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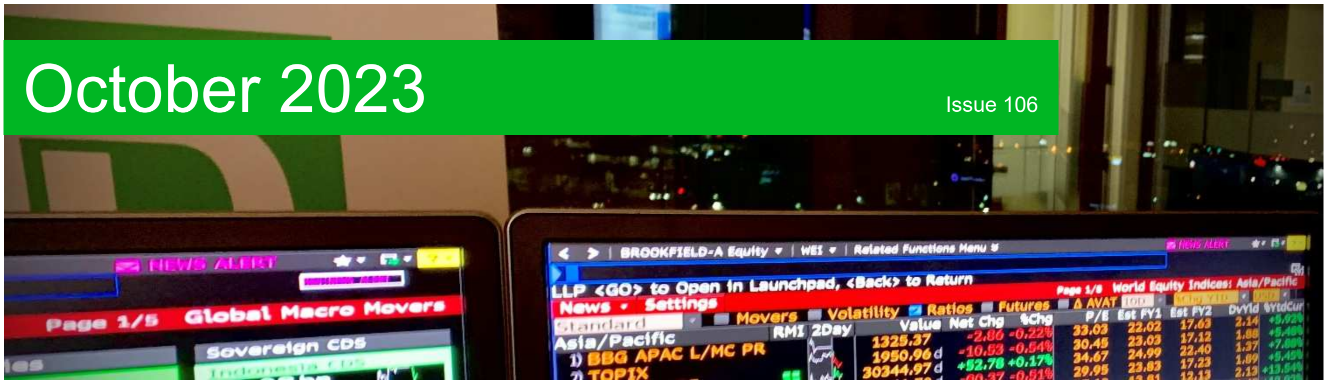

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Economic & Market Update

Volatility & Vigilantes

Those pesky Bond Vigilantes.[1] They are back. And they are not in a good mood.

When there are no viable plans for reducing government budget deficits, bond investors can start to "vote with their feet" by selling.

These realists have been historically referred to as Bond Vigilantes.

As I wrote in this space last November, the Bond Vigilantes caused a bushel of problems in September 2022 for the U.K. in particular, and for the global stock and bond markets generally. After hibernating for decades, they were roused from their slumber by the short-lived U.K. government of Liz Truss and a plan to cut spending which would widen the U.K. budget deficit. Bond investors see growing deficits as a threat to the value of their bond holdings, so they sell *en masse*, driving bond prices down and current bond yields up.

In the last couple of months, the Bond Vigilantes have been doing their math and have started to conclude that growing U.S. deficits, along with no plan to control them, is our destiny. This is usually inflationary which will erode the purchasing power of the payments

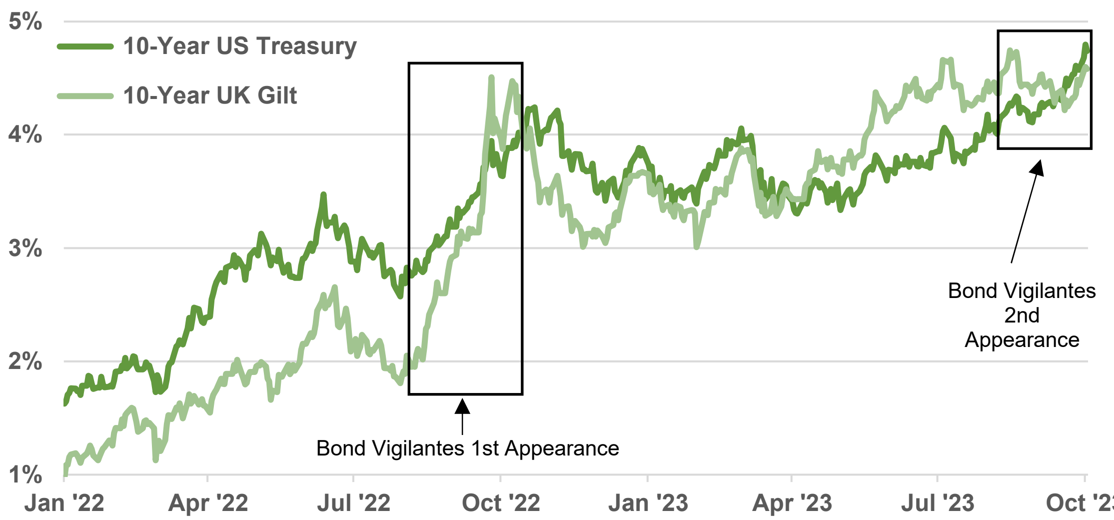
[1] This term was coined by economist Ed Yardeni when he was at Prudential-Bache Securities in 1983 and really came into vogue in the later 1990s when the Clinton administration was trying to push for a budget that would have increased the deficit. The Clinton administration backed off and the Vigilantes won. This likely contributed to the U.S. budget surpluses from 1988 to 2001. Those were the last surpluses.

