



CUMBERLAND

Strategy Review

June 2010

Deflation or Risk Aversion?

The month of June picked up where May left off as bond yields moved substantially lower, while equity markets experienced another sharp decline. As has been the case throughout the current correction, equity markets are declining pretty much across the board with little differentiation among individual stocks or sectors. Measured in U.S. dollars, the S&P 500 fell 5.4% in June following an 8% drop in May and is now down 7.6% for the year. The Canadian equity market also fell, but as in May, its drop was more muted than the U.S. decline: the TSX dropped 4% and is now lower by just under 4% for the year. On the commodity front, oil was relatively stable, down just 0.6% following a steep 15% drop in May. Gold on the other hand, continued to benefit from economic uncertainty and climbed a further 2% to bring its gain this year to just over 13%. Finally, the Canadian dollar had a second consecutive down month, dropping a little under 2% while the Euro showed signs of stabilizing as it rallied off its lows and ended June down just 0.6%.

The catalyst for the rising level of fear remains pretty much the same: growing panic that we are going to have a relapse of 2008's global economic recession. This view is being driven by worry that the U.S. is trapped in a deflationary debt de-leveraging spiral and is heading back into recession, concern over the implementation of austerity programs in Europe and the resulting potentially negative effect on EU growth, and fear that China's property market "bubble" is popping, resulting in dramatically slower Chinese economic growth.

Co-incident with the fall in equity markets has been a sharp decline in bond yields as, for instance, the U.S. 10 year Treasury has moved from 4% a few short months ago to well below 3% today. Many market observers have interpreted these very low

bond yields as implying that credit markets are signaling a looming deflationary "double dip" recession. Back in 2008, credit markets seemed to realize the dangers lurking ahead far sooner than equity markets so, if credit markets really are signaling worries over a 2008 "relapse" then the equity market could very well be in significant danger. But, are credit markets really signaling this kind of relapse? Or, are low yields just a consequence of risk aversion as investors flee equity markets amid economic uncertainty? In other words, are credit markets leading the equity market or is it the other way around?

Low yields by themselves do not signal a relapse of 2008. From our point of view, many other important indicators within credit markets remain significantly different (and better) than they were as the world tumbled toward the credit crisis. For example, although the interbank lending rate has risen recently in Europe, at 80 basis points it is still far below its crisis level (over 500 basis points) and remains below what would be considered "normal" relative to the bank rate. Credit spreads on U.S. corporate bonds have widened somewhat through May and June but are not indicating pending economic collapse and the subsequent deterioration in credit quality that would result. In Canada, the bond market behaved somewhat differently. Government of Canada yields fell as well, but much more at the short end than the long end. The performance in Government of Canada bonds appears to have been driven much more by the weaker-than-expected economic data and continued problems in Europe which could potentially slow the pace of rate hikes in Canada. Corporate bonds performed better than in the U.S. as well, with credit spreads remaining generally flat in June as demand for high quality yield products continued to outstrip supply.



Strategy Review

June 2010

So if credit markets aren't indicating a pending collapse, what are equity markets indicating? Equity markets have moved significantly lower and at just over 10 times the current 2011 consensus earnings estimates, are already discounting meaningfully lower earnings than the street is currently forecasting. If we look to recent economic indicators in the U.S. which have been coming in below street expectations over the past two months, we don't believe they necessarily indicate a pending "double dip".

Slower growth? Yes. A double dip? We don't think so. For example, recent readings of the ISM measuring strength in industrial production have recently been coming in lower month over month (shown in chart 1 below). Although the ISM is historically choppy month to month, the bear argument says that inventory replenishment drove the first half recovery and now that it has finished, we're going to roll back into recession due to a lack of fundamental demand.



Source: Cowen & Co.

