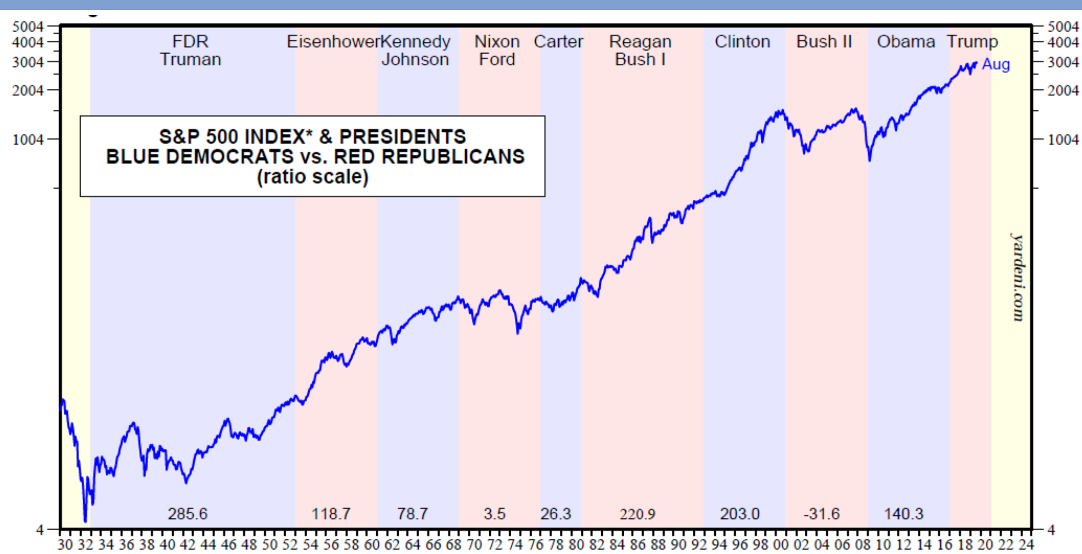
Third Quarter In Review

NORTH AMERICAN EQUITY STRATEGY

At our recent investment meeting a discussion ensued about the fact that Elizabeth Warren had taken over as frontrunner in the Democrats' race for US president. I think the general consensus is that Trump will win again in 2020, but you probably would have said that about Hillary Clinton three years ago at this point in the race. A Warren President would likely mean higher taxes, more regulation and perhaps some form of Medicare for all. It would probably be the opposite of a Trump second term, meaning more uncertainty for the markets surrounding the electoral outcome.

That sounds bad, but remember how the stock market was supposed to sell off if Trump got elected? That lasted about three hours. Anyway, the election is still over a year away and a lot can happen between now and then so it's too early to assess what the impact will be on the market. Then there is the Trump impeachment inquiry in the House of Representatives. Never say never, but this looks highly unlikely because even if this did pass through the House, it would require at least 20 Senate Republicans to vote against Trump to remove him from the Whitehouse, as a conviction requires a 2/3 majority Senate vote. As indicated in Exhibit 1, bull markets have survived many presidents both Democratic and Republican, but no doubt there will probably be a lot of negative predictions between now and November 2020. At least we have history on our side.

Exhibit 1
Do Politics Matter in the Stock Market?



* End-of-month daily data through 8/31/2016.
Note: Blue (red) shades represents Democrats (Republicans) in White House. Data above timeline are percentage changes in S&P 500 for each shade.
Source: Standard & Poor's Corporation.

