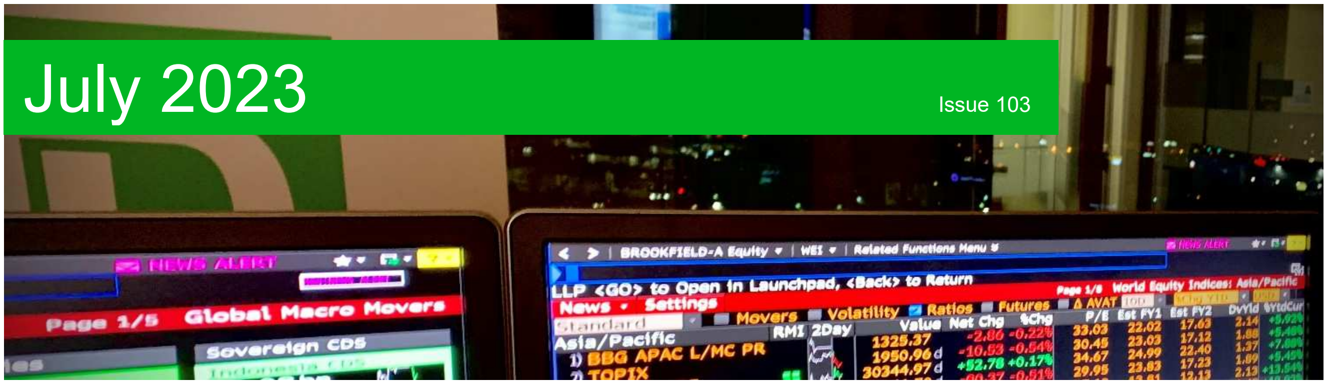
The Charter Group Monthly Letter



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Economic & Market Update

Blame Generation X

A few years before I entered grade 1, the elementary school I attended in West Vancouver had a peak enrollment of well over 200 students. By the time I graduated from there in 1979, enrollment had dwindled to less than 100. In most years, I was in a split-grade class because there weren't enough of us to fill a classroom. Before the term "Generation X" was ever coined, we knew something was happening. It was obvious that there were less of us compared to the generation before.

There are fewer of Generation X relative to preceding and following generations.

Less of them, with less capital at a time when there is a growing need for capital.

It's a recipe for higher prices for capital (otherwise known as interest rates).

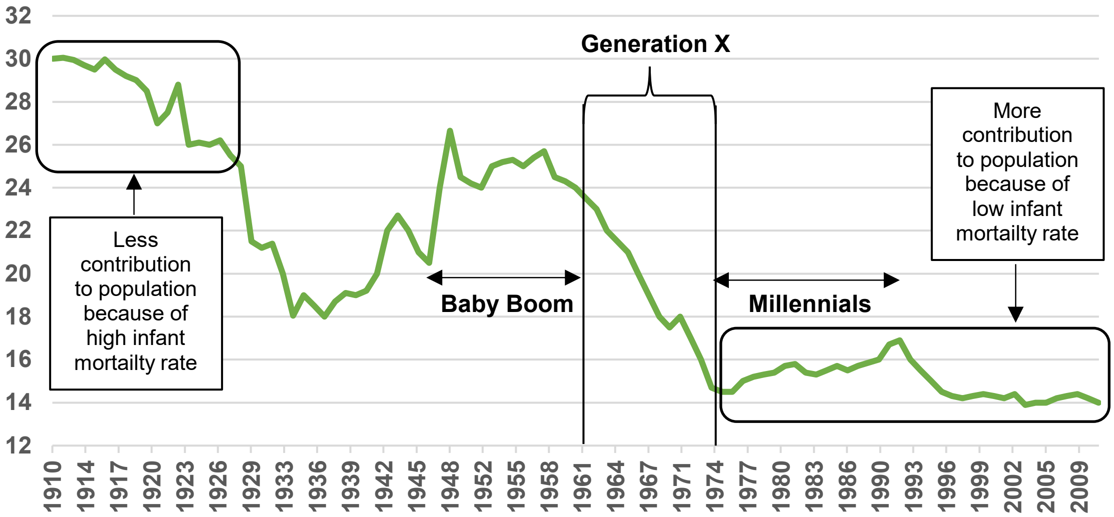
My definition of Generation X includes the cohort that was born between 1961 and 1974 in the U.S., Canada, Great Britain, Australia and New Zealand. They came of age in the 1980s and influenced the youth and college culture of that decade.[1] The rapid decline in

