CUMBERLAND

"Nothing to Worry About"

Whew, that was close. There for a while I thought the politicians in Washington might actually come up with a resolution to the "fiscal cliff" and eliminate the last of the big macro issues that we faced in 2012.

Fortunately, they managed to "kick the can down the road". Yes, they did deal with the revenue piece of the puzzle by increasing taxes on individuals earning more than $400,000 annually and eliminating the 2% payroll tax cut which will hit everyone. So don't kid yourself; this won't help the economy, but it won't push it over the cliff either.

On the spending side, there was no agreement other than to defer the discussion on "sequestration", mandatory spending cuts, for two months. To make these negotiations a real donnybrook, the Federal debt ceiling will be under consideration given the U.S. Government hit its limit this past December 31st , but the Treasury can juggle the books without difficulty until about mid-February. Remember August of 2011? That fight resulted in the U.S. debt rating being downgraded from AAA to AA+ and the market dropping by about 18%.

So, now we have at least something to worry about in 2013. Why would I worry if there was nothing to worry about?

Well, last quarter I wrote about a basic investment principle, that everything eventually regresses back to the mean. Nothing goes up or down forever and that "fear" was about to give way to caution and maybe eventually optimism. This quarter, I want to introduce another investment principle. Most investors understand that the market discounts the future. It doesn't reflect current conditions. That's one of the reasons economists generally are not good investment forecasters. Current economic conditions do not necessarily reflect the market's trend. It's why markets can do well while the economic news is lousy as the market generally looks ahead six months to a year.

However, to be a successful investor doesn't require a crystal ball. After all, no one can predict the future. Maybe Warren Buffet put it best when he said that "God made market forecasters to make fortune tellers look good."

All the forecasts made for the future at this time of the year are interesting but not generally very accurate. What is more important is to determine which and how much of a forecast is already "priced in".

As an investor, I think of myself as a contrarian, believing that things will eventually regress to the mean. But also as a bit of a skeptic, you have to be a little cynical in order not to get caught up with the crowd.

So if the market is discounting a highly unknowable future, a successful investor has to try to determine how much of that future has already been factored into the stock prices. All of it, or is it just getting going? What if the market is entirely wrong, and this doesn't just apply to positive outcomes? Negative expectations are often great buying opportunities once the worst case has been built in. In the last couple of years, Europe's sovereign debt problems have been thought to be the financial apocalypse. The market factored it in a couple of times but it didn't happen. Properly handicapping or knowing what's priced in, can either keep you out of trouble or present an opportunity. For instance, the good news happens but it's already fully discounted – there's no upside left, or the good news doesn't materialize and the market sells off. You've seen this when XYZ reports a 20% earnings improvement. Pretty good news. Trouble is the market priced in 30%. Now you're looking at a loss. And conversely, how often have you seen a company report absolutely horrible earnings but the share price goes up because the earnings weren't as bad as everyone thought they would be?

So what's this got to do with my comment on the upcoming year? Well, first it gets me off the hook on trying to make any forecasts. The reality is that which will impact the market the most, is that which isn't anticipated. Donald Rumsfeld's "Unknown, Unknowns". And second, those big "macro" issues that have dominated the headlines over the last several years seem to be losing their impact. It is resulting in lower market correlations but it's also harder to know what the market is anticipating. That's why I was relieved to see Congress leave us with a big issue to get focused on. At least that way I'll know what's being discounted.

So, let's look quickly at last year. The year started off well enough until Greece had a misfire on a national election and the specter of withdrawal from the European Monetary Union again became an issue. Then Spain put up its hand to request €100 billion to bail out its banks.

Not to let Europe hog all the headlines, U.S. economic numbers got soft and China looked like it might have a hard economic landing which would have been bad news for commodities for sure.

To finish off the year, we witnessed the U.S. election that mercifully put an end to all the campaigning and the countdown to the "fiscal cliff", which if unresolved would surely have pushed the U.S. economy into a recession.

That's enough bad news to keep any rational investor on the sidelines. But that's my point. If the worst happened who would be left to sell? If the worst didn't happen and it didn't, then there was reason to change one's attitude from cautious to something more optimistic. And, that is what happened throughout the world. Just look at this sampling of investment returns from last year.

Country	% Gain
United States (S&P 500)	13.52%
Canada	4.34%
Europe	15.17%
Germany	25.24%
Italy	6.93%
Ireland	2.24%
Portugal	-2.22%
Greece	-2.35%
Spain	-4.76%
Pacifi - ex Japan	17.38%
Japan	18.85%
India	27.86%
Venezuela	302.80%
Egypt	50.80%

But, the biggest winner would have been Greek ten year bonds where yields dropped from 43.9% in March to 11.73% after Standard and Poors surprisingly raised their credit rating 6 notches to B-, stable. Not too many saw that one coming.

So much for last year's worries. They could come back, but right now they're lost on page two of the financial rags. Temporarily out of sight and out of mind. What are the odds that they resurface? Well, looking at some of the facts, things seem to be getting better, so maybe the worst is behind us.

Europe

The fix was put in last July when Mario Draghi said the European Central Bank (ECB) would do whatever it had to do to keep the Euro together. That was the first time a "lender of last resort" with enough fire power to be effective stood up and made a commitment. So far it seems to have worked, but as I've said in other quarterlies, it is only one element in turning things around. What is now required is a growth strategy, especially by the most affected countries, to bring their debt to GDP ratios back to sustainable levels.

Slowly there is evidence that things are turning. The Markit Eurozone PMI Composite rose for the second consecutive month to a nine month high in December.

Germany:
- December economic expectations surged 226 points, the 5th largest gain ever.
- October factory orders rose 3.9%, the biggest jump in nearly 2 years.

