CUMBERLAND
Private Wealth

January 6, 2021

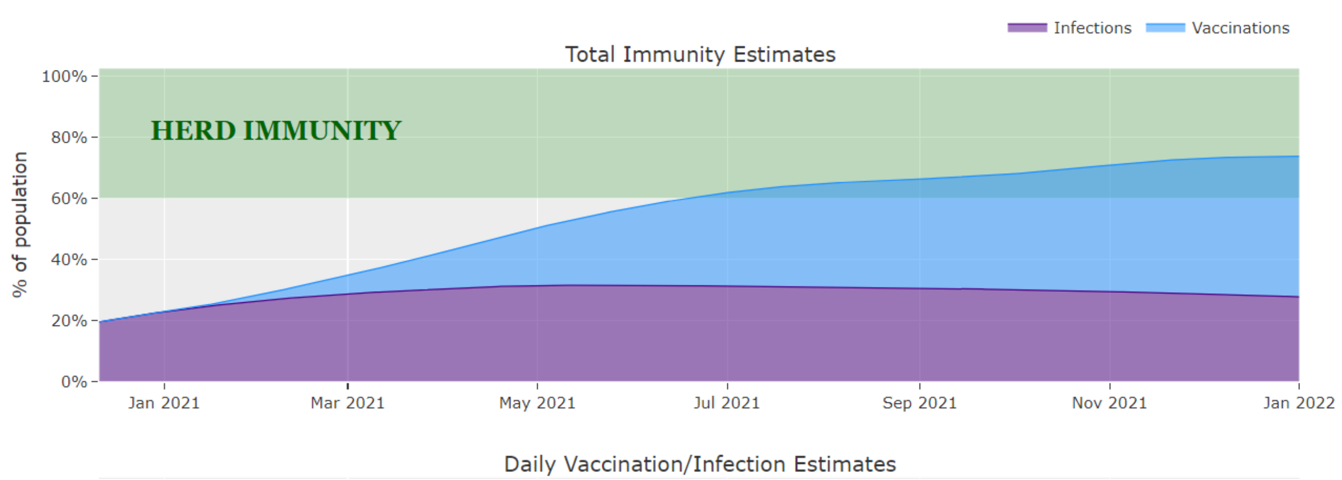
Year End Review

NORTH AMERICAN EQUITY STRATEGY

Happy New Year and Good Riddance to 2020! This global pandemic has now killed over 1.8 million people; however, there have been many plagues and pandemics in history and the important fact to know is that they **always end.** The 1918-1919 Spanish flu killed an estimated 50 million people and there was no vaccine. We currently have two approved vaccines (Pfizer and Moderna) in Canada and the US with potentially more approvals in the coming months.

While there are many models predicting when we could have herd immunity (likely > 60% of population immune), the consensus seems to be that this may occur by late summer or early fall as shown in **Exhibit 1.** As indicated in the chart, roughly half the immunity is expected to be achieved via natural infection and the other half by vaccination.

Exhibit 1
Path to Projected Herd Immunity



Source: Youyang Gu (https://covid19-projections.com/)

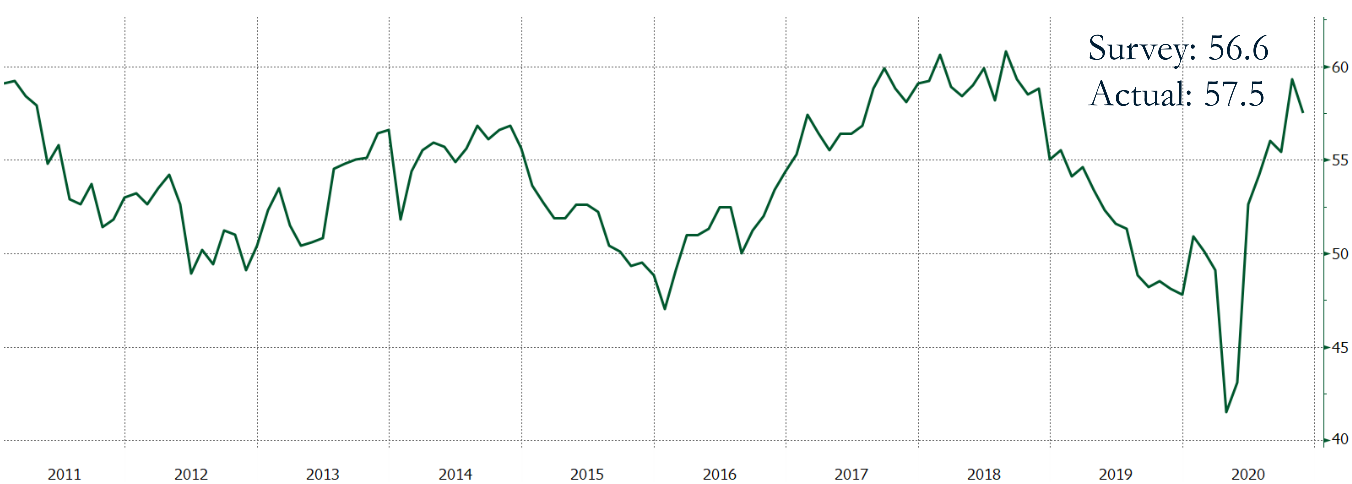
So perhaps there is a light at the end of the tunnel. And if history repeats itself, the period after the Spanish flu was followed by the "The Roaring Twenties", which was a period that was good for the economy and the stock market.

