TD Wealth

The Charter Group Monthly Letter

Mid-July 2020

Issue 66

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Economic & Market Update

Canadian COVIDollar

Twenty years ago, I was standing in Tiananmen Square in Beijing and my camera ran out of film (this was a year before I bought my first digital camera). After about a minute, someone who saw my predicament came up to me and offered to sell me film. I apologized for the fact that I was not carrying local currency and told him all I had were U.S. dollars. "Even better" he exclaimed, and our transaction was completed in a flash.

Now imagine being in Washington, DC, perhaps walking along the National Mall, with the same predicament and whipping out a wad of renminbi[1] notes from the People's Republic

If a currency sits atop the pyramid of acceptability and availability, that country has more flexibility in managing economic crises.

If not, the choices are more limited.

[1] "Renminbi" translates into "The People's Money", which is kind of like saying "communist money." The actual primary denomination of renminbi is called a "yuan."

of China (P.R.C.). That would probably kill the deal.

This contrast underlies a powerful and informal distinction: The U.S. dollar is the world's reserve currency. Not only do global financial institutions and governments accept the U.S. dollar without hesitation, so do many average people on the other side of the world.

The U.S. occupies the top of the pyramid as the world's effective reserve currency.

The P.R.C. would be the next level down, having "reserve" status at the International Monetary Fund (IMF).

The Canadian dollar is neither a global reserve currency or a technical "reserve" currency at the IMF, and it would be very unusual if trade conducted between two other countries outside Canada was transacted in Canadian dollars.

The P.R.C yuan is officially categorized as a reserve currency by the International Monetary Fund (I.M.F.) because it is now included in the basket of currencies used to determine the value of a Special Drawing Right (or S.D.R.), a particular "unit of account" maintained by the I.M.F. The P.R.C. government has made much of this, proclaiming that their currency now has "reserve" status. But, if you can't convince that merchant on The National Mall, the term is merely a technicality. The U.S. dollar continues to be the only functional global reserve currency, regardless of how informal that distinction is.

Why is this important? Because it provides the U.S. will unmatched flexibility in managing its monetary and fiscal affairs. It also provides advantages during an economic recovery when emerging from a crisis like the Coronavirus.

Figure 1:
The Tale of Three Currencies

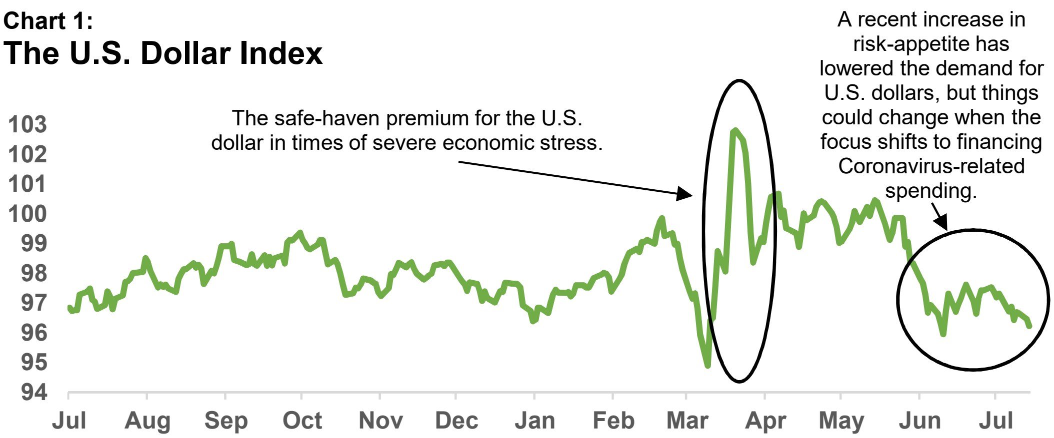
Source: Clipped images from Mark Jasayko's undeposited "100" denomination banknote collection.

As Canadians, we don't hesitate to keep our cash in Canadian dollars (CAD). Many of us are also not averse to holding a fair amount of cash in the form of U.S. dollars (USD). We might have some mild concerns about the USDCAD exchange rate, but we are not generally concerned about its liquidity and tend to trust it as a store of value. Now, what if someone proposed holding a sizable amount of cash in the form of P.R.C. yuan?

