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September 1, 2010
Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Equity markets are firm this morning right across the board, seemingly underpinned by a stronger-than-expected Chinese purchasing managers' report for August (went to 51.7 from 51.2 — consensus was at 51.5. It's amazing what the "beat" of a whole 20 basis points can do to investor psychology). Bonds are predictably selling off on this move — even though we saw a softening in these same diffusion indices out of Europe (the good news for the bulls is this was already priced in and the data did not come in below consensus estimates).

Adding to the pro-cyclical sentiment was the news that Australia's economy expanded last quarter at its fastest rate in three years (nearly a 5% annual rate). Corporate bond risks are receding as evidenced by today's 6bps tightening in CDS spreads across the pond.

In the FX market, the DXY is sliding 60bps in the early going — a sign that global risk-taking is back on the table, at least for today. Commodity markets are moving in tandem — copper has broken out as it tests levels not seen since last April. Gold is up another five bucks today and is about to meet a critical test as it approaches its prior springtime peak.

Barton Biggs is on the tapes saying *"This is not a time where you want to be underinvested. The odds of a significant slowdown are one in five, pretty remote."* The kiss of death, perhaps? He obviously is talking about equities, despite the domination of the bond-bullion barbell in 2010. Moreover, after that Q2 "one-handle" on U.S. GDP growth, isn't that "slowdown" already here? It's not even a forecast any more. It's arrived. In fact, the economy never really seemed to completely pull itself out of the recession that began 33 months ago. Example? To put yesterday's consumer confidence index into perspective, consider that during a typical recession it averages 72, and in an economic expansion, the level is typically 102.

As good as the Australian numbers were, the Canadian GDP data for Q2 disappointed — real final sales were even softer than in the U.S.A., at a microscopic 0.2% annual rate. The domestic demand deflator was basically flat. Little growth and no inflation at all and yet almost every research department on Bay Street still believes the Bank of Canada (BoC) is going to hike rates again next week (we don't think so). We can't see the logic in another move under current conditions given how far Q2 GDP growth and inflation are now coming in benchmarked against official expectations — maybe it's just a case of the Street becoming enamoured with a nice round number (1.00% on the policy rate if the Bank makes its third move).

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In any event, the Bank's ability to navigate this stable-price environment has been a boon to the Canadian fixed-income market as Government of Canada bonds, provincial bonds and corporate bonds have each generated returns of 7% year-to-date (and a blowout 2%-plus in August). S.I.R.P. lives!

We are kicking off September with a positive tone to what remains a highly volatile and schizoid stock market

To sum up, we are kicking off September with a positive tone to what remains a highly volatile and schizoid stock market. Keep in mind that all we heard for months was about the fabled "summertime rally", which never did seem to materialize. In fact, this was the worst August since 2001 — S&P 500 and the Dow both slipping well more than 4%. Not to mention the first losing August in five years — seasonally, this is usually a pretty, pretty, pretty good month for Mr. Market. Alas, roughly $700 billion of "paper wealth" vanished last month. The Nasdaq was clobbered 6.2% on the month (supposedly we are told by the economics community that we are into a capex-led recovery and yet the tech component of the stock market is down 11.5% this year — the worst of all 10 sectors!). And just to put today's bounce into context, these moves should fade.

Oh yes, for those who don't see how deflationary pressures are escalating in the labour market, have a look at *New Job Means Lower Wages for Many* in today's NYT. And this stress is spilling into the consumer spending space to boot — see today's WSJ article *Back-to-School Shopping Bust Heralds Holiday Woes.* According to MasterCard Advisors, sales are *"far short of 2008 levels"* (when the economy was already eight months into recession) in *"barely every sales category"* and focused only on *"bare necessities and budget-priced deals"* (and this is with sales tax holidays in many states, including biggies like Texas and Florida). And, the WSJ runs with an article today that Borders is shaving 20% off its electronic-book models — see *Borders Escalates E-Reader Price War*. Umm … and bonds are in some sort of a bubble in this sort of sashimi-like economic environment. Are you kidding me?

