

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Talk about the battlefields that investors now confront. Gadhafi versus the rebels. State governors versus the unions. Bernanke versus the Senate and the House. The Republicans versus the White House to keep the government open. Fine Gael versus the EU. Beijing versus Jasmine Revolution enthusiasts. The world always has its trouble spots, but there are more than just a handful to contend with right now. Risk premia justifiably are on the rise, although what is amazing is the still-high level of investor complacency.

Based on the myriad of Wall Street voice blasts this morning, the oil price shock is widely considered to be a crimp in growth but that U.S. consumers have already been accustomed to elevated energy costs so this is no big deal. Meanwhile, the major impact does seem to land more heavily on the emerging market space and China has already indicated that its growth rate will likely be trimmed a full percentage point. Everything in the markets is at the margin so this is not insignificant, and oil shocks are almost always game-changers. So far, there has been little contagion from the Libyan turmoil although there are reports of protests and demonstrations in Bahrain and there is news of unrest now in Oman. Despite all the reports of Saudi Arabian spare capacity (that is heavy crude we are talking about) and when you consider that overall spare capacity and storage reserves are estimated to represent about 6% of global usage, that is a pretty thin cushion. So the geopolitical risk premium in the oil price seems set to remain intact or may even widen in coming weeks — crude hit a fresh 29-month high overnight with WTI pressing firmly against the \$100/bbl threshold.

In Europe, it does look as though a new coalition government in Ireland is going to push quickly for a renegotiation of the country's international "bailout" package — 10-year Irish paper is up three basis points to 9% and other bond yields in the periphery are following in tandem (at last count, Fine Gael won 70 of the 166 parliamentary seats).

In the FX market, the U.S. dollar has broken support to the downside as the DXY slips to a four-month low. The broad expectation is that Ben Bernanke is going to vigorously defend the Fed's aggressively accommodative policies tomorrow at his semi-annual Congressional testimony and reinforce expectations in the market that even if other central banks begin to raise rates sooner rather than later, a tightening in the U.S.A. is not even remotely on the radar screen. How can it be with the housing market still in disarray and the government is about to dismantle the Fannie and Freddie (the GOP is pushing hard to kybosh the HAMP mortgage relief program)?

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Within the equity universe, Asian markets are enjoying a bounce from oversold levels – the Kospi was a notable exception. Bonds are quiet after U.S. Treasury yields just rallied to their lowest levels in a month. Copper is bid and gold is challenging its prior highs – a quadruple top in the making? The Canadian dollar continues to perform admirably as it now trades at a 2 ¼% premium to par against the greenback. At the rate the loonie is advancing so far this year, we will be talking about breaking through the November 2007 peak by the time summer rolls around (it's not just about commodity prices, either, but also about budgetary discipline – Ottawa ran a mere \$1.4 billion dollar deficit in December, down from \$3.1 billion a year ago).

So we have the Mideast, Ireland, Bernanke versus the Senate Banking Committee, and the conflicts between various state governments and public sector unions (what we are seeing take hold in Wisconsin, Indiana, Michigan, and Ohio is stuff for history textbooks – see page A2 of today's WSJ; and the front page of the WSJ that runs with *Governors Scramble to Rein in Medicaid* – the definition of what truly is an 'entitlement' is going through a radical, yet necessary change) are all on tap.

What else? Well, Congress is back from a week's recess and we have up to Friday at midnight until the U.S. government finds that its borrowing authority has been expired, barring a breakthrough agreement between the White House and the Congressional Republicans. Any solution is going to necessarily involve spending cuts and the only question is how deep and to what extent has the economic community factored any fiscal tightening going forward into the macro forecast. Bloomberg News runs with a big bold article today showing how the National Association of Business Economists just lifted their full-year real GDP growth forecasts for 2011 to 3.3% from 2.6% in November – prior to the ballyhooed fiscal stimulus that included a payroll tax cut and tax goodies for companies to go spending money on capital equipment.

