CUMBERLAND

Second Quarter Review and Outlook
Cumberland Income Fund
June 2016

THIS YEAR IN REVIEW

The 'On-Again, Off-Again' Fed

For most of the second quarter, fixed income markets were driven by the uncertainty of whether the Federal Reserve would follow through with further policy interest rate increases. The vacillation of opinion was evident in the Fed Funds futures market, where the probabilities 'for' and 'against' summer rate hikes shifted four times during the quarter.

The Fed's first increase of the Fed Funds Rate since the 2008 financial crisis occurred in December 2015, a move policy makers justified by stronger US economic growth. However, risks from higher US interest rates and a strong US dollar (USD) reverberated through global financial markets in early 2016, requiring the Fed to soften their stance on the pace of future hikes.

Global stock and corporate bond markets stabilized by early April and investors again started to forecast interest rates would rise. Fed Funds futures markets implied a strong probability of rate increases by the summer and bond yields rose nearly ¼%. Supporting the case for higher rates was robust job growth in the US, a weaker USD and inflation at or approaching the Fed's stated 2% target.

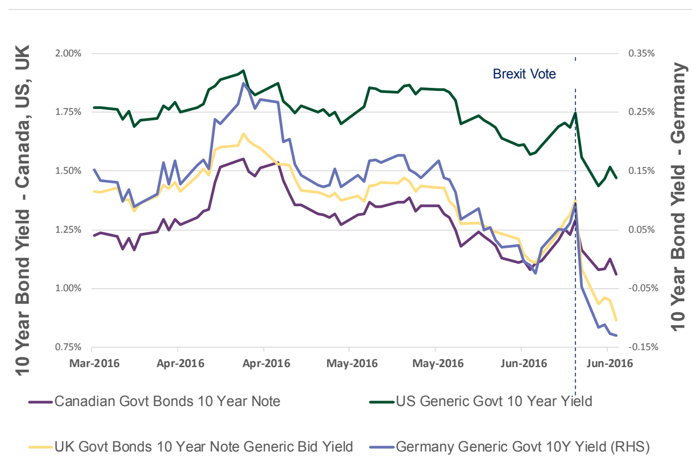
However, with a preponderance of soft economic data in late April/early May, the call for an imminent rate hike was off the table. Corporate profits fell in the first quarter of 2016 due to weak global demand and a strong USD that hurt in the translation of foreign earnings. Business investments and capital expenditures were scaled back. US job growth slowed and retail sales softened. In its preliminary reading, US GDP registered growth of only 0.5% in the first quarter and futures markets reverted to a very low probability of rate hikes until late 2016.

On this occasion, the Federal Reserve held firm in its commitment to raise rates in June or July. The Fed Chairwoman, Janet Yellen dismissed the weak data as either temporary - i.e. retail sales were affected by a warm winter - or transitory - i.e. a weaker USD and higher oil will eventually boost profits and inflation. The Fed's message was no more explicit than when Janet Yellen spoke at Harvard University on the Friday afternoon before the Memorial Day weekend. She said, "the economy is continuing to improve" and "it's appropriate... for the Fed to gradually and cautiously increase our overnight interest rate over time. Probably in the coming months such a move would be appropriate." Interest rates rose following these comments given the likelihood of a summer rate hike.

Yet again, the Fed's intent to raise rates was squashed by a June jobs report showing a sharp drop in hiring. On the back of this, the FOMC's own internal survey of economic conditions was lowered and the probability for a summer rate hike disappeared.

While the Fed's shifting position on rates created volatility in the second quarter, government bond yields and corporate credit spreads were ultimately little changed until the final week of June (see chart below). That changed with the UK's vote to leave the European Union (EU).

10 Year Government Bond Yields



Source: Bloomberg

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Brexit

Markets debated the impact of the United Kingdom's June 23rd referendum on EU membership for months but with hindsight, it is evident few positioned for a 'Leave' vote. In arguing for the UK to remain in the EU, many prominent economists and public officials warned of the 'disastrous' economic consequences of a 'Leave' vote. The message helped to keep the 'Remain' camp ahead in the polls until the final days of the campaign. However, the message also contributed to the market's sharp negative reaction when the vote to 'Leave' was announced. Most significantly, worries about an economic slump across Europe sent European government bond yields plummeting. In a flight to safety, German 10-year government bonds traded at negative yields, meaning investors are willing to lose money lending to the German government. British 10-year government bond yields fell by half of one percent to yield less than one percent. The Brexit vote also sent Canadian and US bond yields lower with the Canadian 10-year yields dipping below one percent.

