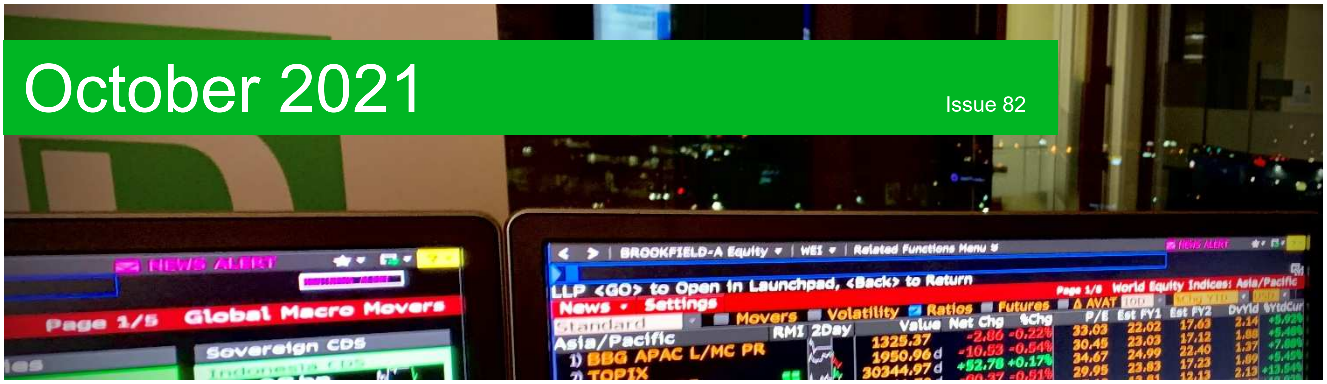
The Charter Group Monthly Letter



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Economic & Market Update

Seasonal Market Disorder

Stock markets are theorized to follow a "random walk" over the short to medium-term (albeit up an incline over the long-term).[1] As a result, with enough years' worth of data, one might expect no seasonal patterns to occur. If the returns fell randomly into every month, the returns for each month would eventually converge.

If stock market returns were random at the monthly level, over the long-term, the returns in each month would converge.

But they don't.

So, what the heck is wrong with September and October?!?

Using my Bloomberg terminal, we are now able get daily data for the Dow Jones Industrial Average (the Dow) going all the way back to its inception on May 26, 1896.[2] It is a

[1] For the statistical geeks out there, daily and monthly market index observations are theoretically expected to produce a "normal distributions" with a means greater than one which reflect the long-term appreciation in returns. Those normal distributions, with 124 years of data should be consistent regardless over which month there are divided into. However, actual results exhibit persistent seasonal trends which challenge the normal distribution, or random walk, hypothesis.

[2] Until a couple of years ago, the Bloomberg terminal historical data would peter out when going back to the1920s. However, now I am able to go all the way back and I am also able to see the daily closing levels as well instead of just monthly data. As a result, it becomes much easier to do a more detailed analysis further back in time. Daily data for the S&P/TSX Composite Index only goes back to 1977, so I focused here on the Dow Jones Industrial Average instead which I think is a reasonable proxy for illustrating investor behavior in North America, including Canada.

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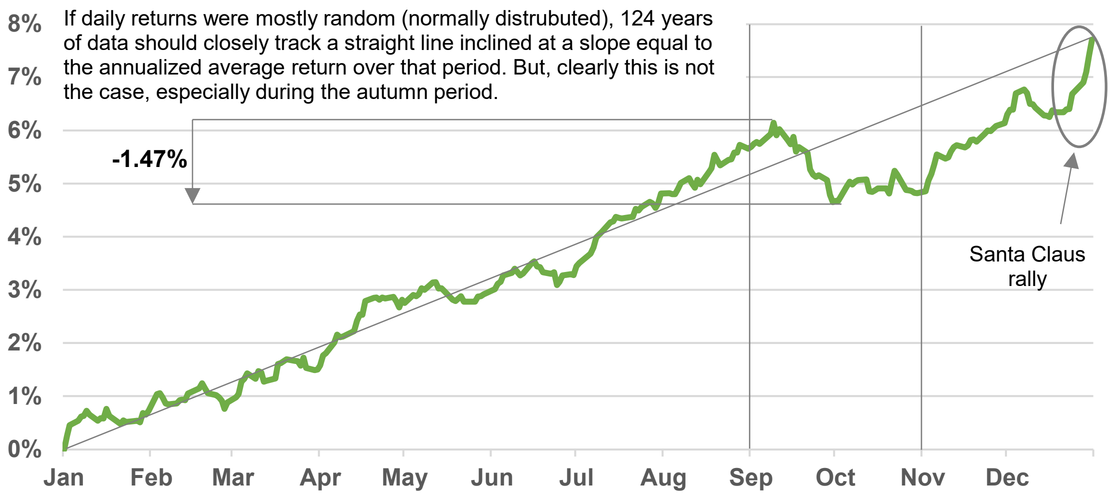
relatively easy exercise to build an average annual price progression chart for the Dow over the last 124 calendar years beginning with 1897 and going through to 2020. Again, with 124 years of data, the annual average chart should approximate an inclined straight line through the year. But it doesn't (**Chart 1**). For the first eight months of the year, there is a good fit with that line. Then, around the first week of September, the market often hits some turbulence. From peak to trough, the market has moved down 1.47% on average within the September to October period over the last 124 years.

