CUMBERLAND

Relief Rally or Part of Something Bigger?????

If you're one of Bay Street's perma bears you've got to be pulling your hair out, one client at a time right now.

Things seemed to be going their way last May when Greece returned to the headlines with an election stalemate that threatened their remaining part of the Euro. Spain followed up in June with a request for $100 billion to bail out its banks.

Global economic growth also took a turn for the worse and we saw stock markets around the world take a dive similar to what they had done in the previous two years.

So what happened? The stars had aligned for a real market shake out. But, since the June 4th low, the MSCI European Index – ex-UK had gained 20.6% to its September 14th high. Spain, Greece and Italy, three of the little piggies, are up 31%, 62% and 27.8% respectively. European banks have rallied 33% and even Greek 10 year bonds have more than doubled in price since their May lows.

In addition, the Euro has made steady progress against other world currencies as hedge funds unwound a record, short interest of 214,418 future contracts worth U$33.4 billion.

Currently, 82% of the global markets are above rising 200 day moving averages while 21 of 45 markets are within 10% of their four year highs.

That's a real disconnect from what we read in the news every day. Front page stories repeatedly remind us of the coming "Fiscal Cliff" in the U.S., Europe's sovereign debt mess, China's hard economic landing and a potential Middle East blow-up if Israel attacks Iran.

In past quarterlies, we've tried to put these issues into perspective and give you our own interpretation of the consequences. But for this quarterly, let's put them aside for the time being. Not that they aren't important; they are, and I'm sure we will come back to them at a later date.

However, right now the market isn't focused on these problems, it's giving us a different message. Maybe things just aren't as bad as we feared, but bad nonetheless, which would justify a relief rally. Or, maybe there are some reasons to be encouraged and fear may possibly be giving way to an acceptable tolerance for risk.

<u>What's going right?</u>

<u>Europe</u>

For Europe to finally signal that it has turned the corner, there are three elements of a plan that have to fall into place.

1. There has to be a clear lender of last resort that has deep enough pockets to resolve any liquidity issues. Until recently, a series of bail-out funds had been proposed but no unlimited access to liquidity that could finance weak sovereign governments on manageable terms during an adjustment period;
2. Troubled sovereigns have to put their fiscal house in order and reform the never ending borrowing for social welfare programs. Until this happens, it will be impossible to attract investments to a country that could potentially go broke or change currencies;
3. A credible plan to restore economic growth and reduce unemployment.

On the first point, the fix may be in. On July 26th, Mario Draghi, head of the European Central Bank (ECB) promised to do "whatever it takes" to defend the Euro. Since then, there have been a number of proposals made but none yet implemented. Still, the market has taken Mr. Draghi's comments seriously and certainly he has spoken for the only institution capable of delivery of this challenge.

On fiscal reform, there is painful progress as austerity budgets are met with public protest. This is never a straightforward process and will face several challenges. However, the ECB's pledge comes with strings attached to assure countries remain on a course to responsible government finances.

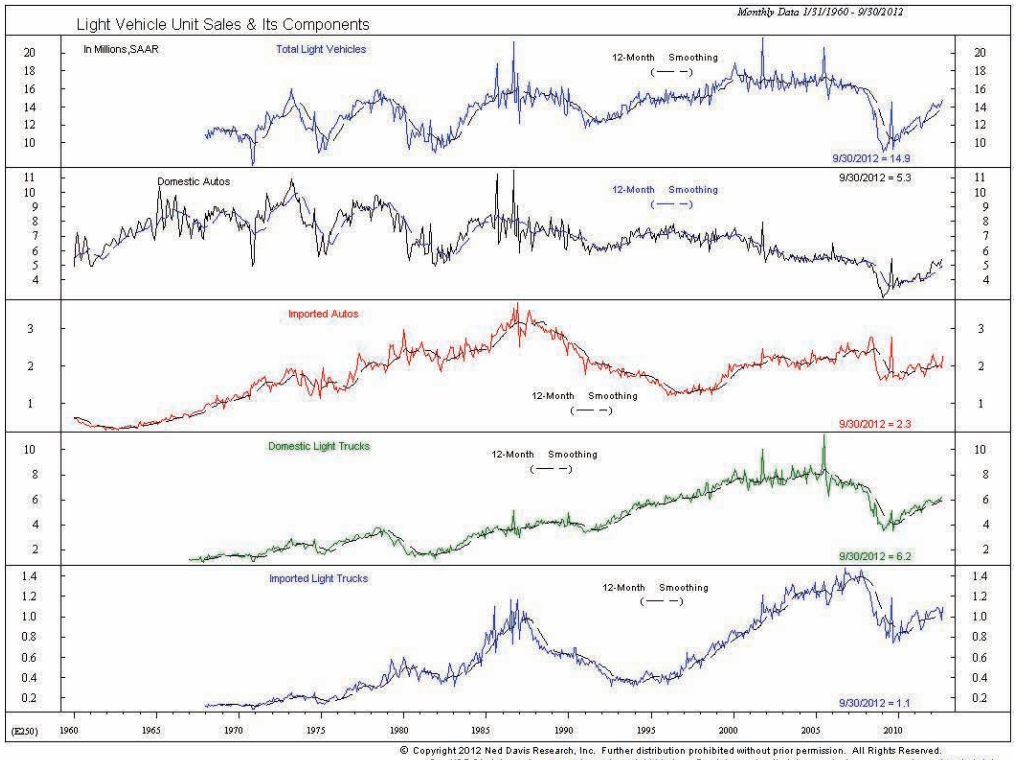
A growth strategy for Europe unfortunately remains elusive. Traditionally governments have three options to stimulate a recovery.

1. Monetary policy – as previously mentioned, the ECB may have just put in a fix to ensure lower interest rates and sufficient liquidity;
2. Fiscal policy – unfortunately this option is unavailable for many of the European countries that are out of money;
3. Regulatory policy – Changes here could enlist the help of major corporations which have the funds to reverse the economic decline. This will require changes to both labour and product market regulations which face the headwinds of 60 years of Euro sclerosis. With the ECB's recent actions, policy issues become the focal point, not monetary policy, and this will require structural changes.

