

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Equity markets mixed with European bourses up fractionally and most of the Asian markets were either flat or turned in uninspiring gains overnight. Little change in bond markets but marginally on the defensive side ahead of today's \$21 billion U.S. 10-year Treasury note auction. The commodity market is a tad lower, led by oil ahead of today's DoE inventory report. Gold is hanging in nicely; although silver has really been the place to be over the course of the past year.

On the data front, things were a little soft – German exports tanked 6.3% in January, a big surprise to a consensus that was expecting +0.5%. The Euro, to little surprise, softened on the news. And, we see out of the U.K. that manufacturing production sagged 0.9% MoM in January as well. So much for the global boom – it seems to have bypassed Europe.

Not only that, but overnight we also saw Japanese core machine orders fall 3.7% in January and Chinese exports sagged for the second month in a row in February – down 2.2% on top of the sequential 5.5% slide the month before (the YoY trend of 45.7% is misleading due to depressed year-ago effects). So much for the speculation over an aggressive Chinese revaluation if these poor export data are sustained.

Meanwhile, risk assets are trading as if we are in a sustained economic boom and yet if that were indeed the case one would have to wonder why it is that the Senate is going to vote today on extending, yet again, jobless benefits to the swollen ranks of the unemployed. One chart that looks particularly impressive – practically a straight line up – is the Aussie-Sterling cross rate, which just reached its highest level in a quarter century.

As for yesterday's action, take note that volume surged as the stock market gave up its gains in the afternoon. Once again, the jury is out until the S&P 500 can manage to move above that mid-January high of 1,050 and what the market internals look like if and when that occurs. So far it is a struggle and this is still a market that has only managed to range trade on either side of the 1,100 mark for the past five months. As far as this move back towards the nearby highs, much of it looks like post-Greece short-covering – the net short position on the NYSE was cut 1.2% in the final two weeks of February. Clipping coupons through this stretch has not been a bad plan at all.

Moreover, for all the concerns over China starting to sell U.S. Treasuries, well, those unfounded fears are dealt with very nicely on page 2 of the FT (*China Still Keen to Buy US Bonds* and *Soothing Words Hint at Limited Reserve Options*).

IN THIS ISSUE

- While you were sleeping – overseas equity markets mixed; global economic data on the soft side; risk assets are trading as if we are in a sustained economic boom
- Market commentary – it is truly amazing that the equity market bulls are looking for the next leg up to come via improvement in the U.S. labour market
- Survey says... U.S. small business still in a dismal state; 34% of the respondents in the NFIB survey continue to cite “poor sales” as their number one problem
- JOLTS report does show an improvement in job openings and hiring, but looking at the charts, both measures are still near all time lows
- IBD/TIPP economic optimism index slips in March – the lowest level since this time last year
- For the first week of March, retail sales (according to the Redbook data) were up 3.1% off the ultra-depressed base of a year ago



In a nutshell, China needs to have its FX reserves in liquid assets and there is nothing more liquid than the U.S. bond market, followed by Europe. In addition, China has still been buying mid- and long-term U.S. Treasuries; it has merely been allowing short-term bonds to mature and roll off their books. As an aside, Martin Wolf is a must-read today (*The Eurozone Crisis is Now a Nightmare for Germany* on page 11 of the FT). One must wonder if at some point the fiscal tightening that is going to be required of the profligate countries on the continent will be too much to bear. May be time to bone up on what ultimately caused the other monetary unions in Europe to fall apart less than a century ago.

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MARKET COMMENTARY

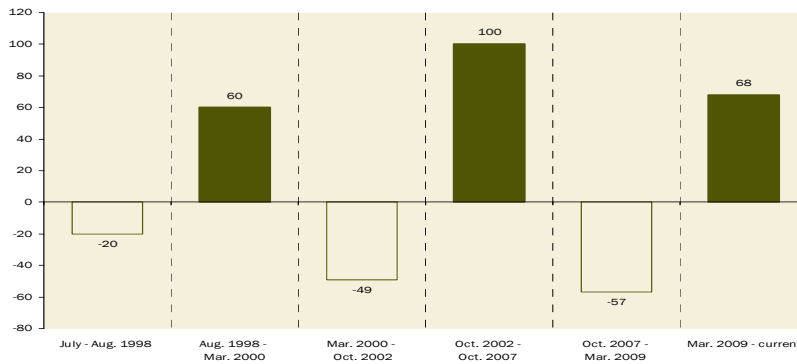
We invoked the Shiller normalized P/E ratio yesterday as a great historical benchmark to use in terms of valuation purposes. Using this metric, we found that the S&P 500 enjoyed above-average multiples each month from November 1988 right through to November 2008. Imagine as we mean-revert how long the market will have to trade below historical multiples.

