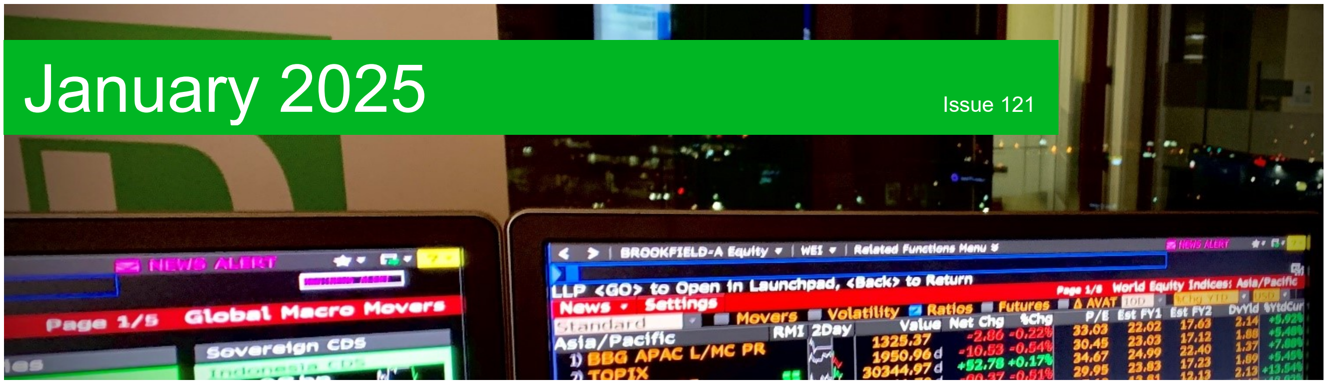
The Charter Group Monthly Letter



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Economic & Market Update

Looking Back and Forth

A second very good year for stocks.

Last year was the second consecutive very positive year for stocks in the U.S. Also, equity markets in Japan, Canada, Australia, and most of western Europe other than France had a good year.

The excitement around Artificial Intelligence and the hope of interest rate cuts provided much of the fuel.

Much of 2024 was driven by the enormous expectations for artificial intelligence (AI), which was basically a continuation of 2023. In fact, this started in late 2022 when Wall Street was grasping for a narrative after a dismal 2022 and along came Chat GPT 3.5, an iteration of an AI large language model that captured the public's imagination with its ability to effortlessly compile seemingly detailed written responses to queries.

The prospect of falling interest rates also fueled investor appetite for risk last year. As I have written about many times, the consensus among economists, strategists, central bankers, and other policymakers was that once the supply chain disruption from the pandemic got resolved, inflation and interest rates would recede to where they were in the decade before the pandemic. Two issues with that. The first is this consensus didn't see inflation coming. And, second, when it was evident that it was a concern, it was labelled as "transitory." That was three and a half years ago.

Although Jerome Powell, the Chair of the U.S. Federal Reserve Board (the Fed) stated that it was eventually time to retire the word "transitory" by late November 2021, his actions and comments suggested that he still believed that inflation would be temporary (my opinion was that the word was retired because it was becoming subject to growing mockery, not because the Fed had changed its inflation outlook).

Central bankers appeared to really want to cut rates. The same central bankers who did not anticipate the appearance of inflation which required raising rates in the first place.

Markets were willing to look past this inconvenience.

Investors in 2024 were willing to accept the consensus belief that rates were going to fall. And falling rates usually translate into higher share prices.

