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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite with Dave

WHILE YOU WERE SLEEPING

Investors are fleeing to the relative safety of Treasuries and it is truly remarkable to see the *mea culpa* from Wall Street economists — at the start of the year, the consensus thought that we would see the yield on the U.S. 10-year note rise to 4.14% by the end of 2010 — and even in May that forecast was sitting at 4.04%. Even as projections come down, everybody still thinks that the trend from here in yield activity will be up, not down (and we can see reading research notes and the Bloomberg screens this morning that there seems to be this craving among analysts to once again view this selloff in equities as a buying opportunity).

Inflation, not deflation, is still seen by the masses as the primary risk going forward. We recall all too well the Barron's column last December titled *2010 Unlikely To Make Treasury Holders Smile.* Of the 11 economists polled, five saw the 10-year note yield at 4% or higher by mid-year and only two believed it could actually be as low as 3% (the other nine economist where expecting 3.5% or higher). The lone bond bulls at the time were us and the terrific economics team at Goldman Sachs. We have noticed several articles (in the WSJ, NYT and Bloomberg) recently talking about how everybody missed the big story of the year, which was this huge rally in the bond market. Well, if truth be told, not everybody missed it.

If there was a piece of good news overnight, it was in the form of the German manufacturing orders data for April — up 2.8% MoM and this was on top of a 5.1% surge the month before. The problem is that April now seems like a lifetime ago — the euro was sitting at 1.35, bund yields were north of 3% and the stock market was testing new highs for the cycle.

BAD SESSION, BAD WEEK

I'll have the goulash soup and a side of tzatziki.

Not only was the stock market pummeled last Friday but the selling was on much higher volume. Distribution days are never a good sign, and not one Dow stock could manage to eke out a gain. The blue-chips are now at their lowest level since February 8 and the S&P 500 broke below the 1,070 level, which had been acting as a very critical support of late. You can see within the action that risk-aversion is increasingly setting in with the Dow's 2% decline last week comparing to the 4.2% slump in the Russell 2000.

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

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VOLATILITY THE HALLMARK OF A BEAR PHASE

In the past 30 trading days, the difference between the intraday low and high in the Dow has exceeded 200 points in 23 sessions or over three-quarters of the time. That's insane. If you look at the daily swings of 100 or more points (between the intraday high and low), then we are talking about 21 consecutive trading days or 106 days in the last 107! Now how's that for a heart-stopper? But there is a way to minimize the wide fluctuations and allow the capital to grow prudently over time — even in a bear market too, so long as you are on the right side of the trade. It's called true hedge funds or classic long-short strategies.

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A FEW MORE DISTURBING EMPLOYMENT TIDBITS

First, if it weren't for the plunge in the labour force, the U.S. unemployment rate would have climbed to 10% in May. Second, the Household survey actually flagged a 35,000 outright decline in employment last month. Third, the 41,000 increase in private payrolls, about one-third of what was widely expected and the low-water mark for the year, was exaggerated by a 29,000 boost from the "birth-death" model. Fourth, the fact that the hottest sector of the economy, manufacturing, could only post a 29,000 gain, a sharp slowing from 40,000 in April is quite disconcerting — especially since it is clear that the ISM index has peaked for the cycle. Fifth, the declines in the financial sector, construction and State/local governments are a vivid reminder that the parts of the economy that were most affected by the bursting of the housing and credit bubble are still licking their wounds and cannot be relied upon to play any role in helping revive what is still very much a moribund jobs market.

GROWTH SLOWDOWN COMING

While the focus over the weekend was on Hungary's fiscal crunch and the spreading debt crisis in Europe, let's not take our eyes off the economic ball. The pace of activity is on the precipice of slowing down sharply. Indeed, the smoothed ECRI leading index slipped in the May 28th week for the fourth week in a row and now in eight of the past nine. It is now at its lowest level since June 12, 2009 — when the S&P 500 was sitting at 946 (interestingly enough from a technical standpoint, right near the 50% retracement level of the bear market rally from the March 2009 low to the April 2010 high. The ECRI is now just basis points shy of breaking below zero but a double-dip is going to become a real likelihood if the index breaks to and through the -10 threshold.

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IT'S STILL ABOUT DEFLATION

Maybe this is why Bill Gross was rumoured to be in buying long Treasuries late last week. It is never too late to change one's mind, and secular trendlines offer all sorts of opportunities to do so. Imagine the labour market softening at a time when underlying inflation is running below a 1% annual rate. And, we haven't even seen the full impact of the stronger U.S. dollar and the pullback in commodity prices hit home yet. If German bund yields are heading down to 2½%, make no mistake — Treasury and Canada yields are not far behind.

Gluskin Sheff at a Glance

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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.

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$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $11.7 million[2] on March 31, 2010 versus $5.7 million for the S&P/TSX Total Return Index over the same period.

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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.

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

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