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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Equity markets are rallying today, effectively shrugging off yesterday's dramatic reversal in the U.S. markets (at one point, the Dow was up 125 points yesterday and yet finished down 40 points to close below the 9,900 mark). The rally so far today has occurred despite the fact that the cost of protecting European corporate bonds from default actually rose 9bps to 623bps (the Markit iTraxx Crossover Index) for high yield and by 2bps to 139bps for the investment grade space.

The euro as well as a slate of Asian and commodity-based currencies (including the loonie) are firmer as well, in line with today's move towards healthier investor risk appetite. Oil prices and anything correlated with crude have received a big lift from yesterday's tight inventory data — U.S. stockpiles down for two straight weeks. The chatter in the markets is that the rate hike today by New Zealand (to 2.75% and the central bank talked rather "hawkishly" about inflation prospects) together with a nice employment release in Australia (26,900 versus consensus expectations of 20,000) were factors underpinning some confidence in the global economic recovery. After all, these two countries are widely viewed as being "cyclical plays" on world growth.

The news that China's exports zoomed ahead 48.5% YoY in May has added some reinforcement to this view too, although curiously enough, the Shanghai index is one of the few stock markets overnight that posed a decline (off 0.8%). Go figure. And, the tone of the Fed's Beige Book was moderately positive — all 12 districts reporting improved activity and that unanimity last took place in October 2007. Bonds are selling off moderately — though JGB yields are hanging in quite nicely below 1.2% — and the U.S. dollar and gold are trading lower so far today as the classic safe-havens take a breathe … for now. Investor bidding at yesterday's U.S. 10-year T-note auction was more than just decent.

As we said yesterday, use the interim bounces, when they occur, as an opportunity to purge the risk and cyclicality from the portfolio and move up the quality chain. The charts don't lie and the trend lines in the major stock market averages have peaked out and rolled over. What was key yesterday was not only the outside reversal — on no news to boot — but that the new lows on the NYSE and the Nasdaq combined reached triple-digits for the fourth session in a row. That is not a good sign for the bulls. The most effective way to mitigate the intense volatility is to invest in real hedge funds.

THE "YIELD" THEME CONTINUES UNABATED

In the face of all the cries from Wall Street research departments that bonds are in some kind of bubble, the general public seems to be on a different page. Equity funds posted a $654 million net outflow last week while bond funds took in $4.25 billion.

IN THIS ISSUE

What the strategy and economics world doesn't see, for whatever reason, is that fixed-income is woefully under-represented in the household balance sheet (true in both the U.S. and Canada) and that the median age of the boomer is 55 years old and as a result is at an age where capital preservation strategies win out over a strict capital appreciation focus, which worked oh so well in the 80's and 90's. As an aside, yours truly was a 'perma bull' during much of that period — then again, we were in a secular bull phase so it wasn't difficult to be bullish when you looked at the primary trend.

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Take a look at Chart 1 and you will see that the market, like life and the seasons, moves in cycles — 16 to 18 year cycles, in fact. Sadly, this secular down-phase in the equity market began in 2000 when the major averages hit their peak in real terms, and so the best we can say is that we are probably 60% of the way into it. This by no means suggests that we cannot get periodic rallies along the way, but in a secular bear market, these rallies are to be rented, not owned. In contrast, corrections in a secular bull market, as we saw in 1987 (as scary as it was), are opportunities to build long-term positions at more attractive pricing. In secular bear markets, the indices do hit new lows during the recessions (2002, 2009), when they occur; in secular bull markets, you do not make new lows — they are just corrections (ie: 1987, 1990, 1994, 1998).

CHART 1: THE LONG HISTORY OF THE DOW — SECULAR BEAR PHASES, SECULAR BULL PHASES

United States: Dow Jones Industrials Index, in constant dollars
(monthly range of daily closes)

Source: Topline Investment Graphics

As for valuation, the median of our models show that indeed, the S&P 500 has closed the excessive valuation gap that has been in place for the past nine months. But bottoms typically occur when the market slices almost 20% below the median fair-value line and besides that, the Shiller P/E, while coming down in this correction, is still sitting at 20x, which is 20% above the long-run norm. In other words, the market is not as cheap as the pundits, who rely on year-ahead EPS estimates, deem it to be.

