NORTH AMERICAN CAPITAL APPRECIATION STRATEGY

Third Quarter 2018 Review

The latest quarter has been influenced by increasing market concern around protectionism as both the NAFTA trade issue came to a head and we saw the implementation of new tariffs on China. In any negotiation, there are usually winners and losers but when we compare the returns of the S&P500 over the past three months and year to date to Canada, or even globally, it feels like the S&P500 is in a "Heads I win, Tails you lose" scenario. During the third quarter of 2018, the S&P500 index was up 7.7% in US dollars. Adjusting for currency, the S&P500 returned +5.9% in Canadian dollars, as the Canadian dollar appreciated about 1.4 cents, closing the quarter at US$0.775. Year to date, the S&P500 returned 10.6% in US dollars and 14.1% in Canadian dollars as the Canadian dollar depreciated from US$0.795 at December 31st, 2017. Contrast this to the returns in Canada where the TSX return in the third quarter and year to date was -0.6% and 1.4% respectively. Even returns outside North America as measured by the MSCI EAFE index in Canadian currency were only -0.3% and 2.2% in the third quarter and year to date. So clearly the US market is benefitting from strong economic growth and tax reform but maybe there is more to it as the uncertainty around trade seems like less of a bite to the US relative to other countries. Looking at the two extreme trade outcomes might shed some insight on why investors are favouring the US and why, even though we think the US market is getting expensive, we are not completely steering away from it just yet. The first scenario is the happy ending scenario in which Canada, the EU and China settle all trade disputes with the US. We think most would agree under this scenario world markets would probably move higher at least initially until investors refocus on other factors such as economic growth, earnings and the level of interest rates. Second is the no trade resolution scenario. Under this scenario, we are stuck with a continuation of US protectionism. However, the US economy has just started benefiting from US tax reform reducing the top corporate tax rates from 35% to 21%, which is below the average OECD corporate tax rate of 24%. Add to this over $300bn of repatriation from offshore accounts in the first quarter alone on an estimated $2.6 trillion base that could be repatriated and marking almost an initial ten-fold increase from last year. It is questionable whether this will just end up being plowed into stock buybacks (which would be good for the S&P500) or capital expenditures on real tangible assets, but keep in mind the Trump administration also introduced an accelerated write-off of capital expenditures, at 100% in some circumstances. This, combined with protectionism, tax reform and repatriation of capital could be an extremely powerful combination that could continue to drive, and even surprise to the upside, the future level of US economic growth. "Heads I win, tails you lose". It almost seems brilliant.

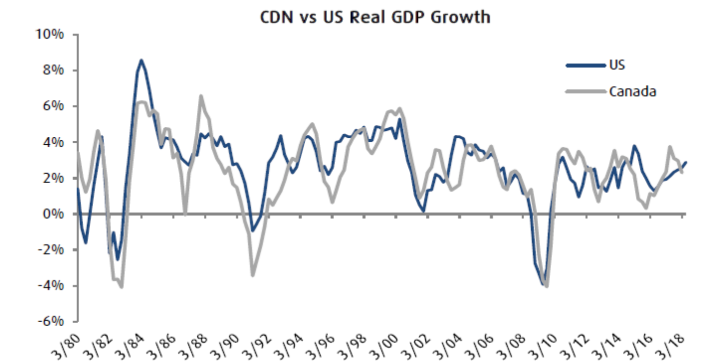
So in that context, even though the S&P500 is expensive, we continue to like the US market which if anything, could surprise to the upside. The Canadian market is also dirt cheap, and with NAFTA uncertainty now behind us, Canada's earnings acceleration into 2019 seems too good to pass-up. International markets are getting cheaper but they currently lack the underlying economic growth prospects and earnings potential to support any large reacceleration at least at this point.

