The Heward Global Leaders Investment Strategy

SUMMER 2022

HEWARD
INVESTMENT MANAGEMENT INC.

"The More Things Change, the More They Stay the Same."

-Jean-Baptiste Alphonse Karr

While change is constant in one's life, its pace and magnitude clearly are not — given the changes we are experiencing globally, it forces investment managers to recalibrate their investment assumptions in very short order. The events of the first half of 2022 have brought a moment of reckoning to investors, forcing a fresh perspective and challenging long-held assumptions about investment risks. Such moments also usher in new opportunities for those who learn quickly and adapt. While the current inflationary environment has its own unique profile, professional investors are looking for parallels from the past to guide them. At a minimum, we know that the risk of sustained high inflation brings a paradigm shift in long-term expectations that influences the behaviors of consumers, businesses, and investors seeking to protect the real value of their assets. The quarter just ended offered investors a strong rollercoaster ride, and the current process of the US Federal Reserve moving from what has been essentially a regime of "free money" to "not so easy money" is causing severe indigestion for the stock market in the near term as stocks discount the process and consider what such a change in monetary policy will mean for equity valuations moving forward. China's zero tolerance policy toward COVID in Shanghai and in Beijing along with Russia's incursion into Ukraine naturally has added to supply chain and oil price dysfunction as well as stoking inflation uncertainty.

Year-to-date (ending June 30th 2022) the Heward Global Leaders Fund and strategy is down 8.65% vs. its benchmark down 17.02% and for the last twelve months -2.8% vs -10.31% respectively (all before fees and expenses).

June was a particularly difficult month with all three major indices ending the session in the red, probably taking note from the comments from J P Morgan President and CEO, Jamie Dimon at a NY conference:

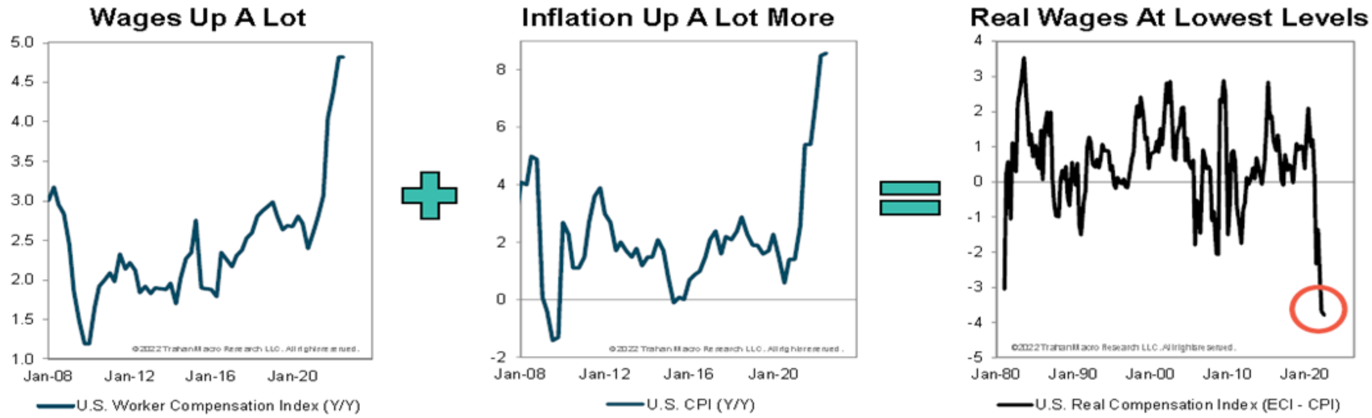
"*You know, I said there's storm clouds but I'm going to change it... it's a hurricane,* referencing a U.S. economy that is struggling with "fiscally induced growth, QT and the war in Ukraine. *"Right now, it's kind of sunny, things are doing fine, everyone thinks the Fed can handle this".* "*If you look and you go back to 2010 and say, 'Who are all the major buyers of Treasuries?' All that time it was central banks, foreign exchange managers, banks who were topping up their liquidity profiles, because we had to for regulations. All three, it won't happen, this go-around. Banks are topped up, foreign exchange managers are topped up, the central bank would be selling, not buying, and governments have much for fiscal deficit to finance. That's a huge change in the flow of funds around the world. I don't know what the effect of that is. I'm prepared for - and you're talking about a minimum, huge volatility."*

