Quarterly Report
AUTUMN 2022

HEWARD
INVESTMENT MANAGEMENT INC.

Managing For Inflation, High Yields, Geopolitical Change & a Probable Recession

OVERVIEW

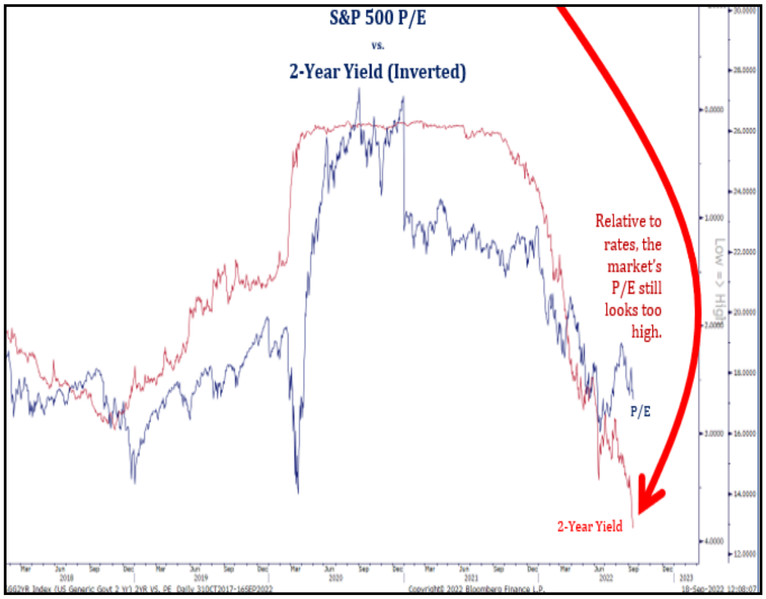
Global markets are at a crossroads, reflecting deep concerns around inflation, interest rates, moderating economic growth and elevated political uncertainty. Market sentiment has swung dramatically, from its bullish peaks in 2021 to extreme bearish levels in recent weeks. Sentiment indicators are now close to the lows of 2009. This is notable considering that the state of the economy is certainly stronger than 2009, when the U.S. economy was reeling from the impact of significant financial imbalances and an imploding housing market. Sentiment indicators are also reflecting the anticipation of economic headwinds and that consensus earnings estimates could be revised lower (but staying positive) in the coming quarters.

It looks like Fed Chairman Powell has finally made himself clear. First at Jackson Hole summit, then reiterated after the September rate hike; “we must keep at it until the job is done.” After a bizarre summer where markets had convinced themselves that a peak inflation story and possible “pivot” towards easier money was imminent, the Federal Open Market Committee (FOMC) announced another 75 bp rate hike. They also made it clear that they have a broader focus than just “peak inflation”, and that they will not pursue a stop-and-go strategy. It was a mistake in the 1970’s that did not work out well (stagflation). The pursuit of price stability may indeed cause economic “pain”, but for the Fed, that is understood & considered worth it.

The downward trend in 10-year Treasury yields that has persisted ever since the Fed under Paul Volcker slew inflation is over. If Jerome Powell and the Fed succeed as they hope, and replicate Volcker, then maybe they can start another downward wave. But that will be a new trend, not a resumption of this one. When viewed from a technical perspective, any version of the downtrend line has been breached, and the yield is now well above its 200-day moving average, a measure of the long-term trend. The 10-year yield broke slightly further above the long-term trend in 1994, which not coincidentally was the last time the Fed (under Alan Greenspan) surprised the market with an aggressive series of rate hikes. But it’s still a big deal that the most important measure in finance is the furthest above its trend in 28 years. As another indicator that the ice has been broken, all one needs to do is look at the losses that this selloff has inflicted. 2022 (end September) is already the worst year for bond investors in six decades.

