

# The Heward Global Leaders Investment Strategy

AUTUMN 2022

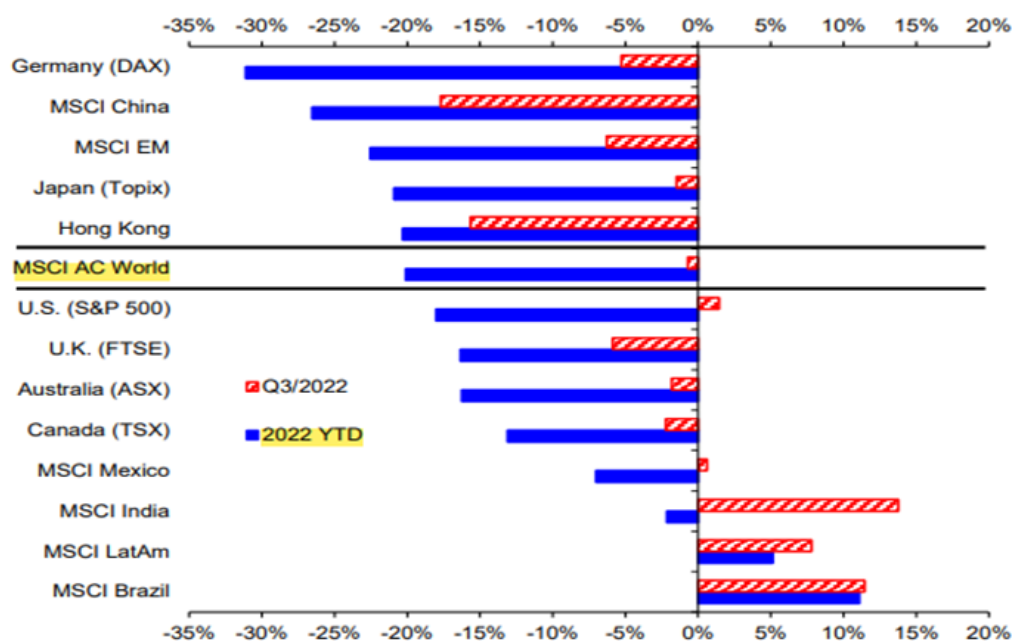


*“The stock market is a device for transferring money from the impatient to the patient.”*

– Warren Buffet

There is a character in Greek mythology called Sisyphus. The Gods punished him with the fate of rolling a boulder up a hill for all of eternity, then watching it roll down and starting again. Tasks or professions with a similar quality of being impossible to complete and repetitive are sometimes called Sisyphean tasks. If you haven't realized it yet, markets and the pursuit of gains through them meet the definition pretty well. Indeed, the first book on markets ever written by a Dutch trader named Joseph de la Vega introduces markets to his readers with this same mythological allusion. Remember that markets have perplexed people for hundreds of years and hopefully will for hundreds more. Markets today and the ebb from bull to bear market and back again are like the rolling of Sisyphus's rock of all stripes and with few exceptions. An interesting fact, year-to-date the S&P500 has seen 35 moves of 2% or more so far in 2022 vs 7 in 2021!

## GLOBAL EQUITY RETURNS (IN CAD\$) - Q3/2022 & 2022 YTD



Source: Scotia Bank, Bloomberg

**Year-to-date (ending September 30<sup>th</sup> 2022) the Heward Global Leaders Fund and strategy is down 11.42% vs. its benchmark down 17.18% and for the last twelve months -7.21% vs -11.80% respectively (all before fees and expenses).**

One could be excused for having the feeling that financial history is being written or perhaps said better? Rewritten! When stripped down to its basic elements, a major issue is a set of worsening tensions between the markets and governments (this dynamic has been particularly severe outside the US) and in this context, you can argue that the recent price action in almost all asset classes marks a clear rejection of the policies that dominated the post Great Financial Crisis (GFC) period and were overwhelmingly deployed in the COVID era on both the fiscal and the monetary side. Said another way? The “macro complex” especially foreign exchange and currency markets are punishing a lack of discipline, be it on behalf of policy makers, governments or speculators (crypto, meme stocks, ARK Funds etc.)

