CUMBERLAND

Private Wealth

December 31, 2022

Fourth Quarter & Year End Review

NORTH AMERICAN EQUITY STRATEGY

2022 was another year of tremendous volatility, although we ended the year with some positive recovery as the S&P500 total return for the fourth quarter was +7.6% in US dollars. Adjusting for currency, the S&P500 returned +6.3% in Canadian dollars, as the Canadian dollar appreciated about 1.5 cents, closing the quarter at US$0.7381. The TSX total return was +6.0% in the fourth quarter. For the year, the S&P500 total return index was down -18.1% in US dollars or -12.5% in Canadian dollars, as the Canadian dollar depreciated -5.3 cents. The TSX total return for the year was -5.8%. To put this negative performance for 2022 in context, recall that in 2021, the S&P500 total return index was up +28.7% in US dollars or +27.5% in Canadian dollars, while the TSX total return for the year was +25.2% and that followed positive returns in 2020 even with the large COVID-19 drawdown in March of that year. As well, the North American Capital Appreciation strategy has managed to do better than the markets over these past two years.

Exhibit 1 is a total return decomposition for the S&P500 for 2022. As indicated in the chart, the total return in $US of –18.11% is entirely comprised of a forward Price / Earnings multiple (P/E) contraction of -22.07%, offset by a positive contribution from dividends (+1.33%) and positive forward earnings (EPS) of +3.37%. In other words, most of the decline in stock prices was a result of people willing to pay less for every dollar of earnings in 2022 than they had been previously following higher interest rates and perceived risk.

Exhibit 1: Return Decomposition (12m forward earnings, F12m)

S&P 500 in USD

Date	Price Index	Dividends	Total Return Index	Earnings ($) 12MF	Earnings Multiple (x) 12MF	10-year Average Earnings Multiple (x) 12MF
12/31/2021	4,766.18		9,986.70	$ 222.34	21.44x	
12/30/2022	3,839.50		8,178.02	$ 229.83	16.71x	17.34x
% Change	-19.44%	1.33%	-18.11%	3.37%	-22.07%	

Source: Bloomberg, 12/31/2022, BEst EPS (12m blended forward EPS estimate) & BEst P/E

Exhibit 2, courtesy of Ned Davis Research (NDR), compares all forward P/E contractions since they began tracking data in 1984, and 2022 represents the second largest P/E contraction over this time period. According to NDR, two year stretches of P/E multiple contraction are rare and while not unheard of, 2021-2022 would rank number 1 as the greatest two year P/E multiple contraction over the past 38 years. The only time we had three years of consecutive P/E multiple contractions was in the early 1990's and mid-2000's, periods in which the Federal Reserve was also raising interest rates and the economy did not fall into a recession.

Exhibit 2: Price/Earnings (P/E) Multiple Contraction (F12m) vs Historical P/E Contractions

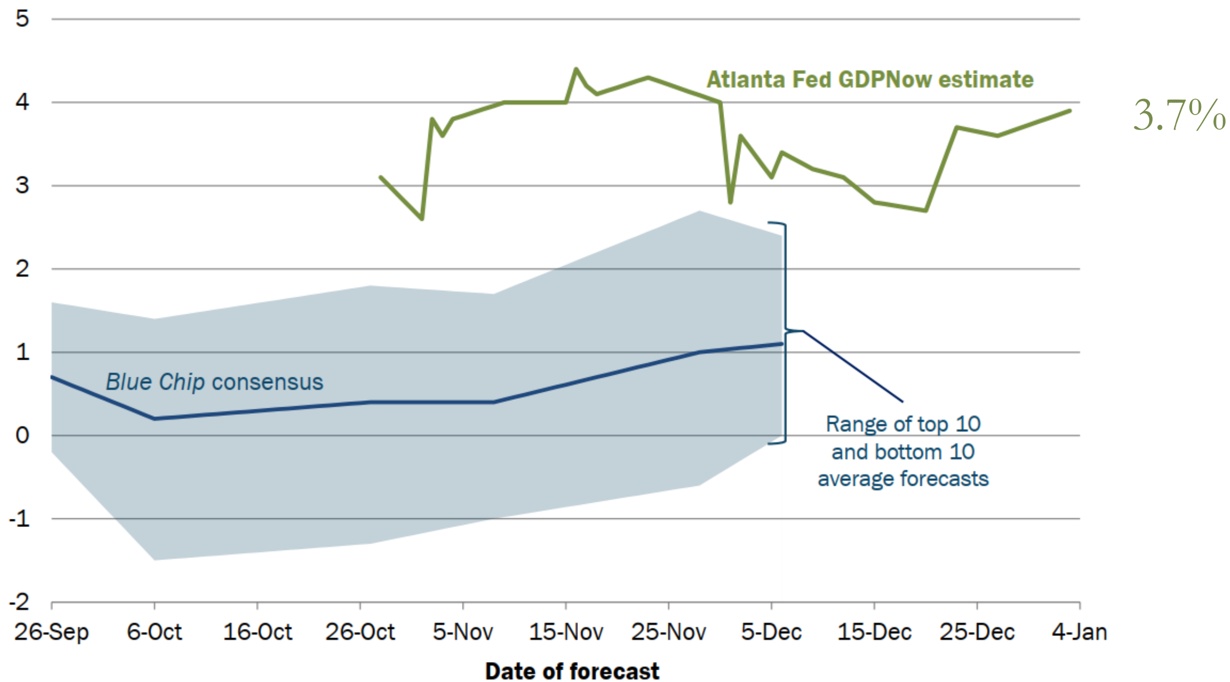
S&P 500 P/E Ratios

Earnings Metric	2022 Estimate*	One-Year Point Change	Rank**	Two-Year Point Change	Rank**
Forward Operating	16.8	-3.9	2	-5.8	1

* Based on 12/24/2022 closing price for S&P 500 and latest earnings estimates
** 1= biggest decline on record. 39 forward and trailing operating P/Es and 96 trailing GAAP P/Es
Source: S&P Dow Jones Indices
Ned Davis Research Group

While there are no shortages of negative economic forecasts for 2023, we are not totally in the recession camp. We think there is a reasonable chance the Federal Reserve will manage to tame inflation and we expect the economy to remain resilient. Even if we are wrong and we do experience a mild recession, our best guess is that long term interest rates will be falling, leading to P/E expansion and support for market valuations, potentially reversing the greatest P/E contraction we have experienced over the past 38 years. Consider that after a weaker first half 2022, the final reading on third quarter 2022 real GDP, which was reported just prior to Christmas, was revised up to 3.2% from 2.9%. **Exhibit 3** shows the Atlanta Fed GDPNow tracking model forecast for fourth quarter 2022 real GDP, which currently sits at 3.7%!

