Quarterly Report
WINTER 2024

HEWARD
INVESTMENT MANAGEMENT INC.

Markets Correctly Forecasted a Fed “Pivot” and are Now Calling for a “Soft Landing”! Can the Fed deliver?

OVERVIEW

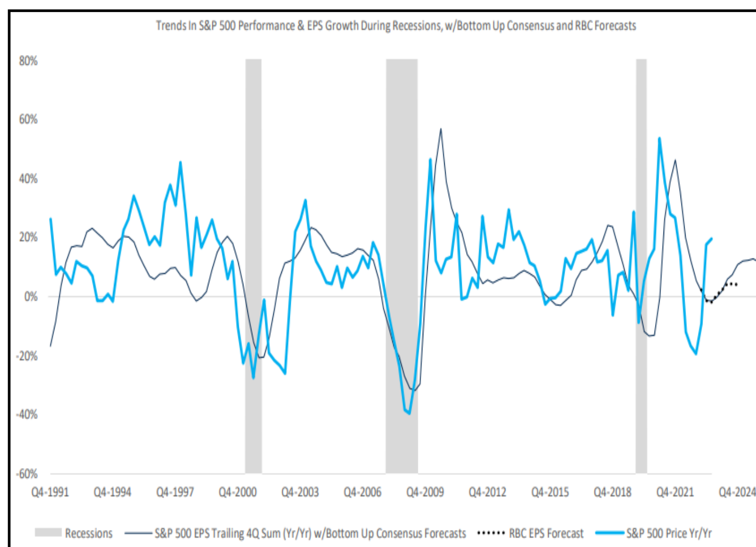
Investors spent most of 2023 fretting about inflation and interest rates, but, since the end of October, with data showing that the inflation was clearly slowing down, markets were convinced that further rate hikes were now off the table and that the Fed’s fight against inflation would be winding down. Bond yields plunged and investors have been snapping up everything from stocks and bonds to crypto and even gold. The simultaneous surge across assets sparked the debate about whether the “everything rally” marked the arrival of a lasting bull market, or just a fleeting sugar high at the end of the Fed’s tightening cycle. With the Fed seemingly “pivoting” at their last meeting of the year, and appearing ready to now backstop the economy, investors have been seemingly justified in their run to equities. However, two questions linger: 1) Can the Fed deliver a “soft landing”, 2) Will this prove to be Mr. Powell’s “Volker moment”?

If there’s one risk that clouds all others at present, it can be expressed in one word: “Trump.” Some consider this a risk with great upside; others, a nightmare. But polls of the Republican primary electorate and the general election suggest it’s incumbent on everyone to start working out what a second term would mean. No institution may be more impacted than Federal Open Market Committee (FOMC), which sets interest rates. Chairman Powell will need to defend the Fed’s viability as an institution. The risks from the lagged effects of Fed policy are that they could prompt a slowing economy heading into the election and sink Biden’s chances. If this were to happen, former President Trump is most likely to be elected president and may remake the Fed truly in his image. This could damage the institution’s credibility more than Powell would have by lowering rates into the presidential campaign. Add that if there is any case at all to be made that the Fed is acting to help Biden, it’s a total certainty that Candidate Trump would make it.

Tech stocks had a blowout 2023, with the “Magnificent Seven” leading the bull run. The rally had three drivers: expectations for a Federal Reserve pause; a new commitment to cost-cutting from the tech world; and, of course, Artificial Intelligence (AI). 2023 was the year generative AI went mainstream, a trend that revived investor interest in AI-relevant chip, software, and infrastructure companies. The market concluded that AI was the biggest thing to hit the tech sector since the slide rule. Technological innovation and deployment were also at the heart of the boom in productivity in the 1990’s. Recent breakthroughs in AI may provide a sense of “déjà vu”. The Bank Credit Analyst states: “there is a high probability that AI will have a beneficial impact on productivity, perhaps as much, or even more than the internet’s impact. Timing however, remains uncertain”. Also, just as the internet productivity boom did not prevent the 2001 recession, the AI boom will not keep the U.S. out of recession, if one is to come!

