March 31, 2023

First Quarter Review

NORTH AMERICAN EQUITY STRATEGY

It's hard to believe that the S&P500 and TSX delivered positive returns during the first quarter. After all, inflation is still high, the Federal Reserve (the Fed) continued to increase interest rates in March, consensus 2023 earnings are down almost -12% from their peak and on March 10th, Silicon Valley Bank (SVB) failed -the second largest bank failure in US history. During the first quarter the S&P500 total return was +7.5% in US dollars. Adjusting for currency, the S&P500 returned +7.4% in Canadian dollars, as the Canadian dollar appreciated about 2/10ths of a cent, closing the quarter at US$0.7398. The TSX total return was 4.6%.

Silicon Valley Bank

Let's address the last issue first since it's the one that is probably keeping some of us up at night. There appeared to be a set of idiosyncratic circumstances that led to the failure of SVB, which in hindsight with proper oversight and regulation could have been avoided. The main issue was that SVB's management did not effectively manage its interest rate and liquidity risk.

SVB had a concentrated business model, serving the technology and venture capital sector. It also grew exceedingly quickly, tripling in asset size between 2019 and 2022. During the early phase of the pandemic, venture capital investing was experiencing an unprecedented bull market as money poured into technology, health care and business and financial services companies. As a result, SVB saw significant deposit growth. The bank invested these deposits in longer-term securities, to boost yield and increase its profits. Longer-term securities often decline in value more than shorter-term securities as interest rates rise, and 2022 experienced one of the most aggressive interest rate hiking cycles in history. However, SVB did not effectively manage that interest rate risk or develop effective interest rate risk measurement tools, models, and metrics.

At the same time, SVB failed to manage the risks of its deposits, which are considered liabilities to a bank. These liabilities were largely composed of deposits from venture capital firms and companies in the Tech sector, which were highly concentrated and could be volatile. Because these companies generally do not have high operating revenue, they keep large cash balances in banks, to make payroll and pay their operating expenses. Venture capital investing began to slow in 2022 and companies were drawing down on their deposits so SVB's deposit growth had already turned negative. These depositors were connected by a network of venture capital firms, and when stress on the bank began, its depositors essentially acted together to generate an unprecedented bank run.

Specifically, on Wednesday March 8th, SVB announced it had sold securities at a $1.8bn loss to raise liquidity to cover deposit outflows and that it planned to raise additional capital all of which was interpreted by depositors as a sign that the bank was in severe distress. On March 9th $42 billion of deposits were withdrawn and that evening, SVB communicated to bank regulators that an additional $100 billion of cash would be demanded by deposit holders the next day. Since SVB did not have the cash or collateral to meet these outflows, federal regulators (the FDIC) took control of SVB on Friday March 10th making SVB the second largest bank failure in history. To put the speed and magnitude of these outflows into context, in 2008 the largest bank failure ever, Washington Mutual Bank, with almost 50% more assets than SVB, saw a bank run of $16.7 billion over 9 days.

With the SVB turmoil, another bank that was highly vulnerable to a bank run, Signature Bank, which had exposure to cryptocurrency and other issues, also failed. The FDIC then announced over the weekend that all deposits would be guaranteed (insured and uninsured) for SVB and Signature Bank. They introduced the "Bank Term Funding Program" allowing all banks to access additional liquidity by pledging government securities, that would be valued at par even if they had declined in value, as collateral. While the unrealized security losses and liquidity issues at SVB were extreme, this program essentially dealt with the issue of unrealized security losses due to interest rate increases that other banks may have had, while creating liquidity to fund deposit outflows and help avoid further systemic risk. Unlike 2008, this was not a credit issue, but rather a liquidity issue brought on by mismanagement and improper oversight. It may still however bring on tighter lending standards and bank regulation resulting in some further tightening of financial conditions.

Currently, we have no exposure to US banks, little exposure to European banks and some exposure to Canadian Banks within our portfolios. All six Canadian banks are Domestic Systemically Import Banks (D-SIB). In addition, Royal Bank and TD Bank are classified as Global Systemically Important banks (G-SIB) and are therefore subject to additional capital requirements and increased supervisory scrutiny. D-SIBs are so important to the functioning of our financial system and the economy that they "cannot" be wound up under a conventional bankruptcy and liquidation process should they fail. Financial products such as loans, mortgages and lines of credit would remain unchanged, and chequing and savings accounts would be accessible and continue to receive Canadian Deposit Insurance Corporation (CDIC's) protection. Customers would be able to access online and phone services and ATMs with no interruption. The regulation and stability of the Canadian banking system is recognized as a gold standard for other advanced economies around the world.

Having said that and as outlined Exhibit 1 below, that's not the reason we own Canadian banks and stay invested in them even through challenging times. Canadian Banks are consistently more profitable as measured by "return on equity" than US and European banks, so when problems do occur, Canadian banks can mange through their losses better usually without the need for external capital.

Exhibit 1: Return on Equity Comparison for Banks by Region							
	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**Average**
US Banks	9.2%	11.6%	11.3%	7.9%	11.6%	10.6%	10.4%
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%

Source: CIBC Capital Markets, FactSet

Economic Projections

Turning to the Federal Open Market Committee (FOMC) interest rate decision in March, despite the banking turmoil, the Fed increased rates by 25 basis points, bringing the upper end of the federal funds rate to 5.0%. The FOMC Statement highlighted that "recent developments (the bank failures) are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring and inflation". They removed the quote "ongoing increases in the (interest rate) target range will be appropriate" and replaced it with "some additional policy firming may be appropriate". **Exhibit 2**, shows the Fed's Summary of Economic Projections (SEP). They did not adjust down their target of 5.1% for the Fed funds rate in 2023 and in fact, they raised their 2024 target to 4.3% from December's projection 4.1%. Exhibit 3 compares the Fed's projection (orange line) of the Fed Funds rate to the market's projection (purple line). Clearly the market expectations are quite different than the Fed as the market expects about 85 basis points (0.85%) of rate decreases in 2023. The question we are grappling with is whether the market expectation for lower rates is a function of lower inflation and slower growth or a recession? Regardless, it's clear that the rate hiking cycle is over.

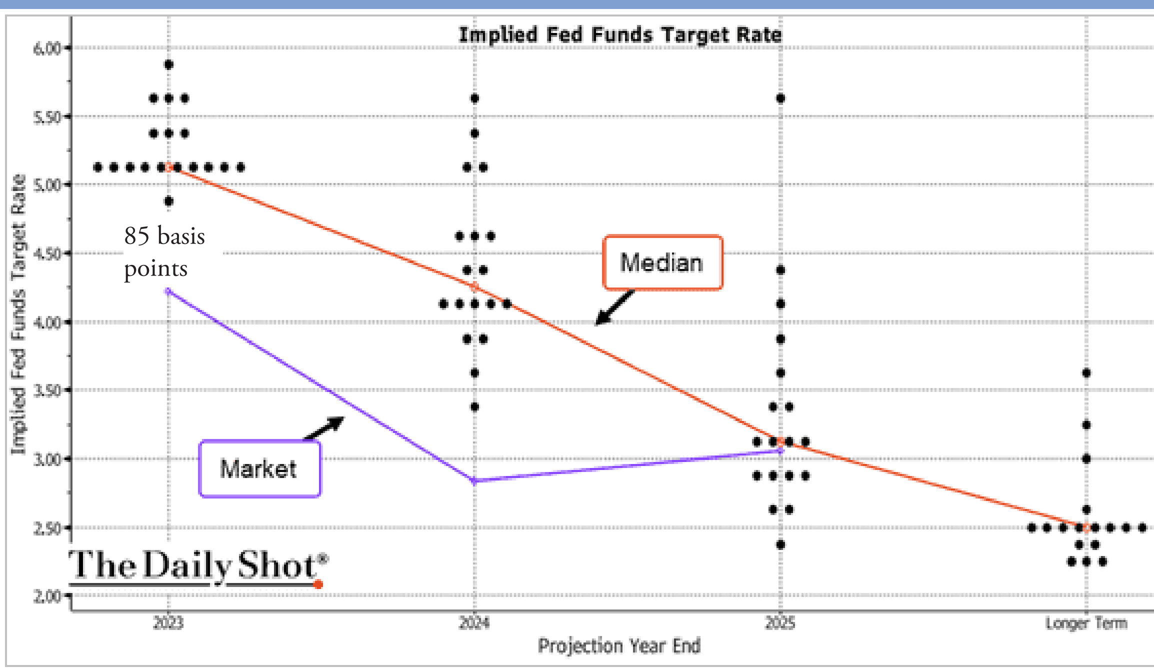
Exhibit 2: FOMC Summary of Economic Projections