Exhibit 3: Atlanta Fed GDPNow real GDP Estimate Q4 2022



Source: Blue Chip Economic Indicators and Blue Chip Financial Forecasts
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey

Exhibit 4 shows the Federal Reserve's "Summary of Economic Projections" from the December 14th, 2022 meeting. Admittedly, the Fed's track record has not been particularly good; however, they are forecasting "slower growth" (0.5% real GDP), not a recession, and according to Powell "*a softening labour market, by which I mean unemployment goes up but not a great deal*" (3.7% currently to 4.6% forecast), interest rates peaking at 5.1% versus 4.25%-4.5% today and PCE inflation falling to 3.1% in 2023 from 5.6% at the end of 2022.

Exhibit 4: FOMC Summary of Economic Projections

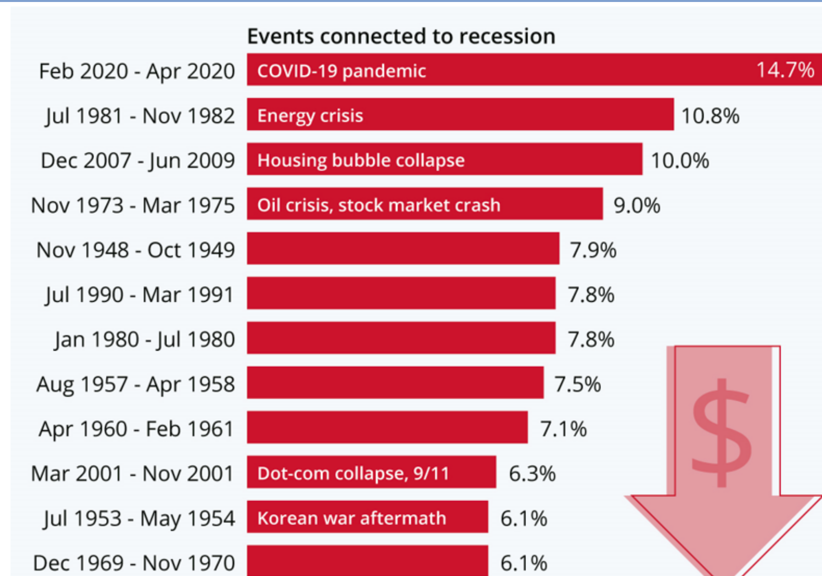
Percent

Variable	Median				
	2022	2023	2024	2025	Longer run
Change in real GDP	0.5	0.5	1.6	1.8	1.8
September projection	0.2	1.2	1.7	1.8	1.8
Unemployment rate	3.7	4.6	4.6	4.5	4.0
September projection	3.8	4.4	4.4	4.3	4.0
PCE inflation	5.6	3.1	2.5	2.1	2.0
September projection	5.4	2.8	2.3	2.0	2.0
Core PCE inflation	4.8	3.5	2.5	2.1	
September projection	4.5	3.1	2.3	2.1	
Memo: Projected appropriate policy path					
Federal funds rate	4.4	5.1	4.1	3.1	2.5
September projection	4.4	4.6	3.9	2.9	2.5

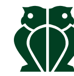
Source: Federal open Market Committee, Federal Reserve (Dec 14, 2022)

Exhibit 5 shows peak unemployment during each US recession since World War II. As indicated in the chart, peak unemployment during recessions is considerably higher than the Fed's 4.6% expected rate in 2023 and the 3.7% level today.

