

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

As we said yesterday, either the stock market was going to pierce the January highs ... or endure a failed test. So far it looks as though the buying power has subsided, or at the very least an overvalued market is facing a reality check. Not that it is a bad thing that the consensus believes we have finally entered the holy grail of job creation, but that something pretty good had to have been priced in with a 70% rally occurring alongside a net job plunge of 3.3 million.

So, what we see overnight is a whole lot of profit-taking in the global equity markets, the U.S. dollar and the Yen are firming while the U.K. pound has slid to a 10-month low (part and parcel to risk aversion trades); corporate bond risks, as per CDS spreads, are back on the rise; oil is trading lower and gold is retesting its 50- and 100-day moving averages to the downside; bonds, in the meantime, are rallying across the board.

There were no economic data releases overseas, but what there was in the U.S.A. were mixed. The Manpower hiring intentions survey showed some vigour with 16% of companies polled saying they intend to hire in Q2 while 8% said they are still in job-shedding mode. The net 8% to the positive side of the ledger was the most since the records began in 1972.

At the same time, the National Federation of Independent Business (NFIB) small business sentiment index faltered in February, dropping to 88.0 from 89.3. The index measuring expectations for the next six months dropped to its lowest level since, dare we say, last March. (Maybe the Manpower survey forgot to survey small companies, which, after all, account for two-thirds of the job market pie.)

Speaking of last March, the media are all over the fact that today is the one-year anniversary of the 12-year low in the stock market reached on March 9, 2009, when the S&P sagged to that diabolical 666 level. (Funny how nobody celebrates October 9, which is the anniversary of the 1,565 high set back in 2007.) A lot has changed over a year, and that includes the factors that have supported the recovery in the equity market:

- The VIX was 50, not 17.
- The yield on the 10-year Treasury note was 2.9%, not 3.7%.
- The budget deficit was \$900 billion, not \$1.5 trillion.
- Baa spreads were 540bps and tightening, not 260bps and widening.
- The market was 20% 'cheap' as per Shiller P/E ratio, not 25% overvalued.
- The DXY was at 90 and depreciating, not 80 and appreciating.
- Oil was at \$47/bbl, not \$82/bbl (we can see \$80+ crude being good for the Saudi market; we're not sure how it fits in bullishly to the S&P call).
- Equity PM cash ratios were at 5.5%, not 3.6%.

IN THIS ISSUE

- While you were sleeping — we are seeing a whole lot of profit-taking in the global equity markets; the USD and the Yen are firming, while the Pound is hitting 10-month lows; no data overseas, but early data releases in the U.S. were mixed
- Some market thoughts — As everyone talks about 1,200 as the next stop for the S&P 500, we are finding it fascinating how eerily similar this low volume, divergent rebound is to what followed the initial July 2007 sell-off
- Credit contraction continues — looking at the consumer credit data, we are seeing that the revisions to the data over the past two months paint a much different picture of the level of improvement
- Canadian housing market — supply catching up

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- Market Vane bullish sentiment was at 32%, not 53%.
- Real GDP was -6.4%, not +5.9%; and the ISM was 36, not 57 (we were in the basement looking up, not on the rooftop looking down).

Enough said. This market has come a long way. It was not until September 2006, nearly four years into the last bull market, that the equity market managed to rise this far off the lows. This time it has taken less than 12 months.

While it is fashionable to look at how little the market has retraced its peak to trough declines and instead look at the market in that perspective in terms of potential future gains, recall that at the 'peak' of the last cycle, there was so much leverage underpinning corporate earnings that 40% of the profit pie was being influenced by financial activities. There was so much air at the 1,565 peak that it is almost unjust to do any real analysis from such a fictitious high. (There was a reason why one of the most moderate economic growth cycles of all time managed to see profits as a share of GDP soar to its highest level in five decades back in 2008 – it's called financial engineering.)

The reality is that as the fluff was written down, reported earnings slumped 90% in the bear market and the S&P 500 dropped 60%. This is why the market bottom occurred a year ago with valuations at stretched levels relative to previous troughs. What changed were the rules of engagement as the Fed blew out its balance sheet in support of the mortgage industry, the government guaranteed the survival of the large banks, the shorting industry was sharply curtailed and the banks were allowed to hide losses again on their illiquid assets via accounting changes that were foisted onto the SEC from Congress in the name of saving the system. And of course, a government deficit that is now running at a record \$1.5 trillion, and the spending to get the economy going has been so acute that even if revenues had not gone down with the economic turndown, the budget gap would still far exceed the \$1 trillion mark.

