CUMBERLAND
Private Wealth

March 31, 2024

First Quarter Review

NORTH AMERICAN EQUITY STRATEGY

Markets are off to a strong start so far in 2024. During the first quarter of 2024, the S&P500 total return was +10.6% in U.S. dollars. Adjusting for currency, the S&P500 returned +13.3% in Canadian dollars, as the Canadian dollar depreciated about -1.6600 cents, closing the quarter at US$0.7385. The TSX total return was +6.6% in the first quarter.

In our view, the current market advance is a result of the combination of a strengthening economy, growing earnings and the expectation of rate cuts later in 2024. The market's focus has pivoted away from concerns about rising interest rates, which facilitated the rally during the fourth quarter of 2023, focusing on the forecasted earnings growth in both 2024 and 2025 (after flat earnings in 2023) which took the markets to new heights in 2024 year to date. Price/earnings (P/E) multiple expansion (i.e.: an increase in what investors are willing to pay for every dollar of earnings) is not unusual at this point in the cycle as earnings estimates catch up. This leads to stock valuations that are higher than historical averages, however with that said, we still don't believe they are unreasonable for this point in the cycle. Finally, last week's update by the Federal Open Market Committee of the U.S. Federal Reserve (Fed), seems to support our expectation of a lower Fed Funds Rate (and therefore lower interest rates) in the second half of 2024.

Exhibit 1 shows the Federal Reserve's Summary of Economic Projections (SEP) released on March 20th, 2024. The Fed raised its economic forecast for real GDP growth for 2024 materially from 1.4% to 2.1%, reduced their target unemployment rate from 4.1% to 4.0%, while maintaining PCE inflation (the Fed's preferred inflation measure) forecast flat at 2.4%. We cannot help but draw on the fairy-tale, Goldilocks analogy of an economy that is neither too hot nor too cold, but just right. In other words, an economy that sustains moderate economic growth, with relatively low inflation, which allows for market-friendly monetary policy. What could possibly go wrong?

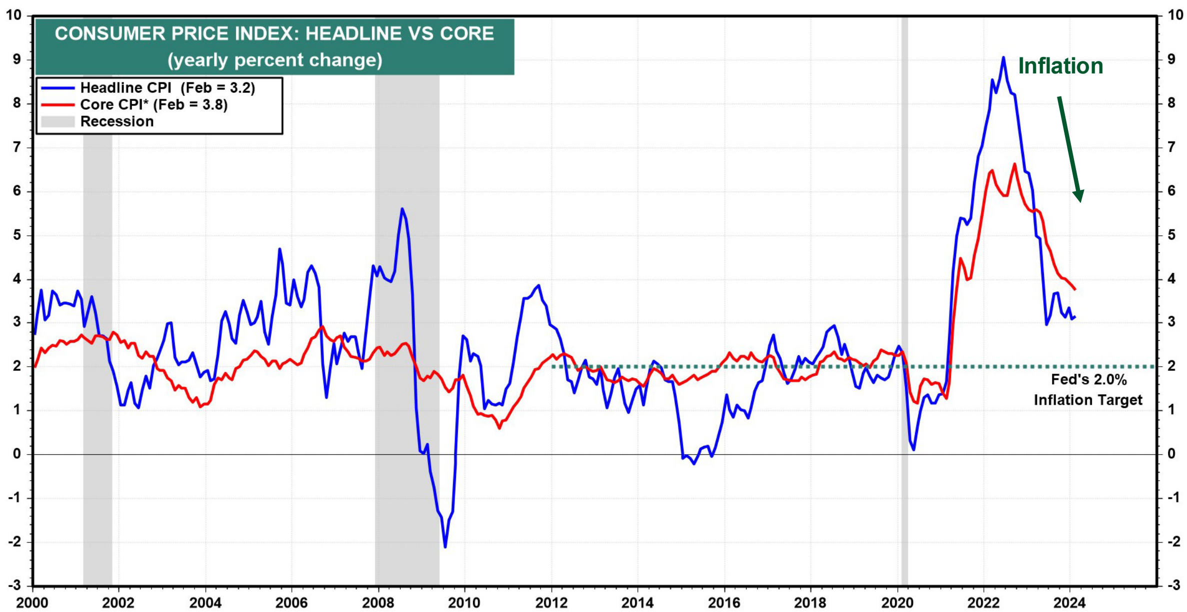
Exhibit 1: FOMC Summary of Economic Projections

Variable [in %]	Median			
	2024	2025	2026	Longer Run
Change in real GDP (March)	2.1	2.0	2.0	1.8
December projection	1.4	1.8	1.9	1.8
Unemployment rate (March)	4.0	4.1	4.0	4.1
December projection	4.1	4.1	4.1	4.1
PCE inflation (March)	2.4	2.2	2.0	2.0
December projection	2.4	2.1	2.0	2.0
Core PCE inflation	2.6	2.2	2.0	
December projection	2.4	2.2	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	4.6	3.9	3.1	2.6
December projection	4.6	3.6	2.9	2.5

Source: Federal Open Market Committee (FOMC), Summary of Economic Projections, March 20, 2024

Well, one of the biggest concerns to this Goldilocks scenario is in fact the outlook for inflation. February's year over year headline CPI inflation rate in the U.S. was a little "bumpy", using Fed Chairman Jerome Powell's own words, ticking up 0.1% to 3.2% although Core inflation eased 0.1% to 3.8%, the lowest reading since the spring of 2021. These are still well above the Fed's 2.0% inflation target (**Exhibit 2**), which has brought into question the number of interest rate cuts we will see this year. The result is that we have seen a shift in market expectations. Back in January, the market had priced in as many as six rate cuts this year, but now is only pricing in about three today. This is now in line with the Federal Reserve's 2024 projection for three rate cuts to 4.6% in the March SEP (**Exhibit 1** above).

