



MARKET MUSINGS & DATA DECIPHERING

Special Report: The Case for Commodities, Credit and Canucks

WITNESS FOR THE PROSECUTION

I stand accused of having missed the turn and that accusation comes from the throngs who believe that the only way to generate a positive return is through the equity market. You see, for so many pundits, you are labeled a “bull” or a “bear” based on how you feel about the equity market. You turn on the various business shows on bubble-vision, and it’s all about equities; one would think that there is no other market on the planet.

The equity market, of course, is the asset class that captures most of the attention and is the asset class that portfolio managers are most bullish on. It is truly a commentary on human nature; the asset class that has generated the most negative return for investors over the last decade — despite the S&P 500 piercing a record 1,500 on three separate occasions and even with the 60% rally of the March 2009 lows — continues to generate the most enthusiasm.

I never did turn bullish enough at the lows, which is true. But I did turn neutral and while I did see the prospect of a complete throw-in-the-towel move towards 600 on the S&P 500, I can recall putting in print that the good news was that the bear market was about 95% over. Why quibble about another 60 points at that juncture. And, in the name of keeping an open mind, in my final report at Merrill Lynch, I played a game of Devil’s Advocate with myself ... what if I was unduly bearish?

I didn’t stay bearish at the lows, which is contrary to popular opinion. I was basically neutral. And I continued to — still do, by the way — frame what we have experienced in the context of a bear market rally as opposed to the onset of a new secular bull market (the first you rent, the second you own). I am always skeptical of rallies that are purely premised on technicals and liquidity but bereft of a solid economic foundation. While green shoots did appear in the economic data, all the growth we have seen globally, and in the U.S.A. in particular, has come courtesy of unprecedented government stimulus. We see nothing organically in the economy to get us excited.

So many pundits use the label “bull” or “bear” based on how you feel about the equity market

But of course, the equity market is not the only asset class out there

It’s true that I never turned bullish enough at the lows...

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Even if the recession is over, as we saw in 2002, a listless recovery is not generally conducive to an extended rally as a 45% initial surge in the Nasdaq that year was completely unwound – and then some – in the latter months of the year. If the S&P 500 were currently hovering between 800 and 850, where it would be pricing in a 2% GDP growth environment and basically in the zone of normality in terms of what is a typical move off a recession low at this point of the cycle, we would be more positive on the outlook for equities. Simply put, it has moved too far, too fast, and we will wait for the fundamentals to play catch-up (though the market is at least 25% overvalued based on our metrics).

THE EQUITY MARKETS HAVE MOVED TOO FAR, TOO FAST

In contrast, when the market was peaking back in the summer and fall of 2007, at least you could watch and assess as the S&P 500 hovered around the 1,500 plateau for months. But from the March 2009 lows, it has been virtually straight-up – there was no bottoming-out process; no re-testing phase this time around. So at the time I decided to leave Merrill Lynch, the S&P 500 was trading below 700, and by the time I arrived at Gluskin Sheff, the index had already blown through the 900 threshold. The market had already rallied nearly 40% at that point – what it normally takes two years to accomplish off a bear market low we did in two months.

It is now up 60% from the lows, a rebound that usually occurs by the time the economy is in the third year of recovery. Again, it is a comment on human nature – greed overwhelming long-term resolve – when people consider it to be normal to have the equity market up 60% at the same time when 2.5 million jobs disappeared. Again, what's normal is that when the stock market has put in such a sizeable advance in the past from a recession trough, employment, as lagging as it may be as an economic indicator, is at least up more than 2 million. How can you possibly have the sustainable recovery that equity markets have priced in without any job creation?

Put simply, the stock market very quickly went from pricing in a 2.5% GDP contraction and \$50 on operating EPS to a 4.0% GDP expansion and \$83 on corporate earnings. We can see that many former bears have capitulated, but I have never been one to have the market make up my mind for me. Several did so in 2007 as well, if memory serves me correctly, when every investment bank was publishing reports in a doomed attempt to redefine 'global liquidity'. I let my view of the macro fundamentals dictate my views on the market, and when the former changes, so does the latter. I don't tend to make it a habit to "whack" my view around. What some call "stubbornness" I like to call "consistency". People know where I stand, and while I can never guarantee that my timing will be perfect, I do enough homework that I always back up my views with facts.