Percent

Variable	Median[1]			
	2023	2024	2025	Longer run
Change in real GDP	0.4	1.2	1.9	1.8
December projection	0.5	1.6	1.8	1.8
Unemployment rate	4.5	4.6	4.6	4.0
December projection	4.6	4.6	4.5	4.0
PCE inflation	3.3	2.5	2.1	2.0
December projection	3.1	2.5	2.1	2.0
Core PCE inflation[4]	3.6	2.6	2.1	
December projection	3.5	2.5	2.1	
Memo: Projected appropriate policy path				
Federal funds rate	5.1	4.3	3.1	2.5
December projection	5.1	4.1	3.1	2.5

Source: Federal open Market Committee, Federal Reserve (Mar 22, 2023)

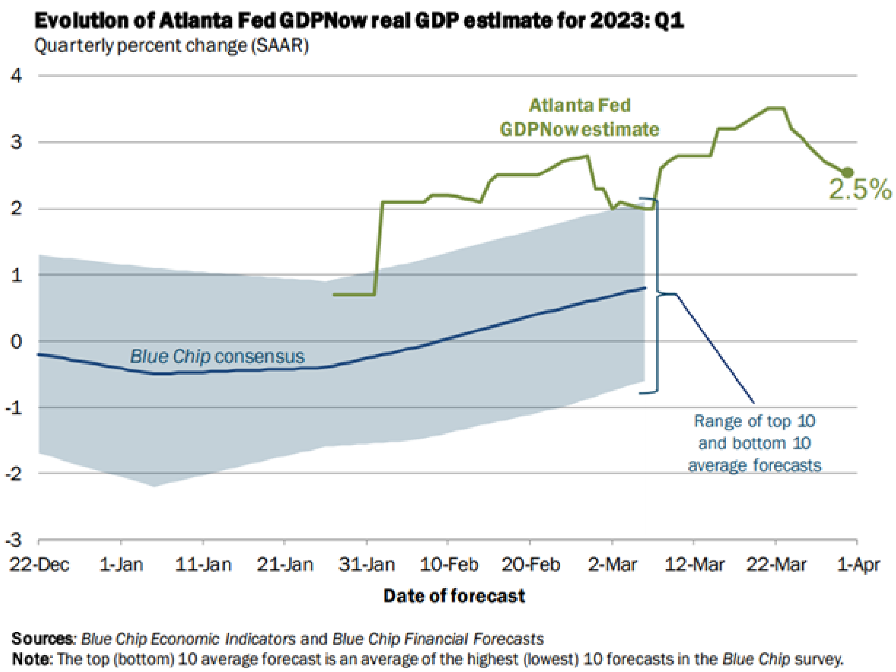
Exhibit 3: FOMC Implied Fed Funds Target (Median Dot Plot)



Source: @TheTerminal, Bloomberg Finance L.P. Daily Shot

Exhibit 2 also shows that the FOMC lowered the forecast for growth in real GDP for 2023 from 0.5% at December to 0.4% in March. **Exhibit 4** shows the Atlanta Fed GDPNow forecast for the first quarter of 2023 at 2.5% and that compares to 2.6% in Q4 2022. We may be a little rusty with our linear Algebra but if the 2.5% real GDP growth rate is correct for Q1 2023, and the Fed is forecasting 0.4% for this calendar year then some or all the rest of 2023 must be negative!

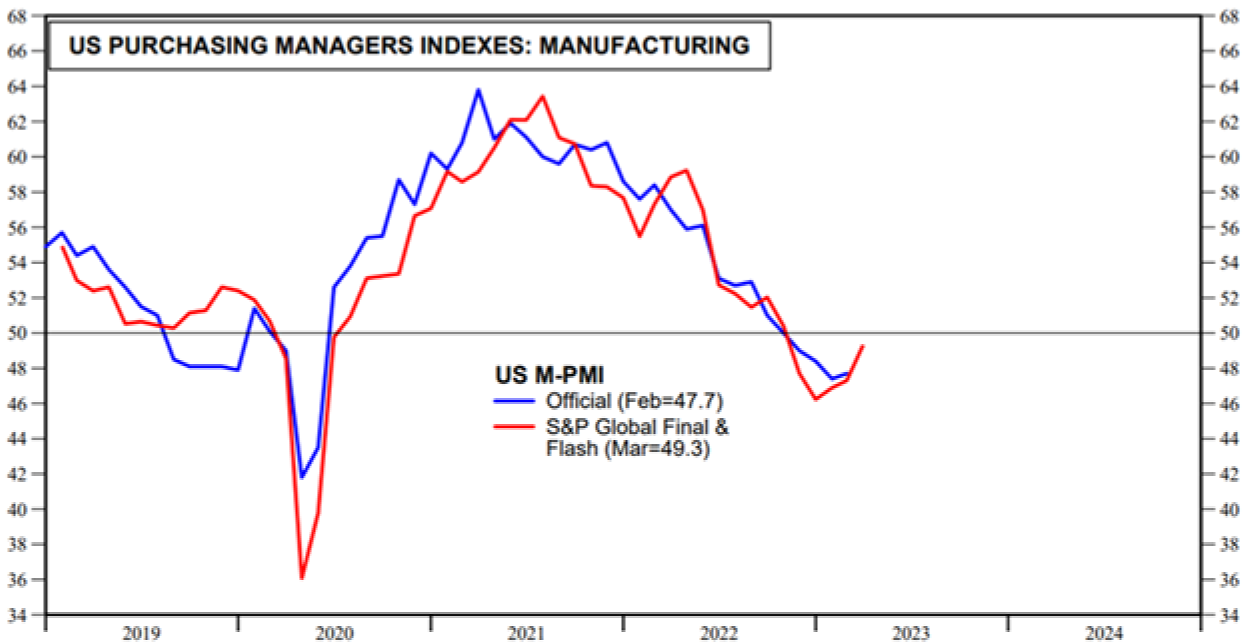
Exhibit 4: GDPNow Estimates by Atlanta Fed



