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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

IN THIS ISSUE

WHILE YOU WERE SLEEPING

Equities around the world are in the green column after yesterday's impressive U.S. rally, which was completely technical in nature. There is no doubt that the global economy is cooling down; it's only a matter of severity at this point. Bond markets are generally well bid.

In a sign that housing is weakening again beyond U.S. borders, Canadian resale activity tumbled last month and U.K. home prices (Halifax survey) fell 0.6% in June, on top of a similar decline the month before. It's still a deflationary world out there, which is why bond supply alone will not be enough to prevent long-term yields from grinding irregularly lower in coming months and quarters, despite bearish consensus views on the matter.

On the economic data front, we saw some mixed results. Australia printed a solid June jobs report (+46k) and German industrial output was strong, coming in at +2.6% MoM, and there was an upward revision to April. At the same time, U.K. manufacturing output came in light at +0.3% (the consensus was expecting 0.6%) and Japanese core machinery orders sank 9.1% MoM in May, crimping the capex outlook there.

DOUBLE DIP REVISITED

John Lonski, from Moody's, was on CNBC yesterday morning and when asked about double-dip recession odds he said that in the past few months they have gone up from 10-15% to 20%. Mr. Lonski, along with everyone else, painstakingly made the point that what is important is that the odds are still below 50%. We are not so sure that is the major point. The major point is that, at the margin, double-dip risks are rising and the odds of a V-shaped recovery are fading. So, if you draw the probability curve, even if not a base-case, there is now a fatter tail around the double-dip view than there was one, two or three months ago. I would add that if jobless claims end back up at 500k, those 15-20% odds will rise five-fold.

What is more important is that the U.S. economy is very fragile and more vulnerable to an exogenous shock than has been the case in the past. Take the situation in 1997-98 when we had the Asian crisis, or the 1994-95 period when we had the fallout from the Mexican fiasco. In both cases, the economy managed a "soft landing" and intermittent weakness in the equity market was a great buying opportunity. But in both cases, the Fed had room to cut rates and stimulate the economy, easing no fewer than three times to prevent a soft landing from becoming a hard landing.

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It takes time for these shocks to percolate — six months in 1995 and 12 months in 1998 — and we have yet to feel the full brunt of the European debt crisis hit home, in terms of the depressing impact of their aggregate demand on our export growth. Where the offset from government stimulus comes from next will be interesting to see. If it's not fiscal policy or the Fed, then something tells us that the bond market is going to have to work that much harder.

The bond market remains the only game in town when it comes to stimulating the U.S. economy

MORE WORK FOR MR. BOND

The bond market remains the only game in town when it comes to stimulating the U.S. economy. The commensurate slide in mortgage rates has triggered a mini-boom in mortgage refinancing activity, which rose 9.2% in the July 2nd week, on top of a 12.6% surge the week before — up 157% over the past year to boot. This is helping, at least at the margin, put some cash into homeowner's pocketbooks.

Still, just to show what little effect it is having, refinancing activity in the U.S. is still some 40% lower than it was the last time we had a major rally in the bond market in late 2008 and early 2009. In fact, coming out of the 1990-91 recession and the 2001 recession, the YoY trend in mortgage refinancing was over 1,000%(!), not 157%, just to put this in some perspective. The reason for the anemic growth this time around is because at the historic lows in yields, which we saw a year and half ago, just about everyone who could at the time managed to refinance, so today's rally does them little good. Plus, with one in four mortgage debtors "upside down", they don't have the ability to refinance. But every penny counts, and the bond market is doing the best it can to get things going.

The slide in mortgage rates has triggered a mini-boom in mortgage refinancing activity in the U.S. …

What is really amazing is how most strategists hate the bond market, and only see inflation and interest rates having to rise. But yet, when asked why it is they are so bullish on equities, the quick and dirty answer is "well, look at how low bond yields are." Go figure.

