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What Drives Us

Spring 2023

The first quarter of 2023 has ended, and as expected, there has been no shortage of excitement in the financial markets.

The appearance of cracks in the US Banking System has made headlines, with the Federal Reserve stepping in to support two regional banks. Of course, history rarely repeats itself, but for many, the past few weeks' events are reminiscent of 2008. Rest assured, however, post-2008 has brought increased regulations, and banks are stronger. Incidents are more isolated and appear to be related to individual banks' risk management. And though this drama makes for great news, there is a regulatory framework in place to handle failures and to ensure a strong and healthy banking system.

These moments of fear and uncertainty surrounding the markets often provide opportunity. For example, investor sentiment has led to a flight towards safety, namely bonds, driving their prices up and yields down - good news for those with balanced portfolios and a welcome break for anyone negotiating a mortgage. Such events are why our clients are invested in a diversified portfolio of quality financial assets and why we believe in professional portfolio management, which allows for tactical changes as the economic situation evolves.

In this edition, our feature article provides additional insight into the collapse of Silicon Valley Bank. Then, on the back page, we showcase our team's sponsorship of a unique local event supporting a fantastic local charity.

Stay Well,

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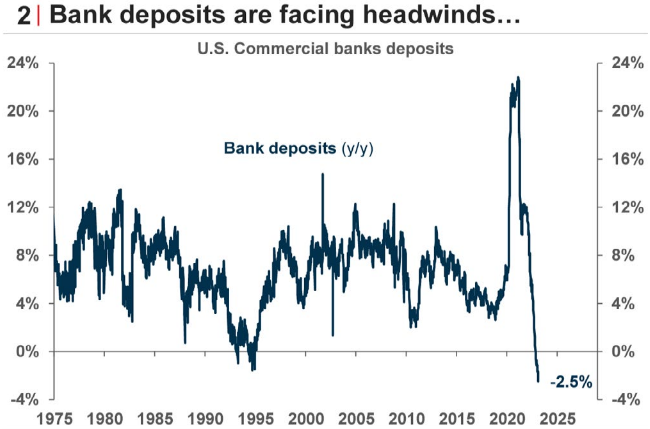
Quick Take

What's going on?

In its most simplified form, a bank's activities traditionally boil down to taking deposits (a shortterm liability for the bank) and making loans (a longterm asset). To ensure its sustainability, the financial institution must therefore ensure that it maintains sufficient high-quality liquid assets to meet bank withdrawal demands at all time.

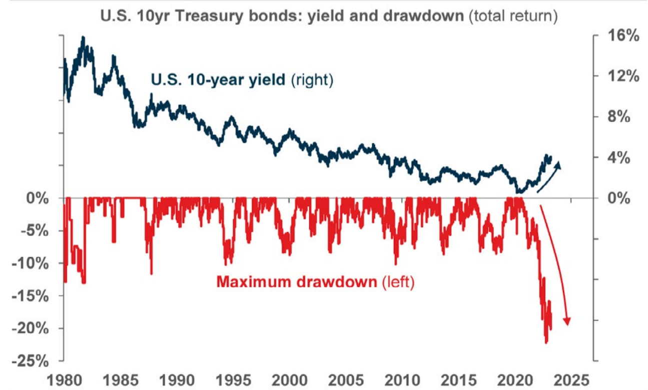
Now, the peculiarity of the current environment is the speed and magnitude with which the Federal Reserve has raised interest rates over the past year, with two important consequences for banks. First, it has put downward pressure on bank deposits, as alternative investments with attractive risk-free returns now exist (as evidenced by the slowest annual growth in U.S. bank deposits since records began, **Chart 2**). Second, as with all investors, the market value of bonds held by banks has declined significantly since the start of the rate hike cycle (**Chart 3**).

2 | Bank deposits are facing headwinds...



CIO Office (data via Refinitiv).

3 | ... following an unprecedented drop for bonds



CIO Office (data via Refinitiv).

In and of itself, downward pressure on bank deposits together with a drop in the value of bonds held to ensure the ability to pay withdrawals is certainly a challenge for any financial institution. However, it is not necessarily problematic, provided that (1) the profile of depositors is relatively diversified and (2) the duration of the assets held by the bank has a similar profile to its liabilities, allowing it to ride out fluctuations in the market value of bonds until it recovers its capital at maturity. In SVB's case, (1) the significant concentration of its clients within the technology sector – flush with cash in 2020-2021... much less so now – as well as (2) a balance sheet significantly overexposed to long-term bonds quickly became problematic. Faced with a mismatch between its assets and liabilities, SVB attempted to raise new capital in early March, which instead highlighted the fragility of its financial position, causing its depositors to run to the "cash out" button and its shareholders to the "sell" button.

