Quarterly Report
SPRING 2018

HEWARD
INVESTMENT MANAGEMENT INC.

Central Bankers Begin to Take Away the “Punch Bowl” While Trade Frictions Add to Investor Angst

OVERVIEW

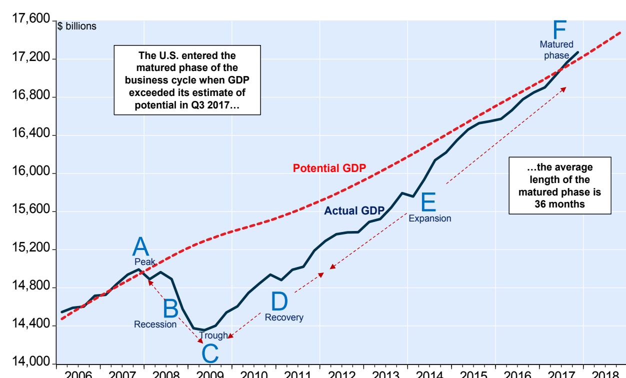
On January 26th, markets were sitting at all-time highs and investors marveled at what an impressive start to the year it had been. Suddenly, and all too swiftly investors were reminded that markets can also fall by what was strangely enough “a good news story”: higher U.S. wage growth. The immediate trigger for investor angst stemmed from a belated awakening that torrid global growth will lift inflation, causing bond yields to rise and central banks to push up interest rates. Unlike 2013 (taper tantrum) and 2016 (China concerns & low energy prices) however, the U.S. Federal Reserve let investors sweat out the market volatility. They did not see anything nasty or potentially dangerous developing to threaten serious macro-economic damage. The latest market sell-off however, seemed to reflect risks that were already present and should not have come as a surprise. The Facebook plunge and the protection of personal data is a perfect example. As Barron’s magazine wrote “the utterance of social media in the same sentence as privacy seemed to be the definition of an oxymoron”. The biggest culprit however, was the escalation of trade tensions on about $60bn of products from China, which helped to erase some $1.8 trillion from the value of U.S. equities (Wilshire Associates). The step-up of trade conflicts would seem to be the least surprising aspect of the Trump administration, as while he has changed views on many things, he has been steadfast in blasting the U.S. trade deficit.

Across most of the western world inflation had been the dog that didn’t bark. Over the last nine years of economic recovery inflation stayed low, confounding many forecasts that tighter labor markets would prompt higher wage growth. This caused many to suggest that the traditional relationship between unemployment and inflation (aka the Phillips Curve) was effectively dead. That is, until recently, when the forces of excess demand seemed, quite suddenly, to have driven wage inflation higher. The next few quarters should see markets primed for surprising levels of inflation due to limited spare capacity, expansionary fiscal policy, higher commodity prices and (as per General Mills) unexpected high increases in supply chain costs.

Capex has now become the most important driver of global growth. Developed markets (DM) were leading the way, but emerging markets (EM) have now joined the party. With global growth progressing, business sentiment has improved and investment related indicators are now hitting multi-year highs. This is especially evident in the U.S., where we can see a genuine acceleration in capex, which will drive higher productivity. Meanwhile, buoyed by quickening economic growth, hearty business confidence and co-operative financing markets, the environment for deal making has become robust. M&A activity is up more than 50% with activity in Japan and the UK more than doubling and German volume up fourfold. Companies have come to recognize that tremendous opportunities exist to drive growth through M&A.

After a 10% correction to cool the market’s run up in the first four weeks of January, it seems ironic that some of the same voices that had cried for a 5 – 8% correction now apparently feel that it wasn’t enough. At times of transition, whether it’s via the process of interest normalization, or wage acceleration in a post recovery expansion, or commodity price movements as the global economic recovery gains traction, some market volatility is the norm. This is typically how markets react as the process of price discovery runs through various asset classes and the markets that trade in them. At times like this it is important for investors to recognize the distinction between short term trading and longer term investing.

