PRIVATE CLIENT SOLUTIONS

April 3, 2023

Insights & Strategies

March Madness

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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.

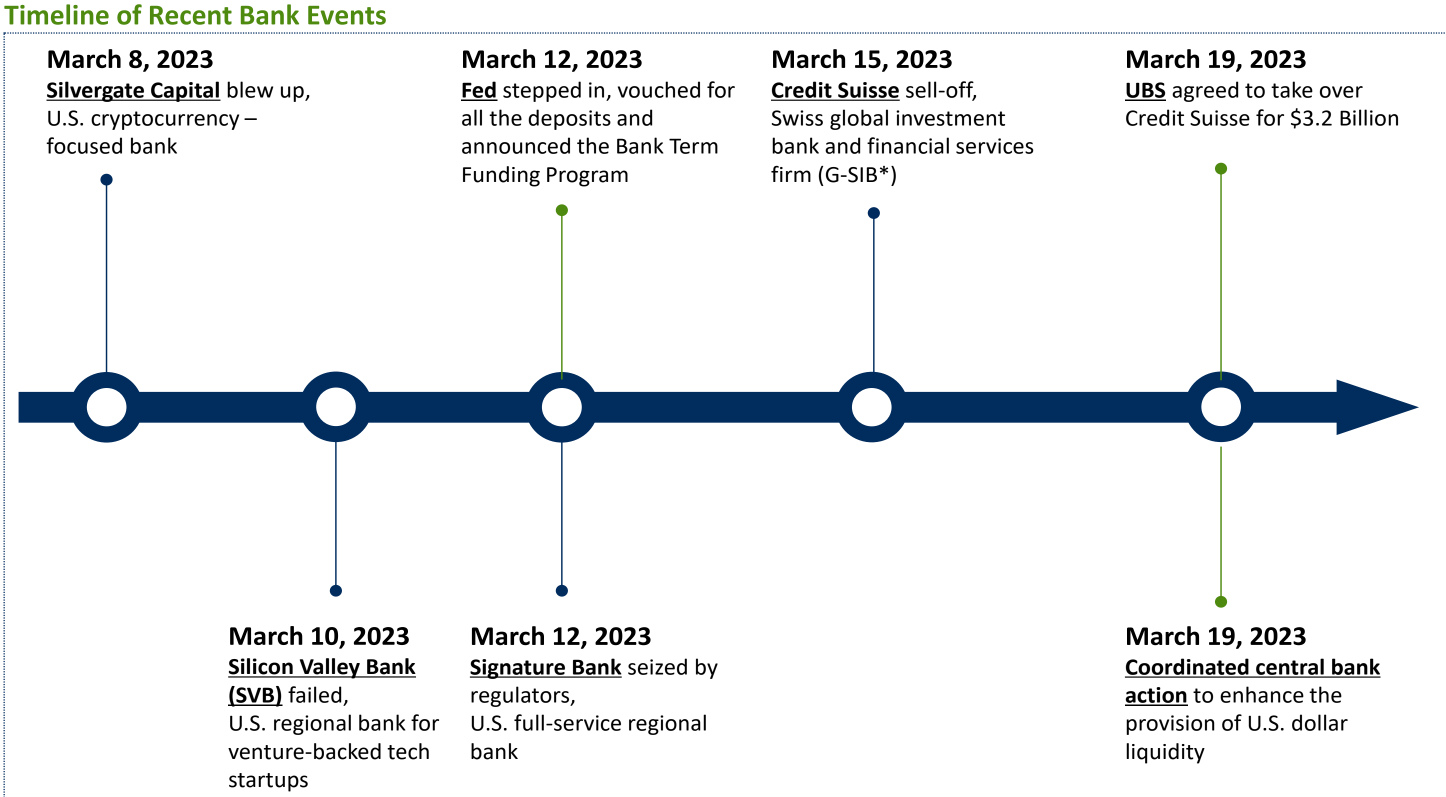
The failure of SVB, which marks the second-largest bank failure in U.S. history, unnerved many U.S. regional bank deposit holders and shareholders. U.S. regional banks experienced deposit outflows, while large money-centred banks like JPMorgan and Bank of America experienced inflows. The iShares U.S.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

