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INCOME STRATEGY FIRST QUARTER REVIEW

Will Trump Deliver on Promises?

In our last quarterly commentary, we talked about the renewed market optimism of growth and inflation as Trump's proposed fiscal stimulus, deregulation and protectionist policies certainly have pro-growth and inflationary tendencies. In addition, a clean sweep by Republicans to gain control of the House and Senate raised market expectations of a smooth passage for Trump's reforms. The "Trump trade" continued well into Q1/17 and faced its first real challenge in mid-March following the failure of the very first legislative reform tabled by Trump's administration. The Republican-controlled House abandoned a healthcare bill to repeal and replace Obamacare – arguably an area where all the Republicans have had a unified front. While we certainly do not want to rule out Trump's ability to deliver, this event was significant in the sense that it calls into question the prospects of his administration's other big reform initiatives such as tax reforms, deregulation and infrastructure spending.

For now, we continue to believe that Trump will continue to make a push toward implementing his policies but we remain cautious about the extent to which his administration can deliver versus market expectations as some of his policies may need to be watered down. We also remain concerned with the market's patience for Trump to deliver legislative changes as we head towards the end of the first 100-days of the new administration without any major legislative reform passed. We will be closely watching the developments in the US political arena over the coming months to determine the level of gridlock that still exists. We believe that this analysis will be critical to determine the direction of the financial markets – both equity and fixed income.

Quarterly Review

The US economy continued to show signs of strength, posting Q4/16 GDP of 2.1%, once again led by strong consumer spending. However, GDP was down from 3.5% in Q3/16 largely due to detraction from net exports. Consumer confidence remains at multiyear highs. With the unemployment rate at 4.5% and wage growth at 2.7%, the economy is running at close to full employment. Various core inflation and forward inflation measures have started to stabilize just above the Fed's 2% level. Small business optimism also remains robust at multiyear highs. Business investments continue to be a source of concern; however, the promise of deregulation and tax cuts are likely to be positive for businesses. The recent PMI data remains robust, although it is down from recent highs. In summary, the US economic outlook continues to look healthy.

The Canadian economy's resilience has surprised many so far as the recent data has been much better than market expectations. Yet, we believe it is too soon to draw a conclusion on the Canadian economic outlook as NAFTA renegotiation uncertainties, overburdened consumers, weak energy prices and European election uncertainties are likely to continue to weigh on the economy. In Q4/16, Canadian GDP grew by 2.6%. Business investments continue to disappoint and remained negative. However, consumer spending remained strong and consumer confidence remains robust as well. We remain concerned about the spillover impact of higher interest rates into household imbalances that could impact consumers at some point, although that is less of a concern at these levels. Inflation trends in Canada are still diverging versus US, with headline inflation of 2.0% and various core inflation measures ranging from 1.3-1.9%, all remain below Bank of Canada's 2% target.

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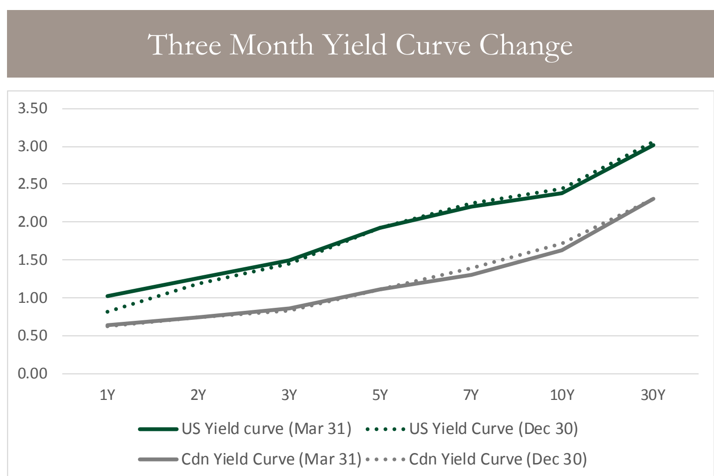
For most of the first quarter, we saw the US Treasury yield curve drift higher as the financial markets continued to adjust to the "Trump trade" of higher expected growth and inflation. The markets and recent economic data also presented a perfect opportunity for the Federal Reserve to deliver its first 25-basis point (bps) rate hike out of the three that it anticipates in 2017. However, the move higher in interest rates through the quarter was completely reversed towards the end of the quarter following the failure of Republicans to come together to pass healthcare reform.

As seen in the chart below, the US yield curve flattened over the quarter as the front end of curve rose about 5-10 bps while the longer end of the US yield curve fell by about 4-5 bps.

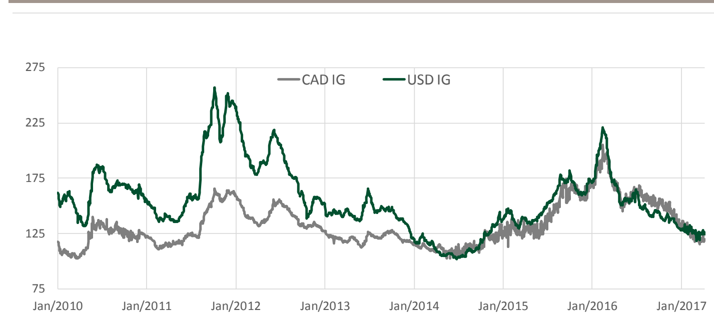
The Canadian yield curve followed the US yield curve to a large extent as the 5-year and under part of the curve rose by 1-3 bps, 7-year to 10-year part of the yield curve fell by 8-10 bps while the long end was largely unchanged. We continue to expect the Canadian yield curve to be correlated with the US yield curve until we get further clarity on the impact of US policies on the Canadian outlook.

