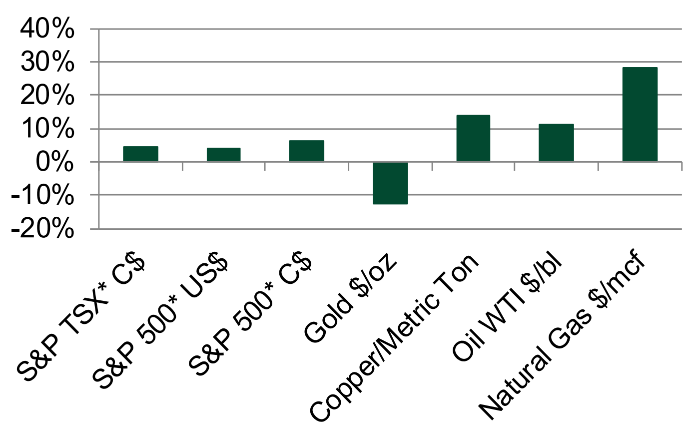
# North American Capital Appreciation Strategy
# 2016 Year End Review

The Trump presidential victory on November 8th, once again, demonstrated that anti-establishment politics appear to be becoming the new normal. The initial reaction, as the election results were being announced, was investor panic. The Dow futures were down 800 points overnight and the S&P500 futures down 5%. However, the S&P500 quickly shifted direction after the President-Elect's acceptance speech and has generated a total return of 5.0% in US dollar terms from the election-day through to December 31st 2016. The TSX followed suit with a total return of 4.8% over the same period.

While still "putting America first", Trump's acceptance speech seemed much more conciliatory than his pre-election rhetoric. The reality though, is that regardless of who won the election, investors' focus was on the implications for the market. The interpretation seems to be that the pro-growth policies, including tax reform, regulation roll-back and increased fiscal stimulus, perhaps at the expense of higher inflation and interest rates, look pretty good. The tax cuts alone could add $10 to $15 to S&P500 earnings according to some estimates, which is no small measure, and potentially positive for stock valuations. However, the market seems to already be factoring in some of these benefits in advance of more perfect information or certainty of implementation.

During the fourth quarter, the S&P500 total return was 3.8% in US dollar terms, so all of the positive return for the quarter for the S&P500 was generated post the election. Adjusting for currency moves, the S&P500 returned 6.3% as the Canadian dollar fell almost two cents to US$0.74 in the 4th quarter. For the calendar year, the S&P500 total return was 11.9% in US dollar terms, adjusting for currency moves, the S&P500 was up 8.6% due to the Canadian dollar appreciation from US$0.72 at December 31st, 2015. The TSX total return for the quarter was 4.5% and for the year was 21.1%. Similar to the US, all the positive return during the fourth quarter in Canada was post the Trump victory on November 8th.

Exhibit 1: Percentage Change for Quarter to December 31, 2016




Source: Bloomberg * Total Returns

The market did not equally reward all sectors during the fourth quarter rally with a significant divergence in sector returns as shown in Exhibits 2 and 3 below. We believe the market sector leadership was already changing prior to Trump's election to some degree, and there was evidence of this during the third quarter of 2016. However, Trump's victory was a clear catalyst for acceleration of sector leadership change.

