## Year In Review

# NORTH AMERICAN EQUITY STRATEGY

This decade will be remembered for a few things. From a stock market perspective, it will not only be remembered as the longest bull market in history, but also the best performing decade in history. However, some strategists have also coined this the most 'hated bull market in history'. That's not necessarily a bad thing because if everyone had been in love with this market and fully invested, then who would be left to buy it? Let's start by recapping where we were a year ago as compared to today.

Exhibit 1 compares the performance for the S&P500 and the TSX indices for the past two years. We also included the EAFE (markets outside North America) for some perspective as the pattern of performance is reasonably consistent.

**Exhibit 1**
**Decomposition of Index Returns and changes in Forward EPS & P/E ratio**

| S&P 500 (US Dollars) | Total Return % | Dividend Return% | Price Return % | % change in Forward EPS | % change in Forward P/E ratio |
|---|---|---|---|---|---|
| 2018 | -4.4% | 1.9% | -6.2% | 17.9% | -20.5% |
| 2019 | 31.5% | 2.6% | 28.9% | 1.8% | 26.7% |
| 2018 & 2019 (not annualized) | 25.7% | 4.9% | 20.8% | 20.0% | 0.7% |
| | | | | | |
| S&P/TSX Composite Index (CAD Dollars) | | | | | |
| 2018 | -8.9% | 2.8% | -11.6% | 13.6% | -22.2% |
| 2019 | 22.9% | 3.7% | 19.1% | 0.2% | 18.9% |
| 2018 & 2019 (not annualized) | 12.0% | 6.7% | 5.3% | 13.9% | -7.6% |
| | | | | | |
| EAFE (US Dollars) | | | | | |
| 2018 | -13.3% | 2.8% | -16.1% | 5.7% | -20.7% |
| 2019 | 22.8% | 4.3% | 18.4% | -4.2% | 23.7% |
| 2018 & 2019 (not annualized) | 6.4% | 7.1% | -0.7% | 1.2% | -1.9% |

Source: Bloomberg
Data source: SPX Index, SPTSX Index, MXEA Index, daily returns
Forward EPS & Forward P/E –blended forward 12 months

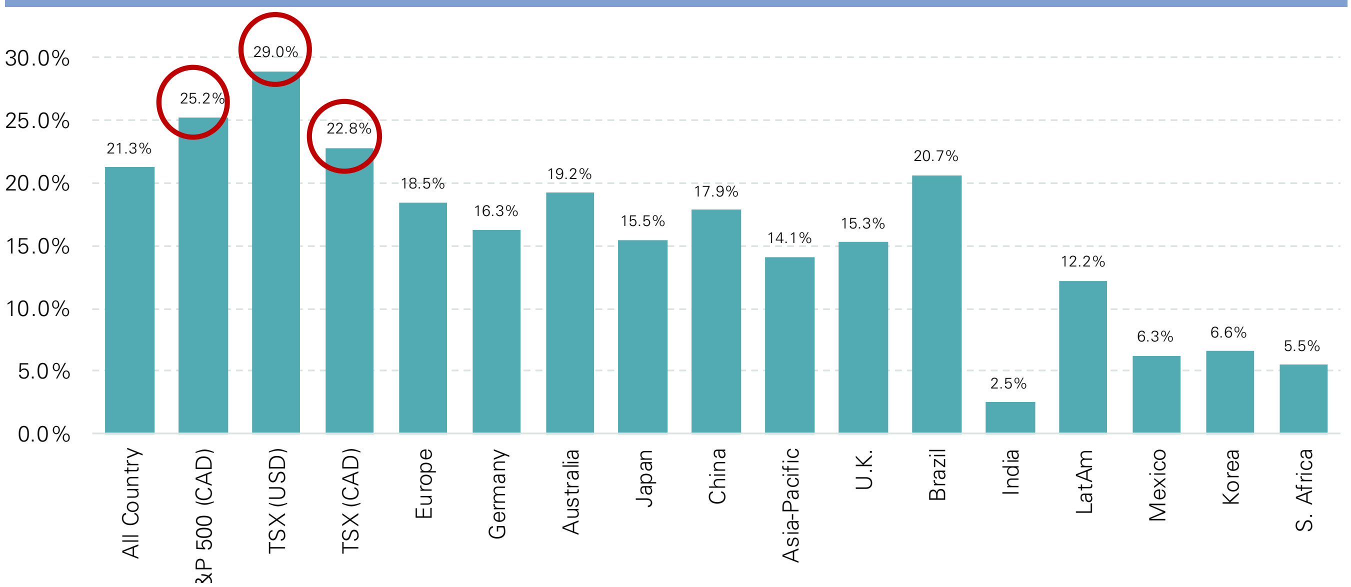
What we see is that while the returns for 2019 look extraordinary good (+31.5% S&P500, +22.9% TSX +22.8% EAFE), the returns for 2018 look comparatively bad (-4.4% S&P500, -8.9% TSX, -13.3% EAFE) and when you actually normalize the earnings for the past two years, it is easier to account for the divergence.

