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Economic Commentary

Gluskin Sheff

**MARKET MUSINGS & DATA DECIPHERING**

# Breakfast with Dave

## WHILE YOU WERE SLEEPING

Mixed start to the day with either modest gains or losses across European and Asian equity markets. The two notables were the 0.6% decline in cyclically sensitive Kospi index and the Sensex, which remains under intense selling pressure, down 1.5% today to its lowest level in seven months and already down by 15% year-to-date.

Bonds are stable ahead of today's $32 billion three-year U.S. Treasury-note auction (first of three Treasury offerings this week) though we do detect an updrift in JGB yields which bears watching — back above 1.3% after today's three basis points backup in the 10-year maturity (today's auction of 40-year JGBs went poorly — up 6.5bps to 2.295%).

The DXY is faltering just below the 100-day moving average, which itself is in descent. And in a mirror image, gold is a tad firmer in the wee hours of the morning as it moves to retest its 100-day m.a. line to the upside. Even so, the gold-silver ratio has declined to a five-year low on yet another sign of increased global economic optimism (since silver is more economically sensitive).

On the data front, we saw the INSEE business confidence index in France hit a three-year high in January but this was balanced against the unexpected 1.5% slide in Germany's industrial production in December and this was on top of a 0.6% drop in November — the consensus was looking for +0.2% but then everyone quickly blamed it on the weather (apparently it was winter during the month and someone forgot to tell the statisticians — shades of the recent nonfarm payroll report).

With respect to policy, we saw China raise interest rates for the third time in the past four months — raising the one-year lending rate from 5.81% to 6.06%. This in turn is helping re-establish a positive real interest rate as inflation is running at 4.6% currently. Some parts of the commodity complex, notably copper, have sold off on the news.

Is it the news that makes the market?

Not according to the legendary Bob Farrell who coined the phrase "it is the market that makes the news".

## IN THIS ISSUE

Still, there were a few interesting nuggets in the morning papers today that are worth mentioning:

The front page of the WSJ ran with an article talking about how cash deals are helping revive housing markets in depressed areas. This goes to show how distressed sales are the key force — this is not organic demand but investor demand for the most part and these units are ultimately converted into rentals (where there is strong demand given the stigma of homeownership today — "oh you rent? Good for you"). Don't just take our word for it — go to the front page article in today's USA Today (*In Housing Bust, a New Normal*). To wit: "Families have adjusted too. Forget dreams of making big bucks in California real estate. Many here now count the years — guessing really — until they'll no longer owe more on their homes than they're worth."

The gold price may be in a bit of a respite right now but those who write off the secular bull market are probably making a big mistake — see *J.P. Morgan Will Accept Gold as Type of Collateral* on page C1 of the WSJ, as well as *Midas Touch from Paulson: The Hedge-Fund Titan Juiced Returns By Going On the Gold Standard* on page C3.

The muni bond market should respond kindly to *Florida Governor Seeks Cuts in Budget* on page A4 — despite all the hysteria over a wave of defaults, it does look increasingly as if it is the contract with the unions, and not the contract with the bond holders, that is most at risk as this budget crisis gets resolved.

While page C9 runs with *Yield on 'Junk' Approaching All-Time Low* (indeed, the average yield is down below 7% and the group trades at 3.6% premium to par), investors in this space will probably like the news the companies have so radically termed out their debt profile that the amount of liabilities coming due by 2014 has plunged by 44% over the past two years (Bloomberg runs a fascinating story on this — *Debt Maturity Wall Crumbles by $482 Billion*). Fully 56% of the new debt issuance last year was for refinancing purposes. Everyone seems to believe that the equity market is the only game in town, but the high-yield corporate bond market generated a net positive return of 15% last year and this followed on the heels of a 58% gain in 2009 (and up 2.5% so far this year). Good thing we have been positive on the group — and the sector, without much fanfare, it has smoked the stock market by 3,400 basis points in total return spread over the past two years.

It is interesting that as investors flock to the riskiest part of the U.S. bond market ($4.8 billion net inflow to U.S. high-yield funds so far this year, which is about one-third of last year's total intake) as they dump the riskiest part of the stock market — a huge $7 billion was pulled out of emerging market equity funds just in the week of February 2nd. See *Emerging Markets Fall Behind* on page A7 of the Investor's Business Daily.

