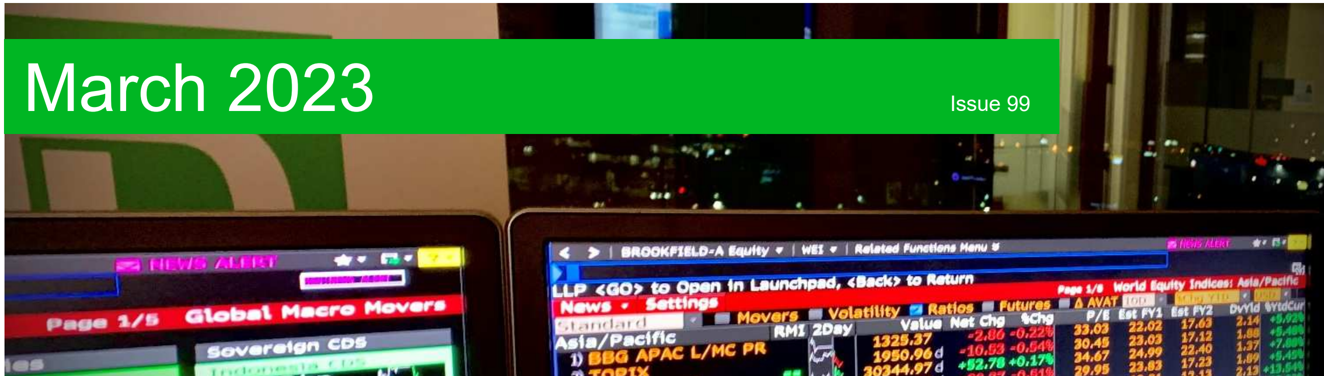
The Charter Group Monthly Letter



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Economic & Market Update

Forecasting Has *Always* Been Hard

Last month I had a little bit of fun highlighting the Bank of Canada's recent record of forecasting inflation (**Chart 1**). Despite employing a few hundred people in its economics division, within a few months, the actual rate of inflation usually deviates significantly from the forecasted rate. The other notable pattern is that the forecasted rate, regardless of when the forecast was made, gravitates towards 2%.

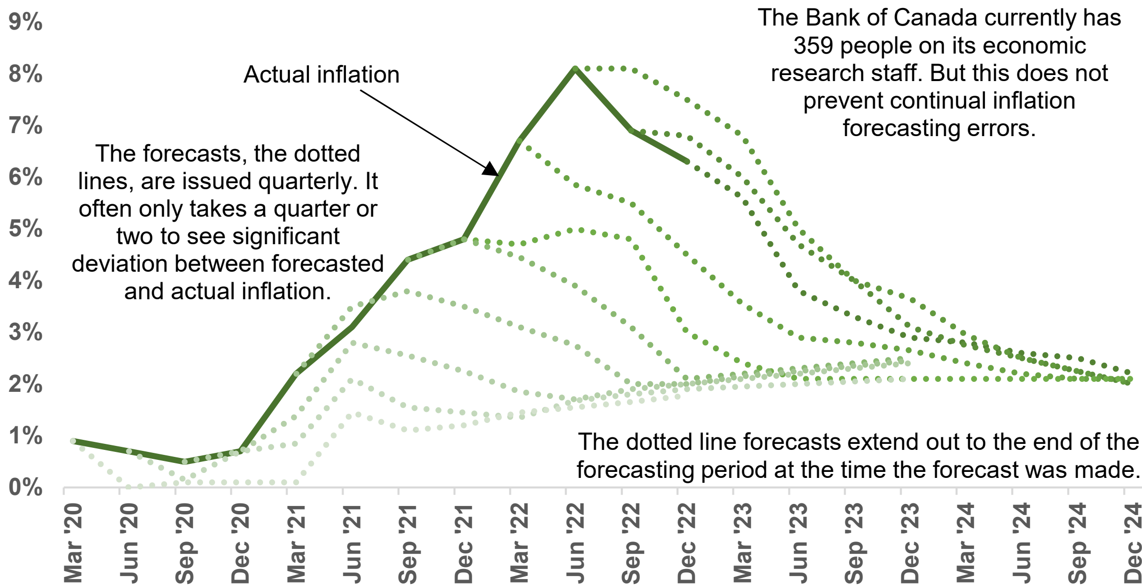
2% is the targeted inflation rate at not only the Bank of Canada, but also at the U.S. Federal Reserve, the Bank of England, and the European Central Bank among others. Perhaps the forecast is injected with some wishful thinking that current monetary policies will be effective and that a retreat to 2% inflation is within sight. My estimation is that humans as a whole are naturally optimistic, and that it is not overly surprising that optimism infiltrates forecasts, even from central bank economists who are trying their best to be objective (at least I hope that they are striving for objectivity, otherwise the growing chorus questioning central bank credibility, after botching things two years ago by assuring us that inflation was transitory, could become deafening).

