



CUMBERLAND

## AS GOOD AS IT GETS?

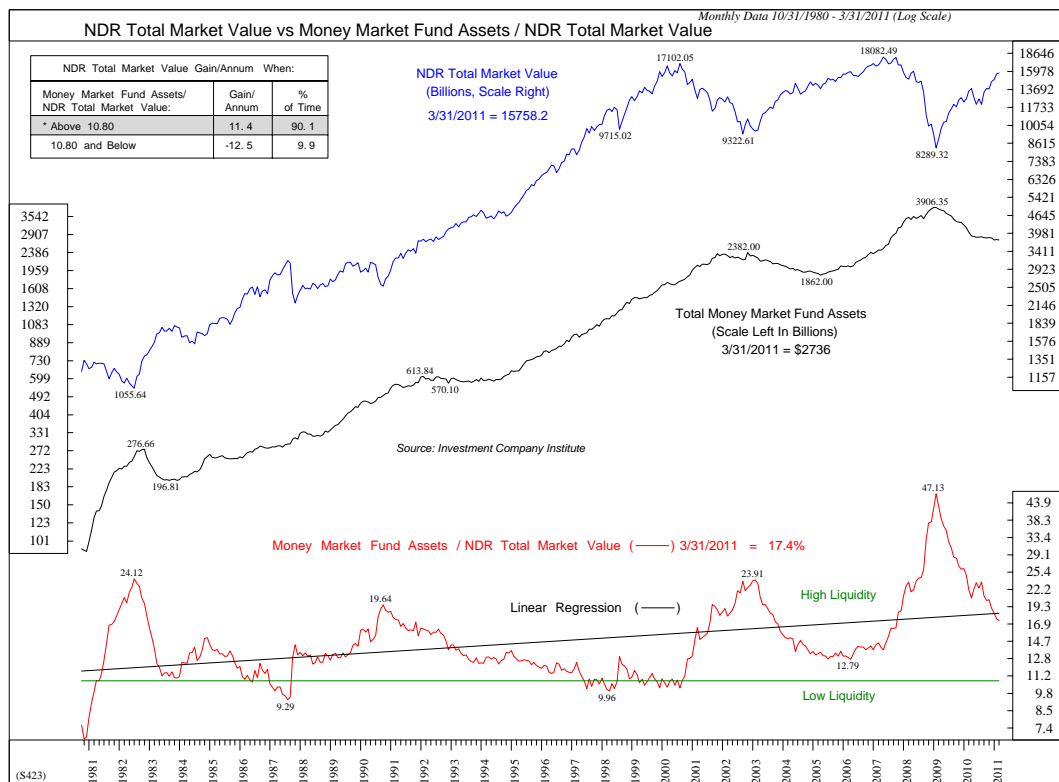
The unknown, unknowns ganged up on us last quarter but the market remained remarkably resilient.

Uprisings in the Middle East, so what? Earthquakes in Japan, that's unfortunate. More Sovereign Debt problems in Europe, been there, done that.

So what's it going to take to set this market back? Well, I've got a list that I will share with you in a minute. But let's start with why this market is so strong, and in my opinion it can be summed up in a word. Liquidity.

There's simply a lot of money around that has to go someplace and right now its favourite destination is the stock market.

Staying focused on this one issue has helped us avoid all of the "noise" we hear daily and it explains why the market didn't perform poorly in the face of several negative headlines.



I've shown this chart repeatedly as an example of the amount of money resident in money market funds. The ratio of fund assets to the market value has declined because the stock market advanced. Yet, \$2.7 trillion remains in under-earning deposits. Add to this, record high free reserves in the banking system and an estimated \$3.3 trillion sitting on corporate balance sheets globally, and you can understand what is underpinning this market.

This by no means suggests that the market can't experience a setback, and I'm sure it will at some point. But until this liquidity is drawn down, market corrections will probably represent buying opportunities.

What could influence this happy state is any change in the Trifecta of conditions underlying this liquidity – low and slow economic growth, low inflation and low interest rates. A pick-up in any of these would solicit a response from the Federal Reserve that could change such a beneficial equation for the market.

The common belief that a strong economy relates to a strong stock market is only partially correct. In fact, at extremes of either strong or weak GDP, the economy and the stock market are in fact inversely correlated. In other words, too strong is bad news.

Maybe the best example of this is to look at some of the economically strong emerging markets.

Most investors know that the Asian and Latin American economies have seen exceptional growth. But along with this strength has come inflation driven by higher commodity prices, especially agricultural products.

In response, the Central banks in several of these countries have raised interest rates and tightened monetary policy, including Banks in eight Asian countries.

In China alone, interest rates have increased four times since October and bank reserve requirements have been raised six times since then. The Bank of India has raised its key policy rate eight times in the last year after inflation reached 16.2%.

Contrast this against the stock markets in the slow growing, low interest rate developed nations and you'll get my point.

### **1<sup>st</sup> Quarter Performance of MSCI World Index**

United States	5.46%
Canada	4.98%
Europe ex UK	2.21%
Hong Kong	- .74%
Singapore	- 2.32%
Brazil	- .08%
China	2.93%
India	- 5.46%

Economic growth isn't necessarily the key to a strong stock market, liquidity is and when the Central Banks start to withdraw it or the economy demands too much of it, it's time to become cautious.

So, for the time being, a modestly improving economy is driving consumer and business confidence, corporate earnings continue to grow and structurally low interest rates are pushing investors to take more risk in the bond and equity markets.

### Where do we go from here?

Looking out over the next six months to a year, it's hard to see how things can get much better. However, I don't know if any of our "known unknowns" will be enough to derail this market or if they will only result in a solid correction.

Here are some negatives stacking up against our bull market Trifecta.

1. QE II ends in June.
2. Cutbacks by State and local governments start in July.
3. Federal spending from the American Recovery & Reinvestment Act dries up mid year.
4. Higher oil prices.
5. Inflation picks up.
6. Federal Spending Cuts

Let me provide some colour on each of these.

