Quarterly Report
SPRING 2021

HEWARD
INVESTMENT MANAGEMENT INC.

Preparing for Normalization - the Vaccine Tsunami vs the Third Wave

OVERVIEW

The rebound in equity markets since the March 2020 trough has been historically stronger than the average recovery from a bear market but in line with the experience post the Great Financial Crisis (GFC). The significant easing of monetary and fiscal policy (more recently vaccines) explains the strong equity recovery. But we remain in the early stages of a new bull market, transitioning from the "hope" phase to a longer "growth" phase as strong profit growth emerges. The changing mix of policy support in this cycle also suggests a possible inflection point towards a more reflationary environment. This regime shift is likely to drive markets even higher over the coming months and also have important implications for market leadership.

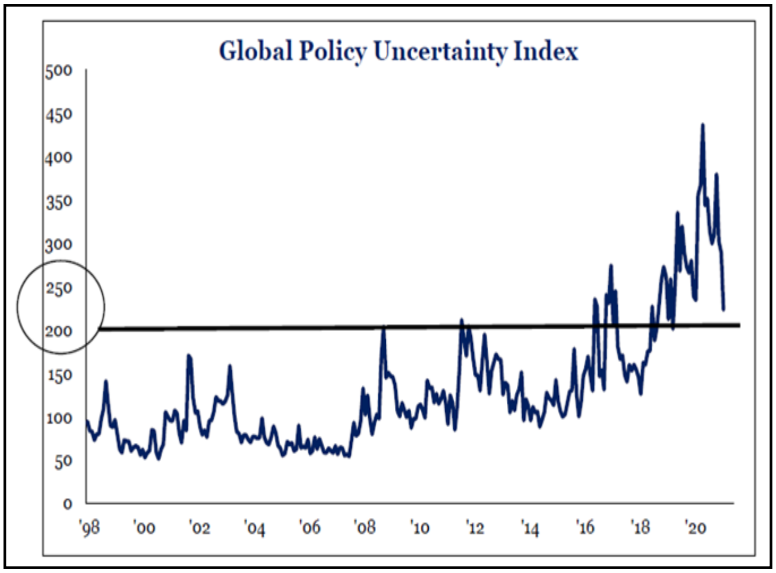
The great reversion to a normalized economy has likely begun. Excess savings are driving asset inflation across all categories, not just equities, as well as a strong recovery in the goods economy and a likely (unquantifiable) backlog building for services. Ultimately, the excess liquidity will be drained, but the earnings per share (EPS) strength will be more durable! Accelerating GDP should result in higher revenues and an even greater gain in EPS, given operating leverage. Additionally, rising rates, copper and oil prices further augment this favorable backdrop. 2021-23 will likely be a race where EPS increase materially, but P/E's contract. How these two variables offset each other will determine overall returns.

It seems that the "inflation is dead" narrative is slowly changing. Break evens, capacity, supplier delivery times and surveyed prices are all useful measures of current and future inflation, and all are projecting upwards. Also, money supply signals are extreme, but have not yet translated into inflation because the velocity of money has collapsed. This will change, and will be particularly true over the next few months when year-on-year comparisons will show a sharp rise in inflation. However, it should prove transitory and should not be mistaken for the start of a new post-pandemic era of higher inflation. It is important to distinguish between a short-lived jump in inflation caused by a one-off shift in prices and a more permanent acceleration caused by a broader rise in prices that is sustained over many years.

Household incomes are expected to rise in most countries this year as easing restrictions allow people to get back to work. The outlook for incomes is brightest in North America. But even in Europe, government support will be tapered only gradually and seems likely to be extended if restrictions remain in place. In 2020, differences in the rates of growth in real household incomes were largely determined by differences in government transfers. This should once again be the case this year as fiscal transfers are set to differ across developed markets (DM).