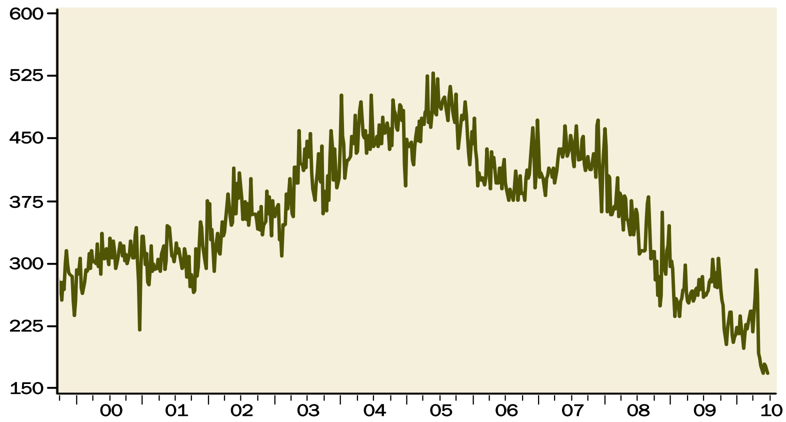
If there is a disturbing development, it is the lack of response on the part of potential homebuyers to the downdraft in mortgage rates. Demand remains anemic, and perhaps this reflects an aversion to taking on debt, and an aversion to buying a depreciating asset. Or perhaps it reflects the allure of landlords dropping their apartment rents and thereby upsetting the rent-buy decision balance. Maybe the White House should embark on a strategy of forcing landlords to hike their rents in a quest to revive the homeownership rate — it's not as if this group doesn't believe in government intrusion into the economy.

… At the margin, this at least puts some cash into homeowner pocketbooks

So, for the third week in a row, and despite a 13bp bond-induced decline in mortgage rates, applications for new purchases fell (by 2%) and are down 35% from year-ago levels; and those year-ago levels were already down 12%. So, after plunging 18% in May and then by 15% in June, mortgage apps for new home purchases are already down 3.4% so far in July. Clearly, as far as the Treasury market is concerned, more needs to be done — and since Mr. Bernanke is done cutting rates, it will be up to Mr. Bond to carry the ball, and likely a little further.

CHART 1: ECRI POINTING TO CLEAR HARD LANDING

United States: Mortgage Bankers Association Mortgage Loan Applications for Purchase
(March 16, 1990 = 100)



Source: Haver Analytics, Gluskin Sheff

NO MORE HELP FROM MONETARY POLICY?

We shall see.

But, indeed, that was the consistent tone from the various Fed officials who dominated the tapes yesterday. Kansas City Fed President Hoenig refuses to budge and wants an immediate hike in the funds rate to 1%, and said he doesn't believe every problem can be solved by the central bank. (Oh, but in a credit collapse, the Fed has to be part of the solution.) Richmond's Lacker thinks it's time for the Fed to withdraw its support from the MBS market. And, on CNBC, Dallas FRB President Fisher stated emphatically that even as he trims his economic growth forecast, the Fed has "done enough."

So, there is a taxpayer revolt going on. There is a revolt going on among the Fed District Bank Presidents too (others like Plosser and Bullard also want the press statement toughened up). For Paul Krugman, these revolts must be revolting.

Meanwhile, we are seeing first-hand how the economy operates when the policy stimulus are taken away — for example, a 0.8% annualized growth rate in real final sales as we saw in the first quarter. Don't think for a second that we are going to see an upturn without some major exogenous shock. If it's not the Fed or more fiscal spending, then it will have to be China (wasn't it the world's saviour in late 2008? Can it turn a blind eye to its credit and property bubble at the same time?), the ECB (will more ease peeve off the Germans?) or perhaps a payroll tax holiday in the U.S.A. (likely a better idea than turning the economy into a welfare state) or anything that will lift this cloud of uncertainty over the small business sector in particular (but is it too late to make any changes to the health care overhaul?).

ANOTHER MISS ON RETAIL SALES?

Despite a warm-weather lift and a nice calendar shift from the timing of Memorial Day into June, the weekly U.S. chain store sales data showed a 3.1% YoY pickup into early July, bit this was still at the lower end of the 3-4% target range that the retailers were expecting for the month.

Yes, U.S. chain store sales are coming in at 3.1% YoY so far in July; however, this is still at the low end of the range that retailers are expecting

MANUFACTURING CYCLE TAKES A BREATHER

The inventory-led boost to GDP growth was the dynamic variable in this nascent one-year recovery phase in the U.S., and now it looks like fatigue is setting in. The ISM is down two months in a row, and by a sizeable amount to boot. We also saw the steepest decline in the factory workweek since the onset of the tech wreck a decade ago; therefore, we are very likely going to see the first decline in industrial production in a year when the June data roll out.

