Quarterly Report
AUTUMN 2019

HEWARD
INVESTMENT MANAGEMENT INC.

The Sum of All Fears – Trade Wars and an Inverted Yield Curve Make for Anxious Markets and Recession Fears

OVERVIEW

Looking for meaning in financial markets is like looking for patterns in a violent sea. The information that emerges is the product of buying and selling by people, with all their contradictions. Prices reflex a mix of emotion, biases, cold-eyed calculations and these days "tweets". Yet taken together the markets express something about the mood of investors and the temper of the times. The most commonly ascribed signal is complacency. Dangers are often ignored until too late. However, the dominant mood in markets today, as it has been for much of this decade, is not complacency but anxiety. And it is deepening by the day. (The Economist).

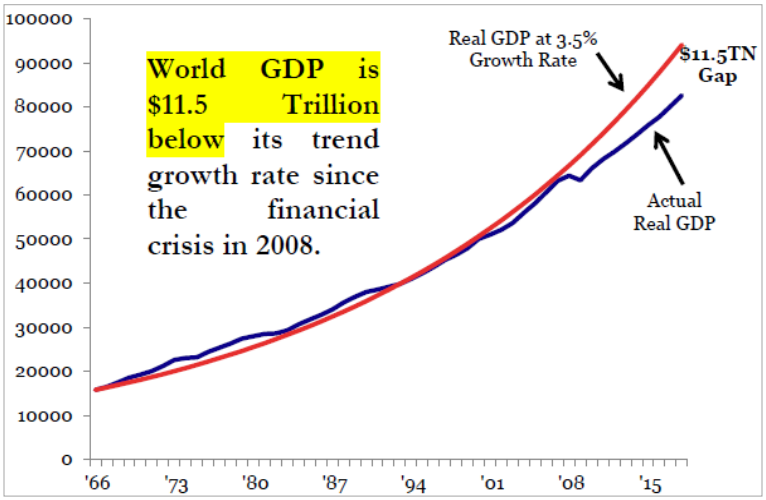
Like other empires in history, America is loath to give up its hegemonic status. Seemingly, Washington still thinks that other nations will do whatever it tells them. The problem is that half the world has prepared to do without America. Preparations include the development of Brazil, Russia, India and China (BRIC), the building of the new silk road right into the heart of industrialized Europe and the most recent opening up of the Northern Sea Route (why buy Greenland?). China already carries more financial clout than is generally perceived, and by 2040 Asia will account for over half of the world's GDP. More of what is produced in Asia will stay in Asia and given its innovative energy, technology exports from west to east will slow. This shift in growth/political influence from West to East is what really lies behind the U.S./China dispute.

Central banks in many countries are now operating at the limits of what monetary policy can actually do. Admittedly, this is not the case in emerging economies. Central banks in Brazil and Indonesia cut rates in September, and have scope to cut them much further if required. Instead, this is a developed world problem. The U.S. Federal Reserve (Fed) has sufficient tools to deal with a moderate slowdown but would struggle to respond adequately to a more significant downturn. More importantly, central banks in the euro zone and Japan are already at the limits of monetary support. That means that any further support would have to come from additional quantitative easing (QE), but there is a growing body of academic work that suggests asset purchases are less effective at stimulating growth and inflation than conventional rate cuts. With over $17 trillion of paper with negative interest rates (one-quarter of government bonds), it's difficult to see how monetary conditions could become much more supportive.

Christine Lagarde has been confirmed as the European Central Bank's (ECB) next president, but work is already piling up on her desk. The European Union (EU) is in danger of becoming the biggest collateral victim of the U.S./China trade war and she will need all her political skills to plot an escape route from the threat of recession. The euro zone is uniquely vulnerable to any blockages in international trade. In 2017 exports (goods and services) amounted to 27.9% of its GDP. While countries such as Germany and Italy might be very different in their commitment to fiscal rectitude, they both share the same export-led model of economic growth. Lagarde's political skills will be sorely needed as the ECB will have to continue with the playbook put together by Mario Draghi. In what would be a seismic shift, she will try to convince the Germans to increase fiscal spending.

The attack on Saudi oil facilities is unlikely to be a disaster for the global economy. Saudi production might resume quite quickly and even if it doesn't, the implications for oil prices and developed country inflation should be limited. However, growing tensions in the Middle East are another headwind for a global economy in already uncertain times, and a full-blown conflict could trigger another leg in the global downturn.

