CUMBERLAND

First Quarter Review and Outlook
Cumberland Income Fund
March 2016

The first quarter of 2016 proved to be another see-saw quarter in fixed income markets. The quarter started with volatility consistent with that experienced in equity markets. Continued concerns over China's growth rate, a slowdown in the North American manufacturing sector, and fallout from collapsing commodity prices steered the markets to traditional safe-haven sectors such as government bonds through to mid-February. During that time, the word "recession" appeared with greater frequency in the financial media and published investment research reports. As seems to be the case with all "crises" post the 2008 Lehman bank failure, this risk of recession "crisis" came and passed, at least for now. As we worked through the last six weeks of the quarter, the risk of recession pricing in the bond market largely unwound. The Cumberland Income Fund's diversified positioning and elevated short-term bond holdings dampened much of the volatility. The Fund also opportunistically deployed capital (cash) into the higher yielding environment prevalent during the quarter, consistent with our stated strategy.

Government bond yields declined further during the quarter supporting bond prices. The government bond sector in Canada returned +1.35% during the quarter as the Government of Canada 10-Year bond yield declined from 1.39% to 1.23% by quarter-end. Repeating the trend we saw at the beginning of 2015, yields started the year at what turned out to be the highs of the quarter and trended lower throughout the middle of the quarter before rebounding somewhat by March 31st as the risk of a recession faded. However, unlike the corporate bond and equity markets, government bond yields did not retrace back up to start of the year levels. Perhaps the main reason, one that we have become all too familiar with since 2009, is further accommodative monetary policy from global central banks. The three main central banks all took action this quarter. The Bank of Japan (BoJ) stunned the markets at the end of January by lowering their policy interest rate into negative territory from 0.1% to -0.1%. Six weeks later, the European Central Bank (ECB) unleashed another round of monetary stimulus of its own, cutting the main policy rate to 0.0%, increasing monthly bond purchases from €60 billion to €80 billion, and initiating a new program to lend money to the commercial banks. And thirdly, at the March 16th Federal Reserve meeting, Chair Janet Yellen backed down from posturing to raise the U.S. policy interest rate by one percentage point this year. Instead, she guided the market's expectations to just a 0.5 percentage point increase by the end of 2016. In all three cases, central bankers cited concerns/risks in their economy's ability to reach its 2% inflation target – the key central bank mandate driving monetary policy around the globe.

In the case of Yellen's stance on U.S. inflation, we remain puzzled by her updated view point. Throughout 2015, Yellen consistently framed the declining inflation rate as *transitory* – a function of depressed commodity prices, a thesis Cumberland also subscribed to. However in a speech in March, Yellen reversed her stance citing downside risks to the inflation outlook. What's puzzling is her stance has changed in the face of an *increase* in inflation measures so far in 2016. As evidence of her "transitory" thesis began to actually bear out, Yellen decided to back away from that thesis and rather emphasized risks from "global economic and financial developments". At a speech at the end of March, Yellen also resorted to commenting on financial market pricing – something that is usually outside the mandate of central bankers - to justify lowering the market's expectation of higher interest rate policy. Comments such as "...oil prices could resume falling, and the dollar could start rising again" were peppered throughout her speech. As shown in the chart below, three key measures of inflation have picked up significantly so far in 2016.

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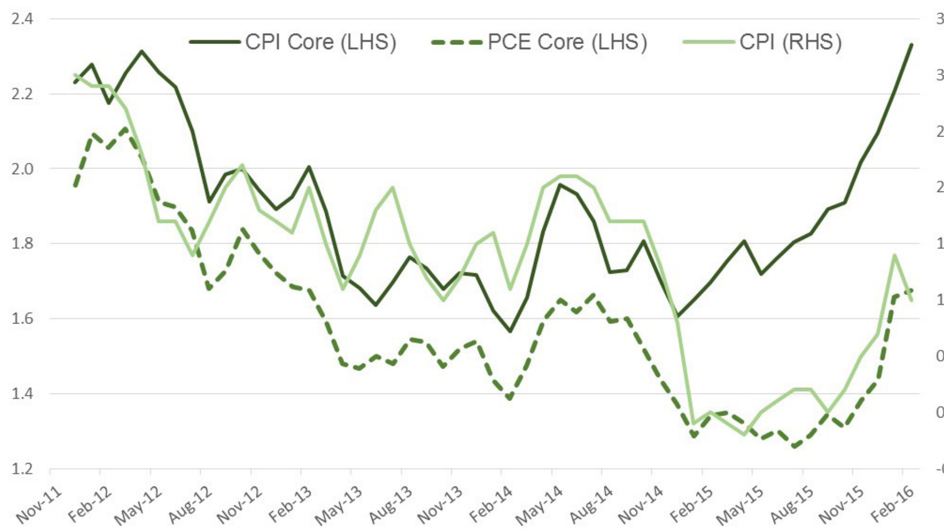
U.S. Measures of Inflation (year-over-year %)



