Quarterly Report
AUTUMN 2017

HEWARD
INVESTMENT MANAGEMENT INC.

The Most Unloved of Bull Markets - It's all About the Trend, not the Peak

OVERVIEW

As the current expansion approaches its 100th birthday (measured in months), numerous market watchers are already predicting its demise. The most common cause of U.S. recessions and bear markets in the postwar era has been monetary tightening by the Fed as a means of fighting inflation. Today however, while the Fed is looking to continue to gradually raise rates (in a low inflationary environment), the prevailing news is that global activity has embarked on the strongest and most synchronized period of expansion since 2010. Many of the headwinds that had been suppressing global growth are now abating, implying that real interest rates may now be below the equilibrium rate, as secular stagflation begins to fade.

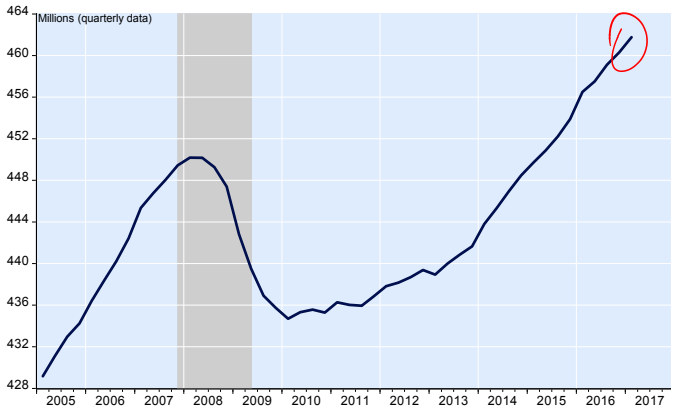
U.S. markets are contending with a rare but favorable environment: an economy that is expanding but not too fast, unemployment at multiyear lows and inflation that has remained stubbornly below the Fed's 2% target. All this suggests to investors that the Fed is unlikely to raise rates aggressively. Furthermore, with economists projecting a pickup in global growth and a weakening dollar, we have a combination that is helping boost earnings of multinational companies. This can be seen in the earnings reports of most S&P 500 companies (both domestic and multinational) who are on track to report strong numbers for 2017. This bodes well for the stock market, whose trajectory is ultimately determined by the rate of earnings growth.

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 has finally escaped 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 that euro zone is witnessing. Investor excitement around Europe has escalated as numerous leading indicators are at multi-year highs. Although rising headline inflation has squeezed incomes and appears to be weighing on household consumption as expected, the corporate sector seems to have picked up the growth baton to a greater degree than previously anticipated.

Markets have been buffeted by North Korea's nuclear threat. While most agree that a severe response is called for, and would like China to do it (economically), the view is that China would not implement harsh sanctions on its neighbor. China has two major objectives: to become the largest economy in the world, and to play a major role in international geopolitics. The first will happen naturally, probably by the mid 2030's. If China took steps to scale back or stop North Korea's nuclear development program, that would catapult it to a highly respected position among world leaders. However, no significant policy move is going to take place before the meeting of the People's Congress in November, where Xi Jinping will try to solidify his power.

While it is still too early to sound the death knell for the U.S. dollar bull market, the selloff needs to be monitored closely. To rebound, however, the dollar needs U.S. inflation to regain its footing, policy action by the Trump administration, and for investors to believe that the Fed will once again raise rates. Meanwhile, the Canadian dollar has been on a tear, rising over 10% against its U.S. counterpart from its May lows. It has been boosted by a string of strong economic indicators and policy rate increases by the Bank of Canada. Sentiment turned after May's data showed exports jumped nearly 18%, triggering the first hike. A strong 2Q GDP number, employment indicators, retail sales and business related intentions gave the Bank of Canada further confidence that the time was right for the second rate hike in early September.

