Quarterly Report
WINTER 2019

HEWARD
INVESTMENT MANAGEMENT INC.

Navigating Markets Subject to Politics, Slowing Growth, Contracting Liquidity & the Return of Volatility

OVERVIEW

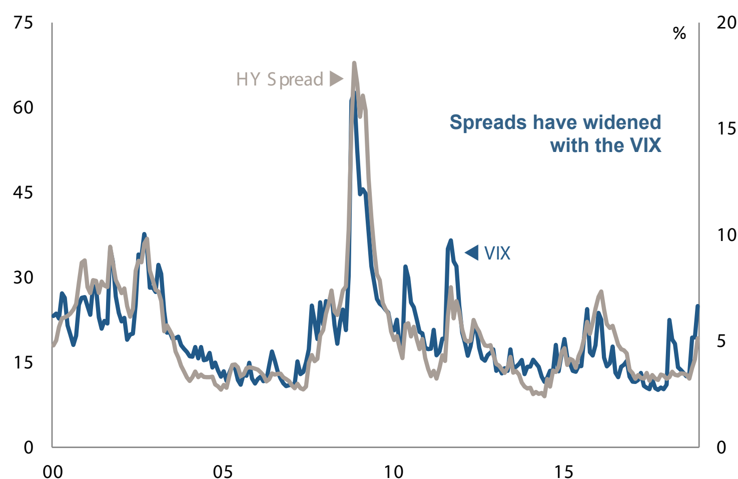
The firm ended 2018 with a more subdued tone than at the start. Global markets began the year positively, as tight labor markets, weak inflation and potential business investment contributed to investor optimism and slightly excessive P/E's. Possible trade wars coupled with a rising interest rate environment caused markets to stumble in February, before recovering through the mid part of the year. The autumn brought even more uncertainty, with volatility more than doubling since the end of September. October bore witness to one of the worst monthly stock performances in years, until December's selloff decimated markets.

Global growth is clearly in the midst of slowing. Over the next few months what we see developing looks rather challenging and will have implications for financial markets. While the U.S. economy continued to expand at a rapid pace through 2018, we expect it to lose momentum through 2019. The boost from the fiscal stimulus will fade and tighter monetary policy is already causing a slowdown in rate sensitive sectors. Investors have also been concerned with the Chinese economy which has been losing steam from: property markets that have cooled, the lagged effects of past policy tightening measures and the trade/tariffs impact on the economy. In Europe, the outlook has continued to deteriorate as business and consumer sentiment has softened and GDP growth keeps sliding. Investors fear that Italy's economy is likely to flirt with recession and Brexit is still to be dealt with. With some exceptions, consensus expectations for emerging markets also have GDP growth slowing.

However, we may be at or close to a market bottom as a survey from Bank of America Merrill Lynch indicated that investors made a record shift into bonds as equities suffered through year end. Conversely, it also reported bets on equities falling to their lowest levels in two years. Also, an interesting theory which probably magnified the year end debacle in equities emerged from Raymond James strategist Jeff Saut. He alluded to approximately 150 hedge funds closing their doors at year end, and who sent letters out to clients on November 15th advising them that they had a six week "window" to pull their invested funds. With those liquidations, combined with the long-only mutual fund selling, tax loss selling and ETF liquidation by panicked retail investors, participants sold into a vacuum of NO BUYERS!

Furthermore, while global growth is moderating, the excess pessimism seems unwarranted. Looking through the short term volatility and market "noise" and focusing on what seems to be the forgotten fundamentals, should eventually prove positive for equity investors. This economic cycle is not over. Monetary policy remains accommodative in most advanced economies, inflation is likely to remain subdued, which in turn will reduce pressure on the U.S. Federal Reserve to tighten too much. While the U.S. fiscal impulse will gradually fade, fiscal policy elsewhere should be neutral or slightly expansionary. Germany clearly has ample leeway to ease policy and the political tensions in the euro zone may provide an added incentive to do so. Although China is unlikely to return to fiscal and credit profligacy, its leadership will do enough to maintain growth above 6.0%. If trade tensions were to dissipate, Chinese growth could surprise to the upside. With the proper attention political tensions in Europe should subside (Italy and France) and the nature of Brexit will become clearer. Also, the imbalances in emerging markets (EM), which contributed to market setbacks in 2018, should be mended to some degree.

