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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite with Dave

STICK WITH WHAT IS CERTAIN IN AN UNCERTAIN ENVIRONMENT

As we highlight below, there is actually a significant chance that the economy will either sputter or contract in coming quarters and the good news is that Ben Bernanke gets it. Whether QE2 will do more than cushion the blow remains to be seen, but suffice it to say that we have no conviction at all over the $95 operating EPS consensus estimate for 2011 (S&P 500). Either we see at least 7% nominal GDP growth (we last saw that in 1989 when, um, inflation was running at 5%) or profit margins have to soar to new all-time highs; not impossible, just not very probable. Equities as an asset class are priced off the income statement, so a lack of conviction in the latter necessarily implies a lack of conviction on the former.

It's a good thing that corporate balance sheets are still in very solid shape so that we can continue to favour credit strategies.

We have an unbelievably tumultuous financial market backdrop on our hands — the equity market has experienced six (!) mini bull and bear markets so far this year. What's the best strategy here in order to grow capital and minimize volatility? True long-short strategies; hedge funds that really hedge out the risk.

What else? Well, as the U.S. economy — the industrialized world economy, in fact — sputters, emerging Asia and other countries with solid sources of autonomous growth are doing just fine. Call it de-coupling light. Therefore, our preference is to play the growth in the emerging markets that have really emerged via the commodity complex. After all, the U.S. consumer is the marginal buyer of health, education, financial and recreation services but it is the emerging Asian consumer that is adding to the wardrobe, buying a new car for the first time and changing his/her dietary habits. Change is at the margin, and at the margin, Asia drives the commodity consumption bus. For Canada that is a good thing, and one reason why the Canadian dollar continues to behave extremely well, if in a tight range in recent months.

Finally, bonds look very good, if for any reason than the Fed, which has even deeper pockets than Bill Gross, is contemplating how, not whether, to embark on a bond-buying program, which is destined to flatten the still-steep Treasury curve in a very material way. The total return potential is significant. See *Fed Mulls New Bond Approach* on page A2 of today's WSJ.

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- While you were sleeping: sloppy day so far on global equity markets; commodity prices and resource-based currencies are under a tad of pressure
- Stick with what is certain in an uncertain environment
- Did you know that 30% of the U.S. population now has a FICO score of under 620?
- Reality check on the U.S. macro outlook
- What has been working? Our call on bonds (both Treasuries and corporates), commodities, and gold

WHAT HAS BEEN WORKING

We continue to field criticism that we "missed the call" on the equity market. Well, no doubt we did not see the 1930-style bungee jump last year, but: (i) it's over, and (ii) there were many other asset classes we liked that did very well.

Look at the S&P 500. It had one of the worst months on record in August followed by a smashing rebound in September that still leaves it in the 1,022-1,217 range for the year. At today's level of 1,142, the S&P 500 is barely changed since mid-November; nothing to show but flattish returns and a ton of volatility.

The TSX has done a little bit better and in fact we have favoured Canada over the U.S. given the resource and gold exposure. Even here, at 12,190, the TSX is little better than it was in mid-March, so in this case it is six months of a do-nothing market. It is still within the 11,092-12,280 range of 2010.

But we can understand the need for people to label market commentators as being "bullish" or "bearish"; however, in the final analysis, it is all about growing capital in a prudent manner. If somebody was "bullish" on equities at the start of the year and told you to load up on tech stocks (which are actually down), was he/she more correct than someone who wasn't as "bullish" on the overall market but told you to load up on telecom (+7.0%) and staples (+5.0%) in an overall equity underweight? Or even in the past 12 months, with the overall market up barely double-digits, would a "bullish" strategist have been right if he/she advised you to be long the financials, which are down 4.5%. Or could it be the "bearish" strategist was actually more prescient by being underweight but advising clients to have a core position in basic materials (which happen to be up 9.0%)? There is more to investment advice than merely being "bullish" or "bearish" on a particular asset class, as is usually the case, the real gems are what lies beneath the surface of the forecast as opposed to what makes the headlines.

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Our call on bonds has been solid with Treasury market returns of 10% over the past year (outperforming the S&P 500 by more than 50bps). We have been through most of the past year positive on commodities, and the CRB index is up 13%.

The theme of strong corporate balance sheets has been constructive — returns in the corporate bond market have been a solid 11% — equity-like returns for less risk and volatility.

And of course, what has done better than gold, which is up more than 30% in the last 12 months.

Gluskin Sheff

Gluskin Sheff at a Glance

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$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $10.9 million[2] on June 30, 2010 versus $5.4 million for the S&P/TSX Total Return Index over the same period.

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$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $10.9 million[2] on June 30, 2010 versus $5.4 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.

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