U.S authorities have consistently taken the view that since all U.S. dollar transactions settle through bank branches in the U.S., they have the right to know the who is involved. This over-reach has never really sat well with many countries, especially China and Russia, and has led to speculation that in time, it would lead to the decline of the U.S. dollar-based payment system. Now, because of sanctions placed on Russia earlier this year, it looks like all roads will no longer lead to Rome! In financial terms, it means that more and more countries are looking to bypass U.S. controls (trade in dollars). As the links between Russia and Western economies have been severed, Russia is working to establish new trade links with the rest of the world. This is being implemented with a new payment system independent of the dollar. This correlates well with China’s geopolitical (and economic) aspirations. A key goal is to pay for imports, especially oil, in renminbi as they are already doing with Russia. China has also promoted the idea to Saudi Arabia. In addition to Russia and China, the new system has clear attraction for Iran, Turkey, and possibly India (and others), and would be a game changer for them. In short, the writing is on the wall. The U.S. dollar network has started to contract, and the contraction is set to accelerate with fewer transactions being implemented in U.S. dollars.

RATES BURDEN MULTIPLES



Source: Strategas

UNITED STATES

The fall is upon us and President Biden is enjoying somewhat of a rebound, while the sense of gridlock that had dominated Capitol Hill for a year appears to have broken. The Biden's team will be stepping up its regulatory and foreign policy agenda as just around the corner are the midterm elections, which will be more competitive than expected. At the Jackson Hole summit, Fed Chairman Powell's speech was brief, but packed a punch. He made it clear that while rising interest rates, slower growth and a softening labor market "would bring pain to businesses and households", the Federal Reserve remains laser focused on tamping down decades high inflation. But, with a still strong labor market (initial jobless numbers keep declining), wage growth tracking 5.2% (August), urban consumer shelter rates still climbing and the U.S. Corporate Bankruptcy Index at multi-decade lows, Chairman Powell and the Federal Reserve do not have to blink. The level of interest rates also matters of course, but so does the duration of time in restrictive territory. The Fed may indeed stay hawkish for an extended period, but there is already some evidence they are getting what they want. U.S. housing (an interest rate sensitive sector & leading indicator) is clearly weakening with affordability at its lowest point. Nonfarm payrolls continue to rise, but there were downward revisions to early summer months. Furthermore, supply chain issues seem to be evaporating. Surprisingly, the latest U of Michigan sentiment survey shows a resurgence of optimism among consumers, but it is from a very low base. How is that possible? Look no further than the oil price.

