The Heward Global Leaders Investment Strategy

Q3, 2021

HEWARD
INVESTMENT MANAGEMENT INC.

"What Me Worry?"

-Alfred E Neuman "MAD Magazine"

We wrote in August that we were concerned about the potential for a pullback in global equity and fixed income markets in the months ahead and came to believe then, that the stock market was being too complacent about the impacts of the Delta variants and the collapse in consumer confidence and business confidence – two measures we watch closely for the "health" of the US economy. Markets have corrected somewhat, below the surface however, "the average stock" is indeed down approximately 12% from their highs recorded this summer. We are of the view that many of the worries we had in August have been played out and are "known knowns" in the market. As Jason Trennert, the respected strategist from Strategas Research Partners in New York wrote: "It's been a tale of two markets this year – higher long-term interest rates and the outperformance of cyclicals in the first quarter and again in September, interrupted by lower rates and the outperformance of growth stocks in-between. Why would it be easy? For the most part, the most speculative elements of the market witnessed at the start of the year – e.g. meme stocks, Special Purpose Acquisition Company (SPACs), Initial Public Offering (IPOs) etc. – have come off the boil. But, like water, interest rates find their own level and a negative real cost of capital is leading to exceptional levels of activity in both the economy and the financial markets. (Housing prices up 19% y/y and WTI Crude near $80.) That may be why, little by little, it appeared that those circumstances which were long considered to be unsustainable started to change, even if only at the margin."

As the third-quarter earnings season begins in mid-October, the economic macro backdrop is less certain relative to recent quarters. The comparisons are tougher with corporate America confronting several headwinds: There are severe and bigger supply chain disruptions, labor shortages, and rising commodity prices (especially in oil and gasoline)—all of which have prompted many strategists to downgrade their economic growth expectations. While job growth has disappointed in the last two months for various reasons, job openings are near record highs and workers are seeing growth in wage income. Business sentiment remains relatively strong, with the most recent Institute for Supply Management (ISM) Manufacturing Index rising back above 60, well above 50 level that indicates businesses are expanding. Another important factor is that inventories are still at low levels suggesting robust business spending in the months ahead.

In this corporate reporting season, investors will be especially interested to hear management commentary about the impact of supply chain disruptions and the impact of inflation on their respective businesses. It is clear that many companies are having a more challenging time securing the components and finished goods that they need. The main culprit is the unprecedented surge in goods consumption (furniture, appliances, cars, consumer electronics, etc.) since the spring of last year. As a result, supply chains are stretched very thin, and given how tight things are in the system, any disruption has an outsize impact on goods availability. the logistics networks are simply not able to handle the sheer volume of goods, especially during peak import times.

This is resulting in long delays at the ports. But the good news is that recent production outages are improving—the COVID-19 wave in Southeast Asia is easing and petrochemical plants should continue to recover.

Now that we have moved past the peak import season (August and September), the bottlenecks at the ports have stopped getting worse. The number of container ships waiting for a spot at the ports of Los Angeles or Long Beach has fallen to 61 from over 70 in September.

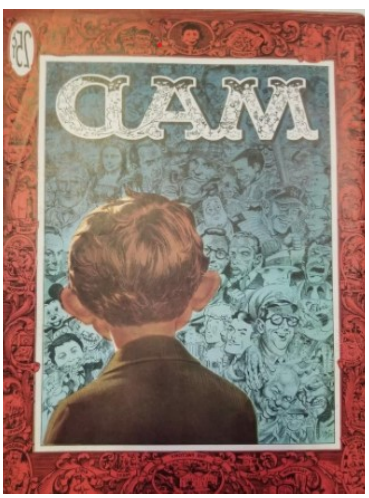
At this time of writing, it appears that the earnings drag from supply chain issues will be the worst in the fourth quarter before conditions hopefully start to improve. The sectors most likely exposed are industrials, consumer discretionary, consumer staples and tech hardware. It is unlikely that financials, internet, and healthcare should be severely affected by supply chain problems but we are monitoring these groups. With energy, a big caveat is the ongoing situation with shortages and delivery issues in natural gas and coal in Europe and especially China. A colder-than-normal winter could result in rationing of energy consumption that might lead to factory shutdowns, and any new COVID-19 wave could also have negative implications. Those risks are hard to predict, but we will be watching them closely. The US is in a much better position than most other countries as US natural gas inventories are only 5% lower than normal and coal inventories are more than adequate. The US should have ample energy supplies for the winter.

