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Economic & Market Update

COVIDebt

Governments around the world are on an unprecedented spending spree in response to the Coronavirus. This is especially the case in North America where remarkable federal government borrowing power may help to finance the expected record deficits.

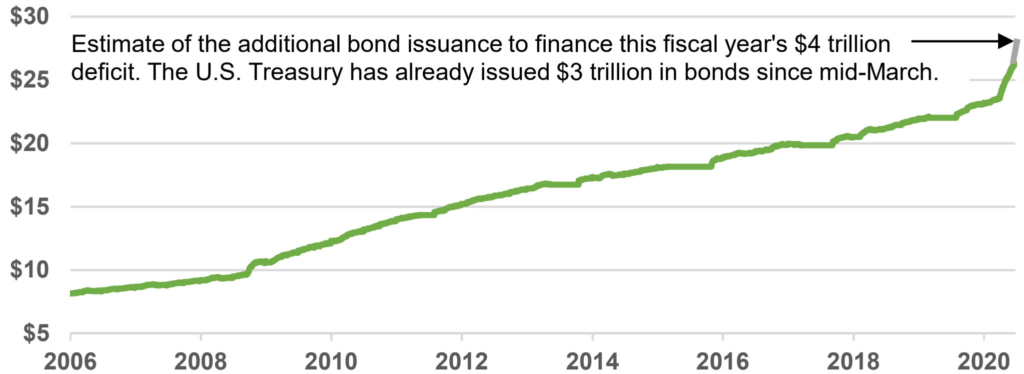
On January 28, before the economic implications of the Coronavirus were evident, the non-partisan U.S. Congressional Budget Office estimated that the U.S. federal deficit for fiscal 2020 would be US$1 trillion [1] (which already represented a sizable increase compared to four years ago). Now, it might be near US$4 trillion[2] (**Chart 1**).

Who will pay for the enormous government spending associated with the Coronavirus?

The market will likely have a significant reaction when this is decided.

[1] The Congressional Budget Office, "The Budget and Economic Outlook: 2020 to 2030." January 28, 2020.
[2] Sarah Hansen, "Federal Budget Deficit Will Approach $4 Trillion in 2020, CBO Says" *Forbes*, April 24, 2020.

Chart 1:
Total U.S. Treasury Debt Outstanding in Trillions



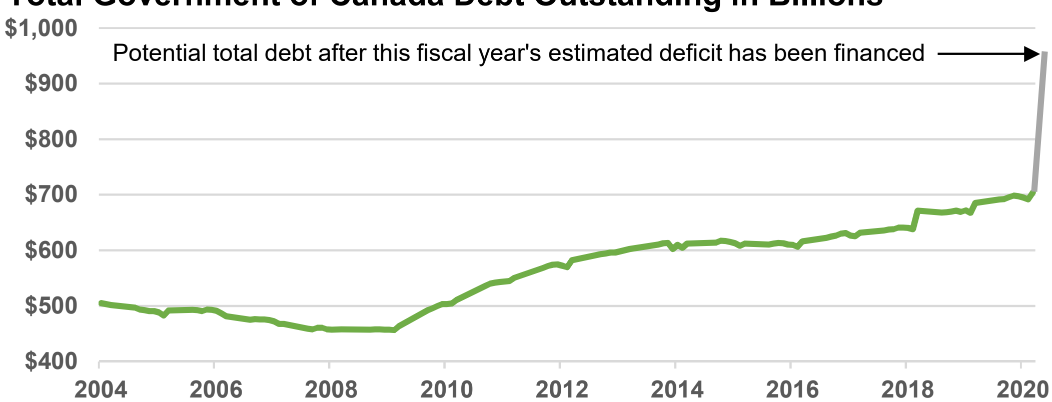
Source: Bloomberg Finance L.P. and the U.S. Treasury Department as of 7/3/2020

U.S. and Canadian federal budget deficits are rising by about 400% and 1000% respectively.

In Canada, the situation is not much better. Back in December, via a fiscal update, the federal government projected a deficit of C$26.6 billion (this was actually an increase from an earlier estimate of C$19.8 billion).[3] The government also tallied the cumulative deficit projection for the next four years at C$111.5 billion, averaging C$27.9 billion per year.[4]

Now, Canada's parliamentary budget officer has warned that *this* year's deficit could hit C$256 billion (**Chart 2**), an almost ten-fold increase from the pre-Coronavirus estimate.[5] This might have been a factor in a recent downgrade of Canada's federal debt from AAA to AA+ by one of the "big three" U.S. rating agencies."[6]

Chart 2:
Total Government of Canada Debt Outstanding in Billions



Source: Bloomberg Finance L.P. and the Department of Finance Canada as of 7/3/2020

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[3] Paul Vieira, "Canada Widens Budget Deficit Forecasts." *The Wall Street Journal*, December 16, 2019.
[4] Ibid.
[5] "Federal deficit could hit $256 billion, PBO says in new report." The Canadian Press, June 18, 2020.
[6] Barbara Shecter, "Fitch strips Canada of AAA rating as finances deteriorate." *The Financial Post*, June 24, 2020.

