CUMBERLAND

"IT'S THE ECONOMY STUPID"

The title of this "Quarterly" was a popular campaign slogan used by Bill Clinton in his first presidential run and something that investors would like to see adopted by most of the world's leaders today.

Concerns over European sovereign debt are still acute but slowing economic growth in China, the United States and elsewhere have bumped it off the top of the leader board as the number one concern. In fact, investors are starting to appreciate that the possibility of sovereign debt defaults are directly linked to economic growth and further European economic contraction will likely drag the rest of the world's GDP down with it.

Economic concerns are also being compounded by pending changes to U.S. tax legislation referred to as the "Fiscal Cliff" and the current earnings reporting season where analysts fret over earnings coming in below estimates and corporate guidance for the balance of the year.

They're worthy concerns, if in fact, things continue to deteriorate. So, maybe it's best to examine each of the issues before deciding on an investment strategy.

However, I would make an observation. Although investor sentiment seems pretty negative, the stock market isn't confirming the feared outcomes.

As a gauge of sentiment, I refer to a survey of sell-side strategists completed by Merrill Lynch that revealed them to be the most bearish in 15 years as their average allocation to equities is only 49.3%, the first time below 50% since 1997. The good news is that in the last 27 years, the market has appreciated 30% in 100% of the cases when the averages hit this level.

There was also a poll done by the American Associates of Individual Investors which showed that 44% felt that the market would decline over the next six months, the 8th consecutive week that pessimism has stayed above the 25-year average of 30%.

This poll reached an all time high of 70.3% on March 5, 2009, four days before the S&P 500 bottomed at a 12 year low.

Things most likely to change their opinion would be a resolution to the European sovereign debt crisis, a stronger U.S. economy and Congress addressing the "Fiscal Cliff" issue.

In retrospect, the S&P 500 bottomed last October 3rd and rallied 28.1% through April 2nd of this year. It then corrected by 9.9%, bottoming in early June. The rally through the balance of the month left the S&P 500 up 8.3% through the first six months.

A market correction of less than 10% and an advance of over 8% year-to-date do not seem to reflect a great deal of concern when you consider that the stock market is one of the best lead indicators.

Furthermore, the European composite indexes were also higher, but constrained only by the usual suspects, Italy, Spain, Portugal and Greece. The fifth little piggy, Ireland was actually up 5.46%.

<u>Europe</u>

So, what about the main concerns? Let's start with Europe.

Sovereign debt issues recaptured the headlines on May 6th after the Greek election resulted in a stalemate that threatened to elect a government that would abandon the Euro. This forced a second election on June 17th which restored the predecessor parties to power. However, in the interim there was a great deal of uncertainty and speculation that again the Euro zone would be forced to dissolve as contagion would spread from Greece through Portugal, Spain and Italy.

To some degree speculators were correct, as Spanish banks fell victim to bad loans and a government incapable of bailing them out.

By the end of June, the Spanish government had requested as much as €100 billion to recapitalize their institutions, which set up another confrontation between Germany and other Euro group nations.

Essentially, most of the Euro countries would like some form of joint liability in order to "borrow" Germany's credit rating. Germany, on the other hand, is focused on improving structural measures to control tax and spending. Their strategy has been to incrementalize every major issue to extort a condition for their concurrence. Note that the June 28th meeting was actually the 19th crisis summit.

Yet, Germany remains caught between the proverbial rock and a hard place. Ultimately, they are faced with approving further fiscal transfers or massive defaults and a collapsing economy.

Let me lay out a few facts:

- 60% of German exports do not leave the European Union but contribute 50% to their GDP
    - -Recession in Europe will include Germany.
- German banks have loans to the PIIGS that total €323 billion.
- The Bundesbank also has yet unpaid commitments of:
    - -€22 bn for the 1st Greek bailout,
    - -€211 bn for the European Financial Stability Facility (EFSF)
    - -€190 bn for the European Stability Mechanism (ESM)
    - -€12 bn for the European Financial Stabilization Mechanism (EFSM)
    - -€40 bn for the Securities Market Program.
- Wage settlements in Germany are set to give 2 million public service workers a 6.3% raise over two years, the biggest increase since 1992.

