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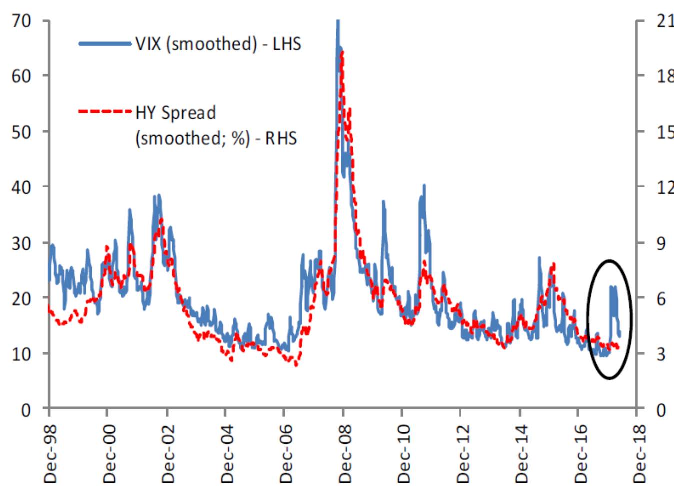
NORTH AMERICAN CAPITAL APPRECIATION STRATEGY

Second Quarter 2018 Review

No one wants to be a contrarian just for the sake of being one but right now it might pay to take advantage of the volatility. It feels like everyone involved in capital markets has turned more negative. While the investment outlook does feel a little less certain given the headlines on protectionist trade issues and foreign investment limitations on sensitive US technology that has resulted in a spike in volatility, volatility was at 20-year lows so some level of normalization should probably be expected. In Exhibit 1, we compare volatility as measured by the VIX, commonly referred to as the Fear Index, to high yield credit spreads (the interest rate demanded by investors in high yield bonds over similar maturity investment grade or government bonds).

Exhibit 1

Spike in VIX Not Corroborated by HYS

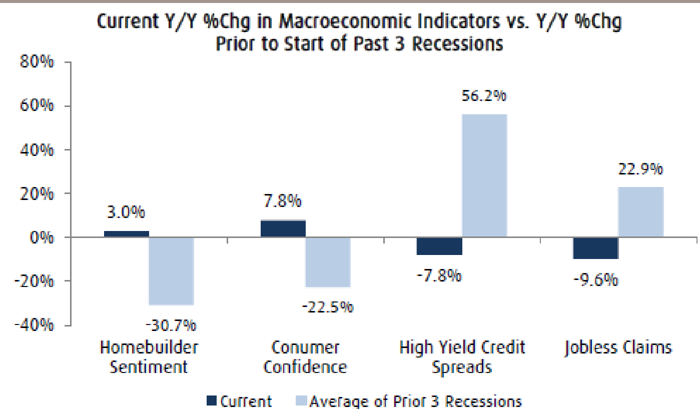


Source: Scotiabank GBM Portfolio Strategy, Bloomberg

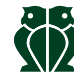
While this is only one measure (although a very good one), if the recent rise in volatility were really a signal to be concerned about, credit spreads would be widening and they are not.

Also consider the US Federal Reserve's (FED) more hawkish stance in its mid-June report when it increased interest rates for the second time this year. Perhaps this is a better indication of how well the US economy is performing as both US real GDP and core inflation forecasts were upgraded. The FED now targets real GDP growth for 2018 at 2.8%, up from 2.7% in March, while core (Personal Consumption Expenditures / PCE) inflation is estimated to rise from 1.9% to 2.1%. The FED also lowered the 2018 unemployment target rate to 3.6% from 3.8% in March and versus the May reading of 3.8%. This was enough to shift the market bias to four interest rate hikes instead of three in 2018. That means two more rate hikes are expected in 2018. So, the outlook for economic growth in the US for the balance of this year and even into 2019 still looks pretty good according to the FED. Perhaps the next logical question might be how this growth outlook relates to capital markets. In Exhibit 2 below, we analyze a number of other leading economic indicators including consumer confidence, homebuilder sentiment, high yield credit spreads and jobless claims.