Source: Federal Reserve Bank of Atlanta 03/31/2023

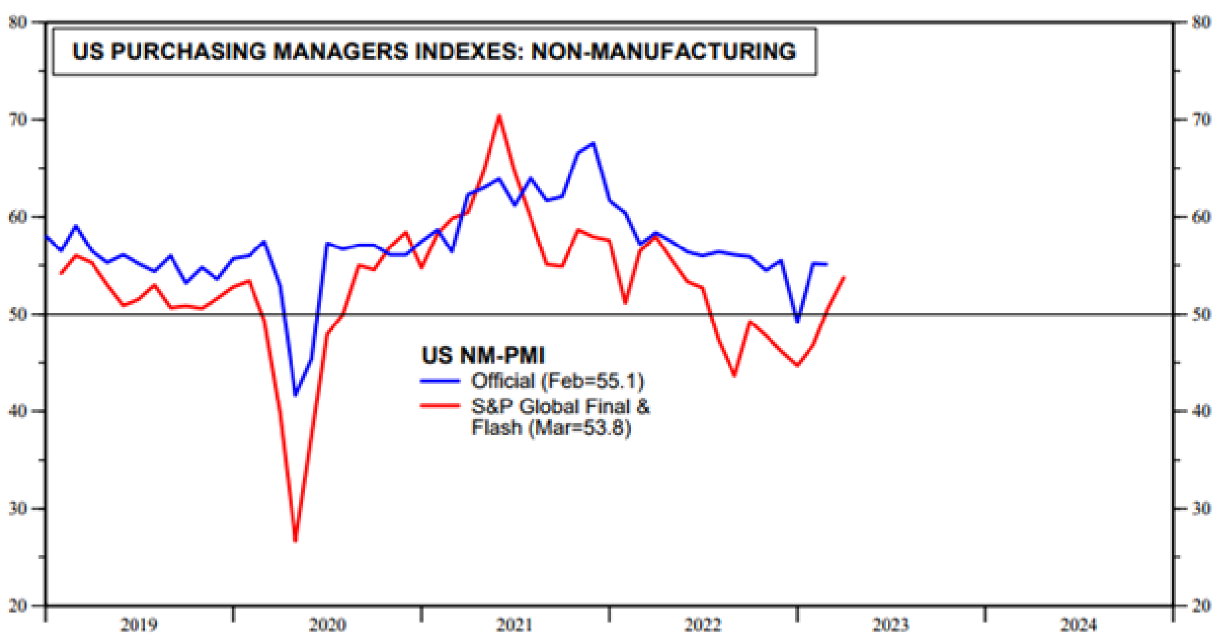
We find this outlook by the Fed somewhat extreme when we consider the following charts. **Exhibit 5** and **Exhibit 6** show the latest S&P Global flash estimates for Manufacturing PMI and Non-Manufacturing PMI released March 24th (red lines) as compared to the official ISM PMI that will be reported in early April. The S&P Global flash manufacturing PMI advanced 2pt to 49.3 while services improved 3.2pt to 53.8. Note the correlation between the two lines is relatively high and being monthly data, it gives an accurate current read on economic activity. Finally, let's look at recent housing data. New home sales (**Exhibit 7**) rose in February to 640,000, climbing for the third month in a row as mortgage rates eased off their highs of the past year. Existing home sales (**Exhibit 8**) jumped 14.5% m/m during February to 4.6 million units (saar). It was the first monthly gain in 13 months and the largest increase since July 2020. It's quite possible that low inventories of existing homes also held back sales so the number could have been higher. Taking the current level of employment into account at 3.6% or even the fed's higher projection of 4.5% from **Exhibit 2**, it seems more likely to support the soft-landing economic scenario.

Exhibit 5:



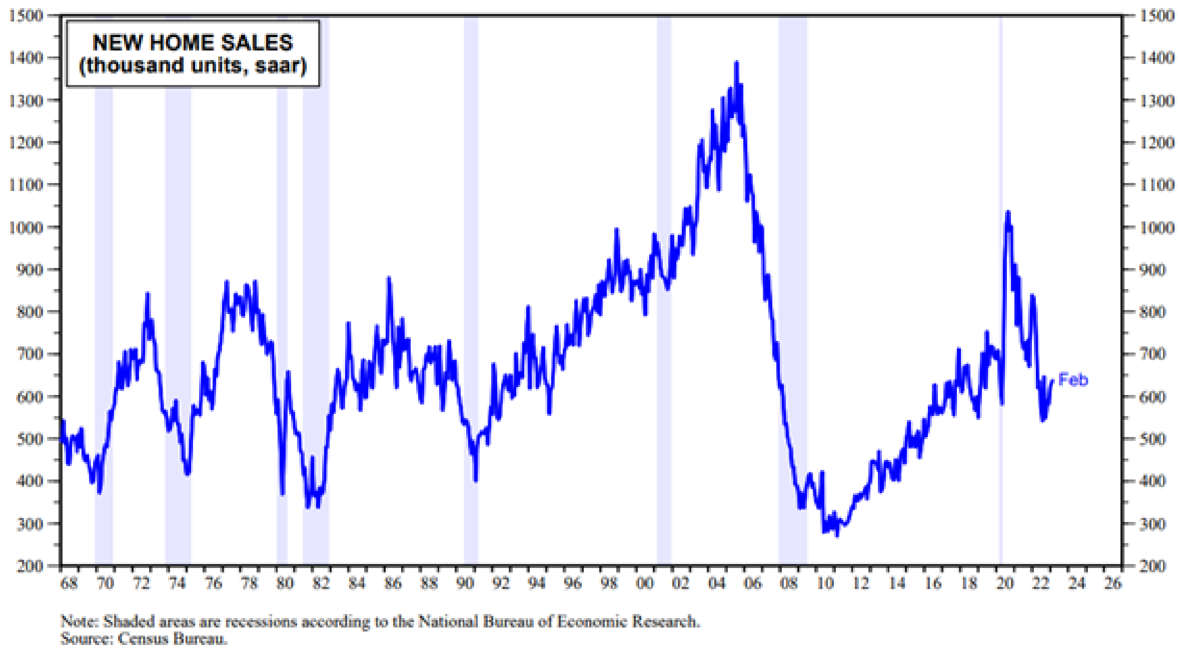
Source: Yardeni Research, Global Economic Indicators: Markit Flash PMIs 3/24/2023

Exhibit 6:



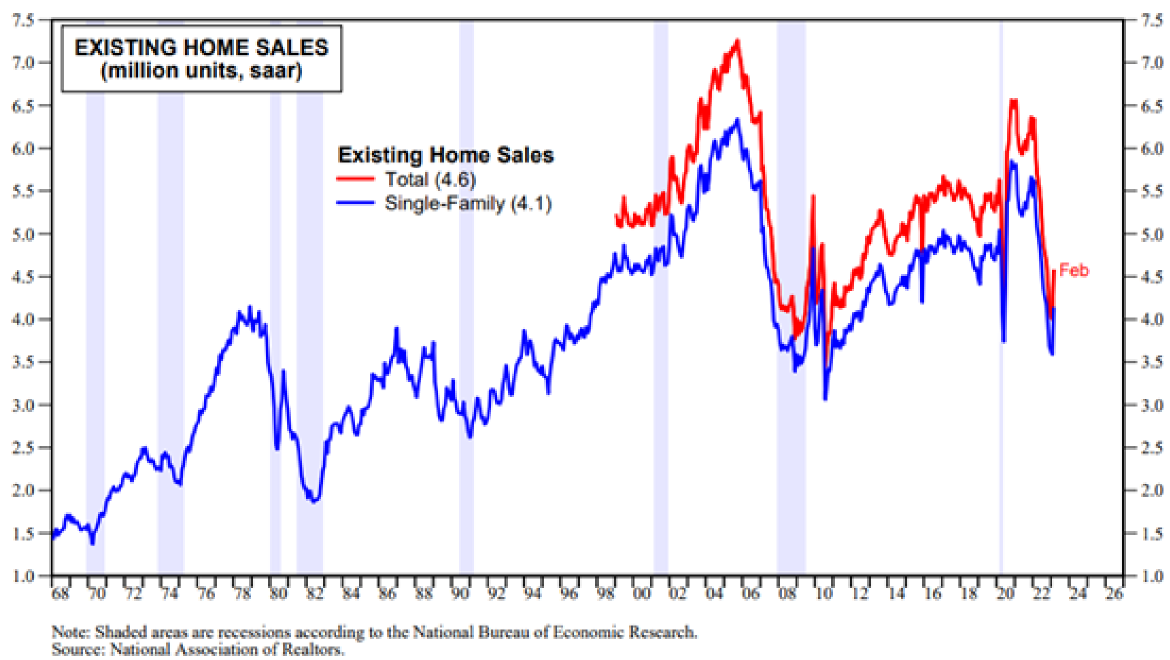
Source: Yardeni Research, Global Economic Indicators: Markit Flash PMIs 3/24/2023

