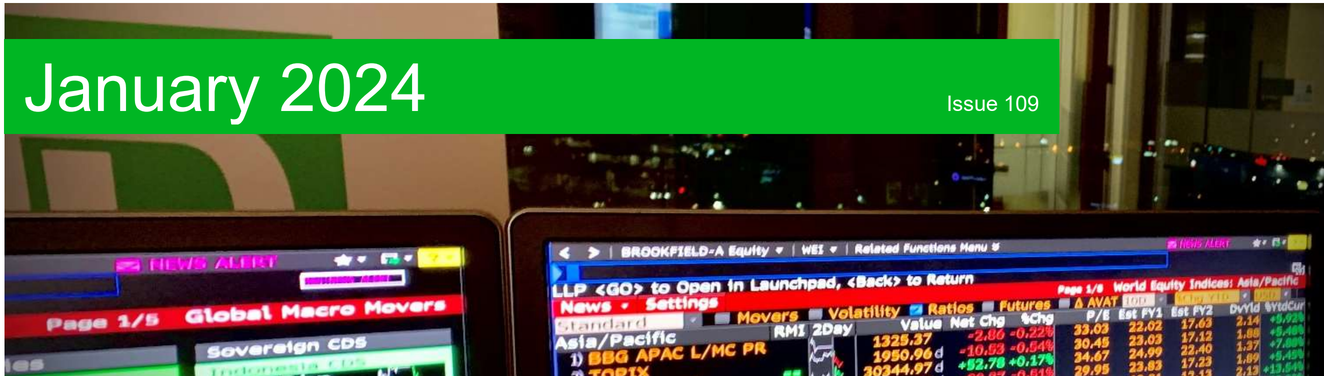
The Charter Group Monthly Letter



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Economic & Market Update

Everything is Awesome

Almost all risk assets rose significantly for the last two months of 2023.

Evidence for this enthusiasm will need to be presented fairly early into 2024 if recent advance in the markets is to be justified.

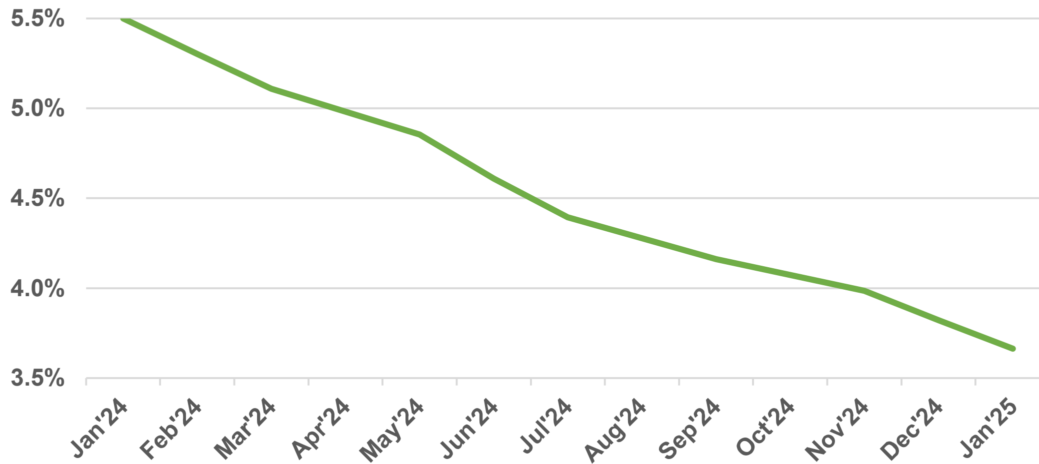
From late October through to the end of the year almost all asset classes were significantly higher. Canadian stocks, U.S. stocks, international stocks, emerging market stocks, government bonds, corporate bonds, junk bonds, bitcoin, gold, silver, all higher. It would be more usual for many of these wide-ranging asset classes to move opposite of each other over short-term periods, but growing investor enthusiasm was sufficient to drive all these higher. The only notable areas of weakness over the last two months were the U.S. dollar and basic commodities (energy, materials, and food[1]).

How did we suddenly go from a year characterized by investor malaise (with the exception of the Magnificent Seven – big tech stocks with an artificial intelligence angle) to an explosion of optimism? It was almost all due to a growing anticipation of interest rate cuts in 2024 (**Charts 1, 2, 3**). There was a sense that previous rate hikes had conquered inflation without inducing a recession. It seemed like mission accomplished.