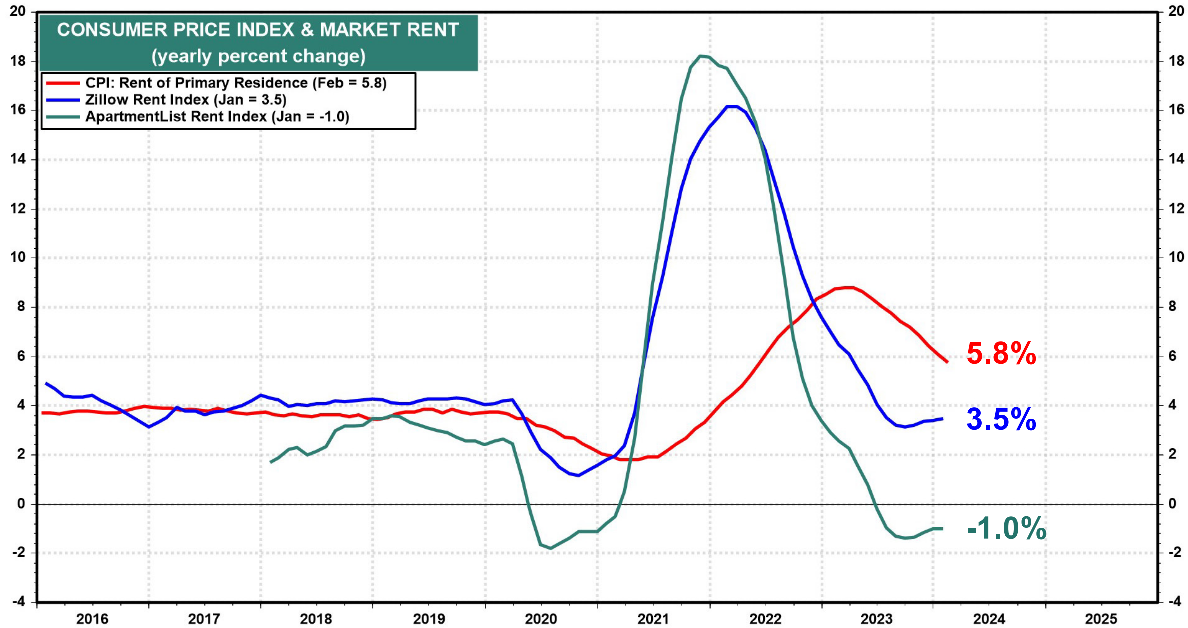
Exhibit 2: Consumer Price Index (Headline and Core)



Source: Yardeni Research, Morning Brief, March 13, 2024

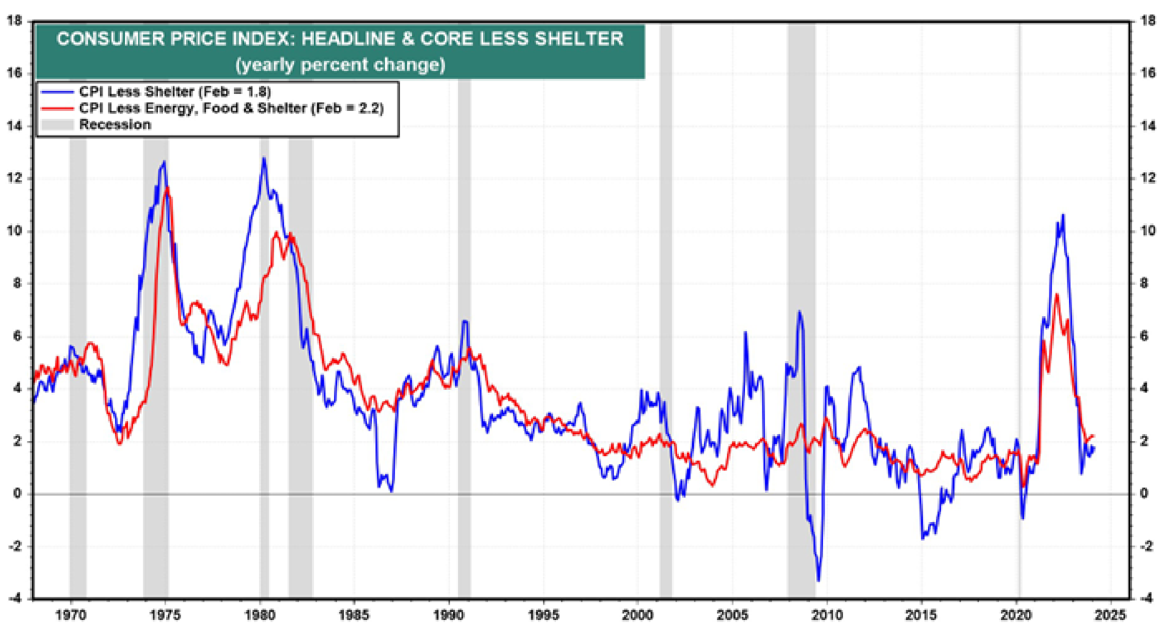
One issue with both CPI and Core CPI data is that the shelter component (red line **Exhibit 3)**, which accounts for over one third of the overall inflation index, is a lagging indicator compared to other market-based indicators. It peaked at 8.3% in March 2023 and was down to 5.8% in February. However, other market-based indexes such as the Zillow Observed Rent Index (+3.5% YoY, blue line **Exhibit 3**) and Apartment List Rent Estimates (-1.0% YoY, green line **Exhibit 3**) have already moved lower. If we remove the shelter component from CPI and Core CPI, CPI and Core CPI less shelter are closer to the Federal Reserve's inflation target at 1.8% and 2.2%, respectively (**Exhibit 4**). We think as we move through 2024, inflation will likely continue to move closer to the Federal Reserve's target of 2%, allowing for interest rate cuts in the back half of 2024.

