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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

U.S. SLOWDOWN

Only a fool or the most visually challenged can't see that growth is moderating significantly. Forecasts for a slowing towards 2% real GDP growth are no longer rare. Canada too is softening and the cracks are starting to deepen in the housing market. This could get exciting, and the stock market, as it was in 2000 and 2007, is seemingly oblivious.

U.S. retail sales fell 0.5% in June and this was after a 1.1% slide in May — there were notable downward revisions too. Just to put this in perspective, a back-to-back retail sales decline in the context of a supposedly expanding economy is a 1-in-35 event. Moreover, this was the same month that average hourly earnings fell 0.1% — a 1-in-50 event. Mortgage applications for new purchases just sank to a 14-year low, which is incredible. Manufacturing output dropped 0.4% in June, the first decline since the recession allegedly ended last year, and the July survey data from the New York and Philly Fed point to further weakness — not to mention another likely two-point trimming off the ISM index.

The producer price index (PPI) flagged deflation pressure and this was reinforced by the first decline in the core intermediate goods index (which excludes food and energy) since May of last year. And, excluding oil, import prices slipped 0.6% last month too, which will feed into renewed deflation in the core goods CPI at a time when service sector prices are moderating at an unprecedented rate. Some pundits who make it their livelihood to sugarcoat the data say it is normal to have a "pause" at this stage of the cycle. This begs the question as to what point are we exactly purported to be in. From the bottom in real GDP last year, real final sales have rebounded at a tepid 1.2% annual rate in what is the worst recovery ever … despite a record amount of bailout, monetary and fiscal stimulus. That is indeed, cause for pause.

In addition, the top brass at the Federal Reserve is starting to get nervous. The only important snippet out of the latest Beige Book was this: *"prices of final goods and services were largely stable as higher input costs were not being passed along to customers and wage pressures continued to be minimal."* At best, that means stable prices, which in turn would be consistent with an eventual test of 2.5% on the long bond yield. At worst, this comment has the label "margin squeeze" written all over it, which means a stock market bracing for a 35% increase in earnings next year is at risk for some disappointment.

Meanwhile, as we suggested the day of the last FOMC meeting (June 23), the Fed (both the staff and the policymakers) cut their forecasts for growth and inflation. A few things caught our eye, notably:

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- Haven't we learned? In today's WSJ, there was an article that completely dumbfounded us
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- Bullish sentiment is back, Jack! In addition to the II poll released earlier this week, the AAII survey of investor sentiment also showed bullish sentiment soaring
- Manufacturing sector continues to slow: the NY Empire and the Philadelphia Fed manufacturing indices came in weaker than expected and is suggesting a further decline to the national ISM index
- Manufacturing production in the U.S. sinks: yes, total industrial production rose 0.1% MoM in June, but what caught our eye was the 0.4% decline in manufacturing output
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"Participants judged that house prices were likely to remain flat or decline somewhat further in the near term."

"Some participants judged the risks to the outlook for inflation as tilted to the downside, particularly in the near term, in light of the large amount of resource slack already prevailing in the economy, the significant downside risks to the outlook for real activity, and the possibility that inflation expectations could begin to decline in response to low actual inflation. A few participants cited some risk of deflation."

"Participants generally anticipated that, in light of the severity of the economic downturn, it would take some time for the economy to converge fully to its longer-run path as characterized by sustainable rates of output growth, unemployment, and inflation consistent with participants' interpretation of the Federal Reserve's dual objectives; most expected the convergence process to take no more than five to six years."

The Fed is more than implicitly telling us that deflation risks predominate and in such an environment, it is critical to deploy strategies that minimize volatility, preserve capital and spin off an income stream.

Haven't we learned anything during this credit bubble burst?

HAVEN'T WE LEARNED?

We just came off the largest credit bubble-turn-bust experience since the 1930s: one in seven mortgage debtors are either in arrears or already in the foreclosure process, 90 banks have failed so far this year, and 25% of the U.S. household sector has a sub-600 FICO score. But yet, we see this article in the Wall Street Journal —*Signs of Risky Lending Emerges in U.S.* — and are completely dumbfounded. The country is going to fight a debt deleveraging process by enticing the riskiest borrowers to line up at the trough yet again.

