Quarterly Report
SPRING 2024

HEWARD
INVESTMENT MANAGEMENT INC.

Inflation Victory is Proving Elusive, Challenging Central Banks and Sowing Doubts as to the Number and Timing of Rate Cuts.

OVERVIEW

Led by the S&P 500, the major indices in the U.S. and Canada established new highs in the later part of March. Investors continued to flock to equities betting on a goldilocks scenario, based on a resilient US economy, strong labor markets, inflation largely under control and the Federal Reserve's unicorn-like soft landing very much in sight. Wall Street of course, is now hoping this all means interest rate cuts, now pricing in 3 in 2024. But despite the 5,000-point milestone, there's caution that the S&P 500's more than 20% rise since early November may hit a roadblock. Technically, weakening momentum in technology (Strategas), retreating sentiment indicators (RBC Capital) and the election may become headwinds short term. Longer term, the positive outlook remains intact. Meanwhile, with inflation numbers stronger than expected, the Fed kept its main interest rate at a 22-year high for a fifth straight meeting. Markets have taken that decision pretty much in stride with a June cut now widely expected. Initially driving markets since year end had been the mega cap technology stocks with exposure to Artificial Intelligence (AI). But expectations for a stronger economy fueled by consumer spending, healthy profits, infrastructure spending and declining (albeit slower than desired) inflation has broadened out the markets, spilling over into the more cyclical sectors.

Inflation is proving to be stickier than expected in the U.S. and Europe, creating a headache for central bankers and sowing doubts on whether investors are too optimistic about the world economy. The decline in inflation from the highs across advanced economies in 2022 represents the easy gains, as supply-chain blockages eased and commodity prices, especially for energy, normalized. The "last mile" however, is proving tougher. Underlying inflation, which excludes volatile food and energy prices, slowed to 3% in the second half of last year across advanced economies but has since moved up to 3.5%, according to JP Morgan estimates. That is forcing investors to rethink bets that inflation would steadily decline to central banks' targets, generally around 2%. There are even concerns it could surge again, mirroring the second wave that characterized the high inflation of the 1970s. The Fed however, believes inflation is on a somewhat bumpy path toward 2%, and strong economic growth allows policymakers to wait.

Every March, thousands of executives take over a downtown hotel in Houston to reach oil and gas deals and haggle over plans to tackle climate change. This year, the dominant theme of the energy industry's flagship conference was a new one: artificial intelligence (AI). Tech companies roamed the hotel's halls in search of utility executives and other power providers. More than 20 executives from Amazon and Microsoft spoke on panels. The inescapable topic, and the cause of equal parts anxiety and excitement, was AI's insatiable appetite for electricity. But it isn't clear just yet how much electricity will be required to power an exponential increase in data centers. But most everyone agreed that the data centers needed to advance AI will require so much power they could strain the power grid and stymie the transition to cleaner energy sources.

Western moves to deny Russia access to the US dollar financial system have forced Moscow to sell its commodities in emerging market currencies. This has become a game-changer for the global currency landscape. The de-dollarization of trade is a gradual process. But now that a significant percentage of emerging markets' trade in commodities has been de-dollarized, it is hard to imagine the US dollar will ever win that share back.

