

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Yesterday's rally was important as it took the S&P 500 back ever so slightly into positive terrain for the year (by five basis points) even if on very low volume. The economic data are coming in squishy soft, to be sure, but remember that this is a market being driven by technicals. The smart money knew going into yesterday's action that the odds of having a winning session on the first trading day of the month is nearly two-thirds versus just over 50% over the past decade and the past century for any given day in the month. If all you did was buy and sell on the first day of the month for the past decade, you would be up 28% in your portfolio (and the S&P 500 is down 24% over this interval!). Thanks to our friend Howard Silverblatt over at Standard and Poor's for that little ditty. According to Walter Murphy, a move in the S&P 500 above the 1,116 would be a constructive near-term technical signpost and we are very nearly there.

Equity markets are firm in most parts of the world today: Europe up fractionally, led by the FTSE. It was mixed to higher in Asia: the Nikkei edged up 0.5%, to 10,221 but the Hang Seng gave up 150 points, or 0.7%, to 20,906 and Shanghai lost 0.5%. The Kospi index, however, gained an impressive 1.3% overnight. As we said – mixed.

Bonds are selling off in Europe and over here, although JGBs did rally a basis point, which is a big deal when 10-year yields are already sitting at 1.28%. The DXY index is up a few ticks, which emboldens the bulls as they can lay claim that the rally in equities has not required a weaker greenback. Sterling is down for a sixth day in a row as political and fiscal risks intensify – this could well be the next country in the firing line; and the Euro is being pressured by news of a new strike by Greek civil servants. The VIX index, at 19.3, just about says it all in terms of investor complacency levels. Default risks are receding as per credit default swaps. Oil is off a tad and copper is down from its lofty 15-week highs, but gold is hanging in very nicely above its 50-day and 100-day moving averages; the uptrend in the 200-day m.a. still symbolizes a secular bull market in bullion.

On the data docket, we saw Euroland inflation rate slow in February, to 0.9% YoY from 1.0% in January; producer prices are down 1.0% YoY (have a look at *Deflation Threat is Latest Headache for Euro Zone* on page A14 of the WSJ). The regional unemployment rate is hanging in at an 11-year high. German car registrations came in 30% below year-ago levels on February but all the press headlines warn us to dismiss the YoY trend because of the 'base effects' from the onset of the car-scrapping program. (Oh, but a year ago at this time, the boom in year-over-year auto sales from the German government support program was being treated as the real deal of a sustainable demand recovery – "A Decade High" the headlines screamed at the time. Thanks for coming out.) This is what a global recovery looks like?

IN THIS ISSUE

- While you were sleeping – equity markets are firm in most parts of the world today; bonds are selling off in Europe and in the U.S., but did manage to rally a basis point in Japan; Euroland inflation rate slows in February
- Some thoughts on Canada: demand conditions in Canada are solid, but the lingering concerns at the BoC (overvalued Loonie and the recovery risks in the U.S.) have not gone away
- In the U.S., income "less weak" than it looked, but spending "less strong"
- Adding some perspective to U.S. inflation and employment
- Some facts about the ISM – overall, yes, the ISM is still above 50, but it is now telling a story of more moderate growth ahead in the manufacturing sector
- Canada wins another gold: real GDP came in stronger than expected in Q4, at 5.0% at an annual rate, and in contrast to the U.S., inventories play no part at all

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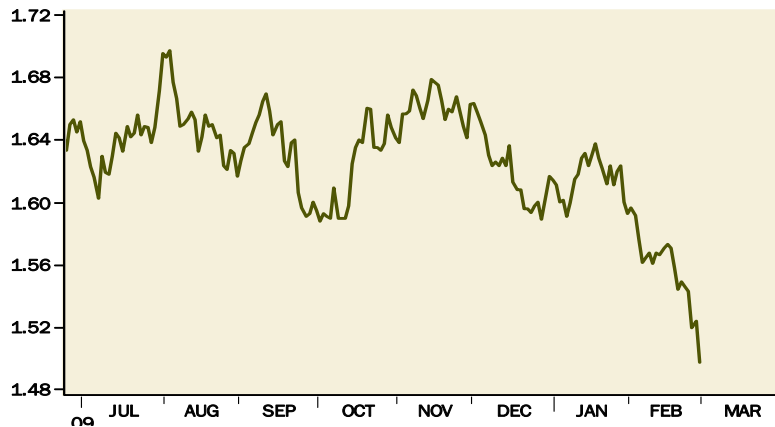


On the policy front, the Reserve Bank of Australia did hike rates 25bps to 4.0% (largely expected) but issued a neutral press statement, which is why the A\$ had difficulty advancing on the move. Finally, the Fed is about to lose a 40-year veteran as Don Kohn just announced his retirement (slated for June). If anyone is irreplaceable, it is he – go and read transcripts from FOMC meetings in the past and you will see first-hand what an impact he had on policy formulation (Greenspan really leaned on this guy). The number of Fed governors who are economists is about to dwindle to two. President Obama has the opportunity now to “reshape the Fed” – the Wall Street Journal’s words, not ours – by filling Mr. Kohn’s vacancy and two others on the board of governors.

