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Economic & Market Update

Musings on the Post-Coronavirus World – Volume 2

This compilation of thoughts adds to the list from the previous issue of *The Charter Group Monthly Letter*. It would require a sustained barrage of unexpected and negative news regarding the Coronavirus to push markets back to the March lows. As a result, investors may be looking more forward than backward at this stage. However, examining the forward path may be much more complex than many prognosticators suggest. Getting any forecasted sequence of events in the right order will be a challenge. The timing of the events is just as important. We can also expect unforeseen forks in the road if the collection of all the variables move in slightly unexpected ways sufficient to alter the overall trajectory of the recovery. This leads to a multitude of things to ponder, perhaps more than one would expect. The list musings continues on the next page.

The Plankton Theory

Plankton are tiny organisms floating throughout the world's oceans. To the eye, they are an unimpressive collection of bacteria and algae. However, their appearance bellies their importance. Because of the oceanic food chain, if the plankton were to disappear, so would the larger organisms, up to and including whales.

Bill Gross, once the manager of the largest bond mutual fund in the world, observed that housing prices around where he lived in Southern California had stagnated. On the surface, everything looked normal and it was a bit of a puzzle that the normally hot Southern California real estate market had cooled off. He eventually arrived at the conclusion that it was the lack of new buyers coming into the market. If there is a dearth of new buyers, then existing homeowners find it difficult to trade up to bigger homes (that were typical in Bill Gross' neighbourhood). Gross tagged the new buyers with the 'plankton' label when theorizing about the leveling off of the price of his 'whale' of a home in Laguna Beach.

New buyers are an important component of the real estate market in the Lower Mainland as well. If young people, who were already stressed about the price of local real estate, are less confident about their employment prospects, they may be far less willing to take on the risk of a mortgage and could delay household formation. As a result, Lower Mainland real estate prices may behave more like they did in the 1980s than they did in the 2010s.

One Silver Lining for Real Estate

Central banks have deployed almost everything at their disposal to combat the economic impact of the Coronavirus lockdowns. Many of those efforts have contributed to lowering interest rates. Although mortgage rates may not be at their all-time lows, there won't be much upward pressure on them if policy rate targets remain low. The question will be whether job confidence will be low enough to counter this positive effect. Also, interest rates may not remain low for long (discussed below).

The Biggest Competitor in the Borrowing Market? Government

It is consensus that we are going to see record deficits at most levels of government in Canada and the U.S. as a result of the unprecedented level of bailouts, wage subsidies, and unemployment assistance. Governments in general had already ramped up spending levels over the last four decades. Low interest rates, facilitated by central banks, made debt more affordable than ever. In response to the Coronavirus, governments have hit the accelerator with respect to incurring more debt.

When governments go to the debt markets to borrow, they “crowd out” private borrowers (individuals and companies). Sovereign borrowers (usually federal governments that have the right to print money), go right to the head of the line because of the extremely remote possibility of default. As a result, they get first crack at satiating the appetite of lenders around the world. And, if that appetite begins to wane, a sovereign borrower can simply offer to pay more interest to entice lenders back into the market. Paying more interest is less consequential when you own a money-printing press.

However, companies and individuals don’t control money-printing presses. They find it more difficult to offer to pay a higher interest rate. Many may not be able to compete if sovereign borrowers’ need for massive capital results in higher interest rates. That’s what they mean by “crowding out.”

In my 1980s textbooks, we studied the crowding out of private borrowing and spending that occurred in the 1970s. And we lived it. Governments made it expensive for people to borrow to buy things. The notion of someone borrowing to buy something that was not essential to living was a somewhat shocking concept back then.

Discretionary Spending

Even if people have less confidence regarding their future job prospects, they will still buy things like toothpaste, laundry detergent, shampoo, etc. There are the very last things to be cut from a household budget. As a result, economists call them “non-discretionary.” You “need” those things.

But, do you need an 80-inch television to hang on the wall? Probably not. Those kinds of things along with vacations, dining out, jewelry, granite countertops, etc. fall into the category of “wants.” Decades of economic growth and falling borrowing costs created immense industries catering to an expansive, and very much indebted, middle class.

Because those industries that focus on “wants” are so significant, the overall economy may have a very difficult time recovering unless the middle class has the confidence to keep accumulating debt. For the first time in almost four decades, a sizable swath of the population is not very confident about the future. A second wave of the Coronavirus, or an entirely new pathogen in the next couple of years, could jeopardize their employment.

There will always be demand for nice things among the wealthiest in society. But, discretionary industries where the middle class was a relatively recent driving force may be years away from recovery. Good bye avocado toast?

Spending Commitments

Also related to the issue of job security are industries that rely on customers to make payments before the service or product is delivered. Who's going to prepay for that trip of a lifetime now? Unlikely if someone is not sure if they are going to have a job next year. And definitely unlikely if they fear that the airline will cancel and only offer a voucher instead of a refund. There have been plenty of cases in the news of refunds that have expiry dates and in the case of a future flight costing less than the original flight results in a forfeiture of the difference (I can personally attest to this after reading the fine print on my voucher received for my cancelled flight to this year's CFA Annual Conference in Atlanta). Prepaying provides many industries with working capital and improves their ability to plan and operate at higher efficiencies. Sometimes, these factors are so vital to certain companies that the loss of this type of revenue would force them to restructure the business at great cost. Perhaps at a cost too great to survive.