TECH'S INTERNAL MOMENTUN CONTINUES TO CONTRACT

Source: Strategas/Bloomberg

UNITED STATES

A year ago, Fed Chair Jerome Powell used his biannual testimony to Congress to spark a sharp rise in bond yields. When he spoke in March, the outcome could scarcely have been more different. He stuck to the script, saying that the fed funds rate was "likely at its peak" while adding that it would "likely be appropriate to begin dialing back policy restraint at some point this year." Even a second month of firmer than expected inflation data in March didn't change the Fed's view on the timing (likely June) or number of rate cuts. Providing the Fed with more support are the latest employment surveys that showed that the labor market is performing almost exactly as the Fed might hope. While the headline number was up, digging into the details provides a bit of a different story, as many of the "tighter" signs from the January report were revised away, reversed or some combination of both. Also, the rate of quitting is back to normal while vacancies continue to fall. The bottom line is that pockets of weakness have rolled through the U.S. economy, with housing & manufacturing already taking a hit. Housing however, may be turning as lower rates (from last fall) and now-rising inventory of homes for sale may be giving buyers more choice. Sticky inflation is likely pressuring the U.S. consumer, but until employment weakens significantly, fundamental support remains. The influx of millions of unauthorized migrants in recent years has sparked a political firestorm that has paralyzed Congress and consumed election campaigns. But it has also had a benefit: a bigger, faster-growing economy and 1.7 million additional potential workers (Congressional Budget Office).

CANADA

In March the Bank of Canada (BoC) held its policy rate steady for a fifth consecutive meeting, reiterating that it was still "too early" to consider rate cuts. Given Ottawa's choice of April 16th for the Federal Budget, the BoC would also prefer to wait and see the full contents of the Budget and therefore won't be in a position to formally incorporate its effects until after April's meeting. Also, the most recent economic report showing robust gains in the first two months of the year is also buying the BoC time before it needs to ease policy rates. Canada's real estate market may be beginning to show some cracks. The home sales to new listing ratio (an indicator of how tight the market is) declined for the first time in 5 months. Another concern is the latest Equifax report that found business insolvencies climbed more than 40% in the fourth quarter of 2023 and may go even higher as many are now stuck repaying pandemic loans. The sharp rise underscores the financial pressures faced by businesses and their need to manage debt and adapt to changing market conditions. Meanwhile, automobile sales continue to confirm that rumours of the demise of the Canadian consumer have been greatly exaggerated. The large number of new immigrants, the 480K new jobs created since the end of 2022 along with soaring wages, have all added up to strong auto sales. After years of being seemingly landlocked, the Canadian oil sector now has a solution. It's an expensive one, however. At a cost of C$35 billion (US$26 billion), the government, rather than the private sector, has built a pipeline linking the oilfields in Alberta with a port near Vancouver. The first barrels could be moving before June.

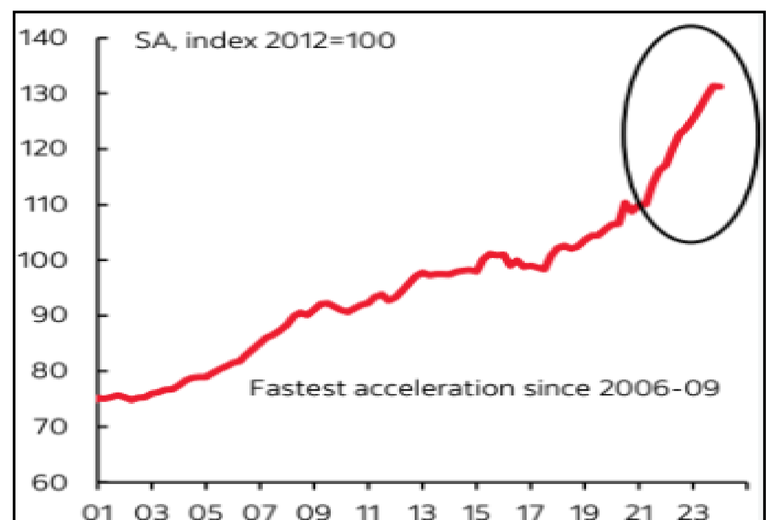
EUROPE

Christine Lagarde, President of the European Central Bank (ECB) said that the bank is "making good progress" in pushing down inflation, but is not yet prepared to commit to a path of interest rate cuts. She did drop a clue about the timing of a rate cut however, saying that they would remain data dependent and that "we will have a little in April and a lot more for our June meeting." Meanwhile the outlook for the European economy has brightened as activity continues to rise at services companies. They have been able to increase their selling prices at a "strong pace by historical standards". While still contracting (Germany & France) the more positive data from the euro zone composite purchasing managers' index (PMI) (led by the rest of the bloc) rose to a nine-month

