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CIBC PRIVATE WEALTH

PATIENCE

APRIL 2023

By Brahm Satov

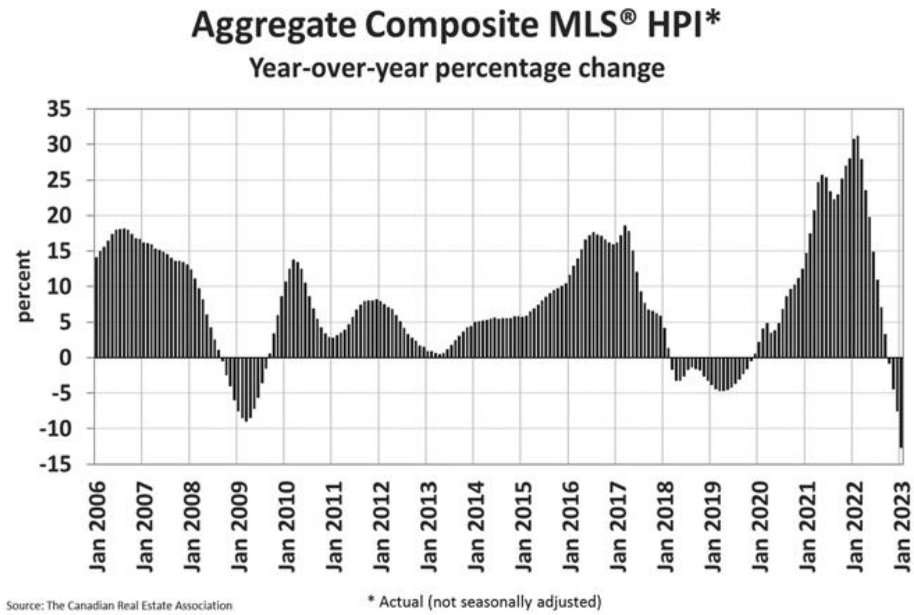
When stock markets rally, everyone wants to participate. It is tempting to get back in, especially when you hear that others are profiting. However, I believe that it is important to understand that sometimes these rallies are likely to end poorly. In other words, it is important to recognize if we are in a bull or bear market. For those chomping at the bit to get back into the markets, I would suggest patience. I remember back in 1988, when Guns N' Roses' song "Patience", was played on the radio. It seems like only a short time ago, but 35 years have gone by. Much has changed since then, and that holds true for the stock markets as well. Back then we had a steep yield curve and that year was part of an 8 consecutive year bull market. Presently the yield curve is still inverted, and last year, in 2022, we had about 8 bear market rallies and the S&P finished lower by almost 20%. I do expect even more rallies this year, but I still think the trajectory for the stock markets at this time is likely to be lower.

One of my dearest friends would remind me that I should not take a position, bearish or bullish, as I could be wrong. We sometimes joke about market professionals on BNN when they say that the stock markets will either be up, down, or may be flat when they make their forecasts… Nonetheless, I continue to believe that the likeliness of lower equity markets continues to be high, and similarly I am expecting Canadian home prices to continue lower. So for those looking to get in, once again I am suggesting, just a little "patience".

