TD Wealth

Private Investment Advice

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Economic & Market Update

Asian Demographics = Aging Demographics

Observations during an October trip to South Korea and Taiwan.

During the second half of October, I travelled to South Korea, Taiwan, and Hong Kong. It is always interesting to make economic observations while on the ground and to compare them to previous visits, and to what is reported in the financial press.

It has been about a decade since I was last in South Korea and Taiwan. Not much has changed except for the fact that demographically, both those countries are getting older. An aging population is an economic headwind. Older people require more social services and healthcare which subtract from the capital that is available to invest in future economic growth.

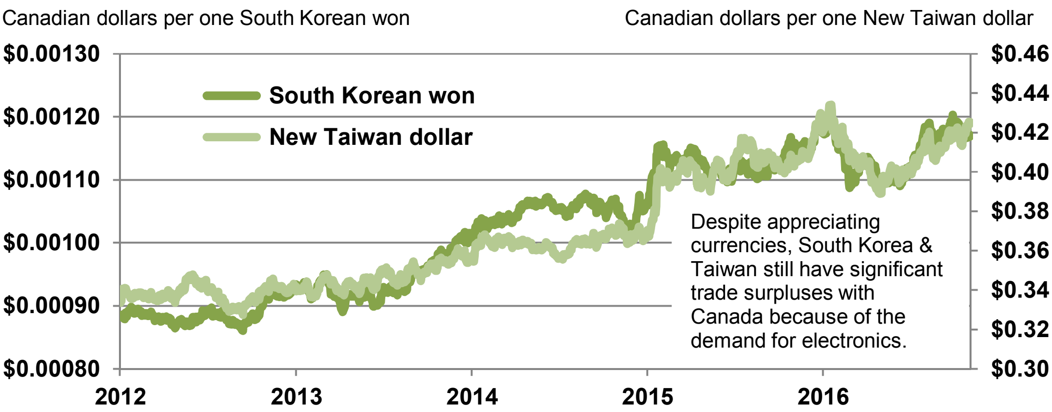
Compared to Canada, it is more prevalent to see older people out and about in South Korea and Taiwan. There are two main reasons for this. First, the fertility rates have plummeted to the point where out of 224 countries examined, South Korea ranks 220th and Taiwan ranks 222nd.[1] Second, by North American standards, there is a dearth of immigration. Apart from South Korean and Taiwanese men looking for foreign brides from other Asian countries, there are no other significant trends that drive immigration. Although Canada also has a relatively low fertility rate (183rd out of 224 countries) and is slowly getting older, the impact is significantly offset by immigrants seeking economic opportunities. As a percentage over overall population, immigrants represent 21.7% in Canada compared to 2.9% and 4.0% for South Korea and Taiwan respectively.[2]

South Korea and Taiwan are getting older.

The problem is associated with a lower fertility rate and a lack of immigration.

Chart 1:

South Korean & Taiwanese Currencies Versus The Canadian Dollar



Source: Bloomberg Finance L.P. as of 11/1/2016

Another surprising sight is how many older people are working in manual labour jobs. When was the last time you saw someone in their 60s or 70s working outside doing landscaping work for pay? For the average citizen, there has not been the accumulation of capital through homeownership or through investing and there aren't significant pensions or a generous social safety net.

When an older generation lacks savings and there are not enough young people, domestic capital formation is weak.

These observations indicate that domestic capital formation is difficult. Most people who have worked all their lives don't have the savings that they can invest back into the economy. That creates a deficiency of investment capital. Additionally, the relative lack

[1] CIA World Factbook 2016.

[2] The UN Report: *Trends in International Migrant Stock*, 2015.

of younger participants in the economy creates a deficiency of human capital. All of this makes South Korea and Taiwan very dependent on foreign capital.

Without enough domestic capital, countries are dependent on foreign capital.

In the current environment, dependency on foreign capital has been a productive strategy because of the anemically low level of interest rates which represents the cost of capital. Foreign capital is cheap at the moment and many countries around the world have taken advantage of it.

South Korea and Taiwan take advantage of foreign capital because it is cheap at the moment.

