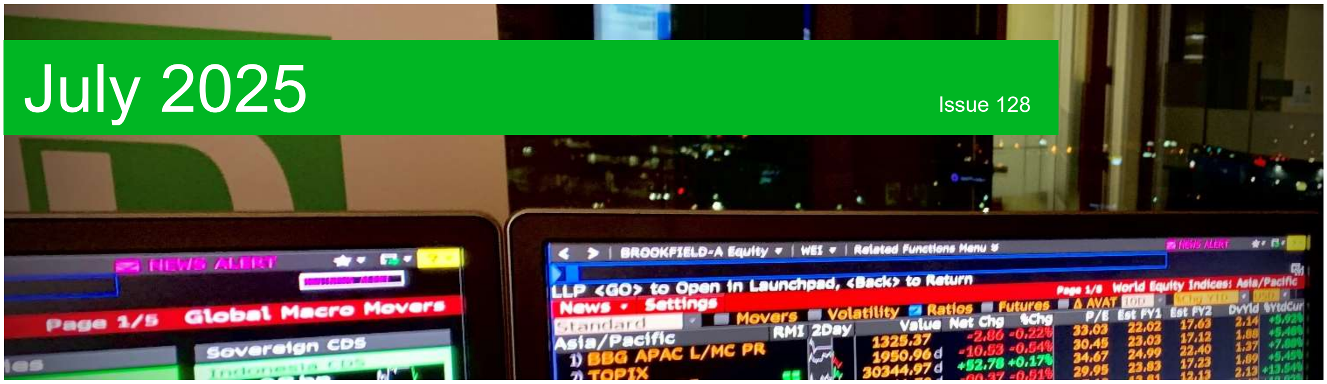
The Charter Group Monthly Letter



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Mark Jasayko, MBA, CFA
Senior Portfolio Manager & Senior Investment Advisor
TD Wealth Private Investment Advice
The Charter Group, Langley, BC

Economic & Market Update

Trump & The Markets Want Lower Interest Rates

To be honest, this isn't news. I can't think of a President who has ever pleaded for higher interest rates. And stock market investors tend to do well as interest rates are falling. Generally, over the short-term, falling interest rates are a positive for economic growth as it encourages businesses and consumers to borrow at a lower cost and to spend or invest that money. And when people like me do valuation calculations, using a lower interest rate increases the present value of an investment. If the markets are efficient enough, this higher present value will be reflected in higher share prices.

So why don't central banks just cut rates to zero so that we can live happily ever after?

The primary reason is that there is often a trade-off in the form of inflation. At times this trade-off is not very apparent as was the case during the two decades before the pandemic. At other times, during the 1970s for example, the suppressing of interest rates had the effect of pushing up consumer prices.

President Trump and stock market investors want lower rates.

A growing contingent is beginning to think that we could see significant rate cuts.

However, they are overlooking a number of hurdles as well as the risk of the trade-offs involved.

There were a number of factors that contributed to the degree of the trade-off depending on the era. From the mid-1960s to the mid-1980s, the world was embroiled in the Cold War which contributed to a much higher level of defense spending. When more is spent on defense, that additional government spending "crowds out" private spending. The demand for military inputs such as labour and materials causes the prices of these to increase. The private sector only has access to what is left over and has to pay more for it. These higher costs are passed onto consumers.

The main trade-off is that central bank interest rate cuts can ignite inflation.

The other underlying contributing factor was the general susceptibility to supply shocks. Specifically, there were two major oil shocks during the 1970s that appear to have a direct correlation to a spike in inflation (**Chart 1**). Also, rolling shocks in the food supply was a constant feature of the decade as the world was not as globalized, making it almost impossible to access agrarian land outside the free world.

Sometimes this trade-off can become more pronounced like during the 1970s.