... But I did turn neutral and would have thrown in the towel if the S&P 500 moved towards the 600 level

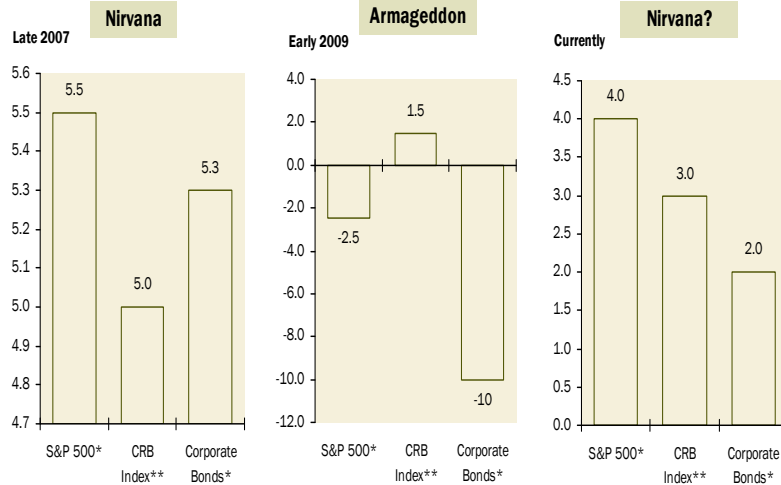
But now, we believe that the U.S. equity markets have moved too far, too fast

The macro economic fundamentals dictate my views on the market; not the other way around



CHART 1: WHAT IS PRICED IN?

United States: Real GDP Growth Being Discounted (annual percent change)



Source: Haver Analytics, Gluskin Sheff

TWO OUT OF THREE AIN'T BAD

Now to be fair, while I was never bullish enough at the lows, I never advised clients to stay in cash either. There is more than one way to skin a cat, and frankly, even at the lows I never did consider equities to possess greater return potential than corporate bonds, which were priced for a much worse economic outcome (and that remains the case today, though the gap has narrowed). There was more than one report I wrote on this file in my last few months at Merrill Lynch, and several thereafter at my new digs, though the portfolio managers at Gluskin Sheff were on top of this story long before I came on board and our clients have been served well by this income-oriented strategy, especially for the comparable risks involved.

In fact, looking at the U.S. data, investment-grade credit – not junk, but good quality credits – have actually moderately out-returned the equity market so far this year. We doubt that is a factoid that you will hear on Fast Money!

And, I also published a series of positive commentaries on the outlook for commodities, and indeed, the CRB index, so far in 2009, is up more than 20% and the Goldman Sachs Commodity Index has rallied 30% – both outpacing the S&P 500.

So, I did miss the magnitude of the equity bull-run, but as Meatloaf said, “two out of three ain’t bad.”

Did you know that investment-grade credit is moderately outperforming the equity market so far this year?

And, our commodity call is also performing well against the equity market

COMMODITIES IN A SECULAR BULL MARKET

As we have said in the past, equities continue to grab the imagination of the investment public even though they are now barely half-way through an 18-year secular bear market. In fact, as Chart 1 below vividly illustrates, the Dow Jones Industrial Average has had this historical tendency going back a century of moving in 18-year cycles. This does not mean that cyclical bull markets cannot occur – they did even in the 1930s and in Japan in the 1990s. After all, the S&P 500 managed to reach two historical price peaks (September 2000 and October 2007) during the current secular bear market phase. But what is critical is that in secular bear markets, rallies are to be rented, not owned. Whereas in secular bull markets, selloffs are to be treated as opportunities to build long-term positions at better price levels.

CHART 2: THE STOCK MARKET MOVES IN 18-YEAR CYCLES

Dow Jones Industrial Average



Source: Haver Analytics, Gluskin Sheff

We believe that the commodity market entered a secular bull market right around the same time that the equity market entered its secular bear market – a tad later actually, in November 2001. Not surprisingly, the last secular bear market in equities, from the mid-1960s to the early 1980s, also took hold alongside a secular bull market in commodities; we are seeing something very similar take hold this time around but for very different reasons.