Exhibit 2



Source: BMO Capital Markets



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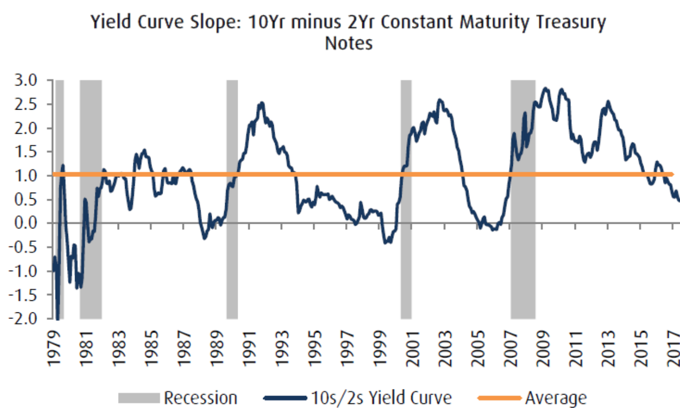
The chart compares the current year over year change for each of these leading indicators to the year over year change prior to the past three recessions. As indicated in the chart, both homebuilder sentiment and consumer confidence declined significantly prior to past recessions while credit spreads and jobless claims materially increased. None of this appears to be happening today and given most bear markets are associated with recessions, it would suggest it is premature to be making any major tactical asset allocation decisions just yet.

An inverted yield curve has also proven to be a reliable indicator of a future recession. Exhibit 3 below looks at the shape of the US yield curve slope as measured by the difference between 10-year and 2-year constant maturity US treasury note going back to 1979.

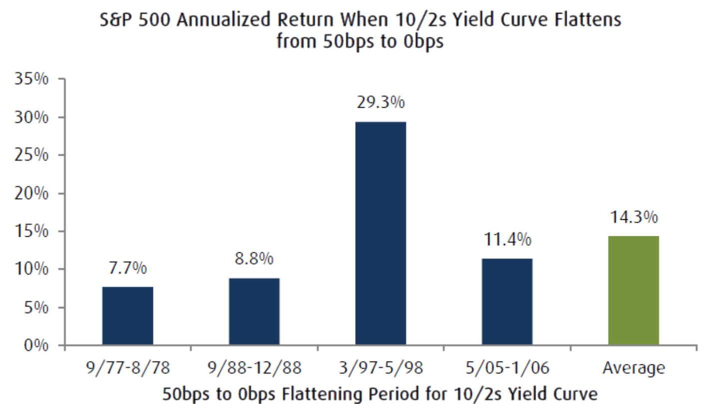
Exhibit 3



Source: BMO Capital Markets

The grey areas indicate recessions and as indicated in the chart, in each case the yield curve inverted or went negative prior to the recession. While the yield curve has been flattening, it is not inverted (ie: negative on the chart) so clearly we are not there yet. Similarly Exhibit 4 shows the average return for the S&P500 in the period leading up to the yield curve inversion or when the yield curve flattened from 0.5% to 0.0% (currently 0.32%).

Exhibit 4



Source: BMO Capital Markets

In each case the S&P500 return was positive with an average return of 14.3%. According to BMO Capital Markets, the historical average length of time after the yield curve inversion until a recession or bear market begins is also at least 15 months. So once again it appears to us premature to significantly reduce equity exposure just yet. Having said that, we are still holding about 13% in cash and short-term bonds and have been leaning towards what we would characterize as more earnings durable/defensive names in the portfolio such as Rogers Communications, Metro Inc., Brookfield Asset Management and Canadian Utilities all purchased earlier this year.

