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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

When we say mixed we mean mixed when it comes to the equity market action overnight. Europe was down fractionally and in Asia we saw the Nikkei down 94 points to close at 9,471 (down for the third day in a row) but the Hang Seng, Sensex, Shanghai and Kospi were all higher today.

Bonds are generally well bid but in the European periphery, they are up, and in some cases, rather sharply, as fiscal concerns are still on the front burner. The U.S. dollar is softer — a solid Ifo report out of Germany is giving the euro a lift — and as such we see that gold (see more below) is now just pennies away from breaking above $1,300/oz and silver is trading at a three-decade high as well. Besides the Ifo, which jumped in September to over a three-year high of 106.8 from 106.7, France GDP was revised up as well, to +0.7% from +0.8% for Q2.

As we said yesterday, not a day goes by that I'm not asked when I'm going to turn more bullish. Well, if the truth be told, I've been bullish on gold now for a decade with very infrequent episodes when I thought a pullback could be coming. Last I saw, the yellow metal was up 18% for the year and up nearly 350% over the past decade. Bonds have also been a favorite of mine and as Chart 1 below suggests, being "bullish" on the bullion-bond barbell has not been a bad call at all. In fact, we have been long-standing fans of the commodity complex in general, not so much as a hedge against our deflation call, but rather as a play on the secular growth dynamics in emerging Asia. As we say that, we can see that the entire base metals complex is firming up in the wee hours of the morning, led by lead.

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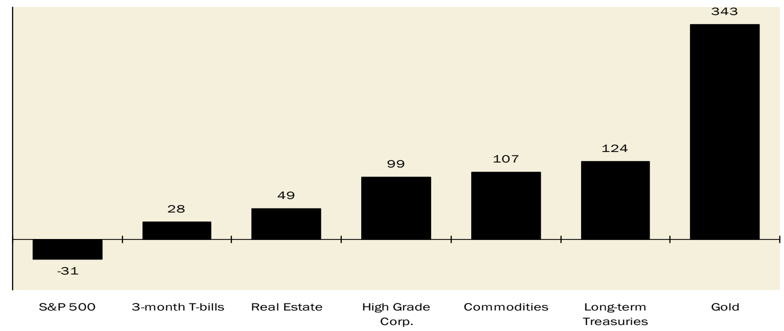
- Gold going higher still: it may be overbought on a near-term technical basis, but gold is likely to remain in a secular uptrend for quite a while longer

CHART 1: STOCKS FOR THE LONG RUN?

United States
(10-year returns by asset class: August 2000 to August 2010: percent change)



Source: Haver Analytics, Gluskin Sheff

Gluskin Sheff

The secular bear market reality in the equity market is such that if you invested $10,000 in the S&P 500 on December 31, 1999 and waited it out, you would have little more than $9,400 to show for it right now. And that includes reinvested dividends, by the way. The case for active asset management has rarely been as strong as it is today, which is one reason I chose to cross over to the wealth management business.

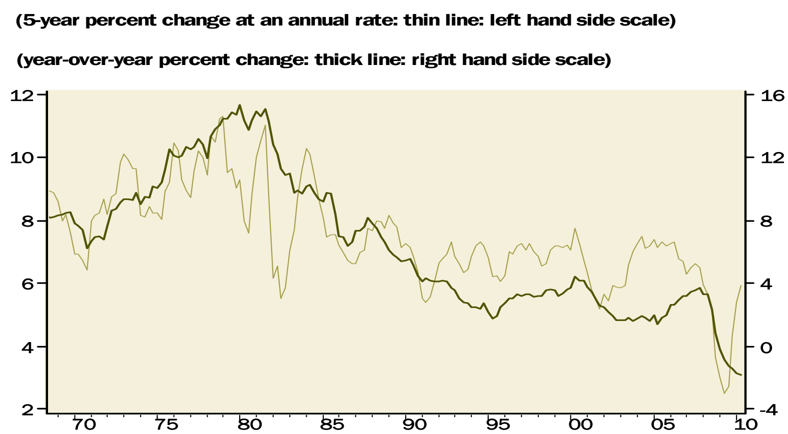
The National Bureau of NBER may have called for the technical end to the recession, but almost did so as if they themselves did not believe it

