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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Mixed action in the equity market; Europe up fractionally, but Asia off to a rocky start to the week (-0.5%) — down for three days in a row. The Nikkei closed down 1.1%, to 9,951, and the Hang Seng lost 0.6%, to 19,550. China's Shangai index was roughly flat and the Korean Kospi index fell 0.9% — this cyclical bellwether is now down almost 8% on a year-to-date basis.

Bond yields are flat to modestly higher — the Treasury market is bracing for a record-tying $81 billion of newly-minted notes and bonds in three auctions beginning tomorrow. Gold and commodities are broadly unchanged as well following their recent drubbing, though the resource-based and economic-sensitive currencies like the A$ and the NZ$ are still under some moderate downward pressure. Yuan forwards have also traded down to six-week lows on market chatter that the Chinese government intends to resist currency appreciation so as to underpin exports. (Isn't an export revival part of Obama's economic plan? How can every country pursue this mercantilist goal at the same time?)

Alan Greenspan's comments on Meet the Press are making their way through the morning business media reports (that the recovery "is going to be a slow, trudging thing" … really?). Bond yield spreads between baklava and bratwurst have widened seven basis points this morning to 350bps on news of a Greek civil strike in response to the government's belt-tightening proposals. We can understand the economics community's jubilation over the details of Friday's U.S. jobs report (we were less impressed … surprised?) but if things were so good, it begs the question as to why the G7 finance ministers had to pledge to keep the system flush with fiscal stimulus? It may be because these government officials realize that beneath the veneer of government intervention, there is no impetus at all towards economic growth — funding current growth from future taxpayer pocketbooks is still the only game in town. It's what we call the 'D.R. Horton economy' — everyone was initially so excited about the return to profit growth after the company came out with its earnings numbers last week, until we were reminded what was responsible for the good news — tax breaks everywhere (home buyer tax credits, longer tax-loss carry-backs and the list goes on).

When I was on CNBC's 'Closing Bell' on Friday, we were reminded by the plethora of growth-bulls on the panel that it goes to show that the stimulus is working, a point we wouldn't debate. The more important question is how the economy is going to perform once all this stimulus wears off. The ceiling for government debt ratios is higher in the U.S.A. than it is elsewhere to be sure, but as we are seeing in Europe right now, every country has its limit.

IN THIS ISSUE

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We were scolded on CNBC for not having enough respect for the 5.7% real GDP spurt in Q4, but as we saw with the 3.5% turned 2.2% in Q3, revisions are coming and based on what employment and hours worked performed (negatively) in the fourth quarter, it seems likely that another downward revision will be coming our way. Why do people make such a big deal out of a preliminary data-point anyway, especially when the sample of sector information is so incomplete?

Nearly three quarters of firms that have reported are beating consensus expectations — on average by 13%

Q4 EARNINGS UPDATE

After a busy week of reporting, the fourth quarter earnings growth rate remained at 206% YoY (comprising nearly 65% of S&P 500 companies). Excluding the Financials sector, earnings inched up, to 16% from the previous week's 15% tally.

Nearly three quarters of firms have beat analyst expectations and on average companies are beating expectations by 13%. That is significant, but looking at the market action, seemingly priced in long ago. Revenues, on aggregate, are up 7.0% YoY, unchanged from last week as well. Once Financials are stripped out, the results are less impressive but at least in positive terrain, with YoY growth at 2% (again unchanged).

We also saw more companies issue Q1 guidance last week — 53% of the universe thus far have issued negative guidance versus 52% in Q4 and 40% had positive EPS announcements (versus 40% in Q4). So, this is roughly in-line with Q4 pre-announcements. Analysts expect another great quarter for Q1, with 38% earnings growth — unlike a year ago when "green shoots" provided an upside surprise, today's market has hefty expectations to live up to.

