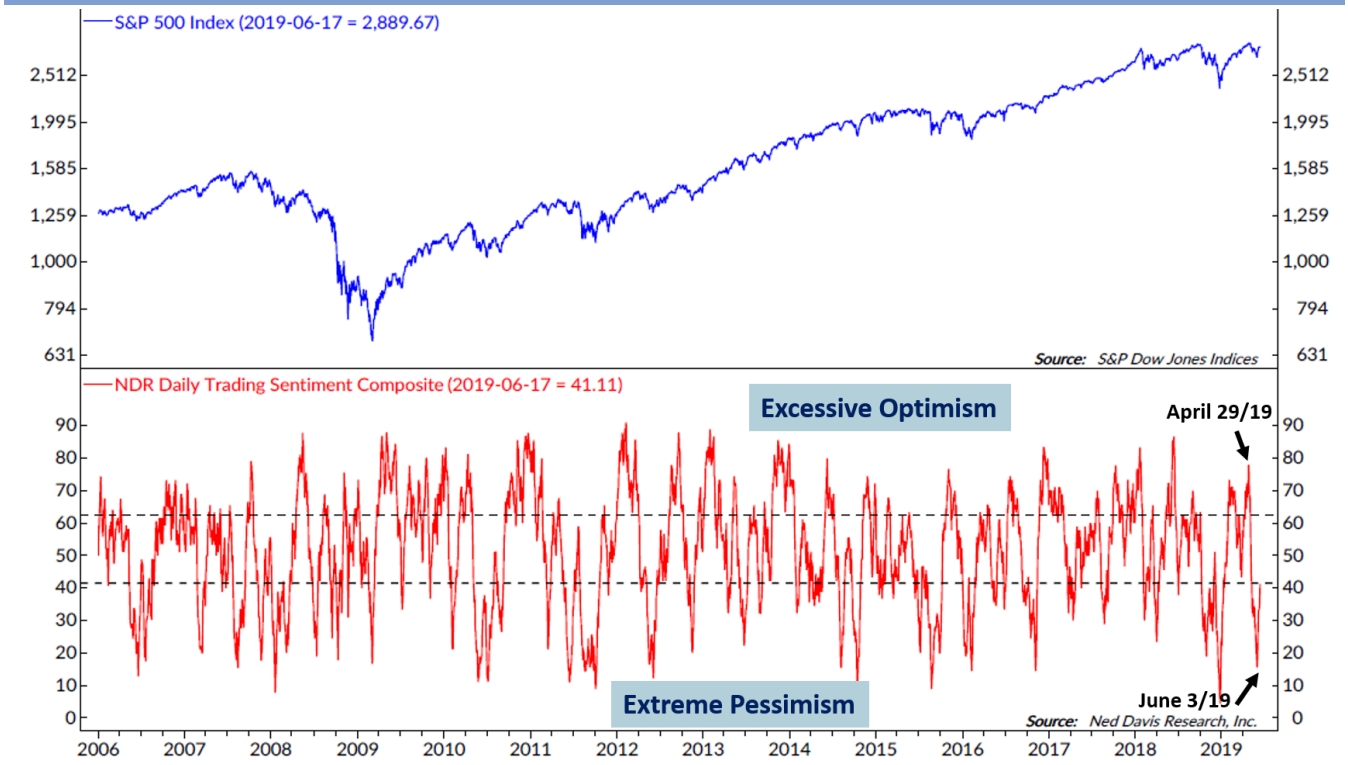
CUMBERLAND
Private Wealth

Second Quarter In Review

NORTH AMERICAN EQUITY STRATEGY

How about those Raptors!? I have to admit I am more of a Leaf fan but I definitely got on the Raptor bandwagon; after all, how often do you win an NBA championship? The S&P500 also seemed to have a bit of a bandwagon feel midway through the second quarter. After a positive move in April, the S&P500 lost, in US$ terms, almost 7% in May as trade talks were derailed and President Trump tweeted that he would raise tariffs from 10% to 25% on $200 billion worth of goods and potentially introduce tariffs on an additional $300 billion. Then there was the attempt to use tariffs as a weapon against Mexico to reduce or eliminate the number of illegal aliens crossing into the US. That was resolved quickly, but it was enough to kill the positive market sentiment from April and to send the market lower. Exhibit 1 shows the Ned Davis Short Term Sentiment Indicator. Optimism rose to 78% bullish (positive on the stock market) on April 29th, 2019 after which the stock market corrected sharply before bottoming at 16% bullish on June 3rd, 2019. We did not get on this selling bandwagon and stayed nearly fully invested. In June, the market recovered all that was lost in the previous month.

