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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

There is a positive tone to start off the week with European equity markets in the green pretty well across the board. It was much more mixed in Asia where gains in the Sensex, Singapore Straits and Hang Seng were offset by losses in Japan (TOPIX down for five days in a row), China and Australia.

Government bonds are getting whacked pretty hard in Europe, despite signs of the state data suggesting that German inflation in June dipped well below 1%. It looks as though a heavy slate of supply is weighing on the continental bond market – Treasuries are actually quite stable this morning. It's fascinating to see how everyone detests the bond market in part because it is the enemy of the stock market and the inverse correlation between the two asset classes has never been stronger than today. But a Bloomberg News article starts off *"Global bond returns may have nowhere to go but down after the best first half since 2005."* Really?

Not much in the FX market --- investors have drawn a line in the sand at 1.20 on the euro. The DXY is consolidating as it kisses the 50-day moving average. The New Zealand kiwi is softer as it falls from a six-week high on poor business confidence data, though the Aussie dollar is firm on the recent political shift and likely change in the resource tax initiative. Comments made by President Obama that he expects more revaluation efforts out of China have allowed yuan forwards to strengthen further. The yen is slipping against the euro, which is the FX market's way of saying "it's okay to take on more risk." That said, the creeping-up in the TED spread would suggest otherwise. Gold continues to hang in nicely – the chart looks fabulous. Silver is keeping pace as well – the "poor man's gold" is just above $19 an ounce and Deutsche Bank analysts released a report with a year-end target of $22/oz.

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 THIS ISSUE

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 key takeaway in the G20 meeting in Toronto was the acknowledgement by the world leaders on fiscal restraint

"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. In any event, here are some snippets from the Krugman piece that the perma-bulls should consider (especially with the consensus still north of $96 on 2011 EPS projections):

The third depression: a deflationary depression

"Recessions are common; depressions are rare. As far as I can tell, there were only two eras in economic history that were widely described as "depressions" at the time: the years of deflation and instability that followed the Panic of 1873 and the years of mass unemployment that followed the financial crisis of 1929-31."

"We are now, I fear, in the early stages of a third depression … primarily by a failure of policy."

"There is no evidence that short-run fiscal austerity in the face of a depressed economy reassures investors. On the contrary: Greece has agreed to harsh austerity, only to find its risk spreads growing ever wider; Ireland has imposed savage cuts in public spending, only to be treated by the markets as a worse risk than Spain, which has been far more reluctant to take the hard-liners' medicine."

"The Fed seems aware of the deflationary risks — but what it proposes to do about these risks is, well, nothing. The Obama administration understands the dangers of premature fiscal austerity — but because Republicans and conservative Democrats in Congress won't authorize additional aid to state governments, that austerity is coming anyway, in the form of budget cuts at the state and local levels."

According to Paul Krugman, *"We are now, I fear, in the early stages of a third depression … primarily by a failure of policy."*

"In the face of this grim picture, you might have expected policy makers to realize that they haven't yet done enough to promote recovery. But no: over the last few months there has been a stunning resurgence of hard-money and balanced-budget orthodoxy."

"… both the United States and Europe are well on their way toward Japan-style deflationary traps."

As we said before, this is a powerful indictment against the current policy stance. But many other entities do not share Mr. Krugman's view, or that more government intervention will do much good. The BIS (Bank for International Settlements) just published a report that came to different policy conclusions (cited in today's FT):

"A programme of fiscal consolidation – cutting deficits by several percentage points of GDP over a number of years – would offer significant benefits of low and stable long-term interest rates, a less fragile financial system and, ultimately, better prospects for investment and long-term growth.

Cutting interest rates to record lows was necessary to prevent the complete collapse of the financial system and the real economy, but keeping them low for too long could also delay the necessary adjustment to a more sustainable economic and financial model … they may still need to tighten monetary policy sooner than consideration of macroeconomic prospects alone might suggest."

Fiscal consolidation may actually be necessary at this point but the call for monetary tightening into an environment of rising deflation risks is a little nutty.

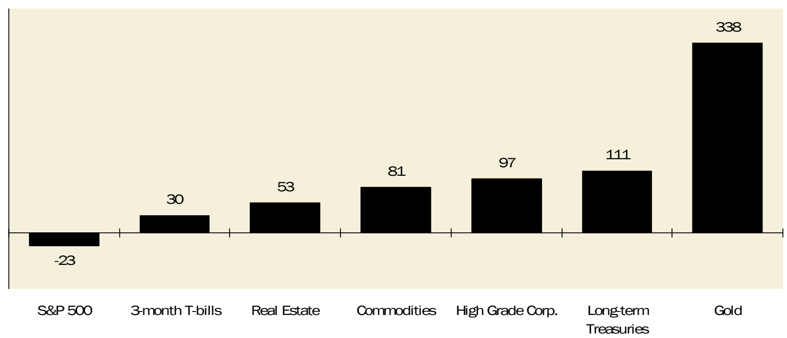
The allure of the equity market is likely not going away; however, one cannot deny that bonds and bullion have clearly been, and will likely remain, the top-performing asset classes

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.