We also paid attention to what the US Federal Reserve Chair Powell said where he was very hawkish in a recent speech that was held at The Wall Street Journal's Future of Everything Festival. *"If we go past Neutral, we won't hesitate". "The underlying strength of the U.S. economy is really good right now. The U.S. economy is strong, the labor market is extremely strong. It is still at very healthy levels. Consumer balance sheets are healthy. Businesses are healthy. The banks are well-capitalized. This is a strong economy. We think it is well-positioned to withstand less accommodative monetary policy and tighter monetary policy. Of course, we do monitor global events, and global events have been important to our economy. The war in Ukraine is something that has upset the global commodity picture, while also threatening the global world more broadly".*

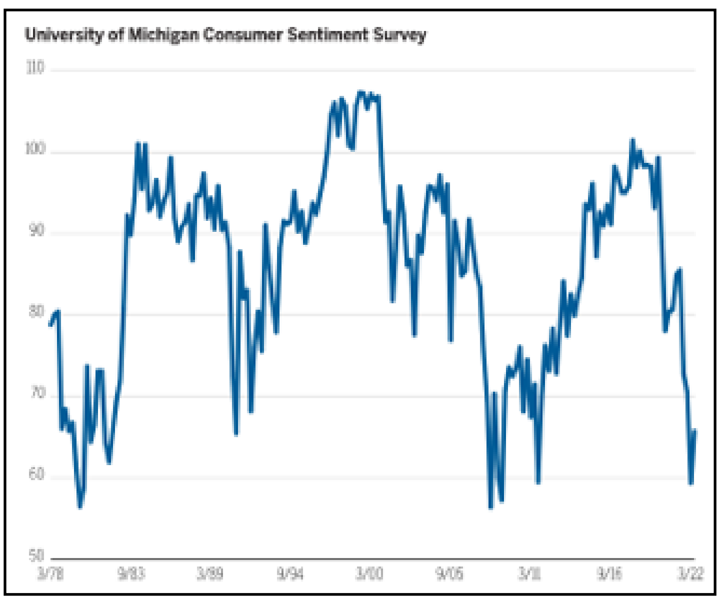
Our friend Jason Trennert at Strategas Research Partners recently wrote; "*While valuation is a poor timing tool, it does give the average investor some sense of how much risk they are taking at a given time. We believe that the relatively rapid transition of Fed policy from quantitative easing to quantitative tightening may be one of the most significant developments for the financial markets since the 2008 global financial crisis".*

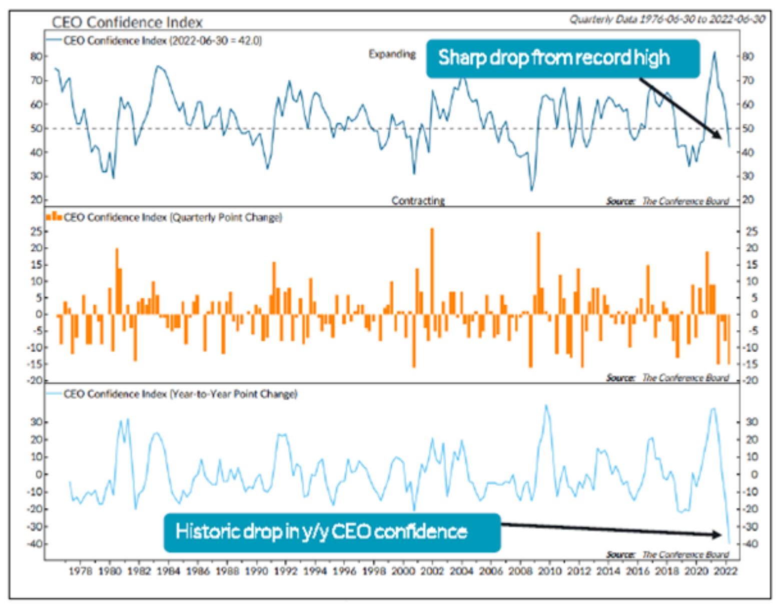
We continue to use a 40% chance of a U.S. slowdown / recession, and a 15% chance of an upside surprise. The U.S. labor market is still dealing with the thrust from previous 2020/21 stimulus. It looks to us that through decades of a steadily declining cost of money is over. It's hard to imagine the 10-year yield moving calmly in a horizontal line from here; the current price is a compromise between those who believe that a new inflationary era has begun, and those who expect the Fed to "pivot" or reverse course any day now.

