Quarterly Report
SPRING 2023

HEWARD
INVESTMENT MANAGEMENT INC.

Living Through Historic Times Where Central Bankers are Caught Between a "Rock and a Hard Place"

OVERVIEW

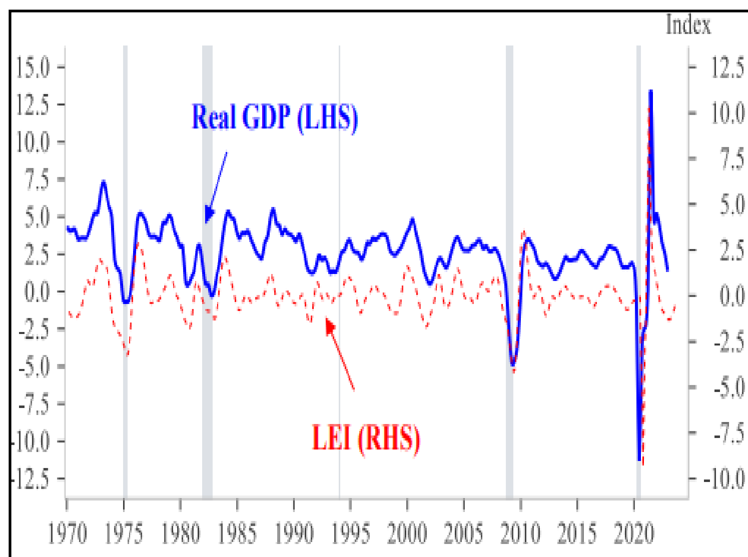
Global central bankers are now finding themselves caught between a global economy that is doing well, stubborn inflation and a regional banking shock. Surprising signs of economic vitality from the U.S. to China and Europe are complicating the fight to bring down inflation. The global economy is showing vigor with recent business surveys pointing to a widespread revival in growth despite rising borrowing costs and elevated energy and food prices. Strong economic data since the start of 2023, has confounded predictions from the World Bank and other economists that the global economy was set for one of its weakest years in recent decades. While this is promising for governments, that resilience may persuade central bankers that they need to raise interest rates further than anticipated to cool prices. However, the problems that came to light in March within the banking sector could throw a monkey wrench into the financial system, probably translating into a slowdown in economic growth.

The Federal Reserve now finds itself walking a tightrope between inflation and a banking turmoil. At their March meeting (rates hiked 25bp) the Fed recognized that something was breaking with recent data pointing to accelerating economic growth and underlying inflation remaining stubbornly high. Earlier, the Fed Chairman had indicated to Congress that the trends likely would require rates to rise above 5.25%, perhaps by a lot. However, because of the concerns over the regional banking sector, Mr. Powell and his colleagues may abandoned those plans. The US Federal Reserve will face a tough choice over the coming months. Either it will have to concede defeat and accept that inflation will continue to run at around 5% indefinitely, doing an Arthur Burns. Or to continue the fight against inflation, it will have to raise interest rates aggressively enough to push the real yield on three-month Treasury bills into positive territory, doing a Paul Volcker, with all the pain that will entail.

When it comes to U.S./China policy, it seems as though there is no backing down from either side. Relations are deteriorating and doing so quickly despite efforts to de-risk following the U.S. and Chinese elections last Fall. Increasingly, national security concerns are receiving greater precedence among policymakers when considering U.S./ China issues and, for the first time since the Berlin Wall fell, national security is taking precedence over economic efficiency. This is evidenced by recent legislative, regulatory, and executive action, which is expected to continue, with companies caught in the crossfire. More and more companies are indicating plans to relocate outside of China. Legislation like the CHIPS & Science Act shows the bipartisan prioritization of securing US supply chains and bringing manufacturing back to the U.S.