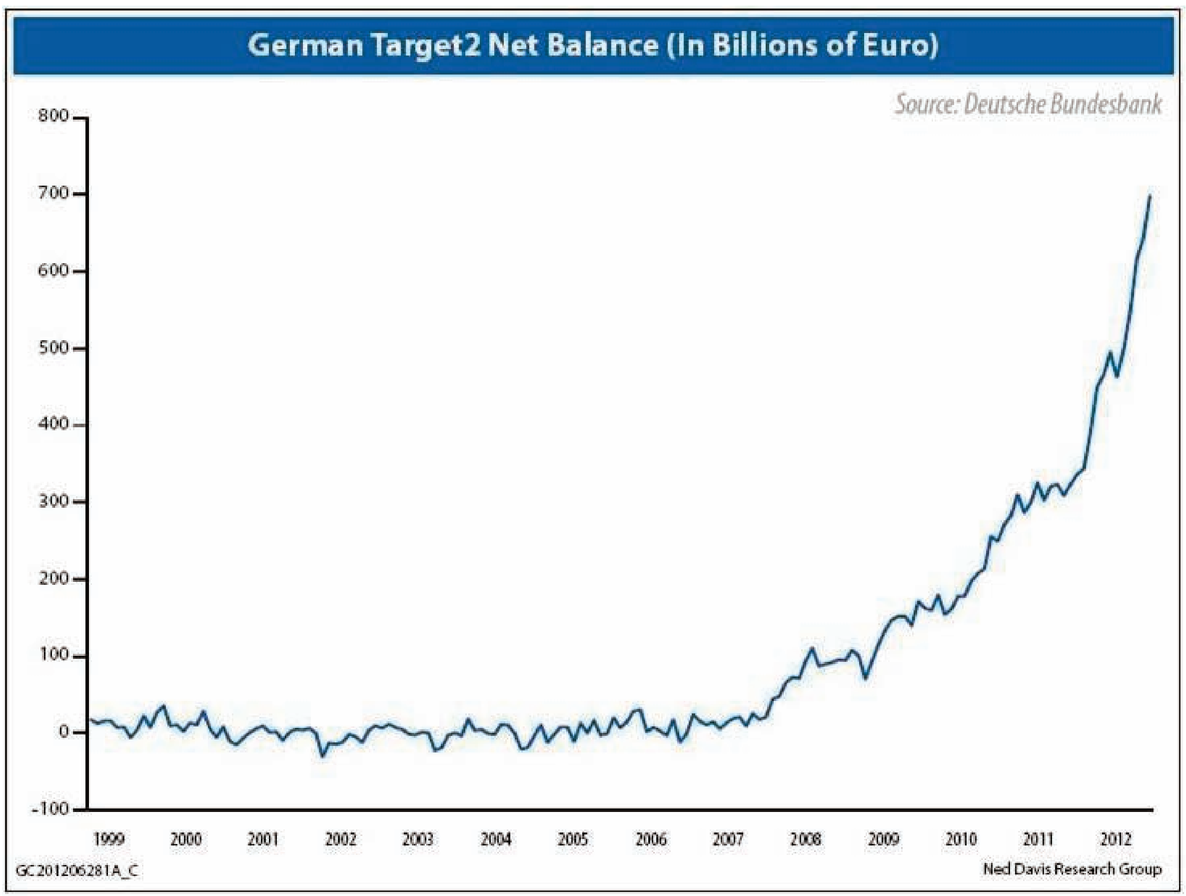
- There are also obligations under the Trans-European Automated Real Time Gross Settlement Express Transfer System better known as Target 2. Although a discussion of this system is going up a notch or two in complexity, it is worth understanding how subtly the Bundesbank is getting drawn deeper into funding some of the other Euro countries.

Target 2 was established to facilitate transfers amongst European banks to settle commercial transactions. However, with the concerns about the Euro breaking up, depositors in Greece, Spain, Italy and other countries are electing to move their Euro deposits out of their home country, say Greece, and re-deposit them in a German bank.

