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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

European equity markets are up for a sixth day in a row and government bonds on the continent are selling off moderately — even with the news that France's inflation rate dipped in June, to 1.7% from 1.9% (the market was expecting 1.8%). The other economic data-point dismissed was the German ZEW investor sentiment index, which was crushed in July, to a 15-month low of 21.2 from 28.7 (again, below consensus expectations of 25.3, but nobody seems to care). The world is turning warmer towards European banks with the prevailing view that stress tests will be met and that the Basel changes on capital rules will be less stringent than earlier thought. What investors don't know won't hurt them; we suppose.

While Eurozone equities are in a land all their own right now — up more than 1% right across the board — the euro did succumb to the news that Moody's downgraded Portugal's credit rating by two notches, to A1. In other words, the debt problems in Europe remain very intense, even with the apparent calm that has recently surfaced in the marketplace. According to Nobel Prize winner Robert Mundell, there is a 20% chance that we end up seeing a default in Spain, Portugal or Ireland and 40% for a Greece restructuring (Italy is at 10%) — these are non-trivial probabilities.

On the fixed-income front, Bloomberg runs today with articles indicating that Blackrock sees tremendous value in the BB-rated sliver of the high-yield space (as we do) and that PIMCO has made a switch from European bonds towards the Treasury market (we concur with that move as well). On the equity front, the Lex column (page 14 of the FT) makes the case as to why we are likely to see more share issuance as opposed to share buybacks despite the mountain of cash sitting on corporate balance sheets.

For some reason, as European bourses rally, we see that Asian markets are slipping. Most of the region was in the red column overnight, ostensibly on concerns that more policy tightening is coming in China. The country's GDP was just reported to be +10.5% YoY in Q2 from 11.9% in Q1, and other data showed a marked slowing in home prices — first decline in 18 months. Comments from the housing and urban-rural ministry seemed to suggest that lending curbs were going to remain intact to dampen speculative pressures in the property market. This is likely why the resource complex and commodity-based currencies are also under some selling pressure so far today (copper down for the second session in a row), although, Portugal's downgrade has put a bid back into gold, which is hanging in around its 50-day moving average.

It is still very early in the U.S. reporting season, but the two biggies thus far (CSX and Alcoa) basically came in line with "whispered" estimates, but top-line growth was decent, as was guidance.

IN THIS ISSUE

- While you were sleeping: European equity markets continue to rally, now up six days in a row, while, Asian stock markets are slipping; Moody's downgraded Portugal's credit rating by two notches, to A1; China's economy appears to be cooling down
- What's driving the markets in the U.S.? Answer: it is receiving a few jolts of liquidity and short-covering
- Just call it a whole lot of volatility: for the first half of 2010, the action in the S&P 500 has been very volatile
- Small business sentiment in the U.S. gets smaller: the latest NFIB optimism index fell to a three-month low in June
- Bank of Canada outlook surveys: slowing growth and easing credit conditions

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WHAT'S DRIVING THE MARKET?

We've been asked repeatedly how the stock market has managed to bounce off the nearby lows with such veracity. Especially with the ongoing weakness we have seen in the incoming U.S. economic data due to the fact that the retail investor still refuses to participate and is solely focused on income-generating strategies. The answer is that the market may have been on the receiving end of another few jolts of liquidity. M2 money supply has expanded $38.5 million in the past two weeks and the M1 money multiple has risen from 0.839 to 0.862.

Last week's 5.4% increase was the best performance since mid-July 2009; however, the in the prior week, the S&P 500 saw the largest decline in eight weeks

When we go to the weekly data from the Fed, we see that "trading assets" on commercial bank balance sheets expanded to $325 billion in the past two weeks from $297 billion. And, when we go to the Commitment of Traders report, we see that there has been a big swing in the net speculation position on the S&P 500 "E-minis" on the Mercantile Exchange (futures and options) to a net long position of 28,172 contracts from 15,155 net shorts just two weeks ago. That's a big part of the bounce-back — prop traders and short-coverings. Nothing fundamental here, as far as we can see.

