CUMBERLAND

Private Wealth

January 1, 2019

## The Year In Review

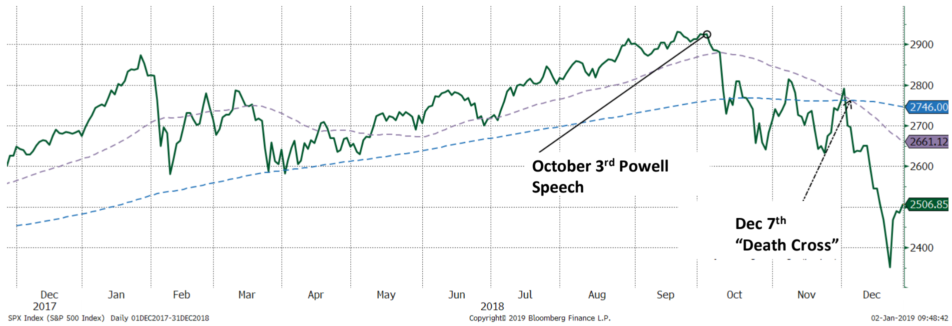
# NORTH AMERICAN EQUITY STRATEGY

We will start by stating the obvious, valuations have become a whole lot cheaper. However, earnings growth is beginning to slow, and we put more weight on that particularly with short term interest rates on the rise. Let's start with a quick review of what we think has caused the market selloff during the fourth quarter as it helps to establish the correct course of action going forward.

## Fourth Quarter Key Events

The S&P500 peaked in late September (**Exhibit 1**) and started to selloff, almost to the day, after Federal Reserve Chairman Jerome Powell said on October 3rd, that interest rates were a "long way off from the neutral rate of between 2.5% to 3.5%" or the rate at which Fed policy is considered neither restrictive nor accommodative.

**Exhibit 1**
**S&P 500 Index' Performance in 2018**




**Oct 3/18: Federal Reserve Chairman Powell says we're 'a long way' away from neutral on interest rates**

**Dec 6/18: The Death Cross-Crossover of the 200 day Moving Average (blue) by 50 day Moving Average (Purple)**

Source: Bloomberg

- The Fed increased the Fed funds target rate to 2.0%-2.25% on September 26th.
- Powell even suggested the Fed could go past the neutral rate and this implied more rate hikes forthcoming with the market then fully anticipating a fourth rate hike in December 2018 and three more in 2019.
- The market got some temporary relief mid and late November when Powell, as well two Fed members, changed the tone slightly suggesting policy rates were more "close to neutral" or "not too far from neutral" and hikes would be more data dependent going forward.

December culminated with an even greater selloff and the list of reasons seemed almost endless including a Trump/China trade "truce" that looked more like "much ado about nothing", inversion of the 5 year/2 year treasury bond yield, widening credit spreads, waning US fiscal stimulus, slowing global economic momentum and declining nation-wide US housing market sales.

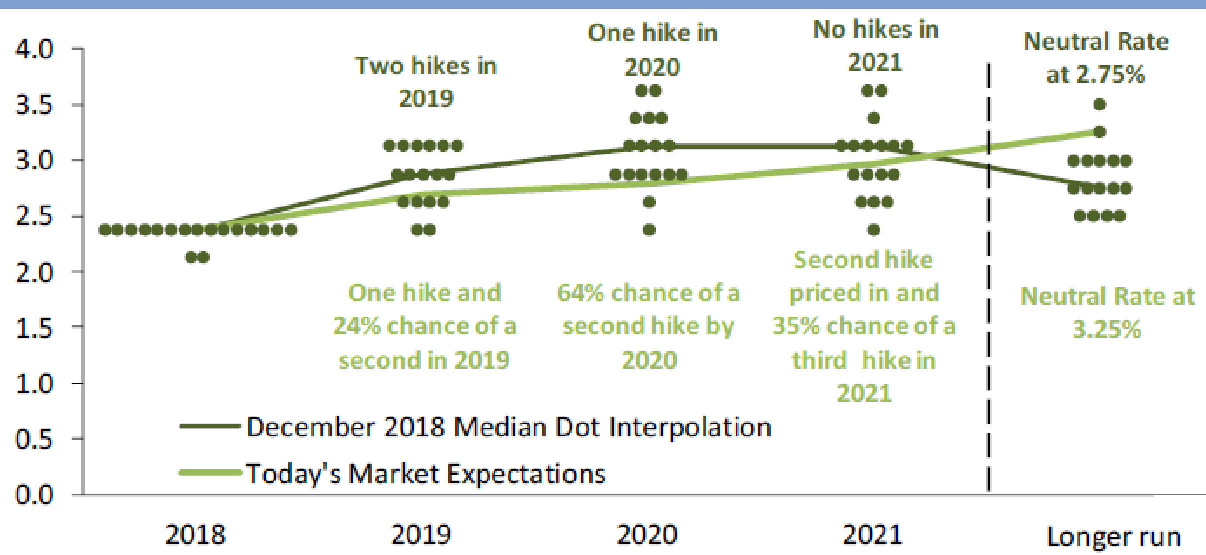
Finally, the technical picture for the S&P500 broke down December 7th with the 50 day moving average falling below the 200 day moving average or commonly known as the death cross (**Exhibit 1)**, which is a technical signal of more downside in store for the markets.

