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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

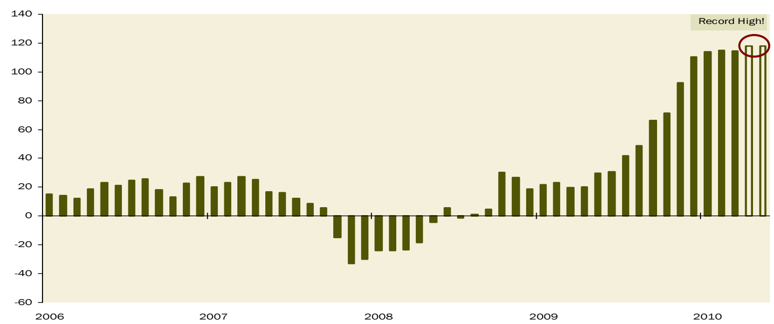
Lunch with Dave

FROM BOCA WITH LOVE

We just hosted a dinner in Boca Raton, Florida, and once again, the interest among American high net worth families in Canada is overwhelming. Indeed, the relative risk-reward opportunity of investing in Canadian assets relative to the Unites States has rarely been as compelling as is the case today.

CHART 1: FOREIGN INVESTORS REDISCOVER CANADA

Canada: Net Foreign Purchases of Canadian Stocks and Bonds
(12-month total, C$ billions)

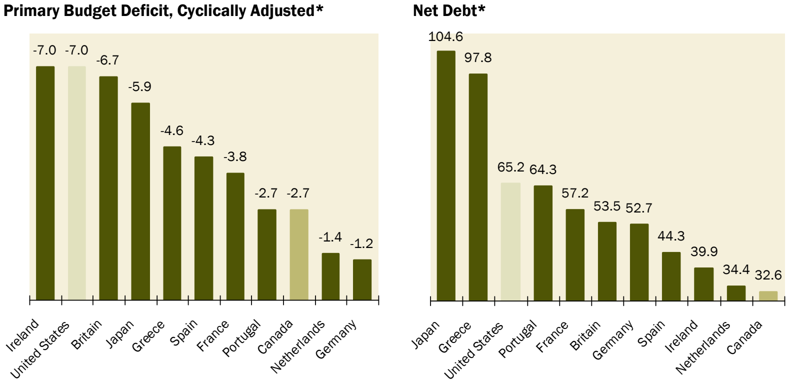


Source: Haver Analytics, Gluskin Sheff

Canada has a structural budget deficit that is one-third the size of the U.S. and ditto for debt-to-GDP ratios. Canada is one of the few sovereigns that actually does have a AAA rated balance sheet.

CHART 2: CANADA, ONE OF THE FEW COUNTRIES WITH A "AAA" BALANCE SHEET

As a percent of GDP, 2010 Estimate



**General government. Source: Haver Analytics, Gluskin Sheff*

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- From Boca with love: We just hosted a dinner in Boca Raton, Florida, and once again, the interest among American high net worth families in Canada is overwhelming
- More deflationary signs: Q2 U.S. productivity numbers missed expectations; unit labour costs remain muted; wholesale inventories rose just 0.1% in June
- Retirement blues: the dramatic collapse in asset values in the past two years has generated severe trauma to the baby boomer balance sheet
- Small business sentiment gets smaller: the U.S. NFIB optimism index falls again in July
- Roof caving in on the Canadian housing sector: housing starts fell 1.6% MoM in July with single-home starts down 11%

