CUMBERLAND

ROTATION

For some reason, the day after Labour Day always feels like the start of a new business year. People are back from holidays, cottages are being closed and it's time to get refocused on business.

If you were distracted by all the good weather, the market actually had a pretty good summer after getting a little jolt from Britain's decision to leave the European Union.

Consequently, we thought we might try to pull it all together for you. We'll start with the general consensus on the market, then give you our views and finish by trying to elaborate on the bull and bear cases for equities. Along the way, we'll work in some comments on the Federal Reserve's interest rate policy and the upcoming U.S. Presidential election and other popular concerns.

So let's start with some unfinished business. Brexit. At the time of our last quarterly, we just had a vote in the UK to exit the European Union. Although it was a surprise, the catastrophic consequences of the election have yet to show up. In fact, no one thinks there will be any dramatic consequences for several years to come as the UK and Europe sort out their new trade arrangements. The global equity markets had a knee-jerk reaction that lasted only a matter of a couple days and the US market is now at all time new highs. So it seems to be over. Although Brexit may not turn out to be dramatic, we should be aware that it might be an inflection point that we want to pay attention to. There are a number of European countries that have divided views. Even if the more extreme parties don't get elected, the pressure on mainstream governments will cause them to adjust and become more protectionist and probably limit immigration.

So the feared consequences of Brexit is that it metastasizes into a general rejection of free trade, skepticism of existing trade agreements and growing isolationism. U.S. presidential candidate Trump's popularity is a reflection of those fears. There is also a fear over greater immigration and loss of jobs to immigrants that has generated concerns over ethnic issues.

Generalized, it's a backlash against the establishment and globalization. The general feeling is that the EU may be too big and involve too many countries that have their own special interests. It's without central leadership, the bureaucracy is cumbersome, expensive and overly regulatory. This is not conducive to business expansion or hiring. One journalist described it as "*a demographically doomed political quagmire led into cultural irrelevance by economically obtuse bureaucrats.*" The quote comes from an excellent research piece written by Ned Davis Research. It's too long to properly summarize here but please see the appendix which has a number of sound bites from the piece that will give you a sense of the prolonged issues facing Europe.

We bring this up as a little housekeeping item on what was anticipated to be a major event that would affect the market's future direction and perversely maybe it did, if you consider the US markets are now at all-time highs – either way, it's a good example of how useful market forecasts are.

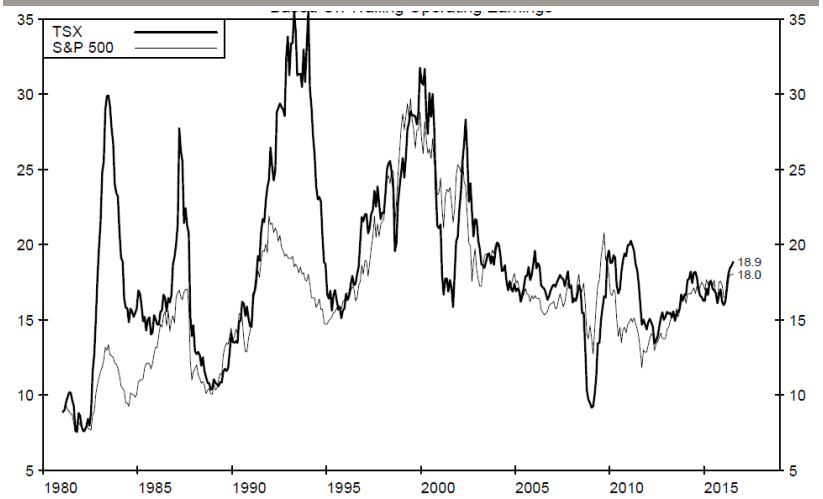
Current Market

So, let us start with the current market sentiment. As we said, the averages are at an all-time high and concerns are best summed up by this chart which looks at the valuation of the TSE and S&P 500 using price to earnings (P/E) ratios. They're high and certainly above the average which would be closer to 16x, however you can see there have been several higher peaks.

The bulls say the market is only a bit expensive in absolute terms but cheap relative to other asset classes such as bonds or real estate.

The bears believe that interest rates are going higher and that earnings estimates are too optimistic, both of which will result in an even more overvalued market.

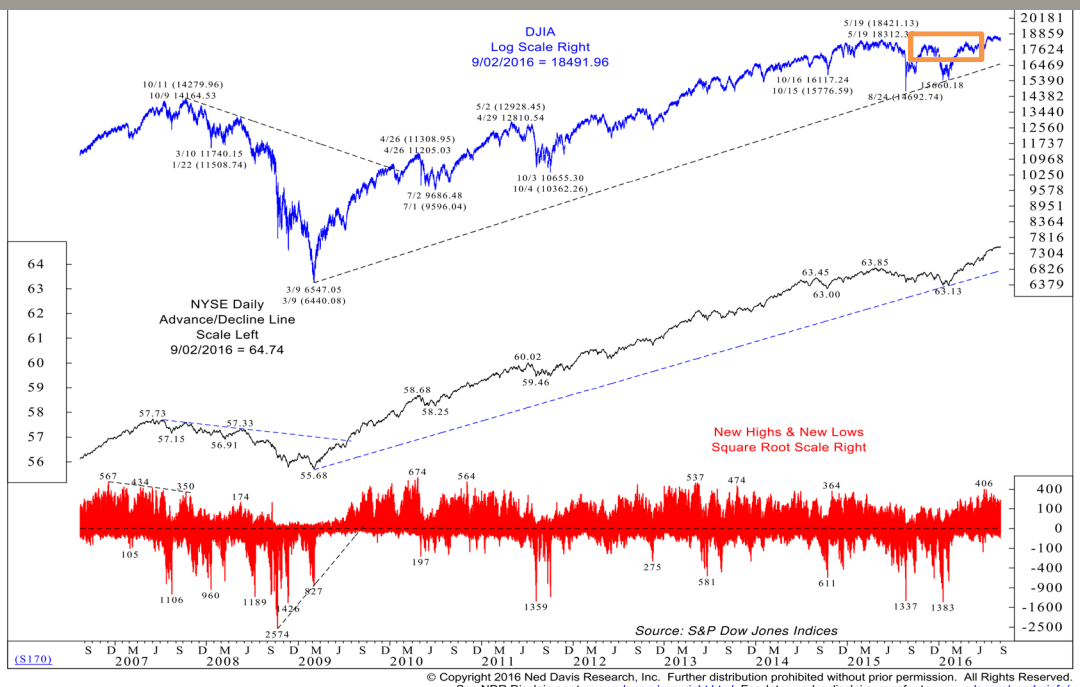
Price-Earnings Multiples
Based on Trailing Operating Earnings



Our View

Our take on the market is a little different in that we're not necessarily predicting higher averages but we do think you can make money in this market due to rotation.

