Quarterly Report
SPRING 2022

HEWARD
INVESTMENT MANAGEMENT INC.

While the Investment Landscape is Always Filled with Uncertainties: Today's Backdrop Seems Dotted with More than Normal

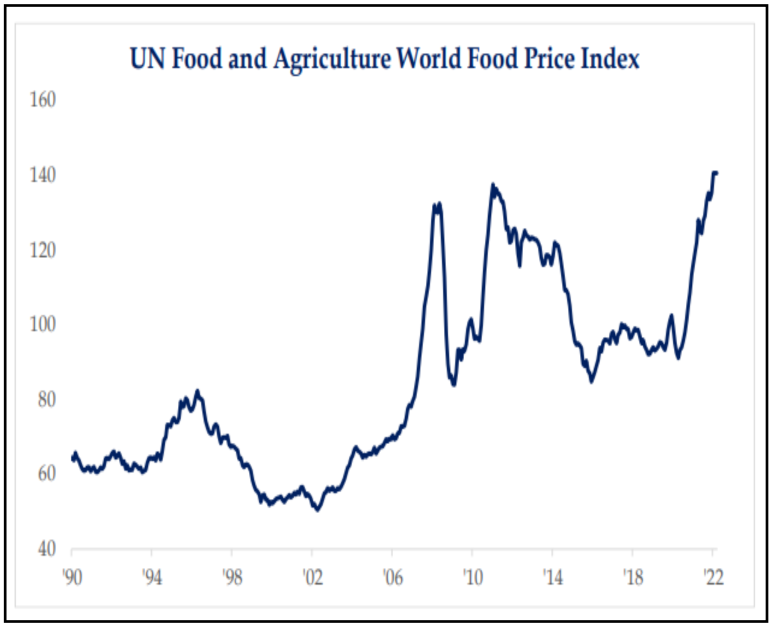
OVERVIEW

It is now over a month since the Russian invasion of Ukraine started to dominate all thoughts and all discourses. But if one looks at the markets, it appears as though it's safe to take risks again and the worst is over, as illustrated by U.S. stocks which are now comfortably higher than they were at the start of the invasion. However, the range of possibilities for how the conflict might ultimately be resolved remains bafflingly wide, and the economic damage is only just starting to be felt. Furthermore, while investors seem somewhat optimistic, people running businesses seem much more despondent. So how can the market possibly be rallying? There are two possible broad reasons. One is that the market can see something that many of the rest of us cannot, and is confident of some market-friendly resolution to the conflict (and crucially, some kind of swift resolution to the attendant economic sanctions.) The other is that the stock market is rallying for reasons that have nothing to do with Ukraine. The most obvious is the volte-face toward financial easing in China, but it seems premature to stoke a rally in U.S. equities until we know a lot more about how Chinese policy evolves and their COVID situation.

While recession concerns are legitimate, they are probably overstated. Fed tightening, negative real wage growth, declining consumer confidence, decelerating profits and the Ukraine do make up a cornucopia of headwinds. However, while each of these issues is legitimate, a review of the data suggests a more benign near-term outlook for the economy than feared. Current consensus projections (Credit Suisse) call for a 3.6% real GDP growth for 2022, versus a 20-year average of 1.9%. The Institute of Supply Management (ISM) Manufacturing's most recent number (although weaker) is consistent with such an outlook. Given the pace of economic growth and inflation, Fed policy is far too accommodative. Even if they raise rates 7 times in 2022, policy would still be too loose. Both oil prices and inflation are problematically high, but forecasts are for both to decline as we move towards 2023. Taken by itself, negative real wage increases should lead to weaker spending. But a strong job market and wealth effects offset this headwind, keeping retail sales buoyant. Projected declines in CPI would also help to alleviate these pressures. In contrast to the weak University of Michigan's confidence survey, the Conference Board's readings remain quite healthy. On the earnings front, despite higher input costs, they are still projected to grow at a rate of 3% this year and when looking at COVID, cases are plummeting and restrictions are being relaxed. With regards to the Ukraine war, continued hostilities would be problematic, but history indicates that conflict driven market volatility tends to fade rather quickly.

