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

August 23, 2010
Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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- U.S. economy is contracting: the growth rate in the ECRI leading index has now been -10% or worst in the past five weeks
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WHILE YOU WERE SLEEPING

Mixed market performance overnight with Asian equities down but European indices are staging a comeback on more M&A speculation. Bonds overseas are trading defensively to start off the week. The U.S. dollar is trading a tad lower and the Asian FX complex is firm, which is a plus from a global liquidity standpoint, hence the improvement in credit default swaps over in Europe this morning. All that said, it has been a very sloppy few weeks for the equity markets and last Friday we saw three of the four (save for Nasdaq) U.S. averages undercut their recent lows, and on higher volume to boot. Crude oil is still flirting with six-week lows on world demand concerns.

Economic data releases were sparse but we did see the combined manufacturing and non-manufacturing purchasing managers' index in Euroland soften to 56.1 in August from 56.7 — the consensus was at 56.3. The Aussie dollar is down as investors try to sort out the election results, which so far seemed to have produced the first minority government in seven decades. The Canadian dollar is being pressured by the weakening in the economic data — and very well-contained inflation numbers — and expectations of more BoC rate hikes receding in the marketplace (but not among the majority of street economists, for whatever reason). As for gold, if you have run out of reasons for having a core position in the yellow metal, go straight to page 9 of today's FT (*The Risk is Rising of Another Global Trade War*).

Another eight U.S. banks were closed on Friday by the FDIC, bringing the year-to-date tally to 118. Credit card rates were just lifted to a nine-year high, 22% of Fidelity's 401(k) holders are drawing loans against their plans, fully one-quarter of American households have a sub-600 FICO score, and 48% of the 1.3 million folks who enrolled in the Administration's mortgage relief program had dropped out by the end of July. So, we are supposed to believe that credit strains are easing just because of the recent Fed Loan Officer Survey showing a greater willingness by the banks to extend credit? What else are the banks going to tell the pollsters with the huge political backlash against the lending community?

Let's look at what the banks are actually doing, and what we see is that in the August 11th week, they reduced their aggregate loan books by $12.5 billion, the third net reduction in the past three weeks. If they are lending to anyone, it is to Uncle Sam — the banks continue to play the yield curve, belatedly, and were net buyers of government securities to the tune of $15 billion last week on top of the $8 billion net investment the week before. Moreover, the banks are sitting on even more cash, up $35 billion last week, to $1.3 trillion, so there is lots of buying power to take these long-term Treasury yields even lower in the same bull-flattener game the banks played so profitably back during the credit-healing days of 1992 and 1993, which, as long-standing bond bulls, we remember all too well, and quite fondly too.

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Investors' thirst for yield (and duration!) is so intense that there is growing talk of 100-year bonds coming to the fore — see *Rethinking the 'Long' Bond* on page C1 of the WSJ. Everyone focuses on the risks of a renewed uptrend in bond yields. We will likely face recurring spasms; however, it is difficult to see where the cyclical risks are going to come from regarding our 'safety and income at a reasonable price' theme — especially since there seems to be another post-Labour day round of job cuts coming (see *Hiring Spree Gets Long in the Tooth* on page C1 of today's meaty WSJ). There are still plenty of opportunities out there in the fixed-income universe, which is why the article on page B9 of the WSJ really caught our eye today (*Thornburg Seeks 'Worthy' Risks in Muni-Bond Market*).

Investors' thirst for yield (and duration!) is so intense that there is growing talk of 100-year bonds coming to the fore

If there is a quote of the day, it must surely go the Lex column on page 12 of today's FT: *"For investors, the only thing worse than a low-yielding world is denying that it exists."*

Yes, demand for cash is extremely high, and when this happens, when the cost of capital is as low as it is today, then that must tell you a thing or two about perceived returns on invested capital. But, by definition, they are very low, and the government has run out of traditional policy bullets and the next moves by Bernanke et al, as per his "what if" speech of 2002, will involve more experiments as the Fed chairman probes the outer limits of monetary policy.

