GLOBAL EQUITY AND CUMBERLAND INTERNATIONAL FUND STRATEGIES

Third Quarter 2018

Global Macro Review

We were in Hong Kong recently where we had the opportunity to listen to many thought leaders speak on their specialized fields. For this quarter's macro review, we would like to share with you a summary of some thought-provoking topics with a perspective from Asia.

According to the former U.S. ambassador to NATO Nicolas Burns, we are living through a period of the greatest global turbulence and instability since 1945. This is driven by the challenges posed by a resurgent China, along with other populous nations, compounded by a Trump doctrine that is a radical departure from the policies of previous presidents. We are reminded that in 1987, Trump ran full page advertisements in various New York papers criticizing U.S. foreign policy, specifically the government's subsidizing of defense budgets in wealthy countries like Japan and Saudi Arabia. He continues to promote the same view, except now he is the President of the United States.

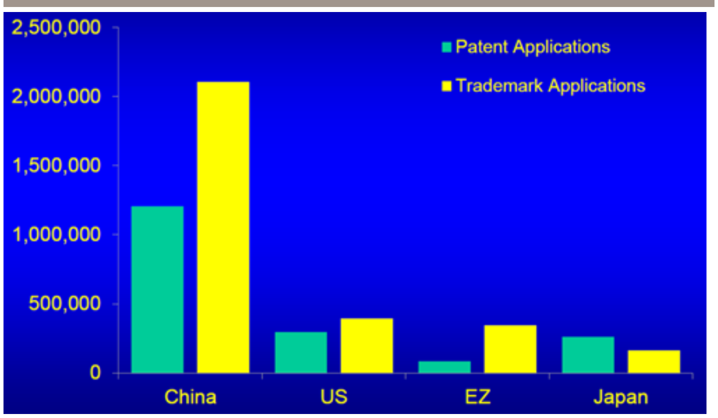
Despite the negative headlines against immigrants in the U.S., the Pew Research Center has found that Americans are more likely to say growing diversity makes their country a better place to live. The U.S. is experiencing a gradual shift to a majority non-white population overlaid with a record share of Americans getting older. In 2017, the percentage of foreign born people in the U.S. was 13.7%, a share not seen since 1910. In recent years, the trend is not so much with Latin-Americans crossing the border but with educated people from Asia obtaining visas. Yet, in the major European countries, populism is being fueled by anti-immigration racism and it appears there is less acceptance of diversity. Anti-immigration was one of the underlying issues with Brexit and many other elections throughout Europe in the past several years. Former CIA director John Brennan is of the view that some governments amplify tensions over race, culture and income inequality and he expects this trend to continue around the world. And based on independent researchers, populism is expected to rise in the democracies.

The post-World War Two rules-based order created by the United States does not appear to be working. In the U.S., we are witnessing a new world order, with bipartisan hostility towards China, and on trade and global influence in general. This, in short, is a backlash against globalization. America does have genuine issues on intellectual property theft and currency manipulation by China. Meanwhile, Europe views China as both a strategic threat and a market opportunity. We should not be surprised that the U.S. and China are colliding. Historically, great powers have been at war; now, the conflict is in different forms, such as economic warfare, cyberwar and other active measures. Consequently, countries will have to find new ways to defend their borders and sovereignty.

China has created a new social contract with its people as an alternative to democracy and this provides more economic goodies in exchange for less freedom and greater country loyalty. Chinese President Xi Jinping will implement his policies, such as his One Belt, One Road pan-Asian infrastructure program that will enable China to gain more influence around the region and to show its prowess in the disputed South East China seas. Nonetheless, Trump is convinced that China will eventually give way; we have not seen him willing to listen to the many American companies that have expanded their supply chains deep into China. As of now, many multinational companies are adopting a wait-and-see attitude rather than changing their supply chains. Trump came from a world of one-dimensional trading strategies compared to the multiple dimensions he finds himself in now. According to Shaun Rein of China Market Research, he does not expect China to back down over the trade war anytime soon. Hence, it may not be a foregone conclusion that Trump will be able to close the deal.

