**TD Wealth**

# The Charter Group Monthly Letter

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## Economic & Market Update

### Alberta's Oilapocalypse

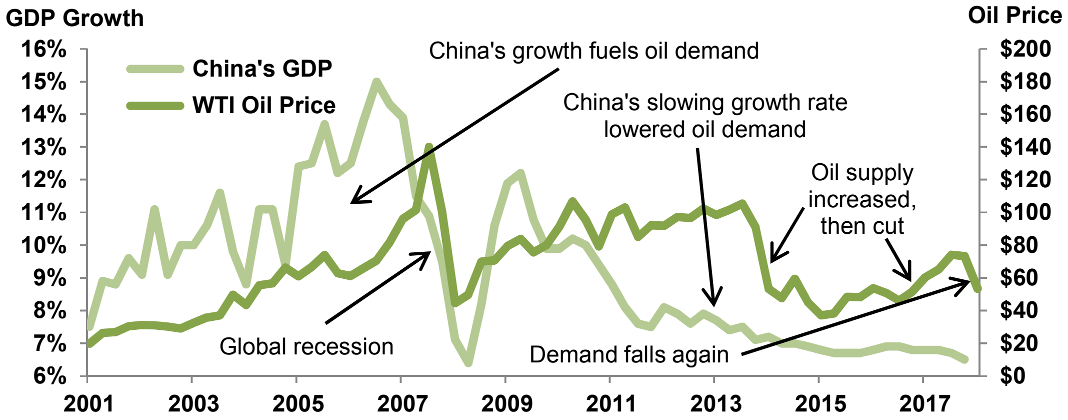
I began to underweight exposure to energy companies about five years ago on the expectation that slowing growth in emerging market economies would reduce demand at the margin enough to impact the price of oil. Prior to the global rececession in 2008, economic growh in China was well above 10%, peaking at 15% on a year-over-year basis (**Chart 1**). This massive growth, which was also evident in countries like Russia, Brazil, and India, created a voracious appetite for resources and a global commodity boom beginning in 2001. Oil went along for the ride, rising from around $20 a barrel in late 2001 to a peak of $145 in 2008 (**Chart 1**).

**There was confidence in Canada's economic prospects among politicians and monetary policymakers until Alberta got hit by a perfect storm.**

For Canada, this had a multitude of implications. In provinces with large exports of recources, economic growth took off. Alberta, Saskatchewan, Newfoundland, and BC all did well. However, manufacturing exports, concentrated in Central Canada, were hit because of the rising Canadian dollar (Canadian resources need to be purchased in Canadian dollars which increased the demand for Canadian dollars). However, rising tax revenues and royalties from the resource sector, plus bouyant markets in real estate and stocks, helped to offset those manufacturing woes.

**Alberta and Canada benefitted from the commodity boom created by China's rapid growth in the 2000's.**

**Chart 1:**
**China's Economy and the Price of Oil in US dollars**




Source: Bloomberg Finance L.P. as of 12/01/2018. West Texas Intermediate (WTI) as the global benchmark.

Then the global recession hit.

**Then, the global recession of 2008-to 2009 hurt the demand for commodities, including oil.**

By employing massive state-directed stimulus measures, China was able to recover faster than developed countries. That produced the illusion that China would emerge relatively unscathed from the global recession. However, the initual large doses and subsequent steady doses of stimulus were not enough and China's growth rate fell back to levels that were only half as much as during the expansion of the early to mid 2000's. Without the previous levels of energy demand from China, oil prices were never able to recapture their highs prior to the recession. Canada, and primarily Alberta, had lost that incredible economic tailwind provided by the commodity boom.

But, this is only the demand side of the story. As we know from economics, supply is also a major factor in determining prices.

