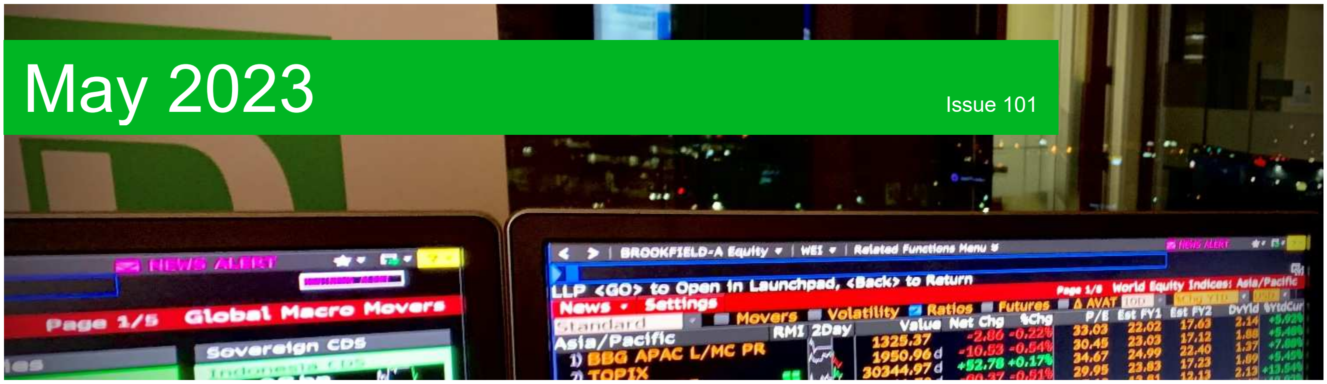
The Charter Group Monthly Letter



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Economic & Market Update

Feeding the Dragon

By 1986, the annual growth rate of U.S. inflation had finally dipped below 2% for the first time in 20 years. The unpopular tough-medicine policies of the U.S. Federal Reserve were taking effect. The stubbornness of Federal Reserve chairman Paul Volcker had finally paid off and his "slaying of the inflation dragon" became a common refrain.[1]

Although monetary authorities have reluctantly hiked interest rates to combat the inflationary "dragon", it continues to get fed by high levels of government spending.

The inflation dragon was fed by a combination of high levels of government spending and a gun-shy application of monetary policy starting in the mid-1960s. By the end of the 1960s, the inflation dragon was on a rampage.

Fast forward to today and we have a similar combination of high and increasing government spending and a collection of international central bankers who, while making up for the mistake of forecasting "transitory" inflation, are hardly advocating for a Paul

[1] The dragon, in the legend of Saint George, is an insatiable beast who goes around extorting from villagers much like inflation would steal the purchasing power of workers' wages. In the end, Saint George, riding horseback, slays the dragon with his sword.

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Volcker-style prescription of a full out monetary policy attack on inflation with minimal regard to the costs to growth and employment. Also, central bankers have avoided from applying any visible pressure on profligate governments.

Central bankers are not pushing back on rising government spending that could undo the inflation-dampening impact of higher interest rates.

The spectrum of debate on government spending ranges from maintaining the current high level to accelerating upwards to new levels. The public is not voting for austerity, which would make campaigning on austerity to be a lousy political strategy. Even most opposition politicians, who might have historically challenged governments on spending, are staying away from the subject.

There is no real argument against this. This is how democracy works. If very few voters want it, it won't be offered. Instead, it might be better to shift the debate toward the inflationary consequences of increasing levels of spending, not on the virtues of the spending itself. However, a theoretical discussion of the consequences lacks the impact of addressing the pain of actual consequences, so we might have to wait a while.

But, voters are not voting for austerity in general.

Recent legislation has turbocharged spending at the federal level in Canada and the U.S. Much of it is masked in budgets that refer to "austerity" and "inflation reduction". This may make things a little more palatable. However, one of the outcomes has been a renewable energy subsidy war initiated by the U.S., leading to a recent eye-popping subsidy offered by Canada to lure battery manufacturing to the country.

Budgets tend to playdown the potential for spending acceleration.

Apart from all this *subsidypalooza* masquerading as industrial policy, there are other worrisome catalysts for accelerated spending. Labour has gained more power relative to capital over the last number of years resulting in more government workers considering strike action. It might be reasonable to argue that workers deserve to make up for the decline in purchasing power caused by inflation. However, this still leaves us with more government spending. Additionally, the recent agreement reached with Canada's civil servants could set a benchmark for other negotiations that has the potential to resurrect the wage-price spiral of the 1970s which impacted both public and private sectors.

