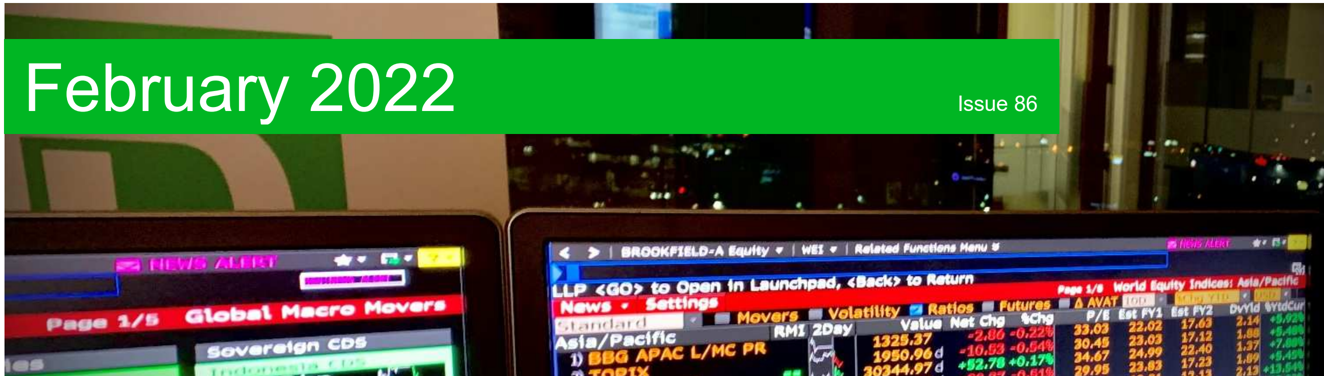
The Charter Group Monthly Letter



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Economic & Market Update

Saturday Night Special[1]

In July 1979 Paul Volcker was nominated by President Jimmy Carter to become the Chairman of the Federal Reserve Board of Governors (The Fed). During his confirmation hearings before the Senate Banking Committee, Volcker was direct about the importance of quelling inflation that had been ravaging the American economy and banking system for over a decade. However, because of inflation's harmful effects, it was naturally at the top of the agenda for the previous three Fed Chairmen. As a result, Volcker's direct comments were somewhat expected. And, after a decade of ham-fisted policy measures, often politically influenced, people weren't expecting him to be much different.

How much credibility do today's central banks have with respect to fighting inflation?

Do they have the ability to apply sustained tough medicine in the face of adversity?

However, early on there were hints that things might be different this time. Immediately after his appointment, Volcker began to raise the Federal Funds Rate (the interbank overnight lending rate) despite rising unemployment. This was not politically friendly and

[1] This was a term used to refer to an unscheduled major policy announcement from the Fed in October 1979. Some press reports also called it the Saturday Night Massacre, but this term was previous used to describe a Watergate-era event where President Nixon demanded the firing of a special prosecutor leading to resignations by those who refused to carry out the order.

created some consternation for the Carter administration. Until that point, American central bankers tended to bend to the will of the White House if pressured enough.

Central bankers of the 1970s did not have much inflation-fighting credibility … until Paul Volcker came along.

