CUMBERLAND

"INVESTOR CONFIDENCE IS SHOT"

I don't know about you, but I'm getting tired of the daily barrage of economic reports.

It's Monday and the Purchasing Manager's Index is up – great. Oh! Sorry, it's now Tuesday and Housing Starts are disappointing. Wednesday, Consumer Sales numbers are lousy but that's good news because things are not as bad as we thought they would be. Thursday, inflation is low but, oh no, maybe it's too low. Friday, European Banks are on the verge of collapse, for the 5th time. Saturday, thank God it's the weekend and no one reports.

Is it any wonder why investors are confused and discouraged? How do you reconcile above average earnings growth with below average economic statistics? Are we in for another bout of inflation or is deflation staring us in the face? What about the economy, will it continue to recover or are we headed into a "double dip"?

Investors are tired of worrying about the market. They don't know who to listen to, but they do know one thing, and that's that they can't take another big hit in the stock market. So, in many cases they are avoiding equities in favour of something more assured – bonds. Why buy stocks when the economy and Sovereign Government debt are on the verge of collapse?

Believe me, I get it. I'm an investor too and I own the same stocks that you do. So before I address these issues, let me make it clear at the outset that I'm bullish. Could that change, could I be wrong? For sure! I'm not going to paint myself into a corner as some of the bearish economists have. Instead, it's our job to be realistic about the future and the stock market, and right now the evidence is still constructive. If I am wrong, I'll admit it and get off that position and limit any damage. But understand, there are also risks in being too negative right now.

So let me see if I have the sentiment right. As a bear, I've given up on the stock market and I'm prepared to buy a 10 year government bond and make 2.5%.

It may not be a very good return, but in 10 years I know I'll get my money back and a 2.5% return. Even if that's too low, at least it's positive and safe.

The Bears are right of course, but after tax, that return is closer to 1.25% and for most of us that doesn't cut it. At some point, rates this low force investors to start taking on a little more risk to earn a better rate of return.

To some extent this is already happening as people have bought corporate bonds for a better yield, which has resulted in a dramatic rally in the bond market and has also left many companies flush with cash and their balance sheet in the best shape in decades.

So, is what we're seeing today new and different? Nope. It's classic psychology.

My father lived in the shadow of the "Great Depression" and always feared its return. My generation of investors is a function of the '70's and sky high inflation. We're always looking over our shoulder wondering when all the money printing is going to result in run away prices.

And today's investors have the 2008 market crash burned into their brain, fearful of another episode. Will it happen? Well, if everyone is so guarded against it, maybe it won't. Big adjustments come out of left field and catch people by surprise. That's what causes a big reaction.

Psychologically, watching and waiting for this market to collapse probably assures that it won't happen because the adjustments to portfolios have already occurred. The reaction, if you will, is already priced in.

Now, contrast today's investor sentiments to that of 2007 when everyone knew oil was going to $200.00 per barrel. Investors were exchanging stories about who made the most last year and those of us warning about bum mortgages and sloppy lending practices were just party spoilers. Everything was great. The similarities here, are that after a major market or economic setback, investors drive while looking through the rear view mirror, always suspicious of a repeat. In contrast, when they are bullish they are always looking out over the horizon and discounting any near term storm clouds, much like what we saw at the end of the "tech" bubble. The reality is, that to do well in the market you can't be part of the crowd and get carried away with consensus thinking.

Mind you, it isn't acceptable just being ornery and fighting the crowd either. It only pays off when you're realistic and are an independent thinker.

So my first point is that market sentiment doesn't seem consistent with a market that is about to collapse. It's just too cautious right now. As a matter of fact, I think the sentiment may have swung so far that some investors are actually rooting for the Bears. They're out of the market and negative news supports their positions. Should things turn out to be better than expected they will be proven wrong, once again, at the turn.

So, how about some facts you might ask? Well let me start with the bond market. Then I'll make a couple of remarks on stock market valuation and the economy.

Today, a lot of economists are pointing at the extremely low yields on government bonds as an indicator of future economic performance. If the depression is coming, you want to own government debt.

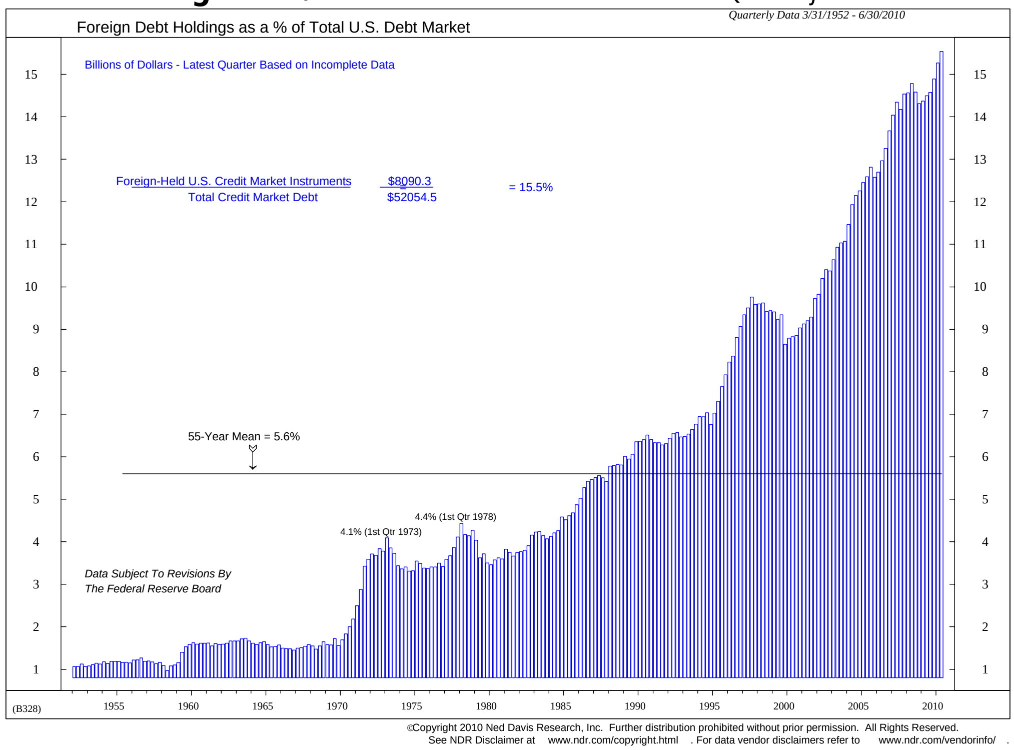
I don't buy it. I think it's the convergence of events that has caused these low yields and once they have run their course, today's bond buyers may regret their choice.

