David A. Rosenberg
Chief Economist & Strategist
drosenberg@gluskinsheff.com
+ 1 416 681 8919

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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Asian stock markets are mixed overall (dipping 0.2% in the aggregate — first decline in six days) but European equities have rallied on strong U.K. retail sales data (pushing the pound to a one-month high against the greenback) as well as the announced plan out of Spain to publish bank stress tests (helping Spain sell $4.3 billion of new bonds today). And, Spanish-German 10-year spreads came in 10bps (the Spanish issue has rallied 4bps in the aftermarket) but still far exceed 200bps. German equities are up now for four days running -- the Handelsblatt newspaper reported that the country is actually going to exceed its tax revenue targets this year and next. As for that U.K. sales number, it was up 0.6% MoM in May versus the consensus view of +0.1%; at least it had the direction right.

The pro-risk trade, however, is not as evident today in the FX market where the yen is firm and the commodity-sensitive currencies are losing a bit of steam — the Aussie is down for a second straight day. Copper and oil look to be taking a breather here as well — the former definitely should not have liked those U.S. housing numbers too much, that is for sure. As for the latter, we did see U.S. crude inventories climb unexpectedly by 1.69 million barrels last week. Gold is hanging in nicely but we should respect the fact that even while he is a long-term bull, the legendary Bob Farrell told us that he sees an overextended and overcrowded trade here on a near-term basis and sees potential for a 10-20% pullback, which would be a nice buying opportunity. Bob, much like us, sees less upside potential and more downside risk in equities and the need to scale up in quality across all portfolios.

As for the economy — come on — if things were good, we wouldn't be seeing the just-released Rasmussen poll showing President Obama's approval rating all the way down to a record (!) low of 42%. That can't possibly be all related to the BP oil spill. The lesson learned here is that the solution to every problem, including the share price, is to cut the dividend. It always seems to be such a cathartic experience. Beyond the realm of polls, the FedEx earnings miss and the action in its share price (down about 6% yesterday) underscore the view among the few that things on the global economic front just may not be as rosy as what investors had been pricing in.

GETTING A GRIP ON REALITY

Double-dip risks in the U.S. have risen substantially in the past two months. While the "back end" of the economy is still performing well, as we saw in the May industrial production report, this lags the cycle. The "front end" leads the cycle and by that we mean the key guts of final sales — the consumer and housing.

IN THIS ISSUE

We have already endured two soft retail sales reports in a row and now the weekly chain-store data for June are pointing to subpar activity. The housing sector is going back into the tank — there is no question about it. Bank credit is back in freefall. The recovery in consumer sentiment leaves it at levels that in the past were consistent with outright recessions. By our estimates, the diffusion index on the Conference Board's leading economic indicator (LEI) in May came in at a disconcerting 40% for the second month in a row. Jobless claims are one of the 10 components of the LEI and last year's improvement not only stalled out completely, but at around 460k is consistent with stagnant to negative jobs growth. And exports, which had been a lynchpin in the past year, will feel the double-whammy from the strength in the U.S. dollar and the spreading problems overseas.

In the U.S., we have already endured two soft retail sales reports in a row and now the weekly chain-store data for June are pointing to subpar activity

Spanish banks cannot get funding and another Chinese bank regulator has warned in the past 24 hours of the growing risks from the country's credit excesses. A disorderly unwinding of China's credit and property bubble may well be the principal global macro risk for the remainder of the year.

Another key source of uncertainty over the economic, financial and indeed the political outlook is this uncontrollable oil spill. Geopolitical risks are extremely high -- and it's more about Turkey and its eastward move that is now most unsettling. What was interesting yesterday was to hear BoC Governor Carney strike a more balanced tone — all of a sudden, more rate hikes in Canada aren't such a sure thing (see more below).

That the equity market has been able to digest this news seems impressive on the surface. But remember, it's the same stock market that was hitting new highs well into the fall of 2008, even after the onset of home price deflation, the shutdown of New Century Financial, and the collapse of two Bear Stearns hedge funds. Just because George Chuvalo lasted 10 rounds against Ali and his punishing left hook did not mean he won the fight (or avoided a stint at the hospital).

BONDS STILL HAVING MORE FUN

As we said yesterday, 2009 was the anomaly in that junk low-quality surge off the lows. This is the year of SIRP — safety and income at a reasonable price. Long bonds have generated an annualized 20% return and corporate credit has generated high single digit returns (U.S. figures). Equities are flat with a tremendous amount of volatility to boot. Moreover, while portfolio managers, flash traders, prop desks and hedge fund types have been buying and selling (ostensibly to each other — do we have to dust off the Pig Farmer story again?), the general investing public (you know — the ones with the savings that ultimately determine where funds will be allocated) is still focussed squarely on the fixed-income market. This deserves a dissertation from the school of behavioural economics.

