Quarterly Report
WINTER 2020

HEWARD
INVESTMENT MANAGEMENT INC.

A Shift in Global Growth
Is a Break in the Clouds Developing?

OVERVIEW

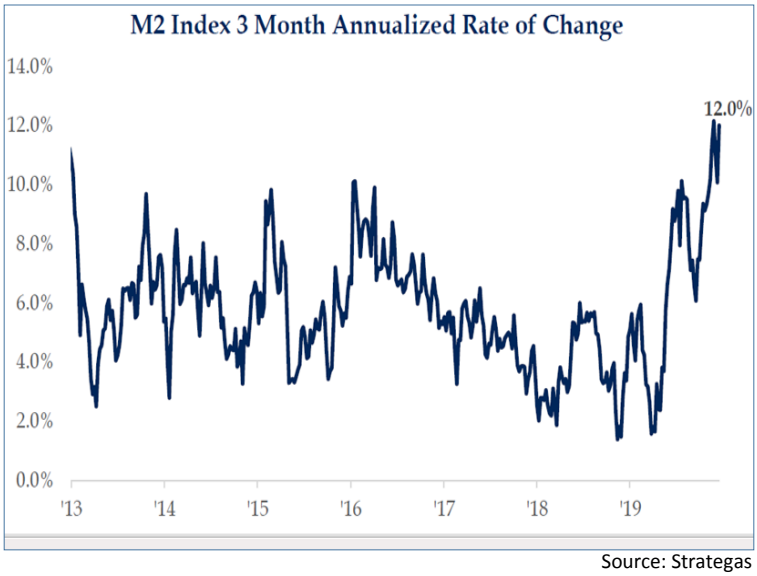
2019 produced (as predicted) a slowdown in global growth with deceleration spread relatively evenly across the major economies. The two main demand-side reasons were namely: 1) reduced U.S. fiscal stimulus and 2) tighter financial conditions. Negative surprises were concentrated in Europe, especially Germany, and several emerging market (EM) countries, causing many market participants to worry that we are on an inexorable path to a hard landing. However, our own view is that the risk of recession is considerably low. Many commonly used yield curve measures are distorted by the sharp decline in term premium, which makes a flat or inverted yield curve both more frequent and less meaningful than in the past. Easy monetary policy, growing M1 & M2 and low unemployment rates don't usually translate into market tops. The strong financial position of households and businesses across most advanced economies and the absence of imbalances, inflationary or financial, are also a positive. Also, there are green shoots of recovery starting to appear in China as authorities target spending/growth initiatives, as well as indications of a turn around within the global auto manufacturing sector.

The global economy will bottom out either in Q1 or early Q2 2020, with growth recovering thereafter. However, the pace of this recovery will be relatively slow and, perhaps most importantly, it may be spread unevenly across regions. The trade war market (spring 2018 to September 2019), which was basically a defensive, large-cap biased market rally is behind us, and we are now in a market where investor attention will be more on the U.S. presidential election. The trade war market shifted in September fueled by rate-driven economic stimulus, and will continue to move on optimism over the U.S./China trade deal (phase 1), USMCA and Brexit. Our outlook assumes a modest improvement in year over year earnings per share growth, most noticeable in cyclicals industries. P/Es, which are at the high end of a 20-year range, may be a headwind.

Pessimism about China's economy is rife around the world, especially in America. Forgotten by many is that on becoming President in 2012, Xi took the proverbial axe to China's growing dependence on credit, and the clean up that followed resulted in a number of public sector companies and banks to fail. Now however, the signals that the foundations of recovery are being laid can be seen in both the official and private sector PMIs, in the industrial production data (Nov 6.2%), in the recovery of M2, in the improved sales of appliances and rising consumer and business confidence. The interim trade deal, if finally confirmed in January, will at a minimum raise sentiment even though it looks more like a truce rather than a fundamental change in the relationship between the U.S. and China. While the deal as outlined does seem to harvest all the low hanging fruit, there are no concrete details on plans for a "phase two". Furthermore, it does not mark the end of tensions between the U.S. and China, which are likely to persist in the areas of technology and investment as decoupling continues.