Source: Yardeni Research

Third Quarter Review

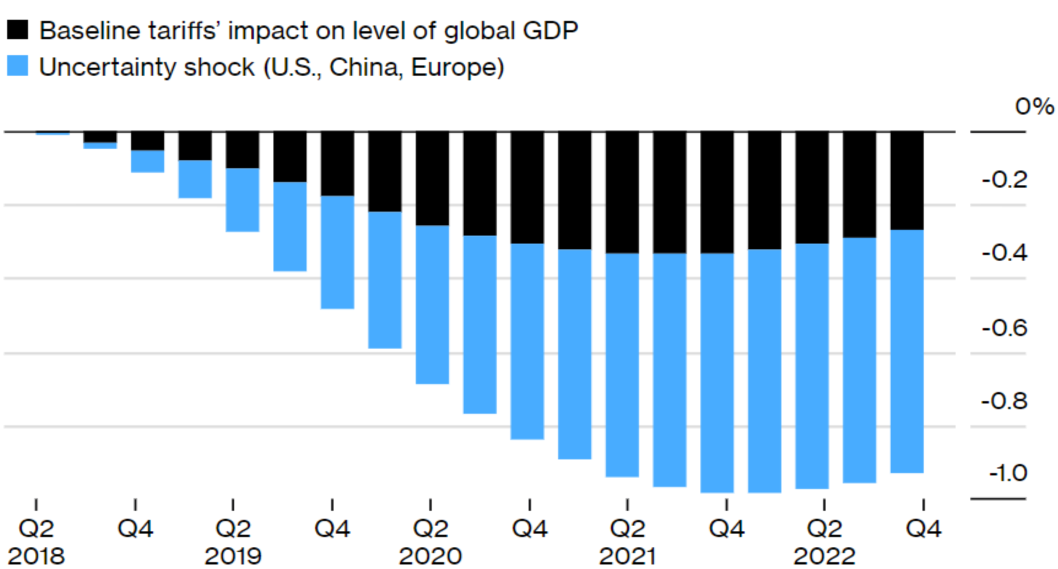
As for the third quarter of this year, in our view three significant developments occurred that could impact the economic outlook and financial markets. We will try to address each one of them.

Tarrifs

The first was the August 1st announcement of additional tariffs on the remaining $300bn of goods imported from China to take effect in September. In our second quarter review we went through our calculation of the impact that a full-blown trade war, or tariffs of 25% on about $500 billion worth of goods exported from China to the US, could have on US GDP growth. We estimated the hit to US GDP growth, assuming constant currency (which is not the case but a reasonable estimation) could be about 0.6% on the Federal Reserve's latest estimate of 2019 GDP growth of 2.2%. In terms of who has the most to gain or lose in this trade war, as we also discussed, China accounts for a very large portion (47%) of the US trade deficit and China has become much more dependent on China exports to the US, which represent 21% of their total exports as compared to US exports to China, which represent only 7% of total US exports. Based on this alone, the motivation for China to get a compromise should be there. What's unnerving is any news that delays the negotiation creates uncertainty or volatility in capital markets that is not easily quantifiable.

Exhibit 2 shows that the overall cost to Global GDP of the trade war impact as estimated by Bloomberg economics, shown in black, and it is not even as much as we estimated for the impact to US GDP of 0.6%. However, they estimate the uncertainty shock to global GDP (shown in the blue bars) could be twice as much.

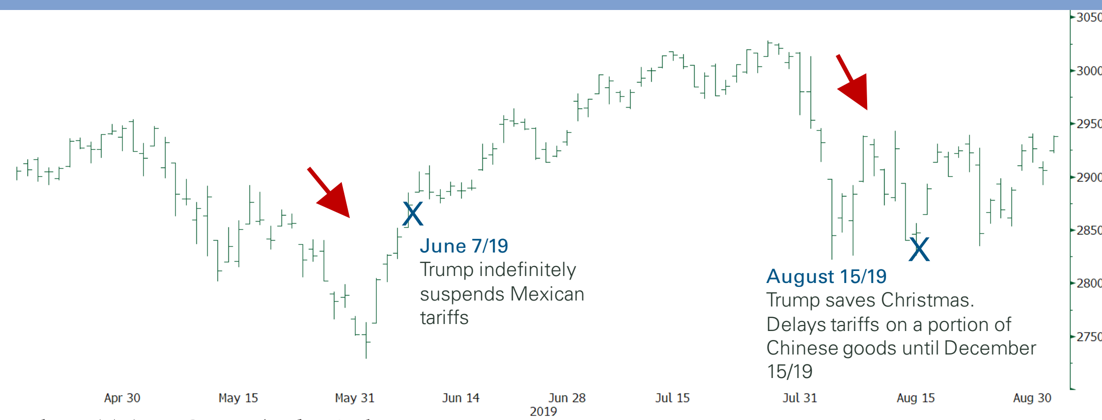
Exhibit 2
Trade War Impact: The Cost of Uncertainty



Source: Bloomberg, Nigem, Pennock Idea Hub

The good news is that so far President Trump seems to have the market's back as he has developed a history of reacting to stock market weaknesses as shown in Exhibit 3.

