David A. Rosenberg
Chief Economist & Strategist
drosenberg@gluskinsheff.com
+ 1 416 681 8919

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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

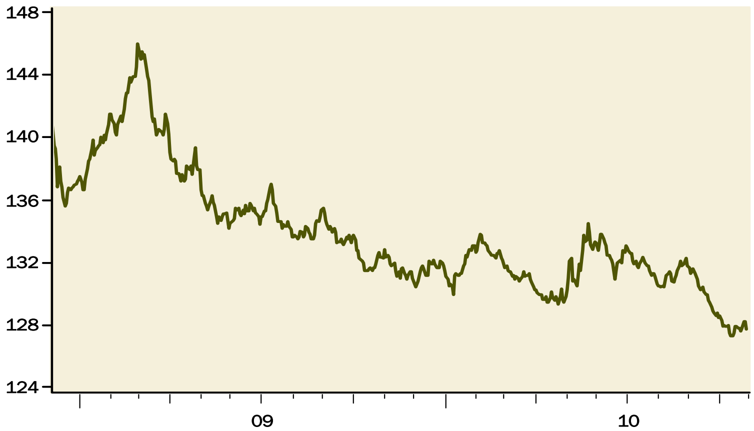
WHILE YOU WERE SLEEPING

The risk-on trade is clearly on. The Dow followed the Nasdaq to a new recovery high a day later (the S&P 500 is 1.6% away but if the financials can respond positively to the latest political and monetary policy events, watch out). Overnight, the positive action has spilled over. Equities are surging across the globe and bond markets overseas are getting hammered — the 1.3% surge in the German DAX and a 1.5% jump in the MSCI Asia Pacific index have taken both to two-year highs, as an example. With the U.S. dollar breaking down — the DXY has slid to a new low for the year — we see that commodities are well bid (back to October 2008 highs). Oil is testing six-month highs and up over 5% so far this week. There is growing market chatter that we could soon see crude break above $90/bbl.

The flip side of the decline in the USD, global capital flows to emerging markets are surging and this has taken the Thai baht to a 13-year high, much to the chagrin of its central bank. Credit default swaps have fallen further — to six-month lows in the high-yield bond market — and the VIX index (a measure of volatility) is back below 20.

CHART 1: BROAD DECLINE IN THE U.S. DOLLAR

United States: Nominal Trade Weighted USD vs Other Important Trading Partners
(January 1997 = 100)



Source: Haver Analytics, Gluskin Sheff

There was mixed news on the data front with New Zealand posting solid employment gains but Australian retail sales coming in well below expected. U.K. home prices, as per the Halifax survey, showed a nice 13% bounce and the 0.3% rise in EMU producer prices for September lined up with consensus estimates.

IN THIS ISSUE

- While you were sleeping: risk trade is clearly on again — equities are surging across the globe and bond markets are getting clobbered; U.S. dollar is breaking down; commodities are well bid
- Thoughts on QE2: the Fed is clearly trying to reflate asset values in order to generate a more positive wealth effect on personal spending and pull down the cost of debt to re-ignite business "animal spirits"
- More thoughts on QE2: in some respect, the Fed did as little as possible yesterday. What good is another handful of basis points decline really going to do for the economy?
- When bullish is bearish: chasing the market is human nature, but this behaviour is very important for investors
- Long/short strategies from the Challenger report: the Challenger layoff/hiring report contains some nice details at the industry level
- ADP private payroll result was better than expected; but we are not that excited
- U.S. service sector humming
- Factory orders point to upward revision to U.S. Q3 real GDP
- Toronto housing market — springing a leak?

U.S. FEDERAL RESERVE — QE2 THOUGHTS

There was nothing in the Fed press release yesterday that was really surprising. In fact, the market's initial dramatic reaction (all over the map) was what's most surprising. The Fed is going to be buying $600 billion of Treasuries (in the 5-10 year part of the curve) through mid-2011 and another $250-300 billion via coupon reinvestments, which they were going to do anyway.

There was nothing in the Fed press release yesterday that was really surprising

The "number" that was key for the markets is that $600 billion figure, which is about $75 billion per month. That is in the middle of consensus expectations of $50-100 billion. Not "shock and awe", based on what was broadly expected, but not "light" either considering that the economy, at least so far, has managed to avoid double-dipping.