The RBA did hike rates 25bps to 4.0% overnight, but it also issued a neutral press statement

CHART 1: NOT EXACTLY A STERLING PERFORMANCE

U.K. Pound
(US\$/Pound)



Source: Haver Analytics, Gluskin Sheff

SOME CANADA THOUGHTS

The Canadian dollar is still on fire after yesterday’s penny up-move in response to the 5% real GDP performance and the markets pricing in more Bank of Canada tightening ahead (see more on this below). The Bank has never moved rates ...

1. With the unemployment rate this close to a cycle peak;
2. The level of real and nominal GDP still below their prior highs, and;
3. In advance of the Federal Reserve.

The Canadian Q4 real GDP results are discussed in more detail below. As impressive as the numbers were (though business spending and commercial construction both contracted and it is doubtful as to whether housing will be contributing to the headline for much longer, or net exports for that matter) the Bank in the past required more than just one quarter of strong growth to embark on a tightening path. Go back to 1994 or to 2004 for that matter and we needed to see at least a three-quarter string of solid GDP gains before the rate-hiking cycle began.

To be sure, 5% growth in any given quarter is impressive, but was this the start of a new trend – an inflection point? Or is it merely an interruption in what is still a secular downtrend in the pace of economic activity (as seems to be the case south of the border)? Canada posted a 5.0% GDP performance in the third quarter of 2000, the second quarter of 2001 and we saw 4.2% in the second quarter 2007 – the biggest mistake the central bank could have made back then was extrapolate those quarterly growth spasms into the future (and thankfully it didn't).

We also have a high prospect of seeing a relatively austere federal budget coming our way this week and the *de facto* tightening from a firming Canadian dollar that has gone further than the terms-of-trade (export prices) would have suggested. The latest speeches by Ben Bernanke, Janet Yellen and Bill Dudley paint a somber picture over the outlook for a sustainable recovery south of the border.

Yes, demand conditions in Canada are solid, but the lingering concerns at the BoC, which have been an overvalued Loonie and recovery risks stateside have not gone away. Yet the BoC has yet to talk the markets out of pricing in a series of rate hikes and the longer the Bank goes in maintaining the language it has gone with, the higher the odds are going to be that they will box themselves into a premature tightening in policy. Then again, we may be completely wrong and this is a central bank determined to chart its own course irrespective of what the Fed is going to do or not do. We shall find out soon enough.

INCOME “LESS WEAK” THAN IT LOOKED, BUT SPENDING “LESS STRONG”

U.S. personal income came in below expected, coming in at +0.1% MoM in January versus expectations of a 0.4% increase. This was the weakest increase in six months but the gain was held back by declines in interest, dividend and farm incomes – the key was that wages and salaries rose 0.35%, to the second decimal place, the strongest in nine months. Transfers from the government have become a mainstay, rising 0.7% MoM in January and 12% on a year-over-year basis. Just to make matters more confusing, 'real personal income excluding government transfers' fell 0.2% MoM and this is the measure the NBER uses to determine if the economy is in recession or expansion.

What about the spending side? Well, in nominal dollars, consumer outlays rose to what appears to be a healthy 0.5% MoM pace, and +0.3% in real terms. In fact, we have the consumer now having a +2% “build in” so far for Q1. But 60% of that headline consumer spending print came from food and energy – everything else rose a tepid 0.2%. In fact, spending on durables or ‘big ticket’ items rose by less than 0.1% in its weakest showing in four months. Almost all the growth was in non-durables, which surged 1.8% and most of that were groceries and gasoline – the two ‘G’s. Services eked an advance of less than 0.2%, held back by housing/utilities.

To be sure, 5% economic growth in any given quarter is impressive, but was this the start of a new trend or is it merely an interruption in what is still a secular downtrend

All in, the gap between income and spending growth last month pulled the savings rate down to 3.3% in January from 4.2% in December, the lowest it has been since October 2008. This is indeed a surprising result, but then again, the government has been doing everything it can to promote consumption over the course of the past year.

While spending of all kinds still shows up in the GDP data whether it be on speedboats or ice cream, we think it is important to do a proper accounting of what the drivers are in any given month, quarter or year. It is tough for us to come to the conclusion that the consumer is feeling too good about the future when spending on items that requires a high degree of confidence over the economic outlook tapers off as was the case in January. Auto spending was cut by 1.2%, the first decline since last September. Furniture spending fell 0.5%. Home improvement outlays dropped 2.1%. Just a few examples about how the household sector still refuses to make a long-term commitment to the economy.