[1] This includes the basic ingredients of food products, not retail prices at the grocery store.

Chart 1:

Implied Future U.S. Federal Funds Rates (Upper Bound)

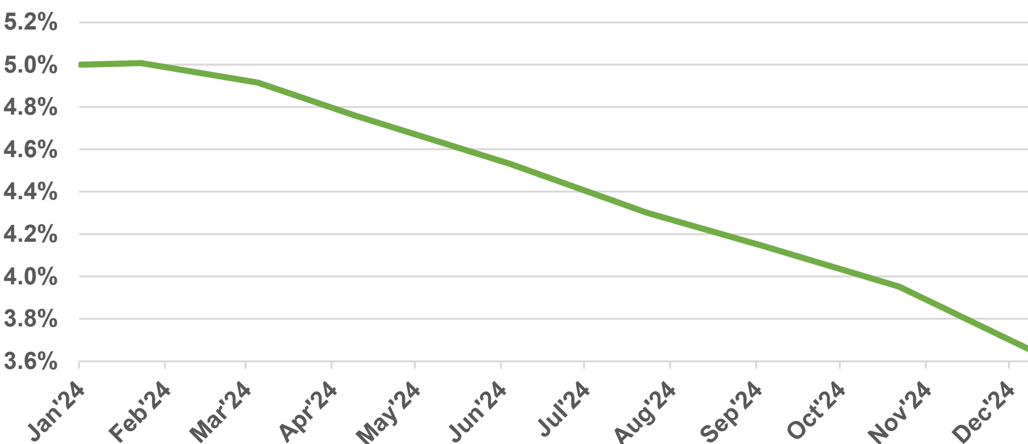


Source: Bloomberg Finance L.P., Chicago Board Options Exchange as of January 2, 2024

Central bank-determined policy rates are expected to decline relatively rapidly through 2024 (as implied by the pricing of interest rate futures contracts).

Chart 2:

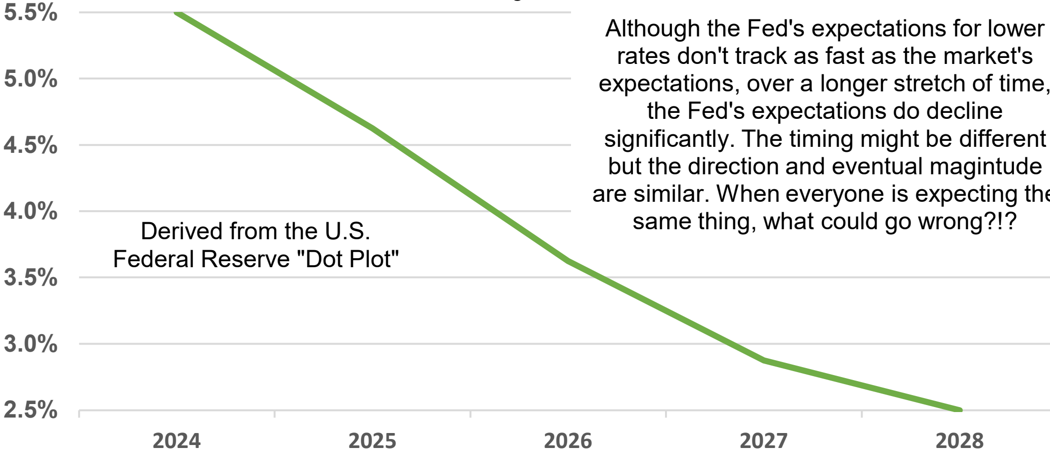
Implied Future Bank of Canada Rates (The Bank Rate)



Source: Bloomberg Finance L.P., Chicago Board Options Exchange as of January 2, 2024

Chart 3:

Median of U.S. Federal Funds Projections from FOMC Members



Source: Bloomberg Finance L.P., U.S. Federal Reserve Board as of January 2, 2024

The central bankers themselves are also projecting rate cuts albeit at a slower pace.