What really caught our eye this time around was that during the vicious selloff in commodities last year, the price of virtually every commodity bottomed at a higher price than during any other recession in the past. Oil, for example, bottomed this cycle at \$39.20/bbl (using monthly averages). In the 2001 recession, the oil price bottomed at \$19.33/bbl; in 1990, it bottomed at \$16.81/bbl; in 1982 at \$28.48/bbl; and in 1975 at \$10.11/bbl. We bottomed this cycle at levels that were peaks in prior cycles.

Virtually every commodity bottomed at a higher price than during any other recessions in the past

The same holds true for copper – it hit its trough at \$1.39/pound this time around versus \$0.630 in 2001 and \$1.00 in 1992. Ditto for the ‘softs’ – soybeans bottomed at \$8.48/bushel this time, compared with \$4.15 in 2001, \$5.42 in the recession of the early 1990s and \$5.32 in the early 1980s downturn.

TABLE 1: COMMODITIES BOTTOMED AT HIGHEST RECESSION LEVELS EVER

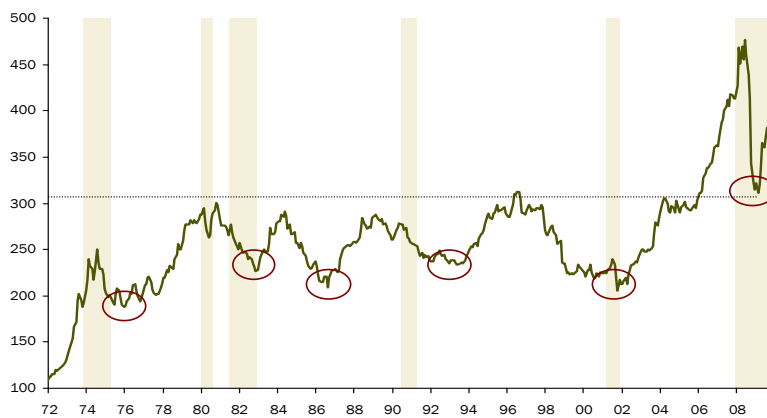
Where Commodities Bottomed This Cycle		Where Commodities Bottomed During Recessions	
(December 2007 to current)		(average of five recessions)	
Wheat	\$4.86/bushel	Wheat	\$3.08/bushel
Soybean	\$7.59/bushel	Soybean	\$5.05/bushel
Corn	\$2.72/bushel	Corn	\$2.08/bushel
WTI	\$30.81/bbl	WTI	\$20.00/bbl
Gold	\$712.50/oz	Gold	\$307.30/oz
Copper	\$1.25/Lb	Copper*	0.70¢/Lb
Silver	\$8.81/troy oz	Silver	\$5.76/troy oz
Lead	61.72¢/Lb	Lead*	38.27¢/Lb
Zinc	57.42¢/Lb	Zinc*	51.17¢/Lb
CRB Spot (1967 = 100)	302.34	CRB Spot (1967 = 100)	229.11

*average of the last two recessions
 Source: Haver Analytics, Gluskin Sheff

Take the entire CRB spot index and again it is plain to see: the bottom this cycle was 307.4 versus 211.2 in 2001, 237.5 in 1992, 226.8 in 1982, 187.2 in 1975 and 107.1 in 1971. We are impressed.

CHART 3: COMMODITY PRICES BOTTOMED AT PREVIOUS PEAKS

CRB Spot Index (1967 = 100)



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



As an aside, the way to view the 40% slide in the commodity complex last year is the same way that the crash of October 1987 should be treated; at the time, it felt like the end of the world, but in fact, it was a deep correction from a bubble that formed in the spring and summer of that year. Who knew at the time that this was the fifth year of what was turning out to be, as we know with perfect hindsight, a classic 18-year secular bull market? That would have been an impossible story to sell back then, but that is exactly what it was. When you take a look at the long-term charts today of the Dow, S&P 500 or Canada's TSX index, the brutal 35% slide in the fall of 1987 now looks like a speck of dust, and if you overlay the experience of last year's commodity meltdown with the equity market performance that year, it looks eerily similar. A steep correction from dramatically overbought levels in what is still the early stage of a secular (ie, multi-year) bull phase.