But spending on feel-good pleasure stuff certainly did improve.

- Personal care products jumped 2.9% (more cosmetics).
- Clothing rose 0.6% (women's +1.0%; men's +0.4% — surprised?).
- Health services were up 2.9%.
- Magazines/newspapers rose 1.1% and books by 2.1%.
- Spending on cable picked up 0.9%.
- Jewelry rose 1.7%.
- Video/audio equipment spending increased 1.1%.
- Spending at restaurants rose 0.7%

While people did spend more on luxury items and things to help them improve their mood during these tumultuous times, there was still very much a frugal 'stay at home' cocooning theme in the spending report. For example, there was less spending activity on sports events (-0.7%), amusement parks (-0.3%) and movie theaters (-4.2%). Instead, people spent more money on books (+2.1%), cable (+0.9%) and television sets (+0.7%). Games and toys were up 1.4% — family fun for everyone! While there was more money for fast food outlets, grocery spending was more robust during the month (+1%). People cut back on their travel, that is for sure too — rails down 1.5% and airline spending was flat. Hotels were cut back by 4.4%.

There was also a bit of a 'do it yourself' theme in the data too — sewing items up 1.6%, clothing materials also up 1.6%, auto parts rose 0.7% and furniture repairs were cut back by 0.2% while laundry services stagnated. Accounting and business services spending was sliced 0.7%. Interestingly enough, we can still see a relatively high level of insecurity in the data. How else to explain that gambling rose 0.6% in January and within that even more spending on lotteries, which has risen in each and every month since January 2009?

The gap between income and spending growth in the U.S. last month pulled the saving rate down to 3.3% in January from 4.2% in December

ADDING SOME PERSPECTIVE

Judging by the statistics the NBER pays closest attention to, plus the timing of when the Conference Board's coincident indicator hit bottom, it is reasonable to assume that the recession officially ended last June. Actually, this is great news for bond bulls when you consider what inflation and employment have done in this first seven months of the so-called economic recovery. The core inflation rate is now sitting at 1.6% whereas it is normally at 4.5% at this stage of the recovery phase. Only one other time historically has the core inflation rate been this low at this juncture and that was back in 1961. However, at that time, the next recession was eight years away – we are probably not going to be so lucky this time around given the historical tendencies of economic fragility following the collapse of a credit and asset bubble. Deflation risks will dominate, especially in view of the already low level of the core inflation rate. And, not just the core but the headline as well – at 2.6% it is well below the average 4.2% at this early stage of recovery.

And, when was the last time the 12-month Federal Reserve Bank of Dallas Trimmed Mean PCE inflation rate was as low as its January 2010 reading of 1.17%? The answer: Try NEVER. The inflation-phobes are advised to chill for the next few years, especially since it is highly likely that the 5.9% inventory-induced real GDP print for Q4 in the U.S. was the peak for what is probably going to be a truncated economic cycle. .

Look at the employment backdrop too – we are already in the mother of all jobless recoveries. Here we are seven months off the lows in real output and yet nonfarm payrolls are down 1.1 million – this has never happened before. In the last two jobless recoveries the level of employment was down 528,000 (2002) and 237,000 (1991) and both times the Fed did not tighten for well over about two years after the recession statistically came to an end. Historically, the number of jobs created through the first seven months of recovery comes to a cool one million – so for those who think that the Fed should be responding in a normal fashion to an abnormal recovery that followed an abnormal recession may want to check out the extent of their normality.

SOME FACTS AROUND ISM

- At 56.5 in February, the headline came in well below the 57.9 that was expected by the consensus.
- The 1.9 point slide was the steepest since December 2008.
- Only 61% of industries reported growth, down from the six-month average of 66%.
- Orders fell to a four-month low of 59.5 from 65.9; and the orders/inventories dropped to 1.26x, down from 1.42x in January and down from the nearby high of 1.80x in August. This confirms that the ISM peak has been turned in for the cycle. It usually takes 2-3 years after the recession ends to breach the 58 mark but this stimulus-led V-shaped turnaround happened in barely more than six months after the downturn ended.
- In a sign of global cooling, export bookings fell to 56.5 from 58.5.

ISM index: at 56.5 in February, the headline came in well below the 57.9 that was expected by the markets and the 1.9 point slide was the steepest since December 2008

- With the price index down to 67 from 70 in January, the 'nominal ISM' index slipped nearly five points last month and, like the equity market, has made no ground at all since October.
- On a bright note, the employment index hit a five-year of 56.1 from 53.3 in January.

