



Learning From the Past but Being Rooted In the Present

While facing a double edged choice between growth and inflation, we are nearing the point where global central bankers initiate the first moves towards policy tightening and gradually withdraw financial and monetary stimulus. The popular economic myth is that for the U.S. Federal Reserve to extricate itself from these actions will require both skill and luck. Moving too fast may provoke a new economic downturn, waiting too long could unleash inflation while moving clumsily could unsettle markets. *History however, shows that the Fed can wait until the economy and capital markets are properly healed before tightening.* Bank of America research shows inflation is a long-lagging indicator and one of the most regular features of past U.S. business cycles is that when the economy recovers, core inflation falls. It declines in the face of strong GDP growth, booming commodity prices and thus a weakening dollar and negative interest rates. There will be pressure to tighten policy prematurely just as there was in the summer of 2008 when conservative columnists, monetarists and central bank hawks pushed the Fed to hike rates. Fortunately, the Fed ignored bad advice. However, recent moves such as raising the discount rate and the early closure of a number of lending facilities are tools available to Mr. Bernanke in light of improving conditions in financial markets.

If credit investors were tempted to think that the crucible of the past two years had endowed us with the skills (or the stomach) to handle anything, 2010 opened as a not so subtle reminder that this market will continue to offer challenges. Sovereign risk surprised many by the rapidity of its unfolding turmoil, and if you went by the headlines then the European Union (EU) looked to be in turmoil. By initially focusing on the Greece situation, member states promised to take determined and coordinated action to aid debt ridden Greece, provided it went along with certain requirements. This early announcement allowed investors to breathe initially, a sigh of relief. Greece followed up by delivering a new package of austerity measures that, despite strikes by organized labor and Greek politicians protesting bitterly about the harsh treatment from the EU, had polls indicating that there was public support for the new policies. However, with the German government feeling hamstrung by its concern that signing the official plans to help Greece would violate their “no bail-out” clause on the euro and expose it to legal action, those initial plans were put on hold. Finally however, France and Germany thrashed out a deal to involve the IMF in a rescue package, a move which would avoid potential objections from the German constitutional court. The EU must also still deal with the problems of Portugal, Spain and Ireland. While Spain is in financially better shape than Greece, it is far bigger and if its balance of payments continues to deteriorate some kind of bailout may be required. The ramifications of such action would be much farther reaching and until the all clear is given, the euro will probably continue to weaken versus the dollar and other reserve currencies.

Coming into 2010 consensus pointed to a good year, especially in the first half as monetary policy remained accommodative, inflation low and the economic recovery, albeit slow, seemed to be on track. Since then a sense of apprehension seems to have taken over. History indicates that this is not unusual, but in fact a common occurrence at this point of the market cycle as investor focus becomes fixated on the first phase of monetary tightening and its consequences. Moving from a backdrop of low interest rates, expanding multiples and weak corporate earnings to an environment of rising rates, strong corporate earnings and contracting multiples, should result in an upward grind for equity markets over the next 12 – 18 months. We would expect volatility in equity and debt markets to remain high, with the high

Can the U.S. Federal Reserve wait until the economy and capital markets are properly healed before tightening?

Sovereign risk surprises by the rapidity of its unfolding turmoil.

Resolving the euro zone’s turmoil will have ramifications for the euro.

The U.S. may be headed in the right direction, but it is too early to declare that the recovery is secure.

Canada’s recession was sharp but relatively short. A stronger than expected recovery has turned the Bank of Canada more hawkish on inflation.

China has taken away the punch bowl from the economic feast it laid out in 2009.

Markets have driven valuations to levels that make scant allowance for any systemic shock.



beta strategy less appropriate in this kind of environment. A strategy focused on the defensive/cyclical trade together with stock selection and buying the dips while not chasing rallies too hard should work well over the next few quarters. Though the ingredients for a healthy recovery are in place, progress will be slowed by indebted balance sheets which are forcing both households and the financial sectors to pay down debt. Investors are driving into the new decade with the yellow flag still flying- a caution warning that economic debris may still be in our path.

United States

While the U.S. is facing a long and arduous road as it attempts to correct the over-indebtedness and wasteful expenditures of the past two decades, the good news is that the economy is unlikely to slip back into recession. By increasing the discount rate the Federal Reserve is signaling that it believes it has brought the financial system back to health. While the U.S. economy may be headed in the right direction, a “V” shaped recovery is unlikely. More than likely, we will get more of the same - a continuation of the recovery phase that began last year. Stimulus spending and inventory replenishment cannot form the foundation of a durable turnaround. Even though corporate balance sheets are flush with cash, businesses will only unleash their capital spending programs when they are confident that demand will continue to rise. On the positive side, recently released ISM data seem to suggest that the expansion is continuing in the manufacturing sector, with new orders, production and manufacturing employment all posting growth. Gains have been seen in vehicles, technology, food, chemicals and plastic products. While the signs of near term restocking are clearly positive, more help seems to be on the way with U.S. President Obama recently having signed a multibillion-dollar employment package designed to create jobs. The recovery may taper off as we move into the second half of 2010, as industrial production generally recovers after consumer spending – a sector that is likely to remain relatively weak following this recession.