Geopolitical Posturing

It's a good bet that the 2020 U.S. presidential campaign is going to pivot hard on the issue of the candidates' views regarding the People's Republic of China (P.R.C.). There is almost bi-partisan consensus that the relationship between the U.S. and the P.R.C. needs to be re-examined. The focus of the last four years has been on trade and has resulted in an assortment of tariffs levied by both countries. However, issues of diplomacy, trust, espionage, technology theft, and possible military conflict have entered the conversation. Reminiscent of the Cold War era, this has the potential to put a cloud over the stock market and may impact sectors that thrived under the previous world order that existed from the early 1990s until now.

Model Portfolio Update[1]

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

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

During the first two weeks of May no changes were made to the asset allocations or to the specific securities in the model portfolios.

No changes were made to the model portfolios during the first half of May.

U.S., Canadian, and international stocks continue to remain in a trading range but are up over 18%, 15%, and 8% respectively since the beginning of April.[2] Gold also continues to be a positive contributor to the results as it is up over 9% over that period in U.S. dollar terms.[3] And, the liquidity provided to the bond markets by the U.S. Federal Reserve (the Fed) and the Bank of Canada has helped to establish fairer pricing which has resulted in higher bond prices in general since April 1.

Stocks have held onto the gains from April as investors have been buoyed by promises from the U.S. Fed to do "whatever it takes."

The mood of investors have generally been positive since the March stock market lows. A cresting of the Coronavirus infection curve in various hotspots, therapies for COVID-19

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 5/20/2020. 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.
[2] Source: Bloomberg Finance L.P. as of 5/20/2020. Using the S&P 500 Index for U.S. stocks, the S&P/TSX Composite Index for Canadian stocks, and the MSCI EAFE Index for international stocks.
[3] Source: Bloomberg Finance L.P. as of 5/20/2020.

symptoms, and promising early vaccine trials have contributed to this news. However, it is the pledge of the Fed to do anything it takes to prop up the U.S. economy that has really buoyed investors. Even if it appears the Fed will have to start printing money to cover the debts associated with the bailouts and handouts, the net effect could be positive in the short-term. The long-term might be a different story if related inflationary effects emerge.

Investors seem happy with all the help from the central banks during the Coronavirus pandemic.

But, what if all this money-printing creates inflation in the future?

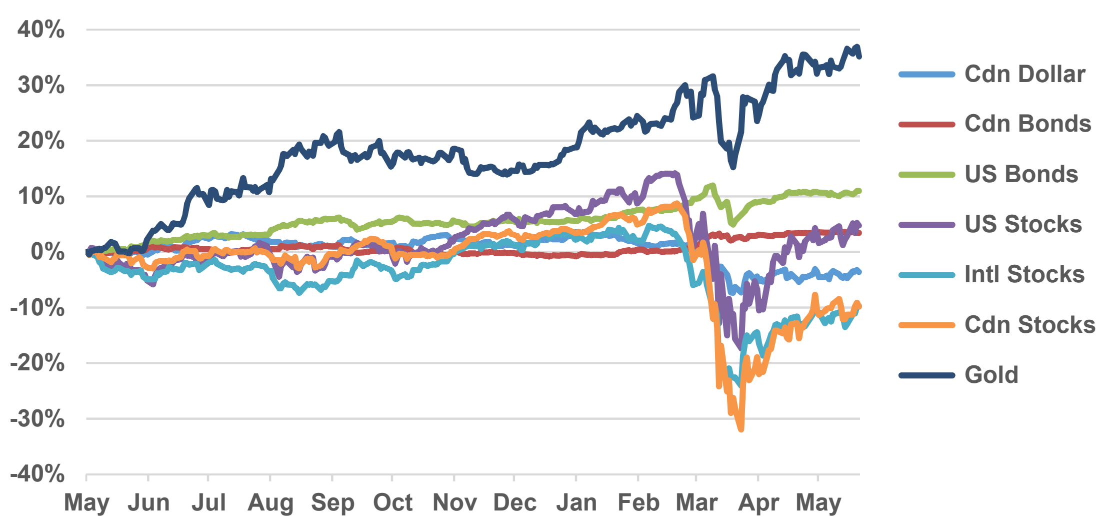
Over the next six months to a year, the markets might follow a path where the share prices of most companies benefit from the flood of government and central bank assistance. Low interest rates may even keep some firms with business models that are now questionable to successfully raise money through bond offerings. Surprisingly, a couple of cruise lines have been able to pull this off over the last month! However, eventually investors will start to demand profits which could lead to some volatility for companies unable to adjust to the post-Coronavirus world.

Some companies are taking advantage of the low interest rates to issue debt. But bond investors may demand profits to lessen the chance of defaults.

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 1**).[4]

Chart 1:

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



Source: Bloomberg Finance L.P. from 5/1/2019 to 5/21/2020

[4] 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 current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[5]

Issue	Importance	Potential Impact
1. U.S. Fiscal Spending Stimulus	Significant	Positive
2. Coronavirus Geopolitics	Significant	Negative
3. Canadian Dollar Decline	Moderate	Positive
4. Canadian Federal Economic Policy	Moderate	Negative
5. China's Economic Growth	Moderate	Negative
6. Short-term U.S. Interest Rates	Moderate	Positive
7. Canada's Economic Growth (Oil)	Moderate	Negative
8. Deglobalization	Medium	Negative
9. Global Trade Wars	Medium	Negative
10. Long-term U.S. Interest Rates	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 May 21, 2020.

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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