China spends almost 2% of its GDP on research and development, which is almost in line with the Eurozone, while the U.S. spends slightly more than 2.5%. And shown in the chart below, the number of Chinese international intellectual property applications exceeds any other region. Even if we discount some of these as bogus, China should be considered as a formidable force in developing their intellectual property. China is also spending substantial amounts on their military in order to gain stronghold in the region and closing the gap in terms of military spending with the United States.

International Intellectual Property Applications



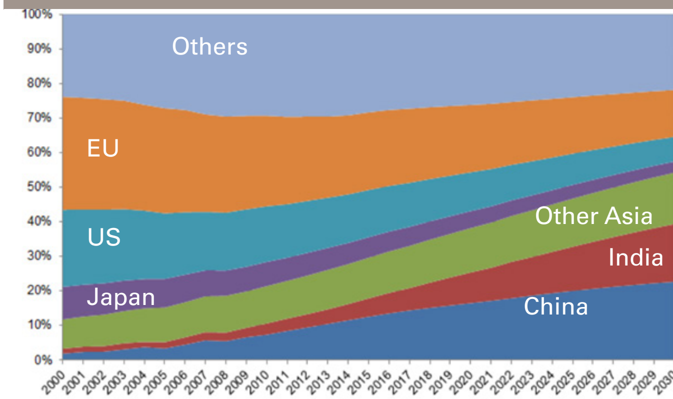
Source: World Bank WDI, Independent Strategy

So far, the geopolitical picture looks grim with rising populism and the lingering conflict between China and the U.S. The crucial question then, is how do we wade through this noise and establish any investment ideas?

One idea we want to share with you centers on the major secular trends derived from the global demographics data.

The evolution of the middle class is one of those trends and has been discussed before, but the distribution trend may surprise you. The global distribution of the middle class as we move towards 2030 is tilted towards India and China, with the decline in the European Union (EU) and predominately in the U.S. as depicted in the following graph.

Global Distribution of the Middle Class to 2030



Source: Homi Kharas, The Brookings Institution

According to the Brookings Institute, 88% of the next billion entrants into the middle class will come from Asia and by 2030, Asia could represent two-thirds of the global middle class population.

There will be 350 million people in China, 380 million in India and 210 million in the rest of Asia while the rest of the world will contribute 130 million middle class. This is based on the assumption that the middle class market in the U.S., the Eurozone and Japan are projected to grow at only 0.5% per year compared with annual growth of 6% or more in China and India.

An interesting milestone was reached this month. For the first time, more than half the world's population is living in either the middle or upper class, where five people join the ranks every second. Most of this is taking place in Asia. This is important for future growth as half of global economic demand is generated by household demand from transportation, consumer products, food, and financial products. We need to understand that the middle class is the engine of modern economics.

We can see that the East, especially China, is having a re-emergence after its fall from dominance a couple of centuries ago.

Within our own portfolios, we have participated in the burgeoning middle class in Asia for a number of years. To highlight some of these investments, AIA is number 1 in the Asian life insurance market that provides saving and protection products for the growing middle class. Similarly, Julius Baer, a Swiss private bank is expanding their Asian operations to cater to the increasing wealth in this region. As people move into the middle class, one of the first things they want to do is purchase products they dreamed about such as cosmetics from Kao or foreign spirits like Johnnie Walker from Diageo or simply buying better quality household products from Unilever.

Next, we want to talk about aging. Other than this being unavoidable, based on a study provided by the United Nations, almost half the world's population is between 25 and 59 years of age. However, Europe is the region with the largest exposure to those over the age of 60. Along with Europe, other developed markets like the U.S. and Japan, are also experiencing an increase in the developed world's aging population. This secular theme has also been part of our portfolios for a number of years.

For example, our portfolio includes companies such as Coloplast, a leader in ostomy and continence care, Roche, a leader in oncology drugs, Essilor, the global leader in glass lenses and Johnson and Johnson, a leading pharma and consumer goods company. While these companies originate in Europe and the U.S., their growth is derived by diversifying globally.

At the younger end of the age spectrum, the millennials will represent the most influential consumer segment through to 2030. Asia is home to almost one billion millennials and three-quarters of them live in China, India, Indonesia, Japan and South Korea. There are 400 million millennials in China and India each, making each country larger than the entire U.S. population, making the 80 million millennials in the U.S. pale in comparison.

