Quarterly Report
AUTUMN 2023

HEWARD
INVESTMENT MANAGEMENT INC.

Tactically Investing in an Environment of Higher-For-Longer Rates, High Energy Prices and Growing Geopolitical Risks!

OVERVIEW

The year has just passed the three-quarter mark, and the markets have already barreled through most Wall Street estimates (despite September's sell off) for year end levels. In the process, they have defied the gloom accompanied by recession risks, soaring inflation and aggressive monetary tightening, instead believing in the Fed's ability to engineer a soft landing. New data points have emerged over the last nine months, moving markets and investor sentiment while justifying higher year-end levels than seemed likely on January 1st.

Comments from the Bank Credit Analyst focus on the unsustainability of a soft landing. While they believe the Fed could temporarily achieve a soft landing, they remain skeptical that it could stick that landing for very long. The reason is that once an economy achieves full employment, anything that pushes growth above trend could stoke inflation, while anything that pushes growth below trend could lead to a rise in unemployment. And due to the feedback loops, once unemployment starts rising, it usually keeps rising.

Moreover, just because a first wave of inflation is passing does not necessarily mean inflation returns to target and stays there. History shows that a second wave of U.S. inflation starts on average 30 months after the first peak (Strategas Research). We are "only" 15 months past the June 2022 peak in the Consumer Price Index (CPI) of 9% year over year, which is too early to know with confidence that the inflation anchor is firm. True, the Fed may have now paused given the improving U.S. inflation trajectory over the past several months. But that's likely not enough to declare victory.

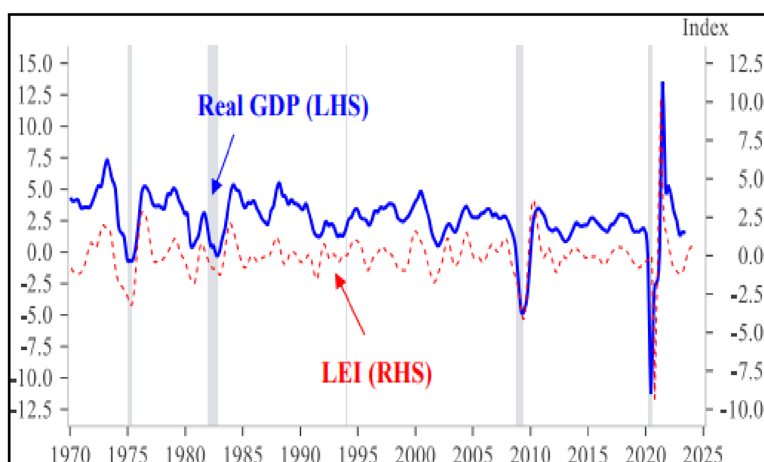
Whether a recession will hit the U.S. economy in the coming months has evoked a big divergence of views. It's an important debate as a recession will impact earnings, valuations and Federal Reserve decisions. But politically, this is also an important debate. Recessions have proven to have outsized importance on the outcome of the U.S. presidential elections.

After years of blacklisting Chinese companies and scrutinizing their investments in the U.S., the Biden administration sent an unmistakable signal to American business to steer investment away from China. An executive order President Biden issued in August, while targeted at critical leading-edge technologies with military, surveillance and cyber capabilities, more broadly aims to reorder the flow of American capital and expertise away from its biggest rival.

The alliance between Saudi Arabia and Russia has boosted crude prices. That's created angst over inflation, and a renewed dose of allegations that central banks' emphasis on core inflation, excluding energy, shows that they are trying to distort figures downward, or to pretend that energy prices don't matter. These aren't fair criticisms, but they do raise profound issues. The reason central bankers prefer to look at inflation excluding energy is because energy is vastly more volatile than the rest of the index. None of this means that higher oil prices don't hurt a lot, because they do. But, because the developed economies are far less "oil-intense" today, it takes up a far lesser share of the economy, even when it's expensive.

