The Heward Global Leaders Investment Strategy

JANUARY 2022

HEWARD
INVESTMENT MANAGEMENT INC.

"Physics isn't controversial, it's guided by laws, finance and business is different, it's guided by people's behaviors." – Morgan Housel

Writing an end-of-year article is often one of our more difficult tasks. There is very little utility in making a series of bold predictions that turn out to be completely wrong. Sometimes it would be nice to take a leaf out of J. P. Morgan's book. When asked what markets would do, he replied "they will fluctuate", and then went about his day. So…. Some parting thoughts on 2021!

The year began with a marriage of fiscal and monetary policies the likes of which the world had never seen; the year ends with President Biden's "Build Back Better" agenda failing to pass and a central bank that's quickly getting out of the bond buying business. Looking back, despite so much intoxication at the time, it's notable how many things topped out in Q1 -- not only in the reflation foot race (the high close on 10-year bond yields was 1.74% on March 31st), but also in highly valued tech names, especially in the renewables space and "NFT's" and Special Acquisition Companies – "SPACS". In a way, it's remarkable that the first quarter marked peak exuberance, yet the broader market continued to make higher highs for many months thereafter; again, this is largely to the credit of the US mega cap tech names, who yet again beat the pants off most every other item on the global menu.

Looking back, January saw headline inflation (CPI) register a print of +1.4% yr/yr while in December the last inflation reading was +6.8%... it's not crazy to think that number could be upwards of 7% come January. If you had told me at the start of the year how the inflation narrative would pan out, I certainly wouldn't have predicted 10-year bond yields would be around 1.50% nor that gold would be (gasp!) down 6% and being honest, I don't think I would have predicted that the S&P 500 would make a high of over 4700. I'll again reference a quote from J. P. Morgan: "We think about and are taught about money in ways that are too much like physics (with rules and laws) and not enough like psychology (with emotions and nuance). Physics isn't controversial, it's guided by laws, finance is different it's guided by people's behaviors."

However, in 2022 Morgan may well be far closer to the mark than we would care to admit. In the aftermath of the Covid-19 pandemic, the global economy is more unstable than ever and the global stock of debt is at an unprecedented level. "Portfolio management 101" reminds us that leverage amplifies returns to the up and downside. Some leverage is usually justified however huge amounts of leverage make for instability, something which is true at the individual, corporate and country level. The COVID pandemic has unleashed a huge wave of stimulus, and accelerated digitalisation and innovation. Markets therefore face strong cross currents, both bullish and bearish, and we think they may will indeed fluctuate, and fluctuate wildly.

Restarting a stalled global economy has proved an awkward exercise. The most severe (and abrupt) recession since the 1920s and ongoing Covid restrictions have crimped supply, while the enormous fiscal and monetary stimulus has boosted demand. The global economy is now struggling to squeeze robust demand through a narrow supply channel. The restoration of supply chains, reallocation of labor and rebalancing of supply and demand, these will be the critical factors that determine both economic growth in 2022 and the strength and persistence of inflation. We see several early signs that supply chains are incrementally improving and bottlenecks look like they are easing.

More specifically, some key freight rates have declined, container backlogs appear to be coming down modestly, and auto production has started to pick up in some areas. Our sense is that these developments will alleviate some inflation concerns although higher wage inflation is unlikely to ease in 2022 and the strength and persistence of inflation. We see several early signs that supply chains are incrementally improving and bottlenecks look like they are easing.