It's not surprising that after returns from the energy sector (U.S.) of roughly 55% and 65% in 2021 & 2022 respectively, the greatest skepticism among investors is to carry an overweight in energy. Given the prospects of a recession and the propensity of the industry to light money on fire, this is understandable. While history has proven it wrong to say "its different this time", it actually may be - for a number of reasons. There is the new found capital discipline as a result of the Environmental, Social and Governance (ESG) movement while marginal producers are facing a higher cost of capital. Then there is the potential demand increase as China reopens its economy and the fact that amongst the world's poorest economic regions demand remains relatively inelastic. Finally, the U.S. Strategic Petroleum Reserve (SPR) rests at levels not seen since 1983 and must be refilled.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD) REAL GDP (Y/Y %, LHS) VS. OECD G20 LEI 6 MO. % CHANGE (+ 6 MOS, RHS)



Source: Strategas

UNITED STATES

In a unanimous vote, the Fed raised rates +25 bp to 4.75%-5.0% at last month's Federal Open Market Committee (FOMC) meeting (despite the recent turmoil in the banking system). While the Fed aspires to another hike in their dot plot forecast for 2023, there is no certainty that they are going to be able to get it in this cycle. There is an attempt to split the tools aimed at financial stability vs. monetary policy. Their statement noted "recent developments are likely to result in tighter credit conditions. The extent of these effects is uncertain." The Federal Reserve also released money growth statistics for February showing that money supply is contracting at the fastest pace in our lifetime. More importantly, the sharp drop in bank deposits since the Silicon Valley Bank (SVB) collapse suggests that money growth continued to decelerate into March. This is important as the sharp drop in money supply is likely dragging inflation down. The bad news is that this inflation reduction is coming at the expense of financial stability and slower economic growth. The labor market and consumer spending are two key supports for the U.S. economy. There has been momentum through Q1, but they are expected to taper off as banks tighten standards following last month's banking crisis. While the Leading Economic Indicators have ticked up, the risks are still skewed to the downside. Meanwhile, slowing inflation, pay raises negotiated last year, cost-of-living adjustments for retirees and state tax cuts have lined up to lift consumer purchasing power. These have helped to fortifying spending and economic growth through Q1 at a time when many were predicting a slowdown or even a recession.