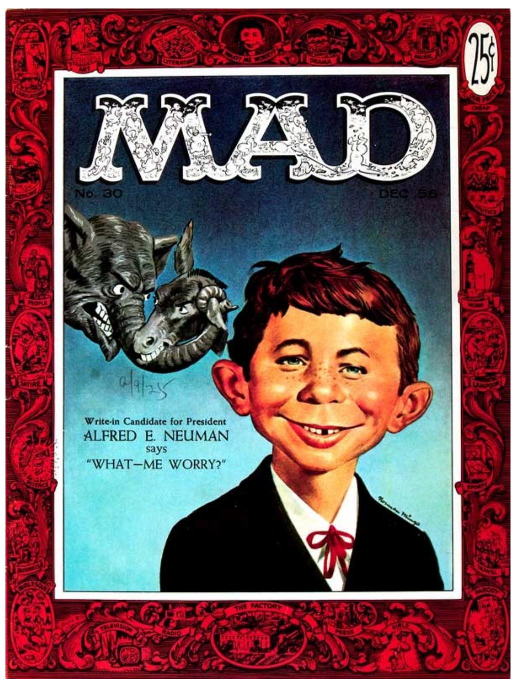
Labor shortages and rising wages have also been topical with investors and so far, the overwhelming majority of large US companies have been able to generate higher profitability despite rising labor costs because sales growth has been so strong. Looking at some company specific details, PACCAR cut truck deliveries by nearly 18% for the third quarter blaming semiconductor shortages, while Sherwin Williams cut guidance twice in September due to raw material constraints and price inflation. Nike results were impacted by longer transportation times and also due to the shutdown of their factories in Vietnam. A few weeks ago, FedEx highlighted labor availability and higher labor costs as a big reason for its earnings miss. In technology, these issues haven't been as severe, for example Accenture reported strong results and management suggested they weren't having much trouble finding staff. The same was true with Oracle and Adobe where both mentioned that they were not seeing any major disruptions with their supply chains in any meaningful way.

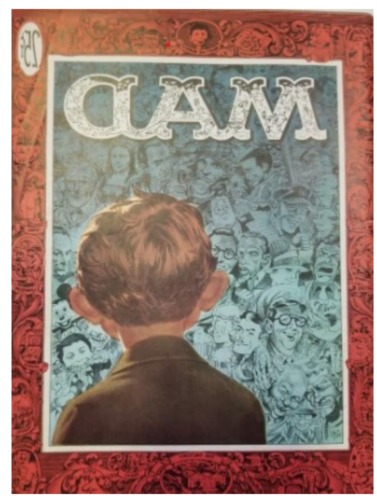
DÉJÀ VU 2008, 1950 – 1960'S?

The nearest memory of early cycle companies' impact on the market is almost exactly three years ago when companies warned about tariffs and slowing macro conditions during during third quarter 2018 earnings (3Q18) earnings. Those warnings and a hawkish Fed resulted in a 20% decline in the S&P 500. The current setup has similarities in that companies are warning about supply chain disruptions and labor shortages as the Fed sets the stage for tapering later this year. Others such as the editor of Gavekal Research have written that the world economy now faces conditions more akin to the 1950s than any other decade. We apply Alfred E Neuman's slogan from MAD Magazine to the worries that have suddenly gripped many investors and market economists, which seem to be way overdone. These worries were neatly summarized by Bloomberg News in early October just before the shakeout in equities began: "The global economy is entering the final quarter of 2021 with a mounting number of headwinds threatening to slow the recovery from the pandemic recession and prove policymakers' benign views on inflation wrong."

