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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast 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 sub-par 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. Last year's improvement in initial jobless claims not only stalled out completely, but at over 470k 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. Indeed, perhaps the equity market finally realized yesterday that allowing China more control to defuse an internal property and credit bubble may well be a classic case of "be careful of what you wish for."

THE CASE FOR BONDS

In the discussion about the outlook for U.S. Treasury bonds, the point must be emphasized that supply alone has been an inadequate focus for predicting future price/yield. You don't have to do much more than to go back to examples like these: the 30-year Treasury bond yield went from 4.7% to 6.7% in 1999, even though bond issuance by the Treasury was practically nil. And, the decline in JGB yields over the last 20 years, even though deficit spending has been spectacular in Japan and debt-to-GDP is approaching 200%. The last I saw, the 10-year JGB yield was at 1.2%.

The problem with trying to assess either supply or demand in the current market environment is that everything is so confusing in the early stages of this new secular paradigm of a global credit collapse. There is no way to get it completely right. As Lacy Hunt has always maintained, it makes much more sense to assess the outlook for inflation as the primary effort in predicting Treasury rates. Simple and elegant. Maybe perhaps instead of inflation, we should really be discussing deflation, which has emerged as the primary trend, and governments have few bullets left in the chamber to deal with it.

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- The bond cycle and deflation: while fiscal policy may have a 40% correlation with the direction of bond yields, inflation is twice as important
- Income is king: with corporate balance sheets in terrific shape in Canada and the U.S., the case for credit remains quite compelling
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Bond yields have been low for some time, and they will remain low. But don't be lulled into numerical micro-phobia (the fear of small numbers that plagues the bond bears). The near 30% slide in the Chinese stock market suggests that we have three to six more months of deflating commodity prices. And, if the trend in Japanese, German and Swiss yields are any indication, bonds in the United States and Canada have plenty of room to fall further.

Don't be lulled into numerical micro-phobia, bond yields in the U.S. have been low for some time, and they will remain low

THE BOND CYCLE AND DEFLATION

I was at an event recently where I was able to see two legends among others – Louise Yamada and Gary Shilling. Louise made the point that while secular phases in the stock market generally last between 12 and 16 years, interest rate cycles tend to be much longer – anywhere from 22 to 37 years; and she has a chart back to 1790 to prove the point! So while all we ever hear is that this secular bull market in bonds is getting long in the tooth, having started in late 1981, it may not yet be over. After all, the deleveraging part of this cycle has really only just begun and if history is any guide, it has a good 5-6 years to go – at a time when practically every measure of underlying inflation is running south of 1%.

Gary not only ran with a terrific chart showing, over time, the gap between aggregate supply and the inflation rate (talk about compelling), but a table showing (and this one goes back to 1749!) how the primary trend during peacetime is one of deflation and in wartime it is inflation (including the Cold War).

Expand your horizons and go back before 1945 and you would see that during the American Revolution, inflation averaged over 12% per year, to then be followed by 28 years of peace that coincided with deflation of nearly 2% annually.

The War of 1812, which really lasted four years, saw prices advance at nearly an 8% average annual rate, while the next three decades of peacetime saw prices deflate by 2.4% per year.

Prices surged at a 15% annual rate during the Civil War and then we went through 51 years in which the price level fell at a 0.7% annual rate. So looking back over the past three centuries, we have had 92 years of war and prices rose at an average annual rate of 6%. Gary goes on to show that when we are not at war, prices typically decline at a 1.2% pace (wars lead to government procurement policies and soaring demand for material that goes into the munitions process).

The secular bull market in bonds may not yet be over; the deleveraging part of this cycle has really only just begun

This is important because while fiscal policy may have a 40% correlation with the direction of bond yields, inflation is twice as important.

INCOME IS KING

SIRP (safety and income at a reasonable price) remains one of our core strategy themes. And with corporate balance sheets in terrific shape on both sides of the border – debt/equity, liquid asset/short-term liability, and long-term-to-short-term debt ratios – the case for credit is still quite compelling.

The latest Fitch data shows that defaults in the high-yield space fell to an annual rate of 1% in the first five months of 2010 – only nine issuers affecting $1.7 billion of bonds (this is far below the 13.7% default rate of 2009). A 1% default rate is hardly sustainable in this sector but what it does show is that: (i) the companies that emerged from the Great Recession are true survivors who will not be staring into the abyss again anytime soon, and (ii) there is a huge yield spread cushion right now for investors in this area of the bond market.

In case it wasn't made clear before, I strongly believe that escalating global economic imbalances have dramatically increased the vulnerability of the global recovery

A SHIFT IN G20 TONE

My, how times have changed. A year ago, it was all about rampant fiscal stimulus to bolster the global economy. Now we come off the G20 Finance Ministers meeting with a completely different tone, and it has nothing to do with the sustainability of the recovery, which is now in doubt, but rather the focus is on fiscal stabilization because of the growing investor anxiety over bloated government balance sheets. This cannot possibly be constructive for risk assets, which owed last year's humongous rally to all the efforts by governments across the planet to sacrifice their balance sheets at the expense of the private sector, specifically the banks.

The bottom line is that all levels of society, and across most countries in the industrialized world, have far too much debt and far too much debt-servicing costs in relation to income. The world is awash with $222.5 trillion of total liabilities across public and private sector claims, or the equivalent of 362% of global GDP. Extinguishing this debt will be deflationary even as central banks will be forced to print money as an antidote and we are really in the early stages of this deleveraging cycle.

