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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

APPLE PIE WITH DAVE

To our American friends, Happy 4th of July!

The U.S. turned 234 years old yesterday, and yet over half of the nation's money supply was created since Helicopter Ben took over the flight controls four years ago. No wonder gold is in a full fledged bull market. The annual output of gold has declined 12% in the past decade while the marginal cost has more than doubled, to $500, according to David Hale. Moreover, David points out in his recent report that since 1900, more than 80% of the world's proven reserves have ready been mined. The marginal cost of pressing on Dr. Bernanke's printing machine is basically zero, and, the prospects of a re-expansion of QE by the Fed as double-dip risks rise with each and every passing data-point are rather high. Gold has corrected to the 50-day moving average in recent weeks, which in the past has been a terrific entry point — for the past six months, each low has been higher and each high has been higher too. Nice upward channel that is to be respected and to be bought.

As for double dip risks, the ECRI leading index is predicting over 50-50 odds of such, and is exactly where it was in December 2007 when unbeknownst to the vast majority at the time that the downturn was just getting started. As an aside, even after cutting his growth forecast on Friday, Bank of America's chief economist went on CNBC after the market closed and declared that the economy would manage to "muddle through" — this has now become the widespread consensus that all this is nothing more than a temporary soft patch. Jeffrey Frankel, a member of the NBER's business cycle committee, had this to say over the weekend:

"You cannot rule out a double dip, in light of Europe's problems … I think the next couple of months of indicators will be more telling than the last couple of months."

Economists have spent so much time trying to assess when the last recession ended that they have taken the eye off the ball as to when the next one would begin. Yet this is what the NBER is grappling with — maybe the same day the NBER announces that the last recession ended in June 2009, they will tell us that another one began in June 2010. Can a sub 3% yield on the 10-year note and the "flattest" Treasury curve (still near 230bps, mind you, for the 2s/10s spread) in nine months really be sending out the wrong message of heightened hard-landing risks? Or, for that matter, the lowest close in the S&P 500 since September 4th of last year. Did anyone back then think we would go from Labour Day to Independence Day with nothing to show for it?

IN THIS ISSUE

- The U.S. is now 234 years old and yet over half the nation's money supply was created since Helicopter Ben took over the flight controls four years ago
- European bourses are slightly lower, ditto for most of Asia except in Japan and South Korea; bonds are rallying; economic data in Euroland and China coming in weaker than expected
- The week that was: the Dow is now down seven sessions in a row — a streak not seen since early October 2008; what we have on our hands is no longer a financial event but rather an economic event
- Hard landing risks in the U.S. rise further, according to the ECRI weekly leading index
- Where will the positive shock come from? Every single low in an equity market selloff occurred because of some major exogenous positive shock
- The Fed was pushing on a string, fiscal policy was pushing on a string, and now the bond market is pushing on a string too
- The problems with U.S. housing and mortgage market linger on
- A bullish Gene
- Do we have anything positive to say?

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Since the April 23rd peak, a total of $2.4 trillion of paper wealth has been wiped out by the 16% correction in the stock market. Guidance is going to be the key in the coming earnings reporting season, and the very early indications are not rosy (according to Rosie).

Since the April 23rd peak in the U.S. stock market, $2.4 trillion of paper wealth has been wiped out by the 16% correction

In the U.S., not only was (i) total payrolls, (ii) the workweek, (iii) the labour force, (iv) the employment rate, (v) the wage number, and (vi) the diffusion indices all lower in June, but what really caught our eye was the Household survey on a population and payroll-concept adjusted basis. This measure puts the Household survey on the same comparable basis as the Establishment survey, and should be seen as a more representative number because it actually is sensitive to what is happening at the small business level, and it plunged 363k in June. That is certainly cause for pause and another decline in July would sow the seeds for a double-dip, in our view. Jobless claims finishing off the month at 472k is also particularly disturbing.

What does not get enough play is that Fed policy is tighter than it should be right now, based on the Taylor Rule, believe it or not — zero policy rate and the size of the Fed's balance sheet is equivalent to a -2% rate, when at this stage the two tools should be equivalent to a -5% rate. And, fiscal policy is actually far less stimulative than meets the eye when the impact of State/local government restraint is factored into the equation. In the past two months, whether one looks at the Kansas City or St. Louis Fed's stress indices, there have been 60 basis points of tightening in overall financial conditions, just as the economy is hitting a possible inflection point.