Non-financial firms in developed markets (DM) have built up a pile of cash, so their balance sheets are not as precarious as first feared. Governments have prevented profits, in aggregates at least, from falling anywhere as near as far as they would have given the hit to the economy. To different degrees in different countries, a mixture of subsidised payrolls, tax relief, mortgage holidays, rent forbearance and temporary layoffs have reduced costs which together with fiscal transfers have made up for a slump in operational revenues. Not only have profits held up, but investment has fallen sharply. Between resilient profits and cash accumulation, net debt ratios have already returned to pre-virus levels. It seems that much of the fearful commentary surrounding corporate debt has been overblown. In fact, once restrictions are lifted, high corporate savings poses an upside risk to any current forecast for fixed investment.

POLICY UNCERTAINTY REMAIND HIGH BY HISTORICAL STANDARDS BUT DECLINING FAST



Source: Strategas

UNITED STATES

In spite of the most recent durable goods number adding to the package of weaker month-over-month data released for February (weather-related disruptions), betting on a boom in economic activity in the U.S. this year is the closest thing we have seen to a "sure bet" in quite some time. There is a strong probability that between the solid state of existing private sector balance sheets, a Fed willing to let things run hot (their only target this year is full employment) and an administration eager to spend more, economic growth could easily breakout to levels not seen in a long time. In the context of rising capacity utilization and a low-rate environment, the economic recovery could be extended by a true capex cycle. Already, with vaccinations ramping and improving expectations for an economic recovery, there is a boost in new orders, resulting in lengthy delivery times. The combination of the $1.9 trillion of fiscal stimulus together with nearly $1.3 trillion of incremental savings being unleashed on an economy increasingly "open for business" suggests the operating levers are in place for businesses to see a reacceleration in revenues and profits. Supplementing this, the Biden administration is already working on the next $3T spending plan which incorporates infrastructure spending. This plan will most likely be presented in separate pieces. Between both the physical and social infrastructure plans, Biden is aiming to spend $4 trillion over 8-10 years while raising $3 trillion in taxes. If analyzed properly, the plan suggests that the short-term impact may lead to a net fiscal drag in 2022 and 2023 as tax increases are immediate while spending is lagged.

