TD Wealth

The Charter Group Monthly Letter

January 2019

Issue 44

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Economic & Market Update

Better Years after Bad Years? Well, Statistically

Is there anything that 2018 tells us about 2019?

The fact that investors are more sober heading into this year than they were last year is a positive sign, but no guarantee of how 2019 will turn out.

Considering the smooth ride in markets over the last number of years, 2018 was a bad year. For large North American stocks, it was the worst calendar year since 2008. The Dow Jones Industrial Average was down 5.6%, only the 2nd negative year since 2008 (it was down 2.2% in 2015). The S&P/TSX Composite Index was down 11.6%, its 3rd negative year since 2008 (it was down 11.1% in 2015 and 11.1% in 2011).[1]

However, "calendar years" don't capture the full magnitude of peak-to-trough declines (unless the peak conveniently occurs on the first business day of the year and the trough occurs on the last day). From July 12th to December 24th of 2018, the S&P/TSX

[1] Source: Bloomberg Finance L.P. as of 1/7/2019

Composite Index fell 16.8%. The Dow Jones Industrial Average fell 18.8% from October 3rd to December 24th.[2]

2018 was a difficult year, but paled in comparison to the selloffs of 2000-2002 and 2007-2009.

Although 2018 was a testing year, it paled in comparison to the stock market selloffs of 2000-2002 and 2007-2009 when investors faced some extreme fundamentals and risks. 2000-2002 came on the heels of record overvaluations for stocks in general, and dotcom companies in particular. It also included the events surrounding 9/11.

Those previous selloffs were characterized by much more distressing fundamentals and events.

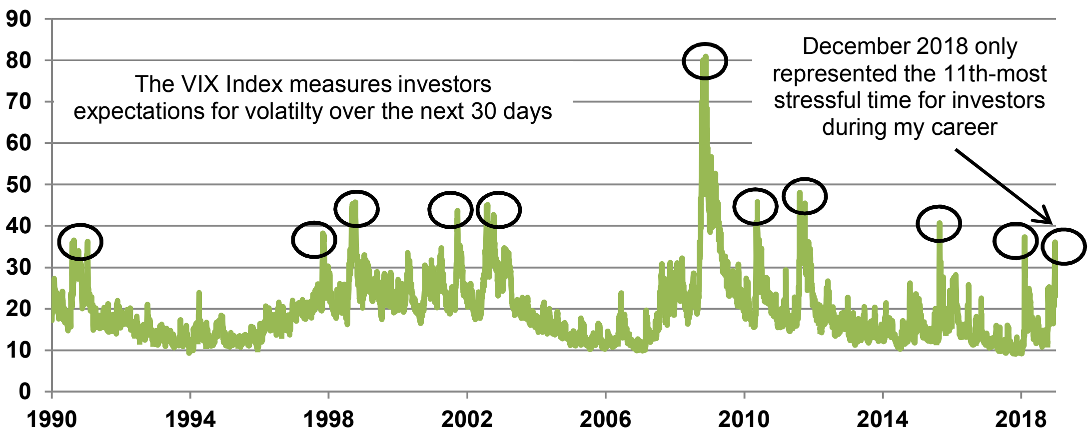
2007-2009 was precipitated by a global credit crisis and the worst economic contraction since the Great Depression which brought down some prominent and previously venerable financial institutions.

Using expected volatility as a fear gauge, investors were more stressed during those previous selloffs than they are currently.

Using the CBOE Volatility Index, otherwise known as the "VIX", as an anxiety indicator, investors were more stressed then than they are now (**Chart 1**).

Chart 1:

CBOE Volatilty (VIX) Index - The Fear Gauge



Source: Bloomberg Finance L.P. as of 1/7/2019. CBOE is the Chicago Board Options Exchange.

In fact, according to the VIX, investors were relatively more stressed earlier *this year* when stocks fell in January in response to concerns over rapidly rising interest rates.

Potential for rising interest rates continues to be the primary catalyst for volatility and investor anxiety.