There are plenty of reasons to be trading the stock market from the short side with appropriate hedges in place to limit the volatility and downside risk during the periodic whippy bear market rallies. Yesterday's action was a case in point as the S&P 500, after exciting so many bulls by appearing to break out just a few days ago, settled below the key 1,130 mark, which has so often of late acted as a major resistance to the upside. Now after three sessions of losses, we could be in for a test of the 200-day moving average to the downside in this tightly-traded market we have been in all year long.

Did we read this right? Page A2 of the Investor's Business Daily runs with *"Buffett: 'We're Still in Recession'"*. Didn't the Oracle say a few weeks back that economic conditions were improving across all of his company's business lines? So maybe what we have seen in the past year is just a gyration around a fundamental economic downtrend. The National Bureau of Economic Research (NBER) may have called for the technical end to the recession, but almost did so as if they themselves did not believe it — or believe that a recovery has actually begun.

CHART 2: THE NOISE AROUND THE TREND LINE

United States: Nominal GDP



Source: Haver Analytics, Gluskin Sheff

With regard to the U.S. housing market, we see that a saviour is in the making — Canadians flocking en masse for cheap subprime real estate south of the border. See *U.S. Housing Calls to Canadians* on the front page of the USA Today.

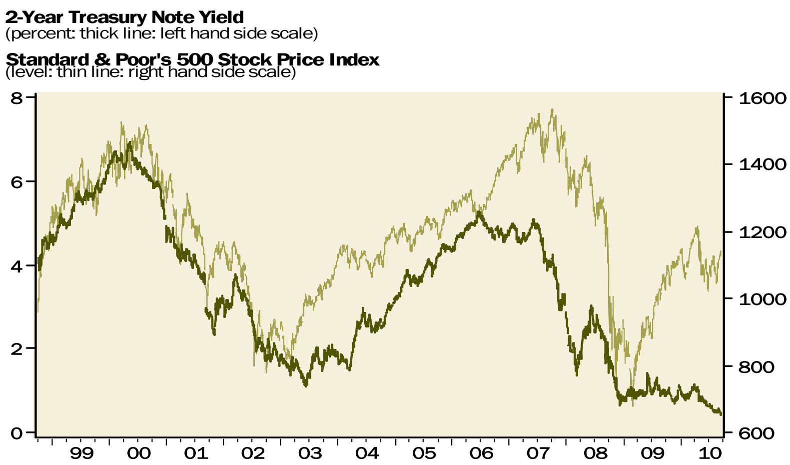
Meanwhile, the cranes that dot the Toronto skyline remind me of the late 1980s (though interest rates are thankfully a fraction of those levels today) and there is plenty of anecdotal evidence that it is Americans (and Asian investors too) who are coming in and gobbling up these (overpriced for the most part) condo units. Was this part of the Free Trade Agreement — condo swapping?

TWO-YEAR NOTE AND S&P 500 CANNOT BOTH BE RIGHT

Folks — something has to give … yields on the 2-year T-note (thin line, right hand side on chart below) has a 75% POSITIVE correlation with the S&P 500 and just hit a cycle low. Either it's a short or the equity market is … take your pick

CHART 3: TWO-YEAR NOTE AND THE S&P 500 CANNOT BOTH BE RIGHT

United States



Source: Haver Analytics, Gluskin Sheff

HOUSING STILL IN A DEEP FUNK

After a 27% MoM plunge, what did you expect? So, existing home sales “bounced” 7.6% MoM in August in what can only be described as noise around a fundamental downtrend. The level of single-family sales, at 3.62 million annualized units, is currently the second lowest level in 15 years.