Exhibit 5: Peak Unemployment During Recessions since WWII



Source: NBER, U.S. Bureau of Labor Statistics, Statista



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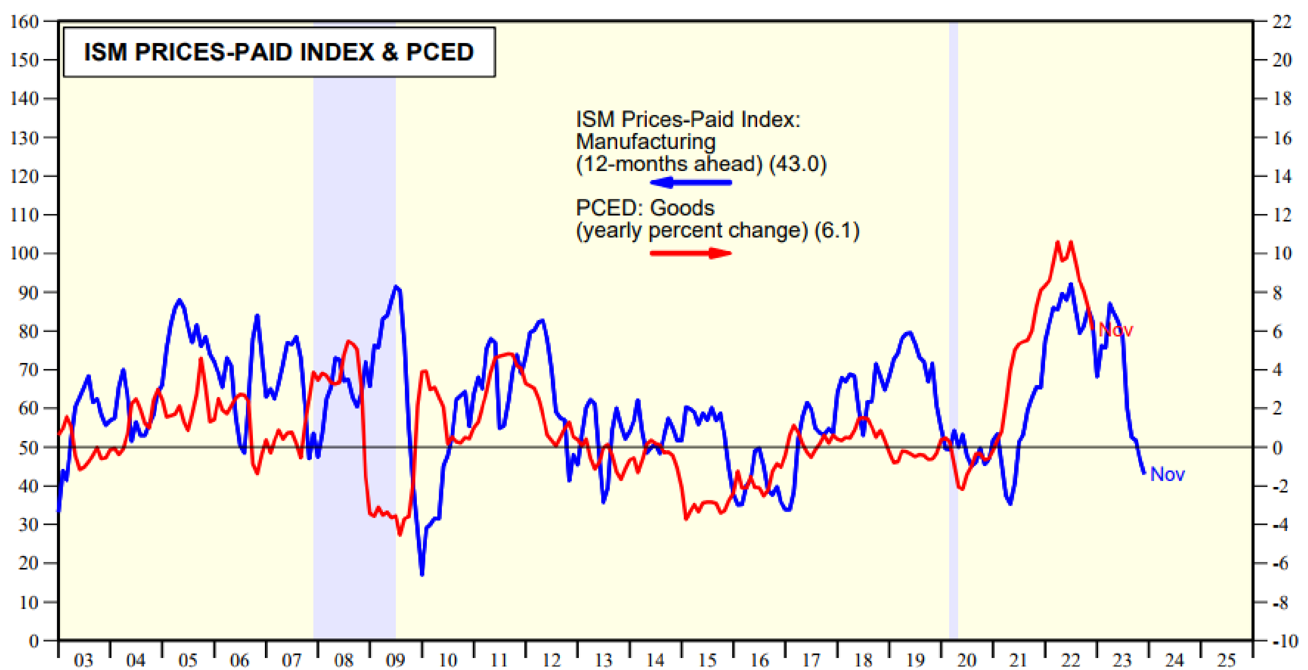
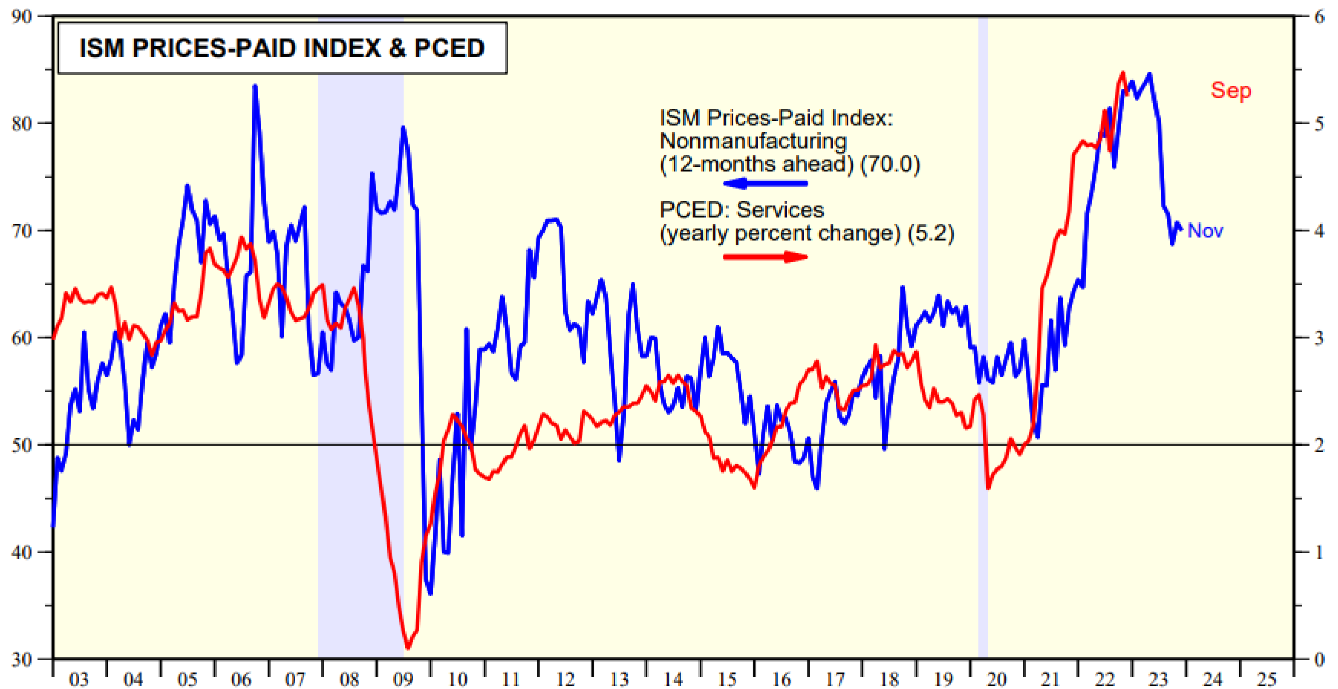
The real issue in our minds is whether the Fed can tame inflation fast enough so that they no longer have to continue increasing the Fed Funds rate and thereby avoid a recession. The two charts below (**Exhibits 6 and 7**), show the November Manufacturing and Non-manufacturing ISM prices paid index as compared to PCE inflation data for goods and services. The charts indicate inflation has peaked for manufacturing or goods with non-manufacturing or services inflation (which includes things like rent and labour) possibly not far behind.

Exhibit 6: ISM Prices Paid Index Manufacturing vs PCE Goods Inflation



Source: Yardeni Research

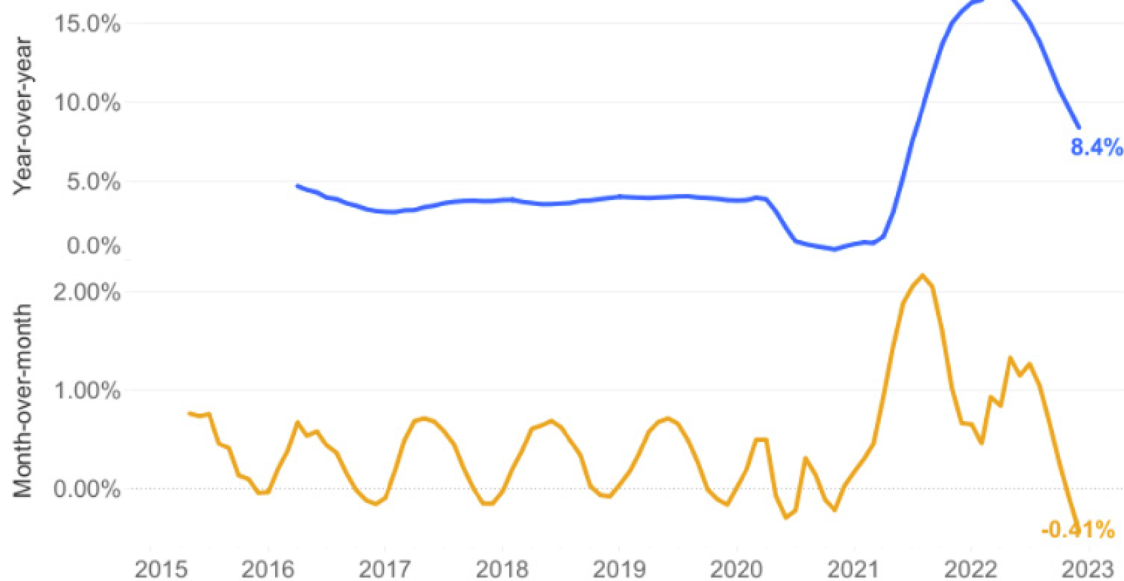
Exhibit 7: ISM Prices Paid Index Non-Manufacturing vs PCE Services Inflation



