TD Wealth

The Charter Group Monthly Letter

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

Economic & Market Update

Who Is Going To Buy Trump's Bonds?

Governments have a love affair with spending. It is a feature of a liberal democracy. Promises are made during election campaigns and they usually involve money. Because this is such an effective vote-winner, there is enormous temptation to ratchet up the level of promises. Regardless of the political party, spending unites them all. The main difference is the rate of spending.

Central banks have been the biggest purchasers of government bonds the last few years. Who's going to buy those bonds if central banks scale back?

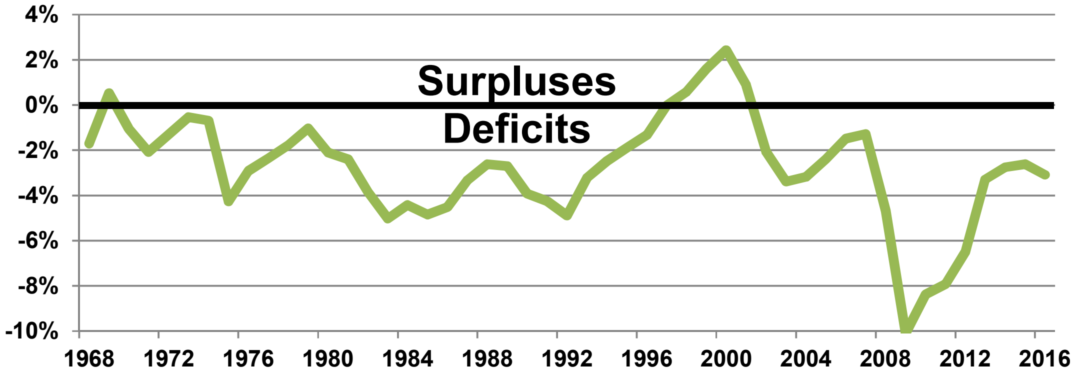
However, spending is only one side of the equation. How *that* spending is financed is the other side. Ideally, in a fiscally conservative utopia, all of the spending would be financed by taxes, fees, and royalties. Because of the temptation of out-promising the political competition, there are usually not enough of these types of revenues to cover the eventual spending bill.

To make up the gap, governments issue bonds. Exceptions to this are limited to rare occasions. In my lifetime[1] there have only been five surplus years for the U.S. federal government: 1969 under Richard Nixon, 1998, 1999, & 2000 under Bill Clinton, and 2001 under George W. Bush (**Chart 1**). In some of those years, the numbers had to be twisted like a pretzel to get an official surplus, and in the other years there was a confluence of events outside of the U.S. federal government's control that helped.

U.S. federal government budget surpluses are a rarity because politicians like to promise too much.

Chart 1:

U.S. Federal Surplus/Deficit (% of GDP)



Source: Bloomberg Finance L.P. as of 11/7/2017

In the 2016 U.S. election campaign, Trump, like his predecessors, gave in to the temptation of costly promises. He highlighted infrastructure projects, upgrading and expanding the military, and the border wall. And, although there were some comments on saving money by renegotiating things, there was no clear platform that included specific spending cuts. As a result, the entitlements (U.S. Social Security, Medicare, and Medicaid) from the previous eras would be left in place.

President Trump is no different when it comes to over-promising.

Prior to last year's election, I wrote in the *Monthly Letter* that there was little to distinguish Donald Trump from Hillary Clinton with respect to total spending. However, on the financing side, they differed. Trump was vocal about the need for tax reform that was aimed at a reduction in federal corporate taxation which implied that the deficit would have to be financed with debt (this was somewhat obscured by his claim that a tax reduction would lead to more economic growth which would then generate more tax revenues).[2]

Because Trump wants to reduce taxes while increasing spending, trillions in more bonds will likely be issued.

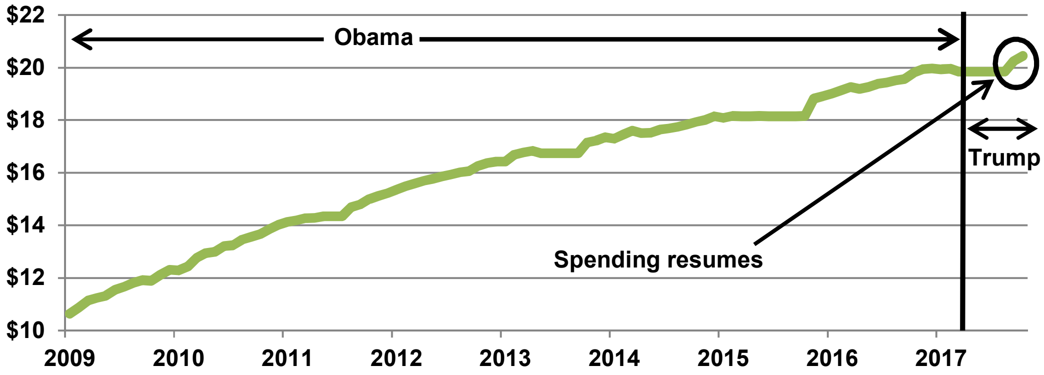
[1] Born in 1966, for those keeping score ☺

