CUMBERLAND
Private Wealth

GLOBAL EQUITY AND INTERNATIONAL FUND STRATEGIES

Second Quarter 2017

Global Macro Review

The European election cycle is turning out to be more of a feel-good story rather than being tension-filled as originally anticipated. With the Dutch and French elections behind us and the populist parties being defeated in both cases, the antagonists Geert Wilders and Marine Le Pen appear to have left the stage. We still have to wait until September for the German election to take place.

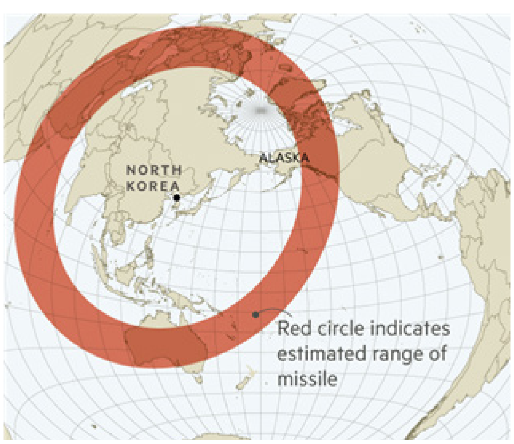
Meanwhile, Prime Minister Theresa May called a snap general election in Britain back on April 18 given polls gave her Conservative Party a 20-point lead. This was shortly after Britain started the process of leaving the European Union by officially triggering Article 50 of the Lisbon treaty on March 29. However, on June 8, the UK found themselves with a hung parliament. Unfortunately, May's objective of having her own mandate to end division in Parliament over the negotiations to leave the European Union did not come to fruition. As such, the negotiations are expected to be difficult, especially given the complexity of unwinding the membership with a two year deadline.

The pro-Brexiters' stance was centered on a cut in immigration and regaining their sovereignty resulting in what they believed would lead to a better Britain. However, the British households suffered the longest sustained decline in disposable income in over four decades in the nine months through March, highlighting the scale of the squeeze on living standards following the Brexit vote. According to the Office for National Statistics, U.K. households' disposable income fell by 1.4% on the quarter in the first three months of 2017, the fastest pace of decline in four years and the longest stretch of falling disposable income since the late 1970s. At the time of the Brexit vote last year, France was considered a leading candidate for the title of "sick man of Europe" while Britain was prospering compared to other European countries. Ironically, France has renewed optimism in themselves and positive momentum is taking place after the victory of Emmanuel Macron while UK's economy is stalling with higher inflation caused by the pound's decline and thereby cramping living standards. Ironically, some may refer to the UK now as the "sick man of Europe".

We too felt the positive momentum associated with France's reinvigoration during our recent visit to Paris. The word "revolution" is even on the lips of the French although President Macron won the French election based on a positive and optimistic message. Based on a centralist policy, Macron wants to free up markets and businesses to create jobs while maintaining an open stance on trade and immigration. We should note this is a policy contrary to that of the US president. Macron's first mission will be to reduce the unemployment rate which is double that of Germany. The more worrisome statistic is the unemployment of the 'Under 25' which hovers above 20%. The lack of flexibility in labor laws and high employment taxes hinder this level improving, but Macron's policy is to deal with this friction and provide economic reform. His first reform is to bring about three changes: to devolve more bargaining over pay and hours to firms, to merge different works councils and to cap any redundancy awards for unfair dismissal. The wind is currently in Macron's back to help him succeed in this French revolution.

In early June, the OECD provided their updated economic outlook with global GDP growth expected to rise to a little over 3.5% by 2018. They concluded that global growth is expected to pick-up modestly with upside risks. Confidence is increasing and investment and trade are also expected to pick-up from their low levels. However, there are some risks including financial vulnerabilities, geopolitical and trade protectionism risks.