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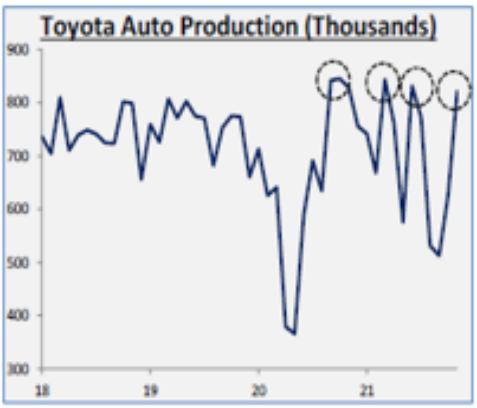
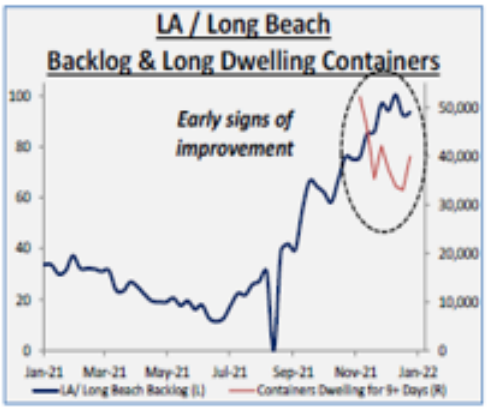
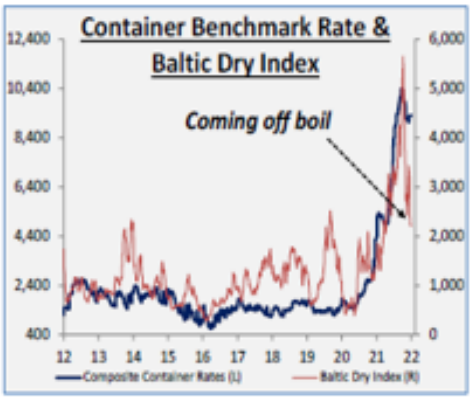
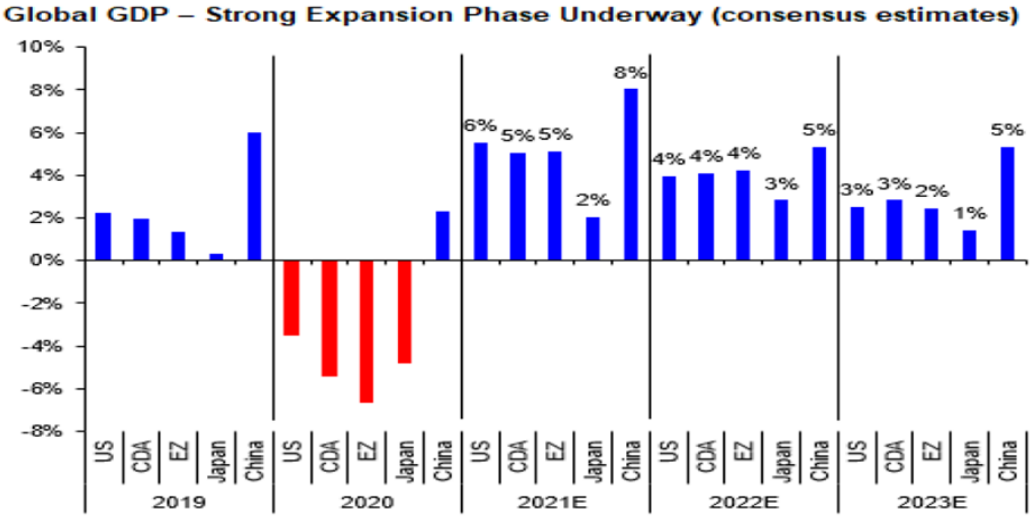






Sources: Wolfe Research, Japan Automobile Manufacturers Association and Bloomberg

The support provided by governments and central banks since the outbreak of the pandemic has ensured that the world does not suffer from a lack of demand. The problems faced by the world economy stem from the inability to meet that demand either because of a lack of components or workers, or because products cannot be delivered. For most major economies growth rates next year may be above average (between 4% and 6% in the US and Europe), though the rate will decelerate over the course of the year as the boost from reopening fades and economies finally make up the lost ground from lockdowns. Given the incredible government stimulus in the system plus with the cost of capital so low (for now), global growth looks strong for the next couple of years.