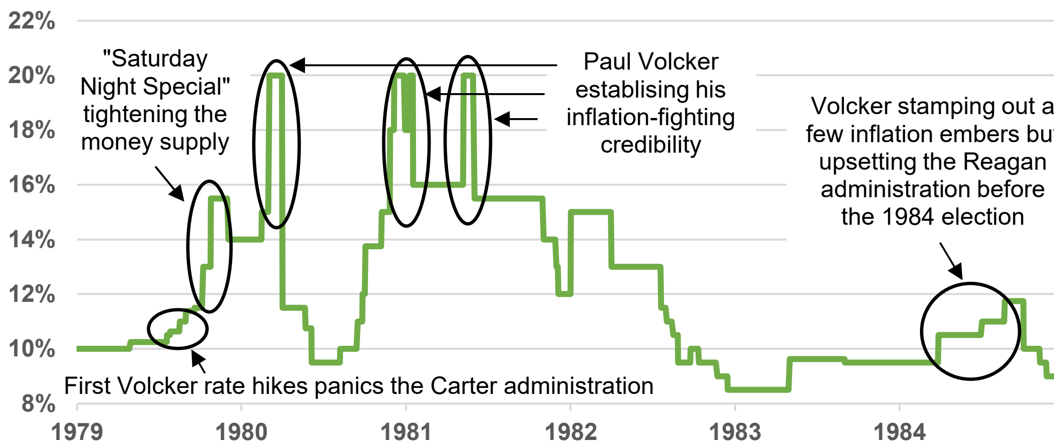
Then, on the evening of Saturday October 6, 1979, Volcker scheduled an impromptu press conference.[2] He informed the media that there had been an unplanned meeting of the Federal Open Market Committee[3] earlier that day and that they had agreed to tighten the money supply. Normally, the Fed would focus on setting the Federal Funds Rate. Targeting the money supply was new territory.

He initially astounded the markets by announcing unprecedented measures.

In accommodating the tighter money supply, the Federal Funds Rate would rise by a full four percentage points before the end of October 1979 and then spiked to 20% by March 1980, 8 ½% higher since the fateful Saturday (**Chart 1**). The Rate fell to under 10% by the summer of 1980, but rebounded back up to 20% again before the end of the year. Targeting the money supply was expected to create significant interest rate volatility, but that was the price Volcker was willing to pay to bring inflation under control.

But even that was not enough at the start to gain him credibility as inflation continued to rise.

Chart 1:



Source: Bloomberg Finance L.P. as of 2/1/2022

So, did the "Saturday Night Special" work?

Not right away. Inflation finally peaked at the end of March 1980, six months after the Saturday night press conference (**Chart 2**). However, the battle wasn't over. As a lesson, during the 1970s inflation peaked at the end of 1974 at over 12% and then declined for

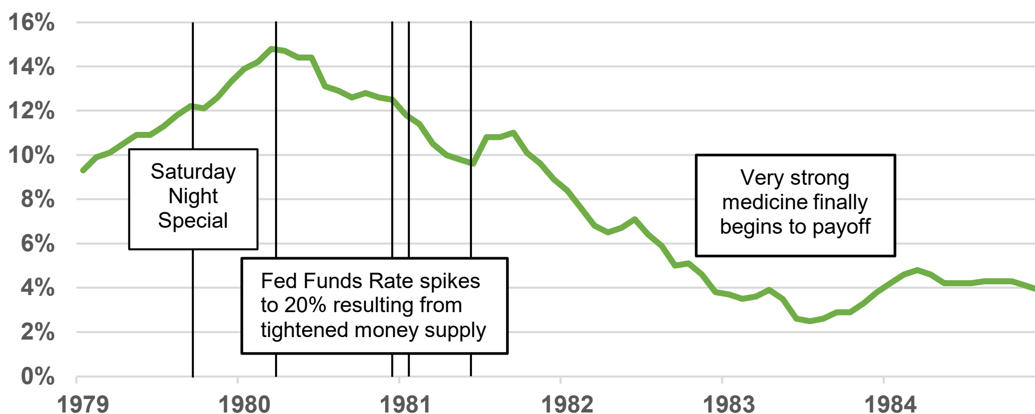
[2] Fed press conferences were a rare event back then. A press conference on a Saturday night was unheard of.
[3] The Federal Open Market Committee, or FOMC, is the committee that votes on monetary policy. Although it is heavily influenced by a chairperson, there are 11 members who get a vote and the majority result determines the policy.

the next two years before vexing policymakers by making a comeback later in the decade (**Chart 3**). This time around, Volcker kept money tight, inducing a recession in the latter half of 1980, and a much more prolonged and severe recession in 1982 (**Chart 4**). Homebuilders were dumping lumber and bricks on the steps leading up to his office as high interest rates pummeled the demand for new homes (even home prices here in B.C. plunged as a result!). A wave of business bankruptcies ensued, and politicians were calling for him to be fired. However, he kept at it. And, by 1983, although we didn't know it at the time, we had arrived at a new era of lower and more stable consumer prices.