So, all eyes turned to the Fed's announcement on December 19th in hope of a dovish response and that too was a disappointment at least for equities. Perhaps the Fed wanted to demonstrate its independence from the White House as pressure from Trump to stop rate hikes mounted, who knows. We think that increasing rates by 0.25% and signaling at least two more rate hikes in 2019 instead of three, when the market wanted zero was enough to drive equities even lower but also ironically may be enough to seal the fate on no more rate hikes in 2019 given the turmoil.

## Where Are We Right Now?

**Exhibit 2** indicates what is built into the market expectations today versus the Federal Open Market Committee's (FOMC) median dot plot interpolation from its December 19th meeting, suggesting only one hike in 2019 is priced in to the market and a second hike is not fully priced in until 2021.

**Exhibit 2**
**FOMC Dots and Market Expectations for the Federal Funds Rate**




**The market now prices in just one hike for sure in 2019. A second is not fully priced in until 2021.**

Source: Cornerstone Macro

- What the Fed did say and was not in previous press releases, and which seemed to be completely ignored by the market, was that it would "monitor global economic and financial developments and assess their implications for the economic outlook", which in our view is a message of a willingness to slowdown or stop policy hikes if the outlook deteriorates from here.
- The fact is that the US economy and even the economic outlook has yet to really deteriorate and had the Fed indicated a move to the sidelines in December only to to potentially flip-flop after a month or two, it would have lost credibility.
- So perhaps it did the best it could with the set of circumstances and information available at the time.

## Are We in a Bear Market?

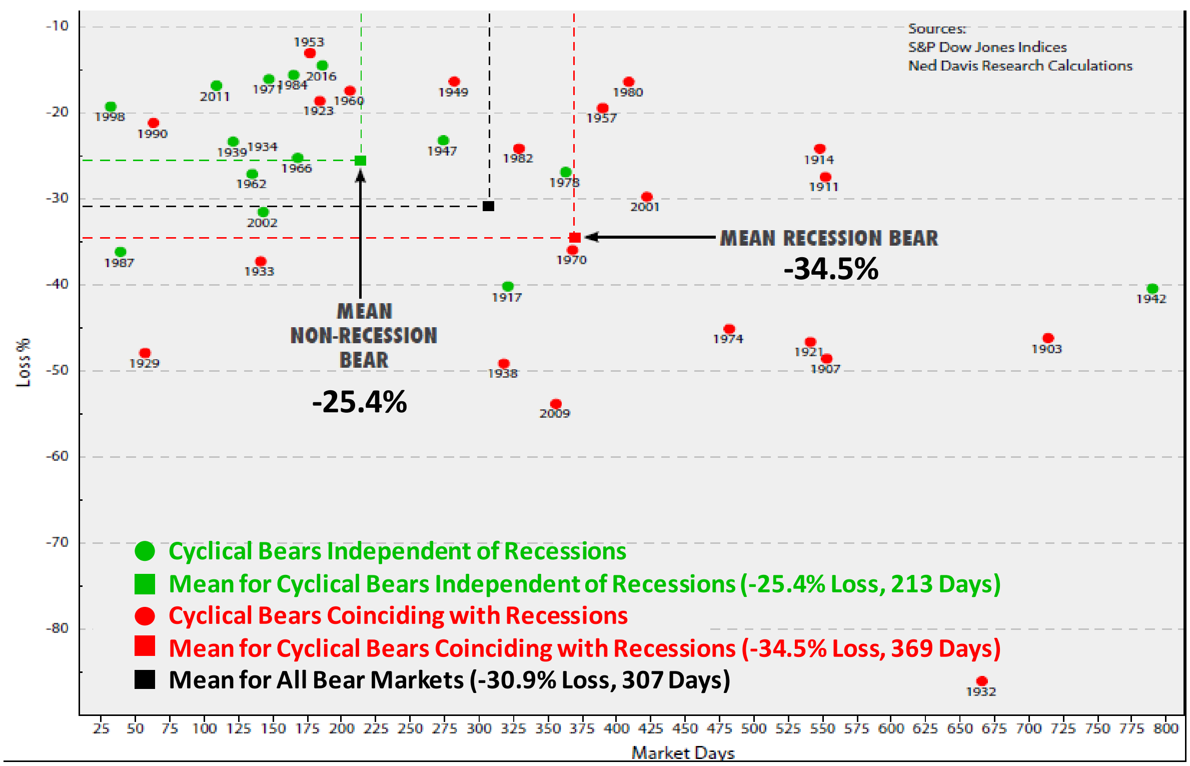
From the market peak in late September to the trough on Christmas Eve (at least so far) the S&P500 was down -19.8%. Technically a bear market is a -20% drop but it feels close enough. We read an interesting quote recently that bear markets cause maximum pain to both bull and bear investors. We interpret that to mean there can be false starts at the bottom that even bring the bears on the sidelines back into the market, that eventually lead to even more loses. This is the reason why we can't buy this market just because it's sold off a lot, until we see some stabilization in the deceleration of earnings growth or a move by the Fed to the sidelines or preferably a combination of both.

