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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Global equity markets retain their solid bid, though bond markets are not selling off on this latest up-leg in stock prices. The news out of China was the latest excuse to pile into risk assets — the Shanghai index managed to surge more than 2% on the data, which were strong right across the board. Industrial production rose 12.3% YoY in August versus consensus expectations of +11.3%. In a sign that the Chinese consumer is stirring, retail sales were up 15.4% YoY, marginally better than the 15.3% pace penned in by the consensus. Policy remains hugely stimulative as M2 soared by a record 28.5% YoY in August, and the news that the Chinese CPI actually managed to deflate 1.2% YoY (talk about Goldilocks) has investors believing that the People's Bank of China is going to keep the monetary spigots on indefinitely. Rally ho! Of course, the additional news that the OECD leading indicator jumped to a 97.8 in July from 96.3 in June, which is now the highest level since September 2008, has added to the enthusiasm in the capital markets.

All this wonderful news from abroad has also reinforced the downward trend in the U.S. dollar, which is on a six-day losing streak — the longest since March. The Euro is at a nine-month high, Sterling at a one month high, the Asian FX complex is taking off (the Yen is firming against everyone) as are the commodity currencies (causing central bank officials in New Zealand to take a feather out of the Bank of Canada's cap in openly lamenting the rise in its dollar — see more below). The U.S. dollar's downdraft has helped take gold to within $1.70/oz of the $1,000 mark — a test that has failed on four other occasions in the past two years (a break now would be significant).

While we have been fans of the commodity complex and remain so on a long-term basis, this trade now looks crowded over the near-term. To be sure, the Chinese data have been firm but the basic material that is going into the production process there may be coming out of inventory after the massive amount of stockpiling that occurred in the first eight months of the year when, for example, Chinese imports of copper skyrocketed by 80% YoY. Nobody knows how to 'buy low' and 'sell high' than they do. So, it is interesting to see that even steel production rose 22% YoY in August; prices in the Chinese market have tumbled — down 18% in the last five months. Iron ore imports just hit their highs for the year. Lead prices slid 12% yesterday and are down more than 2% today on news that production in China just hit its highs for the year.

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- Commercial real estate; delinquency rate doubled since March to 4.1%

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TRYING TO MAKE SENSE OF IT ALL

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The Dow surges 80 points and the S&P 500 rallies 10 points to fresh 11-month highs and we see that BoA was basically flat, and the likes of G.E., Intel and Wal-Mart were all down on the day. Amazing. The S&P energy space rallied 1.7% even though crude inventories were higher than expected; and even with higher oil prices, the transports managed to fly 2.4%. Incredible.

Meanwhile, the yield on the U.S. 10-year note fell 12bps to 3.35% and copper prices slid 2.8% (LME stockpiles up for 10 days running) which would seemingly make no sense in a pro-cyclical reflation trade. Maybe the bond market was responding to the fact that the unexpected widening in the U.S. trade deficit is now forcing economists to take down their bullish 3Q GDP estimates by as much as three-quarters of a percentage point. We like the Canadian dollar long-term, but at 93 cents, and with a $1.4 billion July trade deficit along with a Bank of Canada statement that *"persistent strength in the Canadian dollar remains a risk to growth"*, all we can say is that there are likely to be better price points upon which to turn to bullish in the not-too-distant future.

As an aside, while acknowledging the obvious, which is that the economic clouds over the near-term have parted somewhat due to the rampant global fiscal stimulus (accounting for over 100% of the growth, believe it or not), the Bank of Canada still sees deflation as the principal battle. To wit: *"While the underlying macroeconomic risks to the projection are roughly balanced, the Bank judges that, as a consequence of operating at the effective lower bound, the overall risks to its inflation projection are tilted slightly to the downside."*

IT'S ALL ABOUT LIQUIDITY, ROSENBERG!

This is what we are hearing. The fundamentals take a back seat because there is so much liquidity to be put to work, and it all must go into equities. This reminds us of all the liquidity talk during the bubble peak of late 2007. The reality is that the mountain of money is no higher or lower than it was when the market was plumbing the depths through 2008 — money market mutual funds back then were $3.5 trillion and guess what? Today they are $3.5 trillion. Go figure.