What does not get enough play is that Fed policy is tighter than it should be right now and that fiscal policy is actually far less stimulative than meets the eye

As for inflation expectations, 10-year TIPS breakeven levels collapsed almost 20bps in the past week, to 1.77% (it touched 2.5% a mere six months ago). As we said last week, based on the Cleveland Fed's model we uncovered that the combination of the real rate, risk premium and inflation expectations generates a forecast of 1.9% for the 10-year note yield and the relationship between core inflation and yields suggests that we could see a 2.4% long bond yield. If one is looking for a possible 30% total return with no loss of capital, if you choose to hang onto it, and just clip the coupon, look no further than here.

All that said, we have to keep an eye out for true capitulation, which we have not seen nearly enough of yet. We recently read that John Paulson has turned extremely optimistic over the outlook for both the economy and the U.S. housing market, as one example. The likes of David Bianco, Brian Belski, Abby Cohen, Ned Davis, Laszlo Birinyi and even Bill Gross are all still optimistic, at least last we looked. We did see one such sign today on our Bloomberg screen — perma-bull Barton Biggs reportedly cut his equity allocation in half since June 29 (he was at 70%).

WHILE YOU WERE SLEEPING

It's a mixed start to the week — most European equity markets are off, but only fractionally in the early going. Same for Asia where only the Nikkei and Kospi managed to eke out gains. China slipped 0.8% and is now down 27% for the year (if the S&P 500 was down that much, it would be sitting at 815 right now and there would be pandemonium).

China continues to cool off — we are now hearing forecasts of 8% GDP growth with downside risk by the fourth quarter

Bonds are rallying in size across the pond too — between 2-6 basis points on the back of Trichet comments urging fiscal austerity. German bund yields are back flirting near the 2½% mark. The U.S. dollar is firm as expectations mount that the ECB will keep policy easier for longer.

On the data front, Euroland retail sales edged up 0.2% in May — problem is that the consensus had penned in a 0.4% increase. The Eurozone combined manufacturing and services PMI dipped in June to an as expected 56.0 from 56.4. Last year's green shoots are starting to wilt.

As for China, the country continues to cool off. Auto sales "slowed" to 10.9% YoY in June from 25% in May and the country's service-sector PMI slipped to a 15-month low of 55.6 from 56.4. We are now hearing forecasts of 8% GDP growth with downside risks by Q4. This is not good news for the commodity complex (Goldman Sachs just sliced its full-year forecast to 10.1% from 11.4%).

THE WEEK THAT WAS

The Dow is coming off seven losing sessions in a row, a streak not seen since early October 2008 when we had a post-Lehman financial panic on our hands. What we have today is something completely different. Rather than a series of cataclysmic declines, which one would like to see in order to hit a true capitulation bottom, what we have now is a slow bleed that must truly be painful for the bulls. It's almost like the sort of market we had coming off the peak in August 1987 that ultimately morphed into something big, and those that were prepared to take advantage of the eventual plunge profited handsomely. Back then, of course, we had a ripping economy — the problem was one of Fed tightening and constricted liquidity conditions. But when the plunge did come, the Fed had plenty of ammunition to kickstart the bull market.

The macro landscape in the U.S. is looking bleak and the leading economic indicators are rolling over … and the Fed and the federal government have few options to restimulate the economy

What we have on our hands today is much more complicated. This is not a financial event any longer. It is an economic event. The macro landscape is looking bleak and the leading economic indicators are rolling over, but this time around the Fed and the federal government have few options to restimulate the economy. It's not just equities but anything with a cyclical feel to it is sliding in price — oil fell 8.5% last week too and was down for five days running and is now bordering on $72/bbl.