During the fourth quarter of 2020, the S&P500 total return index was up +12.2% in US dollars. Adjusting for currency, the S&P500 returned +7.1% in Canadian dollars, as the Canadian dollar appreciated about 3.4 cents, closing the quarter at US$0.785. The TSX total return in the third quarter was +9.0%. The fourth quarter was influenced by a rebound in economic strength and better than expected earnings but, specific events related to the vaccine announcements, a Biden victory with a split congress and the appointment of Janet Yellen as Treasury Secretary - who is more than likely committed to further stimulus, all contributed to the strong market performance this past quarter.

For the year, the S&P500 total return index was up 18.4% in US dollars or 16.1% in Canadian dollars, as the Canadian dollar appreciated 1.6 cents. The TSX total return for the year was 5.6%.

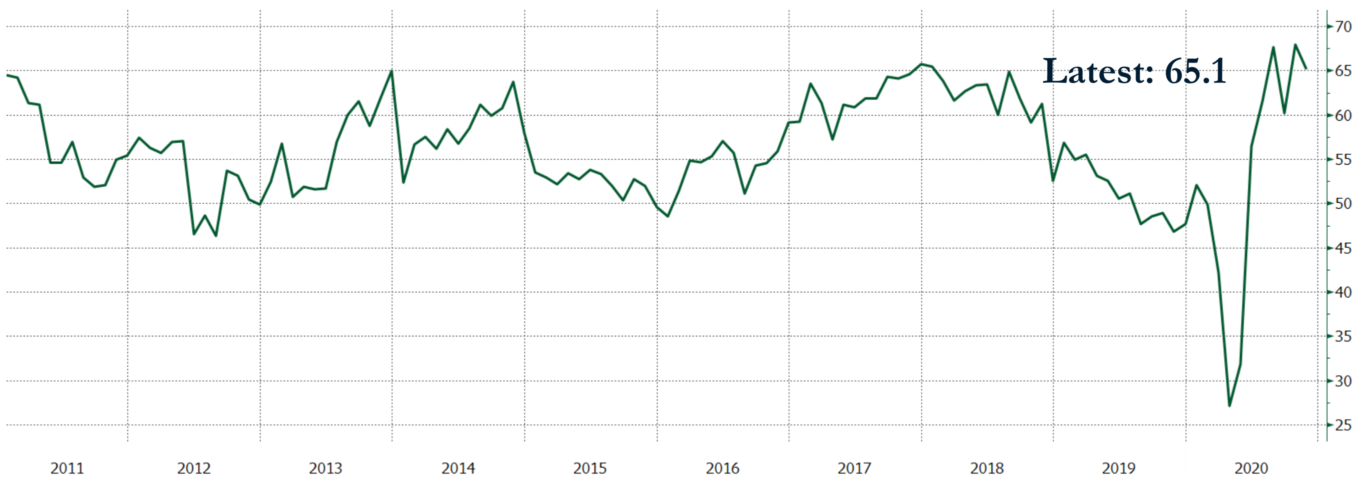
Regarding the economy, **Exhibit 2** shows the strength in the Manufacturing PMI as measured by the Institute of Supply Management (ISM), which was up through November 2020 at 57.5%. Anything above 50% is considered expansion and the latest data for November marked the seventh month in a row of expansion after the severe contraction last April. New Orders (**Exhibit 3**), which registered 65.1% for November, are also near peak levels. And finally, when we look at the "customer inventories" (**Exhibit 4**) as measured by PMI, it registered its lowest reading since June 2010 at 36.3% a level also considered positive for new orders and future production.