For all the excitement, this further expansion of the Fed's balance sheet will add between 0.25-0.5% to real GDP growth; however, this will take the size of the Fed's balance sheet to a Japanese-style 20% of GDP!

What the Fed is clearly trying to do is reflate asset values in order to generate a more positive wealth effect on personal spending and pull the cost of debt and equity capital down in order to re-ignite business "animal spirits" and hence corporate investment and hiring. In a balance sheet or deleveraging cycle, success is not always guaranteed even by the most aggressive of monetary policies.

Through its actions, the Fed creates excess reserves in the banking system. But with one-third of the household sector gripped with a sub-620 FICO score, 1-in-7 mortgage debtors are either in arrears or in the foreclosure process, and with an estimated 25% of homeowners "upside down" in their mortgage (negative equity), there is at least some non-trivial probability that, as was the case with QE1, there will be no visible impact on the willingness to borrow, the money multiplier or velocity, which is what we would need to see to declare this radical policy experiment a success.

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In a nutshell, with core price trends running below 1% and the economy past the peak of growth for the cycle, the Fed is not far off the mark in its deflationary concerns. The critical aggregate here is the unemployment rate — policy is aimed at redressing the glaring "gap" or chronic excess capacity in the labour market.

Go back two years ago when the Fed was on the brink of cutting the Fed funds rate to zero and the central bank was expecting to see, by now, a 7% unemployment rate. On the eve of QE1 in the opening months of 2009, the Fed's base case was an 8% jobless rate by now. Instead, the jobless rate is sitting near 10% and only an atypically low participation rate has prevented the official unemployment rate from being higher than 12%. Moreover, counting in the vast degree of "under-employment", the real unemployment rate is closer to 17%.

The one asset that has responded miserably to the Fed announcement is the long bond — it is getting clobbered, in part because the Fed bond buying is in the mid-part of the curve. Looking at the huge spread between 30-year bonds and the 5-year note, if inflation does not rear its ugly head, the best risk-reward is now really at the long end, which is universally despised and may be one reason to like it even more!

CHART 2: SPREAD BETWEEN THE 30-YEAR AND THE 5-YEAR AT A RECORD

United States: 30-year Treasury Bond minus 5-year Treasury Note
(percentage points)

Source: Haver Analytics, Gluskin Sheff

The U.S. dollar is on the verge of breaking down — the recent countertrend rally in the DXY may well be snuffed out quickly. The 50, 100, and 200-day moving averages in gold are all in major uptrends despite the corrective phase from overbought levels.

It's difficult to see how equities can rally on this Fed move alone or the election results for that matter seeing as a GOP victory in the House and QE2 had both been widely discounted in recent months. There have been no surprises here over the past 24 hours. Just confirmations on what had already been priced in.

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Meanwhile, risk assets from equities, to credit, to emerging markets have, in recent months, become correlated with a weaker U.S. dollar in an unprecedented fashion. A weaker dollar, in turn, fits in very well with Ben Bernanke's reflationary strategy by cheapening exports and buying jobs from abroad, not to mention adding extra impetus to foreign-currency translated corporate earnings. The question is whether the dollar's descent becomes destabilizing or what the responses to this overt weak dollar policy will be in other parts of the world. Currency wars tend to lead to trade wars and trade wars do not tend to end very well (gold being an exception).

In the interim, the risk the market faces in the near-term is economic disappointment from three possible sources that could inflict some pain on the consumer:

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1. The five million 99ers who are about to lose their jobless benefits (can even a lame duck Congress be that heartless?);
2. The looming tax hikes on January 1 if a GOP-White House deal isn't brokered, and;
3. The bite into discretionary spending from the spike in food and energy prices — at exactly the most important shopping time of the year. Look out for a big bite out of GDP from what will likely prove to be at least a sharp upward move in the price deflator (have a look at *Food Sellers Grit Teeth, Raise Prices* on page B1 of today's WSJ as well as *Apparel Makers To Lift Prices* on page B2).