It might be prudent not to expected a big drop in oil prices anytime soon. Investors are pointing to the Russia/Ukraine war to explain the spike, and that makes sense. Russia is the world's third-largest producer and top exporter to global markets. Now with the West refusing to do business with Russia, this will crimp supplies. Hence the recent spike. But if you zoom out, one will see that oil prices have been on a choppy upward march since April 2020. Like your typical commodity, the oil industry runs in cycles. Oil prices rise, production increases, supply exceeds demand and then prices fall. Rinse and repeat! The problem is production is not increasing much this time around. Almost every U.S. energy company has embraced the need for capital spending restraint, and small production increases seems to be the new paradigm. Energy-company management teams are not about to rock the boat, especially given the regulatory clouds hovering over the industry from the Biden administration's anti-fossil fuel policies.

THE WORLD FOOD PRICE INDEX IS ALREADY AT HISTORICAL HIGHS



Source: Strategas

UNITED STATES

In a widely expected move, the Federal Reserve raised its benchmark interest rate by 25bps. However, forward guidance was far more aggressive than it was in December, pointing to six more rate hikes over the course of the year. The Federal Open Market Committee minutes also showed significant upward revisions to inflation forecasts, helping to strengthen Fed credibility. They are attempting to create a pathway for a slowdown (not a recession), but both the private & International sectors will have considerable say in whether they will succeed. Supporting this theory is the matter of excess savings showing that consumers are broadly far wealthier today than pre-pandemic, and also indicates that lower income consumers haven't even dipped into excess cash balances yet. This has thus far limited any "demand destruction", and according to Raymond James, this is being confirmed by airlines, homebuilders, restaurants, Walmart ect… From the top-down perspective, it doesn't appear rational to expect a big slowdown (but expect some) in demand over the next few months given cash balances, wage increases and job growth & job openings. Meanwhile, political rhetoric has shifted dramatically in recent weeks, and while accelerating de-carbonization remains a priority, concerns around energy security and rising energy costs for both businesses and consumers are now clearly front and center. On a positive note, inflation is bolstering state revenue growth. In January, state revenues were up 26% (YOY) and were at an all-time high. There is now a growing list of states whose policymakers are responding to higher inflation with proposed gasoline & grocery tax cuts.