First, let's update both the US and Canadian economic outlook. On September 26th the US Federal Open Market Committee (Fed) announced its third rate hike for 2018 citing US labour markets that have continued to strengthen and economic activity that remains strong. In fact, the latest reading on second quarter US GDP was 4.2% up from 2.2% in the first quarter while core inflation, currently 2.2%, remains roughly in line with the Fed's objective of 2% over the medium term. Up until now, there are few signs that escalating trade tensions have had any notable impact on aggregate GDP or consumer prices. With $50bn in tariffs on Chinese goods already in effect, President Trump recently announced tariffs on a further $200bn late in September at a 10% rate that will escalate to 25% in January. However, in an economy of close to $20trillion we just don't think this alone will have that dampening effect. According to J.P. Morgan, a 25% tariff on $250bn of goods would cut US GDP by 0.15% and boost inflation by 0.2%, which isn't drastic. Perhaps more worrisome is the pace of future Fed rate hikes as we are on target for one more in 2018 and three next year. The Fed has been doing a pretty good job, at least so far though, in managing a sustained expansion of economic activity, while maintaining strong labour market conditions and inflation in line with its objectives.

Turning to Canada, the good news, at least so far, is that economic conditions up here are almost a mirror image of the US at least statistically, although it does not really feel that way perhaps as a result of previous NAFTA uncertainty? Consider that second quarter GDP was running at a 2.9% annualized rate up from 1.4% in the first quarter and the latest core inflation data at 2.0% is also running in line with the Bank of Canada's target of 2% inflation, both of which are positives. While the latest unemployment data in Canada was a touch weaker at 6.0% compared to 3.9% in the US, it was related to a large drop in part time jobs whereas full time employment saw a respectable increase.

One of the reasons we are not as negative on Canada as one might expect relates to the historical relationship between the two economies and the current strength south of the border. In these first two charts we compare the correlations of Canada and US real GDP growth. Exhibit 1 measures real GDP growth in Canada and the US back to 1980 and as you can see, the lines are pretty correlated.

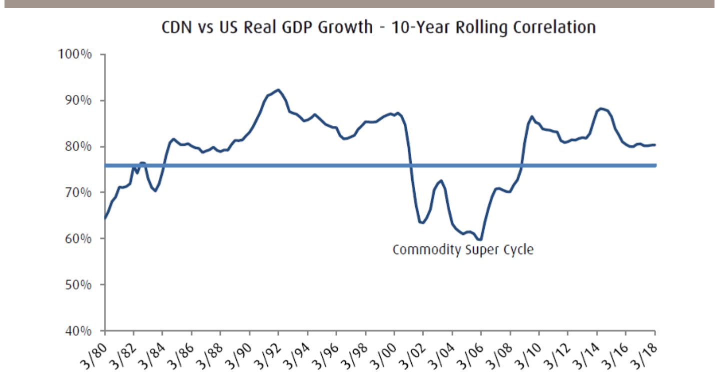
Exhibit 1
Canada and U.S. - Real GDP & Rolling Correlation



Source: BMO Capital Markets Investment Strategy Group, Haver, BEA Statistics Canada

Exhibit 2 shows the 10-year rolling correlation between the two economies, and apart from the commodity super cycle in early 2000's where the TSX outperformed, the correlation has been quite high and is now running about 80%. So despite all the NAFTA noise, Canadian economic growth is generally tied to how well the US economy is doing.

Exhibit 2
Canada and U.S. - Real GDP Growth 10-Year Rolling Correlation



Source: BMO Capital Markets Investment Strategy Group, Haver, BEA, Statistics Canada

The evidence to support this can also be seen in the level of earnings growth for both the S&P500 and the TSX.

Exhibit 3 compares the year to date performance, the 2018 and 2019 estimated earnings growth, forward price earnings and 10 year average forward price earnings for both the S&P500 and the TSX as well as the MSCI EAFE index.

