Quarterly Report
SUMMER 2017

HEWARD
INVESTMENT MANAGEMENT INC.

Managing Through an Upswing (Synchronized) in Global Growth and Geo-Political Uncertainty

OVERVIEW

With the first half of 2017 under our belt, there seems to be little pushback against our thesis of a synchronized global recovery. Most advanced nations are enjoying moderate economic growth, while performance in many emerging market (EM) nations is stabilizing or improving. Such synchronized growth is fairly rare. Investors have recalibrated their expectations for U.S. growth, and concerns over European politics have been alleviated. Confidence is up and growth has been exceeding official government forecasts in the UK, the Eurozone and Japan. China had shown a few signs of slowing in the spring, but the most recent growth estimates have rebounded. Even the IMF has nudged its global forecasts a little higher and is now expecting 3.5% global GDP growth this year and 3.6% in 2018.

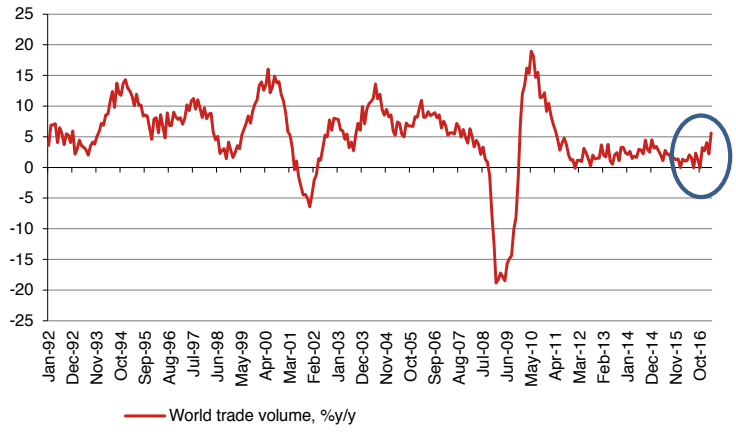
The subtext of a good part of the financial reporting about the market since the Election has been that the market keeps rising, ignoring the fact that the Trump Administration has delivered on none of its promises on the economy. This line of thinking, leads to the conclusion that the market is running on fumes and is due for an inevitable comeuppance. What has largely been lost in the discussion is that the market's rally since the election has coincided almost perfectly with an end to the four quarter earnings recession that started in the fourth quarter of 2015. First and foremost, stock prices are driven by corporate profits, and if businesses make more money, their shares become ever more valuable.

China has once again become a concern as the weak recent PMI data, the People's Bank of China (PBOC) tightening since the start of the year and the forcing of institutions to liquidate leveraged positions has unnerved markets. Armed with these developments, many analysts are now claiming that China's recovery is not sustainable, which we believe to be the wrong interpretation. Markets are failing to recognize that the economy continues to expand and measures to "clean-up" the financial sector and to remove the worst of the speculative activity are long term positives. Furthermore, with the worst of the speculative activity having been wrung out of the system, the PBOC is likely to respond quickly to any slowdown and once again begin supplying liquidity to the markets.

After chipping away for over five years with its available tools, the European Central Bank (ECB) has helped create an environment in which the euro zone economy might finally escape weak and flimsy growth. Mr. Draghi has navigated the ECB through its political, legal and operational constraints long enough for its policies to underpin the current surge in confidence. Investor excitement around Europe has jumped, leading indicators are at multi-year highs and firms have picked up the growth baton to a greater degree than previously estimated. Political risk has fallen and unemployment is declining, while growth by euro standards is robust.

Global investors have been desperate to find evidence that the mortgage problem that plagued the U.S. and the UK before the "Great Financial Crisis" is prevalent in Canada. Supplemented by lower energy and commodity prices, this has generated a big "short" mentality towards Canada. What gets ignored however is the far more limited role that lightly regulated "non-bank" institutions play in the Canadian mortgage market (banks - 74% of residential mortgages). What also seems to be ignored is the fact that lower down payment mortgages (less than 20%) are required by law to have mortgage insurance, which receive an explicit government guarantee. Furthermore, the Canadian funding model is much more retail driven, unlike the more volatile market-based funding products that were used in the U.S. and the UK.