Dow Jones Industrial Average and NYSE Breadth Indicators



We've seen the market consolidate for roughly 21 months as seen in this chart with a taint of a bear market as more than half (269) of the S&P 500 companies fell more than 20% between May 2015, the market peak and the end of July. This could be considered an internal correction, roughly similar to what we saw in 2011 when the averages declined by 19%.

This market consolidation is consistent with the earnings recession that we have witnessed where earnings have declined for six straight quarters starting in the 4th quarter of 2014.

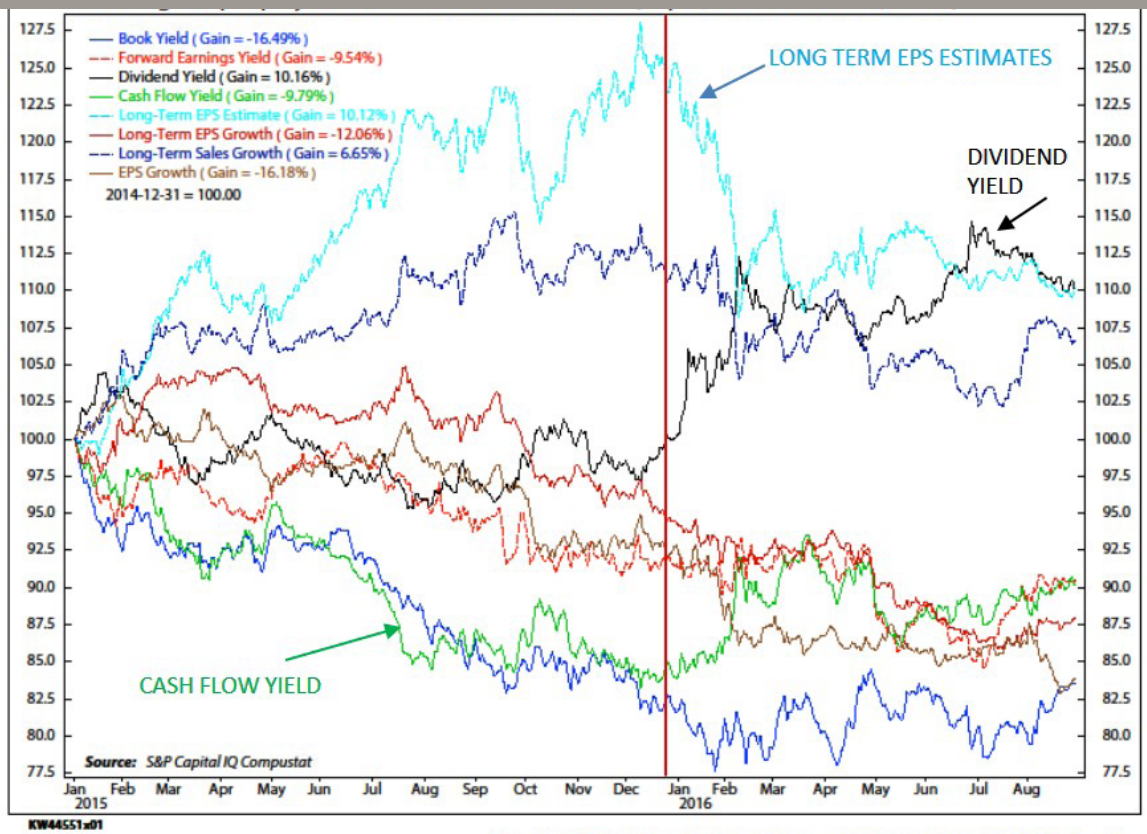
During this period we saw "growth stocks", those companies that were able to show sustained earnings growth, appreciate to extraordinarily high price/earnings (P/E) ratios as epitomized by the FANG stocks (Facebook, Amazon, Netflix and Google). These types of companies received what we would describe as a "scarcity premium" because there were so few companies showing any earnings growth.

Now, we think the economy is on the verge of reaccelerating on the back of continued improvements in employment and the stabilization in the price of oil.

If we're right, the more economically sensitive companies – let's equate them to "value", will show an earnings acceleration which should mitigate the scarcity premium "growth" companies that have experience.

And we think we're already seeing this play out. Take a look at this chart.

NDR large-Cap Equity Series Growth & Value Factors (top quintile/ bottom quintile)

