The Charter Group Monthly Letter

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Economic & Market Update

Unreal Estate

There are many things that a house can do for us. It can provide us with shelter. If it is relatively close to the workplace, it can provide a convenient commute. It can provide pleasure with aesthetics and, perhaps, a view. If large enough, it might provide space for gatherings of friends and family, and even recreational activities. And, if we are lucky, it can even add to our retirement savings if we are able to eventually sell above the purchase price.

Real estate can provide us with many things – shelter, space, joy, convenience, and wealth.

Not only can houses help us with all those things, but they can also help with the economy. All the expenses and costs associated with maintaining a living space get added to the measures of national economic output. Furniture, paint, lawn mowers, appliances, etc. can really add up. Plus, the buying and selling of real estate can produce realtor commissions, bank fees, and moving company revenues. All of this also gets added to Canada's economic output. Then top it all off with property taxes, property transfer taxes, and capital gains taxes on second homes. At this point, real estate can start to appear to like a fountainhead showering us with all sorts of economic goodness!

It can be tempting to over-rely on real estate to lead Canada to economic bliss, but this can also risk crowding out investment in companies and industries that provide us with real intrinsic growth.

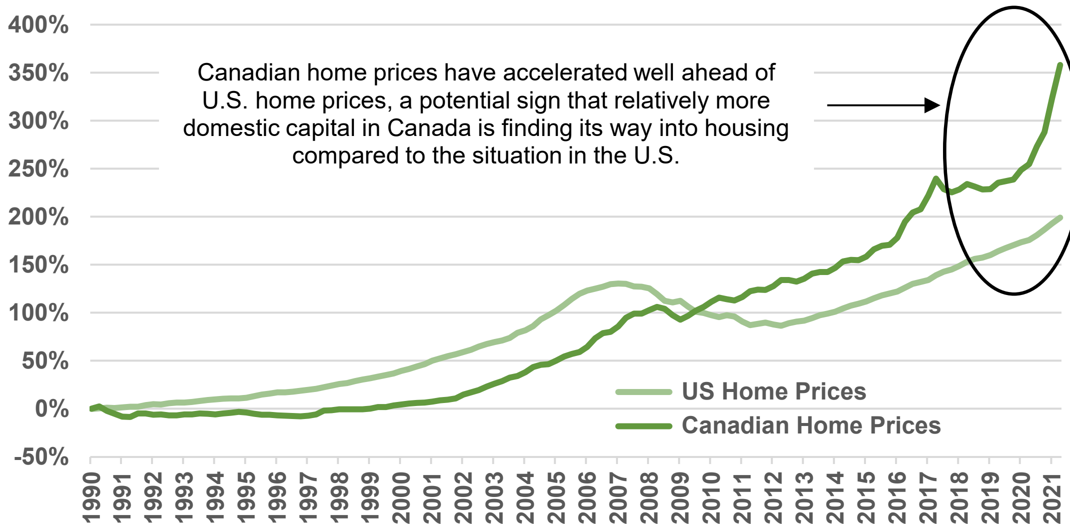
TD Wealth

Then add in the dramatic rate of price growth and passive wealth accumulation by homeowners over the last few decades (**Chart 1**) and it's easy to understand why real estate gets so much attention to the point where it has arguably become a Canadian national pastime.

Rising Canadian home prices can become a self-fulfilling prophecy as people rush in to get a stake driven by a fear of missing out.

Chart 1:

U.S. & Canadian Home Prices



Source: Bloomberg Finance L.P & the Federal Reserve Bank of Dallas International Nominal Housing Price Indices as of 9/8/2021

So, should Canada eschew other industries that require capital, incubation, nurturing, education, and innovation? All of that is expensive, risky, and time-consuming. In contrast, real estate looks like an easy fast track to national prosperity.

Should Canada de-prioritize other industries and focus on real estate to drive the economy?

Although real estate has added to the economic growth of Canada, there are serious questions when it comes to building a reliable and flourishing economy based on property.

