TD Wealth

Private Investment Advice

The Charter Group Monthly Letter

August 2017

Mark Jasayko, MBA, CFA
Portfolio Manager & Investment Advisor
TD Wealth Private Investment Advice
The Charter Group, Langley, BC

Economic & Market Update

Leaping Loonie

Clients have recently noticed that something is holding back the portfolio results. The culprit is the Canadian dollar / U.S. dollar exchange rate. The current targeted exposure of The Charter Group Balanced Portfolio to the U.S. dollar is at 51.25% (compared to 42.05% to the Canadian dollar and 6.70% to other international currencies). If the Canadian dollar strengthens relative to the U.S. dollar, it will weaken the results provided by the U.S. dollar-denominated investments in the portfolio. This episode began in May when the Bank of Canada surprised the market with talk of potentially higher interest rates.

The anticipation of higher Canadian interest rates has boosted the value of the Canadian dollar compared to the U.S. dollar.

On July 12th, the Bank of Canada followed through by raising the Bank Rate from 0.50% to 0.75%. The current implied probability of another hike by the October 25th meeting of Bank of Canada officials is 70.1%.[1]

Confident rhetoric emanating from the Bank of Canada is leading some to think rates have further to rise.

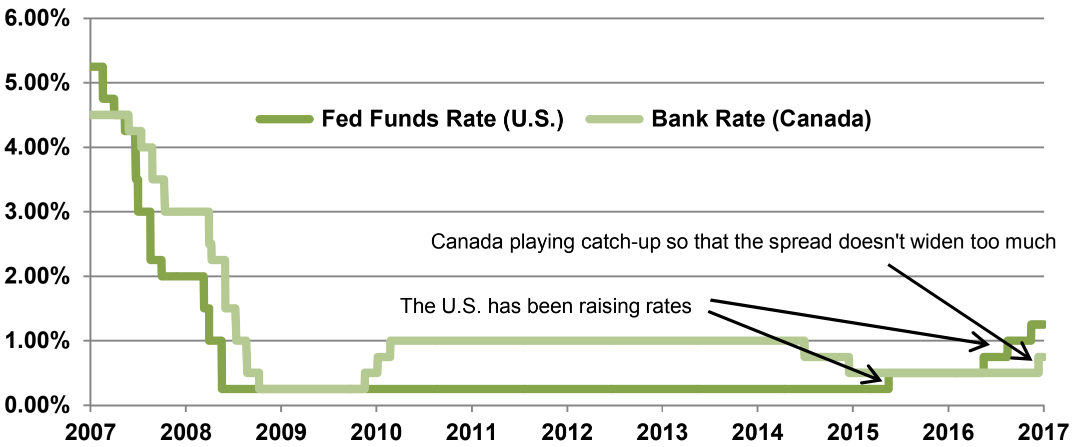
So, why is the Bank of Canada raising interest rates? The official explanation is that the economy is growing as evidenced by steady retail spending. It is not a very strong argument, which may be an indication that it is not the real reason.

However, it could also be because of a desire at the Bank of Canada to build up rates in order to have something to cut during the next recession.

In the search of other hints as to why officials want higher interest rates, it helps to look back at recent policy. In 2015, rates were cut twice in an effort to stimulate the Canadian economy by making it cheaper to borrow. The rate cuts were also designed to boost exports as lower rates tend to depress the value of the Canadian dollar which lowers the cost of Canadian goods in the international marketplace.

There is also a sense that we need to catch-up to the U.S. rate increases in order to make sure the spread in rates between the two countries does not become too wide.

Chart 1:
Short-term Interest Rates in the U.S. & Canada



Source: Bloomberg Finance L.P. as of 8/1/2017

There was a sense that the Bank of Canada felt that it had overshot things by going with two rate hikes in 2015. One problem was that they did not get the desired increase in exports. The other problem was that the lower rates added more fuel to an already heated real estate market. Finally, with the Bank Rate at just 0.50%, the Bank of Canada would have very little ammunition with which to fight the next recession (central banks often cut rates to combat a recession, sometimes dramatically).