There are a few challenges with the prospect of holding cash in the P.R.C.'s currency. First off, there are actually two different exchanges rates! One is for yuan trapped inside the P.R.C. because of capital controls. The other is for offshore trading that mainly occurs in Hong Kong, London, and Singapore. It is less than ideal to have money trapped inside a country even if one can trade it outside. This is because capital controls reduce transparency and distort valuations. Plus, one of the exchange rates may influence the other. So, one has to follow both.

Secondly, even though the P.R.C. is the 2nd largest economy in the world, it does not have much of a tax base, especially on a per capita basis. If the U.S. needs to ratchet up taxes to pay for things, it has massive population of taxpayers (citizens that can and are willing to pay taxes if required to do so). This provides enormous fiscal backing for the currency, reducing the need to rely on monetary solutions like printing money that could place the valuation of a currency in jeopardy.

Chart 1:
The U.S. Dollar Index



Source: Bloomberg Finance L.P. as of 7/15/2020. Calculated using a basket of currencies including the Euro, Japanese yen, British pound, Canadian dollar, Swedish krona, and Swiss franc.

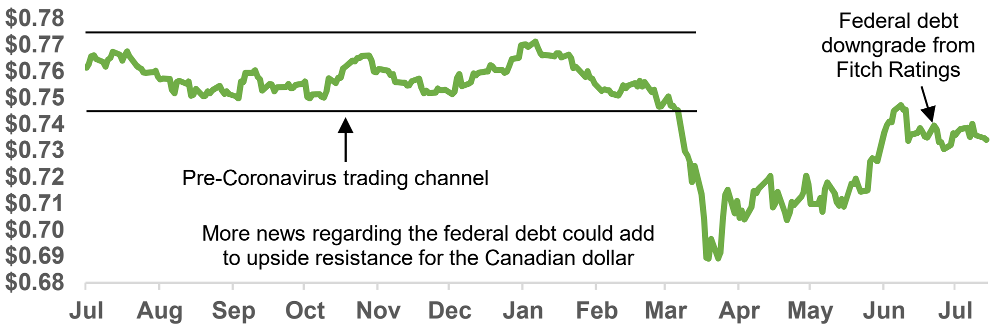
Finally, aspects of the U.S. dollar's circulation make it attractive to hold. The circulation is enormous, including outside of the U.S., so it is relatively easy and cost-effective to get some. Plus, there are no capital controls or other restrictions on the U.S. dollar, so it circulates easily almost everywhere.

The U.S. dollar has no capital controls, has very wide circulation around the world, is backed by the rule of law, and is backed by an unrivalled base of taxpayers.

What's the point of all this? If a currency is universally accepted as a safe-haven store of value (**Chart 1**), the country that produces that currency has extraordinary latitude in adjusting its money supply in order to combat financial crises.

More than any other country, the United States can expand its money supply with the least impact on the value of its currency. What else are holders of the U.S. dollar going to do? Every other currency lacks the intrinsic characteristics that make the U.S. dollar appealing. Some people, and maybe some financial institutions, might buy gold instead. However, gold is a little inconvenient when it comes to storage or using it for transactions. And, there is not that much of it. According to the U.S. Federal Reserve, the broad definition of the U.S. money supply currently adds up to about double the total value all the gold mined through history.

Chart 2:
The Canadian dollar versus the U.S. dollar



Source: Bloomberg Finance L.P. as of 7/15/2020

The Canadian dollar has some of the advantages of the U.S. dollar. In my opinion, the main strength inherent in the Canadian dollar involves cross-border trade, where American importers need to pay Canadian exporters in Canadian dollars, thereby creating demand for the currency. This becomes more pronounced during periods of high commodity prices. Additionally, Canada is relatively stable politically, has the rule of law, and a strong tax base from which to sustain government revenues. But the U.S. dollar has all of that as well which cancels these things out between the two currencies.

As a result, if the Canadian government starts printing money, there is the potential for currency traders to get nervous and to reflect this by selling Canadian dollars and purchasing U.S. dollars. The mere prospect of printing can set these wheels in motion.

If Canada is forced to print extra money in order to help with the unprecedented Coronavirus-related deficit, currency traders might get nervous.

It's unlikely that Canada would get the latitude that the U.S. might get in this respect.