This is the year of SIRP — safety and income at a reasonable price

The median age of the 78 million boomers is 54 going on 55 and even after two bubbles bursting less than a decade apart, this cohort still have 55% of the asset base in equities and real estate and a mere 6% in bonds. And, it is the latter piece of the pie that is expanding the most and will be expanding the most in the future as demographic, deflation and deflationary realities — investing in 3D — make it imperative for the wide swath of aging boomers to focus less on capital appreciation strategies and focus more on capital preservation stories. Income is king and the proletariat have already figured it out despite Wall Street research houses still advocating the equity market even though the S&P 500 has generated no return but plenty of heartburn for 12 years now; the hallmark of a secular or primary bear market: rent the rallies, don't own them.

Bonds may be boring, but they do pay interest, are more capital secure, and they mature! In a deleveraging cycle, boring can be rather sexy!

Indeed, this seems to be the strategy among those whose savings inevitably set the market price for assets and securities. As a microcosm for what has gone on now for a good 15 months, the Investment Company Institute (ICI) data for last week showed net mutual fund inflows of $2.1 billion — great news for our industry! But guess what? All the inflows and then some — $4.7 billion — were in fixed-income of some sort. Equity funds posted net outflow of over $2.9 billion — in just one week. Another $220 million were put into hybrids — what we call "bonds in drag."

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As a sign for how the elite still cannot wrap it around their head that we are still in the throes of a secular bull market in "income", have a look at *Treasury Bonds Defy Expectations* in the FT (our expectations certainly have not been defied, that much we assure you).

THE OUTLOOK IS ONE OF…

- Deflation: own income-generating securities, which include dividend yield and dividend growth.
- Corporate balance sheet strength and liquidity: own corporate bonds with liquidity, marginal refinancing needs and stable cash flows.
- Intense volatility: invest in classic hedge funds — true long-short strategies that preserve capital and minimize fluctuations in the portfolio.
- Ongoing sovereign credit concerns and recurring rounds of currency depreciation: ensure the portfolio has a core holding in precious metals (gold and silver). These are effective hedges against lingering concerns over the stability of the global monetary system.

I realize that I am viewed as a perma-bear, but it's my forecast that is bearish, not my personality. I'm bullish on my kids. I'm bullish on my friends — the few I have. I'm bullish on the New York Yankees — please don't hold it against me. And I'm bullish on my firm. Look — if I really believed that cash was where investors should be, I'd be working at a bank, not a wealth management firm.

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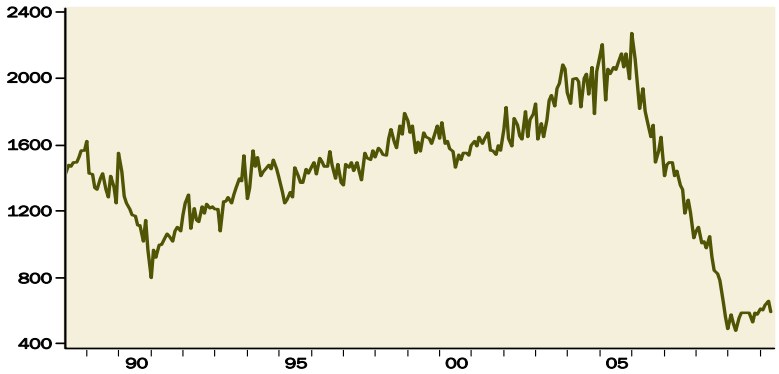
HOUSING HANGOVER

One of the first post-tax credit housing data points was a huge disappointment. Housing starts in the U.S. fell 10.0% MoM in May, nearly three-times more than expected. On top of the decline, the April data were revised down and are now back to pre-tax credit levels.

CHART 1: NO V-SHAPED RECOVERY HERE

United States: Housing Starts
(thousand units)



Source: Haver Analytics, Gluskin Sheff

Most of the details of the report were ugly. What really caught our eye was the 17.2% MoM plunge in single-family starts, which was the largest monthly decline since January 1991. The level of single-family starts is now at 468k, the lowest since May 2009. Not one region was spared, with all areas reporting drops in single-family starts. The recently-released National Association of Home Builders housing market index, which also declined in May, is suggesting that housing starts will remain at or below these levels in the second half of the year, according to our models.