World trade growth is at multi-month highs



Source: Haver/Netherlands Bureau of Economic Policy Analysis

UNITED STATES

The longevity of this U.S. economic cycle hinges on: 1) the tightness of money supply, 2) the health of the corporate sector, and 3) the timing of the next macro shock. History shows that one (or a combination) of those three factors brings about the end of the economic cycle. In recessions the system is then reset and the stage is now set for renewed economic expansion. In that respect, as written by Longview Economics, there was a "mini-reset" of the U.S. economy last year, in which: 1) the Fed significantly backed away from raising rates, *credit conditions eased*, 2) companies retrenched from an overstretched position, cutting capex, drawing down inventories and restoring a positive cash flow position. A phase of reacceleration (and then ongoing expansion) is therefore likely in the U.S. This will be partially driven by households who are benefitting from a strong housing wealth effect and wage growth, which is broadening and trending higher. On the surface, the recent payroll numbers appear weak, but glancing at the Job Openings & Labor Turnover Survey, job openings are plentiful and companies are reporting that they plan to spend more on employees. The unemployment rate and underemployment rate are now at levels last seen in 2007. By contrast, core inflation has disappointed in recent months. However, some of the weakness is related to methodological changes and other one-off factors. While insisting that they should not overreact to recent weaker inflation data, the Fed raised rates as generally expected. They also made it clear that there is a strong desire to implement balance sheet normalization, despite recent weak data.

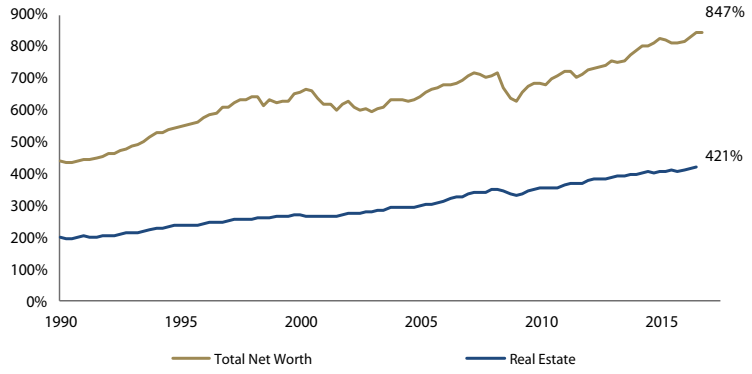
CANADA

The crisis at Home Capital had reignited worries that there is a housing bubble in Canada that could burst. Real residential property prices have increased more than in other countries and the property gap is above what the Bank of International Settlements (BIS) considers exposed levels, which points to a bubble. What foreign investors seemingly fail to grasp, is that the increase in housing prices has been driven by a few regions, and prices have responded to macro prudential measures (i.e. Vancouver), which is inconsistent with a nationwide problem. Meanwhile, strength in the Canadian economy may have pulled forward expectations for the Bank of Canada (BoC) to hike interest rates in early 2018. Through most of the recent run of stronger data, the BoC has maintained a determinedly dovish tone. However, in a recent speech, the BoC Senior Deputy Governor Carolyn Wilkins laid out the clearest signal from the central bank that they are prepared to begin removing monetary accommodation. While output growth has been impressive (modestly firmer than the BoC had forecast), she also emphasized that the Bank views recent growth as more favorable. They were also influenced by signs that growth is broadening across regions and sectors, although not all to the same extent. The adjustment to lower oil prices, increased range of industries hiring and broader output growth are all seen as positive above and beyond firmer growth itself. The BoC's adoption of a more hawkish (rate increase by September?) tone has had a positive impact on the Loonie.

EUROPE

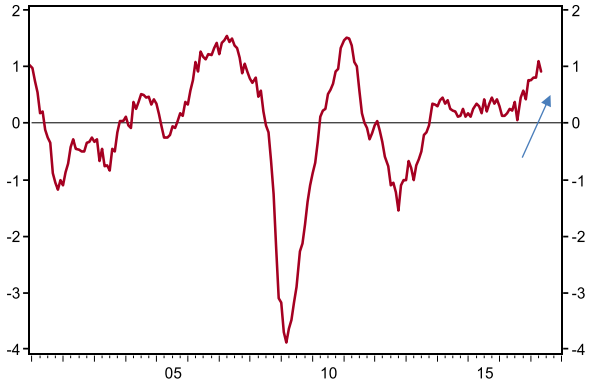
As 2017 opened, euro zone politicians still raw from the shock of the Brexit vote and the Trump presidential triumph were nervously awaiting elections in the Netherlands and France. They feared that discontent would propel the populist wave into the heart of Europe and usher in the far-right, anti-euro leaders. However, that predicted surge failed to materialize, and now the economic picture for the currency union is looking brighter. Economic growth is relatively strong and unemployment in the bloc is at its lowest in almost eight years, *and it is not all Germany*. Business surveys suggest the New Year's momentum has carried on into the second quarter, while sentiment indicators are at their highest point in ten years, a key indicator for markets as GDP growth closely tracks