Exports are crumbling in China and across Asia, showing the deepening toll that rising interest rates are taking on global trade and economic growth. Trade has been slowing for months, but the pullback has further to run as central banks keep up their campaign to beat back inflation and the U.S. and Europe slide towards recession. While Chinese exports have fallen at their fastest pace since the early days of Covid, other Asian powerhouses have also reported sinking overseas sales. Exports from Taiwan, Vietnam and South Korea are all softer.

OECD REAL GDP (Y/Y%, LHS) vs OECD G20 LEI 6 MONTH % CHANGE (+6 MOS, RHS)



Source: Strategas

UNITED STATES

There's a saying that economic expansions don't die of old age: They're murdered by the Federal Reserve. If that's the case, then the U.S. economy is outrunning its would-be assailant. (The Wall Street Journal) The economy has benefited this year from an easing of pandemic-driven labor shortages as more immigrants and native-born Americans join the workforce. Also, companies are holding onto workers and bumping up their pay. Real after-tax incomes rose 3.8% in July from a year earlier and have risen year-over-year each month since January. All of those have helped fuel robust consumer spending, which in turn has powered the economy. While Americans might not be spending like there is no tomorrow, they are certainly spending like they think tomorrow is going to be all right. The most recent retail sales report can be viewed as solid gains and adds to evidence that GDP growth in the third quarter will likely be strong. But, signs of recession are building in the U.S. According to Fed data, the share of U.S. debt newly transitioning into delinquency (30+ days late) has increased for most type of loans. The regional bank surveys are very dire, as is the National Federation of Independent Business (NFIB) small business optimism index. While consumers are spending, they are clearly depleting their cash reserves which had been accumulated thanks to Uncle Sam. Also, banks are tightening credit which will eventually impact households and businesses. Tightening standards will also include loan rejections and the elimination of the Employee Retention Credit channels by year end. While cracks in the labor force are just beginning to appear, the full impact of credit tightening lies ahead, not behind us.

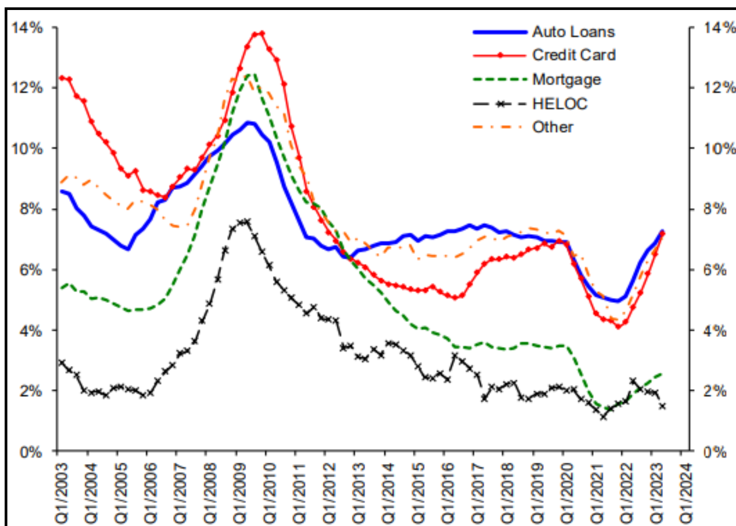
CANADA

In trying to balance the risks of under/over tightening and as signs of an economic slowdown grow, the Bank of Canada (BoC) decided to keep their policy rate at 5.0% at their September meeting. And, in the face of increasing political pressure to stop raising rates, BoC Governor Macklem reiterated that there may be a need to raise the policy rate further if inflationary pressures persist. His comments couldn't have been more-timely as the following day Statistics Canada reported that the labour market blew through expectations and wages grew faster than expected, signaling that there is still some gas left in the jobs machine. Partly behind the jobs report is the significant increase in the population, particularly the working age group. While this latest data does not seal the deal for a rate increase, it does leave the door wide open. However, the second quarter slowdown of the Canadian economy is proof that the Bank of Canada's interest rate hikes are effectively working their way through the system. Also, the data released at the beginning of September was weaker than what economists had forecasted and pointed to an overall cooling of the country's economy as spending and residential investment receded, while corporate profits continued to decline. With profits being a key driver of job creation, the continuing decline will likely lead to weakness in the labor market in the months ahead and a further drag on overall GDP. Hoping to stimulate supply, the Federal government announced that it will remove the GST from new rental constructions. A few provinces (ON, NFLD, BC) also committed to removing their respective provincial taxes.