What often seems like a paradox in the commodity business is really a question of what's known and discounted and what is not. There are some subtle signs of optimism across the commodity patch with crude oil and copper both firming as we approached year end. Furthermore, the Equal-Weighted Commodity Index has flipped to positive in the Strategas Technical Strategy proprietary trend model for the first time in two years. To say that the Energy sector is out of favor at about 4.0% weight in the S&P is an understatement, yet to declare oil or metals as future leaders would be irresponsible at this stage. However, there are enough contrarian data points out there to make investors stand up and take notice. Also, supply may become an issue across a large part of the commodity spectrum in the near future.

LIQUIDITY REMAINS A BIG MARKET POSITIVE



Source: Strategas

UNITED STATES

While there may be a lot of talk about a looming recession in the U.S. economy, one data point does not support this theory and in fact articulates how healthy it actually looks. Mortgage delinquency rates, for single to four family properties, have been declining since the great recession and currently stand at their lowest levels since 2007. This would only seem natural with unemployment at 3.5% and household savings rate ticking up to 8.0%. Further evidence that the U.S. is not headed towards recession is the Atlanta Fed's "GDP Now" tracking estimate for 4Q real GDP which is running at 2.0%, a soft landing. While slowing, the consumer continues to be the workhorse for the economy. Some seem concerned that November retail sales were weaker than expected, but the fact that Thanksgiving holiday fell towards the end of the month and overlapped into December, could probably account for this. With the Fed having cut rates three times in 2019, it was not surprising to see M2 money supply growth reaccelerate (there is a good inverse correlation between fed funds and liquidity). Both Fed chair Powell and Vice Chair Clarida stated that the current stance of policy is "likely to remain appropriate", and Mr. Powell went on to say that "in order to move rates up, I want to see inflation that's persistent and that's significant". For the better part of 2019, there have been numerous reasons the U.S.$ should be weakening: 1) large U.S. trade and budget deficits, 2) Fed easing and 3) U.S. administration jawboning the dollar lower. If global growth and trade recover as we expect in 2020, dollar weakness will be a key factor.

