Quarterly Report
SUMMER 2019

HEWARD
INVESTMENT MANAGEMENT INC.

Trade Wars and Geopolitical Conflicts Create Uncertainty and Market Volatility – *As Well As Opportunities*

OVERVIEW

The predominant issue at the turn of the year was whether the downturn in the global economy in the final few months of 2018 would prove to be a temporary soft patch or would persist into 2019. The improvement that seemed to be underway through Q1 was quickly curbed by trade tensions that caused equity markets to ebb and flow with U.S./China trade headlines. While some thawing in trade relations are now visible, there is no sugar coating the fact that slower trade and tariffs are likely to lead to slower growth, weaker earnings and a hit to business confidence. As China tries to transition from being the world's factory to being more competitive in higher-value manufacturing and technology, tensions between the two countries will persist as they try to coexist with different political and economic systems.

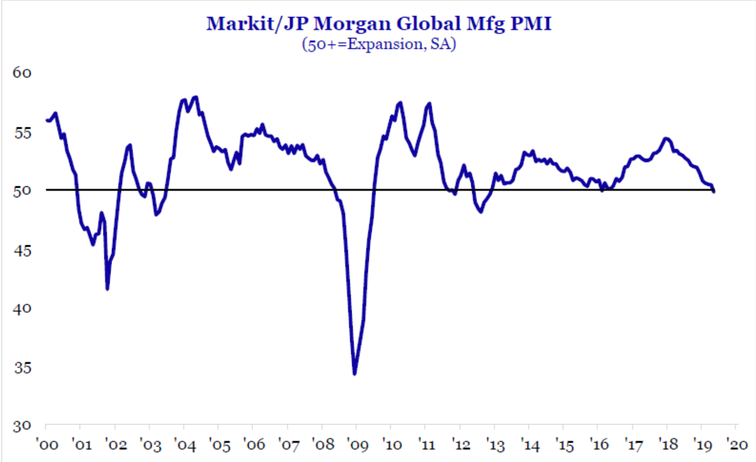
Waves from the trade war have resonated around the world and will extend the global slowdown into the second half of 2019, and possibly longer if no agreement is reached. However, after the G20 meetings and the additional trade talks there is enough to feel better about the state of U.S./ China trade negotiations. But it did not alter the economic environment in any significant manner. Thus, each week that passes brings the chance of greater damage to the U.S. economy, and delays a much-needed ramp up in business spending that is critical to extending the current cycle. China however, is already stabilising and will recover faster due to increased stimulus and controlled RMB depreciation. A stronger U.S. dollar and weaker RMB are already hurting emerging markets (EMs) and major exporters such as Japan and Germany.

However, even if China's economy is coming back (which should be a positive), it may not turn out to be the shot in the arm the rest of the global economy would like to get. In the past, good economic news in China typically spread to the rest of the world. Yet, this recovery might be different. While China has announced an array of stimulus measures to slow the economy's deceleration, current moves are more muted and focused on the domestic consumer. Typically, Germany and Japan benefitted from Chinese efforts to prop up its economy, but thus far they have seen little in the way of a boost to their respective economies.

After the U.S./China talks, getting the USMCA deal ratified is considered a top priority for President Trump. Now that there is deal on steel and aluminium, as well as a deal on avoiding tariffs on Mexican goods, the administration plans to submit the implementing legislation to Congress. With Canada and Mexico starting the ratification process, the Administration is hoping that it will put pressure on speaker Pelosi to bring up the deal for a vote in the House. Although Pelosi is still pushing for changes to the agreement to satisfy her caucus, there is increasing momentum for the deal to be finalized.

Cutting interest rates, or at least flagging the possibility, is currently in vogue with central banks as the holy grail of inflationary pressures remains elusive. That, along with the uncertainty of the broader economic outlook, had Federal Reserve Chairman Jerome Powell and some members of his committee openly discussing the possibility of a rate cut. Rate cuts are also on the mind of the European Central Bank (ECB) as it recently gave its clearest indication that the Bank would cut rates and relaunch its asset purchase program if measures of inflation remain low. Inflation was also the focus of Russia's central bank, while in Japan Governor Haruhiko Kuroda signalled a willingness to act if needed to give inflation another push. Meanwhile in the UK, warnings by the Bank of England (BoE) policymakers about the potential for rate hikes are clashing with market expectations for cuts.

