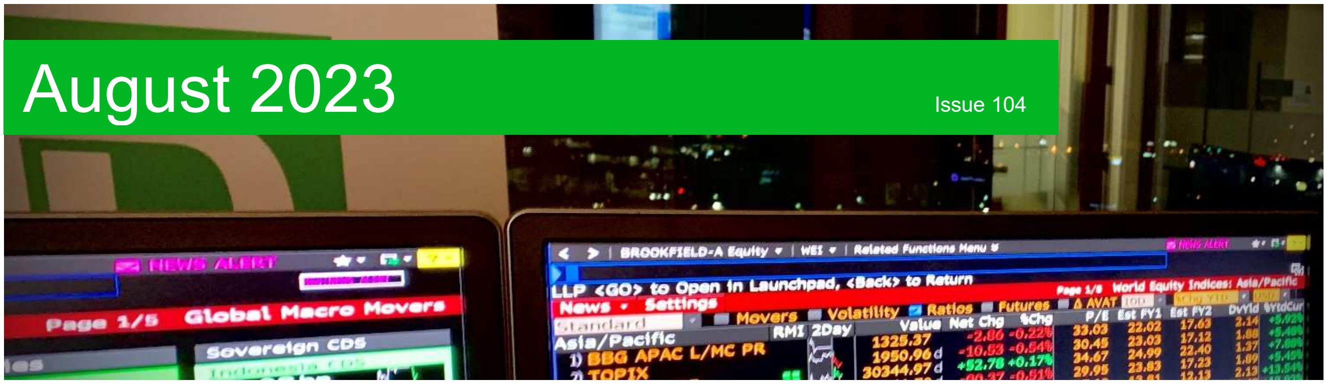
The Charter Group Monthly Letter



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Economic & Market Update

The Land of the Rising Rates

It appears as though the global bond market didn't get the memo about summer vacation.

Japanese benchmark government bond yields have jump to levels not seen since early 2014 (**Chart 1**) (In fact, that yield is actually higher than where it dipped to back in 2003!). The U.S. 10-year Treasury bond yield is retracing back up to the 15-year highs set last autumn (**Chart 2**). And, Fitch Ratings, a U.S.-based debt rating agency, downgraded the U.S. federal government's credit rating from AAA (Fitch's highest rating) to AA+ (down one notch).[1]

For what was supposed to be the "Year of Bonds" judging by many of the projections from investment strategists at the beginning of the year, the results so far indicate otherwise.

After bonds had an awful year in 2022, expectations were that things would bounce back.

Instead, the bond market has disappointed.

Japanese rates, downgrades, stubborn inflation, and U.S. federal government spending may be the culprits.

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[1] The three major U.S. credit-rating agencies (Standard & Poor's, Moody's, and Fitch) all use slightly different nomenclatures for their credit ratings below triple A. For instance, S&P uses AA instead of AA+ for one notch below AAA.