Continued tough monetary policy despite outcries from politicians and the public eventually convinced the markets that Volcker might have to ability to finally beat inflation.

Chart 2:

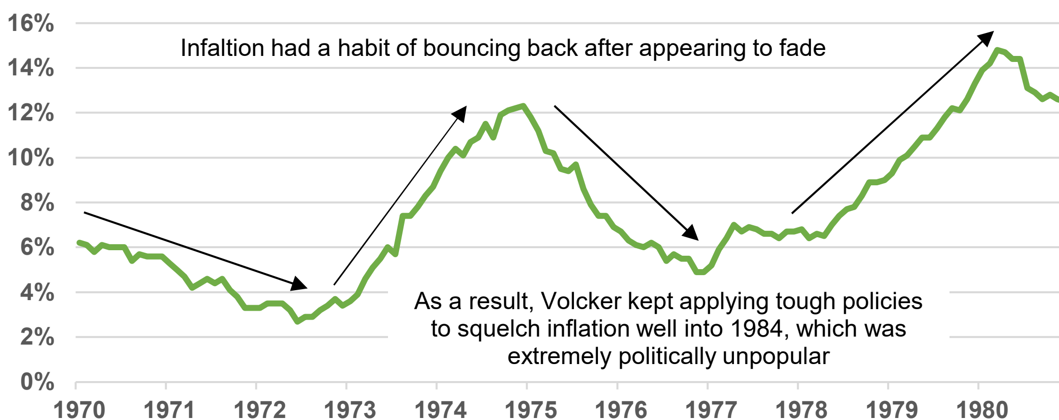
U.S. Consumer Price Index: Year-over-Year Inflation Rate



Source: Bloomberg Finance L.P. as of 2/1/2022

Chart 3:

U.S. Consumer Price Index: Year-over-Year Inflation Rate - 1970s

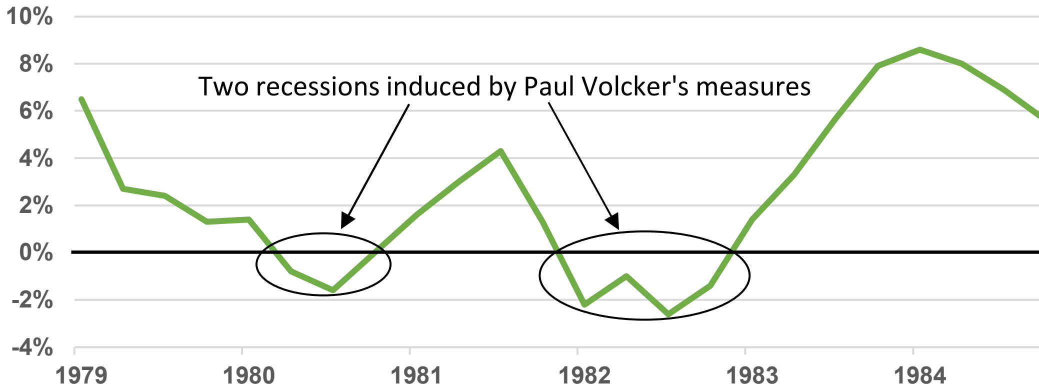


Source: Bloomberg Finance L.P. as of 2/1/2022

In 1984, just to be safe, he tightened credit once more. The Reagan administration, and Treasury Secretary James Baker in particular, were apoplectic, fearing that this would endanger their chances at re-election in November 1984 (Volcker's policies prior to the 1980 U.S. election may have been one of the factors that contributed to Carter's defeat).

Chart 4:

U.S. Gross Domestic Product (GDP) - Annual Economic Growth



Source: Bloomberg Finance L.P. as of 2/1/2022

It is important to note that it took a while for consumers and investors to believe that Volcker would persevere. His predecessors wilted under pressure. It was the shock of the Saturday night press conference, followed by spiking interest rates all while resisting the protests from politicians, lobbyists, and interest groups that changed the mood. At some point it was like "hey, this guy might actually be serious enough to finally beat inflation."

