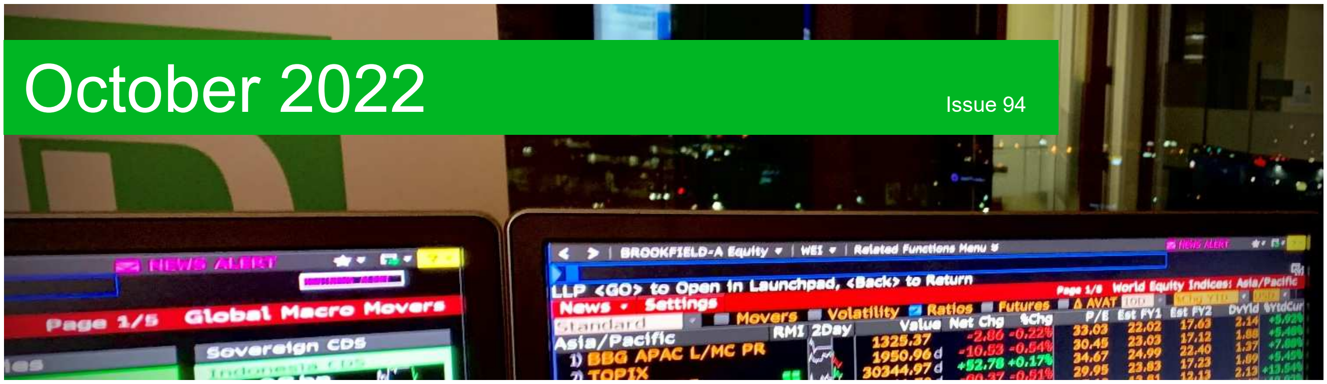
The Charter Group Monthly Letter



October 2022

Issue 94

Mark Jasayko, MBA, CFA
Senior Portfolio Manager & Senior Investment Advisor
TD Wealth Private Investment Advice
The Charter Group, Langley, BC

Economic & Market Update

A Market Selloff in the "No Good Options" Era

Imgflip.com, Jake Clark - Tumblr

If you were a politician or an economic policymaker and you had to choose between recession or inflation, which would you choose?

Decision makers who set economic policies are, for the first time in decades, stuck between a rock and a hard place. The economic numbers over the last year and a half suggest that they need to choose one or the other, or a combination of the two. The era of having the luxury of stimulating economic growth with minimal immediate consequences appears to be over.

To investors, this has been a growing source of uncertainty since November of last year when a

For decades, policymakers had it easy – they could stimulate the economy without immediate consequences.

Now, it appears that stimulative policies will contribute to inflation.

The choice: inflation, or higher interest rates that can hamper economic growth.

growing consensus was beginning to conclude that inflation was not as "transitory" as central bankers were claiming at the time. The uncertainty was especially focused on the role that interest rates would play in a solution for the inflation. The world economy had changed enormously since the last episode of high interest rates and it will not be easy to gauge their impact based on the impact bank then. If the central banks had to increase interest rates to dampen demand, thereby helping to reduce price pressures, what would be the knock-on effects on stocks, bonds, housing, and unemployment? How high would interest rates have to go to suffieciently quell inflation? Would higher interest rates actually do much against inflation considering the fact that there are plenty of contributing factors that have little connection to monetary and fiscal matters (supply-chain quagmires, geopolitical strife, weather, etc.)?

In addition to hampering economic growth and inducing unemployment, higher interest rates can also impair asset values.

How much increase in interest rates can the economy stand?

Looking at the investment market action since the beginning of the year, we might get some clues as to what the consensus is thinking now. Clearly, there is a general sense that interest rates would have to rise high enough in order to impair the value of all sorts of assets. Interest rates are key to valuations as they are used to discount all future cash flows back to the present time; the higher the interest rate, the more potent the discounting effect, the lower the present value of the asset. That might explain why we saw the worst start for many stock markets in 50 years, and the worst start for the North American bond market, *ever*. Investors appear to be thinking that interest rates will rise high enough to hurt valuations. That might be a big source for the selling that we have seen.

In addition to economic uncertainty, investors need to apply higher interest rates in discounting future investment cashflows. This realization might have added to the selling pressure.

However, there are other areas of the markets that appear to communicate that a majority of investors feel that this won't take too long. They may be concluding that a few months worth of tough medicine will be enough to push inflation down to levels that we saw over the previous decade, prior to the pandemic. We can see this in the pricing of traditional inflation hedges, such as precious metals and inflation-adjusted bonds. Their prices have been down this year. After all, who would want these kinds of investments if the inflation problem is solved relatively soon! The "it will soon be solved" crowd may be more populated by traders, as opposed to investors, who are keen to trying their luck at timing the markets over the short-term, selling recently with hope of buying back in when the victory over inflation is imminent.

Despite all the inflation angst, inflation hedges are not priced at a premium, implying that the consensus believes that the inflation fight will be won relatively soon.

