CUMBERLAND

Private Wealth

December 31, 2021

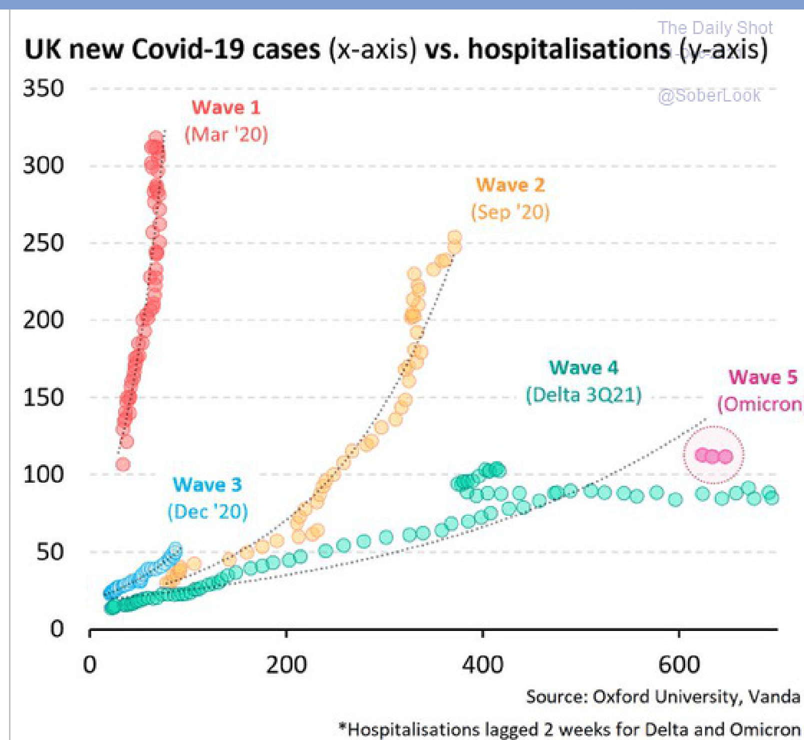
# Fourth Quarter and Year End Review

# NORTH AMERICAN EQUITY STRATEGY

*Happy New Year and Good Riddance to 2020! That is what we wrote last year at this time and it kind of feels like ground hog day.*

The good news, from a stock market perspective, is that returns were even better in 2021 than 2020. The bad news is that as we write this family and friends are being exposed to and/or falling victim to Omicron, which may have a basic reproduction rate (R-value) as high as 10, far exceeding earlier variants and second only to Measles. However, cases so far seem to be less severe resulting in fewer hospitalizations and deaths. **Exhibit 1** compares the different waves of COVID-19 in the UK where daily cases have spiked to an all-time high. Although the uncertainty will be high over the next few weeks, we are leaning to this wave being short-lived.

**Exhibit 1: UK New Covid Cases vs Hospitalizations**




Source: Daily Shot, Oxford University, Vanda

During the fourth quarter of 2021, the S&P500 total return index was up 11.0% in US dollars. Adjusting for currency, the S&P500 returned +10.7% in Canadian dollars, as the Canadian dollar appreciated about 0.3 cents, closing the quarter at US$0.791. The TSX total return in the fourth quarter was +6.5%. The fourth quarter was influenced by the continued rebound in economic strength and better than expected earnings, although the recent developments of the new variant introduced increased volatility going into the final month of the quarter. For the year, the S&P500 total return index was up 28.7% in US dollars or 27.5% in Canadian dollars, as the Canadian dollar appreciated 0.6 cents. The TSX total return for the year was 25.2%.