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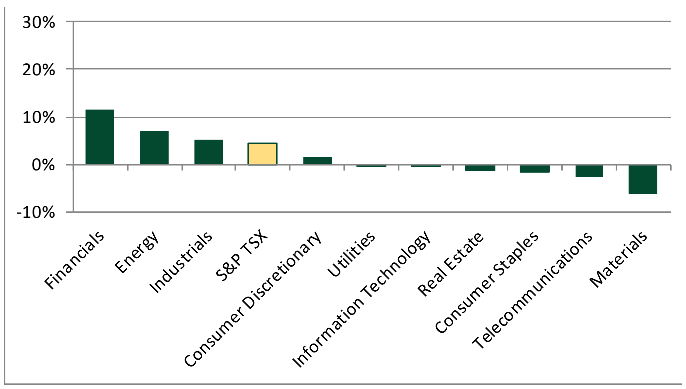
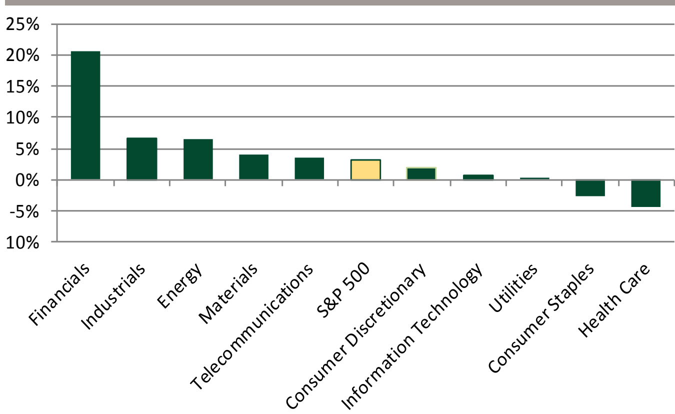
Exhibit 2: S&P TSX Sector Performance (C$)
3 months to December 31, 2016




Source: Bloomberg * Total Returns

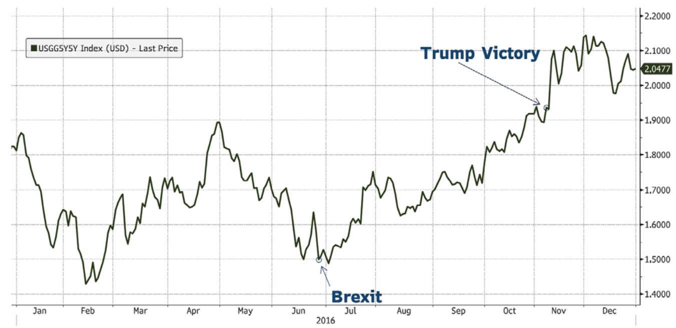
Exhibit 3:S&P500 Total Returns (US$)
3 months to December 31, 2016




Source: Bloomberg * Total Returns

Exhibit 4 plots forward looking inflation expectations over the next five years, which bottomed this past summer around the Brexit vote. At that time the market had factored in a greater chance of an interest rate cut than an interest rate hike.

Exhibit 4: US Inflation Expectations




Source: Bloomberg

However, the prospective outlook for a step up in fiscal policy, which was probably in the cards under the leadership of either presidential candidate, in combination with near full employment in the US, appear to have accelerated inflation expectations. Commensurate with this change in inflation expectations, financial conditions in the US have tightened as measured by the spike in the US 10-year treasury yields shown in Exhibit 5, which also bottomed about the same time last summer.

Exhibit 5: US 10 Year Treasury Yield


Source: Bloomberg

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The economic recovery in the US has also continued to accelerate through the fourth quarter of 2016. The latest reading for real gross domestic product increased at an annualized rate of 3.5% in the third quarter of 2016, up from 1.4% in the second quarter. The unemployment rate in the US hit a nine year low of 4.6% in November and average hourly wage gains, which are currently running at 2.5% annualized, are ahead of the 2% inflation target set out by the US Federal Reserve (Fed). Exhibit 6 shows the relationship between the unemployment rate and wage growth over the past 30 years and suggests some catch-up in wage growth is in store in the future. These trends, combined with the pro-growth policies embedded in Trump's platform, not only confirmed the Fed interest rate increase in December but also accelerated the number of interest rate hikes in 2017 to three from two.

Exhibit 6: Wage Inflation vs. Unemployment Rate


Source: RBC Capital Markets

This has had implications for the US dollar. Since the election, the US Dollar Index has increased 4.6% through to December 31st 2016. In our view, the US dollar strength is a reflection of the current and anticipated interest rate policy direction of the Fed versus that for the rest of the developed world. While the election outcome appears to have increased the bias to interest rate increases, the US dollar was already trending upwards anyway given the divergent policies.