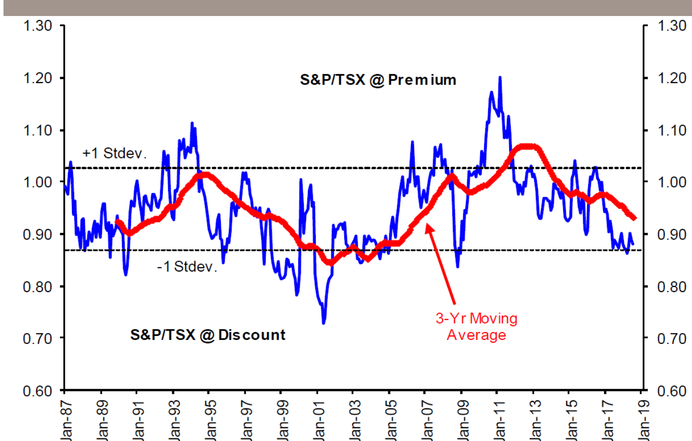
Exhibit 3
Performance, EPS Growth, Forward and 10 year Average P/E

	% change	EPS Growth		**Forward P/E**		**P/E**
	YTD CAD$	**2018**	**2019**	**2018**	**2019**	**10 Year Average**
S&P 500	14.1%	16.6%	10.4%	18.1x	16.4x	14.7x
TSX	1.4%	13.4%	13.2%	15.6x	13.7x	14.5x
EAFE	2.2%	9.2%	7.8%	14.2x	13.2x	13.1x

Source: Bloomberg

What's clear from the chart, is that both the S&P500 and the TSX are experiencing strong double digit earnings growth commensurate with the strong economic growth just discussed. The difference though is that the year to date stock index performance for the TSX is not commensurate with its level of earnings growth so far in 2018 or even looking out to 2019 where the estimated earnings growth actually exceeds the S&P500. As a result, the TSX valuation relative to the S&P500 has reached an extreme low as illustrated in Exhibit 4 which compares the ratio of the 12 month forward price earnings (P/E) ratios for the TSX and the S&P500.

Exhibit 4
TSX vs S&P500- 12M Forward Relative Price/Earnings



Source: Scotiabank Global Banking and Markets Research

The blue line in the chart represents the ratio of the TSX forward price/earnings multiple to the S&P500 forward price/earnings multiple. Currently, the TSX is trading at almost a 15% discount to the S&P500, or 1-standard deviation lower as indicated by the lower dotted line as compared to a 3% discount when Trump was elected. Also note that, other than a brief period during the Financial Crisis in 2008, this is the largest discount since the early 2000's. Also worth noting in Exhibit 3, based on the 2019 earnings outlook, the TSX is trading at just 13.7x compared to the 10 year average forward P/E of 14.5x. The EAFE index is also starting to look cheap trading at 13.1x 2019 P/E, near its long-term average P/E of 13.2x, although the estimated earnings growth rate is still notably less than the S&P500 and TSX.

Asset Allocation for our North American Capital Appreciation Strategy

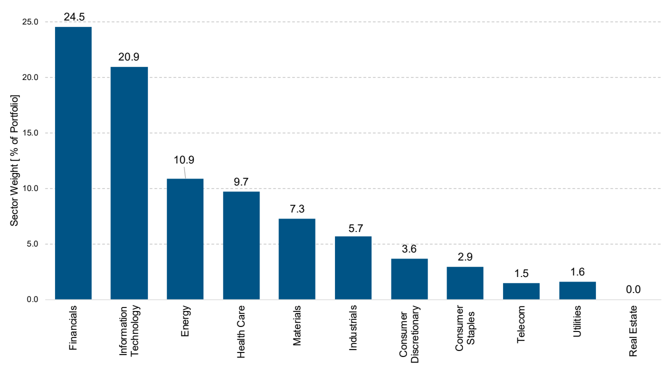
As at September 30, 2018

Equities	89%
Fixed Income	4%
Cash	7%

During the quarter our asset mix shifted in favour of Canada versus the US as our Canadian equity weight increased 3% to 49% while our US weight declined 1% to 40% such that our overall equity exposure increased from 87% to 89% at the expense of cash which decreased from 8% to 7% and short-term bonds which decreased from 5% to 4%. Over the past two quarters, our Canadian asset allocation has risen 9% while our US has declined 5%. As discussed above, valuations in Canada continue to look more attractive relative to the US while earnings growth, looking out into 2019, for the TSX is accelerating faster than the S&P500. Our target international asset allocation in the North American plus International model is 22% unchanged from June 30th. Like the Canadian market, valuations internationally are getting cheap as well, however they are not yet supported by the stronger economic conditions and the pace of earnings growth we see in the Canadian and US markets. If economic conditions improve and earnings pick up however, we will review our international exposure in due course.

