Quarterly Report
SPRING 2019

HEWARD
INVESTMENT MANAGEMENT INC.

Staying Cautiously Positive in the Face of Slowing Global Growth, Expected Weaker Earnings and General Pessimism

OVERVIEW

Markets are increasingly worried that a recession is imminent, either this year or next. The consensus estimates of the probability that real GDP will be falling in the quarters ahead, has now reached its highest level since 2008 (Survey of Professional Forecasters). However, the latest consensus odds remain at levels well below those that are historically associated with a recession actually occurring. Furthermore, because of demographics, technology, globalization and numerous other reasons, inflation remains quiescent and the economy continues to grow modestly. Moreover, key central banks have been fine tuning their monetary policy to avoid violent swings in the economic cycle. To the stock market, this is “Mana from Heaven”! Last year to be successful you had to find a way to stay cautious in the face of nothing but optimism. This year however, investors need to stay positive in the face of nothing but pessimism.

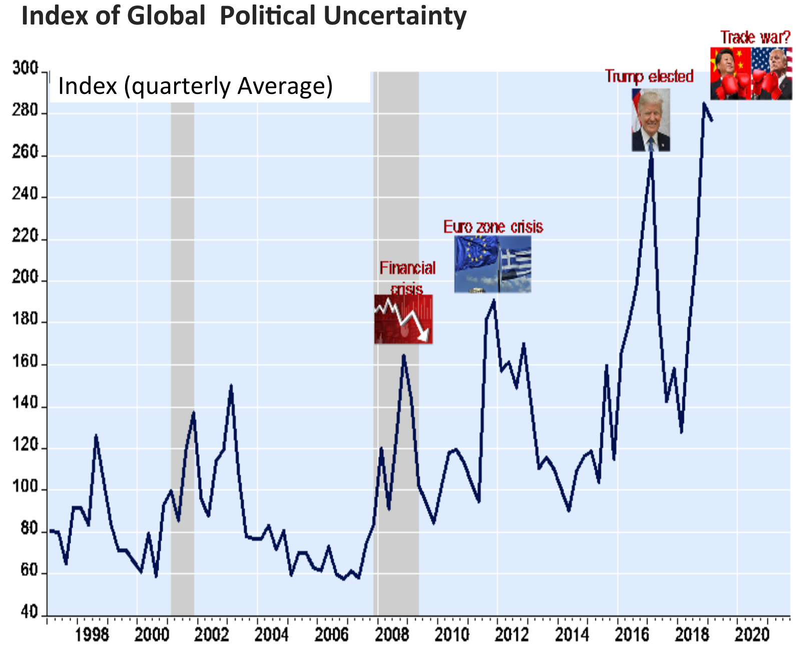
While a broad swathe of survey data suggested that the global economy slowed in the final quarter of 2018 and early 2019, we are looking at the glass as being half full. The slowdown was most pronounced in the euro zone. A big part of the slowdown was due to the disruption caused to vehicle production, which should prove to be temporary. The remainder being a combination of weak household spending and a drop-in investment and exports, which could change with trade deals being finalized. In China, there have been pockets of weakness and the import data suggest that domestic demand is softening, probably the result of past policy tightening. As more recent policy stimulus starts to feed through, the Chinese economy should stabilize over the second half of the year. Meanwhile, if there is an agreement coming between the U.S. & China, the escalation of existing tariffs will be taken off the table, and if so, fiscal policy stimulus will likely dwarf the effect of tariffs in 2019. We are also optimistic that once deals are announced (including Brexit), we will see the return of capex, a key part of the global economic equation which has been missing. Also, while still far too early to say for sure, March’s manufacturing Purchasing Managers Indices (PMI’s) offer some hope that the worst is over for the downturn in global manufacturing. The new trade pact (USMCA) is not yet a done deal. Congress seems no more eager to approve it without amendment than it was willing to give Trump a win on the border wall.

However, if there are economic fears associate with this corner of uncertainty, they aren’t Canada’s! For one, NAFTA remains in force while this process drags on. Also, currently in force and not requiring ratification, is the side letter that Canada and the U.S. signed on autos. It grants Canada an exemption from any U.S. national security auto tariffs barring an unlikely surge in Canadian auto production.

