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November 15, 2010
Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

The action in equities is rather mixed but with a downward bias. Europe is seeing moderate downward pressure. Asia saw the Shanghai index up smartly (+1%) but the Korean Kospi was flat and the Hong Kong's Hang Seng index finished lower, down 0.8%. The Nikkei closed up 102 points or 1.1% and the chart right now shows one of a breakout — and doing so without much fanfare. It didn't hurt things to see Japanese real GDP post an upside surprise of 3.9% at an annual rate in Q3 versus 2.5% expected, and double the U.S. pace).

The bond markets on either side of the ocean are still selling off, so there is no flight to safety taking place amidst this equity market correction — the U.S. 10-year does now seem on its way to test 3% for the first time since mid-summer. The U.S. long bond, which was left to its own devices as the Fed chose to focus its buying activity on the front- and mid-part of the Treasury curve, is now relishing its role as Little Orphan Annie, and the only one not selling off in recent days. In our view, this segment currently offers the most compelling risk-return attributes.

In the FX market, the U.S. dollar is firm on continued debt concerns regarding Ireland. At 78.5, the DXY index is now kissing the 50-day moving average. The fact that Greece just revised last year's deficit-to-GDP ratio to 15.4% from 13.6% hasn't done much to shore up confidence in the periphery. Commodities and the resource-based currencies are a tad softer to kick off the week. We also see the Baltic Dry Index struggling again, which is not consistent with a pro-growth global economic view that has very quickly become the consensus view. This could be a reason why the bond market selloff will inevitably prove to be as attractive a buying opportunity as it was last spring when the yield highs for the year were being turned in under similar widespread cyclical views. All we can say is that the same Wall Street economists that were cutting their GDP forecasts at the lows in the equity market last August are now starting to raise them just as the S&P 500 is testing its highs for 2010. Something to consider as year-end approaches, strictly from a contrary standpoint.

U.S. CONSUMER CONFIDENCE — LESS THAN MEETS THE EYE

The University of Michigan consumer sentiment index ticked up in November, to 69.3 from 67.7 in October, and the headlines were screaming at how it hit a five-month high. There was no mention of the fact that:

1. It is still off the 76.0 nearby peak posted in June.
2. At 69.3, it is not only well below average economic expansion levels of 99.0, but is still below what we generally see in recessions (74.0).

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3. The report itself was hardly universally positive — sentiment was down in the Northeast (64.5 from 65.2), the South (65.2 from 68.3) and was basically flat in the Midwest (72.8 from 72.4). All the strength was in the West — 77.1 from 63.3 — and was likely more due to the Giants' World Series victory than anything to do with the economy.
4. People aged 35-54 saw their confidence levels fall too (only the breadwinner age group) — to a four-month low of 70.2 from 70.5 (a record high unemployment rate of over 8% likely at play here for this age group).

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What's incredible was how little impact the weak U.S. dollar and the bounce in commodity prices have had on household inflation expectations. The median 5-10-year inflation expectation measure remained at 2.8%, about where it has been for six months. Now the one-year median inflation expectations gauge did rise to 3.0% in November from 2.7% in October and 2.2% in September, so this is not a case of the consumer being ignorant about what is happening to the price of crude, copper and food. It is just that the consumer knows that the commodity boom and weakness in the U.S. dollar is likely not going to be a multi-year feature of the landscape any more than it was when oil was piercing $140/bbl in the summer of 2008 (recall that six months later, everyone was talking about deflation — who would-a thunk?).

So, when you do the simple math, Joe Sixpack sees inflation at 3% in the coming year (from 1% now) and then averaging 2% in the next four years. Depending on how food and fuels play out, this could well be consistent with a zero or even sub-zero environment as far as core consumer price trends are concerned. This is why long Treasuries are likely to remain in a secular bull market for some time to come.

