First Quarter Review

NORTH AMERICAN EQUITY STRATEGY

We witnessed the S&P500 drop -33.9% from its February 19th high through to the low reached on March 23rd as the global coronavirus pandemic unfolded. While the news regarding the virus, and the spike in cases here in North America, is likely going to get a lot worse before it gets better, our sense is that the world is waking up and doing what it can to help prevent the spread until a vaccine or treatment is found.

We looked at the outbreak in China and Italy in relation to their respective stock markets. The Shanghai composite year to date peak was January 13th. The number of coronavirus cases started to accelerate around January 22nd, with the outbreak appearing to have peaked around February 4th at 3,384 new cases that day apart from an anomalous spike of about 20,000 cases on February 12th and February 13th. Our guess is that the reporting of cases in the beginning was probably not consistent but likely more accurate today particularly with the availability of greater testing. For the sake of being conservative, let's use February 14th as the day the outbreak turned the corner in China with new cases that day declining to 2,641, before falling steadily to just 45 new daily case at the time of writing this (March 29th). So, from January 22nd to the peak in daily cases on February 14th was about 23 days. We are all a little skeptical of Chinese data but perhaps their stock market is a more reliable indicator.

The Shanghai stock exchange was halted from January 24th to February 2nd or for 9 days including weekends. Since the re-opening on February 2nd, the Shanghai composite has generated a slight positive return and is down about 11% from its January 13th year to date peak. Hence, the Shangai stock exchange started to discount the end of the outbreak before it was confirmed by the actual data over this period.

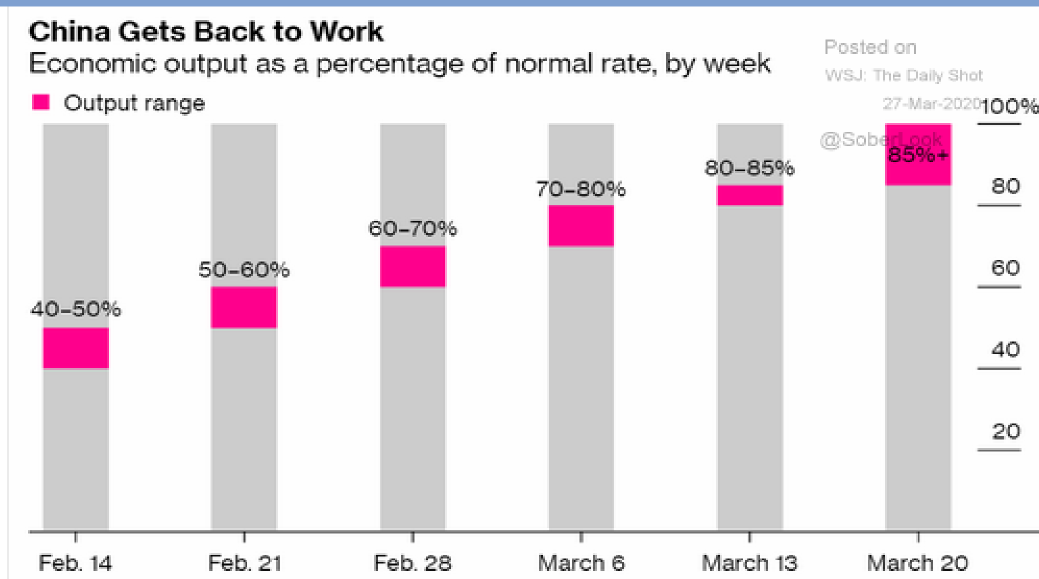
At the other extreme is Italy, which has only just been surpassed in terms of number of cases by the US this past weekend. Yet Italy has five times the number of deaths as the US and three times the number of China. If we compare the performance of the Borsa Italiana (Italy's stock exchange) through this crisis, from its all-time peak on February 19th (which happens to be the same day as the S&P500 peaked), it declined -41.5% through March 12th. Daily new cases started to rise from about February 23rd and appear to have peaked March 21st or after about 27 days. The Borsa Italiana has since recovered about 13% from its lows but is still down -33.9% from its high in line with the drop in the S&P500.