[1] Many will argue that Generation X started later and finished later. The decline in enrollments occurred well before I entered school, indicating that I, born in 1966, was not at the forefront. To be more specific, Generation X is really the rapidly declining slope on the backend of the Baby Boom Generation which reached its nadir by 1974. The socio-economic experiences and the relative size of the cohorts were notably different for those with birth years preceding 1961 and following 1974. Perhaps, because of the catchiness of the term, Generation X was applied to a wider swath of birth years stretching into the 1980s. However, by then, birthrates had stabilized,

the birthrate set the stage for substantially different cultural and economic experiences relative to the bulk of the Baby Boom Generation that preceded it.

Chart 1:

United States Birth Rate (Births Per 1,000 Population)



Source: U.S. Census Bureau

Demographics have a profound impact on economics, and the differences between one demographic cohort and another have the potential to establish generational turning points.

An economic feature that greeted Generation X'ers entering the workforce following graduation was a surplus of labour. The preceding population bulge had filled most available starting positions, especially following double recessions in 1980 and 1981. And, when there is a surplus of something, the price falls. In this case, it was the price of labour, or wages, that had declined, likely helping to extinguish the last of the high-inflation era of 1965-1982. It was a great time to be hiring, with all sorts of qualified candidates willing to work for less! Despite the relatively small size of Generation X, there were still enough of them which contributed to a problem of growing youth unemployment (providing much material for the movies and popular culture that defined the 1980s and early 1990s).

While Generation X is in now in a wealth accumulation phase, the Baby Boomers are in wealth reduction phase, and the Millennials are in a debt accumulation phase.

That said, it was a great time for the economy overall. The Silent Generation (born between 1928 and 1945) were well into the capital accumulation phase of life, a phase that the Baby Boomers were just starting to enter. As a result, in addition to a surplus of

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and with declining infant mortality, resulted in an expanding generation, thus fundamentally different from Generation X.

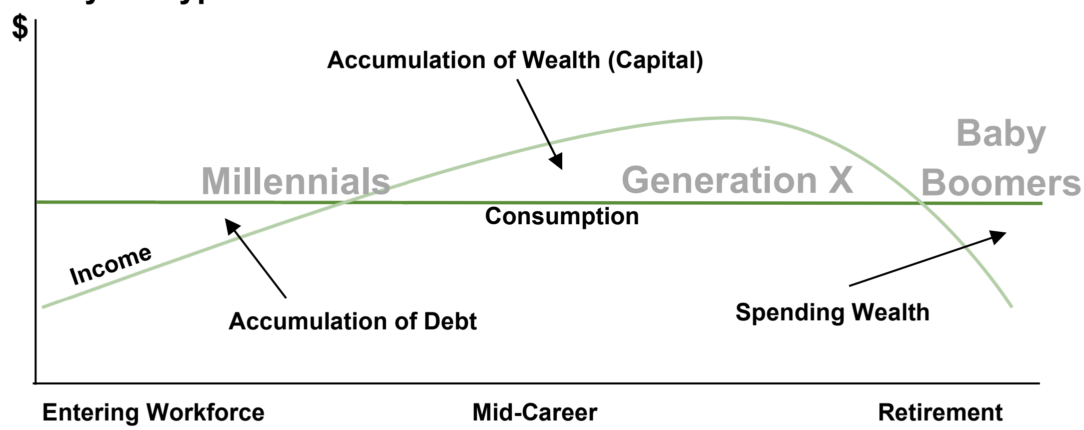
labour, there was an emerging surplus of investment capital. The price of capital is represented by interest rates, and those rates began their 30+ year secular decline. Cheap labour plus cheap capital provided the foundation for a rising tide, lifting the economy as well as investment markets.