President Obama showed off his apparent lack of knowledge on how the economy works by openly pressuring businesses to start hiring more workers as

a quid pro quo for all the government support that has been bestowed upon them — see *Obama Says Tax Breaks Should Now Spur Hiring* on page A4 of the WSJ. So let's see — the way to have the economy operate efficiently and competitively is for companies to hire people they don't think they need. Somehow that is the road to long-term prosperity. Adam Smith must be rolling … (as we say that, we see that the IBD/TIPP Presidential Leadership Index rose to 51.6 in February from 50.4 in January and 45.5 in December — quite remarkably, tracking the chart of the S&P 500).

Oh yes, and lest you think that the calm you see in Europe may be occurring before the storm, have a look at *Ireland's Election Adds to Bond Risk* on page 23 of the FT.

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### GIVE' EM CREDIT?

Much is being made of the $6 billion increase in U.S. consumer borrowing in December — the third increase in a row as per the Fed's data published yesterday. There was a massive — a record — $25 billion surge in nonrevolving credit at finance companies. Outside of that, credit contracted, negative at the banks and securitized pools and flat at credit unions and savings and loans. Go figure.

It does look like a lot of that pickup is being reversed by either charge-offs or prepayments because the weekly Fed data are showing large declines in consumer credit outstanding (mortgage loan balances too) through last month. In fact, total system wide banking assets are contracting sharply again, as we highlighted yesterday.

Like most things, the economy continues to dig itself out of a deep hole, as per the sequential pickup in December. This is what the big picture tells you (below) — total revolving credit at the end of the past three years, courtesy of a long-time reader and friend:

- 2008: $989.1 billion
- 2009: $894 billion
- 2010: $826.6 billion

And that 2010 reflects the "strong" Christmas the retailers enjoyed! Just as an aside, the last time we closed the year with revolving credit this low was in 2004.

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I still believe that across many economic indicators, this goes down as a horrible recovery, especially in view of all the stimulus. Of course things look much better than they did in the "double dip" risk days of last summer but absent the impact of the GDP deflator's collapse and the decline in the savings rate, Q4 real GDP would have actually come in closer to +0.5% SAAR than the posted +3.2% print.

While there are some pockets of vigour, I think the macro backdrop is still overall tepid by the standards of past second-year recoveries and the huge imbalances in the economy have still not been redressed. Usually at this stage of the expansion, we are seeing real GDP growth rates in excess of 5% and with far less government aid.

### THE TREND IS YOUR FRIEND — UNTIL IT IS BROKEN

As Doug Kass most eloquently put it, a trend is special because it doesn't break on its own. Some countervailing force, exogenous shock or surprise has to act as the inflection point — in both directions. Last year in the fall, when the stock market was about to break down to a new range but the trend was broken by the quasi announcement of QE2, followed by the substantial fiscal stimulus that bought time for another year. So what happened was that the 'double dip' concerns undermining market sentiment were reversed and a new trend of positive sustainable growth has re-emerged. While we are likely to see the economy slow down in the coming quarters, there is nothing we can see to suggest a contraction in GDP is forthcoming that quickly. So recession odds have been increasingly taken off the table, though the policy vacuum is likely to cause more than just an air pocket for the economy in 2012 (and recessions have this nasty historical tendency of taking place during election years). This market has managed to climb despite many a wall of worry and it has withstood the tests to date.

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The S&P 500 was wobbling and seemingly on its way to a new and lower range just prior to the QE2 announcement from Mr. Bernanke last August — and the QE2 was a catalyst that helped break the downtrend. The improvement in the data and the added fiscal thrust have nurtured this new uptrend too. But what could happen to force a break in the other direction? After all, if you go back to the interim peak of last year, which took hold in late April, there was something that broke the uptrend and it had nothing to do with double-dip recession risks that came much later. It was when the yield on the 10-year note broke to 4% in early April of 2010 and provided some competition for the stock market that we started to see equities embark on a new downward trend for the next 3-4 months.

Well, you don't have to be a chartist to see that we do have a breakout in the 10-year U.S. Treasury-note yield on our hands and before we go any further, the answer is no, we have not all of a sudden become inflation-phobes or bond bears. Far from it. But the prospect of an inflation scare and more upward pressure on yields over the near-term is the one development few people are talking about that could upset the apple cart.