[2] https://www.cnbc.com/2016/09/15/trump-claims-his-economic-plan-would-create-35-annual-gdp-growth.html

Now that Trump is president and it looks like tax reform has a reasonable chance to become law (albeit involving a compromise from his original position), projections for further deficits look very likely. It should also be noted that a number of political distractions, the legislative morass in Congress, and a lack of focus from the Trump administration actually slowed the rate of spending over the first year of his term. It was only in the last couple of months that the level of total U.S. federal debt began to climb again (**Chart 2**) after a pause that followed years of eye-popping increases during the Obama administration.

Chart 2:

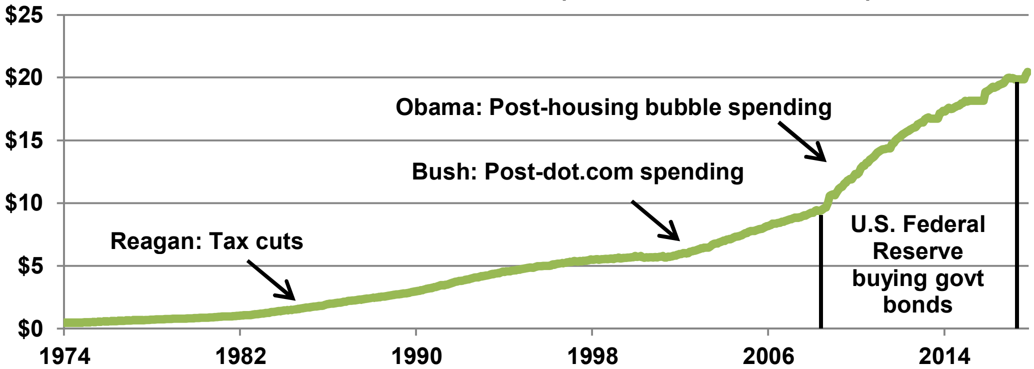
Total U.S. Federal Government Debt (in trillions of dollars)



Source: Bloomberg Finance L.P. as of 11/7/2017

Chart 3:

Total U.S. Federal Government Debt (in trillions of dollars)



Source: Bloomberg Finance L.P. as of 11/7/2017

Once the bills for President Trump-related spending ramp up while taxes are being reduced, the U.S. Treasury will likely have to issues trillions of dollars worth of bonds over the next few years. Unlike the Obama era (**Chart 3**), the U.S. Federal Reserve (the Fed) has announced that it does not intend to purchase the Treasury bonds. In fact, it will try to sell the Treasury bonds (and mortgage bonds) that it still holds beginning at

The problem for the Trump administration is that the U.S. Federal Reserve may not be a keen buyer of those new bonds.

the rate of $6 billion per month and eventually rising to $30 billion per month.[3] So, where the Fed used to aid the government by buying bonds, it may now be moving in the opposite direction. The result is that new buyers will have to be found. Although banks and insurance companies have an appetite for U.S. Treasury securities because of their safety and the slightly higher yield compared to government bonds elsewhere in the world, it is inconceivable that this demand will be sufficient to offset the departure of the Fed from the bond market.

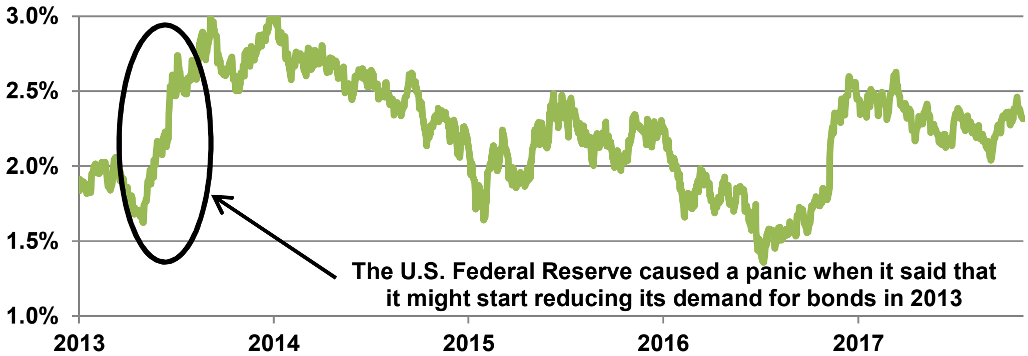
In addition, portfolio managers like myself see bonds as intrinsically more risky than in the past because of the potential damage that interest rate increases (from such a low level) can do to a bond portfolio. As a result, we may not as willing to buy the bonds.

If there is less central bank demand for the new bonds, interest rates will have to be increased to attract demand.

