WATERMARK PRIVATE PORTFOLIOS MARCH 2023 COMMENTARY

Markets continue to be volatile, both to the upside and downside, with US regional bank risk dominating news headlines in March. Surprisingly, the broader S&P500 held up well as large-cap tech stocks, with large weights in the index, had a strong month (Apple was up 11.9% and Microsoft was up 15.6%) as the US Federal Reserve pumped money into the system and interest rates fell. As a result, the S&P500 finished up 2.6% in CAD, while the TSX Composite Index fell 0.2% as oil and financial companies had poor months.

Government bonds rallied in March as capital rotated into the asset class due to the US regional banking concerns and fears of a pending recession. Interest rates fell quickly over a 5-day period once the banking issue came to light, resulting in the Canadian Universe Bond Index rallying 2.2% in March. However, daily moves in the bond market continue to be larger than expected.

Markets

Global stock markets were extremely volatile in March, especially amongst different sectors, with rates dropping quickly on concerns over the solvency of US regional banks (smaller banks), especially those in California. Based on this fear, the US Regional banking index dropped 28.2% for the month:

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It seems pretty crazy to us that we're facing our 2nd banking crisis of the last 15 years but central banks have had too big of a footprint in markets for too long, causing massive greed and speculation when keeping rates too low. When it spills to the banking system, as bankers take more risk than necessary (again greed) it can cause the whole economy to slow as credit tightens. In regards to the current banking crisis in the US:

1. When interest rates were low coming out of Covid, smaller banks purchased longer-term bonds with their reserves to receive the higher interest these bonds paid.

2. With low interest rates, banks could profit on the spread they made from receiving larger interest from the longer-term bonds versus the interest they paid out on the cash in the accounts (which at that time was nothing).

3. However, when interest rates started going up due to inflation and concurrently, central banks raised short-term interest rates:
    a. The longer-term bonds started to decrease in value, resulting in losses for the reserves of these banks (the cash clients deposited into their bank accounts was invested in bonds that were now losing money).
    b. The banks had to pay higher rates on the cash and for GICs, resulting in losses piling up.

4. When large customers of the Silicon Valley Bank, such as large technology companies, started withdrawing money, the bank was forced to sell long-term bonds at a loss to pay out the clients. Making it worse, accounting rules allowed the banks to hold these bonds at a loss, as long as the intention was not to sell them and hold them to maturity.

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5. When these losses were then reported, it became evident that some banks were also holding large undisclosed losses on their books, and because of these losses, they could not cover all the deposits of all their clients (so if all clients asked for their money, they wouldn't get it).

6. This resulted in a bank run on Silicon Valley Bank and then these concerns spread to other US regional banks.

7. Lastly, European banks that have struggled for years, like Credit Suisse and Deutsche Bank, came under pressure.

In an effort to contain the risk, the US Federal Reserve pumped massive amounts of money into the system during the month while also increasing interest rates another 0.25%, just a few days after the European Central Bank increased interest rates by 0.5%. On one hand, we have central banks pumping the gas pedal by injecting liquidity, while at the same time pushing down on the brake l as they raise interest rates, leaving investors confused with their actions as they try to fight off inflation to contain systematic risks that increases with higher interest rates.

With risks in the banking sector percolating , we continue to remain defensive, keeping our equity exposure to a minimum while holding short-term bonds that are yielding 4.8% providing income for our portfolios while we wait for clarity on the economy and for risks to diminish, which will likely take some time.

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