Here we are 33 months later and the levels of everything from home prices, to GDP, to organic personal income, to employment are all, to varying degrees, lower than they were just before the "Great Recession" began

As for the economy, here we are 33 months later and the levels of everything from home prices, to GDP, to credit outstanding, to organic personal income, to employment are all, to varying degrees, lower now than they were just before the "Great Recession" began. We can understand that this is not exactly cocktail conversation, but this is a Japanese-style (even worse perhaps) modern-day depression. It's not the 1930s because soup lines have been replaced with unemployment insurance lines — over 10 million checks and for up to 99 weeks. The poor souls who endured the bitter 1930s had no such relief.

Here we are, almost three years after the recession bomb was detonated, and our beloved policymakers are still tinkering with their chemistry set to figure out how to stop a post-bubble credit collapse in its tracks. The Fed is now openly contemplating QE2 (though admittedly, with no broad consensus just yet — they want to see if things get worse first. Thanks!).

And, we now see that a $1.5 trillion deficit just isn't enough for the folks at the White House who, the WSJ reports today, are *"considering a range of new measures to boost economic growth, including tax cuts and a new nationwide infrastructure program."* Wait a second — these are "new"? Wasn't this part of the ballyhooed round of fiscal stimulus unveiled a year-and-a-half ago? Amity Shlaes — please get ready to publish your second edition of "The Forgotten Man".

Households, left to their own devices without all the distortions by relentless government meddling, are finding ways to expedite the process

Maybe, just maybe, the government should move out of denial and into acceptance that it is a futile exercise to play around with nature. Perhaps the process of mean reverting to a household debt/asset ratio of 12.5% (now 20%) and household debt/income ratio of 65% (now 130%) requires additional deleveraging of $6 trillion and should be allowed to occur as quickly as possible. Short-term pain for long-term gain. Households, left to their own devices without all the distortions by relentless government meddling, are finding ways to expedite the process. One example of this is the growing number of U.S. homeowners who are opting to pay down their mortgages by reducing their effective amortization schedules upon refinancing — the share of who refinanced into a 15-year term so far in 2010 has shot up to 26% from 18% last year (CoreLogic data).

ADP EMPLOYMENT DROPS

The ADP survey showed a 10k loss in August versus expectations of a 15k gain. This was the first decline since January and represents a huge shift from +37k in July and the 60k-plus gains in April and May when visions of a V-shaped recovery were getting many a bull completely bulled up.

The August drop in ADP was the first monthly decline since January

Goods-producing job declines picked up to -40k – the most in seven months and the 41st decline in a row! What a recovery. Service-sector job gains slowed to +30k and as such, could not provide a full offset. Small businesses shed labour by 6k and mid-sized companies by 5k, while even large companies only added 1k and payrolls here have largely been stagnant since April (hey, didn't those Wall Street economics geniuses tell us that all those Census workers were going to get absorbed into the private sector?).

Watch the consensus take a knife to Friday's number now -- it had been penning in a 42k increase in private payrolls.

MARKET COMMENT

Quite the session yesterday with lots of bobbing and weaving, and in the final analysis, no recovery in the equity market and this followed a day when there was no follow-through from the ridiculously-dubbed "Bernanke rally" from last Friday. Treasuries retained their solid bid as deflationary pressures morph into reality and the latest on this score is what's now happening in the steel market, which is a glut of supply forcing iron price prices down. After doubling last year, there looks to be a 10% reversal through to year-end.)

FOMC MINUTES REVIEW

As for the FOMC minutes from the July meeting, all we really learned was that there was less dissent on the Fed than was generally assumed, and if anything, there was general acceptance of the Fed trying to provide more experimental stimulus if the economy fell short of expectations — as it is destined to do since the central bank remains too hopeful over a more discernible growth pattern in 2011 after acknowledging that conditions have surprised policymakers to the downside in recent months. Take a look at the underlined comments — the ones that are bolded and underlined provide the reasons why it makes perfect sense to expect yields out the Treasury curve to remain on a downward trajectory over the intermediate term) The staff and the Committee continue to set themselves up for disappointment.