Exhibit 1
Ned Davis Short Term Sentiment Indicator



Source: Ned Davis Research

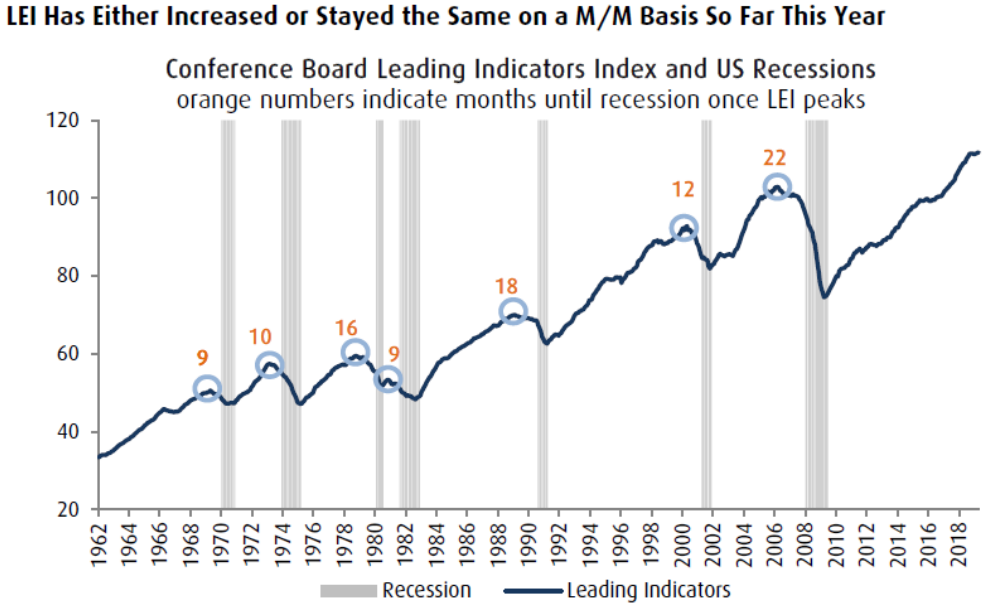
Oddly enough the June stock market recovery was tipped off by negative US payroll employment numbers for May and downward revisions for both March and April. In some way, this bad economic news was good news for the markets as it brought to bear the case for the Federal Reserve (Fed) to cut interest rates. Adding in Trump's tweet confirmation of his plans for an extended meeting with President Xi at the G-20 in Japan and the Federal Reserve's signaling on June 19th that they were ready to act given the growing risks of a slowing economy, that was enough to secure the rally in June.

During the second quarter of 2019, the S&P500 total return index was up +4.3% in US dollars. Adjusting for currency, the S&P500 returned +2.2% in Canadian dollars, as the Canadian dollar appreciated about 1.3 cents, closing the quarter at US$0.762. The TSX total return in the first quarter was +2.6%.

Staying The Course

So, what was our rationale for staying the course? One reason is that the US economy remains in pretty good shape with first quarter GDP growth running at an annualized rate of 3.1%. And despite the disappointing jobs report discussed above, the US unemployment rate is still currently at a 49-year low of 3.6%. Is it possible the low employment gains reflect the fact that there are fewer workers left to hire? Exhibit 2 compares the Conference Board Leading Indicators Index (LEI) to US Recessions going back to 1962. It shows that the LEI has peaked prior to each US recession with an average lead time of about 14 months. Yet, in the chart it can be seen that the LEI continues to remain at record highs and has yet to contract on a sequential basis in 2019. It suggests the economic cycle still has some time left. And finally, whether we consider Core CPI at 2% or Core PCE inflation (the Fed's measure of inflation) at 1.6%, both measures are in line with the Fed's long-term inflation target suggesting that the current inflation level is not a barrier to cutting rates.

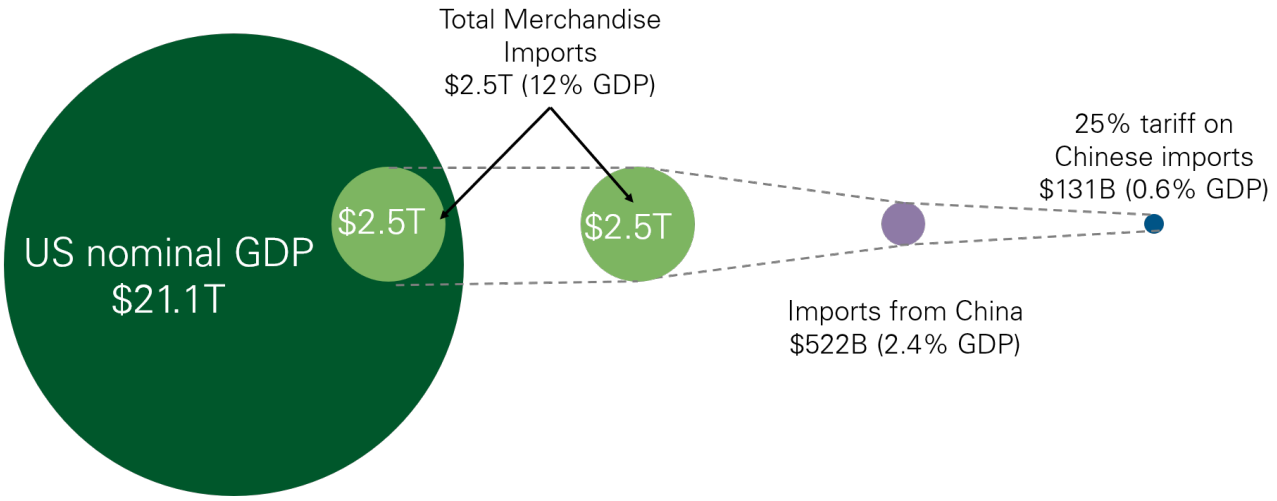
Exhibit 2
Leading Indicators Suggest Recession Is Not Imminent