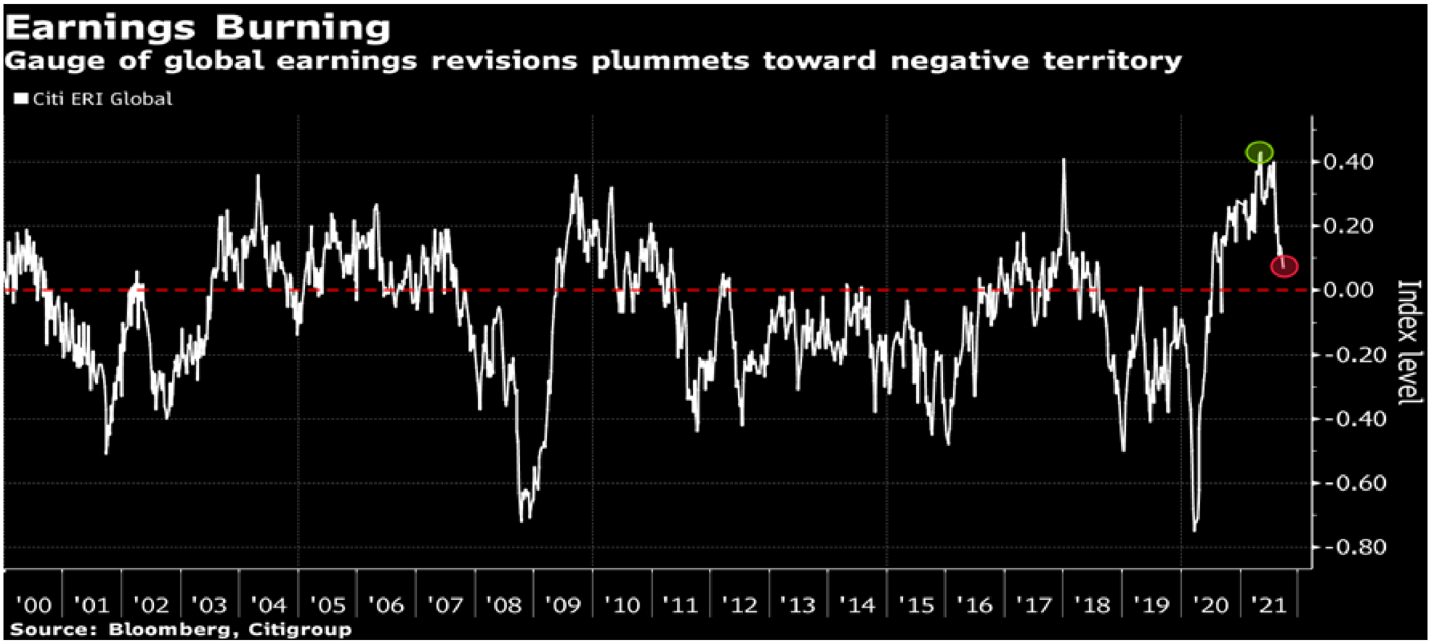
It may be that the worries listed above are either a) already discounted, b) exaggerated, c) transient or d) irrelevant to equity prices. In Gavelkal's opinion, markets have already discounted the delta variant and the Evergrande crisis but that leaves three genuine concerns: Chinese regulation, energy shortages and long-term stagflation.