It has been said by various respected strategists we listen to that the US is the world's cleanest dirty shirt. This is not an overly original idea the dollar index is trading at levels not seen since 2002, or witness specific moves like USD/GBP (from 1.425 at the start of 2022 to under over 1.05) and the USD/EUR from 1.25 to 0.985. What about the US? Clearly the US is by no means exempt from this rejection-of-policy theme with one independent example being the S&P500 which is trading below where it

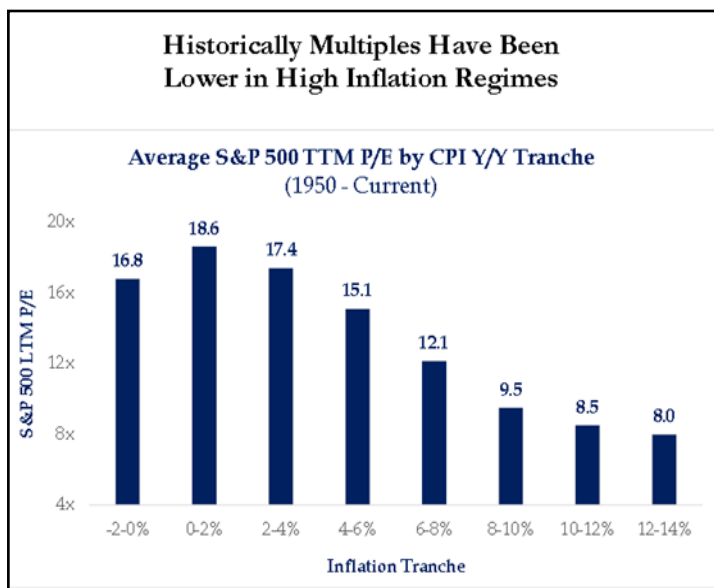
closed on the day of President Biden’s inauguration despite the fact that since that date, the US government has printed ~ \$1.7tr of Quantitative Easing (QE) in addition to ~ \$3.5tr of extra fiscal spending that has been passed (and approximately of that, \$1.7tr has been spent).

The world has been hooked on cheap money for years. Now we’re witnessing what withdrawal looks like. Lifting interest rates from basically zero has produced a historic crash in bonds and a sell-off in global equities. This is the product of the end of near-zero interest rates, with the Federal Reserve lifting its key policy rate a total of three percentage points in 2022, including another 0.75 of a point mid-September. Equally important, that has pushed real, or inflation-adjusted, rates well above zero. Measured by Treasury inflation-protected securities, the five-year real yield has risen to positive 1.60% from negative 1.61% a year ago, according to Bloomberg. Foreign exchange volatility has surged, with the U.S. Dollar Index DXY soaring to a 20-year high, creating huge strains for other currencies. The most notable loser: the British pound, as markets react violently to the United Kingdom’s plan to borrow to fund tax cuts. Japan has had to intervene to support the sliding yen for the first time since 1998, even as it tries to keep its interest rates low.

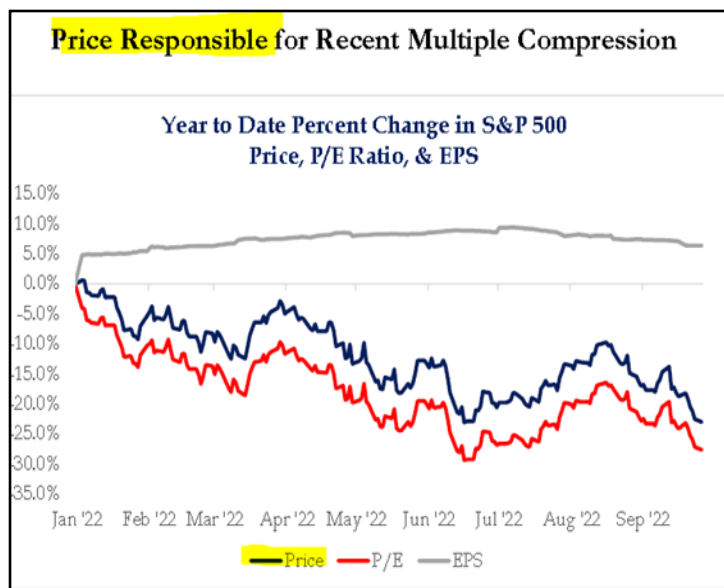
As we have written, there has been a saying of “Don’t fight the Fed” and today this saying is very clear. In September, Fed Chair Powell again noted the need to reduce the pace "at some point" but it is apparent it will not be soon. Powell in response to a question said; ““We will be looking for compelling evidence that inflation is moving down, consistent with inflation returning to 2%. We anticipate that ongoing increases in the target range for the federal funds will be appropriate. “Higher interest rates, slower growth and a softening labor market are all painful for the public that we serve, but they're not as painful as failing to restore price stability and having to come back and do it down the road again, at a time when actually, now people have really come to expect high inflation. If the concept of high inflation becomes entrenched in people's economic thinking about their decisions, then getting back to price stability, the cost of getting back to price stability just rises. So, we want to avoid that. We want to act aggressively now and get this job done and keep at it until it's done....”