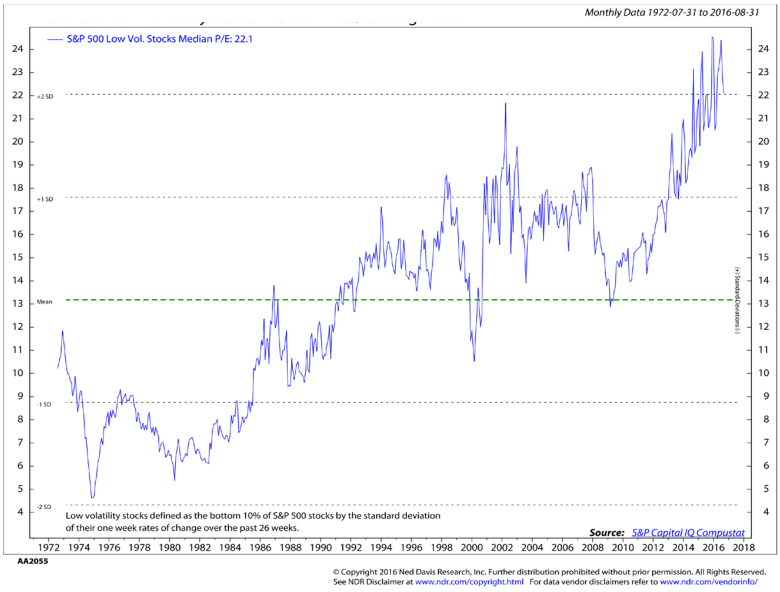


Here you can see the "long term EPS estimates" (Turquoise line), peaked at the end of last year (these are the FANG and "Biotech" stocks). The growth scarcity premium started to fade. What replaced it was a chase for dividend yield as the Fed backed away from raising interest rates and investors turned to bond substitutes. You can see this in the black dotted line that represents "dividend yields" which peaked in June. Our favoured valuation metric is the "cash flow yield" (the green line) which did not do well through 2015, improved in the first part of this year only to falter in May, but has now re-accelerated again as economically sensitive stocks are starting to outperform.

The overvaluation in bond substitutes can be seen in this chart on "low volatility stocks" that include utilities and consumer staples stocks.

They collectively trade at over 22x earnings. Utilities alone trade at almost 20x earnings with projected growth of only a little over 3%.

S&P Low Volatility Stocks Median Price/Earnings Ratio



Historically low interest rates and low inflation have been good for value styles and low P/E stocks but this time low rates have been symptomatic of low growth, so the favoured valuation metric has been yield which explains the previous chart. With the uptick in economic growth, we think low price earnings should reassert themselves.

J.P. Morgan recently did a study contrasting value versus growth. They found that between 2010 and 2015 the global price to book factor (their proxy for value) lost over 5% per annum while price momentum, or growth, gained by almost 10%. That was in contrast to the historical performance of 4% and 1%, respectively. This spread in performance has been closing in 2016 as momentum has declined by 12% while price to book has gained more than 4%.

So our opinion that investors could do well is based on 3 principles.

1. This first is liquidity. There is a lot of money around that has to go someplace if it isn't being taken up by the economy.

   Bull markets usually end due to excesses, generally too strong an economy that causes the Fed to clamp down.

   There are lots of ways to measure liquidity but we'll give you just one to make our point. According to J.P. Morgan, 74% of sovereign debt outstanding currently yields less than 1% and 36% of government bonds have negative yields. In fact, bonds worth 2.3 trillion Euros or 31.5% of the bonds in the system yield less than the European Central Banks (ECB) deposit rate – which marks the floor that the ECB can pay.

   This may seem like a mundane point but consider this. Currently 63% of German bonds trade below that

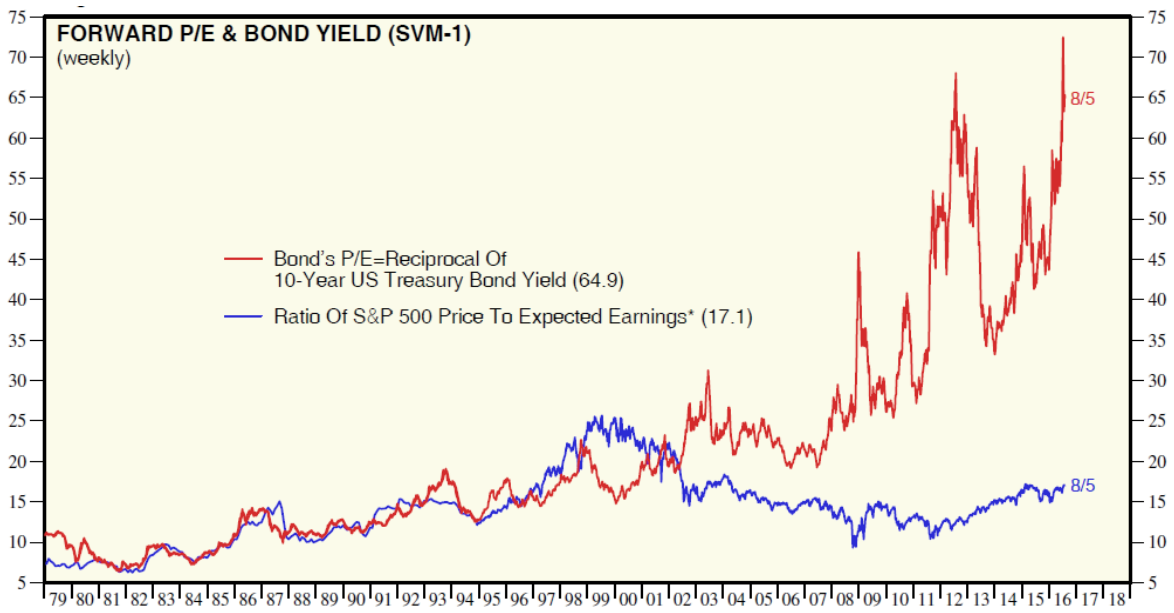
floor and the ECB is mandated to buy bonds relative to the size of the country's economy. Germany is the biggest. So the ECB is running out of bonds to buy and many analysts think this will happen before year-end. Consequently central bank watchers are curious as to what they will do. They could buy more corporates or they could follow Japan and buy equities. Today Japan is already a top-five owner of 81 companies in the Nikkei 225, which is an index that holds Japan's largest companies. Again, liquidity has to go somewhere if the economy doesn't take it up and historically it has flowed into financial assets. Will equities be the next candidate for Quantitative Easing? Well, Japan has already crossed that bridge and Fed Chairwoman Janet Yellen in a recent Kansas City conference said that the Fed might be able to help the US economy in a future downturn if it could buy stocks and corporate debt. This bond buying panic that we have witnessed has resulted in about a quarter of the global economy now having negative rates.

2. This brings us to the second principle – reversion to the mean. Nothing goes up or down forever, eventually things revert back to the norm and I think we have two examples of this.

