TD Wealth

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Economic & Market Update

Better Years after Bad Years (One Year Later)

2018 was the worst year for stocks in both Canada and the U.S. during the last decade. Contrastingly, 2019 was the best year of the decade for Canada and 3rd best for the U.S.[1]

Bad years for stocks tend to be followed by good years.

However, the opposite tendency is not quite as strong.

In the January 2019 edition of the *Monthly Letter*, I wrote about the tendency for markets to bounce back after a bad year. This is a component of something called "Regression to the Mean," a statistical term that describes how things move back towards their long-term average rate of return after a period of outperformance or underperformance.

[1] Source: Bloomberg Finance L.P. as of 1/7/2020, using the TSX/S&P 500 Composite Index as a proxy for Canadian stocks and the Dow Jones Industrial Average as a proxy for U.S. stocks.

During the last quarter of 2018, stock markets experienced relatively significant declines. That was enough to breed concern among investors that 2019 was destined to be gloomy despite most of the critical economic indicators being nowhere near as alarming as they were during the run-up to the 2008 Global Credit Crisis. Yet, investors were still worried that a slow rise in interest rates beginning about three years prior would be enough to derail the markets.

Investors were skittish after a challenging 2018.

Positive market performance in 2019 relegated that skittishness to a distant memory.

So, if bad years tend to be followed by good years (statistically), do good years tend be followed by bad years? Generally, the answer is no. Good years tend to be followed by a string of more good years.

This is likely a function of economic growth which persists over the long-term (for the last 350 years or so anyway). Economic growth spawns profit growth, part of which is reinvested into the pursuit of innovation which further establishes the economic march upwards. Eventually, share values reflect this. An old favorite quote I like is: The market is a random walk up an 9.3% grade.[2] There may be some short-term randomness, but beneath the market is an incline representing economic progress. Regression to the Mean is about migrating to the long-term average rate of return, not about going back to zero.

The progression of annual market returns tends to include multiple positive years after a negative year.

Inertia from economic growth helps to sustain this pattern.

Chart 1:
Dow Jones Industrial Average: Total Return Including Dividends

Source: Bloomberg Finance L.P. as of 1/7/2020

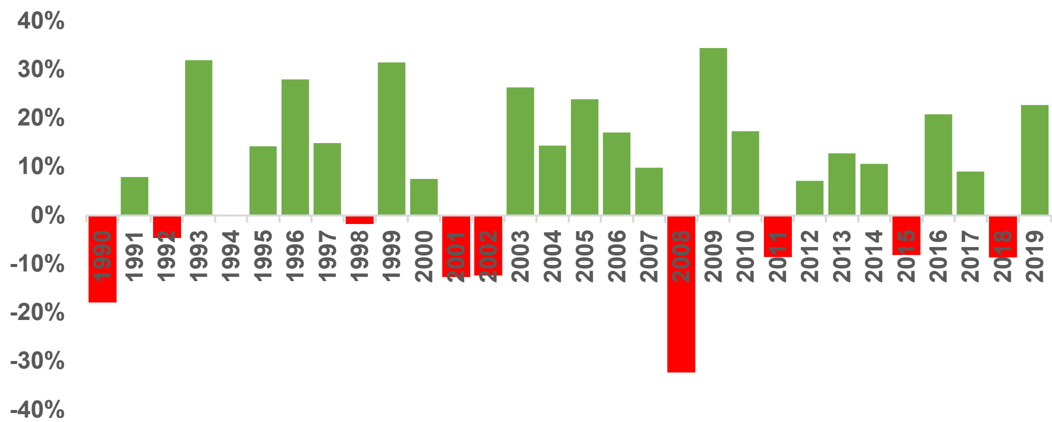
So, how does all this bode for 2020? Long-term economic growth is a positive factor, but it is not a guarantee that market will be higher at December 31.

[2] Gary B. Helms, *Doubled Down: A Nove of Wall Street In The 1970's*. Bloomington, IN. iUniverse, 2019.

For more clues, it might help to look at the progression of annual market returns over the last three decades (**Charts 1&2**).

