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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite with Dave

U.S. FEDERAL RESERVE — QE2 THOUGHTS

There was nothing in the Fed press release yesterday that was really surprising. In fact, the market's initial dramatic reaction (all over the map) was what's most surprising. The Fed is going to be buying $600 billion of Treasuries (in the 5-10 year part of the curve) through mid-2011 and another $250-300 billion via coupon reinvestments, which they were going to do anyway.

The "number" that was key for the markets is that $600 billion figure, which is about $75 billion per month. That is in the middle of consensus expectations of $50-100 billion. Not "shock and awe", based on what was broadly expected, but not "light" either considering that the economy, at least so far, has managed to avoid double-dipping.

For all the excitement, this further expansion of the Fed's balance sheet will add between 0.25-0.5% to real GDP growth; however, this will take the size of the Fed's balance sheet to a Japanese-style 20% of GDP!

What the Fed is clearly trying to do is reflate asset values in order to generate a more positive wealth effect on personal spending and pull the cost of debt and equity capital down in order to re-ignite business "animal spirits" and hence corporate investment and hiring. In a balance sheet or deleveraging cycle, success is not always guaranteed even by the most aggressive of monetary policies.

In the interim, the risks the market faces in the near-term is economic disappointment from three possible sources that could inflict some pain on the consumer:

1. The five million 99ers who are about to lose their jobless benefits (can even a lame duck Congress be that heartless?);
2. The looming tax hikes on January 1 if a GOP-White House deal isn't brokered, and;
3. The bite into discretionary spending from the spike in food and energy prices — at exactly the most important shopping time of the year. Look out for a big bite out of GDP from what will likely prove to be at least a sharp upward move in the price deflator (have a look at *Food Sellers Grit Teeth, Raise Prices* on page B1 of today's WSJ as well as *Apparel Makers To Lift Prices* on page B2).

The equity market loves the liquidity boost but as I said, it is priced in. There are twice as many bulls as there are bears in the sentiment surveys and the stock market is trading near the top end of the 2010 range. Moreover, the two "critical" events that got Mr. Market all excited in the last two months are now yesterday's news.

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- While you were sleeping: risk trade is clearly on again — equities are surging across the globe and bond markets are getting clobbered; U.S. dollar is breaking down; commodities are well bid
- Thoughts on QE2: the Fed is clearly trying to reflate asset values in order to generate a more positive wealth effect on personal spending and pull down the cost of debt to re-ignite business "animal spirits"
- More thoughts on QE2: in some respect, the Fed did as little as possible yesterday. What good is another handful of basis points decline really going to do for the economy?
- When bullish is bearish: chasing the market is human nature, but this behaviour is very important for investors
- Long/short strategies from the Challenger report: the Challenger layoff/hiring report contains some nice details at the industry level
- ADP private payroll result was better than expected; but we are not that excited
- U.S. service sector humming
- Factory orders point to upward revision to U.S. Q3 real GDP
- Toronto housing market — springing a leak?

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MORE THOUGHTS ON QE2

The Fed, in some respect, did as little as possible yesterday. Not so much in size, though they could have done more on that score (equivalent to a rate cut of 50-75bps), but more in terms of where the central bank is focusing its bond buying activity. The bulk of the bond purchases are in the mid-part of the curve where yields are already 1%. What good is another handful of basis points decline really going to do for the economy at this part of the curve? Not much. Only 6% of the bond buying is in maturities of 10 years or longer and that is what matters most for the economy and that is the only part of the curve where there is any juice left, in terms of basis point yield impact. Bottom line: While the Fed could have done more yesterday, it didn't because the economy is doing better than expected at this juncture, even if still quite fragile.

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ADP: BETTER THAN EXPECTED BUT WE'RE NOT THAT EXCITED

The October U.S. ADP employment figures came in better than expected, with private payrolls rising 43,000 in October, more than double consensus estimates. To put things into perspective, when the recession started in Q4 2007, ADP was averaging north of +60k

The details were mixed; both small- and medium-sized businesses registered gains, up 21k and 24k, respectively. However, large business hiring was down 2k, which doesn't bode well for Friday's number given that NFP has a larger orientation towards large businesses. So, the -2k print on large company payrolls in the ADP data may be a more accurate barometer, as far as tomorrow's data are concerned.

The manufacturing sector shed 12,000 jobs, following 15,000 jobs lost in September. This certainly seems at odds with the recent reading of the October ISM, which had the employment sub-component rising.

U.S. SERVICE SECTOR HUMMING

Good news from the service side of the U.S. economy were the non-manufacturing ISM rising to 54.3, better than expected, from 53.2 in September. Most of the components were positive with the closely watched employment component rising to 50.9 from 50.2. New orders also rose strongly, up nearly two points to 56.7.

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TORONTO HOUSING MARKET — SPRINGING A LEAK?

Existing home sales in the Toronto area came in at 6,681 in October, down 21% from year-ago levels. Meanwhile, the supply of backlog is growing inexorably — active listings surged 21% to 18,305 units from 14,771 in October 2009. The average number of days that homes for sale have been sitting on the market is up 19%, to 31 days, versus 26 days a year ago. Average selling prices are still 5% higher today than they were a year earlier, but the bloom is off the rose and that pace is poised to reverse in coming months.

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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.

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.

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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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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.

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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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For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

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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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