#### QE II ends in June

Last fall the Federal Reserve approved a plan to purchase \$600 billion of government debt by the end of this June. To accomplish this goal, they have been buying between \$4 and \$6 billion of treasuries each day.

The fear is that when this program ends, and liquidity dries up, bond yields could rise. But reality can sometimes defy logic. When this program was announced, yields didn't decline as one might expect. The 10 year treasury yield, in fact, increased from 2.67% last November to 3.75%. There was also a marked slow-down of funds flowing into bond mutual funds from an average of \$5.8 billion per week before QE II to approximately \$2.0 billion per week after its initiation. Maybe yields were too low and stocks looked too cheap, but most of the decline can be attributed to a scare over State and Local bond defaults and net withdrawals from municipal bond funds.

The banks which are primary dealers with the Fed have also been doing some selling, either to accommodate the Fed's purchases or to set up for the end of quantitative easing. Currently, dealers are net short about \$20 billion in 3 to 6 year securities and net short over \$17 billion in 6 to 11 year maturities.

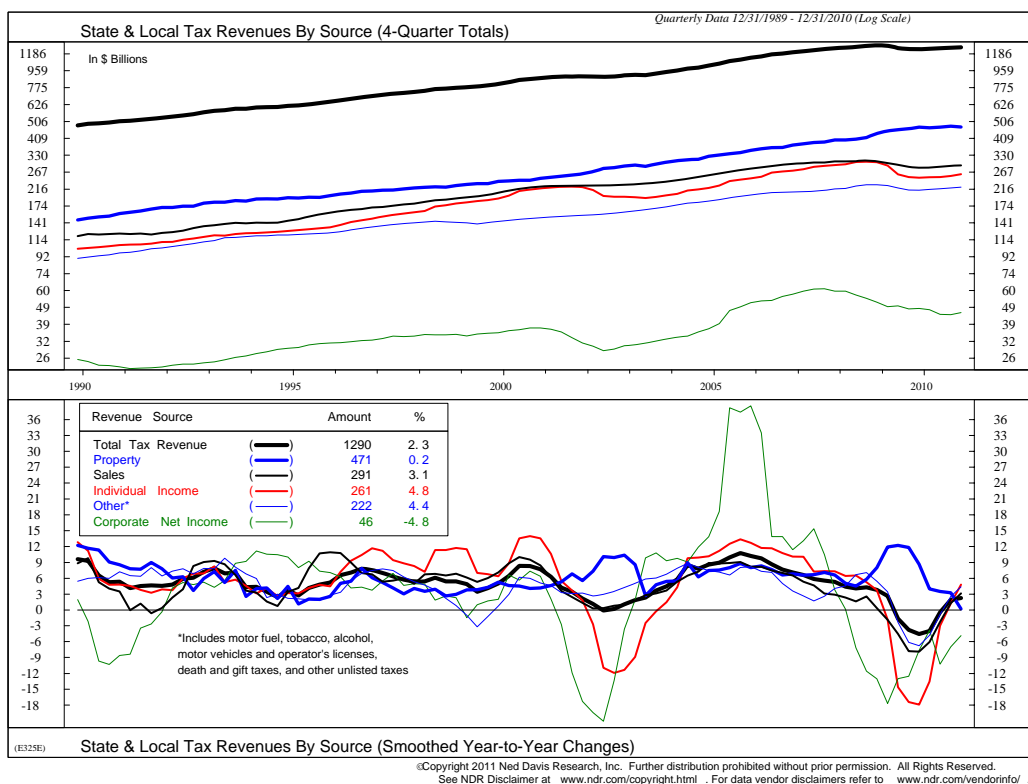
Logic says it is best to be cautious on this issue because it could cause interest rates to rise and liquidity to diminish. But, there are enough variables to suggest that things may turn out differently than expected. Yet, it's hard to see how this is going to be positive.

## Cut Backs by State and Local Governments starting in July

This is another issue that could affect the economy as spending cutbacks and the firing of government employees to balance the books will create a lot of fiscal drag. By law, states are required to balance their budgets and a new fiscal year starts on July 1<sup>st</sup>. Combined, state and local spending fell 2.4% in the 4<sup>th</sup> quarter and is expected to fall again this year. By comparison, this spending accounts for about 12% of nominal US GDP versus 8% for federal spending. So, it's not insignificant.

The States' combined budget gap is expected to be over \$140 billion in 2012 as Federal aid to the States diminishes from \$158 billion to just \$6.0 billion.

However, the median amount of state debt only amounts to 2% of state GDP and revenues continue to improve.



As can be seen in the bottom clip of this chart, state and local government tax revenues rose 2.3% year over year in the 4<sup>th</sup> quarter, which was the 5<sup>th</sup> consecutive gain. Corporate tax revenues improved by 14.3%, which was the first time since the 1<sup>st</sup> quarter of 2009, and individual tax receipts increased 10.1% for a fourth straight gain. General sales taxes also improved 2.3%. Only property taxes have yet to advance.

My bet is that this won't be a problem as tax revenue will probably increase faster than planned and a \$140 billion decline on a \$14 trillion economy doesn't seem that significant.

Federal Spending from the American Recovery and Reinvestment Act dries up in mid year.

This spending has been tapering off and a significant portion of these funds was directed to state and local municipalities. This funding will decline to \$6 billion for fiscal year 2012 from \$59 billion in 2011 and \$68 billion in the previous year.