The massive rally in the U.S. Treasury market is a signpost that bond investors see the prospect of another hard landing rising by the day, and at a time when underlying consumer price trends are already running below 1%. The chance that we head into either outright deflation or a prolonged stretch of price stability is also very high right now. And, deflation in a period of debt deleveraging is a disastrous development since it drives up defaults. Indeed, solvency issues are a lingering concern, not so much with the financial or corporate sector, but at the State and local government sector — this is 13% of GDP and as such, the retrenchment to deal with the fiscal challenges is posing an ongoing drag on domestic demand. All eyes are now on Jefferson County's $3.2 billion in sewer debt — talk about a stinky situation — which is on the precipice of becoming the largest municipal default in U.S. history (see page B11 of the weekend WSJ).

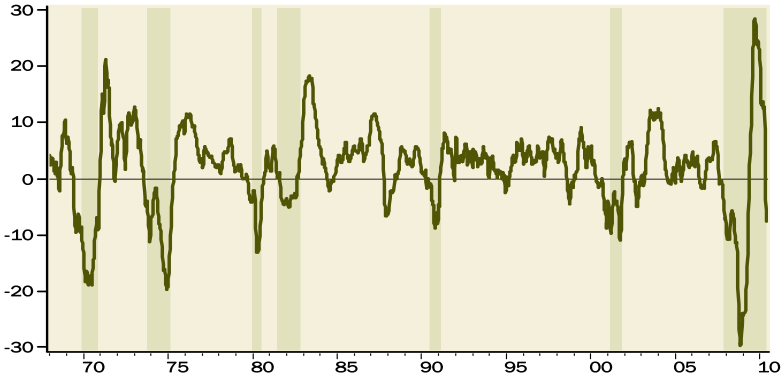
The weekly ECRI leading index moves closer to fully discounting a recession

ECRI – HARD LANDING RISKS RISE FURTHER

The ECRI index moved closer to fully discounting a recession. The 'spot' index fell 0.6% in the June 25th week, to 122.2 — the lowest level since the week of July 29th of last year when the S&P 500 was 975, so please, do not tell us that 1,000+ is still somehow a "cheap" level.

CHART 1: ECRI POINTING TO CLEAR HARD LANDING

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

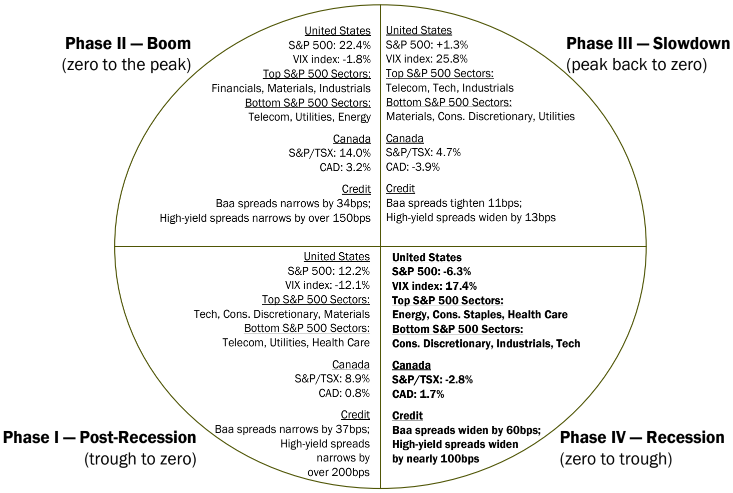


Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

The growth rate in the ECRI index dropped further, to -7.7% from -6.9% on June 18th and -5.8% on June 11th — this was the eighth week in a row of deterioration. It may end up being different this time, but never before has a -7.7% print sent off a "head fake". In fact, the only two false signals occurred at levels that were not as negative as what we have on our hands today: the -4.5% print in 1998 after the LTCM debacle and -6.8% in the aftermath of the crash of '87. As the pie chart of historical market performance illustrates below, it is not too late to reduce the risk and cyclicality in the portfolio and become more defensive. Moreover, Chart 3 clearly suggests that flat to negative GDP growth in the back half of the year would not be out of the realm of possibility with the prior track record.

