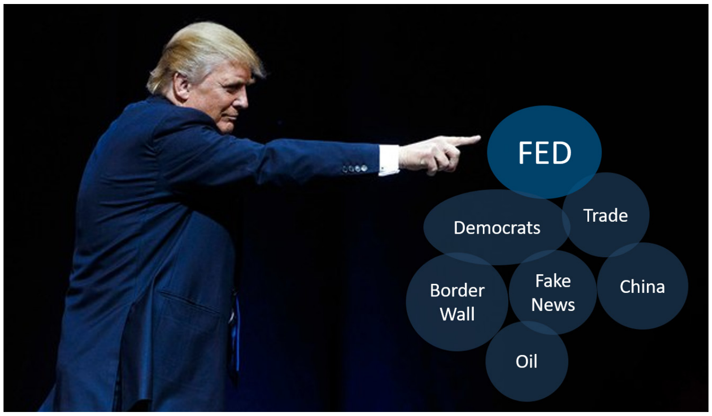
CUMBERLAND
Private Wealth

CUMBERLAND INCOME FUND ("FUND") STRATEGY YEAR END REVIEW

How did we get here? Negativity is Contagious.

Every action causes a reaction – so has the negativity just spiraled out of control to a self-inflicted recession? The fourth quarter started with a lot of promise as the third quarter ended with a lot of positives: 1) NAFTA being "resolved"; 2) the Fed continued on pace with its well-telegraphed interest rate hike (signaling a strong economy); and 3) oil at a 52-week high of US$76/bbl (WTI crude). However, the best highs seem to be short lived and the fourth quarter ended in a more dire state – oil went into a tailspin with WTI crude hitting a 52-week low of US $42/bbl with oversupply concerns, growth fears were amplified as Q3 earnings in the S&P were mixed from expectations (guidance were revised lower on trade tariffs impact and slower growth) as the S&P tumbled to a 52-week low. While the data coming out shows the economy continues to chug along (for now), skepticism continues to build as negativity continues to spread first in equities and then throughout every other market. It is a vicious cycle.

Is the Fed to blame for this?



When things do not go as planned there tends to be a lot of finger pointing – in this case towards the Fed. Trump's aggressive tweets and comments on the Fed and their mistake for higher interest rates has put a cloud over a board that has historically been independent.

The reason for the Fed to be independent from the government is to ensure that monetary policy is separated from day-to-day political agendas. Governments tend to favour lower rates (especially if they need to print more money), and it helps with reducing unemployment and therefore hopefully produces growth. However, due to government policy for lower corporate taxes and increased spending, the funding gap for 2019 is estimated to be over $1 trillion (yes, that is not a typo) – of course Trump wants lower interest rates! As for unemployment, the US is already at a historical low at 3.7%! US GDP is currently at 3% while 2019 is forecasted at 2.3%. Yes, growth will need to slow - particularly when much of it was fueled by cheap debt and corporate tax cuts: that is not sustainable for an economy to be running at full capacity and still on so much stimulus. The problem now is that there is the impact of trade tariffs that are affecting businesses across the globe. The US government shutdown over the holidays did not help ease uncertainty. As well, global political relationships are just plain right touchy.

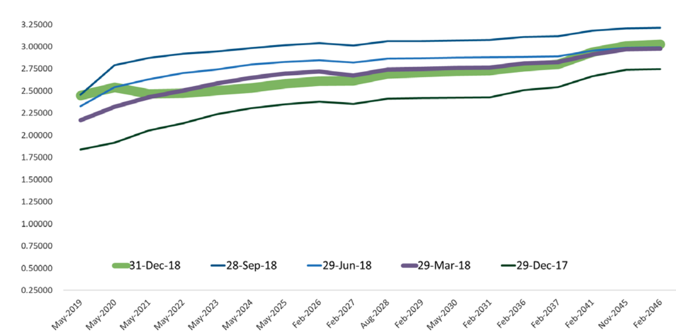
During Q4, the Fed increased interest rates for its fourth time in 2018, putting overnight interest rates in the 2.25%-2.5% range. The Fed has discussed trying to get back to the neutral range of 2.5% to 3.5% where the economy would be at full employment and stable inflation; however, this range is not set in stone. Given we have a lot of economic uncertainty and other global political moving parts, this range could move as the economy adjusts to the changes. The Fed has been very clear in its approach of examining economic data and deciding on its path to interest rates: they too will need to see how Trump's actions to 'Making America Great Again' impacts the economy.

Quarterly Review

During the quarter, the US increased its overnight interest rate by another 25bps (its fourth and final interest rate increase in 2018). Meanwhile, Canada increased interest rates by another 25bps in its October meeting taking its overnight interest rate to 1.75% (its third and final interest rate increase in 2018). We will continue to watch the data but we do anticipate fewer hikes (if any) for both central banks in 2019 than in 2018.