All we really learned from the FOMC minutes from the July meeting was that there was less dissent on the Fed than was generally assumed

To wit:

"In the economic forecast prepared for the August FOMC meeting, the staff lowered its projection for the increase in real economic activity during the second half of 2010 but continued to anticipate a moderate strengthening of the expansion in 2011. The softer tone of incoming economic data suggested that the pace of the expansion would be slower over the near term than previously projected ... Over the forecast period, the increase in real GDP was projected to be sufficient to slowly reduce economic slack, although resource slack was still anticipated to remain quite elevated at the end of 2011."

We have asserted time and again, the scars from the trauma that hit the U.S. household balance sheet have not fully healed

"Weighing the available information, <u>participants again expected the recovery to continue and to gather strength in 2011</u>. Nonetheless, most saw the incoming data as indicating that the economy was operating farther below its potential than they had thought, that the pace of recovery had slowed in recent months, and that growth would be more modest during the second half of 2010 than they had anticipated at the time of the Committee's June meeting..."

*"...**<u>members generally saw both employment and inflation as likely to fall short of levels consistent with the dual mandate for longer than had been anticipated</u>**."*

"Most members judged, in light of current conditions in the MBS market and the Committee's desire to normalize the composition of the Federal Reserve's portfolio, that it would be better to reinvest in longer-term Treasury securities than in MBS. While reinvesting in Treasury securities was seen as preferable given current market conditions, reinvesting in MBS might become desirable if conditions were to change. A few members worried that reinvesting principal from agency debt and MBS in Treasury securities could send an inappropriate signal to investors about the Committee's readiness to resume large-scale asset purchases."

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"***All but one member concluded that it would be appropriate to begin reinvesting principal received from agency debt and MBS held in the SOMA by purchasing longer-term Treasury securities in order to keep constant the face value of securities held in the SOMA and thus avoid the upward pressure on longer-term interest rates that might result if those holdings were allowed to decline***."

FRUGALITY AT ITS BEST

As we have asserted time and again, the scars from the trauma that hit the U.S. household balance sheet have not fully healed. The asset deflation and credit contraction have radically altered consumer spending behaviour — perhaps for a generation.

The article on page B1 of the Saturday NYT really resonated — *Travel Plans, But Frugality Comes Along For the Ride*. The best line came from Forrester Research who concluded that *"people are travelling with one hand firmly clasped to their wallets."*

Businesses are being forced to respond in a highly deflationary manner. To wit: *"In response, hotels, cruise lines and other travel-related businesses are discounting rooms, advertising reward programs and adding incentives."*

QUOTE OF THE DAY

The quote of the day has to go to Alan Blinder in his comment on Ben Bernanke's menu of quantitative easing options outlined last Friday (why this could elicit a rally in anything is truly a mystery). Here it goes:

"The Fed has run out of the strong tools, and is turning to weak ones. When you're fighting in a foxhole and you've used up the machine guns and hand grenades, then you pull out the sword and start throwing rocks."

Quote of the day:

"The Fed has run out of the strong tools, and is turning to weak ones. When you're fighting in a foxhole and you've used up the machine guns and hand grenades, then you pull out the sword and start throwing rocks." Alan Blinder

HOW BAD IS THE U.S. JOBS MARKET?

So bad that the Economist runs with three huge articles this week discussing the situation:

Joblessness in America: A Stickier Problem on page 11.

Unemployment and the mid-terms: To Help or Not To Help on page 23.

There is More to America's Stubbornly High Unemployment Rate than Just Weak Demand on page 68.

