CUMBERLAND
Private Wealth

April 1, 2019

First Quarter In Review

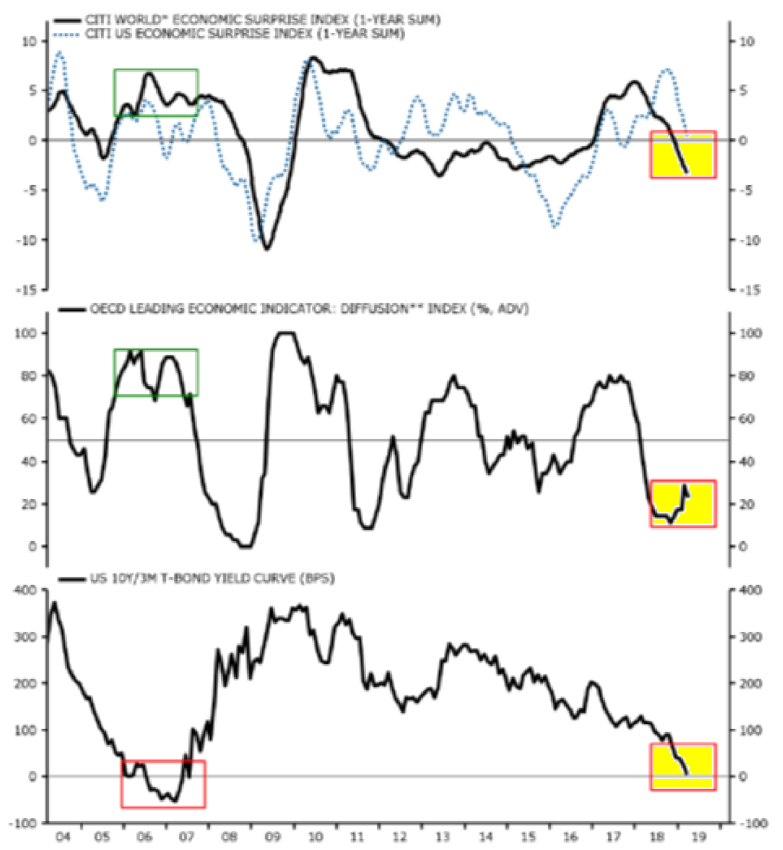
NORTH AMERICAN EQUITY STRATEGY

Last week we attended a retail conference in Toronto which included the Who's Who of Canadian 'bricks and mortar' retail. The first question the moderator asked of each panelist was whether there were any signs of a slow-down at the retail level or a shift in consumer spending patterns that might signal some caution. They all answered no. So take that with a grain of salt but over all the years we have been analyzing companies, we have found that the boots on the ground research is often the best research. We mention this notwithstanding the negative rhetoric regarding slowing global growth, a complete U-turn in US monetary policy and a yield curve inversion between the 10 year Treasury bond and the three-month Treasury bills which can be a leading indicator of an economic downturn.

The top clip in Exhibit 1 compares the US and global economic surprise indices. Last year, the US economy was able to decouple from the rest of the world, thanks in part to the fiscal reflation (tax cut) provided. However with this fading, it remains to be seen whether the US will be able to sustain this diverging trend. The middle clip in Exhibit 1 shows the OECD leading Economic Indicator Diffusion index which comprises over 30 countries. Generally this index needs to be above 50 for economic momentum to reaccelerate and throughout the first quarter, many of the key country global PMI's have been falling not rising.

The other big news in March was the repositioning of the Federal Open Market Committee (FED) after taking a more dovish (favoring keeping rates at current levels) stance in January which is what sparked the rally in stocks through the first quarter of 2019. Not only did the FED not raise rates in March, it removed the two rate hikes for 2019 from its December 2018 projection and downgraded the outlook for the US economy with 2019 projected GDP growth of 2.1% as compared to 2.3% in December. That is still a respectable level