Fast forward to the present. The Fed, under the leadership of Jerome Powell, is telegraphing the intent to fight the inflation that has reached 7% year-over-year in the U.S. (after he spent enormous energy for most of last year trying to convince the markets that this inflation was only a "transitory" blip). However, he and his three predecessors had reputations of backing away from potentially hawkish policies once the stock market had fallen enough. Does that sound like Paul Volcker? Will Jerome Powell and the current Fed be able to withstand the howls from politicians and consumers if the inflation-fighting medicine becomes too painful?

We will have to wait and see if today's central banks can follow through.

However, their actions over the last couple of decades indicate a tendency for appeasement.

In Canada, year-over-year inflation has now reached 4.7%. There was an 82% probability on January 18th that the Bank of Canada would raise rates at their January 26th meeting.[4] However, the Governor of the Bank of Canada, Tiff Macklem, felt that the Omicron variant was sufficient for him to delay a rate hike to March. Does that sound like Paul Volcker?

Coincidentally, the Fed and the Bank of Canada both held their periodic policy meetings and press conferences on the last Wednesday of January. Those hardly added up to a Wednesday Afternoon Special, never mind a shocking Saturday Night Special of yore.

[4] Source: Bloomberg Finance L.P. as of 2/1/2022

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 across the model portfolios. However, we did remove a portion from the exposure to the S&P 500 Value Index and reallocated the proceeds to shares in AT&T Inc. as well as to the Russell 2000 Value Index.

The AT&T position was prompted by a desire to shift towards more individual stocks as opposed to general index exposure. Also, in my opinion, AT&T is trading at a discount to the average stock in the S&P500 Index and its high dividend yield of 8.16%[6] provides some defense against potentially volatile markets. Plus, the U.S. telecom industry's retirement of 3G and the rollout of 5G makes the sector one that we want to be in.

The shift towards the Russell 2000 Value Index from the S&P500 Value Index was motivated primarily by the better relative valuations in smaller capitalization stocks.

No changes in the asset allocations during January, but there were some changes in the investment holdings.

We sold some of the exposure to large value-type stocks and added exposure to small value-type stocks.

We also added a position in AT&T Inc.

[5] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 2/1/2022. 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.
[6] Source: Bloomberg Finance L.P. as of 2/1/2022.

During January there was weakness across all the asset classes in the model portfolios. Fortunately, there was some recovery towards the end of the month which helped to mitigate the overall down move.

All the asset classes used in the model portfolios decreased during January.

U.S. and international stocks were the biggest drags on the results and appeared to be driven lower by the anxiety over potential interest rate hikes this year. Higher interest rates increase the valuation discount of future cash flows back to the present, putting pressure on the prices of stocks. Also, the generally higher starting valuations for U.S. and international stocks made those markets even more susceptible to interest rate fears.

The downside was limited by a recovery at the end of the month.

U.S. and international stocks reacted poorly to the risk of rising interest rates to combat inflation.

