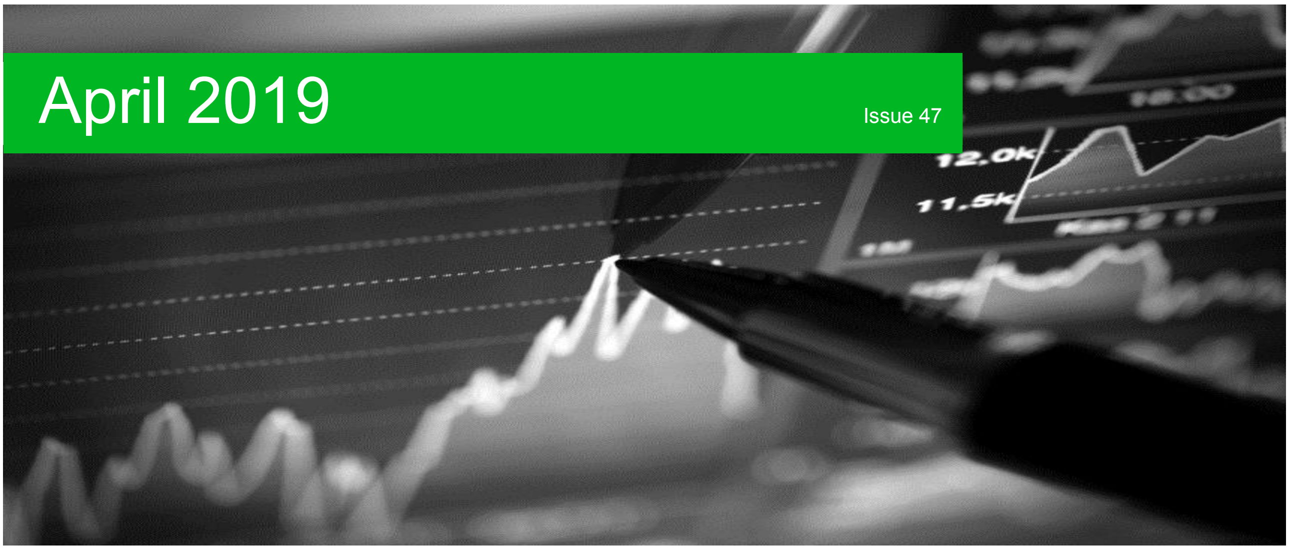
TD Wealth

The Charter Group Monthly Letter



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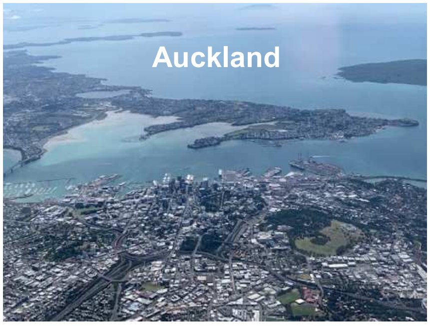
Economic & Market Update

A Tale of Two Cities

Two cities in two different hemispheres separated by an ocean and 8,800 miles are being impacted in similar ways by a common economic denominator: interest rates.

The economic importance of interest rates is evident in property prices across far-flung locations.



During March, I was on a trip for a couple of weeks that took me through both Auckland, New Zealand and Dubai in the United Arab Emirates. Even though they seem worlds apart, the headlines in the local media in the two cities were similar with respect to the news coverage of struggling real estate prices.

What the news coverage did not focus upon was the impact of global interest rates. Instead, the stories focused on the supply of homes and the previous run-up in prices.

Just like Vancouver, Auckland and Dubai have been the beneficiaries of record-low interest rates over the last number of years.

The housing market in Auckland resembles the situation in Vancouver. It is a harbour city with natural geographical limits on development which makes it difficult to scale up housing to meet demand. Much of that demand is also offshore money seeking a haven and, as in Vancouver, has pushed up prices beyond levels justified by local economic growth.

The situation in Dubai fueled more by risk-taking developers. With respect to natural geographical limits, Dubai has a coastline bordering the Persian Gulf. The waterfront is the desirable location in town and has spurred impressive land reclamation projects whereby sand is dredged up from the surrounding shallow waters. However, inland across the desert, the land is limitless. And, with the coastline almost completely built out, developers began to shift their focus inland during the market recovery following the global credit crisis of 2008-09.