So who's buying bonds? There are 5 groups.

1. Foreigners. When the European Sovereign debt issue blew up in May, there was a massive shift in asset and currency allocations away from Europe and into the United States.

   This, combined with foreign central banks recycling trade surplus dollars back into U.S. investments is causing unusual demand for U.S. dollar denominated fixed income instruments, as seen in this chart.

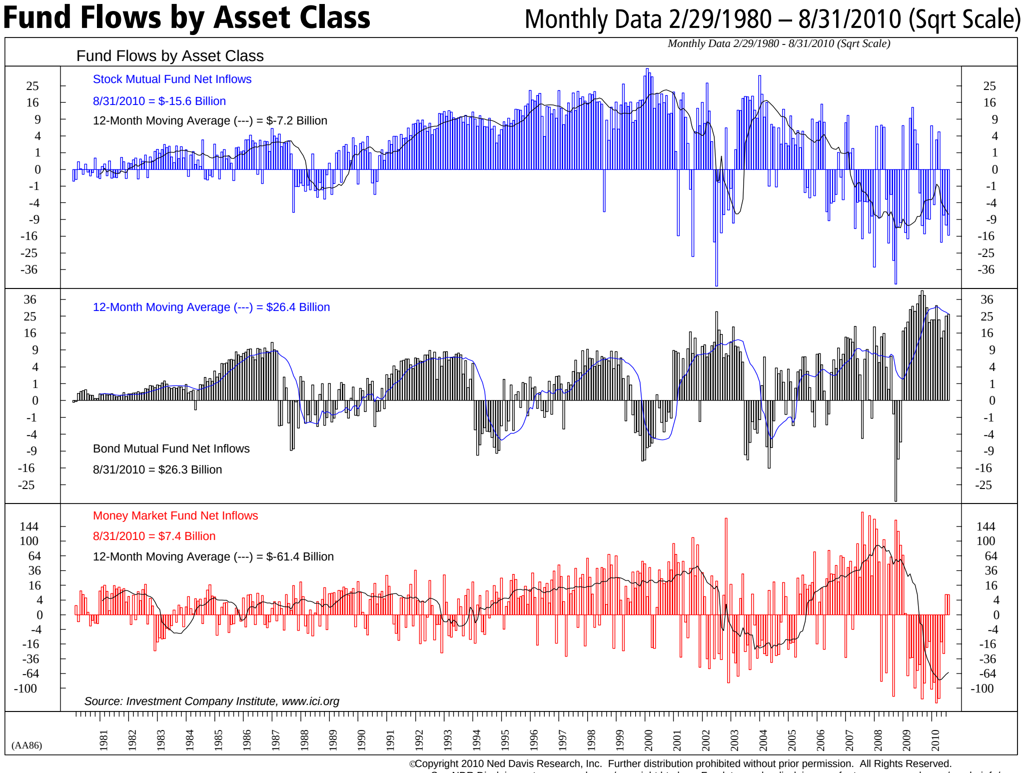
Foreign Debt Holdings as a % of Total U.S. Debt Market Quarterly Data 3/31/1952 – 6/30/2010



Foreigners now own over 15% of the overall U.S. debt market and climbing.

2. Individuals. As I said, individuals are giving up on equities and opting for bonds. One of the best ways to track this is by looking at mutual fund sales. From January, 2008 through June 2010, outflows from equity funds totaled $232 billion while bonds funds have seen a $559 billion inflow according to the Investment Company Institute. This next chart extends back to the bull market in the early 1980's and also shows the recent flows out of equities and money market funds and into bond funds.

Fund Flows by Asset Class Monthly Data 2/29/1980 – 8/31/2010 (Sqrt Scale)

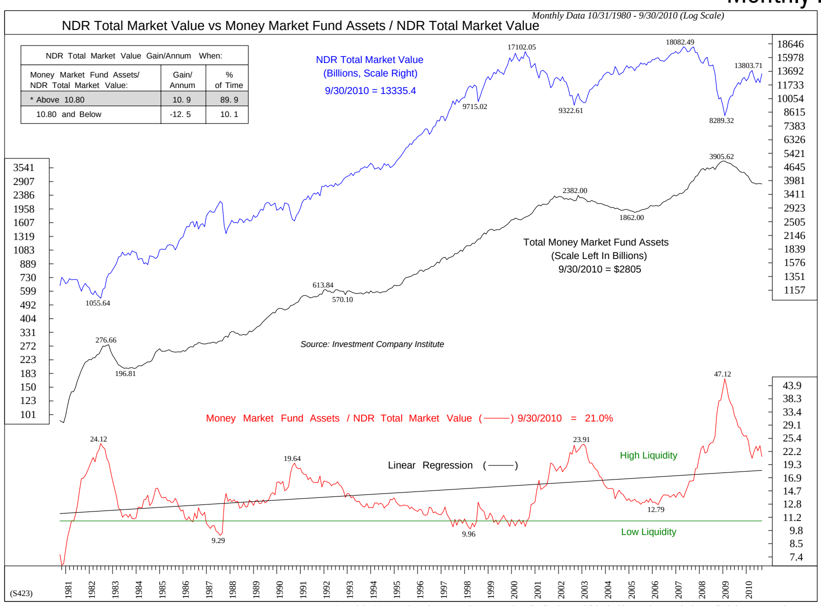


This is very similar to what we saw in the 1970's as investors continued to redeem their mutual funds for roughly 8 years. This lead to a Business Week cover story on August 13, 1979 proclaiming "The Death of Equities". This article observed that "The masses long ago switched from stocks to investments having higher yields and more protection from inflation".