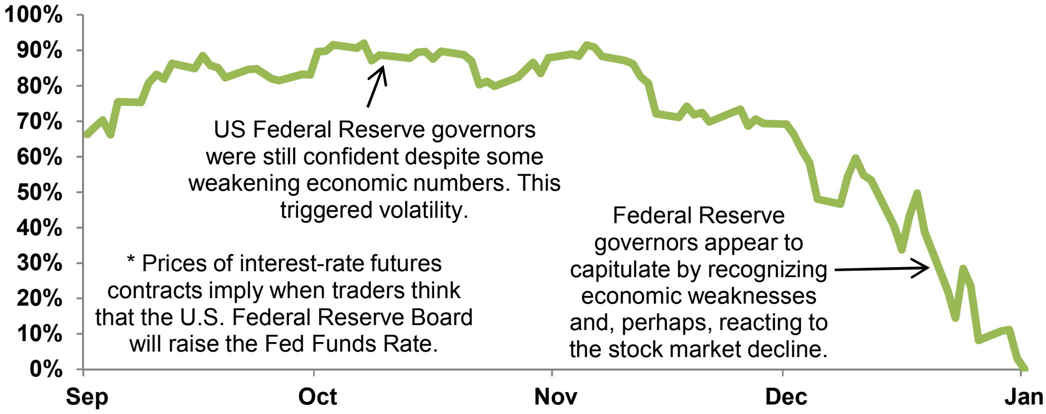
And, it is the specter of rising interests that continues to be the most significant factor impacting markets in my opinion. Trade wars, political drama, and fiscal spending/taxation issues are secondary factors and tend to get more attention once interest rate concerns trigger the initial volatility.

[2] Source: Bloomberg Finance L.P. as of 1/7/2019

So, what's the synopsis then on interest rates? Going back a few months, the consensus outlook was for multiple rate hikes though 2019. When it appeared that the U.S. and global economies were beginning to slow, and before interest-rate policymakers changed their confident tone, investors were especially concerned that these rate hikes would further hamper growth. However, interest-rate futures prices now imply that there may be no short-term interest rate hikes during 2019 (**Chart 2**).

The declining stock market appears to have caused the US Federal Reserve to back off on its pledge to rapidly increase interest rates through 2019.

Chart 2:
Implied Probability Of One 1/4% Short-term Rate Hike By The End Of 2019*

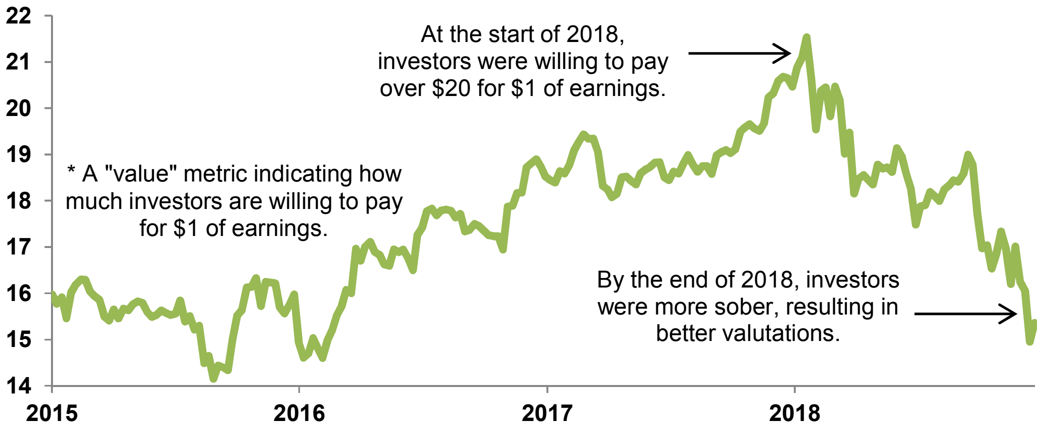


Source: Bloomberg Finance L.P. as of 1/7/2019

In addition to rate hikes seeming to be off the table for now, stock market valuations are at more sober levels (**Chart 3**). At the start of 2018, share prices generally did not leave much room for error. As the market declined through the autumn, more reasonable valuations could help provide more cushion going into 2019.

The pain of falling stock prices has resulted in better valuations heading into 2019.

