HEWARD
INVESTMENT MANAGEMENT INC.

Managing for Inflation and the Most Anticipated Recession That Markets Have Ever Forecasted!

OVERVIEW

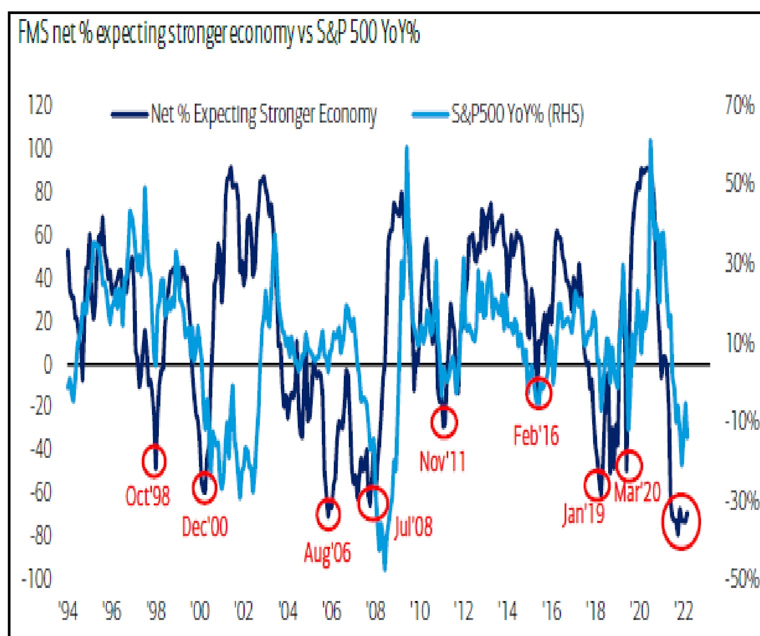
2022 turned out to be a year in which growth generally disappointed, central banks struggled with sticky inflation and the lingering effects of the pandemic remained the biggest source of uncertainty for macro and market outcomes. Also, Russia invaded Ukraine, which has come to be seen as the fundamental moment of change for the post-Cold War world. Prices were already rising sharply as economies emerged from the pandemic, but Putin's war supercharged food and energy costs, helping push headline inflation rates to four-decade highs across the US, Europe and most emerging markets (EM). More worryingly, as recovering demand ran into supply constraints, core inflation increased to rates not seen since the 1970s. In response, central banks spent most of last year scrambling to raise interest rates, resulting in the most aggressive tightening cycle seen in four decades. The flip side of rapid policy tightening is the growing likelihood that the global economy falls into recession. Surveys are now consistent in showing a sharp slowdown in growth and recession in Europe, while at the same time pointing to a high probability that the US will be in recession at some point in 2023.

Investors aren't supposed to fight the Fed. It's one of the most constant aphorisms driven into the mind of any investor that they should never do it. But in the later part of 2022, the conflict intensified. In December, the Fed brushed aside good news on prices and revised the interest-rate path upwards and economic growth down. After raising interest rates by the expected half-percentage point, Fed Chairman Jerome Powell and his colleagues laid out an economic and interest-rate forecast premised on a painful, drawn-out battle with inflation, completely at odds with the markets.

Prices at the pump, as measured by the American Automobile Association, are now below their level on the eve of Russia's invasion of Ukraine. This reduces headline inflation, but also possibly increases pressure on other prices by releasing money from household budgets. But the critical point is that one of the biggest one-time upward pressures on inflation is in abeyance for now. However, this doesn't seem to have affected the market's implicit judgment that a recession is coming soon. Two of the best mainstream market indicators of economic bearishness are the bond yield curve (if shorter-term yields are higher than longer-term ones, that implies a belief that the economy is due a fall) and the ratio between consumer discretionary and consumer staples stocks (when discretionary stocks underperform, it implies that bad times are coming). On these simple measures, a recession looks ever more likely.

2023 could be a year where underinvestment in commodities (not just oil) comes back to bite! Just as commodity markets have been dominated by the dollar in 2022, they are likely to be shaped by the lack of investment since after the Great Financial Crisis. From a fundamental perspective, the near-term setup for most commodities is more bullish than it has been at any point since initial comments of a super cycle possibly developing back in October 2020. Despite broadly depleted working inventories and spare capacity nearly exhausted across most markets, capital in 2022 proved to be unresponsive to near record prices as market positioning remained skewed for a recession. However, the global business cycle is far from over. Global economic growth will be underpinned by China, which is already seeing the reopening happening, Europe improving its energy efficiency in a one-off decline in industrial activity and the eventual slowing of the aggressive Fed rate hikes in the U.S.