The US yield curve shifted downwards and yields decreased anywhere between 18bps to 41bps across the curve, negating the move from last quarter and more. We are now back to Q1 yield levels, discounting the three additional interest rate hikes since the end of Q1/2018. The 2-year to 30-year curve steepened 5bps.

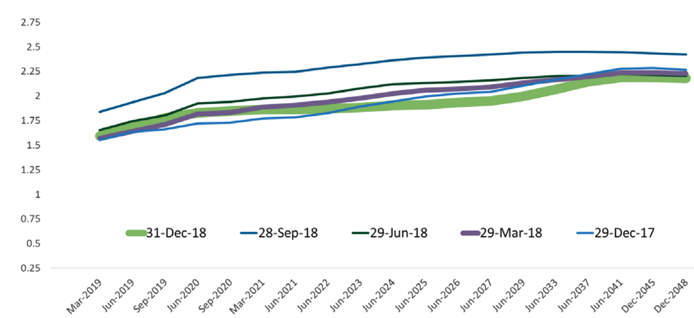
Exhibit 1: US Yield Curve



Source: Bloomberg

With the uncertainty of the US, and the large move in oil prices, the Canada yield curve was also impacted. The Canada yield curve shifted downwards and yields decreased anywhere between 24bps to 48bps across the curve. This move also has moved the curve back to levels seen back at the beginning of the year and depending on the area of the curve, negating much of the three interest rate increases we saw in 2018 and even more. The 2-year to 30-year curve steepened 13bps.

Exhibit 2: Canada Yield Curve



Source: Bloomberg

Canadian investment grade corporate spreads increased between 25bps to 55bps across the curve and rating categories, driven by the broader market sentiment for risk-off product as investors fled to 'safer' government bonds. Returns for various fixed income asset classes are in the table below. During the quarter, long government bonds outperformed as equity markets collapsed and fears of slower economic growth spread across all markets. The annual return for the bond universe really only materialized in the last quarter of 2018.

Asset Class Returns	2018	Q4/18	Q3/18	Q2/18	Q1/18	2017
Bond Universe Index	1.41%	1.76%	-0.96%	0.51%	0.10%	2.52%
Corporate Bond Index	1.1%	0.86%	-0.46%	0.42%	0.28%	3.38%
FTSE High Yield Canadian Index	2.15%	-1.68%	1.04%	0.57%	0.91%	9.94%
S&P/TSX Preferred Index	-12.21%	-11.17%	1.54%	0.47%	-0.40%	13.44%

Outlook and Positioning

Since our last quarter's update, we are still tweaking our corporate bond exposure and continue to look for opportunities to enhance the value for the Fund. With the global uncertainty still brewing and value within our universe to still transpire more fully, we are cautious not to stretch for yield too soon nor stretch into longer maturities in the Fund for marginal incremental value. Note: 30-year Government of Canada bonds yielded 2.15% at the end of 2018, while 30-day Bankers' Acceptance yielded 2.31% on an annualized basis. Patience will be the key.

With the move in investment grade corporate spreads, we feel there could be a lot of opportunities in the space that we can take advantage of as we expect new investment grade corporate bond supply in early 2019 could further put pressure on bonds spreads and steepen out the credit curve. We are in a good position to take advantage of extending in duration given we have 70% of the fund in maturities of 5 years or under.

While the quarter was punitive to preferred shares, we have a 5% weighting in preferred shares and are comfortable with the names we do hold despite the decline in value over the quarter. We use preferred shares as an additive to enhance yield. We do have ample capacity to add more if we see fit as maximum weighting in the Fund is 20%.

High Yield also had a lackluster year, but we are also on the lower end of our weighting at 5% with capacity to add more when we see fit (maximum weighting the Fund allows is 15%).

Duration continues to be short at 3.3 years and we anticipate that over the course of the year we will be extending it as we see fit.

Diane Pang
Portfolio Manager, Fixed Income
Cumberland Investment Counsel Inc.
January 3, 2019

Asset Allocation				
Asset Class	**Q4/18**	**Q3/18**	**Q2/18**	**Q1/18**
Cash and Cash Equivalents	1%	1%	1%	1%
Government Bonds	0%	0%	4%	17%
Provincial Bonds	0%	0%	5%	18%
Investment Grade Bonds	89%	90%	82%	58%
High Yield	5%	5%	4%	2%
Preferred Shares	5%	4%	4%	4%
	100%	100%	100%	100%

Duration (years)	Q4/18
Cumberland Income Fund	3.3
FTSE TMX Canada Universe	7.5

Yield[1] Comparison as at December 31, 2018	
Cumberland Income Fund	3.49
FTSE TMX Canada Universe	2.73

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. Past performance does not guarantee future results.

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.