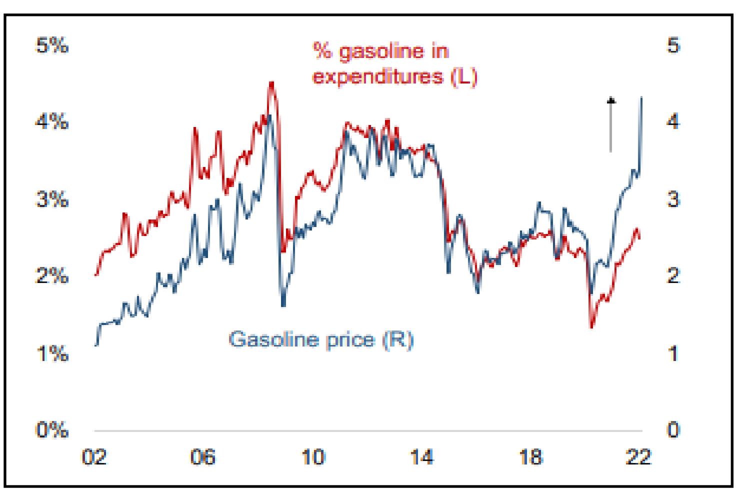
CANADA

Job creation in Canada surged (February) with 336,000 jobs being added as pandemic restrictions started to be wound down. Job growth was driven by the private sector and was broad based across multi-industries and regions. Job growth and the difficulty in finding workers, have contributed to The Bank of Canada's (BoC) Business Survey Outlook which recorded firms' wage expectations at record highs. This would suggest that wage growth could accelerate to far above the pre-pandemic norm this year. With little sign yet of a rebound in productivity growth, such a strong pace of wage growth would present a clear upside risk to most inflation forecasts. Canada continues to be the fastest growing country in the G7, spurred on by a large immigrant influx. This has helped the housing market to be a major economic driver for Canada during the economic bounce back from the pandemic recession. The question now is whether the tightening by the Bank of Canada will cool this sector down? Meanwhile the latest data from airport traffic is another sign that the economy has been normalizing. Domestic traffic has displayed a strong recovery, while December recorded the highest number of international aircraft movements since the start of the pandemic. Even though the fragile global network of energy supply has been upended, Canada is limited in its ability to make big gains in oil and gas output owing to scarce new export pipeline capacity and the pullback in recent years of capital spending. Producers have directed their cash flows to paying down debt, and to boosting dividends and share buybacks.

EUROPE

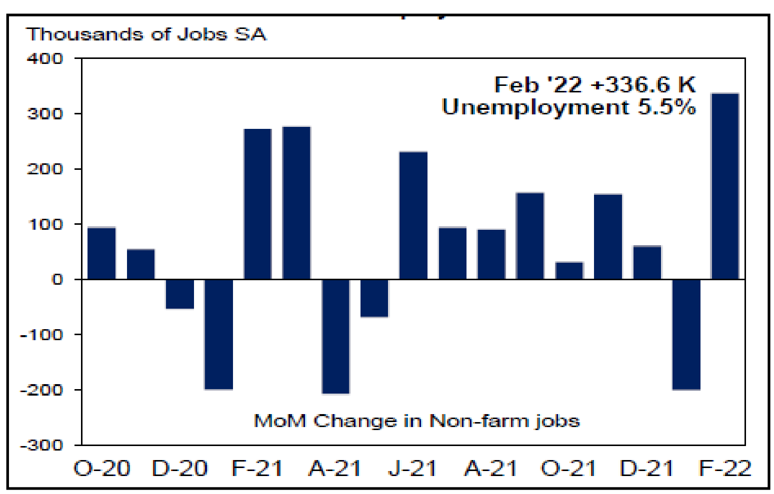
The Ukraine war has clearly overturned the comfortable status quo that has prevailed across Europe since the fall of the Berlin Wall. Gone are the days of ever-falling defense budgets and on relying on an undemocratic Russia for cheap energy imports. It is no exaggeration to state that Russia's invasion of Ukraine is a brutal wake-up call with severe consequences. First and foremost is the humanitarian crisis and the near-term challenge of absorbing the flow of refugees coming out of the Ukraine. Then there is the fact that Europe now finds itself mired in one of the worst energy crises in history. Wholesale prices are now almost four times what they were at the start of the corona virus pandemic. Governments are having to take emergency action to support domestic and industrial consumers faced with crippling bills. After just a month, the war is bringing factories all across Italy

FEELING THE PINCH AT THE PUMP
US GASOLINE PRICES AND BUDGET SHARE



Source: Numera Analytics

CANADA EMPLOYMENT



Source: Statistics Canada

to a standstill. According to a study by the Fim-Cisl union more than 25,000 workers have already been affected by the economic fallout of the fighting. Mariupol, Ukraine was a major supplier of metal slabs for the steel industry and estimates call for warehouses to be empty by mid-spring. Similar disruptions are happening across Europe, as the one-two punch of the war and China's COVID-19 disruptions rock global supply chains yet again. Meanwhile, in the UK, the Bank of England raised its key rate for the third time in as many policy meetings. This was a fresh sign that central banks in many parts of the world are giving priority to countering a surge in inflation rather than slowing growth as their countries brace for the negative impact of the Russia/Ukraine war.

