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Economic & Market Update

COVIDominos

The concept of a domino theory emerged during the Cold War between the U.S. and the Soviets. The concern was that if nothing was done to stop the spread of communism, one by one, countries would fall under the influence of collectivist ideology. This was the driving force behind the involvement of the U.S. in Vietnam.

A "domino theory" in geopolitics assumes a chain-reaction will fully complete its course leading to a very dismal outcome.

With decades of hindsight, we can see that communism wasn't able to expand beyond its maximum geographic reach attained by the mid-1970s. So, either the Vietnam War was a success, or the chain-reaction of geopolitical dominos lost their momentum and petered out. Given that Viet Cong was victorious, it could be safe to assume that it was the second reason.

The recent market selloff suggests some investors are embracing this theory with respect to the coronavirus.

My anecdotal observations over the years tend to suggest that domino theories almost always fall well short of the prophetic headlines. As a portfolio manager, I am obligated to consider every worrying proclamation. Most of these are relatively minor but frequent, and often issued by perennially bearish investment strategists, or by politicians who see some benefit in whipping up fears. However, when the warnings involve war or global pandemics, public attention and anxiety can dramatically spike.

Historically, it is rare to have all the dominos fall.

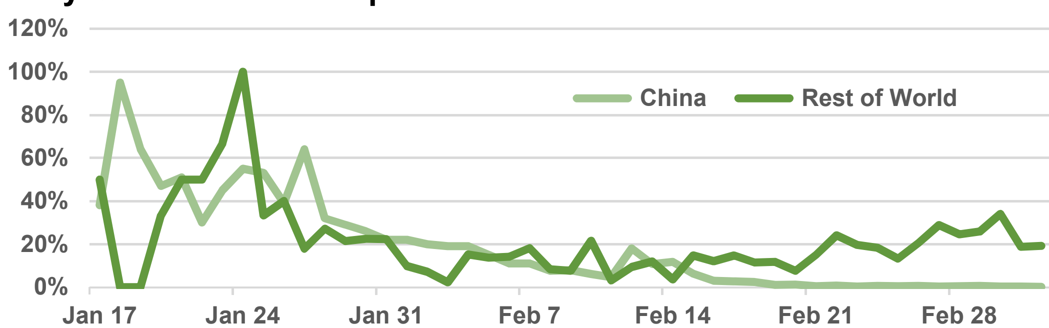
So, why do domino theories have difficulty reaching prophetic conclusions? Primarily because the concerns that they create induce new countervailing forces.

If there was *no reaction* to the news of the COVID-19 coronavirus, perhaps we would witness some of the more extreme epidemiological forecasts. Instead, the reaction has been immense. Massive containment measures, accelerated vaccine research, washing hands and wearing masks, communication and advice from health authorities, and possible further fiscal and monetary stimulus.

Somewhere along the line, the initial episode breeds countervailing forces which can slow down the falling dominos or even interrupt the chain.

Chart 1:

Daily Growth Rate of Reported Infections



Source: Wikipedia "2019-20 coronavirus outbreak" and "2019-20 coronavirus outbreak data/ International medial cases" as of 3/4/2020

Regarding potential additional fiscal stimulus (basically government spending), the U.S. Treasury has now raised over $1.4 trillion since the beginning of August via the issuance of bonds.[1] As discussed in the December issue of *The Monthly Letter*, I speculated that there was likely a huge incentive for the Trump administration to spend as much of that money before the U.S. presidential election on November 3rd. I had also mentioned that there were some hurdles to spending *all* the cash, some of that related to the need to get Congressional approval for some projects. Now, with the coronavirus, who wants to be that politician getting in the way of spending aimed at responding to the outbreak and the associated economic risk?

The coronavirus might provide even more justification for high levels of U.S. government spending.

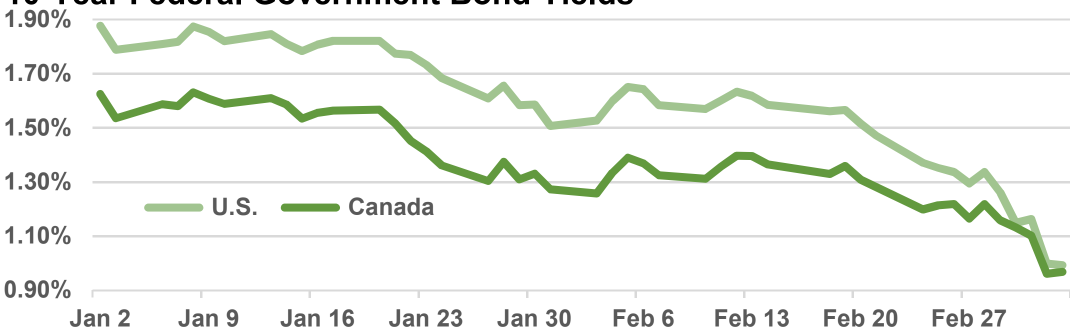
[1] Source: Bloomberg L.P. as of 3/4/2020. Currently the total is $1,418,070,000,000, to be more accurate.