A question that is now more relevant than ever is: How *do* governments finance deficits? Unfortunately, there are no painless solutions. They include:

1. Cutting spending.
2. Raising taxes.
3. Incurring debt.
4. Printing money.

No easy painless answers with respect to how to finance the deficits.

I am pretty sure that governments won't be going on an austerity drive any time soon. Right across the political spectrum there appears to be high levels of support for increasing spending to deal with the economic fallout from the pandemic.

Cutting spending does not seem realistic at this time.

Raising taxes might be tempting for the Canadian federal government, and might be on the radar screen for the U.S. if Joe Biden wins the presidential election in November. However, the implementation of tax hikes is often a perilous exercise both in terms of the hit to political popularity and taxpayer behaviours that can result in less revenue than expected because of tax avoidance strategies or a scaling back of business activity if the final "return on investment" after-tax doesn't justify the risks. Also, even massive tax increases may hardly put a dent into the gargantuan growth of the deficits.

Raising taxes is easier said than done. There may be rhetoric, but that hardly means that it will happen.

Borrowing and adding to the debt is probably the most likely option. Plus, in the short-term, it may be the option with the least pain. Federal governments also have a few tricks up their sleeve to accommodate the potential magnitude of the debt issuance. Central banks, like the U.S. Federal Reserve and the Bank of Canada, can step in and buy a tremendous amount of the bonds (**Chart 3**). This helps to keep rates relatively low and reduces the reliance on the appetite of bond market investors. However, this approach implies that eventually there will be budget surpluses and that these bonds will either be redeemed or will just mature without the need to roll them over into a new bond issue. I would deem those scenarios to be implausible, as might much of the bond market. The fear is that the debt is merely taking the long road towards monetization: eventually printing money to pay off these bonds when they mature.

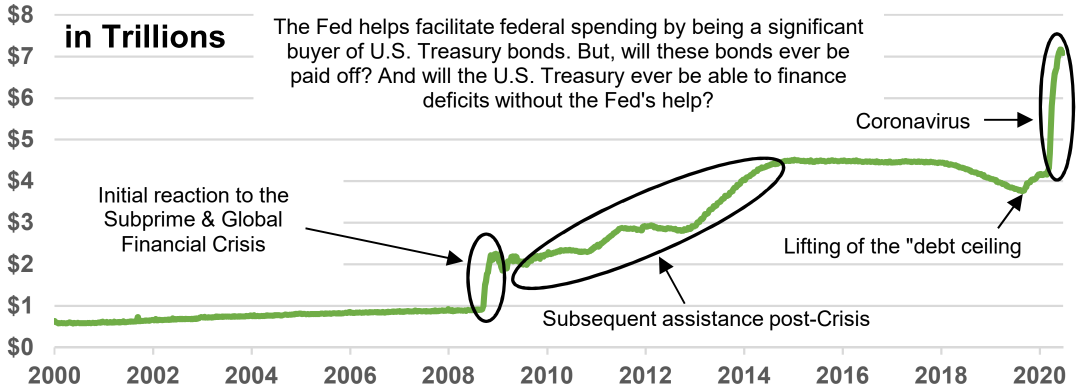
Borrowing is likely the easiest option, especially with the help of central banks "buying" the bonds that are issued.

This dovetails into the fourth option. Sovereign governments (those with the right to print money) may see some short-term benefits of printing money to cover spending as long as there is no political cost. We may be far enough removed from the inflation on the 1970s where today's voters may be okay with such an experiment.

Major central bank involvement may eventually tempt money-printing to escape a debt-induced crisis. But that could create a currency crisis.

Chart 3:

Total Value of Securities on the U.S. Federal Reserve's Balance Sheet



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

One final note on the option to borrow by issuing bonds. Last summer, we saw a situation where the U.S. federal government lifted the debt ceiling which lead to a rush to issue bonds because of the pent-up spending desires. At the time, we experienced a rather unusual situation where there was a lack of investor demand for those bonds (in recent years, the appetite has been voracious, especially with insurance companies and pension funds). Even during that episode (which was far smaller in scale compared to what we are now seeing), the U.S. Federal Reserve was forced to become a major buyer of those bonds. If it had not done so, the U.S. Treasury would have likely been forced to offer much higher interest rates to entice investors back into the market for Treasury bonds. The problem with this is that it increases the borrowing rates for every other borrower since they can't match the safety of a government that owns a printing press.

The borrowing option may hit turbulence if there is little bond market appetite to digest heavy issuance at such paltry interest rates.