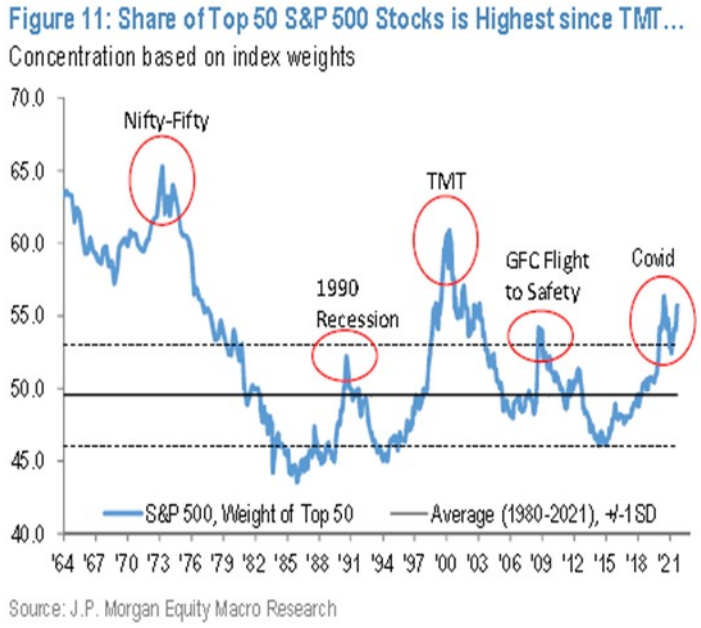
Source: Scotiabank GBM Portfolio Strategy, Bloomberg.

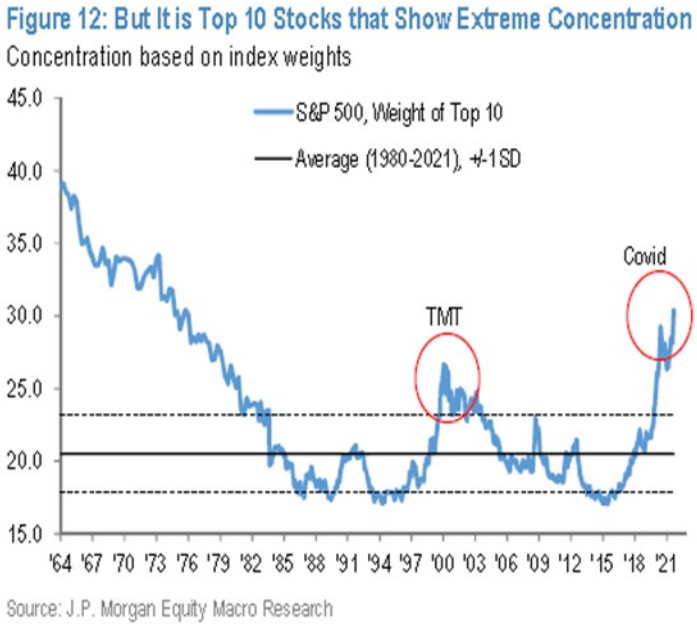
"SOMEONE IS SITTING IN THE SHADE TODAY BECAUSE SOMEONE PLANTED A TREE A LONG TIME AGO."

- WARREN BUFFET

According to a recent Morgan Stanley report, "*Analysis of equity market concentrations since 1960s the flight to perceived safety post-Covid-19 has driven the market-cap weight of the top 50 stocks to the third highest level. Today, the largest 50 companies account for 56% of the index compared to the technology (TMT bubble in 1999-2000) concentration peak of 61% and the "Nifty-Fifty" (1972-73) peak of 65%.*

More importantly perhaps, the current episode is largely due to global investors' search for safety / income / liquidity ("pseudo bonds") in a world where sovereign bonds are likely to deliver negative real returns in the foreseeable period. Also, the largest S&P 500 companies currently have proven track record of delivering organic growth, higher pricing power, and superior capital return. The companies have several advantages over prior leaders given most are platform companies with captive users, global reach, enviable tech innovation, stronger balance sheets, and low capital intensity. During the TMT bubble however, valuations for the largest companies were severely inflated due to the market's unrealistic terminal growth assumptions of hyper growth stories such as Cisco, Amazon, and AOL. Even the Nifty 50s, dominated by consumer stocks such as Polaroid, Avon, Disney, Black & Decker, had a lower moat compared to companies today. Concentration in mega-cap stocks today could be a risk for the market if rates were to move sharply higher or the governments legislate more restrictive policies (e.g., higher tax rates for multinationals, anti-trust to name a couple of risks)." (As we currently are writing bond yields have spiked higher and the high growth / high valuation stocks are being hit and hit hard).