Exhibit 3
Trade War Impact: Tariff Man Reacts to Market Weakness



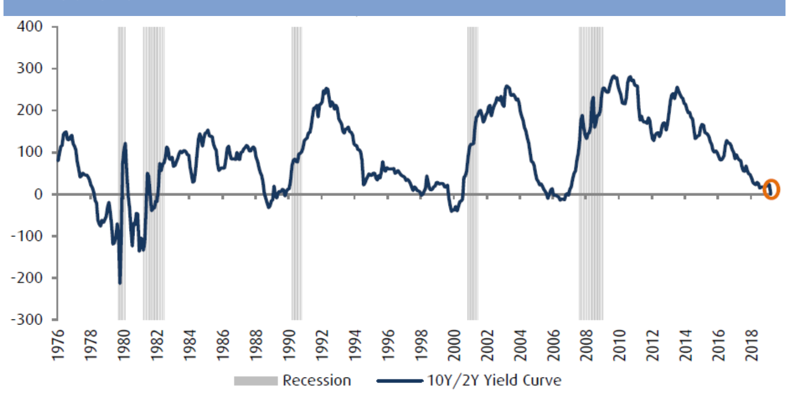
Source: Bloomberg, Twitter, Pennock Idea Hub

We saw this on June 5th when he indefinitely suspended the implementation of Mexican tariffs and on August 13th when he apparently saved Christmas by postponing the full implementation of tariffs on September 1st on a portion the remaining $300mm of imported goods from China. Arguably, the cause of the stock market selloff in both cases was somewhat Trump-induced, however his subsequent tweets resulted in an immediate rally in the S&P500. So, while there is definitely uncertainty out there, the most powerful man in the world appears to be on the side of investors, which is a good thing.

Yield Curve Inversion

The second development was the 10 year / 2 year yield curve inversion, the first since 2005. Exhibit 4 shows similar periods of yield curve inversions going back to the mid -1970's. The historical significance of this cannot be ignored, as indicated by the grey bars in this chart, which show each yield curve inversion going back to the 70's preceded a recession. However, if a recession does happen this time, it will go down as probably one of the most expected slowdowns in history.

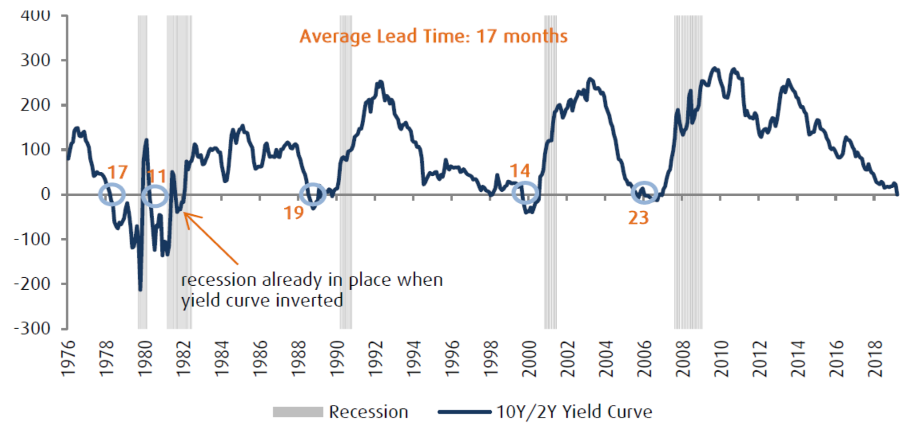
Exhibit 4
BRIEF 10Y/2Y Yield Curve Inversion Has Scared Investors



Source: BMO Capital Markets

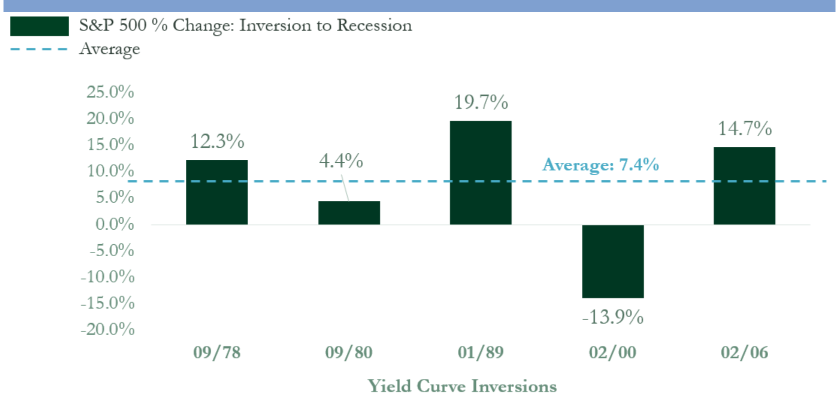
Having said that, history also shows, as indicated in Exhibit 5, that it typically takes 17 months before a recession begins after a yield curve inversion and the lead time is about 15 months on average before the start of a bear market.