Crude oil markets remain reasonably supported despite late winter being a period of weak demand due to refinery turnaround season and a plethora of macroeconomic headwinds that continue to weigh on the market. Global pricing has been up 20% since the start of the year, not withstanding a Trump tweet calling for lower oil prices. The physical market continues to look constructive despite excess gasoline inventories that remain in a number of key consuming markets. Prices will continue to be supported by: 1) ongoing signs of strong Saudi leadership in production management; 2) growing supply risk in other key producing regions; 3) U.S. capital discipline and production restraint becoming a larger focus (capital spending plans have surprised to the downside for 2019).

World: A Stressful Environment

Index of Global Political Uncertainty



Source: NBF Economics and Strategy (data via http://www.policyuncertainty.com/global_monthly.html

UNITED STATES

The U.S. economy is probably going to experience a soft landing as it joins the ranks of a global slowdown in 2019. However, the odds of a recession remain low. This is consistent with the message from both the equity and bond markets. With global PMIs weakening, it was not surprising to see the Philadelphia Federal Reserve index fall. However, the labor market is still healthy and low interest rates are already starting to put a floor in key sectors. Also, favorable changes to the child tax credit should represent a positive refund cycle in 2019, as the benefit doubled and the income phase-out threshold rose. A fair amount of negative press initially surrounded the disappointing early tax refunds, not realizing that government regulations restricted the payments of funds on returns utilizing the child tax credit until mid-February. We have not yet seen weakness in the nonfarm payrolls and some of the recent month over month moves were more like noise (i.e. government shut down, market volatility) instead of an actual signal that trouble was brewing. Jobless claims have turned back down (after a mild uptrend in a holiday week) while consumer confidence and housing already look to be rebounding. Another part of the soft-landing story is that the Federal Reserve (Fed) "gets it". After the March meeting, Chairman Powell said that "it may be some time" before the central bank needs to adjust its monetary policy. The comments came as he unveiled another startling dovish outlook that saw projections for future interest rate increases slashed along with an announcement that quantitative tightening would end even earlier than thought, in September.

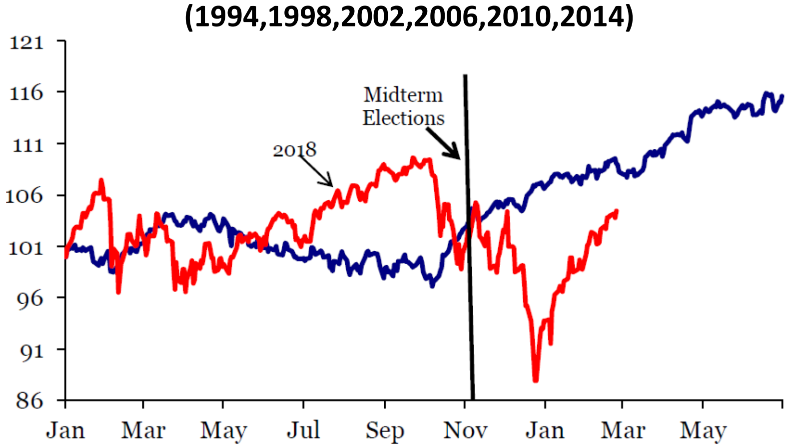
CANADA

While the federal Liberals announced $21 billion in new expenditures in their recent budget, it is hard to spot a center piece among those initiatives. Instead, it seems to be a grab bag of voter-friendly measures and results in a little-changed deficit profile including shortfalls of nearly $20 billion in each of the next two fiscal years. Those deficits are just small enough to push debt-to-GDP slightly lower in the near term, but a softening economic outlook for 2019 leaves little room for error. The Bank of Canada (BOC) left rates unchanged as the economy limped past the finish line in 2018. Recent data suggest that the slowdown in the global economy has been more pronounced and widespread than the bank had forecast in the January Monetary Policy Report. While the sources of moderation appear to be multiple, trade tensions and uncertainty are weighing heavily on confidence and economic activity (GDP growth is running at its lowest levels since Q2, 2016. Housing starts continue to fall and prices have followed suit as the latest household finance data is highlighting a challenging environment for Canadian consumers. A key metric, the debt service level (share of household income going towards principal and interest payments on debt), has increased for five consecutive quarters). However, in a recent speech, a senior deputy governor of the BOC reiterated expectations for growth to improve in the second half. To keep Canada in gear, we'll have to tap into the ongoing growth in U.S. markets, see a finely tuned interest rate judgement by the Bank of Canada, and perhaps, a bit more fiscal stimulus at the federal level to counter provincial restraint.

