Quarterly Report
SPRING 2017

HEWARD
INVESTMENT MANAGEMENT INC.

Balancing the Investment Scales - Positive Economics versus Political Uncertainty

OVERVIEW

Economic and political cycles have a habit of being out of sync, but today, almost ten years after the most severe financial crisis since the Depression, a broad-based economic upswing seems to be under way. In the U.S., Europe, Asia and the emerging markets, for the first time since a brief rebound in 2010, all cylinders seem to be firing at once. However, the political mood seems to be sour. A populist rebellion, nurtured by years of sluggish growth, is still spreading. An economic nationalist sits in the White House while markets focus on upcoming elections in Europe and the various malcontents. If populist politicians win credit for a more buoyant economy, their policies will gain credence, with potentially devastating effects. As the long awaited upswing lifts spirits and spreads confidence, the big concern is what lies behind it?

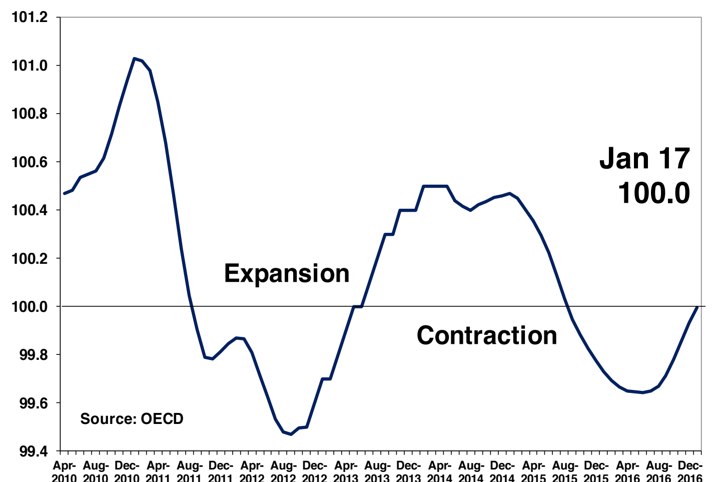
The most striking feature of the "consensus" global economic outlook is the current low level of standard deviation measured across individual forecasters, despite the numerous points of policy uncertainty. This suggests that economic agents have learnt to live with higher levels of uncertainty shocks such as the ones that have struck over the last two years, be it China, fears on global growth, Brexit or the Trump victory. Ultimately, each of these events (at least thus far), has had a far more modest impact than initially feared. A key reason has been the rapid reaction of central banks and their dovish monetary policies. Moreover, some of these shocks are fairly slow moving. Brexit will take time to unfold and, for now, the UK remains a full member of the European Union. Similarly, it will be several months yet before clarity is reached on the Trump administration's fiscal policy.

After years of fighting against deflation, the U.S., the euro zone and Japan are showing glimmers of life in consumer prices and wages, evidence that an era of exceptionally low inflation is receding from the economic landscape. Several factors are behind the move, including; improving growth, a recovery in commodity prices, tightening labor markets, the potential for fiscal stimulus, rumblings of protectionist policies, a rebound in energy prices and easy credit conditions. As the inflation picture trends back to normalization, we should see continued gradual tightening of monetary policy, albeit there will be some notable exceptions. In turn, bond yields should continue their upward climb with the U.S. economy leading the global cycle.

The problem with oil is that there is always too much or too little. By March oil markets once again feared that there was "too much" due to a surprise build in inventories and comments from Saudi Arabia's oil minister that OPEC may not extend its current production cutbacks. However, investors fretting about too much oil supply may get some cheer from demand, or at least the statistics that constantly underestimate it. The International Energy Agency's (IEA) closely watched estimates of global crude demand have been revised up for the past seven years. Thus far, the IEA has already raised its 2017 demand forecast by 200,000 barrels a day. Furthermore, while the Permian basin in the U.S. has received all the accolades (raised production), there are supply challenges in other parts of the world which have more than offset these increases.

While there is much to like about the markets, there are many good reasons to hit the pause button. The decision to cancel the vote on the controversial Affordable Health Care Act (AHCA) represents the rejection of the legislation from both the right and the left, and casts a pall over expectations that the Republicans can govern effectively enough to deliver on other priorities. Also, the reflationary/Trump trade sectors require time to correct following a near-parabolic post-election rally. Furthermore, markets are elevated and it is difficult to find cheap stocks. As such, we continue to operate with caution until the policy fog dissipates.

