

Market Commentary



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At Cambridge, we have been saying that the market's risk/reward wasn't very attractive for a while now – but we believe that changed this week. Short-term market dislocations can go on for a while, but we believe we are buying real companies, with real earnings, and real growth prospects at very attractive valuations. Eventually the markets will recognize this.

We have been spending our cash. As always, we try to find the best risk/reward opportunities while focusing on protecting the downside. And, while there could be additional downside in the near term if the markets continue to overreact, we believe there are terrific opportunities on a long-term basis.

This is not 2008. The financial system and economy are in a much better position. Stocks are discounting a very negative outcome. Why it isn't 2008:

- **The system is very liquid:** U.S. credit markets are not showing signs of stress and the yield curve is sloping upward. Corporate balance sheets are flush with cash, banks have a lot of capital and reserves, and the U.S. savings rate has been 7% annually over the past three years. Bank reserves are abundant and we are not seeing U.S. credit indicators showing stress like we did in 2008. In fact, investment grade and high-yield spreads are all better than at the start of 2011 and only slightly wider from June. Since the 1956, 10 out of 10 recessions were preceded by an inverted yield curve.
- **U.S. consumers and corporations now have tailwinds:** Oil is US\$30 lower than its high and bond yields are 120 basis points lower. These will likely be the drivers of spending and investment in the second half of the year. Inventories are also low, as are expectations. Look for the U.S. consumer to surprise on the upside in the second half.
- **Stocks are cheap, especially vs. bonds:** The after-tax dividend yield on the S&P 500 Index is now *above* the 10-year Treasury bond yield. Dividends can grow, while bond yields can't. Other than briefly at the end of 2008, this is the first time this has happened since 1962.
- **The market is oversold:** The relative strength index (RSI), bull-bear indicators, and others are hitting lows. In fact, the RSI is at a level not seen since March 2009.

We are seeing a crisis in Europe, not unlike the Asian Crisis in 1998 and Long-Term Capital Management crisis in 1997. In both of those instances we saw sharp market declines, similar to what we are seeing



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now. Assuming we don't tip back into recession – credit indicators suggest it's unlikely – we should see a rally from here.

As for the U.S. debt situation, the bond market is saying it is okay with what is going on as 10-year bond yields hit all time lows and the U.S. dollar rallies. If the bond market had lost confidence in the U.S., yields would be going up and the dollar down – which is what is happening in Europe.

In Canada, the economy and banks are in good shape relative to the rest of the world. Although there are indications China is slowing. At this point, the S&P/TSX reflects more global growth than Canadian fundamentals. We choose to offer more diversified portfolios by gaining exposure outside of Canada. Domestic fundamentals are great, but the TSX is global growth play.

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