TD Wealth

Private Investment Advice

The Charter Group Monthly Letter

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Economic & Market Update

The Charter Group's Brexit

Source: Mark Jasayko

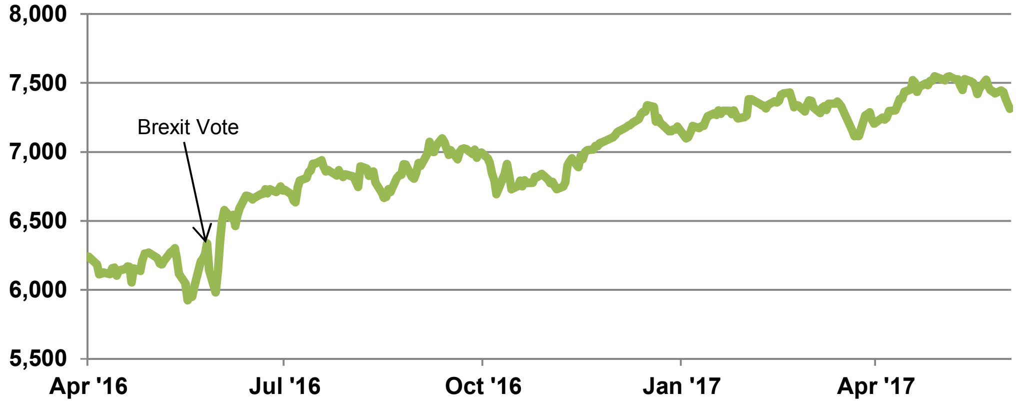
Writing this edition of *The Charter Group Monthly Letter* on the return flight from London Heathrow to Vancouver gave me an opportunity to reflect upon my observations and thoughts during my one week visit to the United Kingdom ("U.K."). Of specific interest was how on-going Brexit deliberations and shifting interest rate policies might impact U.K. investments (a portion of The Charter Group Balanced Portfolio has had an allocation there for a couple of years).

A recent trip to the U.K. provided some insights into the conditions that impact our decision to invest there.

The Charter Group's stance with respect to Brexit is that it was a net-positive once the pound sterling fell following the vote (**Charts 1&2**). Under the current (European Union ("E.U.") regime, too much sovereignty was forfeited in order to capture some increased trade. The U.K having less say over trade agreements and immigration while dealing with expanding bureaucracies introduced considerable inefficiencies and financial costs.

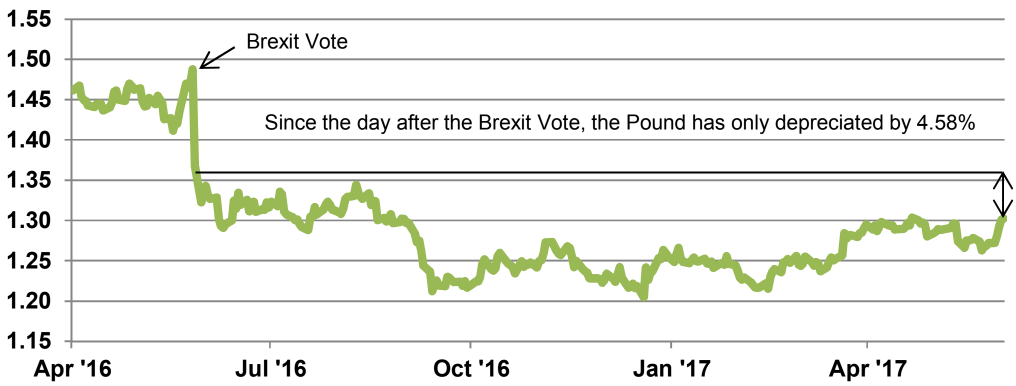
Brexit was a net-positive from an investment perspective.

Chart 1:
The Financial Times Stock Exchange (FTSE) Index - U.K. Stocks



Source: Bloomberg Finance L.P. as of 7/1/2017

Chart 2:
British Pound Sterling verus the U.S. Dollar



Source: Bloomberg Finance L.P. as of 7/1/2017

Being bombarded by the British media during my trip, it was easy to conclude that the previous clarity with respect to how Brexit negotiations would be conducted is being lost. This is primarily because of the recent general election that forced Prime Minster Theresa May to form a power-sharing agreement with a regional party from Northern Ireland (the leadership of Labour, the main opposition party, did not want to remain in

Less clarity with Brexit threatens some of the potential positives.

the E.U. either, but that sentiment is not necessarily shared by their rank and file). The bottom line is that less Brexit clarity equates to less good for the British economy.

The other potential economic concern involves rising interest rates. Recently, central banks have been chirping about potentially higher rates after the U.S. Federal Reserve hiked rates four times since December 2015. The Bank of Canada increased rates for the first time in seven years and has insinuated that further rate hikes are coming (despite the risk that this would present to the housing market). The European Central Bank has become a little less dovish lately and so has the Bank of England. There is a sense that all these central banks would want to keep pace with rising American rates.

