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November 18, 2010
Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Global equity markets are down a tad so far today and there is a very modest bid to government bonds. European bourses are down almost across the board while it was much more mixed across the hot Asian markets. The Shanghai index was up 0.8%, but India's Sensex, and the Singapore Straits indices were all lower. The risk-on trade looks to be a little off today and that is even with a softer tone to the U.S. dollar as it hits resistance at the 50-day moving average. Usually a weaker greenback coincides with a breath of fresh liquidity air for the pro-beta trades, but not so far today.

Ben Bernanke delivered a speech today in Frankfurt where he pointed the finger at China as a source of global imbalance (never mind that the U.S. dollar has collapsed 70% against the yen since I joined the business in the mid-80s and the bilateral trade deficit with Japan hasn't come down one iota. Maybe a good part of the imbalance is a U.S. tax code that massively promotes consumption at the expense of savings.) As an aside, Mr. Bernanke's subtle approval of President Obama's fiscal policies in today's sermon is sure to draw the ire of the new GOP-dominated Congress. Part of the reason why the euro has a bit of a pop in its step this morning is because Ireland is supposedly moving closer to accepting a bailout package for its banks (isn't that wonderful news?), as well as, a reaction to higher-than-expected producer prices out of Germany (+4.3% YoY in October from +3.9% in September and above market views of +4.1%).

That said, who would want to hold onto euros for very long when it seems so obvious that none of these fiscally-challenged countries can possibly meet their deficit targets without sending their economies into a destabilizing tailspin. The bond market realizes this, which is why yields in Ireland, Greece, Portugal and Spain have surged to levels that are far too high relative to nominal GDP growth, which will make debt-service payments that much more onerous and default that much more of a reality once the can is no longer kicked down the road, which is probably within the next two years.

Debts will be restructured, banks in Europe will be forced to take huge haircuts and likely will need help from their respective governments and the fate of the euro is truly up in the air. We can understand that an investment community trained to only look one quarter ahead at the next earnings report has difficulty looking 18 months out, but the looming sovereign debt restructuring in Europe is going to remain an overhang just as the fiscal risks in Washington remain acute (yesterday's FT ran with an article that began with *"Britain has promised Ireland billions of pounds in loans in any bailout operation"* … talk about the blind leading the blind!). Not to mention the deflationary retrenchment ahead at the state and local government level.

IN THIS ISSUE

- While you were sleeping: the risk-on trade looks to be a little off today; the USD hits resistance at the 50-day moving average; Bernanke points to China as a source of global imbalance; secular bull market in bonds is not over; CAD hanging in very well
- U.S. index of leading economic indicators a mixed report: it rose 0.5% MoM in October (as expected) but once again, this was boosted by the yield curve and the stock market. Removing these two components, the 'real economic LEI' was only up 0.1%
- Whoa Philly! The Philly Fed manufacturing index jumped in November, to 22.5 … and the components were very positive as well
- No holiday cheer: The U.S. House of Representatives failed to pass a bill that would have extended unemployment benefits to millions of Americans

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Gold still looks very good in this uncertain and unstable environment — even in the face of another round of policy tightening by the People's Bank of China (PBOC) — hiking reserve requirements another 50bps (fifth such move this year), to 18.5%.

Gold still looks very good in this uncertain and unstable environment

We see on our Bloomberg screens that PIMCO's Paul McCulley, who we have tremendous respect for, went on record as saying that *"the grand super secular bull market is essentially over"* with respect to the Treasury bond market. We are not convinced. Core inflation is gravitating towards zero just as the U.S.A. begins to embark on a grand experiment of fiscal tightening. Bernanke's $600 billion QE2 experiment may get investors into a prolonged frenzy, but in the end, all it does is add 0.25% to real GDP growth and trim the unemployment rate two-tenths of a percentage point as a stand-alone static event. Thanks for coming out (today's must read is *What's Really Behind Bernanke's Easing* by Andy Kesler on page A19 of the WSJ — hint, a highly vulnerable banking system where entities like BofA and Citi are selling well below book value).