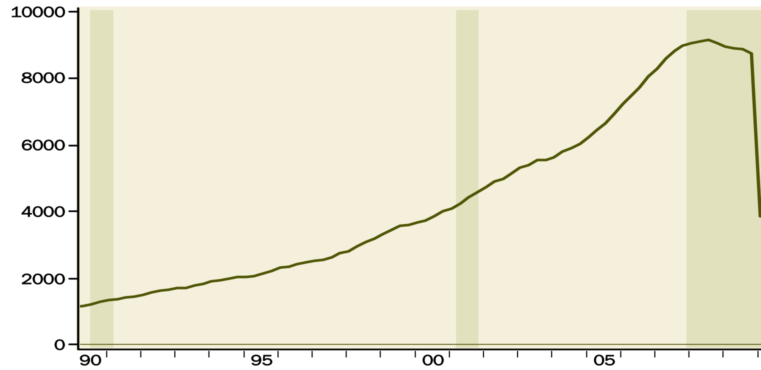
Look at the charts below. Despite the most aggressive government efforts in the modern era to kick-start the economic cycle, what we still have on our hands is a broken financial system. We hope this is not lost on the perma-bulls among us, but the pool of credit under the umbrella of private label asset-backed consumer and mortgage asset loans has collapsed by over $5 trillion, or by 60% (!), over the past two years. The private market for securitized credit is back to where it was in 2000 when the economy was two-thirds the size it is today. What few people realize is that 100% of the increase in GDP during that wonderful, though obviously artificial, economic recovery coming out of the tech wreck from 2002 to 2007 was funded by the explosion in the securitized credit market. This market is now, for all intents and purposes, defunct and replaced by Uncle Sam's family (Fannie, Freddie, Sallie … and the FHA too).

Despite the most aggressive government efforts in the modern era to kick-start the economic cycle, what we still have on our hands is a broken financial system

At the same time, who wants to be a lender today — despite the most aggressive intervention efforts ever (and ongoing threats of cramdowns). Whatever improvement we are seeing in default and delinquency rates have actually been rather marginal and in some cases, especially in the home loan market, have not improved at all. (However, people are making sure they are staying current on their cherished credit card — no strategic defaults here!)

CHART 1: TOTAL ABS AND MBS ASSET POOLS

United States
(US$ billions)

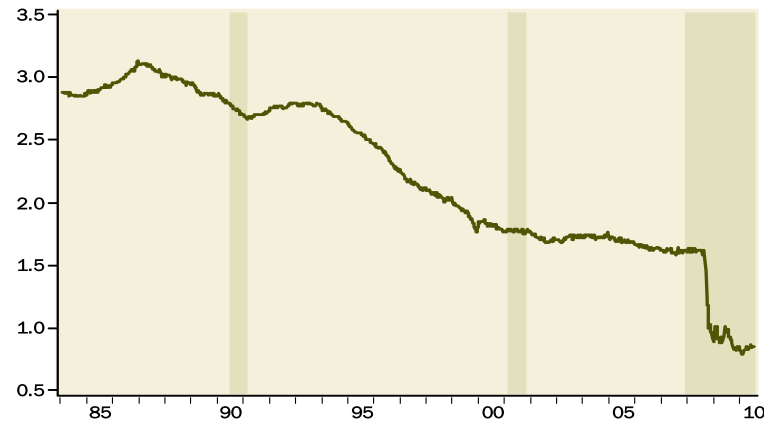


Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

As of yet, there is very little impetus in the money multiplier or money velocity even if they have stabilized at depressed levels; the Japanese charts look eerily similar.

CHART 2: STILL NO PICKUP IN THE MONEY MULTIPLIER

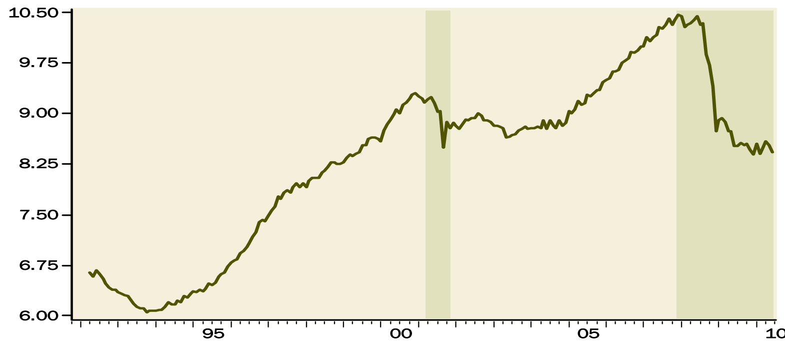
United States: St. Louis Fed M1 Money Multiplier
(ratio)



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

CHART 3: STILL NO PICKUP IN VELOCITY

United States: Velocity of Money
(ratio of nominal GDP to M1 money supply)



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

The last charts below illustrate how focused households, businesses and banks are in terms of maintaining historically high levels of liquidity despite the fact that interest rates are at microscopic levels. This says something about the desire on the part of economic agents to maintain very high levels of precautionary balances, ostensibly because they understand that recession risks are high and that means an emphasis on survival kits.