EUROPE

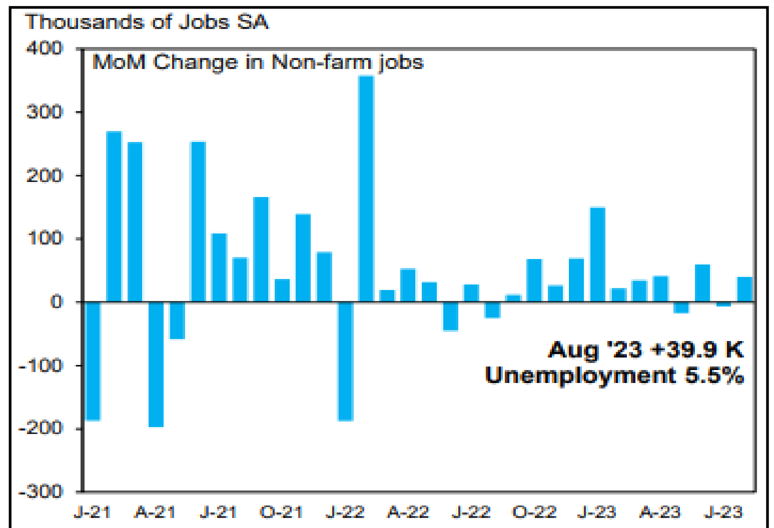
In September, the European Central Bank (ECB) raised interest rates by a quarter percentage point to a record high, choosing to press ahead with its fight against persistent inflation despite concerns that it could tip the Eurozone into recession. The ECB also sent a clear message: its hiking campaign is over for now and the newest stage in the evolution of the Eurozone monetary policy is to keep rates at current levels for an extended period. New economic forecasts published by the ECB now suggest that eurozone growth will slow significantly more than previously expected. With both manufacturing new orders and new export orders

LOAN TRANSITION INTO DELINQUENCY (30D+, % OF BALANCE, 4Q MOVING SUM)



Source: Scotiabank GBM Portfolio Strategy, New York Federal Reserve

CANADIAN EMPLOYMENT



Source: Statistics Canada

having deteriorated rapidly, business activity appears likely to stay weak for some time, and the weakness is now spreading to services. Rising borrowing costs and stagnating Chinese demand for European goods are paving the way for another miserable economic winter for the Eurozone this year. Credit standards have become extremely tight and credit demand has collapsed in response to the rapid rise in interest rates charged to the private sector. Moreover, money supply is contracting at its fastest pace since the creation of the Eurozone. The Bank of England left its key interest rate unchanged for the first time since November 2021 amid signs that inflation is cooling and the U.K.'s economy is teetering on the brink of contraction. The Confederation of British Industry (CBI) said its survey suggests that private sector activity will continue to stagnate or contract, with respondents to the survey saying that lower demand, cost pressures and general uncertainty were prompting companies to cut investment.

