CUMBERLAND
Private Wealth

# NORTH AMERICAN CAPITAL APPRECIATION STRATEGY

**Second Quarter Review**

**June 30st 2017**

Last quarter we talked about how soft sentiment data such as the survey of expected business conditions could be a leading indicator of a stronger US economy ahead. However, with US GDP coming in at 1.4% for the first quarter down from 2.1% in the fourth quarter as well as weaker industrial production and retail sales in May, the hard data is mixed at best. Nevertheless, this did not stop the US Federal Reserve (Fed) from increasing the federal funds interest rate again in June for the second time in 2017 citing the continued strengthening of the US labour market and expansion of economic activity including household spending and business fixed investment. It also appears there could be one more rate hike between now and year-end based on the Feds projections from its June meeting. The Fed also announced it will begin unwinding its $4.5 trillion in securities holdings by decreasing the reinvestment of the principal payments it receives from securities held on its balance sheet. Effectively, the Fed will cap (in graduated increments) the amount it will reinvest from maturing securities going forward, which equates to another form of monetary tightening, the exact impact of which is uncertain.

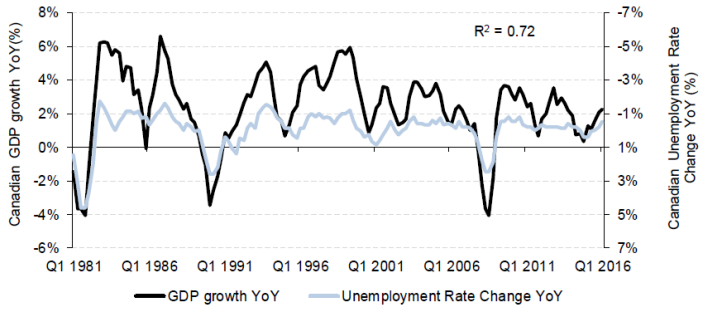
Meanwhile in Washington, the plan to repeal and replace the Affordable Care Act with a new Republican healthcare bill is still not complete, which also likely pushes out any Trump tax plan into 2018. There has even been talk about a watered-down version of the tax plan being proposed by House republicans with tax changes that would be more revenue neutral. This could result in even fewer corporate tax cuts and less fiscal stimulus. Given the multiple expansion we have experienced in the S&P500 since the election from 16.1x to 17.5x, there may be something built into the market for tax reform that could end up short of expectations.

During the second quarter of 2017, the S&P500 Index was up 3.1%. Adjusting for currency, the S&P500 Index returned 0.5%, as the Canadian dollar appreciated two cents, closing the quarter at US$0.77. Year to date the S&P500 gained 9.3% in US dollars and 5.7% adjusting for currency.

In Canada, the TSX total return in the second quarter and year to date was -1.6% and 0.7%, respectively. Canadian equities have underperformed relative to US equities so far in 2017 given the poor investor sentiment towards housing related stocks, lower oil prices and US trade fears. However, economic momentum in Canada has been reasonably strong lately and arguably better than the US, so there seems to be a disconnect between how the Canadian economy is faring and the performance of the TSX. Q1 GDP in Canada was +3.7%, well above the US GDP noted above and the pace of employment growth in Canada is the strongest it's been since 2009.