World: This is finally starting to look like an expansion
Total employment in the advanced economies (G7 and rest of EU 28)



Source: NBF Economics and Strategy

UNITED STATES

The U.S. economy rebounded from a disappointing start to the year. Key drivers of growth were consumer spending, fixed asset investment (led by non-residential and equipment spending), trade and government expenditures. The ISM Manufacturing Index remains at levels consistent with annualized GDP levels considerably higher than current forecasts while the ISM New Orders Index has remained elevated for six of the last eight month. The New Orders Index is a key leading indicator of both capital spending trends and S&P 500 earnings. Furthermore, the current pace of growth is broad based and that indicates that the economy is stable and that the business cycle should get extended in the absence of any serious inflationary pressures and a sharp adjustment in monetary policy. With cyclical momentum indicators strong, payroll growth running well above what the Fed believes is sustainable, the Fed is poised to "stick with the program;" balance sheet reduction and further rate hikes. Meanwhile, the Federal Open Market Committee (FOMC) minutes did show policy makers puzzled and exploring possible explanations as to why low inflation and low unemployment are currently coexisting. The other major risk is a possible serious policy error coming out of the White House. Fortunately, there seems to be a new mood of discipline in the West Wing since John Kelly became chief of staff. While the president remains unpredictable, the organizational chaos that existed before seems to have been transformed by his leadership. Steve Bannon's departure is another sign of greater discipline within the White House.

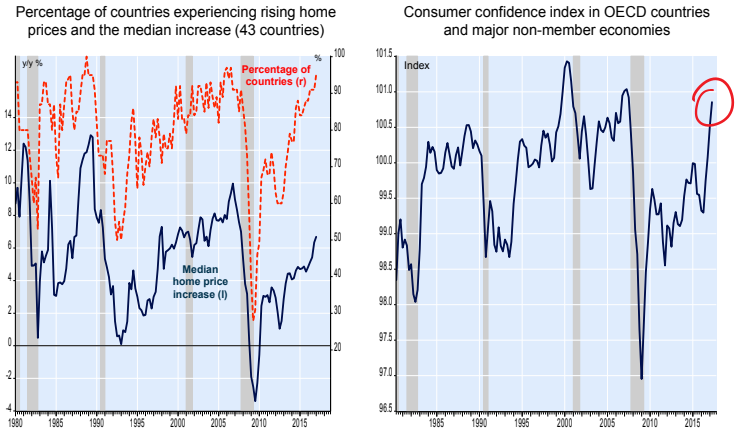
CANADA

For some time now, both the Bank of Canada (BoC) and the business community have used weakness in the Loonie to herald the imminent arrival of improved exports. Weakness, they professed, would result in tighter capacity constraints and support for increased business investment. For most of this period, "serial disappointment" has been the norm, until July when the BoC specifically cited improved exporter optimism as one of the reasons for the 25bp hike. The central bank then forged ahead with another interest rate hike in September, citing that Canada's stronger than expected economic performance warranted a removal of some of the "considerable" stimulus in place. Given the economy's strong growth profile and the U.S. Federal Reserve hiking cycle, odds are that they will continue to raise rates through 2018. Housing developments remain a crucial variable in Canada's outlook and thus far it seems to be a continuation of the construction trends that have been in place for an extended period of time. While the latest data did point to somewhat softer household formation trends, there are few signs that construction is poised to slow. Furthermore, while permits issued remain at elevated levels, a closer examination of the long run supply and demand fundamentals suggest they are within historical norms. Foreign Affairs Minister Chrystia Freeland outlined Canada's goals for NAFTA renegotiation, and while done with a tone of optimism, clear lines in the sand were drawn regarding some of the U.S.'s more controversial demands. She also signaled that Canadian exit from NAFTA was an option should talks sour.

EUROPE

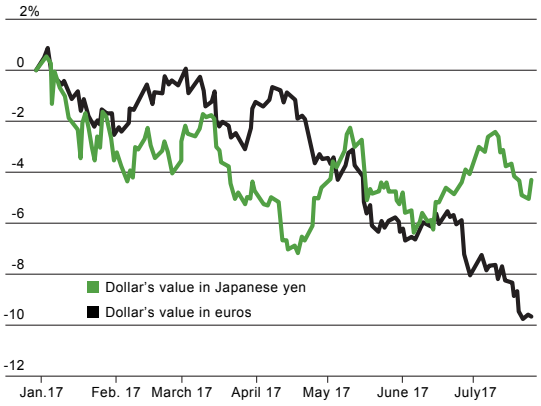
You don't have to climb one of the mountain peaks in the Alps to feel breathless this summer, as just keeping an eye on the euro's steady climb would probably suffice, and it may not yet be at its peak! As it stands, the euro's strength will make it increasingly difficult for the European Central Bank (ECB) to insure that inflation will head back to its target. In spite of this, ECB President Mario Draghi has begun to discuss in relatively explicit terms the possibility of a tapering, something that is likely to begin once existing asset-buy programs expire in December. Meanwhile, economic data continues to be upbeat and economic growth has rebounded to more than respectable levels. The Purchasing Managers' Index (PMI) remains in expansionary territory, French confidence is holding at multi-year highs,

World: Consumer optimism at the highest in a decade



Source: NBF Economics and Strategy (data via Datastreamand OECD)

Since the beginning of the year, the U.S. dollar has declined against the Japanese yen, and more sharply against the euro.