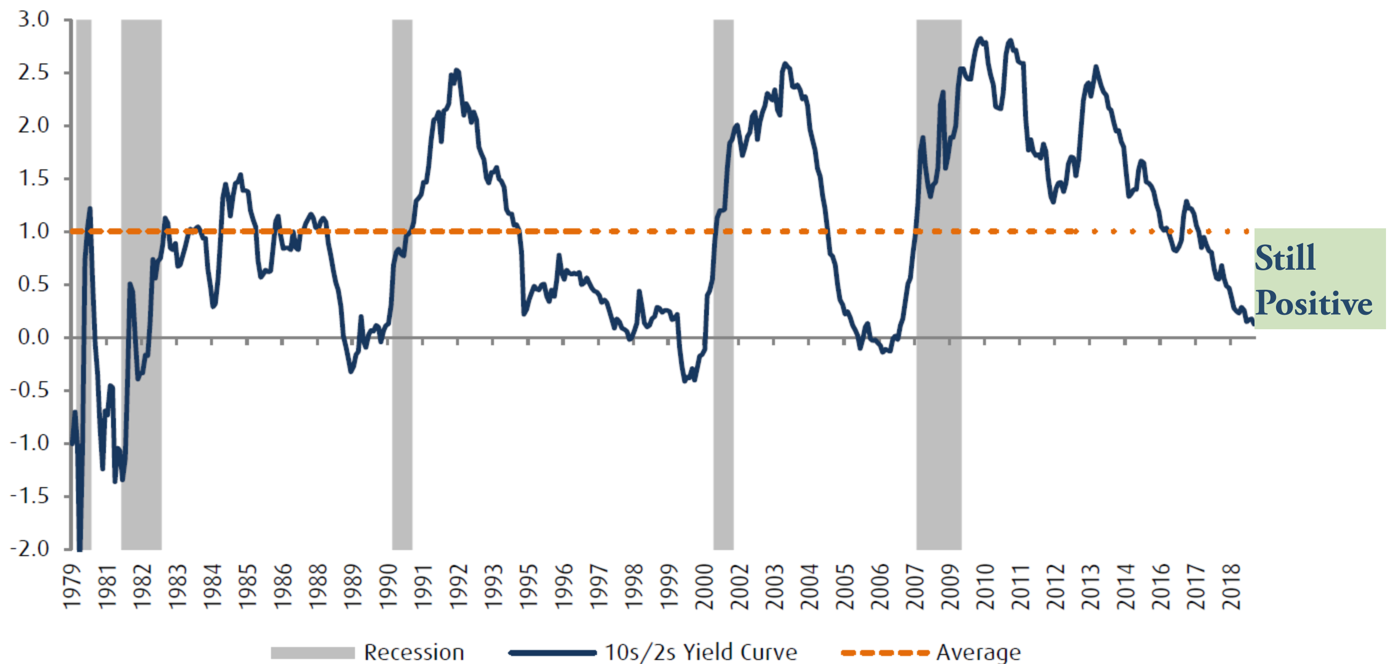
Exhibit 1
US Economy: Downshifting and Recoupling with the Global Economy



*AVG of G-10 and EMs** Up to 35 countries
Source: Thomson Reuters Datastream, Cannacord Genuity estimates

of growth and pretty much in line with the long term averages, but it could weigh on the markets' outlook for earnings growth. The Fed also announced that it will wind down its quantitative tightening program by September 2019 which will remove an additional supply of bonds from the market with the technical effect of driving rates lower. The timing of this was earlier than expected and it did coincide with the 10-year/3month yield curve inversion (bottom clip in Exhibit 1). So the combination of these actions may be partly to blame for the yield curve inversion and had it been happening during a period where the Fed was imposing tighter financial conditions (ie. raising rates) we might be more concerned. Secondly, the primary yield curve spread that equity markets traditionally focus on is the 10-year/2-year yield spread not the 10-year/3-month yield spread. As indicated in Exhibit 2 which shows yield curve inversions for the 10-year/2-year note going back to the 1970's, the yield curve has not inverted, at least not at this point.

Exhibit 2
Yield Curve Slope: 10 Yr Minus 2 Yr Constant Maturity Treasury Notes



Source: BMO Capital Markets Investment Strategy Group, FRB, Bloomberg

What is apparent in the chart is that when the 10-year/2-year yield curve does invert (ie. short rates are higher than long rates), this has inevitably been followed by a bear market and a recession (grey shaded area). However, it is important to understand that the yield curve inversion is a leading indicator and it typically takes on average 15-17 months before a bear market or recession begins. In addition, a flattening yield curve as opposed to an inversion, or the period we are in now, has actually historically been good for stocks. Exhibit 3 shows an analysis of periods of prolonged yield curve flattening.