When interest rates finally began to rise, it became difficult to sustain property price increases.

In both cities, prices are off from their peaks. Although the details with respect to the run-ups are different leading to differences in the magnitude of the price moves, interest rates, and how they impact the availability of credit, are a large determinant of the timing of the price cycle.

Concurrent with the US Federal Reserve Board keeping interest rates at rock-bottom lows from 2009 to 2015 (**Chart 1),** Auckland and Dubai experienced dramatic price gains of 100% and 79% respectively (**Charts 2&3**).

As can be seen in the charts, record-low interest rates are not a guarantee that property prices will go up through the entire period. In the case of Dubai, lower rates helped to eventually reignite the pre-crisis building boom. However, this led to another over-supply situation by 2014, especially in the wide-open inland desert areas, giving buyers the confidence to negotiate lower prices and placing a number of the developers into financial jeopardy. However, record-low rates likely kept the situation from spiraling into a real national crisis.

There are local factors that impact each market differently, but the direction of interest rates is like an underlying tide.

The charts also suggest that there is a lag between interest rate movements and a corresponding change in the direction of prices. This might explain why the change global interest rate policy direction since the end of 2018 has yet to show up in property prices.

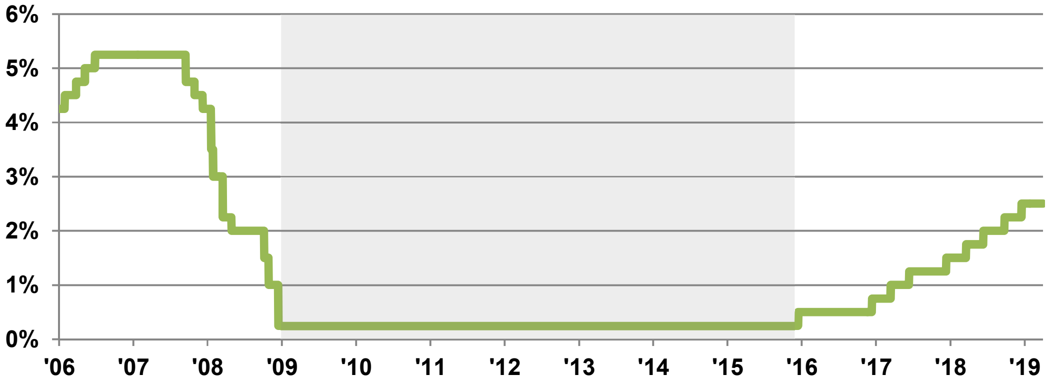
Historically there has been some lag between interest rate changes and property prices.

The relative difficulty of transacting real estate might contribute to this.

This might also help to explain why all the enthusiasm in stock markets over the last three months in response to the levelling off of interest rates has not shown up in the property markets yet.

Chart 1:

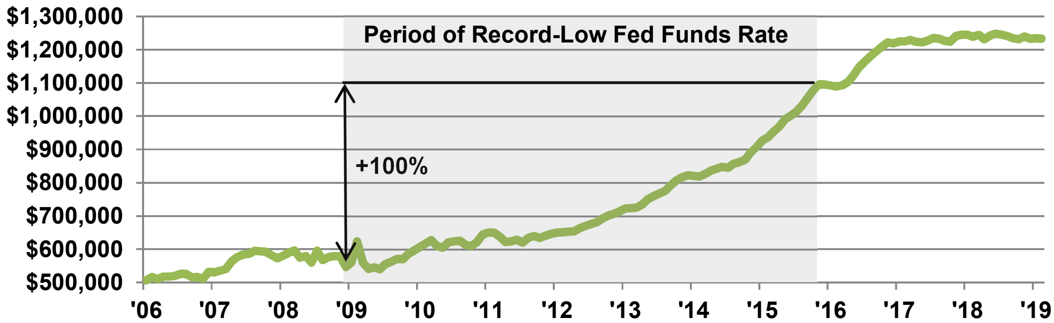
US Federal Funds Target Rate (Upper Bound)



Source: Bloomberg Finance L.P., US Federal Reserve as of 4/1/2019

Chart 2:

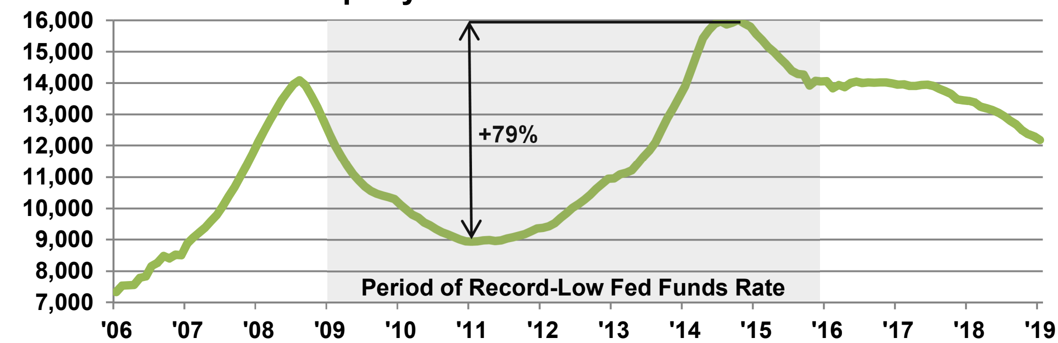
Auckland City - Average Price of Residential Property



Source: Bloomberg Finance L.P. as of 4/1/2019

Chart 3:

Dubai - Residential Property Price Index



Source: Bloomberg Finance L.P., Bank of International Settlements as of 4/1/2019

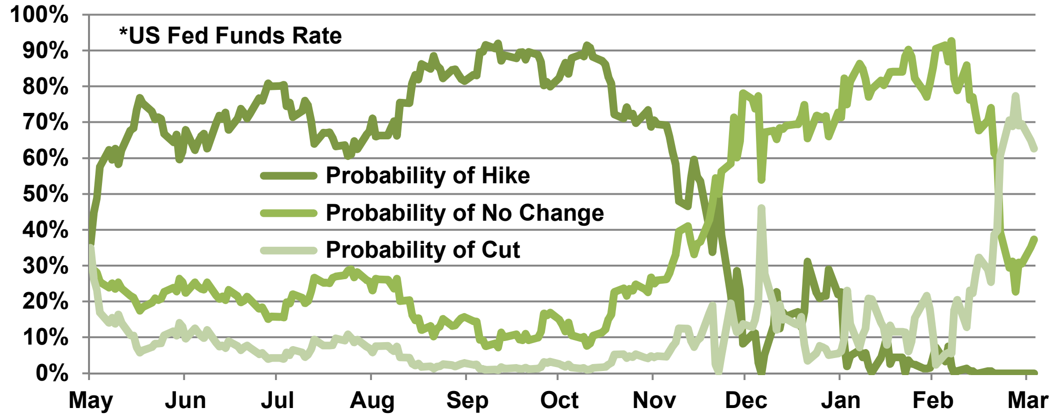
So, what are the chances that policymakers will continue to move in the direction of easy money and lower rates? The market thinks that the changes are pretty good (**Chart 4**). Interest rate futures that trade on the Chicago Board Options Exchange are implying that the US Federal Reserve (the Fed) will probably cut rates by the end of 2019 (about a two-thirds probability). If that is the case, it appears that the current rate-hiking cycle has stalled for the foreseeable future. It might have been the stock-market selloff in the Autumn that scared the policymakers at the Fed. It could have even been the political pressure excerted by President Trump (although the Fed would surely defend the notion of its independence). Whatever it was, monetary policy in the US, and globally as well, has eased up in terms of the availability of money and credit.

If interest rates level off for an extended period of time, will it reignite property markets?

Well, it won't hurt. But local factors could interfere to an extent.

Chart 4:

On-going Probability of an Interest Rate Increase by End of 2019*



Source: Bloomberg Finance L.P. as of 4/1/2019

If the rate hikes have ceased for now, will it be good times again for real estate in Auckland, Dubai … or Vancouver? It would be hard to imagine that merely keeping rates fixed for a while would lead to a sustained up-trend in property prices. But, there could always be a minor relief rally similar to what we have seen in global stock markets since the change in interest rate policy direction in late December. Stocks are much easier to transact than real estate, which helps facilitate a more immediate response.

