# Quarterly Report
# WINTER 2021

HEWARD
INVESTMENT MANAGEMENT INC.

## Reboot, Restart & Recover - Vaccines Offer a "New Hope"

### OVERVIEW

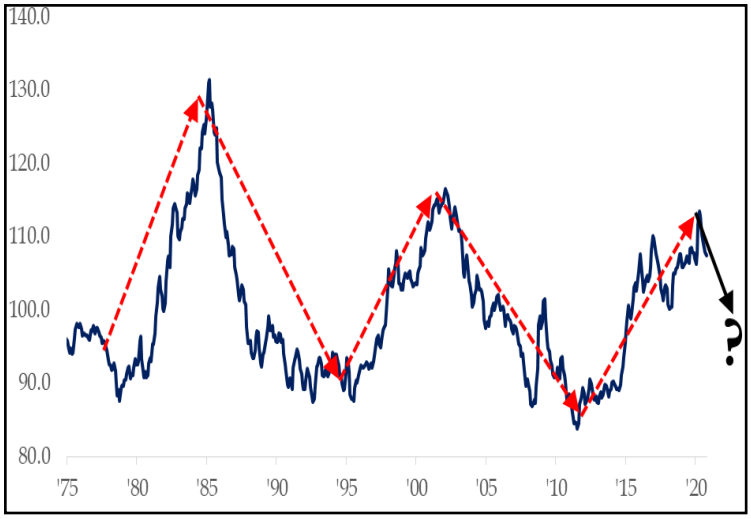
Some years loom large in history, as the end of a war or the onset of a revolution punctuates the shift from one chapter to another. 2020 will be an exception. COVID-19 has not just pummelled the global economy, it has changed the trajectory of the three big forces that are shaping the modern world. Globalisation has been truncated. The digital revolution has been radically accelerated while the geopolitical rivalry between the US and China has intensified. At the same time, the pandemic has worsened one of today's great scourges: inequality. However, by showing the toll of being unprepared for a low-probability, high-impact disaster, it has focused more minds on the coming century's inevitable and even higher impact disaster, that of climate change. All this means there is no going back to the pre-COVID world (the Economist).

For the market's price action and fundamentals, the last few months have been anything but uneventful. Since the start of September, investors have witnessed a stalling of the mega and large-cap share dominance that defined the market off the lows, morphing into a phenomenon which has led to a notable broadening of participation. While a difficult few months still lie ahead, the news of effective vaccines has led to the upward revision of global GDP expectations for 2021. Investors have grown more comfortable with the probability that life (the economies and corporate earnings) will return back to "normal" once vaccines become widely available. While the economic implications will vary according to the speed/quantity of distribution of the vaccines and by the effects that the pandemic has had so far, the impact will be biggest in developed markets (DM). The euro zone and the UK may expect the biggest revisions to GDP expectations due to the make up of their economies and the severe and repeated lockdowns. The US will also benefit quickly given their access to the vaccines, but the effects will be will be smaller given that limits on activity have been less draconian. While China's economy will feel the shift from spending on goods to services by DMs, its recovery has broadened out to its own consumer sector, and together with new government spending will help to sustain growth.

Households around the world responded to the coronavirus pandemic and its related effects by sharply boosting their savings. What they do with that cash will ultimately shape the recovery. Savings rates in many countries have soared since last spring as governments pumped stimulus money into people's pockets while consumers trimmed their spending (work from home, business closures, infection fears). That has left many consumers with less debt and more cash to burn. If they open their wallets readily, that could unleash a wave of pent-up demand that spurs strong growth in the short term. However, if they hold back, that would restrain the economic recovery initially, but would provide more fuel for more spending in the longer term.