**Exhibit 2:**
**Federal Reserve: Summary of Economic Projections**

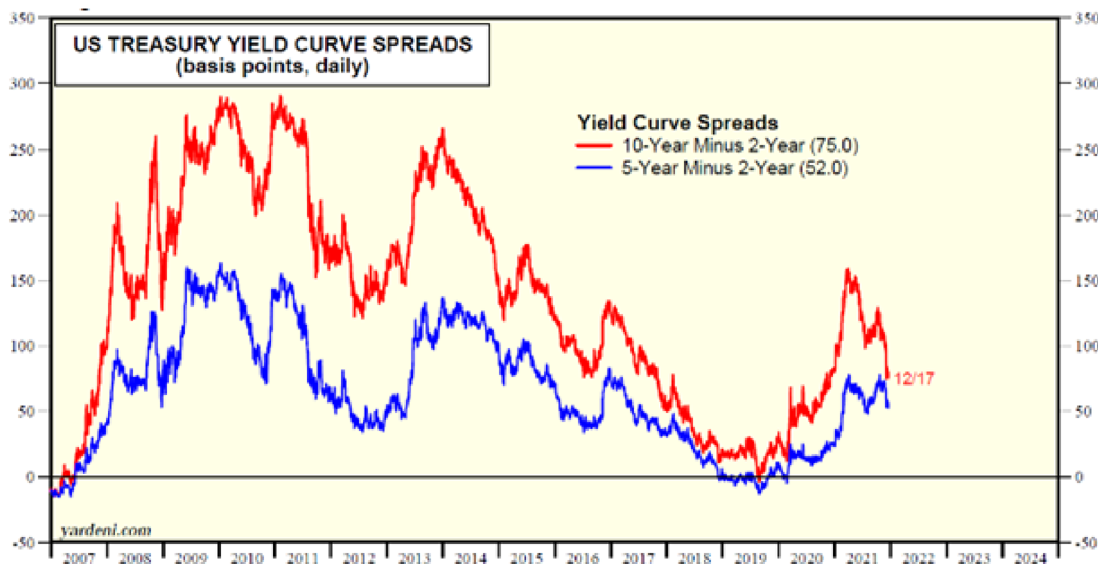
| FOMC Forecasts | Median | | | | |
|---|---|---|---|---|---|
| | 2021 | 2022 | 2023 | 2024 | Longer-run |
| **Change in real GDP** | 5.5 | 4.0 | 2.2 | 2.0 | 1.8 |
| September projection | 5.9 | 3.8 | 2.5 | 2.0 | 1.8 |
| **Unemployment rate** | 4.3 | 3.5 | 3.5 | 3.5 | 4.0 |
| September projection | 4.8 | 3.8 | 3.5 | 3.5 | 4.0 |
| **PCE Inflation** | 5.3 | 2.6 | 2.3 | 2.1 | 2.0 |
| September projection | 4.2 | 2.2 | 2.2 | 2.1 | 2.0 |
| **Core PCE Inflation** | 4.4 | 2.7 | 2.3 | 2.1 | |
| September projection | 3.7 | 2.3 | 2.2 | 2.1 | |
| **Projected Policy Path** | | | | | |
| **Fed funds rate** | 0.1 | 0.9 | 1.6 | 2.1 | 2.5 |
| September projection | 0.1 | 0.3 | 1.0 | 1.8 | 2.5 |

Source: FOMC, Renaissance Macro Research

**Exhibit 2** reviews the Summary of Economic projections of the Federal Open Market Committee (FOMC) from the December 2021 Federal Reserve meeting. These projections, in particular, the increase in core PCE inflation for the period 2021 through 2023 no doubt influenced the Fed's pivot to a more hawkish stance at its December meeting. While the committee's statement noted that the "path of the economy continues to depend on the course of the virus", with inflation having exceeded 2% for some time, the FOMC decided to speed up the monthly pace of tapering its bond purchases from $15 billion to $30 billion starting in January. "The Committee judges that similar reductions in the pace of net asset purchases will likely be appropriate each month". At that pace, it will set the stage for the completion of the Fed's $120 billion per month bond buying program in the first quarter of 2022 and for hiking the federal funds rate as early as March 2022.

Supporting this was Federal Reserve Governor Christopher Waller's comment that March would be "a live meeting", which pretty much says it all as Fed members rarely speak out of line without the Fed Chairman's Jerome Powell's blessing. Finally, the FOMC participants' assessment of appropriate monetary policy, or what is commonly referred to as the Fed's dot plot, released after the FOMC meeting on December 15th, showed that all 18 members of the FOMC now expect at least one rate hike in 2022, up from only nine in September's forecast. Furthermore, 12 of them now see at least three quarter-point hikes during the year, and two think four increases will be necessary.

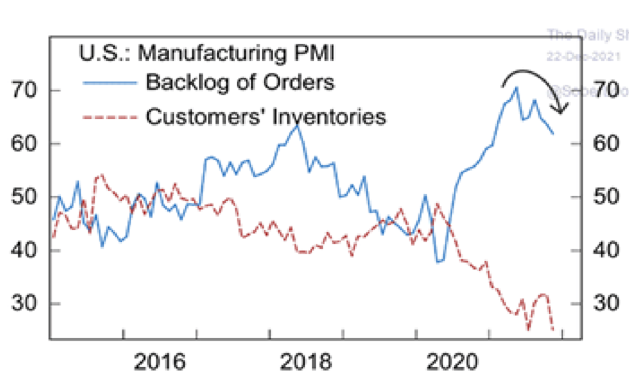
**Exhibit 3: US Treasury Yield Curve Spreads**