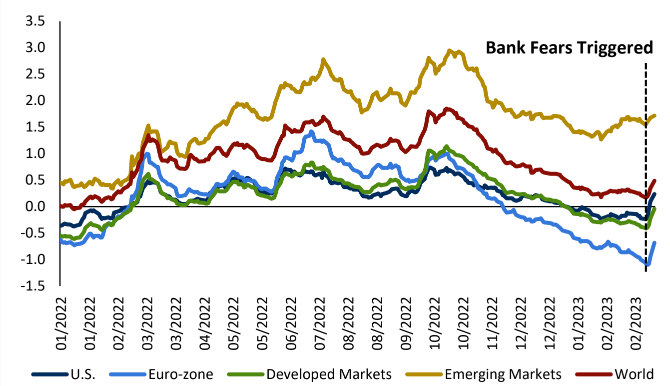
Silver Lining

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

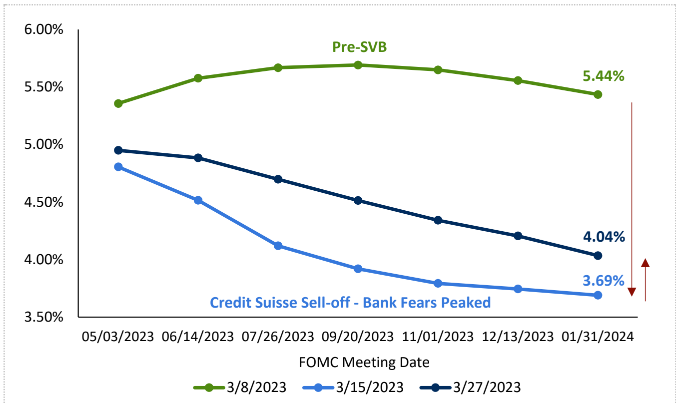


Source: Capital Economics; Raymond James Ltd.; Data as of March 13, 2023.

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.

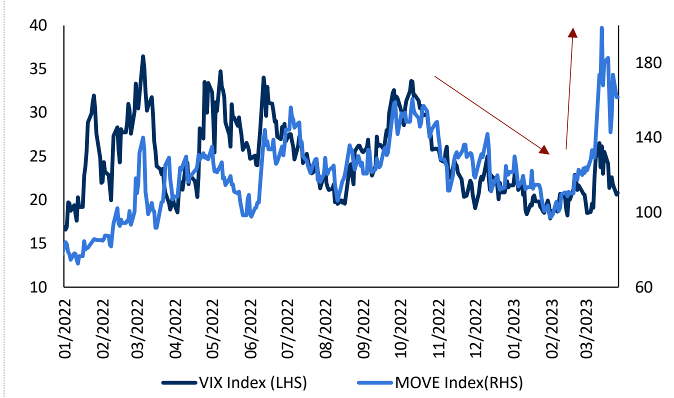
Threading the Needle

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



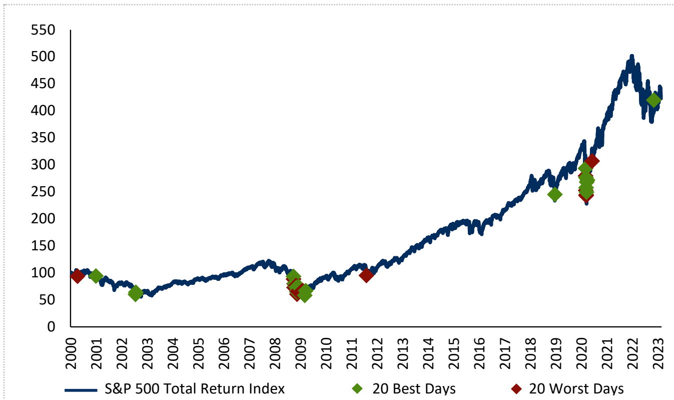
Source: Factset; Raymond James Ltd.; Data as of March 13, 2023.