Exhibit 3: CPI Rent versus Market Rent



Source: Yardeni Research, Morning Brief, March 13, 2024

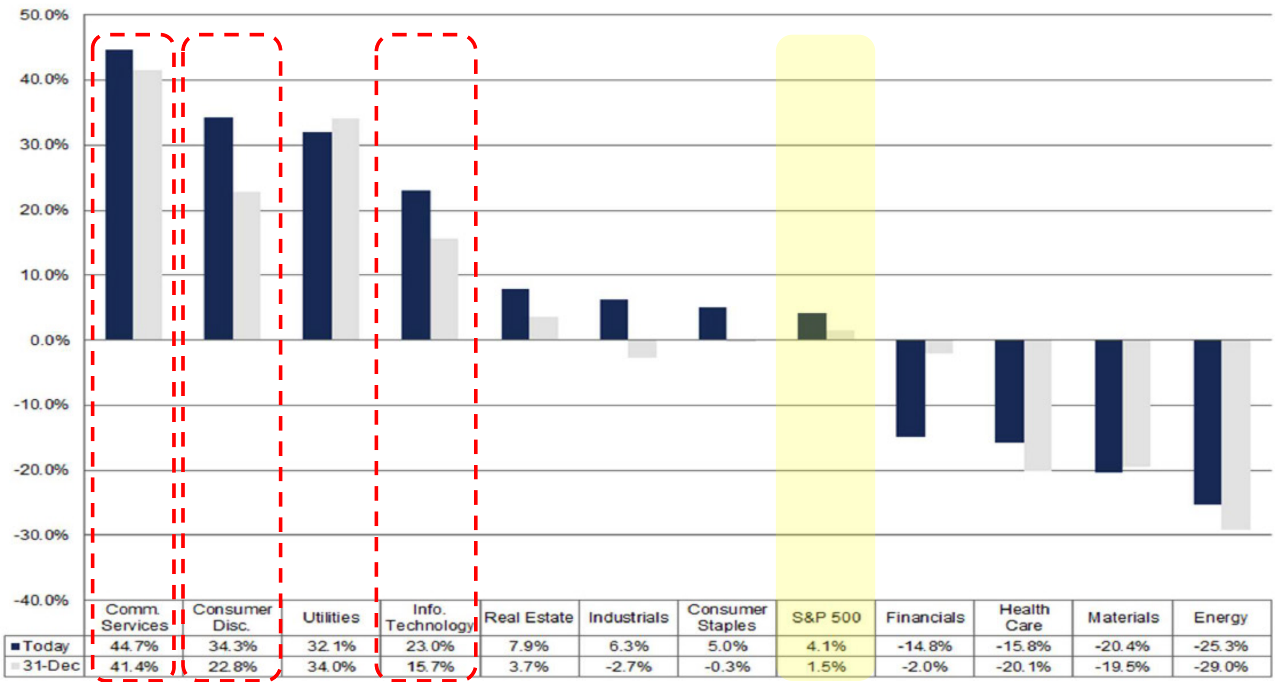
Exhibit 4: CPI Headline and Core Less Shelter



Source: Yardeni Research, Morning Brief, March 13, 2024

Exhibit 5 shows the Earnings growth Scorecard for Q4 2023 in which 73% of S&P 500 companies have reported a positive EPS surprise and 64% of S&P 500 companies have reported a positive revenue surprise. Highlighted in yellow in the chart, the S&P500 earnings grew 4.1% year over year in the quarter, much stronger than the 1.5% market consensus growth rate as of December 31, 2023. As indicated in the chart, this has been skewed by the positive earnings surprises in Communication Services +44.7% (includes Meta, Alphabet), Consumer Discretionary +34.3% (includes Amazon, Tesla) and Information Technology 23.0% (includes Microsoft, Apple, Nvidia) or the Magnificent 7 stocks, especially given the large weight they carry in the S&P500 of nearly a third (~29%).