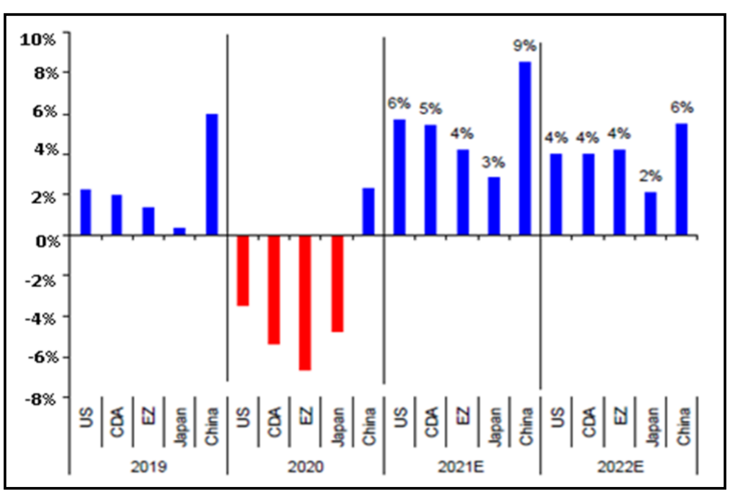
CANADA

Despite some recent outperformance, Canadian equities have performed poorly relative to their U.S. peers over the last decade. However, the last time we hit such levels of sustained underperformance, the TSX 2000-2010 outperformance cycle was about to start. With global/U.S. (and Canada) economic activity expected to expand at a pace not seen in years, Canadian equities should key beneficiaries. The pillars of growth are well known: excess liquidity, huge monetary and fiscal support, lockdowns abating and vaccinations accelerating. The relative earnings momentum looks to have Canadian forward earnings rising faster than their U.S. peers. The stars seem to be aligning for the banks and non-bank financials (32% of the index). The sector should benefit from the strong bounce in GDP growth that is coming, as well as the intense real estate/mortgage activity, steepening yield curve and stronger capital markets. Energy and materials (combined weight of 24%) should benefit from the recovery in global GDP. Furthermore, with the recent approval of the $1.9T stimulus bill, the Biden administration can now turn its focus on to another campaign promise: a multi-trillion-dollar infrastructure package. Multiple countries are taking cues from the same playbook, which will boost demand for all types of commodities. Finally, over the last few years Canadian and foreign equity investors have fled the Canadian equity market in search of better opportunities. However, with the macro landscaping heading in the right direction and the nascent rotation towards value, the bleeding of the last few years may be about to reverse (Scotia McLeod).

EUROPE

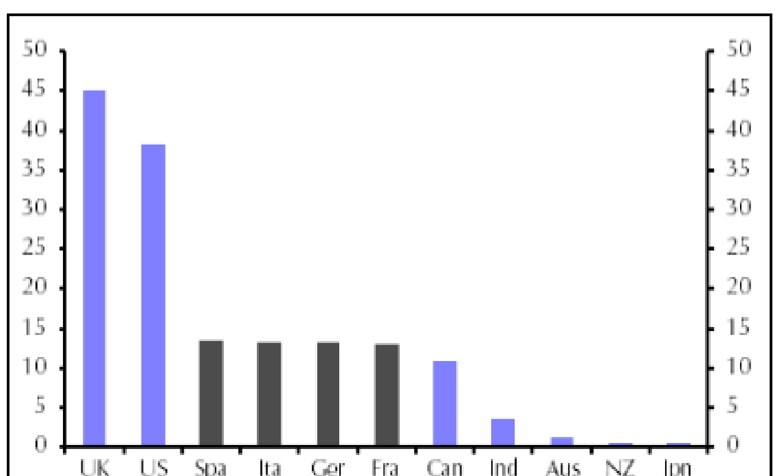
Anyone glancing at the latest business surveys would get the impression that the euro zone economy is booming. The EC (Economic Capital) Economic Sentiment Indicator, published at the end of March, echoed the message from the Purchasing Managers Index (PMIs), and showed activity strengthening through March in all sectors and countries. However, the deterioration in the health situation has forced several governments (Germany, France & Italy included) to extend their virus restrictions. The slow pace of the vaccine rollout is not the only source of angst in Europe, as policy makers are also increasingly worried about the gulf between the size and pace of U.S. and Euro zone fiscal stimulus. The latest set back surrounds the Next Generation EU (NGEU) programme because it might violate the EU treaties and German

GLOBAL GDP– STRONG EXPANSION PHASE (CONSENSUS ESTIMATES)



Source: Scotiabank GBM Portfolio Strategy/Bloomberg

TOTAL VACCINES (PER 100) OF VACCINATION



Source: Our World in Data

constitution. Similar problems caused delay to the Lisbon and European Stability Mechanism (ESM) Treaties in 2009 and 2012. Also, the European Central Bank's (ECB) March policy statement was more dovish than most had anticipated. Most notably, it explicitly stated that the bank purchases, over the next few months, would be done at a significantly higher pace than earlier in the year. It would also "purchase flexibility according to market conditions with a view to preventing tightening of financial conditions". Meanwhile in the UK, Bank of England Chief Economist Andy Haldane reiterated the bank's view that the UK is set to enjoy a rapid post pandemic recovery. His said people desperately want to get their lives back to normal: back to work, back to spending and socializing. If that happens, spending will increase and if people spend just some of their savings then the UK will see a "rip-roaring" recovery.