So, on balance, Europe is currently no longer the threat to the world's financial markets that it was earlier this year. Its struggles will no doubt cause problems again for the markets, but for the time being, assurances from the ECB seem to have resolved the fears of a worst possible outcome.

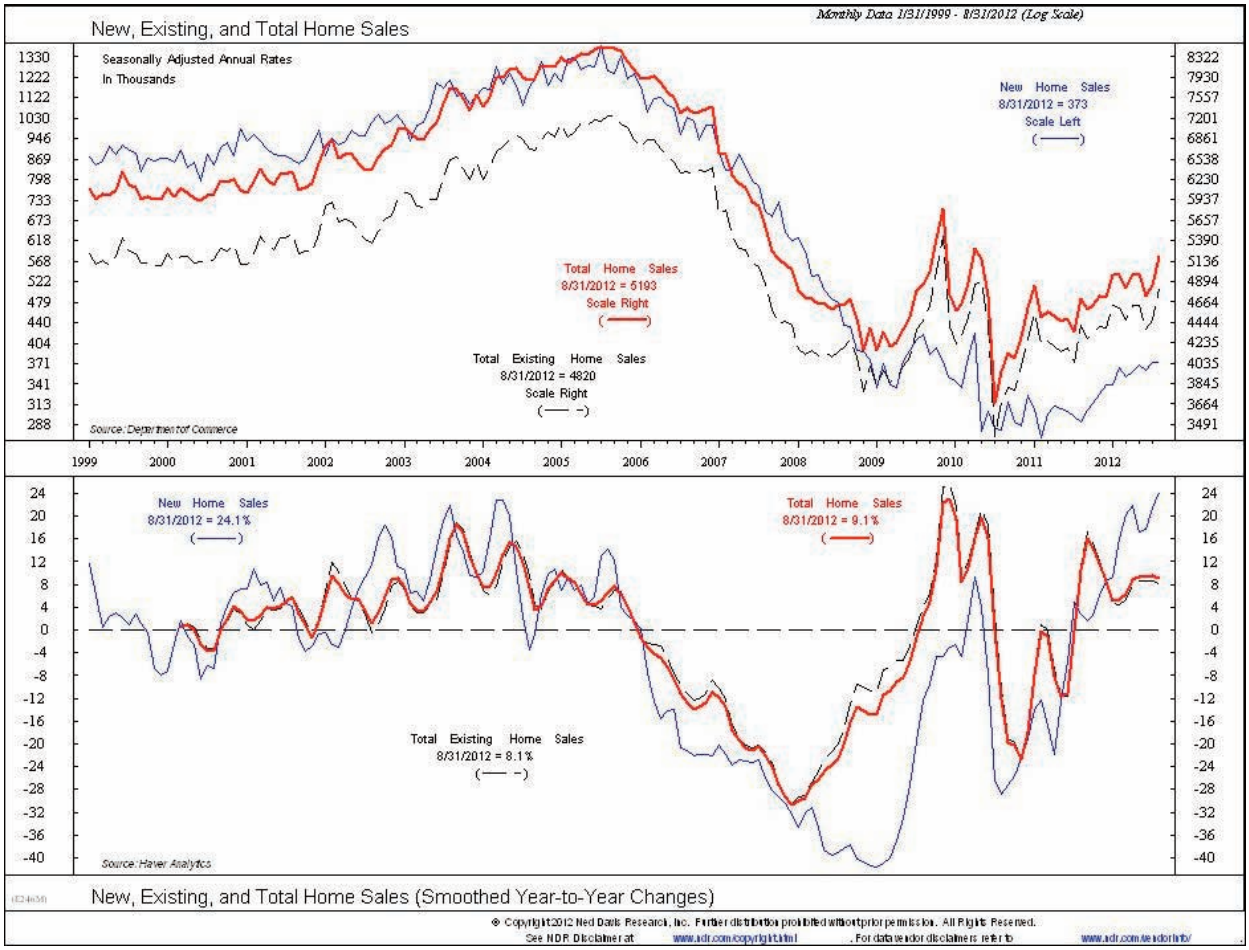
United States

Signs of an economic slowdown have been apparent for most of the summer in the U.S., but I've been intrigued by the recovery in both housing and auto sales. These are generally early cycle economic leaders, meaning that they are usually the first industries to respond to easing monetary policy. But, this time there was a delay as consumers deferred purchases in favour of cleaning up their personal balance sheets. That process isn't complete but there have been major improvements that will support pent up demands, especially for autos.



Auto sales reached 14.9 million units on a seasonally adjusted basis in September and were up 16.5% year over year to the best levels since March 2008, as can been seen in the top clip of this chart.

Sales have now been trending higher for well over a year supported by a replacement cycle for cars that average over eleven years old. So, this should probably continue until we get back to the 16.8 million average which we saw from 2000 to 2007.



Housing sales are also increasing. As seen in the bottom clip of this chart, total home sales improved 9.1% versus a year ago. However, new home sales increased 24.1% during the same period and have a much bigger impact on employment. Apparently, this wasn't lost on the Federal Reserve as its latest bout of Quantitative Easing is targeting mortgage backed securities to keep housing affordability high.

