David A. Rosenberg
Chief Economist & Strategist
drosenberg@gluskinsheff.com
+ 1 416 681 8919

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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

NO ROOM FOR SHORT MEMORIES

Two weeks ago, Ben Bernanke congratulated himself on CNBC for helping to boost the Russell 2000 by 30%.

More recently, the San Francisco Fed Reserve Bank published a report doing likewise, citing QE2 as a success because the inflation rate is currently a percentage point higher than it would have been absent the Fed intervention.

Everyone should be made aware of the insanity of it all, and that preserving their capital and growing it slowly and prudently is a totally appropriate strategy for this radical money easing environment. This type of policy breeds speculative and dubious rallies, but what they inevitably trigger are boom-bust cycles such as the ones we saw in 1999-2002, 2006-2009, and the current one we are in today. This is no time for short memories.

The Fed has created an "inflation" mentality in commodities, foodstuffs and stocks — aided and abetted from a U.S. dollar that has sunk back to two-month lows. At the same time there is still a "deflation" mentality for many final consumer goods, which is unlikely to change until the employment picture improves further.

Incomes are unlikely to keep up with "headline" inflation, so the first reaction is for consumers to draw down their personal savings. We saw that in classic fashion in the Q4 real GDP report.

The Fed has all but given up on trying to create wealth by reviving the housing market. That was QE1, which concentrated on expanding the central bank's balance sheet via mortgage loans. But the headwinds from the ongoing foreclosure crisis and lingering massive excess supply are once again weighing heavily on real estate values.

The structural impediments are far beyond the Fed's control, so QE2 has been all about forcing investors to rebalance their portfolios in favour of the equity market, which is outside its mandate but cloaked in the form of stating that inflation is too low (obviously not including the trip to the gas station or grocery store). The Fed's manipulation of relative asset prices is so epic that it has replaced China as the single largest owner of Treasury securities ($1.1 trillion on its balance sheet).

IN THIS ISSUE

Home prices in the U.S. are resuming a downtrend and soon we will see the household sector having to rebuild its savings without aide from the government. The view that Washington takes care of everything will disappear with looming austerity. This year it is a state and local government story, next year it will be the federal government.

An illusion of prosperity has been created, but it won't last

With short-term rates at zero combined with increasing food and energy prices, this is obviously bad news for savers. It is an illusion of prosperity that has been created, but it won't last. Given the intractable nature of the U.S. fiscal deficit, the Fed needs to encourage more domestic savings but it will not, at least for now, due to near-term deflation fears.

The aim here for the Fed is a reflationary wealth effect via rising equities; buying time until the market for jobs and homes turns around on a sustained basis. The offset is the pinch to real wages from not only ongoing excess capacity in the labour market, which Bernanke does not see ending for another five years, but from the Fed's own policies that have exacerbated the punishing run-up in food prices.

It sounds like a cliché, but I have little doubt that this cyclical bull market will end in tears. Admittedly, however, there could be more upside near-term, but a last gasp I would expect, especially now that the retail client has thrown up his/her hands, thrown in the towel, and moved back into equities after the market has already doubled. That is human nature, and it is a classic contrary signpost (as per Bob Farrell's Rule number 5).

Zero rates and asset purchases are fine in a crisis, but in order to build long-term savings and foster efficient longer term capital allocation, it can become counter-productive

In the end, we will look back at the FOMC dissenting rogue, Kansas City's Tom Hoenig, in the sense that he had it right all along. The Fed needs to stop QE2 and get rates to around 0.5-1.0% as soon as possible. Zero rates and asset purchases are fine in a crisis, but in order to build long-term savings and foster efficient longer term capital allocation, it can become counter-productive.

I can go on but I have seen this movie before. It will end in further wealth destruction via a stock market blow-up or significantly higher inflation down the pike. Given the record structural deficits and the "kick-the-can-down-the-road" monetary and fiscal policies I see no other outcome. Just remember what happened the last time the Fed contemplated an exit strategy — that, you don't need a long memory for. It was not even a year ago and precipitated the near-20% May-June market correction.

NEXT SURPRISE?

Could be two-to-three months of core CPI prints of 0.3%, which the market hasn't seen in over two years, and it might not know what to do with that either.

Back in the last commodity boom we did have a period from the fall of 2007 to the summer of 2008 when core CPI came in at or above 0.3% no fewer than four times. (It is unlikely that the U.K., euro zone, India, China, Brazil and practically the entire planet is openly grappling with an inflation spike and that

this will bypass the U.S.A.). While it ultimately proved brief and the bond selloff was a great buying opportunity, the yield on the 10-year U.S. Treasury note did jump 80bps over a two-month span, to 4.2%; and recall that spasm occurred as the recession deepened. The equity market has managed to navigate through the election, health care, Europe, Egypt, double-dip fears, but it has yet to show much of an ability to deal with 4% Treasury note yields. This could very well upset the apple cart in coming months.

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DIGGING INTO THE ISM

We are busy doing some preliminary ISM work. Looking at the historical record, the index may still be five months from a peak. But interestingly, GDP growth slows thereafter, inflation rises, bond yields edge up and stock market gains subside in the aftermath of the highs. This could require some quasi "stagflationary" strategies such as basic materials, precious metals, energy, TIPS, and credit. Here's what we found when we dug back through the data to the 1950s.

1. To put the 60.8 January reading into historical perspective, this level is relatively high and we found that on an upswing, we only see readings close to this level around 2% of the time. Moreover, the percent of the time this level represented a high was 20%. On average, the index peaked five months later and five points higher — so we could see the ISM go higher over the next few months.
2. Economic growth tends to slow after a post-60 reading. Real GDP averaged 6% four-quarters before the peak and about 3.5% after. Industrial production averaged 10% before and about 5% a year after.
3. What about equities post-ISM peaks? We found that the S&P 500 rallied 15% in the year leading up to the peak, and 4% one year after.
4. One standout detail in the January report was the ISM prices paid component, which rose to 81.5. We could still go higher from here though, as the current level represents a peak 25% of the time.
5. We found that around prices paid peaks, total inflation averaged 3.4% a year before, 4% at the peak and 6% after. Core inflation (excluding food and energy) averaged 3% before, 2% at the peak and 3% after (so no real effect on core inflation). The 10-year note yield tended to average about 50bps higher post peak than pre-peak.
6. Profits tend to slow around both ISM peaks and prices paid peaks. Using economy-wide profits from the National Accounts, profit growth ran at 15% pre-ISM prices paid peak versus 5% after.
7. Margins are set to compress and compress sharply and likely weigh against consensus views of +15% earnings growth this year. See *Steel-Price Rises Pressure Supply Chain* on page B1 of the WS. Unit labour costs are falling, albeit at a far slower rate than a year ago (-0.2% YoY versus -3.5% this time last year). And look for non-unit labour costs, like higher inventory financing expenses, to bite into profit margins as well — see *Fearing Inflation, Firms Stocking Up* on page C1 of the WSJ.

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 December 31, 2010, the Firm managed assets of $6.0 billion*.

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.

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.

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.

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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:

Unless otherwise noted, all values are in Canadian dollars.

** Preliminary estimate as of January 17, 2011*

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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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