Although the market bottom wasn't reached until April, 1980, I can tell you 1979 wasn't a bad time to buy stocks for a long term investor.

NDR Total Market Value vs. Money Market Fund Assets/NDR Total Market Value

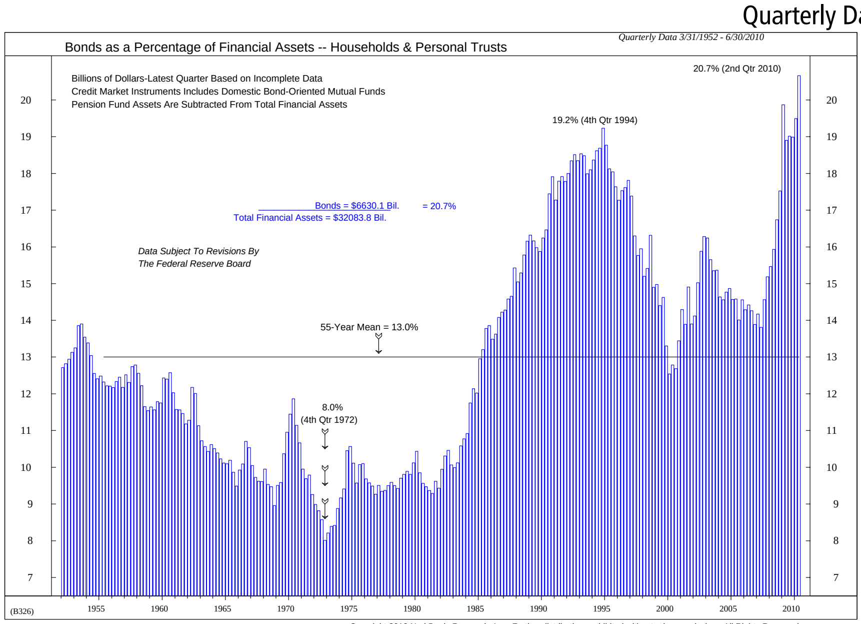
Monthly Data 10/31/1980 – 9/302010



Assets in Money Market funds have also declined from $3.9 trillion at the peak to $2.83 trillion at the end of August as seen in this chart. That still leaves a lot of liquidity sitting on the sidelines and still amounts to almost a quarter of the total equity market's valuation. However, investors can no longer afford a Zero rate of return and are taking on more risk by extending term in the bond market. As a percentage of financial assets, this next chart of household and personal trusts looks similar to that of foreign holdings and now stands at a record 20.7% of assets.

Bonds as a Percentage of Financial Assets – Households & Personal Trusts

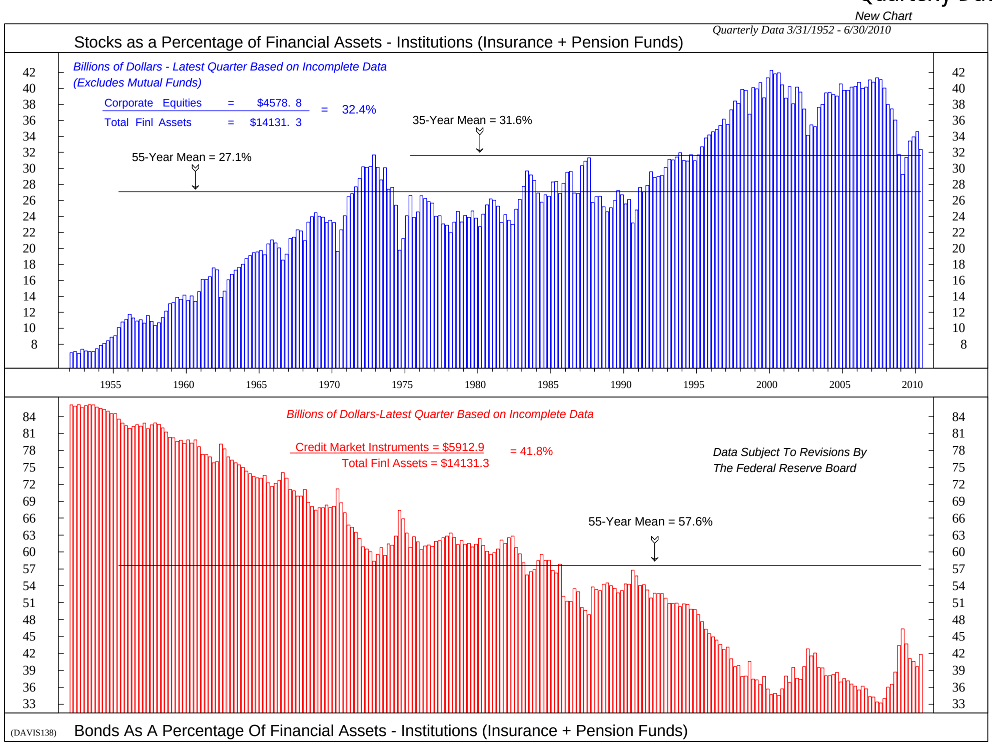
Quarterly Data 3/31/1952 – 6/30/2010



3. Corporate Pension Plans. According to a study by Greenwich Associates, pension plan exposure to bonds dropped from 40.7% to 33.8% in 2008. As seen in the chart below, bonds as a percentage of assets have bounced back to 42% at the end of June. It's also interesting to note the general trends. In the top clip, one can see the increase in equity exposure since the early '50's until the last couple of years and the decline in bond exposure in the lower clip. These both seem to be at inflection points.

