Quarterly Report
WINTER 2022

HEWARD
INVESTMENT MANAGEMENT INC.

Omicron, Rising Rates and Inflation Notwithstanding, the Global Recovery Will Continue
But at a Slower Pace

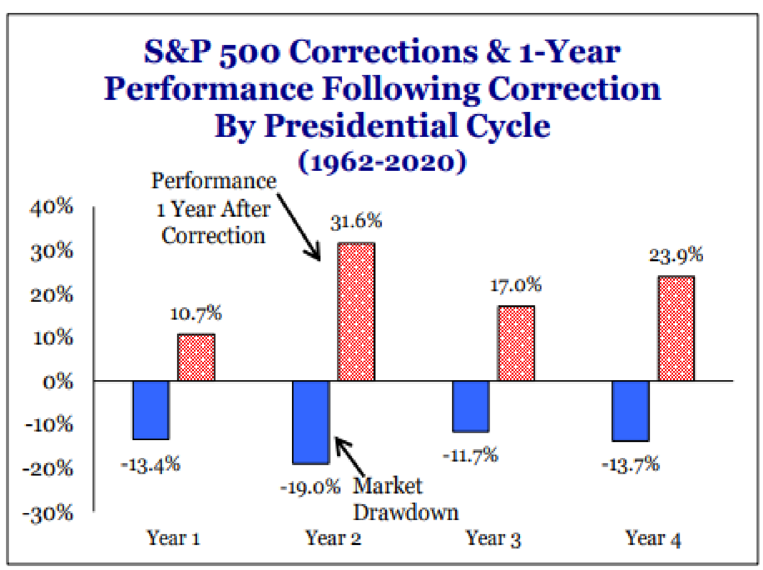
OVERVIEW

Economic growth peaked last summer, and while a cooling growth rate tends to unnerve investors, “peak growth” does not rhyme with “no growth”. There is still a tremendous amount of stimulus in the system, which will potentially lead to a slower pace of normalization. Global growth is likely to surprise in 2022, and possibly even in 2023 as the world economy fully re-opens. Both consumer and business spending should be robust as balance sheets have improved and excess liquidity remains elevated. Financial conditions, with real bond yields deeply into negative territory and tight credit spreads, remain quite accommodative. Also, traditional recession indicators are still flashing green. Unless Omicron renders vaccines ineffective and completely derails current economic projections, 2022 & 2023 appear likely to display above average growth. While the macro picture suggests that equities will end 2022 on a higher note, what happens between then and now is were returns will be generated or lost.

Investors and economists are dealing with conflicting signals. On the one hand, high-frequency macro data reinforces the view that the global economy will have grown rapidly in Q4/21, owing to cyclical conditions in the U.S. and Asia. On the other hand, new Covid cases are accelerating across the Northern Hemisphere, while the discovery of Omicron has sent shock waves through financial markets. The key concern is that the new variant may blunt the effectiveness of existing vaccines, causing a spike in critical cases and derailing the recovery. So far however, COVID vaccines are proving highly effective at preventing steep output losses. As an example, in Europe cases hit an all time high in Mid-December, but death rates were 3.5X lower than their peak in Q4/20. While mobility has declined, the drop is no where near as pronounced as during the “second wave”.

With underlying inflation to remain uncomfortably high for at least the next six months, most central banks will continue or begin to raise interest rates this year. But in some cases, markets may be overestimating the degree to which policy is tightened in 2022. Also, not every central bank will tighten policy. In China, December’s cut in the 1-year LPR rate may be a prelude to further easing this year. And, President Erdogan has zero appetite for higher interest rates in Turkey. However, the common thread running through central bank meetings in December was a hawkish pivot by policymakers. While the Bank of England stole the show by raising interest rates (albeit only 15 basis points) Federal Open Market Committee (FOMC) members raised their projections for interest rates in 2022, and even the European Central Bank was a little more hawkish than had been expected. Add in the fact that the Norges Bank, the Central Bank of Russia (CBR) and several Emerging Market (EM) central banks hiked rates, we are now in the broadest global tightening cycle since 2011.

Chief Executive Officers can’t stop talking about supply chain problems, and for good reason. Each passing month seems to bring a new shortage that is disrupting supply chains and driving up prices. In short, the right goods are not being delivered at the right time and place. When something like Covid delivers multiple supply and demand shocks, it is hard for entrepreneurs to adjust, as the hits are neither one-offs (hurricane) nor permanent (a technological discovery). “Reshoring” production is an option, but pandemic conditions will abate some day and thus most are unwilling to junk their commitment to an existing supplier network. Adjusting to new demand is similarly difficult as it is not easy to predict which behavioral changes wrought by Covid will become the “new normal”. Companies will continue to do capital spending to gradually resolve bottlenecks and capitalize on demand, but it will take time and capital.