The fundamentals are taking a back seat because there is so much liquidity to be put to work

So you see, liquidity is a catch-all term when nobody can really explain why the market is going up. This rally is based on a lot of hope that we are going to see a V-shaped economic recovery in the U.S. The S&P 500 is priced for 4% real GDP growth. We don't see it. Try 2%, which is what the investment-grade corporate bond market is priced for. If we get 4% GDP growth then the equity market is fully priced, but that sort of economic expansion would take Baa spreads of U.S. Treasuries down another 100bps to 200bps, if historical relationships were to hold. But if we see 2%, then at least you will clip your coupon in the fixed-income market. The S&P 500, which at one point would have licked its chops over such a possible outcome (back when it was priced for -2.5% growth last March), would now see 2% growth as a disappointment and would correct down towards 850, again, based on our models.

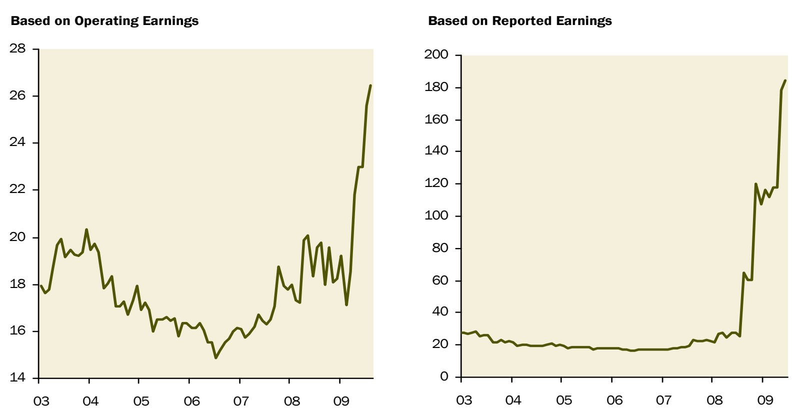
Let's say that growth in 2010 is zero — then, we would see the S&P relapse back to 670, which would be a -30% return (shades of 2002!) but total returns in corporate bonds would be around -8%, by our estimation (clearly not good either, but a lot better than -30%). Our primary point here is that there is much more downside protection in the fixed-income market than there is in the equity market.

Let us say that growth in 2010 is zero, we would see the S&P 500 relapse back to 670

All we know is that we have a trailing P/E multiple (operating earnings) on the S&P 500 of 26.5x — a record eight multiple point expansion from the low over a six-month span. Take note that this is the highest P/E multiple since March 2002, which is right around the time that the bear market rally at that time (also premised on post-crisis V-shaped recovery hopes) began to roll over. It took a good year for the fundamental bottom in the market to be put in, and that was heresy back then too. The P/E multiple on non-scrubbed reported earnings has soared 60 points since March to 184x — not only a record but five times more expensive than what we saw during the peak of the dotcom bubble a decade ago (oh, but we forgot — write-downs don't matter).

CHART 1: Massive P/E Multiple Expansion

United States: S&P 500 P/E Ratio
(based on trailing earnings)



Source: Haver Analytics, Gluskin Sheff

One thing we do see is that the private client is taking the prudent approach towards risk. There have been $50 billion in net new cash flowing into equity mutual funds over the past four months. It is hard to believe that these flows can really push a $10 trillion market higher by 50%. But we do see that $130 billion of retail fund flows have gone into hybrids and bond funds — income is the key in a deflationary backdrop.

Going back over the last six decades, we know that the market typically faces serious valuation constraints once it breaches the 25x P/E multiple threshold. The average total return a year out for the S&P 500 is -0.3% and the median is -6.2%. The total return is negative a year later 60% of the time, so when we say that there is too much growth and too much risk embedded in the equity market right now, we like to think that we have history on our side.

The operating trailing P/E multiple on the S&P 500 is currently at 26.5x — in the last six decades, we see that the market typically faces serious valuation constraints once it breaches 25x

As an aside, coming off a record $22 billion consumer credit contraction in July and 89 failed banks so far in 2009 — more than the combined number over the last 15 years — it is clear that the financial strains are not over, despite the Fed's attempts to paper them over. The most glaring non-confirmation (and we checked this with Walter Murphy) of the equity rally, notwithstanding its veracity, is the fact that the yield on the U.S. three-month Treasury bill is 14 basis points above zero. That is a clear message that deflation remains the primary intermediate-term risk and that there are still tremendous balance sheet problems that are intact in the household and banking sectors. Fundamental imbalances still have to be worked out.

