CUMBERLAND

Global Equity and International Fund Strategies
2013 Year End Review and Outlook

Year End Review

It has been five years since the collapse of Lehman Brothers almost sank the global economy and 2013 arguably marked the year when the financial crisis came to an end. Conventional as well as unconventional methods were used by central banks, especially in the U.S. and Japan to aid economic expansion. As has been the case for the past three years, there have been obstacles in the way of the economic recovery, but the U.S. has managed to keep growing slowly, despite the first partial government shutdown in seventeen years that led to a loss of 0.6% of output for the quarter. The annual U.S. budget deficit has declined dramatically from 10% of GDP in the wake of the financial crisis to the current level of less than 4% with continuous improvement expected in the coming years.

The European crisis was dominant in the headlines over the past couple of years, yet Europe managed to avoid a collapse of the Euro among other disasters and appears to be headed for a slow recovery. Nevertheless, while the purchase of EU government bonds by the European Central Bank has stabilized the financial markets, the state of the ordinary people in many countries is still precarious.

While many questioned China's influence on the economic stage given their decline in growth, it remains the second largest economy and is expected to post a 7.6% increase in 2013. The emerging markets were the greatest victims of the Fed's prospective tapering actions and were also negatively impacted in 2013 by the strength in the US dollar. As we wrote in last year's review, we expected correlations among the different stock markets and asset classes to return to a more normal range with an increasing tolerance for risk. This was evident as these correlations had a dramatic fall and inflows into equities improved throughout the year.

Most markets around the world closed at yearly or five year highs, with major stock market indexes climbing more than 25% in 2013. The developed markets outperformed emerging markets. The U.S. was one of the best performing markets among the developed markets in U.S. dollar terms and European stocks had their largest annual gains since 2009. The emerging markets, however, posted a wide range of returns across regions, with the MSCI Emerging Market Index at -2.3% for the year and Shanghai ranked as Asia's worst performing market. For global currencies, the key story was the depreciation in the Yen which led to a big rally in Japanese equities.

A significant expansion in valuation multiples contributed to over 70% of the S&P500 increase in 2013, which is unlikely to be replicated in 2014. Low quality stocks had better performance than high quality stocks and similarly, small caps outperformed large caps. For example, companies with return-based quality factors such as high returns on equity, assets, and capital had weaker performance than companies with low returns but with prospects of a turnaround. Equity multiples in the developed markets are no longer cheap, although their dividend yields are still attractive when compared to bonds yields.

The price returns *(excluding dividends)* for the major markets are provided in the table on the following page in US dollar and their local currency terms.

	2013 USD Return %	2013 Local Return (%)
MCSI World	24.1	26.3
S&P 500	29.6	29.6
Canada S&P/TSX	2.7	9.6
Euro Stoxx	23.3	17.9
MCSI Emerging Markets	-5.0	0.9
Germany DAX	31.2	25.5
UK FTSE 100	16.6	14.4
France CAC 40	23.3	18.0
Switzerland SMI	23.7	20.2
Japan Topix	24.6	51.5
Hong Kong Hang Seng	2.8	2.9
Korea KOSPI	2.1	0.7

Outlook

As Fed Chairman Ben Bernanke stated in his last scheduled news conference, "the economy is continuing to make progress, but it also has much farther to travel before conditions can be judged normal". Home prices in the twenty largest U.S. cities have increased 13.6% from year-earlier levels according to Case-Shiller index. Yet, after four years since the recovery officially started, there are still just under three unemployed people for every job opening and the income of the median household in the U.S. is barely higher than it was a year earlier. The labor participation rate where Americans are working or actively looking for work is 63%, near the lowest level in 35 years. November's 7% unemployment rate is the lowest in five years, but the drop has been driven in part by the falling participation rate. This labor-force-participation puzzle is complicating the central bank's effort to judge the effectiveness of their stimulus programs as they plan to exit from their $85 billion per month bond buying program.

So, in the U.S., there appears to be a disconnect between the financial markets and the economic environment felt by many Americans. Businesses have cut costs, built up cash and margins are at historical highs. The potential danger of the financial system collapsing is no longer a threat reflecting bolstering of financial institutions' capital bases. Yet, corporations are still being cautious and appear to be more committed to driving return of capital rather than obtaining a return on capital. This will become an important issue given peak corporate margins and potentially muted economic growth in the coming year.