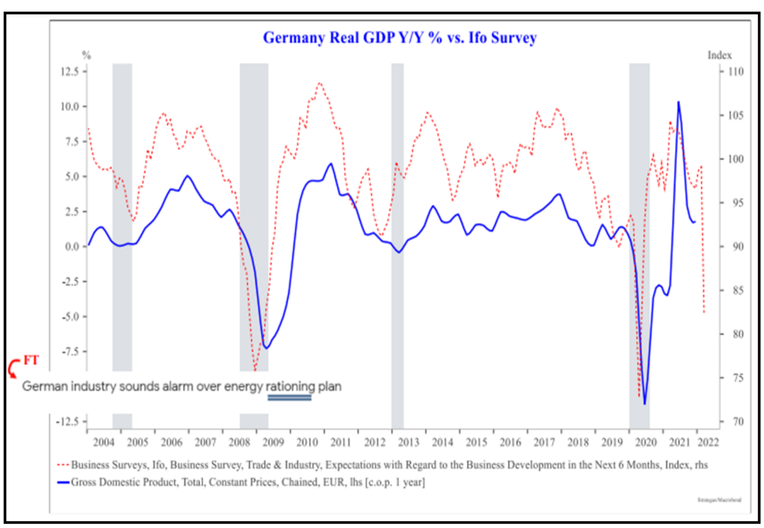
EMERGING & DEVELOPING MARKETS

China has been preparing for global financial/economic conditions to deteriorate through at least the first half of 2022. It has been loosening monetary policy and expanding fiscal tools through tax and other incentives, and through these policies building a sizeable war chest for local governments to be spent on infrastructure. Meanwhile, when it comes to emerging markets, investors must start to contemplate the probability that the "buy anything related to commodities" trade could be about to run out of steam as demand destruction sets in. Any further rise in commodity prices will hurt an ever-greater number of emerging markets more than they will help. Net importers like India and South Korea are already reporting deteriorating trade balances. Also, policy tightening will pose an increasing headwind. Food and energy typically make up between a quarter and a half of emerging market consumer inflation baskets. As a result, disruptions in supplies of energy, wheat and fertilizer exports from Russia and Ukraine will have an outsized impact on emerging market inflation rates. This is also a worry in Japan, where policymakers have long favored Yen weakness. It raises the profits of Japanese corporations that sell overseas and raises the Yen cost of imported energy and raw materials. This was always a handy addition to domestic inflation in an economy struggling to stave off a slide to outright deflation. But, with the Yen now down 5.5% in a month and with the big rise in U.S. dollar oil prices, Japanese policymakers are beginning to suggest that much more Yen weakness (and the imported inflation that it brings with it) could be too much of a good thing.

COMMODITIES

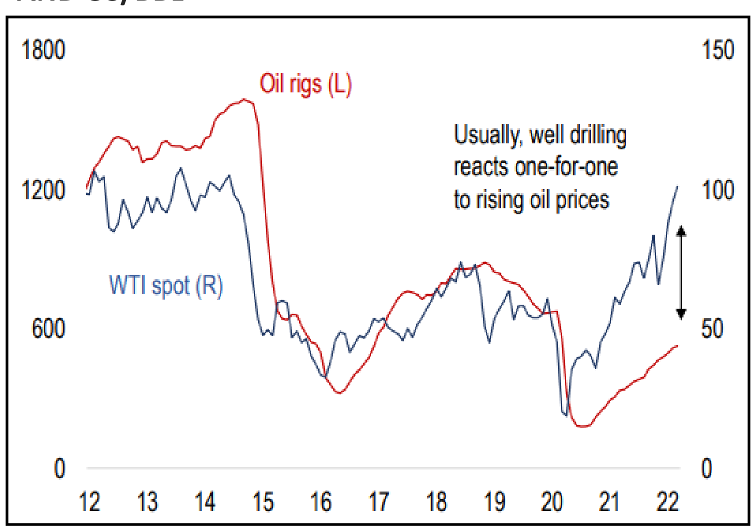
Despite the historic volatility over recent weeks, the fundamental oil backdrop can only be described as the most bullish in decades. Low global inventories of both crude oil and refined products are a conundrum that is difficult to solve without prices moving materially higher (the cure for high prices is high prices). European prices for natural gas have also skyrocketed to record levels. There is a ferocious degree of physical buying of global marginal barrels, which can be seen in the multi-year highs across the North Sea and West African physical crude differentials. Higher prices have developed despite an agreement by members of OPEC to boost shipments by an additional 400,000 barrels per day, in line with previous monthly increases. That, along with the early March agreement by members of the International Energy Agency (IEA) to release 60 million barrels of stockpiled crude, have failed to constrain prices that were on the move even before Russia invaded Ukraine. But, new outbreaks of COVID (especially in China) could become a big fear factor for the oil market. Meanwhile, the Ukraine feeds much of the world, especially the Middle East and Egypt. Who is farming wheat right now, and how can it be moved out of ports that are under siege? Between the Ukraine and Russia 30% of exported wheat may be off the market due to an inability to farm, move to market, or trade sanctions. In recent weeks, gold and other precious metals have followed bond yields higher, a signal that the investment environment has changed. The fixed income market and the gold market are sending the same message: deflation is no longer the main threat for portfolios.