There is also another constituency that is getting some press with their claim that central banks will "pivot" away from fighting inflation when the costs become apparent. A rapid collapse in economic growth, or increase in unemployment might do the trick. Or, perhaps a large financial institution gets into trouble which can result in a systematic shock through the financial system. Paradoxically, they are bullish in that the bad news will force central banks to lower rates, leading to higher asset values. Again, this is more the domain of speculators and traders, but they are occasionally having an impact (such as the summer rally from the beginning of July to mid-August).

Some investors are also thinking that the central banks will have to back off if too much damage is inflicted.

That might lead to a lowering of rates and an increase in asset prices.

Our model portfolios tend to focus on narratives outside the domain of these traders and speculators, as well as investors who over-simplify the inflation challenge and are optimistic that central bankers will negate the need for inflation hedges.

I have written for many years now about how stimulative economic policies will eventually force a reckoning. A "transitory" inflation dilemma that can be quickly knocked out with some midly higher interest rates (by historical standards) is *not* the "reckoning" I was writing about! Instead, there is so much inertia built up over years of permissive economic policies, and an igniting of dozens of contributing factors, that there may not be enough blunt force provided by recent central bank actions to do much about inflation in the short to medium-term. Perhaps the policy focus now should be on what is needed in order to have the tools to cool inflation in the mid to later innings of the battle.

After decades of policies that were setting things up for a reckoning, there might be too much hope that the inflation issue can be easily solved.

However, regardless of how entrenched inflation might become, central bankers are human, impacted by the emotions resulting from the consequences of their policies. It would not be surprising if they lightened up on the fight if it appeared that a recession was becoming more of a certainty, and with job losses becoming an economic and political risk. At this point, my best guess is that they will choose a bit of both of the two "no good options." That might provide some oxygen for a market recovery, but would likely drive more uncertainty and resulting volatility into 2023 if investors begin at that point to accept that a solution to inflation is much further out into the future than initially assumed.

Central bankers are also human and may not be able to withstand the turmoil that higher interest rates may cause. They might choose a combination of inflation and reduced economic sluggishness.

* * *

Some perspectives on the recent selloff:

Unless one has been significantly exposed to large tech stocks (in the form of the Nasdaq Composite Index for instance), the magnitude of this selloff has been notably less than the declines we saw at the outset of the pandemic. From peak-to-trough, in early 2020 the Dow Jones Industrial Average, the S&P 500 Index, the Nasdaq Composite Index, and the S&P/TSX Composite (Canadian stocks) were down -37.09%, -33.92%, -30.12%, and

-37.43% respectively. From their interim peaks to now, they are down -21.94%, -25.20%, -34.14%, and -16.45% respectively.[1]

The recent selloff still does not compare in terms of magnitude to other major selloffs in the past.

Also, volatility is not where it was in previous selloffs.

The primary volatility index for stocks (the VIX which measures the implied volatility of the S&P 500 Index over the next 30 days using S&P 500 Index options) has not come near its high in early 2020, or the subsequent highs through 2020 and into early 2021. This might be an indication that although markets have declined recently, investors have hope that things will moderate more quickly than investors thought during the reverberating market panics through the duration of the pandemic.

This selloff is frustrating because so many more asset classes and sectors are down in unison – leaving fewer places to hide.

The aspect that makes the current selloff unique (and what we discussed in the July 2022 issue of this newsletter) is that *both* stock *and* bond markets, and most sub-sectors of the two, are falling in unison. There are far fewer places to hide than in previous selloffs.

In early 2020, U.S. and international bonds fell from peak-to-trough by -6.30% and -8.77% respectively, but then quickly recovered.[2] Contrast to this year where since January 1st, U.S. and global bonds have fallen -14.61% & -19.89% respectively.[3]

The best safe havens have been inflation-resilient companies and shorter-term bonds.

Even cash is at risk as it is eroded by inflation.

The best defense this time has been exposure to the types of stocks that are structured to be more resistant to inflation, and to keep bond maturities very short so as to mitigate the impact from higher interest rates. Or, one could have put all their money into energy stocks which have still done quite well year-to-date despite falling oil prices over the last few months. Otherwise, there is not much else out there. Even cash, which is often perceived as a safe harbour, is getting ravaged by inflation, and then forces the investor to time the market when getting back into stocks and longer-term bonds.

The bottom line: Things need to deteriorate much more in order to match the decline of the 2000 Dot-com bust, the 2008 sub-prime mortgage crisis, or the 2020 pandemic selloff. However, as alluded to the section above, any retreat from the fight against inflation could help to break the downward trend established in mid-August. It could even be an opportunity of providing the time to tilt the model portfolios further toward inflation-resistant asset classes, sectors, and companies before the pain of inflation again outweighs the pain of recession as policymakers grapple with the "no good option" dilemma.

---

[1] Source: Bloomberg Financial L.P. as of 10/3/2022
[2] Source: Bloomberg Financial L.P. as of 10/3/2022
[3] Source: Bloomberg Financial L.P. as of 10/3/2022 – U.S. bonds represented by The Bloomberg U.S. Aggregate Bond Index, and international bonds by The Bloomberg International Aggregate Bond Index.