When we go to the bear market, what we see is that the S&P 500 did not move into fair-value until November 2008 – think about that for a minute. The first 13 months and 40% of the bear market merely eliminated the overvalued condition in the stock market. And for the next five months, the S&P 500 was undervalued, having hit a 20% breach at the March lows. By May 2009, however, when the S&P 500 crossed the 900 mark to the upside, the index had managed to move back above the fair-value line where it has stayed ever since – and now a breach of 25% in terms of overvalued terrain. Further to this thought process, have a look at Andy Kessler’s op-ed column on page A23 of the WSJ (*Lessons of a Dow Decade*).

When we look at the past 12 years, dating back to LTCM and the bailout that ensued, we have endured a 60% rally, followed by a 50% selloff, followed by a 100% rally, followed by a 60% selloff, followed by a 70% rally. The whole way along, the equity market is basically flat for a buy and hold investor.

CHART 1: TWELVE-YEARS RACKED WITH VOLATILITY

United States: S&P 500
(percent change)



Source: Haver Analytics, Gluskin Sheff



The point in all this is the intense volatility that has been and continues to be nurtured by government policy. The lesson is that investors will now lose out by going long after a 50% selloff from the high and are unlikely to feel much pain from selling into a 70% rally from the low. All the while, the name of game is to minimize the volatility in the portfolio and embark on strategies that have low correlations to the equity market.

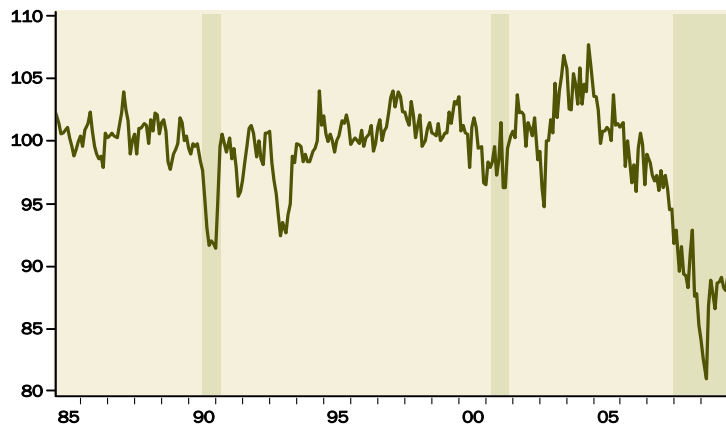
Finally, what is amazing is that equity market bulls are looking for the next leg up to come via improvement in the U.S. labour market. The USA Today runs with an article (page 4B) concluding that *“investors need to see a Labor Department report that says employers are creating more jobs than they’re cutting. Until then, investors are going to stay cautious.”* This is a truly unbelievable comment considering the S&P 500 has surged 70% in the past year – 10 years of price appreciation lumped into one – even though 3.3 million jobs were lost. Since when has Mr. Market shown that it really has an eye on the labour market? It’s all about a chase for relative yield in a low rate environment – a highly speculative environment, which is why U.S. companies have managed to float a huge \$12 billion of new bond supply in each of the past two days; the hunger for yield.

SURVEY SAYS

The National Federation of Independent Business (NFIB) small business survey was fairly dismal, heading down to 88.0 in February from 89.3 in January and still very much at recessionary levels. In fact, this is below the lows of each of the prior three recessions and the third decline in the past four months.

CHART 2: SMALL FIRMS IN THE U.S. STILL IN A DISMAL STATE

United States: National Federation of Independent Business Optimism Index (1986 = 100)



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

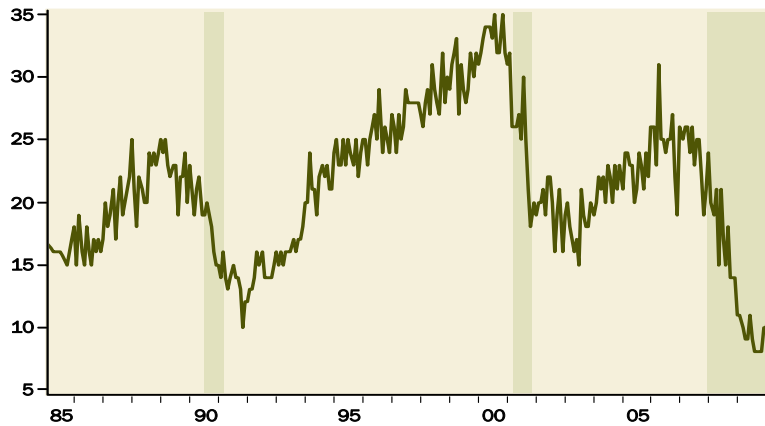
Small businesses in the U.S. are still in a dismal state, heading down to 88.0 in February from 89.3 in January and still very much at recessionary levels

Expectations of any thawing in credit restraint (-13 to -14), the net share of those expecting the economy to improve (+1 to -9), expansion plans (+5 to +4), plans to boost inventories (-4 to -7) dragged down the index. Capex intentions (at 20) and hiring plans (at -1) were unchanged. Bond bears should note that the net share complaining about inflation stayed at a historic low of 3%; ditto for labour costs. Meanwhile, 10 times as many cited “poor sales” (34% – up from 31%) as their largest problem.