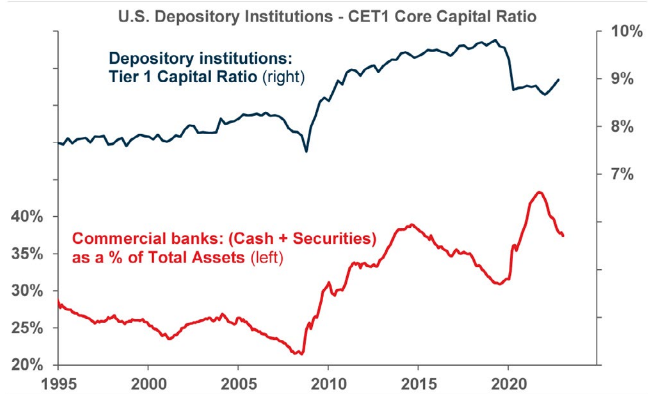
This is not a financial crisis...

This classic “bank run” is reminiscent of a certain September 2008. However, 15 years later, the situation differs in several fundamental ways, including two in particular.

First, the speed at which government agencies intervened. By Friday, just three days since SVB’s demise, the Federal Deposit Insurance Corporation (FDIC) took control of the bank. By Sunday evening, the Fed, the FDIC and the U.S. Treasury announced that all (above the usual 250k) bank deposits would be covered. In addition, the Fed set up a loan facility that allows other potential troubled banks to borrow against the face value (par) of the bonds they hold rather than being forced to sell them at heavy losses in the markets. In short, while the monetary and fiscal authorities’ belated response in 2008-09 ensured that they would face more than a decade of criticism, they could hardly have stepped in more quickly this time.

Second: the better capitalization of the banking sector. Overall, today’s banking regulations impose a much more conservative balance sheet management, as illustrated by the upward trend in the CET1 capital ratio and in cash and securities as a percentage of total assets (**Chart 4**). Clearly, there are exceptions, but fortunately, we no longer face the same systemic risk as in 2008-09.

4 | Banks are significantly better capitalized



CIO Office (data via Refinitiv, FDIC & FRED).

... but it’s not inconsequential

On the micro level, we should probably expect more restrictive regulation for U.S. regional banks – they often fall outside of stricter Basel III liquidity standards – while additional closures and/or consolidations cannot be ruled out. That said, for now, it is probably on the macro front that the consequences are most significant, with markets now expecting only one rate hike this year, compared to a minimum of four hikes barely a week ago. To put things in perspective, this change in expectations took 2-year yields 109 bps lower in just three days, a move that is comparable only to the infamous October 1987.

Every tightening cycle comes with its set of surprises, and the recent distress of U.S. regional banks is a prime example. One thing is certain, the Fed’s balancing act is getting more complicated as the central bank seeks to harmonize inflation with employment while ensuring financial stability. A tall order.

For the unabridged version of this National Bank Investments Inc. document, please visit: https://bit.ly/3Zyexou

How are your investments protected at Brazier Dupuis Wealth Management?

Recently, Rob Carrick at the Globe and Mail had an excellent write-up on investment protection in Canada. The full article is worth reading and can be found here (**https://www.theglobeandmail.com/investing/personal-finance/article-cdic-cipf-investment-protection/**). Here are a couple of key takeaways from the article: "'CIPF is designed to protect client assets when an investment firm becomes insolvent and there are client assets that are missing," and "it would be unusual for all client assets to disappear in the insolvency of an investment company,' " says CIPF Vice president Ilana Singer. "A basic way to de-risk your investments is to ensure you're diversified in stocks, bonds, and cash without big bets on risky sectors, securities or assets. Dealing with an investment company that participates in CIPF adds another layer of protection."

More details on the CIPF can be found at **https://www.cipf.ca/** and details on Canadian deposit insurance at **https://www.cdic.ca/** Of course, the team at BDWM is always here to help if you have any questions.

BDWM IN THE COMMUNITY

W.E. Care for Kids

The Brazier Dupuis team were proud sponsors and attendees of the WE Care for Kids Under the Big Top Kids Gala. This unique event was created to allow children to enjoy a variety of circus acts, acrobatics, live music, tasty treats, hands on activities and an all-kids dance party. In addition to being a fun family night out, this event raised nearly $100,000 to help support paediatric programs in Windsor-Essex.

Since 1997, W.E. Care for Kids (a local non-profit) has raised more than $10.8 million in support of equipment for paediatric programs and services across the region through foundation events and initiatives. If you'd like to learn more about this important local charity, please visit **https://wecareforkids.org**.