Source: BMO Investment Strategy Group, Conference Board, FactSet, NBER

Regarding the trade war, in Exhibit 3 we examine the data to try to understand what impact it may have on the US GDP growth outlook. We should mention there are other factors such as currency effects that could impact the outcome (and have in the past), but let's keep the math simple. In the diagram, the large green circle represents US nominal GDP for the 12 months ending March 2019 and at $21.1 trillion it's a pretty big number. US merchandise imports represent $2.5 trillion or 12% of US GDP, and of that, imports from China at $522 billion are 21% of total imports, or 2.4% of total GDP. If we assume a full tariff of 25% on 100% of all goods imported from China is passed through in constant currency as higher import costs to the consumer, it could impact GDP growth by about 0.6%. To date, there has been little to no effect on GDP with the current tariffs in place as price reductions and China's devaluation of their own currency has provided an offset. However, if this were to come to pass, it would likely have some negative effect for the US consumer, based on these assumptions, but in our view, not enough to completely derail the US economy.

Exhibit 3
Trade War Impact on GDP Growth Expectations



Source: Yardeni Research

In terms of who has the most to gain or lose in this trade war, in Exhibit 4 we examine the data. China accounts for a very large portion (47%) of the US trade deficit and China has become much more dependent on exports to the US with US exports representing 21% of their total exports as compared to the US where exports to China only represent 7% of total exports. So, it seems clear to us that Trump's goal is to either level the playing field through resolution or move that manufacturing base somewhere else. Based on the math, there should be greater motivation on China's part to get a compromise. As we are writing this report going into the weekend of G-20, perhaps it will all be a moot point but at least you can see why the numbers do not justify selling down our investments on this data alone.

Exhibit 4
Trade War Imapct: Who Wins? Who Loses?

		% of total
China exports to US	$522 billion	21%
US exports to China	$144 billion	7%
US merchandise trade deficit	($408 billion)	
Total US merchandise trade deficit	($868 billion)	
% deficit with China	47%	

Source: Yardeni Research

The other consideration for staying the course is the outlook for earnings and valuation.

In Exhibit 5, we show a breakdown of the contribution to the second quarter total return from dividends, earnings and multiple expansion (contraction). In the case of the S&P500 total return, there was some multiple expansion (which means you are just paying more for the same earnings), however more than half of the return was from forward earnings growth and dividends. For the TSX total return, all of the contribution to the total return was from forward earnings growth and dividends as the 12m forward price earnings multiple actually contracted from 14.6x to 14.4x during the second quarter. So, the second quarter performance was not all about two markets getting a lot more expensive as there was commensurate growth in earnings and dividends at the same time. Generally, we are constructive on the markets if we see that and valuations are not too high. If we look out to 2020, S&P500 and TSX' earnings are expected to grow about 11% and 8%, respectively. With the S&P500 trading at 15.8x 2020 earnings and the TSX at only 13.9x, that is not too expensive compared to the ten year average for the S&P500 at 15.0x and very cheap compared to the ten year average for the TSX at 14.8x.

Exhibit 5
Contribution to Second Quarter TOTAL Return

SPX

	Price	Dividends	Total Return	EPS (Fwd 12m)	P/E (Fwd 12m)	P/E 2020	Aug 10 yr P/E
2019-03-29	2,834.40		5,664.46	172.05	16.47		
2019-06-28	2,941.76		5,908.25	174.99	16.81		
						15.8x	15.0x
% Change	3.79%	0.52%	4.30%	1.71%	2.05%		

