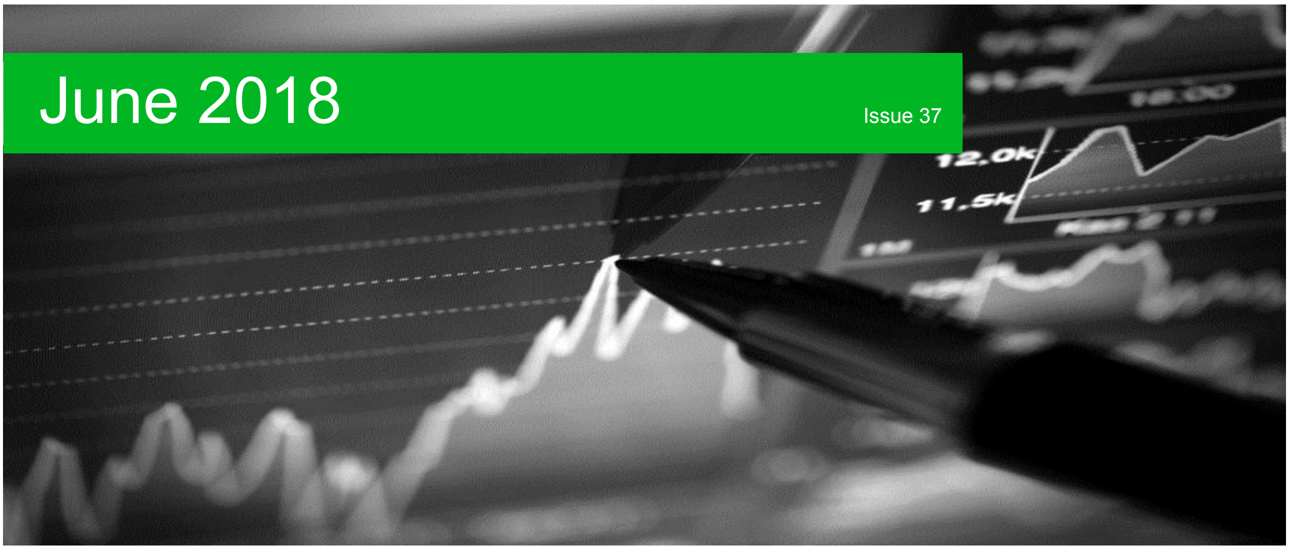
TD Wealth

The Charter Group Monthly Letter



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Economic & Market Update

The "Middling" Kingdom

Figure 1 - Source: Mark Jasayko

For a week in mid-May I attended the 71st CFA Institute Annual Conference in Hong Kong. It was an opportunity to gain new insights into investing in general and investing in China in particular. And, as I am apt to do after a trip, I was able to take advantage of the period between mealtime and bedtime on the return flight home (**Figure 1**) to write down some observations and thoughts for the *Monthly Letter*.

China is great at getting positive headlines about their economy.

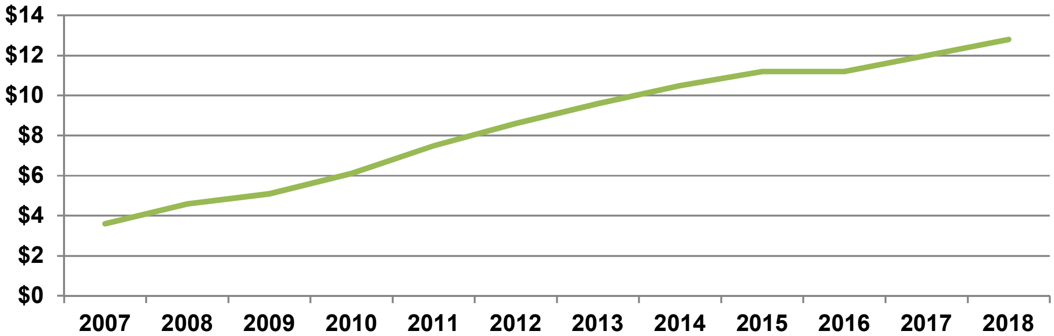
But, does this mean that there are opportunities for investors?