HOUSING AND JOBS

The FT runs with *Construction Holds Key to Rebuilding Jobs Market*. We wonder if the causation doesn't run in the other direction – housing needs a better labour market. I mean, how is it possible, with 10 construction workers employed for every housing start versus the long-run average of three that we can rely on the construction industry to embark on a hiring spree?

IT'S NOT JAPAN ALL OVER AGAIN?

We hear (or used to hear anyway) how the U.S.A. is not Japan due to its flexibility and better demographics. Meanwhile, government policy (see Barro in Monday's op-ed section of the WSJ) and the record number of people upside-down on their mortgage have seriously impaired the flexibility of the labour market. And, what is this about demographics? The birth rate has declined for two consecutive years in the U.S. and is at its lowest level in a century (the number of births fell 2.6% last year; the rate dropped to 13.5% from 14.3% in 2008), Visa applications are declining and the labour force has contracted 0.5% over the past year.

YOU CALL THIS CAPITULATION?

The Wall Street Journal came out and said that

"Goldman Sachs has one of the most pessimistic outlooks for growth among Wall Street banks, but even it sees the economy growing 1.5% in the second half of this year and early 2011. Goldman economists put the likelihood of a double-dip recession at 25% to 30%, a substantial risk but still unlikely."

This is what passes for pessimism today – the weakest forecast is positive 1.5% growth and a 2 in 3 chance of sustainability.

This is not typically what helps equity markets to find a bottom. This type of forecast underscores the general level of complacency lingering out there.

In a similar vein, the WSJ quoted a senior bond trader as saying (in the aftermath of Bernanke's sermon on last Friday):

"Stocks are reading the Bernanke speech and they see he's going to provide a ton of stimulus into the system so no deflation. It is not a good sign for long-dated bonds."

This quote is really typical of most folks we talk to. It's only when everyone adores the bond market that yields will find the secular lows. However, as long as the pundits are bearish, the smart money is likely to stay bullish. Let's just say in response to above quote that first, the Fed's stimulus is coming via purchases of bonds, not stocks. Doesn't it therefore make sense that, *ceteris paribas*, bond prices should have a fairly constant bid with the help of the Fed's deep pockets?

Second, it seems highly unlikely that the economy will come out the other side of this rough economic patch with market interest rates rising. Domestic demand needs lower borrowing costs for its revival, not the other way around.

Third, what difference will it really make if bank balance sheets are stuffed with even more cash when the $1.3 trillion already infused by the Fed's overtly generous hand has only been sitting idle for the past year. Is liquidity really the issue when corporate coffers are flush with cash, or do we have on our hands a

terribly uncertain economic outlook undercutting household and business confidence?

As for *"a ton of stimulus",* please. Since the Fed first unleashed QE in late 2008, the core inflation rate has come down more than 100bps and the unemployment rate has climbed 200bps; and, that includes the massive runup in the fiscal deficit. There really is no more certainty that all this intervention will end up being any more successful than been the case for so long in Japan.

THE VISIBLE HAND

The two largest economies in the world are being sustained by the long arm of the law. At least in China it's to be expected that a communist country would be fuelled by command central, but in this miracle story, below the surface it is becoming abundantly clear that Beijing is becoming increasingly involved. The front page article of the Monday NYT uncovered how the economy is delivering its red-hot growth rates: *"New data from the World Bank show that the proportion of industrial production by companies controlled by the Chinese state edged up last year … investment by state-controlled companies skyrocketed, driven by hundreds of billions of government spending and state bank lending."* No wonder the Chinese economy and stock market have diverged.

The two largest economies in the world are being sustained by the long arm of the law … but at least in China, it's to be expected

Is it really much different in the U.S.A. today with every 1 in 6 Americans now receiving some form of government assistance? More than 50 million Americans, from food stamps, to Medicaid, to extended jobless benefits, are on one or more taxpayer-supported programs. This likely explains why this depression does not have that 1930s feel of despair to it. But a depression it is.