CHART 2: THE ECRI LEADING INDEX AS AN INVESTMENT TOOL

United States: ECRI Weekly Leading Indicator: Growth Rate

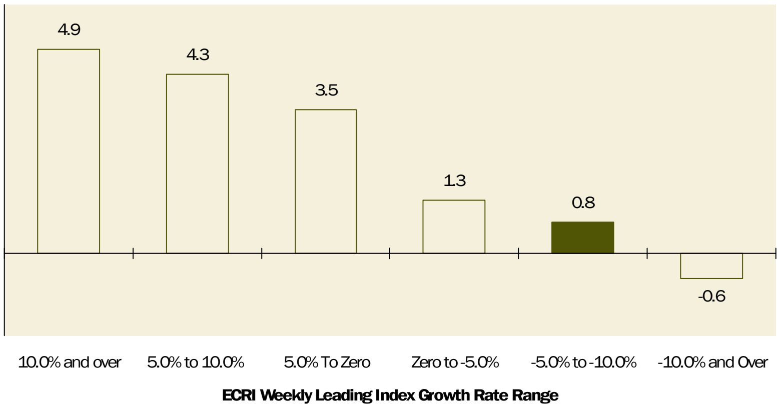

Phase II — Boom
(zero to the peak)
United States
S&P 500: 22.4%
VIX index: -1.8%
Top S&P 500 Sectors:
Financials, Materials, Industrials
Bottom S&P 500 Sectors:
Telecom, Utilities, Energy
Canada
S&P/TSX: 14.0%
CAD: 3.2%
Credit
Baa spreads narrows by 34bps;
High-yield spreads narrows by over 150bps
Phase III — Slowdown
(peak back to zero)
United States
S&P 500: +1.3%
VIX index: 25.8%
Top S&P 500 Sectors:
Telecom, Tech, Industrials
Bottom S&P 500 Sectors:
Materials, Cons. Discretionary, Utilities
Canada
S&P/TSX: 4.7%
CAD: -3.9%
Credit
Baa spreads tighten 11bps;
High-yield spreads widen by 13bps
Phase I — Post-Recession
(trough to zero)
United States
S&P 500: 12.2%
VIX index: -12.1%
Top S&P 500 Sectors:
Tech, Cons. Discretionary, Materials
Bottom S&P 500 Sectors:
Telecom, Utilities, Health Care
Canada
S&P/TSX: 8.9%
CAD: 0.8%
Credit
Baa spreads narrows by 37bps;
High-yield spreads narrows by over 200bps
Phase IV — Recession
(zero to trough)
United States
S&P 500: -6.3%
VIX index: 17.4%
Top S&P 500 Sectors:
Energy, Cons. Staples, Health Care
Bottom S&P 500 Sectors:
Cons. Discretionary, Industrials, Tech
Canada
S&P/TSX: -2.8%
CAD: 1.7%
Credit
Baa spreads widen by 60bps;
High-yield spreads widen by nearly 100bps

Bolded quadrant represent the phase we are currently in

Source: Haver Analytics, Gluskin Sheff

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

WHERE WILL THE POSITIVE SHOCK COME FROM?

Every single low in an equity market selloff occurred because of some major exogenous positive shock. Consider the following:

- The double low in October 2002 and November 2003 came about as the Fed cut rates 75bps and the Bush tax cuts kicked in.

- The bottom was put in following the LTCM fiasco in September 1998 as the Fed cut rates a total of three times.
- The lows in late 2004 were aided and abetted, again, by the Fed's move to cut rates three times the following year, which began to get priced in just as the S&P 500 was forming an interim trough.
- The bottom in October 1990 followed on the heels of a 200 basis point easing out of the Fed, as well as a rolling-over in peak oil prices from $40/bbl at the time to $20/bbl four months later.
- The lows again following the October 1987 crash were turned in as the Fed came to the rescue with a 50bp rate cut.
- And, the lows in August 1982 came on the back of an aggressive 300 basis point rate cut out of the Fed during the prior three months coupled with the effects of the first Reagan tax reductions (from 70% to 50% for the top marginal rate).

Every single low in an equity market selloff occurred because of some major exogenous positive shock. Where will the positive shock come from this time around?

The question that must be answered is what the catalyst will be this time around — if at all. Policy rates are at zero. The deficit is at 10% of GDP and there is little public appetite for more fiscal largesse. If oil prices do come down sharply — a *de facto* tax cut — it would likely only come about if China heads into an economic downturn, which would carry with it its own set of complicated economic and geopolitical repercussions.