To execute this transaction, the local bank losing a deposit, transfers the funds to their central bank. That central bank then moves the money to the European Central Bank (ECB) electronically by creating a debit on its books and a credit at the ECB. The ECB then forwards the funds, again electronically, to the Bundesbank by creating a debit on its books and a credit at the Bundesbank, which then does the same thing to forward the money to a local German bank. This leaves the Bundesbank with a credit against the ECB, the ECB flat, and debits at the central bank that transfers the funds out of the country.

It's true that the ECB sits on the other side of the Bundesbank note, but then who owns the ECB? Well the obligations of the ECB are the obligations of all 17 Euro participants proportionate to the size of their economy, provided they can pay.

At the end of May, the Bundesbank was owed €699 billion, almost 26% of German GDP.



The ECB held assets of about €3 trillion on paid-up capital of €6.4 billion. Collectively, all the European central banks would be expected to pick up their fair share of a loss.

With at least five Euro members likely to default, it's easy to see where the so called "buck" would stop.

What's maniacal about Target 2 is that it is an automatic transfer system that the Germans have already agreed to. So, as long as they continue to play tough on negotiating with struggling countries, the more money will flow out of the threatened country and into the Bundesbank, further expanding German's exposure to Europe's problems. In public, Germany is against Euro bonds but when you look at what is happening through the Target 2 system, it looks like Europe has already taken the back door into a collective agreement.

In my opinion, Germany can continue its "nein" policy to extort conditions, but when push comes to shove they have no option but to go along with further monetization and bailout programs or risk the collapse of their own economy.

So far, the evidence is on my side that the risk is not a self liquidity debt death spiral but the consequences of reflation. If I'm correct, bonds will not be the asset class of preference, especially not German bunds.

Let's look at the latest changes that were recently negotiated for Spain that sparked the month-end rally.

But first, let's go back to last December when the ECB set-up the Long-Term Refinancing Operations (LTRO). This facility satisfies liquidity needs for the banks as the ECB can lend or buy debt, which it did to the tune of €1 trillion, but it cannot buy equity in a bank. So the facility helps deal with liquidity issues such as banks losing deposits. However, the facility does not help a bank's capital ratio or solvency issue.

To deal with this, we have the EFSF and ESM. They cannot lend directly to the banks or buy equity in them. But they can lend to sovereign governments, which then can purchase equity in a bank.

The problem with this is that lending to overextended countries further impairs their debt to GDP ratio and pushes the rating agencies into further downgrades with its obvious impact on the country's cost of borrowing. It's a vicious circle because lower bond values further impair bank capital.

At first Germany was against the ECB's LTRO program, but eventually relented.

In the case of Spain, which has requested as much as €100bn to shore up their banks, the Germans felt the Spanish government should do the borrowing to recapitalize the banks, thereby setting off this vicious cycle.

Spain is already fighting to get its debt to GDP ratio down and this borrowing, if done by the country would add another 10% to the debt side of the equation and earn them another downgrade. But Germany insisted on extorting further conditions.

At the June 28th leaders summit, there was again a concession before Germany apparently backed down.

The following was agreed to:

- The ESM can provide funding directly to banks without going through the sovereign, which avoids adding further debt to the country's balance sheet.
- Lending to Spain will not subordinate existing bond holders.
- ESM and EFSF will be allowed to buy sovereign debt directly and in the secondary market.

What did Germany extort? Well, none of this can take effect until there is a single regulator of all European banks which will be the ECB. The timetable on this is anywhere from the end of this year to the second half of 2013.

In the meantime, Spain will borrow from the EFSF to refinance its banks, which will weigh on its debt to GDP ratio. However, this borrowing will be shifted to the ESM and become a direct obligation of the banks once central bank supervision is established.

Another baby step, but at least it is in the right direction.

How much more of this are we likely to see? Well, it is suggested that of all the banks that took part in last year's capital stress test, most of the €114.7 bn of the additional capital required has already been raised.