Take the S&P500 for example. While the 2019 price return was driven by significant Price to Earnings ("P/E") multiple expansion (+26.7%; meaning investors were willing to pay significantly more for the same dollar of earnings than they were last year) with almost no earnings growth (+1.8%), the 2019 return was skewed by the large market sell-off in the fourth quarter of 2018, which saw almost +18% earnings growth and a contraction of the P/E multiple of over -20%. Taken together, the total return of about 25% for the S&P500 over the past two years makes sense. With about 5% from dividends and 20% from price appreciation, this is almost exactly the same as the 20% earnings growth such that there was virtually no multiple expansion over the two year time period. This does not mean however, that the S&P500 is not a bit expensive here, trading above its historical averages, but ultimately it will depend on how much earnings growth there will be in the future, which we will discuss in more detail below.

The TSX and EAFE show a similar two year pattern of multiple contraction and expansion, however the TSX has had the larger return from dividends than the S&P500, the largest multiple contraction and yet still generated almost 14% earnings growth and a 12% return over the two years.

**Exhibit 2** shows the breakout of global equity performance by country for 2019. The S&P500 continued to dominate, with the TSX a close second, well ahead of many other global markets.

**Exhibit 2**
**Performance of Global Equities for 2019 by Region/Country**

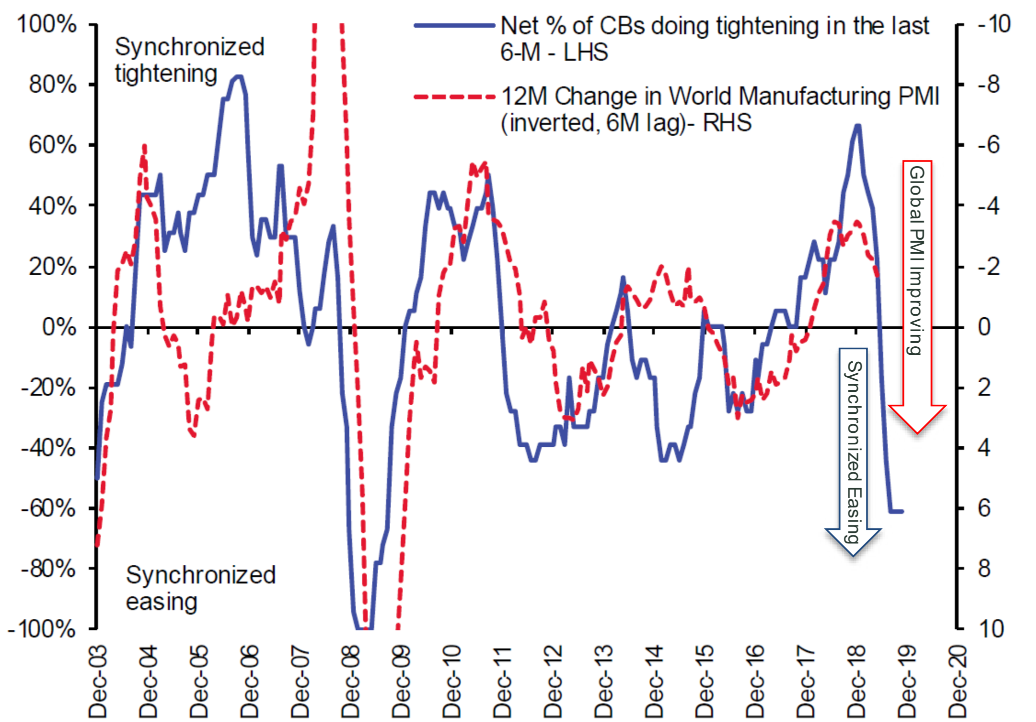



Source: Bloomberg
Total returns shown in Canadian Dollars unless otherwise indicated. Period of calculation – 12/31/2018-12/31/2019
MSCI indices used in chart above: All Country -MSCI ACWI Index. Europe-MSCI Europe Index. Germany-MSCI Germany Index. Australia-MSCI Australia Index. Japan-MSCI Japan Index, China-MSCI China Index, Asia-Pacific-MSCI AC Asia Pacific Index. United Kingdom-MSCI United Kingdom Index. Brazil-MSCI Brazil Index. India-MSCI India Index. Latin America-MSCI Emerging Markets Latin Am Index, Mexico-MSCI Mexico Index, South Korea-MSCI Korea Index, South Africa-MSCI South Africa Index.
Germany data (MWDE Index) data calculated for period 12/28/2018-12/30/2019. No data available for dates used for the other indices.