Subsidies and rising wage demands could be very difficult to cap before the pain of any inflationary consequences hit.

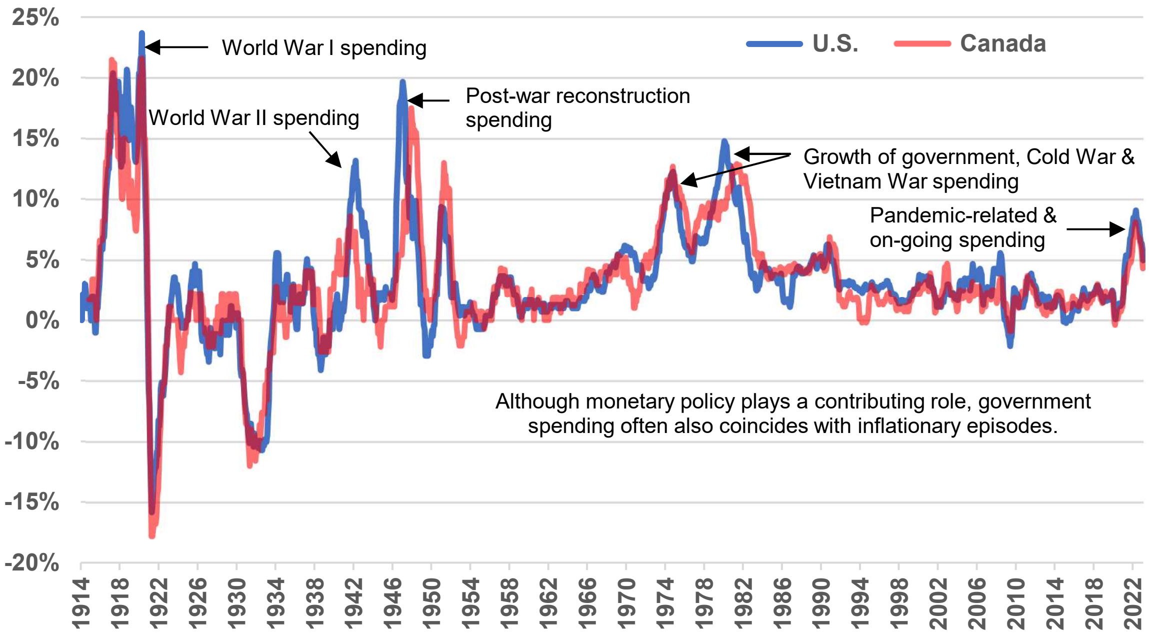
Finally, the budgetary behemoth that is military spending needs to be stacked onto all the other spending increases. Although there has been plenty of rhetoric and promises to meet the geopolitical challenges from Russia and China, virtually none of this has been budgeted yet. The "peace dividend" that emerged following the end of the Cold War may now transform into a "war tax" in order to discourage or prevent the rising odds of war.

Governments have started to express the need for defense spending, but have generally not budgeted for it.

It is this last contributor to spending that has coincided with some of the most impressive bursts in inflation over the last century (**Chart 1**). The money that governments spend on defense crowds-out consumer and business spending. Basic resources tend to be fixed over the short to medium term. So, when the government increases its consumption of them, the resulting lessened supply can contribute to price pressures as consumers and business bid for what is left.

Inflationary episodes have often been a combination of monetary policy mistakes at a time of rising government expenditures.

Chart 1:
Inflation - Annual Growth Rate



Source: Bloomberg Finance L.P. as of May 1, 2023

There is much hope that somehow inflation recedes back to its forecasted target of 2% without any heavy lifting done by governments in the form of austerity. Central bank policy in the 1970s was also characterized by much wishing and hoping, and by a reluctance to challenge governments on spending.[2] The metrics of the current economic landscape are different than the 1970s, but much of what we see today is beginning to rhyme with that era. Perhaps it's time to starve the current-day adolescent inflation dragon before it becomes a big problem for consumers and businesses.

Delayed or limited inflationary-fighting monetary policies combined with accelerating government spending appear to be a feature of the current economic landscape.