Exhibit 7: US Dollar Index


Source: Bloomberg

As highlighted in our last quarterly review, we removed the currency hedge (for our Canadian resident clients following the North American Capital Appreciation strategy) in June. Our current US dollar exposure in the portfolio is about 54%. By removing the currency hedge, the return during the fourth quarter was enhanced by the decline in the Canadian dollar on these securities. The US dollar strengthening also makes US goods less attractive to foreign purchasers and negatively impacts profits earned by US companies abroad when translated back to USD. Foreign revenues make up about 31% of total revenues for S&P500 companies suggesting the S&P500 earnings could be negatively impacted moving forward. Exhibit 8 (courtesy of BMO Capital Markets) however, shows the US dollar's direction going back to 1975. The chart illustrates that US dollar directional trends has, historically, had little impact on overall stock

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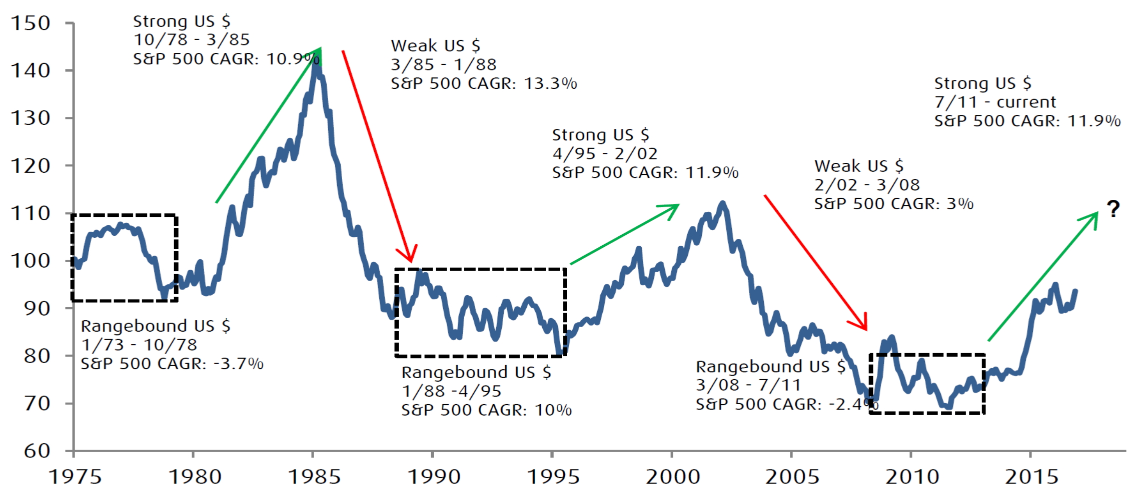
Exhibit 8: Dollar Direction Has Little Impact on Stock Performance Historically*




Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB

* Nominal Trade-Weighted Exchange Value of US$ vs Major Currencies

market performance and there are periods in history where the S&P500 has performed reasonably well during periods of both dollar strength and weakness. They also noted that periods of moderate US dollar strength are usually associated with positive trends in corporate profit growth, GDP and stock market performance.

The most significant beneficiary of the Trump victory was the Financial Sector (Exhibit 3), and in particular, the US banks due to the real and projected future increase in bond yields (Exhibit 5) since the election. This, combined with further potential rate hikes by the Fed and Trump's campaign pledge to repeal onerous bank reforms that came about post the 2008 financial crisis, has been well received by investors and reflected in the overall strong performance of this sector in the last quarter. All of this is potentially positive for bank net interest margins, which drive their profitability. According to FactSet Research, the US sub-indices with the highest percentage of companies raising 2017 profit estimates are all bank-related sub-indices. Canadian Financials (Exhibit 2) also benefited as the outlook for stronger global growth moved long term interest rates higher in Canada as well. During the fourth quarter, Financials were, and are still the largest sector weight in the portfolio, currently at about 24%.

Other news in the last quarter that helped drive portfolio returns was the announcement of the OPEC and non-OPEC production accord that pledged to cut 1.2 million and 558,000 barrels per day (bpd) of production respectively by January 1, 2017. This was a catalyst for the rise in the price of WTI oil, which increased from US $45.23 just prior to the announcement to $53.72 at December 31st . This will, no doubt, have further impact on inflation expectations. Energy, is the second highest sector weighting in the portfolio, at 16.4% going into

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the quarter, also contributed to our out-performance. We have since decreased this weighting back to 13.3%. However, we remain bullish on the sector. It is worth noting that about 1/3 of OPEC's targeted production of 32.5mm bpd is produced in high risk or unstable countries, and with low oil prices since 2014 there have been few major global long term investments made in the past two years.