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).

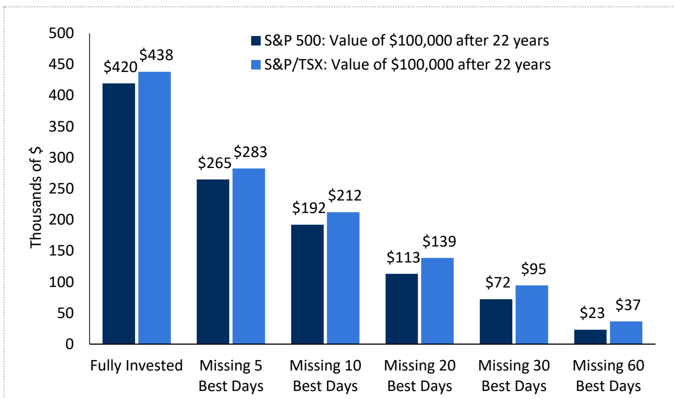
We remind investors that the best and worst days in the market tend to be clumped together, and attempting to time the market can negatively impact your long-term returns. Take the S&P 500 index as an example. Over the past 22 years, if an investor were out of the market for the best 20 trading days, 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.

Strategy Committee

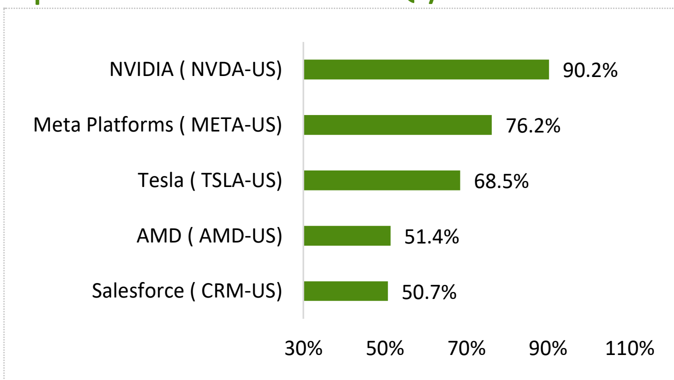
Q1/23: S&P 100 Leaders and Laggards

This month, we look at the top and bottom performers within the S&P 100 Index for the quarter, highlighting stock- and industry-specific drivers behind the leaders and laggards.

Information Technology Recovering from 2022 Lows

The top five companies with the highest price return in Q1/23 experienced declines greater than 40 per cent in the previous year (2022). Companies like **NVIDIA (NVDA-US)** and **Advanced Micro Devices (AMD-US)** benefited from trends in AI as ChatGPT gained popularity and could become the fastest growing app in history. This helped improve sentiment, as those companies are considered critical tools in the development of generative AI software.

Top Five S&P 100 Performers in Q1/23



Source: FactSet; Data as of March 31, 2023.

Meta Platforms (META-US) was the top performer in the communication services sector after reporting Q4/22 earnings that resulted in a 23.3 per cent increase. Management provided guidance of lower operating expenses and capital expenditures in the future, which meaningfully lifted operating income and free cash flow outlooks. Meta also announced its US$40 billion share buyback program, which also positively affected investor sentiment.

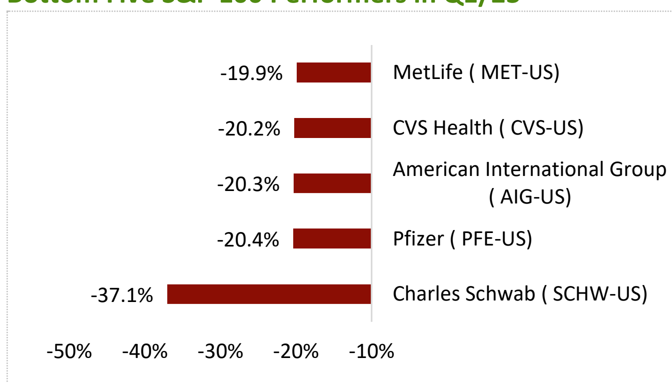
Within the consumer discretionary sector, **Tesla (TSLA-US)** was the top performer and increased 68.5 per cent in Q1/23 after declining approximately 65 per cent in 2022. In January 2023, management reported sales and earnings for Q4/22 that were mostly in line with estimates and only missed sales by 0.1 per cent. Its price rally was driven by the previous year's oversold conditions and investors' hopes for a re-acceleration of growth.