Exhibit 7:



Source: Yardeni Research, U.S. Economic Indicators: New Home Sales & Housing Market Index, 3/23/2023

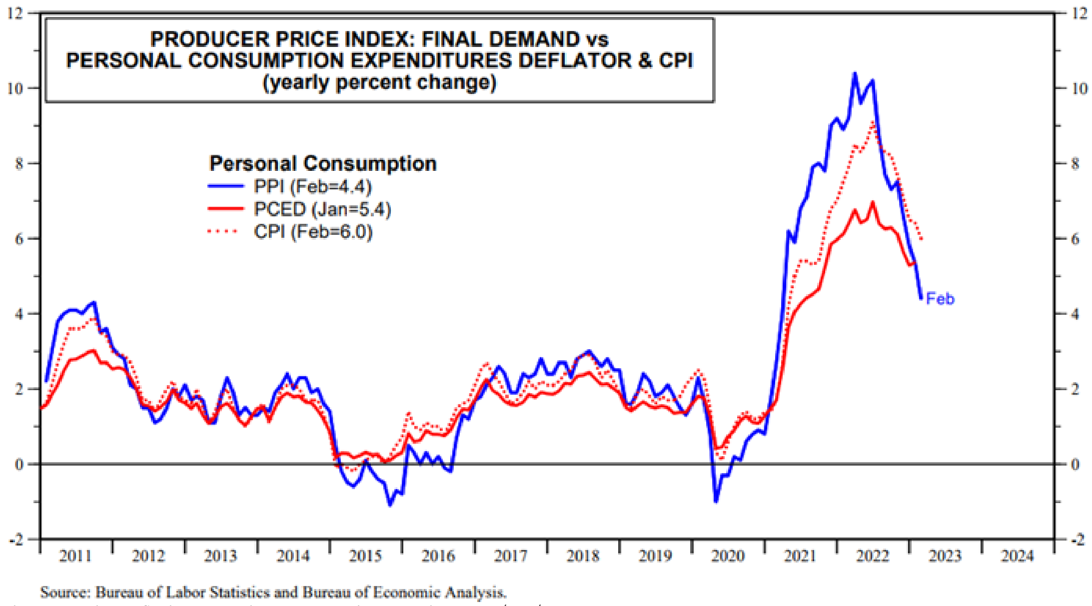
Exhibit 8:



Source: Yardeni Research, U.S. Economic Indicators: Existing & Pending Home Sales, 3/23/2023

Turning to inflation, the FOMC revised up their outlook for PCE inflation (**Exhibit 2**) from 3.1% to 3.3% for 2023. The reading for January, which was the data they would have had when making this projection, came in slightly higher than expected at 5.4% up from 5.3% in the previous month. However, exhibit 9, shows the trend for all three measures of inflation (PCE, PPI and CPI) is clearly lower.

Exhibit 9:



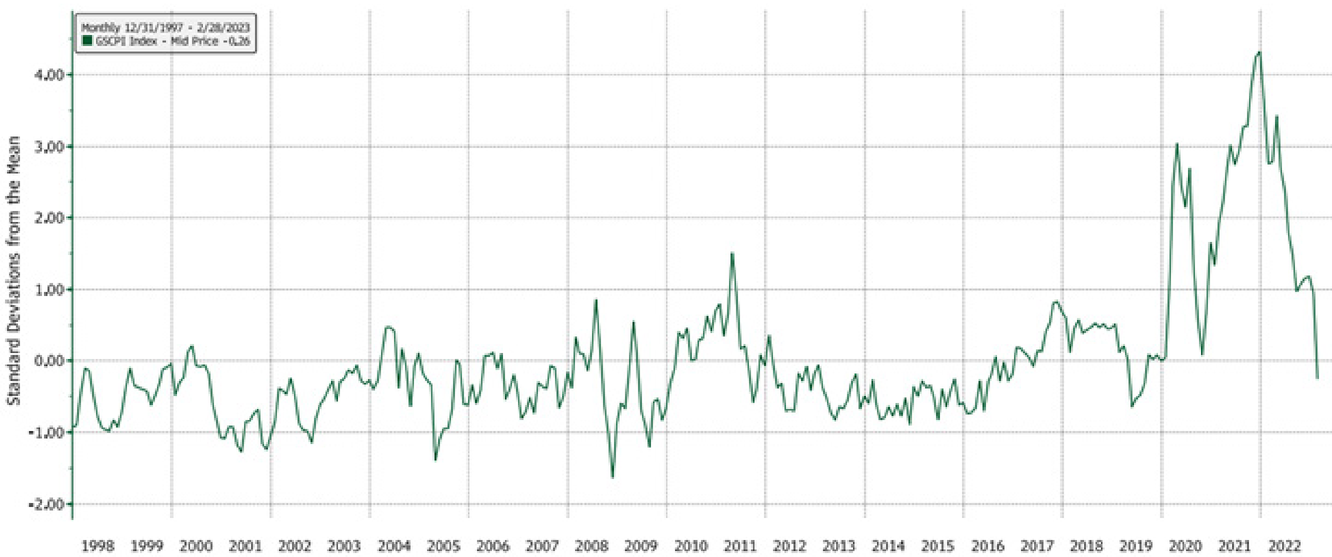
Source: Yardeni Research, Inflation Monitor II: Producer Prices, 03/19/2023

Exhibit 10 shows a relatively new indicator, the Global Supply Chain Pressure Index (GSCPI), which was unveiled by the New York Federal Reserve in January of 2022. The GSCPI measures 27 components of supply chain transportation costs including air freight, shipping and PMI sub-components from seven interconnected economies. It peaked at +4.3 standard deviations (SDs) in December 2021 and has averaged +2.1 SDs above the long-term average since the start of 2020. In statistical terms that's huge. However, it decreased considerably in February 2023 and is now down below its historical average, its lowest reading since August 2019. According to the NY FED "the GSCPI's recent movements suggest that global supply chain conditions have returned to normal."

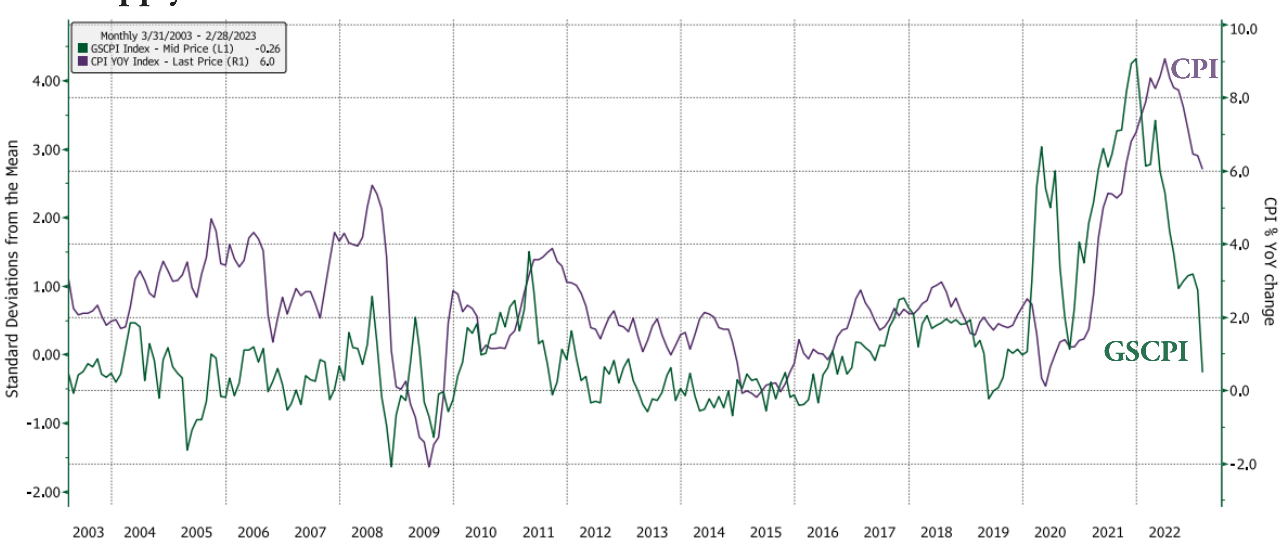
The second clip in **Exhibit 10** compares the GSCPI (green line) to US CPI inflation (purple line) and implies that with supply chain pressures normalizing, so should CPI inflation.

