September 30, 2022

# Third Quarter Review

## NORTH AMERICAN EQUITY STRATEGY

Market volatility continued through the third quarter initially to the upside with the S&P500 rising almost 14% through mid-August on the possibility of a pivot by the US Federal Reserve (Fed) to soften its stance on fighting inflation, only to give back those gains as the reality set in that the fight against inflation is not yet over. For the third quarter ending September 30th, the S&P500 total return was -4.9% in US dollars. Adjusting for currency, the S&P500 returned +1.9% in Canadian dollars, as the Canadian dollar depreciated about 5.4 cents, closing the quarter at US$0.7231. The TSX total return was -1.4% in the third quarter.

"Don't fight the Fed". This phrase was coined in the 1970's by famed investor Martin Zweig. Here we are approximately 50 years later, and we think the same quote could not be more applicable. At the September Fed press conference, Jerome Powell said that the main messaging has not changed from his speech at Jackson Hole in August 2022. Here are some quotes of what he said then:

**"Today, my remarks will be shorter, my focus narrower, and my message more direct"**

**"Restoring price stability will likely require maintaining a restrictive policy stance for some time."**

**"We will keep at it until we are confident the job is done."**

**- Jerome Powell**

The Fed has made its position clear. Fighting inflation with higher interest rates is a top priority and anyone who assumes otherwise may be disappointed. So…

DON'T FIGHT THE FED!

Below (**Exhibit 1**) is the Fed's "Summary of Economic Projections" from its September 21st meeting. As indicated in the chart, which shows the Federal Open Market Committee's (FOMC) projections over the next three years (plus 2025) compared to where they were in June, the FOMC once again downgraded its GDP projections through 2024, boosted its forecast for unemployment, while also increasing its inflation outlook. They now expect inflation to return to their target 2% range by 2025. Also, like in the June report, the projections are based on materially increasing the Fed's forward guidance for the Federal Funds rate to 4.4%, 4.6% and 3.9% from 3.4%, 3.8% and 3.4% through 2022, 2023 and 2024, respectively, and from its current level of 3.0%-3.25%. That suggests another 100-125 basis point rise between now and year end! **Exhibit 2** shows the Feds funds futures curve a week prior to and going into Fed announcement. As

**Exhibit 1: FOMC Summary of Economic Projections**

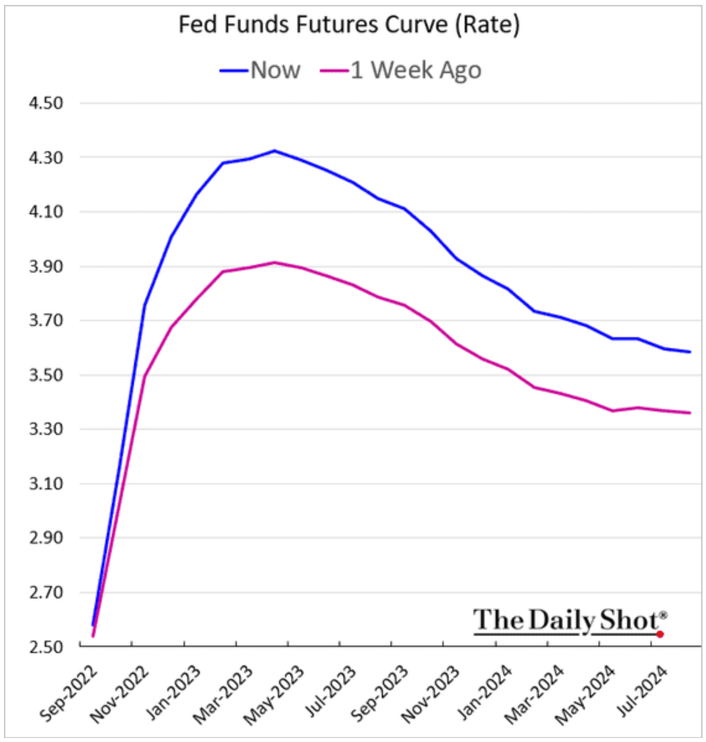
Percent

| Variable | Median[1] | | | | |
|---|---|---|---|---|---|
| | 2022 | 2023 | 2024 | 2025 | Longer run |
| Change in real GDP | 0.2 | 1.2 | 1.7 | 1.8 | 1.8 |
| June projection | 1.7 | 1.7 | 1.9 | | 1.8 |
| Unemployment rate | 3.8 | 4.4 | 4.4 | 4.3 | 4.0 |
| June projection | 3.7 | 3.9 | 4.1 | | 4.0 |
| PCE inflation | 5.4 | 2.8 | 2.3 | 2.0 | 2.0 |
| June projection | 5.2 | 2.6 | 2.2 | | 2.0 |
| Core PCE inflation[4] | 4.5 | 3.1 | 2.3 | 2.1 | |
| June projection | 4.3 | 2.7 | 2.3 | | |
| Memo: Projected appropriate policy path | | | | | |
| Federal funds rate | 4.4 | 4.6 | 3.9 | 2.9 | 2.5 |
| June projection | 3.4 | 3.8 | 3.4 | | 2.5 |

**Inflation expected to return to target 2% range by 2025**

Source: Federal open Market Committee, Federal Reserve indicated in the chart, the market was already in the process of adjusting up its projection for interest rates prior to the announcement although the Fed's forecast was perhaps even a little higher than the market anticipated.