In my opinion, Europe is following a fairly traditional pattern. The first phase is austerity brought on by debt servicing problems which result in economic contraction, falling financial asset prices and worsening debt to GDP ratios. The second phase is monetization of this debt to bring nominal GDP growth above nominal interest rates along with currency devaluation. There are numerous historical examples of this as set out in a report by Bridgewater Associates.

If Europe is on this path, we should start to see more monetization, a weakening currency and some economic stimulation programs. On this last issue, there was a € 120bn growth pact included in the June summit to boost GDP by building highways, railroads and air links. However, the best pro growth strategies will involve deregulating the labour markets and providing incentive to private enterprise. Airbus' recent announcement that they are building an assembly plant in Mobile, Alabama must be a wake-up call.

In the meantime, European economies continue to contract as measured by the Purchasing Managers' Index ("PMI").

The only positive signs were German factory orders which rose 0.6% in May after declining 1.4% in April. Orders from the Euro zone jumped 7.7% and even construction activity improved 3.1%.

Regardless, austerity is not a growth strategy and sooner rather than later, the European focus has to shift towards improving their economy. Until then, the Euro drag is likely to slow economic growth in other regions of the world.

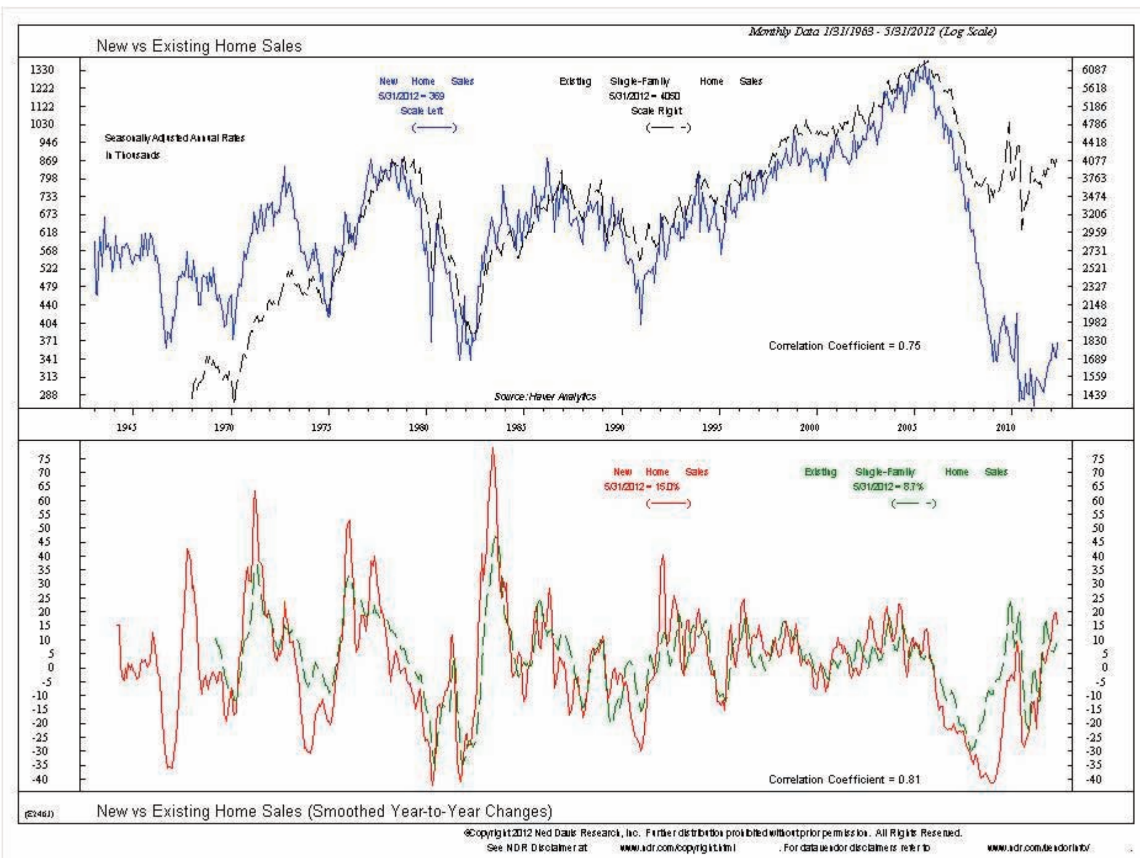
U.S. Economy

Earlier in the year, we felt pretty good about the U.S. economy's growth prospects, but recent results have tempered that enthusiasm.

