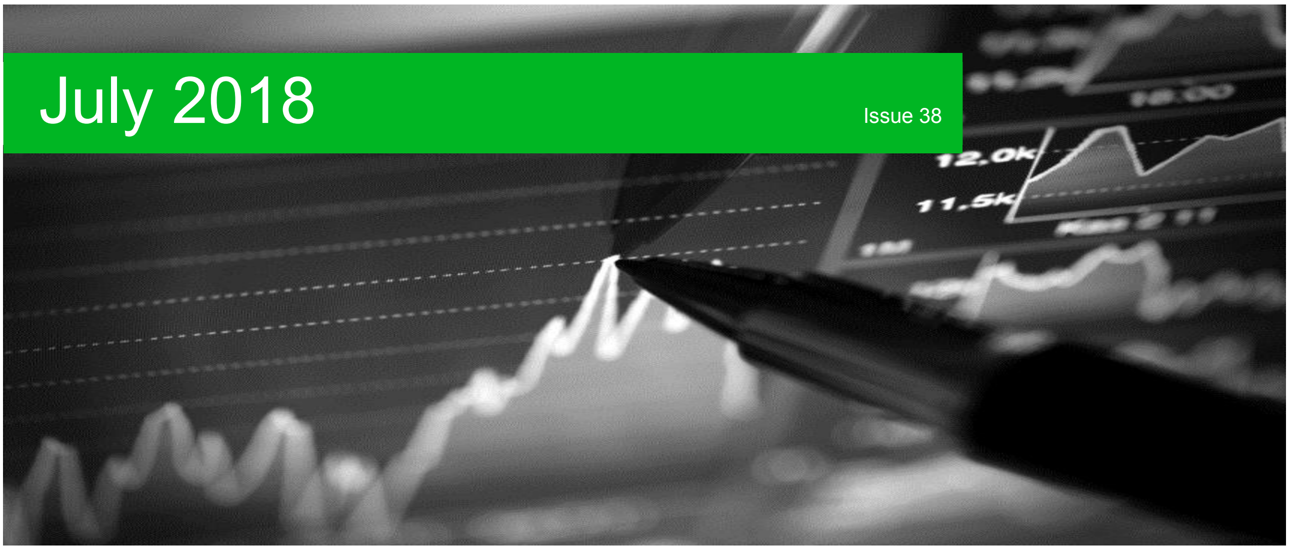
TD Wealth

The Charter Group Monthly Letter



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Economic & Market Update

Winners & Losers in the Interest Rate War

Interest rates are on the rise. Through the 1980's, 1990's, and 2000's it would have been unimaginable to make such a generalized statement. But, it now appears that interest rates – which impact all sorts of investments as well as our personal spending decisions – have entered a new era.

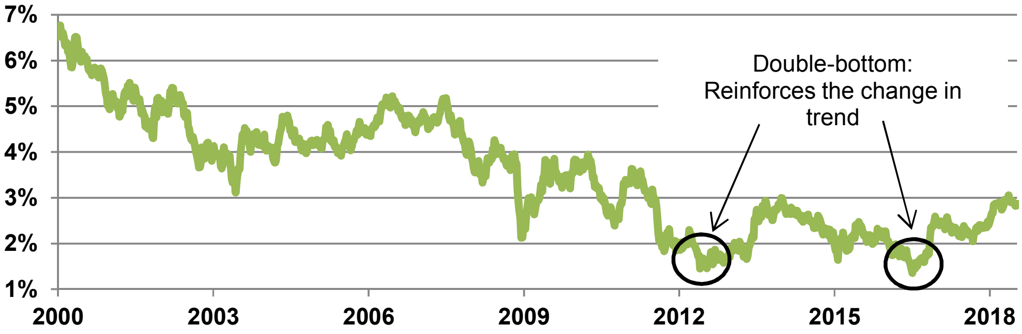
The trend of increase interest rates has become more established.

Some will rejoice while others will be anxious.