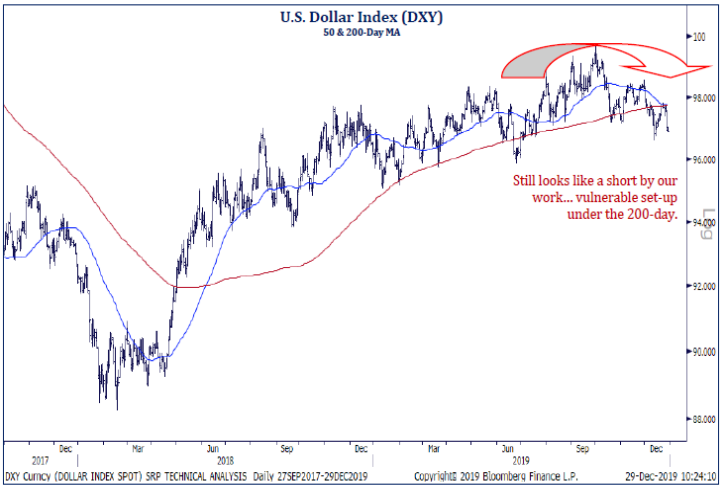
CANADA

Many players in the Canadian oil industry saw the past federal election as a decisive moment to regain some momentum for the sector. To their dismay, the victory by the Liberal party (minority government) means many of the biggest issues for the sector haven't really changed. However, December did see the embattled oil industry receive some positive news with the announcement of 150,000 bpd of new pipeline capacity (Enbridge & TC Energy) and the go ahead for the Trans Mountain Pipeline. In a widely expected decision the Bank of Canada (BOC) held its key interest rate steady at 1.75%. While parting ways with most of its global peers, the BOC believes historically low rates will likely be the norm for some time as several structural factors conspire to keep the global economy in a period of slow growth. The BOC also issued the results of a recent survey that suggests business sentiment has edged up, but that there are pronounce differences between the Prairies and Central Canada. The more positive responses frequently mention strategic investments in technology, automation and software as well as capital spending plans to support growth. But, several businesses, many of them in the Prairies, reported that regulation, uncertainty (energy sector) and balance sheet positions are holding back investment plans. The Canadian dollar might look cheap to those with memories of parity, but for exporters its not cheap at all. That's been evident in Canada's lackluster trade performance, and looking into the details of sluggish exports, part of the story is that we need to pay more attention to the loonie's value against currencies other than the U.S. dollar.

EUROPE

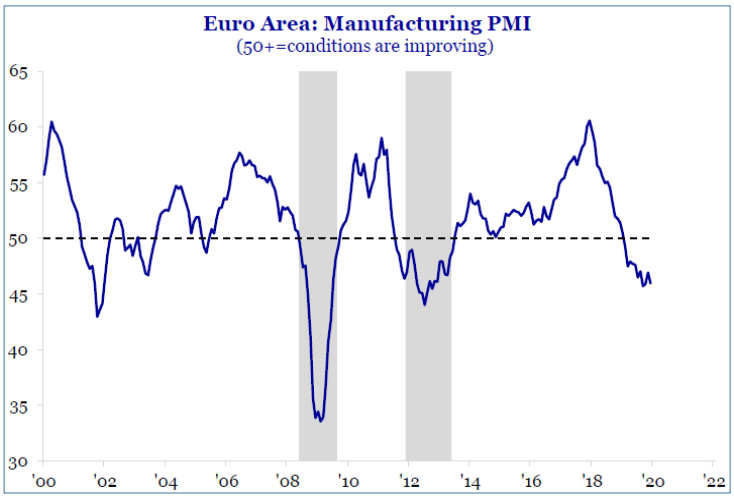
Budget proposals submitted to the European Commission in October raised hopes for big fiscal stimulus for 2020. These however, should be taken with a pinch of salt. Admittedly, Germany has pledged to reduce its structural surplus but it promised to reduce its surplus last year and it did not. Germany is in fact a "serial offender" in that respect. Unless the unemployment rate rises sharply, we should not expect much. With any fiscal stimulus likely to be small and still lackluster economic data, we are likely to see more action from policy makers, central banks and governments. However, we are now seeing some initial signs of stabilization and the recent rise in the ZEW economic sentiment index (ESI) (generally a decent leading indicator for GDP) suggests that the German economy will soon

U.S.DOLLAR CONTINUES TO LOOK LIKE A SHORT



Source: Strategas

LEADING DATA STARTING TO BOTTOM IN EUROPE



Source: Strategas

rebound. In her first major speech since becoming president of the European Central Bank (ECB), Christine Lagarde emphasized that the euro zone needed to create more of its economic growth at home, including greater public investment. While not discussing monetary policy, she did say that the central bank would continue to do its part to support the economy, would likely change its inflation target and make its voting system more transparent.

Having attained the largest parliamentary majority since 2001, Boris Johnson should have no problem ensuring that his Brexit deal is ratified on time. Meanwhile, UK GDP is likely to accelerate in 2H of 2020 and beyond on account of 1) more expansionary fiscal policy, 2) more supportive global growth and 3) less pernicious policy uncertainty. However, it is the UK's destination once outside the EU that carries the most profound macroeconomic consequences.

