Quarterly Report
SUMMER 2018

HEWARD
INVESTMENT MANAGEMENT INC.

Crunch Time for Trade Wars – Scary Headlines, But Fundamentals Trump the Macro Outlook

OVERVIEW

True leadership may be the most undervalued human attribute, and finding people who truly embody the qualities associated with leadership can make all the difference in the world. Equity markets tend to be the same way. In bull markets leadership is clear and strong. Its presence is undervalued and greatly missed when absent, as it has been thus far in 2018. Rarely have we experienced such low leadership and as a result, markets have taken on a much different complexion. Long gone are the days of record-low volatility and supportive financial conditions. Instead, 2018 has ushered in a period of much higher volatility and tighter financial conditions with very little performance at the index level, across virtually all asset classes and regions.

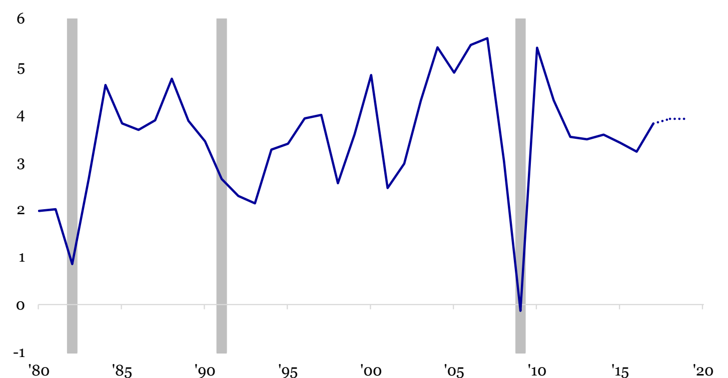
Since the end of the year, a number of factors have rekindled investor concerns that the downside risks to growth are building. Fears have included rising protectionism, lower PMIs, less accommodative central banks, the adverse impact of rising yields and the U.S. dollar and recent political events. Nevertheless, growth has held up relatively well as 1Q18 moderating developed market (DM) growth was offset by emerging market (EM) strength, while in the second quarter, the leadership was reversed. Dollar strength has begun to challenge growth in certain Latin America and CEEMEA (Central and Eastern Europe, the Middle East and Africa) but this has been offset by growth in Asia (larger economically) ex-Japan. Hence, while growth appears to be less synchronized in 2017, in aggregate it remains above trend.

U.S.-China trade tensions have risen sharply, and the next few months may indicate whether these tensions escalate into full-blown trade wars. The bumpy road ahead suggests uncertainty will remain high and will continue to have an adverse impact on sentiment and activity, while the direct impact of the announced tariffs remains modest. Full-blown trade wars (not our base case) would have much a larger impact on both investor sentiment and economic activity, and is currently not being discounted by the markets. Meanwhile, with scary headlines currently more hype than reality, equity markets have remained resilient. Worries about foreign exposure, foreign exchange (FX) and inflation have taken a backseat to earnings.

The U.S. market has proven remarkably resilient in the face of uncertainties that ebb and flow on a day to day or weekly basis. Many believe that it is market complacency that has kept the market in what could be described as an "acceptable range". The bottom line however, may be just that, the bottom line, as for now it's been all about corporate earnings. Furthermore, the impact of fiscal stimulus and deregulation has just begun to be felt, and the market may be underappreciating the amount of infrastructure spending that will come from already-approved budget appropriations. Full and immediate expensing of capex (capital expenditure) should prompt companies to invest in capital rather than engage in financial engineering, resulting in stronger productivity.

Dollar funding of EM economies has been in turmoil for some months now. The upheaval stems from the Federal Reserve's (Fed) long awaited moves to trim its balance sheet and a substantial increase in issuing U.S. Treasuries to pay for tax cuts. The unintended consequence has proven a "double whammy" for EMs as dollar funding has evaporated notably from sovereign debt markets while EMs have witnessed a sharp reversal of foreign capital flows. The rout in EM assets has sparked concerns that the turbulence could spread from the distant corners of the world. As a result, EM bonds and currencies have fallen in value.