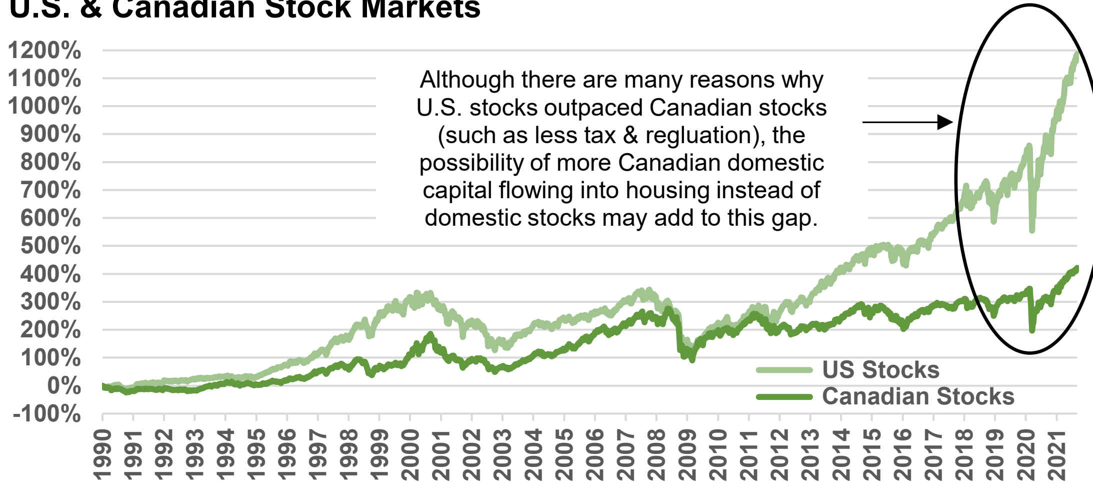
Until the 1800s, it was common for most of an economy's wealth to be tied up in land. Average people didn't have bank accounts and virtually no one had portfolios containing financial securities. Landowners held the economic power and often had a near-monopoly on the right to cast a vote. With capital just sitting in land, there was very little ability to use that capital to finance industry or trade. As a result, things grew and moved much more slowly compared to today's standards.

If real estate is used as a store of wealth, its contribution to economic growth and job creation might be very limited.

In recent times, local real estate has been the beneficiary of Canadian and international investors seeking a safe place to store wealth. Beyond what one needs from a primary residence, capital that flows into second homes or investment properties begins to recreate the dilemma that economies faced before the 1800's. All that investment housing capital might otherwise flow into innovative industries and technologies capable of providing an economy with intrinsic real growth.

Also, more capital going into real estate means less capital potentially going into research, development, and business formation.

Chart 2:
U.S. & Canadian Stock Markets



Source: Bloomberg Finance L.P. as of 9/8/2021. The S&P 500 Index is used for U.S. stocks, and the TSX/S&P Composite is used for Canadian stocks.

As long as current homeowners experience rising prices, they are unlikely to be too fussed by this kind of argument. However, non-homeowners, or new homeowners aspiring to eventually trade up to more substantial properties, could be frustrated. Also, this cohorts tends to be the younger demographic with the education and talents that would provide the fuel for the kind of long-term economic growth that would make Canada competitive in the world. A combination of domestic home prices that don't correlate with economic reality and the enticement of higher pay outside Canada could lead to enough of an exodus to further adversely impact the economy.

If "carrying costs" such as property taxes, maintenance, and mortgage rates increase, this can draw even more capital away from Canadian industries.

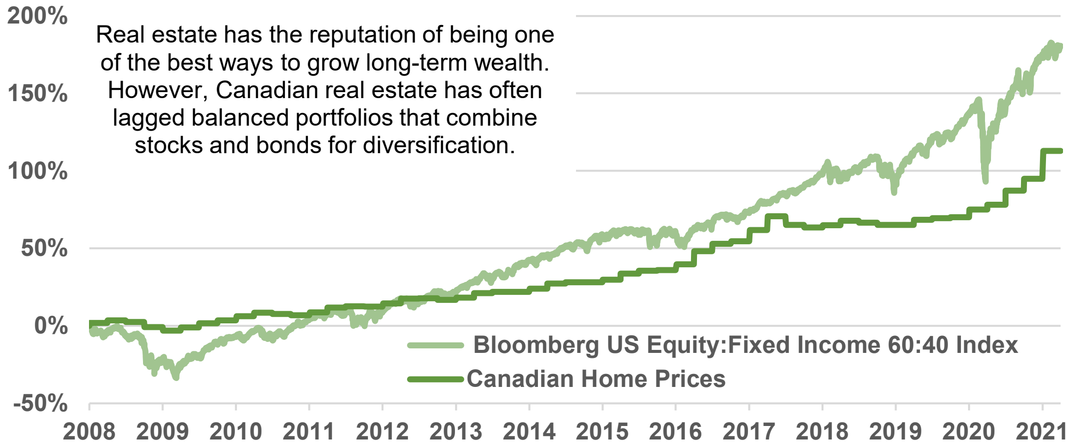
A further complication could emerge if homeowners encumbered with mortgages are subjected to rising interest rates. The level of mortgage debt in Canada is growing at a pace not seen since 2007.[1] If there is an increase in interest rates, a significant number of Canadians might have to redirect even more of their savings away from investing in companies and towards paying interest on their debt loads.

[1] Michelle Zadikian, "Increased use of HELOCs create 'worrisome' trend: Equifax Canada." BNN Bloomberg News, August 20, 2021.

There's no guarantee that interest rates will rise, but, as I have written about on numerous occasions, the secular long-term decline in interest rates that began in the early 1980's looks to have run its course. Massive growth in government debt and early inflation indicators could impact future interest rate trends.

Chart 3:

A Balanced Portfolio versus Canadian Home Prices since 2008



Source: Bloomberg Finance L.P & the Federal Reserve Bank of Dallas International Nominal Housing Price Indices as of 9/8/2021.