Exhibit 2:
ISM Manufacturing PMI



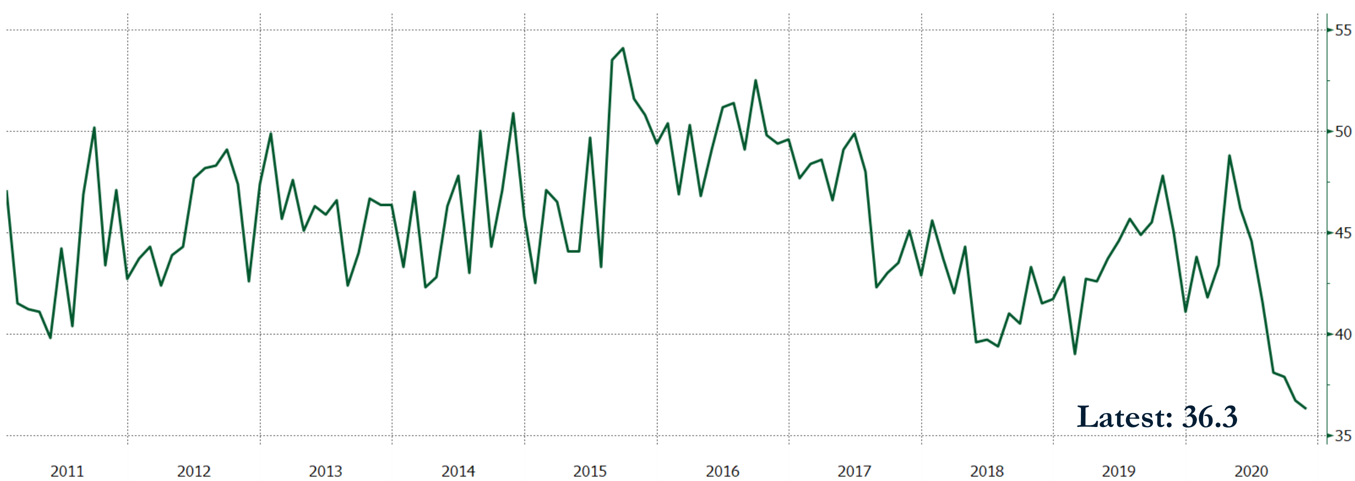
Source: Bloomberg

Exhibit 3:
ISM Manufacturing PMI New Orders



Source: Bloomberg

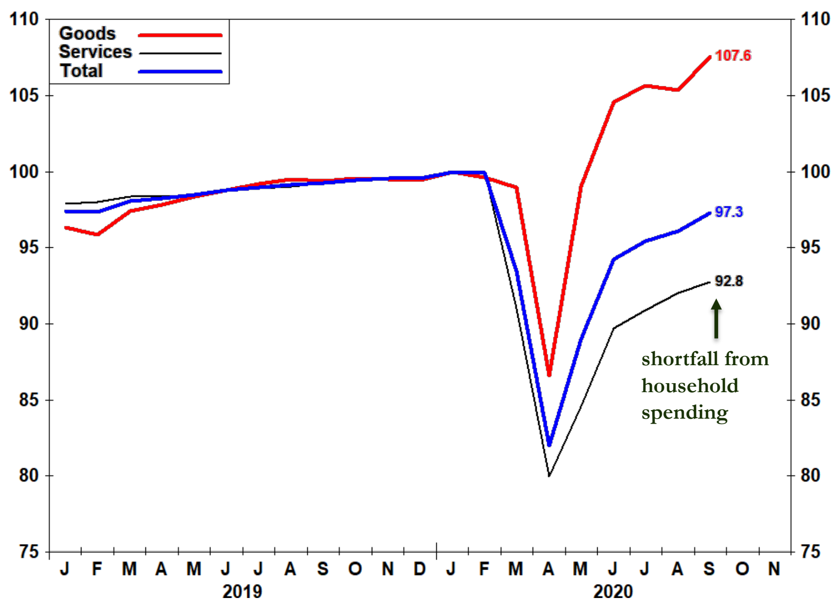
Exhibit 4:
ISM Manufacturing PMI Customers' Inventories



Source: Bloomberg

To sum up, what we are seeing here is a classic inventory restocking cycle coming out of a recession led by the demand for goods as shown by the red line in the chart in **Exhibit 5**. This chart is indexed to 100 as of January 2020. So overall, consumer spending and demand for goods is now through pre-Covid levels. And the demand is pretty much across the board as the ISM reported growth in 16 of the 18 manufacturing industries included in the survey. A lot of the spending is being directed at durable goods like autos and housing related items. Typically, these types of spending decisions are longer term in nature, difficult to reverse, and are generally a sign of strong consumer confidence.

Exhibit 5:
U.S. Real Consumer Spending Index

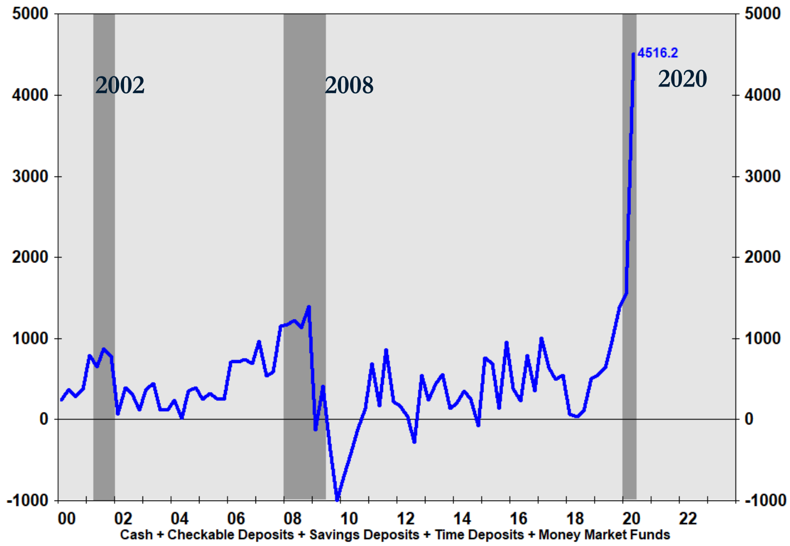


Source: TD Securities, Jan 2020 =100

The other key take-away from this chart is the total shortfall (the blue line) is primarily from household spending on "services" or the black line in Exhibit 5. However the lack of spending on "services" such as restaurants, hotels and airlines probably has more to do with the Corona virus, and in our view, this could snap back relatively quickly with a vaccine available, which should be good for employment and provide another leg up for consumer spending. I am sure we have all refreshed our bucket lists of things we want to do when the wretched pandemic is finally over!

Consider the chart in **Exhibit 6**, which shows that consumers still have a lot of cash on the sidelines. The current level of Household savings is materially higher in 2020 compared to the two previous recessions of 2000 and 2008, which supports the notion that there is still a tremendous amount of pent-up demand particularly for "Services" once we reach herd immunity.

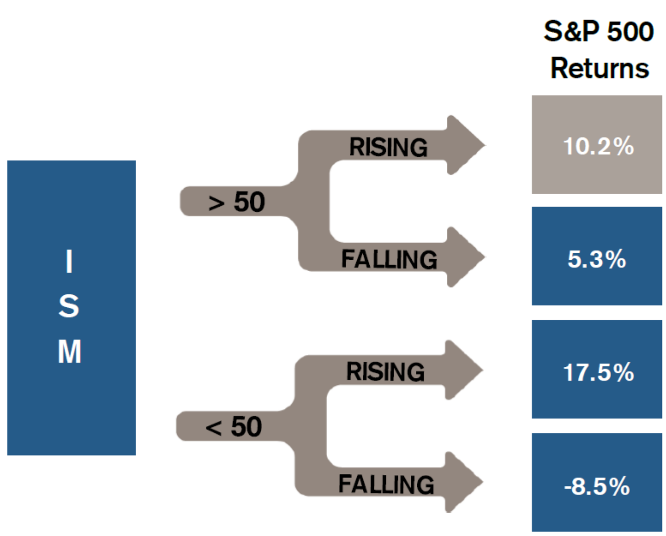
Exhibit 6:
Household Savings Are High



Source: TD Securities

Exhibit 7 is a familiar chart we have used before that demonstrates why ISM data is so relevant to the stock market. As indicated in the chart, when the ISM data is above 50 and rising, the average 12 month forward return for the S&P500 has historically been +10.2%. Remember, the latest ISM read for November 2020 was 57.5.