One of the biggest differences last year versus this year is probably the positioning of the Federal Reserve (Fed). Recall that in 2018, the Federal Reserve increased the Federal Funds rate 4 times with the last increase December 19, 2018 that culminated in the S&P500 dropping almost -8% over the following 4 trading days. In the Fed's December 2018 press release, it discussed the need for "some further gradual interest rate increases" into 2019 such that at that time, the Federal Open Market Committee (FOMC) participants had an additional 3 interest rate hikes projected for 2019. The Fed's positioning drastically changed in early 2019 however, and instead had three rate CUTS since July of 2019. The language in the December 11, 2019 FOMC statement was that the "current stance of monetary policy is appropriate" and will continue to be data dependent to assess the appropriate path. It didn't necessarily imply additional rate cuts ahead but no rate hikes either. Currently, the FOMC participants' midpoint projection is for no change in the Federal Funds rate in 2020 while the Fed Funds futures curve puts a 57% probability of one more rate cut by the end of 2020.

**Exhibit 3** compares the percentage of global Central banks that are either easing or tightening (blue line) to the change in Global Manufacturing Purchasing Managers Index (PMI, red line).

**Exhibit 3**
**Central Bank Activity versus World PMI**

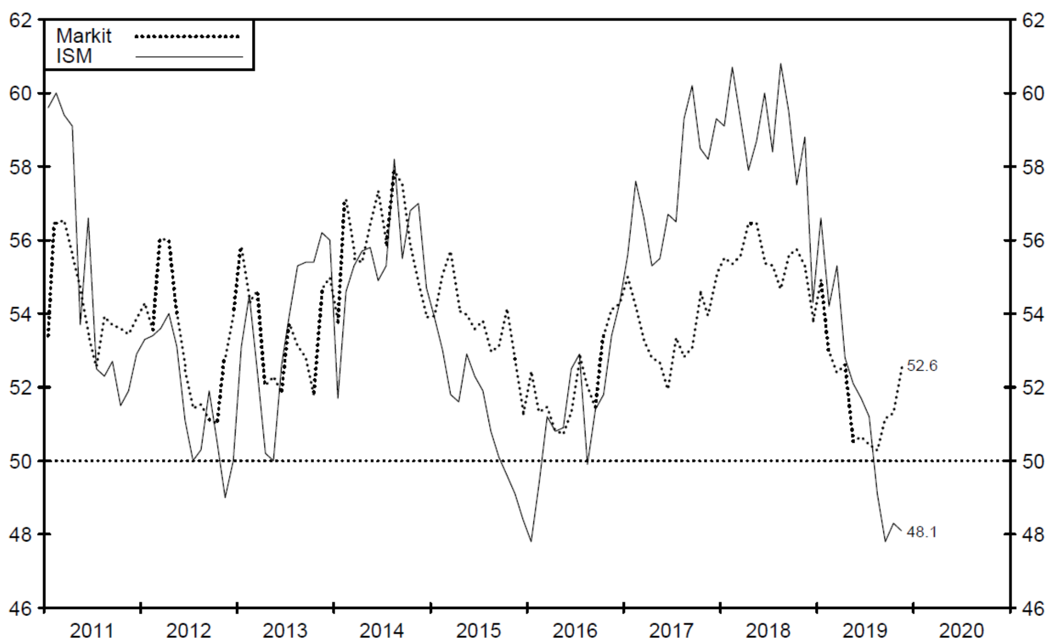



Source: Scotiabank GBM Industry Report, 2019

The chart shows that through 2019, there has been a shift to synchronized global easing by most Central Banks. In November, the Global Manufacturing PMI index posted a seven-month high of 50.3, back above the 50.0 line that divides expansion from contraction, for the first time since April. In the US, the ISM manufacturing index, which peaked in 2018 and has fallen almost every month through 2019, bottomed in September of 2019 and remains below the all-important expansion / contraction threshold of 50.

There is no doubt that the previous four interest rate hikes in 2018 and the tariffs have taken their toll. However, if there is a silver lining, it is shown in **Exhibit 4**, which compares the US ISM manufacturing index to the IHS Markit US PMI. Both indices essentially measure the same thing: US economic activity, although there are subtle differences between the two, which we will review in a second. As indicated in the chart, the IHS Markit PMI has turned up and is diverging from the ISM, which is still below 50. The divergence may be explained by the fact that the IHS PMI puts a heavier weight on forward looking data like "new manufacturing orders" and the IHS survey is about twice as large and incorporates a larger mix of purely domestic participants making the data more US centric and less volatile than the ISM data. So as much as four interest rate hikes in 2018 were a negative to manufacturing growth in 2019, the three rate cuts in 2019 should start to support growth in 2020 and if the trend in global synchronized monetary easing and global PMI's as well as IHS PMI data is any indication, then the ISM data should start to improve in the months ahead.