Maybe, just maybe, we will have to wait for a bottom that is premised on a market that simply gets so cheap that it won't even need the helping hand of Uncle Sam to precipitate a firm and durable bottom to feed off. That, in turn, could mean a trough multiple of 10x on a forward earnings estimate of $70, rather than a 15x multiple on some consensus $95 EPS forecast that so many cling to. Look at the good news from this math — at least we don't break below the March 2009 low!

THE BOND MARKET IS PUSHING ON A STRING TOO

The Fed was pushing on a string, which is how the fund rate ended up near 0% (and the central bank sheet then becoming pregnant).

The fiscal policy stimulus also pushed on a string because we were told that it was going to take the unemployment rate down to 8%. Now, just like a funds rate of 0%, fiscal policy has hit its limit with a deficit of 10% of GDP.

And now the bond market is pushing on a string too, and the front end of the Treasury curve has figured this out, which is why the yield on the 2-year note has fallen to a record low of 0.63%. It is only a matter of time before the maturities out to the 30-year mark do the same.

Look — if it were a case that the bond market was doing enough to stimulate the economy then we would be happy to join the dominant bond-bear crowd. But unfortunately, the data compels us to remain bond bulls because the economy still needs more help and the Treasury market can certainly do much more. Don't you think?

Without the beloved bond rally, 5-year auto loan rates could not possibly have fallen 40 basis points in the past six months and 100bps in the past year, to 6.4%. And even with that, auto sales still tumbled more than 6% in June to 11.1 million annualized units — the 15th weakest number in the past 27 years, not to mention, well below new estimates of replacement demand of around 14 million (and the consensus was at 11.4 million for the June tally).

Without the bond rally, we would not have seen the mortgage rates decline to their lowest level since the records began in 1971 — down 11bps in the past week, to 4.58%; however, and even with that, new home sales and pending home sales contracts plunged over 30% to new all-time lows in May. The fact that mortgage applications for purchases sank 15% in June to a fresh 13-year low speaks volumes to how little impetus even the dramatic decline in mortgage rates has provided the beleaguered residential real estate sector. More needs to be done.

Let's add the fact that we are increasingly heading into a deflationary mindset. This is bullish for our SIRP strategy. If you don't like the CPI or the PCE or unit labour costs, then just go to the financial markets and see that a discounter like Dollar Tree stands a mere 1% off from its 52-week high. Why is Autozone finding support at its 10-week trendline? Ditto for value-focused Ross Stores.

This new and lasting trend towards frugality is totally consistent with the trend towards price stability, and that trend towards price stability is in turn totally consistent with an ultimate move in the 10-year note to 1.9% and the long bond towards 2.4%. Folks — if this were to happen in the coming year, we would be talking about a 30% total return.

This is no time for complacency with regard to the outlook for house prices and mortgage defaults in the U.S.

THE PROBLEMS WITH U.S. HOUSING AND MORTGAGE MARKET LINGER ON

This is no time for complacency with regard to the outlook for house prices and mortgage defaults in the U.S.

First, here are some numbers:

Two-thirds of American homeowners have a mortgage — 56 million in total.

Around 50% are guaranteed by the GSEs, 35% are held directly on the balance sheets of the banks, and 15% are private label.

Estimates I've seen suggest that 14% of these 56 million mortgages are already in arrears or in the foreclosure process. This means that about eight million Americans have stopped paying their mortgage. Staggering.

Other estimates suggest that over 90% of these late-paying/non-paying debtors will never get back to being current. So what we are looking at is something like 7.2 million mortgages that will inevitably go into foreclosure in the near future.

Meanwhile, the pace of foreclosures has been slowed via loan modifications brought on by government pressure and the simple fact that banks do not want to take deflated property onto their books. What does not get reported often enough is that the rate of non-foreclosure on delinquent borrowers is surging — 24% of the people who have not made a single mortgage payment in the last two years have still not been foreclosed on. The banks don't want to take the hit and in the meantime the foreclosure pipeline is completely clogged up. (It has to be said that the banks are content in kicking the can down the road since homeowners are making good on their second lien — $842 billion outstanding, most held at the big four banks, and they are holding these at par even as the first lien has already gone bad!)

