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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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- Save the banks and then spank them – yesterday's selloff in the equity market was blamed on President Obama's stepped up attack on the banking sector
- U.S. initial jobless claims surged – claims office are now caught up and the number of new claimants rose 36k during the week ending January 16
- Philly Fed index gets whipped – the index is now at a three month low
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WHILE YOU WERE SLEEPING

Global equity markets are following yesterday's U.S. action with Europe off 1% thus far and Asia was just a sea of red (down five days in a row) with the Nikkei shedding 277 points, or 2.6%, to close at 10,590, the Hang Seng down 136 points, or 0.7%, to 20,7267; Shanghai off 1% and the Kospi losing 2.2%.

Yesterday was the biggest drubbing in equities since last June and both the Dow (-0.4%) and the Nasdaq (-0.15%) are now down for the year (the S&P 500 is 12 basis points away from that fate). We shall see what happens by the end of the month and if the market is down, how many pundits and market commentators will be discussing the fabled 'January effect'. (We will undoubtedly be told not to worry since it didn't work last year – just wait and see; but if the markets finish the month in the green, well, suffice it to say that it will make it to the front pages).

Bonds are generally bid but there was an absolute monster rally (10bps) in Australia today (perhaps related to flows out of the stock market as the government proposed a new tax on mining projects).

In the FX market, the U.S. dollar is now stalling at the 200-day moving average; though gold is now barely hanging on to its 100-day moving average (a test of the 200-day could see it go down near-term to $1,012/oz and this would represent a salivating opportunity to build those long-term positions). The oil price, at around $76/bbl, is also in the process of testing its 100-day moving average and a break to the downside would likely mean a further move down towards $70/bbl. Copper is also showing signs of fatigue as it loses ground for the second week in a row. Again, all in the context of a secular bull market in raw materials.

The VIX took a huge 19% jump yesterday, to 22.27 – the largest move in three months (since the Dubai fiasco) – and corporate spreads are now starting to widen out, which is to be expected after the straight-line-down move of the past 10 months. Credit default swaps are widening and high-yield and emerging market bonds are under pressure.

After months of watching a variety of risk assets move back into nosebleed territory, it goes without saying that we had been preparing for the correction taking place right now. Our hope is that this is only a correction and not something more nasty, but having cash to ultimately put back to work is something we intend to do – and to keep our cool as others lose theirs.

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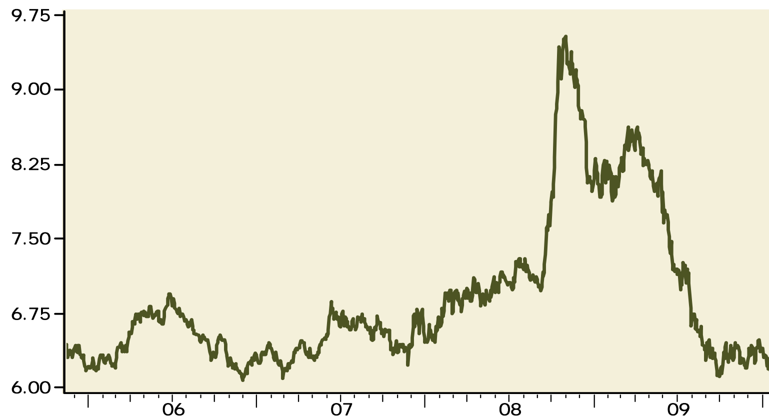
CHART 1: BACK TO SILLY SEASON FOR CORPORATE BOND YIELDS?

United States: BAA Rated Corporate Bond Yield
(percent)



Source: Haver Analytics, Gluskin Sheff

As an aside, not every baby was thrown out with the bath water in yesterday's negative action. The regional banks actually broke out as they stand to benefit from the proposals to de-risk the big commercial lenders. And even during these uncertain times, we still have to eat so with that in mind consider than in the worst equity session in months the likes of Buffalo Wild Wings rallied 3% on huge volume and Panera Bread hit a fresh 52-week high.

There's more good news. The bond market that everyone seems to hate has rallied to a point where the U.S. 30-year fixed rate mortgage has dipped back below the 5% mark. The homebuilding group needs all the help it can get.

Overall, the economic data were pretty good overnight. Germany revised up its estimate for November manufacturing orders, to +2.8% from +0.2%. Overall Euroland order books expanded 1.6% in the month, which was triple what the consensus was expecting. French business confidence also jumped in January to 92 versus the 90 that was widely expected. The only party-pooper was the U.K., which released a soft retail sales figure for December (+0.3% versus the +1.1% print that the consensus had penned in).

AS IF WE NEED ANYTHING MORE TO WORRY ABOUT

Greece. Portugal. Ireland. China tightening. Bank bashing. Foreclosures. The housing and mortgage market. Jobs. The Fed's exit strategy (if it happens).