One area we continue to monitor closely is the US oil production trend. Production has rebounded by over 200,000 bpd in the fourth quarter after falling more than 600,000 bpd through the first nine months of the 2016. While the resurgence in the US oil rig count, by some 200 rigs, after declining from 1,600 rigs to about 300 oil rigs will no doubt aggravate any large rise in oil prices going forward. Overall, we still believe the supply/demand picture is favorable for the sector and the prospect of energy deregulation under the Trump regime could create further opportunities for oil services companies, like Schlumberger and other names we are researching. Finally, our exposure to energy centric companies in Canada, such as Canadian Western Bank, West Jet Airlines and Russel Metals, was also a positive contributor to returns this past quarter.

The latest readings on growth and inflation measures in Canada were subdued. This should keep the Bank of Canada on the sidelines with respect to any changes to monetary policy and should continue to weigh on the direction of the Canadian dollar. After increasing for four consecutive months, real Gross Domestic Product in Canada was down 0.3% in October on the back of weaker manufacturing output; the weakest in three years. The latest inflation data for November also came in weaker than expected declining to 1.2% after October's increase of 1.5%. Finally, while the unemployment rate did improve from 7% to 6.8% in the latest reading for November, it was not a reflection of significant new job creation but rather reflected people permantently dropping out of the workforce.

Asset Allocation for Capital Appreciation Strategy
As at December 31, 2016

| | |
|---|---|
| Equities | 83% |
| Fixed Income | 4% |
| Cash | 13% |

Our asset mix shift in the fourth quarter reflects a slightly more cautious tone after the recent strength in the markets both in Canada and the US. Our equity exposure declined from 89% to 83%, mostly as a result of profit taking in the larger weightings that had increased, including Financials (JP Morgan, Wells Fargo and Industrial Alliance) and Energy (Pembina Pipelines, Suncor and Shawcor). Fixed income exposure declined from 5% to 4% while cash increased from 6% to 13%. The split between US and Canadian equities is about 46% US and 37% Canadian as the stronger economic prospects, at least outside of energy, favour the US over Canada. As we mentioned earlier, including cash and fixed income our total US holdings represent about 54% of the portfolio and are currently unhedged.

Turning to our sector and stock selection, currently our largest exposures are Financials (24.1%), Energy (13.3%) and Consumer Discretionary (9.7%). As discussed, we reduced Financials and Energy weightings on recent strength although we did add one new name in Financials, that being Intact Financial Corp.

# North American Capital Appreciation Strategy
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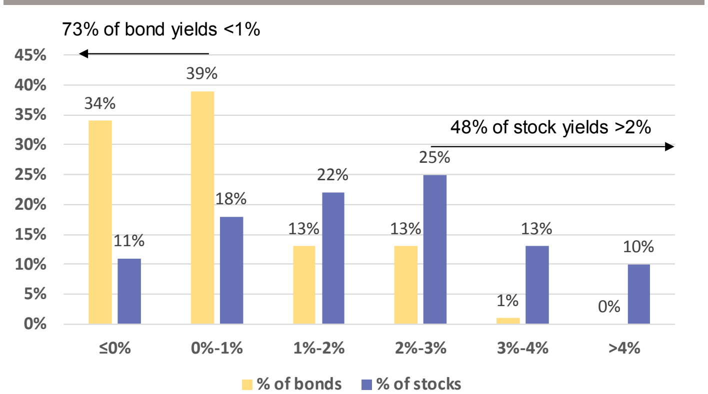
Finally, the consumer discretionary sector should benefit from stronger economic growth in the US and the proposed lower taxation policies. During the fourth quarter, the portfolio continued to have no exposure to the Utilities and Telecommunications sectors, both of which trade like bond proxies and typically underperform when interest rates rise. A summary of new positions added to the portfolio during the quarter, including business fundamentals and valuation metrics, is contained in Appendix 1.