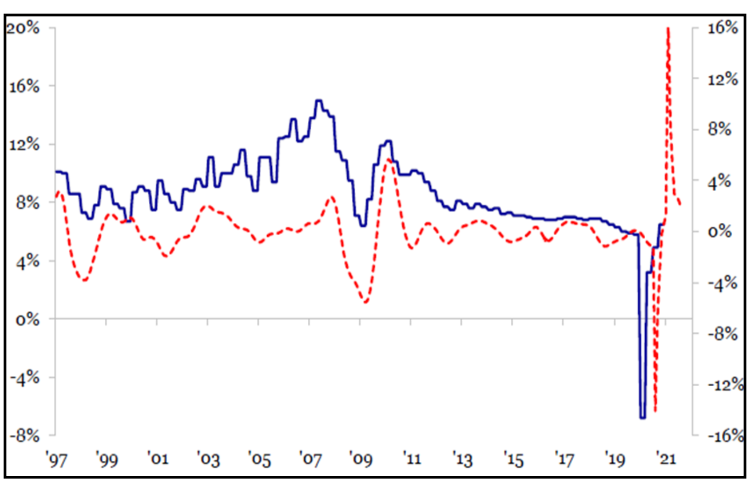
EMERGING & DEVELOPING MARKETS

China's economy recovered faster than most from the pandemic. However, while it appears that boom times are back, the combined January/February data must be interpreted carefully as it partly reflects the low base in 2020. Recent 2021 timely data has weakened in line with the Peoples Bank of China (PBOC) tightening. The central bank had been warning for some time that policy would be less accommodative as economic momentum gathered pace. Their focus was a build up in speculative activity in financial markets, and a concern that housing prices had begun to run away again. In March, a new Five Tear Plan was introduced. While many topics were not new, the more challenging external environment may have increased the urgency for changes. On economics and innovation, the government has opted for setting one-year rather than five-year ahead numerical GDP targets, a sign of pragmatism. The plan has policies designed to boost consumption while emphasising the need to stabilize manufacturing's share of GDP. Inflation has remained remarkably tame in Emerging Markets (EM) since the onset of the pandemic. While EM exchange rates weakened at the onset of the crisis, the extent to which they depreciated was more limited than in past crises. Also, increased credibility in EM policymaking meant that inflation expectations remained more-tame, and the opening up of significant spare capacity across EMs has weighed on underlying inflationary pressures. In Japan, the recovery from the "great lockdown" continues to be slow, but upwards. Recent data releases show that trades, machine orders, and industrial production are all recovering to pre-pandemic levels.

COMMODITIES

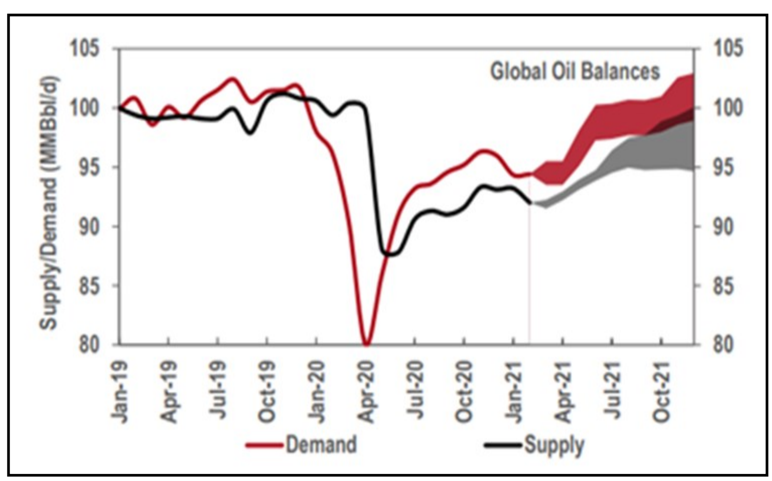
Correlated with the initial announcements of a vaccine and subsequent global rollouts, the recovery in the energy sector has been refreshing. A weaker U.S. dollar, an ultra-loose monetary policy globally and the continued agreement of OPEC+ production cuts have also been key. Short term, there was some concern that prices may have run to far, and the Suez Canal blockage did not help. However, at their latest meetings OPEC+ announced that they would recommence the tapering process with Saudi phasing out its own unilateral production cuts. The positive reaction to the announcement is a nod to the market's ability to absorb additional barrels. Also, the Saudi follow up by raising prices to key demand areas in Asia, is another show of confidence. Meanwhile, commodities have risen to their highest levels in almost eight years amid a booming investor appetite for everything from oil to corn. Hedge funds have piled into what is becoming the biggest bullish wager on this asset class in at least a decade. Its a collective bet that government stimulus plus near zero interest rates will fuel demand, generate inflation and further weaken the U.S. dollar as the global economy rebounds from the pandemic. Several experts are even forecasting that commodities appear to have begun a new super cycle – an extended period during which prices are well above their long-run trend. For now, however, companies remain well positioned to thrive in this higher price environment. Furthermore, with the backdrop remaining positive and companies growing their free cash flows, the sector could see multiple expansion amid rising investor interest.

