TD Wealth

Private Investment Advice

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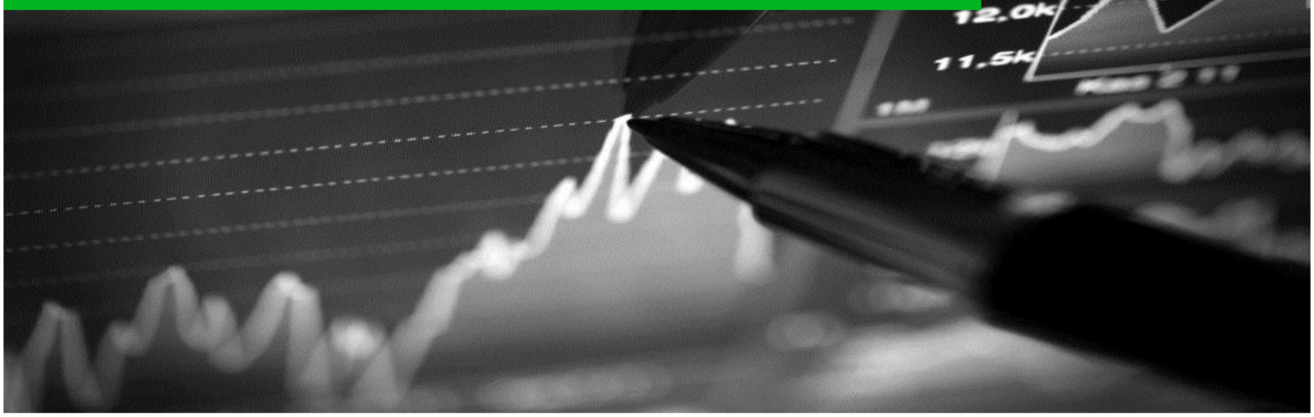

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Economic & Market Update

The Artificially Intelligent Federal Budget

What's not to love about high technology?

Embracing high tech is a new form of the "kissing babies" political strategy: Not much downside.

It makes everyday life easier. It's a source of economic growth. It creates companies that can be a source of national pride. It's green. It creates high value-added jobs for well-educated candidates. And so on.

Therefore, it should not be surprising that politicians of all stripes and at all levels of government embrace it. The Mayor of Vancouver wants to double the number of clean tech jobs by 2020.[1] The Premier of B.C. committed $100 million to early-stage tech companies[2] and has vowed to increase the number of tech-sector graduates by 2022.[3] And, the Prime Minister of Canada followed up last year's Budget, which provided $800 million in technology funding, with one that offers additional incentives for innovation,[4] earning the name "The Innovation Budget" from the press.

Local, provincial, and federal politicians all love technology initiatives.

The pledges to promote high technology at the municipal and provincial levels are mostly feel-good rhetoric. Neither of those governments have the tools or resources to generate much of an impact. At the margin, there may be a few more jobs that emerge which would be good news for prospective high tech grads. But we should not expect any material impact on economic growth. Outside forces such as overall national economic growth, federal tax policies, tax policies in competing jurisdictions, and international trade policies will ultimately determine how many tech jobs are created at the local and provincial levels.

Technology initiatives at the local and provincial government level have minimal impact.

Those outside forces are primarily the domain of the federal government. Looking at the 2017 Federal Budget in isolation, there are a number of positive aspects. Addressing technology and innovation is a whole lot better than ignoring it. Unfortunately, economically-impacting technology is a story of "scale" which is something that the Budget did not attempt to address (**Chart 1**).

The federal government can do a lot to create a robust tech industry, but usually fall short of being bold enough to make an economic difference.

Scale provides the critical mass that leads to rapid technological development and the U.S. is the role model for this. And important step in achieving scale begins with decades of investment in pure research that is not initially concerned with commercial value. The U.S. government finances 42 Federally Funded Research and Development Centers. Additionally, the U.S. Department of Defense runs 15 University Affiliated Research Centers. Eventually the benefits of this research seep into the private sector to the point where the imprint on the U.S. tech sector had been massive.

Technology needs "scale" in order to make a measurable difference in economic growth.

Total Canadian federal government research and development (R&D) spending is currently at just over $5 billion USD per year.[5] In contrast, the U.S. currently spends $148 billion USD per year on R&D,[6] about three times greater on a per capita basis.