While single-family starts plunged, multi-family permits (*ie:* condos and apartments) jumped 33% on the month, to the highest level since May 2009. What was slightly disconcerting was that in the five-units or more category, starts jumped 38% MoM. This suggests that the supply response in the multi-family sector could help re-establish the downtrend in rental rates, putting downward pressure on the CPI (where rental prices just slipped below the zero-line on a year-over-year basis).

Forward-looking building permits did not fare much better, falling 5.9% MoM, adding to the 10.9% decline in April. Again, a similar story here, with a steep drop in the single-family category. After yesterday's data, we think the balance of risks to Q2 GDP is to the downside — the economist community has penciled in 3.3% QoQ annual rate GDP for Q2 but we expect this to come in under 3.0% at around 2.75%.

We should note that analysts underestimated the impact of the tax credit on the April data (housing starts, existing and new home sales all came in much stronger than expected) so it's very likely there we will likely see a lot of volatility around the incoming housing data. The next housing data points are existing home sales (June 22) and new home sales (June 23), so stay tuned.

The overall tone of the industrial production report in the U.S. was positive; however, the CAPU data, although improving, still highlights the enormous amount of slack in the economy and the deflation pressures that come along with it

PRODUCER PRICES TAME

U.S. producer prices were also released yesterday but compared to the plunge in housing starts, the data were far less shocking (boring, actually). Total producer prices fell 0.3% MoM in May, less than the -0.5% expected, as commodity prices were weaker on the month. On a year-over-year basis, total producer price inflation slowed to 5.3% vs. 5.5%.

The closely-watch core measure (excluding food and energy) was also a bit stronger than many expected, coming in at 0.2% versus 0.1%, which boosted the year-over-year comparison to 1.3% to 1.0%. Tobacco prices jumped by an outsized 2.2%, which was likely the culprit for the miss.

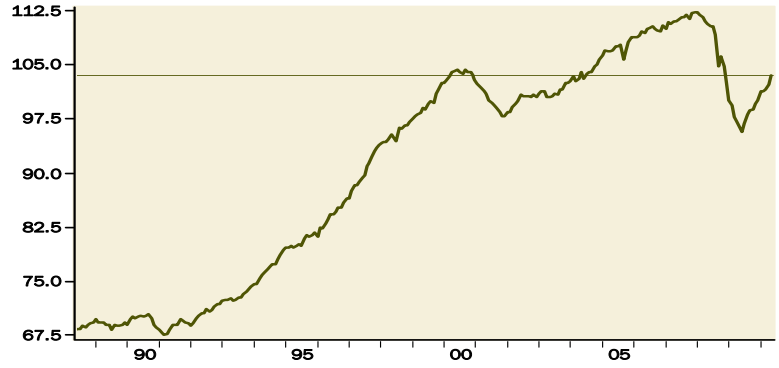
Most of the pipeline details were constructive. Intermediate core goods were up 0.3% MoM (following a 1% jump in April), although the year-over-year rate moved up 6.1% from 5.6%. Further down the pipeline, core crude prices were up 1.6% MoM versus 4% in April) and here the YoY rate looks to have rolled over to 41% from 50% in April. If there was one negative detail in yesterday's PPI report, it was that finished core consumer goods PPI was up 0.3%.

PRODUCTION IMPROVING BUT STILL LOADS OF SLACK

The overall tone of yesterday's industrial production report in the U.S. was positive but the capacity utilization (CAPU) data, albeit improving, still highlights the enormous amount of slack in the economy and the deflation pressures that come along with it.

CHART 2: INDUSTRIAL PRODUCTION BACK TO APRIL 2000 LEVELS

United States: Industrial Production
(seasonally adjusted, 2002 = 100)



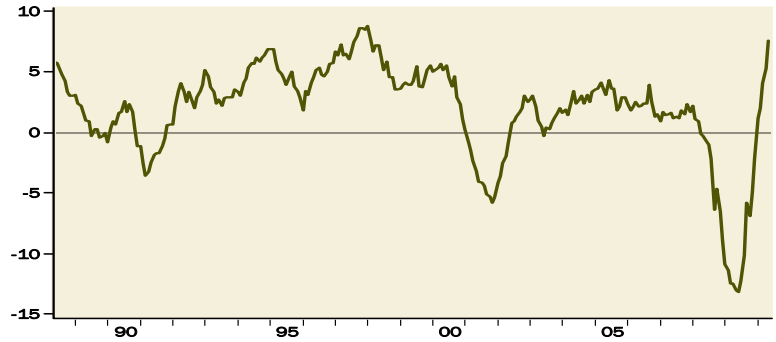
Source: Haver Analytics, Gluskin Sheff

Total industrial production was up 1.2% MoM in May versus the median forecast of 0.9%. The source of the miss was likely the near 5% jump in utilities (likely a giveback after three soft months). The manufacturing sector saw a 0.9% increase on the month, helped in part by a strong 5% increase in motor vehicle production.