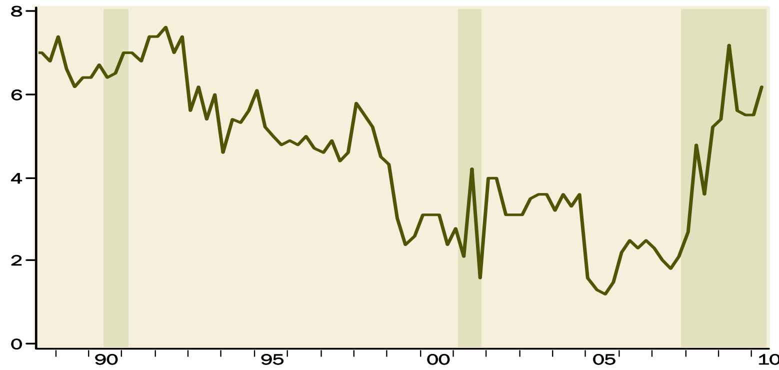
There are no quick fixes to a post-bubble credit collapse — time and shared sacrifice are the only viable solutions

But when everyone is building their liquid assets at the cost of not putting the funds to work in the real economy, then what we get is the infamous paradox of thrift. The government is there to help counteract these deflationary excessive savings trends in the private sector, but the problem now is one of high and rising structural deficits and a debt-to-GDP ratio that is a year away from breaking above 90%, which is the Rogoff-Reinhart threshold for when fiscal policy does more harm than good for the broader economy.

There are no quick fixes to a post-bubble credit collapse. Time and shared sacrifice are the only viable solutions and people on this side of the ocean should probably go and ask the folks that endured the Asian collapse and depression back in the late 1990s what it took beyond intestinal fortitude to get to where these "emerged" markets are today (*ie*, radical economic, financial and political reforms). By letting failed companies and banks survive with the help of government intervention, what the U.S. government decided to do was to avoid further pain after Lehman collapsed — and what you pay for by putting an artificial floor under the "levels" of output, spending, credit etc, is that it becomes difficult to achieve any meaningful "growth rates". There may be something to be said to rebuild the system from the rubble, which is what Japan never did but what the other Asian countries managed to accomplish as social contacts were rewritten and sacred cows laid to rest. Why is America sending troops into harms way and at the same time finding different ways to subsidize delinquent mortgage borrowers?

CHART 4: HOUSEHOLDS SAVING MORE

United States: Personal Savings Rate
(percent)



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

CHART 5: AND THE BANKS ARE HOARDING CASH AS WELL

United States: All Commercial Banks: Cash Assets as a share of Total Assets
(ratio)

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

One final note before we move on — it is a mystery as to how folks can get away with some of the things they say. For one, we see this article on page B1 of today's Globe and Mail titled *Bumpy Economic Road? Truck Drivers Don't Think So.* But the article shows a chart of the Ceridian-UCLA Pulse of Commerce Index which measures trucking activity. Ed Leamer, one of the architects of the index, is quoted as saying *"I don't think that a double-dip is in the cards."*

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We're not sure whether to be happy or sad over the fact that some of our long-standing views — once viewed as controversial — are now making the headlines in the popular press

The problem is that when you see the chart, two things jump out. First, it looks to be a perfectly coincident index. Actually, it looks to have peaked in early 2008, after the recession actually began. Second, although this index did recover in July, it looks to have already turned in a classic double top.

There's also a column on page B7 of the Globe and Mail that poses the question: "*How can we be entering a double-dip recession if commodities are peaking?*" Yet, we see that the CRB Futures index actually already peaked in April at 280 right around the same time the equity market has turned in its highs — and is sitting at 267 today.

CONSENSUS PLAYING CATCH-UP (TO US!)

We're not sure whether to be happy or sad over the fact that some of our long-standing views — once viewed as controversial — are now making the headlines in the popular press. Do we rejoice over the acceptance, or do we start to fade the trade?

Frugality has been a key theme of ours, and now we see *How to Be Frugal and Still Be Asked on Dates* on page B1 of the Saturday NYT.

Gold as a currency play as opposed to being strictly a commodity — have a look at *Rethinking Gold: What If It Isn't a Commodity After All* on page B7 of the weekend WSJ.

