CUMBERLAND

Strategy Review

December 2010

Not as Easy as it Looked (or Looks)

Looking back on the past twelve months, it would be tempting in hindsight to call it, at least from an investment standpoint, "an easy year". Equity markets were up double digits, commodities were up even more, corporate profits are back to record highs, the global economy continued to improve and neither inflation nor interest rates rose materially. How much easier could it be?

In practice, it turns out that investing successfully in 2010 for many investors was anything but easy. The consensus view entering the year was that growth in developed economies would be "subpar" at best, with a significant risk of sliding back into a double dip recession becoming the predominant call as late in the year as August. China was expected to slow, potentially dramatically, as its real estate bubble deflated while economic growth in Europe was definitively going to collapse under the weight of severe austerity plans and runaway sovereign debt. It is important to remember that because of these views, many investors (especially professional ones) failed to stay meaningfully invested in equities, let alone grow their allocation to this asset class, until relatively late in the year (if at all).

And equity markets turned out to be the asset class to own in 2010. Equities finished the year on a tear, with the S&P up 6.5% through December alone and up 13% for the year (both measured in U.S. dollars). Measured in Canadian dollars, the S&P was up a much more modest 3.3% in December and up 7% for the year as the Canadian dollar rallied almost 5.5% in 2010 (over half of which came in the last month), finishing at just over parity with the U.S. dollar. Canadian equity markets rode solid increases in gold, energy and other resource stocks to a 14.5% gain for the year, capped by a 3% rise in December. A dramatic increase in demand for gold from the investment community pushed the yellow metal up almost 30% in price last year, finishing December up 2.5% and near an all time record of US$1,421. Finally, the price of crude oil rose 8% in December, breaching US$90 per barrel for a total gain in 2010 of just over 15%.

Bonds had a wild ride in 2010, marked by declining rates through the first half of the year as investors sought safety from the woes in Europe and a feared double dip in the U.S. Despite the Fed's stated intention of using a second round of quantitative easing (QE2) to keep long term rates low, the actual effect was a catalyst for inflation expectations and rates to move substantially higher. This in turn led to a painful second half of the year for large holders of government bonds as rising rates meant falling bond prices. Higher yielding corporate bonds fared much better as the improved economic outlook lowered credit spreads, helping offset the rise in rates in the latter part of the year.

At Cumberland, our core competency is our commitment to remain disciplined to our investment process and values. A hallmark of our success has always been our willingness to move into and out of assets based on our absolute view of risk and reward. Importantly, we believe risk is simply the probability of suffering a loss of capital, not whether we are underweight or overweight relative to any particular index. As a result, we have the confidence to move against the consensus view when our process tells us to. Over the course of last summer we made the case that the Fed would do more quantitative easing, that equities were remarkably cheap, that government bonds were expensive and that asset prices generally were not properly discounting the potential for the economy to surprise to the upside. As it turns out, those calls, and in particular, our implementation of them into our clients' capital appreciation and income portfolios, was the key to delivering investment success for our clients last year.

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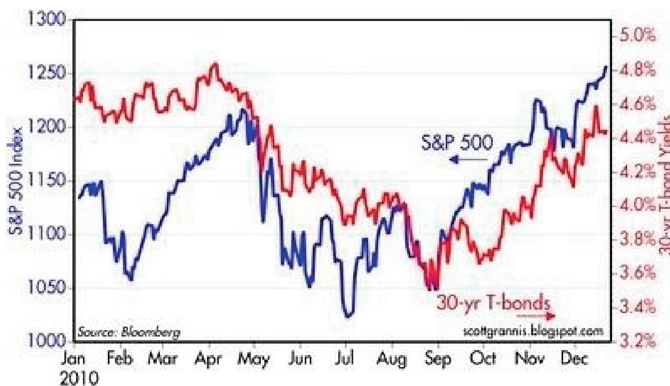
Not only did we stay invested in equities within capital appreciation portfolios through the summer, we increased our allocation through July and August. As a result, we were able to benefit from both the substantial rally in equity markets last fall and the consistently strong security selection skills of our investment research team. Our income portfolios benefited from our move to floating rate notes in shorter maturities and to higher yielding corporate issues in the longer dated maturities. Overall, both capital appreciation and income oriented portfolios successfully protected and grew our clients' capital in 2010.

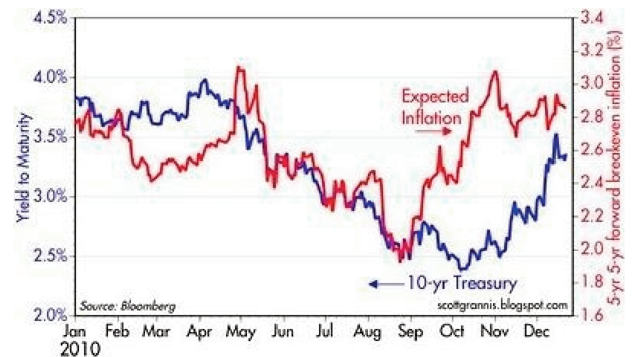
Before we get into our thoughts on 2011, we did want to spend a few minutes discussing the major move from the U.S. Federal Reserve in 2010, now fondly known as QE2. Under this initiative, the Fed embarked on a program to purchase roughly $100 billion in U.S. Treasuries each month beginning last November with a plan to finish the program by July of 2011, although this will be subject to economic conditions at the time. The Fed first let the cat out of the bag regarding their intention to pursue further quantitative easing at its Jackson Hole conference in late August. From that moment forward, bond yields have been climbing and so have stock prices (chart 1).