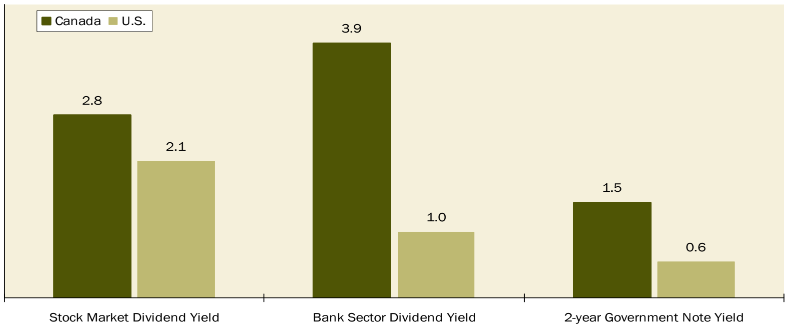
A tax wedge is occurring too. The top personal income tax rate in Toronto is 44% versus 53% in New York City. Corporate tax rates in Canada of 25% compared to 35% south of the border. And, the Canadian unemployment rate, on a comparable U.S. basis, is 7.3% compared with 9.5% state-side.

Indeed, the relative risk-reward opportunity of investing in Canadian assets relative to the Unites States has rarely been as compelling as is the case today

But yet, Canada, with that tighter labour market, actually has a lower inflation rate (1.0% versus 1.1% in the U.S.). And, since the Canadian economy has managed to recover more quickly than the U.S.A., and with less government support, the Bank of Canada has been able to raise interest rates modestly, but enough to give global investors a nice premium over U.S. alternatives. That goes along with a higher dividend yield in the domestic equity market (especially the banks) — and together with the more attractive bond market, has lured substantial inflows into the local fixed-income market. This is key for a world craving an income stream.

CHART 3: CANADA OFFERS A YIELD PREMIUM

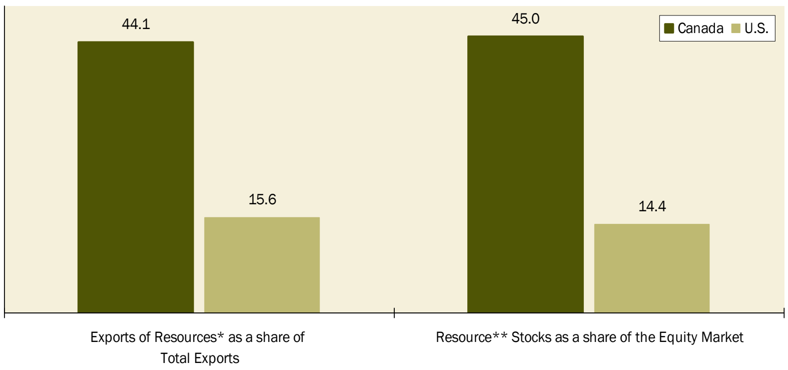
(percent)



Source: Haver Analytics, Gluskin Sheff

CHART 4: CANADA ALSO OFFERS RESOURCE EXPOSURE

(percent)



**Sum of industrial goods and materials, energy products and lumber products.*

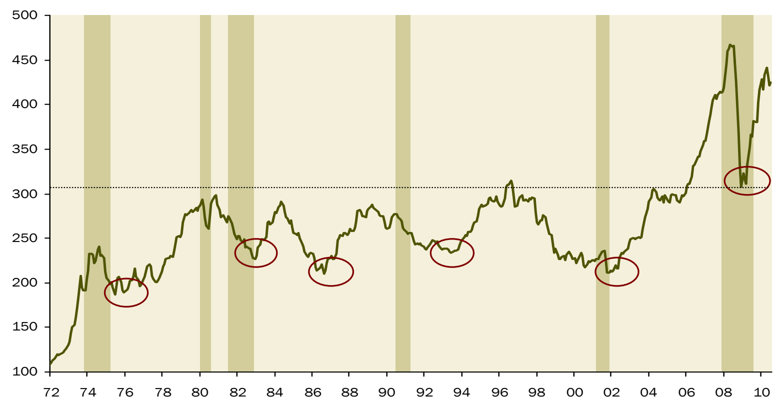
***Sum of Materials and Energy for the TSX and the S&P 500*

Source: Haver Analytics, Gluskin Sheff

On top of that, Canada has triple the exposure to the raw material sector — the sector that China is increasingly paying up for as its industrialization and urbanization phase continues unabated. So, the combination of a yield pickup and resource exposure has placed the fair-value line on the Canadian dollar into a nice secular bull pattern.