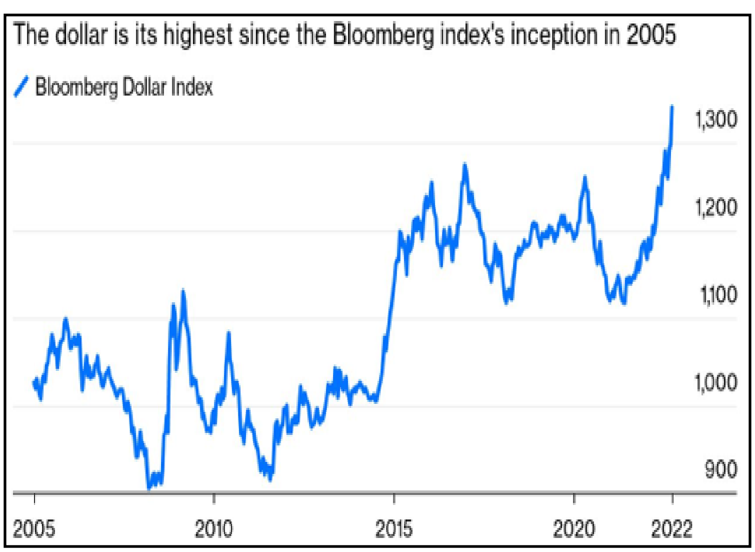
CANADA

The Bank of Canada's (BoC) tighter monetary policy is starting to curb activity. Higher mortgage rates have put a damper on sales and home prices across large Canadian cities. While the banking sector's mortgage book is considered very "low risk", this, along with slowing economic growth may become a valuation headwind for Canadian banks. But the group is expected to experience only modest losses through the next credit downturn. In sharp contrast to the U.S., Canada's job creating machine is clearly losing momentum. August numbers were the third straight month of job losses pushing the unemployment rate up to 5.4%. Since May, Canada has lost 114,000 jobs in three back-to-back months, which historically has not occurred outside of a recession. The BoC however, is expected to stay the course until it is convinced that the over inflation is won. On this front, there is still work to be done as the August data showed food inflation hitting new highs. As the extended and broad-based inflation eats into Canadians' wallets, they will likely curtail discretionary spending. The recent collapse of Western Canadian Sedimentary Basin (WCSB) natural gas prices is in sharp contrast to what is happening globally. The compounded impact of several maintenance restrictions across the WCSB pipeline system and connected export pipes is the main cause. Two features of the Alberta Crown royalty system may be contributing to market distortions, but prices should recover during the winter season. On a more positive note, the Canadian economy should benefit from the outlook for energy and commodities. Supply issues and droughts should be enough to sustain high prices.

EUROPE

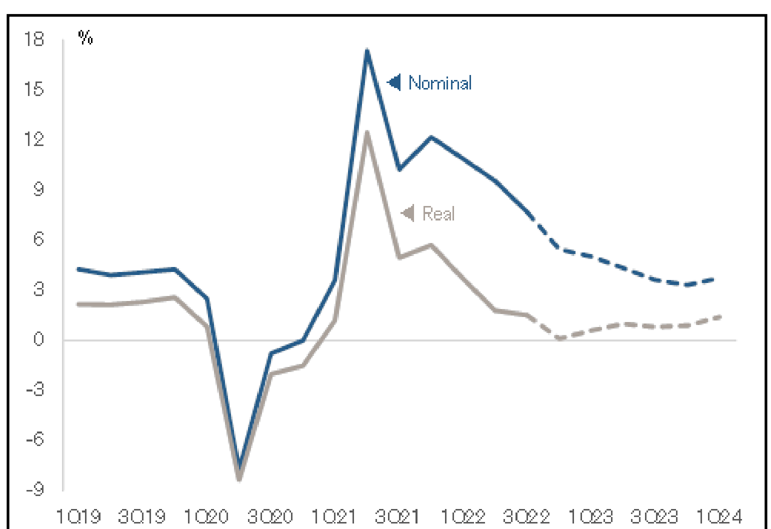
The economies of Europe and the UK are facing more extreme inflationary pressures than are those in North America. Clearly the war in Ukraine has been more harmful, with both the proximity and the fall-out from its dependence on Russian fossil fuels largely to blame. Earlier this summer the European Central Bank (ECB) unveiled its first interest rate hike in more than a decade, ending the era of negative interest rates. The ECB raised rates once more (75bp) in September as inflationary pressures seem to be more entrenched. Also in September, the 19-member euro zone agreed to take coordinated and targeted steps to shield households and businesses from rapidly rising energy costs. Any interventions would be coordinated with the monetary policies of the ECB

NEW TERRITORY



Source: Bloomberg

NOMINAL AND REAL GDP WITH CONSENSUS FORECASTS



Source: Credit Suisse

and efforts will be made to avoid adding to inflationary pressures. Scorching temperatures through the summer drained some of Europe's main rivers. Shipping costs skyrocketed, fueling already high inflation, as the rivers are key arteries for transporting everything from grains, to chemicals to oil. The low water levels also curtailed hydropower generation, adding to Europe's energy problems. In the UK, the Bank of England (BOE) warned it would raise interest rates as much as needed to hit inflation targets. Meanwhile, markets became concerned that the new government's plans for big tax cuts ($48us billion) with no spending reductions would spark higher inflation and put both their growth agenda and finances at risk. Forced to do something over investors' angst about the potential for a crisis in global debt markets, the BOE said that they would be buyers of long-term UK bonds.