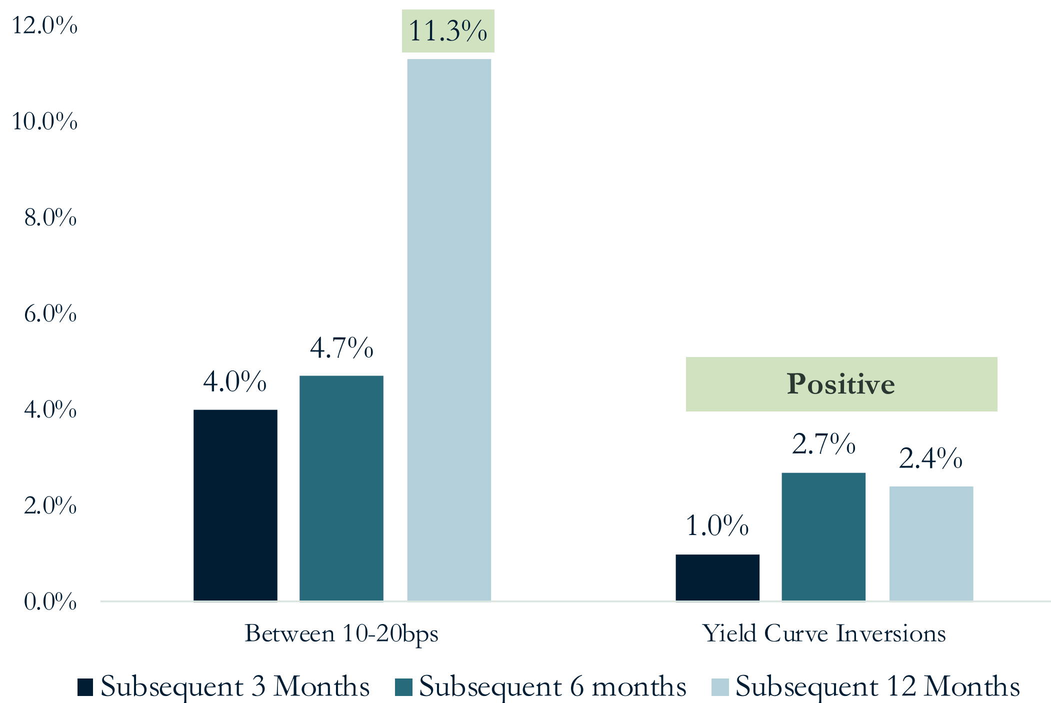
Exhibit 3
Analysis of Prolonged Periods of a Flattening Yield Curve

Start	End	Duration (months)	S&P 500 Annualized Return
7/31/1980	8/31/1981	13.2	0.8%
11/30/1983	8/31/1984	9.2	0.2%
7/31/1985	3/31/1986	8.1	40.0%
4/30/1988	3/31/1989	11.2	14.1%
9/30/1992	12/31/1994	27.4	4.3%
2/28/1996	6/30/1998	28.4	27.7%
5/31/1999	8/31/2000	15.3	13.1%
8/31/2003	11/30/2006	39.6	10.7%
2/28/2011	7/31/2012	17.3	2.8%
12/31/2013	?	62.8	8.3%
	Average:	**23.2**	**12.2%**

Source: BMO Capital Markets Investment Strategy Group, FRB, Bloomberg

As indicated in the chart, the historical average annual return during periods of yield curve flattening is +12.2%. Exhibit 4 shows the historical performance for the S&P500 leading up to and after an inversion. Currently the spread between the 10-year/2-year treasury bond yields is between 10-20 basis points. The three bars on the left in Exhibit 4 show the typical historical returns for stocks in the subsequent 12 months is 11.3% at this spread level going back to 1980. Returns after inversion (horizontal bar on the right) are historically still positive for another 12 months suggesting there is no reason to panic.

Exhibit 4
S&P 500 Average Returns Following 10s/2s Yield Curve Scenarios
based on monthly data beginning 1980



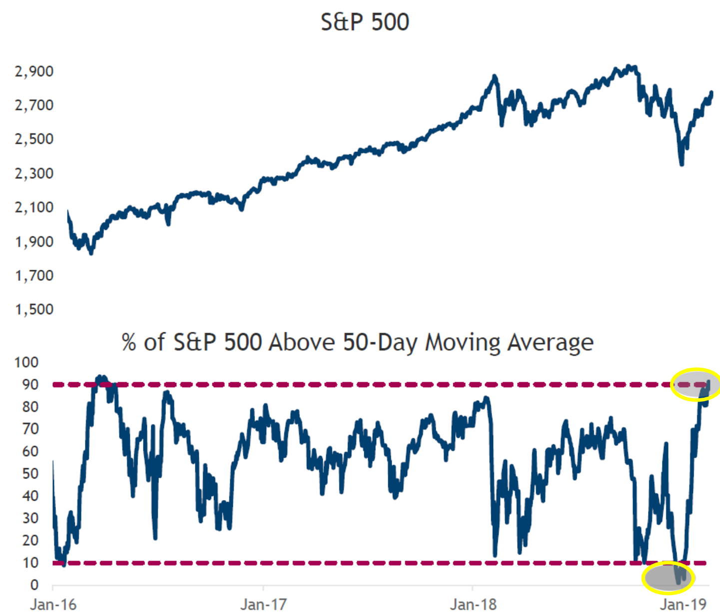
Source: BMO Capital Markets Investment Strategy Group, FRB, Bloomberg, NBER