VIX vs. High Yield Spread



Source: CBOE, Federal Reserve, Bank of America Merrill Lynch, Haver Analytics®, Credit Suisse

UNITED STATES

For 2019, the impetus of fiscal policy on the economy will be smaller than it was in 2018, but it will still be positive. The labor market remains on solid footing as strong job growth continues even though we are late in this cycle. The good news is that on a year over year basis wage growth is also growing. December's interest rate increase was representative of the Fed staying its tightening course. At the same time, the Fed is now set to go off its "auto-pilot" of quarterly rate hikes, stressing data dependency. However, the impact of rising yields on the economy remains manageable. Not only is the interest coverage ratio for the economy as a whole is still above its historic average, but 30 year mortgage rates have fallen to almost a nine month low. Furthermore, the private sector is running a financial surplus, meaning that it earns more than it spends. Not only does this make the economy more resilient, it also provides the government with additional savings with which to finance its budget deficit. The trade war with China is now the biggest impediment to growth. The manufacturing sector has stalled, but GDP growth remains robust because the plunge in gasoline prices is supporting strong consumption. The manufacturing slowdown likely has further to run, given the abrupt rollover in import demand from China, as well as the disruptions to supply chains and the increased costs of raw materials and components. The silver lining here is that the obvious pain inflicted on both economies means that both President Xi and Trump are highly incentivized to strike a substantive deal.

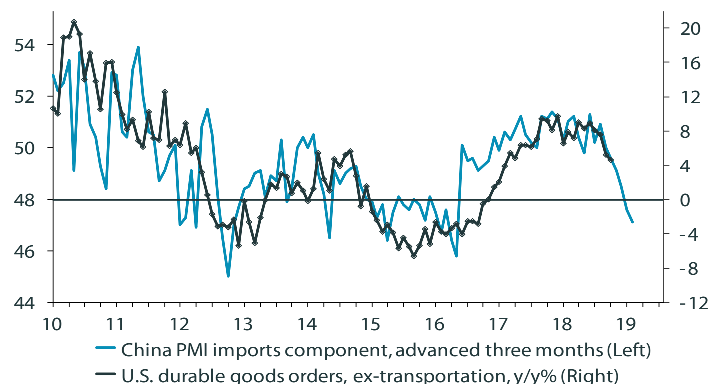
CANADA

In an effort to address the significant Canadian crude glut (and low prices), Alberta Premier Rachel Notley announced that the government would implement an 8.7% cut (325 mmbbl/d) in the production of raw crude oil and bitumen. While positive for oil price differentials, this will likely have a negative impact on Canada's first quarter GDP, as it holds back investment in the oil patch. Bank of Canada (BOC) Governor Stephen Poloz has also chimed in on the low oil prices, saying that he does not believe the country has another 2014-15 oil shock on its hands, but that the central bank needs more time to figure out just how hard the current slump in Canada's oil market will hit the broader economy. That said, in recent media appearances the Governor continued to emphasize that the economic backdrop in Canada remains solid (high capacity utilization, unemployment at a 40 year low & inflation around 2%). He did however acknowledge the risks to the backdrop, including the potential for stagflation from worsening global trade (i.e. higher tariffs) and lower oil prices. Meanwhile, a sharp decline in residential investment may cause the BOC to move to the sidelines before they achieve their target of neutral rates (2.5 – 3.5%). Having said that getting there would be a "journey", in the end it will be the economy which dictates how high rates can go, not inclinations of the central bank. Meanwhile, the Canadian economy continues to create jobs, but at a slower pace than in the U.S. While job creation does provide further reason for the BOC to steadily raise rates, declines in wage growth has become a concern and markets are pricing in one further hike through 2020.