The “market consensus” remains that virtually all the major economies will have brought inflation down to 2%, or only a little above it, by 2024 (and the Federal Open Market Committee (FOMC) members, whose median projection for 2024 is 2.3%, are with the consensus). We hope “consensus is right but unfortunately, we think this may be too optimistic. Markets have reacted to Powell’s words. So far, the declines in markets have mainly reflected lower price/earnings ratios; cuts in earnings forecasts are just beginning. Goldman Sachs strategist David Kostin has cut his year-end S&P 500 target to 3600 from 4300, reckoning that higher rates merit a P/E multiple of 15 times an assumed \$234 of S&P earnings per share in 2023 (or just under the \$240 Wall St consensus from FactSet). Jason Trennert, who heads Strategas Research, sees a profit recession that could cut 2023 S&P earnings to just \$200. He argues in a recent report that earnings recessions typically happen twice as often as economic contractions, and this one would reflect the faster rise in producer prices than in consumer prices. The estimated drop of about 10% would be far less than the median slide during a recession, however and the falling earnings estimates could mean the next leg of the bull market is upon us, he concludes.

**WITH HIGHER INFLATION AND HIGHER YIELDS, THE MARKET “P/E HAS FALLEN BACK TOWARDS HISTORICAL LEVELS**



Source: Strategas Research Partners LLC.



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For the S&P 500, here are various assumptions which derive possible outcomes. In yellow, are assumptions from Strategas Research. In green, are more optimistic assumptions (especially inflation coming down to the FED's 2% target).

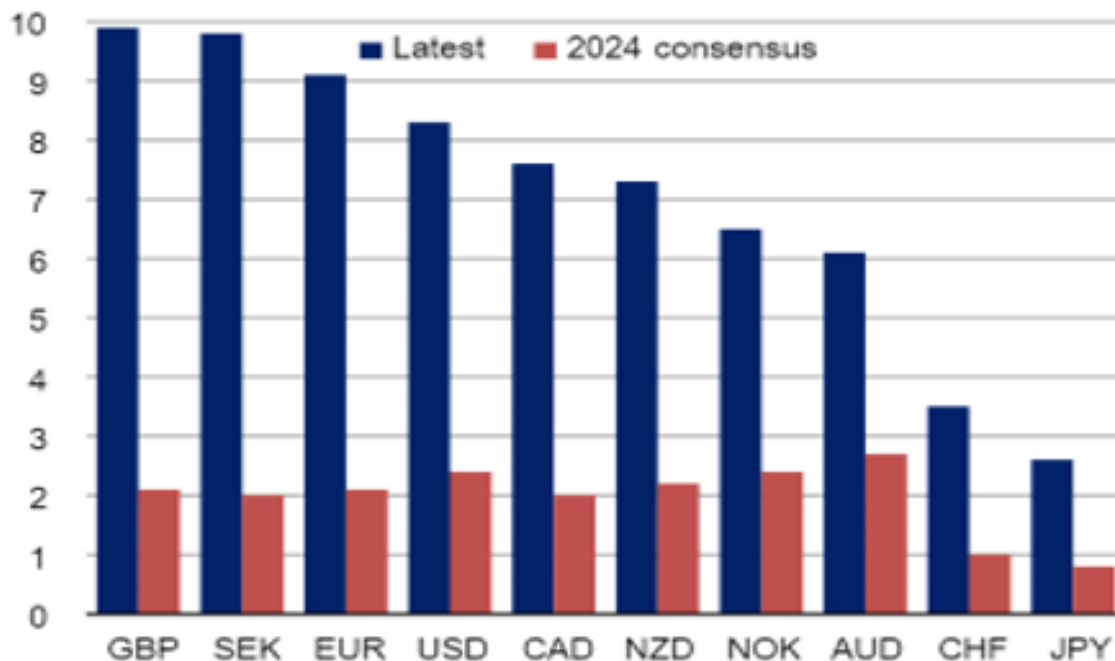
Expected Value Construction										
	CPI Tranche ?	-2-0%	0-2%	2-4%	4-6%	6-8%	8-10%	10-12%	12-14%	
	Avg Tranche P/E ?	16.8x	18.6x	17.4x	15.1x	12.1x	9.5x	8.5x	8.0x	
Earnings	Strategas CY'23	\$199.50	3,352	3,711	3,471	3,012	2,414	1,895	1,696	1,596
	Strategas CY'22	\$220.50	3,704	4,101	3,837	3,330	2,668	2,095	1,874	1,764
	TTM (3Q'22)	\$222.00	3,730	4,129	3,863	3,352	2,686	2,109	1,887	1,776
	Consensus CY'22	\$223.83	3,760	4,163	3,895	3,380	2,708	2,126	1,903	1,791
	NTM (3Q'23)	\$236.03	3,965	4,390	4,107	3,564	2,856	2,242	2,006	1,888
	Consensus CY'23	\$242.22	4,069	4,505	4,215	3,658	2,931	2,301	2,059	1,938