The supply calculus for the global oil markets began to change dramatically around 2012 with the stunning growth in US shale oil production. Better technolgy lowered the cost of extracting this very high quality oil. This was so startling that Saudi Arabia began to panic and came up with a plan to pump more oil in order to lower the price enough to make the shale oil producers unprofitable. For the most part, that didn't work. The shale drilling technolgy improved and costs fell more. Saudi Arabia then reversed tack and, along with Russia, agreed to implement production cuts in order to push up prices and to help mend the destructive impact that low prices were having on their economies. But, the shale oil producers survived and thrived. In fact, shale production has now catapulted the US to becoming the world's largest oil producer.[1]

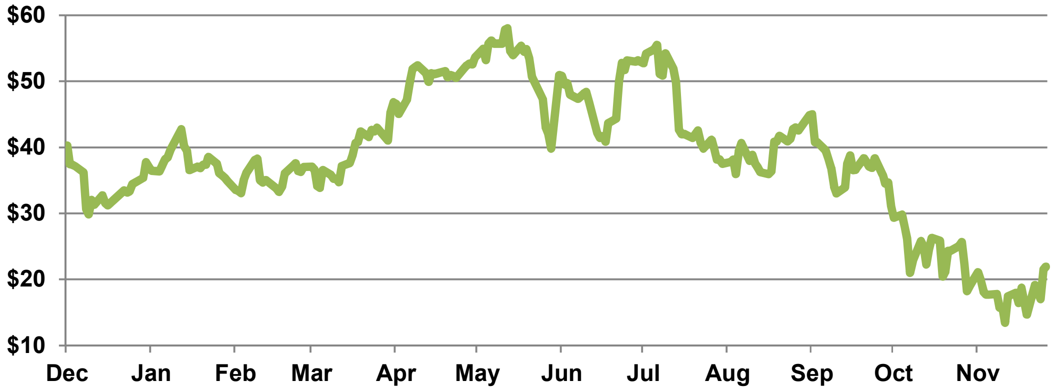
Bullish analysts started predicting even higher prices this year based on a number of supply factors including a lack of pipelines to get all the US shale oil to refineries, a continuation of the Saudi/Russia cuts, and impending sanctions on oil from Iran. However, more pipelines emanating out of the major US shale formations have come on-line, and an unexpected number of exemptions to the sanctions on importing Iranian oil were granted to countries that had a significant dependence.

**Factors surrounding waning oil demand have overtaken the issues that were related to supply.**

**Waning demand contributed to further lowering of oil prices.**

However, it is demand that has come back to really haunt the oil market. China and other emerging market countries continue to slow down economically. Difficulties resulting from trade restrictions imposed by the US, a stronger US dollar and rising interest rates have hit these economies harder than the optimists anticipated. The result has been a reversal to the rising trend in oil prices over the last three years (**Chart 1**).

**Chart 2:**
**Western Canadian Select - Alberta Oil (in US dollars)**




Source: Bloomberg Finance L.P. as of 12/1/2018

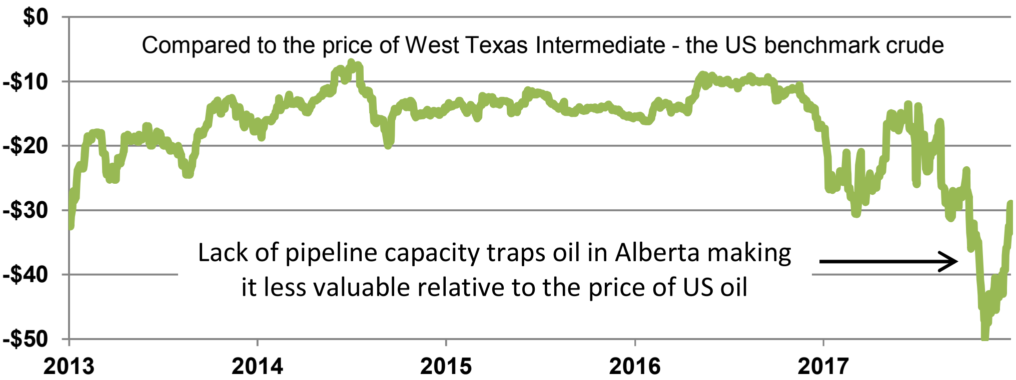
For Alberta, this has resulted in a perfect storm. With the lack of new pipelines, it is not possible to get all the oil produced by the province to refineries in the US and overseas. As a result, oil just starts piling up in costly storage tanks or gets shipped at a higher

[1] Source: Bloomberg Finance L.P. as of 12/1/2018

cost by rail or truck. Buyers factor these costs into the price that they are willing to pay (**Charts 2 & 3**). Even if oil prices begin to recover, the sizable discount in the price of Alberta crude will likely persist because of transportation constraints (this is in addition to the historical discount resulting from the low quality of the oil which requires greater refinining costs).