The level of single-family homes sales is currently the second lowest level in the past 15 years

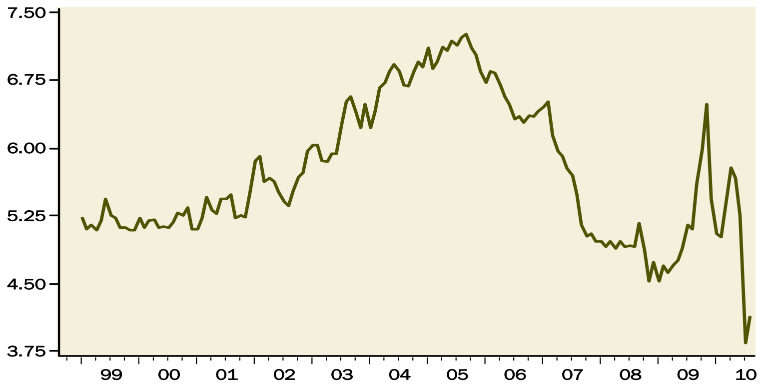
The gyrations in such a volatile indicator can drive a person around the bend, but here is the reality: the three-month trend in single-family sales is -72% at an annual rate; the six-month trend is -31%; and the 12-month trend is running at -19%. So, what is this telling you? That the trend is down and, actually, the pace is gaining momentum on the downside. Not good.

With all due respect, and we say so respectfully, the August recovery in both single-family and condo sales managed to reverse the grand total of 15% of the slide from April to July. Just to put what happened last month into perspective.

The August recovery in both single- and multi-family sales managed to reverse a grand total of 15% of the slide from April to July

CHART 4: EXISTING HOME SALES STILL NEAR THE LOWS

United States: Total Existing Home Sales
(seasonally adjusted at an annual rate, million units)

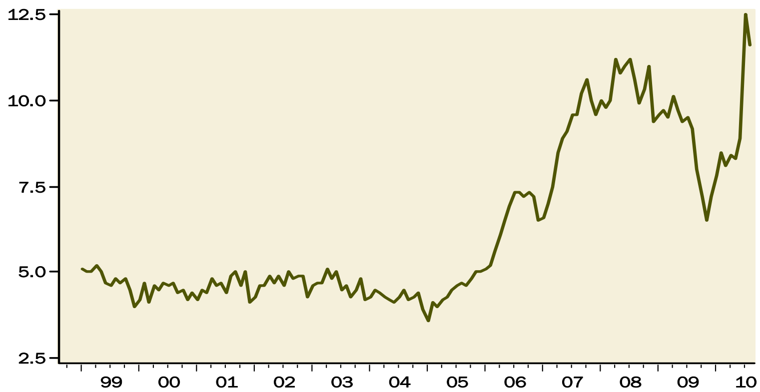


Source: Haver Analytics, Gluskin Sheff

The number of active listings did dip in August but are still up 1.5% over the past year — so the months' supply is at 11.6 (was 12.5 in July) but is up considerably from the 9.2 level this time last year. This is consistent with excess supply and deflationary pressure in the residential real estate market, as we have seen in the FHFA home price data now for the past two months. Median resale prices in this National Association of Realtors (NAR) survey showed a 1.9% average price decline in August — the steepest decline in seven months — on top of a 0.5% drop the month before.

CHART 5: ELEVATED SUPPLY DOES NOT BODE WELL FOR PRICES

United States: Months' Supply of Total Existing Homes
(months)



Source: Haver Analytics, Gluskin Sheff

FOLLOW THE LEADER?

So the U.S. leading economic indicator (LEI) rose 0.3% MoM in August. But it also rose 0.4% in July 2007; as if that told us what was going to unfold in the months and quarters that followed.

The entire gain in the LEI was due to the shape of the yield curve and nothing more

The way that the LEI is constructed, it is not the movement in the yield curve that matters — it only has to stay positively sloped and it contributes to the index. In August, the entire gain in the LEI was due to the shape of the yield curve and nothing more. The other nine components aggregated to ZERO in terms of the growth. Then tack on the other two "financial" variables, money supply and the stock market, and what we see is that outside of these influences, the "economic" components were actually down 0.1% as the financial variables came in at +0.4%.