Exhibit 7:
ISM vs. S&P 500 Future Returns



Source: Credit Suisse

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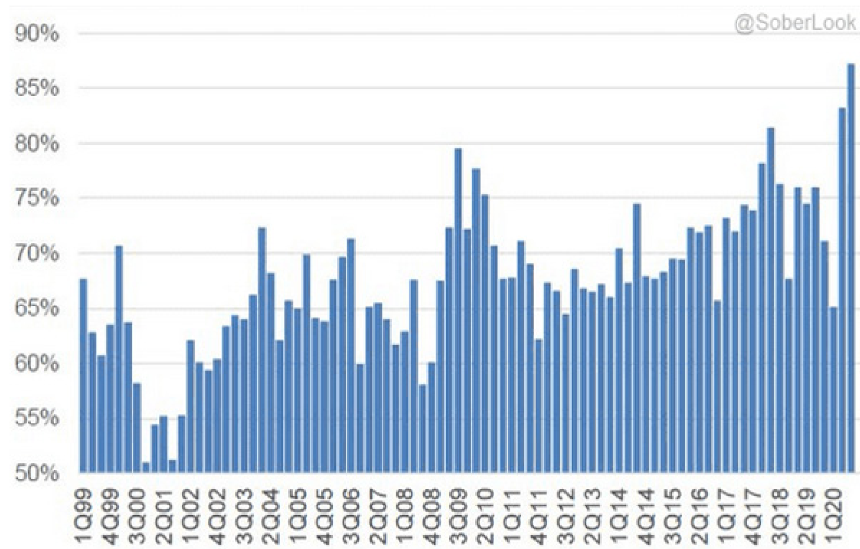
Exhibit 8 looks at the percentage of S&P500 companies reporting positive earnings surprises going back to the first quarter of 1999. In the third quarter of 2020, 85% of companies reported positive earnings surprises and 79% reported positive revenue surprises. This marks the highest level of positive earnings surprises going back to the time this data first started being recorded. Also interesting is the setup so far for the fourth quarter of 2020. Normally analyst earnings estimates start out too high and are revised lower over time. However, so far in Q4 analysts have increased estimates on average 3.6% as compared to the average quarterly estimate reduction of -4.2% over the past ten years.

Exhibit 8:
Earnings Surprises

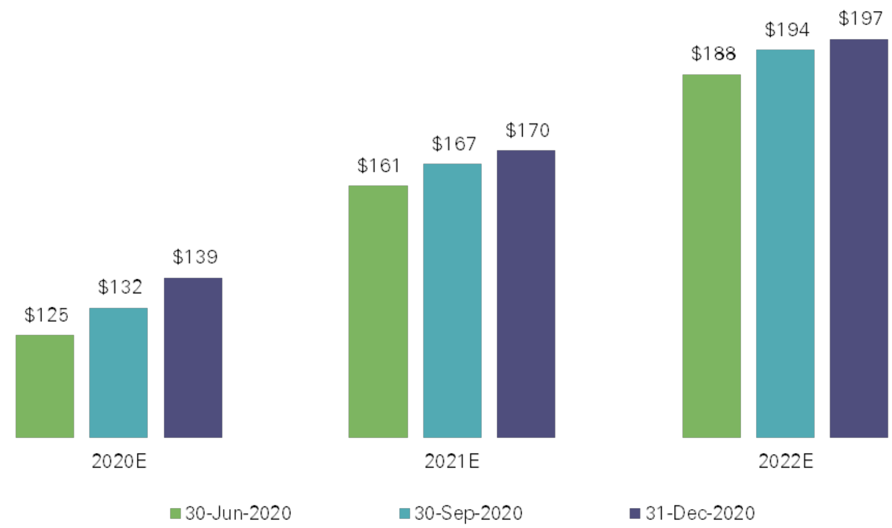


Source: Daily Shot

The next chart (**Exhibit 9**) compares the progression of consensus earnings estimates for the S&P500 for 2020, 2021 and 2022 through the June, September and December quarters. As indicated from the last chart, the underlying earnings surprises in Q3 and positive forward Guidance in Q4 are leading to material upward earnings revisions for the S&P500 for 2020, 2021 and 2022.

So that's the good news. The resurgence in Covid-19 cases into year-end and the logistics to administer and distribute the vaccine however will likely weigh on the normalization of the economy during the first part of 2021. This could lead to some choppiness in economic data and markets near term; however, investors may look through this or use it as a buying opportunity given the expected low level of interest rates for the foreseeable future.

Exhibit 9:
S&P 500 Consensus EPS: Current vs Sept 30 vs June 30



Source: Bloomberg

Exhibit 10 shows the summary of changes to economic projections by board members and presidents of the Federal Open Market Committee (FOMC) meeting held in December 2020. As indicated in the chart, the consensus for GDP and inflation were revised higher in both 2021 and 2022, while the unemployment rate was revised lower. Notwithstanding this positive shift in all three economic variables, there was no change in accommodation by the Federal Reserve (Fed) as interest rates were effectively left at zero for the next three years. This form of "passive easing" alongside the more upbeat outlook presented by the Fed is no doubt a reflection of the level of uncertainty in the forecasts. Still, this low level of interest rates is supportive of the current market valuations. The Fed has also made it clear that the improved outlook is heavily dependent on actions from elected officials and the Treasury, which have also been moving in the right direction with the recent passing of the $900 billion coronavirus relief bill.