The overarching narrative in the oil market this year has been a collapse in capital investment along with the drop in prices. This collapse in investment has seen US rig counts crater and US production fall (2mn/bpd). Even as demand recovers the capital shortage won't ease greatly as the sector continues to face its most challenging fundamental period since the Great Energy Depression of 1981-1995. Multiple headwinds exist ranging from investor demands for greater Environmental Social and Governance (ESG) accountability, the push for de-carbonization amid climate change concerns, and increasing adoption and market share for electric vehicles (EV's) and renewables. However, with OPEC+ maintaining most of their production cuts through the first quarter of 2021 in line with evolving demand, this constraint on capital could eventually lead to a supply squeeze as demand recovers with the global distribution (2H 2021) of the COVID-19 vaccines.

**REAL BROAD TRADE WEIGHTED DOLLAR INDEX**




Source: Federal Reserve Board/Strategas

## UNITED STATES

With another virus wave rippling through the country, the US economy seems to be in a holding pattern, but healthier than where it was in the spring. This was reiterated by Fed Chairman Powell who after the election held rates near zero and also made a fresh appeal to Congress to pass another relief package to help troubled businesses and out-of-work Americans. And, while It may have taken time, an agreement was finally reached (and finally signed by the President). While it may not have the most productive measures, what we have learned over time is that size matters, and this package has size, and seems to be coming just in time. With stubbornly high initial jobless claims combined with the loss of momentum in retail sales, it appears that the advancing US economy is troughing uphill. However, there will be a new president in the White House, one who has campaigned on "having a plan" to contain the spread of the virus. It would we natural to expect that if there is a lockdown 2.0, it would be a "smart lockdown" which would not have the same negative impact. Even though the economic recovery has not transformed itself into a strong V-shaped recovery as many had expected, the National Association of Home Builders housing market index continues to rise, hitting new cycle highs. Also, recent data shows that applications for new businesses have been on the rise. Business formation saw an 82% increase (Y/Y) catalyzed by low interest rates, high savings rates and a questionable job market. Furthermore, with the selection of Janet Yellen as Treasury Secretary, the Biden team has sent a strong signal to the market that it will prioritize economic recovery.

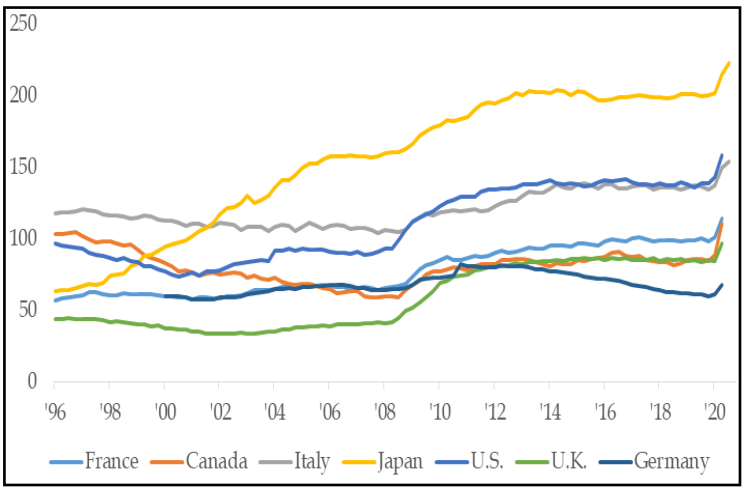
## CANADA

The massive policy response from the Bank of Canada (BOC) and the Federal government successfully preened the country's financial system from buckling. Signs of overwhelming financial strain are few, and the risk of a wave of consumer defaults seem low. By most measures, households with expired debt deferrals have resumed payments and governments are helping businesses in many sectors manage cash flows. However, the BOC believes it will take quite some time for the economy to fully recover. In Fact, Governor Macklem, in his last speech of the year, stressed that uncertainty remained elevated and that the new restrictions could trigger a small contraction at the start of 2021. As such, the BOC reinforced its commitment to keeping interest rates at historical lows, pledged to continue buying government bonds to suppress longer term borrowing costs and to retain current levels of stimulus. The BOC also made changes to the quantitative easing program. These moves were characterized by Governor Macklem as "a natural evolution as the central bank shifts its policy goals away from stabilizing financial markets and more towards providing stimulus". Canada's oil market access headwinds appear to be fading. Anchored by the oil sands, Canada's oil supply is bouncing back from shut-ins, curtailments and maintenance. In October, with production well below curtailment targets and inventories having declined, Alberta lifted mandated production cuts. Meanwhile, higher oil prices, commodity fundamentals and GDP expectations should continue to put a tailwind to the Loonie.

