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Private Wealth

June 30, 2021

Second Quarter

NORTH AMERICAN EQUITY STRATEGY

During the second quarter of 2021, the S&P500 total return index was up +8.6% in US dollars. Adjusting for currency, the S&P500 returned +7.0% in Canadian dollars, as the Canadian dollar appreciated about 1.2 cents, closing the quarter at US$0.807. The TSX total return in the second quarter was +8.5%, as can be seen in greater detail in Appendix 2. The biggest performance driver was positive earnings growth in both markets. While earnings were expected to be strong, actual earnings in the first quarter for the S&P500 rose 52.5% year over year as compared to an expected gain of 23.7% at March 31st, far exceeding market expectations.

As discussed in our Q1 quarterly commentary, either a short-term pullback, a correction in time (as earnings caught up to valuations) or a complete reassessment of the positive earnings outlook were all possible scenarios we considered as the market earnings implied earnings of $201.51 (see **Exhibit 1**) were about 11% ahead of consensus forward 12month (F12m) of $180.82 at that time. However, with the material upward beats on Q1 earnings and subsequent upward revisions to estimates, it now appears the complete reassessment to positive earnings guidance is the scenario that has played out. Applying the same analysis now to the S&P500 indicates that this market is still not super cheap; however, consensus forward 12m earnings today are $200.51, up 10.9% over the three months as compared to our market implied earnings calculation of $205.18 such that the market implied earnings premium is now only 2% instead of 11%. This primarily reflects the combination of the decline in the ten-year treasury yield, which is the main variable used to calculate the market implied earnings (numerator) and the +10.9% change in forward earnings (denominator) during the quarter.

Exhibit 1
Last 9 Months Treasury Yields, S&P 500 Index Earnings and Market Valuation Metrics

	Date			
	Oct 6/20	Jan 5/21	Mar 26/21	Jun 23/21
10-year Treasury Yield	0.74%	0.95%	1.68%	1.49%
10-year Average Equity Risk Premium	3.42%	3.41%	3.39%	3.35%
Implied Earnings Yield	4.16%	4.36%	5.07%	4.84%
Market (close)	3,360.95	3,726.86	3,974.54	4,241.84
Implied Earnings Estimate (per share)	139.82	162.49	201.51	205.18
Consensus Earnings Estimate (per share)	157.36	166.55	180.82	200.51
Price/Earnings (estimate BF 12m)	21.4x	22.4x	22.0x	21.2x
Ratio (Consensus/Implied EPS)	1.13	1.02	0.90	0.98

Source: Bloomberg (BEst EPS BFI2m), Cumberland(Asset Mix Review Dates)

In **Exhibit 2**, we show the change to calendar year earnings for 2021 and 2022 from the end of March to June 2021. We also included the consensus 2023 estimate as in six months we will be looking out to 2023. As indicated and this is probably not a surprise, there has been material upward revisions to both the 2021 and 2022 yearly estimates. If you compare the market's implied earnings today ($205.18) to the 2022 and 2023 estimates, these imply a 3% and 12% respective discounts to those forward earnings estimates, which suggest to us that the market's implied earnings outlook versus consensus earnings is more balanced.

Exhibit 2:
Change in S&P500 Calendar Year Earnings Expectations

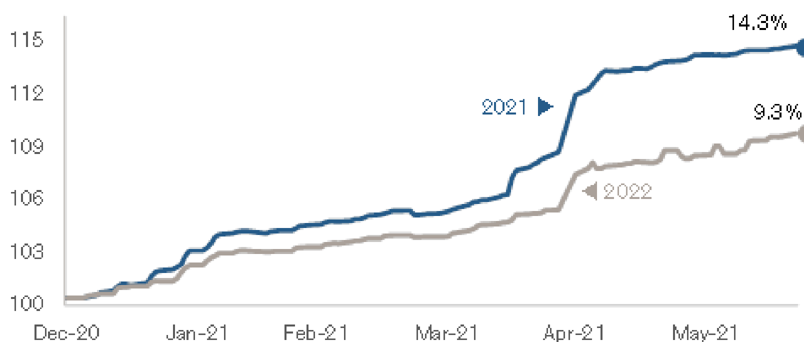
	March 26, 2021	June 23, 2021	% change
2021E	172.93	188.97	9.3%
2022E	199.16	210.85	5.9%
2023E	221.75	233.40	5.3%

Source:Bloomberg

Exhibit 1 also shows the forward F12m price/earnings (P/E) multiple as at the end of March and today. As indicated, the F12m P/E multiple has declined almost a full point turn (22.0x to 21.2x) over the three-month period despite the 6.7% price appreciation over the same time period. So, the market actually looks cheaper today, at least from a forward P/E multiple perspective, given the material rise in forward earnings expectations.

