



CUMBERLAND

## Strategy Review

July 2010

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### A Nice Bounce in July...Now What?

Global equity markets bounced sharply in July following two consecutive down months through May and June. The U.S. equity market rallied almost 7% in U.S. dollars over the course of the month, reducing its loss year to date to 1.2%. The S&P's gain was more muted in Canadian dollars (up only 3.4% in July on that basis and still down 3.5% year to date) as the loonie gained 3.3% in July relative to the greenback. Canadian equity markets rallied 3.7% and closed July down a relatively mild 0.3% year to date. Commodity markets recovered along with equities and were led by oil which rose over 4%.

Fears of an economic collapse within the Euro zone seem to have dissipated relatively quickly, consistent with our view that EU fears were way overdone, at least in the medium term. As a result, July witnessed the continued sharp recovery in the relative value of the euro which climbed close to 7% last month to once again move back above the US\$1.30 level (it was below US\$1.20 less than two months ago). The gradual decline in the overall fear gauge reduced the appetite for gold as a safe haven and the yellow metal fell 5% but at US\$1181 it remains within easy striking distance of the \$1200 threshold.

Increased volatility across most equity and commodity markets continued to push fund flows toward the seeming stability of credit markets. Treasury yields continue to set all time lows as, for example, the 2 year Treasury ended July yielding just 0.55%. With the 2 year Treasury pretty much considered "nailed to the floor" credit investors have gone further out the yield curve searching for better returns and have moved both the 5 year and 10 year Treasuries sharply lower once again, continuing to flatten the curve by bringing longer yields down. Yields on the 5 year Treasury have moved from 2.74% in early April, to 1.8% at the end of June, to

1.6% at the end of July and are well under 1.5% as we write this monthly. Although, we have had a cautious view on the long term prospects for U.S. treasuries that has clearly not played out – yet, one does have to wonder just how much lower yields can go from here. Fortunately, credit spreads tightened considerably through July and are now pretty much back to their best levels of the recovery. Income portfolios within our client's accounts performed very strongly because of this as both our corporate bond investments and yield oriented equity investments enjoyed a strong month.

So as nice as the bounce has been for those of us with exposure to the equity market, heightened volatility has taught everyone how quickly a good thing can turn ugly and vice versa. The big question is whether July's gains are sustainable or whether markets are going to head lower again and continue trading within the range from 1000-1050 to 1100-1150 on the S&P. Which way that balance tips depends on whether the U.S. slides back into a recession as we move through the second half of the year. A "yes" will likely send us on a trajectory through the bottom of that range while a "no" could do the opposite to the upside. Our view has been "no", at least over the next 12-18 months, largely because we believe fiscal and monetary authorities will be much more stimulative, and for longer, than most people seem to expect. We have maintained that uncertainty on the outlook will remain elevated for a long period of time for the simple reason that the policy measures put in place during the depths of the credit crisis are unprecedented in both type and scope. It is impossible for anyone, even the Fed, to say with certainty what the long term outcomes will be as markets react to the implementation and eventual removal of these measures.



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What we do know however, is what the Chairman of the Federal Reserve THINKS should happen. Ben Bernanke spent virtually his entire academic career studying the causes of the Great Depression and proposing policy measures which, in his view, would have been successful in mitigating the damage and speeding up the recovery from a deflationary credit collapse. Nobody knows for sure whether this will work as planned or what unintended consequences might come out of it, but we're pretty sure about how the Fed under Bernanke's guidance is going to tackle it.

It doesn't matter if you agree or not, it only matters what the guy who pulls the levers thinks and whether you can find a way to profit from his actions. In short, he will stimulate by flooding the system with money and liquidity and he will do it on a scale never contemplated before. The quantitative easing and other credit relief programs we have seen to date from the Fed may be new but they are by no means all they can and could do. The Fed decision this week to recycle proceeds from Mortgage Backed Securities (MBS) back into longer term Treasuries is an example. Now the balance sheet of the Fed won't "runoff" but will be maintained at current elevated levels. Now they aren't purchasing MBS to keep mortgage rates low, they're purchasing Treasuries to keep everyone's (including the U.S. government's) borrowing costs low. If the economy doesn't react to that, then what about more fiscal stimulus? Worried about funding the deficit? Then what about an even bigger Treasury purchase program by the Fed?

In our mind, policy makers are intent on forcing both inflation and the price of risk assets higher. Areas of risk include the U.S. dollar and, eventually, interest rates as they attempt to unwind these massive programs. In the meantime though, economic growth may be sub par but it is still growth. Corporate profits and balance sheets are excellent and valuations are low. Relative to other places to invest capital, we still like the equity market at current levels. Risk management keeps us with a healthy allocation to bonds and a much smaller allocation to cash. Within our client's equity portfolios we have taken profits in selected energy and cyclical names and have allocated capital to selected technology stocks at what we feel are compelling valuations. As long as markets move sideways while corporate profits grow at a healthy clip, the discount to fair value widens like an elastic band. Unless a recession lowers the profit outlook meaningfully, we expect that pressure to eventually drive equity markets higher.

**John Wilson**  
Chief Investment Officer  
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