[1] Source: Bloomberg Finance L.P. as of 8/1/2017. This probability is implied from current trading in the futures contracts market for interest rates. In that market, traders speculate or hedge against possible future changes in the level of interest rates.

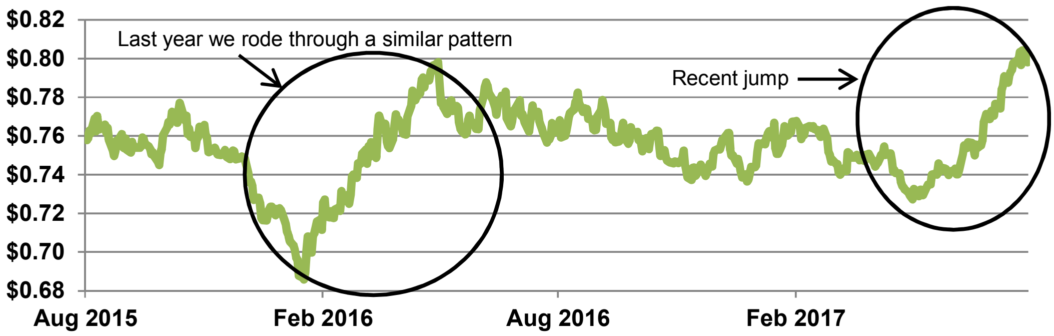
With this lingering remorse, it was reasonable to assume that the Bank of Canada would seize upon the earliest opportunity to increase rates. That opportunity was partially provided by the U.S. Federal Reserve when it began a cycle of rate increases beginning in December 2015, leading to four rate hikes so far and which has considerably widened the spread between Canadian and U.S. rates. This, combined with steady Canadian retail sales numbers, gave the Bank of Canada its chance to move.

That's the past. What about the future?

As stated above, there is a 70.1% implied probability that the Bank of Canada will raise rates again by October 25th. A good chance, but hardly a certainty.

Chart 2:

Canadian dollar / U.S. dollar Exchange Rate



Source: Bloomberg Finance L.P. as of 8/1/2017

There are some very serious hazards associated with higher interest rates given the current state of the Canadian economy. It is not secret that the growth in real estate prices and in all of the activities associated with real estate has been the main reason why we have avoided a painful recession.[2] Otherwise, the damage to the energy sector caused by declining oil prices would have hit Canada very hard. The conundrum with real estate is that it is very interest rate-sensitive. Because mortgage borrowing can add enormous amounts of leverage onto a household balance sheet, the resulting debt burden can become a big problem for many Canadians when it is time to renew. Additionally, for many people who are looking to enter the housing market, higher interest rates can ruin the math of affordability. The bottom line is that if higher rates cool down the Canadian housing market, it will spell trouble for the Canadian economy unless there is some other sector that will step in and pick up the slack (which is an unlikely scenario at this time).

If rates continue to rise, it could put the real estate sector at risk.

The real estate sector has been a very important contributor to Canadian economic growth recently.

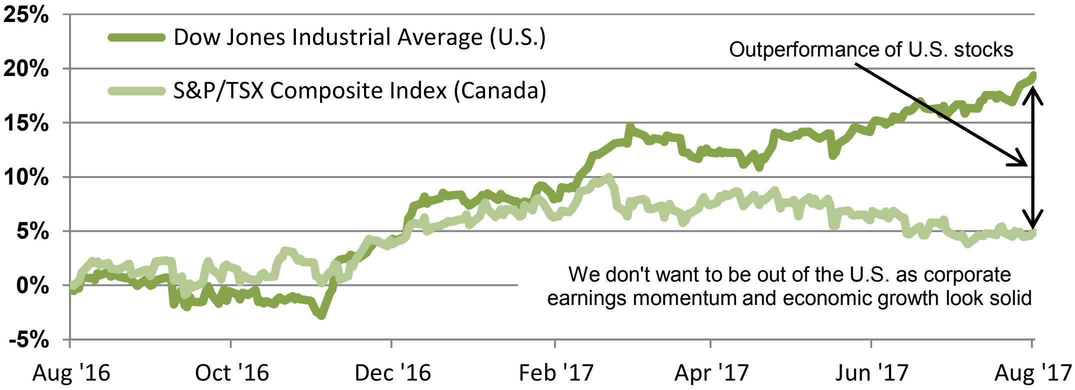
[2] Technically, Canada had a recession in 2015, defined as two quarters of economic contraction in a row. However, it was so shallow that it barely made headlines.

