Quarterly Report
SUMMER 2021

HEWARD
INVESTMENT MANAGEMENT INC.

Investor Optimism May be Justified but Sifting Through Market & Stock Valuations is Required

OVERVIEW

Whereas many experts initially argued that the pandemic would depress global economic output until at least 2024-25 (some to 2030), most have reworked their earlier assessments. In its world economic outlook published in April, the International Monetary Fund (IMF) forecast that most Advanced Economies (AE) would now return to their re-pandemic paths by 2022. Key for the IMF was the incoming data which was stronger than expected, and the huge scale of global fiscal and monetary stimulus (highest level to GDP since WW II). Also, the factors that would typically get an economy stuck on a lower growth path after a crisis don't apply now. The pre-crisis global growth rate was already unusually weak, so the recovery bar has not been set all that high. And, government support schemes have limited supply side damage to economies and have caused private sector balance sheets to be stronger than before the pandemic.

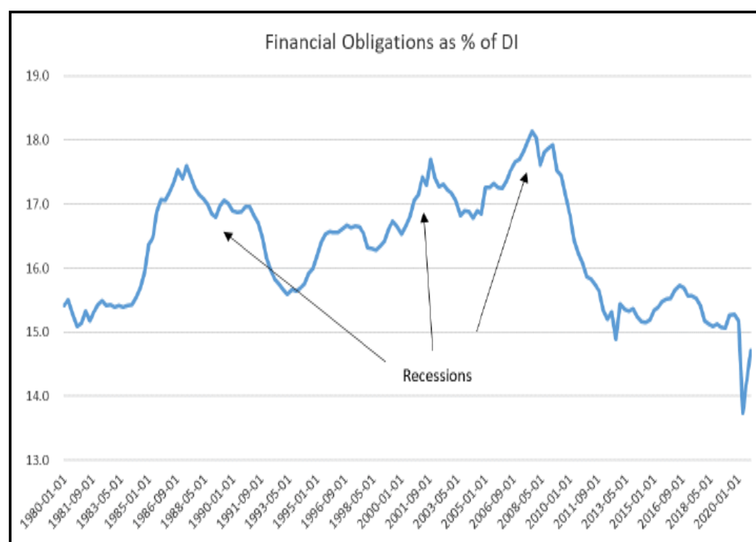
The inflation debate continues unabated. It is clear from the latest data that consumer prices have been on an accelerating path from the combination of recovering consumer demand and supply bottlenecks. The largest increases have been in Oceana and the Americas which are the first economies to rebound from the pandemic. In Europe, where the vaccine rollout has been slower, the inflation uptick has been milder. So, should investors be concerned or are we seeing "inflation fuss"? Perhaps yes, but most of the pressure has come from transitory factors. These include the "base line" effect as many prices fell a year ago as the pandemic hit, current supply chain disruptions which are occurring as the economies open up again, and the sudden pickup in demand for many products (and soon to be services) as consumers are able to move back into a normal operating mode. Once these short-term adjustments work through, we anticipate the price environment returning to a contained range closer to what we have been used to.

As we go to press, OPEC PLUS allies were locked in a tense diplomatic standoff. They seemed to be on their way to announcing a modest production increase that would see output raised by 400Kb/d per month from August to December. However, the United Arab Emirates (UAE) has thrown a dramatic curveball into the deliberations by demanding an adjustment of the baselines used to determine individual country production levels.

It is our understanding that this is a fundamental, not cosmetic, area of contention and that Abu Dhabi is preparing to dig in its heels over the baseline issue. With them failing (as of this writing) to reach an agreement, the automatic fallback is now to rollover the current quotas into August and beyond, probably leading to sharply higher prices. This is not something OPEC Plus members really want to see.