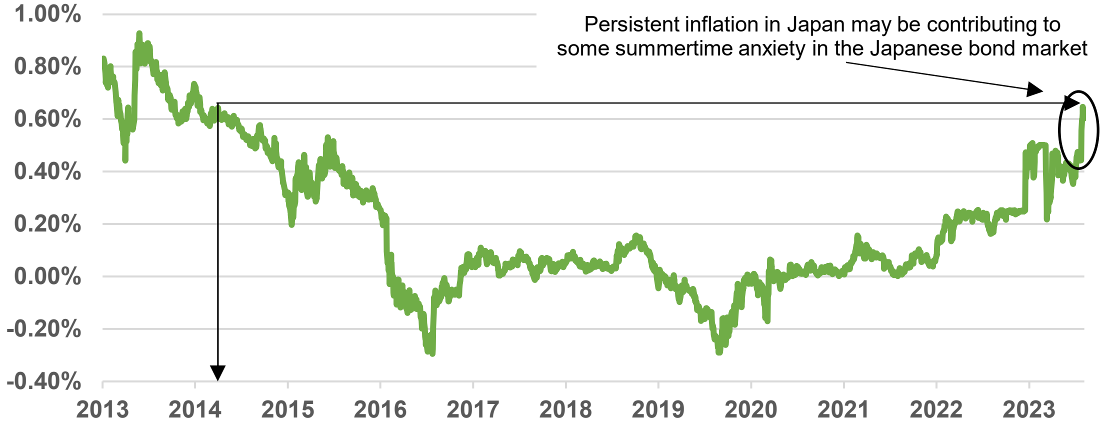
TD Wealth

2022 was the worst year for North American bonds since bond market indices were developed in the 1970s. Interest rates rose from an historically low base which resulted in a stunning absolute jump in rates. The 10-year U.S. Treasury bond yield ended 2022 more than double the level where it had started the year. The price impact on longer duration bonds had investors sitting on losses of more than 15%, which also included the coupon interest they received.

There was some expectation that interest rates would ease, producing a capital gain in bond portfolios while also capturing a relatively high yield.

Chart 1:

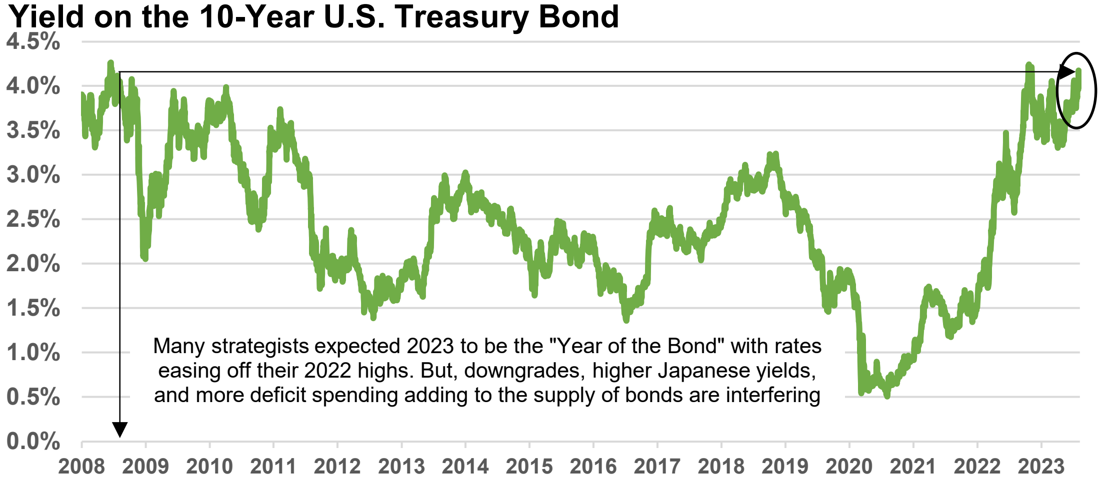
Yield on the 10-Year Japan Government Bond



Source: Bloomberg Finance L.P. as of August 4, 2023

Chart 2:

Yield on the 10-Year U.S. Treasury Bond



Source: Bloomberg Finance L.P. as of August 4, 2023

The consensus argument was that rates had risen high enough by the end of 2022 and that it was time to buy long duration bonds to benefit from the expectation that rates would fall back towards levels considered normal over the last decade. On top of potential capital gains, investors would be able to collect a yield that looked generous compared to yields offered over the last decade.

However, at publication, an ETF for longer-duration U.S. bonds (the iShares Core U.S. Aggregate Bond ETF) is *down* 0.35% Year-to-Date including interest received, and an ETF for longer-duration Canadian bonds (the iShares Core Canadian Universe Bond Index ETF) is *down* 1.17% Year-to-Date including interest received.[2]

Instead, many bond ETFs are in negative territory for the year.

So, what is going on?!?