While debt has been on the rise, assets have run at a significant pace as well
Ratio of total net worth and real estate investments to disposable income



Source: StatsCan; Haver Analytics; RBC CM Canadian Equity Strategy

Euro Area: Business Climate Indicator



Source: European Commission

sentiment. Nobody expected the ECB to make any changes to interest rates at their June meeting, and Mario Draghi did not disappoint. He did however deliver a modest change, moving to drop a key reference to the possibility that rates could move even lower if warranted. In the UK, the only certainty is that there will be a period of heightened uncertainty ahead. With the Tory party relying on support from the Irish DUP on key issues, it probably increases the odds of a softer, more manageable Brexit. Meanwhile, UK economic outlook appears increasingly challenged. The economy should continue to expand in the second half, but the pace is slackening. Higher inflation is eroding real income growth and weakening consumer spending. Jobs growth however, is keeping the aggregate pay packet rising and consumer confidence remains around average.

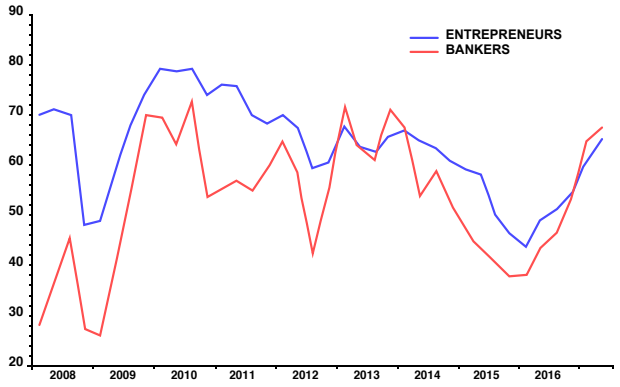
EMERGING & DEVELOPING MARKETS

Beijing's regulatory shake-up is a reversal of the past decade's financial deregulation, and should not be feared but in fact welcomed. After trying almost everything to stop capital outflows, China has stabilized forex reserves with the help of more nuanced, targeted capital controls, the stabilization of growth and stealthy rate hikes. President Xi of China has had to wage a number of internal fights which he seems to have won, in an effort to consolidate his authority and to eliminate the worst of corrupt practices. The focus is now on deleveraging the financial system, restructuring industry, and investing for the future either domestically or through One belt, One Road (OBOR) countries. Meanwhile, the PBOC's second quarter survey of entrepreneurs and bankers was at the highest level since 2013/14, hardly suggesting that China's economy is going to slow in the second half. This is supported by recent data on True M1, which correctly forecasted the slower growth in the second quarter just completed and the strong rebound in 2016. Recent high frequency data suggest that the Indian economy is getting back on track, after lagged effects from demonetization. The recovery is being led by cash-intensive rural consumption, external tailwinds and better infrastructure sector output growth. In Japan, the labor market has tightened significantly and businesses are strongly sensing a labor shortage. While Government policies should help to some degree, firms are increasing capex to maintain efficiency and productivity. This should help Japan exit from a situation of deflation and weak domestic demand and push the potential growth rate up in the mid-to-long term.