With the S&P 500 at more than 20X earnings (forward) and the 10-year Treasury at about 1.5% it seems almost cliché to say that future returns for risk assets will be challenged. Nominal GDP growth for the U.S. over the next two years will be much stronger than what we have become accustomed to, result in stronger top line growth than in any period we've seen in decades. The problem is that the ratio of inflation to total nominal GDP is likely to increase markedly over the next few years. Easy money and profligate government spending can lead to much better-than-expected growth in revenues. But for those companies held hostage to higher input costs, margins are likely to decline. Quantitative Easing (QE) can obscure the natural advantage value stocks may have in periods of time in which inflation makes up a greater proportion of GDP, but it stands to reason only those companies that can pass on their higher input costs to their customers will outperform. Our challenge becomes to sift through the noise and find those companies.

FINANCIAL OBLIGATIONS AS % OF DISPOSIBLE INCOME IS ESSENTIALLY AT 40 YEAR LOWS



Source: St. Louis Federal Reserve, Raymond James Research

UNITED STATES

As the U.S. confronts a series of challenges, the COVID 19 pandemic, growing income inequality, climate change, and the rise of China foremost among them, there is renewed debate about the role of industrial policies, or government support for particular industrial goals and specific industries that are deemed strategically important. The Biden administration has made it clear that a new U.S. industrial strategy is essential to respond to China, secure critical supply chains and advance innovative technologies. Meanwhile, GDP in Q2 will prove to have been strong as stimulus boosted demand continued to outpace supply. Looking forward, consumption is poised to shift from goods to services, providing the economy with more octane for the next few quarters. Even though inflation has started to rise, Fed Chairman Powell maintains his belief that it is not yet time to consider tapering as the U.S. remains a long way from full employment. While the employment numbers were not where the Fed would like them to be, expanded unemployment benefits are set to run out in September and the data points should improve. While some have accused the Federal Open Market Committee (FOMC) of making the same mistakes as in the 1960s, Powell has pushed back on this idea, believing upward pressures on prices to be "transitory". Bottlenecks have also become somewhat of a concern, but after consulting with their business contacts the Fed believes these too shall pass. After the Great Lockdown in 2020, residential housing & building saw a strong bounce. But it now appears that rising mortgage rates, building costs and home prices are putting a dent on home sales and optimism.