Potential investments in China can be seductive because of high economic growth, the promise of reforms, and massive government incentive programs.

For an investor who has not been to the region and casually scans headlines related to China's economy and financial markets, it often appears like a great place to invest. The economy is growing officially at 6.8%,[1] and the economy has more than doubled over the last decade in U.S. dollar terms (**Chart 1**). Plus, at current growth rates, China's economy is projected to overtake the U.S. economy in terms of total size by 2029.[2]

Chart 1:

Size of China's Economy in USD (in trillions)



Source: Bloomberg Finance L.P. as of 6/7/2018

Another highlight is China's ambition to construct trades routes over land and sea on a foundation of massive infrastructure along the way to Europe in order to facilitate more trade. The $1 trillion dollar project is known as "One Belt, One Road."[3]

Yet another item in President Xi's smorgasbord of economic initiatives is something called "Made in China 2025" (sloganeering is somewhat of a Chinese Communist Party tradition!) which attempts to challenge American technological leadership by incentivizing home-grown high-tech research and industrial development.

So, is it onward and upward for the Chinese stock market? Maybe. Maybe not.

I was also in Hong Kong about 10 ½ years ago attending a different conference and the presenters from Mainland China were unanimously optimistic about the prospects for the Chinese stock market back then. Attendees of that conference who invested based on that rosy outlook, and held on for the intervening decade, are probably not happy. Since then there has been a bit of a roller-coaster ride and the Shanghai Composite

[1] Bloomberg Finance L.P. as of 6/7/2018
[2] https://www.bloomberg.com/graphics/2016-us-vs-china-economy/
[3] Common estimates of the financial size of "One Belt, One Road" are $1 trillion, but some estimates go as high as $8 trillion if all President Xi's visions are met: https://www.csis.org/analysis/how-big-chinas-belt-and-road

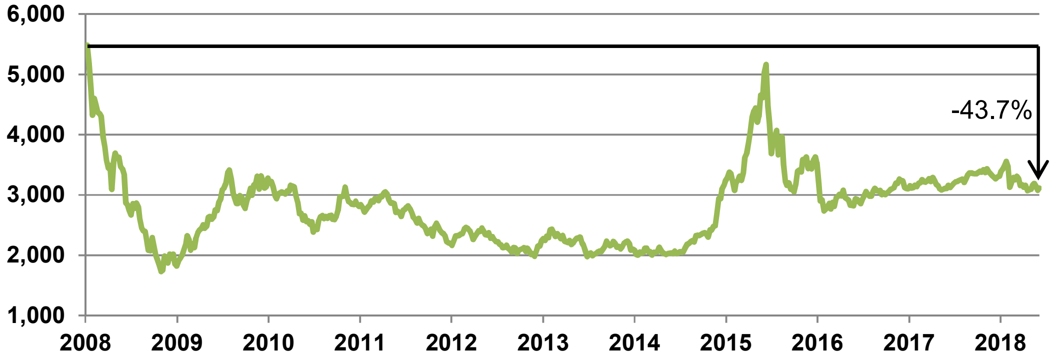
Index is actually lower over the period (**Chart 2**). The size of the economy doubled yet the stock market was down almost 45%? What gives?

Such rosy potential was prevalent a decade ago as well.

Yet, stock markets in China have suffered declines despite terrific economic growth.

Chart 2:

Shanghai Composite Index (Stocks) - 10 Year Chart



Source: Bloomberg Finance L.P. as of 6/7/2018

One challenge is that financial market reform in China unfolds much slower than promised. At that conference in 2007, many presenters were enthusiastic about the potential of a newly implemented program called the "Through-Train" which established a path for capital to move between stock markets in Mainland China and Hong Kong. Two weeks after that conference, the Global Credit Crisis and the resulting volatility led officials to shelve the program. It wasn't until seven years later when the "Through-Train" was resurrected. Other reform promises, such as completely opening up the investment markets in Mainland China to foreign investors or removing restrictions on the currency, the yuan, follow a similar pattern of a great deal of teasing but with little or no follow-through. This is not helpful at nurturing investor confidence.