**Lower prices due to slowing global economic growth have been combined with a lack of pipeline capacity to seriously hurt Albertan oil prices.**

**Chart 3:**
**Discount for Western Canada Select - Alberta Oil (in US dollars)**

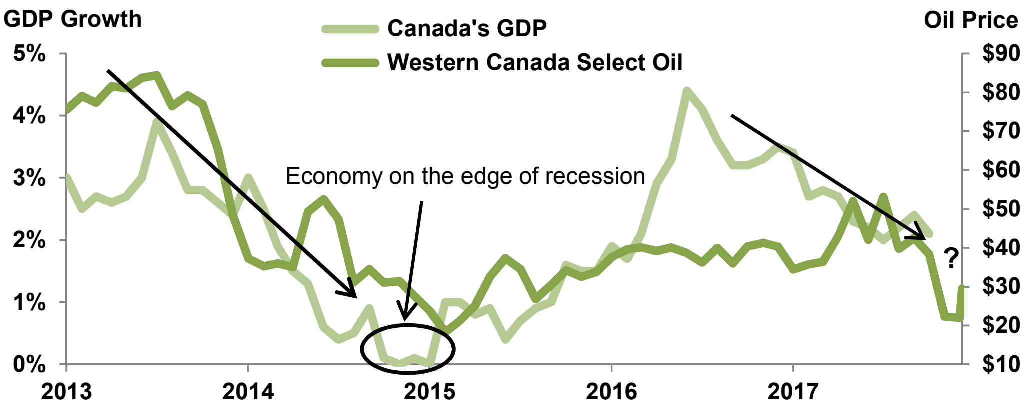



Source: Bloomberg Finance L.P. as of 12/1/2018

For now it only looks like an "Alberta problem" judging by the reaction from the federal government. However, the price of Alberta crude is so low that it is reasonable to expect that it could impact Canada's overal economic growth if the recent price level persists. Although the energy sector has declined in terms of its contribution to Canada's GDP over the last five years, the potential tax and royalty revenues still make a big difference. Without those revenues, Canada's economy could begin to face challenges heading into the federal election next October.

**If a potential economic slump in Alberta is significant enough to impact the overall Canadian economy, it could turn into a political issue in next year's federal campaign.**

**Chart 4:**
**Canada's Economy & The Price of Canadian Oil**




Source: Bloomberg Finance L.P. as of 12/1/2018. WCS in US dollars. Year over year quarterly GDP growth.

## 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 | 23.8 | None |
| U.S. Bonds | 2.5 | None |
| Alternative Investments: | | |
| Gold | 7.5 | None |
| Commodities & Agriculture | 2.5 | None |
| Cash | 3.7 | None |

There were no changes to the asset allocation or the individual holdings in The Charter Group Balanced Portfolio model during November.

**No changes were made in the model portfolios during November.**

Although volatility was still a dominant theme during November, the Balanced Portfolio benefitted from a declining Canadian dollar as well as higher stock market prices in the US, Canada, and internationally. Will that positive stock market performance continue? I think might depend primarily upon the US-China trade battle and interest rate movements.

**Stock markets and a weaker Canadian dollar were positive contributors during the month.**

The US-China trade battle requires separating the rhetoric of both President Trump and President Xi from the actual implementation of any aspects of an agreement. For instance, the US is demanding action from China in stopping commercial cyber-theft. It is easy for President Xi to say that he will make it a priority but it may be very difficult to actually prove that he is doing something about it. Unfortunately, any agreement has

**Investors are looking closely at US-China trade negotiations.**

[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.

been postponed to the end of February, so things are in a holding pattern until then. Expect the rhetoric in the meantime to outweigh real policy developments. This might even be a positive for now if the rhetoric is optimistic about potential deal.