Stocks as a Percentage of Financial Assets – Institutions (Insurance & Pension Funds)

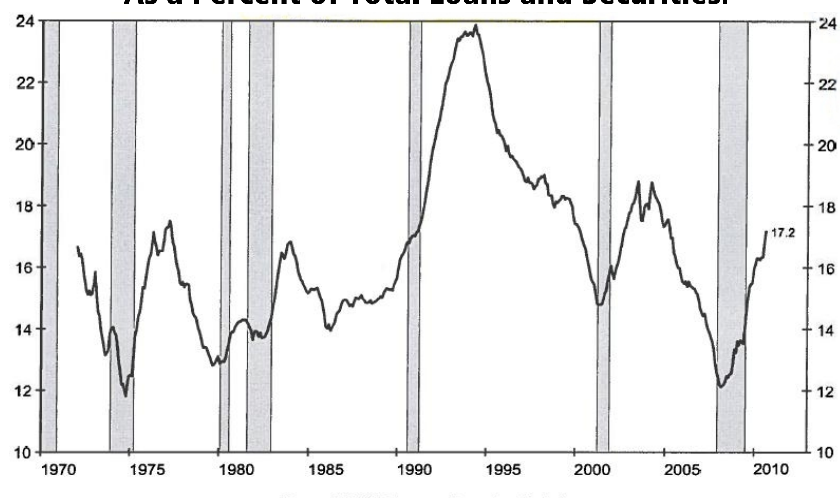
Quarterly Data 3/31/1952 – 6/30/2010



For corporations this may continue, even with very low yields, because of the implications of mark-to-market accounting rules that will ultimately transfer the full impact of pension investment volatility to the corporation's balance sheet according to Greenwich Associates.

4. Banks. In the second quarter, one of the only areas of asset growth for the banks was U.S. Treasuries which grew by $8.1 billion or 5.2%.

U.S. Commercial Bank Holdings of Treasury & Agency Securities
As a Percent of Total Loans and Securities.



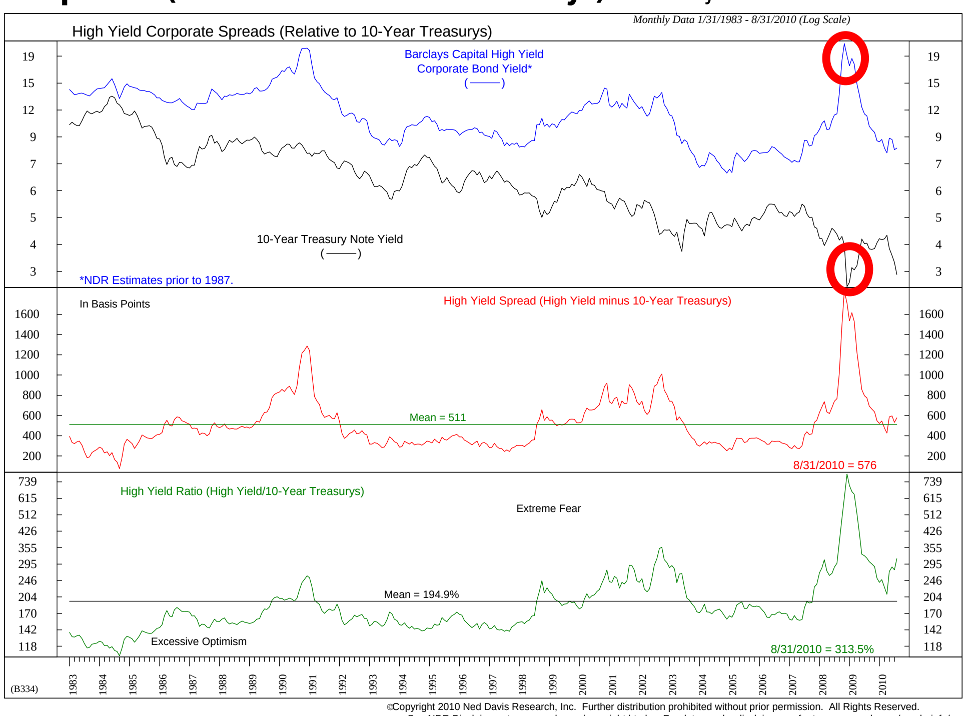
At the same time, loans and leases declined by $95.7 billion. Since then the trend has continued with agency and treasury holdings expanding a further $101 billion while loans contracted a further $39 billion.

Clearly, there is little loan demand from corporations as they are getting their funding from the bond market. Meanwhile, banks buy government bonds to put their surplus funds to work as shown in the previous chart.

5. Federal Reserve. To deal with the financial crisis of 2008 the Federal Reserve purchased over two trillion dollars of investments, many of them mortgage backed securities and government bonds. They refer to this as quantitative easing. Now that some of these investments are maturing, the government doesn't want this to become a monetary drag as people have to repay these loans. So to offset these payments, the government intends to recycle the funds by buying more government bonds which will add about $1.0 trillion to government bond demand.

In my opinion, this all adds up to a short term shift towards bonds that, once completed, will set a peak in demand. So, I don't think that the 10 year bond yield is predicting deflation and depression. If you want to look for bad economic news it isn't in the rate of return, it's in the spread between yields on corporate and government issues.