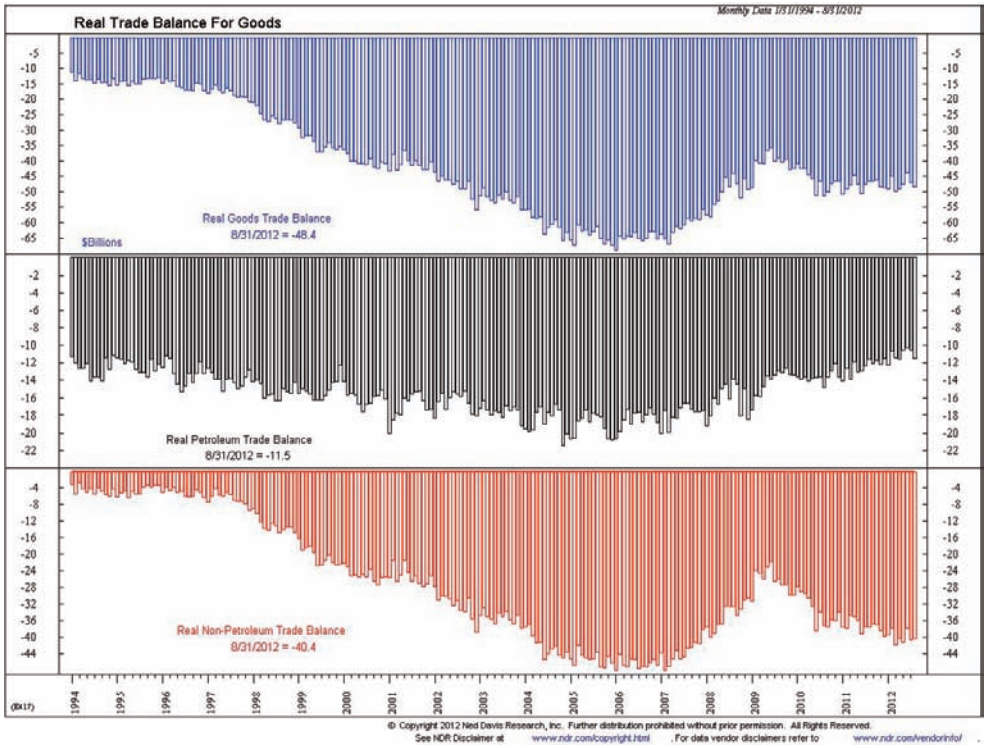
It's also encouraging that the University of Michigan's consumer confidence index just hit a five year high and unemployment is at a four year low.

So, we're inclined to believe the economic weakness that we've witnessed has to do with political uncertainties, especially the Fiscal Cliff which is causing businessmen to defer decisions until there is greater clarity. Although it is unlikely that 2013 can escape any fiscal drag, it is likely that the greatest impact from tax increases and spending cuts will be either deferred or modified to avoid driving the economy back into recession.

Long-Term Progress

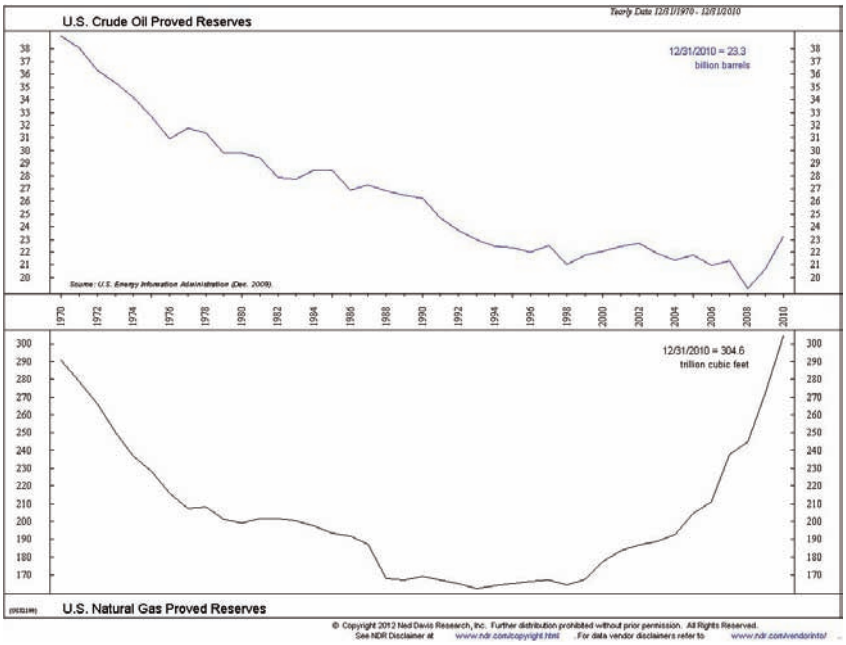
However, there are other, more secular themes that are buried behind the newspaper's front pages that are in fact very encouraging for the longer term. It's possible that investors are sensing a change for the better in America's fortunes that could provide a more lasting improvement.

First, the U.S.'s dependence on oil is declining. With the advent of new technological processes such as hydraulic fracturing there has been a renaissance in drilling for natural gas and petroleum – oil output has risen to 6.1 million barrels/day (mbd) from 5.5 mbd a year ago and is the highest since October, 1999.



The U.S. now imports 23% less oil than it did in 2006 as seen in the middle clip of this chart.

Yet the real revolution has come from the freeing of natural gas from shale.



As seen in the bottom clip of the previous chart, natural gas reserves in the U.S. have almost doubled from 1998 to 2010.

Currently truck fleets are converting to LNG as truck stops around the nation start to add LNG tanks as gas is substantially cheaper than diesel.

At the end of 2010, there were approximately 12.7 million natural gas vehicles worldwide and the numbers have grown substantially since then.

Political leadership focused on promoting natural gas for transportation could have a major impact on the U.S. in two ways. Firstly, it will reduce the trade deficit where oil imports amount to about 2.2% of GDP and secondly, from the expansion opportunities to build out the infrastructure to take advantage of this new found resource.