In the face of this prospect, it is reasonable to assume that the Bank of Canada will be much more cautious than their recent enthusiasm for rate hikes would suggest. And, if this materializes, the bullish traders lifting the Canadian dollar would have to scramble for other reasons to bolster their case. As a result, it could be very challenging for the Canadian dollar to sustain its recent trajectory.

As mentioned, a rising Canadian dollar is generally not good for a portfolio containing U.S. investments. In light of this, is it possible to avoid the short-term ups and downs caused by exchange rate fluctuations? Not really. It is possible to hedge or buy insurance against changes in the currencies, but the cost of doing so would severely detract from a portfolio's long-term results. However, there is some merit in attempting to capture secular shifts in exchange rates that may persist for many years and this is an implicit part of the strategy that we apply to our model portfolios. This is different from attempting to outsmart currency speculators in the hope of capitalizing from a move in the exchange rate that may only last for a couple of months.

Chart 3:

U.S. Stocks versus Canadian Stocks - One Year



Source: Bloomberg Finance L.P. as of 8/1/2017

A stronger Canadian dollar reduces the net return on U.S. investments from the perspective of a Canadian investor.

However, we are reluctant to cut back our exposure to attractive U.S. stocks because of exchange rate fluctuations.

Additionally, trying to navigate the short-term vicissitudes of exchange rates would create havoc with the underlying investment strategy in a portfolio. In our case, we are more hopeful about the potential of the U.S. stocks that we have in our Balance Portfolio than we are about the Canadian stocks. However, to chase a possible increase in the value of the Canadian dollar, we would be forced into a position where we would have to trim back those U.S. stocks. And, as we can see in (**Chart 3**), U.S. stocks in general have provided better results than the Canadian stocks over the past year.

Model Portfolio Update[3]

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

	Target Allocation %	Change
Equities:		
Canadian Equities	15.0	None
U.S. Equities	35.7	None
International Equities	9.3	None
Fixed Income:		
Canadian Bonds	25.5	None
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2	None

As mentioned in the previous edition of *The Charter Group Monthly Letter*, we swapped out our exposure to U.K. stocks and added the proceeds to our existing exposure to stocks in Australia, Switzerland, Germany, Hong Kong, Ireland, and Singapore. Otherwise there weren't any other changes to The Charter Group Balanced Portfolio during July.

No changes were made to the asset allocation of the Balanced Portfolio during July.

However, the exposure to U.K. stocks was removed and redistributed to other developed countries outside North America.

As mentioned in the Economic & Market Update section of this month's *Letter*, The Balanced Portfolio continued to be stung by the bounce in the Canadian dollar as more than half of the investments are currently denominated in U.S. dollars. However, if the Bank of Canada gets cold feet with respect to further rate hikes (especially because of the real estate situation), the Canadian dollar could be vulnerable.

The Canadian dollar continued to strengthen during July.

Looking forward, there appears to be a consensus building regarding the sustainability of good U.S. corporate earnings. If there is volatility in the U.S. markets, the brunt of it may impact the most over-valued, extremely large technology companies. Beyond that

[3] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 5/5/2017. The asset allocations of individual clients invested in this Portfolio will 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.

particular sector of the U.S. markets, valuations are relatively reasonable[4] as long as the 10-year Treasury bond yield stays below 3%.[5]