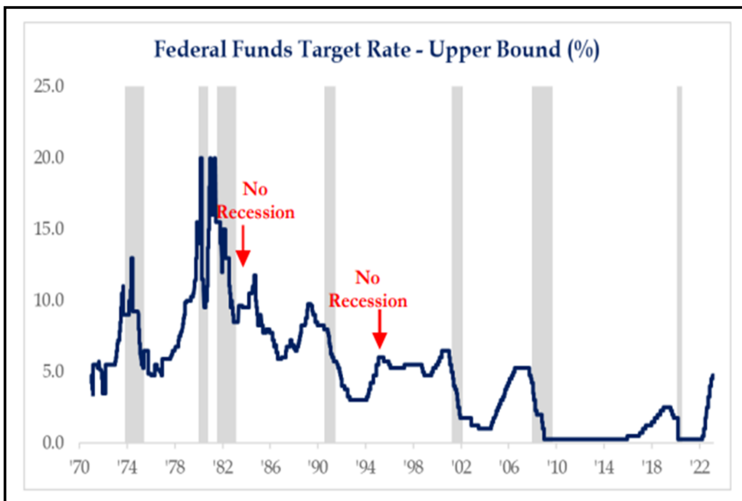
CANADA

In keeping its main interest rate unchanged in March, the Bank of Canada (BoC) said that the latest economic data points to inflation sharply decelerating toward its 2% target. The BoC's core inflation measures have now dipped below 5.0% (YoY) for the first time since spring of 2022. It seems Canada is experiencing a sounder price environment than many of the other developed economies, which means that the BoC's "conditional pause" will probably remain in place. Finance Minister Chrystia Freeland tabled her federal budget with a projected deficit $10 billion higher than initially forecasted. While a faltering economy means Ottawa will collect less revenue this year, to keep a lid on the mounting deficits, she is proposing a series of tax increases on the rich and large corporations while also cutting government spending. Freeland's budget is being pitched as a focused plan to address inflation and to position the economy for the future through multi-billion-dollar tax credits to stimulate the clean energy sector. In-spite of concerns over a slowdown, the Canadian economy started the year with a very strong jobs report. Numbers overwhelmingly beat forecasts with the jobless rate also declining. The employment gain was largely driven by full time workers and was widespread across industries. While the recent problems in U.S. regional banks have caused wide-spread fears across global markets, the Canadian banks seem to be largely insulated from the type of risk that led to Silicon Valley Bank failure. The group has a very diversified client base and only modest exposure to higher-risk tech companies, and had less of a deposit surge since the outset of the pandemic.

EUROPE

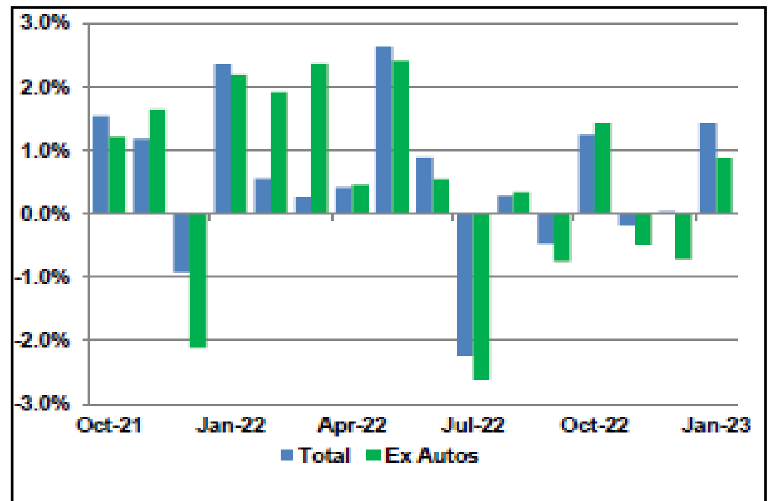
The European Central Bank (ECB) took a big risk by going through with a 50 basis-point hike, and in effect put its faith in an established central banking doctrine. By hiking as aggressively as it did, the ECB was projecting confidence that the rescue of Credit Suisse was going to work. The February numbers showed European inflation running hot! While one month does not make a trend, we would suspect that Europe will have a harder time seeing their Consumer Price Index (CPI) move lower compared to the U.S. What started out as energy specific inflation in Europe has a greater chance of turning into a wage spiral in the region given substantial union membership in the private sector, more employment in the

RECESSIONS TYPICALLY FOLLOW TIGHTENING CAMPAIGNS



Source: Strategas

CANADA RETAIL TRADE % CHANGE SEASONALLY ADJUSTED (SA)



Source: Economap

public sector relative to the U.S., and generally more wage contracts with CPI inflators. A significant shift has occurred in the price of natural gas. Late in 2022, European wholesale gas prices were expected to average €150 per megawatt hour. Now, because of warmer weather, conservation and rapid imports of liquid gas, current projects are that prices will only be around €70 per megawatt hour, improving Europe's economic outlook dramatically. The UK avoided a recession in 2022 thanks to fans driving up sales at local pubs during the World Cup. But that will be of little comfort this year as economist expect the economy to shrink slightly through the first six months of this year, followed by very weak growth in the foreseeable future. Among the G-7, the UK has had the weakest economic recovery from the COVID-19 pandemic, and according to the Bank of England, the economy may not return to the level of output recorded at the end of 2019 until 2026.