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The runup in yields so far, from the October lows, has been just about four parts "real rate" driven and one part "inflation" driven. The real rate adjustment reflects the improvement we have seen in the real economy as well as heightened risk appetite among investors. But we have had, nonetheless, a situation where food costs have surged at a 60% annual rate since last Fall and energy prices at a 45% annual rate. Considering that food and fuels make up

23% of the CPI, it would stand to reason that we are going to be seeing some pretty big headline numbers coming soon, even if the grocery chains come close to fully passing these costs to consumers. As we said yesterday, 4% headline inflation is when the stock market buckles for good, and based on our models and spreadsheets if this were to happen, it wouldn't be until the very end of the year.

The key also will be the core because the markets have not had to contend with a +0.3% print since July 2008, which for many of us was a lifetime ago. This would be a surprise, and yet the last time we had commodities rising as sharply as they are today, we had a handful of them of 0.3% prints. If we do go to 4% on the 10-year Treasury note on the back of higher inflation expectations, then rest assured the broad expectation will be that it is headed next to 4.5% and it will be interesting to see how the equity market would respond to that prospect.

**This is what is different today from a year ago — the surge in raw material prices**

This is what is different today from a year ago — the surge in raw material prices. There are lags in terms of impact through the real economy, pricing and margins. The reason why we cannot rule out +0.3% for the core CPI or perhaps even a couple of nasty, even if brief reports, is that airlines are passing on the fuel costs and we know that apparel retailers will soon pass on the cotton-induced price increases. Moreover, unlike a year ago, the rental components of the CPI are no longer decelerating. This does pose a bit of a near-term problem because the best leading indicator of core goods CPI is the core intermediate PPI and it has risen now by 0.3% or more for four months in a row and at an annual rate of around 6%.

Imagine what printing a couple of 0.3%'s on core CPI in coming months will do to QE3 prospects — seriously damage them is what — at a time when 40% of market participants already believe that this is baked in the cake.

As an aside, consumer discretionary, financials, and utilities within the equity sectors would be the ones most negatively affected by the scenario depicted above; energy, technology, and materials are the areas that would have the lowest correlation with a near-term inflation and market interest rate spasm.

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## LOOKING AT SALES, NOT JUST EARNINGS

We are hearing how great S&P 500 sales are doing so far for Q4 — up 7.7% and beating estimates by the highest margin in a half-decade. We scoured the data as best we could and found that almost all the growth in sales is coming from outside the U.S.A. where revenues are growing at barely a 3% annual rate. The pace is around 20% for foreign-derived sources. So the question is what happens to revenues if the foreign stuff comes under some downward pressure in view of the policy tightening in most emerging markets and the fiscal tourniquet being applied through most of Europe.

The two reasons why companies have had such success in driving their profit growth into a V-shaped recovery has been via an exceptionally robust foreign sales performance and relentless cost-cutting. But you can't cut costs forever

and we are already seeing signs that the downward momentum in unit labour costs is subsiding. On top of that is the surge in material costs, which we have not seen percolate yet, but will surely compress margins from their current five-decade highs.

We should start to get some corporate guidance numbers next week but for the time being we do have the analyst upgrade-downgrade ratios, which has stagnated recently. They are no longer going up and are actually going down in six of the ten sectors. Those with positive momentum include technology and materials. Utilities and consumer discretionary are not screening well at all.

**Remember that the savings rate drawdown added 0.4 of a percentage point in Q4, courtesy of the cash flow impact of much higher mortgage refinancings and the equity wealth effect**

### ANOTHER LOOK AT GDP

Because of a quirk in the oil import data, we had a collapse in the GDP price deflator in Q4, which played the largest role of all in terms of generating a 3.2% real GDP growth rate in Q4. If the deflator had come in closer to the norm of 2.5%, we would have seen real GDP growth come in closer to a 0.9% annual rate (and the Q3 data would have been 2.1%, not 2.6% as was reported). Not only that, but remember that the savings rate drawdown also added 0.4 of a percentage point in Q4 too, courtesy of the cash flow impact of much higher mortgage refinancings and the equity wealth effect. So aside from the effects of the deflator and the savings rate, we could well have been looking at a +0.5% growth rate to close out the year. Turns out the double-dippers were at least closer to the mark, absent these distorting effects.

### HOUSE PRICES A LINGERING RISK

The housing market may be long and forgotten but it is still the largest asset on the household balance sheet by a country mile (27% share of assets). Home prices nationwide are down five months in a row and by an 8% annual rate and these declines occured all across the country. According to CoreLogic, we have a total of 6.5 million homes in shadow inventory or the equivalent of 12.5% of all mortgaged homes, representing 15 months' supply of unsold backlogs. While there is still momentum from Q4 being pushed into Q1 of this year because of the payroll tax stimulus, the lingering effects of declining real estate values and a very soft labour market can be expected to take their toll on confidence and spending beyond this quarter.

