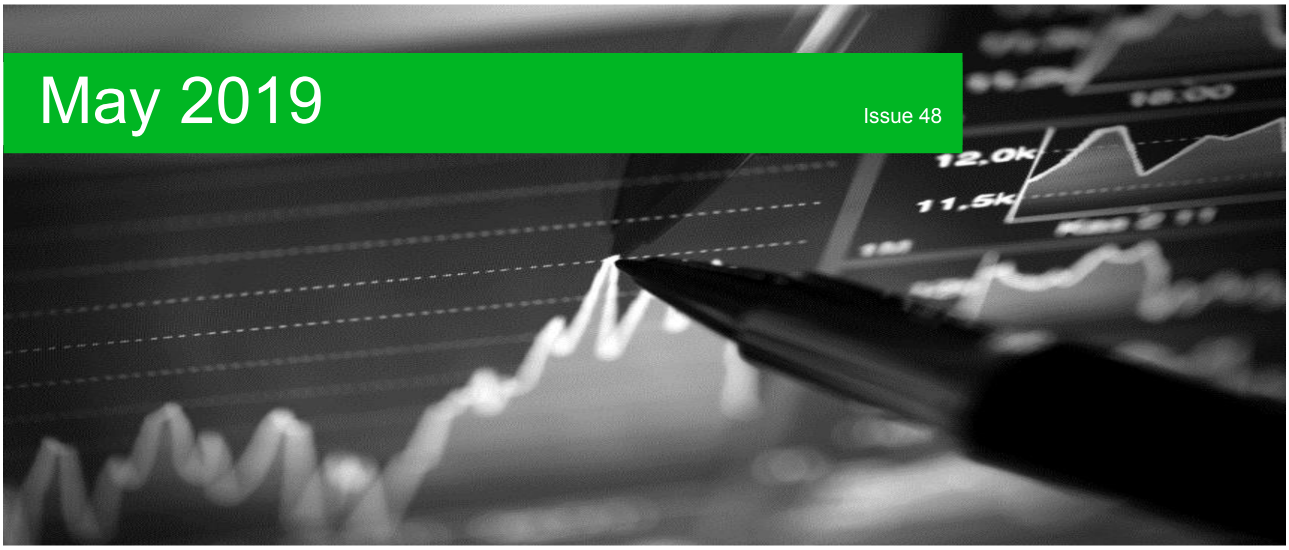
TD Wealth

The Charter Group Monthly Letter



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Economic & Market Update

Fashionable Government Spending

Budget deficits are generally a constant feature found in liberal democracies throughout the world. Politicians frequently over-promise during campaigns and tend to downplay how these promises will be financed. The eventual realization is that total tax revenues are insufficient to pay for everything. Governments must then incur debt (usually by issuing bonds) or print the needed money.

Government deficit spending is nothing new but now appears to becoming *more* fashionable.

Government debt, especially at the federal level, is different than personal consumer debt. Federal governments have the sovereign right to print money if it appears that there is no way to eventually pay back bondholders. If a consumer tried to personally print money to pay off debts, it would constitute a serious crime.

When Prime Minister Trudeau quipped about how the federal budget would eventually balance itself, he wasn't that far off in terms of reasoning. If you and I were allowed to create money by using our home computer printers, *all* of our personal budgets would balance themselves as well!

Federal governments can print money which can make deficit spending seductive, and feasible.