Source: Outset global trading

and German business and consumer confidence remains elevated. There is even a whiff of optimism about the Italian economy. A state bail-out in July of the country's oldest bank, coupled with the rescue of two lenders in the Veneto region, has left the troubled financial sector looking healthier. Brexit continues to negatively impact the UK economy via inflation and consumer spending. Despite the robust labor market, consumers are no longer the work horse of the economy. While more people are becoming employed, real wage growth is in negative territory and residents are spending less in volume terms, using debt to pay for necessities. Even though a smooth transition to Brexit may have been assumed as a central case, uncertainties about the final arrangements are already weighing on business decisions. Investment plans should be significantly stronger, given the pickup in the National Account measures of profit seen thus far.

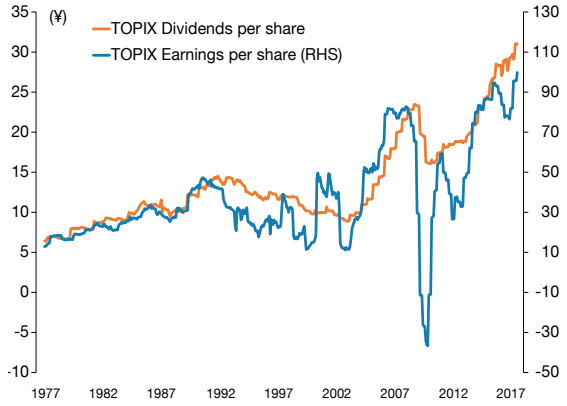
EMERGING & DEVELOPING MARKETS

The most important political event of the year for China, the 19th Party Congress, will open in November. The Political report, presented by Xi Jinping, will set the policy priorities for the country in the next five years. The report will likely highlight the "new normal" status of China's economy, where decelerating growth is a reality, but not a problem. It will also emphasize the transition to innovation-driven growth. The "New Economy" spending now accounts for one third of GDP (2016) but closer to 70% if the spill-over effects are included. China plans to move from being an innovation sponge to becoming an innovation leader by spending heavily on R&D and the sciences, and by better utilizing their 30,000 odd science PhDs annual graduates. Meanwhile, consumer confidence rose to the highest level since 1996, business confidence continues to improve and industry profits are recovering well. Japan is improving glacially and quietly in the background of the global stage. While manufacturing PMIs have ticked down fractionally and the third quarter started off with exports stagnating, hiring and optimism hit multi-year highs. Small business confidence continues to improve and the IMF has revised upwards its outlook for Japan. Closing of the output gap, a tighter labor market and a highly accommodative Bank of Japan are likely to drive Japan back into a sustained inflationary environment. While, the crisis on the Korean peninsula has been escalating for over a year now, the regional economy is actually getting a bit stronger. The region is quite levered to global trade and after a slowdown in 2016 global trade is back on track.

