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Economic & Market Update

Minority Report

Minority Report, a 2002 film starring Tom Cruise, featured a view of the future through both dystopian and utopian lenses. The 2019 Canadian federal election, which resulted in a minority, featured dystopian scare tactics and utopian promises.

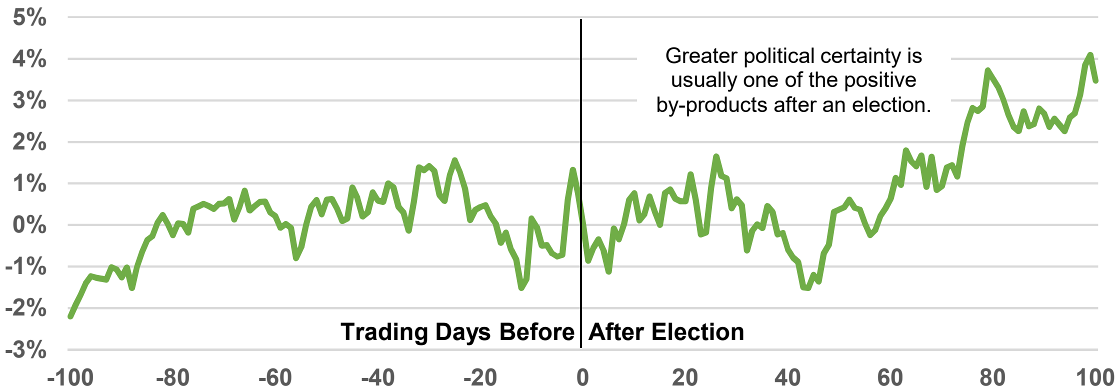
Voter preference for deficit spending will likely have a bigger impact on Canada's economic trajectory than the specific results of the federal election.

What really characterized the election was that the degree of fearmongering and economic fantasizing squelched any real debate on national or foreign policy issues that could have a significant impact on the economy in the future. Instead, the campaign saw an endless volley of "pocketbook" promises (like handouts for camping) in amongst the mudslinging.

At The Charter Group's Autumn Economic & Market Update presentation this month, I discussed that historically Canadian stocks and the dollar don't get impacted much by federal elections. If anything, there is slightly stronger performance following the election date. Regardless of which party wins, markets often appreciate the greater amount of certainty that follows the results. At least the markets know who they are dealing with.

I saw the recent election campaign being dominated by pocketbook gimmicks while a debate over economic strategy was absent.

Chart 1:
S&P/TSX Composite Index Average Performance Relative to the MSCI World Index Before and After Canadian Federal Elections



Source: Bloomberg Finance L.P. as of 10/29/2019, Averaged for all federal elections from 1979 to 2015.

Longer term, it appears that the health of government finances has a more dominant impact on where Canadian markets head.

With that, there is a new trend among Canadian voters which could result in financial storm clouds further out into the future. None of the parties competing in this year's election proposed to balance the budget within a year or two of the election. Only the Conservative party pledged to eliminate the deficit. However, their plan would not achieve this until the 2024-2025 fiscal year.[1] This contrasts against the balanced budgets of the Jean Chrétien Liberals of the later 1990s when Paul Martin, Jr. served as Finance Minister. Were the Liberals more fiscally conservative in the past than the Conservatives are now?

Investors tend to be more interested in debates over future economic strategy than incoherent piecemeal financial promises.

Back then Canadian voters could be swayed by the importance of balancing the budget in order avoid burdening future generations and to put the country in a stronger fiscal position in order to battle future recessions. However, judging by the election results, and by the profligate shift in the Conservative fiscal platform, those are not as high priorities

Voters used to be much more worried about government debt.

[1] "Canada's opposition Conservatives pledge to balance budget with no public job cuts," Reuters.com, October 11, 2019.

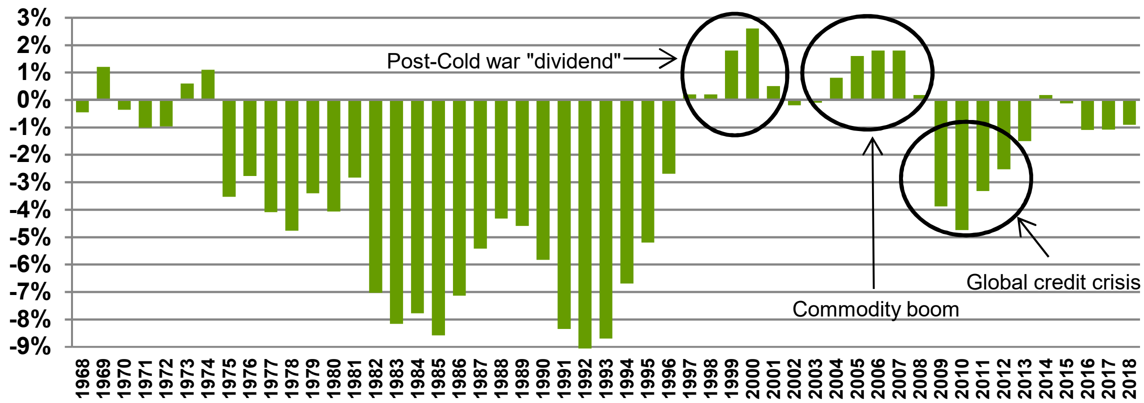
for Canadian voters as they once were.