   The first is the bond market which reminds us of the tech blow off in 1999 when the dot coms went to extraordinary valuations while value stocks sold off.

   A good way to look at this is to convert the bond market yield to a price earnings ratio. You do this by dividing the bond price by the yield and then comparing that to the price earnings ratio for the stock market.

   This chart looks a lot like the dot com era at the end of the 90's, and suggests the bonds are trading at about 65x earnings.



* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly thereafter.
Source: Standard & Poor's Corporation and Thomson Reuters I/B/E/S.

For perspective, from 1958 through the present, the average U.S. 10-year treasury yield was 6.19% versus 1.49% today.

A reversion here may not result in a collapse in bond prices as central banks support them. But investors are looking for alternatives and earnings growth could be the catalyst for value stocks.

The other reversion is also similar to the late 90's when value started to perform better than growth. We think that has started as mentioned earlier.

Performance

Jan 1 to July 6		July 6 to Sept 1	
Utilities	22.3%	Technology	10.0%
Telecom	22.1%	Financials	8.8%
Energy	13.2%	Materials	7.3%
Consumer Staples	9.2%	Industrials	4.4%
Industrials	5.1%	S&P500	3.6%
Materials	4.6%	Consumer Discretionary	2.2%
S&P 500	2.7%	Energy	0.9%
Health Care	1.2%	Health Care	-0.2%
Consumer Discretionary	0.9%	Consumer Staples	-1.9%
Technology	-1.2%	Telecom	-5.8%
Financials	-5.8%	Utilities	-8.0%

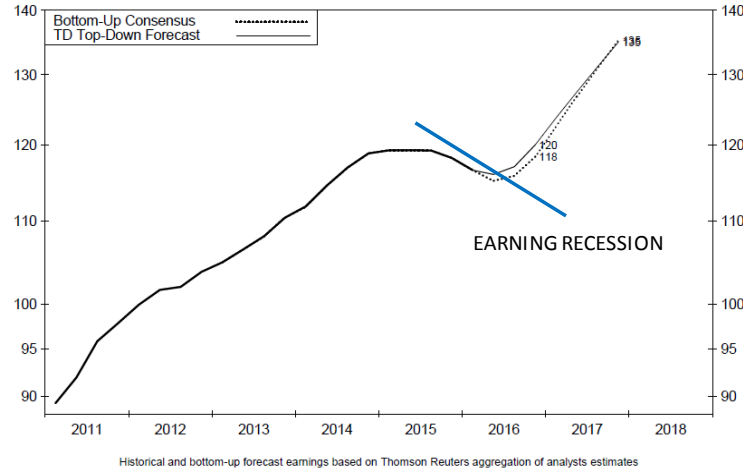
This table will show you the reversion by sectors that has taken place during the summer rally. You can see the dramatic improvement in Financials which is the biggest weighting in Value while bond substitutes are regressing back to more realistic valuations.

3. Our third principle has to do with the economy. We've said for a long time that we don't think this bull market will end until you see either a contraction in monetary policy or a recession.

The economy is growing, but slowly. The recession we have witnessed has been in earnings over the last six quarters and we think that is coming to an end.

This chart shows that earnings recession from the end of 2014 until the middle of this year.

S&P 500 Operating Earnings



Most of the decline can be attributed to Energy, which now seems to have stabilized. As you can see in this table, the S&P was experiencing positive growth through most of 2015 when energy related earnings were excluded.

S&P 500 Earnings		
	With Energy	Ex-energy
Q4 – 2014	-6.0%	-3.6%
Q1 – 2015	-6.2%	-7.7%
Q2 – 2015	-11.4%	+1.2%
Q3 – 2015	-14.7%	+2.3%
Q4 – 2015	-14.8%	+1.8%
Q1 - 2016	-8.5%	-5.9%

In the second half of this year, the oil industry comparison should get easier.

As shown on the above earnings chart, earnings are expected to recover to about $118 this year and grow a further 14% next year to $135.

With this earnings recovery we think you'll see "value" revert to the mean and outperform "growth."

To some extent, our thesis supports the bull argument that stocks are the only alternative. It is a relative comparison, which can be dangerous, but as we just showed you with the chart on 10 year treasuries, the bond market could be pretty risky. A 1% change in the 30-year treasury yield would equate to about 25% loss of capital.

Interest rates also influence Real Estate as seen in this table:

REAL ESTATE			
NOI	$100,000	Cap Rate 3.5%	Value $2,857,143
NOI	$100,000	Cap Rate 4.5%	Value $2,222,222 (-22%)
LEVERAGED			
NOI	$100,000	Cap Rate 3.5%	Value $2,857,143
50% leverage at 3.5%=$50,000 cut rate cost=$50,000 net or 3.5%ROI			
NOI	$100,000	Cap Rate 3.5%	Value $2,857,143
Leveraged at 50% at 3.5% = 35% ROI			
SUMMARY			
Rates go up by 1%			
Building value declines $643,925 or 22%			
ROI leveraged at 50% goes to 2.43%			

The operative valuation metric for real estate is the "Cap Rate". It's calculated by dividing the net operating income (NOI) by the value of the building.

Today cap rates are around 3.5%. So for a property that generates $100,000 of (NOI), its value would be $2.9 million. If cap rates, which are tied to interest rates, rose 1% to 4.5% the value of that building, would decline 22%. If you're leveraged 50% which would not be unusual, a 1% increase in rates would see you lose 45% of your investment and your Return on Invested Capital (ROIC) would go from 3.5% to 2.43%.

So anything tied to low interest rates, whether bonds or real estate, may have greater downside risk than most appreciate if interest rates revert back to the mean.