REAL WORLD GDP GROWTH ($2010 USD, $BN)



Source: Strategas

UNITED STATES

With global economic growth clearly slowing, the U.S. business cycle now the longest in the post-war period and the yield curve having inverted (briefly), it is no wonder that investors have become increasingly focused on the potential for an economic downturn. However, CPI/PCE remain well contained, wages are edging higher, businesses continue to hire and companies are having little trouble making (C&I) loan payments. Yes, Purchasing managers Indexes (PMIs) are stalling out, but not enough for a broad-based recession. Furthermore, while housing activity remains sluggish, it is not contracting. Also, with the nature of the American economy being so dependent on consumer spending and less so on exports, this would suggest that while slowing, it remains far from recession. However, with data from the CASS Freight Index showing just how large the decline in goods being moved across America is, with manufacturing now at its lowest levels in three years and with more slowing evident in the construction industry, the Federal Open Market Committee (FOMC) cut rates once again in September. In doing so, the Fed chairman called it a "midcycle adjustment" rather than an easing cycle, and he was right in doing so. The Fed isn't trying to generate faster inflation or lower unemployment than it was before. It is simply trying to recalibrate policy to avoid inadvertently killing the expansion. The Fed also seems to be betting on sustaining the consumer, as with business confidence notably decreasing, it is becoming critical that consumers shrug off the negatives and keep spending. CEO confidence began to decline following tariffs going into effect in June 2018. CEO confidence leads investment, and as it stands today suggests no new investment for the remainder of the year.

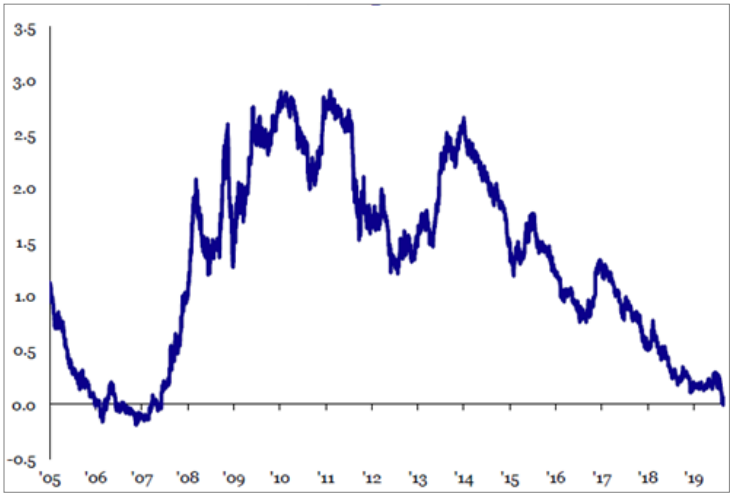
CANADA

As central banks in Europe, Japan and China turn dovish, the U.S. Fed has cut to avoid further U.S.$ appreciation, thereby supporting exports. That's how the story may also play out in Canada. It has no reason to cut rates now, with growth holding up and inflation running on target (August inflation flew past expectations and GDP numbers were strong). However, a stand pat policy could threaten headwinds for exporters as other central banks take rates lower, and in the process nudging the loonie higher. A token quarter point, if and when it happens, won't set off a housing or auto boom, but might be key to keeping the Canadian dollar at levels at which exporters can compete. Furthermore, while the central bank's September rate decision did not offer a clear indication of its longer-term plans, several references to the worsening effects of trade tensions on the world economy suggest they are ready to cut if necessary. Its quite conceivable that they cut after the Federal elections. Meanwhile (contrary to popular foreign belief), the sky is not falling on Canadians. Having ridden a broad-based rebound in goods exports driven by energy shipments, the economy blew past projections by expanding at an annualized pace of 3.7% in the second quarter. This was the strongest three-month stretch of growth in two years. Also, the job market continues to be strong, as does housing. The national housing market appears to be getting over the "stress test" and other cooling measures. The slumping markets of Vancouver, Calgary and Edmonton now seem to be in the early stages of a turnaround while things are back on track in Toronto.