Numbers can often be deceiving. There is no doubt that we have been enjoying an inventory-led recovery in industrial activity, but year-on-year trends that are based off depressed base effects can provide a pretty distorted story. Look at the one, two or even five-year trends in U.S. industrial production and you can see that all we are doing is digging out of a very deep hole. So let's keep in mind that even with the burst of activity in May that dominated the headlines yesterday and today, and this goes to show that nobody will ever get penalized for being optimistic, but in reality all that has happened is that output has risen all the way back to where it was … a decade ago.

CHART 3: WOW! A V-SHAPED RECOVERY IN INDUSTRIAL ACTIVITY

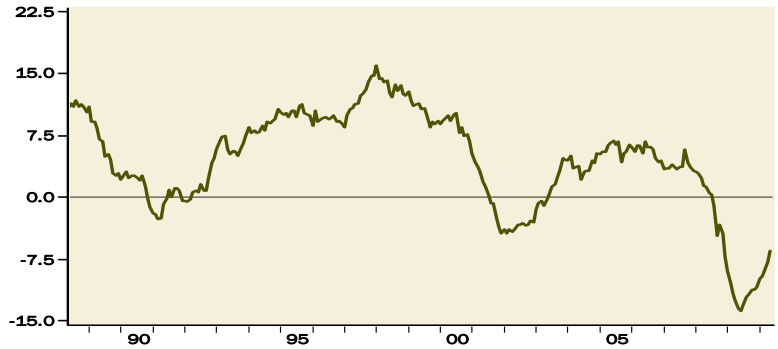
United States: Industrial Production
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

CHART 4: A LITTLE LESS V-LIKE ON A TWO-YEAR TREND BASIS

United States: Industrial Production
(two-year percent change)



Source: Haver Analytics, Gluskin Sheff

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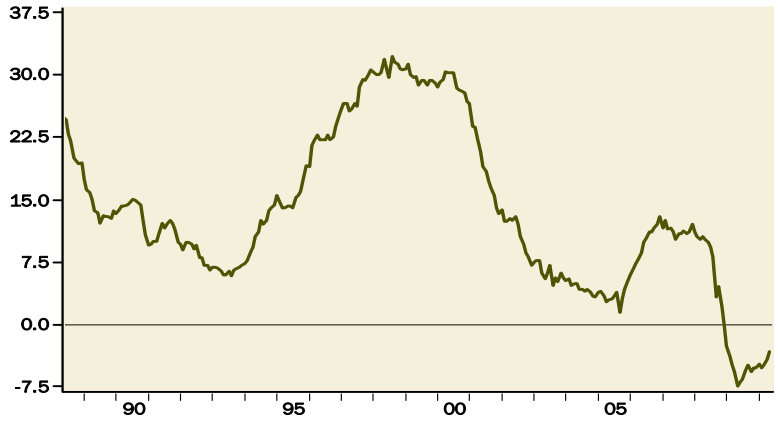
CHART 5: EVEN LESS V-LIKE ON A FIVE-YEAR BASIS

United States: Industrial Production
(five-year percent change)



Source: Haver Analytics, Gluskin Sheff

We screened for the best and worst sectors, in terms of year-over-year industrial production growth. Fastest growing sectors include: primary metals (+50%), motor vehicles & parts (+40%), computer and electronic products and machinery (+14%). The worst sectors (either declining or slow growth rates) include aerospace (-1.0%), printing (-0.3%), furniture (0.6%), and petroleum and coal products (2.9%).

While it is encouraging that industrial production is improving, there is still a tremendous amount of slack in the economy. Even though capacity utilization improved to 74.7% in May, it is still nearly five percentage points below the long-term average. The manufacturing sector, which is running at 71.5% capacity, is about 7ppts below normal conditions — it's hard to envisage inflation picking up in such an environment.

We ran another screen for sectors that are below/above long-term trends for capacity utilization (see table below for complete list):

- There are only two sectors where current capacity utilization is above its long-term trend — mining (91%) and petroleum and coal products (86%). It's interesting to note that mining has a had a very strong rebound since the June 2009 low in total CAPU — in 11 months, CAPU has increased by 10ppts.