The only way for the U.S. Treasury to entice investors is to offer higher interest rates. However, because U.S. Treasury bonds set the floor for other interest rates, this could mean higher rates for all types of borrowing and could potentially place economic growth at risk. Back in 2013, the Fed first suggested that it was looking at backing away from providing demand to the bond market and the market promptly freaked out by pushing rates up without waiting for the Fed to actually move (**Chart 4**).

Chart 4:

U.S. 10-Year Treasury Bond Yield



Source: Bloomberg Finance L.P. as of 11/7/2017

The new chair of the U.S. Federal Reserve recently appointed by President Trump might be dovish enough to start buying those bonds if the economy stumbles.

President Trump's advisors may have been looking forward when they proposed appointing Jerome Powell to be the next chair of the Fed. Of the replacement candidates, he was most like his predecessor Janet Yellen who championed the notion that the Fed should always be willing to come to the rescue if the economy was at risk. The Trump administration might be depending on that if spending-related debt gets a little out of control, causing investors to push interest rates higher.

[3] https://www.federalreserve.gov/monetarypolicy/files/FOMC_PolicyNormalization.20170613.pdf

Model Portfolio Update[4]

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

No changes were made to The Charter Group Balanced Portfolio during October.

The Canadian dollar continued to weaken through October ending the month down over 3% relative to the U.S. dollar. This provided a bonus for the Balanced Portfolio and added to the results from rising U.S., Canadian, and international stocks. In fact, none of the asset classes used in the Balanced Portfolio's asset allocation decreased during the month. So much for October's reputation for being a scary month!

From one perspective, the markets have ignored a number of concerns (North Korea, the Middle East, record high stock prices) and have continued to climb a "wall of worry." Another perspective would declare that the momentum in U.S. corporate earnings, easy-money policies in Japan and Europe, the promise of U.S. tax cuts, and reduced U.S. regulations are driving the markets higher. At the current time, the second camp is

No changes were made to the Balanced Portfolio model during October.

The weakening Canadian dollar helped the valuation of the non-Canadian investments.

All the asset classes used in the Balanced Portfolio rose during the month.

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 11/7/2017. 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.

winning the argument and we will likely have to wait until there is a seismic event geopolitically or economically for the market to jolted from its upward path.

There is an outside possibility that stock markets might be subject to a psychological selloff if the "FANG" stocks (Facebook, Amazon, Netflix, and Google) begin to level off. They have contributed so much to the recent rise in the markets that it would not be easy finding another engine for further record highs if these stocks take a breather.

With respect to Canadian stocks, the Canadian economy is causing a touch of anxiety as growth is a little more wobbly than it was when it peaked in the 2nd quarter of this year. Plus, NAFTA negotiations have not gone well and Canada is more dependent upon a positive outcome than the U.S. If we head into the holiday period without good progress, the Canadian dollar along with Canadian manufacturing-export stocks could be vulnerable.

Below is the October 2017 performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 5**).[5]

The market appears to be climbing a "wall of worry."

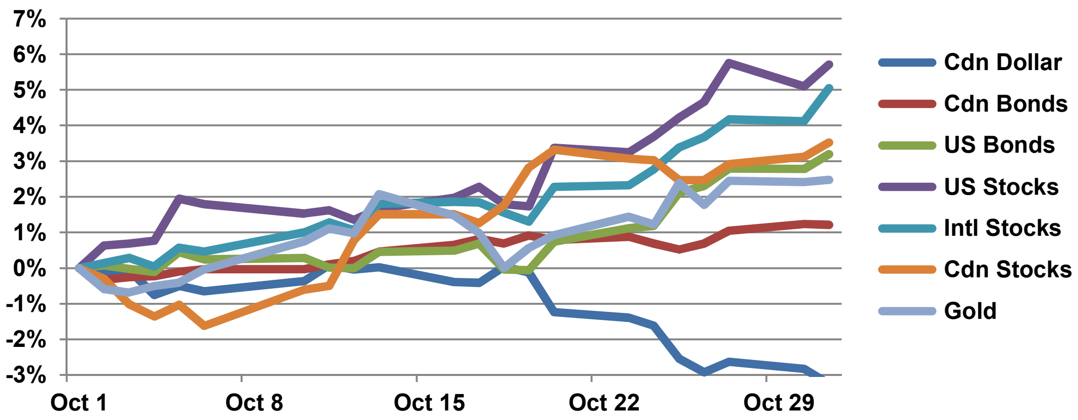
However, there are still some positive fundamentals contributing to the market's advance.

The focus will be to see if technology stocks can continue to drive markets higher in the U.S.

Canadian stocks and the Canadian dollar will have to grapple with some uncertainty regarding the pace of Canadian economic growth.

Chart 5:

October 2017 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 11/7/2017

[5] 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[6]

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
6. East Asian Geopolitics	Moderate	Negative
4. U.S. Fiscal Spending Stimulus	Moderate	Positive
5. Canada's Economic Growth (Oil)	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

[6] 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 November 7, 2017.

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