From my perspective, markets have entered a new long-term, or "secular", trend and we are beginning to see more evidence of this. As with other transitions into new investment market eras, things don't move in a straight line. Often it looks like things will go back to how they were in the preceding era only to reverse. At a number of points during the first half of the year, it looked like the market thought we were heading back to a year like 2015 when U.S. 10-year yields were less than 2% and both inflation and overnight bank rates were negligible. However, reports of stubborn core & wage-related inflation, increased deficit spending, the Fitch downgrade, and a jump in Japanese rates laid waste to this hope for now.

My view is that we are in a longer-term (secular) bear market in bonds and that the challenges in the bond market reflect this.

There is a reluctance for many investors to accept this. This contributes to the "surprise" when the bond market does not traverse back to where it was for most of the last decade.

Anecdotally, we have seen more labour action (strikes and heated negotiations) than I can remember over most of the last four decades. Workers see other workers rewarded which could lead to more demands, adding some inertia to the rise in wages.

Although price inflation for many things has declined over the last year, there are areas of stubbornness – especially with wages and services.

With respect to the downgrade, some analysts have pointed out that the bond market reaction was relatively muted and that the downgrade was not warranted. I would agree with some of those conclusions. Fitch focused on the uncertainly that the U.S. debt ceiling saga created. However, I would also conclude that the debt rating agencies are beginning to telegraph their concerns about where massive fiscal spending and accommodative monetary policy are taking us and the impact that will have on the price of bonds as well as on the purchasing power of future payments to bondholders. Maybe it's better to take some action now rather than getting blamed for not anticipating a potential bond market trainwreck down the road.

Plus, news of the U.S. federal debt being downgraded may impact the mood at the margin.

It should be noted that S&P downgraded the U.S. federal debt back in 2011. So that leaves Moody's as the last of the three major credit rating agencies not to have downgraded yet. Will this add pressure to follow the crowd? And, what message will it

[2] Source: Bloomberg Finance L.P. as of August 4, 2023

send if all three agencies downgrade?

Finally, regarding the issue of Japan. For years, the Japanese yields have represented the rock-bottom foundation of global yields. Institutions were able to make money by borrowing for next-to-nothing in Japan and then investing that capital in U.S. Treasury bonds to earn a profit. As Japanese yields rise, this trade becomes less profitable and, at the margin, there would be less demand for U.S. Treasuries as a result. Less demand for U.S. Treasuries tends to push their prices down and their yields up. Higher rates in Japan have the potential of inducing higher rates everywhere else. After years of not worrying about this, suddenly investors are getting a little concerned.

The yield on Japan Government Bonds has jumped, potentially increasing their demand and potentially reducing the demand for U.S. Treasury Bonds.

This might have the effect of lifting the yields (rates) on those U.S. Treasuries, adding to the stress we have seen recently in the bond markets.

It will depend on the monetary policy pursued by the Bank of Japan (BoJ). Unfortunately, my experience with the communication from the BoJ is that it is often opaque or contradictory to earlier proclamations.

Japan has experience some of its highest inflation in 40 years. Plus, the last reading showed annual inflation in Japan to be higher than in the U.S. earlier this year. The BoJ suggested that they were going to alleviate some of the interest rate suppression in which they were engaging, and that the higher rates might lower consumer demand thereby driving inflation lower. Then the debate started to focus on the nature of the inflation, much of which was considered imported as a result of higher commodity prices. Higher rates may not help limit prices if this was the case. Suddenly, it then seemed that interest rate suppression was back on. Then, over the last couple of weeks, there was some language from the BoJ which sounded like they would let rates rise to a limit before moving back in with bond purchases that would help to hold rates at that limit. Whew!

While it's hard to understand the details of the BoJ's monetary policy, the bottom line is that the yield on the 10-year Japanese government bond has suddenly spiked to levels not seen since January 2014.

The summer action in the bond markets challenges the notion that we are not going back to the friendly conditions of the past any time soon. Those conditions were good for bondholders, and great for the owners of growth stocks, especially in the tech sector. For those who were hoping for a return of those halcyon days, they will have to come up with a plausible scenario that counters what we have seen in the bond market recently.

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

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

No portfolio changes during July.

