TD Wealth

Private Investment Advice

The Charter Group Monthly Letter

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Economic & Market Update

Donald Trump Raised My Mortgage Rate! [1]

So much for the predictive power of polling. After the 2013 B.C. provincial election results and the outcome of this year's Brexit vote, perhaps we shouldn't be too surprised. That said, virtually everyone *was* surprised. In contrast to the political and financial state of affairs up until November 8th, the U.S. presidential election flipped U.S. federal politics on its head and also shook up financial markets across almost all asset classes.

The Trump victory had significant implications for almost all types of investments.

[1] Indirectly.

Stock jumped after the U.S. election.

From November 9th to the end of the month, the Dow Jones Industrial Average (U.S. stocks) was up 4.31% and the S&P/TSX Composite Index (Canadian stocks) was up 2.91%. [2]

Bonds fell after the U.S. election.

Longer-term bonds fell especially hard.

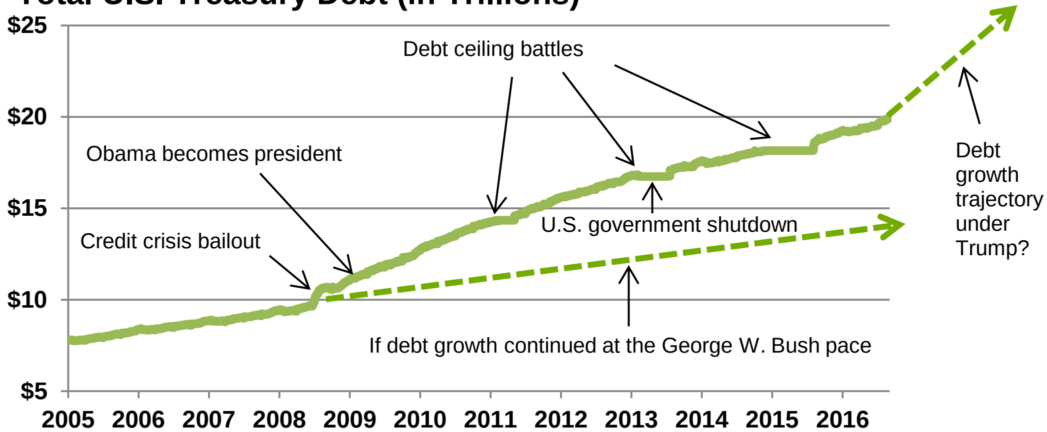
The stock market gains were driven by the promises and rhetoric surrounding a $1 trillion infrastructure program and a significant cut in taxes. Unfortunately, bond investors are not thrilled by any of this. The infrastructure spending has the potential to nominally increase the overall U.S. economic output which concerns bondholders because of the potential for some inflation (and a shift from an extended period of extremely low inflation to *some* inflation is enough to cause indigestion).

Many bond investors are concerned about a significant increase in U.S. government debt and the potential for increased inflation.

The proposed widening of the gap between spending and taxation needs to be financed by increasing debt, which also alarms bond investors. The U.S. government incurs this debt by flooding the bond market with more U.S. Treasury bonds. This increases the supply of bonds in the market at a time when demand for bonds is not rising. As a result, bond investors have to be enticed somehow to buy the additional bonds. The way to do this is to increase the interest rates that these bonds pay. In addition, the increased concern regarding potential inflation will lead the bond investors to demand an inflation premium in the form of an even higher interest rate from those bonds. Clearly, the overriding theme of all this is *higher* interest rates.

Chart 1:

Total U.S. Treasury Debt (in Trillions)



Source: Bloomberg Finance L.P. as of 12/1/2016

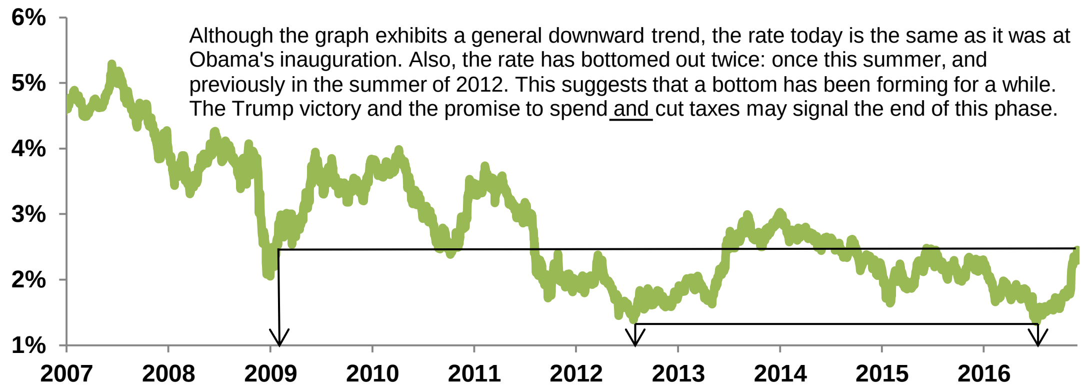
But wait a minute. Didn't Obama's spending significantly increase the U.S. federal debt? Yes, it did **(Chart 1)**. But the growth in the debt was somewhat tempered by higher

[2] Source: Bloomberg Finance L.P.

taxes used to pay for some of that spending as well as budget battles when spending hit the previously legislated debt ceilings. This helped to keep interest rates somewhat range-bound in recent years **(Chart 2)**.