that they get from the bonds in the form of coupons as well as the principal repayment at maturity. In response, they are selling bonds which is driving up the yields on the benchmark U.S. Treasury bonds, which, in turn, drives up the general level of interest rates that all borrowers must pay. In the last month, those yields have risen to levels that would have certainly surprised most investment strategists at the beginning of the year who appeared relatively confident that yields would decline over 2023. So much so that there was a consensus that the "smart" money should have bought longer-term bonds in January in an attempt to generate some capital gains as rates fell. Thanks in large part to the Vigilantes, an investment in the iShares Core U.S. Aggregate Bond ETF on January 1, 2023 would have produced a *capital loss* of -4.18% and a total return of -1.91% despite reinvesting the coupons into ever more generous yielding bonds over the period.[2]

Bond Vigilantes see growing budget deficits as a threat to the value of their bond holdings.

Chart 1:

Government Bond Yields



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

Much of the "surprise" likely results from the muscle memory developed over the last couple of decades where free money and almost no inflation seemed normal. The Vigilantes are doing their best to welcome us to the "new normal."

In addition to causing turmoil in the longer maturity part of the bond market, rising interest rates can also contribute to stock market volatility (**Chart 2**). We saw that in September 2022 when the Bond Vigilantes appeared resulted in selloffs in the S&P/TSX, the Dow Jones Industrial Average, and the NASDAQ Index of -5.59%, -8.84%, and -10.50 respectively. That was actually worse than what we saw last month (**Chart 3**).

Bond Vigilantes were in hibernation during the low inflation and low interest rate era of the last two decades.

They may now be a sign that a new era and a new normal have arrived.

[2] Bloomberg Finance L.P. as of October 4, 2023.

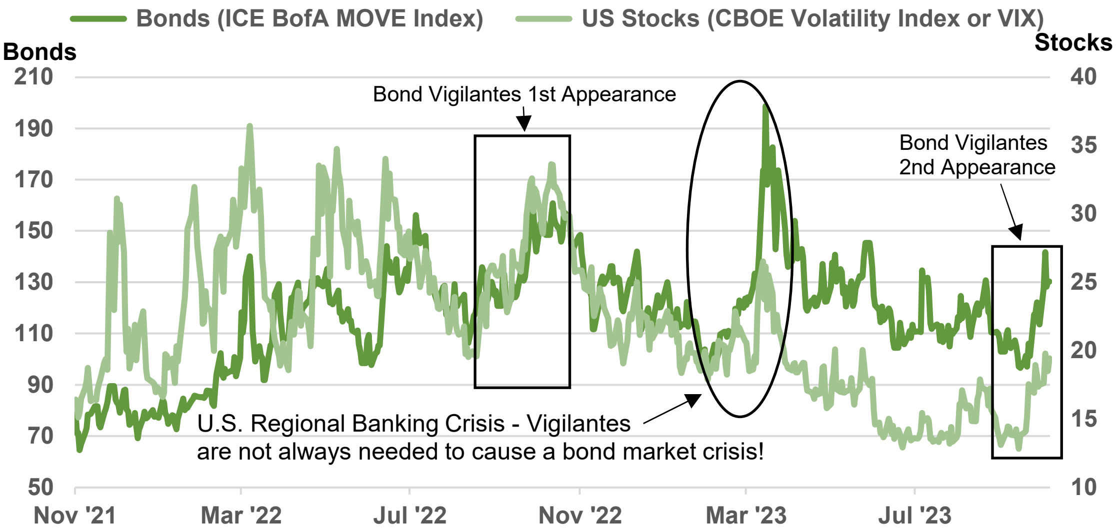
I continue to believe that we are in a new, very long-term era for bonds characterized by a higher level of interest rates. As I wrote last month, I think the earliest indication of this change was in July 2012 (with the benefit of hindsight), and then really began in earnest post pandemic, aided by the startling acceleration in government spending.