So overall the US economy is slowing but not likely heading for a recession just yet. Meanwhile, progress in the US-China trade talks and policy stimulus in China have improved market sentiment and contributed to firmer commodity prices. In Canada, The Bank of Canada projects GDP growth in 2019 of 1.7% down from 1.8% in 2018. This mostly reflects slower growth in the first half of 2019 from oil producing regions, however prices have recovered in Western Canada and January GDP surprised to the upside coming in at an annualized rate of 1.6%. We think it goes without saying that additional rate increases in Canada are on hold given the latest move by the FED in March.

During the first quarter of 2019, the S&P500 index was up +13.7% in US dollars. Adjusting for currency, the S&P500 returned +11.3% in Canadian dollars, as the Canadian dollar appreciated about 1.7 cents, closing the quarter at US$0.749. The TSX return in the first quarter was +13.3%. The MSCI EAFE index return in Canadian dollars was +7.9% for the first quarter.

As we mentioned above, the strong performance in the first quarter was triggered by Fed Chair Powell's first speech in the new year, where he said the Fed was prepared to adjust policy "quickly and flexibly and to use all our tools to support the economy to keep the expansion on track". The S&P 500 rallied 3.4% that day and so far has recovered about 80% of its Q4 loss. The strong performance in the first quarter also reflected a strong bounce off a much oversold level at the end of fourth quarter of 2018, as indicated in Exhibit 5, where fewer than 10% of S&P500 stocks were trading above their 50 day moving average. We talked about all the reasons for the selloff last quarter so we won't rehash that but looking at Exhibit 5, today we see the exact opposite situation where more than 90% of stocks are trading above their 50 day moving average. While it is tough to argue that some period of consolidation may be in order given the recent strong upward move, history has shown that the strong broad-based buying witnessed in the market recently can have positive implications for future performance of the S&P500 as shown in Exhibit 6.

Exhibit 5
Broad-Based Market Gains



Source: FactSet, SunTrust IAG

Exhibit 6
S&P Performance After 90% of Stocks Trade Above Their 50-Day Moving Average

	3-Months Later	6-Months Later	12-Months Later
02/06/91	5.7%	9.1%	15.6%
06/09/97	7.9%	14.0%	29.6%
03/24/98	1.3%	-6.9%	14.7%
11/05/98	9.7%	18.2%	20.8%
05/05/03	6.1%	13.4%	20.8%
11/12/04	1.9%	-1.6%	4.3%
05/04/09	8.8%	17.5%	32.5%
08/03/09	3.3%	10.0%	12.3%
04/01/10	-12.8%	-2.8%	12.0%
10/05/10	9.6%	14.8%	-5.3%
10/24/11	5.7%	10.9%	12.7%
01/18/13	5.1%	14.1%	24.1%
05/15/13	1.6%	6.6%	12.8%
03/16/16	2.2%	4.9%	17.7%
02/15/19	?	?	?
Average	4.0%	8.7%	16.0%
Median	5.4%	10.5%	15.2%
% Positive	93%	79%	93%
Max Gain	9.7%	18.2%	32.5%
Max Loss	-12.8%	-6.9%	-5.3%

Source: FactSet, SunTrust IAG

Exhibit 7
Earnings Growth and Valuations

	EPS Growth 2018/2019			EPS Growth 2020/2019
	Sep/18	Dec/18	Mar/19	
S&P 500	10.4%	8.3%	4.1%	11.5%
TSX	13.2%	10.4%	2.8%	12.8%

	2019 Forward P/E			10 year average P/E	2020 Forward P/E
	Sep/18	Dec/18	Mar/19		
S&P 500	16.4x	14.2x	16.3x	14.9x	15.1x
TSX	13.2x	12.3x	14.6x	14.7x	13.4x

As indicated in this chart and comparing to 14 other similar periods going back to 1990 when more than 90% of stocks traded above their 50 day moving average, the S&P500 was higher on average by 16% over the next 12 months in 13 out of 14 cases.