Based on history, the U.S. economy doesn't go into recession without labor market weakness, but accelerating wage gains reinforce concerns about "sticky" inflation. We worry about the loss in consumer confidence given that 2/3rds of the US economy is driven by consumer spending. Why? As the following charts show, consumers are facing higher costs and the inflationary impact on "real wages" (after inflation) is not a pretty picture. No wonder we are seeing more labor strikes and disruptions which are likely to remain until layoffs increase and unemployment becomes a worry.



Source: Trahan Macro Research

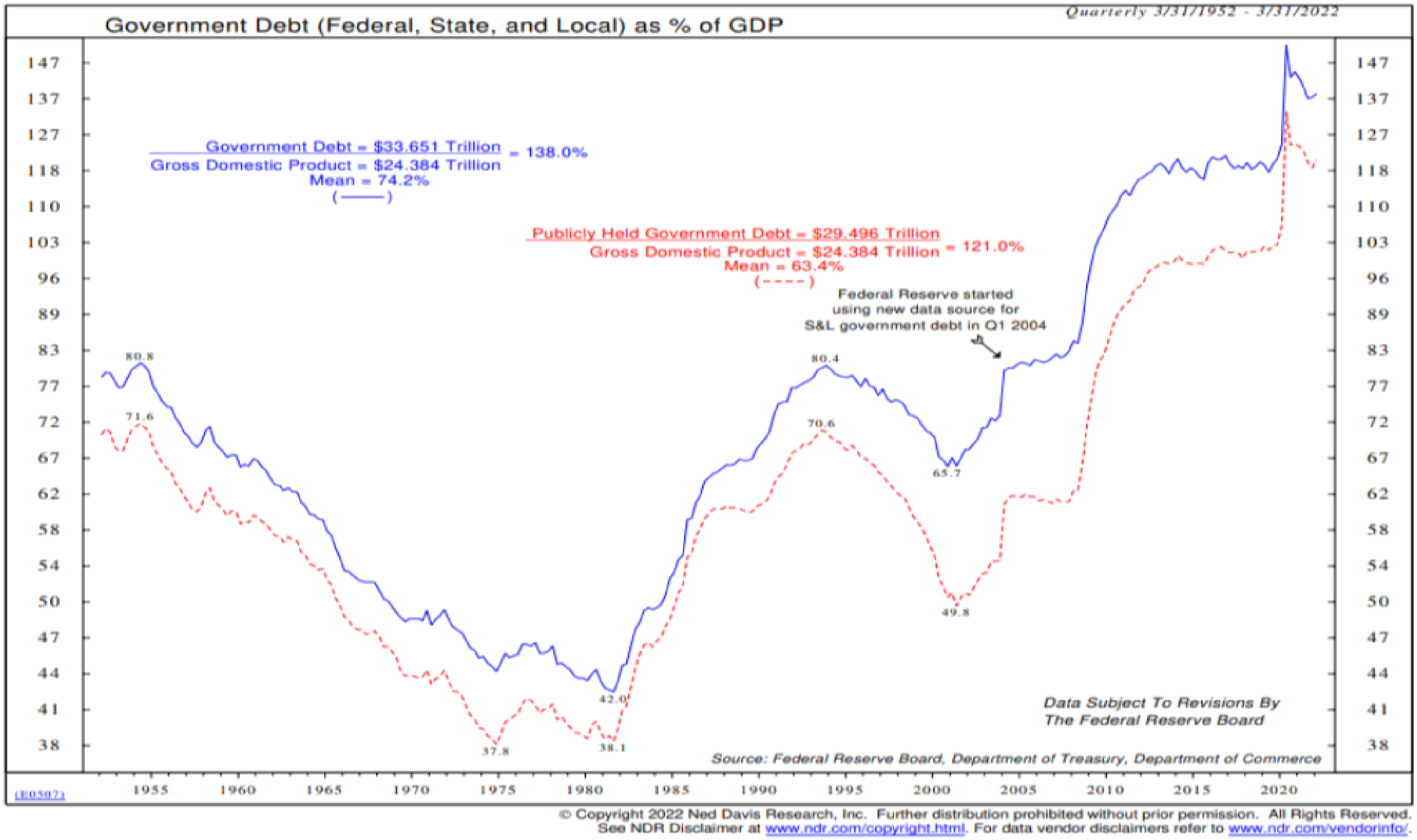




Source: Bloomberg, University of Michigan Chart Data: 31 March 1978-30 April 2022

