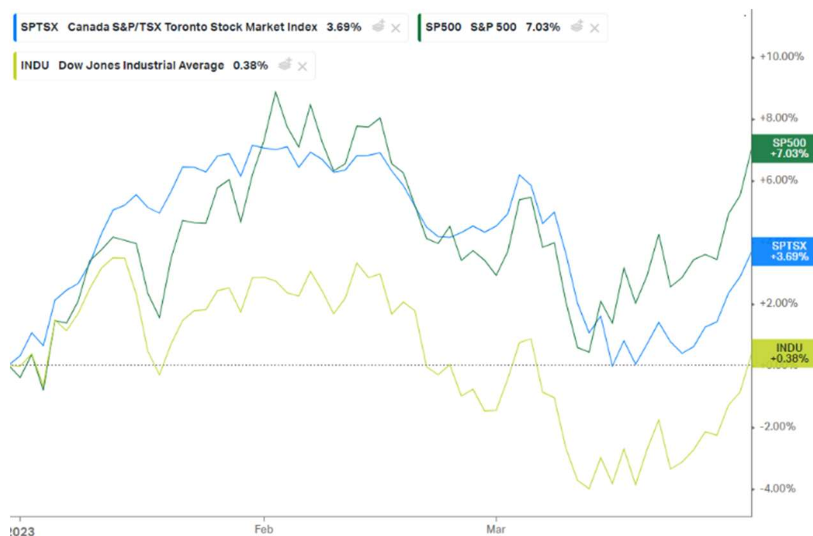
Lee
Turner

Investment Quarterly
April 2023

Review

2023 kicked off in a similar fashion to how 2022 ended. The interest rate/inflation dynamic continued, as monetary tightening slowly made its way through the economy. Consumers kept spending their savings while the labour market stayed stubbornly resilient, despite mass layoffs across several sectors. Oil prices cooled off for eight consecutive months, which may have contributed to a nearly identical downward trend in inflation rates in North America. Globally, the war in Ukraine continued, and China fully reopened its economy after its zero-COVID policy failed. January and February were going as market participants had largely expected, that is, until March Madness tipped off.

In early March, Silicon Valley Bank, a regional bank in the US experienced some substantial financial issues when they needed to sell assets at a significant loss to cover a 'bank run' – elevated cash withdrawals from its clients. The subsequent knock-on effects tore through the headlines and several other US regional banks saw similar internecine behaviour from clients in the coming days. To date, this crisis has seen the second and third-largest bank failures in US history, and the takeover of one of Europe's largest financial institutions (Credit Suisse). All said, equity and corporate bond markets were left rather bearish. Towards the tail end of the quarter, some reassurances were made to ensure stability moving forward, so much so that Chairman Jerome Powell of the Federal Reserve continued his rate hike campaign by 25bps.



Markets were undoubtedly rattled by the stresses in the financial system, but the S&P TSX finished in positive territory, up +3.69%. Canadian banks held up at +0.6%. Energy was the only sector detracting (-3.6%) from the index. Every other sector saw gains, led by Information Technology (+26.5%), Materials (+7.5%), and Industrials (+6.2%). The S&P500 still managed to close the quarter +7.03% higher, while the Dow Jones Industrial Average saw a modest gain of +0.38%.

Forecast

A common heuristic among 'experts' is that when central banks start to raise rates, they generally keep doing so until something breaks. As we saw in March, something broke. While the fallout will drag on for the coming months, we believe Canadian banks are unlikely to see this shock materialize because of Canada's stricter regulatory environment, higher liquidity requirements, and the banks' more diversified balance sheets. But what else could break? With rates increasing at the fastest (relative) pace ever, we're likely to see more calamity in interest rate-sensitive (dependent) sectors that have a longer lag time to their exposure to higher rates. While leverage benefited many during times of near-zero rates, it is now a significant issue to manage for those who took on more risk than they had forecast.

Suite #790 - 999 West Hastings Street
Vancouver, BC V6C 2W2
Telephone: 604-689-3289

We expect the Bank of Canada to stick to its guidance and pause rate hikes until the summer. This period of pause is meant to allow their aggressive hikes over the year to do their work: reduce inflation. And it should, as we're now comparing current inflation to last year's already-high rates. In our October 2022 newsletter, we believed that high single-digit inflation had likely passed. So far, this has proven true, but as we've firmly stated in the past, inflation is not transitory. The BoC is projecting inflation to fall to around 3% in the middle of 2023 and reach the 2% target in 2024. We see a low probability that this scenario will play out, and we would not be surprised if there were shock spikes in inflation rates this year driven by continued strong consumer demand for services and the resilient labour market (particularly wage inflation) we mentioned above.

Policy response from the central bank will not be easy. If they continue to hike, they could be sending a strong signal they are comfortable seeing a recession materialize (despite fiscal policymakers working against it). If they cut the benchmark rate, they risk reigniting inflation and producing a similar economic cycle to the 1970s and 1980s. Their final option is to hold the rate, which may not be enough to tame inflation. We know it takes several months for interest rate changes to impact the broader economy, so if the current interest rate does not cool down the inflation rate, we could see elevated prices for longer. No doubt, the BoC's credibility on the line, as is the value of the Loonie.

A recession, in our view, will materialize. The response to the banking crisis in the US and decline in energy prices may have pushed it out slightly, but we believe we will see slower economic growth in the coming quarters. As to the severity of this recession our focus will be placed on commodity prices, employment data, and corporate profitability to tell us if this will be a 'hard' or 'soft' landing.

Strategy

Our asset allocation will remain unchanged. We have spent a lot of time considering adding bonds to our portfolios given the recent market volatility, but yield curves have demonstrated their own uncertainty (if not held to maturity) and unattractive return characteristics. The Canada 5 Year Government Bond almost reached an attractive yield for us to include in portfolios, but alas it did not. We will continue to monitor the bond market for appealing risk/return set ups.

For now, we still see equities as our preferred asset class. Specifically, we believe that equity sectors that drive input costs are leading indicators of the current cycle, and important drivers of inflation. Prices of energy, materials and industrial services are costs that other companies must factor into their profitability. For example, a grocer must pay for its raw goods from suppliers who consume energy, fertilizer, and heavy equipment to produce goods. That grocer must also pay for the distribution costs to its retail locations, real estate, labour, technology platforms and so on. As these input costs rise, so does the end-user cost. Just within the grocery ecosystem we see opportunities where we can capitalize on sticky inflation and most importantly allocate capital to high quality companies, which will remain our focus.

Our communication with you

If you would like to opt for emailed quarterly packages and discontinue mailed quarterly packages, please email trevor@lee-turner.com and let us know. Thank you.

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