Exhibit 10: Global Supply Chain Pressure Index

Global Supply Chain Pressure Index



Global Supply Chain Pressure Index vs. CPI Inflation



Source: Bloomberg, Federal Reserve Bank of New York, GSPCI Index (Global Supply Chain Pressure Index)

Regarding earnings, 2023 and 2024 consensus earnings estimates have fallen nearly -12% and -11% respectively from their peaks in the spring of 2022. However, valuations (the price investors are willing to pay for a dollar of earnings) are more reasonable today having declined from a peak in 2022 of about 21.5x to 18.3x today as shown in **Exhibit 11**. Looking out to 2024 earnings, as the market typically will towards mid-year, valuations improve to about 16.3x.

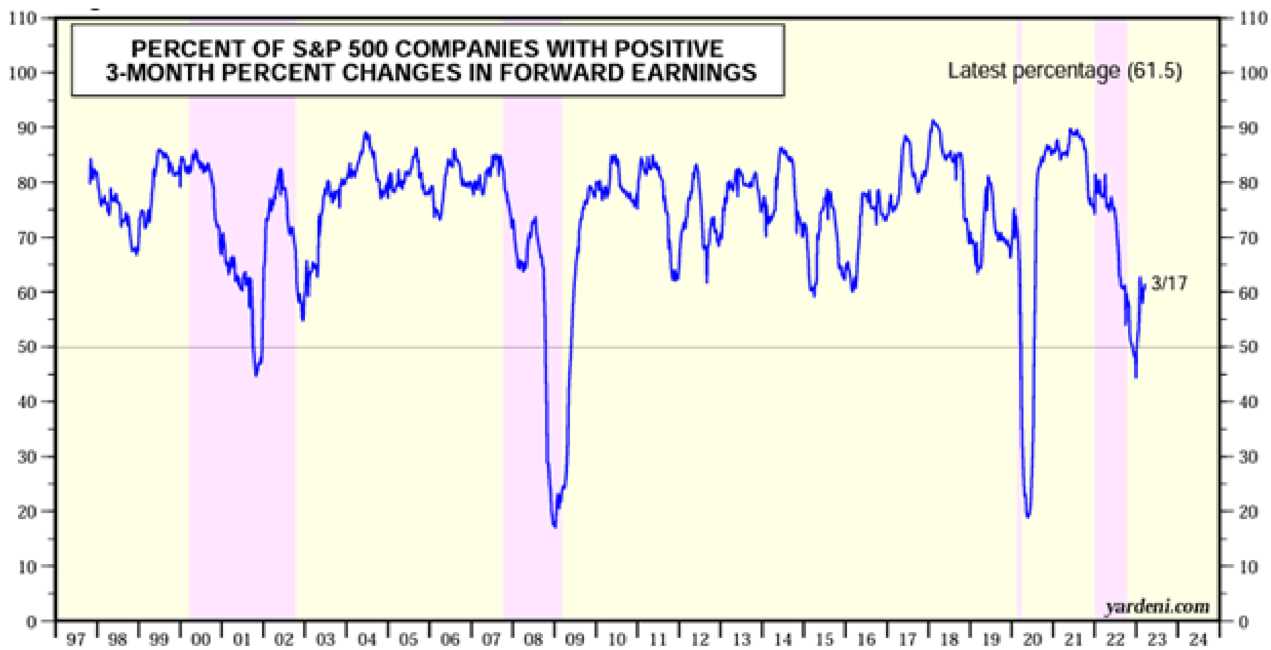
Exhibit 11: Gold Performance Around Peak in Fed Fund Rates

	2022	2023	2024	2025	10 Year Average
Peak estimates	$ 228.25	$ 250.24	$ 276.37		
Current estimates	$ 216.04	$ 220.34	$ 247.01	$ 273.49	
% Change	-5.30%	-11.95%	-10.62%		
Price/Earnings	18.6x	18.3x	16.3x	14.7x	17.5x

Source: FactSet March 29, 2023, S&P500 4027.81

Exhibit 12 shows the percentage of S&P500 companies with positive 3-month percent changes in forward earnings. The red shaded areas represent bear market declines of -20% or greater. As indicated in the chart, periods of bear market declines experience the lowest percent of S&P500 companies with positive 3-month percent change in forward earnings just like we saw in 2022. The good news is that this has begun to inflect positively in 2023 with the latest reading of 61.5%.

Exhibit 12:

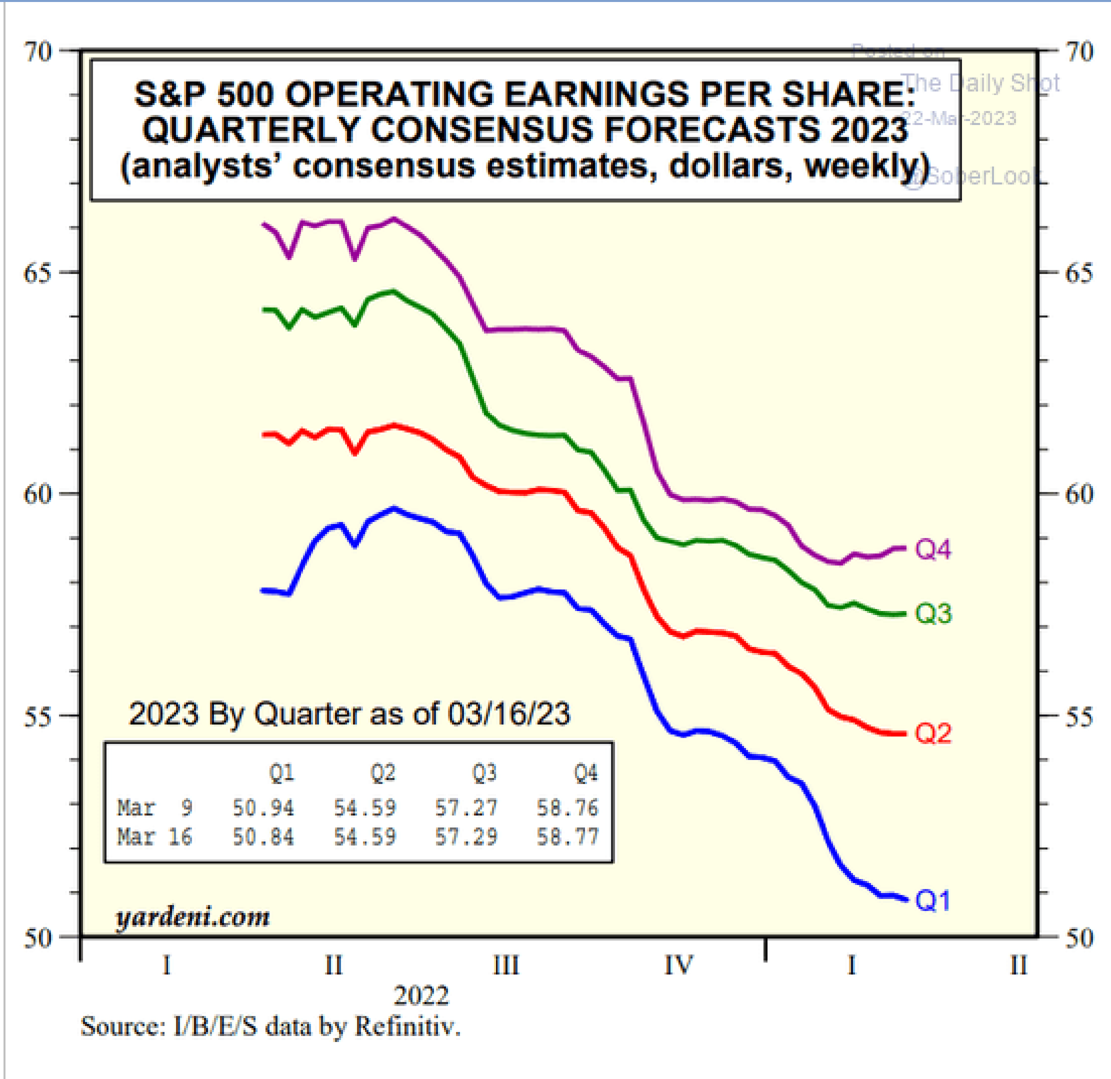


Note: Shaded red areas are S&P500 bear market declines of 20% or more. Yellow areas are bull markets.
Source: Haver Analytics. I/B/E/S data by Refinitiv and Standard & Poor's

Source: Yardeni Research, Stock Market Indicators: Net Revenue & Earnings Revisions by Sectors, 3/21/2023

Exhibit 13 shows the recent changes in quarterly consensus earnings estimates for 2023 and while very short term, they are also beginning to inflect positively in the back half of this year.

Exhibit 13:



Source: Yardeni Research, I/B/E/S data by Refinitiv

Portfolio Review

Asset Allocation for our North American Equity Strategy As of March 31, 2023	
Equities	94%
Fixed Income	0%
Cash	6%

During the quarter, our overall equity exposure decreased 2% to 94% from 96% on December 31st. Our US equity exposure increased from 38% to 40% while our Canadian exposure decreased from 58% to 54%. Cash increased from 4% to 6%. Note that our clients' portfolios that are invested in our North American plus International Equity strategy, have equity holdings proportionately less than this by the allocation to international companies.

Currently our portfolio overall is positioned toward value-oriented stocks (including financials, consumer discretionary, industrials, energy and materials) making up 61% of the portfolio versus 63% on December 31st while exposure to growth stocks (including healthcare, technology and communication services) increased slightly at 31% up from 29%. Staples (2%), which we don't classify as either growth or value, make up the balance of our equity exposure.

During the first quarter, we actively added a few new positions that we believe will benefit from an economic recovery and declining interest rates while lowering our exposure to more defensive sectors like Staples and Healthcare. These included new positions General Motors Company, Canfor Corporation, Avery Dennison Corporation, BCE Inc and Meta Platforms Inc.

General Motors (autos) and Canfor (lumber) are classic early cycle stocks that should benefit from lower interest rates and an economic recovery in housing and autos which arguably have already experienced their recession in 2022 with share price declines of -42% and -33% respectively. From a valuation perspective, both stocks trade at single digit price earnings multiples, so are rather cheap.

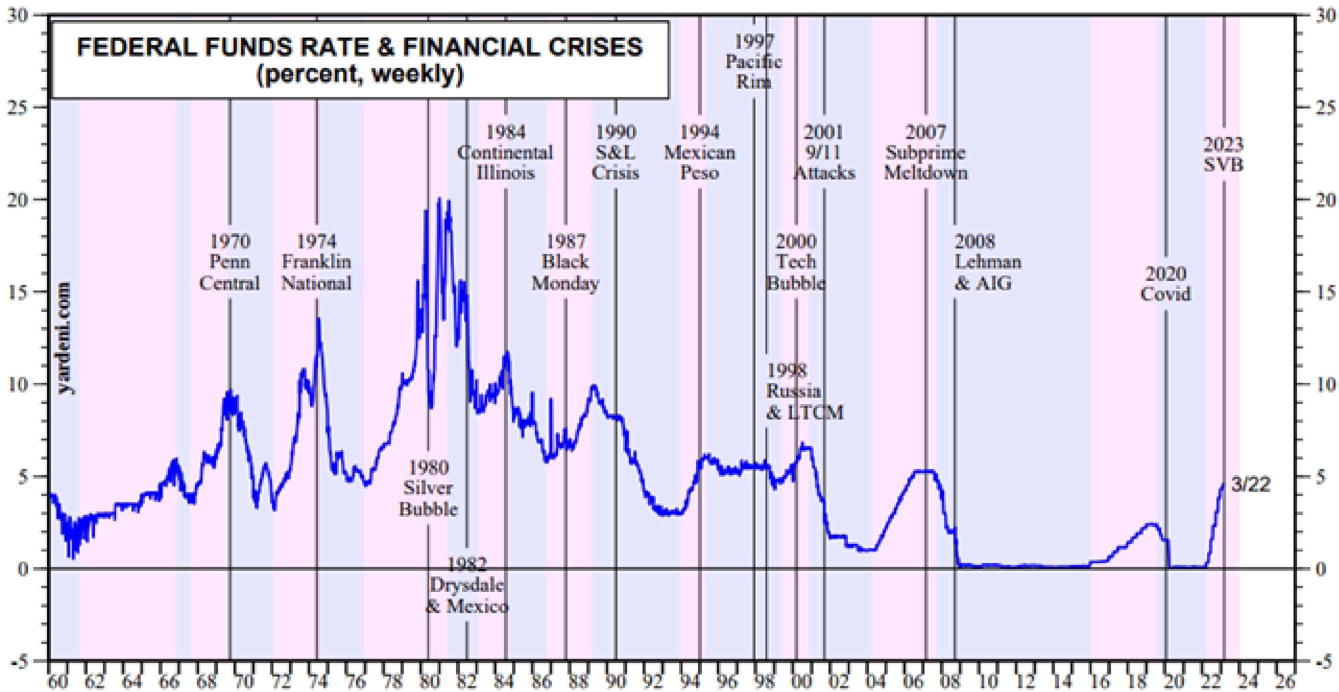
Meta Platforms run the largest social media platforms globally, with over 3 billion monthly active users across their family of apps which include Facebook, Instagram, and WhatsApp. We returned to Meta after having sold it higher last year as Meta has improved their business and most of the issues that compelled us to sell it last year have been resolved or mitigated. A complete review of the business and fundamental outlook for new companies purchased during the quarter can be found in **Appendix 1.**

Closing Comments and Outlook

The first quarter of 2023 turned out to be positive in terms of total return for both the S&P500 and the TSX notwithstanding bank failures that potentially threatened a broader banking contagion, stubbornly high inflation, a federal reserve continuing to increase interest rates, and consensus earnings estimate declines.

Exhibit 14 compares the Fed Funds rate cycle to various historical financial crisis. In many cases these were related to bank failures including Penn Central in 1970, Franklin National in 1974, Continental Illinois in 1984, the Saving and Loan crisis in 1990 and the 2007 subprime meltdown. In each case, these failures identified the peak in the Fed Funds rate cycle. The statement out of the FOMC March meeting would suggest a possible similar approach given the SVB bank failure. Now, clearly if this were happening at a time when the economy was already contracting and employment wasn't at a multi decade high as it is now, and earnings were set to decline further then all bets would be off. However, that is not our base case.