Canada

Compared to past recessions, the 2008-09 slump was sharp but relatively short. Economic momentum began to pick up in the second half of 2009, producing a 5.0% annualized GDP result in the fourth quarter. Furthermore, on the heels of what appears to be an equally sizzling sprint for the first three months of the year, data are aligning for the second quarter to also produce strong numbers, driven by both domestic demand and exports. Despite the improved sentiments of businesses, growth may level off in the 2nd half of 2010. With the U.S. accounting for close to 70% of our exports and being the source of much of our foreign investment, their outlook continues to exert an enormous amount of influence on our economy. On the home front, both the continued availability of credit and labor gains have worked together to boost consumption and brighten our outlook. The recent report on wholesale numbers remains constructive and consistent with a broadening expansion. Federal and provincial level stimulus-related infrastructure spending looks to total more than 6,000 projects and will consume more than \$27 billion. The recovery in developing markets along with the stronger than expected pickup in global trade should continue to support commodity exports. Not only has the Bank of Canada taken its first steps towards returning the country to a more normal interest rate environment, but it has also come out with a more hawkish tone on inflation. Meanwhile, the finance minister presented his latest budget, which turned out to be much ado about nothing.

Euro zone

The European Central Bank’s (ECB) interest rate policy seems to imply that current rates remain appropriate given the economic outlook, and it may be on hold for an extended period of time. More importantly, Europe needs to show that it has a strategy to end its internal financial crisis. What has not changed since the last crisis in 1992 is that European policymakers and their economic advisors still lack a basic understanding of how financial markets react to policies or, in this case, to a lack of policies. While it may have been Greece that set off the crisis rattling the euro zone, it is Spain that may determine the future of the euro. Spain is the euro zone’s fourth largest economy, has an unemployment rate of 19%, a deflating housing bubble, big debts and a gaping budget deficit. In the United Kingdom, which has almost no role to play in the aforementioned drama, recently released GDP data had something for everyone. Optimists used it to point out that the economy was climbing out of recession more quickly than originally thought. Meanwhile, pessimists have noted that the hole to climb out of was deeper than previously estimated.

Asia/China/Japan/Emerging Markets

Through government announced powerful reflationary policies, 2009 established China as a greater counterbalance to the US on global economics. However, with its recently announced increases in reserve ratio requirements, China has taken away the punch bowl from the economic feast it had laid out and confirmed to the economic establishment that monetary stimulus is over. China’s intake of commodities and risk assets will slow, which may significantly impact global markets



and the recovery. However, the urbanization process continues, allowing a large number of people to make the transition from subsistence farming to salaried jobs, thus increasing the size of the consuming population. Meanwhile, Japan has narrowly been able to hold on to its position as the world's second largest economy as it saw corporate and capital spending increase for the first time in two years. While the news was somewhat positive, the Bank of Japan saw fit to double the size of its liquidity program which may help to reduce borrowing costs and bolster corporate sentiment, all in an effort to fight deflation. The pick-up in global uncertainty in the aftermath of the sovereign debt crisis plaguing the Euro periphery has triggered a decline in appetite for Latin American (LatAm) assets. On a relative basis however, LatAm continues to outperform because of its better fiscal position and sheer geographic distance from the Greece situation. Australia is also in a better fiscal position than the North Atlantic economies. The expected small buildup of public debt is the envy of the advanced G20 world and there is a fairly plausible path back to a balanced budget within the next few years.

Commodities

China's Strategic Reserve Bureau was a large buyer of commodities early in 2009 supporting markets at a time of weakness. As China's quest for global resources intensified throughout the year, commodity prices experienced significant rallies, reaching levels where they were discounting too much of a good thing. They were due for a breather. With the current environment of low tanker rates together with the Baltic Dry Index continuing to decline and stabilizing at very low levels, we are led to believe that China's intake of commodities is slowing and that the short term outlook has turned less positive. Furthermore, recent data indicate that Chinese buying of U.S. treasuries has clearly risen, providing a further negative for commodity pricing. It seems pretty clear that a dollar trade is in place, but against what cross asset? It may be the euro as the latest data point to hedge funds buying commodities and metals, while adding to their bearish bet on the euro. This would explain a lot of the volatility seen in metal prices through the first quarter. Longer term however, the secular bull market for raw materials (hard assets) remains very much intact. Not only are most commodities positioned to outperform as emerging market demand recovers, but are increasingly being viewed as a store of wealth and attractive alternative to traditional fiat currencies.

