TD Wealth

The Charter Group Monthly Letter

Mark Jasayko, MBA, CFA
Portfolio Manager & Investment Advisor
TD Wealth Private Investment Advice
The Charter Group, Langley, BC

The Charter Group's October 15th WebEx Seminar Summary

Ranking the October Risks

October seems to be a time of year when investor anxiety begins to peak. This can especially be the case when, every four years, the U.S. presidential election takes place on the Tuesday immediately following October. Which risks are worth worrying about, and which ones can we mostly ignore? On October 15th we had 170 clients and guests tune in to find out.

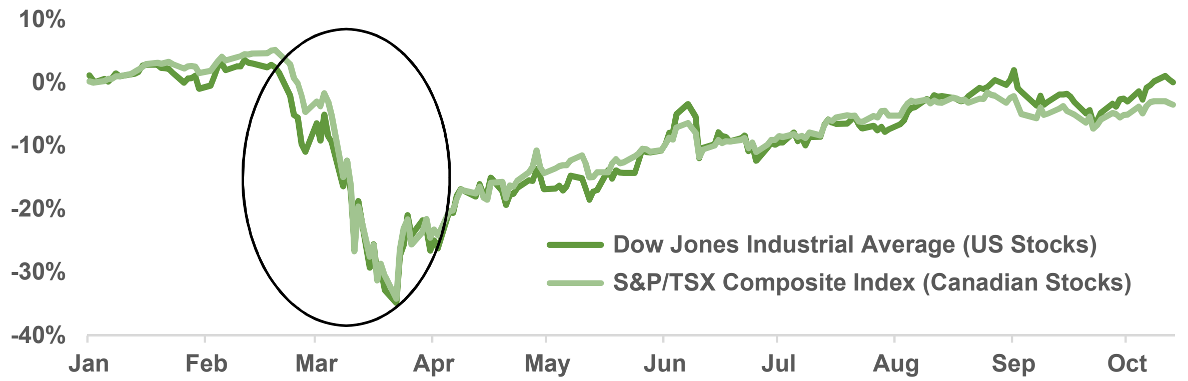
Check out the summary below to see what we discussed:

We are conducting on-line WebEx presentations until we are able to resume our in-person seminars normally held in February, May, and October.

Looking Back

- The presentation started off with a quick recap of 2020.
- Initial uncertainty surrounding the Coronavirus fueled the dramatic selloff in March (**Chart 1**).

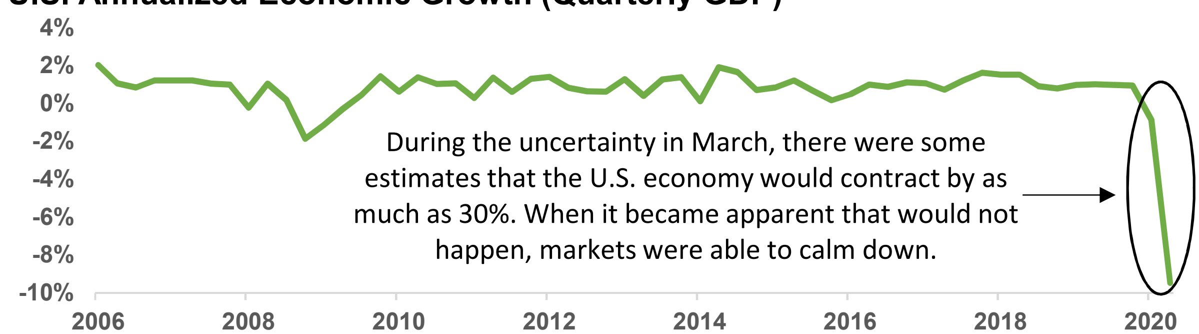
Chart 1:
U.S. & Canadian Stocks - Year-to-Date (Percentage Change)



Source: Bloomberg Finance L.P. as of 15/10/2020

- An old investment adage: "Markets abhor a vacuum."
- Negative news at least provided a baseline against which to evaluate any subsequent positive news.
- Once the extent of the virus was better understood, the economic damage could be estimated (**Chart 2**).