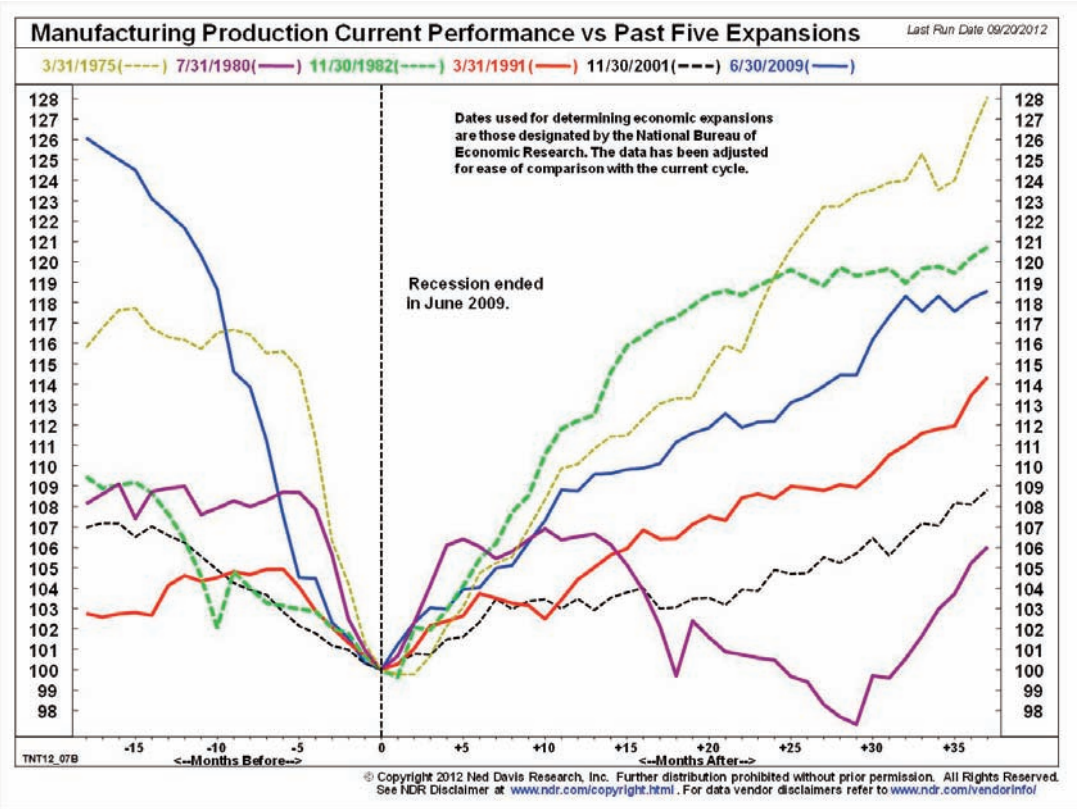
There are even some forecasts that suggest that the U.S. could be self-sufficient in energy by 2020, which is quite a contrast to the "peak oil" sentiment of 2007.

Second, add the term "re-shoring" to your financial vocabulary. It defines a return of manufacturing to North America.

Since the peak in 1979, manufacturing employment has declined from approximately 20 million workers to about 12 million today. That is down 38.8% and as a percentage of GDP; it has fallen from a peak of 28.3% to only 11% in 2009 before recovering to 12.2% last year.

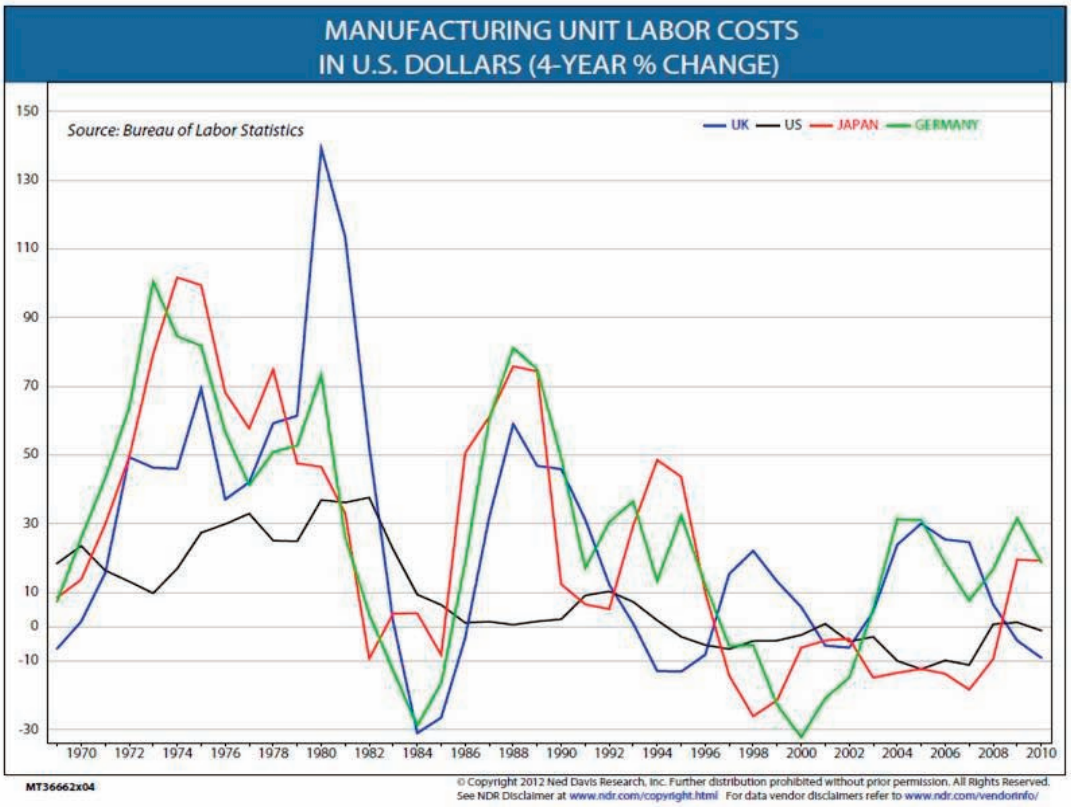
The United States isn't alone in these statistics as 22 million jobs in the biggest 20 economies have been lost to automation.

However, there has been a clear and at least cyclical recovery in production since the end of the recession which has been comparable to previous recoveries.



There are a number of factors that could transition this from a cyclical to a secular recovery.

Again, there is the improvement in energy self-sufficiency and costs, especially in natural gas, which also influences the costs and dependability of electricity. To appreciate the magnitude of this energy advantage one need only scan the world map above which displays the landed costs for LNG.