The impressive gains in real estate during the pandemic (fueled by the Bank of Canada keeping rates very low and by buyers looking for additional space to facilitate working from home more in the future than in the past) have likely added to the attraction of homes as an appreciating asset. However, home prices have struggled to keep pace with the returns generated by some balanced-portfolio indices recently as well as going back to the Great Recession of the later 2000's (**Chart 3**).

Although home price increases have garnered much attention, they often lag returns produced by financial securities.

A primary residence that can enhance one's quality of life is important. Real estate's contribution to the economy over the last few decades is notable. However, betting on real estate to take Canada to the next level is debatable. And, Canadians who add exposure to property beyond a primary residence may not be as rewarded as much as investing in a risk-managed balanced portfolio of financial securities.

Over-investing in real estate could create opportunity costs when evaluating foregone investment market returns.

Model Portfolio Update[2]

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

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

There were no changes to the asset allocations or the investment holdings in our model portfolios during August.

No changes were made to the model portfolios in August.

The central banker conference in Jackson Hole, Wyoming passed without much immediate impact on the markets. As I discussed in previous months, the conference is often used as a platform from which to announce changes in monetary policy. There was a sense that if the inflation numbers were high enough, they might force the U.S. Federal Reserve (the Fed) to tighten up money and credit in order to choke off rising prices before it was too late. However, the Fed continued to stick to its argument that rising prices were only "transitory" and that the prices for food and other staples would level off next year once imbalances in the global supply chain were sorted out.

Markets reacted positively to the U.S. Federal Reserve kicking the can down the road and prolonging easy monetary policy.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 9/8/2021. 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.

Despite economic statistics indicating a surprising amount of inflation, markets decided to give the Fed the benefit of the doubt and assumed that the Fed would be able to continue its market-friendly easy money policy. We will likely have to look ahead now to the Fed's policy meeting scheduled for early November to get any clues about how much longer it will pursue its current policy path.

Inflation apparently was not enough (yet) to alter the direction of policy.

With no hints from the Fed, stocks (U.S., Canada, and international) ended positive for the month and the other asset classes were close to unchanged.

In addition to looking ahead to the Fed meeting in November, investors will also need to traverse a part of the calendar that is sometimes not kind to stocks. September is statistically the worst month of the year followed by October. Awareness of these tumultuous months can impact psychology when investors start to scrutinize valuations and ask more questions. However, this doesn't happen every year, and has been happening less during the last decade as monetary and fiscal stimulus has provided steady tailwinds for the markets.

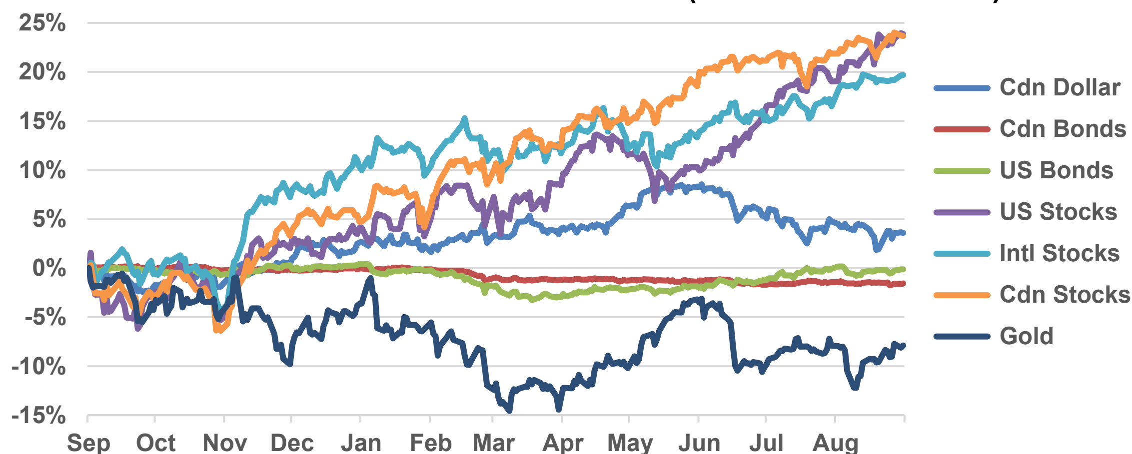
Stock market history in September and October warrants some caution.

Otherwise, eyes will be on the U.S. Fed's November policy meeting.

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**).[3]

Chart 4:

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



Source: Bloomberg Finance L.P. for the interval from 9/1/2020 to 8/31/2021

[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	Moderate	Negative
3. Canadian Dollar Decline	Moderate	Positive
4. Short-term U.S. Interest Rates	Moderate	Positive
5. Canadian Federal Economic Policy	Moderate	Negative
6. China's Economic Growth	Moderate	Negative
7. Deglobalization	Medium	Negative
8. Global Trade Wars	Medium	Negative
9. Canada's Economic Growth (Oil)	Light	Positive
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 September 7, 2021.

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