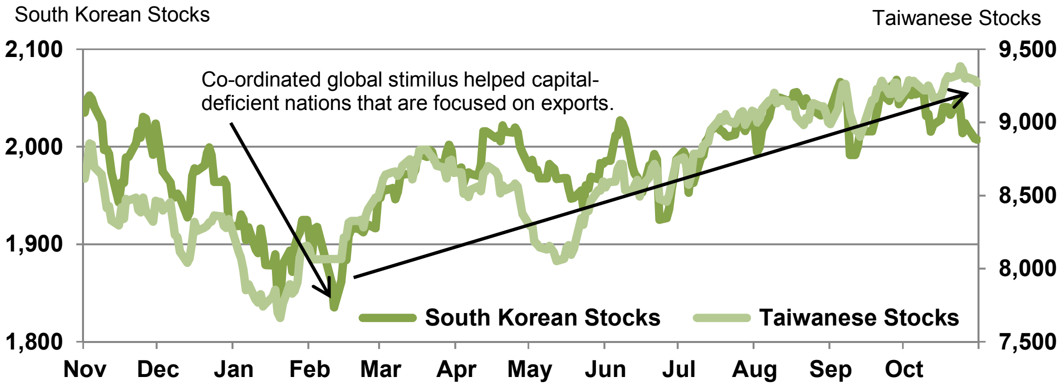
A few other things help South Korea and Taiwan combat their demographic challenges. First has been their geographic proximity to China. Both countries run sizable trade surpluses with China because they manufacture the flat screen TVs, Android phones, semiconductors, and other electronic components that China wants and needs and China is right next door which helps with shipping costs and logistics.

Close proximity to China has resulted in trade surpluses.

Although it is more expensive to ship to Canada, both countries also have trade surpluses with us. And, this is despite the significant weakening of the Canadian dollar versus both the South Korean won and the Taiwanese dollar (**Chart 1**). The increased cost of imported TVs and electronics has not impacted our appetites for those goods.

Chart 2:

South Korean & Taiwanese Stocks - One Year



Source: Bloomberg Finance L.P. as of 11/1/2016
South Korean Stocks represented by the KOSPI Index, Taiwanese stocks represented by the TAIEX Index

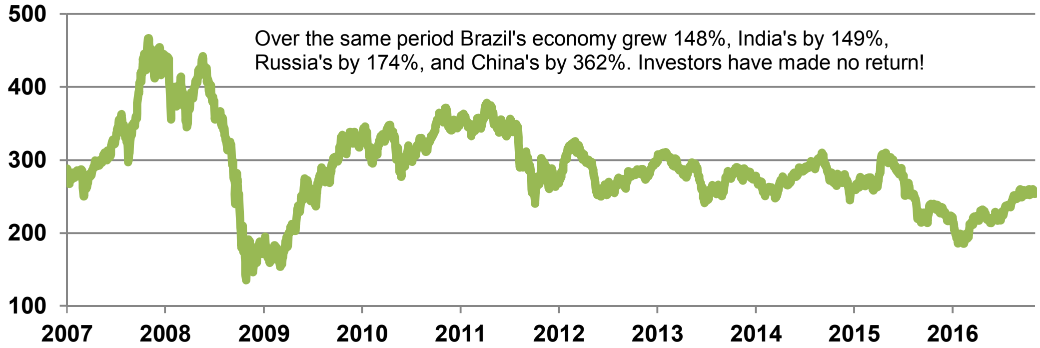
Access to cheap foreign capital and trade surpluses have powered the South Korean and Taiwanese stock markets higher over the past year (**Chart 2**). However, the good times may not last. As discussed, demographics, barring drastic changes in immigration policies, is a growing headwind. Also, the age of very cheap foreign capital may be coming to an end. Global interest rates take their cue from U.S. interest rate policies. At

However, cheap foreign capital and ease of trade access with China won't go on forever.

the moment, those policies are pointing higher rates because of the damage that low rates are doing to retirement savings and pensions. If foreign capital become less cheap, capital flows can reverse quickly as we saw about a year ago when the U.S. Federal Reserve Board increased interest rates by just ¼%.

Chart 3:

MSCI BRIC Index (Brazil, Russia, China, India)



Source: Bloomberg Finance L.P. as of 11/1/2016

The recent jump in South Korean and Taiwanese stock market performance was a surprise and emanated from co-ordinated global stimulus lead by the U.S., Japan, Europe, and China back in February. This ensured an extension of cheap foreign capital for a while longer.

The other problem facing South Korea and Taiwan are related to trade with China. The trade surpluses are likely to shrink as China looks to punish South Korea for allowing the U.S. to install a missile shield against potential North Korean nuclear weapons, and looks to punish the new government in Taiwan for not kowtowing to China's interpretation of Taiwanese sovereignty.