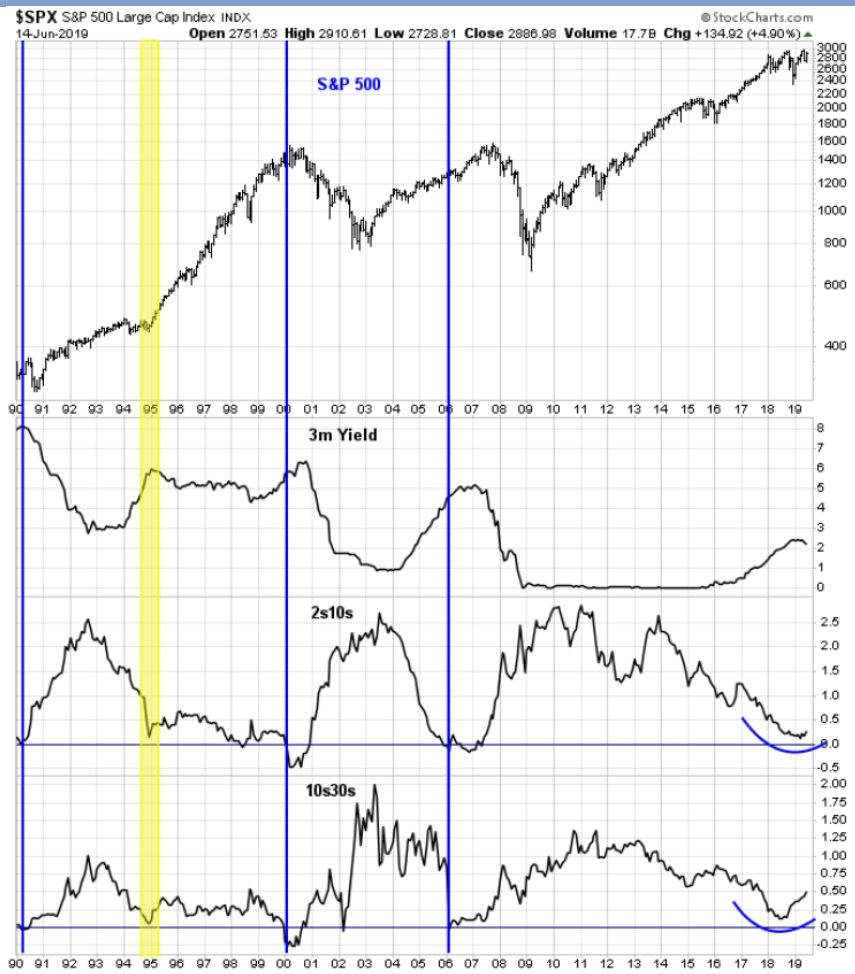
SPTSX

	Price	Dividends	Total Return	BEst EPS (Fwd 12m)	BEst P/E (Fwd 12m)	P/E 2020	Aug 10 yr P/E
2019-03-29	16,102.09		55,745.50	1102.60	14.60		
2019-06-28	16,382.20		57,186.51	1136.74	14.41		
						13.9x	14.8x
% Change	1.74%	0.85%	2.58%	3.10%	-1.32%		

Source: Bloomberg

Having said all that, going forward there is justification for multiple expansion as well, particularly in an environment where the Fed could provide a precautionary interest rate cut as insurance against any further economic weakness caused by uncertainty around a protracted trade dispute. Currently there is a100% chance implied by the market for a least one rate cut (and a 20% chance for two) at the next Federal Open Market Committee (FOMC) meeting at the end of July. If history is any indication, then perhaps "an insurance rate cut" or two may be enough to help keep this bull market intact. Exhibit 6 compares today's yield curves, which have not inverted for 2-10s and 10-30s curves, to the same period in 1995 when the Federal reserve provided similar insurance in the form of three rate cuts. Also shown in the chart are the 2000 and 2007 periods where the yield curve had inverted, and it was too late for a precautionary rate cut. The top clip shows how the S&P500 performed and as indicated, it continued its run for another 5 years. When one considers the chaotic nature of these trade negotiations such that even a fully agreed to trade deal by both sides can be unwound with one tweet, a precautionary rate cut makes sense to us.