And now we have Ben Bernanke's confirmation hearings in the Senate and this is not a 'done deal'. His current term as Fed Chairman ends on January 31 and a vote has been delayed until next week at the earliest – and he needs 60 supporters and a few Democrats have already said publicly that they will not support his reappointment and therefore he will need GOP help. Volatility is still very cheap even after yesterday's jump.

The last time we had a sudden and unexpected turnover at the Fed was back on June 2, 1987 when Paul Volcker surprisingly announced his resignation. That day, the S&P 500 slipped 0.5%, which was a big deal then since we were in the throes of a major rally, the yield the 10-year note surged 27 basis points, the VIX index jumped 5%, the DXY was crushed 1.2% and gold rallied 1.3%. Keep that in your back pocket just in case.

SAVE THE BANKS AND THEN SPANK THEM

"If these folks want a fight, it's a fight I'm ready to have."

Eight years ago that would have been George Bush the son talking about terrorists.

But today (yesterday actually) it is President Obama talking about the banks. For some reason, the bonuses on Wall Street were deemed to be "obscene" but no such mention was made of Fannie and Freddie, and no mention of the "excessive risks" and "binge of irresponsibility" being taken on by the FHA in its quest to promote homeownership with virtually no down-payment at taxpayer expense … wait for those losses to mount. No wonder a Bloomberg poll just found that 77% of U.S. investors polled see the President as being "anti-business".

With credit demands dormant and the banks relying heavily on their proprietary trading capabilities, the big investment banks face the largest hurdles. Although Goldman Sachs and Morgan Stanley can sidestep the proposed trading restrictions and drop their bank charters – it was those same charters that saved them a year ago.

Indeed, yesterday's selloff was "blamed" on President Obama's stepped up attack on the banking sector. All 10 S&P sectors were down and the worst performer was basic materials, so China's recent policy tightening moves were at play as well. The earnings season thus far has been more mixed and the financials in particular have not fared all too well when it has come to top-line growth, loan loss provisioning and guidance.

Even decent reports that included nice top-line performance like we saw out of Google yesterday and G.E. today are not eliciting much of a giddy response as would have been the case during the "green shooty" days last spring and summer and that again attests to how much of the good news is already "in the price". And what if the news doesn't to turn out to be so "good". The vagaries of an overvalued market – remember that Mr. Market chose October 19, 1987 to plunge 23% in the same quarter in which the macro fundamentals could scarcely have been better with 7% real GDP growth at an annual rate and a 55% trailing trend in corporate earnings. The problem at the time was that the S&P 500 was overvalued on a Shiller P/E basis by nearly 30%, as is the case today, so sometimes good just isn't good enough. In an overvalued market there is rarely much room for error. In an undervalued market, by way of comparison, rallies can occur on better sequential news even if you can't feed your kids or pay your bills with less-negative data.

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But as Bob Farrell always said, *"it's the market that makes the news; the news does not make the market."* So the recent giveback probably reflects a deeply overbought market that has hit the fatigue button. In other words, the buying power that propelled last year's rally has likely exhausted itself.

As for President Obama's plan to de-risk the banks, which was as inevitable as the Sarbanes-Oxley legislation that followed the tech wreck seven years ago, the timing is questionable (except that it quickly followed on the heels of the Scott Brown Senate victory). But just as the focus on health-care reform (as laudable a goal as that is) ended up freezing activity in the small business sector, which represents two-thirds of the employment pie, creating a heightened sense of uncertainty in the financial space, which, at this time, is only going to stand further in the way of creating jobs. After all, this is a sector that employs nearly three million people (the unemployment rate in New York City has soared to 10.6% and look for it to remain on the up-escalator).

Which brings us to this point; while the equity market and risk assets in general enjoyed an absolutely phenomenal year in 2009, the economy shed four million jobs, which was even larger than the three million that were lost in 2008 and that was the year that we lost Bear, Lehman and Fannie and Freddie as we had known them. Not only that, but the President's first year on the job was the worst on record in terms of job loss, and by a long shot. To this day, with over six million or a record 40% of the unemployed having been out of work for at least six months, there is still no concrete plan out of Washington to deal with what is the most acute crisis – the utter lack of job creation.

Bashing the banks at this time is not very likely going to do much except perpetuate this very high level of uncertainty in the business sector and pose another roadblock on the way to better times in the labour market. The census hiring could not have come at a better time, but these are hardly full-time positions and not exactly part of any long-term strategy to stimulate employment and retool the swelling ranks of the unemployed.