Inflation forecasts by private economists tend to be just as error prone as those issued by central banks.

In fact, they tend to make similar errors, making it difficult to ascertain much difference between the inflation forecasts.

TD Wealth

Chart 1:
Canada's Annual Inflation Growth Rate
Actual versus Bank of Canada Forecasts



Source: Bloomberg Finance L.P. and the Bank of Canada Monetary Policy Reports 2020-2023 as of 3/7/2023. The left axis represents the growth in Canada's Consumer Price Index, or CPI, measured from 12 months prior.

Let's leave the central bank economists alone for now and focus on the inflation forecasts of other economists. It would be safe to assume that this group would not be married to the notion of a perpetual destination of 2% annual inflation growth. It is not *their* promise. As a consensus, one might think that they would arrive at a different terminal rate for inflation.

However, the reality is that we get private sector inflation forecasts that looks a lot like the central bank inflation forecasts (**Chart 2**)!! And, this has been going on for years.

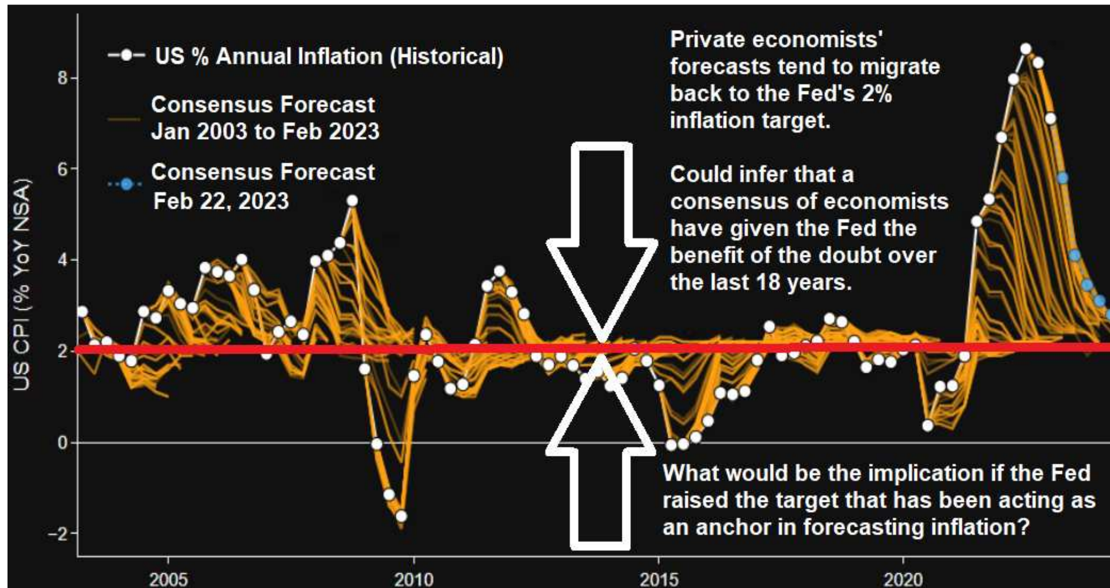
My perspective on this phenomenon has been that economists and investors started to accept central bank proclamations, including inflation targets, at face value. Inflation targeting was initially introduced by the Reserve Bank of New Zealand in 1989, about eight years after inflation had begun to descend from the elevated heights of the late 1960s to early 1980s. New Zealand appeared to have success in that within three years, inflation was well below the target, coming down from a level that was about 3% above the ceiling when the policy was established. This attracted much attention from other central banks around the world and, by the end of the decade, numerous central banks had followed suit.

Central bank inflation targeting has been perceived as a success over the years.

As a result, private economists appear to be willing to give it considerable weight.

