TD Wealth

The Charter Group Monthly Letter

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Economic & Market Update

The Race to the Bottom

A cheaper currency can induce some short-term economic wonders for a country. Essentially, a cheaper currency reduces the price foreign importers pay. As a result, they will tend to buy more goods and services that "appear" to be on sale. The trade balance of the "cheap currency country" improves and the net increase in exports contributes directly to overall economic growth.

Economists are generally not that thrilled with this kind of policy. They often use the term "Beggar-Thy-Neighbour" to describe the concern. Essentially, by devaluing your own currency for short-term economic gain, you will be inflicting a commensurate amount of economic pain on your trading partners. Their currencies will become relatively more expensive which reduces their ability to maintain the same level of exports as before. Often, such a policy will set off a currency war as the trading partners will want to reduce the value of their currency to the previous relative position in order to recapture the former level of exports. Then, this might be followed by a second round of retaliation, and so forth, until everyone's currency is spiraling downwards relative to the value of real assets such as gold (**Chart 1**).

Spiraling retaliation is the recipe for a currency war.

Currency wars can make real assets like gold look attractive.

Chart 1:

Gold Spot Price (in USD)

Source: Bloomberg L.P. as of 7/9/2019

One might appreciate how tempting this would be to politicians (who are normally not that sympathetic to the worries of economists). How fantastic would it be for them to juice up economic growth by simply devaluing their currency before an election? Can you think of *anyone* currently who might be seduced by this prospect? Full marks if you guessed President Donald Trump! After all, there is a presidential election coming up in November of 2020 and he has hitched his wagon to the notion that he is the pro-economic growth candidate.

The political temptation may be too great to resist.

We know that he is enamored by this prospect because he has said so many times recently via Twitter and comments during press gatherings.

He berated the U.S. Federal Reserve Board (the Fed) when they were reluctant to stop raising interest rates, and then again when they were reluctant to cut rates. Lower rates make the U.S. dollar less attractive on a yield basis to foreign investors. This tends to push down the value of the U.S. dollar relative to the other major currencies.

It appeared that President Trump finally got his wish then the Fed acquiesced and signaled that they would seriously consider lowering rates this summer. He then went further and pleaded for multiple rate cuts in order to more effectively battle with China during their on-going trade war.

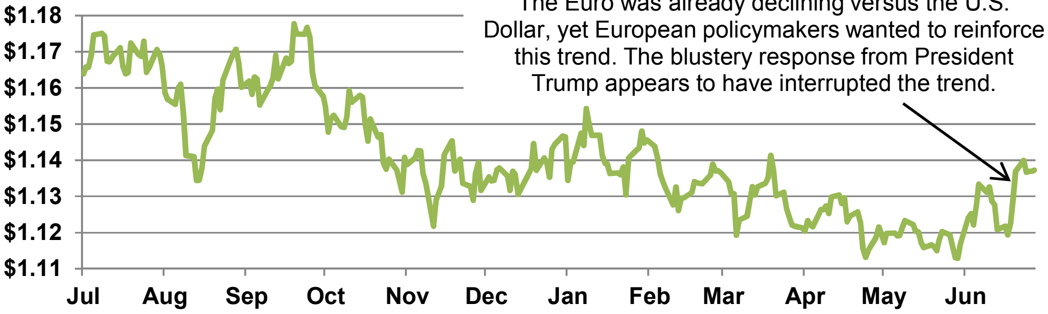
Then Mario Draghi (European Central Bank president), who was worried about Europe's waning economic growth, declared that he would likely be slashing rates in order to further weaken the Euro (**Chart 2**) and shore up European exports. President Trump was apoplectic upon hearing this news judging by his response in a tweet on June 18:

> "Mario Draghi just announced more stimulus could come, which immediately dropped the Euro against the Dollar, making it unfairly easier for them to compete against the USA. They have been getting away with this for years, along with China and others."

So, President Trump has been trying to get U.S. policymakers to devalue the U.S. dollar, and then gets upset when trading partners try to devalue their own currencies in response (**Chart 3**). It's pretty easy to see the comedy in all this.

