TD Wealth

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Economic & Market Update

Thoughts on the Post-Coronavirus World – Volume 3

Continuing from the previous editions of *The Charter Group Monthly Letter*, I have a few remaining musings on issues that we may face in the post-Coronavirus world.

Deficits

It is growingly obvious that deficits will literally expand by order of magnitude. Corporate bailouts, municipal bailouts, federal transfers to provincial governments, wage subsidies, unemployment benefits, small business assistance, and other promises all add up to an unprecedented increase in spending. But that is only one side of the equation. The revenue side, which involves the collection of taxes, will likely shrink as there will be less profits to tax and, additionally, there could be deferrals permitted for previous taxes owed.

In December the federal government projected an annual budget deficit of $26.6 billion (that was actually an increase from an earlier projection of $19.8 billion).[1] Now compare that to last week when the Parliamentary Budget Office estimated that the deficit might be around $260 billion! [2]

For some historical perspective, the annual deficits (unadjusted for inflation) from the early 1980s to the mid-1990s (Pierre Trudeau – Mulroney – Chretien) were roughly about $30 billion per year. During the depths of the Global Financial Crisis in 2008-09, the Harper government posted a $56 billion deficit.[3]

Generally, it is a lot easier to ramp up government spending than it is to reign it in. It would not be that unreasonable to expect higher deficits compared to the pre-Coronavirus years to perpetuate well into the future.

New Spending Priorities

Long-term senior care wasn't a top agenda item before the Coronavirus. Now it is. It is an issue that many politicians across all parties and levels of government have prioritized. One part of the solution might be the implementation of better management and practices. A bigger part of the solution will probably be money. And lots of it. The issue involves a growing share of the population as the Baby Boomers age and it is highly labour intensive. As a budgetary item, it is relatively open-ended when determining what constitutes quality care. Plus, a costly bureaucracy often accompanies this type of initiative.

It is also possible that the Coronavirus will lead to other new agencies or an expansion of existing agencies that focus on public health, early pathogen detection, early economic and social response, domestic personal protection equipment production, domestic medical equipment production, and more hospital capacity. Add all that to the bill.

Higher Taxes

Budgets don't balance themselves. But here might be a few policy tools to help mitigate

[1] Vieira, Paul. "Canada Widens Budget Deficit Forecasts." *The Wall Street Journal*, December 16, 2019.
[2] Press, Jordan. "Canada likely now has deficit of $260 billion due to coronavirus pandemic, PBO says." Global News, May 26, 2020.
[3] "Canada's deficits and surpluses, 1963 to 2015." CBC News, April 21, 2015.

them. One of those is to increase taxes. Despite Canadians' relatively heavy tax burden, governments may be tempted squeeze more from taxpayers. However, this can induce certain types of behaviors. Because of the expected increase "cost" of paying more taxes, people might be willing pay a higher "cost" to accountants to figure out legal ways of reducing tax bills. Also, if the marginal tax rate at the top income brackets becomes too severe, wealthy people often reduce business activity because lower net profits may not be worth the effort (this was a common topic in my college economics texts from the mid-1980s as there were plenty of American and British case studies highlighting the ineffectiveness of high marginal tax rates before Reagan and Thatcher came along).

Inflation

If increased taxes don't help much to contain deficits, then a federal government can always just print money to pay for things. This is still a taboo subject among economists and policymakers at central banks because of its potential to fuel inflation. If the public wises up to the fact that the money supply is expanding because of more money being printed, people might develop an expectation of inflation and adjust behavior accordingly. They may start hoarding items before prices increase. And, they may also start to bargain harder for wage increases to hedge against those expected higher prices.

Also, as discussed in the May edition of *The Charter Group Monthly Letter*, any de-globalization caused by the Coronavirus can lead to higher production costs which could also add to inflationary pressures.

Emerging Markets Cease to be Emerging

The last couple of decades has been a halcyon period for emerging market countries. Low borrowing rates in the developed world have effectively been exported to the developing world. Plus, sustained economic growth in developed countries have provided a source of demand for products that can be produced cheaply in emerging markets.

Now, if developed countries like Canada need to borrow more than ever before, that could increase borrowing costs as we and other countries compete for capital.

Higher borrowing costs and less global demand for manufactured goods could speed up the economic demise of many of the countries that were the darlings of optimistic and adventurous global investors. However, I wouldn't consider this result to be a total surprise as I believe most of the emerging market countries never took advantage of their good fortune by doing the difficult things necessary to reform their political systems and economies that might have elevated them to "developed country" status.

China Longing for the Good Ol' Days of the Last Three Decades?

The People's Republic of China (P.R.C.) was perhaps the biggest beneficiary of the post-Cold War global system. However, my sense is that the U.S. was in a long retreat from being the guarantor of unfettered global trade. It's expensive to maintain the most potent navy in history. The last four presidents have been notably less enthralled about foreign policy than their predecessors. It may be what the American public generally wants.

Judging by the "Belt and Road" trade route and "Made in China 2025" initiatives, the P.R.C. may have seen the writing on the wall. But now the Coronavirus pandemic may have accelerated the reality of a less secure global trading system by a number of years.