So the bad news is that it's about to get a lot worse here in North America in terms of daily new cases; however, perhaps there are some guideposts as to what to expect in the future based on what has happened in terms of the spread of the virus in other countries and its impact on other stock markets. If the S&P500 were to regain its ground back to -11% off its high as the Shanghai composite did, then from its low of March 23rd the S&P500 could increase 34% or 18.5% from current levels. The Italian scenario does not suggest any upside for the S&P500 but perhaps no further downside either assuming the US (and Canada) follows a similar path in term of new cases as Italy. Italy is however earlier in their containment of the outbreak, so their market may still react favourably if the number of cases there continues to flatten.

Exhibit 1 below shows that economic output in China has begun to normalize since the active cases peaked in mid- February and it stands to reason that Italy and other countries could follow a similar pattern of recovery. The timing will be impacted by the aggressiveness of containment measures, which appear to be effective once implemented, as evidenced by positive trends emerging in new daily cases in some countries outside of North America. Containment measures are expected to take some time to show results, with new cases reported today possibly arising before restrictions began in many countries.

Economic output is normalizing.

Exhibit 1
China Gets Back to Work



Source: Bloomberg Economics

Exhibit 2 shows six recessions over the past 50 years and compares the decline in the S&P500 to the cycle length from peak to trough. The average decline in the S&P500 of -39% compares to the current 2020 peak to trough decline of -33.4% whereas the average duration of the decline of 487 days compares to 33 days this time around, which we will have more to say about later herein. Clearly, the world today moves much faster than it did in the past and arguably, the S&P500 being forward looking has adjusted much more quickly than what has historically played out. However the magnitude of the decline is somewhat in line with historical patterns.

Exhibit 2:
Average S&P 500 Price Decline in Percent and Days During Recessions

	S&P 500 Price Cycle			S&P 500 Price Decline		
Recession	Peak	Trough	Cycle Length	Peak	Trough	Decline
1969/1970	5/14/1969	5/26/1970	377 Days	106.2	69.3	-34.7%
1973-1975	1/11/1973	10/3/1974	630 Days	120.2	62.3	-48.2%
1981/1982	11/28/1980	8/12/1982	622 Days	140.5	102.4	-27.1%
1990/1991	7/16/1990	10/11/1990	87 Days	369.0	295.5	-19.9%
2001	9/1/2000	7/23/2002	690 Days	1,520.8	797.7	-47.5%
2007-2009	10/9/2007	3/9/2009	517 Days	1,565.2	676.5	-56.8%
	Average Price Cycle Length:		487 Days	Average Price Drop:		-39.0%

Source: Bloomberg and CIBC World Markets Inc.

Exhibit 3 shows the decline in S&P500 earnings over the same six recessions and the length of time it took for earnings to trough. S&P500 12-month forward earnings peaked January 31st at $178.54 and have since declined -17.1% using fresh estimates released in the past seven days. This compares to -28.4% on average, in 697 days, over the past six recessions.

Perhaps another way to look at this is using our Cumberland equity risk premium valuation model for which there are three inputs - the current level of trailing earnings for the S&P500, the current level of interest rates (using the 10 year treasury yield) and the current level of the S&P500. Normally, we solve for the implied or forecasted price target for the S&P500 using these inputs to obtain a forecasted return for the market. Given the current volatility in the outlook for earnings, we might be remiss in using this model today. However, we do know all the other variable inputs (the level of interest rates and the level of the market at its recent trough)

and the historical average equity risk premium and can therefore solve for the implied or forecasted level of trailing earnings. It suggests that the market is pricing in a drop in trailing earnings for the S&P500 from the $152 peak level on January 27th to $93.80 in the future or approximately -38%!