JUST CALL IT A WHOLE LOT OF VOLATILITY

- Last week's 5.4% increase was the best performance since mid-July 2009 (week of July 17th). But yet, prior to last week, the S&P 500 saw the largest decline (-5% during the week of July 2nd) in eight weeks, and it was down two-weeks to boot (July 2nd and June 25th weeks).
- Last week also saw three days of positive performance, a streak we last saw in mid-April of this year. However, prior to those three positive sessions, the S&P 500 was down five trading days in a row.
- Last week's increase also comes in the heels of declines in June and May, which was the worst back-to-back decline since January and February 2009
- In Q2, we saw the worst quarter (-12%) since Q4 2008 and before that, Q3 2002. In fact, going back to 1946, a decline in the quarter of 12% or more is only a 1 in 20 event (we have only seen 12 quarters of 12%+ declines in the past 64 years).
- For the first half of the year, we have seen three up months (February, March, April) and three down months (January, May, June).
- The 80% increase in the stock market that we saw from March 2009 to April 2010 is the largest increase in such a short period of time since the period of May 1935 to April 1936.

Putting in perspective the latest reading in the NFIB small business optimism index, at 89 in June, it has never been as low as it is today in the context of an expansion in economic activity

SMALL BUSINESS SENTIMENT GETS SMALLER

The National Federation of Independent Business (NFIB) optimism index followed in the ISM's footsteps and slipped 3.2 points in June, to 89 — a three month low. Let's put this into some sort of perspective. A year after the 2001 recession ended, this barometer of small business sentiment was sitting at 101.9. In the year after the 1991 recession, it was sitting at 99.5. A year after the 1982 recession, it was already at 107.

In the near 40-year history of the survey, it has never been as low as it is today in the context of an expansion in economic activity. Equity market bulls should note that 70% of the decline in the index this past month was "from deterioration in the outlook for business conditions and expected real sales gains." The index measuring corporate earnings trends fell four points in June; the index assessing real sales activity sank five points.

Small businesses in the U.S. are also seeing tighter credit conditions; however, according to the NFIB's Chief Economist, *"Credit's not the issue, customers are the issue"*

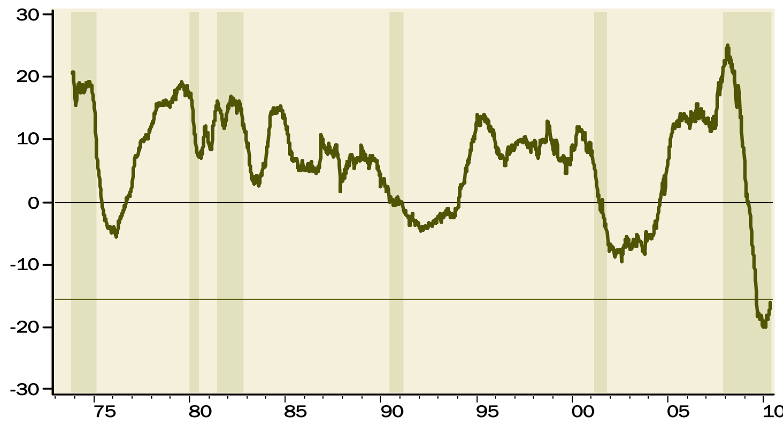
Moreover, what did the NFIB's Chief Economist, William Dunkelberg, say in the press release? He said that *"The U.S. economy faces hurricane force headwinds and the government is at the center of the storm, making an economic recovery very difficult."*

Ouch. That hurts.

The declines were broadly based, with no improvement in the hiring indicators and plans to boost capital spending (down a point) and inventories (down five points) receded sharply. Credit conditions were also reported to be tighter on the month. How big a surprise can that be? At the end of June, the total outstanding volume of commercial and industrial loans from the banking system stood at $1.1381 trillion, the lowest level in over three years and down 25% from the credit bubble peak.