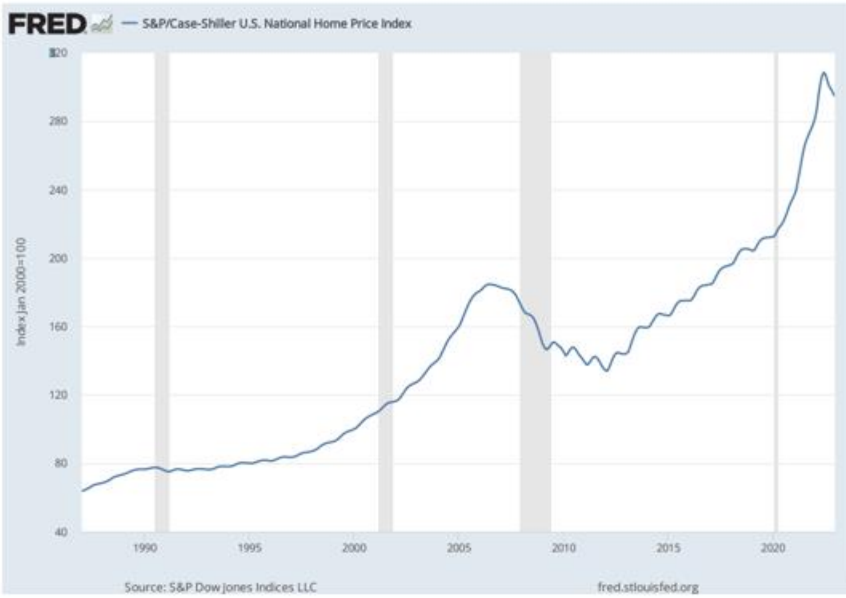
One of the best leading indicators, in my opinion, is real estate and I get many calls to garner my thoughts on this sector. So, I will do my best to share. It is my opinion that for most Torontonians who work in that sector, it likely already feels like a recession. Now if someone tells you that it is unusual to see home prices in Canada fall, they are correct. However, according to CREA (Canadian Real Estate Assoc.), in Feb.2023 Canada's monthly activity was down 37.1% below Jan. 2022 and national home prices were down 12.6% year-over-year. Average Toronto home prices continue to fall on a year-over-year basis, marking the steepest price decline ever recorded (or at least since realtors started keeping track of this metric in 1988). It was down 17.9% between February of 2022 and February of 2023.

Furthermore, detached homes in Toronto saw average price decreases of 19.9% year-over-year to $1.44M. Last year, many asked me if I thought it was time to buy a home, I strongly suggested that it would make sense to be patient. I believe this downturn has the potential to be more severe than many past housing corrections for Canada. The reason I think this downturn will be more severe for Canada is our general exposure to variable rates. Canada has more exposure to variable rate mortgages than most nations. In other words, our housing market is much more sensitive to the short end of the yield curve. And given this sharp rise we have seen in rates at the short end, and the inversion we are currently experiencing, this could have serious ramifications for Canada's housing market.

For those who recall the 2007/08 crises, Canada's housing market correction was not that bad. I believe that was because central banks lowered rates aggressively in that correction. So for Canada's housing market, because we have so much exposure to variable mortgages, it created instant relief - an instant stimulus. Now with variable rates going up profoundly, unfortunately those with exposure to these mortgages will see their monthly expenses rise and home purchases become far less attractive. In this environment, it is possible that due to the profound rise in rates, static monthly payments may not fully cover interest payments and overall loan balances could be growing.