Canadian federal debt has been on the increase again in recent years.

So, Canadians will get the deficits that they voted for. But, what will investors get? History might provide a few clues. **Charts 2&3** illustrate Canada's federal budget deficit and total federal debt going back over the last number of decades. Generally, the total debt in **Chart 3** is an accumulation of the annual deficits in **Chart 2** (correspondingly, the total debt falls in years with a budget surplus).

Chart 2:

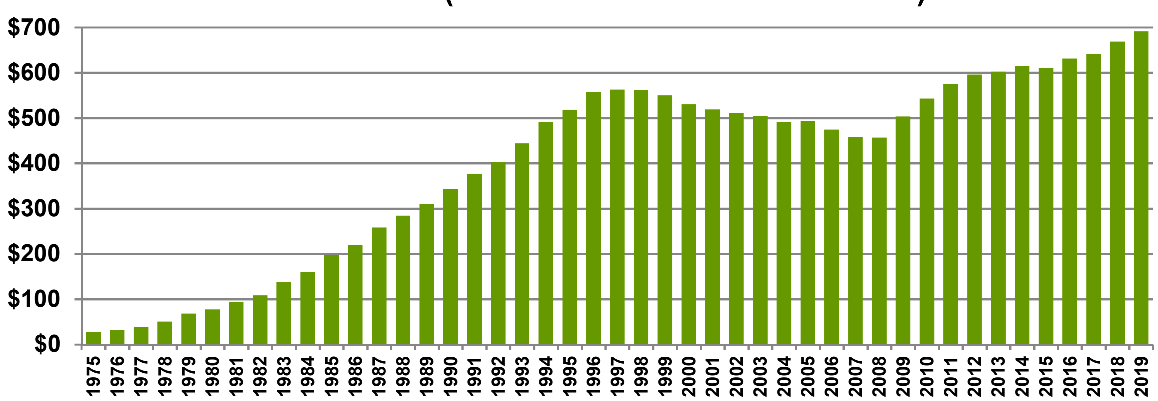
Canadian Annual Federal Budget Deficit (as a % of GDP)



Source: Bloomberg Finance L.P., Organisation for Economic Co-operation and Development as of 10/29/2019

Chart 3:

Canada: Total Federal Debt (in Billions of Canadian Dollars)



Source: Bloomberg Finance L.P. as of 10/29/2019. The 2019 total is as of 8/31/2019.

Canada's love affair with debt began during the Pierre Trudeau era as the federal government experimented with various social engineering projects. Unfortunately, this stretch ran headlong into the 1982 recession, the worst Canada has seen in the since the 1930s. The cost of servicing that debt load was exasperated by high interest rates which, in turn, significantly increased the budget deficit and accelerated the growth in total debt.

The previous episode of rising federal debt was from the mid-1970s to mid-1990s.

The interest rate expense was becoming a large part of the federal budget itself.

Brian Mulroney didn't have much success in reducing the deficits as the national unity "cause" had a high price tag. Also, it was becoming more common for governments around the would to use deficit spending as a form of economic stimulus and the Mulroney government found it hard to resist the temptation.

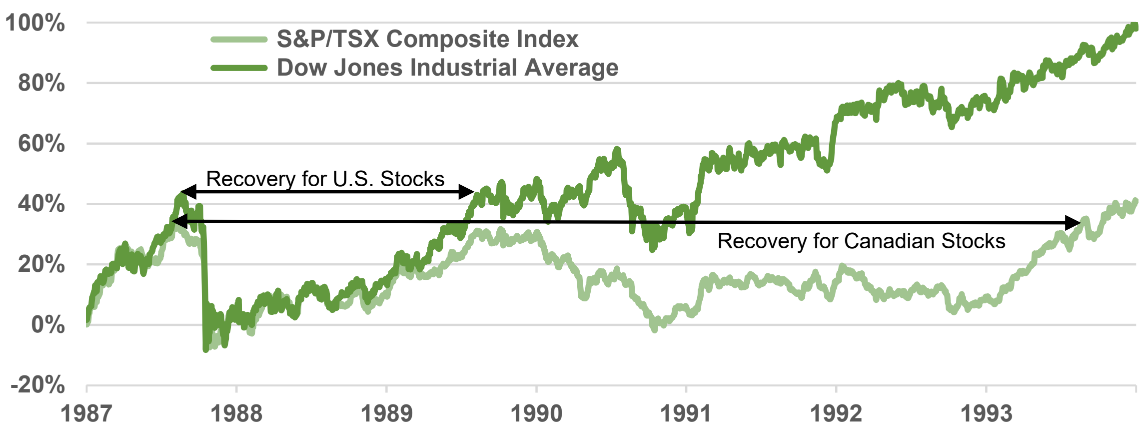
The heavy cost of the two decade-long debt party became evident during the global stock market crash of October 1987 and the Canadian recession in 1991. From the depths of the stock market crash, it took Canadian stocks almost six years to regain the pre-crash level compared to less than two years for American stocks (**Chart 4**).

