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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

IN THIS ISSUE

- While you were sleeping — overseas equity markets mixed; bonds sold off; oil prices fell again
- Exposure to silver, whether it be in bars, coins, ETFs or mining companies, is likely going to be prove to be a very attractive investment in coming years
- Canadian market looking overvalued
- Bank credit still contracting

WHILE YOU WERE SLEEPING

Sluggish overnight with European markets off 0.8% and decidedly mixed action in Asia – outside of Hong Kong and Singapore, it's actually a sea of red across the continent. Not even Cadbury's upped ante for Kraft has managed to give the market much of a sugar high.

Interestingly, bonds are selling off, especially the gilt market (yields surged 9bps, to 4.02%) on the back of some ugly UK inflation data (the YoY CPI trend jumped to 2.9% -- at least a 13-year high – versus consensus expectations of 2.6% and the 1.9% trend in November).

The oil price fell again – the sixth time in the past seven days on recurring inventory concerns; however, gold is snugging its 50-day moving average very nicely.

The Yen has climbed to a four-week high despite the JAL bankruptcy announcement (how many is this now for the beleaguered airline?) as investors opt for the defensive safe-haven currencies (the commodity currencies are dipping from their lofty perch). Sterling has also been given a lift from heightened post-CPI interest rate expectations and is now trading at a four-month high against the Euro. Meanwhile, the lingering fiscal problems in Greece have also put the Euro in the penalty box – and semi-permanently.

On the data front, the closely-watched German ZEW sentiment index fell more than expected – to 47.2 in January from 50.4 in December (fourth decline in as many months and below the 50 that was widely expected). At the same time, Japan's consumer confidence index slipped to 37.6 in December from 39.5 in November. Except for Australian employment, and YoY Asian export data that are only slightly skewed from year-ago base effects, we would have to say that the global economic numbers of late have had a distinctly brown-shooty feel to them. As for diffusion indices, it will be interesting to see how the market will respond to the next ISM survey, since it did such a marvellous job at predicting the 0.1% dip we saw in U.S. manufacturing output last month.

It is fascinating how over the past year, silver has very quietly risen 77%, to little fanfare, and yet the fact that corporate bonds returned more than 20%, the S&P 500 by 35%, gold up by 40%, the Nasdaq by 50% and bellwether emerging market equities like the Korean kospi by 55% seems to be headline news.

On the political front, we have a very important election today for the "Kennedy seat" in the Senate. This could well have a huge influence on the political agenda since what is up for grabs is the Democrats' 60-seat supermajority. At the current time, let's just add that if the voting public were believers in the economics community's declaration that the recession is over, then we probably would not be seeing the latest USA Today/Gallup poll at 45%, lower than any post-WWII president at this stage (end of year one) of the political cycle. The editorials on this file in today's FT and WSJ are both worth a read.

Keys on the data calendar this week relate to housing (NAHB housing market index today at 1 pm), housings starts tomorrow. If you are wondering how it is that housing managed to form a tentative bottom last year, the Fed added about $1 trillion of mortgages to its balance sheet and the FHA went from insuring 2% of the mortgage market in 2006 to 25% (and that number is soon poised to hit 50%). But now those loans are souring and the taxpayer is on the hook, and Congress is finally raising the credit bar with an announcement to this effect likely this week -- see the front page article in today's WSJ: *Souring Mortgages, Weak Market Force FHA to Walk a Tightrope*.

On the earnings front, we have five Dow components and 57 S&P 500 companies reporting – a busy week in particular for the financials (and the rails – watch what CSX has to say today). Rail cargo volumes are down 12 % YoY as of the week ending January 9 and off 28% from the same period in 2008. (Is the economy double-dipping already or did the recession that began in December 2007 never end?) See more on page C1 of the WSJ.

If you want to know how high the bar is for Q4, the consensus is looking for +186% YoY earnings growth. Sales performance and guidance will be key. On this basis, what Borders had to say regarding its holiday experience (the 11 weeks ending January 16) was not so good – revenues dropping 15% and this was not just a market-share loss story because Barnes & Noble reported a 5% drop in sales from November 1 to January 16.

SILVER LININGS

Below we show the latest Commitment of Traders report and we show the net noncommercial long and short positions for a variety of asset classes. It struck us, especially as long-time gold bulls, what little attention silver gets even though the two precious metals are driven by similar developments over time.