Exhibit 14: Federal Funds Rate and Financial Crisis

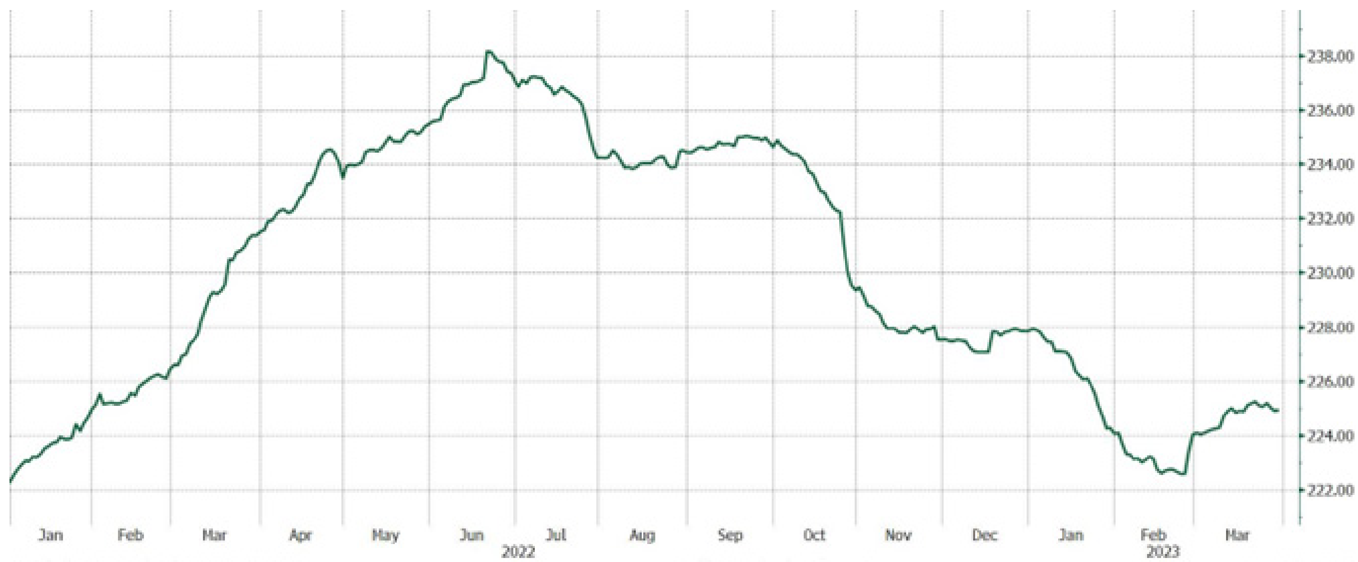


Note: Blue shaded areas are periods of monetary easing between cyclical peaks and troughs in the federal funds rate. Red shaded areas are monetary tightening periods.
Source: Federal Reserve Board.

Source: Yardeni Research, Federal Reserve Board.

Exhibit 15 looks at the consensus forward 12M earnings estimates for the S&P500, which are essentially a combination of 9 months of 2023 earnings and 3 months of 2024 earnings. After declining since mid-June of last year F12m consensus earnings estimates bottomed in February are now increasing.

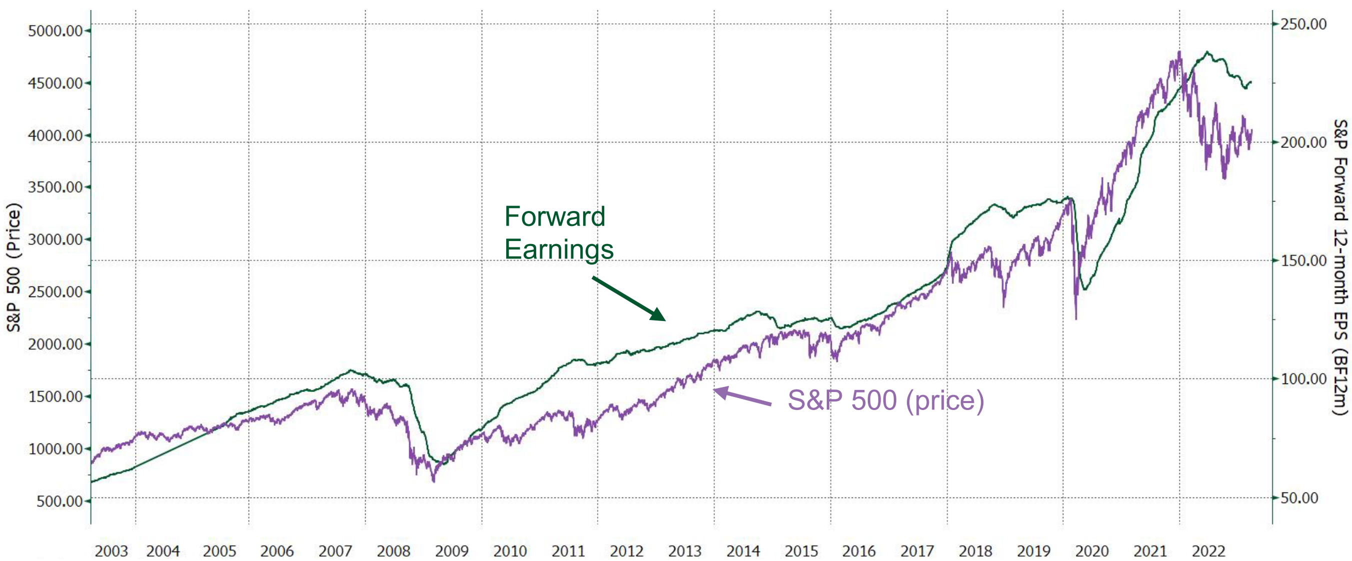
Exhibit 15: S&P500 Forward 12-month Consensus Earnings Estimates



Source: Bloomberg

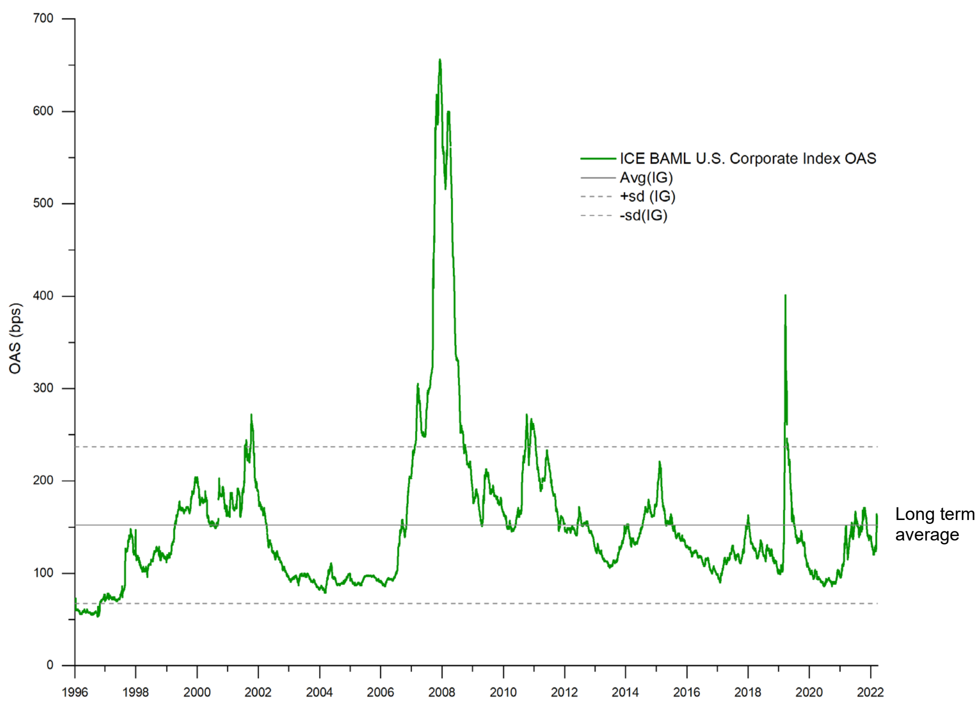
Exhibit 16 is the same consensus forward 12M earnings estimate chart as Exhibit 15 except it covers a period of 20 years rather than the past 15 months. The difference is here we compare the forward 12M earnings estimates (green line) to the S&P500 price performance (purple line). As indicated in the chart, this is probably the most powerful driver of share price performance and if earnings continue to inflect positively, this should provide a tailwind for further positive share price performance. The other driver of share price performance is valuation, which is highly correlated to the level of interest rates as interest rates compete against the stock market from a flow of funds perspective. With the Fed likely closer to a peak in the Fed rate hiking cycle this too could become a tailwind.