Chart 2:

US 10-Year Treasury Bond Interest Rate



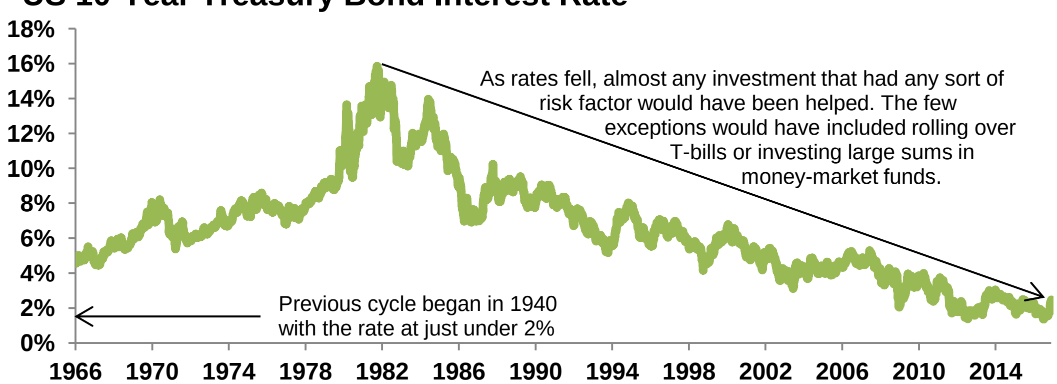
Source: Bloomberg Finance L.P. as of 12/1/2016

There are increasing signs that interest rates may be bottoming after a 35-year downward trend.

It is still early to conclude once and for all if this is the end of the 35-year odyssey of declining interest rates **(Chart 3)**. However, we have already begun to see some impact the election has had with respect to the potential for higher rates. The interest rate on the 10-year U.S. Treasury bond has increased to 2.43% on December 1st from 1.85% on the eve of the U.S. election. The interest rate on the 10-year Government of Canada bond rose from 1.27% to 1.66% over the same period as Canada's debt needed to compete harder for attention in the bond market.

Chart 3:

US 10-Year Treasury Bond Interest Rate



Source: Bloomberg Finance L.P. as of 12/1/2016

The interest rate on government debt has an effect on all other interest rates. This is why we saw some Canadian lending institutions increase the interest rate on mortgages during November. Over time, if the interest rate increases on government debt are sustained, we will likely see higher rates for all types of lending (automobile leases, home equity loans, credit card debt, etc.).

Investment Implications of Higher Interest Rates

The level of interest rates impacts almost all investments. As rates fell from their peak in 1981, it created a tailwind for bonds, stocks, and real estate. There were some cyclical fluctuations in these asset classes, but declining rates almost always provided a positive net impact. It is reasonable to assume that rising rates will generally have an opposite effect. However, the level of interest rate sensitivity across investment varies widely and gauging the specific sensitivities will be a major consideration in portfolio strategy going forward (**Chart 4**).

If interest rates do begin to rise again, the price sensitivity to interest rates will become an important investment consideration.

Investments that tend to suffer the most in a rising rate environment would include the stocks of highly indebted companies, bonds that have a very long time to go until maturity, and emerging markets where debt has been relied upon for growth.

A middle tier of interest rate sensitive investments might include preferred shares (perpetuals), real estate investment trusts (REITs), lower-quality bonds, and companies whose business models involve some leverage (banks, mortgage investment corporations, specialty lenders, some private equity firms, and some hedge funds).

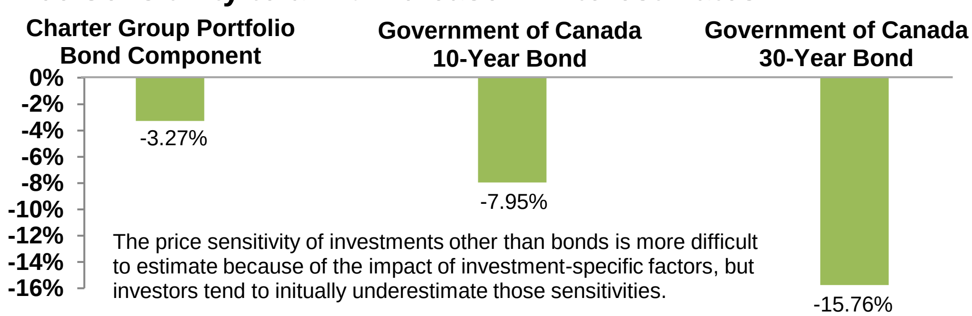
The best defense in a rising rate environment might include companies will little or no debt, consumer staple stocks, shorter-term bonds, and currencies of developed countries where increasing interest rates could attract yield-seeking capital.

