Monthly Newsletter
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Figure 1: Business Cycle Positioning

Macro Indicator	Upside Risk Early Stage (22%)	Mid Stage (42%)	Current Positioning Late Stage (22%)	Downside Risk Recession (13%)
Economic Growth	High	Moderate	Low	Negative
Inflation	Low	Moderate	High	Low to Negative
Monetary Policy	Loose	Neutral	Tight	Loose
Term Premium	High	Moderate	Low	Low to Negative
Credit Conditions	Loose	Loose but Tightening	Tight	Enter: Tight; Exit: Loose

Source: TD Wealth Investment Office, March 2023

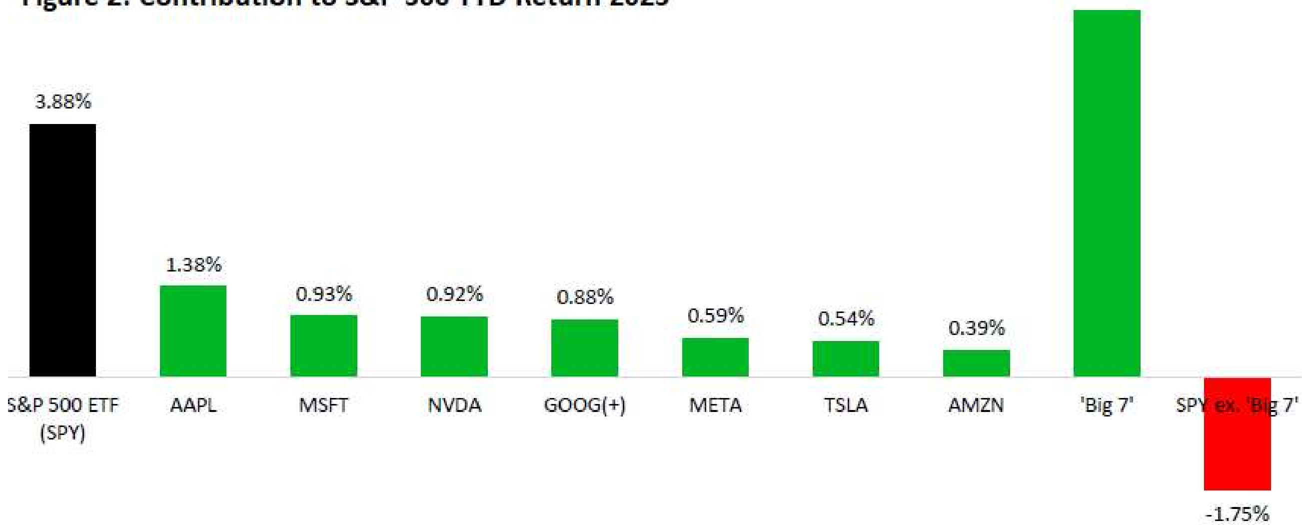
Wise Investor – April 2023

Executive Summary

- **Why did some banks fail and what happens now**
- **How stocks and bonds are pricing in very different economic scenarios**
- **Why long-term interest rates may be too low if the economy grows**
- **Why earnings expectations may be too high if the economy slows**
- **How to position a portfolio for this stage of the cycle**

It's been a strong start to the year which has certainly been welcomed after 2022 and provides a good opportunity to adjust portfolios for late cycle/defense in case of a recession, figure 1. Surprisingly, whatever fell the most in 2022 has risen the most this year. In fact, without the big technology stocks, the U.S. S&P 500 Index would be negative year-to-date, figure 2. In this article I will review the year so far and provide an update on my outlook and the fork in the road ahead of us.