The reality is that bullish sentiment on gold right now is infinitely higher than it is for silver; and keep in mind that while gold is the most malleable metal of all (the only metal that will look the same 1,000 years from now as it does today), silver pieces going all the way back to pre-biblical times were the primary medium-of-exchange (fiat paper currency, in the overall scheme of things, is a relatively new phenomenon and a convenient one for politically sensitive central banks). How well known is that up until 1968, silver certificates were redeemable for an equivalent amount of silver?

Since that time, these have been replaced by the Federal Reserve Notes declared as being official Legal Tender and backed by a printing press (now operated by none other than Ben Bernanke, who in four years has managed to create out of thin air 60% of the entire monetary base of the country since the United States was established 233 years ago). And how well known is it that the Coinage Act of 1965 removed all the silver from newly-minted quarters and dimes?

The difference between precious metals and fiat money is that the latter is not backed by any physical asset and as such has no intrinsic value whatsoever – a medium of exchange, perhaps, but backed by nothing except its 'legal tender' status. Keep that in mind when you flip through your wallet (the term 'dollar', as an aside, was not a made-in-U.S.A. development but in fact was adopted from the Spanish dollar which itself was a silver coin from a Bohemian mine).

Silver also is very likely the metal that has the most industrial uses from batteries to mirrors to video equipment, so it is more than just a store of value as gold is. The silver price is more tan 60% below its prior peaks even after the impressive rally of the past year. And when you take a look at where silver trades to gold, which is still flirting near record highs, it would have to triple to get to where gold was in relative terms at the peak back in January 1980 (gold was trading near $740/oz – more than 30% below where it is today – when silver was trading at its record peak back in January 1980 at $45/oz).

Relative to oil, silver could surge 4x from here and it still wouldn't match the prior high in this relationship over three decades ago. Considering the problems that plague every major currency in the world, from the U.S. dollar, to the Yen, to the Euro, to sterling, and knowing from the McKinsey report that the need to monetize the surge in public debt will be required to cushion the economic blow from what will likely be another 5-6 years of deleveraging in the private sector, and given the much more stable supply outlook for silver (all the low-cost shallow mines on the planet have already been gutted) and where it trades relative to gold, not to mention what little attention the metals grabs and how under-owned it still appears to be, exposure to silver, whether it be in bars, coins, ETFs or mining companies, is likely going to be prove to be a very attractive investment in coming years.

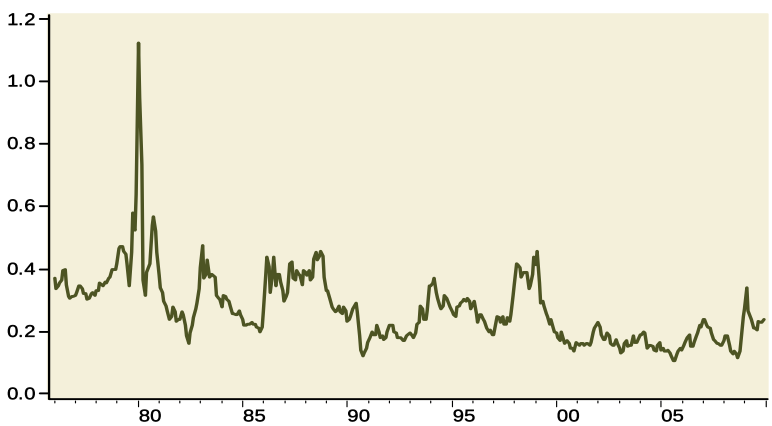
CHART 1: THE SILVER-TO-GOLD PRICE RATIO IN A HISTORICAL CONTEXT

(ratio)

Source: Haver Analytics, Gluskin Sheff

CHART 2: THE SILVER-TO-OIL PRICE RATIO IN A HISTORICAL CONTEXT

(ratio)



Source: Haver Analytics, Gluskin Sheff

WHAT ABOUT THE CANADIAN EARNINGS OUTLOOK?

We ran a simulation with domestic and global growth, as well as commodity prices, and came up with a TSX operating earnings forecast of $710 for 2010. For all the talk about being "perma bears" – quite to the contrary. That would represent a 15% earnings bump over 2009's expected result. The problem, as is the case with the United States, is what is being priced in at the current time. In two words – too much.