Meanwhile, housing is still collapsing even from its already depressed levels whether it be sales or starts. Auto and retail sales are anaemic. Commercial construction is beset by decades of high vacancy rates. State and local governments are downsizing. The federal government is facing a loss of public appetite for more fiscal largesse. The inventory cycle has run its course. Capex is running at a decent rate but is being held back by lingering excess capacity.

No wonder President Obama reiterated his goal (more like a dream) of doubling exports over the next five years. During the best of times, historically, U.S. exports double over a 10-year time frame. Like magic, export growth will double in the next half-decade at a time of a global debt deleveraging. Good luck, Mr. President, with that forecast.

Even the once-strong growing trading partners like Canada is showing signs of cooling down — highlighted by the latest building permits, retail sales, home sales and manufacturing data — the last item underscored by yesterday's news that the Ivey PMI sagged to 58.9 in June from 62.7, still high, but wrong direction nonetheless. And, one has to wonder whether Canada is about to see downside employment surprise this Friday — that would be a rarity — as the jobs index slipped to a three-month low of 53.6 from 58.1 in May (not to mention the steepest decline in the Ivey employment index since last October).

The inventory-led boost to GDP growth was the dynamic variable in this nascent one-year recovery phase and now it looks like fatigue is setting in

SENTIMENT POLLS GET THE BULLS EXCITED

Well, we had Doug Kass declare that the lows were already turned in and at the same time we received the Investors Intelligence poll showing that sentiment was at the lowest level since July 2009. Interestingly, back in July of last year, the S&P 500 was struggling at the 900 level! Anyway, the reality is that bulls still outnumber the bears — 37.0% (from 41.1%) versus 34.8% (from 33.3%). Believe it or not, the correction camp only has 28.2% in their ranks.

CANADIAN HOUSING SECTOR COOLING OFF

It looks like the impact of modestly higher interest rates and CMHC's incremental moves to tighten up its underwriting guidelines have taken the steam out of the real estate market

It looks like the impact of modestly higher interest rates and CMHC's incremental moves to tighten up its underwriting guidelines have taken the steam out of the real estate market, and perhaps the dramatic erosion in affordability that followed on the heels of the parabolic surge in prices simply crowded out a slate of potential buyers. In any event, Canadian housing activity is moving into reverse, and according to our calculations, 100% of the recovery, both directly and indirectly, was rooted in the real estate surge and splurge through most of 2009 and into the opening months of 2010.

Resales in Toronto sagged 23% YoY in June and activity in Vancouver slipped 30.2%. Even in Calgary, where there was less evidence of a bubble, sales fell 42% in June from year-ago levels. And, the supply backlog is starting to rise — and you know what that means for pricing. Indeed, the days of double-digit price appreciation in the Toronto area are now behind us with prices showing an average 8% rise YoY last month.

New listings in Toronto rose 13% in June and active listings ballooned 28%. The number of active listings in Vancouver has soared more than 30%. With demand slipping and supply rising means one thing from a pricing perspective — we are likely in for a bout of deflation. For homeowners, it will be time to recalculate your net worth; for renters, it will be time to start licking your chops at the chance to get into the market at more affordable levels.

SOME (NOT SO) NIFTY CHARTS

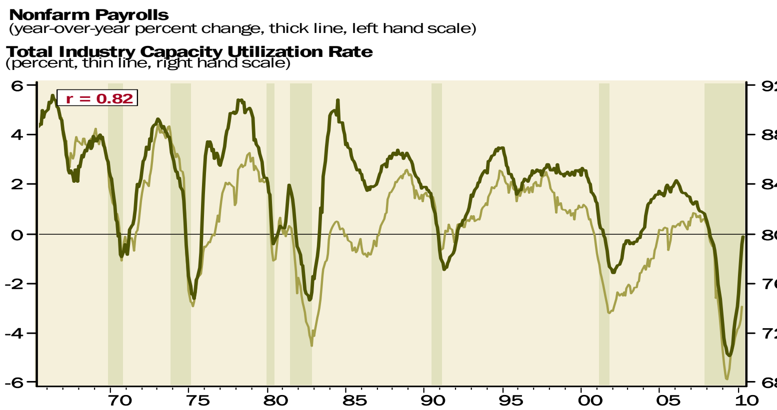
Looking at the charts below (thanks to Josh Frankel, our long time friend and former Merrill Lynch colleague), one would think that, yes, we have a V-shaped recovery in the U.S. But the reality is that the economic data in these charts, especially the YoY comparisons, are about to hit some resistance in the months ahead. Moreover, the leading indicators (*ie*, housing starts) are starting to sputter or have rolled over, and that is what really matters.

