

# The Charter Group Monthly Letter

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## Economic & Market Update

### Forecasting is Hard

In finance and economics, forecasting can be borderline impossible. Even for central banks like the U.S. Federal Reserve and the Bank of Canada which employ armies of people holding a Ph.D. in economics.

Often, economic and market forecasts are distilled to one number. If this number is communicated authoritatively, it can sound convincing, especially if it comes from experts.

However, statistics teaches us that, if we don't have a crystal ball, the future is a distribution of probabilities. In most cases, there is a range of possible outcomes each with a forecasted probability. Knowing that, a user of this information might hedge their bets since there would be a clear risk to wagering on the single number outcome.

The problem is that the financial press does not like ranges of possibilities. That is too hard to communicate within a single headline. So, forecasters can fall into a trap of making a single specific forecast.

**Economic forecasting is very routine. Despite that, its error rate is surprisingly high.**

**Even institutions that are brimming with experts have enormous difficulty reducing forecasting errors.**



When examining the track record of economic and market forecasts, the results are generally terrible. Things get even worse when a specific time horizon accompanies the forecast.

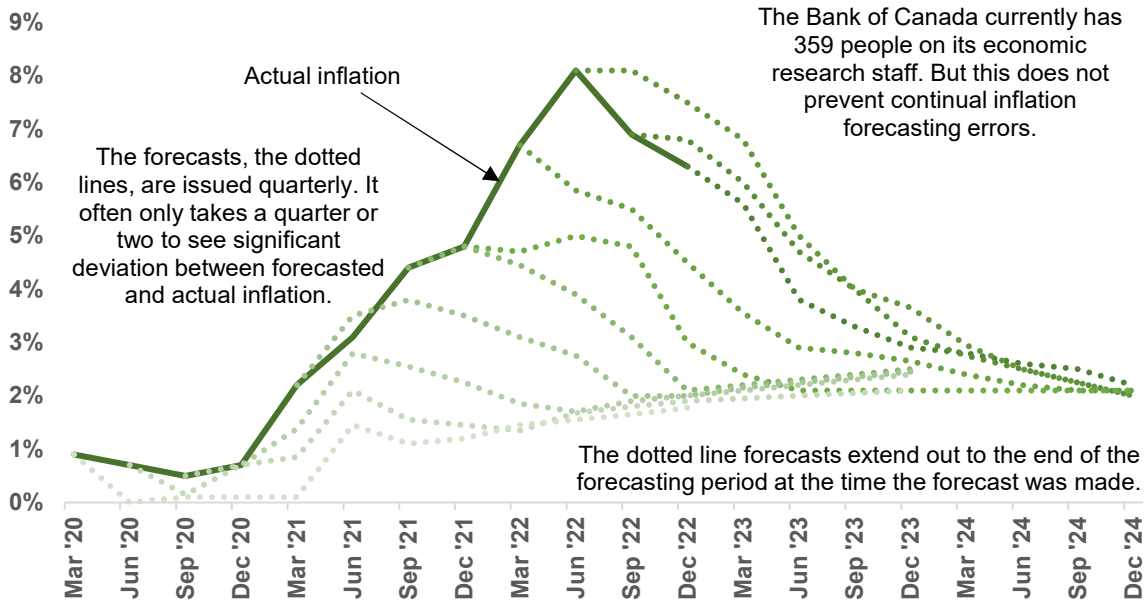
All of this likely led to an adage that I first learned in business school: "Forecast, and forecast often." If one frequently updates a forecast, maybe it will bamboozle people with respect to the accuracy of previous forecasts. The Bank of Canada (**Chart 1**) issues an inflation forecast every 90 days. By looking at the latest forecast, the synopsis looks potentially valid. However, when overlaying the previous forecasts, the magnitude of the errors become evident which should lead one to be skeptical of the most recent forecast regardless of how authoritative and confident it might sound.

**One forecasting trick is to make many of them so that previous errors might be forgotten.**

**The Bank of Canada makes an inflation forecast every 90 days.**

**Focusing on the Bank of Canada's latest forecast might help shift attention from previous forecasts.**

**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 2/2/2023. The left axis represents the growth in Canada's Consumer Price Index, or CPI, measured from 12 months prior.

If we look back to the summer of 2020, Tiff Macklem, the Governor of the Bank of Canada assured Canadians that "interest rates will be low for a long time."<sup>1</sup> After all, the Bank's inflation outlook was benign (in fact, they were forecasting an increase from a very low level, believing that inflation around 2% was somehow good for the economy). At a post rate-decision press conference, the Governor turned out to be wrong on almost all the

**In 2020, the Bank of Canada was relying on its forecast of low inflation to justify its claim that interest rates would be low for a long time.**

<sup>1</sup> July 15, 2020. "Macklem: BoC Being Unusually Clear Rates to Be Low for Long Time." *Bloomberg News*.

major points that were made, primarily because he appeared to be relying on inflation to stabilize at 2%. He was worried about *not enough* inflation. Within a year, it was evident that he got more than he bargained for.