Source: Ned Davis Research and Canaccord Genuity

The sell-off in high growth / high multiple stocks and risk assets could continue as interest rates rise and the cost of capital increases. It has been seen and proven that those stocks or assets that see a slowing growth rate typically see a compression in multiples. They are still growing and could be fantastic companies but the market won't assign a historically high multiple if the growth rate is slowing (even if the absolute growth rate is still high!) This is the primary reason we continue to heavily favor Value over Growth. The S&P 500 forward P/E has fallen to approximately 17x consensus estimates and the NASDAQ forward P/E currently around 21x. Although market multiples are lower and not as expensive, it is possible they could fall further to longer term (20 yr.) averages. Many economists and strategists are talking about comparisons to the 1970's where inflation was high and markets sold off. The problem today is that there is too much debt relative to Volker's era to use the same playbook.



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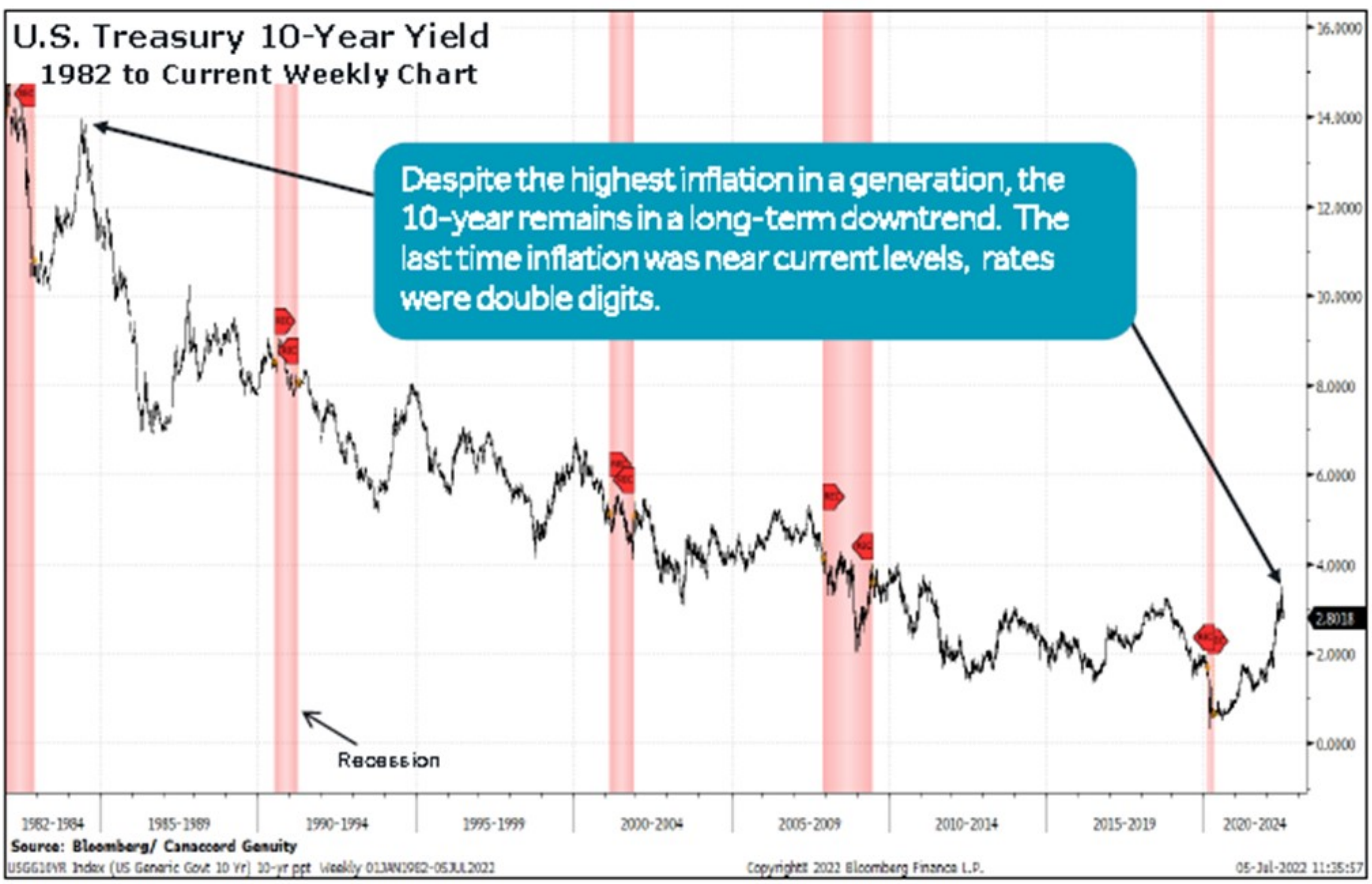