EUROPE

Geopolitics (U.S./China trade dispute and Brexit negotiations) have become a major headwind for Europe. Not only can the EU do very little to stop it, but the monetary union has few tools with which to combat a trade-induced slowdown. The deepening manufacturing downturn is now being accompanied by a slight moderation in the service sector growth, a broad-based downturn in demand for business loans and suppressed consumer confidence. Overall inflows of new work have stagnated and business sentiment has fallen to its lowest levels since 2014, causing

2/10 SPREAD



Source: Strategas

CAPACITY UTILIZATION

Source: Credit Suisse

companies to take a cautious approach to hiring. With September's policy decision Mario Draghi appears to have locked the ECB into Quantitative Easing (QE) for several more years. However, the new measures were a disappointment as the deposit rate cut was less than anticipated and the rate of asset purchases will be slower than the median forecast. Meanwhile, the ECB's appeal for fiscal policy to become the "main instrument" supporting the euro-zone economy appears not to have fallen on deaf ears. The Dutch government announced a fiscal expansion in its budget for 2020, while Germany's finance minister has implied that they could spend up to 50 billion euros if needed. At its September meeting, the Bank of England (BOE) left monetary policy unchanged. It cautioned that Brexit-related contingency planning had injected a considerable degree of volatility into the high-frequency data, making it difficult to discern the pace of growth in the manufacturing sector. They also underscored their longstanding view that the tightness of the labor market would continue to feed through to underlying inflationary pressure.

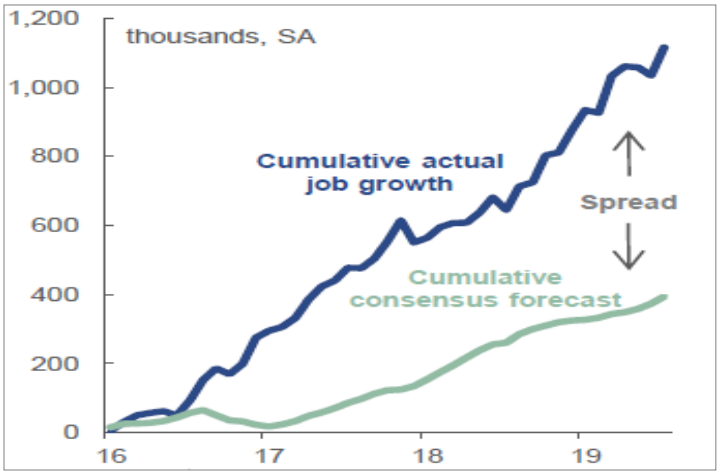
EMERGING & DEVELOPING MARKETS

China has developed its contingency plans should trade negotiations collapse. According to Premier Li, China will adopt a multi-pronged approach to tackle any downward economic pressure. In keeping with his decree, the theme of September's State Council meeting was to ensure that funding would be in place to meet local governments borrowing needs. Bond quotas had to be issued by the end of September and disbursed to projects by the end of October. The use of these bonds will be expanded by focusing on transportation infrastructure, energy projects (power grids) and natural gas pipelines. Priority will be given to life sciences in education, medical care, the elderly and urban utilities. The long-term plan is to have China emerge from being the global hub of manufacturing to becoming the global center of household spending. Data continues to portray a wobbly economy in Japan. Geopolitics and domestic headwinds have dampened economic growth and the economy does not appear robust enough to weather the next headwind from Value Added Tax (VAT) hike scheduled for October. The trade deficit continues to deepen which is discouraging news for the export-heavy country, while manufacturing remains weak. Investor apprehension after weeks of Hong Kong protests may lead to some giving up on Asian growth prospects. However, there are lots of expanding markets outside of China and Hong Kong in Southeast Asia. The region's burgeoning middle class remains its key long-term catalyst for economic growth. Neither the U.S./China trade war nor tumult in Hong Kong is likely to change that.

