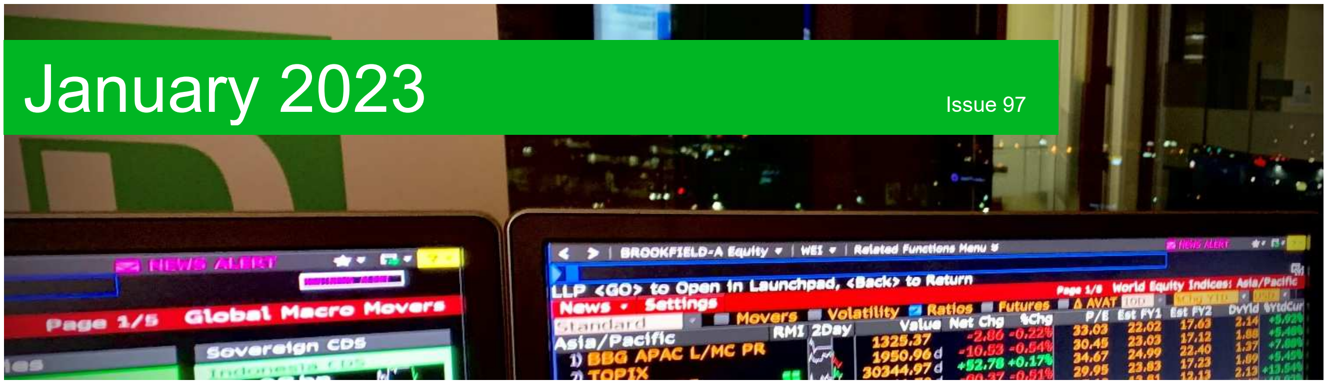
The Charter Group Monthly Letter



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Economic & Market Update

It Takes Two

Often it is tempting to sit back and watch someone else do the work.

In the battle of inflation, it has been the central banks around the world that have been doing the heavy lifting. This involves increasing short-term "policy" interest rates[1] as well as attempting to selloff the gargantuan inventory of bonds that central banks have accumulated since the Global Financial Crisis of the late 2000's.[2]

On the first point, most economic participants (individuals and companies) do not like higher interest rates. They make mortgages and other loans more expensive to service. And, they tend to cause a reduction in the price of assets, from real estate to securities.

Fighting inflation may take a joint effort by central banks and governments.

Central banks have taken the initiative by starting to do some of the necessary difficult things.

Governments appear to be sitting back and waiting to see how things go.

[1] The "policy" rate in the U.S. is the Fed Funds Rate which is used to govern overnight lending between banks as they scramble at the end of the day to get onside with respect to required reserve ratios. It is the most-watched policy rate, which makes it useful for the U.S. Federal Reserve Board to signal its intentions with respect to monetary policy.

[2] When a central bank sells a bond that it was holding, the buyer of the bond pays with cash, and that cash is removed from the money supply. The theory is that a reduction in the money supply will reduce inflationary pressures just as an increase in the money supply (printing too much) will increase inflationary pressures.

On the second point, the bond market becomes an unhappy place when a central bank floods the landscape with more supply when there is already too much for buyers to absorb. This is a recipe for lower bond prices.

As a result, central banks are not popular when they try to fight inflation.

Governments risk losing re-election if voters aren't ready to vote for fiscal austerity.

Meanwhile, governments, which can contribute to the battle by cutting back on spending, are conspicuously quiet. That's understandable. Politicians tend to loath austerity and voters tend to like government largess. Austerity might make things difficult for incumbent politicians to win when elections roll around.

In the U.S., the battle against inflation effectively began in November 2021 when the Chair of the U.S. Federal Reserve Board (the Fed), Jerome Powell, declared that the use of the word "transitory" as it pertains to inflation was being "retired."[3] The raising of interest rates and the selling off of bonds didn't commence until March 2022, but those moves were telegraphed for months and investors, consumers, businesses, and governments had time to prepare.

Current government spending does not resemble the relatively austerity during the last inflation battle 40 years ago.

