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Economic & Market Update

Talking Turkey

Although it is currently overshadowed by on-going political dramas in the general media, there is a financial crisis in the emerging markets that is garnering increased attention.

Among these emerging market countries, Turkey and Argentina have attracted most of this attention. They share one particular economic characteristic in common: high amounts of government debt that was issued in US dollars instead of their own currencies.

Often, emerging market countries will issue bonds in US dollars in order to increase the marketability of those bonds. If they attempted to issue bonds in their own currencies, the potential currency risk for institutional investors from established countries might be

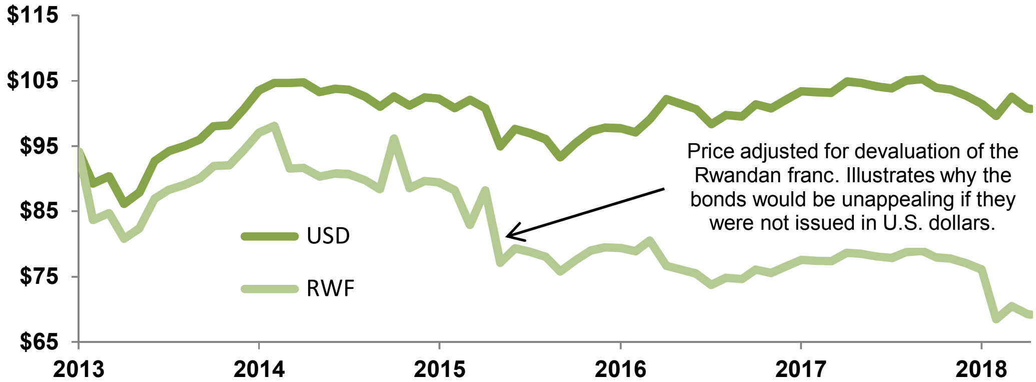
Emerging market countries can significantly increase the demand for their bonds if they issue those bonds in US dollars.

But what happens when those bonds mature and investors want their money back?

too much to bear, requiring a very high interest rate to compensate.

For investors in these bonds, being denominated in US dollars has often provided a pleasant experience regardless of any economic or political turmoil in the issuing country during the term of the bonds.

Chart 1:
Price of the May 2, 2023 Government of Rwanda U.S. Dollar Bonds



Source: Bloomberg Finance L.P. as of 9/10/2018

One of my favourite examples is an issue of 10-year US dollar bonds issued by Rwanda in May 2013 (**Chart 1**). Yes, I am talking about *that* Rwanda, if you can recall all the gory headlines in the 1990s. It's primarily an agrarian economy with up to 40% of the annual government budget financed from foreign donor aid, yet 63% of the population still lives in extreme poverty.[1] Yet, despite all that, those bonds are currently only yielding 6.59%.[2] With less than five years left on their term, it would not be unreasonable to expect a continued pleasant experience for bondholders until maturity in May 2023. However, let's assume Rwanda *does not* progress economically and their budget woes continue. The country will need to refinance by issuing new bonds to replace the maturing bonds. Rwanda does not have any meaningful amount of US dollars held in reserve and probably long ago spent the US dollars received in May 2013. So, they are likely going to have to muster up enough Rwandan francs, exchange those into US dollars, and then payoff the original bond holders. The trouble with that is the Rwandan franc is already trading at more than 30% lower versus the US dollar since the bonds were issued[3] (and there is still 4 ½ years to go!). If Rwanda ends up in this bind, which is very probable, a response might be to print Rwandan francs in order to buy enough US dollars, the prospect of which would further devalue those francs.

Rwanda is actually referred to as a "frontier market" which is a category below "emerging market".

Yet, Rwanda can still borrow money at a relatively low rate if they issue their debt in US dollars.

However, those US dollars can get very expensive when it is time to pay back the bondholders.

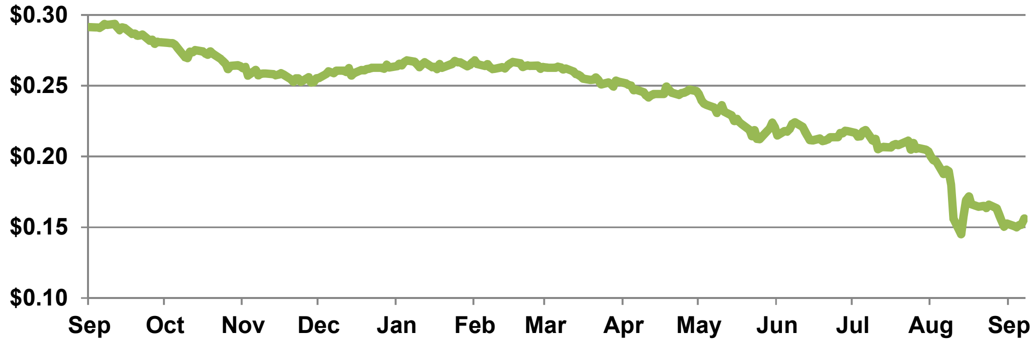
[1] The World Economic Forum: "Five things to know about Rwanda's economy." April 7, 2016.
[2] Source: Bloomberg Finance L.P. as of 9/10/2018.
[3] Source: Bloomberg Finance L.P. as of 9/10/2018.