In a depression, radical changes occur in terms of social norms and spending behaviour. In recessions, people don't cancel their life insurance policies — as one example. But in a depression, tragically, this is what happens — almost 35 million Americans now have no such coverage, up from 24 million five years a go. This reflects the focus by households to pay down their debts at all costs and how companies have bolstered profits — by eliminating benefits. See *More Go Without Life Insurance* on page C1 of the Monday WSJ.

It's not just households and businesses that alter their behaviour in a depression. That goes for any entity with balance sheet constraints — like cash-strapped state and local governments who are closing hospitals en masse to cut costs (see *Cash Poor Governments Ditching Public Hospitals* on page C3 of Monday's WSJ) and at the same time, boosting taxes (on the same page, see *States See Pickup in Tax Revenue*).

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U.S. CONSUMERS DRAWDOWN SAVINGS RATE TO SPEND; DISINFLATION TREND STILL INTACT

U.S. personal consumption rose a slightly better-than-expected 0.4% MoM pace in July, and in real terms, it was up 0.2% MoM. Spending on durables rose 1.0% in July, the best reading in three months, spending on non-durables up 0.3% MoM, the best result in four months, and spending on services rose 0.4%.

With the U.S. household still in the deleveraging process and given the current state of the labour market, it is highly unlikely that the consumer will continue to drawdown their savings further

Since spending outpaced income, consumers had to once again dip into their personal savings to pay for their purchases. As a result, the savings rate fell to 5.9% in July from 6.2% in June. However, with the U.S. household still in the deleveraging process and given the current state of the labour market, it is highly unlikely that the consumer will continue to drawdown their savings further.

As for the implications for the third quarter, despite the strong reading in July, the build-in going into Q3 for consumer spending is 1.3% at an annual rate, which is slower than the 2.0% pace we saw in the second quarter.

Personal income came in slightly below market expectations, rising 0.2% MoM versus a forecast of a 0.3% increase. Yes, this was an increase from the slightly negative reading in June, but keep in mind that this result is lower than the readings we saw in May, April and March. In real terms, we are now seeing no growth in real personal income and the monthly trend declining since April. Moreover, real disposal income fell 0.1%, which is the first decline we have seen since the beginning of the year. Combined with the anemic labour market, this is probably reason enough for the National Bureau of Economic Research (NBER) to stand pat in their recession call, notwithstanding the brief though intense mini-inventory cycle.

Inflation wise, it was pretty tame in July with the YoY pace on the PCE deflator holding steady at 1.5%

Inflation wise, it was pretty tame in July with the YoY pace on the PCE deflator holding steady at 1.5%. Core PCE (which excludes food and energy) rose 0.1% MoM (in line with expectations) and the YoY rate held at 1.4%. Some may look at the market-based PCE as a signal that inflation is on the rise; however, the 0.2% rise in the market-based PCE deflator was just reversing the two 0.1% decreases in the prior two months and the YoY rate is running at a non-threatening 1.3% rate. Moreover, the core market based PCE is up 0.1% MoM again in July (we have now seen 0.1% increases in this metric since February); however, going to two decimal places, the core is only 9bps from the zero line. And, the YoY rate is sticky, now at 1.1% in the last four months.

CANADA: NO LONGER GOLDEN

It's official, Canada's spectacular economic performance that spanned two quarters has ended

It's official, Canada's spectacular economic performance that spanned two quarters has ended. Second quarter GDP moderated to just 2.0% QoQ SAAR (only four tenths higher than U.S. Q2 GDP growth!), missing our and the consensus estimate for a 2.5% increase. It turns out that the BoC's downgraded 3.0% estimate was too lofty as well (although, the Bank is probably thinking thank goodness they took their original 3.8% forecast from April down.) While still impressive, Q1 GDP was taken down a few notches to 5.8% from 6.1%, adding to the overall negative tone of the release.

