David A. Rosenberg
Chief Economist & Strategist
drosenberg@gluskinsheff.com
+ 1 416 681 8919

July 23, 2010
Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Asian equity markets are flying high this morning and Europe is mixed-to-up as it rides a four-day winning streak. Emerging markets gained 0.8% today, closing at the best level since May 4th. Asia-Pac surged 1.7% today. The Chinese market has undergone a resurrection, having posted its best week in seven months, and is breaking out, which bodes well near-term for the commodity complex – and if you strain your eye just enough, you will see the Baltic Dry Index is forming a bottom.

Copper is heading towards its best week in five months (+9%), oil is still hovering near 11-week highs and gold has made its way back towards $1,200/oz on dollar slippage and news of higher India imports. As such, the resource-based currencies are firming up again – the Australian dollar is back trading at a two-month high, as an example. Earnings season is going well thus far– not across the board but across some heavyweights with CAT and MSFT (beating on both the bottom and top lines) the latest reports to generate enthusiasm.

The latest economic data points out of Germany have been surprisingly good – especially the just-released IFO survey for July, which soared to a three-year high of 106.2 from 101.8 – the consensus was at 101.5 (though other numbers in the Eurozone such as French consumer spending left a tad to be desired). U.K. GDP for the second quarter also offered up an upside surprise –+1.1% (not annualized!), the best since 2006Q1 and about double the consensus expectation (Sterling has rallied a further 1% today on the news).

We just got some soft CPI data out of Canada that should help Carney sleep better at night. The headline dipped 0.1% in June, as expected, reducing the yearly rate to 1.0% from 1.4%. After a year of huge housing-induced growth, we have a 1% inflation rate in this country. The core CPI was a surprise, dropping 0.1% as well and this took the YoY rate down to 1.7% from 1.8% – a touch below the BoC's estimate for Q2. No doubt we will see a pop in July due to the HST, but the inflation trends are actually very conducive to friendly rates environment.

Optimism abounds over the European bank stress tests. So earlier concerns of a European economic meltdown have yet to occur, and likewise regarding fears of a bubble-bust or social unrest in China where signs of a cooling off in property prices have triggered expectations of an early exit from the government's policy tightening program.

IN THIS ISSUE

The safety of government bonds is losing a bit of an allure here as the 10-year T-note yield seems set to retest the 3% mark on the upside but let's not lose sight of the visible slowing taking place right now in the U.S. economy. Sentiment is one thing; economic reality something else altogether. Be aware – the overwhelming consensus is for no double-dip, for yields to rise and for a summertime equity market rally (which seems to have already occurred, though both Bob Farrell and Walter Murphy have recently entertained that view that this thing may have more legs).

Sentiment is one thing; economic reality something else altogether

On the technicals, a break of 1,100 on the S&P 500 would be widely viewed as a significant and positive near-term development by many a chartist. While volume has been lagging (we highlight that below), what many a bull will point to is the fact that the ratio of new highs to new lows has risen now for .... three days running.

<u>So what else are the bulls looking at right now</u>?

- Congress extending jobless benefits (yet again).
- Polls showing the GoP can take the House and the Senate in November.
- Some Democrats now want the tax hikes for 2011 to be delayed.
- Cap and trade is dead.
- Cameron's popularity in the U.K. and market reaction there is setting an example for others regarding budgetary reform.
- China's success in curbing its property bubble without bursting it.
- Growing confidence that the emerging markets, especially in Asia and Latin America, will be able to 'decouple' this time around. We heard this from more than just one CEO on our recent trip to NYC and Asian thumbprints were all over the positive news these past few weeks out of the likes of FedEx and UPS.
- Renewed stability in Eurozone debt and money markets – including successful bond auctions amongst the Club Med members.
- Clarity with respect to European bank vulnerability.
- Signs that consumer credit delinquency rates in the U.S. are rolling over.
- Mortgage delinquencies down five quarters in a row in California to a three-year low.
- The BP oil spill moving off the front pages.

- The financial regulation bill behind us and Goldman deciding to settle –more uncertainty out of the way.

- Widespread refutation of the ECRI as a leading indicator … even among the architects of the index! There is tremendous conviction now that a double-dip will be averted, even though 85% of the data releases in the past month have come in below expectations.

- Earnings season living up to expectations, especially among some key large-caps in the tech/industrial space – Microsoft, AT&T, CAT, and 3M are being viewed as game changers (especially 3M's upped guidance). Even the airlines are reporting ripping results.