Exhibit 3 shows the path of consensus earnings for the S&P500 for 2021 and 2022 since December 2020, while **Exhibit 4** provides an updated summary of economic projections from the recent June Federal Open Market Committee (FOMC) meeting. As indicated in Exhibit 4, Federal Reserve committee members increased their real GDP growth targets again for 2021 from 6.5% to 7% and from 2.2% to 2.4% in 2023. There was no change to their 2022 projections, which were showing growth at an already above trend level of 3.3%. We believe this positive outlook for GDP growth in 2021 through 2023 is supportive of the strong consensus earnings path outlined in both Exhibit 2 and Exhibit 3.

Exhibit 3:
Path of 2021-2022 Consensus EPS (Indexed to 100)



Source: : Credit Suisse Securities

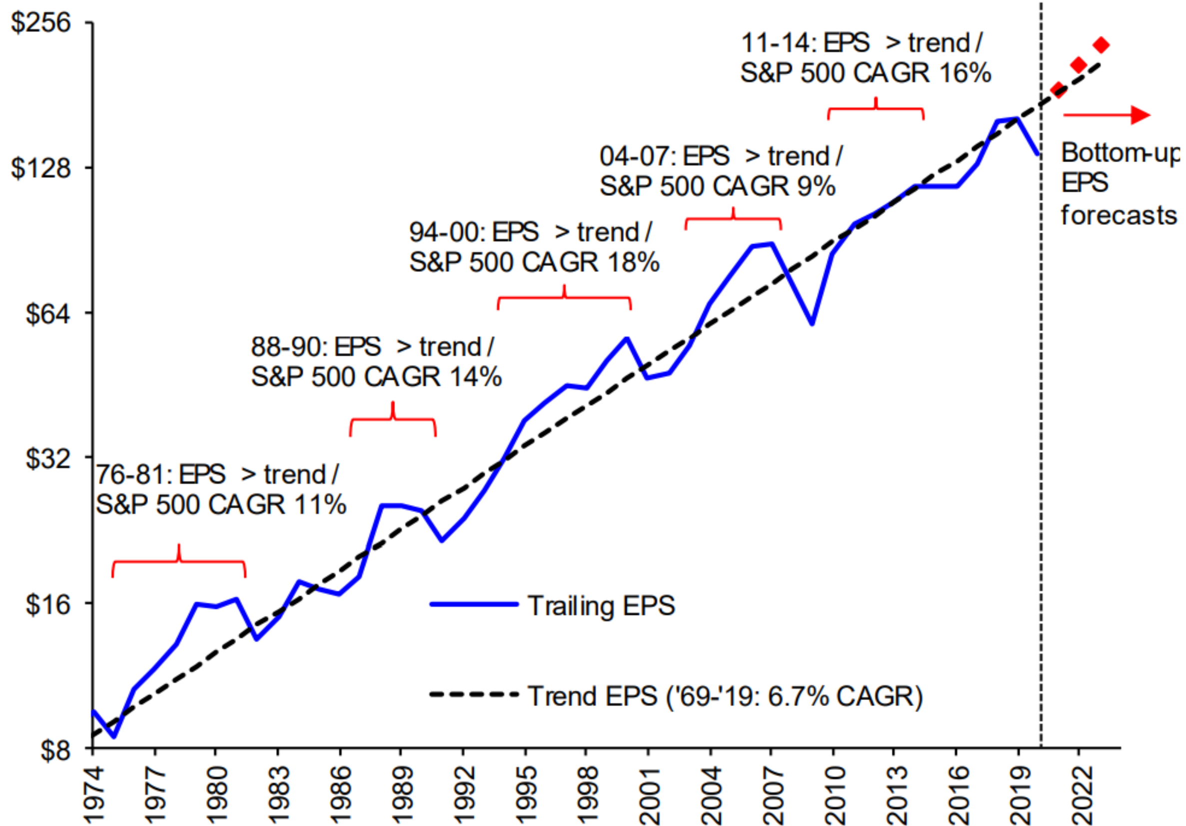
Exhibit 4:
US Economic Projections from Recent June FOMC Meeting

