CUMBERLAND

Year End Review and Outlook
Cumberland Income Fund
December 2016

The Trump Effect on Fixed Income Markets

As we look ahead to 2017, we face renewed market optimism, of growth and inflation as well as new uncertainties of growing protectionist policies. Trump's surprise clean sweep win in the US elections (versus what was indicated by polls) caught market participants off guard, as most expected a Clinton victory and status quo. The overnight risk-off tone (Equity Futures down 800 points and treasuries lower by 10-15 bps) was gone by market open and had completely reversed in what many phrased as "Brexit playing out in a few hours". Trump's proposed fiscal stimulus, deregulation and protectionist policies are certainly pro-growth and have inflationary tendencies. Markets swiftly repriced their expectations taking the S&P500 to record highs and US 10 year bond yields to above 2.6% for the first time since 2014. However, we remain cautious as Trump's plan does introduce reasons for optimism but with significant longer term tail risks (lower probability events with high market impact) to growth and inflation to the upside as well as downside. As a result, we could experience increased market volatility.

Prior to Trump's victory, the US economy showed signs of strength, posting Q3/16 GDP of 3.5%, once again led by strong consumer spending. Consumer confidence remains at multiyear highs. With the unemployment rate at 4.7% and wage growth ticking up to 2.9%, the economy is basically running at close to full employment. Various inflation measures had also started to slowly move up towards the Fed's 2% target. These growth and inflation expectations were further boosted by Trump's expected election platform. Business investments remained barely positive to GDP contribution; however, the promise of deregulation and tax cuts are likely to improve the outlook for businesses. In addition, the CEO confidence index and small business optimism have jumped post-election.

The Canadian economy is still undergoing a complex transition. The Q3/16 GDP growth of 3.5% was firmer than expectations but we remain cautious as the Q3/16 was not a clean read on the economy (similar to Q2/16) as the Alberta wildfire impacts were reversed. Business investments trended positive due to a one-off large offshore oil project in Newfoundland and Labrador, while investments in machinery and equipment continued to fall. In addition, residential contribution turned negative as concerns on Canadian housing mounted. However, consumer spending remained strong and their confidence is robust as well. We remain concerned on the spillover impact of higher interest rates into household imbalances that could impact consumers at some point, although that is less of a concern at these levels. Inflation trends in Canada are diverging versus the US, with headline inflation of 1.2% and various core inflation measures ranging from 1.3-1.9%, all remain below Bank of Canada's 2% target.

Cyclical versus Structural

The year ahead is likely to see an intense macroeconomic debate as a late-cycle fiscal stimulus push, could lead to higher growth and significantly higher inflationary pressures. In addition, the global cyclical indicators have all turned positive recently. However, the structural forces of high government debt, ageing demographics, a shrinking workforce and political instability (particularly in Europe) are likely to persist as an offset to global expansion. There remains a significant risk of faster than expected rate increases by Federal Reserve and a stronger US dollar to counteract fiscal growth push. Furthermore, protectionist policies leading to reversal of global trade remains a risk to global growth.

As seen in the chart below, despite the recent back up in global rates, the longer term trend still reflects the structural growth and inflation concerns that are persistent in developed markets.

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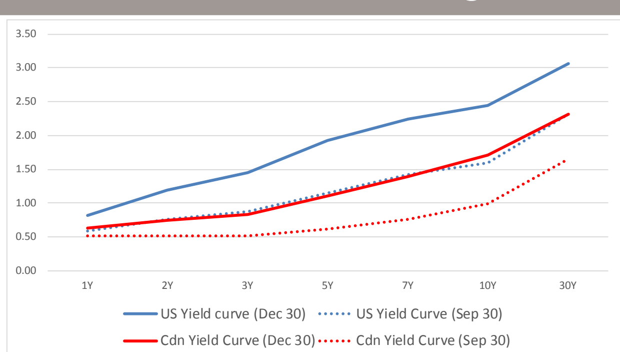
10 Year Government Bond Yields

Source: Bloomberg

Quarterly Update

The US Treasury market clearly views Trump as an inflationary president and, as cited earlier, was swift to price in higher than expected inflation. In addition, the Federal Reserve was more optimistic on the US economic outlook and raised rates in December and now expects three rate hikes in 2017. As seen in the chart below, the longer end of the US yield curve was higher in the quarter by about 75-85 bps with the front end of the curve higher by 45-75 bps.

3 Month Yield Curve Change

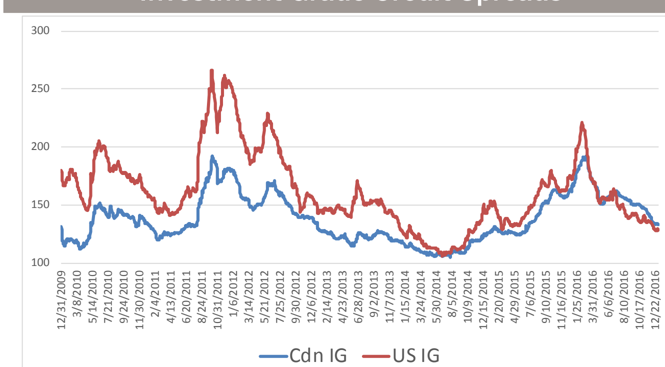


Source: Bloomberg

The Canadian yield curve was driven higher largely due to an increase in global term premiums and the longer end of the curve was higher in the quarter by 65-75 bps. A broader agreement between OPEC and non-OPEC members to cut oil supply was also supportive to higher rates. However, the front end of the Canadian yield curve outperformed due to Bank of Canada's stance. As such, the front end of the yield curve was higher by 25-50 bps.