Both the average and median one-year forward P/E multiple on the TSX is just over 14x, so our earnings projection would yield a 'fair value' on the Canadian market at around 10,150. That would suggest a current overvaluation of 15%. Even the consensus earnings view of $750 – which would imply over a 20% profits surge this year (highly unlikely in our opinion) would spin out a fair-value index level of 10,725 – nearly 9% overvalued. No matter how you slice it, this is an overvalued market - -perhaps not egregiously so and certainly not as overdone as is the case in the USA, but it is expensive nonetheless.

EARNINGS SEASON TELLING US SOMETHING

Alcoa kicked things off last week by missing with its 1 cent per share earnings gain – the market was expecting something closer to 6 cents. Here we are in an alleged global boom, and this is the best this play on the global economy could muster? After all, from 2003 to 2007, it never did worse than 16 cents a share.

It goes without saying that if the company had put up this number a year ago, the stock would have soared instead of sliding 10% as has been the case over the past week. In fact, when Alcoa printed its 51 cent per share loss in last year's first quarter (release was April 7), it beat estimates by eight pennies and the stock price surged 13% in the ensuing week. And in fact, from the March lows, it had soared 230% right up until last week's earnings report.

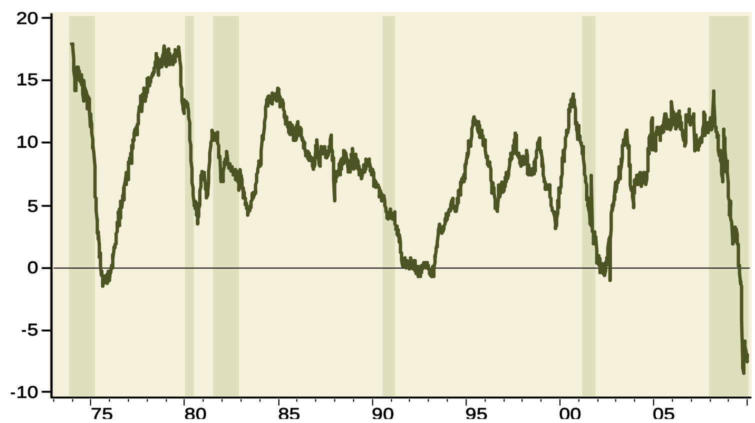
But 10 months and 230% later, the market is expecting more now than just a green-shooty improvement in the second derivative. And the fact that we had two best-of-class companies -- Intel and JP Morgan – see their stock price go down 2% in the session after their recent earnings results is another case in point.

BANK CREDIT STILL CONTRACTING

The numbers for the first week of the year (to January 6th) were not pretty. Total bank lending slipped $18 billion to $6.697 trillion, and has now contracted a massive $642 billion or 9% from the peak of $7.339 trillion on November 14th, 2007. The decline last week was quite broad based – real estate credit -$8 billion; consumer credit -$6 billion; and commercial/industrial loans -$4 billion. Whoever said the credit contraction was over? (Certainly not Mckinsey!)

CHART 3: ONGOING CONTRACTION IN BANK CREDIT

United States: Loans and Leases in Bank Credit: All Commercial Banks
(year-over-year percent change)



Shaded region represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

EARNINGS UPDATE

We've seen about 30 S&P 500 companies report Q4 earnings so far (this week is big week for earnings with 50+ companies reporting, including Goldman, Google, Bank of America, Morgan Stanley and many other financials).

On the earnings side, while it's still very early, results have been good, with the blending growth rate tracking 186% year-over-year as of last Friday, slightly higher than the 184% penciled in last week. Over 80% of the companies beat analyst expectations with the average "beat" coming in at nearly 18% (much better than the 2.1% long-term average). Outside financials, the blended EPS growth rate is at 8% YoY, slightly higher than 7% last week.

Top-line growth has been much softer. Blended estimates for total S&P 500 remain at 7% and ex-Financials are at 1% (no change from last week). In aggregate, companies missed analyst revenue expectations' by 0.4% -- so much weaker than the 18% beat on earnings. Something to watch next week.

