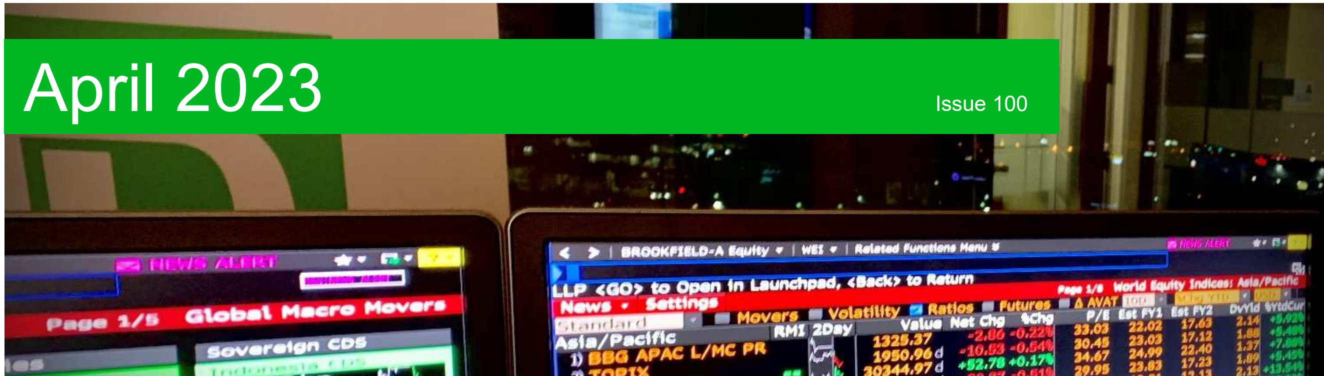
The Charter Group Monthly Letter



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Economic & Market Update

Bank of A. Levy

Reading the headlines of U.S. banking troubles can be concerning.

But the U.S. banking system is quite different than the Canadian banking system.

When I was in graduate school in the U.S. I was assigned an academic advisor by the name of Robert Dince who was a visiting professor from the University of Georgia. From 1975 to 1978, he was the Deputy Comptroller of the Currency at the U.S. Treasury Department. In that role, he would have been one of those primarily responsible for chartering all 768 national banks and regulating them in addition to thousands of small community banks.[1]

When I was an undergraduate attending a Canadian university, most of the banking part of the curriculum focused on the Canadian and international banking systems. Professor Dince was aware of this and spent considerable time with me contrasting the significant differences with the U.S. banking system.

[1] There are currently 768 national banks in the U.S. as of February 28, 2023. It is required that they have the word "National" in their name, or use the abbreviation N.A. for "National Association." For instance, the Toronto-Dominion Bank has a couple of wholly-owned subsidiaries in the U.S. that operate as national banks: TD Bank USA, N.A, and TD Bank, N.A. There are a total of 4,844 commercial banks in the U.S. as of March 13, 2023, but most of these are state banks.

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One major difference was the number of banks. In the later 1980's, there were about 13,000 domestic commercial banks in the U.S.[2] At that time, there were about two dozen Canadian domestic banks, but the system was dominated by the five large chartered banks.

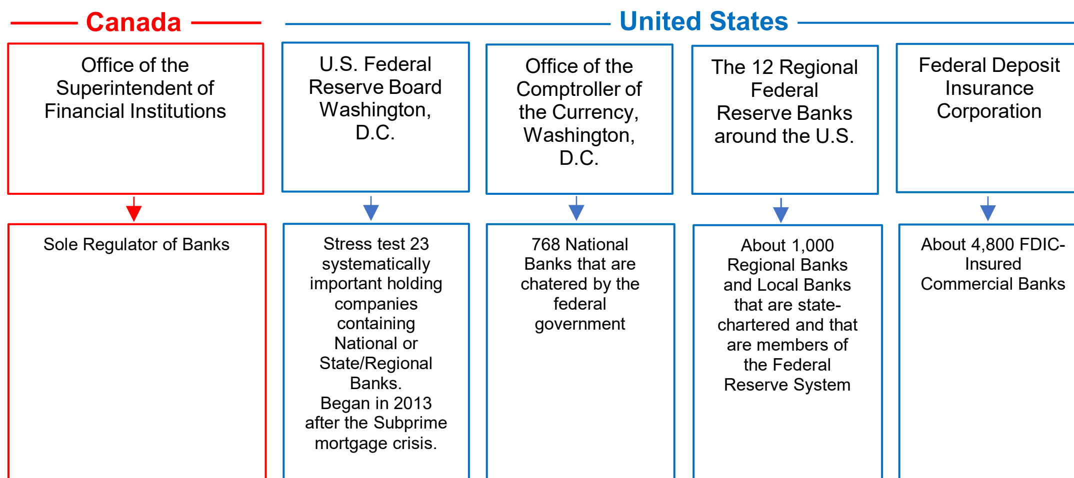
There are thousands of banks in the U.S. with different and often overlapping regulators.

