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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast Lite 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 TODAY'S 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).

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.

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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%).

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Gluskin Sheff at a Glance

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