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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHAT PASSES FOR RESEARCH THESE DAYS

Somebody sent us a piece of research late last week that apparently calls into question everything from the deleveraging cycle, to the ongoing crisis in real estate, to double dip risks, to deflation. This was yet another in a long list of published reports laying claim that private sector employment is actually running at a faster rate now than it was coming out of the 2001 recession. As if. Pretty heady stuff, nonetheless (we spent at least an hour shaking our heads; that much is for sure).

Again, I've been asked to respond. Look, we know that the Fed just cut its macro forecast twice in two months, Obama felt the need to announce yet another fiscal stimulus package, and the latest Fed Beige Book was pretty well the softest it has been in nearly a year. The macro backdrop could not possibly be more clouded.

It is also worth questioning the frequent use of mindless cycle-on-cycle charts that try — shamelessly in my opinion — to convince people that the U.S. labour market isn't in that bad of shape with nearly 15 million unemployed and another 11 million underemployed. As a share of the workforce, these are levels last seen in the 1930s. Never in the post-WWII era have we seen almost half the unemployed ranks out of work for over six months. That share in the past didn't go above 30%, even in the worst downturns. Relying on "headline" payrolls (not even taking hours or total labour input into account) and the 2001 tech wreck as the prime example, a "recession" that contained not one quarter of decline in consumer spending and no home price deflation at all, is not what I'd call very useful. I'm not even sure what it's telling us. If it's saying that we are enjoying a better bounce off the "recession" lows compared to 2001, then it's only really a debate as to when did that downturn "really" end and if in fact the most recent recession has fully terminated.

So, what I'm saying, or even recommending, is that we be extremely judicious in terms of how external research should be interpreted. I also read a lot of research from the bears too, by the way — it cuts both ways.

It has been assumed that the homebuilders have cut production sufficiently to cut into the inventory backlog and provide the launching pad for a new housing cycle. But the assumptions used to drive the conclusion is that net household formation is 1.2 million — but it's barely above 600k at an annual rate and for homeownership purposes demographic demand is 67% of that figure.

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If I was going to publish a bullish report on the U.S. economy, it certainly wouldn't be based on consumption, employment or housing. It would be based on innovation, patents, and the likelihood that the U.S. is embarking on a manufacturing renaissance of sorts — partly reflecting the new permanently higher level of energy prices, which has negatively affected globalization, years of U.S. dollar depreciation, which has helped act as a protective tariff for local producers as well as a major competitive boost.

I have no problem with reports that are bullish on specific themes but ...

Remember how aviation technology accelerated dramatically in the 1930s depression? Nothing is to say that we can't see major advances in coming years in energy, medical and transportation technologies even as the economy continues to struggle with expunging all the debt and spending excesses of the last cycle. I have no problem with reports that are bullish on specific themes but at the same time I strongly feel that we should treat reports that shamelessly attempt to downplay the very serious and complex headwinds in the U.S. labour and housing markets, with the utmost of skepticism.

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MORE THOUGHTS ON CORPORATE BONDS

Further to our comment in yesterday's *Breakfast with Dave,* where we said *"[a]ll we can say is that the most compelling risk-return attributes lie in the BB sliver of the bond market",* we ran our corporate bond models, which showed that BB bonds are the most undervalued, followed by BBB bonds. The most overvalued bonds are (not surprisingly) A, AA and AAA in that order, according to our models.

WHAT DO THE RICH DO WITH EXTRA CASH?

According to a report from Moody's Analytics, when wealthier Americans get tax cuts they save the extra money, rather than spending it. The authors of the report found that spending by couples earning more than 210k, tend to be influenced by "*business-cycle issues than …tax cut issues".* The research suggests that allowing Bush tax cuts for the rich to expire will not have an effect on aggregate consumer spending.

MOST CANADIANS STILL LIVING LIKE IT'S A RECESSION

According to Statistics Canada, Canada's recession was short-lived, beginnning in Q3 2008 and ending a year later in Q3 2009. But why doesn't it feel like that for nearly 60% of Canadians?

Canada's recession may have been short-lived, but why doesn't it feel that way for nearly 60% of Canadians?

According to the Canadian Payroll Association, 59% of Canadians are living paycheque-to-paycheque and report they would be in trouble if their paycheques were delayed by a week. This is the same number of people that said they were stretched last year when this poll was conducted (and the economy was in a recession).

RISKS TO CANADA'S ECONOMIC OUTLOOK

The OECD published an in-depth report on Canada. Before launching into the negative aspects of the report, it pays to stand back and appreciate that the world recognizes that Canada was able to weather the recession quite well due to "*a sounder banking system, a less leveraged corporate sector and a relatively strong fiscal position*".

According to a report published by the OECD, despite strong fundamentals, there are significant risks to Canada's economic growth

Despite these strong fundamentals, there are significant risks to Canada's economic growth. Yesterday's release of the National Balance Sheet accounts was case in point, showing that the household debt-to-GDP ratio is now at a record high of 94.2% and debt-to-personal disposable income is at 146% (about 20 percentage points HIGHER than the U.S.), which the OECD says "*implies a growing vulnerability to any future adverse shocks to any future adverse shocks.*"

As the OECD points out, most of the increase on household balance sheets has been through mortgage debt. They figure that "*housing looks too overpriced on the basis of price-to-rent and price-to-income measures*." Our models suggest Canadian home prices are about 10-20% overvalued, which would pose another negative risk to the economy.

U.S. SMALL BUSINESS CONFIDENCE STILL IN RECESSION

The latest National Federation of Independent Business (NFIB) Optimism Index just came out for August and it rose to 88.8 from 88.1 in July. This level in small business sentiment is just awful and suggests that small business owners will experience sub-par revenue growth in the second half of this year. Consider that historically, this index averages 91.8 during recessions and over 100 in a true economic expansion.

Inflation remains very low on the worry list for small firms in the U.S. as only 3% of respondents stated that it was a problem

Looking at the components, only four out of the 10 that make up the index rose in August. Most of the improvement was centered on two metrics: firms expecting the economy to improve (up 7 points after plunging 9 points in July) and higher sales expectations (up 4 points in August, which brings the level to zero). However, as the NFIB press release states, *"despite their improvements, both measures are still in recession territory."*

As for inflation, the percentage of firms raising average selling prices rose for the third straight month (+3 points in August), but the level remains negative (at -8%), which means that prices are still falling. As for future price increases, the percentage of firms expecting to raise average selling prices is stuck at 10%. Indeed, inflation remains very low on the worry list for small firms as only 3% of respondents stated that it was a problem.

Gluskin Sheff

Gluskin Sheff at a Glance

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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.

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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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