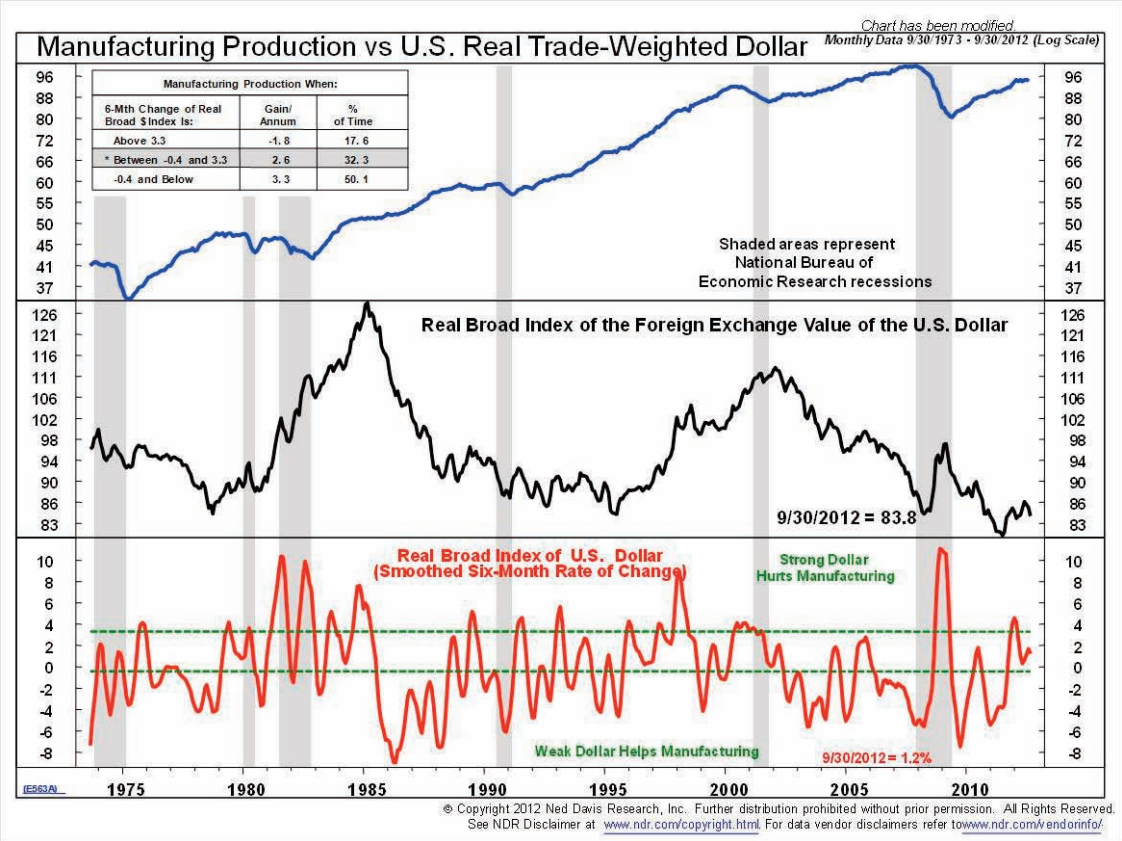
Improvements in U.S. productivity have also contained unit labour costs, which compare very favourably to China where wage increases have grown at approximately 15% per year since 2005.

Other factors that are influencing the shift back to North America include shipping costs, time to market, technological leadership, labour flexibility (especially compared to Europe), a legal system that protects rights and a cheaper U.S. dollar.

The poster child of this movement is Airbus, a European government supported aeronautical company which recently announced a $600 million new plant in Alabama.

According to the Boston Consulting Group, 37% of US based manufacturers with sales over $1.0 billion are either planning or actively considering re-shoring some of their production.

There is also the advantage of an almost 30 year decline in the value of the U.S. dollar.



In terms of foreign currencies almost everything has become cheaper in the U.S.

Although energy independence could slow or possibly even reverse this dollar trend, there is the offsetting factor of the "Safe Haven Premium" which I shall address shortly.

And finally, there is the U.S. banking system. It has its problems, but it is well ahead of most countries in cleaning up its mess. This is especially true in Europe where bank balance sheets are shrinking and loans to companies are becoming more difficult which further stifles growth.

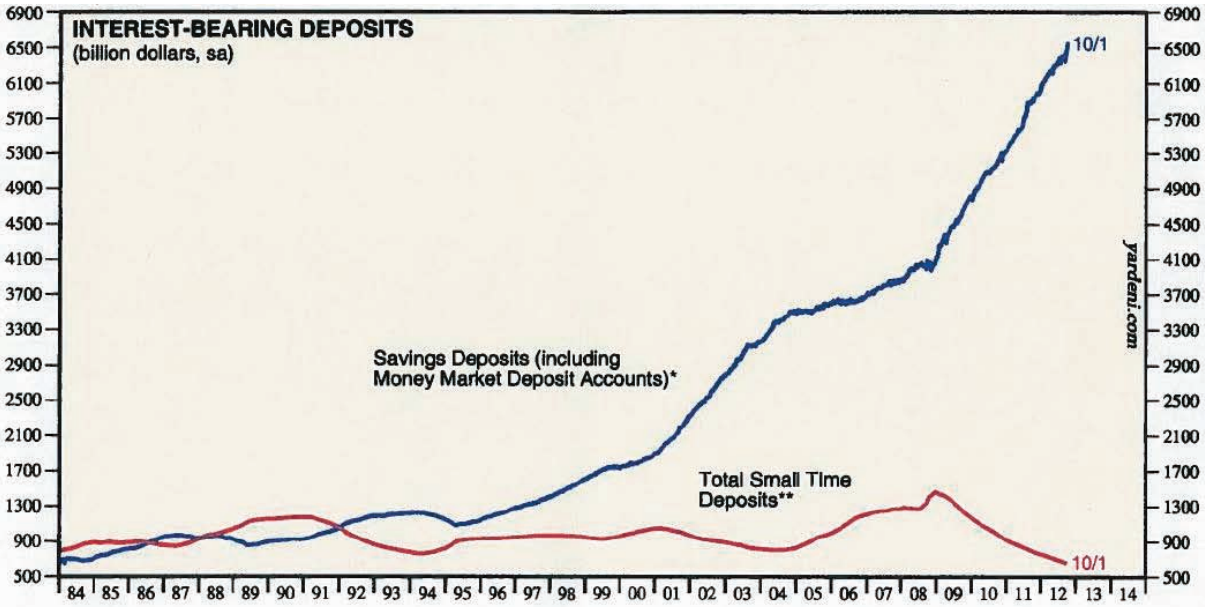
Liquidity

After over 40 years in the investment business, if there is one thing that I have learned it is that liquidity trumps the economy when it comes to the direction of the stock market. No matter how good or poor the economy seems to be, the Federal Reserve will influence the stock market through monetary policy.

