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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

The equity market has become near-term oversold and we do have month-end technical considerations, so it is not surprising to see stock markets recovering today. After all, the just-released AAII poll showed a huge 9.9 point slide in bullish sentiment to 36.6%, which is actually below the long-run norm of 39%; and the bear share rose 10.6 points to 36.1% so all it took was a few days of decline to throw a scare into a whole lot of folks.

Yes indeed — markets do not generally move just in one direction as was the case with the nonstop QE2-induced rally since last fall. But we do finish the week with the risk aversion trades that have recently dominated seeing some profit-taking — bond prices, credit default swaps, the Swiss franc, Japanese yen, oil and gold, the classic safe havens, are all lower overnight. While the focus has been squarely on the Middle East and North Africa, don't forget that Irish voters head to the polls today — and for a country with a 13%+ unemployment rate, what hangs in the balance is possible debt default (or what is otherwise known as a "restructuring").

What seems to be clear is that the tenor of the global economic recovery is undergoing a bit of a change here, and not for the better unfortunately. Then again, in the U.S.A., growth projections on the economy have almost doubled since last November to nearly 4% for current quarter GDP. How can you possibly improve on perfection? But all of a sudden, while the manufacturing diffusion indices are still decent, the data on new home sales, real estate prices (resale values down to 2002 levels) and durable goods orders do offer up some cause for pause.

We also see that business confidence in China dropped in February, the fifth month in a row, and consumer confidence there declined in Q4 for the second quarter in a row. It would seem as if the credit tightening moves, as incremental as they have been, are starting to percolate. At the same time, protests are not being limited to just Greece and Bahrain, but even in the U.S.A. we are seeing the unions now out in full force in Michigan and Wisconsin. Limiting collective bargaining rights may be a bit extreme but given the current near-insolvent backdrop, the Governors need to take some draconian action because bankruptcy is not an option.

IN THIS ISSUE

Gluskin Sheff

Few economists we read have much fiscal drag in this year's macro forecasts and that could end up being a critical error. At the same time, one has to wonder what businesses are thinking when the trend in core capex orders and shipments start the year in decline — hopefully that is not more than a weather report (see more below). It is also worth contemplating what it means to have a tech giant like HP cut its revenue forecast for the entire year — that is not the news a stock market bracing for 15% profit growth for 2011 wants to hear, that much we are certain of. While the jobless claims trending down is a good sign that the pace of firings is abating, there is scant evidence of a significant pickup in new hirings. The excess supply of labour in the U.S.A. may be as understated as much as the official home sales data (as we now find out) have been overstated.

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The IBD/TIPP poll of American adults that was just published showed 35 million American households — 28% of the universe — which have at least one member looking for work right now. This translates into a job-seeker rate of 23%, which is one reason why, unlike the 1970s, the surge in energy and food prices are highly unlikely to get passed on to Mr. and Mrs. Consumer for very long, if at all (good luck to the airlines). Households deemed to be "job-sensitive" — those with at least one job seeker or a household concerned about layoffs — now total 47%. That should shed some light on the recent consumer sentiment surveys, which have been lately driven by the wondrous gains in the Bernanke-led equity market rally than any meaningful improvement in the labour market.

I have to say that it is amazing how myths become so quickly promulgated in the financial industry. First, it is now taken as a given that the Saudi Arabian political regime will remain intact because surveys show how well loved the King is and how great it is to see the population now being bought off with $36 billion of fiscal assistance from the Royal Family. As if the population is going to be bribed into trading in economic freedom for fiscal transfers, especially if the large Shiite population sees democratic concessions take hold in neighbouring Bahrain (where most of the people are Shiites, many from Iran, and ruled by the Sunnis).

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Second, this emerging view that Saudi Arabia can just step in and replace Libyan oil seems totally off base, as a loyal subscriber informed us yesterday, it is not so simple. The reason: Libya's crude is a perfect feed for ultra low sulphur diesel. The oil Saudi Arabia would supply to replace, it is not. Apparently you need three barrels of Saudi crude to get the same number of barrels of diesel you could get from one Libyan barrel. Further, the Saudi crude is very high in sulphur. The refineries that process the Libyan crude cannot remove the sulphur. The question is what happens if we lose Libyan crude and if strategic stocks are not released (1.6 billion barrels I believe) — then $150/bbl is certainly not out of the question and that is before we start talking about Algeria.