**Exhibit 2: Fed Funds Futures Curve (Rate)**




Source: Daily Shot

The question on our mind is how will the stock market react to this news going forward given the S&P500 is already down over -20% year to date?

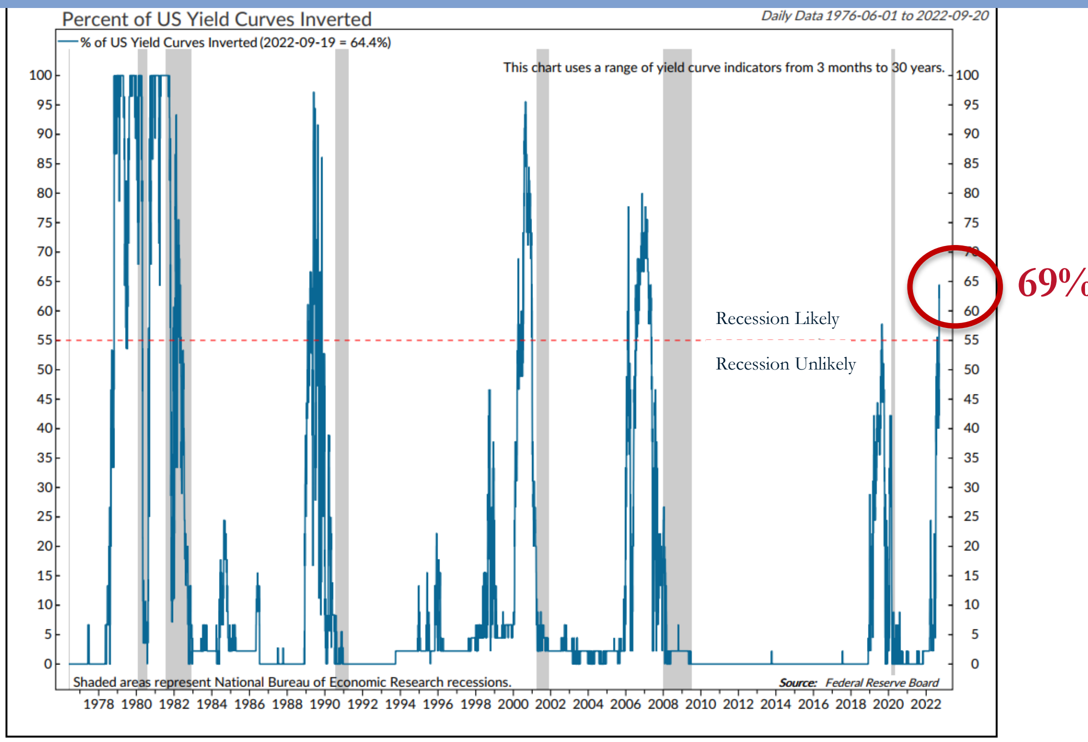
**Exhibit 3** shows the S&P500's path after at least an 18% fall from a bull market peak going back to the 1920's. Recall the S&P500 peaked on January 3rd, 2022 and subsequently fell -23.6% by June 16th, 2022. As indicated in the chart, the average historical path of the stock market going forward depends on whether a recession develops. The red circle indicates approximately where we are today from a timing perspective. In both the recession and non-recession case, the market historically rebounds off the initial bottom like it has off the June lows, before determining the recession/no-recession path. The issue with the no-recession path is that in most cases the Federal Reserve is cutting rates not forecasting to increase them by 50% as it is today. However, if there is a silver lining, if we can call it that, might be that the distance from where we are today to the bottom of the blue line is about -5% -10% suggesting most of the damage may be done.

## Exhibit 3: S&P 500 After 18%+ Declines


Source: Canaccord Genuity, Ned Davis

So, Exhibit 3 begs the question what is the likelihood of a recession? Many strategists/ economists look at the shape of the yield curve as a key recession indicator as an inverted yield curve is often associated with an oncoming recession. The problem is each yield curve (10 year / 2 year, 10 year / 3-month etc.) may provide different signals so which should you look at? There isn't a clear answer but **Exhibit 4**, courtesy of Ned Davis Research (NDR), cumulatively looks at all yield curves going back to the 1970's and calculates the percentage that are inverted across the whole yield curve. As indicated in the chart, if the cumulative percentage exceeds 55% (currently at 69%) or the red dashed line in the chart, a recession is likely according to NDR. Certainly, the odds of a recession after the latest Fed rate move and new projections in September are higher now than they were before.