Higher Oil Prices

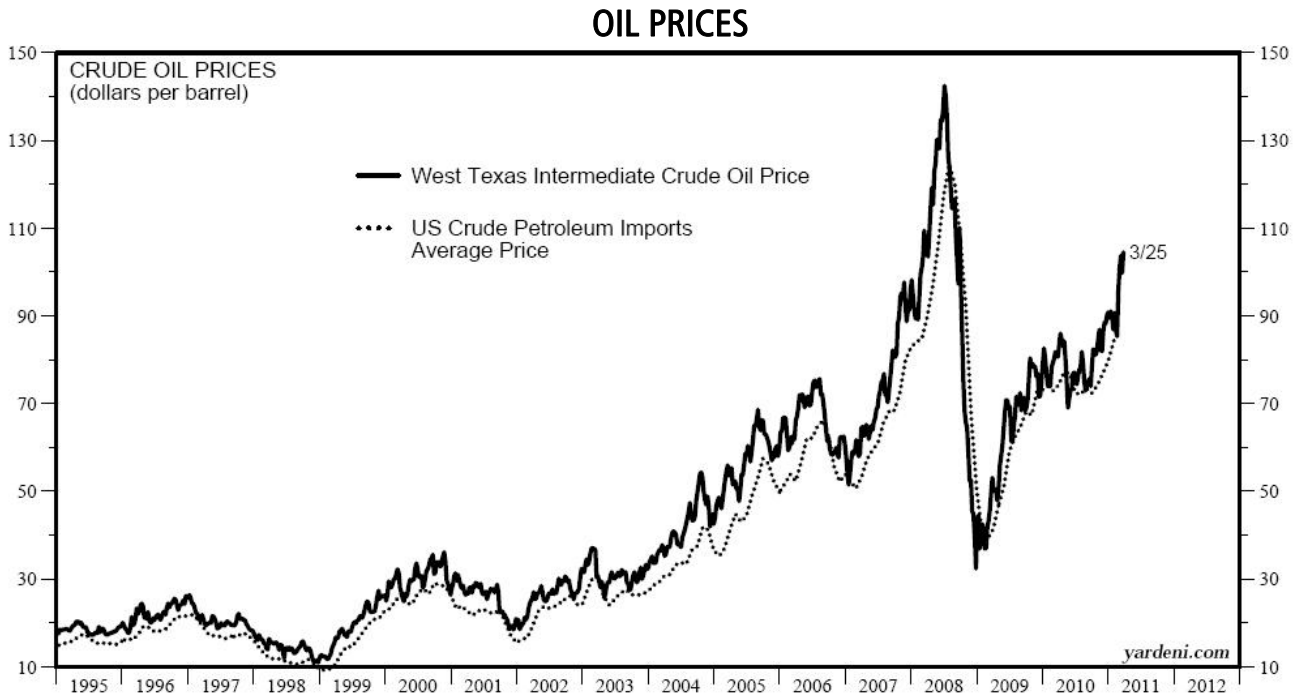
Higher oil prices would not be good for either inflation, nor the economy, and there is now talk of oil rising to \$150.00 per barrel.

I'll concede that demand will continue to pick up but I don't think it justifies current oil prices above \$110.

As with many other commodities, I believe there is a significant speculative influence in the prices of many of the industrial and agricultural commodities.

In my year-end commentary, I singled out copper where one trader holds between 80% and 90% of the London Metal Exchange (LME) inventory or about half of the world's stock pile. Aluminum also has one holder of 90% of the LME's open interest, while Nickel and Zinc had single traders controlling 50% and 80% of the inventory.

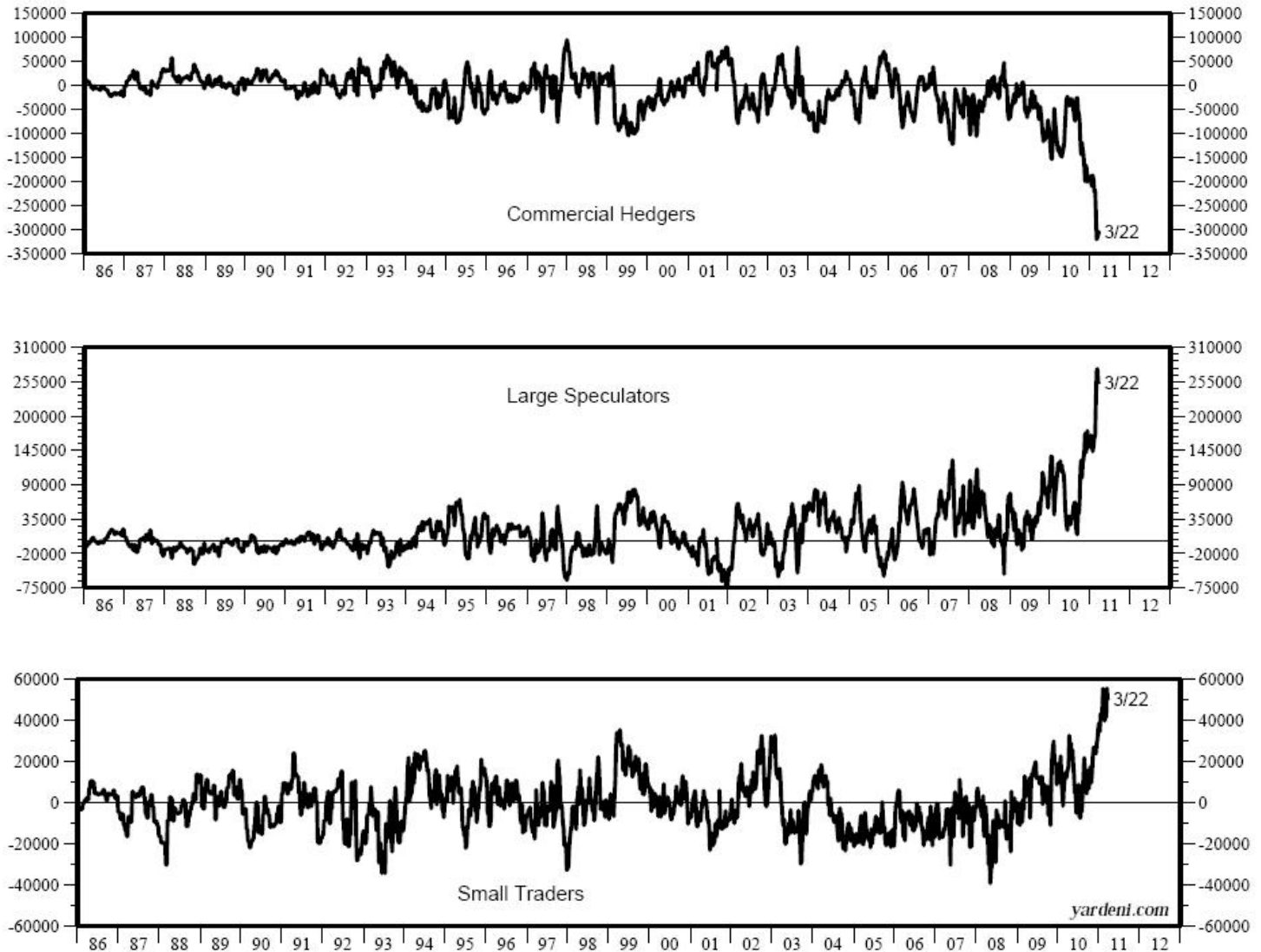
The last time I highlighted oil was in the summer of 2008 when I pointed to speculators, and not the laws of supply and demand, as influencing its prices. This time, the impact of traders is quite apparent.