Lack of new jobs is the biggest disappointment, having declined from an average of 225,620/month in the first quarter to only 75,000/month in the second quarter. However, it still leaves full time employment up about 5.0 million since the cyclical trough.

Other soft numbers include a small decline in May's retail sales, a 1.4% drop in exports, albeit from a record high, and an 0.1% fall in industrial production; the first since July, 2009.

But there are positives that are domestically driven and do not depend on foreign economies. The first is housing. New home sales rose 7.6% in May, that's up in six of the past nine months, 35.2% off the cyclical low in February 2011 and 15% year-over-year. Home building permits also rose 7.9% in May.



New home sales are very important because they relate to construction employment and as that improves so does family formation and consumption, which feeds back into new home construction.

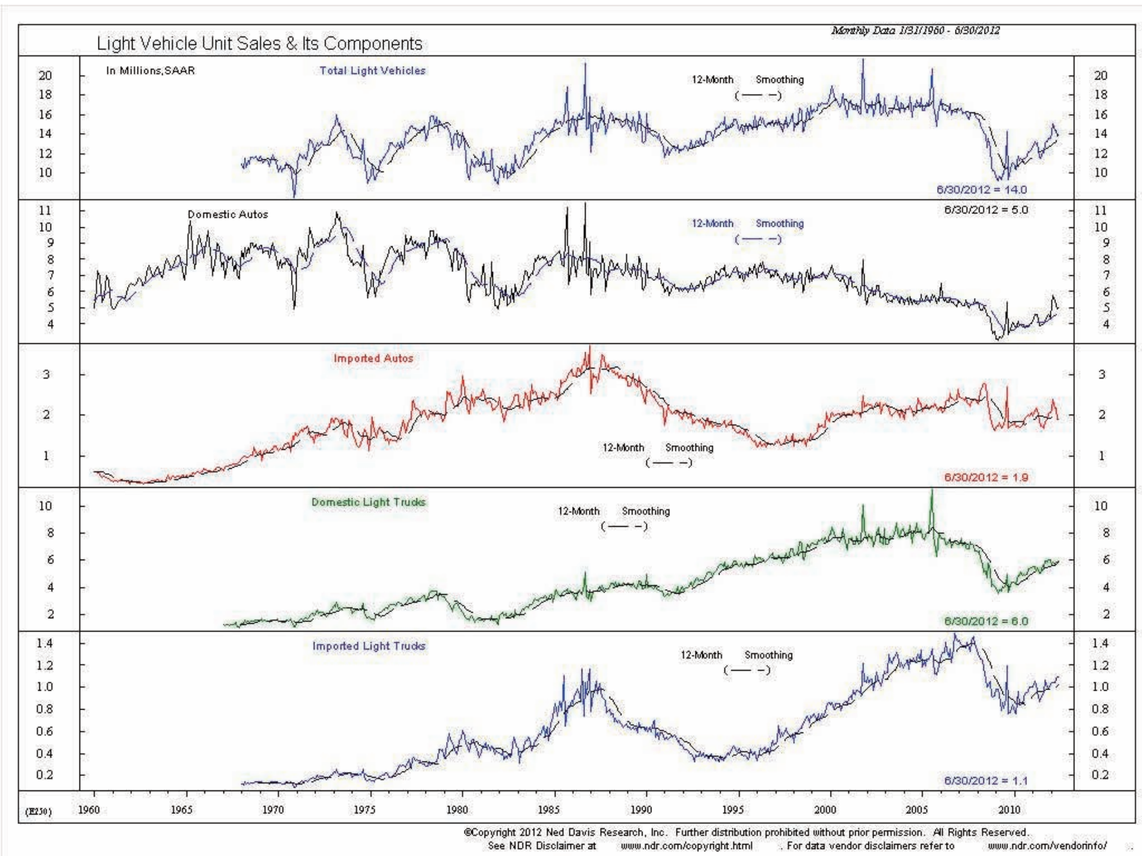
Pending home sales also rebounded in May by 5.9%, the most in seven months, and are now up 13.3% year over year, and the highest in two years.

