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The Charter Group Monthly Letter

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Economic & Market Update

Pipeline Power Play

Lately we have been inundated with wide-ranging news coverage of the debate over pipeline construction in Canada: delays regardless of approvals, connecting carbon taxes with approvals, looming provincial trade wars, court battles, and federal versus provincial jurisdictional disputes. Much of the limbo is explained by politics: a balance of power dynamic in B.C., an unpopular government in Alberta, a sliding government in Ottawa, and a federal-provincial power struggle that could re-ignite the "Quebec issue."

Canada's economy is what it is: Consumer-driven and built on a foundation of resource exports.

Pretending that it is something else does not make it so.

We are interested in the economic and financial impact and the strategies needed to address any investment opportunities or threats. Who ends up winning politically as a result is up to the voters. Once that is determined, we will then distill the results into factors that might impact our investment portfolios.

So, what are the potential portfolio implications?

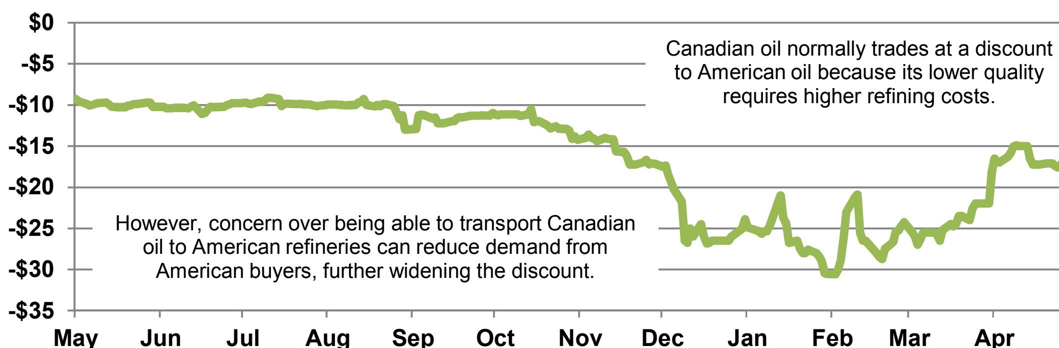
Since we are investing on the behalf of predominantly Canadian high net-worth investors who will eventually have spending needs in Canadian dollars, exposure to Canadian stocks and the Canadian dollar will always be a feature of our portfolio strategy (although we do vary the amount of exposure depending on our insights). With that, a lack of completed pipelines and the corresponding economic fallout would pose challenges in managing Canadian investor portfolios.

Anti-pipeline proponents often attempt to make economic arguments, but their assumptions can become stretched.

Some have argued that there would be little or no adverse economic impact. Anti-pipeline proponents often claim that moving away from pipelines will actually benefit our economy by spurring the development of new alternative energy businesses (it should be noted that China plans to capture this potential opportunity by offering massive subsidies in conjunction with its "Made in China 2025" national economic strategy). Some go even further by disputing the fact that the oil sector is a significant driver of the Canadian economy despite clear evidence to the contrary. When this contingent begins to "play economist," they could be hurting their case beyond their traditional base of support. Average voters can sometimes be seduced by a sleight of hand in an economic argument. But, when the logic becomes severely stretched, common sense is usually enough to move voters in the middle to the other side of the argument.

Chart 1:

Price Discount of Canadian Oil Compared to U.S. Oil (in USD per barrel)



Source: Bloomberg Finance L.P. as of 5/1/2018. The USD price per barrel of Western Canadian Select (WCS) versus West Texas Intermediate (WTI). WCS would normally trade at a discount anyway since it is a heavy crude that requires higher refining costs, but the discount can widen because of delays and increased costs associated

The reality is that energy is a major driver of the Canadian economy and will remain as one for years to come without a different industry emerging to take its place anytime soon.

One aspect that can't be ignored is that the structure of the Canadian economy has an enormous amount of inertia. Regardless of political outcomes, our economy five years from now is probably going to look basically what it looks like now. To shift reliance from energy exports, or even reliance on specific form of energy, would reasonably take a

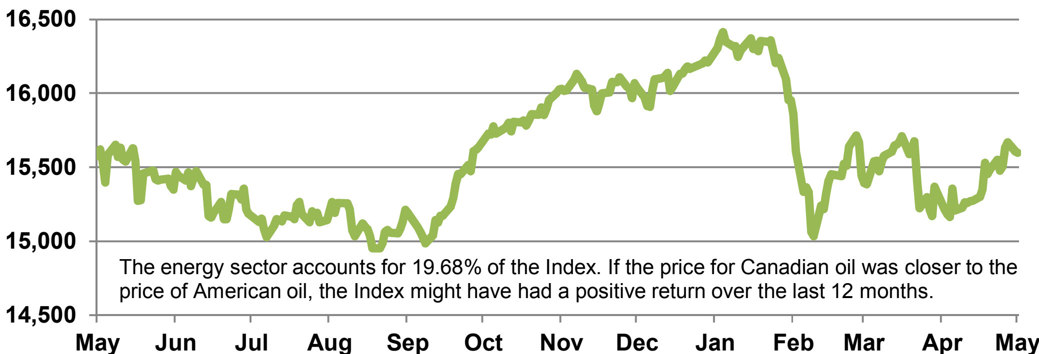
generation. Even then, the economic incentives would have to be significant in order to develop new industries. This might include a tax regime that encourages private investment or a reduction in regulatory burdens in order to reduce costs. At the moment, there is not much progress or general political support in these areas.