This will not prevent the massive slack in the labour market from ultimately leading to deflating organic wages and salaries, and now absent government fiscal support going forward. Ben Bernanke's term as Fed Chairman does not end until February 2014 and so it is reasonably safe to say that this student of the 1930s is not going to be tightening monetary policy between now and then; there is a near-90% correlation between the "cost of carry" and the long bond yield and the normal spread between the overnight rate and the 30-year Treasury bond yield is 200bps. That gap is now north of 400bps and so it stands to reason, as per Bob Farrell's Rule 1 (do we really need to remind you?), that in the mean-reversion process, bringing this Treasury curve back to its typical shape will inevitably require much lower yields out the curve.

It will never be a straight line down, but the primary trends in long-dated yields is still down. Recall that the 2% low in the long bond in the U.S.A. in the early 1940s and to sub-1% levels in the JGB yield in the 1990s occurred a decade after the initial credit and asset shock — despite years of massive government reflationary efforts. Those calling for an end to the secular bull market in bonds — the vast majority of pundits — are clearly in need of a history lesson.

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It is the equity market that is most overbought at the current time. Portfolio managers are all the way down to just 3.5% cash ratios. According to the latest Investors Intelligence survey, there are now 56.2% bulls and a mere 23.6% in the bear camp — we have not seen such a gap since early May and within the next two months the S&P 500 was down more than 12%. The buying has exhausted itself.

Meanwhile, as we saw in the latest Barron's Big Money Poll, 62% of portfolio managers see the stock market as the best performing asset class in the next 6 to 12 months compared with just 3% for bonds. In other words, the expectations bar has been set very high for the former and very low for the latter. We are pumped!

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CHART 1: STILL ROOM TO GO ON THE LONG BOND YIELD

United States: Long Term Treasury Bond Yield
(percent)

Source: Haver Analytics, Gluskin Sheff

What is interesting is how QE2 has suddenly lost its allure — or perhaps all of it and then some was already priced in with all the Fed chatter that occurred in September and October to reignite investors "animal spirits". But since the November 3rd Federal Open Market Committee (FOMC) meeting, the stock market has gone nowhere (S&P 500 from 1,198 to 1,196), bond yields have gone down, not up (to 2.9% for the 10-year T-note from 2.67%), mortgage rates just hit a three month high (!) as well, and the U.S. dollar, for all the brouhaha (who doesn't know that Bernanke wants it to depreciate as a pro-reflationary development?), has risen to 72.5, on the DXY, from 71.4. And, as for the mid-term election, tell those five million folks that are about to roll off the emergency/extended jobless benefit lines at an income loss of $75 billion in the next five months just how much 'gridlock is good'.

To be sure, the data of late have been mixed, though a lot of folks are leaning on the side that they are coming in better than expected.

- Philly Fed up; NY Empire down.
- Industrial production has been soft and has stagnated since July, despite what the ISM says.
- Retail sales were firm but the "control" index that feeds into consumer spending in the National Accounts data were soft-ish.
- The National Federation of Independent Business (NFIB) small biz index was good news but the National Association of Home Builders (NAHB) housing index was weak and housing starts tumbled last month.
- Claims are definitely in a lower range but not yet at levels consistent with sustained job creation and while the payroll survey has been better of late, the Household survey shows clearly that whatever jobs are being created are in part-time, not full-time, work (see *Few Businesses Sprout, With Even Fewer Jobs* on page B1 of today's WSJ).

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Confusing, indeed, but it looks like real GDP is chugging along at a tepid though still above-water annual rate of between 1% and 2% at an annual rate. But the fragility is what is important — see Paul Krugman's *Axis of Depression* on page 25 of today's NYT.

Anyone who may have had concerns over Ottawa's recent decision regarding the BHP Billiton failed bid for Potash, remember that this was only the second time in the last 20 years that a foreign takeover plan been rejected… Canada remains open for business

Despite the decline in the Canadian dollar in the last two weeks, we remain long-term bulls on the loonie. Anyone who may have had concerns over Ottawa's recent decision regarding the BHP Billiton failed bid for Potash (only one other time in the past 20 years has a foreign takeover plan been rejected) should have a look at *Brazil Investors Push for Canada Mines* on page B5 of yesterday's WSJ. Canada remains open for business. Canada remains governed by a right-of-center party, which is tough to find these days. Canadian corporate tax rates, and in some cases personal rates, are falling below U.S. levels. Global investors are looking for yield, which Canada offers in both the debt and equity capital markets relative to what is provided state-side. That Toronto recently elected a mayor that would feel very much at home in the Tea Party, it hardly seems likely that the political winds are shifting north of the border either, and the central bank here is run by someone who actually had years of private sector experience outside of academia. So long as China can navigate its way through its current inflation phase, the secular uptrend in commodities will remain intact and along with that, the multi-year revival in the Canadian dollar, which we see rising another 15-20% over the next five years.

