The Heward Global Leaders Investment Strategy

WINTER 2022

HEWARD
INVESTMENT MANAGEMENT INC.

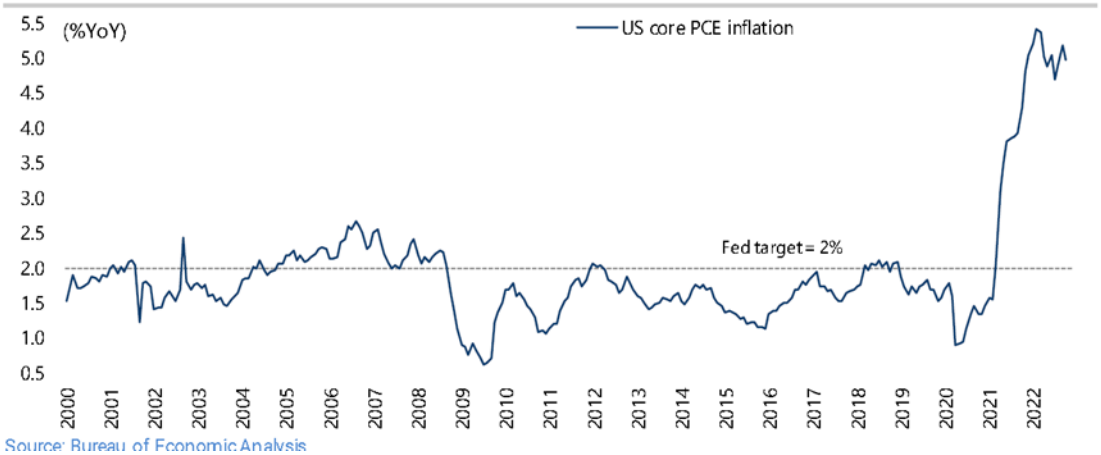
"A man hears what he wants to hear and disregards the rest." – Paul Simon

To briefly summarize 2022, global equities endured their worst year since the Great Financial Crisis, with the MSCI AC World Index falling 19.8% in 2022. (All performance numbers are YTD and in USD, unless otherwise stated.) Globally aggressive monetary policy tightening in response to elevated inflation crushed valuation metrics around the world. Last year there was almost no place to hide: equities suffered losses across all regions, with Europe (-19.2%), Asia-Pacific (-19.4%) and the US (S&P 500 -19.4%) generating roughly the same performance in 2022. In Canada, the TSX (-8.7% in C$; -14.6% in US$) managed to outperform most if its peers, benefitting from robust commodity/energy prices. In the energy space, WTI prices spiked as high as US$123/bbl. in March following the invasion of Ukraine. Then prices began to trail off on a slow descent on growing recession worries. Overall, West Texas crude oil ended 2022 up 6.7% to US$80.26 and Brent crude (+10.5%) while Natural Gas prices rose by 20.0%. Turning to metals, Gold (-0.3%) ended 2022 basically unchanged, Silver (+2.8%) ended slightly higher, while copper, the most economic sensitive metal fell -14.6%. U.S. bond yields surged across the maturity spectrum, with 2-yr yields (4.43%) rising 369bp and 10-yr yields (3.87%) rallying 236bp. No wonder the Bloomberg U.S. Aggregate Bond index (-13.0%, TR) suffered its worst selloff since the beginning of the series in 1976. Similarly in Canada, the FTSE Canada Universe Bond Index (-11.7%, TR) also posted a major decline.

As of December 31 2022, The Heward Global Leaders Fund and strategy returned -1.6% (all before fees and expenses.)

We are of the view that 2023 will offer opportunities and that being stock pickers vs. buying indexes will benefit our clients. Our long standing saying "Expect the unexpected" will play out again this year. One thing we are paying very close attention to is the fact that central banks globally are determined to beat inflation and that higher rate increases are likely with NO cut or pivot in 2023. US Federal Reserve Chair (and his European Central Bank Lagarde, and Bank of Canada's Macklem) all are saying the same message. One lesson the market has taught us is "don't fight the Fed", and we won't! Fed Chairman Jerome Powell was quoted: "The committee decided to raise interest rates by 50 bps… and we still have some ways to go". We are taking forceful steps to moderate demand so that it comes into better alignment with supply." "Reducing inflation is likely to require a sustained period of below trend growth" and we will stay the course until the job is done". "Our Focus is not on rate cuts or prematurely loosening policy as we're going into next year with higher inflation than we thought". BOTTOM LINE: Fed policy = Higher for Longer.