## EUROPE

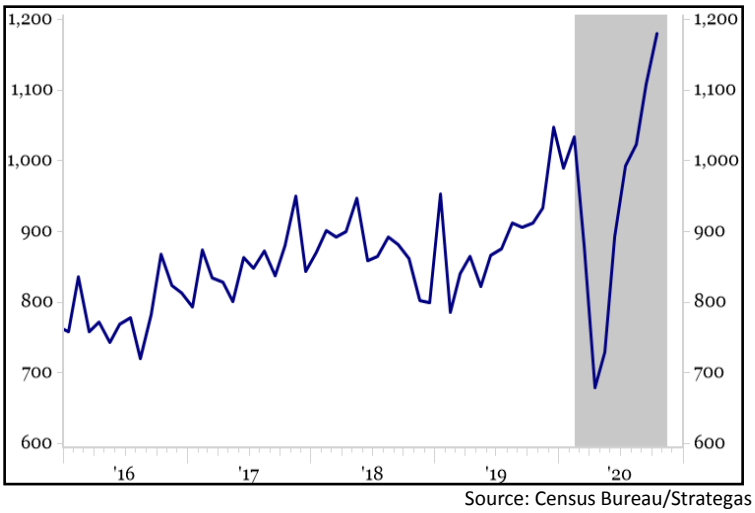
The latest restrictions in Europe will prove to have been damaging to Q4 GDP. However, the lifting of some restrictions in France, the rebound in Composite Purchasing Managers Index (PMIs) and the increase in the German Ifo Business Climate Index provide some hope that the euro zone GDP won't fall quite as much in Q4 as originally feared. However, the big picture for services activity in the region will remain weak for a while yet, holding back the economic recovery. Given the certain slump in economic activity through the fourth quarter the European Central Bank's (ECB) dovish message in December came as no surprise. The raft of measures the ECB announced was pretty much in line with

**GENERAL GOVERNMENT DEBT AS A OF TOTAL GDP (NOT SEASONALLY ADJUSTED, %)**




Source: Strategas

**HOUSING STARTS: 1 UNIT/ SEASONALLY ADJUSTED ANNUAL RATE (SAAR), THOUSAND UNITS**




Source: Census Bureau/Strategas

what senior policymakers had already signalled and included: three more rounds of Targeted Longer-Term Refinancing, and increasing the Pandemic Emergency Purchase Program. These moves should reassure investors that there will not be a reversal of the compression of bond yields anytime soon. Meanwhile, the EU and China are close to reaching a long-awaited business investment deal as Brussels seeks to boost opportunities for European companies operating in the Chinese market. Also, the UK finally clinched an historic trade deal with the EU, averting the threat of an messy breakup and laying the foundations for a new relationship with its biggest commercial partner. The agreement will allow for tariff and quota-free trade in goods after December 31st, but won't apply to the services industry or the financial services sector. Firms exporting goods will also face a race to prepare for the return of customs and border checks at year end amid warnings of disruptions at Britain's ports.