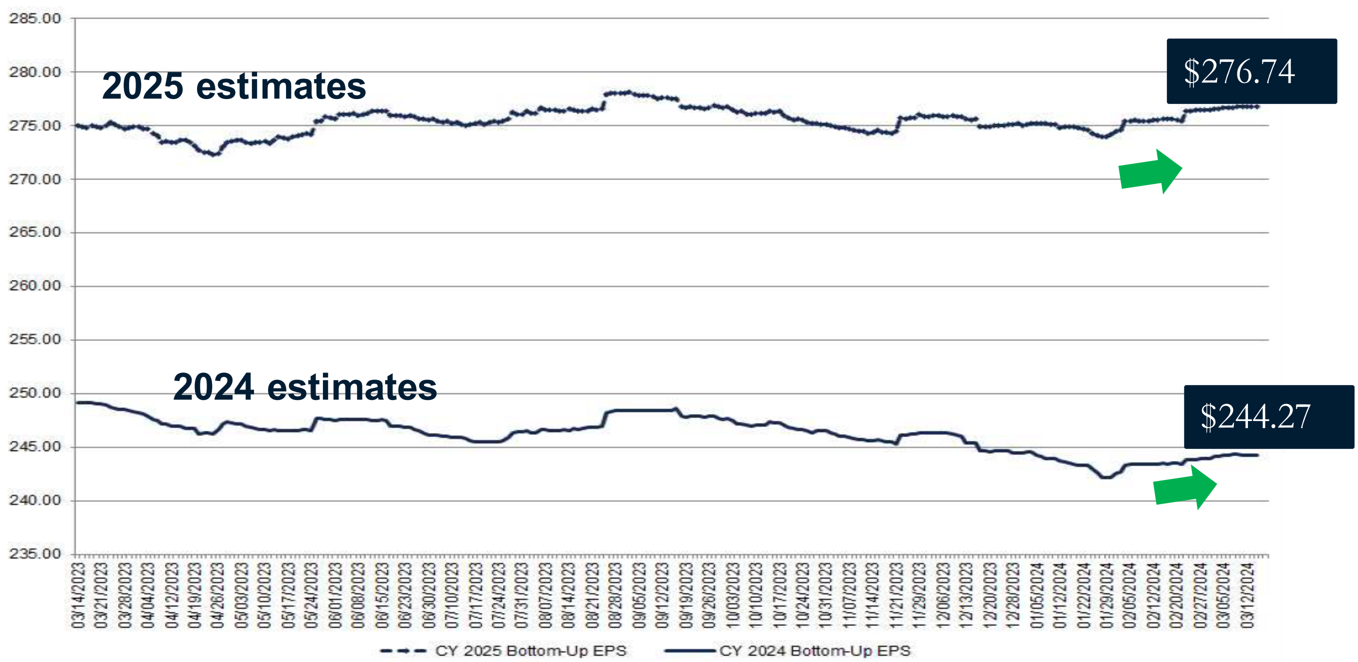
Exhibit 5: Q4 2023 S&P500 Earnings Growth



Source: FactSet Earnings Insight 3/15/2024

This also marks the second quarter of overall positive earnings growth for the S&P500 after three negative quarters. **Exhibit 6** shows that Calendar earnings growth for 2024 and 2025 has also turned positive in February of this year. While there have been some false starts to this, two quarters of back-to-back better-than-expected positive earnings results give us some confidence in the calendar forecasts.

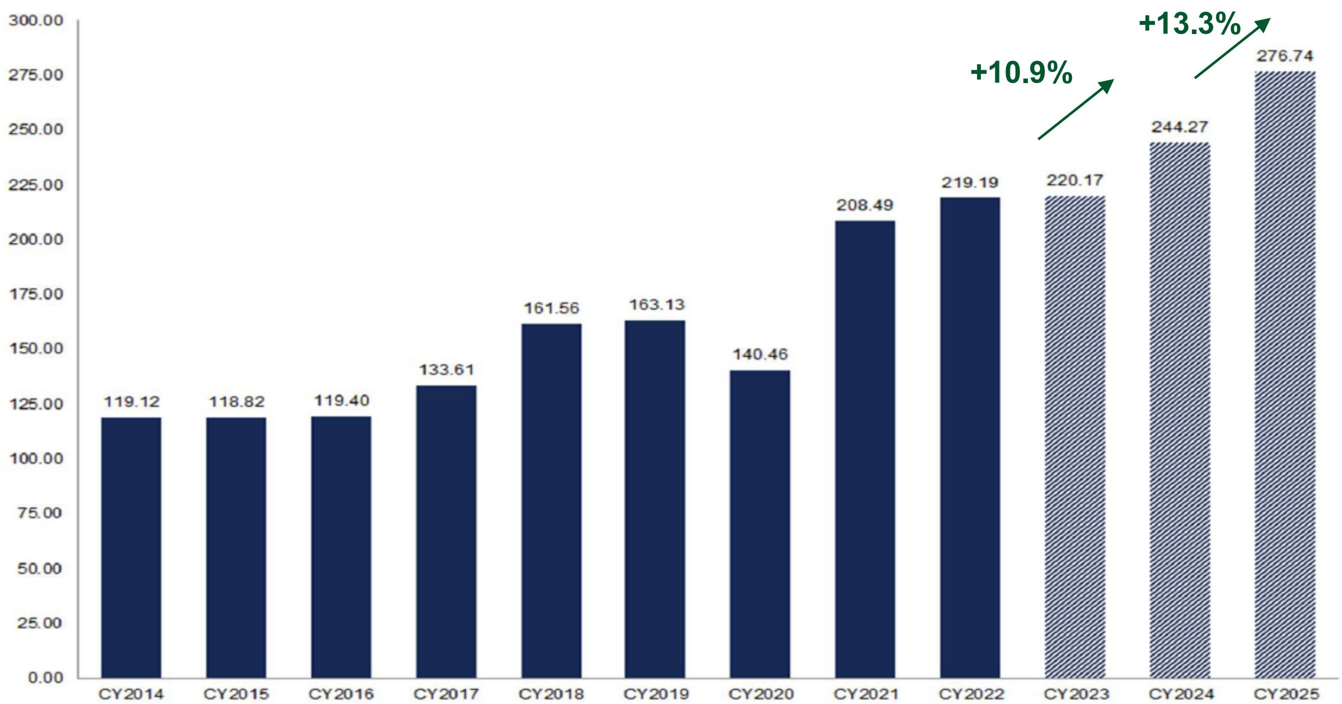
Exhibit 6: S&P500 Calendar Year 2024 and 2025 Earnings Growth