## Outlook

Last quarter, we highlighted the chart below (Exhibit 9) and made the point that almost three quarters of global developed bond yields were trading below 1% while almost 50% of global stock yields were above 2%. We noted this valuation gap likely would not persist and that the asset mix shift out of bonds into stocks could ultimately create the next top in equity markets, It appears that this is continuing, but has not yet reached a conclusion.

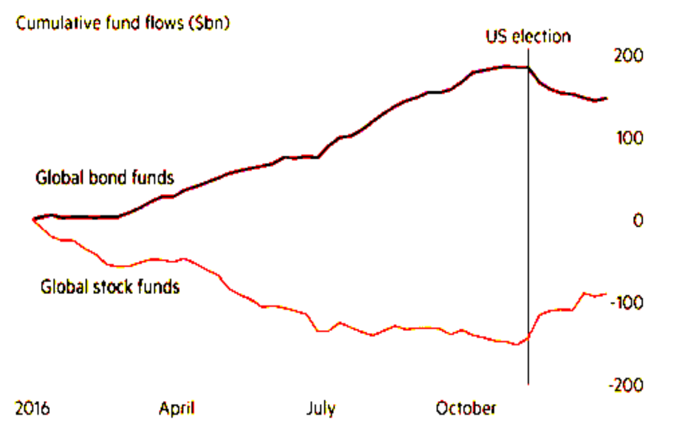
Exhibit 9: Bonds Yield vs Stocks Yield




Source: RBC Capital Markets

Exhibit 10 shows the cumulative impact, since the US election, on global bond and stock fund flows. It suggests that this asset mix rotation is now underway. The fact that the market capitalization of the S&P500 has increased, by about US $1 trillion, since the election seems to indicate investor preference to move away from bonds.

Exhibit 10: US Election Propels Broad Market Rotation




Source: EPFR, WSJ's The Daily Shot

***What don't we like about the market?*** Earlier, we alluded to financial conditions tightening, namely long term interest rates rising, a stronger US dollar and a move to normalization of interest rates by the Fed. Generally when these financial conditions exist in rising equity markets, they can create greater volatility and potentially be negative for equities longer term. As we discussed earlier, a strong US dollar is not necessarily bad for US equity markets under the right growth conditions, and while interest rates are rising, they are arguably still a long way from normalized levels.

CUMBERLAND

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Our asset mix valuation metrics, including equity risk premiums (ERP) of the S&P500 and the TSX, the historical price/earnings (P/E) ratio, dividend yield, and earnings revision momentum also show mixed signals right now. From a pure ERP perspective, we appear to be in corrective territory. Dividend yields are now below the historical 10 year averages for both the S&P500 and TSX and P/E multiples at 16.9x 2017 for the S&P500 and 16.4x for the TSX are higher than they were a year ago at this time at 16.1x and 14.3x, respectively and above the long term average of 15.4x. We have pointed out in the past however that valuation, on its own, is not a reason to get in or out of the market.

***What do we like about the market?*** Earnings momentum continues to look positive and this, in itself, trumps many of the other measures we have discussed above.

Speaking of Trump's policies, earlier we said proposed tax cuts could add $10 to $15 dollars to S&P500 earnings. However, the consensus earnings report has yet to factor this into future estimates. Trump's tax reform talks about cutting the corporate tax rate from 35% to 15%. Yardeni research estimates the average effective corporate tax rate in 2015 was 27.5%. So assuming 2017 earnings of about $132 for the S&P500 and adjusting for a 10% reduction in the effective tax rate, the S&P500 earnings for 2017 could rise to $150. Suddenly, the S&P500 would be trading at 14.9x 2017 forcast earnings versus the current estimates of 16.9x. For 2018, it drops to 13.5x from 15.3x based on 2018 earnings of about $146. Now, Trump did not get elected purely on potential tax reform. There are other anti trade/immigration policies that put him into office that could negatively impact the market, not to mention a border tax that might offset some of that back of the envelope math we just did here on corporate tax rates. Still, the simple fact is that, the market is beginning to pay up for the impact of these policies on furutre earnings. That is why we are somewhat cautious at this point and have raised some cash; perhaps not enough if the market goes down and perhaps too much if the euphoria continues. Finally, when we look at some of the market technicals, as well as other factors, such as credit spreads or recession indicators such as the shape of the yield curve, the overall picture still looks pretty good. So for now, we remain cautiously bullish on the market, but are happy to have some resources to add positions if the market pullsback in the near term.