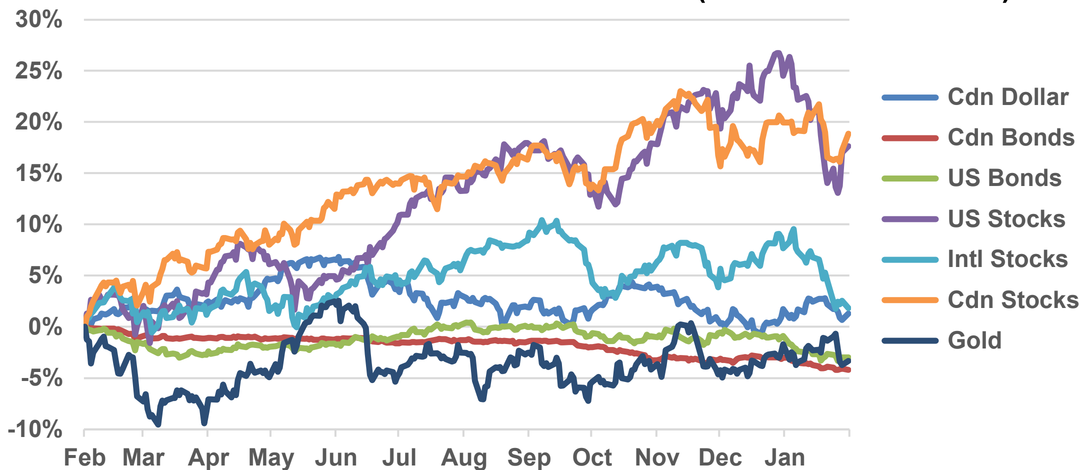
However, as discussed in the first part of this *Monthly Letter*, it might be hard for central bankers to follow through with all the expected interest rate increases. If stock markets begin to sense that possibility, it could shift investor psychology from negative to positive. We might get a better handle on this once the Fed and the Bank of Canada actually begin to raise rates and then to provide some clearer future guidance. Later Spring might be a good timeframe to expect any developments regarding this.

However, if central bankers can't follow through on rise increases, stocks might find some tailwind.

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**).[7]

Chart 5:

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



Source: Bloomberg Finance L.P. for the interval from 2/1/2021 to 1/31/2022

[7] 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[8]

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

[8] 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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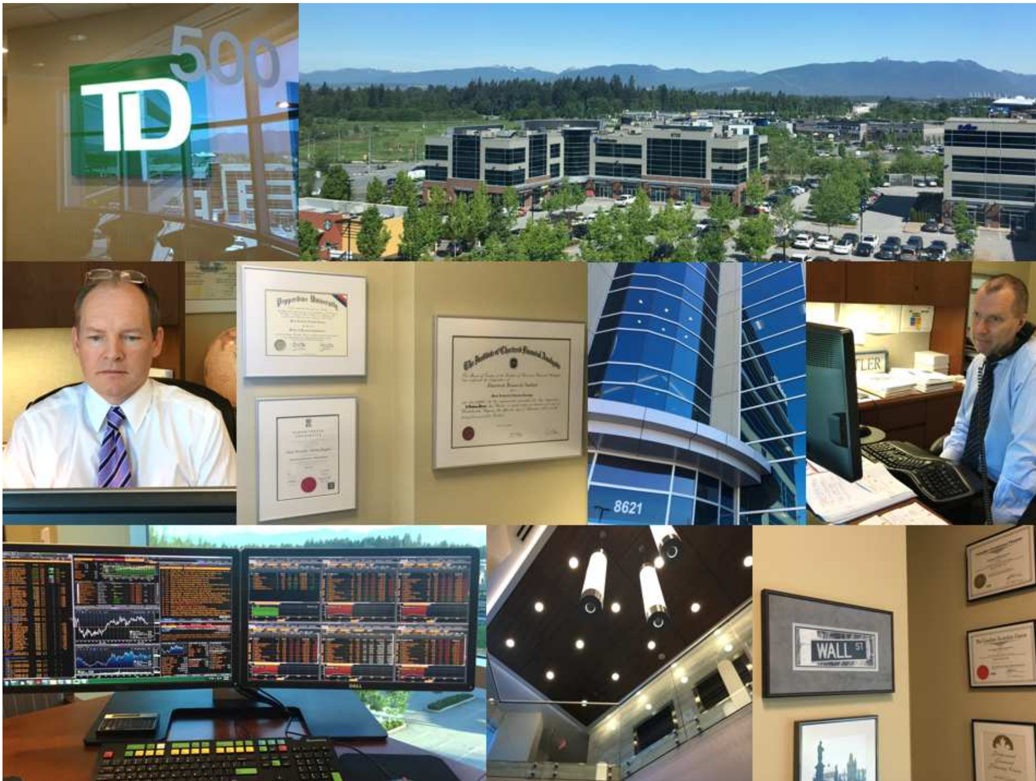
The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do 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 February 1, 2022.

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