Housing is now a ball and chain to the baby boomer population as opposed to a viable retirement asset has been a critical theme of ours for the past several years. Sure enough, what do we see on the front page of today's NYT? A column supporting this view titled *Your Home as Sure Nest Egg? That Era is Over, Analysts Say*.

Finally, this deliberate asset-allocation shift out of equities and into bonds by the general public (as opposed to being a classic "contrarian" move) — see *In Striking Shift, Investors Flee Stock Market* on the front page of the Sunday NYT.

IT'S EARNINGS ESTIMATES THAT MATTER MOST

It must be extremely frustrating for the bulls to see the market down 12% from the April peak even with 12-month trailing EPS rising 18% since then.

So what's changed for the worse?

The answer is analyst earnings revisions. The Thomson IBES 12-month forward earnings estimates have been trimmed more than 7%, to $87.89 from $94.79 back in April. Come to think of it, the peak in earnings forecasts coincided with the peak in the market.

And guess what? The forecast peak in the last cycle was in October 2007, again right when the S&P 500 was hitting its highs. Before that, earnings estimates were starting to get cut in August 2000, just ahead of the peak in the market.

If you are just watching the earnings themselves, on average they are off six months from the time the stock market rolls off the peak. Earnings estimates seem to be a perfectly good timing device.

The U.S. economy is contracting again, and the consensus is still behind the curve at 2.5% annual rate

The same holds true at bottoms. Forward estimates hit their trough in March 2009 right at the same time the market bounced off the lows. If you waited for the actual earnings to revive, which they did in November 2009, you would have missed eight months of 65% gains in the S&P 500.

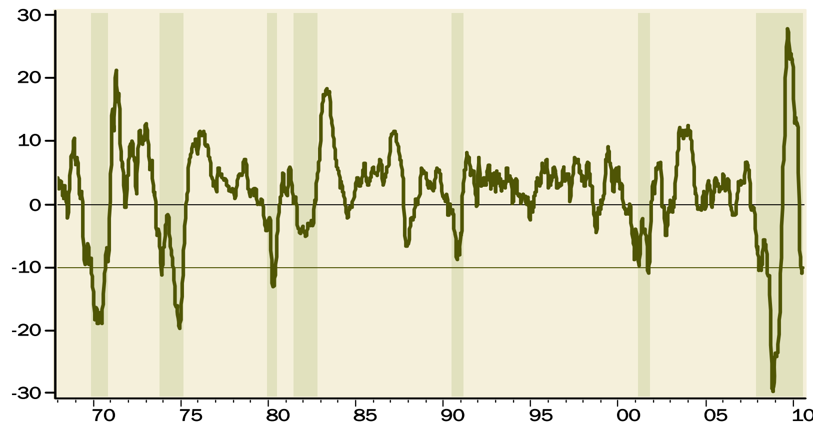
Go back to the cycle before that one and you will see that earnings forecasts only began to rise in January 2003 — right when the equity market was carving out a bottom. If you decided to jump in when actual earnings bottomed, which was much earlier at December 2001, you would have been clocked by the huge correction that occurred just under a year later.

U.S. ECONOMY IS CONTRACTING

The ECRI leading index (smoothed) came in at -10 for the August 13th week from -10.2 the week before. This is the fifth week in a row that it has been -10 or worse and so I would assume that this meets the "persistence and intensity" requirement for a recession. The Macroeconomic Advisers monthly GDP data already show two months in a row of contraction. It now looks like Q2 real growth will be around 1.2% and the Fed has cut its Q3 view twice in the past six weeks. In a nutshell, the economy is contracting again and the consensus is still behind the curve, at +2.5% annualized rate.

CHART 6: THE ECONOMY IS CONTRACTING

United States: ECRI Weekly Leading Index Growth Rate
(percent)



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

The National Bureau of Economic Research (NBER) posted a note last November that strongly suggested that rather than being in a new uptrend in the economy coming off the lows in GDP, all we had was a transitory blip in what is still a downward trend. To wit: .