Exhibit 5 shows our sector weights for the North American strategy.

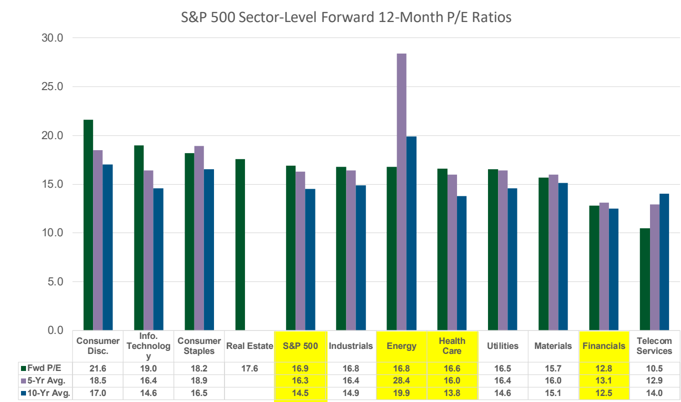
Exhibit 5
North American Equity Portfolio: Sector Weights



Source: Cumberland

During the quarter our Information Technology weight has come down from about 25% in June to 21% reflecting a slowing earnings growth outlook for some specific technology issues. Health Care increased from 5% to almost 10% due to more attractive valuations as well as positive demographics for the group as a whole. Health Care companies generally are also more earnings durable or less reliant on the economic cycle for growth. So we have begun repositioning the portfolio into sectors that should do well even under a scenario of slowing economic growth while still maintaining some late cycle exposure to rising commodities prices and rising interest rates. To that end, our exposure to Canadian Financials and Energy remain an important part of the portfolio as also shown in the chart. Exhibit 6 shows the Forward 12 month price earnings ratio at the sector level. As indicated in the chart, Financials, Energy and Health Care all trade at forward valuation multiples less than the S&P500 and in some cases below the 5 and 10 year average P/E.

Exhibit 6
Forward 12M P/E Ratio: Sector Level



Source: FactSet

During the quarter we added four new positions, including Baxter International, Johnson & Johnson, Cogeco Communications and Bank of Nova Scotia. Baxter International (BAX) provides a broad portfolio of essential healthcare products including dialysis therapies, sterile intravenous solutions, infusion systems and devices. CEO Joe Almeida has turned the company around since joining in 2015 improving margins and free cashflow and these positive metrics are expected to continue going forward.

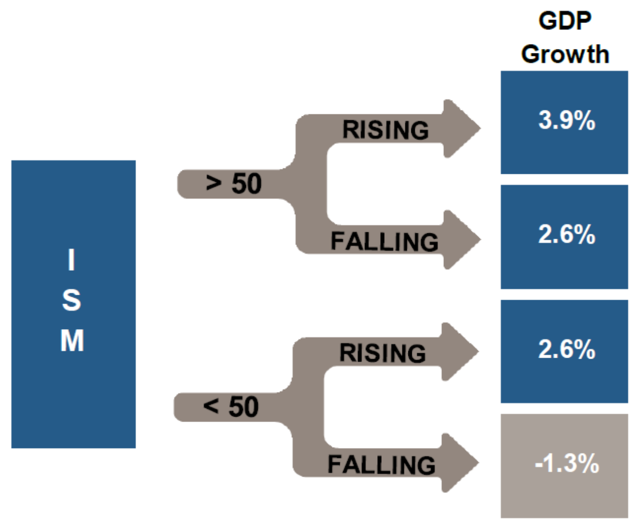
Johnson & Johnson (JNJ) is best known for its consumer brands such as Listerine, Tylenol, Benadryl, Stayfree, and Band-Aid to name a few, combined with its pharmaceutical and medical device segment. The stock has fallen out of favor due to disappointing results last quarter, which we see as transitory, however this allowed for an attractive entry point into the name. Cogeco Communications INC (CCA) provides cable and telecom services in Ontario, Quebec and parts of the Eastern US. The stock is down this year on softer subscriber additions and concerns around their wireless expansion plans. On the latest earnings call in July however, management outlined their capital allocation priorities, which are developing their US business which is over 30% of revenues and building out its broadband capabilities. Increased commitment in these areas should help address some of the market's concerns and with an 11% free cash flow yield, and an annual dividend growth rate of about 10%, we took an initial position in the name. And finally, Bank of Nova Scotia (BNS).