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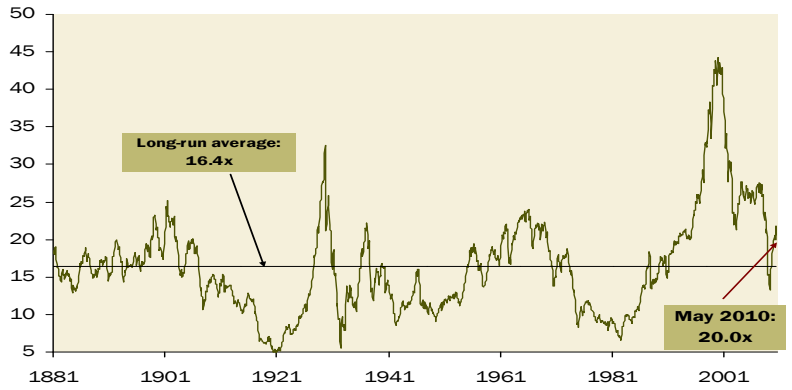
CHART 2: SHILLER P/E STILL 20% ABOVE THE LONG-RUN NORM

United States: Shiller P/E Ratio*
(monthly range of daily closes)

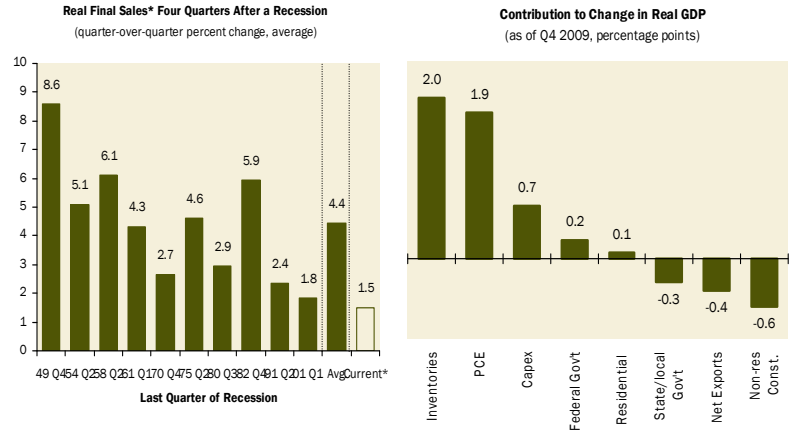


**Shiller's P/E uses the 10-year average of as reported earnings.*
Source: Robert Shiller, Gluskin Sheff

Ben Bernanke made a statement yesterday that cannot go unchallenged, with all deference to his IQ and brilliance as an (academic) economist. To wit: *"it appears to us that the recovery has made an important transition from being supported primarily by inventory dynamics and by fiscal policy towards a recovery being led more by private final demand."* What is he looking at? The chart below shows that this goes down as just about the weakest recovery ever in terms of real final sales growth, which has essentially been non-existent in per capita terms. Private payrolls grew in May at one-fifth the pace posted in April, it looks to us as if consumer spending stagnated for the second month in a row in May, and mortgage applications for new home purchases have sunk to a fresh 13-year low.

CHART 3: *NOT* A V-SHAPED RECOVERY

United States



**Average from Q3 2009 to Q1 2010. Source: Bureau of Economic Analysis, Gluskin Sheff*

As for Mr. Bernanke's notion that the economy is off life support, well, it's time for him to climb down from his ivory tower. Food stamp usage just soared to a new record high — 40.2 million persons or 18.5 million households receive benefits. How is it possible that spending is going to drive the economy by any meaningful pace with so many people clearly in some stage of duress?

Mr. Bernanke, climb down from your ivory tower — the economy is not off life support

MARKET THOUGHTS

The critical 1,040 threshold on the S&P 500 has indeed held, but the question is for how much longer. Recall that the 1,065 flash-crash low was supposed to hold — we enjoyed a three-day rally that took the market up 5½% and that created a whole lot of renewed enthusiasm until the trap door opened again. Treat these intermittent recoveries very skeptically.