Exhibit 5
Yield Curve Inversion: US10Y/2Y Yield Curve and Recessions
Orange numbers indicate months until recession once yield curve inverts



Source: BMO Capital Markets

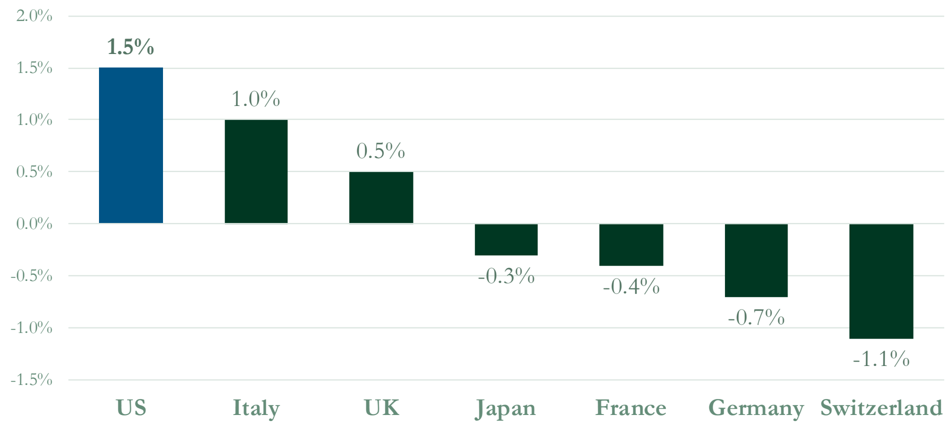
Exhibit 6
S&P 500 Price From 10Y/2Y Yield Curve Inversion to Start of US Recession
Based on monthly data beginning in 1976



Source: BMO Capital Markets

Exhibit 6 shows that during this time period, the historical average performance of the S&P500 before the recession begins has been +7.4%. So, while there is downside risk of being in the market if there is a recession, there is also opportunity cost of being completely out of the market based on historical precedence especially if there is no recession. And, not that we want to say it is different this time, as indicated Exhibit 7, interest rates were negative across most of the world such that in total about $14 trillion of negative yielding global securities are potentially weighing on more attractive positive US yields.

Exhibit 7
Yield Curve Inversion: Global 10-Year Yields



Source: Credit Suisse

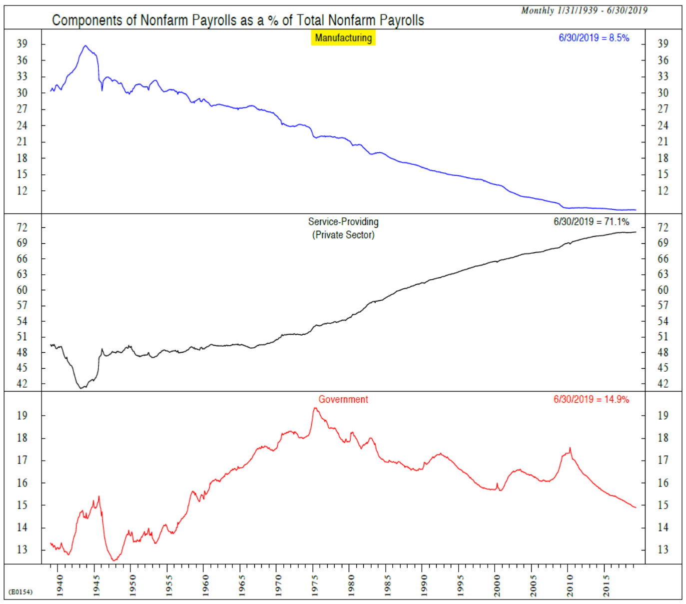
This raises the question of whether this has influenced global Investors to switch into US treasuries causing the recent US yield curve inversion. In terms of the flow of funds, both mutual fund and ETF bond purchases in the US were over $75 billion this summer, up from $40 billion in June and $20 billion in May. So, given rates are so low globally, these other technical factors could be influencing the shape of the US yield curve.

Interest Rates

The third development of significance was that on July 31st, the Federal Reserve cut interest rates for the first time since 2008 and followed this with a second "insurance" rate cut in September as Chairman Powell, referred to it in his opening statement at his press conference that day. On the positive side of his speech, Chairman Powell sighted robust household spending supported by strong job growth and an unemployment rate at half century lows, as well as rising incomes and solid consumer confidence offset by weakening business investment and exports amid falling manufacturing output caused by slower growth abroad and trade policy uncertainty.