CPI: U.S. Consumer Price Index YoY%

CPI Core: U.S. Consumer Price Index ex Food and Energy YoY%

PCE Core: U.S. Personal Consumption Expenditures ex Food and Energy Price Index YoY%

Source: Bloomberg

We surmise that her comments on possible continued commodity price weakness and concerns about the global economy to lower policy rate expectations was an attempt to weaken the U.S. dollar (USD). The strong USD has been a headwind to U.S. corporate earnings and a source of volatility to emerging markets and we believe Yellen wanted to stabilize these imbalances, at least temporarily. Regardless of her motives, we consider this diversion between Yellen's speech and the current direction of inflation a risk to bond yields reverting back to higher levels, thereby putting downward pressure on bond prices. Compounding this risk to higher bond yields in Canada is the new Liberal Party federal government's budget. The Liberal Party announced in March a federal budget with increased fiscal spending, financed by deficits, to reinvigorate growth after the headwinds caused by declining commodity prices. The fiscal spending may result in inflationary pressures and a pick-up in GDP growth, both potential catalysts for higher bond yields/lower bond prices in Canada. The Fund continues to keep duration near three years (compared to the FTSE TMX Canada Universe Bond Index duration of 7.5 years) in the bond portion of the Fund thereby keeping sensitivity to interest rate volatility relatively low.

Investment grade corporate bonds (credit rating BBB- or higher) had a volatile quarter as corporate spreads widened (corporate bond prices cheapened relative to government bonds) significantly into the middle of the quarter only to reverse all the damage by quarter end. As a result, the FTSE TMX Canada Corporate Bond Index returned +1.51% for the first quarter, slightly outpacing the broader FTSE TMX Canada Universe Bond Index's return of +1.39%. As mentioned above, the first half of the quarter was defined by a high level of anxiety over the risks of a recession. The corporate bond market was clearly flashing signs of these risks, but this pricing was not being confirmed in the economic data, in our view. Data such as unemployment, consumer confidence, and loan delinquencies were not deteriorating at a rate consistent with an imminent recession. Without that confirmation corporate spreads stopped widening and began to improve (decline).

The ECB also played its part. During March the ECB not only expanded the amount of its monthly bond purchases from €60 billion to €80 billion as described previously, but it also added investment grade corporate bonds to the list of assets that are eligible for purchase under the asset purchase program. Investors began snapping up corporate bonds in anticipation of this larger "new" buyer entering the corporate bond market. Coinciding with this selloff in corporate bonds earlier in the quarter, Royal Bank of Canada (RBC) and Wells Fargo (WFC) issued bonds into the Canadian bond market. The bonds were attractively priced in our view and thus we purchased an RBC bond with a coupon of 3.31% to be called on January 20th 2021 and a WFC bond with a 2.22% coupon maturing March 15th 2021. Both bonds benefited from the compression in spreads by quarter-end.

10-Year Indicative Canadian Corporate Bond Spreads

Source: BMO Capital Markets

After being down -2.1% by the end of February on a year-to-date basis, the FTSE TMX Canadian High Yield Index (bonds with a credit rating of BB+ or lower) climbed back during March to record a +0.9% return for the first quarter. There was no new high-yield issuance during the quarter as investor appetite for new non-investment grade bonds was virtually non-existent. However, there were positive outcomes of note during the quarter in two of the Fund's high yield holdings. The first related to our holding of the Corus 4.25% 2020 bond. During the quarter, Corus Entertainment Inc. acquired the media assets of Shaw Communications Inc. for $2.65 billion. The transaction was so large that Corus tripped a debt covenant and was forced to call their bonds. The bonds went from $93 to $106 immediately after the announcement and we subsequently sold the position. The second outcome involved our holding of Centric Health Corp 8.625% 2018 bonds. These high yield bonds have been out of favor since we purchased them in 2013 at par, trading between 80 – 85 cents on the dollar during 2015. However, after selling a portion of their business, Centric management announced the proceeds would be used to buyback the bonds at 100 cents on the dollar. The buyback was completed by the end of February and we have exited the position having been made whole.