But job openings improved to +11 from +10 – a six-month high. That was the bright light in an otherwise dim report.

CHART 3: A POSITIVE FROM THE NFIB SURVEY: JOB OPENINGS IMPROVED IN FEBRUARY

United States: National Federation of Independent Business: Percentage of Firms with One or More Jobs Open
(percent)



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

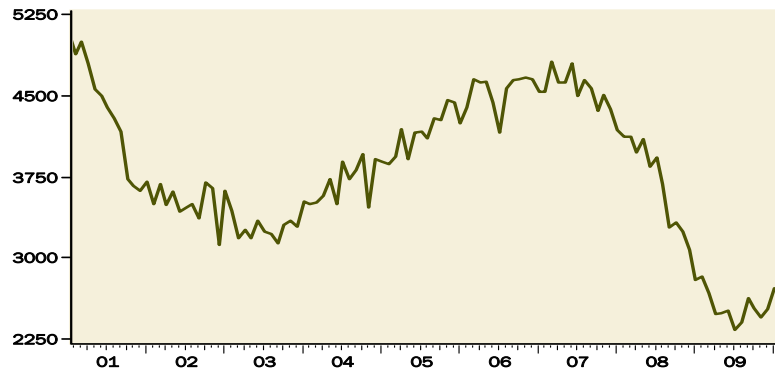
The improvement in job openings was also evident in the January JOLTS report that came out yesterday too (Job Opening Labor Turnover Survey from the Bureau of Labor Statistics). The number of job openings rose 193k in January after a 75k rise in December. Layoffs also fell 159k and have been down now for three of the past four months – they are at their lowest levels since April 2008. And, new hires also increased 83k in January.

But look at the charts below and measure the extent of the “improvement”. Job openings and new hires still look as though they are doing little more than bounce along a recession bottom – despite all the monetary and fiscal stimulus. As Billy Joel was known to say, “is that all you get for your money?”



CHART 4: IT APPEARS THAT THE NUMBER OF JOB OPENINGS ARE JUST BOUNCING ALONG A RECESSION BOTTOM...

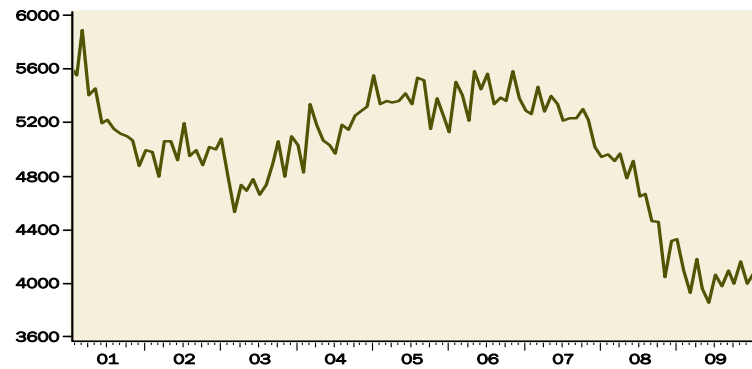
United States: Job Openings and Labor Turnover Survey (JOLTS)
Total Job Openings
(thousands)



Source: Haver Analytics, Gluskin Sheff

CHART 5: ... DITTO FOR HIRINGS

United States: Job Openings and Labor Turnover Survey (JOLTS)
Total Hiring
(thousands)



Source: Haver Analytics, Gluskin Sheff

Not only that, but the very latest surveys for March, from the IBD/TIPP economic optimism index, slipped to 45.4 from 46.8 in February and 48.8 in January – to stand at its lowest level since March 2009 when everyone seemed to think the world was coming to an end. It is amazing how a 70% rally in the stock market can alter that view.

As for actual spending, we got the first week of March in terms of Redbook retail sales and they were up 3.1% off the ultra-depressed base of a year ago and below plan of 3.7%. Warm weather, Spring Break, early Easter (extra week lift) and St. Patty's Day celebrations have put nary a dent in retailer optimism, however, based on the early-month reports at our disposal.

Gluskin Sheff at a Glance

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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.

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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.

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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