EUROPE

While the slowdown in global growth was largely contained to advanced economies, France, Germany and Italy have fared worse than other major countries due to their relatively high exposure to turning points in the world economy. After slashing its growth forecast, the European Central Bank (ECB) announced a round of fresh stimulus, which left investors even more concerned. There are increasing calls for a big fiscal stimulus from Germany, and there are compelling reasons for Germany to do so. They ran a large budget surplus in 2018 so there is plenty of "fiscal space" and its debt-to-GDP ratio is set to be less than

Average S&P 500 Performance Following Midterm Elections (1994,1998,2002,2006,2010,2014)



Source: Strategas

China & the Rest of the World Manufacturing PMI's

Source: Capital Economics

60% this year, the lowest in the G7. The ECB's new Targeted Longer-Term Refinancing Operations III programme should help to prevent credit conditions from tightening next year, but any boost to lending growth would be small. Mario Draghi, recently suggested that the ECB is likely to provide more policy accommodation within the next six months or so. While continuing to think that the recent weakness in the data is more likely a soft patch rather than a prelude to a downturn, the ECB conceded that the weakness has been more persistent than previously anticipated. Fortunately, the retail sector is holding up well. The Bank of England (BoE) said that Britain faces its weakest economic growth in a decade as uncertainty over Brexit mounts and the global economy slows. Prime Minister May has asked for an extension to the Article 50 process and the EU has granted one but only until April 12th. At quarter end, her third attempt to get the agreement through parliament failed, but she was entertaining the thought of trying one more time before the deadline.

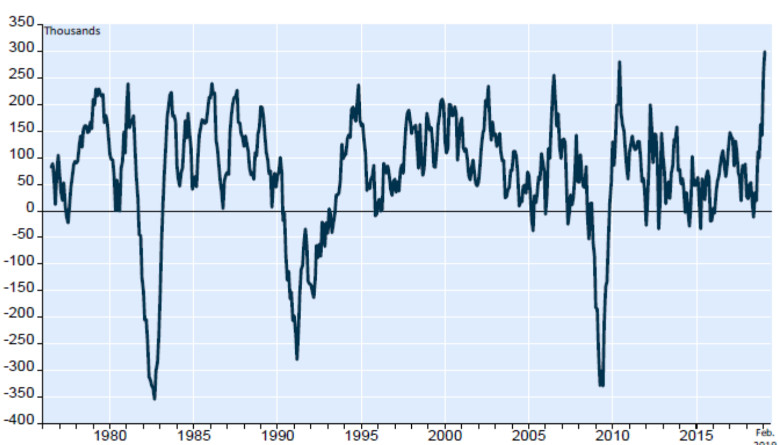
EMERGING & DEVELOPING MARKETS

While growth has clearly slowed in China, fears of a "hard landing" or dramatic further slowing may be misplaced. Against the near-universal gloom about China's economy, spring shoots of recovery can be found. By mid-February, data on lending and aggregate financing hit new highs. There was also the recovery in air conditioning, washing machine and refrigerator sales at year end, which has continued into 2019. Monetary easing appears likely to continue and the year-over-year change in the credit impulse, which tracks the overall financing relative to GDP, continues to improve. The credit impulse has seen its momentum turn positive at the depth of each slowdown since the financial crisis and increased credit availability could once again lead to a growth revival. It seems last year's softer patch (May to October) was caused by the credit clampdown and by sentiment being impaired by the U.S. policy on tariffs. Typically, a rebound in the credit impulse growth leads to a recovery in manufacturing PMI and commodities in the following months. Meanwhile trading activity shows Japan started the year on a weaker note. China's slowdown, weaker global growth and persisting uncertainty generated from the U.S./China trade tensions caused exports to decline. Imports were only up slightly, which is a gloomy signal for domestic spending. Japan needs a recovery in global trade and the right stimulus ahead of the Value Added Tax (VAT) rate that is coming in October. At its last policy meeting the Bank of Japan left policy intact and revised growth expectations lower.