Promises of reform are eagerly reported in the Western press, but they regularly peter out.

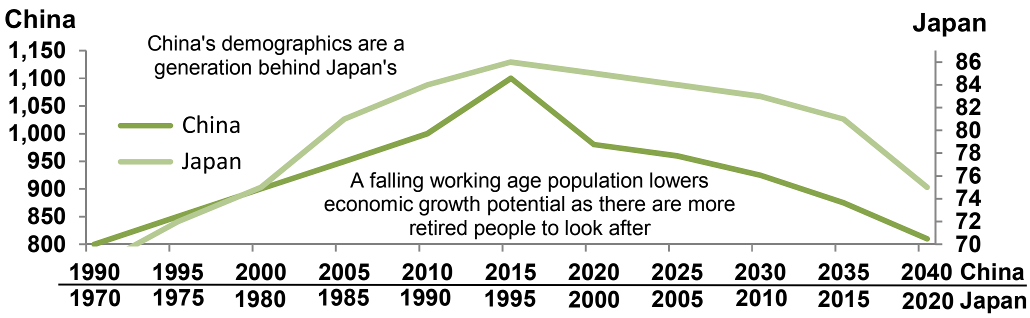
China's stock markets have also faced a number of social, economic, and political hurdles over the years.

Aging demographics might be China's biggest challenge going forward. For years now, concerns have grown over the detrimental impact of the one-child policy: fewer young people to finance the increasing cost of social programs to take care of the elderly. While I was in Hong Kong, there was an article in the *South China Morning Post* about plans to scrap limits on family size by the end of the year. But that doesn't solve the problem. The working age population has begun to fall (**Chart 3**) and China needs more 20-year olds, *now*. And, we don't need to sign up for a biology class to know it takes 20 years and nine months to produce a 20-year old.

China is getting old.

The one-child policy has led to a deficit of young people needed to fuel economic growth and pay for the social programs to care for the elderly.

Chart 3:
Working Age Population (in millions)

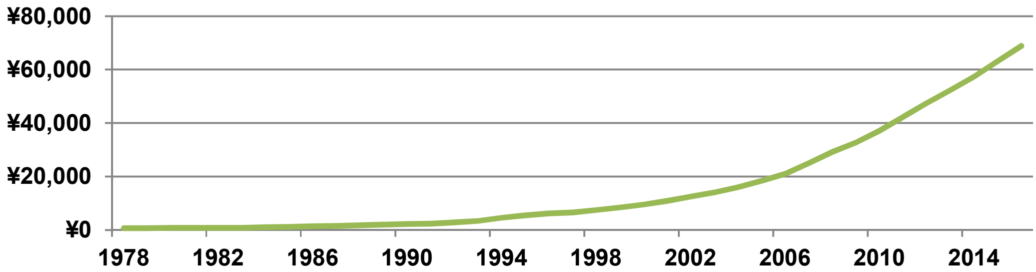


Source: Charles Schwab & Co., Inc., based on UN poplation data as of 8/20/2013

High wage growth and increasing total debt have eroded important economic advantages.

