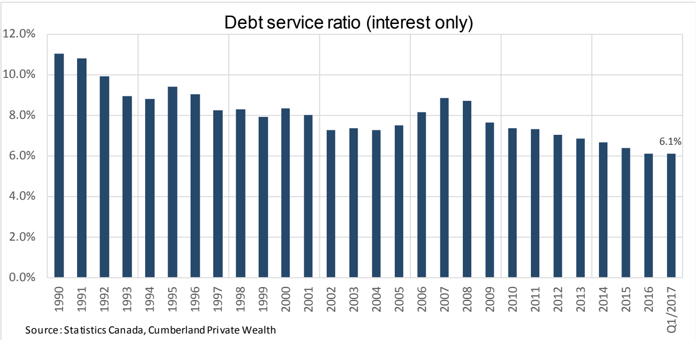
CUMBERLAND
Private Wealth

INCOME STRATEGY SECOND QUARTER REVIEW

Bank of Canada's Hawkish Turn

While we're still waiting for the political gridlock in the US to resolve and the Trump administration to deliver on its campaign agenda, the focus has shifted to the Bank of Canada's (BoC) hawkish turn in June, which led to the Canadian yield curve repricing higher and meaningfully strengthening the Canadian dollar. The BoC focused the change on broadening improvement in growth and the diversity of the Canadian economy to adjust to the oil shock. As such, the BoC believes it has become appropriate to remove some monetary policy accommodation.

While the recent economic growth and strong employment numbers are noteworthy, we believe that Canadian consumer indebtedness and a coordinated government effort to cool down home prices in Toronto/Vancouver are also a significant factor in the BoC's hawkish turn. Canadian household debt to disposable income has increased to 169% and household debt to GDP is at 100.8%. In spite of the debt levels, Canadians today are paying record low levels as interest payment component of debt service ratio. Interest payment is at 6.1% of disposable income as seen in the chart below.



We believe the recent economic strength has provided the Bank of Canada with an opportunity to temper further rise in consumer leverage but will have to be cautious not to trigger any financial system vulnerabilities as it removes accommodation.

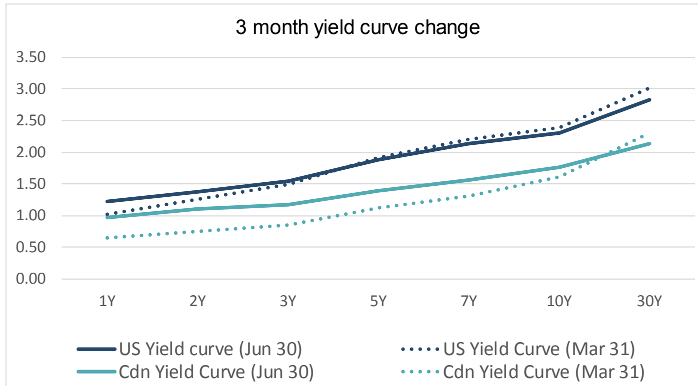
Quarterly Review

The US economy continued to show signs of strength with stable growth, employment and inflation trends. Although Q1/17 GDP at 1.4% was weaker than expected, consensus for Q2/17 growth is around 3% given the strength of the recent economic data, which keeps the economy on a stable growth trajectory. Although consumers disappointed in Q1/17, we are comforted by the fact that US economy remains close to full employment with healthy wage growth which underpins solid fundamentals for consumer spending. In addition, Consumer confidence remains at multiyear highs. We are very encouraged by strong showing of business investments in Q1/17 after several quarters of weakness and the continued optimism of small businesses. One source of concern remains the softening inflation trends while the Federal Reserve (Fed) remains determined to deliver series of interest rate hikes and a gradual balance sheet unwind. Various core inflation and forward inflation measures remain stable around Fed's 2% level. The prospects of deregulation and tax cuts, if delivered, are likely to be further positive for growth. The recent PMI data remains robust.

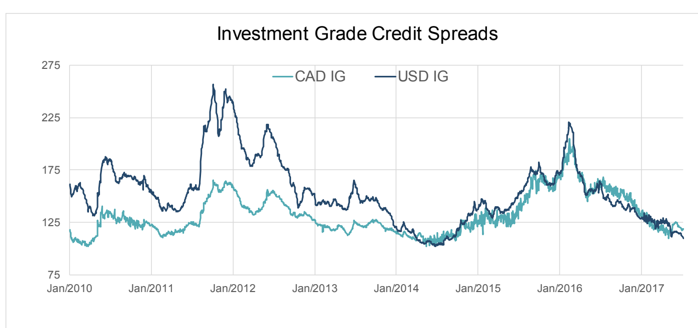
The Canadian economy's resilience has surprised strongly to the upside and leading indicators trends remain strong setting up expectations for a healthy Q2/17 as well. In addition, Canada continued to post extremely strong employment numbers over the last 12 months with a net employment number of a healthy +351,000 led by full time jobs at +248,000. In Q1/17, Canadian GDP grew by 3.7%. Business investments continue to disappoint but have stabilized and are no longer a drag. In addition, the sentiment of business and sales outlook have materially improved pointing to stronger numbers over the coming quarters. Consumer spending remained strong and consumer confidence remains robust as well. Inflation trends in Canada continue to be a source of concern, with headline inflation of 1.3% and various core inflation measures ranging from 1.2-1.5%, all remain well below Bank of Canada's 2% target.