In Exhibit 7 we compare the percentage change in earnings growth from 2018 to 2019 (top clip) since last fall 2018 to the change in valuation (bottom clip) as measured by the Price/Earnings (P/E) multiple for the S&P 500 and the TSX. As indicated in the chart, the earnings growth rate for the S&P500 and TSX has decelerated from double digit levels last fall to mid/low-single digit levels today and the valuation multiples have essentially round-tripped back to or above last fall's level. The concern on earnings, at least in the first half of 2019, has to do with the one year lapping of US tax reform, the year over year 7% strength in the US dollar which impacts foreign earnings repatriated back to the US companies as well as the 13% decline in oil prices in the first quarter of this year compared to last year. Clearly to be more constructive on the market going forward, we will need to see this decline in earnings inflect to the positive. The good news is we have already seen this in the S&P500 forward earnings recently, suggesting analyst forecasts may have now have reset the bar low enough. Also shown in Exhibit 7 is the projected earnings growth out to 2020 which, as we work through the earnings issues discussed above, shows a positive double digit rebound for both markets next year. The wild card is still a boost on the trade front which would be good not just for the US but globally however, it is still anyone's guess how that plays out.

Source: Bloomberg, FactSet, TD Securities

Asset Allocation for our North American Capital Appreciation Strategy
As at March 31, 2019

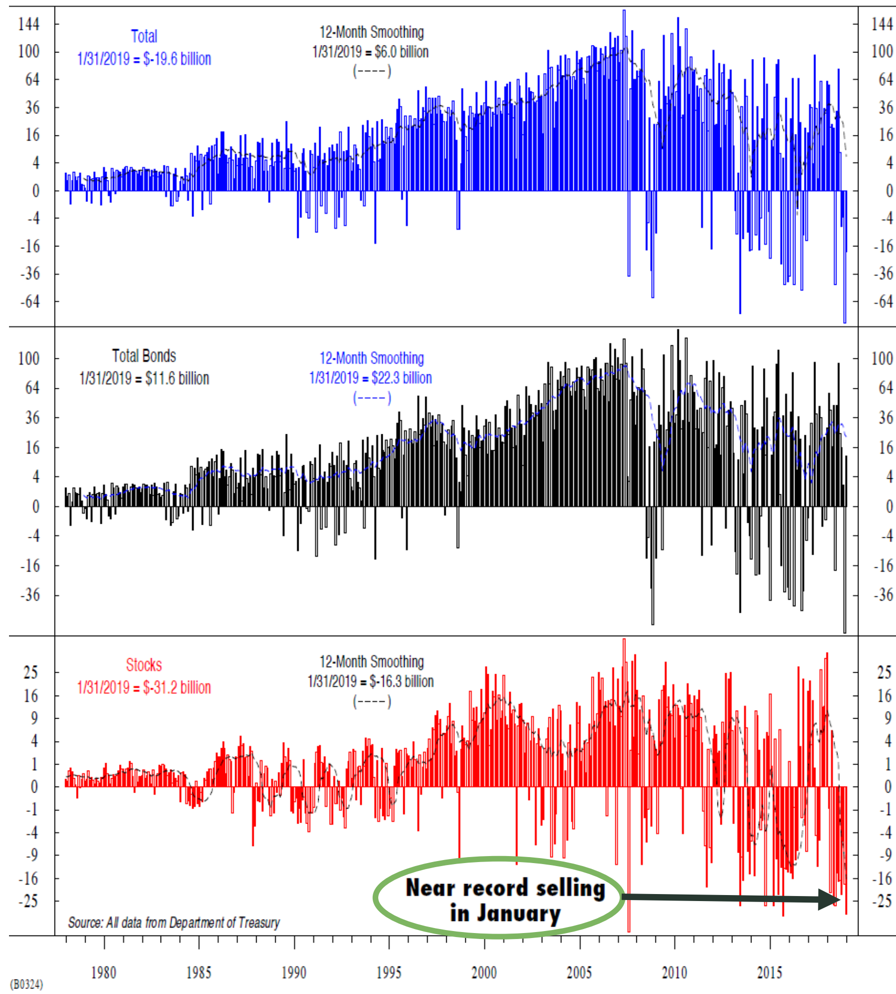
Equities	**92 %**
Fixed Income	**1 %**
Cash	**7%**

During the quarter our overall equity exposure rose 3% to 92% from 89% at year-end 2018. Our exposure to US equities rose 5% from 40% to 45% and our exposure to Canadian equites declined slightly from 49% to 47%. The TSX continues to remain the cheapest market from a valuation perspective with lowest P/E relative to its ten year average, however the S&P500 earnings are proving to be more resilient at least so far in 2019 such that both markets remain attractive in our view. Our exposure to short term bonds declined from 5% to 1% and cash increased slightly from 6% to 7% as it just does not pay to term out cash given the flat nature of the current yield curve. There were no major shifts in sector weights although we did add to consumer discretionary in the US with the purchase of two quality earnings compounders, TJX and Nike Inc. A complete review of each company's business and fundamental outlook that was purchased in the quarter can be found in Appendix 1.