Strategy Review

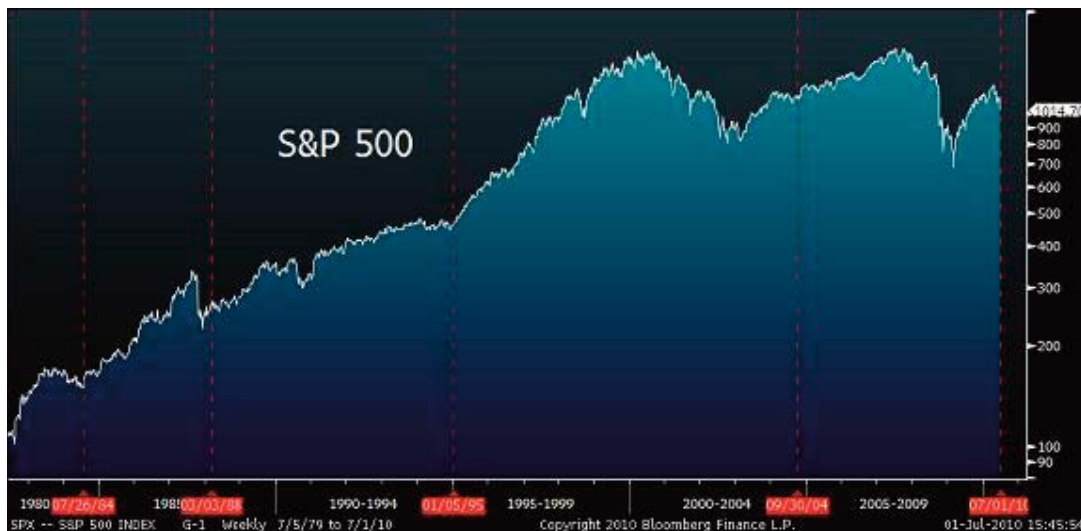
June 2010

In our view, recent ISM readings are still showing expansion of industrial production (readings over 50 indicate expansion) and the slowing in the rate of expansion is fairly typical at this stage of a recovery. We have anticipated for some time that U.S. economic growth would slow in the second half of the year as

inventory building slowed and could slow further in 2011 as tax hikes kick in and federal stimulus rolls off. In fact, if you look at past recoveries (Chart 2), when the ISM starts to slow in its rate of expansion it has not even been a leading indicator of poor equity performance (Chart 3).



Source: Cowen & Co.



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CUMBERLAND

Strategy Review

June 2010

We are not arguing whether or not the major developed economic zones of Europe, the U.S. and Japan face significant challenges in the future related to public and private debt levels - they do. Those issues however are going to play out over an extended period of time measured in years not quarters or months. What we would argue is that we are not about to tip back into a global economic collapse like the one experienced in 2008. Further, we also don't think the U.S. is about to sink back into negative economic growth nor do we believe European growth is about to "double dip". We expect economic growth in China to slow but from current growth rates of 11-12% down to a more normal (for China) growth rate of around 8%. Quite simply, in our view, equity markets have started to price in a much too bearish view of the next 6 to 12 months.

From a strategy standpoint, we have been anticipating for some time a future with much higher than normal volatility as economic uncertainty rises and wanes. Given our view of the economic landscape, we have not cut back our equity exposure at current levels as we expect equity markets to recover as they

realize global economic growth is slowing yet not turning negative. As that occurs, we believe that, over time, the positions we have established within our client portfolios will be able to demonstrate the business strength and earnings power that we feel is not yet reflected in their current valuations. On the other hand, we haven't raised our equity allocations either as we feel economic uncertainty still demands a decent allocation within bonds. Certainly, should future events and data unfold in a manner which is inconsistent with our forecast, we are prepared to adjust and adapt accordingly. For now however, we remain comfortable with our current positioning.

John Wilson

Chief Investment Officer

June 2010

Cumberland Private Wealth Management Inc. is an independent world class investment firm that provides discretionary investment management and wealth management services for high net worth individuals, their families and foundations, with \$1 million or more in investable assets. All of Cumberland's investment mandates are centered on building and preserving our clients' financial wealth. Founded in 1997, the firm is privately-owned by its employees and headquartered in Toronto, Canada.