Source: Strategas Research Partners LLC.

We believe (and hope!) that markets (and the Fed) will be right that inflation rates will fall globally by late 2023 /2024.

### Exhibit 3: G10 latest and 2024 consensus inflation rates

Consensus still expects inflation to drop to 2% by 2024

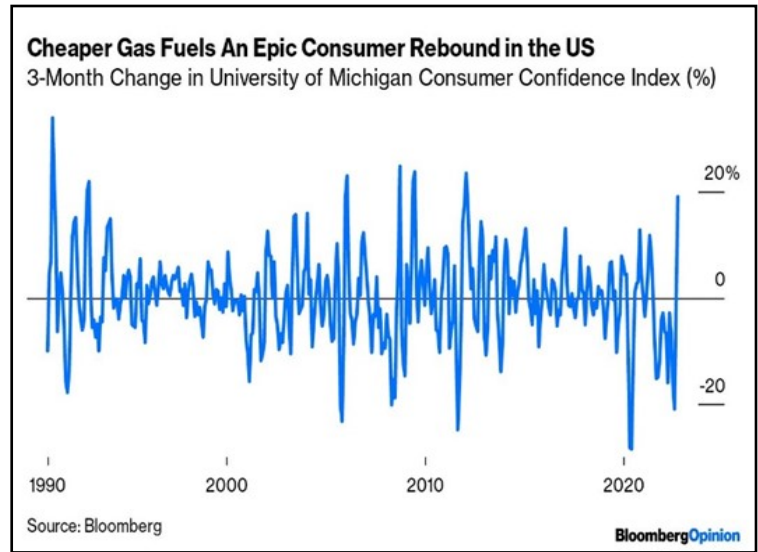


Source: Bloomberg and BofA Global Research

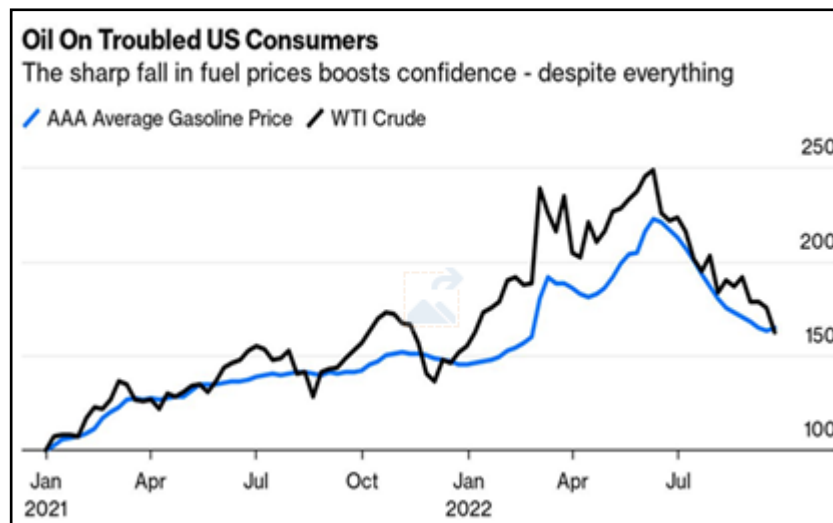
Evidently and unsurprisingly, confidence is much lower than it was before the pandemic. But in markets “it is the moves at the margin” that matter and the resurgence of optimism over the last three months, albeit from a low base, has been remarkable. Here is the rolling 3-month change in the sentiment index, showing that the last quarter has seen the biggest boost in sentiment in more than a decade.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

The rising gas price was bad for the Federal Reserve because it raised inflation. But the falling gas price, by stimulating extra consumption at a point when the Fed wants to engineer a slowdown, also promises to be a problem. It's also threatening many political calculations by reviving the fortunes of President Joe Biden, who appeared to be beyond hope only a few months ago. The oil market may yet have another move higher and its power should not be underestimated - neither should the enduring optimism and power of the US consumer.