CHART 1: STOCKS FOR THE LONG RUN?

United States
(10-year returns by asset class: May 2000 to May 2010)



Source: Haver Analytics, Gluskin Sheff

Before the secular bear market in U.S. equities and the secular bull market in precious metals ends, both the Dow and the gold price will be sitting at 5,000. Where will bond yields be? Considering that we are heading into a permanent environment of 2-3% nominal GDP growth – along with low real growth and modest deflation – we should expect the long bond to ultimately drift into that range. After all, real final sales is running at a mere 0.8% annual rate as it is, and the leading economic indicators are rolling over. So, how we manage to avoid a double-dip, especially with the Fed and the government bereft of any policy options, is a legitimate question at this juncture; and with underlying inflation at 0.9%, and the risk of a widening output gap as benign economic growth fails to absorb widespread excess capacity. In manufacturing, commercial real estate, housing and labour, it is an equally legitimate question as to whether outright deflation can be avoided at this point.

The U.S. Treasury market remains the most despised asset class. The "Current Yield" column of Barron's shows that nobody (except us) sees bond yields heading lower by year-end

Based on last week's post FOMC meeting press release, these seem to be the issues front-and-center on the Fed's collective mind. If all that happens is that headline inflation converges on core inflation, and that real GDP growth converges on real final sales, then we could well be talking about sub 2% nominal growth. So when we talk about the long bond heading towards a 2-3% range, it is not a stretch to see it ultimately break below that band, as it did in the late 1930s.

In any event, the long bond is currently still north of 4% and so the potential for huge capital gains if the yield moves in tandem with nominal GDP growth, as has always been the case, is huge.

Meanwhile, the Treasury market remains the most despised asset class. The "Current Yield" column of Barron's shows that nobody (except us) sees bond yields heading lower by year-end, and ditto for mid-2011 (six out of 10 economists polled see the Fed tightening and the 10-year note yield break to or through 4%).

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. The best part of the article was the last part; the conclusion:

Oh Canada! The opposite direction that Canada and the U.S. are going is rather striking

"That's [note: limiting the fiscal stimulus to two years] *not flying with Canada's economic liberals, but to American ears it sounds downright libertarian. Mr. Flaherty is also a proponent of a strong Canadian dollar and the champion of a recent unilateral tariff reduction that will remove "thousands of tariffs on inputs for manufactured goods" by 2015. Last week, his government ratified the Canada-Colombia free trade agreement. Tax cuts, limits on stimulus spending, a strong currency and freer trade. Who says Canada is boring?"*

IS BRITAIN THE POSTER BOY FOR FISCAL RENEWAL?

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

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.

Asset sales are also coming as we go through an epic transfer of wealth from public to private hands. This certainly worked well in Canada during the austere 1990s; and, it may well have to be part of the solution in the Unites States – where non-defense assets on the government balance sheet are valued at around $8 trillion.

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.

Nobody ever said deleveraging cycles were painless events. Just read Rogoff and Reinhardt, or the McKinsey report for that matter. Also have a read of a shorter "take" on what is coming down the pike; on page 16 of the weekend FT – *Spectre of Deflation is Back to Haunt Investors*.

It would be nice to try to grow our way out of this debt morass; however, aging demographics and rising dependency ratios are complicating factors

In a deflation environment, income is king. Two articles come to mind from our weekend reading: *Dividends Are Back* on page B7 of the weekend WSJ and *Muni Bonds: Don't Hit the Panic Button Yet* on page B8.

For the dividend theme, after a hiatus in 2009, this strategy has really taken off with the U.S. stock dividend index up 1.9% year-to-date while the overall market is down 2.5%. So far in 2010, the good news is that income-seeking equity investors have seen 136 of the S&P 500 companies raise their payouts, or initiate new programs, while only two have cut or suspended theirs. After a net cut of $37 billion in payouts last year, dividend payments have rebounded $11 billion so far in 2010 (there is more on this theme too on page 5 of the Sunday NYT biz section -- *Dividends Are Rising: Will Stocks Follow?*).

As for the muni article, it contained a lot of useful information dispelling the myth of widespread municipal defaults, notwithstanding the intense fiscal challenges of the day. For example, from 1970 to 2009, the 5-year default rate on municipals has averaged the grand total of 0.03%– compared with 0.97% for corporates. On average, there are have been eight muni insolvencies per year since 1934 – so focus on cash reserves, tax capacity and the refinancing calendar and avoid the risky credits. Muni bonds are not CDOs, subprime mortgages, Greek debt or speculative tech stocks.