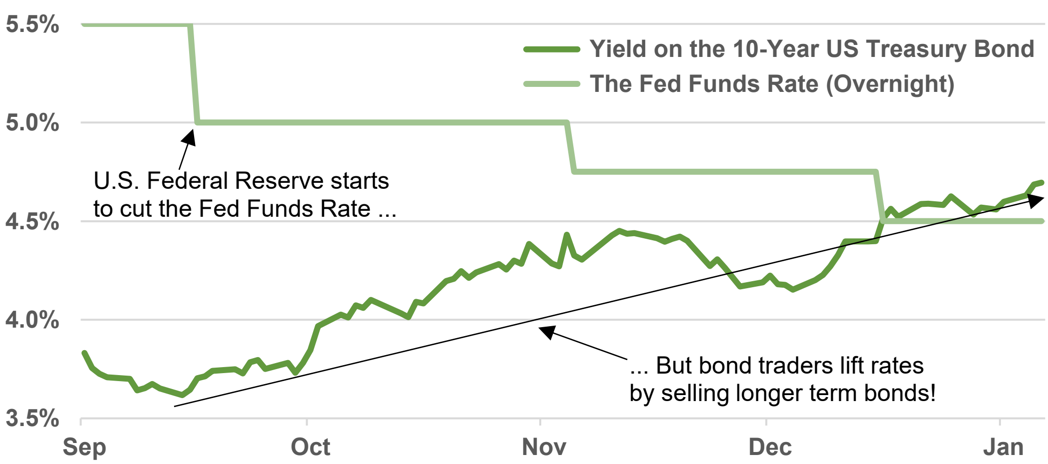
In September, the Fed finally began cutting rates (the Bank of Canada started in June), and it seemed that prior investor risk-taking was vindicated.

However, as the Fed went on to cut rates by a total of one percent the 10-year Treasury yield *rose* more than one percent by the end of the year! (**Chart 1**) The rate that the Fed is cutting is an overnight interbank lending rate. In the great scheme of things, it is the yield on longer-term government securities that have a more profound impact on lending rates. The notion that it was becoming more expensive to borrow despite the Fed's rate cuts began to impact investors by the time we got to December (**Chart 2**). As a result, December was a rough time for stock market investors … unless they had a lot of exposure to the big tech stocks or crypto that appeared to benefit from some of the campaign promises of President-elect Trump.

Central bankers eventually did cut short-term rates, only to have the market push up long-term rates. Equity investors weren't thrilled.

Chart 1:

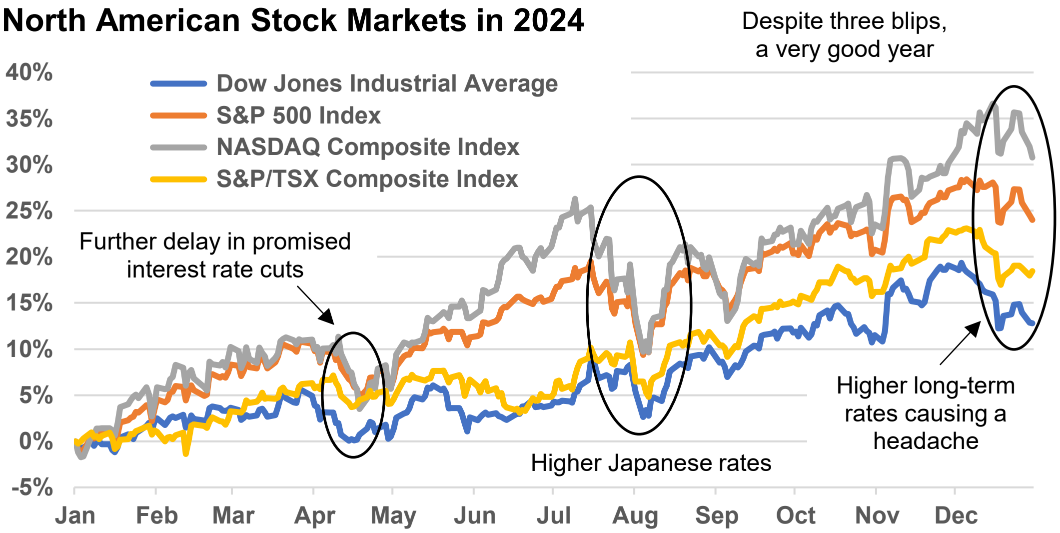
10-Year US Rates versus the US Overnight Rate



Source: Bloomberg Finance L.P. as of January 9, 2025

Chart 2:

North American Stock Markets in 2024



Source: Bloomberg Finance L.P. as of January 9, 2025

Despite the continued victories for big tech and other growth stocks over the last year, there were also good returns for investors who more defensively positioned.

That included us.