There's that "uncertainty" word again, and let's face it, US manufacturing is slowing if the latest Purchasing Managers Index (PMI) data is any indication. However, we would argue that given the average US consumer still has a job and that consumption represents 70% of US GDP, as long as they are employed, the likelihood of a recession is low. Exhibit 8 and 9 look at manufacturing's share of employment and GDP going back to the 1940's and 1950's, respectively.

Exhibit 8
Manufacturing's Share of Employment Near a Record Low

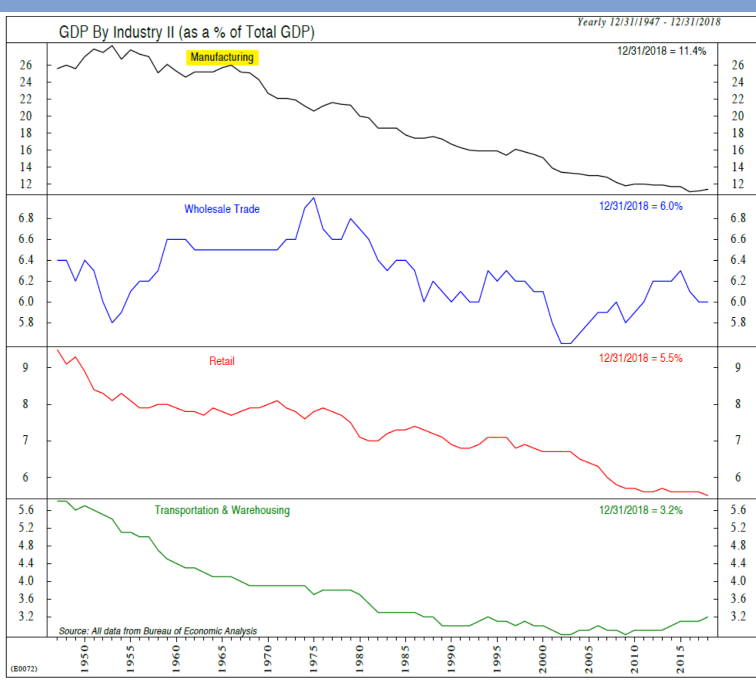


Source: Ned Davis Research

Manufacturing's share of payrolls has tumbled from 38.8% in 1943 to 8.5%.

As indicated in Exhibit 8, manufacturing's share of payrolls has declined from 38.8% in 1943 to 8.5% today and manufacturing's share of the economy has slid from a peak in 1953 at 28.3% to 11.4% today.

Exhibit 9
Manufacturing's Share of GDP close to a Record Low



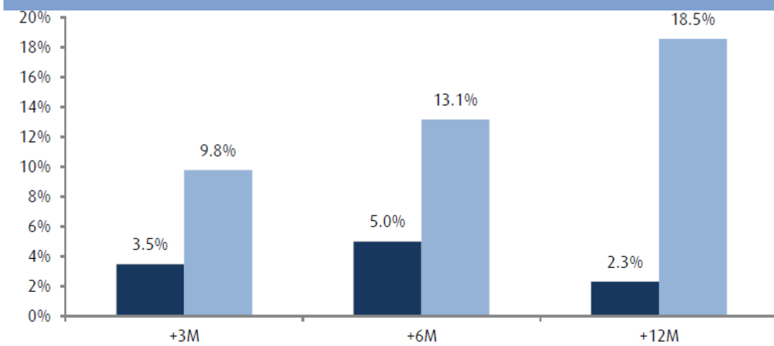
Source: Ned Davis Research

Manufacturing's share of US economy has slid from a peak of 28.3% in 1953 to 11.4%.

Both are still important, however; compared to the services sector of employment growth where spending on such things as intellectual property has grown from 7% to 34% of all nonresidential investment spending over roughly the same time period, manufacturing may not be as important as in the past. Besides, spending on intellectual property is something businesses are afraid to cut for fear of falling behind. The bottom line is that we are watching the manufacturing PMI's drift lower but we are not that concerned about it unless it begins to spill over into the services side of the equation.

Exhibit 10 shows average performance for the S&P500 since the mid 1980's following two interest rate cuts. The dark bars represent all periods while the light blue bars represent non-recessions periods only, the difference being the dark blue average performance includes the 2008 great financial crisis and the 2000 Nasdaq Tech-wreck, neither of which seem relevant today. If history is any indicator, then in the non-recession case (light blue bars), it implies potentially double-digit upside over the next twelve months.

