TD Wealth

The Charter Group Monthly Letter

September 2019
Issue 52

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

Economic & Market Update

Does The U.S.-China Trade War Deserve All This Attention?

Trade war headlines have been prominent in the press this summer. This appears to have added to financial market volatility, especially when President Trump's trade-related tweets emerge seemingly out of the blue (**Chart 1**).

Trade wars are much more dramatic than discussing policies related to spending, taxes, and interest rates.

As a result, trade war news can excessively dominate the financial news headlines.

The accusations from both the U.S. and China (the People's Republic of China or P.R.C.) are dramatic and often incendiary. This likely increases the amount of airtime and print they garner from news producers. And, there is a whole industry of pundits willing to offer reactionary insights, often only serving to heighten anxieties.

All of this has helped to elevate the perceived importance of the trade war. However, much of it also obscures important economic factors that could have a much more significant impact on growth than the trade spat.

Trade war headlines have been dizzying, but are the markets paying too much attention?

Chart 1:

Dow Jones Industrial Average - Last Four Months

Source: Bloomberg Finance L.P. as of 9/5/2019.

One could argue that a trade battle has been in progress between the U.S. and the P.R.C. for the last three decades. This only difference now is that the U.S. has decided to counterpunch.

Recent news coverage makes it look like the U.S. started the trade war, but from some other perspectives it merely looks like the U.S. finally decided to fight back.

For many years, U.S. industries and politicians ignored trade violations and intellectual property theft, consigning those tactics to the cost of gaining access to the P.R.C.'s consumers. Plus, the hope was that if the P.R.C. was able grow in wealth, enlightenment would lead to political and economic liberalization. However, the U.S. eventually came to the realization that level-playing field access was highly unlikely. Politicians from both major parties then began to question the on-going cost of intellectual property theft to the American economy (it's one of the rare issues upon which President Trump and presidential contenders Elizabeth Warren and Bernie Sanders actually agree!).

Democrats and Republicans generally agree that the U.S. needs to defend itself against trade violations and state-level technology theft.

A U.S. independent and bipartisan study estimated the cost of the P.R.C.'s theft of American intellectual property to be up to $600 billion annually.[1] Billions worth of economic potential has also been lost as the P.R.C. has forced joint-partnerships instead of allowing U.S. companies to operate on their own as the U.S. permits P.R.C. companies to do so. Additionally, forced technology transfers (usually legal) are often

Technology theft is estimated to be in the hundreds of billions every year.

[1] The Commission on the Theft of American Intellectual Property, March 8, 2018.

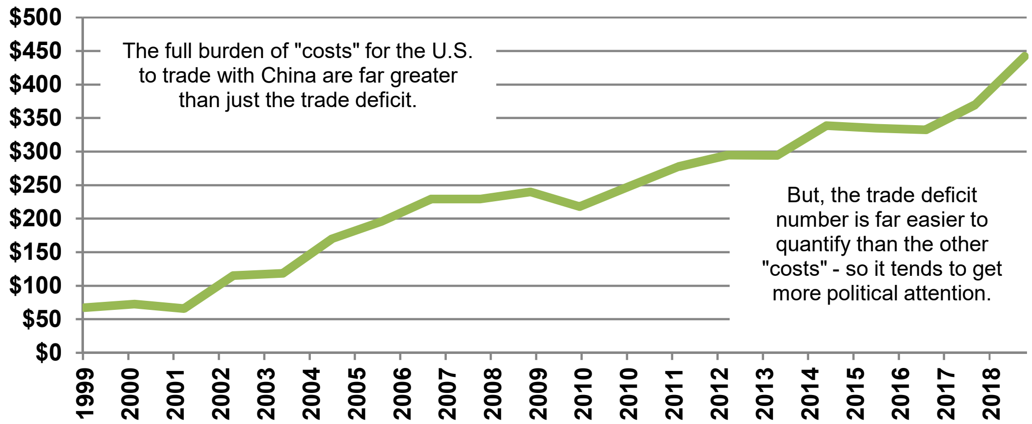
demanded from U.S. companies after they have invested in establishing a beachhead in the P.R.C. Finally, dozens of massive U.S. web-based enterprises are barred from operating in the P.R.C. (in the P.R.C. you can't use Facebook or Google for example– instead, you will be limited to using domestic social media champions such as WeChat and Baidu). Up until the recent blacklisting of some P.R.C. tech firms, such as cell-phone company Huawei, the U.S. opened their doors to virtually any company that wanted to gain access to the U.S. market. Given all these inequities, and other forms of unenforced trade violations, it would be reasonable to estimate that the current economic "cost" shouldered by the U.S. for the privilege to trade with the P.R.C. approaches a trillion dollars annually.[2]

Debates over tariffs and trade deficits involving soybeans, pork, or consumer products are a bit of a sideshow in the grand scheme (**Chart 2**). If tariffs eventually incentivize the P.R.C. to change laws, making things like intellectual property theft illegal and enforceable, they might payoff for the U.S. in the long run. Costs associated with tariffs are currently substantially less that the on-going tally related to trade disadvantages in my opinion.