High federal debt reduced the government's flexibility to navigate the October 1987 stock market crash and the 1991 recession.

Oil prices, which can drive Canada's economic and stock market results, traded in a fairly tight range between $13 and $24 USD per barrel (with the exception of a six-month spike during the first Gulf War). Over this stretch, energy prices were not the culprit for the Canadian stock market malaise or the 1991 recession.

Chart 4:

Canadian Stocks Versus U.S. Stocks from January 1, 1987



Source: Bloomberg Finance L.P. as of 10/29/2019

Debt growth is being established again, and there will be another recession someday.

Over the short- to medium-term, investors in the Canadian stock market probably won't put too much weight on the specifics of the federal election outcome. Regardless of who won and regardless of whether it was a majority or minority result, the pocketbook gimmicks that characterized this campaign seem unlikely to energize investors in lieu of honest long-term economic strategies. The federal debt will probably continue its robust growth, and there will be a recession someday. Those who have forgotten the financial market history of government debt-induced damage may indeed be doomed to repeat it.

Investors who don't take notice might repeat the frustrating experience of Canadian stock market investors from 1987 to 1993.

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

There were no changes to the specific holdings or the targeted overall asset allocation in the model portfolios during the month of October.

No changes to the model portfolios during October.

Stocks in the U.S. and internationally were relatively docile considering October's scary reputation. Canadian stocks had a difficult start to the month, possibly related to the uncertainty of the federal election outcome. However, Canadian markets steadied post-election. As discussed in the previous section, at least investors knew who they would be dealing with in government over the next two to four years.

Equity investors were relatively calm despite October's volatile reputation.

The Canadian dollar strengthened as it appeared that the Bank of Canada would not follow the U.S. Federal Reserve with rate cuts on October 30. This may not be sustainable given some weakening Canadian economic numbers relative to the U.S. growth rate.

The Canadian dollar strengthened as foreign exchange traders outside of Canada might be too optimistic about Canada's economy.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 10/29/2019. 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 was also a relatively poor month for bonds as prices on longer term securities were hit by rising rates. Prior to the month, many strategists had anticipated rates declining due to recessionary fears.

Bond prices lagged when interest rates rose in response to fading economic pessimism.

Going forward, the massive spike in U.S. Treasury bond issuance (over $950 billion since the beginning of August)[3] could be an indication that U.S. government spending is set to accelerate. This might be due to President Trump's re-election efforts as he has positioned himself as the pro-business and pro-economic growth candidate. If the cash raised from the bond issuance quickly finds its way into infrastructure and military projects, there could be a measurable jump in economic growth and stock market performance. Clearly, this kind of economic policy has the potential for a whopping hangover effect somewhere down the road, but election cycles tend to limit political foresight to the short-term.

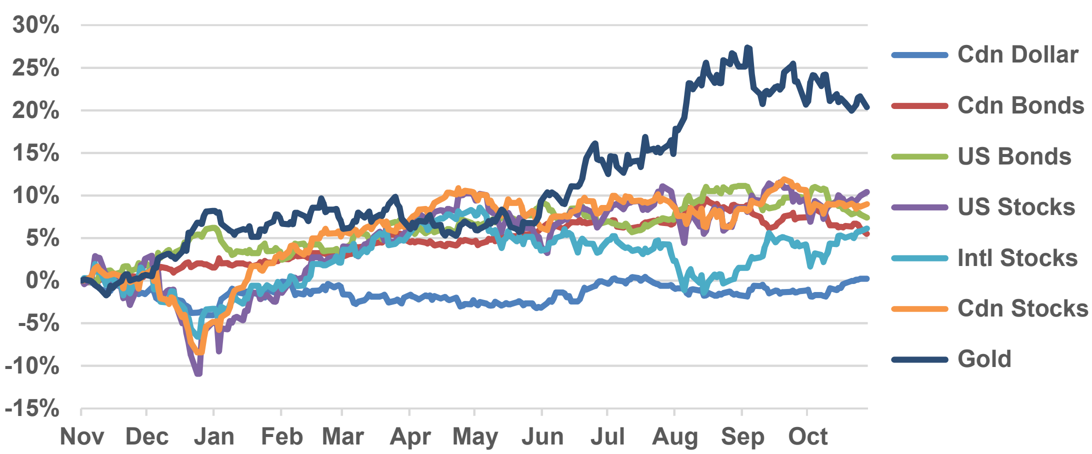
Between now and the November 2020 U.S. presidential election, it appears that the U.S. government will be spending heavily.

Excess spending can be a positive for the economy and stocks over the short-term, but long-term there can be costs associated with this.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 5**).[4]

Chart 5:

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



Source: Bloomberg Finance L.P. from 1011/2018 to 10/29/2019

[3] Bloomberg Finance L.P. as of 10/29/2019.

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

[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 October 29, 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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