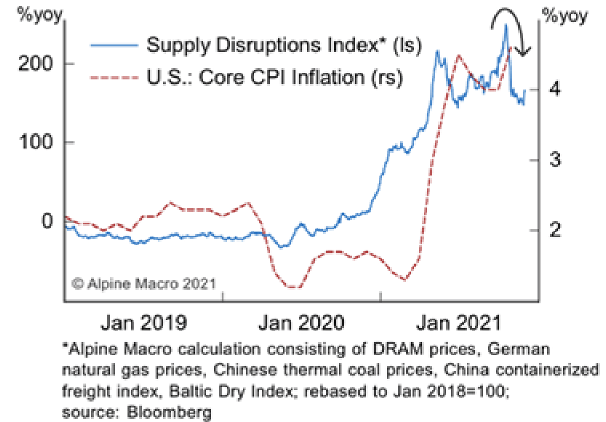



Source: Yardeni, Federal Reserve Board

**Exhibit 3** shows that the yield curve spread between the US treasury 10-year yield and the 2-year yield (red line) has been decreasing over the past few months yet is still positive (ie: the yield curve is flattening without inverting), which is an indication that the bond market believes that three rate hikes may be enough to lower inflation without killing the economy.

## Exhibit 4:
## Signs of Supply Chain Bottlenecks Easing

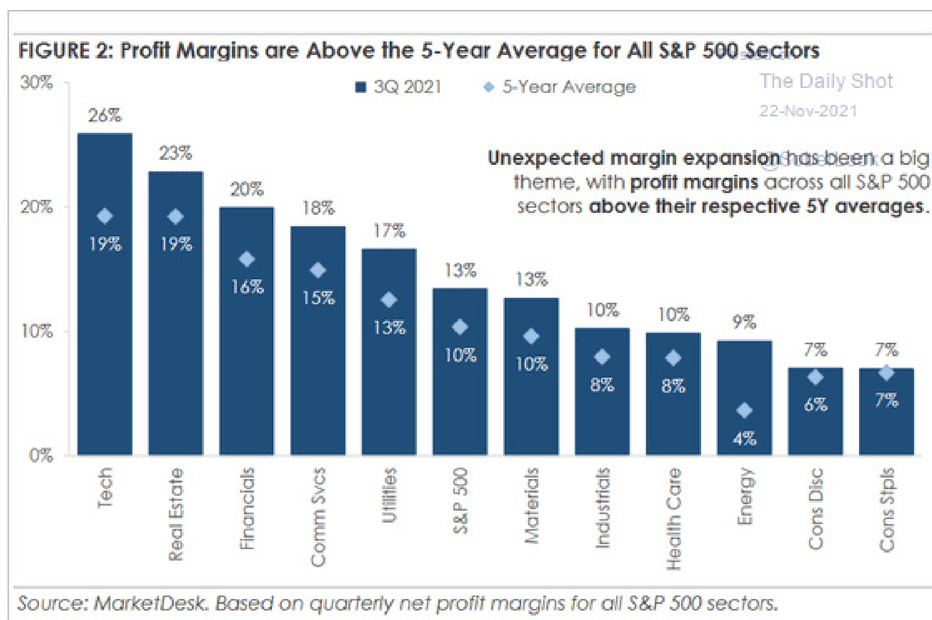


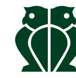

Source: Alpine Macro, Daily Shot

**Exhibit 4** also suggests that supply bottlenecks may have peaked. The chart on the left looks at US PMI manufacturing Backlog of Orders compared to Customer Inventories which now appear to be rolling over. The chart on the right is a supply disruptions index consisting of scarce commodities including semiconductors and containerized freight rates, which is compared to US core CPI inflation. Again, it suggests supply bottlenecks are starting to ease, which could also reduce inflationary pressures.

## Exhibit 5:
## S&P 500 Profit Margins




Source: Market Desk, Daily Shot.