We've only seen Q4 guidance so far and companies have guided lower. There have been 79 negative EPS announcements vs 60 positive. With more companies reporting next week, we will be hearing more on Q1 2010 guidance.

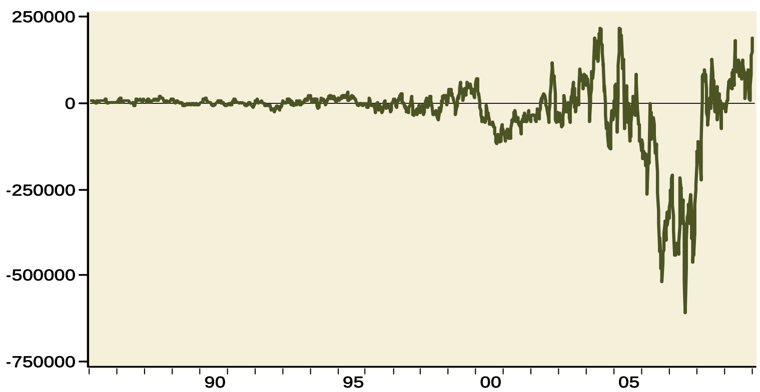
LATEST COMMITMENTS OF TRADERS REPORT (COT)

A look at what the speculators are doing (based on the latest COT report is often a good "contrary" indicator (ie. in terms of assessing what is overbought and oversold).

The bond market looks to be way oversold here. The net speculative short position on the 10-year T-note on the Chicago Board of Trade (futures and options) has surged to 211,515 – the highest since March 29, 2005. A month later, the 10-year note yield was down 40bps.

CHART 4: NET SPECULATIVE SHORT POSITIONS ON 10-YEAR T-NOTE

United States: Net Reportable Noncommercial Short minus Long Positions
(number of contracts)

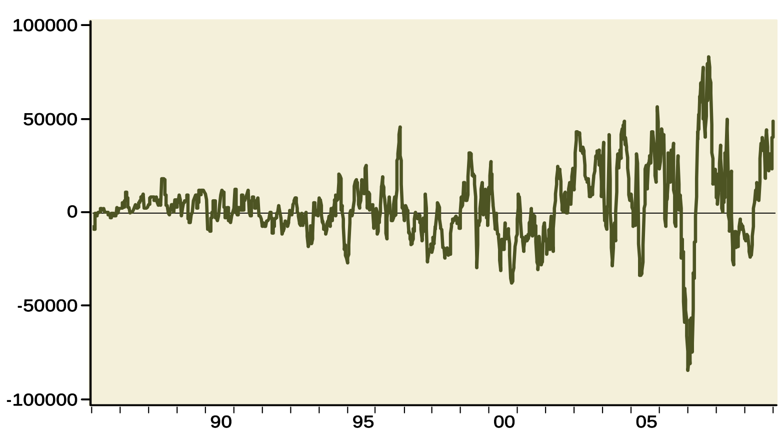


Source: Haver Analytics, Gluskin Sheff

The net speculative long position on the **Canadian dollar** on the Chicago Mercantile Exchange has reached 49,091 contracts (contracts of C$100,000) … the most bullish the noncommercial accounts have been since June 3, 2008. A month later, the Loonie was off 2% (now you know what I mean by being overbought and vulnerable).

CHART 5: NET SPECULATIVE LONG POSITIONS ON THE LOONIE

Canadian Dollar: Net Reportable Noncommercial Long minus Short Positions
(number of contracts)



Source: Haver Analytics, Gluskin Sheff

The net speculative long position in the **Australian dollar** has also surged to levels (59,439 contracts) that were last seen on May 20th, 2008 (was down more than a penny within a month).

CHART 6: NET SPECULATIVE LONG POSITIONS ON THE AUSTRALIAN DOLLAR

Australian Dollar: Net Reportable Noncommercial Long minus Short Positions
(number of contracts)