If the bulls have a retort, it is that in the post-WWII era you have to go back to 1947 to find the last time that there was no follow through from year-one to year-two of a bull run. Well, maybe that is what we have to do in a post-bubble credit collapse where the economic growth is being dictated primarily by state capitalism ... go back to 1947, or before.

In a nutshell, it comes down to valuation. Are you willing to outbid everyone else at the auction for the Ford Focus? Today's WSJ has an interesting debate between Jeremy Siegel (bull) and Robert Shiller (bear) on the appropriate valuation metrics to deploy. The WSJ, usually an optimistic read, settles the score by invoking the work Boston-based Ben Inker, who relies on margins and corporate cash flows. Based on this particular model, the S&P 500 is currently overpriced to the tune of 20%, which makes fair-value around the 900 mark (what our research also shows).

The U.S. stock market has come a long way. It was not until September 2006, nearly four years into the last bull market, that stocks managed to rise this far off the lows...

... This time around, it only took 12 months to surge to 70% off the lows

According to a model by Boston-based Ben Inker, and reported by the WSJ today, the S&P 500 is currently overpriced to the tune of 20% ... similar to what our research shows



As we said before, it will be interesting to see where the next round of buying for equities will come from. The general public has been selling into the rallies. So have corporate insiders. Portfolio managers have their cash ratios near record lows and foreign investors have been minor participants. Have a look at the front page article of today's NYT — half of U.S. corporate pension funds are re-allocating from equities towards fixed-income (*Public Pensions Are Adding Risk to Raise Returns*). Indeed, it is State governments, who have massive fiscal deficits to close, and are busy adding risk to their pension funds (lord help us). They are still assuming average 9.5% returns in equities (and 5.75% in bonds) despite the fact that the trend in nominal GDP definitely augurs for nothing less than a 5-6% range for the future. And, many are still locked into a 60/40 asset mix middle (stocks/bonds) despite the realities of a post-bubble deflationary world.

MARKET COMMENT

As everyone talks about 1,200 on the S&P 500 as the next stop, what we find fascinating is how eerily similar this low volume, divergent rebound is to what followed the initial July 2007 sell-off. Again, there was a flashy low volume rally, with the secondary indexes making new recovery highs in September-October 2007, just before the break. And back then, as is the case now, portfolio managers were sitting on 3.6% cash, sentiment readings were bullish and the VIX index was a teenager.

There is this illusion that we are in a sustainable recovery, but instead what has happened is that the government fooled the public by printing massive amounts of money and expanded the Fed's balance sheet to levels nobody ever thought could be possible. Meanwhile, all the problems in State budgets are being ignored, as are the huge numbers of either empty houses or houses where the owners are not paying their mortgages, not to mention the changes in some basic accounting rules to help banks hide their losses.

Now back to employment. When jobless claims were at 470k, on a four-week moving average basis, in the last cycle, we were losing over 200k payrolls and the markets were puking. The economy was not generating employment on a consistent basis until claims broke below 400k in the summer and fall of 2003. There is a bit of a disconnect but remember the size of the last benchmark payroll revision — private nonfarm jobs in the Household survey have fallen 192k on average in the past six months (and down 89k in February). Not a number that you will find reported anywhere.

What is important is that with all the fiscal and monetary stimulus, which have been in place for more than two years, together with the recent boost from inventories, there has yet to be a turn in terms of positive payroll prints. The fiscal withdrawal from growth in the second half of this year and the boost from inventories is fading. So, if productivity does not collapse, what happens to payrolls?

It will be interesting to see where the next round of buying power for equities will come from

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CREDIT CONTRACTION CONTINUES

It's fascinating to watch this game when it comes to the release of the Fed's consumer credit data. The numbers for December, which came out on February 5, came in far better than expected – falling only \$1.7bln in December versus expectations of -\$10.0bln. At the same time, the November figure, to very little fanfare, was revised to -\$23.9bln from -\$17.5bln initially. And last then this past Friday, December consumer credit was revised lower, by \$2.9bln, to now show -\$4.6bln from -\$1.7bln initially. Hmmm. So what we have here are the revisions in the data over the last two months painting a much different picture of the level of improvement.

We don't like to appear as conspiracy theorists, but if you recall, the equity market bottomed on February 5 on two pieces of news that triggered a significant intra-day reversal. The first was the initial hints of an EU rescue plan for Greece. Later in the day, December's consumer credit data were released, showing a modest decline of \$1.7 billion versus the estimate of a \$10 billion contraction. When you take into account the downward revision to November, what comes out of the wash is a December level of consumer credit outstanding that is was actually \$6 billion lower than expected. But obviously not the way the data are being treated by Wall Street research departments or the media for that matter. Finally, with last Friday's number, December was revised down an additional \$3 billion as mentioned above. Hence, December's number, which originally helped turn the market around, was \$9 billion lower than November, versus the original release of -\$1.7 billion.