We read in this morning's WSJ that Fannie is offering financing to first-time homebuyers who only have a $1, 000 down-payment, and several banks are offering clients home-equity lines of credit of up to $2.5 million

Fannie is offering financing to first-time buyers who only have a $1,000 down-payment. Several banks are now offering clients home-equity lines of credit of up to $2.5 million. According to FICO and J.D. Power, 8% of all loans made last quarter by the banks were to borrowers with the weakest credit scores — up from 6.2% at the end of last year. Surreal.

INCOME THEME INTACT

To the frustration of many a bull, we are sure, Main Street investors continue to ignore Wall Street strategists by shunning the ever-volatile equity market for safety and income at a reasonable price. The ICI data just came out for the July 7th week and it showed a net outflow of $4.2 billion from equity funds while bond funds attracted $6 billion of fresh money on top of $3.5 billion the week before. This demographic drive for income is increasingly emerging as a secular theme.

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The focus on boosting savings in a prudent way is also going to become extremely pronounced too because a study published by the Employee Benefit Research Institute found that the "early baby boomers" in particular, those between 56 and 62, have a 47% chance of not having enough money to fund their basic expenses in retirement. Fully 1 in 3 middle-class workers will have run out of money altogether after 20 years of retirement — the comparable share for low-income earners is 10 years.

The big surprise in coming years will be the return to a 10% savings rate. This in turn will be very, very deflationary, but absolute fodder for income-oriented investment strategies.

BULLISH SENTIMENT IS BACK, JACK!

"Lloyd, it's good to be back!"

Well, well. No sooner did we mention how the Investors Intelligence poll swung to a net bearish result, which, in technical parlance, is a bullish contrarian signal — and all it took for the worrywarts to re-emerge was a 16% correction following an 80% flashy bear market rally. If anything, getting scared off this quickly attests to the low level of conviction in this marketplace.

Then, lo' and behold, we get the AAII survey (American Association of Individual Investors) and it showed bullish sentiment soaring 18.4 points last week to 39.4%, while bearish sentiment sank 19.3 points to 37.8%. Geez. Take a sedative.

Bullish sentiment is fractionally above the 39% historical norm — and we can hardly see why this should be the case given such an uncertain outlook. As per the FOMC minutes:

"Overall, participants continued to expect the pace of the economic recovery to be held back by a number of factors, including household and business uncertainty, persistent weakness in real estate markets, only gradual improvement in labor market conditions, waning fiscal stimulus, and slow easing of credit conditions in the banking sector."

Other than that, Mrs. Lincoln, how was the play?

MANUFACTURING SECTOR CONTINUES TO SLOW

We got a slew of data reports yesterday (see our take below). The timeliest of these reports were the July Empire and Philly Fed manufacturing surveys. In a word, the reports were weak and from these early readings, our model suggests that the ISM (due in early August), will continue to fall, by about 2-3 points (currently sitting at 56.2).

The Philly Fed Manufacturing survey fell to 5.1 in July from 8.0 and missed analysts' expectations for a modest increase to 10.0. Yes, at current levels, this survey and the Empire (more below) are still suggesting that the manufacturing sector is expanding but at a slower pace. What we think is worth noting is how quickly growth is slowing — July levels are now back to 2009 levels.

The weakness in both the July NY Empire and Philly Fed manufacturing surveys suggests that the national ISM index could fall further

What really stuck out in the details of the Philly Fed report was how weak most of the components were. The most striking was that new orders went negative, to -4.3 from 9.0 (the first negative since July 2009). Current shipments melted to 4.0 from 14.2, and it wasn't just the current situation that slipped: views on business conditions over the next six months slipped to 25 from 40.2, the lowest since March 2009.

Similarly, the NY Fed Empire Manufacturing also disappointed, with the headline falling to 5.1 in July from 19.6, the weakest since December 2009. This survey tends to be a good proxy for the tech sector. Components were also soft, with new orders slipping nearly seven points, back to February 2010 levels.

The employment tone from these surveys were mixed, which is unfortunate since the initial claims data are currently very noisy and are offering little clarity on the current employment situation. In the Philadelphia region, the employment index went up in July, to 4.0 from -1.5, along with the workweek index. However, in the NY region, the Empire employment subcomponents were weak — its employment index slipped to 7.9 from 12.4 but what was eye catching was that the average workweek was negative.