Chart 2:

The Euro Priced in US Dollars



Source: Bloomberg L.P. as of 7/9/2019

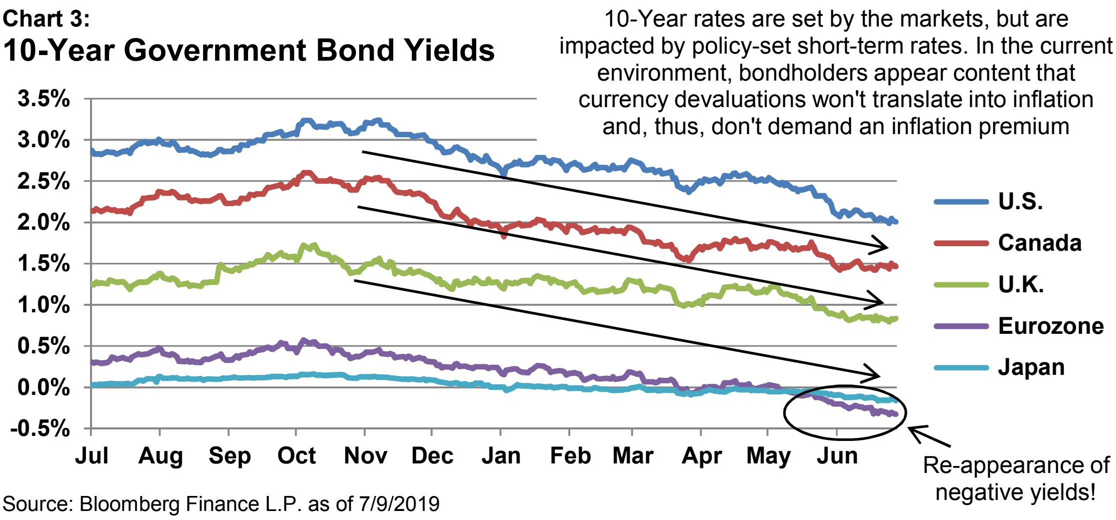
A currency war has some portfolio implications. One the positive side, global interest rates begin to fall as counties cut to make their currencies less attractive. Lower rates tend to lift both stock and bonds. Additionally, by making it more affordable to borrow,

Currency devaluations can have short-term economic benefits.

However, they can negatively affect companies and industries that have significant foreign features.

Chart 3:

10-Year Government Bond Yields



Source: Bloomberg Finance L.P. as of 7/9/2019 companies, governments, and consumers increase debt and, in turn, spend or invest those borrowings. This can provide a temporary boost to overall economic growth.

On the negative side, currency devaluations wreak havoc in businesses that have substantial overseas operations, or have significant foreign expenses and revenues. It becomes much more difficult to manage these companies and their share prices could suffer accordingly. For example, will a company be able to pass on the cost of higher foreign expenses to customers that might result when its own government decides to devalue?

International investors could also decide to avoid a country suspected of planning a currency devaluation as this would also devalue investments when translated back into the home currency of those investors.

However, in the short-term, the positives tend to outweigh the negatives. And, because of the constraints of the election cycle, most politicians focus on the short-term.

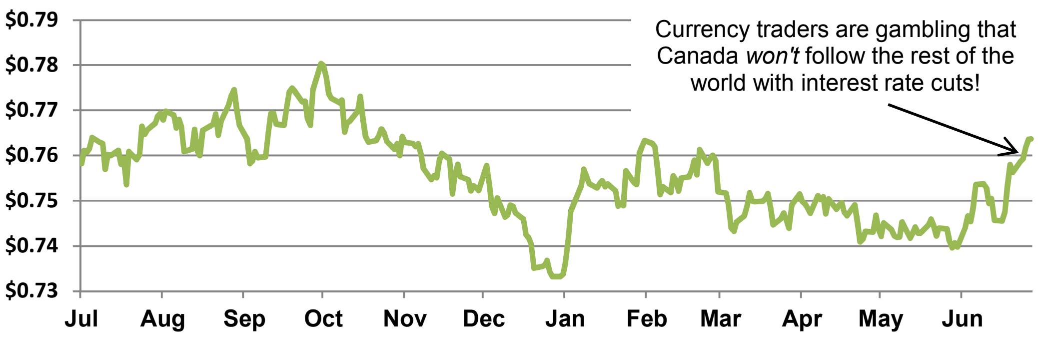
Since we are talking currencies, what might be the impact on the Canadian dollar? (**Chart 4**) Well, it depends on how the Bank of Canada responds to rate-cutting and currency devaluations in other countries, especially vis-à-vis the U.S. Is Canada's economy robust enough to withstand a decline in exports to the U.S.? Is economic growth enough for the incumbent government to feel confident going into the Federal election on October 21? It might also be useful to recall that the current governor of the Bank of Canada, Stephen Poloz, comes from the export-side of the economy, serving as President and CEO of Export Development Canada. I can't predict whether the Bank of Canada will cut rates and weaken the Canadian dollar if the Americans cut rates. However, one can surmise that there *will* be pressure to join the race to the bottom.