Three Month Yield Curve Change



With regards to credit, demand continues to remain robust for investment grade corporate bonds. Markets continued with a "risk-on" trade as pro-growth US policies are beneficial for US credit spreads. The global tone along with better than expected Canadian economic data over the quarter led to even tighter Canadian credit spreads. Demand for corporate new issues continues to remain extremely strong. Domestic funds continued to flow into bond funds and balanced funds. Flows into pure bond funds had somewhat slowed in November, but picked up again in 2017. In addition, latest available data shows international investors continued to purchase Canadian corporate debt securities. As such, Canadian investment grade credit spreads were tighter by approximately 12 basis points for the quarter. This is positive for corporate bond returns. US investment grade credit spreads were tighter by 2 basis points for the quarter.

Investment Grade Credit Spreads



Returns for various fixed income asset classes are in the table below. Being overweight corporate bonds, high yield and preferred shares helped the fund's performance.

Asset class returns	Q1/17	2017
Federal Bond Index	0.64%	0.64%
Provincial Bond Index	1.38%	1.38%
Corporate Bond Index	1.83%	1.83%
High Yield Index	3.20%	3.20%
S&P/TSX Preferred Index	7.51%	7.51%

Outlook and Positioning

While the economic data has been strong in both US and Canada, we expect the quarters ahead to be full of event risks as we expect to get more color regarding the implementation of Trump's agenda, French election risks, potential talks about the Fed's balance sheet normalization and Brexit negotiations with European partners to name a few.

We remain cautious regarding the fixed income asset class outlook through Q2/17 but are a little more constructive than we were in the previous quarter. We believe that event risks will offset some of the positive economic data that we have seen, and favorable year over year comparisons for inflation come to an end given the current level of oil prices. In addition, the sentiment in the treasury markets is much more improved.

For our base case, we currently continue to expect "Trump-lite" policies such as deregulation, lower tax rates and loose fiscal policy. We assume protectionist policy rhetoric to be watered down and used primarily as a negotiating tactic. As such, we continue to expect favorable economic growth and stable inflation in 2017. For now, we continue to expect the Fed to be able to deliver three hikes this year but yields to be range bound over the coming quarter.

In Canada, our outlook remains uncertain. Stability in commodity prices has helped stabilize the economies of energy Provinces but it is Ontario, BC and to some extent Quebec that have held the overall Canadian numbers at a respectable level. We believe that measures to cool down the housing markets in Toronto and Vancouver are likely to be a headwind to the Canadian economy at some point. The direction of exports rests on Trump's renegotiation of NAFTA, but the uncertainty is likely to hamper business investments by exporters. However, if Mexico is largely the target of NAFTA renegotiations, there is a chance that Canada could benefit a great deal from US growth. We continue to believe the Bank of Canada will be on hold in terms of interest rate increases well into 2017 until the economic outlook is more certain.

Low sovereign yields, along with the demographic trends in Canada are likely to keep investor fund flows strong into bonds and balanced funds. This will continue to be constructive for the fixed income market – particularly corporate bonds. Preferred shares are likely to continue generating strong returns as relative valuations remain attractive.

As such we continue to remain overweight corporate bonds and preferred shares in the Income fund and are 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 Our Outlook

We continue to monitor the risks to our central scenario.

One of the major risks to lower yields remains the continuation of political gridlock in the US, which makes passage of any legislative reform extremely tough. This could lead to a swift reversal of the "Trump trade" that we have seen since Trump's election victory. In addition, a reemergence of Eurozone growth concerns (Brexit impacts, Eurozone political risks), growth concerns in US/China or a broader Canadian recession could lead to lower yields and higher bond prices. Extreme protectionist policies may be near term inflationary but the longer-term risk to global growth will remain high which again could result in even lower yields.

One of the biggest risks to higher than expected yields remains extreme protectionism, including trade wars or import tariffs. Another policy on our radar is the magnitude of fiscal stimulus implemented by Trump and whether it is targeted to address cyclical growth or longer term structural issues. The former would be inflationary resulting in higher yields and therefore lower bond prices. In Canada, a sustained recovery in commodities or sustained pick-up in non-energy exports would lead to some stability and a pick-up in growth/inflation, and again resulting in higher yields.

Some of the unknown tail-risks are a change in monetary policy mandates and political pressure on the independence of central banks.

Gaurav Dhiman
Portfolio Manager, Fixed Income

Asset Allocation as at March 31, 2017	
Asset Class	**% of Portfolio**
Cash and Cash Equivalents	0.4%
Government Bonds	27.0%
Corporate Bonds	63.0%
Preferred Shares	9.6%

Yield[1] Comparison as at March 31, 2017	
Cumberland Income Fund	2.6%
FTSE TMX Canada Universe	2.1%

Performance[2] (Rolling 1 year) as at March 31, 2017	
Cumberland Income Fund	4.5%
FTSE TMX Canada Universe	1.5%
Value Add	3.0%

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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