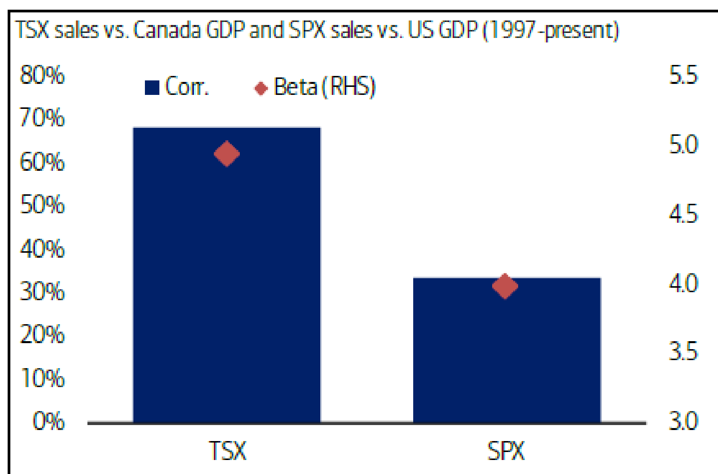
CANADA

Canada's economy continues its run of surprising strength, validating expectations that activity is on its way to returning to pre-pandemic levels. While holding its key interest rate at historic lows and maintaining its current pace of bond purchases, the Bank of Canada (BoC) has forecasts for this year and next. Citing the improved outlook on the quickly evolving vaccination rollout, the BoC started to taper its massive asset purchases at the end of April. While their expectations put them ahead of the U.S. Fed, we are still a long way off before we see our first interest rate increase in Canada. Meanwhile, the Loonie has continued to test new highs, which ordinarily would be considered a drag on exports, and another reason why the BoC could push back the time table for interest rate hikes. Trade however, is being negatively impacted by supply chain disruptions and in particular by global semiconductor shortages. Both imports and exports reflect the disruptions in the auto sector as worldwide shortages of computer chips forced auto companies to idle plants. Investors' focus has also been on Canada's housing boom and the evident concerns it has raised in Ottawa. This triggered a financial system review from the BoC that highlighted the risks of what it sees as unsustainable house price appreciation, and a move to require insured borrowers to show their ability to pay a higher reference rate. Meanwhile, Canada's banking watchdog is boosting a key threshold for the big banks' capital reserves saying the move was prudent given the evolving environment, as economic shocks from the pandemic have eased.

EUROPE

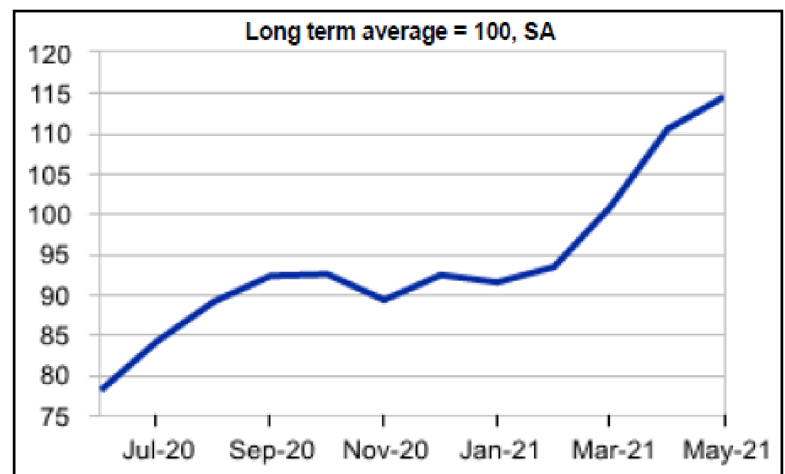
The euro zone (EU) economy has suffered through a bleak winter recording a weak real GDP performance, soft retail sales and business investment. Led by Germany, this state of affairs looks like it is about to end. The euro zone recovery from the pandemic has been slow, mainly resulting from the slow vaccine rollouts. But we are now starting to see a significant ramp up in the vaccination rollouts in all major EU countries. The EU's economic sentiment indicator is also moving in the right direction with confidence improving in all sectors. Not surprisingly, activity increased particularly rapidly in the services sector as many hotels and restaurants re-opened, prompting a surge in restaurant bookings and job openings as well as an increase in high-frequency mobility data. It's quite possible that core countries may be back to

TSX SALES HAVE HISTORICALLY BEEN MUCH MORE CORRELATED AND SENSITIVE TO GDP THAN S&P SALES



Source: BoA US Equity and Quant Strategy, FactSet

EURO ZONE ECONOMIC SENTIMENT INDEX



Source: European Commission

pre-pandemic levels by early next year, but the tourist reliant southern countries will require more time. Thus far there has been no evidence of "re-opening inflation", but the experience in the U.S., and to a lesser extent in the UK, would imply that prices will soon rise in the euro zone too. However, while headline inflation is likely to rise above initial expectations, it should prove to be transitory here as well. With the UK being a global leader with wide spread initial doses, the economy has been reopening & restrictions have been relaxed without a major flare-up in the number of COVIS 19 cases. Accordingly, consumer confidence & spending, business confidence, manufacturing, capex, budget deficits and inflation are all improving. Employment data, which is a lagging indicator, seems to have stabilized.