FOMC Forecasts	Median			
	2021	2022	2023	Longer Run
Real Change in GDP	**7.0**	**3.3**	**2.4**	**1.8**
March Projection	6.5	3.3	2.2	1.8
Unemployment Rate	**4.5**	**3.8**	**3.5**	**4.0**
March Projection	4.5	3.9	3.5	4.0
PCE Inflation	3.4	2.1	2.2	2.0
March Projection	2.4	2.0	2.1	2.0
Core PCE Inflation	**3.0**	**2.1**	**2.1**	
March Projection	2.2	2.0	2.1	
Projected Policy Path				
Fed Funds Rate	0.1	0.1	0.6	2.5
March Projection	0.1	0.1	0.1	2.5

Source: Federal Reserve

Exhibit 5 examines a longer time frame by showing the trend in earnings growth for the S&P500 over the past 50 years. During this period, earnings have expanded at a compound annual growth rate (CAGR) of 6.7% as indicated by dashed trend line in the chart. Also identified in the chart are periods of above trend EPS growth represented by the red brackets, which are associated with periods of strong performance for the S&P500 ranging from 9% to 18% per annum CAGR in total return performance. Given the FOMC's recent upward GDP revisions, we think this may provide a positive set-up for further earnings acceleration in the second half of 2021 and 2022 and if history repeats itself, this could prove to be positive for the market.

Exhibit 5:
S&P 500: Above-Trend EPS Tends to Come with Strong Total Return Performances



Source: Scotiabank GBM Portfolio Strategy, Bloomberg, Shiller, Thomson Financial

Some potentially less positive news from the FOMC's summary of economic projections was the trend in core PCE inflation (the Fed's preferred measure of inflation). PCE inflation is now expected to rise 3.4% in 2021 before trending back to just above 2% in 2023, the Fed's long term targeted level. While Fed Chairman Jerome Powell downplayed inflation as being transitory, as many components of recent CPI data such as used vehicles prices, auto rentals, airfares and lodging probably were transitory, it is possible that a reacceleration in employment and future wage gains may not be so transitory.

With this, consider the charts in **Exhibits 6 and 7**. **Exhibit 6** looks at the latest data on job openings, which hit an all-time record in March at 8.1mm, while **Exhibit 7** looks at small business job openings and hiring plans. During May, a record 48% of small business owners had job openings, with 27% planning to increase hiring over the next three months, both at the highest levels since the 1970's. On September 6th, the supplemental $300 per week Federal unemployment aid package is set to expire; however, at least 25 states have prematurely cut off this aid package to try to get people back to work. Time will tell whether this all leads to something more than just transitory inflation but it does support the Fed's projection of the unemployment rate declining to 4.5% by year end from May's level of 5.8%.