The stock has underperformed about 9% relative to other Canadian banks recently probably related to NAFTA concerns due to its Mexican business exposure but also due to a flurry of acquisitions that will not start to contribute to earnings per share until 2020. Our view is that the stock got too cheap and notwithstanding the pause in earnings contribution from acquisitions, the solid dividend growth rate of around 8% and attractive dividend yield of 4.5% are worth the wait.

Outlook

As we discussed in this note and in previous updates, we remain positive in general on the macro outlook for growth in both the US and Canada. The one caveat is the possibility that the current global trade situation does not get resolved but as we discussed above, given the strong growth outlook in the US and the relative overall size of the impact, it seems manageable. We also believe any level of reduced uncertainty would be viewed positively by all markets. From a valuation perspective, the S&P500 is more expensive today than three months ago (16.8x vs 16.2x 12 month forward earnings) as compared to the TSX which is cheaper (14.2x vs 14.8x 12 month forward earnings), yet the TSX earnings growth estimates are accelerating faster looking out into 2019. Also, the size of the discount in valuation of the TSX relative to the S&P500 at 15% has reached decade low valuation levels. Having said that, we believe the surprise for the S&P500 could be that earnings estimates remain too conservative and if revised upward, would lower forward P/E multiples. Central Bankers both north and south of the border are expected to continue to tighten monetary policy by increasing interest rates between now and year end and into 2019. The Federal Reserve has removed the term accommodative from its language on rates, which suggests we are closer to the time when further interest rate increases will begin to restrict growth. However, since inflation remains fairly benign, at least at this point, the pace of expected rate hikes should allow for US economic growth to continue for some time yet. Exhibit 7 shows US GDP growth under different scenarios of US manufacturing growth as measured by the ISM Index.

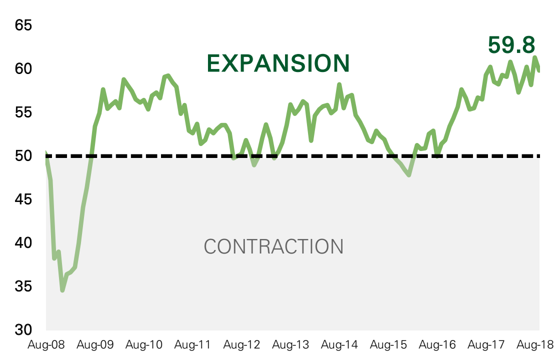
Exhibit 7
GDP Growth Under Different ISM Index Scenarios



Source: Standard and Poor's, ISM, Haver Analytics, Credit Suisse

The ISM Index is an index that monitors conditions in national manufacturing in the US. It is essentially a survey of purchasing managers that are at the forefront of their company supply chains. When the ISM Index is above 50, and depending on whether it is rising or falling, GDP growth typically averages between to 2.6% and 3.9% which is shown in the two top right boxes in the chart. During periods like this, economic contractions are highly unlikely in the subsequent 12 months. Exhibit 8 shows the latest ISM reading for September was quite strong at 59.8 suggesting the outlook for US economic GDP growth over the next twelve months should remain positive.

