

**MARKET MUSINGS & DATA DECIPHERING**

# Breakfast with Dave

## WHILE YOU WERE SLEEPING

Global equities are a tad firm across the board and bonds are selling off moderately as some calm is restored in terms of investor sentiment (credit default swaps in Europe are improving dramatically today).

The equity market had become very oversold on a technical basis so this latest bounce does not come as much of a surprise and we would not read too much into it. Although it is fair to say that the news-flow has improved; Alcoa and Amex receiving analyst upgrades and some sold financial results out of D.R. Horton's and Whirlpool, not to mention UPS (with some positive guidance on the shipping and pricing outlook to boot). Moreover, Greece's deficit cutting plan has gone from mythology to reality as the restraint package received EU backing today. So that certainly is being greeted as positive news and hence the U.S. dollar is trading lower so far today and the Euro, as well as the Asian FX complex, are gaining ground.

Copper, oil and gold are also all in rally mode for the third day in a row. This latest bout of exuberance has not at all been dented by the data, which came in squishy soft today — notably the service sector PMI in Euroland, which dipped in January, to 54.2 from 53.7, and the U.K. services CIPS index also fell, to 54.5 from 56.8, in a sign that global economic momentum is starting to roll over.

## WHAT A DIFFERENCE A YEAR MAKES

- A year ago, China was embarking on a massive fiscal and credit stimulus plan that would send commodity prices and global exports surging. Today, the People's Bank of China (PBoC), along with other Asian central banks, is now withdrawing the stimulus (India as well). Is the near 10% correction in the Chinese stock market telling us something about the Chinese economic outlook? Something tells us the Reserve Bank of Australia was on to something when it didn't hike rates yesterday when the market was fully priced for another move — after all, China is Australia's most important customer.
- A year ago, it was all about saving the insolvent banking sector. Now it is popular to bash the banks and de-risk them. Notice how the financials haven't done a thing in five months?
- A year ago, it was all about fiscal reflation. While there is now tepid support for job creation and small business incentives, the emphasis is also on ending the Bush goodies and taxing the rich (defined as anyone making more than \$250k).
- A year ago, it was all about quantitative easing and the need for the Fed to add more than \$1 trillion of mortgages to its balance sheet. Today, it is all about the exit strategy.

## IN THIS ISSUE

- While you were sleeping — global equity markets are firmer across the board and bonds are selling off moderately
- What a difference a year makes. A year ago, China was embarking on massive fiscal and credit stimulus, it was all about saving insolvent banks and it was all about fiscal reflation. Now, it is the opposite, China is withdrawing the stimulus, as is the U.S., and being critical of banks has become a pastime
- The U.S. consumer looks fatigued
- The U.S. economy would be contracting without the stimulus
- Don't uncork the ISM champagne just yet
- U.S. labour market angst continues unabated — there are now 19 states with a jobless rate topping 15%
- More good news for the Republican party
- U.S. housing still in the doldrums — total shadow inventory continues to raise, homeownership rate continue to fall
- Hey, the news isn't all that bad — indeed, the U.S. earnings season is actually coming in quite decent

Please see important disclosures at the end of this document.

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- A year ago, the U.S. dollar's bear market rally was about to give way to a 6%-plus decline in support of global carry trades. Today, the dollar has broken out on a trade-weighted basis and has broken above the 50, 100 and 200-day moving averages.
- A year ago, the VIX index was at 40. Today, it is barely above 20.
- A year ago, Baa corporate bond spreads were in excess of 550 basis points. Today, they are 260 basis points.
- A year ago, the S&P 500 was undervalued by 18%, on a Shiller normalized P/E basis. Now, it is overvalued by 25%.
- A year ago, we were coming off a -6.4% real GDP print in the U.S. and a 35 ISM reading and only 'green shoots' lay in our path. Today, we are coming off a +5.7% GDP headline and a 58.4 ISM index and the days of "sequential improvement" are clearly over.
- A year ago, 10-year Treasury note yields were 2.7% and rising. Today, they are 3.7% and falling.

#### **THE U.S. CONSUMER LOOKS FATIGUED**

After seeing a 2.8% annualized pickup in consumer spending, which came on the back of large-scale fiscal stimulus in Q3, the consumer went on to slowdown expenditures to 2.0% in Q4, and so far this quarter there is no momentum to speak of at all. While auto sales did not collapse, they came in at 10.8 million units at an annual rate, which is down 4.2% sequentially from the 11.2 million tally to end 2009. And, the weekly chain store sales left much to be desired too with the Redbook showing a +1.0% YoY gain versus a planned increase of +1.2%.

#### **THE ECONOMY WOULD BE CONTRACTING WITHOUT THE STIMULUS**

We ran some simulations to see what would have happened in 2009 without all the massive amounts of fiscal and monetary stimulus. Instead of real GDP contracting 2.4% for all of 2009, it would have been close to a 4.0% decline. And, as for the last two "positive quarters" — well, Q3 would have been -1.0% QoQ at an annual rate and -1.5% for Q4 (as opposed to the +5.7% annualized print). Still no sign of organic private sector growth and here we have the Fed discussing exit strategies and the Obama team about to soak it to the rich (for anyone who makes over \$250k). This is what is otherwise known as a 'low quality' recovery.

