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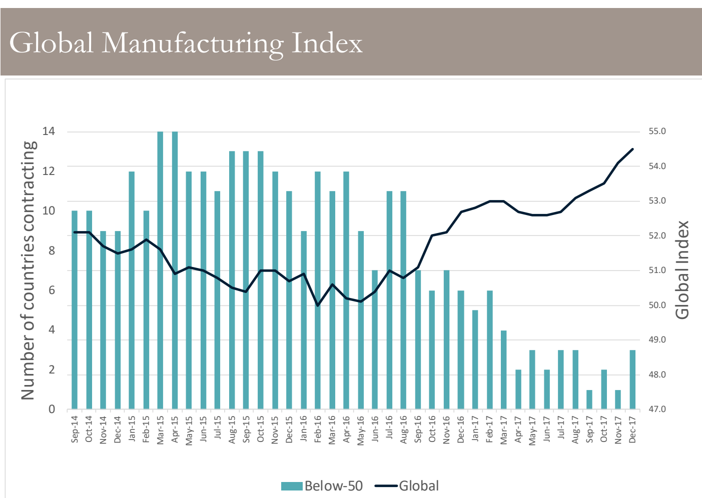
INCOME STRATEGY FOURTH QUARTER REVIEW

Synchronized Global Growth vs. Stretched Valuations

Continuing with the theme from our last quarterly review, global economic activity expectations in Q4/17 showed further signs of strengthening to cyclical highs among the major markets. There was evidence of even stronger synchronization across the globe, as only three of the major countries we track is in contraction (light blue bars). This broadbased pick up continues to support our conviction of global recovery over the first half of 2018.



Source: Bloomberg, CPWM

In addition, global inflation remains low and stable around the 2% level, which gives us comfort that there should be no urgency for central banks to deviate from their current path of gradual removal of accommodation. As such, we continue to expect interest rates to gradually rise over the near term driven by sound economic fundamentals. While the constructive macro environment should remain generally supportive of the current, in our view stretched, valuations in corporate credit in the near term, we are becoming more cautious and looking for opportunities to reduce our overall exposure in corporate credit.

Quarterly Review

The US economy continued to show signs of strength with stable growth, employment and inflation trends. Q3/17 GDP of 3.2% and consensus for Q4/17 growth of 2.7% keeps the economy on a stable growth trajectory of 2-3%. Economic indicators continue to remain strong and we are comforted by the fact that the 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 the continued contribution of business investments towards growth and the continued optimism of small businesses. The recent Purchasing Managers Index (PMI) data remains robust as well. Forward inflation measures remain stable around Fed's 2% target level.

The Canadian economy's growth cooled, as expected, to 1.7% in Q3/17 vs 4.5% in Q2/17. However, Canada continued to post extremely strong employment numbers over the last 12-months with a net employment growth of a healthy 422k jobs, led by full time jobs at 390k. Consumer spending remained strong and consumer confidence remains robust as well. Business investments, similar to the US, have turned positive over the past few quarters, which is a welcomed development. In addition, the business investment sentiment and sales outlook remain at respectable levels. Inflation trends in Canada remain around the 2% level, with headline inflation of 2.1% and various core inflation measures ranging from 1.5-1.9%.

The Canadian yield curve flattened over the quarter as the Bank of Canada maintained a neutral stance to policy and Canadian employment and wage growth data continue to support gradual policy tightening. In addition, low inflation, economic uncertainty and global quantitative easing kept the long end of the yield curve low. The yield curve continued to flatten with the 5-year and under part of the curve higher by 10-15 bps, and long end of the yield curve lower by ~20 bps.

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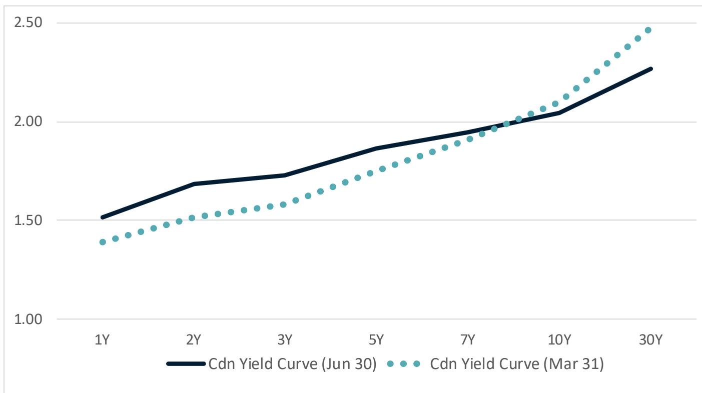
3 Month Yield Curve Change



Source: Bloomberg

Regarding credit trends, demand continues to remain robust for investment grade corporate bonds. The global risk-on tone of the general market along with strong Canadian economic data over the quarter led to tighter Canadian credit spreads. Demand for corporate bond new issues continues to remain extremely strong. Domestic cash continued to flow into bond funds and balanced funds. Flows into pure bond funds 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 were tighter by approximately 10 basis points for the quarter. This is positive for corporate bond returns.