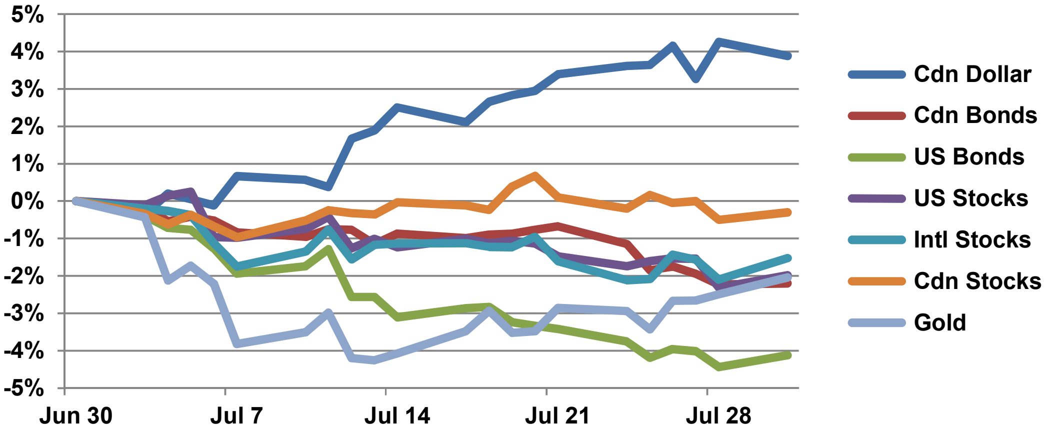
Going forward there appears to be some decent opportunities associated with good U.S. corporate earnings momentum.

Arguably, the performance of the Trump administration has depressed the U.S. dollar, but currency traders could be overacting to things. Paradoxically, administrations that don't get too active in managing the economy tend end up with better economic results. If this appears to be the case again, the U.S. dollar could get some lift.

The less involved the Trump administration is with the economy, the better it might perform.

Below is the July 2017 performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 4**).[6]

Chart 4:
July 2017 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 8/1/2017

[4] Valuations are higher than the historical average, but are currently not near where they have been during previous major market peaks

[5] The 10-year U.S. Treasury bond yield is currently 2.25% according to Bloomberg Finance L.P. as of 8/1/2017.

[6] 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 iShares Canadian Universe Bond Index (XBB); U.S. bonds are represented by the iShares Core U.S. Aggregate Bond Index (AGG); U.S. stocks are represented by the iShares Core S&P 500 Index (IVV); International stocks are represented by the iShares MSCI EAFE Index (EFA); Canadian stocks are represented by the iShares S&P/TSX 60 Index (XIU); Gold is represented by the iShares Gold Trust (IAU).

Top Investment Issues[7]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. Canadian Dollar Decline	Moderate	Positive
3. Long-term U.S. Interest Rates	Moderate	Negative
4. U.S. Fiscal Spending Stimulus	Moderate	Positive
5. Canada's Economic Growth (Oil)	Moderate	Negative
6. East Asian Geopolitics	Moderate	Negative
7. Short-term U.S. Interest Rates	Medium	Negative
8. Massive Stimulus in China	Medium	Positive
9. Japan's Money Printing	Light	Positive
10. Europe's Money Printing	Light	Positive

[7] 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, we encourage you to email mark.jasayko@td.com and set up a time to talk face-to-face or by phone.

TD Wealth

The Charter Group

Mark Jasayko, MBA, CFA | Portfolio Manager & Investment Advisor
Mike Elliott, BA, CIM, FCSI ® | Portfolio Manager & Investment Advisor
Laura O'Connell, CFP ®, FMA | Associate Investment Advisor

TD Wealth Private Investment Advice

604 513 6218
8621 201 Street, Suite 500
Langley, British Columbia V2Y 0G9

The Charter Group at TD Wealth Private Investment Advice 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 August 1, 2017.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor 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.

Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS.

Index returns are shown for comparative purposes only. Indices are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index.

The Charter Group consists of Mark Jasayko, Portfolio Manager, Investment Advisor, Mike Elliott, Portfolio Manager, Investment Advisor, and Laura O'Connell, Associate Investment Advisor. The Charter Group is part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. TD Waterhouse Canada Inc. is a subsidiary of The Toronto-Dominion Bank. TD Waterhouse Canada Inc. – Member of the Canadian Investor Protection Fund.