COMMODITIES

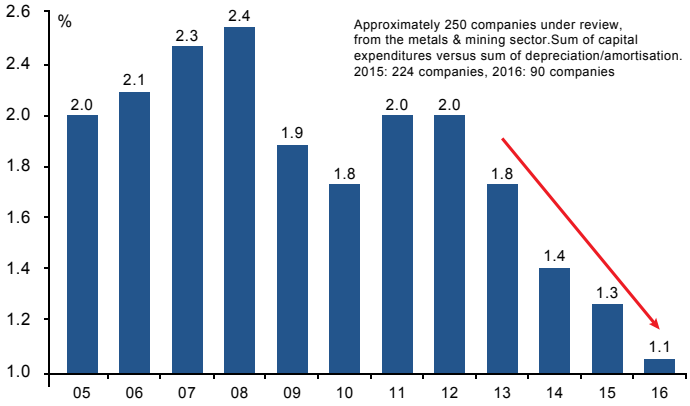
Oil markets are enjoying a number of tailwinds: healthy demand, modest production increases (2017), declining inventories and a bout of U.S. dollar weakness. Prices are well supported for now, but as we venture into 2018, markets face the end of OPEC/non-OPEC production cuts and uncertainty over China's stockpiling intent. For now however, demand strength remains a key highlight as for the third consecutive year oil demand is set to grow well above historical trend levels. Furthermore, while there is little doubt that the market remains well supplied with crude and refinery runs are well above last year's levels, global crude oil inventories are declining while finished product stocks are not building. Rising "breakeven" economics for U.S. shale production should also be supportive of higher oil prices. The backdrop for industrial metals is looking more supportive than it has in years. After consolidating for the better part of a year, copper has quietly accelerated and broken out to new highs. While not having the same demand/supply characteristics, aluminum, iron ore and zinc have also rallied over the summer. Furthermore, M&A activity within the sector has picked up as companies look to make acquisitions and/or take toehold stakes to supplement their depleting reserves and declining production profiles. The gold price has climbed noticeably above the $1,300 mark to reach its highest level in over a year. It has been driven up by the significant depreciation of the U.S. dollar, the ongoing political wrangling in Washington and the North Korean situation.

TOPIX Trailing 12-month EPS and DPS - Both at an all-time high



Source: Bloomberg, Morgan Stanley Research. Data as of July 31 2017.

Capex to depreciation ratio of global miners supply won't follow



Source: Rio Tinto, Factset, SG Cross Asset Research.

RECOMMENDATIONS

Our focus remains on improved economic fundamentals worldwide as well as relatively strong corporate earnings. Monetary conditions are signaling a rebound in global economic activity and OECD's Composite leading indicators are confirming the recovery. Growth is gaining momentum in France, Germany, Brazil, China and five major Asian countries, with stable growth in nearly all others. The U.S. economy is growing at a 2.0 - 2.2% annualized rate that appears to be sustainable, even without added stimulus from the administration's current agenda. At the end of August, China's two economic ministers stated that the government will be "more proactive and effective in implementing a pro-growth fiscal policy", a strong signal that fiscal purse strings will be loosened. While bears can make a case that valuations are too lofty, economic and monetary indicators disagree. Both GDP growth and unemployment are not excessive relative to their respective averages at prior market tops. Neither are housing starts, the yield on 10-year treasuries nor the yield curve. Real narrow (M1) money growth, while slightly below recovery averages, remains healthy. Finally, while not fearful, investor sentiment is far from exuberant, and bull markets tend to go out with a "bang" not a "whimper".

Given this scenario, we continue to over-weight equities, using the recent strength of the Canadian dollar to increase foreign exposure (while remaining overweight Canada). We have increased our exposure to late cycle sectors, favoring financials, technology and materials (base metal producers should benefit from sustained global growth). Healthcare remains a key theme while we look for a trade to develop in energy. It was a difficult quarter for the fixed income component of investment portfolios as strong economic data, dwindling unemployment and upward pressure on inflation changed investors' outlook on interest rates. With both the Fed and Bank of Canada raising base rates, bond markets went into a tailspin resulting in a -1.65% return for the benchmark through the quarter. Due to a more conservative average term and the positive contribution from preferred shares, convertible bonds and higher yielding equities, our fixed income component was down marginally 0.25%. As we expect upside pressure on interest rates to continue over the next few quarters, albeit at a slower pace, we will continue to take a more cautious stance. Our slight over weight in preferred shares, convertible bonds and select higher yield equities should contribute to better than benchmark returns.

FORECAST 2017

	Current 30-SEPT-2017	2017 Range	2017 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	1.00%	0.50% - 1.00%	1.00%
Federal Funds Rate	1.25%	0.65% - 1.50%	1.50%
10-year Canadian Treasury	2.11%	1.55% - 2.40%	2.35%
10-year US Treasury	2.33%	2.05% - 2.60%	2.55%
COMMODITIES			
Gold (US$/oz.)	$1,280	$1,150 - $1,350	$1,325
Copper (US$/lb)	$2.94	$2.40 - $3.25	$3.20
Oil WTI (US$/bbl)	$51.67	$42.20 - $55.00	$54.00
MARKETS			
S&P/TSX Composite Index	15,635	14,468 - 16,800	16,700
S&P 500 Index	2,519	2,250 - 2,680	2,670
CANADIAN DOLLAR/US DOLLAR	$0.80	$0.72 - $0.83	$0.81

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