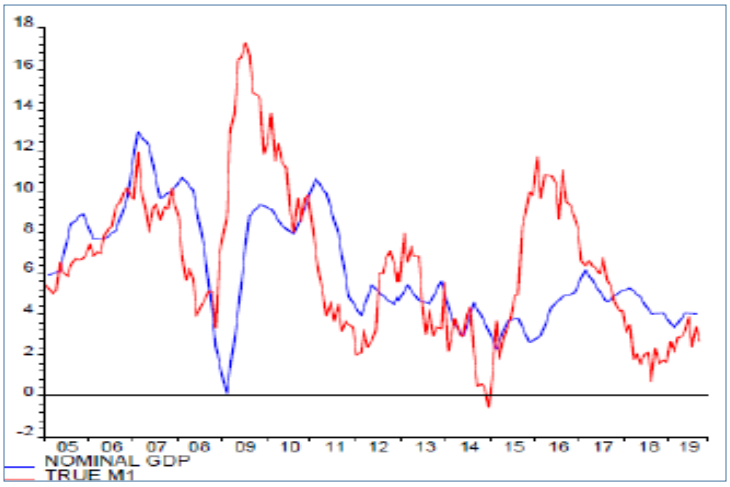
EMERGING & DEVELOPING MARKETS

The downward slide in China's growth continued through Q3 and into Q4. The economy is now growing at its slowest pace since 1992 and is officially performing at the bottom end of the government's range of 6.0 – 6.5%. With trade issues at the core of this slowdown, the government has been looking to cultivate new areas of consumption by tapping into peoples' needs and market trends. The plan calls for stirring up both online and offline consumption in urban and rural areas. "Local government" special bonds will be leveraged to stimulate private investment and construction of major projects. Meanwhile the focus and support will be targeted to the central and western part of the country. The result has been that the seeds of recovery have begun to be seen in the economic trenches (both the official and Caixin PMIs recovered in November). Since the end of September various fabricators have experienced a rush of new orders, often from the auto and appliance industries. 21 infrastructure projects were approved in late 2019, with a value of double those in the same period of last year. Also, real estate will now be supported as the government has achieved its principal objective of stabilising prices. Meanwhile, the data in Japan continues to portray a wobbly economy in the post-VAT hike. Trade has been a negative while the All Industry Activity index keeps trudging sideways. Furthermore, geopolitics and domestic headwinds (U.S./China trade, Brexit and a dispute with South Korea) have hurt economic growth. However, a variance has emerged between the economic data and the stock market as Japanese equities are quietly improving.

COMMODITIES

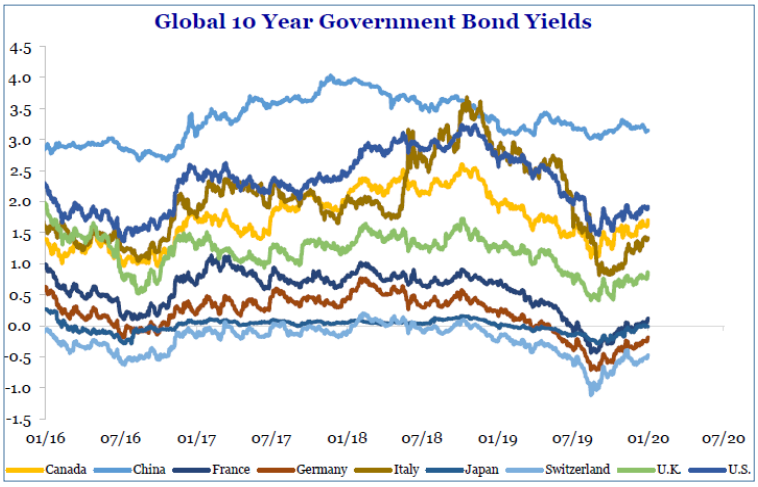
At its December meeting OPEC+ delivered three surprises: 1) it announced an even larger physical cut in production than had been forecasted, 2) it did not extend the duration of this cut beyond expectations and 3) Saudi introduced an unprecedented threat of higher output should others not comply. This crystallized an important shift in strategy for Saudi, to managing short-term physical imbalances from trying to correct long-term ones. While this should support slightly higher prices, it should not lead to significantly higher U.S. shale production. Poor financial performance, excess leverage and an increased focus on emissions have pushed the cost of capital for shale oil producers sharply higher. With pressure now being brought to bare by equity and debt markets, expect the recent shale restraint to persist even at moderately higher prices. Macroeconomic concerns relating to global trade tensions, Brexit uncertainty, the Hong Kong situation and more recently Chilean unrest, dominated the narrative for material/commodities in 2019. However, the bear market for commodities in the 2012-16 period (and now once again in 2019) resulted in massive under-investment by the capital-constrained mining sector. This is likely to produce another strong commodity cycle sometime in the near future as demand once again overtakes waning supply. Copper is the perfect example. Following two years of more or less balanced markets, 2019 saw a meaningful deficit as the poor performance of the supply-side more than offset the weak demand environment. We expect fundamentals will reassert themselves as inventories become physically squeezed.