With respect to monetary policy (short-term interest rates and the money supply), the U.S. Federal Reserve announced an emergency cut in rates by 0.50% on March 3rd (not waiting until the scheduled March 18th FOMC meeting. This was a complete about face compared to a month ago when the markets were not even sure if we would get a single 0.25% rate cut for all of 2020. In addition, long-term rates set by the market were already falling during the spread of the virus (**Chart 2**). As these rates have a major impact on lending rates, the decreases could have a positive effect on the economy.

The U.S. Federal Reserve cut short-term rates by 1/2%, something that was completely unforeseen a month ago.

Chart 2:

10-Year Federal Government Bond Yields



Source: Bloomberg Finance L.P. as of 3/4/2020

It is also important to note that the nature of the spread of the coronavirus is currently different from that of the seasonal flu. In most cases, when we get the flu we have no idea who we got it from. With COVID-19, with only rare exceptions so far, it can be traced to a carrier who has a connection to a vulnerable region or country (either travelling back from one of these areas or interacting with someone else who has returned). Plus, these vulnerable areas have peculiarities which are not found everywhere. In the case of the People's Republic of China and the Islamic Republic of Iran, there are authoritarian governments who tend to suppress the circulation of bad news because of the political consequences. In countries with a free press, bad news may make people anxious, but people are able to take early precautions rather than being left in the dark until things get dangerous. (The sizable infection numbers in South Korea and Italy also appear to have peculiar local factors that helped accelerate the spread).

The coronavirus spread is enhanced by particular regional factors and is still mostly traceable.

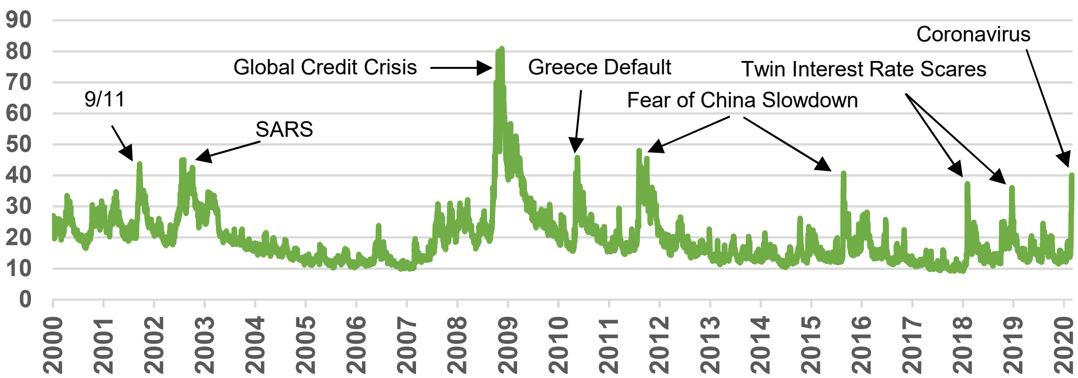
As mentioned in last month's edition of *The Monthly Letter*, the peak-level of infections are likely to be dramatically higher than current levels due to a lack of testing or a reluctance to fully report. Indonesia, which is in a region full of countries admitting to infections, and with which they have significant trading relationships and high flows of people travelling to and from, currently claims that it has only two infections.[2] Maybe it's true, but it's very hard to believe. As the infection rate data becomes less latent, the markets could continue to react adversely. However, the sense is that investors are pricing scenarios that are much more tilted towards the worst-case despite mitigating factors evident in the current spread.

Wouldn't be surprising to see more infections reported as it takes time for tests and the results to get compiled.

To provide some context of the fear surrounding the current market selloff, we're at similar levels reached on five previous occasions over the last decade (**Chart 3**). However, we are still well below the peak levels set during the subprime mortgage crisis in 2008-09.

Chart 3:

The VIX Volatility Index (The Fear Gauge)



Source: Bloomberg Finance L.P. as of 3/4/2020. The VIX is the implied expectation of volatilty derived from the pricing of S&P 500 index options contracts that trade on the Chicago Board Options Exchange.

Finally, it might also be prudent to consider a couple other factors that are adding to the current selloff. First, valuations were becoming a little rich after market gains through the 2nd half of last year and the first six weeks of this year, seemingly ignoring any negative news. Second, the emergence of Bernie Sanders as the leader in the race to become a Democratic party nominee for president over the last three weeks was causing some indigestion amongst investors. When valuations are high, investors might start looking for reasons to sell, even if those reasons don't have significant probabilities. The Bernie Sanders news might have been sufficient to trigger a market correction on its own.

Market valuations were already at the higher end of their historical levels which can cause investors to look for things to worry about: Bernie Sanders, Mideast strife, coronavirus.

