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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite with Dave

NOT MUCH OUT OF G20

Much of the pledges made are standard fare. The key takeaway is the acknowledgment of fiscal restraint, which will be the dominant macro theme for at least the next three years. This confab was in stark contrast to the pro-growth stimulus theme of a year ago. No mention of currencies in the aftermath of the Chinese announcement to revalue; at least moderately.

All in, the stress on fiscal consolidation implies the need for policy rates to remain at ultra-low levels for a prolonged period of time. This in turn limits the chance of any sustained rise in government bond yields. In terms of any goals established, there is an objective to shave fiscal deficits in half by 2013, and to stabilize debt-to-GDP ratios with a 2016 deadline. But specific timelines are at the discretion of each government. Ditto on the issue of bank taxes and global financial regulations.

"THE THIRD DEPRESSION"

That is the title of today's spirited column by Paul Krugman in the NYT's editorial section. His arguments can be debated as we are sure the entire Austrian school (along with Robert Barro) would take him to task on the efficacy of even more government intrusion at this point. However, Krugman's view on what this cycle is all about is right on the mark: a deflationary depression. In our view, the best medicine from governments is to prevent credit bubbles from occurring in the first place – it's not as if the U.S. didn't have warning signs once Fannie and Freddie morphed into *de facto* hedge funds.

A LOOK BACK IN TIME … NO HAPPY RETURNS

When we lunched with Bob Farrell two weeks ago, he brought along a report he wrote back on December 27, 1999 titled *"Here Comes Santa Clause and the Bus Stops Here."* The major point on the front page of the report was that investor expectations for annual returns from the equity market *"in the next 10 years have risen from 14 per cent to 19 per cent in the past year."* However, instead of +19% per year, investors have endured -3% returns annually over the past decade. The allure of the equity market is likely not going away; however, one cannot deny that bonds and bullion have clearly been, and will likely remain, the top-performing asset classes.

OH CANADA!

We wrote a piece last week reiterating why it is that Canadian assets have been re-rated coming out of the credit collapse. With that in mind, it was extremely encouraging to see *Canada: Land of the Free* on page A11 of the weekend WSJ, based largely on an interview with Finance Minister Flaherty. The opposite direction that Canada and the U.S.A. are going is rather striking.

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- While you were sleeping: European bourses starting off the week on a positive note, but mixed action in Asia; government bonds are getting whacked pretty hard in Europe, but U.S. Treasuries are stable
- Not much out of G20 but the key takeaway is the acknowledgement for fiscal restraint
- *The Third Depression*, this is the title of Paul Krugman's article in today's NYT; his view on the current cycle is on the market: a deflationary depression
- A look back in time … no happy returns for the equity market
- Oh Canada! The opposite direction that Canada and the U.S.A. are going is rather striking
- Is Britain the poster boy for fiscal renewal? Only time will tell
- Deflation is the primary risk ahead
- Deleveraging at its penultimate
- Double dip in the U.S.? What flavour?
- U.S. housing still in disarray
- Diminishing returns and dealing with pension changes in the U.S.

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IS BRITAIN THE POSTER BOY FOR FISCAL RENEWAL?

Only time will tell if the emergency budget unveiled by the new U.K. government will prove to be a colossal policy error that tips the economy back into recession – with global repercussions – or an absolute necessity. The retrenchment is one part tax hikes (the VAT surges next year to 20% from 17.5%) to four parts spending cuts, which will drain GDP by 6.3% over the next five years.

Pressures are building in Washington to start exercising some fiscal prudence too, though there is little sign that the White House is listening

DEFLATION THE PRIMARY RISK AHEAD

The weekend press was filled with stories of dramatic restraint still coming out of the State and local government sector, and not just to deal with huge budget deficits but also massive unfunded pension liabilities. For one example of how deep the cuts are, see *Facing Deficit, Oakland Puts Police Force on Chopping Block* (this is happening in one of the country's most crime-laden cities). And in today's FT, also have a look at this article on the matter – *U.S. State Budget Crises Threaten Social Fabric*.

Pressures are building in Washington to start exercising some fiscal prudence too, though there is little sign that the White House is listening. But as we saw last week with the failed attempt to pass yet another extension of jobless benefits, it is Congress that legislates, not the Administration. And there are other pressures building from within – just have a read of *U.S. Deficit Proved Key to Orszag Departure* on page 3 of the weekend FT.

The trend back to fiscal probity is gaining popularity. We see it in Canada and look what is happening in the U.K. – talk about resolve if the budget austerity measures actually see the light of day (Mr. Osborne considers himself to be a modern-day Maggie Thatcher). The Germans are turning a deaf ear to President Obama's calls for more stimulus. Japan is set to double its consumption tax rate. The Club Med countries have no choice but to undergo dramatic retrenchment – either that, or face default.

This move towards fiscal restraint has triggered no shortage of complaints from the neo-Keynesians, but the reality is that 80%-plus debt-to-GDP ratios are a real game changer in the industrialized world. You reach a point of diminished returns, and we are likely at that point. And at a time of a sputtering recovery, fiscal belt-tightening will likely intensify global deflation pressures – with the risk that the deflation itself will impede, though not necessarily reverse, the move towards fiscal rectitude.

DELEVERAGING AT ITS PENULTIMATE

The entire special section on the credit contraction in the Economist is a must-read, if there ever was one. The section provides evidence of just how large the problem is – total private and public sector debt in the 10 largest industrial economies soared from 200%of GDP in 1995 to 300% in 2008. Servicing this debt is becoming increasingly onerous and acting as a dead-weight drag on the developed world economy.

Gluskin Sheff

Gluskin Sheff at a Glance

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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.

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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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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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