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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

U.S.A. TODAY!

We want to emphasize how important it is to go back and re-read these two articles in Wednesday's USA Today edition — *Mortgage Rates Fail to Motivate* and *Recession's Impact on Us*. These articles go a long way towards assessing the dramatic secular changes underway in this cycle of credit contraction and chronic unemployment.

New home sales are at their second lowest level on record despite record low 4% long-term mortgage rates. So if QE2 brings rates down to 3%, who cares? And with 11 million U.S. households upside down on their mortgages, refinancings have failed to boom and add cash flow to pocketbooks as was the case in 2003-04.

At the 2006 bubble peaks, households were engaging in mortgage equity cashouts to the tune of over $80 billion per quarter. That provided the thrust for the spending binge even as the jobs cycle lagged behind, similar to what we had seen in the past as the economy continued to adjust the vagaries of the post-dotcom bubble bust. Today, cash-out refinancing activity is running at one-tenth that good ol' pace of five years ago. Indeed, attitudes towards "being in debt" have shifted so radically that nearly 1 in 4 households are now "cashing in" and paying down their mortgage debt. Nearly 1 in 3 upon refinancing are doing the most unAmerican thing of all; choosing to accelerate their paydown by reducing their amortization terms! This means maintaining or increasing the same monthly payments in a lower rate environment, which in turn helps explain why spending intentions on other things are going down. What can Dr. Bernanke do when the shift in attitudes is so profoundly psychological?

Look at the facts (the USA Today articles contained some nifty factoids).

Since many people have negative equity in their homes, their mobility has become seriously constricted — the share of people who have not moved in the past year has risen to 84.6% from 83.2% in 2006.

Change is always at the margin. For the first time on record, the share of single women over the age of 18 has increased and in the past decade, the unmarried share of the 25-34 year age cohort has surged to 46.3% from 34.5%. In addition, the share of the population holding a bachelor's degree or higher has risen to a historic high of 28% — a direct result of the lack of job opportunities but also a factor that is impeding homeownership rates and housing demand.

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Gluskin Sheff

GOLD STILL SHINING

Look, it's not just the Fed signalling its intent on embarking on QE2. The Bank of England has done likewise. With fiscal pressures building in the Eurozone, the ECB is going to have to extend its accommodative posture. Industrial production in Japan has now declined three months in a row. The yen has just about gone back to where it was two-weeks ago when the Bank of Japan pulled off its unsterilized FX intervention effort, and now the central bank is also planning more monetary easing efforts.

Look, it's not just the Fed signalling its intent on embarking on QE2; the Bank of England has done likewise

We may not have a whole lot of conviction over the corporate profit outlook, but we do have conviction over the looming growth rate of fiat currency and we do have conviction over the supply curve for gold, which is perfectly inelastic on a near- and intermediate-term basis.

Gold — and silver — are likely going much higher still.

AFFORDABILITY SURGES … SO WHAT?

The U.S. housing affordability index rose 3.8% to 168.3 in August — the second increase in a row and highest since April 2010. Although median family income continues to be flat, this increase was not surprising given that home prices fell (median sales price for existing single-family homes down 2%), and mortgage rates plunged to record lows (4.76% in August).

Housing affordability in the U.S. surges in August … but so what

Be that as it may, mortgage applications for new purchases are down 36% from what were already depressed levels a year ago. The bottom line is that even with the Fed — and the Treasury market — doing everything it can to drag interest rates down, the problem is that the creditworthiness of the broad household sector is still very poor. Fewer than half possess good credit scorecards — 30% have a sub-620 FICO score and will not benefit from the Fed's aggressive actions, both in the past and in the future.

As capitalism takes an elongated sabbatical, perhaps the government should just pass legislation and give poor credits new FICO scores.

RENEWED HOUSING DEFLATION

The latest data on U.S. new home prices, Case-Shiller and the FHFA data series are all pointing in this direction.

A new wave of foreclosure supply is saturating the U.S. housing market

The culprit?

A new wave of foreclosure supply is saturating the market. According to RealtyTrac, 24% of all homes that changed hands last quarter were homes sold that had been foreclosed (the number is closer to 43% in California and 34% in Florida).

TALK ABOUT INSATIABLE INVESTOR INCOME APPETITE

Amazingly, investors gobbled up $100 billion of investment-grade bonds so far this month, and another $100 billion-plus into high-yield.

We get asked all the time whether this is becoming a crowded trade. Answer — not yet. We have said for years that households were underexposed to bonds and there is a growing acknowledgment that income-generating strategies are optimal in a deflationary backdrop.

Regional manufacturing indicators mixed: Chicago PMI came in stronger than expected, but the Milwaukee PMI came in weak and at its lowest level since October 2009

REGIONAL INDICATORS MIXED

The Chicago PMI came in stronger than expected in September — up to 60.4 from 56.7 in August (the market was looking for a decline to 55.5). Bear in mind that this does not erase the 5.6 point decline we saw in August.

Importantly, the employment index did not fare well as it fell 2.1 points (second decline in a row) to 53.4 — a four month low.

The inflation readings lined up bond-bullish with delivery delays slowing to 58.4 from 61.2 and is the lowest level since March. Prices paid is now at 55.0 — lowest reading since November 2009 and is down 16.4 points since the peak back in April.

We also got the Milwaukee index yesterday, which fell to 50 in September from 59 in August — the lowest level since October 2009.

To be sure, the Kansas City Fed manufacturing index was solid — the production index rose to 14 in September after it plunged to 0 in August. Basically, it just recouped the decline from last month. As was the case with Chicago, the employment index was weak — stuck at -2 in September.

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.

OVERVIEW

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.

PERFORMANCE

$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.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $10.9 million USD[2] on June 30, 2010 versus $8.6 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.

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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.

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.

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For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

1. *Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.*
2. *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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