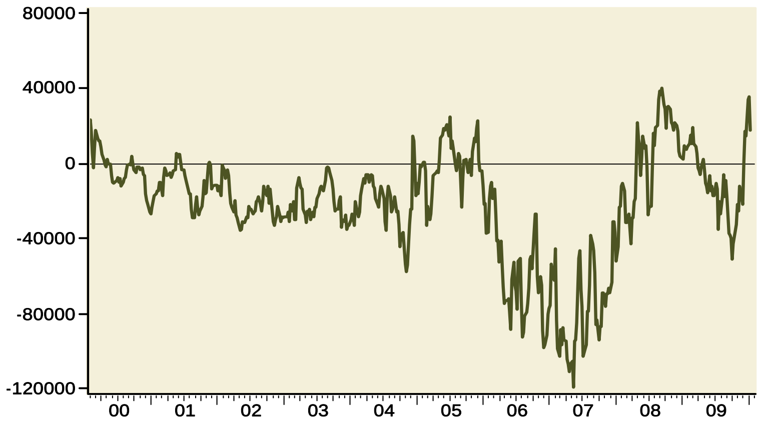
Source: Haver Analytics, Gluskin Sheff

The currencies with a net short position are …

- **Sterling** (35,376) – contracts of 62,500 pound contracts.
- **Japanese Yen** – where the speculators had been net long from July 7, 2009 through to December 22, 2009, have shifted to a net short position of 15,588 contracts (12.5 million Yen), the most negative since August 16, 2008 (in the wake of the new finance minister who favours a weaker yen).
- **Euro** (near-record 15,925 contracts) – contracts of 125,000 euros.
- The net short position on safe-havens like the **Swiss Franc** were closed last week. Could be a sign of things to come for the Yen over the near-term, which is also viewed as a 'defensive' liquid currency.

CHART 7: NET SPECULATIVE SHORT POSITIONS ON THE EURO

Euro: Net Reportable Noncommercial Short minus Long Positions
(number of contracts)

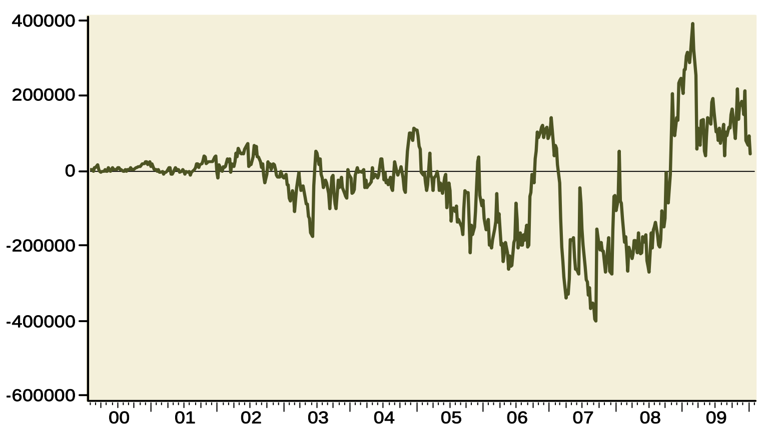


Source: Haver Analytics, Gluskin Sheff

The froth is coming out of the equity market but there is still more work to do on this front. The net speculative long positions in the **S&P 500** (the index X 50) have come down to 42,383 in the past month from 214,869. Similarly, there are still a net 3,852 short contracts on the VIX, though again, these shorts are being unwound gradually as they stood at 18,918 a month ago.

CHART 8: NET SPECULATIVE LONG POSITIONS ON THE S&P 500

S&P 500: Net Reportable Noncommercial Long minus Short Positions
(number of contracts)



Source: Haver Analytics, Gluskin Sheff

Talk about chasing performance --- we haven't seen this much excitement over the **copper price** in five years. The net speculative long position has swelled to 22,332 contracts ($25,000 per pound), more than doubling in the past month, to stand at its highest level since June 21st, 2005.

CHART 9: NET SPECULATIVE LONG POSITIONS ON COPPER

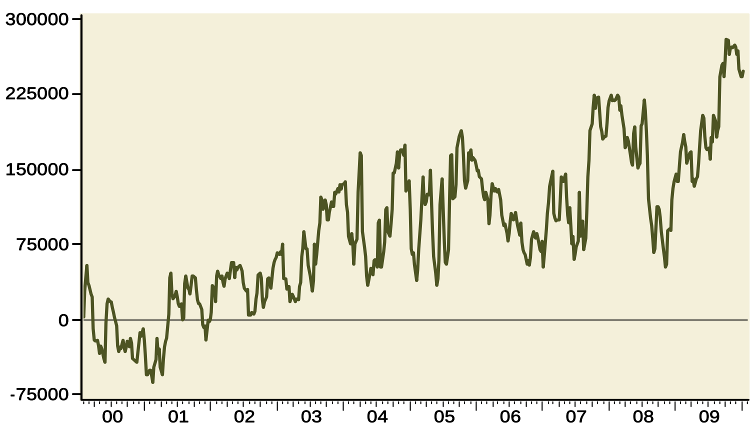
Copper Price: Net Reportable Noncommercial Long minus Short Positions
(number of contracts)

