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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite with Dave

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.

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.

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).

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.

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- While you were sleeping: global equity markets are rallying today, shrugging off yesterday's reversal in the U.S. markets; strong economic data out of Australia and China; bonds selling off modestly
- Yield theme continues unabated: bond funds saw inflows of $4.25bln last week, while equity funds posted a $654mln outflow
- Market thoughts: the critical 1,040 threshold on the S&P 500 has indeed held, but for how much longer?
- Demand for gold … coming from many sources: it is no longer about investor demand through ETFs driving the gold price, physical demand for gold coins and bars are also very strong
- Apps slaps: it is truly amazing to contemplate a sustainable recovery in U.S. housing when mortgage applications for purchases are down significantly
- Leading the leader

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

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).

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.

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

Gluskin Sheff

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.

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$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.

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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.

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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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$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.

For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

1. *Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.*
2. *Returns are based on the composite of segregated Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.*

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