Quarterly Report
WINTER 2015

HEWARD
INVESTMENT MANAGEMENT INC.

Finally Embarking on the Long Road Back to Normalization - While Remaining Within the Same Slow Growth Environment

OVERVIEW

2015 drew to a close with monetary policy moving in opposite directions among the major central banks. The Federal Reserve began maneuvering back towards normalization with its recent rate hike (emphasizing a slow pace for future increases), while the European Central Bank (ECB), Bank of Japan (BOJ) and People's Bank of China (PBOC) are all expected to ease further. Conventional thinking says it represents some risk to the Emerging Market (EM) outlook for 2016 and may put upward pressure on the U.S. dollar. However, logic counters with the fact that most EM economies are better positioned for Fed normalization than they were during the "taper tantrum" and this well telegraphed Fed hiking cycle is unlikely to be a large shock to financial markets.

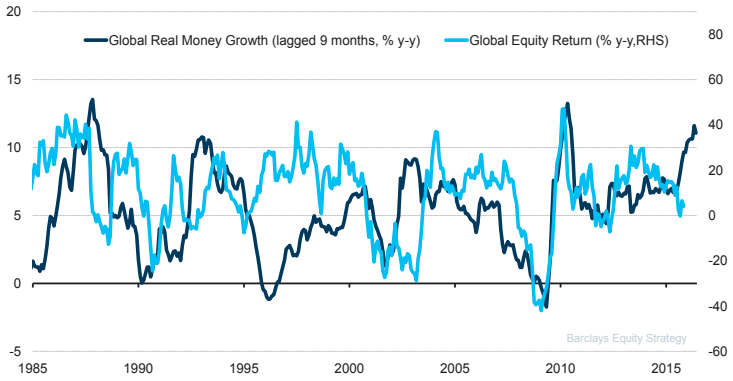
After five years of post-crisis blues, we may finally be seeing some semblance of a globally synchronized recovery, albeit well below trend levels. While it is only inching forward, the J.P. Morgan/Market index of factory orders is at least headed in the right direction, fuelled by a wave of monetary stimulus across the world and an end to fiscal austerity in the West. The first green shoots of a global manufacturing revival are emerging as Europe, the U.S. and Japan shake off the recession scare. China remains a battle ground between the bulls and bears, they have probably hit a cyclical trough and the drag from EM should decline.

China's trend growth could fall to around 4 – 6% through the next decade with continuing high cyclicality. However, the growth drivers will be different and the quality of growth should improve. Macro rebalancing, policy bias, reforms and demographic shifts are ushering in new waves of demand and reshaping the China story to the "new normal" or consumption oriented economy. This can be seen in the import/export numbers which are weak, whereas iPhone sales are up more than 70%, Nike sales have jumped +30% and food importation is up over 20%. This concept of a "new normal" has been garnering investors' attention as they weigh the impact on their portfolios.

Saudi Arabia's decision to dislocate its role as the oil market's ballast of stability has unleashed a laisse faire oil market in which unbridled market forces are ruling. Today's oil market has become increasingly characterized by intensified oil price volatility and a wave of deflation that is putting downward pressure on the global oil supply cost curve. Just what role Saudi Arabia and OPEC elect to play one the oil market regains some semblance of balance is an open question. However, behind closed doors, according to the Financial Times of London, they say they would like to see prices stabilize between $60 and $80 a barrel. That level, they believe, would foster oil demand but not encourage too much supply growth, a goldilocks scenario.

The short-term outlook for base metals/materials is more of a concern. We continue to see acute oversupply despite several publicly announced mine closures. Longer term however, we remain more optimistic on their outlook. One of the key themes in China is the redeployment of capital, or more specifically the large scale selling of U.S. treasuries by Chinese entities. This, together with the desire to pay for goods in Yuan, would eventually put downward pressure on the U.S. dollar, a positive for commodities. Then there is the five year plan, and the ten year build out of the "One Belt, One Road" initiative, a transportation system that basically will run from Beijing to Rotterdam. The construction of that belt way requires spending on water services, rural construction, railways as well as the build-out of the electricity grid. Massive amounts of copper and iron ore will be required.

Monetary growth is strong
Markets should be able to withstand a Fed rate hike



Source: Barclays Research, DataStream, MSCI, OECD.