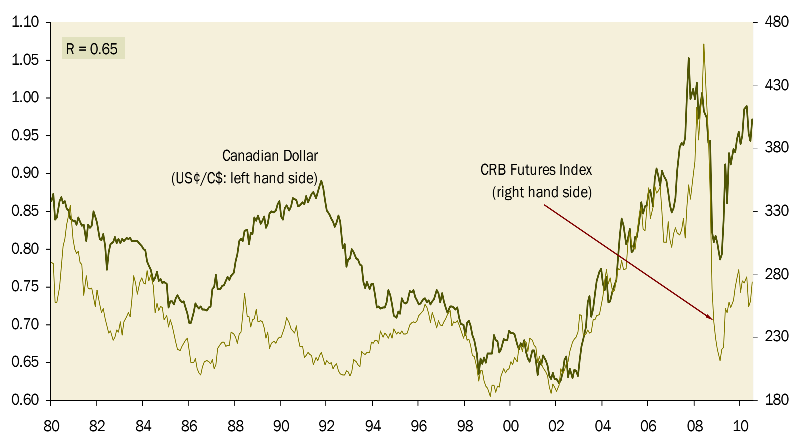
CHART 5: COMMODITY PRICES BOTTOMED AT PREVIOUS PEAKS

CRB Spot Index



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

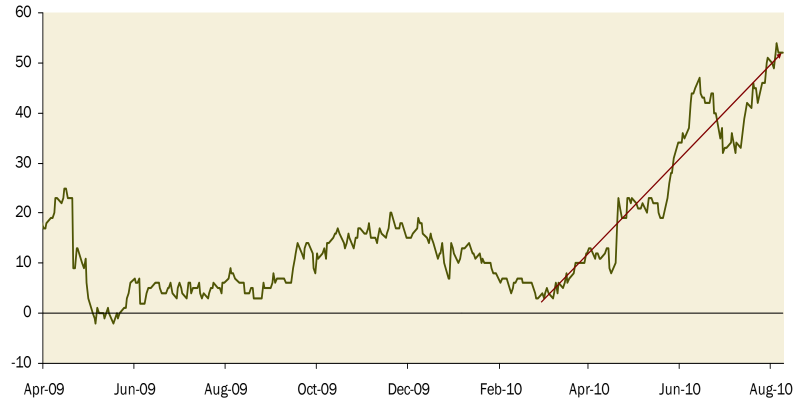
CHART 6: COMMODITY PRICES AND THE CAD MOVE TOGETHER



Source: Haver Analytics, Gluskin Sheff

CHART 7: CANADA/U.S. SHORT-TERM INTEREST RATE SPREAD WIDENING AS BOC MOVES AHEAD OF THE FED

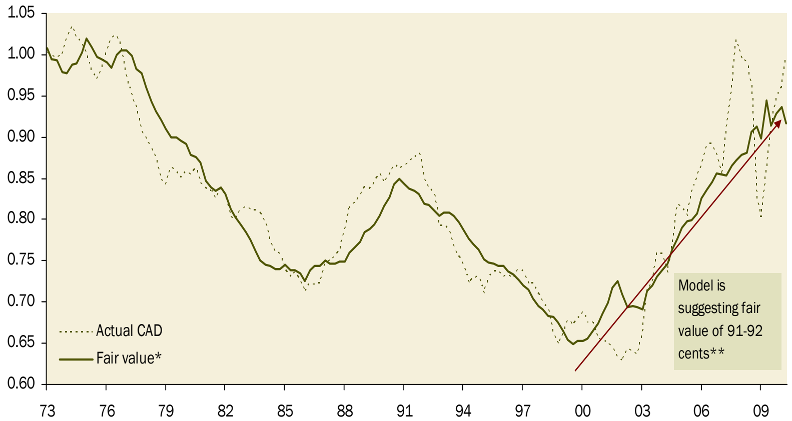
Canada minus U.S. 3-month Treasury Bill Spread
(basis points)