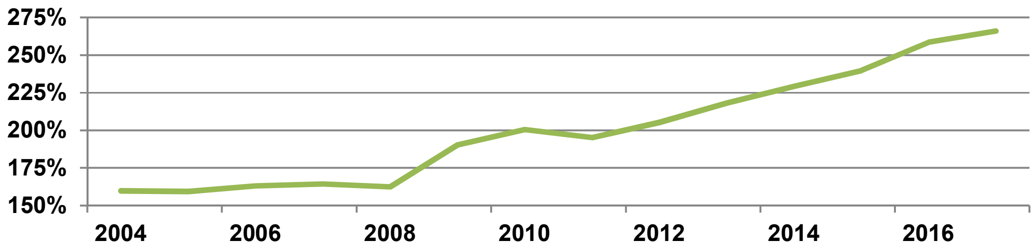
Some of China's early economic advantages have eroded. When Deng Xiaoping opened up trade, there were very low wages (**Charts 4**) and virtually no debt burden. However, over the last decade, China is now grappling with higher wages which makes exports less competitive and an explosive growth in debt (**Chart 5**) that threatens future economic expansion. These issues have been buzzkills for investor enthusiasm.

Chart 4:
Average Wage of a Worker in China (in yuan)



Source: Bloomberg Finance L.P. as of 6/7/2018

Chart 5:
Total Debt in China as a Percentage of GDP



Source: Bloomberg Finance L.P. as of 6/7/2018

Looking forward, there are a number of conflicts involving trade and geopolitics. Recent headlines have been filled with stories where the U.S. and China are butting heads over tariffs and military maneuvers. On trade with the U.S., China has arguably had the better deal as evidenced by their persistent significant trade surplus. But China's real victory has been in the transfer of intellectual property from U.S. corporations and research institutions to Chinese entities. Research is expensive. Forcing companies, that want access to Chinese consumers, to give up technology is not expensive. Previously, U.S. companies generally saw this as a net gain, but recently, the cost of losing proprietary innovation to future potential competitors has shifted that sentiment. Suddenly, U.S. industry is not automatically opposing hawkish trade rhetoric. In the process, Chinese companies who saw this as an alternative to financing their own research will see increased financial costs if they want to maintain technological competitiveness. Higher costs potentially result in fewer profits for Chinese publically-traded companies.

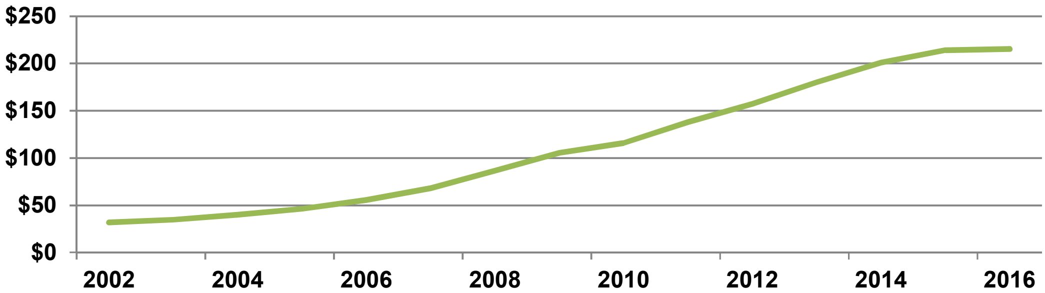
China's trade advantage with the U.S. may be in jeopardy now that trade has become a hot political issue in the U.S.

Finally, as with the case of many emerging economic giants in the past, China is beginning to flex its growing military might (**Chart 6**). Recent developments include the militarization of artificial islands in the South China Sea outside China's boundaries, provocative training exercises around Taiwan, and skirmishes with Japan around disputed islands. In addition, the activities are accompanied by incendiary sabre-rattling by military officials and government-approved journalists. Regardless of the arguments involved, none of this is comfortable to investors who are naturally averse to such risks.

China is spending more on its military. The potential for confrontations makes investors uneasy.

Chart 6:

China: Military Expenditures in USD (in billions)



Source: Bloomberg Finance L.P. as of 6/7/2018

So, where will China be ten years from now? Inertia suggests that its economy will be larger as a whole (but not likely on a per capita basis). However, for the stock market to appreciate, economic growth only helps so much. If investors are not confident, share prices could behave much like they have over the past decade. At present, The Charter Group is not invested in China at all. That might say something about our sentiments.