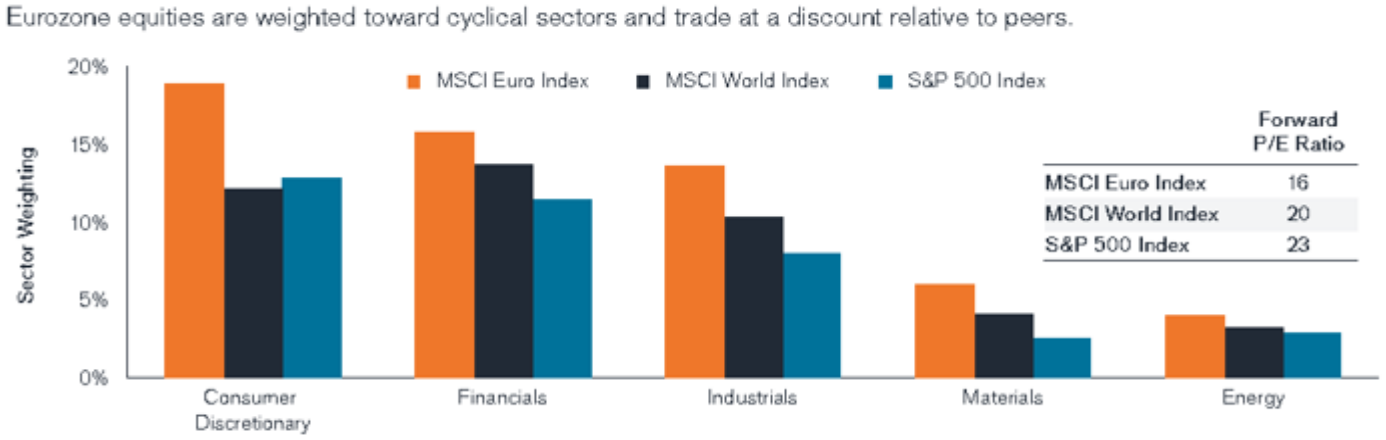




US equity valuations are high but on a relative basis, valuations for European equities versus US equities have reached historic lows. This discount is not merely because multiples for mega-cap US technology stocks are high; most European sectors are trading at a discount to their US counterpart. However, the key questions we wonder is what of inflation and higher interest rates? Potential weakness in bond markets poses a risk to higher growth technology names with longer-term future discounted cash flows. In the event of protracted above-trend inflation, tech stocks could continue to underperform. We seek to mitigate the risk of inflation and higher interest rates through managing position sizes and by balancing high-growth, high-valuation names with investments in more stable growth companies with compelling valuations.

Two (smaller) holdings we have in the tech sector (Microsoft and Alphabet) have relative valuations that are currently higher than historical norms however, we believe these stocks deserve a premium multiple versus the broader market due their improving returns on invested capital (ROIC), superior growth prospects and incredibly strong balance sheets. We expect persistent strength in IT spending and in industrial and car sector demand for chips and components. Experts predict robust global IT spending will moderate, but remain at a high level of growth in 2022.

While we remain positive on the outlook for U.S. equities, the eurozone has a cyclical tilt, with sectors such as consumer discretionary, financials and industrials making up a large percentage of the MSCI Index. The benchmark also trades at a lower P/E ratio relative to the developed market average.



Bloomberg, MSCI and S&P Global. P/E data based on estimated, 12-month forward earnings and as of 5 November 2021

In the emerging markets, COVID outbreaks along with regulatory changes and debt restructuring in China weighed on stocks in the second half of 2021. As with Europe, we think the area could benefit from continued growth in the global economy in 2022, especially if demand for the region's commodities and exports rise. In particular, Southeast Asia could see a sharp re-bound as factories get back online and if local governments adopt less draconian measures to manage COVID cases. China's outlook is more complex in light of ongoing policy changes and political interference. Stocks may be "cheap" but no one knows the potential fall out from the governments influencing Chinese corporations.