Figure 2: Contribution to S&P 500 YTD Return 2023



Source: Bloomberg Finance L.P, TD Wealth Investment Office, March 24, 2023

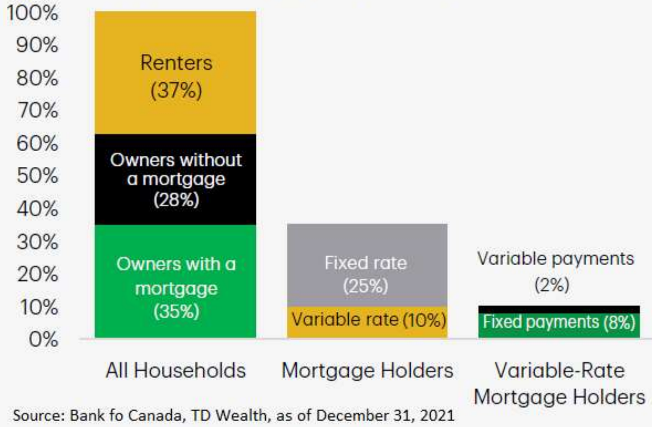
What's Happened Lately

By now I think a lot of us have a decent understanding of how a couple notable banks failed in March so I will only provide a quick summary and focus more on the ramifications. In simple terms, when we make a deposit into a bank account, we are lending a bank money to go and invest in such a way that they can earn more on their investments than they pay out in interest rates. That money will be invested by the bank both short-term (known as available-for-sale AFS) and long-term (known as held-to-maturity HTM) based on their expectation for withdrawals and other liabilities. Some banks will invest more long-term than others. As the name might suggest, HTM investments are expected to be held to maturity therefore it doesn't really matter what their market value is on any given day as no daily reporting must be done. Unfortunately, in the US, most of these investments were government bonds which were/are deeply underwater due to the inverse relationship bonds have with interest rates and the fasted rate hiking cycle in over 45 years. If the bank has enough AFS investments to pay back depositors requesting their money on any given day, then no problem. If, however, too many depositors want their money back on the same day, and the bank did a bad job of matching assets and liabilities, those HTM investments need to be sold and any gain or loss realized. Silicon Valley Bank and a few others did a bad job of matching assets to liabilities and realized huge losses when they were forced to sell their HTM investments when depositors all wanted their money back at the same time, a 'bank run'. In the EU there was writing on the wall for Credit Suisse's failure after several years of pain as a result of numerous scandals and frauds that had lost the bank billions of dollars. Fortunately, banking regulation in Canada and the U.S. for those 'too-big-too-fail' banks is quite a bit different, and we have no worries of some sort of a 2008 financial disaster.

Surprisingly, the broad market has managed to remain resilient through the bank turmoil. Canadian markets have been buoyed by the materials and commodities sector despite financials weakness and the U.S. supported by the largest US tech names as mentioned earlier. Market performance to start 2023 has been the opposite of 2022 and the question remains, how long can it last.

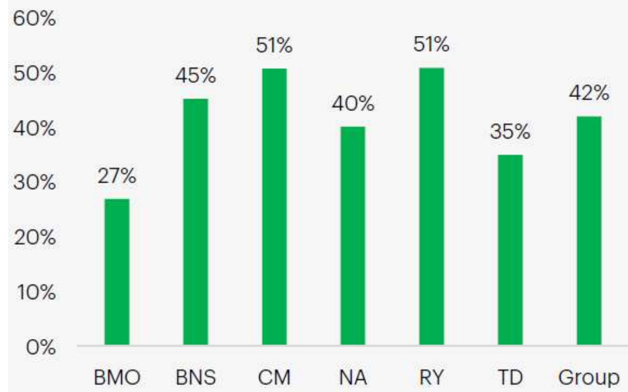
In challenging times, we always find it useful to revert to our Recessionary Indicators Dashboard which has not changed since January, pointing to economic weakness on the horizon. Will there be a recession or will there not be a recission is the big question and we will only know the answered to that in the future. What is clear is that we're in a late-stage economy and caution and patience should be warranted in the short-term, with the prospect of total returns looking pretty good in the longer-term. Let's first understand the short-term and why we should care.