UNITED STATES

More than at any time in this expansion, the fortunes of key sectors of the U.S. economy are diverging. A strong dollar, weak commodity prices and slow global growth are restraining U.S. factories, highlighting a deepening divide between the American service sector and manufacturers exposed to international turmoil. New orders for durable goods; turbines, trucks and other products designed to last at least three years, offered the latest evidence of malaise at factories. Thus far, while international troubles may be starting to bleed into certain areas of the economy, the global turmoil and domestic manufacturing slowdown haven't infected U.S. households much. Consumer spending has been steady, for instance, helping to buoy the auto industry, sales are on pace to match volumes last seen in the early 2000's. Meanwhile, the housing continues to gather strength as improvements appear on a number of fronts. Demographic fundamentals are normalizing, headwinds from household deleveraging and excess supply are waning, lending standards are easing on the margin and pressure from pent-up demand is weakening. In addition, we see the negative impact of Fed hiking on the housing market to be modest and manageable. Up until now, most of the demand has been in multifamily rental construction. However, this may be about to change. Full employment and rising wages along with more expensive rents, should ignite single family demand. As long as mortgages stay below 6.0%, it will be cheaper for young American households to buy a home rather than to rent one.

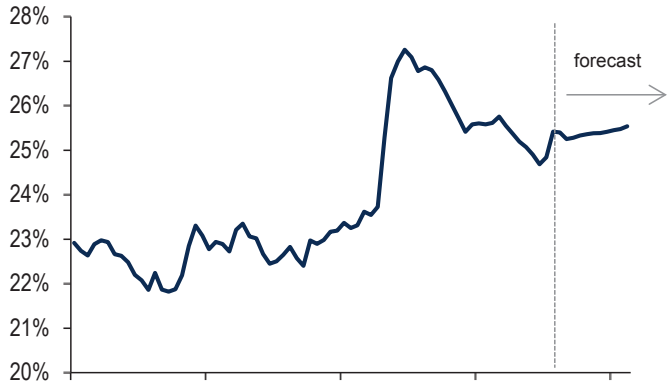
CANADA

The Canadian outlook for 2016 sees two conflicting forces at play. The first is an energy sector which is still licking its wounds from oil prices having collapsed by more than 50%. Energy related investments are slated to have fallen by nearly 40%, dragging down overall capex numbers and GDP. The second is a long disappointing non-energy sector that is tentatively showing signs of life, poised to benefit from firmer U.S. domestic demand and a weak currency. The sharp drop in commodity (not just energy) prices slammed Canada in 2015 and the outlook for a gradual (possibly U shaped) price recovery suggests trend line growth at best in 2016. Energy production's share of GDP has fallen from roughly 8% in 2014 to 5% in 2015, and is likely to remain there as jobs, investment and resources continue to be funneled away from the sector. Without a resurgent factory sector, economic growth will be held up by less than ideal drivers. The new federal Liberal government promises rising spending on infrastructure which will lift activity, but will leave the public sector rising uncomfortably as a share of GDP. Also, the low-rate environment should continue to boost housing and consumption, a trend that could persist through 2016-17. Given sluggish growth and low oil prices, the Bank of Canada (BoC) is likely to keep the policy rate on hold, preferring to watch how the economy reacts to the 50bp of rate cuts in 2015. Another downside shock could trigger a further ease, but for now, the BoC would prefer to save its ammunition.

EUROPE

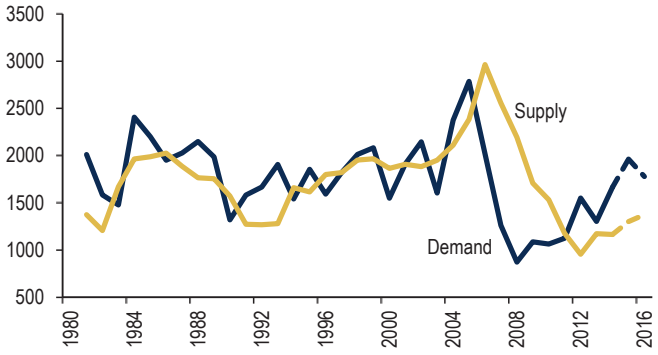
After the December meeting where the ECB did everything expected, except increase the size of the program, rumors swirled that Mr. Draghi had lost a power struggle with other members of the committee. As the eloquent Arthur Cashin, Managing Director of UBS Financial Services Inc. wrote, "The hawks may have reined him in, and if so, a vulnerable Europe may be even more vulnerable if the central bank is less nimble". Three particular adjectives may serve to summarize the current state of the euro area recovery: resilient, widespread and slow. For now, the recovery is expected to become increasingly inward looking, with private consumption forecast to be the dominant source of support. However, given the low (or absent) productivity growth, only modest structural reforms and high levels of structural unemployment, long term growth is expected to remain below trend. Notwithstanding its slow pace, however, the cyclical recovery remains intact, with momentum appearing remarkably unfettered over