At the very least, the fact that commodities bottomed at their highest cyclical troughs ever in the face of the most severe global recession in 70 years tells us what the floor is

IT'S DIFFERENT THIS TIME – IT REALLY IS

The fact that commodities bottomed at their highest cyclical troughs ever in the face of the most severe global recession in 70 years tells us what the floor is, at the very least. We always cringe when we hear the words “it’s different this time”, but in fact, in the case of the resource sector, this indeed seems to be the case. Why? It’s all about the shifts in the supply and demand curve.

On the supply side, we have a much more concentrated sector with fewer players than in past cycles following the wave of global consolidation over the last decade in particular. Moreover, the executives of these resource companies are business people, not geologists, and as such have been much more disciplined from a production standpoint.

CHART 4: ONE SIGN OF REDUCED CAPACITY

Number of Publicly Listed Materials Companies in the TSX Composite

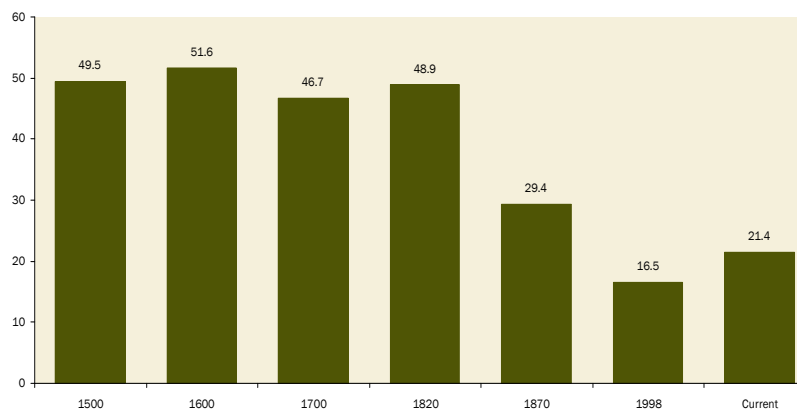


Source: Bloomberg, Gluskin Sheff

On the demand side, emerging Asia climbed out of its depression just over a decade ago with restructured economies, vastly improved balance sheets and changed political landscapes. What we refer to as emerging markets once commanded more than half of global GDP before the industrial revolution, and are on track to regain that lost share in coming decades; likely sooner rather than later given China’s critical mass and double-digit growth rates – its economy just surpassed Germany on the third rung of the world GDP ladder.

CHART 5: “CHINDIA” CAPTURING MARKET SHARE IN GLOBAL GDP

China-India Share of Global GDP
(percent)

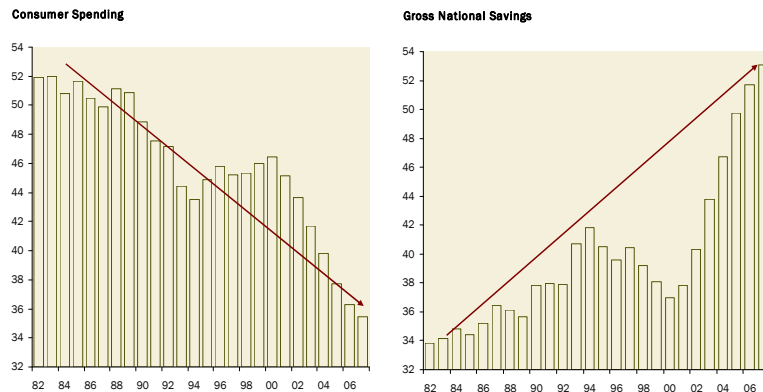


Source: Bloomberg, Gluskin Sheff

In contrast to the United States, which is the marginal buyer of services – health, education, recreation and, of course, financial – Asia, China in particular – is and has been for the past decade the marginal buyer of basic materials.