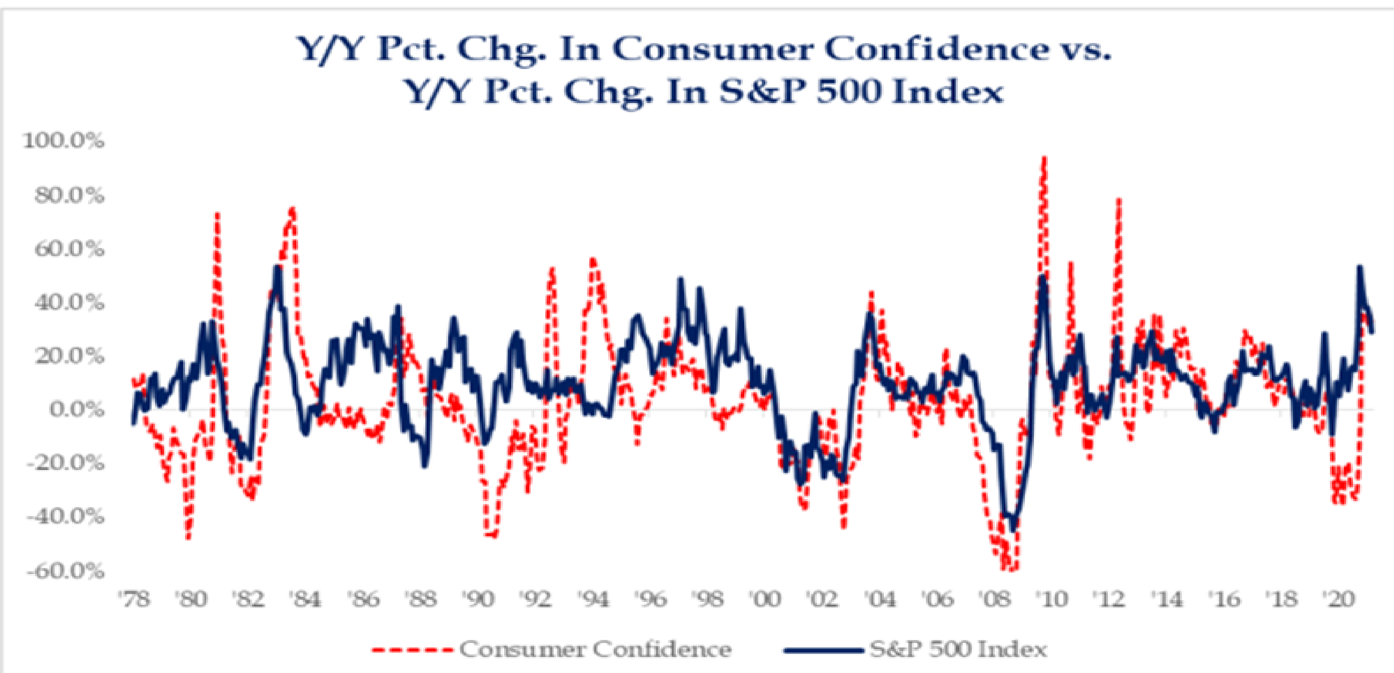
The U.S. has now returned to its pre-virus level of GDP but the euro zone is still 3% below its pre-virus level of GDP due to a combination of smaller stimulus and longer lockdowns but it too is on track to get back. Due to this success, as most economies having recouped much of their lost output, growth in most major economies is likely to slow over the coming quarters. As mentioned, we will be closely watching what management teams will be discussing in their quarterly calls with investors. However, we are paying attention to a recent Bloomberg report where they wrote; One of the key foundation stones of the global equity rally is crumbling, just when it is needed most. Earnings expectations are rapidly retreating, with analysts marking down their estimates for the world's stocks as third-quarter reports are being prepared. Citigroup's Global Earnings Revision Index, a worldwide measure of analyst upgrades minus downgrades of profit expectations, is plummeting toward negative territory after hitting an all-time high in May. A drop in global growth expectations and the impact of higher prices on margins are likely behind the move, one that is likely to continue given that a gauge of commodities from Bloomberg soared to a record in early October. Up until this summer, investors were able to brush off fears about rising inflation, higher bond yields and slowing growth, in part because earnings estimates were still climbing. We have argued for years that the direction for the market follows earnings! A reversal of the earnings expectations trend could make equity markets more vulnerable to the growing list of potential speedbumps into year-end.



Source: Bloomberg

Consumer confidence is another important indicator and that too has rolled over recently….

