The Charter Group Monthly Letter

November 2022

Issue 95

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

Economic & Market Update

The Bond Market Vigilantes

> "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."
>
> James Carville, *The Wall Street Journal*
> (February 25, 1993, p. A1)

For the last two decades, legislators and policymakers could engage in unprecedented deficit spending without inciting a bond market revolt.

It looks like that might have changed.

And, with that quote, James Carville, a prominent advisor to President Clinton, entered investment finance lore.

At the time, the Clinton administration was in the midst of formulating a number of spending proposals aimed at stimulating the U.S. economy. Investors in the bond market were not keen on seeing a flood of new Treasury bonds issues to finance the additional expenditures and threatened to drive up interest rates by selling.

In response, the Clinton administration felt the pressure to moderate the level of spending. The "Bond Market Vigilantes" had achieved their aim of forcing a more prudent fiscal policy which helped to enhance the value of their bond investments as prices rose through to the autumn of 1993.

The term "Bond Market Vigilantes" is often used to describe a bond market revolt.

Arguably, the intimidation from the "vigilantes" contributed to a fiscal policy that resulted in four years of U.S. federal budget surpluses from 1998 to 2001 (there has not been a surplus since).

It turned out that the economy really did not need the stimulus proposed by the Clinton administration in 1993 as the economy ended up running hot enough to induce inflation concerns. The U.S. Federal Reserve and the "vigilantes" pushed rates higher through most of 1994. It appeared that the politicians got the message and backed off on the spending spigots for the remainder of the decade.

Because of the size of the bond market, it has been able to limit or alter the spending ambitions of governments.

After that, the "vigilantes" went into a long hibernation.

Global inflationary forces receded and there was enough demand for government bonds from Japan, China, banks, insurance companies, and pension funds to keep bond prices steady and elevated. Governments around the world were able to increase deficit spending because the demand for bonds easily absorbed the increasing supply.

However, the "vigilantes" were quiet for 20 years as inflation was low and demand for bonds was high, lifting bond prices.

When it looked like that demand wobbled during the global financial crisis of 2008-09, central banks stepped in and became massive buyers of bonds (through to this year). This kept rates low, bond prices high, and the global economy humming. The low inflation during this period kept the "vigilantes" content.

And, then suddenly, a couple of weeks ago, the "vigilantes" reappeared and, in my opinion, precipitated the resignations of the U.K. Prime Minister Liz Truss and the U.K. Chancellor of the Exchequer Kwazi Kwarteng (the finance minister).

Unfortunately for the U.K. government, the "vigilantes" have returned and may have had a significant impact in changing the political leadership and the government's fiscal planning.

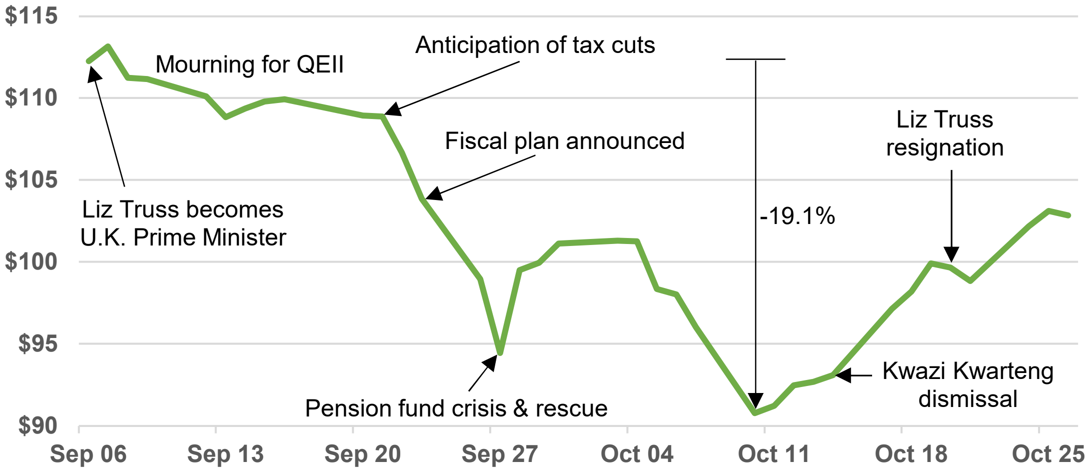
Truss and Kwarteng proposed a series of tax cuts and spending increases (despite a 10.1% annual U.K. inflation rate!)[1] to reignite the British economy, and the "vigilantes" responded by pummeling the prices of U.K. Gilts (which are the name for British

[1] Partington, Richard. "UK inflation rises to 10.1% on back of soaring food prices." *The Guardian*. October 19, 2022.

government bonds). The combination of cutting tax revenue while increasing expenditures is the recipe for significantly increasing the supply of Gilt bonds. Plus, a significant source of demand was in jeopardy as the Bank of England had telegraphed its intention to cease buying bonds at the end of October. Increasing the supply of Gilt bonds in the face of declining demand would likely hit prices hard. The "vigilantes" didn't wait and began selling. In the end, their efforts resulted in a new Prime Minister, a new Chancellor of the Exchequer, and a pension fund crisis to boot (many pension funds were using derivatives to wager that that interest rates would not rise much).