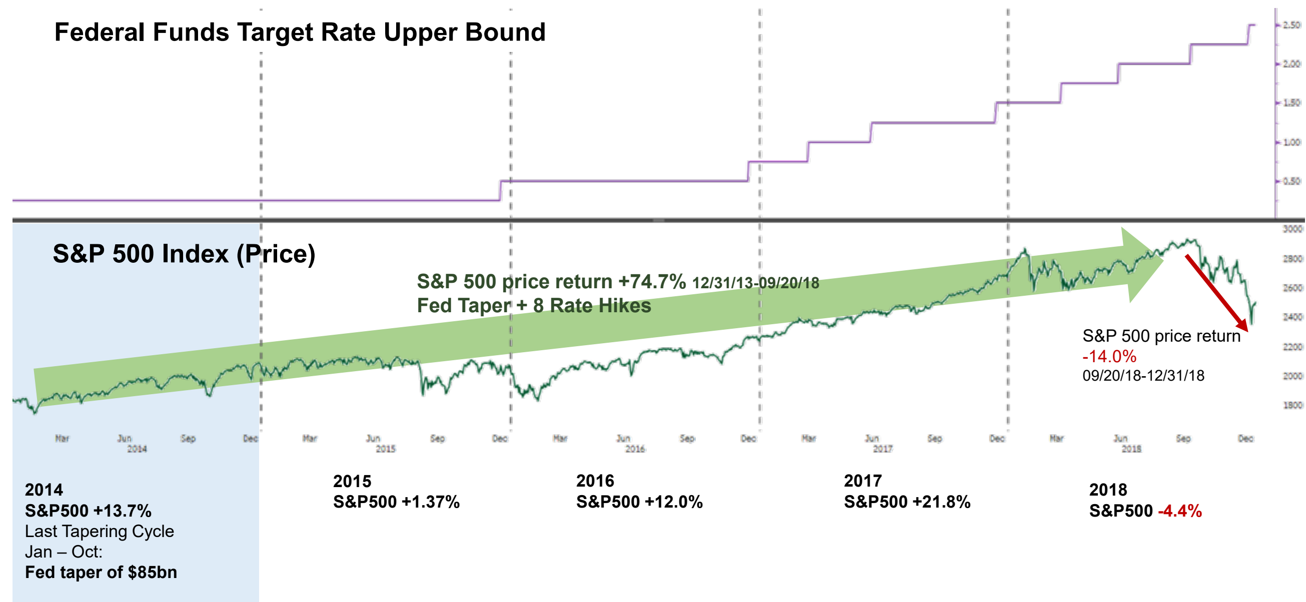




Notwithstanding inflationary pressures, our bottom-up analysis indicates that our companies have pricing power with profit margins holding up pretty well to these cost pressures. **Exhibit 5** shows that margin expansion has created a positive outcome across all sectors of the S&P500 resulting in profit margins in the third quarter of 2021, well ahead of the five-year averages.

**Exhibit 6:**
**S&P 500 vs Fed Funds Target Rate**

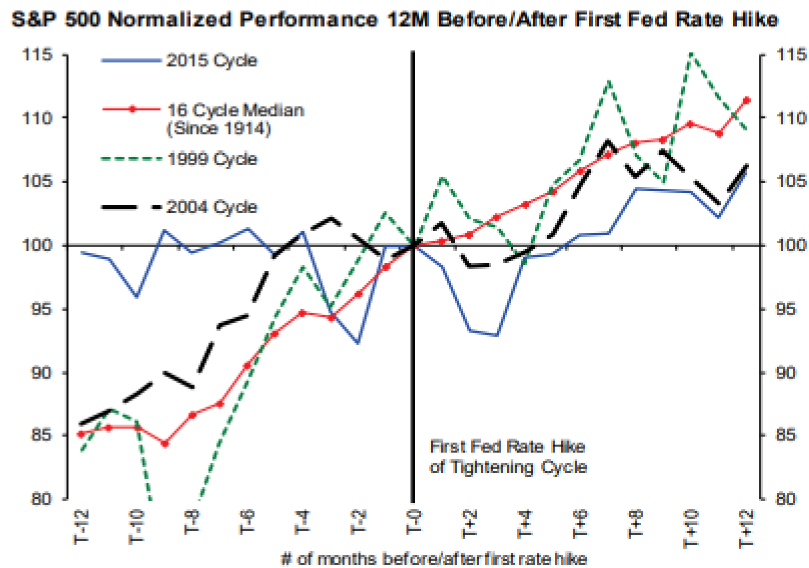
S&P 500 total returns shown in USD




Source: Bloomberg

**Exhibit 6** looks at the last taper/rate tightening cycle that took place from December 2013 through to December 2018. The point of this chart is not to suggest that history will necessarily repeat itself, however; there are a few points to note. First is that we have the same Fed Chairman today as we did for at least part of the last rate tightening cycle who is well aware of the policy mistake made two years ago when he signaled aggressive rate hikes to come, which led to the market sell-off during the fourth quarter of 2018. He likely does not want to make the same mistake. Another observation is that the S&P500 was up +13.7% in 2014 during the period in which the Fed reduced its bond buying program (the last tapering cycle) from $85 billion to zero. Finally, the S&P500 total return was +74.7% from the beginning of the Fed taper (January 2014) through to September 2018, which also encompassed 8 rate hikes.

## Exhibit 7:
## S&P 500 Performance Before and After Rate Hike




Source: Scotiabank

**Exhibit 7** looks back at equity behavior for the S&P500 through 16 historical tightening cycles since 1917. Stocks historically have increased going into the first Fed rate hike and in the 6-12 month period following liftoff. This is because the initial rate hikes usually are a signal of a very strong economy. The table in Exhibit 8 shows the historical average total returns associated with these time periods for both the S&P500 and the TSX and in both cases, the pre and post 12 month period for both markets has had double digit positive returns ranging from 13% to 21%. And, according to Scotiabank, the historical odds of generating a positive return in the 6 and 12 month period following the first rate hike are 81% and 69% for the S&P500 and 93% and 80% for the TSX respectively.