Generation X had a delayed start to careers, impairing per capita wealth (and available investment capital) relative to the Baby Boomers.

Generation X eventually did find their way into the labour market as the Silent Generation retired and the Baby Boomers rose through the ranks, creating more space at the entry level. Better late than never. However, this delayed start detracted from the ability of Generation X to accumulate wealth at the same per capita pace as the previous two generations. This could have an economic and investment market impact as we continue through the 2020s and into the 2030s.

Most wealth accumulation tends to occur from mid-career to retirement (**Chart 2**). Prior to this phase, people are in a debt accumulation phase, spending money on housing and family formation, and borrowing to do so. Then at retirement, people normally experience a drop in income (peak work salary is usually much greater than retirement income), and

Chart 2:
Life Cycle Hypothesis



Source: The Charter Group. Based on a concept developed by MIT professor and Nobel laureate Franco Modigliani where consumption is assumed to be relatively steady through life in contrast to income that changes.

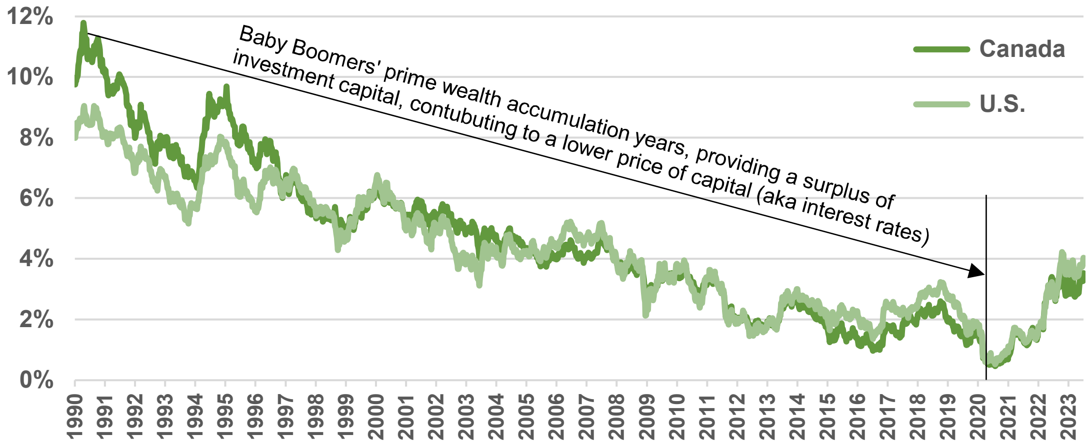
so consumption begins to erode capital in order to enjoy the fruits of a lifetime of work.

Most Millennials, those following Generation X, are well into the debt accumulation phase. And, almost all the Baby Boomers are into the wealth reduction phase. On a net basis, the Baby Boomers have provided all the capital that they are going to, and the Millennials have yet to really start their contribution of investment capital to the economy.

That leaves Generation X to do the heavy lifting of providing capital. However, as one might have gathered from the discussion above, there are not enough of us, and individually, we don't pack as much punch as the Baby Boomers. The surplus of capital is evolving into a deficiency. Less labour capital means higher wages, contributing to inflation. And, less investment capital probably means higher interest rates.

Chart 3:

10-Year Federal Government Bond Interest Rates



Source: Bloomberg Finance L.P. as of June 7, 2023

The capital drought could last into the next decade. It might depend on when most Millennials exit their debt accumulation phase and start saving. Given that Generation X spans about 13 years, that might be a reasonable expectation for how long it will take.

We might have to wait until the Millennials begin to accumulate significant wealth before the capital drought ends.

There are other sources of capital, but they may not come close to providing a solution. Labour capital can be enhanced through immigration, but that is plagued with costs and lags.

Investment capital can be supplied from countries that don't have a Generation X, like China or Japan. However, we are probably well beyond the halcyon days when those exporting nations would enthusiastically direct their current account surpluses into western country government bonds regardless of the level interest rates.

Other sources of capital may not be sufficient to effectively supplement Generation X's lack of capital.

Central banks could also reintroduce quantitative easing focused on purchasing government bonds, giving governments the capital to continue their historically high rates of spending. However, from many angles, this can start to look like an inflation timebomb which might limit the temptation.