The preferred share market remained under siege during the quarter. After declining -15% in 2015, the TSX Preferred Index declined another -15% in the first two weeks of 2016 alone. As with most credit related securities, we have alluded to above, preferred shares rallied after that point closing the quarter down just -5.6%. Part of the reason for the selloff was a result of bond yields heading lower during the quarter and credit spreads widening – both headwinds for rate-reset style preferred shares in particular. However, compounding the pricing pressure was a significant amount of issuance of preferred shares by Canadian banks. In a sense, the banks were "forced" issuers of the preferred shares for regulatory capital requirement purposes. The entire preferred share market repriced lower due to the large supply and Cumberland added to the attractively priced preferred share sector including shares issued by Pembina Pipeline Corp. (PPL.PR.K), National Bank (NA.PR.X), Royal Bank of Canada (RY.PR.R), and Laurentian Bank (LB.PR.J); all of which were issued with coupons ranging between 5.50% and 5.85%.

Dividend-paying stocks performed exceptionally well during the quarter. The sector experienced a similar intra-quarter return profile as corporate bonds and preferred shares with the TSX High Dividend Index declining -8% by the first two weeks before closing the quarter up +8.7%. This sector performed well within the Cumberland Income Fund during this quarter. Core equity holdings (Northland Power Inc. (NPI), Fortis Inc. (FTS), and Morneau Shepell Inc. (MSI)) had total returns between 10-20% during the quarter, while American Hotel Income Properties (HOT-U) and Chemtrade (CHE-U) both closed roughly flat. Towards the end of the quarter, we sold a partial position in Northland Power to bring the portfolio weight back to target after strong price appreciation over the past six months. The Fund also added Pembina Pipeline Corp. (PPL) to the equity segment. PPL operates oil pipelines, stores oil, gathers and processes natural gas primarily in Western Canada, and ended the quarter with a

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dividend yield of 5.5%. In general, the difference between bond yields and the dividend yield of high dividend-paying stocks remains well above the 5-year average and therefore equities remain an attractive source of income generation, in our view.

OUTLOOK

We believe the favorable returns in fixed income markets during the first quarter mask a greater amount of risk than investors may not yet appreciate. The routine of lower policy interest rates, more asset purchases (BoJ and ECB), and negative bond yields is ultimately a path to potential corporate credit deterioration. With slower global growth, companies have had a tendency to issue bonds (exploiting the low interest rate environment) to fund share buybacks to drive shareholder returns. Generally, this cycle could lead to a financial leverage profile where the risk/reward profile becomes skewed to risk and away from reward. In addition, we continue further into unchartered waters with negative interest rate policies in certain major economies around the world (including Europe and Japan) to which the ultimate unintended consequences remain unknown. Nevertheless, the U.S. economy continues to improve albeit in fits and starts, and the price of oil has rebounded somewhat from the mid-February lows, both of which should be supportive to the Canadian economy. With this backdrop in mind, our strategy of selecting securities (be it bonds, preferred shares, or common shares) issued by companies with attractive risk/reward characteristics including stable and predictive cash flows is a crucial pillar to generating a reliable income stream while preserving capital. Furthermore, we see no reason to expect the volatility experienced in fixed income markets in 2015 and so far in 2016 to subside any time soon. Global monetary policy continues further into experimental territory and uneven and uncertain global growth seems to be the most likely investing backdrop. We continue to retain a high level of liquidity to dampen volatility somewhat and remain opportunistic in the event of higher bond yields.

R. Schulte-Hostedde
Portfolio Manager, Fixed Income
April 2016

Asset Allocation as at March 31, 2016

Asset Class	% of Portfolio
Cash and Cash Equivalents	7.9%
Government Bonds (incl. Floating Rate Notes)	15.9%
Corporate Bonds	52.6%
Preferred Shares	9.4%
Equities/Income Trusts	14.2%

Yield[1] Comparison as at March 31, 2016

FTSE TMX Canada Universe	2.0%
FTSE TMX Canada Government	1.7%
FTSE TMX Canada Corporate	2.7%
Cumberland Income Fund[2] (today)	3.7%

1. Yield is the rate of income generated on an annualized basis. Yield does not represent the total return of the Fund or the indices shown in the above table.
2. Gross of fees.

Cumberland Private Wealth Management Inc. is a leading independent investment firm that provides discretionary investment management and wealth management services for high net worth individuals, their families and foundations, with $1 million or more in investable assets. All of Cumberland's investment mandates are centered on building and preserving our clients' financial wealth. Founded in 1997, the firm is privately-owned by its employees and headquartered in Toronto, Canada.