# The Charter Group Monthly Letter


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## Economic & Market Update

## Omicron Oscillation

With more and more variants of the SARS-CoV-2 virus, many of us have become familiar with a veritable Frat Row of Greek letters. On November 26, the World Health Organization (WHO) identified a new "variant of concern" which justified applying a new moniker, Omicron, the 15th letter in the Greek alphabet.

For those keeping score, there have now been twelve "variants of concern" and "variants of interest", all of which have been assigned a Greek letter. So, how did the WHO jump to the 15th letter in the alphabet instead of the 13th? The 13th letter is Nu and apparently the WHO wanted to avoid confusion with the word "new" if there are future variants, in which case Nu would become old. And, the 14th letter is Xi – but I will leave it to your imagination as to why the WHO skipped that letter as well.[1]

**There's a new virus variant and it is causing some indigestion in the markets.**

**What might be some of the longer-term implications of the Omicron variant?**

[1] Lynn Chaya, "WHO skipped over Nu and Xi to avoid causing cultural offence in naming new variant." *National Post*, November 29, 2021.

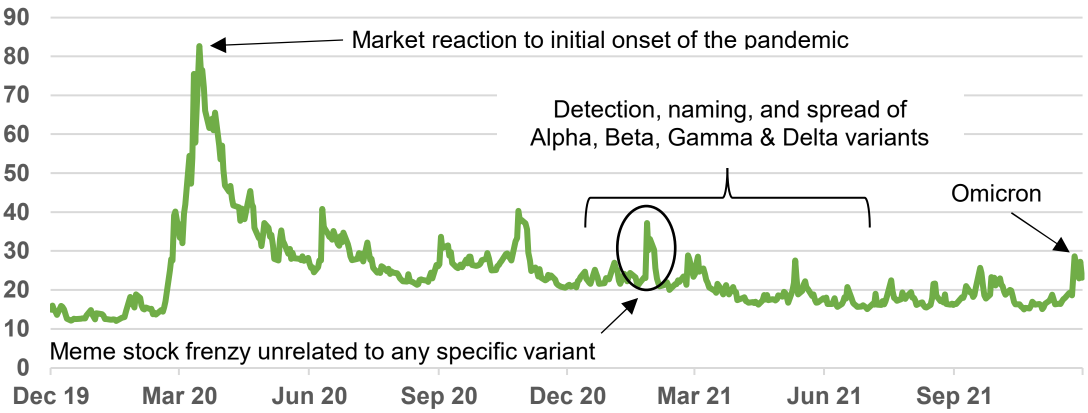
Omicron was first detected in South Africa[2] and made news when it was quickly elevated to a "variant of concern" of which there have only been four others so far (Alpha, Beta, Gamma, and Delta). The rapid dissemination of the news regarding its appearance combined with its elevation in status, combined with countries announcing travel restrictions in response, and combined with American investment industry personnel recovering from Thanksgiving-related carb comas, all added up to create a spike in market volatility on Friday November 26th.

**The Omicron variant appeared on an American holiday which might have accentuated the volatility.**

The four previous "variants of concern" had a muted impact on investor anxiety. Even Delta which was infectious enough to virtually crowd out the other three variants, and which could lead to serious symptoms, hardly registered with investors (**Chart 1**). In fact, after the massive increase in volatility associated with the uncertainty surrounding the initial emergence of the pandemic, it was only the selloffs following the various "meme stock" frenzies that produced enough concern to notably impact the mood of investors.

**The previous "variants of concern" had a muted market impact.**

**Chart 1:**
**CBOE Volatility Index (The VIX or "Fear Gauge")**



Source: Bloomberg Finance L.P. 12/1/2021

However, I would argue that Delta began to have an impact on the structure of the investment markets despite not creating much reactionary volatility. Its persistence added to the disruption of global supply-chains that have been blamed the inflationary pressures that we have seen over the past year. As an example, a small number of Delta infections lead to the complete shutdown of a number of enormous container ports in the People's Republic of China. As discussed in last month's issue of *The Charter Group Monthly Letter*, these disruptions added to the cost of containers and shipping and increased the

**The Delta variant was the most serious but didn't cause investor panic. However, it did have an impact on the stocks of more economically vulnerable companies.**