If the average historical trailing earnings decline in recessions is -28.4% over 697 days (from **Exhibit 3**) and the market has already priced in a drop of -38% based on our equity risk premium analysis and analysts have cut forward estimates -17.1% over the past 56 days, would this not suggest that perhaps we have seen the worst?

Exhibit 3:
S&P 500 Trailing Earnings Declines in Recessionary Periods

	S&P 500 EPS Cycle			S&P 500 EPS Decline		
Recession	Peak	Trough	Cycle Length	Peak	Trough	EPS
1969/1970	5/14/1969	7/30/1971	807 Days	6.1	5.0	-17.6%
1973-1975	1/31/1975	2/27/1976	392 Days	9.6	7.6	-21.6%
1981/1982	11/28/1980	7/29/1983	973 Days	15.4	12.1	-21.5%
1990/1991	6/29/1990	12/31/1991	550 Days	23.4	15.6	-33.3%
2001	10/2/2000	6/21/2002	627 Days	55.4	42.0	-24.1%
2007-2009	9/10/2007	12/23/2009	835 Days	90.0	42.9	-52.4%
		Average EPS Cycle Length:	697 Days		Average EPS Drop:	-28.4%

Source: Bloomberg and CIBC World Markets Inc.

Exhibit 4 shows historical 12m forward and trailing peak to trough (so far) price earnings multiples. Comparing these to the P/E contraction during the same six recessions periods shown in **Exhibit 5** shows similarities in terms of the relative magnitude of the drop at -30.5% and -33.9% today versus -38.6% in the previous six recessions, the difference being the timing of the decline. Once again it suggests that a lot of damage may have been done.

Exhibit 4: P/E Multiple Contraction

	February 19/20	March 23/20	% change
Forward P/E	19.0x	13.2x	-30.5%
Trailing P/E	22.3x	14.7x	-33.9%

Source: TD Securities

Exhibit 5:
Trailing P/E Multiple Contraction During Recessions (Peak-To-Trough)

	Peak and Trough Trailing P/E Multiples		
Recession Period	Peak P/E	Trough P/E	Multiple Contraction
1969/1970	18.1x	12.9x	-28.7%
1973-1975	19.6x	7.3x	-62.8%
1981/1982	9.5x	7.0x	-26.3%
1990/1991	16.0x	13.1x	-18.1%
2001	30.6x	17.3x	-43.5%
2007-2009	18.0x	11.0x	-38.9%
Averages	**18.6x**	**11.4x**	**-38.6%**

Source: Bloomberg and CIBC World Markets Inc.