Source: Strategas

UNITED STATES

Growth rates will decline but they will remain above trend for 2022. The Omicron variant will be a drag on Q1 and the rest of the year will see a gradual slowdown as the positive impulses from continued reopening, pent-up saving and inventory restocking contend with a steady headwind from diminishing fiscal support. At its final meeting of 2021 the Federal Open Market Committee (FOMC) tilted "hawkish" and announced a faster timeline for pulling back the stimulus it had deployed, as inflations fears look to persist. They doubled their bond purchases and projected three interest rate hikes in 2022, accelerating their expected timeline for raising borrowing costs. With inflation having exceeded 2% for some time now, the committee said that it would be appropriate to maintain this target range until labor market conditions have reached levels consistent with their assessment of maximum employment. However, the return to higher labor force participation is expected to take longer, as medical issues, child-care concerns and early retirements (early retirees jumped by about 2.4 million above-trend during Covid) have resulted in employers having difficulty finding workers. Meanwhile, state and local government budgets are in their best shape seen in our lifetime. Tax revenues are pouring in and state spending as a percentage of GDP is at its lowest level since 1985. With business confidence and capacity utilization both high, there are reasonable grounds to expect an acceleration in capital expenditures. A combination of strong employment and wage growth, as well as an historic rise in household net worth, appear likely to support consumer spending.

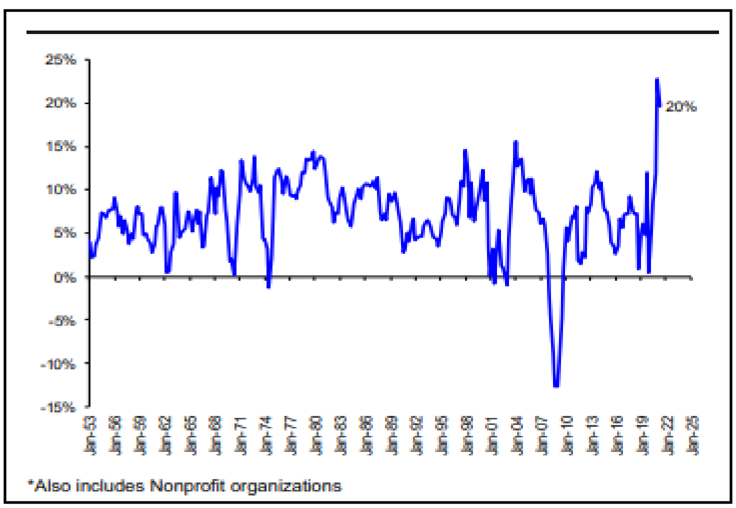
CANADA

The strong rise in GDP in October and the preliminary estimate of another solid gain in November imply that fourth quarter GDP growth will be stronger than the Bank of Canada (BoC) anticipated. This new found strength left the Liberals with a financial windfall and an un-forecasted reduction in the budget deficit. With the rebound intact, the labor market continued to heal with it. Since emerging from the third wave of COVID earlier this year, 600,000 net new jobs were generated, helping to bring employment back above pre-pandemic levels. The big gains were also a reflection of the large number of people exiting the unemployment ranks, a development that was expected following the termination of key government programs. Those gains have prompted the BoC to pare back its stimulus efforts while warning of bring forward interest rate increases. It also announced it will maintain its 2% inflation target for the next five years, but has formally been given license to moderately overshoot it to "support maximum sustainable employment". Consumer prices rose at a more modest pace in November, but the increase in the BoC's preferred measure of core inflation suggests that price pressures are broadening. Energy drilling in Canada is forecast to increase in 2022, in what the sector hopes is evidence of what will be an industry sputtering back to life after years of decline. Meanwhile, the surge in coronavirus infections means that there are growing risks to activity in the coming months. But, by allowing the Accommodation & Food and Retail Trade sectors to operate at reduced capacity, the economic impact should be less than the previous two phases of closures.