Source: Haver Analytics, Gluskin Sheff

We have been secular **gold** bulls but do have to acknowledge at least a tad of near-term nervousness when we see that the net speculative longs have remained near a record high of 248,300 contracts (100 troy ounce).

CHART 10: NET SPECULATIVE LONG POSITIONS ON GOLD

Gold: Net Reportable Noncommercial Long minus Short Positions
(number of contracts)

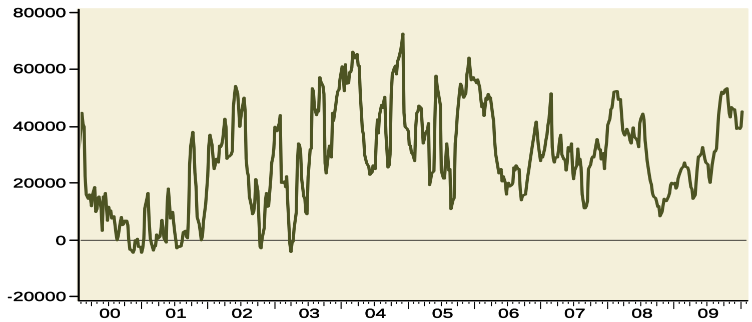


Source: Haver Analytics, Gluskin Sheff

Silver has been of late and may remain over the near-term, a more profitable way to play the bull market in precious metals, considering how less "overbought" it is relative to gold bullion. The net speculative long position is high 45.059 contracts (5,000 troy ounce) but nowhere near the relative highs that have been hit in the gold market.

CHART 11: NET SPECULATIVE LONG POSITIONS ON SILVER

Silver: Net Reportable Noncommercial Long minus Short Positions
(number of contracts)



Source: Haver Analytics, Gluskin Sheff

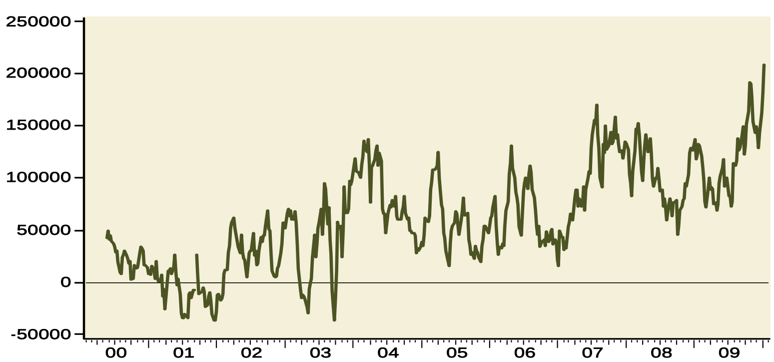
The net speculative long position in **light sweet crude** has ballooned more than 60% in the past month, to 248,360 contracts (1,000 barrels). This takes out the last high set on October 17, 2008 (191,523) and the one before that on July 31, 2007 (169,966).

At that October 17, 2008 high, oil had so much air underneath it that it proceeded to slide 20% in the ensuing month; coming off that July 31, 2007 high in the net spec long positions, WTI was off 8% a month later.

Now compare that huge speculative position in oil to the net SHORT position in natural gas to the tune of 80,424 contracts (10,000 MMBTUs). You have to go all the way back to December 12, 2006, to see the last time the noncommercial accounts were net long nat gas contracts (the price is 25% lower today than it was back then).

CHART 12: NET SPECULATIVE LONG POSITIONS ON OIL

Oil: Net Reportable Noncommercial Long minus Short Positions
(number of contracts)



Source: Haver Analytics, Gluskin Sheff

Gluskin Sheff

Gluskin Sheff at a Glance

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OVERVIEW

As of September 30, 2009, the Firm managed assets of $5.0 billion.

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.

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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.

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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

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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