Figure 3: Variable Rate Mortgages are one-third of total



Source: Bank fo Canada, TD Wealth, as of December 31, 2021

Figure 4: Mortgage loans as a percentage of total loan



Source: Company reports, TD Wealth, as of January 31, 2023

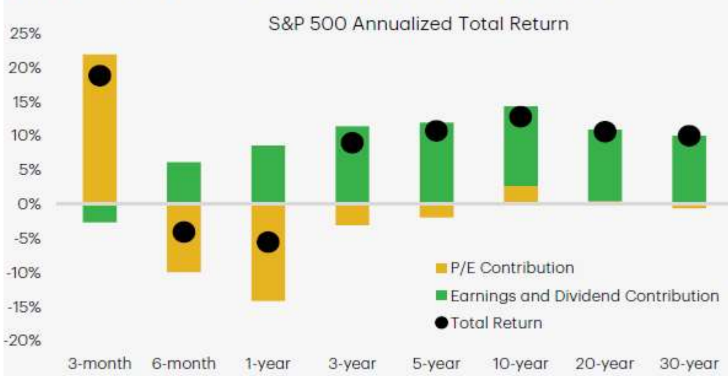
Why Should We Care

Firstly, on the banking crisis, although the dust has not settled, and more of the same problems could pop up in smaller banks, I believe the quick government intervention should slow any more bank runs or large liquidity issues. This turns my focus to a different problem which is access to credit (borrowing) for small business. Since US regulators have clamped down to avoid further failures, borrowing will be harder for small businesses and consumers, which will help with inflation but slow the economy. Canadian banks are not facing the asset/liability mismatch like in the US but the rapid rise in interest rates brings into question all the variable rate mortgages outstanding in Canada. At this point, default rates remain at record lows, thanks to excess pandemic savings and the strong labour market but warrants monitoring in the quarters ahead.

Taking a deeper dive into Canadian bank balance sheets, we believe the risk is manageable. According to the Bank of Canada (BoC), only 35% of Canadian households own their property with a mortgage and only one-third of those mortgages are variable rate, with the majority (80%) having a fixed payment. There is a bit of a difference in variable rate loans at National and BNS as payments step up with every rate increase but at the other big banks a borrower's payments are fixed until a trigger rate is hit. In the last report we have from October 2022, the Bank of Canada estimated that about 50% of all variable-rate mortgages with fixed payments had already reached their trigger rate. In summary, we are not concerned about an interest rate driven financial crisis in Canada, and more weakness in Canadian banks might be a good opportunity. With that said, there will be some challenges over the next few years if rates don't come down with a large degree of fixed mortgages and commercial loans up for renewal.

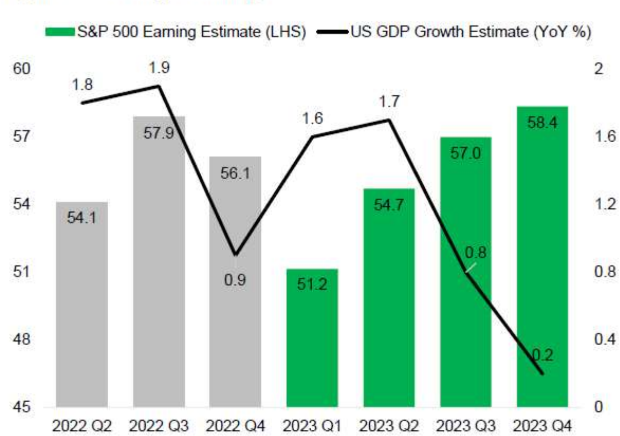
In the near term, I believe a more important thing to watch is tightening financial conditions and an apparent disconnect from stock markets. While sentiment and the influence of interest rates on price/earnings multiples drive stock prices in the short-term, corporate earnings drive long-term stock market performance, see figure 5. Last year, prices were reset from very high valuations and the pain in markets was driven by rapid rate hikes, even with strong earnings growing. If the economy is slowing, then the current expectation for increasing earnings are too high, figure 6. The stock market is pricing in earnings growth, yet the bond market is pricing in economic weakness and interest rate cuts. One of them is probably wrong.

Figure 5: Coporate earnings and long-term stock performance



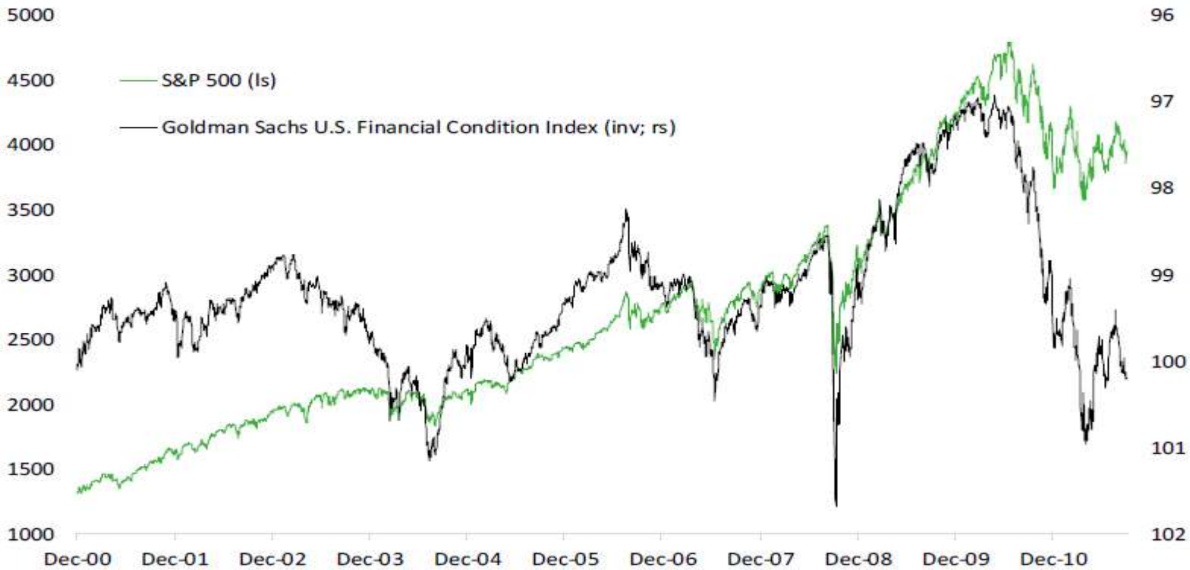
Source: Bloomberg Finance L.P. as of February 15, 2023