Source: Haver Analytics

CHART 8: CANADA/U.S. SHORT-TERM INTEREST RATE SPREAD WIDENING AS BOC MOVES AHEAD OF THE FED

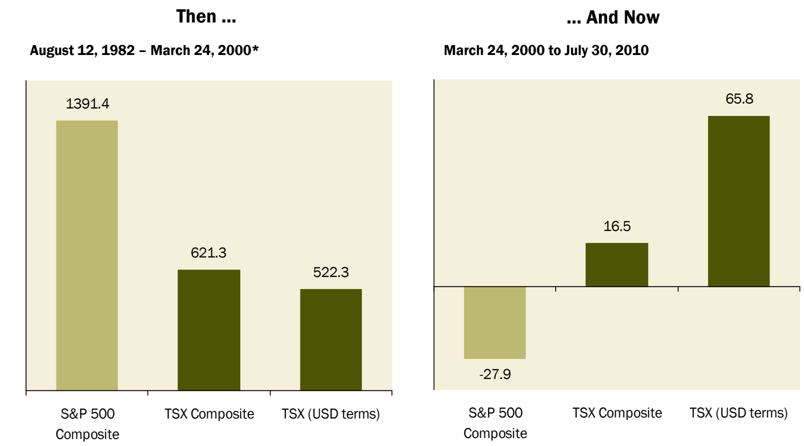
Canadian Dollar
(US¢/C$)



Source: Haver Analytics

Plus, politically — Canada is being run by fiscal conservatives who understand and respect the fact that global capital will flow to where it is treated the best. The Harper government — a throwback to the pro-business Reagan/Thatcher years — doesn't have to go to the polls for at least another two years, and currently lead in the public opinion surveys. This stands in stark contrast to the move towards more interventionist and left-leaning policies in the Unites States.

CHART 9: HALFWAY THROUGH THE CANADIAN STOCK MARKET OUTPERFORMANCE



**Dates reflect the trough (August 12, 1982) and the peak (March 24, 2000) in the S&P 500 Composite Index*
Source: Bloomberg, Haver Analytics, Gluskin Sheff

This is why the folks we have met here in South Florida are starting to crave some Northern Exposure.

MORE DEFLATIONARY SIGNS

Second-quarter productivity numbers missed expectations by a mile falling 0.9% QoQ annualized versus the +0.1% penned in by analysts. The decline was driven by slower output and a jump in hours worked. GDP revisions released last week were reflected and it looks like about 0.2-0.5 percentage points were shaved off productivity growth over the past few years.

Second quarter productivity came in weaker than expected, and so did unit labour costs; these data are increasingly consistent with a looming deflationary backdrop

Unit labour costs were weak, up 0.2% QoQ (versus 1.5% expected) and Q1 saw a big downward revision, to -3.7% versus 1.3% prior. On a year-over-year basis, unit labour costs are running at -2.8%, the sixth quarter in which they have tracked below zero. On top of this, real compensation per hour was flat for the quarter (actually negative to two decimals) and this is the fourth quarter in a row we have see flat/declining real comp per hour on a quarter-over-quarter basis. These data are increasingly consistent with a looming deflationary backdrop.

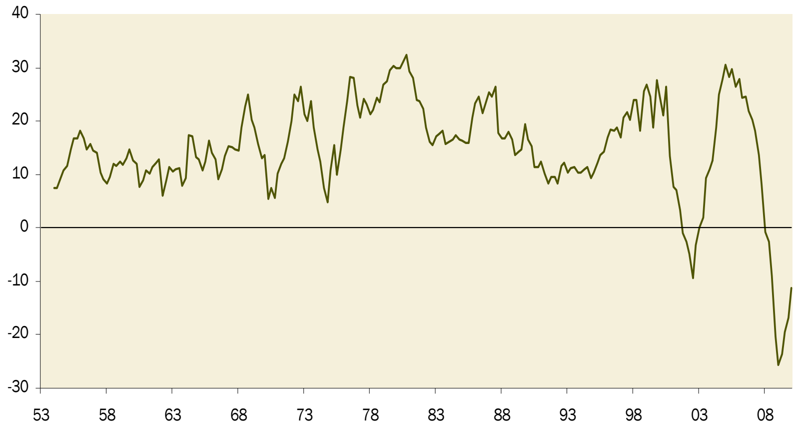
In a separate release, wholesale inventories rose just 0.1% in June, lower than 0.4% consensus estimate. This was also lower than the Bureau of Economic Analysis' estimate (remember that the Q2 GDP report released over a week ago still had a few data gaps in it, June wholesale sales being one). At this point, it looks like Q2 Advance GDP could be revised down slightly from the 2.4% originally reported, with a lower inventory contribution (in fact, this is would be consistent with the downward revisions of the recent past, as GDP has been revised down by about two tenths on average from the Advance to the Preliminary release).