With regard to credit, demand remained extremely strong for investment grade corporate bonds. Markets took a risk on position as pro-growth US policies are beneficial for US credit spreads. That tone spilled over to Canadian credit spreads. Demand for corporate new issues continues to remain extremely strong. Canadians continued to invest into bond funds and balanced funds although flows into pure bond funds slowed somewhat in November. In addition, the latest available data shows international investors continued to purchase Canadian debt securities (including Government and Corporate bonds). As such, Canadian investment grade credit spreads were tighter by approximately 17 basis points for the quarter. This is positive for corporate bond returns. The US investment grade market also continued to tighten and moved by 13 basis points for the quarter.

Investment Grade Credit Spreads



Source: BAML Indices, Bloomberg

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Returns for various fixed income asset classes are in the table below. Being overweight in corporate bonds and preferred shares helped the Fund's performance.

Asset class returns	Q4/16	2016
Federal Bond Index	-3.27%	0.00%
Provincial Bond Index	-4.85%	1.76%
Corporate Bond Index	-1.82%	3.73%
S&P/TSX Preferred Index	3.88%	1.25%

Outlook and Positioning

Faster than expected developed market growth and inflation were the risks that we had highlighted in our last client quarterly review and Donald Trump's victory brought exactly that optimism to the markets. Political uncertainties are typically associated with a lack of clarity regarding the economic outlook, leading to negative sentiment or uncertainty. However, the recent strong economic data including healthy Purchasing Managers' Index numbers, multiyear highs in consumer confidence and small business optimism, deregulation and promised fiscal stimulus has put the risks surrounding Trump's protectionist policies on the back burner for now.

We remain cautious regarding the fixed income asset class outlook through Q1/17 as strong headline inflation (due to favorable year over year comparisons with energy hitting bottom in Q1/16) is expected to reinforce some of the reflationary theme in the market. The sentiment in the Treasury market remains weak as Central bank accommodation and negative rate policies have potentially reached their limits. Much of the reflationary trade is priced into the market but the tail risks that we mentioned before are still a concern. We will have a better sense of market direction once we get clarity regarding the extent of implementation of Trump's inflationary policies.

For our base case, we currently expect "Trump-lite" policies such as deregulation, lower tax rates and loose fiscal policy. We assume protectionist policy rhetoric to be watered down and used primarily as a negotiating tactic. As such we expect higher economic growth and inflation in 2017. However, higher rates and strong USD are likely to offset some of the growth policies.

In Canada, a rebound in commodity prices have helped stabilize the economies of energy provinces. But, it is Ontario, BC and to some extent Quebec that have held the overall Canadian numbers at a respectable level. We believe that measures to cool down the housing markets in Toronto and Vancouver are likely to be a headwind to the Canadian economy in 2017. Direction of exports rest on Trump's renegotiation of NAFTA, but the uncertainty is likely to hamper business investments by exporters. However, if Mexico is largely the target of NAFTA renegotiations, there is a chance that Canada could benefit a great deal from US growth. Low sovereign yields, along with the demographic trends in Canada, are likely to keep investor fund flows strong into bonds and balanced funds. This will continue to be constructive for the fixed income market – particularly corporate bonds. Preferred shares are likely to continue generating strong returns as relative valuations remain attractive.

As such, we continue to remain overweight in corporate bonds and preferred shares in the fund and are underweight government bonds. Importantly, we have a very liquid portfolio should we need to adjust our portfolio weights as a result of a change in our expectations for the fixed income markets.

Risks to Outlook

We continue to monitor the risks to our outlook. One of the biggest risks to higher yields remains extreme protectionism, including trade wars, import tariffs or labeling China as a currency manipulator. Another policy on our radar is the magnitude of fiscal stimulus implemented by Trump and whether it is targeted to address cyclical growth or longer term structural issues. The former would be inflationary. In Canada, a sustained recovery in commodities would lead to some stability and pick up in growth/inflation.

Risks to lower yields include a reemergence of Eurozone growth concerns (Brexit impacts, Eurozone political risks), growth concerns in US/China or a broader

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Canadian recession. Extreme protectionist policies may be near term inflationary but the longer term risk to global growth will remain high.

Some of the unknown tail risks are a change in monetary policy mandates and political pressure on the independence of central banks.

Gaurav Dhiman
Portfolio Manager, Fixed Icome

Asset Allocation as at December 31, 2016

Asset Class	% of Portfolio
Cash and Cash Equivalents	10.0%
Government Bonds	15.9%
Corporate Bonds	60.3%
Preferred Shares	13.8%

Yield[1] Comparison as at December 31, 2016

Cumberland Income Fund	2.8%
FTSE TMX Canada Universe	2.1%

Performance[2] (Rolling 1 year)

Cumberland Income Fund	4.3%
FTSE TMX Canada Universe	1.7%
Value Add	2.6%

1. Yield is the yield to maturity for bonds and current dividend yield for equities and preferred shares. 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.