#### **DON'T UNCORK THE ISM CHAMPAGNE JUST YET**

Remember, Mr. Market is a discounting mechanism (supposedly). So, when the ISM is plumbing the depths as it just over a year ago, it was clearly not the time to turn up the cyclical temperature in the portfolio. In fact, history also bears that out before the 2008 downturn in the index. And the same holds true, in reverse, when the ISM is peaking — as it is now.

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**In 2009, what would growth be in the U.S. without the massive stimulus? We ran the numbers and real GDP would have declined close 4.0% as opposed to the reported -2.4% tally**

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We went back into the history books and found that in the year after a plunge to 35 or lower, the S&P 500 is up more than 30%. And in the years when the ISM is on an uptrend, the year after it hits the 58 threshold, as it just did, the S&P 500 is basically flat in the ensuing 12 months.

In terms of relative equity sector performance, in that 12-month period after the ISM slices below 35 it is the cyclicals that go on to outperform – basic materials, consumer discretionary, tech and industrials. Again, this is a sign of how the market has already priced in the kitchen sink at the ISM lows (and then some) and can sniff out the inevitable recovery.

Fast forward to that cyclical uptrend in the ISM – to the point that it breaks 58, and staples, telecom services and utilities emerge as outperformers. Again, the market is looking ahead to the imminent time that the index begins to roll over ... and we're probably not more than a month or two away from that happening.

#### **LABOUR MARKET ANGST CONTINUES UNABATED**

The detailed U.S. regional data were released and showed that of the 372 metro areas, unemployment rose in 306 of them in December. The number of cities with double-digit unemployment increased to 138 from 125; nineteen had jobless rates topping 15%. This is what has the economics community excited about a recovery?

In the meantime, Senate Democrats are about to cobble together the \$80 billion jobs program proposed by the President. The question is how the coinciding increases in top marginal tax rates and higher taxes for multinationals are going to pose an offset to hiring subsidies for small businesses. One thing is for sure, \$80 billion is a start but considering that on Friday we are going to find out that the total job loss since late 2007 was closer to 9 million than 7 million, and given the long-term nature of the employment reductions, more is clearly going to have to be done.

As of December, there was a record of over 6 million, or 40%, of the ranks of the unemployed who have been looking for work fruitlessly for at least six months. There more than 9 million – another record – who are working part-time only because there is no full-time job for them. The level of unemployment AND under-employment is massive – over 17% of the workforce. Over 8 million Americans have been laid off permanently – nearly tripling in the past two years. To a very large extent, these jobs are not going to come back because many companies in the wake of the credit collapse have permanently shuttered production capacity – see *Radical Shifts Take Hold in U.S. Manufacturing* on page B1 of the WSJ; and also have a look at *Weak Outlook for New Hiring* (considering the huge supply of part-timers ready to go back to full-time) on page B6.

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**Labour market angst continues unabated in the U.S. – out of the 372 metro areas, 306 of them reported that unemployment rose in December**

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**MORE GOOD NEWS FOR THE GOP**

Not only did the Democrat filibuster-proof majority evaporate with the Scott Brown victory in Massachusetts but there is a legitimate chance that the Republicans will take over the Senate over the next four years. It's all about the turnover – the Democrats have 23 seats to defend in 2012 compared to 10 for the GOP; and the Dems have 14 in 2014 while the GOP have 13 members up for re-election.

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**The shadow housing inventory in the U.S. continues to rise**

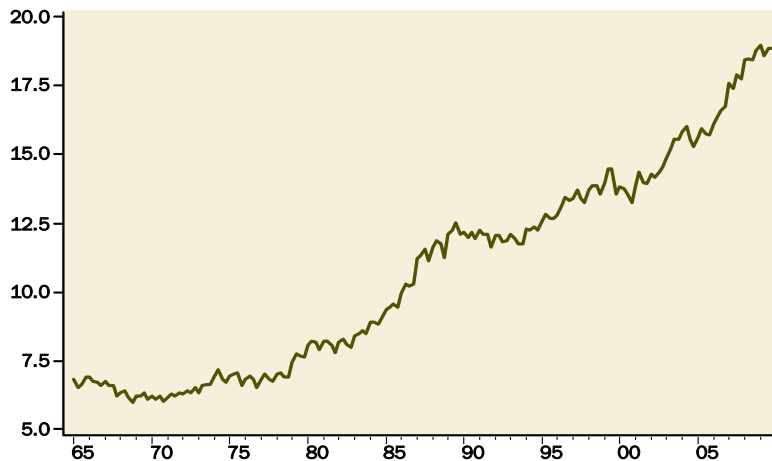
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**HOUSING STILL IN THE DOLDRUMS**

The 1% rebound in the pending home sales index was more than just a tad disappointing after that 16.4% plunge in November. That points to a flat reading in existing home sales in January (after that massive 16.7%, to 4.45 million annualized units, in November). In addition, we just got the Q4 data from the Census Bureau which showed that the total number of vacant housing units, instead of declining, rose to a near-time high of 18.876 million – up 33k from Q3 and up 291k from Q2. The key 'vacant for sale' component also increased to 2.087 million from 1.985 million in Q3 and 1.904 million in Q2.