## EMERGING & DEVELOPING MARKETS

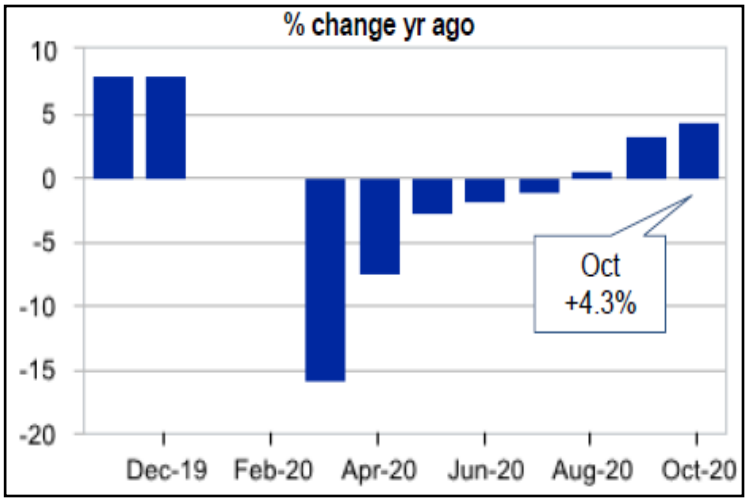
China's recovery from the pandemic decline is basically complete. November data shows that the recovery has become broad based with consumer spending (1/3 of GDP) having come back fairly strong. Not only has it caught up with the industrial sector, but now consumption looks to become the driver of growth. While fiscal policy will not go away, expect less of a push. There are early signals suggesting that the growth momentum will slow in Q1/21, as the People's Bank of China (PBOC) is already gently tightening and more is expected in January. This is the time of year banks want their loans repaid before issuing new loans later in the new year. What happens to China's economy has global implications as the country accounts for 19% of global GDP, but 28% of global growth. China's recovery has been driven by funneling credit into the important State Managed Enterprises (SME) and private sectors. Going forward the government's mantra seems to be one where projects should be financed from equity issuance and savings rather than debt. As the new year dawned on Japan the government was considering whether or not to declare a state of emergency in order to reduce infection risks emanating from bars and restaurants.

Meanwhile, the Bank of Japan (BOJ) has maintained the status quo across all monetary policy parameters. It also extended its corporate finance support programs in response to COVID-19 to the end of September 2021, which is in step with the government's additional economic stimulus package. Perhaps more importantly, the BOJ announced plans to review monetary easing, with a view to achieving its 2% inflation target.

## COMMODITIES

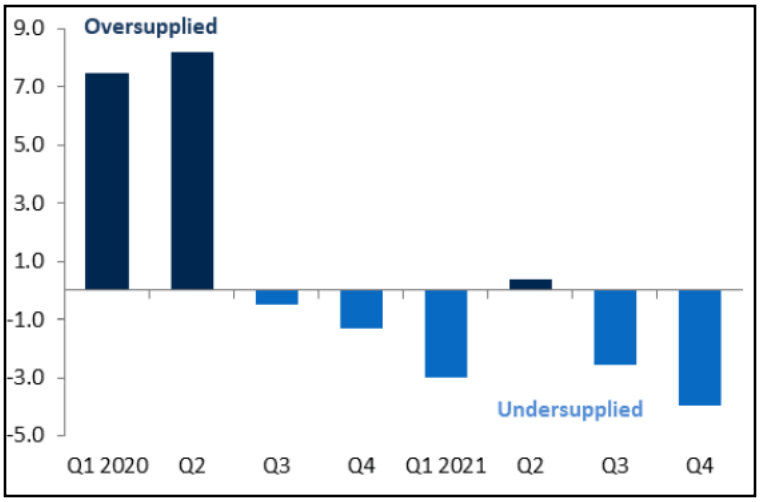
The global oil market has stabilized following surreal conditions earlier this year amid OPEC+'s brief price war and the ongoing COVID-19 pandemic. Looking forward, market focus will rest on OPEC+ cuts and compliance, global inventory balances and demand as well as the new US administration's view of the Iran nuclear deal. Refiners globally are likely to boost utilization rates in lockstep with demand, but this is likely to contain cracks until product inventories draw meaningfully. The collapse in capital investment, owing to the need to deleverage balance sheets, should weigh on non-OPEC supply growth, particularly in the U.S. Surviving the volatile price collapse earlier in the year left many operators financially reeling and has kept capital budgets lower as a result. A strong recovery in China and supply disruptions have driven metal prices and equities mostly back above pre-COVID levels. While China's overall economy is giving off strong growth signals, there are signs of stalling in specific sectors. This "planned stalling" is part of the leadership's strategy to ensure the start of "robust growth" comes prior to the July 2021 100th anniversary of the Chinese Communist Party (CCP) which is also the 10th anniversary of Xi's leadership. Projects, which have already been announced, will be unleashed into the economy at March's National Policy Committee meeting. Also, the food/soft commodities industry is seeing an improvement in fundamentals. Demand for both food and fertilizers has been resilient and market fundamentals have not been this good in six years. The industry is seeing strong crop pricing, tighter stock to use ratios and improved farmer profitability.