The Bond Vigilantes made an appearance in September 2022 and then again over the last month.

Higher stock market and bond market volatility tends to coincide with their appearances.

Chart 2:

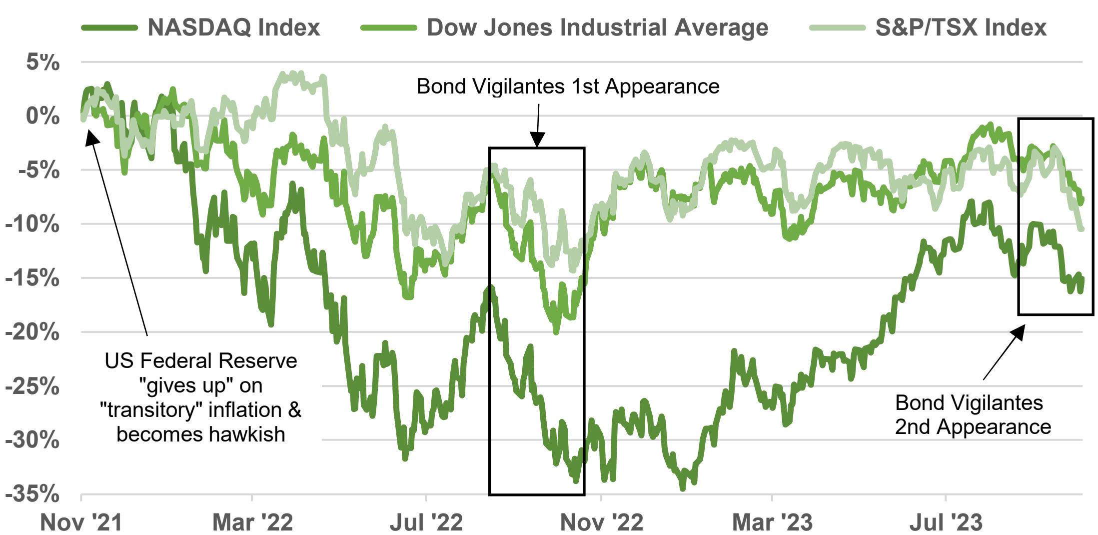
Measures of Volatility since November 1, 2021



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

Chart 3:

Stock Market Performance since November 1, 2021



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

That said, history tells us that interest rates don't go up like an escalator. It more often resembles "two steps up, one step back." After the kind of spike that we saw over the last couple of months, it is common to have some relief. It would not be shocking to see equity investors respond enthusiastically to such a development.

In addition to this possibility, markets are entering into a season that is traditionally favourable to stocks (**Chart 4**).

In line with the idea that we are in a long-term phase of rising rates, any bounce in stocks would constitute a temporary reprieve. The Bond Vigilantes are correct: there is no plan to generate budget surpluses in the future, in the U.S. or elsewhere. The pressures that we saw over the last few months might recede but will be bubbling beneath the surface.

In addition to runaway deficits and debts, "supply side" factors (labour, inventory management, supply chains, materials, energy) are still potentially menacing with respect to inflation which adds to upward pressure on interest rates.

Chart 4:

Dow Jones Industrial Average - Seasonal Average 1990-2022

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

This doesn't mean the end of profits for investors. But it continues to indicate that we are headed to a "new normal" and many investors will struggle to let go of the "old normal." Given how incredibly long the previous era was, the beliefs of the more stubborn market participants may be more baked in than usual, prolonging the struggle. At the end of this decade, history may look much more favourably upon the early adaptors who were willing to tune out the consensus calling for a return to the good ole days and to stick with investments that are more resilient to higher rates and inflation.

Like their previous appearance in September 2022, this recent appearance of the Bond Vigilantes could be relatively short-lived.

However, if we are in a new era for bonds, they could make appearances next year and beyond.

