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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite with Dave

Q&A WITH THE BEAR

Gregory Zuckerman at the Wall Street Journal just published a Q&A on the market and the macro outlook, featuring me alongside James Paulsen, Chief Investment Strategist at Wells Capital Management, whom I like a lot, but basically disagree with 99% of his views. Mr. Zuckerman only had so much space and while he did a great editing job, what I thought I would do is pass below the full-fledged responses from my end. Enjoy!

Where is the market headed the rest of this year and over the next 12-18 months?

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 (*ie,* 2002, 2009), when they occur; in secular bull markets, you do not make new lows — they are just corrections (*ie,* 1987, 1990, 1994, 1998).

The market is not as cheap as the pundits, who rely on year-ahead EPS estimates, deem it to be. When one incorporates cyclically-adjusted corporate earnings in 'real' terms, equities are still roughly 20% overvalued even after the recent correction.

More fundamentally, it would seem reasonable to expect that the equity market will trade down to a valuation level that is historically commensurate with the end of secular bear markets. This would typically mean no higher than a price-earnings multiple of 10x and at least a 5% dividend yield on the S&P 500. So, we very likely have quite a long way to go on the downside.

But it will not be a straight line and there will be intermittent rallies, as we experienced a year ago April; however, not even that 80% bounce off the lows managed to violate any of the long-term trend lines, which continue to portray a primary bear market, not unlike what we endured from 1966 to 1982. Back then the principal cause was an inflationary spiral; this time it is a deflationary debt deleveraging that is the root cause. Within the next 12 to 18 months, I can see the S&P 500 breaking back below 900, and a substantial test of the March 2009 lows cannot be ruled out.

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- An interview with the Bear: Gregory Zuckerman at the Wall Street Journal published a Q&A on the market and the macro outlook, featuring me alongside James Paulsen, whom I like a lot, but basically disagree with 99% of his views
- How will the U.S. mid-term election affect stocks, if at all? Tax rates on income and capital are going up next year, and gridlock will not give us strong leadership — hardly positives for the economic or market outlook
- What could happen that would turn you into a bear/bull?
- The U.S. equity market is still overvalued, according to the latest Shiller P/E ratio reading
- The roof collapses on U.S. housing: the NAHB housing index caved in again in July
- A meat-grinder market: typically, what happens after a once-in-a-generation-type decline are powerful rebounds, but it never moves in a straight line
- Tough slog for employment: a survey by Accenture showed that businesses in the U.S. do not plan to restore their workforce to pre-recession

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What should investors do with their portfolios?

Regardless of the outcome of the mid-term elections in the U.S., tax rates on income and capital are going up next year, and gridlock will not give us strong leadership

My primary strategy theme has been S.I.R.P. (Safety and Income at a Reasonable Price) because yield works in a deleveraging deflationary cycle. Not only is there substantial excess capacity in the global economy, primarily in the U.S. where the "output gap" is close to 6%, the more crucial story 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 what it means is that disinflationary, even deflationary, pressures will be dominant over the next several years.

Moreover, with the median age of the boomer population turning 55 in the U.S., there is a very strong demographic demand for income and with bonds comprising just 6% of the household asset mix, this appetite for yield will very likely expand even further in coming years. Within the equity market, this implies a focus on squeezing as much income out of the portfolio as possible, so a reliance on reliable dividend yield and dividend growth makes perfect sense.

We are in a period of heightened financial market volatility, which is typical of a post-bubble deleveraging period when the forces of debt deflation are countered by massive doses of government reflationary polices. This to-and-fro is the reason why in the span of a decade we have seen two parabolic peaks in the equity market (September 2000 and October 2007) and two depressed bottoms (October 2002 and March 2009). As I have said before, 80% rallies in a 12-month span, as we saw in the year to April, last happened in the early '30s and were followed by gut-wrenching spasms to the downside. So for any investor, return of capital is yet again reemerging as a very important theme, and the need to focus on risk-adjusted returns. This, in turn, means a strategy that minimizes both the volatility of the portfolio and the correlation with the equity market is completely appropriate — the best way to play this is with true long-short hedge fund strategies.

Gold is also a hedge against financial instability and when the world is awash with over $200 trillion of household, corporate and government liabilities, deflation works against debt servicing capabilities and calls into question the integrity of the global financial system. This is why gold has so much allure today. It is a reflection of investor concern over the monetary stability, and Ben Bernanke and other central bankers only have to step on the printing presses whereas gold miners have to drill over two miles into the ground (gold production is lower today than it was a decade ago; hardly the same can be said for fiat currency).

Moreover, gold makes up a mere 0.05% share of global household net worth, so small incremental allocations into bullion or gold-type investments can exert a dramatic impact. Gold cannot be printed by central banks and is a monetary metal that is no government's liability. It is malleable and its supply curve is inelastic over the intermediate term. And central banks, who were selling during the higher interest rate times of the 1980s and 1990s, are now reallocating their FX reserves towards gold, especially in Asia.

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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.

PERFORMANCE

$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.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $8.7 million USD[2] on March 31, 2010 versus $6.9 million USD for the S&P 500 Total Return Index over the same period.

INVESTMENT STRATEGY & TEAM

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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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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