

Recession Concerns Increase as Central Banks Forced to Act and Catch Up to Inflation!

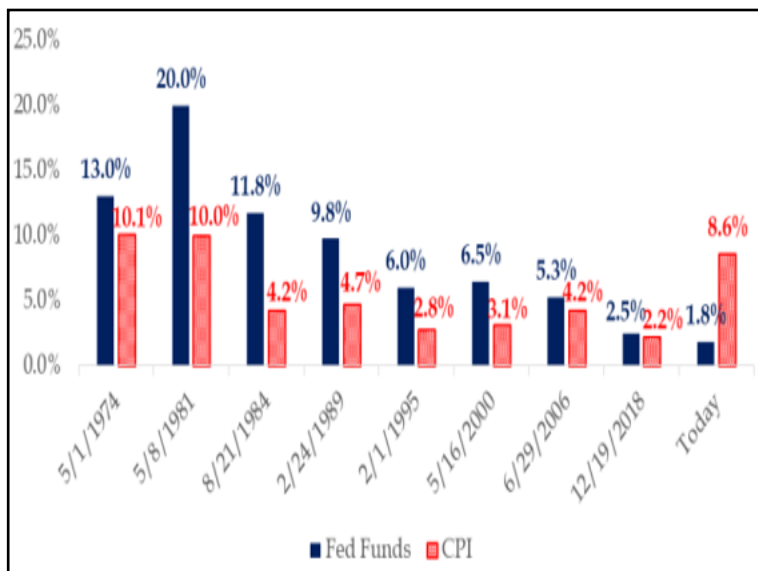
OVERVIEW

With the economic warning signs mounting, many are seeing the ghosts of the dot-com bubble, the 2008 housing crisis and the Covid crash preparing to strike again. Investors are starting to imagine the cracks spreading in the economic foundation. Inflation is at its highest level in more than 40 years, supply shortages and price shocks rage as war ravages Eastern Europe. Each one of these alone would gut investment values. Together, they have left many wondering what is coming next and how to prepare. The debate centers around whether inflation has accelerated to such an extent that a recession has now become necessary to bring it under control. There is also a variant perception centering on how long it will take for the Fed to complete its mission and bring inflation near its target of 2-2.5%. Its worth bearing in mind that since the 1970's, the Fed has only stopped tightening after the Fed Funds rate exceeded the prevailing rate of inflation as measured by the CPI. With the Fed Funds rate at a mere 1.6% and CPI currently running at 8.6%, we may have a long way to go. It seems reasonable to expect the rate of inflation to peak soon, but unlikely that the Fed will stop tightening any time soon.

Whether or not we get a recession, by any sensible definition we are in a bear market. It's been decades since a market sell off has been met with higher rates, and few people active in finance today have any experience of a moment like this. Markets have become a matter of valuation. While not a timing tool, valuations are critical in choosing which stocks offer compelling returns over the long run, and judged compared to their own history, U.S. valuations do now begin to look a little more defensible. As a multiple of expected earnings, the S&P 500 has returned to the middle of its range since the dot-com bubble. This isn't a compelling case to buy, but there isn't the screaming overvaluation of a few months ago. They could still go lower, but the bulk of the valuation-led part of the sell off is over. However, from a macro perspective, it seems logical that profits are going to come down. Higher prices will eat into demand and revenues, rising rates will increase financing costs, wage demands will tighten margins and so on. If companies have enough pricing power to get their customers to pay for their goods, then all is well and good. But the Fed is now on a concerted campaign to try to ensure that they can't do that. One of the first things one learns in this business is to "not fight the Fed".

