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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Sloppy day so far on global equity markets; both the Nikkei and Hang Seng lost more than 1% apiece. The Euro Stoxx 50 index is up fractionally and interestingly enough, along with volume, bond yields and financials, this also never did "confirm" the latest interim high in the U.S. stock market, notwithstanding all the post CNBC/new orders jubilation heading into the weekend.

Commodity prices and resource-based currencies are under a tad of pressure this morning and we see that European government debt concerns have made it back to the front burner (see *Ireland, Portugal Stir EU Fears* on page A17 of the WSJ, and *Spanish Unions Call Strike Wednesday* too).

There were two valuable lessons from yesterday's market action. First, gold can rally (four days in a row) even with the rebound in the U.S. dollar and the giveback in oil and copper, which ratifies the view that it is trading more and more like a monetary metal and less and less like a traditional commodity. Second, we learned that even with a yield of barely more than 40 basis points above zero, investor demand for bonds is insatiable. The yield at yesterday's $36 billion 2-year note auction was the lowest since the government began selling them on a quarterly basis in September 1974 (according to Bloomberg). The bid-cover ratio for such an apparently puny yield was the highest in three years (3.78) and the indirect bidding ratio of 39% was 10 percentage points higher than it was at the time of the last auction on August 24.

On the data front, South Korea's consumer confidence index went in the opposite direction of the soaring Kospi index as it dropped to a 14-month low in September (the index slipped to 109 from 110, the second decline in a row). We did, however, get a positive reading out of U.K. retail sales volumes, which rose to the highest level in September in over six years.

STICK WITH WHAT IS CERTAIN IN AN UNCERTAIN ENVIRONMENT

As we highlight below, there is actually a significant chance that the economy will either sputter or contract in coming quarters and the good news is that Ben Bernanke gets it. Whether QE2 will do more than cushion the blow remains to be seen, but suffice it to say that we have no conviction at all over the $95 operating EPS consensus estimate for 2011 (S&P 500). Either we see at least 7% nominal GDP growth (we last saw that in 1989 when, um, inflation was running at 5%) or profit margins have to soar to new all-time highs; not impossible, just not very probable. Equities as an asset class are priced off the income statement, so a lack of conviction in the latter necessarily implies a lack of conviction on the former.

IN THIS ISSUE

It's a good thing that corporate balance sheets are still in very solid shape so that we can continue to favour credit strategies.

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We have an unbelievably tumultuous financial market backdrop on our hands — the equity market has experienced six (!) mini bull and bear markets so far this year. What's the best strategy here in order to grow capital and minimize volatility? True long-short strategies; hedge funds that really hedge out the risk.

What else? Well, as the U.S. economy — the industrialized world economy, in fact — sputters, emerging Asia and other countries with solid sources of autonomous growth are doing just fine. Call it de-coupling light. Therefore, our preference is to play the growth in the emerging markets that have really emerged via the commodity complex. After all, the U.S. consumer is the marginal buyer of health, education, financial and recreation services but it is the emerging Asian consumer that is adding to the wardrobe, buying a new car for the first time and changing his/her dietary habits. Change is at the margin, and at the margin, Asia drives the commodity consumption bus. For Canada that is a good thing, and one reason why the Canadian dollar continues to behave extremely well, if in a tight range in recent months.

Finally, bonds look very good, if for any reason than the Fed, which has even deeper pockets than Bill Gross, is contemplating how, not whether, to embark on a bond-buying program, which is destined to flatten the still-steep Treasury curve in a very material way. The total return potential is significant. See *Fed Mulls New Bond Approach* on page A2 of today's WSJ.

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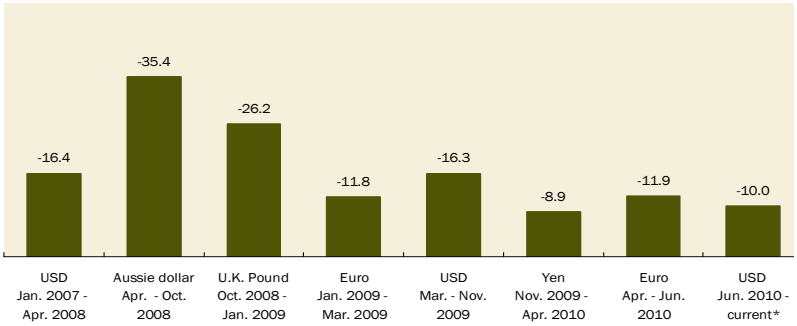
And of course gold, which we remain steadfastly bullish on. It is taking a much-needed breather — it could correct 10% from here and no long-term trendline would be violated. But as we have argued, what is fascinating is the shifting characteristics of bullion this year — from commodity to monetary metal. It is behaving more and more like a currency — a currency that is no liability of any government. With this in mind, it was interesting to hear what Guido Mantega, Brazil's Finance Minister, had to say yesterday:

"We're in the midst of an international currency war, a general weakening of currency. This threatens us because it takes away our competitiveness."