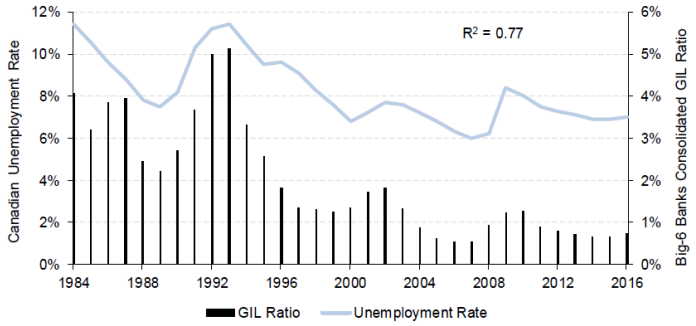
Recent comments from the Bank of Canada Governor and deputy Governor seem to confirm this strengthening suggesting the two 2015 emergency interest rate cuts are no longer required and could begin to reverse as early as July's meeting. And while oil prices seem to be range bound in the US$45 – US$55 price level, they are significantly higher than the $26 we experienced in early 2016. Clearly, rising interest rates in Canada could have some impact on the housing market. However, what typically drives mortgage defaults and increased credit loss for Canadian banks is not the cost of funding the mortgage but rather the level of unemployment. Exhibit 1 shows the relationship between GDP growth and the Canadian unemployment rate while Exhibit 2 shows the relationship between Canadian unemployment and Canadian bank "gross impaired loans". As indicated in the charts, the data is highly correlated (r-squared of 72% and 77% respectively) suggesting that if Canadian growth remains robust so to should employment keeping the level of impaired loan formations in check.

Exhibit 1
GDP is an important driver of unemployment




Source: Statistics Canada; NBF analysis

Exhibit 2
The correlation between the unemployment rate and the Bank Gross Impaired Loans (GIL) ratio is strong

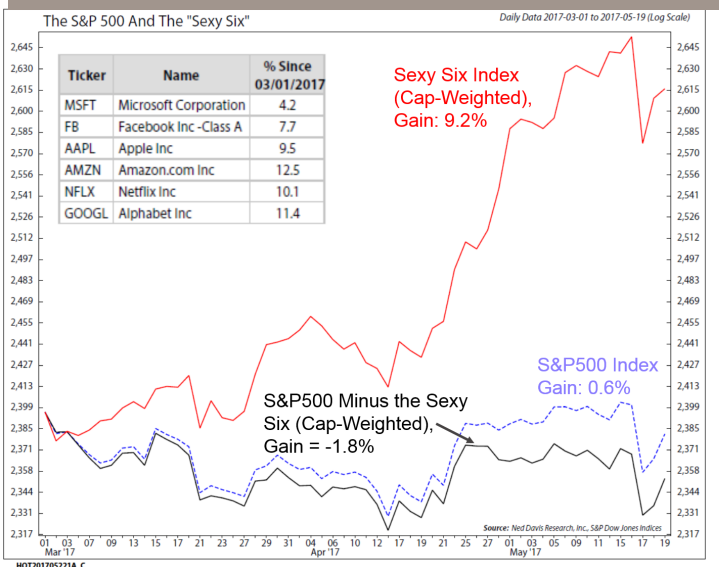



Source: Statistics Canada, Company Financials; NBF analysis

Inflation remains the one consistent area of weakness both in Canada and the US as the Fed reduced its PCE (personal consumption expenditures) inflation expectations for 2017 from 1.9% to 1.6%. Meanwhile, the latest CPI (consumer price index) data out in Canada was also weak at 1.3% annualized rate for May down from 1.6% in April. Ed Yardeni, a strategist we follow in the US speculated that powerful secular forces may be keeping a lid on price inflation, which is also keeping wage demands in check in the tighter labour markets we are seeing both north and south of the border. These forces include competition resulting from globalization, deflationary technology innovations, and demographic drag from aging populations. Under this lower for longer inflation scenario, valuation multiples may stay high and/or even go higher, which could extend this eight year old bull market for some time. Having said that, we can never rule out the possibility of a market correction in a secular bull market and lately, as is typical in all maturing bull markets, the concentration of leadership tends to narrow.