- Bernanke indicating that he can and will become more aggressive at stimulating monetary policy if he feels the need and yesterday urging the government to refrain from tightening fiscal policy (including tax hikes).

- Practically every street economist took a knife to Q2 and Q3 GDP growth, which has left PM's believing we are into some sort of capitulation period where all the bad news is now "out there".

From our lens, this is still a meat-grinder of a market. The bulls have the upper hand, but only until the next shoe drops in this modern-day depression and post-bubble credit collapse. The S&P 500 is still down 2% for the year, the Dow by 1%, the FT-SE and Nikkei by 11%, the Hang Seng by 5% and China by over 20%.

Ask the bullish community if by this time of the year we were supposed to see bonds outperforming stocks – folks like our friends Byron Wien at Blackstone and Jim Caron at Morgan Stanley thought we were on our way to a 5.5% yield on the 10-year T-note. So let's keep the whippy, albeit positive, action in the equity market into perspective. This is the sixth (!) multi-week bounce in the equity market so far in 2010 and the year is barely seven months old.

Ask the bullish community if by this time of the year we were supposed to see bonds outperforming stocks

So the best we can say is that we do have a tradable rally on our hands and that at the 50-day moving average on the S&P 500 we also are at a critical technical juncture - but remember, in a secular bear market, these rallies are to be rented, not owned. To be sure, 140 companies have reported so far and the news overall is good … but earnings are a coincident, not a leading indicator.

As for the bond market, it is quite remarkable that everyone focuses on what Ben Bernanke has to say and what the impact will be on equity market sentiment (we even field calls as to whether the Fed would ever buy equities!). Well, all we know is that historically, there is a 160 basis point spread between the Fed fund rate and the 10-year T-note yield, and a 210 basis point spread between the funds rate and the long bond yield. So at a minimum, all the Fed has to do is continue to pledge to keep the overnight rate close to 0% and then do the math as we embark on Bob Farrell's Rule #1, which is classic mean reversion and you will see why it is that seeing the 30-year down to 2-1/2% is a far less controversial call than meets the eye.

And that remains the pain trade for many a fixed-income portfolio manager who fear small numbers but do not see the huge potential gains in total return terms because of the power of convexity at today's interest rate levels. The answer is "no" – there is not one way for bond yields to go in a prolonged deleveraging cycle, and "yes", this is Japan all over again. The record-low yield on the 2-year note after a year of statistical economic recovery has already told you that (not to mention the need for the Fed at this point to even have to contemplate another round of quantitative easing)!

CAN YOU HANDLE THE TRUTH?

The suggestion that somehow generating 3% real GDP growth a year after a bottom is bullish ignores the deep the hole we are still trying to climb out of. Normally, two years after a recession starts, nominal GDP is up 16% and real GDP is up 7.5%. Currently, nominal GDP is up 1.1% while real GDP is down 1.5% from pre-recession peaks.

According to earlier White House projections, that $800 billion fiscal gorilla unveiled last year was supposed to pull down the unemployment rate to 7% by now. Instead, we are at 9.5%. In fact, it's really even worse than that, for if the participation rate had stayed constant at the April level, than unemployment rate would be 10.2% today.

According to earlier White House projections, that $800 billion fiscal gorilla unveiled last year was supposed to pull down the unemployment rate to 7% by now

What about jobless claims? They lead employment. Below 400k, you can have a bullish stance. Above 500k – the opposite, and recession risks rise materially. Well, that rise in the past week to 464k from 427k was even worse than it appears because the non-idling of auto plants this summer has given a temporary downward skew to the claims data – the underlying number is now closer to 475k. The upcoming seasonal factors that are "looking for" a decline are actually going to end up boosting the adjusted claims data and a test of 500k in the weeks ahead is a good bet.

What would that trigger?

Answer: more talk of a "double dip". Claims back above 500k would be horrible for the markets (not bonds though).

The earnings news has, on net, been positive but not a slam dunk. The stock market is responding well to the Q2 reports but remember that the quarter was skewed by a strong start – after all, April was when the ISM hit its peak (in other words, it would be reasonable to assume that much of the Q2 earnings growth was "front loaded") . The economic data are interesting because they reveal a serious loss of momentum as the quarter drew to a close and there does not appear to have been a pickup in July at least based on the limited amount of survey data at hand.