**Exhibit 8: Historical Asset Returns Pre/Post First Fed Rate Hike (Total Return)**

| | 12M Before | 6M Before | 6M After | 12M After |
|---|---|---|---|---|
| S&P 500 | 21% | 11% | 8% | 14% |
| TSX (C$) | 19% | 10% | 6% | 13% |

Source: Scotiabank, Bloomberg

**Exhibit 9** is an extension of the work we have shown in our previous quarterly commentaries where we try to interpret the market implied forward earnings using our equity risk premium model and the current level of bond yields, and then compare this to the consensus forward 12-month (F12) estimates. As indicated in the chart below, the consensus S&P 500 F12 earnings estimates have risen steadily from the beginning of 2021 from US $166.55 to the current level of US $220.89. This compares to the market implied earnings today of US $219.96 such that the implied earnings are about in line with the F12 consensus estimates suggesting the S&P500 is not expensive at least relative to the current level of bond yields. Overall, the S&P500 has become slightly cheaper on a forward P/E basis this past year having declined from 22.4x to 21.2x notwithstanding the market increase of over +25% year to date.

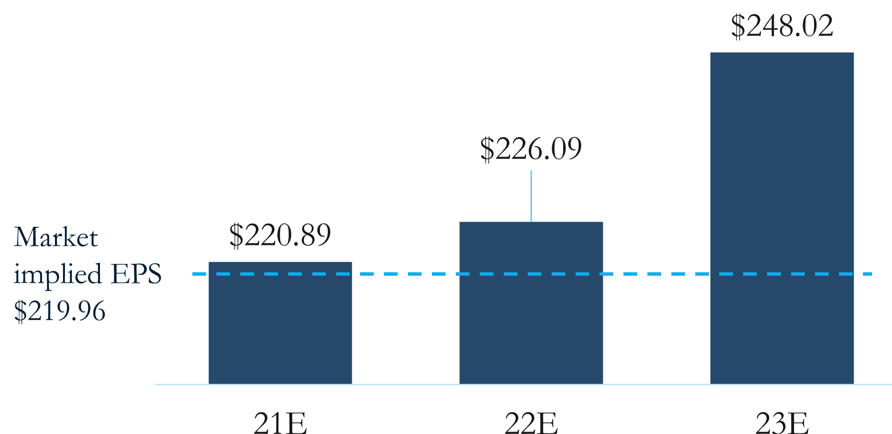
**Exhibit 10** looks at consensus earnings per share (EPS) estimates over the next 12 months as well as 2022 and 2023 calendar year EPS estimates. Again, the market implied earnings of $219.96 from Exhibit 9 suggests there is upside of 2.8% and 12.8% to 2022 and 2023 consensus earnings targets and with the market being forward looking, we would expect 2023 to be more relevant as we move into the new year.

**Exhibit 9:**
**Ratio: Consensus Earnings/Implied Earnings vs S&P 500**

| | DATE | | | | |
|---|---|---|---|---|---|
| | Jan 5/21 | Mar 26/21 | Jun 23/21 | Sep 14/21 | Dec 7/21 |
| 10-year Treasury Yield | 0.95% | 1.68% | 1.49% | 1.28% | 1.47% |
| 10-year Average Equity Risk Premium | 3.41% | 3.39% | 3.35% | 3.29% | 3.22% |
| Implied Earnings Yield | 4.36% | 5.07% | 4.84% | 4.58% | 4.69% |
| Market (close) | 3,726.86 | 3,974.54 | 4,241.84 | 4443.05 | 4686.75 |
| Implied Earnings Estimate (per share) | 162.49 | 201.51 | 205.18 | 203.49 | 219.96 |
| Consensus Earnings Estimate (per share) | 166.55 | 180.82 | 200.51 | 214.67 | 220.89 |
| Price/Earnings (estimate BF 12m) | 22.4x | 22.0x | 21.2x | 20.7x | 21.2x |
| Ratio (Consensus/Implied EPS) | 1.02 | 0.90 | 0.98 | 0.95 | 1.00 |

Source: Bloomberg (BEst EPS BF12m), Cumberland (Asset Mix Review Dates)

**Exhibit 10:**
**S&P 500 Consensus EPS Forecast**




Source: 21E: blended forward 12m estimate (CPWM Asset Mix 12/7/2021)22E & 22E: 12/23/2021 – Bloomberg EPS EEO (calendar year estimates)Market implied EPS: CPWM Asset Mix 12/7/2021

**Asset Allocation for our North American Equity Strategy As at December 31, 2021**

| | |
|---|---|
| **Equities** | **97%** |
| **Fixed Income** | **0%** |
| **Cash** | **3%** |

During the quarter, our overall equity exposure increased by 1% to 97% from 96% at September 30th. Our US equity exposure increased from 47% to 50% while our Canadian exposure decreased from 49% to 47%. Cash decreased from 4% 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 33% up from 31% at September 30th; while that of value stocks, which are more dependent upon and should benefit from an economic recovery, are down slightly at 58% from 60% at September 30th. Staples, which we don't classify as either growth or value, make up the balance of our equity exposure.