GLOBAL GROWTH EXPECTATIONS PESSIMISTIC BUT TENTATIVE SIGNS OF TROUGH



Source: BofA Global Fund Manager Survey, Bloomberg

UNITED STATES

Given the signals from Federal Reserve officials, the Fed's downshift to a 50 bp hike in December was not a surprise. This came in spite of an employment report that showed continued strong hiring and brisk wage growth, trends that the Fed is trying to slow to prevent from growing embedded across the economy. Capital spending data was also strong. Falling prices for energy, automobiles and houses and soft readings on consumer prices had made investors borderline euphoric over the outlook for inflation. However, the Fed was having none of it. After raising interest rates by the expected half-percentage point, Fed Chairman Powell and his colleagues laid out an economic and interest-rate forecast based on a painful, drawn-out battle with inflation and going against investor aspirations. According to the central bank's latest forecast, the U.S. economy could slow to a crawl in 2023. However, there are several cushions that could help limit the damage. While it may seem reasonable to expect consumers to become more cautious, there remains excess cash savings left over from the fiscal stimulus which came about in response to the pandemic. Also, the latest data shows personal incomes rose more than expected. The U.S. labor market is so tight that there are nearly 2 job openings for every person unemployed, with mounting evidence of labor hording by companies who seem to be reluctant to shed jobs. Meanwhile, U.S. policy is shifting from one of globalization over the past 40 years, to one of de-globalization, and these policies are accelerating. In the past six months, Congress has paid the semi-conductor industry $75B to come home.

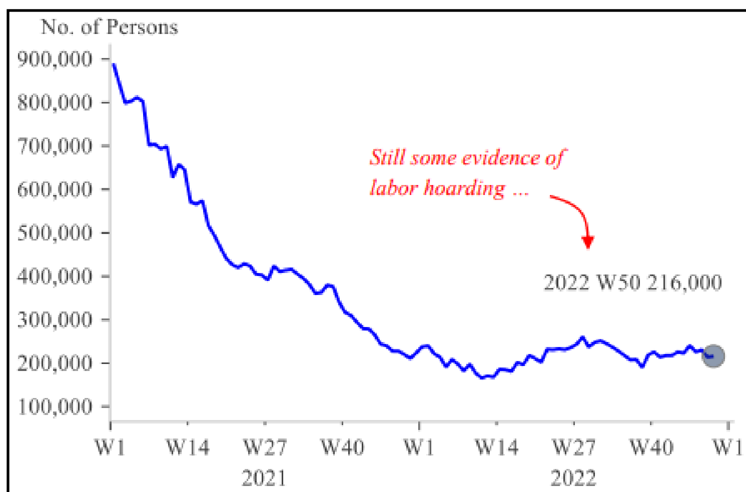
CANADA

Canada has been a world leader in terms of cumulative GDP growth over the past five quarters during which the economy has gone on a tear. However, inflation came in much higher than what had been forecasted, driven in part by the Russia/Ukraine conflict and in part by tightness in the labor market. After scrambling to raise rates all year long, the Bank of Canada (BoC) hiked rates by 50bps at its last meeting of the year, but left the door a little "less open" to continuing to raise its policy rate. It appears that they have taken the first steps to sounding more cautious with their forward guidance from the October meeting, and built upon that in December. Instead of "will need to rise further" alongside conditional language around future hikes after this one, they are now "considering" whether to hike again. On the surface it sounds a little less decisive, but as the policy rate pushes further into restrictive-territory they should be transitioning toward something that is more sensitive to new information. Their concerns about doing too much, are an indication that "the effects of recent policy rate increases are becoming evident in interest-sensitive areas of the economy" (read housing market). Canada's overreliance on housing for economic growth, could turn out to be the driver of a "more severe recession" than currently forecasted. But, while the Canadian economy is more interest rate sensitive relative to the U.S. and other developed economies, it has a better chance at a "soft landing". Elevated oil prices on China's reopening, tight inventories and the need to refill the Strategic Petroleum Reserve should all support the economy and a stronger dollar.