Exhibit 3 is a chart examining the performance from March through May of what Ned Davis refers to as the "sexy six" – Amazon, Apple, Facebook, Alphabet, Microsoft and Netflix as compared to the performance of the S&P500. As indicated in the chart, these stocks

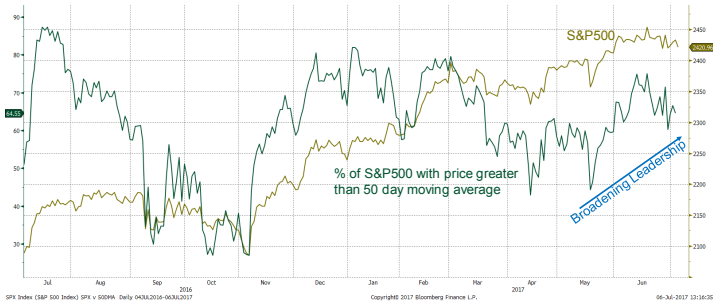
Exhibit 3
The S&P500 and the "Sexy Six"




Source: Ned Davis

have had a large impact on overall performance this year for the S&P500 although lately, since mid-May, that leadership has shown some signs of broadening as measured by the number of stocks increasingly trading above their 50-day moving average (Exhibit 4).

Exhibit 4
Broadening Leadership




Source: Bloomberg

The table in Exhibit 5 shows the number of days the S&P500 has gone without a 5%, 10% or 20% correction. As indicated in the bottom row we are currently well past the historical averages so again, a pullback of some sort can't be ruled out.

Exhibit 5
S&P500 Number of Days Before the Start of Corrections

Mean Market Days Without Corrections

| | 5% | 10% | 20% |
|---|---|---|---|
| Secular Bulls | 84 | 331 | 1105 |
| Secular Bears | 31 | 91 | 486 |
| All Periods | 50 | 167 | 635 |
| Current Case | 247 | 341 | 2086 |

Source: Ned Davis

Exhibit 6 examines all years with drawdowns of less than 5% during the first half of the year as compared to the maximum -2.8% drawdown experienced in the first half of 2017. The average and median gain for these low drawdown first half years, in the second half, was 8.1% and 10.1% respectively. So, to net this all out, overall the North American economy is still performing relatively well with Canada showing some signs of improvement. And while the S&P500 has outperformed year to date, the TSX has lagged and is probably due for some relative catch-up.

Exhibit 6
S&P500 Performance: No 5% Drawdown in 1st Half of Year

| Year | 1st Half Gain/Loss | Biggest Drawdown in 1st Half | 2nd Half Gain/Loss | Biggest Drawdown in the 2nd Half |
|---|---|---|---|---|
| 1995 | 18.6 | -1.7 | 13.1 | -2.5 |
| 2017* | 8.9 | -2.8 | N/A | N/A |
| 1964 | 8.9 | -3.1 | 3.7 | -3.6 |
| 1954 | 17.7 | -3.6 | 23.2 | -4.4 |
| 1963 | 9.9 | -3.6 | 8.1 | -6.5 |
| 2015 | 0.2 | -3.6 | -0.9 | -12.3 |
| 1985 | 14.7 | -3.7 | 10.1 | -7.7 |
| 1989 | 14.5 | -4.2 | 11.1 | -7.6 |
| 1961 | 11.2 | -4.3 | 10.7 | -3.9 |
| 1958 | 13.1 | -4.4 | 22 | -4.2 |
| 1959 | 5.9 | -4.4 | 2.4 | -9.2 |
| 1996 | 8.9 | -4.6 | 10.5 | -7.3 |
| 1983 | 19.5 | -4.6 | -1.9 | -6.6 |
| 1976 | 15.6 | -4.7 | 3 | -8.4 |
| 1986 | 18.7 | -4.9 | -3.5 | -9.4 |
| 1972 | 4.9 | -4.9 | 10.2 | -5.1 |
| Mean | 12 | -3.9 | 8.1 | -6.6 |
| Median | 12.2 | -4.3 | 10.1 | -6.6 |
| Mean (All Years) | 3.7 | -11.2 | 3.6 | -12.3 |
| Median (All Years) | 4.9 | -9.2 | 4.8 | -9.1 |

Source: Ned Davis

The table below (exhibit 7) compares the change in price performance (excluding dividends), to the change in earnings estimates and valuation (Forward P/E) for the S&P500 and the TSX over the first half of 2017. As indicated by the price performance and as discussed above, the S&P500 has outperformed the TSX by a considerable margin. The largest portion of the outperformance can be explained by the increase in earnings estimates for the S&P500, however the balance represents multiple expansion as the S&P500 multiple of forward earnings has risen from 17.0x to 17.5x during the first half of 2017.