US CORE PCE INFLATION



Source: Bureau of Economic Analysis

Although market participants were hopeful that the Fed would pivot towards rate cuts as early the 2nd quarter of 2023, Fed Chair Jerome Powell threw cold water on that hope during various speeches last year. Fed Vice Chair Lael Brainard echoed this sentiment in a recent prepared speech: "We are in this for as long as it takes to get inflation down." She reiterated until inflation comes down to the Fed's target do not expect any cuts: "While the precise course of action will depend on the evolution of the outlook, I am confident we will achieve a return to 2% inflation. Our resolve is firm, our goals are clear, and our tools are up

to the task. **Thus, it is clear they will continue to tighten policy until they see inflation come down to that 2% target or until there is a material breakdown in the real economy, namely in unemployment and earnings. Overall, we take the Fed at their word that they are fully committed to fighting inflation by slowing growth and curtailing demand**, even if that means seeing a modest rise in unemployment and accepting a shallow recession to achieve their price stability mandate. The labor market also continues to be tight, as evidenced by the rather low unemployment rate of 3.7% and multi-decade low ratio of unemployed workers to job openings. The US is adding over 400,000 in jobs per month! This imbalance pushes nominal wages higher, which in turn feeds into core inflation. Ultimately, although commodity prices and gasoline appear to be moving lower, components of core CPI remain elevated—and sticky CPI, which the Federal Reserve Bank of Atlanta calculates based on goods and services that are slow to change, is now at 6.0%.

RATIO OF WORKERS TO JOBS HITS MULTI-DECADE LOW

Source: Federal Reserve Bank of St. Louis

As we start the beginning of a new year, we expect many of the G7 economies to weaken under the weight of restrictive monetary policy and the ongoing reduction of excess liquidity. A "restrictive and hold" policy by the US Fed (and the European Central Bank) could trigger a deeper than expected downturn. **Markets tend to bottom about two-thirds of the way through a recession, not before they even begin**. Given the ongoing geopolitical instability in Europe, along with OPEC+ cutting oil production and COVID-19 challenges in China, there will likely be continuing volatility this year. Our equity team expects 2023 to be challenging. We believe the best course of action for equity investors is to concentrate capital in compounders i.e., high quality companies that generate market-leading returns on capital and can sustain those returns over time. Our base case scenario had been that the United States could avert a recession, but with the Fed signaling that a policy pivot is some time away, that view is looking less tenable.

A SOFT LANDING OR STAGNATION?

All this begs the question: Is a soft landing plausible, or is the US economy inevitably headed for a recession? And if a recession is inevitable, then how deep will it be? Negative quarters of gross domestic product (GDP) in the first half of 2022 led some to fear a severe recession, but the strength of the labor market along with the divergence between GDP and Gross Domestic Income, another measure of economic output, strongly suggests the US is not yet in a recession. Whether one occurs depends on two factors: how high the Federal Reserve must raise rates to combat inflation, and whether exogenous risk factors weigh down the US economy. Overall, given the strength of the labor market and household balance sheets, which remain robust, we are cautiously optimistic that a severe recession can be avoided. For instance, decreasing job openings gives us optimism that the Federal Reserve and the US economy can walk the tightrope. But there is clear uncertainty.

Our base case scenario had been that the United States could avert a recession, but in light of the more severe tightening we now expect from the Fed, the risk of the Fed hiking too aggressively, and sparking a recession, is very real. Even with our base case shifting to recession, however, we remain confident it will be a shallow, cyclical one. This implies a recession with moderately higher unemployment, e.g., 5–6%, and two to four quarters of GDP contraction. Such a downturn should not create any meaningful systemic risks. However, that does not mean markets will be immune. We feel we have seen peak hawkishness, but inflation could stay higher than investors and central banks like.