RETIREMENT BLUES

The dramatic collapse in asset values in the past two years has generated severe trauma to the baby boomer balance sheet. The era of consumer frugality is proving to be a secular trend — some low-end businesses, such as McDonald's, actually have benefitted from the "scaling-down" theme, so its not necessarily bad news for everyone.

CHART 10: RECORD IMPLOSION IN HOUSEHOLD NET WORTH

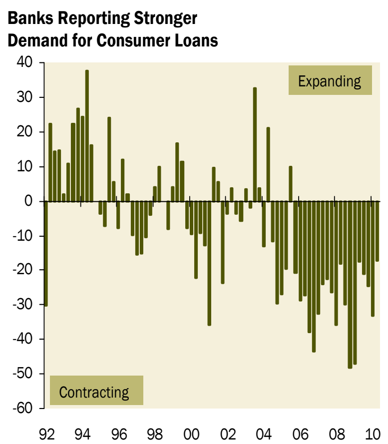
United States: Household Net Worth
(two-year percent change)

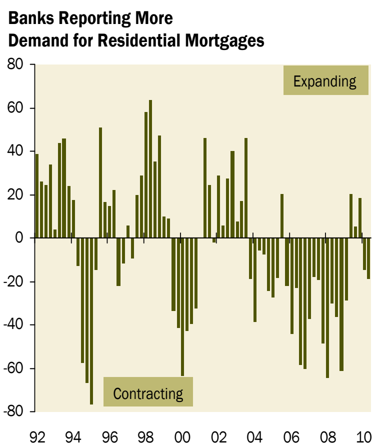


Source: Haver Analytics, Gluskin Sheff

CHART 11: HOUSEHOLD DEMAND FOR CREDIT IS DECLINING

United States: Federal Reserve Board Senior Loan Officer Survey
(percent)





Source: Haver Analytics, Gluskin Sheff

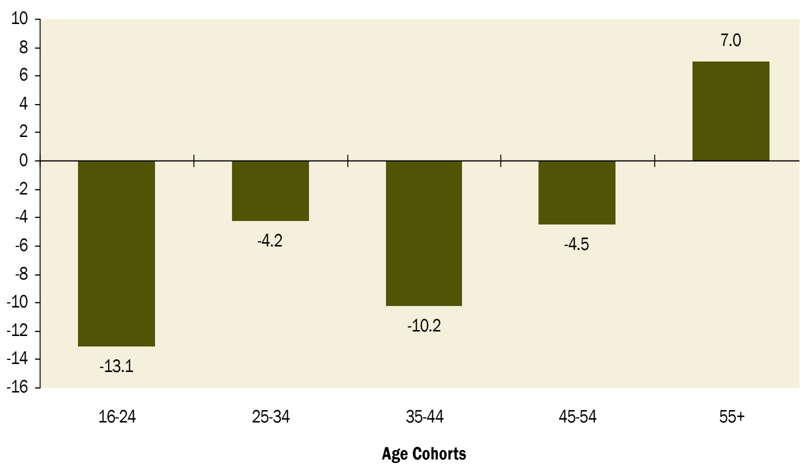
Be that as it may, consumer attitudes towards homeownership, discretionary spending and credit have been altered semi-permanently, and the adjustment has cut across all socioeconomic strata:

- The youth jobless rate is well over 20%
- The adult male unemployment rate is flirting with all-time highs; and,
- The boomers over the age of 55 are being compelled to come back into the labour market to garner the income as an antidote to the severe wealth loss incurred by the dual bear phases in real estate and equities. For a good thorough grim take on this file, see the front page of the USA Today (*For Boomers, Retirement Jobs Can Be a Tough Fit*).

