Quarterly Report
AUTUMN 2016

HEWARD
INVESTMENT MANAGEMENT INC.

Managing for the Environment We Are In...
Rather Than the One We Would Like It to Be

OVERVIEW

Irrespective of what is going on with regards to monetary or fiscal policy, geopolitical happenings or natural disasters, there is always the business cycle. While this business cycle has clearly been different, being able to identify shifts from one phase to another remains critical when crafting a framework for an economic outlook. Currently, there are enough signs to suggest that the U.S. economy has moved into the late phase of its economic expansion. However, lest we ruffle feathers unnecessarily, "late" need not be a dirty word. Not only is it an important phase of the business cycle, but it can last anywhere from several months to several years.

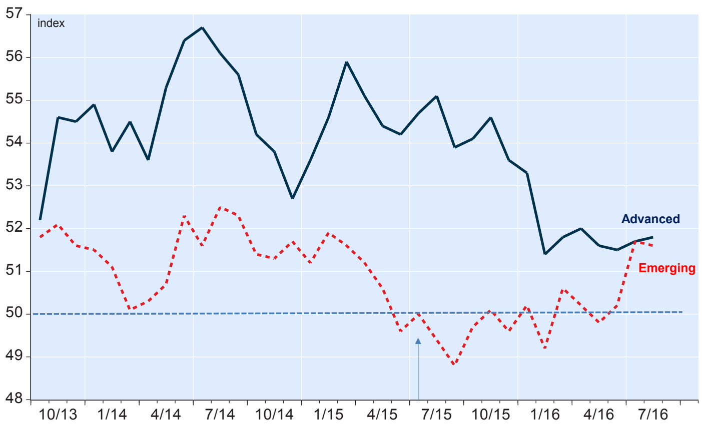
Austerity is now all but over. While the July G20 finance ministers meeting in Chengdu did not appear to endorse any major policy initiatives, a closer inspection of the communique would reveal a strong desire for fiscal policy to be implemented. Meanwhile the IMF, in its April report, suggested that "fiscal policy should stand ready to support demand and bolster monetary policy where needed". While markets scrutinize fixed asset investment data in China, ironically they should also be glancing more at budget numbers closer to home. Regardless of who wins the White House in November, fiscal spending is going to rise. Mr. Trump is known to love debt and Hillary Clinton has already laid out big ticket proposals. With the UK set to do a "fiscal reset" in Autumn if need be and Japan open to rolling fiscal stimulus, there are more surprises to come.

Until September, fixed income investors had everything going their way. However, in recent weeks bond markets have been shaken by three different events and long dated bond yields have shot higher. The movement has its roots in Japan, with the government now emphasizing fiscal stimulus and the central bank signaling a desire for a steeper yield curve. In the U.S., the Federal Reserve has maintained the optionality for a rate hike sometime in 2016. Furthermore, the most recent European Central Bank (ECB) meeting seemed to confirm the notion that European bond yields are so suppressed that the ECB can be less dovish. However, while these moves are substantial *and low yields have been the predominant driver of equity markets,* they should not be seen as a regime change for markets. While at the margin the environment for bonds is less friendly, bond yields will stay low by historical standards, just not as low as they have been.

Given the Brexit vote, the failed Turkish coup and the nomination of Donald Trump as the Republican presidential candidate, it's hardly surprising that geopolitics and protectionism are often cited as two of the biggest risks facing financial markets today. Those who operate within the financial markets instinctively favor the free flow of goods, people and capital. The multilateral system of institutions, rules and alliances has underpinned global prosperity for seven decades. It has enabled the rebuilding of post-war Europe, sawed off the closed world of Soviet communism and, by connecting China to the global economy, brought about the greatest poverty reduction in history. Politicians today however, find themselves stuck between voter demands for local control and the international forces that shape economies.

While there seems to be a growing appetite to raise rates on the Federal Open Market Committe (FOMC), the Fed decided to leave rates unchanged. Not only was the meeting about as close as one can get to raising interest rates, but in further parsing their communique, it shows a bizarre display of "pretzel logic". While claiming that the case for an increase in federal funds rate had strengthened, they "decided, for the time being, to wait for further evidence of continued progress towards its objectives". It continues to look like Ms. Yellen is attempting to soothe the various markets.