Chart 2:
U.S. Annualized Economic Growth (Quarterly GDP)



Source: Bloomberg Finance L.P. as of 15/10/2020

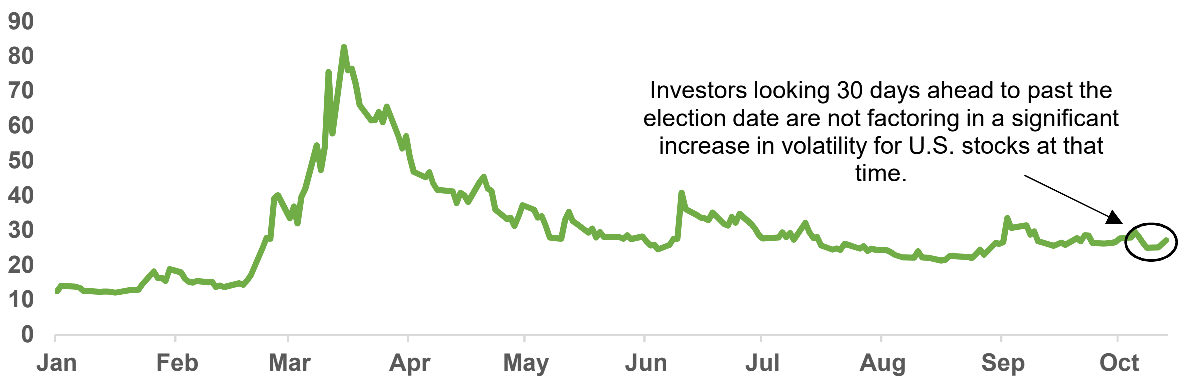
- Positive stories regarding the pace and shape of a possible recovery entered then the news stream.
- This combined with a promise from central banks and governments declaring that they would do whatever it took to bolster an economic recover was the main force driving stock market gains through to October.
- Central bank money-printing, government spending, mailbox money, virus therapeutics, and potential vaccines outweighed the negative news.

Looking Forward

- What's next? Investors are finding things to worry about. It's October after all.
- The future is a distribution of probabilities. Not a binary "will or won't."

- But, the media prefers "will or won't." It's simple and dramatic.
- Investors often adopt this habit – which can contribute to investment mistakes.
- Who will win the U.S. election? Polls are looking decisive.
- But, 2016 reminds us that election dynamics might differ from polling. But, a close race is usually needed.
- If there is a transition of power, will it go smoothly?
- How much of a public appetite for contesting the results?
- In the case of a lopsided result, is it worth taking up such a fight?
- Markets may be skeptical regarding the potential of electoral disruption considering the relatively steady expected volatility for the next 30 days. (**Chart 3**).

Chart 3:
The VIX - Implied 30-Day Foward Volatility on the S&P 500 Index



Source: Bloomberg Finance L.P. as of 15/10/2020. The VIX is the implied expectation of volatility for U.S. stocks using stock index futures trading on the Chicago Board Options Exhange.

- The real fight seems to be for the control of the U.S. Senate – things are looking like a toss-up.
- This result can impact the pace of subsequent legislation. Gridlock? Or fast-track?
- Markets tend to like gridlock as it maintains the status quo and reduces policy uncertainty.
- Rhetoric involving tax hikes – would this be a likely policy as the economy struggles?
- Regardless of the outcome, there is no one calling for austerity measures.
- Politically difficult for any politician to scale back consumer and business assistance for the time being.
- Both major parties in the U.S. are focused on spending to promote recovery.
- The differences tend to be minor details. The market likes the short-term stimulus of any proposal.
- The leadership of both parties are concerned and suspicious regarding the People's Republic of China.
- This may contribute to a continuation of de-globalization and decoupling from China in particular.
- Will China continue to militarily test the resolve of India and the U.S.?
- Will military encounters give China insight into a response regarding aggressive tactics towards Taiwan?
- Will this increase the probability of a military engagement?
- We have had two global coronavirus outbreaks in 17 years (including SARS in 2003).
- The pathogenesis of both was almost identical.

- Is any work being done to ensure that there won't be a common origin for a third outbreak?
- Nobody knows. There are no updates. There are few demands for information. Lessons learned?