EUROPE

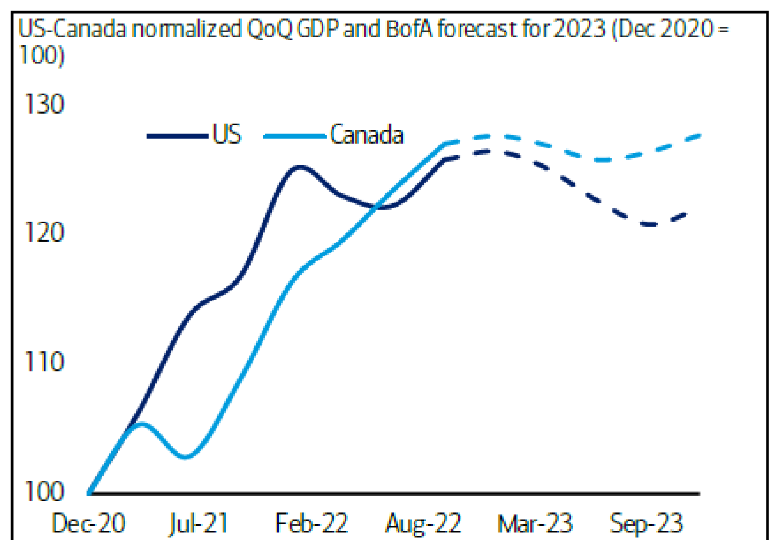
For the first time in 17 months, inflation in Europe appears to be easing. According to the first look at official data for the 19 countries that use the euro, November's data was down from a record 10.6% jump the previous month, and was lower than economists were expecting. Prices are still rising at an uncomfortable pace however, with food and energy the main culprits. While facing stronger near-term headwinds than the US, Europe may have scope to grow faster beyond the next six-to-nine months, but a stabilization of the European energy market is essential for euro area durable goods consumption to improve. As their key trading partner, China's economy remains the wildcard for European economic activity. However, with the European Central Bank (ECB) governing

US JOBLESS CLAIMS, INITIAL, TOTAL SEASONALLY ADJUSTED



Source: Strategas/BLS/ Macrobond

WE EXPECT HIGHER GROWTH FOR CANADA IN 2023



Source: BofA Global Fund Manager Survey, Bloomberg

council members generally sounding hawkish, the broad message for the market is that it should not get ahead of itself and price in a policy pivot. ECB President Christine Lagarde, said that they must keep raising interest rates to fight off inflation, even if it increases the odds of a euro zone recession. The performance of the labor market will be key. It is worth noting that over the last 50 years, every time employment fell, the ECB or its predecessors, cut interest rates. While Europe has been hit hard by the fallout of the war in the Ukraine, UK companies are suffering far more than their mainland counterparts. Inflation is running higher than its group of seven industrialized peers (except Italy). GDP shrank in the third quarter, likely setting up the UK for recession in 2022, and the British economy is forecasted to shrink in 2023 as well, faring worse than every G20 economy except Russia.

EMERGING & DEVELOPING MARKETS

The results of the mid-October's 20th Party Congress initially led investors to fear the continuance of growth-destroying policies. Instead, those feared policies are now seemingly being dialed back. With the draconian measures to contain the omicron variants becoming politically unsustainable, the government has given up on its Covid containment strategy, and shifted its focus instead, on reopening the economy. The last few weeks have also seen a significant pivot on property policy. The latest measures, which include a central-bank relending program and the lifting of longstanding restrictions on equity market and shadow finance fundraising, should be more effective. While easier financing is not a silver bullet, the clearer trajectory toward reopening also greatly improves the chances of a successful stabilization of the property sector, and thus of overall economic growth. The Bank of Japan (BOJ), the last proponent of ultraloose monetary policy, has becoming fractionally more hawkish. Before Christmas, the BOJ said that it would allow benchmark bond yields to trade as high as 0.5%. The context in which they offered this change may now fan a prolonged period of speculation that it may be building up to bigger potential changes. 10-year bond yields have surged past their previous ceiling. India's economy is recovering nicely, even if the latest quarterly growth data showing a 13.5% year-on-year expansion was flattered by favorable base effects. Looking forward, the problem is an adverse external backdrop that is hurting exports and leaving India's capital markets vulnerable to another risk-off move as global liquidity tightens.