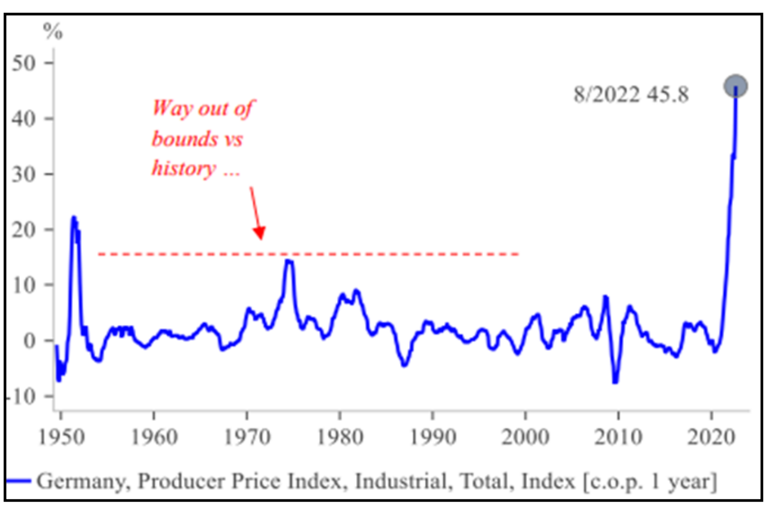
EMERGING & DEVELOPING MARKETS

China's 20th National Congress of the Chinese Communist Party is set for October. Priorities established during the event will help set China's political, economic and foreign policy trajectory for the next five years and beyond. China faces several issues (both internal and external) which has caused growth to slow this year. The external includes frayed relations with the U.S., growing tensions over Taiwan, and a focus on building an alternative (to the U.S. dollar) trading and currency platform. Internal problems include the impact of rolling lockdowns, falling real estate activity and declining household and private business confidence. On the real estate side, it seems local government financing entities are borrowing funds to make huge land purchases to inject cash into cities and provinces that are under stress due to the collapse of private property developers. Meanwhile, China has taken on a leading role, together with Russia, in building up the "New Alliance", an alternative structure to the Western Alliance's dominant role globally. This has clearly taken up a lot of the leadership's time. The sound and fury associated with global central banks tightening (and some not) has detracted attention from the growing stresses in the world's frontier economies. It is tempting to dismiss troubles in frontier markets as unimportant, but that would be a mistake. The top 15 frontier economies account for an 18% weighting in JP Morgan's EMBI global diversified index. In spite of support packages by the IMF for a number of countries, this means there is a sizable risk of contagion to the broader emerging market bond complex should stresses rise further.

COMMODITIES

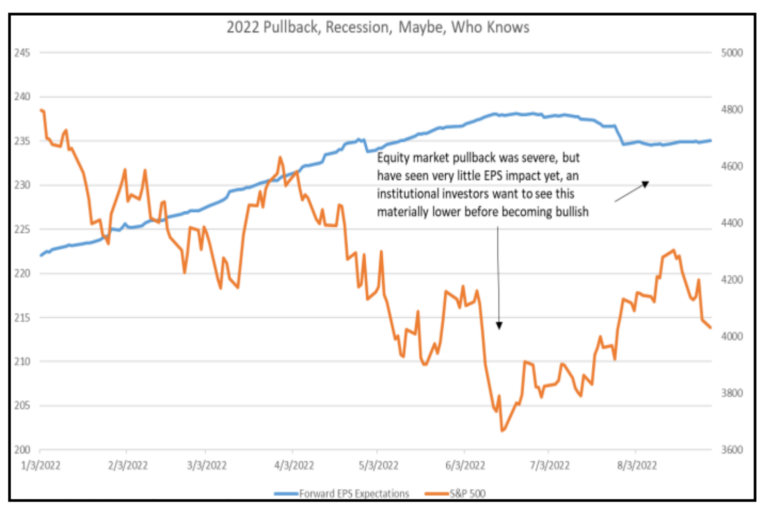
When OPEC+ meets in October, they will have to decide "how much fire power to deploy to staunch a sum-of-all-fears macro selloff that caused crude to slide below pre-invasion levels" (RBC Capital markets). They see a good chance that the group goes for a sizeable cut to signal that there is indeed an effective circuit breaker in the market. The tricky part is the balancing act between considerations of how many barrels may come off the market due to the ongoing Russia-Ukraine war and how much they want to front-run what could be a significant outage in the coming months. With markets very tight. Some of the hottest hot cakes this winter are ships able to ferry oil and gas. Vessels are being booked out, driving up freight rates of everything from Liquified Natural Gas (LNG) to crude to naphtha imports for Northeast Asia. The ongoing cyclical slowdown is a clear headwind for metal commodities. We expect a strong recovery from this downturn, but it will take time as a gradual, policy driven recovery in Chinese demand is offset by near-term weakness in the West. While policy support is being rolled out in China, COVID restrictions and the property market downturn are still problems, and recovery in China may take longer than previously thought. Meanwhile, the global agriculture complex continues to tighten. If the droughts in Europe, China, and the Corn Belt weren't enough, the floods in Pakistan have destroyed half of the country's crop. With one-third of the country underwater, it's unlikely that wheat can be sowed in October. This will boost Pakistan's need to import grain. Pakistan also supplies 5% of the world's cotton, and at least half of the crop is now ruined.

