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Strategy Review March 2011

Summer 2010 The Sequel: Summer 2011?

Global equity and bond markets pretty much finished the month of March where they started, which is not to say that the month was uneventful. March of 2011 will be remembered for the massive earthquake, tsunami and subsequent nuclear accident which struck Japan mid-month. As if the crisis in Japan didn't add enough uncertainty, the situation in the Middle East continued to deteriorate with Western nations joining forces to launch air strikes against Libya. Markets reacted in knee-jerk fashion, as equity markets declined over 5% within a few trading sessions then turned on a dime and reversed all of the losses by month end. The TSX dropped 0.1% even as oil rallied a further 10% to almost US\$107 per barrel and gold climbed another 2%. The S&P 500 ended March down 0.1% in U.S. dollar terms but down 0.3% in Canadian dollars as the loonie continued its climb to 3 cents above parity relative to the greenback. In Europe, any concern over an imminent bailout of Portugal appeared to be more than offset by growing conviction that the European Central Bank would begin raising interest rates in April (which they eventually did this past week). As a result, the Euro continued to rise against the U.S. dollar, passing through the \$1.40 level to close the month at US\$1.42. Finally, the bond market played out in opposite fashion to equity markets, with prices climbing and yields dropping as the crisis unfolded then reversing back again once equity markets got back on a roll. Credit spreads finished the month slightly wider as the market absorbed an elevated amount of new issuance through March.

Over the past few months, we have been selectively and gradually lowering our allocation to equities within our clients' capital appreciation portfolios. As markets declined sharply in reaction

to the crisis in Japan, we decided that the sell off offered opportunity and that we should buy equities which appeared set to benefit from the unfolding situation within Japan. First, we believe Japan will need to increasingly rely on its existing coal fired power stations to make up for lost capacity from its nuclear stations, and so we added to positions which export coal to Japan. Second, we believe production levels for the Japanese auto manufacturers will be heavily impacted as it could take several months to get their Japanese plants and supply chain back to full capacity. Here, we added to existing positions in a major North American auto manufacturer which we believe could benefit through better pricing, fewer sales incentives and perhaps even increased market share over the next several months.

Although we did end up modestly adding to a few of our clients' equity positions as described above, we remain committed to lowering the level of overall equity risk within our client portfolios as we have been describing for the last few months. Specifically, we have lowered our clients' exposure in energy, industrials and more recently, in selected higher risk financials. The reason for our caution has largely been our view that equity markets had become somewhat overly focused on near term momentum in corporate earnings and were not properly discounting rising risks elsewhere. While we do believe the upcoming first quarter corporate earnings season will be quite good, we worry that very good earnings are already fully baked in. Furthermore, guidance for the second quarter could be less robust than the bulls expect as rising input costs begin to make their presence felt on profit margins.



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Beyond the near term earnings outlook, potentially serious macro risks involving sovereign debt, monetary policy, interest rates and inflation are also in front of us. In fact, you could make a strong argument that many of the risks on the near term horizon today bear striking similarity to the ones that prompted a substantial correction in equity markets last summer. Call it, "Summer 2010, The Sequel". The formula for a decent sequel is to keep the main characters as familiar as possible, add a few plot twists to make it a little different and offer up drama with the potential to be bigger and better than the first time. On all three of these counts the "Summer of 2011" has the potential to be a real thriller, although, just like with Hollywood blockbusters, there is no such thing as a "sure thing" with investing.

Starting with the main characters, they are all back:

1. First up: the sovereign debt crisis in Europe. Last spring it was Greece seeking a bailout, this spring it is Portugal. Although the Portuguese economy is a little smaller than that of Greece, it makes up for it by not even having a government in power to negotiate its bailout. As an added bonus, Spain is the next domino waiting in the wings instead of 2010's Ireland. Spain has a GDP over four times the size that of Greece and over 6 times that of Ireland.

2. Second is the decline in U.S. fiscal stimulus. Last year, markets worried that the bulk of the fiscal stimulus package put in place in 2009 would be rolling off by the second half of 2010 with a resultant drag on economic growth. This year, for an added plot twist, the U.S. government will hit their debt ceiling within the next 5

weeks. Without an increase in the ceiling by Congress, the U.S. will literally be unable to borrow any more money. Given that the Administration and the Republicans debated until midnight on the eve of shutting down the government last week over a mere few billion dollars in budget cuts for this fiscal year (which is already half over anyway), we're not optimistic about the odds of a quick and easy resolution to the budget ceiling negotiation. It will get done eventually, but it will get plenty ugly before then, perhaps even missing the formal deadline and forcing the U.S. Treasury to improvise for a few weeks. The Republicans won control of the House with a pledge to cut deficits and they are simply not going to let this one pass by without milking it for every last drop.

3. Just like last spring, we once again have the Chinese tightening policy in an attempt to moderate both economic growth and inflation. As was the case last summer, we think the Chinese will manage to keep their economy growing around 7-8% but markets, particularly commodity markets, are likely to get some heartburn until this is more certain.

4. Last but not least, we have the U.S. Federal Reserve. This time last spring, selected Fed Governors were working the speaking circuit talking about the variety of ways they could remove the vast accommodation put in place with the first round of quantitative easing. This spring we once again have several Governors opining how the Fed could remove the second round of easing put in place (forget about the first round, that's still there). The implications here are significant. As we all now know, once QE1 ended last June, economic data began to



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soften, markets rolled over hard and the Fed caved in, announcing QE2 by mid-August. In our view, the Fed caved not because the S&P 500 was down 15% in 3 months, but because Treasury yields had dropped below 2.5% and were effectively discounting deflation (Bernanke's bogeyman). This summer, as the Fed allows QE2 to expire (once again in June) expect rates to *rise*, not fall. Momentum in the U.S. and global economy is stronger now than it was last summer, and by ending QE2 the Fed removes itself as the primary purchaser of U.S. Treasuries. Others will fill the breach, but unlike the Fed they will be price sensitive and will demand higher yields. Beyond a yield of 4.5% or so for the 10 year U.S. Treasury, we think higher yields become a drag for the U.S. economy, not to mention a serious budget problem for the U.S. Government (how would you like to see your interest payments on \$14 Trillion in debt rise by 30 %?).

In summary, we are continuing down the path we have been describing over the past three months. Rising risks on the heels of a tremendous run make us incrementally more cautious on equities. Potential for further increases in interest rates makes us cautious on interest rate risk and keeps our clients' income portfolios tilted toward shorter maturities and higher yield. It may be that the economy has been primed enough that it can take over from stimulus and keep growing at a healthy clip. If so, our current actions may forgo a bit of opportunity for the sake of capital preservation. I actually hope that is the case – after all, I've never really liked sequels anyway.

John Wilson
Chief Investment Officer
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