TD Wealth

Private Investment Advice

The Charter Group Monthly Letter

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Economic & Market Update

Brexit: Will They Stay, Or Will They Go?

On June 23rd, citizens in the UK will go to the polls to vote in the United Kingdom European Union Membership Referendum. Those in favour of leaving the European Union (EU) framed the issue by capitalizing on the phrase "Brexit" (evolving from the term "Grexit" used to describe the possibility of Greece leaving or being ejected from the EU during bailout talks). A little late to the game, the best that the Remain campaign has come up with is "Staysit."

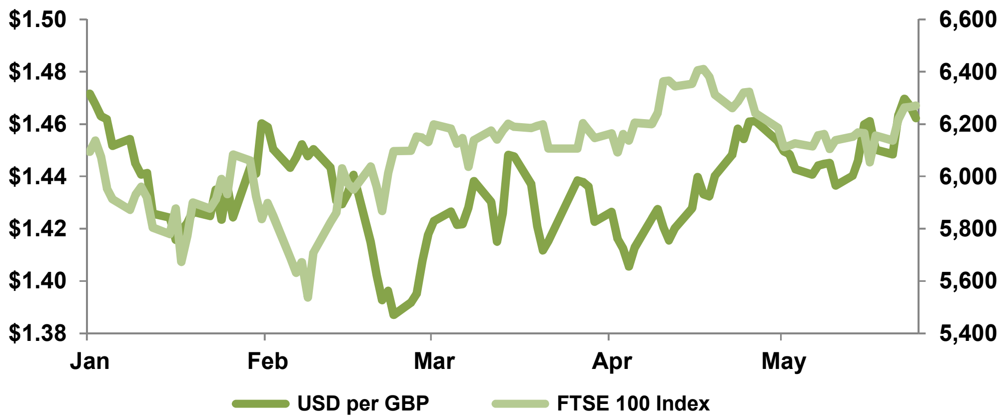
Referendums attract tremendous investor attention, but the longer term impact tends to be more muted than the heated rhetoric suggests.

Establishment leaders are tending to lean towards the Remain campaign as this will mitigate near term uncertainty. This group includes UK Prime Minister David Cameron and Bank of England Governor Mark Carney (a little surprising since he is an unelected technocrat at the head of a supposedly politically-independent institution, *and* a Canadian to boot). Their economic argument is that a Brexit will lead to higher interest rates, a lower British pound, and a potential recession. If these are valid concerns, then the markets appear to be implying victory for the Remain campaign as both the pound and U.K. stocks have been mostly unchanged year-to-date (**Chart 1**).

Establishment leaders preferring stability tend to support the "Remain" campaign.

Chart 1:

British pound & British Equities Year-to-Date



Source: Bloomberg Finance L.P. as of 6/1/2016

British markets are currently pricing in a "Remain" victory.

It is important to note that the debate is fully non-partisan. There are many Euro-skeptics among David Cameron's own Conservative Members of Parliament. This could increase the possibility that the Prime Minister's message will be undercut by people normally expected to agree with him. As the debate reaches a crescendo ahead of the vote, the effect may be to tighten the race (this dynamic is common with other referendums held elsewhere in the world).

A tight race would bring its own set of problems even if UK citizens decide to stay in the EU. As we have seen in referendums also related to separation in both Scotland and Quebec, the losing side almost immediately calls for a rematch. This is such a common tactic that political pundits have created the term "neverendum" to describe it. Some observers have recently stated that the Remain campaign would have to win by at least 60% in order to put an end to the debate for a prolonged period.

A close vote to stay in the EU may only encourage yet another referendum and increase political uncertainty in the UK.

If the Remain campaign wins only by a slim margin, David Cameron's leadership will likely be called into question and it would be reasonable to expect a push for a vote of no-confidence which may garner enough support from the Prime Minister's own MPs.

An ensuing leadership race would bring back the Brexit debate full-force as many of the contenders would certainly burnish their Euro-skeptic credentials in order to contrast how different they are from Cameron.

Regardless of the outcome, the debate will likely continue on.

The issues that prompted the referendum won't go away: control of borders, freedom to make trade deals, EU regulatory burdens, time and effort dealing with the financial issues of weaker member states. The debates go back decades and a single referendum without a very clear result won't end them.

