Quarterly Report
AUTUMN 2020

HEWARD
INVESTMENT MANAGEMENT INC.

Concerns Over the Pace of the Global Economic Recovery, a Second COVID Wave and the U.S Presidential Elections Take Center Stage

OVERVIEW

It would be a mistake to draw a line between the latest bout of negativity and those that preceded it. Earlier sell-offs involved an attempt to correct the excessive prices in some of the dominant tech names. The late September sell-off was more about re-thinking assumptions that the U.S. and global economies would continue to recover, buoyed by the central banks' largesse. The pace of the global recovery, a possible second COVID wave and Geopolitics have become paramount in investors' minds. However, recent developments in the U.S. were more likely responsible for triggering the end of quarter sell-off. The death of Supreme Court Justice Ginsburg had no direct effect on markets, but the political conflict it has engendered does create much uncertainty over whether any kind of fiscal stimulus can be thrashed out soon. Also, the street seems to have taken some of Fed Chairman Powell's comments out of context.

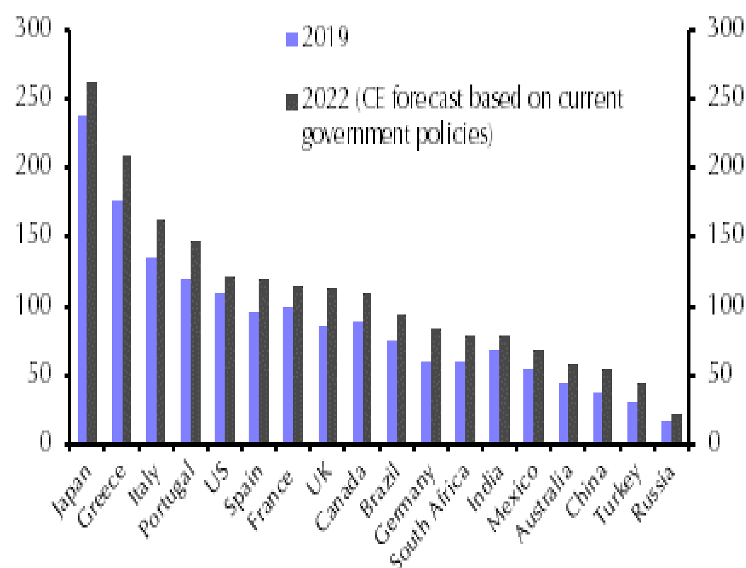
Economic activity rose sharply in most economies as lockdowns eased during May and June. However, outside of China, GDP is still well below pre-COVID levels and there are signs that renewed virus fears are already prompting a slowdown. Gains in industrial production were generally weaker in July than in June. Also, if the high frequency mobility data are anything to go by, the impressive rebound in consumer spending appeared to stall in August. The question investors now face is not if the economy will continue to recover, but by how much. While we expect the global recovery to continue (Leading Economic Indicators across the globe continue to improve), it seems to have entered a slower phase and will resemble more of a square root sign (as per our June commentary) than the V-shape recovery traced-out by equity markets.

One important point that gets missed in the debate over the likely shape of the post-virus recovery is that different economies are already rebounding at different speeds. According to the latest data China is leading the way. Beijing has followed the usual playbook, leaning on state owned banks to lend, instructing state-owned firms to invest and boosting infrastructure spending. As a result, the recovery has been credit fueled and investment led and will ultimately exacerbate the structural problems at the heart of China's economy, but not for a few years or so. While it will lift global GDP growth over the next year or two, the key for other countries is the extent to which this translates in to greater demand for imported products.

Markets have considered a Trump re-election as good for equities and a Biden victory as bad for equities given the latter's tax and regulatory policies. However, there are elements of Trump's policies that likely magnify in a second term, elements that have consistently roiled the markets, trade & tariffs. While low tax payers will clearly be targets for Biden and his call for higher corporate tax rates, a Trump win likely re-ignites the China trade friction.

With a few short lines, the U.S. Federal Reserve has set the stage for a quiet shift in central banking. For the past thirty years the orthodoxy has been that central banks should focus on controlling inflation, targeting a rate over a key policy horizon. In his address to the Jackson Hole symposium, Fed Chairman Jerome Powell signaled a break from that orthodoxy by announcing that the Fed would adopt "a flexible form of average inflation targeting". A subtle shift perhaps, but one that reflects a clear break from the past. It follows that a burst of above average inflation will not just be tolerated, but in fact targeted. In what may be referred to as "Nirvana", rates will stay where they are until inflation gets back to 2%, in combination with maximum employment, which according to the Fed's own estimates would be 4.1%.