In the meantime, markets might find a few reasons to rally into the end of the year in addition to the notion that the last few months, as a whole, tend to be positive for stocks.

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 September.

No changes were made to the model portfolios in September.

All the asset classes used in the model portfolios were down for the month. As mentioned in the above section, rising interest rates were the culprit as the Bond Vigilantes began to hammer bonds in response to their frustration over perpetual budget deficits. Stocks suffer because they need to compete with the higher current yields in the bond markets and because many companies that relied on low borrowing costs now need to adjust.

Rising interest rates had a negative impact on all the asset classes used in the model portfolios.

The rise in U.S. interest rates also punished currencies around the world, including the Canadian dollar, as this increases the demand for U.S. Treasury bonds which can only be bought with U.S. dollars. The Canadian dollar is also likely having difficulty because of the limited scope that the Bank of Canada has to increase rates as this could have an adverse effect on the balance sheets of Canadian consumers. Canadians have become more indebted than Americans on an individual basis since the sub-prime mortgage crisis.

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

Plus, Canadian fixed mortgages are generally reset to the prevailing rate after a five-year term. As Canadians renew, the new rates will almost certainly be higher than the rates they were paying (Americans generally have mortgages of up to 30-year terms where the rate is fixed over the entire period!). As a result, Canadian consumers could face a much more difficult time in a rising interest rate environment than their American counterparts. If the Bank of Canada is worried enough about this and ends up not hiking rates to keep pace with the U.S., the lower relative rates here would tend to make the Canadian dollar even less attractive versus the U.S. dollar going forward.

Rising interest rates may be a greater relative threat for the Canadian economy.

As a result, the Bank of Canada may be more cautious compared to the U.S. Federal Reserve which it comes to increasing rates.

However, higher U.S. rates could have an adverse impact on the Canadian dollar.

Also, gold bullion had a tough time last month as the strength of the U.S. dollar makes it possible to buy an ounce of gold with less dollars.

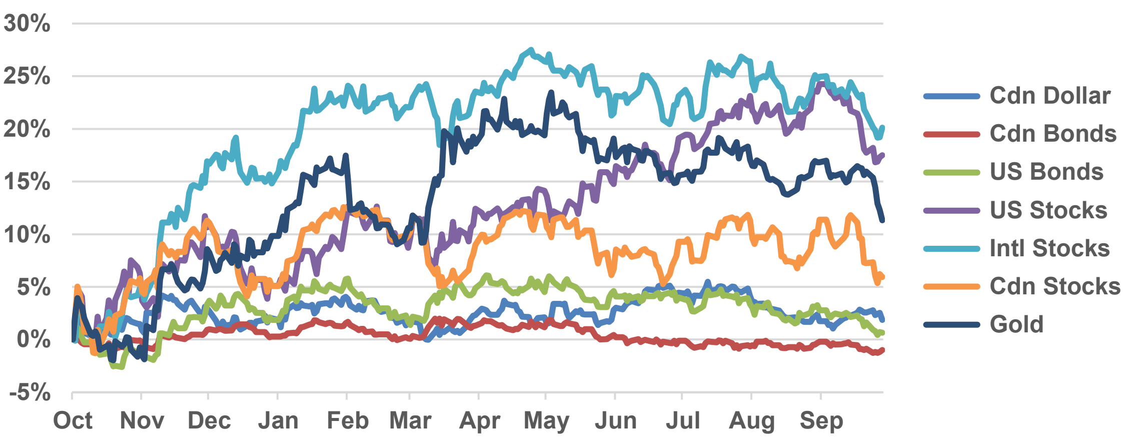
In the first section I talked about the good seasonality for stocks over the last three months of the year. Plus, we might get a temporary breather with respect to interest rates and energy prices which could lift the spirits of investors, leading to a decent finish for the year. The recent U.S. and Canadian "political theater" and global geopolitics may just be sideshows over the last quarter of the year even though they may make for dramatic headlines. If there are any hiccups, it could come from the growing focus on the challenges that 2024 might present.

After the volatility of the last couple of months, we could get a breather unless something unforeseen, economically or geopolitically, materializes before year-end.

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 5**).[4]

Chart 5:

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



Source: Bloomberg Finance L.P. for the interval from October 1, 2022 to September 30, 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 October 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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