Capacity utilization rate and the year-over-year change in nonfarm payrolls

Correlation between the CapU rate and the YoY change in payrolls is very high, at 82% going back to 1967.

CHART 2: YEAR-OVER-YEAR TREND IN PAYROLLS AND THE CAPU RATE IS HIGHLY CORRELATED

United States

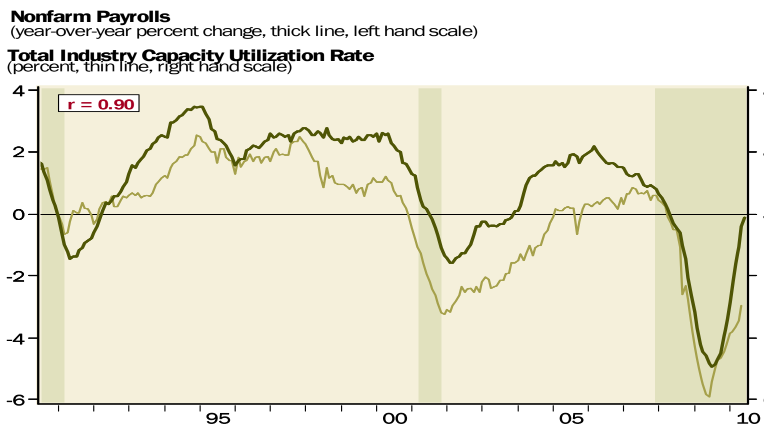


Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Moreover, in the last 20 years, the relationship between the two got stronger, at 90%, and looking at the last five years, the two series are almost perfectly correlated, at 96%. The YoY trend in payrolls will likely continue to rise because of the easy comps this time last year, which would suggest that the CapU rate will continue to rise for the next few months.

CHART 3: IN THE LAST 20-YEARS, THE RELATIONSHIP BETWEEN EMPLOYMENT AND THE CAPU RATE GOT STRONGER …

United States



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

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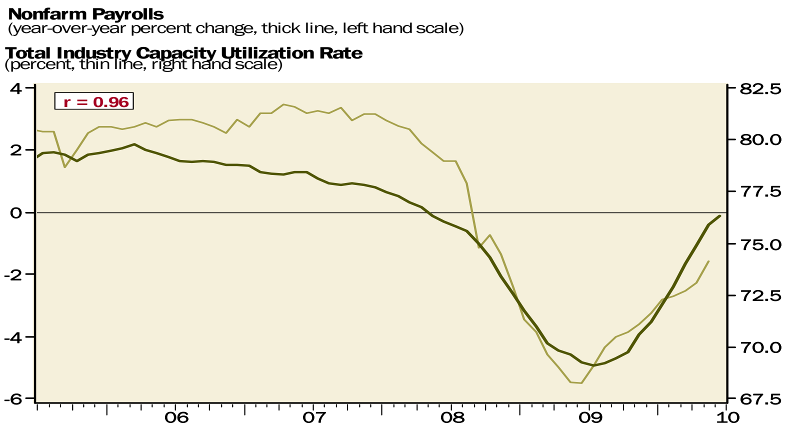
CHART 4: … AND IN THE LAST FIVE YEARS, THE TWO DATA POINTS ARE ALMOST PERFECTLY CORRELATED

United States



Source: Haver Analytics, Gluskin Sheff

Housing starts and the unemployment rate

Historically, housing starts and the unemployment rate have a correlation of 27%; however, starts do lead the jobless rate by about a year (the historical correlation between the two increases to nearly 50%).