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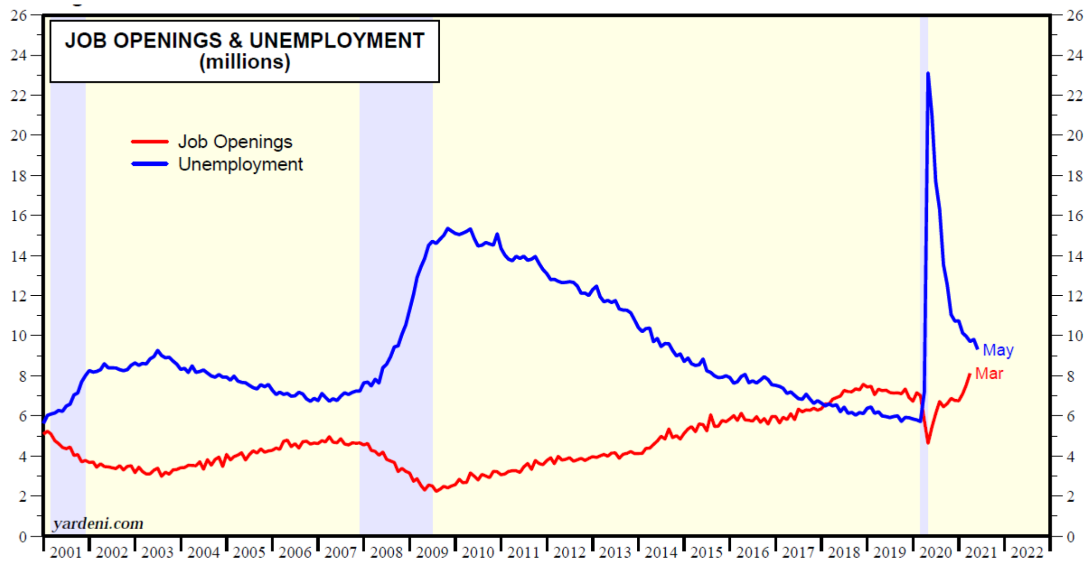
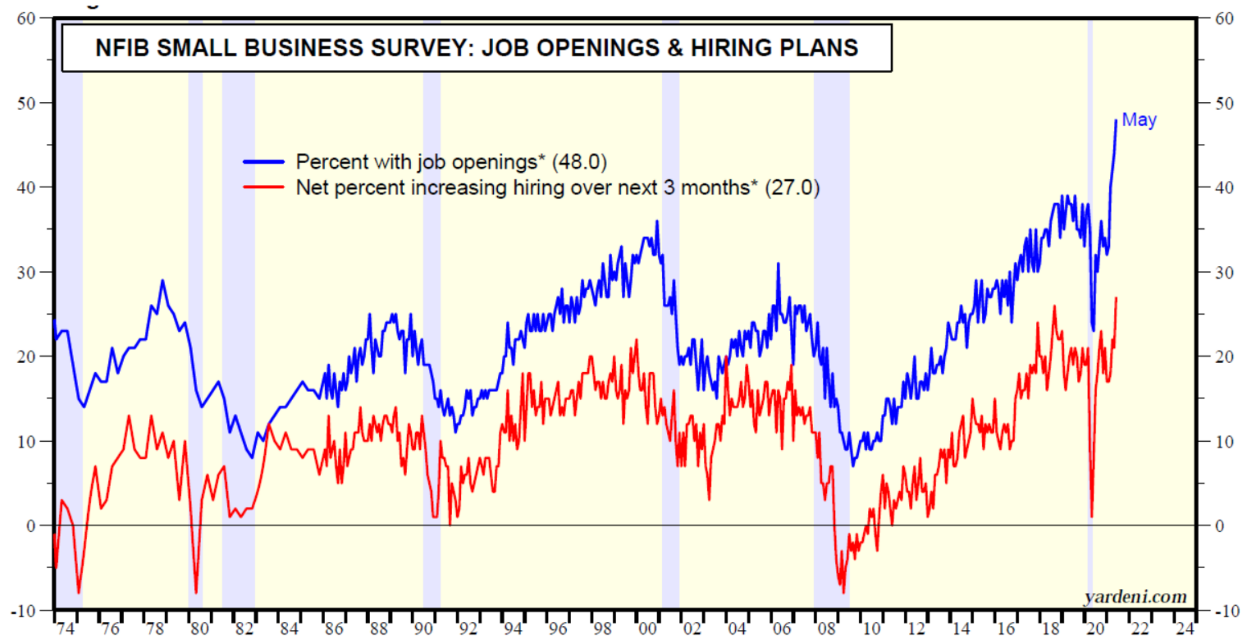
Exhibit 6:
Past Two Decades of US Job Openings & Unemployment Rates