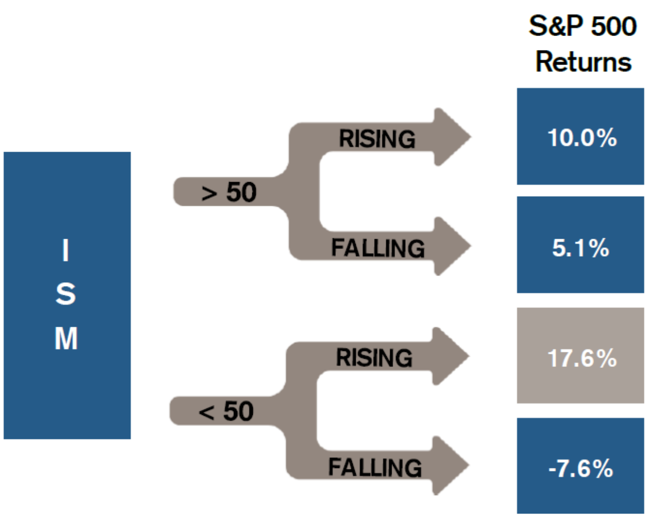
**Exhibit 4**
**Two U.S. Manufacturing PMI Measures – Markit & ISM**




Source: TD Securities, Monthly Chart Package Strategy 12/03/2019

**Exhibit 5** shows the historical relationship between US ISM manufacturing and the S&P500. As indicated, the S&P500 returns are the strongest when the ISM is rising from below the 50 expansion / contraction threshold.

## Exhibit 5
## U.S. ISM versus S&P 500 Returns




Market returns are strongest when the ISM recovers from depressed levels, currently 48.1.

Source: Credit Suisse, U.S. Equity Strategy Navigator 02DEC2019Note: 1970 to present, forward 12-month returns based on ISM change

**Exhibit 6** shows the "Credit Suisse Recession Dashboard", which compares the economic conditions in periods of recessions going back to the 1970's until today. The only recessionary condition they identify at present is manufacturing which, as discussed above, we expect to improve going forward. The yield curve and earnings are ranked as neutral, while US inflation, jobs, housing activity and credit performance conditions are all still expansionary.

## Exhibit 6
## Recession Dashboard

| Start of Recession | Yield Curve | Mfg. | Inflation | Jobs | Housing Activity | Credit Perform | Earnings |
|---|---|---|---|---|---|---|---|
| Nov-73 | ↓ | ↓ | ↓ | ↓ | ↓ | -- | ↓ |
| Jan-80 | ↓ | ↓ | ↓ | ↓ | ↓ | -- | ↓ |
| Jul-81 | ↓ | ↓ | ↑ | ↑ | ↓ | -- | ↓ |
| Jul-90 | ↓ | ↓ | ↓ | ↓ | ↓ | ↓ | ↓ |
| Mar-01 | ↓ | ↓ | ↓ | ↓ | ↔ | ↓ | ↓ |
| Dec-07 | ↓ | ↓ | ↓ | ↔ | ↓ | ↓ | ↓ |
| **Present** | ↔ | ↓ | ↑ | ↑ | ↑ | ↑ | ↔ |

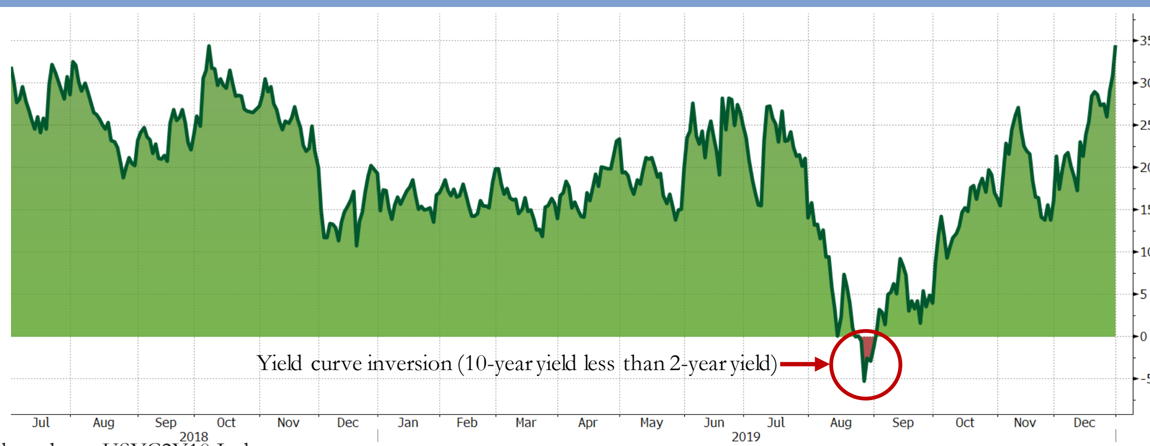
**Key:** ↓ Recessionary ↑ Expansionary ↔ Neutral

Source: Credit Suisse, U.S. Equity Strategy Navigator 02DEC2019

The yield curve inversion is also highlighted as being neutral in the dashboard above.