During the third quarter, we added two new stock positions including Rogers Communications Inc. and SVB Financial Group. We initiated a position in Rogers Communications stock after a period of significant underperformance versus its peers, despite strong operational performance, due to a well-publicized boardroom fight, which we thought was nearing an end (a subsequent court ruling has now essentially settled the issue). Rogers has the best operational leverage to a slowly reopening economy relative to its peers, material synergies from its proposed merger with Shaw Communications and an EV/EBITDA valuation discount to its peers at the highest level in over 6 years. SVB Financial Group is a fast-growing bank with strong roots providing banking services to venture capital backed companies resulting in significant exposure to higher growth verticals such as Technology and Healthcare. In recent years, SVB Financial has transformed itself from catering to start-ups only to now providing large companies with traditional banking products that go well beyond the IPO stage. SVB meets our bank scoring criteria given its low Return on Asset variability and high tangible book value growth. A complete review of the business and fundamental outlook for each company can be found in **Appendix 1**.

## Closing Comments and Outlook

While this year felt a lot like last year in terms of dealing with COVID-19, the good news from a stock market perspective is that the returns were even better in 2021 than 2020.The fourth quarter was influenced by the continued rebound in economic strength and better than expected earnings, although the recent developments of the new variant introduced increased volatility going into the final month of the quarter.

Recently, we have seen the VIX (a pricing volatility index commonly referred to as the fear index) spike from a low of around 15 at the beginning of November to 31 at the beginning of December driven by Omicron fears and Fed Powell's comment regarding maximum employment and inflation goals being met. Omicron worries appear to be fading, however, we have gone from pricing in zero rate hikes in 2022 as of last July to now pricing in 3 rate hikes by the beginning of 2023. So, the good news is that the market is baking in a lot of bad news. The chart below (**Exhibit 11**) shows the performance of the S&P500 in the subsequent 2 and 3 month periods after a spike in the VIX. If history is any indication and with the VIX now pulling back to 17 at the time of

writing, we could see some positive price momentum from here. We think the big concern is the speed of the tightening cycle. If the Fed repeats the mistakes from 2018, that will not be good. However, perhaps Powell learned his lesson then and will not signal rapid fire lockstep rate increases at every Fed meeting, which could scare the market into thinking the economy would suffer and the yield curve would invert. Avoiding that scenario, relatively soon we think the market should begin to look forward and start to focus on the 2023 earnings forecasts, which look pretty good.

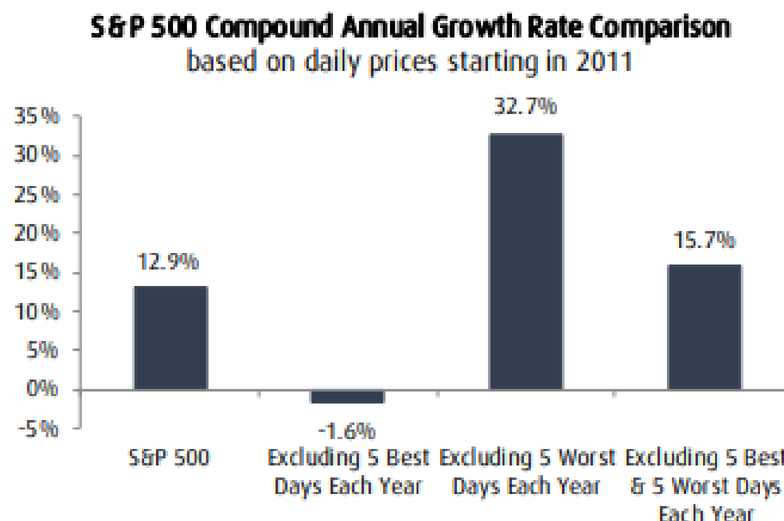
**Exhibit 11:**
**Future Returns Based on VIX Levels**

| % | S&P 500 | | Russell 2000 | |
|---|---|---|---|---|
| **When VIX > 15** | **Return** | **Annualized** | **Return** | **Annualized** |
| Subsequent 2 Months | 0.9 | 5.3 | 1.4 | 8.8 |
| Subsequent 3 Months | 1.1 | 4.6 | 2.0 | 8.3 |
| **When VIX > 20** | | | | |
| Subsequent 2 Months | 4.8 | 32.5 | 6.4 | 45.1 |
| Subsequent 3 Months | 5.6 | 24.4 | 8.3 | 37.7 |
| **When VIX > 25** | | | | |
| Subsequent 2 Months | 6.1 | 42.6 | 8.1 | 60.0 |
| Subsequent 3 Months | 8.6 | 39.2 | 12.2 | 58.6 |