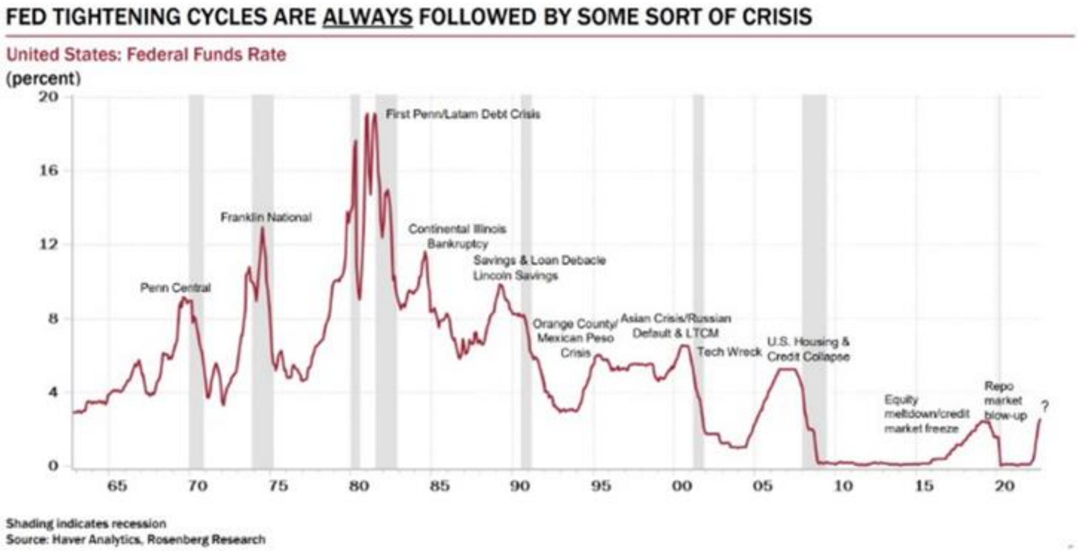


Some may be wondering if it is a good time to buy in the U.S and whilst I do expect that housing downturn to fare better than ours, I still think it makes sense to wait for a better opportunity. Home prices in the US have been falling for seven consecutive months. As intended, higher rates are slowing down the economy, including the housing sector.



I would be remiss if I did not discuss the issues in the banking sector. Recently, I received a call and they said that the banking failure, including SVB, came out of nowhere. In my Dec 2022 newsletter, I wrote about the likeliness of a financial crises, so whilst this specific bank's issues may be a surprise, I cannot say that this problem came out of nowhere. This is what I wrote in that December newsletter:

"One more thing I should mention, I do think it is highly likely that we experience a financial crisis as a result of our overdependence on debt coupled with speedy increases in bank rates and quantitative tightening. It is common that tightening cycles lead to a crisis as can be seen in the chart below. I recall in 2007 when I thought we would have a housing related crisis, before we saw or heard any talk of it on any news stations, although it seemed that it took longer than it should have to realize. It would be reasonable to expect a collateralization crises whereby financial institutions see their asset base diminish and as a result experience liquidity and collateral issues. Let me explain how this works. Banks need collateral to lend against, often that collateral is in the form of interest paying bonds, but we have just witnessed a severe correction in bond prices, many are down well over 20%. Remember as prevailing interest rates rise, the value of existing bonds fall. In other words if you have a 10 year government bond that is yielding 10%, and a week after you buy it the government increases rates and now a 10 year government bond is yielding 12%, the value of your bond is now worth less, it has just lost value if you want to resell it because instead of your 10 year 10% bond, investors can get a 10 year 12% bond with essentially the same maturity. For financial institutions that lend against their asset base comprised of bonds or perhaps cryptocurrency, this could become problematic as the value of these assets have becomes worth less."



Signature Bank (had over $100B in total assets) and was one of the largest bank failures in U.S. history, and SVB was considerably larger (over $200B in total assets). Credit Suisse had just about $600B in assets. It is a huge bank, one of the 50 largest in the world! For those who recall, Lehman also had over $600B in assets. Just because central banks panicked and swooped in to support the banking sector, does not negate the pressure on the sector due to the inversion of the yield curve.

It is my opinion, that this crisis could be more severe than many expect. Although I don't anticipate an imminent correction, usually markets have a significant rally when it looks like central banks are done raising rates and rate hikes often take quite some time to work through the economic system. It was not so long ago that most households had single income families, and I am of the opinion that the move to two income households acted as a significant boost for the economy. I believe it is likely that in this downturn, we could see one of those two working individuals, get laid off, or experience reduced hours. It will also be harder to find new employment, given the weaker economic backdrop. I believe the correction that we witnessed in 2022 was largely due to the increase in the discount rate, I don't think we have seen the impact from lower earnings, yet. I deem it probable that the softness in the housing and equity markets will weigh on the Canadian banks, with rising loan delinquencies and lower gross margin. It is customary to have many rallies in a bear market, but important to realize that it is still a bear market. The good news is that for those looking to buy a home, or buy into the stock markets, I do expect an excellent opportunity in the not-too-distant future. However, for those looking to get into the markets now, real estate or stock markets, I would suggest, just a little "patience".

Thank you for taking the time to read this, please feel free to e-mail me any feedback or comments.

Sincerely,

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