Chart 1:

Price of the U.K. Gilt 0.125% Coupon, Maturing Aug 10, 2031



Source: Bloomberg Finance L.P. as of 11/1/2022

Will the "vigilantes" try to intimidate other governments into reigning in spending?

Will the "vigilantes" reappear to intimidate another country's politicians and policymakers? There is no shortage of countries with sketchy fiscal and monetary conditions. Plus, it was so easy to float bonds over the last two decades that there are more bonds in more markets than there were in the 1990s. So, lots of opportunities in terms of intimidation!

If they do, we could see lower bond prices and interest rates.

With the U.S. in particular, the fiscal situation is not as precarious as it is in the U.K. However, with the risk of inflation expectations becoming un-anchored, and with the U.S. Federal Reserve losing some of its inflation-fighting credibility, the "vigilantes" might force the Biden administration to scale back spending levels which are still relatively high by historical standards despite the fading economic pain from the pandemic.

For the last couple of years, I have been writing about how the bond market would be the "final judge and jury" with respect to years of deficit spending and debt growth. We may now be seeing what I was talking about.

Model Portfolio Update[2]

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

The asset allocations were unchanged in October.

However, we did sell JP Morgan and Qualcomm, replacing them with AIG (insurance) and IBM.

We also rebalanced all the portfolios in order to reinvest the growing cash balance.

The asset allocations remained unaltered in October, but we did make a couple of investment changes, and rebalanced all the portfolios to use the cash proceeds from an earlier bond maturity. That cash was helpful in acting like a buffer against the market volatility that we have seen this year, but it was time to put it back to work.

During the month, the positions in JP Morgan and Qualcomm were sold and replaced by AIG and IBM. We were not overly confident with the JP Morgan exposure during times of rising interest rates (even though the bank said this was generally advantageous). AIG's very efficient policy management over the last couple of years has been impressive and has not been fully reflective in the price of the shares in our estimation.

With respect to Qualcomm, we had bought it initially in February 2017 when it was getting sued for competitive practices and we felt that they had a strong argument in these cases.

---

2 The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 11/1/2022. 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.

They ended up turning the tables and winning almost all the cases while benefitting from very robust Samsung and Apple smartphone upgrade cycles. The strength of those upgrade cycles has waned. Plus, we had become concerned about the fact that more than two-thirds of Qualcomm's revenues were from the People's Republic of China (where they sell to a host of domestic discount brand smartphone makers). By adding IBM as the replacement, we get a company that is strong in enterprise system applications, consulting, software, and the cloud business while generating a dividend yield of around 5%. It's certainly not just the old mainframe-focused business of yesteryear.

If central banks scale back interest rate increases, it would likely be positive for stocks.

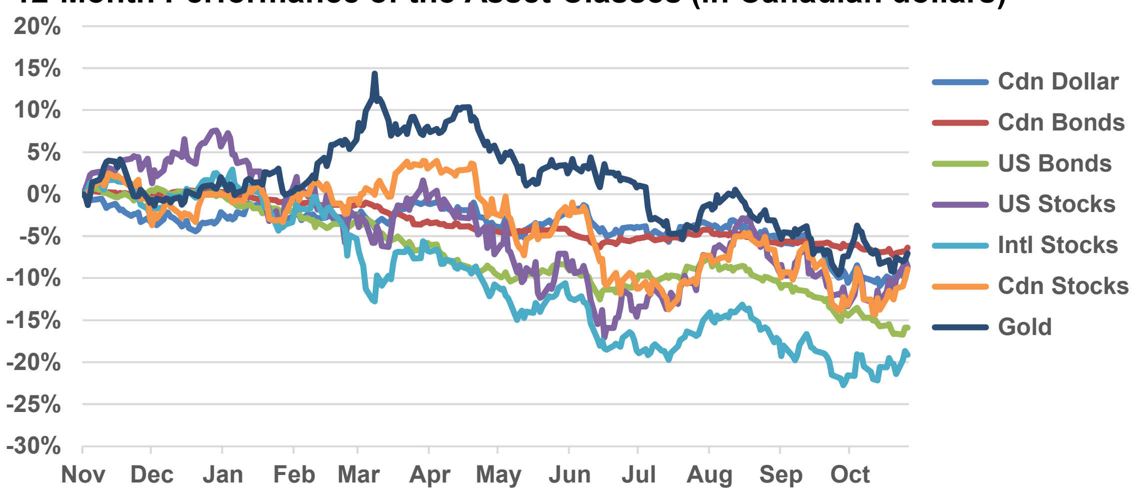
Looking forward, there is some indication that the Bank of Canada and the U.S. Federal Reserve would like to cut back on the inflation-fighting rate hikes and eventually pause them altogether in the 2nd quarter next year. If there is further confirmation of this, it would be like catnip for stocks. That said, there is a risk that inflation reignites and central banks need to restart the battle or risk their credibility at that point. Separately, the U.S. mid-term elections in early November might be helping to boost markets. Polling is showing an increased chance of a split Congress, which usually means gridlock. Wall Street tends to like gridlock because it tends to put the brakes on the growth of government.

Potential U.S. Congressional gridlock after the November mid-term elections could be looked upon favourably by Wall Street.

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 2**).[3]

Chart 2:

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



Source: Bloomberg Finance L.P. for the interval from 11/1/2021 to 10/31/2022

[3] 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[4]

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

[4] 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 November 1, 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.