**Peter Jackson**
Chief Investment Officer
January 2, 2017

# Appendix 1
# New Equity Investments:
# North American Capital Appreciation Strategy
# Quarter Ended December 31, 2016

## United States

### Accenture PLC (NYSE: ACN)

Accenture is a global provider of management consulting, technology services, and outsourcing. With over 380,000 employees, operations in over 120 countries, and deep specialization in about 40 vertical industries, the Company is regarded as a leading IT services provider. Accenture collaborates closely with its clients in order to improve their efficiency, value, and growth prospects. Despite a highly competitive environment, we believe Accenture is well placed given its global scale and deep industry specialization which allows it to maintain long-standing relationships with global multinationals. 94 of the Fortune Global 100 companies and more than 80% of the Fortune Global 500 companies work with Accenture. Accenture is a high-quality IT stock, with management consistently outperforming revenue and EPS expectations.

### Becton Dickinson and Company (NYSE: BDX)

Becton, Dickinson and Company is a high quality health care company that develops, manufactures, and sells medical supplies, devices, laboratory equipment, and diagnostic products worldwide. It operates in two segments, BD Medical and BD Life Sciences. BDX is focused on enhancing its relevancy as a value-added partner to healthcare providers capable of addressing critical unmet needs across life science research, diagnostics, and medication management. All-in, the road map points to what we see as an escalating ROIC trend over the coming years. BDX is a leader in most of the Life Sciences markets it operates in but remains subscale in areas like molecular and genomics. With ample free cash flow being generated from legacy business, BDX has flexibility to deploy into R&D to enhance its capabilities, organically or via acquisition.

# Appendix 1
# New Equity Investments:
# North American Capital Appreciation Strategy
# Quarter Ended December 31, 2016

**TJX Companies Inc. (NYSE: TJX)**

Founded in 1956, TJX is one of the world's largest apparel companies, with unmatched scale, reach and sourcing capabilities. TJX operates over 3,600 stores in nine countries, which included the United States, Canada, the United Kingdom, Ireland, Germany, Poland, Austria, the Netherlands, and Australia, as well as through three e-commerce sites. The Company has grown itself to a U$49BN company, with over U$30BN in sales, utilizing 18,000 vendors, +1,000 buyers, with 13 buying offices in ten countries. TJX's core target customer is between 24 and 54 years old, middle to upper middle income, fashion and value conscious, and shops high-end department and specialty stores. Although TJX primarily targets the middle to upper middle income customer, the retailer has a broad range of customers across many demographic groups and income levels which spans across all geographies. TJX has an impressive track record for consistency of sales, with only one year of negative comparable store sales growth in the last 34 years.

<u>Canada</u>

**Intact Financial Corporation (TSE: IFC)**

Intact Financial Corporation is Canada's largest publicly-listed property and casualty insurer with 17% market share, underwriting policies for personal automobile, personal property and commercial coverage. Despite operating in a very competitive and mature market, Intact has delivered significantly better growth and profitability versus its industry peers. We attribute this outperformance to a number of sustainable competitive advantages including superior risk segmentation, claims management, distribution and scale. By continually leveraging these advantages, we believe Intact will gain market share both organically – by winning new policies and higher premiums rates - and through acquisitions – possible targets include bank-owned insurers or Canadian subsidiaries of foreign insurers. Intact maintains a strong balance sheet with capital levels well in excess of those required by regulators or credit rating agencies. The capital strength allows Intact to pay a dividend yielding 2.4% per annum while pursuing its 10% earnings growth objective. Additionally, Intact will in time benefit from rising interest rates and is less susceptible to the economic cycle owing to the mandatory requirement of insurance.