Seymour
INVESTMENT MANAGEMENT

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Following a strong start to the year, global equity markets stumbled in March on the news of banking stress and an uncertain economic outlook. Over the quarter the S&P TSX Composite Total Return Index (TSX) rose 4.6% with the S&P 500 Total Return Index rising 7.2%.

Central banks around the world have sought to ease inflation pressures by swiftly increasing interest rates. The effects of these tighter monetary conditions take time to work their way through the economy. Now, roughly a year later, we are starting to see the higher rates taking effect.

Tighter monetary policies, such as higher interest rates, can cause financial distress to any company, household, and or government that relies on high levels of debt. Cash burning technology firms that no longer had access to capital were one of the first to feel the effects, evidenced by significant layoffs. Following this, over the past month, a handful of banks have fallen to the weight of this financial pressure.

The recent turmoil in the banking sector, particularly in the United States and Europe, brought with it a cascade of banking trepidation and turmoil that rippled around the world. While policymakers have enacted measures to prevent widespread financial distress, the failure of Silicon Valley Bank (SVB) and others, and the hastily arranged takeover of Credit Suisse, exposes the vulnerabilities that exist for leveraged entities. To provide context to the events and commentary on where and how impacts of these collapses are felt, we dive into the American, European, and Canadian banking environments below.

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Liquidity Crunch in American Banks

Silicon Valley Bank (SVB) and Signature Bank are both medium sized, regional banks in the United States (U.S.). Although not as large of some of the well-known institutions, both are significant, representing more than $100 Billion in assets each. SVB, the larger of the two sits as the 16th largest bank in the US and controls approximately 1.2% of annual cash deposits.

Although the situation at both banks share similarities, we will focus on SVB as it is the larger of the two and it is where the problem began. The failure of SVB highlights a number of critical banking decisions, regulatory controls, and economic factors.

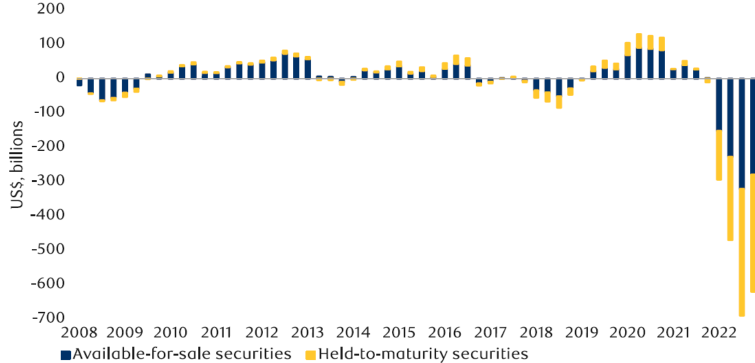
For much of the last decade, SVB, based in California, has been the bank of choice for more than half of all U.S. venture-backed technology and life science companies. As this sector grew during the days of easy money and rising valuations for all things technology, SVB experienced a consistent net inflow of cash.

Although ‘too much cash’ does not sound like a negative, for banks this can present a risk. Typically, banks look to diversify their client base so that as some clients are in need of loans, others are depositing cash. Using low rate deposits to fund higher rate loans earns banks a profitable spread between the two. In the case of SVB, as SVB’s clients had little need for loans, management made the decision to invest these significant amounts of cash in long-dated bonds to generate income to pay interest on client deposits.

By deciding to invest the cash deposits for their clients in long-dated bonds, such as five and ten year Treasury Bills, SVB Management was taking on ‘duration risk’ or ‘term risk’. SVB mismatched the short-term cash needs of deposits coming in and out of their bank with long-term investments. As Federal Reserve Vice-Chair for Supervision Michael Barr told the U.S. Congress when referencing SVB’s decision to invest in ‘riskier’ bonds than it could handle, it’s a “textbook case of mismanagement”.

SVB was able to maintain its strategy until two things happened. First, interest rates rose significantly and bond prices dropped. As a result, last year was the worst year for fixed income assets in over 40 years. Much of SVB’s long-dated fixed income investments saw significant declines. Also, at the same time, many of their technology focused clients experienced headwinds and a reduction in easy-to-access financing and began to draw on their cash deposits at SVB.