CHART 6: ASIA HOLDS THE KEY

China
(as a percent of GDP)



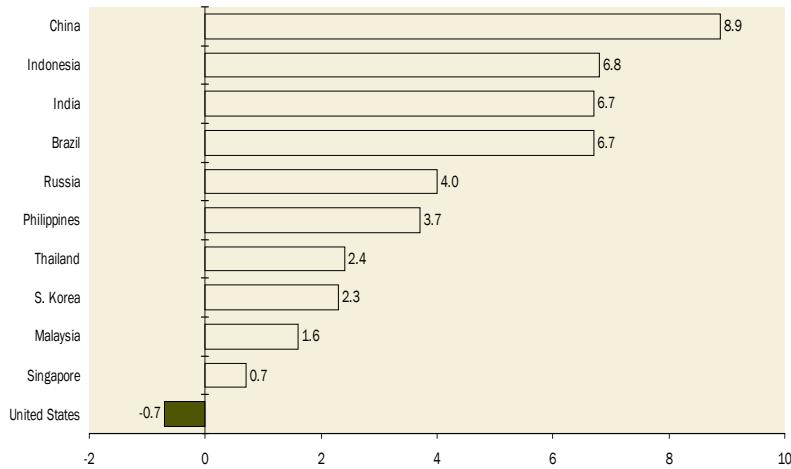
Source: IMF, Datastream, Gluskin Sheff

DECOUPLING WAS WORKING UNTIL LEHMAN COLLAPSED

While it became convenient to knock the global deflationists down after the world economy went into freefall post-Lehman, believe it or not, there may have been more to their argument than meets the eye. After all, the U.S. economy was in recession for nine months before the Lehman disintegration, and despite that, China’s economy was humming along at a 9% annual rate, India by 6% and most of the rest of Asia was advancing at annual rates between 3% and 5%.

CHART 7: DECOUPLING WAS WORKING UNTIL LEHMAN COLLAPSED

Real GDP: Pre-Lehman Collapse
(3Q 2008/ 4Q 2007, percent change at an annual rate)



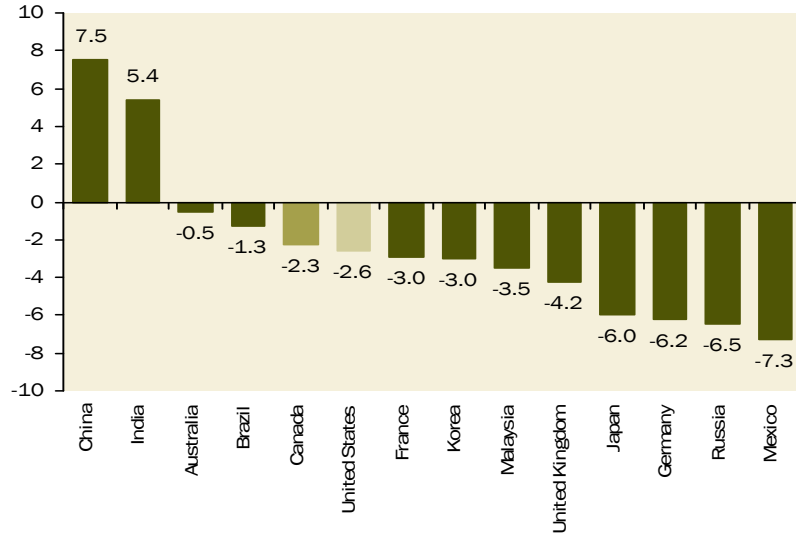
Source: Haver Analytics, Gluskin Sheff

Now there was no country that was accelerating at that point, but the positive growth rates across the continent were, for the most part, intact even if moderating. That these countries went into freefall along with everyone else post-Lehman when global trade finance evaporated misses the point – they were all still expanding during that nine-month period of initial recession in the United States, and now, with the U.S. still contracting, albeit fractionally, emerging Asia is expanding again and growth forecasts for the region are still being revised higher.

CHART 8: ASIA TO REMAIN THE GROWTH LEADER IN 2009 ...

