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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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WHILE YOU WERE SLEEPING

Equity markets are starting the week on a firm note; Asia up 0.4%. However, government bond yields in Europe are rising sharply alongside easing concerns over Ireland's fiscal situation (next test will be tomorrow's bond auction).

The U.S. dollar is softening to a five-week low ahead of tomorrow's Federal Open Market Committee (FOMC) meeting, but that hasn't stopped U.S. equity futures from flashing green (the year-to-date loss has now been wiped out). In turn, gold is climbing to new record highs — the yellow metal is now up 17% for the year. As an aside, gold's little brother, silver, has gained 17% just this month alone and is up 26% for the year. Copper also just managed to touch a five-month high. The commodity currencies are receiving an added lift from some "hawkish" comments coming out of Australia's central bank, which is sending the Aussie dollar to a two-year high (ditto for the Asian FX complex in general).

Keys this week are the FOMC meeting tomorrow where the Fed is expected to trim its macro outlook yet again, and the plethora of housing-related data.

GOLD BREAKS OUT … AGAIN

What is amazing is that there are just about as many naysayers about gold out there as there are bond bears. Until the investment elite catches on, the odds of these two asset classes continuing as relative outperformers are quite high because no bull market ends until the masses fall in love with the asset or security in question.

What makes the gold story so interesting is that bullion has so many different correlations — with inflation, with the dollar, with interest rates, with political uncertainty — and it also has different faces. This year, for example, gold has shifted from being a commodity towards being a currency — the classic role as a monetary metal that is no government's liability. This year, there are three events have catapulted gold into currency status, and they all involve attempts by governments around the globe to devalue their own currencies or at least jeopardize the sanctity of the central bank balance sheet:

1. The ECB's decision to allow non-investment grade bonds as collateral on its balance sheet.
2. The Fed's decision not to allow, as was planned, an unwinding of its pregnant balance sheet with obvious implications for the growth rate in the monetary base.
3. The decision by the Japanese government to unilaterally intervene in the foreign exchange to reverse the yen's strength.

Nobody wants a strong currency, and nobody, outside of a few small countries, wants higher interest rates, and now, we have rising U.S.-Chinese trade tensions. Greek bond yields remain at punitive levels and are currently pricing some probability of default. In addition, Ireland seems to be experiencing intense financial difficulties that have compelled the ECB to step in for support. The Mideast peace talks don't seem to be going anywhere. The U.S. political backdrop is one of intense uncertainty and the most likely scenario post-November 2nd is one of gridlock. How can gold not thrive in this environment?

This year gold has shifted from being a commodity towards being a currency

The other day, we were asked what would turn us bullish? The assumption of course is that we aren't bullish on anything. Well, go back and look at my track record and you will find that we have been gold bulls now with near consistency for the better part of the past decade.

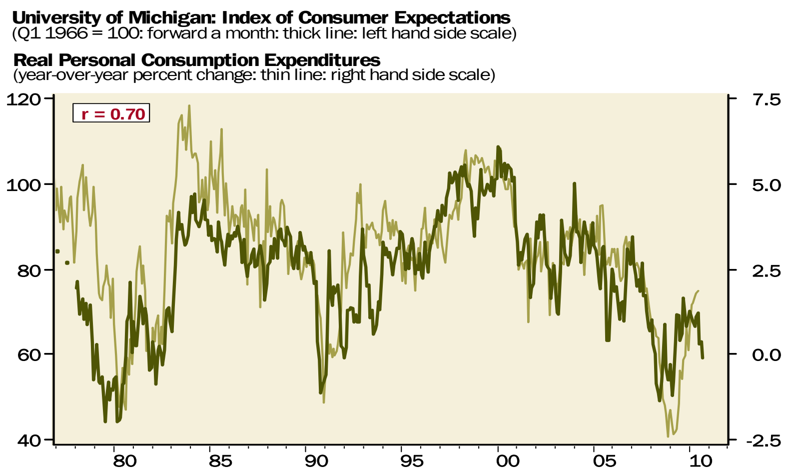
SENTIMENTAL VALUE

Friday's University of Michigan consumer sentiment report was quite the shocker to the downside, with sentiment slipping to 66.6 in September from 68.9 in August, 67.8 in July and 76.0 in June (back to where it was in August 2009). We would be tempted to call that a pattern.