BETTER NEWS ON THE JOB FRONT? HARDLY

Yes, initial jobless claims did come down 26k (from yet another upwardly revised figure — the 23rd in a row) to 550k in the September 5th week. But claims are basically range-bound and at 550k are clearly still consistent with net job loss — they need to break below 500k to stop the bleeding in the U.S. labour market altogether and below 400k to start the process of reversing the uptrend in the unemployment rate. At this stage of the 2002 decline in claims from the peak, they were hovering just above 400k, not 550k, and that turned out to be a huge jobless recovery. This will make a mockery out of that one and the prospect that we see the spread between the U6 and the official unemployment rate measures mean revert will imply an unhappy meeting in the middle at around 12%. Just in time for the mid-term elections; tell us that we will not see a U.S. dollar depreciation as the next rabbit out of the hat (a la FDR circa October 1933).

The total level of claimants, including those on extended benefits, soared 158k in the August 22nd week to a fresh all-time high of 9.8 million. Before the onset of the recession in late 2007, that number was hovering around 2.5 million.

The problem in the U.S. job market is not so much with firings any more; it's more about a lack of new hiring

The problem is not so much with firings any more; it's more about a complete lack of new hiring. The NFIB index that measures job openings fell again in August — from 9.0 to a 27-year low of 8.0. Challenger hiring plans collapsed 24% in August to a three-month low. Someone obviously forgot to tell the folks at Manpower that the recession was over because its employment plan index for the U.S. just broke below the worst levels of the last three economic downturns. The JOLTS data from the Bureau of Labor Statistics also showed that job openings plunged 121,000 in July and we now officially, for the first time on record, have six unemployed people competing for every possible job opening out there. No wonder organic wages and salaries are deflating a record YoY rate of nearly 5%.

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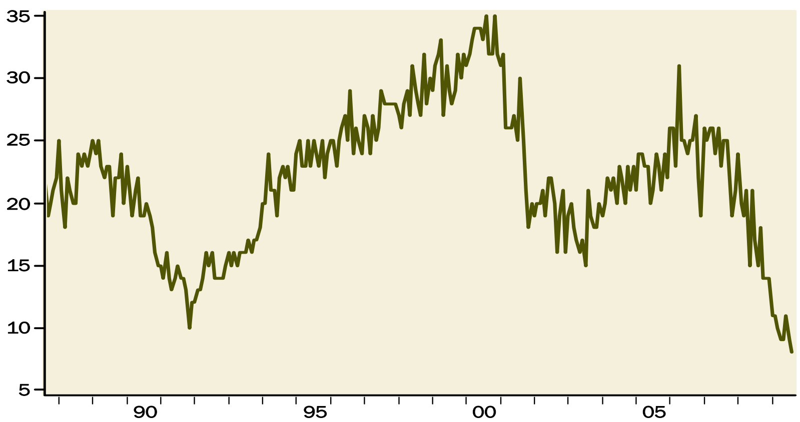
CHART 2: HIRING INTENTIONS DOWN TO A 27-YEAR LOW

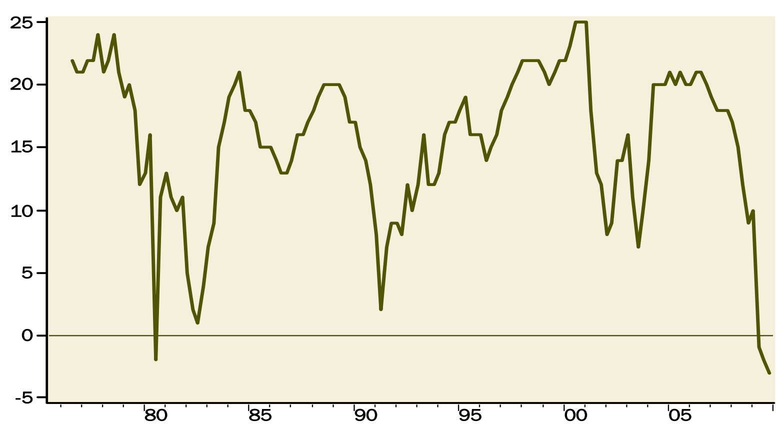
United States: National Federation of Independent Business Survey
Percent of Firms with One or More Jobs Open



