CUMBERLAND

Strategy Review
April 2011

The Usual Suspects

Global markets were fairly mixed over the course of April as the U.S. dollar continued to lose ground against most other currencies. The U.S. equity market had another good month in U.S. dollar terms (the S&P 500 was up 2.8% for April) but was only mildly positive in Canadian dollars (up just 0.3%) as the loonie rallied a further 2.5% relative to the U.S. dollar. The Canadian equity market declined for the second month in a row, dropping 1.2% in April following the modest 0.1% drop in March. The Canadian market was pulled lower by its three largest groups: Financials, Energy and Materials - all of which declined in April. Energy was particularly interesting as the price of oil climbed over 6%, while oil exploration and production stocks fell. Fortunately, we have positioned the energy holdings of our clients' capital appreciation accounts much more heavily toward energy service stocks, which gained in value during April.

The weaker U.S. dollar helped drive gold higher by over 9% for the month, but elsewhere within the materials complex the action has turned decidedly less positive. More concern over Chinese efforts to cool their economy (they raised reserve requirements in April for the fourth time since last October) led to declines in fertilizer, copper and other base metals. Incredibly (at least to us anyway), the euro rallied almost 5% to over US$1.48 despite the increasingly obvious deterioration in the ability of its weaker states to fund themselves going forward. Even if the currency market wasn't paying attention to rising risk in the Eurozone, the bond market was. A "flight to quality" out of Europe and comments from the central banks in the U.S and Canada drove a North American bond rally in April (pushing yields lower), reversing bond market losses from earlier this year. The Federal Reserve indicated they were in no hurry to tighten policy once the current Quantitative Easing (QE2) program ends this June and the Bank of Canada hinted that the stronger Canadian dollar made rate hikes in the near term less necessary. Corporate bonds also performed well as spreads tightened modestly and overall yields moved lower. Given that the Federal Reserve is currently buying the vast majority of new U.S. debt being issued, we continue to believe U.S. Treasury yields risk moving meaningfully higher once QE2 ends this summer and we have positioned our income portfolios accordingly.

So.....back to the same old suspects: the EU debt crisis, Chinese growth and the U.S. debt debate. To us, all three appear to be moving higher in terms of risk and yet markets continued to appear somewhat oblivious through the month of April. Our lineup of suspects and their descriptions follow below.

Suspect #1: The EU Debt Crisis:

Greece will eventually need to restructure its debt either by giving current holders a haircut on the value of their holdings or by revising the term (out much further) and/or the rate (much lower) of its existing debt. The math is actually fairly simple. Greece is already using almost 15% of their total tax revenue just to pay interest on their current outstanding debt. The average interest rate on this debt is "only" 4.5%. Current market quotes for this debt range from almost 7% for very short term paper to over 25% for 2 year bonds. In other words, their current interest load is unsustainable, they are still running large deficits and any new financing will come at a much higher rate of interest.

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Why not just throw Greece overboard and let them sink? Because European banks (including the European Central Bank) are chock full of debt owed by the governments and companies from the peripheral countries at risk. Whatever deal the EU works out with Greece, get ready for Ireland and Portugal to eventually follow suit. The EU may surprise us and pro-actively deal with the ongoing crisis in a timely and effective matter, but in our view it is more likely to bobble the issue back and forth while they try to prod all the member states into some sort of agreement. The latter scenario will cause uncertainty and financial markets do not like uncertainty.

Suspect #2: Popping the Chinese Growth "Bubble":

Pundits have been predicting a collapse in Chinese economic growth for over a decade now, based largely on the premise of the law of large numbers: the bigger you are, the more you have to add in growth each year to keep growing at the same rate. Inevitably, the theory goes, growth needs to slow considerably once you reach some undetermined, but large size. These pundits have been proven wrong so far, as China has continued to consistently grow between 8% and 10% per year. Now however, China has become the world's second largest economy and although growth remains robust, problems are becoming more evident. Inflation is a key trouble spot the Chinese government would like to reign in and so they continue to gradually tighten policy in an attempt to cool growth. While a soft landing would be terrific, markets worry that the tightening efforts could overshoot, causing a more severe contraction in growth. While slower Chinese growth would be negative for the world economy overall, the intensive infrastructure investment within China leaves commodities particularly vulnerable to any slowdown.