Spain:
- Labour overhaul has made it cheaper for companies to fire workers, reduce severance pay and prevent unions from maintaining wage deals made earlier. Since 2009, labour costs have declined by 7%.
- The auto industry is returning due to competitive labour costs at €20.60/hour compared to €30.10/hour in Germany and €34.20/hour in France. This is helping to eliminate the current account deficit that amounted to 10% of GDP. Spain is now forecasting a surplus this year, the first since joining the Euro zone.
- Other countries are following Spain's example to become more competitive.

Italy:
- Has eased rules on firing workers and opened up industries previously closed to competition.

Greece:
- Ran a current account surplus in July of €642 million.
- Cut minimum wage by 22%.

Portugal:
- Has cut the number of national holidays.

PIIGS:
- They are generally on track to run current account surpluses in 2013. Ireland's current account surplus soared to 9.2% of GDP in 2012.

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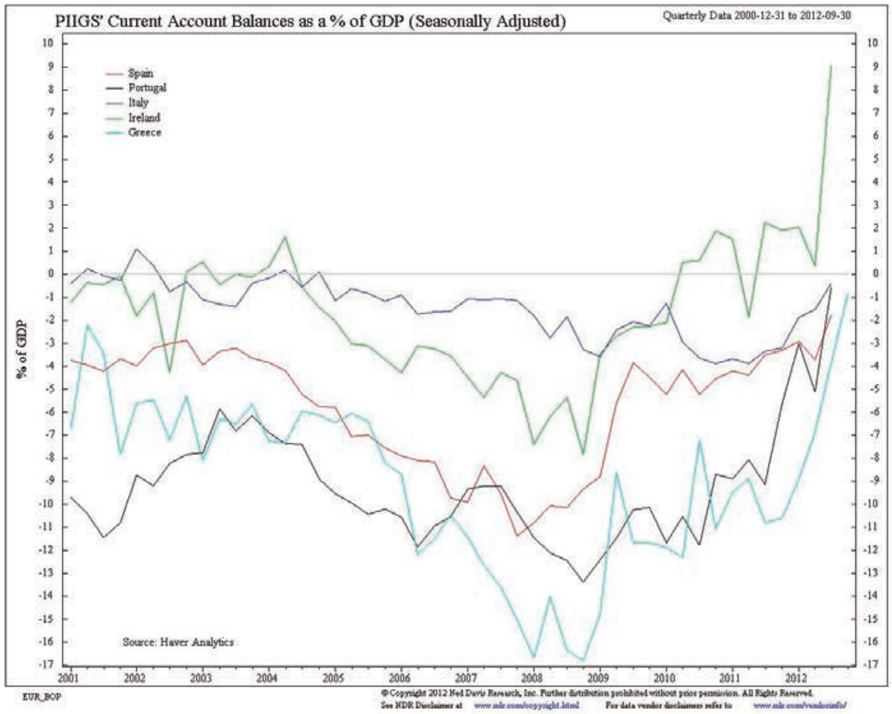
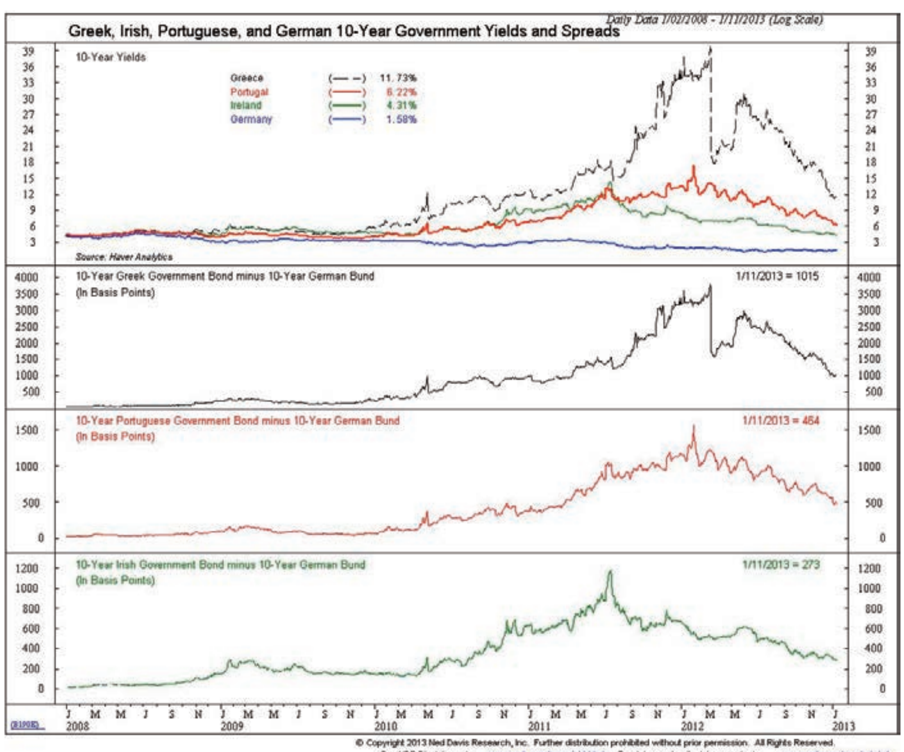
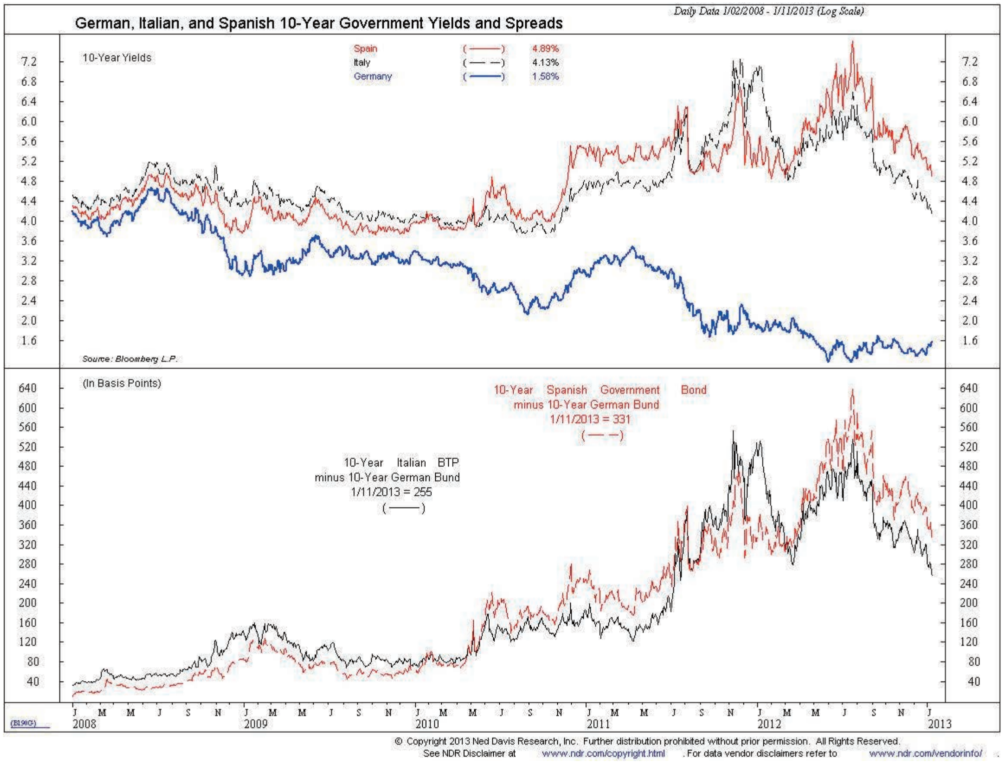