Outlook

At our recent client quarterly event in early March, we talked about the conditions we felt were necessary to continue to be constructive on this market. These include (but are not limited to) an accommodative Fed, steady economic growth, accelerating earnings and attractive valuations. Looking at each of these one by one, we have definitely seen a shift by the Fed from last fall to the January 4th speech just discussed. Fast forward to the Fed's meeting in March and the question now for us is whether things have slowed too much? The Fed did downgrade its 2019 GDP, Unemployment and PCE inflation targets to 2.1%, 3.7% and 1.8% from 2.3%, 3.5% and 1.9%, respectively. However, analyzing these new data points on an absolute basis, it's just not enough for us to change our view on the markets from an economic standpoint. Regarding earnings and valuations, there is no question that earnings expectations have come down at least for the first half of 2019 for the reasons already discussed. However our sense is that global growth expectations have come down as well and the bar may be set low enough now such that it sets the stage for better comparable data going forward relative to the depressed level we are seeing today. We think the fiscal reflation efforts in China and any positive development on trade talks would also provide further stimulus. From a valuation perspective and looking out to the back half of 2019 and to 2020, the S&P500 and TSX are currently trading close to or below their respective ten year average Price/Earnings multiples such that neither market is expensive providing earnings do not further deteriorate. Finally, we discussed how the market technically looks overbought. However our historical analysis suggests that the broad-based buying that's occurred this quarter is a positive medium term signal for the market in over 90% of the cases studied. To emphasize this point Exhibit 8 shows total net foreign purchases of US stocks and bonds going back to 1980.

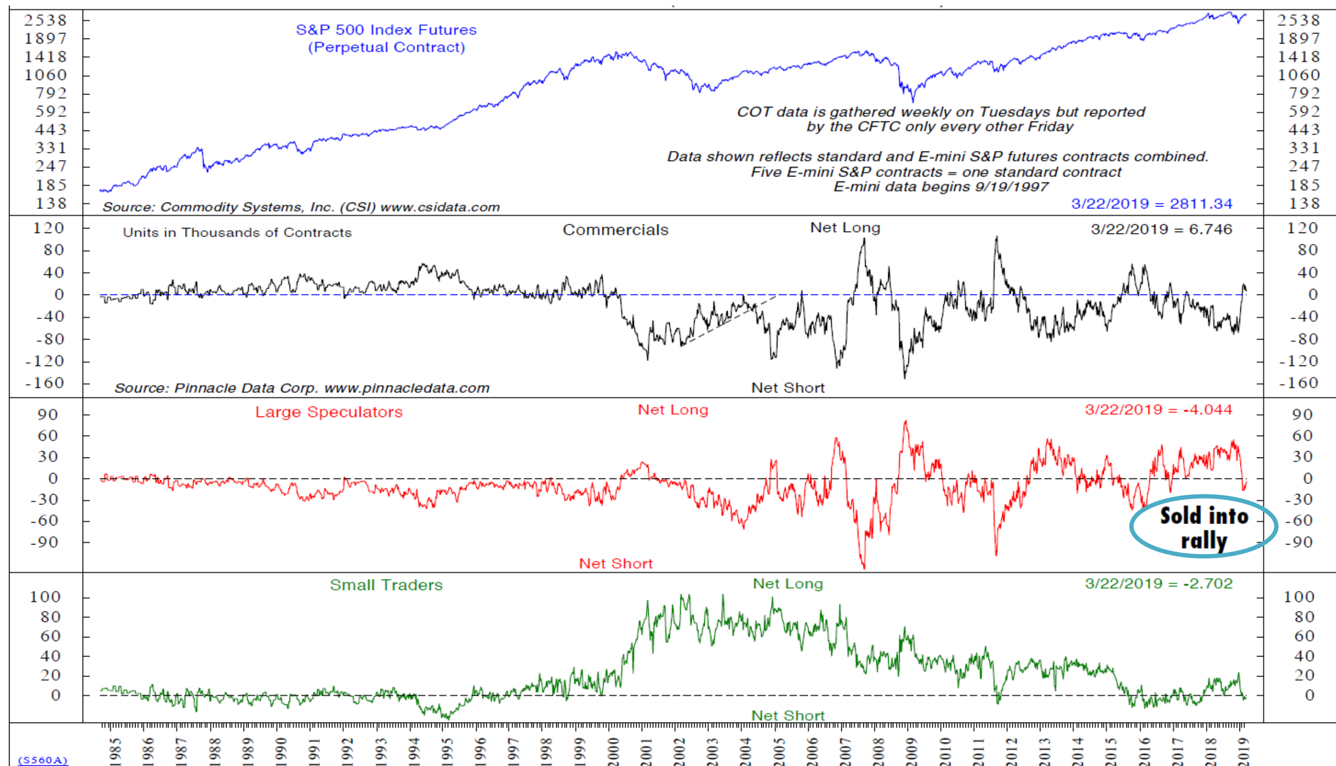
Exhibit 8
Total Net Foreign Purchases of US Bonds and Stocks