So far, Canada has resisted.

But, for how long?

Chart 4:

Canadian Dollar Versus The U.S. Dollar



Source: Bloomberg Finance L.P. as of 7/9/2019

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	24.5	+1.0
U.S. Bonds	3.5	+1.0
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	4.0	-2.0

With the proceeds from some bond redemptions over the last month, we purchased two provincial government bonds with maturities of two and four years as we still want to keep the overall duration of the bonds relatively short. Interest rates may be falling for now, but this may not be the longer-term trend.

Proceeds from recent bond maturities were re-invested.

We also sold our position in WestJet as it was trading at a premium because of the proposed takeover by Onex Corp. Those proceeds were then invested into Finning International, the Vancouver-based dealer of Caterpillar-brand heavy equipment which was trading at a price that we assessed to be an attractive valuation.

WestJet was sold and replaced with Finning International.

The results of the Balanced Portfolio for the month were enhanced by very strong advances from most of the asset classes on the hope that the U.S. Federal Reserve would cut rates over the summer, and on the hope that the U.S. and China would inch toward some sort of trade deal. In fact, there were some informal concessions made by

The Balanced Portfolio was helped by the fact that almost every asset class was higher during June.

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 7/9/2019. 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.

President Trump at the G20 meeting in Osaka with respect to lifting restrictions on the Chinese telecom company Huawei.

Gold was higher on fears of a currency war and on geopolitical tension involving Iran, Russia, and China.

Gold bullion was the big gainer of the month rising over 4% in Canadian dollar terms. US, Canadian, and international stocks also posted very good numbers in general.

The strength of the Canadian dollar hurt the results a little.

One detriment for the Portfolio was the strength of the Canadian dollar over June, gaining 3.23% versus the U.S. dollar.[2] This has the impact of detracting from the investments denominated in a foreign currency, which adds up to about 52% of the overall Portfolio's assets. However, it's possible that the Canadian dollar could face significant resistance in light of the fact that most other major currencies are being devalued (as discussed in the first part of this month's *Monthly Letter*).

But, it will be challenging for the Loonie to maintain this momentum.

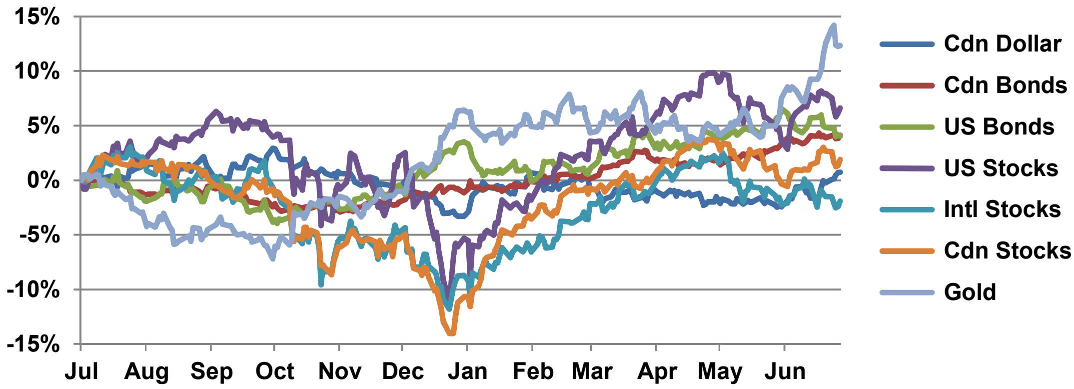
Stocks and bonds have had a good run but may require further promises of interest rate cuts into the autumn, especially with some expected weakness in overall corporate earnings. Also, a bona fide trade deal stuck between the U.S. and China would help immensely (an unlikely possibility in my view).

Investments will have to navigate some hurdles resulting from weaker earnings and elusive trade deals.

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**).[3]

Chart 5:

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



Source: Bloomberg Finance L.P. from 7/1/2018 to 6/30/2019

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[2] Source: Bloomberg Finance as of 7/9/2019.

[3] 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[4]

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

[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.

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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.

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The information contained herein is current as of July 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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