Exhibit 7
Changes in Price Earnings Estimates and Forward P/E

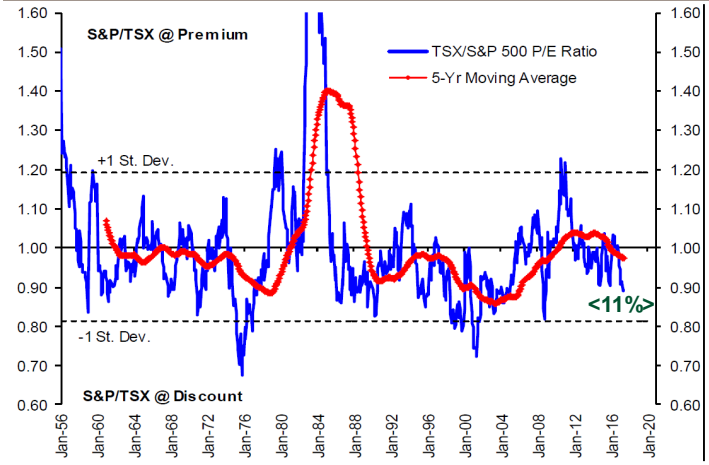
| EPS | | | |
|---|---|---|---|
| | Dec 31/16 | Jun 30/17 | Change |
| S&P 500 | 131.4 | 138.3 | 5.3% |
| SPTSX | 928.8 | 964.7 | 3.9% |
| **PRICE** | | | |
| | Dec 31/16 | Jun 30/17 | Change |
| S&P 500 | 2,238.8 | 2,423.4 | 8.2% |
| SPTSX | 15,287.6 | 15,182.2 | -0.7% |
| **Forward P/E (x)** | | | |
| | Dec 31/16 | Jun 30/17 | Change |
| S&P 500 | 17 | 17.5 | 2.8% |
| SPTSX | 16.5 | 15.7 | -4.4% |

Source: Bloomberg

However, given the price performance of the TSX relative to its earnings growth of 3.9% over the first half, which is almost as much as the S&P500 earnings growth, the multiple for the TSX has declined almost

one complete turn from 16.5x to 15.7x and currently is almost two turns less than the S&P500. Exhibit 8 shows this relative forward multiple comparison for the S&P500 and TSX going back to the 1950's and it indicates that the 11% discount the TSX is trading at versus the S&P500 is approaching a 15year low except for a brief period during the financial crisis.

Exhibit 8
12 Month Forward Relative P/E since 1956




Note: Trailing P/E from 1956 to 1984.

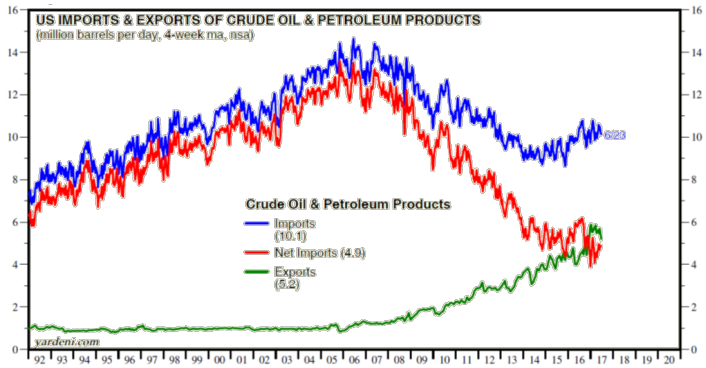
Source: Scotiabank GBM Portfolio Strategy; Thomson Financial; CPMS; Shiller