Overall, investor reaction to the COVID-19 coronavirus may be a fear of worst-case scenarios. If investors act on that strategy, they are going to need almost all the dominos to fall. History generally tells us that this is very rare in the case of pandemics or wars. As a result, a market-timing reaction at this point likely constitutes a bet against history.

But, betting on a domino theory is a bet against history. It pays off on the rare occasion, but that's about it.

[2] Source: Wikipedia "2019-20 coronavirus outbreak" and "2019-20 coronavirus outbreak data/ International medial cases" as of 3/4/2020.

Model Portfolio Update[3]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	13.0	-2.0
U.S. Equities	38.0	+2.3
International Equities	8.0	-1.3
Fixed Income:		
Canadian Bonds	24.5	None
U.S. Bonds	3.5	None
Alternative Investments:		
Gold	8.0	+0.5
Commodities & Agriculture	3.0	+0.5
Cash	2.0	None

As the markets were selling off in the later part of February, we increased our exposure to U.S. stocks, assessing that the American market now represented better value relative to earnings and other fundamentals than either the Canadian or international markets. Additionally, the recent news regarding the difficulty of approving large projects in Canada made it easier for us to make this change in the asset allocation.

We increase the exposure to U.S. stocks and decreased it to Canadian and international stocks at the end of the month.

Three U.S. stocks were sold from the portfolio. Full valuations for these stocks increased the risk of holding the positions for much longer. They included Waste Management, Walmart, and Travelers (a property and casualty insurance company). The proceeds from these sales, and some of the proceeds from lowering the Canadian and international exposure, were used to increase the U.S. exposure through the additional purchase of existing U.S. positions. We will likely wait until the current market turbulence abates before increasing the number of U.S. equity positions again.

We also sold positions in Waste Management, Walmart, and the Travelers Group based on valuations relative to the rest of the market.

[3] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 3/4/2020. The asset allocations of individual clients invested in this Portfolio may 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.

Despite the downdraft for stocks during the month, it was not all bad news. Gold was up 0.83%, U.S. bonds (the Bloomberg Barclays US Aggregate Bond Index) were up 2.87%, and Canadian bonds (the FTSE TMX Canada Universe Bond Index) were up 0.31% (all these returns are stated in Canadian dollar terms).[4]

Despite the selloff in stocks during February, there were positive portfolio contributions from gold, bonds, and a stronger U.S. dollar versus the Loonie.

We were also helped by a 1.16% decline in the Loonie versus the U.S. dollar[5] which helped to mitigate the downside from the U.S. stocks in the portfolio.

As mentioned last month, we are still focusing on the potential for massive U.S. federal government spending between now and the presidential election on November 3rd. If anything, the COVID-19 coronavirus has provided the Trump administration with more justification to opening up the spending spigots.

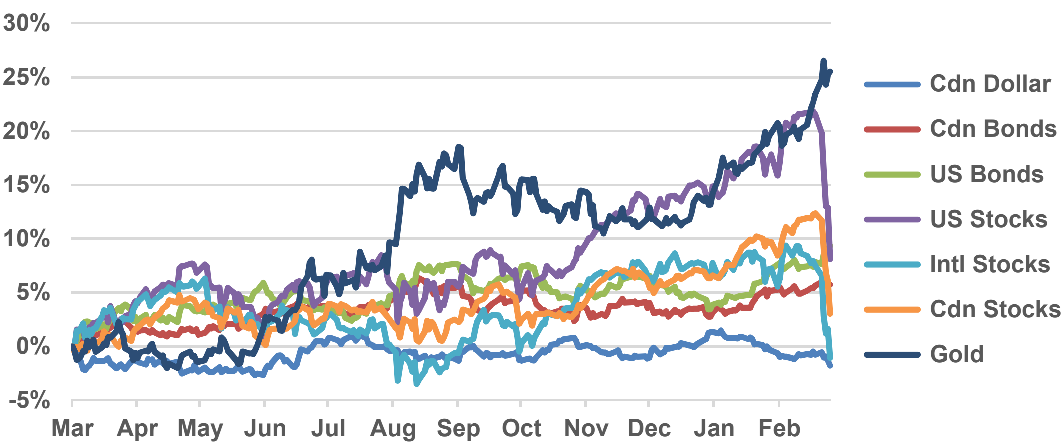
The rate of U.S. government spending is still formidable enough to counter balance much of the virus fears.

A close eye will be kept on the spread of the virus, but we might be getting to the stage where the data will really need to take a turn for the worse to fuel a further significant decline.

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 3/1/2019 to 2/28/2020

[4] Source: Bloomberg Finance L.P. as of 3/4/2020.
[5] Source: Bloomberg Finance L.P. as of 3/4/2020.
[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 Economic Growth (Virus)	Moderate	Negative
6. Long-term U.S. Interest Rates	Moderate	Positive
7. Global Trade Wars	Moderate	Negative
8. Canadian Federal Economic Policy	Medium	Negative
9. Massive Stimulus in China	Light	Positive
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 March 4, 2020.

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