Unlike North America, the P.R.C. is not a consumer-driven economy. As a result, they especially need to get their finished products to willing consumers in North American and Europe. They have a navy, but it is mostly designed for coastal defense and to keep Taiwan on edge, not to keep the global peace.

America Winning the "Least Dismal" Prize?

Writing off the U.S. is an obsession in many countries that see America as a competitor, frenemy, or outright enemy. However, this tends to overlook the country's total and per capita economic output compared to all others. Additionally, the flexibility of its social and political institutions allows for tremendous bending without breaking. As horrific and emotional as the recent urban unrest has been, it is hardly an existential threat to the country or its system of governance (compare this to a number of Canadian constitutional crises that have been ignited by regional economics, language, or cultural differences).

The dynamism of the U.S. may have contributed to a higher Coronavirus infection rate in urban areas. But it is this dynamism that might separate the Americans from most others when we enter a recovery phase where the race will be on to determine who will claim the most prominent positions in the next global order.

Model Portfolio Update[4]

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

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

No changes were made to the model portfolios during May.

Over the last month, U.S., Canadian, and international stocks continued to charge ahead partly on the hopes that we will see a relatively quick recovery. Also, investors are not completely sure of what the landscape will look like further down the road, so they are merely placing their initial bets which has helped stocks. Later on, when certain stocks look like they won't be able to adapt to that new landscape, there could be a rush to sell. But for now, the market action resembles the "buy on rumour, sell on fact" pattern.

Stocks rose on the hopes of a relatively quick economic recovery and on a desire to invest now and worry about underperformers later.

Also, with the continued advance in stocks, the March lows are even further back in the rearview mirror. This is probably one of the main reasons for the reduction in general fear and panic over the last month. The Dow Jones Industrial Average is trading above the May 2019 low and is at levels that were common from early 2018 through to the second

Revisiting the March lows is less of a risk as more time passes.

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 3/31/2020. 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.

quarter of 2019. The S&P/TSX Composite Index (representing Canadian stocks) is trading at levels mostly seen in 2017. All of this is better than when the March lows were taking us back to levels from five years ago or more. Also, current market volatility, as measured by the CBOE VIX Index, is now well below the peaks from two interest rate "tantrums" of 2018, the China growth concerns of 2015, and the Greek debt crisis of 2011.[5]

Volatility continues to ebb and is now lower than at the peak of all the major crises that we saw in the last decade.

I would expect it to require a tremendous torrent of unexpected bad news to get us back to the March lows. There is always a risk of a second wave of infections, but it is far from a certainty. A pathogen's strength is its element of surprise. It's tough to surprise when almost the entire population is aware (similar to when people were concerned about a second terrorist attack after 911 – but everyone was focused on anything suspicious after being caught off guard by the initial attack).

A second wave is real risk. But, what is the probability?

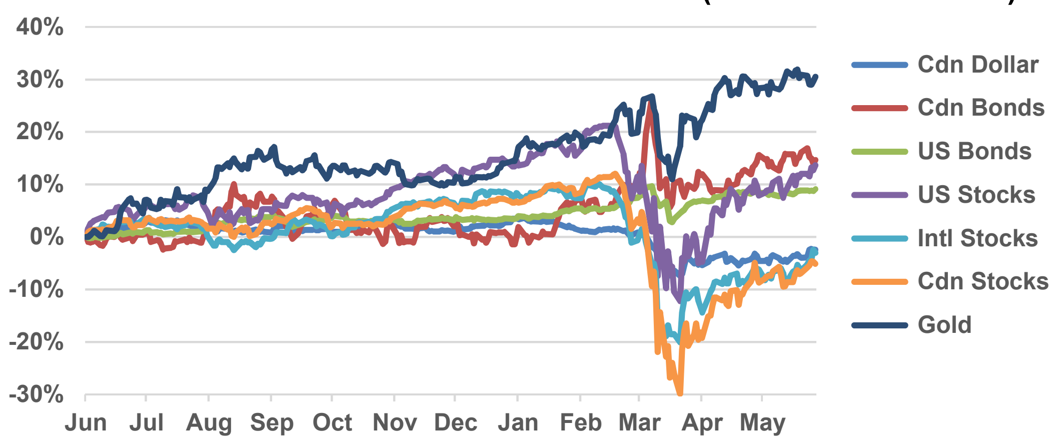
Also, until there is real debate about how we will pay for the colossal government spending, it could be a relatively docile stretch for most investments. Also, until financing becomes the concern, the Canadian dollar might be able to sustain its recent gains (which detracts from the performance of U.S. dollar investments in the model portfolios).

The markets may be relatively calm until there is more serious debate regarding how to pay for colossal government spending. Same might be said for the Canadian dollar.

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**).[6]

Chart 1:

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



Source: Bloomberg Finance L.P. from 6/1/2019 to 5/31/2020

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[5] Source: Bloomberg Finance L.P. as of 6/3/2020.

[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 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[7]

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

[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 June 3, 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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