Salesforce (CRM-US) also notably increased in Q1/23 after announcing earnings results that noted strong margin improvements by management, but also better-than-expected bookings/revenue results in what was a difficult 2022 macro environment. Post-earnings release, the stock jumped 11.5 per cent after beating consensus estimates on sales, EPS, billings and operating income.

Worst Performers

The S&P 100 bottom performers were from the financial and healthcare sectors. The worst performing company in Q1/23 was **Charles Schwab (SCHW-US)**, which declined 37.1 per cent with the release of Q4/22 quarterly results that saw the company face pressure with its interest-earning assets and the firm forced to lean on short-term borrowings to provide bank liquidity in the near term. The collapse of SVB and **Signature Bank (SBNY-US)** also weighed heavily on the sector, as investor sentiment turned negative due to fears of possible bank runs. **American International Group (AIG-US)** and **MetLife (MET-US)** also gave up their 2022 gains in Q1/23. For AIG, the stock declined in early February 2023 after it announced it terminated its Interim CFO and EVP, Global Chief Actuary and Head of Portfolio management as the company became aware he violated his confidentiality and non-disclosure obligations. MET declined after announcing its Q4/22 earnings results that missed on sales, EPS and free cash flow estimates by 9.7 per cent, 1.6 per cent and 72.8 per cent, respectively.

Bottom Five S&P 100 Performers in Q1/23



Source: FactSet; Data as of March 31, 2023.

Within the healthcare sector, **Pfizer (PFE-US)** and **CVS Health (CVS-US)** saw the greatest declines. PFE declined throughout the quarter as its recent acquisition of SGEN faced mixed feedback from investors, and many thought they priced the deal too high. CVS declined throughout the quarter as its forward guidance for 2023 operating income came in lower than estimates. In addition to the guidance miss, COVID benefits falling off and the Centene contract loss also weighed on sentiment during the quarter.

Peter Tewolde
Senior Equity Specialist

Spotlight: Mutual Fund Managers

What is your current outlook for financials? Where do you see the biggest risks and/or opportunities in the next 12-18 months within the sector?

Nadim Rizk, NBI U.S. Equity Fund

"The U.S. financial sector should see increased volatility in the short term with banks facing increased pressure following the recent collapses, falling long-term rates and the increased uncertainty surrounding the Federal Reserve's future path for interest rates. In order to mitigate risks, the team has devised a plan to continue monitoring companies in the portfolio within the financial space and other companies that could indirectly be affected by the current challenging economic conditions.

*Nevertheless, the **NBI U.S. Equity Fund** currently has no direct exposure to U.S. banks, which has positively impacted the fund's performance over the short term, and the team continues to focus its efforts on other key diversified financials such as Moody's, CME Group, MSCI and Mastercard. Although revenues could be negatively impacted in the short term for these key holdings, the team is confident in their ability to generate attractive returns over the long run. Each of the above's thesis remains fully intact, as they continue to benefit from high barriers to entry, strong pricing power, attractive financials and strong management. The team remains laser focused on a single style of investing, in which they endeavour to identify high quality companies that can generate a high return on invested capital and that ideally have attractive growth potential, with the intention of holding on to those companies for an investment horizon of 10-20+ years."*

Date: March 29, 2023

Don Simpson, Dynamic Active Cdn Dividend ETF

"While the events unfolding around select U.S. and European banks are unfortunate, it reminds us that we are fortunate that the Canadian banking system has been a relative source of stability globally. As such, we want to highlight the structural differences underpinning our financial system and why we feel comfortable owning some of the Canadian banks as core holdings throughout a full market cycle.

