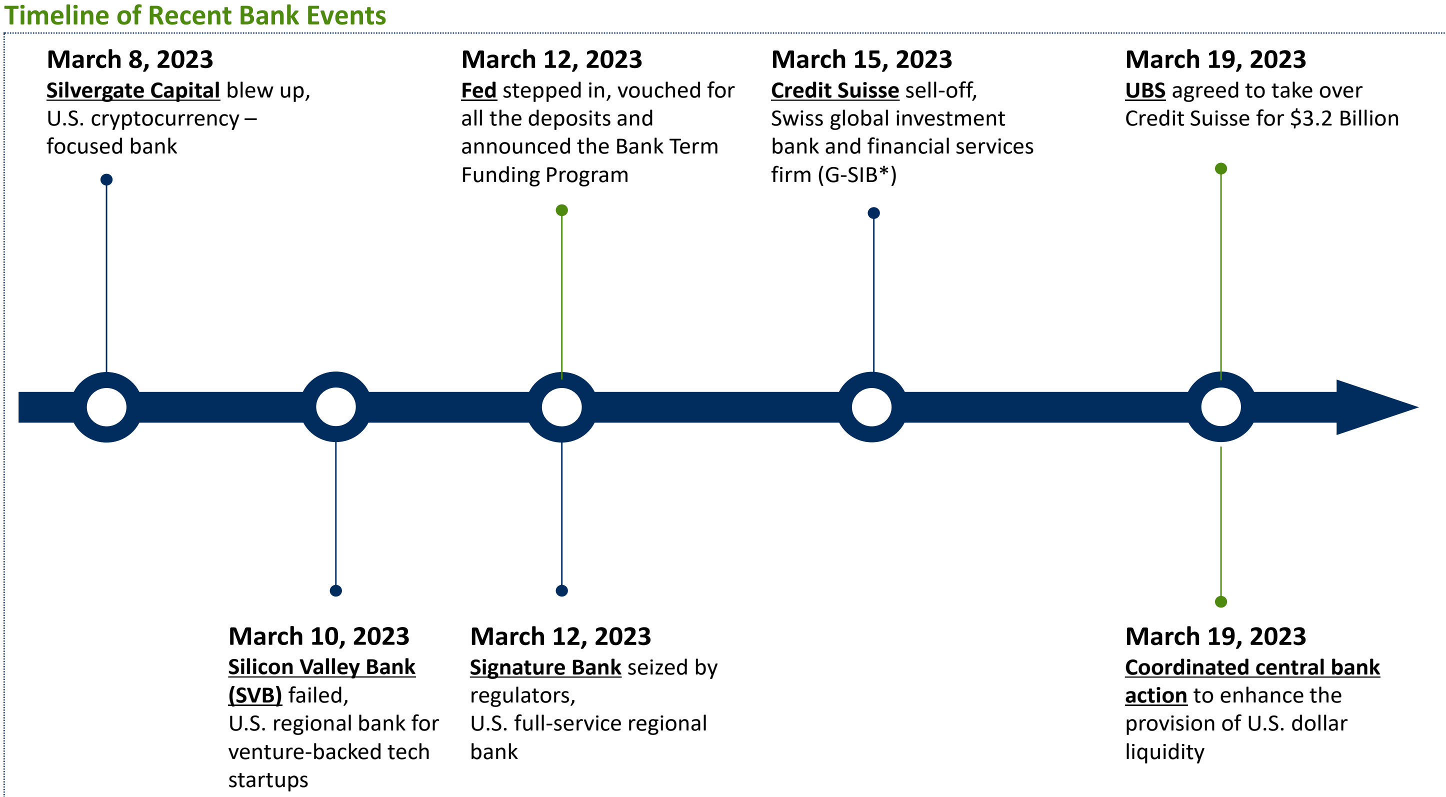
The failure of SVB, which marks the second-largest bank failure in U.S. history, unnerved many U.S. regional bank deposit holders and shareholders. U.S. regional banks experienced deposit outflows, while large money-centred banks like JPMorgan and Bank of America experienced inflows. The iShares U.S. Regional Banks ETF slipped over 30 per cent in March.