You can see the recent spike in the price of oil which coincides with the turmoil in the Middle East.

The first news reports blamed this on supply disruptions.

### Commitments of Traders Light Sweet Crude Oil (WTI) (contracts of 1,000 barrels)



Source: New York Mercantile Exchange, Commodity Futures Trading Commission.

However, the bottom two clips of this chart show the number of oil contracts owned by traders and it correlates perfectly with the price of oil.

Now it's not unreasonable for people to purchase future contracts as a hedge against the Middle East conflicts creating shortages.

However, U.S. crude oil inventories in the week of March 4<sup>th</sup> amounted to 348.9 million barrels, about the same as two years ago. But, the large speculators held options to purchase 78% of the entire inventory (271.9 mbbbls) through crude oil future contracts. That was up 89.7% from five weeks earlier and the highest ever.

So I think a lot of the price move in oil from \$90 bbl to \$110 bbl can be attributed to a "fear premium". Should things settle down in the Middle East, this premium is likely to disappear.

Could oil be a negative for my Trefecta - for sure, if uprisings in the Arab oil producing states escalate and curb supplies. But if they don't, then there is a large concentrated ownership that is likely to get unwound.

### Inflation Picks Up

Economists are in agreement on this issue. Inflation will remain subdued because of excesses in labour and manufacturing capacity, a surplus of real estate curbing rents, and a desire by households to pay down debt thereby curtailing demand.

Again, I touched on this in my year-end quarterly and one has to look at this issue from two perspectives. In economics 101 you learn that there are two causes of inflation – cost push and demand pull. Well cost push is here and its sister is potentially waiting in the wings.

Of all the issues I've listed, this one and the debate on the Federal Budget deficit, which I will come to next, could have the greatest impact on shaping the markets in the second half of this year.

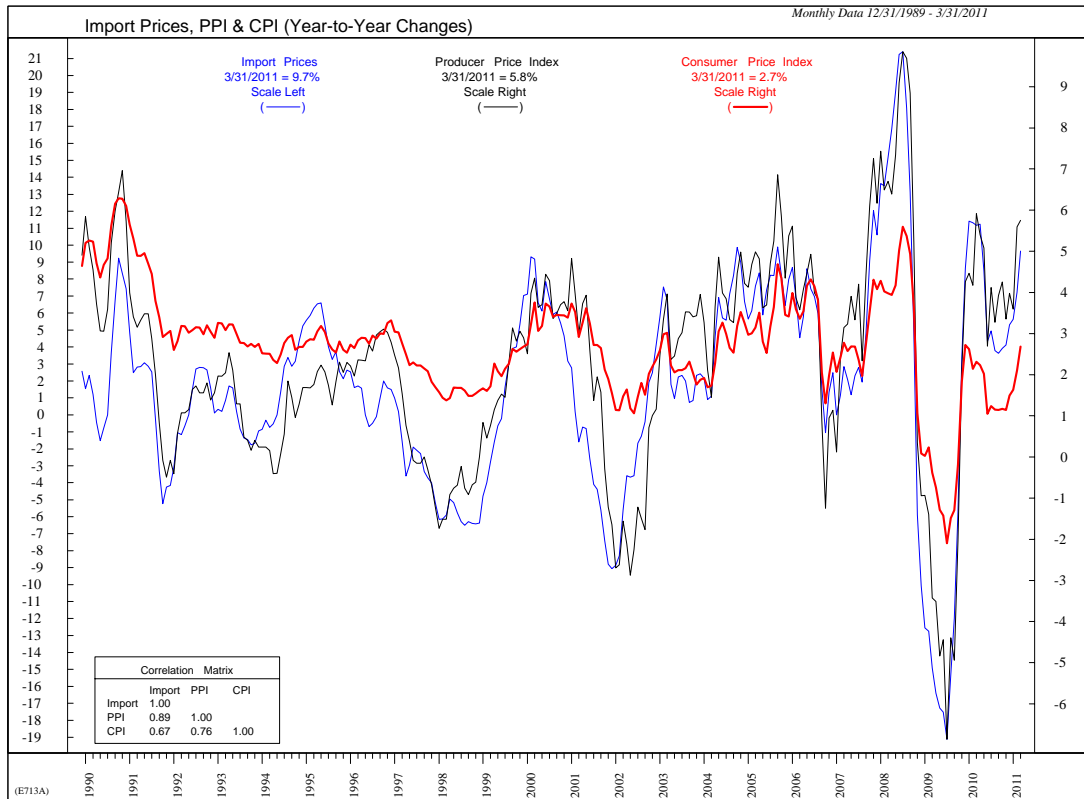
I've already mentioned the significant levels of inflation that are prevalent in the emerging economies where governments have unanimously responded by raising interest rates. Europe only needed a scent of inflation to cause the European Central Bank to raise rates by 25 bps with further increase expected to come by year-end.