Source: Haver Analytics, Gluskin Sheff

CHART 3: MANPOWER HIRING INDEX AT A NEW LOW

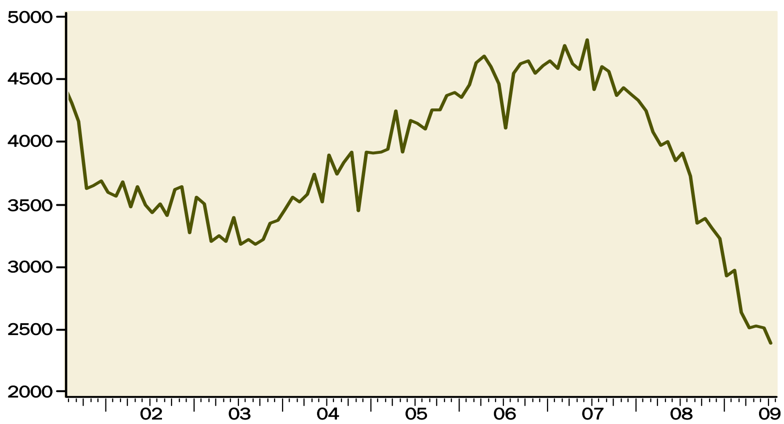
United States: Manpower Employment Outlook Survey: All Industries
(net higher, percent)



Source: Haver Analytics, Gluskin Sheff

CHART 4: A REAL JOLT TO JOB OPENINGS — RECORD LOW

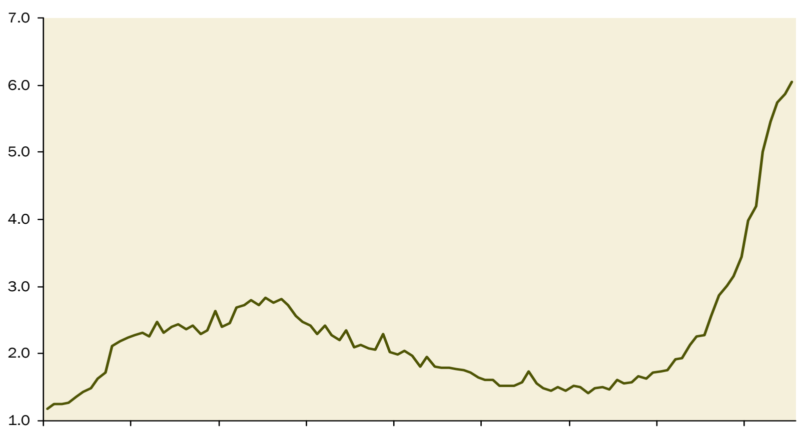
United States: Job Openings and Labour Turnover Survey (JOLTS): Job Openings
(thousands)



Source: Haver Analytics, Gluskin Sheff

CHART 5: THE TRUEST PICTURE OF EXCESS LABOUR SUPPLY

United States: Number of Unemployed per Number of Job Openings
(ratio)



Source: Haver Analytics, Gluskin Sheff

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INCOME SHORTFALL

The U.S. Census Bureau just reported that Americans' household income last year took the sharpest drop since the government began keeping records in 1947. Median household income sank 3.6% to $50,303, after adjusting for inflation, during the first full year of the recession. At that level, median income is now down to its lowest level since 1997 — a decade's worth of gains wiped out in just one year. Those that think we are going to see the return of the U.S. consumer into the dealer showrooms and malls on any sustained or meaningful basis for the next several years are dreaming in Technicolor.

In 2008, U.S. household income took the sharpest drop on record

Moreover, the companies that recognize this secular deflationary theme towards consumer frugality are more than likely going to be the ones that reap the rewards, as P&G did yesterday with its upbeat outlook. The world's largest consumer products maker is finding that "new and improved" is still good, but "lower price" is working better. After seeing its sales decline all year long as households cut back and traded down to cheaper competitors, P&G officials said Thursday they are raising guidance because of new products, lower prices and more promotions. For all the talk about how inflation is going to come back because of the Fed's bloated balance sheet, someone has to explain why it is that all this liquidity has bypassed diapers and detergents because the company intends to start slashing its prices by 10% across its global product line!

COMMERCIAL REAL ESTATE — IN DRERDE!

We just found out that the delinquency rate on commercial real estate loans has doubled since March to stand at 4.1% — remember that this indeed may turn into a financial event seeing as banks have $1 trillion of these loans sitting on their books and an additional $530 billion in direct construction loans. The National Association of Realtors is estimating that in the retail sector vacancy rates are likely to approach 13% by mid-2010 from 11.7% now, which would be the highest since 1991; the office vacancy rate in the U.S.A. is expected to jump to 18.8% from 15.5%.

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Gluskin Sheff at a Glance

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As of June 30, 2009, the Firm managed assets of $4.4 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 65% 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).[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.

PERFORMANCE

$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $9.0 million[2] on July 31, 2009 versus $5.0 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 $10.7 million USD[2] on July 31, 2009 versus $8.1 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 30% to 40% 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, with the noted addition of David Rosenberg as Chief Economist & Strategist.

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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 Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.*

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