Quarterly Report
WINTER 2017

HEWARD
INVESTMENT MANAGEMENT INC.

"Progress, not Perfection"
Unfettered Synchronized Global Growth but the Most Unloved of Bull Markets

OVERVIEW

Forecasting is difficult, but 2017 showed exactly how pointless it can be as most prognosticators missed their marks. For the first time since 2010, the world economy outperformed most predictions, and we expect this strength to continue through 2018. The global economy has made impressive progress transitioning from an upturn fueled by fading drags to a phase of synchronized strength where spending, and financial conditions are now generating a positive feedback loop. This loop has been in place for several quarters, and the consistent upward revisions have been accompanied by rising equity prices, narrowing credit spreads and rising business and household confidence. With monetary policies remaining easy and fiscal measures still to come, synchronized global growth clearly has legs under it.

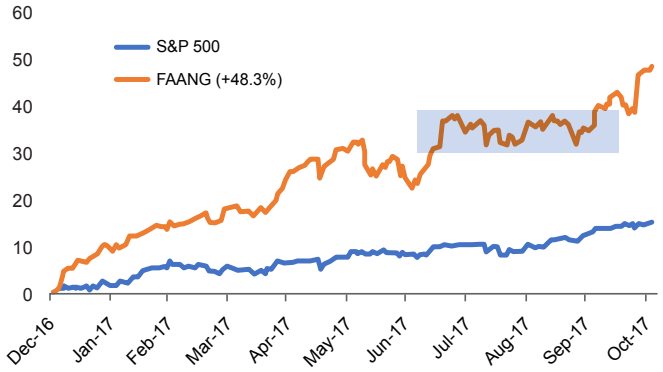
The OECD is forecasting global growth to reach 3.7% in 2018, close to the 1990-2007 average. In the U.S., growth rates are expected to accelerate (tax reform & infrastructure spending) while broadening cyclical growth in Europe is likely to alleviate several areas of investor concern. In China, growth has rebalanced towards consumption which should continue to support consumption-related assets and keep macro and emerging market volatility low. In line with these expectations, the World Trade Organization is forecasting merchandise trade volume to expand in line with global growth. Amid this environment, easy financial conditions will prevail, allowing central banks to continue to normalize at a gradual pace.

The predominant outcome of the upturn in Emerging Markets, the stabilization and recovery in commodity prices and the resurgence in corporate profits has been the acceleration in global goods demand and production (PMI's). While consumer goods spending growth has bounced in recent quarters, growth in business equipment stands out as capacity utilization rises globally. Right now, capex seems to be in the driver's seat of the global cycle, driven by expanding business confidence, rising profits and low rates. Even more encouraging are signs that spending will be sustained into 2018. The trend appears broad based across both advanced and emerging economies, signaling a further pick- up in industrial activity and global trade.

With the completion of the recent Communist Party Congress (CPC) meetings, China is entering a new political economic cycle. The next five years will be critical as to whether or not they can stride over the middle-income trap. To deliver on their promise to double 2010 GDP and per capita income by 2020, growth will need to be maintained at current levels. Making this more difficult is the plan to transition from rapid growth to high quality development, which requires improvements to its economic structure and the need to foster new growth drivers. Advanced manufacturing, rural vitalization, coordinated regional development, financial and SOE (State Owned Enterprise) reforms and the pursuit of the Belt and Road initiative will all be keys. The CPC also pledged to win the battle against poverty and elevated environmental protection to an unusually high level.

While failing to achieve central bank targets, inflation is not dead. Wage pressure is surfacing in the U.S., PPI numbers in Germany continue to climb and rising inflation in the UK is pressuring retail sales. Even Japan is seeing a turn, as producer prices escalated in November with 75% of the index rising in price. Meanwhile, investors remain mesmerized by a flattening U.S. yield curve failing to realize that this type of action is correlated with rising inflation. It is normal that late-cycle dynamics see both a flattening yield curve (as central banks raise rates) and rising inflation (full employment, capacity is strained). Until the yield curve actually inverts (consistent with a business cycle ending, not just maturing), this is probably the operative paradigm.