I sense that the whole issue of who pays for the eye-popping spike in spending is getting a free pass. This appears to be substantiated by the fact that governments are planning further stimulus packages, or in the case of Canada, still willing to offer sizable international Coronavirus-related assistance without much fear of who will eventually pay. However, that question will work its way back onto the agenda. Perhaps it will be 2021 when we are past the U.S. election or during a possible Canadian federal election. Opposition politicians may see value in highlighting the issue at which time it might be challenging for investors to digest all of the less-than-ideal deficit payment options.

Elections this year in the U.S. and possibly next year in Canada may uncomfortably place the whole "Who's going to pay" debate on the agenda.

The decision of how to finance the spending could have significant ramifications for the Canadian dollar and interest rates, which will be discussed in upcoming issues of *The Charter Group Monthly Letter*.

Model Portfolio Update[7]

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

No changes to the investment holdings or to the asset allocations during the last part of June.

The asset classes used in the model portfolios have traded in relatively narrow channels over the last six weeks.

There were no changes to the specific holdings or the targeted overall asset allocation in the model portfolios during the last half of June.

Since the third week of May, all the asset classes used in the model portfolios have been trading in fairly tight channels. Market moods seems to oscillate depending on the news. In contrast to the steady progression of "not-so-bad" and positive news regarding the virus and the economic impact up to that third week in May, the news now alternates between bad (resurgent infections in some U.S. states and emerging market countries) and good (a decrease in the mortality rate and further successes with therapies for the symptoms of COVID-19). A dose of bad news takes us near the floor of the trading channel, and a dose of good news takes us near the ceiling.

Additionally, the current higher level of overall valuations in equities may be acting as a headwind. Plus, some of the feverish speculation has tapered off.

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[7] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 7/3/2020. 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.

Related to the topic in the first section of this *Monthly Letter*, gold may be finding some lift as initial concern over how to pay for the spending seeps into the mindset of enough investors. In Canadian dollar terms, gold bullion increased over 2.5% during June and is now up almost 29% over the last year.[8] Significant increases in government debt and the potential risk of printing money to help pay for things have historically tended to devalue currencies and gold has traditionally been one of the better hedges to protect against this.

Gold continues to rise. Perhaps this reflects some initial concerns over how to pay for skyrocketing government spending.

The U.S. presidential election is slowly coming into view. Joe Biden reiterated his desire to reverse President Trump's tax cuts. These were primarily corporate as opposed to personal cuts. I am not quite sure how palatable it would be to increase taxes which raises the cost of doing business which, in turn, becomes a drag on an economy already getting pummeled by the Coronavirus. Additionally, it might be hard to ask Corporate America to help by increasing hiring when simultaneously increasing corporate taxes. At the moment, it appears that markets are calling what might be a bluff on Biden's behalf as he is leading in most of the polls and markets don't seem to be too fearful of the potential policies if he gains office.

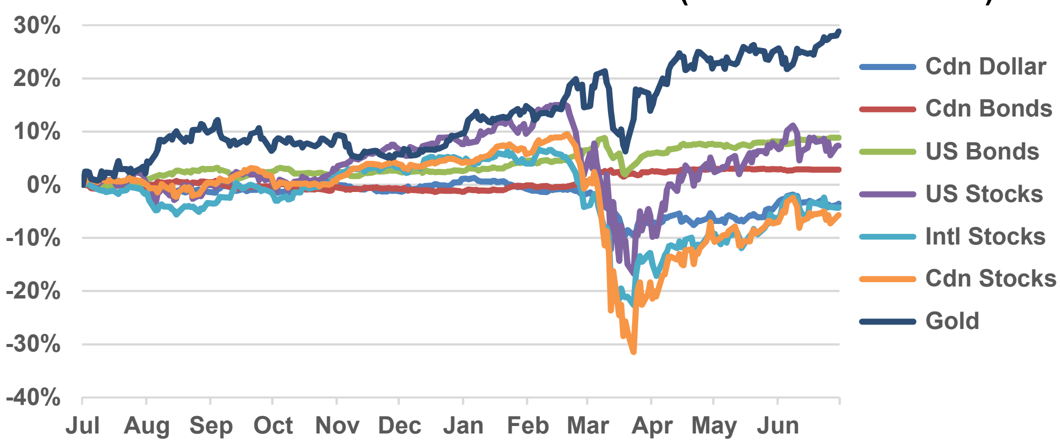
Joe Biden is leading in most polls yet markets are not reacting much to his tax-raising rhetoric.

Maybe investors are betting that it will be too hard for him to do so in the near future if he wins the election.

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**).[9]

Chart 4:

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



Source: Bloomberg Finance L.P. from 7/1/2019 to 6/30/2020

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

[9] 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[10]

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

[10] 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.

TD Wealth

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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 July 3, 2020.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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