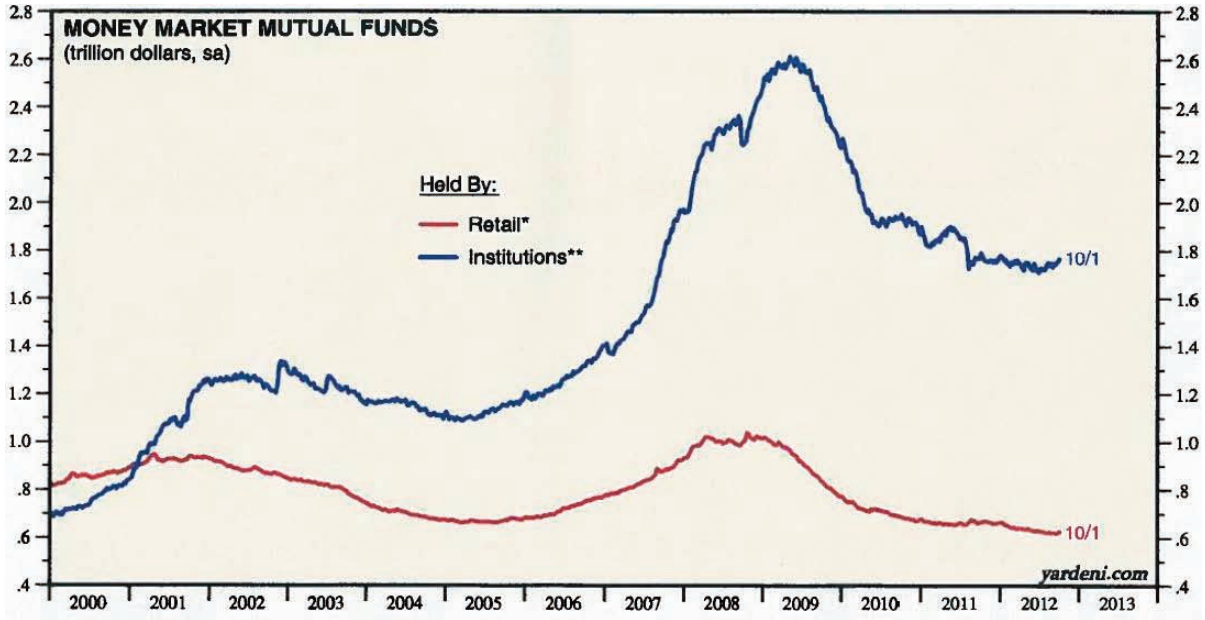
And today, you are seeing monetary policy on steroids with QE3 in the U.S., unlimited accommodation promised by the European Central Bank, Japan again expanding its asset purchase fund and the United Kingdom conducting its own QE2. In all, more than two dozen countries have cut interest rates this year.

Will it work? Well, if you look at the stated intentions I think you'll agree that it has.

1. Quantitative Easing is designed to reduce long-term interest rates in order to stimulate the economy;
2. It's also intended to increase asset values, specifically the stock market, which improves confidence. As Fed Chairman Bernanke stated in the Washington Post, low interest rates will push people to take more risk. This is the primary transmission mechanism between monetary policy and the economy;
3. It will reduce the value of the dollar making U.S. businesses more competitive;
4. It is designed to increase bank liquidity where reserves are now at all time record highs.



* Included in M2.
** Included in M2. IRA and Keogh account balances are excluded.
Source: Board of Governors of the Federal Reserve System.



* Included in M2. IRA and Keogh account balances are excluded.
** Included in MZM, but not in M1 or M2.
Source: Federal Reserve Board.

In the U.S. alone, deposits in savings accounts and money market funds earning almost nothing amount to approximately U$9.4 trillion.

The scramble for yield has moved out along the risk spectrum from government bonds to corporate bonds, to safer utility type stocks with reasonable dividends and now to major blue chips with solid balance sheets and attractive yields.

Right now, the news headlines are pretty unpleasant, leaving investors with lots to worry about. So is this market really a disconnect from reality? Well, in my opinion no, things are improving and there are some secular trends that could be very beneficial to the economy and the stock market going forward and I would classify these as "fundamental" factors.

But there is also something else going on in this market that influences the "valuation" side of the formula and that has to do with the "risk premium".

Stock Market

I often refer to our investment style as being contrarian which is simply an uncomplicated way of expressing the investment principle that over the long-term everything reverts to the mean. In other words, nothing goes up or down forever and those tops and bottoms are usually recognized by investor sentiment, greed and fear. Just think back to the top of the technology cycle in 2000 or peak oil in 2008. There was no refuting that these trends would continue higher. Nor was there any doubt that real estate was a lousy investment in the mid 1990's, all of these to be proven wrong.

So, what is about to revert to the mean today? Well, I think it is "risk".

Let me explain because I think this will be one of the most important factors influencing the market over the next several years and today; investors don't want it.

Traditionally, the shorter the term of an investment, the lower the risk. Treasury bills are safer than bonds which are safer than stocks. Quality also counts. Governments are less risky than corporations. The U.S. dollar is safer than the Euro or heaven forbid the Drachma.

When 2008 hit, investors learned exactly how much risk they had been taking, intentionally or not. Throw in a few frauds and scandals on Wall Street and it was easy to conclude that stocks were "too" risky and only bonds could assure you of the return of your capital, especially government bonds. This resulted in investors taking $138 billion out of equity market mutual funds and depositing over $1.0 trillion in bond funds which has driven interest rates to all time lows and bond prices to record highs, what I would refer to as a risk premium.