[2] By the 1970s, much of the academic literature suggests that central banks should have known better because, with the historical data at the time, they could look back to see the impact of government spending. In earlier inflationary episodes, central banks were still in their infancy and mostly guessing what to do (the U.S. Federal Reserve was founded in 1913). Thus, they could be somewhat forgiven.

Model Portfolio Update[3]

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

No changes to the model portfolios in April.

Markets were generally unchanged during the month, holding onto year-to-date gains.

The asset allocations and the specific securities holdings in the model portfolios remained unchanged in April.

Despite the banking concerns which emerged in March, markets held within a relatively tight band in April. International stocks saw some lift as the U.S. dollar declined against many of the other major currencies (except for the Canadian dollar). Canadian stocks were also marginally higher on the strength of the energy sector.

At the end of April, growth stocks across the globe in developed economies were notably higher year-to-date. In North America, the rally has been driven by relatively few stocks, mostly a resurgence of the large capitalization technology companies. As a result, there may be some inherent vulnerability if earnings or revenues don't materialize as expected.

[3] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of May 10, 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.

Much of this bounce-back from a dismal 2022 involves the notion that inflation will evaporate to pre-Covid levels and that interest rates will follow suit. As implied by the trading of interest rate futures contracts at the end of last June, a consensus of investors had expected rate cuts as early as the U.S. Federal Reserve meeting on May 3rd.[4] That didn't happen. Now that consensus is wagering that cuts will start in September.[5] Economic realities may keep pushing that date further into the future, which would not be normally beneficial to interest rate-sensitive investments such as this year's high flying growth stocks.

The other issue on the horizon that is starting to get more media coverage is the debate over the U.S. debt ceiling. Most scenarios have this being resolved, but the small chance that it won't be is creating some anxiety and could contribute to volatility at a time of year when the markets often rollover. If the debt ceiling issue does get resolved, we might get a significant bounce. That might be a subject for next month's newsletter.

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**).[6]

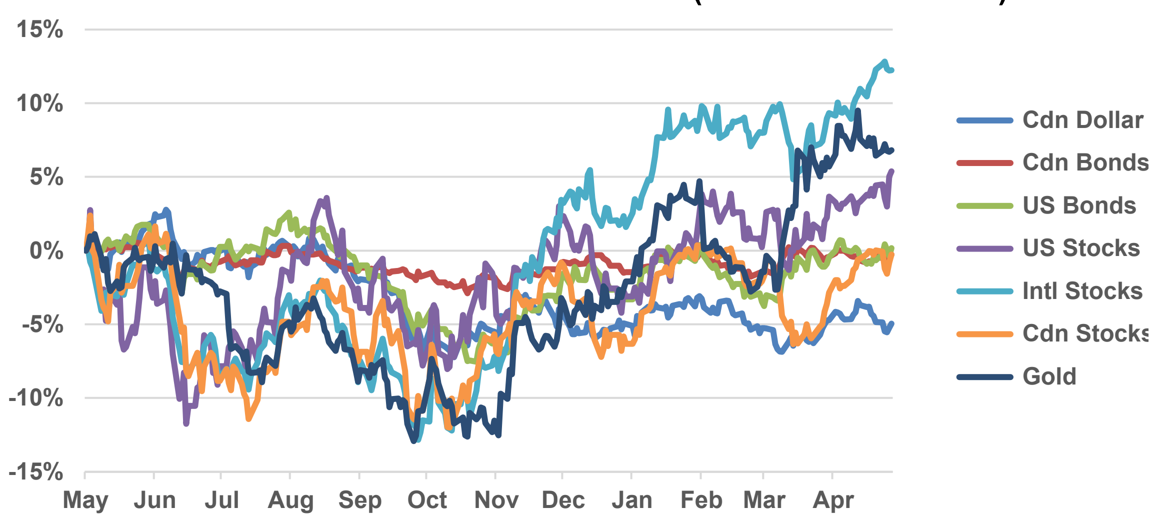
Much of those gains may be predicated on the notion that inflation will melt away and interest rates will retreat to pre-pandemic levels.

If that doesn't happen, there could be a re-pricing of stocks, especially growth stocks.

The market is also keeping an eye on the U.S. debt ceiling debate, but not overly panicked at this point.

Chart 2:

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



Source: Bloomberg Finance L.P. for the interval from April 30, 2022 to April 30, 2023

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[4] Source: Bloomberg Finance L.P. as of May 10, 2023.
[5] Ibid.
[6] 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[7]

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

[7] 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 May 10, 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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