Figure 6: Economy vs Earnings



Source: Bloomberg Finance L.P, Federal Reserve Bank of St. Louis, as of March 28, 2023

Figure 7: Financial conditions and the S&P 500



Source: Bloomberg Finance L.P, TD Wealth, as of March 16, 2023

Why Should We Care *Con't*

In summary, I believe that we are at a fork in the road with two possible paths. The positive path results in the avoidance of a recession with stock markets continuing higher for longer which would require a lot of things to go right. The most recent banking crisis would have to prove to be over; interest rates would need to be normalized lower because inflation dropped rapidly and not because of economic weakness. This would mean that we would avoid a large rise in unemployment allowing consumer spending to stay strong, the economy to stay resilient and no further cuts to corporate earnings expectations would be needed. In this scenario, the stock market is currently priced fairly and would continue to grow alongside earnings and the economy. I will not rule this scenario out, but it is not my base case.

The negative path would mean that we end up with economic weakness or a recession which probably means stock prices are a little ahead of themselves and we may see a little more volatility ahead. Although I suspect that the worst of the banking crisis is behind us, there may be more small regional bank trouble, and further tightening of credit. As a result, borrowing would become harder and credit less available, meaning stock prices might be a little rich as they typically follow financial conditions, figure 7. Small business would be challenged with less cash available just as the past year of aggressive rate hikes start to hit the economy (each rate increase is estimated to take 9-12 months to be felt by the economy). Rates are not cut in 2023 because inflation remains too high, amplifying the pressure on businesses and the consumer. This would likely cause a further economic slowdown which may result in a recession meaning earnings would fall. It's possible that October 2022 was the low for this cycle, but stocks are currently pricing in scenario one and probably have a little downside if we end up in scenario two, my expectation.

It's not all bad news. Even with economic weakness/recession there is a path to a positive outcome this year. And if we fast forward two or three years ahead, current prices/valuations provide a pretty good starting point with lots of upside for total returns. In an economic slowdown scenario, stocks will price in the earnings decline long before earnings actual trough and the markets will price in the recovery long before we are out of a recession. This could mean that any pain ahead could be short lived and the positive start to the year has given us a chance to right size equity allocations across portfolios to have a little dry powder to take advantage of it. Along with that, we are getting paid to wait with cash and bonds yielding close to 5% which will support overall portfolio returns. Any stock market weakness would give us an opportunity to redeploy cash and recoveries from an earnings recession can be quick and strong. Without yet knowing which fork in the road we may end up on, timing, strategy and proper diversification become very important, outlined on the next page with my investment strategy.

1

Tactic: Fixed Income: Take advantage of global diversification across fixed income

Rationale:

- TD Wealth's Asset Allocation Committee is maximum overweight fixed income. Yields across the asset class are well above the lows of the past decade and offer attractive potential returns.

2

Tactic: Equities: Avoid expensive areas of the market and overweight defensive sectors

Rationale:

- Valuations across equity markets are fair after recent pullbacks. While we expect further headwinds. As valuations and earnings are likely to compress further, there will be attractive opportunities to add defensive positions.
- Focus on segments with stronger balance sheets, profitability, and greater pricing power, such as monopolistic or oligopolistic businesses.
- Utilities, consumer staples, and health care tend to provide protection against inflation and economic slowdown. Demand for goods and services in these sectors are less dependent on economic conditions which is helpful during economic contractions.

3

Tactic: Allocate to absolute-return strategies

Rationale:

- Absolute-return strategies provide idiosyncratic returns independent of directional swings in the market.