Chart 3:
Price to Earnings Ratio* for the Dow Jones Industrial Average



Source: Bloomberg Finance L.P. as of 1/7/2019

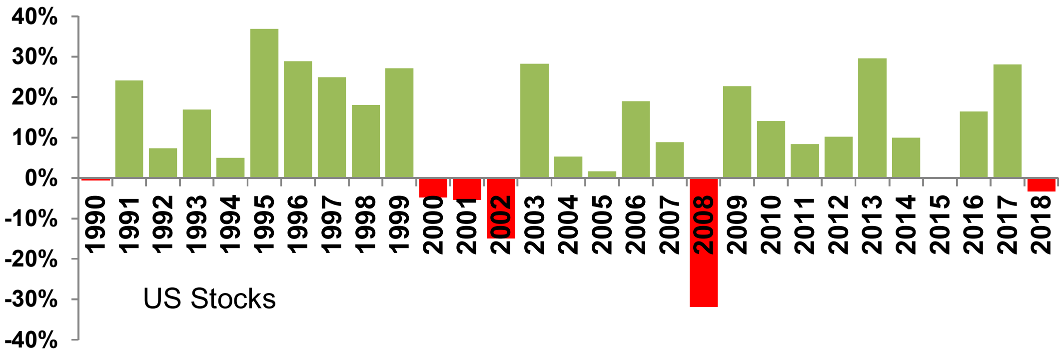
It's also worth pointing out that consecutive negative years in North American stock markets are a relative rarity, last occurring at the beginning of the 2000's (**Charts 4&5**).

Consecutive negative years in stocks is relatively rare.

This is partly due to the negative factors abating during the following year.

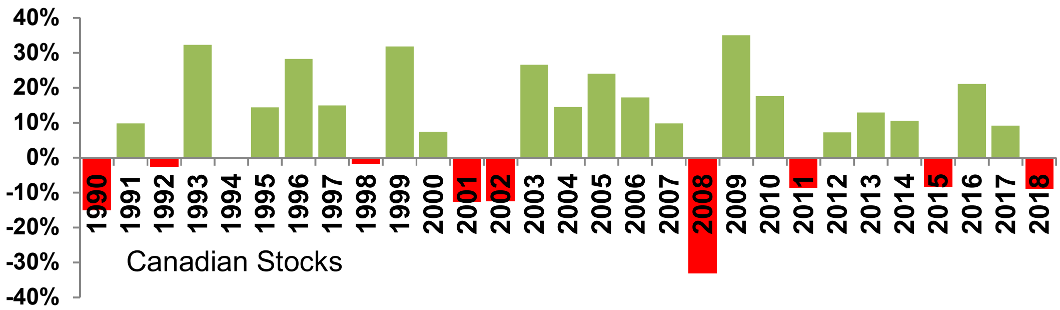
It is also partly due to better valuations after a selloff which produce the potential for better future returns and better current dividend yields.

Chart 4:



Source: Bloomberg Finance L.P. as of 1/7/2019

Chart 5:
S&P/TSX Composite Index: Total Return Including Reinvested Dividends



Source: Bloomberg Finance L.P. as of 1/7/2019

None of this is to suggest that 2019 is guaranteed to be a positive year for stocks. Although some of the pressures have been alleviated due to a reprieve from higher interest rates (likely temporary) and because of better valuations, there is always scope for unforeseen detrimental events as well as considerations for 2020 and beyond that could impact markets in 2019. There is also a chance of long-term interest rates rising despite short-term rates holding firm. China is not much of a buyer of US Treasury bonds anymore and the US Treasury might have to increase the rates to make them attractive to other potential buyers. Also, enormous federal government spending in the US and Canada, which looks to continue, may eventually introduce inflationary pressures if the debt becomes unserviceable with current tax revenue levels. Short- and long-term rates tend to rise in such a scenario.

Statistically, positive years follow negative years.

However, unforeseen events, such as 9/11, can provide an exception.

It should also be noted that future positive years could be much more volatile compared to recent experience.

Model Portfolio Update[3]

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	+1.7
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2.0	-1.7

During December there were a few changes to the individual holdings in The Charter Group's portfolio models. Also, all clients invested in the models had their portfolios rebalanced back to the original targets.