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 individual securities in the model portfolios during September. The proceeds from the March bond maturity continue to remain in cash which has been a benefit during this year's bond market volatility. That said, I might be on the cusp of rebalancing all the model portfolios which would significantly reduce that cash buffer.

No changes in the model portfolios during September.

Some of the cash that has built up may be invested via an upcoming rebalancing of the portfolios.

All of the asset classes were down for the month expect for gold which had a tepid climb in the last couple of weeks as perhaps more investors viewed it as more attractive just in case inflation lingers longer than expected.

All asset classes except for gold were down during the month on rising interest rate concerns.

Stocks in the U.S., Canada, and internationally were mostly down in the 4 to 5% range in September when measured in Canadian dollars. The returns tended to be worse in the types of stocks which led the last decade, and in the emerging market realm where the

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 10/3/2022. 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.

stronger U.S. dollar is wreaking havoc. Thankfully, we have little to no exposure to those areas.

A strong U.S. dollar is hitting the loonie hard. But that is helping the performance of U.S. investments in Canadian dollar accounts.

Speaking of the U.S. dollar, its strength was also reflected in a battered loonie which had its worst calendar month since January 2015, falling 5.06% against the greenback (although it did drop more than that mid-month in March 2020 before recovering at the end of that month). At least the falling loonie significantly helped improve the performance of U.S. stocks in Canadian investor portfolios.

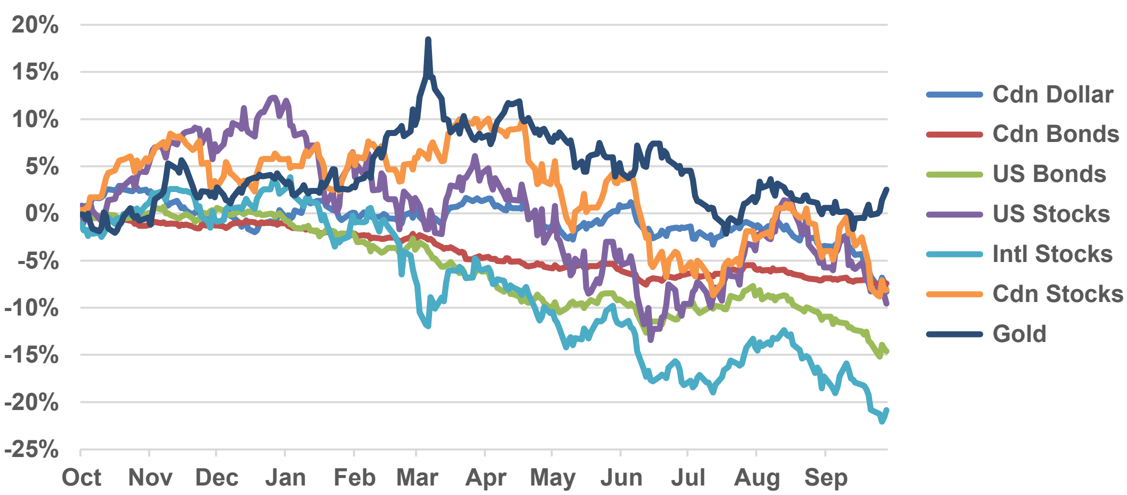
The Bank of England lost is nerve and had to halt its inflation fight because of the bond market stress it was causing. Could this be a preview to what other central banks might do?

As mentioned previously in this newsletter, central bankers could lose some nerve if it appears like they are breaking the economy and putting stress on the financial system with higher interest rates. In fact, the Bank of England at the end of the month dramatically reversed course when rates were causing a plunge in government bond prices and leading to margin calls to institutional investors who were depending on more stable bond prices to make their investment strategies work. This could be a bit of a preview as to what other central banks might do over the next couple of months.

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 1**).[5]

Chart 1:

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



Source: Bloomberg Finance L.P. for the interval from 10/1/2021 to 9/30/2022

---

[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. Global Geopolitics	Significant	Negative
2. Canadian Federal Economic Policy	Moderate	Negative
5. Inflation (Portfolio Impact)	Moderate	Positive
3. China's Economic Growth	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
7. Short-term U.S. Interest Rates	Medium	Negative
6. U.S. Fiscal Spending Stimulus	Medium	Positive
8. Global Trade Wars	Medium	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.

The Charter Group

Mark Jasayko, MBA, CFA | Senior Portfolio Manager & Senior Investment Advisor
Mike Elliott, BA, CIM®, FCSI® | Senior Portfolio Manager & Senior Investment Advisor
Kiran Sidhu, BCom, CIM®, CFA | Associate Investment Advisor
Laura O'Connell, CFP®, FMA | Associate Investment Advisor
Kelsey Sjoberg | Administrative Associate

604 513 6218
8621 201 Street, Suite 500
Langley, British Columbia V2Y 0G9

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 3, 2022.

The information contained herein has been provided by Mark Jasayko, Senior Portfolio Manager and Senior 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.

Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS.

Index returns are shown for comparative purposes only. Indices are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index.

The Charter Group is a part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. which is a subsidiary of The Toronto-Dominion Bank.