Compounding the growing uncertainty surrounding Brexit is the possibility of higher interest rates.

In my estimation, it has been the U.K. which has been the biggest beneficiary of declining rates over the past three decades (among developed nations). This was mainly because of the low economic base from which they started the era. British politics and the wayward economic policies of the 1970s were partly responsible. However, there have been a few more permanent factors that have always tended to create headwinds for the U.K. economy.

The U.K. has benefited more than other countries from falling interest rates.

It may have relatively more trouble in a rising interest rate environment.

Although U.K.'s geography has some positives for trade and commerce, it is no match, for example, compared to the geography of the U.S. Regardless of where the next global economic hotspot emerges, the U.S., with its Pacific and Atlantic coastlines, has the advantage in terms of shipping and logistics. As things turned out, it was China that emerged as the hotspot over the last two decades and it was America's west coast ports that were ideally situated. In order to counter this natural advantage, China is trying to finance and construct a trillion dollar overland and seaborne trade route project to Europe. However, this project faces daunting obstacles because of the number of different countries that have to sign on and participate. And, it will take decades to sort out the politics, to pay for it, and to construct it.

The U.K.'s geography could exacerbate economic difficulties during a period of rising rates.

The geology contained within the U.K.'s geography also limits things compared to the U.S. The ability of the U.S. to extract resources reduces its vulnerability to economic slowdowns. While there are considerable oil deposits off the east coast of Scotland, the U.K. is still a significant energy importer whereas the U.S. appears set to become energy-independent within a few years.

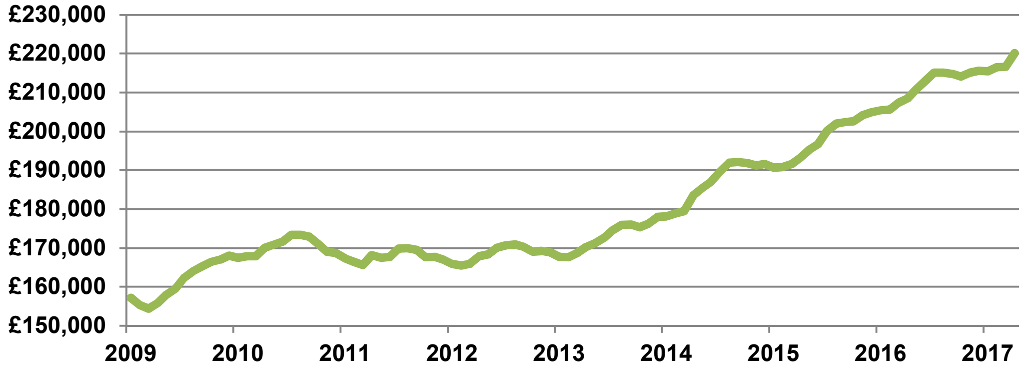
One area where geography is not a primary concern is in financial services. With good communications infrastructure, limited regulation, and the rule of law, London became one of the most important financials centres in the world. However, it can be argued that declining interest rates was the critical ingredient that made this possible. Rising rates could reverse a lot of that financial industry growth.

A relative lack of modern infrastructure is another perennial economic concern for the U.K. While aging infrastructure has become a political issue in the U.S., much of Britain is forced to rely on relics from the very distant past. Airports and motorways are stunningly out of sync with the size of the population, especially in southern England. The pervasiveness of small-scale farming entrenches inefficiencies and limits the flexibility needed to adjust supply to meet demand (talk of a looming butter shortage was all the rage across BBC network during the visit). There are also cases of sizable populations in the further outlying counties being choked off by medieval road networks.

Insufficient infrastructure could also increase the pain if interest rates rise since it limits economic flexibility.

Apart from infrastructure, other aspects of the nation's "capital stock" can limit how well the U.K. will be able to adjust to economic trends caused by higher interest rates. Housing prices are elevated to levels similar to Canada (**Chart 3**) which limits labour mobility. Plus, the quality of the labour force is a notch below that in the U.S. in terms of being adaptive and solution-orientated.

Chart 3:
U.K. House Price Index - Average Price for All Dwellings



Source: Bloomberg Finance L.P. as of 7/1/2017

The recent epoch of declining interest rates was as close to an economic panacea for Britain in overcoming these deficiencies. As a result, if the Bank of England's recent brave talk finally does lead to rate increases, it will be very difficult for the U.K. to fight through the economic headwind. As a result, we have removed our weighting to the U.K. in The Charter Group Balanced Portfolio. Perhaps, later in the interest rate cycle, once the U.K. has had a chance to adjust, we will revisit the possibility of investing there.