Conversely, equity valuations fell as low as 10 times earnings in 2008 and again to that level in the fall of last year with valuations not seen since the 1990's and less than half of the levels reached in 2000. In other words, a "risk discount."

It is not only the last four years but since 1981 when U.S. government bond yields peaked at over 15½% where returns from the fixed income market have been good and certainly beaten the stock market's returns since the start of this millennium.

Consequently, it's not unreasonable that this long-term favourable trend has conditioned investors to believe that bonds are a better, less risky, investment especially during uncertain times like today.

But aversion to risk, like any trend, can go too far and result in exactly the opposite of what is believed. In my opinion, we could be approaching that inflection point. As Fed Chairman Bernanke said, his policies are designed to cause investors enough financial pain to eventually take on more risk.

So far, that's pushed investors out of government issues and into corporate bonds and now investment grade corporates don't yield much more than governments. But bonds, as an asset class, are safe, are they not, especially relative to volatile equities? So, high yield junk debt is the next natural extension. In the first nine months of this year, investors have bought a record $34 billion of junk bond mutual funds and it has earned them 21% (gains plus interest) in the past twelve months and 12% year-to-date. Confirmation that it was the right decision.

However, the yield on the average junk bond has now reached a record low of 6.15% which is below the 10 year average of 9.2%.

Companies sold a record $247 billion in junk bonds in September alone and it is financially weaker companies that are coming to the market. Companies with a "BB" rating and above declined to about 20% of the offerings from the average of 30% year-to-date.

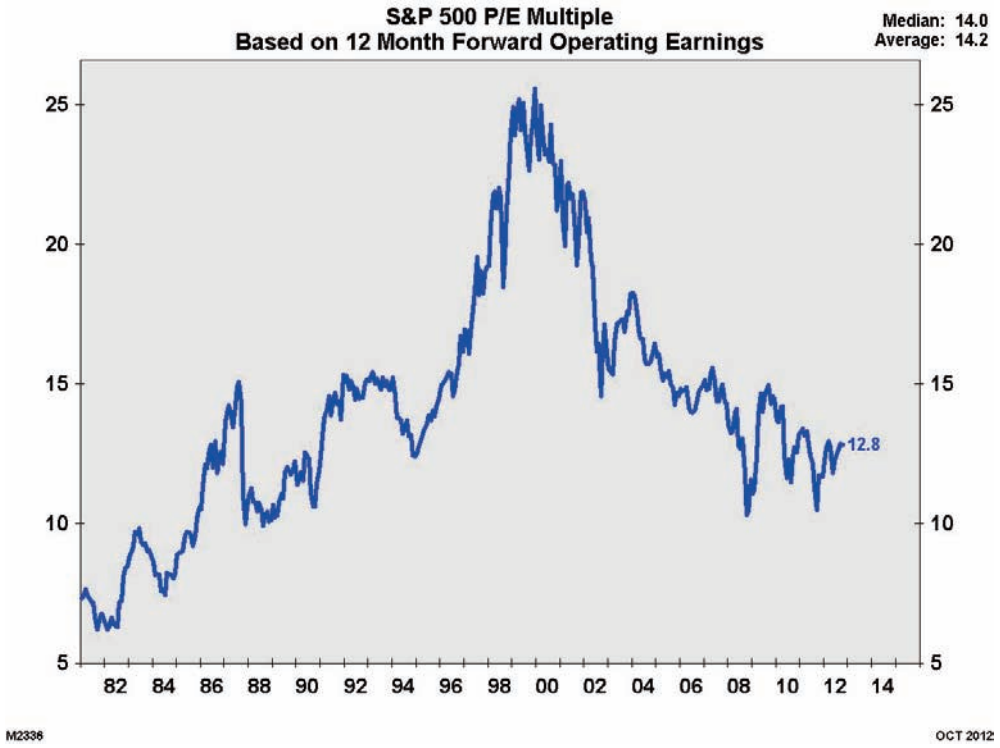
Yet, S&P downgraded 45% more companies than it upgraded in 2012 which reversed the trends of 2010 and 2011.

Further, a number of these low rated companies are borrowing the money to pay out as a dividend to a private equity owner. Year-to-date, $33 billion of "dividend deals", a record high, have come to the market.

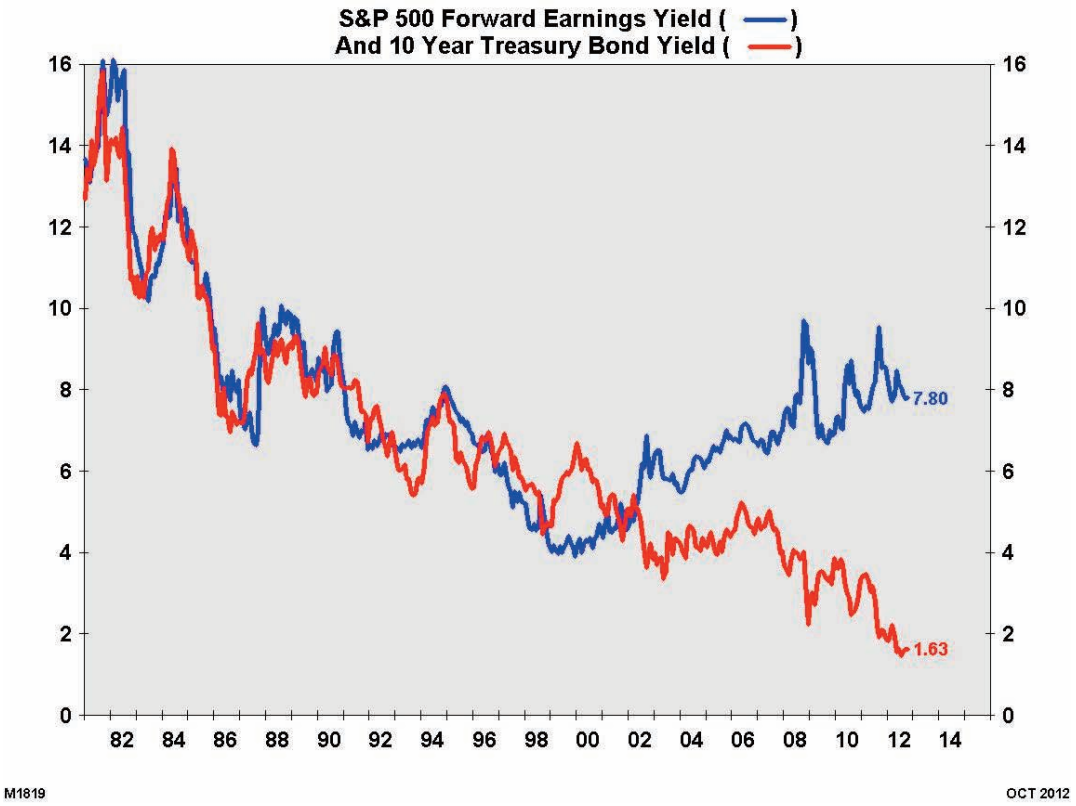
Also, a number of these deals have provisions that the borrower can pay interest in the form of more bonds instead of cash.