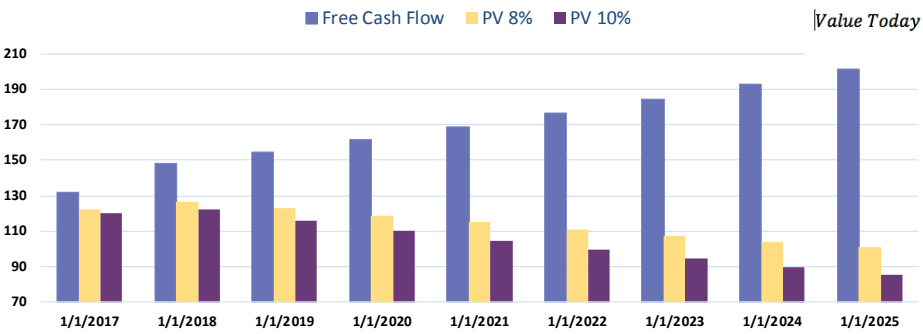
Bull Case

And if they don't, then let us give you an example of what could happen to the stock market. This is the Bull case.

Today most analysts calculate the value of a company based on a discounted stream of free cash flow. That discount rate hasn't changed much in the last few years even though interest rates have declined dramatically.

Currently we generally use a 10% discount rate and need a valuation that is 20% above the stock's current price to give us a margin of safety.

So as an example, if we assume a company can grow at 5% per year with a terminal growth rate slowing to 3% and is generating $2 per share in free cash flow, it would have a discounted present value of about $35, if we discounted that stream of income at 10%. If we change that discount rate to 8%, the present value jumps to about $55, roughly 57% higher.

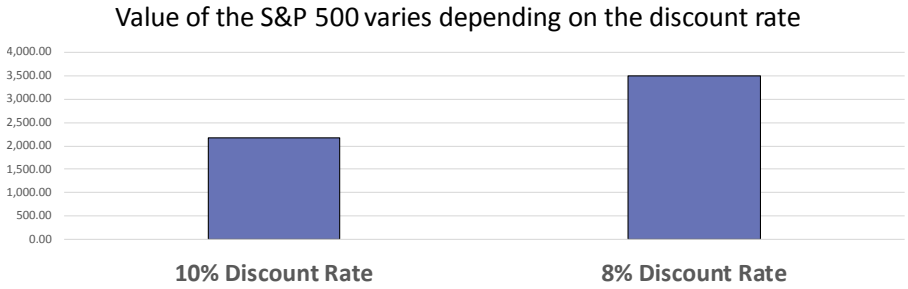


$$Value\ Today = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \frac{CF_4}{(1+r)^4} + \frac{CF_5 + SP_5}{(1+r)^5}$$

Future cash flows are discounted to a present value. A future cash flow is worth more now if we use a lower rate to discount it.

We applied the same logic to the stock market. In this case, we assume the market's free cash flow is about $117, this year's estimate. If we grow those earnings at 4.5%, the expected nominal growth rate for GDP and discount them at 10%, the market is trading at fair value.

However, if you believe that interest rates will be "lower for longer" then an 8% discount rate should be realistic.



The S&P 500 appears fairly valued using a 10% discount rate.

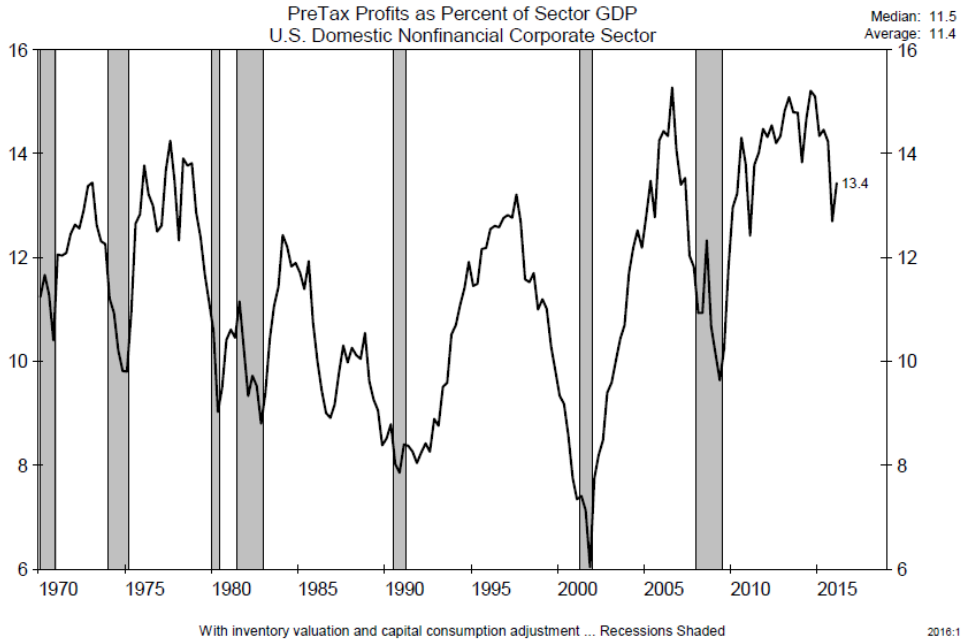
However, the market could rally 50% if investors lower their discount rate to 8%.

Using the same cash flows and growth rates but discounting them at 8% gets you a valuation that is 50% higher.

