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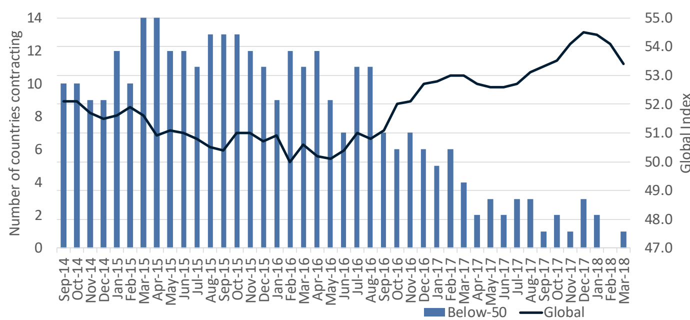
INCOME STRATEGY FIRST QUARTER REVIEW

For the past few quarters, the themes we focused on were synchronized global growth, stable (albeit strengthening) inflation trends and gradual removal of central bank accommodation. Today, we believe most of these themes are largely intact.

Global economic activity expectations in Q1/18 continue to be strong, although they have trended down from last quarter. Similar to the previous quarter, only one of the major countries we track (South Korea) is in contraction (blue bars). This broad-based synchronized strength continues to support our conviction of robust global growth over the first half of 2018.

Global Manufacturing Index



Source: Bloomberg, CPWM

Globally, inflation trends globally have picked up although they remain around the 2% level, which gives us comfort that central banks should continue on their current path of gradual removal of accommodation.

As such, we continue to expect interest rates to rise gradually over the near term, driven by sound economic fundamentals and higher global term premium. While still not our central scenario, the one change from our last quarterly is the elevated risks of protectionism and higher than expected inflation that can derail our global growth and stable inflation assumptions.

Quarterly Review

The US economy continued to exhibit strong fundamentals with stable growth, employment and strengthening, yet stable, inflation trends. Q4/17 GDP of 2.9% and consensus for Q1/18 growth of 2.2% keeps the economy on a stable growth trajectory of 2-3%. Economic leading 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 underpinning 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 current optimistic outlook of small businesses. The recent Purchasing Managers Index (PMI) data remains robust as well. Forward inflation measures remain stable – slightly above the Fed's 2.0% target level.

The Canadian economy's growth cooled in H2/17, as expected, with 1.5% growth in the latest quarter. However, Canada continued to post extremely strong employment numbers over the last 12-months with a net employment growth of a healthy 296k jobs, led by 335k full time jobs. Consumer spending somewhat slowed, however consumer confidence remains robust. 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 2.2% and various core inflation measures ranging from 1.9-2.1%.

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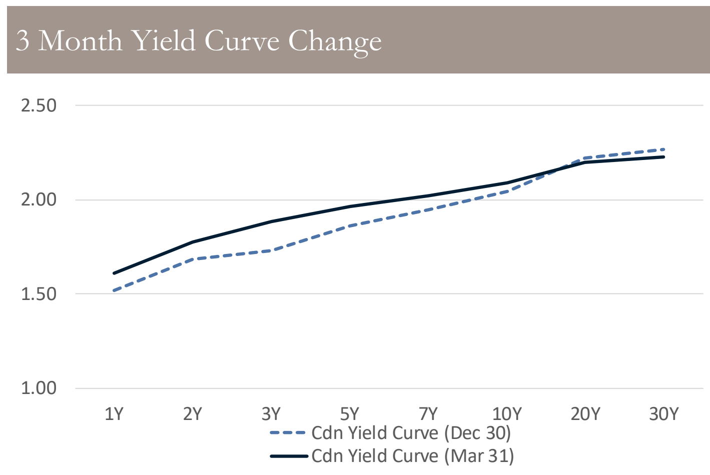
The Canadian yield curve flattened modestly over the quarter as the Bank of Canada maintained a neutral stance to policy. Canadian employment and wage growth data continue to support gradual policy tightening while economic uncertainty and enduring low global term premium as a result of global quantitative easing kept the long end of the yield curve low. The yield curve flattened approximately 15 basis points (bps) or 0.15% with the 5-year and under part of the curve higher by 10-15 bps, and long end of the yield curve lower by 3-4 bps.