Commerzbank AG's economist estimates that these countries, except Italy, have eliminated more than half of their labour cost disadvantages relative to the region's most competitive economies.

Sovereign debt costs are declining





As can be seen in these charts, the cost of debt has collapsed for Greece from 43.9% in July to 11.73% currently and for Spain from 7.61% to 4.90% over the same period.

This should help those economies. The flight of capital as represented by those spikes in the interest rates, resulted in higher bank lending costs. To maintain deposits, banks had to raise interest rates.

As an example, Banco Santander lost 6.3% of its deposit base in July last year. Banco Popular Espanol S.A. lost 9.5% and Eurobank Ergasias S.A. in Greece, the country's second largest bank, lost 22% of its deposits in the twelve months ended in March last year.

This has pushed the cost of a consumer loan to 8.2% in Italy and 7.35% in Spain versus 4.5% in Germany.

The ECB is betting that bringing sovereign debt costs down will also reduce bank borrowing expenses and therefore consumer loan charges.

Our outlook for Europe is that the economy is still weak, but there is a good chance that a recovery starts this year. Austerity has about run its course and growth measures will start to take hold.

<u>Asia</u>

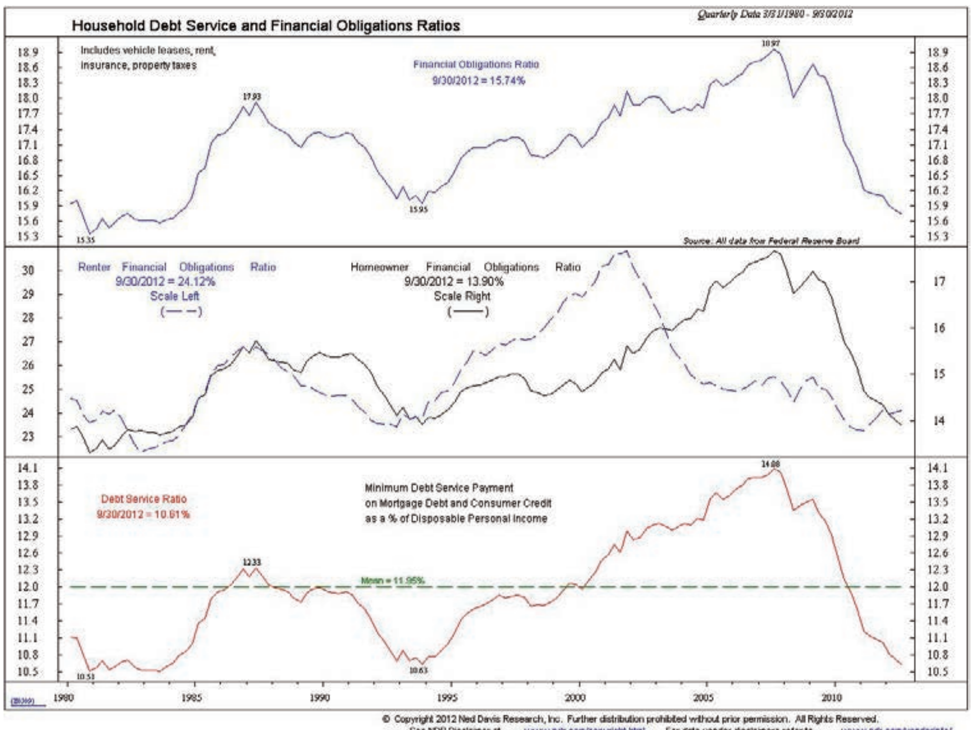
China:

- New leadership has said its goals are to increase imports and speed up urbanization to boost domestic consumption.
- November PMI rose to 50.6, the highest in 7 months. Anything over 50 represents positive growth.
- The country plans to raise its budget deficit by 50% to 1.2 trillion Yuan to stimulate domestic demand.
- Industrial profits accelerated by 22.8% in November, up from 20.5% in October and 7.8% in September.