Focusing on better priced stocks relative to their value and by avoiding longer-maturity bonds generated surprisingly good returns as last year was the best ever for the model portfolios. This could be an indication that there is a growing number of investors that are looking to be cautious and are willing to pay a premium to establish some defensiveness.

Although rate cut hopes and AI provided the octane for some areas of the market, defensive investments also did well.

2025 could be a continuation of this "tale of two markets." Optimists versus realists. 😊

Representing the optimists are 20 Wall Street strategist whose forecasts were compiled by Bloomberg.[1] *All* of them are expecting 2025 to be another positive year with 12.3% being their average expected gain for the S&P 500 Index. That average would represent some cooling off of the torrid returns of 24.2% and 23.3% for 2023 and 2024 respectively. However, another modest upward year after two very strong years would be statistically remarkable.

Much of this optimism could depend on the efficacy of the President-elect Trump's promised policies. It might be reasonable that a few months following the inauguration

[1] Source: John Authers. "Your Happy New Year Depends on Trump and Inflation." Bloomberg Finance L.P., January 6, 2025.

that the market will begin to demand some results. The reality is that campaigning is much easier than governing and the current pricing of some of the higher-flying tech and growth stocks may be already assuming that the policies will yield the desired results. If not, it could be the recipe for some volatility, making it challenging to meet those strategists' forecasted return for the S&P 500 Index.

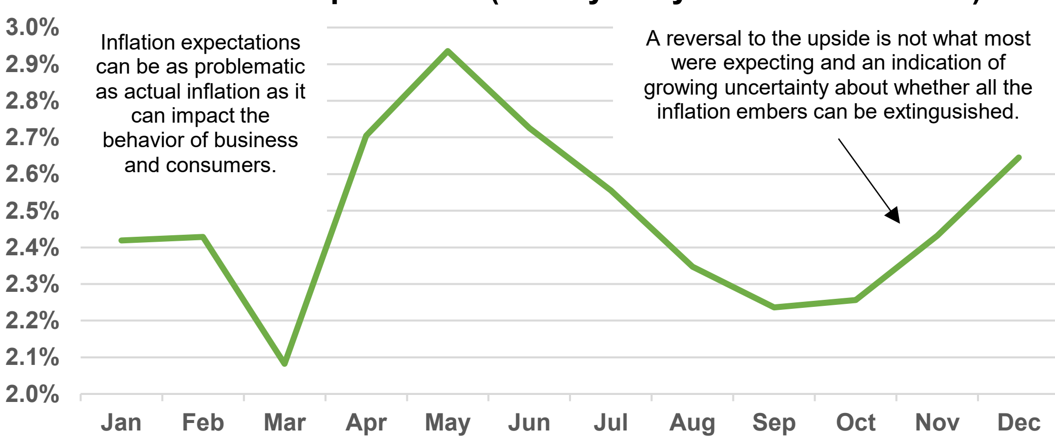
The 2023-24 tug-o-war between optimists and realists could continue into 2025.

Where inflation goes and how the new U.S. administration's policies pan out could break the deadlock between these two groups of investors.

Also, many of the Trump's proposed economic policies are seemingly contradictory. Things like more fiscal stimulus, tariffs, a reduction in labour supply have a real potential to fan inflation and keep interest rates high. We could get to May, the beginning of a more difficult seasonal stretch for stocks, with investors frustrated that the policies are not mostly producing the expected results.

Chart 3:

One Year Inflation Expecations (Surveyed by the Cleveland Fed)



Source: Bloomberg Finance L.P. and The Federal Reserve Bank of Cleveland as of January 9, 2025

So we might see a continuation of a "bifurcated" stock market in 2025, where one side of investors are confident that we will go back to the very low interest rates and inflation of the pre-pandemic world, and another side of investors more of whom could start concluding that the future will be different and, therefore, less certain (**Chart 3**). In the last two years, both sides were rewarded, but that can't go on forever. At some point it will become clear to enough investors that we are either going back to what was a comfortable time, or we are going forward towards a new era that will take some getting used to.

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 allocation targets were unchanged in December, but I did make some changes to the portfolios, reducing the exposure to financial stocks while increasing it to nuclear power and defense stocks.