The "expectations" component leads consumer spending with a 70% correlation and is pointing to near zero growth in real consumer spending in coming quarters — it fell from 62.9 to 59.1, the lowest since the economy was at bottom in March 2009.

CHART 1: CONSUMER "EXPECTATIONS" INDEX POINTING TO FLAT REAL PCE GROWTH

United States



Source: Haver Analytics, Gluskin Sheff

Everyone has this view that growth will merely be slow but that there will be no double dip. Nobody seems to entertain the notion that we may still be in a recessionary state. After all, the UofM confidence index averages 73.7 in recessions and 90.9 in expansions. So not only is the index 24 points below what is consistent with growth, it is also seven points below what is typical of actual recessions. That is why this is more likely a 'single-scoop' recession than a 'double dip' … we likely never fully emerged from the one that began in late 2007.

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The details of the report were as grim as the headline:

- Homebuying plans slipped to a five-month low.
- Autobuying intentions literally plunged to their lowest level since the aftermath of the Lehman collapse — December 2008 levels.
- 41% of respondents believe Washington is doing a "poor job" while 16% see them as doing a "good job".
- 56% believe the economy is in worse shape than a year ago while only 36% see conditions having improved.
- Only 23% believe that economic conditions will be better a year from now too.
- 20% think their incomes are at risk of deflating in the coming year.

What more can you say? I mean, can we really sit back and conclude that government policies have been successful when real median household incomes are down 4.8% over the 2000-2009 decade? That's even worse than the 1970s when under Nixon, Ford and Carter we saw real median incomes drop 1.9%. We are at a point where so many people have fallen below any acceptable level of income that half the country doesn't pay any tax. Even with record use of food stamps and stepped-up jobless insurance benefits, the number of folks living below the so-called poverty line jumped 10% last year — an apparent economic recovery year — to 43.6 million people.

So, we have 1 in 6 Americans either under or unemployed and another 1 in 7 who live in poverty and somehow we have a legion of economists and strategists who see what we are in some typical recession-recovery cycle on our hands. Just read the editorial of the current Economist for how mainstream the "muddle through" view has become — downside risks are widely seen as marginal because we have never seen a real "double-dip" recession before.

In America, 1 in 6 are either under or unemployed and another 1 in 7 live in poverty or close to it

Reminds us of how everyone was saying back in 2006 not to worry too much about housing risks because national home prices have never declined before on a year-over-year basis. Remind us of how we shouldn't worry about recession risks in 2007 because the Fed never did tighten rates sufficiently to really invert the yield curve all that much and that there has never been a recession without a policy-induced inversion of the yield curve. And then, through 2008 all we heard was that history teaches us "not to fight the Fed." So it's really encouraging to hear how everyone is back to the "it's never happened before so don't worry about it" mentality.

Yes, yes, the ECRI weekly leading indicator has improved for two weeks in a row and this has taken the smoothed index from -10.1% to -9.2%, but the damage has already been done and the fact is that the index has been locked in a rough -8% to -10% range since the end of June. The statistical recovery remains extremely fragile and if this current last leg up in the inventory cycle is involuntary — we will only know for sure in hindsight, but the latest small business stockpiling plans index was not encouraging — then we have a pretty big storm cloud over Q4 GDP. For the time being, it does look as though we have another "1-handle" for Q3 GDP growth (that big improvement in the July trade deficit provided a really big assist) and the markets seem to have breathed a sigh of relief that it is not negative. However, it would seem that we would need something a little better than such a tepid trend to warrant a break of technical resistance (of 1,130) on the S&P 500, which may be why the S&P 500 is currently struggling at the top end of its multi-month trading range.

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INFLATION MELTING AWAY

To be sure, there are many pundits that dislike the Consumer Price Index (CPI) for a whole host of reasons — conspiracy theories about the government purposefully keeping the index low to save on Social Security; all the hedonic shifts over time; the excessive reliance on housing and imputed rent. So this is why 'adjusted' CPI numbers that attempt to take out the noise and volatility in the data are useful, and the Cleveland Fed actually does that for us.