**The pace of interest rate increases might slow if central bankers follow through on recent dovish comments. Stocks will pivot on whether or not this happens.**

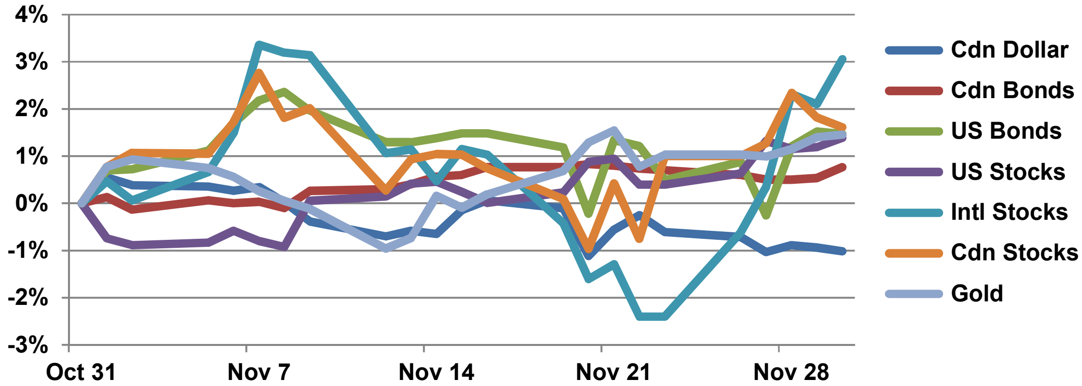
With respect to interest rates, there has been a slightly dovish shift from central bankers in Canada and the US over the past month suggesting that rate increases will occur at a slower-than-expected pace. If that actually proves to be true, it could lift stocks, including international stocks which have had a rough year. But, if this apparent shift turns out to be false, volatility could make a roaring comeback.

**Policies related to the upcoming Canadian federal election could impact the confidence of Canadian stock market investors.**

On the subject of Canadian stocks, the federal election is now on the horizon and the confidence of investors might be significantly influenced by economic policy decisions aimed at re-election. We will keep an eye on that.

Below are the November performance (**Chart 5**) and the Year-to-Date performance (**Chart 6**) of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio.[3]

**Chart 5:**
**November Performance of the Asset Classes (in Canadian dollars)**

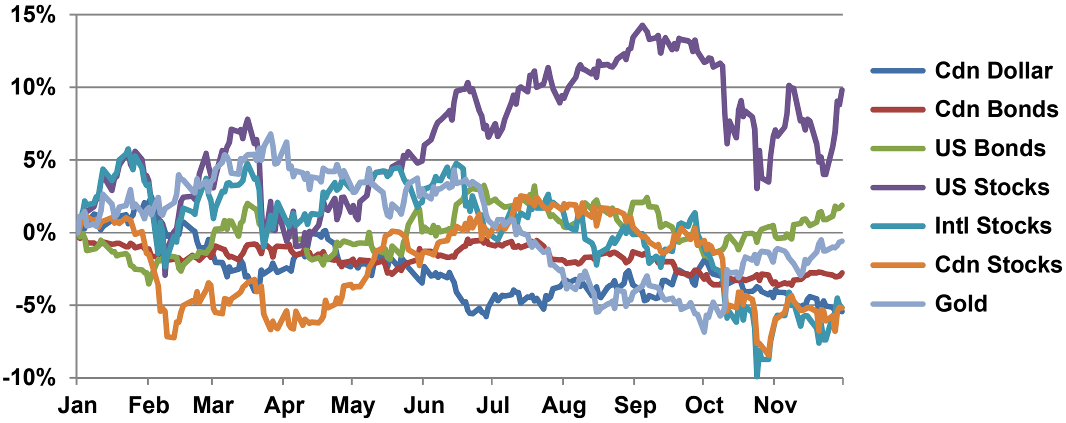



Source: Bloomberg Finance L.P. as of 12/1/2018

[3] Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one 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).

**Chart 6:**

**2018 YTD Performance of the Asset Classes (in Canadian dollars)**




Source: Bloomberg Finance L.P. from 1/1/2018 to 11/30/2018

## Top Investment Issues[4]

| Issue | Importance | Potential Impact |
|---|---|---|
| 1. China's Economic Growth | Significant | Negative |
| 3. Canadian Dollar Decline | Moderate | Positive |
| 2. Long-term U.S. Interest Rates | Moderate | Negative |
| 4. U.S. Fiscal Spending Stimulus | Moderate | Positive |
| 5. Global Trade Wars | Moderate | Negative |
| 7. Short-term U.S. Interest Rates | Moderate | Negative |
| 6. East Asian Geopolitics | 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.

# TD Wealth

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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 December 5, 2018.

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