Exhibit 1: Unrealized Gains (Losses) on Fixed Income Assets held at U.S. Banks



Source: Federal Deposit Insurance Corporation, Macrobond, RBC GAM

As clients withdrew funds SVB was forced to sell these long-dated bonds, which had declined in value, at a loss. Capital asset requirements triggered the need to sell additional bonds. As word got out SVB was running low on cash in the tight-knit technology community, more and more companies started withdrawing their funds, leading to a spiral that resulted in the collapse of the SVB and necessitated the Federal Reserve’s intervention.

The Federal Reserve stepped in to guarantee the deposits held at SVB and other banks, helping ensure depositors have access to their funds and avert a contagion effect.

Profitability Crunch in European Banks

In Europe, a similar situation was unfolding with Credit Suisse, a large Swiss Bank. In the past, Credit Suisse had struggled with a series of scandals and corruption inquiries, strategic errors, and notable underperformance to its peers. It became a target for nervous investors and depositors, and experienced a similar situation to SVB in the US. Fearing a financial contagion, the Swiss regulators stepped in and forced Credit Suisse to merge with UBS. This alleviated fears and contained any further financial distress.

Credit Suisse is not the only European Bank with a profitability problem. The average European bank has generated a return on equity of 5.3% since 2017, as demonstrated in the chart below. At this rate, banks are barely, if at all, earning above their cost of capital.

Exhibit 2: Average Return on Common Equity for Canadian and European Banks 2017 - 2022

Group	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	Average
European Banks	4.7%	6.0%	5.3%	2.0%	7.0%	7.0%	5.3%
Canadian Banks	15.9%	15.8%	15.0%	12.2%	16.6%	17.4%	15.5%

Note: Includes 6 Canadian banks and 15 European banks (HSBA, BNP, ACA, BARC, SAN, GLE, DBK, ISP, LLOY, UBSG, INGA, UWG, UCG, CSGN, STAN
Source: FactSet, Capital IQ, CIBC World Markets Inc.

Canada is Different

Looking at the present situation south of the border, one can quickly highlight a few key differences. Notably, in stark contrast to the fragmented U.S. banking landscape which has over 5,000 banks, Canada is made up of an oligopoly of six big banks. As a result, the banks in Canada have a considerably larger and more diversified client mix than the regional and industry specific banks. This allows the banks in Canada, as with other large institutions in the U.S., to not need to hold such a large proportion of their assets in long-dated investments. In addition to the sheer size, scope and strength of the Canadian banks, the regulators in Canada pride themselves on taking a more conservative approach.

Canadian Banks are well positioned to navigate through challenges that lie ahead.

Similarly, as demonstrated in the chart above, Canadian banks are in the unique position of being consistently profitable. This strong level of profitability provides strength and stability to the banking sector. A high level of profitability is a bank's first line of defense during inevitable periods of stress; allowing the bank to face multiple challenges and rebuild capital as needed.

Canadian Banks are well positioned to navigate through challenges that lie ahead. Their high profit levels, strong credit positions, and stable and conservative regulatory environment, provide greater stability as compared to their European and American peers. Nevertheless, the recent global banking turmoil will leave an economic legacy that impacts countries with even the most well-capitalized of banking institutions in the form of tighter credit conditions. Some calculations suggest the tighter credit conditions as a result of the recent banking turmoil have added the equivalent of a 0.5% interest rate hike to the economy, effectively doing some of the work of the Bank of Canada to help slow the economy and address the Bank's most significant concern: inflation.

Getting inflation under control is the primary goal of the global central banks. The resulting higher interest rates lead to leveraged companies, banks, households, governments, and investors to suffer. When a recession might come and how deep it might be is impossible to predict. However, with a long term time horizon we know that recessions will come as part of the natural ebb & flows of economic cycles. As such, our philosophy remains to find good quality businesses, with low debt levels and strong management teams that are well positioned to navigate economic, geopolitical, and other unforeseen challenges.

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Riding the Roller Coaster of Volatility

Typically the market is looking ahead to try to predict what might transpire in the future. As we know, predicting the future is very difficult. In the current environment, there is concern with high inflation, rising interest rates and a possible recession. This has resulted in stock markets exhibiting a higher than normal level of volatility.