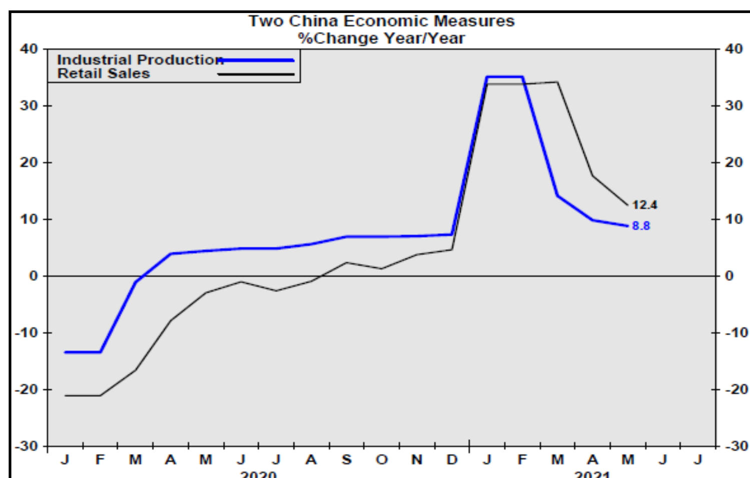
EMERGING & DEVELOPING MARKETS

There is little question that China as a "brand" has suffered long-term damage with the U.S. and the rest of the world since the emergence of the COVID-19. In addition, China's ability to use trade as a means to enact economic pain on another country (Australia) in the face of political disputes has served as a wake-up call. Meanwhile, China's leadership is preparing for difficult times ahead. Their concerns stem around America's fiscal and monetary policies creating a weak dollar and global inflation, as well as the more aggressive efforts to contain China's economic growth and its global expansion via its Belt and Road Initiatives (BRI). The leadership is emphasizing the need to deleverage the economy by reducing corporate and local government debt. The opportunity is also being taken to restructure parts of the economy by using the stronger Yuan to focus on importing raw material products rather than raw materials themselves. China has also forced banks to hold more foreign currencies in reserve for the first time in more than a decade, in a move to rein in the surging Yuan. In keeping with the government's new focus on debt reduction, monetary stimulus is being reduced while planned projects are being cancelled. For Japan, the recovery looks like it will be delayed until next year. Recurring virus waves coupled with a slow vaccination rollout means that Japan's recovery will disappoint this year. However, next year's prospects look promising as Japan will be a key beneficiary from any efforts by manufacturers at home and abroad to expand capacity in response to supply shortages. The Bank of Japan is expected to keep policy loose for longer.

COMMODITIES

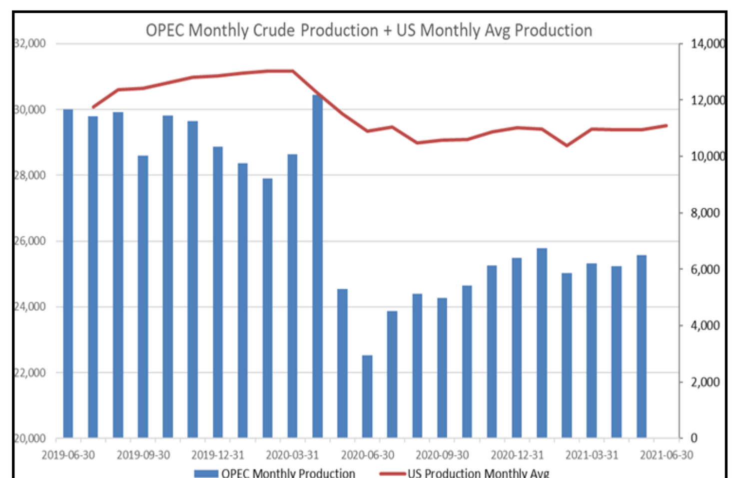
While the macro-economic backdrop remains supportive of commodities, most have already enjoyed a strong ride this year. Copper, for instance, has penetrated previous highs set in 2011 (copper up 67% last 12 months). The combination of mine supply constraints, less scrap supply than had been anticipated, less substitution than feared and relatively price-inelastic demand have caused tighter markets and higher prices. Political risk in Peru as well as tax/royalty and strike action risk in Chile have also contributed. Copper does not stand alone in this scenario, as Iron ore, steel, lumber, corn, soybeans, wheat, coffee and cotton all hit multi-year highs. However, while prices remain elevated, sentiment seems to have changed (Fed comments) and costs are rising. Markets are also seeing some near-term weakness as China continues to implement policies to prevent abnormal price changes and speculative trading, including selling major industrial metals from state stock piles. Notwithstanding the current OPEC PLUS dispute, the International Energy Agency (IEA) sees oil demand growth continuing to out-pace supply. It has been since OPEC PLUS cut production in 2020, and the shortfall is expected to widen even if Iran is allowed to boost exports. Through the recently completed quarter, OPEC PLUS production lagged demand by approximately 150,000 barrels per day (bpd), and according to the Paris watch dog the shortfall is expected to widen to 2.5 million bpd by year end. This would have been more than sufficient to absorb the OPEC PLUS production that was to be returned to markets. The current impasse however, would lead to no production increases, squeezing an already tight market.