## Exhibit 4: Percent of US Yield Curves Inverted




Source: Ned Davis

**Exhibit 5** breaks down the contribution to total return for the S&P500 for the nine months ending September 30th, 2022. As indicated in the chart, while the total return for the nine months was -23.9%, the earnings multiple contraction was actually greater than this at -29.0% as the earnings contribution was positive +6.0%. The massive multiple contraction can be explained by the rapid rise in interest rates, in particular the 10 year Treasury yield increasing from 1.43% to 3.80% year to date.

## Exhibit 5: Return and P/E decomposition

SPX

| Date | Price Index | Dividends | Total Return Index | Earnings ($) 12MF | Earnings Multiple (x) 12MF | 10-year Average Earnings Multiple (x) 12MF |
|---|---|---|---|---|---|---|
| 12/31/2021 | 4,766.18 | | 9,986.70 | $ 222.71 | 21.40x | |
| 9/30/2022 | 3585.62 | | 7603.14 | $ 236.00 | 15.19x | 17.23x |
| % Change | -24.77% | 0.90% | -23.87% | 5.97% | -29.01% | |

Source: Bloomberg,BEst EPS (12m blended forward EPS estimate), and BEst P/E

**Exhibit 6** shows the change in consensus calendar forward earnings and price earnings multiples from December 31st 2021 to September 30th 2022 for 2022, 2023 and 2024. We will focus on 2023 and 2024 given we are already 9 months through 2022.

Based on the current consensus forward projections for 2023 and 2024, the S&P500 is trading at 15.0x and 13.8x forward estimates compared to 19.6x and 17.6x at December 31st 2021 and the 10 year average shown in Exhibit 5 of 17.2x. So the market is getting cheaper compared to nine months ago and the long term historical averages.

However, the problem is that the 10 year average P/E period measures the P/E in a CPI inflationary period of about 2% not the current 8.3% level in August 2022.

## Exhibit 6: Calendar Year Estimates of Earnings per Share for S&P 500

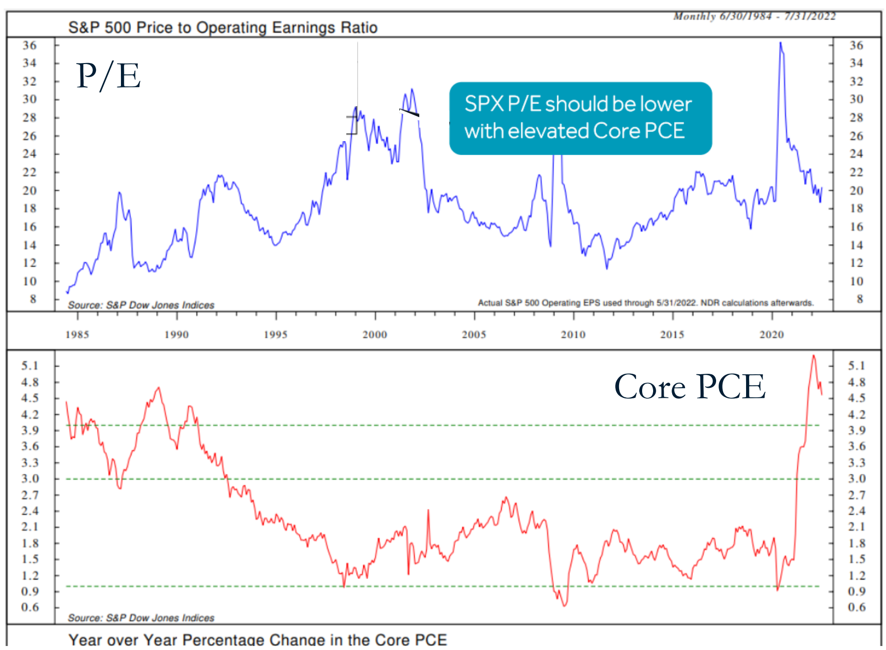

| | CY '22E | CY '23E | CY '24E | | CY '22E | CY '23E | CY '24E |
|---|---|---|---|---|---|---|---|
| Forward P/E | 21.5x | 19.6x | 17.6x | Forward P/E | 16.18x | 14.97x | 13.80x |
| Earnings Growth | | +9.86% | +11.08% | Earnings Growth | | +8.08% | +8.46% |

Source: FactSet 09/22/2023 and S&P500 price 3757.99

**Exhibit 7** compares core PCE inflation (the Fed's preferred measure) going back to 1985 to the forward 12m P/E multiple. As indicated in the box in the top clip, which shows the average P/E level based on changes in year over year core PCE inflation, when core PCE inflation is above 4% the historical P/E multiple is closer to 13.8x. The good news from Exhibit 1 is that the Fed projects core PCE inflation coming down to about 3.1% in 2023 and 2.3% in 2024, which supports a forward P/E multiple of 16.45x to 19.35x for 2023 and 2024 respectively, which are both higher than the 15.6x and 14.4x projections discussed above. This suggests the market is still cheap based on 2023 and 2024 earnings if inflation does indeed come down to Fed forecasts. We just need to get there.

