CUMBERLAND

Private Wealth

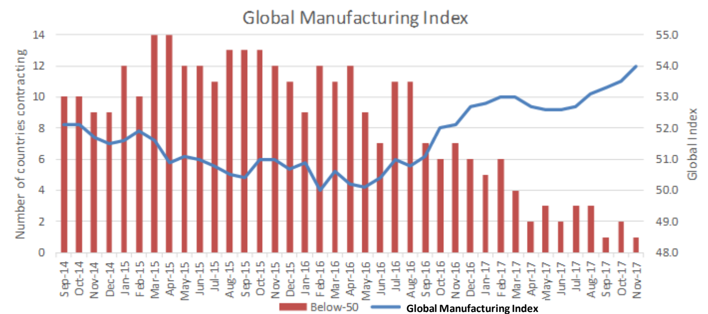
NORTH AMERICAN CAPITAL APPRECIATION STRATEGY

Year End Review

I can't help but think back to a phrase I first heard in the early 1990's, "the Goldilocks economy", the reference is to the children's story, The Three Bears. It best describes the current state of the US economy as being not too hot and not too cold or in other words an economy with moderate economic growth and low inflation. So far, it seems like everything is just about right. US GDP has continued to pick up through 2017 with the latest third quarter reading of 3.2% up from 1.2% and 3.1% in the first quarter and second quarters respectively. Inflation has remained in check notwithstanding the latest November reading of headline inflation, which climbed to 2.2% mostly due to rising energy prices. Excluding food and energy, core inflation is running at 1.7% and more importantly, the latest reading for the Federal Reserve's (Fed) preferred measure of inflation, the Personal Consumption Expenditures (PCE), was only 1.5%, well below the Fed's notional target of 2%. The other factor the Fed looks at in determining future interest rate policy is employment, which has remained solid so far in 2017 with the November unemployment rate at 4.1%, a 17-year low.

And it's not just the US economy that is doing well as all economies globally are experiencing a strong synchronized upward path of growth. Exhibit 1 shows the average global Purchasing Manufacturing Index (PMI) for 30 developed and emerging markets (blue line) and compares it to the number of countries that are currently contracting (red bars). Of the 30 largest developed and emerging markets globally, currently only 1 of the 30 has a reading less than 50 or is considered contracting. Every other country is expanding. The added fiscal stimulus from US tax reform passed just before Christmas will no doubt also continue to fuel this growth. All of this seems to justify the Fed's three rate increases in 2017, with the latest one in December and its plan for three more in 2018.

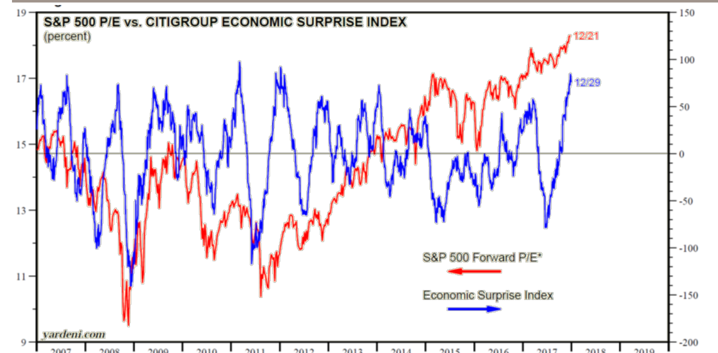
Exhibit 1
Global Manufacturing Index



Source: JP Morgan

The question we are asking ourselves is, "Is this is as good as it gets?". If it is, that's not in itself a reason to sell the market as things could stay this way for a while, but it is worth investigating the context of what we are paying for future earnings. Exhibit 2 compares the Citigroup Economic Surprise Index (blue line) to the S&P500 forward price earnings-(P/E) ratio (red line).