World: Perspective on economic momentum
Markit PMIs: Emerging and advanced ecnomies



Source: NBF Economics and Strategy (data via Bloomberg)

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UNITED STATES

Although GDP growth had disappointed through the first half of the year, most tracking models have the U.S. economy gathering a little momentum in the third quarter. However, the longest slide in worker productivity since the late 1970's is haunting the economy's longer-term prospects. Furthermore, the most recent numbers for construction are indicating that spending contracted in both July and August, proving that the factory sector was not the only misfiring part of the economy over the summer. However, after a sharp drop in August, the rebound in the ISM manufacturing index in September should soothe fears that the U.S. economy is headed for a serious downturn. The new numbers are not only welcomed, but logical. The weak August number was difficult to square with the signals coming from the timelier regional surveys, as well as the improved global manufacturing picture, particularly in China. Meanwhile, the latest JOLT survey suggest that labor market conditions continue to tighten, which should generate an acceleration in wage growth. While the pace of hiring has slowed recently, job openings remain unusually high and the voluntary "quits" rate has hovered around 2.0% for the last few months, *both unusual levels for the current level of unemployment.* While the strength in consumption through the second quarter was largely funded by a decline in the savings rate, consumer spending should continue to grow in the months ahead. Banks continue to loosen lending standards on mortgages and other consumer loans and confidence has held broadly steady at a high level based on past standards.

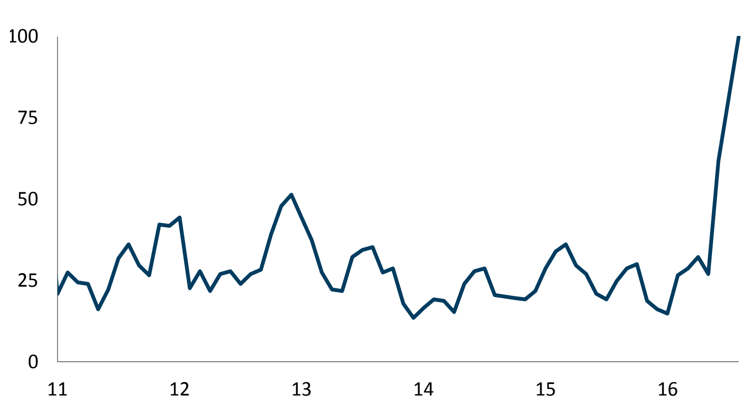
CANADA

Low interest rates around the world are fueling a familiar threat of housing bubbles, and central bankers are caught between supporting their economies and addressing financial threats. The problem is being acutely felt in Canada, where home prices are soaring even as the country's energy and mining dependent economy slows. Yet, even as the Bank of Canada governor Stephen Poloz worries about a potential bust, he is on record saying that rising home prices wouldn't prevent him from driving rates even lower if he believed that the economy needed to be stimulated. Meanwhile, data released since the last bank of Canada rate decision has been mixed. Employment growth remains weak although the broader measures of labor market slack (including the bank's own composite labor market indicator) remain at or below levels that prevailed at the end of last year. Headline GDP growth in the second quarter was slightly weaker than forecast, with the difference entirely attributable to the larger-than-assumed disruption to activity in the oil patch from the Fort McMurray fires. They will ultimately prove to be transitory, as the third quarter should come in much stronger. There are some concerns about export growth which posted weak numbers. Part was due to the wildfires and pullback in energy exports, but non-energy was also down (14%). This however, was probably due more to volatility than an actual trend, and with the U.S. economy expected to show good growth into year end, exports should rebound. Meanwhile, consumers increased their appetite for both mortgage and consumer loans, but debt-to-asset and household net worth were unchanged reflecting increased asset values.