The “shadow” housing market overhang also seems to be correcting. The number of defaults, auctions and seizure notices sent to homeowners in April totaled 187,780, down 14% from a year earlier and the lowest since July, 2007.

Delinquency rates also fell to 7.4% in the first quarter, the lowest level in three years after peaking at 10.1% in the first quarter of 2010.

Finally, home listings also fell 22% in March to an average of 6.3 months supply, which is almost normal.

The other bright spot is auto sales. In June, they hit 14 million units at a seasonally adjusted annual rate (SAAR).



Sales should continue to be strong as we remain in this early stage of a huge replacement cycle and a new generation reaching driving age.

There are also other positive indicators. Temporary help climbed to a new four year high and the index of aggregate hours worked improved 0.4% to a new cyclical high. In fact, factory overtime hit a 5 year peak of 4.3 hours.

Also, both manufacturing and non-manufacturing business surveys on employment remain relatively strong.

The price of gasoline, which has fallen from $3.90/gallon in April to $3.38/gallon today, is another positive. Each penny of decline equates to an extra $1.0 billion of extra disposable income for consumers.

Although employment growth is slower than what we would like to see, it is still positive. That combined with strong housing and auto sales, wage increases, a longer work week and declining gasoline prices suggests consumer spending could improve.

What caused the slowdown could very well be a confidence issue for businesses concerned over what is happening in Europe given that it seems to be coincidental with the May 6th Greek non-election, which put Europe's fate on hold until the second vote on June 17th, and then Spain's banking crisis which met some resolution at the end of June.

Still ahead are concerns over the "Fiscal Cliff" and China, which will further suspend or defer business decisions.

Fiscal Cliff

I won't spend too much time on this other than to outline the issue.

On January 1st, the Bush tax cuts will be repealed. It will result in the top individual tax rate climbing to 39.6% from 35%, capital gains rates increasing from 15% to 20% and dividend taxes dramatically expanding from 15% to the ordinary tax rate, (i.e. 39.6% at the top end).

For those making over $200,000 per year or $250,000 for couples, you can add 3.8% to each of these increases to cover Obama's Affordable Care Act. So, for top earners the tax rate on dividends could go from 15% to 43.4%, for a 289% increase.

Also, long term unemployment benefits would end as would the accelerated depreciation allowance for capital spending.

Automatic spending cuts would also kick in amounting to $1.2 trillion. These would be spread out over 10 years with $500bn coming from defense spending and $700bn from non-defense.

The Congressional Budget Office estimates that this would reduce the Federal budget deficit by 5.1% of GDP between calendars 2012 and 2013. GDP growth is estimated to drop to 0.5% next year with a 1.4% contraction in the first half and an expansion of 2.3% in the second half.

Other estimates are for as much as a 4% contraction in 2013.

The betting line is that nothing gets done before the elections and then there would only be eight weeks following the election for a lame duck congress to resolve the issue.

So, it is not unreasonable for businessmen to be concerned over the stalemate and potential outcome.

My opinion is that we can probably count on the U.S. Congress to do what they do best – nothing and defer the January 1st effective date to allow the new congress to take up the problem.

Earnings Season

Another concern for the market is the earnings reports for the second quarter. With the turmoil in Europe and weaker economic statistics, analysts have cut their estimates by 3.3% between April 5th and July 5th. We won't know how much the past quarter's earnings have been impacted for another couple of weeks but negative surprises are getting baked into stock prices. Maybe more of a concern is the forward looking guidance that most companies will provide. There's a high likelihood they will remind us of how bad things are in Europe.

China

The last negative for this market is economic growth in China which is still reasonably strong compared to other economies but soft relative to expectations.

For a fact, growth has slowed but it has left forecasters divided between those that see the economy as a house of cards that is about to collapse and those that see growth resuming before year-end.