The median Cleveland Fed CPI series in August came in at the grand total of +0.05% month-over-month and has been +0.1% or lower now for 12 months. That is close to price stability as you can get without actually slipping into a deflationary state. In fact, the year-on-year trend in this index was +1.7% a year ago, +1.2% at the end of 2009, and now sits at +0.5%; that's fifty basis points shy of deflation.

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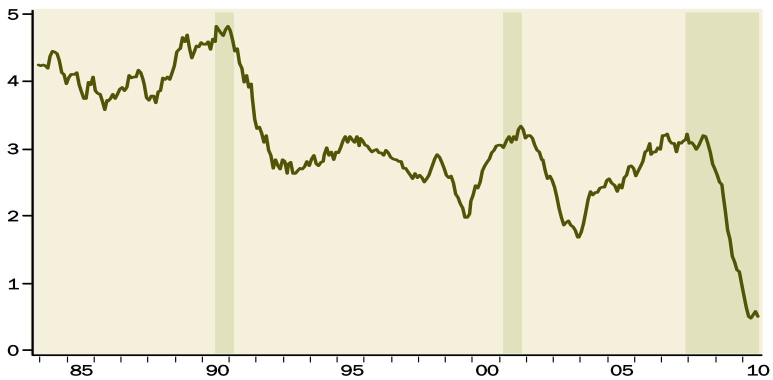
Look Chart 2 and tell us what the fundamental trend is, and what is exactly going to stop it from heading below zero — there is so much talk about the Fed doing all it can to prevent this from happening and all it has to do is drop bags of money from the sky. But you see, the Fed does not think that deflation is a serious enough risk to do anything right now beyond keeping its balance sheet stable. In fact, the central bank believes we are going to see real GDP growth of 4% in 2011. Yes, Bernanke has shown how aggressive he is willing to be, but he has never shown a tendency to wanting to be early in his policy moves.

CHART 2: INFLATION MELTING AWAY

United States: Federal Reserve Board of Cleveland Median CPI
(year-over-year percent change)



Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

At +0.5% on the underlying CPI (according to the Cleveland Fed measure), it is tough to call the bond market in a bubble. In a bubble, you don't see headlines like these making the Wall Street Journal (*Bond Markets are Growing Riskier* and *Treasurys Can Be Painful, as History Shows*). If the real rate approximates the trend in real GDP at around 1%, and assuming some reasonable level for the term premium, then it would certainly be appropriate for nominal bond yields at the long end of the Treasury curve to enter a 2.0-2.5% range before the bull market in fixed-income runs its course.

Household inflation expectations at 2.8% and bond market inflation expectations are 1.8%, while the underlying trend in inflation, as per the Cleveland Fed index, is down to 0.5% and still on a slippery slope. So, there is plenty of room for the 'inflation" expectations component within the nominal bond yield determination process to roll back and take longer-dated market interest rates to the levels that ultimately prevailed towards the end of the last depression. We're talking 2% here. Under-funded pension funds — take note.

As an aside, for all the bubble talk, the latest Commitment of Traders report shows there to be an extremely small net speculative long position in the 10-year Treasury note and that there is a still a hefty net short position in the 30-year bond (over 25,000 contracts). Normally, in a bubble, there are tremendous speculative pressures. There is simply no evidence of that, at least not from the futures and options positions by non-commercial accounts on the Chicago Board of Trade. Go back and have a look at what the net speculative long position in the QQQ's (Nasdaq stocks) during the bubble peaks of a decade ago — not remotely comparable today.

CHART 3: STILL ROOM TO GO ON THE LONG BOND YIELD

United States: Long-Term Treasury Bond Yield
(percent)

Source: Haver Analytics, Gluskin Sheff

This is not an attempt to be bullish, bearish or otherwise. It's an attempt to be realistic, read the economic tea leaves without blinders on, call it the way we see it, and come up with investment strategies for how to navigate the portfolio through a deflationary backdrop. And so, below we highlight our seven major themes for how to not only survive, but to thrive, in such an environment.