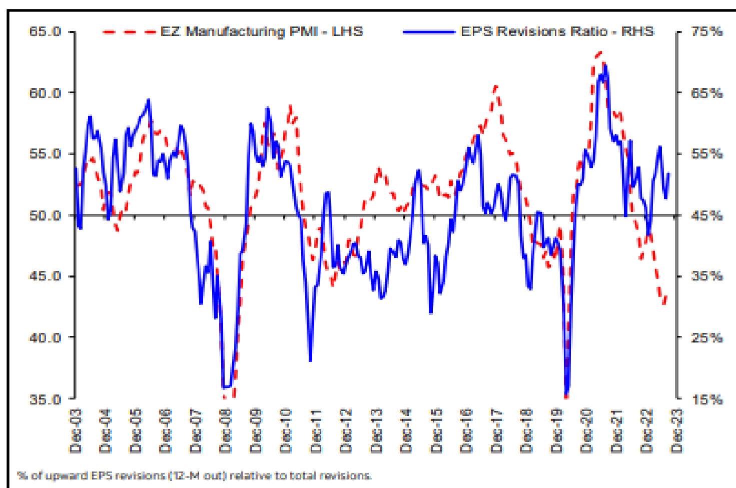
EMERGING & DEVELOPING MARKETS

Beijing seems still too confident about China's economy. With the country's economy either slogging through a normal post-pandemic soft patch or on the brink of something much worse, Beijing seems inclined to stick to half measures. While boosting support for favored sectors like electric vehicles and talking up entrepreneurs, they do so without rolling out the big monetary and fiscal guns. The bulls contend that a simple reversion to the mean (as happened in other economies) would put the economy on a much stronger footing. The bear argument is that what is happening in China is not analogous to any other economy. China's property market is in a deep downturn, developers are financially stressed and the project pipeline has collapsed. Exports, which helped to mitigate the housing downturn in 2021 & 2022, are declining again. Meanwhile, Chinese households, which are by some measures now more indebted than American ones, have been taking it from all sides. The danger is that Beijing mistakes the economy's current troubles for something transitory, and that further weakness in exports and construction start to drag the overall labor market down again. The Bank of Japan's monetary policy (+/- 50bp around 0.00% for 10-year Japan Government Bonds) does signify a pre-emptive move to handle future risks from speculative or fundamental moves by other central banks. More yield curve controls are likely to be introduced next year which could result in the Yen rising against the U.S.$ and most other currencies. Meanwhile, retail sales were stronger than expected but industrial production undershot expectations and housing starts disappointed.

COMMODITIES

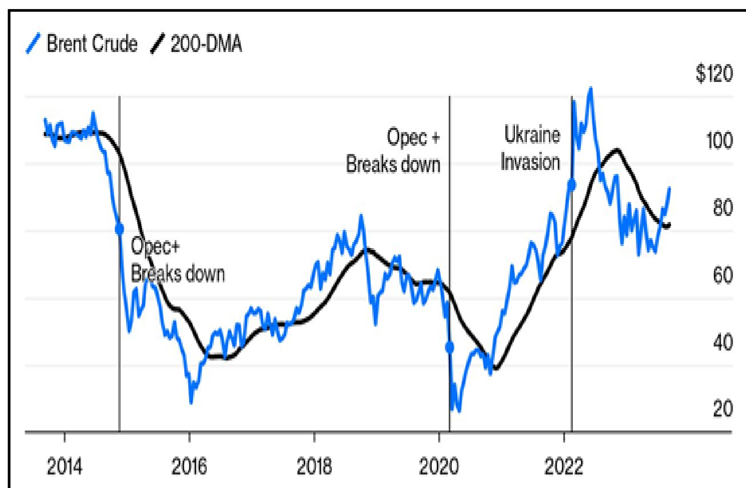
At the World Petroleum Conference in Calgary last month, Price Abdulaziz (Saudi Oil Minister) made his first public comments since Saudi Arabia decided to extend its 1 million barrels per day unilateral production cut through year end. He stated that OPEC must remain "proactive, pre-emptive, and precautious" in the face of continued uncertainty surrounding Chinese demand, European growth, and global central bank action. Noting that "the jury is still out" on the outlook for oil, he reiterated that the cut will be subject to monthly reviews. It seems that Saudi Arabia (and OPEC+) remain firmly behind the wheel driving oil prices, and supportive for continued robust pricing. Russia has announced a ban on diesel and gasoline exports. The Kremlin has justified the move as important to the stabilization of prices domestically. However, given the global product inventory backdrop, the action is another signal that Russia isn't done with its energy weaponization strategy. On the Canadian Prairies, overall production is estimated to have fallen as yields for all principal field crops are forecast to decline due to widespread drought. Exports of all principal field crops are projected to decline significantly y/y due to the lower production and supply. Prices however, are projected to decrease due to higher global supplies, but will be supported to some extent by continued strong world demand. Weak Chinese trade data, tumbling new bank loans and prolonged trouble within the property sector heightened the concern over demand for base metals. The fundamentals of copper however, are projected to persist in the long term, driven by energy transition, lack of sufficient supply growth and population growth.