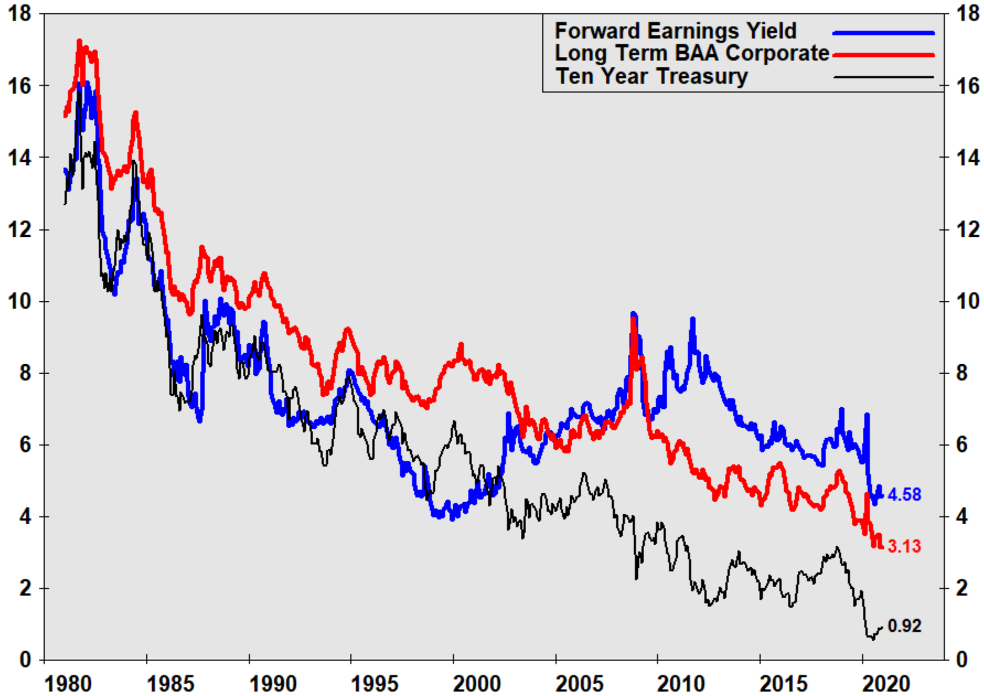
**Exhibit 10:
FOMC Forecasts**

FOMC Forecasts	Median				
	2020	2021	2022	2023	Longer-run
Change in real GDP	-2.4	4.2	3.2	2.4	1.8
September projection	-3.7	4.0	3.0	2.5	1.9
Unemployment rate	6.7	5.0	4.2	3.7	4.1
September projection	7.6	5.5	4.6	4.0	4.1
PCE Inflation	1.2	1.8	1.9	2.0	2.0
September projection	1.2	1.7	1.8	2.0	2.0
Core PCE Inflation	1.4	1.8	1.9	2.0	
September projection	1.5	1.7	1.8	2.0	
Projected Policy Path					
Fed funds rate	0.1	0.1	0.1	0.1	2.5
September projection	0.1	0.1	0.1	0.1	2.5

Source: Renmac & Federal Reserve (Summary of Economic Projections 12/16/2020

Turning to valuation, the S&P500 is currently trading at 22.1x and 19.1x 2021 and 2022 forward earnings as compared to the historical 10 year average price/earnings (P/E) multiple of 15.9x. However, comparing where investment grade corporate bond yields and risk free alternative ten year treasuries are trading today relative to the forward earnings yield for the S&P500 (inverse of the S&P500 forward P/E), we would argue the S&P500 is probably more fairly valued than it looks from an historical P/E perspective. Even Fed Chairman, Jay Powell agreed during his latest press conference: "Admittedly P/E's are high, but that's maybe not that relevant in a world where we think the 10 year Treasury is going to be lower than it's been historically from a return perspective". **Exhibit 11** compares the yield on these three different asset classes and given the low level of interest rates, even the Fed agrees stocks are attractive relative to bonds.