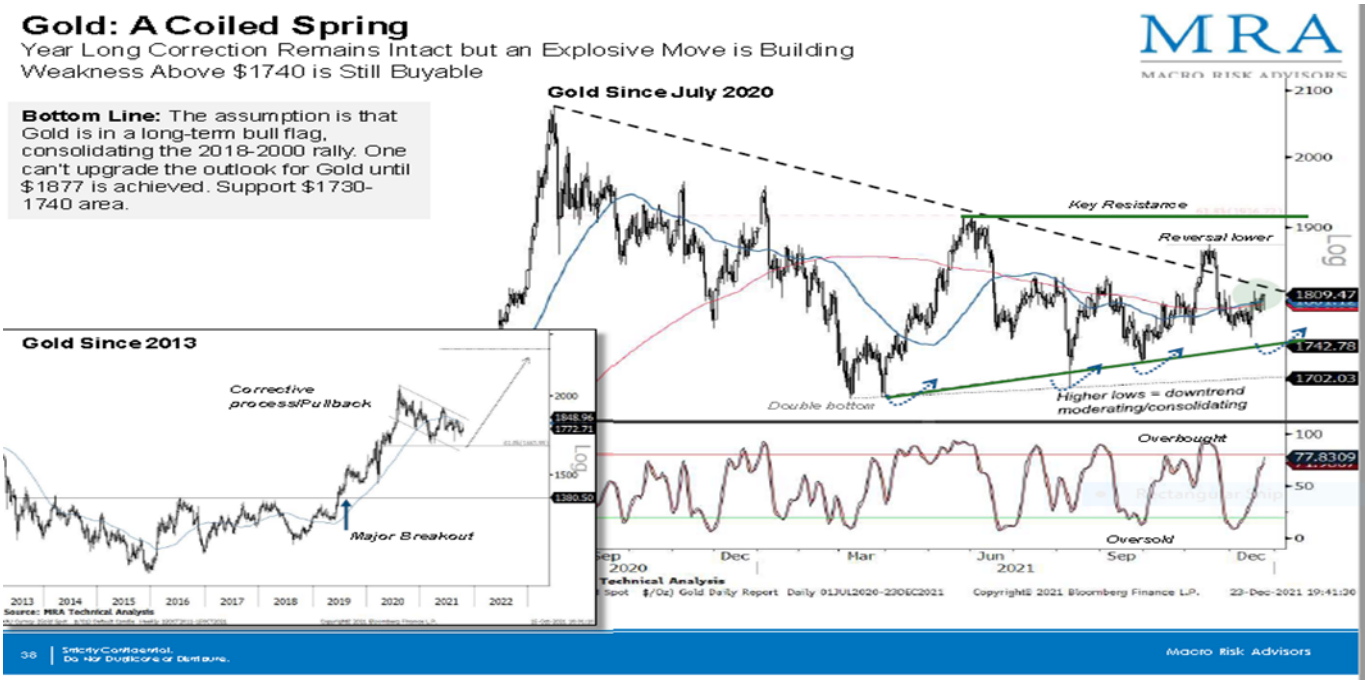
Last year was not a good year for fixed income (bond) investors where the Bloomberg U.S. Aggregate Total Return Bond index dropped 1.5%, while in Canada the FTSE Canada Universe Bond index fell 2.5% in 2021.

With inflation running north of 5% and government spending running at high (and unsustainable) levels, income investors have sought out dividend paying stocks. We have said that "we have seen this movie before, only the actors have changed." Ed Yardeni, an independent economist coined the term bond vigilante in the 1980s to describe investors who sell bonds amid signs of fiscal deficits with inflation getting out of hand.

According to Wikipedia, "Bond vigilantes are bond market investors who protests against monetary or fiscal policies considered inflationary by selling bonds, thus increasing yields. In the bond market, prices move inversely to yields. When investors perceive that inflation risk or credit risk is rising, they demand higher yields to compensate for the added risk. As a result, bond prices fall and yields rise, which increases the net cost of borrowing. The term refers to the ability of the bond market to serve as a restraint on the government's ability to over-spend and over-borrow. If history is a guide, we have seen it before… From October 1993 to November 1994 US 10-year yields climbed from 5.2% to just over 8.0% fueled by concerns about federal spending in what became informally known as the "Great Bond Massacre." With some guidance from Robert Rubin, the United States Secretary of the Treasury, the Clinton administration and Congress made an effort to reduce the deficit, and 10-year yields dropped to approximately 4% by November 1998.

We have argued that inflation is a problem and have maintained exposure to gold. We think after a year of digestion, gold prices are set to move higher and with it, gold equities. The gold companies we own also produce a lot of copper and with gold prices north of $1800 and copper prices $4.50+, the earnings and cash flow generation for these companies will be significant. In our work we do our fundamental analysis and also look at other quantitative and technical factors.