Chart 2:

The U.S. Annual Inflation Growth Rate
Actual versus Private Economist Consensus Forecasts



Source: Bloomberg Finance L.P. as of 3/7/2023

Declining inflationary forces (globalization, relative global peace, a minimum of disruptive events such as pandemics, etc.) might have had more to do with capping inflation than central bank inflation targets. However, it is difficult to isolate the impact of monetary policy from the secular global trends that contributed to price stability. In the midst of this, my conclusion is that economists and investors just began extending central banks the benefit of the doubt and attributed much of the slowdown in inflation to the policy targets.

Hence, we get private sector economist forecasts approximating central bank economist forecasts. The wide acceptance of the 2% inflation target has been baked-in to today's economic thinking and outlooks.

What might happen if central banks raise their inflation targets in order to give themselves more monetary policy flexibility?

There has been some chatter recently of how the growth in inflation over the last two years might eventually force the U.S. Federal Reserve to abandon its 2% target. Perhaps 3% or 4% is more realistic if painfully higher interest rates are insufficient at pushing inflation down.

However, the ramifications of this could be seismic. Much of the global economy is tuned in order to function in an environment of low interest rates and low inflation. If central banks give up on the notion of 2% inflation, we might see inflation premiums added to

longer term interest rates, and investors accepting that the halcyon days of big technology companies, who thrived in the previous environment, are numbered. After a couple of decades of inflation and interest rates being anchored, abandoning the low targets could unleash pent-up forces and lead to volatility in sectors and companies that were the leaders in the pre-pandemic era.

If the inflation targets are raised, it could be safe to assume that the inflation consensus among private economists will also rise.

That, and any related increase in long term interest rates, could have ramifications for how *all* assets are valued.

Model Portfolio Update[1]

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 specific securities holdings in the model portfolios remained unchanged in February.

No changes in the model portfolios during February.

Whereas January saw investors bid up the riskier parts of the market on the hope that interest rates would soon be levelling off and then declining in the 2nd half of the year, February was plagued by a number of indicators revealing that inflation was proving more stubborn than previously hoped. That implied that interest rates could reach a higher level and stay there longer compared to previous estimates.

Many of the gains from January were washed away as inflationary concerns reappeared after a couple of months.

As a result, international and domestic stocks and bonds were down across the board.

The prospect of higher U.S. interest rates also strengthened the U.S. dollar, thereby weakening the price of gold by over 5%. The Canadian dollar also suffered as a result.

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 3/7/2023. 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 interest rate futures market implies an expectation of U.S. interest rates racing out ahead of Canadian interest rates during the Spring.[2]

There is a concern that higher U.S. interest rates will be needed to reduce wage gains and other inflationary pressures.

Despite the prospects of higher U.S. rates over the next four months, there is *still* an expectation that interest rates will start falling by September.[3] The U.S. Federal Reserve (the Fed) continues to believe that we will head back to its 2% inflation target, reducing the necessity of elevated interest rates. If one uses decades of interest rates to discount future earnings of growth stocks, then only one year of higher rates is not going to have much impact. However, as discussed in the first part of this issue of *The Charter Group Monthly Letter*, if the Fed, and other central banks, give up on their lower inflation target, we could see the riskier parts of the market encounter significant volatility. Alternatively, if investors continue to see higher than expected inflation reports, they could begin to assume that the targets are unrealistic and start selling before central banks finally acquiesce on the inflation targets. The difficulty is in trying to time these scenarios. If it happens soon, then we could get a reckoning amongst richly valued tech and growth stocks. If it happens later, then the overall market may have more room to run.