To stem the flow of deposits and avoid additional bank failures, the Fed stepped in to provide liquidity by announcing a new emergency lending program, the Bank Term Funding Program (BTFP), designed to ease pressure on the banking system. In addition, the U.S. treasury department implicitly suggested all regional deposits were safe, though Yellen would later walk back any explicit government guarantee of uninsured deposits.

There are a few takeaways from SVB's failure. First, SVB was somewhat of a unique situation and offered a lesson on why diversification is a key ingredient in mitigating risk. SVB focused on cash-hungry technology start-ups that needed their money on demand. Unfortunately, SVB invested the majority of those cash deposits in long-dated bonds. This ended up being a toxic combination or, in industry terms, a mismatch between assets and liabilities.

To meet the shortfall, SVB unloaded long-dated U.S. treasury bonds at a significant loss, which spooked deposit holders and caused a run on the bank. While U.S. treasuries are a safe investment, bonds with longer terms to maturity may see larger price fluctuations.

Timeline of Recent Bank Events



Source: Raymond James Ltd.; The New York Times; As of March 27, 2023. *G-SIB: Global systemically important bank.

As well, if an investor sells before the bonds mature, it can result in a loss.

As technology firms faced more challenging capital markets, they began to draw down more rapidly on deposits at SVB. Deposits at the bank accounted for about 90 per cent of funding versus the 65 per cent average for banks, leaving SVB susceptible to funding shortfalls.

Essentially, SVB was being hurt on both sides, as tech firms needed cash and withdrew their deposits at a time when SVB investments were severely impacted by the rapid increase in interest rates.

However, as we outline below, the troubles facing the U.S. regional banking industry are both a risk and perhaps a silver lining for markets.

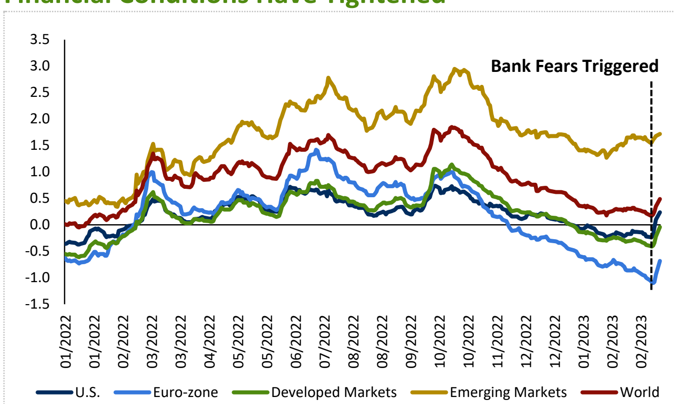
Silver Lining

The second takeaway is the impact on monetary policy.

The Fed has a dual mandate—to pursue the economic goals of maximum employment and price stability. A good old-fashioned bank run would have severe negative implications for both employment and price stability, so it's in the Fed's best interest to avoid such a crisis of confidence.

The market is doing some of the Fed's work as financial conditions have tightened (banks less willing to lend). This will slow the economy and address the Fed's most significant concern: inflation.

Financial Conditions Have Tightened

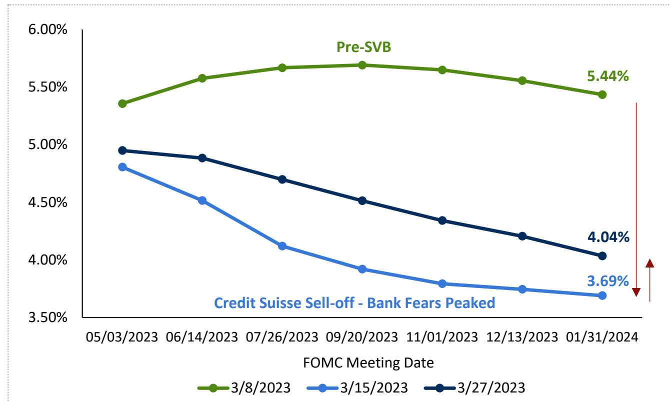


Source: Capital Economics; Raymond James Ltd.; Data as of March 13, 2023.