Recommendations

In our last quarterly release we raised the yellow flag, as we were concerned that markets had driven valuations to levels that made scant allowance for further systemic shocks. While many of our predictions and forecasts have played out, we remain cautious but given the more positive tone to recent economic data, we have raised our equity exposure back to benchmark levels. As we have written and spoken about for quite some time, dividends and dividend growth will be an important element of overall performance. Since the beginning of the year, companies in the S&P 500 index have announced \$4.4 billion in combined net dividend increase, the best figure since the fourth quarter of 2007. Within our equity groupings, we continue to underweight the commodity sectors. Although it remains one of our key long term themes, mixed messages of recovery in Europe and the U.S., along with China's actions to rein in bank lending and liquidity are overhanging concerns. Our preferred sectors and stock allocations are based upon their exposure to the strength of the Canadian economy and, through mega-cap international companies, to growth opportunities in developing and emerging countries. Agriculture and gold continue to play important roles within our portfolios. Although subject to regulatory oversight and sometimes political interference, infrastructure remains a key theme. Energy, led by oil sands development and natural gas (longer term) figure prominently. History also tells us that in periods such as the one we have entered the pharmaceutical and consumer staples sectors outperform. Our interest rate outlook calls for a gradual increase in short term rates, probably by midyear. Although this is definitely a change in the trends, we by no means expect a dramatic tightening of the monetary reins by central bankers in the developed economies. Consequently, we expect a flattening of the yield curve and only a moderate move upwards of the full curve. As a result, we expect the biggest increase in rates to occur in the short maturities (between one and three years) while the rest of the market should see small gradual moves. After having realized great returns over the past twelve months by focusing on corporate bonds and preferred shares, our fixed income strategy will now focus on risk control. We remain fairly low in duration and will keep it that way until 10 year government yields move back into the 4.0 – 4.5% range (now 3.6%). In the meantime, we will look for opportunities in areas where we see mispricing occur. This is still the case in the corporate bond sector, as well as in the preferred share market. The latter offers good opportunities for taxable accounts.



FORECAST YEAR-END 2010

	Current Q2/10	2010E Range	2010E Year-end
Interest Rates			
Bank of Canada Overnight rate	0.25%	0.25%-1.1%	1.10%
Federal Funds Rate	0.13%	0.13%-0.75%	0.75%
10-year Canadian Treasury	3.60%	3.40%-4.25%	4.25%
10-year US Treasury	3.80%	3.50%-4.25%	4.25%
Commodities			
Gold (US\$/oz.)	\$1,120	\$1,000-\$1,350	\$1,300
Copper (US\$/lb)	\$3.35	\$2.85-\$3.60	\$3.30
Oil WTI (US\$/bbl)	\$81.50	\$72.00-\$90.00	\$85.00
Markets			
S&P/TSX Composite Index	11,850	11,000-13,000	12,800
S&P 500 Index	1,135	1,050-1,270	1,250
Canadian dollar/US dollar	\$0.96	\$0.95-\$1.05	\$1.05

ABOUT THE FIRM

Headquarters: Montreal, Quebec
Founded: 1981
Staff: 21
Portfolio Managers: 6
Investment Style: Growth at a Reasonable Price (GARP) with a value bias.
Investment Process: Top-down / Bottom-up
 Focused portfolios, 30-45 positions
Investment Objective: To provide long-term capital growth
Assets Under Management: \$816 million

CORE INVESTMENT THEMES

- Favouring Dividend Growth Companies
- Energy (Oil/Oil Sands)
- Infrastructure (Spending)/ Technology (Upgrading)
- Emerging/ Developing Markets Exposure (direct/ indirect)
- Basic Materials (Gold, Agriculture/Fertilizer, Base Metals)

CONTACT US



C.F.G. HEWARD
INVESTMENT MANAGEMENT LTD.

Tel (514) 985 5757 2115 rue de la Montagne
Email heward@heward.com Montreal, Quebec
Website www.heward.com H3G 1Z8

C.F.G. Heward Investment Management Ltd.'s primary objective with this document is to provide timely information in respect of current developments in the financial marketplace and as such it may not provide sufficient detail for investors to make fully informed investment decisions. Although we endeavor to provide accurate information, there is no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. All opinions are based on our analysis and interpretation of this information and constitute our judgment as of the date hereof and are subject to change without notice. COPYRIGHT 2010 C.F.G. Heward Investment Management Ltd. No portion of this article can be reproduced in any form, in whole or in part, without the express written permission from the copyright holder.