Longer-term rates established a double-bottom (**Chart 1**) beginning in July 2012. I had written a few months after that it would be difficult for the 10-year U.S. Treasury rate to fall much further given the economic fundamentals at the time and that the three-decade bull market in bonds was likely over. The 10-year rate did bounce off that low but eventually tested it again in July 2016. It fell 3 basis points, or 3/100ths of a percent, below the July 2012 low-water mark. We are now 24 months past that 2nd bottom.

Chart 1:

10-Year U.S. Treasury Yield



Source: Bloomberg Finance L.P. as of 7/16/2018

Rates on longer-term bonds are set mostly by investors in the marketplace. Short-term rates are mostly influenced by central banks. Shorter-term rates have been increasing as well (**Chart 2**) and at a faster pace than longer-term rates (**Chart 3**).

Both short-term rates and long-term rates have been rising.

Short-term rates have been rising at a faster pace.

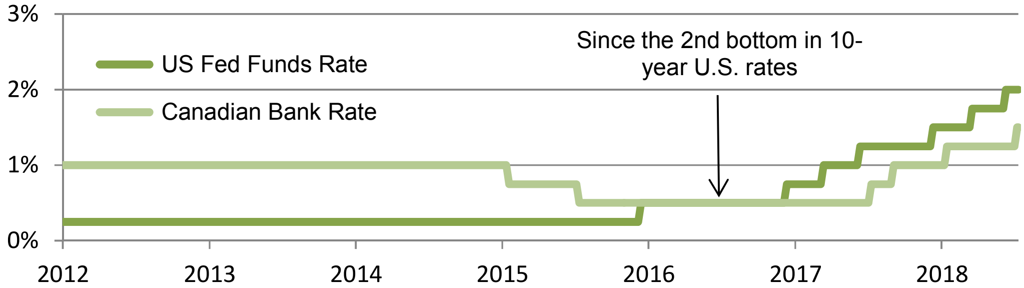
Since the July 2016 2nd bottom for U.S. 10-year rates, the 10-year rates in other countries have *also* risen (**Chart 4**).

Rising rates is just not a North American phenomenon.

The trend in interest rates, over various maturities and over various developed counties, is becoming undisputed. The only real argument left is over the pace of interest rates increases and what the impact will be on the global economy and on the economies of individual countries.

Chart 2:

Short-term Policy Rates

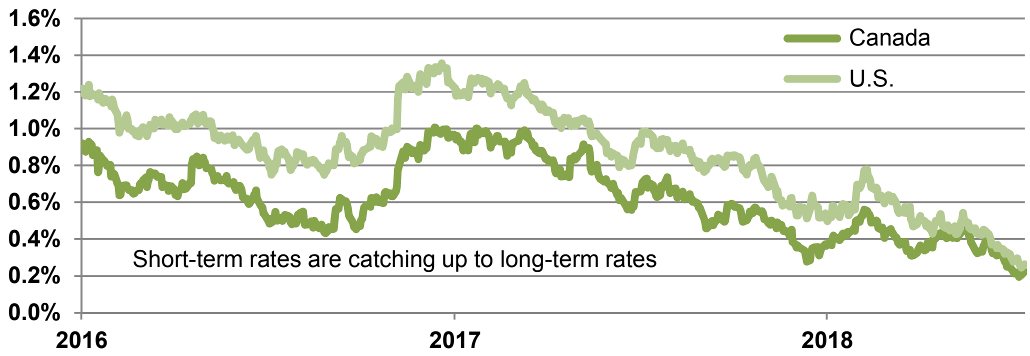


Source: Bloomberg Finance L.P. as of 7/16/2018

Focusing on Canada, the Bank of Canada, which sets the Bank Rate (which is the overnight rate at which it lends to chartered banks), appears to be confident in the strength of economic growth. Therefore, it sees room to hike rates in the future on top of four ¼% hikes over the last year.