<u>Lots of Risks, but Which Risks Have the Potential to Imperil the Investment Markets</u>

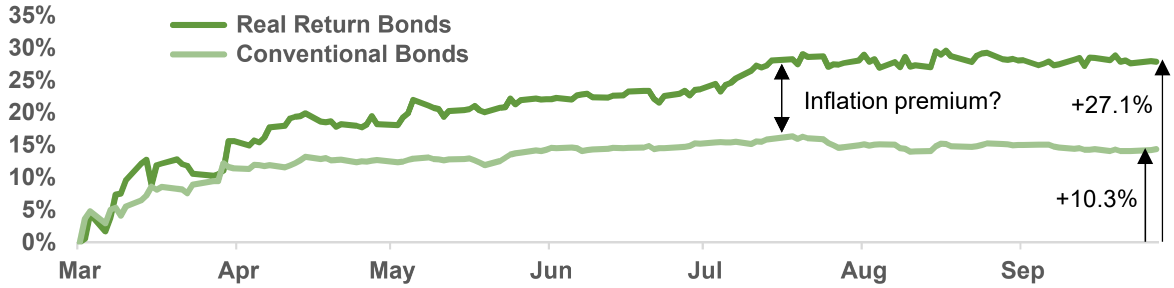
- There are two factors that have disproportionately impact markets historically.
- 1. **<u>Cost of Money</u>** (interest rates).
- 2. **<u>Uncertainty</u>** (as we experienced with the Coronavirus).
- Do issues regarding the U.S. election relate much to these two factors? Not really.
- Is the media focusing too much on political drama? It usually does most of the time.
- However, journalists are not investment fiduciaries.
- Reasons for journalistic attention are usually not related to the impact on investments.
- So, news coverage may not help much in understanding interest rates or causes of significant uncertainty.
- **<u>Cost of Money</u>** – could be impacted when attention focuses on how to pay for government spending.
- May not be a near-term risk as it will take a while for the bills to mount.
- Eventually governments will have to make a decision to tax or borrow.
- Increasing taxes could put the recovery in jeopardy.
- Higher taxes will leave less money for companies to maintain payroll, never mind hiring new people.
- Higher personal & corporate taxes can contribute to disinvestment – less capital to expand business.
- So, often borrowing becomes the attractive alternative.
- People appear supportive of expanding government debt.[1]
- This reduces the near-term risk for politicians with respect to advocating increased borrowing.
- However, if governments everywhere simultaneously borrow in the public market, costs might rise.
- This is because of the "demand" for money would be greater than the "supply" of money. Prices increase.
- Interest rates are the "price."
- Central banks will try to cap the price by committing to buy the bonds used for borrowing.
- But, can central banks do this with no limit?
- Central banks tend to have few legislative limits.
- However, there is a natural limit in the form of inflation.
- This is driven by consumer fears and the expectation of higher prices in the future.
- Once in motion, this fear has an element of inertia and can be a self-fulfilling prophecy.

[1] Bill Curry, "Canadians supportive of borrowing to pay for federal pandemic response: poll." *The Globe and Mail*, October 14, 2020.

- Some inflation fears may be manifest in recently higher prices for inflation-protected bonds and for gold (which has historically acted like an inflation hedge) (**Charts 4&5**).

Chart 4:

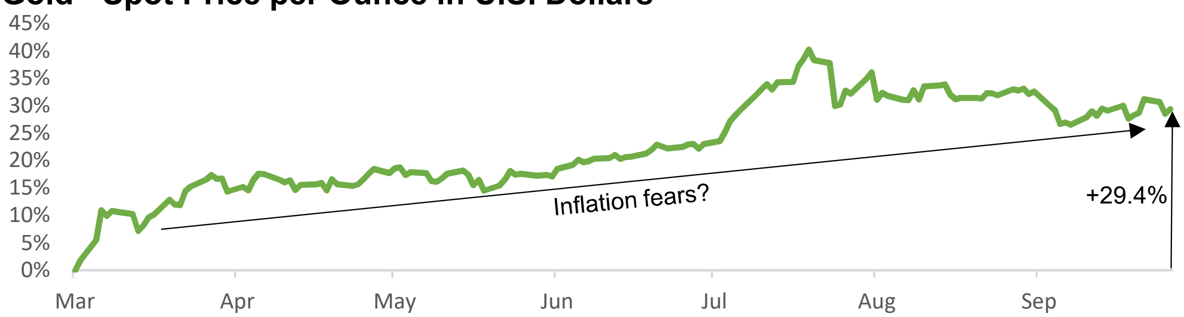
Real Return Bonds versus Convential Bonds since Market Bottom



Source: Bloomberg Finance L.P. as of 10/15/2020. The iShares Canadian Real Return Bond Index ETF is used as a proxy for Real Return Bonds, and the iShares Core Canadian Universe Bond Index ETF is used as a proxy for Conventional Bonds.