Going back to the inception of the Dow Jones Industrial Average, it has, on average, exhibited an anomalous decline beginning in September and an anomalous recovery in mid-December.

(It should also be noted that the market often stages a rally towards the end of the year, often referred to as a "Santa Claus" rally in the financial press. That's the other significant anomaly also depicted in **Chart 1**).

Chart 1:

Dow Jones Industrial Average
Average Annual Price Progression Since 1897



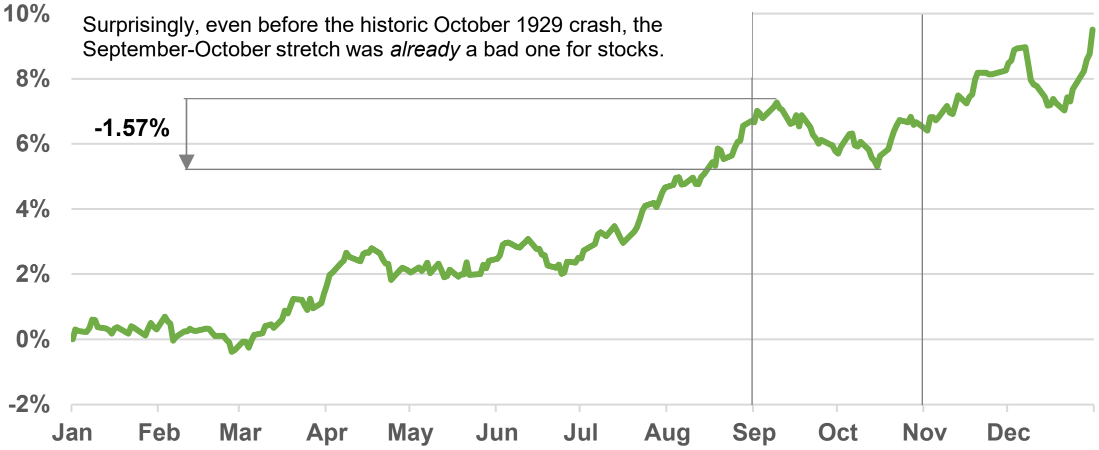
Source: Bloomberg Finance L.P. as of 10/7/2021

So, what is going on here? If market performance was completely random, it is highly unlikely that there would be any identifiable trends at various times of the year.

The best explanation is persistent investor psychology. The September-October selloff was a pattern that developed early in the era of recording stock market prices. Previous to the founding of *The Wall Street Journal* in 1889, there wasn't much of a daily record with respect to what was happening in the markets. Although there were some prices of shares quoted by various sources, there wasn't an overall record of things until the inception of the Dow in 1896. Even in the decades *before* the stock market crash in October 1929, the Autumn was already known as a bearish season for stocks (**Chart 2**).

Much of this might be investor psychology impacted by the knowledge of, or personal experience with, the history of markets. That, combined with negative headlines, could result in volatility.

Chart 2:
Dow Jones Industrial Average
Average Annual Price Progression From 1897 to 1928



Source: Bloomberg Finance L.P. as of 10/7/2021

From 1929 onwards, the pattern has persisted (**Chart 3**). During my freshman year of college in 1984, *The Great Crash, 1929* by John Kenneth Galbraith was required reading.[3] After reading the book, the impression was that Autumn was a precarious time of year for stocks was reinforced. Perhaps this contributed to the anxiety that helped fuel the Black Monday crash in October 1987. That was during my senior year of college and I remember the constant media references citing Galbraith's book during that episode.

If anything, these seasonal trends have become more pronounced on average over the last four decades.

Chart 3:
Dow Jones Industrial Average
Average Annual Price Progression Since 1929

Source: Bloomberg Finance L.P. as of 10/7/2021

[3] John Kenneth Galbraith, *The Great Crash, 1929*. Boston: Houghton Mifflin Company, 1955.

With the 1987 experience added to the stories of 1929, the pattern looks like it has become more pronounced (**Chart 4**). This might be an indication of a self-fulfilling prophecy.

Chart 4:

Dow Jones Industrial Average
Average Annual Price Progression Since 1987

Source: Bloomberg Finance L.P. as of 10/7/2021

Much of the investor psychology might be due to what investors are experiencing personally at certain points on the calendar. More joyous times of year may make investors more resilient to bad news.