## Exhibit 7: S&P 500 Price to Operating Earnings Ratio

| Average S&P 500 P/Oper EPS When: | |
|---|---|
| When Yr/Yr Change in Core PCE is: | Average P/E |
| *Above 4 | **13.82** |
| Between 3 and 4 | **16.45** |
| Between 1 and 3 | **19.35** |



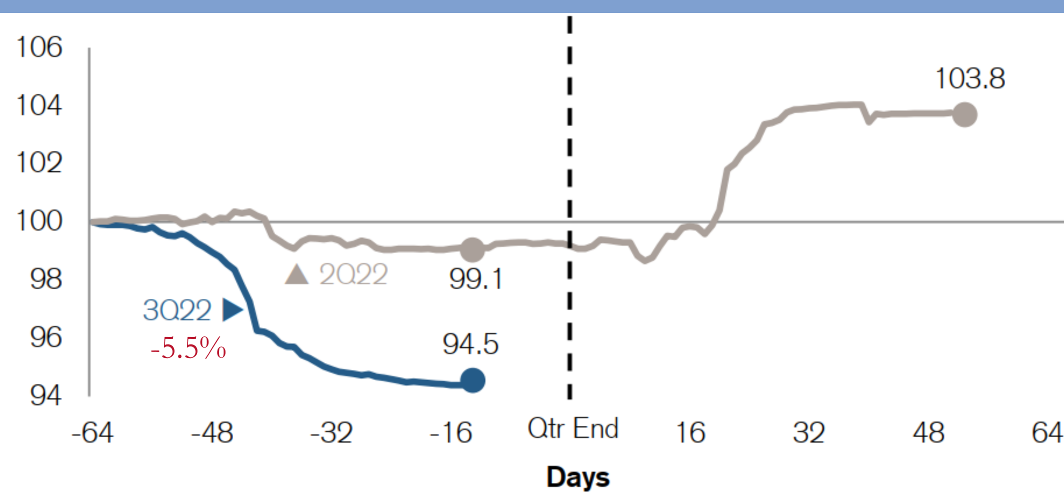

Source: Canaccord Genuity & Ned Davis Research, September Picture Book , 09/07/2022

The other issue is whether we can in fact believe the consensus forward earnings projections given we may be heading into a recession. Does earnings growth of 8.1% in 2023/2022 and 8.5% in 2024/2023 make sense? **Exhibit 8** compares the direction of earnings revisions (blue line) to US 10 year Treasury yields (grey line inverted) advanced 18 months. As indicated by the correlations in the chart, higher rates are historically a headwind to forward earnings. **Exhibit 9** shows the path for Q3 consensus earnings, which are down -5.5%, and materially lower than Q2 at the same point in time going into earnings season. As indicated by the grey line, we ended up with a nice recovery in Q2 earnings so time will tell how things will play out in Q3. **Exhibit 10** shows the correlation between earnings (blue line) for the S&P500 and price (red dotted line) going back to 1985. The correlation is about 95%, so the direction of earnings do matter!