Japan:
- In December, the country elected a new Prime Minister, Shinzo Abe, who pledged a massive spending program. He also promised to drive down the value of the Yen to make exports more competitive.
- The new government is pressuring the Bank of Japan to provide unlimited monetary easing and the bank is considering adding $1.2 trillion to its asset buying program.

North America

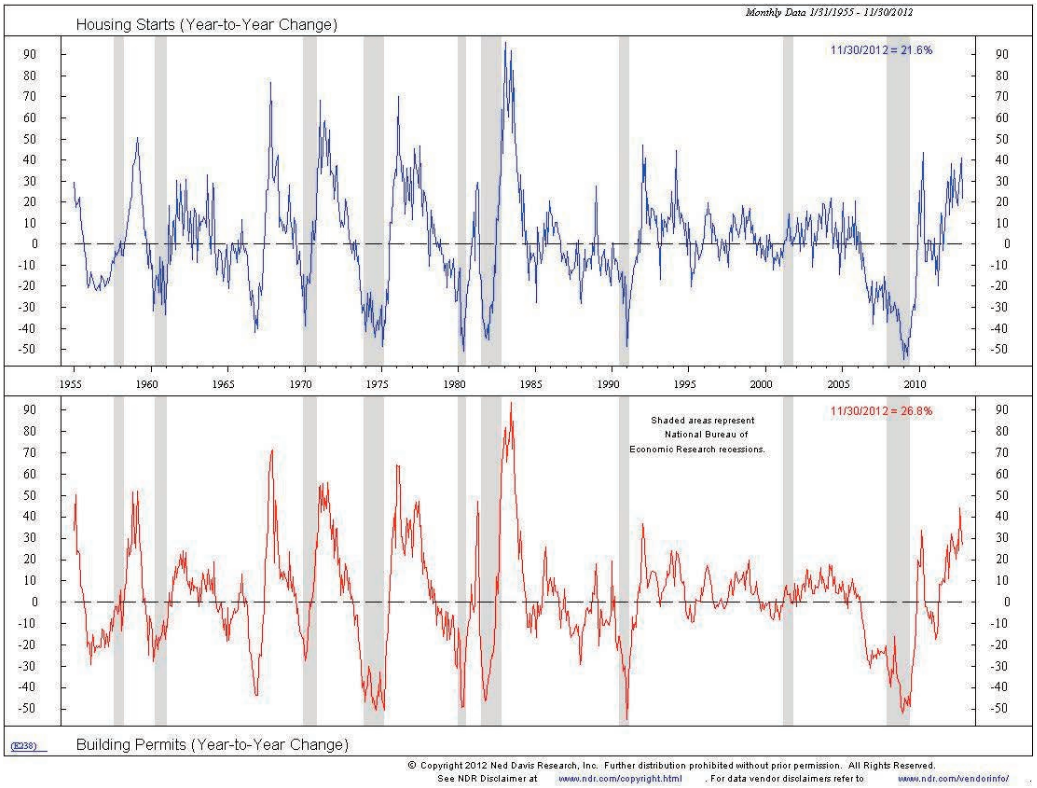
- Payrolls are expanding and jobless claims continue to decline.
- As I've said in earlier quarterlies, I'm intrigued that two early cycle industries, namely autos and housing, are now driving the economy. Why the delay?



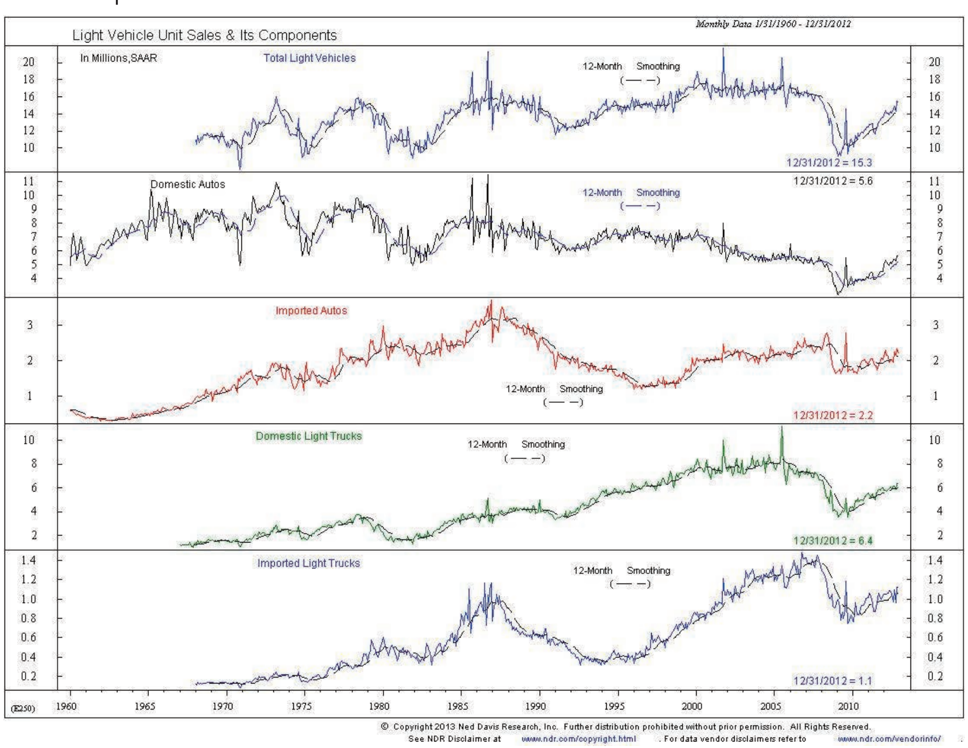
Maybe this chart will help explain it. The financial obligation ratio in the top clip measures the carrying cost of a home, consumer credit, auto lease, etc. compared to disposable income. One can see the peak of the credit bubble in 2007 and the progress that has been made to bring that debt under control.

