TD Wealth

The Charter Group Monthly Letter

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Economic & Market Update

Trumpian Trade Tiffs & Tariffs

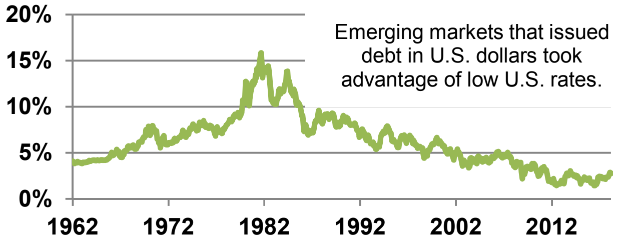
Stock markets were in the midst of making a nice recovery from their early February lows when threats of tariffs and the potential scuttling of trade deals began to dominate financial news headlines in March.

President Trump campaigned on the notion of getting tough on trade.

Regardless, the markets appear surprised that he is following through on this promise.

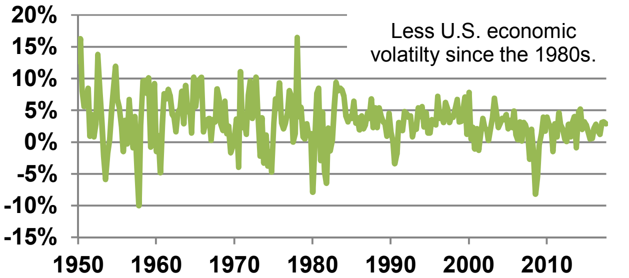
This should not have been a big surprise as President Donald Trump campaigned fiercely on these issues. It was unlikely that we were going to go through an entire four-year presidential term without an attempt to match policy with campaign rhetoric. Generally, trade disputes are seen as bad for economic growth for all sides. Perhaps this is what many investors may have been contemplating. However, headlines often only provide a simple view of things and the second-order effects of trade disputes between the U.S. and its trading partners might be a little different than the initial fears.

Chart 1:
US Interest Rate of 10 Year Treasury Bond



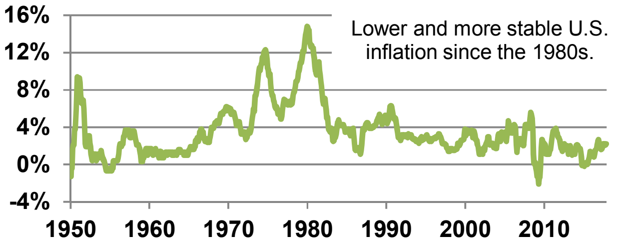
Source: Bloomberg Finance L.P. as of 4/5/2018

Chart 2:
US GDP Growth (Quarter over Quarter)



Source: Bloomberg Finance L.P. as of 4/5/2018

Chart 3:
US Annual Inflation



Source: Bloomberg Finance L.P. as of 4/5/2018

Having had the opportunity to travel extensively around the world over the last couple of decades, I have repeatedly taken note of the difference between the actual nature of international economies and how they are reported in the financial press. Usually the press coverage is kind and somewhat congratulatory. Minor financial and political reforms are trumpeted. The promises of future reforms are often written about as though they are a certainty. And, often there is an attempt to correlate economic growth with these reform measures.

In the media, international economies are often given the benefit of the doubt with respect to potential.

As a result, their abilities to respond to trade threats may be over-estimated.

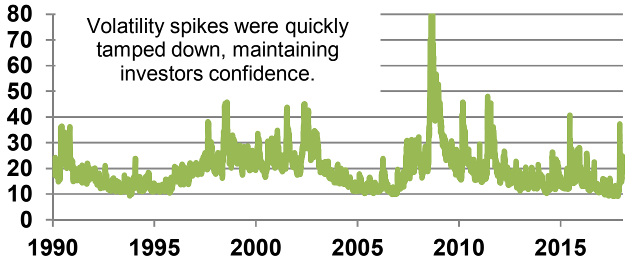
In contrast, economic growth elsewhere is almost always a result of factors emanating from the U.S. economy. The U.S. aggressively pursued the liberalization of international trade following the Cold War. This was the era which gave us the North American Free Trade Agreement (NAFTA) and the ascendency of China to the World Trade Organization (WTO) which was enthusiastically endorsed by the U.S.

After almost three decades of a unanimous push for trade liberalization, political support for it in the U.S. has fragmented.

The U.S. also became the exporter of low interest rates to the rest of the world by lowering their level of interest rates over the last 35 years. It is hard to conceive developed and emerging economies outside of the U.S. expanding at the rate they did if they were burdened with the kind of interest rates that prevailed until the early 1980s (**Chart 1**).