In any event, the banks are going to get re-regulated and the banking analysts are probably going to be valuing the sector as utilities going forward. On this basis, a 4.1% dividend yield on the latter certainly looks a lot more attractive than the puny 1.5% yield that currently exists in the U.S. financial space. How about coming to Canada where the yield in the financials is 3.9% and 4.9% for the utilities sector. Plus – you get a better currency.

On a final note for this section – the editorial in today's Investors Business Daily (page A10 - - *Shifting the Blame*) is a must, must read. At least in our opinion.

U.S. JOBLESS CLAIMS SURGE

Well, well. All of a sudden, the claims offices have played catch-up with their files and now see that after some administrative delays, claims are now at 482k (up 36k in the January 16th week) and this is definitely consistent with ongoing net job loss. And the latest data on the entire gamut of continuing claims, including all the

extended and emergency benefit schemes, surged 1.144 million in the January 2nd week to a fresh all-time high of 11.933 million. A shocking result to say the least.

The real key was the four-week moving average hooking up, to 448,250 from 441,250 – this effectively terminated a 22-week string of declines. You have to go back to the week of August 29 to see the last time the four-week m.a. rose … could be a sign that the improving trend has hit bottom.

PHILLY GETS WHIPPED

The Philly Fed was also worse than expected in January, dropping to 15.2 from 22.5 in December and the lowest in three months. The consensus was closer to 18.0, so this was definitely not of the 'green shoot' variety. Orders were particularly soft – they fell to 3.2 in January from 8.3 in December and 13.1 in November.

In the "special question", manufacturers were asked about how strong demand was for their products (excluding any seasonal effects) – 58% said either flat or weak, and 73% reported that sales were either in line or below what they had been expecting. That does not sound like much of a V-shaped inventory cycle as far as we are concerned.

FUND FLOWS STILL FAVOUR FIXED-INCOME

The ICI data are out for the January 13th week and while equity funds had decent inflows (for a change) of $5.78 billion (after yesterday, they are already under water), bond funds took in another $7.36 billion versus $6.86 billion the week before).

THE BANK OF CANADA IS AS CONFUSED AS THE REST OF US

In yesterday's Monetary Policy Report, the Bank of Canada played two hands at the bridge table when it came to the view on the global economic outlook:

"It is possible that the recovery in global demand could be more vigorous than projected, resulting in stronger external demand for Canadian exports."

"Another important downside risk is that the global recovery could be even more protracted than projected."

The folks that think the Bank of Canada is going to tighten policy in the second half of the year are sadly mistaken. I don't mean to sound bold, but they don't have the right read on Mr. Carney. He realizes the risks are to the downside with regards to both growth and inflation and the concern with an overvalued currency and a questionable domestic demand outlook south of the border are well documented. What is not well documented is that fiscal policy stimulus is about to be withdrawn as we are likely to see in the March 4 budget – and the BoC realizes that going forward, it, not CMHC or the Department of Finance, will be the only game in town to ensure that the economy does not relapse.

EXCESSIVE HOUSING INVENTORIES

As we said in yesterday's piece, we have supply, both potential and actual, of over nine million homes and condos nationwide. That is a huge overhang. On top of that, an 11%-plus rental vacancy rate as a viable option for households looking for a place to live. The Lex column in the FT also ran with something similar called *For Sale For Sale For Sale For Sale*. Almost 9% of the 53 million outstanding mortgages are either in arrears or the foreclosure process, up from 5% a year ago.

Meanwhile, employment in the key 25-44 year old category is down 8% since the recession began, so the underlying demographic demand isn't exactly there to absorb this excess inventory. Any reasonable assessment of the supply and demand curves suggest that home prices still have a long way to go before they bottom. The November Case-Shiller index, to be released on January 26, looms very large.

Also keep in mind that according to Moody's.com, 2.4 million more homes will move into the foreclosure process this year – at a time when there are four million loans that are very delinquent. Indeed, that will be the big surprise for the year -- another 10-15% decline in average home prices. Few are braced for such a prospect.

A BIT OF SECTOR TRIVIA

Table 1 shows S&P 500 sectors and health care is the only one that outperformed the market in each of the past three decades (secular growth). Telecom services is the only sector to underperform in all three.

Table 1: S&P 500 Sector Performance
(percent)

	1980-89	1990-99	2000-09
S&P 500	**227**	**316**	**-24**
Energy	162	132	102
Materials	164	97	25
Industrials	185	253	-11
Consumer Discretionary	287	315	-21
Consumer Staples	564	233	32
Health Care	355	353	11
Financials	173	328	-40
Information Technology	71	1179	-54
Telecommunication Services	132	216	-64
Utilities	115	38	11

Source: Gluskin Sheff

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Gluskin Sheff at a Glance

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Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 65% 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 $15.5 million[2] on September 30, 2009 versus $9.7 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 $11.2 million USD[2] on September 30, 2009 versus $8.7 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.

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.

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For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

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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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