Source: Yardeni

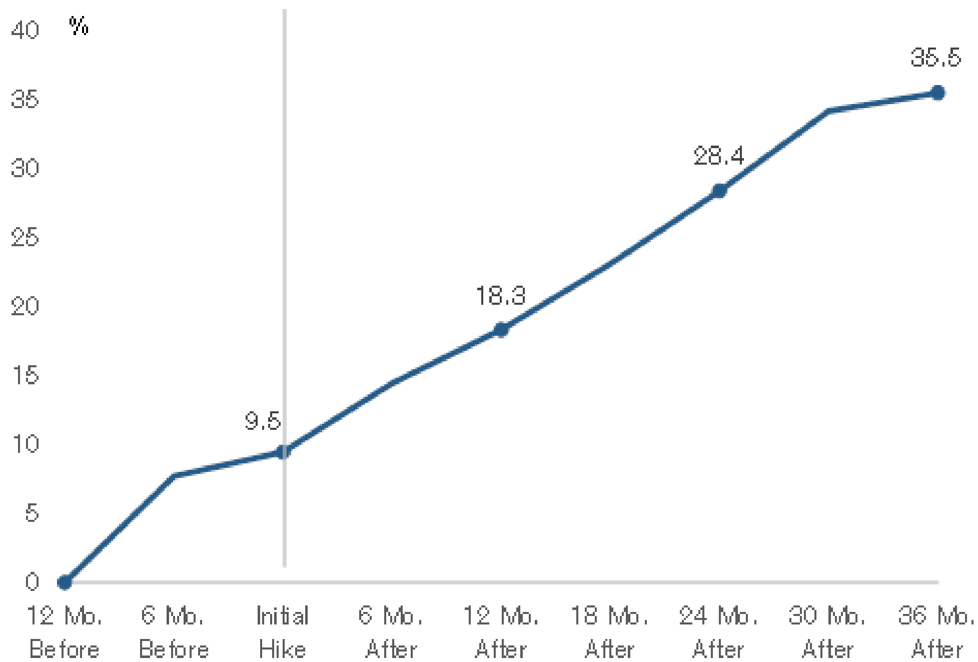
Exhibit 7:
US Small Business Job Openings & Hiring Plans



Source: Yardeni

Having said this, the revised inflation outlook did help pull forward the timing of a policy shift towards two rate increases in 2023. Also, several Fed members indicated a willingness to begin the discussion about the tapering of asset purchases. What this might mean for the markets is shown in Exhibit 8, which reviews the historical performance of the S&P500 over four previous interest rate cycles. As indicated, the average returns both 12 months prior to the first rate increase and 36 months after that, have remained quite positive. It is not until the yield curve flattens or inverts that market returns typically turn negative.

Exhibit 8:
Average S&P 500 Returns Before and After Initial Rate Hike



Source: Credit Suisse Securities

Asset Allocation for our North American Equity Strategy As at June 30, 2021

Equities	97%
Fixed Income	0%
Cash	3%

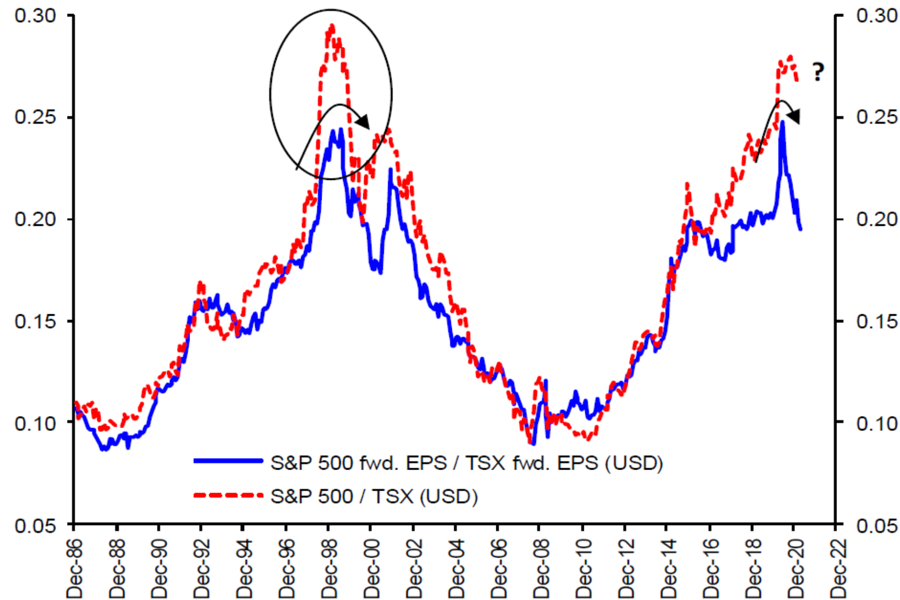
During the quarter, our overall equity exposure increased by 3% to 97% from 94% at March 31st. Our US equity exposure remained flat at 48% while our Canadian exposure increased by 3% from 46% to 49%. Cash decreased from 6% to 3%. It is important to note that many of our clients' portfolios are invested 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.