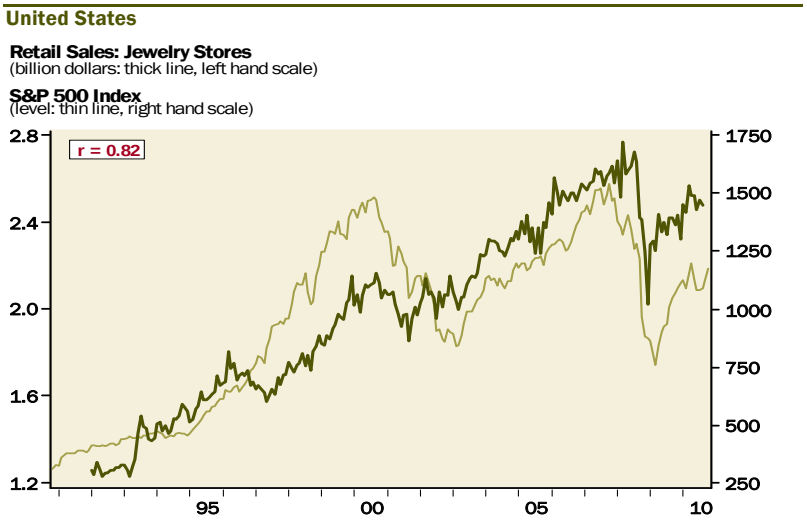
… But the report itself was not universally positive — sentiment was down in three of the four regions

One interesting development in the data is the divergence we are seeing between low and high-income household sentiment measures — the former edged up to 65.0 from 63.7 and the latter turned in a much more decisive increase, and to a higher level too, to 77.3 from 74.9. This would tend to support the increasing view that luxury retail sales will be an outperformer heading into the holiday shopping season (see *Will They Shop* in the current BusinessWeek; *High-End Retailers Expected to Set a Fast Pace in Christmas Sales* on page A6 of today's Investor's Business Daily; and *Recovering Rich Spur Pace of Sales* in the weekend FT).

Be that as it may, the bar has been set pretty high for this year — the International Council of Shopping Centers is projecting a 6-8% YoY sales gain for November-December. The BusinessWeek article cites a survey concluding that those households that earn less than $50,000 plan to spend 1.2% less this year than in 2009, while those bringing home over $50,000 intend to spend 2.9% more on average.

As the chart below illustrates, there is an 82% correlation between the stock market and high-end retail sales, such as jewellery. So there is obviously some truth to the equity wealth effect playing a role in consumer spending, but more towards the luxury goods area. By way of comparison, there is barely more than a 70% correlation between the equity market and clothing and 60% for food. But while Mr. Market hath giveth since late August, Mr. Market may well taketh from now to the end of the year, which may, in turn, dampen the blatantly positive expectations for high-end retail sales.

CHART 1: EQUITY WEALTH EFFECT PLAYING A ROLE IN CONSUMER SPENDING, BUT TOWARD LUXURY GOODS



Source: Haver Analytics, Gluskin Sheff

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THE LONG AND THE SHORT OF IT

Following the Fed's first strong hints at QE2 in late August, we saw some wild movements in terms of market positioning across a variety of asset classes. These swings are highlighted in the weekly Commitment of Traders report, which we have discussed in the recent past. While fundamentals, valuation and technicals are all key in determining the direction of asset prices, how investors are positioned is no less important and right now, there is still an extreme level of speculative activity in some cases that is set to unwind as the risk-on trade fades away.

There was a tremendous amount of ebullience over the outlook, beginning in late August, and while some of the data have looked a little better, there is still a list of lingering concerns deserving of a higher, not a lower, risk premia, and in a word it comes down to discord, policy discord, to be precise. Discord within the Fed (Warsh torpedoes any plan for another round of quantitative easing). Discord within Congress (a deal over the Bush tax cuts is still wanting). Discord at the G20 (nothing concrete coming out of the meeting; 17 of the 20 members are not supportive of current U.S. economic policy — see *Obama Tries to Repair Damage* on page A9 of the WSJ).

Discord over trade issues (the planned U.S.-Korea trade pact was scuttled). Discord within the euro area (see *Ireland Stirs Specter of EU Default* and *Euro-Zone Growth Data Underline a Widening Gap* on page A7 of the WSJ).