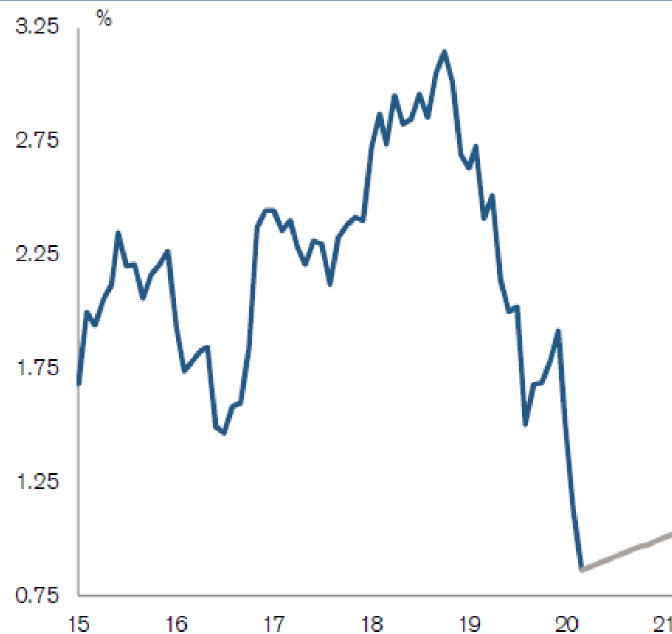
Government Response

Apart from the 150 basis points of rate cuts from both the Federal Reserve (Fed) and the Bank of Canada, the Fed has been using an unprecedented range of its authority to provide powerful support for the flow of credit to both families and businesses. This includes unlimited quantitative easing, support for commercial real estate, $300 billion credit facility in support of consumers and businesses, support for investment grade corporate bonds and consumer credit and small and medium-sized businesses. Then last week the Senate passed the $2 trillion Coronavirus Aid, Relief and Economic Security Act (CARES Act), which also provides direct payments to Americans, expands unemployment insurance and offers healthcare providers additional resources. At 9.3% of US GDP, the stimulus package is almost twice as large as the stimulus package of the Great Financial Crisis in 2009. There is even $500bn allotted for large corporations (such as airlines and Boeing) to provide loans and loan guarantees not to exceed five years in term. This should go a long way to minimize the damage notwithstanding the fact that earnings will likely go down, job losses will likely increase and concerns around credit will also likely get worse.

If there is a silver lining, it might be evident in **Exhibits 6 and 7.**

Exhibit 6 shows the impact on 10 year treasury yields as well as the outlook for yields into 2021. The implication being that if bond yields are going to stay lower for longer, it should ultimately be good for stocks, especially dividend-paying stocks of companies that can maintain and grow their dividends.

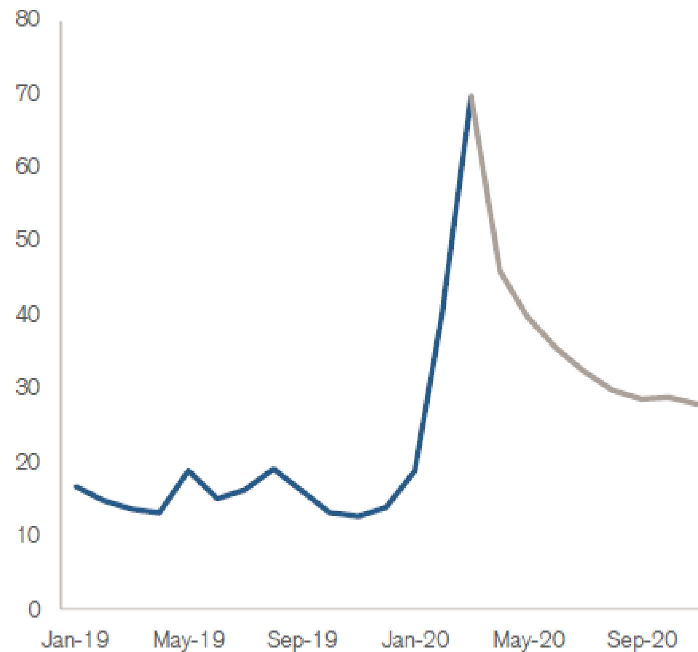
Exhibit 6:
10-Year Treasury Yield with Futures



Note: Estimates based on futures market
Source: Federal Reserve, The Bloomberg Professional service, Credit Suisse

Exhibit 7 shows the VIX or what is commonly referred to as the "fear index". The VIX is a measure of the equity markets near-term volatility. A rising VIX or increasing volatility is usually associated with lower equity markets and the recent spike in the VIX from 20 to 70 was no exception. What's interesting is looking out into the May and balance of 2020 as the futures indicate volatility will drop, which is supportive of a recovery in equity valuation.

Exhibit 7:
VIX with Futures



Note: Estimates based on futures market

Source: Federal Reserve, The Bloomberg Professional service, Credit Suisse

During the first quarter of 2020, the S&P500 total return index was down -19.6% in US dollars. Adjusting for currency, the S&P500 returned –12.1% in Canadian dollars, as the Canadian dollar depreciated almost 6 cents, closing the quarter at US$0.710. The TSX total return in the first quarter was –20.9%.