Model Portfolio Update[1]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	15.0	None
U.S. Equities	35.7	None
International Equities	9.3	None
Fixed Income:		
Canadian Bonds	25.5	None
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2	None

No changes were made to the individual investments or the overall asset allocation in The Charter Group Balanced Portfolio during June. However, as mentioned above, we did remove the investment exposure to the U.K. in July. The proceeds from that sale were then added to the existing exposure we have to stocks in Germany, Australia, Hong Kong, Singapore, and Ireland.

No changes were made to the Balanced Portfolio during June.

However, the exposure to U.K. stocks was removed and redistributed to other developed countries outside North America.

The Balanced Portfolio was hurt during the Quarter by the increase in the Canadian dollar versus the U.S. dollar, especially from early May to the end of June. The Bank of Canada began talking about how the Canadian economy was strengthening and that they were looking to raise interest rates as a result. However, while there has been some strong top-line economic growth since last autumn, a number of underlying economic statistics are not that firm. Additionally, the economy has benefited from robust real estate activity supported by expanding levels of household debt which now stands at 169% of disposable household income.[2] And, the economy also has to deal

A stronger Canadian dollar was the main detractor from the results for the month.

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 5/5/2017. The asset allocations of individual clients invested in this Portfolio will 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.

[2] Source: Bloomberg Finance L.P. as of 7/1/2017

with the lack of recovery in oil which has impacted a sizable portion of economic output as Canada is a significant energy exporter.

If the housing surge flattens out and energy does not make a comeback, the Bank of Canada's rhetoric of further interest rate increases may not come to fruition. In that scenario, the Canadian dollar will have a very difficult time holding on to the recent gains made against the U.S. dollar.

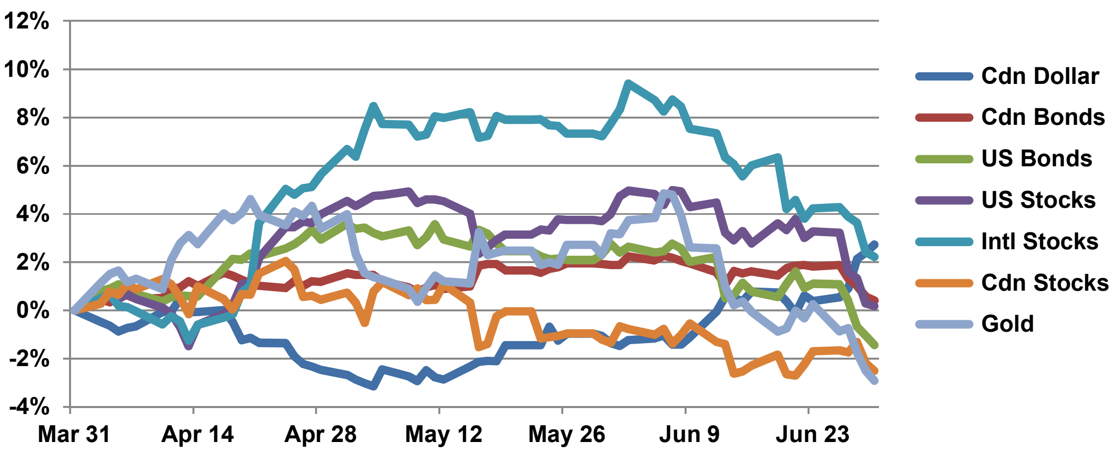
Below is the 2nd Quarter 2017 performance of the asset classes that we have used in the construction of The Charter Group Balanced Portfolio (**Chart 4**).[3]

The Canadian dollar rose with the news of interest rate increases in Canada.

However, there is a question regarding how much more interest rates can be hiked without stalling the Canadian economy.

Chart 4:

2nd Quarter 2017 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 7/1/2017

[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 iShares Canadian Universe Bond Index (XBB); U.S. bonds are represented by the iShares Core U.S. Aggregate Bond Index (AGG); U.S. stocks are represented by the iShares Core S&P 500 Index (IVV); International stocks are represented by the iShares MSCI EAFE Index (EFA); Canadian stocks are represented by the iShares S&P/TSX 60 Index (XIU); Gold is represented by the iShares Gold Trust (IAU).

Top Investment Issues[4]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. Canadian Dollar Decline	Moderate	Positive
3. Long-term U.S. Interest Rates	Moderate	Negative
4. U.S. Fiscal Spending Stimulus	Moderate	Positive
5. Canada's Economic Growth (Oil)	Moderate	Negative
6. East Asian Geopolitics	Moderate	Negative
7. Short-term U.S. Interest Rates	Medium	Negative
8. Massive Stimulus in China	Medium	Positive
9. Japan's Money Printing	Light	Positive
10. Europe's Money Printing	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, we encourage you to email mark.jasayko@td.com and set up a time to talk face-to-face or by phone.

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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 11, 2017.

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