For most of the quarter, the US Treasury yields traded range bound. Partial reversal of the "Trump trade" due to failure to pass any major legislation yet along with several event risks (French elections, probes regarding Russian interference in US election, North Korea risks and US government shut down speculation) all weighed on markets. This was offset by the hawkish tone from the Fed with regards to removal of monetary policy accommodation. As a result, the US yield curve flattened in the quarter as the front end of the yield curve rose and the longer end of the yield curve declined due to increased uncertainty versus last quarter.

The Canadian yield curve largely followed the US yield curve for most of the quarter until mid-June when Bank of Canada shifted its balanced tone to a decisively more hawkish one. That led to a significant repricing of the Canadian yield curve. The yield curve flattened as well with the 5-year and under part of the curve rising by 30-35 bps, the 10-year part of the yield curve also rising by 14 bps while the long end followed the US long end lower by about 15 bps. We believe that most of the two rate increases that we expect the BoC will deliver is now mostly priced in.



With regards to credit, demand continues to remain robust for investment grade corporate bonds. The global risk-on tone along with strong Canadian economic data over the quarter led to tighter Canadian credit spreads. Domestic funds continued to flow into bonds and balanced funds while pure bond fund flows have remained extremely robust so far in 2017. In addition, latest available data shows international investors continued to purchase Canadian government and corporate debt securities. As such, Canadian investment grade credit spreads narrowed by approximately 4 basis points for the quarter. This is positive for corporate bond returns. US investment grade credit spreads were narrower by 12 basis points for the quarter.



Returns for various fixed income asset classes are in the table below. In Q2/17, the Provincial Index outperformed largely due to the longer duration of this index, which hurt our relative performance in the quarter. For the year, our positioning in preferred shares and high yield was partly offset by being underweight provincial debt.

Asset Class Returns	Q2/17	2017
Federal Bond Index	0.20%	0.85%
Provincial Bond Index	2.12%	3.53%
Corporate Bond Index	1.02%	2.87%
High Yield Index	1.70%	4.96%
S&P/TSX Preferred Index	1.12%	8.72%

Outlook and Positioning

For our central scenario – we are starting to bake in expectations of a coordinated removal of monetary policy accommodation by the major global central banks (albeit at different stages of removal). We expect sovereign yields to rise as net supply of sovereign bonds increases with global central banks becoming less relevant buyers. As such, the focus will increasingly shift to fundamentals, which is likely to play a much more significant role going forward.

In US, we currently continue to expect "Trump-lite" policies such as deregulation, lower tax rates and loose fiscal policy to further support economic growth; although we admit that further signs of delays could be negative for risk assets as the markets have been very patient so far. We assume protectionist policy rhetoric to be watered down and used primarily as a negotiating tactic. For now, we continue to expect the Fed to deliver its third rate hike this year and begin the balance sheet unwind process towards the end of the year. Our one concern remains recent softer inflation trends. While the Fed has insisted on calling it transitory, the trend of softening owner's equivalent rent, declining healthcare, auto prices and apparel remains a source of concern for inflation trends making the next few readings of inflation a focal point. Nonetheless, market measures of forward inflation still point to inflation around 2%. If business investments and consumers show a healthy number in Q2/17, it would put the US economic growth on very sound fundamentals with removal of monetary policy accommodation a potential headwind to be mindful of over the next 12 months.

In Canada, while we are encouraged with the strong economic trends that have been in place for the past few quarters, our outlook remains uncertain in the longer run. Canadian consumers indebtedness has further increased to support the recent growth. Consumers are due for a cycle of deleveraging particularly as rising interest rates increases the debt service component of consumers. In addition, we believe that measures to cool down the housing markets, particularly in Toronto and Vancouver, are likely to be a headwind at some point. Trump's renegotiation of NAFTA is another uncertainty that 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. We look for Infrastructure spending (already financed) to provide some cushion to the economy. In conclusion, we believe that Bank of Canada is likely to initially remove the 50 bps rate cut "insurance" taken in 2015 after which they are likely to pause and see how the economic fundamentals unfold.

From a funds flow perspective, we expect flows into bond funds to slow temporary as we await more clarity from path of interest rates in Canada. However, we continue to believe that demographic trends will continue to be supportive of the asset class in the longer run. Preferred shares are likely to continue generating strong returns as relative valuations remain attractive.

As such we continue to remain overweight corporate bonds and preferred shares in the Income 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 central scenario.

One of the major risks to lower yields remains the continuation of political gridlock in the US, which makes passage of any legislative reform extremely tough. This could lead to a swift reversal of the "Trump trade" that we have seen since Trump's election victory. Trump's election campaign probe regarding Russian involvement remains an ongoing event risk to keep in mind. In addition, we continue to monitor escalation of geopolitical risks from North Korea as further tests of Intercontinental Ballistic Missiles reaching US could trigger a conflict in the region. In Canada, a slowdown in consumption and softening in home prices could lead to Canadian yields going lower.

One of the biggest risks to higher than expected yields remains an uncontrolled spike in term premiums due to an adverse market reaction as global central banks gradually reverse course on monetary policy accommodation. Extreme global protectionism, including trade wars or import tariffs, the magnitude of fiscal stimulus implemented by Trump and whether it is targeted to address cyclical growth or longer term structural issues are some other key policies to watch. In Canada, a sustained recovery in commodities or sustained pick-up in non-energy exports would lead to some stability and pick-up in growth/inflation and again resulting in higher yields.

Gaurav Dhiman

Portfolio Manager, Fixed Income