Source: FactSet Earnings Insight 3/15/2024

Exhibit 7 shows that after a flat year for earnings growth in 2023 compared to 2022, 2024 and 2025 consensus calendar earnings growth is expected to reaccelerate to double digit levels of 10.9% and 13.3%, respectively.

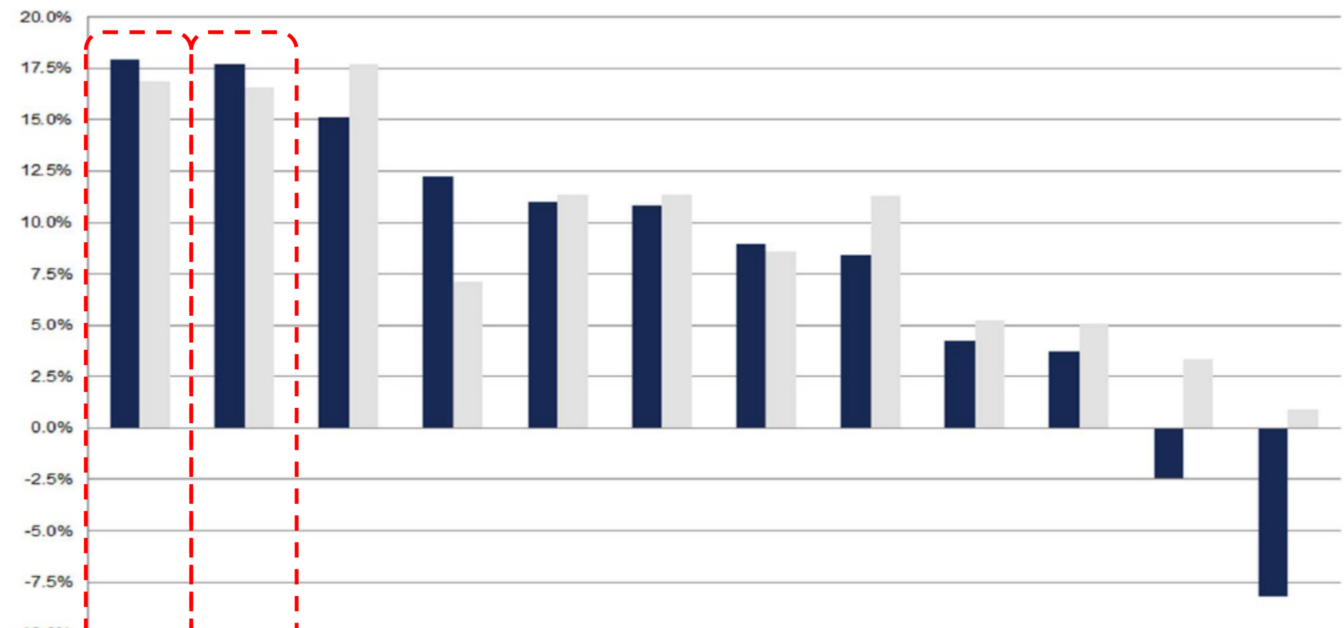
Exhibit 7: S&P500 Calendar Actuals and Consensus Estimates



Source: FactSet Earnings Insight 3/15/2024

Exhibit 8 shows 2024 calendar forecasted earnings growth broken down by sector. What's notable is that Information Technology at 17.9% and Communication Services at 17.7% are again materially positive standouts in terms of forecasted earnings growth.