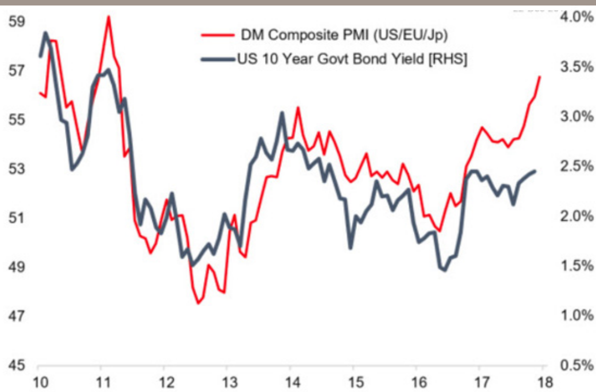
Exhibit 2
S&P500 P/E vs. Citigroup Economic Surprise Index



Source: Yardeni

The Economic Surprise Index measures how good actual economic news is compared to consensus expectations. As indicated in the chart, there have been more positive surprises than negative surprises taking the index up to close to its highest level over the past 10 years. There also appears to be a reasonably high positive correlation between the change in the direction of the Citi Economic Surprise Index and the S&P500 forward P/E ratio, suggesting that the economic data not only needs to stay positive but also beat consensus, otherwise the forward P/E multiple may pause or possibly contract. It is worth noting that the P/E ratio, at over 18x forward earnings, is also at a ten-year high. Exhibit 3 compares the composite developed market global PMI to US 10-year treasury yields, and once again there is a positive correlation between the two.

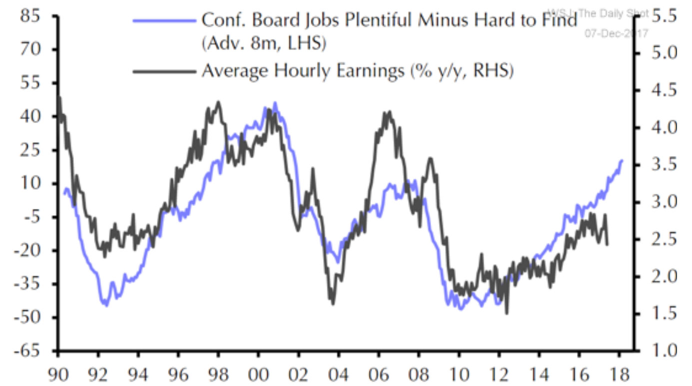
Exhibit 3
Developed Market (DM) PMI vs. Bond Yields



Source: Topdown Charts, Thomson Reuters, Markit

Given the recent divergence evident in the chart, it suggests US treasury yields may have some catching up to do (meaning higher yields) in the near term. This is not necessarily a bad thing as higher yields are generally a sign that the economies are strengthening. Also bank earnings benefit from rising rates as we have discussed previously, and Financials still represent our largest sector weighting at 24%. The problem is that if treasury yields rise too much, they start to compete with other corporate investment grade and high yield credits and eventually equities. Exhibit 4 compares the net jobs plentiful index (LHS) to average hourly earnings changes (RHS). It also supports the idea that although we have not seen much wage inflation yet, pricing pressures may just be around the corner.

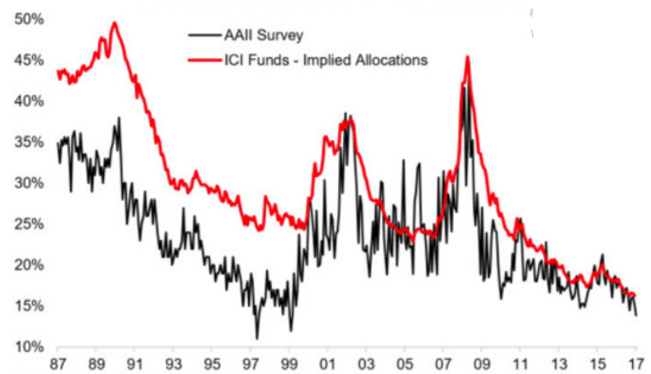
Exhibit 4
US Net Jobs Plentiful Index & Earnings



Source: Thomson Reuters, CE

This could put upward pressure on long term rates and cause the Fed to accelerate the pace of rate increases, which would likely put downward pressure on forward earnings multiples as equity prices fall. In Exhibit 5 we look at the average cash levels currently held by individual investors and mutual funds.

Exhibit 5
Investor Asset Allocations - Cash Allocations



Source: Topdown Charts, AAII, Thomson Reuters

As indicated in the chart, cash levels are approaching the lowest levels seen since 1999, which begs the question then "who is left to invest?" So that's another reason why we are asking ourselves if this is as "good as it gets" and whether now is the time to be raising more cash. We will provide more detail on market valuations later in our outlook, but we would sum up by saying that right now, we see a bit of a balancing act between becoming overly cautious about the outlook too soon and staying invested as the current economic trends are all positive and may remain so for a while.