We don't have a lot of modern examples of inflation in the industrialised world, and nobody who is still active in markets really remembers the '70's. I don't pretend I do, but when you look back at that time inflation in the 70's was very volatile partly because of the base effects, once inflation moved into wages, you got a spurt in inflation and then it slows down and then you had another spurt. In the 70's inflation shot up to 7% and then fall back to 3% and then back up to 9% and then back to 4%. We

could have a few years (hopefully not a decade!) of this phenomenon. Also keep in mind, the 70's made for some volatile rallies and drawdowns, pretty wild peak to trough numbers and annual returns fairly nauseating as well …but basically markets didn't go anywhere for better part of a decade as CPI vacillated from low single digits to low teens (twice).

SPX ANNUAL RETURNS 1970-1986 –
DOUBLE DIGIT RETURNS IN BOTH DIRECTIONS

Source: Bloomberg

CHINA – THE ELEPHANT IN THE ROOM?

China's GDP growth rate is expected to slump significantly in 2022. However, with a sharp rise in people's mobility as the country pivots away from the strict zero-covid policy, its GDP grow this likely to rebound in 2023. After easing Covid measures, China's retail sales are likely to recover but the decelerating income growth may be a challenge, however we don't underestimate the pent-up demand and the desire for Chinese citizens to get out and spend. There could be a spending boom as we saw in North America and parts of Europe especially in high-end luxury goods.

In a recent report from Outset Global Trading, they wrote; "*We feel like the China consumption boom could surprise many – anyone have a good sense for this? I'm looking at that chart below and seeing how Chinese consumption got cut IN HALF from 2019 to 2022 - yes, "common prosperity" etc. this time around is greater but it seems like China could offset a Western slowdown …"*

GLOBAL SALES OF PERSONAL LUXURY GOODS

Source: Bain Altagamma Luxury Report 2022

In a recent Gavakel Report they wrote; *In China we expect there will be a surge in consumption. You have to remember that it's not three months, but three YEARS of pent-up demand. Going into the pandemic, households in China had about 9 trillion RMB in cash in their bank accounts. Today that number is over 15 trillion, and it has gone up more than 50% because for three years all that people did was work and then go home. They are more cashed up than ever before! Another fact rarely mentioned in the west is that mortgage rates have just dropped 150 basis points while in the west, when people came out of lockdown and saw that interest rates had fallen 50 or 75 basis points, many decided to buy a new property or a new car. There was a surge of consumption driven by low rates and easy money lending. Well, in China mortgage rates are near record lows today, the same goes for car loans. How big is the release of pent- up demand in China going to be? It's going to be ENORMOUS!*

There are several ways to slice and dice China's reopening, which has been described as "bumpy," especially as economic activity remains well below pre-pandemic levels. For Mark Haefele, global chief investment officer at UBS, *China's actions mean it's prioritizing one thing above all else: growth*. There are many questions around China and Chinese consumption. What does China's opening up mean for monetary policy globally? How will this affect the signs that global inflation has peaked? Will it increase consumers' demand for goods and services? Broadly, what are the opportunities and risks after three years of standstill? All these questions are valid — and they all remain unanswered. We do believe that Chinese consumers are and will be back, and we own some leading global brands that will benefit.

'THERE IS A CRACK IN EVERYTHING, THAT'S HOW THE LIGHT GETS IN' - LEONARD COHEN

A big question is has the US Dollar peaked? The dollar index (DXY) has appreciated nearly 27% since mid 2021 (before receding slightly recently) when the Fed tightened its monetary policy tone. Since then, the dollar has benefited from significant Fed rate hikes, risk aversion related to the war in Ukraine and China's aggressive zero Covid policy. The dollar is now very overvalued and, in our opinion, has recently reached its peak at the end of September. **Cracks are now showing up in the Forex markets with the Fed's rate hike cycle coming to an end next year, we expect the dollar to fall further in 2023**. We feel that the market will focus more on the sharp slowdown in US growth and the expectations of rate cuts that MAY follow in late 2023 and 2024. Global growth is also expected to improve in 2023 particularly in China with the end of the Covid policy. In this context, investors will continue to reduce their exposure to the dollar in favour of other undervalued currencies where the potential for a rebound will be more significant as global uncertainties diminish. The risk to this scenario would be a fall in the stock markets against the backdrop of a continued rise in Fed Funds rates well above 5%.