EUROPE

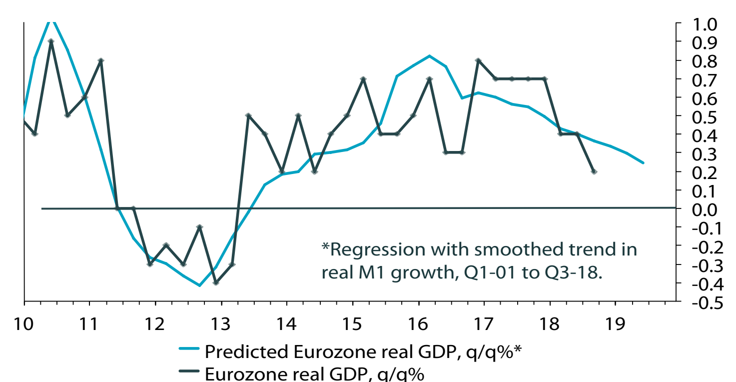
The European Central Bank (ECB) continues to reaffirm its plans to normalize monetary policy gradually, expressing very little concern about the run of weaker economic data. Acknowledging that both the hard data and surveys have been "somewhat weaker" than expected, President Draghi stressed that it represented weaker momentum, not a downturn. With that, the ECB took the watershed decision to halt its 2.6 trillion-euro bond buying program, capping massive monetary support even though the euro-zone economy still looks vulnerable. Mr. Draghi stated that the Bank had plenty of tools at its disposal should downside risks grow. Interest rates in the meantime are expected to remain at record lows, "at least through the summer" of 2019. The ECB also remained confident about the rising inflation outlook. The Bank said they were buoyed by the recent rises in negotiated pay, which were a "comforting sign" that the recent uptick

The tariff wars are hurting industry...



Source: © 2017 Pantheon Macroeconomics

Slower growth, but no collapse, in the Eurozone



Source: © 2017 Pantheon Macroeconomics

in wage growth would be sustained. Meanwhile in Italy, the government seems to have kicked the can down the road. Its new budget shows no change in the structural deficit, which is a positive surprise, but the plan merely delays, rather than resolves its fiscal problems. In the UK Prime Minister Theresa May survived an attempt by her own party to oust her, creating uncertainty on how this Greek tragedy will play out. What is clear however is the E.U. leaders have said they will not make substantive changes to the Withdrawal Agreement, which likely won't placate the MPs who voted against Mrs. May. Meanwhile GDP growth and inflation are undershooting expectations, as have the Purchasing Managers Index (PMIs) but wage growth has surprised to the upside.

EMERGING & DEVELOPING MARKETS

In a move to further de-escalate trade tensions, Beijing appears to be easing its push on its "Made in China 2025" industrial policy. An initiative which has long irked Washington, it was a plan to help China catch up with global rivals in key economic areas. Beijing plans to replace this initiative with a new one designed to play down China's bid to dominate manufacturing and will seek to be more open to participation by foreign companies. In its drive to maintain economic growth, the government had promised new measures. Just before Christmas, two important themes for economic recovery were made official. The People's Bank of China (PBOC) announced the establishment of a "Targeted Medium-Term Lending Facility" which will allow banks to borrow from the PBOC at a reduced rate to provide funds for the Small Medium-Sized Enterprises (SME)/Private sector. Secondly, and equally important, Beijing will allow local governments to lift many of the restrictions that have been imposed on the issuance of mortgages and buying of property. The government knows that real estate is just too important to the economy to be held back. Also, to serve the online consumer sector, an increasing number of Chinese banks and other financial institutions are forming joint ventures with large-scale online platforms (i.e. Alibaba, Tencent and JD.com). Japan's latest Tankan survey indicates that the economy is due some rebound after the string of natural disasters that hit the country. The projections of non-manufacturing firms are still rising, while the upcoming fiscal budget should provide more clarity on how the government intends to smooth out the effects of the slated consumption tax.

COMMODITIES

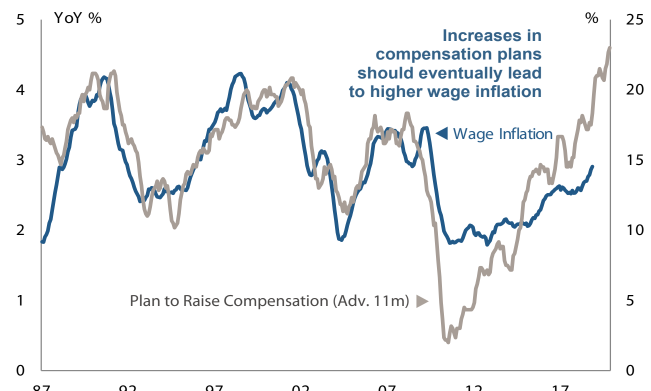
In what appears to be a rerun of stimulus that boosted the Chinese economy in 2009 and 2015, Beijing has dramatically reduced the reserve ratio of the banking sector and simultaneously reduced the cost of lending. In the two previous interventions, the impact of this monetary stimulus was seen in the following years in a significant increase in the level of new loan growth in China and subsequently on the commodity price deck globally. Furthermore, today the commodity industries are no longer facing the same growth in supply that characterized the end of the "super cycle". Investment in new mine supply fell in lockstep with falling commodity prices from the peak of 2012 to the lows of 2016. Hence, notwithstanding the changing structure of the Chinese economy, the current position of many commodities more closely resembles 2008 (tight demand/supply fundamentals) than 2015 (new mine supply). Global oil demand has beat expectations every year for the past five years underpinned by: GDP growth which has surprised to the upside and low oil prices which have been simulative to demand growth. Now however, oil demand growth has probably peaked and is likely to slow (not decline). Meanwhile, the recent plunge in oil prices driven by the combination of stronger than expected U.S. production and the ramp up of Saudi/Russia production to offset lower Iranian exports (only to have President Trump grant 900 MBbld waivers), clearly shows that global oil producers need to slow their enthusiasm for growth. With the recently announced OPEC+ cuts, global demand and supply should reach a fine balance in 2019 (as per the Saudi oil minister).