Of course, there is also this issue of China feeling compelled to fight a food-led inflation surge by tightening monetary policy. This has implications for the commodity complex that may not be so favourable over the near-term. The strong likelihood that this was Bernanke's last kick at the can means that whatever QE3 expectations being priced into the market (and that is the only way anyone can explain the blowoff following the QE2 announcement, which should not have come as a big surprise) is now in the process of being unwound. Moreover, the chances that a lame duck Congress reaches an agreement on taxes and jobless benefits is not 100%, which Mr. Market had believed at the recent S&P 500 peak.

So, it may pay for the time being to avoid the areas of the market where net speculative long positions exist and is in the process of unwinding. Long covering is a critical source of selling pressure.

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- Equities: There are currently 5,780 net long contracts on the Chicago Mercantile Exchange (CME).
- Oil: There are a near-record 208,226 net long contracts on the NY Mercantile Exchange.
- Gold: There are a near-record 253,528 net long contracts on the Commodity Exchange (COMEX).
- Copper: There are a near-record 25,139 net long contracts on the COMEX as well.
- Silver: Not a record or a near-record but still a significant 42,556 net long contracts on the COMEX.
- Australian dollar: 49,743 net long contracts on the CME.
- Canadian dollar: Not as large as Aussie but still high net speculative long exposure, at 21,579 contracts.
- Euro: Huge net speculative long position of 35,879 contracts on the CME.
- The 10-year Treasury note: It now has a net long position of 15,781 contracts on the Chicago Board of Trade (CBOT).
- The 5-year T-note: It is most exposed with a net speculative long position of 167,729 contracts — of course, this is the part of the curve the Fed is targeting.
- The 2-year T-note: It commands a net speculative long position of 43,220 contracts even with a yield that recently was 30 basis points north of zero.
- The 30-year bond: It is the only maturity with a net speculative short position — of 1,917 contracts.

- Volatility: With the risk-on trade in full force for the past two months, the VIX futures has a net speculative short position of 13,345 contracts, which is at the high end of the historic range.

So, here's how one would construct a strategy to take advantage of the prospect that we are now beginning to see as these speculative positions reverse course:

- It would involve a flattener in the bond market;
- Although we are still long-term bullish on the commodity space, looking at the position in the COT report, selling calls for protection in the commodity space could be a sound strategy. Expect silver to outperform gold still;
- Going long the U.S. dollar against the euro, but within the resource-based units, look for the loonie to outperform the Aussie;
- Look for the S&P 500 to now trade down to the low end of the 14-month long 1,000-1,200 range;
- Buy volatility, which is inexpensive and underexposed on the CBOE, which is bullish.

As for bonds, the Commitment of Traders data show the long bond to be under-bought, and as such, ripe for a rally, especially seeing how high the yield gap is between it and the rest of the Treasury curve. The 5-year Treasury is quite expensive at current levels and even the 10-year is still vulnerable near-term given its net speculative long position and the fact that it is just 3bps away from a technical level that could well set the stage up for a return to 3%-plus yields, which would be a wonderful buying opportunity. There is not a whole lot of fundamentals here behind these moves — the moves of the past week and likely ones in the next few weeks.

The asset classes are merely unwinding the excess risk-on trades and pricing out the chances that QE3 will ever see the light of day. Yes, this is what the market was starting to think since Bernanke left the door open for more in the press statement, but we are finding out ex-post that the Fed chairman has less support around the table than was generally perceived. When Governor Warsh basically comes out and says that he supported Bernanke only because he wanted to be seen as a team player suggests that any further experimentation with the Fed's balance sheet will not be met with just one dissent from Tom Hoenig. While Martin Wolf did make some good points in the FT last week supporting the Fed, one has to wonder how the Fed's balance sheet is going to be exposed to huge losses if bond yields ever do back up. I mean, this latest round of Fed bond buying occurred with the yield on the 5-year note at 1.1% and the 10-year yield at 2.4%.