Refineries world wide are struggling to meet global demand for diesel and gasoline, exacerbating high prices and aggravating shortages. World fuel demand has rebounded to pre-pandemic levels, but the combination of pandemic closures, sanctions on Russia and export quotas in China are straining the ability of refiners to meet demand. Two years ago, margins for making fuel were in the dumps due to the pandemic, leading to multiple closures. Now, the situation has reversed, and the strain could persist for the next couple of years. Operating U.S. refiners are running full-tilt to meet demand, with capacity use currently exceeding 92%, the highest seasonally since 2017. Meanwhile, Energy stocks have taken a big hit through the latter half of June. The reason for this pullback is not the hope that energy supply is set to surge, but that demand will falter as big economies get closer to recession. This reflects the contraction at the heart of all "Malthusian" bull markets: the fear that at some point, the rising cost of energy, or other commodities, will choke off the expansion on which the rise depends. Right now, the Organisation for Economic Co-operation & Development (OECD) leading indicators do show that the threat of a recession is growing. However, In Europe, energy storage facilities are running critically low, while in China once Covid restrictions are no longer seen as a threat, there will likely be a travel boom that causes energy demand to surge.

FED FUNDS TARGET RATE UPPER BOUND & CPI AT THE END OF PRIOR TIGHTENING CYCLES



Source: Strategas

UNITED STATES

Given the recent inflation and inflation expectation data, the Federal Reserve sent a clear and decisive message to the markets. By raising the fed funds rate by 75bp in mid-June, it amplified its intentions to end the year with a restrictive policy in place to help restore price stability. Given the lack of progress on this front in recent months, their plan is to raise rates more aggressively until there is clear evidence that inflation is coming down. As demand is still running hot and above available supply, their basic premise is that: if supply cannot rise to meet demand, demand has to fall to meet supply. Mr. Powell also noted that there remains a pathway to achieve this outcome without inducing a recession. Strong consumer balance sheets (and the willingness to spend) along with high levels of job openings would be key to cushioning the blow to the U.S. economy. However, the chairman also stipulated, that factors beyond their control (supply chain issues and geopolitics) would determine whether they can bring inflation down to 2% with a labor market still strong. An overheated housing market is another reason the Fed is raising rates. The questions being asked is whether the sector can be brought into some kind of even keel without causing an accident along the way, and which parts of the financial system might be most vulnerable. Higher rates have already-impacted the housing sector. Mortgage applications for home purchases, which tend to lead housing data like building permits and sales, have fallen sharply. As the housing sector acts as a leading indicator for other sectors (discretionary spending) this is a worrying sign for the broader U.S. economy.

CANADA

GDP growth is poised to remain positive in spite of lingering supply bottlenecks, shortages, elevated inflation and the removal of monetary accommodation, but it is moderating. After a strong start to the year, healthy household balance sheets, strong labor income, elevated commodity prices and the resumption of pandemic-affected services will support