Indeed, look at the chart below over what has been happening since the credit collapse began — a series of rolling currency depreciations. Nobody wants a strong exchange rate. Hence the rally in gold, and it has tested highs across all the major currencies this year, including, it would seem, Brazil, considering that the Brazilian real has surged 25% against the U.S. dollar so far this year.

CHART 1: ROLLING BEAR MARKETS IN VARIOUS CURRENCIES

(inverted scale: peak-to-trough decline, percent change)



**As of September 24, 2010*

Source: Haver Analytics, Bloomberg, Gluskin Sheff

DID YOU KNOW …

… that 30% of the U.S. population now has a FICO score under 620 (*ie,* not credit worthy)? Here is the reality. The bulls claim that the net reduction in household debt reflects writedowns and not paydowns. The question is, why it is seen as good news that the deleveraging process is coming more from people stiffing their lenders than people actually moving to redress their debt burdens.

In any event, it hardly seems likely that we are going to be kick-starting a reflationary credit cycle any time soon because the 30% of the population who really want the credit are these folks who can't get it while the other 70% are still healing from the trauma their balance sheets endured from the collapse in net worth, which has exceeded $100,000 per household over the last three years.

THE NIGHT CHICAGO DIED

We received a regional Fed survey yesterday that fell short of confirming the newly widespread view that everything was okay as far as the U.S. economic backdrop was concerned. The Chicago Fed National Activity Index, which is just about as close a proxy to monthly GDP as you can get (a composite of 85 economic variables!), slipped to -0.53 in August from -0.11 in July. The index has been negative for four months running and is indicative of an economy slowing to growth rates that are well below potential. With core inflation running below 0.9%, this is added ammo for the deflationist crowd — perhaps one reason why the Treasury market rallied, and rallied hard yesterday.

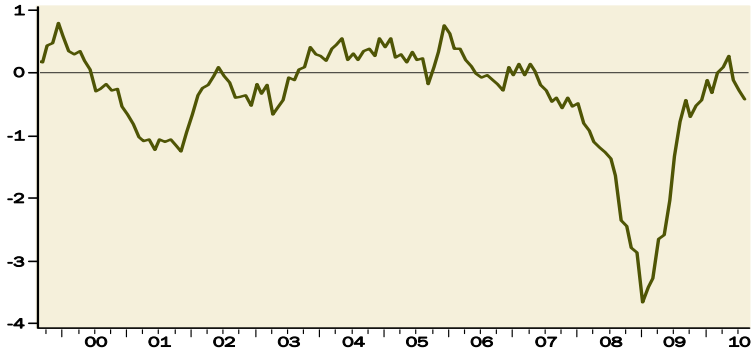
All four sub-components were below the zero line in August — employment, income, consumption/housing, and sales/orders/inventories. This condition last existed in June 2009 when the economy was still contracting!

The real critical one is consumption/housing since it does, after all, represent nearly 75% of the U.S. economy (and 18% of the global economy) and it came in at -0.40 — it has been negative now for 44 months in a row.

The smoothed three-month index fell for the third month in a row — from -0.27 in July to -0.42 in August, the worst reading of the year. As Chart 2 shows, the V-shaped recovery (off the depressed 2009 bottom) that dominated the industrial landscape last year is over.

CHART 2: THE CHICAGO FED NATIONAL ACTIVITY INDEX NOW DOWN THREE MONTHS IN A ROW

United States: Federal Reserve Board of Chicago National Activity Index
(3-month moving average, positive = growth above trend)

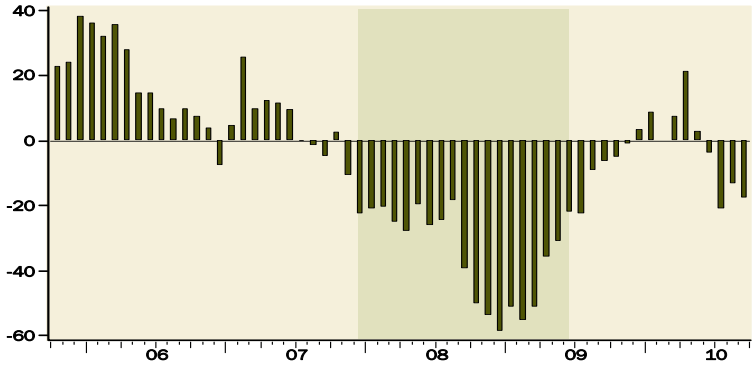


Source: Haver Analytics, Gluskin Sheff

Just to show you that it is not just about the Midwest, we were also on the receiving end of the Texas manufacturing index from the Dallas Fed — it went from -13.5 in August to -17.7 in September. Again, this diffusion index has been in negative terrain for three months running, and, like the Philly Fed and NY Empire Index that came out before, it is pointing in the direction of: (i) a lower ISM index, and (ii) a peaking-out in the inventory cycle.

