CUMBERLAND

Strategy Review
June 2011

Dumb and Dumber

Global financial markets continue to undergo wild gyrations as politicians on both sides of the Atlantic appear intent on doing their very best to make bad situations in the E.U and U.S. even worse. As to which group is "Dumb" and which is "Dumber", I'll leave it up to you to decide . In my opinion, it is pretty much a dead heat between the two. The U.S. debt debate is playing out (at least so far) pretty much as we expected. The first deadline for agreeing to raise the debt ceiling back in May was ignored, causing the U.S. Treasury to come up with some account juggling in order to extend the timeline for an agreement to August 2nd, 2011. Incredibly, with only 2 weeks to go until the Government of the United States is forced to start choosing which bills not to pay, both parties are sticking to their ideological ground and remain almost as far apart as when they started negotiations 4 months ago. That, in our view, is just plain dumb. Meanwhile in Europe, markets have now waited over 18 months to hear how the EU will deal with the obvious insolvency of an EU member state – Greece. While the politicians have bickered and dithered for more than a year over how to handle the grass fire on the back lawn (Greece), the front lawn (Portugal), garage (Spain) and now the main house (Italy) have all caught fire. This in our opinion was also pretty dumb, and unless the U.S. surprises us, will probably ultimately be viewed as actually being even "Dumber" than what has occurred in Washington.

Financial markets certainly don't like uncertainty and yet these leaders seem unable to acknowledge serious problems and make timely decisions to help resolve them. As a result, global equity markets declined steeply through the first three weeks of June (down over 5%) before rallying back significantly during the final week of the month. The Canadian equity market closed June down 3.6%, dropping its total return so far in 2011 to a loss of 1.1%. Financials, energy and materials (even gold) were all down over the course of the month with the commodity sector hit particularly hard. The U.S. equity market fared better, with the S&P 500 down just 1.8% in U.S. dollars as of month end although in Canadian dollars the size of the June loss was 2.3% (the S&P is still up 1.4% in Canadian dollars year to date). The Canadian dollar continues to demonstrate relative strength to the U.S. dollar as it gained a further 0.5% last month and is stronger by 3.6% so far this year.

The bond market is having similar difficulty grappling with the high degree of macroeconomic uncertainty causing U.S. Treasury yields to fluctuate over a relatively wide range during June. The 10 year Treasury yield started June with a sharp decline to 2.86% but finished the month with an even sharper rise to 3.16%. So far in July, the 10 year yield has already retraced most of June's rise and is now once again well below 3%. Rates in Canada face pressure to the upside driven by climbing inflation and relatively stronger economic growth offset by pressure to the downside driven by the perception of rising risk of sovereign default in the E.U., the U.S. or both. In the end, Canadian rates didn't move much at all through June although we suspect the Bank of Canada will be uncomfortable waiting to raise rates too much longer as long as inflation remains above their 2% target.

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From an investment standpoint, our client capital appreciation portfolios have benefited from our decision during the first quarter of this year to lower equity risk both through a lower equity allocation as well as by transitioning our equity portfolios to lower volatility and higher yield. Our client income portfolios continue to be positioned for an environment where rates are likely to rise although that hasn't occurred in any meaningful way so far in 2011. The logical question now is what adjustments, if any, we should make to our positioning as we look into the second half of the year?

As far as our view of risk relative to reward in the equity market, we are likely to start moving back the other way – that is gradually increasing the allocation to equities within our client capital appreciation portfolios as well as transitioning that allocation to become less defensive. Our reasons for this are threefold:

1. We do not believe the U.S. will begin defaulting on its debt. We also don't expect any meaningful progress on realistically fixing the burgeoning U.S. fiscal debt (over $14 trillion and counting). Most likely in our view will be a last minute deal to allow President Obama to raise the debt ceiling though possibly not by enough to last through until the 2012 election. Any spending cuts included in this agreement are likely to come two or more years out into the future – plenty of time to be changed again following the next election. In the end, this will keep the U.S. paying its bills and borrowing more money but will not address a debt to GDP ratio that is moving past 100% and growing at 10% per year.

2. We expect the EU to also come up with a last minute arrangement to fund Greece which will likely include some method of reducing their outstanding debt (default, re-profiling or buyback). This in turn will necessitate some program to deal with banks which hold this debt (mostly Greek but also Italian, French and German). The big problem in the EU has now become Italy which is the 3rd largest issuer of debt in the world with €1.6 trillion outstanding (the U.S. is #1 and Japan is #2). Italian 10 year bond yields are hovering near 6% and should they move much farther (say, over 7%) it will become difficult for Italy to keep funding itself. Italy's problem is not its annual deficit (now below 4% of GDP) but its very high total debt outstanding (over 120% of GDP). In summary, a resolution on Greece would be positive in our view but we remain wary of the developing situation in Italy.

3. Finally, the U.S. economy has been in a soft patch over the past few months but we believe an immediate recession will likely be avoided. Consumers are adapting to higher fuel costs and the lingering effects on global manufacturing from the Japan earthquake are starting to diminish. Further, there is still plenty of money on the sidelines earning virtually nothing and, at current yields, bonds aren't nearly as attractive as equities.

In summary, the investment landscape has been difficult over the past few months, but we had expected this would be the case. The recent sell off in equities combined with the likely lifting of the U.S. debt ceiling make us incrementally more comfortable with equities. For income accounts we re-

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main comfortable with our positioning for rising rates as we expect overall government yields to move higher as immediate sovereign default risk fades. All of that said, we reserve the right to change our mind – after all, forecasting the future is difficult when the main actors are "Dumb and Dumber".

John Wilson
Chief Investment Officer
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