4

Tactic: Employ unconstrained strategies

Rationale:

- Unlike traditional mandates, unconstrained strategies don't have to be fully invested in equities or fixed income if opportunities are scarce. This flexibility allows them to take advantage of opportunities across asset classes, markets and sectors.

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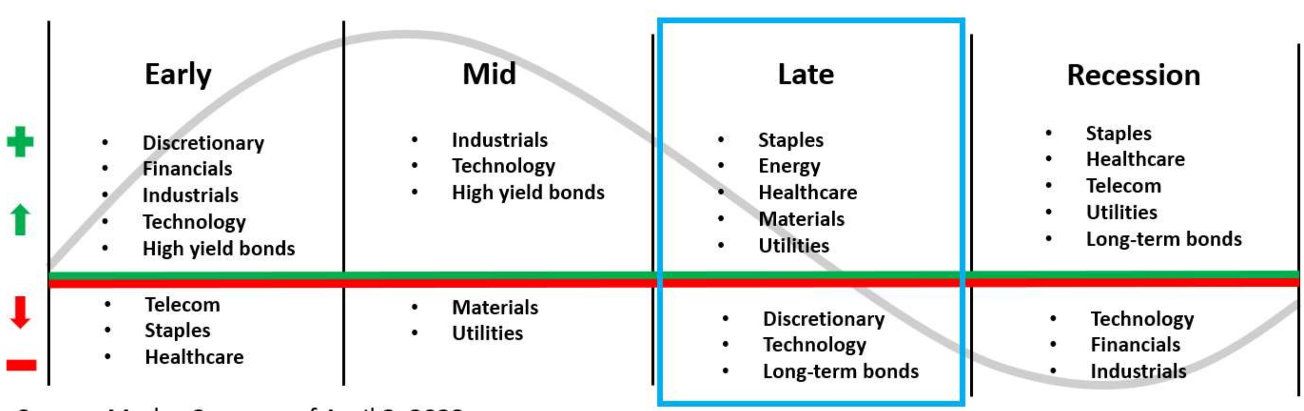
What Should We Do – *Investment Strategy*

Nobody can know the ultimate path of the economy or markets, but we can be confident that we are in the later stages of the business cycle, see figure 1 and 8. As mentioned, I think bonds make a ton of sense at this point and we have focused on 1-to-3-year maturities which provide a lot of security, liquidity, and the highest yields. For the cash raised from equity trimming we are sitting in high interest savings which also yields close to 5% and is immediately liquid should opportunities present themselves. We will always maintain some equity exposure as its impossible to time getting completely in or out of the market and when things bounce back it is often when the news is the worst, and the world is full of despair. With that said, we can tactically position the equity portion of the portfolio to those areas that have the highest probability to outperform late cycle and into a slowdown, figure 8. Within our equity allocation we also recommend a portion to absolute return and unconstrained funds that can add positive returns even if we experience some further volatility. All in all, I see a path to a positive outcome and, barring any sort of surprise event, believe we are in the later stages of this investment weakness with a high likelihood of above average returns in the years ahead. Although strategy is more important than it has been in a while, it's time in the market and not timing the market that matters for long-term returns.

Figure 8: Business Cycle Playbook



Source: Marley Snow, as of April 3, 2023

Personal Note

One of my aunts and her family have been enjoying retirement by spending some of the winter months down in Mexico and away from -20 Manitoba. More and more of our family have opted to join them through their extended getaway over the years and this year my 92-year-old grandmother joined the party. She decided the whole Snow family needed to be there and we called it a forced a family reunion vacation. When 'Baba' called and demanded attendance, our rubber arms were twisted, and we spent the last week of February at a place called Puerto Aventuras, about an hour south of Cancun.

When we got a break from chasing Kingston down the beach, we did a little adventuring. I would say the highlight of the trip was jumping in a big bus with all the cousins for a cenote exploring tour. A cenote is a natural lake, pond or cave resulting from underground waterways and the collapse of limestone bedrock. There are over 3,000 of them in Mexican state of Quintana Roo, no two the same. I highly recommend a tour if ever down there.

Easter is a special time to get together with our families and enjoy loving company. We missed a few through the pandemic so the holiday seems even more essential now. I want to wish you and yours an amazing Easter even if that egg hunt is a little wet this year.

All the very best, Marley

"Wealth is not his that has, but his that enjoys it."

Benjamin Franklin

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