COMMODITIES

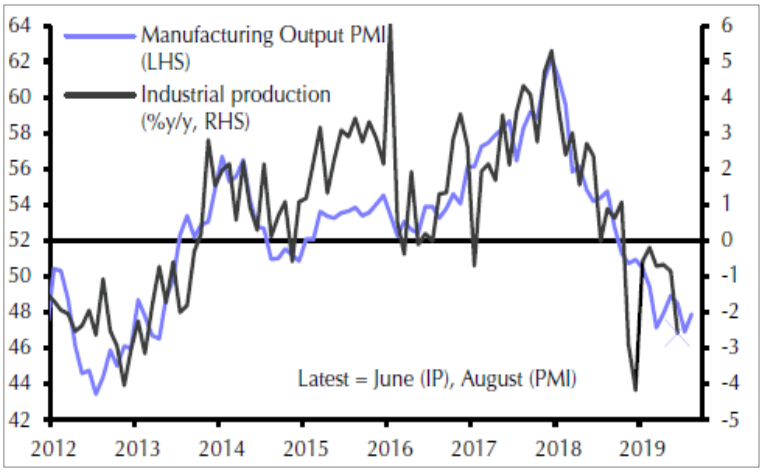
Regardless of the culprit, the September attack on Saudi oil facilities provides a stark reminder that geopolitical risk to global oil supplies is very real. In recent months, oil prices had traded predominantly on demand-related fears surrounding the U.S./China trade war. This attack however, illustrates that geopolitics can be much more consequential to the overall oil supply/demand equation. Disruptions of this magnitude (5mmbpd initial reports) are extraordinary events. While the immediate response from Saudi Aramco was that it would draw down inventories to replace the lost barrels, the reality is that Saudi does not have enough oil in storage to offset such a loss for more than a few weeks. Also, there are conflicting reports as to just how long production will be lost. The Saudis have said that it would be a matter of weeks while some experts/oil strategists claim it will be months. Amid the global growth slowdown and faced with what looks akin to an industrial recession and the headwinds of a stronger-than-expected U.S. dollar, the metals (copper in particular) have failed to impress. While there has been evidence of a poor demand picture in China, we are now starting to see tentative signs of an improved outlook in Chinese demand. Grid orders are accelerating due to an expanding distribution network triggered by advances in Electric Vehicles (EV) and 5G. Also, auto production, which was particularly depressed as a payback for brought-forward demand in 2016-17, though mildly seems to be recovering. Meanwhile, despite the decline in copper prices, supply-side fundamentals have remained solid this year, partly on a string of disruptions.

JOB GROWTH CONTINUES TO BLOW AWAY CONSENSUS FORECASTS



Source: Scotiabank Economics, Bloomberg

EUROZONE INDUSTRIAL PRODUCTION & MANFACTURING OUTPUT PMI



Source: Refinitive, Markit, Capital Economics

RECOMMENDATIONS

Sentiment regarding the near-term prospects for the global economy had soured through the summer, but as the quarter came to an end some key developments promise hope for a better geopolitical and economic outlook. The exit of John Bolton from the Trump administration could have wide rippling effects on major geopolitical matters (the attack on Saudi oil assets will not help). Also, both sides in the U.S./China trade war have recently made conciliatory gestures easing some of the tensions between the two, creating new hope for the next round of talks which are scheduled for October. Any progress however, should be incremental at best. That said, as things stand, fears that the global economy is headed towards recession seem overdone, as some recent gloomy economic reports are being offset by other more positive data. In China, where exporters may be struggling, the China Activity Index (Capital Economics) suggests that strength elsewhere (i.e. the property sector) has helped shore up growth. Also, we should begin to see the impact in the fourth quarter from already implemented government initiatives. Meanwhile in the U.S., the economy may have taken a number of hits, but the consumer base remains solid and credit conditions are still contained. All of this would be consistent with our view that global growth is slowing rather than collapsing. Given our outlook, we remain around benchmark for equities with higher cash balances than we would typically hold. While Technology, Industrials & Financials represent our key sectors, we continue to monitor the market in general for any opportunities that may arise (buying or selling). As economic indicators continued to weaken, interest rates have continued their decline. In August the downtrend steepened to a point where the 10-year Canada yield hit a cycle low of 1.10% before recovering to current levels. While we don't believe that a recession is imminent, we also don't expect a dramatic improvement in economic conditions given the significant geopolitical issues that currently dominate the global scene. We expect interest rates to remain lower for longer with the established trading range (high 1.63% - low 1.10%) for the 10-year bonds to give us a sense of direction for the near future (subject to a quick resolution of trade issues). We remain considerably underweight duration.

FORECAST 2019

	CURRENT 30-SEPTEMBER-2019	2019 RANGE	2019 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	1.75%	1.50%- 1.75%	1.50%
Federal Funds Rate	2.00%	1.75%- 2.50%	1.75%
10-year Canadian Treasury	1.36%	1.08%- 2.05%	1.30%
10-year US Treasury	1.68%	1.35%- 2.80%	1.50%
COMMODITIES			
Gold (US$/oz.)	$1,475	$1,275- $1,550	$1,500
Copper (US$/lb)	$2.55	$2.30- $3.20	$2.70
Oil WTI (US$/bbl)	$54.58	$46.00- $65.00	$56.00
MARKETS			
S&P/TSX Composite Index	16,659	14,300- 16,900	16,700
S&P 500 Index	2,975	2,440– 3,028	2,925
CANADA DOLLAR/US DOLLAR	$0.76	$0.74- $0.78	$0.76

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