These ratios are now back to levels seen in the early 1980's and consumers are finally feeling comfortable enough to again take on new debt, which is usually required to purchase a home or auto as they're big credit items.

A Bloomberg survey of 15 economists estimates that existing home sales will increase 7.2% this year to 4.98 million units, which would be the highest since 2007. Prices are expected to increase 3.3% after a 4.5% jump in 2012. They see the inventory of new homes at its lowest level in half a century.



Housing starts, the top clip of this chart, are at an 861,000 annual rate, up 21.6% year over year, while building permits, shown in the bottom clip, are close to a four year high. Still new home sales are only about one third of what they were at the peak in 2005.



Auto sales are similarly recovering and are running at a 15.3 million units, as seen in the top clip of this chart.

This is the highest sales level in five years and is being driven by affordability and pent up demand, as the average age of vehicles on the road is eleven years old.

Projections are for a further 7% increase in sales this year.

Furthermore, industries create jobs.

Combining these with some of the long term factors I mentioned in my last quarterly, such as energy self-sufficiency and the return of manufacturing to the U.S., it is very possible that the U.S. is in a sustainable recovery.

Will the residual fight over spending costs from the "fiscal cliff' push the economy back into recession? I doubt it. Slow growth probably, but I'd still bet things are on the mend.

<u>So, What about the Market</u>?

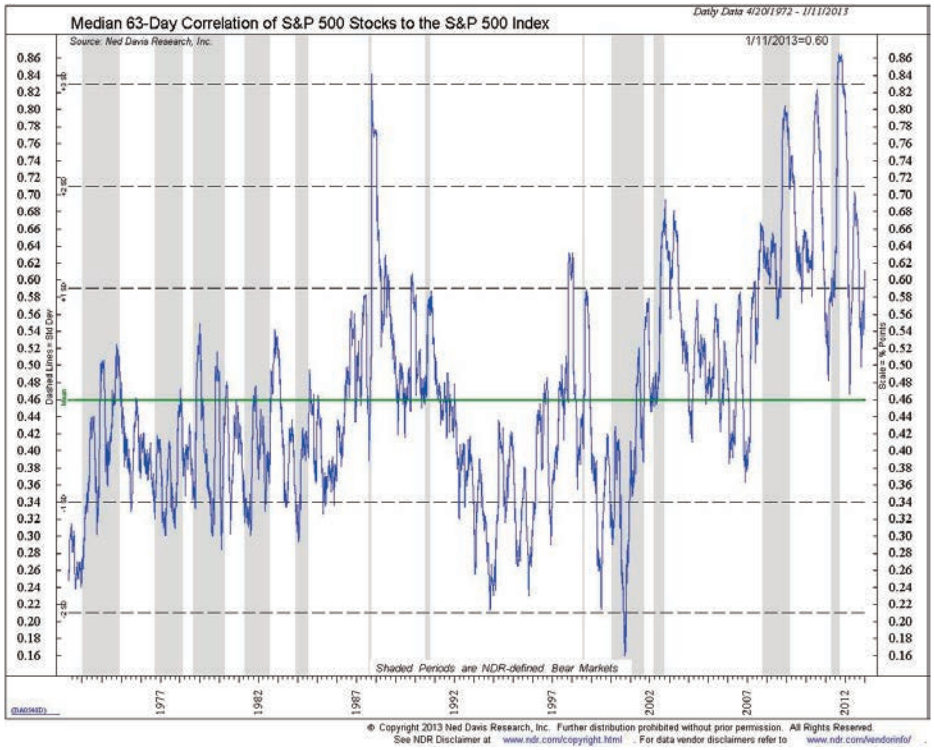
I think the market will work its way higher this year because volatility will decline, earnings will improve, valuations are reasonable and liquidity is overwhelming.

However, the volatility issue is probably the most important concept and ties into the lack of macro issues that I mentioned earlier. Yes, there is still the spending side of the "fiscal cliff" and maybe we will face a showdown over the debt ceiling as we did in 2011. But I think the market has learned some lessons from that experience and so have the politicians, so it's not likely to be as painful this time.

But without big macro issues to focus on such as the European sovereign debt crisis or the "fiscal cliff", it's difficult to get highly correlated beliefs which result in extreme volatility. And frankly, volatility scares the hell out of investors. They'd rather earn nothing on their investments and get their capital back than go through another 2008 experience.

So how do correlated beliefs work? Woody Brock, an Economist and strategic thinker that we've used for over twenty years, defined it this way: "A 'correlated' mistake structure is one in which investors share a common forecast that proves to be wrong. An 'uncorrelated' mistake structure is one where investors' forecasts are widely spread out symmetrically around the "Truth" that emerges. When forecasts are uncorrelated and distributed symmetrically around the Truth, then once the Truth is learned, for every seller there will be a buyer and the market price does not change. There is no volatility. In the case of a correlated structure, the reverse is the case: everyone becomes either a buyer or seller in unison, resulting in sharp changes in price".

So, correlation is the highest when there is a common belief and it leads to more volatility. This happens when there are one or two macro issues or big events. When these do not exist, the focus gets dispersed into many smaller issues. For the stock market, the ultimate alternative is a focus on thousands of company earnings reports.



This chart records the correlation of the S&P's 500 individual stocks to the S&P 500 Index going back to the early 1970's. One can see that the correlation is usually less than 50% of the stocks to the index except at extremes, usually near a market bottom. Getting over a 70% correlation is pretty rare.