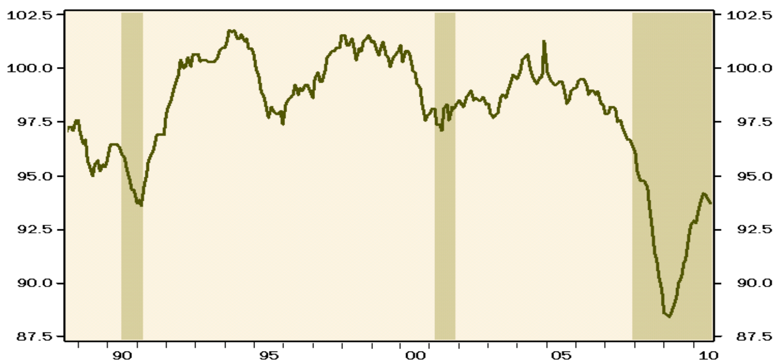
So as not be confused, what this is saying is that we had a completely lopsided report where (absent the equity market, yield curve and money supply) the LEI (and the other seven components combined) actually fell 0.1%. Not only that, but this revised LEI, using only the economic or "real" variables, has now declined for three months running and in four of the past five — not to mention peaking last March. Surely, there has to be some valuable information in that factoid.

By not allowing M2, the shape of the Treasury curve or the stock market to obscure the leading "real economy" indicators, we can see that this modified LEI also ran into a three-strikes-and-you're-out from August to October of 2007. Remember those days, when the mantra was "soft landing", and today, it is "no double dip". Give me a giant break.

And the growth bulls also have something else to answer for: the coincident-to-lagging indicator, which is almost like a book-to-bill ratio for the overall economy and actually has this nasty tendency to lead the leading indicator, actually fell 0.2% in August and is down now three months in a row. When that happened from November 2006 to January 2007 it really led … and as such, there was no excuse for not being prepared (unless, of course, you were not following it). This index peaked in May — pack that in your back pocket for future reference.

CHART 6: COINCIDENT-TO-LAGGING INDICATOR LEADS LEI

United States: Coincident Composite Index/Lagging Composite Index
(index level, 2004=100)



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

GOLD GOING HIGHER STILL

It may be overbought on a near-term technical basis, but gold — now on the precipice of breaking above $1,300/oz — is likely to remain in this secular uptrend for quite a while longer. We're talking years. We're still talking $3,000/oz. Gold has made this transition this year away from being a strict commodity towards a role befitting a monetary metal that is no government's liability. Look at what is happening around the world.

Gold is likely to remain in this secular uptrend for quite a while longer

The Fed is openly contemplating a round of quantitative easing. So is the Bank of England. The Bank of Japan's latest unsterilized intervention effort to reverse or at least stem some of the yen's strength was quantitative easing in a different form. The Swiss National Bank has spent countless of resources to prevent the franc from firming and now some Asian countries, and even Brazil, are thinking about taking similar actions. The ECB already jeopardized the sanctity of its balance sheet during the height of the Eurozone debt crisis this spring.

No country wants a strong currency. All we have seen this year, and the past few years in fact, is a series of rolling bear markets in various currencies (for an example of this, just take a read of the article on page C8 of today's WSJ — *A Return to Beggar Thy Neighbor?)*, which is why gold has managed to hit new highs against a whole host of FX units this year. Just as an equity market strategist will always be focused on breadth, the same can be said in reference to bullion. And make no mistake, this latest leg up in gold has not been speculative at all — real long-term money, from what we are hearing, is coming into the bullion market.

When you look at gold in real items, or normalized by the money supply (U.S. or global), you can see that we have a way to go to get to the old highs nearly three decades ago. When you look at what prior bubbles did across asset classes, you can also see that this bull market in bullion also has a way to go before it even enters a manic stage, let alone bubble territory.

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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.

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.

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$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $10.9 million[2] on June 30, 2010 versus $5.4 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.

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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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