Source: Yardeni Research

In Chair Powell's December 14th press conference, he broke inflation down into three buckets, goods, rent and labour and as Exhibit 6 shows, there is strong evidence goods inflation has peaked with things like used car pricing lower, gasoline prices now below levels from year ago and supply chain logistics issues behind us. In his speech, Powell went on to talk about rents and the fact that new lease rates, while high, are beginning to come down as evidenced in **Exhibit 8**. According to Zillow Group, the most visited real estate website in the US, while asking rents are up 8.4% year over year, they are down from their peak of +17.1% last February and they declined month over month -0.4% in November, the largest one-month decline in the seven-year history of the Zillow Observed Rent Index. And the decline comes on the back of a -0.1% drop in October ending a two year period of above-average monthly rent increases that began in November 2020.

Exhibit 8: Zillow Observed Rent Index (smoothed) November 2022



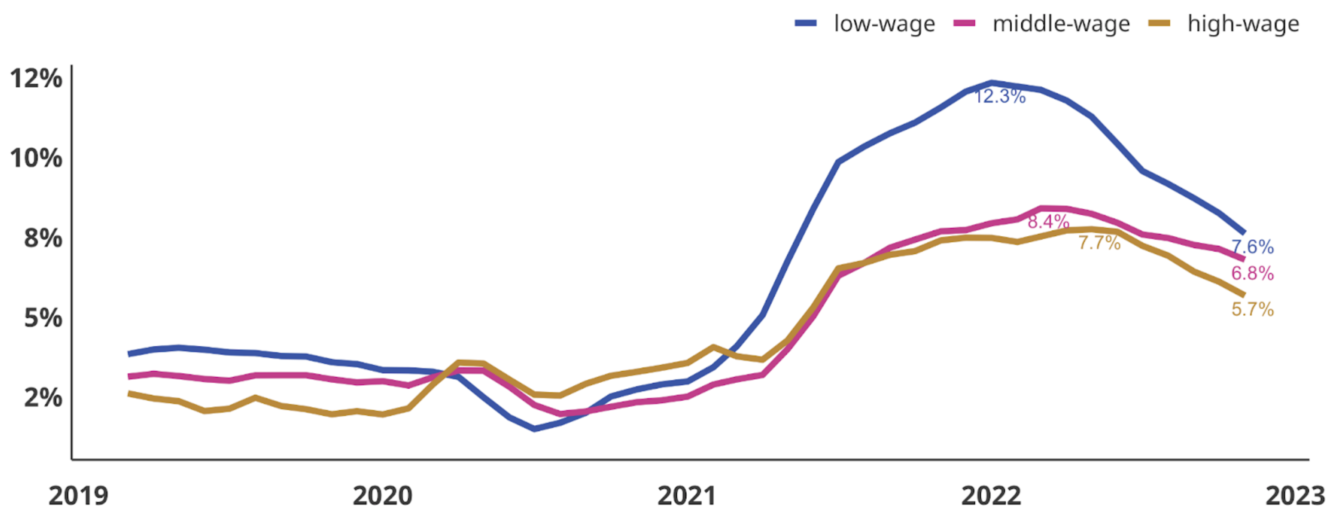
Source:Zillow Group

And finally, **Exhibit 9** looks at two Wage Tracker charts from Indeed Inc. the world's largest job search website, which has over 300 million users per month in 60 countries. The Indeed Wage Tracker measures the growth in wages and salaries advertised in Indeed job postings and may be a leading indicator of broader measures of wage growth. The top chart indicates a substantial slowdown in posted advertised wage growth from its collective peak of +9% year-over-year growth in March 2022 to +6.5% year-over-year growth in November 2022. Posted advertised wage growth remains elevated from pre-pandemic rates of +3.1%, but clearly show signs of slowing.

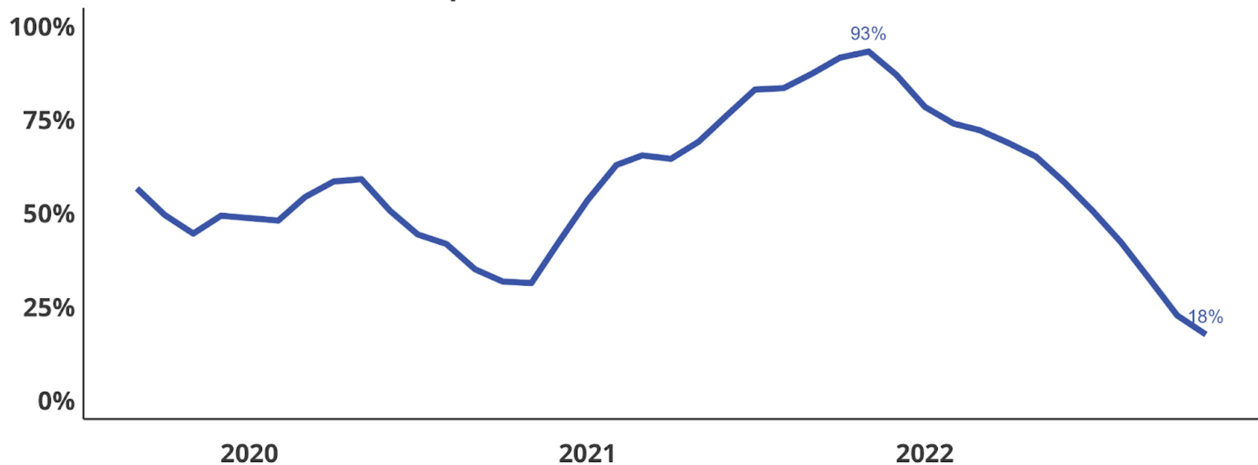
The bottom chart measures the percentage of occupational categories seeing growth in wages and salaries advertised. Currently only 18% of occupational categories are seeing their posted advertised wage growth hold steady or increase in the six months from May 2022 to November 2022. That compares to 93% of occupational categories observed steady or increasing in the same six month time period the year prior (May 2021 to November 2021).

