



CUMBERLAND

Strategy Review

May 2010

Rising Fear is Generating Compelling Investment Opportunities

The period from May through June has traditionally been a very difficult seasonal period for equity markets, and May 2010 definitely lived up to its billing. Global equity markets continued to demonstrate high volatility, though mostly to the downside, as sovereign risk in Europe, worries over the potential for fading growth in China and rising concern that the U.S. could suffer a “double dip” recession all took turns hogging the spotlight. It doesn’t matter that none of those three threats appear imminent – investors have a “hair trigger” following the crisis of 2008, and are demonstrating a willingness to rush to the sidelines at the first hint that there could be trouble.

It now seems like a law of nature that the U.S. dollar should rally while equity markets tumble, and vice versa. Of course this was not always the case. Long ago (like before 2005) in an age with much less leverage, fiscal recklessness and massive monetary stimulus, the fate of equity markets was not merely to move opposite to the U.S. dollar. Still that seems to be a relationship which is destined to exist until either global growth takes hold and fiscal balances improve or, more worrying, global investors finally lose confidence in the full faith and credit of the United States. For now, the U.S. dollar and Treasury Bills remain the safe havens as buyers retreat from equities.

Over the course of the month, the Canadian dollar fell 2.5% relative to the greenback but has remained among the strongest global currencies on that basis, and is still almost 1% stronger relative to the U.S. dollar so far this year. The Bank of Canada did raise rates in May after all, though only by a relatively mild 25 basis points and with the added touch of very dovish language regarding any further rate increases given global economic risks. Still, Canada is the first G7 country to raise rates, and we continue

to believe the country is moving into the exclusive category of developed country safe haven which should support further strength in the Canadian dollar over time.

U.S. equity markets suffered a meaningful setback, with the S&P500 down over 8% in U.S. dollars in May and ending the month down almost 2.5% for the year. The Canadian market fared somewhat better, falling “only” 3.7% in May, or essentially flat for the year. We have continued to hold a healthy weighting in cash, bonds and gold within capital appreciation portfolios and this helped moderate the downward move in equity markets within our client portfolios. Gold in particular has continued to move higher as an ultimate safe haven, climbing over 4% in May back above US\$1,200/oz and within striking distance of its all-time highs (at least in nominal dollars).

U.S. economic data over the past month has generally come in weaker relative to expectations than had been the trend for the past several months. While the economy is still expanding, a stubbornly slow recovery in employment and looming tax increases for capital gains, dividends, federal, state and local taxes as well as new health care taxes have the potential to act as a drag on growth as we move into 2011. Counter balancing these concerns are an extremely accommodative Fed and the fact that we continue to find exceptional businesses with global franchises and strong growth prospects at extremely attractive yields and valuations. Even without increasing our allocation to equities, we have found opportunities to take advantage of the recent selloff by switching into stocks offering better relative values and/or dividend yields.

Commodities generally weakened materially over the course of the month as fears that slowing global



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growth (whether from Europe, China or the U.S.) would cut into demand for oil, metals and other commodities. Crude oil declined almost 16% in May to less than US\$75/barrel but natural gas finally bounced, climbing almost 8%. The outlook for energy companies has also been clouded by the offshore oil spill disaster at the hands of BP and the potential implications for regulation, exploration and costs within the industry generally. We believe the ultimate consequences of the spill could be much greater than most currently anticipate, and as a result we expect offshore drilling, at least within North America, to become at a minimum much more expensive and potentially produce much less oil. Fortunately, our positioning within energy is almost entirely onshore with a heavy focus on the emerging resource plays and service companies with leverage to onshore unconventional, or "tight oil", deposits. With some estimates of potential lost production from offshore resources reaching as high as 6% of current overall U.S. production, we expect the more economic and increasingly accessible unconventional onshore resources to become increasingly valuable going forward.

Finally, markets remain obsessed with every little tremor emerging from Europe. Over the past few weeks, one credit rating agency lowered its rating for Spain one notch from AAA to AA+. In our view, over the past few years credit rating agencies have done a tremendous job of proving they are not exactly leading indicators of credit worthiness. More to the point, the rapidly declining euro had been telegraphing the deteriorating credit condition of countries like Spain for the past 6 months and the Euro has

continued its decline, falling a further 7.4% in May. More recently, the deteriorating fiscal health of Hungary has become cause for market concern, with some politicians there stating that the country could default. We would point out that Hungary is not even a Euro zone country, much less of sufficient size to make any meaningful impact on the European economy or banking system. We continue to believe the recent US\$1tn EU/IMF rescue package will at least temporarily stabilize EU banks and sovereign yields, allowing the EU time to demonstrate it can get its fiscal health in order.

Overall, prudent risk management has kept us from becoming fully invested in our clients' capital appreciation accounts but has allowed us to switch in to better yield, relative value or reduced risk. We do not expect current conditions to warrant a cascading collapse of equity and credit markets like those experienced in 2008, but we do expect uncertain macroeconomic outcomes to drive continued volatility in markets worldwide. We remain confident that our investment process, our discipline and our commitment to value will allow us to continue to protect and grow our clients' capital in that type of environment, particularly if investment opportunities continue to become more compelling.

John Wilson

Chief Investment Officer

May 2010

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