In December, we sold the positions in Marsh & McLennan and Telus, replacing them with Pfizer and Cameco.

Among the US stocks, the position in Marsh & McLennan, an insurance brokerage, was sold and replaced with Pfizer, a large pharmaceutical company. We wanted to become a little more defensive as the US economy slows down. Marsh's fortunes are much more tied to the economic cycle compared to Pfizer. Plus, Pfizer was trading at an attractive valuation.

In the Canadian holdings we replaced the position in Telus with Cameco. If the Canadian economy continues to slow, it could be a challenge for Telus to grow its subscriber base. The monthly expense of telephone, TV, home phone, and mobile phone services could force stretched consumers to cutback to more basic plans if the

[3] 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.

household budget, mortgage cost concerns, or job security becomes an issue. Also, Telus has invested in next-generation cell phone infrastructure using equipment from a Chinese firm called Huawei. There is a reasonable probability that the Canadian federal government could ban Huawei from participating in the development of this infrastructure on the basis of national security concerns (the US, Australia, and New Zealand, all of which are vital allies with Canada in intelligence gathering, have already done so). Cameco was attractive because of valuation and the prospects to provide fuel for a growing number of nuclear reactors around the world where it is being seen as a way to wean off of coal power dependency and the associated pollution.

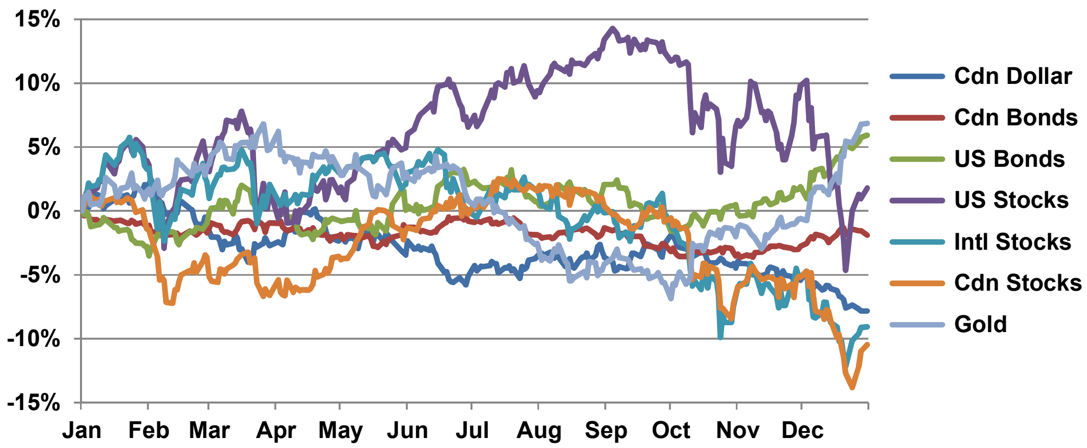
We also conducted a rebalancing of all the model portfolios in order to take some capital from positions that did well and invest that into positions that lagged.

A rebalancing of all modelled portfolios, which occurred on December 13, trimmed the positions that had done relatively well since the last rebalancing in June and added this capital to the positions that had not done as well. Effectively, we are "dollar-cost averaging" when we do this, taking some profits and adding that capital to investments that we assess to have potential.

The rebalancing also brought our allocation to bonds back up to the strategic target.

Below is the 2018 calendar year performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 6**).[4]

Chart 6:
2018 Performance of the Asset Classes (in Canadian Dollars)



Source: Bloomberg Finance L.P. from 1/1/2018 to 12/31/2018

[4] 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[5]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. Canadian Dollar Decline	Moderate	Positive
3. U.S. Fiscal Spending Stimulus	Moderate	Positive
4. Long-term U.S. Interest Rates	Moderate	Negative
5. Global Trade Wars	Moderate	Negative
6. Short-term U.S. Interest Rates	Moderate	Negative
7. Canada's Economic Growth (Oil)	Medium	Negative
8. Massive Stimulus in China	Medium	Positive
9. East Asian Geopolitics	Medium	Negative
10. Stock Market Valuations	Light	Positive

[5] 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 January 7, 2019.

The Charter Group is part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. which is a subsidiary of The Toronto-Dominion Bank.

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