There are also a wide range of categories of banks, ranging from huge money-center banks to small town community banks.

Related to this, Professor Dince told me a story where he and his wife were driving along Pacific Coast Highway through Oxnard, California when he noticed a bank off to the side of the road with a large sign that read "Bank of A. Levy." He said to me, "Mark, here's a bank named after someone I've never heard of. Regulators likely only have a general idea with respect to what A. Levy is doing with customer deposits. Things are probably fine at any one bank, but when there are thousands of these small banks across the U.S., how can regulators be sure *that every one of them* is okay?"

With so much to examine, the burden on regulators can be daunting.

The answer is that they are likely not very sure. The most rigorous testing is done on what are considered systematically important bank holding companies (which are overseen by the U.S. Federal Reserve and which can hold national and state banks). The problem with this is that there are only 23 that currently undergo this kind of examination. The U.S. banks that recently ran into trouble had holding companies that were considered below the systematically important threshold.[3]



Source: Mark Jasayko and The Charter Group as of April 5, 2023.

[2] There has been considerable consolidation since then, but the number of U.S. banks is still far greater than the number of Canadian banks, even when adjusted for population.
[3] TD Group US Holdings LLC is the holding company for TD Bank USA, N.A., and TD Bank, N.A. Also, TD Group US Holdings LLC *is* one of the 23 bank holding companies stressed tested by the U.S. Federal Reserve.

In Canada, banks are supervised by the Office of the Superintendent of Financial Institutions (OFSI), an independent agency that reports to the Minister of Finance, and would be a relatively close approximation to the Office of the Comptroller of the Currency in the U.S. Although OFSI is also responsible for supervising insurance companies and pension plans, it is not spread as thin with respect to bank oversight.

There have been banks that have gotten into trouble in Canada, but none since 2001. Over the same period, there have been 562 bank failures in the U.S.,[4] but the vast majority were not large enough to become international news. Less regulatory burden is not a perfect safeguard against banks getting into trouble, so it could still happen in Canada. However, even though Canadian bank stocks did decline in the midst of the recent U.S. bank troubles, I don't think this had anything at all to do with worries about insolvency. Similarly, I wouldn't have concerns about the biggest U.S. banks having difficulty with insolvency. Their operations tend to be much better diversified than the regional banks, plus it appears that they have been the benefactors of receiving deposits from the customers of the regional banks.

Instead, I think the big Canadian and American bank stocks are down because of something called the "interest rate gap." This shows the profit risk to a bank's traditional lending and deposit-taking operations if interest rates go up. The interest rates on non-term deposits tend to be variable (a cost to a bank). The interest rates on loans (revenue to a bank) tend to be fixed. So, costs tend to go up and revenues tend to be relatively stable during a period of rising interest rates. Bad news for profitability, and now investors are beginning to learn about this again after a few decades of not being overly concerned.