GROSS GENERAL GOVERNMENT DEBT (AS % OF GDP)



Source: Refinitiv, IMF, Capital Economics

UNITED STATES

The latest market sell-off in equity markets appears to recognize that the horrible state of U.S. politics could get in the way of the economic recovery, while also acknowledging that the market remains dependent on extended central bank largesse. While the growth rate is likely to slow, the economy has had a nice initial bounce triggered by the re-openings. New home sales have been surging, arguing that a subset of the population is willing to take some risk. True, the strength remains in purchases of things vs services, but probably because person to person contact is still too risky for health reasons. Also, it argues that homebuyers could be higher up the income scale, reflecting the divergent fortunes in the 2020 recession (most layoffs have been concentrated in low income positions). The inequality issue is likely to be dealt with at the ballot box. While the macro economy is firing unevenly, business confidence as measured by the Business Roundtable CEO Index was up through August. This matters as confidence is a leading indicator for capital spending and also effects employment. There are still uniquely impaired areas (i.e. aircraft), but CEO's appear to be planning for a durable economic bottom, even if it will take some time to recover to the prior levels of economic activity. It's the paradox of a pandemic that has crushed the U.S. economy: 12.9 million lost jobs and a dangerous rash of businesses closing, yet the personal finances of many Americans have remained strong, and in some ways have even improved. Employment metrics continue to get incrementally better, but have recently lost some momentum.

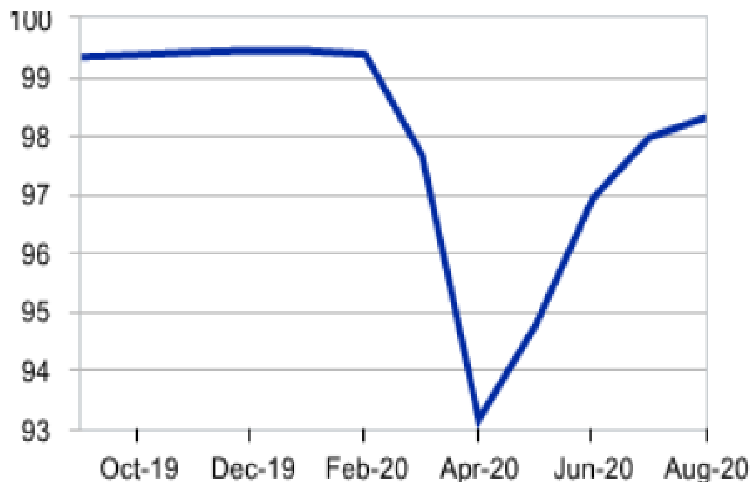
CANADA

Canada's households are emerging from the historic downturn flush with cash, which bodes well for the nascent recovery. Even though GDP plunged by an annualized 38.7% through June, household disposable income surged, with much of it still not spent. Furthermore, household debt to disposable income dropped to its lowest level in more than a decade. Both of these developments can be traced back to massive government transfers and payment deferrals. The data suggest that the aggressive government spending has more than offset the impact of the recession on family finances, making the biggest contribution to a quick recovery and limiting the potential long-term damage. However, no one was really expecting the explosive gains recorded in the initial stages of re-opening to be fully maintained. Increasingly, it appears that the quickest/easiest part of the rebound is behind us, making continued recovery more of a grind, a "slow and choppy" recuperation phase, if we can borrow from the Bank of Canada's fresh assessment. The recovery of jobs lost during the lockdown continued through the summer. The details through August were encouraging as no less than 84% of jobs added in the month being full time. On the flip-side, we are still 1.1 million jobs short of the pre-COVID February peak. Meanwhile, housing starts continued to surprise and were stronger than expected for the fifth month in a row (August). Both data points heavily influenced estimates targeting a GDP rebound of nearly 40% in Q3. However, the pace of the recovery remains highly uncertain and dependent on the evolution of the pandemic both at home and abroad.