EUROPE

The Euro Zone has weathered the turbulence of the H1-16 surprisingly well as indicated by average quarterly GDP growth rates which remain above trend. Sentiment indicators post-June on balance suggest that the heightened uncertainty has only had a moderate adverse impact on investment thus far. Clearly there is some weakness visible in the manufacturing sector, but for now it is being outweighed by gains in the quantitatively more important services sector. While manufacturing PMIs indicate that cross-country divergence of growth is set to increase, consumer confidence remains robust. Meanwhile, underlying price pressures in Germany have increased, presenting further upside for Euro Zone inflation, though it is unclear how swiftly this will be reflected in core CPI. While the ECB decided to leave their QE program unchanged (speculation had them extending the length of the

Popularity of News Searches for "Fiscal Stimulus"



Note: 100 is peak popularity for the search period; 3-month moving average

Source: Google Trends and RBC Capital Markets

China Nominal GDP & Narrow/Broad Money Growth

Source: Thomson Reuters Datastream

plan), markets remain hopeful to see more stimuli on the way from fiscal policy. It would be logical to expect governments to use this fiscal space, especially ahead of elections in France and Germany. In the UK, Bank of England Governor Mark Carney took pre-emptive measures to loosen monetary policy ahead of a post-Brexit slowdown. He cut the benchmark interest rates to record lows, alongside a bond buying program (larger than expected) which included a corporate debt segment as well as a new funding scheme for banks. At the same time, the Bank of England (BoE) downgraded their assessment of the economy for 2017. However, to almost no one's surprise, the MPC voted unanimously to keep its stance on monetary policy unchanged at the September meeting.

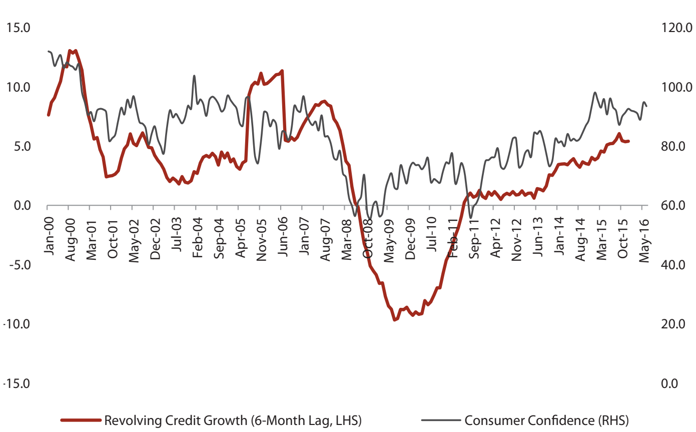
EMERGING & DEVELOPING MARKETS

China is going through a difficult transition, both economically and politically. Both are intertwined as the country has always been about politics. Until the politics are sorted out reform, restructuring and growth will be muted. There are signs that president Xi may be about to consolidate his authority. If successful, the world will be surprised by the recovery of this trilogy. Meanwhile, although first half growth was mediocre for the country as a whole, many provinces did show solid growth which has laid the foundation for growth to accelerate in the second half and into 2017. Accelerated growth will largely be built around 25 infrastructure projects which the NDRC has recently released, a recovery in real estate construction, continued gains in consumer spending, widening the fiscal deficit and improvements in foreign trade. The three large policy banks, which have raised $509 billion this year, will finance most of these projects. A key leading indicator, "True M1" has been suggesting for some time that business activity will be on the rise. In an effort to kick start its long moribund economy Japan announced a $45 Billion stimulus package. Furthermore, the Bank of Japan (BOJ) added a long-term interest rate target to its massive asset-buying program, overhauling its policy framework and recommitting to reach its 2 percent inflation target as quickly as possible, but will it work? Japanese consumers seem to have given up on their policymakers as surveys show confidence has once again declined. However, a series of indicators in late July were stronger than expected and recent PMI numbers were positive.