EUROPE

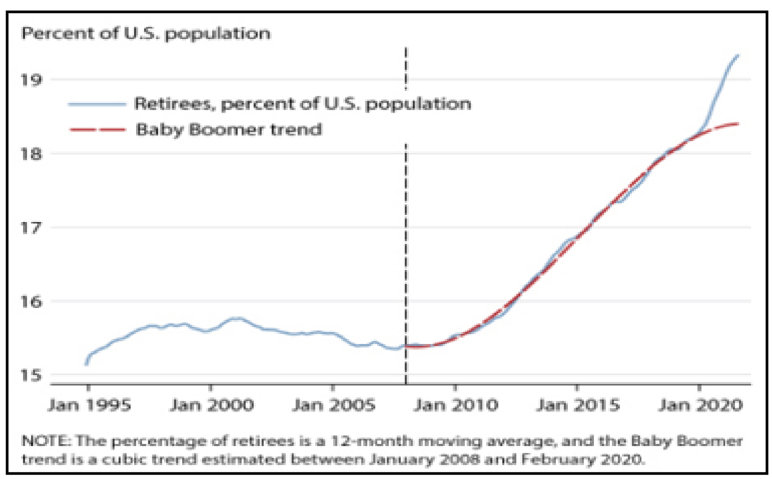
Risks for projected growth rates early in the year are skewed to the downside amid the recent sharp rise in COVID cases and emergence of the Omicron variant. But, the outlook for the latter part of 2022 remains constructive given the likely easing of industrial bottlenecks, significant catch-up room for services spending and persistent fiscal support. The majority of December's multiple central bank decisions turned out to be a little more hawkish than had anticipated, and the European Central Bank (ECB) was no exception. First, they committed to reduce the monthly pace of asset purchases a little faster than projected. Secondly, the ECB's forecast for inflation to be 1.8% in 2024 means it is not far away from its 2.0% target. The bank would only need to nudge this forecast up slightly next year to set the stage for it to raise the deposit rate in 2023. The latest (November) detailed inflation

US HOUSEHOLDS* NETWORTH (YOY)



Source: Scotiabank GBM Portfolio Strategy, FRED

PERCENTAGE OF RETIREES IN THE US POPULATION AND THE BABY BOOMER RETIREMENT TREND



Source: Current Population Survey and author's calculations breakdown shows that the increase in price pressures is not just due to high energy costs and global demand/supply imbalances for durable goods. Price pressures have also increased in the services sector. That said, there are still no signs of faster wage growth which could lead to persistently higher services inflation. The Bank of England (BoE) surprised by raising the Bank Rate in their December meeting. Given the strong labour market and inflation data, as well as the BoE's renewed focus on inflation expectations, two more hikes are likely before summer. The sharp increase in headline inflation continues to be broad-based, with the largest contribution coming from transport prices on the back of high fuel and used car prices.

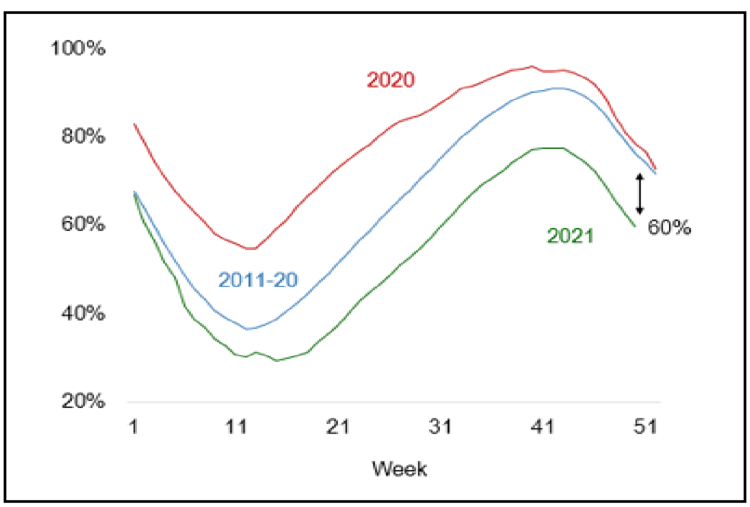
EMERGING & DEVELOPING MARKETS

The foundations for China's economy were laid out in early December at the annual Central Economic Working Conference. It was revealed that "monetary policy should be flexible and appropriate and liquidity levels should be reasonable and adequate". In short, there will be a gradual easing of policy, but no sudden lurch. Greater emphasis will be given to fiscal policy by accelerating fiscal expenditures and front-load infrastructure investments at an appropriate pace. However, the country's leadership will remain cautious by not allowing local governments to increase debt levels. This qualification will make it difficult for many large projects to be authorized. Internally, the economy remains weak. The weakness stems from tight fiscal and monetary policies designed to help the deleveraging process, a slowdown in exports, the impact of the new Covid variant and measures to be taken to ensure a pollution-free Olympic Games. The problems with Evergrande will prove to slow the economy without crashing it. Latin America will have probably posted a growth rate near 6% for 2021 as it benefited from improving mobility, high commodity inflation and low global financial stress. However, as these tail winds fade, it will increase the likely hood that LatAm will experience stagflation. High vaccination rates and declining infection rates have boosted mobility across the region. Cell phone tracking data now shows that away from home traffic is back to pre-Covid levels. Yet, despite improving mobility, regional GDP continues to underperform. In addition, the leading activity index (Numerica Analytics) for LatAm points to weak growth in the coming quarters.