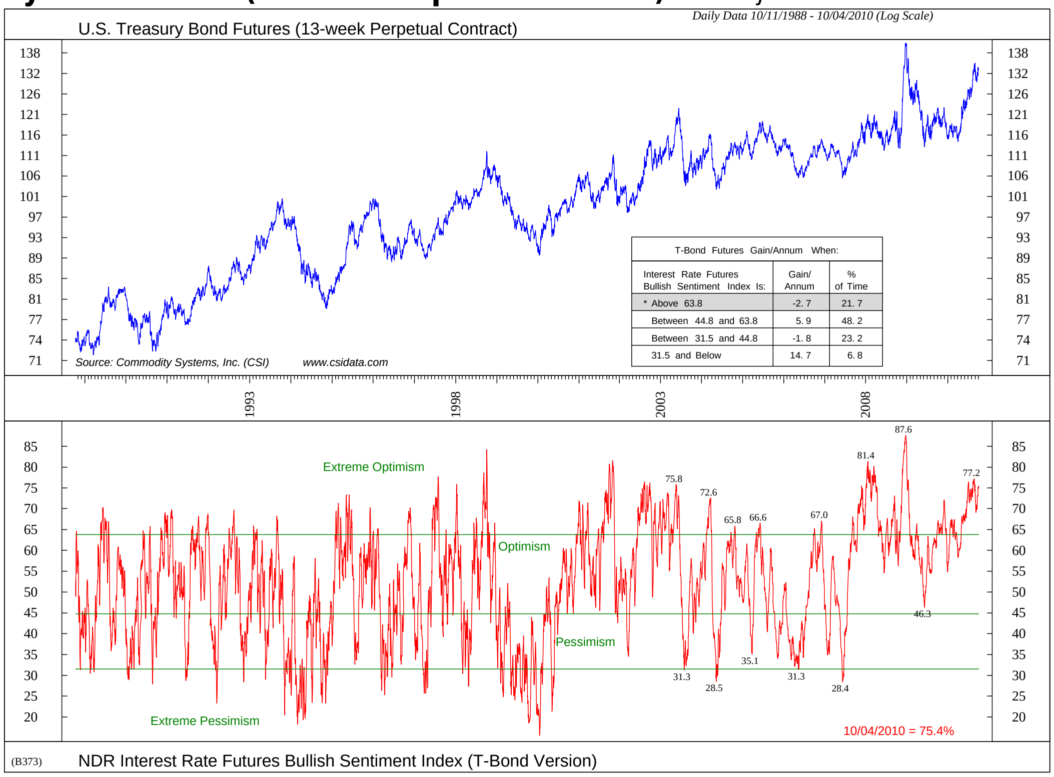
High Yield Corporate Spreads (Relative to 10-Year Treasurys) Monthly Data 1/31/1983 – 8/31/2010 (Log Scale)



One just has to look at the top clip of this chart to see my point. At the height of the economic crisis in 2008 investors were truly worried about the economy and rates on high yield bonds exploded to over 19% while government bond yields collapsed to close to 2%. The spread between government yields and corporates blew out to about 18% as seen in the middle clip. That spread today is back down to the long term mean, suggesting there is little investor concern over the economy being priced into bond yields.

So, it could be that bond yields are a good indicator; not of recession, but instead as an inverse sentiment indicator for the stock market.

U.S. Treasury Bond Futures (13-week Perpetual Contract) Daily Data 10/11/1988 – 10/04/2010 (Log Scale)



As I said earlier, crowd sentiment is usually wrong at turning points and the above chart on interest rate futures shows an extreme optimism towards bonds.

So, as noted at the outset, many investors are resolved to earning very low yields (i.e. 2½ % on 10 year governments) for the assurance of safety and a guaranteed absolute rate of return. And, there is nothing wrong with this, except that it manifests a collective action that in the end results in exactly what you are trying to avoid. It's fine to say that you'd rather miss a big rally in the market than take the chance of losing any more, until yields reverse. The last time yields on treasuries were this low was 1955. In the subsequent 10 years the annual return on bonds was 1.9%, only slightly above inflation.

If 10 year yields go from their current 2½ % yield to 4%, where they were this past April, the capital loss on the market value of the bond would be more than 3 times the current yield.

Yes, it's true that if you hold the bond to maturity you will get your money back plus 2 ½%, pre tax. It's also true that you may see some mark-to-market losses during that period. But what do you do when a 1½% after tax return doesn't cut it any longer?

It seems to me, that of the three major classes of borrowers; individuals, mostly through mortgages, corporations, and governments, one is still going the wrong way.

Consumers remain over extended but are at least moving in the right direction, but it will take time.

Governments are over extended and most are still going in the wrong direction.

Corporations on the other hand are financially in good shape and earnings are rising.