**Exhibit 8: Earnings Revisions and 10-Year U.S. Treasury Yields**

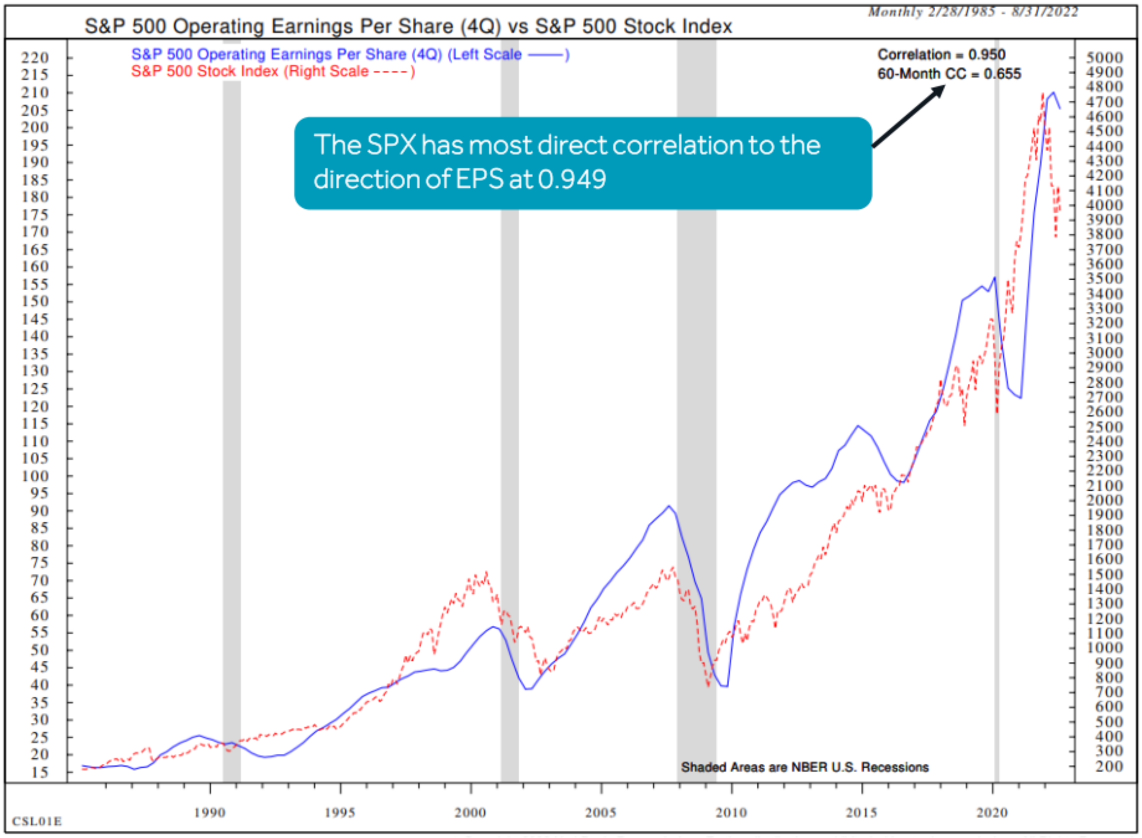

Source: Daily Shot, SoberLook

**Exhibit 9: Path of Consensus S&P 500 EPS: 3Q22 vs. 2Q22**




Source: Credit Suisse

## Exhibit 10: Earnings Outlook - The SPX Correlates to Direction of EPS




Source: Canaccord Genuity, Ned Davis

| Asset Allocation for our North American Equity Strategy As at September 30, 2022 | |
|---|---|
| Equities | 90% |
| Fixed Income | 0% |
| Cash | 10% |

During the quarter, our overall equity exposure increased 1% to 90% from 89% at June 30th. Our US equity exposure decreased from 39% to 37% while our Canadian exposure increased from 50% to 53%. Cash decreased from 11% to 10%. 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.

Currently our portfolio is positioned toward value-oriented stocks making up 56% of the portfolio versus 53% at June 30th while maintaining exposure to growth stocks at around 30% of the portfolio, which was down slightly from 32% at June 30th. Staples (4%), which we don't classify as either growth or value, make up the balance of our equity exposure.

Our shift to value included one new purchase, Linamar Corporation, which is is an advanced manufacturing company composed of two operating segments – the Industrial segment and the Mobility segment, both global leaders in manufacturing solutions and world-class developers of highly engineered products. In the latest quarter, Industrial and Mobility sales grew 28.2% and 25%, respectively, on strong pricing and market share gains. Also, some of the headwinds the company had been experiencing such as higher feedstock commodity prices, shipping costs and the chip shortages are now becoming tailwinds. Linamar also saw record dollar high content per vehicle in North America and European regions. Given the significant low auto inventory situation in North America, the industry is predicting at least two years of strong production just to refill the pipeline regardless of demand. The company is having great success winning new business with their new business book now at $4.9 billion, which should add $600-800 million of revenue in each of the next two years on a current revenue run rate of about $7.5 billion. Also, 74% of YTD new business is for hybrids or electric vehicles (EVs) and Linamar trades at just 7.2x next year's earnings.

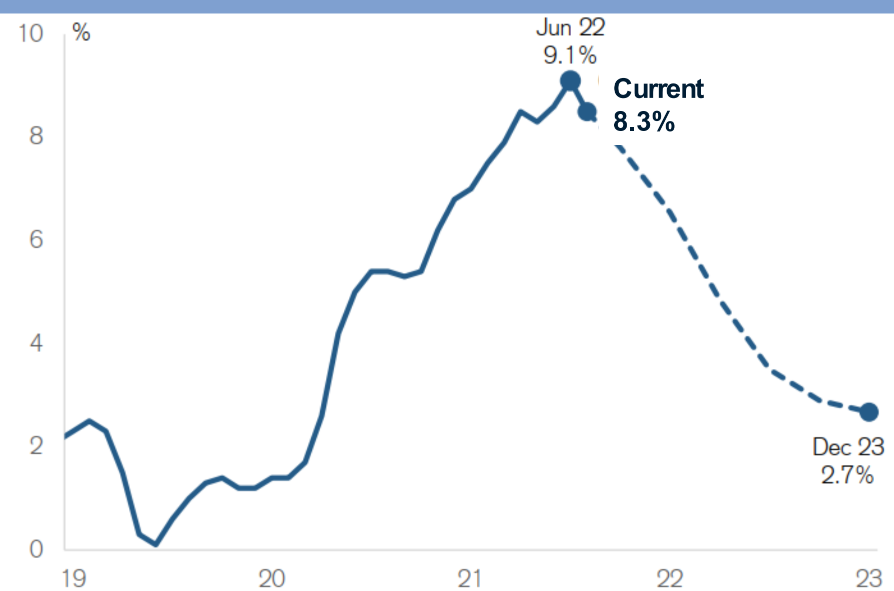
Given the recent pullback in energy through the third quarter, we also took the opportunity to increase our energy exposure slightly in existing portfolio names Keyera Corp. and Topaz Energy Corp. A complete review of the business and fundamental outlook for new companies purchased and additions during the quarter can be found in **Appendix 1.**