Measured by daily price movements outside -1% to 1% of the S&P 500, 2022 saw more than a third of days above or below this threshold. By this metric, 2022 was the most volatile year since 1945!

Volatility is a flame driven by uncertainty, fanned by readily available information and easily accessible online trading platforms, and ignited by emotions. A recent example of volatility occurred on Monday, March 12, one of the most active trading days year to date. Following the collapse of SVB, market turnover saw a 75% increase as compared to the already elevated year to date volumes as reported by BMO. Notably, institutional block trading was up only 12% that same day, indicating a significant portion of the activity was driven by individual and retail traders who saw banking headlines over the weekend, felt the fear of the 2008 financial crisis fresh in their minds, and sold their positions first thing Monday morning.

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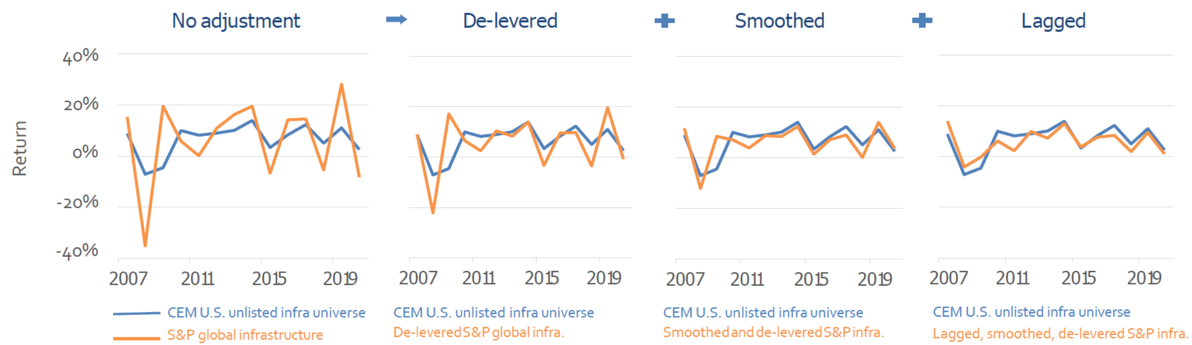
History has shown that in most cases, either doing the opposite or doing nothing at all leads to more successful outcomes. Although it is never easy to experience the volatility of corrections and recessions, as the prolific American investor Peter Lynch once said "far more money has been lost by investors trying to anticipate corrections, than lost in the corrections themselves."

As a result of surging volatility, investors are increasingly turning to private investments to smooth the roller coaster of minute by minute price movement. As much as we have seen public equity valuations decline, private equity valuations have remained relatively consistent.

The private markets, whether that be private equity, real estate, infrastructure, debt or other assets, can and do experience a smoother ride. Private investments often use leverage and conduct valuations of their assets on a less frequent (typically monthly or quarterly) and often on a trailing basis. The chart

below seeks to compare listed to non-listed infrastructure investments by removing the effects of leverage used, ‘smoothing’ by reducing the frequency of pricing, and a time delay or ‘lag’ for the information to be available.

Exhibit 3: Public and Private Similarities Arise When Adjusted for Leverage, Smoothing and Lag



Source: BMO, CEM Benchmarking, Inc.

The graph highlights the way that similar assets, whether private or public, do experience similar long term returns as it is the value of the underlying company that drives long term value not how often it is marked to market. Whether this business is priced every minute or priced once a year, over the long-term investors are rewarded for the growth of that business. While volatility in publically priced equities can be stomach churning at times, the benefits include getting access to liquidity and the occasional opportunity to buy those companies significantly below fair value due to investor fear and emotions.

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It has been a challenging period in financial markets as the impact of higher interest rates work their way through the economy. Through the volatility and recessions, banking turmoil and geopolitical strife, our philosophy remains consistent. Investing in well managed companies that have strong competitive advantages and trade at reasonable valuations will continue to be a very successful long-term strategy.

While we cannot predict the length and depth of the current economic downturn, we believe Canadian equity valuations are in many cases already discounting a modest recession. Although there could be more downside in the short term and the timing of the of the market recovery is uncertain, equity markets are forward looking and will eventually bottom, setting the stage for a new bull market.

Please do not hesitate to reach out at any time.

Sincerely,
The Seymour Team