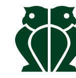
Note: 2010 to present; Source: Standard & Poor's, Russell, Haver Analytics®, Credit Suisse

Source: Credit Suisse

**Exhibit 12:**
**Missing Best & Worst Days Can Have a Significant Impact**



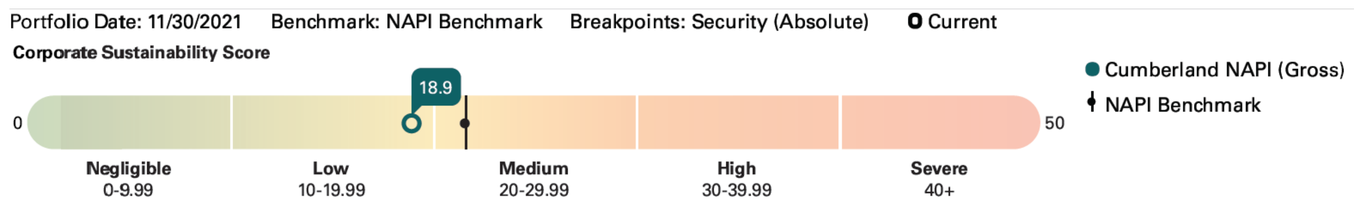

Source: BMO Capital Markets Investment Strategy Group, FactSet




In **Exhibit 6,** we showed you the historical performance in the last taper/rate tightening cycle and in Exhibit 7 we showed the performance over 16 previous tightening cycles going back to 1917. In **Exhibit 12,** we explore the performance of the S&P500 excluding the 5 best and 5 worst days per year going back to 2011. The point of the chart is to suggest that market timing can be rewarding, however it is very difficult at best and is a tactical strategy that requires very high conviction. If you miss the 5 best days, you essentially lose all of your return and then some. We are not at a point where we have enough conviction to meaningfully reduce our equity exposure at this time. Based on where we see valuations now and based on historical periods similar to those today, we think the best strategy right now is to stay the course.

**Exhibit 13** shows the Environmental, Social, Governance or ESG score for our North American plus International strategy at 18.9 compared to the benchmark at 21.5 (lower is better, details are provided below).

**Exhibit 13: ESG**
Sustainability Score – North American plus International (NAPI)
11/30/21




Source: Morningstar
Benchmark: 40% S&P 500 TR, 40% SP/TSX Composite Index TR, 20% Morningstar DM xNA TME NR CAD
Percent of AUM covered: 94.1%

**The Morningstar Portfolio Sustainability Score** is an asset-weighted average of Sustainalytics' company-level ESG Risk Score. The Sustainalytics' company-level ESG Risk Score measures the degree to which a company's economic value may be at risk driven by ESG factors. Like the ESG Risk Scores, the Portfolio Sustainability Score is rendered on a 0-100 scale, where lower scores are better, using an asset-weighted average of all covered securities. To receive a Portfolio Sustainability Score, at least 67% of a portfolio's assets under management (long positions only) must have a company ESG Risk Rating. The percentage of assets under management of the covered securities is rescaled to 100% before calculating the Portfolio Sustainability Score.

Cumberland's NAPI holdings reflect those of a representative account as of the date shown. The Benchmark Index is blended and includes 40% S&P/TSX Composite Index total return, 40% S&P 500 Index total return and 20% Morningstar DM X NATME NR in Canadian dollars, with constant weights.

This Benchmark represent the universe from which Cumberland's NAPI equity strategy selects the equity securities, targeting up to 100% in Canadian, US and Non-North American equities in the portfolio at any time, which are different from the Benchmark. The NAPI strategy may hold less than 100% in equities (with the balance typically invested in bonds, preferred shares, and other income securities including cash and equivalents).

We measure our ESG score across all of our equity mandates and while we are not a pure play on sustainable investing, and set criteria have not been integrated into our investment process at this time, we do score materially better than our benchmarks. One of the positive outcomes of our investment process is that our rigorous focus on profitability, valuation and risk coupled with proven leadership and strong management teams, has driven favourable, consistent ESG scores for our Cumberland strategies for many years. We think it is fair to say that owning high quality compounding companies led by experienced executives and savvy boards also supports lower risk ESG scores.