Weak private sector leaves government as a high share of GDP
Government consumption and investment as a % of GDP



Source: BofA Merrill Lynch Global Research, Statistics Canada

Housing demand overshooting supply (000s)



Source: BofA Merrill Lynch Global Research, Census Bureau

what has been an undeniably tumultuous period. 10 consecutive quarters of growth have now been registered and the expansion is now broadening out beyond the four largest economies of the region. In Europe, the debate on refugees is entangled with the debate on economically motivated migration flows. Though fundamentally different phenomena, both should ultimately affect the target country's labor supply in the long term. Furthermore, in its most recent set of forecasts, the European Commission argues that potential growth could indeed be bolstered.

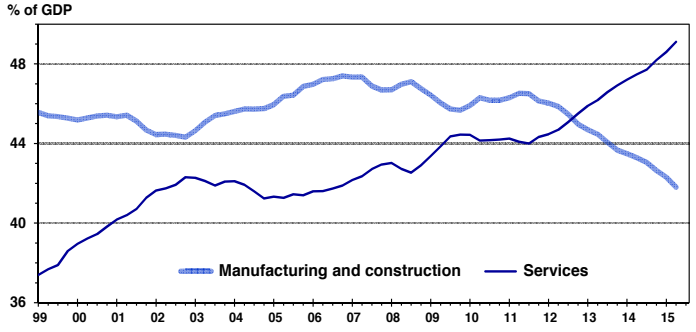
EMERGING & DEVELOPING MARKETS

There are copious reports on China's economy, and nearly all have the same theme, the country's financial sector is a mess and its economy is slowing or sinking into recession. Both views are wrong. What is true is that the government is undertaking the massive task of transforming the economy from being investment and export led towards being driven by consumption and services. Part of this involves clamping down on real estate, and since it accounts for over 40% of GDP when all direct and indirect input sectors are factored in, the hangover has been immeasurable. Recognizing that the economy needs help both, monetary and fiscal policy, have become more supportive. Furthermore, we hear that government has started to release orders for infrastructure spending. The downturn in emerging Europe, which is mainly due to weakness in Russia, is showing signs of having bottomed. Indeed, growth in the rest of the region has held up relatively well in recent months. Similarly, although economic activity in Brazil remains weak, growth in the rest of Latin America has been broadly in line with the performance of the past couple of years. Brazil is facing one of the longest recessions in its history, and so far, there are no signs of a reversal. A better political scenario is needed to encourage a rebound in investment and demand. Inflation still looks likely to rise in most EMs next year, despite the recent slump in oil prices. However, the rebound will be more gradual, which will allow central banks in most economies to keep interest rates lower for longer.