[1] https://www.bloomberg.com/news/articles/2015-09-30/vancouver-pivots-to-tech-from-mining-to-lead-canadian-growth
[2] http://www.timescolonist.com/business/b-c-pumps-100-million-into-tech-sector-1.2128954
[3] http://www.theglobeandmail.com/news/british-columbia/premier-clark-vows-increase-in-tech-sector-grads-if-re-elected/article34308156/
[4] http://business.financialpost.com/fp-tech-desk/what-canadas-tech-gurus-want-from-trudeaus-800b-innovation-budget?__lsa=744a-c0c3
[5] http://www.statcan.gc.ca/daily-quotidien/150528/cg-d001-eng.htm

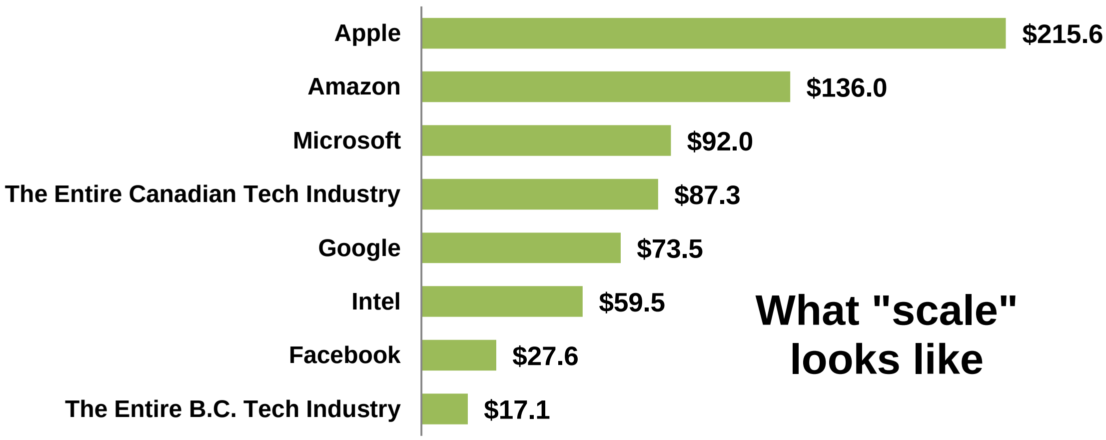
The U.S. also has an economic environment that attracts and rewards the best and the brightest. With tax policies and a financial industry environment that promote capital formation, the U.S. has created mind-boggling personal wealth among its tech industry luminaries. Bill Gates of Microsoft down in Seattle is the world's richest person. Jeff Bezos of Amazon, also located in Seattle, recently became the world's 2nd richest person, leapfrogging Warren Buffett.[7] Since the beginning of March, Bezos has gained more wealth than the *entire* net worth of Jim Pattison, B.C.'s richest person. What would Canadian voters think if the federal government's budgets and policies laid the foundation for a new breed of gazillionaires that would dwarf the current vanguard of the Canadian establishment? That might be a tough sell.

The U.S. has the ideal template for creating "scale."

However, that template can dramatically affect wealth distribution.

Would Canadians be ready for the changes that a bold technology initiative might induce?

Chart 1:
2016 Total Revenue - U.S. dollars (in Billions)



Source: Bloomberg Finance L.P., The Toronto Star, Vancouver Economic Commission

Much of the U.S. technology-generated wealth is plowed back into private R&D. Bezos' Amazon has become the number one threat to traditional retailers as it innovates new ways to undercut and out-deliver competitors. And, on the side, it has become *the* dominant force in global cloud computing (a rapidly growing area with no Canadian leadership – almost all Canadian cloud-related jobs are with subsidiaries of U.S. companies).

Although the U.S. template creates numerous billionaires, their propensity to re-invest back into research is substantial.