From our perspective, we don't know, but doubt the collapse scenario will materialize since the Chinese government has a lot of maneuvering room with both fiscal and monetary policies.

On the negative side:

- China's June Purchasing Managers Index fell to 50.2, just above contraction
- GDP growth has slowed to 7.6% in the 2nd quarter from 8.1% in the 1st quarter
- Real estate sales and prices were down
- Steel and cement shipments are lower as is the stock market
- Coal stock piles are up 40% in the year
- Production of electricity was flat year over year in June
- Others estimate that it will take a further drop of 28% in private housing starts to get supply back in line with demand
- Estimated bad loans in the banking system could amount to as much as $1.0 tn versus GDP of $7.5 tn.

Positives would include:

- A sub-index of new orders that includes freight, retail and building rose in June
- Another sub-index for the property sector rose to its highest level since December, 2010 while the new orders component rose to reverse an 18 month period of continuous decline
- CPI is down to 2.2% allowing for monetary easing
- Tax revenues are up 17% year-over-year
- Private surveys, similar to the Fed's Beige Book, show that retail sales and manufacturing strengthened last quarter and property sales increased
- Retail sales rose 13.7% in June year-over-year
- Urban fixed investment increased 20.4% in the first half
- June exports were up 11.3% year-over-year

• Peoples Bank of China's (PBOC) assets have increased over 170% in the last five years to $4.44 trillion at the end of last year. That compared to $2.87 tn for the Fed and €2.74 tn for the ECB. However, 83% of those holdings are foreign exchange reserves.

The evidence is mixed at best and unreliable at worst.

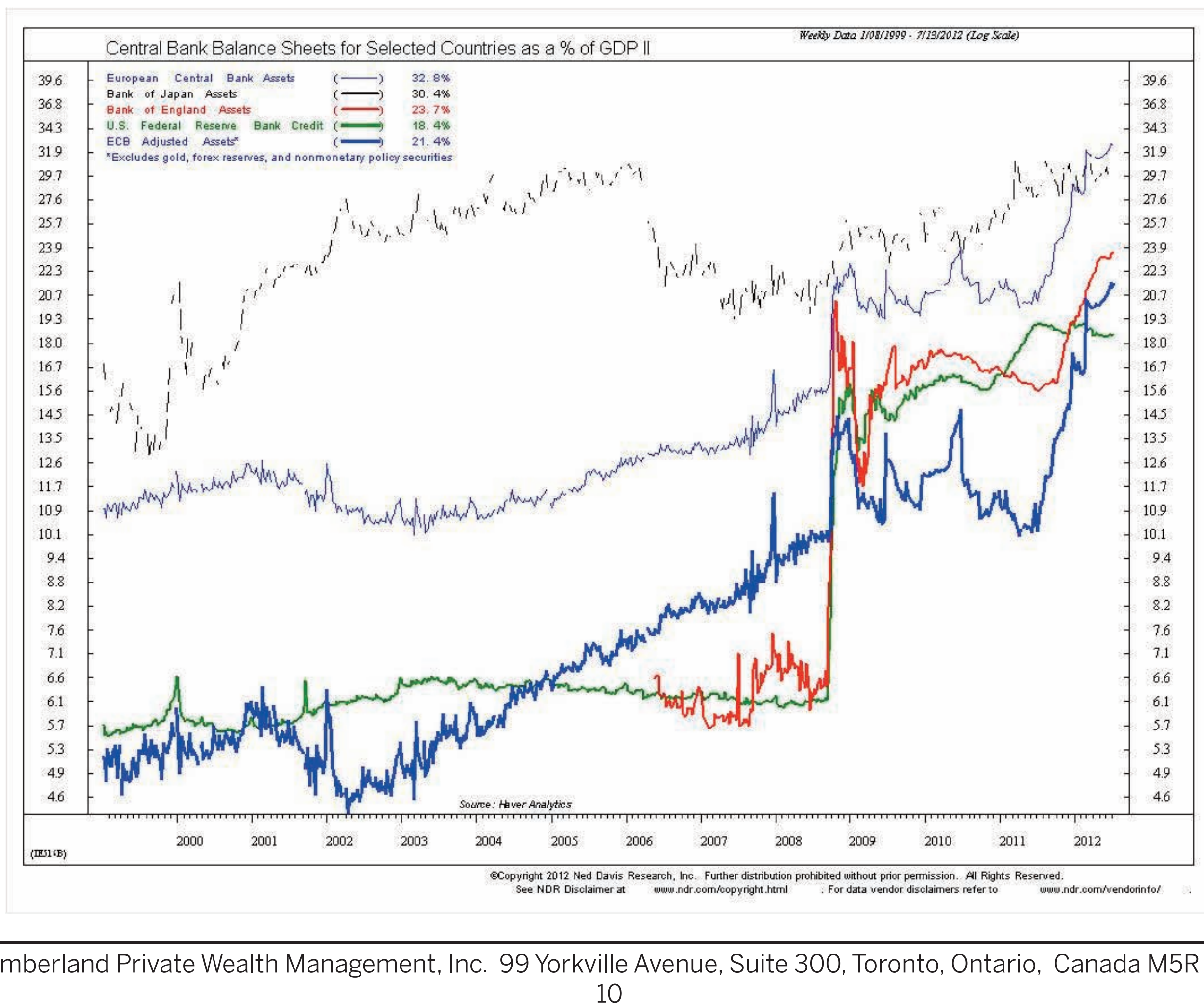
Regardless, China's Premier Wen Jiabao has addressed the problem and pledged that his government would implement more pro-growth strategies. As I noted before, China is one of the few countries that has the wherewithal, to actually effect such a strategy, which tips the balance in their favour.