THE CHART BELOW IS "A PICTURE WORTH A 1000 WORDS'…

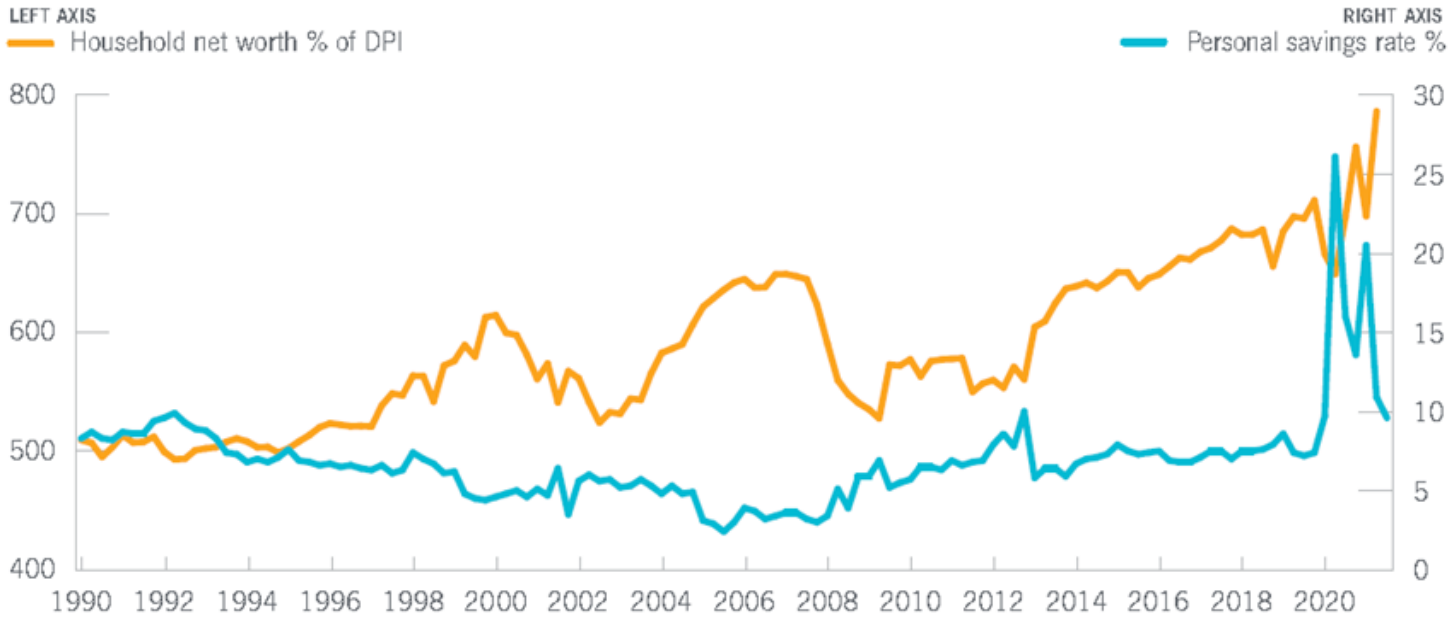


IN SUMMARY - WHERE WE STAND

2021 was a year of historically strong growth, fueled by a combination of unprecedented fiscal and monetary stimulus and a once-in-a-century global economic reopening. Growth was suppressed mainly by the unexpected surge in COVID-19 that interrupted the global recovery and exacerbated issues with products reaching consumers. Most factors that contributed positively to growth will fade in 2022, but strong consumer demand and the inflation it helped create remain as we head into a new year.