1. *Stringent regulation: OSFI provides very conservative capital adequacy, liquidity and accounting practices. OSFI recently increased the capital buffer ratios of the Canadian banks to 12 per cent as an extra level of protection.*
2. *Closer supervision: The Big Six banks dominate the Canadian market. Our concentrated system is easier to monitor versus the more fragmented banking system in the U.S. and Europe.*
3. *Proper scale: Many of our large banks are better diversified in terms of business mix, geographic footprint and client base.*
4. *A conservative risk culture: We believe the board of directors, management teams and clients tend to be more conservative and risk-averse than in the U.S., with the Global Financial Crisis being a perfect illustration of our banks holding up better than anywhere else in the world.*

*The **Dynamic Active Canadian Dividend ETF (DXC.TO)** owns a diversified group of Canadian financials consisting of select Canadian banks, insurance companies and alternative asset managers. Looking out 12-18 months, we are cautious from a macro perspective due to what we believe will be higher loan loss provisions, subdued M&A transactions and a general slowdown in lending activity. Conversely, many of these risks are well understood by the market as some of these high-quality franchises are trading at the low range of their historical valuation ranges."*

Date: March 28, 2023

David Lambert, RBC European Equity Fund

"Recent events in the banking sector have undoubtedly rattled markets. It is likely that the tangible effects of the events concerning Credit Suisse – and indeed Silicon Valley Bank before it – will take time to crystallize. However, there are several immediate insights that investors are able to glean.

The first is that, as far as we can see, the strong regulation of the European banking sector (which has sometimes been viewed as being overly onerous) may prove to be a tailwind in the longer run as the far stronger financial position banks find themselves in at this juncture is in stark contrast to that of 2008. However, just because regulation has held up so far does not mean the sector won't come under more scrutiny in the short term, which may weigh on stocks. This may also be accompanied by a pause in two of the key drivers of banks performance, namely rising interest rates and capital returns.

*The second is that, despite the fact that the events at Silicon Valley Bank and Credit Suisse are mostly idiosyncratic in nature, investor confidence may be dented for the time being as the market waits to see if any further stress causes other institutions to capitulate. We remain constructive on many areas of the European financial sector. The **RBC European Equity Fund** seeks out high-quality, long-term investments and events like these, where excellent businesses may see de-ratings that have nothing to do with their underlying fundamentals, may provide long-term buying opportunities when coupled with deep knowledge of the businesses themselves."*

Date: March 21, 2023

Luke Kahnert, MBA, CIM
Mutual Fund and ETF Specialist

Taking a Peek Inside the Fed's Toolbox

When you think about some of the tools the Fed has at its disposal, one typically thinks of the federal funds rate, open market operations, quantitative easing, tapering and so forth. Following the recent turmoil sweeping through the banking sector, which saw three U.S. banks collapse within days of each other, the Fed and regulators stepped in to backstop customer deposits, enhance the availability of U.S. dollars across the global financial system and ultimately quell market fears. To make sense of how markets reacted to this recent global banking crisis, we wanted to focus specifically on the Fed and some of the programs they decided to pull out of their toolbox.

Swap Lines and FIMA Repos … Huh?

As concerns about the brittleness of the global banking sector spread from the United States to Europe, a sudden surge in demand for U.S. dollar funding emerged as relatively smaller banks began to witness a torrent of customer deposits leaving their coffers and roiling markets in the process.

In order to relieve a shortage of dollar funding in moments of unwanted market stress, the Fed announced a coordinated action with five other major central banks (the Bank of Canada, Bank of England, European Central Bank, Swiss National Bank, and the Bank of Japan) to boost U.S. dollar liquidity through a standing agreement called U.S. dollar swap lines. The goal is to ensure that the major economies have an adequate supply of the global reserve currency to meet local demands. If it becomes difficult for a foreign bank to fund their USD-denominated assets, their central bank can draw on its swap line with the Fed and provide the foreign bank with U.S. dollars without having to tap their foreign currency reserves. Swap lines serve as an important liquidity backstop to ease strains in global funding markets and help to underpin confidence and the steady supply of credit to households and businesses. The mechanics of this tool are actually quite straightforward. It essentially involves two simultaneous transactions:

1. A foreign central bank sells some amount of its own currency to the Fed in exchange for U.S. dollars at the prevailing market exchange rate. The Fed will hold this foreign currency at the foreign central bank, and the U.S. dollars that the Fed provides will be deposited in the foreign central bank's account held at the Federal Reserve Bank of New York.
2. The Fed and the foreign central bank enter into a formal agreement, stipulating that the foreign central bank will buy back the currency it had put up (and return U.S. dollars) at a future date at the exact same exchange rate.

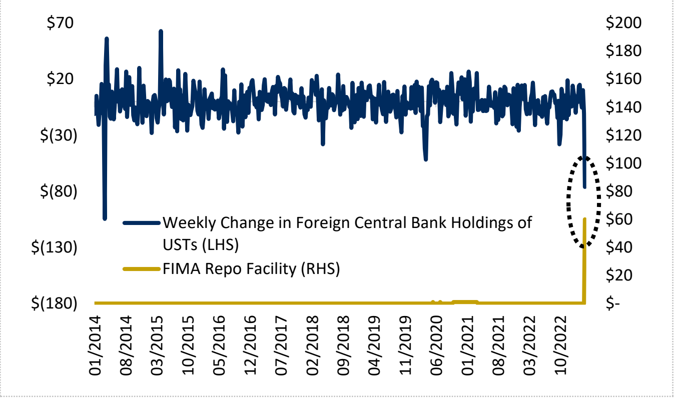
Another Fed's tool is the Foreign and International Monetary Authorities (FIMA) Repo Facility. Any foreign central bank or international monetary authority with a FIMA account at the Federal Reserve Bank of New York can access this facility. How it works is quite simple. The FIMA account holder would enter into a repurchase agreement with the Fed by temporarily exchanging their U.S. Treasury securities for U.S. dollars. In essence, this facility provides the foreign entity with U.S. dollar funding without having to liquidate their U.S. Treasury holdings in the open market.

Are These Tools Working?

In order to gauge the level of stress in the U.S. banking system, one important indicator is the FRA-OIS spread, which is the difference between the U.S. three-month London Interbank Offered Rate (LIBOR), which includes a level of credit risk, and the overnight index swap (OIS) rate, which is essentially the risk-free rate. If you look past the 2020 COVID-induced market panic, March saw the FRA-OIS spread hit its highest levels since 2009. While the spread has narrowed in recent weeks, banks are still facing some pressure.

Recent Fed data showed that foreign holdings of U.S. Treasuries logged the largest weekly decline since March 2014, while the FIMA facility was simultaneously tapped for a record $60 billion. This shows that demand for U.S. dollar funding remains high. At the end of the day, the Fed will continue to leverage its various tools in order to provide easy access to a seemingly unlimited supply of U.S. dollars in a bid to shore up confidence. However, there are concerns whether deposits continue to flee from banks and if the Fed's toolbox is deep enough to provide a prolonged liquidity backstop in order to ease pressures in global funding markets. Time will tell.

Foreign Institutions Dump Treasuries for USD (billions)



Source: FactSet; Raymond James Ltd.; Data as of March 22, 2023.

Ajay Virk, CFA, CMT
Head Trader, Currencies

Understanding Bank Bond Risk

Recent liquidity events at U.S. and European banks have renewed interest in understanding the true safety of one's debt holdings. The vast majority of investment grade securities pay principal and interest on time, but we understand that conversion features may cause some investors to pause. Below we review the key classifications of bank debt available today.

Guaranteed Investment Certificates (GICs)

Commonly issued by Canadian banks and credit unions, GICs are guaranteed by the issuer but may carry additional insurance for added investor protection. GICs can qualify for Canada Deposit Insurance Corporation (CDIC) insurance, where eligible deposits up to $100,000 for each insured deposit category, per member institution, would be protected. Credit union products may also carry provincial insurance from regional agencies, such as CUDIC in British Columbia or FSRA in Ontario, but maximums vary. Before purchase, ask your advisor for more details.