OECD Composite Leading Indicator – Amplitude Adjusted



Source: CPB World Trade Monitor, Moody's Analytics

UNITED STATES

There is more to the U.S. economy than the occupant of the Oval Office, but you might not know that looking at confidence surveys. Since the election, consumer and business sentiment surveys have been scrambled like never before along partisan lines. Confidence among Republicans has soared while it has crumbled for Democrats, even though most measures show little change in how the economy is behaving. While not buying in to any "Trump" boost to economic growth, employment or inflation, Fed policy makers raised rates for the first time this year. Monetary conditions remain loose however, as the Fed still see the risks as being "roughly balanced" and stuck with its promise to tighten at a "gradual" pace. Meanwhile, amid the din of immigration lawsuits and setbacks in filling political appointments, President Trump announced that he will present a tax reduction plan, to coincide with the bi-annual release of the Office of Management and Budget (OMB) budget. This is expected to contain a "wish list" of the Administration's 10-year tax and spending policies, including tax cuts, infrastructure spending and assorted reforms. Investors however, are now worried that the failure to pass the AHCA could put the entire Trump pro-business agenda in jeopardy, especially tax reform. His plan for a border crackdown on immigration could become a significant restraint on the labor force growth while a more general tightening of border security could also dissuade foreign visitors to the U.S., both of which would be negative for the general economy. Meanwhile, the most encouraging part of the recent positive jobs report was the continuing return of prime age workers (age 25 to 54) to the labor market.

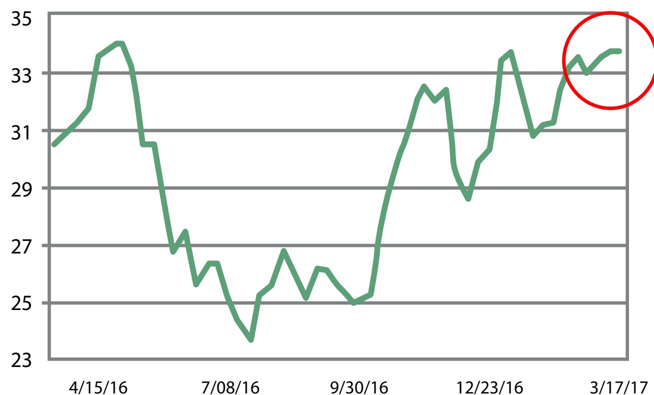
CANADA

The recent budget was somewhat less than exciting, mainly because last year's budget laid out all the big numbers, and because the targets for debt-to-GDP ratio only allowed for modest new spending. Some of the themes from their first budget, innovation in particular, are now seeing detailed initiatives, while fears of sweeping new tax hikes (i.e. taxes on capital gains) were allayed, at least for now. Meanwhile, overall growth is expected to improve in 2017 as the latest Business Outlook Survey sees an improvement in business sentiment, while consumer spending should remain a major contributor to growth fuelled by strong employment gains. Household indebtedness remains a concern however, and may constrain some spending. Inflation, which should remain around 2.0%, may be volatile, subject to a base effect from the energy components. It will also likely remain in a tug-of-war between continued pass through from a weaker Canadian dollar and the impact of continued excess supply. Furthermore, the stabilization of the Alberta economy is a welcome sign, even though it looks like we may be entering a relatively slow/flat growth environment. While there is much uncertainty about the future of trade relations between Canada and the U.S. following the election of President Trump, it should be noted that the U.S. administration's focus is mainly on countries with which the U.S. has a trade deficit (surplus with Canada). Furthermore, we are also the main customer of U.S. goods and services. Similarly, the renegotiation of NAFTA promised by president Trump seems mainly directed at the relationship with Mexico, not Canada.

EUROPE

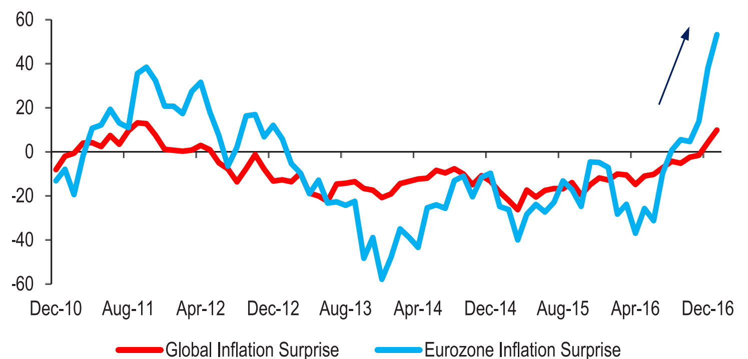
2016 saw a net outflow from European equities as many investors gave up on continental Europe. This stance made sense when optimism was riding high in the U.S. and the risk of further populist upsets in Europe were all that anyone could talk about. With the French and German elections getting closer there is still scope for voters to cause investors trouble. However, for the first time in many years, there is also a non-negligible chance that politics in the euro zone will not just muddle along, but end the year in a stronger position to support growth and reform. Meanwhile, both growth and inflation continue to accelerate, and Europe has been faring better than the U.S. in the latest indices of surprises. Some countries like Italy, Portugal and France are lagging behind, but others are steaming ahead at well over