FAANG* Stocks vs. S&P 500 in 2017:YTD % Change



*Facebook, Apple, Amazon, Netflix and Alphabet's Google
Source: Bespoke Investment Group

UNITED STATES

Both the U.S. economy and equity markets have arrived at current levels mostly on the merits of monetary policy that has successfully fostered economic growth. On the heels of an economy that has managed to grow at an annualized pace of 2.0 - 2.5% over the past eight years, corporate revenues and earnings have improved over the last six quarters. This is a trend that should continue well into 2018, driving equity markets to new highs. Further enhancing this trend should be the appointment of Jay Howell for the Federal Reserve Chair. Once thought of as a "long shot", Mr. Howell is being widely portrayed as a continuity candidate for the job - *a safe pair of hands*. Meanwhile, recent data shows the number of workers voluntarily quitting their jobs remains in an uptrend. This is important because the labor market "churn" rolled over well in advance of the last recession. On the manufacturing front, the Empire State data continues to signal strong activity and durable goods orders are up, igniting talk of pent-up demand for capex. Increased fixed asset investment often precedes a rise in production, further suggesting that firms are feeling more confident about the economic outlook. The Tax Cuts and Jobs Act is a major coup for U.S. corporations, but a mixed bag of give-and-take for individual taxpayers, with benefits sharply skewed to the wealthy. To pay for the cut in the corporate tax rate, the final bill reneges on many of its original objectives that would have benefited individual wage earners.

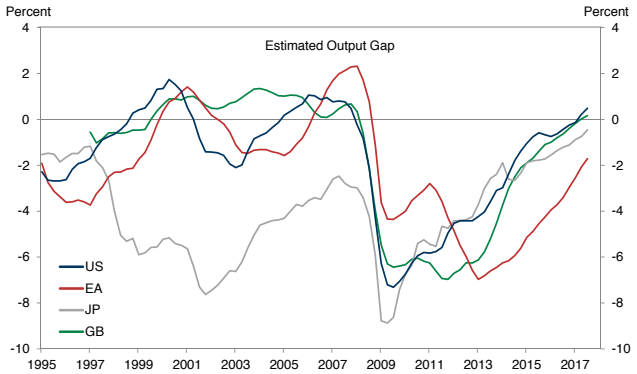
CANADA

With a strong global recovery and rising trade volumes backstopping growth, Canada's economy has been running at a pace rarely seen in the past couple of decades. It has rapidly eliminated spare capacity and prompted the Bank of Canada (BoC) to raise interest rates twice. As such, it should not come as a surprise to see economic momentum slow over the coming year, *but remain above trend line*. Interest rate sensitive segments such as consumption and residential investment look set to contribute less to overall activity. However, improvements in the labor market, some acceleration in wage growth and the expansion of the Federal enhanced child benefit system should provide a degree of underlying support for consumption. Growth should also find supported from Federal government's infrastructure investments, greater capex and higher commodity prices. Expectations of a continuing moderate U.S. expansion and firming global growth will continue to underpin exports. While the low point in core inflation looks to be behind us, risks to the inflation outlook remain roughly balanced. While the output gap is closing, any pricing pressures are expected to be offset by global structural forces and the slow pass-through of labor market improvements to faster wage growth. The macro issue facing the Canadian equity market is probably the outcome of NAFTA negotiations. There is a low degree of predictability for the eventual outcomes and negative tail risks could have meaningful broader impacts.

EUROPE

The euro area is enjoying a period of robust and above-trend synchronized growth. The region has benefitted from reduced political and policy uncertainty, very loose monetary policy, accommodative financial conditions a recovery in bank credit growth and more growth-friendly fiscal policies. All these factors have helped propel consumer and business confidence to near-record highs and sparked a strong revival in consumer spending and investment demand. Output gaps have closed in most places and Germany has moved past full employment. The positive earnings growth seen in Europe through 2017 should prove to be the beginning of a new profit cycle, rather than a base one-off event as some experts fear. With revenue finally showing signs of returning to growth, this should bring back operating leverage, re-gearing balance sheets and rising margins. These, together with fiscal stimulus, should lead to the return of capex. Nine months after the UK started the Brexit proceedings, the terms of divorce are broadly

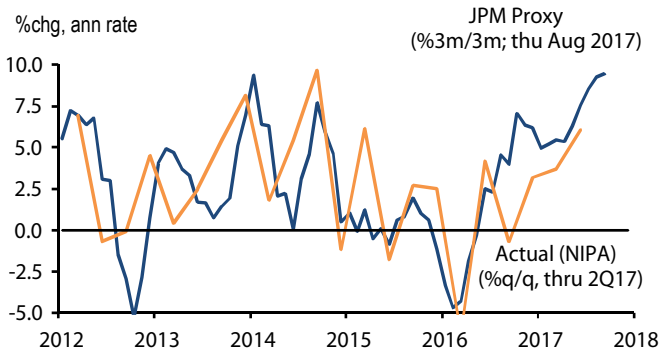
Output Gaps Are Closing



Note: estimates show the gap between actual and potential GDP, measured as a share of potential.