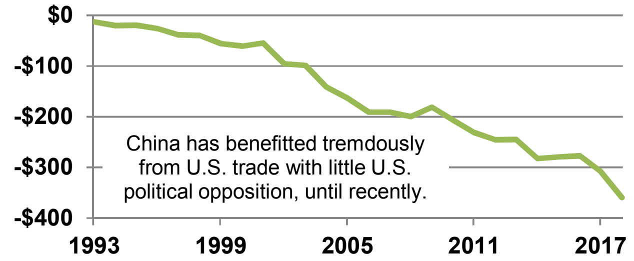
Finally, from an economic and financial point of view, the last three decades have been

Chart 4:
S&P 500 Volatilty Index



Source: Bloomberg Finance L.P. as of 4/5/2018

Chart 5:
Annual US Trade Deficit with China (in billions)



Source: Bloomberg Finance L.P. as of 4/5/2018

a relatively quiet period compared to history. This helped increase global growth by reducing investment uncertainty. We don't have the same magnitude of fluctuations when it comes to economic growth, inflation, and investment markets (**Charts 2,3,&4**). Although economic and business cycles are hardly dead, proactive U.S. monetary and fiscal policies have done a remarkable job of kicking the can down the road and buying relative calmness in the meantime (proactive policies likely contributed to the economic and market turmoil of 2008-09, but the U.S. doubled-down with even more dramatic policies to resuscitate things and effectively kept the long-term policy-engineered growth intact).

International economies have benefitted from an environment that was the result of U.S. economic leadership.

The vulnerabilities of these economies may become evident in a more hostile setting.

All of this has added up to an environment in which international economies have thrived.

China has been the biggest beneficiary of this environment. There were specific aspects of the Chinese economy that helped including a young demographic, a vast pool of low-cost labour, and a "command & control" economy which can adapt to opportunities more quickly than democracies which require compromises.

China has been the biggest beneficiary of American economic leadership. This might lead to relatively greater vulnerabilities if things get really adversarial.

China has also had an additional benefit of an uneven playing field. American firms have been seduced by the notion of having access to a potential market of 1.4 billion consumers and accepted demands for technology transfers and joint-venture requirements instead of being able to sell unhindered into China. Conversely, any restrictions facing Chinese companies selling into the U.S. have paled by comparison.

Up until the last few years, there was not much political will in the U.S. to demand fair and free trade with the China. Also, there has been a strong U.S. corporate lobby against this for fear of risking access to Chinese consumers. There was also a hope that once China reached a sufficient amount of economic success, Chinese politicians would accept fairer terms. However, the sense is that after 15 years of WTO membership, China appears to be showing no signs of trading on fairer terms to the point where this has become a political issue in the U.S. significant enough to impact election outcomes.

President Trump's calculation might be that China and other countries stand to lose more than the U.S. in a trade war. He may be right. In the end, all countries, including the U.S., could be worse off, but the U.S. could end up with a larger percentage of a smaller global trade pie. It is hard to imagine China succeeding to the extent that it has if it was limited to trading with Europe, Russia, and other areas of Asia. The spending power of the American consumer is unrivalled.

Targeting China might allow President Trump to score some rhetorical victories to be used in future elections.

But these victories may not necessarily be real ones in an economic sense.

It is important to note that China has not graduated to a "consumer-driven" economy like we see in the U.S., Canada, and Western Europe.[1] The bottom line is that China still badly needs U.S. consumers to buy their products. And, China can ill afford a loss of access to innovative U.S. technology (China has proven capable of copying and even enhancing some current technologies, but the innovation required to create the next game-changing product is still likely to emerge from the U.S.).

The whopping trade deficit that the U.S. now has with China (**Chart 5**) underscores China's vulnerability. As a result, any effort by the U.S. to even things out could hit China much harder and force them to find less attractive alternative markets for its exports.

A probable outcome from all of this is a partial climb down on both sides once the rhetorical objectives have been achieved. Besides, it would be very difficult to measure the net results of trade barriers and tariffs for use in future election campaigning.

The markets as a whole may know this. The recent volatility may not have as much to do with trade issues as the media suggests. Instead, the concerns over interest rates and the valuation of technology stocks which led to the initial bout of volatility in late January may still be the primary underlying reason for the volatility that we are witnessing now.

In the end, all sides may significantly climb down once they have achieved some respective rhetorical victories.

[1] CIA World Factbook 2018: Household consumption as a percentage of GDP stands at 39% for China, 58% for Canada, 65% for the U.K., and 69% for the U.S.