## SECOND THOUGHTS ON INFLATION – WHAT IF / HAS INFLATION PEAKED?

Today, after saying that inflation was transient, the fear is that the Fed might overtighten as it embarks on its fastest rate-hiking cycle since the early 1980s and effectively tip the US economy into a recession. Central bank officials now forecast that rates would reach 4.4% by the end of this year and 4.6% in 2023, a more hawkish shift in their so-called dot plot than anticipated. What if these same Fed officials are wrong (again)? From Bloomberg on September 27, they wrote about what economist Ed Hyman has been saying to his clients: Should the Fed even keep tightening?

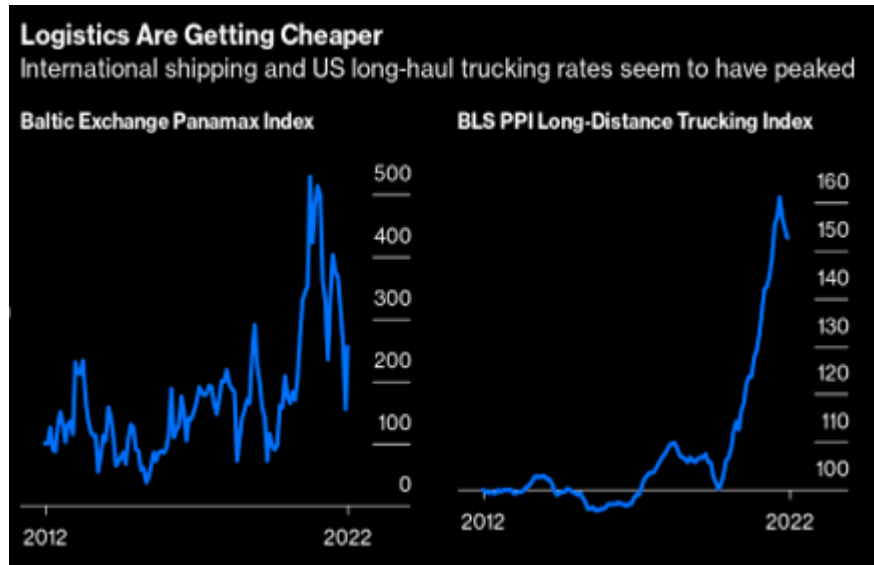
The founder of Evercore ISI enumerated 14 signs that inflation is abating. "So far, the Fed is not impressed and are ignoring these indicators" he said. His list of indicators that he watches and with his annotations in yellow are:

1. Commodity prices [have fallen and are still falling]
2. Median rent [falling in new leases]
3. Pricing power [the National Assoc for Business Economics finds more cos. have falling than rising profit margins]
4. Services Purchasing Managers' Index (PMI) prices [well below peak]
5. Manufacturing PMI prices [also well below peak]
6. Trucking freight rates [down from their May peak although still very elevated]

7. Shipping freight rates [back to typical prices from the post-crisis decade]
8. Used car prices [falling, albeit not as fast as hoped]
9. Core import price inflation [negative in each of the last three months]
10. Average hourly earnings [rising slower than prices]
11. Consumer inflation expectations [reduced and seemingly thoroughly under control]
12. Core Producer Price Index (PPI) [elevated but below its peak]
13. National Association of Business Economics (NABE) prices survey [moderating]
14. National Federation of Independent Business planned price increases survey [declining from historic highs]