WHERE WE STAND & OUR OUTLOOK

For global equities, we see lower earnings than consensus forecast and expect corporate margins to be impacted. Resilience and quality will be the name of the game in 2023. The macroeconomic slowdown that we expect for 2023 will clearly impact the corporate sector adversely even though supply constraints are easing. The two key channels will be obviously weaker demand (as real wages have slumped) and higher borrowing costs. The direct consequence to us is twofold; One, EPS growth will be weak this year and second, corporate margins will shrink on average although some corporates clearly use their market power to avoid too much compression. Downward revisions for both have logically increased over the last few months and **we anticipate analysts to cut their numbers further and multiples will also compress further**. We expect flat EPS growth in our base case scenario. What can we expect from history which has several messages. During Fed tightening, do not expect PE expansion. When the Fed pauses, whether we have a soft landing or a recession matters a lot (1994 being the ideal soft landing). **Equities typically rebound 5-6 months before the end of recession and the median rebound in the next 12 months is roughly 10%. (**Markets tend to bottom about two-thirds of the way through a recession, not before they even begin.)

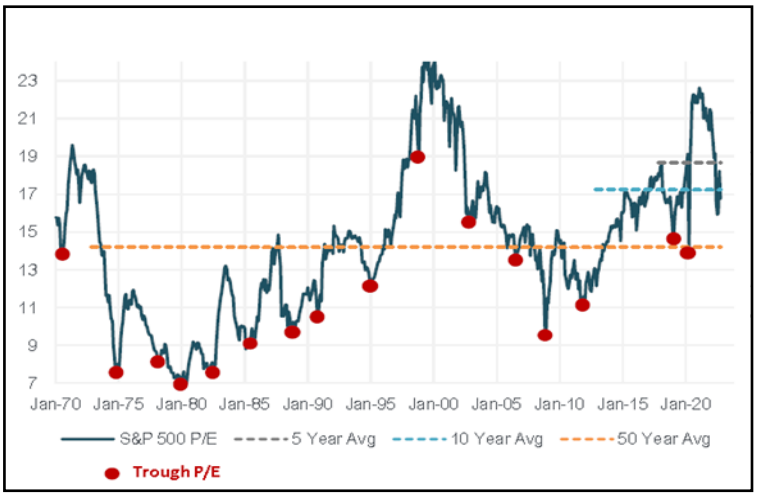
A "restrictive and hold" policy by the Fed could trigger a deeper-than-expected downturn. There is thus a high risk

that the equity market will see a new low next year. For this year, one of our worries is the vulnerability of US equities to adverse shocks (more hawkish Fed or deeper recession than expected). If a US recession materializes in Q1 2023 the SPX would enter recession with the one of the highest valuations in history (only second to the Tech Bubble). Second, we expect a mild recession but also a mild US recovery with little fiscal or monetary support. We like European equities and they are generally much cheaper than US stocks.

US CYCLICALLY ADJUSTED PRICE TO EARNINGS PREMIUMS SINCE MID-2000'S

Source: Société General Research

PRICE/EARNINGS PER SHARE FACE DOWNWARD PRESSURE AHEAD … BUT THERE IS NO "AVERAGE" LEVEL WHERE MARKETS BOTTOM



Source: Piper Sandler Research

As we enter 2023, major equity market trends are attempting to shift to positive from negative. These early signs of a potential trend change is not enough to convince us the worst is fully behind us. The technical structure of stocks is attempting to improve but we remain neutral at best at the time of writing this outlook piece. This is an environment that demands a "defensive" asset allocation, at least according to the advice of most sell-side strategists. This of course, is sensible guidance and probably the most likely scenario for 2023. Still, bearing in mind the woeful performance of economists' predictions in 2022, it is worth considering the risks to the current consensus. One possibility is that we are underestimating the severity of any 2023 downturn. Perhaps something will break in financial markets or, more likely, the weakness in property markets will prove systemic. For their part, central banks are ignoring the "long and variable lags" in monetary policy.

WE SAW MANY BEAR MARKET RALLIES IN 2022 AND EXPECT MORE IN 2023

Source: Piper Sandler Research

Potential List Of Bear Market Rally Catalysts

- Lower Gasoline/Oil Prices ✓
- Softer Inflation ✓
- Weak Employment Data? ← Up Next??
- Actual Fed Pivot?
- End Of Russia-Ukraine War?
- Global CB Currency Coordination ($)?