IMF World GDP & Forecast
(Annual %)



Source: Strategas

UNITED STATES

After many years of lackluster economic growth following the Great Financial Crisis, the U.S. economy is firing on all cylinders. This has caused the Federal Reserve (Fed) to not only raising rates in June, but also issuing a more hawkish revision to their forward looking statement. Their sentiment was supported by recent retail sales data and the home construction industry which, after a slow start to the year, has gain momentum with builders breaking ground on more homes. The Labor market is probably slightly beyond full employment. This assessment rests more on a whole range of indicators that now signal a tight labor market (job openings, the underemployment rate U6, quits and skill shortages) than on the sub-4% unemployment rate. With the consumer accounting for more than 70% of the economy, it was nice to see the May consumer confidence report continuing to rise , for both the present situation and future expectations Meanwhile, lower corporate tax rates and the elimination of the output gap seem to have finally enticed the return of capital spending. Data from the recently released Institute of Supply Management (ISM) survey along with the National Federation of Independent Business (NFIB) and regional Fed surveys confirms spending plans of 8.6% by non-manufacturing and a double digit increase of 10.1% for manufacturing companies. Unfortunately, the country remains saddled with more chaotic and restrictive trade and immigration policies, which are likely to be headwinds to the supply side. While the U.S. budget deficit remains a major concern, most of the bad news may now be baked in as the short term estimates will begin to fall over the next few months as tax revenues come in higher than expected.

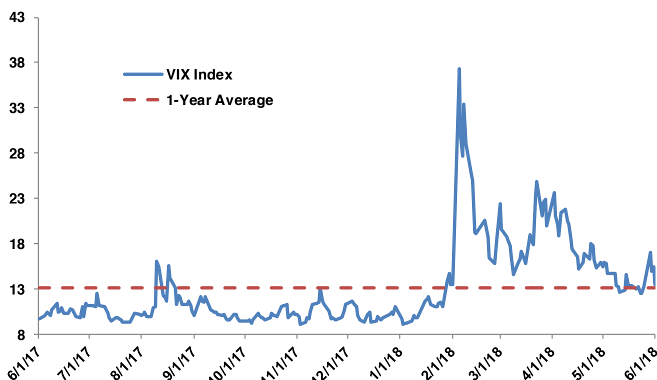
CANADA

The Canadian expansion continues, albeit at a slower pace. Overall activity data has held up rather well, and forward looking indicators continue to point to continuing growth momentum, despite some weakness in the hard data (recent declines in housing starts and employment). The Bank of Canada's (BOC) business outlook showed only modest declines in business conditions, and remains at levels consistent with above-trend growth. The unemployment rate, in spite of the recent declines in the employment numbers, remains low averaging 5.8% to date and thus below estimates of full employment of 6.0 – 6.5%. Higher oil prices are now acting as a tailwind. However, we do expect growth to moderate, driven primarily by slowing consumption growth. Household spending contributed substantially to Canada's above-trend growth in the first half of 2017, achieved largely through rising levels of debt. With debt-to-income levels at record highs, the consumer will be extremely sensitive to higher interest rates. Consumption growth has already shown signs of moderating, with retail sales rolling over in recent months. However, slack in the Canadian economy has been significantly reduced, particularly in the labor market and in response wage growth is starting to stir. Furthermore, with the U.S. economy getting pumped with stimulus (taxes and fiscal spending), this should create stronger demand for Canadian goods and services. Meanwhile, the recent G7 meetings held in Quebec City ended on a positive note as one might have expected, only to be followed by a volley of elevated rhetoric between Canada and the U.S., which some fear could destabilize NAFTA negotiations.

EUROPE

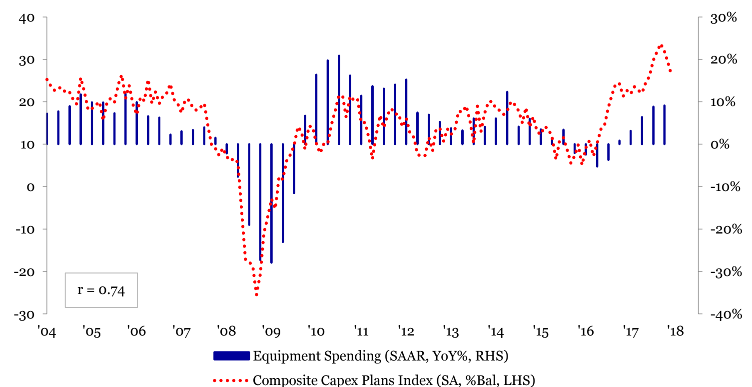
While there is some justification in blaming the poor start to the year on temporary factors, the recent euro area "flash" PMI composite output surprised to the downside in May, continuing its march lower since the beginning of the year. That said, Purchasing Managers' Index (PMI) across the continent as well as IP surveys all remain in expansionary territory. Despite the slight deterioration in the growth situation, the macroeconomic fundamentals remain positive. Demand remains strong and is supported by continuing labor market improvements and high corporate profitability. Easy financing conditions are not going away, as the European Central Bank (ECB) delivered a dovish surprise, despite