### The Economy - Canada and the U.S.

Turning to the economy, overall the outlook for GDP growth in both Canada and the U.S. is still a respectable 2.1% and 2.3%, respectively, for 2019 as compared to the latest reading of 2.2% annualized for October in Canada and 3.4% final read for Q3 US GDP. Core inflation remains subdued and close to both Central Banks target rate of 2% with core November CPI in Canada at 1.9% and core November PCE inflation (the Fed's favourite inflation indicator) in the US at 1.8%. Meanwhile the Canadian unemployment rate of 5.6% currently sits at the lowest level since 1976 while the US rate of 3.7% represents a 49 year low.

As for the Bank of Canada, it maintained its target Overnight rate in December at 1.75% as compared to the Fed Funds target rate increase to a range of 2.25%-2.5% noting weakening oil prices and slowing growth in major advanced economies outside of the US. Obviously, this data on the economy is somewhat backward looking but if we were to assume neither economy is rolling into a recession in 2019, it could potentially affect our timing on the stock market outlook as indicated in **Exhibit 3**.

### Exhibit 3
### A History of Bear Markets II: Dow Jones Industrial Average (1900 - Present)

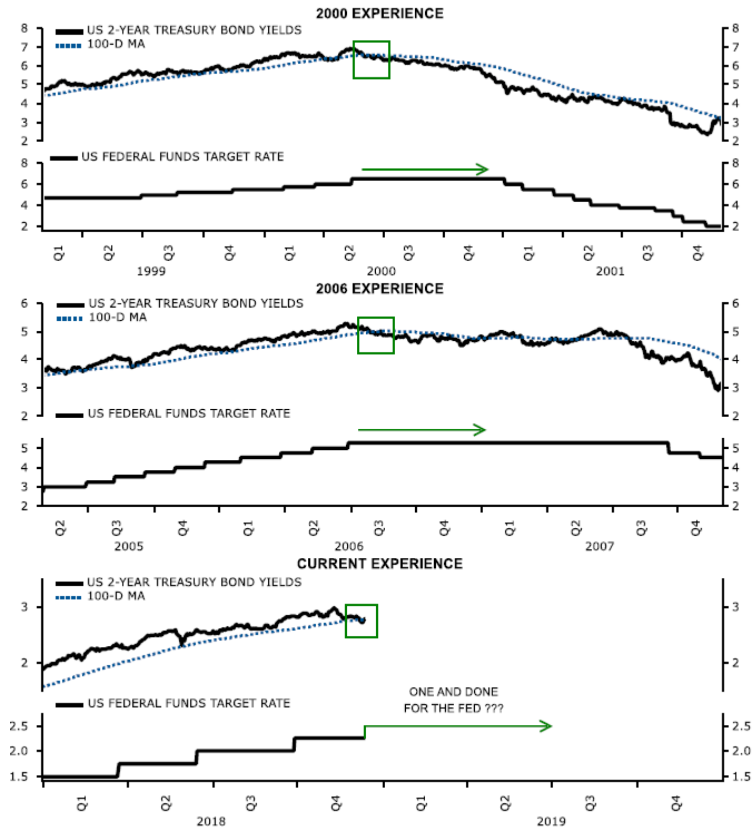



Source: Ned Davis

**Exhibit 3** shows the history of bear markets for the Dow Jones Industrial Average (Dow) dating back to 1900. It compares the performance of the Dow for both recession and non-recession bear markets. As indicated in the chart, the average decline for non-recession bears is -25.4% over 213 days. As noted above and depending on whether you look at the Dow or the S&P500, the market is down 18.8% and 19.8%, respectively, peak to trough over about 100 days. The point here is that cyclical bear markets that do not overlap with recessions have been shorter and less severe than bear markets that have overlapped with recessions. Taking that into context and assuming the current projections on the US and Canadian economy are accurate, then perhaps most of the damage is already done.

So let's address the potential catalysts that might restore a more positive outlook for the market. As discussed, clearly a pause in future rate hikes by the Fed is a potential catalyst.

**Exhibit 4**
**Federal Reserve: A Pause Likely with 2-Year Yields Below Their 100-DMA**




Source: Canaccord Genuity