I can remember writing about the housing bubble in 2007 and commenting on the gimmicky mortgages that allowed the mortgagor to pay his monthly payment by adding it to the principal value of his mortgage.

So remember what I said about the reversion to the mean. At some point the 6.15% yield is going to head back towards 9.2% and bond holders will lose money.

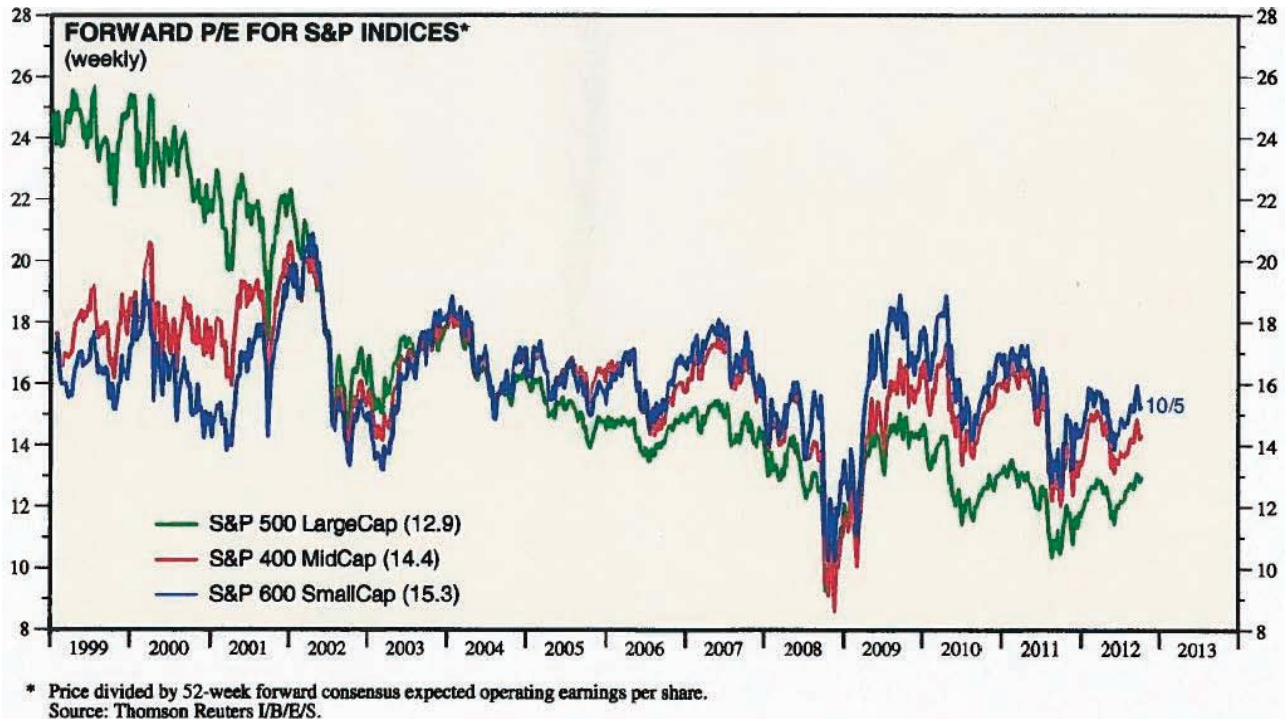


How does this affect the stock market? Well, right now, price earnings ratios on the S&P 500 are at levels last seen in the 1990's. In my opinion, it's a risk discount that could also revert to the mean.



If I convert the price earnings ratio to a yield, one can easily see the difference between bonds and stocks on the above chart.

Not only will these asset classes converge but also quality could have a reversion.



If you go back before 2000, you can see that smaller cap companies, which are usually riskier, traded at cheaper (discount) multiples than bigger caps.

However, in today's world where the perception of risk is higher, the biggest and best companies are in fact trading at the lower valuation. Once again, it's something we think will get straightened out.

And finally there is the risk premium in the U.S. dollar. When worldwide economies and governments falter the U.S. dollar is considered a "safe haven" and appreciates against other currencies. This is something we have seen repeatedly since 2008.

If some of the macro factors we envision take place, this safe haven premium is likely to disappear meaning a lower dollar and with it will go some of the interest rate risk premiums built into the government bond market where much of this money is hiding.

Will that be good for the stock market? I think so. As people are willing to take on more risk or become exposed to under-appreciated risk in bonds, money flows will start to favour equities and some of this will be self-reinforcing.

The flight from the U.S. dollar will cause a weaker currency. This will be bad for bonds but good for corporate earnings from foreign sources.

So, am I still bullish on the market? In the long-term, yes. I think the fundamentals are improving even in a slow economic environment. The news isn't all bad. However, what will move the market is "valuation "as investors become less risk averse and bonds prove to be more dangerous than perceived; then there will be a reversion to the mean.

In the short term, I think you'll probably see better buying opportunities as markets react to headline risk. It will be an opportunity for those who understand the underlying principle of risk reversion.

Gerald R. Connor
October 4, 2012

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