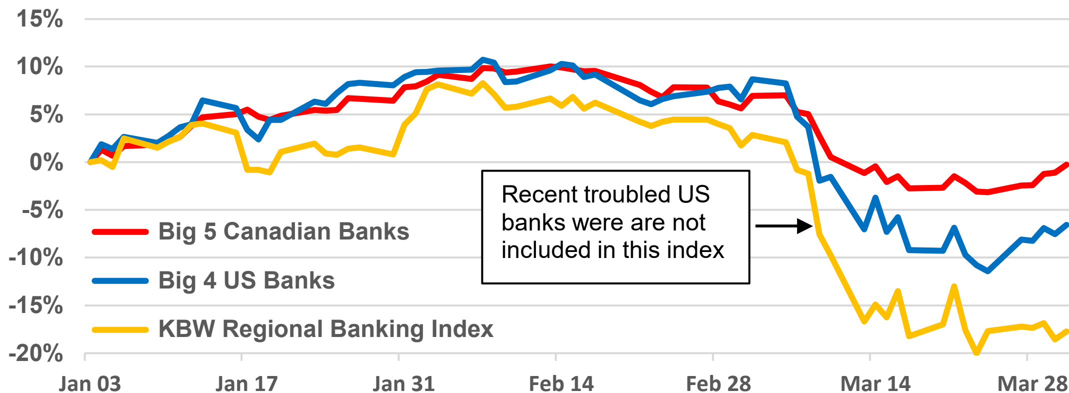
Solvency is not something that I worry too much about with the bank stocks that we hold.

The "interest rate gap" is something Professor Dince would have covered. I don't know how much focus there is on this concept these days in business schools and economics departments. It has been years since I have seen any bank stock research reports that use the term. Instead, most bank stock research reports talk about the "net interest margin" which adds up revenue (interest rates on loans) and subtracts costs (interest rates on deposits). It's an informative statistic up to a point, but it doesn't address how potential changes in interest rates might cause problems. But, with the increase in interest rates for the first time in a long time, this issue needs to be analyzed again.

Instead, I am more focused on the impact that higher interest rates have on the profitability of the traditional lending & deposit business.

[4] Turley-Ewart, J. (2023, March 14). Canada doesn't have bank failures because we learned our lesson 100 years ago. *Financial Post*.

Chart 2:
Bank Stocks - Year to Date 2023



Source: Bloomberg Finance L.P. as of April 5, 2023. Big 5 Canadian Banks is an average of the performance of Toronto-Dominion Bank, Royal Bank of Canada, Bank of Montreal, Bank of Nova Scotia, and the Canadian Imperial Bank of Commerce. The Big 4 US Banks are an average of the performance of JP Morgan Chase & Co, Citigroup Inc, Bank of America Corp, and Wells Fargo & Co.

I could see selling some of our bank stocks going forward if interest rates continue to rise, but it would be the "interest rate gap" that I am concerned about, not solvency.

If interest rates are pushed up by central banks, there could be more solvency pressure on regional banks in the U.S.

With regards to the U.S. regional banks, to which we don't have exposure, will there be more news of troubles? That is difficult to answer. However, if the U.S. Federal Reserve concludes that inflation requires interest rates to be higher for longer, that would heighten the risk of more U.S. regional bank drama hitting the headlines.

But, it may be hard to spot the trouble before it emerges because of the number of banks in the U.S.

So, what eventually happened to Bank of A. Levy you might ask? It was eventually bought by First Interstate Bancorp in 1995 which, itself, was merged into Wells Fargo in 1996. It appears that Bank of A. Levy was managed well enough to become an attractive asset worthy of purchase!

Model Portfolio Update[5]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

The asset allocations and the specific securities holdings in the model portfolios remained unchanged in March.

No changes to the model portfolios in March.

Despite all the banking concerns in the U.S. and internationally, it wasn't a bad month for most asset classes. The biggest contributor to results was an almost 8% surge in the price of gold bullion resulting from a weaker U.S. dollar. U.S. and international stocks were slightly higher for March thanks to a recovery in the last week of the month. Even bonds were higher on a consensus hope for a cut in interest rates in the 2nd half of this year. The only notable asset class that was lower was the one representing Canadian stocks, which was only down a fraction.

Markets did reasonably well despite the banking turmoil.

Gold bullion was the star of the month on U.S. dollar weakness.