Asset Allocation for our North American Capital Appreciation Strategy
As at June 30, 2017

| | |
|---|---|
| Equities | 87% |
| Fixed Income | 4% |
| Cash | 9% |

During the second quarter our asset mix has shifted about 5% in favour of Canadian equities (+37% to 42%) while our US equity exposure has declined about 1% (46% to 45%). This reflects the better valuations we are seeing in Canada today as well as some sector specific themes. The increase in our equity weight was sourced from cash. New names added in Canada include Keyera Corporation and Kinder Morgan Canada as well as additional weight to Enbridge Inc. which was added during the first quarter. Thematically we don't see a large upward price move in store for oil, however with the emergence of advanced technology in exploration and development particularly in the US and Canada, breakeven costs have and should continue to fall, which will drive higher production volumes of both oil and natural gas. While there is some uncertainty over when the potential demand for transportation fuels may peak as a result of electric cars and ride sharing, we believe that as breakeven costs come down, there will be greater opportunity to export crude and petroleum products. Exhibit 9 shows the balance of US imports and exports of crude oil and petroleum products. It suggests the US is moving closer to net self-sufficiency and could ultimately be a net exporter in the future.

Exhibit 9
US Imports and Exports of Crude Oil and Petroleum Products




Source: Yardeni Research; US Department of Energy and Haver Analytics

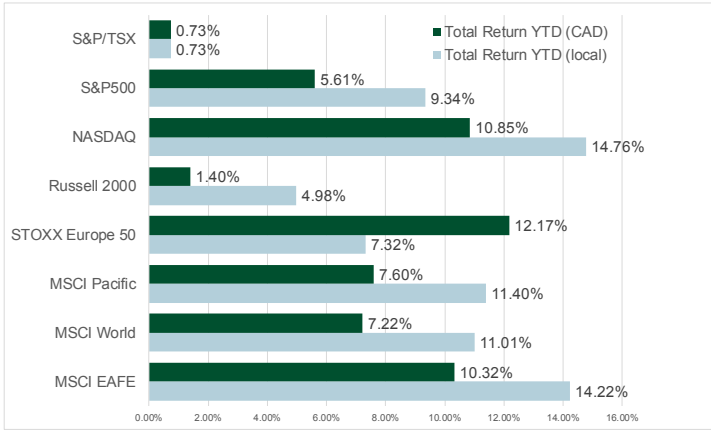
The other trend we are seeing is the expected increase in demand for feedstock petroleum liquids from the petrochemical industry due to the low cost and security of supply in North America. Currently there are over 300 petrochemical projects being launched in the US and last year expenditures in the chemical industry alone accounted for about half of all capital investment in US manufacturing according to the Census Bureau and the Wall street journal. Companies such as Keyera Corp., Enbridge Inc., Kinder Morgan Canada and Pembina (one of our existing long term holdings) help store, transport and produce feedstock that is used in the chemical production process to produce plastics, an industry that typically grows above global GDP growth. These companies all offer attractive stable dividend growth with current dividend yields in the 4.5% range.

On the US side of the portfolio we are taking a slightly more cautious approach and have invested in more stable franchises including coffee (Starbucks Corp) and cigarettes (Philip Morris International). We think both names offer predictable growth rates in earnings and dividends even in a weaker economic environment. A complete summary of new positions added during the quarter, including business fundamentals and valuation metrics, is contained in Appendix 1.

## OUTLOOK

Exhibit 10 compares the performance of the TSX to a group of other major global markets year to date through June. Judging from the performance of the TSX versus other markets and the fact that the TSX is one of the few markets to experience a multiple contraction in the first half of the year, it may be due for a catch-up trade in the back half of 2017.