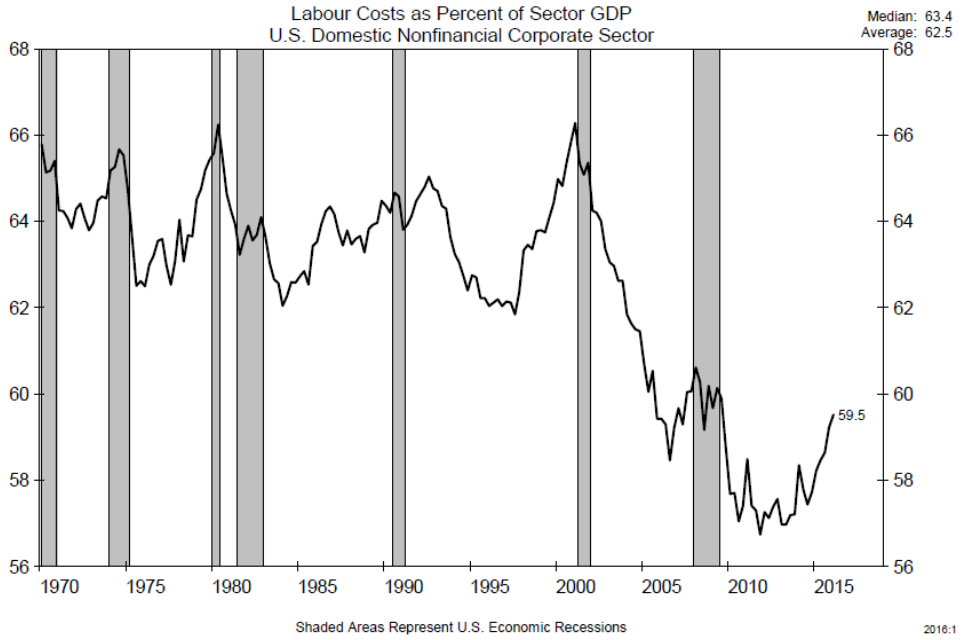
What is important to understand about this model is that as long as the discount rate falls faster than the earnings growth forecast, the market's fair value rises, so even in an economic slowdown you could justify higher valuations.

Bear Case

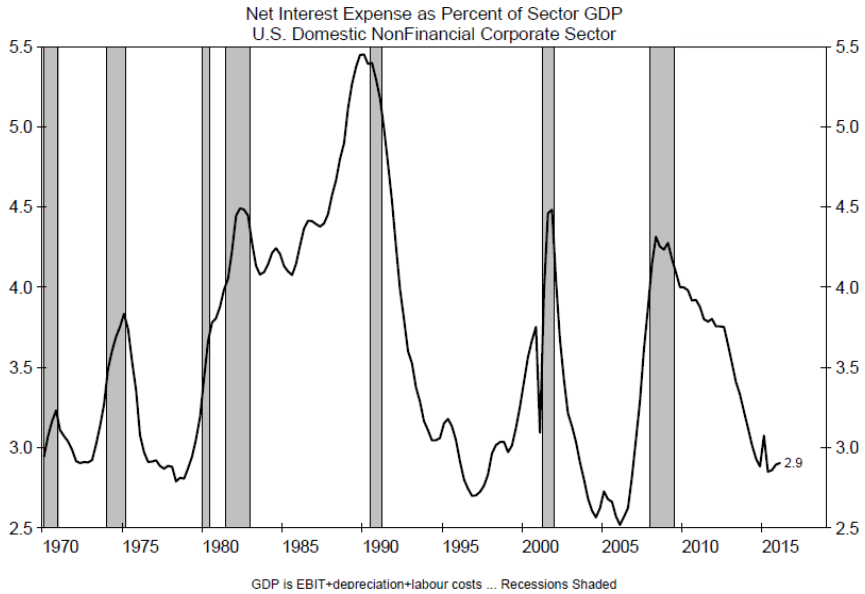
Now let us briefly touch on the Bear case. It's pretty straight forward and predicts profit margins decline, either because of a recession or higher interest rates and labour costs.



This chart shows the pretax corporate profit margin near their peak at 13.4%. Any decline would be bad for earnings.



This chart shows the cost of labour as a percentage of sales. Here you can see that labour costs are low and if they rise back to normal levels, corporate profits would be hurt. Fed Reserve Chairwoman Janet Yellen and presidential candidate Clinton would like to see higher labour costs. It's why any suggestion of a higher minimum wage affects labour intensive businesses such as restaurants.



The other cost that is unusually low is interest cost. Again the bears would contend higher rates from Fed tightening will be bad for earnings. It's true, but no one, including us, is looking for a dramatic increase in interest rates and furthermore most corporate debt is fixed or termed out for a number of years. So, even if interest rates were to increase, it would take a number of years to impact the bottom line.

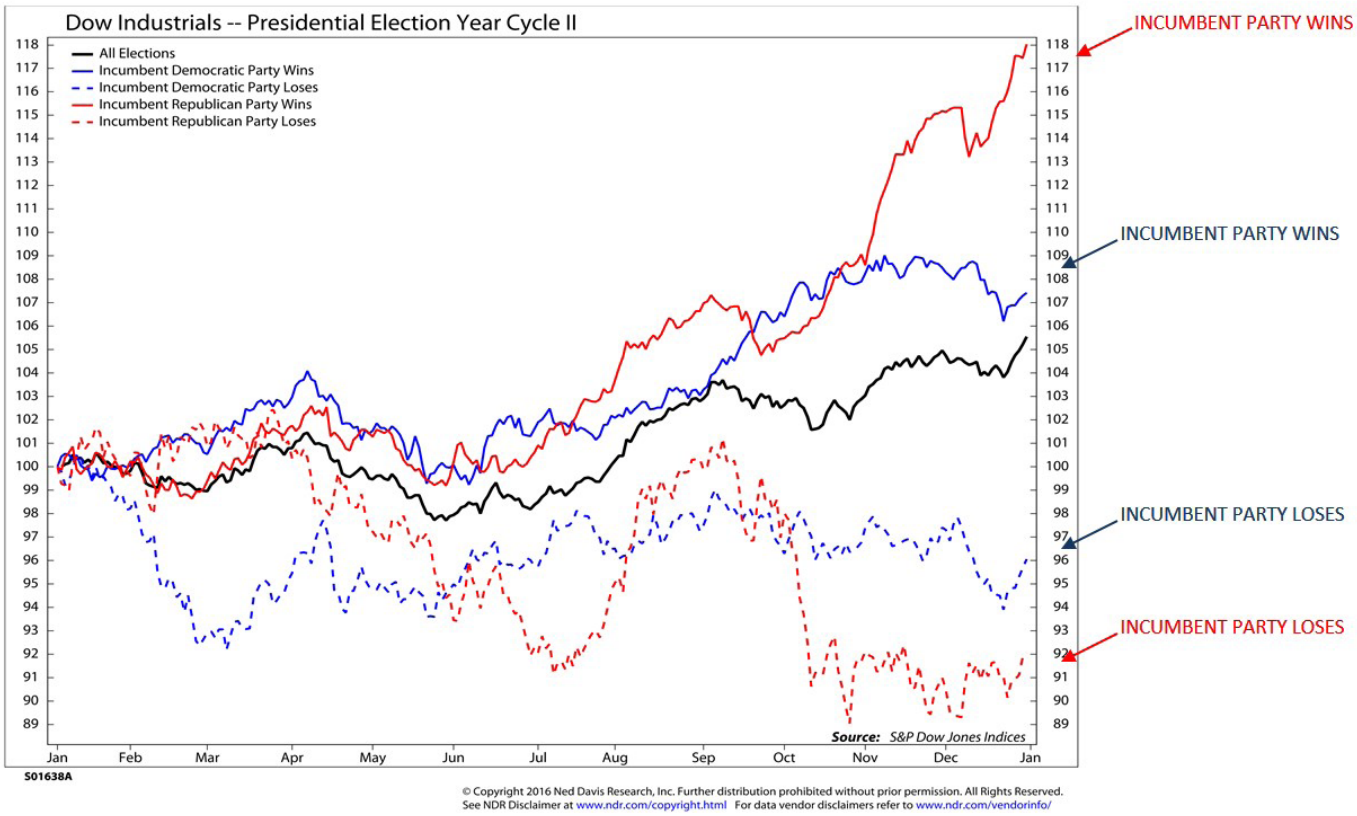
So, we wouldn't dispute any of the bears' concerns but we don't think these issues are currently on the horizon.