S&P 500 2000-02 BEAR MARKET

Source: Piper Sandler Research

S&P 500 2008-09 BEAR MARKET

Source: Piper Sandler Research

EVERY RISK HAS ITS PRICE

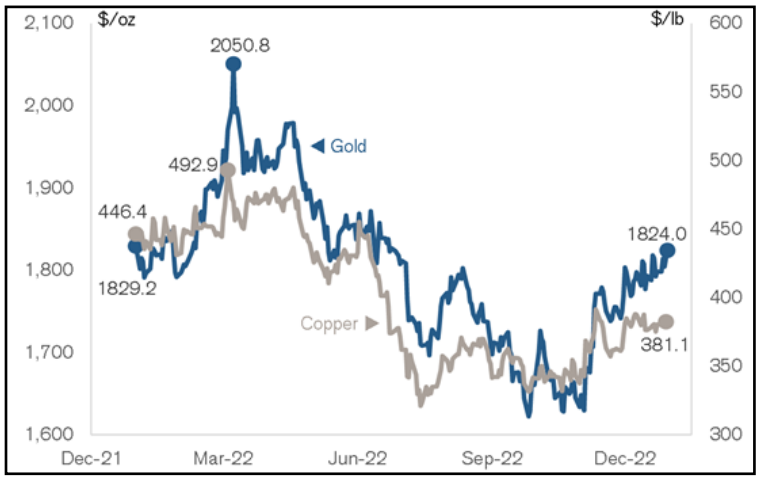
There are usually a handful of key judgements upon which one's investment views ultimately rest.
Today, there are three particular questions that matter enormously for return prospects in 2023.

1. When will the US Federal Reserve and other major central banks pivot towards lowering policy rates?
2. How deep will the growth and earnings correction be?
3. (The biggest unknown) How great will geopolitical disruption from China, Russia-Ukraine, the US, and Europe (including the UK) be in 2023?

Nobody knows the answers to these questions, but any surprise or resolution will likely benefit investors. The biggest risk continues to be higher interest rates from the central banks to fight inflation. Main street and the average person are feeling the effects of inflation and global central banks are concerned.

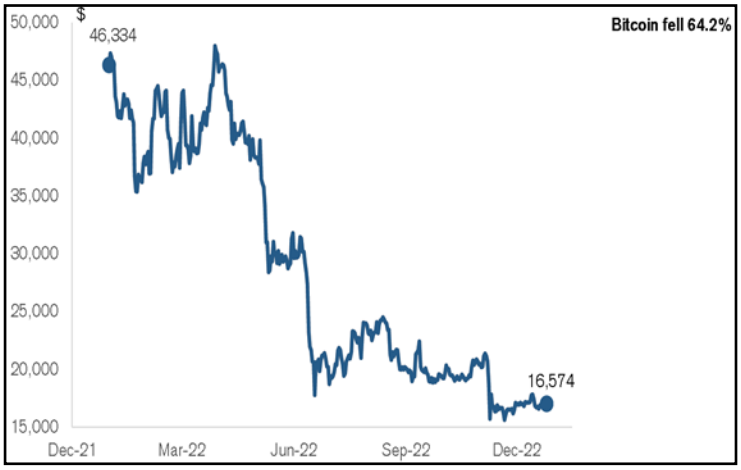
We continue to have exposure to gold and gold equities and believe after a pause (perhaps from the irrational flows into Bitcoin) Gold has held up quite well and in many global currencies, gold prices are at or near all time highs. We see gold setting new highs in 2023. We also see the weakness in oil gasoline and the US Dollar benefiting consumers and exporters.

