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CIBC PRIVATE WEALTH

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In this newsletter:

- Comments on our firms ‘Monthly Market Report’-see attachment.
- How are returns doing so far this year?
- What are our expected longer-term returns in equity and bond markets?
- Estate planning, the basics.

As we were about to email out our latest newsletter, California’s ‘Silicon Valley Bank’ ceased operations and was closed by regulators - over the weekend of March 11th. Although we feel the effects from the failure of the U.S ‘s sixteenth largest bank will be contained, we thought it prudent to touch on this event as it’s all over the news and influencing certain areas of the market.

Silicon Valley Bank (SVB) was the “go to” bank for younger technology companies, especially those that had venture capital firm backing. There was a ton of interest from investors in financing unprofitable technology companies during the tech boom from 2020 to 2021. As a result, SVB took on a lot of deposits from these tech companies, a number of which did initial public offerings (IPO’S) to take advantage of what -in many cases- were overvalued share prices. Funding from investors then dried up. And as said, a lot of these tech companies were losing money. Thus, deposit balances at SVB began dropping.

In addition to this problem, SVB bought longer-term U.S government (treasury) bonds with a lot of deposit money. Interest rates then increased rapidly, causing large losses on SVB’s government bond positions. Most banks hedge this interest rate risk, but SVB failed to do so. Investors were unaware of these losses initially as U.S. GAAP accounting does not require bank owned longer term government bond holdings to be “marked to market.” Word though got out about SVB’s financial position, and depositors began to withdraw money. To raise cash, SVB was forced to sell these bonds (at large losses); but it could not raise enough cash to meet deposit or capital requirements.

The U.S government acted quickly and has guaranteed all client deposits at SVB bank. They are also allowing banks in future to borrow on U.S. treasury bonds at par value - if needed to meet depositor withdrawals. Due to this quick government action, we feel fallout relating to SVB’s collapse will be contained. In contrast to SVB, Canadian banks are in excellent financial shape and employ some of the best risk management practices in the world. And the larger U.S banks are similarly well positioned.

This is another example of how “surprises” can move markets. Although as it looks to us now, we do not see this as material risk. Now, on to our newsletter!

How are we doing so far this year?

This month’s (see attached) ‘Monthly Market Report’ does an excellent job explaining what investors have been focused on for over a year now, namely - high inflation and the record-breaking increase in short term interest rates. This one topic has garnered almost all of investor attention. Therefore, of late, most day-to-day movement and volatility in financial markets can be explained by the markets “laser focus” on economic indicators that affect or relate to inflation and interest rates.

When we saw some slowing economic indicators in January, the market rallied, cheering on that “interest rates were close to peaking.” Client portfolios thus had a great start to 2023. However, of late, indicators are showing the economy (particularly employment) is stronger than anticipated. Both stock and bond markets have reacted negatively as investors worry that better than expected economic indicators will cause central banks to inflict more pain (through higher interest rates) to reduce inflation. Thus “good news of late was bad news and bad news (in January) was good news.”

Both investors and central banks want the economy to slow just enough to tame inflation without causing too much economic damage. While markets are right to focus on this admittedly ‘big issue,’ there are numerous other things going on that also affect markets. In contrast to an ‘AI based algorithm,’ (that can instantaneously digest hundreds of variables and produce an expected outcome) us humans need to simplify things. As time goes on, major market themes always change, and investors move on to different risks and opportunities. Think for a second about some past major events…Covid, Brexit, Donald Trump worries…and going back, the 2008 financial crisis, 9-11, the two wars in Iraq, etc. All these events, which were quite scary at the time, only had temporary and short-term impacts on markets.

Expectations for Portfolio Returns

So, if it is NOT the stuff we read and hear about day to day that will materially affect longer term stock market returns, what will do so? It will be simply “how much do companies earn,” and “what kind of valuation multiple will investors be willing to pay for these earnings.”

The market ‘price to earnings’ (PE) multiple determines the valuation part and the PE multiple will go up and down based on investors valuation of longer-term corporate earnings expectations. Regardless of the day-to-day changes in stock prices, if the average company earns a profit and grows earnings overtime, then the stock market must, in the long term, increase in value. Along the way of course, investors also earn a portion of company profits through dividends.

To produce a reasonable expectation of longer-term equity returns, let us start with what companies are earning now. This is the inverse of the ‘price to earnings ratio’- which is called the ‘earnings yield.’ Here is an example, based on one your many stocks - TD bank. TD is trading at about 10.5 times this years expected earnings. So, for every $10.50 of share price, you (as you own part of the company) are earning $1 in after tax earnings. Therefore, you enjoy an earnings yield of $1/$10.5 which is 9.5%. That is a good after-tax return, even if TD's earnings never grow. Of course, though, in the past TD has grown its earnings. Thus, in the longer term, its shares have gone up nicely in value. TD pays out about half its after-tax earnings to investors in the form of dividends. And TD retains the other half of its earnings to invest in its business - or to buy a competitor's bank as it is doing right now in the U.S.