Exhibit 8
US ISM Index

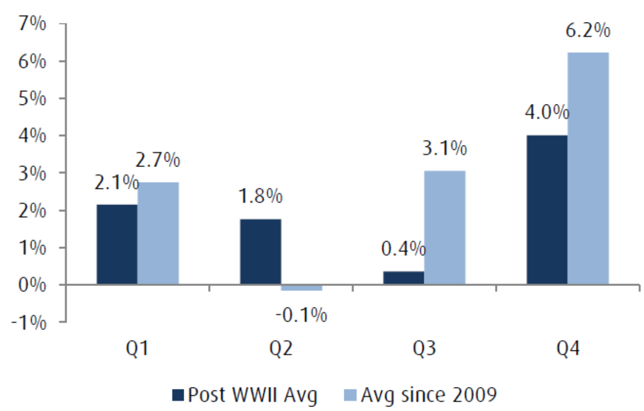


Source: Bloomberg

CUMBERLAND
Private Wealth

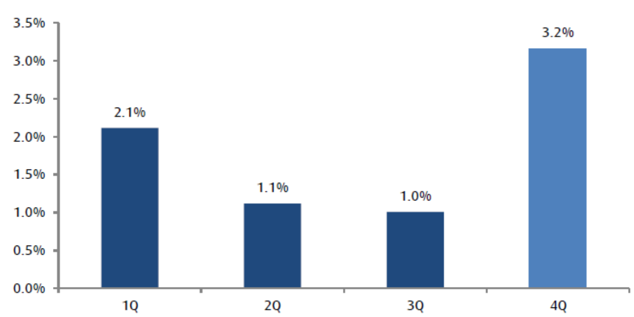
And, given the high correlation with Canadian GDP growth we discussed earlier. this should bode well for our economy and probably the TSX. Finally, from a seasonal perspective, Exhibit 9 and 10 show the seasonal price performance for the S&P500 and the TSX.

Exhibit 9
S&P 500 Quarterly Price Performance Seasonality based on calendar quarter average



Source: BMO Capital Markets InvestmentStrategy Group, FactSet, Bloomberg

Exhibit 10
TSX Quarterly Price Performance Seasonality Since 1935



Source: BMO Capital Markets Investment Strategy Group, S&P, FactSet

As indicated in the charts, the fourth quarter is typically the best performing quarter for stocks in Canada and the US with the S&P500 on average increasing 4% and the TSX on average increasing 3.2%. Furthermore, looking back to 1935, during periods where the TSX has posted flat returns during the first nine month of the year as it has this year, the TSX return has almost always been positive in the fourth quarter with the average historical price return of 4.1%. So, our conclusion, like last quarter, is to continue to stay the course in equities. We remain optimistic on the economic outlook and the level of earnings growth for both the S&P500 and the TSX. In the meantime, we have also maintained some cash reserves and begun the shift in the portfolio towards less volatile/more earnings durable companies.

Peter Jackson
Chief Investment Officer
October 1, 2018

APPENDIX 1

NEW EQUITY INVESTMENTS:

CUMBERLAND NORTH AMERICAN CAPITAL APPRECIATION MANDATE

CANADA

Bank Of Nova Scotia (BNS)

Bank of Nova Scotia is Canada's third-largest bank with International operations representing over 30% on it net profits. While its core banking operations are performing strongly, BNS made six acquisitions in the past year for $7 billion, requiring a $1.5 billion equity issue in June. The acquisitions and dilutive equity issue have weighed on BNS stock price, allowing us to acquire shares at substantial discount to its historical valuation. We believe the Bank's valuation will recover with earnings growth stemming from strengthening economies, cost cutting initiatives and the successful integration of its recent acquisitions.

Cogeco Communications (CCA)

Cogeco Communications is a telecom company focussed primarily on providing internet and cable television services in Quebec and Ontario in Canada (51.6% of total revenue) and a number of eastern seaboard states in the U.S. (37.3% of total revenue). It has used cashflow from existing operations to finance a very successful acquisition strategy in mid-sized markets in the U.S. where competition is quite limited from incumbent telecom operators who focus on the larger urban centers in their footprints. Despite their acquisition track record the stock trades at a material valuation discount to their telecom peers in Canada which we don't feel is justified given the expected free cash flow growth and future dividend prospects.