**Exhibit 4** compares the 2 year Treasury bond yield to the US Fed Funds target rate during the two previous rate tightening cycles. It shows that a break in the rise of the 2 year bond yield below its 100 day moving average, as we saw in mid-December 2018, has historically confirmed a pause in further rate hikes. So the bond market may be expecting a pause and this is something we are keeping our eye on.

## Earnings and Valuations

Turning to the earnings outlook for the S&P500, the TSX and EAFE, **Exhibit 5** provides a summary of the estimated growth rate in earnings as well as the forward price earnings (P/E) multiples for 2019 at September 30th and December 31st. Also included is the 10 year average P/E multiple and the P/E to Growth (PEG) ratio for each market. The PEG ratio is used to help value the markets price earnings multiple while adjusting for the different levels of expected earnings growth in each market. The higher the PEG ratio, the more expensive something is relative to its expected growth rate. It helps explain why the multiple for the S&P500 at 18.5x was as high as it was around this time last year given the fiscal tax cuts in the US that drove earnings growth for 2018 of over 20%.

However, the point of the comparison here is that even though P/E multiples have decreased quite materially from three months ago, the PEG ratios have actually increased due to reduced growth expectations meaning you are paying more today for that 2019 growth in earnings than you were in September. Having said that, it is not all bad news. All forward P/E's now trade below the ten year averages and with the S&P500 ten year earnings growth rate of about 8.1%, the current PEG ratio for the S&P500 is 1.7x, which is actually below the ten year average PEG ratio of 1.8x.

So what we need is to get some comfort with the sustainability of the current earnings growth rate.

**Exhibit 5**
**Performance, EPS Growth, Forward and 10 year Average P/E, PEG Ratio**

| | EPS Growth 2019 | | Forward P/E 2019 | | P/E 2019 | PEG Ratio 2019 | |
|---|---|---|---|---|---|---|---|
| | Sept | Dec | Sept | Dec | 10 Year Average | Sept | Dec |
| S&P 500 | 10.4% | 8.3% | 16.4x | 14.2x | 14.8x | 1.6x | 1.7x |
| TSX | 13.2% | 10.4% | 13.7x | 12.3x | 14.6x | 1.ox | 1.2x |
| EAFE | 7.8% | 6.9% | 13.2x | 11.9x | 13.2x | 1.7x | 1.7x |

Source: FactSet, Bloomberg

## Market Performance and Outlook

During the fourth quarter of 2018, the S&P500 index was down -13.5% in US dollars. Adjusting for currency, the S&P500 returned -8.9% in Canadian dollars, as the Canadian dollar depreciated about 4.6 cents, closing the quarter at US$0.732. For the year 2018, the S&P500 returned -4.4% in US dollars and 4.0% in Canadian dollars as the Canadian dollar depreciated from US$0.795 at December 31st, 2017. The TSX return in the fourth quarter and for the year was -10.1% and -8.9%, respectively. The MSCI EAFE index (international equities) return in Canadian dollars was -7.9% and -5.7% for the fourth quarter and for the year, respectively.