Suspect #3: The U.S. Debt Debate:

May 16th, 2011 is estimated to be the date when the U.S. government debt will reach the borrowing limit set by Congress, officially US$14,300,000,000,000 (if you lost track of the zeroes, that's US$14.3 trillion). The Administration has proposed a debt reduction plan which "only" adds $5 trillion to the debt over the next ten years (instead of the planned $10 trillion) although almost all of the required spending cuts and tax increases occur well out into the future when President Obama is no longer President. The Republicans have responded with a plan which only adds $4 trillion over a similar time period but which is almost entirely paid for by spending cuts to the least wealthy while ruling out any tax increases. Evil Knievel would have an easier time jumping the Grand Canyon than these two parties are going to have bridging their current divide. As we expected, it appears the debt ceiling will not be raised before it is reached, forcing the U.S. Treasury to juggle accounts in order to keep the U.S. Government funded for the next month or two. We still expect a debt deal to be reached before the U.S. officially defaults on any debt but unfortunately, we don't believe this deal will be nearly strong enough to meaningfully alter the course of U.S. deficit spending. Over the near term, uncertainty over the outcome of negotiations will probably be negative. Over the medium term, resolution of the negotiation along with an increase in the debt ceiling will probably be positive. Over the long term, the U.S. fiscal situation is likely to continue to deteriorate until a crisis forces decisive (and painful) action to be taken sometime down the road.

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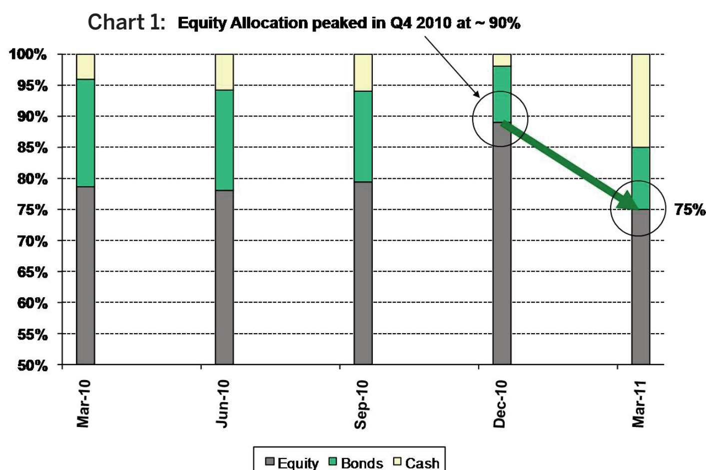
Our Strategy:

The usual suspects, described above, are the ones we have been most worried about over the last few months and our investment strategy has been adjusted accordingly. While we were adding to equity allocations within our clients' capital appreciation portfolios through the summer of 2010 as markets sold off, we have been reducing our clients' allocation to equities over the course of the past quarter to lower the risk profile. Chart 1 below demonstrates the changing asset mix of our capital appreciation model over the past five quarters. The allocation to equities peaked in the fourth quarter of last year at around 90% but was reduced over the course of the first three months of this year to just 75%. During the month of April, we have remained at a similar allocation to equities although we have continued to alter the mix of equities within our client accounts toward those companies with greater dividend yields and lower volatility. Within our clients' income portfolios, we remain very cautious on the outlook for long term bond yields given rising inflation and the risks outlined above. As a result, we continue to favour high yielding corporate bonds over lower yielding government bonds and shorter maturities over longer ones.

In summary, we remain on the lookout for new risk suspects as well as the usual ones but given what we know today, we remain comfortable with the current positioning of our client portfolios. Although we attempt to project how events may unfold in the future, the script is unlikely to play out exactly as we expect. We do believe that the "usual suspects" we have highlighted this month present significant risks and appear to be cresting at the same time over the next few months. With that in mind, our investment objective remains tilted toward capital preservation.

John Wilson
Chief Investment Officer
April 2011

Chart 1: **Equity Allocation peaked in Q4 2010 at ~ 90%**



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