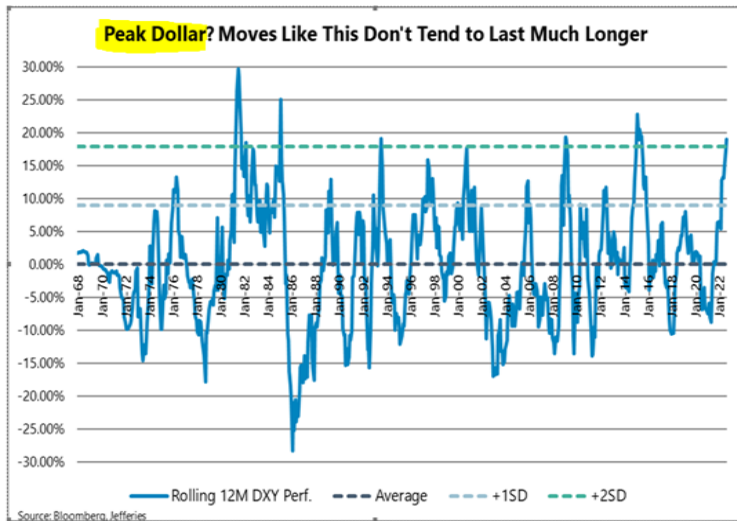
Bloomberg also reported in late September that US home prices are falling for the first time in a decade as higher mortgage rates begin to bite. The S&P CoreLogic Case-Shiller index, a national measure of prices in 20 large cities, fell 0.44% in July, the first drop since March 2012. The Federal House Financing Agency's survey, which already has numbers for August, suggests that last month saw the sharpest fall for national house prices in more than a decade.

Also, other indicators such as global shipping and North American trucking rates are falling.



Source: Bloomberg

**Finally, with the extreme moves in the USD, historically it doesn't last.** A weaker USD at some point, will benefit exporters, commodity producers and many companies in Europe, Asia (and the rest of the world).



Source: Jefferies Research, Bloomberg



Source: Bloomberg

All of these indicators need to be watched because as soon as markets get a whiff of slowing inflation, a peak in interest rate hikes and weaker USD, it could be the start of a sustainable turn in sentiment with higher asset prices ahead.



## SUMMARY AND WHERE WE STAND

For investors, there is a time for risk taking and times for patience. This year has taxed the patience of investors given the economic and financial realities. We have stated for a long time that given the economic, geopolitical and financial circumstances, playing defense and being conservatively positioned would be safest and best investment strategy. To be clear, this message is not one grounded in pessimism, but rather grounded in our belief that the best guidance and advice is being truthful and transparent, even if it can be difficult to accept or to convey sometimes. At the beginning of this year, we said that inflation was not transitory and that higher interest rates were ahead. We expected global markets would face various headwinds and uncertainty that investors would need to navigate.

Many people are expecting / hoping that the US central bank will “pivot” and stop raising rates or cut them given the declines experienced. We don’t see that happening. The Fed is likely to require more evidence that inflation is firmly under control and the US labor market is cooling before it eases off on interest rate hikes. With financial stress now appearing in places where central banks are unwilling to tolerate it, Morgan Stanley’s Chief US Equity Strategist Mike Wilson highlights that the primary question on many investors' minds has once again shifted to when the Fed pivots, not if. *With global US dollar liquidity now into the danger zone where "bad stuff" happens, it's only a matter of time before these stresses finally convince the Fed to back-off* he wrote. *The moment the Fed decides to put out the fire, stocks and other risk assets are likely to rally sharply. However, trying to play that for more than a tradable bounce is a bad idea because the market still has to deal with the oncoming earnings recession, which is likely to pick up steam this earnings season and next.* Mike points out that forward earnings estimates are down just 1% and adds that the Fed remains in tightening mode (for now) and dollar strength poses a further risk to corporate earnings.

There are some reasons to be hopeful, particularly for investors with patience. The US labor market remains relatively strong, inflation expectations have fallen, suggesting that conviction remains high that prices will come under control.

We stress for investors to think about being opportunistic and look longer term. Valuations across equities and bonds are much more favorable now than they were as we entered 2022. Our base case is that global equity markets will take a bumpy road higher by summer 2023. On balance, we think this is an environment to be invested and diversified, but also being selective. This is not an environment to be positioned too heavily for any given short-term scenario, but being opportunistic and having some exposure in owning high quality leading global brands.

Our long-standing saying of “expect the unexpected” certainly has played out and there are possible scenarios either positive or negative that could play out.

We maintain a bar-bell portfolio favoring pharmaceutical and health care companies whose services and products are deeply embedded in the lives of consumers as well solid exposure to energy. 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. Although our gold exposure has hurt performance, we maintain some exposure to gold as we believe earnings and cash flow generation for these companies will be significant. Most gold producers 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 and see the USD being vulnerable.

If you have any questions or would like to discuss our investment strategy, we would welcome the opportunity to meet.

### FOR MORE INFORMATION OR TO SCHEDULE A MEETING;

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