Maybe the next decade for China will look like the last decade: economic growth but a lagging stock market.

Model Portfolio Update[4]

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 May. The proceeds from the two bond maturities in March remain in cash. However, new bonds will likely be purchased in conjunction with an upcoming rebalancing of all the model portfolios.

No changes in The Charter Group Balanced Portfolio model in May.

During May, the day-to-day volatility in U.S. stocks settled down to levels prior to the 10% market selloff in January. Investors appeared to brush off any bad news and focus on positive outcomes. Despite the vicious trade rhetoric from the U.S. and potential financial problems brewing in Italy, stock markets defied the old adage of "Sell in May and go away." But, summer, with its historical pitfalls, still has a long way to go.

U.S. stock market volatility has calmed down and stocks gained significantly during the month.

The Canadian dollar edged lower during the month, helping the returns on the U.S. stocks in the Portfolio. If the dismal prognosis for the NAFTA agreement becomes

[4] 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.

reality, there could be more downside for the Canadian dollar versus the U.S. dollar. Additionally, although a Bank of Canada interest rate hike in July has become a consensus expectation[5], it may be the last one of the year unless the Canadian economy shows some renewed vigor. A slow-down in the pace of interest rate increases could spell further bad news for the Canadian dollar.

The Canadian dollar drifted lower on NAFTA headaches.

The U.S. economy showed some signs of acceleration during May which might present the U.S. Federal Reserve Board with two opportunities to raise rates before the end of the year without handcuffing their economy. Much of the acceleration is still being attributed to the benefit of tax cuts and reduced regulation for industries.

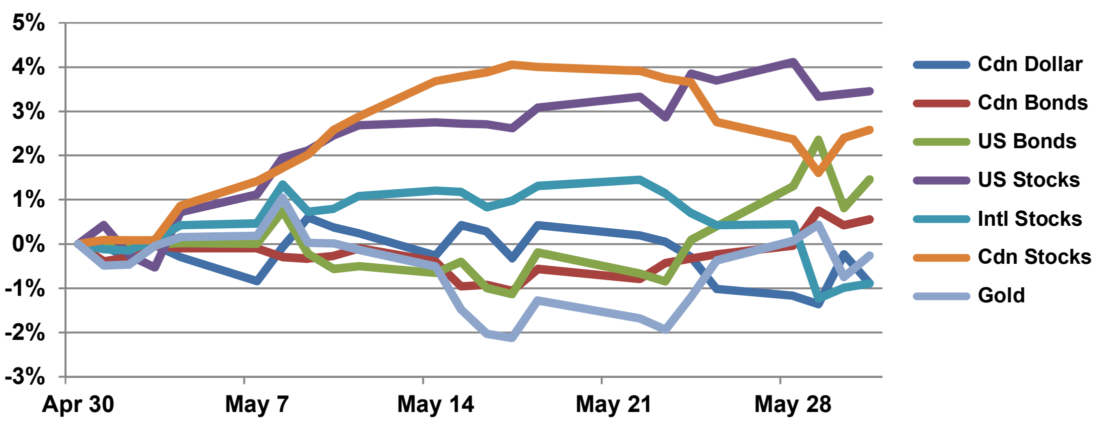
U.S. economy improved as gains continue to be realized from tax cuts and a reduction in red tape for businesses.

However, economic growth and investor psychology are not always positively correlated. As previously discussed in the *Monthly Letter*, investors might get indigestion if a buoyant economy paves the way for faster interest rate increases.

Investor psychology might deviate from the economic results if higher interest rates become more of a concern.

Below is the May 2018 performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 7**).[6]

Chart 7:
May 2018 Performance of the Asset Classes (In Canadian dollars)



Source: Bloomberg Finance L.P. as of 6/7/2018

[5] Bloomberg Finance L.P. as of 6/7/2018 interest rate futures implied a 71.6% probability of a July hike.
[6] 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[7]

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

[7] 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 June 7, 2018.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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