By 2030, Euromonitor projects U$14.5 trillion increase in consumption in the region's top five economies. Their interests range from the food & beverage sector, housing, transport and services, and digital media. The markets are focusing on the Chinese as their purchasing power and desire to acquire are higher compared to India. While the millennials were growing up, China's growth per capita GDP between 1990 and 2017 was over 25x compared to a little over 2x for the U.S. According to Young China Group, the Chinese millennials will be relevant to the world given their global view and connectivity. While many have studied or worked abroad, they are proud and there is a higher tendency to be cool with expressing their Chinese culture and characteristics. And therefore, we can expect companies to lead from China rather than localize for China. With 700 million Chinese mobile phone users compared to America's 200 million, there is a large difference in digital engagement.

We mentioned Diageo as a suitable company catering to the middle class segment. But with Diageo's large portfolio of spirits, it is also meeting the needs of millennials. An interesting trend is that millennials spend less on beer but more on spirits as they like to discover new liquor brands to share with their friends. With the importance of this demographic segment, we shall continue to search for companies that will benefit from this secular trend.

A few years after Donald Trump wrote his op-ed in the NY Times that we mentioned earlier, Hollywood produced its first movie with an entirely Asian cast. The Joy Luck Club was screened at TIFF twenty-five years ago. The movie chronicled the immigrant life of four families, of their struggles and joys in America. Fast forward twenty-five years and it is that amount of time Hollywood took to make another movie with an entirely Asian cast. Yet, this time, it is not a story about immigrants or martial arts, but a romantic comedy about "Crazy Rich Asians", filmed on location in Singapore. If Hollywood is known to go where they can make money, perhaps this is a case where art imitates life.

Portfolio Review

Investors have built up the largest overweight position in U.S. equities in three years, which can be viewed as a bearish sign. Cumberland's Global Equity Portfolio has been underweight in U.S. equities in its geographic allocation, which partially detracted from our performance. Another trend has been Growth investing as a style has outperformed the Value investing style and this has contributed to the performance of both portfolios. Emerging markets have underperformed all regions and having little direct exposure to this area has contributed to performance. There has been an outflow by foreigners in Japanese equities but this has been offset by the support from the purchase of Japanese equities by the Bank of Japan, leading to Japan being a strong performer in Asia.

The equity market's working assumption is that a deal between the UK and EU will be found before the Brexit deadline of March 29, 2019. UK PM May presented her proposal at a recent summit in Salzburg between the UK government and the EU. PM May wants to keep the UK signed up to the EU's rule book for goods but not for services or people. This was a reality check for May as the EU will not allow the UK to cherry-pick the "four freedoms" (goods, services, capital, and persons) that form the pillars of a single market in the EU or, in the words of France's finance minister Bruno Le Maire, would spell "the end of Europe". The EU's position is if Britain wants to opt out of the rules of a single market, it can have a trade deal. If it wants friction-free access, then it can choose something modelled on the European Economic Area, with the associated obligations. The concern is that leaving the EU with no deal would be a catastrophe with varying estimates on the economic cost to the British economy, begging the question as to whether there could be a possibility of a second referendum or a Remain vote. Both portfolios are underweight the UK compared to their respective benchmarks.

Another country we are keeping our eye on is Italy. Italy is a major medium term structural and governance problem for Europe. Italy is Europe's largest bond market and has the second highest debt-to-GDP ratio after Greece at 130% which is in breach of the EU's 60% ceiling. The new budget proposed by the coalition government to fund its expensive election promises is creating three years of deficits at 2.4% compared to 0.8% target in 2019. The prior target was a surplus at the end of three years. The result has been a spike in the Italian bond yields with a decline in the Italian bank stock prices. Cumberland's direct equity exposure in Italy is limited, with Luxottica being the only company listed on the Italian exchange. However, Luxottica's key geographic exposure is to the United States, with their LensCrafters and Sunglass Hut retail stores, and their future growth will be more dependent on their merger with Essilor.

During the quarter, we made few changes to our portfolios. The International Fund added Sika as a new holding while the Global Equity Portfolio sold its position in Philip Morris while introducing Johnson and Johnson.

