



CUMBERLAND

Strategy Review

April 2010

A Trillion Here, A Trillion There.

Pretty soon, you're talking real money.

The month of April was yet another example of the refusal of the Greek crisis to fade into the background. In fact, all eyes have been firmly glued to Europe since the end of the month and so, while the events of the past week are officially news from May, we're going to address them in the April monthly. The good news is that the Europeans have now discovered what happens when you have a crisis to deal with and you dither and delay instead of dealing with it head on. The bad news is that the price of that lesson will be a massively more expensive bailout and support package. Just to round out the list of problems over the past month, the SEC charged Goldman Sachs with fraud and the Chinese launched another round of tightening to try and reign in runaway housing prices. All three combined to keep a lid on equity markets last month, although clearly the European situation has moved front and center over the past week.

The credit crisis of 2008 was fairly straightforward in terms of gauging its eventual impact on the stock market: poor mortgage lending practices led to defaults, which led to lower housing prices, which led to more defaults. Defaulting mortgages led to weaker banks and reduced credit. Reduced credit and lower home values led to a weaker consumer, which led to a weaker economy. A weaker economy and reduced access for small/medium businesses to credit led to higher unemployment, which weakened the consumer further. A weakening consumer and economy led to lower earnings, which led to lower stock prices. Now market participants are trying to make the same connection with Europe, only this time the catalyst for weaker banks and restricted access to credit will be defaulting sovereign debt.

Although we remain skeptical over the longer term (say, the next two to three years) that governments in Europe will be able to make the really hard choices to balance budgets, we also believe that, at least in the near term, markets last week were attempting to price Armageddon too far in advance. In our view, there are still many actions governments can and likely will take to stem the panic and buy time to sort out their problems. The announcement this past weekend of the US \$1tn (yes, that's "tn" for "trillion") European rescue package appears likely to achieve this. Importantly, it combines the two key elements implemented by U.S. authorities to stem the tide in the 2008 crisis: a massive TARP-like fund and direct purchases of debt from weaker states such as Greece, Portugal and Spain (similar in many respects to the Quantitative Easing program implemented by the Fed with mortgages). This massive response to the crisis does not guarantee they will ultimately address and fix the solvency of weaker member states and in so doing, save the Euro. It does however buy the Euro zone more than a few months, if not a year or more, to try and demonstrate they can get there.

As for market performance in April, the greenback did manage to gain ground for the third consecutive month against the euro which fell 1.6% last month before falling a further 5% just last week. The U.S. equity market pushed 1.5% higher and closed April up 6.4% for the year in U.S. dollar terms before giving pretty much all of that back last week. The Canadian dollar held its ground relative to the U.S. dollar, falling a relatively mild 0.3% although "flight to safety" last week pushed it lower a further 3%. We actually believe that Canada could be set to join the



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U.S. as a “safe haven” for global investors, a development which would be bullish for the Canadian dollar and government bonds over the near to medium term. Oil managed to rise a further 2.3% to just over US \$86 before plummeting below US \$75 last week. Gold began to re-establish itself as the ultimate safe haven, climbing almost 5% in April to US \$1167 an ounce and pushing to the US \$1200 level last week as panic took hold.

Over the past few months we have increased our allocation to stable higher yielding equities, and overall our client portfolios held value much better than the market indices did last week. Clearly, news of the European rescue initiative is set to move capital back out of safety and into commodities and equities, and we expect to benefit from that move. We still see opportunities in selected category leaders which have become much more attractively priced over the past few weeks and we expect to take advantage of the value they offer. Regarding fixed income, recent developments in Europe may reduce the Bank of Canada’s willingness to raise rates in the very short term, although we still believe Canadian short term rates will begin an upward trajectory sometime this summer. While credit spreads widened dramatically last week, we expect them to return to previous levels as fear over an immediate global credit freeze diminishes.

While we are always on alert for risks that would make us materially lower equity allocations within our client portfolios, we don’t believe the current situation yet warrants any dramatic moves in that direction. In summary, markets remain volatile and in our view will continue to require a higher than normal degree of proactive decision making and active management of our client portfolios to protect and grow their capital.

John Wilson
Chief Investment Officer
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