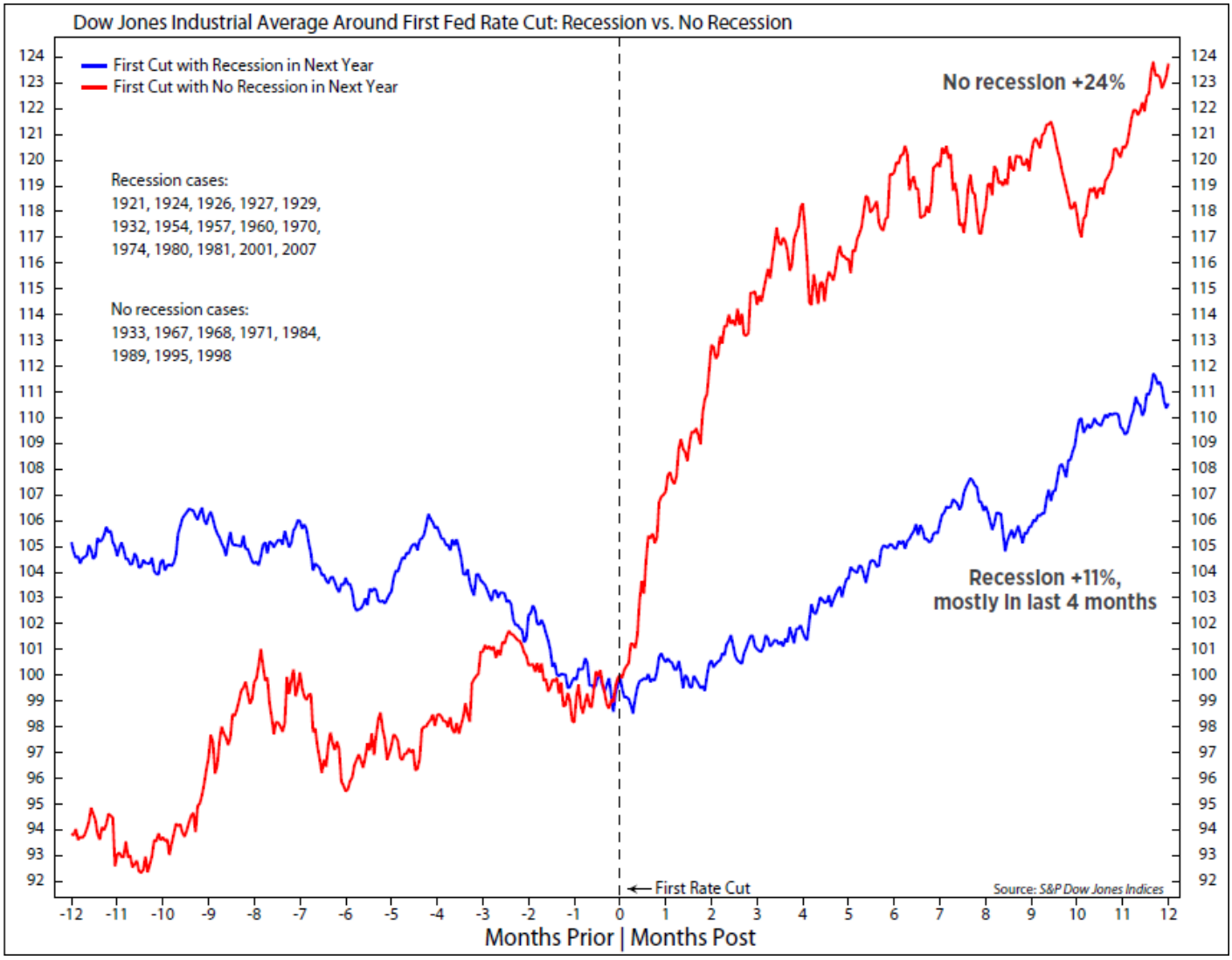
Exhibit 6
The S&P 500 and Yield Curves



Source: Pennock Idea Hub, Stockcharts

Exhibit 7 shows the historical market reaction around the first Fed rate cut going back to the 1920's. The chart highlights both recession and non-recession periods. In the year before the first rate cut, the Dow Jones Industrial Average (DJIA) was up 6.6% in non-recession cases and down 7.1% during recession cases. As the DJIA is currently up 9.6% in the past year and we are not currently in a recession, it would suggest the non-recession scenario applies where the DJIA was up 7 out of 8 times with an average gain of almost 24% one year after the first rate cut. Exhibit 8 shows historical impact on valuation multiples, which again just confirms that historically, forward P/E's expand on average 1.7x, six months after the first rate cut during non-recessionary periods.

Exhibit 7
Rate Cuts Especially Friendly Without Recessions



Source: Ned Davis Research

Exhibit 8
Stocks Have Performed Well After the First Non-Recessionary Rate Cut

Figure: Initial Fed rate cuts and resulting forward market returns and NTM PE delta
Since 1971