Sika is a Swiss-based specialty chemicals company which develops, produces, and sells systems and products for bonding, sealing, reinforcing and protecting in the building sector and motor vehicle industry worldwide. This Company is highly innovative with 1500 new products launched in the past five years along with 70 new patents issued last year. Their innovations provide solutions to their customers such as providing critical products for making cars lightweight and meeting safety, fire, earthquake and quality requirements in buildings. We expect secular growth in both sectors Sika operates in and with their innovations, we expect the Company to be a leader on a global scale.

Johnson and Johnson (JNJ) is a U.S. healthcare conglomerate operating in three key segments: pharma, medical devices, and consumer. The Company had fallen out of favor due to their disappointing results within its Medical Device and Consumer segments. Management has taken a number of steps to address these issues and yet, it was trading at the lower end of its historical range. We expect JNJ to be a beneficiary of the aging demographic trend we discussed earlier and they have opportunities to accelerate their top line and expand their margin.

Cumberland's Global Equity Portfolio with a return of 3.1% matched the MSCI World Index benchmark's return of 3.3 % in the third quarter. Cumberland's Global Equity Portfolio was overweight in the best performing sectors in the MSCI World benchmark which were the Healthcare, Information Technology, and Industrial sectors. In addition, it was underweight in the Materials, Real Estate, and Energy sectors which were the lowest contributors to the Index. Specific to Cumberland's Global Equity Portfolio, the key contributors in terms of stock selection for the quarter were our holdings in Honeywell, Schweiter Technologies, and JP Morgan while the main detractors were Julius Baer, Fresenius SE, and TE Connectivity.

The MSCI EAFE Index benefited from strong returns from the Healthcare and Communication Services sectors during the third quarter. Cumberland's International Fund's third quarter return of 0.4% continued to benefit from its overweight exposure to the Information Technology and Healthcare sectors while its benchmark, the MSCI EAFE Index had a return of -0.2%. The Fund's holdings in TSMC, Kao, and Safran were the main contributors to its outperformance and our positions in Julius Baer, Fresenius SE, and British American Tobacco were the main detractors during the quarter.

Cumberland Global Equity Portfolio Performance as at September 30, 2018 (Gross)			
C$%	**Q3**	**YTD**	**One Year**
Cumberland Global Equity Portfolio	3.1%	7.0%	13.6%
MSCI World	3.3%	8.9%	15.3%
Value Add	-0.2%	-1.9%	-1.7%
Cumberland International Fund Performance as at September 30, 2018 (Gross)			
C$%	**Q3**	**YTD**	**One Year**
Cumberland International Fund	0.4%	6.2%	11.0%
MSCI EAFE	-0.2%	1.8%	6.5%
Value Add	0.6%	4.4%	4.5%

Outlook

Our working assumption is the probability of a recession over the next year in the U.S. is low. Based on the profit outlook for 2019, the EPS growth for the US and the Eurozone are lower than 2018; 10.5% for the U.S. and 9.9% for the Eurozone. Brexit negotiations are obviously having an impact on the expectations for the UK, with earnings growth coming in at 7.7%. U.S. companies continue to generate higher operating margins compared to companies in other regions, which may explain for part of the higher multiples paid for the companies. However, the U.S. market is much more expensive than any other region due to the record-breaking divergence between U.S. equities and the rest of the world. Relative performance of the S&P 500 vs. the rest of the world is now at its most extreme since at least 1970. This is reflecting strong economic numbers in the U.S. while consumer confidence in the Eurozone has fallen to its lowest level in more than a year in September. Given the stretched valuation of the U.S. market, we are satisfied with our underweight exposure in U.S. equities in the Global Equity Portfolio.

While the European Central Bank (ECB) has confirmed they will phase out of their asset purchases at the end of the year, their monetary policy will remain ultra-loose even if it is not getting any looser. This reflects a view that growth is still expected in the Eurozone. However, we must be mindful of the ongoing rounds of tariffs that are being imposed globally and the potential impact this may have on different economies generally and equity markets specifically. This warrants an investment strategy that is prudent and conservative with the global political risks that exist today.

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October 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.