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Economic & Market Update

Canada's China Syndrome

In November 2007, the Canadian dollar peaked at $1.09 to the US dollar (**Chart 1**).[1] The world was in the midst of a commodity boom. Economic growth in both developed and emerging markets was impressive. Suddenly, commodity-exporting countries like Canada and Australia were in the spotlight. In Canada, getting stuff out of the ground and shipping it to other markets is what we did, and do, best. It has always been our economic Plan A.

Recent geopolitical events have jeopardized one of Canada's economic Plan B's.

(Plan A has been to rely on resource industry exports).

Unfortunately, it is not a plan for all seasons.

[1] Source: Bloomberg Finance L.P.

This has always concerned Canadian policymakers and politicians. In response, the federal and provincial governments do things like heavily promoting tourism or advertising Canada as a destination for branch operations of international businesses.

When the economic contribution from resources slows down, politicians and policymakers scramble to find other ideas for growth.

In addition to these initiatives, Canada is occasionally the passive beneficiary of larger economic trends. Excess overseas capital has found Canada's real estate to be an attractive store of wealth. And, relatively low global interest rates have allowed the Canadian consumer to maintain historically high levels of spending. As I have written in previous editions of *The Monthly Letter*, these situations have helped to offset the negative effects from the decline in the energy sector, which is a major component of our Plan A. However, these accidental Plan B's are likely not reliable enough to become mainstays at the core of Canada's economic engine.

Table 1:

Canadian Exports (2016)

Rank	Country	Billions (CAD)	% of Total
1	United States	$297.3	70.9%
2	United Kingdom	$18.0	4.3%
3	China	$15.4	3.7%
4	Japan	$11.0	2.6%
5	Mexico	$8.9	2.1%
6	South Korea	$4.6	1.1%
7	Germany	$4.4	1.1%
8	India	$4.1	1.0%
9	France	$3.5	0.8%
10	Belgium	$3.3	0.8%
11	Netherlands	$2.9	0.7%
12	Italy	$2.5	0.6%
13	Hong Kong	$2.4	0.6%
14	Brazil	$2.1	0.5%
15	Australia	$1.9	0.5%
16	Spain	$1.9	0.4%
17	Taiwan	$1.7	0.4%
18	Norway	$1.6	0.4%
19	Saudi Arabia	$1.4	0.3%
20	Switzerland	$1.4	0.3%
	Rest of the world	$29.2	7.0%
	Total	$419.3	100.0%

Source: Statistics Canada. Table 12-10-0011-01.

One of the most prominent Plan B's was freer trade with the US. The results were sustainable and significant, so much so that policymakers began to worry about our dependence on the US (**Table 1**). That is when the calls began for the need to develop more trade with countries other than the US. Although there has been some notable progress in establishing trade agreements with Europe and the Pacific Rim, the preferred real prize was gaining more access to the massive market in China.

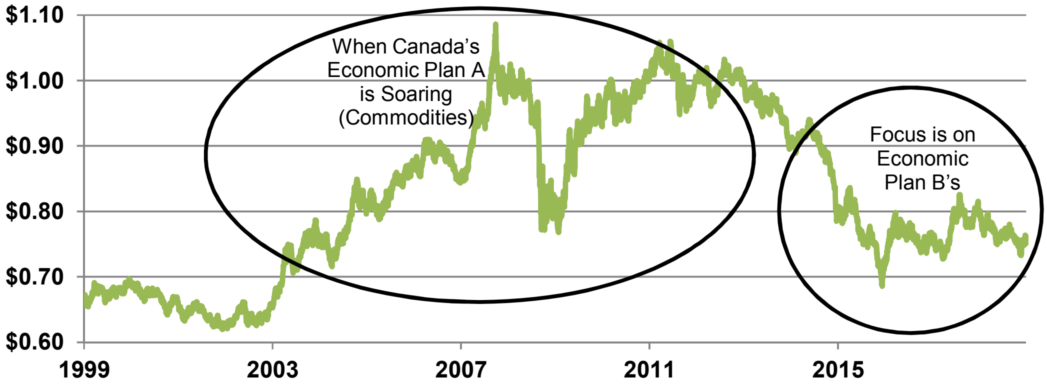
Free trade is one of the more important Plan B's.