First, these forecasts will likely now be revised down given the latest events, which have driven fuel and food prices sharply higher. It pays to note that oil price shocks affect the economy with a two-year lag. So many economists use the rule of thumb that every \$10 increase reduces GDP growth by about ¼ of a percentage point but that is just in year-one. If the elevated price persists, the effect is then to drain growth by a full percentage point in year-two – see page B4 of today's NYT for more.

Second, no mention is made of just how inadequate a 3.3% GDP growth rate is for an economy moving from year two of the economic recovery into year three. During this transition period from early-cycle to mid-cycle, the U.S. economy is ripping along at a 4.5% clip and monetary policy is moving towards restraint, not unprecedented accommodation, and the range has been from 3.6% growth to 5.6%. Sorry, but 3.3% sounds good but really isn't, and such a pace will actually make little inroads into meaningful labour market improvement barring a substantial falloff in productivity growth which has yet to occur.

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RANDOM THOUGHTS

According to Newton's First Law of Motion, a body that is in motion stays in motion until faced with an outside repelling force. Something tells me that what is unfolding across the planet right now is a game changer. The combination of sharply higher oil prices, the global food crisis, the accelerating geopolitical risks abroad, and the switch in the United States from fiscal stimulus to restraint — all will serve to complicate the macro and market outlook further. Valuation may not be at an extreme, but most measures of market sentiment are. And some folks are beginning to notice that the wheels are starting to fall off the tracks after going into hibernation because short interest on the NYSE rose a hefty 2.8% in the first half of February. The best way to hedge? See *Why Oil Stocks Still Have Legs* on page B7 of the weekend WSJ.

At the same time, it is very clear that the U.S. economic recovery is extremely fragile. How else can it be that the radical easing in Fed policy and the announcement late last year of another round of fiscal stimulus, could manage to only muster a 2.8% annualized advance in real GDP. While manufacturing diffusion indices have remained buoyant, the actual data on capital spending, real consumption and housing are all triggering cutbacks in once-rosy forecasts for current-quarter growth.

Home prices are down five months in a row. Both the trends in core durable goods orders and shipments are decelerating. Gasoline prices just hit a two-year high of \$3.29 a gallon and the 'experts' are talking about \$4 a gallon by spring. The retailers are highly vulnerable, especially absent a visible acceleration in the pace of net job creation. This recovery is almost two years old and we have but two decent payroll months to show for it — the jobless rate is at 9% only by the good grace of a labour force participation rate sliding to its lowest level in 27 years. Otherwise, it would have cleared 12% by now to the upside. We couldn't help but notice J.C. Penney guide lower to close the week and see its stock price tumble 6.5%.

Many pundits seem to believe that the theme of frugality that caught on like wildfire during the depths of the credit collapse has vanished because of Ben Bernanke's magical act — a \$600 billion wave of the wand and voila, we have a vertical run-up in equity values and a wealth effect on spending, especially at the high end. How nice is that.

The Fed made no bones about generating a rally in the stock market as its goal with QE2, which helps the 20% of the population that actually own equities directly and can make the connection between their monthly statements and what their net worth is. The Fed also wanted to create inflation and indeed it has — in food and energy, at least partly responsible in any event. Talk about a regressive tax on the population. Moreover, the Fed's policies have done nothing to backstop home prices because, except for a few weeks perhaps, QE2 never did bring down bond yields and mortgage rates.

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When we go to the University of Michigan consumer sentiment (see more below) for February, what we see is that confidence rose 9.7% for the high-end income earner and fell 1.4% for the low end. Nice.

For the folks out there that seem to believe that the frugality theme was dead because of the Fed, well, we have some news for you. It was dormant. It wasn't dead, and now it's back. For a good read of how this is affecting the consumer landscape, read the brilliant article on page B1 of the Saturday NYT – *Use it Up, Wear it Out: Recession-Wary Consumers Are Keeping Their Stuff Longer*. It's called the hand-me-down economy.

Those that think the Fed has more bullets in its chamber may want to have a look at Christina Romer's piece on page 5 of the business section of the Sunday NYT – *The Debate That's Muting the Fed's Response*.

And if you think the geopolitical risk premium in the oil price is about to subside, have a look at *Protestors Bill Bahrain's Capital and Yemeni City Feeds Unrest's Roots* on page A9 of the Saturday NYT, and *The Vacuum After Qaddafi* on the front page of the Sunday NYT.