BACK TO SOMETHING LIKE NORMAL



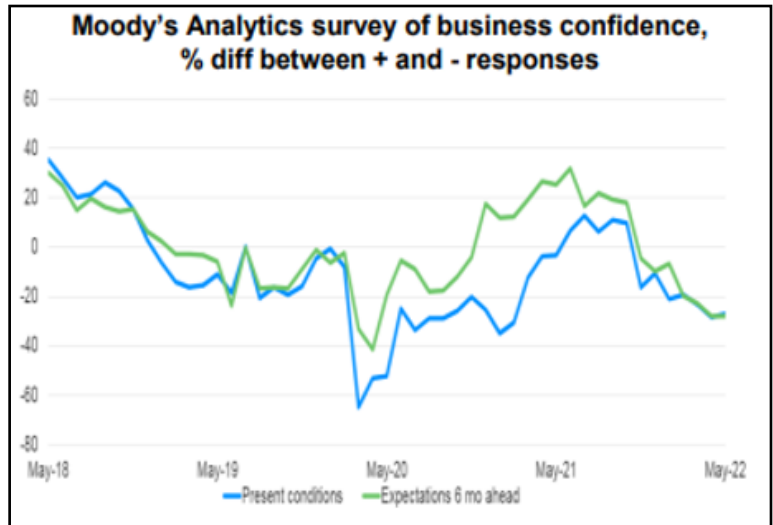
Source: Bloomberg

continued growth. Manufacturing however, may face slower growth as headwinds remain challenging. Inflation, which increased by 7.7% in May, has accelerated and broadened out in recent months and will remain elevated in the near term before slowing later this year and into 2023. The May increase was the fastest rise since 1983, with food, gasoline and accommodations being the main culprits. This is likely to push the Bank of Canada (BoC) to follow the U.S. Federal Reserve and hike rates 75bp in July. Like other central banks it faces a challenge as it fights the "inflation battle", as most of the inflation woes are coming from the supply side, which the bank has very little control over. It will continue to work towards dampening domestic demand in the hope that it can keep inflation expectations anchored and avoid wage pressures developing. Business investment is expected to remain elevated, supported by high commodity prices and a tight labor market. Surveys cite multiple reasons for wanting to invest more including: 1) to ease labor related constraints through digital technologies and automation, 2) to alleviate physical capacity bottlenecks or to address transportation and logistics challenges, and 3) to proceed with long-term investment plans as uncertainty related to the pandemic diminishes.

EUROPE

Activity in the euro zone is slowing down faster than had been thought. The composite purchasing manager index (PMI), including both services and manufacturing, has dropped sharply below expectations. Whether this has been driven by higher rates, China and/or the Ukraine/Russia conflict, or all of them, worries about growth are back. However, inflation has become a bigger concern. This matters, because the anchor for markets for the last generation has been the credibility of central banks, which has now been shredded with the return of Inflation. This has investors tracking closely what the European Central Bank (ECB) is saying and doing. They are also wary of the high levels of debt in Europe, in particular in Italy, and how a tighter monetary policy could become a

GLOBAL BUSINESSES LOSE EXUBERANCE



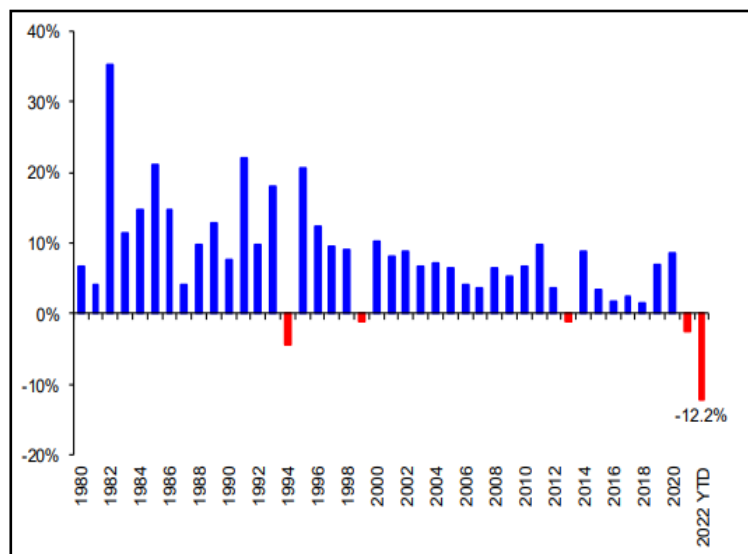
Source: Economap Inc.

financial constraint for these economies. From their annual conference in June, ECB President Christine Lagarde downplayed concerns about a recession in the euro zone while also saying that her team is ready to raise rates at a faster pace if needed. Having markedly revised down growth forecasts for the next two years, she still expects positive growth due to domestic buffers against the loss of growth momentum. Macro headwinds for the UK continue to build across cost-of-living issues, further drag on trade from Brexit and slowing capital account support. Rates are at the whim of a dovish but volatile Bank of England (BoE), which is facing increased political pressure from MPs, new fiscal support and another leg of higher energy prices. But the BoE has said that the trigger for more aggressive action would be evidence that inflation has become embedded in pricing behavior of firms.