Exhibit 8: Calendar Year 2024 Earnings Growth by Sector

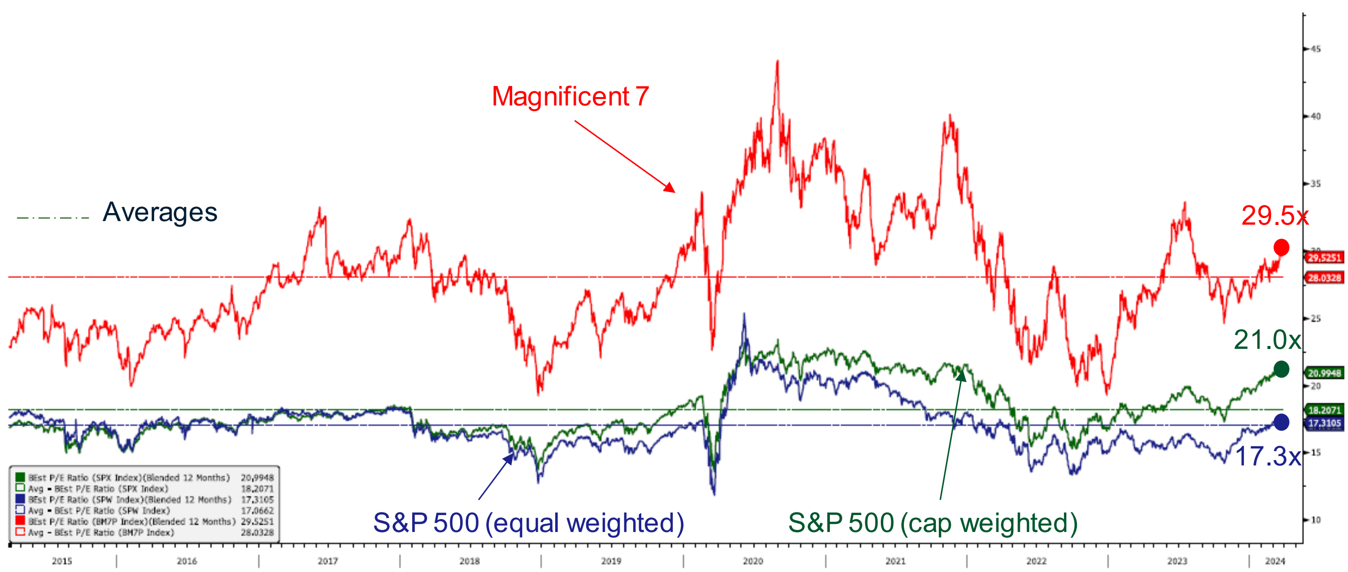


	Info. Technology	Comm. Services	Health Care	Financials	S&P 500	Consumer Disc.	Utilities	Industrials	Consumer Staples	Real Estate	Materials	Energy
Today	17.9%	17.7%	15.1%	12.2%	11.0%	10.8%	9.0%	8.4%	4.2%	3.7%	-2.4%	-8.2%
31-Dec	16.9%	16.6%	17.7%	7.1%	11.3%	11.4%	8.6%	11.3%	5.3%	5.1%	3.4%	0.9%

Source: FactSet Earnings Insight 3/15/2024

This brings us to valuation. **Exhibit 9** shows the forward 12-month price to earnings (P/E) multiple for the S&P500 (green line). At 21.0x currently, the S&P500 is trading at a premium relative to its historical long-term average of 18.2x. However, the P/E for the Magnificent 7 stocks (top red line), currently at 29.5x, heavily skews the multiple for the S&P500 upward since it is a market capitalization-weighted index (meaning the biggest companies have the biggest influence) and these seven stocks represent ~29% of the S&P500 index weight (on 3/26/24). If we adjust for this by equal weighting stocks in the index (purple line), the S&P500 trades at a more reasonable multiple today of 17.3x as compared to its long term average of 17.1x.

Exhibit 9: Magnificent 7 (red) versus S&P 500 (Market capitalization weighted in green and equal weighted in purple)



Source: Bloomberg, 3/26/2024, Magnificent 7 corresponds to the BM7P Index with constituents MSFT, AAPL, NVDA, AMZN, META, GOOGL, TSLA

Perhaps the more relevant question is whether the current valuation or P/E multiple for the Magnificent 7 is justified. When we compare the level of Q4 earnings growth shown in **Exhibit 5** and the expected forward 2024 earnings growth shown in **Exhibit 7** for the Magnificent 7 sectors, the answer is probably Yes. **Exhibit 10** shows the historical forward P/E ratio premium of the Magnificent 7 relative to the S&P500. At its current level of 40%, the premium is large, however it currently sits at the low end of its 9-year trading range of about 30% to 80%. We don't own all of the Magnificent 7 stocks, and we are still comfortable with our current positions which include Amazon, Apple, Alphabet, Meta and Microsoft.

Exhibit 10: Forward P/E Ratio Premium of Magnificent 7 to S&P500

Source: Bloomberg, 3/26/2024, BEst P/E BF12m for SPX Index & BM7P Index

Asset Allocation for our North American Equity Strategy As of March 31, 2024	
Equities	95%
Fixed Income	0%
Cash	5%

Our overall equity and cash exposure were unchanged this quarter at 95% and 5%, respectively. Our U.S. equity exposure increased from 47% to 52% while our Canadian exposure decreased from 48% to 43%. Note that in the case of portfolios invested in our North American plus International Equity strategy, the actual weights of US and Canada within the equity holdings will be proportionately less than these given the allocation to international stocks.