WEAK GLOBAL OUTLOOK FOR REST OF 2019



Source: Strategas

UNITED STATES

A patient approach "for some time" was the Federal Reserve's base case, until something broke. What broke this cycle seems to have been inflation expectations, with tariffs that look medium-term deflationary as the final tipping point. The latest Fed meeting has now set the stage for multiple interest rate cuts, possibly as early as July. Americans seem to be less positive about home buying now than at any time since the mid-2000s housing bust. However, with interest rates down the housing market could get additional support, while the latest data reflexes a bottoming process that is now into its fourth month. Business investment continues to weaken reflecting worries about the China trade fight and a slower U.S. economy. Durable goods orders have declined sharply, due mostly to the lack of orders for jets, autos and trucks while also reflecting the build up of inventories in the first quarter. The good news is that manufacturing is still expanding, even if it is at a "snail's pace". The latest SLIM results indicate supplier delivery times tightened for the first time in nine months. Furthermore, the non-manufacturing sector is strengthening, and typically, it does outperform manufacturing in this part of the business cycle. Also, the contribution from services is four times greater than that of manufacturing. Given the strength of new orders and business activity this sector is seeing, it should be more than enough to carry the U.S. through this manufacturing soft patch. A solid labor market, accelerating wage growth and consumer sentiment are still supporting consumer spending, and the economy should get a further boost from expanding money supply (M2).

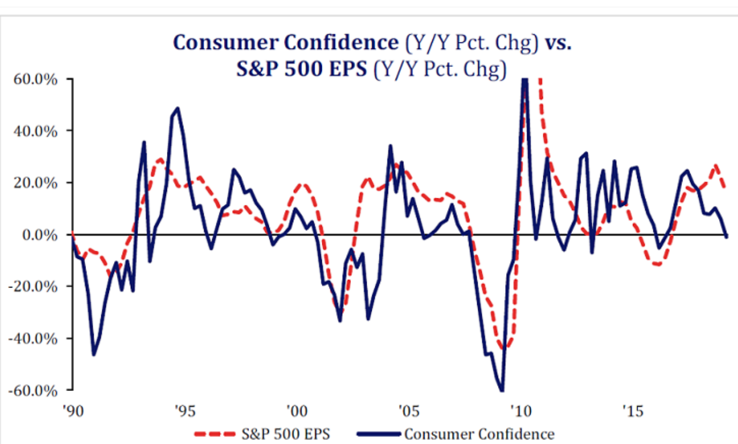
CANADA

While downside risks to growth make Bank of Canada (BoC) cuts this year still somewhat more likely than hikes, the recent acceleration in core inflation lowers the odds of a cut actually occurring. Furthermore, according to the BoC threats to the financial system from household debt and home prices are easing. The bank says people are borrowing less, as the two hottest real estate markets, Toronto and Vancouver, have cooled in response to higher interest rates and stricter mortgage rules. Meanwhile, a recovery in oil production, easing of pressures in the housing market and the end of an unseasonably cold winter saw the economy post a solid increase in March paving the way for stronger gains ahead. This was evident in the April and May employment data (106,000 & 27,700 jobs created), which along with accelerating wages will help mitigate the pressure on household finances and prevent a more radical pullback in consumer spending. Business confidence has weakened with the manufacturing sentiment index slipping into negative territory in April for the first time in three years. Global policy uncertainty, frictions with the U.S, and the Chinese government's banning of Canadian canola oil all played a part. The Government of Canada (GoC) recently announced that it has re-approved the Trans Mountain Expansion Project and is currently targeting "shovels in the ground" for this summer. While the GoC's approval will provide the Canadian energy sector with some much-needed positive sentiment, investors' attention will now shift to potential court/legal challenges, or delays in provincial/local permits, that may ultimately delay activities.

EUROPE

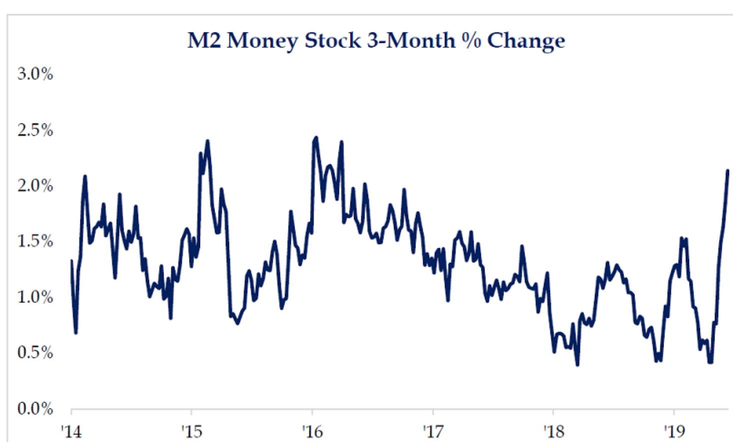
With inflation expectations having dropped like a stone and "frustrated" that investors did not respond to his initial press conference in early June, Mario Draghi followed up with a second one. This time his speech set out the bank's plans in words of one syllable and was the clearest indication yet that the bank will cut rates and relaunch its asset purchase program if inflationary pressures don't turn around. Mr. Draghi also blamed the weakness of the economy almost entirely on external uncertainties, notably the trade war, Brexit and "vulnerabilities in emerging