This hasn't dissuaded the Bank of Canada from issuing inflation forecasts. Somewhat unsurprisingly, they are expecting inflation to fall from its current level of 6.3% back down towards 2%<sup>2</sup> (which also serves as the official target for the Bank).

Inflation growth is falling due to the year-over-year comparison to the very high levels last year. But what if that decline begins to lose momentum before it gets anywhere near 2%? How confident will the Bank be to start lowering interest rates when inflation is still notably above target? Right now, a consensus thinks they will start cutting rates potentially by this July.

I would suspect that the Bank's inflation forecast would have to miss significantly on the high side for there to be any real possibility of an interest rate cut. However, investors appear to be convinced enough that during January we saw a notable advance in the prices of risky assets that would normally do well during a period of rate cuts.

On the flipside, what if the Bank's inflation forecast continues to be plagued by the same errors over the last few years and fails to anticipate inflationary pressure that might emanate from wage gains, high government & consumer spending, and continued supply chain imbalances? Under this scenario, I would think that, after a pause in rate hikes, the Bank might actually *increase* rates a little further. Virtually no aspect of this has been discounted into the price of stocks (especially after the run up in stock prices during January). The scenario could set the stage for a repeat of last year's volatility.

In summary, the markets appear to think that the Bank of Canada's current inflation forecast is too high. I think there is a risk that it is too low. If the Bank of Canada is right for a change, or if I am right, it could be very difficult for stocks to hold on to their January gains.

Will I be right? Will the markets be right? Will the Bank of Canada be right? We just don't know precisely, because forecasting is hard.

**The Bank of Canada's hope of low interest rates for a long time dissolved a year later. Now we are seeing the highest interest rates in 15 years.**

**Investment performance over the next year will likely be impacted by whose forecast is right.**

**The markets see lower inflation relatively soon which could lift investments. The Bank of Canada sees inflation easing only slowly which could test investors. I see inflation being somewhat stubborn which could also test investors.**

**Inflation forecasting is hard, so it's difficult to guess who will be right.**

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<sup>2</sup> Bank of Canada, Monetary Policy Report, January 2023.

# Model Portfolio Update<sup>3</sup>

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 in the model portfolios remained unchanged in January, but there were a few additions to the U.S. equities that we hold.

GE spun off its healthcare division into a new stock called GE HealthCare Technologies Inc. Following a rebalance of the portfolios, both GE and GE HealthCare were brought up to an equal weight relative to the other U.S. stocks in the portfolio.

The primary reason for adding GE HealthCare as a full new position is its market leadership in diagnostic technologies. They are number one in ultrasounds, and number two in many of the other technologies (primarily behind Siemens). The aging of the Baby-boom demographic plus the pent-up demand for post-pandemic treatments which were delayed are forcing many hospitals to make capital investments in order to increase capacity.

<sup>3</sup> The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 2/2/2023. 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.

**A couple of new U.S. stocks were added to the model portfolios.**

**GE HealthCare Technologies which is a market leader in diagnostic equipment.**

**Freeport-McMoran, a resource company that has a focus on the metals used in EVs and the energy transition in general.**

We also added a new position in the form of Freeport McMoran Inc., a resource company with significant production of the metals needed for the renewable energy transition and advances in batteries: copper, cobalt, and molybdenum. Increased demand over the last couple of years has helped to maintain profitability and free cash flow. The hope is that there is inertia in the growth of demand as governments subsidize a number of renewable energy initiatives.