**CHART 1: TOTAL VACANT HOUSING UNITS HITS RECORD HIGH... AGAIN**

**United States: Total Vacant Housing Units**  
(millions)



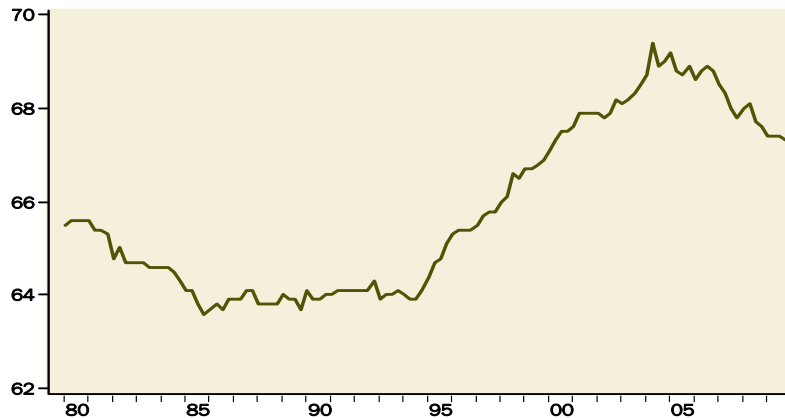
Source: Haver Analytics, Gluskin Sheff

The shadow inventory (vacant units but held off the market “for other reasons”) – rose 3.497 million units from 3.403 million. Fully 13.4% of the housing stock is currently vacant and that degree of excess capacity is very likely going to exert ongoing downward pressure on residential rents and precipitate another downleg to housing prices.

Meanwhile, the process towards mean reversion continues at a snail's pace. The homeownership rate dipped to 67.3% in Q4 from 67.4% in Q3. There is still a long way towards getting back to the historical norm of 64%.

## CHART 2: MEAN REVERSION IN THE HOMEOWNERSHIP RATE CONTINUES AT A SNAIL'S PACE

United States: Homeownership Rate  
(percent)



Source: Haver Analytics, Gluskin Sheff

As a sign that home values are slipping again, Zillow just released some data showing that in December, buyers paid an average of 2.7% below list price — this last happened 11 months ago and this obviously heightens concerns over more homeowners being pushed into a negative equity situation (owing more than their real estate is worth). New research shows that when a home's value falls below 75% of the outstanding mortgage balance, homeowners start to seriously contemplate whether or not to walk away — see *No Aid or Rebound in Sight, More Homeowners Just Walk Away* on the front page of the NYT. To put the situation into perspective, it is estimated that there is now \$745bn of residential mortgages that are “upside down”. That's almost as big as the entire fiscal stimulus package.

### HEY — THE NEWS ISN'T ALL BAD

We are still very cautious over the U.S. stock market and see that there is too much ‘growth’ priced in at current levels — it has been that way for months, in fact. But the earnings season is actually coming in quite decent. So far, 78% of the S&P 500 companies that have reported have beaten estimates — well ahead of the 61% long-run average. Profits are up 204% YoY and 15% when the financials are stripped out — though to be fair, this is coming off a depressed base of a year ago. Even so, the level of earnings thus far is coming in 15.3% above expectations, which is a record “beat” in terms of magnitude. What is key is that revenue growth is joining cost cutting in these efforts to bolster bottom-line performance — coming in +6.7% on a YoY basis and also 3.5% above consensus estimates.



But here lies the rub — the market is expecting +38% YoY earnings growth for Q1 and going forward, the flattering growth rates from extremely depressed 'base effects' are going to wear off. As we said, it's not that the news is bad. Of course a lot of what we are seeing, as discussed above, is due to Uncle Sam's generosity, but there is too much growth and hence too much risk in the U.S. market to be overweight at this juncture.

In Canada, it is a bit of a different story. The market here is only fractionally overvalued, although there may be reason to be a tad concerned over the near-term commodity outlook given the efforts in China to cool off demand pressures. Our secular views of income-orientation, capital preservation, a constructive view on credit and commodities and Canadian assets over the U.S. remain fully intact.

# Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and focused primarily on high net worth private clients, we are dedicated to the prudent stewardship of our clients' wealth through the delivery of strong, risk-adjusted investment returns together with the highest level of personalized client service.

## 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 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).<sup>1</sup>

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 \$15.5 million<sup>2</sup> on September 30, 2009 versus \$9.7 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 \$11.2 million USD<sup>2</sup> on September 30, 2009 versus \$8.7 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](mailto:questions@gluskinsheff.com)*

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