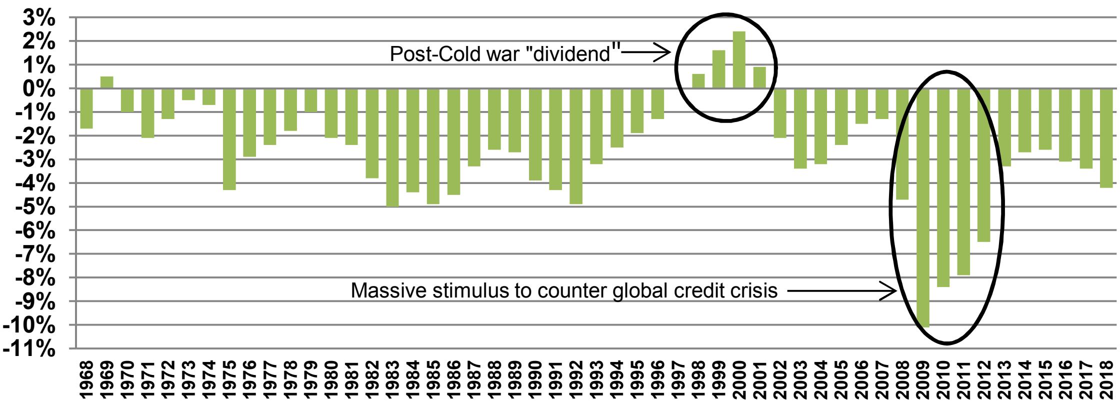
On relatively rare occasions there are budget surpluses, but often resulting from less controllable external circumstances instead of government austerity or prudent policy. President Clinton and Prime Minister Chretien crowed about their "abilities" produce surpluses when their real genius was that they happened to hold office during the post-Cold War halcyon period characterized by an opening up of global trade, a reduction in military expenditures, and a tech boom that significantly increased productivity (**Charts 1&2**). The enormous commodity cycle driven by China in the 2000's also produced a couple of surpluses each for Prime Ministers Martin and Harper primarily because of Canada's lucky fortune of having plenty of energy and materials to export.

Budget surpluses do occur, but are relatively rate and are often associated with unique economic circumstances or creative accounting.

In the last 50 years, there have only been 14 federal surpluses in Canada, and only 5 in the U.S. Plus, the average magnitude of the deficits have been dramatically larger than the surpluses.

Chart 1:

U.S. Annual Federal Budget Deficit (as a % of GDP)



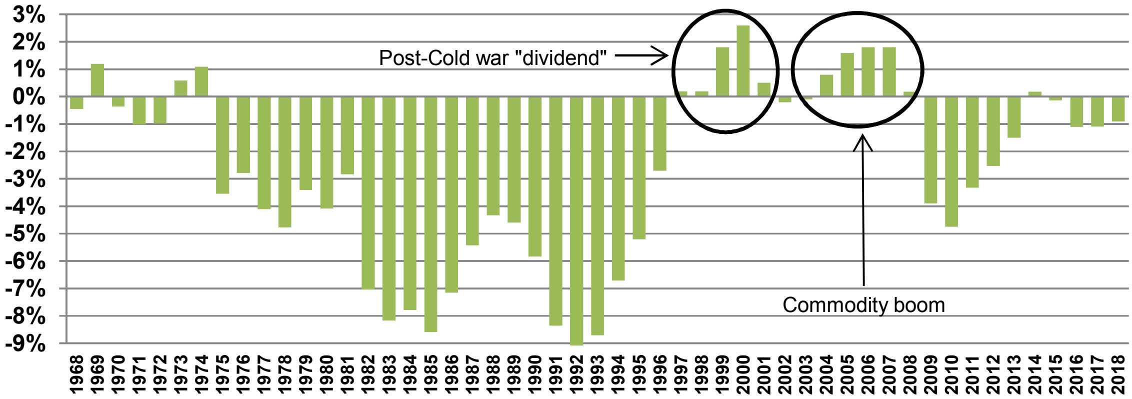
Source: Bloomberg Finance L.P., US Department of the Treasury as of 5/3/2019

It should also be noted that some budget surpluses are the result of pushing the limits of accounting treatments in order to squeeze out a small positive number in order to claim a balanced budget for campaigning purposes. However, these surpluses tend to be fleeting as the stretched results using gimmicks are not very sustainable. Canadian federal and provincial politics are often characterized by these shenanigans.

Speaking of campaigns, both Canada and the US are on the verge of heading into some heated political battles with a Canadian federal election on October 21st this year, and a U.S. presidential election in November 2020. However, it appears that the respective electorates are not demanding fiscal prudence at the current time allowing politicians to embrace even more spending.