Source: Ned Davis

The bottom clip shows the near record selling of US stocks in the January reading as markets were rallying. The commitment of the traders report in Exhibit 9, shows that large speculators (read: hedge funds) also sold the rally in January into short positions.

Exhibit 9
Commitments of Traders in S&P 500 Index Futures (Combined Net Positions)



Source: Ned Davis

It is quite possible that many of these sidelined investors who missed the rally will buy the dips as history has shown when the majority of stocks participate in broad-based rallies, like we have witnessed in the first quarter., this is a healthy sign.

Peter Jackson
Chief Investment Officer
April 1, 2019

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APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

IA Financial (IAG)

IAG believes they can sustain 10% annual compound EPS growth through 2022. This compares with the previous 5 year annual CAGR of 10.96%. At the mid-point of 2019 consensus guidance the Stock trades at 8.2x 2019 EPS versus the rest of the insurance group at 9.4x. For the past three years, IAG has generated an ROE of 12.5% as compared to its current book value $47.40 and its current share price of $49 (1.03x P/BV). Companies with this level of ROE should trade north of 1.4x book value implying the stock is undervalued at current levels. Capital ratios are strong exiting 2018 and IAG's organic capital generation is expected to be $250-$300 million per year up from $200million previously, allowing it to complete its 5% normal course issuer bid (NCIB) initiated in November 2018. Current dividend yield is 3.2%. The ability to sell mortgage insurance and other life products to millennials over the next ten years should provide a decent tailwind of organic growth.

UNITED STATES

Apple Inc. (AAPL)

We think Apple is going to reignite growth by improving its customers' experience. Apple's announcement late last year that it would no longer report quarterly iPhone, iPad and Mac unit sales numbers marked an important pivot in their business. While the investment community wasn't thrilled about removing disclosure, it was an important step to nudge its internal culture to think long term, cultivate their ecosystem and act in their customers' best interest. For example, Apple is making their older phones last longer. That will hurt volumes in the short run, but the long term positives are increased number of active phones, lower churn rates, higher resale value of the phones, and the ability to sell more services to those active phones such as music and news. Those improvements could hurt short term performance and take a while to show up in their results. But we agree with their strategy and think we bought Apple opportunistically in the mean time.

Cognizant (CTSH)

Cognizant is one of the top tier IT consulting companies and will benefit from continued and expanding IT budgets as companies modernize their infrastructure. We believe Cognizant trades at an unjustified discount to some of its peers (~15x next year's earnings compared to some of its peers which trade over 20x). We think this valuation gap can narrow as it earns a higher proportion of revenues from providing more modern IT solutions such as cloud migrations, artificial intelligence applications, and new digital solutions for its customers.

Honeywell (HON)

Honeywell is one of the best positioned multi-industrial companies in North America with $37 billion in sales. After refocusing their business by spinning off lower quality and cyclical non-core assets, it is directly exposed long term thematic shifts in aviation, software, and warehouse automation. Honeywell is becoming a software industrial company, thereby reducing cyclicality in the business and expanding profit margins. The business is projected to generate returns on equity over 30% in the coming years and continuing to grow in the mid-single digits after adjusting for the recent spin outs.

Medtronic (MDT)

Medtronic is one of the world's largest medical technology companies with a presence in more than 150 countries. The company provides a number of products and services that help manage heart rhythm disorders, heart failure, coronary artery disease and heart valve disorders. Medtronic also operates within the diabetes industry offering a wide range of products including insulin pumps and glucose monitoring systems. The company has market leading positions with #1 or #2 market share positions across the majority of its business segments. Given aging demographics, its leadership position and its tremendous scale, Medtronic is well positioned to generate top line growth of 4-5% and also generate margin expansion. Medtronic currently trades at a wide discount its MedTech peers but we believe that this discount will narrow significantly as the company achieves its sales and operating margin objectives.

