

**MARKET MUSINGS & DATA DECIPHERING**

# Breakfast Lite with Dave

## WHAT'S DRIVING THE MARKET?

We've been asked repeatedly how the stock market has managed to bounce off the nearby lows with such veracity. Especially with the ongoing weakness we have seen in the incoming U.S. economic data due to the fact that the retail investor still refuses to participate and is solely focused on income-generating strategies. The answer is that the market may have been on the receiving end of another few jolts of liquidity. M2 money supply has expanded \$38.5 billion in the past two weeks and the M1 money multiple has risen from 0.839 to 0.862.

When we go to the weekly data from the Fed, we see that "trading assets" on commercial bank balance sheets expanded to \$325 billion in the past two weeks from \$297 billion. And, when we go to the Commitment of Traders report, we see that there has been a big swing in the net speculation position on the S&P 500 "E-minis" on the Mercantile Exchange (futures and options) to a net long position of 28,172 contracts from 15,155 net shorts just two weeks ago. That's a big part of the bounce-back – prop traders and short-coverings. Nothing fundamental here, as far as we can see.

## JUST CALL IT A WHOLE LOT OF VOLATILITY

- Last week's 5.4% increase was the best performance since mid-July 2009 (week of July 17<sup>th</sup>). But yet, prior to last week, the S&P 500 saw the largest decline (-5% during the week of July 2<sup>nd</sup>) in eight weeks, and it was down two weeks to boot (July 2<sup>nd</sup> and June 25<sup>th</sup> weeks).
- Last week also saw three days of positive performance, a streak we last saw in mid-April of this year. However, prior to those three positive sessions, the S&P 500 was down five trading days in a row.
- Last week's increase also comes in the heels of declines in June and May, which was the worst back-to-back decline since January and February 2009
- In Q2, we saw the worst quarter (-12%) since Q4 2008 and before that, Q3 2002. In fact, going back to 1946, a decline in the quarter of 12% or more is only a 1 in 20 event (we have only seen 12 quarters of 12%+ declines in the past 64 years).
- For the first half of the year, we have seen three up months (February, March, April) and three down months (January, May, June).
- The 80% increase in the stock market that we saw from March 2009 to April 2010 is the largest increase in such a short period of time since the period of May 1935 to April 1936.

## IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- While you were sleeping: European equity markets continue to rally, now up six days in a row, while, Asian stock markets are slipping; Moody's downgraded Portugal's credit rating by two notches, to A1; China's economy appears to be cooling down
- What's driving the markets in the U.S.? Answer: it is receiving a few jolts of liquidity and short-covering
- Just call it a whole lot of volatility: for the first half of 2010, the action in the S&P 500 has been very volatile
- Small business sentiment in the U.S. gets smaller: the latest NFIB optimism index fell to a three-month low in June
- Bank of Canada outlook surveys: slowing growth and easing credit conditions

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## **BANK OF CANADA OUTLOOK SURVEYS: SLOWING GROWTH AND EASING CREDIT CONDITIONS**

We had some fresh insight on the Canadian economy yesterday, with the release of the Bank of Canada's Business Outlook Survey (this covers the period from May 19<sup>th</sup> to June 15<sup>th</sup>). The key takeaways include: slower expected sales over the next year, less spare capacity, more hiring but less capex and inflation expectations that remain well anchored.

The 'headline' figure, the number of net firms expecting sales to increase over the next 12 months, fell to 25% from 44% in Q1. Not only is this the weakest reading since Q1 2009 but this is half the 50%+ readings we saw late last year and corroborates what the early Q2 data has been saying – that economic growth is clearly slowing from the super-charged rates we saw in the last two quarters (we are tracking sub-3% real GDP growth in Q2).

Future employment prospects rose to 40% from 38%, coming on the heels of the spectacular 93,000 June employment figure. However, while firms plan on adding bodies, they don't plan on investing in machinery and equipment (M&E). Net investment in M&E fell to 12%, from 22%, implying slower capex going forward, which could disappoint the BoC (in the latest 1 June press statement, the Bank had stated that "[t]he anticipated pickup in business investment will be important for a more balanced recovery."

There was more evidence that the slack in the economy had diminished with the percent of firms having some difficulty in meeting current demand rising to 35% from 26%, the highest level since Q3 2008 (not overly surprising given the 5%+ GDP figures in Q4 and Q1). Labour shortages remain low, unchanged at 12%, which are near record lows.

On inflation, 34% of companies reported higher input inflation (likely reflecting the fact that commodity prices outside of energy rose another 5% in Q2). However, output inflation remained steady at 28% – suggesting that firms may not be passing on input-price increases, rather absorbing the increase through profit margins.

Inflation expectations remained well anchored for the most part. Fifty percent of firms expect inflation to remain in the 1-2% range while 45% expect inflation to be in the 2-3% range (so 95% of firms expect inflation to remain within the Bank's 1-3% target). In the two extreme categories – below 1% and above 3% inflation, there was little change – 2% expect inflation to come in below 1% (up from 0% in Q1) and 3% expect inflation above 3%, a decline from 6% in Q1 (and actually the lowest since Q4 2008 – this should provide some comfort to the BoC).

There was good news on credit conditions. Both this survey and another survey released by the BoC (the Senior Loan Officer Survey) showed that credit conditions eased, especially for large firms. The Senior Loan Officer Survey indicated the conditions were the easiest since Q2 2005.

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**The key takeaways in the BoC's latest outlook surveys are: slower expected sales over the next year, less spare capacity, more hiring but less capex and inflation expectations that remain well anchored**

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# Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and focused primarily on high net worth private clients, we are dedicated to the prudent stewardship of our clients' wealth through the delivery of strong, risk-adjusted investment returns together with the highest level of personalized client service.

## OVERVIEW

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).<sup>1</sup>

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.

## PERFORMANCE

\$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to \$11.7 million<sup>2</sup> on March 31, 2010 versus \$5.7 million for the S&P/TSX Total Return Index over the same period.

\$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to \$8.7 million USD<sup>2</sup> on March 31, 2010 versus \$6.9 million USD for the S&P 500 Total Return Index over the same period.

### Notes:

Unless otherwise noted, all values are in Canadian dollars.

1. Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.
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.

## INVESTMENT STRATEGY & TEAM

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.

For corporate bonds, we look for issuers with a margin of safety for the payment of interest and principal, and yields which are attractive relative to the assessed credit risks involved.

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.

## PORTFOLIO CONSTRUCTION

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.

*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.*

\$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to \$11.7 million<sup>2</sup> on March 31, 2010 versus \$5.7 million for the S&P/TSX Total Return Index over the same period.

*For further information, please contact [questions@gluskinsheff.com](mailto:questions@gluskinsheff.com)*

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