**CHINA RETAIL SALES**




Source: National Bureau of Statistics of China/ECONOMAP

**GLOBAL SUPPLY AND DEMAND BALANCE**




Source: RBC CAPITAL MARKETS

## RECOMMENDATIONS

Despite the arrival of the vaccines, the macro healing process is going to extend well into 2021. The resurgence in COVID-19 cases will influence the speed of economic recovery, but not the direction. There is no end in sight for monetary support, as central bankers have taken the Fed's lead and the play book is clear; print money and keep rates near zero, probably well into 2023. While market valuations are high, there is value beneath the surface. Indicators are pointing to a cyclical bias over defensives as a move from "COVID winners" to "COVID losers" permeates the market. The USD looks to continue to weaken as both fundamental and technical indicators are pointing lower. A short-term rally however, would not be a surprise. After a year of big swings in valuations, 2021 will be about who can deliver on earnings. As such, we favor reasonably priced stocks/sectors that will benefit the most from a return to "normalization" and will benefit from underappreciated leverage. As this develops, investor focus should shift to Canada (relative to the S&P 500) where there are more value versus growth names within the index. We have positioned our portfolios for a recovery in activity and plan to use market weakness to further over weight our equity positions, favoring late cycle sectors: Financials, Industrials, Consumer Discretionary and targeted Technology names. In structuring fixed income portfolios we need to consider that while the COVID-19 crisis worsens, economic numbers continue to beat cautious expectations due to the ongoing support from central banks and governments in most countries. Even with the rollout of the vaccines and the return of "natural" growth, it is clear these policies are here to stay for quite a while. Official rates are therefore going to stay low for longer. Nevertheless, as the situation improves, bond yields may gradually (and modestly) move higher, meaning that longer term bonds are likely to underperform. As a result, we will continue to populate our portfolios with mainly short-term (mainly corporate) bonds, convertible debentures and select preferred shares, which should provide higher nominal returns. They are also likely to benefit from declining credit spreads which usually occur in an improving economic environment.

## FORECAST 2021

| | CURRENT 31-DECEMBER-2020 | 2021 RANGE | 2021 YEAR-END |
|---|---|---|---|
| **INTEREST RATES** | | | |
| Bank of Canada Overnight | 0.250% | 0.25%- 0.25% | 0.25% |
| Federal Funds Rate | 0.090% | 0.00%- 0.25% | 0.25% |
| 10-year Canadian Treasury | 0.675% | 0.60%- 1.40% | 1.40% |
| 10-year US Treasury | 0.916% | 0.80%- 1.60% | 1.60% |
| **COMMODITIES** | | | |
| Gold (US$/oz.) | $1,895 | $1,770- $2,200 | $2,000 |
| Copper (US$/lb) | $3.52 | $3.40- $4.20 | $4.00 |
| Oil WTI (US$/bbl) | $48.52 | $43.00- $60.00 | $55.00 |
| **MARKETS** | | | |
| S&P/TSX Composite Index | 17,433 | 16,900-19,300 | 19,000 |
| S&P 500 Index | 3,706 | 3,500– 4,100 | 4,000 |
| CANADA DOLLAR/US DOLLAR | $0.7853 | $0.77- $0.83 | $0.82 |



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