FROM THE SUBLIME TO THE …

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It was almost humorous to read the morning papers today. The front page of the WSJ ran with *Fed to Bare Tightening Plan* and quotes NY Fed President Bill Dudley as saying at *"If the Fed were to raise the interest rate paid on excess reserves, this would raise the price of credit. That, in turn, would limit the demand for credit."* Meanwhile, the Fed's own Senior Loan Officer Survey for the three months to January showed that even as the banks become less tight in their scoring guidelines, household and business demand for credit continues to recede at a discernible rate.

Then, page 15 of the WSJ runs with *G7 Seeks to Calm Market Fears* and the opening sentence reads *"Group of Seven financial leaders sought to downplay the threat Greece's debt woes pose to the financial system …"* — as if these politicians have any credibility. All we can think of was the commentaries coming out of the Fed and the Treasury back in 2006 and 2007 that the problems in housing and mortgages would stay "contained" — imagine that Ben Bernanke's estimate of what the mortgage crisis would cost was something in the order of $150 billion. Thanks for coming out.

Moreover, despite the fact that mortgage debt-to-disposable income has soared to record heights, that urban-area home prices have surged at a rate that is multiples of personal income growth and that the homeownership rate has risen to four-decade highs and now rival where the U.S. was circa 2006, we see this on page B4 of today's Globe & Mail (*Ottawa Says Housing Bubble Not a Concern*) — this is otherwise known as 'whistling past the graveyard' and the byline read *"No Plan to Tighten Mortgage Rules"* (as was the case in the United States, housing is 'motherhood' and once politicians begin to offer the public 'goodies' in this particular sector, it is very difficult, politically, to dismantle the stimulus). Rest assured that when this topic makes it to front page of the WSJ, as was the case today (*Housing Rebound in Canada Spurs Talk of New Bubble*), the likelihood that the bubble started months ago is likely very, very high.

The Canadian housing market makes it to the front page of the WSJ — the likelihood that the bubble started months ago is likely very, very high

WHAT GOES AROUND COMES AROUND

First the governments bail out the banks who were (are) basically insolvent. Then these governments, especially in Europe, see their balance sheets explode and face escalating concerns over sovereign default. The IMF now predicts that the government debt-to-GDP ratio in the G20 nations will explode to 118% by 2014 from pre-crisis levels of around 80%.

Now, the ball is put back onto the banks because many have exposure to the areas of Europe that are facing substantial fiscal problems right now. According to the Wall Street Journal, U.K. banks have $193 billion of exposure to Ireland. German banks have the same amount of exposure and an additional $240 billion to Spain. Many international bond mutual funds also have sizeable exposure to sovereign debt of Portugal, Ireland, Greece and Spain as well. Contagion risks are back. Stay defensive and expect to see heightened volatility.

In a nutshell, toxic assets have basically been swept under the rug in the hopes that we will outgrow the problem. Leverage ratios across every level of society are still reaching unprecedented levels as the public sector sacrifices the sanctity of its balance sheet in its quest to stabilize the dubious financial position of the household and banking sectors in many parts of the world.

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Whatever bad assets have been resolved have almost entirely been placed on the books of governments and central banks, which now have their own particular set of risks, as we have witnessed very recently in places like Dubai, Mexico, and Greece, not to mention at the state and local government level in the United States. We simply have not seen a reduction in the percentage of properties with mortgages that are "under water", hence the FDIC has identified 7% of banking sector assets ($850 billion) that are in "trouble", so how can it possibly be that the financial system is anywhere close to some stable equilibrium?

When accurately measured, including the shadow inventory from bank foreclosures, there is still nearly two year's worth of unsold housing inventory in the United States, and commercial vacancy rates are poised to reach unprecedented highs, and this excess supply is bound to unleash another round of price deflation and debt defaults this year. The balance sheets of governments are rapidly in decline across a broad continuum, and it is particularly questionable as to whether Europe is in sound enough financial shape to weather another banking-related storm.