The ISM index is still above 50 but is now telling a story of more moderate growth ahead in the industrial sector. Consumer spending in the U.S.A. seems to be doing better in Q1 than it was in Q4 of last year when it slowed to a tepid 1.7% annual rate but the jury is really out on how much this large 70%+ share of GDP can carry the ball.

Housing looks set to turn down again and we see from yesterday's data that total construction spending sagged 0.6% MoM in January – with nonresidential spending sinking 1.4% (both private and public) and there were sizeable downward revisions to the back-data. Housing is still the quintessential leading indicator of the economy, which is why building permits is one of the 10 items that go into the Conference Board's barometer. It was this sector that led the downturn so it would see reasonable that this will have to be the area of the economy that leads us into a sustainable expansion – yet there are scant signs that this is occurring. This by no means suggests that other areas of the economy untouched by the asset and credit bubble should be avoided – tech, health care, food and beverage products as prime examples. But we are seeing, whether it is the latest data on ISM, capex orders and shipments, housing starts and sales, and consumer confidence, signs that this nascent recovery may be on precipice of sputtering.

CANADA WINS ANOTHER GOLD

There is no denying the strength in the Q4 real GDP in Canada, which came in well above expected, +5.0% at an annual rate, and in contrast to the U.S.A., inventories played no part at all. In fact, they were drawn down and actually posed a 0.7 percentage point drain on the headline figure.

Consumer spending in Canada was twice the strength as the U.S., up at a 3.6% annual rate on top of a similar Q3 performance. Housing was the major contributor – up at a 30% annual rate in the strongest advance in a quarter-century. Non-residential construction was a weak link, contracting at an 8.5% annual rate, the fifth decline in a row, and capital spending also contracted at a 9.2% annual rate – a stark contrast to the double digit gain south of the border. And, no doubt that the healthy 0.6% MoM expansion in December's GDP report suggests a strong "build in" for the first quarter – already 2.2% growth before we have even seen the figure for January.

Be that as it may, let's put the data into a certain perspective:

2009: Q4 = 5.0%, Q3 = 0.9%, Q2 = -3.5%, Q1 = -7.0%

2008: Q4 = -3.7%, Q3 = 0.4%, Q2 = 0.3%, Q1 = -0.7%

There is no denying the strength in the Q4 real GDP in Canada. Economic activity rose 5.0% at an annual rate and in contrast to the U.S.A. inventories played no part at all

Canada printed a 5.0% GDP quarter after seven reports that ranged from bad to horrible. One would think that sustainability is the key and whether what we are witnessing is a new positive trend or noise around what is still a secular downtrend. The level of real GDP is still 2.2% below the pre-recession level in 2007 Q4. The level of nominal GDP is 4.5% below its peak and never before have we seen this over a five-quarter period. In fact, nominal GDP today is lower than it was two years ago, which is unprecedented. This is why we feel the Bank of Canada need not be in a big hurry even as it is cajoled by Bay Street to start hiking soon and the futures contracts price in nearly five tightenings ahead. Amazing.

The peak-to-trough decline in nominal GDP in the 2001 tech wreck was 1.6%; in the awful early-1990s period the decline was 0.5%; and here today we are into some sort of recovery phase and nominal dollar GDP is still 4.5% below where it was at the nearby peak. And, there are calls from numerous circles that the BoC is behind the curve with its 'emergency' interest rate setting – that should be taken as a sign of just how much complacency there is out there.

In terms of volume (real) GDP, it is actually lower today than it was in the first quarter of 2007. That is with the last two quarters of positive growth. We have basically gone three years with no economic growth and after one really decent quarter – one! – the BoC is being pushed into a rate hike in the name of moving off "emergency levels". We are not sure what "emergency" means – rates are 1% or below across the G7 and nobody is talking about rate hikes except for Canada. The problem is that once you begin to hike, it becomes very difficult to convince the markets that we aren't going to then see a series of tightenings. Our hope is that the BoC recognizes the fragility of the recovery, notwithstanding the very nice 5% headline, and will hold its fire until there are convincing signposts that the economy is on a sustained uptrend.

In the early 1990s downturn, it took 3½ years for Canadian real GDP to reach a new peak and the Bank of Canada did not start to raise rates for another nine months after that and actually only when the Fed began to embark on its tightening cycle.

We went back to 1960 and the answer is no, the BoC has never began a tightening campaign with GDP below prior peaks. On average, nominal GDP is 2.3% above prior peaks and real GDP is 1.2% above. As we said above, currently, nominal GDP is 4.5% below its prior peak and real is down 2.2%. This means that we could be talking about the Bank being on hold for another year or more depending on the timing of when the economy manages to not only improve in growth terms but to reach gold medal status in level terms as well.

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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.

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Notes:

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1. Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.

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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.

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