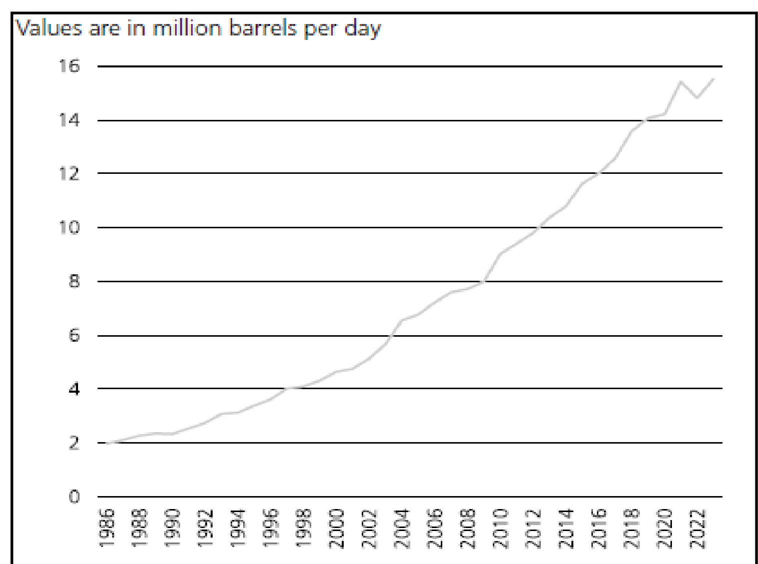
COMMODITIES

The recent December 4 OPEC+ ministerial meeting and December 5 launch of the European Union's (EU) sixth package of sanctions are largely viewed as events that can be considered as key milestones for oil prices next year. The measurable impacts from these policy decisions however, remain unclear for now while the market continues to grapple with inflationary pressures, central bank tightening, recessionary fears and the Russia-Ukraine conflict. Meanwhile, weak Asian demand, milder weather and industrial demand destruction has led European natural gas prices lower in recent weeks and allowed for storage to be filled ahead of winter. With Europe now having moved into gas withdrawal season, prices are likely to be determined by LNG flows and near-term weather-driven demand levels, while the scramble to re-fill storage next summer should support higher prices. Copper's near-term direction continues to be dominated by the daily moves in the USD and associated Fed sentiments. Also key, are China's COVID policies and efforts to re-start the economy and steer the property market towards a soft landing. Volatility is enhanced by a tight physical market and historically low inventories. Slowing global growth remains an overhang for 2023. Meanwhile, farmers in Brazil, the world's largest soybean exporter, have gambled on La Nina to boost profits. Advanced sales for the next soy crop have been halted as farmers await higher prices, according to the consulting firm Safras & Mercado. Growers are betting on a third consecutive year of La Nina may cause drought losses in Brazil's far south and in Argentina, boosting future prices.

OWING TO STROGER OPTIMISM ON CHINA

Source: BofA Global Fund Manager Survey, Bloomberg

CHINA'S OIL DEMAND WILL FALL THIS YEAR, BUT WE EXPECT A REBOUND NEXT YEAR



Source: IEA, UBS estimates

RECOMMENDATIONS

Investors are understandably eager to leave the tumult of 2022 behind, but we doubt that equity markets are in the clear just yet. Leading Economic Indicators (LEIs) continue to highlight that there remain downside risks to global economies, while our own work implies further pain for markets at some point in 2023. Exceptional macro volatility has kept the pain trade to the upside for both equities and credit as inflation rolls off the peak, jobs stay resilient and markets quick to discount the Fed's ability to "thread the needle." Although risk assets are already looking through to a policy pivot, we continue to believe that a recession looms, which spells trouble ahead for equities regardless of when the Fed reaches the end of its tightening campaign. 3Q earnings were uninspiring to say the least, and while forward estimates are moving lower, we remain convinced that 2023 consensus is still too high. The key inputs driving Financial Year 2023 EPS estimate have continued to weaken, with U.S. goods consumption, negative operating leverage driven by moderating inflation, and slowing non-U.S. growth all presenting greater headwinds. Given our macro-outlook and our belief in Fed Chairman Powell when he says "higher for longer", we remain underweight equities. However, we don't believe it will be a hard nor prolonged period of economic contraction, so we will be using anticipated market weakness to rebuild equity positions back to neutral/over-weight. We remain positive on energy (trading at 50% pre-Covid multiples), while looking for opportunities from the eventual full re-opening of the Chinese economy. Financial and healthcare remain key sectors, while in technology stock selection is now paramount. The fourth quarter proved to be another volatile quarter for fixed income markets. With inflation still trending above expectations, the quarter started off with longer term yields continuing their sharp rise. However, things took a swift turn once it became clear that slower economic growth prospects started to weigh on Central Bank positioning. Short off suggesting an immediate end to rate hikes, it became clear that the tightening cycle might be coming to an end some time in the first half of 2023. Fixed income investors took this message to heart and 10-year yields fell almost 100 basis points from 3.68% to 2.71% in less than 2 months, before moving back up again towards today's level (about unchanged from the September 30th levels). While we believe that bond rates will continue to fluctuate considerably in the months ahead, given the more difficult economic environment that we foresee, they should have a slightly downward bias. As such, we have added a bit to longer bond positions.

FORECAST 2023	CURRENT 31-DECEMBER-2022	2023 RANGE	2023 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	4.25%	3.50%- 4.75%	4.50%
Federal Funds Rate	4.50%	3.75%- 5.00%	4.75%
10-year Canadian Treasury	3.30%	2.50% - 3.50%	2.50%
10-year US Treasury	3.88%	2.75% - 4.10%	2.75%
COMMODITIES			
Gold (US$/oz.)	$1,826	$1,826 – $2,100	$2,050
Oil WTI (US$/lb)	$80.26	$70.00 – $95.00	$95.00
Copper (US$/bbl)	$3.811	$3.45– $4.25	$4.20
MARKETS			
S&P/TSX Composite Index	19,385	18,200 - 20,700	20,000
S&P 500 Index	3,839	3,400 - 4,000	4,000
CANADA DOLLAR/US DOLLAR	$0.7382	$0.7200 – $0.7750	$0.7750

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 © 2023 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.