Banker's Acceptances (BAs), Bearer Deposit Notes (BDNs) and Deposit Notes

BAs and BDNs are issued in both Canadian and U.S. dollars by banks. In Canada, these are among the most used investments under one year. They rank as one of the highest quality investments on an issuer's balance sheet. For maturities over one year, deposit notes used to be frequently issued, however, legislation changes now prevent domestic systemically important banks (D-SIBs) from creating deposit notes with a term to maturity over 400 days. Thus, major banks now offer subordinated bonds with bail-in or non-viability contingent capital (NVCC) terms to comply with these laws.

Bail-In Debt

Bail-in debt was introduced to align with the change in laws, replacing 1-5-year deposit notes. Functionally, bail-in bonds rank one step lower than deposit notes but higher than most other debt on a bank's balance sheet. This is reflected by the higher credit ratings assigned to them.

Non-Viability Contingent Capital (NVCC) Subordinated Debt

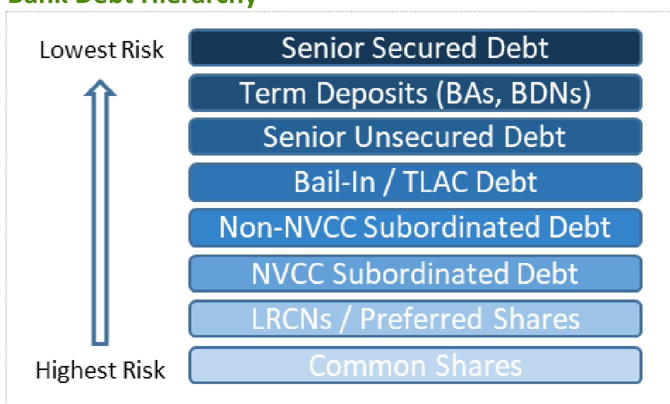
NVCC debt is most often issued as a 10-year bond that has a fixed coupon for the first five years, and then if not called, it would float at a spread over three-month CDOR for another five years. Due to this structure, such bonds are called fixed floaters. NVCC fixed floaters rank below bail-in bonds, but above LRCNs.

Limited Recourse Capital Notes (LRCNs)

LRCNs are issued by Canadian banks and qualify as Additional Tier 1 (AT1) capital. They are issued with 60-year maturities and carry a five-year call option. However, they rank in line with preferred shares – lower in the capital structure than other bonds. Thus, these are only offered to certain client types with high purchase minimums.

If a Canadian bank were to experience non-viability as determined by the Office of the Superintendent of Financial Institutions (OSFI), different bond classes would be treated differently. In such an event, an LRCN holder's sole recourse would be the delivery of the preferred shares held by a special purpose vehicle. Although both are AT1 capital bonds, LRCNs are unlike the Credit Suisse CoCo bonds, which were issued as perpetual bonds and did not have a conversion to equity feature. In the event of failure, NVCC bond automatic conversions would be triggered, converting all outstanding NVCC debt to equity. This would respect the creditor hierarchy, where preferred shareholders and subordinated debtholders are dealt losses only after common shareholders have been impacted. Only at this point, if losses remained, would a portion of bail-in debt be converted to equity.

Bank Debt Hierarchy



Source: Raymond James Ltd.

For investors who wish to avoid the potential of conversion, we suggest looking at bail-in bonds (last to be converted in dire circumstances), deposit notes (legacy issues of D-SIBs or those offered by non-D-SIB banks like Laurentian Bank), high-ranking debt of another corporation (e.g., Hydro One, OMERS Realty). Investors can also explore provincial issues, which are available from six months to 30 years in term. It is worth noting that as you improve the quality of your investment (more conservative), generally speaking, your yield or return would be lower, which is a tradeoff you must consider.

Harvey Libby
Head Trader, Fixed Income and Currencies

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: Disclosures https://raymondjames.bluematrix.com/sellside/Disclosures.action

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