Chart 2:

Canadian Annual Federal Budget Deficit (as a % of GDP)



Source: Bloomberg Finance L.P., Organisation for Economic Co-operation and Development as of 5/3/2019

By merely looking at totals for government spending, it is not possible to determine how much of that spending is being driven specifically by re-election politics. There are times when, for example, infrastructure needs to be improved or the military needs to be upgraded regardless of where we are in the political cycle. However, President Trump's badgering of the U.S. Federal Reserve (the Fed) over interest rates probably signals that he is willing to pull out all the stops in order to produce maximum economic growth leading up to November 2020. The Fed is officially politically independent and has been mostly left alone over the last four decades. For a President to comment on interest rates is an extremely provocative and revealing economic act.

Upcoming elections and a lack of public concern regarding the risks of debt might induce even more government spending.

The U.S. Office of Management and Budget, which is actually a department within President Trump's White House, has highlighted the growth in spending and has produced some eye-popping projections for the deficit heading into the presidential election next year (**Chart 3**). Often there are headlines regarding budget battles over "wall funding" and other spending measures involving a billion here and a billion there. However, those amounts pale in comparison to the amount of latitude that a presidential administration has in ramping up spending. And, often, Congressional opposition is minimal as politicians from both parties have a natural affinity for spending.

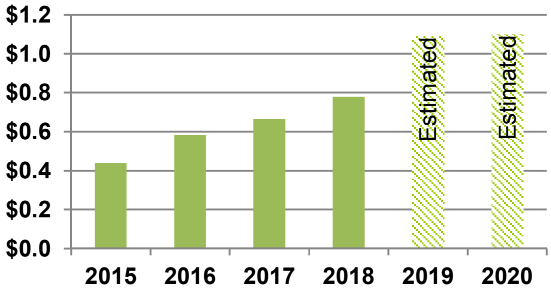
Previous increases in U.S. deficits have been the result of battling recessions, financial crises, or wars. However, the recent increase is coinciding with strong economic growth numbers and rising U.S. tax revenues (**Chart 4**). Excessively stimulating the economy involves borrowing from tomorrow to spend today. As a result, it raises questions as to why it would be a priority when the economy is already strong. Re-election politics appear to be the likely culprit.

Increasing spending when the economy is already doing well seems aggressive.

But, if politicians are allowed to spend, it is natural for many to take full advantage.

Chart 3:

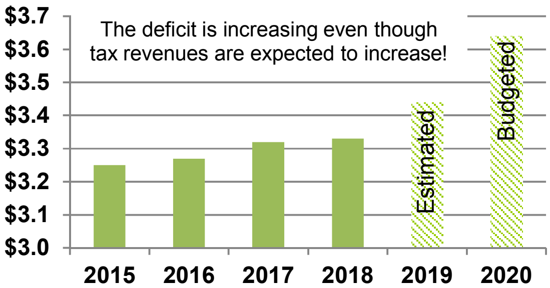
U.S. Federal Deficit (Trillions)



Source: US Office of Management & Budget as of 5/7/2019

Chart 4:

U.S. Federal Tax Revenue (Trillions)



Source: US Office of Management & Budget as of 5/7/2019

In Canada during March the federal government introduced a budget that increased spending by $22.8 billion. Despite campaigning in 2015 on the notion of a balanced budget, Prime Minister Trudeau appears to have been lured by the political expediency offered by increased spending and handouts. And, with a recent decline in approval ratings, increased spending may be one of the few remaining campaign tactics available with only six months before the federal election.

Also, there were significant promises of infrastructure development during the last federal election. Without much visible progress yet, it might be reasonable to expect a flurry of "high price-tag" announcements soon.