However, as we transition into the New Year, the hopes and aspirations of 2023 had better begin to materialize soon. Effectively, the market is expecting the U.S. Federal Reserve (the Fed) to cut by 0.25%, *77 days from now (*from January 2*).* It's no longer just a vague reference to "sometime next year." Otherwise, it may be very difficult to justify the magnitude of the gains from the last two months. Beyond January, there will only be seven more Fed interest rate meetings.[2] A 0.25% cut at all of those meetings will be needed to approximate the market's expectations of where the Fed Funds rate will be by the end of 2024. Time is now of the essence.

In order for the market's expectation of significant rate cuts to be fulfilled, those cuts are going to need to come very soon.

Given that markets have raced out ahead and are potentially pricing things for perfection, it may not take much to throw a spanner into the works. Inflation could be more stubborn and economy more resilient than anticipated (this has been the case for two years now as economic recession forecasts have yet to be accurate). I have talked about these challenges at length in previous issues of the *Monthly Letter*.

There are a couple of major and potentially disruptive factors that could interfere with the hopes for a rapid slashing of interest rates. Overall government spending is still flying high without any hinderance. Regardless of party affiliation, there is not much interest in austerity. This is highly stimulative for the economy via the expansion of jobs in the civil service and the job-creation potential of government outlays and subsidies to the private sector. A number of headlines recently have focused on the disproportionate number of elections scheduled for 2024.[3] Despite that, an aggregate reduction in government largess is not a focus. Generally, electorates are not interested in the subject. Thus, politicians are not going to volunteer to put it on the agenda.

A continuation of the massive rate of government spending among industrialized economies could keep demand elevated, entrenching inflation at a higher level than central banks want.

This rate of government spending increases "funding" anxiety. If a government is able to finance excess spending through debt, they will be likely assessing how much and what type of debt they will need to issue in 2024 (I can't find any budget surpluses among any of the governments that are issuers of bonds, so it's safe to assume all of them will be concerned about "funding" their spending from something other than tax revenues).

Governments with budget deficits will need to keep coming back to the bond market to raise capital.

The main challenge with "funding" is that governments need to find buyers for bonds. In the case of the U.S. Treasury, the U.S. Federal Reserve used to be a big buyer. They are now a big seller, which effectively makes them a competitor with the Treasury with respect to seeking buyers which could put upward pressure on "funding" costs, otherwise known

Will the appetite for government bonds be sufficient at current yields?

[2] The Federal Funds Rate is announced at the conclusion the Federal Open Market Committee (FOMC) Meeting which is held roughly every six weeks.
[3] "2024 is the biggest election year in history." *The Economist*, November 13, 2023.

as interest rates. This is the opposite of what the markets were getting all excited about recently.

Another, and admittedly somewhat obscure, fact is that as the U.S. Federal Reserve sells from its still massively bloated inventory of trillions of dollars of U.S. Treasury bonds, it receives money for those that it is able to sell. This effectively takes "money" out of the economy. When the supply of something falls (in this case, money), the price (in this case, interest rates) rises. This all led to some turbulence during December in the overnight markets used by U.S. banks to lend and borrow from one another.[4] The overnight lending rates spiked during the month, and could be a preview for next year if the U.S. Federal Reserve continues its liquidation of U.S. Treasury bonds. Investors basically missed or overlooked this news during the Santa Claus Rally in December.

An excess supply of bonds has the effect of taking money out of the private sector.

This can quietly keep upward pressure on interest rates, including overnight *and* long-term lending.

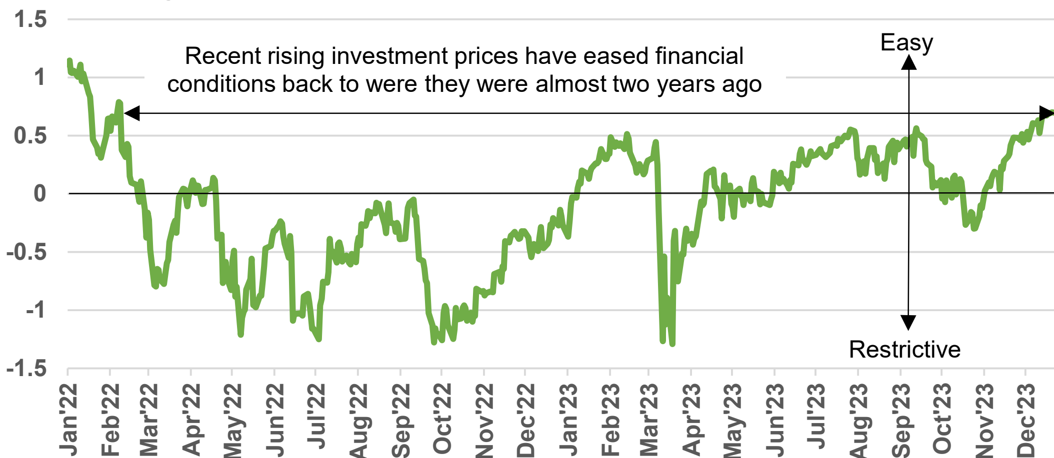
The other growing threat to the number of rate cuts expected by the market is the easing of general financial conditions (**Chart 4**). Investors are racing out ahead of the policymakers. When the market lifts the prices of stocks and bonds, it is effectively reducing the cost of capital. This is what the anticipated interest rate cuts are *supposed to do*. Thus, this may reduce the need for those expected cuts.