Real GDP

(2009 forecast, annual percent change)

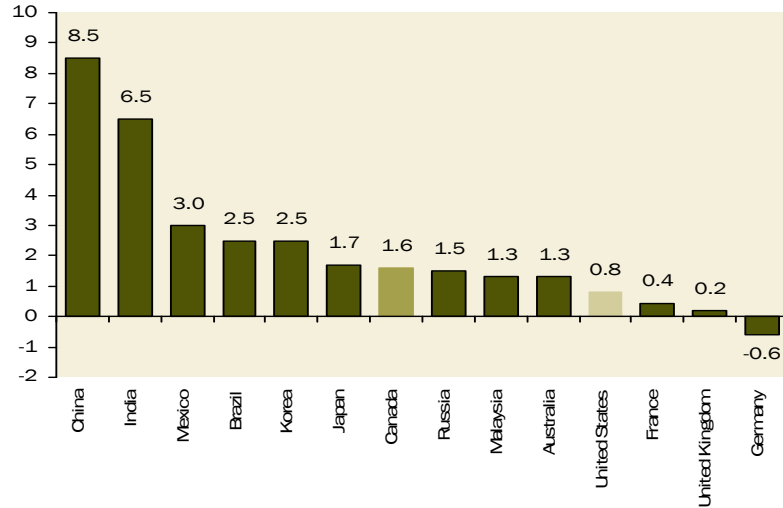


Source: IMF, Gluskin Sheff

CHART 9: ... AND AGAIN IN 2010

Real GDP

(2010 forecast, annual percent change)



Source: IMF, Gluskin Sheff



Clearly the fiscal stimulus in China is percolating through its economy faster than is the case in the U.S. The consensus and official forecasts, say like those published by the IMF, show China and India at the top of the heap for global GDP forecasts both this year and next. Even though the commodity sector is near-term vulnerable to the general pullback in risk-taking, the reassessment of the general economic outlook under way and concerns over China's excessive stockpiling in recent months, we still see resources/basic materials as being in the first half of a secular bull market. This implies that selloffs are long-term buying opportunities; in other words, the sector ought to be bought on pullbacks.

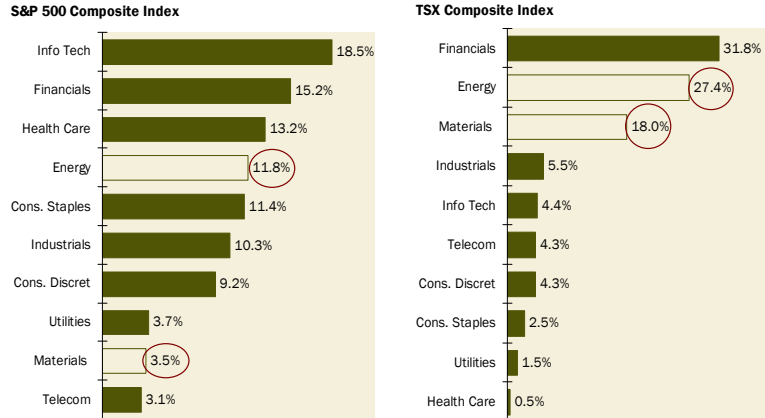
With commodities in a secular bull market, this implies that Canada will likely outperform the U.S.

BULL MARKET IN COMMODITIES = CANADA TO OUTPERFORM THE U.S.

This is where Canadian outperformance relative to the United States comes into play – nearly 45% of the TSX composite index is in resources; almost triple the share in the U.S. Almost 60% of Canada's exports are linked to the commodity sector, roughly double the U.S. exposure. This explains how it is that the Canadian equity market has managed to outperform the S&P 500 this year by a cool 2,000 basis points (in this sense, Canada is basically a low-beta way to play the emerging markets via commodity exposure).

CHART 10: CANADIAN EQUITY MARKET GEARED MORE TOWARDS BASIC MATERIALS

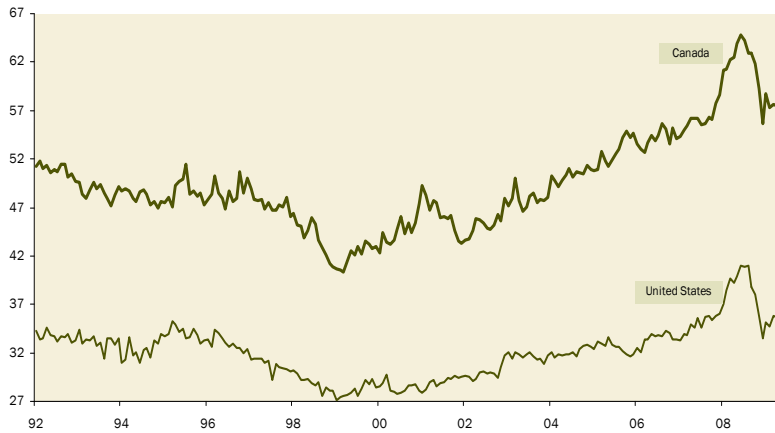
Equity Sector Weightings
(percent)



