Quarterly Report
SPRING 2020

HEWARD
INVESTMENT MANAGEMENT INC.

A Black Swan Event – the Coronavirus Breakout and Oil Throw a Curve Ball into the Global Recovery

OVERVIEW

One of the most commonly used expressions around our office is to "expect the unexpected". Trade wars, geopolitical concerns and most anything involving the U.S. president have made up the majority of issues over the last few years with what we can call the "obvious risks". The outbreak of the Coronavirus on the other hand, is not that. In spite of the early uncertainty over the human toll and economic impact, financial markets were initially acting like they had been inoculated against risk by the tried and true application of "lots of easy money". However, with the virus having escaped China's borders, and seemingly out of control in the rest of the world (ROW), and with the immediate effects on the global economy becoming increasingly clear, markets sharply reversed course. With the global economy set to go through what appears to be a deep (but short) recession, equities careened into a bear market.

For veteran investors recent price action has been reminiscent of the dark October days of 2008. As stocks tumbled across the world triggering circuit breakers, liquidity dried up, rallies were sold and equities continued to close near their lows. Today's markets have followed a similar pattern. The coronavirus outbreak is truly a black swan event, unforeseen, unpredictable and hitting right as the markets were priced for perfection. Where the transition from an S&P 500 bull market to a bear market typically takes 10 months, this correction took 16 trading sessions to hit bear market levels (Strategas). Governments world wide have enacted emergency measures, both to stop the spread of the virus and to combat the economic fall-out (having commitment to do whatever is needed). Unfortunately, the duration and the full impact of the virus outbreak is unknown at this time, as is the efficacy of government and central bank interventions.

Over the last half of March, the escalation of the coronavirus crisis and the exceptionally poor January/February data out of China, have led to downgrades of global growth forecasts. The March Flash PMIs for advanced economies were dreadful and the composite PMI for developed economies plummeted to a level just shy of its all time low. With lockdowns only having gotten underway in March, the data should be worse in April, confirming that advanced economies are tumbling into recession. At least there seems to be some early signs of recovery in activity in China, so barring a new "imported" outbreak of coronavirus, GDP should start to rise again in Q2. Two other consolation points for investors are: 1) once the virus is brought under control, we should see a rebound in global economic activity, and 2) amid the turmoil in financial markets, the global banking system does not appear to be in imminent danger.

The next several months will likely be an exercise in pain endurance for investors in the energy sector. The unprecedented pairing of a price war and pandemic remains open-ended from a duration standpoint. Yes, prices will rebound upon production capitulation, but calling a bottom is difficult. While many investors expect a short-term "V-shaped recovery" in commodity prices, previous price wars involving Saudi Arabia (1985 & 1997) have played out over 10 to 18 months. Furthermore, you are dealing with the ego of Russia President Vladimir Putin. The longer the price war plays out, the lower the price ceiling becomes when the market rebounds given that barrels will pile into inventory. This means the market will have to work off a significant glut before prices can meaningfully rebound. Oddly enough, the U.S. now finds itself in the unfamiliar position of lobbying for higher oil prices, while China is enjoying what amounts to be a major rebate from crude oil's crash just as it tries to recover from the coronavirus.

COMPARISON OF DAILY TRADING IN THE S&P 500 IN FEBRUARY-MARCH 2020 TO LATE 2008

Source: RBC US Equity Strategy, FactSet 2020 time series through 3/27/2020

UNITED STATES

The U.S. economy expanded only "moderately" last year as it was slowed by a slump in manufacturing and weak global growth. However, the likely hood of a recession, before the Coronavirus, had receded as trade conflicts diminished, global growth was showing signs of stabilizing and financial conditions had eased. However, that was before COVID-19. While White House officials initially said that the impact on the U.S. would be "minimal", economists were much less optimistic, and the spread of the virus and the recent "state of emergency" declared by the president have proven them to be right. Schools and offices have been closed, sporting/ entertainment events have been cancelled in broad fashion, oil prices have declined and how deep of a recession is now the question. Even before the intrusion of the virus, the economy's outlook was further dimmed by January data that showed slowing industrial production, while February followed up with weak business surveys, claims and payroll data. The slowdown in consumer spending, together with a deepening downturn in business investment, weak manufacturing and a wobbly jobs market, had already cast a shadow on the longest economic expansion on record (now in its 11th year). Meanwhile, the Fed wasted no time in introducing new facilities to ensure that the current liquidity crisis does not morph into something deleterious like a credit crisis. While following a script from 2008, they went a step further and announced two new facilities aimed directly at the corporate bond market.