Then there's Google which generates so much cash flow from online ad revenue that they are able to finance seemingly outlandish projects such as self-driving cars, virtual reality goggles, and balloon-distributed Wi-Fi from 60,000 feet in the sky. *And*, they outspent the entire Canadian government by $3 billion USD in R&D last year.[8] Google is

[6] https://www.aaas.org/page/historical-trends-federal-rd
[7] http://money.cnn.com/2017/03/29/technology/jeff-bezos-richest/
[8] http://fortune.com/2014/11/17/top-10-research-development/

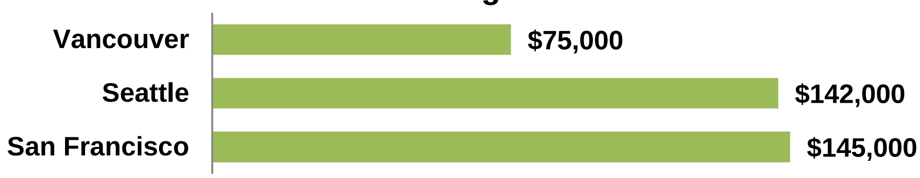
throwing stuff at the wall to see what sticks. If anything does stick, the potential for job creation with all the spinoffs could be immense.

In addition to Amazon and Google, other tech leaders like Microsoft, Apple, IBM, and Facebook are all feverishly investing billions into experimental side projects.

Meanwhile, in Vancouver, the local tech industry was abuzz over the potential of U.S. subsidiaries to ramp up employment in Canada with foreign workers who might be caught in Trump's clampdown on temporary work visas.[9] Some of that excitement may fade when Vancouver's housing costs are considered (**Charts 2 & 3**). Regardless of the housing aspect, the concept of "scale" was *completely* absent in the story as it usually is with local tech industry media coverage.

Chart 2:

Annual Income for Software Engineers - Canadian dollars



Source: The Globe and Mail, Point2Homes

Chart 3:

Median Home Prices - Canadian dollars

Source: The Global and Mail, Point2Homes

The Canadian tech industry is still far short of the "scale" that it needs to replace the economic contribution from the energy and real estate sectors.

As I have written about before, Canada's economic octane came from the growth in the energy sector until oil prices began to fall in 2014, and then from real estate and its related sectors since 2014. It is understandable that governments want to expand the tech sector as an economic back-up plan. But technology initiatives that can measurably add to a country's economic growth require colossal amounts of investment over long periods of time with new tax regimes that challenge other tech-focused countries. That could cause seismic disruption in Canada's industrial fabric and in how wealth is accumulated and distributed. The bottom line is that it requires policies and incentives that Canadians have never, *en masse*, voted for in the past. The 2017 Federal Budget is a reflection of that.

[9] http://www.cbc.ca/news/canada/british-columbia/bc-tech-travel-ban-1.4029005

Model Portfolio Update[10]

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

	Target Allocation %	Change
Equities:		
Canadian Equities	15.0	None
U.S. Equities	35.7	+1.7
International Equities	9.3	-1.7
Fixed Income:		
Canadian Bonds	25.5	-2.5
U.S. Bonds	2.5	+2.5
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2	None

During March the target asset allocation of The Charter Group Balanced Portfolio was shifted slightly toward U.S. stocks and U.S. bonds and away from Canadian bonds and international stocks. We wanted to have a little more exposure to the U.S. dollar and to the U.S. economy in general. Although the Canadian economy has had a decent couple of months, we feel that there is some uncertainty with respect to the continuation of this trend. Canadian dollar bulls were hoping that oil prices would advance further with OPEC's agreement to cut supply. However, whenever oil prices rise, U.S. supply ramps up which, in turn, dampens the price again. Canadian dollar bulls were also putting faith into the federal government's "Innovation Budget", which we think is misplaced for reasons discussed in the first section of this *Monthly Letter*.

In March, the Balanced Portfolio was shifted more towards U.S. stocks and bonds.

Exposure to Canadian bonds and international stocks was slightly reduced.

We also added a new position to the portfolio in the form of CVS Health Corp., a U.S. retail pharmacy that also operates as a pharmaceutical benefits management provider. We like the company from an earnings perspective and because of its balance sheet strength. CVS's exposure to the baby-boomer demographic is an added bonus.

CVS Pharmacy is a new U.S. holding in the Balanced Portfolio.

[10] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 3/3/2017. The asset allocations of individual clients invested in this Portfolio will 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.

After some middling performance over the last couple of years, international stocks were finally a contributor to portfolio performance. We also decided to realize some of these gains by trimming our international exposure during March.

The other major contributor to performance was the strength in U.S. stocks as the post-election rally continued during the 1st Quarter, although it tailed off a little towards the end.