Exhibit 10
S&P500 Average Price Performance Following Second Fed Rate Cut
since 1985; 1988, 1995, and 1998 were non-recession cuts



Source: BMO Capital Markets

Portfolio Review

In Exhibit 11 we break down the historical performance by industry sector for the S&P500 12 months after the first interest rate cut going back to the 1970's. This combines both the recession and non-recession cases and depending on whether or not the economy is in a recession, the performance outcome by sector has historically been different with the exception of two sectors that have consistently outperformed regardless of the economic environment: Consumer Staples and Health Care which have outperformed 78% of the time.

Exhibit 11
Performance 12 Months After First Rate Cut

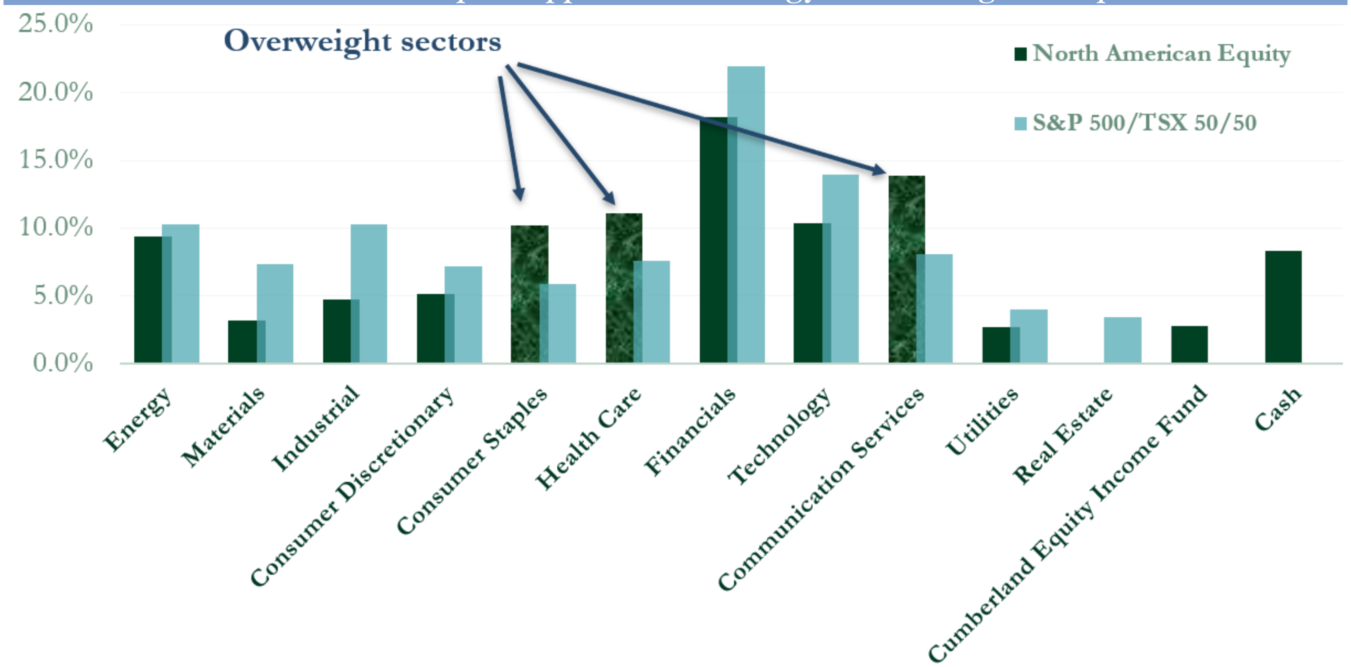
S&P 500 Sector	All Cases Median Return (%)	% Outperform
Consumer Staples	25.7	78
Health Care	22.7	78
Industrials	21.2	67
Consumer Discretionary	20.2	67
Financials	14.1	56
Communication Services	15.8	44
Information Technology	10.9	44
Energy	10.5	44
Materials	4.4	44
Utilities	5.9	22
S&P500 Index	19.0	

Consistent outperformance Recession /No Recession

Source: Ned Davis Research

These represent two of the three sectors we are currently overweight at this time in the Cumberland North American Capital Appreciation strategy, as shown in Exhibit 12. Our third sector overweight is Communication Services, which is defensive and historically has performed well in an economic downturn and should help in the event we find ourselves in that scenario.

Exhibit 12
Cumberland North American Capital Appreciation Strategy: Sector Weight Comparison



During the third quarter of 2019, the S&P500 total return index was up +1.7% in US dollars. Adjusting for currency, the S&P500 returned +2.9% in Canadian dollars, as the Canadian dollar depreciated about 0.8 cents, closing the quarter at US$0.755. The TSX total return in the third quarter was +2.5%. For the first nine months of 2019, the S&P500 total return index was up 20.6% in US dollars. Adjusting for currency, the S&P500 returned 17.0% in Canadian dollars as the Canadian dollar appreciated about 2.1 cents since December 31st, 2018.The TSX total return for the nine months was 19.1%.