Source: Ned Davis Research and Canaccord Genuity

SUMMARY AND WHERE WE STAND IN OUR INVESTMENT OUTLOOK

The seemingly indiscriminate "take no prisoners" selling of stocks at certain points over the past 12 weeks (and since the start of the year) point to emotional market participants hitting the "panic button,". In the midst of what is likely to remain a bear market phase, it is not uncommon to find that "babies (good stocks worthy of ownership) get thrown out with the bathwater" on a day-to-day basis as traders driven by greed, fear and leverage do their thing and fret about catching the proverbial "falling knife" pondering where "the bottom" to it all will be found. **Such selling in our view likely presents longer-term investors like ourselves with opportunities to consider dollar cost averaging and "layering-in" to names placed "on sale" in the mayhem of a sell off.** A soft-landing scenario with inflation moderating somewhat without a hit to growth is our base case, and could surprise markets and is an upside risk.

In the US, there are some indications of a potential peak in inflation, including in goods inflation (look for example the inventory / sales ratio appears to have bottomed). Despite the difficult fundamental backdrop, our investment positioning we anticipate a summer rally like 1994, 2000, or 2018 based on the short period of time when the market transitions from the fear of higher interest rates creating an economic slowdown / recession to when the data shows it actually becomes a reality. As Tony Dwyer in New York wrote; *The summer rally in all these periods took place in this transitional window, which showed the following conditions: 1. The market stabilizes from an extreme oversold/pessimistic enough condition to generate a sharp bounce, 2. The belief the bond market had discounted the hawkish Fed, 3. The hope for the rare "soft landing" because the data was slowing, but not yet clearly recessionary. In addition, Durable Goods inflation, commodity prices, market-based inflation expectations, and long-term U.S. Treasury yields have fallen sharply. In other words, you still have the set-up for a summer rally: (1) Our intermediate tactical indicators are bouncing from extreme oversold and a positive internal divergence, (2) increasing expectations the Fed might be able to back off their planned hikes, and (3) weakening but still positive economic and corporate profit outlook.* Most investors don't realize that the major market indices made their lows in June.

While services inflation has been strong due to reopening pressures, early signs of a slowdown in the housing market will feed through to shelter inflation. China is implementing a number of easing policies to counter a contraction in its economy and some senior officials are pushing for more. While the fiscal policy is negative in most regions relative to the COVID-era, fiscal policy remains generally expansionary in the European Union and in the UK, due to various programs and subsidies aimed at mitigating the impact of cost-of-living increases. Further fiscal easing in the second half of the year is an upside risk, particularly in China and Europe, and could partly offset the global growth slowdown. Given the increases seen in the cost of borrowing, and a strong US (overvalued) Dollar, there is a possibility for an inflation surprise (lower number). It already appears that Fed Funds futures are now forecasting a possible CUT in the Fed Funds rate in 2023. The bond market has seen 10yr US Treasury Bonds move from 3.50% to the 2.85%. If equity markets see peaking inflation and interest rate increases? There could be an upside surprise to markets – and a big one!