Many feel that the success of freer trade with the US has made Canada too reliant on the US.

It should be noted that there has been a general consensus among Canada's two major governing parties with respect to increasing trade with China.

Chart 1:

Canadian Dollar versus the US Dollar



Source: Bloomberg Finance L.P. as of 2/11/2019

Following a chilly start in relations because of human rights issues, economic realities prompted former Prime Minister Stephen Harper to increase engagement with China by visiting a number of times while leading fruitful trade missions.

Diversifying trade with other countries such as China was seen as a potential remedy.

Prime Minister Justin Trudeau's enthusiasm for even greater bonds with China could be the result of his father's legacy characterized by a political affinity with the People's Republic of China and the establishment of diplomatic relations in 1970 before the US did so. And, perhaps in a not-so-subtle message to both the US and China, Prime Minister Justin Trudeau even changed the title of the federal trade minister from Minister of International Trade to Minister of International Trade *Diversification*!

The title of "Minister of International Trade" was even changed to "Minister of International Trade Diversification."

Unfortunately, the promise of further economic growth and diversification with China has come to a virtual halt because of the re-emergence of a factor that used to significantly plague international economics a generation ago: geopolitical risk.

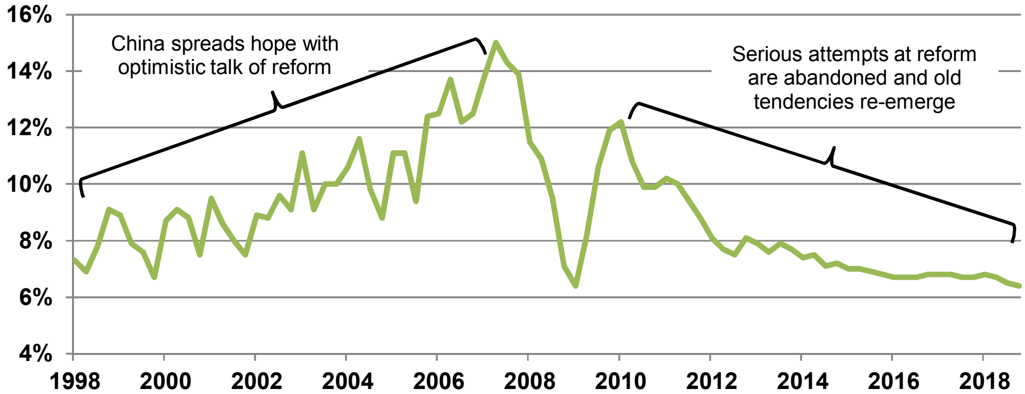
Since the Cold War with the Soviet Union, the level of international trade has increased by multiples. In the process, many destitute economics were lifted out of poverty. It was hoped that this would enlighten previously authoritarian or despotic countries to embrace the values upheld by liberal democracies that had enjoyed relative economic success since the Second World War. Certainly, there has been a lack of conflict between the major powers over the last three decades suggesting that everyone was beginning to gain a mutual understanding. However, political and economic reform, although being featured in the rhetoric, never really gained much traction. In hindsight, it might have been the fact that it was the mere mutual enjoyment more wealth that reduced the friction between everyone.

China's recent belligerence and retaliation might have scuttled Canada's ambitions for a formal free trade agreement.

The credit crisis and corresponding recession in 2008 was a point of notable inflection in the post-Cold War order. Suddenly, the easy economic growth was over and many countries had to resort to massive fiscal and monetary stimulus in order to keep things going. However, these policies have limits before they begin to cause problems.

Chart 2:

China's Annual Economic Growth Rate (GDP)



Source: Bloomberg Finance L.P. as of 2/11/2019

Once the benefits of high levels of government borrowing and spending (induced by suppressed interest rates) began to wear off, a number of countries started to fall back into old habits involving nationalism, statist policies, and authoritarianism in an attempt to regain control of stumbling economies, or to avert potential economic and, correspondingly, political problems coming down the road (**Chart 2**).

China and other emerging market countries are losing enthusiasm for promised reforms.

Reforms can make economic growth more challenging and can be a political threat.

Canada's economic engagement with China looked like a golden ticket until China's renewed embrace of policies reminiscent of its dark past led to threats, intimidation, and hostage diplomacy aimed squarely at Canada. The notion of the federal government trying to sell a free trade agreement with China as a Plan B to Canadian voters now looks politically futile for the foreseeable future.