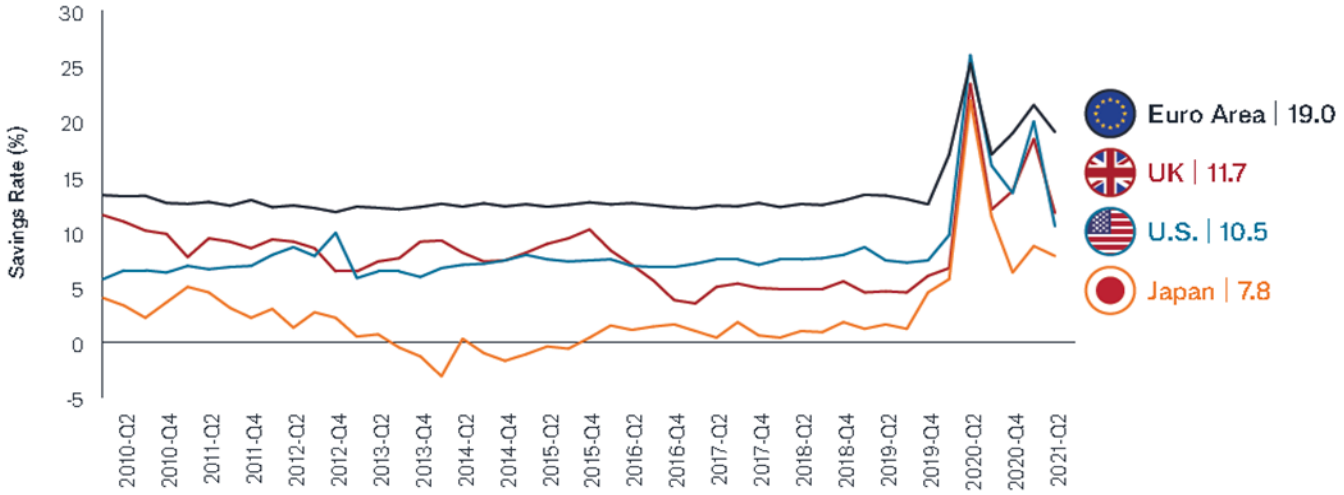
Despite fading government stimulus and continued supply/ demand imbalances, we retain a positive outlook for growth and investment returns for several reasons. First, private sector balance sheets are uncommonly strong. U.S. consumers as always, are the key for global growth. US household net worth has hit new all-time highs thanks to higher savings and rising asset prices, and the trillions now sitting in cash should continue to fuel high spending growth well into 2022. These measures are far better predictors of economic behavior than consumer sentiment opinion polls, which have probably been too skewed by politics.

U.S. CONSUMERS ARE STILL SUPPORTED BY GROWING WEALTH, RISING INCOMES AND EXCESS SAVINGS



HOUSEHOLD AND PERSONAL SAVINGS RATES EURO AREA, UK, U.S., JAPAN

Thanks to pandemic-related government assistance programs and deferred spending, consumers have more purchasing power.



Source: Financial Times, Federal Reserve Bank of St. Louis (as of 29 October 2021, Bloomberg LLP.

MARKET RETURNS MAY BE LOWER IN THE YEARS AHEAD, BUT THAT DOESN'T MEAN WE'RE NOT SEEING OPPORTUNITIES.

Our outlook for global equities remains constructive and positive but for 2022 we see modest equity gains compared with 2021. Looking back over the last couple of years, it seems that while so much in our world has changed, much has remained the same, yet we've learned a few lessons along the way. We seem to be emerging from the worst of the crisis and although we expect elevated volatility and an economic recovery that is likely to be uneven globally, the overall outlook is good. From an investment perspective, the main takeaway is that the core strategies and approach we use to manage the global investment strategy and fund remain as relevant as ever.

As we mentioned in previous commentaries, our investment positioning has a barbell approach. As we begin the year, our global investment strategy is focused on the financial, materials, energy and industrial sectors. We also continue to hold leading global health and consumer companies. We see opportunities in cash-rich companies with solid business models, impressive margins and strong cash flow generation. We continue to maintain gold exposure and we would opportunistically add on weakness.

THE HEWARD GLOBAL LEADERS FUND AND STRATEGY

The Heward Global Leaders Fund and strategy seeks to generate consistent returns over the long term by identifying high-quality growing global businesses that are attractively priced. The companies we invest in are leaders in their respective business field, have high defendable barriers to entry, great management teams, with solid balance sheets and high returns on invested capital and consistent return of capital via dividends. **Essentially, we Invest in global, high quality stocks, gaining exposure to opportunities not generally seen in Canada.**





THE HEWARD GLOBAL LEADERS FUND AND STRATEGY CORE INVESTMENT THEMES

- Technology / Digital
- E-Commerce
- Demographics: Rise of the Millennial and Gen Z & Health and lifestyle of the aging population
- Infrastructure Spending
- Gold

For more information or to schedule a meeting;

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