The earnings news has, on net, been positive but not a slam dunk.

Housing is still in disarray – existing home sales are a bit of a lagging indicator but even with the extension of the tax credits to deals signed but not yet closed, turnover still dropped 5.1% last month (-10% was expected) taking sales back to March levels.

What was more critical was the huge jump in months supply... now at 8.9 months' versus 8.3 months' in May – the highest since August 2009, and well above the 5-6 months' that would typify a well-balanced market.

Of course, we also had the "official" leading indicator come out and verify what the ECRI has been saying – when the financial market components are stripped out, the decline goes to -0.4% (as opposed to -0.2%) which is the second decline in the past three months. And the coincident/lagging ratio, a favourite among some pundits (like a book-to-bill ratio for the entire economy) dipped for the first time since February of this year.

The stock market still seems to be driven by technicals

The stock market still seems to be driven largely by technicals and momentum trading. The economy has clearly reached an inflection point and this won't be ignored indefinitely. The gains yesterday were large and broad-based, but lacked volume again, which calls into question the overall level of conviction.

And the fact that the Treasury market retains such a positive overall tone is a development that is failing to ratify the whippy bounce in the major averages back to their 50-day moving averages.

The summer rally came, we shall see soon enough if it is over, but with all the sturm and drang, let's face it – we're exactly where we were one month ago – on June 22nd, the S&P 500 was sitting around 1,095. And with 10 of the 22 trading days producing moves of 1% or more, one usually has to go to Six Flags for rides like this (thanks Josh!).

EXISTING HOME SALES – GETTING EXCITING ABOUT A 5% DECLINE?

Details of the existing home sales were weak

You know things are bad when economists and the markets are excited by the fact that existing home sales declined by "only" 5.1% MoM in June (as opposed to the -10% expected). The troubling aspect of this "better than expected number" is that it still skewed by the housing tax credit (in other words, there are still sales that were boosted by the tax credit that are included in this number; if not for the credit, sales would have been weaker).

The details were soft as well. Single-family sales sagged 5.6%, following a 1% decline in May and condos slipped 1.5%. On a year-over-year basis, median prices managed to get back into positive territory. However, there remains very strong headwinds on the pricing front as months' supply of inventory rose to 8.9 vs. 8.3, the highest August 2009. The inventory problem was especially apparent in single-family sales, which jumped to 8.7 from 7.8 months.

BOC: EUROPEAN DEBT WOES TO IMPACT CANADIAN AND GLOBAL GROWTH

Gluskin Sheff

Yesterday's Monetary Policy Report from the Bank of Canada provided more insight to the new growth and inflation forecasts contained in Tuesday's statement accompanying the 25 bps rate hike. The Bank was clear that over the long-term their "*projection includes a gradual reduction in monetary policy stimulus*." While the current risks are "*roughly balanced*" there are many uncertainties surrounding the outlook and Governor Carney stressed in the press conference yesterday that "*risks around the projection are elevated, and there's no pre-ordained path for interest rates*". In other words, the outlook for interest rates over the short-term is much murkier and will be highly data dependent.

There are many uncertainties surrounding the BoC's fresh forecasts

On the Canadian side, we got a bit more insight into the Bank's GDP forecast for 2010. Second quarter GDP was marked down to 3.0% and Q3 is now at 2.8% (vs. 3.5%) and Q4 at 3.2%. For the near-term we continue to monitor soft GDP growth, closer to 2.5% in Q2 – May's GDP report (due July 30) will be key.

Overall, the Bank made no material changes to the inflation outlook, expecting core inflation (which strips out the eight most volatile items) to hover slightly below 2% until the end of 2012. As mentioned in the Bank's statement, they now expect the output gap to close by end of 2011, which will keep a lid on inflation pressures.

One thing that caught our eye was the work the Bank had done on the European sovereign debt crisis and the impact on Canada and the rest of the world, something they are clearly very worried about. The Bank cut its forecasts for virtually the entire world for 2011-12, partly due to the impact of European debt and fiscal problems. In fact, if they were to be part of the private-sector consensus forecasts, at 3.8% and 4.0% for world GDP growth for 2011 and 2012, respectively, they would on the slightly less optimistic side of estimates. (For 2010, they actually boosted world GDP estimates to 4.6% as Japan is now expected to outperform.)