One other thing, revolving credit slid \$1.7 billion in January and the level, at \$864.4 billion, is now the lowest since October 2006. This is key and attests to the lingering consumer frugality theme.

Moreover, the government was the sole supplier of funding that actually showed an increase in consumer exposure. All the gain was in federal government loans, they surged more than \$10 billion and this was a student loan program being offered by the federal government. Every other lender – commercial banks (-\$5.5bln), credit unions (-\$1.4bln), ABS pools (-\$1.1bln), savings institutions (-\$500mln), nonfinancial business lenders (-\$1.9bln), and finance companies (-\$3.9bln) each posted declines in outstanding credit during the month. So, the credit contraction is far from over despite the illusion of the headline number.

In addition, it was also interesting to see how the 'seasonal adjustment factors' helped skew the data. On a raw basis, consumer credit outstanding fell \$3.8 billion in the second steepest January decline in the past eight years and somehow this was translated into a \$5.0 billion increase on a 'seasonally smoothed' basis. Right.

Revolving consumer credit (credit cards) slid \$1.7 billion in January and the level, at \$864.4 billion, is now the lowest since October 2006...

... This is key and attests to the lingering consumer frugality theme

Meanwhile, we have more data through the last month on lending and borrowing behaviour and they fit very nicely into our ongoing credit contraction theme. Total bank credit falls \$20.0bln in the latest reporting week (February 24); this is on top of the \$38.1bln decline the prior week. The declines in credit are dramatic and remain broad based:

- Total loans and leases in bank credit: -\$12bln, on top of the \$29.7bln drop seen the prior week.
- C&I loans: down \$4.4bln, \$7.3bln the prior week.
- Real estate loans: down \$15.0bln, \$31.1bln last week.
- Consumer loans: down \$2.3bln, on top of the \$5.1bln decline last week.

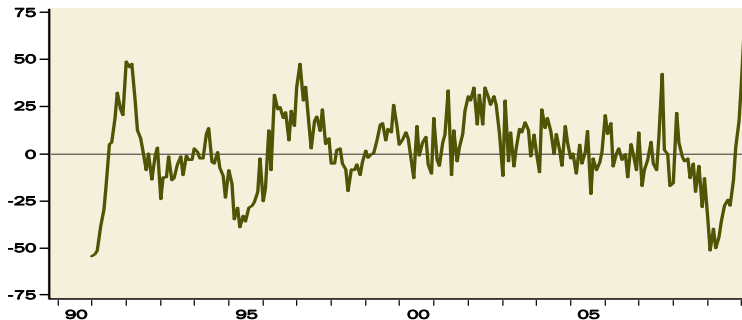
Not only is credit not in abundance, or jobs for that matter, but gasoline prices have soared around 70% YoY and are pushing towards \$2.30/gallon. As we said, shades of July-October 2007. It looks as though gasoline prices will hit \$3/gallon during the spring, and while this no longer carries 'shock value', still keep in mind that the last time we were there in early 2008 the unemployment rate was 5%, half of today's 9.7%. So, the economy's ability to withstand such a move this time – let alone sustained outperformance of consumer discretionary stocks – is going to look a tad iffy at best.

CANADIAN HOUSING MARKET – SUPPLY CATCHING UP

Canadian housing starts rose 6.1% in February, to 196,700 annual rate, better than expected (consensus was expecting 190.0k). This is the second increase in a row, although, January's level was revised lower, to 185.4k from an initial estimate of 186.3k. The bulk of starts came from multi-starts, which surged 19.1% MoM in February – possibility weather related as multi-starts in Ontario (+73.1% MoM – best monthly performance since March 2009) and British Columbia (+22.6% MoM) surged due to unseasonably warmer weather. On a year-ago comparison, Canadian housing starts are on fire – total starts running at 71.0% YoY (a record).

CHART 1: BUILDING BOOM

Canada: Housing Starts
(year-over-year % change)



Source: Haver Analytics, Gluskin Sheff

In addition to credit not in abundance, and jobs for that matter, gasoline prices have now soared around 70% YoY

Gluskin Sheff at a Glance

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OVERVIEW

As of December 31, 2009, the Firm managed assets of \$5.3 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 54% 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 million² 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 USD² on December 31, 2009 versus \$9.2 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 Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.

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.

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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For further information, please contact questions@gluskinsheff.com

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