U.S.: Perspective on the business cycle
Actual vs. potential* real GDP



* As calculated by the Congressional Budget Office (CBO) - NBF Economics and Strategy (data via Fed of St-Louis)

Source: National Bank Financial Markets

UNITED STATES

Congress passed the Bipartisan Budget Act of 2018, which lifted the cap on federal spending. This had played an important role in restraining the growth in public sector spending since its introduction in 2013 and was part of the deal to avoid the "fiscal cliff". As a result, federal spending is set to surge by $67.9bn in FY 18 and $184.3bn in FY 19. This is the second piece of noteworthy fiscal stimulus recently enacted, increasing our conviction that the U.S. economy will remain in an above-trend growth path this year and next. These measures will continue to push unemployment lower and support a return of inflation to the Fed's target. Even without these measures, the U.S. continues to create jobs showing that companies are still hungry to hire more than eight years after the economic expansion began. The number of job openings recently hit a record high at 6.3 million, and people leaving jobs on their own (the quite rate) is at a post-recession high. Better still is the fact that worker pay is rising at the fastest yearly pace since 2009. While inflation is expected to get a boost from prior dollar depreciation and fiscal stimulus, these pressures will be offset somewhat by: structural deflation in core goods, softer shelter inflation and enhanced flexibility for corporations to use higher after-tax earnings to absorb increases in input costs. In his first Congressional testimony new Fed Chair Jerome Powell hinted that more aggressive action on raising rates could be warranted this year. With incoming economic data being consistent with continued above trend growth, the latest rate increase was not a surprise to markets, but forecasts of three increases instead of four was.

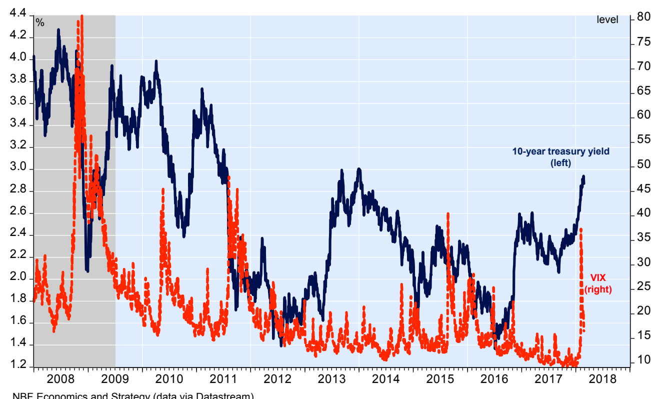
CANADA

Supported by a still-accommodative monetary policy and financial conditions, as well as public infrastructure spending, the Canadian economy finds itself close to capacity. This has been accompanied by a significant reduction in labor market slack with shortages more apparent and intense than they were a year ago. In spite of tight labor markets and rising wages, growth is expected to remain at or even slightly above potential well into 2019. This should dampen some of the Bank of Canada's (BoC) concerns about the Canadian economy. Inflation will likely migrate towards the BoC's target of 2% and will likely trigger rate increases. More recently, trade worries have coincided with uneven economic data to force a decline in the dollar. Statistics released earlier this month have revealed a sharp drop in both exports and imports, after a cut in U.S. corporate tax rates may have tipped the scale in favor of making business investments in the U.S. instead of Canada. Meanwhile, global demand from progressing growth should drive commodity prices higher providing support to the natural resource sectors. Oil producers should receive a boost from price increases, declining differentials and the weaker dollar as the railroads and pipelines (to a lesser extent) increase their ability to transport barrels of heavy oil. It's not that they did not want to, but lack of capacity and power (locomotives) restricted their capacity. The year ahead is likely to be filled with volatile and sometimes difficult headlines on trade. NAFTA's key elements will remain in place through a period of uncertainty, with agreement to be reached eventually on a renegotiated and modernized pact.