Most economists chalk up the difference between China's 5.4%, CPI and the U.S. CPI of 2.1% to the cost of food which is up 10.1% in China but only 1.4% in the States. Excluding food and energy (i.e. core inflation) the numbers are much closer, 1.65% vs. 1.1%.

A lot of this can be attributed to how the indexes are calculated. In the US, food and beverages only account for 14.9% of the Consumer Price Index.

Regardless, the commodity-based, cost push inflation in China is working its way through to the consumer level and eliciting an interest rate response. Yet, the economists say, don't worry, it won't happen over here.

But, I think that some of the pass through could happen in the United States as production costs escalate and the lower U.S. dollar results in an increase in the cost of imported goods.



You can see from this chart that the CPI in the U.S. was 2.7% at the end of March. However, the PPI was 5.8% and import prices were up 9.7%. So it's not just food and energy.

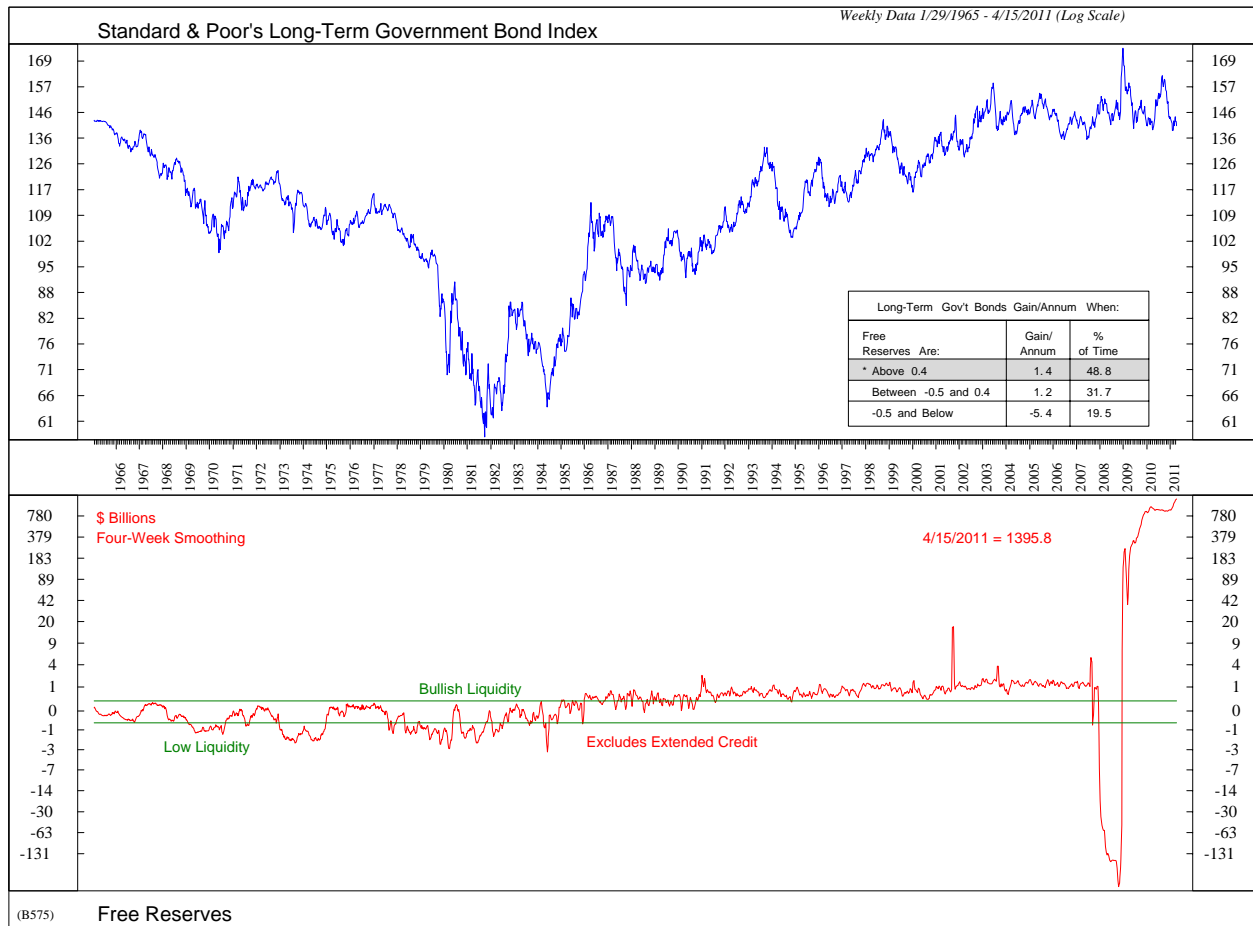
Year over year food prices increased 18.9%, the most on record, and for the month of March petroleum prices rose 10.5%.

I know commodity prices can be volatile and could just as easily decline. But, I doubt that higher interest rates in Asia are going to cause bigger harvests to dampen price increases in agricultural products.

The Federal Reserve is confident that these cost increases at the producer level will not get passed through to the consumer. But the Philadelphia Fed does a price survey of manufacturer's expectations. Currently only 22.6% say they have an ability to pass through these costs. However, asked what they see six months ahead, 38.1% say they expect to raise prices, so the trend in expectations is going the wrong way.

I like the quote from Congressman Steve Pearce who recently told Ben Bernanke "there are more people who believe aliens landed in Roswell, New Mexico, than believe inflation is currently 1.6% (through January)". I have to concur. If I'm wrong and some of these costs don't get passed through, there will certainly be pressure on the profit margins of any producers who depend on some of these more costly imports. Bottom line, all of this will certainly have an impact on our stock selection.