However, in addition to investor psychology, markets are also driven by economic and corporate factors. Maybe investors don't respond as anxiously to negative headlines at other times of year. Perhaps there is enough positive psychology connected to the Christmas holiday season or the improving weather and vacationing during the Northern Hemisphere Spring and Summer respectively. Then, once everyone is back at work in September and into a routine, portfolios are examined with greater attention and the headlines receive more scrutiny.

Markets don't always sell off during the September-October period. Sometimes there is not enough news to trigger investors. And, as has been the case in many years over the past two decades, the policies of governments and central banks has been so friendly for stocks that investors sometimes ignore many of the bad headlines, concluding that bad news will lead to more help.[4] But remember, investors more than a century ago seemed to be affected psychologically by the seasons. The evidence suggests that we don't appear to be much different with respect to such behaviour.

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[4] This year appears to have a little more negative news than usual. As a result, we have gotten some stock market volatility over the past month. More on this in the next section below!

Model Portfolio Update[5]

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 September.

All of the asset classes used to construct the model portfolios were down during the month. U.S., Canadian, international stocks, and gold were down 4.3%, 2.4%, 2.7%, and 3.1% respectively in Canadian dollar terms. Higher interest rates also eroded bond prices.

Much of the negative news emanated from the People's Republic of China. A gargantuan property development company named Evergrande faced difficulty when trying to pay what they owed to their bondholders. Although this was news last week, concerns regarding Evergrande have been discussed by analysts for a decade now. As the above section in this month's *Monthly Letter* points out, it might just be that time of year when investors react more adversely to bad news.

There were no changes to the model portfolios in September.

All the asset classes used in the model portfolios were down during the month.

Negative news out of China as well as headlines about inflation and shipping problems could have dampened the mood of investors.

[5] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 10/7/2021. 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.

In addition to the talk of bond defaults, disruptions in the global supply chain were also making headlines. Consumers and companies may have to wait months or pay much more for ordered goods. This is a major departure from the remarkable efficiencies in shipping and logistics that we have taken for granted over the last couple of decades. Shipping costs from Asia to North America are, in some cases, ten times higher than they were at the same time last year. Much of this could be an echo of the manufacturing shutdowns caused by the pandemic. However, we are now being warned that the bottlenecks may not be resolved until well into 2022.

The global supply chain is experiencing its most challenging time in decades.

This is adding to shipping costs which eventually need to be absorbed by consumers.

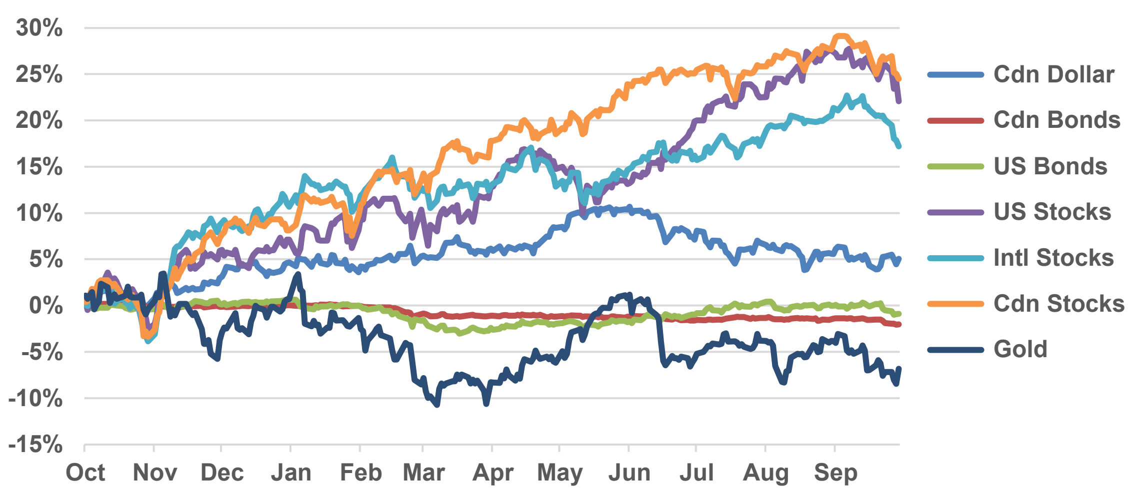
These challenges, along with a recent spike in energy costs, are adding to inflationary concerns. At this point, markets are generally giving the central bankers the benefit of the doubt by assuming that any inflation will be transitory. Stock markets might have to recalibrate if the higher prices for goods and services look like they might continue into next year. When inflation becomes a political problem, things start to get real!

We might get government and central bank policy reactions to higher inflation if this becomes a political problem.

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 5**).[6]

Chart 5:

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



Source: Bloomberg Finance L.P. for the interval from 10/1/2020 to 9/30/2021

[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	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

[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 October 7, 2021.

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