In the current environment, we have continued to position the portfolio toward value-oriented stocks to benefit from the economic recovery that is underway while maintaining exposure to growth stocks for about a third of the portfolio. More specifically, our current allocation to growth stocks, which typically rely on trends independent of an improving economy, is about 35% up slightly from 33% at March 31st, while that of value stocks, which are more dependent upon and should benefit from an economic recovery, are at about 57% up from 56% at March 31st. Consumer Staples, which we don't classify as either growth or value, make up the balance of our equity exposure.

Our allocation to Canada, which has predominantly value-oriented positions, has risen from 40% to 49% (in Financial Services, Consumer Discretionary, Industrials, Energy and Materials) since June of 2020. Our corresponding US equity allocation has shifted from 55% to 48% (in Information Technology, Communications Services and Health Care) over the same time period as the growth sector investments are typically sourced in the US.

Exhibit 9 compares the ratio of the S&P500/TSX forward earnings growth to the relative performance of the indices over time. As noted, the TSX forward earnings are currently inflecting to the positive vs. the S&P500, which may mark a turn for the TSX's outperformance if history is any guide. Year to date, the TSX has outperformed the S&P500. **Exhibit 10** compares the relative valuation of the two markets based on the 12m forward Price Earnings ratio (P/E). As indicated, the TSX trades at a significant discount to the S&P500 today, and the last time it reached this level, it marked a turn in the outperformance cycle for the TSX.

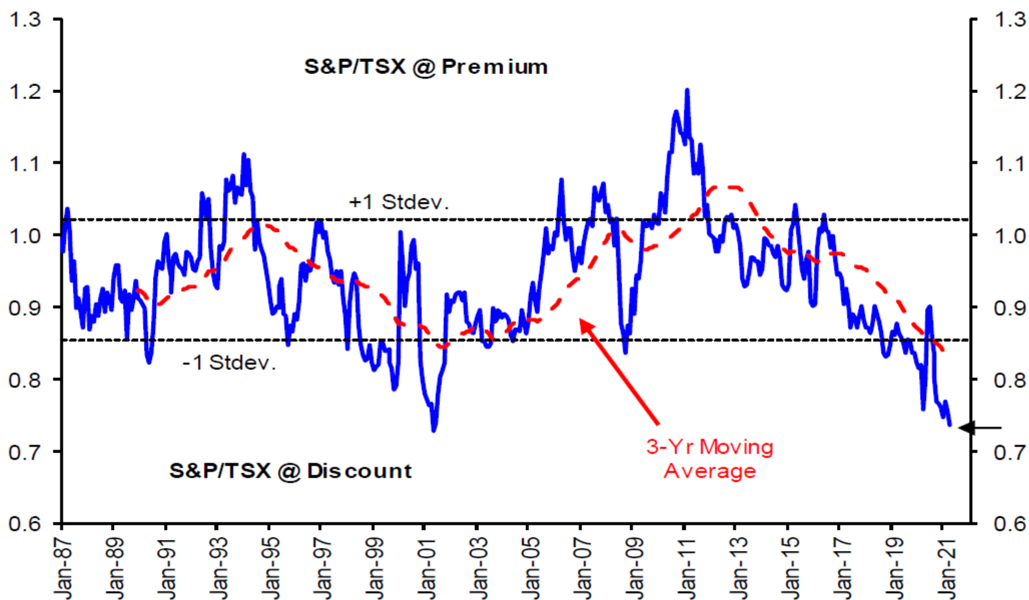
Exhibit 9:
S&P 500 vs TSX: Fwd. EPS Ratio and Relative Performance



Source: Scotiabank GBM Portfolio Strategy, Refinitiv, Bloomberg

Source: Scotiabank GBM

Exhibit 10:
S&P/TSX vs. S&P 500-12M Forward Relative P/E



Source: Scotiabank GBM Portfolio Strategy, Refinitiv.

