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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite with Dave

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.

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.

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).

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- While you were sleeping: A mixed performance in Asian equity markets, but the European bourses are rallying on strong economic data out of the U.K.; however, the pro-risk trade is not evident in the FX market
- Getting a grip on reality: double-dip recession risks in the U.S. have risen substantially in the past two months
- Bonds still having more fun: the general investing public is still focused on the fixed-income market — the latest mutual fund flow data shows that $4.7bln were invested in bond funds
- The outlook is one of deflation, corporate balance sheet strength and liquidity, intense volatility and ongoing sovereign credit concerns
- U.S. housing hangover: one of the first post-tax credit housing data was a huge disappointment
- Producer prices in the U.S. remains tame
- U.S. production improving but still loads of slack in the economy
- Bank of Canada's Carney still dovish and in data-watching mode
- A cold spring for the Canadian housing market

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.

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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.

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).

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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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:

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