What's waiting in the wings is potentially demand pull inflation. In theory, it's created by too much money chasing too few goods.

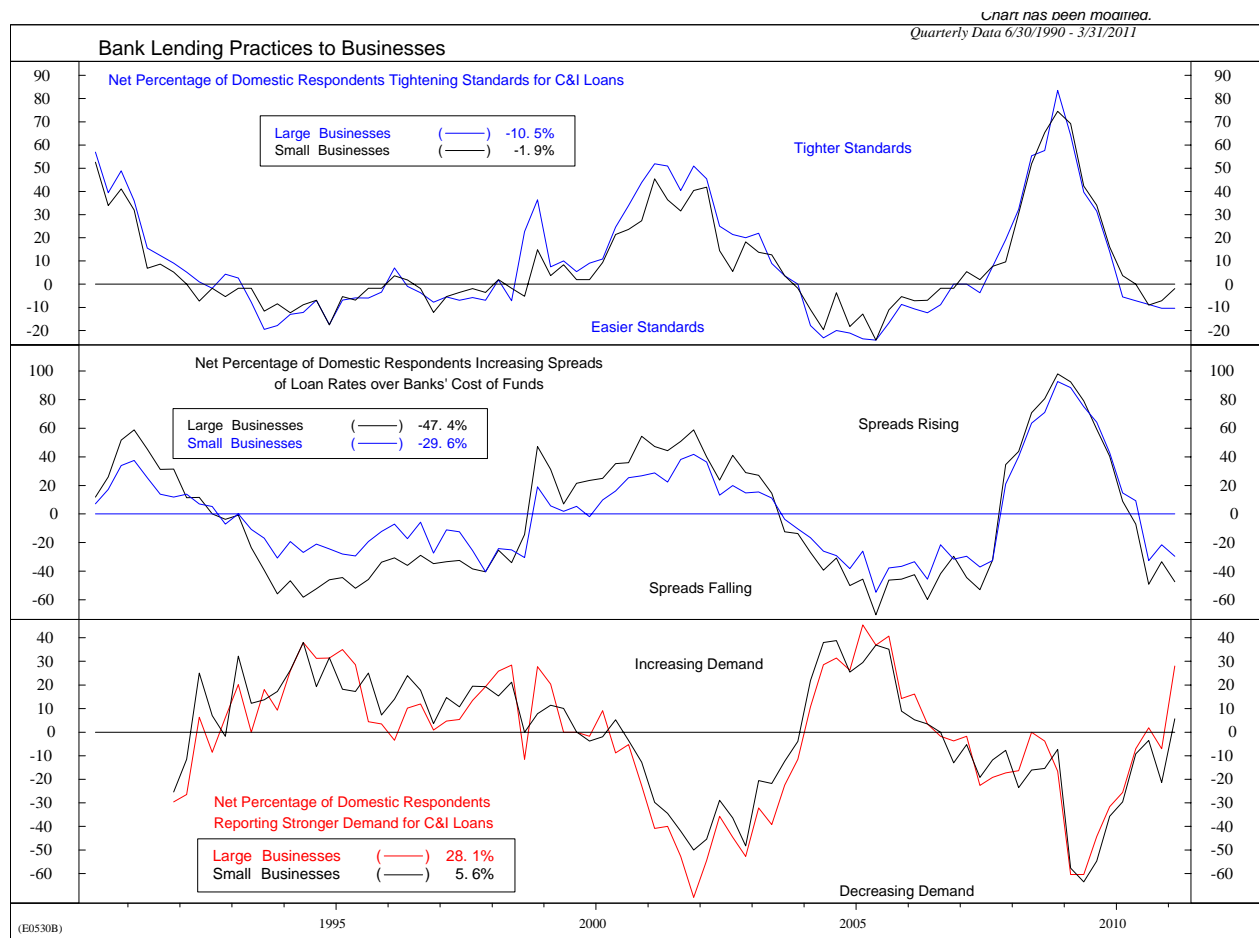


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I've shown this chart before. The bottom clip represents the result of the Fed's QE II and is one of the two extraordinary anomalies that remain from the 2008 economic salvage program. The other is a \$1.6 trillion U.S. government budget deficit. Both of these have to get resolved before you can consider the economic recovery that we've seen to date as anything close to normal.

What this chart shows, is that there is \$1.396 trillion dollars being held at the Federal Reserve for the chartered banks which can lend \$10.00 for every \$1.00 in reserves. In theory, the amount of lending power here equals the size of the entire U.S. economy, so imagine increasing the spending power by that much while the amount of available goods remains the same. Now that would be inflation, and that is one of the big worries looking forward. How does the Fed disarm this potential inflation time bomb?

So far, these reserves have been benign because the banks haven't been lending. But that seems as though it's about to change.



Looking at this chart, the top clip indicates that banks have loosened their lending standards significantly for businesses. The bottom clip shows that business demand for loans has increased. At the end of last year, commercial and industrial loans showed their first increase in two years. There's also been a pick up in loans for Mergers and Acquisitions, just witness the J.P. Morgan's \$39 billion commitment to AT&T for the purchase of T-Mobile U.S.A. For the first quarter M&A activity reached \$267 billion an increase of 84% from a year earlier. Even the demand for commercial real estate loans is the highest in five years. Only demand for residential mortgages remains weak.