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The global economy is set to cool off. Not only is China and India warding off inflation with credit tightening measures but most of the fiscal and monetary stimulus thrust in the U.S.A. and Canada is behind us as well. And, the fiscal tourniquet is about to be applied in many parts of Europe, especially the PIIGS (referring to Portugal, Ireland, Italy, Greece and Spain — these countries account for a nontrivial 37% of Eurozone GDP). Greece's GDP has already contracted by 3.0% YoY, as of Q4, and is expected to contract 1.1% in 2010 and 0.3% in 2011 as a 13% deficit-to-GDP ratio is sliced from 13% to 3% (assuming this fiscal goal can be achieved politically). Portugal has a 9.2% deficit-to-GDP ratio that is in need of repair and Spain has a deficit ratio that is even worse, at 11.4% of GDP.

The bottom line is that even if the fiscally-challenged countries of Europe do not end up defaulting, or leaving the Union, the reality is that they will have to take draconian measures to meet their financial obligations. Devaluation was the answer in the past in Greece but it cannot rely on that quick fix this time around without leaving EMU and if it did, then that could make it even harder to service its Euro-denominated debts — at least not without a restructuring. And, if Greece did attempt at a debt restructuring, rest assured that Italy, Spain, Portugal and Ireland would be next — we are talking about a combined $2 trillion of potential sovereign debt restructuring that would more than triple the $600 billion direct cost of the Lehman bankruptcy.

This poses a hurdle over global growth prospects at a time when Asia will feel the pinch from the credit-tightening moves in China and India. And heightened risk premia will also exert a dampening global dynamic of their own in terms of economic decision-making by businesses and households alike. The intense sovereign risk concerns are not limited to Europe either. In the U.S.A. we saw CDS spreads widen out to their highest levels since the equity markets were coming off their lows last April. According to the FT, the Markit iTrax SivX index of CDS on 15 western European sovereign credits rose above 100bps on Friday for the first time ever.

HOW TO INVEST AROUND A US DOLLAR RALLY

This massive reduction in risk appetite has triggered a flight to safety and liquidity, which in turn means the USD, has been a major beneficiary from all this uncertainty. On a trade-weighed basis, the greenback has firmed to seven-month highs, and this also has implications for how to be positioned in other asset classes.

For example, this is the primary reason why gold has succumbed — selling by hedge funds closing out long positions and outflows in ETFs as well; though the yellow metal has hung in well relative to other commodities and is still range-trading in most other currencies.

Copper, meanwhile, sank 6.5% last week and on heavy trading volumes and crude oil broke below its 200-day moving average. We seem to recall warning that the U.S. dollar had moved to a huge oversold level late in 2009 and to extend a countertrend rally that could cause a short-term reversal in the basic materials complex — where we are still secular bulls. But nothing moves in a straight line and this is more than just a countertrend rally in the greenback — having broken all its major averages in recent weeks. Be positioned accordingly.

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Since the onset of the credit crisis in 2007, there have seen three occasions when a surge in risk aversion caused a period of U.S. dollar strength on flight-to-safety trades — July 15, 2008 to September 11 2008 (around the GSEs); September 22, 2008 to November 21, 2008 (post-Lehman financial collapse) and then from December 17, 2008 to March 5, 2009 (the final leg down in the financials). Here is what happened, on average, during these dollar-rally episodes — ultra-defensive strategies and heightened volatility:

- The DXY (U.S. dollar index) rallied an average of 12.3%.
- During these episodes, the Canadian dollar sank 11% against the U.S. dollar, but was only down 1.9% against a basket of non-U.S. currencies.
- The S&P 500 corrected an average of 18.5%. Underperforming S&P equity sectors included materials, energy, industrials and financials. Outperformers included utilities, staples, health care, tech and telecom.
- Despite the downdraft in commodities, the TSX performed in line with the S&P — losing 18%.
- In the TSX sectors, the winners and losers were different than in the U.S.A.: Financials and industrials actually outperformed. Only materials and energy seriously dragged down the Canadian market. As in the U.S., staples, health care, utilities, tech and telecom outperformed. Outside of resources, the TSX sectors actually outperformed their S&P comparable.
- Still, it pays to note that we are talking about "relative" performance. Every equity sector on both sides of the border was down during these periods.
- The oil price, on average, fell 26%, and gold was off an average of 11%. The CRB index corrected an average of 22%.
- The VIX index surge an average of 34% during these U.S. dollar-rally episodes.
- We saw a bull steepening in the bond market — 2-year T-note yields plunge an average of 36bps while 10-year T-note yields dipped 8bps.
- Baa corporate spreads widened an average of 54bps; and by 268bps for high-yield bonds.

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EMPLOYMENT BACKDROP STILL SLUGGISH

With the recent revisions to the U.S. employment data, the total job loss during this recession was 8.4 million

With the revisions, we now know that the total job loss in this recession was 8.4 million. It would take eight years of 200k monthly gains just to recoup this decline, adjusting for the growth rate in the workforce. At least we know that the next inflation cycle is eons away.

The drop in the unemployment rate to 9.7% is very misleading since the number of discouraged workers rose 137k in January, to 1.1 million. What is key is that the economy still shed 20k payrolls and normally at this stage of the cycle, nearly two-and-a-half years after the first Fed rate cut, the economy is already generating at least 150k net new jobs, month-in, month-out. Hopefully this puts a minus-20k payroll figure into its proper perspective. As an aside, TrimTabs adjusts the jobs data using income tax receipts and its metric shows that employment contracted by 104k in January.

Of course, there are economists out there who see that temp agency jobs going up 52k and the rise in the workweek as "leading indicators" of future job creation because these measures worked in the past. But this is a different cycle than its other post-WWII predecessors — a credit contraction and wealth destruction cycle of massive proportions. Businesses have adjusted their order books, production schedules and staff requirements in line with a level of overall private sector credit that is $1 trillion smaller now than it was a year ago. And, as we saw in December with the $2.7 billion decline in consumer credit (11th contraction in a row, the longest stretch since the records began in 1943) this deleveraging cycle is ongoing. It may well be the case that temp agency employment and the workweek adjustments have actually become new cost-efficient strategies to manage the labour force in this new paradigm of credit contraction rather than traditional "leading barometers" of job growth. This is the time to think out-of-the-box and not to rely exclusively on relationships that worked in past cycles that basically have little in common with today's post-bubble economic and financial realities.

We have been saying for some time that a well thought out strategy needs to be implemented to deal with the jobs crisis — a strategy that transcends 'quick fixes' like a return to the questionable tax credits under the Jimmy Carter era. What we have in mind is something like an Eisenhower plan of the 1950s (highways), Kennedy in the 1960s (space) and Reagan in the 1980s (defense) that involves job creation linked to some sort of lasting infrastructure enhancements. This is why Bob Herbert's op-ed piece in the Saturday NYT is so relevant (*Time is Running Out*): *"A new, saner more sustainable economy will have to be more export-oriented, powered by cleaner fuels, bolstered by innovation that comes from a renewed focus on research and development, and committed to delivering a better-educated, more highly skilled work force."*

VALUATION MATTERS

It may well pay to have a read of the Long View column in the weekend FT and the discussion around the Shiller cyclically-adjusted P/E ratio, which bottomed at 5.8 in 1932, 6.8 in 1982 and 13.3 in 2009; and even normalizing for tax changes, the gaps between 2009 and the other troughs in 1932 and 1982 are just as glaring. Something tells us — probably nothing more than common sense — that the secular bear market in equities will not come to its final conclusion until the Shiller P/E breaches the 10x threshold to the downside.

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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 $10.7 million[2] on December 31, 2009 versus $5.5 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 $11.7 million USD[2] on December 31, 2009 versus $9.2 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.

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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:

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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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