## Sector Performance

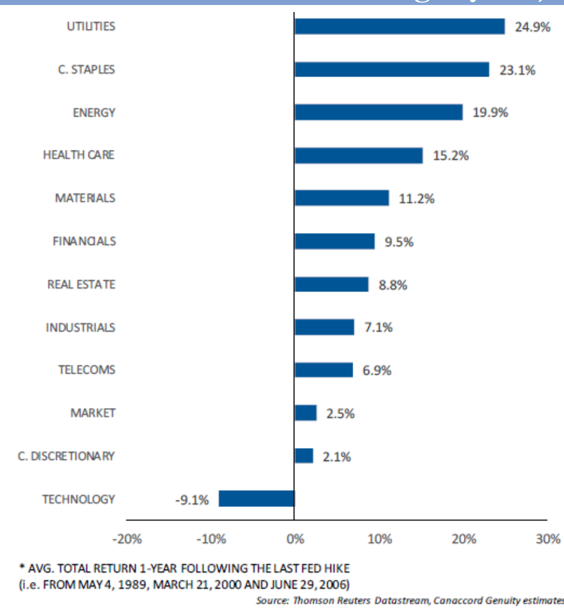
**Exhibit 6** shows the average sector performance over the three months after a bull market peak going back to 1973. **Exhibit 7** shows the average sector performance for one year following the last Fed rate hike. Both charts are relevant assuming the market peaked September 2018 and December marks the end (or close to it) of the interest rate tightening cycle.

**Exhibit 6**
**Sector Performance Over the Three Months After Bull Market Peaks**

| S&P 500 Sector | Average % Loss |
|---|---|
| Utilities | -1.9 |
| Energy | -3.38 |
| Consumer Staples | -6.71 |
| Communication Services | -6.98 |
| Health Care | -8.52 |
| Materials | -11.42 |
| Information Technology | -12.47 |
| Consumer Discretionary | -12.94 |
| Industrials | -13.17 |
| Financials | -13.41 |