Meanwhile, governments continued to spend at about the same rate as they did before. As an indication of that level of spending, since November 2021, the U.S. Federal government has added over $2.5 trillion to the total U.S. Treasury debt outstanding.[4] When the Fed successfully fought inflation 40 years ago, $329 billion in Treasury debt was added, which would equate to $1.3 trillion in today's dollars.[5] However, *that* was stretched over a period of 41 months from August 1979 to the end of 1982, compared to only 13 months so far in the current inflation battle (**Chart 1**).

The chances of fiscal austerity any time soon looks slim. There has been a dearth of such conversation amongst governments in Canada, the U.S., Europe, and elsewhere in the developed world. Some observers might argue that the current Republican opposition to raising the U.S. Federal Debt Ceiling is about austerity. However, past increases in the Debt Ceiling eventually pass after some brinkmanship and political horse-trading, and

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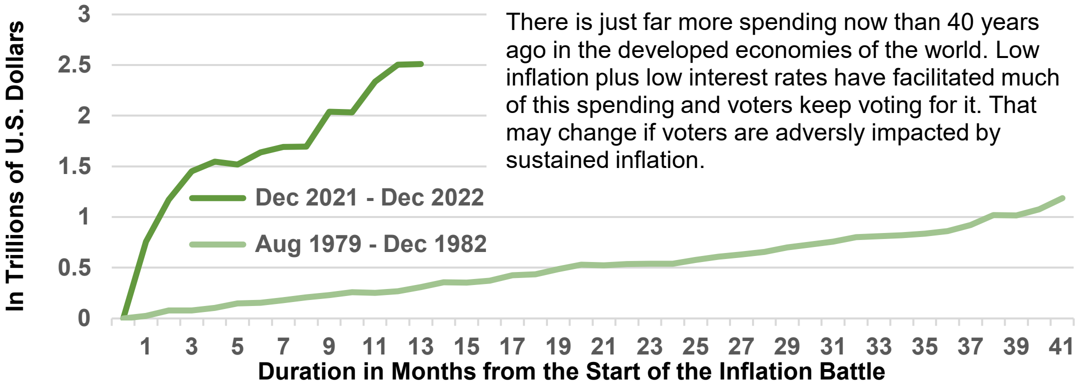
[3] Miller, R. (2021, November 30). Jerome Powell Ditches 'Transitory' Tag, Paves Way for Rate Hike. *Bloomberg News.*
[4] Source: Bloomberg Finance L.P. The increase in Treasury debt is being used as a proxy for the level of spending as the actual amount of spending in 2022 won't be known for months. Plus, the debt numbers are more granular as they are monthly versus annual for the spending number.
[5] U.S. Bureau of Labor Statistics Inflation Calculator from August 1979 to present.

because it's about the need to finance *previous* spending, much of which was incurred by the Trump administration in addition to current and past Democrat administrations.

Chart 1:

Increase in Outstanding U.S. Treasury Debt - Inflation Adjusted



Source: Bloomberg Finance L.P. & the U.S. Bureau of Labor for monthly inflation. As of 1/11/2023.

Recent political posturing in the U.S. about Debt Ceiling battles and scaling back military spending may not be as much about austerity as it seems.

Also, the House Republicans are murmuring about a need to scale back military spending. That might have sounded reasonable prior to the increase in geopolitical tensions with Russia and the People's Republic of China, but now sounds to be incongruent with the military challenges that the U.S. might have to deal with in the future. So, I am not expecting much austerity on this front either.

Government spending in developed countries is still very elevated. Voters are not voting for austerity at this stage.

Can inflation be defeated by central banks without the help of government austerity? I think that is highly unlikely. 40 years ago, it took a Fed Funds Rate that rose to 20% on four occasions between March 1980 to May 1981 during an era when governments were not spending anywhere near as much as they do now. Currently, voters still vote for spending. The inflation bite is beginning to hurt, but not enough yet. Until voters indicate otherwise, governments unlikely to significantly reduce expenditure.

Without some government austerity, it might require significantly higher interest rates to lower inflation and then to keep it down. Central banks may not be keen on such a policy which might lead to stubborn inflation going forth.