COMMODITIES

It seems that the threat that the Omicron variant of Covid could shut down developed markets and key EM economies has faded (1/3 recovery in prices). Together with OPEC+'s exquisite supply management, and an outlook that has global oil demand on a recovery path through 2022, the longer-term pricing outlook remains positive. However, with the first quarter supply/demand picture looking much less tight than it did in October, short term time-spreads have failed to recover nearly as much. The failure of time-spreads to recover has much to do with the absence of a real winter emergency in the Americas and NE Asia, the headwinds of covid related partial lockdowns and the release of more than 50 million barrels from Strategic Reserves. Global natural gas prices have been particularly volatile this year, with tighter markets driven by both supply and demand factors across all regions. While the rally has been broad based, regional disconnects have emerged in recent weeks. With natural gas inventories sitting well below the norms, European prices have remained firm. In North American prices have fallen amid milder weather and more resilient associated gas supply. Copper prices have been supported by low inventories. However, mine supply is expected to grow by 5% in 2022 (Barclays). While demand growth is also expected to be above historical averages, it will be tough for copper markets to ignore China's deceleration. Given how embedded copper is to the overall economy from property to infrastructure, to transport to electronics, and to appliances to industrial uses, what happens to copper consumption is a reflection of economic activity.

EUROPE STRUGGLING TO CONTROL GAS SUPPLY
EU NATURAL GAS STOCKS (% STORAGE CAPACITY)



NOTE: EU gas inventories as a share of overall storage capacity. Blue line is the 2011-2020 average.

Source: Gas Infrastructure Europe (GIE); Numera calculations

CHINA LAI AND COMMODITIES ACTIVITY INDEX
DEVIATIONS FROM TREND (SD)

Source: Numera Analytics

RECOMMENDATIONS

We expect global growth rates to be above potential in 2022, but the prospect of a winter COVID wave and a drag from the Omicron variant pose a downside risk. Also, investors should not fear the start of rate hike cycle. History shows that the transition from easing to tightening usually creates volatility, but also proves positive for equities. Performance favors equities over fixed income, as the latter tends to suffer from rising bond yields when tightening starts. Higher real yields favor value over growth and from a market sector standpoint, late cycle stocks tend to lead defensive areas following the initial rate hike. History also shows that stocks have been the most volatile in midterm election years with sizeable corrections. Yet, the larger than usual corrections have historically turned out to be great buying opportunities, with the S&P 500 higher one year later every time since 1962. With these historical trends in mind, and not having seen a market correction of any significance since the start of the recovery (April 2020) we felt a more cautious stance going into year end was appropriate. We also believe there are enough macro issues (geopolitical, economic & medical) short term to warrant an under-weight position through Q1/22. Mind full of these, we continue to believe that markets will end the year marginally higher than their 2021 peaks. As such, market opportunities will be used to build equity positions back up. With the Omicron variant putting a dent in early 2022 growth expectations, upside pressure on interest rates has waned (10-year rates ended the quarter where they started). While inflation rates will decline from year end levels, they will persist for longer than initially expected. We therefore expect rates to rise once the present Omicron wave subsides, but not to levels where they will choke off growth. On a year-to-date basis, rates increased considerably, causing havoc on bond markets and forcing the Broad bond universe to register negative returns. Our fixed income portfolio on the other hand, registered a positive return. Our strategy to incorporate a lower than benchmark duration, a more diversified strategy, a focus on higher yielding corporate and convertible debentures, preferred shares and select equities were key contributors. Given our outlook, we will continue with this strategy going forward.

FORECAST 2021

	CURRENT 31-December-2021	2022 RANGE	2022 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	0.250%	0.25%- 1.00%	1.00%
Federal Funds Rate	0.080%	0.00%- 0.75%	0.75%
10-year Canadian Treasury	1.426%	1.20%- 1.90%	1.80%
10-year US Treasury	1.512%	1.20%- 1.90%	1.80%
COMMODITIES			
Gold (US$/oz.)	$1,830	$1,750- $1,900	$1,875
Copper (US$/lb)	$4.46	$4.35- $5.00	$4.80
Oil WTI (US$/bbl)	$75.40	$57.00- $80.00	$74.00
MARKETS			
S&P/TSX Composite Index	21,223	19,000- 22,100	21,500
S&P 500 Index	4,766	4,150– 4,950	4,800
CANADA DOLLAR/US DOLLAR	$0.79	$0.76- $0.83	$0.81

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