Quarterly Report
SUMMER 2023

HEWARD
INVESTMENT MANAGEMENT INC.

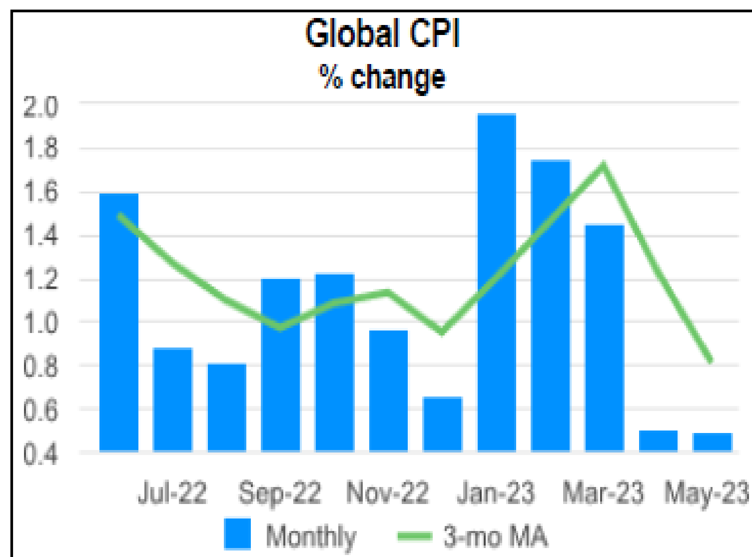
Managing in an Environment Where the Fed Fights Inflation While the Markets Fight the Fed

OVERVIEW

Harry Truman famously asked his aids to find him a one-handed economist. All the ones he was consulting with would moan “say on the one hand this….” but “on the other hand that…”. The former president’s quip has become synonymous with a profession that is prone to hedging its bets. Most of the time this is justified, and right now the global economy is particularly difficult to read. Growth within the services sector (70-80% of GDP in most economies) appears to be strong. The Institute of Supply Management (ISM) non-manufacturing index did fall back last month in the U.S., but the service sector Purchasing Managers' Index (PMIs) in the U.S., UK and the euro zone are all comfortably above the crucial 50-mark (separates expansion from contraction). Also, while core inflation rates in the U.S. and the euro zone have begun to ease, they remain high, while in the UK, core inflation has turned up. None of these, scream of economic weakness, let alone recession. Set against this, are the global manufacturing sectors which are a better bellwether of global activity. They are struggling! Manufacturing PMIs in the U.S., euro zone and UK fell in May and are now consistent with a contraction in manufacturing output in major advanced economies which can be seen in global trade volumes. This weakness is being driven by a drop in new orders, which are suggesting that future demand is faltering. With regards to labor, the U.S. is now close to breaching the “Sahm rule” which states that a 0.5% increase in unemployment rate from a year-earlier levels is a near-flawless indicator of recession. So, while the post-pandemic economy may be a puzzle, the most likely outcome is that a slowdown/ recession has been pushed back rather than cancelled.

The Federal Reserve held rates steady at their June meeting but, it appears to be more of a “skip” than a “pause”. It accompanied their decision by publishing an update of governors’ projections showing that the great majority expect the fed funds rate to reach 5.6% by the end of this year. When they last published projections (in the form of the fabled “dot plot”) three months ago, they were expecting a rate of only 5.1%. This was an unequivocal “hawkish” surprise. So, if the Federal Open Market Committee (FOMC) is still convinced that rates need to be higher for longer, why pass on them now? The explanations being offered have nothing to do with long-term strategy. First, the Fed was boxed in by a series of decisions, and by its own communications, and decided against inflicting a nasty surprise on markets by hiking. The debt-ceiling imbroglio may have had an effect, as it made it hard for the Fed to ramp up warnings of higher rates. By the time default had been avoided, the central bank had entered into its “quiet period”. Then there was the speech by in coming vice-chairman Philip Jefferson who clearly indicated that the Fed would “skip” this meeting. To go against that would have annoyed the markets and offend the vice-chairman. A final factor boxing in the Fed may have been the need to make sure that the banking sector was on firm footing, even if the crisis seems to have been averted.