	First rate cut of year	Recession period	Rate change	Forward Return (months from cut) 3M	6M	9M	12M	NTM PE Delta (months from cut) 3M	6M	9M	12M
1	1/13/1971	No	(50bp)	11.3%	8.9%	7.3%	11.8%	1.8x	0.9x	(0.0x)	0.2x
2	7/6/1974	Yes	(375bp)	(25.5%)	(16.1%)	(1.5%)	13.4%	(2.3x)	(0.7x)	1.4x	2.1x
3	4/22/1980	Yes	(850bp)	18.4%	27.2%	30.3%	30.2%	1.6x	2.1x	2.0x	1.9x
4	6/17/1981	Yes	(450bp)	(10.2%)	(7.9%)	(18.5%)	(16.6%)	(1.4x)	(0.0x)	(0.8x)	0.2x
5	10/2/1984	No	(175bp)	2.2%	10.4%	17.3%	10.8%	0.6x	1.4x	3.0x	2.3x
6	10/19/1987	No	(37bp)	12.1%	15.5%	21.0%	22.4%	0.9x	0.7x	0.6x	0.7x
7	7/6/1989	No	(38bp)	11.0%	11.9%	5.3%	11.3%	1.8x	2.7x	1.7x	2.9x
8	7/6/1995	No	(25bp)	5.0%	12.0%	18.0%	21.1%	0.5x	1.4x	1.1x	1.4x
9	9/29/1998	No	(25bp)	16.8%	22.3%	25.4%	21.8%	3.0x	3.0x	2.7x	1.1x
10	1/31/2001	Yes	(50bp)	(7.3%)	(11.8%)	(19.1%)	(17.0%)	(1.6x)	(4.0x)	(7.3x)	(7.1x)
11	9/18/2007	Yes	(50bp)	(4.9%)	(15.2%)	(10.5%)	(17.6%)	(0.6x)	(1.9x)	(1.3x)	(2.2x)
	All Periods										
	Average		(193bp)	2.6%	5.2%	6.8%	8.3%	0.4x	0.5x	0.3x	0.3x
	Median		(50bp)	5.0%	10.4%	7.3%	11.8%	0.6x	0.9x	1.1x	1.1x
	Win Ratio			63.6%	63.6%	63.6%	72.7%				
	Expansionary Periods										
	Average		(58bp)	9.7%	13.5%	15.7%	16.5%	1.4x	1.7x	1.5x	1.4x
	Median		(38bp)	11.1%	12.0%	17.6%	16.4%	1.3x	1.4x	1.4x	1.3x
	Win Ratio			100.0%	100.0%	100.0%	100.0%				
	Recessionary Periods										
	Average		(355bp)	(5.9%)	(4.8%)	(3.9%)	(1.5%)	(0.9x)	(0.9x)	(1.2x)	(1.0x)
	Median		(375bp)	(7.3%)	(11.8%)	(10.5%)	(16.6%)	(1.4x)	(0.7x)	(0.8x)	0.2x
	Win Ratio			20.0%	20.0%	20.0%	40.0%				

Source: Fundstrat, Bloomberg, Factset

1.7x NTM P/E expansion over 6 months following initial rate cut during expansionary periods

Source: Pennock Idea Hub, Fundstrat

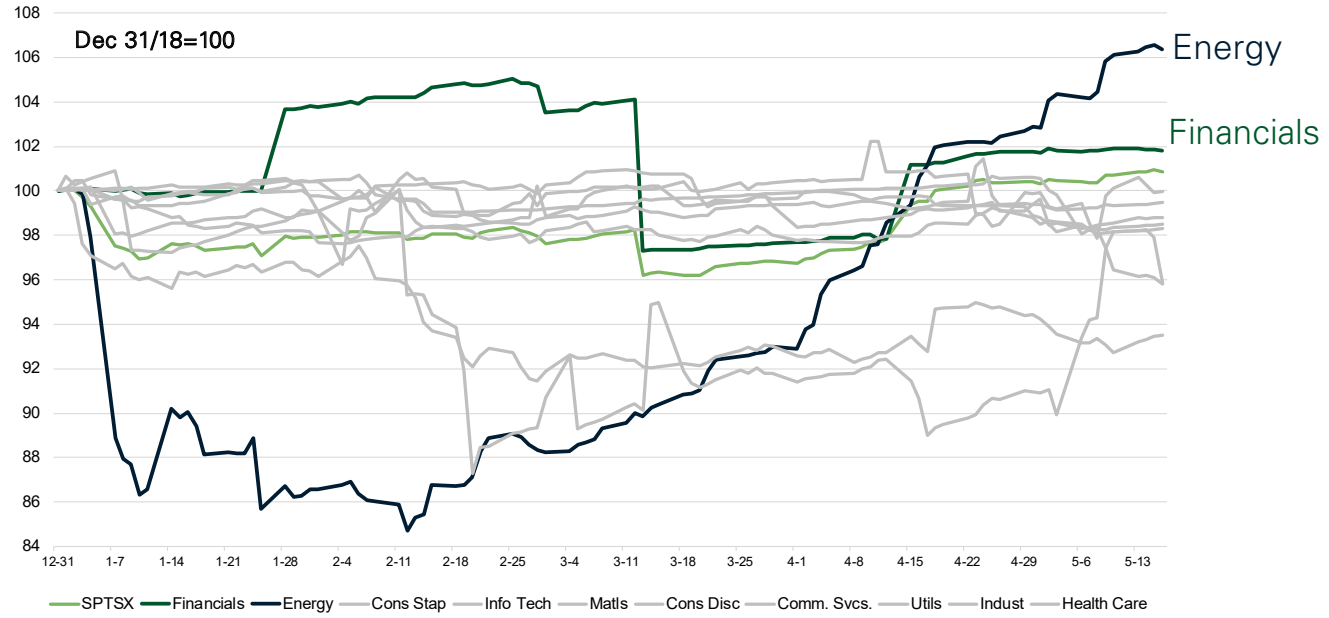
Asset Allocation for our North American Capital Appreciation Strategy
As at June 30, 2019