3 Month Yield Curve Change



Source: Bloomberg

Regarding credit trends, we talked about stretched valuations in January and we did see credit spreads widen in February and March as risks around protectionism and trade wars started to worry investors at the margin. However, overall demand continues to remain robust for investment grade corporate bonds after the recent widening in spreads. As a result, investors have started to demand some new issue concession to add to corporate bonds. Domestic cash continued to flow into bond funds and balanced funds – however skewed towards global exposures. The latest available data shows international investors were net sellers of Canadian government and corporate debt securities. As such, Canadian investment grade credit spreads were wider by approximately 5 basis points or 0.05% for the quarter.

Returns for various fixed income asset classes are in the table below. In Q1/18, our overweight positioning in preferred shares and corporate bonds slightly hurt our performance versus the benchmark; however, that was partly offset by our underweight position in provincial bonds.

Asset Class Returns	Q1/18	2017
Federal Bond Index	0.33%	0.13%
Provincial Bond Index	-0.27%	4.33%
Corporate Bond Index	0.28%	3.38%
High Yield Index	1.47%	9.94%
S&P/TSX Preferred Index	-0.15%	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 the 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. The tax reform is expected to add modestly to US growth.

In Canada, we are encouraged with the respectable 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, the outlook remains uncertain in the longer run. We believe that the increase in Canadian consumers' indebtedness has supported consumption based growth so far. However, we believe consumers are due for a cycle of deleveraging, particularly as rising interest rates increase 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. With regards to NAFTA, while we are encouraged by the recent willingness shown by the Trump administration to successfully come to an agreement, we remain concerned on the details of any agreement before we become more constructive. The longer the negotiations linger, the more likely it is that they will hamper business investments by exporters. We expect the Bank of Canada to continue on its path of gradual removal of accommodation with an additional one or two 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.

We believe the Canadian bond market is now pricing in the possibility of two more interest rate hikes in 2018 at the time of our writing. This has come down from the last quarter when we viewed markets as being too optimistic on Canada and still believe that two more rate hikes this year is the upper end of stimulus withdrawal that the Bank of Canada is willing to undertake at this point as risks related to further policy withdrawal remain high.

We welcome the recent widening in credit spreads in corporate bonds and have taken the opportunity to add to some higher quality names. Overall, we still remain cautious on corporate credit as we believe that valuations offer limited upside. We continue to remain overweight corporate bonds with a preference for higher rated issuers. We continue to trim our preferred shares weighting as we believe corporate bonds offer better relative value given the uncertainty in Canadian fundamentals. We 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 an economic slowdown. In addition, we continue to monitor the escalation of protectionism and trade wars as a major challenge to our assumption of synchronized global growth. We continue to monitor the trend in US tariffs and potential for a US-China trade war primarily through the level of aggression shown by the use of section 301 by United States Trade Representative (USTR). Trump's election campaign probe regarding Russian involvement remains an ongoing event risk to keep in mind. 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 a 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 addition, the late cycle fiscal stimulus in a fundamentally strong economy raises the risk of inflationary pressures. 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 March 31, 2018	
Asset Class	**% of Portfolio**
Cash and Cash Equivalents	0.4%
Government Bonds	35.4%
Corporate Bonds	60.3%
Preferred Shares	3.9%

Yield[1] Comparison as at March 31, 2018			
Cumberland Income Fund			2.90%
FTSE TMX Canada Universe			2.57%
Performance[2] March 31, 2018	**YTD**	**2017**	**2016**
Cumberland Income Fund	-0.03%	3.07%	4.26%
FTSE TMX Canada Universe	0.10%	2.52%	1.66%
Value Add	-0.13%	0.55%	2.60%

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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