## Closing Comments and Outlook

In closing, we attempted to cover some of the issues facing this market including the likelihood of a recession and its potential impact on the market going forward, the effect inflation (and interest rates) has on market valuation and the current earnings outlook including the possibility that earnings projections may be too high especially if we experience below trend growth or a recession.

**Exhibit 11** shows the consensus economists forecast for CPI inflation dropping to 2.7% by the end of 2023. The Fed's own projections from Exhibit 1 show PCE inflation declining from 5.4% to 2.8% by the end of 2023. The Fed is attempting to accomplish this at the expense of higher unemployment and below trend growth through 2024. As it was in the 1970's and 80's the Fed is being forced to focus on price stability at the expense of economic growth. However, as we noted above the market can likely support a higher valuation multiple of 16.45x-19.35x's if inflation can be brought down and inflation expectations remain low.

**Exhibit 11: CPI with Economist Forecasts**




Source: Credit Suisse

**Exhibit 12** looks at the mean (-21.57%) and median (-10.28%) historical percent change in S&P500 earnings during recessions. Although we can't rule out a greater crisis in eastern Europe or something else, for this exercise we have chosen to focus on the median decline of -10.28% as the mean decline is heavily skewed by the COVID-19 (-61.38%) and the Great Financial Crisis (-76.59%) events, which we believe may be beyond the potential declines in the current environment. Applying the type of earnings decline suggested by the historical median to the current estimates from Exhibit 6 implies adjusted earnings estimates of approximately $214.89 and $233.07 for 2023 and 2024, respectively. Assuming the Fed's planned policy move is restrictive enough to slow the economy and ease inflation and applying the target P/E levels from Exhibit 7 of 16.45x and 19.35x for 2023 to the 2023 earnings adjusted for the historical median earnings decline, results in a range for the S&P500 of 3,534.94 to 4,158.12 or approximately -2% to +15% from current levels. The 2024 level would be higher using similar analyses. This suggests that the risk reward for stocks is improving depending on the actual future path of earnings and inflation. Anecdotally, from Exhibit 12, the mean and median S&P500 % gain per annum is +5.87% and +4.50%. This implies there must have been material price/earnings multiple expansion during these recession periods to produce those gains because the corresponding earnings gains were negative. Multiple expansion due to lower inflation and correspondingly lower long term interest rates would suggest further support for the market.

### Exhibit 12: Standard & Poor's 500 Earnings During Recessions

| | Earnings % Gain | Earnings % Gain Per Annum | S&P 500 % Gain | S&P 500 % Gain Per Annum | Days |
|---|---|---|---|---|---|
| 1948-11-30 to 1949-10-31 | 1.31 | 1.43 | 15.50 | 17.00 | 336 |
| 1953-07-31 to 1954-05-31 | 2.75 | 3.30 | 23.59 | 28.96 | 305 |
| 1957-08-31 to 1958-04-30 | -15.56 | -22.52 | -1.17 | -1.76 | 243 |
| 1960-04-30 to 1961-02-28 | -5.21 | -6.23 | 20.05 | 24.54 | 305 |
| 1969-12-31 to 1970-11-30 | -11.25 | -12.22 | -1.87 | -2.05 | 335 |
| 1973-11-30 to 1975-03-31 | 3.55 | 2.66 | -7.95 | -6.03 | 487 |
| 1980-01-31 to 1980-07-31 | -4.25 | -8.34 | 9.40 | 19.74 | 183 |
| 1981-07-31 to 1982-11-30 | -17.22 | -13.21 | 14.03 | 10.34 | 488 |
| 1990-07-31 to 1991-03-31 | -4.00 | -5.95 | 7.91 | 12.11 | 244 |
| 2001-03-31 to 2001-11-30 | -45.66 | -59.85 | -0.90 | -1.35 | 245 |
| 2007-12-31 to 2009-06-30 | -88.65 | -76.59 | -34.82 | -24.84 | 548 |
| 2020-02-29 to 2020-04-30 | -14.70 | -61.38 | -1.06 | -6.16 | 62 |
| **Mean** | -16.58 | -21.57 | 3.56 | 5.87 | 315 |
| **Median** | -8.23 | -10.28 | 3.50 | 4.50 | 305 |