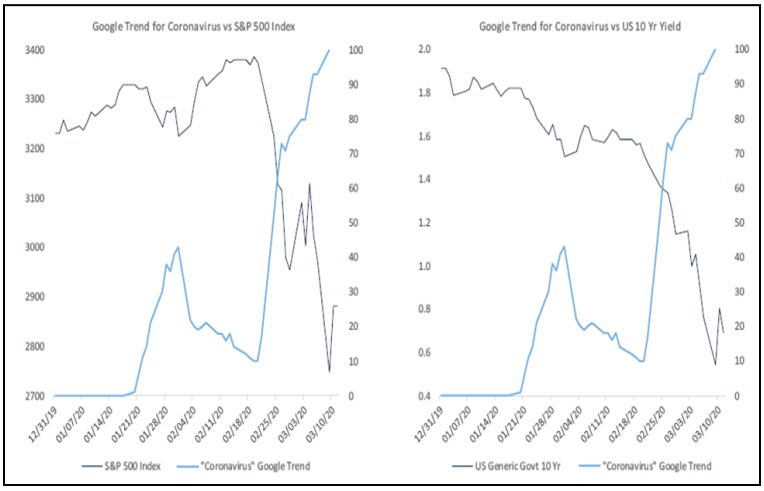
CANADA

Hit by both the coronavirus and the oil market, Canada is going to join a growing list of countries facing an economic contraction. Output is likely to continue to drop through the second and well into the third quarters. Stern measures such as school closures, cancelled events and so on will slow the contagion rate and will probably keep the country from looking like Wuhan or Italy. However, even milder forms of social distancing have economic consequences. Roughly a quarter of Canadian consumer spending is in discretionary goods and services that will be pared back as the population hunkers down in their homes. Stretching out the period in which the disease spreads (essential in preventing an overrun medical system) lengthens the period in which the economy feels a bite. Fiscal and monetary stimulus will cushion the downside and protect debtors while leaving more spending power to fuel a recovery when it starts. However, Canadians won't really go out shopping again, and business confidence won't roar back, until we have the virus under control, or a vaccine. Meanwhile, we also have to deal with the economic consequences of an oil price collapse that some estimates see shaving a half percent off GDP growth. That is not as severe as 2014/15 for two reasons: The prior slide started from $100/bbl and in 2014 the energy sector capital spending was more than 3.5% of GDP. We are talking of less than half of that now. Still, in oil producing provinces it's a major setback for output, employment and government revenues. However, federal help may be on the way according to Finance Minister Bill Morneau.

EUROPE

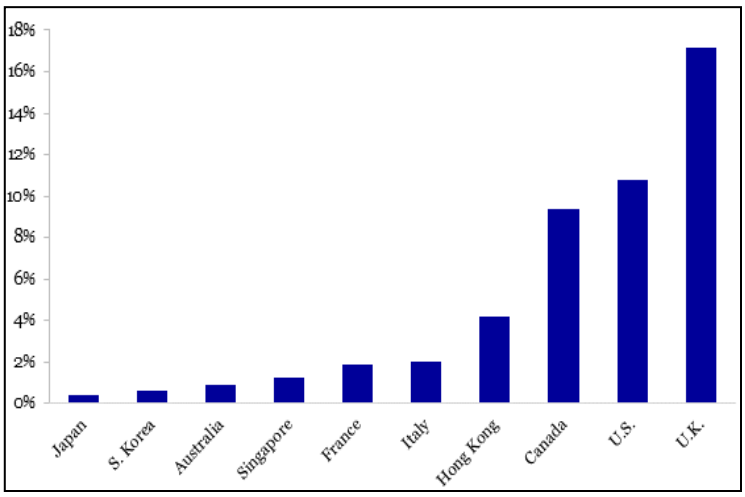
The coronavirus has continued to spread rapidly across Europe. Although Italy remains the most effected country, the number of infections has increased rapidly elsewhere and strict containment measures have now been adopted in France and Spain. The fiscal outlook for Europe has deteriorated sharply with high-frequency indicators pointing to a substantial hit to GDP. While measuring the economic fallout from the coronavirus is fraught with uncertainty, early estimates call for dramatic downturns, especially for the second quarter. The hit is likely to be largest in Italy, but sharp downturns will be seen in Germany, France and Spain. Unemployment will surge, probably giving up seven years' worth of gains in a matter of months. While European authorities have taken steps to support the economy, what matters is not how big any announced measure is, but whether or not governments are prepared to offer an open-ended commitment to do whatever it takes to put a floor