EQUITY MARKET SENTIMENT STILL TOO BULLISH

As we said last week, the fact that the Market Vane Sentiment Poll was at the high end of the range, the Investors Intelligence poll showing more than twice as many bulls as there are bears, the Barron's Big Money poll revealing 62% bullishness towards equities and only 3% towards bonds, and the fact that equity PMs are now just sitting at 3.5% cash, were all signs of a stock market that was overextended and ripe for a corrective phase. And, despite the sloppy week the market just endured — for the first time in over two months — page B7 of the weekend WSJ still runs with a huge article titled *How to Play a Market Rally*. We're not sure, from a contrary perspective, if this is what a bull wants to see at the high end of the range for the S&P 500.

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DISCORD, NOT ACCORD

In late 2008, the G20 got together in Washington to solve the world's problems as the Great Recession deepened. This actually turned out to be a major turning point since everyone was on the same page in terms of rescuing the global economy. China came out of the gates with a massive fiscal package, which started to percolate right away; Germany was the first to unveil a 'cash-for-clunkers' program to spur consumer spending; then the U.S. unveiled a large-scale fiscal stimulus plan, which of course, never did live up to its advanced billing in terms of redressing what is now very clearly a chronic unemployment problem.

So, this latest G20 meeting where lots was discussed but little action taken may well be a watershed but in a different direction because what it underscored was how divided the world is right now and how insular it has become. The front page of the weekend WSJ said it best, *U.S. Gets Scant Help at Divided Summit*:

> *"The Group of 20 Nations, hailed less than two years ago by economists and policy makers as a new model of global economic cooperation, concluded its latest meeting here with a thinly disguised discord, as the U.S. was unable to persuade other countries to take measures it believes are necessary to end currency wars and promote sustainable growth. With the world confronting hefty economic imbalances and rising tensions over currencies, monetary policy and trade, the leaders of the world's G20 most powerful economies concluded the summit with almost as many disagreements as when they started — undermining the idea of the fledgling G-20 as a form for hashing out global policy."*

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Indeed, the U.S. blames other country's currency policies for global imbalances without any expression of how its tax policy, which promotes consumption over savings, is equally at fault. Then again, big tax changes may be coming, including sacred cows like universal mortgage interest deductibility, which most certainly will have an impact on U.S. long-term growth prospects but absolutely essential in order to get the fiscal house under control.

PUTTING THE POP IN THE CROP

If you are looking for secular growth, then focus on the farm — great article on this file on page A3 of the weekend WSJ — *Land Becomes Cash Crop in Farm Belt*. Farmland values in the U.S. are up a healthy and hardly bubbly 6.4% over the past year. And, because of the runup in cotton, corn wheat and soybean prices, net farm incomes have enjoyed a 24% increase, to $77 billion. The continued protein shift in China coupled with the weak U.S. dollar remains a boon for this sector of the economy and perhaps one reason why the latest economic data out of the Midwest have looked particularly decent.

Canadian real estate of all kinds have been in a bull market too and while looking pricey in many areas, it could well reflect demand from fundamental forces as opposed to speculative pressures. In particular, organic growth from solid demographics. Just have a look at the front page of the Saturday NYT — *Defying Trend, Canada Lures More Migrants*.

THREE REASONS WHY I'M WORRIED ABOUT U.S. RETAILERS

Unlike last year, they are actually bracing (more like praying) for a solid holiday shopping season:

1. In the last two months, the U.S. retailers have, on net, hired 27k workers. So they have hired staff at a pace we have not seen since the boom of 2006. This time last year, retailers cut 102k from staffing in the Sept-Oct decline.
2. Outside of autos, total consumer spending volumes sales are flat. This was the case in September and looks to have been repeated in October.
3. Inventories are no longer that lean. The inventory-to-sales ratio for general merchandise stores has gone from 1.39x in March to 1.43 currently; from 1.68x in furniture/appliances to 1.74x, and to 2.34x from 2.25x in clothing.

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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 Equity Portfolio in 1991 (its inception date) would have grown to $9.1 million[2] on September 30, 2010 versus $5.9 million for the S&P/TSX Total Return Index over the same period.

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We have a strong history of insightful bottom-up security selection based on fundamental analysis.

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For further information, please contact questions@gluskinsheff.com

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