INVESTMENT STRATEGY IN A DEFLATIONARY ENVIRONMENT

1. Focus on safe yield: High-quality corporates (non-cyclical, high cash reserves, minimal refinancing needs). Corporate balance sheets are in very good shape.
2. Equities: focus on reliable dividend growth/yield; preferred shares ("income" orientation). Starbucks just caught on to the importance of paying out a dividend.
3. Whether it be credit or equities, focus on companies with low debt/equity ratios and high liquid asset ratios – balance sheet quality is even more important than usual. Avoid highly leveraged companies.
4. Even hard assets that provide an income stream work well in a deflationary environment (ie, oil and gas royalties, REITs, etc...).
5. Focus on sectors or companies with these micro characteristics: low fixed costs, high variable cost, high barriers to entry/some sort of oligopolistic features, a relatively high level of demand inelasticity (utilities, staples, health care — these sectors are also unloved and under owned by institutional portfolio managers).
6. Alternative assets: allocate significant portion of asset mix to strategies that are not reliant on rising equity markets and where volatility can be used to advantage.
7. Precious metals: A hedge against the reflationary policies aimed at defusing deflationary risks — money printing, rolling currency depreciations, heightened trade frictions, and government procurement policies.

GOING WITH THE FLOW

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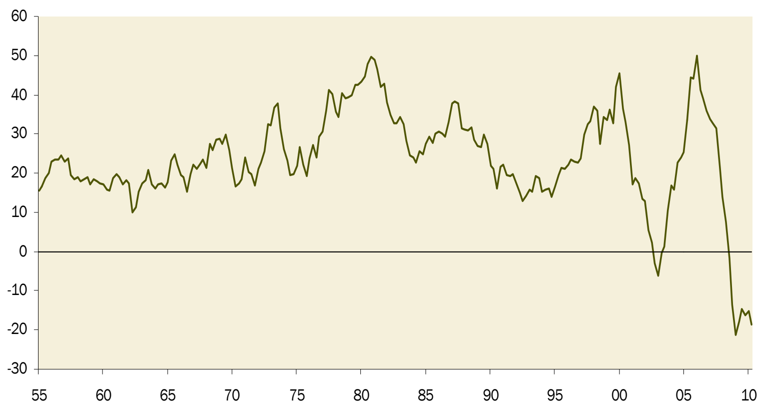
- Households deleveraged by $57 billion in Q2. This was the 7th quarter in a row in which they cut their mortgage, consumer and bank debt.
- Despite these efforts, household net worth still fell $1.5 trillion in the first contraction since the first quarter of 2009. Over the past three years, household net worth has plunged $12.5 trillion — equivalent to a full year's worth GDP. The problem in Q2 was the sharp $1.2 trillion slide in equity-related asset values. If not for the shrewd move into bonds, there would have been another $4 trillion hit to the net worth line last quarter.
- Household net worth relative to disposable income, at 472%, is well off the 635% peak of the last cycle and is at the same level today it was three decades ago when the savings rate was 10%. In other words, the frugal move to 6% from near-zero so far in this post-bubble credit collapse is merely a resting stop.
- The dramatic improvement in nonfinancial corporate balance sheets has come to a thundering halt. At least the ratio of long-term debt-to-total debt remained at a historic high of 73.8% in Q2, debt/equity ratios rose from 55% to a four-quarter high of 63% and the liquid asset ratio ticked up, to 50.8% from 49.8% . In a nutshell, $229 billion on net was raised in the corporate bond market in Q2, while $208 billion of equity was retired — at annual rates. Moreover, the nonfinancial sector financing gap was positive, at $38 billion — not nearly at danger levels but still a big swing from the third quarter of last year when it was -$104 billion (this is the gap between capital spending and internally-generated funds).

CHART 4: RECORD IMPLOSION IN HOUSEHOLD NET WORTH

United States: Household Net Worth
(three-year percent change)



Source: Haver Analytics, Gluskin Sheff

Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and focused primarily on high net worth private clients, we are dedicated to the prudent stewardship of our clients' wealth through the delivery of strong, risk-adjusted investment returns together with the highest level of personalized client service.

OVERVIEW

As of June 30, 2010, the Firm managed assets of $5.5 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 54% 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 $10.9 million[2] on June 30, 2010 versus $5.4 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 $10.9 million USD[2] on June 30, 2010 versus $8.6 million USD for the S&P 500 Total Return Index over the same period.

INVESTMENT STRATEGY & TEAM

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.

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.

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For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

1. *Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.*
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