The equity market loves the liquidity boost but as I said, it is priced in. There are twice as many bulls as there are bears in the sentiment surveys and the stock market is trading near the top end of the 2010 range. Moreover, the two "critical" events that got Mr. Market all excited in the last two months are now yesterday's news. The recent Barron's Big Money Poll smacked of the complacency we saw in the fall of 2007 when nobody seemed to see a recession looming. Today, 4 in 5 surveyed in the Barron's poll are dismissive of double-dip risks, perhaps prematurely. The mistake here may be in confusing derailment with delay.

MORE THOUGHTS ON QE2

The Fed, in some respect, did as little as possible yesterday. Not so much in size, though they could have done more on that score (equivalent to a rate cut of 50-75bps), but more in terms of where the central bank is focusing its bond buying activity. The bulk of the bond purchases are in the mid-part of the curve where yields are already 1%. What good is another handful of basis points decline really going to do for the economy at this part of the curve? Not much. Only 6% of the bond buying is in maturities of 10 years or longer and that is what matters most for the economy and that is the only part of the curve where there is any juice left, in terms of basis point yield impact.

It would be one thing if the Fed radically shifted its forecast, we could understand why the Fed did the least amount of easing possible under the situation of having boxed themselves in. Household spending is increasing, though "gradually", and at the same time "constrained" by a variety of impediments. Housing is "depressed" and the recovery "continues to be slow". Business spending is rising "less rapidly", and nonresidential construction activity is deemed to be "weak".

What good is another handful of basis points decline really going to do for the economy at this part of the curve?

So while the Fed may not have downgraded its forecast, as it seemed to be thinking at the last meeting that the economy could be double dipping by now, the description of the economic backdrop in the press release was certainly one of a listless recovery at hand.

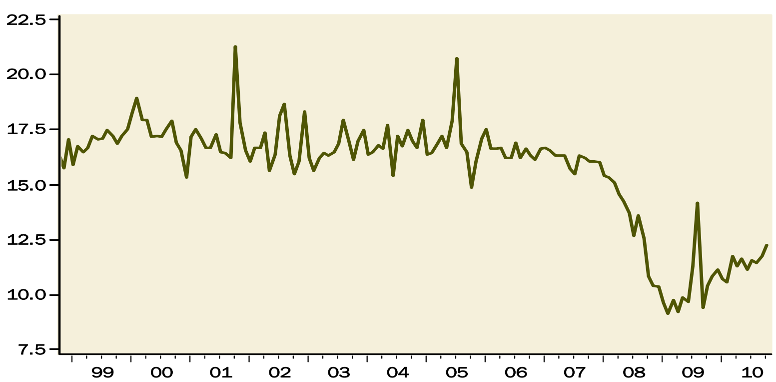
I can only surmise that the Fed had a view six-weeks ago that the economy would be contracting by now and it clearly isn't. Or that Bernanke would have faced more dissents had he targeted the 10-year and above part of the Treasury curve, which would have been far more stimulative. It is truly hard to believe that targeting a part of the curve that is already yielding 1% is going to have much of a macro effect. And, much of what happened was already priced in. Perhaps the biggest news is that, as soft as it is, the U.S. economy is not falling apart at the seams and that seems to be all the equity market needs to see to grind higher. The two outcomes from yesterday that have some certainty attached to are: (i) the steeper Treasury yield curve, which along with a GOP controlled House, is positive for the financials that have been lagging, and; (ii) a further weakening of the U.S. dollar (good for anything negatively correlated with the greenback, from basic materials, to energy, to precious metals).

While the Fed could have done more yesterday, it didn't because the economy is doing better than expected at this juncture, even if still quite fragile

Bottom line: While the Fed could have done more yesterday, it didn't because the economy is doing better than expected at this juncture, even if still quite fragile. Auto sales, for example, did rise to 12.3 million at an annual rate in October from 11.8 million in September (best result since August 2009). However, recall that motor vehicle sales also jumped 2.4% in September and all that translated into was a +0.08% inch-up in total real consumer spending, which was one of the weakest months of the year. Consumer spending excluding auto will now be key to watch.