Source: Ned Davis Research

**Exhibit 7**
**North American Equity Sector Performance (After the last Fed hike in a late-stage cycle*)**

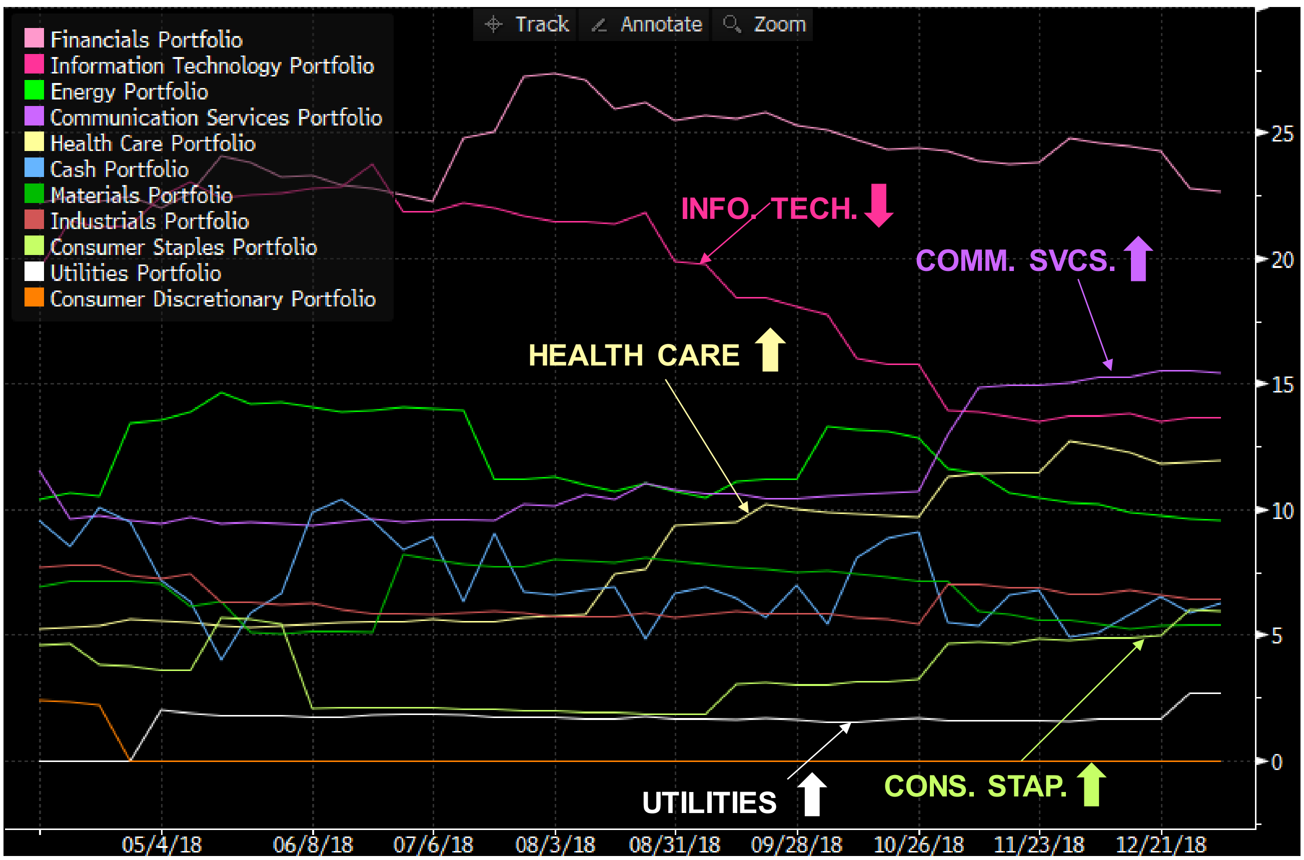



Source: Canaccord Genuity

What is clear is that Utilities, Consumer Staples, Communication Services and Healthcare perform relatively better than Technology, Consumer Discretionary and Industrials.

- **Exhibit 8** shows the sector shifts we have made from the end of the first quarter of 2018 through to year end 2018.
- As indicated in the chart, our Consumer Staples, Communication Services, Healthcare and Utilities weights all increased mainly at the expense of Technology, which we reduced from a mid 20% weight to about 13%.

**Exhibit 8**
**Sector Changes (% weight of portfolio) - NA Equity**




Source: Bloomberg

## Our Strategy and Themes

The theme for our stock selection has not really changed. We have continued to position the portfolio in sectors that should do well even in a scenario of slowing economic growth, favouring defensive sectors and companies with higher earnings durability and lower earnings variability. We have maintained some late cycle exposure to rising commodities prices (Energy) and focused on some of the more earnings durable financials such as Brookfield Asset Management and Intact Financial.

**Asset Allocation for our North American Capital Appreciation Strategy As at December 31, 2018**

| | |
|---|---|
| Equities | 89% |
| Fixed Income | 5% |
| Cash | 6% |

During the quarter our overall equity exposure did not change at 89% nor did our exposure to Canadian and US equities at 49% and 40%, respectively. The TSX continues to remain the most attractive market from a valuation perspective with lowest P/E relative to its ten year average, the strongest earnings growth and lowest PEG ratio. Our exposure to short-term bonds and cash ended the year at 5% and 6%, respectively.

Our biggest sector increases during the quarter were into Communication Services with the addition of Comcast Corporation and Shaw Communications, Consumer Staples with the addition of Walmart and Constellation Brands and Health Care with the addition of UnitedHealth Group.

A complete review of each company's business and fundamental outlook that was purchased in the quarter can be found in **Appendix 1**.

Our target international asset allocation in the North American plus International Equity mandate is 22% unchanged from September 30th. Like other markets, valuations internationally are getting cheap as well, however we have not added further to our international weight as the cheaper valuations 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 weight in due course.

## Outlook

It is hard to believe the stock market performance in 2018 given that 2018 earnings growth for the TSX is estimated at 14.5% and over 20% for the S&P500, which is the strongest on record since 2010. And in the US, it was not all driven by tax reform as revenue growth of 8.9% and profit margins of 12% were also the best on record since 2011 and 2008, respectively.

We have been cautious since the second quarter of 2018 however and as we discussed above, there is now a long list of reasons not to like the market currently. Clearly the trade situation could become a bigger issue but as we discussed in our last quarterly update, with the positive macroeconomic outlook for 2019 at least in Canada and the US, the impact on a $20 trillion economy seems manageable.