Now let's quickly touch on some of the topical issues that will influence this market.

Election

The first is the US election. I've heard it described as being like "*electile dysfunction*" – the inability to be aroused by either candidate. We're not making predictions, but it would seem that Hilary Clinton is in the lead. But, then again, we didn't think Britain would vote to leave the European Union.

So let's just look at what the market usually does given different outcomes.

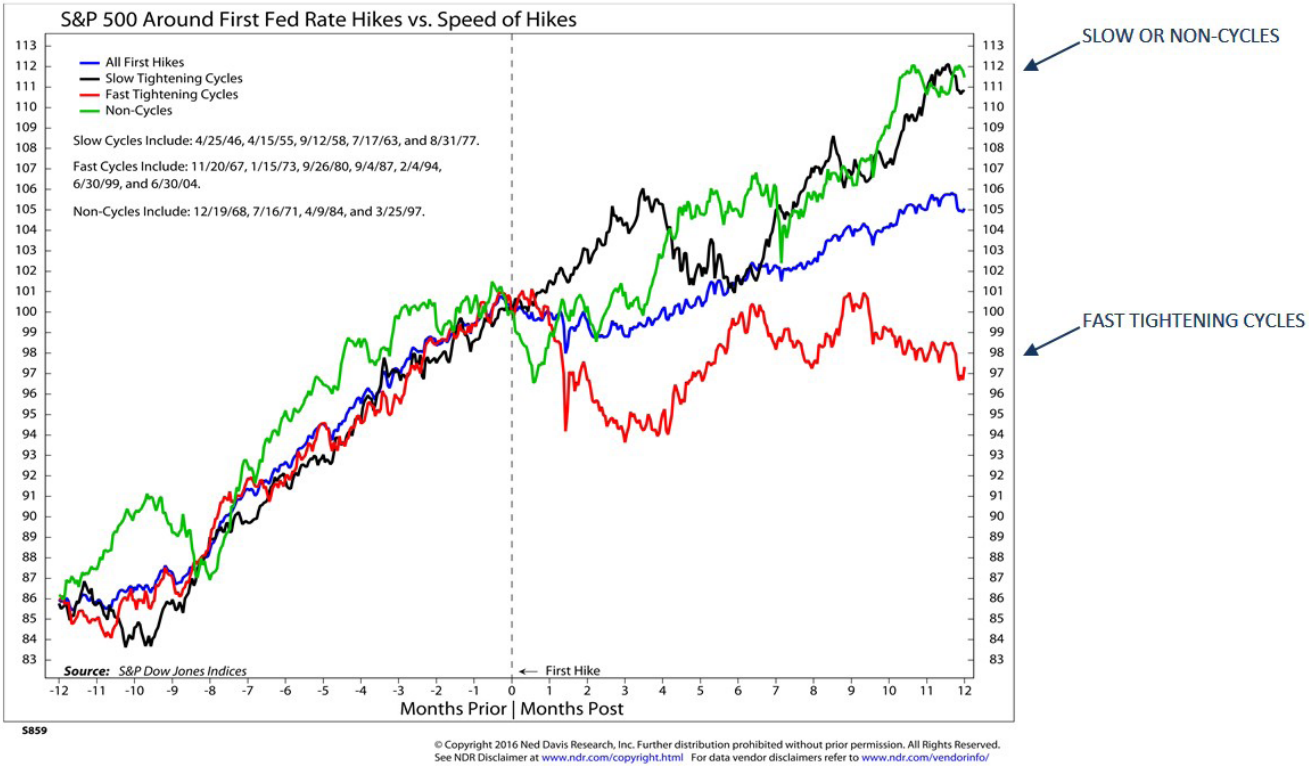


The average of all election years sees the market higher with a rally starting in July, correcting a little in September and October and then climbing for the balance of the year.

It underperforms if the incumbent party loses and does better than average if the incumbent party wins, especially if it is the Republicans. This election is a little different. The majority of Americans would like to see a meaningful change in Washington but they are uncertain as to how radical a Trump victory might be. Hillary Clinton represents the status quo provided that the Republicans can retain control of at least the House of Representatives. Consequently, the political impact on the market will more likely be the outcome of the congressional elections.

Fed Rate Hikes

The other market obsession has been the Federal Reserve policy and when they will again raise interest rates.



As you can see in this chart, the market rises going into the first rate hike and then generally sells off for three months or so following the first rate hike. We saw the first increase in December last year and the market did sell off in the first quarter. The market's performance subsequent to that first hike can be determined by how aggressively the Fed tightens.