Exhibit 9: Indeed Wage Tracker

Wage growth is fading fastest in low-wage categories



Wage growth is falling in most categories



Source: Indeed

Asset Allocation for our North American Equity Strategy As at December 31, 2022	
Equities	96%
Fixed Income	0%
Cash	4%

During the quarter, our overall equity exposure increased 6% to 96% from 90% at September 30th. Our US equity exposure increased from 37% to 38%, while our Canadian exposure increased from 53% to 58%. Cash decreased from 10% to 4%. It is important to note that many of our clients' portfolios are invested in our North American plus International Equity strategy, meaning that the actual weights of US and Canada within their equity holdings will be proportionately less than this, given the allocation to international companies.

Currently, our portfolio is positioned toward value-oriented stocks (including financials, consumer discretionary, industrials, energy and materials) making up 63% of the portfolio versus 56% at September 30th, while maintaining exposure to growth stocks (including healthcare, technology and communication services) at around 29% of the portfolio, which was down slightly from 30% at September 30th. Staples (4%), which we don't classify as either growth or value, make up the balance of our equity exposure.

During the fourth quarter, we actively added a number of new positions that we believe will benefit from secular trends and declining interest rates and can compound earnings growth even in a slowing economic environment. These included Arthur J Gallagher & Co., Eaton Corp. PLC, Elevance Health Inc. and Enghouse Systems Ltd. Like our existing position in Marsh & McLennan, Arthur J Gallagher is an insurance broker such that it does not assume any (or very little) specific insurance risk. Insurance is defensive in nature given that most insurance (auto, home etc.) is non-discretionary. We believe that the insurance industry will benefit from a number of tailwinds including cyber security, changing weather patterns, and possibly new forms of insurance that emerge following the COVID pandemic. The insurance brokerage industry is a highly fragmented industry and Arthur Gallagher has a strong track record as a consolidator in the space. We expect this to continue in the years ahead. Eaton Corp. PLC is a power management company, which provides energy-efficient solutions for electrical, hydraulic, and mechanical power. Eaton should benefit from the electrical super cycle just getting underway including semi-conductor reshoring, EV charging stations, energy transition to renewable energy, energy grid expansion and digitization to the cloud. Their strong order and backlog growth should provide growth in earnings for Eaton even through an economic slowdown.