**Exhibit 7** shows the 10 year / 2 year yield curve spread as of today. After the brief yield curve inversion in August 2019, the 10 year / 2 year spread is no longer inverted and is now as steep as it was in November 2018. Last quarter we discussed some of the technical reasons for the brief inversion, for example, the $14 trillion of negative yielding global bonds that might have driven investors into US Treasuries causing longer term US interest rates to decline. However, we can't ignore the fact that the economy was slowing last summer and until market participants were convinced the Fed was serious about lowering rates, there was also some concern about a recession looking into 2020. However, as the recession dashboard indicates, there are other factors to consider and most of them still look pretty good. Even the shape of the yield curve today supports that economic conditions may be stabilizing.

**Exhibit 7**
**2-Year/10-Year U.S. Treasury Yield Spread**




Source: Bloomberg, USYC2Y10 Index
Period: 06/30/2018-12/31/2019
Description: Market Matrix US Sell 2 Year & Buy 10 Year Bond Yield Spread. Bloomberg calculated yield spread that replicates selling the current 2-year U.S. Treasury Note and buying the current 10-year U.S. Treasury Note then factoring the differences by 1000.

Part of this optimism may have to do with the improving trade situation between the United States and China. We discussed the tariff impact on US GDP growth in previous quarterly commentaries but suffice it to say, with the shift from the August 1st tweet where Trump announced additional tariffs on the remaining $300 billion of Chinese goods imported to the US to a Phase One deal in December that cut the September 1st tariff rate from 15% to 7.5% on $120 billion of goods and cancelled the 25% tariff on the remaining goods scheduled to take affect December 15th, this was well received by the market. For now, it looks like this won't be a further impediment on the strength of the US consumer, which still represents 70% of US GDP growth.

**Exhibit 8** outlines the consensus outlook for earnings growth and valuations for both the S&P500 and the TSX for 2020 and 2021.

**Exhibit 8**
**Earnings Growth & Valuation**

Earnings Growth

| | 2020/2019 | 2021/2020 |
|---|---|---|
| S&P 500 | 9.9% | 10.3% |
| TSX | 7.0% | 8.1% |

Forward P/E - Valuation

| | 2020 | 2021 | 10-yr Average |
|---|---|---|---|
| S&P 500 | 17.9x | 16.2x | 15.1x |
| TSX | 15.0x | 13.9x | 14.7x |

Source: Bloomberg and TD Securities, Monthly Chart Package Strategy 12/03/2019

As we showed in Exhibit 1, the earnings outlook for 2020 and 2021 is coming off a pretty flat base of earnings growth in 2019. A lot of that had to do with lapping of US tax reform, which inflated 2018 earnings 7% to 9%, the strength of the US dollar in 2019, which hurt US companies with international earnings repatriated back to the US, lower commodity prices and the tariff impact on US companies importing from China.

However, looking into 2020, many of those headwinds could potentially become tailwinds or at least not further headwinds. The consensus is for earnings growth of about 10% for the S&P500 in 2020 and 2021. The 2021 earnings projections we take with a grain of salt as inevitably there will be revisions; however, both 2020 and 2021 are reasonably positive and that should be the focus. As long as the forward 12 month earnings momentum remains positive, which it is at this time, we are generally constructive on the market provided it does not get too expensive. If we had to draw a line in the sand on valuation for the S&P500, over 19x earnings, which would represent two standard deviations over the long term P/E average, is where we would consider paring back our equity exposure or at least shift to other markets. For now, while it's trading a little over its long-term average, the S&P500 is still trading below that level where we would consider it meaningfully overvalued. For the TSX, 2020 and 2021 earnings growth still look reasonable as well, at 7% and 8% respectively, and the TSX is still trading about in line with its long-term average P/E valuation. On the flipside, the latest GDP and employment data in Canada have not been that robust; however, our Central bank has been steadfast in holding interest rates steady through 2019 instead of cutting them as in the US. This means that Canada still has some dry powder to cut in 2020 if needed.

During the fourth quarter of 2019, the S&P500 total return index was up +9.1% in US dollars. Adjusting for currency, the S&P500 returned +6.9% in Canadian dollars, as the Canadian dollar appreciated about 1.5 cents, closing the quarter at US$0.769. The TSX total return in the fourth quarter was +3.2%.

