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Even Better than the Real Thing?

Markets finally took notice last month of the myriad of risk factors which have been looming on the investment horizon and reacted in a predictable fashion: equity markets and bond yields declined while the U.S. dollar strengthened. The S&P 500 dropped by 1.4% last month but actually climbed 1% in Canadian dollar terms as the U.S. dollar strengthened by almost 2.5% relative to the Canadian dollar. The U.S. equity market finished May up about 7% so far this year in U.S. dollar terms but up only 3.8% for 2011 when measured in Canadian dollars. The Canadian Equity market was led lower by a substantial decline in the price of crude oil (down 10% during May) and dropped for a third consecutive month, falling a further 1% from its April close. May's decline lowered the year to date return for the TSX index to 2.7%. The stronger U.S. dollar translated into a lower gold price last month (down 1.7%); although the yellow metal is still up over 8% from where it started 2011.

As mentioned earlier, bond yields declined once again in May as economic data continued to come in weaker than expected and concern grew that momentum in the economy has moved to deceleration. Housing prices in the U.S. have retraced the brief bounce from last year and are now plumbing new lows for this cycle. Although few expected housing to recover quickly, failing to establish at least a bottom five years following the peak is certainly not encouraging. Perhaps more concerning is the recent loss of momentum in the U.S. job market. Unemployment claims have remained stubbornly high and the May jobs report was well below expectations. Weak housing, employment,

and manufacturing data could be signaling either economic trouble ahead or a soft patch in the recovery caused by high energy prices and supply chain disruptions caused by the Japanese earthquake in March. In our view, it is still too soon to be certain and calls for a looming recession seem premature. In reaction to the souring outlook on the U.S. economy, the ten year U.S Treasury yield is now just 3%, well below its February peak of 3.73%. A strong Canadian dollar and weaker U.S. growth has convinced the Canadian bond market that the Bank of Canada won't be raising interest rates anytime soon – the market is now discounting no rate hike in Canada until well into the fall. Finally, credit spreads widened a little reflecting increased concern over the health of the economy, which was more than offset by declining government bond yields.

Last month's letter reviewed "The Usual Suspects" in terms of market worries, namely the EU debt crisis, the outlook for Chinese economic growth, and the raging debate on how to best deal with the massive (and quickly growing) U.S. debt. Certainly all three of these issues remain relevant and all three have the potential to negatively impact both U.S. economic growth and world financial markets. Recent weakening in U.S. economic data is putting an exclamation point on these concerns: what if the recovery is fading even before any of those three issues goes wrong? Perhaps a better question is whether the economic and market recovery witnessed since last summer was "real" or whether it was just "stimulated" by the Fed's second round of quantitative easing (QE2) and the extension of



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the Bush tax cuts. If the recovery hasn't become self sustaining, but instead has been just a bounce juiced by monetary and fiscal stimulus, then the pending end of QE2 and increased focus on federal, state, and local budget deficits could be a significant problem. Of course if market participants have their way, none of that really matters anyway. If QE2 made the market go up a lot, now that the market is going down, why not just do QE3? Wouldn't that be even better than the real thing?

The short answer is of course, "No", it wouldn't be even better than the real thing. What would be best would be the virtuous cycle of improving economic growth, higher employment, higher incomes, higher spending, higher tax revenues, lower deficits, and lower tax rates and thus, more economic growth. Unfortunately, none of that appears to be happening right now which makes QE3 seem appealing to many. In our view, the U.S. Federal Reserve will resist uncorking the bottle on yet another round of quantitative easing anytime soon for the following reasons:

1. QE2 is only sort of ending. The Fed has indicated that when the current round of U.S. Treasury purchases ends at the end of June (currently running around \$115 - \$120 billion per month) they will continue to reinvest the proceeds of maturing Mortgage Backed Securities (MBS) on their balance sheet back into U.S. Treasuries (about \$30 - \$40 billion per month). So, although the size of their balance sheet won't expand anymore, it won't decline back to normal either and they will still be in the business of buying U.S. Treasuries, though at a lower monthly amount.

2. Quantitative Easing is an "extraordinary" policy. Seemingly lost in all the conversation about whether or not the Fed should immediately embark on QE3 is how exceptionally unusual doing quantitative easing at all is supposed to be. This isn't part of the normal everyday monetary policy toolbox, this is the stuff you keep in the bunker along with all the canned food to combat the 100 year flood.

3. The law of diminishing returns. If quantitative easing delivered all gain, no pain, then central banks would use it all the time. The problem is that it makes the monetary system increasingly unstable. The more you use it, the more difficult it is to remove and the more likely you are to create other problems down the road (like really bad inflation). Each time you do it, the market will worry a bit more about the pain part and give you a little less gain. At some point, if you keep it up long enough, you're likely to end up with all pain and no gain.

In summary, we don't expect a new easing program from the Fed anytime soon. In fact, we don't think any such action will be taken unless and until conditions become materially worse than they were before QE2 last summer. In the meantime, market perception of risk has increased noticeably over the past few months and has accelerated through the early part of June. Our decision earlier this year to reduce our risk profile by lowering our clients' overall exposure to equities (as well as transitioning equities within our client accounts to more defensive names) has worked out well so far. Going forward we remain cautious on the outlook for equity markets over the near term al-



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though we expect the economy to muddle through in the end. We believe that this market weakness could provide an excellent opportunity to put the relatively high levels of cash which we have raised within our client accounts to work over the course of the next quarter or two. Until that time, we are content to focus on preserving our clients' capital while waiting for the right opportunity to put excess cash back to work.

John Wilson

Chief Investment Officer

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Cumberland Private Wealth Management, Inc. 99 Yorkville Avenue, Suite 300, Toronto, Ontario, Canada M5R 3K5