EMERGING & DEVELOPING MARKETS

China is facing a rough period where the difficulties are immense. Domestically, there is a leadership squabble even though President Xi will probably be re-elected for a third term. The economy is in deep trouble not just from lockdowns, but from policies that have been pursued over the last year or so. Business and household confidence has been shattered and will take months to recover despite the stimuli packages that are being unveiled. Actual GDP won't recover this year and may also be weaker than anticipated for next year. China will also have to navigate a difficult international environment as external problems are magnifying. Weakening global business activity will impact exports while relations with America, Europe and others seem to be getting worse. However, Chinese 10-year bonds, which have ignored the trend in global rates for much of the last year, are quietly attempting to turn up right now. The implications are significant, and may speak to the market's expectation that the worst of the China slowdown (and Covid restrictions) is in the rear-view mirror. The Bank of Japan (BoJ) did absolutely nothing, as universally expected. Governor Kuroda rejected a need to conduct another policy

FTSE CANADA BOND UNIVERSE(TR) 30-JUNE-2022



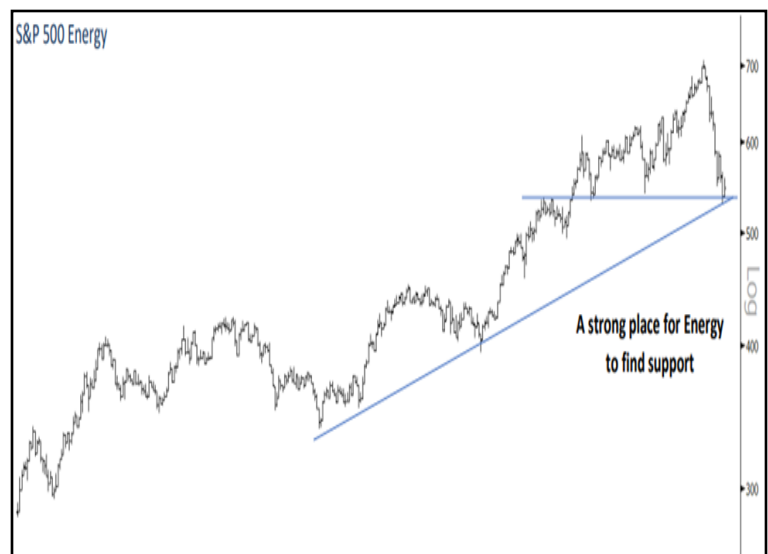
Source: Scotiabank

review and said that the sustainability of its 25bps yield curve control stance toward 10-year Japanese Government Bonds (JGB)s is not at risk. He went on to add that it would not be appropriate to tighten monetary policy, because that could cause an economic contraction. The BoJ to date has looked through yen weakness due to transitory effects on inflation that are incompatible with its medium-term inflation goals.

COMMODITIES

The recent downside moves in crude oil, and the resulting elevator rides down in energy equities has rattled investor confidence in the sector. Fundamentally, nothing has changed, with the oil complex remaining in a structural, multi-year tightening cycle that will go as far as demand will take it. Also, there are those that believe that the supply side of the equation has largely been de-risked. North African and North Sea physical crudes (barrels of last resort) continue to see incredibly strong buying trends. They are important markers and speak to the tight crude trading market. Also, drilled but uncompleted (DUC) wells in U.S. oil plays are at the lowest level since mid-2014, and are 57% below peak levels. Producers remain committed to maintenance-to-modest growth programs despite oil prices that now sit \$25.00+ above budget levels. Tight service conditions and raw material availability put governors on altering 2022 plans. If macro conditions hold, we would expect some growth in 2023. The decline (22%) in copper prices is the result of concerns over a Fed-driven recession. In the near term, further central bank tightening will likely exert more downward pressure on both demand and prices, even though supply has been negatively impacted by labor outages and protests in South America. Since June, the Ukraine, known as Europe's breadbasket, has been hunting for alternative paths to export its crops. Russia's blockade of Black Sea ports has stoked fears of higher global food prices and concerns over hunger. Producers are resorting to sales through European neighbors, forcing them to ferry grain by rail, road and river.