TWO CHINA ECONOMIC MEASURES % CHANGE YEAR /YEAR



Source: John Aitkens Investment Strategy

OPEC MONTHLY CRUDE PRODUCTION + US MONTHLY AVERAGE PRODUCTION



Source: OPEC

RECOMMENDATIONS

There is clear evidence that that supply remains a problem for many companies, just as demand is picking up. These issues have been particularly acute in certain inputs (materials and chips). But with May's employment report, the market has focused on labor availability which may also turn out to be a critical headwind for re-openings. Furthermore, while these problems haven't broadly effected margins yet, it's quite likely they will at some point, and stocks are discounting machines and they don't always wait for an engraved invitation. The recent move lower in U.S. 10-year Treasuries suggests some weakness (short term) is ahead, and we may be in for choppy markets over the summer. However, the pace of the global recovery is set to accelerate in the months ahead. Accelerating vaccine rollouts, a backdrop of broadly generous policy support and the results of June's PMIs all point to more economies expanding their re-openings. Any market weakness that may develop near-term (delta variant concerns & China tightening) would be viewed as an opportunity to position our portfolios for the expected growth that is about to be unleashed. Late cycle sectors (Energy, Financials, Industrials & Materials) would be targeted to over-weight equities. With the Canadian market trading at a discount (steepest since the tech bubble) to the S&P 500, and where the composition is much better positioned to benefit from the global economic recovery, we would over-weight Canada. Meanwhile, we will continue to manage (buy & sell) our core portfolio holdings based on valuations, fundamentals and market opportunities. With renewed confinement measures in the early part of the quarter, upside pressure on interest rates have waned. Even significantly rising inflationary pressures have not worried the bond market, and as it stands, ten-year rates (Canada & U.S.) may end the quarter below March end levels. However, given our expectations for renewed growth, we consider present levels to be a new floor, from which interest rates will eventually trend higher. But we continue to believe that any rise will be gradual and that rates will not reach levels that might be considered to be harmful to the recovery for quite some time. We are maintaining our strategy of emphasizing medium-and-short term bonds (overweight in corporate bonds), while also keeping a significant exposure to preferred shares, which continue to provide attractive returns. We also continue to hold a select group of higher yielding equities.

FORECAST 2021

	CURRENT 30-June-2021	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	1.388%	0.67%- 1.90%	1.85%
10-year US Treasury	1.459%	0.92%- 2.00%	1.90%
COMMODITIES			
Gold (US$/oz.)	$1,771	$1,675- $1,900	$1,875
Copper (US$/lb)	$4.29	$3.45- $4.77	$4.70
Oil WTI (US$/bbl)	$73.55	$47.00- $80.00	$74.00
MARKETS			
S&P/TSX Composite Index	20,165	17,300-20,800	20,500
S&P 500 Index	4,297	3,660– 4,500	4,350
CANADA DOLLAR/US DOLLAR	$0.81	$0.77- $0.88	$0.85

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