Financial conditions have eased over the last two months as a function of the willingness of investors to buy up risky assets.

It may be concerning if central banks cut rates after financial conditions have already eased. Backing off on the inflation fight could resemble the consequences of doing such in the 1970s.

Chart 4:

Bloomberg U.S. Financial Conditions Index



Source: Bloomberg Finance L.P. as of January 2, 2024

By the end of 2023, investors were bullish in a way that suggested 2024 would be "Goldilocks" year, with everything playing out just right. But, history has shown the market to be a serial offender in terms of getting a little too ahead of things from time to time.

[4] Alexandra Harris, "Fed's Balance Sheet Leaps Into Spotlight After Repo Volatility." Bloomberg News, January 2, 2024.

Model Portfolio Update[5]

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 in the model portfolios during December.

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

As mentioned above, almost everything was up over the last two months.

As discussed in the previous section, almost everything was up for the month, including all the asset classes that we use in the construction of the model portfolios.

As recently as late October, the model portfolios were slightly underwater for the year. However, with the recent rally, the year ended with the model portfolios showing modest gains, a pleasant surprise given the first nine months of the year.

2024 is suddenly here and investors are anticipating rate cuts soon judging by the ascent in stock and bond prices.

Looking forward, there will be considerable focus on the hoped-for rate cuts. Although the march towards the 2% central bank target for inflation stalled during the last quarter of the year, investors were willing to look past that given how much inflation has fallen from its peak in June 2022.[6] However, if the annual inflation growth number flattens out at its current level of a little over 3%, patience will be tested. It would be a little startling if the

[5] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of January 2, 2024. 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.
[6] Annual inflation growth peaked at 9.1% in the U.S. and 8.1% in Canada, both in June 2022.

Fed and the Bank of Canada started to cut rates in the face of stubborn inflation lest this reignites price growth and creates a much more longer-term problem for consumers.

There will be talk of the U.S. presidential election in 2024 and how this is usually a good omen for stocks. When one looks closer at that claim, it is only when there is an incumbent running. Plus, one needs to cherry-pick the particular stock market index to get a good fit with the claim. The Dow Jones Industrial Average extends back to 1896 (thus it may be the best index to use) and spans 22 presidential elections with an incumbent in the race. In six of those years, the Dow ended the year with a negative result. That is marginally better than the overall ratio of negative to positive years for the Dow. The average calendar performance for the Dow since inception has been 7.59% while its average calendar performance in a year in which an incumbent is running is 8.49%.[7] There are many other far more potent anomalies with respect to seasonality and cycles than this one. It would be fairly safe to discount this notion the next time it is mentioned in the headlines!

Hope surrounding the notion that this is a presidential election year, which is supposedly good for stocks, should be tempered. The anomaly is not as established as some claim it to be.