S&P 500 ENERGY



Source: MKM Partners JC O'Hara, CMT, CAIA

RECOMMENDATIONS

The tightening of monetary policy by global central banks has led to an extraordinarily difficult period for investors. Both stocks and fixed income have endured substantial losses on the back of growing pessimism that it will be difficult for the global economy to avoid a downturn. It almost seems as if inflation is “passe” and the growing focus is on the downturn! Our own work calls for a 40% chance of recession, but if it occurs, it should be shallow. Anticipating a recession, multiples (S&P 500) have fallen from just over 21X to levels more or less in line with their long-term averages. While a strong case can be made for current market levels having fully priced in higher inflation, it is far more difficult to make the same claim about earnings and earnings guidance. One of the trickier calls facing us now is evaluating the difference between a bounce in a bear market versus the start of a more durable advance. But, with the growing evidence of a cyclical slowdown, Europe still dealing with the impact of the Russia/Ukraine conflict and the U.S. beginning to feel the impact of a more restrictive monetary policy, we believe that any near-term rally would be nothing more than a bear market bounce with lower lows ahead. Until a clearer picture evolves, we will remain on the sidelines, maintaining an underweight position in equities.

However, we will be actively managing our positions, using market opportunities to both buy/add and sell/trim individual holdings. Our core focus remains on the basics, favoring businesses with secular growth, solid management teams, clean balance sheets and strong free cash flows. Technology, healthcare and energy remain favored sectors. Out of control inflation and tough Central Bank talk all around the world pushed interest rates out along the curve during the quarter under review. As a result, the bond market mayhem that started in the first quarter continued unabated. As global Central Banks are trying to catch up with the economic realities, short term rates are expected to rise further during the second half of the year. Mid and long-term rates, which have already priced in more aggressive tightening by Central Banks might pause around present levels and could even back off a bit once inflation begins to ease (Q4-early 2023). With nominal rates now at more interesting levels, the outlook for bond returns has improved. However, we continue to tread carefully in our fixed income components, keeping duration below benchmark and being more selective about credit quality.

FORECAST 2022

	CURRENT 30-JUNE-2022	2022 RANGE	2022 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	1.50%	0.25%- 3.00%	3.00%
Federal Funds Rate	1.58%	0.12%- 3.00%	3.00%
10-year Canadian Treasury	3.218%	1.43% - 3.75%	3.50%
10-year US Treasury	3.021%	1.61% - 3.75%	3.50%
COMMODITIES			
Gold (US\$/oz.)	\$1,807.90	\$1,790 – \$2,100	\$1,975
Oil WTI (US\$/lb)	\$105.73	\$74.00 – \$127.00	\$110.00
Copper (US\$/bbl)	\$ 3.695	\$3.50- \$4.75	\$4.25
MARKETS			
S&P/TSX Composite Index	18,861	18,000 - 22,087	20,000
S&P 500 Index	3,786	3,350 - 4,818	3,800
CANADA DOLLAR/US DOLLAR	\$0.7768	\$0.776 – 0.80	\$0.80

Heward Investment Management Inc.'s primary objective with this document is to provide timely information in respect of current developments in the financial marketplace and as such it may not provide sufficient detail for investors to make fully informed investment decisions. Although we endeavour to provide accurate information there is no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. All opinions are based on our analysis and interpretation of this information and constitute our judgment as of the date hereof and are subject to change without notice. Copyright © 2022 Heward Investment Management Inc. No portion of this article can be reproduced in any form in whole or in part without the express written permission from the copyright holder.

2115 rue de la Montagne, Montreal, QC H3G 1Z8

Telephone: (514) 985-5757

Toll Free: 1-800-567-5257

Email: info@heward.com

www.heward.com



HEWARD
INVESTMENT MANAGEMENT INC.