CHART 3: MOTOR VEHICLE SALES BREACH THE 12-MILLION MARK

United States: Total Vehicle Sales
(million units at an annual rate)



Source: Haver Analytics, Gluskin Sheff

I have to admit that the news out of MasterCard SpendingPulse is amazing considering what wage growth is doing (perhaps the stimulus from strategic mortgage defaults is at play here): *"retail sales showed a noticeable improvement versus a year earlier, fueled by online sales and strong demand for luxury goods, jewelry and apparel"* (see page A2 of the Investor's Business Daily). And for Q4 GDP, the critical question will be real final sales growth and the extent to which net exports swing positively, if at all.

In the past, Bernanke discussed how useful the Fed's communication skills can be in terms of being a policy tool. One of the reasons why the Fed did not have to resort to 'shock and awe' or target longer-term Treasuries is because all the talk since late August had already produced the desired results. This is what Bernanke had to say about it in today's Washington Post:

> *"This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*

Notice how he mentioned the stock market twice — in just one paragraph. And, as the legendary Dennis Gartman emphasizes in his commentary today, what former Fed Governor Larry Meyer had to say yesterday on CNBC was very telling indeed (*"What happens over time to the equity market").* Asset prices have always played a role in monetary policy and in the wealth effect on spending but never as much as is the case today. And, just by talking the talk for the past two months, the equity market has managed to rally 14% — creating $1.7 trillion of incremental "paper" wealth without having to lift a finger (yet). Poof! Yes indeed, for Dr. Bernanke, it is a case of the hand being quicker than the eye.

It seems that a new theme has emerged, which is that the risk-on/risk-off trade is taking its cue increasingly from the U.S. dollar

Finally, it seems that a new theme has emerged, which is that the risk-on/risk-off trade is taking its cue increasingly from the U.S. dollar. The correlations are high, intensifying and unprecedented.

- Over the past six months, the inverse correlation between the trade-weighted dollar and the S&P 500 has risen to 80%; and to 90% in just the past two months.
- The inverse correlation to emerging market equities is even stronger, at 90% in the past six months and 92% over the past two months.
- The positive correlation with corporate spreads is now 70% on a six-month basis and 80% over the past two months.
- There has always been a strong inverse correlation with the CRB index but that relationship has firmed dramatically to 90% in the last six-month and 95% in just the past two months.
- Even with the VIX index, the positive correlation is now running at 80%.

In other words, all one needs to do today is follow the greenback to be a successful investor. Hard to believe it's that easy, but this seems to be the environment that Ben Bernanke *et al* have managed to create in their quest to reflate the global economy.

WHEN BULLISH IS BEARISH

Chasing the market is human nature but this behaviour is very important for investors. At the recent stock market lows, one by one, economists took down their real GDP estimates radically and bullish strategists, at a minimum, went neutral. Sentiment was wildly negative in July and much of August as deflation and double-dip risks were intensifying. Talk of QE2, hopes of political change and a better tone to several pieces of economic data (except for personal income — "only" 80% of the economy — which just posted its first decline in over a year) have now prompted a reversal in psychology.

The reality is that there are still two bulls for every bear out there and that may be the reason why the market is in the process of plateauing near the highs for the year

The Investors Intelligence poll now shows the bulls at a 46.7% share from 45.6% a week ago; the bears have remained at 24.4%. The reality is that there are still two bulls for every bear out there and that may be the reason why the market is in the process of plateauing near the highs for the year.

LONG/SHORT STRATEGIES FROM CHALLENGER DATA

The Challenger survey of layoff announcements contains some nice detail at the industry level.

On a year-over-year basis, the sectors with the best trends, in terms of job expansion plans as of October, are:

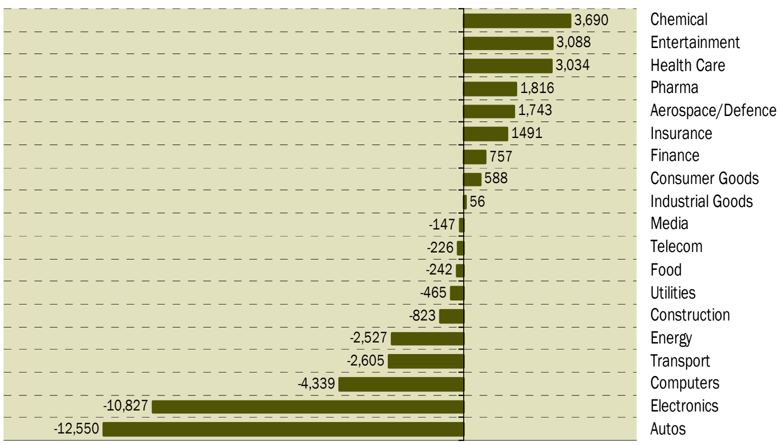
- Autos
- Tech
- Construction
- Energy
- Food
- Media
- Utilities
- Transports
- Telecom
- Electronics