For Canada specifically, the impact of European debt/fiscal problem could be as much as 0.3ppt off GDP growth next year and 0.2ppt in 2012. Also important for the Canadian dollar, is the impact on oil and commodity prices—they estimate that debt crisis could shave nearly 1% in commodity prices and about 2.5-3% of WTI in 2011-12. Our most recent update of the Canadian dollar fair-value model suggests that the fair-value for the CAD is around 91-92 cents – all else equal, declines in commodity prices could bring fair-value closer to the 90 cents range or lower (the BoC took down its operating assumption for the CAD to 96 cents from 99 cents as well).

CANADIAN RETAIL SALES

It was real mixed bag for the latest Canadian retail sales report but the key takeway is that most economic data points in Canada are slowing and suggest sub-par GDP growth in Q2 (we are tracking 2.5% for Q2 vs the BoC's fresh3.0% forecast).

Latest Canadian data point also suggests soft Q2 GDP figures

Total retail sales came in at -0.2% for the month of May vs +0.4% expected. Stripping out the decline in autos left sales down 0.1%. Lower gasoline pump biased the total downward and in fact once prices were taken into account, sales were up 0.4%.

Despite the mixed picture, there were some trends that stood out, mainly anything to do with housing is slowing. Buidling materials/garden supplies fell 4%, the third decline in four months. Electronics/appliances are also down the past three of four months. After four straight months of declining, furniture sales did pick up, however.

Gluskin Sheff

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 June 30, 2010, the Firm managed assets of $5.5 billion.[1]

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).[2]

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.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $8.7 million USD[3] on March 31, 2010 versus $6.9 million USD for the S&P 500 Total Return Index over the same period.

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[2] 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

Notes:

Unless otherwise noted, all values are in Canadian dollars.

1. *Preliminary unaudited estimate.*
2. *Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.*
3. *Returns are based on the composite of segregated Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.*

IMPORTANT DISCLOSURES

Gluskin Sheff may own, buy, or sell, on behalf of its clients, securities of issuers that may be discussed in or impacted by this report. As a result, readers should be aware that Gluskin Sheff may have a conflict of interest that could affect the objectivity of this report. This report should not be regarded by recipients as a substitute for the exercise of their own judgment and readers are encouraged to seek independent, third-party research on any companies covered in or impacted by this report.

Individuals identified as economists do not function as research analysts under U.S. law and reports prepared by them are not research reports under applicable U.S. rules and regulations. Macroeconomic analysis is considered investment research for purposes of distribution in the U.K. under the rules of the Financial Services Authority.

Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments (e.g., options, futures, warrants, and contracts for differences). This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report.

Securities and other financial instruments discussed in this report, or recommended by Gluskin Sheff, are not insured by the Federal Deposit Insurance Corporation and are not deposits or other obligations of any insured depository institution. Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Levels and basis for taxation may change.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report. Investors in such securities and instruments effectively assume currency risk.

Materials prepared by Gluskin Sheff research personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of Gluskin Sheff. To the extent this report discusses any legal proceeding or issues, it has not been prepared as nor is it intended to express any legal conclusion, opinion or advice. Investors should consult their own legal advisers as to issues of law relating to the subject matter of this report. Gluskin Sheff research personnel's knowledge of legal proceedings in which any Gluskin Sheff entity and/or its directors, officers and employees may be plaintiffs, defendants, co-defendants or co-plaintiffs with or involving companies mentioned in this report is based on public information. Facts and views presented in this material that relate to any such proceedings have not been reviewed by, discussed with, and may not reflect information known to, professionals in other business areas of Gluskin Sheff in connection with the legal proceedings or matters relevant to such proceedings.

Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

The information herein (other than disclosure information relating to Gluskin Sheff and its affiliates) was obtained from various sources and Gluskin Sheff does not guarantee its accuracy. This report may contain links to third-party websites. Gluskin Sheff is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this report and is not incorporated by reference into this report. The inclusion of a link in this report does not imply any endorsement by or any affiliation with Gluskin Sheff.

All opinions, projections and estimates constitute the judgment of the author as of the date of the report and are subject to change without notice. Prices also are subject to change without notice. Gluskin Sheff is under no obligation to update this report and readers should therefore assume that Gluskin Sheff will not update any fact, circumstance or opinion contained in this report.

Neither Gluskin Sheff nor any director, officer or employee of Gluskin Sheff accepts any liability whatsoever for any direct, indirect or consequential damages or losses arising from any use of this report or its contents.