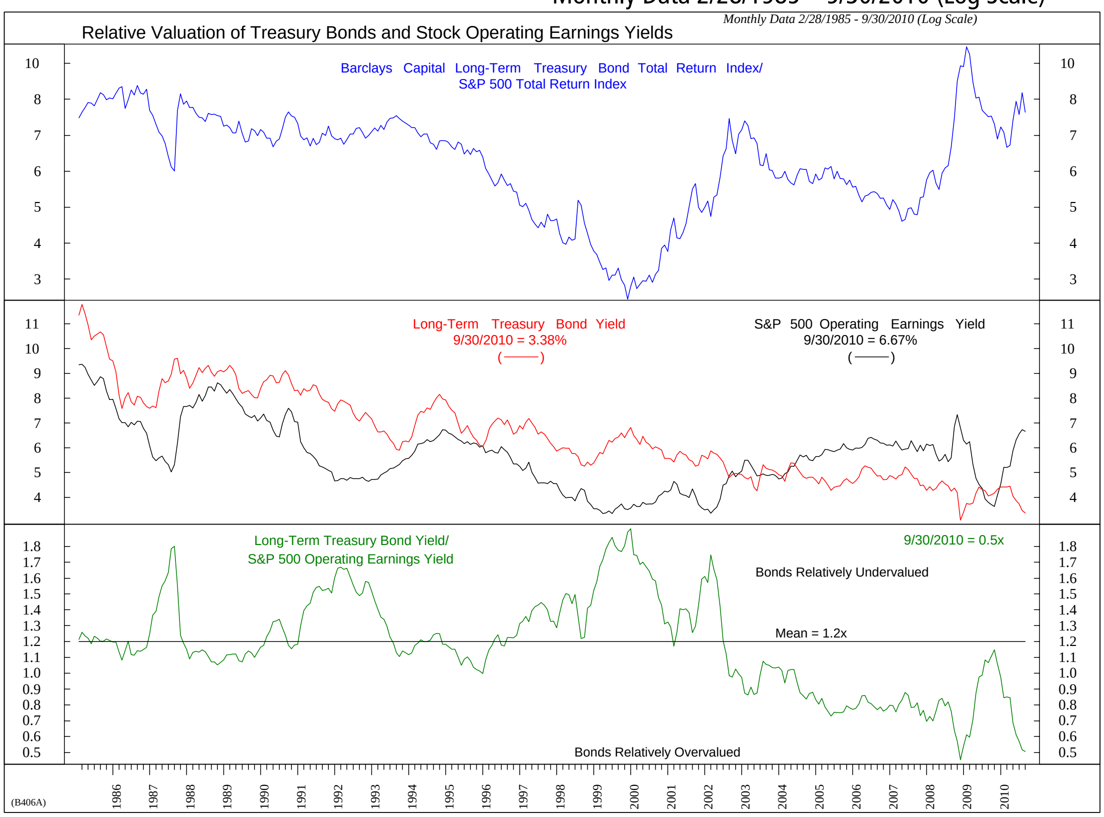
Of the three, my preference is to invest in the financially strong corporate group, and for sure not governments where history tells us that we have the most risk from inflation or possible default. Under current government projections, even the U.S. government bonds will face the possibility of a credit rating downgrade from AAA and that will ripple through all bond yields.

So if not bonds what – stocks? Well, investors have already taken a step out on the risk curve by selling their money market funds and taking on duration and credit risk. Is it too big a risk to slip out a little further into equities? When we compare bond yields to either earnings yields or dividend yields the evidence would support it being a smaller step than many would believe.

Let's start by comparing earnings yields, which are determined by dividing corporate earnings by their share price, and comparing this to bond yields.

Relative Valuation of Treasury Bonds and Stock Operating Earnings Yields

Monthly Data 2/28/1985 – 9/30/2010 (Log Scale)

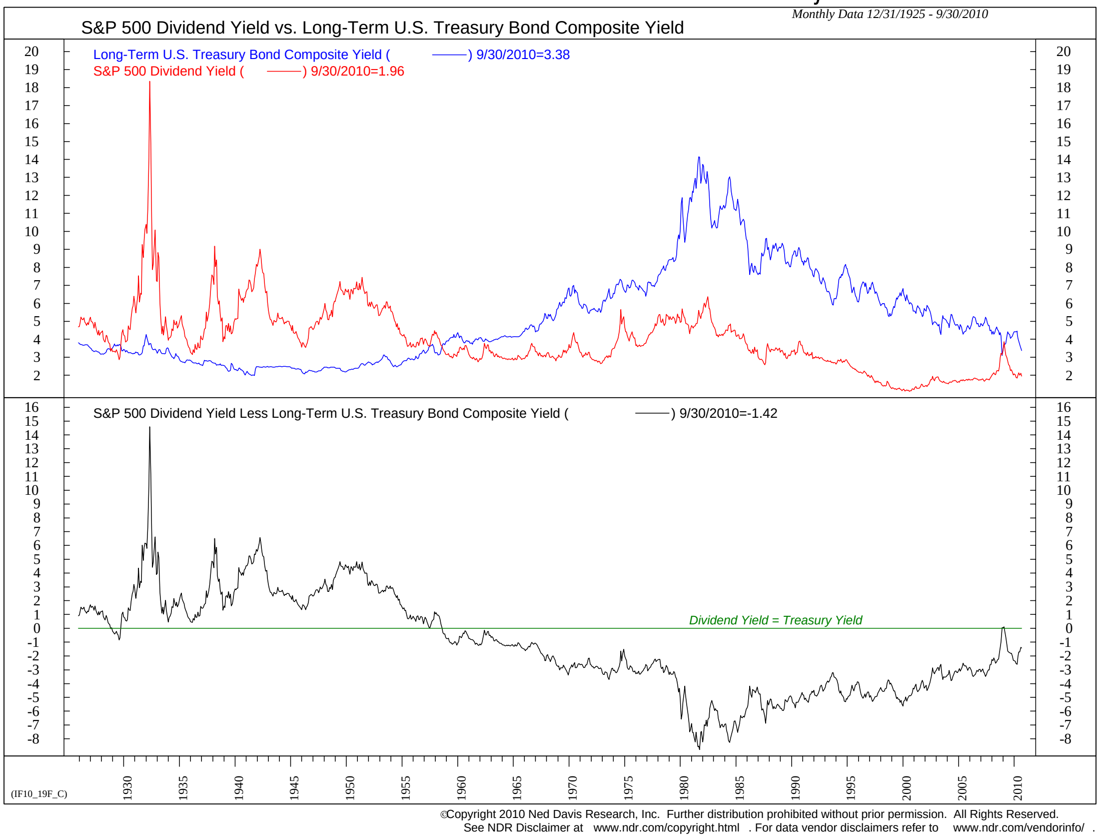


The middle clip of this chart indicates that 30 year government bonds yield 3.38%, while the S&P operating earnings yield is 6.67%. This chart also indicates that long government bond yields generally exceed corporate earnings yields. The bottom clip compares the two yields and is at a level that we haven't seen since 1975, suggesting that either corporate earnings yields are too high or government yields are too low. Central bankers are already on record stating that they don't want interest rates to go higher. So if this gap closes, it could very well favour equities.