CONSUMER CONFIDENCE AND THE S&P APPEAR TO EBB AND FLOW WITH ONE ANOTHER

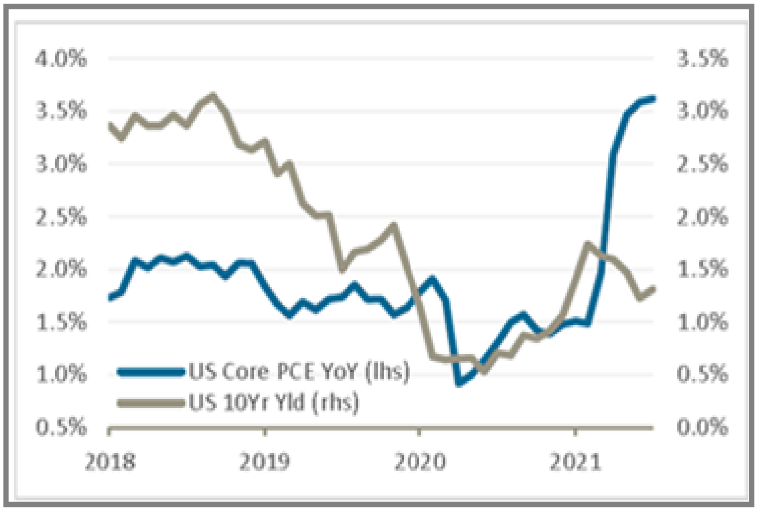


Source: Strategas Research Partners LLP

Monetary policy remains accommodative, but the late September statement by the Federal Open Market Committee (FMOC) strongly foreshadowed a QE tapering, putting markets on notice that "a moderation in the pace of asset purchases may soon be warranted". U.S. consumers have been hit by rising prices and a resurgent virus in recent months, but part of the reason the economy has remained so resilient is their willingness to spend. Because of hefty fiscal stimulus and employment growth, consumption by households has not only driven GDP growth, but the composition of their spending is now shifting from goods to services.

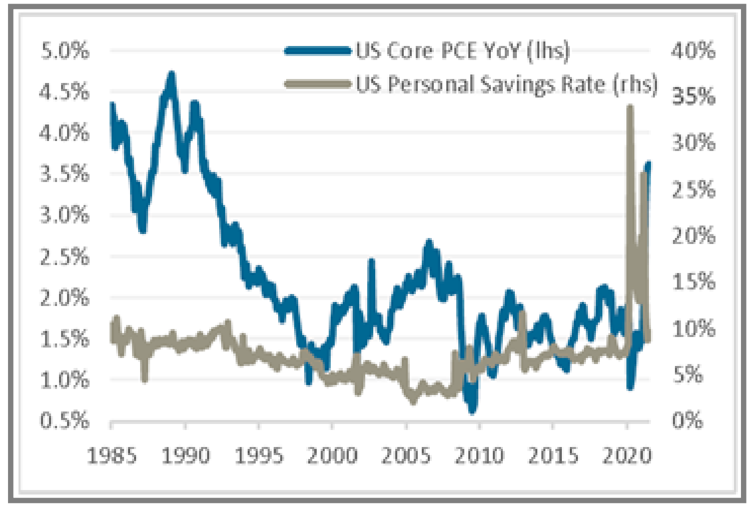
With household finances at their best shape in decades, Mr. Powell suggested that there is less of a relationship now between the state of the pandemic and the economic picture than there had been in the past.