When we take those economic aspects and mix in "easy" monetary policy, it can add more fuel to inflation. "Easy" refers to a monetary environment where interest rates are kept low by central banks. The most egregious example of the 1970s era was when the Chairman of the U.S. Federal Reserve Board, Arthur Burns, was pressured by President Nixon to keep rates low in order to keep the economy humming along.

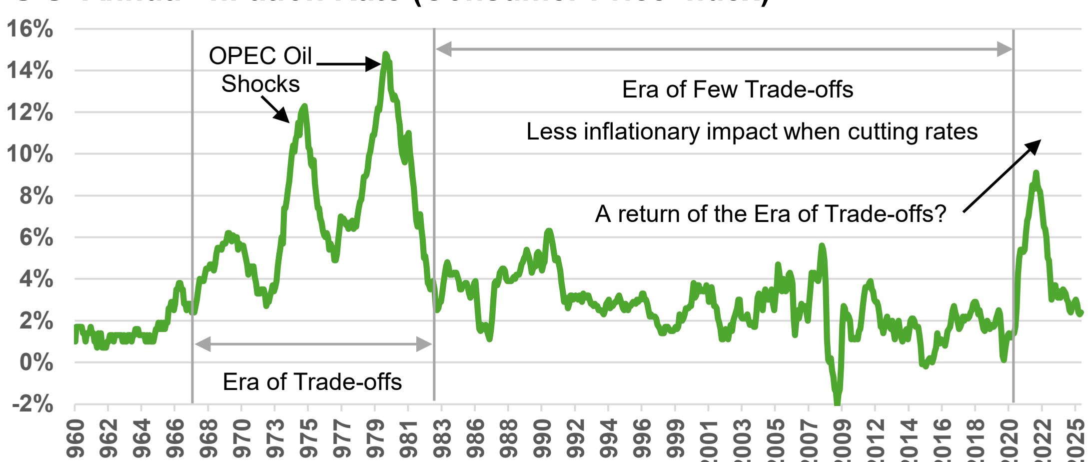
There is a risk that we are heading into an era that features some of the inflation-contributing factors that we saw in the 1970s.

The trade-off of low interest rates was a very high level of inflation that raged through the 1970s (**Chart 1**). The inflation was so persistent and painful that U.S. policymakers and economists eventually promoted the opposite trade-off which involved very high interest rates to douse inflation. It should be noted that Canada and many other Western countries pursued the same tough medicine policies in the early 1980s to quell inflation.

With the reemergence of the rate cut/inflation trade-off, there is a possibility that political leaders and investors will become frustrated.

Chart 1:

U.S. Annual Inflation Rate (Consumer Price Index)



Bloomberg Finance L.P. as of July 15, 2025

In the era that followed, there was an enormous peace dividend with the end of the Cold War. Global trade also exploded as there weren't many areas of the world that were considered off limits anymore. All this contributed to a more benign inflation environment and slowly central banks realized that they could lower rates without much of the inflationary trade-off of the previous era. This era extended until the pandemic. Suddenly, many of the economic features of the 1970s era began to reappear (**Chart 1**). As a result, many central banks, including the U.S. Federal Reserve, have recently kept interest rates at levels that were higher than during the previous couple of decades.

This has caused some consternation among politicians, most notably President Trump. He has threated to fire the current Federal Reserve Chairman, Jerome Powell, and replace him with someone more malleable with respect to be pressured into cutting rates. When the U.S. Supreme Court ruled that this wasn't possible, the Trump administration threated a number of other tactics to apply the pressure for lower rates. One of these involved choosing the next nominee for Chairman very early. That might allow this individual to comment and criticize the current policy, perhaps having an indirect impact well before the appointment (Jerome Powell's term as Chairman ends on May 15, 2026).

It is likely that President Trump will appoint a monetary "dove" as Chairman who will advocate rate cuts.