Much of the formidable investment in time, money, and effort over the years in pursing closer economic ties with China will probably have to be written off. That leaves us with the remaining hodge-podge of Plan B's. There's the tech industry. But that still lacks the scale need to compete in terms of research. Real estate appears to be under political assault as well as a general waning of interest from foreign buyers. And then there's the consumer. But, we will have to hope for interest rates to remain relatively low for longer so that those consumers can afford to borrow in order to maintain historically high levels of spending.

If the economic Plan B of more free trade with China is scuttled, Canada will have to look to other potentially less promising ideas for economic 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	25.5	None
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2.0	None

No changes were made to the individual holdings or the overall asset allocation in The Charter Group's model portfolios during January.

The rebalancing of all the model portfolios in December was conducted about 10 days before the interim lows in the Canadian and US stock markets. In retrospect, it was an opportune time to do some dollar-cost averaging. Notably, the subsequent rise in the price of General Electric shares especially illustrates this. The contribution to the results would not have been as favourable without the rebalancing.

During January, stocks markets in North America and, to an extent, overseas made a significant comeback once the US Federal Reserve (the Fed) backed away from telegraphing multiple rate hikes for 2019. We don't know if the Fed felt intimidated by President Donald Trump's tweets regarding rising rates, or if the Fed felt that the economic data no longer provided the confidence needed to raise rates. Regardless,

No changes were made to The Charter Group's model portfolios during January.

We saw some benefits from a timely rebalancing of all the model portfolios in December.

Stocks in Canada, the US, and internationally staged a comeback in January.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 2/7/2019. 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.

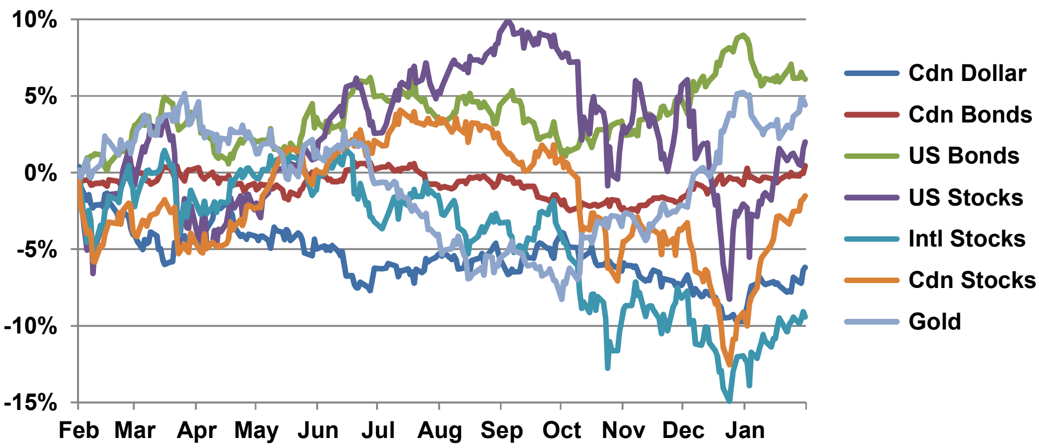
investors began to bargain hunt for stocks which were trading at overall lower valuations than they were at the beginning of 2018.

Expectations for rate hikes have evaporated as there is now an implied probability of 0.2% for any rate increase between now and January of *next* year.[3] This isn't a guarantee that the Fed won't find new reasons to raise rates. Things could change if the stock market skyrockets to new all-time highs. However, it is a major change in interest rate expectations compared to last summer.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 3**).[4]

Chart 3:

12-Month Performance of the Asset Classes (in Canadian Dollars)



Source: Bloomberg Finance L.P. from 2/1/2018 to 1/31/2019

Investors appeared to be relieved by the change in tone regarding higher interest rates in the future and went on a bit of bargain-hunting shopping spree.

However, just as the US Federal Reserve's tone on interest rates changed significantly from last summer, new economic and investment market data could change things again.

[3] Source: Bloomberg Finance L.P. as of 2/11/2019. This probability is implied by futures contracts that hinge on the direction of the US Federal Reserve Board's Fed Funds Rate.

[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 February 11, 2019.

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