Our last quarterly presentation was titled "Three Elections and a War (Maybe)". We still maintain the possibility of a war as a 'maybe'. Recently, the uncertainty in the Korean peninsula has escalated to an uncomfortable level. North Korea continues to threaten with nuclear destruction on its enemies and their objective of reaching continental United States is closer to a reality as shown in the map below. The G20 Summit will be taking place after we conclude writing this piece and with world peace at risk, we expect the topic of North Korea will be at the top of the agenda. President Trump, in an interview with Reuters in April, admitted that the job as a President is more work than his previous life and that he thought being President would be easier. In his previous career, he would have been able to say "you're fired" to characters that caused trouble, like the North Korean dictator Kim Jong-Un, but that is not possible when millions of lives are at stake. Furthermore, in his underestimation, Trump and his administration have failed to make any significant progress on their reflationary reform agenda or taken any protectionist measures. Nevertheless, the US economy remains healthy with the unemployment rate at its lowest level in sixteen years.



Source : FT Estimated range of the North Korean missile

Portfolio Review

We were pleased with the earnings reported by our companies for the first quarter. The results either met or beat market expectations. In addition, the full year outlook was confirmed by those who provided any future guidance. This is important as we believe strong earnings growth is the key to future stock appreciation.

The case for Europe has been gradually gaining traction with investors, and April may have been the turning point for European equities. After the outcome of both the Dutch and French elections, the market may have put political risk aside for now. The European economic backdrop has been improving steadily and based on the commentary from our company holdings, their operations in Europe have been stable. The upward movement of equities during May reflected the theme of synchronized global recovery. The earnings season in the US was strong, with over three-quarters of the US companies beating revenue estimates. Even Japan showed some positive macro data where consumer prices rose for the fourth straight month in May. However, the UK and European markets gave up most of the quarter's gains during the month of June while the US, Japan and the emerging markets were able to hold on to most of their gains for the quarter.

We had the opportunity to attend a CEO conference hosted by a leading European broker in mid-June, days before the latest attack on the Champs-Élysées. There were common themes on the minds of CEOs of major European companies including the following:

1. Digitalization
2. Ways to use big data
3. Global growth
4. Blurring industry lines
5. Geopolitical risk

Based on our initial review of our portfolio holdings, we believe our companies maintain a competitive advantage in light of the continuous changing landscape. Based on the presentations, we found companies will either use digitalization to achieve or maintain leadership while others will use it as a defensive tool such as obtaining cost efficiencies. Automation continues to be an important area of focus for executives to achieve those efficiencies and margin expansion, especially in an era of limited growth potential. Related to this topic is the ability for companies to use big data, allowing them to know their customer base better, understand the threats and opportunities and capitalize on the growth potential the data provides.

Another key issue is disruption and the mere survival of industries and the blurring of lines between different industries. One key example is the blurring between media and consulting. For example, Accenture, a holding within both our International Fund and our Global Equity portfolio has grown strongly driven by digitalization and they are expanding their business into advertising. An important success factor, especially in today's environment of disruption, is being close to the customer and the ability to define who the customer is, and even being able to define the desires and needs of customers. Agencies are underweight in higher growth segments while Google, a holding within the Global Equity portfolio, along with Facebook have absorbed most of global growth. And disrupters such as Amazon are changing the landscape of the ecosystem. Maurice Levy, the Chairman of Publicis spoke about mobile phones playing a key role given that it has taken the lion's share of digital communication. And it is deep data, not just big data.

A sign of late cycle behavior is the level of mergers and acquisitions (M&A) activity. While we generally favor organic over inorganic growth, there are times when M&A make sense. As shareholders of Walgreens, we were supporters of them merging their operations with Rite Aid. However, at the end of June, Walgreens announced they would be terminating their $9.5 billion merger after receiving feedback from the Federal Trade Commission (FTC) that they planned to block the deal. Instead, Walgreens will buy only 2,186 of the Rite Aid's stores for about $5.2 billion rather than 4,600 stores. This new plan will still allow Walgreens to accomplish many of the same goals as before and having a higher probability of obtaining approval from the FTC.