Politicians focus on trade deficits to make their case. But trade violations and related illegal practices can cost much more.

Chart 2:

U.S. Annual Trade Deficit with China



Source: Bloomberg Finance L.P. and the U.S. Census Bureau as of 7/31/2019.

In light of all this, is current investment market volatility caused by the trade war headlines justified? A concern is that tariffs will reduce trade and lower the level of U.S. exports. Additionally, consumers will have to pay more for imported goods, potentially prompting them to spend less which, in turn, impairs economic growth. Some analysts

[2] $600 billion from IP theft in addition to the cost of legal forced IP transfer, the cost of forced joint-ventures, and the cost of shutting out many of the U.S.'s largest web-based corporations from an economy that represents about one-fifth of all internet users and 42% of the global e-commerce market.

add all this up and conclude that a recession is imminent. On a net basis, tariffs have historically had a negative effect. But, it is unlikely that tariffs by themselves could induce a recession.

Tariffs by themselves are likely insufficient to trigger a recession in the U.S.

As discussed in previous issues of the *Monthly Letter*, falling interest rates are one of the most potent elixirs for economic growth. When commentators are panicking over an imminent recession, this is one aspect that they tend to ignore or gloss over. It may be lousy monetary policy to gin up the economy by lowering interest rates, especially when unemployment is at a record low, but we should not discount the short to medium-term impact of this policy.

Another topic that is rarely considered in the media is the stunning increase in U.S. federal government spending. The annual U.S. federal budget deficit has grown from $439 billion in 2015 to $867 billion in 2018.[3] Federal government revenue has been relatively steady over this timeframe despite tax cuts. As a result, the increase in the deficit basically approximates the increase in spending. So, compared to four years ago, the U.S. economy is being showered with about $400 billion in more spending *every year*. Additionally, the U.S. Office of Management and Budget estimates that despite an increase in U.S. federal government revenues of approximately $200 billion, the deficit will still hit $1 trillion by the end of 2019![4] This implies an increase in annual spending of about $740 billion compared to 2015.

The tailwinds created by the suppression of interest rates and by an avalanche of increased government spending might be enough to overcome the negative impact of tariffs on the U.S. economy.

Tariffs have a cost. But compared to the potential stimulus created by interest rate cuts and by gargantuan government outlays, it is difficult to buy the argument that tariffs are going to lead to a recession.

Markets are certainly justified in worrying about a day of reckoning associated with aggressive interest rate tactics and spending policies, but that is likely somewhere over the medium-term horizon. There is always a probability that a recession can occur over the short-term. After all, there has not been one in the U.S. since 2009, so by some measures one is overdue. However, investment markets could be overreacting to trade war developments and overestimating the near-term probability of a recession while not considering *all* the potential economic factors.

If there was more news coverage on interest rate cuts and government spending increases, the markets may not be in as much of a volatile mood.

[3] U.S. Congressional Budget Office: *An Update to the Budget and Economic Outlook: 2019 to 2029*, August 21, 2019.
[4] United Press International: *White House Office of Management and Budget: U.S. federal deficit will top record $1 trillion*, July 16, 2019.

Model Portfolio Update[5]

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	24.5	None
U.S. Bonds	3.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2.0	None

No changes to the model portfolios during August.

Bonds and gold did well.

The other asset categories were flat despite a bit of a roller-coaster ride.

More central banks cut rates which helped bond prices.

There were no changes to the specific holdings or the targeted overall asset allocation in the model portfolios during the month of August.

Despite being a volatile month for stocks, the model portfolios saw a very positive contribution from gold which was up 8.9% in Canadian dollar terms,[6] and from bonds where prices were helped by dramatically falling interest rates.

Bonds were helped by central banks announcing more interest rate cuts in order to head off some signs of a global economic slowdown. However, since these kinds of policies tend to increase the risk of currency devaluations, inflation hedges like gold did well.