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. The Economist put it well, and it put it succinctly:

"This special report will argue that, for the developed world, the debt-financed model has reached its limit. Most of the options for dealing with the debt overhang are unpalatable. As has already been seen in Greece and Ireland, each government will have to find its own way of reducing the burden. The battle between borrowers and creditors may be the defining struggle of the next generation."

It would be nice to try to grow our way out of this debt morass, but aging demographics and rising dependency ratios are a complicating factor on this score.

It would be nice to reflate but, an estimated 53% of the industrial world government debt rolls over in the next five years and if investors were to sniff out an inflation cycle, the interest rate on this debt would likely rise and frustrate the deleveraging process by forcing interest charges higher. This makes debt monetization a risky proposition. It looks like the only way out is for debtors to accept a radical change in the way they spend and save and a haircut for the creditors as at least part of the debt burden will have to be restructured. As we have said time and again, this is a painful process and a deflationary one at that. Our responsibility is to our unit-holders, and the best offense in this environment is a good defense namely, dividend growth; positive net free cash flow yield; high-quality bonds; earnings stability; strong balance sheets; and liquidity.

It is extremely important that investors be selective, even in the corporate space and even with all the liquidity on the business balance sheet

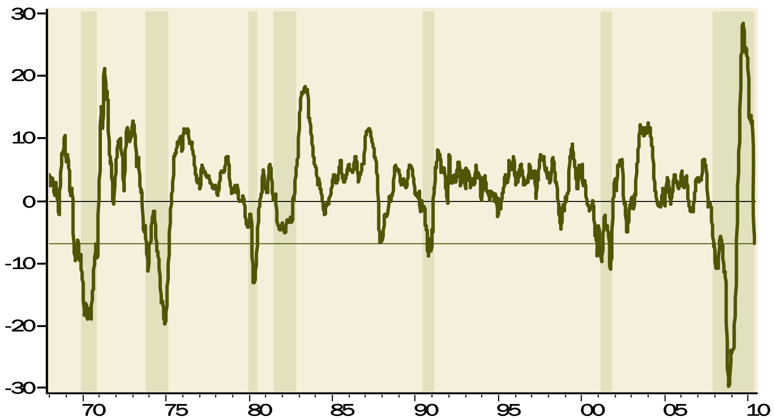
It is extremely important that investors be selective, even in the corporate space and even with all the liquidity on the business balance sheet. The U.S. private sector debt-to-GDP ratio was 50% in 1950 and is now 300%. The average bond rating today on American companies in 1981 was A-rated and today it is BBB- (barely above junk status – see page 14 of the Economist).

DOUBLE DIP? WHAT FLAVOUR?

While the ECRI "spot" index did bounce back last week for the first time since the week of April 30th, to 122.92 from 122.43, the damage has already been done as the growth rate slid further into negative terrain, to -6.9% from -5.8% last week and -3.7% the week before that.

CHART 2: GROWTH RATE IN THE ECRI LEADING INDICATOR POINTING TO A DECISIVE SLOWDOWN

United States: ECRI Weekly Leading Index: Growth Rate
(percent)



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

The reversal from +21.2% at the turn of the year is stunning, not to mention unprecedented. When it first hit this level back in December 2007, the recession was already beginning. When it hit -6.9% in December 2000, the recession was only three months away – surprising a befuddled consensus economic forecast that only called for a "soft patch."

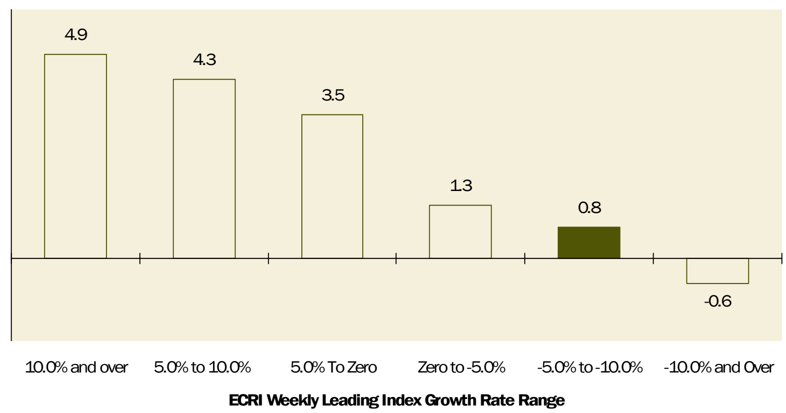
While the ECRI "spot" index did bounce back last week for the first time since the week of April 30th, the damage has already been done as the growth rate slid further into negative terrain

Back in 1990, it first attained this level in October when the recession was already three months old! We ran some logit models and found that 'double dip' odds are now up to 48%. This compares to 5% in May and near zero at the turn of the year. Going back to when the data began in 1970, once this model breaks above 50%, recession ensues every time. The economics consensus has the blinders on as it did in the final few months of 2007.