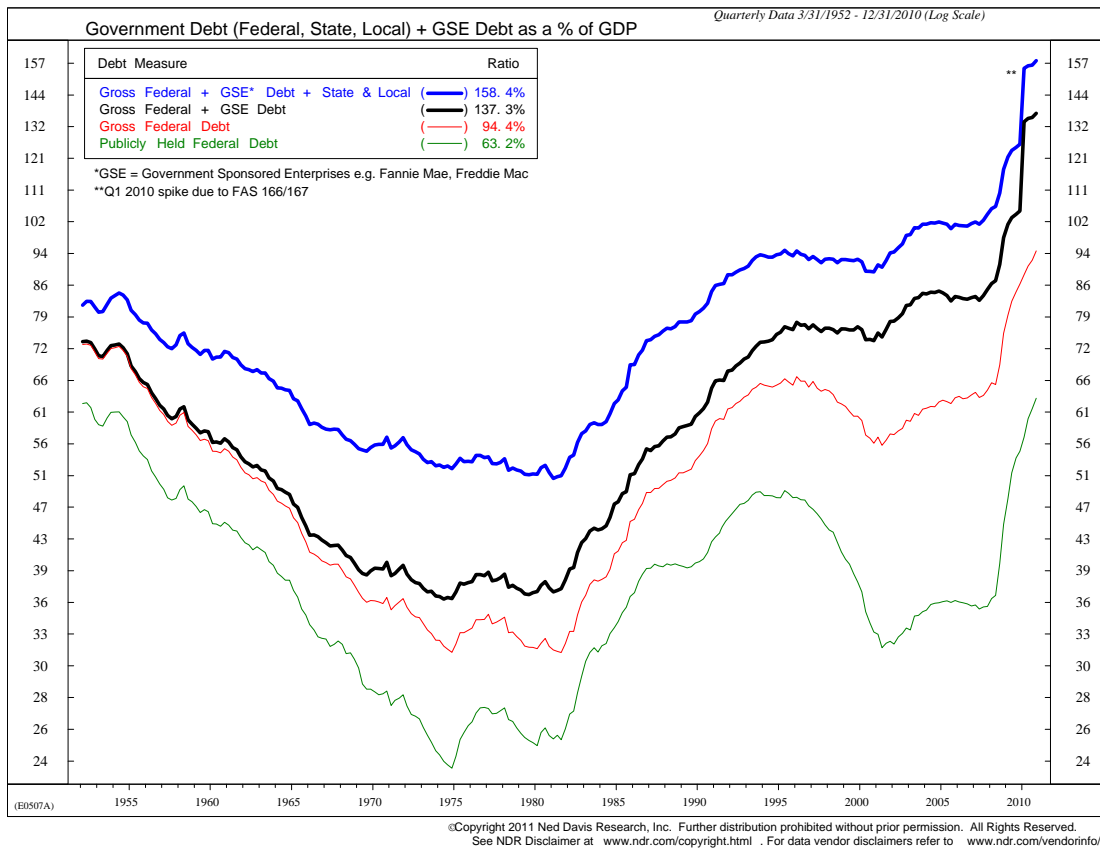
But lending equals money growth and historically that has meant more demand pull inflation.

We'll have to wait and see how this plays out. But the optimists on inflation seem to be fighting some headwinds on this one. I hope they're right, because if they aren't, interest rates will have to rise, liquidity will be drained from the system and there goes two of the props from under this market.

Let's hope a correction in commodity prices takes this issue off the table.

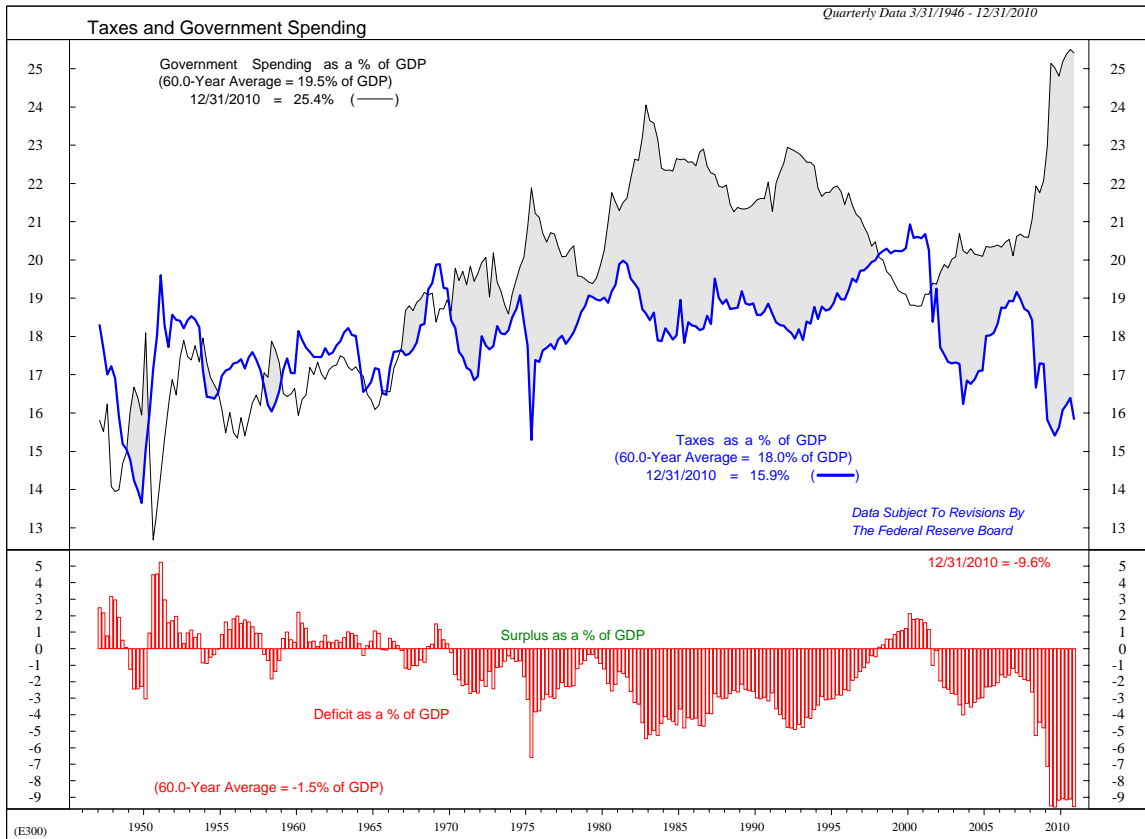
## Federal Spending Cuts

Last year President Obama projected a budget deficit of \$900 billion equal to 6% of GDP. Revised projections for 2011 are now for a \$1.645 trillion deficit equal to 11% of GDP and trillion dollar deficits well out into the future. Now that's a serious forecasting error. So there isn't much confidence in government projections.