Summary

There is no doubt that world economic growth has down shifted from the expectations earlier this year. If it continues to falter, it would certainly be a negative for the market.

However, I'm still in the slowdown camp as opposed to believing that we will have a hard landing.

First, the recent economic weakness is relatively mild and mostly induced by uncertainty over the European sovereign debt crisis, "Fiscal Cliff" concerns, global economic growth slowing, especially in China, and the U.S. election uncertainty driven by uncompromising political leaders. A lot of this will start to clear by year-end.



As can be seen in this chart, there has been a huge attempt to reliquefy the system through central bank purchases of assets, which expands their balance sheets thereby reliquefing the system and lowers interest rates.

The ECB recently lowered their base lending rate by 25 bps to 75 bps, the UK launched a 3rd round of quantitative easing, China cut interest rates for the second time in one month, the U.S. extended its "Operation Twist" and Brazil cut its benchmark rates by 50 bps, its eighth straight cut.

There is no doubt that monetary conditions are very favourable for investing.

Nevertheless, I think we all suffer from financial news myopia and go from headline to headline without stepping back for perspective. A recent article in *The Economist* had an in-depth look and concluded that the U.S., has improved markedly in the last three years.

Housing prices are sharply lower and are among the world's most undervalued.

American banks have written off debt and raised equity faster than their peers and are now some of the best capitalized in the world. They note that Citigroup alone has flushed through some $143 billion of loan losses; no Euro zone bank has set aside more than $30 billion.

U.S. exports are surging and have reduced the trade deficit from 6% of GDP in 2006 to about 4% today.

And net imports of oil are on track to be the lowest since 1995, as gas and oil from shale deposits increase.

You can add to that a study by the Hackett Group that found that U.S. companies are exploring an option to reshore nearly 20% of their offshore manufacturing capacity as the cost gap between the U.S. and China has shrunk by nearly 50% over the past eight years and is expected to be at only 16% by 2013.

And the big hope is that the November 6th election in the U.S. will give Congress the mandate to dramatically reduce the government deficit along the lines of the Simpson Bowles plan.

Given the disparity in valuations between bonds, real estate, gold and equities, I still favour high quality stocks. The exact timing is always a challenge but as the year end approaches I think the investing landscape will become clearer and the uncertainty causing investors to sit on the sidelines will dissipate in favour of a higher market.

GRC/amh
July 4, 2012

CREDITS: Bridgewater Associates
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