Although we do not see any risk of recession this year, the dominant cause for recessions during periods of low nominal growth is economic policy tightening. With the US Fed having tightened twice so far in 2017 and further tightenings expected to come, we need to monitor financial conditions carefully. An interesting development is the observation from leading advertising firms that their clients are more focused on cost cutting rather than brand building, a sign of late cycle behavior.

C$%	Q2	Year to Date
Global Equity Portfolio Performance as at June 30, 2017 (Gross)		
Global Equity Portfolio	1.64	7.22
MSCI World	1.59	6.88
Value-Add	0.05	0.34

Our Global Equity portfolio closed the second quarter with a cash level of about 10%. As was the case last quarter, we believe a certain level of cash is prudent in an environment where valuations are elevated and there are signs of late cycle behavior. During the quarter, the top performers were Schweiter Technologies, Newell Brands, and AIA while the detractors were TJX, Walgreens and Essilor.

C$%	Q2	Year to Date
International Fund Performance as at June 30, 2017 (Gross)		
International Fund	4.30	11.56
MSCI EAFE	3.63	9.93
Value-Add	0.67	1.63

During the quarter, the International Fund had strong performance attributable to AIA, Safran, and Samsonite. Similarly to the Global Equity portfolio, a high level of cash along with weaker performance from Dassault Systèmes, Toyota Motor, and Schlumberger detracted from the Fund's performance during the quarter.

Outlook

One of the key questions in looking ahead is the extent to which the bond and equity markets can withstand a gradual reduction in monetary stimulus. Both the equity and bond markets reacted negatively when they misinterpreted Mario Draghi's speech in Sintra as a signal the European Central Bank (ECB) was poised to phase out its economic stimulus measures. In order to allay the market, ECB officials later confirmed that they are further away from ending their quantitative easing program. The positive tone of Draghi's speech was premised on more optimism on the outlook while conveying that any changes to the ECB's monetary policy would be made "prudently" as and when the economic recovery led to a fall in credit conditions. Markets remain cautious on central policy changes.

We are cognizant that risks have risen in the markets with the announcement of quantitative tightening from the Fed. Hence, we should be aware there is an elevated level of risk even though a global recovery is still taking place and companies continue to provide improving earnings. Our companies are in a good position overall to grow their revenue and earnings even in a scenario where the central banks decrease liquidity.

On September 24, Germany will have its election. It would be beneficial for Europe if Angela Merkel gets re-elected as Germany's Chancellor so the momentum gained from Macron's victory can continue. Merkel has outlined the deal Germany would do with France on fixing the governance of Europe's single currency. Furthermore, she has shown some support of an appointment of a Eurozone finance minister and the creation of a common budget. If France and Germany can execute on this, we may witness a reformed Eurozone, which will be positive for European equities.

The MSCI World benchmark is expecting earnings to be U$116.76 for the next twelve months for a valuation of 16.4x forward P/E, which is higher than the ten year average of 13.8x. Similarly, the S&P500's forward 12-month P/E of 17.6x exceeds its ten-year average of 14.3x, so it is more expensive than the MSCI World. The key valuation metrics for the Global Equity portfolio and the International Fund are shown below. Furthermore, both the International Fund and the Global Equity portfolio have higher return on equity metrics than their benchmark market indices while having lower beta metrics, making these portfolios less volatile than the market.

	CPWM Global	MSCI World
P/E Forward 12m	18.8x	16.3x
Net Debt/12m Forward EBITDA	-0.14	0.66
Net Debt/12m Forward EBITDA - ex-Financials	0.20	0.38
Return on Equity (adj.) - Latest FY	23.0%	22.0%
Dividend Yield	2.0%	2.4%
	CPWM Int'l	MSCI EAFE
P/E Forward 12m	18.7x	14.6x
Net Debt/12m Forward EBITDA	1.99	2.70
Net Debt/12m Forward EBITDA - ex-Financials	1.20	1.46
Return on Equity (adj.) - Latest FY	23.6%	15.5%
Dividend Yield	2.2%	3.1%

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