CORONA VIRUS FEARS ARE DRIVING MARKETS IN THE SHORT TERM



Source: RBC US Equity, Google, Bloomberg, RBC Bank Strategy

COVID-19 FISCAL STIMULUS (% OF COUNTRY'S GDP)



Source: Strategas

under economic activity. Within the gloom, there is some good news emanating from the real forward-looking indicators, the monetary aggregates. Latest data releases are current/backward looking, but it is the monetary data which lays the foundations for change in economic behavior (once the virus is contained). The Bank of England (BoE) fired a cannon of its own. As was generally expected, the BoE was unable to hold out until its regularly scheduled meeting at the end of March, and instead early released follow-up measures to its crisis-response package. Further measures included additional asset purchases, and the expansion of its Term Funding program.

EMERGING & DEVELOPING MARKETS

China's growth prospects have been revised down as official economic data are now reflecting the "black swan" quarter. Although monthly data had already signalled that the level of economic activity was very low in February, the official monthly series reflected that weakness to a much greater degree than typically observed in recent periods of economic weakness. As the coronavirus spreads rapidly in other countries, growth outside of China is expected to slow in Q2. With this very weak global backdrop, the recovery in Chinese economic activity is likely to be constrained. This weak H1 activity level clearly puts the annual growth target of "around 6%" for real GDP well out of reach. However, with meaningful stimulus already planned, H2 growth should be above trend, and more forceful policy support could present upside risk. The expected recovery could be delayed if the pandemic is not brought under control globally over the next few months. In Japan, the Bank of Japan (BOJ) has responded to the turmoil in equity markets by increasing its daily Exchange Traded Fund (ETF) purchases. At the same time, unrealized losses on the BOJ's ETF holdings are garnering greater public attention. If markets continue to fall, they would need to book provisions for unrealized losses and net income would likely fall into the red. Even so, this alone would not have a major impact on its monetary stance, and unlike private entities, the BOJ would not encounter funding difficulties. Meanwhile there are some concerns that uncontrollable inflation might occur through a sharp drop in the Yen due to loss of confidence in the currency if the BOJ is faced with a marked deterioration in its financial health.