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When this foreclosure pipeline gets unleashed, I fear that the wave of supply is going to precipitate another leg down in home prices.

Also, keep in mind that the loan modifications are not even working — half of them are re-defaulting within 12 months (and this is happening even after monthly payments have been cut 50%). The principal reason is the negative net equity position most of the homeowners in arrears find themselves in (the amount by which mortgage balances exceed the true value of real estate for those in default or near-default could be as much as $2 trillion).

Currently, over 17% of homeowners are "upside down" on their mortgage and another 10% decline in home prices would take that share up to 27%. This, in turn, would dramatically lift mortgage default rates. If the banks ever do a "short sale", which the Administration clearly wants them to do, then the entire second lien is wiped out — cutting deeply into bank capital (if not wiping it out entirely).

I only bring this up because I heard Dick Bove (and other bank analysts) talk about how the banks are a huge buy now that the financial regulation bill is behind us and the uncertainty gone. Maybe that's true for non-consumer, non-mortgage lenders, but we have to be aware that the problems with housing finance are very likely to remain a huge overhang for many U.S. banks in coming months and quarters.

If Congress is no longer extending jobless benefits and State governments are now attacking public pensions, then it stands to reason that additional support for the housing market out of Washington is not forthcoming. This public backlash against more deficit finance is going to pose a big roadblock for any company linked to the housing sector, especially since whatever revival we experienced in the second half of 2009 and the opening months of 2010 was due to government intervention.

A BULLISH GENE

"A man who has committed a mistake and doesn't correct it is committing another mistake."

- Confucius

Barron's economic guru, Gene Epstein, titles his column in this week's edition *A Second Dip Still Unlikely*. In his piece, he cites this as evidence:

"The Credit Suisse probability model of recession, discussed here last week, put the six-month probability of recession at zero -- and still does."

Wow.

Go back to January 7, 2008, and in his column, Mr. Epstein boldly said: *"So, are we headed for a recession now? Not so fast."* What was his reasoning? Get ready for this:

"Reflecting the December data for private-sector nonfarm payrolls, released Friday, the Credit Suisse six-month model put the chances of an outright recession at 43%."

This recession model was pegging recession odds at 43% and yet the recession had already begun three months earlier.

If that wasn't bad enough, Mr. Epstein, on February 4, 2008, dug his heels in even further even though the recession was five-months old:

"Has a recession begun? Probably not — and a recession probably won't strike in 2008 … By fourth-quarter 2008, real gross domestic product should be running about 1.5% higher than fourth quarter 2007, a slowdown from the 2.5% of the year just ended." Well, instead of GDP being 1.5% higher on a year-on-year basis at the end of 2008, it was in fact 1.9% lower.

Then on May 5, 2008, he acknowledged that there was in fact a recession, but titled his piece *The 2008 Recession Has Been One of the Tamest on Record*. However, didn't it actually end up going down as the 'Great Recession' when all was said and done?

Look, we don't intend on being cruel here and nobody is perfect — it's not as if we believed that 'green shoots' and a short covering rally were going to elicit an 80% bounce in the S&P 500 from the lows (though we rightfully questioned its longevity). But to come out and cite the same survey as saying zero odds of recession that only applied a 43% chance in the last go-around when we were already knee-deep in it, would not likely have impressed Confucius.

As an aside, we updated our ECRI logit model and it is suggesting that we have 52% odds of an outright recession, up from 48% last week.

ANYTHING POSITIVE TO SAY?

Well, some clients and subscribers have asked us if we have anything positive at all to say about the equity market. It took a while, but we can offer up a few items.

First, the correction along with rising payouts has led to a 30 basis point rise in the S&P 500 dividend yield in the past six months, to 2.2%. That is about 40 basis points better than you can get from the belly of the Treasury curve. Second, on consensus earnings estimates, the P/E ratio, at 12.5x, generates a decent 7.9% earnings yield, which is equivalent to the yield an investor garners today from the junk bond market.

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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 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.

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For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

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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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