GOLD AND COPPER PRICES



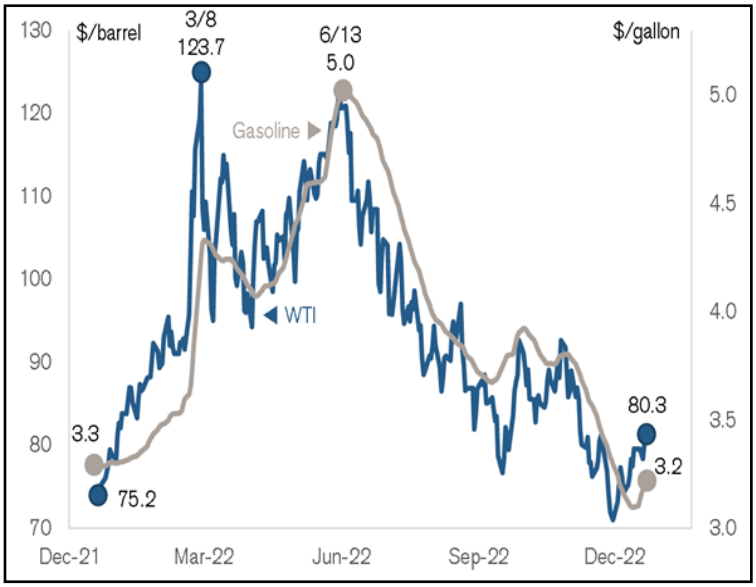
Source: Bloomberg

BITCOIN



Source: Bloomberg

WEST TEXAS OIL AND GASOLINE
(LOWER PRICES WILL BENEFIT CONSUMERS)



Source: Bloomberg

US DOLLAR
(WEAKNESS WILL BENEFIT EXPORTERS)

Source: Bloomberg

When we look at "risk assets" (IE. Stocks, commodities etc.) this year we see higher prices for gold, silver, copper, uranium, oil and gas, while we see weakness in the US Dollar and Bitcoin.

WHY WE REMAIN POSITIVE ON GLOBAL STOCKS

Amidst what remains a challenging outlook, we remain bullish on the longer-term outlook for equities - period. In our view, this point brings up one of the counterintuitive challenges of successful investing: finding the courage and conviction to find investment opportunity in assets when they're not attractive to other investors. We often say that there's no "all clear ring the bell" signal that sounds when the bottom is in and now is a good time to buy stocks. However, for long-term investors and those with sidelined cash available to be put to work, we see quite a few opportunities that in our view, offer solid "risk / reward. We can't say that the market has bottomed at these levels or that the bear market might not grind on for some time to come, but with so much bad news already priced in, the potential rewards of investing at these levels are looking more attractive relative to the risks. But perhaps the most underpriced risk is to the upside, that the global economy proves more resilient than everyone expects. In fact, given the large distortions in the economy, we would not rule out the unscheduled return of Goldilocks. She may stick around for long, but perhaps long enough to provide some welcome respite for investors. While we and markets globally are playing a "waiting game" for the prospective FED "pivot," with monetary policymakers well aware of the lag between each rate hike and its full effect, perhaps will finally ease up on the economic brakes. Even in the face of uncertainty and potential risks of recession, our longer-term outlook for the US economy remains decidedly positive. Once inflation begins to moderate, US growth should begin to recover, supported by consumer demand and business investment. We continue to expect that a growing US economy will help power a global recovery as US import demand draws in goods and services from around the world.

In our Heward Global Leaders Fund and portfolios following the strategy, we continue to overweight cyclicals over defensive stocks and we favor industrials, health care and consumer discretionary (especially "high-end global brands"). We will not bet against the resiliency of the American or the Chinese consumer. We also maintain solid exposure to global financials especially banks, as they should benefit in the eventual steepening of the yield curve which adds to the profitability among companies in the sector. We maintain exposure to the energy and materials sectors as demand will likely remain high for these products as economies around the world continue to move beyond the pandemic and pent-up demand returns. In the Industrial sector for example, we have exposure to manufacturing, construction, infrastructure, aerospace and defense, many of these industrial sectors should continue to be attractive as economic growth shows resiliency and as the global supply chain moves away from "one-country centricity" (IE. China). We don't expect a "de-globalization" but rather a "re-globalization" with a more diversified global supply chain to benefit more than a few emerging and developed economies.

Last Fall we began to shift more of our attention to Europe and the UK from the US as we saw the USD peaking and valuations to cheap to ignore. Many of these companies although based in London, Paris or in Switzerland, they operate globally and have businesses that have solid balance sheets, increasing dividends and resilient business models. We continue find quite a few companies that are based in Europe that fit our investment criteria and our core themes.

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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