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

Equities	94%
Fixed Income	0%
Cash	6%

During the quarter, our overall equity exposure decreased by 1% to 94% from 95% at December 31st, 2019, however as we raised cash both before and during the selloff it reached a low of 87%. Towards the end of the quarter and as discussed above, when it appeared much of the negative news was baked into the market, we began to selectively add to current and new equity positions. Much of what we sold early in the quarter was sourced from energy and financials. The energy sales were used to finance some US purchases such as Abbott Labs and Costco.

Abbott is a premiere medical device and molecular diagnostic company. It is a leader in testing for infectious diseases such as COVID-19. The company has demonstrated industry leading innovation and been a consistent winner for shareholders over the long term. Costco has a uniquely successful business model in retail that generates consistently mid to high single digit same store sales growth. Its core value proposition to their greater than 55 million members is bulk purchases at very low price points. Costco's growth outlook is strong given significant headroom for footprint growth in both developed and emerging markets, while offering the benefit of both offensive and defensive earnings characteristics during this global pandemic.

As noted, we also sold some of our Financials, including trimming JP Morgan and selling National bank pre-crisis, both of which we ended up repurchasing late in the quarter some 29% and 26% lower, respectively. Overall, our US equity exposure increased from 46% to 53% while our Canadian equity weight declined from 49% to 41%.

A complete review of each company's business and fundamental outlook that was purchased in the quarter can be found in **Appendix 1.**

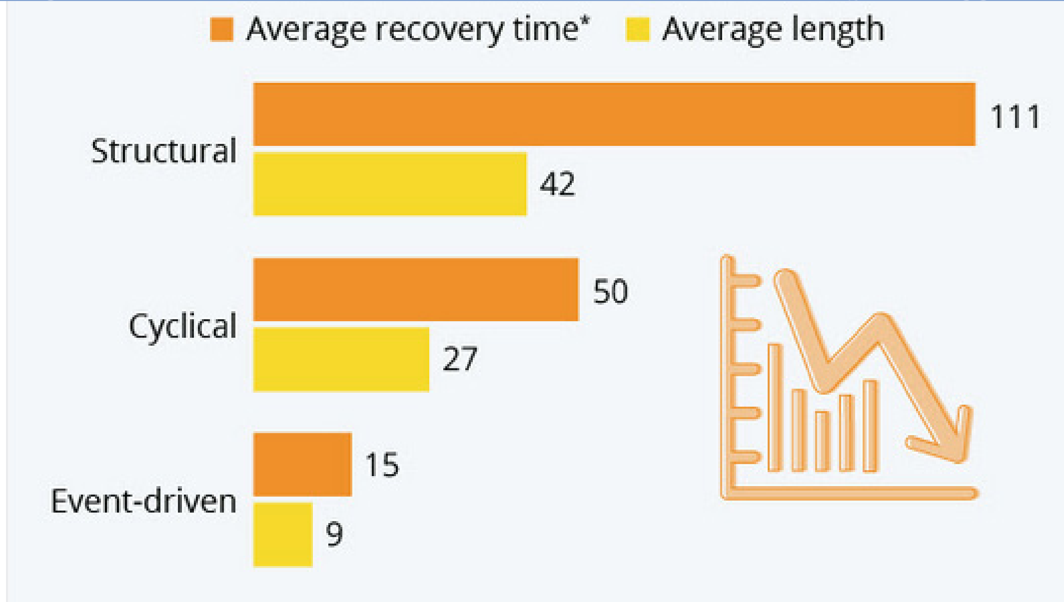
Outlook

Our primary goal in this review was to provide a possible template for how the markets might recover from this crisis but the reality is that there is no known playbook. We think what has unfolded in China and Italy may provide a guidepost but as things stand now, the next few months are going to put a lot of strain on our healthcare system and it goes without saying, short of a cure or treatment, the uncertainty and volatility may stay for a while. The charts comparing the historical impact on index price returns, earnings and valuation multiples indicate that, although the downturn has been sharp and swift, much of the damage may have already been done at least as compared to history. The question remains whether this will be an average recession. The Government's rapid responses, both north and south of the border, have been significant and while it remains to been seen if the stimulus packages are sufficient; our sense is that it is open ended enough to get us through the cycle.