Chart 3:

The Spread Between 2-Year Rates & 10-Year Government Bond Rates



Source: Bloomberg Finance L.P. as of 7/16/2018

However, there is a lot of debate over this with many dissenting views from the Bank of Canada's view. There are a few winners from higher rates: insurance companies (we hold Manulife and Sun Life in the model portfolios), pension funds, and retirees that depend on fixed income yields. However, there are a greater number of entities that would be negatively impacted: consumers with mortgages, consumers that finance a portion of household spending with debt, and companies that normally use a significant amount of financial leverage in their operations.

The Bank of Canada seems confident that it will be able to keep increasing interest rates at a fairly brisk pace.

However, there may be more economic vulnerabilities in Canada which may eventually temper this confidence.

Consumers with variable-interest loans will see an immediate outflow of more dollars each month. Those that hold fixed mortgages will see the higher borrowing cost when they rollover any time between now and five years from now. And those who have let debt increase to levels that provide no flexibility will have to cut back on household spending.

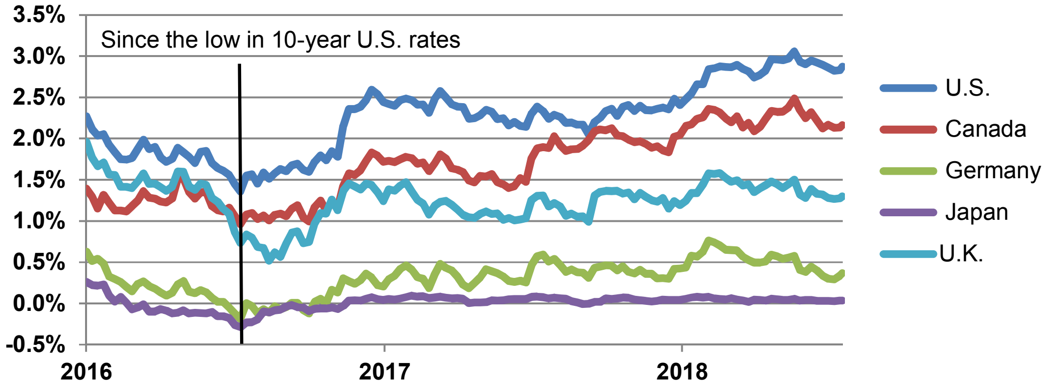
Canadian consumers and business have accumulated debt over the past few decades which increased the interest rate-sensitivity of the economy.

Businesses that rely on financial leverage in order to magnify thin profit margins will have to reassess and potentially scale back operations if the affordability of lending decreases.

If consumers and businesses reduce spending, then economic growth overall is put at risk. The issue for the Bank of Canada to contemplate is to assess the interest rate-sensitivity of the Canadian economy. With respect to business in general, the main Canadian industries don't rely on debt any more than industries in other developed countries. However, with respect to the consumer, interest rate-sensitivity is a big concern.

Chart 4:

10-year Government Bonds Rates



Source: Bloomberg Finance L.P. as of 7/16/2018

Although most Canadian consumers use debt in a responsible way, there are always going to be a large number of households who are right at the margin with respect to being able to afford their interest obligations. Every time Canadian banks increase the interest rate on mortgages and consumer loans in order to keep pace with increases in the Bank Rate, a sizable number of Canadians are no longer going to be able to pay their bills. In a recent survey, about 1/3 of respondents stated that they might face bankruptcy if interest rates continued to rise.[1]

Because of the housing industry's reliance on the availability and affordability of mortgage financing, it might be especially vulnerable to higher rates. As the housing sector has grown to represent a larger percentage of Canadian economic activity, the impact of rising rates on overall economic growth could be significant.

In summary, there are winners and losers in a rising rate environment. Consumers and business that have less need for debt do better. And, anyone collecting a variable rate of interest is going to be pretty happy about things. However, a few decades of low interest rates have encouraged more consumers and business to accumulate debt compared to the past. The Bank of Canada might not feel comfortable increasing rates in a sustained manner while there is such vulnerability in the economy. As a result, it may not be a surprise to see the Bank of Canada push the next rate hike well into next year despite many strategists who are calling for another hike this year followed by multiple increases in 2019.

There are winners and losers when interest rates increase.

Currently, it appears that more will be negatively impacted.