Major S&P Declines Without a Recession 1945 to Present

Start Date	End Date	% Decline	Recession?
5/20/2015	2/11/2016	-15.2%	No
5/2/2011	10/4/2011	-21.6%	No
7/20/1998	10/8/1998	-22.5%	No
8/25/1987	10/20/1987	-35.9%	No
9/21/1976	3/6/1978	-19.4%	No
2/9/1966	10/7/1966	-22.2%	No
12/12/1961	6/26/1962	-28.0%	No
5/29/1946	5/19/1947	-28.5%	No

Source: Strategas

Wage inflation vs. Compensation (Advanced 11 months)



Note: Blended Non-Supervisory pre-2007 and All Employees post -2007; 6-Month Moving Average
Source: BLS, NFIB, Haver Analytics®, Credit Suisse

RECOMMENDATIONS

The final few months of 2018 may have set the tone for what we are likely to see in 2019. The biggest lesson to take away from 2018 is how a change in liquidity can front-run a change to the market's trend. Markets and monetary policy are now colliding, but the story has yet to fully play out. The tightening cycle is still at an early stage in the U.S. and has not even begun in other regions. Obviously there are structural problems in a number of countries, and at some point the global economy will suffer another recession. However, while a rocky road lies ahead, the conditions for a major bear market or recession are not yet in place. Furthermore, the extent to which many market participants are conflating the potential slowdown in both economic activity and earnings growth for 2019 with a recession remains surprising. In fact, it seems that the process of capitulation may have started. There has been a doubling in bearish sentiment since September, and valuations are now down to fair (almost attractive) levels. We continue to believing that the still-accommodative monetary policy, the yet to be seen supply side effects of the tax cut, reflationary policies in China and the euro zone will pave the way for better global economic growth than the current market selloff is pricing in. This leaves a window for risk assets to show renewed strength, but it remains to be seen whether prices will reach new peaks. However, we feel it would be premature to reduce or add to equities as more clarity is required at this time. In this "start-stop" environment, cash (and short term bonds) will remain a reasonable component within our portfolios. After moving to new highs for this cycle, interest rates took a nose dive, mimicking equity markets on fears of significantly slower economic growth. As a result, bond returns took a turn for the better after showing negative returns for most of the year. Unfortunately, whether justified or not, the correction left its trace in the form of widening credit spreads on anything other than government bonds. As a result, the performance of the fixed income component of our accounts is flat for the year after having been ahead of the benchmark for the past several years. Believing that some of the selloff is overdone, we will look for opportunities to benefit from the bargain prices on some of the fixed income products.

FORECAST 2019

	Current 31-DEC-2018	2019 Range	2019 Year-end
INTEREST RATES			
Bank of Canada Overnight rate	1.75%	1.75% - 2.00%	2.00%
Federal Funds Rate	2.50%	2.50% - 2.75%	2.75%
10-year Canadian Treasury	1.96%	1.80% - 2.25%	2.15%
10-year US Treasury	2.68%	2.45% - 3.15%	3.05%
COMMODITIES			
Gold (US$/oz.)	$1,281	$1,225 - $1,350	$1,325
Copper (US$/lb)	$2.63	$2.50 - $3.35	$2.95
Oil WTI (US$/bbl)	$45.41	$45.00 - $64.00	$62.00
MARKETS			
S&P/TSX Composite Index	14,322	14,000 - 16,000	15,300
S&P 500 Index	2,506	2,450 - 2,725	2,650
CANADIAN DOLLAR/US DOLLAR	$0.73	$0.72 - $0.81	$0.79

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