Folks, if you have not yet seen it, you must have a look at the masterpiece just published by Gary Shilling titled *"The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation"*. I highly recommend this book and not just because I agree with everything Gary had to say about the future. It is truly a map of how to navigate the portfolio in these turbulent times.

U.S. LEADING INDICATORS A MIXED REPORT

First all the good news. U.S. Leading Economic Indictors (LEI) rose by an as-expected 0.5% MoM in October and the September data saw a significant upward revision to 0.5% as well. The diffusion index was quite decent with 75% of the components up on the month versus 60% in September, and in fact, is the best reading since December 2009.

But when we really dug through the details, we weren't quite as impressed. We dislike the fact that the level of the yield curve is included (as long as the yield curve is upward sloping, it makes a positive contribution, which doesn't add much value in a zero-policy environment). We noticed that the yield curve added two tenths to the total as did the S&P 500 — so strip out these two components and the 'real economy' LEI was only up 0.1% — so, the 'real economy components' were not that great. Also, the coincident-to-lagging indicator, which leads the leader, was flat and has been down-to-flat for five months straight — not a great sign of future growth.

WHOA PHILLY!

Just as we were shocked with the huge downside miss on housing starts a few days as go, we were equally shocked by the huge upside surprise in the November Philly Fed manufacturing index, which jumped to 22.5 sailing past expectations for an increase to 5.0 from October's read of 1.0.

So far in November, the manufacturing landscape appears to be mixed — Philly Fed index surged, but that is offset by the huge falloff in the NY Empire index

The headline index is not the sum of its parts (like the ISM), so the details are especially important. Here, the components were positive as well, with shipments up in November, to 16.6 from 1.4 prior and the forward-looking new orders index moved up to 10.4. We saw some indication of margin contrition with prices received falling while prices paid increased.

It is difficult to make any conclusive judgements from this report after the very disappointing NY Fed Empire Index, which saw a plunge to -11.4 from +15.7. At this point, we are tracking a small decline in the ISM but there are still several more regional surveys to go.

What was interesting in yesterday's Philly Fed was the "special question," which points to continuing investment in capital equipment.

The first question asked, *"Which of the following best characterizes your plant's current capacity utilization rate and last year's?"*

The average utilization rate for the manufacturing sector in the Philly region was 72.4%, higher than the 68.7% rate this time last year. Keep in mind that the national manufacturing CapU rate (as per the industrial production data that came out two days ago) for October was 72.7%, which is the highest level since August 2008.

The second question asked, *"Is your firm increasing or decreasing spending on plant and equipment over the next year?"*

Nearly 38% of firms said that they are increasing spending in the coming year versus 16.3% when this question was asked last year. On the flip side, 19.5% of the respondents said that they were decreasing spending, versus 40.7% in 2009.

Overall, this supports the notion that the CapU rate for the manufacturing sector continues to improve. Although, let's not get all that excited, consider that the current level of 72.7% is lower than the average level during recessions (77.5%), a lot lower than the average level during expansions (81.4%) and is just hitting the level that in the past signifies the end of a recession.

NO HOLIDAY CHEER

The U.S. House of Representatives failed to pass a bill that would have extended unemployment benefits to millions of people. Even if an extension does end up being ultimately passed, there could be a delay in getting this through given the limited amount of working days left in November. As it stands, without an extension, nearly two million Americans are set to fall off the rolls in December (according to the Department of Labor), which would not be great for personal income (we estimate a $30 billion annualized impact in December alone). This poses an overhang over low-end retailing during the holiday shopping season.

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Gluskin Sheff at a Glance

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Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 49% 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.

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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 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.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $11.8 million USD[2] on September 30, 2010 versus $9.6 million USD for the S&P 500 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.

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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For further information, please contact questions@gluskinsheff.com

Notes:

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2. *Returns are based on the composite of segregated Canadian Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.*

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