Exhibit 10
Total Return YTD in Local Currency and CAD




Source: Bloomberg

Of course, higher commodity prices would especially help oil and gas and it is hard to believe market sentiment can get much more negative on this group. Energy currently represents about 14.5% of the North American Capital Appreciation Portfolio exposure. We also believe Financials, in particular Canadian banks and asset managers should also play some catch-up. Financials still represent our largest sector exposure at just over 21%, of which about 15% is in Canada and 6% in the US. We expect to continue to shift assets back to Canada from the US as we identify opportunities and as long as that valuation gap persists. Having said that, we don't want to sound overly pessimistic about the US outlook. S&P500 earnings are still expected to increase 10.3% in 2017 to $131.69 and 11.6% in 2018 to $147.0. Furthermore, earnings growth for the first quarter of 2017 came in up 14% as compared to estimates of 9% at March 31st. Also, analysts have made smaller cuts to second quarter estimates at -2% versus the ten-year average cut of -5.9%. Short of a policy mistake by the Fed or an unexpected slowdown in the US economy, we expect we will see a continued broadening out of positive performance for the S&P500 in the second half of 2017.

**Peter Jackson**

**Chief Investment Officer**

**July 3, 2017**

## APPENDIX 1

## NEW EQUITY INVESTMENTS:

### Cumberland North American Capital Appreciation Mandate

### United States

**Starbucks Corp (SBUX)**

Starbucks Corporation, together with its subsidiaries, operates as a roaster, marketer, and retailer of specialty coffee worldwide. The company operates in four segments: Americas; China/Asia Pacific; Europe, Middle East, and Africa; and Channel Development. We purchased SBUX this quarter as shares recently pulled back following five consecutive quarters of lower than expected sales growth in its owned stores. On valuation, shares recently traded down to a relative 10-year low versus the S&P500 which we believed to be a good entry point for what is expected to be a long-term holding in the portfolios. Sales are expected to regain their footing this year based on new menu innovations, increased social media presence for key beverage campaigns and heightened focus on driving My Starbucks Rewards program. SBUX long-term growth prospects in China are also very attractive, and we do not believe the market fully appreciates this growth potential just yet.

**Philip Morris (PM)**

Philip Morris International Inc., through its subsidiaries, manufactures and sells cigarettes, other tobacco products, and other nicotine-containing products. Its portfolio of brands comprises Marlboro, Merit, Parliament, Virginia S., L&M, Philip Morris, Bond Street, Chesterfield, Lark, Muratti, Next, and Red & White. Our purchase of Phillip Morris this quarter was predicated on the potential upside to shares with the successful roll out of the Reduced Risk Product (RRP), branded as IQOS. While the combustible cigarette performance could be limited to the upside in the short run, we believe there is sufficient upside to our estimates for the RRP business to at least support the company's EPS growth guidance of 9% to 12% underlying growth in 2017. The opportunity around the incremental sales and profit contribution from RRPs remains significant and we foresee accelerating revenue and profit growth for PMI over the next several years as this "game-changing" technology is commercialized around the world.

### Canada

**Keyera Corp (KEY)**

Keyera provides a range of midstream services to oil and gas producers in Alberta and British Columbia, including gathering and processing, fractionation, storage, pipeline transportation, and logistics. Many of its assets are located in key producing areas where producers are able to turn a profit at lower commodity prices.

The company has an excellent track record creating shareholder value largely from its ability to make investments in underutilized assets and improve their

performance by integrating it into their network. For example, an isolated gas plant could be brought to design capacity by being purchased and connected to Keyera's gas pipelines. We believe that Keyera will continue to create shareholder value with its solid management and focus on productive geologic areas.

**Kinder Morgan Canada (KML)**

Kinder Morgan Canada is a newly listed company controlled by its U.S. parent. The company has a high value pipeline and related assets connecting Alberta oil to tidewater on the west coast. The pipeline is strategic as it reduces dependence on the United States and fetches world pricing for Canadian crude. As a result, its oversubscribed. Kinder has received the necessary regulatory approvals and commercial commitments to more than double the capacity of the pipeline - the Trans Mountain Expansion Project. Construction is set to begin this year.

Despite the potential value of the Trans Mountain Expansion Project, Kinder Morgan's stock faltered off the IPO as investors became nervous about whether the project can be completed in an uncertain political environment (NDP government and First Nations support). Our view is that the market is too negative and isn't weighing the probability of the project proceeding properly. That gave us an opportunity to buy this pipeline at a steep discount with very attractive risk reward potential.