The U.S. April budget data illustrated an exploding US debt servicing cost that now sits at its highest level since August 1999. Debt servicing cost is the key indicator for fiscal policy, as historically once the US government’s net interest cost hits 14 percent of tax revenues, financial markets impose austerity on policymakers. That metric surged a full percentage point in April to 12.7 percent. There is a complacency in Washington that rising debt is a political issue, not an economic or financial one as most policymakers have only served in office with a declining debt servicing cost due to low inflation and interest rates. However, with the U.S. now facing a rising debt servicing cost, the current 30-year trend of accommodative fiscal policy is ending. It’s only a matter of time before the vigilantes arrive and the debt ceiling is just the opening act.



Source: Economap

UNITED STATES

While the stock market is near a one year high (giving investors some comfort), below the surface debt markets are creaking under the strain of rising interest rates. Lending conditions for companies, consumers and real estate developers have tightened through the spring to levels not seen since the height of the COVID pandemic (Wall Street Journal). Bond markets have also become much more expensive because investors are taking less risk. Companies that need borrowed cash to grow, or simply stay afloat, are running out of options. All of this is a consequence of the Federal Reserve's interest rate hiking campaign against inflation and the problems that arose amongst small and mid-cap banks. While many have been predicting a slowdown/recession for months, the employment data (commonly used to gauge economic health) has remained strong. However, cracks are beginning to appear. The average number of hours worked per week has continued to drift lower, typically a lead up to recession. Also, while still comfortably above the 50-mark, the ISM services index declined in May against a projected increase. Manufacturing, on the other hand, is one sector of the economy that continues to struggle and the decline in the new orders index is a sign of declining future activity. Meanwhile, corporate bankruptcy filings have hit their highest number since 2010. The housing market has slowed in the past year and a half as mortgage rates pushed many buyers out of the market. The drop in demand has weighed on home prices, but not as much as some economists expected, because the supply of homes on the market remains low.

CANADA

The Bank of Canada's (BoC) move to increase the overnight lending rate to 4.75% should erase any doubt that policymakers are committed to bringing down inflation. Even with the labor market showing minor signs of a sign that its rate tightening campaign is working. Looking behind the headline numbers, the report was less convincing and not characteristic of what is actually happening in the underlying labor market. The move by the BoC went against expectations and was only anticipated by one in five economists (Bloomberg). While saying the move was data dependent and that nothing is determined going forward, they did set out what variables they are looking at. As a signal of concern about risks that are building up in the financial system, Canada's banking regulator imposed higher capital requirements on the country's largest banks for the second time in about 6 months. The change underscores growing anxiety on how households in Canada are grabbling with the rapid increase in borrowing costs. Also, elevated office vacancies are raising concern that banks may be forced to take some losses on real estate loans. The turnaround in property prices over the past four months is due in particular to the rebound in the resale market. This recovery is taking place against a backdrop of record demographic growth, which is accentuating the shortage of housing supply and has led to a return of competition among buyers. The lagged effects of prior rate increases and the slowdown in global economic activity will keep the Canadian economy's growth below trend over the next 12-18 months

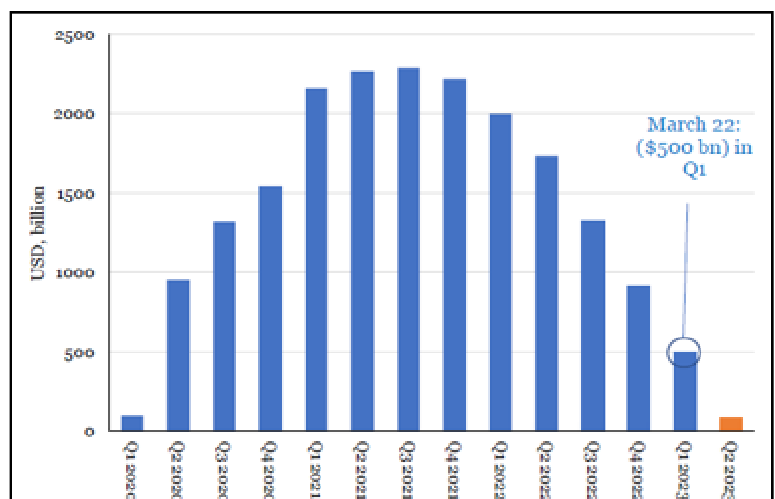
EUROPE

The European Central Bank (ECB) nudged up interest rates by a quarter percentage point in June, contrasting with the Federal Reserve. It extended its campaign against inflation despite the zone having entered (a technical) recession. At her news conference, ECB President Christine Lagarde cautioned that underlying inflation remains far too high with few signs that it is falling, leaving the door open for one or more rate increases over the coming months. The current divergence between Manufacturing and Services PMIs is a significant negative signal for Gross Domestic Product (GDP) growth. While demand for services remains strong