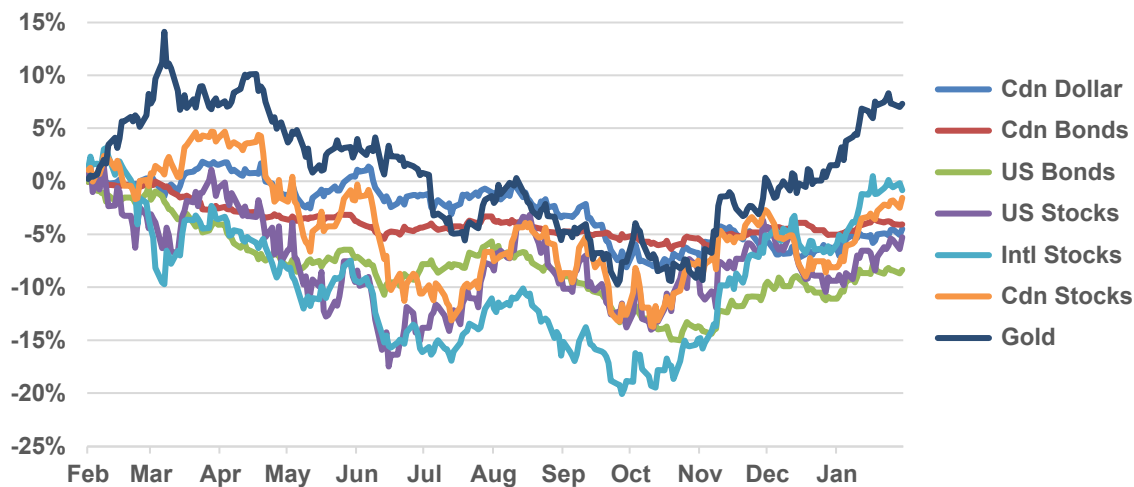
Looking forward, the direction of things will be heavily impacted by what I discussed in the first section of this newsletter. If there are signs that inflation won't substantially subside by mid-year, the January gains in stocks (in the U.S., Canada, and internationally) as well as bonds could be in jeopardy (unusually, all the asset classes used in the construction of the model portfolios were *all* up during the month). It has been the riskier areas of the market that have done the best, potentially signaling that investors are hoping for a return to the pre-pandemic world of low inflation and low interest rates. Anything can happen, but looking into the rearview mirror for investment inspiration is often a poor strategy.

**All the asset classes were positive in January. The market may be assuming that inflation will quickly fade away.**

**If it does not, those gains could be at risk.**

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).<sup>4</sup>

**Chart 2:  
12-Month Performance of the Asset Classes (in Canadian dollars)**



Source: Bloomberg Finance L.P. for the interval from 2/1/2022 to 1/31/2023

<sup>4</sup> 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<sup>5</sup>

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

<sup>5</sup> 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](mailto:mark.jasayko@td.com) or call me directly on my mobile at 778-995-8872.

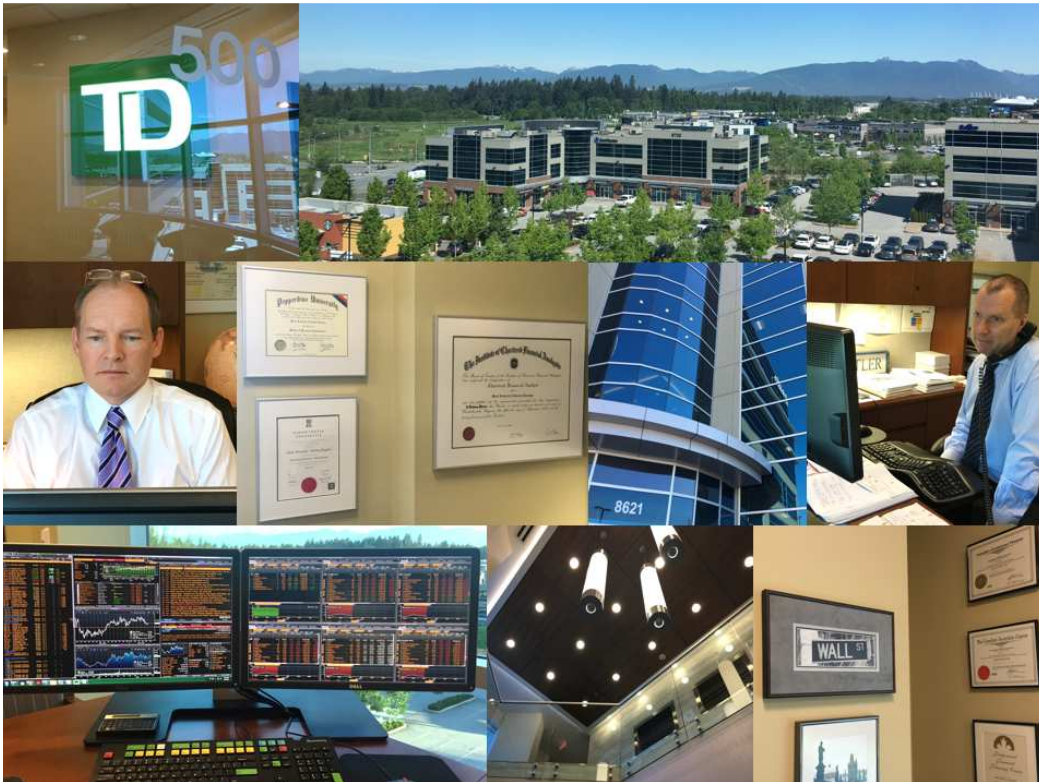
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The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios 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.





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The information contained herein is current as of February 2, 2023.

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