The worst-looking charts belong to:

- Chemicals
- Aerospace/Defense
- Entertainment
- Financials
- Insurance
- Health care
- Pharma
- Industrial Goods
- Consumer Goods

CHART 4: LONG/SHORT STRATEGIES FROM THE CHALLENGER REPORT

United States: Challenger, Gray & Christmas Announced Job Cuts by Industry
(October 2010, year-over-year difference, number)



Source: Haver Analytics, Gluskin Sheff

ADP: BETTER THAN EXPECTED BUT WE'RE NOT THAT EXCITED

The October U.S. ADP employment figures came in better than expected, with private payrolls rising 43,000 in October, more than double consensus estimates. To put things into perspective, when the recession started in Q4 2007, ADP was averaging north of +60k

The details were mixed; both small- and medium-sized businesses registered gains, up 21k and 24k, respectively. However, large business hiring was down 2k, which doesn't bode well for Friday's number given that NFP has a larger orientation towards large businesses. So, the -2k print on large company payrolls in the ADP data may be a more accurate barometer, as far as tomorrow's data are concerned.

The manufacturing sector shed 12,000 jobs, following 15,000 jobs lost in September. This certainly seems at odds with the recent reading of the October ISM, which had the employment sub-component rising.

U.S. SERVICE SECTOR HUMMING

Good news from the service side of the U.S. economy were the non-manufacturing ISM rising to 54.3, better than expected, from 53.2 in September

Good news from the service side of the U.S. economy were the non-manufacturing ISM rising to 54.3, better than expected, from 53.2 in September. Most of the components were positive with the closely watched employment component rising to 50.9 from 50.2. New orders also rose strongly, up nearly two points to 56.7.

Even with the positive headline, 11 of 18 industries reported growth, unchanged from September. In fact, if you go back to the April to July period, 14 of 18 industries were reporting growth, suggesting that gains are becoming more concentrated.

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Also of note was the increase in the prices paid index, from 60.1 in September to 68.3 in October, the highest since September 2008. Airline fares were reported to be higher along with a slew of food and energy prices including, beef, copper, cotton, diary, diesel fuel, gasoline, and pork suggesting that the service sector profits are being squeezed by higher commodity prices as well.

Average selling home prices in the Toronto area are still 5% higher today than they were a year earlier, but the bloom is off the rose and that pace is poised to reverse in coming months

UPWARD REVISION TO Q3 GDP

The U.S. factory orders report is not a market moving report but it does pay to look at the revisions, especially the durable goods orders. Total orders (which include durables, rose 2.1% MoM in September versus 1.6% expected. Core orders (capital goods orders excluding defence and aircraft, which feeds into capex in the GDP accounts) were revised up for both September and August, setting a more positive tone for Q4 GDP (although note that September was still negative).

For the past quarter, core shipments were also revised up, pointing upward to a 12% QoQ annualized increase in Q3. All in, at this point we are tracking real GDP at an annual rate of 2.1% from the original 2.0%.

TORONTO HOUSING MARKET — SPRINGING A LEAK?

Existing home sales in the Toronto area came in at 6,681 in October, down 21% from year-ago levels. Meanwhile, the supply of backlog is growing inexorably — active listings surged 21% to 18,305 units from 14,771 in October 2009. The average number of days that homes for sale have been sitting on the market is up 19%, to 31 days, versus 26 days a year ago. Average selling prices are still 5% higher today than they were a year earlier, but the bloom is off the rose and that pace is poised to reverse in coming months.

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Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 49% 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.

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.

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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.

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For further information, please contact questions@gluskinsheff.com

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