Investors tend to underestimate the price sensitivity to interest rates in the investments that they currently own.

Unless an investor was active in the 1970s, they would not have experienced a sustained rising interest rate environment.

Chart 4:

Price Sensitivity to a 1% Increase in Interest Rates



Source: Bloomberg Finance L.P. Durations and convexiities for the Government of Canada Bonds and the Charter Group Portfolio Bond Component calculated as of 12/1/2016

Model Portfolio Update[3]

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

	Target Allocation %	Change
Equities:		
Canadian Equities	15	unch
U.S. Equities	34	unch
International Equities	11	unch
Fixed Income:		
Bonds	28	unch
Alternative Investments:		
Gold	7.5	unch
Commodities & Agriculture	2.5	unch
Cash	2	unch

No changes were made to The Charter Group Balanced Portfolio's target asset allocation or the specific investment holdings during November.

No changes in any of the Charter Group's model portfolios during November.

The post-U.S. election bounces in U.S. and Canadian stocks were substantial enough to benefit the overall portfolio. It also helped that the Canadian dollar was slightly weaker from the election through to the end of the month.

North American stocks were the top performers during the month.

International stocks and gold were down for the month, but the portfolio weightings in these areas were not great enough to significantly impair the overall results.

International stocks, gold, and bond were lower.

Looking forward, the stock market reaction to the Trump victory bears some similarity to the old adage "Buy on rumour. Sell on news." In this case, the saying might be altered to read "Buy on election. Sell on inauguration."

3 The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 6/1/2016. 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 seven portfolios ranging from conservative to aggressive: Very Conservative, Conservative, Balanced Income, Balanced, Balanced Growth, Growth, and Aggressive Growth.

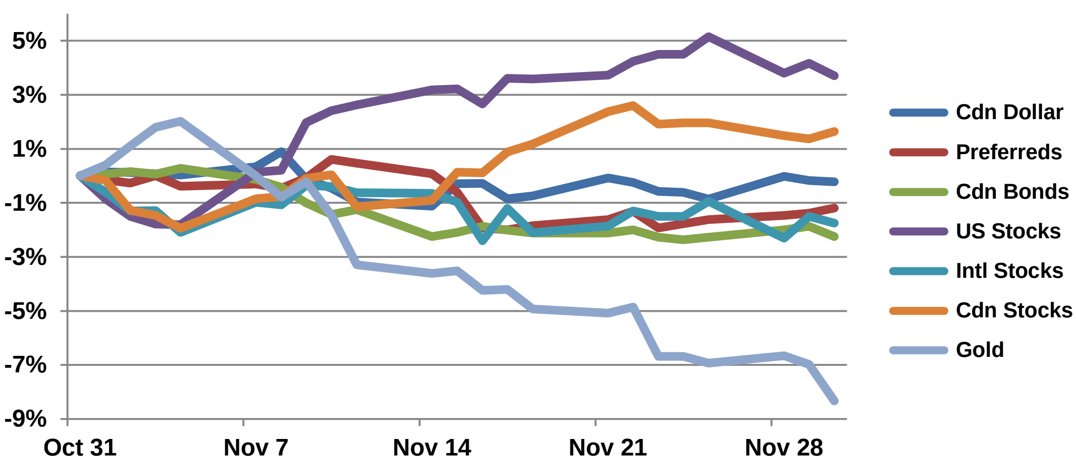
Between now and inauguration day, the media will likely report on Trump's positive rhetoric and a flurry of cabinet member and policymaker appointments. He's not president yet and won't have to face the realities of governing until January 20th. As a result, we might see a bit of a honeymoon period until then. Also, some of America's adversaries have decided to stand back and "study" Donald Trump as Henry Kissinger recently quipped. Trump is an unknown entity when it comes to foreign policy and it may not be worth agitating him with respect to military movements or cyber warfare activity in the meantime.

Potential for a honeymoon period for stocks until Trump has to get down to the difficult business of governing.

A few mileposts to keep an eye on with Trump will be the period right after inauguration, the end of the first 100 days of this term, and the one-year anniversary of his election. At each of these junctures, the investors may have more questions than answers, and that could contribute to some market volatility.

Below is the November performance of the asset classes that we use in the construction the Charter Group Balanced Portfolio (**Chart 5**).[4]

Chart 5:
November 2016 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 12/1/2016

[4] 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; Preferred shares are represented by the iShares S&P/TSX Canadian Preferred Share Index (CPD); Canadian bonds are represented by the iShares DEX Universe (Canada) Bond Index (XBB); U.S. stocks are represented by the iShares 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 Index (XIU); Gold is represented by the iShares Gold Trust (IAU).

Top Investment Issues[5]

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

[5] 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.

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The Charter Group at TD Wealth 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, BC 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 December 5, 2016.

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