Exhibit 8 examines different types of bear markets and according to Goldman Sachs, there are three types.

1. **Structural Bear market:** often triggered by structural imbalances or asset bubbles like the Tech bubble of 2000 or the Great Financial Crisis of 2008-2009.
2. **Cyclical bear market:** a function of the economic cycle (and rising interest rates).
3. **Event-driven bear market:** triggered by a one-off shock such as an Emerging Market (EM) crisis, a war, oil price shock or perhaps a contagion.

Exhibit 8:
Bear Market Recoveries Faster After Adverse Events
Average length and recovery time of U.S. bear markets since 1800, by type of trigger (in months)

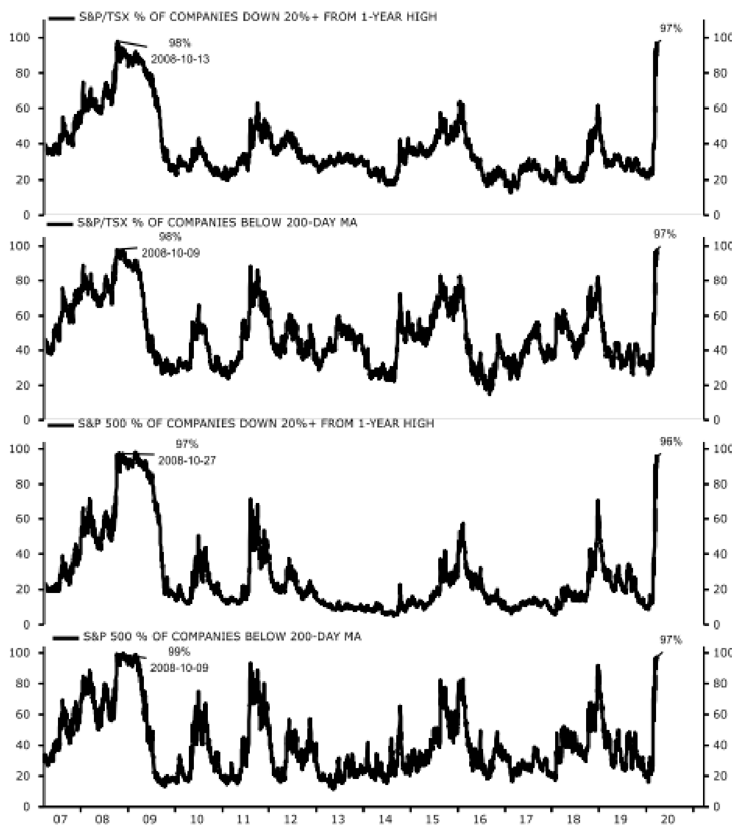


*back to previous level
Source: Goldman Sachs

The key takeaway from this chart unlike the earlier charts, which suggest the period of price and earnings decline could last one to two years, is that in an **event-driven bear market**, the average length and recovery time may be much shorter. We should also not lose sight of the fact that when we came into this, the North American economy was firing on all cylinders.

So, what if something does go right? **In Exhibit 9**, we try and quantify the damage that has been done from a technical perspective. The first two charts look at the TSX and the second two look at the S&P500 but the message is the same for both markets. In the case of the TSX and the S&P500, the number of stocks that are down more than 20% from their one year high is 97% and 96%, respectively, which is back to the level we saw at the peak of the great financial crisis in 2008. In terms of the percentage of stocks currently trading below their 200-day moving average, both the TSX and S&P500 are at each at 97% and again that compares to 98% and 99% at the peak of the Great Financial Crisis. So, stocks are down as much as in 2008 and this is not October 2008!

Exhibit 9:
Equities: Quantifying the Damage



Source: Refinitiv Datastream, Canaccord Genuity estimates

The bottom line is that if things improve, both the S&P500 and the TSX are massively oversold enough to rally materially.