In the Canadian environment, the TSX is not as expensive, from a valuation perspective, compared to US market. Overall, the Canadian economy is still doing okay, notwithstanding the high level of household debt due to elevated house prices. However, the bulk of the mortgages in Canada are insured or backed by the equity in the home. Therefore, if interest rates do not rise too quickly or if employment levels don't decline, the situation is probably manageable. As of January 1st, 2018, new mortgage rules require borrowers with a down payment of more than 20% to qualify for a mortgage based on the Bank of Canada five-year lending rate or the customer's mortgage rate plus 2% (whichever is higher), rather than the actual lower mortgage rates offered by banks. This will also have the impact of potentially slowing down the housing market somewhat in 2018, which is not necessarily a bad thing if the changes are implemented effectively.

According to Bank of Canada Governor, Stephen Poloz, the Canadian economy is on pace for 3% GDP growth in 2017, which is one of the strongest levels among the G7 economies although the latest reading in the third quarter GDP (+1.7%) was lower than previous quarters. Inflation, as measured by the Consumer Price Index (CPI) for the latest November period was 2.1%, while the average core measure of inflation was also below the Bank of Canada's targeted level of 2% at 1.7%. Employment growth on the other hand has shown continued signs of improvement with over 350,000 new jobs created this year and the latest unemployment rate for November has dropped to 5.9% from 6.3% in October. So apart from the strong job growth, which continues to surprise most economists, the economic outlook in Canada looks fairly muted and supported a more of a wait and see approach by the Bank of Canada (BOC) to decide on implementing further rate hikes after raising rates twice earlier in 2017. However, if the economic data in Canada does accelerate more to the positive, and given the Fed's direction south of the border, we could see a more accelerated shift to raise interest rates by the BOC sooner rather than later.

During the fourth quarter of 2017, the S&P500 Index was up 6.6% in US dollar terms. Adjusting for currency, the S&P500 returned 7.2% in Canadian dollars, as the Canadian dollar depreciated vs. the US dollar by just under 1 cent, closing the quarter at US$0.79. Year to date, the S&P500 returned 21.8% in US dollars and 13.8% in Canadian dollars as the Canadian dollar appreciated 5 cents during 2017. In Canada, the TSX return in the fourth quarter and year to date was 4.5% and 9.1%, respectively.

Asset Allocation for our North American Capital Appreciation Strategy As at December 31, 2017

Equities	86%
Fixed Income	5%
Cash	9%

During the quarter our commitment to equities initially increased early in the fourth quarter from 88% to 92%; however, we began reducing our equity exposure so as, to end the year at 86% invested. Currently, the equity portion of the portfolio is split between Canada and US at 42% and 44%, respectively.

Third quarter earnings for the S&P500 were quite strong with 74% of companies beating estimates. This resulted in actual year over year earnings growth in the third quarter of 6.4% compared to projected growth rate of 3.1% at September 30th 2017. Valuations, particularly in the US, have continued to get more expensive, hence our decision to raise some cash and bring down the overall volatility of the portfolio. Positions trimmed or sold during the quarter including Russel Metals in Canada, LyondellBasell Industries and Apple Inc in the US, have a higher level of business cycle exposure or market beta risk, relative to the rest of the North American investment portfolio and the equity market in general. So, we really accomplished two goals, 1) we raised a bit of cash and 2) dampened the overall volatility of the portfolio to reflect