The problem with this fashionable era of excessive government spending is that it risks a day of reckoning in the future. If bondholders become concerned about receiving back their principal as debts grow beyond control, or if governments resort to money-printing in order to pay back bondholders thereby devaluing the money being paid back, bondholders could demand higher interest rates to compensate for those risks, seriously altering the investment market landscape. In the meantime, excessive spending could maintain the current stock market run if the economy keeps growing as a result.

Increased spending might have consequences someday, but it does keep fueling economic growth in the short-term which tends to be good for stocks.

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 April we made no changes 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 portfolio changes during April.

Stocks in Canada, the U.S., and internationally mostly advanced in April. As a result, it was not a surprise to see the model portfolios respond favourably to this. The rest of the asset classes such as bonds and alternatives, like gold, were down fractionally, but not enough to materially impact the results.

Stocks generally did very well during the month.

Stocks continued to be driven by the relatively dovish biases at the Fed and the Bank of Canada which have been evident since late December last year. Additionally, investors were happy with corporate earnings from the recently concluded 1st quarter "earnings season." There is still some inertia present in the Canadian and American economies and companies appear to be capitalizing on that.

Low interest rates and good corporate earnings helped to maintain the rally.

[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.

It may be not reasonable to expect the steady upward march of stock markets to continue unabated. Although we like our positions in Microsoft and Qualcomm (against which Apple recently dropped legal proceedings leading to a large gain in Qualcomm's share price), the valuations of large technology companies overall have risen back to risky levels. One worrying sign is the exuberance surrounding the initial public offerings of a number of tech companies with no earnings, such as Uber.

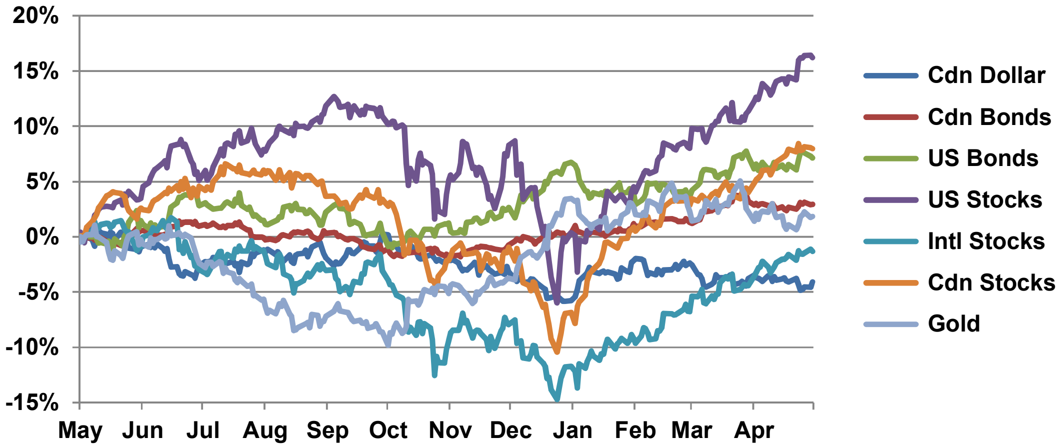
Technology stocks are getting overvalued which might increase risks for the market overall.

Recently, in client meetings, we have been discussing the risks of a breakdown in trade talks between the U.S. and China. I have been skeptical about a conveniently negotiated settlement. The issues surrounding the theft or forced transfer of U.S technology are likely too big to be tackled in the short-term. Markets are certainly hoping for a resolution although press reports now indicate that the Americans are getting frustrated. That said, it has been low interest rates and higher levels of government spending that are fueling markets and a continuation of those factors might be enough to help overcome volatility created by trade war threats.

The U.S.-China trade war looks like it might continue on longer than many investors expected.

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 5/1/2018 to 4/30/2019

[2] Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. 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. Global Trade Wars	Moderate	Negative
5. Long-term U.S. Interest Rates	Moderate	Negative
6. Massive Stimulus in China	Moderate	Positive
7. Short-term U.S. Interest Rates	Moderate	Positive
8. Canada's Economic Growth (Oil)	Medium	Negative
9. Stock Market Valuations	Medium	Negative
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 May 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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