Moody's Economy.com Survey of Business Confidence Diffusion Index 4 wk MA



Source: CPB World Trade Monitor, Moody's Analytics

Inflation is also surprising to the upside globally, but especially in Europe (data surprise indices)



Source: Bloomberg. Inflation data surprise indices.

2.0% growth. Furthermore, the European Central Bank (ECB) monetary policy stimulus is starting to benefit the real economy. The boost in lending activity has resulted in a turn in investment, job creation and Purchasing Managers' Index (PMI), resulting in Euro area growth surprising to the upside. European growth has been hard to notice, in part because the commodity and financial sectors have been depressing earnings. Earnings however, should accelerate in Europe over the next 18 - 24 months. In the U.K., real income growth has slowed significantly since June, house price inflation looks soft, jobs are the weakest in three years, retail surveys are weak and consumer confidence is falling. Consumers here are stretching themselves, keeping the economy growing solidly but probably at the cost of a marked change in fortunes to be seen as we move towards Brexit.

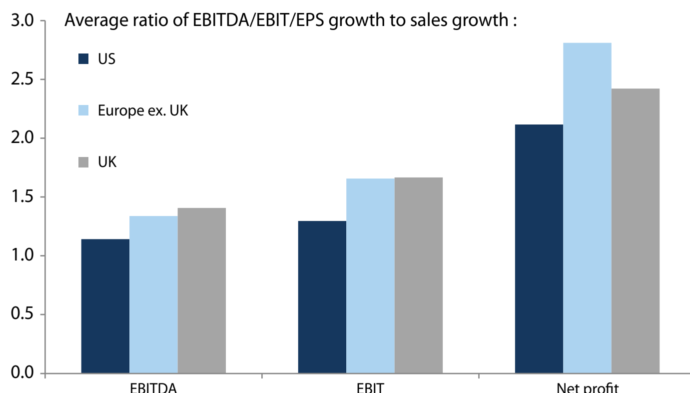
EMERGING & DEVELOPING MARKETS

Economic indicators confirm a strong 2017 start for China's economy. The country is embracing tried-and-true economic growth drivers, betting that it can contain rising financial risks without making painful overhauls in what is shaping up to be a sensitive political year. Yet, throughout this journey doubts have been raised about its sustainability. Although investors have turned more skeptical, China is positioned to avoid a financial shock and complete its transition towards high-value added manufacturing and services. In February, the People Bank of China (PBoC) tapped on the brakes and moved to a slightly less accommodative stance by nudging up the 7-day repo rate and working with other regulators to slow off-balance-sheet financing. Furthermore, decisive steps are being taken to reform the financial system, not the least being the appointment of Guo Shuqing (known as a reformist), to head up the China Banking Regulatory Commission (CBRC). One central bank that seems to have learnt from its mistakes is the Bank of Japan (BOJ). The shift to yield curve control has worked nicely for Japan. It prevents fiscal easing from boosting borrowing costs and crowding out private investment. It also means the global bond market sell-off helps Japan, by weakening the Yen, rather than hurting Japan by raising borrowing costs. Moreover, the BOJ has committed to continue expanding its balance sheet until inflation exceeds 2.0% on a sustainable basis. A ray of hope for a pickup in the global economy has lately emerged, as Korean export growth surged to a multi-year high. Given the close correlation between Korean exports and world trade, this improving trend is another indicator of a pickup in global activity (especially manufacturing).