STRONG RELATIONSHIP BETWEEN CONSUMER CONFIDENCE & PROFITS



Source: Strategas

M2 GROWTH ACCELERATING



Source: Strategas

markets". Data released at the end of May showed a spike in the number of unemployed in Germany while IFO business confidence continued to slide after peaking in November 2017. The manufacturing downturn is beginning to take a toll on employment, suggesting that household spending will not continue to carry the economy as it did in Q1. While the EU has reconsidered putting Italy into an Excessive Debt Procedure, Italy's public finances remain on an unsustainable path, which will keep its relationship with the EU rather rocky. In the UK, BoE officials voted unanimously to not raise rates. Brexit related uncertainty at home and trade tensions abroad are dragging on investment spending and economic growth. The BoE said Britain's economy is on track to stagnate in the second quarter due mainly to the hangover from rapid stockpiling by companies that scrambled to prepare for the original Brexit deadline. Meanwhile, Boris Johnson said that the chances of a no-deal Brexit are "a million to one against" because there is a new mood amongst EU leaders and UK MPs to pass a revised deal.

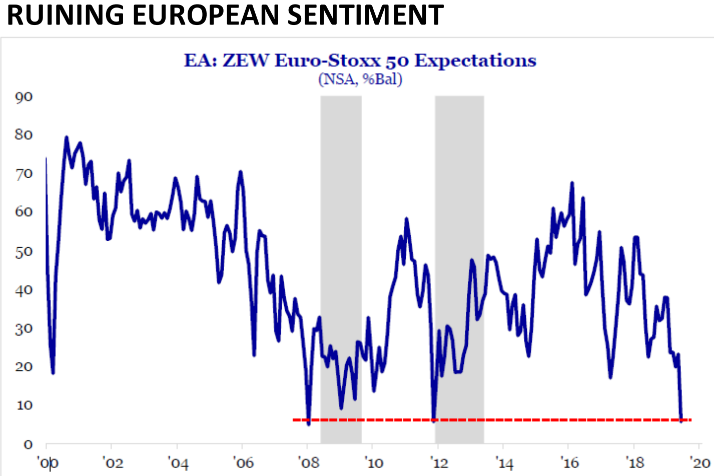
EMERGING & DEVELOPING MARKETS

China faces long term challenges of productivity, an aging population while wrestling with a significant economic transition. For investors, this shift is crucial as China isn't trying to jump start its economy, instead set on creating a new one. While it does entail risk, it will open up new long-term investment opportunities. The slowdown comes as China tries to wean itself off debt-fueled investments (i.e. infrastructure & housing) to more sustainable growth from domestic consumption and innovation. Meanwhile, the country continues to stickhandle a soft landing via balancing stimulus with geopolitics and domestic deleveraging. We could see more stimulus in the coming weeks to offset the negative effects of trade tensions on the economy and stock market. Japan experienced a surprisingly strong first quarter primarily due to positive contributions from net exports (reflecting weak imports) and inventories. Excluding these factors however, GDP growth was almost zero. Despite the deterioration in the economic outlook, the government is expected to press ahead with the sales tax hike scheduled for October 1st. Even so, GDP growth is expected to fall short of potential keeping a lid on inflation and forcing the Bank of Japan to keep policy loose for the foreseeable future. The narrative in emerging markets (and globally) remains quite cautious, with the market's attention on the latest sell-off primarily focused on the potential impact of trade/tariff concerns. This year's Q1 rally in EM equities was predicated on the notion that China's credit stimulus would spill over into the rest of EMs. Thus far there has been little evidence of this happening.