VIX Index of Equity Market Volatility



Source: Chicago Board of Options Exchange, Bloomberg, Oppenheimer Asset Management Research

Capex Plans vs. Actual Capex



Source: Strategas

announcing the likely end of its asset purchase program. Taken together with recent positive consumer confidence data, these factors suggest that growth should remain above trend, but weaker than originally expected coming into 2018. Meanwhile, the greatest fear about Italy was that snap elections could essentially turnout to be a referendum on the country's euro membership. Now however, market fears have turned to the coalition's spending plans which will drive up Italy's public debt. While it has made a slow start to the year, UK economic growth should prove resilient in the face of Brexit. Growth should rebound given that the squeeze on households' real earnings has ended, while CPI should fall further as the impact of post-referendum slide in sterling falters. From all reports, Brexit talks have been slow and it seems the EU27 is better prepared and has a stronger negotiating position. In emerging Europe, tax cuts and slightly stronger wage growth will keep domestic demand rising at a healthy pace.

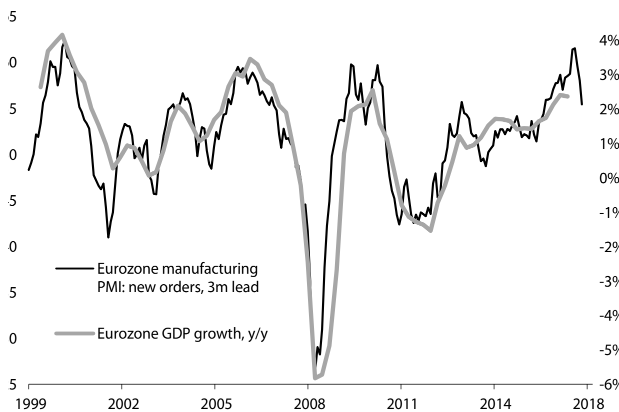
EMERGING & DEVELOPING MARKETS

Slowing Chinese industrial & construction sectors, and more broadly a slowing economy, is a theme that has been seeping into the market's consciousness. However, key reasons to support the thesis that China's growth will remain resilient through 2018 include: 1) the resilience of iron ore and copper prices, 2) a bounce in some of the latest economic data (primarily April & May), and 3) the perceived strength in the Chinese consumer and the narrative that China is shifting into a consumer growth story. There is also that overriding argument that China is an internally contained, self-funded economy and that the government will stimulate in the event that the economy slows too rapidly. Meanwhile in Japan, while the economy cannot be classified as "strong", there is a much greater sense that monetary policy has been transformed from being outright harmful to being a mild positive for the economy. Growing global trade tensions however, do appear to be making Japanese companies somewhat skittish about new investment. Rising U.S. Treasury yields and the dollar's renaissance have ramped up pressure on emerging markets (EM), with public debt positons across the emerging world coming under increasing scrutiny. Markets are concerned that the dramatic events in Argentina may be the "tip of the iceberg" of a broader systemic crisis that may be developing across Asia, Latin America and Africa. However, China's May trade data showed both imports and exports up strongly, and taken together with the bounce back of Korean exports to double digit growth, suggest a picture of gradually cooling trade rather than a sharp collapse.