COMMODITIES

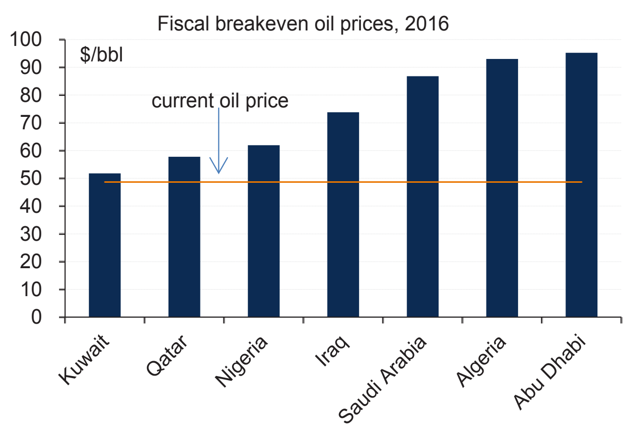
At their Algiers meeting OPEC reached an understanding that a crude oil production cut is needed to lift petroleum prices. While clearly supportive for prices (lifts the downside risks), the real significance of the agreement is not the size of the implied or actual production cut, but the fact that Saudi Arabia and OPEC have returned to active market management. However, as OPEC has provided very few guidelines for now, the uncertainty will contribute to continued volatility over the next two months. The de facto OPEC cut leaves U.S. shale producers relatively victorious in the market share war. Evidence is mounting that, after a yearlong glut, the U.S. natural gas market may be close to finding a balance. Our exceptionally warm summer has been very supportive for natural gas fundamentals, as injections to storage consistently undershot expectations. Current surpluses could be erased by a single frigid winter. Meanwhile, the mining sector is experiencing positive momentum as the macro picture seems more supportive. Asian economic performance is set to improve and a reduced emphasis on monetary policy may see governments use more fiscal expenditure to boost growth. To the end of August, cash flows into commodity funds had beaten the previous record set in 2009. Most of that flow has gone into gold, *amidst the financial sector uncertainty and political risks.* An acceleration of demand growth could coincide with the ongoing deceleration of supply growth in most commodities and lead to higher prices. We may have seen the initial developments of this, as all six industrial metals posted deficits in the first half of 2016 (World Bureau of Metal Statistics).

Credit Growth and Consumer Confidence



Source: Jefferies, Federal Reserve

OPEC government budgets are very strained after a 2 year oil price war.



Source: Bloomberg, BofA Merrill Lynch Global Research

RECOMMENDATIONS

The lazy days of summer have given way to what appears to be a developing challenging outlook. As one of the major fears for market participants recently popped up, *the end of central bank liquidity,* short-term equity sentiment has worsened (loner-term it remains neutral). However, whisper it softly, but the economic outlook does seem to have turned as there is a faint picture of global growth improving; nothing strong, but more synchronized positives than previously observed. The most significant improvement appears to be in advanced economies' industrial production readings, suggesting that the protracted phase of goods inventory adjustment is complete. In the U.S., the employment data continues to be positive, consumer confidence recently hit new highs and new home sales have risen to their highest levels since 2007. In Europe, Brexit fears have receded and U.K. factories have rebounded. Chinese manufacturing PMIs are trending higher, Brazil and Russia are both showing signs of improvement, and India continues to show strong growth potential. These should prove positive for other emerging markets. With this scenario in place, and knowing that this time of year is not usually kind to markets, our strategy is to capitalize on the opportunities that have been developing. We are looking to increase our exposure to equities (currently neutral) by redeploying cash positions which have been higher than normal. Our key themes (technology, financial and healthcare) will be supplemented by increasing our portfolios' exposure to the cyclical/industrial & energy sectors. We continue to position the fixed income component of our portfolios in a combination of short and medium term bonds. Our holdings are focused mainly on corporate & convertible debentures and preferred shares, while remaining underweight in favor of increased cash positions. We are also looking to use some alternative vehicles that have the potential to enhance the overall returns from this component of the portfolio. In order to do so, we will soon introduce a Pooled Income Fund that may eventually replace part or most of the fixed income holdings of individually managed accounts.

FORECAST 2016/2017

	Current 30-SEPTEMBER-2016	2016/2017 Range	2016 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	0.50%	0.50% - 0.75%	0.50%
Federal Funds Rate	0.33%	0.33% - 0.85%	0.58%
10-year Canadian Treasury	0.99%	0.90% - 1.60%	1.15%
10-year US Treasury	1.59%	1.36% - 2.27%	1.80%
COMMODITIES			
Gold (US$/oz.)	$1,320	$1,010 - $1,450	$1,350
Copper (US$/lb)	$2.19	$1.90 - $2.55	$2.25
Oil WTI (US$/bbl)	$48.00	$27.00 - $65.00	$52.00
MARKETS			
S&P/TSX Composite Index	13,309	11,800 - 16,100	15,150
S&P 500 Index	2,173	1,830 - 2,375	2,220
CANADIAN DOLLAR/US DOLLAR	$0.76	$0.68 - $0.85	$0.78

2115 rue de la Montagne, Montreal, QC H3G 1Z8
Telephone: (514) 985-5757
Toll Free: 1-800-567-5257
Fax: (514) 985-5755
Email: info@heward.com
www.heward.com

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