The worst performance comes when the Fed is tightening quickly while slow cycles or non-cycles, that is, when the Fed reverses or stops are the best for the market.

Nothing we have heard suggests that the Fed is going to be aggressive.

Chicago Fed Reserve Bank President Charles Evans said he is increasingly convinced that US economic growth has slowed permanently, a situation that will keep US interest rates low for a long time ahead.

Another Fed Reserve President William Dudley also said, "So, we probably don't have a lot of monetary policy tightening to actually do over time."

Furthermore, the facts barely support moderate tightening.

ECONOMIC DATA AROUND FED HIKES SINCE 1948-01-31 (88 CASES)									
	Real GDP Y/Y%	CPI Y/Y%	Coincident Index Y/Y %	Unemployment Rate %	S&P500 Earnings Y/Y %	Non-Residential Investment Y/Y%	Capacity Utilization*	Output Gap	ISM PMI
Average	4.07	4.49	4.02	5.31	13.45	9.86	83.12	0.56	57.43
Median	3.84	3.48	3.59	5.25	15.45	8.80	83.28	0.59	57.00
Current	1.28	1.46	1.60	5.00	-2.07	-0.53	75.40	-1.86	51.50
ECONOMIC DATA AROUND SECOND FED HIKES SINCE 1948-01-31 (12 CASES)									
	Real GDP Y/Y%	CPI Y/Y%	Coincident Index Y/Y %	Unemployment Rate %	S&P500 Earnings Y/Y %	Non-Residential Investment Y/Y%	Capacity Utilization*	Output Gap	ISM PMI
Average	3.90	3.89	3.52	5.33	11.83	7.74	83.77	0.31	58.25
Median	4.49	3.32	3.76	5.25	12.39	9.35	84.13	0.63	57.65
Current	1.28	1.46	1.60	5.00	-2.07	-0.53	75.40	-1.86	51.50

*Capacity Utilization series starts 1/31/1967
Source: Ned Davis Research Group

Normally the economy is running well above potential when the Fed hikes rates. As you can see in this table, economic growth, inflation, earnings growth, non-residential investment, and capacity utilization are all below historic levels when rates were raised last December. It's only the unemployment rate that is at a qualifying level.

Our only caution would be that today's rate of 0.50% could go up by 25 bps compared to an average of more than 7% between 1965 and 2000. That's a long way to revert.

Summary

From our perspective, we believe the averages are reasonably expensive but not at crazy valuations especially when compared to bonds. If you do believe that interest rates will stay low for longer, then you can build a case that discount rates used for valuations are too high, which would further justify equities over fixed income.

However, the case we're most comfortable with is a market that changes leadership with a shift from "growth" to "value" which will favour the more economically sensitive companies.

Once again, without substantial tighter monetary policy or a recession, we don't see the likelihood of a bear market.

Appendix

Concerns for the future of the European Union may have been manifested by Brexit. Extracts from a Ned Davis Report titled "The New Crazy: My Secular Outlook for Europe", not only address the politics of the European Union but the consequences of European Central Bank policy that can be extrapolated to North America and Japan.

Sound Bite Summary

1. As the Brexit vote loudly showed, the steady expansion of the Union's power has become incompatible with the dream of a lightly regulated free trade area. For 52% of Britons, the losses of sovereignty associated with E.U. membership outweigh the benefits of the common market.
2. Europe is no longer delivering its promise of rising economic prosperity for the periphery. Italy's per capita income is at the same level as it was in ... 1998! Instead of the promised prosperity, Greece, Spain, and Italy are plagued with youth unemployment rates of 50%, 44% and 37%, respectively.
3. Rightly or wrongly, Poland, Hungary and most of Eastern Europe feel that the Union's embrace of migration, communitarianism, and religious diversity is an essential threat to their identities.
4. Angela Merkel took a bold gamble, and lost twice. First, by alienating her European partners who did not share her generous *wilkommenskultur.* Second by underestimating the popular backlash that followed the New Year Eve's sexual assaults in Cologne.
5. The only way that Draghi can address the continent's economic crisis also worsens its social and political crisis. The inegalitarian effects of QE and negative interest rate policy (NIRP) are obvious when we consider the distribution of savings. Continental Europe does not have a capital markets culture. Popular savings are invested in cash-like products that have suffered the most from negative rates. "*Fonds euro" l*ife insurance policies are the primary savings vehicle for middle class households in France, Italy, and Germany. ECB's policies have destroyed this product.
6. QE and NIRP have not only made houses and financial assets unaffordable for popular classes: they have also removed their opportunity to build wealth through thrift.
7. Low rates increase the present value of the assets that are already owned. For households that do not hold assets yet (the young, the poor), zero-rates mean that they will need to save much higher amounts to reach the same level of wealth in the future.
8. Low rates have not boosted lending in Europe. Consumer credit loans have collapsed by 41% in Spain, 20% in Portugal and 7.5% in the euro area as a whole.
9. Eurozone banks made about 1.7% on new business loans and 2% on loans to households. At these rates, banks have no buffers should borrowers default. The solution is to restrict loans to the highest quality credits.
10. By definition, soaring house prices benefit homeowners and penalize first-time buyers.
11. The working and middle classes are progressively evicted from the major metropolitan areas and cut off from their employment opportunities. Urban segregation is the most visible and painful consequence of the NIRP-driven asset bubble. Eviction notices, longer commutes, and lost access to quality schools.

12. Europe's monetary response to the financial crisis has not just worsened inequalities. It has also concentrated economic, political, and regulatory power with the European Central Bank, fueling populists' anger at unelected bureaucrats.
13. Bond yields are no longer set to compensate for inflation, growth, and credit risk. Instead, the yield curve has become a social construct.
14. The new bail-in laws deprive national governments of their prerogative to use taxpayer money to wash away the sinful excesses of bankers.
15. At best, the Italian government is allowed to sign the bailout check, but cannot control its allocation. EU rules and the ECB require the creditors, regardless of their size of financial sophistication (in this case, this would include a lot of low-income retirees who mistakenly bought bonds instead of deposits) feel the pain.

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