Source: Goldman Sachs Global Investment Research.

Global (ex China) capex



Source: J.P. Morgan

settled. The two parties will now move on to negotiations for a transition period and future UK-EU trade. Meanwhile the UK graces the bottom of the G7 growth table for the first time since 1981. Fiscal policy is now expected to be tightened by less than had been thought, while net exports should benefit from the competitive improvement brought on by a weaker sterling and the ongoing global recovery. Consumption, worth 60% of UK GDP, should recover into 2018 as real wage growth rises and the waning effect of lower sterling on inflation is felt.

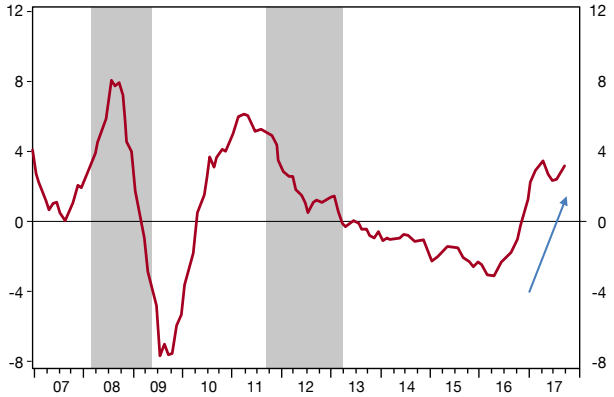
EMERGING & DEVELOPING MARKETS

With the 19th Communist Party Congress now come and gone, plans have been laid out to usher China into a new era, where the "new economy" will become the "new norm". President Xi outlined a number of challenges, opportunities and an ambitious agenda that are likely to be the focus over the next five years, and possibly beyond. Over the past decade, China's major accomplishment has been to shift the balance of its economy from manufacturing and infrastructure to consumer goods and services. Having done so successfully, one of their key challenges now is the gap between "imbalanced and inadequate" development and the peoples' demand for a better life. There are always plenty of China bears in the world, but to us their key risks are skewed internally: policy error, debt burden. While recognizing them, we do not think they are likely to drive a sharp slowdown in growth. In Japan, Prime Minister Shinzo Abe's Liberal Democratic Party and its coalition partners scored a convincing win that should allow Prime Minister Abe to change the constitution and continue with the loose fiscal and monetary policies. Data points continue to indicate a solid pace of growth (3rd quarter GDP running at 2.5%), led by both consumption and exports, and unemployment has dropped to a 25-year low. Corporate profits, as a percentage of nominal GDP are at record highs. In India, the government announced an important plan to recapitalize public sector banks that should boost the deleveraging process significantly. Committing 1% of GDP to recapitalization bonds is a move that marks an important step towards breaking the logjam in new lending and investing.