COMMODITIES

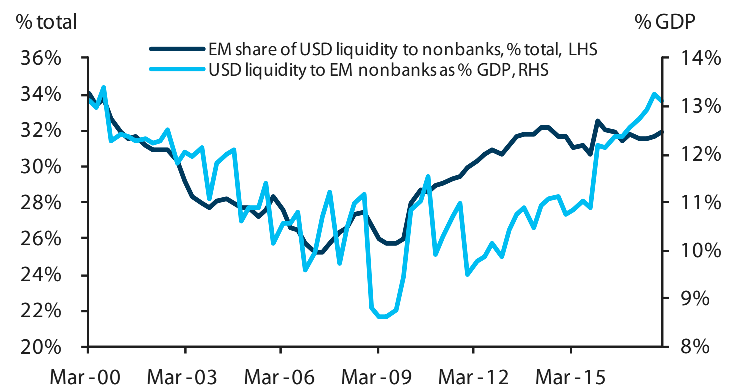
The end of the OPEC/Russia oil production cut agreement has come earlier than expected, but changed circumstances influenced the move. On June 22nd, OPEC reached an agreement in principle to boost oil production, achieving a last minute compromise. The deal reflects a one million barrel-per-day adjustment on paper, but the actual increase will amount to 600,000 barrels per day because many members are unable to raise output. Four things have changed prompting the addition of supplies: 1) President Trump re-imposing sanctions on Iran could reduce 200-500m b/d of supply from current levels; 2) the continued collapse of Venezuelan production, now 500m b/d below targeted levels; 3) President Trump tweeting in late April that oil prices were too high and 4) Brent prices approaching $80 fomenting concerns about a potential adverse impact on demand. Meanwhile, Commodity markets reveling in their best year since 2002, tumbled in June as new tariffs announced by the U.S. and China prompted investors to question the global growth outlook. Heightening trade worries coincided with a strengthening dollar and a more-hawkish Fed, which recently raised rates and has penciled in two more increases in 2018. Furthermore, outside of America, business growth seems to be slowing nearly everywhere. The high level of confidence felt earlier this year seems to have evaporated. Physical business in China is good, but weaker than expected across multiple sectors while in the European Union (EU) fabricators have deferred deliveries until late

Euro area PMI new orders are consistent with GDP growth of 2.2%



Source: Thomson Reuters, Markit, Credit Suisse research

EM nonbank borrowers have become increasingly dependent on USD liquidity



Note: Liquidity includes bank lending and debt securities
Source: BIS, Haver Analytics, Barclays Research

RECOMMENDATIONS

History tells us that markets don't rise in straight lines, but rather climb walls of worry, overcome significant hurdles and legions of negative projections. Experience tells us that leaderless periods typically occur during important transitions in markets. This confused direction for risk appetite reflects a number of coincidently timed headwinds which hopefully prove transitory. While the political backdrop is concerning, U.S.-China trade tensions are the material risk to markets. Even though we expect both parties to move forward with the $50bn tariffs, we do not expect tensions to escalate into a full blown trade war yet, and before anything is settled things are likely to get quite messy. Meanwhile, global demand growth remains in the "Goldielocks Zone". The earnings outlook is positive, inflation is tame, monetary policy remains relatively easy and the capex story is coming. Barring the potential for an exogenous event, most of the basic building blocks of the bull market that started nine years ago, remain in place, and as such we continue to favor equities over bonds, while retaining an above normal cash position. We will be using market opportunities (provided the trade/tariff situation is clearer) to add to equities. Our portfolios are well-balanced (slight overweight in Canada) geographically, while favoring cyclical sectors over defensives. The rippling effects of a continuing to expand global economy should be felt through the financial, technology and industrial sectors, while supply side issues will leave their mark on both energy and commodities. The most recent quarter saw some wild swings in interest rates, more so in Canada than in the U.S. Rates spiked early in the period, reaching peak levels by mid-May on signs of continued economic strength and a more hawkish rhetoric from Central banks. Since then, signs of slowing economic growth (ex-U.S.) combined with global trade tensions have deflated the interest rate bubble, bringing long rates off their highs. In Canada, rates backed-off to where they started the quarter. Given the ongoing uncertainties on trade and further signs of peak global economic growth rates, we expect Central Banks to tread carefully. Base rates will be hiked further in the U.S. (and possibly Canada), but they may not reach levels originally anticipated. Consequently, bond markets will likely move sideways, allowing for a positive return on bond portfolios. In the portfolio, we have increased duration, while continuing to hold some high yield vehicles like preferred shares and select equities.

FORECAST 2018	Current 30-JUNE-2018	2018 Range	2018 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	1.25%	1.00% - 1.50%	1.50%
Federal Funds Rate	2.00%	1.50% - 2.25%	2.25%
10-year Canadian Treasury	2.17%	1.85% - 2.50%	2.40%
10-year US Treasury	2.84%	2.35% - 3.25%	3.25%
COMMODITIES			
Gold (US$/oz.)	$1,255	$1,200 - $1,425	$1,400
Copper (US$/lb)	$2.96	$2.65 - $3.40	$3.10
Oil WTI (US$/bbl)	$74.30	$58.00 - $82.00	$77.00
MARKETS			
S&P/TSX Composite Index	16,275	14,300 - 16,800	16,700
S&P 500 Index	2,715	2,550 - 2,875	2,800
CANADIAN DOLLAR/US DOLLAR	$0.76	$0.70 - $0.82	$0.77

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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

HEWARD
INVESTMENT MANAGEMENT INC.