Model Portfolio Update[2]

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	-1.5
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	3.5	+1.5

During March, a couple of the Canadian bonds in the Balanced Portfolio matured and we let the proceeds from the maturities flow to cash. It is likely that we will deploy the cash back into two new bond positions in April.

Two bonds matured. Instead of reinvesting immediately, the proceeds remain in cash.

During the first quarter, the Portfolio was impacted by the volatility that we saw across stocks, bonds, currencies, and commodities. Despite the roller-coaster ride that we saw in later March, volatility actually peaked in early February. After that point, contributions from various parts of the investment markets essentially cancelled each other out through to the end of the quarter.

The first quarter of 2018 was the most volatile for stocks in 2 ½ years.

However, over the quarter, other areas of the investment markets provided some counter-balancing effects.

Going forward, volatility could be a continuing theme because of the prospect of rising interest rates in the U.S. and Canada. There is currently a 79.9% probability that the U.S. Federal Reserve Board will increase the Fed Funds Rate by 0.25% by their June

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 4/1/2018. 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.

13th meeting, and a 70.0% probability that the Bank of Canada will increase the Bank Rate by 0.25% by their July 11th meeting.[3] Economists are beginning to write about how rising rates might impact indebted companies and consumers as well as real estate.

The headlines may focus on the drama of trade wars, but increasing interest rates in the U.S. is a source of underlying anxiety.

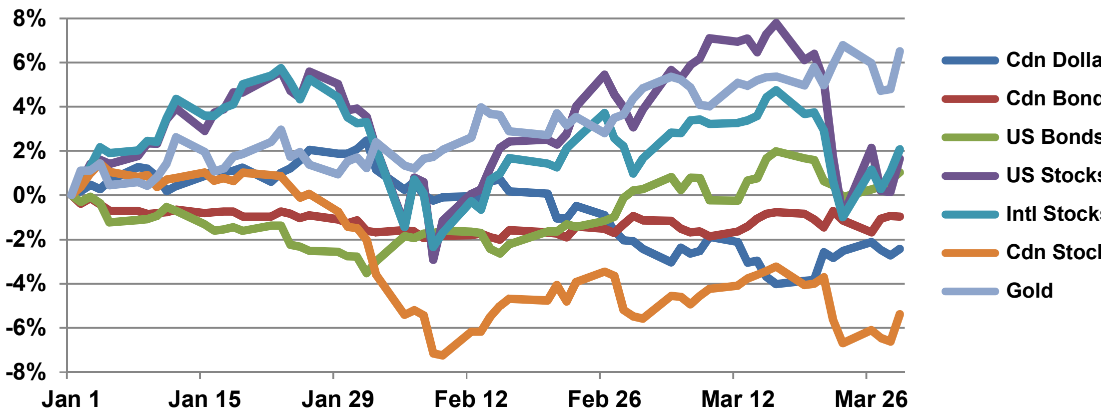
As mentioned in the first section of this *Monthly Letter*, there is intense media focus on looming trade battles. But again, this in the end might not be as much of a concern as compared to the challenges imposed by rising rates (and more specifically, the pace of rising rates).

With respect to Canada, the Canadian dollar had a slight bounce toward the end of March on optimism that NAFTA negotiation timetable has sped up and may be nearing some sort of conclusion in time for U.S. mid-term elections and the Mexican presidential election only July 1st. However, there is nothing concrete and from some perspectives the recent developments regarding NAFTA look more like "a plan to work on a plan" to tackle a few contentious issues sooner than later.

There was some optimism factored into the Canada dollar regarding NAFTA, but that may be somewhat premature.

Below is the First Quarter 2018 performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 6**).[4]

Chart 6:
1st Quarter 2018 Performance of the Asset Classes (In Canadian dollars)



Source: Bloomberg Finance L.P. as of 4/2/2018

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[3] Source: Bloomberg Finance L.P. as of 4/5/2018. The implied probability of rate changes is based on the current prices of interest rate futures contracts.
[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; 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[5]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. Long-term U.S. Interest Rates	Moderate	Negative
3. East Asian Geopolitics	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
5. U.S. Fiscal Spending Stimulus	Moderate	Positive
6. Trade & NAFTA Negotiations	Moderate	Negative
7. Short-term U.S. Interest Rates	Medium	Negative
8. Massive Stimulus in China	Medium	Positive
9. Canada's Economic Growth (Oil)	Medium	Negative
10. Middle East & Russia Geopolitics	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, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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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 April 5, 2018.

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