Stocks, despite trading at historically rich valuations, appear satisfied with corporate earnings, wages, employment, and economic growth so far in 2017. Barring a geopolitical crisis in Asia or Europe, or a psychological selloff, there doesn't seem to be many hurdles for the market to navigate in the next couple of months. There may be some back-and-forth reaction to U.S. regulatory and tax reform, and to U.S. Federal Reserve guidance on the future direction of interest rates, but hopefully that will be the extent of the volatility for now.

Below is the 1st Quarter performance of the asset classes that we use in the construction of The Charter Group Balanced Portfolio (**Chart 4**).[11]

International stocks were a good contributor to performance over the 1st Quarter. We realized some profits by trimming exposure.

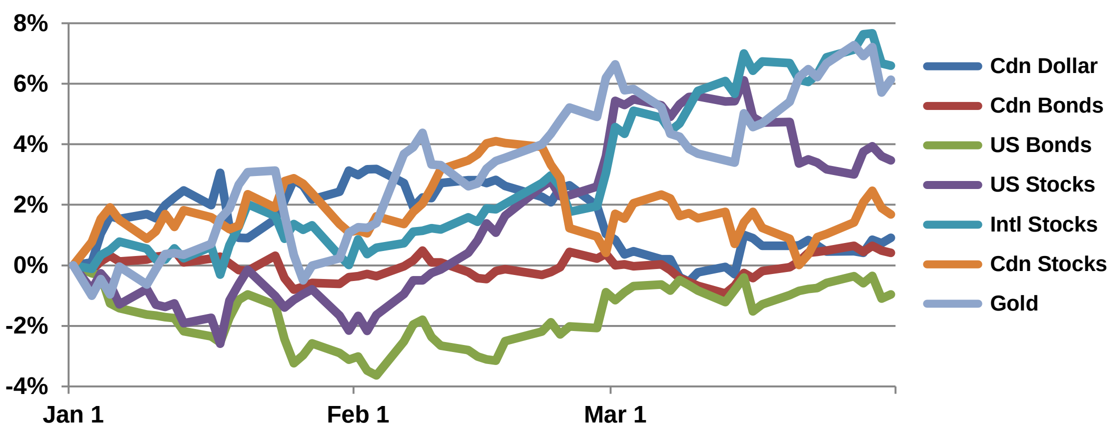
The rally in U.S. stocks post-election continued during the Quarter. Our greater than normal exposure to the U.S. added to performance.

Stocks may be looking for reasons to sell off, but there aren't many at the current time.

Geopolitics or a psychological selloff might be the major risks heading into the Spring.

Chart 4:

1st Quarter 2017 Performance of the Asset Classes (In Canadian dollars)



Source: Bloomberg Finance L.P. as of 3/31/2017

[11] 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 iShares Canadian Universe Bond Index (XBB); U.S. bonds are represented by the iShares Core U.S. Aggregate Bond Index (AGG); U.S. stocks are represented by the iShares Core S&P 500 Index (IVV); International stocks are represented by the iShares MSCI EAFE Index (EFA); Canadian stocks are represented by the iShares S&P/TSX 60 Index (XIU); Gold is represented by the iShares Gold Trust (IAU).

Top Investment Issues[12]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. Canadian Dollar Decline	Moderate	Positive
3. Long-term U.S. Interest Rates	Moderate	Negative
4. U.S. Fiscal Spending Stimulus	Medium	Positive
5. Canada's Economic Growth (Oil)	Moderate	Negative
6. East Asian Geopolitics	Medium	Negative
7. Massive Stimulus in China	Medium	Positive
8. Short-term U.S. Interest Rates	Light	Negative
9. Japan's Money Printing	Light	Positive
10. Europe's Money Printing	Light	Positive

[12] 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, we encourage you to email mark.jasayko@td.com and set up a time to talk face-to-face or by phone.

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The Charter Group at TD Wealth 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 April 5, 2017.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor 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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The Charter Group consists of Mark Jasayko, Portfolio Manager, Investment Advisor, Mike Elliott, Portfolio Manager, Investment Advisor, and Laura O'Connell, Associate Investment Advisor. The Charter Group is part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. TD Waterhouse Canada Inc. is a subsidiary of The Toronto-Dominion Bank. TD Waterhouse Canada Inc. – Member of the Canadian Investor Protection Fund.