In the U.S., consumer attitudes towards homeownership, discretionary spending and credit have been altered semi-permanently

CHART 12: THE "LATE BOOMERS" ARE GRABBING THE JOBS

United States: Employment Growth by Age
(percent change from December 2007 to June 2010)



Source: Haver Analytics, Gluskin Sheff

SMALL BUSINESS SENTIMENT GETS SMALLER

"The performance of the economy is mediocre at best, given the extent of the decline over the past two years. Pent up demand should be immense but it is not triggering a rapid pickup in economic activity… Owners have no confidence that economic policies will "fix" the economy."

The above quote is what the National Federation of Independent Business (NFIB) Chief Economist, William Dunkelberg, had to say about the current economic conditions. The NFIB small business optimism index fell to 88.1 in July from 89.0 in June — the lowest level since February. To put this number in perspective, the average level during recessions is 91.8, and if we are truly in an economic recovery, this index should be around the 100 mark by now. We are now only 7.1 points away from the all time low we saw back in March 2009.

Looking at the components, the declines were broadly based, with six out of the 10 components down on the month. The largest decline was seen in the outlook for business conditions over the next six months, plunging nine points to -15 in July — the lowest level since March 2009. There were marginal improvements in the employment indicators with both jobs hard to get and hiring plans inching (up a point each) higher. Plans to boost capital spending were down again in July, and small businesses believe that their inventory levels are just fine with no firms stating that their inventories were too low and therefore not adding to them.

For small businesses owners in the U.S., poor sales continue to be the biggest problem… inflation continues to be low on the "worry list"

Credit conditions were also reported to be tighter in the month; however, 32% of small firms did indicate that they borrowed at least once in the quarter reported. According to the press release, *"credit is not an issue for most firms"*; the problem is poor sales. Indeed, the single most important problem facing small businesses right now continues to be poor sales (with 29% of the respondents saying so), but what is becoming more troublesome are government requirements (15% of respondents indicated this as a problem in the last two months – highest since February 2000) and taxes (21% said this was their top problem). Inflation continues to be low on the "worry list" with only 3% of the respondents saying this is a problem.

ROOF CAVING IN ON THE CANADIAN HOUSING SECTOR

More signs of cracking in the Canadian housing market with July housing starts falling in July

We saw some more signs of cracking in the Canadian housing market with July housing starts falling 1.6% MoM in July (slightly better than expected). The details were worse than the headline, with single-family starts component garnering particular attention. Single starts plunged 11% in July and are down three of the past four months to levels back to September 2009 — the housing market is fading fast.

Multi-starts jumped 13% and hit the highest level since October 2008. There is clearly overbuilding going on in the condo market to be sure. According to the CPI index, rental prices are running at just 1.3% YoY and given the influx of apartment supply, rental prices will surely soften.

We are already concerned about second-quarter GDP growth (which we think will be in the 2.0-2.5% range versus the Bank of Canada's 3.0% estimate). While we have had limited Q3 data flow, so far it has not been good (the weak housing starts report follows on the heels of last Friday's surprisingly weak employment report).

In a separate release, new home prices rose just 0.1% MoM in June, below expected and the slowest rate in four months. On a year-over-year basis, prices were up 3.3%, picking up from the 2.9% rate but we caution that very weak year-ago comparables are boosting the YoY rates. We suspect that we will continue to see modest increases or outright price declines in the months ahead, especially given that housing starts are still running above household formation rates, which means that inventories are building and this is never a good sign for home prices.

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.

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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.

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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:

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.*

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