Even though we are not currently invested in South Korea and Taiwan, it is our policy to consider them for investment when the time is right. This contrasts with our policy of avoiding emerging market countries like China, Russia, Brazil, and India.

As I have mentioned in the past, our current policy is to avoid the emerging markets. However, South Korea and Taiwan don't fall into this category. Both countries have reasonable press freedoms, rule of law, and robust democracies that came of age in the 1990's. An investor can reasonably assume that the growth in those economies will be reflected in stock prices over the longer term. The same can't be said of China, Russia, Brazil, and India where eye-popping stretches of economic growth are not captured by investors because of a lack of things like shareholder rights, corporate governance, objective investment analysts, and accounting transparency (**Chart 3**).

As a result, South Korea and Taiwan represent potential investments for us. However, given the trends discussed, we probably won't be investing there over the near- to mid-term.

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 October.

No changes were made to the Balanced Portfolio during October.

Heading into the U.S. presidential election, the Balanced Portfolio is continuing its relatively historical conservative stance. As discussed in last month's edition of the Monthly Letter, the year following an election tends to be okay. Regardless of the victor,

[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.

both candidates would be faced with the same challenges regarding the federal debt, pensions, healthcare costs, and other entitlements with no easy solutions available.

The Balanced Portfolio maintains its conservative stance.

After the post-Labour Day volatility that we saw in September, stock markets in Canada and the U.S. were relatively calm during October. U.S. stocks did slide a little toward the end on the month on investor concerns that the opinion polls showed that the race to the White House was tightening up. However, U.S. presidential elections are unique in that each state has its own election. The polls tend to estimate the national popular vote. However, the polling at the state-by-state level indicates that the things are not as close as the estimates of overall national preferences suggest. If Clinton wins, U.S. stocks may recover some of the losses from the late-October decline.

Some investors concerned that the presidential race is tightening.

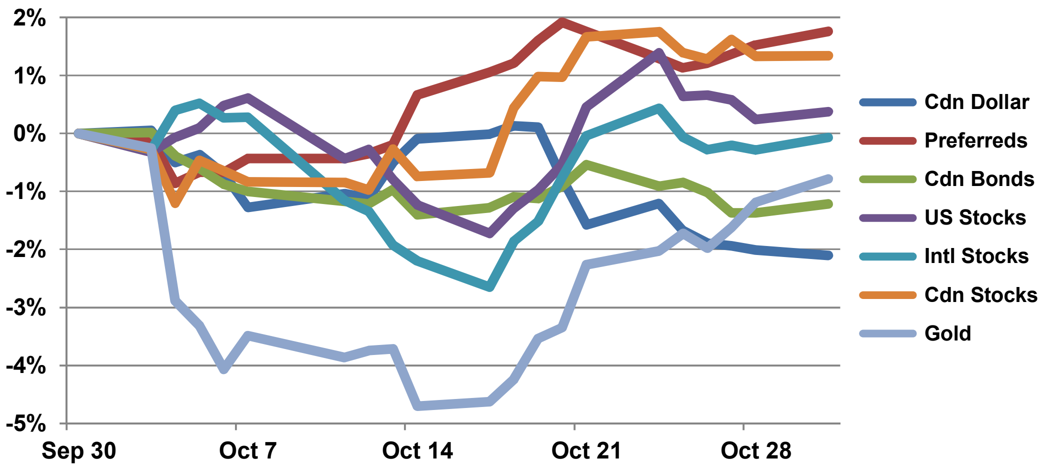
But secondary indicators suggest that the race is not as close as it appears.

Last month the Balanced Portfolio benefited primarily from rising Canadian stock prices and a decrease in the value of the Canadian dollar versus the U.S. dollar (which enhances the performance from the sizable weighting in American stocks (**Chart 4**).[4]

The Balanced Portfolio benefitted from rising Canadian stocks and a declining Canadian dollar in October.

Chart 4:

October 2016 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 11/1/2016

[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. Short-term U.S. Interest Rates	Significant	Positive
3. Canada's Economic Growth (Oil)	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
5. Long-term U.S. Interest Rates	Moderate	Negative
6. Negative Rates - Europe & Japan	Medium	Negative
7. Japan's Money Printing	Moderate	Positive
8. Europe's Money Printing	Medium	Positive
9. Massive Stimulus in China	Light	Positive
10. Intl. Bank & Pension Stability	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.

TD Wealth

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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 November 3, 2016.

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