We've all seen these types of charts which show government debt relative to GDP. In this one, all levels of government debt are included. The green dotted line is the one the government likes to quote, publicly held Federal debt. They don't want to count the debt held by government programs such as the Social Security Trust Fund. When you add that in, gross government debt it is 94.4% of GDP. Add in other levels of debt that could become wards of the Federal Government and you're at a whopping 158.4% of GDP.

I'm not going to get into the composition of the deficit or what happens to the interest cost component as debt continues to mount. This is a complex problem and could easily consume an entire commentary. So let me give you one chart and one set of statistics that reflect the essence of the problem.



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This chart shows spending and taxes as a percentage of GDP and that they've gone their separate ways. Most deficit cutting proposals see these variables returning to more traditional levels of 19.5% for spending and 18% for tax revenue, but right now there is a huge gap, not only in the deficit, but philosophically on how you close it. The Republicans with the backing of a November electoral mandate are focused on cutting spending while the Democrats want social justice through increased taxes.

I think in the end, both will get their way and that the current debate is mostly posturing for future elections.

But, we'll know they're serious if they address the entitlement programs of Social Security, Medicare and Medicaid, which brings me to the set of statistics.

Last year, Social Security and Medicare spending averaged \$30,215 per senior citizen; up from \$11,871 in 1990 for a 154.5% increase. Over that period, the number of senior citizens only increased by 31%.

But going forward, according to the U.S. census bureau, the population of seniors will increase 79.4% from 40.2 million to 72.1 million by 2030. By then, seniors will account for almost 20% of the population.

Currently there are approximately 4 workers supporting every senior citizen but according to a study done by the New York Times that will be down to 2 workers for every senior by 2030.

Consequently, any debate that doesn't include revisions to the entitlement programs is a waste of time.

Why is this important? For two reasons. First, deficits of this size are obviously unsustainable without an impact on interest rates and the value of the U.S. dollar by virtually threatening the credit worthiness of U.S. Sovereign Debt. Second, this is going to be the issue that shapes the 2012 elections and you can expect it to be a high profile issue that affects the market as any resolution will be deemed "austerity" which will threaten economic growth.

Personally, I'm hopeful that the politicians are struck by a random act of rational thinking and adopt Obama's joint committee proposal for deficit reductions. It included cutting the defense budget by \$100 bn, raising the Social Security age to 69, increasing the tax on gasoline by 15 cents per gallon, lowering the corporate tax rate to 25%, limiting federal spending on health care, banning Congressional earmarks, repealing the alternative minimum tax, eliminating interest deductibility on mortgages over \$500,000, cutting the federal work force by 10%, cutting farm subsidies, taxing capital gains and dividends at the same rate as ordinary income, and lowering and simplifying individual tax rates to 9%; 15% and 24%. No doubt the bearish economists are going to have a field day projecting the negative consequences of such a dramatic cut in government stimulus. However, on this one I'm with Winston Churchill who said, "Americans can always be counted on to do the right thing... after they have exhausted all other possibilities."

Whatever the pain, and there might be less than many assume, the current budget deficit is unsustainable.

Why maybe less pain? A Harvard professor recently completed a study concluding "Economic history shows that even large adjustments in fiscal policy, if based on well-targeted spending cuts, have often lead to expansions not recessions. Fiscal adjustments based on higher taxes, on the other hand, have generally been recessionary." In the study he looked at 107 large fiscal adjustments (deficit reduction of at least 1.5% in one year) that took place in 21 OECD countries between 1970 and 2007. His observation was that cutting spending can lead to an expansion, not a recession. Let's hope history repeats and that he's right.

Regardless, get ready for the fallout from this debate as it will be one of the factors shaping the market in the months to come.

### European Sovereign Debt

An issue I haven't touched on, is the Sovereign debt problem in Europe. It hasn't gone away but the so called "can" has been kicked further down the road. So, it seems to be off the table for a little while as the 440bn Euro, Financial European Stability Facility has agreed to purchase bonds directly from distressed countries in the primary market and Spain seems to be able to handle its own problems thereby stopping a dreaded contagion.

Nonetheless, I would expect this problem to resurrect itself, and that sooner or later we have to deal with the reality of defaults or restructuring by Greece and possibly Portugal and Ireland.

## Summary

So what's the conclusion of all this? At the beginning of this year, I said I was cautious and thought we might see a market correction. I also felt that the U.S. market had a good chance of outperforming Canada and that commodity prices were extended.

My thoughts haven't changed.

However, during the quarter, two events may have altered the timing of things. First, the flare ups in the Middle East gave oil another leg up, which may have created an interim price peak unless things deteriorate further in the Arab state. Second, the earthquake in Japan has effectively created QE III as the Bank of Japan hit the system with \$481.0 bn which has helped offset some of the concerns about the end of Quantitative Easing in the U.S.

On balance, I see the world economy continuing to grow, but for the reasons I've enumerated in this report, the growth rate seems destined to decline which should be negative for commodity prices and hopefully inflation. If I'm right, market leadership should change and the adjustment we're witnessing in the market is mostly a transition in leadership in an ongoing cyclical bull market.

Slower economic growth, stable to lower commodity prices and a debate on controlling government deficits should allow the conditions for our market Trifecta to remaining positive. But, maybe not as good as they have been

That said, market optimism is high and a solid correction could clear the air for a further advance.

GRC/amh  
April 12. 2011

Credits: Ned Davis  
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