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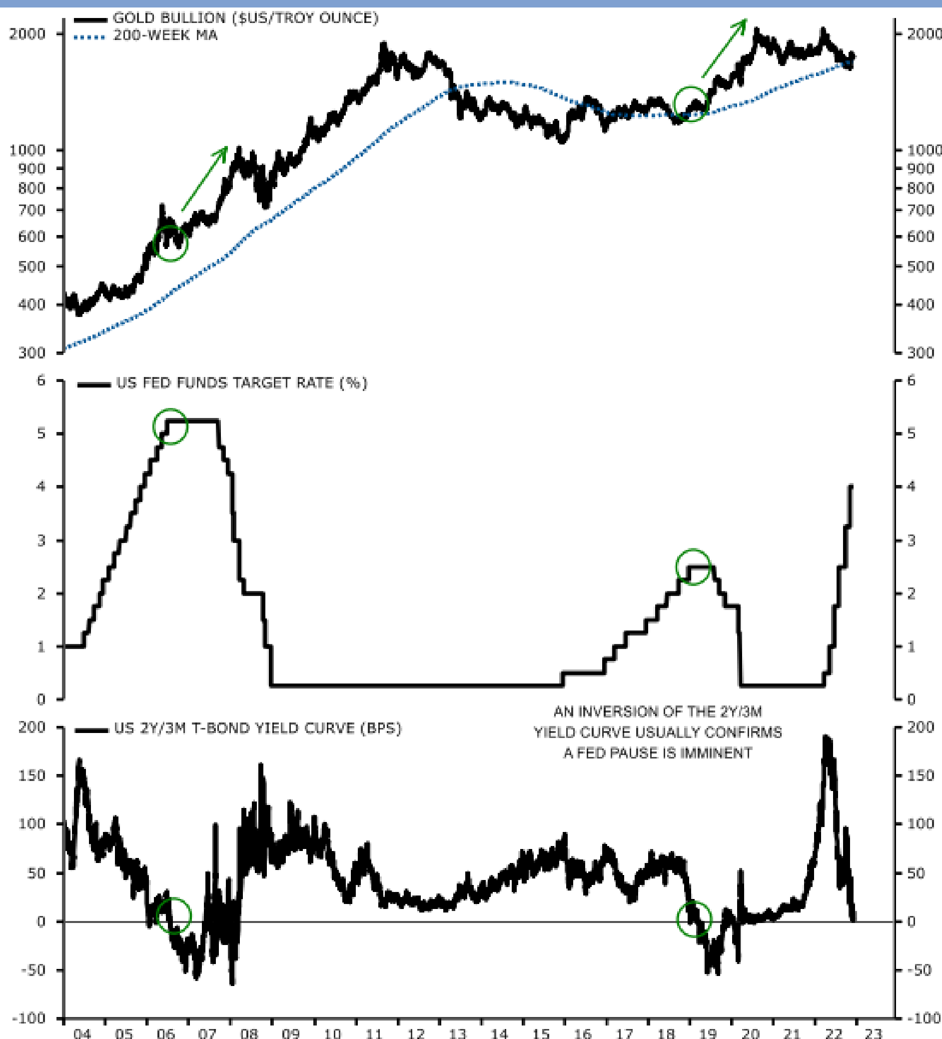
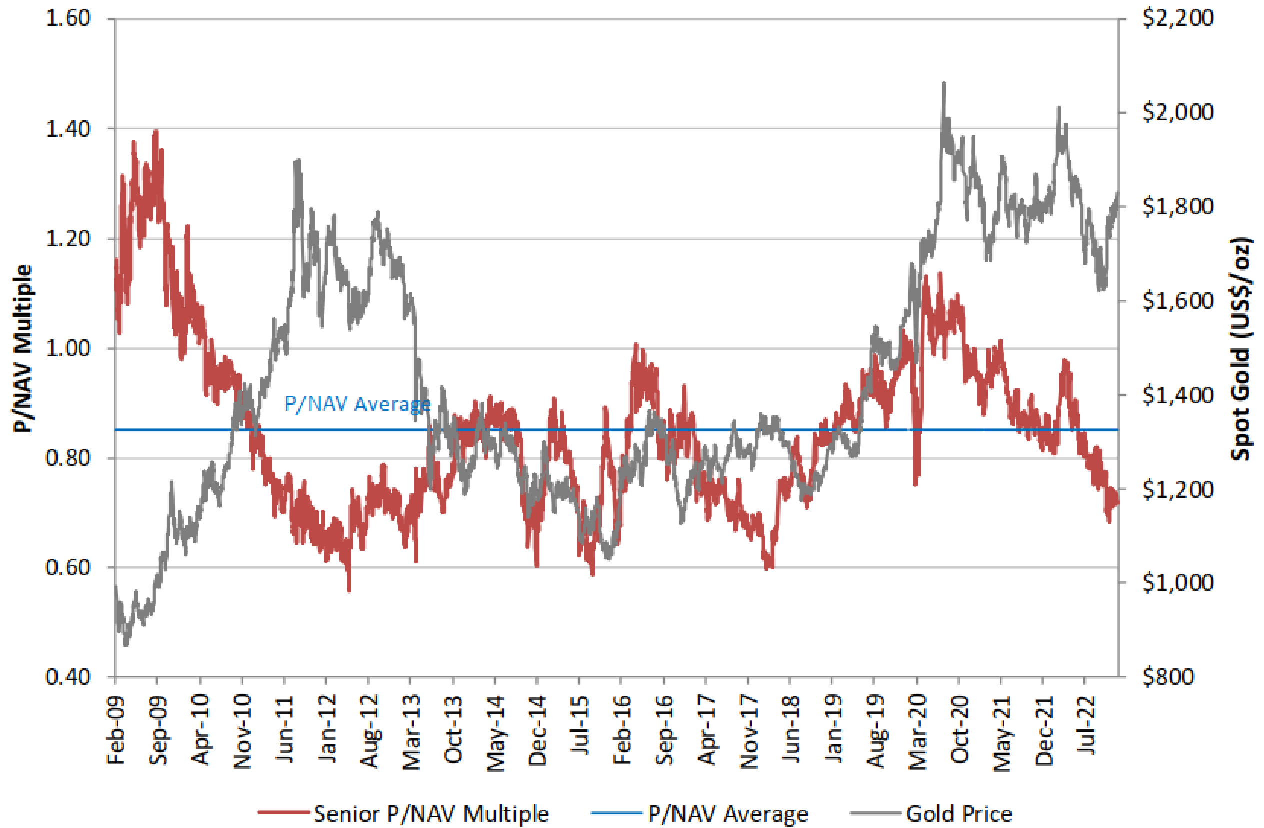
Another new purchase we made that should benefit from a peak in short term interest rates was the S&P/TSX Global Gold Index ETF (or XGD). This ETF replicates the performance of the S&P/TSX Global Gold Index, which covers mostly gold mining companies. The recent inversion of the 2 year / 3 month treasury yield curve (bottom clip of **Exhibit 10**) has historically signaled a pause in the Federal Funds rate hiking cycle (middle clip **Exhibit 10**), which we believe could happen sometime during the first half of 2023.This has historically been followed by a declining Federal Funds rate and has been a positive for gold and hence gold equities (top clip E**xhibit 10). Exhibit 11** shows that gold stocks are currently trading at a discount (red line) to their long term historical average net asset value (blue line) and even below levels seen more recently in 2020 and 2021, in particular in relation to the gold commodity price (grey line). A complete review of the business and fundamental outlook for new companies purchased during the quarter can be found in **Appendix 1.**

Exhibit 10: Gold Performance Around Peak in Fed Fund Rates



Source: Canaccord Genuity

Exhibit 11: Gold Stocks Price/ Net Asset Value (Current vs Historic Average)