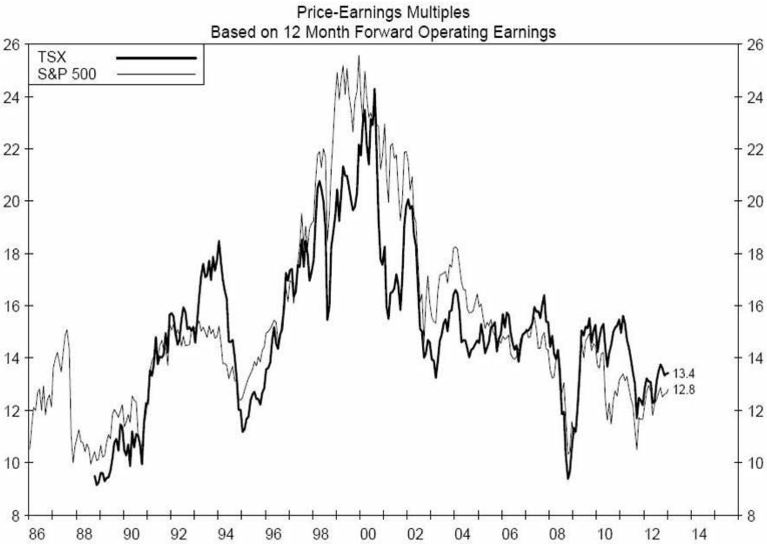
According to Grant's Interest Rate Observer, "In the entire history of the S&P, there has never been a day when all 500 stocks in the index go up or all 500 go down. There have been 11 days when 490 plus stocks all moved in the same direction on a given day. Of those 11 instances, 6 have occurred between July, 2011 and the year-end".

In August, 2011, after the S&P cut the United State's credit rating from AAA, the Dow Jones alternated between losses and gains of 400 points on more than 4 consecutive days, the longest streak on record.

Daily swings in the S&P 500 averaged 1.74% in 2008, the most for any year since the Great Depression. The Index rose or fell 1.58% in 2009, the third largest on record for volatility. In 2011, volatility was 1.24%, the 7th largest on record. While in 2012, volatility was down to 0.59%.

Could it be that volatility is reverting to the mean? If there are fewer big macro issues out there to cause the correlations that result in volatility, then the market might appear to be a safer place to invest. That should be good for valuations, especially when you look at the amount of money sitting in money market funds, deposit accounts and low yielding bonds that earn almost nothing.

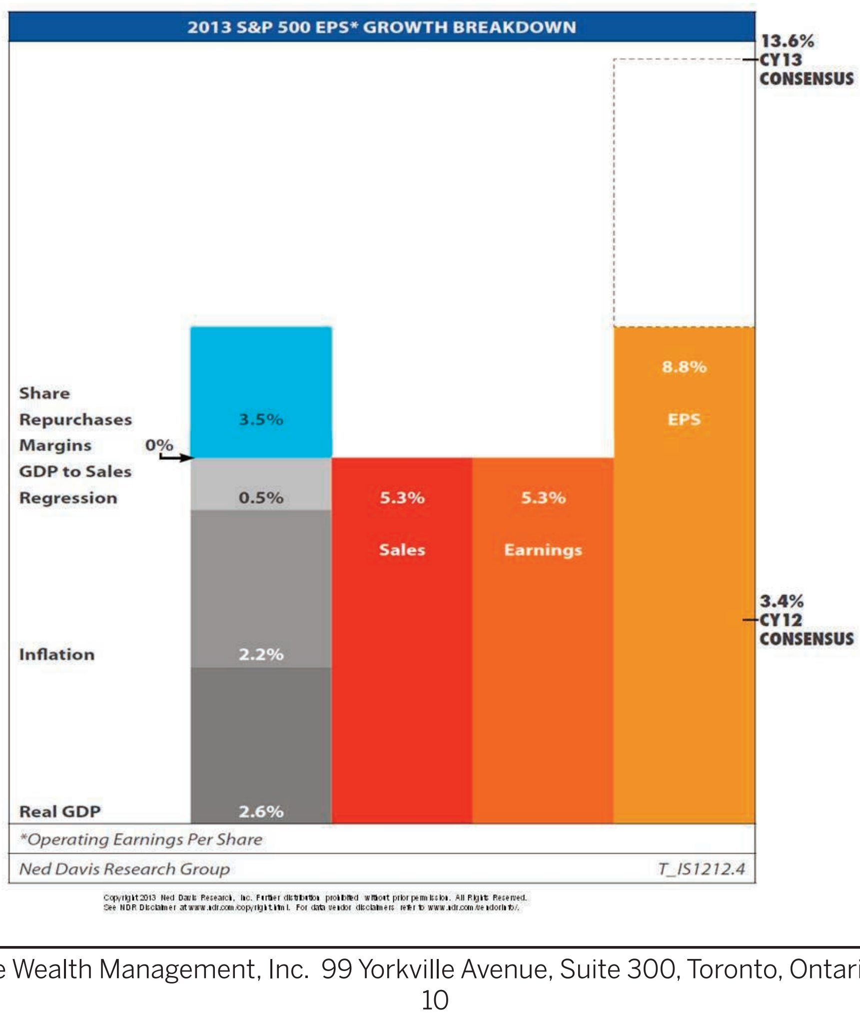
Currently, valuations are reasonable but not as cheap as they might be at a market bottom.



This chart indicates that the S&P 500 is trading at 12.8X this year's expected earnings of $112.99 while the TSX is at 13.4X. Both are well below historic averages, so there isn't too much expectation built in.

However, the $112.99 earnings is a 12.9% increase over 2012 and industry analysts historically start out too high and have to reduce their estimates as the actual numbers come in.

Ned Davis Research did a "top-down" estimate by starting with their economic forecast. It makes more sense to me.



Ned Davis builds their estimates starting with a GDP forecast on the left and then works across to the right side to extrapolate an earnings estimate.