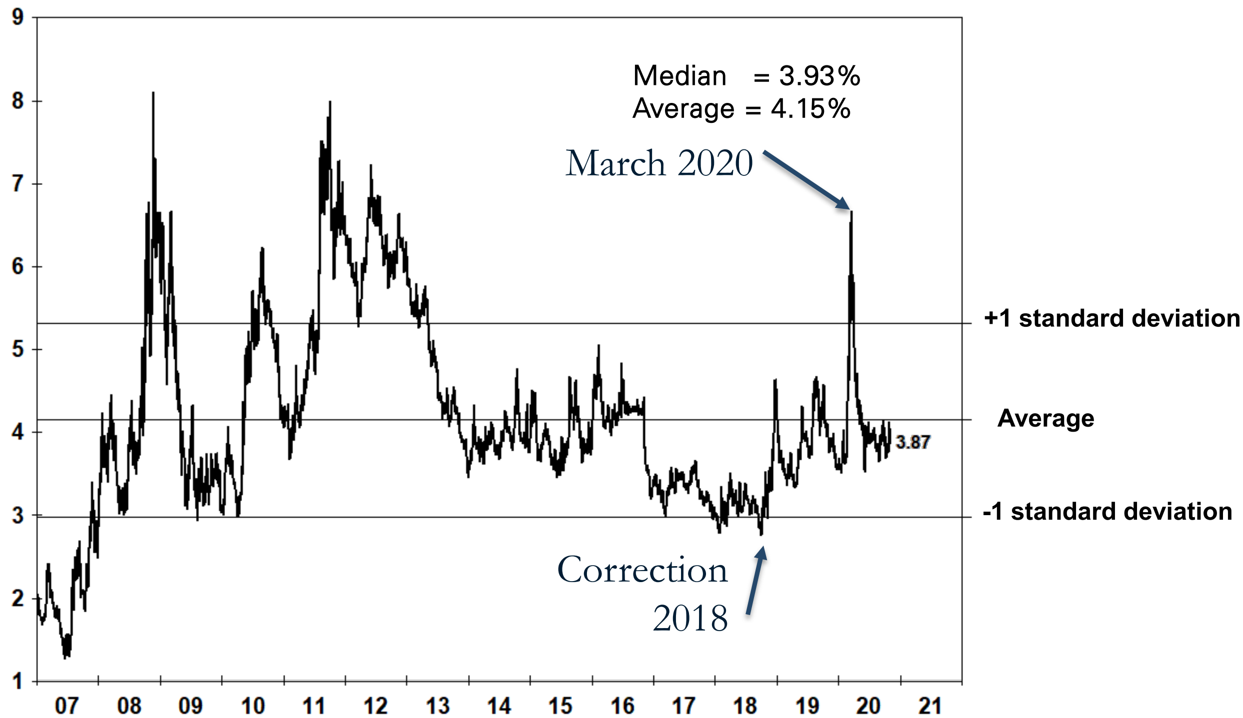
Exhibit 11:
Yields on Risky Assets



Source: TD Securities

What investors really need to think about is whether there is enough return in stocks to compensate them for taking on the higher risk of owning equities versus another asset class such as risk free bonds. This is commonly known as the equity risk premium as shown in **Exhibit 12.** It can be simplistically measured by calculating the difference over time between the earnings yield (E/P), again the blue line in **Exhibit 11**, and the effective risk free rate, where we will use the ten year treasury as a proxy (the black line in Exhibit 11).

**Exhibit 12:
Equity Risk Premium**



Source: TD Securities

In **Exhibit 12** we examine the equity risk premium going back to 2007. The median and average equity risk premium of 3.98% and 4.31%, respectively, (shown in the top right corner) compares to the current level of 3.60% or looking out 12 months of 4.32%. The current level is slightly lower based on forward 2021 earnings but more or less in line with the long term median and average equity risk premium looking out 12 months. A spike in the equity risk premium can signal opportunities like it did in March 2020 when the market sold off or be overdone on the downside signaling the correction we saw in the fall of 2018. Today it is relatively neutral, notwithstanding the higher than average forward P/E of the market, which we believe is more a function of lower interest rates.

**Asset Allocation for our North American Capital Appreciation Strategy
As at December 31, 2020**

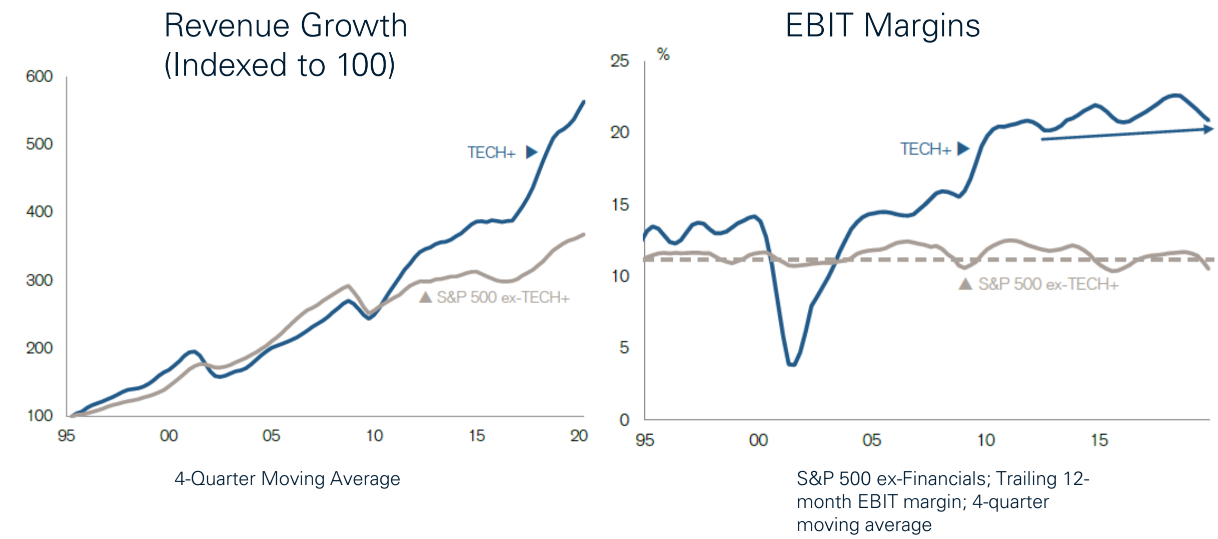
Equities	97%
Fixed Income	0%
Cash	3%

During the quarter, our overall equity exposure increased by 4% from 93% to 97% at December 31st. Our US equity exposure increased from 50% to 52% while our Canadian equity weight increased from 43% to 45%. Cash decreased from 7% to 3%. It is important to note that many of our clients follow our North American plus International strategy for the equity component of their portfolio, meaning that the actual weights of US and Canada within their equity holdings will be less than this given the allocation to international positions outside of Canada and the US.