The details were very mixed to be sure. Personal consumption expenditures slowed to 2.6% from 4.3%, the weakest in a year. Unsurprisingly, residential construction ground to a near-halt, up just 1.2% from 20%+ in the prior two quarters. And this will likely be the best result for some time… the incoming data suggest the housing market will continue to deflate and in our view, residential construction will be a drag on GDP growth for at least two quarters.

There were certainly some positives from the business sector. Non-residential construction actually managed to rise 1.0% after a six-quarter string of declines. Investment in machinery and equipment jumped by nearly 30%, which hopefully will translate into some positive productivity improvements down the road.

We saw more evidence of building inventories – the question for growth going forward is whether they were intended or not. The build was so large in Q2 that inventories added 1.8 percentage points to the 2.0% headline number. Final sales (excluding inventories) were a paltry 0.2%, the weakest since Q2 2009.

Trade was a mixed bag as well with exports up 6% and imports up 16.4%. Overall, net exports were a 3ppt drag on overall growth.

On a monthly basis, June GDP did okay, rising 0.2% MoM, improving on the April and May readings. The hand-off to Q3 is decent and with some monthly growth, Q3 could come in at around 2.5%, which is slightly below the BoC's 2.8% forecast (the downside risk is that we don't get modest growth and in that case GDP will slip below 2%). We will be watching inventories and housing especially for clues on Q3 growth going forward.

For the BoC rate decision next week, it certainly won't be a slam dunk, especially after yesterday's disappointing GDP report. The fixed-income market is pricing in roughly 40% odds that they raise rates. Bay Street economists are more optimistic, collectively voting for a 25 bps increase (but not by a unanimous vote, with eight of 11 economists pencilling in a 25 bps increase). If we had a vote, it would be for the BoC to stand pat next Wednesday, especially in light of a very benign inflation landscape and slowing economy.

MORE EVIDENCE THAT THE CAD IS OVERVALUED

Canada's current account deficit widened to $44.1 billion annualized in the second quarter. We think this is significant, especially as it relates to the Canadian dollar.

While we are long-term CAD bulls, we think this is yet more evidence that the CAD is overvalued from a short-term perspective

Benchmarked against GDP, the current account deficit is 2.7% of GDP, more negative than the 2.1% recorded in Q1. In fact, we haven't seen the current account deficit this wide since Q3 2009, when the dollar averaged about 90 cents (it's currently trading around 93-94 cents U.S.)

While we are long-term CAD bulls, we think this is yet more evidence that the CAD is overvalued from a short-term perspective. Our in-house model (which relies on commodity prices and short-term Canada/U.S. interest rate spreads)

pegs fair value at around 91/92 cents. Given the current account deficit and our model, we are inclined to believe that the Canadian dollar is about 2.5-5.0% overvalued or about 2-4 cents.

HOUSING PRICES — THE LAST HURRAH?

We had positive housing data point yesterday, in the form of the Case-Shiller price index, which rose 0.3% MoM on a seasonally-adjusted basis (vs. 0.2% expected) and up 4.2% YoY, a slight slowing from May's 4.6% rate. We wish we could stop there and suggest that the housing market is recovering.

While we are fans of the Case-Shiller index, there are a couple of problems with reading too much into this data point. For starters, this is June data. On top of this, it is a three-month moving average. This means that the positive effects of the tax-credits are still being captured here. So unfortunately, yesterday's data was 'old'.

There are a couple of problems with reading too much into yesterday's housing data point

The problem is that the 'newer' data in the form of July housing data (i.e., post-tax credits), such as existing and new home sales, not to mention the August NAHB survey, were dreadful. July existing home sales plunged 27% MoM and home prices actually slipped after five months of gains and new home sales fell 12% with prices falling two months in a row. The post-tax-credit data have been so bad in fact, we think we are seeing another leg down in the housing market, not a recovery by any stretch.

CONSUMERS FEELING MORE CONFIDENT BUT…

Consumer confidence rose 2.5 points to 53.5 in August, better than expected. Consumers felt better about the outlook, upgrading future expectations by 7.4 points while still feeling gloomy about the current situation, which fell nearly 5 points.