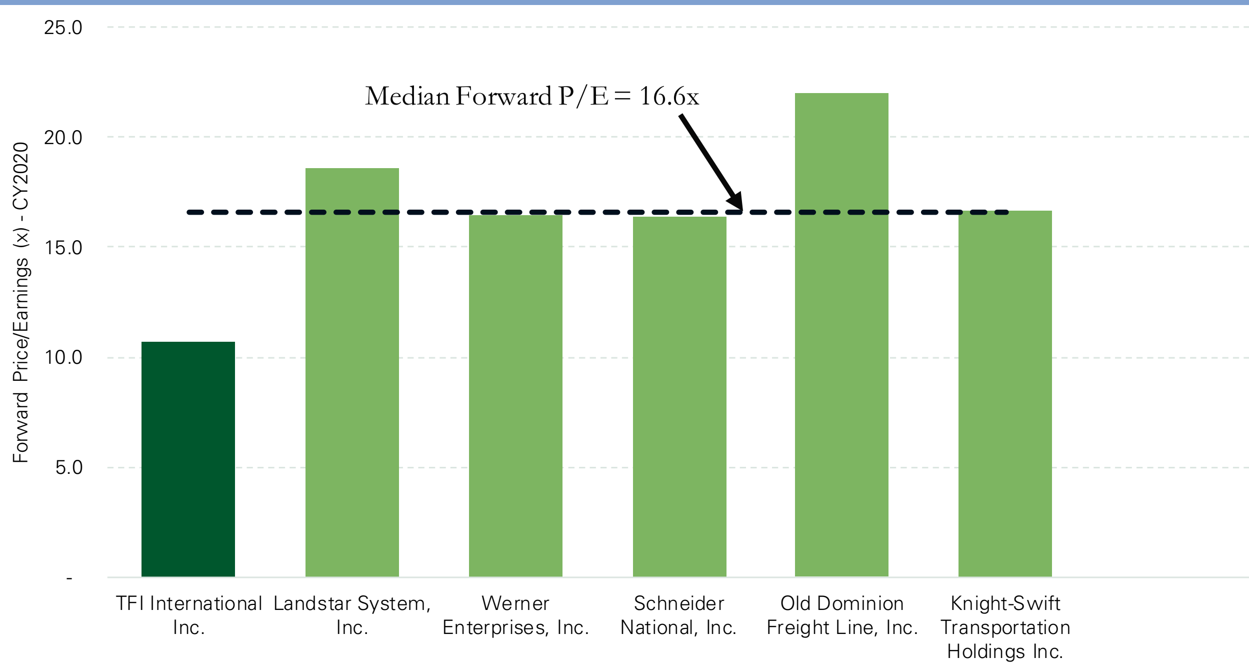
**Asset Allocation for our North American Capital Appreciation Strategy As at December 31, 2019**

| | |
|---|---|
| Equities | 95% |
| Fixed Income | 0% |
| Cash | 5% |

During the quarter, our overall equity exposure increased by 6% to 95% from 89% at September 30th, 2019. Our exposure to US equities increased to 46% from 44% as a result of price appreciation within the portfolio. Our exposure to Canadian equities increased from 45% to 49% as we added to our Canadian industrial exposure through the purchase of TFI International and Canadian Pacific Railway (CP Rail).

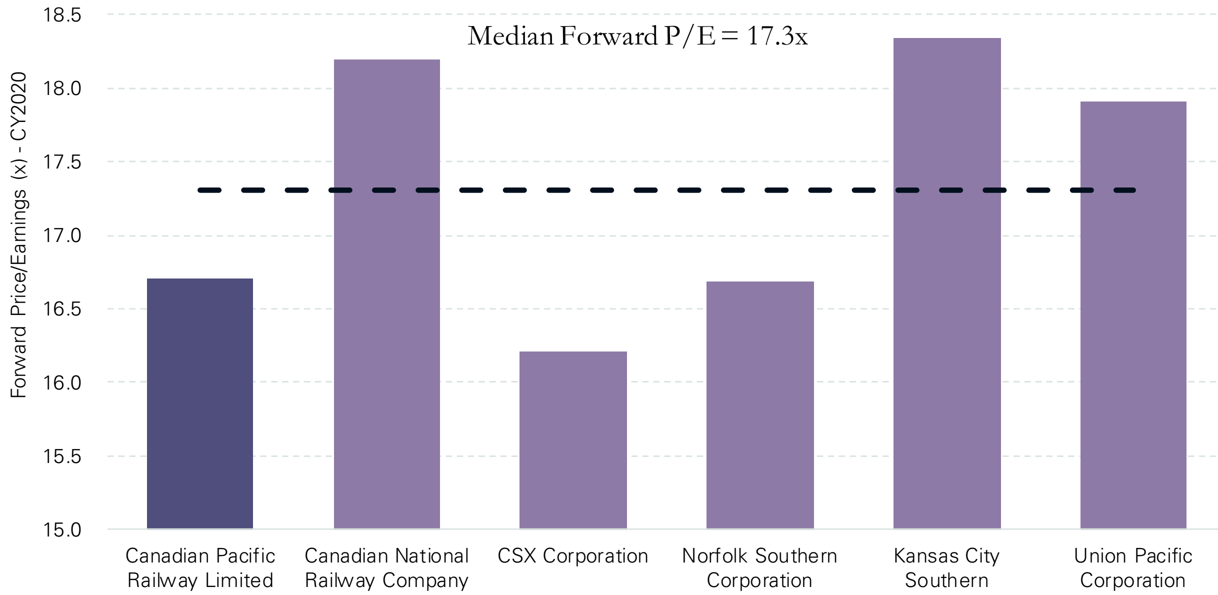
TFI International is the largest trucking company in Canada with a broad reach into the US trucking market representing almost 45% of its revenue, while Canadian Pacific needs no introduction as one of seven class 1 railroads in North America. Both the trucking and rail industry have seen softer pricing and volume declines in 2019 due to weaker manufacturing and trade both north and south of the border which we expect to reverse in 2020 making this an ideal entry point in our view. **Exhibit 9 and 10** compare the valuations for both TFI International and Canadian Pacific to a selection of the major truckers in the US and to all the publicly listed Class 1 railroaders in North America.