Returns for various fixed income asset classes are in the table below. In Q4/17 and for the year, our overweight positioning in preferred shares, high yield and corporate bonds has benefitted our performance versus the benchmark; however, that was partly offset by our underweight position in provincials.

Asset class returns	Q4/17	2017
Federal Bond Index	0.87%	0.13%
Provincial Bond Index	3.38%	4.33%
Corporate Bond Index	1.87%	3.38%
High Yield Index	2.39%	9.94%
S&P/TSX Preferred Index	2.73%	13.62%

Outlook and Positioning

Our central scenario remains unchanged from last quarter – we expected and are now well underway towards a coordinated removal of monetary policy accommodation by the major global central banks (albeit at different stages of removal). With global central banks becoming less supportive, the focus will increasingly shift to economic fundamentals, which is expected to play a more significant role going forward.

In US, with business investments and consumers continuing to show a healthy trend, we believe that economic growth is on sound fundamentals and should be able to withstand a gradual removal of monetary policy accommodation through most of 2018. We are encouraged that the market's patience for tax reform to be legislated paid off which signals willingness of Republicans to work through their differences and pass legislation. The tax reform is expected to modestly add to US growth.

In Canada, while we are encouraged with the strong economic trends that have been in place for the past few quarters. While the extremely robust employment trends keep the economy on trend in the near term, our outlook remains uncertain in the longer run. Canadian consumers' indebtedness has further increased to support 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 (which are likely to have an impact starting Q2/18) 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. We look for Infrastructure spending (already financed) to provide some cushion to the economy. We expect Bank of Canada to continue on its path of gradual removal of accommodation with two or three rate hikes in 2018, assuming the economic fundamentals remain strong. However, if any of our above highlighted risks play out – we could see a pause in tightening in second half of the year.

We believe the Canadian bond market is now pricing in the possibility of almost three more interest rate hikes in 2018 at the time of our writing. While this is certainly possible given the recent momentum in the Canadian economy, we believe that this is likely the upper end of stimulus withdrawal that

Bank of Canada is willing to undertake as risks related to further policy withdrawal are very high.

From a fund flow perspective, we expect flows into bond funds to slow temporarily as we await more clarity from path of interest rates in Canada. However, we continue to believe that demographic trends will be supportive of the asset class in the longer run particularly at higher yield levels versus previous few years. Preferred shares are likely to continue generating positive returns which economic fundamentals hold up. Preferred shares relative valuations remain fair but much less so than a few quarters ago.

We are getting cautious on corporate credit as we believe valuations are stretched and offer limited upside. We continue to remain overweight corporate bonds but prefer higher rated names. We maintain our preferred shares weighting and remain 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 bond yields remains a policy error by global central banks where the coordinated policy removal leads to economic slowdown. Trump's election campaign probe regarding Russian involvement remains an ongoing event risk to keep in mind. In addition, we continue to monitor any escalation of geopolitical risks from North Korea and other regions. In Canada, a slowdown in exports or consumption and a softening in home prices could lead to Canadian yields going lower.

One of the biggest risks to higher than expected bond 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. Another unknown is inflation - further tightening in the labour market is likely to lead to faster wage growth and the unknown remains whether or not that translates to higher inflation or a margin squeeze for companies. 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 ultimately resulting in higher yields.

Gaurav Dhiman
Lead Manager, Fixed Income

Asset Allocation as at December 31, 2017	
Asset Class	**% of Portfolio**
Cash and Cash Equivalents	0.5%
Government Bonds	26.7%
Corporate Bonds	63.0%
Preferred Shares	9.8%

Yield[1] Comparison as at December 31, 2017		
Cumberland Income Fund		3.0%
FTSE TMX Canada Universe		2.5%
Performance[2] September 30, 2017	**1 Year**	**2 Year**
Cumberland Income Fund	3.1%	3.7%
FTSE TMX Canada Universe	2.5%	2.1%
Value Add	0.6%	1.6%

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.

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