In the sense of inevitability, it’s necessary to return to the question of whether the global economy (particularly the US) can make a “soft landing” as opposed to a recession. For investors the difference has profound implications for the performance of different asset classes. If inflation falls without a big hit to growth (soft landing), then stocks will continue to have the wind at their back. In a hard landing, with negative growth and rate cuts, it would be a scenario for bonds to outperform equities. A confident consensus has taken hold that inflation has topped, and that central banks’ campaign of raising rates is over and that cuts are inevitable. Now, the crucial question is how much economic damage the victory over inflation will inflict.

S&P 500 PERFORMANCE HAS BEEN LEADING EPS TRENDS; ALREADY BAKING IN A ROBUST 2024 RECOVERY



Source: RBC US Equity Strategy, Haver, Bloomberg

UNITED STATES

While the Federal Reserve has two mandates (inflation and unemployment), for the last two years it has behaved as if only the first mattered. It had raised interest rates so steeply that it knew it was courting recession. With The Fed's "pivot" in December, it's now getting back to the point where both mandates are important. This pivot means the Fed is ready to backstop the economic recovery. This doesn't rule out a recession, but makes one much less likely. Recent data indicates momentum in the U.S. economy, while at the same time the Fed is winning its fight on inflation. Consumer sentiment surveys surged in December, with both the present situation & expectations components improving. Gasoline prices are down, mortgage rates have topped, and the stock market has rallied. Labor market data and the credit environment will likely be future indicators for the Fed. So far, they are indicating U.S. growth, but the ADP's private payrolls data continues to show fading momentum, driven by small businesses. The jump in resignations seen earlier in the pandemic recovery has dissipated. Economists see a declining rate of quitting as a sign that workers are less certain about the labor market or that they are more satisfied with their current roles. New-home sales have been volatile but trending higher since last summer, while the median sales price has dropped to the lowest level since August 2021. The drop in prices showed home builders are responding quickly to bring down costs for potential buyers. Sales of existing homes however, fell to a 13 year low in October, taking a toll on workers and businesses that rely on spending related to the housing market.