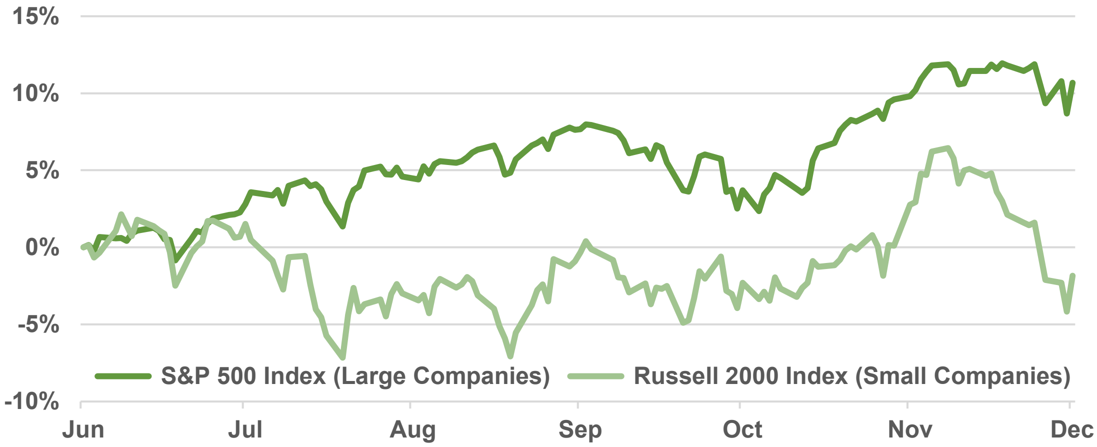
[2] It now appears that the Omicron variant was circulating globally before the detection in South Africa: Andrew Meldrum and Raf Casert, "Infections in Europe pre-date Omicron's identification in South Africa." *The Sydney Morning Herald*, December 1, 2021.

need to maintain costly inventories.

The market then began to seek out the stocks of companies that were perceived to have more resilience to a potential economic slowdown or an ability to raise prices without suffering a decline in sales. In a blunt way, this could be broken down by large companies (resilient) versus small companies (more vulnerable) in **Chart 2**.

**Chart 2:**

**Large vs Small US Companies with the Delta Variant Spread**




Source: Bloomberg Finance L.P. 12/1/2021

As long as investors were weighted towards the companies that were perceived to be more resilient, they hardly felt any overall market effects related to the Delta variant.

**Not clear if Omicron will be as infectious and potent as Delta.**

**However, it may prolong the adverse economic effects we saw with Delta.**

So, will Omicron turn out to be the most formidable variant so far in terms of infectiousness and symptom severity? Early indications are beginning to suggest otherwise. Infectiousness is not well known. The efficacy of existing vaccines is uncertain. However, symptoms appear relatively mild compared to Delta. If that is the case, perhaps increased hospitalizations won't materialize. It is still too early to have any answers, but at this point, it is not obvious that it will be a greater threat than Delta.

**Initially, perhaps investors were merely looking for a reason to sell after a long market advance.**

Perhaps there were other factors that exacerbated the Omicron selloff. We were able to escape the seasonal turbulence which normally characterizes the September to October period. Corporate earnings were good enough to keep anxiety at bay. Plus, market psychology was able to ignore some of the other negative economic fundamentals such as low workforce participation and consumer price inflation. The Thanksgiving market decline could have also been a case of investors finally finding a reason to sell.

One potential outcome of Omicron might be to prolong the economic concerns associated with Delta. It may have even been enough for U.S. Federal Reserve (the Fed) Chair Jerome Powell to finally abandon his belief that inflation would be "transitory" (this had been going on for a year now which already extends beyond a period that most would define as transitory, but it was still likely difficult for him to walk back from a term that he essentially came up with himself in an attempt to allay fears at the time).[3]

**Omicron appears to have raised inflation fears at the U.S. Federal Reserve.**

**We might see interest rate increases sooner than later.**

**However, it is always possible that the policymakers will lose their nerve as they have done in the past.**

**As long as they look determined to fight inflation, stocks could see headwinds.**

**However, if they back off, there could be another up move in the markets.**

Mr. Powell seems to be indicating a desire to accelerate the end of the Fed's bond-buying program that was designed to pump massive amounts of liquidity into the U.S. economy during the pandemic. Essentially, the program needs to end before the Fed can start raising interest rates (from basically zero) in order to fight inflation.

There are a few risks with this. First, removing liquidity and raising interest rates could dampen the economy. It is harder for consumers and business to spend if the cost of borrowing is higher.

Second, if consumers continually hear policymakers and politicians talking about inflation, it could lead to expectations for more inflation and demands for wage increases.

Third, it could be a negative for the stock market, especially for companies that rely more on borrowing money or raising money by issuing equity.

This all circles back to the resolve of the Fed. Will they follow through with eliminating their bond-buying and with raising interest rates sooner than later? Or will any induced market decline cause them to back off? Over the last few decades, they have always backed off. It is different this time with inflation being higher, but they will probably have to eventually decide if that is serious enough to commit to strong medicine which is likely to be unpopular. My three-decade career does not extend far enough back to the last era when policymakers, and the politicians who appointed them, face such no-win dilemmas. It was my textbooks of the 1980s documented these travails. The Omicron variant might cause us to revisit history and separate some of the wheat from the chaff in an investment sense: resilient companies versus vulnerable companies, need versus want, cash versus promises. I expect there to be opportunities, but they may not be widespread.