**Exhibit 9**
**TFI International Valuation versus Peers – Forward Price-Earnings Ratio (calendar year 2020)**




Source: S&P Capital IQ

**Exhibit 10**
**Canadian Pacific Railway versus Peers- Forward Price-Earnings Ratio (calendar year 2020)**




Source: S&P Capital IQ

As indicated in **Exhibit 9** TFI trades at a significantly lower valuation multiple than comparable US truckers, yet its 5 year earnings per share compound annual growth rate has been about double the industry average. We expect they will seek a US listing, which should help increase the US industry coverage and close the valuation gap. While CP Rail is not the cheapest of all Class 1 railroaders, it does trade at a discount to the group average shown in **Exhibit 10** and it has the lowest industry operating ratio (a key measure in the railroad industry) of all North American rails making it the most efficiently run railroad company. A complete review of each new, Q4 portfolio company's business and fundamental outlook can be found in Appendix 1.

## OUTLOOK

Like last quarter, the economic backdrop is still mixed but we think it's improving given the interest rate cuts in the second half of 2019 and the improving trade situation between the US and China. To the extent we should be concerned about the brief yield curve inversion, other recession indicators such as US inflation, jobs, housing activity and credit performance are all still pretty favourable. In addition, since the average recession occurs 22 months after a yield curve inversion if history is any indication, it would suggest that a recession likely wouldn't occur until sometime in mid-2021. Combine these factors with positive forward earnings momentum, we are constructive on the outlook going into 2020 with the one caveat being valuation, which we will continue to play close attention to. Regarding the portfolio's valuation, quality and risk characteristics, the Cumberland North American Capital Appreciation Strategy remains quite favourable relative to its respective benchmarks as outlined in **Exhibit 11**.

**Exhibit 11**
**Cumberland North American Capital Appreciation Strategy: Portfolio Comparison to Benchmark**

| | Portfolio | 50/50 S&P TSX |
|---|---|---|
| **Valuation** | | |
| Forward P/E (12m) | 16.5x | 16.4x |
| Forward EV/EBITDA | 13.0x | 12.9x |
| **Profitability** | | |
| ROE (5 year average) | 22.1% | 20.6% |
| ROIC (5 year average) | 10.7% | 9.5% |
| **Risk** | | |
| Standard Deviation (%) | 8.9% | 9.3% |
| Beta (Portfolio) | 0.92 | 1.00 |
| **ESG - Environmental, Social & Governance** | | |
| Sustainalytics Score | 69.5 | 52.9 |

Source: Bloomberg, PORT, NA Equity Portfolio 12/31/2019. Standard Deviation-Bloomberg Risk Model (Regional) – prospective model-based estimate
2. ESG Score = Sustainalytics feed-through to Bloomberg PORT

So in closing, 2019 turned out to be a pretty good year and we don't see any reason to be negative at this time. For those who are negative, we thank them as it means there are still potential future investors in the market.

**Peter Jackson**
Chief Investment Officer
January 1, 2020

# APPENDIX 1

# NEW EQUITY INVESTMENTS:

# NORTH AMERICAN EQUITY MANDATE

## CANADA

### TFI

TFI International Inc. is a transportation and logistics company providing trucking, courier and delivery services. Its market capitalization is $3.3 billion with revenues of about $4.5 billion (55% Canada, 45% US). We like this company for a variety of reasons but, most importantly, we believe its leader, Alain Bedard, leads with a founder's mentality and always prioritizes return on investment over revenue growth. TFI has first class operating metrics relative to other trucking companies, and we believe that as they grow their operations in the United States, they will earn the same valuation premium as some of the other large US trucking companies. We started investing in this company at 10x its earnings which reflects an overly pessimistic view of their market opportunity given that other large US trucking companies trade above 15x.