**CHINA REAL GDP (YOY%, LHS) VS.
CHINA 6 MONTH % CHANGE (6 MO. LEAD, RHS)**



Source: Strategas

GLOBAL OIL BALANCES



Source: Energy Aspects, US EIA and CIBC World Markets

RECOMMENDATIONS

While the start to the year was marred by renewed virus outbreaks, earthquakes, storms and scarcity, we think that the economic recovery in 2021 will turn out to be strong. Backed by manufacturing (PMIs continue to paint a positive picture), the global situation looks positive as it awaits the re-opening on the services side. With vaccine rollouts accelerating, this should allow restrictions to be removed (the third wave notwithstanding) and general activity start to get back on track in most DMs sometime in H2 2021. Some EMs will lag, particularly South America and Africa, but most major EMs in other parts of the world should benefit from a relaxation of restrictions (as vaccines become available) before the year is out. With economies reopening, stimulus abundant, and fed policy uber-accommodative, GDP growth may run hotter than most forecasts. Inflation will pick up around the world, but this will be driven by temporary factors and should not be mistaken for a persistent demand-driven increase. Within this scenario, we are looking to "buy the dips" to go over weight equities. Being in the later stages of a market/business cycle and on a tactical/trade basis, our focus is mainly on the industrial, material, energy and financials sectors. Within our core holdings there will always be opportunities (buy & sell) and we will deal with them appropriately. A sense of foreboding continues to haunt global bond markets. Having dropped back at the start of March, government bond yields have risen once more backed by the vaccines, strong growth expectations and somewhat higher inflation rates. Even though central bankers continue to preach "lower for longer" rates, bond investors have started to price in higher yields down the road. While 10-year yields in Canada have more than doubled through the quarter (one of the fastest rises on record), yields remain low by historical standards and have not reached levels than should be considered a threat to growth. It is quite likely that 10-year rates may stay below 2% at least until year end. Obviously, bond investments bear the wounds of higher yields and are likely to continue to have difficulty through the remainder of 2021. Our emphasis on corporate (regular & convertible) bonds, preferred (especially reset) shares and some higher yielding equities, while maintain a below benchmark duration, has helped the performance of our fixed income component (positive year to date versus a negative benchmark). We will continue this strategy going forward.

FORECAST 2021	CURRENT 31-MARCH-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	0.675%	0.67%- 2.00%	1.95%
10-year US Treasury	0.916%	0.92%- 2.00%	2.10%
COMMODITIES			
Gold (US$/oz.)	$1,707	$1,600- $1,950	$1,850
Copper (US$/lb)	$3.99	$3.50- $4.50	$4.35
Oil WTI (US$/bbl)	$59.32	$48.00- $68.00	$62.00
MARKETS			
S&P/TSX Composite Index	18,700	17,300-20,000	19,700
S&P 500 Index	3,980	3,600– 4,200	4,050
CANADA DOLLAR/US DOLLAR	$0.79	$0.77- $0.83	$0.82

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