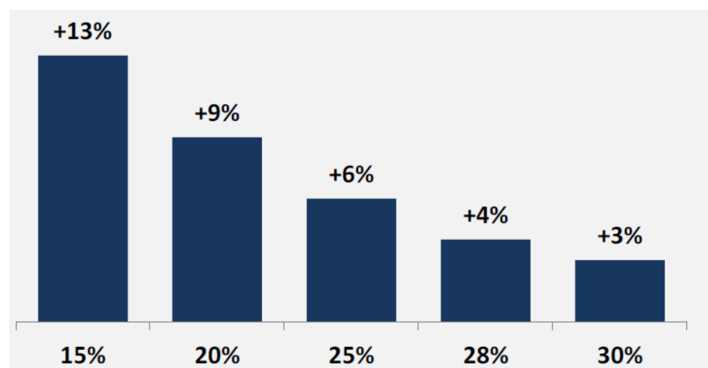
the fact that equity valuations are moving higher generally and we are becoming slightly more cautious in our outlook, notwithstanding the strong economic and market performance discussed above. We added two new positions during the quarter, TE Connectivity and Raytheon Co. Both of these high-quality ideas were derived from our focus and review of the major themes we anticipate will be relevant going forward into 2018. Our interest in TE Connectivity, has to do with the secular shift to electric vehicles and autonomous driving. TE Connectivity provides a complete line of connectors and relays that help protect the flow of data and power to enable electric mobility, which should have strong secular tailwinds of growth for many years. On the theme of defense and space, Raytheon is one of the leading global defense contractors that should benefit in a world where the threat level is constantly rising, in particular more recently for the US.

Cash levels have increased from 4% to 9% while fixed income declined from 8% to 5%. With 86% invested in equities, we are still exposed to the market but less so than at September 30th 2017 and with slightly lower overall volatility. Most of the portfolio's fixed-income investment is held in the Cumberland Short-Term Bond Fund, which has a short duration of less than three years. Both the cash and the fixed income portion will act to dampen the volatility of the total portfolio in any type of market correction or pullback and will be available for reinvestment. A complete summary of new positions added during the quarter, including business fundamentals and valuation metrics, is contained in Appendix 1.

Outlook

On our November client update call, we discussed how we thought the market was expensive, but that on its own was not a sufficient reason to move to the sidelines. We outlined what could challenge the market, (higher than expected inflation/ faster upward acceleration in interest rates or a recession, for example) that could lead to an equity bear market, but in our opinion those concerns were remote. While a correction can't ever be ruled out, so far, the outlook for projected earnings growth for both the S&P500 and the TSX remain strong for 2018 and 2019 at high single-digit to low double-digit levels. Lately the earnings surprises in the third quarter have been more to the positive than to the negative. Also, we can add the positive impact from the implementation of US tax reform, which was finally passed last month. Exhibit 6, shows the impact on S&P500 earnings from US tax reform changes under various taxation scenarios.

Exhibit 6
S&P 500 EPS Impact at US Corporate Tax Rates



Source: Wolfe Research, WSJ

Going from a 35% tax rate to 21%, looks like the impact could be a positive 8% or 9% for S&P500 earnings. Last quarter, the consensus outlook for 2018 and 2019 corporate earnings was $145.1 and $159.9 while current estimates are $146.6 and $161.3, which still represents 11% and 10% growth rate, respectively. However, it does not appear that there is much included for tax reform in these numbers, based on the limited change in earnings estimates from three months ago. So the good news is that the US economy is strong with a pretty decent earnings tailwind coming likely over the short term for the S&P500. However, at 18.2x 2018 earnings compared to 17.4x last quarter and the ten-year average of 14.4x, it's definitely not cheap relative to historic terms. Even factoring in the 8% earnings bump from the tax benefit, it still trades at 16.9x. So perhaps the market is beginning to build in some expectation for this future earnings growth and that's the risk if for some reason it does not come to fruition.

Exhibit 7 compares the Russell Value (blue line) versus the Russell Growth (green line) indices going back to 1998. It clearly shows that as an investment style, Growth has been outperforming Value in 2017. The chart also indicates a mean reversion tendency over time and certainly the performance over the last month of some of the financials and consumer

stocks may suggest some sector rotation to Value is underway.