For those who believe the public sector unions will win the battle over state governors seeking durable fiscal solutions to their budgetary crises see *Wisconsin Assembly Passes Anti-Union Bill as Senate Democrats Stay Away* on page A12 of the Saturday NYT.

And for those who don't think that the GOP aren't serious about spending cuts as a quid pro quo to keep the U.S. government running, see *GOP Stopgap May Avert Federal Shutdown* on the front page of the Saturday NYT.

DOWNWARD REVISIONS

Not only are economists who were at 4% for first quarter U.S. real GDP growth now in the process of trimming their numbers, but we also saw that the Commerce Department did the same to Q4 – now estimated at 2.8% at an annual rate from 3.2% initially and well below the 3.5% consensus estimate a few months ago.

The key was the downward revision to the U.S. consumer, to 4.1% at an annual rate from 4.4% in the advance reading, as well as the sharper downdraft in the state and local government sectors – now estimated at -2.4% instead of down 0.9% initially, and we can expect this segment of the GDP data to remain a dead-weight drag through the end of this year at the least. Wait until we see the data in the second half of 2011 that will encompass the radical cuts that will kick off the start to this sector's fiscal year.

CONFIDENCE ... REALLY?

The University of Michigan consumer sentiment data came in for the whole month of February and it managed to surprise to the upside. However, the question that will be answered two weeks from now is the extent to which the

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surge in gasoline prices, the headline news over all the fiscal turmoil at the state and local government levels, and the pullback in the stock market from the highs may have caused a reversal.

At 77.5 in February, the consumer sentiment index is at its highest level since January 2008, up from 74.2 last month and above consensus views. But a more complete picture would include this — 77.5 is the very weakest this index has ever been 20 months into a post-recession recovery, and even in the jobless recovery in 2002, it stood at 90.9 at this juncture and in the jobless recovery in 1992, it stood at 85.3. So sorry, 77.5 still does not do much for us.

Keep in mind that half the responses were taken by February 9th and that the survey ended February 23rd, so the vast majority of the survey captured the period to February 18th when the S&P 500 spiked to a high of 1,343.

IT'S NOT JUST ENERGY

Don't forget, especially as U.S. gasoline prices approach or break above \$4 a gallon this spring that the grocery bill is also ratcheting higher. The lagged impact of corn, which is up 88% in the past year, wheat (+76% YoY), and soybeans (+37% YoY), will also act to curb the other less essential parts of the household budget. Moreover, the surge in grains has also lifted the price of hogs and cattle to new all-time highs.

So, the share of after-tax personal income now being devoted to food and fuels has risen to 12.6%, and remember at the start of the last recession, the number was at 13%. With wages in nominal terms under pressure — see *A U.S. Recovery Built on Low-Paying Jobs* on page 14 of Bloomberg BusinessWeek as one reason why that is the case — in real or "inflation" adjusted terms, they can be expected to contract given what consumer prices are going to be doing in coming months.

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Nonetheless, we don't see a sustained outbreak of inflation nor do we see a spread to other sectors as we did in the 1970s. Real incomes and profit margins are very likely going to get squeezed sharply in the near- and intermediate-term.

DEFLATION IN U.S. HOUSING A REALITY FOR SOME TIME TO COME

Just consider that a growing share of the home sales taking place are not first-time homebuyers turning confident but rather distressed sales of foreclosed homes. This will be key to bringing closure to the housing downturn but the volume of what is in the foreclosure pipeline — at least two million — promises to make the adjustment a multi-year affair going forward.

The problem for existing homeowners is what all of this supply coming into the market is going to mean — especially with the nation-wide average resale home price back to 2002 levels — considering that these foreclosed units are being transacted at discounts that are averaging 28% relative to the prevailing price for other homes in the secondary market.

If you want to be involved in a part of the residential real estate story that at least has a somewhat decent balance, look to the multi-family sector. New rental apartment construction plummeted to a 50-year low in 2009 and so the sector has become somewhat supply constrained especially as homeownership rates decline. See *Apartments Are on the Rise Again* on page 42 of the current Bloomberg BusinessWeek.