That the newswires could ascribe the market pickup to Ben Bernanke's testimony to the House Budget Committee is almost laughable. Here is what the Fed Chairman said that supposedly got investors into a bit of a frenzy: *"the economy — supported by stimulative monetary policy and the concerted efforts of policymakers to stabilize the financial system — appears to be on track to continue to expand through this year and next."* He added that *"the effects of the* [European] *crisis on economic growth in the United States seem likely to be modest."* Talk about the proverbial kiss of death.

Back on March 28, 2007, he told Congress (the Joint Economic Committee) that *"…the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained."* And his call on the economy, at the July 2007 semi-annual testimony to Congress was *"the U.S. economy appears likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend."* Well, real GDP growth in the second half of the year was just a smidge below 3% so one would think that based on what he had to say back then, Mr. Bernanke's view for 2008 would have been somewhere between 3% and 4%. Instead, we got 0.4% real growth in 2008 (and then -2.4% in 2009).

DEMAND FOR GOLD … COMING FROM MANY SOURCES

It is no longer about investor demand through ETFs and the like that have been driving the gold price — physical demand for gold coins and bars has also been very strong. The U.S. mint has been busy supplying investors with 23,000 American Eagles so far in June after a run of 190,000 in May. The Rand refinery in South Africa, according to the Financial Times, is running at full capacity. The World Gold Council is projecting a new high for investor gold demand in 2010 (after the 1,910 tons in 2009, which also was a record).

Demand for gold is not just coming from private investors; central banks around at the world are now boosting their gold reserves

Moreover, demand is not just coming from private investors — remember, central banks have very deep pockets as well. We see in the WSJ that Russia bolstered its gold reserves by $1.8 billion in May and there are also unconfirmed reports that Iran has also been in buying the yellow metal.

Yesterday, two articles really caught my eye: *Stimulus Talk Yields to Calls to Cut Deficits* on the front page of the NYT and Martin Wolf's editorial on the FT titled *Fear of the Markets Must Not Blind Us to Deflation's Dangers* (also see today's NYT editorial on page A26 — *The Wrong Message on Deficits)*. Mr. Wolf concludes that *"premature fiscal tightening is, warns experience, as big a danger as delayed tightening would be."* Meanwhile, the public opinion polls in the United States are revealing a groundswell of support for budgetary restraint. Meanwhile, policy rates are at 0%. This really only leaves the Fed balance sheet as the primary source of stimulus for the economy, especially when the next downturn occurs. This may well be what the gold bugs are sniffing out.

It may simply be a pure coincidence, but since mid-2007, the Fed's balance sheet has ballooned from $850 billion to $2.3 trillion and during that time, the gold price has risen from $650/oz to $1,230/oz. In other words, about two-thirds of the bull market in gold has occurred in just the past three years.

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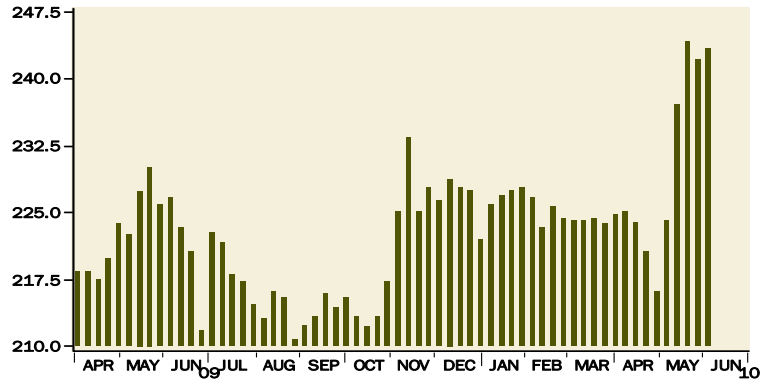
APPS SLAPS

It is truly amazing that anyone can be talking about a sustainable recovery when mortgage applications for home purchases is down 38% from a year ago — and that level a year ago was down almost 20% on a YoY basis itself. This is all very disturbing.

What has not been written about regarding the MBA purchase index (the BEST leading indicator of home sales) is the average loan size differential between now ($243k) and when the homebuyer tax credit expired ($218k). As you would expect, the lower end of the market is now DEAD; if you can't sell your starter home you can't trade up. Big problems ahead for the housing market … the tax credit did more to distort things than anything else; in essence, how the distribution of sales was skewed to the lower end due to government support.