In the next few months, we will likely see the annual rate of inflation slowdown, but this will mostly be because of the base effect where it is difficult for inflation to expand at a sustained rate when the rate was already high a year ago. So, I would not take that as a sign of success in the inflation battle. The U.S. Federal Reserve, the Bank of Canada, and the European Central Bank have all expressed a determination to get inflation back to 2%. In addition to a myriad of other factors, continued high levels of government spending is going to make it very difficult to get below 4% without significantly higher interest rates in my opinion. Perhaps central banks should communicate to governments that they need to do their share.

Model Portfolio Update[6]

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 and the securities holdings in the model portfolios were unchanged during December.

No changes in the model portfolios during December.

December saw a reversal of much of the gains from November. The only asset class that we use in the model portfolios that was higher was gold.

Except for gold, all the other asset classes were lower.

The bond and stock markets were frustrated with U.S. Federal Reserve Chair Jerome Powell's determination to keep interest rates higher and for longer than investors as a whole were expecting. Markets sagged towards the end of the year, adding misery to one of the worst years with respect to declines across a wide array of asset classes and industry sectors. Thankfully, the model portfolios were down only a fraction of the magnitude of the general market losses.

In December, investors were frustrated by the potential for higher-than-expected interest rates.

[6] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 1/11/2023. 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.

The first couple of trading days of 2023 saw markets rising on the hope that inflation will soon pass and that rate cuts would commence by this upcoming summer. However, it should be noted that investor consensus for the last two years has been an expectation that we will go back to the low interest rate and free money landscape of the pre-pandemic world. That consensus has been offside and likely contributed to the investor consternation of 2022.

Investor optimism for lower rates returned with the start of the New Year.

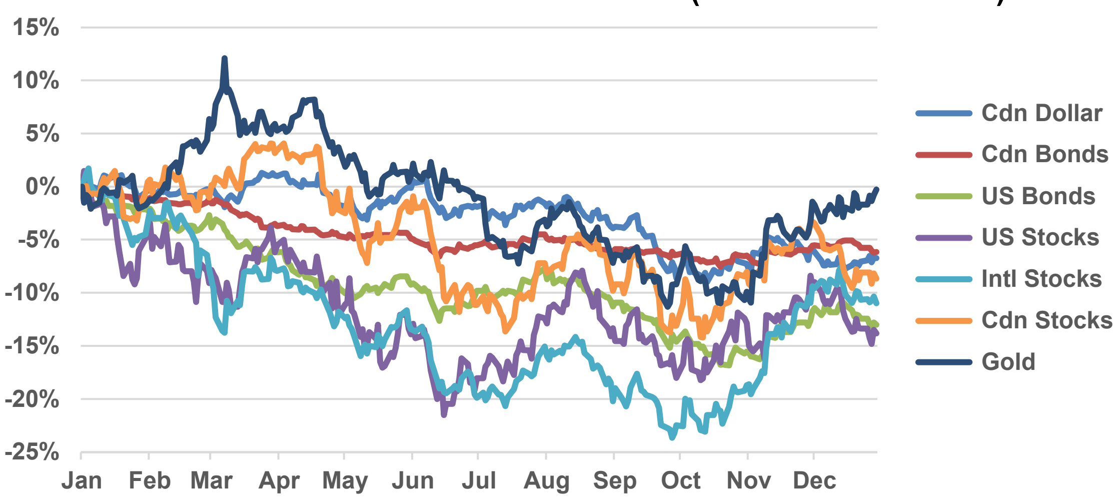
It's possible that this optimism will have some momentum during the first quarter of 2023. The annual inflation growth rate will likely slow because of last year's already high level. This could feed into the narrative that inflation is about to fade away. The next few inflation reports in the U.S. and Canada could be enough to challenge investor hopes of a return to pre-pandemic economics, leading to uncertainty and an increase in volatility across both stocks and bonds. Plus, if inflation appears to be more stubborn than expected, traditional inflation hedges (gold, silver, inflation-adjusted bonds), which have yet to be fully embraced, could suddenly find popularity.

If the next few inflation reports disappoint on the high side, some of that optimism could evaporate, pushing more investors into inflation hedges and away from growth stocks.

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**).[7]

Chart 2:

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



Source: Bloomberg Finance L.P. for the interval from 1/1/2022 to 12/31/2022

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

[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 January 11, 2023.

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.

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