In the Bank of Canada's (BOC) Monetary Policy report in May the BOC did, just about everything in our view, to indicate a further interest rate hike at the July meeting was likely, pointing to stronger than expected first quarter GDP growth and slightly higher headline inflation. The recent release of the Bank of Canada's business outlook survey combined with the latest reading on April GDP at 2.5% would seem to cement at least one more move in 2018 although ongoing uncertainties about trade policies, a slowing housing market as a result of new mortgage

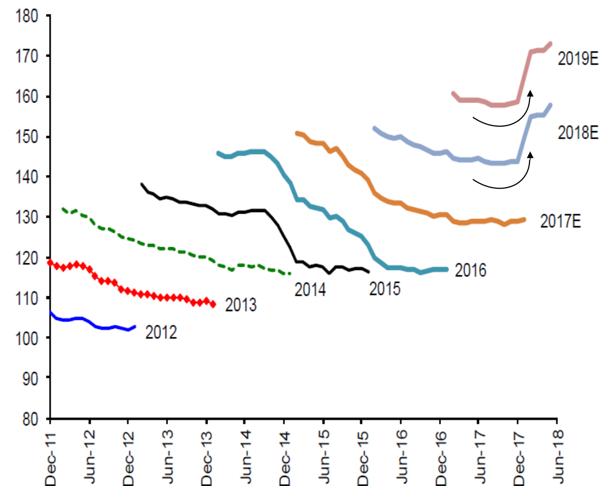
guidelines and higher borrowing costs are likely to cause the BOC to pause following that. Offsetting this, the recent spike in oil prices should provide some relief for western Canada, not to mention the positive impact it has had on our energy holdings.

The recent decision out of OPEC to add 600,000 to 1 million barrels per day (mmbpd) of oil production when taken in the context of other supply/demand fundamentals does not actually seem like that much of a production increase in our view. Seasonal demand alone should add 1.2mmbpd to 2.0mmbpd according to OPEC and the International Energy Agency (IEA). Venezuela production could also decline another 800,000 bpd by the end of next year according the IEA, which leaves us thinking that the oil market is more prone to another shock if there are any further disruptions like Iran or even the recently announced Syncrude outage. During the second quarter we increased our energy exposure from just under 10% to almost 14%, with an addition to our existing position in Pembina Pipelines as well as a new position in Imperial oil which we will elaborate more on in the portfolio review section.

Turning to valuation and earnings growth, not much changed in terms of valuation over the past three months; however, the growth in earnings for both the S&P500 and TSX continues to impress. Exhibits 5 and 6 show the bottom-up estimates for the S&P500 and the TSX by year going back to 2012. What is interesting is that analysts usually start the year with overly optimistic estimates and end up revising lower over the course of the year. However, in 2018 and 2019, for both the S&P500 and the TSX, analysts are still revising estimates up. Whether this continues or not remains to be seen but it does support our decision to remain in the market.

Exhibit 5

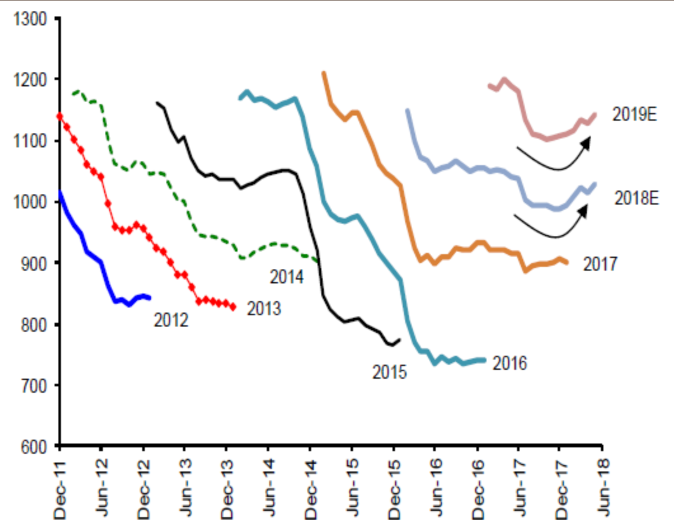
S&P 500 FY EPS Estimates
(Bottom-up consensus)-USD