GERMANY PRODUCER PRICE INDEX (PPI) YoY %



Source: Strategas, Bundesbank, Macrobond

WE ARE IN AN UNCOMFORTABLE PLACE – INDEX DOWN, WAITING ON EPS...



Source: FactSet, Raymond James Research

RECOMMENDATIONS

With central banks' all out attack on inflation, global economic activity is clearly slowing. While not in recession, China is feeling the impact of slowing global trade as well as Covid shutdowns. If not already in one, Europe will almost certainly enter recession while North America teeters on the edge of one. As such, earning estimates are probably too high, putting markets at further risk. Thus far market declines have been driven far more by multiple compression than earnings adjustments. And, while the growth in inflation may have peaked, the run-rate of inflation will be higher than pre-pandemic due to several factors, including wages and rents. So numerous central banks have gotten more restrictive (often by more than expected), giving us reason to worry less about inflation "surprises" and focus more on possible recession scenarios. We continue to anticipate choppy conditions through year end, as stocks are caught in a tug of war between deeply bearish sentiment (bullish) and further tightening and its longer-term economic ramifications. Given our macro-outlook we are maintaining our equity exposure below benchmark, but as always, will use market opportunities to buy/sell and/or add/trim positions. Higher inflation for longer suggests shorter duration equities that return money to shareholders will outperform long duration stocks trading at steep valuations. Geopolitical concerns, demand for energy and materials, as well as droughts, have us favoring domestic over international equities. Despite early signs of softening economic growth, central banks are continuing their attack on inflation. But while we are getting close, and believe that bond markets have already priced in an imminent top (especially in Canada), its still too early to call one. Mid term rates are still above June levels, but long-term rates have actually declined, especially in the government sector. Meanwhile, widening credit spreads have continued to push yields higher on corporate bonds and preferred shares. Here too, however, we expect to see some respite. Given our outlook, we have been reducing our exposure to preferred shares while increasing our short and mid term vehicles. With nominal yields now at much more interesting levels, we expect to achieve positive returns going forward.

FORECAST 2022	CURRENT 30-SEPTEMBER-2022	2022 RANGE	2022 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	3.25%	0.25%- 4.00%	4.00%
Federal Funds Rate	3.25%	0.12%- 4.25%	4.25%
10-year Canadian Treasury	3.17%	1.43% - 3.65%	3.25%
10-year US Treasury	3.81%	1.61% - 4.1%	3.90%
COMMODITIES			
Gold (US$/oz.)	$1,659.70	$1,627 – $2,070	$1,750
Oil WTI (US$/lb)	$79.71	$74.00 – $130.00	$84.00
Copper (US$/bbl)	$ 3.395	$3.00– 5.03	$3.30
MARKETS			
S&P/TSX Composite Index	18,444	17,600 - 22,250	18,000
S&P 500 Index	3,599	3,350 - 4,806	3,500
CANADA DOLLAR/US DOLLAR	$0.7240	$0.71 – 0.81	$0.74

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