In our allocation to countries outside of North America, the UK has the second largest weighting after Japan. As a result, what happens there can potentially have some impact on our portfolios. The rhetoric of both sides of the campaign suggest we are at a fork in the road and that either route will have permanent consequences. However, regardless of the outcome of the referendum, I would view it as merely another chapter in a very long and drawn out debate. There might be some market reaction in the weeks following the vote, by as the months roll on, it may not be the source of volatility and uncertainty that it is being made out to be.

Up and Down, Down Under – Part 2

A follow up to my April 2016 *Charter Group Monthly Letter* article regarding the observations I made while travelling around Australia in March:

Australia was hoping that the rally in commodities, and especially iron-ore, was real …

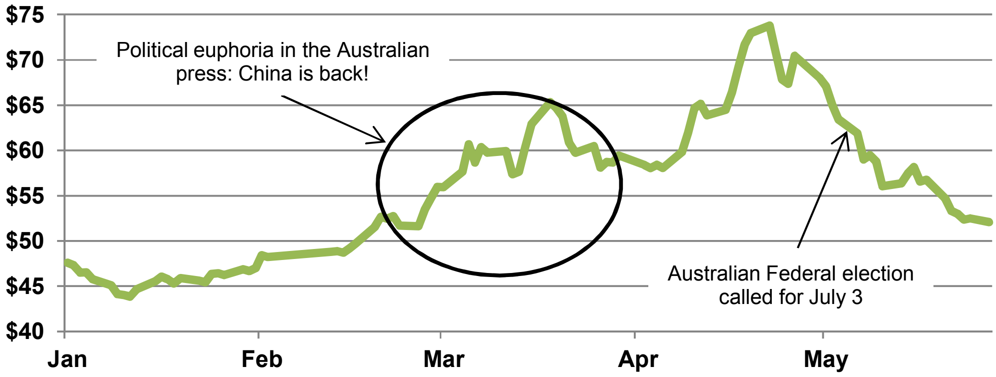
An Australian Federal election has been called for July 2nd. If the current government was hoping for a continuation of the dramatic rally in iron-ore prices and the Australian dollar from earlier this year, they are not going to be pleased with what has been unfolding since my warning (**Charts 2 & 3**).

… but it looks like it might have just been a mirage.

The effect of massive debt stimulus injected into the Chinese economy late last year and early this year has showed signs of wearing off recently. In commodity exporting countries like Australia and Canada, there was much excitement as commodity prices and currencies abruptly turned a corner in January in the hope that China's economic growth was about to accelerate again. Now that there are some conflicting economic signals coming out of China similar to last autumn, the Australian dollar has plunged

Chart 2:

Iron-Ore (USD per tonne) Year-to-date in Dalian, China



Source: Bloomberg Finance L.P. as of 6/1/2016

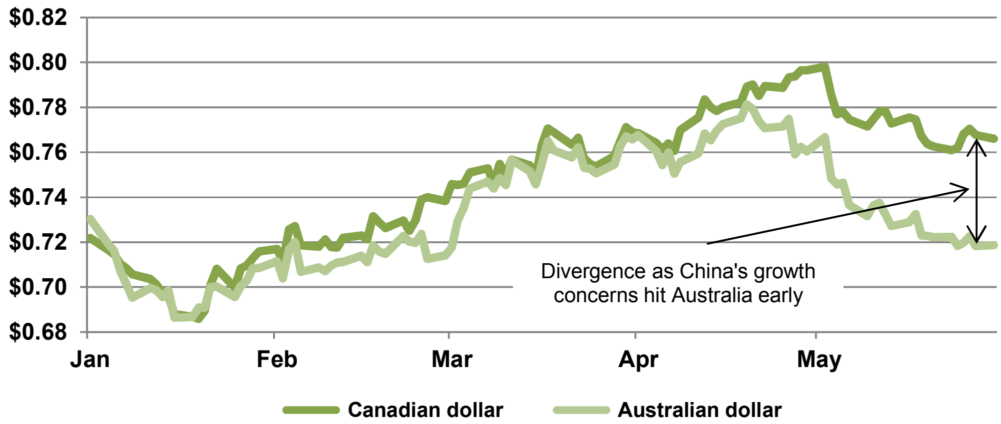
As Australia goes, so goes Canada?