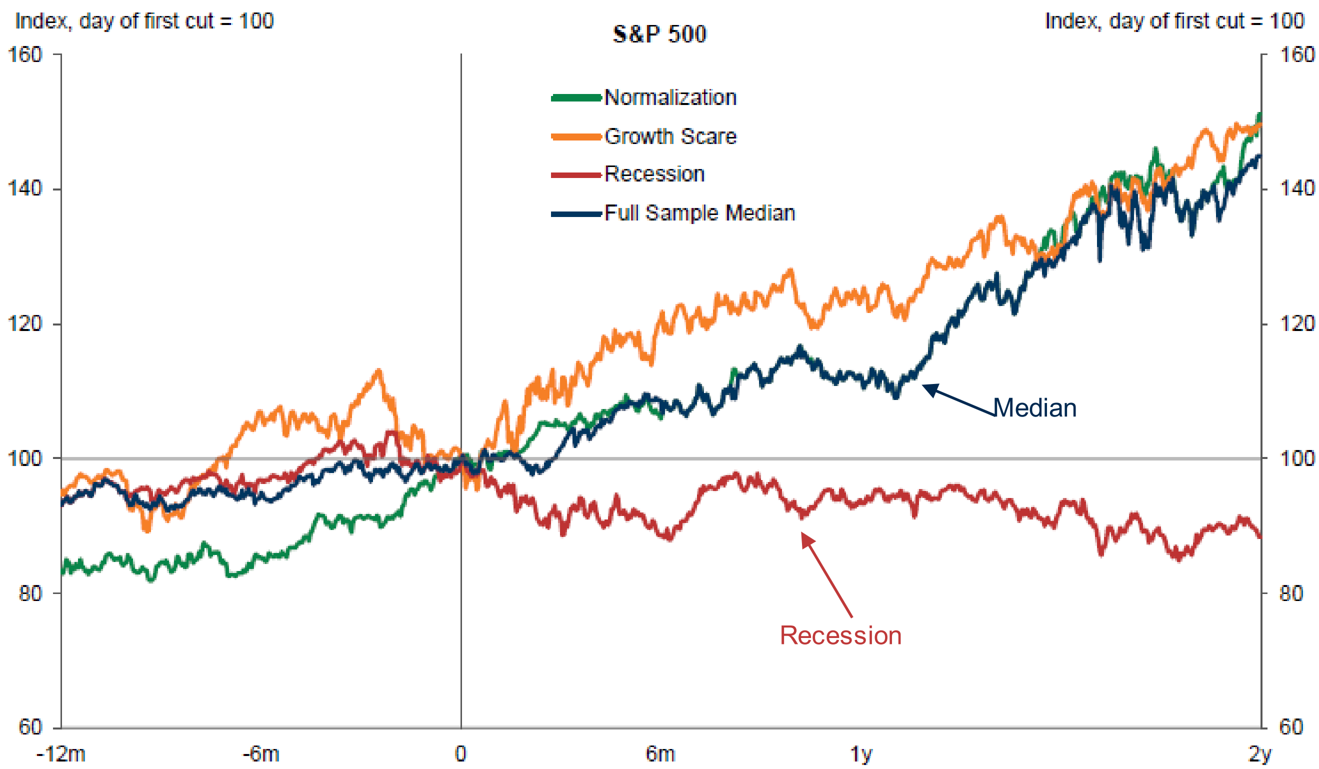
During the quarter we continued to shift our allocation in favour of US equities (+5%) over Canadian equities (-5%). While there are pockets of strength in Canada, overall forward 12month earnings growth remains negative in Canada as compared to the positive earnings and improving breadth of earnings in the U.S. Our Canadian holdings are positioned within these pockets of strength, and most of these Canadian companies have globally diversified revenue sources despite being headquartered in Canada.

During the quarter, we added two new positions in Mastercard Inc. and O'Reilly Automotive. Mastercard operates a payment network with integrated solutions that link consumers, banks, merchants, and merchant acquirers. The network business is a duopoly with Visa (also owned in Cumberland portfolios), and is protected by a network effect as merchants are more likely to subscribe to many consumers carrying Mastercard cards; and consumers are more likely to carry a Mastercard because many merchants can process it (like Visa). We believe Mastercard's competitive positioning will allow it to continue to earn excess returns that won't likely be displaced by competition in the foreseeable future. O'Reilly Automotive (ORLY) owns and operates automotive parts distribution warehouses and a network of 5,600 retail stores predominantly in the U.S., but also in Mexico and Canada serving both the pro/do-it-for-me market (DIFM) as well as the consumer/do-it-yourself markets (DIY). While auto OEMs (original equipment manufacturers) and car part manufacturers can have variable earnings, the aftermarket parts business is much more stable due to the non-discretionary nature of replacement parts, which results in a stock with much lower overall volatility. ORLY has an excellent track record of allocating capital with an average return on invested capital of approximately 43% over the last 10 years. A complete review of the business and fundamental outlook for new companies purchased during the quarter can be found in Appendix 1.

Closing Comments and Outlook

The upcoming monetary easing cycle is likely to take place against a backdrop where economic / GDP growth is solid, the unemployment rate is low, and inflation continues to move toward target levels. In an environment with the normalization of interest rates, or essentially monetary policy moving away from a more restrictive stance, stock markets have historically performed well. **Exhibit 11** looks at 10 cutting cycles since 1984 and as indicated in the chart, the median returns (blue line) for the S&P500 have historically been quite positive 12-24 months out following the initial rate cut. It is only in the recession scenario (red line) that returns have been sub-par and a recession is not in our base case forecast, nor does it appear to be in the minds of investors now.