Getting back to Turkey and Argentina, a similar dynamic is happening, but on a larger scale. Also, the Turkish lira and Argentinian peso trade much more freely against the US dollar as compared to the Rwandan franc. As a result, investor sentiments with respect to those currencies become much more quickly apparent. This is what has been generating those headlines over the last month and a half. The Turkish lira is down over 28% since the beginning of July against the US dollar, and down over 46% over the last 12 months (**Chart 2**). The Argentinian peso is down over 22% since the beginning of July, and down over 53% over the last 12 months (**Chart 3**).

Turkey and Argentina use the same strategy as Rwanda.

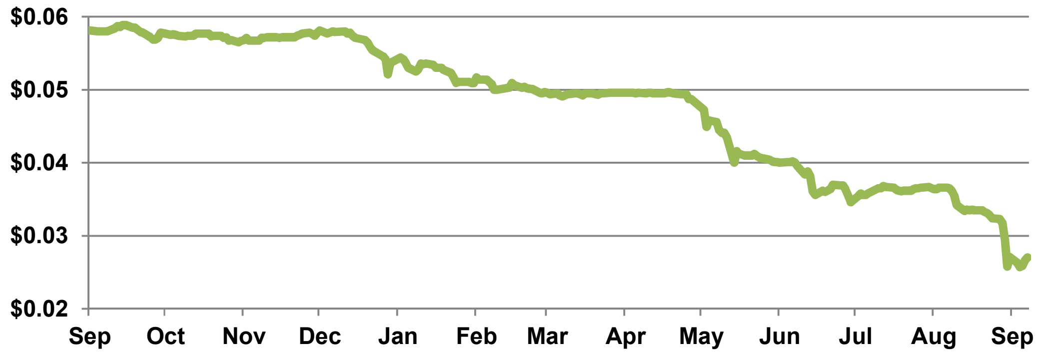
Investors are now worrying that it will be very expensive for these countries to buy the US dollars needed to pay back bondholders.

Chart 2:
Turkish Lira in U.S. dollars



Source: Bloomberg Finance L.P. as of 9/10/2018

Chart 3:
Argentinian Peso in U.S. Dollars



Source: Bloomberg Finance L.P. as of 9/10/2018

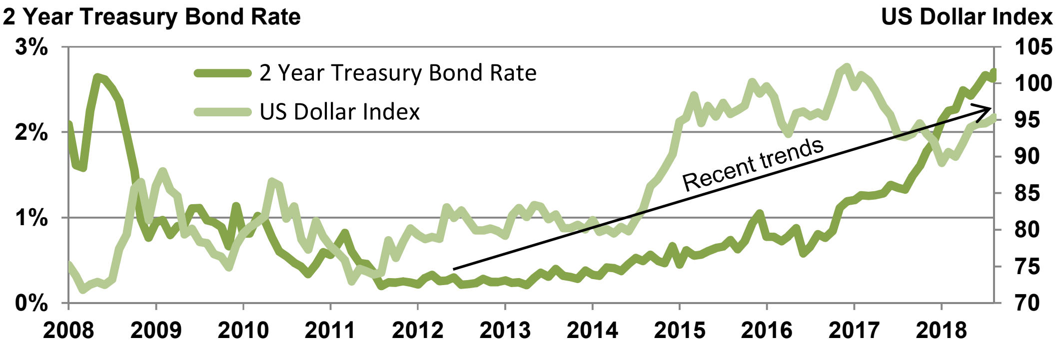
In contrast to Rwanda, which only has one issue of US dollar bonds, Turkey and Argentina have dozens of issues of bonds that are *not* denominated in their own currencies (instead, issuing almost all their debt in US dollars, Euros, and Japanese yen). So, whereas Rwanda might be facing a reckoning out in 2023, Turkey and Argentina face this dilemma on an on-going basis.

The fear is that Turkey and Argentina might be tempted to print money to buy those US dollars.

Turkey and Argentina have never really been paragons of fiscal prudence. So why are there so many more crisis-related headlines now? Two factors are causing headaches. First, US interest rates have been rising and it appears that they will continue to do so if policymakers are to be believed. Secondly, the US dollar is getting stronger against almost all other currencies, not just emerging market currencies. On a relative basis, already weak emerging market currencies get ever weaker and at a faster rate.

Printing Turkish lira and Argentinian pesos to buy US dollars can be very inflationary.

Chart 4:
US Interest Rates & US Dollar



Source: Bloomberg Finance L.P. as of 9/10/2018. The US Dollar Index, or DXY, averages the exchange rates between the US dollar and major world currencies.