> *"In both recessions and expansions, brief reversals in economic activity may occur—a recession may include a short period of expansion followed by further decline; an expansion may include a short period of contraction followed by further growth. The Committee applies its judgment based on the above definitions of recessions and expansions and has no fixed rule to determine whether a contraction is only a short interruption of an expansion, or an expansion is only a short interruption of a contraction. The most recent example of such a judgment that was less than obvious was in 1980-1982, when the Committee determined that the contraction that began in 1981 was not a continuation of the one that began in 1980, but rather a separate full recession.*
>
> *The Committee does not have a fixed definition of economic activity. It examines and compares the behavior of various measures of broad activity: real GDP measured on the product and income sides, economy-wide employment, and real income. The Committee also may consider indicators that do not cover the entire economy, such as real sales and the Federal Reserve's index of industrial production (IP). The Committee's use of these indicators in conjunction with the broad measures recognizes the issue of double-counting of sectors included in both those indicators and the broad measures. Still, a well-defined peak or trough in real sales or IP might help to determine the overall peak or trough dates, particularly if the economy-wide indicators are in conflict or do not have well-defined peaks or troughs."*

That's why this is could well be one continuum and what we are seeing is one broad cycle — a "single scoop" as opposed to a "double dip".

In the U.S, will it be Japan all over again? Even since St. Louis Federal Reserve Board President Bullard dared to draw the comparison a few weeks ago, everyone has been contemplating this possible reality

IS IT JAPAN ALL OVER AGAIN?

Even since St. Louis Federal Reserve Board President Bullard dared to draw the comparison a few weeks ago, everyone has been contemplating this possible reality — especially as the Treasury yield curve flattens out in sashimi-like fashion. What is interesting is that things are evolving much more quickly in the United States than in Japan.

In Japan, the move towards deflation, negative nominal GDP and 2.5% yields on 10-year bonds did not occur until 1998-99, a good nine years after the initial shock. Japan let its imbalances linger for longer, which is why the unemployment rate never did break above 5.6%, and here it sits at 9.7% today in the U.S.A. But while this suggests that markets clear more quickly in the U.S.A., this also points to a larger output gap here.

Demographics still matters, especially the 45-54 age cohort, which is the particular part of the baby boomer population that is driving spending, wealth gains and income

Also keep in mind that in Japan, the personal sector had a 10% savings rate at the onset that it could pull down to 3% and hence cushion the blow to the economy. In the U.S.A., the savings rate started at zero and has risen to 6½% and is likely going to remain on an uptrend in an overall uncertain economic and financial market outlook. Plus, Japan for much of the past two decades had a global economic boom for its exporters to ride off of; U.S. manufacturers will have no such luxury.

The best we can say is that the U.S. post-bubble transition will not last 20 years as has been the case in Japan, but another five years of painful transition and shared sacrifice and the deflation that goes along with them are probably baked in the cake, and this means even lower long-term bond yields. Let's make one thing perfectly clear. We are not talking about a downward spiral in prices when we discuss deflation risks. Even in Japan, the deepest negative price trends were -1.5% on a YoY basis for core inflation and -2.5% for the headline. Yet these were enough to generate sub-1% yields on 10-year JGBs and sub-2% yields at the very long end of the Japanese bond curve, which generated handsome returns for fixed-income investors.

DEMOGRAPHICS MATTER

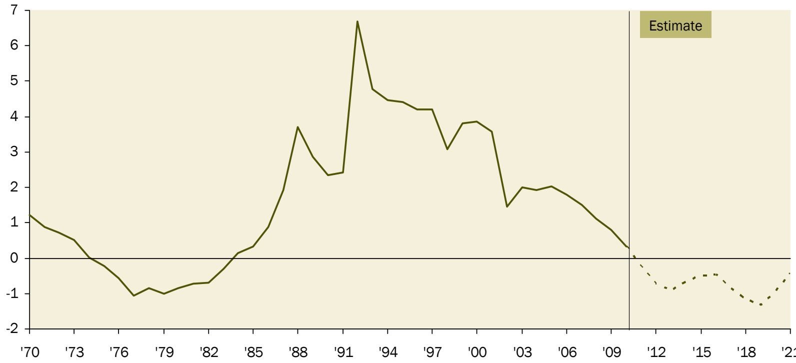
Harry Dent is one of the world's most widely read demographers and market commentators and we saw something in one of his publications that really caught our eye. A focus on one particular part of the Baby Boom population — notably the one that really drives spending, wealth gains and income. It's the 45-54 year old cohort.

Indeed, we back checked through the assertion by sifting through the Fed's database (mainly the survey of consumer finances) and found that this cohort does indeed have the lowest savings propensity, the highest earnings level and the greatest increase in net worth compared to other age categories.