This might encourage the Bank of Canada to slow down the pace of future interest rate increases.

[1] MNP Ltd. Consumer Debt Sentiment Survey, July 2018

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	2.0	-1.5

During June we purchased a couple of bonds using the cash generated by some previous bond maturities. We added a Telus bond maturing March 28, 2022 and a Tran-Canada Pipelines bond maturing July 19, 2023. With the addition of those two bonds, our overall duration (which is related to maturity) sits at just over three years. This is low for our Balanced Portfolio by historical standards as we don't want to be exposed to long maturities in a potentially rising interest rate environment (rising interest rates lower the prices of bonds, and have the effect of lowering the prices of long-dated bonds even more).

We used the cash proceeds from previous bond maturities to add a couple of new bonds to the Balanced Portfolio.

Overall, June was an uneventful month for the Balanced Portfolio as parts of the asset allocation that did well were offset but those that did not. However, continued weakness in the Canadian dollar notably helped the performance of U.S. dollar-denominated assets in the Portfolio.

During June, strong asset classes countered weak asset classes. But the weakening Canadian dollar helped overall.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 7/16/2018. 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.

Despite all the vitriolic trade rhetoric over the past month, the markets have focused more on the potential of good US corporate earnings and the continued benefits from US tax and regulatory cuts. The markets are also eyeing continued high levels of US government spending that could further stimulate US economic growth. There will almost certainly be a hangover-effect from all this, but the day of reckoning may not be for a few years.

Trade disputes have gotten the most media attention.

The markets mostly ignored this and focused on corporate earnings, tax cuts, and reduced regulations.

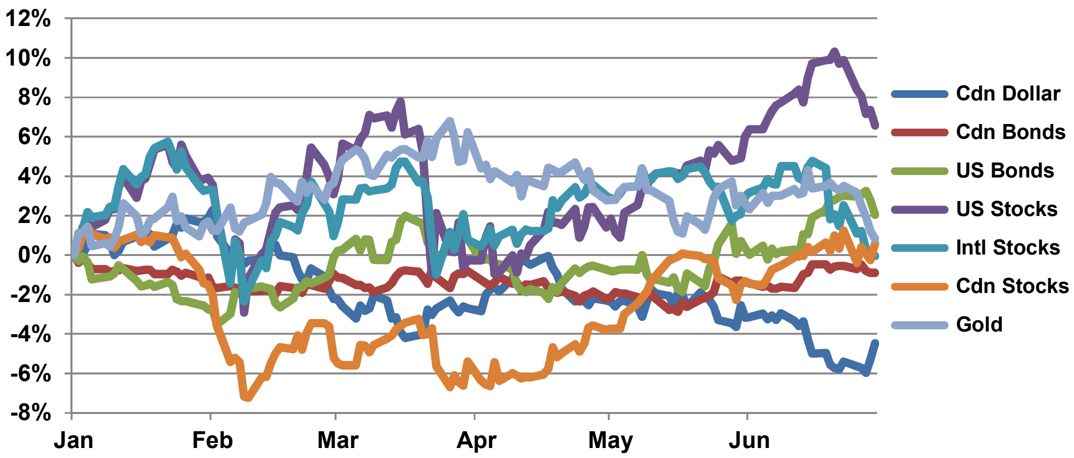
Also, our view of the Canadian dollar has not changed. There are very few Canadian economic scenarios that could push the dollar higher. However, scenarios that involve impairment of trade because of disputes, sluggishness of resource industries as demand from China stagnates, difficulties for the Canadian consumer, and Canadian interest rate increases lagging the pace of U.S. interest rate increases are more abundant, and less helpful, for the Canadian dollar.

Barring any unexpected geopolitical events or psychological investor stress, there might be some decent inertia in current market trends.

Below is the Year-to-Date 2018 performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 5**).[3]

Chart 5:

YTD 2018 Performance of the Asset Classes (In Canadian



Source: Bloomberg Finance L.P. as of 7/16/2018

[3] 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[4]

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 & Global Trade Wars	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

[4] 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 July 16, 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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