There are still local factors that can keep real estate pinned down. Some of these included new taxes or restrictions (Auckland, similar to Vancouver, has introduced measures that attempt to deal with affordabilty for the local population). But nothing can impact property markets like local economic growth and interest rates. And, on the subject of interest rates, it appears that clouds have lifted for a while.

Model Portfolio Update[1]

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

During the month of March, there were no alterations to the asset allocation or the individual securities held in The Charter Group Balanced Portfolio or in any of the other model portfolios that we manage.

No changes were made to the model portfolios during March.

Except for gold, all the other asset classes used to construct the model portfolios experienced a positive month. Canadian stocks continued their positive momentum as did US and international stocks. Those results from the non-Canadian stocks were also enhanced by a slight weakening in the Canadian dollar.

March was one of those rare months when most asset classes did well.

It would be folly to expect the hot start to 2019 for investments and portfolios to continue through to the end of the year. Seasonally, at the beginning of May, stock markets have traditionally faced headwinds. Investors tend to look more closely at earnings and question valuations and the validity of the prognostications for the economy and the markets. Because of the impressive early-year returns, investors might find more

We are heading into a traditionally more challenging time of year for stocks. Investors could begin to question this year's gains.

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 3/1/2019. 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.

incentive to be skeptical. Any coinciding negative news could then increase the potential for a correction. Such news might include headlines on a further slowing in global economic growth or further delays for a trade agreement between the US and China.

That said, with interest rates seemingly capped for now and with massive rates of government spending in the US (deficit is projected to be more than $1 trillion this year) and in Canada ahead of a federal election, politicians and policymakers appear intent on keeping things rosy. Barring a seismic geopolitical event or something else over the horizon that we cannot yet see, the continued application of economic stimulus through a proverbial firehose will do a lot to mitigate the concerns of investors for now.

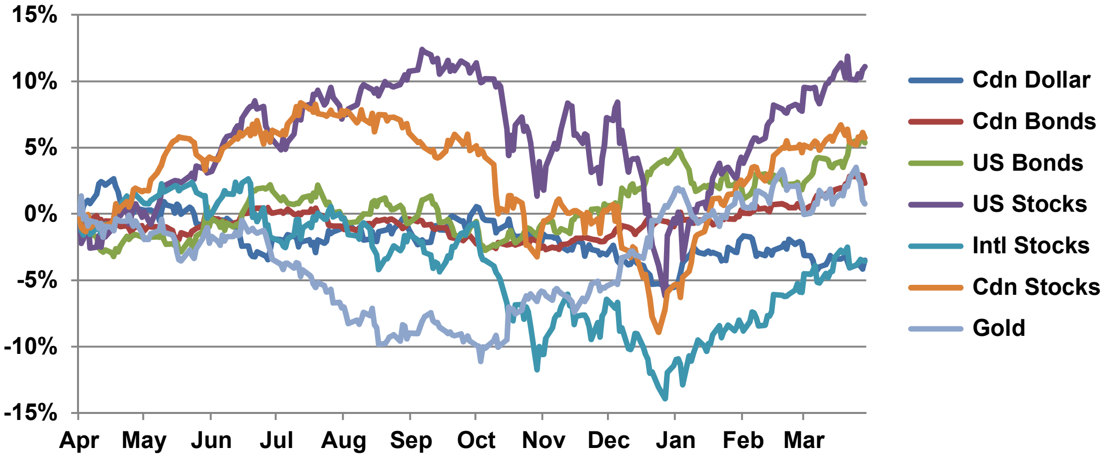
Politicians and policymakers are maintaining high spending and keeping interests at current levels.

This tends to be positive for investments in the short- to medium-term.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 5**).[2]

Chart 5:

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



Source: Bloomberg Finance L.P. from 4/1/2018 to 3/29/2019

[2] 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[3]

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. Massive Stimulus in China	Moderate	Positive
7. Short-term U.S. Interest Rates	Moderate	Negative
8. Canada's Economic Growth (Oil)	Medium	Negative
9. Stock Market Valuations	Light	Positive
10. East Asian / South Asian Geopolitics	Light	Negative

[3] 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 April 9, 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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