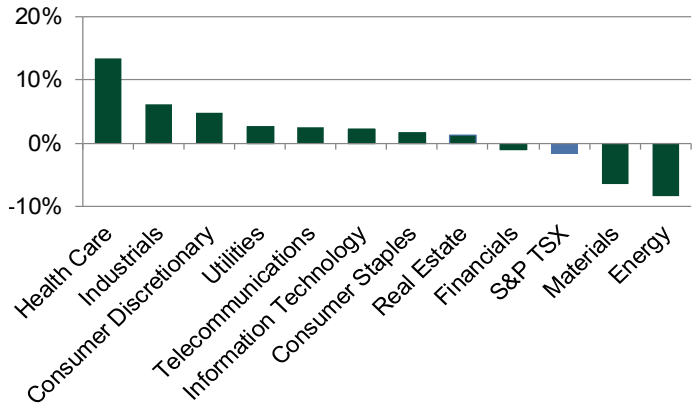
**IGM Financial (IGM)**

We initiated a position in IGM Financial Inc. (IGM), one of Canada's largest mutual fund managers with nearly $150b billion assets under management. IGM is best known by its two primary brands: Investors Group and Mackenzie Investments. The Company has been spending heavily in recent years on digital technology, investment talent and branding and, these expenses have weighed on profit margins. However, these investments are now paying off, evidenced by a strong acceleration in mutual fund sales in 2017. These higher asset balances, coupled with some planned curtailment of spending, are expected to drive earnings growth in coming years. Higher earnings will support IGM's current 5.6% dividend yield while allowing the Company to continue making next-generation growth investments, such as its recent investments in Wealthsimple, Personal Capital and China AMC.

## APPENDIX 2

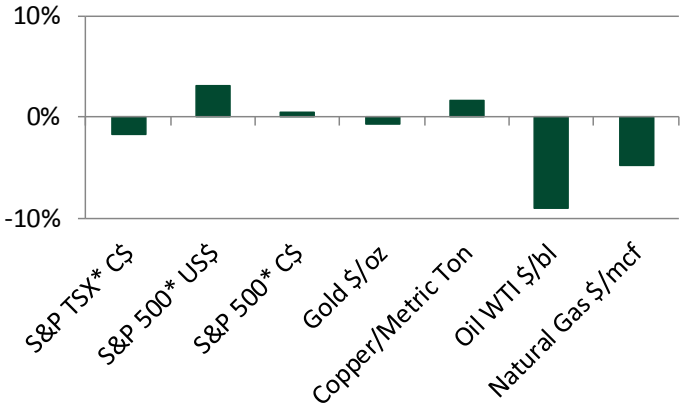
## PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending June 30, 2017



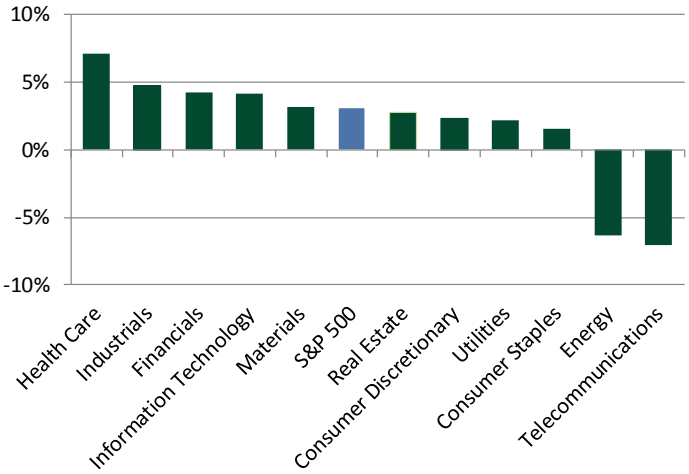

Source: TD Securities

Quarter % Change
Quarter Ending June 30, 2017




Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns
Quarter Ending June 30, 2017




Source: TD Securities