From 1984 to 2010, this cohort rose each and every year. That didn't prevent business cycles from occurring or the odd vicious bear market, but over that period, the stock market, in constant dollar terms, advanced 240%. But starting next year, this key age cohort for both the economy and the markets will begin to decline — according to official forecasts, each and every year to 2021. The last time we saw sustained declines in this part of the population was from 1975-83, which was an awful time for both the economy (except for that very last year when the negative growth rate in this age segment was drawing to a close) as the S&P 500, in real terms, was as flat as pancake and real per capita income barely expanded.

CHART 7: DEMOGRAPHICS MATTER, ESPECIALLY THE 45-54 AGE COHORT

United States: 45-54 Age Cohort Population
(year-over-year percent change)



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

NO BUBBLE IN BONDS

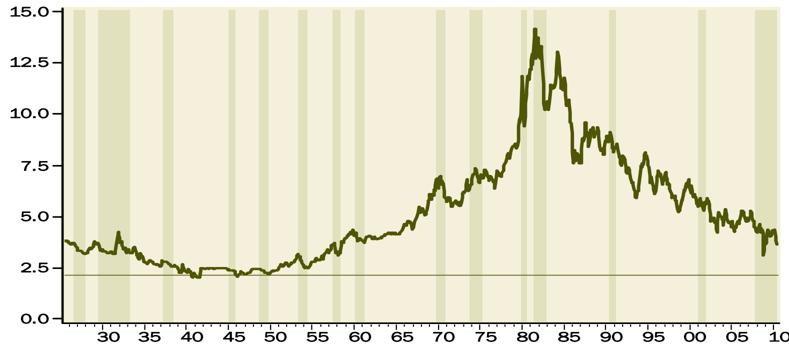
Not only did Paul Krugman really nail it on the head in his column in last Friday's NYT, but The Economist also weighed in — see *A Bull Market in Pessimism* on page 59. The last paragraph just about said it all:

> *"None of this* [note: apparent overvaluation]*, however, may be enough for investors to start bailing out of bonds. With economic growth painfully slow throughout the rich world it will be a long time before the threat of deflation can be written off. Central banks are not only likely to keep their policy rates on hold for the foreseeable future, they may, for good measure, buy more bonds themselves. Low yields could be here for a good while yet."*

Indeed, look at the long, long-term chart of the long bond and see what it did after the last depression endured in the 1930s. Indeed, it touched the 2% threshold, which is exactly where it should be on a 'normal' yield curve basis if the Fed does in fact, as we expect, hold the funds rate near zero for the next several years.

CHART 8: NO BUBBLE IN BONDS

United States: Long Term Treasury Bond Yield
(percent)



Shaded region represent periods of U.S. recession
Source: Federal Reserve Board, Gluskin Sheff

THE BERNANKE 'PLAY BOOK' TO FIGHT DEFLATION — TARGET LONG-TERM BOND YIELDS

Fed Chairman Ben Bernanke, *Deflation: Making Sure "It" Doesn't Happen Here*, before the National Economist Club, Washington, D.C., November 22, 2002

"So what then might the Fed do if its target interest rate, the overnight federal funds rate, fell to zero?"

"One relatively straightforward extension of current procedures would be to try to stimulate spending by lowering rates further out along the Treasury term structure--that is, rates on government bonds of longer maturities."

"One approach, similar to an action taken in the past couple of years by the Bank of Japan, would be for the Fed to commit to holding the overnight rate at zero for some specified period."

"A more direct method, which I personally prefer, would be for the Fed to begin ***announcing explicit ceilings for yields on longer-maturity Treasury debt*** *not only would yields on medium-term Treasury securities fall, but (because of links operating through expectations of future interest rates) yields on longer-term public and private debt (such as mortgages) would likely fall as well."*

"Of course, if operating in relatively short-dated Treasury debt proved insufficient, the Fed could also attempt to cap yields of Treasury securities at still longer maturities ... The most striking episode of bond-price pegging occurred during the years before the Federal Reserve-Treasury Accord of 1951. ***Prior to that agreement, which freed the Fed from its responsibility to fix yields on government debt, the Fed maintained a ceiling of 2-1/2 percent on long-term Treasury bonds for nearly a decade****."*

"To repeat, I suspect that operating on rates on longer-term Treasuries would provide sufficient leverage for the Fed to achieve its goals in most plausible scenarios. If lowering yields on longer-dated Treasury securities proved insufficient to restart spending, however, the Fed might next consider attempting to influence directly the yields on privately issued securities."

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Gluskin Sheff at a Glance

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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).[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.

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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.

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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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