CHART 3: THE TEXAS MANUFACTURING INDEX ALSO DOWN THREE MONTHS IN A ROW

United States: Federal Reserve Bank of Dallas: Texas Manufacturing Outlook Survey: Current General Business Activity Index
(positive = economic expansion)



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

REALITY CHECK ON THE MACRO OUTLOOK

We think it has to be understood that over 80% of the economic growth we saw from the lows of 2009 in real GDP was due to the massive amounts of federal government stimulus and the huge inventory swing. In other words, the underlying trend in organic real final sales is barely above 0.5%. One has to therefore wonder, with an estimated 1.7 percentage point drag from fiscal withdrawal in the coming year and the evident signs of a peaking-out in the inventory contribution to growth, how the economy does not contract heading into 2011 (perhaps starting in Q4 — the biggest mistake being made right now is confusing the delay of the double-dip with derailment).

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Of course, we are likely on our way for a positive monetary shock out of the Fed, but let's be honest, if QE1 had truly been successful (outside of the narrow goal of bringing in mortgage spreads from the orbit), then we wouldn't be hearing about QE2 right now. That said, the drag from fiscal restraint alone is worth seven 25bp hikes out of the Fed, so it would seem as though Bernanke et al are going to have their work cut out for them to prevent this fiscal shock from turning the economy over, as was the case in 1937-38. And to think that just six months ago economists on Wall Street were debating when the Fed was going to take "extended period" out of the press statement and embark on the process of tightening monetary policy.

Finally, we are sure to get calls today saying "why are you so bearish? Didn't you see that article on page A4 of the WSJ discussing how state and local government revenues are rising?" Indeed, there is a column on this today — as of Q2, state and local government revenues have edged up 1.7% YoY — the third increase in a row. Ordinarily, that might be construed as a good sign — after all, at the peak of the GDP growth rates in 2005, revenues were coming in at a near 14% annualized pace.

But it's one thing for governments to be generating a revenue stream via a booming economy and quite another that is caused by rising taxation, for the latter merely saps spending power out of the private sector, which is exactly what is happening. In the past year, state governments raised taxes the most since data were complied staring in 1979 — 29 of them raised taxes in one form or another (see *Local Taxes Sway Races* on the front page of the WSJ), and 10 of these involved income tax hikes (yikes!). Amazingly, despite the lingering deflation in residential real estate, property tax revenues managed to climb 3.3%. We wonder how.

WHAT HAS BEEN WORKING

We continue to field criticism that we "missed the call" on the equity market. Well, no doubt we did not see the 1930-style bungee jump last year, but: (i) it's over, and (ii) there were many other asset classes we liked that did very well.

Look at the S&P 500. It had one of the worst months on record in August followed by a smashing rebound in September that still leaves it in the 1,022-1,217 range for the year. At today's level of 1,142, the S&P 500 is barely changed since mid-November; nothing to show but flattish returns and a ton of volatility.

The TSX has done a little bit better and in fact we have favoured Canada over the U.S. given the resource and gold exposure. Even here, at 12,190, the TSX is little better than it was in mid-March, so in this case it is six months of a do-nothing market. It is still within the 11,092-12,280 range of 2010.

But we can understand the need for people to label market commentators as being "bullish" or "bearish"; however, in the final analysis, it is all about growing capital in a prudent manner. If somebody was "bullish" on equities at the start of the year and told you to load up on tech stocks (which are actually down), was he/she more correct than someone who wasn't as "bullish" on the overall market but told you to load up on telecom (+7.0%) and staples (+5.0%) in an overall equity underweight? Or even in the past 12 months, with the overall market up barely double-digits, would a "bullish" strategist have been right if he/she advised you to be long the financials, which are down 4.5%. Or could it be the "bearish" strategist was actually more prescient by being underweight but advising clients to have a core position in basic materials (which happen to be up 9.0%)? There is more to investment advice than merely being "bullish" or "bearish" on a particular asset class, as is usually the case, the real gems are what lies beneath the surface of the forecast as opposed to what makes the headlines.

Our call on bonds has been solid with Treasury market returns of 10% over the past year (outperforming the S&P 500 by more than 50bps). We have been through most of the past year positive on commodities, and the CRB index is up 13%.

The theme of strong corporate balance sheets has been constructive — returns in the corporate bond market have been a solid 11% — equity-like returns for less risk and volatility.

And of course, what has done better than gold, which is up more than 30% in the last 12 months.

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For further information, please contact questions@gluskinsheff.com

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