The irony is a stronger oil sector could generate the wealth to help counter-balance the costs of a transition to an alternative form of energy.

One thing that could ease the transition to an alternative energy regime would be increased national wealth. The voting public might be more amenable to the costs associated with new forms of energy if, as a whole, they are doing better economically. The conundrum is that current energy exports *are* a major driver of economic growth. Pipeline expansion could add to that growth and provide the additional wealth needed to drive a transition over the next generation.

Instead, governments are often convinced that technology industries will grow sufficiently in order to replace the economic contribution from oil exports.

Chart 2:



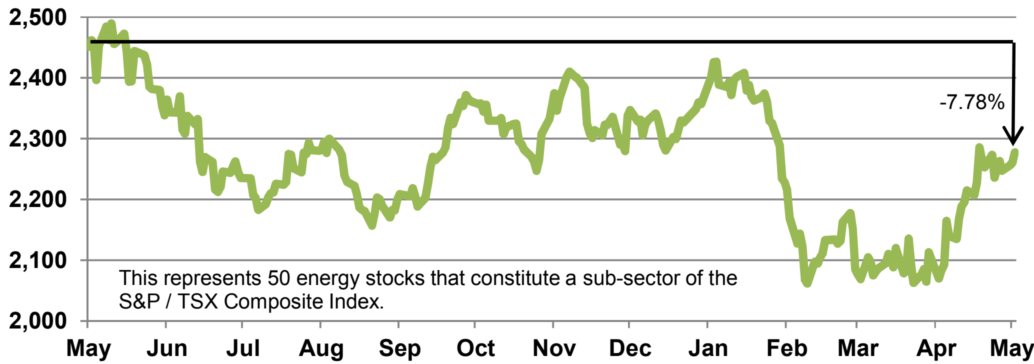
Source: Bloomberg Finance L.P. as of 5/1/2018

However, the problem is that governments and voters aren't interested in addressing the challenges and incentives need to establish a powerful technology sector in Canada.

Unfortunately, the mandates provided by the voters and the conflicting legal and regulatory processes appear to be getting in the way of this potential. And, discouragingly, local and national politicians are resurrecting the "high tech nirvana" economic strategy evidenced by an extremely hyped event in Vancouver at the end of April announcing that Amazon is looking to possibly add 3,000 jobs in Vancouver by 2022. To add some perspective, Glassdoor.com indicates that there are 2,949 job openings at Amazon's Seattle headquarters alone, right now! The possibility of 3,000 jobs in Vancouver is better than no jobs at all, but we feel that it hardly makes the region a "Silicon Valley North" or even a "Seattle North." And it certainly doesn't qualify as part of a strategy that will help Canada to transition to non-energy sectors in the future. The energy sector has massive scale and is built upon generations of expertise involved in extracting and getting product to markets. The tech industry in Canada is basically a sideline endeavour at the current time.

Chart 3:

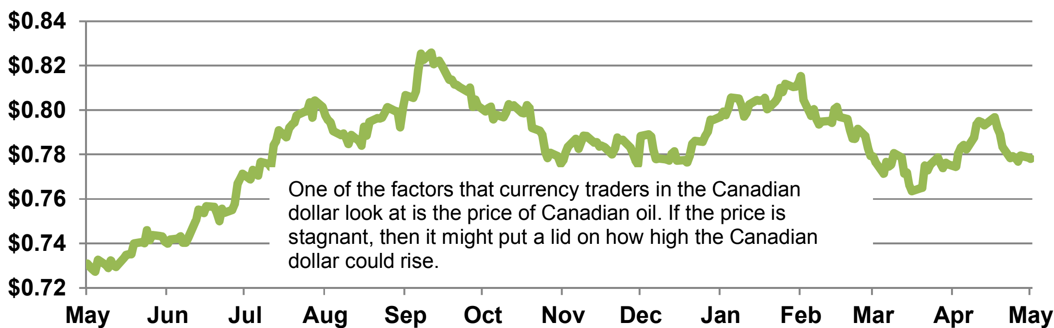
S&P / TSX Composite Energy Sector Index



Source: Bloomberg Finance L.P. as of 5/1/2018

Chart 4:

Canadian dollar versus U.S. dollar - One Year



Source: Bloomberg Finance L.P. as of 5/1/2018

Without a plan to expediently drive towards transparent pipeline conclusions, political fighting and a lower price for Canadian oil might keep a lid on Canadian stock market performance and the value of the Canadian dollar.