US SUPPLY CHAIN SLUMP: INDEX MEASURING TRANSPORT, WAREHOUSING AND INVENTORIES GOES IN REVERSE

Source: Logistics Managers Index/ Bloomberg

US HOUSEHOLDS 'EXCESS CASH' (LEVEL, US$, BILLION) WITH LONGVIEW FORECAST



Source: Longview Economics/Federal Reserve

and resilient, industrial order backlogs are eroding, pointing to further manufacturing weakness ahead. Fresh out of an energy crisis, Europeans are facing a food-price explosion that is changing diets and forcing consumers across the region to tighten their belts-literally. The continued surge in food prices has caught central bankers off guard and pressured governments to come to the rescue. France has been the first to react, with Emmanuel Macron seemingly successful in strongarming France's supermarkets into cutting food prices or face financial sanctions. While other central banks are dealing with inflation rates that are declining irritatingly slowly, the UK is seeing price gains that have reached new highs. Core consumer price inflation (no food and energy) has risen to its highest in more than three decades. This has forced the Bank of England to raise its key lending rate by 50 basis points. It was a more aggressive rate rise than its peers, and raised fears that the central bank may have to push the economy into recession in an effort to contain prices.

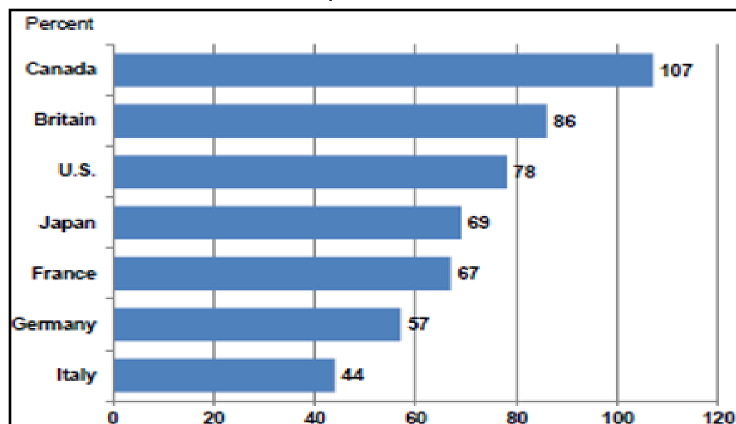
EMERGING & DEVELOPING MARKETS

China seems to have shifted to stimulus mode after the reopening surge petered out. While the People's Bank of China (PBOC) has started cutting rates, markets seem disillusioned by the lack of concrete steps being announced on the package of stimulus measures reported by Chinese state Media. The government seems to be aiming to stabilise growth not far above its target, while aiming support primarily at the real estate sector. This reflects a shift in their focus to 'quality' growth rather than just growth itself. Incremental policy easing should drive a modest recovery in H2/23. Its also probable that markets may see additional aggressive stimulus if the housing crisis deepens, economic activity stumbles and/ or unemployment picks up as any combination of these could drive fears of social instability. India has now become the world's most populous country and has overwhelming economic potential due to its demographic makeup. Along with protectionist trade policies under Prime Minister Modi's Made-in-India push, the government has introduced production-linked financial incentives for sectors such as electronics and automobiles. The $24 billion subsidy program is showing some success with companies such as Apple and Samsung expanding their footprint in the Indian market. The Bank of Japan (BoJ) is monitoring the impact of the Spring wage negotiations, or "Shunto". This year secured an average 3.7% y/y wage increase compared to 2.1% last Spring. The BoJ has said that sustained increases of 3% are required to durably achieve its 2% inflation target over time. In the meantime, Japanese household spending has sharply disappointed.