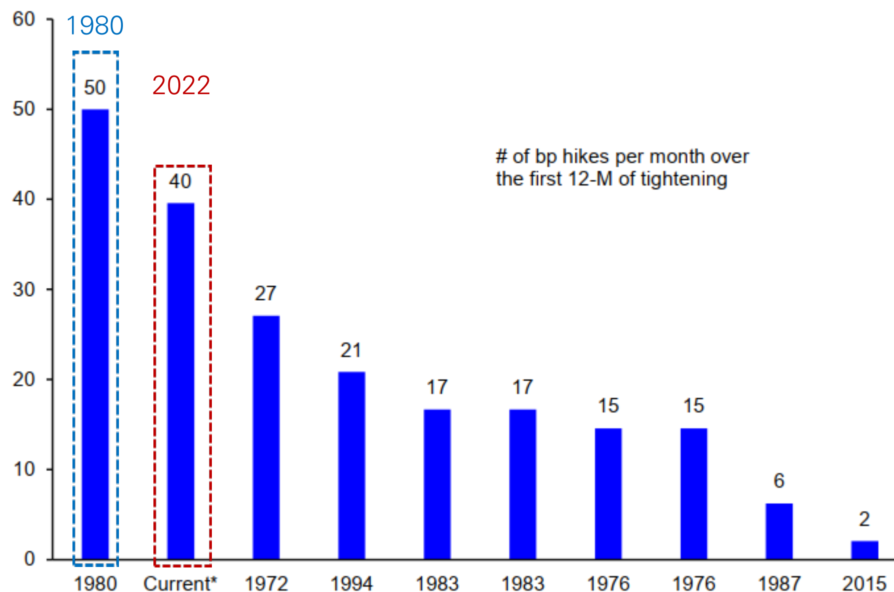


Source: Canaccord Genuity

Closing Comments and Outlook

As a result of inflationary pressures, 2022 will go down as one of the most aggressive monetary tightening cycles in the past 50 years. As shown in **Exhibit 12,** only the inflationary era of the 1980's when Fed Chair Paul Volker raised interest rates to 20% did we experience a more aggressive 12 month tightening cycle than the previous 12 months of 2022.

Exhibit 12: First year Fed rate tightening cycles since the 1970's



Source: Scotiabank Global Equity Research, Ste-Marie et al, 12/05/2022

Exhibit 13 looks at the performance of the S&P500 during this Volker era in June 1981 when the Federal Reserve Chair Paul Volker raised interest rates to 20%. As indicated in the chart, from the S&P500 peak (November 28, 1980) to the S&P500 trough (August 12, 1982) the S&P500 fell -27% similar to the drop from the January 3rd, 2022 peak to the October 12, 2022 trough (if in fact that was the trough) of -25.4%. What's interesting to note is that from the August 1982 S&P500 trough to when Volker said he may shift tactics in October 1982, it only took 4 months for the S&P500 to recover its entire loss. Since October 12th 2022 to Dec 31st 2022 the S&P500 has already recovered +7.3%.

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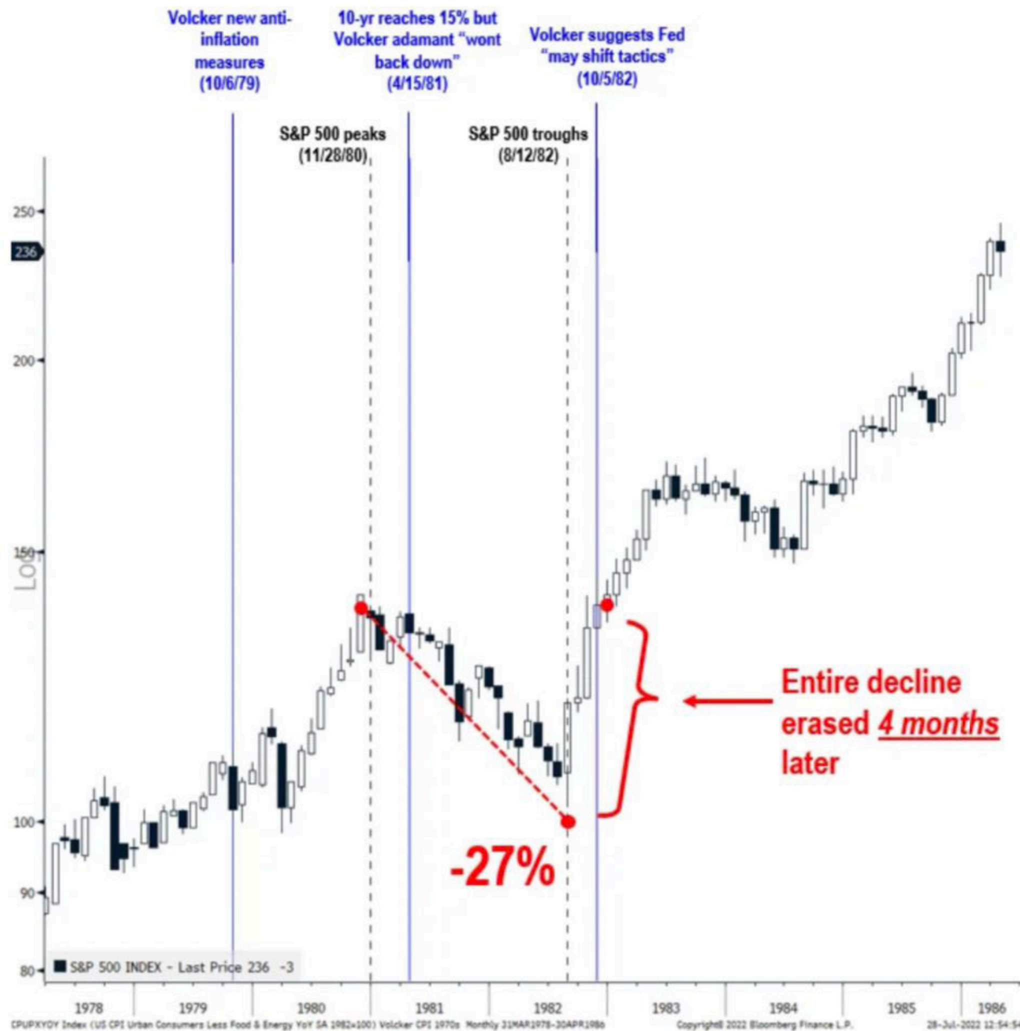
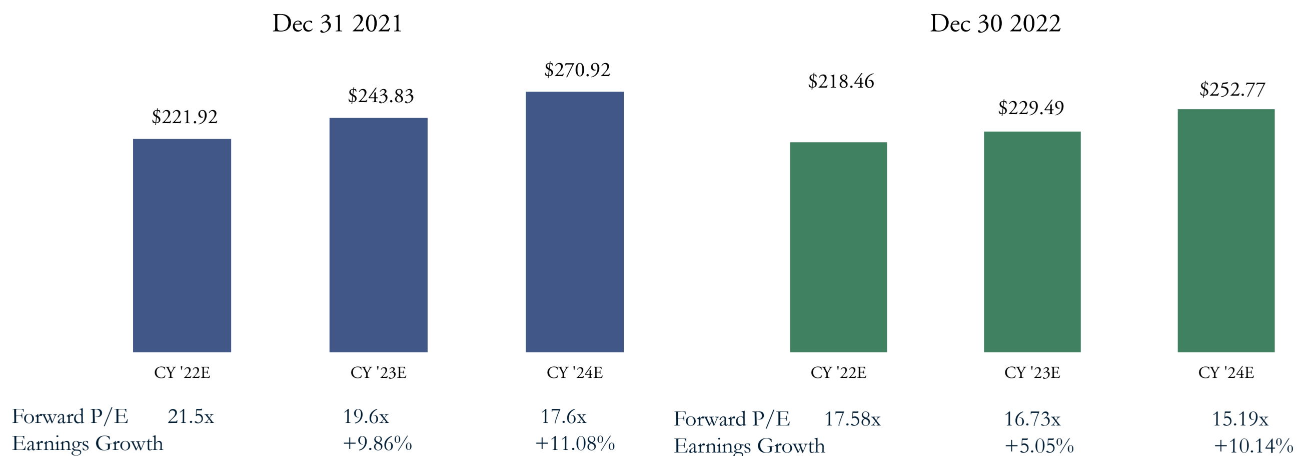
Exhibit 13: Volcker Interest Rate Policy