Chart 5:

Gold - Spot Price per Ounce in U.S. Dollars



Source: Bloomberg Finance L.P. as of 15/10/2020

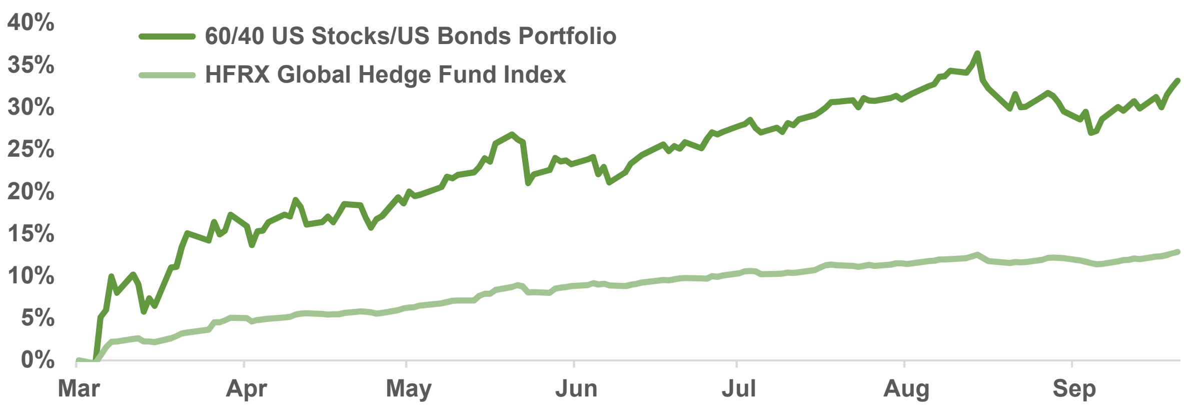
- If central banks induce inflation, will they back away from buying government bonds?
- Then governments will be forced to borrow from private investors.
- Rational private investors could demand an inflation premium in the form of higher interest rates.
- Higher interest rates can be toxic to the stock market, especially for "growth" stocks.
- It has been a generation since the last episode of significantly higher interest rates.
- Many investors may be unprepared because it is not part of their lifetime investment experience.
- **Uncertainty** – the other major risk.
- Uncertainty can be triggered by unforeseen events that are difficult to "model" ahead of time.
- This difficulty stems from a "long-tail" or small probability characteristic.
- Also, these challenges are like earthquakes. Everything is okay until suddenly it is not.
- Because they are difficult to model, it is hard to account for those risks in a portfolio.
- Coronavirus is the most recent example of an event that induced massive uncertainty.
- Wars of a certain scale have historically been another source.
- Oil embargoes in the 1970's were another example.

- What is the probability of a critical mass event in any one year triggering massive uncertainty?
- That probability is small. But the effects are large.
- What are some of the current candidates?
- An escalation of military conflict (minor skirmishes in the Himalayas and South China Sea could expand).
- New presidents are often tested by international geopolitical events.
- Another candidate would be a brand-new coronavirus in quick succession.
- There is no rule that they happen every 17 years. It is random. The next one could be next year.
- We don't have any clear information about what is being done at the origin of the last one.
- The press does not have access to report freely in this regard.

<u>The Portfolios</u>

- Limited portfolio changes have turned out to be better strategy.
- Hedge funds are lagging "patient" money invested in conservative balanced strategies (**Chart 6**).

Chart 6:
Hedge Funds versus A 60/40 Balanced Strategy Since the Market Bottom



Source: Bloomberg Finance L.P. as of 15/10/2020. The HFRX Global Hedge Fund Index includes all hedge fund strategies.

- Hedge funds are more prone to taking active bets which has generally not worked well since March.
- We may rebalance back to the investment and asset allocation targets to slightly de-risk the portfolios soon. We will assess the current risk exposure to determine whether we need to scale back some.

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The Charter Group

Mark Jasayko, MBA, CFA | Portfolio Manager & Investment Advisor
Mike Elliott, BA, CIM, FCSI ® | Portfolio Manager & Investment Advisor
Laura O'Connell, CFP ®, FMA | Associate Investment Advisor
Kelsey Sjoberg | Client Service Associate

604 513 6218
8621 201 Street, Suite 500
Langley, British Columbia V2Y 0G9

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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 October 15, 2020.

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