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

Equities	89%
Fixed Income	0%
Cash	11%

During the quarter, our overall equity exposure was reduced by 4% to 89% from 93% at June 30th, 2019. Our exposure to US equities was unchanged at 44% and our exposure to Canadian equites declined from 49% to 45% partly reflecting the strength in the US dollar, which skewed the US equity weight higher relative to Canada during the quarter and the trimming of one position in Canada that was close to full value.

Exhibit 13
Cumberland North American Capital Appreciation Strategy: Earnings Growth & Valuation

Earnings Growth			
	2019/2018	**2020/2019**	
S&P 500	2.4%	10.5%	
TSX	4.5%	8.7%	
Forward P/E - Valuation			
	2019	**2020**	**10-yr Average**
S&P 500	18.2x	16.4x	15.0x
TSX	15.5x	14.3x	14.7x

Source: Bloomberg, Factset, TD Securities

In Exhibit 13, we review earnings growth and valuation for the S&P 500 and TSX. Here it is evident that earnings growth has slowed to low/mid-single digit in 2019 from 2018. This is due to a number of factors including the lapping of US tax reform last year which added 7% to 9% to 2018 earnings, the strength of the US dollar, which hurts US companies with international earnings repatriated back to the US, lower commodity prices and the impact from trade war concerns. However, consensus estimates are expected to improve into 2020 as we potentially lap some of these one-time issues. Furthermore, any resolution on the trade front would no doubt be greeted by the market positively.

In the bottom clip of Exhibit 13, we see valuations also look better in 2020 compared to 2019 and relative to the long-term averages shown on the bottom right. We would characterize the S&P 500 earnings valuation at 16.4x next year's earnings as not super cheap relative to the ten-year averages but not overvalued either given the double-digit earnings growth outlook for 2020. And considering that we still have a fairly strong economy, at least adjusted for the weaker manufacturing sector, an accommodative Fed and a President that seems to want the stock market higher rather than lower, it's a strong combination of positive tailwinds.

The TSX continues to trade at a substantial discount relative to the S&P 500 and even its own historical average, again shown in the bottom clip in Exhibit 13. The TSX earnings growth rate for 2020 of 8.7% remains quite attractive although not as high as the S&P500.

During the quarter we added two new positions on the US side of the portfolio including, PepsiCo Inc. and Diageo PLC, both of which complement our strategy of overweighting the Consumer Staples sector which, as discussed, has a strong historical record of outperformance at this point in the cycle. A complete review of each company's business and fundamental outlook that was purchased in the quarter can be found in Appendix 1.

Outlook

We are aware that the economic backdrop is mixed; however, it is not enough of a negative at this point to change our overall constructive view. Forward earnings momentum for the S&P 500 is positive and this is a critical component of our investment strategy. The valuation, quality and risk characteristics of the Cumberland North American Capital Appreciation Strategy also remain favourable relative to our respective benchmarks as outlined in Exhibit 14. So, given the positive outlook for earnings and the positioning of the two most critical people that can influence the direction of the stock market (Fed Chair Powel and President Trump) appear to be on the side of the market we will continue to stay the course with the proviso that if the economic situation deteriorates further we are prepared to move to the sidelines.

Exhibit 14
Cumberland North American Capital Appreciation Strategy: Portfolio Comparison to Benchmark

	Portfolio	50/50 S&P TSX
Valuation		
Forward P/E (12m)	16.2x	15.7x
Forward EV/EBITDA	12.9x	12.6x
Profitability		
ROE (5 year average)	20.9%	19.5%
ROIC (5 year average)	11.3%	9.5%
Risk		
Standard Deviation	8.7%	10.0%
Beta (Portfolio)	0.87	1.00
Debt/ EBITDA	3.4x	4.0x
ESG - Environmental, Social & Governance		
Sustainalytics Score	62.0	60.0

Source: Bloomberg, NA Equity Portfolio

Peter Jackson
Chief Investment Officer
October 1, 2019

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

UNITED STATES

PepsiCo:

PepsiCo is a leading snack company and the second largest non-alcoholic beverage company worldwide. PepsiCo's products are enjoyed by consumers more than one billion times per day in more than 200 countries and territories around the world. The company's food and beverage portfolio includes strong brands such as Ruffles, Lay's, Doritos, Gatorade, Pepsi-Cola, Quaker and Tropicana. PepsiCo's product portfolio includes 22 brands that generate more than $1 billion each in estimated annual retail sales. One of the key attractions to PepsiCo's business is the dominant position it enjoys in the snacking category. The snacking category is one of the fastest growing categories within consumer goods and it is expected to remain that way due to a number of global trends.