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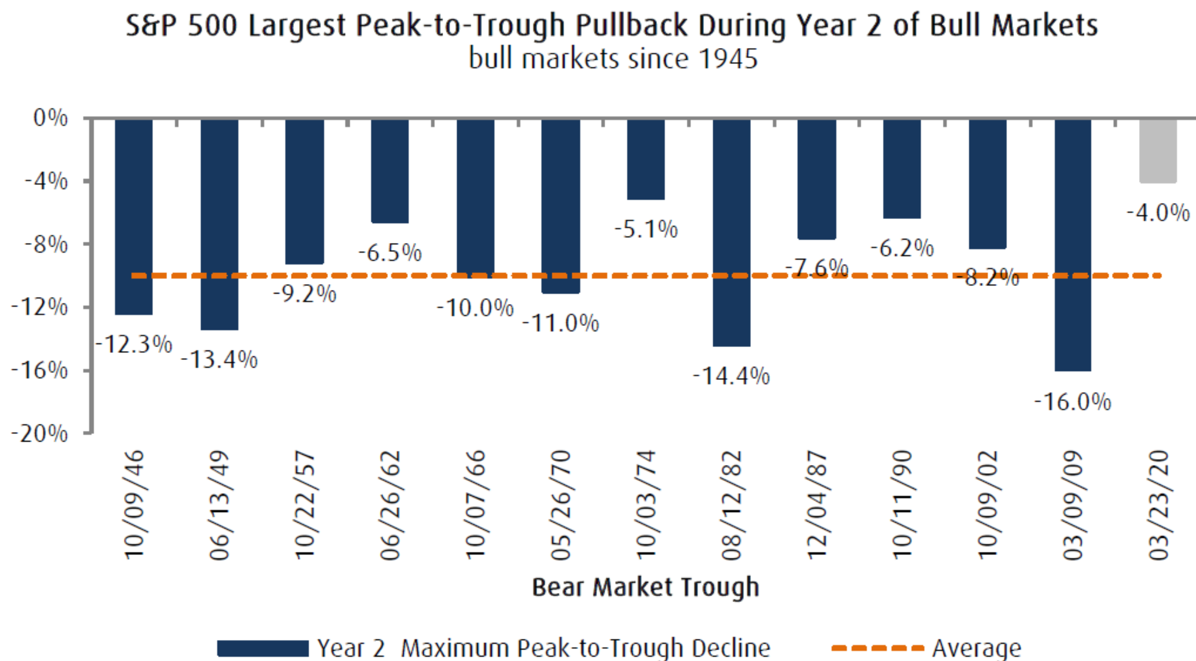
Moving on to currency, we recently removed the balance of our US dollar hedge. With the timing of the US Federal Reserve beginning to taper (and ultimately raise interest rates) being brought forward, there appears to be less certainty that the Bank of Canada will move that much in advance of the Fed, which we believe was one of the drivers of our currency outperformance over the past six months. In addition, the idea that the higher CPI inflation 10 Year Treasury data is transitory appears to be fully baked into the market given the recent direction (lower) of US 10 Year Treasuries yields. If this turns out to not be the case, it will likely result in higher US interest rates sooner, potentially putting upward pressure on the US greenback.

Meanwhile, oil prices have moved up over 50% year to date and rig counts are starting to recover, which should gradually increase oil supply, potentially putting a damper on further oil price increases. To the extent that our Canadian dollar is considered a Petro-currency, oil prices may be less of a tailwind to the Canadian dollar in the future. Finally, while we remain positive on the outlook for the markets into 2022, we can't rule out a market pullback. **Exhibit 11** illustrates that the average Peak to Trough pullback in the second year of a recovery going back to 1945 is about -10%. In that scenario, a flight to safety would likely result in US dollar strength further supporting our decision to remove our US currency hedge.

Exhibit 11:
S&P 500 Largest Peak-to-Trough Pullback During Year 2 of Bull Market



During the quarter, we added one new position Topaz Energy Corp to the portfolio, a review of which can be found in **Appendix 1.**

Closing Comments and Outlook

During the first quarter of 2021, earnings rose 52.5% up from the 23.7% increase that was expected at March 31st. As we had previously discussed, either a short-term pullback, a correction in time or a complete reassessment of the positive earnings outlook were the three possible scenarios. With the material increase in earnings in Q1 and the recent decline in long term interest rates, it now appears that the latter scenario played out in Q2 as the market implied earnings expectations are now more or less in line with the forward consensus. Both the Federal Reserve's and consensus estimates for GDP growth also continue to rise, which is positive for further upward revenue and earnings revisions. We will keep a close eye on inflation and employment gains as these could pull forward the timing of Fed tapering asset purchases and lift-off (increasing rates). While we can't rule out a market pullback, markets can still generate positive returns in a rising interest rate environment at least until the yield curve flattens or inverts. The bottom line, in our view, is that given the overall strength of the economy and the strong outlook for continued positive earnings momentum, as long as interest rates remain low, it makes sense to continue to own equities.