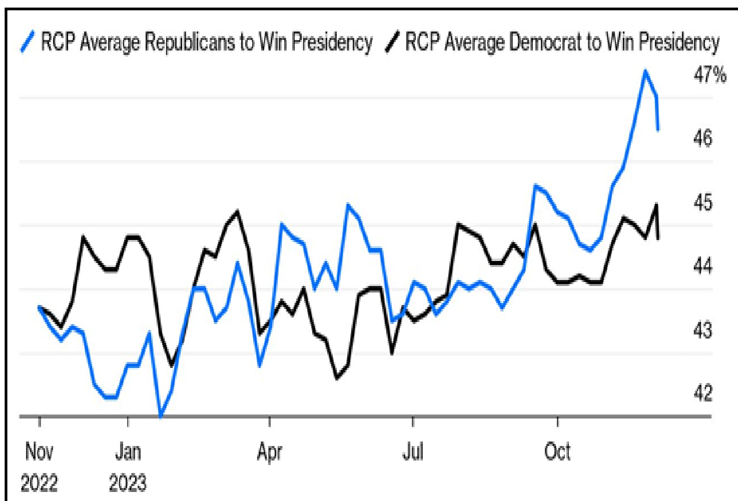
CANADA

The combination of high interest rates and household leverage is having the expected effect of depressing economic activity. The question now becomes the degree of weakness, not the direction of travel. Also, a spontaneous growth rebound is highly unlikely until there is a catalyst (financial conditions or even fiscal impulse). In December, the Bank of Canada (BoC) kept their policy rate steady at 5 per cent while maintaining its hawkish stance. Their stance may have been a reflection of current wage trends (4-5% y/y) which are inconsistent with inflation reaching target. Union wage settlements might stay high even if the unemployment rate rises, as workers focus on catching up to what happened over the past 3-4 years of their last contract. If workers remain able to extract concessions from employers, the adjustment process will be slow. Many are now expecting a shallow recession and below trend growth through 2024. As such, the interest rate sensitive parts of the economy should remain under pressure, especially with household credit running at the lowest rate since the early 1990s. For the labor market, an unemployment rate approaching 7% would be something other than a soft landing. But, if most of the rise comes from rising labor force growth (particularly immigration) then it would be less worrying than if it came from job losses. Meanwhile, the downtrend in some Canadian fixed-mortgage rates may be welcome news for eager home buyers, but housing affordability challenges persist. The structural forces of immigration, land supply, a housing shortage and insufficient multi-dwelling units should prevent a large downturn.

EUROPE

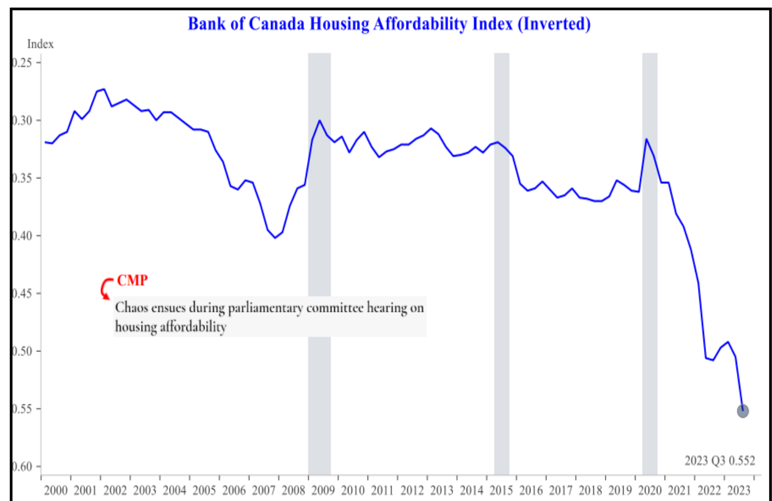
In December the Fed gave central bankers a window to move in a dovish direction. But in Europe they didn't take it. Instead, the European Central Bank (ECB) opted to speed up its policy of quantitative tightening, selling bonds onto the market to push up their yields. At the same time, the Bank of England tried to douse expectations for a fall while in Norway, the Norges Bank actually hiked. In spite of these actions, opinions about the ECB's likely behavior next year have now turned on a dime. Europe is differentiated from virtually everyone else by the intensity of the energy price crisis it suffered last year due to Russia's invasion of Ukraine. Prices have now abated. This means that headline inflation, most important in politics

TRUMP: FRONT RUNNER, THE RACE IS OPEN BUT REPUBLICANS HAVE THE ADVANTAGE FOR NOW



Source: RealClearPolitics.com. Bloomberg

BANK OF CANADA HOUSING SURVEY SHOWS UNAFFORDABILITY AT RECORDS



Source: Stratgeas

and in moving consumer behavior, has collapsed after peaking in double figures. The direction of travel is the same across the continent, with the improvement looking greatest in the countries where gas prices rose most a year ago. Over the last four months, core goods inflation has been running below zero, while core services inflation is back to the 2% target and falling. Expectations are now calling for future policy moves by the Fed and the ECB to be coordinated. A December survey reported that businesses in the UK became more downbeat about the economic outlook. However, retail results showed that sales volumes strongly beat expectations and gains were widespread. Meanwhile, the Office for National Statistics reported that November's public sector borrowing was higher than forecasted by Reuters. The numbers are being watched to see if there is any room for giveaways ahead of the general elections expected in 2024.