### Canadian Pacific Railway

We like CP because of the limited competition it faces, and the price and environmental advantages it provides over other modes of transportation. Although rail traffic is down across North America, we think CP has the more positive outlook as it is better insulated from trucking competition than other railways with longer routes over more sparsely populated areas. Further, it has a more favourable bulk shipment mix with higher exposure to agricultural shipments and less exposure to thermal coal. Finally, shippers are choosing CP over other railways for its better service and speed as it can get product across North America from the pacific coast faster than other rail companies.

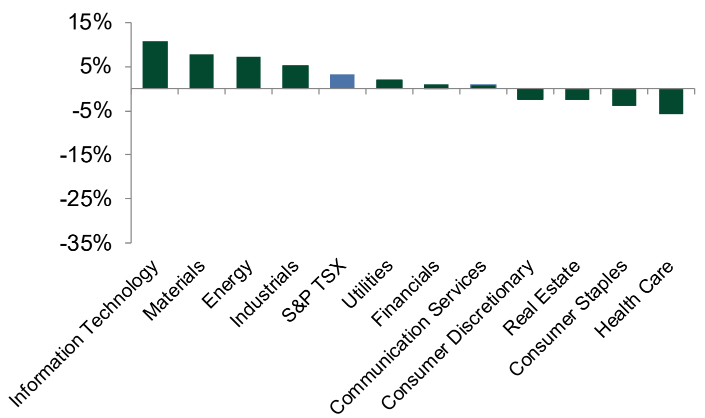
### Canadian Tire

Canadian Tire has three marquee Canadian retail brands: Canadian Tire, Sportchek, and Mark's. The iconic retailer has survived the dominance of Walmart and now Amazon by leaning their product selection toward "need it now" and to larger items (which are harder to buy on-line) such as Tires or backyard furniture, and by growing their well regarded proprietary brands such as Mastercraft, MotorMaster, and more. As a testament to their durability, over the last five years, Canadian Tire has posted higher and more consistent same-store-sales growth than Walmart Canada. Further, with 69.4% ownership of CT REIT, they own ideal real estate with potential opportunities for further development. We believe Canadian Tire will increase its profitability over the next few years by improving supply chain logistics and implementing better IT control systems.

## APPENDIX 2

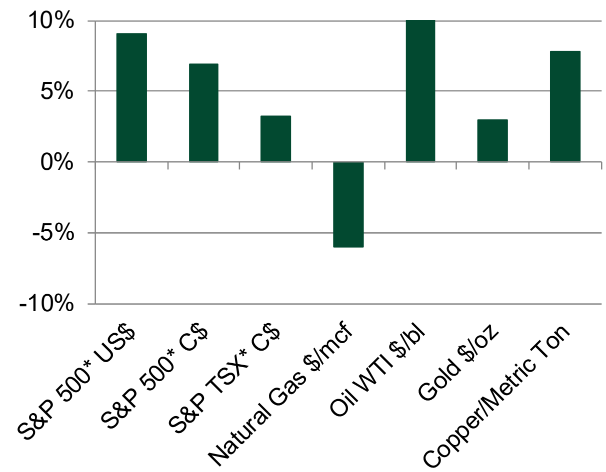
## PERFORMANCE CHARTS

### S&P TSX (C$ Total Returns)
### Quarter Ending December 31, 2019



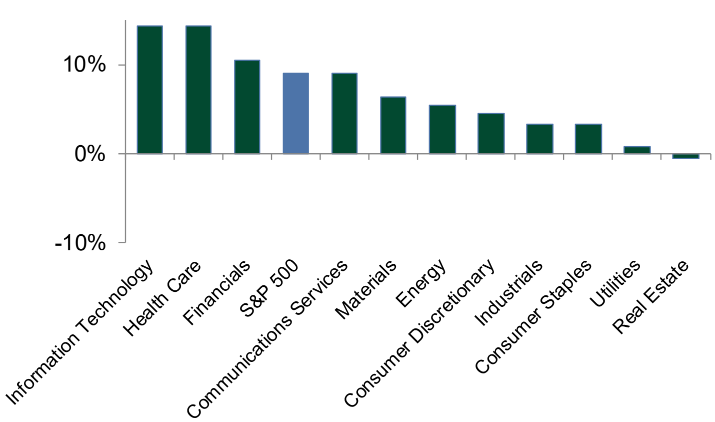

Source: TD Securities

### Quarter % Change
### Quarter Ending December 31, 2019




Source:Bloomberg *Total Returns

### S&P 500 (US$ Total Returns)
### Quarter Ending December 31, 2019




Source: TD Securities

*Cumberland refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). CIC acts as sub-advisor to certain CPWM investment mandates.

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