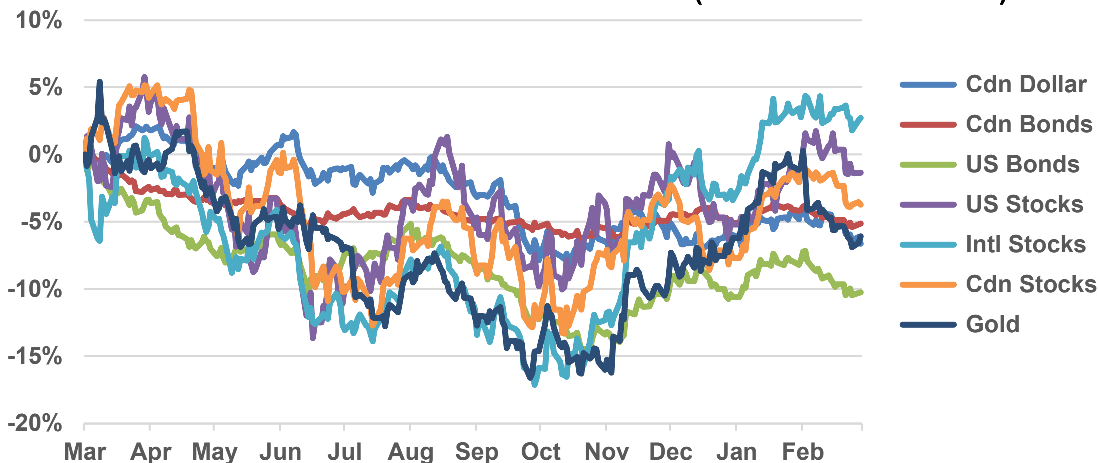
Higher U.S. interest rates have strengthened the U.S. dollar relative to most currencies, including the Canadian dollar.

Investors still appear to hope that inflation and interest rates will recede in a few months. That conviction could be tested if more discouraging inflation data emerges.

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 3**).[4]

Chart 3:

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



Source: Bloomberg Finance L.P. for the interval from 3/1/2022 to 2/28/2023

[2] Source: Bloomberg Finance L.P. as of 3/1/2023. Expectations for the Fed Funds Rate are implied by the pricing of interest rate futures contacts on the CBOE.

[3] Ibid.

[4] 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[5]

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

[5] 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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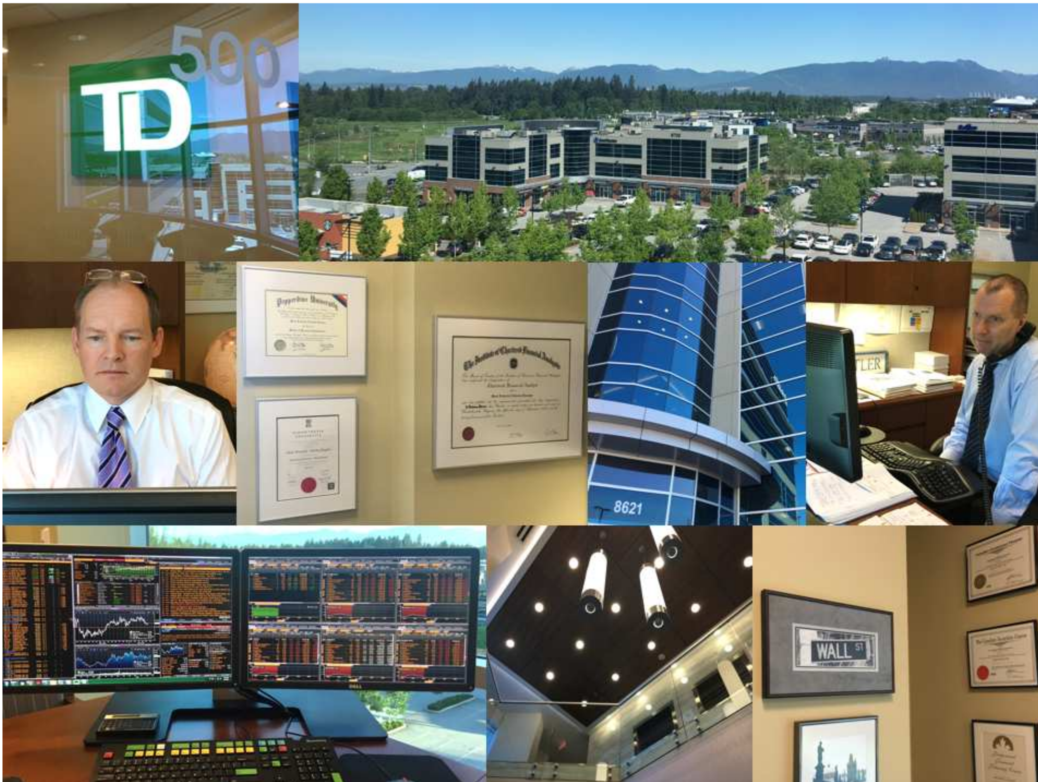
Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.



The information contained herein is current as of March 7, 2023.

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