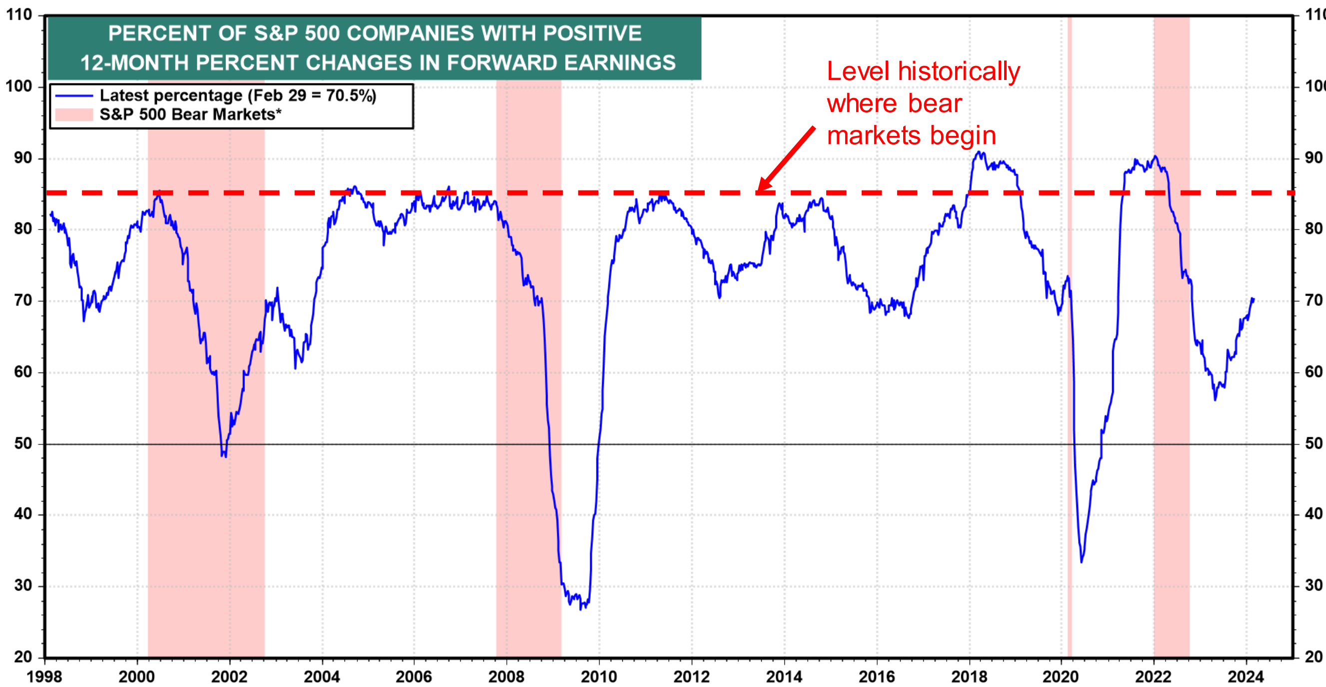
Exhibit 11: Stocks Rally After the Fed's first-rate cuts, except in a recession scenario



Source: Goldman Sachs, 02/24/2024

Growing earnings could also provide a catalyst for further market appreciation. **Exhibit 12** shows the percentage of companies with positive changes in forward earnings growth going back to the 1990's (blue line) with bear markets shaded in pink. Currently, we are sitting at about 70.5% of companies with positive changes in forward earnings growth, up from the mid-fifties in the spring of 2023. If history is any indication, earnings breadth may continue to broaden out (i.e.: more companies may report positive changes) and historically bear markets don't begin until this number approaches about 85-90%, suggesting we still have some room to go from an earnings growth perspective.

Exhibit 12: Percent of S&P 500 Companies with Positive 12-month Percent Changes in Forward EPS



Source: Yardeni Research, Morning Brief, 03/04/2024

Finally, we are in an election year. History has shown that periods of political turmoil have not typically derailed stock markets as evidenced in **Exhibit 13**. According to Ed Yardeni, one U.S. strategist we follow, it's only when geopolitical problems disrupt supply chains, trade, and global energy markets or when domestic partisanship prevents the government from functioning, that these considerations matter to companies and their investors. While we can't rule out a pullback moving toward the November 5th election day, particularly as moderate pullbacks of 5-10% tend to happen most years at some point or another, as the chart below shows, stocks tend to rise regardless of which party is in the White House or controls the House and Senate.

Exhibit 13: S&P 500 versus U.S. Presidents' Parties

Source: Yardeni Research, Morning Brief, 03/04/2024

So overall, we remain positive on the markets given that the upcoming monetary easing cycle and the fact that the decline in interest rates is likely to take place against a backdrop of solid economic growth, low unemployment, declining inflation and improving earnings.

Peter Jackson
Chief Investment Officer
March 31, 2024

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

UNITED STATES

Mastercard Inc.

Mastercard operates a digital payment network with integrated solutions that links consumers, banks, merchants, and merchant acquirers. Mastercard's business is protected by a network effect as merchants are more likely to subscribe to Mastercard's network because many consumers carry its cards; and consumers are more likely to carry a Mastercard because many merchants can process it. We think Mastercard has a long runway for growth as they benefit from the ongoing secular shift from cash to electronic payment, especially outside of North America, and the continued adoption of their value-added services, which include fraud detection, data analytics, and loyalty programs.

O'Reilly Automotive

O'Reilly Automotive owns and operates automotive part distribution warehouses and retail stores predominantly in the United States, but also in Mexico and Canada. O'Reilly serves both the do-it-for-me (pro) market, through speedy distribution of parts from its warehouses and stores to garages, as well as the do-it-yourself (consumer) markets through its network of 5600 stores. O'Reilly's main advantage is its warehousing and store strategy, with 30 distribution centres located in 30 major cities, which it uses to ship directly to customers as well as to replenish stores. It has used its distribution advantage to build out a pro-business, which appreciates their best-in-class speed and service, which now makes up 45% of its revenues. As a result, O'Reilly has better inventory turns, working capital management, and higher return on invested capital compared to most of its peers.