Although it is possible for the Canadian dollar to face some headwinds versus the U.S. dollar when the bills come due for all the Coronavirus-related spending, this is certainly not a prediction of doom. If the Canadian dollar weakens much below 70 cents, cross-border trade can provide some bedrock as Canadian goods and services, which would then be relatively cheaper, would be more in demand by Americans because of price. Also, focusing on only one aspect (such as anxiety that might cause currency traders to seek the safe-haven of the U.S. dollar in times of a deficit spending crisis) assumes that all other factors are held constant. Other intervening factors, such as a jump in oil prices for example, may be sufficient to counter downward pressure on the Canadian dollar.

Model Portfolio Update[2]

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 the first half of July.

Although it appears that all the asset classes that we use in the construction of our model portfolios remained in the trading channels that I talked about in the last issue of the *Monthly Letter*, the equity asset classes (Canada, U.S., & international) and gold have pushed toward the ceilings of those channels.

The Canadian dollar has remained in an even tighter channel going back six weeks now as some of the global money that found a safe-haven in the U.S. dollar has now found its way into more peripheral currencies. There has been relatively more "risk-appetite" since the beginning of June with the further development of COVID-19 therapies and vaccines. That said, when the agenda shifts to financing the humongous deficits, the U.S. may look like a relative safe-haven again (see the first section of this *Monthly Letter*).

No changes were made to the specific investments or to the asset allocations during the first two weeks of July.

The asset classes used in the model portfolios have remained in relatively narrow channels for almost two months.

Greater global "risk-appetite" has benefitted the Canadian dollar recently.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 7/15/2020. 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.

By the next edition of the *Monthly Letter*, we should know who Joe Biden's running mate is. If the market perceives it to be a radical choice, U.S. election politics may start impacting the market again (much like it did when Bernie Sanders was the leading Democrat contender). If the choice is someone who might be resemble the traditional meekness of a vice-president, then the markets might wait until the homestretch to decipher what is rhetoric and what actually might be policy following the election.

Investors may be waiting to see to Joe Biden will choose for a running mate.

Although infection numbers have accelerated in some U.S. states and in some developing countries overseas, the markets may need to see an increase in mortality rates in order to respond to the news.

Markets may be looking past the recent jump in Coronavirus infections.

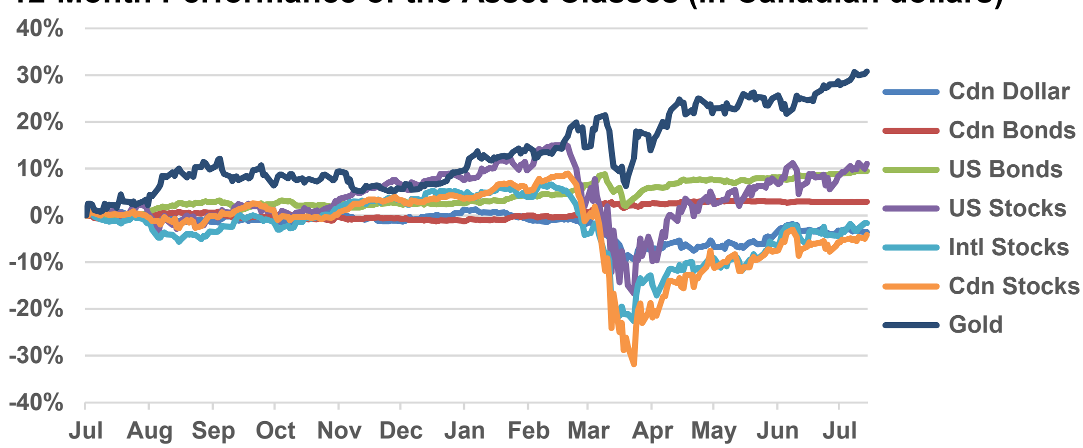
Finally, the markets are doing a pretty good job of ignoring the worsening state of relations between the U.S. and the People's Republic of China (P.R.C.). Previous market selloffs related to the P.R.C. had to do with concerns about the nation's ability to contribute to global growth. Perhaps the on-going Coronavirus saga has already baked in lower expectations for global growth regardless. However, if we get any sort of military engagement between the two countries, the market's calculus could change in a hurry.

Markets also seem to be ignoring the deterioration in U.S./P.R.C. relations … for now.

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 3**).[3]

Chart 3:

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



Source: Bloomberg Finance L.P. from 7/1/2019 to 7/15/2020

[3] 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[4]

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

[4] 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 July 15, 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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