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INVOKING BOB FARRELL'S RULE #5

Which is ...

"The public buys most at the top and the least at the bottom".

Now let's see if that is true.

At the March 2009 market lows, the U.S. retail investor yanked a near-record \$25.6 billion out of equity funds.

At the September 2002 lows, equity funds suffered a \$16.1 billion net redemption.

At the August 1998 low, these funds saw net outflows of \$11.6 billion.

In October 1987, at the height of the panic, retail investors withdrew a net \$7.5 billion, which was a record at that time.

Now what about at the highs ...

There were two peaks in 2007 – July and October. Equity funds saw net inflows of \$11.2 billion the first time and then \$10.9 billion at the very next high.

At the September 2000 high in the S&P 500, equity funds took in a huge \$17.6 billion. Even worse, over one-third of that was in 'aggressive growth' as many clung to the view that the entire tech sector was going to take over the world. At the very peak of the tech bubble in February of that year, aggressive growth funds alone attracted a net \$24.3 billion.

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On the eve of the Asian crisis back in July 1997, the private client sector ploughed in a net \$26.5 billion into equity funds ahead of one of the worst global financial storms of all time. You really cannot make this stuff up.

In September 1987, just before the biggest one day slide in the market since the 1929 crash, investors put \$1.5 billion of their capital into equity funds – a sum that back then was far above average.

Okay. So why go through this exercise. For your benefit – history doesn't rhyme but it sure sounds the same. U.S. based equity funds attracted a net \$19.5 billion in January 2011 – the third inflow in a row but what made this one different is that it was the largest since February 2007. By our estimation, that



was four months away from the double-top of the decade. Yes, yes, four months for some is an eternity, but it doesn't hurt to be early when the storm hits.

Many will make a federal case out of the fact that U.S. bond funds posted a net outflow of \$1.8 billion in January on top of the \$20 billion net redemption in December 2010. And a sign that bonds are in some sort of a bubble and that the general public finally sees the light as it abandons public enemy #1 – the evil Treasury market. If the truth be told, safe-income remains in a secular bull market. Taxable bond funds took in \$10.6 billion in January and that was in addition to \$7.1 billion the month before. Hybrids attracted \$6.3 billion on top of \$1.8 billion of fresh funds in December.

What retail investors are doing, again at probably the worst time, is fleeing the municipal bond market en masse AFTER the damage has already been done – \$12.4 billion in January and \$12.9 billion in December of net redemptions. Hold me down, Billy! If anything, it is munis that have been priced for disaster that may very well end up proving to be the turnaround asset class of the year. It should come as little surprise that just as Ma and Pa have fled the municipal bond market, that it in turn posted the best returns out of all the fixed-income classes in February – stemming five months of losses (according to Bloomberg that tax-exempt bonds returned 1.6% last month versus +0.5% for corporate bonds and -0.23% for Treasuries). But to see the retail investor finally capitulate on equities after the major indices have doubled from the lows is an absolutely classic signpost for anyone with a mild contrarian streak.

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Which then brings us to Bob Farrell's Rule #6: "Fear and greed are stronger than long-term resolve."

Well, ain't that the truth.

CRITICAL EVENTS CALENDAR

March 1st: Ben Bernanke's testimony on monetary policy to Congress

March 3rd: ECB policy meeting

March 4th: U.S. nonfarm payrolls

March 17th: CPI report

March 24th: EU Summit

March 27th: Key German state election in Baden-Wurttemberg

April 5th: When the U.S.'s \$14.29 trillion debt ceiling is likely to be breached (showdown?)

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 December 31, 2010, the Firm managed assets of \$6.0 billion.

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.

PERFORMANCE

\$1 million invested in our Canadian Equity Portfolio in 1991 (its inception date) would have grown to \$10.2 million² on December 31, 2010 versus \$6.5 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 \$12.9 million USD² on December 31, 2010 versus \$10.6 million USD for the S&P 500 Total Return Index over the same period.

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 Canadian Equity and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.

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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.

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.

PORTFOLIO CONSTRUCTION

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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