Source: Scotiabank GBM Portfolio Strategy, Thomas Financial

Exhibit 6

TSX FY EPS Estimates
(Bottom-up consensus)-CAD



Source: Scotiabank GBM Portfolio Strategy, Thomas Financial

Exhibit 7 shows the change in forward 12 months earnings for the second quarter and the change in the forward 12 months price/earnings (P/E) multiple for the S&P500 and the TSX. This chart supports what is shown in Exhibit 5 and 6 but it also confirms that the market has become a little cheaper as measured by the forward P/E's for the S&P500 and the TSX.

Exhibit 7 Earnings vs. Forward P/E

S&P500	**12 M Forward Earnings**	**12 M Forward P/E**
6/30/18	167.8	16.2x
3/31/18	161.1	16.4x
% Change	4.2%	-1.2%
TSX		
6/30/18	1100.3	14.8x
3/31/18	1035.0	14.9x
% Change	6.3%	-0.7%

Source: Bloomberg

In our last quarterly commentary, we talked about how rising interest rates can be a headwind for equity valuations and multiple expansion. Year to date, the S&P500 forward P/E has contracted -12.4% from 18.5x in January to 16.2x today while the TSX has contracted -9.2% from 16.3x to 14.8x respectively. If we compare the current forward P/E multiples for the S&P500 and the TSX relative to the long-term average multiples for both markets of 14.6x and 14.5x respectively, we are pretty much there in Canada and actually below the long-term average looking out at 2019 earnings making the TSX the more attractive market currently at least from a purely valuation perspective.

During the second quarter of 2018, the S&P500 Index was up 3.4% in US dollars. Adjusting for currency, the S&P500 returned +5.4% in Canadian dollars, as the Canadian dollar depreciated about 1.5 cents, closing the quarter at US$0.761. Year to date, the S&P500 returned 2.6% in US dollars and 7.7% in Canadian dollars as the Canadian dollar has depreciated from US$0.795 at December 31st, 2017. In Canada, the TSX total return in the second quarter and year to date were 6.8% and 1.9% respectively.

Asset Allocation for our North American Capital Appreciation Strategy

As at June 30, 2018

Equities	87%
Fixed Income	5%
Cash	8%

During the quarter our asset mix shifted in favour of Canada versus the US, as our Canadian equity weight increased 6% to 46% while our US weight declined 4% to 41% such that our overall equity exposure increased from 85% to 87% at the expense of the cash weight, which decreased from 10% to 8%. As mentioned above, valuations in Canada continue to look more attractive relative to the US while earnings growth looking out into 2019 for the TSX is beginning to accelerate faster than the S&P500.

During the quarter, we added four new positions, all on the Canadian side including Brookfield Asset Management, Metro INC, Stella Jones INC and Imperial Oil LTD. Brookfield (BAM.A) is a global alternative asset manager investing in long-life infrastructure assets. What is unique about Brookfield is its global reach and scale employing 80,000 people with boots in the ground in 30 countries. Today the significant scale of its operations creates a natural economic moat to pursue transactions few others are able to consider . Brookfield has experienced strong growth in fee-bearing capital and associated earnings, which we believe will persist given low interest rates and Brookfield's demonstrated global expertise in this asset class.