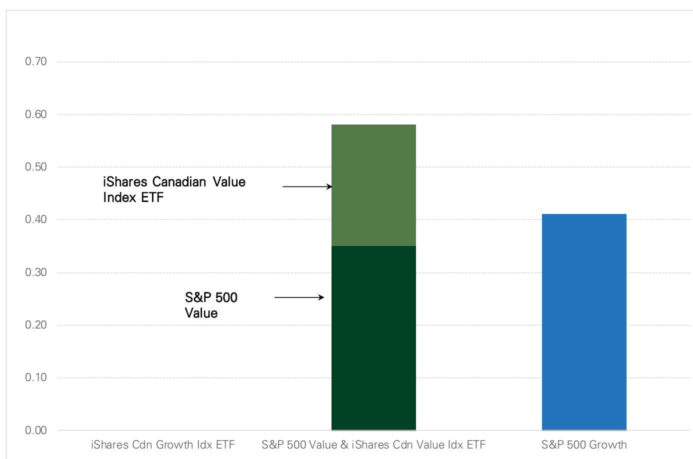
Exhibit 7
Russell Growth and Value Index

Source: Bloomberg

This is good for the market and potentially our portfolio as it suggests greater breadth to the market and potentially more upside if you are in the right sectors.

Exhibit 8 shows the split of the Cumberland portfolio between Growth and Value. Clearly we have some growth component concentrated in technology for diversification and that has not hurt us in 2017. However, as shown in the chart the overall makeup of the Cumberland portfolio still has a strong value tilt and would benefit from a rotation into Value stocks outperforming growth.

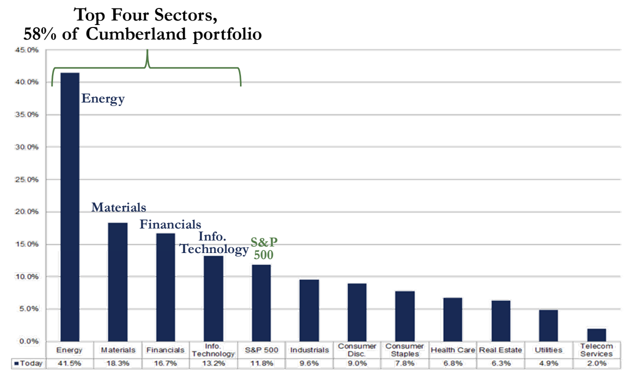
Exhibit 8
Style Analysis - North American Capital Appreciation



Source: Portfolio IQ

Exhibit 9 shows the outlook for S&P500 earning growth by sector. As indicated in the chart while the earnings outlook is strong across the board, the top four groups (Energy, Materials, Financials and Information Technology) are even stronger than the average for the S&P500, and these four groups currently represent 58% of our portfolio or almost 70% of our 86% invested in equities.

Exhibit 9
S&P 500 Earnings Growth 2018



Source: FactSet

In Canada, valuations for the TSX companies are not super cheap either trading at 16.3x 2018 earnings as compared to 16.0x last quarter. At 14.6x 2019 earnings, the TSX looks relatively cheaper a year from now and is also projecting some relatively strong earnings growth in 2018 and 2019 at 7.8% and 11.7% respectively. So, from a valuation and earnings growth perspective, Canada could play some catchup.

Exhibit 10 compares the profitability, valuation and risk characteristics of the Cumberland portfolio to the S&P500/ TSX 50/50 benchmark. As indicated in the chart, our portfolio characteristics are generally more favourable from a quality perspective as measured by Return on Equity (ROE) and

Return on Invested Capital (ROIC). Our portfolio also trades at a lower valuation as measured by the Price/Earnings (P/E) and EV/EBITDA multiple and has low volatility (as measured by beta, debt leverage and active risk) relative to the overall market. We believe having a quality and value style bias will position the portfolio well for 2018.

Exhibit 10
Portfolio Characteristics

	Current Portfolio	50/50 Benchmark
Profitability		
EBITDA Margin (%)	28.2	31.2
ROIC 5 Year (%)	11.6	9.7
ROE Latest FY (%)	20.9	20.8
Asset Turnover	0.548	0.514
Valuation		
Price/Earnings 12m (X)	16.2	17.1
EV/EBITDA (X)	10.6	11.7
Dividend Yield (%)	2.5	2.3
Price/Cashflow (X)	10.9	10.8
Risk		
Beta	0.93	1.00
Debt/EBITDA (X)	2.6	3.6
Active Risk (%)	2.95	-

Source: Bloomberg

Peter Jackson
Chief Investment Officer
January 1, 2018

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.