Chart 2:

S&P/TSX Composite Index: Total Return Including Dividends



Source: Bloomberg Finance L.P. as of 1/7/2020

Similar to 2019, U.S. stocks (represented by the Dow Jones Industrial Average or "the Dow") bounced back in 2003 and 2009 after some dismal performances (**Chart 1**). It is notable that in both cases, the U.S. stocks did not use up all their octane in those years. 2003 was followed by four positive years and 2009 was followed by eight positive years.

So, the fact that 2019 was a very impressive bounce back year, it does not necessarily mean that the U.S. markets have used up all their potential for further positive years.

However, past annual patterns don't guarantee the same pattern going forward.

Other factors, such as geopolitical risks, can blindside investors and disrupt historical patterns.

Annual returns on Canadian stocks (**Chart 2**) tend to be less smooth than U.S. stocks. So, although a bounce back year tends to be followed by another positive year, the trend is less persistent. The Canadian market is much more concentrated in a couple of sectors (Resources & Financials) and, thus, more dependent on those sectors doing well. The Canadian market is also more vulnerable to single factors (a commodity boom, a real estate boom, an immigration boom) that are often not sustainable over the longer term.

Charts 1&2 only focus on a quantitative (numerical) element. If qualitative factors are strong enough, they can, from time to time, override a typical pattern of market returns. Shortly after ringing in the New Year, we were introduced to potential geopolitical risks emanating out of the Middle East. Geopolitical risks were more top-of-mind for investors back in the days of the Cold War. If they begin to emerge with similar frequency and magnitude as back then, it could be possible that markets will be subject to greater volatility. This may especially be the case as these risks may take some getting used to after three decades of mostly not needing to deal with them. Although unanticipated countervailing forces interrupt most domino theories, uninitiated investors can panic before those aspects become apparent.

So, statistically, 2020 has a few things going in its favour based on history. The inertia from current economic growth bolstered by on-going monetary and fiscal stimulus should help. But, there is always a risk of something coming out of left field and throwing a wrench into the works.

But, 2020 is just *one* year. Since we are at the start of a new decade, an analysis of rolling ten-year returns might provide a little more context on how things could evolve over the next ten years. We need to go back 81 years to 1939 until we find the Dow ending a ten-year period with a negative number (**Chart 3**). In fact, the ten-year periods ending in 1937, 1938, & 1939 all had negative numbers. It didn't help that the Dow fell over 89% from September 1929 to July 1932.[3] Plus, governments, which were still working in the dark with respect to implementing monetary and fiscal policies, likely amplified the economic problems and extended the market declines.

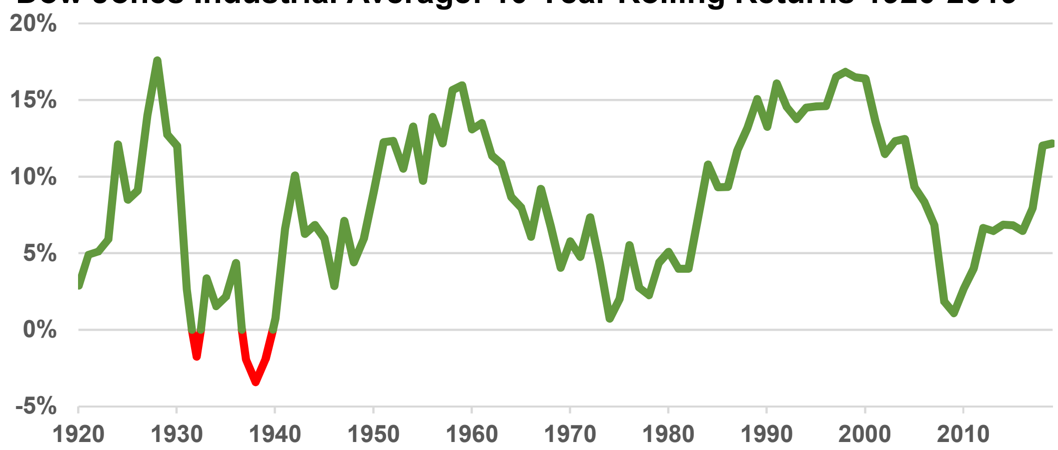
Investors can get seasick focusing on one-year returns.

Looking at returns over ten years smooths the results considerably.

Since then, history has been filled with wars (hot and cold), inflation, and energy crises. Yet, since 1939, ten years has been enough to ameliorate the worst of those episodes.