MANUFACTURING PRODUCTION SINKS

U.S. industrial production rose just 0.1% MoM in June, slightly better than expected. Another boost from utilities (+2.7%) kept the headline positive.

There remains a considerable amount of slack in the U.S. economy with capacity utilization nearly six percentage points below its long-run trend

What caught our eye was that manufacturing output fell 0.4% and was the weakest since May 2009. Auto production fell 2.0%, the second decline in three months. Anything housing related — from wood products to furniture — also declined in yet another sign that the housing market remains in deep trouble.

There remains a considerable amount of slack in the U.S. economy with capacity utilization remaining at 74.1%, nearly six percentage points below long-term trends. This explains why we continue to see very little inflation from the manufacturing sector as a whole.

In terms of sector performance, motor vehicles, wood products and printing appear to have the most amount of slack relative to long-term trends, which is a negative for pricing power going forward. However, the IT sector (computers specifically), mining and petroleum and coal products are running at or near long-term capacity, suggesting that these sectors are the best positioned in terms of pricing power.

INITIAL JOBLESS CLAIMS – BEWARE OF THE NOISE

Beware of reading too much into the dip in the initial claims data

Initial jobless claims fell to 429,000 for the week ending July 10, from an upwardly revised 458,000 the prior week. However, beware of reading too much into this drop as the data are skewed by auto shutdowns that typically occur at this time, which tend to wreak havoc with the seasonal factors. In addition, this particular week was also affected by the July 4th holiday, causing another distortion of the seasonals.

The Department of Labor was quoted as saying that their seasonal-adjustment factors were expecting larger layoffs for this particular week, which did not occur. Our former colleagues from the BAC-ML economics team estimate that if the auto shutdowns had occurred as expected, claims would have remained flat or have been slightly higher. We have seen announcements of auto layoffs, so they are coming.

We will likely see a reversal over the next few weeks, especially has auto layoffs resume and we wouldn't be surprised if claims were back up to 460-470k in a matter of weeks.

PRODUCER PRICES: WEAK TO THE CORE

Yet another benign data point on inflation. Following the 1.3% plunge in June import prices, producer prices fell, confirming that deflation, not inflation, is the biggest threat to the U.S. economy.

Total producer prices PPI for June fell more than expected, coming in at -0.5% MoM versus market expectations for a 0.1% decline. This is the third consecutive monthly decline and the year-over-year rate slowed to 2.8% from the recent high of 6.0%. The market often focuses on core PPI (excluding food and energy) and this came in as expected, at 0.1% in June. Here, the annual rate slowed to 1.1% and has basically been hovering around this range for nine months. So very little in the way of inflation pressures.

The details were quite weak, as finished consumer goods continued to decline, by 0.6% in June, the third drop in a row. Pipeline pressures remained very subdued as well, suggesting that future readings will continue to be weak. The core intermediate goods PPI fell 0.4%, slowing the YoY trend to 5.4% from 6.1% in May. Crude goods PPI fell 2.4% in June, down three months in a row.

We could see soft readings in July as the pricing details from the July manufacturing survey were also soft. The 'prices received' components for both the Empire and Philly Fed manufacturing surveys were negative. For the Empire Index, the index fell -1.6, the first negative since December 2009 and the Philly Fed 'prices received' fell to -8.4, the second consecutive negative reading, to the lowest since September 2009.

CANADIAN HOUSING MARKET ROLLING OVER

Canadian housing market cooling off dramatically

With all the U.S. data yesterday, it was easy to miss the Canadian economic data. The June housing data probably raised the most eyebrows … home sales fell dramatically, down 8.2% MoM and down 20% from year-ago levels.

Average home prices fell 2.5% on the month; however, are still up 5.0% YoY (quite the dramatic slowing from the double-digit price gains a few months ago). Even if prices remain flat for the next few months, we estimate that year-over-year trends will be in negative territory by the fall.

The deteriorating inventory situation could suggest that prices may decline instead of remaining stable over the coming months. In June, months' supply ticked up to 6.9 months, the highest since March 2009. Rising inventories are not limited to the existing home market — we estimate that builders have been building inventories of new homes for about eight months or so.

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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.

PERFORMANCE

$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.

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.

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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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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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