Regarding Metro Inc. (MRU), we think the in-market Quebec purchase of pharmacy Jean Coutu will provide

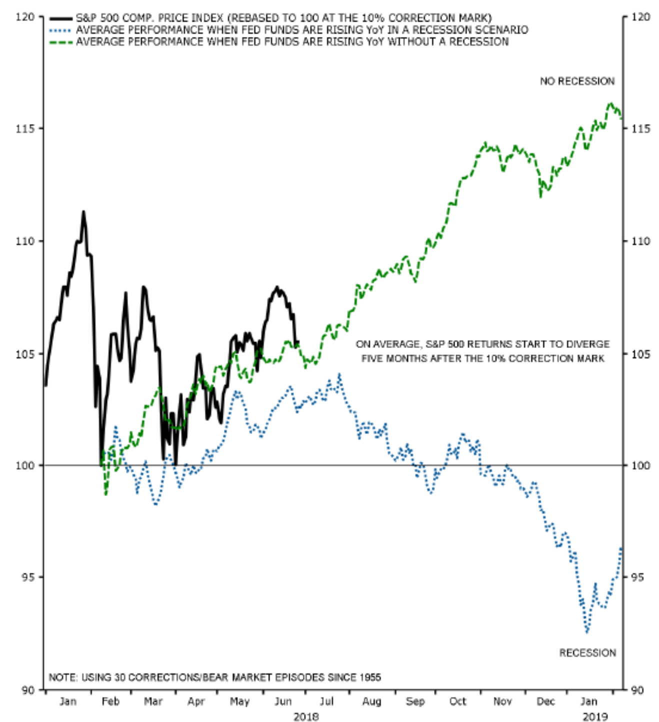
a lot more revenue and cost synergies than is being accounted for by the market, as we saw the same thing when Loblaw's bought Shoppers Drug Mart and this transaction is materially free cash flow per share accretive for Metro even without the synergies. In the case of Stella Jones (SJ), 70% of revenues are tied to utility type revenues for the replacement of railway ties and utility poles. We believe this company has experienced a classic inventory correction, where inventories of railway ties were overbuilt and have now been falling for 12 straight months and currently are at the lowest levels since August 2015. Management stated on the Q1 call that they are confident they can get back to historical EBITDA margins over the next 24 months, which now seems possible given where inventories are today and the fact that pricing is now turning up. Imperial oil (IMO) is a high quality integrated oil, company trading at about a 20% discount to its intrinsic value, at the time of purchase, using a long-term oil price of about US$60 per barrel versus US$74 today. IMO has materially increased its oil production during the recent period of low oil prices such that the growth in production operating leverage has been masked in the company's reported funds from operations during this time. This was evident in the latest quarter as cash flow beat expectations by 22% and IMO increased its dividend by 19% compared to its ten-year average compound annual growth rate of 6.5% suggesting a high level of conviction by the management and the board in the future outlook.

Outlook

As discussed last quarter, four factors influence our asset mix investment policy decisions: 1) macro outlook, 2) central bank policy, 3) valuation and 4) technical, which helps us from a timing perspective. As discussed above, our conclusion on the macro outlook is that it is too soon to be concerned about a material slowdown in the growth outlook. The one caveat is that the current trade rhetoric could turn into something more sinister, however at this point that is not our base case because the economies both in Canada and the US remain on track for solid growth and it would take a lot to derail that. We also think that Central bankers north and south of the border have done a pretty good job in terms of transparency such that the risk of an overtightening interest rate shock is low. From a valuation perspective, both the S&P500 and the TSX are cheaper today than they were three or six months ago and earnings for 2018 and 2019 have continued to increase through the first half of the year between five and ten percent, respectively, for both markets. Exhibit 8 looks at the S&P500 from a historical perspective and compares it to 30 corrections/bear market episodes since 1955 from the February 2018 10% correction low.