As we discussed last quarter, we have taken somewhat of a barbell strategy with our large sector exposures split between what we consider growth versus value companies. In the current, still uncertain environment, it is important to position the portfolio to benefit from the economic recovery while not fully depending on it. So our current split between growth stocks, which are typically more dependent on trends independent of an improving economy is about 40% (up from 38% at September 30th) versus value stocks, which are more dependent on and should benefit from an economic recovery at about 51% (up from 49% at September 30th). Staples, which we don't classify as either growth or value, make up the balance of our equity exposure. Recent performance in the fourth quarter has benefitted from the shift into value stocks and overall, shifting our allocation towards value in the second half of 2020 from the low 40's percent to 51% has been a positive contribution.

Our growth style stocks are represented by reasonably priced positions with strong secular tailwinds that are in place regardless of the economic environment. For example, trends such as the transition to cloud computing, digital payments and ageing demographics, many of which have only strengthened during the pandemic. These are represented by Information Technology, Communication Services and Healthcare sectors. **Exhibit 13** shows the long term secular revenue and operating margin growth for Information Technology in the S&P500 relative to the S&P500 ex-Information Technology. At times, Information Technology can look relatively expensive, which is when we tilt the portfolio more towards value / cyclicals and now could be considered one of those times. Having said that as the old adage goes "you get what you pay for" and as it can be clearly seen in **Exhibit 13**, the Information Technology secular revenue growth and EBIT (earnings before interest and tax) margin growth has far exceeded the rest of the S&P500, which is why we maintain our holdings in this sector.

Exhibit 13:
The Case for TECH+

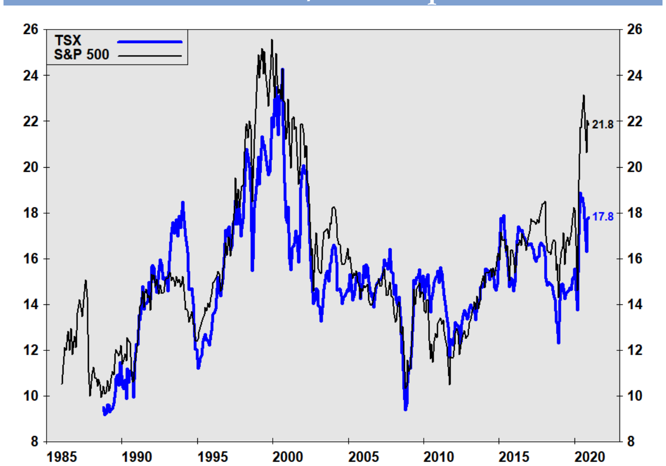


Source: Credit Suisse

Our value style investments are within the more economically sensitive cyclical sectors in Financials, Consumer Discretionary, Industrials, Energy and Materials, which are often associated with our Canadian exposures in the TSX. **Exhibit 14** compares forward P/E multiples for the TSX and the S&P500. As indicated in the chart, the correlations between the indices are historically very high. However, from time to time gaps do open up in the valuation as a result of the higher cyclical make-up of the TSX. In **Exhibit 15**, we compare that valuation gap between the TSX and the S&P500 to previous recessions. Based on prior recessions, the chart suggests that the current valuation gap may close coming out of this recession as the market shifts from growth to value providing some catch-up for the TSX relative to the S&P500.

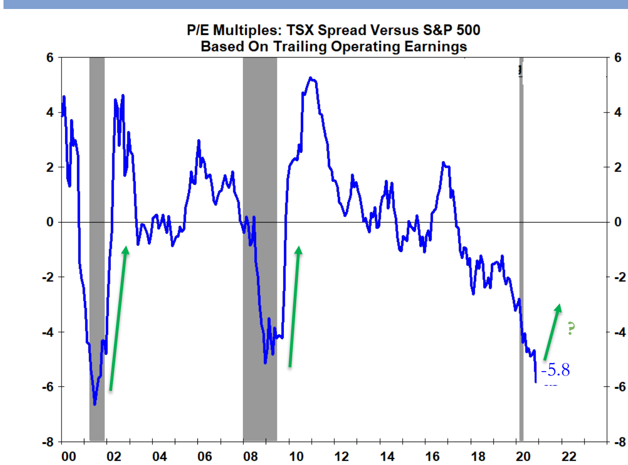
Canadian Update

Exhibit 14: Forward P/E Multiples



Source: TD Securities

Exhibit 15:



Source: TD Securities

Coincidentally with our move toward more cyclical exposure, we have also partially hedged our US dollar exposure. **Exhibit 16** is a long term chart of the CAD/US dollar exchange rate. As indicated the Canadian dollar is currently at the lower end of this 30 year range. However, similar to the performance of the TSX in **Exhibit 15**, the Canadian dollar has had multi-year upward runs after the previous two recessions.

Exhibit 16:
Canadian/US Dollar

Tradingview.com

During the quarter, we added four new positions to the portfolio including Analog Devices Iinc., Intuit Inc., Morneau Shepell Inc. and Sherwin-Williams Corp. A complete review of the business and fundamental outlook for each of the companies that were purchased during the quarter can be found in **Appendix 1**.

Outlook

In summary, as we get closer to the end of this ordeal, markets have begun to discount some of the positive news regarding an improving economic outlook and higher forward earnings. We think there is still more upside to this inventory restocking cycle and the second wave of economic activity expected to come from the service sector should lead to higher consumer spending and lower unemployment. Also, as we highlighted, the current level of savings is high and supports this potential pent up demand. Equity valuations are not cheap from an historical price/earnings perspective; however, according to Fed Chairman Jay Powell, they are cheap relative to bonds and it appears, at least until we reach herd immunity, interest rates will likely remain low. In this environment, we will remain buyers of equities.

Peter Jackson
Chief Investment Officer
December 31, 2020

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

Morneau Shepell Inc.