COMMODITIES

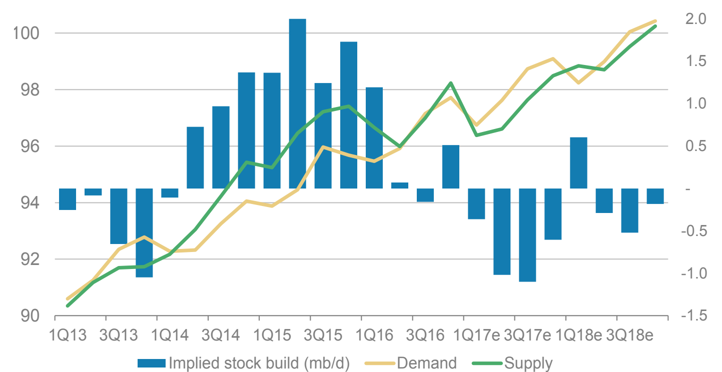
Headline data is commanding the hearts and minds of the oil market while the deeper fundamentals are being brushed aside. The short term focus has been on U.S. shale producers as they work hard to disrupt OPEC's price stabilization strategy, hedge funds that had pledged a record amount of long bets in the oil market and a U.S. rig count that was busy rising by 40.0% year over year. Finally, one too many elevated U.S. crude inventory reports sent prices into a tailspin. It seems like the oil market is more concerned about its front bumper instead of looking a mile down the road, ignoring the anticipated demand growth over the next few years. With the high compliance to the proposed OPEC/non-OPEC cuts, along with the macro data suggesting that the strong growth momentum of late 2016 is continuing, we see rebalancing oil markets and an eventual gradual draw in global inventories. During the commodity super-cycle, prices largely marched up and down in unison, fuelled by the strength (or weakness) of demand in China. Up until recently, commodity prices had been enjoying their best run in years, fresh evidence that investors are betting on a pickup in global economy, after years of sluggish growth and scant inflation. Mining executives have started sounding triumphalist and hedge funds have piled back in. The latest global growth forecasts and acceleration in demand for copper should create a deficit in copper sooner than expected, a huge reversal from a year ago where chants of "surplus" were rampant. Furthermore, as metal markets don't have an immediate response like "shale oil", this spells supply problems for the next few years.

Europe has had the highest net profit growth to sales growth. Sensitivity to changes in sales since 1982.



Source: Worldscope, Datastream, Goldman Sachs Global Investment Research

Global supply/demand balance



Source: IEA, Morgan Stanley Research; e = Morgan Stanley Research estimates

RECOMMENDATIONS

For the last six months or so there has been increasing evidence of growing economic activity. It has been clearest in the export-oriented economies of Asia, but also in Europe, in the Americas and even in hard hit markets like Russia and Brazil. However, markets are currently in that part of the cycle where every piece of news is a reason to buy equities. Inflation is rising, a sign that the global economy is picking up, and investors have been salivating at the prospect of nice fat tax cuts from the new president. Furthermore, the potential that Trump triggers a new global trade war and the risks of a victory for the far right in the imminent French elections, are being brushed under the carpet. While this kind of herd behavior may provide a temptation, when everyone else is buying, to swallow any doubts and do likewise, we believe a pull-back is looming, and prefer to wait before committing additional funds to equities. As we still have an accommodative monetary policy coupled with fiscal and regulatory stimulus, we should see stronger growth later this year. More importantly, the failure of the American Health Care Association (AHCA) shouldn't prevent Congress from regrouping on tax reform. Indeed, the Republicans may now try to find common ground to accomplish one of their two key agenda items following the election as well as to protect their mandate ahead of the 2018 Midterm elections. This should induce the future outperformance of cyclicals and financials, which along with the material and energy stocks will become our focus groups as we redeploy cash and build up the economically sensitive segment of our portfolios. In the process we expect to reduce our percentage exposure to Canada, in favor of increased European and International equities. After an initial rise in interest rates earlier this year, long term interest rates found themselves declining by quarter end. Markets perceived that Trump's failure to replace Obama Care would also result in a failure to enact his economic stimulation and tax plans any time soon. Dovish talk by the Federal Reserve did not help. However, we do not see a return to a low rate environment. Rather, despite a better global economic environment, the risk of a quick and strong upward move (as many expected) in rates is not imminent. Under this scenario, a combination of medium and short term bonds, complemented by convertible debentures, preferred shares, REITs and select high yielding equities, will allow our fixed income component to provide better than benchmark returns.

FORECAST 2017

	Current 31-MAR-2017	2017 Range	2017 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	0.50%	0.50% - 0.50%	0.50%
Federal Funds Rate	0.82%	0.66% - 1.16%	1.16%
10-year Canadian Treasury	1.62%	1.55% - 1.95%	1.90%
10-year US Treasury	2.45%	2.20% - 2.85%	2.80%
COMMODITIES			
Gold (US$/oz.)	$1,247	$1,150 - $1,300	$1,275
Copper (US$/lb)	$2.65	$2.40 - $3.00	$2.90
Oil WTI (US$/bbl)	$50.60	$47.20 - $62.00	$60.00
MARKETS			
S&P/TSX Composite Index	15,548	15,300 - 17,200	17,000
S&P 500 Index	2,362	2,250 - 2,500	2,480
CANADIAN DOLLAR/US DOLLAR	$0.75	$0.72 - $0.78	$0.78

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