Third, the view that the economy will escape relatively unscathed is another pie-in-the-sky view from Wall Street research houses that we heard not just in 2007 but through the first nine months of 2008 when the recession was in full flight. If economic research houses were already assuming say $80 oil for the year, and now we are heading to $100, then right there that subtracts one percentage point off real GDP growth. If WTI follows Brent to $120/bbl, then we are talking about a two percentage point drag on the pace of U.S. activity. As it stands, about half of this quarter's fiscal stimulus from the payroll tax cut has been wiped out by what is happening at the pumps. For the rest of the year, between the moderate spending cutbacks being proposed by the Republicans and the accelerating fiscal restraint at the state and local government levels, we could easily be talking about an additional one to two percentage point drain from real growth.

About half of this quarter's fiscal stimulus from the payroll tax cut has been wiped out by what is happening at the pumps

With nominal bond yields falling of late but inflation expectations modestly higher, there has been a visible decline in real interest rates. Since real interest rates necessarily equate to the marginal productivity of capital, perhaps it is therefore not going to be a big surprise to see real capital spending slow down from last year's double-digit rate, notwithstanding record cash on the balance sheet and the bonus depreciation allowance. Start looking for the trend towards consensus growth upgrades we saw take hold last fall to reverse course and along with that a broad investment thrust towards capital preservation strategies, and here are strategies that we like:

- Relative value strategies (true long-shorts hedge funds)
- High quality stocks over low quality stocks
- Dividend yield and growth, including Canadian banks
- Defensive growth over non-resource cyclicals
- Oil and gas equities
- Large cap stocks over small caps stocks
- Low P/E stocks over high P/E stocks
- Corporate bonds
- Precious metals — accumulate on dips
- Ongoing overweight to Canada and the Canadian dollar
- Hybrid funds that carry a yield better than one can get in the government bond market and with low beta to the overall stock market.

WHAT REALLY DRIVES THE MARKET?

Well, we use to say there were four key drivers:

1. **Fundamentals**
2. **Fund flows**
3. **Technicals**
4. **Valuation**

Then we introduced another one last week:

5. **The Fed's balance sheet**

Now that is not going to be included in any of the Graham & Dodd textbooks, that is for sure. But since Dr. Bernanke embarked on his non-traditional monetary maneuvers two years ago, there has been an 86% correlation between the S&P 500 and the movement in the Fed's balance sheet. No wonder St. Louis Federal Reserve Bank President Bullard is opting for QE3 — he's probably long the market!

And now there is a sixth:

6. Corporate earnings surprises

Yes, this works with a 90% historical accuracy rate. For example, we went into 2008 with consensus S&P 500 EPS forecasts at $102.67 and finished the year at $65.47. The S&P 500 was down 39% that year. Then we went into 2010 with the consensus at $77.71 but instead we got $84.60 and the market rallied 13% point-to-point. The only year in the last 10 that this metric didn't work was 2009, which was a completely bizarre year with an economic detonation and market plunge in the first several months of the year followed by a policy-induced bounce-back of historical proportions in the second half.

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HEADWINDS AHEAD, SIX TO FOUR

Let's make no mistake about the headwinds facing the U.S. economy:

- Declining home prices
- Contracting bank credit
- Listless jobs market
- Soaring oil prices
- Accelerating spending cuts and tax hikes at the state/local government levels; the Fed is about to follow suit on the spending side
- Policy tightening overseas and impact on domestic demand and U.S. export picture

The tailwinds:

- Lagged impact of last year's fiscal stimulus announcement
- Quantitative easings
- Strong corporate balance sheets
- Manufacturing renaissance