Morneau Shepell is almost evenly split between 1). Consulting services primarily related to the design and construction of pension plans and their outsourced administration and 2). Computer-based wellness self-help offerings for a company's employees ranging from child and senior's care to mental and physical health management. While the closest comparable to MSI's consulting operations was recently acquired at a 50% premium to MSI's valuation, the real hidden gem in the company involves the scalable and growing wellness operations where comparable companies trade at materially higher valuations.

UNITED STATES

Analog Devices Inc.

Analog Devices is one of the world's leading analog integrated circuit and power management semi-conductor companies. Its analog chips help bridge the physical world into digital by sensing and processing waveforms such as speech, music, video, and more. Their products are an integral part of many exciting new technology developments such as industrial automation, autonomous vehicles, and vehicle electrification; with many years of growth ahead as they increase their exposure to these growing markets.

In addition to their organic growth opportunity, Analog Devices has successfully grown its business through acquisitions. It has bought companies with leading positions in related products, such as power management, and has been able to create shareholder value through both cost and revenue synergies. Its latest acquisition, Maxim Integrated, is expected to close in 2021 and will deepen its leading position in power management chips - giving its increased exposure to automotive and data center markets.

Intuit Inc.

Intuit is a leading provider of business and financial management solutions for small businesses, consumers, accounting professionals, and financial institutions. The company is best known for its flagship products QuickBooks, TurboTax and Quicken. Intuit was founded in 1983 and is headquartered in Mountain View, California.

Throughout its history, Intuit has fostered a culture of innovation and vision. The company also aspires to be at the forefront of the technology curve. In recent years, the company has successfully transitioned over 400 of its applications to the cloud. This provides Intuit with a dataset that can provide unique insights as it leverages its artificial intelligence and machine learning capabilities. The company is well positioned for growth given that the majority of small businesses in the United States still don't use any accounting software and the majority of US citizens still pay professionals to help file their taxes.

Sherwin-Williams Corp.

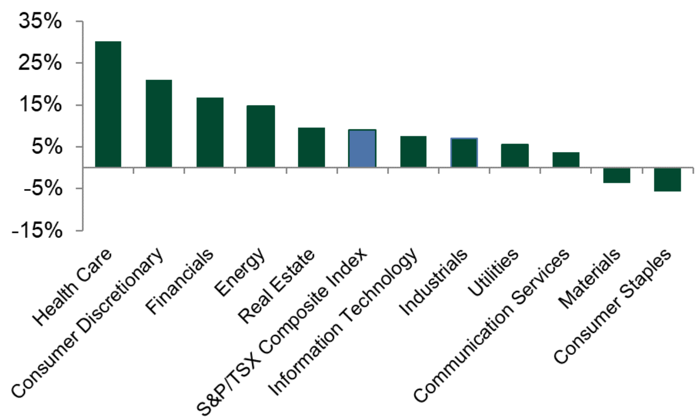
Founded in 1866, Sherwin-Williams is a global leader in the manufacture, distribution, and sale of paints, coatings, and related products to professional, industrial, commercial, and retail customers. The company sells its products through a chain of more than 4,900 company operated stores. The company also sells its products through leading mass merchandisers, home centers, independent paint dealers, hardware stores, automotive retailers, and industrial distributors. The Performance Coatings Group supplies a broad range of highly-engineered solutions for the construction, industrial, packaging and transportation markets in more than 120 countries around the world.

The company's crown jewel is the North American paint store network, which caters primarily to professional painting contractors. This store network continues to expand and it generates very strong returns on invested capital. The company enjoys strong pricing power and there is an opportunity to improve the margins from the businesses acquired from Valspar. The company is benefitting from the strength in the US residential housing market and is also starting to see a recovery in its industrial end-markets as the global economy recovers from COVID-19.

APPENDIX 2

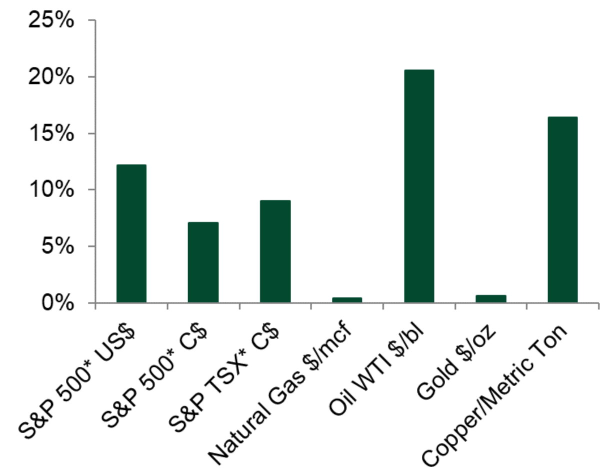
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending December 31, 2020



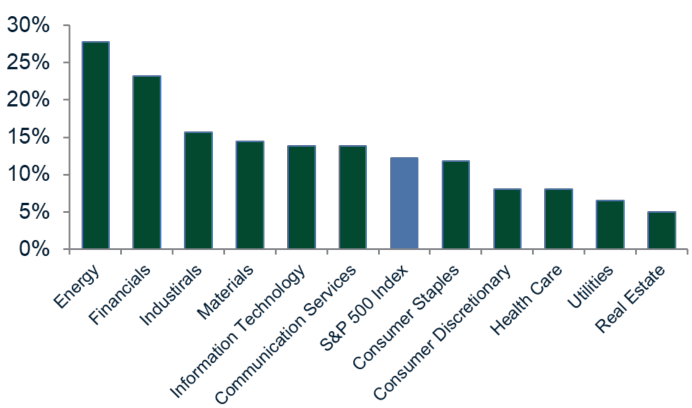
Source: TD Securities

Quarter % Change
Quarter Ending December 31, 2020



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending December 31, 2020



Source: TD Securities