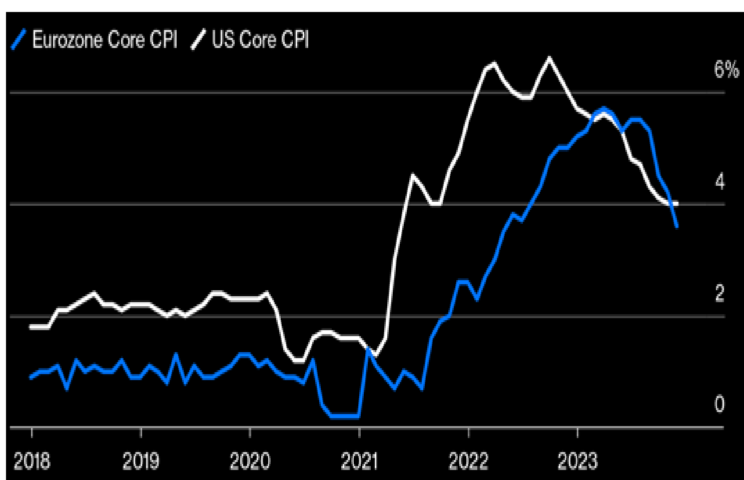
EMERGING & DEVELOPING MARKETS

China's move to pump a record amount of cash into the economy coincided with renewed support for the property sector, sending a more powerful stimulus message to investors after piecemeal approaches had left them disheartened. That came on the heels of a relaxation of home buying curbs, in an extension of policy efforts to stem an unprecedented housing downturn. While investors have been looking to more forceful measures, Chinese authorities also face the challenge of balancing monetary and fiscal stimulus so that just enough liquidity is added to support government bond sales without triggering a slump in the yuan. This tricky task explains why policymakers have refrained from deploying more aggressive monetary tools in recent months, such as an interest-rate cut. Meanwhile, the rules of the game keep getting harder for China's internet sector. In its fight against gaming addiction, the new rules include restrictions against incentives to play or spend more online. The Bank of Japan (BOJ) relieved markets by leaving its negative interest rate unchanged, after the recent weak CPI data. But it could rise again with support from what could be the two strongest back-to-back years for wage gains since the 1990's, depending on the outcome of the spring negotiations. Meanwhile, a BOJ survey showed a broad recovery in corporate moods thanks to upbeat profits. India continues to outperform other major economies thanks to continued strength in services and industry, even as weak rainfall hurts agricultural harvests. Much of India's growth performance can be attributed to domestic demand, state investment and buoyant consumer sentiment.

COMMODITIES

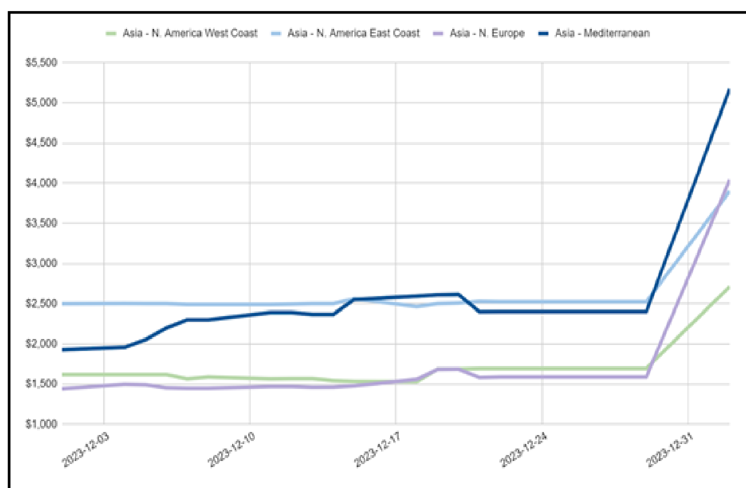
In 2014, OPEC (abated by Russia) sought to check the influence of North American shale, by flooding the market with crude in an attempt to regain market share. That collapse sent a jolt through the economics of US shale, ending years of breakneck production growth. The shale industry emerged from that setback (and the pandemic) with a resolve to prioritize returning cash to investors instead of chasing production gains. The OPEC+ alliance, as it came to be known, worked to enforce supply quotas among member nations as part of a broader strategy to maintain robust prices. That self discipline helped stabilize the market in 2020, and again this year, but since November crude prices have slipped. And all the while, U.S. shale output has crept higher. Part of what makes the US crude surge surprising is that companies managed to increase production even as the number of drilling rigs fell roughly 20% this year. That productivity gain has confounded many oil experts who have long relied on the so-called "rig count" as a predictor of future crude output. China has been gobbling up staple crops from around the world. The country has also been scooping up wheat in huge amounts, with imports heading for a record. Following a splurge on Australian wheat earlier in the year, large volumes have been purchased in Q4 from other exporters including the US, Canada and France. Bad weather has been an important driver of the buying spree. Simon Hunt Strategic Services is hearing from credible sources that the Chinese government is planning a massive state infrastructure investment. This would be very positive for metals. An announcement is expected in March.