You can perform this same exercise of comparing earnings yields to Baa corporate bond yields and the conclusion is similar. Bond yields are at a record low compared to corporate earnings yields.
What if they don't revert? Well, we have some history on that too.

S&P 500 Dividend Yield vs. Long-Term U.S. Treasury Bond Composite Yield

Monthly Data 12/31/1925 – 9/20/2010



The bottom clip of this chart shows that almost the entire period from 1927 to 1958 saw dividend yields higher than government bond yields. But it didn't hurt returns as indicated in this table.

S&P 500 AVERAGE ANNUAL GAINS 1927 - 1958	
Investment	Gain/Annum
S&P 500 Total Return	10.2%
S&P 500 Without Dividends	4.5%

1927-1958
MOST STOCK
GAINS CAME FROM
DIVIDENDS

S&P 500 AVERAGE ANNUAL GAINS 1959 - 2009	
Investment	Gain/Annum
S&P 500 Total Return	9.2%
S&P 500 Without Dividends	5.9%

1959-2009
MOST STOCK
GAINS CAME FROM
APPRECIATION

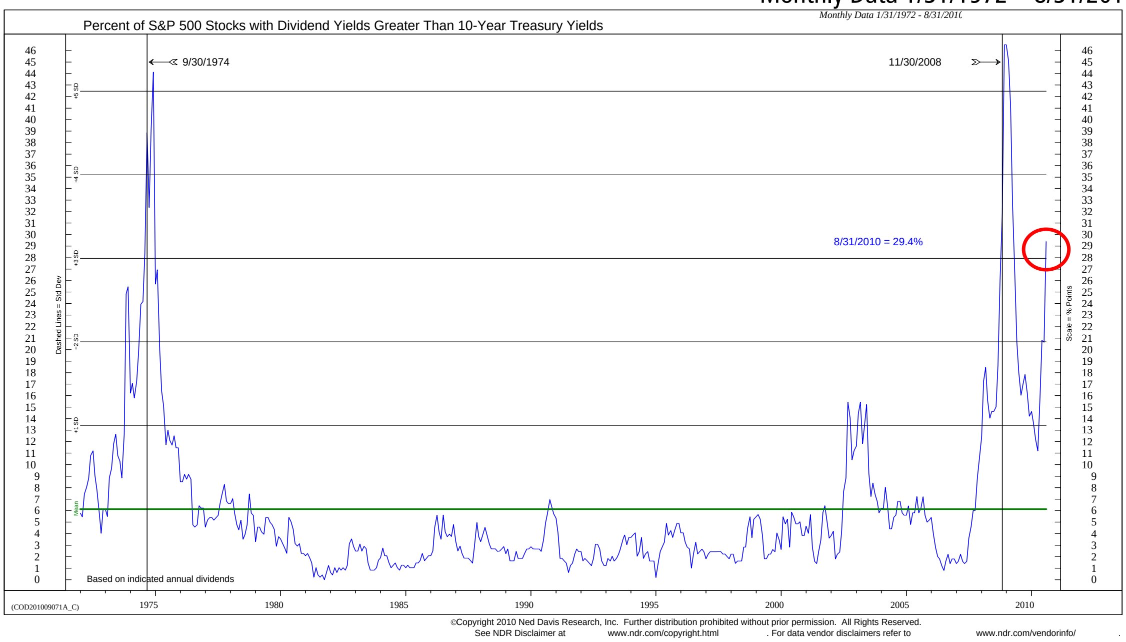
While government bond yields wallowed around the 3% level in that earlier period, not only did dividends provide a better yield but investors got an extra bump from capital appreciation.

In fact, during the high dividend yield period total returns were actually higher than the period from 1959 to 2009. The differential was the higher returns from dividends.

Not only are earnings yields at historically high levels versus bond yields but actual dividend payments are also at an extreme.

Percent of S&P 500 Stocks with Dividend Yields Greater Than 10-Year Treasury Yields