Exhibit 8

S&P Performance Past The 10% Correction Mark

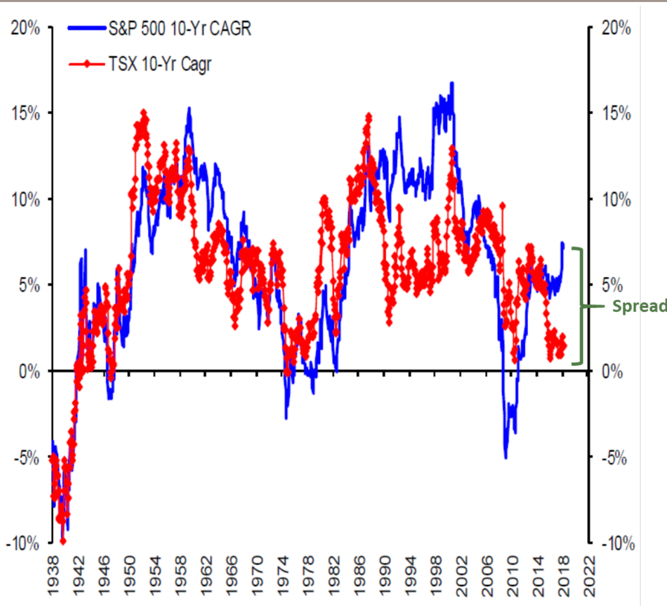


Source: Thomson Reuters, Canaccord Genuity estimates

As indicated in the chart, historically the S&P500 begins to diverge in performance about 5 months after the correction depending on the economic outlook (recession/no recession). When there is no recession, performance is positive and when there is a recession, it's negative. So, our best guess is that the market will likely trade in limited range until the actual performance of the economy confirms the positive outlook, at which point, if history repeats itself, the market should move higher. Regarding the Canadian market specifically, Exhibit 9 shows the gap in 10-year returns between the S&P500 and the TSX.

Exhibit 9

S&P 500 vs. TSX -10-Yr CAGR



Source: Scotiabank GBM Portfolio Strategy, Bloomberg

Currently this gap is at its widest since the late 1990's suggesting some catch-up is overdue for the Canadian market. From a technical perspective, nothing looks broken and the S&P500 200 day moving average offers big support as it is about 2% below where we sit currently. So, our conclusion, like last quarter, is to continue to stay the course. As discussed, we have also maintained some cash on the sidelines to take advantage of the volatility through this period of consolidation and transitioned to some more defensive names.

Peter Jackson
Chief Investment Officer
July 3, 2018

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.

APPENDIX 1

NEW EQUITY INVESTMENTS:

CUMBERLAND NORTH AMERICAN CAPITAL APPRECIATION MANDATE

CANADA

Brookfield Asset Management (BAM.A)

We acquired shares of Brookfield Asset Management which through its subsidiaries, Brookfield owns and operates over US$125 billion in fee-bearing 'real assets' for both its shareholders and third-party investors. The real assets include real estate, regulated utilities, ports, toll roads, timberlands, hydroelectric dams, wind/solar farms and other private businesses. Real assets have gained in popularity as alternatives to stocks and bonds given their stable long-duration, inflation-protected cash flows. Mirroring this popularity, Brookfield Asset Management has experienced strong growth in fee-bearing capital and associated earnings, which we believe will persist given low interest rates and Brookfield's demonstrated global expertise in this asset class.

Metro Inc. (MRU)

We initiated a position in Metro Inc., Canada's third-largest grocer with stores primarily in Quebec and Ontario. Metro recently closed its $4.5 billion acquisition of Jean Coutu, Quebec's market-leading franchisor in retail pharmacy. Jean Coutu is a stable and profitable business that, when combined with at least $75 million of annual cost savings, will materially improve Metro's free cash flow. The combination will also allow Metro to unlock shareholder value through debt repayment, share buybacks, real estate sales, geographic expansion and enhanced offerings in private label and cosmetics.

Stella-Jones (SJ)

We also recently added Stella Jones to the North American strategy. Successfully pursuing a growth-by-acquisition strategy for a decade, Stella Jones is now North America's leading supplier of railway ties, utility poles and other treated wood products. Demand for the Company's products is stable since tie and pole replacement is largely a recurring maintenance expense for railroads and electric utilities. However, the Company has recently seen lower margins due to competitive industry pricing. We believe margins will improve in coming quarters as Stella's pricing power is restored with rising demand, tighter inventories and rising lumber prices.