Most of this buoyancy may have been the paradoxical result of the insolvency of Silicon Valley Bank, in addition to a few others. The thinking is that the U.S. Federal Reserve may be forced to pause on the inflation-fighting interest rate hikes.

The hope that central banks will become more dovish added to investor optimism.

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[5] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 3/7/2023. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

Higher interest rates were at the core of the banking problems as they reduced the market prices of the Treasury bonds held by the banks. Normally these banks would not have to mark these bonds to current market prices, but when depositors began withdrawing *en masse*, banks had to sell those bonds, thereby realizing the lower prices.

Hawkish inflation-fighting policies increased the pressure on some banks. This may be why much of the markets expect the U.S. Federal Reserve to back off.

Now, there is a general belief in the interest rate futures market that short-term policy rates in the U.S. and Canada will be cut in June or July.[6] If rising rates were a problem for banks, then it would be logical that falling rates will ease the pressure.

However, this could increase the risk of inflation.

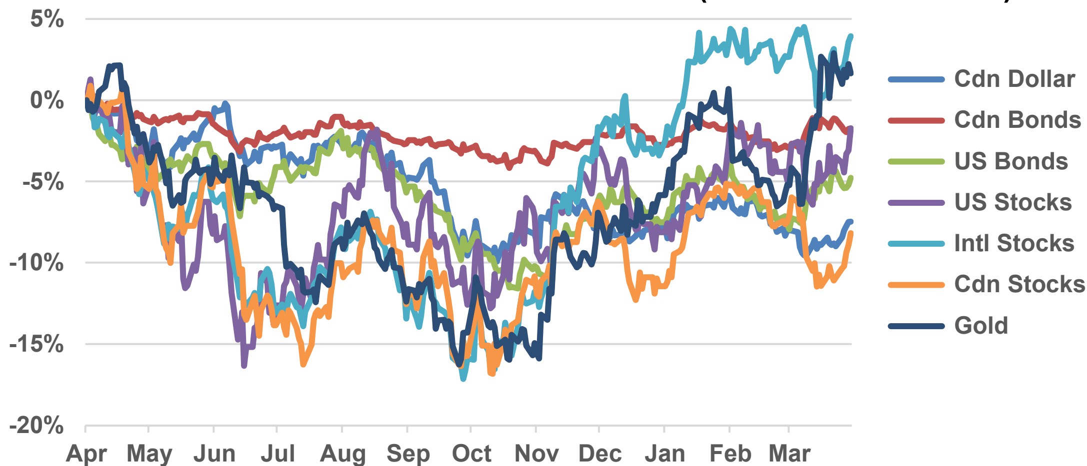
Unfortunately, this ignores the lingering problem of inflation and the factors that are still contributing to it such as higher consumer demand and an insufficient supply of labour. If interest rates are forced down, then it could start to fan the inflationary embers and undo the impact of the interest rate increases over the past year.

My sense is that central bankers still see inflation as the more serious issue which could lead to higher rates being more persistent than expected.

My suspicion is that interest rate cuts won't materialize as soon as the market is currently expecting, which could cause a selloff in stocks and bonds if that is what happens.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 3**).[7]

Chart 3:



Source: Bloomberg Finance L.P. for the interval from March 31, 2022 to March 31, 2023

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[6] Source: Bloomberg Finance L.P. as of April 5, 2023

[7] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[8]

Issue	Importance	Potential Impact
1. Global Geopolitics	Significant	Negative
2. Canadian Federal Economic Policy	Moderate	Negative
5. Inflation (Portfolio Impact)	Moderate	Positive
3. China's Economic Growth	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
7. Short-term U.S. Interest Rates	Medium	Negative
6. U.S. Fiscal Spending Stimulus	Medium	Positive
8. Global Trade Wars	Medium	Negative
9. Long-term U.S. Interest Rates	Medium	Negative
10. Canada's Economic Growth (Oil)	Light	Positive

[8] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of April 5, 2023.

The information contained herein has been provided by Mark Jasayko, Senior Portfolio Manager and Senior Investment Advisor, TD Wealth Private Investment Advice, and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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