Source: Bloomberg, Gluskin Sheff

CHART 11: CANADIAN ECONOMY MORE EXPOSED TO THE COMMODITY CYCLE

Exports of Commodities* as a share of Total Exports (percent)

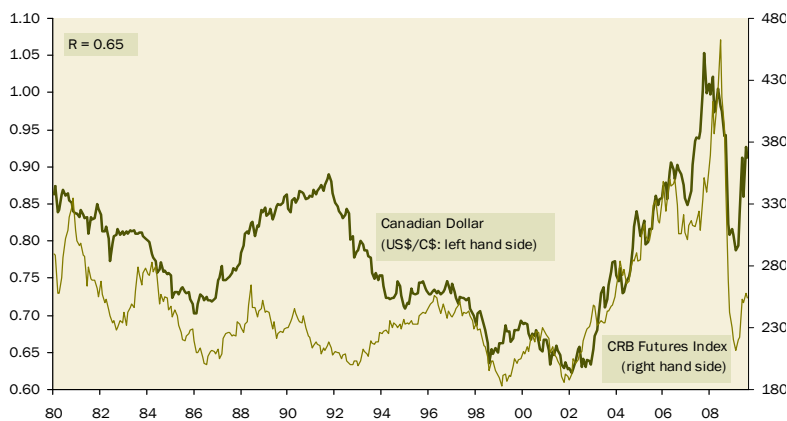


*Composed of industrial goods and materials, forestry products, energy products, and agricultural and fishing products

Source: Statistics Canada, Census Bureau, Gluskin Sheff

Moreover, considering that the Canadian dollar enjoys a 65% correlation with the CRB index, the added boost from the appreciation in the Loonie means that an American investor putting money in Canada would have garnered a 28% gain on a currency-adjusted basis (versus +4.0% in the S&P 500).

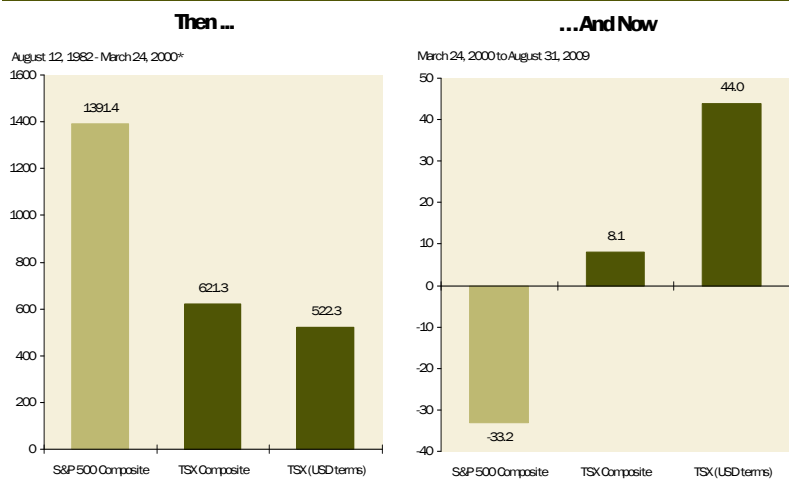
CHART 12: COMMODITY PRICES AND THE CANADIAN DOLLAR MOVE TOGETHER



Source: Haver Analytics, Gluskin Sheff

As the charts below illustrate, what we are witnessing is the reverse of the 1982-2000 secular bull market in U.S. equities and secular bear market in commodities when the Canadian equity market underperformed by 87,000 basis points. But ever since the secular bear market in U.S. equities and bull market in commodities began in classic mean reversion nine years ago, Canadian equities have outperformed by 8,000 basis points. If the history of long cycles is any indication, this period of Canadian market outperformance is barely halfway done.