While U.S. banks have recapitalized themselves and written off debt, this cycle has been dominated by governments socializing the losses and taking the bad debts from the private sector and transferring the liabilities to the public sector balance sheet. Therefore, what has happened is that the governments bailed out the banks. To fund the bailouts and the huge stimulus to put a floor under the economies of the world, governments had to issue record amounts of bonds as they did not have the revenues to fund the largesse.

In case it wasn't made clear before, I strongly believe that escalating global economic imbalances have dramatically increased the vulnerability of the global recovery. The chances of a growth relapse in the second half of the year are higher than the equity market, and to a lesser extent the credit market, have priced in. Treasuries seem to be the asset class that most closely shares my cautious views. Anyone with a pro-cyclical bent has to answer for why it is that the yield at mid-point on the coupon curve is barely above 2%, a year after a whippy rally in equities and commodities and what appeared to be a sizeable policy-induced GDP jump off the bottom.

The U.S. economy is susceptible to a growth relapse, with all deference to the various purchasing managers' reports, which portfolio managers should treat as coincident indicators. Historically, equities have done far better the year after ISM comes off the 30 level than the years after the 60 milestone is reached, just as an example.

A variety of recent consumer-related reports, including the May employment and retail sales data, have been sub-par and are posing appropriate questions as to whether the recovery will be V-shaped. That mortgage applications for new home purchases have plunged 40% in the past six weeks to a 13-year low despite a 20bps decline in mortgage rates is, to be polite, disconcerting.

When the VIX plunged to 15x in early spring, it reflected a widespread view that the green shoots of 2009 would be extended into a sustainable growth phase into the future. In addition, given the massive government intervention across the planet, it can hardly come as a surprise that economic activity began to recover exactly a year ago. The recovery in international trade and the reversal of the inventory cycle contributed to a "V-like" recovery initially and fostered optimism that global economies were well on their way to a sustained recovery. Meanwhile, real final sales have all but stagnated in per capita terms in what has turned out to be a subdued rebound in demand. Not a good assumption then; and not one now.

Even if we don't get a double-dip recession, economic growth will probably be insufficient to absorb the still-large amount of excess capacity in the system. What that means is that the U.S. unemployment rate will remain high for as far as the eye can see. It also means that inflation and interest rates will remain low for a sustained period of time, and that a stock market priced for peak earnings in 2011 could be in for some disappointment.

Excessive debt in the household and government sectors remains a significant problem, and this is a hurdle for the corporate earnings outlook globally. Governments continue to adopt policies that seem to suggest that the problems are merely liquidity-related, when in fact they are highly structural in nature and will require years of fiscal belt-tightening on the part of consumer in much of the industrialized world, and in the public sector as well.

For the entire OECD countries, general government debt as a share of GDP alone has ballooned from 73% when the recession started in 2007 and will climb to a record 104% next year. It took 15 years for this ratio to go from 63% to 73% and just four years from 73% to 103%. Total claims in the OECD at all levels of society just broke above 360% of GDP and that is clearly unstable. Suffice it to say that many of these debts will not be serviceable — identifying where the defaults and haircuts take place, across countries and sectors, will require a tremendous level of skill.

The world is awash with debt. All levels of society, and across most countries in the industrialized world, have far too much debt and far too much debt-servicing costs in relation to income

The reason why SIRP (safety and income at a reasonable price) works is because yield works in a deleveraging deflationary cycle. There is substantial excess capacity in the global economy, primarily in the U.S. where the "output gap" (the gap between aggregate supply and aggregate demand) is close to 6%. The more crucial real story, however, is the length of time it will take to absorb the excess capacity. It could easily take five years or longer, depending of course on how far down potential GDP growth goes in the intermediate term given reduced labour mobility, lack of capital deepening and higher future tax rates. This is important because it means that disinflationary, even deflationary, pressures will be dominant over the next several years, which suggests that the trend in high-quality bond yields will be down, not up.

We are now seeing the consumer sputter with what looks like a very weak handoff into the third quarter, and the housing sector is collapsing again

DOUBLE DIP, ANYONE?

The data suggests that we are now seeing the consumer sputter with what looks like a very weak handoff into the third quarter. The housing sector is collapsing again. The export-import data are pointing to a sudden deceleration in two-way trade flows. Commercial real estate is dead in the water. Bank credit is in freefall right now.

There is still something left in the tank as far as capex and inventory investment is concerned, but by the fourth quarter, we could well be looking at a flat or even negative GDP print. This is exactly what happened in the second half of 2002 when by the end of the year real GDP converged in real final sales near the zero mark after a sharp but truncated mini-inventory cycle. That may not have been classified as a double-dip recession, but it was a growth collapse nonetheless — an aborted recovery for a consensus that went into the second half of that year, much like this one, with a forecast of 3% real economic growth. The lesson, is that expectations had surpassed reality to such an extent that it didn't even take another recession to take the equity market down to new lows, which happened in October 2002 (not October 2001!), fully 11 months after the downturn officially ended.

Not only are the economists calling for 3% real growth, which would imply something close to 4-5% nominal GDP growth, but the consensus among equity analysts is that we will end up seeing over 30% operating EPS growth to a new high of $95.59 for 2011.

Gluskin Sheff

Gluskin Sheff at a Glance

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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.

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