Source: Ned Davis Research

Our strategy in dealing with this period of high inflation and increased volatility is to concentrate on owning high quality companies with lower volatility, consistent earnings and strong and growing dividends combined with some extra cash reserves on the sidelines. To this end **Exhibit 13** compares the characteristics of our North American Equity strategy portfolio to the 50/50 SPX/TSX benchmark. As indicated in the chart, our portfolio has higher EBITDA margins (earnings before interest, tax and depreciation and amortization), higher average 5 year Return on Invested Capital (ROIC) and higher forecasted Return on Equity (ROE) characteristics than the benchmark, quality factors that represent the cornerstone of our investment process. Our projected three-year dividend growth rate is also 13%, which is above the benchmark with more or less roughly the same dividend payout ratio.

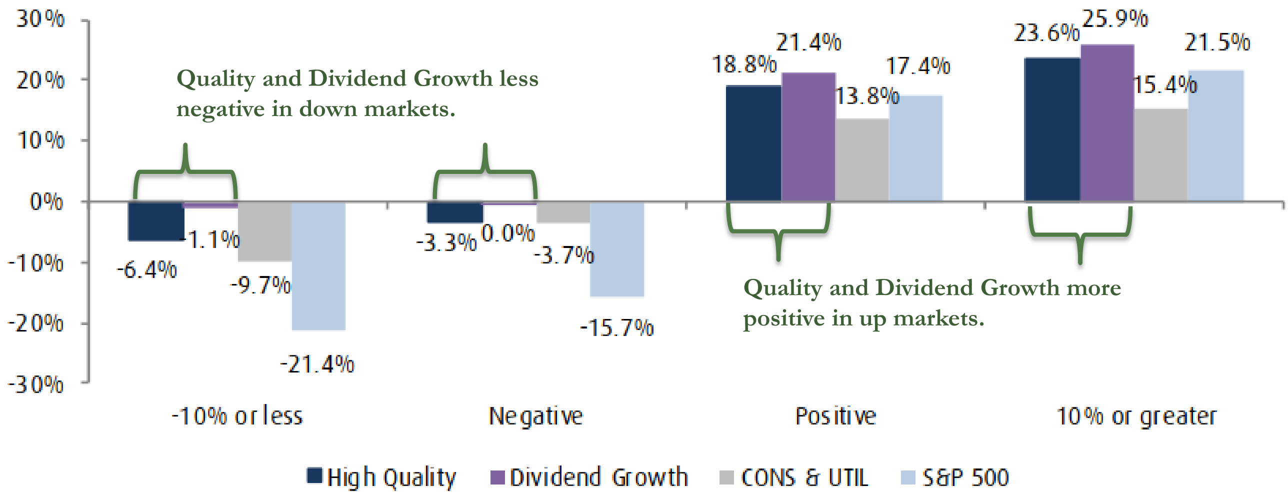
**Exhibit 13: Charcteristics of the North American Equity Strategy**

| | Strategy | Benchmark |
|---|---|---|
| EBITDA Margin (Last Qtr) [%] | 36.3 | 33.2 |
| ROIC (5-year Average) [%} | 12.6 | 9.9 |
| ROE (Latest FY) [%] | 28.4 | 25.0 |
| Dividend Payout Ratio [%] | 45.7 | 44.5 |
| Projected 3 Year Dividend Growth Rate [%] | 7.8 | 6.9 |

Source: Cumberland Capital Appreciation Fund, 09/21/2022, Bloomberg PORT

**Exhibit 14** compares the performance of high quality / dividend growth companies going back to the 1990's to both the defensive Consumer staples and utilities group and the S&P500 in both up and down markets. According to BMO Capital Markets, high quality and dividend growth stocks have historically done a better job than these traditional defensive sectors of providing downside protection amid market declines. Also indicated in the chart is that high quality/dividend growth companies outperform the S&P500 during periods of market advances.

**Exhibit 14: High Quality/ Dividend Growth Performance versus Defensives**




Source: BMO Capital Markets

So given the high level of uncertainty, particularly in relation to future earnings growth, we feel we are well positioned as we expect to both weather the market turbulence and participate in the upside that may come given that we are likely now closer to a market bottom. However, as we have pointed out in the past, the true beginning of a new bull market typically doesn't feel like a very comfortable time to invest when it may just be the best time to do so.

