CUMBERLAND

Strategy Review
September 2010

Nice ‘n Easy

The title of this month’s letter reflects two important themes from our most recent monthly strategy reviews, both of which came to the fore in September. Our August letter detailed the overwhelming imbalance in risk/reward favouring equities over bonds. As it turned out, we didn’t have to wait very long for the imbalance to start narrowing. September ushered in a historic performance for equities with the S&P 500 experiencing the largest rally since September 1939 – “Nice”. Our July Monthly Review had highlighted our belief that monetary authorities, particularly the U.S. Federal Reserve, would deploy tools such as Quantitative Easing (printing money) more actively and on a scale which markets were not properly discounting. In our view, the Fed would go to tremendous lengths to avoid deflation by promoting inflation and higher prices for “risky” assets. Sure enough, the Federal Reserve ended its September meeting with a promise to “provide additional accommodation if needed” , and in fact went even further than we expected by explicitly targeting inflation – “Easy”. In this letter, we’ll look at the details behind the “Nice” part first, and then spend some time on the implications of “Easy” monetary policy afterwards.

The best September performance since 1939 certainly scored a “Nice” for the U.S. equity market, up 8.8% last month in U.S. dollar terms and now modestly positive (up 2.3%) for the year. Importantly, the rally came on better volume and broad participation as leadership was spread across several industry sectors. Canadian equity markets also had a “Nice” month, up almost 4% in September and pushing the gain on the TSX year to date above 5%. The rally in the TSX was helped along by a 7.6% rise in the price of crude oil (to just over US$79/barrel) and a surge in the price of gold through the $1,300 level (up 4.8% for the month). Promises of further Fed buying of government bonds drove Treasury yields lower once again, although the size of the moves continue to get smaller given the very low level of absolute yields. While credit spreads remained relatively constant, the drop in yields was positive for our fixed income investments.

So much for the “Nice”, what about the “Easy”? Well, for starters, the price of just about every financial asset is becoming increasingly focused on the potential future actions of the world’s central banks and in particular, the Fed. Growing market acceptance of future Fed plans to launch more quantitative easing (initially a leaked story to the Wall Street Journal in early September) has been the catalyst behind the equity rally, historic new lows for Treasury yields, and last but certainly not least, the wild volatility in currency markets. We are not even going to attempt to address the long run implications on the economy of further large scale quantitative easing by the Fed for two reasons. First, I’m not sure anyone really knows the answer to that question and second, because it’s not that important right now (at least to us). In our view, the more important question is: What effect will the Fed actions have in the near and medium term on asset prices? We’re going to tackle this question in three parts: the impact on bonds, currencies and finally, equities.

<u>Bonds.</u> Without a doubt, the key to the Fed’s actions is to target inflation expectations. Deflation is the boogieman to be avoided at all costs by the Fed since, rightly or wrongly, they believe they know how to tackle inflation but are much less sure on deflation. As a result, the new round of quantitative easing which we believe is coming is squarely focused on driving inflation expectations higher. Remember, the real interest you earn on a bond is the nominal rate less inflation. If inflation is rising, then the real return you earn is dropping. Chart 1 (below) shows the real yield currently priced in the market for longer term (average of 5 and 10 year) Treasuries. Unlike the first QE program (QE1 on the chart) which

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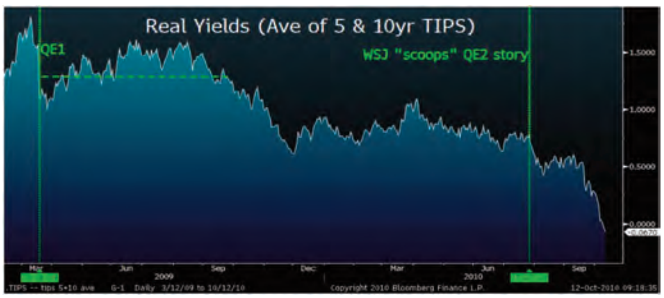
was aimed at easing credit conditions for housing by buying Mortgage Backed Securities, this new program (QE2) is aimed at boosting inflation expectations. As a result, you can see that real yields have been plummeting since the WSJ story and are now *negative.* As long as the Fed succeeds in creating inflation, negative real yields are not a compelling return for any investor.



Cowen and Company, Bloomberg Finance LP

Currencies. There is no free lunch and the U.S. dollar is picking up the tab for the Fed's program. As the Fed ramps the size of its balance sheet and, indirectly, the amount of U.S currency in circulation, the expected future value of a U.S. dollar falls. The Canadian dollar is back near parity, the Japanese Yen is at all-time highs relative to the U.S. dollar (despite recent intervention by their central bank) and the Euro has come back from $1.19 earlier this summer to a recent $1.40. This makes foreign travel and imports more expensive if you're American but helps your exports, and there is the rub. Every nation would like a cheaper currency to help their exports in order to stimulate their own economic recovery. The danger lurking here is the potential for a trade war. In the meantime, "real" assets such as commodities and precious metals are screaming higher.

Equities. The good news for equity investors is that both of the situations described above are likely positive for equity markets. We have highlighted in past letters the relatively better dividend yields currently available from high quality public companies and these yields are likely to appear even more attractive as real Treasury yields go negative. Second, businesses are "real" assets as well, with real products, brands, customers and market share. Over the coming quarters we expect a gradual rotation out of fixed income markets (the recipient of virtually all positive fund flows over the past 18 months) and into equity and commodity markets.

The equity rally in September was unusually large and fast and as a result could cause some profit taking over the near term. That said, the underlying case supporting the relative risk/reward in equities remains, if anything, even stronger. For clients with capital appreciation accounts we continue to gradually reduce our allocation in bonds and increase our allocation to equities. For income oriented portfolios, we continue to favour higher yielding corporate debt and, where possible, stable equities with attractive dividend yields. Finally, for portfolios that are able to do so, we are maintaining a full hedge against further depreciation in the U.S. dollar.

In summary, the dynamics of markets, economies and policy makers are all changing rapidly in the current environment and we believe our objective approach to risk and reward is best suited to preserving our clients' capital.

John Wilson
Chief Investment Officer
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