COMMODITIES

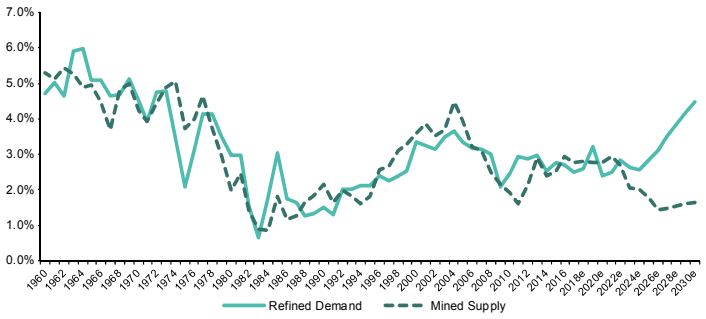
Global crude oil inventories are continuing their downward trend. By the end of the third quarter, U.S. commercial inventories were well off their February peaks. Furthermore, OECD data showed a halving of global surpluses since the start of the year as OPEC supply has been broadly flat (excluding the Libya increase) with compliance running high. While the rate of well completions is still growing in the U.S., it is not yet matching the pace of wells drilled so the number of drilled, uncompleted wells (DUCs) continues to rise. This may be the result of shareholders putting the screws to shale executives in ways that are changing the financial calculus of hydraulic fracking, and could ripple through the global oil market. However, if prices continue to climb all bets are off as Jan Stuart of Cornerstone Macro said "There is no such thing as a Texas wildcatter getting religion". The long-term demand-led recovery on base metals should continue into the foreseeable future. Economic growth in the U.S. is expected to become somewhat more dynamic. Tax reform and infrastructure spending in the U.S. will attract considerable attention while the euro area economy will continue to experience a strong upswing through its ultra-expansionary monetary policy. Meanwhile, China will remain the most important metal market. Long-term demand drivers range from the One Belt One Road initiative to the SOE rationalization in the ferrous and nonferrous sectors. The market's ongoing fascination with Electronic Vehicle (EV) technologies (both in automotive powertrains and energy storage) should not be underestimated.

Germany: PPI Total Industry excluding Construction
% Change - Year to Year SA, 2010=100



Source: Deutsche Bundesbank

10 Yr Rolling Avg Supply & Demand Growth Rates in Copper



Source: Wood Mackenzie, CRU, AME, Corporate Reports, Bernstein Analysis & Estimates

RECOMMENDATIONS

As the calendar rolls into a new year, we expect many of the thematic factors from 2017 to apply over the next twelve months, boosting markets higher for a third straight year. Over the last two years, the combination of recovering global growth and low inflation has seen risk assets move substantially higher, yet this bull market remains amongst the most "unloved" in history. While investors remain nervous (many are in the show me camp), we see a global economy that has finally moved onto a stronger footing, with above average growth likely the story for 2018 and the risk of another downturn (recession) remote. Strong capital spending, on higher profits and confidence, are boosting global growth expectations, *which are being continually upgraded*. Core inflation rates are no longer decelerating and the global "output gap" is closing. Risk is clearly "on" and with macro (synchronized growth) and market (rising earnings) risks being relatively low, it makes it harder for key decision makers not to move up the "risk" curve. With this as a backdrop, our call for 2018 is to be overweight equities. Near term however, high valuations, high speculative S&P positioning along with the Relative Strength Indicator (RSI) *which has reached its highest level (extreme territory) in two decades*, have driven us to reduce our equity exposure closer to neutral. This is a strategy which we anticipate further deploying through the early part of 2018. While corrections (if and when they occur) make investors nervous, we will view it as an opportunity to redeploy funds and once again going overweight equities. Due to the continuing low levels of inflation, bond yields finished the year at the same levels as they started. Yet, Central Banks started to act and/or sound more hawkish as the year progressed, and yield curves flattened as both the U.S. and Canada saw two rate hikes. Given that the economic scenario remains upbeat for 2018, we expect monetary conditions to continue to tighten in the year ahead. This time however, it is likely that the entire yield curve will rise resulting in higher bond yields by year end. This means that after another year of moderate bond returns, 2018 looks to be more challenging. However, as proven over the past year, our strategy of using a variety of yield enhancing products (i.e. preferred shares, convertible bonds and select equities) along with regular bonds has provided above average returns. We anticipate getting similar results for 2018.

FORECAST 2018

	Current 31-DEC-2017	2018 Range	2018 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	1.00%	1.00% - 1.50%	1.50%
Federal Funds Rate	1.33%	1.40% - 2.00%	2.00%
10-year Canadian Treasury	1.95%	1.75% - 2.50%	2.40%
10-year US Treasury	2.37%	2.25% - 3.00%	2.80%
COMMODITIES			
Gold (US$/oz.)	$1,309	$1,200 - $1,350	$1,330
Copper (US$/lb)	$3.30	$2.90 - $3.60	$3.40
Oil WTI (US$/bbl)	$60.42	$52.00 - $66.00	$60.00
MARKETS			
S&P/TSX Composite Index	16,209	15,600 - 17,500	17,200
S&P 500 Index	2,673	2,525 - 2,950	2,880
CANADIAN DOLLAR/US DOLLAR	$0.79	$0.72 - $0.82	$0.78

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