The main stock market indices in the U.S., Canada, and internationally were generally higher during the month. This might be driven by a hope that somehow central bankers are able to engineer a soft economic landing during their attempt to stamp out inflation with higher short-term policy rates. The enthusiasm for stocks is understandable if investors think that a recession will be avoided and that we will soon be back to cheap loans and stable prices. However, with what is happening in the bond market this summer (see the above section), there is an element of "whistling past the graveyard" while clinging to this hope. It might be hard to sustain this stock market rally unless there is more news that confirms the wishful thinking.

The stock market appeared to believe that excess inflation might be extinguished without much adverse impact on the economy.

But, there is a large "hope" factor involved.

[3] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of August 4, 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.

Looking forward, two possible hurdles might need to be navigated. One is the "base effect" impacting the annual inflation rate calculation. We will begin to lose the high inflation levels of last year when computing annual inflation which could have the effect of pushing the number higher. It remains to be seen what the psychological impact on the market might be after being assured by politicians and policymakers that inflation might have been quashed.

Markets might need to absorb the news of annual inflation rising as we no longer have the peak levels involved in the calculation.

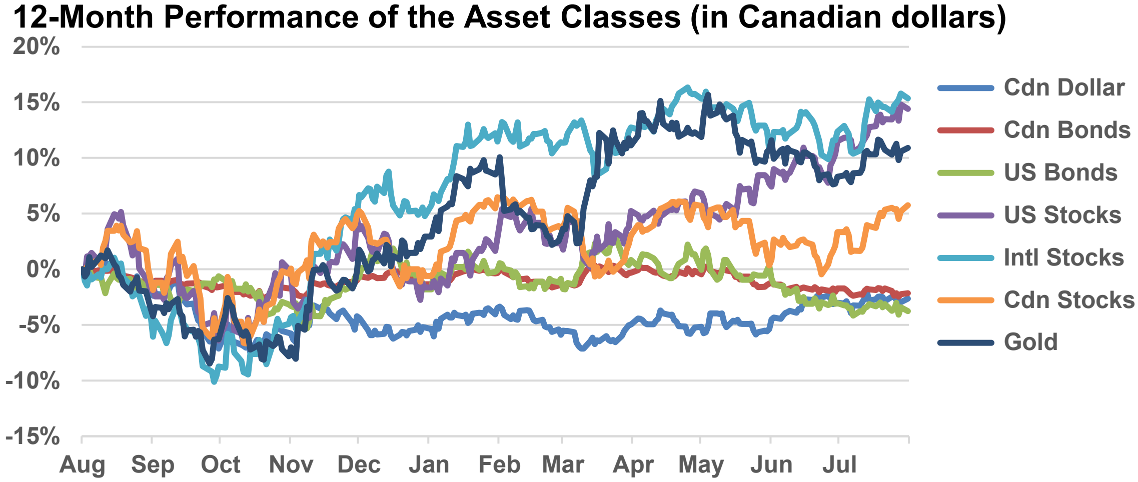
The second hurdle is the U.S. Treasury Department's eye-popping funding needs. The debt-ceiling restricted the Treasury from issuing bonds earlier this year. That, combined with the spending tsunami connected with aggressive industrial policy subsidies, will force the Treasury to unleash a torrent of bonds onto the market. We can expect a couple hundred billion over the next month, and upwards of a trillion dollars' worth through to the autumn months. The U.S. Federal Reserve is no longer a buyer after soaking up much of the previous supply in to support the U.S. economy since the Great Recession and Subprime Mortgage Crisis, and especially during the Pandemic. Plus, there may not be as much demand from Japan because of higher domestic rates there. Weak demand and rising supply is the recipe for falling bond prices and rising yields. And, rising yields clash with the wishful thinking.

The supply of bonds will expand rapidly as the U.S. federal government needs to finance huge spending ambitions. Higher yields may be needed to generate enough demand for those bonds.

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 August 1, 2022 to July 31, 2023

[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 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

[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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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 August 4, 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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