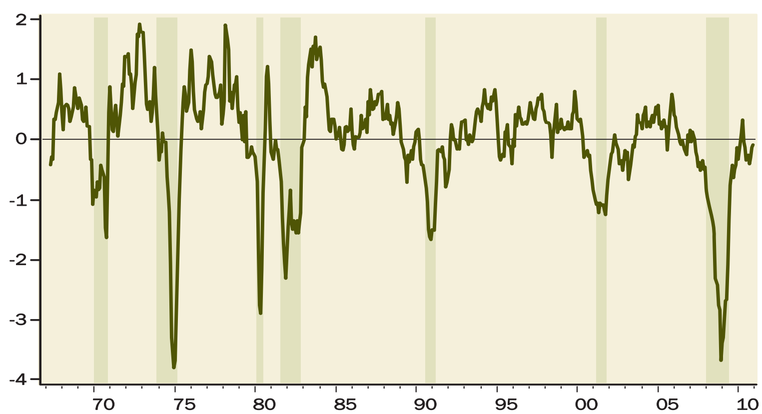
I don't know but if I was keeping score, it would be the headwinds in the lead by a score of six to four.

CHICAGO FIRE?

The Federal Reserve Bank of Chicago publishes a monthly National Activity Index (NAI) that covers the entire economy — as close to a monthly GDP proxy as you can get. The NAI swung to -0.16 in January from +0.18 in December and has been below zero now in five of the past six months. The Chicago Fed urges us to look at the three-month smoothed NAI as the data can be volatile and on this basis it came in at -0.10 and has been negative for eight months in a row. During the double-dip scare last August it got as weak as -0.35 — anything worse than -0.70 and the chances are good that the economy is heading back into recession, so we came close six months ago but not quite. But between 0 and -0.70, where we are now, the economy is expanding but at a below trend pace, which itself is highly unusual considering all the government-administered steroids that have been applied. It does also go to show that basing your assessment on how the economy is really doing just by focusing on the possible macro message from a liquidity-induced speculative rally in the equity market may not be the most ideal strategy.

CHART 1: THE INDEX HAS BEEN NEGATIVE FOR EIGHT MONTHS

United States: FRB Chicago National Activity Index
(three month moving average, + indicates growth above trend)



Source: Haver Analytics, Gluskin Sheff

HOUSE OF CARDS

The one thing we were remiss in saying yesterday as we trashed the existing U.S. home sales data was that the resale numbers are really deals that closed three-months ago so they tend to be a lagging indicator. Now the January data always have to be taken with a grain of salt after seasonal adjustment but there was nothing really glaring in yesterday's figures on new home sales. The "raw" (not seasonally adjusted) data showed a whopping 13.6% MoM decline. Going back to 1963, not once have we ever seen a decline in January of that magnitude, and that covered plenty of storms, sleet and hail and some doozy recessions too. In fact, January is usually an up-month for new home sales despite the typically lousy weather; it is to smooth over the typical weakness in December as everyone is in the shopping malls that month instead of signing deals with their real estate agents. So what is normal is that new home sales rise 13% in

January; this time around they fell a record 13.6%; and that means "seasonally adjusted", new home sales plunged 12.6%, and that works out to be a decline of 80% at an annual rate.

Supposedly we are in the 20th month of a recovery and by this time, what is "normal" is that new home sales are up 27% by now and currently they are down 28% from the time this fragile expansion began in mid-2009. Never before have new home sales been down this far into an expansion before — until now. At 284,000 housing units at an annual rate, sales are now the sixth lowest they have ever been. Nice to see QE2 doing its job to help out the housing market!

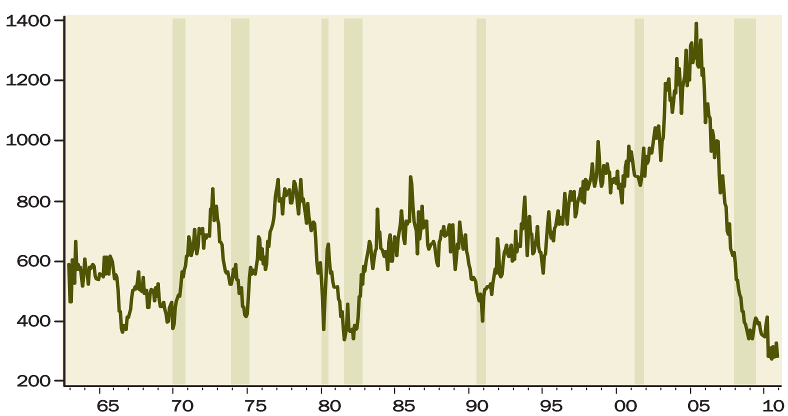
Now to be fair, the decline in January was centered in the West where sales sank 36.5% but that was after a 62.5% surge the month before and the giveback reflected the expiry of California's homebuyer tax credit (as if the state can even afford something like that). So what happened here at the national level with this distorting effect is that 93% of the surge we saw in December was reversed in January and the 284,000 units last month are barely higher than the 281,000 tally in November.