GERMANY REAL GDP
YEAR OVER YEAR % VS. IFO SURVEY



Source: Strategas

US OIL RIGS AND WTI SPOT PRICE NUMBER OF RIGS AND US/BBL



Source: Numera Analytics

RECOMMENDATIONS

Under a frame work of knowns and unknowns, the world is a confusing place right now with the Russian invasion of the Ukraine taking center stage. It has cast a stagflationary shadow over the world economy and posed a dilemma for central banks: should they support flagging growth or fight skyrocketing inflation. For now, many of the world's centra banks have moved decisively against inflation, but with past economic models of little use in this environment, they are navigating without a clear road map. We could be also on the verge of what history may show as the single most important change in the financial markets in more than a decade, the Quantitative Easing (Q.E.) era is ending. In such an environment, where one cannot count on the fact that the cost of capital will remain negative indefinitely (real terms), valuation matters and it matters a lot. While watching the market's interpretation and pricing of events and given the current levels of uncertainty, we have reduced our equity exposure to a level slightly below neutral. We did this by booking profits in the material sector and reducing our heavy overweight in energy. But we stand ready to reverse our stance and take an overweight position in equities, if/when the clouds over the market clear. We are focusing our attention on what can be analyzed (earnings/cash flows) as we try to identify companies that can continue to deliver at a reasonable price. We are also focused on dividends and those companies that will have the ability to grow them, as dividend returns may form a large part of total returns going forward. Meanwhile, the war in the Ukraine, relatively strong economic growth, skyrocketing commodity prices and tough talk by Central Banks (on inflation) have all resulted in a spike in medium- and longer-term interest rates. As a result, bonds had one of their worst quarters on record, with the bond benchmark gapping down by about 7.00%. With our fixed income strategy focussed on shorter term/higher yield corporate bonds, our returns were significantly better than the benchmark. Because of widening spreads, preferred shares also had a more difficult quarter, while our reduced equity component was about flat. All in all, the fixed income component made a small negative contribution to overall results. Although upward pressure on interest rates may continue, we think any further move in yields will be gradual. However, they will also have a positive impact on future performance. Given the brutal nature of the sell-off, some kind of rebound (trading opportunity) should be expected.

FORECAST 2022	CURRENT 31-March-2022	2022 RANGE	2022 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	0.50%	0.25%- 1.75%	1.75%
Federal Funds Rate	0.33%	0.12%- 1.75%	1.75%
10-year Canadian Treasury	2.404%	1.43%- 3.00%	2.95%
10-year US Treasury	2.331%	1.61%- 3.00%	2.95%
COMMODITIES			
Gold (US$/oz.)	$1,936	$1,790- $2,100	$1,975
Copper (US$/lb)	$4.73	$4.35- $4.93	$4.50
Oil WTI (US$/bbl)	$100.73	$74.00- $127.00	$85.00
MARKETS			
S&P/TSX Composite Index	21,890	20,242– 23,300	22,700
S&P 500 Index	4,554	4,175– 4,850	4,700
CANADA DOLLAR/US DOLLAR	$0.80	$0.77- $0.83	$0.82

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