Economic slowing in China will continue to challenge Canada.

rapidly. Although the Canadian dollar is down as well, some encouraging economic news regarding the US and a rebound in oil prices have obscured, from a Canadian perspective, the issues related to China. The Australian economy is a little more levered to China than the Canadian economy, but not by much. If the realities of a slowing China are beginning to weigh again on Australia, it is likely only a matter of time before it also fully impacts the Canadian economy and dollar. (**Chart 3**).

Chart 3:

The Canadian dollar vs The Australian dollar (all priced in USD)



Source: Bloomberg Finance L.P. as of 6/1/2016

Model Portfolio Update[1]

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 May.

Gains in US stocks and the US dollar were significant contributors to performance during May.

Gains in international stocks also helped.

Strong performance in the US markets combined with a stronger US dollar helped power the Balanced Portfolio higher. The S&P 500 Index (U.S. large company stocks) gained over 6% during the month while the US dollar gained over 4%. The bounce back in the US dollar reversed a dramatic weakening trend extending back to mid-January.

Although the Canadian dollar fell to oversold levels in January, I felt that that the subsequent rally was overdone (see "Loonie Tunes" in the May 2016 issue of the *Charter Group Monthly Letter*). As a result, the decline in the Canadian dollar during May was not very surprising. I would feel more comfortable with a Canadian dollar in the low 70's range vis-à-vis the US dollar.

[1] 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.

The other major contributor to positive performance during the month was the weighting in international stocks. The weakening of the Canadian dollar further enhanced the gains in those stocks for Canadian investors.

Gold was the largest detractor from performance during the month as US policymakers talked about increasing interest rates.

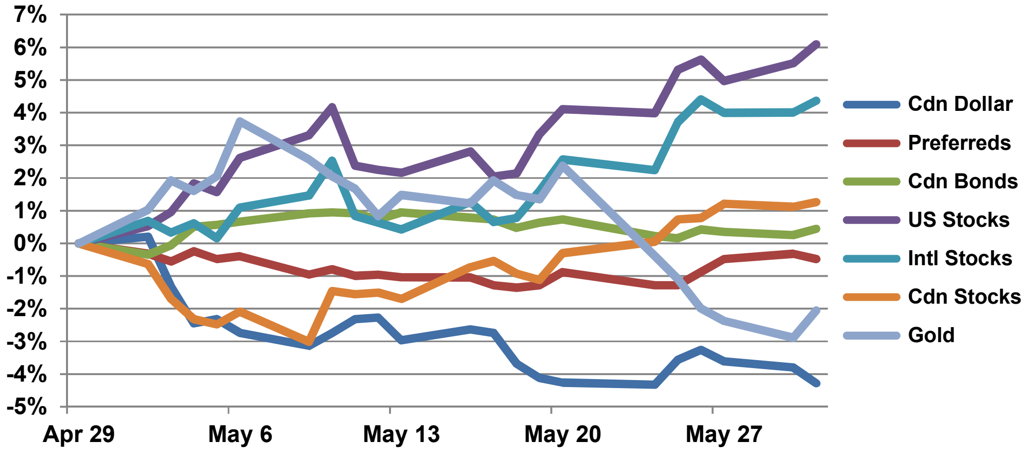
After a torrid start to the year, gold cooled off in May and was the largest detractor from performance. Gold doesn't typically do well when the talk of possible interest rate increases begins to swirl in the US. Higher interest rates and tighter availability of credit reduces the possibility of long-term inflation and gold, as an inflation hedge, gets sold. However, if it appears that the US Federal Reserve will hike rates once and then back off for longer than expected, gold has a chance of doing well like we saw after the December rate increase.

Overall, the Balanced portfolio got off to a very good start at what is a trickier time of year (see "Sell in May and Go Away" in the May 2016 issue of the *Charter Group Monthly Letter*). That said, the Balanced Portfolio is still maintains a conservative bias relative to where it has been historically.

Below is the May 2016 performance of the asset classes that have the most significant impact on our model portfolios, including the Balanced Portfolio (**Chart 4**).[2]

Chart 4:

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



Source: Bloomberg Finance L.P. as of 6/1/2016

[2] 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[3]

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. Japan's Money Printing	Moderate	Positive
7. Europe's Money Printing	Medium	Positive
8. Negative Rates – Europe & Japan	Medium	Negative
9. Massive Stimulus in China	Light	Positive
10. Middle East Geopolitics	Light	Negative

[3] 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 June 1, 2016.

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