It is fair to conclude that ten years from now, TD's share price (with an earning yield of 9.5% that will likely increase in the long run) will be higher than it is today. In the meantime, its share price will of course fluctuate due to general market ups and downs, combined with company and industry specific factors.

You of course do not only own TD. You own a diverse portfolio of stocks (over thirty) and five broad based equity exchange traded funds (ETF's) which in-turn own over 6,000 companies all over the world. So, lets now look at the average earnings yield on all your companies. Right now, that would be about 7.5%. This is a bit lower earnings yield than on TD. Despite Canadian banks delivering strong and consistent profits over their entire history, investors have almost always given bank stocks a lower valuation multiple (P.E) than the whole market. And the lower the PE ratio, the higher the earnings yield. Canadian bank's low PE ratios remind me of comedian Rodney Dangerfield's famous saying, "I don't get no respect!"

The after-tax earnings yield in client equity portfolios of 7.5% is a bit higher than the current earnings yield on the whole global equity market index of about 6.5%. This is because we are underweighting portions of the more expensive U.S stock market, and slightly overweighting higher earnings yield (lower PE) Canadian, European, and Asian markets.

There is a 'virtual' long-term certainty that the average company will experience longer-term earnings growth of at least a bit higher than inflation. After all, most inflation comes from companies increasing prices, which in turn increases company revenue. Loblaws is good example here. As much as it hurt to go grocery shopping this past year, as Loblaws shareholders, we have benefited from the price increases. Thus, owning equities has traditionally been a particularly good way to hedge against inflation risk. Our current 7.5% after tax earnings yield (plus expected growth in earnings overtime) makes us confident that clients will experience a ten-year average return that will meet or exceed our return objectives - on the stock portion of your portfolio.

In addition, tax wise, you gain substantial tax benefits in non-registered portfolios by earning dividends and capital gains vs highly taxed interest income. Speaking of interest income, the average yield right now on the bond portion of client accounts is about 6.5%. This is up substantially from a low of about 3.5% at the beginning of 2022.

Where do we see the economy going forward

The market is also fixated right now on the word 'recession.' Our guess is that we will see a mild recession - as companies and governments adjust to a higher interest rate environment. We have never experienced a harsh recession when employment levels are as strong as they are today. If we do though see a harsh recession (say later this year) this will not be viewed kindly by markets. This should not be a material factor regarding longer-term returns. We have had countless numbers of recessions over market history so as they say at Seattle's famous Ivar's Seafood restaurant, "Keep Clam." Even if we do experience a tough recession, this will be followed -as it always has been- by a good recovery. And strong companies will benefit as weaker competitor companies fall by the wayside.

Overall, our longer-term expectation is that we will experience an economy a bit slower than what we experienced pre-pandemic - as interest rates likely settle in a bit higher than pre-pandemic times. Also, we expect economies to experience four major secular trends:

1. **Ageing Demographics** - namely an aging global population, meaning below average longer-term GDP growth, particularly in the developed world. This should cause interest rates to decline a bit from here, but not to the artificially low interest rates we have experienced since 2008.
2. **Shrinking Fiscal Deficits** - Most governments carry too much debt and free money financing is over. Thus, higher interest rates will force governments to back away from the large fiscal deficits many have been running. Less fiscal stimulus will contribute to slower economic growth.
3. **Decreasing central bank asset levels** - Central bank balance sheets are very stretched due to pandemic related quantitative easing (buying bonds with electronically printed money). As central banks shrink their balance sheets over the years ahead, this will also take some 'steam' away from the economy.
4. **De-Globalization** - In the past 20 years or so, globalization contributed nicely to global economic growth. Today though, we see increased protectionism, and a re-organization of global supply lines to make them more diversified. Protectionism is fundamentally wrong from an economic standpoint, but politics trumps economics here... Diversifying global supply chains also comes at a 'cost' but as we have seen of late, this is necessary due to elevated levels of geopolitical risk.

Based on our above longer-term view, we prefer our defensive tilt to equities, namely high-quality dividend paying (reasonably valued) companies that provide goods and services that will still be in good demand in a lower growth economy.

Estate Planning

With our average client now age 69, estate planning has become a much larger part of our practice. We have many years of practical experience in this area. Our team has developed our own 'check list' of various estate planning options. This includes all the basics (Powers of Attorney's, Living Wills, joint accounts instead of single name accounts, proper use of beneficiary designations, etc.). It also includes more complex (but right for some clients) planning. Examples are Alter Ego Trusts, Joint Spousal Trusts, corporate estate freezes, implementing a second Will for corporate assets to avoid probate tax, using whole life insurance to eventually get money out of holding company mostly tax free, setting up ones own charitable foundation, etc... Together with your lawyer, we are here to help ensure that clients have peace of mind that all is in order.

Bits and Bytes

Its' tax time once again. Cheryl continues in the role of 'Vice President in charge of helping you get this done as easily as possible.' And all the rest of us are here to help as well.

We used to have a lot of pre-booked in person meetings at our office which understandably ceased during Covid. Some clients have resumed coming in, and some of you have shifted to telephone or virtual meetings. What ever method you prefer, please feel free to reach out to Melanie or any of us to book a time for a good review.

Cheers!

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