COMMODITIES

Commodities maps are being redrawn by shifting trade flows, de-dollarization, and a surge in gold reserves. Russia appears to be pursuing a three-pronged strategy where the country is looking to build new trade routes that do not pass through waters controlled by the West, de-dollarize its energy exports, while also opening new markets to diversify away from China. Russia has been successful in finding new customers for its oil, but rerouted gas supplies have so far proven unable to replace the pre-war exports to the EU. Crucially, Russian products exported eastward and southward will either be sold in the local currencies of the buyers or in currencies of countries that Russia perceives as friendly. A shift by some Emerging Market central banks of their reserves into gold saw global central banks buy a net of 1,078 tonnes of gold in 2022, the highest annual demand growth on record (Global Commodities, Jun 1st). The Organization of the Petroleum Exporting Countries (OPEC+) marathon working weekend in early June ended with a compromise agreement that managed to address several issues facing the group. The announcement of an additional 1 million barrel per day reduction by Saudi Arabia demonstrated that once again that it is willing to midwife the recovery and that it is back in the "whatever it takes" mode. The fact that it is willing to shoulder it alone adds to the credibility of the cut. The global gas markets have moved from fear of supply worries along with massive price spikes to what currently looks like calm. This is on the back of record US export of liquefied natural gas (LNG) that has allowed Europe to quickly fill up storage amid curtailed consumption and the lack of any real green shoots as yet from the Asian Buyers club.

HOUSEHOLD DEBT IN THE G7
AS A PERCENTAGE OF GDP, 2021



Source: Economap

CRUDE BACK TO THE LOWS FOR THE 4TH TIME SINCE MARCH

Source: Strategas

RECOMMENDATIONS

Historically, the movement in stock prices has had a stronger relationship with inflation and long-term interest rates than it has with the unemployment rate. Still, we are left with a simple question, can a new and durable economic cycle and market cycle begin when the economy is already starting at full employment? History also shows that forward stock returns are better coming off peak unemployment rates rather than troughs. While the banking crisis may be over and interest rates close to peaking, global money supply continues to contract, a negative for equities. As are the tighter lending standards caused by the banking problems! Furthermore, Leading Economic Indicators published by the Conference Board have not been great. A final piece of the puzzle are the inverted yield curves. When US T Bills (2year/10 year) invert, its usually a sign of trouble brewing. However, when the 3month/10year inverts, a recession has always followed, and they inverted last November. All these factors tend to attest to the fact that an economic slowdown is coming, and with it, a decline in corporate profits. Equities always follow earnings! Given our concern for equities near term, but not expecting a major selloff, we are maintaining an underweight position. While underweight, we continue with our strategy to Buy/Add when issues get oversold, and Sell/Trim when over bought. Our favored sectors include energy and technology, while watching the financials carefully. Despite indications that economic growth is slowing, inflation has proved to me sticky causing Central Banks to continue to pursue a more cautious approach. After pausing for a while the BoC raised its base rate again in June, with one more hike still possible. From these developments, medium and longer-term interest rates moved up as well, resulting in a negative performance for the benchmark. Because of a lower allocation to long term bonds and a positive contribution from preferred shares, our fixed income component was down marginally during the quarter. Looking forward, we still expect economic growth and inflation to moderate further, and given the persistence of core inflation, rate cuts may not happen until Q1/24. We will therefore continue to focus on shorter and medium-term maturities, which should provide higher nominal returns than long bonds.

FORECAST 2023	**CURRENT 30-JUNE-2023**	**2023 RANGE**	**2023 YEAR-END**
INTEREST RATES			
Bank of Canada Overnight	4.75%	4.25%- 5.00%	5.00%
Federal Funds Rate	5.25%	4.50%- 5.50%	5.50%
10-year Canadian Treasury	3.27%	2.70% - 3.75%	3.25%
10-year US Treasury	3.84%	3.25% - 4.00%	3.50%
COMMODITIES			
Gold (US$/oz.)	$1,929	$1,804 – $2,125	$2,025
Oil WTI (US$/lb)	$70.64	$66.00 – $90.00	$85.00
Copper (US$/bbl)	$3.74	$3.50– $4.50	$4.50
MARKETS			
S&P/TSX Composite Index	20,155	18,700 - 20,700	20,025
S&P 500 Index	4,450	3,800 - 4,450	4,150
CANADA DOLLAR/US DOLLAR	$0.7550	$0.7200 – $0.7625	$0.7525

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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.