For years, emerging market countries had the luxury of low US interest rates (which lowers the interest demanded by bondholders of US dollar-denominated bonds), and a relatively low US dollar (which makes things easier when the bonds matured). There was a massive opportunity to capitalize on this good fortune by implementing tough reforms in order to build a better financial foundation for the future. Unfortunately, the political will was lacking and now the window appears to be closing (**Chart 4**), which is adding to the panic of investors exposed to the currencies of these countries.

This crisis is occurring now because the US dollar and US interest rates are rising.

It should be noted that China is *not* experiencing the same challenges as Turkey and Argentina. The amount of Chinese US dollar-denominated bonds that can be held by foreigners is miniscule. Plus, China has massive US dollar reserves that other emerging countries don't have. (China *does* have plenty of other economic headaches such as ageing demographics, rising costs and wages, and a brewing trade war with the US).

Rising US interest rates makes it more expensive to borrow in US dollars.

A stronger US dollar makes it more expensive to pay off the bonds at maturity.

We have zero emerging market exposure in The Charter Group model portfolios. However, emerging market turmoil could be a precursor to slowing global growth. And, at the moment, very little of this risk is priced into Canadian or American stocks.

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	23.8	-1.7
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	3.7	+1.7

On August 6th there was an Ontario Hydro bond that matured. We let the proceeds remain in cash. With the talk of rising interest rates and the choppiness that this is causing in the bond market, we held off reinvesting as we continue to survey the landscape. That cash will likely find a home in another bond in September.

A bond came due in August. This increased the cash allocation slightly and lowered the bond allocation by the same amount.

The most meaningful contribution to the results during August came from US stocks as US economic growth and employment dazzled. There is a question of sustainability going forward, but investors appear to be celebrating the results by driving share prices higher. Also, US stocks have barely reacted to the political drama in Washington D.C. Perhaps investors figure that President Trump will remain until at least 2020 and that there will not be any change in legislative direction until then. Also, if the Democrats gain control of the House of Representatives in November (which many polls are indicating),

US stocks jumped on strong economic growth and record-low unemployment.

Also, US stocks seemed to be ignoring the political drama.

[4] 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.

they may be able to stifle future Republican legislation, but they won't be able to undo the tax reform which has helped to bolster US stock market enthusiasm this year.

Canadian stocks and the Canadian dollar were down slightly during the month as a number of developments kept things subdued. A failure to wrap up NAFTA negotiations despite hopes and another twist in the pipeline saga in the form of a judicial ruling are beginning to test the patience of investors looking to deploy capital in Canada.

NAFTA tribulations and pipeline politics kept a lid on the Canadian dollar and Canadian stocks.

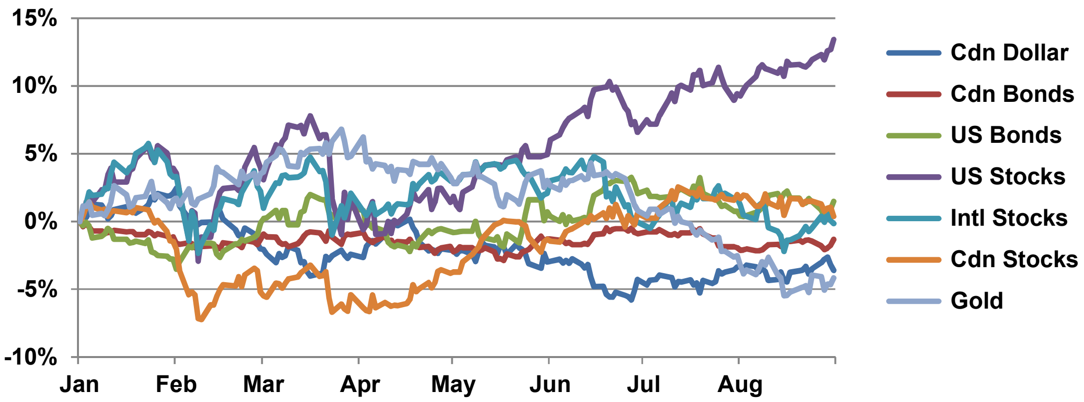
One story to keep an eye on continues to be that of rising interest rates and, specifically, the pace of those interest rate increases. Any acceleration could cause significant volatility in stocks like we saw in January. In Canada, policymakers were engaging in some economic brave talk that suggested more rate hikes only to be surprised by a very poor employment report at the beginning of September. In the US, it looks like it is "all systems go" for a series of rate hikes extending to at least the middle of 2019.

Main concern going forward continues to be the speed of expected interest rate increases.

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**).[5]

Chart: 5

2018 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. from 1/1/2018 to 8/31/2018

[5] Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one US dollar; Canadian bonds are represented by the iShares Canadian Universe Bond Index (XBB); US bonds are represented by the iShares Core US 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[6]

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. NAFTA & Global Trade Wars	Moderate	Negative
6. East Asian Geopolitics	Moderate	Negative
7. Short-term U.S. Interest Rates	Medium	Negative
8. Massive Stimulus in China	Medium	Positive
9. Canada's Economic Growth (Oil)	Light	Negative
10. Middle East & Russia Geopolitics	Light	Positive

[6] 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 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 September 10, 2018.

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