COMMODITIES

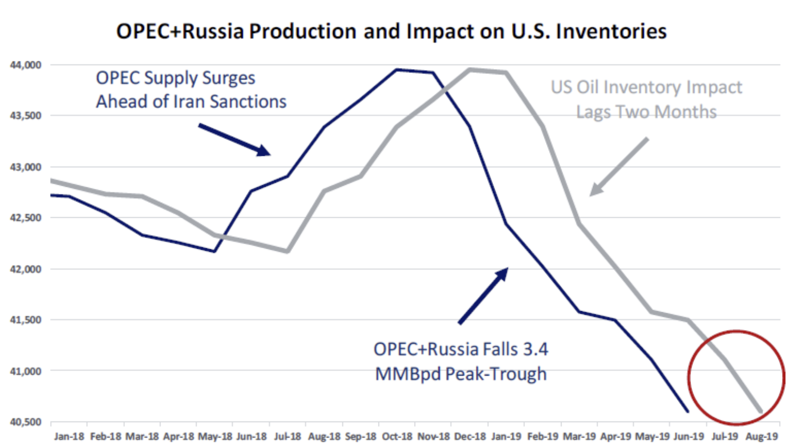
Macro and commodity demand data look middling and consistent with a global economy once again stuck at a mid-cycle pause, the transition point between the recovery and expansion phase of a business cycle. However, risks (assuming a settlement in the trade dispute) are starting to shift to the upside. China recently launched special purpose bonds aimed at infrastructure spending and both Russia and India (post election) have also committed to supporting infrastructure investment. Chile, India and Russia have cut rates, the BoE has left rates unchanged (some were expecting an increase) and the ECB looks to become more accommodative. Combined with the sharp decline in the U.S. rate curve, subdued inflationary pressures stemming from lower commodity prices and a likely rollover of the OPEC + production deal, we may have set the stage for a late 2019 rally in investment, manufacturing and even a rise in commodity prices from current discounted levels. Meanwhile, oil's geopolitical risk premium has staged a comeback on the back of a pair of provocative attacks on energy assets in the Gulf and the downing of an American drone by Iran. Fundamentally, uncertainty on the current and forward states of the global oil market remains high, driven by both uncertain macro and oil demand data as well as volatile production from Iran/Venezuela/Libya. Combined with the expected increase in U.S. production (as the Permian basin debottlenecks) this uncertainty is large enough to swing the global oil market between surplus and a deficit on a monthly basis, something OPEC+ must consider at its July 1st meeting.

GEOPOLITICS & GLOBAL SLOWDOWN RUINING EUROPEAN SENTIMENT



Source: Strategas

OPEC+ CUTS IN MAY SHOW UP IN JULY



Source: Bloomberg, IEA, Raymond James Research

RECOMMENDATIONS

After a solid start to the year the U.S. is set to suffer the delayed effects of previous interest rate hikes and waning fiscal policy. Euro zone growth will remain sluggish (confirmed by the ECB) and risks relating to Italy's fiscal position have increased. Meanwhile, hopes of a recovery in China are likely to disappoint those expecting a repeat of previous efforts. However, economic expansions don't die from old age, they get murdered! Typically, the most common cause has been inflation and central banks' over ambitious attempts to curb it. Fortunately, fiscal and monetary policy are "easy" today, and while some pockets are showing acute signs of stress (the U.S. will likely join the global manufacturing slowdown) the economy as a whole remains in decent shape. The consumer remains a positive, backed by a strong labor market, near historical lows in unemployment, rising wages and elevated personal savings rates. While China's stimulus efforts may disappoint some, it will be enough to sustain "official" projected growth rates, and should be felt to some degree in the second half of 2019. Furthermore, once/when a trade agreement is finally reached between the U.S. and China, there will be positive ripples through other global economies. Given this backdrop, we remain under-weight equities, waiting for more clarity. We remain true to our basic principles (looking for value) while focusing on financials, technology and industrials. Meanwhile, after a period of relative calm and stability, and pushed by further evidence of slowing global economic growth, rates have dropped to new cycle lows. While there are fears that we may revisit 2015 (low rates and fears of deflation), those conditions are absent today (with the possible exception of Europe). However, with economic conditions expected to remain frail, central banks are prepared to do whatever is necessary to avoid a global recession. Against this backdrop, we reduced our long bonds position and started to bottom-fish in the preferred shares market which has been under pressure. We remain over-weight bonds (under-weight duration), neutral on preferred shares and under-weight both equities and high yield vehicles.

FORECAST 2019	CURRENT 30-JUNE-19	2019 RANGE	2019 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	1.75%	1.50%- 1.75%	1.50%
Federal Funds Rate	2.50%	2.00%- 2.50%	2.00%
10-year Canadian Treasury	1.46%	1.30%- 2.05%	1.40%
10-year US Treasury	2.01%	1.75%- 2.80%	1.90%
COMMODITIES			
Gold (US$/oz.)	$1,414	$1,275- $1,500	$1,450
Copper (US$/lb)	$2.71	$2.50- $3.20	$3.10
Oil WTI (US$/bbl)	$58.47	$52.00- $67.00	$60.00
MARKETS			
S&P/TSX Composite Index	16,382	14,300- 17,200	16,900
S&P 500 Index	2,940	2,440– 3,050	3,000
CANADA DOLLAR/US DOLLAR	$0.76	$0.73- $0.78	$0.77

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