Chart 1: Bond Yields vs. Equities



A common misconception is that rising yields mean QE2 is failing (since the Fed described the goal of QE2 as helping the economy by keeping interest rates low). In fact, you can see from Chart 1 that the Fed didn't act in late August because rates had been *rising* but because they had been *falling* to all time lows. The economy appeared to be losing momentum through the second quarter as business and consumer confidence remained low while risk aversion remained high. Above all else, the Fed fears deflation (Japan's problem for the past 20 years) and this is exactly what the low yields were signaling. QE2 was put in place in order to increase inflation expectations (even if it was because of money printing). As inflation expectations rise, the real expected return on bonds declines. Given the very low level of bond yields at the time, it took just a small rise in inflation expectations to start raising bond yields (Chart 2).

Chart 2: Yield vs. Inflation Expectations



A nice side benefit (which was not lost on the Fed) is that as real returns on bonds begin to look unattractive, investors move out of bonds into equities and stock prices go higher. Higher stock prices increase households' net worth and, perhaps more importantly for this cycle, improve business confidence (and therefore hopefully act as a catalyst for employment growth). So, QE2 is working exactly the way the Fed hoped…for now. The big question is whether we are starting down the inflationary spiral of QE3, 4 and 5 or whether the Fed will one day have the will to stop quantitative easing and even start reducing it.

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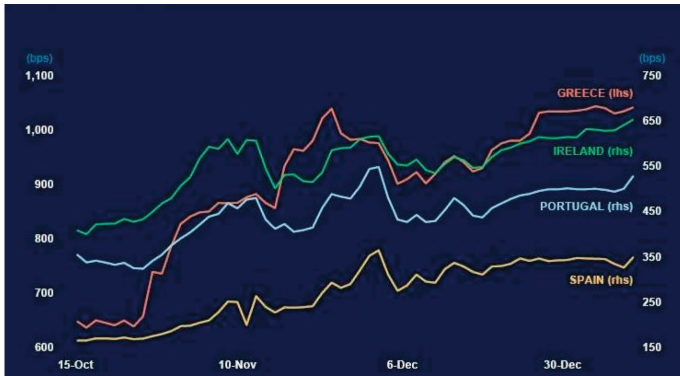
So, what are we thinking as we head into 2011?

First of all, as much as we were optimists on the economy back in August, it appears that consensus opinion on the economic outlook has very quickly swung from bearish to anywhere from modestly to very bullish. This simply makes us nervous. There are plenty of policy, political and economic risks still to be dealt with in the months and year ahead, and it is concerning to us that current investment sentiment appears to have a rapidly shrinking expectation of anything bad happening. Going back to this month's title once again, I don't think 2011 will be as easy as everyone seems to think it will be right now, and markets hate to be disappointed.

Second, as we highlighted last month, we remain very concerned about the continued degradation with the sovereign debt debacle in Europe. The world watched the EU deal with two separate crises in 2010 (first Greece, then Ireland) and the situation still does not appear to be contained. Chart 3 (below) shows the trajectory of CDS spreads (the cost of insuring against default) in the peripheral EU countries on the front line of the sovereign debt mess. Two things should immediately stand out: the risk of default is continuing to rise and Spain is now seen as risky as Portugal was back in October (and Portugal is above where Ireland was!).

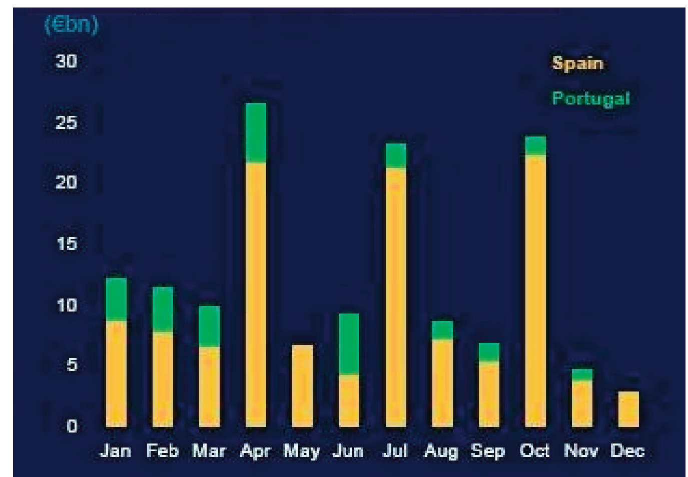
Chart 3: Euro CDS Spreads



Source: Bloomberg, Morgan Stanley

As if Chart 3 wasn't bad enough, Chart 4 shows upcoming debt maturities for Spain and Portugal which will need to be refinanced in 2011, with a very large maturity coming as soon as April. The ability of Spain and Portugal to fund their deficits is going to get tested *every month* in 2011. Germany effectively underwrites any EU bailout and had a massive political struggle just to agree to the relatively small Greece and Ireland fundings. In our view, a bailout for Spain, should it be required, will be extraordinarily difficult to get passed in Germany, potentially putting the Euro, the EU and many European banks at risk.

Chart 4: Sovereign Debt Redeptions in 2011



Source: Bloomberg, Morgan Stanley

All of that said, corporate profits remain strong and, in our view, are likely to deliver a very good fourth quarter reporting season over the next few weeks. While we continue to see tremendous quality and value in the equities we have selected for our client portfolios, it is likely that prudent risk management will dictate a lower equity allocation as we move through the first quarter. As a first step, we have been carefully evaluating stock holdings with significant exposure to the Euro and Europe. It may be that

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the Euro and the EU holds together - certainly that would be in the best interest not just of the EU but the global economy. Recently China and Japan have publicly pledged their intention to purchase Portuguese sovereign debt and that may be enough to swing the tide. Regardless, our first priority is preservation of our clients' capital and until new events in Europe dictate otherwise, we will act accordingly.

John Wilson
Chief Investment Officer
December 2010

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