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[3] I have been following the U.S. Federal Reserve Board for over 40 years now and I can never remember the term "transitory" featuring so prominently in policy statements or policy debates regarding inflation, or any other topic. It might also be useful to note that Jerome Power was reappointed to another four-year term as Governor last week and perhaps it was opportune to fess up and start afresh.

## Model Portfolio Update[4]

**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 November.

**No changes in the model portfolios during November.**

With the exception of U.S. Equities, all the other asset classes used in the model portfolios were either flat or down for the month. However, a relatively significant decline in the Canadian dollar versus the U.S. dollar was enough to counteract all those declines as this accentuates the value of U.S. dollar denominated investments in the portfolios.

**Rising U.S. stocks and a declining Canadian dollar were enough to make it a friendly month for the model portfolios.**

The Canadian dollar was walloped on the expectation that the U.S. will have to raise interest rates sooner than expected to deal with inflation risks. A higher interest rate paid on U.S. Treasury securities tends to attract capital to the U.S. at the expense of countries like Canada.

**The Canadian dollar sold off on the possibility the U.S. may raise interest rates faster than expected.**

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 12/1/2021. 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.

Going forward, we are entering a favourable season for stock markets psychologically, the traditional year-end Santa Claus rally. This might be enough to counter the volatility related to the Omicron variant. However, the challenges of the variant as discussed in the section above are unlikely to go away.

**December tends to be a good time for stocks and could counteract Omicron variant concerns.**

**But, it likely won't extinguish those concerns heading into 2022.**

Also, the geopolitical risks involving Russia and China are elevated. It is impossible to gauge whether this will lead to confrontation, but it is being discussed more in the financial press which could reduce investor risk appetite.

**Some global geopolitical issues to keep an eye on as well.**

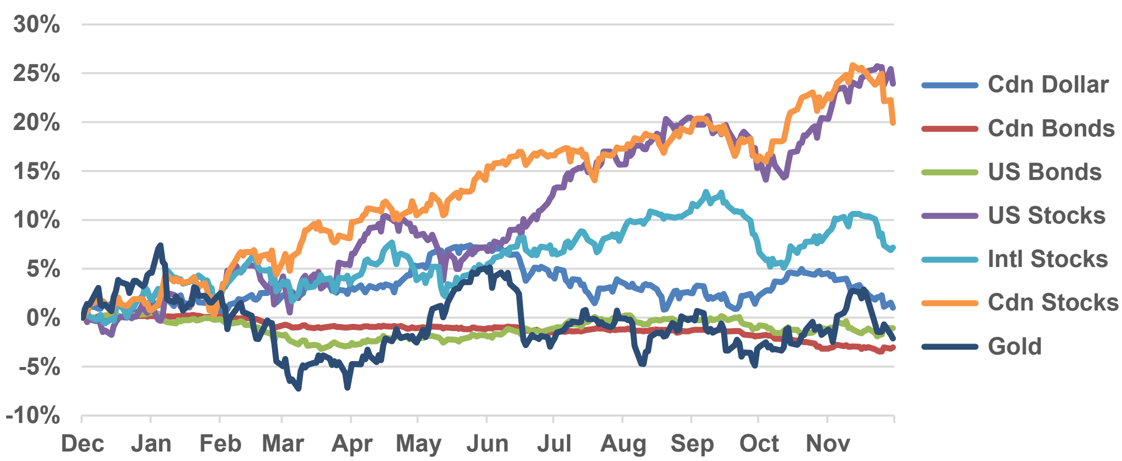
Our thesis for theme-related equities (in the case of our model portfolios, this includes Baby-boomer demographics and atomic energy), is still intact. Our bond durations are at very low levels and we continue to have a tilt towards companies with price-inelastic goods and services which provide a measure of protection against inflation. Despite some of the clouds ahead, we like the prognosis for the investments we have in the model portfolios.

**May not be a good stretch for the overall indices, but specific sectors and companies still have potential.**

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**).[5]

**Chart 3:**

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




Source: Bloomberg Finance L.P. for the interval from 12/1/2020 to 11/30/2021

[5] 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[6]

| 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 | Light | Negative |
| 9. Canada's Economic Growth (Oil) | Light | Positive |
| 10. Long-term U.S. Interest Rates | Light | Negative |

[6] 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 December 1, 2021.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor, TD Wealth Private Investment Advice, 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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