EURO-ZONE MANUFACTURING PMI VS MSCI DM EUROPE EARNINGS REVISIONS RATIO



Source: Scotiabank

FROM PEAK TO PEAK: GEOPOLITICS HAS DRIVEN OIL PRICES, NOT SUPPLY AND DEMAND



Source: Bloomberg

RECOMMENDATIONS

September has a history of not being kind to markets. Throw in the fact that the financial community finally came to grips with the likelihood of a U.S. government shut down, and it should not have been surprising to witness a market selloff. But with investors seemingly panicking, comes opportunities. Yes, earnings projections are all-over the map, and it seems to us that consensus expectations for next year appear too optimistic given an aging business cycle. But the Fed's latest economic projections point to a sustained decline in Personal Consumption Expenditures (PCE) inflation for 2024 & 2025 along with a marginal rise in unemployment, a soft landing. Moreover, a report by Royal Bank of Canada (RBC) Capital Markets which looked at government shutdowns of 10 days or more, showed that equity markets usually experienced a decent size pullback heading into extended shutdowns (and they have). That report also shows that U.S. equity markets have tended to rebound meaningfully after the pullbacks associated with government shutdowns. With this in mind, and our view of higher markets by year end, we have opted for a tactical shift. Using the market opportunities from September's selloff, we are returning our portfolios to a more neutral stance on equities (vs under-weight). Our initial foray targeted over sold Telecommunication companies (high dividend yields) which have come under pressure due to macro reasons, but whose fundamentals remain strong. There are also several other market casualties which we are considering. With sticky inflation and resilient economic activity, global central bankers have furthered their rhetoric of higher for longer interest rate calls. As a result, longer term interest rates have increased quite significantly, resulting in one of the worst quarters for bond investments on record. Although we think that much of the pain is now behind us, rates may still have to rise a bit more before one can say that the top is in for this cycle. Consequently, we will continue to pursue a conservative strategy with lower than benchmark duration bonds and selective higher yielding high quality corporate bonds. If rates move up further, however, we will consider increasing our duration profile. For the first time in many years, the now much higher nominal returns on bonds and other fixed income vehicles make this asset class look much more attractive relative to many other asset classes.

FORECAST 2023	**CURRENT 30-SEPTEMBER-2023**	**2023 RANGE**	**2023 YEAR-END**
INTEREST RATES			
Bank of Canada Overnight	5.00%	4.25%- 5.00%	5.00%
Federal Funds Rate	5.50%	4.50%- 5.75%	5.75%
10-year Canadian Treasury	4.02%	2.70% - 4.50%	4.00%
10-year US Treasury	4.57%	3.25% - 5.00%	4.75%
COMMODITIES			
Gold (US$/oz.)	$1,848	$1,804 – $2,055	$1,925
Oil WTI (US$/lb)	$90.79	$66.00 – $95.00	$85.00
Copper (US$/bbl)	$3.74	$3.55– $4.27	$3.85
MARKETS			
S&P/TSX Composite Index	19,541	18,700 - 20,767	20,100
S&P 500 Index	4,288	3,800 - 4,588	4,370
CANADA DOLLAR/US DOLLAR	$0.7365	$0.7200 – $0.7625	$0.7400

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