



Spring 2023

The first quarter of 2023 saw global equity markets continue their positive momentum. The MSCI (USD) World Index rose 7.88% while the S&P 500 (USD) posted a positive return of 7.50%. The S&P/TSX Composite Index increased 4.55%. However, these positive first quarter returns were not enough to offset the declines in the first half of 2022. On a year over year basis, for the period ending March 31, 2023, the MSCI (USD) World Index, S&P 500 (USD) and S&P/TSX Composite Index declined 6.54%, 7.73% and 5.17% respectively.

Recently headlines have focused on a potential banking crisis. Silicon Valley Bank, (SVB) a California based bank, catering to the high technology industry was declared insolvent and failed. This bank failure was the largest since the financial crisis of 2008. SVB essentially failed because management invested in long dated bonds that dropped dramatically in value as interest rates rose. The large bond losses led to a capital deficiency and a subsequent run on deposits. A brief time later, Credit Suisse, a Swedish bank, also

lost investor confidence and had to be bailed out by its larger rival, UBS, and the Swedish government.

Equity markets reacted negatively as developments have unfolded at SVB, some other American regional banks (notably Signature Bank and First Republic) and Credit Suisse. Investors fear that contagion may spread and that we may be on the verge of another financial crisis. We do not believe that we are on the brink of a widespread banking crisis. SVB and First Republic appear to be cases of a bad risk management policy and not large credit losses. In addition, the U.S. government has effectively guaranteed all deposits further limiting the potential for a broad based run on banks. Global central banks have also intervened in financial markets and guaranteed depositors to ensure that these isolated incidents do not metastasize into a global contagion.

Despite the decisive action that regulators and monetary authorities have taken to address the issues plaguing regional banks in the United States, some uneasiness remains. Consequentially, the share prices of our Canadian bank holdings have experienced some volatility. However, we believe that this concern is unwarranted. As we have noted many times in the past, the Canadian banking sector is a well-capitalized oligopoly with an unassailable retail franchise and deposit base.

Inflation remains a concern. Various economic data points provided differing insights on the increase in the rate of inflation. February and March data

indicate that inflation pressures seem to be waning. However, this slowing rate of inflation was largely the result of lower energy prices. Underlying inflation, particularly in food and services, remains stubbornly high. These persistent price increases for basic goods and services indicate that monetary authorities are having a challenging time cooling inflation. As a result, there are expectations for further rate increases in 2023.

On the other hand, many expect the economy to slow down later this year. The U.S. Federal Reserve's most restrictive monetary policy course in four decades (designed to slow demand for goods and services and ultimately put downward pressure on prices) appears far from over and its effects are yet to be fully realized. There are already notable pockets of weakness in the economy, particularly the manufacturing and housing sectors.

The Conference Board's Leading Economic Index (LEI) continues to fall. The LEI, which is a set of data that may help to forecast future economic activity, declined 1.2% in March. That was far worse than the 0.5% decline registered in February and the lowest reading since November 2020. For the six-month period, the LEI was down a notable 4.5%. This, along with the continued inversion of the Treasury market yield curve, suggests a recession is likely later this year.

Despite rising rates, an anticipated recession and fears of a banking crisis equity markets continue their upward trend during these early months of 2023. Today, equity markets by

all valuation measures are trading substantially above their historical norms. These gains are being driven by the belief that interest rates are going to come down later in the year. If interest rates drop materially, it will be because a severe recession is underway. Consequently, earnings will decline substantially and share prices will follow.

A “Goldilocks” scenario where we experience a mild recession and a sharp decline in inflation is highly unlikely. The underlying causes of inflation are too deep rooted to be tamed by a moderate recession. Interest rates are unlikely to come down materially in the event of a mild and short lived economic contraction. Under either scenario equity markets face serious headwinds that cannot justify the current elevated valuations.

Despite the aforementioned concern, we remain quite optimistic about our potential long term return prospects. Interest rates are likely to normalize at close to historical averages from the near zero levels of the past decade. The next several years could be an environment that favours “value stocks” over “growth stocks” and equities other than large cap technology companies. The wind may finally be at our backs!

Your portfolios are well positioned to take advantage of this coming tail wind. As of March 31st, 2023, the portfolio yield was approximately 4.50% and other valuation statistics were far more attractive than both the S&P/TSX Composite and S&P 500. Our position in T-Bills not only helped our

performance during a down market over the past twelve months, but this “store of wealth” is now providing a return of over 4%.

We were honoured with an invitation to speak at the Ben Graham Value Investing Conference sponsored by the Ivey School of Business, Western University. This highly respected and anticipated gathering of value investors was hosted by Professor George Athanassakos.

Our presentation argued that widely diversified portfolios were highly unlikely to outperform their benchmarks, after fees, over the long term. We further proposed that only highly concentrated portfolios composed of carefully selected securities were capable of adding substantial value over the long term. Our talk was very well received. If you have a moment, the presentation is posted at <https://www.ivey.uwo.ca/media/v5oa0blq/6-maida.pdf>.

We thank you for your continued support and confidence.

Vito Maida