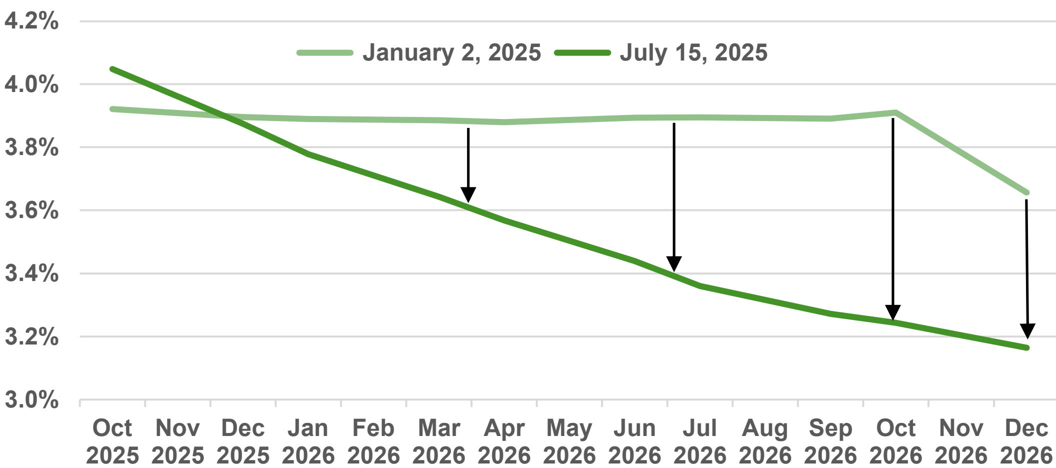
The President has voiced a desire for this to happen before the current Chairman's term ends and has suggested a few tactics to facilitate this. However, this could risk the perception of the Federal Reserve's independence.

Another tactic has been to implicate Powell in not being forthcoming about the cost of renovations to the buildings that house the U.S. Federal Reserve in order to remove him for cause (which is permissible). As much of a critic I have been regarding Powell over the years with respect to various policy moves and reversals, I think this accusation is a stretch. Also, I think it is likely that the bond market will see through this and potentially drive yields higher on concerns that central bank independence has eroded. In such an elaborate effort to cut rates, bond market reaction could actually end up increasing rates.

Perhaps Powell will stay until next May. Or perhaps he will throw his hands up and quit. Regardless, a new Chairman is on the horizon and it would be reasonable safe to assume that this person would be amenable to the push for lower rates. Even the equity markets appear to be embracing the possibility as it might be providing some of the fuel for this year's rally. Expectations of rate cuts over the next 18 months are getting baked-in (**Chart 2**).

The recent ebb in the annual U.S. inflation rate from a peak of 9.1% in June 2022 to 2.7% currently may be lulling political leaders and stock market investors. Tariffs have historically added to prices and we have yet to see their full impact, or even their full threatened implementation. Also, the annual rate of inflation uses a relatively low base from 12 months ago which increases the risk of an upward inflation surprise. This might explain the reluctance of Powell and a majority of those on the interest-rate setting Federal Open Market Committee (FOMC) to cut rates too quickly.

Chart 2:
Future Fed Funds Rate Implied by Interest Rate Futures Trading



Bloomberg Finance L.P. and the CBOE as of July 15, 2025

That said, we could get a rate cut or two before the end of the year if inflation continues to remain muted in the face of implemented tariffs. But any indication that tariffs are leading to higher prices could put that on hold. If I had to guess, maybe we get one token rate cut and then a wait-and-see stance from the Federal Reserve.

Somehow engineering a Federal Reserve that is more amenable to rate cuts is harder than it looks.

The Chairman only gets one vote out of twelve.

And the bond market, which isn't beholden to anyone, will have a say.

Longer-term, barring a recession that produces job losses, I am not as optimistic as the markets are regarding significant rates cuts. There are various hurdles in the way.