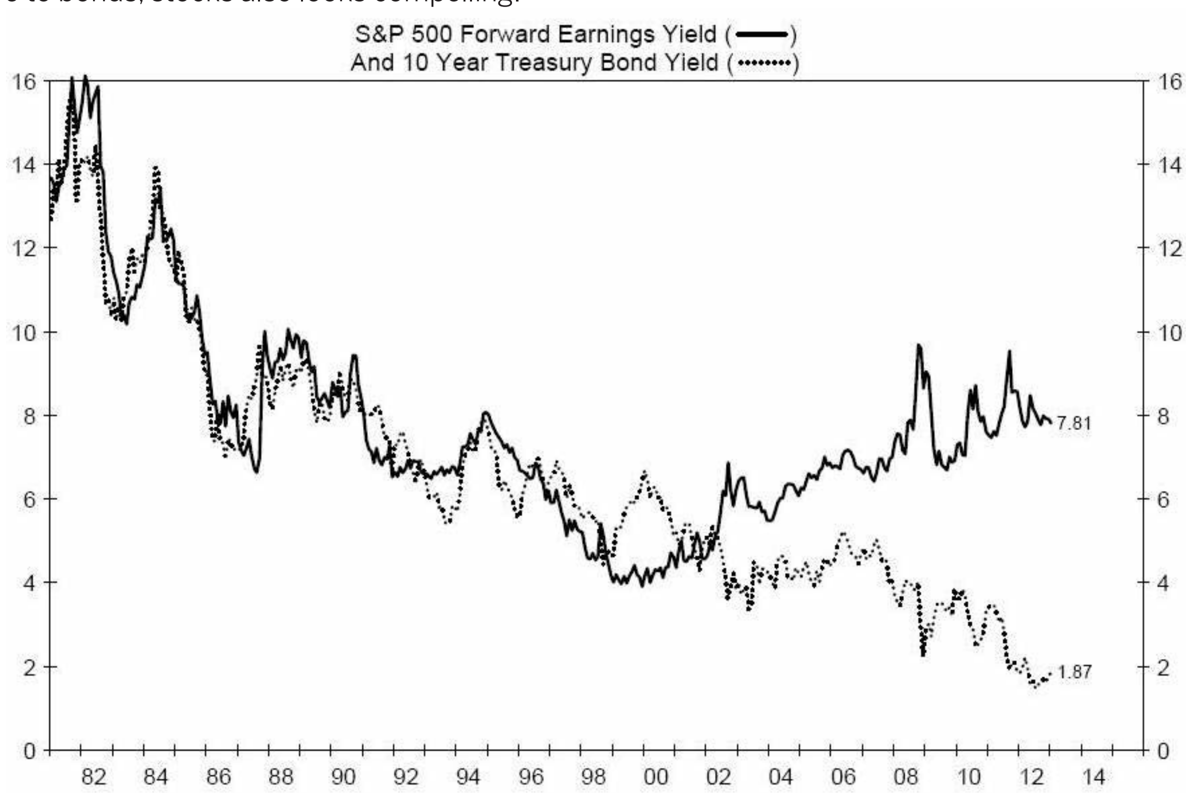
This work-up assumes 2.6% real GDP growth and 2.2% inflation for nominal GDP of 4.8%. Over the past 30 years corporate sales have grown about 0.5% more than nominal GDP.

This gives you an estimated 5.3% corporate sales growth. Operating profit margins are close to their peak so they are assumed to remain flat. Consequently, earnings also grew 5.3%. You then add to this 3.5% to account for share repurchases, which is the average over the last 12 months, to get a total of 8.8% earnings growth for the year.

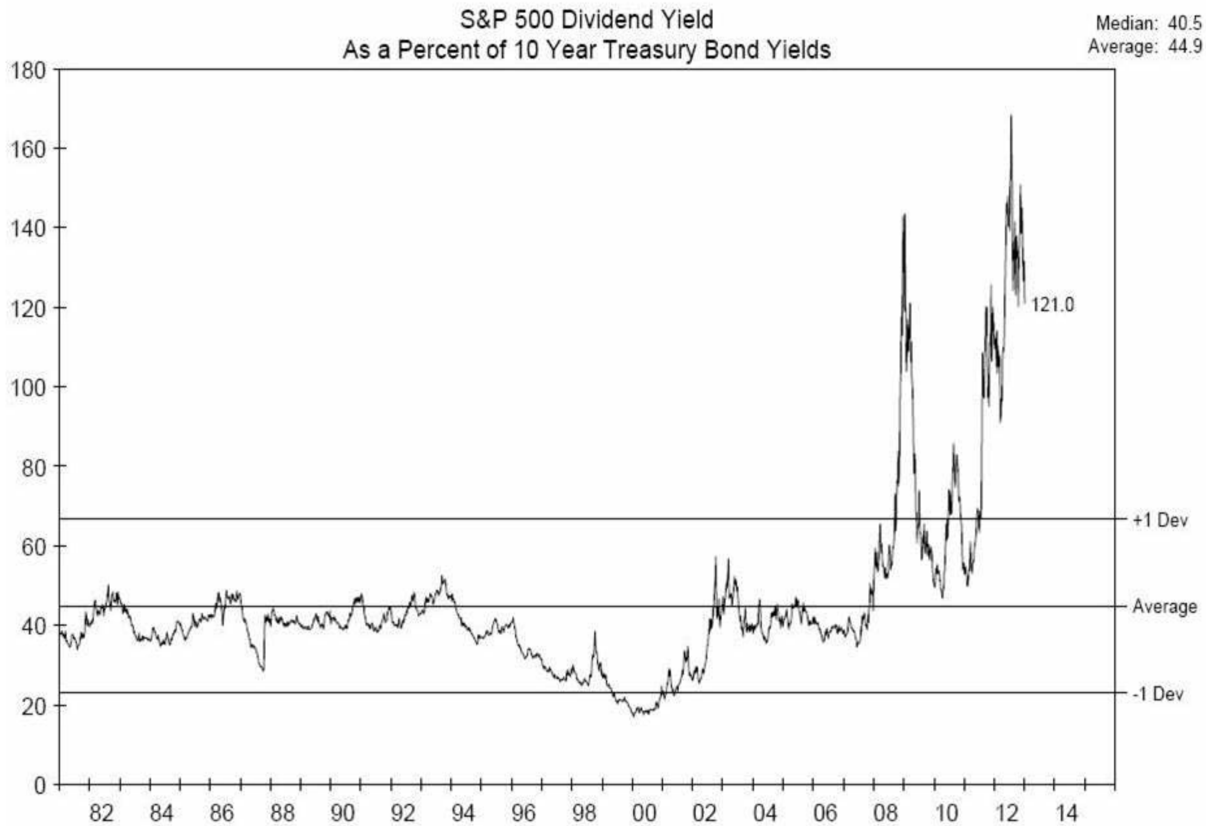
8.8% earnings growth equates to $108/share of S&P 500 earnings.