EUROPE

European Central Bank (ECB) President Lagarde used her early September press conference to convey a less gloomy message about the economy. She also dampened expectations for an early increase in the already substantial Pandemic Emergency Purchase Program or for any efforts to weaken the exchange rate. However, with the growing number of confirmed COVID cases rising rapidly by mid-September and posing a threat to the recovery, things have change. Some policymakers have recently hinted that further policy loosening could be on the way. Furthermore, with the ECB's own forecasts showing core inflation rising to

OECD COMPOSITE LEADING INDICATOR AMPLITUDE ADJUSTED



Source: OECD

GLIMPSES OF NIRVANA– SUB 4.1% UNEMPLOYMENT COMBINED WITH 2% INFLATION IS VERY RARE

Source: Bloomberg

just 1.1% by 2022, there now seems to be justification for more support. The fallback in the euro zone composite Producer's Price Index (PPI's) suggest that the initial V-shaped rebound following the lifting of lockdowns is already fizzling out. This is being confirmed by the decline in PMI's (mainly services). Meanwhile, growth in bank lending to firms has returned to more normal levels, while consumer credit remains subdued. This suggests that firms are no longer desperate for cash while consumers are still wary about spending. In the UK, the government has reversed course and joined other European countries in offering extended help to businesses in the face of a new surge in coronavirus cases. This followed the imposition of a new set of restrictions on the UK economy which has led some forecasters to predict a further downturn later this year. By fusing the outcome of this year's trade (euro zone) negotiations and the implementation of last year's Brexit agreement, the UK government has amplified the fallout from any failure to reach a deal.

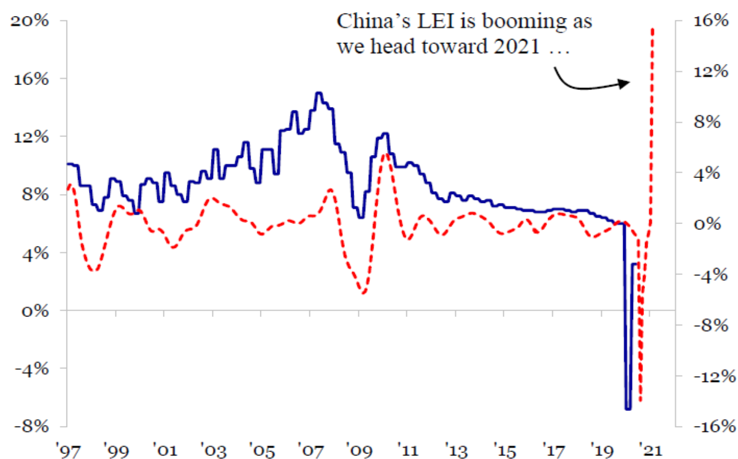
EMERGING & DEVELOPING MARKETS

China is not only ensuring that growth will be strong in 2021 and 2022, the two politically important years, but is also preparing the economy for what they call the "grand global reset" earmarked for the 2023-25 period. Deleveraging and a conservative monetary policy are what will follow, though the People's Bank of China (PBOC) will see that there is sufficient liquidity in the system to allow growth to continue. Meanwhile China remains closest to a "V" shaped bounce, have turned the corner ahead of medical solutions. Both the Caixin and NBS manufacturing and non-manufacturing PMIs show that China's recovery is ongoing. Industrial production and retail sales data are showing increases, and fixed asset investment (while still negative Y/Y) continues to improve. This, matters as it shows that the world's second biggest economy is moving beyond just a bounce in industry and exports. Consumer spending looks to be improving as virus lockdowns ease, giving all the indications that private demand is becoming a broader tailwind. Japan is on the path to recovery. In spite of having kept its COVID-19 case low, the economy was hit hard in Q2 due to the great lockdown. Now however, there are signs that the economy is healing: business sentiment, investor sentiment and manufacturing PMIs all continue to improve. It is expected that emerging Europe as a whole will rebound more quickly from the current crisis compared to other emerging markets. Balance sheets are in relatively good shape and economic activity has recovered strongly in those economies that contained the virus and eased restrictions early.