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 and the specific securities holdings in the model portfolios remained unchanged in June.

No changes to the model portfolios during June.

Stocks in the U.S., Canada, and internationally marched higher during the month as the AI frenzy continued along with some excitement that inflation was continuing to abate (despite some concurrent evidence that inflation is remaining more stubborn than forecasted).

A decent month for equities as AI and other sources of optimism helped.

The primary risk to equities is that many of the large AI stocks may have become overextended as a result of their formidable rally from November of last year. The rest of the broad market has not participated much. A couple of possibilities might include a scenario with the rest of the market catching up to the AI stocks, or a scenario where the AI stocks give up their gains and the rest of the market holds steady. The first scenario would need a significant catalyst, such as an unexpected surge in earnings, or an

Markets are still top-heavy with large AI stocks accounting for most of 2023's gains. The narrow market continues to present some risk.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of July 1, 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.

unanticipated cut in interest rates. Neither catalyst seems likely, which would point to a greater probability assigned to the second scenario.

Also, as we enter the summer, some positive seasonal psychology often sets in. Unless there are unforeseen events that collide into the markets, things can drift slowly upward, leading to a traditional summer rally. By the time we get to Labour Day we should have more clarity on where inflation is heading and the responses from the U.S. Federal Reserve and the Bank of Canada. Europe's inflation is more heated which will likely result in continued rate hikes there, but right now they appear to be in a cycle that is lagging North America by about a year.

Might get a slow drift upwards with a traditional summer rally if there are no major economic surprises.

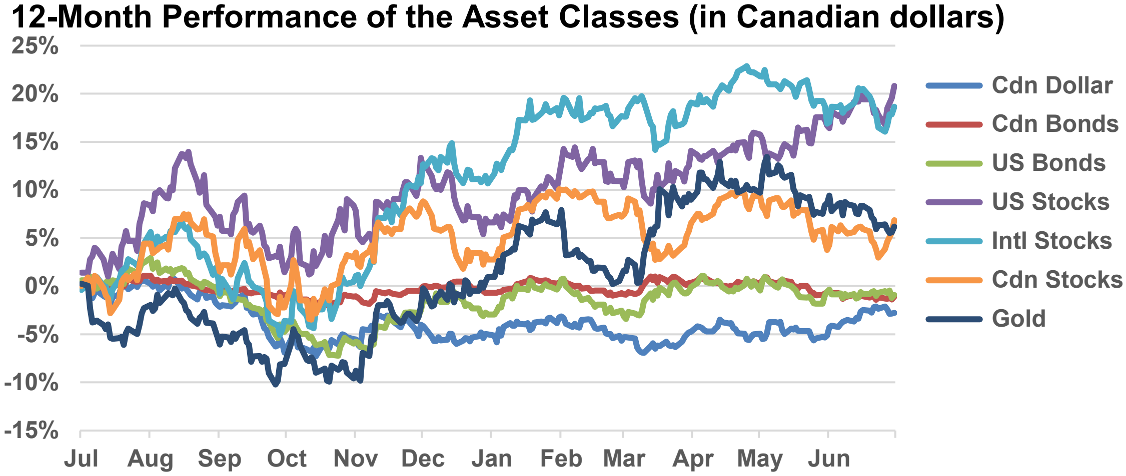
With respect to North American inflation, my expectation is that after we lose the base effect from last year's high levels, any further progress on reducing prices will be limited. Interest rate-sensitive stocks, and companies that can't pass on price increases may begin to hit the same headwinds that they encountered in 2022. Again, that may be something for this autumn as opposed to a summer event.

Eventually though, investors will likely have to grapple with the direction of inflation and corresponding central bank policy reaction.

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 4**).[3]

Chart 4:

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



Source: Bloomberg Finance L.P. for the interval from July 1, 2022 to June 30, 2023

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[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 Industrial 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. Long-term U.S. Interest Rates	Medium	Negative
9. Global Trade Wars	Medium	Negative
10. Canada's Economic Growth	Light	Positive

[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.

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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 July 7, 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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