UNITED STATES

Baxter International (BAX)

Baxter is a global healthcare company that sells its products in more than 100 countries around the world. It is a diversified company that operates across the following business segments: Renal Care, Medication Delivery, Pharmaceuticals, Nutrition, and Advanced Surgery. The company has market leading positions across its segments, it generates significant free cash flow, and it has a very strong balance sheet. In addition to these attributes the company is led by a highly experienced CEO, Joe Almeida. Since he joined Baxter in 2015, the company has enjoyed mid-single digit revenue growth, operating margin expansion of about 6%, and the company's free cash flow has more than tripled. Despite delivering second quarter results that were ahead of consensus expectations, the company's shares sold off due to weakness across two of its business segments. We agreed with management's assertion that the segment weakness was temporary and therefore used the sell-off in the stock as an opportunity to initiate a position.

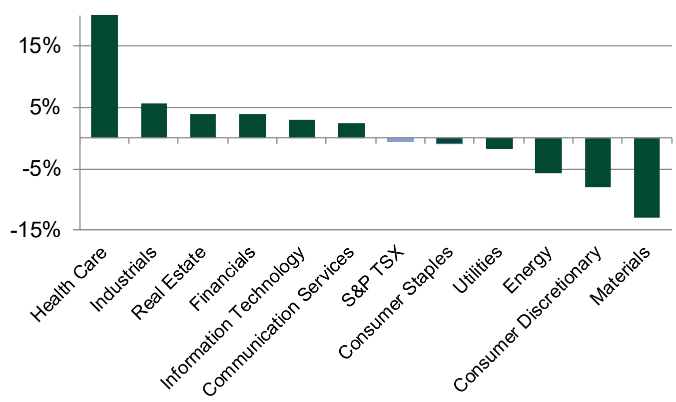
Johnson & Johnson (JNJ)

Johnson & Johnson is a healthcare conglomerate with market leading positions across its Pharma, Consumer, and Medical Device segments. The company generates a significant amount of free cash flow, it has a strong balance sheet, and it operates in a shareholder friendly manner. Although the company is well positioned to benefit from aging demographics around the world, the stock has been out of favour with investors due to disappointing results across its Consumer and Medical Device segments. As a result, we were able to initiate a position in Johnson & Johnson while the company was trading at the lower end of its historical valuation range. Importantly, we believe that these issues are transitory, and that management will gain traction with its initiatives to turn around the Consumer and Medical Device segments.

APPENDIX 2

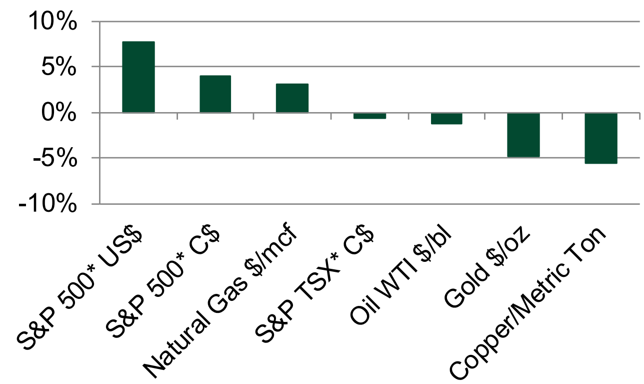
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending September 30, 2018



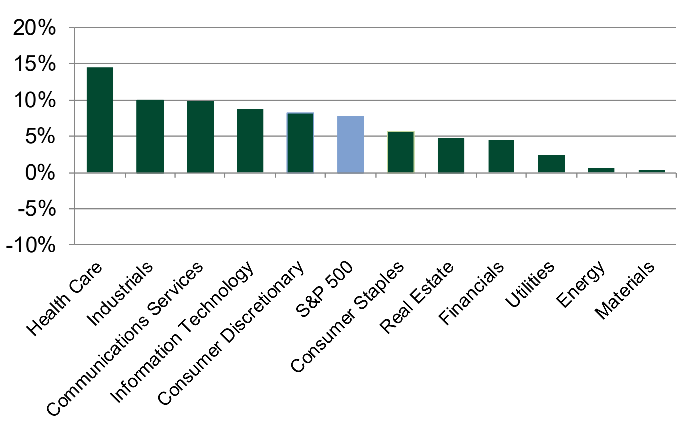
Source: TD Securities

Quarter % Change
Quarter Ending September 30, 2018



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending September 30, 2018



Source: TD Securities