COMMODITIES

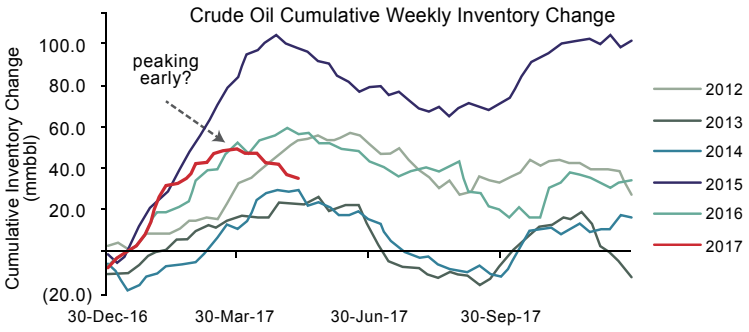
OPEC's and their partners' efforts to raise oil prices by bringing the three year old glut to an end keep running into the uncomfortable fact that rival crude supplies are proving stronger than originally feared. While the countries involved in the deal have cut as much as 1.8 million barrels a day of supply from the market, their efforts just keep getting swamped. U.S. production has risen to its highest level since 2015, and is expected to grow even faster in 2018. The young industry has shown it can squeeze costs down and compete when prices are near $50 a barrel. Furthermore, with the market still squarely focused on U.S. and Middle Eastern energy issues, there have been several political and economic developments in Russia of late that warrant close attention by energy markets. Following the PBOC's recent actions in the interbank market, it's becoming increasingly clear that the liquidity tap has been tightened a notch. This has caused ripples within the commodity complex as market participants have become less confident that order books will keep improving. However, while a slew of government cooling measures have led to some moderation in growth trends in the construction sector, activity in real estate and infrastructure remains resilient and continues to underpin steel demand. Copper is a different story, where short term markets have been negatively affected by the increased availability of scrap metal. By the third quarter this should no longer be a concern, and in a market where mine production for 2017 is forecasted to be short of actual demand, this will cause investors to re-evaluate their positions.

China PBOC Surveys: Confidence



Source: Thomson Reuters Datastream

Crude Oil Inventories Are Peaking Early in the Cycle



Source: DOE EIA; Scotiabank GBM

RECOMMENDATIONS

Economic recovery is at its strongest level since the financial crisis. This was evident at the spring meetings of the world's financial chiefs in Washington, where all participants were brimming with optimism worthy of the season. That confidence was fueled by improving performance in most of the major world economies and the belief that target-only tightening in China will not derail economic growth. Global merchandise trade (and trade growth) has been picking up, growing at about 4.0% (Citi research) in the first three months of the year. If this were to hold, it would be the first time since 2011 that global trade growth outpaces global GDP growth again. Multi-national conglomerates will see their business continue to improve as the recovery spreads across the globe. Mid-and-smaller-cap companies worldwide will benefit as domestic economies feel the rippling effects of a world wherein decoupling of the world's regional economies from one another remains firmly debunked. Furthermore, we may be on the brink of a capex recovery as CEOs put their money where their mouths are. The positive effects on GDP from inventory additions, sustained personal consumption expenditure growth and strength in investment lead us to overweight equities, with a focus on Industrials, Technology and Financials. We are positive on Energy short term, as firming crude oil and petroleum inventories appears to have already taken root while traders continue to focus on U.S. domestic production growth, *losing sight of the forest for the trees*. The decline in bond yields continued in the second quarter, resulting in a further increase in fixed income returns. However, signs of acceleration in global growth (despite uninspiring U.S. data) may start to put some upside pressure on rates in the near term. While any increase should be moderate and slow, we have reduced the duration of our bond holdings and increased our exposure to reset preferred shares, which should do better in a rising rate environment. As spreads have tightened considerably, we have increased our exposure to government bonds (federal and provincial) at the expense of corporate issues. Moreover, we remain underweight fixed income relative to our mandates.

FORECAST 2017

	Current 30-JUN-2017	2017 Range	2017 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	0.50%	0.50% - 0.75%	0.75%
Federal Funds Rate	0.82%	0.66% - 1.25%	1.25%
10-year Canadian Treasury	1.76%	1.55% - 1.95%	1.90%
10-year US Treasury	2.30%	2.15% - 2.85%	2.80%
COMMODITIES			
Gold (US$/oz.)	$1,241	$1,150 - $1,325	$1,275
Copper (US$/lb)	$2.70	$2.40 - $3.00	$2.90
Oil WTI (US$/bbl)	$46.20	$42.20 - $55.00	$54.00
MARKETS			
S&P/TSX Composite Index	15,183	15,300 - 16,800	16,750
S&P 500 Index	2,430	2,250 - 2,680	2,620
CANADIAN DOLLAR/US DOLLAR	$0.77	$0.72 - $0.80	$0.79

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