While it is true that the ECRI smoothed index (the growth rate) has only sent off one head-fake historically, back in 1987, when it reached -6.9%, the reality is that a recession only becomes a sure thing at -10 or worse. For now, the ECRI is predicting a slowing in real GDP growth, to 0.8% at an annual rate in the second half of the year, right where real final sales growth was in Q1. For a market braced for 3% second-half growth, a sub 1% trend will end up feeling like a recession, as was the case back in 2002, which posted a relapse in growth but was never classified as a double-dip. Considering that the stock market took a huge nosedive but did not bottom until October of that year, there was little distinction made between "growth relapse" and "double dip." Only the economics community engaged in that debate.

CHART 3: TWO QUARTERS FOLLOWING A MOVE IN ECRI INTO A RANGE BETWEEN -5% TO -10%, REAL GDP AVERAGES ONLY 0.8%

United States: Average Real GDP Growth Rate Two Quarters Following Various Ranges in the ECRI Leading Index
(percent change at an annual rate)



Source: Haver Analytics, Gluskin Sheff

Yes, yes, the University of Michigan consumer sentiment index came in at 76.0 in June for the final reading, up from 73.6 in May. This is the best reading in consumer sentiment since … January 2008, when the economy was heading into the second month of recession. Hallelujah! In fact, 76.0 is what this index historically averages in recessions. If we want to talk about what is "normal", then what we would be taking about would be 90 on this survey at this stage of the expansion, not 76.0. Sorry – this does not pass the sniff test.

It's amazing that the U.S. housing market started to collapse in 2007 and here we are in year three and there is still scant evidence of a bottoming out

HOUSING IN DISARRAY

It's amazing that the housing market started to collapse in 2007 and here we are in year three and there is still scant evidence of a bottoming out. Not even the tech sector endured such a long workout phase. New home sales down 33% in May (to a record low) and prices down 10% year-to-date. The latest financial results show further erosion in orders and deliveries. Banks remain very slow in modifying mortgages despite tremendous incentives to do so – the government had estimated that under HAMP we would have seen 3 million loan modifications thus far; however, instead there have been a mere 400,000 (this is nearly as good as the Administration's forecast of an 8% unemployment rate with all the fiscal stimulus). The problem is the huge re-default rate and the fact that nearly 1 in 4 households with a mortgage are upside down.

Meanwhile, foreclosures continue to run at a monthly rate of over 300k for the past 15 months. According to estimates cited in the Economist (*Double-Dip Drama* – page 34), it will take eight years to clear out the entire excess housing backlog, including the shadow inventory.

DIMINISHING RETURNS AND DEALING WITH PENSION CHANGES

We received an insightful email from a reader this weekend who noticed something in a chart we included in Friday's edition of Breakfast. Basically, that each of the last three rebounds were smaller than the previous one. In essence, U.S. fiscal and monetary expansion is providing diminishing returns over the past two decades. One has to wonder whether that has to do with the growing U.S. debt load – it too has been generating lower returns in terms of how much economic growth it has managed to create (less and less). Maybe, just maybe, Congress and the Fed need to stop the insanity and just let the economy reset and find its organic equilibrium. This is a painful process, but necessary to make the full transition to the next sustainable economic expansion. Just a thought. After all, the same people trying to revive the economy in Washington were the ones embracing Fannie and Freddie who in the end were more than just bit players in the credit craze of the last cycle.

This same reader asked about the issue of self directed retirement plans and their impact on the U.S. economy and the investment landscape. The point being made, and for what is happening in terms of changes to public pension funds, have a look at what is happening in California on page 15 of the Economist – *Sanity in the Offing*. The state's unfunded pension liability is estimated at $500 billion or seven times the level of debt on the balance sheet!

There is a strong possibility the stock market could provide poor returns (lower multiples even in the face of low interest rates) despite growing earnings simply due to the U.S. public needing the certainty of returns.

As our reader made the point, thirty years ago, if you worked for a company you were guaranteed a pension. Now the company is contributing but it's up to the employee to manage that money. This should be a continuing drag on consumer spending since with smaller returns it takes far longer to save what is needed. And, when more U.S. states and municipalities join that model rather than guaranteeing pensions to their employees, a necessity in balancing their budgets, consumer spending will take another hit as will money coming into the stock market. These are the bigger picture issues that investors need to contemplate for assessing what their future returns will be, and transcend the relevance for the financial market of this Friday's payroll report.

Gluskin Sheff

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