EUROPE

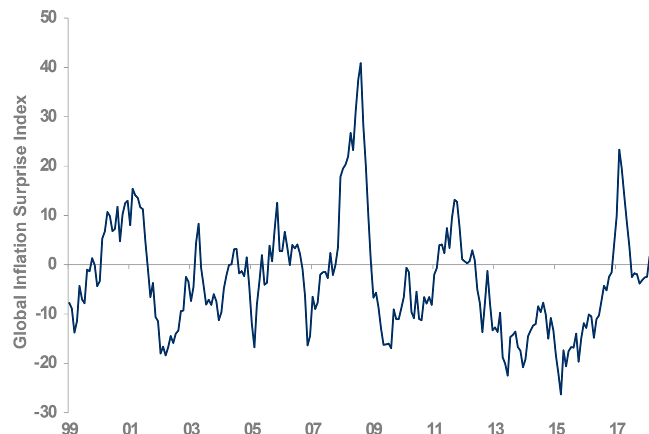
In spite of January's fall in industrial production data (weather related), the euro-zone is enjoying a cyclical expansion that is in full swing. Robust hard data and encouraging survey data ("soft data") continues to roll in, suggesting that Europe's boom will continue for a few more months. Business and consumer sentiment readings for the region remain near historical highs and, in some cases, making new highs. Unemployment finds itself at cycle lows, but not yet at pre-crisis levels (7.3%) indicating that there is still slack in the economy. New car registrations have closed in on pre-recession peaks, a positive indicator and confirmation of consumer confidence. Meanwhile, price growth unexpectedly slowed due to the appreciation of the euro, meaning it will

World: The 10-year Treasury spooks equity markets
Yield on 10-year U.S. Treasury and S&500 volatility index



Source: National Bank Financial Markets

The Global Inflation Surprise Index is back in positive territory



Source: Bloomberg, Morgan Stanley Research

take longer for inflation to hit the European Central Bank's (ECB's) target. Clouding the future however, is the clear and present danger of a trade war. Having secured a reprieve on steel & aluminum tariffs, the bloc remains dangerously dependent on the export of manufactured goods. And while the U.S. administration has taken a tactical decision not to fight the EU and China at the same time, the threat has not gone away. UK GDP growth should be in an upward trajectory in 2018. Impacted by rising Consumer Price Index (CPI) inflation, set against stagnant wage inflation meant that household real disposable income growth ground to a halt, causing consumer spending growth to decelerate. This is expected to reverse in 2018. Consumer spending aside, Brexit is likely to continue to cast a shadow over some aspects of growth, with capex the main culprit.

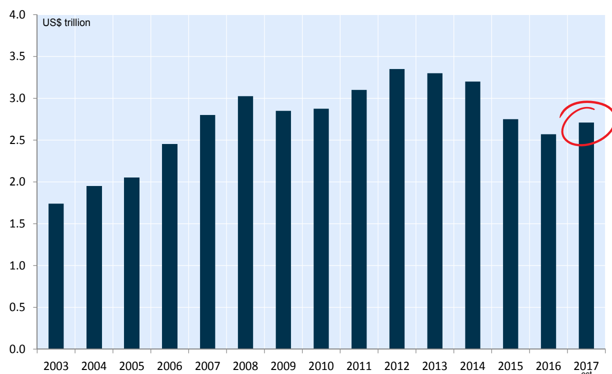
EMERGING & DEVELOPING MARKETS

Escalating trade tensions remain the focus in trade-heavy Asia, especially China. However, even after the March 22nd announcement that the U.S. intends to impose a 25% tariff on $50bn of imports from China, the scale of measures unveiled thus far should not be overstated. Affecting 10% of exports to the U.S., they may impact total GDP by approximately 0.25% (Capital Economics). More aggressive than those announced earlier, which products will be affected (the list will be published by mid-April) is unclear, but they will draw from aerospace, IT and machinery. Meanwhile, the leadership has continued to change the shape of the economic growth model. Since October's National Party Congress, where the emphasis was to move it away from credit fueled and investment driven growth, the message has been re-iterated and reflected in key policy decisions. That being said, China's actual Q1 data has been above expectations, supporting government growth estimates. Japan continues to make progress towards macroeconomic healing. Real GDP has now expanded for eight consecutive quarters, the longest stretch in 30 years. While inflation remains outside of the Bank of Japan's (BOJ's) 2% target, the latest "shunto" results were solid. The Japanese Trade Union Confederation's first survey of wage negotiations supports a forecasted wage hike of 2.3%, driven by improving corporate earnings and policies put forth by the Abe administration. Investors may be overly concerned with the extent to which Emerging Markets (EMs) are vulnerable in a world of rising bond yields. However, the shift by EMs over the past decade or so to issuing debt in local currency has altered this dynamic.