Equities	93 %
Fixed Income	1 %
Cash	6 %

During the quarter our overall equity exposure rose 1% to 93% from 92% at March 31st, 2019. Our exposure to US equities declined slightly from 45% to 44% and our exposure to Canadian equites increased slightly from 47% to 49%. As discussed in our previous quarterly, the TSX continues to remain the cheapest market from a valuation perspective with lowest P/E relative to its ten-year average. Both markets however continue to display positive forward earnings momentum in an environment of lower short-term interest rates, which should bode well for continued upward price momentum. Our exposure to short term bonds was unchanged at 1% and cash decreased slightly from 7% to 6%. There were no major shifts in sector

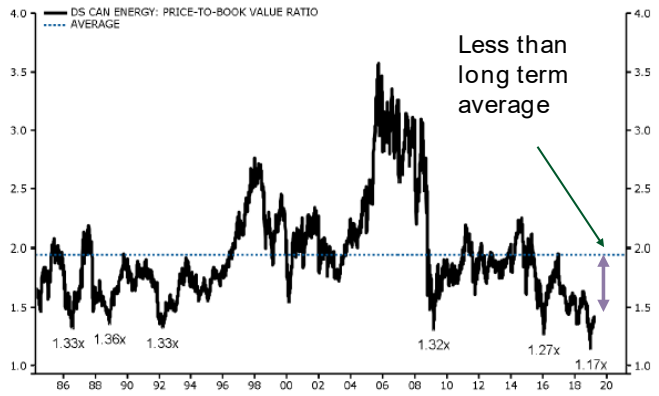
weights during the quarter. In Canada, our largest exposures remain Financials and Energy. Exhibit 9 compares TSX earnings growth by sector so far in 2019. Recent firming of Western Canadian Select oil prices in the first half of 2019 and stable downstream refining margins is driving positive earnings estimate revisions in Energy. Also, Financials have seen an improvement in estimate revisions after the first quarter in which most Canadian banks missed consensus expectations. Exhibit 10 and 11 show that in both cases, Canadian Energy and Canadian banks continue to trade at large valuation discounts relative to their long-term averages. We added to Imperial Oil and Suncor during the second quarter and continue to be well represented in the Canadian banks with positions in Royal Bank, TD Bank, Bank of Nova Scotia and National Bank. We also added two new positions on the US side of the portfolio including Thermo Fisher Scientific, which has performed well so far due to a recent upgrade by the company to its long-term revenue growth targets and Fortive Corp, which was added very late in the quarter. A complete review of each of these companies' business and fundamental outlook can be found in Appendix 1.

Exhibit 9
TSX Sector Earnings Growth YTD



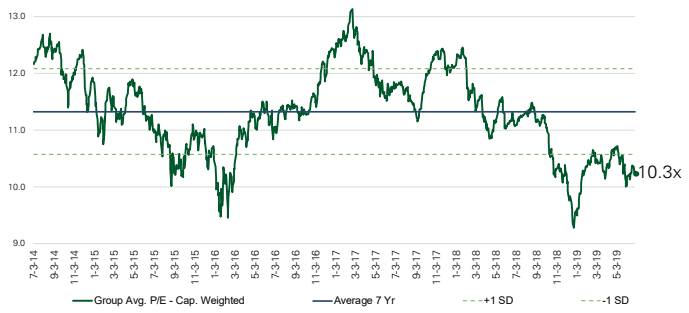
Source: Bloomberg

Exhibit 10
Canadian Energy: Valuation Near Historical Lows



Source: Bloomberg

Exhibit 11
Canadian Banks - Group Forward P/E



Source: S&P Capital IQ

Outlook

It seems there are more moving parts right now with the ongoing trade talks and the potential policy change at hand at the upcoming Fed meeting at the end of July, adding another level of continued uncertainty. However, as outlined above, we have continued to stay the course (being close to fully invested), as we just don't think the trade talks on their own are enough to derail the US economy. Growth and employment news out of Canada recently has also been generally more positive and certainly not been recessionary by any means. The latest jobs data in the US may be indicative of slowing growth, however at the same time, it has also given the Fed the ammunition to be more accommodative and this has historically been good for stocks. Meanwhile the outlook for forward earnings growth remains positive and the valuation for the S&P500 has room to move higher, especially if the Fed cuts rates. The TSX remains dirt cheap whether you analyze it on relative historical price earnings multiple, dividend yield or equity risk premium implied return. All our models are signaling a Buy for this market. In summary, we did not get on the negative bandwagon this past quarter. However, as the situation evolves and if markets overshoot, we are prepared to apply the full-court press, so to speak, and step to the sidelines.