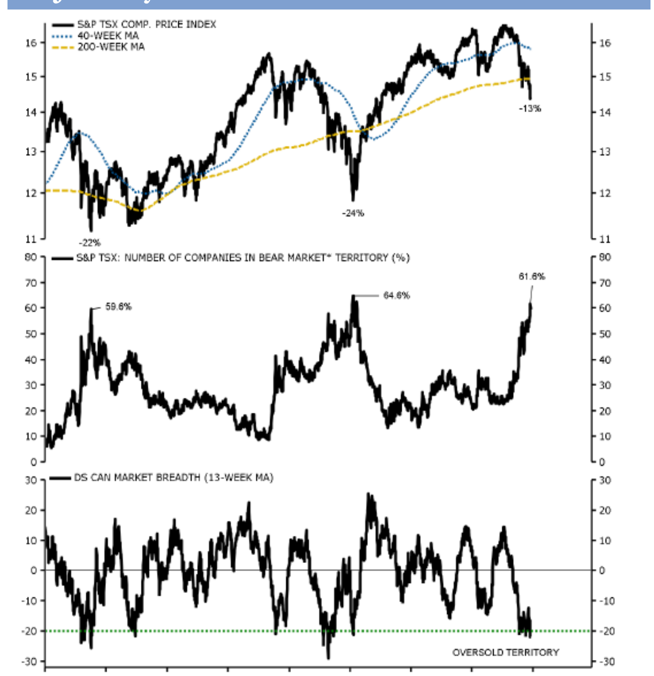
Furthermore, we remain convinced that the fundamental turning points to end this bear market correction will be a signal from the Fed of the last rate hike and a leveling off in the deceleration of earnings growth. We are monitoring these developments closely and while valuation is important we don't believe on its own it is a catalyst for the market to move higher. Having said that, the market has seen a very large pullback in a relatively short period of time and is extremely oversold.

**Exhibit 9** and **Exhibit 10** show the S&P500 price and breadth corrections since the September peak are similar to the January 2016 selloff.

**Exhibit 9**
**S&P 500: Matching The Price and Breadth Corrections of January 2016**


Source: Canaccord Genuity

**Exhibit 10**
**S&P/TSX: Matching The Breadth Correction of January 2016**




Source: Canaccord Genuity

At that time and similar to now, we saw a build-up of negative business sentiment and heightened global macro risks and a Fed threatening four rate hikes in 2016. Our response to this is to position the portfolio to ride through the turmoil and potentially outperform on the other side of it. Meanwhile the level of earnings growth for 2019 in the US and Canada is still attractive at high single and low double digit growth rates. As we build comfort around the sustainability of that earnings growth and the positioning of the Fed and future rate hikes, we may consider adding more to equities. In the meantime, we have maintained some cash reserves and as discussed, shifted the portfolio much more defensively towards less volatile/more earnings durable investee companies.

**Peter Jackson**
Chief Investment Officer

# APPENDIX 1

# NEW EQUITY INVESTMENTS:

# NORTH AMERICAN EQUITY MANDATE

## CANADA

### Shaw Communications (SJR.B)

Shaw Communications has traditionally provided cable television and internet connectivity services in Alberta and BC. With its $1.6 billion acquisition of Freedom Mobile in March 2016, it entered the wireless market and became a full service telecom provider like Rogers. While wireless service requires a lot of upfront capital spending and time to reach sufficient scale to become profitable, we believe that Shaw's wireless service has reached that inflection point now. This should drive superior overall company profit growth and stock performance versus its peers similar to Quebecor's experience after reaching this inflection point in 2014.

## UNITED STATES

### Comcast Corp (CMCSA)

Comcast is a well-run cable and broadband company and it also operates an attractive mass media business through its ownership of NBC Universal.

In recent years Comcast has made substantial investments in its network which has led to a significant speed advantage over telecom competitors which has resulted in customer growth. Comcast generates significant free cash flow and has a history of returning cash to shareholders through dividends and share buybacks. The company trades at a low valuation that does not give enough value to its various assets such as its Theme Parks (Universal Studios) and its Film segment (DreamWorks Animation).

### Constellation Brands (STZ)

Constellation Brands is a fast-growing alcoholic beverage company. The company's portfolio includes top selling brands such as Corona, Modelo Especial, Robert Mondavi and Kim Crawford. From fiscal year 2014 to 2018 the company generated compounded annual growth rates of 12% and 19% for sales and operating income respectively. The company's growth can be attributed to its strong presence in faster growing categories including imported beer, craft beer and premium wines. Looking forward the company has several strategies in place to continue growing its business at an attractive rate. Despite its superior growth profile, Constellation Brands sells at a valuation that is comparable to several prominent Consumer Staples companies that generate significantly lower growth rates. Constellations recent investment into Canopy Growth, Canada's largest cannabis company, provides a means to enter and develop drinkable cannabis products as well as an option on the potential future federal legalization in the U.S.