**Peter Jackson**
Chief Investment Officer
September 30th, 2022

# APPENDIX 1

# NEW EQUITY INVESTMENTS:

# NORTH AMERICAN EQUITY MANDATE

## CANADA

**Linamar Corporation (new position)**

Despite a difficult overall economic background, auto parts suppliers such as Linamar have some material tailwinds countering the tough background. Automotive production has been supply-constrained during the past two years by shortages (such as semiconductor chips) and margins have been weakened by material cost inflation (such as steel). While not totally out of the woods, both are now reversing at a time when dealer inventories are at decade lows. Longer-term the transition to electric vehicles promises significant growth and Linamar has been very successful winning new EV mandates over the last year.

**Keyera Corp (update)**

Keyera is a Canadian midstream energy company providing gas gathering and processing, transportation, storage, fractionation, marketing, and pipeline services to its upstream producer clients. It owns Alberta EnviroFuels whose main output, iso-octane, is blended with traditional fuels to reduce carbon emissions. We think Keyera has an attractive pipeline of projects, including the KAPS pipeline, which will connect their BC gas plant with their Fort Saskatchewan infrastructure. We also like management's efforts to reduce their dependance on commodity prices. Upon completion of the KAPS pipeline, 75% of their EBITDA will be fee-for service and will fully cover the dividend, which currently yields over 6%.

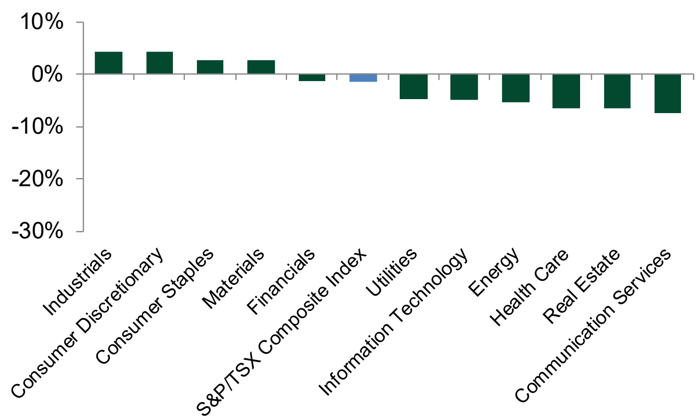
**Topaz Energy Corporation (update)**

Topaz Energy provides an excellent combination of low-risk exposure and yet leverage to strong natural gas prices. With a 5.2% dividend yield (which has been raised 50% since the company went public less than two years ago) and no operating or capital costs, the stock exhibits some of the best downside protection in its industry. With the advent of large-scale liquified natural gas (LNG) exports from Canada in 2025, Topaz is well positioned be able to participate in the meaningfully higher prices attached to these volumes.

## APPENDIX 2

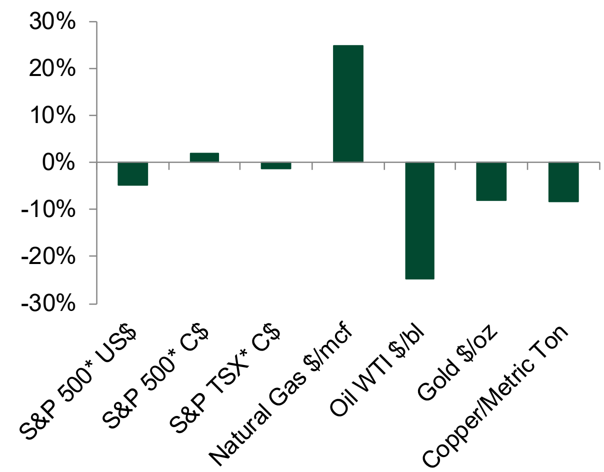
## PERFORMANCE CHARTS

**S&P TSX (C$ Total Returns)**
**Quarter Ending September 30, 2022**



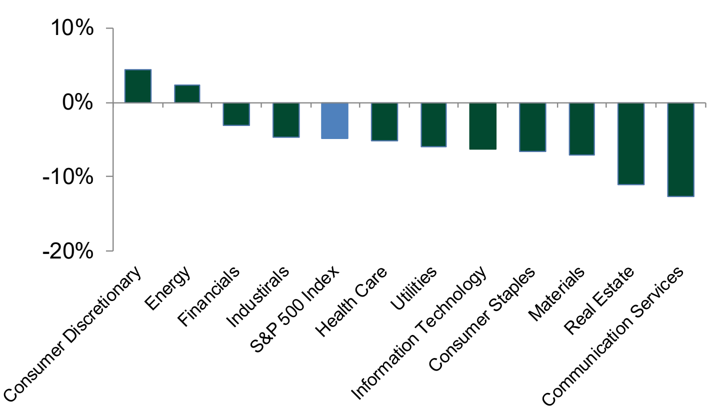

Source: TD Securities

**Quarter % Change**
**Quarter Ending September 30, 2022**




Source:Bloomberg *Total Returns

**S&P 500 (US$ Total Returns)**
**Quarter Ending September 30, 2022**




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.