Peter Jackson
Chief Investment Officer
June 30, 2021

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APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

Topaz Energy Corp.

Topaz Energy is a gas weighted (80%) oil and gas royalty company, which takes a small (2-3%) royalty on each barrel of production on its acreage. Since it doesn't have to commit any capital to exploration on its land, free cash flow margins are very high (90%) and can easily support a 5% dividend with a 65% payout ratio. Topaz has partnered with a select group of top low-cost operators on the fastest growing natural gas play in North America (the north Montney with Tourmaline Oil) and the fastest growing oil play in Canada (the Clearwater with Tamarack Valley and Headwater Exploration). Beyond the dividend, upside will come from volume growth on their acreage and leverage to an improving natural gas price.

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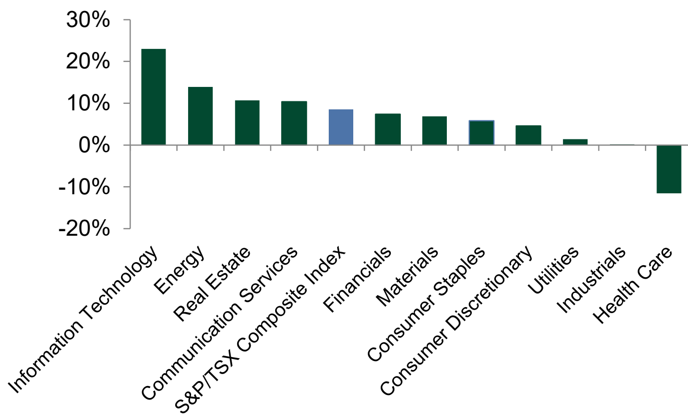
APPENDIX 2

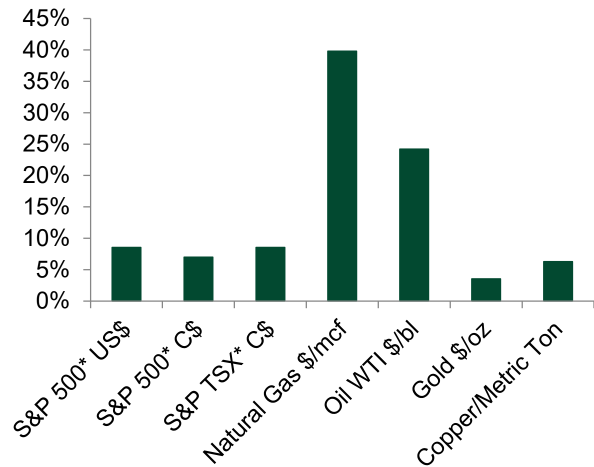
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending June 30, 2021



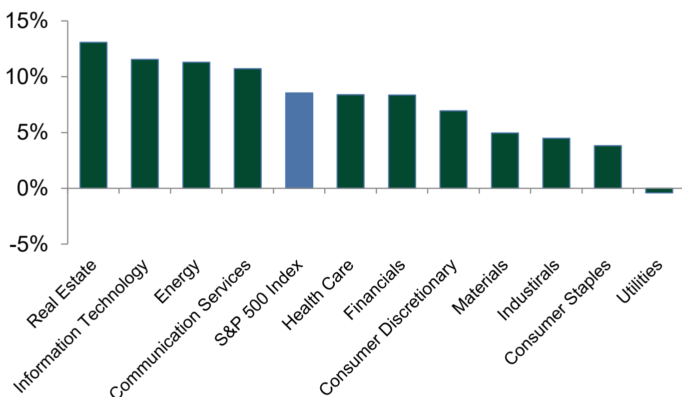
Source: TD Securities

Quarter % Change
Quarter Ending June 30, 2021



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending June 30, 2021



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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