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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Everything in sight continues to rally. It is a true miracle. Perhaps the Bank of Japan's willingness to buy just about everything in sight was the latest inflection point in this whopper of a risk trade.

Equities are up across the board, with another large 172 point, or 1.8%, runup in the Nikkei (helping take the Asian equity market to a 26-month high — the Asian FX complex has also rallied to a two-year high). Decoupling has re-emerged and this time along with the emerging markets, or should we say, ascending markets.

At the same time, 10-year JGB yields have been the proverbial hot knife through butter, slicing 8bps lower today to 0.825%. The U.S. dollar is slipping further (down to an eight-month low against the euro) and gold is up another five bucks this morning to another new high of just under $1,350 an ounce and silver extends its upmove to a fresh 30-year high. It is now very clear after the economics department at Goldman Sachs (the other GS) released its dual scenario for the U.S. macro outlook — "fairly bad" or "very bad", that for the time being the stock market and the economy have become unglued. It's now all about asset purchases by central banks — and it is global. Chuck Prince is likely looking for a dancing partner this very moment. But it does beg the question as to what the catalyst could be to prick the balloon — it will likely be earnings disappointment or negative guidance.

As for bonds, either the fact that the U.S. 5-year Treasury note yield hitting a record low of 1.18% is a sign of looming deflation risks or this is just all about the part of the curve the Fed is going to target.

IS WARREN BUFFETT CORRECT ON THIS ONE?

Hey, everyone is entitled to his or her opinions, especially oracles:

> *"They're making a mistake, the ones that are buying the bonds … It's quite clear that stocks are cheaper than bonds. I can't imagine anybody having bonds in their portfolio when they can own equities, a diversified group of equities. But people do because they lack of confidence. But that's what makes for the attractive prices. If they had their confidence back, they wouldn't be selling at these prices. And believe me, it will come back over time."*

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- While you where sleeping: it's a miracle, everything continues to rally
- *"They're making a mistake, the ones that are buying the bonds … It's quite clear that stocks are cheaper than bonds…"* Is Warren Buffett correct on this one?
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- Consumer fatigue: there is a prevalent view that the American consumer is doing just fine… if 2% growth that is underpinned by government life support is "fine", then we know we are into a new paradigm
- I love gold, but it seems that this market is long overdue for a near-term pullback

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That's quite a statement considering what bonds, even at ultra-low yield levels, have managed to generate in terms of total returns this year compared to the equity market. It's not even close, with all deference to the recent snapback in the stock market.

There is a critical difference between something that is government guaranteed and comes due in 10 years versus something that has downside capital price risks and never comes due

More fundamentally, there is a critical difference between something that is government guaranteed and comes due in 10 years versus something that has downside capital price risks and never comes due (ask former Nortel investors about that one).

So let's examine a high yielding stock in the S&P 500 — say, for example, Pfizer. This is a classic "bond in drag" — it actually started the year with the same yield as the 10-year Treasury note. Pfizer started the year at $19, went to $14, and now in this flashy rally has gone to $17. It's down around 10% for the year. Merck has a similar yield and has experienced no price appreciation at all. But the 10-year bond started the year at 3.85%, a yield that at the time most of these perma equity bulls did not want to touch, and now the yield is down to 2.45% and the price has increased 10% so far in 2010. Not a bad deal, eh?

If the truth be told, the last time we had the 10-year note yield at today's level the S&P 500 was trading near 1,060. In fact, at the 666 lows, the 10-year note yield was also exactly where it is today. The bond market sniffs something — more often than not. It rallies from interim highs, as we have seen since April, and foreshadowed something that was not particularly friendly to risk assets months down the road … July 2007 and February 2000 seem to come to mind. Patience and discipline and continued recital of Kipling's "If".

Then again, this rally has all occurred in a depreciating U.S. dollar environment. Gold is the hardest currency of all and in bullion terms, there has been no bounce-back at all.

ISM … UP OR DOWN?