COMMODITIES

A rebound in commodity prices and investor interest is poised to extend in coming months as the sector gets its traditional boost during the later stages of the global economic cycle. While some investors worry about a possible recession, commodities are expected to benefit from: more dovish monetary policies, an expected U.S./China trade deal, and tightening supplies for both crude oil and industrial metals. Led by copper, which is often seen as a bellwether for the global economy, the 19 commodity Thomson Reuters Core Commodity CRB Index, has rebounded 10 per cent from an 18 month low touched at the end of last year. The rise in prices and more positive outlook (Chinese stimulus and Washington/Beijing agreement) have helped to spur over $2.1 billion of fund flows into commodity index funds thus far. Meanwhile, it seems that Saudi oil minister Khalid al Falah is on a mission and he is messaging the world strongly that the group (OPEC & OPEC+) will find balance in the oil market. The Kingdom is in a "whatever it takes mode" to get oil on a firmer footing due to its growing domestic fiscal needs. In announcing their 2019 budget, there were no repeat austerity measures as in 2015, and instead contained a 7% increase in spending. Their robust revenue assumptions seem to imply a return to higher Brent prices, possibly as high as $80us. OPEC's plans to shelve an extraordinary meeting in April. This will enable the organization to better assess the impact of Iranian and Venezuelan sanctions on market dynamics before making a formal decision on the duration of their production cuts.

Canada: Private Sector Creating Jobs at the fastest pace on records (Employment creation in the private sector, 6-month cumulative)



Source: NBF Economics & Strategy (data via Statistics Canada)

World: Perspective on Commodity Prices
Copper vs. Oil Prices (Brent)

Source: NBF Economics & Strategy (data via Statistics Canada)

RECOMMENDATIONS

In spite of the strong first quarter, investor sentiment remains mixed and pessimism seems to be the operative word when it comes to global growth expectations. The "noise" on Wall Street has been deafening as everyone is now shouting "inverted yield curve" and "bear market/ recession". Meanwhile, advance/decline (AD) lines continue to act well. Strange behavior for a bear market as AD lines usually turn down 3-6 months ahead of major indices. While we agree with the slowing growth scenario, we don't share the view of the many pundits who are calling for an imminent recession. If the global economy stabilizes, trade wars are averted and we see the return of capital spending, earnings expectations could surprise. The potential for last year's tax cut functioning as it was intended (i.e. greater capex leading to higher productivity and growth) is not at all priced into the markets. Furthermore, while the headline numbers in China point towards economic weakness, green shoots of recovery are visible (Simon Hunt Strategic Services). Both fixed asset investment and private investment are giving confirmation that the important part of China's economy is back on the expansion road. While constructive on equities longer term, transient headwinds call for caution in the near-term to monitor the forth coming data closely and reassessing our positions as we move through the second quarter. Contrary to popular belief, historically, the best environment for equites is in a period of modest growth and stable inflation, the "Goldilocks economy". We may be approaching this phase again! Propelled by a weakening global growth and a more dovish positioning by global central bankers, bond yields have continued their downtrend, culminating in an inversion to end the quarter. While the risks for recession have clearly risen, we do not expect that one is imminent. As such, lower bond yields and possibly even central bank rate cuts may be possible. We do not however, expect rates to go down to the levels seen in 2015/16, as inflation is trending somewhat higher. If, as some are forecasting, we do experience a recession, it should be relatively short and shallow. Rates are likely to pause around current levels for a while, until there is more clarity with respect to global growth. For this reason, we have used the bond market's strength to gradually reduce duration. We have also reduced our exposure to higher risk vehicles and are maintaining an overweight position in bonds and money market instruments.

FORECAST 2019	CURRENT 31-Mar-19	2019 RANGE	2019 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	1.75%	1.75%- 1.75%	1.75%
Federal Funds Rate	2.50%	2.50%- 2.50%	2.50%
10-year Canadian Treasury	1.62%	1.50%- 1.90%	1.80%
10-year US Treasury	2.41%	2.35%- 2.80%	2.70%
COMMODITIES			
Gold (US$/oz.)	$1,293	$1,275- $1,350	$1,325
Copper (US$/lb)	$2.94	$2.50- $3.20	$3.10
Oil WTI (US$/bbl)	$60.14	$52.00- $67.00	$62.00
MARKETS			
S&P/TSX Composite Index	16,102	14,300- 17,200	16,900
S&P 500 Index	2,834	2,440- 2,975	2,925
CANADA DOLLAR/US DOLLAR	$0.73	$0.73- $0.78	$0.76

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