EUROPE'S INFLATION ID FALLING FASTER: THE CASE FOR CUTS IN THE EUROZONE LOOKS STRONGER THAN IN THE US



Source: Bloomberg

RED SEA DISRUPTION IMPACT ON OCEAN CONTAINER RATES—FREIGHTOS TERMINAL



Source: Bloomberg

RECOMMENDATIONS

We expect global growth to slow below potential in 2024 due to the continued drag from tight monetary policy and the fading of 2023 positive shocks. In the U.S., get the consumer right and you will get the U.S. economy (and market) right. While the timing is uncertain, we believe the consumer will falter after working through what remains of their excess savings (probably by mid-year). Then, together with inflation and economic data softening, we should have a clearer view of what the Fed will do (rate cuts). The rate of decline (and timing) will depend on whether the economic slide stops at a 'soft landing" or something worse (not our call). At the end of October, markets correctly anticipated a "pivot", which the Fed pretty much confirmed at their December meeting. But after their recent surge, markets may have over-interpreted the Fed, and may now be pricing in too much (rate cuts). Given rich market multiples, tight credit spreads and unusually low volatility, investors believe a recession will be avoided. We however, worry more about the drag from tighter monetary policy that is yet to come and that the associated economic weakness is understated by consensus forecasts. As such, we believe the short-term upside for risky assets is limited, and expect that we will find better entry points. While our plan is to underweight equities, it will be done on a stock-by-stock basis, using our projected trim/sell target levels. We are also anticipating a tactical return to equities, using our disciplined buy/add targets during the anticipated market selloff. After reaching multi year highs in October, bond yields rolled over as investors believed that monetary winds were changing course. Weakening growth numbers and improving inflation data changed the rhetoric from global central banks. From higher for longer, the discussion changed to, not whether interest rates would come down, but to how soon and by how much. This development caused a huge U-Turn in the bond markets, resulting in one of the best quarterly returns on record. However, although a surprise is always possible, we think the market has already priced in most of the expected reductions in short term rates that may be ahead of us. For that reason, we think it is prudent to stick to our strategy of focussing on short and mid term bonds. preferred shares and some high dividend paying stocks.

FORECAST 2024	CURRENT 31-DECEMBER– 2023	2024 RANGE	2024 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	5.00%	3.75%- 5.00%	3.75%
Federal Funds Rate	5.50%	4.25%- 5.50%	4.25%
10-year Canadian Treasury	3.11%	2.90% - 3.50%	3.10%
10-year US Treasury	3.88%	3.25% - 4.25%	3.50%
COMMODITIES			
Gold (US$/oz.)	$2,072	$1,950 – $2,125	$2,090
Oil WTI (US$/lb)	$71.65	$66.00 –$90.00	$85.00
Copper (US$/bbl)	$3.89	$ 3.55 – $4.27	$4.10
Natural Gas	$2.51	$2.10-$4.00	$3.50
MARKETS			
S&P/TSX Composite Index	20,958	18,500 - 21,500	21,300
S&P 500 Index	4,770	4,200 - 4,850	4,650
CANADA DOLLAR/US DOLLAR	$0.7547	$0.7200 - $0.7625	$0.7500

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