Nike INC (NKE)

Nike owns the best-in-class athletic footwear brand in the world and the company is very well positioned to benefit from the structural shift towards health and wellness. Nike is a highly innovative company and it has a strong track record of growing its business with a compounded annual growth rate of 7% for its revenue over the last 10 years. The company is in the process of transitioning its business towards a Direct-to-Consumer model which will have positive implications for sales, margins and returns on invested capital. Nike also has a strong presence in emerging markets with more than 30% of its sales currently generated in developing economies. China alone generates more than $5 billion in annual sales and it has more than doubled in size over the last 5 years. With a strong innovation pipeline, exposure to the growing athletic category and a margin enhancing Direct-to-Consumer model, Nike is very well positioned to grow its business for the next decade and beyond.

TJX COS INC (TJX)

TJX is the largest company in the off-price retail industry with more than 4,300 stores that operate under various banners including Winners, Marshalls, HomeSense and T.J. Maxx. The Off-price retail industry provides a significant value proposition to consumers by offering a broad assortment of high quality, brand name, and designer merchandise at prices that are generally 20% to 60% below department store prices. This value proposition has enabled the off-price retail industry to gain 5% of market share within apparel over the last decade. TJX has been a key beneficiary of this trend, which has allowed the company to grow its sales and earnings per share by 7% and 17% respectively over the last decade. We believe that TJX has a long runway of growth given its store expansion opportunities in the United States, Europe, Australia and Canada.

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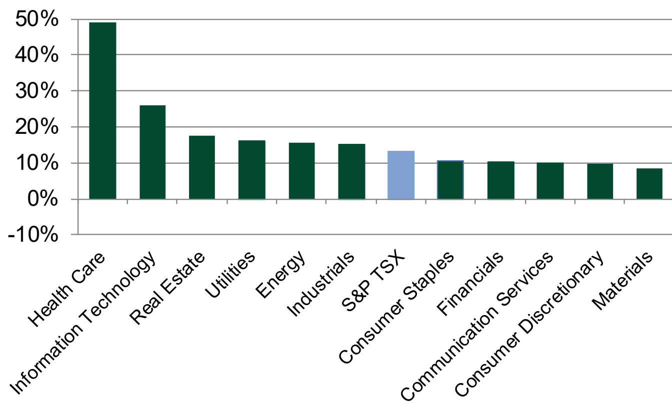
APPENDIX 2

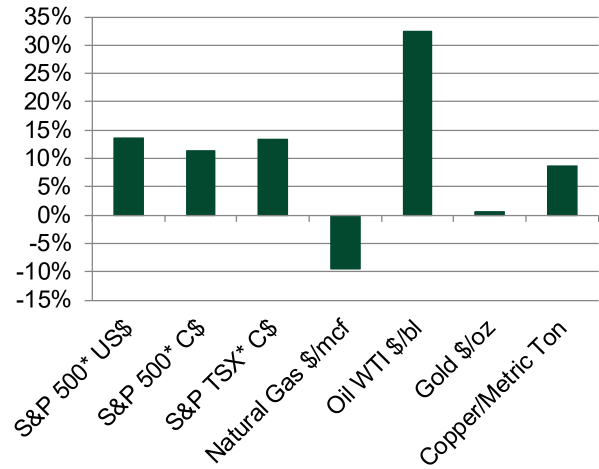
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending March 31, 2019



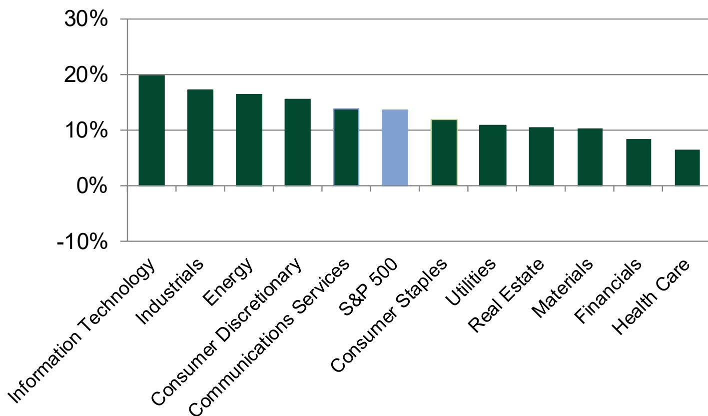
Source: TD Securities

Quarter % Change
Quarter Ending March 31, 2019



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending March 31, 2019



Source: TD Securities