- There are several sectors that are running at diminished capacity — wood products at 55%, motor vehicles at 57% (but note that capacity has increased 20ppts since June 2009 in this sector), furniture at 63% and textile at 69% are the worst.

- The aerospace industry is the one sector where capacity has fallen since the June 2009 low — down 1.4ppts. At 72.6%, and it is slightly below normal conditions for the industry.

TABLE 1: CAPACITY UTILIZATION -- MAY 2010

United States (percent, unless otherwise noted)

	Current reading	**Long-Term Average**	**Above/Below Long-Term Average** (percentage point difference)	**Percentage point difference from June 2009 low**
Mining	90.6	86.9	3.7	9.9
Petroleum and Coal Products	86.1	85.3	0.8	1.6
Food, Beverage, & Tobacco Products	79.9	80.9	-1.0	4.0
Aerospace	72.6	73.8	-1.2	-1.4
Chemicals	73.7	77.3	-3.6	3.0
Total	**74.7**	**79.8**	**-5.1**	**6.4**
Electric and Gas Utilities	81.0	86.1	-5.1	2.3
Apparel and Leather	73.7	78.9	-5.2	10.5
Plastics and Rubber Products	77.1	82.7	-5.6	12.0
Elec Eqpt, Appliances & Components	75.9	81.8	-5.9	6.6
Fabricated Metal Product	69.8	75.8	-6.0	7.7
Computer and Peripheral Equipment	71.1	77.3	-6.2	8.1
Manufacturing	**71.5**	**78.3**	**-6.8**	**6.4**
Miscellaneous Durable Goods	69.3	76.2	-6.9	2.7
Communications Equipment	69.8	76.7	-6.9	0.4
Computer and Electronic Products	69.5	77.5	-8.0	6.7
Machinery	66.1	75.8	-9.7	10.0
Paper	76.0	86.1	-10.1	3.6
Semiconductors and Related Equipment	69.3	79.6	-10.3	12.9
Primary Metal	67.2	78.3	-11.1	21.5
Printing & Related Support Activities	70.2	81.7	-11.5	2.9
Textile and Product Mills	68.6	80.2	-11.6	9.5
Furniture and Related Products	62.7	76.3	-13.6	4.9
Motor Vehicles and Parts	56.8	73.7	-16.9	20.0
Nonmetallic Mineral Products	56.7	75.7	-19.0	1.6
Wood Products	54.5	77.0	-22.5	5.0

Source: Haver Analytics, Gluskin Sheff

BANK OF CANADA'S CARNEY STILL DOVISH AND IN DATA-WATCHING MODE

There was not much new in Bank of Canada Governor's speech yesterday in Charlottetown. We think the biggest take away was the Governor Carney reinforced the dovish sentiment in the June 1 press statement.

While *"[r]ecent activity in Canada is unfolding largely as expected"*, Mr. Carney emphasized that the *"outlook is subject to considerable uncertainties. In most advanced economies, the recovery remains heavily dependent on monetary and fiscal stimulus."* Perhaps the key comment, which is not new, is that *"[i]n light of the scale and volatility of these conflicting forces, it should be evident that no particular path for monetary policy is preordained."* This suggests that the BoC is carefully watching both the domestic data and unfolding world events. At this point, the market is pricing in another 75bps in hikes by year-end, but clearly this is no slam dunk.

A COLD SPRING FOR THE CANADIAN HOUSING MARKET

Canadian existing home sales tumbled 9.5% MoM in May (-4.3% YoY) — not really a huge surprise as an earlier report on large-city sales flagged a decline. The weakness was spread across the country with nearly 70% of cities reporting declines.

Average home prices rose 8.5% year-over-year, clearly rolling over from the double-digits gains recorded earlier in the year. Across the country, the pricing picture is very divided — some cities in the east reporting declines while Ontario and Toronto are still seeing large increases.

The biggest thing on our worry list with respect to the Canadian housing market is the supply backdrop. On a year-over-year basis, new listings are up over 20% and inventory of unsold homes is at 6.1 months' supply, the highest since April 2009. It is not just the existing housing market that has us worried. We estimate that in the new housing market, builders have been building inventories for the past 7-8 months. On top of this, some demand has likely been pulled forward to this quarter ahead of the introduction of HST in B.C. and Ontario.

All told, this points to a much slower market in the second half of the year and in our view, it is very likely that home prices across the country will see outright declines.

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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.

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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.

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.

For corporate bonds, we look for issuers with a margin of safety for the payment of interest and principal, and yields which are attractive relative to the assessed credit risks involved.

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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For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

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