



CUMBERLAND

Strategy Review

November 2010

The Good, The Bad and The Ugly

Financial markets dealt with an amazing breadth of news through the month of November, even by the high standard set over the past two years. In just the first five days of the month, markets had to digest a pivotal mid-term U.S. election, the introduction of a new round of quantitative easing by the U.S. Federal Reserve (QE2) and a better than expected U.S. employment report (which put a dagger through the heart of the “double dip” bogeyman). Equity markets scored it as a perfect trifecta and rallied almost 4% higher in just a few trading sessions. The U.S. market basked in a new 2010 high for all of a day before Europe spoiled the party by launching itself into a new PIIGS crisis, this time led by Ireland. China added to worries by raising reserve requirements for banks in order to throttle back rising inflation. Did we mention North Korea launched a military attack on South Korea?

Global equity markets promptly gave back most (and in some cases all) of their early November gains. The U.S. equity market went on to bounce up and down through a 2-3% range a few more times before November ended and finished the month down 0.2%. The higher risk profile in the back half of the month re-ignited the “fear trade” as global investors fled Europe for the relative safety of the United States. The U.S. dollar rallied against most major currencies while the Euro fell almost 7%. The Canadian dollar was noticeably strong, perhaps indicating growing acceptance as a safe haven currency. Although the loonie fell by 0.7% last month, it was among the strongest of all global currencies relative to the U.S. dollar. The Canadian equity market held in very well, climbing just over 2% in November as gold (up 2%), oil (up 2.3%) and other commodities all gained over the course of the month.

Our concerns over the potential for rising yields in the government bond market (see last month’s letter) also played out through November as U.S. Treasury yields continued to climb. The 10 year U.S. Treasury reached a low of 2.36% in early October, but that yield has already climbed back over 3% and is sitting

at 3.12% as we write this month’s letter (a negative return of 2.3% in just two months). The pain in the longer bond has been even worse, with the 30 year Treasury delivering a negative return of almost 9% since reaching its low yield in late August. Although Canadian government bond yields have also climbed, our orientation to higher yielding corporate bonds and high yielding equities within our clients’ income portfolios delivered a positive return for the month of November.

The title of this month’s letter refers not only to a great Clint Eastwood movie, but also to the situation we find ourselves confronting in financial markets. While not exactly perfect, the direction of the economic data released over the past few months has turned increasingly positive, and in our opinion, can be viewed as “Good”. Housing continues to be very weak in the U.S. but corporate profits remain very strong. In addition, consumer spending, income and overall industrial activity have at least been trending higher, not lower, as the gloom and doom crowd were predicting all summer. Employment data has also been improving, although not as quickly as anyone would like and not consistently either (as demonstrated by the disappointing recent read on November employment). Outside of North America, economic activity remains extremely robust, most notably in China, Brazil, India and other emerging economies. Even more impressive has been the improving economic picture within the EU. Clearly, the sovereign debt issue is extraordinarily serious (we’ll get to that in the “Ugly” section), but actual economic activity on the ground in Germany, France and the U.K has been consistently surprising to the upside. Unemployment in Germany is near 20 year lows, exports are booming and renewed weakness in the Euro will only help. If nothing else were going on, our view would be that risks on economic growth were heavily to the upside.

Unfortunately, other things *are* going on. The “Bad” refers to renewed problems brewing in the U.S. financial system. The large financial institutions at the



CUMBERLAND

Strategy Review

November 2010

center of the mortgage-backed security (MBS) mess of 2008 could be in danger of being dragged back into further capital impairments. Specifically, purchasers of these securitized mortgages appear increasingly intent on attempting to “putback” bad mortgages from these securities to the originating banks. Although it is still early in the legal process (which we expect the banks to fight tooth and nail), potential damages could be very large with some estimates approaching \$150-\$200 billion in total for the industry. A negative legal judgment on any of the early cases could cause financial markets to become concerned all over again on the viability of certain exposed banks. Needless to say, this is unlikely to be a positive development for both equity and credit markets should it occur.

All of which brings us to the “Ugly”. There is really no better word to describe the sovereign debt situation in the periphery of the EU and, especially, the politicians’ handling of it. This new version of the crisis started in October as debt markets began to express severe doubts on Ireland’s ability to fund the bailout of its banks. As funding costs for Ireland began to soar, European politicians (especially German ones) managed to make a bad situation worse by suggesting that bondholders should be expected to take losses on EU sovereign debt defaults. This is not a promising way to attract buyers to debt of Ireland or other debt-laden EU countries. By the time the EU could confer and come up with a more reassuring and unified response, fear had already spread to the sovereign debt of Portugal, Spain and Italy. Even a \$110 billion bailout of Ireland by the EU and IMF (along the lines of the program put in place for Greece in May) failed to reassure bond markets, and spreads for the debt of Spain and Italy kept widening. It wasn’t until the following week, when it appeared that the European Central Bank had been directly buying debt of the affected countries, that markets

calmed down. This is an incredibly important issue to watch going forward. Should a bailout of Spain become required, we believe it will be politically challenging for Germany to support it. Even if Spain were supported, the EU simply would not be able to bailout a country the size of Italy were that to become necessary. If the Europeans cannot put a pin in the sovereign debt crisis here and now, it is hard to see how the Euro survives (at least with Germany in it). Perhaps even more ominous is the fallout with EU banks who are the largest holders of all this sovereign debt. Just as bad subprime mortgages contaminated the global banking system in 2008, spreading bank to bank based on counterparty risk, failing sovereign debt in Europe could start a similar downward spiral.

At Cumberland, we believe our investment process and risk management discipline give us the confidence to be contrarian, when risk and reward get out of balance. Just as we argued for greater equity allocations and reduced bond allocations while markets were going the other way through the summer, we are now growing more concerned on risk as equity markets continue to march higher. Our clients’ capital appreciation portfolios have enjoyed a great run through 2010 as equity markets have rallied; however, as we look forward into early 2011, our wariness on potential risks is definitely rising. Continued improvement in the global economy appears likely and should support further upside in equity valuations. That said, prudent risk management will dictate reduced equity exposure should conditions deteriorate much further in either of the situations (putbacks at U.S. banks and EU sovereign debt) we have outlined above .

John Wilson

Chief Investment Officer

November 2010

Cumberland Private Wealth Management Inc. is an independent world class investment firm that provides discretionary investment management and wealth management services for high net worth individuals, their families and foundations, with \$1 million or more in investable assets. All of Cumberland’s investment mandates are centered on building and preserving our clients’ financial wealth. Founded in 1997, the firm is privately-owned by its employees and headquartered in Toronto, Canada.