Peter Jackson
Chief Investment Officer
March 31, 2020

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

Canadian National Railway

We like the Canadian rails due to their limited competition and their structural competitive advantages over other modes of transportation resulting in price and environmental benefits for their clients. Canadian National Railway (CNR) has the best rail network of all the class 1 rails in North America, providing service to from the Pacific Coast, the Atlantic Coast, and the Gulf Coast. Its routes are more direct than its US peers giving it faster and more reliable shipping capabilities. Further, we believe CNR and CP Rail are both more defensive than the US peers with top quartile balance sheets and limited exposure to the decline of US thermal coal.

Prior to the Coronavirus lockdown, we expected rail volumes to move incrementally higher as North America recovered from a manufacturing recession. That thesis may be delayed, but we are seeing the Canadian rails act resiliently as they are deemed essential services and continue to have positive year over year traffic, despite the Coronavirus slowdown.

Parkland Fuel Corp.

Parkland Fuel Corporation is an independent supplier and marketer of fuel and petroleum products and a leading convenience store operator. It owns well known fuel marketing brands including Ultramar, Esso, and Pioneer. Its main convenience store brands are On the Run and Marché Express. Despite being a part of the energy sector, Parkland's value does not depend on the price of oil, rather, on its ability to sell fuel to its retail customers, and its ability to execute on its growth opportunities.

Management creates value by buying retail and fuel marketing businesses, refurbishing them to Parkland standards, using their convenience store brands to create additional revenue, and lowering costs by integrating them into their supply network. The opportunity to execute their plan in the United States provides Parkland many years to grow its business from here.

Enghouse Systems Ltd.

While the present environment is clearly a difficult one, Enghouse is one of the few companies that may be a beneficiary. Over half of their revenue is from a division called the Interactive Management Group which provides software for call centres as well as videoconferencing services. They have noted some good traction in these areas as companies need to offer work from home solutions and call centre activity moves from central locations to being based in employee's homes. As well, the majority of their growth is through acquisitions and the availability and prices of acquisitions improves materially in environments like the present one. Enghouse has $116 of cash on its balance sheet and no debt.

UNITED STATES

Costco Wholesale Corp.

Costco is the third largest retailer in the world operating 785 warehouses across 12 countries with >80% of them in US & Canada. It has a uniquely successful business model in retail that generates consistently mid to high single digit same store sales growth, product gross profit margins of ~11% and >$3Bn pa of high margin membership fee revenue. Its core value proposition to their >55m members is bulk purchases at very low price points. Aside from attractive savings on household necessities like food, produce, pharmacy and fuel, it also offers a wide & constantly changing array of discretionary items from apparel to consumer electronics to patio furniture to jewelry that gives customers a treasure hunt experience. Costco's growth outlook is strong given significant headroom for footprint growth in both developed and emerging markets, nascent penetration into e-commerce that is now growing >20% and continued average ticket growth.

S&P Global INC

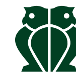
S&P Global is a leading provider of independent credit ratings, benchmarks, analytics, and data to the capital and commodity markets worldwide. The largest company segment is S&P Global Ratings, which provides ratings and research to investors to help them make decisions about purchasing bonds and other fixed income investments. The global ratings market is effectively a duopoly with S&P Global and Moody's controlling more than 80% of the market. S&P Global has a very attractive business model. There is a high percentage of recurring revenue and it's a scalable business model which allows operating margins to increase as revenue increases. S&P Global generates high returns on invested capital, it generates robust free cash flow, and it has a very strong balance sheet.

Abbott Laboratories

Abbott Labs is a diversified healthcare company that operates across 4 business segments including Medical Devices, Nutrition, Diagnostics, and Pharmaceuticals. As a leader within the Medical Device industry, Abbott is very well positioned to benefit from a number of industry tailwinds. A new wave of innovation is powering growth in new markets and reinvigorating growth in mature markets. Beyond innovation, the industry benefits from several durable tailwinds. The global population over 60 years of age will more than double by 2050 and the global middle class is expanding quickly so healthcare spending is on the rise around the world. In addition, most of Abbott's businesses are well aligned with the fastest-growing market segments in both developed and emerging markets. Abbott also has products across every business segment that address conditions associated with growing older.