Peter Jackson
Chief Investment Officer
July 1, 2019

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

UNITED STATES

Fortive Corp. (FTV)

As a spin off from Danaher, Fortive offers investors another chance to own one of the best performing stocks over the last several decades. Fortive is comprised of Danaher's industrial assets, where there is more room for innovation and disruption. Since the spin off Fortive has deployed more than $7 billion on acquisitions. Getting involved with the stock now gives investors an opportunity to own Fortive ahead of the M&A synergies that will play out over the years ahead. Fortive is highly acquisitive and looks for underperforming assets where there is an opportunity to significantly improve margins. The "secret sauce" is its Fortive Business System (FBS), which drives out costs and focuses on continuous improvement. Danaher grew tremendously under this model and it is deeply embedded in Fortive's culture under the leadership of CEO Jim Lico.

Thermo Fisher Scientific (TMO)

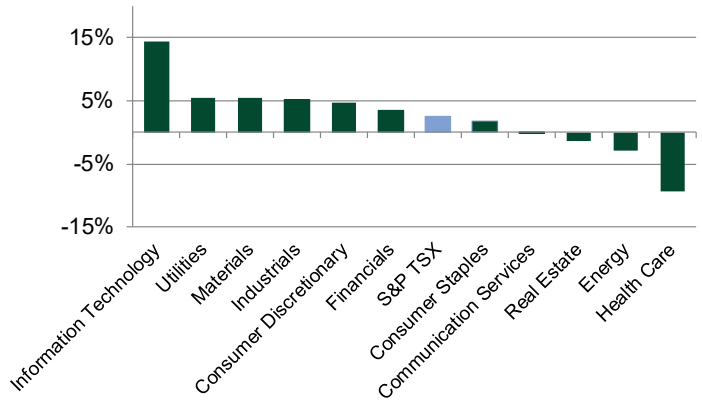
Thermo Fisher Scientific is a leading supplier to pharmaceutical and biotech companies, labs, hospitals, and universities. Its mission is to enable its customers to make the world healthier, cleaner and safer. Its products include instruments, laboratory equipment, diagnostic devices, software, chemicals, and other consumables. Its brands include Thermo Scientific, Applied Biosystems, Invitrogen, Fisher Scientific and Unity Lab Services.

Thermo Fisher's competitive advantage is its scale of production, large sales force, and broad product offerings which appeal to its customers looking to simplify their procurement processes. Further, Thermo's dominant product lines have significant switching costs and, once installed, provide a recurring stream of revenue from service and consumables.

APPENDIX 2

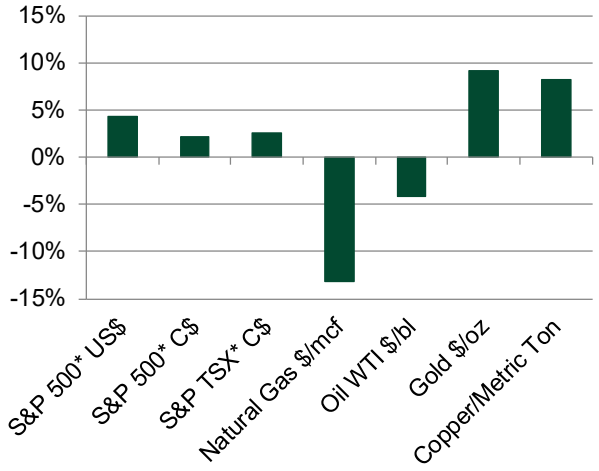
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending June 30, 2019



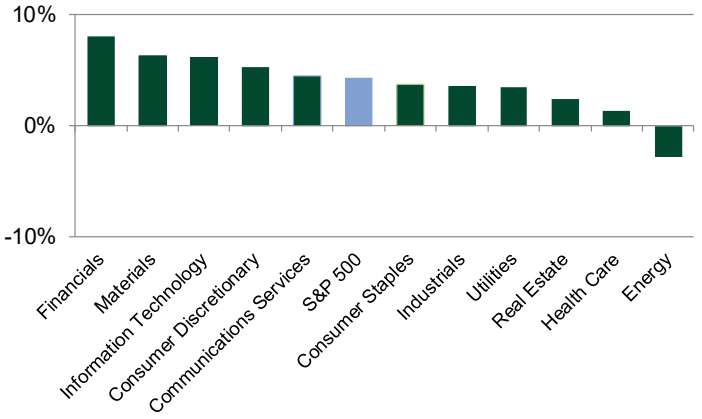
Source: TD Securities

Quarter % Change
Quarter Ending June 30, 2019



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending June 30, 2019



Source: TD Securities