CHART 5: HISTORICALLY, HOUSING STARTS AND THE UNEMPLOYMENT RATE HAVE A WEAK RELATIONSHIP, BUT …

United States

Shaded region represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

CHART 6: …HOUSING STARTS DOES LEAD THE JOBLESS RATE BY A YEAR

United States

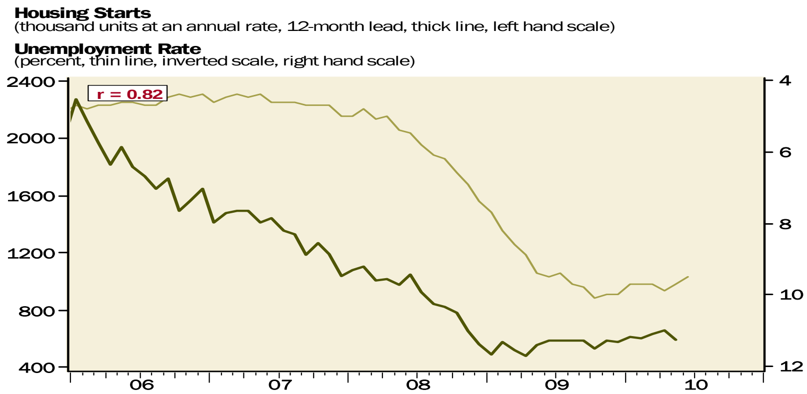
Shaded region represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

In the last 20 years, however, the relationship between these two metrics does increase to 69% and when housing starts is advanced by 12 months, the correlation increases to 80%. Moreover, similar to the relationship between CapU and the year-ago trend in payrolls, in the last five years, the correlation increases some more, at 79%, and a 12-month lead in starts increases the correlation to over 90%.

CHART 7: IN THE PAST FIVE YEAR THE RELATIONSHIP BETWEEN STARTS AND THE UNEMPLOYMENT RATE HAS BECAME TIGHTER

United States



Source: Haver Analytics, Gluskin Sheff

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CHART 8: IN THE PAST FIVE YEAR THE RELATIONSHIP BETWEEN STARTS AND THE UNEMPLOYMENT RATE HAS BECAME TIGHTER

United States

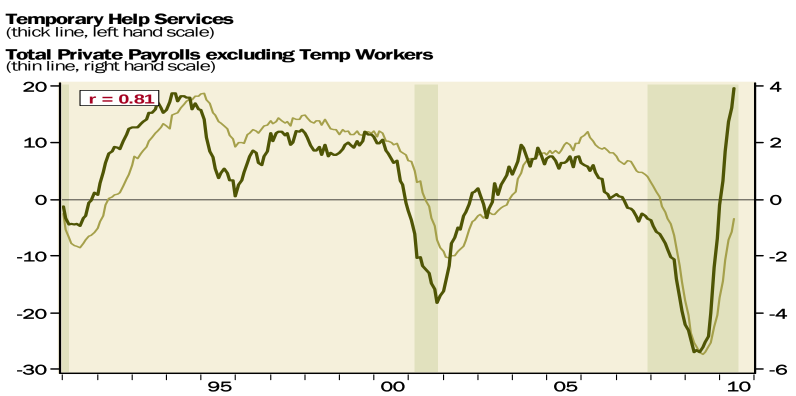
Source: Haver Analytics, Gluskin Sheff

Temp Agency Employment versus Total Private Payrolls (excluding temp workers)

The relationship between the two metrics is high — correlation at 81%. And, as expected the temp agency employment leads by about six months (r = 93%).

CHART 9: RELATIONSHIP BETWEEN TEMPORARY AGENCY EMPLOYMENT AND PRIVATE PAYROLLS IS VERY HIGH

United States
(year-over-year percent change)



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

CHART 10: TEMP AGENCY EMPLOYMENT GROWTH
LEADS PRIVATE PAYROLLS GROWTH … BY SIX MONTHS

United States

Source: Haver Analytics, Gluskin Sheff

So, given that temp employment is running at a near 20% trend in June, albeit from easy comps this time last year, the trend in private payrolls could rise further in the next few months. In October, temp agency employment should start seeing its YoY trend slow down given that it will hit some very hard comparisons.

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Gluskin Sheff at a Glance

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As of March 31, 2010, the Firm managed assets of $5.6 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 54% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

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 have strong and stable portfolio management, research and client service teams. Aside from recent additions, our Portfolio Managers have been with the Firm for a minimum of ten years and we have attracted "best in class" talent at all levels. Our performance results are those of the team in place.

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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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.

Our success has often been linked to our long history of investing in under-followed and under-appreciated small and mid cap companies both in Canada and the U.S.

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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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