An economic slowdown and easing inflationary pressures may give the Fed good reason to slow or even pause its rate hiking cycle.

The market has massively repriced Fed rate hike expectations. As illustrated in the chart below, the Fed funds rate outlook fell from above 5.4 per cent to 4.0 per cent in a matter of a day!

Future Fed Funds Rate Outlook Has Collapsed



Source: Bloomberg; FactSet; Raymond James Ltd., as of March 27, 2023.

A slower pace of hikes or even a pause may provide a tailwind for risk assets. If market participants know the Fed is done raising rates and they are reasonably comfortable with earnings expectations, they can punch these estimates into their Excel models to arrive at fair value for the market.

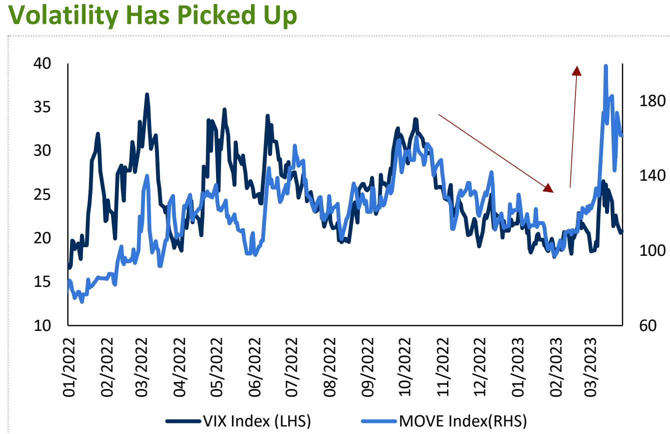
Threading the Needle

A Fed "pivot" is not without risk. A pivot may mean there is an increased probability of recession, or it may give the economy enough wiggle room to engineer the highly sought-after soft landing.

Recession predictions are all over the map, from we're in a recession now to there will be no recession. While recession probabilities have risen in recent weeks, it's hard to conclude that we're in a recession today, given employment and consumer spending data.

The onset of the most well-telegraphed recessions in the history of recessions remains a wild card, and we suspect it's the primary driver of the recent uptick in the bond and equity market volatility.

Volatility Has Picked Up



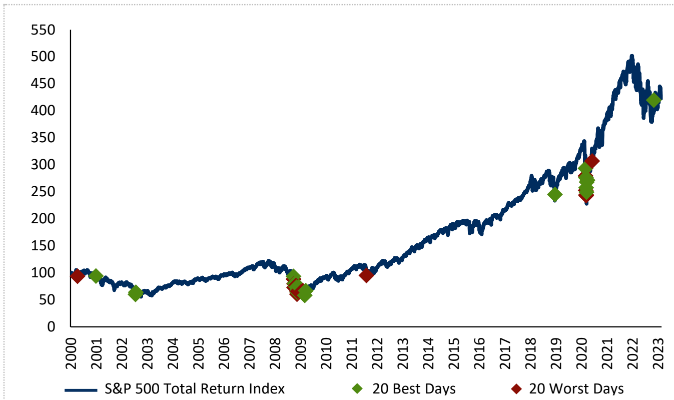
Source: Factset; Raymond James Ltd.; Data as of March 13, 2023.

Bottom Line

This isn't the Fed's first rodeo. They have a playbook for dealing with the financial plumbing issues that have spread to the U.S. regional banks. So while bank runs and failures dominate the headlines, we are confident we are not heading towards a repeat of the Global Financial Crisis (GFC).