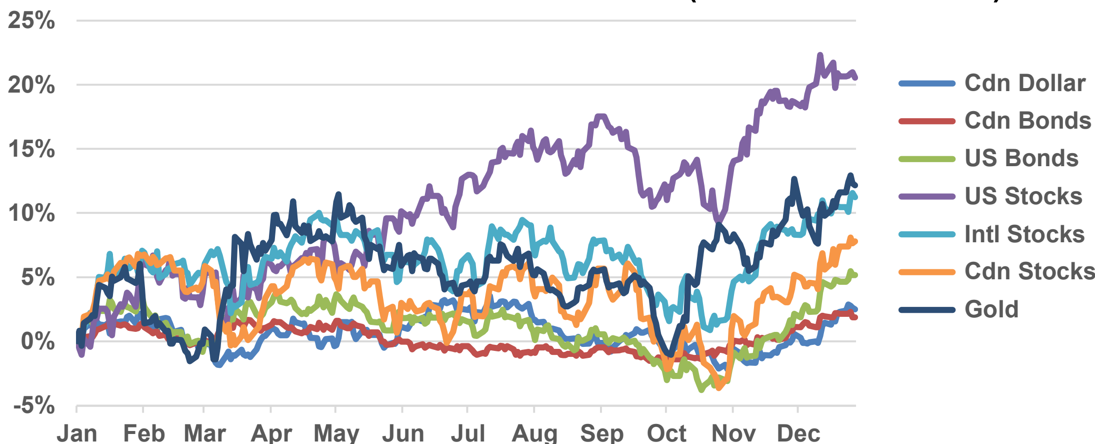
With respect to any potential correction in stocks, keep an eye on those that did best in 2023. Better safe-harbours may be found in higher quality dividend stocks as well as those that have some pricing power with respect to what they sell.

If the market becomes frustrated by the slow pace of rate cuts, avoiding some of the winners from 2023 may be a good way to manage 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 5**).[8]

Chart 5:

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



Source: Bloomberg Finance L.P. for the interval from January 1, 2023 to December 31, 2023

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[7] Source: Bloomberg Finance L.P. as of January 2, 2024.

[8] 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

Top Investment Issues[9]

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

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.

[9] 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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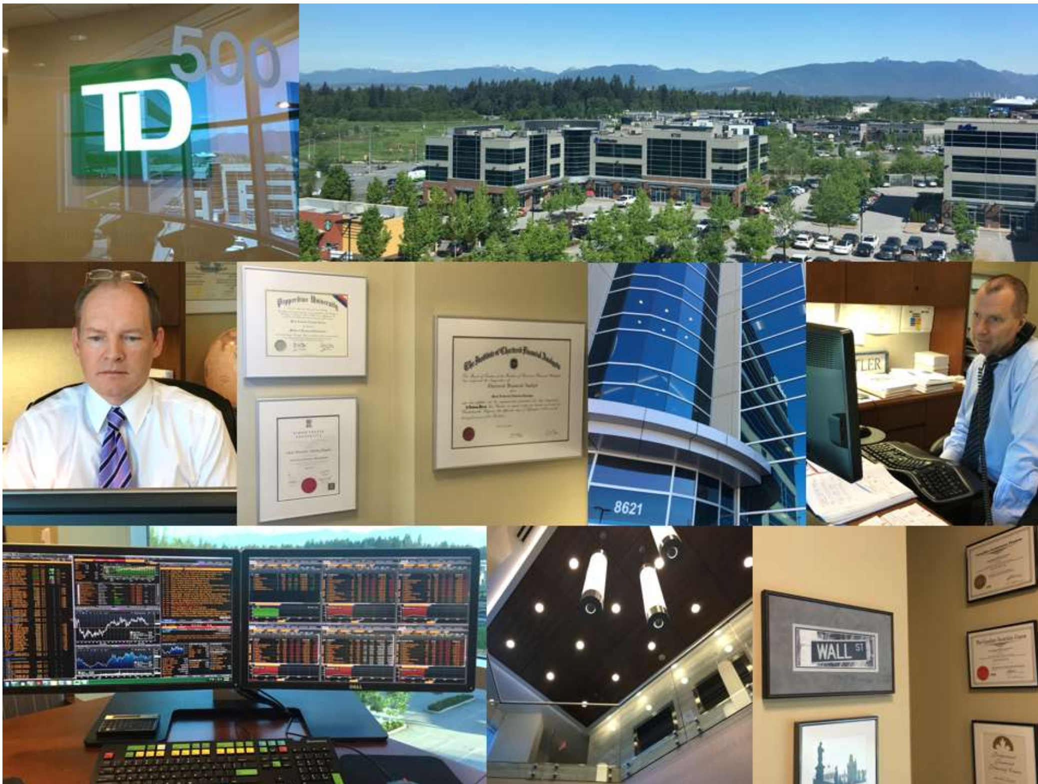
The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do 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 January 2, 2024.

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