CHART 4: AVERAGE LOAN SIZE OF NEW PURCHASES NOW AT $243k

United States: Mortgage Bankers Association: Volume Application Index: Average Loan Size of Total New Purchases (US$ thousands)



Source: Haver Analytics, Gluskin Sheff

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LEADING THE LEADER

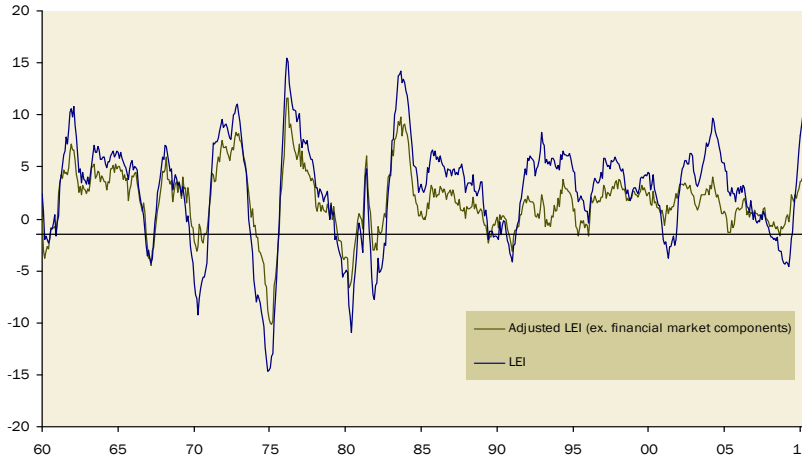
One criticism of the Conference Board's Leading Economic Indicators (LEI) is that it includes financial market data points (the yield curve and the S&P 500 specifically) so it is not a "real economy" indicator. To get around this, we created an adjusted "real economy" LEI, stripping out these two components. We found that in the earlier time periods, from 1960-90, this adjusted LEI did no better than the original specification (in fact, it sometimes was a bit late in turning negative).

Our adjusted real economy LEI leads the LEI by about 1-2 months

However, there has been a shift in the last two decades, particularly in the last 10 years, and this adjusted LEI has generally led peaks and troughs by about two months, on average. It's currently flashing a year-over-year growth rate of 3.3%, one-third the rate of the official 10.2% rate. On a monthly basis, the adjusted metric fell 0.6% MoM in April versus the 0.1% decline in the official LEI.

CHART 5: LEADING THE LEADER

United States: Leading Economic Indicators
(YoY % change)



Source: Conference Board, Gluskin Sheff

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Gluskin Sheff at a Glance

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As of March 31, 2010, the Firm managed assets of $5.6 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 54% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively the largest client of the Firm's investment portfolios.

We offer a diverse platform of investment strategies (Canadian and U.S. equities, Alternative and Fixed Income) and investment styles (Value, Growth and Income).[1]

The minimum investment required to establish a client relationship with the Firm is $3 million for Canadian investors and $5 million for U.S. & International investors.

PERFORMANCE

$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $11.7 million[2] on March 31, 2010 versus $5.7 million for the S&P/TSX Total Return Index over the same period.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $8.7 million USD[2] on March 31, 2010 versus $6.9 million USD for the S&P 500 Total Return Index over the same period.

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We have strong and stable portfolio management, research and client service teams. Aside from recent additions, our Portfolio Managers have been with the Firm for a minimum of ten years and we have attracted "best in class" talent at all levels. Our performance results are those of the team in place.

We have a strong history of insightful bottom-up security selection based on fundamental analysis.

For long equities, we look for companies with a history of long-term growth and stability, a proven track record, shareholder-minded management and a share price below our estimate of intrinsic value. We look for the opposite in equities that we sell short.

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We assemble concentrated portfolios — our top ten holdings typically represent between 25% to 45% of a portfolio. In this way, clients benefit from the ideas in which we have the highest conviction.

Our success has often been linked to our long history of investing in under-followed and under-appreciated small and mid cap companies both in Canada and the U.S.

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In terms of asset mix and portfolio construction, we offer a unique marriage between our bottom-up security-specific fundamental analysis and our top-down macroeconomic view.

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For further information, please contact questions@gluskinsheff.com

Notes:

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