Q4/2018: Last Time Inflation was over 2%, 10 YR Bond yields were 3.5%



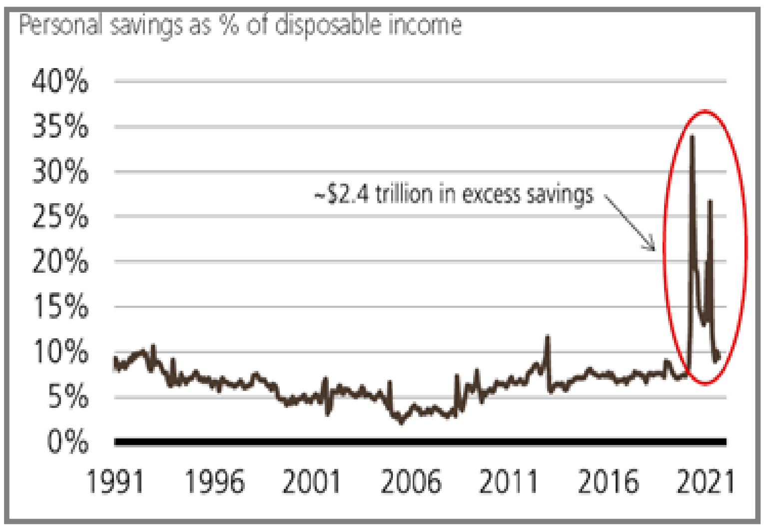
Source: Bloomberg, BTIG Research

Both Inflation and Savings Moving Higher



Source: Bloomberg, BTIG Research

US Consumer Finances are very strong



Source: Bloomberg, UBS As of 11 October / 21

The good news is that the US economy still appears to be relatively strong, but the bad news is that too much money may be chasing too few goods given the current economic backdrop. All the while the insanity going on in Washington D.C. goes on stoking fears of political gridlock and financial mismanagement, what many don't realize is that after approving a spending bill that was just shy of 9% of US GDP six months ago, US politicians appear on the brink of tearing the country apart over an additional $5 trillion in spending despite growing inflationary pressures. As the Fed foreshadowed in their Sept statement, the markets have been warned. Recently, three Federal Reserve policymakers have come out in favor of starting to phase out the bond-buying program the central bank created to help the economy through the pandemic. Fed Vice Chair Richard Clarida, Atlanta Fed President Raphael Bostic and St. Louis Fed President James Bullard noted the economy has improved enough to begin to taper as soon as November. "I myself believe that the 'substantial further progress' standard has more than been met with regard to our price-stability mandate and has all but been met with regard to our employment mandate," said Clarida. In our view, the excessive spending and deficits will result in higher interests rates due to the funding needs by the US Treasury and the massive issuance in gov't bonds. The Fed will not be the major buyer of bonds forever and when they step back and "taper" their purchases? Watch bond yields closely.

Investing in these periods of financial repression and excessive speculation is not easy, however, our investment process and investment policy comes down to our firm's belief; always stick with fundamentals. Owning solid businesses that are generating solid earnings and free cash flow that are reasonably priced, with strong management teams and who are industry leaders, interest us. With valuations generally high, selectivity is key to distinguish between companies with limited pricing power that are relying on cheap liquidity to fund their expansion from those with solid recurring revenues with sustainable business models. We also wish to remind our clients to remember that market corrections will take place and stocks tend not to move in a straight line higher unchallenged for long. According to Morgan Housel, a journalist with Motley Fool and the Wall Street Journal, over the past 100 years the US market has had at least a 10%+ correction every 11 months. However, pullbacks (depending on the catalyst for profit-taking) can often present opportunities to buy "babies that get thrown out with the bathwater."

IN SUMMARY - WHERE WE STAND

Our outlook for global equities remains constructive and positive. Clearly investor sentiment has turned decidedly more cautious over the last couple of months driven by supply chain disruptions, rising interest rates, higher energy prices, uncertainty about China economic growth, and limited clarity on US tax and spending policy. We recognize the number of bricks in this wall of worry seems to continue to grow, but we think these concerns will improve in the coming months. The 3rd quarter earnings season could be an important catalyst to help investors properly quantify the size and duration of the supply chain risk and inflationary impacts. As we mentioned before, we believe the known risks are manageable. We also think it's notable that in just the past month, that although some companies are lowering expectations due to supply chain issues these companies are not seeing a large negative stock price reaction, and the share prices of some companies have been actually rising. To us, this suggests many of the "known knowns" are being discounted and factored in to their share prices. **What about all of the gloomy strategists and economists who keep warning about disastrously repeating 1970s-style stagflation? My reply, in the spirit of the 1960s, will be "What, me worry?" I suspect that the markets will agree.**

As we mentioned in previous commentaries, our investment positioning has a barbell approach and has our global investment strategy focused on the financial and information technology sectors and we also 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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