U.S. HOUSING STARTS

Source: Strategas

CANADA: UNIT LABOUR COSTS



Source: Scotiabank. Bloomberg

high. And, whilst still reeling from the loss of cheap Russian natural gas for its energy intensive industries, business sentiment in Germany seems to be turning. According to the Ifo business-climate index's latest data there is now a better outlook for the economy. In a surprising move, the Swiss National Bank announced a cut to interest rates in a sign of policymakers' confidence over falling inflation. This action made it the first central bank of a major industrialized country to do so in the current cycle. The Bank of England (BoE) also said it was holding interest rates steady, with expectations that it may begin to cut in as little as three months. The BoE also forecasted that falling energy prices would bring CPI below 2% in Q2/24. Also, positive data was seen in the flash U.K. PMI rising to 49.9, the highest reading in 20 months, and a sign that the U.K. may be emerging from its technical recession.

EMERGING & DEVELOPING MARKETS

After the National People's Congress In early March, Premier Li Qiang projected that the world's second-largest economy could defy downbeat assessments and attain a 5% growth rate for 2024. This was in the face of intensifying economic headwinds from inside and outside its borders. There was also an admission that the foundation for China's sustained recovery and growth was not yet solid enough, thus requiring more intervention. China's government has also been trying to boost domestic consumer spending to reduce the economy's dependence on exports, as global trade and geopolitical frictions have mounted. However, Chinese consumers have not risen to the challenge as they've been hard hit by a major negative "wealth effect" as stock and property prices have been falling. Meanwhile China has been focused on moving its manufacturing industries up the value-added chain. With domestic consumption weak, the focus has been on exports, which also means avoiding those importers accusing China of dumping. In March, the Bank of Japan (BOJ) ended negative interest rates after eight years and unwound most of its unorthodox monetary easing policies, saying a new era of stable inflation is in sight. BOJ Governor Kazuo Ueda said the move was justified by steadily rising wages and prices. This was the first-rate increase since 2007. The annual Sunto round of Spring wage negotiations resulted in a preliminary estimate of a 5.3% wage gain. The gain follows a 3.8% rise (2023) and makes for the strongest back-to-back gains since the early 1990s. Meanwhile, sentiment amongst large manufacturers has worsened for the first time in four quarters.

COMMODITIES

The buildout of new data centers required for AI as well as the continued development of energy transition end markets are reasons why the next cyclical upturn in copper seems to have been pulled forward. Because of its electrical and thermal conductivity, copper remains an important metal in power-intensive data centers. Most experts still see copper market deficits this year as a result of strength in non-China demand. Currently accounting for only 5% of global demand, India is becoming a big enough market to move the needle, given its strong growth rates and bigger base. Also, global copper mine supply will decline this year as a result of depletion from existing mines and a lack of new projects. The eventual shift to lower interest rates should be bullish for gold. After hitting an all time high of $2,195US, gold initially backed off before resuming its upward trend and breaking through $2,200US, in spite of the latest views that the Fed will be slow to lower interest rates. Geopolitical uncertainties and substantial buying by global central banks have put upward pressure on bullion. March brought the first fatal Houthi maritime attack since the group formally entered the Israel-Hamas war. Noteworthy is the fact that this was a Saudi-bound ship, and the Houthis had avoided striking any Saudi targets. There are now heightened concerns that the Houthis may use their extensive missile and drone arsenal to strike Gulf oil assets. Meanwhile, Nigeria is seeing a surge in violence which may threaten oil production. While the country's supply and exports have rebounded from the lowest levels in decades, gang violence now poses a risk to the country's oil supplies.