CHART 1: COMMERICAL AND INDUSTRIAL LOANS ARE STILL CONTRACTING AT A DOUBLE-DIGIT PACE

United States: Bank Credit: Commercial & Industrial Loans
(year-over-year percent change)



Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Contemplate that for a moment. One-quarter of bank credit available for businesses has totally vanished during this intense debt deleveraging cycle (and nobody, including the Fed, knows why this credit contraction is ongoing — see *Small-Business Lending is Down, But Reasons Still Elude the Experts* on page B3 of the NYT; although in the article, Mr. Dunkelberg is quoted as saying:

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"Credit's not the issue, customers are the issue" in reference to the view that with capex plans near a 35-year low, the demand for loans is unusually low.

This actually was also reflected in the Q2 data on venture capital financing, which, at just $1.9 billion, was down 49% sequentially and the lowest in seven years — this is 'business as usual' for the equity bulls? Also have a look at *Obama Berated on Business"* on page 2 of the FT for other reasons why the corporate sector is holding back.

If you think that is a grim statistic, there is another "one-quarter" data point that is even more startling — one-quarter of American consumers, or 43.4 million, have now seen their FICO scores dip below 600, which puts them in the "risky borrower" category. That is an increase of 2. 4 million in the past two years and compares to the pre-bubble norm of 15%.

The key takeaways in the BoC's latest outlook surveys are: slower expected sales over the next year, less spare capacity, more hiring but less capex and inflation expectations that remain well anchored

BANK OF CANADA OUTLOOK SURVEYS: SLOWING GROWTH AND EASING CREDIT CONDITIONS

We had some fresh insight on the Canadian economy yesterday, with the release of the Bank of Canada's Business Outlook Survey (this covers the period from May 19th to June 15th). The key takeaways include: slower expected sales over the next year, less spare capacity, more hiring but less capex and inflation expectations that remain well anchored.

The 'headline' figure, the number of net firms expecting sales to increase over the next 12 months, fell to 25% from 44% in Q1. Not only is this the weakest reading since Q1 2009 but this is half the 50%+ readings we saw late last year and corroborates what the early Q2 data has been saying — that economic growth is clearly slowing from the super-charged rates we saw in the last two quarters (we are tracking sub-3% real GDP growth in Q2).

Future employment prospects rose to 40% from 38%, coming on the heels of the spectacular 93,000 June employment figure. However, while firms plan on adding bodies, they don't plan on investing in machinery and equipment (M&E). Net investment in M&E fell to 12%, from 22%, implying slower capex going forward, which could disappoint the BoC (in the latest 1 June press statement, the Bank had stated that *"[t]he anticipated pickup in business investment will be important for a more balanced recovery."*

There was more evidence that the slack in the economy had diminished with the percent of firms having some difficulty in meeting current demand rising to 35% from 26%, the highest level since Q3 2008 (not overly surprising given the 5%+ GDP figures in Q4 and Q1). Labour shortages remain low, unchanged at 12%, which are near record lows.

On inflation, 34% of companies reported higher input inflation (likely reflecting the fact that commodity prices, outside of energy, rose another 5% in Q2). However, output inflation remained steady, at 28%, suggesting that firms may not be passing on input-price increases, rather absorbing the increase through profit margins.

Inflation expectations remained well anchored, for the most part. Fifty percent of firms expect inflation to remain in the 1-2% range, while 45% expect inflation to be in the 2-3% range. In other words, 95% of firms expect inflation to remain within the Bank's 1-3% target. In the two extreme categories — below 1% and above 3% inflation, there was little change — 2% of the participants expect inflation to come in below 1% (up from zero in Q1) and 3% expect inflation above 3%, a decline from 6% in Q1 (and actually the lowest since Q4 2008 — this should provide some comfort to the BoC).

There was good news on credit conditions. Both this survey and another survey released by the BoC (the Senior Loan Officer Survey) showed that credit conditions eased, especially for large firms. The Senior Loan Officer Survey indicated the conditions were the easiest since Q2 2005.

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Gluskin Sheff at a Glance

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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.

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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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Notes:

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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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