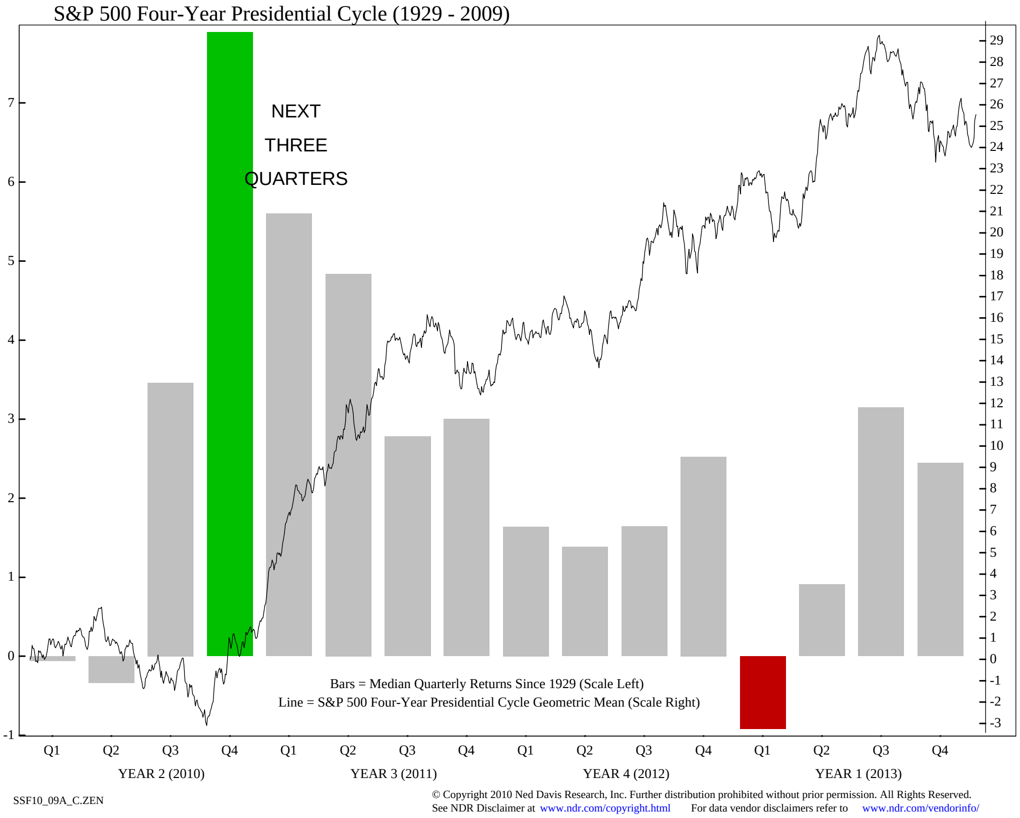
Monthly Data 1/31/1972 – 8/31/2010



This chart shows the number of S&P 500 stocks that have dividend yields greater than the 10 year government bond yield. It currently stands at 29.4 % and is only exceeded twice since the early 1970's. The most recent time was in November, 2008 when the market dropped by 36%. Other than that, one has to go back to September, 1974 which again was brought on by a market decline greater than 30%. This time the ratio of dividend yields above government's was not brought on by a market collapse but by falling bond yields, and at 29% is over a 3 standard deviation event above the long term average.

Now, it's true that the market could remain cheap due to concerns over the economy, which I'll come to in a minute. But there might be a catalyst coming from the U.S. mid term election this November.

This, combined with a historically strong market in the 3rd year of the presidential cycle suggests the market might do better than most predict.



This chart shows the full four years of a presidential term, broken down by calendar quarters. As you can see from the bars, the 4th quarter of the 2nd year and the first two quarters of the 3rd year are exceptionally strong.

On average, the S&P 500 has gained a medium 8% in the 4th quarter of the mid-term election year, and S&P 500 rose 2.4% in the 2 months preceding the election and a further 7.5% in the three months following.

From the mid term elections to the end of the 3rd year of a presidency, the results are remarkable. Since 1962, there have been 12 such, 14 month periods and the average increase was 20.9% with not one down period.

Since 1891 there have been 29, 3rd calendar years of the presidential cycle. The Dow Jones has risen in 24 of them with an overall average gain for all 29 episodes of 12.31%.

History may not repeat itself but odds like this shouldn't be ignored either.

So, the last and maybe most important variable is the economy. As I said, I'm tired of the daily barrage, as all the fragments of information result in too much noise and often distort the underlying fundamentals.

Yardeni Research, Inc. came up with an interesting view on some of the economic statistics which provides some perspective.

- Industrial production has been up every month but one since June 2009 and by 9% in total. This compares to 3.5% and 4.6% over the same 14 month periods during the previous two cyclical upturns.

- Excluding petroleum shipments, business sales rose to a new cyclical high in July of $11.6 trillion. That's up 9.8% from last year's low but still down 6.0% from the record high during July 2008 matching the best pace of increase since October 2008.

- Excluding petroleum, both shipments of manufactures and sales of wholesalers rose to new cyclical highs in July. Retail sales, excluding gasoline and heating oil sales peaked in April of this year and have stalled since then. However, there are signs of a pick up.
- Business inventories hit a cyclical low last September and have increased nine of the past ten months through July. However, they are only 4% off last year's bottom and still 11.1% below the record level reached in August, 2008.
- Employment recovery is lackluster but similar to the last two previous "jobless" recoveries. Over the past 8 months since the cycle bottomed, payrolls have increased by 763,000 compared to 679,000 and 982,000 in the 1992 and 2003 recoveries.
- Business spending on equipment and software is up 15.8% during the first 5 quarters of the current recovery. That compares to an average 13.3% over the comparable period during the previous 6 recoveries.

Although most of these statistical sets have improved, they could in fact move higher.

As for the areas that are under performing, such as housing, it's already bad. So the question has to be, how much worse can it get? They are already flat on their backs and unlikely to get a whole lot worse.

As for the weakness in economic statistics that we saw this summer, I think they should have been expected. Tax incentives to purchase homes and appliances expired in May, census workers finished their jobs during the summer, and the Euro Sovereign debt mess caused a lot of businesses to put plans on hold waiting on an outcome. As the economy transitions from government support to sustainable self-generated growth there are likely to be some bumps. That doesn't mean we're on the wrong road.

<u>Conclusion</u>

There is no doubt that there are still some serious financial (i.e. Sovereign Debt) and economic risks ahead of us. But it is by no means a foregone conclusion that everything is going to be resolved for the worse.

Does the market still have risk? For sure it does, but a lot of the concerns have been priced in and relative to risk free bonds might be the better option.

Don't discount the possibility that the 'cure' is an extended period of good profitability and slow growth with very low interest rates.

Failing the economy falling back into recession, the market will resolve itself to slower growth and refocus on company fundamentals.

So we will continue to draw our conclusions from the facts rather than taking a position and only looking for the facts that support it.

GRC/amh
October 5, 2010

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