APPENDIX 1

NEW EQUITY INVESTMENTS:

CUMBERLAND NORTH AMERICAN CAPITAL APPRECIATION MANDATE

United States

TE Connectivity Ltd (TEL)

TE Connectivity engineers and manufactures electronic parts, sensors and connectors. Its competitive advantage is the extensive integration it provides into its customers products and the high value end markets it serves - automotive and industrial. Although the electronic components space is fragmented, the automotive and industrial end markets require strong vendors with extensive engineering capabilities and a global reach. We think TE Connectivity will benefit from electrification and automation of the car and a growing shift in factories to automate their manufacturing processes.

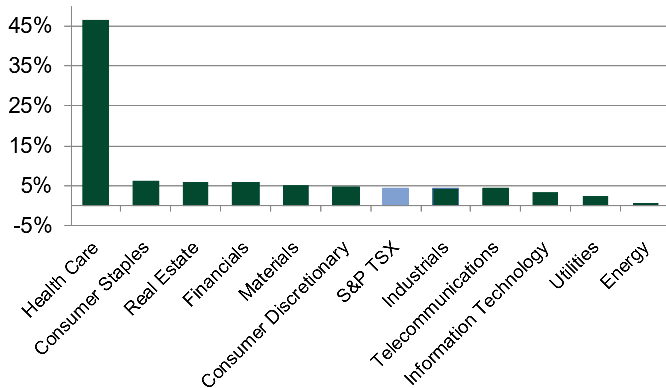
Raytheon (RTN)

Raytheon Company develops technologically integrated products, services and solutions worldwide. It operates through five segments: Integrated Defense Systems, Intelligence, Information and Services, Space and Airborne Systems and Forcepoint. Missiles and the Patriot Defense System drive the narrative against an increasingly volatile geopolitical environment. At home, the Department of Defense (DoD) remains in prime territory to see budgetary increases under the current Administration. International orders continue to build as the threat from Russia, China and North Korea do not seem to subside. Raytheon has less balance sheet risk than its Defense Prime peers, and has a higher proportion of revenue coming from international markets vs its peers. This should make it somewhat less sensitive to changes in the DoD budget, and over the coming years lead to higher operating margins. RTN generates substantial free cash flow, which we expect will continue over the long-term. M&A remains a likely source of in-fill growth for key segments such as cybersecurity, and not for large-scale transformative acquisitions like those in the past.

APPENDIX 2

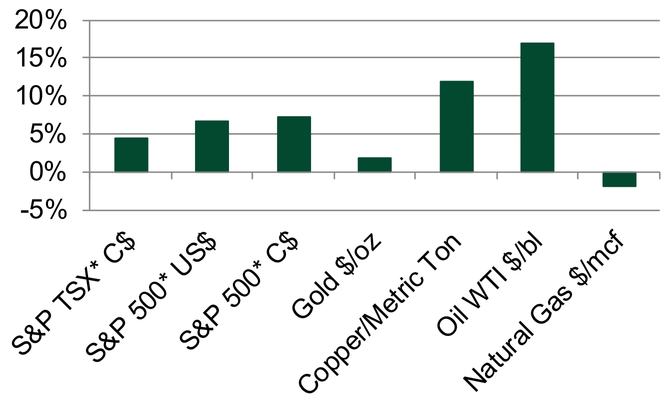
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending December 31, 2017



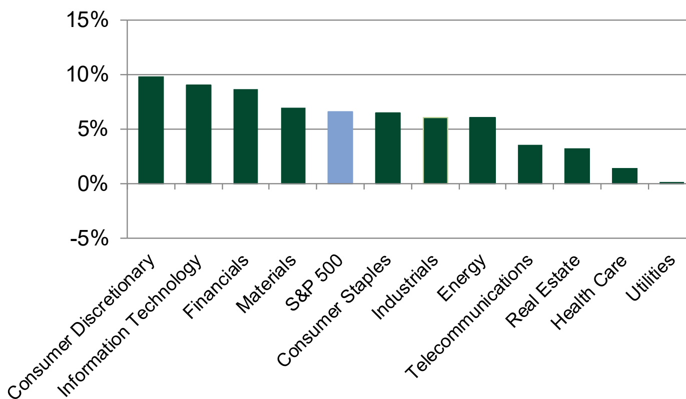
Source: TD Securities

Quarter % Change
Quarter Ending December 31, 2017



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending December 31, 2017



Source: TD Securities