COMMODITIES

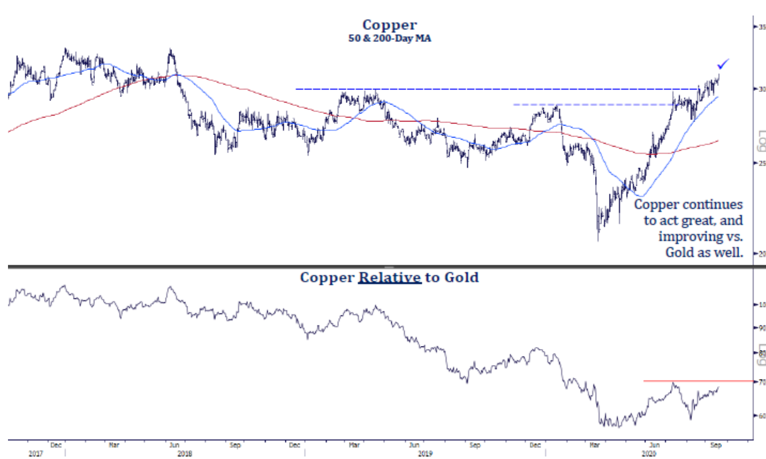
The summer of status quo seems to be over. Crude prices were supported despite percolating signs of weakness in the physical market throughout much of August. The undercurrent of a weakening physical market, which had been building for weeks, led the price pullback that we saw in early September. It began with refiners rejecting crude (abysmal global refining margins) followed by several OPEC countries cutting official selling prices (OSPs). To see the global oil market eventually rebalance will take several steps: Sequentially, refined product demand must improve, product inventories must draw, refining margins must expand and crude demand must firm while prices rally. Instead, firming oil prices over the summer took place in nearly the reverse order. Looking into 2021, we remain cautiously positive for crude prices. Markets have managed to remain in deficit despite a re-immergence of cases globally. We are also encouraged by the discipline by both OPEC+ and shale producers and with the global majors' upstream capex remaining low and shifting towards renewables. "Reports of my death have been greatly exaggerated" Natural Gas. Natural gas prices have been a relative outperformer in the aftermath of COVID-19 and the related economic crisis. The deep hit to supplies has not been offset on the demand side, and at the moment the outlook through winter looks very constructive. Over the summer, gold reached an all-time high ($2065us) before pulling back ($1,860 as we go to print). Despite the recent pullback, the medium-term outlook remains positive, underpinned by an ideal set of macroeconomic/geopolitical factors.

CHINA REAL GDP (YOY%, LHS) VS. CHINA LEI 6 MO CHG (6 MO. LEAD, RHS)



Source: Strategas

COPPER AT FRESH HIGHS, IMMUNE TO EQUITY WEAKNESS



Source: Strategas/Bloomberg

RECOMMENDATIONS

The question facing investors at the end of the quarter is whether the recent sell-off is simply a healthy correction following an over extended rally, compounded by pre-election jitters, or is this the start of a more serious, and long post-stimulus hangover. Our belief is that it would be pre-mature to turn bearish at this time. Clearly, the recovery is losing pace and it will continue to need support. It is policy (print and spend until inflation rises) that will allow the economic recovery this time around to be much quicker than was the case following the Great Financial Crisis (in the case of Europe three times quicker - Credit Suisse). An easy policy will be maintained until unemployment returns to politically and socially acceptable levels. These policies just about guarantee a prolonged period of modest growth and stable inflation, which is an ideal environment for equities. Aside from nosebleed valuations for the market's ten largest stocks, it would be difficult to describe investor sentiment as overly ebullient, and if you look hard enough under the surface (or wait for market opportunities) value can be found. While interest will remain in the "big superstars", we have already seen the initial moves of a rotation as investors begin to focus on late cycle sectors, a signal that markets are broadening out. While not willing to go over-weight equities until we have a clearer picture with regards to the coronavirus, we will continue to fine tune our portfolios concentrating on the technology, healthcare, consumer and financial sectors. It's become increasingly clear that the Bank of Canada and The Federal Reserve are going to keep base interest rates low for an extended period of time. This will result in bond yields remaining fairly low (around current levels), especially for higher quality debt instruments. As such, in order to generate more attractive returns, investors will have to diversify their (fixed) income portfolios by including more of the less traditional investment vehicles. Higher yielding corporate bonds, convertible debentures, preferred shares and selected higher yielding stocks will have to play a more prominent role as we go forward. Given the current low level of rates, portfolio duration should remain below benchmark as the potential for further interest rate declines seems limited.

FORECAST 2020	CURRENT 30-SEPTEMBER-2020	2020 RANGE	2020 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	0.25%	0.25%- 1.75%	0.25%
Federal Funds Rate	0.80%	0.00%- 2.00%	0.10%
10-year Canadian Treasury	0.56%	0.25%- 2.10%	0.50%
10-year US Treasury	0.68%	0.35%- 2.25%	0.65%
COMMODITIES			
Gold (US$/oz.)	$1,887	$1,400- $2,150	$2,100
Copper (US$/lb)	$2.99	$2.06- $3.15	$3.00
Oil WTI (US$/bbl)	$39.86	$21.00- $65.50	$40.00
MARKETS			
S&P/TSX Composite Index	16,121	11,228- 17,975	16,700
S&P 500 Index	3,363	2,237– 3,588	3,400
CANADA DOLLAR/US DOLLAR	$0.751	$0.69- $0.77	$0.75

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