**Walmart (WMT)**

We added Walmart in the North American Capital Appreciation portfolio in late December after the entire Consumer Staples sector traded lower with the market. We think Walmart is one of a few premiere retailers due to (1) its large store footprint; (2) its continual investment in logistics, e-commerce and delivery platforms; and (3) management's willingness to reshape its global business by investing in higher growth and divesting lower growth and lower profit businesses. Walmart has seen their margins fall as they remain price competitive while building out e-commerce and delivery. However, we think that Walmart is still early in its innovation cycle and margins will improve as technology makes them more efficient operators.

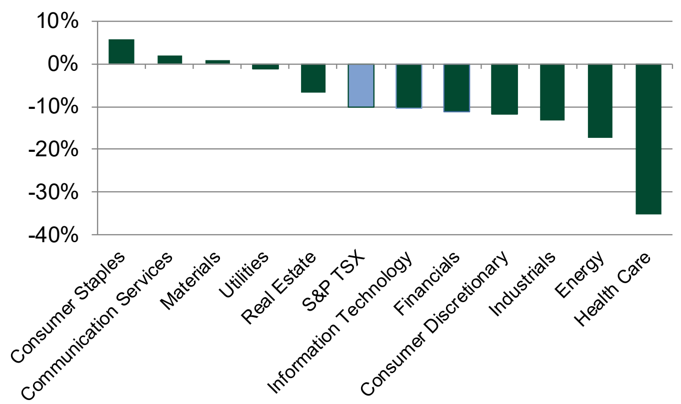
**UnitedHealth Group (UNH)**

Unitedhealth Group is a managed care company that provides a broad suite of health benefit products. UnitedHealth also has a comprehensive services offering via its Optum brand, covering the continuum of healthcare IT, pharmacy benefits, and hospital based care. UnitedHealth's Optum segment is highly differentiated from its competitors and is a competitive advantage for the company. UnitedHealth generates significant cash flow from its operations and it also has a strong balance sheet which it has used to make accretive acquisitions. UnitedHealth Group's business model is very well aligned with the future of healthcare as it should significantly enhance efficiency and quality as the US healthcare industry increasingly moves towards value based care.

## APPENDIX 2

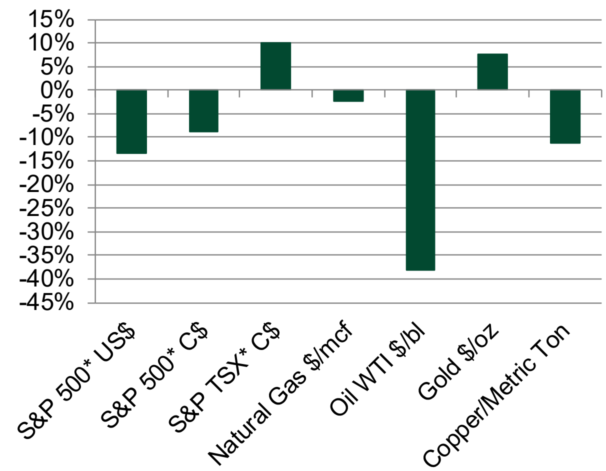
## PERFORMANCE CHARTS

### S&P TSX (C$ Total Returns)
### Quarter Ending December 31, 2018



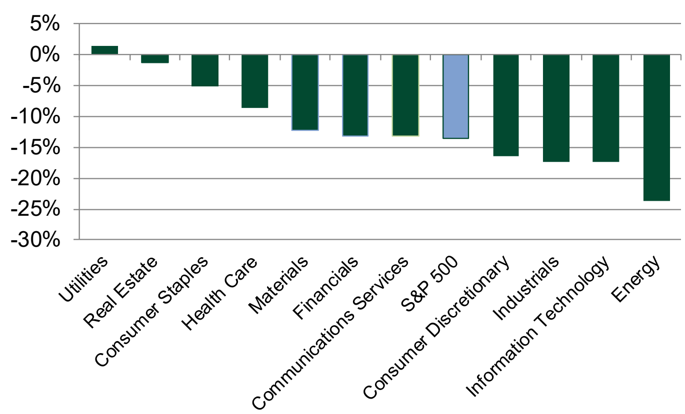

Source: TD Securities

### Quarter % Change
### Quarter Ending December 31, 2018




Source:Bloomberg *Total Returns

### S&P 500 (US$ Total Returns)
### Quarter Ending December 31, 2018




Source: TD Securities