Source: Fundstrat, Bloomberg

In our final chart (**Exhibit 14**), we look at S&P500 bottom-up consensus earnings as of Dec 31st, 2022 and compare it to one year ago. Two observations come out of this: Firstly, the year over year change in earnings estimates are not down that much -1.6%, -5.9% and -6.7% for 2022, 2023 and 2024 respectively. Secondly, current forward earnings growth is still positive for 2023 and 2024 at +5.1% and +10.1% respectively such that the forward P/E multiples are starting to look reasonably attractive at 16.7x and 15.2x compared to the historical 10 year average of 17.3x. Our experience is that the market begins to look forward to the next year (2024) usually by the second quarter of the current year.

Exhibit 14: Earnings Have Not Collapsed



Dec 31 2021	CY '22E	CY '23E	CY '24E
Forward P/E	21.5x	19.6x	17.6x
Earnings Growth		+9.86%	+11.08%

Dec 30 2022	CY '22E	CY '23E	CY '24E
Forward P/E	17.58x	16.73x	15.19x
Earnings Growth		+5.05%	+10.14%

Source: Factset

In closing, while there are no shortages of negative economic forecasts for 2023, we are not totally in the recession camp. As our Chairman Gerry Connor likes to say, *"if you are going to panic, panic early"* and that time was probably a year ago. Henry McVey's (KKR's Global Macro strategist) recent year end strategy review noted that the share of the top 25 global central banks boosting rates in 2023 will fall to 12% compared to 84% in 2022. And as we outlined above, we think there is a reasonable chance the Federal Reserve will manage to tame inflation and we expect the economy to remain resilient. Even if we are wrong and we do experience a mild recession, the Fed will likely shift tactics. Our best guess is that long term interest rates will likely be falling leading to P/E expansion and support for market valuations, which is the opposite of the 2 year P/E contraction we experienced in 2021 and 2022.

Peter Jackson
Chief Investment Officer
December 31th, 2022

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

Enghouse Systems Ltd.

While Enghouse, which acquires and integrates technology companies, benefitted materially from a videoconferencing acquisition during the first year of the pandemic, the last year has seen it suffer from difficult comparables of sequential revenue and EBITDA growth as the "Zoom wave" dissipated. Management was also wary of acquisition prices through this period and built up a war chest of over $200 million, again hurting comps. It's most recent quarter finally showed sequential growth in both revenue and EBITDA and the company has recently announced two significant acquisitions at attractive prices, which should really re-accelerate growth.

UNITED STATES

Arthur J Gallagher & Co (AJG)

Founded in 1927, Arthur Gallagher has grown to become one of the leading insurance brokerage, risk management, and human capital consultant companies in the world. With significant reach internationally, the company employs over 34,000 people and its global network provides services in more than 130 countries. We like the insurance broker industry given its characteristics. It is a steady, picks & shovels type business for the global insurance, reinsurance, retirement, and health benefits industries. Arthur Gallagher does not assume any insurance risk itself, but rather provides analytical and consulting services to help its clients manage their risk, acting as the middle person between the client and the insurance provider. Insurance is also defensive in nature given that most forms of insurance (home & auto for example) are non-discretionary in nature.

Eaton Corp. PLC, (ETN)

Eaton is primarily a power management company that benefits from the secular shift to renewable power and investment in electrification as the grid shifts from a static distribution model to one where there is a dynamic exchange of electricity and data from power producers, distributors, and consumers. Eaton's new order and backlog growth have recently accelerated, driven by manufacturing, EV charging infrastructure, renewable energy generation, energy storage, and grid resiliency products. Eaton also has a strong Aerospace segment that is benefitting from a recovery in commercial airline traffic and higher commercial OEM build rates. The secular tailwinds should support prolonged revenue growth at mid to high single digits.

Elevance Health Inc. (ELV)

Elevance Health is one of the largest health benefits companies in the United States, serving more than 45 million medical members through its affiliated health plans. The company offers a broad spectrum of network-based managed care risk-based plans to Individual, Group, Medicaid and Medicare markets. Elevance's insurance segment provides an array of government and commercial health plans including Blue Cross and Blue Shield plans across 14 U.S. states. In addition to insurance, the company also offers specialty services. These services include home-based nursing care management, behavioural health services, and pharmacy benefit management. Management views specialty services as a key growth opportunity and it is making significant investments in this business as it seeks to capture more of the overall spending that is occurring in healthcare. We like the healthcare industry given its stability and its growth characteristics, which are being driven by aging demographics. We believe that Elevance Health is well positioned to benefit from this trend.