PepsiCo has all of the attributes that we typically look for when we invest in a company. The company generates stable revenue growth, it has a margin expansion program, it generates consistent free cash flow, it maintains a strong balance sheet, it generates attractive returns on invested capital, and it has a shareholder friendly management team.

Diageo:

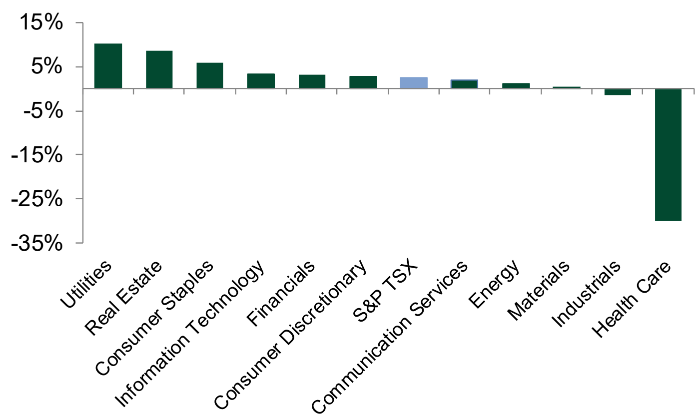
Diageo is the global leader in beverage alcohol with an outstanding collection of brands across spirits and beer. The company sells more than 200 brands which are enjoyed in more than 180 countries around the world. The company's brand portfolio includes Crown Royal, Johnnie Walker, Captain Morgan, Smirnoff, Tanqueray, Guinness, and Baileys. One of the key attractions to Diageo's business is the company's extensive footprint in emerging markets which spans across Asia, Latin America and Africa. Emerging markets generate more than 45% of Diageo's sales and are growing at attractive rates as more people join the middle class. Diageo estimates that an additional 750 million consumers in emerging markets will be able to afford international-style spirits by 2030.

Diageo has all of the characteristics that we look for when making our investments. The company generates stable revenue growth, operating margins are on an upward trajectory, free cash flow generation is consistent, it maintains a pristine balance sheet, it generates attractive returns on invested capital, and it has a shareholder friendly management team.

APPENDIX 2

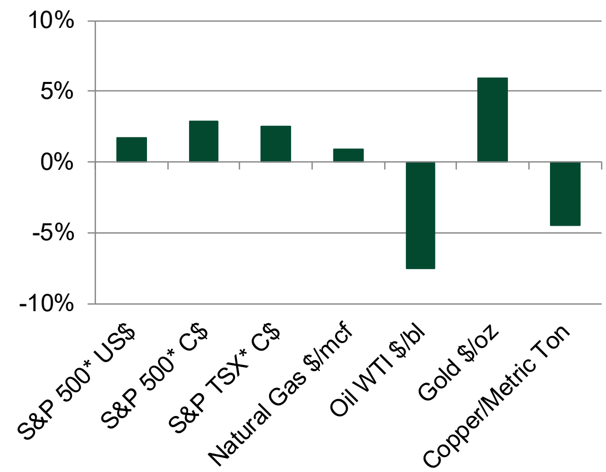
PERFORMANCE CHARTS

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



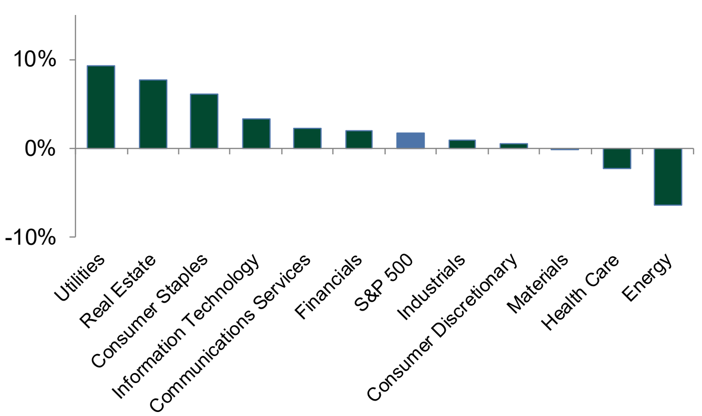
Source: TD Securities

Quarter % Change
Quarter Ending September 30, 2019



Source:Bloomberg *Total Returns

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



Source: TD Securities