The position in Canadian Western Bank was sold ahead of its acquisition by National Bank. Despite that, the portfolios are still a little overweight with financial services stocks.

The addition of defense stocks and more nuclear power stocks is in line with my belief that the future will focus more on materials, energy, and national security and relatively less on the digital economy which drove growth in the two decades up to the pandemic.

During December, none of the asset classes used in the model portfolios were higher, and the month was the worst month for the portfolios during 2024. But as mentioned in the first section, 2024 was still overall the best calendar year the portfolios have ever had.

No changes to the asset allocation in December. But there was a reduction in financial services exposure and increase in exposure to defense industry and nuclear power stocks.

All the asset classes were lower in December causing a significant headwind for the model portfolios. But it was the best calendar year ever for the model portfolios.

[2] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of January 9, 2025. 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.

The post-U.S. election stock market enthusiasm in response to President-elect Trump's campaign policies promoting a more business friendly environment petered out after the first week of December.

Stocks generally lost their momentum as the post-U.S. election rally got tired and inflation was not going away as forecasted.

The markets attention then started to focus on the "stickiness" of inflation and the prospect of getting fewer Fed rate cuts in 2025. Not a good development for stocks generally.

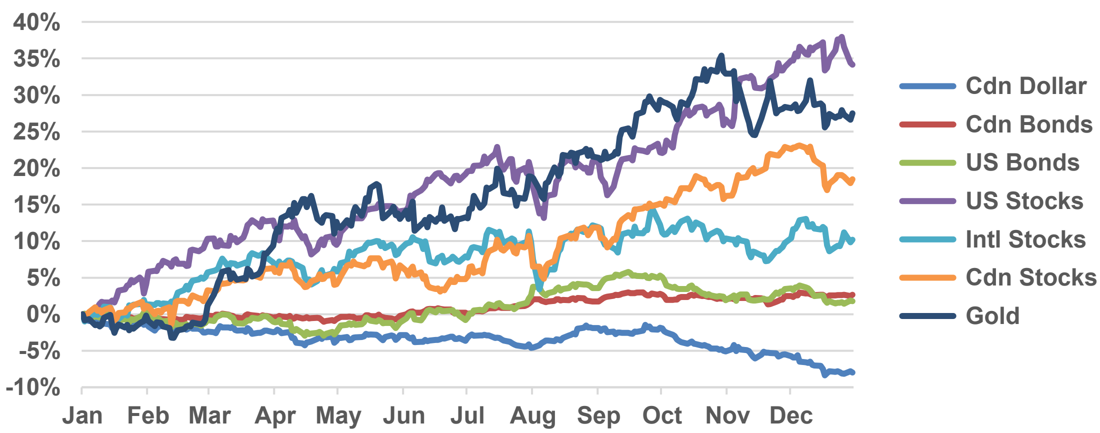
Going forward my estimation is that the markets will focus on any lingering inflation and how this may impact short-term and long-term interest rates in the U.S. In Canada, I think it is a stock picker's market where one would do well to avoid companies that have been plagued by lower per-worker productivity (which has generally plagued the country for more than a decade now). Canadian domestic political drama and the threatened U.S. tariffs on goods imported from Canada may only have a minimal impact on Canadian stocks. Canada's economic challenges are well-known and entrenched and would require years of corrective policies. I think investors will probably look past leadership contests and elections for now. And tariffs are a trade negotiation football between Canada and the U.S. I don't think Canada is a national security threat to the U.S. and so would not likely get the same extreme tariff treatment that the U.S. is applying to China for example.

The important thing will be what will happen with inflation and its impact on interest rates.

Political drama and trade-related tantrums may only be sideshows.

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 January 1, 2024 to December 31, 2024

[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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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 9, 2025.

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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Index returns are shown for comparative purposes only. Indices are unmanaged and their returns do not include any sales charges or fees as such costs would lower performance. It is not possible to invest directly in an index.

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TD Wealth Private Investment Advice

Thank you from The Charter Group at TD Wealth

Thank you to our clients and community for voting The Charter Group, your favorite for Investment Management and Financial Planning in Langley for the fifth year in a row.

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