First, even though many people think that it is the Chairman of the Federal Reserve who sets rates, it is actually a majority vote of the FOMC that does. The Chairman may persuade, but only counts as one vote among twelve. There have been cases where the Chairman loses the vote as happened to Paul Volcker in the mid-1980s when a number of Reagan appointees overruled him. President Trump's challenge in this regard is that he has only two appointments to make during the remainder of his presidential term. So, there's a chance that the current composition of the FOMC continues to be reluctant to cut rates regardless of who the Chairman is.

Secondly, it is only Powell's term of Chairman that expires next May. His term as a Fed Governor with a seat on the FOMC continues through to January 31, 2028. He is entitled to remain on the FOMC and vote how he sees fit. His presence could also influence the other FOMC members, especially with the gravitas of being a former Fed Chairman.

And the current Chairman may stay on after his term and continue to be one of the twelve committee members who vote on monetary policy.

Thirdly, the new nominee will need to be approved by the U.S. Senate. Although Republicans have a slim majority in the Senate, there could be challenges if the nominee looks too pliable with respect to the Trump administration's wishes. The risk for the senators seeking reelection would be if there is a policy error promoted by a new Chairman that bolsters inflation (the cost of living was a top factor in the last presidential election and appears to still be driving campaign platforms if the current New York City mayoral contest is any indication).

Finally, if a lack of Federal Reserve independence does appear to increase the risk of inflation, the bond market, as discussed above, could weigh in by driving yields higher across most maturities. The Federal Reserve only explicitly targets very short-term policy rates. All other maturities are mostly set by the bond market (the Federal Reserve does try to go into the market occasionally to influence rates but likely has nowhere near the buying power to counter a major reaction in the bond market). If the FOMC sees a bond market reaction as a serious risk, the majority of members may eventually push against lower rates regardless of what the Trump administration would prefer. Considering the fact that people like me are still referencing Arthur Burns after 50 years, no one wants to become "that guy" by hastily voting in favour of rate cuts.

Between now and the end of Powell's term, it is possible that the stock market gives President Trump's interest rate reduction tactics the benefit of the doubt and continues its rise. It's tempting as the stock market would generally prefer this outcome anyway. However, because of the hurdles discussed above, there might be more "wish-casting" than sober forecasting, putting equities at risk if it appears there will be fewer rate cuts than hoped.

Hoping and wishing for rate cuts may end up in disappointment if inflationary pressures do not recede and the hurdles to forcing change remain.

Model Portfolio Update[1]

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

Shares in Royal Bank were sold in later June and replaced with Bank of Nova Scotia at the same weighting. Although Royal Bank had been executing impressively, valuations got stretched. Based on an earnings multiple and dividend yield basis, it was concluded that Bank of Nova Scotia was the better relative value. Also, I didn't want to reduce exposure to Canadian banks at this time, so one bank stock was replaced with another.

Royal Bank shares were sold and replaced by Bank of Nova Scotia.

The move was primarily because of valuation.

Despite the change in holdings, the asset allocations of all the model portfolios have remained unaltered.

The asset allocations of the model portfolios stayed the same.

Stocks, especially in the U.S., but also in Canada and internationally, have continued their run since the lows of early April. As I discussed earlier this year in the *Monthly Letter*, the implementation of tariffs is not likely to be near the level of that threatened. My guess is that eventually about one-fifth will be, and much of that will have a national security element involved (ie: China). Stock market investors appear to be aligned with what I was

Stocks continued to rally on the hopes that many of the tariffs would not be implemented, or their effects would be muted.

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of July 15, 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.

thinking earlier in the year. However, we have likely reached the point where the optimism is fully reflected in share prices. Things might even be going beyond that with enough investors now thinking that there will be limited economic consequences after implementation. The historical evidence surrounding tariffs suggests that such a conclusion may not be warranted. The tariffs still need to be implemented, and a time lag in impact would be expected. So, we just don't know – even though the stock market is beginning to think that it does.

Markets are looking ahead to the remaining Fed meetings this year where interest rate policy is set.