The drop in sovereign yields reflects the likely expansion of UK and European Central Bank (ECB) monetary stimulus to counteract the deflationary impetus from slow growth. Interestingly, market-derived expectations for US 'break-even' inflation have not changed materially following the Brexit vote and with real interest rates turning negative, further declines in US Treasury yields will be a challenge.

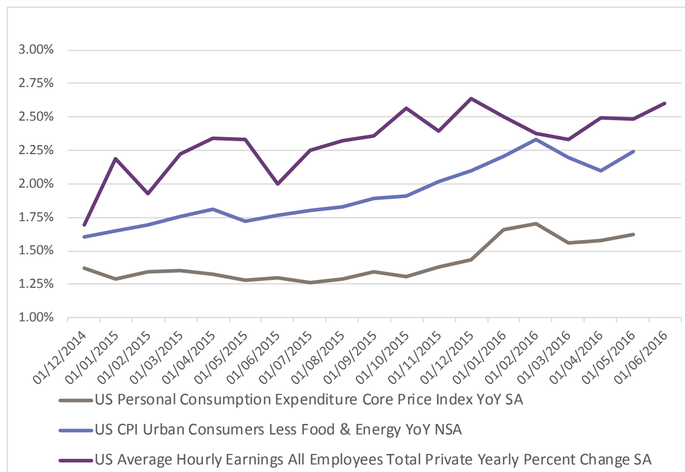
OUTLOOK AND POSITIONING

The Cumberland Income Fund (CIF) is positioned for continued economic growth and rising interest rates, reflected by our outsized holdings of shorter-term bonds and corporate exposure (includes corporate debt, preferred share and common equity).

The duration of the bonds in the Cumberland Income Fund (CIF), at 3.3 years, is much lower than the duration of 7.8 years for the FTSE TMX Canada Universe Bond Index. We have maintained our overweight positioning in investment grade and high yield bonds over the second quarter with allocations of 40% and 12%, respectively. Additionally, the CIF holds 11% in preferred share and 15% in common shares, each of which we consider long duration investments (i.e. they have no pre-determined maturity date).

In our view, the US economy is healthy enough to support a more neutral monetary policy. The Federal Reserve's dual objectives of full employment and two percent inflation have largely been satisfied. The US unemployment rate has dropped precipitously, reaching a cycle-low of 4.7% in May. Consistent with our first quarter commentary, inflation is also trending upwards with the core consumer prices index eclipsing 2%. Importantly, wage growth is also accelerating, confirming the acceleration in prices for consumer goods and services.

US Measures of Inflation (year-over-year %)



Source: Bloomberg

It is understandable that the Fed wants to raise rates but it is hamstrung by a global economy that is not prepared for higher interest rates or a stronger USD. This is further complicated by the Brexit vote. However, the US and Canadian economies are not overly exposed to Europe or the UK and, in our view, Brexit will have a muted impact on the broader North American recovery.

The data driving the Fed's 'on-again, off-again' positioning appears transitory and markets will soon again price in rate hikes for 2016. Even following Brexit, global financial markets have been much more stable than what was experienced at the start of 2016. The USD has depreciated by about 3.5% since January and corporate credit spreads are much lower. An uncharacteristically warm winter also seems to have weighed on sales and hiring.

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Today, stronger consumer and government spending are underpinning economic growth in Canada and the US. Oil prices have recovered and, coupled with a falling USD, will support a recovery in earnings, especially for banks and resource companies. Jobs and wage growth should continue as corporate profits improve. We are closely watching for exogenous shocks from Europe's fragile banking sector or China's currency devaluations, but to date these risks do not threaten our outlook.

Peter Jackson
Chief Investment Officer

Sean Yuile
Portfolio Manager, Canadian Equities
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Asset Allocation as at June 30, 2016

Asset Class	% of Portfolio
Cash and Cash Equivalents	6.8%
Government Bonds (incl. Floating Rate Notes)	16.3%
Corporate Bonds	51.5%
Preferred Shares	10.7%
Equities/Income Trusts	14.8%

Yield[1] Comparison as at June 30, 2016

FTSE TMX Canada Universe	1.8%
FTSE TMX Canada Government	1.5%
FTSE TMX Canada Corporate	2.5%
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.