Chart 3:

Dow Jones Industrial Average: 10-Year Rolling Returns 1920-2019



Source: Bloomberg Finance L.P. as of 1/7/2020. The yearly data are annualized returns for a ten-year holding period for the Dow, including dividends, ending in that particular year.

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[3] Source: Bloomberg Finance L.P. as of 1/7/2020.

Model Portfolio Update[4]

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

No alterations were made to the model portfolios in December.

Many of the underlying positions did surprisingly well.

By maintaining them, we hope these positions run for a while longer.

The Canadian dollar ticked up during the month as the U.S. dollar eased off against most global currencies.

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

Most of the underlying positions were on a roll during the month, so we decided to "let the winners run." In some facets, December extended the run that we saw for most of the 2nd half of the year.

Even though we were happy with many of the results from the individual positions, a strengthening Canadian dollar muted the overall returns in the portfolios over the month. We are still comfortable that the Canadian dollar is confined to a trading range versus the U.S. dollar because of differences in economic growth potential between the two countries. Also, at the higher end of the 70-cent range, tailwinds build up for the Loonie as Canadian exports become a little less competitive. Plus, there are still some indications

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 1/7/2020. 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.

in the interest rate futures trading market that a cut in the Bank Rate is still a possibility sometime in 2020 which could limit the upside for the Loonie.

The Loonie still has some potential headwinds with which to contend.

Another bright spot during December was the jump in the price of gold. This was before the geopolitical fireworks were set off in the Middle East just after the New Year. From December 1 to January 7 (the date of writing), gold was up 7.25% in U.S. dollar terms.[5]

Gold began to rise in early December in response to potential inflation and geopolitical risks.

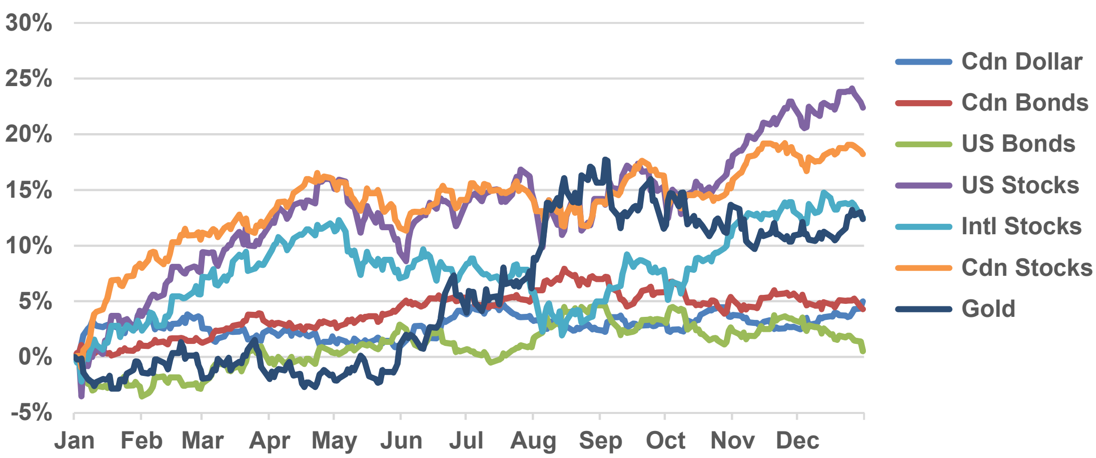
Geopolitics are usually a risk for equities. However, during the recent events equities have been relatively steady. Investors seem to be waiting to assess further developments.

U.S. government spending and central bank liquidity are still important factors when evaluating the potential for stocks in 2020.

Apart from geopolitics, the market will be looking for more interest rate cuts globally and an acceleration in U.S. government spending leading up to elections in November.

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 4**).[6]

Chart 4:
12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. from 1/1/2019 to 12/31/2019

[5] Source: Bloomberg Finance L.P. as of 1/7/2020.
[6] Source: 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[7]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. U.S. Fiscal Spending Stimulus	Moderate	Positive
3. Canadian Dollar Decline	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	Positive
7. Middle East Geopolitics	Medium	Negative
8. Massive Stimulus in China	Light	Positive
9. Stock Market Valuations	Light	Negative
10. Canada's Economic Growth (Oil)	Light	Negative

[7] 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 January 7, 2020.

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