Looking over the near- to medium-term, markets are going to be focused on the upcoming Fed meetings (July 30, September 17, and October 29). As mentioned, I think one token rate cut (0.25%) is possible. But there are signs that investors want more. If they don't get it, then some of the overvalued areas of the market could be subject to a correction in the second half of the year. The main gauge will be the annual inflation rate and how it unfolds over the next six months. Also, the fact that the market is generally overvalued on an historical basis (it has been in that range for more than a year now in my opinion), has added to the vulnerability of growth stocks that have been bid up on the promises of artificial intelligence.

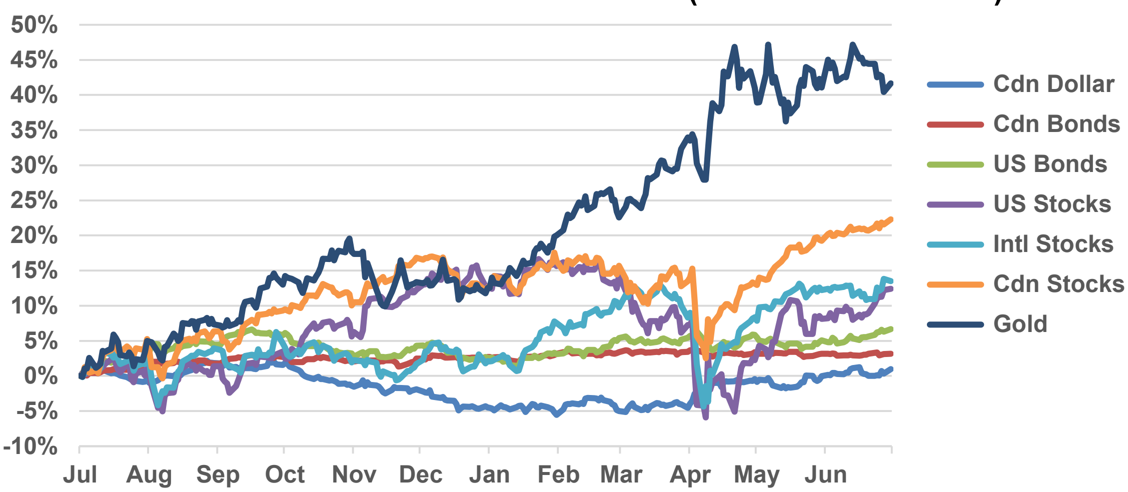
If there continues to be inflationary embers, the markets may not get as much of a reduction in rates as hoped.

That could create some volatility for equities in the second half of the year.

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**).[2]

Chart 3:

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



Source: Bloomberg Finance L.P. for the interval from July 1, 2024 to June 30, 2025

[2] 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[3]

Issue	Importance	Portfolio Impact
1. Global Geopolitics	Significant	Negative
2. Global Trade Wars & Alliances	Moderate	Negative
3. Inflation from Tariffs (Portfolio Impact)	Moderate	Positive
4. Canadian Federal Economic Policy	Moderate	Negative
5. Tariffs: Slowing Economic Growth	Moderate	Negative
6. Canadian Dollar Decline	Medium	Positive
7. China's Economic Growth	Light	Negative
8. Long-term U.S. Interest Rates	Light	Positive
9. Short-term U.S. Interest Rates	Light	Positive
10. U.S. Fiscal Spending Stimulus	Light	Positive

[3] 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.

The Charter Group

Mark Jasayko, MBA, CFA | Senior Portfolio Manager & Senior Investment Advisor
Keith Henderson, BBA, CIM®, CFP® | Associate Portfolio Manager & Senior Investment Advisor
Laura O'Connell, CFP®, FMA | Associate Investment Advisor
Nadia Azam, BA | Associate Investment Advisor
Kelsey Sjoberg | Administrative Associate
Roberto Gomez | Client Service Associate

604 513 6218
8661 201 Street, Suite 410
Langley, British Columbia   V2Y 0G9

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.