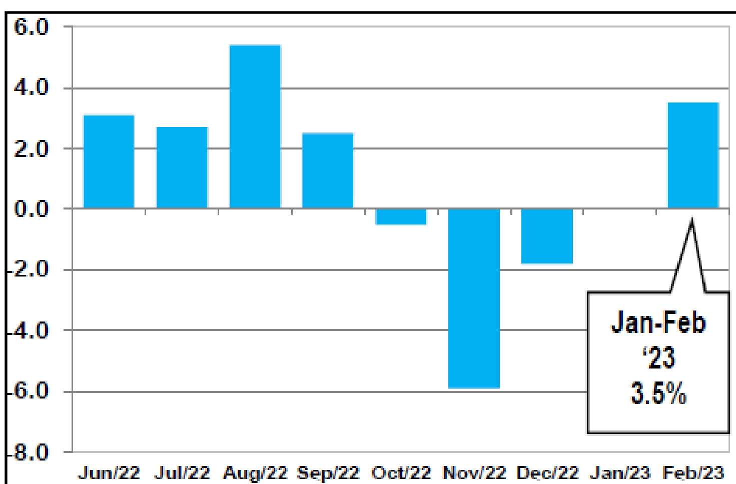
EMERGING & DEVELOPING MARKETS

China's official economic targets for 2023 (Premier Li Keqiang's annual work report) showed a government confident enough in the strength of the coming recovery to hold off on aggressive stimulus. The government budget outlined a broadly neutral fiscal policy with a goal of 5% GDP growth in 2023. While the target is relatively modest, it is in line with lowered targets for growth already provided by individual provinces. The policy settings also suggest that the government is happy to rely on the natural dynamics of reopening from Covid restrictions to deliver a recovery, but compared to other nations' opening consumer splurges, China's spending has been very subdued. People are out and about, but not yet embracing all social activities. Real estate has been the engine of China's economic growth since President Xi Jinping came to office. With the industry in a slump and major developers defaulting on their debts, new policies are now being implemented trying to organize a bailout. However, the latest remarks suggest authorities will maintain their tough regulation over the sector and no developer will be allowed to expand disorderly and hamper stability in the financial markets. In March, Haruhiko Kuroda presided over his last meeting as governor of the Bank of Japan (BoJ). He has been a force of stability in a country that has arguably had too much of it, and his departure will require the world of finance to adjust some deeply held assumptions. Meanwhile, BoJ Governor designate Ueda's recent remarks dampened some concern about a BoJ pivot but getting through Spring wage negotiations and a possible policy review are still ahead.

COMMODITIES

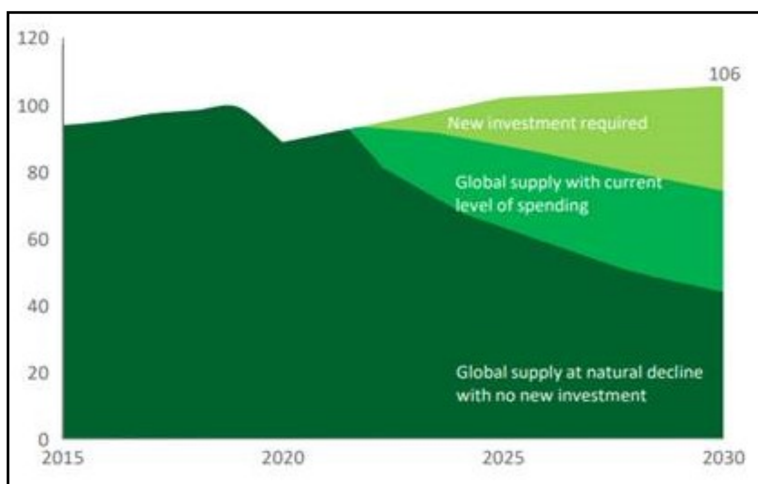
The last month has been brutal for energy markets as it has become all about the macro, with rapidly changing views on growth/recession outlooks happening in the wake of the banking problems. But nothing has changed in the oil and gas supply-demand outlook, and all eyes are now on the OPEC+ alliance going into the next gathering. Here, the Saudi's remain firmly in the driver's seat. The group, led by Saudi Arabia, may cut production if oil appears poised for a collapse in a sell-everything scenario. OPEC admitted making mistakes by not intervene earlier during previous sell offs, such as 2015, then finding themselves in the difficult position of digging out from a very deep hole. According to RBC Capital Markets, 2023/24 are big years for global refinery capacity additions. This has implications for both cracks and crude prices. They see 1.5 million barrels per day (b/d) of new global refining capacity additions or expansions slated for this year and another 2.4 million b/d to follow in 2024. This is the single-largest two-year period for net new refining capacity additions in 45 years. Net new capacity additions over the past 45 years have averaged nearly 580 thousand barrels per day annually. For the metal's complex, ongoing supply side challenges have served to largely offset weaker global consumption. Expect to see a volatile, yet relatively attractive pricing environment over the next few quarters. In the medium and longer term, some are even calling for the emergence of a new commodity super cycle. That outlook is based on the growing demand from global decarbonization efforts to address climate change and amplified by the impact of severe underinvestment in new production capacity.