COMMODITIES

The U.S. Department of Commerce reported that overcapacity in China was the cause of declining U.S. production of steel and aluminum over the last decade. Ironically, what may not be fully appreciated is the fact that China was the main reason behind the global price rebound for both products in 2017. A few years ago unmanageable overcapacity prompted Chinese producers to dump cheap steel on other countries. Today, that view is no longer valid and while it may still occur, it is on a much smaller scale. This is owing to the Chinese government's policy initiatives on the supply-side reforms and environmental restrictions which have reduced production. Chinese steel exports have fallen over 50% from mid-2016, and it's reflected in U.S. producers' margins, which are at their highest levels in years. OPEC is breaking down into two camps: on one side Saudi Arabia who wants oil at $70 a barrel or higher, and Iran which prefers to see a $60 level. The split is driven by differing views over whether $70 a barrel sends U.S. shale companies into a production-frenzy, causing prices to crash. It may prove to be a moot point, as even though U.S. production is tracking above consensus estimates, some experts feel their production is actually constrained. These opinions reflect an industry that is not geared up (infrastructure, regulatory, pressure pumping, sand & people) for these record production levels. These views get some credibility from companies increasingly returning cash to investors instead of putting it in the ground. All in all, OPEC/Russia believes their cuts have been effective and the crude oil market will be balanced (Goldman Sachs says it already is) this year.

World: Capital expenditures are recovering
Global non-financial capital expenditures



Source: National Bank Financial Markets

Global earnings growth is strong and highly synchronised

Note: Based on 67 MSCI country equity indices.
Source: DataStream, Bloomberg, Barclays Research

RECOMMENDATIONS

Global markets have entered a new era of volatility. The first quarter has seen a whirlwind of economic and political news and developments. Global trade frictions have increased, and together with rising U.S. Treasury yields (flattening yield curve) and mixed data flows, have somewhat shattered the complacency that coddled markets. While these developments suggest modestly higher downside risks than before, we reiterate our year end view that a market correction was imminent and would prove to be a temporary pause in an otherwise still positive (if late cycle) global growth trajectory. Rather than the tariff announcements, though, recent weakness is consistent with the classic three (or plausibly five) wave pattern in sell-offs which has been underway since the late January highs. During phases of heightened volatility, equities become especially sensitive to risk appetite (i.e. greed & fear), with those "market mood swings" dominating short term market movements. While volatility is likely to remain elevated near term and the recent market sell-off has caused sentiment and valuations to become less exuberant, global earnings growth has turned strongly positive and appears highly synchronized. Having reduced equities late in 2017 and again in early 2018, we remain true to our strategy of redeploying funds into equities on market opportunities. While we continue to favor late cycle sectors, with emphasis on technology and industrials, stock selection and price discipline are now paramount, and will also drive geographical diversification. With recent developments pointing to a deceleration of synchronized global growth, market players' expectations for the magnitude and timing of further interest rate increases have needed to be adjusted. With the Fed now talking two (vs three) more rate increases this year, it may not come as a surprise that the most recent peak in equities coincided with a (temporary?) top in interest rate levels. Although higher interest rates remain in the offing, the bond market had already priced in much of this. Thus, further increases in bond yields are likely to be gradual, limiting the negative impact on bond prices. Although it still means that fixed income returns will be modest at best, it also means that our strategy (using trading opportunities) and our focus on higher yields and/or less interest sensitive vehicles can continue to provide better than benchmark returns.

FORECAST 2018	Current 31-MAR-2018	2018 Range	2018 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	1.25%	1.00% - 1.50%	1.50%
Federal Funds Rate	1.75%	1.50% - 2.25%	2.25%
10-year Canadian Treasury	2.09%	1.85% - 2.50%	2.40%
10-year US Treasury	2.74%	2.35% - 3.25%	3.10%
COMMODITIES			
Gold (US$/oz.)	$1,329	$1,200 - $1,425	$1,400
Copper (US$/lb)	$3.02	$2.90 - $3.60	$3.55
Oil WTI (US$/bbl)	$60.42	$52.00 - $63.00	$60.00
MARKETS			
S&P/TSX Composite Index	15,367	14,300 - 16,560	16,300
S&P 500 Index	2,641	2,480 - 2,900	2,875
CANADIAN DOLLAR/US DOLLAR	$0.78	$0.72 - $0.82	$0.78

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