In our view, there are more margin expansion and restructuring opportunities outside the U.S. while the emerging markets are providing valuation opportunities. The question is whether investors are willing and interested in investing globally outside the U.S. The recovery in Europe, albeit weak and fragile, should lead to a decrease in their risk premium. The region's corporate return on equity is close to a twenty-year low relative to other global geographic regions and therefore, may present the greatest operational leverage on an improving global macro backdrop.

This coming year will continue to be a transition year for the Eurozone. The asset quality review along with the bank stress tests taking place this year should solidify the European banking system. This would be a minimum requirement and starting point for confidence and growth to resume. We do not believe that the growth will be robust; however, the near-death headlines that dominated the front pages over the past couple of years are expected to diminish.

In 2013, China released their Third Plenum reforms where we saw a glimpse of certain personal and social freedom, such as the change in the one-child policy whereby couples will now be allowed to have two children if one of the parents is an only child. China will be closely scrutinized for their ability to skillfully reallocate their resources from export-led growth to consumption-led growth.

As for Japan, we do not expect to see any major progress with structural reforms or the third arrow initiative under Abenomics. Rising stock prices may have masked the need for the economy to overcome the structural issues that Japan faces and has ignored for the last couple of decades. Eventually, Japan will have to deal with these structural issues to obtain any sustainable growth. However, Japan will likely be least impacted by any Fed tapering since they have their own ongoing quantitative easing program. The heavy lifting of their monetary policy or the first arrow will need to continue given the retrenchment of the fiscal policy, the second arrow.

From a strategic asset allocation perspective, we still favour equities over bonds. Global expansion will continue in 2014, although each region will have its particular challenges. The overriding risk for all developed markets is the risk of long-run deflation in the absence of growth. The corporate sector as discussed above has maintained high rates of profitability in the case of U.S. companies and is implicit in their current valuations levels. If corporate margins decline faster than the rise in GDP, then we would need to reassess valuations. The uptick in bond yields has begun and as economic growth picks up, bond yields will continue to rise. This will also push down equity valuation multiples. We expect market performance to be less correlated with economic surprises and therefore, fundamental analysis of companies will be increasingly important in the coming year.

Performance and Transactions

The key benchmark, the MSCI World Index, had a total return of 27.1% in US$ and 35.7% in C$. The other key benchmarks of MSCI EAFE had a total return of 23.1% in US$ and 31.4% in C$ while the S&P500 had a total return of 32.4% in US$ and 41.5% in C$. International markets outperformed the Canadian market which returned 5.6% in US$ or 12.7% in C$. The Canadian dollar depreciated by 7% against the US dollar compared to the prior year-end, thereby increasing the returns when translated back to the Canadian dollar.

All underlying sectors in the MSCI World Index had positive returns in 2013, ranging from 3.8% (US$) for the Materials sector to 39.6% and 36.7% (US$) for the Consumer Discretionary and Healthcare sectors, respectively. Our Global and International portfolios were overweight in Healthcare, which contributed positively to performance. The key detractor to performance was our allocation to cash in a rising market. In addition, consistent with our mandate, our portfolios hold high quality, large cap companies and as we discussed under the Review section, these companies while providing good returns, underperformed low quality, small cap companies. However, our priority continues to be protection of our clients' capital and over the past cycle, our strategy has demonstrated outperformance.

During the fourth quarter, there were two additions to both the Global and International portfolios: BNP Paribas and Bucher Industries.

BNP Paribas (BNP), based in France has a strong franchise in its retail and wholesale businesses offering a diversified earnings mix. BNP is now comfortably positioned in terms of their capital. The issue centers more around how they will be deploying or returning capital. The next catalysts for BNP will be the return of capital via share buybacks and positive surprises on the revenue line, particularly in wealth management and insurance divisions. BNP is attractive in terms of valuation as it currently trades at a discount to its tangible book value and has a dividend yield of 2.8%. Furthermore, upside could result from cost structure improvement; EUR1.4 billion of savings can add EUR970 million to net profits and raise the return on net asset value from 9.9% into 11.3% in two years' time.

Bucher Industries, based in Switzerland, is an industrial conglomerate with five independently managed divisions. Almost half of group sales and close to 60% of earnings before interest and taxes are generated by Kuhn Group, a leading manufacturer of agricultural machinery. Each of the divisions is either a global or European leader in its field and their strategy is to push its geographic diversification. Given the group's exposure to the agricultural and food industries, our investment case is built on the long-term growth perspective for agricultural equipment. We believe that growth is likely to continue due to increased penetration in North America and South America and new markets such as Russia and China.

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