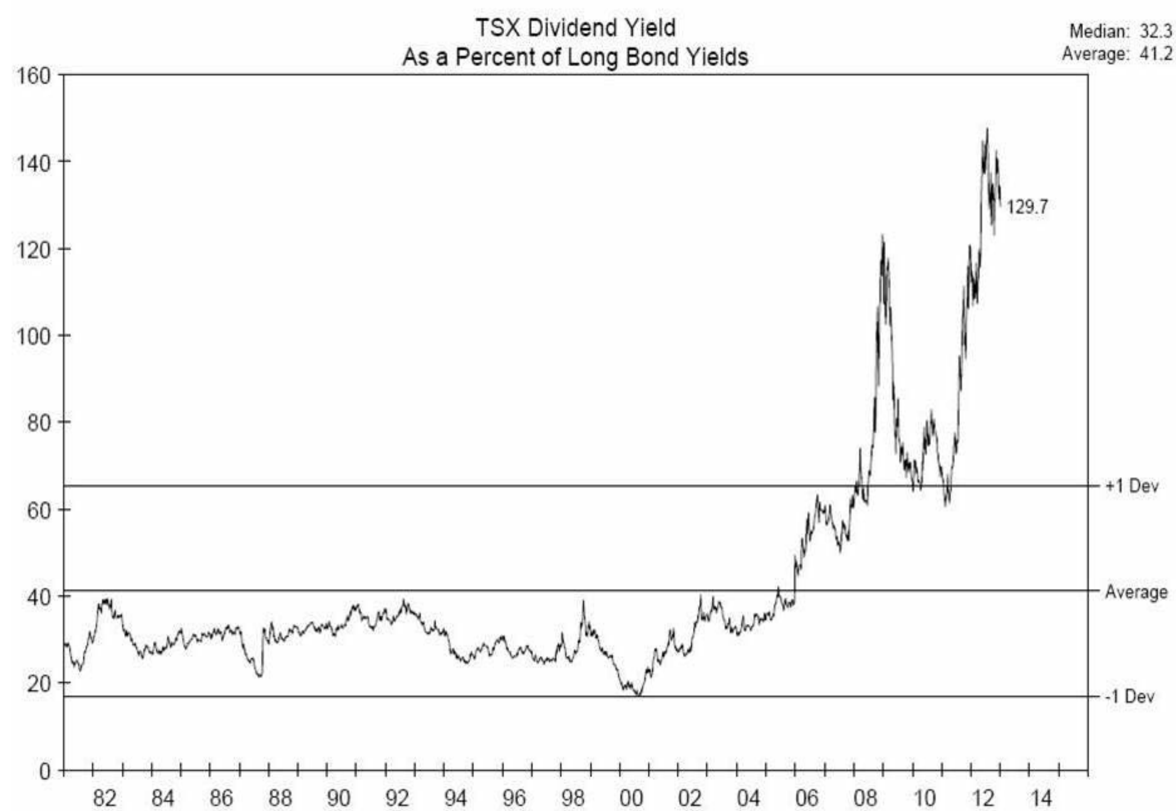
I think you could see price earnings multiples expand to 15X as volatility declines, taking the S&P 500 to 1620 by year-end or 13.59% higher than last year's close. The optimistic $112.99 at 15X would result in an 18.84% improvement.

Relative to bonds, stocks also looks compelling.



We can compare equities to bonds in two ways. The first is the one shown above, which converts a corporation's price earnings ratio to an earnings yield by reversing the equation. In this case, corporate earnings yield 7.81% compared to a government bond yield of 1.87%, which represents a significant divergence since 2001.


S&P 500 Dividend Yield
As a Percent of 10 Year Treasury Bond Yields
Median: 40.5
Average: 44.9
180
160
140
120
100
80
60
40
20
0
121.0
+1 Dev
Average
-1 Dev
82 84 86 88 90 92 94 96 98 00 02 04 06 08 10 12 14


TSX Dividend Yield
As a Percent of Long Bond Yields
Median: 32.3
Average: 41.2
160
140
120
100
80
60
40
20
0
129.7
+1 Dev
Average
-1 Dev
82 84 86 88 90 92 94 96 98 00 02 04 06 08 10 12 14

We can also compare dividend yields to bond yields and once again, we see in the above chart the valuation disparity between the two asset classes.

Bottom line, I think it could be a pretty good year for equity investors, but with a twist. For the last couple of years it was simply a question of whether you were in the market or not. Equities were highly correlated. Last year that started to change. If you owned materials or energy you didn't do too well, but if you owned more U.S. or international equities you did great.

Without big macro issues to focus on this year, I think stock selection and active portfolio management will be the keys to generating returns while an index hugging strategy will generate possibly disappointing results.

GRC/amh
January 12, 2013

Credits: Bloomberg
Grant's Interest Rate Observer
Ned Davis Research Inc.
TD Securities
Woody Brock