CHINA NOMINAL GDP & NARROW MONEY (%6M)



Source: Simon Hunt Strategic Services

GLOBAL BOND YIELDS HINTING AT FIRMING GROWTH



Source: Refinitive, Markit, Capital Economics

RECOMMENDATIONS

It is news to no one that we have been living in unsettled times. Pessimism has been rife as the world economy has been buffeted by trade conflicts while relations between the U.S. and China seem to have been riding a rollercoaster. The enduring uncertainty has clearly done damage to global growth. Yet, the current macro message remains supportive of risk taking. The global economy should bottom out sometime in the first part of 2020. Inflation should stay low so monetary policy is likely to remain supportive. There are green shoots of recovery, especially in China, while the money aggregates (real M1 & M2 – best leading indicators) seem to be laying the foundations for recovery. The global auto industry, which accounts for about 4% of GDP, is also showing signs of bottoming. Furthermore, a recovery in the global inventory cycle, which after being a headwind for most of the last two years, may now become a tailwind. Excess inventories have been run down and are now back to normal, if not below normal, in Europe, China and most of Asia. Meanwhile, there has been a cyclical tone to the market over the last few months, one which may dominate 2020. Industrials, technology and financials have acted well, with energy and materials now participating. With this cautiously optimistic outlook we are looking to increase equities, but not chasing, rather using our disciplined approach to stock selection on market opportunities. Meanwhile, a more optimistic outlook for a U.S./China trade deal, an orderly outcome for Brexit and bottoming economic indicators in most Developed and Emerging Markets caused yields in the U.S. and Canada to rise from their cycle lows (August/September). Although economic growth is expected to re-accelerate in 2020, the magnitude is likely to remain moderate and it may not be synchronized, leaving central bankers to stand pat. With the exception of Canada, yield curves in most countries have normalized after having been inverted earlier on. Short term growth concerns in Canada have kept downward pressure on yields. However, our expected turn in global growth should ripple into Canada, especially with a supportive federal fiscal policy in place, likely resulting in higher yields over the next few quarters. Any rise in yields should not be dramatic and generally, we do not expect global interest rates to reach levels where they would threaten economic growth. After a very strong performance (2019) fixed income returns will be modest at best in 2020.

FORECAST 2020

	CURRENT 31-DECEMBER-2019	2020 RANGE	2020 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	1.75%	1.50%- 1.75%	1.75%
Federal Funds Rate	1.75%	1.75%- 2.00%	2.00%
10-year Canadian Treasury	1.70%	1.40%- 2.10%	2.00%
10-year US Treasury	1.92%	1.70%- 2.25%	2.15%
COMMODITIES			
Gold (US$/oz.)	$1,520	$1,400- $1,600	$1,580
Copper (US$/lb)	$2.80	$2.60- $3.15	$3.05
Oil WTI (US$/bbl)	$61.00	$55.00- $70.00	$68.00
MARKETS			
S&P/TSX Composite Index	17,060	16,000- 18,200	17,800
S&P 500 Index	3,330	2,950– 3,410	3,375
CANADA DOLLAR/US DOLLAR	$0.77	$0.74- $0.80	$0.79

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