**Jobless recoveries are troubling because if they persist, organic personal incomes erode**

Jobless recoveries are troubling because if they persist, organic personal incomes erode. This can be papered over for a while with rampant fiscal stimulus as we have already seen, but what happens when the spigots get turned off? Whether it is excessive debt burdens, excessive housing inventories or excessive labour market gaps, the huge imbalances in the U.S. economy have still not been addressed this cycle. The day of reckoning is indeed coming.

### SMALL BUSINESSES FEELING BETTER

The survey data sure seems to be screaming far ahead of the real side economic data for the most part and this may in fact be due to the psychological impact the liquidity-induced rally in the stock market is having on the poll results.

We shall receive more details later, but we do see that the NFIB small biz confidence index did edge up another 1.5 points in January to 94.1— the highest since the onset of recession in December 2007.

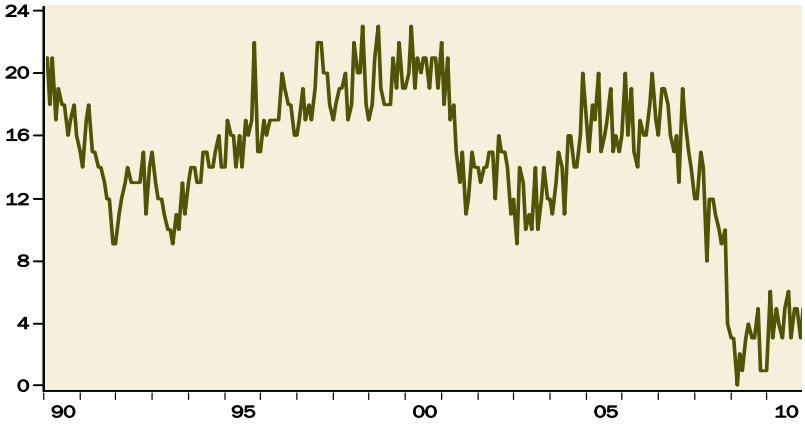
What is interesting from the data is that while the current and lagging components fared very well, the leading ones were less constructive as far as the overall outlook is concerned.

For example, lagging indicators like the net share of small businesses adding to payrolls over the past three months rose a full point to stand at its highest level since January 2008. But the "planning to hire" index actually fell three points last month and the index measuring job openings stagnated.

What caught our eye was that the index measuring intentions to raise wages rose from three to five and still stands near historical lows. But plans to raise selling prices soared from 15 to 19, the fourth increase in a row and the highest since September 2008. Since everything is at the margin, we can see that while only 5% of small businesses see inflation as their most important concern (it had been as low as 2%) and this is near the top end of the range over the past two years.

**CHART 1: NO RAISES HERE**

**United States: Percent Planning To Raise Worker Compensation**
(percent)




*Source: Haver Analytics, Gluskin Sheff*

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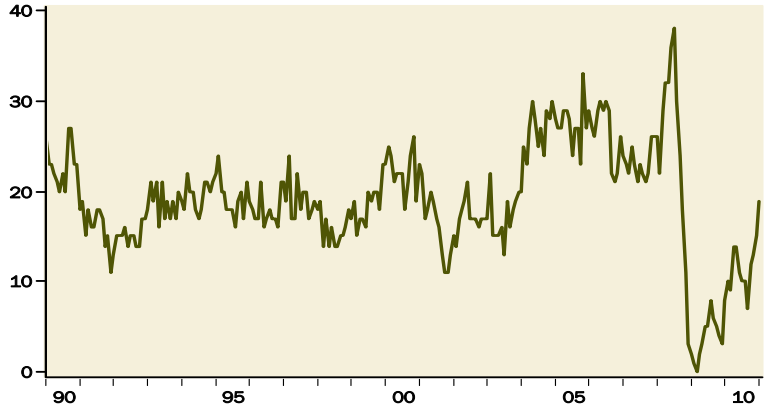
**CHART 2: PLANS TO RAISE SELLING PRICES SOARS**

**United States: Percent Planning To Raise Average Selling Prices**
(percent)




*Source: Haver Analytics, Gluskin Sheff*

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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.

$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.

## 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.*

** 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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