**Peter Jackson**
**Chief Investment Officer**
December 31, 2021

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# APPENDIX 1

# NEW EQUITY INVESTMENTS:

# NORTH AMERICAN EQUITY MANDATE

## CANADA

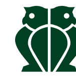
**Rogers Communications INC.**

We bought Rogers Communications stock after a period of significant underperformance versus its peers, despite strong operational performance, due to a well-publicized boardroom fight which we thought was nearing an end (a subsequent court ruling has now essentially settled the issue). Rogers has the best operational leverage relative to its peers to a slowly reopening economy, material synergies from its proposed merger with Shaw Communications and an EV/EBITDA valuation discount to its peers at the highest level in over 6 years.

## UNITED STATES

**SVB Financial Group**

SVB Financial Group is a fast-growing bank with strong roots in venture capital. The bank has significant exposure to higher growth verticals such as Technology and Healthcare. It has been estimated that SVB Financial banks approximately 50% of all US venture capital backed technology and life science companies. For many years, SVB Financial acted as the farm system for the larger banks. Although SVB Financial was there from day one for many of its start-up companies, when these companies reached a certain size, they would often leave SVB Financial and move their business to the larger banks which offered much broader capabilities. In recent years SVB Financial has transformed itself from catering to start-ups only to now providing large companies with traditional banking products that go well beyond the IPO stage. SVB Financial has become a one-stop shop for many of its clients by offering a wide range of products such as capital markets products, personal banking products, and wealth management services. SVB meets our bank scoring criteria given its low Return on Asset variability and high tangible book value growth.



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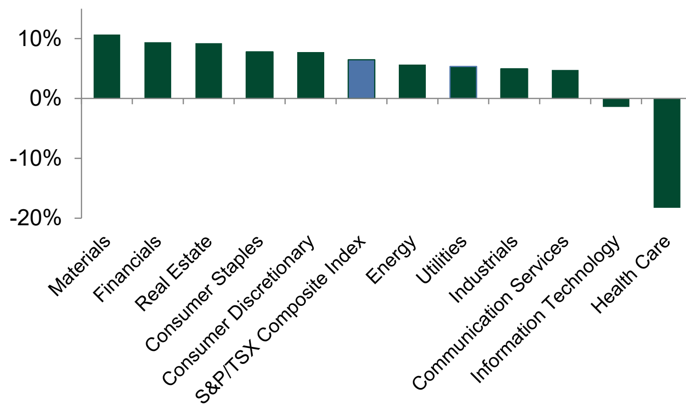
## APPENDIX 2

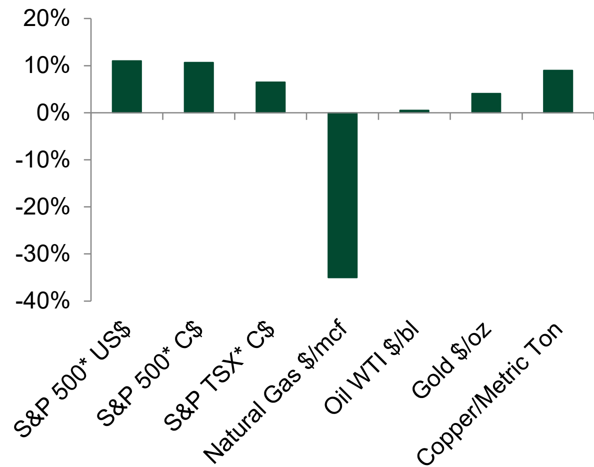
## PERFORMANCE CHARTS

### S&P TSX (C$ Total Returns) Quarter Ending December 31, 2021



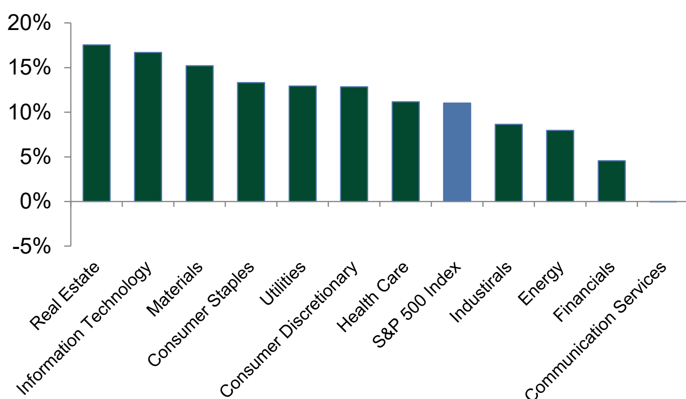

Source: TD Securities

### Quarter % Change Quarter Ending December 31, 2021




Source:Bloomberg *Total Returns

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