The topic of trade tariffs was discussed at length in the first part of the newsletter. However, another aspect that should be noted is that most of the worst case scenarios

[5] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 7/9/2019. 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.
[6] Source: Bloomberg Finance as of 9/5/2019.

might already be factored into stock and bond prices. The bulk of tariffs that were threatened have already been applied and there appears to be a general expectation that the U.S. will follow through on the next batch in mid-December. As a result, any positive news, whether it is real or just rhetoric, could help stocks.

September and October can be tough months for stocks.

Also as mentioned earlier in the newsletter, significant government spending in the U.S. and a suppression of interest rates could be constructive for stocks. In addition, promised increased government spending in Canada (something that tends to coincide with federal election campaigns) might do the same for Canadian stocks. However, the Canadian consumer is stretched which could dampen some of that enthusiasm.

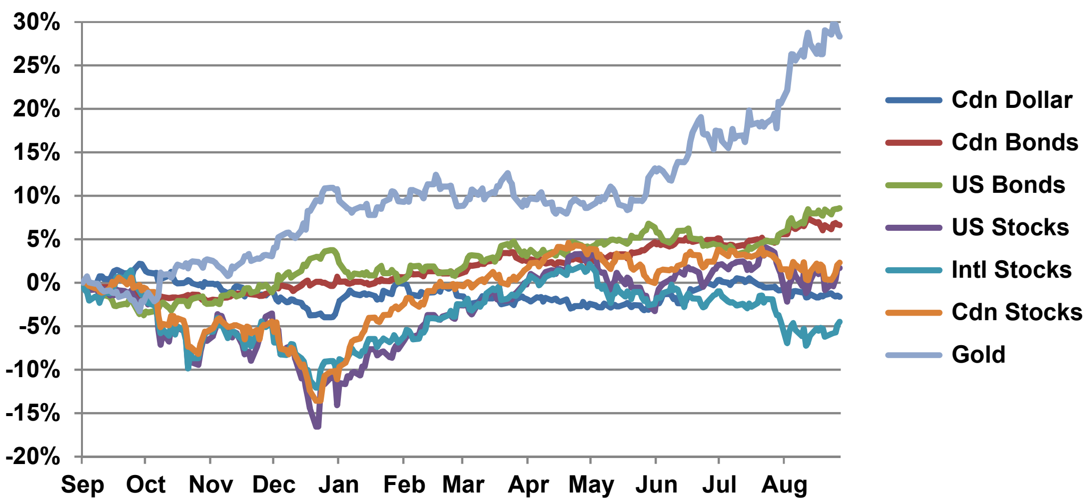
However, lower interest rates and higher government spending could offset those historical patterns.

Finally, September and October are historically the weakest months for U.S. stocks. Over the decades I have observed that investors will often focus on negative factors during this time of year and potentially sell if they are impacted by the experience of markets selloffs that occurred in the past during this seasonal stretch.

Below is the 12-month performance of the asset classes that we have use in the construction of The Charter Group's model portfolios. (**Chart 3**).[7]

Chart 3:

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



Source: Bloomberg Finance L.P. from 9/1/2018 to 8/31/2019

[7] 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); US bonds are represented by the iShares Core US 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[8]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. Canadian Dollar Decline	Moderate	Positive
3. U.S. Fiscal Spending Stimulus	Moderate	Positive
4. Long-term U.S. Interest Rates	Moderate	Positive
5. Short-term U.S. Interest Rates	Moderate	Positive
6. Global Trade Wars	Moderate	Negative
7. Stock Market Valuations	Medium	Negative
8. Canada's Economic Growth (Oil)	Medium	Negative
9. Massive Stimulus in China	Light	Positive
10. East Asian / South Asian Geopolitics	Light	Negative

[8] 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.

TD Wealth

The Charter Group

Mark Jasayko, MBA, CFA | Portfolio Manager & Investment Advisor
Mike Elliott, BA, CIM, FCSI ® | Portfolio Manager & Investment Advisor
Laura O'Connell, CFP ®, FMA | Associate Investment Advisor
Kelsey Sjoberg | Client Service Associate

604 513 6218
8621 201 Street, Suite 500
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.

The information contained herein is current as of September 5, 2019.

The Charter Group is part of TD Wealth Private Investment Advice, a division of TD Waterhouse Canada Inc. which is a subsidiary of The Toronto-Dominion Bank.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor 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.

Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward-looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government regulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS.

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.