Without a coherent pipeline strategy, Canada will have a more difficult time generating wealth, tax revenues, and energy industry profit margins. Obviously, there are jobs at stake as well as the income taxes that those jobs would produce. Additionally, there would be less in provincial royalties collected from the energy producers. And, finally, the discount in the price of Canadian crude versus American crude (**Chart 1**) would have little chance of shrinking (many potential buyers of Canadian crude worry about having it stuck in a storage tank for a while before finding room on a train or in a pipeline in order transport it out of Western Canada). With a clear and balanced pipeline strategy, a positive outcome on all these issues could help facilitate that transition to an alternative energy regime. Instead, we could be setting ourselves up for a summer of constitutional acrimony and facing the resulting headwinds that could impact Canadian stocks (**Charts 2 & 3**) and the Canadian dollar (**Chart 4**).

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Model Portfolio Update[1]

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

There were no changes to either the asset allocation of The Charter Group Balanced Portfolio or to its individual holdings in April. In the last edition of the *Monthly Letter*, we talked about the maturities of two bonds during the month of March and how we were going to let the proceeds remain in cash for a while. Over the interim period, the bond market has been struggling, so we decided to hold off on replacing the matured bonds for another month.

No changes were made to the model portfolios during April.

The proceeds from the bond maturities in March remained in cash. It's a little blustery in the bond market and we want to wait things out for a while.

During April, the day-to-day volatility in U.S. stocks settled down towards the end of the month. The main reason was likely the ratcheting down of geopolitical tensions with North Korea and some decent corporate earnings results for the first quarter of the year.

The Canadian dollar eased off towards the end of the month which helps the performance of the U.S. dollar-denominated assets in the Balanced Portfolio. The

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 5/1/2018. 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.

enthusiasm that foreign currency traders had for the Canadian dollar at the beginning of April was eroded with the realization that Canada's economy may not be able to withstand as many interest rate increases as originally anticipated. The next hurdles for the Canadian dollar will focus on any pipeline debate fallout and the North American Free Trade Agreement (NAFTA) negotiations. Although it looked like progress was being made on NAFTA, it quickly became apparent that things were getting bogged down, potentially pushing back the timing on a revised agreement.

Other themes in April were calmer day-to-day volatility in U.S. stocks and a weakening in the Canadian dollar in the 2nd half of the month as some enthusiasm around NAFTA faded.

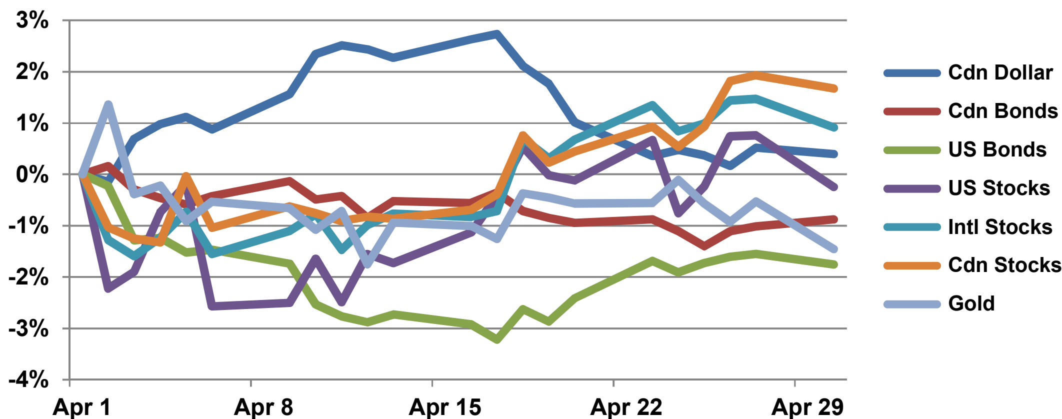
Seasonally, the six-month period beginning in May can test the resolve of equity investors. The main concern this time around is the potential pace of interest rate increases and the stress that this can place on borrowers who have been an important component of economic growth in North America.

Looking forward, we continue to keep an eye on the pace in interest rate hikes as they could create investment market volatility.

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 5**).[2]

Chart 5:

April 2018 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 5/1/2018

[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; 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[3]

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. U.S. Fiscal Spending Stimulus	Moderate	Positive
5. East Asian Geopolitics	Moderate	Negative
6. 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	Positive

[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, 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.

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The information contained herein is current as of May 1, 2018.

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