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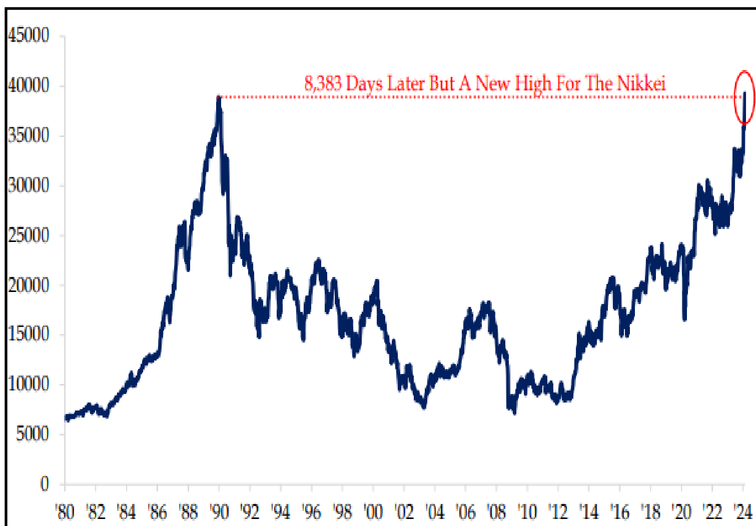

Source: Strategas/Bloomberg

COPPER: QUITE THE DAY AND TECNICHAL BREAK YESTERDAY

Source: TD Securities/Barchart

RECOMMENDATIONS

With equity markets off to a great start this year, investors' appetite for risk assets continues to grow. This combined with some sentiment readings, global elections affecting over 500 million people and what is already priced into markets, are cause for near term caution. However, when we look at volumes, we believe we are not in a euphoric stage, but rather one of excitement, and there appears to be room for more than just tech (AI related) shares to join the party. Strong economic data have given bulls more confidence that the U.S. will benefit from a soft landing and future interest rate cuts (goldilocks scenario). And, with current high valuations on many of the technology/AI names, investors have become somewhat cautious on the group and have begun to look outside of this sector to capture future market gains. The loss of momentum now being seen in some of the technology /AI stocks has morphed the market into a stock pickers paradise. Throw in the fact that the leading edge of global policymakers seem to favor rate cuts by June, then H2/24 is shaping up to be economically more positive for the global economy. If all develops as we are prognosticating, we will be taking our close to neutral equity positions to a somewhat overweight stance as market opportunities present themselves. While we continue to like technology (and healthcare), value is appearing in the late cycle sectors. Coming into 2024 markets were pricing in a fairly aggressive rate cut scenario. But, as we moved through Q1, these expectations were quickly tempered and bond yields retracted a good part of their decline. This resulted in a negative quarter for most fixed income products. However, with our bond portfolio having a shorter average duration, with its concentration on higher yielding corporate bonds and the inclusion of some better performing asset classes (preferred shares), the returns for the quarter were positive, substantially outperforming the benchmark. Our outlook is for rate cuts by late spring with Canada probably moving ahead of the U.S. Given the gap between short- and longer-term interest rates we think the potential for bond rates to come down substantially is limited. Therefore, we will continue to make new commitments, targeting a shorter than benchmark duration, somewhere in the 4-6-year term.

FORECAST 2024

	CURRENT 31-MARCH– 2024	2024 RANGE	2024 YEAR-END
INTEREST RATES			
Bank of Canada Overnight	5.00%	4.25% - 5.00%	4.25%
Federal Funds Rate	5.50%	4.75% - 5.50%	4.75%
10-year Canadian Treasury	3.47%	3.25% - 3.85%	3.30%
10-year US Treasury	4.20%	3.85% - 4.65%	3.95%
COMMODITIES			
Gold (US$/oz.)	$2,217	$1,990 – 2,350	$2,200
Oil WTI (US$/lb)	$83.17	$70.00 –92.00	$82.00
Copper (US$/bbl)	$4.00	$ 3.65 – 4.50	$4.25
Natural Gas	$1.76	$1.69-$2.25	$2.10
MARKETS			
S&P/TSX Composite Index	22,167	20,466 - 22,600	22,000
S&P 500 Index	5,254	4,680 - 5,350	5,100
CANADA DOLLAR/US DOLLAR	$0.74	$0.72 - $0.76	$0.75

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