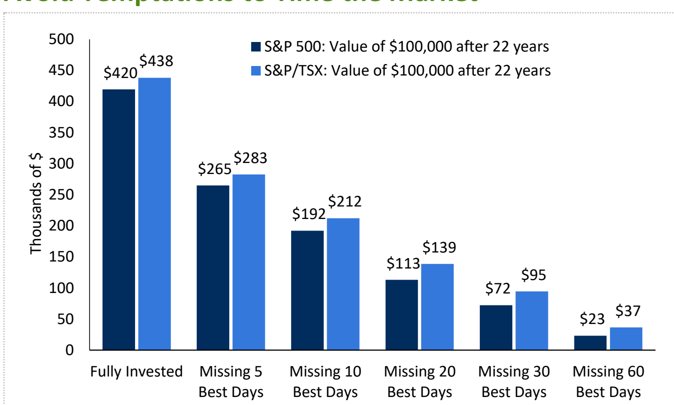
We remind investors that the best and worst days in the market tend to be clumped together, and attempting to time the market can negatively impact your long-term returns. Take the S&P 500 index as an example. Over the past 22 years, if an investor were out of the market for the best 20 trading days, their annual return would be almost zero! Miss the best 10 days, and your annual return is 3.0 per cent compared to 6.7 per cent for a buy-and-hold strategy.

Mama Said There Would Be Days Like This



Source: Raymond James Financial; FactSet; Data as of February 28, 2023.

Avoid Temptations to Time the Market



Source: Raymond James Ltd.; FactSet; Data as of February 28, 2023; For illustration purposes only. Start investing on January 1, 2000 with an initial investment of $100,000.

Nonetheless, headlines and heightened recession concerns are driving a spike in volatility, and investor sentiment is squarely in the pessimism zone.

According to the Bank of America Global Research Fund Manager Survey, positioning is largely defensive, with high allocations to cash, healthcare and staples. The strong appetite for defensive sectors has pushed up valuations, while unloved cyclical pockets like consumer discretionary trade at a meaningful discount.

The contrarian will want to swim against the tide, as is often the case when pessimism is high. Patient long-term investors can benefit from such dislocation in the market.

As we discussed heading into 2023, uncertainties will remain, including the path forward of inflation and interest rates. However, we believe investors should focus on what is in their control – i.e., allocating capital towards global investments that offer compelling risk/reward – versus focusing on the uncontrollable, examples of which are many.

Outperformers (Risk-off Assets) Are Also Expensive

Select Global Equity Indices	09/03/2023 - 16/03/2023	1 Month Return	YTD Return	Premium (RED) / Discount (GREEN)
Canada				
MSCI Canada Growth (Canada)	-1.4	-1.0	2.8	0.6
S&P/TSX Small Cap (Canada)	-2.5	-2.0	2.1	-3.5
S&P/TSX Composite (Canada)	-2.6	-2.8	2.0	-1.7
S&P/TSX 60 (Canada)	-2.7	-3.1	1.7	-1.8
MSCI Canada Value (Canada)	-4.3	-5.2	0.8	-2.6
U.S.				
NASDAQ Composite (U.S.)	3.4	3.7	13.9	5.7
S&P Composite 1500 Growth (U.S.)	1.6	2.4	6.7	0.7
S&P 500 (U.S.)	1.1	1.0	5.2	1.6
S&P Composite 1500 (U.S.)	0.7	0.4	4.9	1.3
S&P Composite 1500 Value (U.S.)	-0.4	-2.1	2.0	1.3
S&P Mid Cap 400 (U.S.)	-3.7	-5.8	1.3	-0.5
S&P Small Cap 600 (U.S.)	-3.0	-6.8	1.0	-2.9
Europe				
Euro STOXX 50 (Europe)	-3.5	0.7	12.1	-0.4
CAC 40 (France)	-3.5	-0.2	12.0	0.1
DAX (Germany)	-3.8	1.0	11.0	-1.1
FTSE 100 (U.K.)	-4.4	-3.0	3.4	-2.3
Asia Pacific				
Nikkei 225 (Japan)	-3.3	4.7	6.9	-0.3
MSCI China (China)	-1.6	0.2	1.5	-0.1
Hang Seng (Hong Kong)	-3.6	-0.6	-0.2	-3.2
Major Aggregates				
MSCI EAFE (DM* ex U.S. & Canada)	-3.6	0.1	6.3	-0.9
MSCI World (Global)	-0.4	0.5	5.5	0.0
MSCI EM (EM**)	-2.7	0.9	2.3	0.3

Source: FactSet; Raymond James Ltd.; Date as of March 27, 2023. All returns are in CAD. Indices are ranked by YTD returns. *DM: developed markets; **EM: emerging markets.

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