The ISM non-manufacturing index came in above expected in September, to 53.2 from 51.5 in August. While better than the 52.0 level that the consensus had penned in, this is still below July's level of 54.3. The bulls will point to sustained positive growth at 50+. Be that as it may, the outsized gain was on supplier delivery performance, which is 25% of the index (surging to 55 from 51) — this alone added a full point to the headline index. Orders and employment both rose but production dropped. Backlogs also fell below the 50 level, as was the case with the manufacturing survey. As an aside, based on some work we did on the ISM orders-to-inventory ratio, we are likely to see the headline ISM dip below 50 by the time December rolls around.

It truly is remarkable how the markets are reacting. Back in early September, the stock market ripped off the good August ISM data and then managed to dismiss the weaker than expected non-manufacturing survey that was released shortly thereafter.

Fast forward to this week and a softer manufacturing data-point was shrugged off and then a better than expected non-manufacturing index was the launching pad for a huge rally. And, if the rally was big enough to get Louise Yamada on board the bull train, then that says something because she is the real deal (ditto for Walter Murphy).

There is a prevalent view that the American consumer is doing just fine … if we consider 2% growth is "fine" given all the stimulus, then we are into a new paradigm

CONSUMER FATIGUE

There is a prevalent view that the American consumer is doing just fine. If 2% growth that is underpinned by government life support is "fine", then we know we are into (dare we say) a new paradigm. The ICSC-Goldman Sachs chain store sales index for the first week of October was pretty tepid — down 0.8% on the week and the YoY trend throttled back to 2.4% from 3.6% at the end of September. The written results were hardly upbeat either:

"Weekly consumer channel tracking survey found very weak customer traffic at most retail segments, including discounters, department and apparel stores over the last week relative to the same week of the prior year."

The Redbook is also signalling a 2.7% YoY sales trend, as of early October, which is marginally below plan. Nothing to write home about.

Yes, yes, auto sales improved in September to an 11.8 million units annual rate from 11.4 million, but the late timing of Labour Day helped a lot. There is always a skew from this that is reversed in October — other years that saw late Labour Days were 2009, 2008, 2004, and 1996-99, as well as 1993. On average auto sales were up 1.5% MoM during the month.

I LOVE GOLD, BUT….

….The recent surge is the same chart as in March 2008, November 2009 and May 2010 … followed by meaningful corrections … that were to be bought. This market is long overdue for a near-term pullback, in our view.

CHART 1: GOLD PRICE AT A RECORD HIGH

Gold Price (US$/troy oz)

Source: Haver Analytics, Gluskin Sheff

CHART 2: GOLD HAS MORE THAN DOUBLED SINCE 2007

Gold Price (US$/troy oz)

Source: Haver Analytics, Gluskin Sheff

CHART 3: GOLD IS LONG OVERDUE FOR A NEAR-TERM PULLBACK

Gold Price (US$/troy oz)

Source: Haver Analytics, Gluskin Sheff

It would seem as though investors are putting down their money on a big inflation bet.

- Gold is up 20% this year alone.
- The gap between the long bond yield and the 10-year note yield has widened to an eight-year high of 129bps from 92bps just six-months ago. This is the third highest spread in the past three decades.
- Since the end of August, 10-year TIPS breakevens have risen from 1.5% to 1.8%.

There is no doubt that we have commodity prices firming, a weaker U.S. dollar and a monetary policy that seems aimed at reloading the gun. These are inflationary tailwinds. But we also have contracting bank credit, a 6% (and rising) personal savings rate, a 6.5% output gap and core inflation already south of 1%. These are warning signs, and the Treasury market refuses to sell off, which has thus failed, to ratify the great inflation trade.

There are now, according to the latest Commitment of Traders report, 79,796 short contracts on U.S. Treasuries on the Chicago Board of Trade, and there are 78,361 long contracts. So how is that a bond bubble exactly?

There are now 70,638 speculative long contracts on the Chicago Mercantile Exchange for the euro, versus 35,308 net short positions. Come again? There are twice as many bullish positions on this piece of you-know-what as their bearish contracts? Yikes! The dollar is hugely oversold here.

And there are now 297,272 net speculative long positions in gold on the COMEX compared with 39,623 net shorts. This has become a very crowded trade, my friends. Silver is far less on the radar screen.

There are also nearly twice as many speculative bulls as there are bears with respect to copper. The global boom trade is on.

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Gluskin Sheff at a Glance

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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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Notes:

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