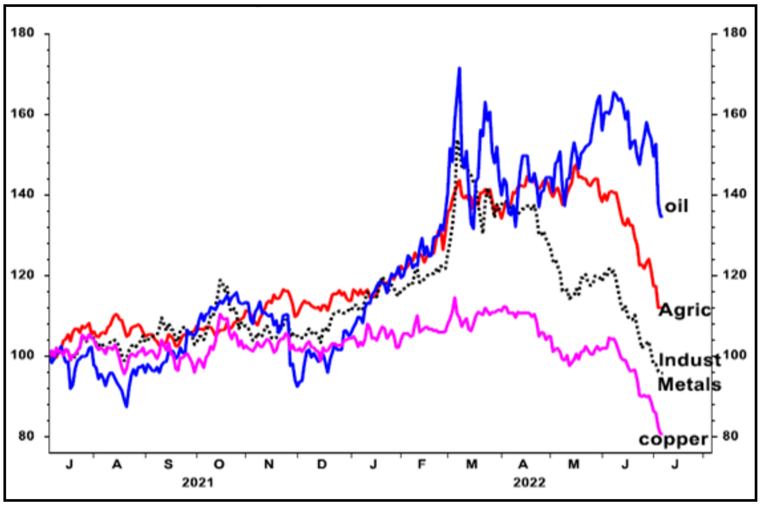
Over the quarter there were some instructive moves in commodity and speculative asset prices. Oil ended June down 14.5% from its high in March, Copper fell over 20% and Bitcoin dropped 58%. The falls in commodity prices may be signaling that investors' confidence in the economic recovery after COVID is waning, while the collapse of Bitcoin is a painful lesson about the rise and deflation of speculative bubbles. In such circumstances you might expect shares of steadily growing, so-called "defensive" companies to do rather better – as investors seek shelter from economically vulnerable industries or from "concept" companies, that may or may not ever earn a profit. We continue to see a case for diversified commodities exposure given structural inflationary pressures stemming from underinvestment in capacity and inventories at multi-decade lows. We reduced our exposure to commodities in May / June to reflect our view for an economic slowdown and increased recession worries.

With slowing growth putting pressure on prices, we favor industrial commodities with acute supply bottlenecks, such as aluminum, and those hit directly by curbs on Russia, such as oil. The oil market remains tight, though the lockdown-induced slowdown in China and the potential impact on demand forced us to cut our exposure to energy and copper.

COMMODITY PRICES HAVE SLUMPED IN THE PAST COUPLE OF MONTHS

Commodity	May Peak Closing Price	July 5 Current Price	% change
Copper	4.35	3.43	-21.1%
Aluminum	2,956	2,377	-19.6%
Zinc	3,965	2,984	-24.8%
Nickel	30,975	22,138	-28.5%
Tin	40,616	26,600	-34.5%
Lead	2,281.50	1,957.50	-14.2%
WTI Crude	117.61	103.42	-12.1%
Natural Gas	8.97	5.56	-38.0%
Corn	813.50	588.40	-27.7%
Wheat	1,277.50	823.50	-35.5%
Soybeans	1,737.50	1,460.60	-15.9%

COPPER LEADING THE WAY - SLUMPING 20% IN THE PAST MONTH



Source: Société Générale, FactSet

We maintain a bar-bell portfolio favoring pharmaceutical and health care companies whose services and products are deeply embedded in the lives of consumers and energy and materials. We see opportunities in cash-rich companies with solid business models, impressive margins and strong cash flow generation and are increasing their dividends and returning money to shareholders. Our investment positioning today is tilted more towards the value end of our "growth-at-a-reasonable-price (GARP) style. We have argued that inflation will continue to be elevated and be a problem that will not go away easily. We maintain exposure to gold and the gold companies we own also produce a lot of copper. With gold prices around $1750 and with copper prices around 3.35/lb, the earnings and cash flow generation for these companies will be significant. These companies also have solid balance sheets and pay healthy dividends. The unrelenting strength in the US Dollar has impacted gold and commodities in general, but we feel that the USD is overvalued. We believe the second half of 2022 should be better for markets and see the USD being vulnerable.

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;

Geoffrey Heward, Partner and Senior Portfolio Manager
The Heward Global Leaders Fund & Strategy
Phone (Mobile): 514-979-3441 Email: gheward@heward.com

heward.com

HEWARD INVESTMENT MANAGEMENT INC.