CHINA RETAIL SALES % CHANGE YEAR AGO



Source: National Bureau of Statistics China/Economap

OIL SUPPLY OUTLOOK



Source: RBC Capital Markets

RECOMMENDATIONS

Many economy watchers have been predicting recession, though with significant differences on the odds and timing. Recent banking developments however, have made recession more likely and may have accelerated its onset. The latest bank issues have shed new light on Fed policy, which just a few weeks ago looked like more tightening as Mr. Powell sought to stamp out inflation. Many had said that rate hikes and Quantitative Tightening (QT) would continue until something broke, and bank failures would seem to qualify. In the Fed's view this is beneficial, as tighter credit conditions will weigh on economic activity, hiring and inflation. This does not necessarily mean that the Fed is finished tightening, but that the tightening will now come from an additional source as banks reduce credit availability. The effect is not small either. Some estimates say that it will be the equivalent of the Fed hiking as much as 100 basis points. Even with the post 2008 reforms having made the economy somewhat less leveraged, it is hard to see how an eventual recession can be avoided. Given this outlook, we continue to be cautious and have chosen to maintain an under weight in equities. Our portfolios are focused for: 1) recession protection, 2) cash flow aristocrats, and 3) energy security. From a sector perspective, these support our focus on energy and healthcare, while we wait for market opportunities to revise our technology, industrial and material allocations. Meanwhile, another volatile quarter for interest rates has drawn to an end. After initially dropping following yearend, rates started rising again quickly, as markets bought into the hawkish Central Bank talk. This all changed when liquidity problems started to show up in the global banking system. Suddenly the rhetoric changed from how high rates would go to how soon Central Banks would start cutting. Given the circumstances, the short-term rate cycle is close to where it should be. Most Central Banks are likely to take their foot of the break, especially those in North America. So far economic indicators have remained quite strong, but we expect those to moderate in the months ahead. That will also put a lid on the inflation numbers which have been much higher than targeted. Slower growth could open the door to some moderate rate cuts possibly late this year or in early 2024. Although there may be opportunities in long bonds later this year, we are still pursuing a much lower duration relative to our benchmark, for now.

FORECAST 2023	**CURRENT 31-March-2023**	**2023 RANGE**	**2023 YEAR-END**
INTEREST RATES			
Bank of Canada Overnight	4.50%	4.25%- 4.50%	4.25%
Federal Funds Rate	5.00%	4.50%- 5.25%	5.00%
10-year Canadian Treasury	2.90%	2.70% - 3.50%	2.70%
10-year US Treasury	3.47%	3.25% - 4.00%	3.25%
COMMODITIES			
Gold (US$/oz.)	$1,971	$1,804 – $2,050	$1,975
Oil WTI (US$/lb)	$75.59	$66.00 – $95.00	$90.00
Copper (US$/bbl)	$4.08	$3.50– $4.50	$4.50
MARKETS			
S&P/TSX Composite Index	20,099	18,700 - 20,900	20,025
S&P 500 Index	4,109	3,800 - 4,200	4,075
CANADA DOLLAR/US DOLLAR	$0.7395	$0.7200 – $0.7625	$0.7525

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