To put this number in perspective, especially as it pertains to recessionary periods, consider that during an average recession, consumer confidence averages about 70 (even with the August improvement, we are nearly 17 points below that). We are nowhere near expansionary level, which averages over 100.

Buying intentions were mixed. Home buying intentions rose, but only recouped part of the two-month losing streak. Despite improvements in the housing component, consumer appetite for big-ticket purchases, such as fridges and the like, fell by three points, the third decline in four months. Car buying intentions were also up — although most of the increase was centered in used cars, so this may not translate to better results for the car companies.

Perhaps the one clear take away from yesterday's report was the detail on the employment components, which can give us clues about the direction of the unemployment rate (August employment data is due this Friday). 'Jobs plentiful' fell to 3.8 from 4.4 (lowest level since December 2009) while 'Jobs hard to get' ticked up to 45.7 from 45.1. The spread between the two, which

is often a useful proxy for the unemployment rate, became more negative, falling to -41.9 from -40.7, implying that the unemployment rate will likely tick up a tenth to 9.6% from 9.5% (in line with consensus estimates).

WHY THE U.S. MAY BE CONTRACTING IN Q3

We are currently seeing a discernable slowdown in the third quarter, suggesting that GDP growth be contracting (versus the 2.5% penciled in by economists) or at the least, real final sales. Consider the following Q3 momentum numbers:

We are currently seeing a discernable slowdown in the third quarter, suggesting that GDP growth may contract

- Real personal income excluding government transfer: flat to slightly negative
- Real personal spending: up at 1.3% at an annual rate, a slowdown from the already tepid 2.0% in Q2
- Housing starts: -32.0% at an annual rate
- Real non-residential construction: flat
- Non-defense shipments excluding aircraft: -1.2% at an annual rate, Q2 was +17.5%

INCOME THEME INTACT

The ICI data were just released for July and again showed large-scale outflows from U.S equity funds – to the tune of $10.44 billion, the third net redemption in as many months and double what we saw in June. Capital appreciation funds have now seen outflows three months in a row totaling $13.918bln (July saw a $8.05bln outflow).

The weekly data by TrimTabs indicate that the flows out of bonds intensified through August 27th – in excess of $12 billion. This would otherwise seem to be a deliberate attempt on the part of the household sector to redress their huge 27% exposure in their overall asset mix in equities (as much as they have in their home!) and ultra-low 6% weighting in fixed-income securities.

Indeed, as for bond funds, there was another huge inflow in July, $30.041bln on top of the $20.602bln in June. That was the 19th straight month of net accumulation in what is now a well-defined secular shift. And, it does not matter what kind of bond fund it is, all categories saw big inflows – corporates $3.162bln, high-yield $2.569bln, government $3.727bln. Is there really a "bubble" in Treasuries with this level of inflow?

In stark contrast to equities, TrimTabs estimates that in August net inflows to bond mutual funds approached $30 billion. Income is clearly king, not cash, because money market funds were wound down to the tune of $6.4 billion on top of $24 billion in June.

At least we know where the mountain of money on the sidelines is going, and it's not equities.

As for liquidity ratios, equity funds portfolio manages have theirs at an all-time low of 3.4%, down from 3.8% in June. Tack on the fact that there are really not very many shorts to be covered – since the market peaked in April, short interest is 4.3% of the S&P 500 market cap (in August 2008 it was 6%) and there's not a whole lot of underlying fund-flow support for the stock market here.

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Gluskin Sheff at a Glance

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OVERVIEW

As of June 30, 2010, the Firm managed assets of $5.5 billion.[1]

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).[2]

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[3] 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.

PORTFOLIO CONSTRUCTION

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.

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.

$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. *Preliminary unaudited estimate.*
2. *Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.*
3. *Returns are based on the composite of segregated Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.*

Gluskin Sheff

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