COMMODITIES

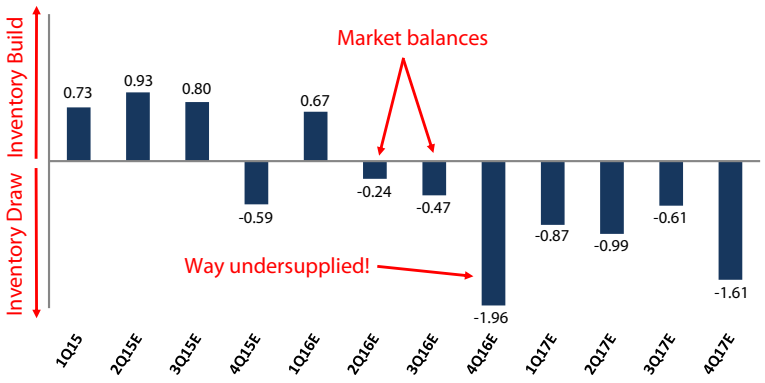
With oil prices now being driven more by market forces rather than by political decisions, it has become an unnerving experience for everyone concerned, from the boardrooms of Houston to the palaces of Riyadh. While unprofitable for shale producers to bring on new production at current prices, the longer term effect may be even more devastating for Middle East (OPEC) producers. However, the eventual cure for low oil prices are low oil prices, and while OPEC arrived at no-decision when it met in December, given the financial difficulties of many of its members, the organization could arrive at a more co-operative stance in 2016. Fundamentally, oil market conditions should show improvements over the course of 2016 amid respectable demand growth, but a rising tide of Iranian barrels could offset much of the decline in non-OPEC production containing the upside recovery. Rebalancing the oil market is taking longer than many expected, but market forces will eventually prevail, it's just a matter of time. For the commodity/materials sector, we continue to see only a modest abatement in China-led commodity demand growth, not the capitulation that year to date price performances imply. The fact that most activity everywhere remains buoyant, commodity trade flows remain intact and that producers are rapidly rebalancing their trades in response to "shockingly low" prices, tells us that the downside risk is limited. After the investor exodus and speculative selling is done, along with additional mine closures announced (the pace of closures to accelerate in 2016), the fundamentals of the commodity complex will again matter to prices.

China's economic rebalancing



Source: Halkin Services

When Will Oil Prices Improve?
Quarterly Global Oil Supply/Demand Balance (MMBbls/d)



Source: IEA, Raymond James Estimates

RECOMMENDATIONS

The global economy looks as though it could be at an inflexion point and many experts are worried about a renewed global downturn. By contrast, our outlook sees a continuation of the trend of sluggish global growth, low inflation and ultra-low interest rates. While the Fed has started to tighten, this is unlikely to lead other central banks to raise rates. Indeed, we still see further easing from the ECB and BOJ, among others. We expect domestic demand to hold up relatively well in developed markets with a less onerous adjustment process from EMs. In the U.S., the employment picture keeps improving and consumers' real incomes are rising. In Europe, notwithstanding its slow pace, the cyclical recovery remains intact, with momentum appearing remarkably unfettered over what has been an undeniably tumultuous period. As ever, key risks remain with politics playing an increasingly important role in 2016. Given our concerns, our portfolios are currently neutral equities, under-weight fixed income while overweight cash, giving us the flexibility to be opportunistic. However, a market rally into early 2016 may present a selling environment if there is no fundamental follow through.

While geographically Europe (over the U.S.) remains an area of interest, investors' pessimism on Canada looks to present opportunities in select issues (outside of resources for first half of 2016). Our focus remains on technology, financials and healthcare, while waiting for opportunities to add to some of the underperforming sectors of the market, including energy. Despite the low interest rate environment, the bond market still succeeded in providing a modest, yet positive year over year return. However, the results were front-loaded as the total return turned negative after last January's big move. Although the present economic scenario hardly calls for a significant rise in rates, bond returns are expected to remain modest. Thus, with expected money market (limited downside risk if rates rise) and bond returns being quite similar, we will continue to overweight the former, complemented by short and medium term corporate and/or provincial bonds. Preferred shares, which were a challenge in 2015, seem to have troughed and with cash returns averaging 5 – 7% present good value. Although they may remain volatile, on a total return basis they are expected to outperform bonds over the medium to longer term.

FORECAST 2016

	Current 31-Dec-15	2016 Range	2016 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	0.50%	0.25% - 0.25%	0.25%
Federal Funds Rate	0.33%	0.33% - 0.75%	0.75%
10-year Canadian Treasury	1.42%	1.20% - 1.60%	1.50%
10-year US Treasury	2.27%	2.00% - 2.80%	2.75%
COMMODITIES			
Gold (US$/oz.)	$1,060	$1,010 - $1,225	$1,200
Copper (US$/lb)	$2.15	$2.00 - $2.60	$2.60
Oil WTI (US$/bbl)	$37.50	$32.00 - $52.00	$50.00
MARKETS			
S&P/TSX Composite Index	13,309	12,500 - 14,200	14,150
S&P 500 Index	2,044	1,940 - 2,140	2,130
CANADIAN DOLLAR/US DOLLAR	$0.71	$0.70 - $0.76	$0.75

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