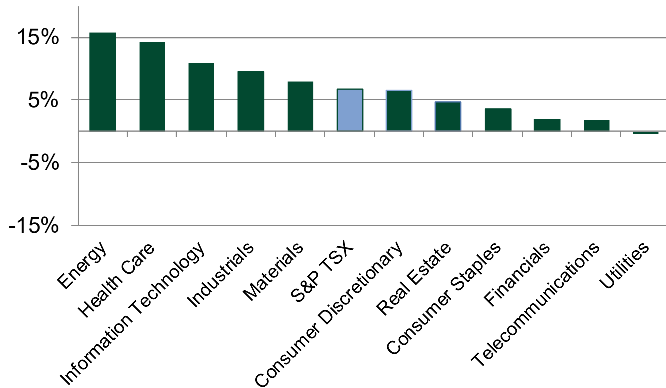
Imperial Oil Ltd. (IMO)

Imperial Oil (IMO) is a high quality integrated oil company trading at about a 20% discount to its intrinsic value, at the time of purchase, using a long-term oil price of about US $60 per barrel versus US $74 today. Both the downstream Refining and Chemicals business at IMO are very stable cash flow generators. The Refining business has generated $8bn in cash flow over the past 5 years averaging between $1.5 to $2.0 bn per year. The Chemicals business has generated $1.2 bn in cash flow over the previous five years averaging between $150mm to $350mm per year. IMO has also materially increased its oil production during the recent period of low oil prices such that the growth in production operating leverage has been masked in the company's reported funds from operations during this time. This was evident in the latest quarter as cash flow beat expectations by 22% and Imperial increased its dividend by 19% compared to its ten-year average compound annual growth rate of 6.5% suggesting a high level of conviction by the management and the board in the future outlook.

APPENDIX 2

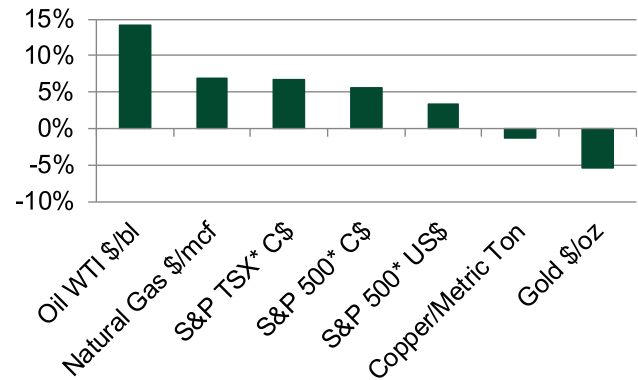
PERFORMANCE CHARTS

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



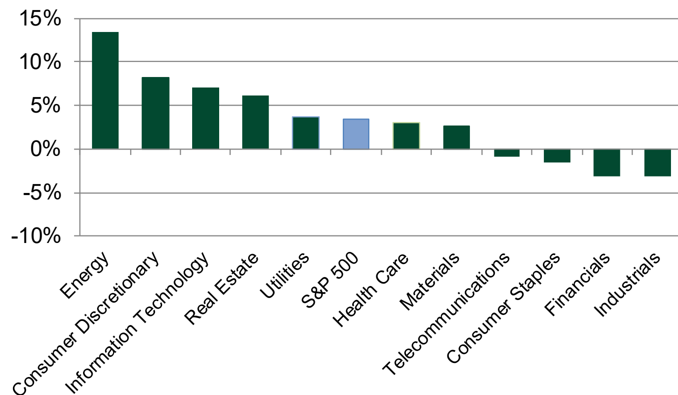
Source: TD Securities

Quarter % Change
Quarter Ending June 30, 2018



Source:Bloomberg *Total Returns

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



Source: TD Securities