With mortgage applications for new home purchases down 2% through the first three weeks of February compared to the January average, we can probably expect another decline in new home sales, perhaps to a new record low.

There was little change in the backlog of unsold new homes for sale so the inventory situation worsened to 7.9 months' supply from 7.0 months in December. As in the market for existing homes, this remains a buyer's market. Average new home prices plunged more than 10% in the month and there is likely more discounting ahead too.

CHART 2: NEW HOME SALES PLUNGED

United States: New One-Family Houses Sold
(seasonally adjusted annual rate, thousands)



Source: Census Bureau, Gluskin Sheff

CAPEX CRUNCHED?

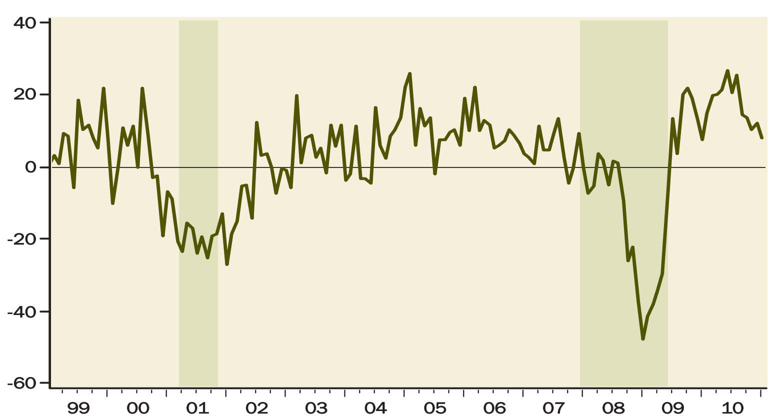
One of the lynchpins for the near 3% real GDP growth rate we saw last year in the U.S.A. was in capital spending — a 15% expansion in volume terms. Well, despite the bonus depreciation allowance announced late last year in a bid to ensure that companies are incentivized to spend (as if a record cash stash on the balance sheet isn't incentive enough), we got off to a very poor start to 2011. In a big surprise to the consensus, core capex orders (non-defense capital goods excluding aircraft) tumbled 6.9% MoM in January in what was the steepest decline since the economy was knee deep in recession back in January 2009. There were big and broad-based declines in tech, electrical equipment and old-economy machinery. Only the metals sector posted gains. The six-month trend on core capex orders has been trimmed to an 8% annual rate — still positive to be sure — from 26% last summer.

Core shipments were also down 2.0% MoM to kick off the year and the "build in" for Q1 is flat, which is not good news at all for a consensus that believes we will be seeing 3.5% real GDP growth this quarter. Our current tracking of U.S. Q1 real GDP is closer to 3%.

Keep in mind the consensus is also well north of 3% for Q2 and the fact that we have a -12.5% "build in" for core capex orders this quarter means that without a rebound we could be looking at an even weaker profile for business capital spending in the second quarter.

CHART 3: CORE CAPEX ORDERS TUMBLED

United States: Manufacturers' New Order – Non-defense Capital Goods excluding Aircraft
(six month percent change annualized, seasonally adjusted, $ millions)



Shaded regions represent periods of U.S. recession
Source: Census Bureau, Gluskin Sheff

Gluskin Sheff at a Glance

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

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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 million[2] 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 USD[2] on December 31, 2010 versus $10.6 million USD for the S&P 500 Total Return Index over the same period.

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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

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