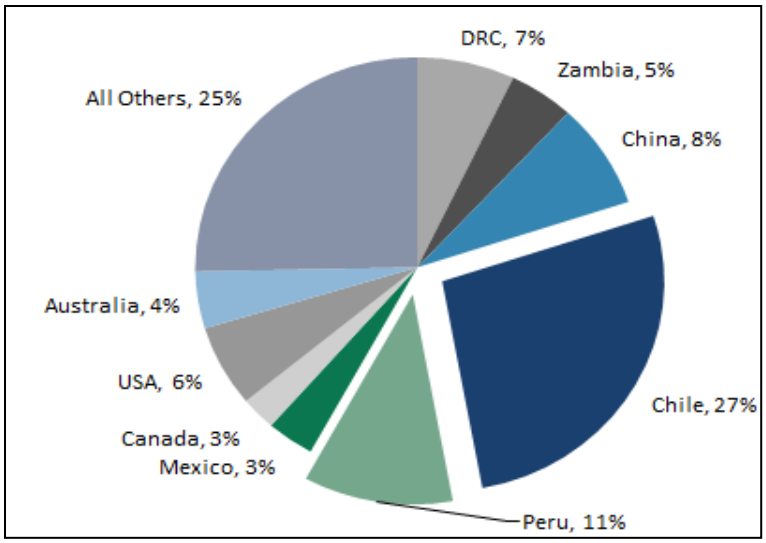
COMMODITIES

Energy producers are confronting unprecedented global oil conditions where weaker economic activity and oil demand, alongside political warfare between OPEC & Russia have left them facing a scenario which combines the worst of 2008/09 & 2014/16. This comes on top of a synchronised downturn across other divisions, including stubbornly oversupplied gas and chemical markets. Along side capital spending and overhead cost reductions, consolidation and dividend cuts (or temporary suspension) are all possible as companies seek to protect their balance sheets. With Saudi Arabia's oil minister instructing its national oil company to keep supplying crude at the elevated rate of 12.3mb/d, it seems OPEC+ is now pursuing a market share strategy over a price protection philosophy. Also, the theme of massive oil oversupply in an exceptionally weak demand environment is manifesting fear over what happens when the world runs out of storage! This may bring about the healthy consolidation and rationalization of the industry which was first projected after oil prices declined in 2014/15. With the announcement of the Coronavirus outbreak in China and the subsequent concerns of an economic slowdown, bulk commodities, base metals and related equities have all posted sharp sell-offs. We expect commodity price volatility to continue until a clearer assessment of the economic impact of the virus is reached and until we see the economic impact of measures enacted by the Chinese and other global authorities. Short term, copper markets may benefit as supply appears to be at risk due to the escalating COVID-19, particularly in Chile and Peru.

US DOLLAR INDEX (DXY) – BULLISH V-SHAPED RISK REVERSAL (DOLLAR BEARISH)

Source: 2020 Bloomberg France LP

2020E MINED COPPER SUPPLY BREAKDOWN BY COUNTRY



Source: Wood McKenzie, Scotiabank, GBM Estimates

RECOMMENDATIONS

With things getting ugly, policymakers have swung into action. The world now finds itself in an extraordinary position with interest rates in the U.S., the euro zone, Japan and the UK having returned to levels which the respective central banks believe are their effective lower bounds. G7 authorities have also committed to do "whatever it takes". One point to stress from the onset however, is that the ability of central banks and governments to put a floor under stock markets is limited as markets are only likely to bottom out when it becomes clear that the flow of new cases has peaked. Also, as the impact on the economy and earnings will be material, it will take time for the markets to digest the full impact. Until this happens, we should expect stock markets to remain volatile and under pressure. From our perspective, we are treating this setback as a temporary (of unknown duration) interruption of the upward momentum that was developing at the end of 2019. Monetary, and now fiscal, stimulus will help minimize the short-term effects and then fuel a recovery at some point. True, the virus has created chaos, rippling across the world disrupting economy activity and wiping out over $3 trillion from stock markets. But with chaos comes opportunity. Having gone through the first quarter with higher than normal cash positions, we had (and have used) the flexibility to take advantage of what we deemed to be intriguing bargains in the market selloff. We constantly reviewing our holdings, using market volatility to initiate, add (or sell) positions, and upgrade holdings. Although to a lesser extent than equities, fixed income markets also got infected by the COVID-19 virus. Government bonds have held up quite well as interest rates declined, but corporate bonds and preferred shares suffered as credit spreads widened substantially. Lack of liquidity in both market segments added to the volatility. At this point it is difficult to determine when sanity will return, but in many cases bond prices have declined to unsustainable levels. We believe that the volatility will continue over the next few weeks, but most of the damage has already been done. Longer term, given a low interest environment and a gradual return to normal economic activity, we expect our fixed income holdings to regain lost ground.

FORECAST 2020	CURRENT 31-MARCH-2020	2020 RANGE	2020 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	0.25%	0.00%- 1.75%	0.50%
Federal Funds Rate	0.10%	0.00%- 1.75%	0.50%
10-year Canadian Treasury	0.73%	0.40%- 1.68%	0.70%
10-year US Treasury	0.67%	0.45%- 1.93%	0.75%
COMMODITIES			
Gold (US$/oz.)	$1,640	$1,450- $1,800	$1,650
Copper (US$/lb)	$2.15	$1.75- $2.85	$2.40
Oil WTI (US$/bbl)	$19.45	$15.00- $62.00	$32.00
MARKETS			
S&P/TSX Composite Index	12,775	10,400- 17,970	16,700
S&P 500 Index	2,590	2,000– 3,394	3,100
CANADA DOLLAR/US DOLLAR	$0.7050	$0.67- $0.77	$0.73

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