Exhibit 16: S&P500 F12M Consensus Earnings Estimates versus S&P500



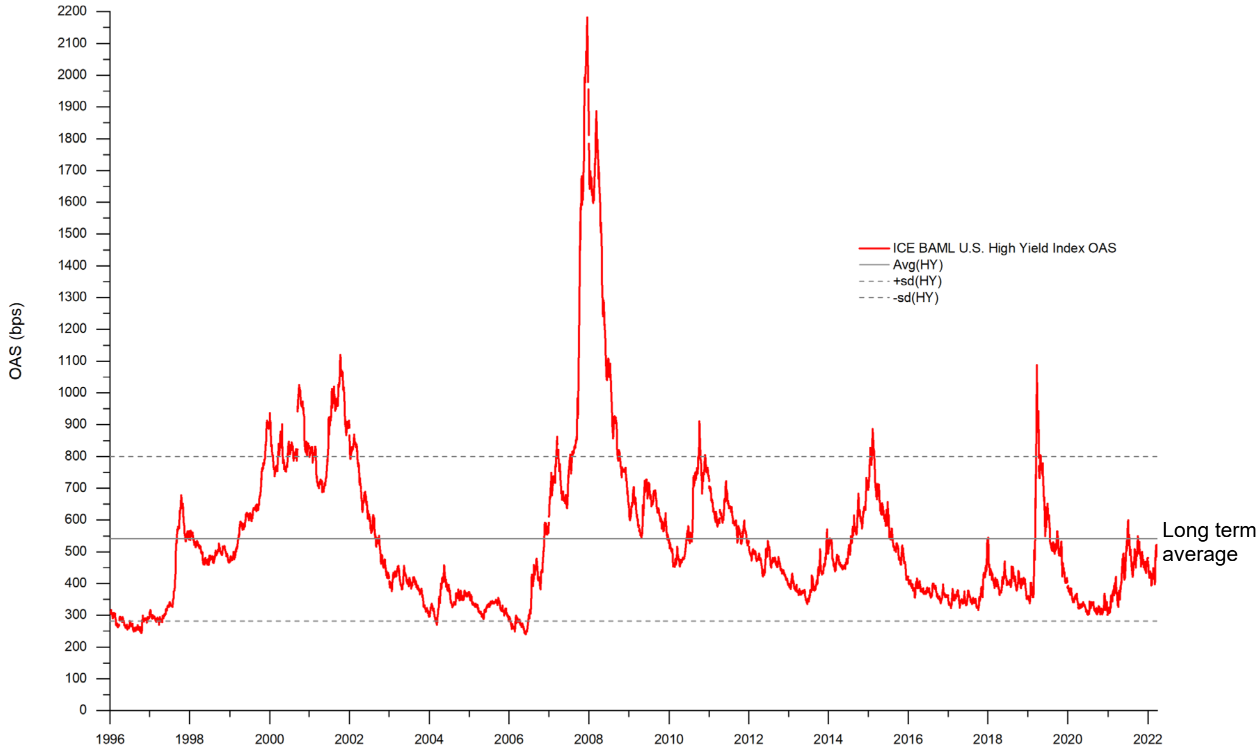
Source: Bloomberg

Exhibit 17: Credit Spreads: US Investment Grade vs US Treasuries



Source: ICE BofA US Corporate Index (Option-Adjusted Spread)

Exhibit 18: Credit Spreads: High Yield US Credit vs. US Treasuries



Source : ICE BofA US High Yield Index (Option-Adjusted Spread)

In closing, we remain constructive on the equity market notwithstanding the recent bank failures and market volatility. **Exhibit 17** compares the credit spreads of investment grade and high yield debt to US Treasuries for the past 25 years. Currently credit spreads are trading right around their long-term averages. If there were financial stress in the system, it would likely be evident here in the bond market first through rising credit spreads. It's not.

Peter Jackson
Chief Investment Officer
March 31, 2023

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

BCE Inc.

BCE represents a stable and defensive investment in uncertain times, where you are paid to wait with an excellent dividend (6% yield). Strategically, they have been laying fiber optic cable to customer homes in the last few years allowing them to gain market share in the important internet access market. When the fiber build ends in the next couple of years capital spending will decline materially, thereby significantly increasing free cashflow.

Canfor Corporation

Canfor is a contrarian deep-value cyclical investment. With around $20.00 per share in unencumbered cash ($13.00) and cash held for software duties ($7.00 where a good deal may ultimately be returned to the company), there isn't a lot of value being placed on their ongoing operations. While only breakeven at present, their lumber operations recently earned over $10 per share in 2021. A combination of declining interest rates boosting housing demand and supply curtailments in BC due to the damage caused by the mountain pine beetle, should return the market to balance over time.

UNITED STATES

General Motors Company

General Motors' vision is to lead the automotive industry in creating a world with zero crashes, zero emissions, and zero congestion. GM has differentiated itself from other manufacturers by making the necessary and significant investments in research and development and supply chain to help realize that vision. GM developed the Ultium platform to achieve scale in electric vehicles and could achieve margin parity with internal combustion engines as early as 2025. Further, they have one of the leading advanced driver assistance systems (ADAS) and were the first company to operate a commercial driverless taxi service in a major US city.

From a valuation perspective, we found GM attractive at a low price-earnings multiple of 6.6x forward earnings at a time when vehicle sales were also quite low. North American new vehicle sales were hovering around 14.5 million compared to a normal year which can be upwards of 16 million. And if you subtract the value for Cruise - their autonomous taxi unit - GM was trading at a little over 3x earnings. At this valuation, GM should perform well if vehicle sales continue to improve; and exceptionally well if they can show progress on their zero crashes, emissions, and congestion vision.

Avery Dennison Corporation

Avery Dennison is a global materials science and manufacturing company that specializes in the production of self-adhesive materials, labeling and packaging solutions, and RFID technology. It is run by highly regarded management who have a consistent record of earning a high return on capital. Its largest segment, Labels and Graphic Materials, manufactures pressure sensitive label and packaging materials. Its an attractive business with the two largest players controlling 50-60% of the global market. With 35-40% share belonging to Avery Dennison, the company benefits from pricing power and economies of scale. Further, Avery Denison is the leading provider of RFID tags, initially used for inventory tracking in apparel, but now increasingly being used for other retail markets as well as logistics. We bought Avery Dennison at roughly the same price-earnings multiple of the market but believe Avery will grow earnings faster than the market.

Meta Platforms Inc.

Meta runs the largest social media platforms globally, with over 3 billion monthly active users across their family of apps which include Facebook, Instagram, and WhatsApp. We returned to Meta Platforms after having sold it higher last year. Meta has improved their business and most of the issues that compelled us to sell it last year have been resolved or mitigated. Daily Active returned to modest growth; Meta has employed Artificial Intelligence (AI) to better target ads after being impacted by Apple's privacy changes; Reels will start to see monetization; average revenue per user is improving; and, in what they call "Meta's Year of Efficiency, " the company significantly reduced expenses and capital spending. Analysts are under estimating Meta's earnings power. When we bought Meta, analysts estimated their operating margin at 28.5% by FY 2025 despite management guiding to 33% after the cost of restructuring in 2023. We feel that future earnings could be much better than expected as Meta becomes leaner and an eventual recovery in ad markets unfolds.