Global Payments INC

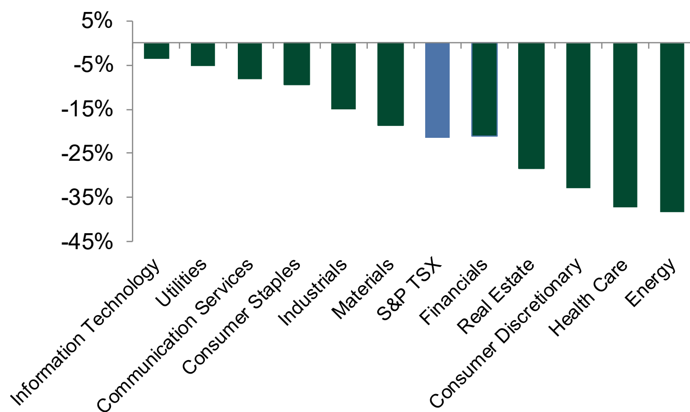
Global Payments is a leading worldwide provider of payment technology and software solutions delivering innovative services to customers globally. The company's technologies, services, and employee expertise enable it to provide a broad range of solutions that allow its customers to accept various payment types and operate their businesses more efficiently. Global Payments is very well positioned to benefit from the secular conversion of cash & checks to credit & debit cards. Global Payments has a global platform and is especially well positioned to grow given that the opportunity in payments is greatest within the international markets. 25-50% of payments are still made through cash & checks in Europe and Asia, and more than 50% of payments are still made in cash & checks in many parts of Latin America and Africa.



APPENDIX 2

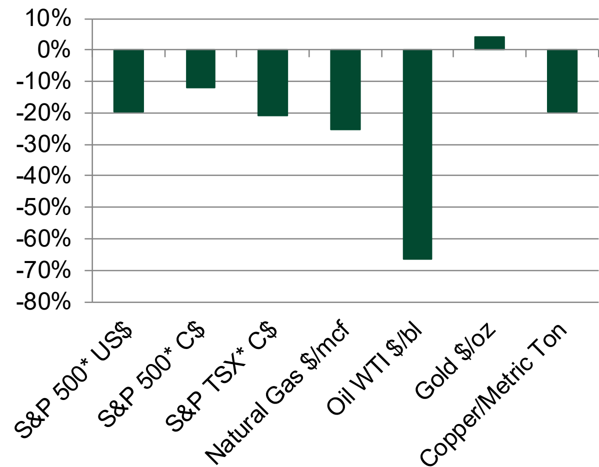
PERFORMANCE CHARTS

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



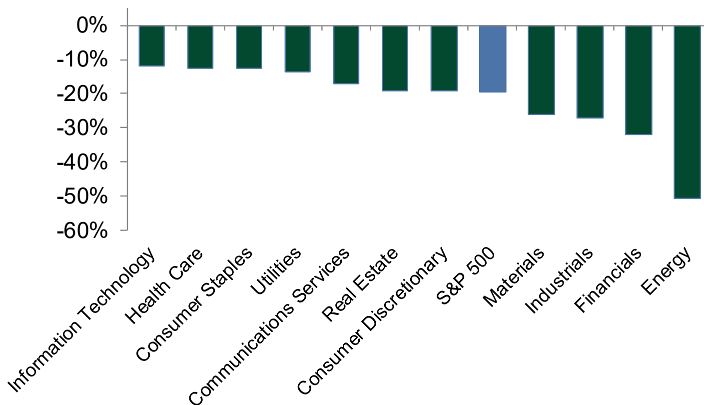
Source: TD Securities

**Quarter % Change
Quarter Ending March 31, 2020**



Source:Bloomberg *Total Returns

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



Source: TD Securities

*Cumberland and Cumberland Private Wealth refer 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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