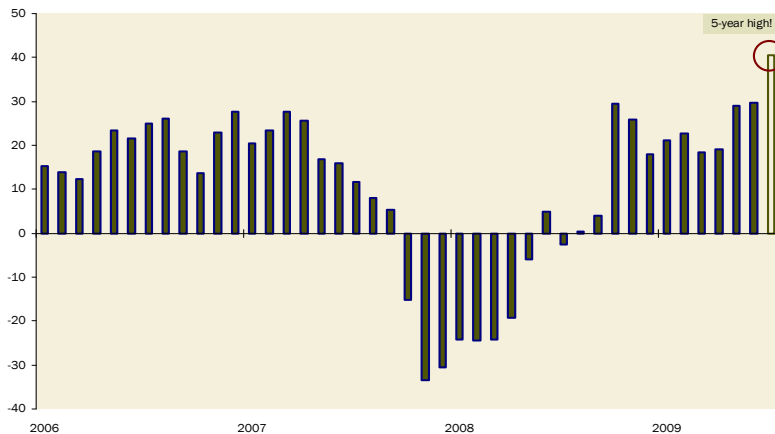
CHART 13: HALFWAY THROUGH THE CANADIAN STOCK MARKET OUTPERFORMANCE



*Dates reflect the trough (August 12, 1982) and the peak (March 24, 2000) in the S&P 500 Composite Index
 Source: Haver Analytics, Bloomberg, Gluskin Sheff

CHART 14: FOREIGN INVESTORS REDISCOVER CANADA

Canada: Net Foreign Purchases of Canadian Stocks and Bonds
 (12-month total, C\$ billions)



Source: Statistics Canada, Census Bureau, Gluskin Sheff



Moreover, if there is durable improvement in the banking sector landscape, the TSX index stands to benefit disproportionately since:

1. The TSX commands twice the financial share, at 30% of the index, compared to the S&P 500.

TABLE 2: CANADIAN BANKS ARE NUMBER 1

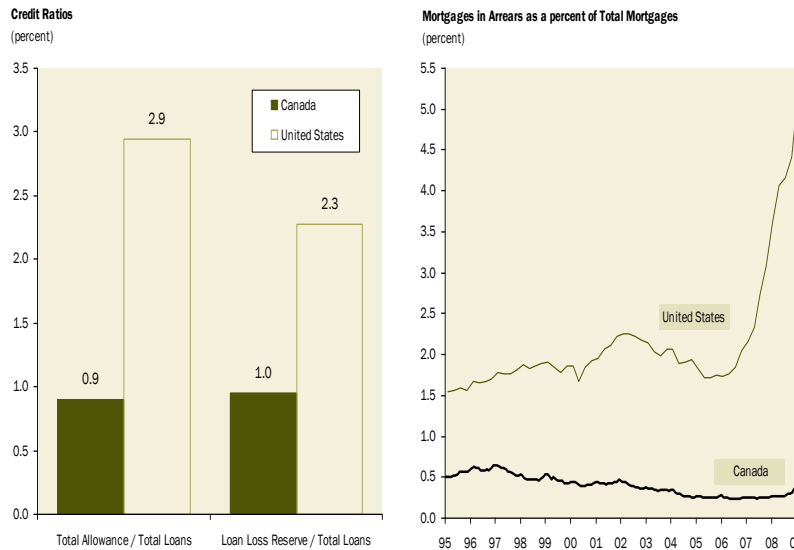
Banks ranked on a scale of 1 (may need government bailout) to 7 (sound)

Rank	Country	Score
1	Canada	6.8
2	Sweden	6.7
3	Luxembourg	6.7
4	Australia	6.7
5	Denmark	6.7
6	Netherlands	6.7
7	Belgium	6.6
8	New Zealand	6.6
9	Ireland	6.6
10	Malta	6.6
40	United States	6.1

Source: World Economic Forum, Global Competitiveness Report 2008-09

2. Canadian banks had non-recourse loans, down payment requirements and plain-vanilla mortgages (as opposed to subprime and IO loans in the U.S.).

CHART 15: CANADIAN DEFAULT RATE EXPERIENCE MUCH DIFFERENCE THAN THE U.S.



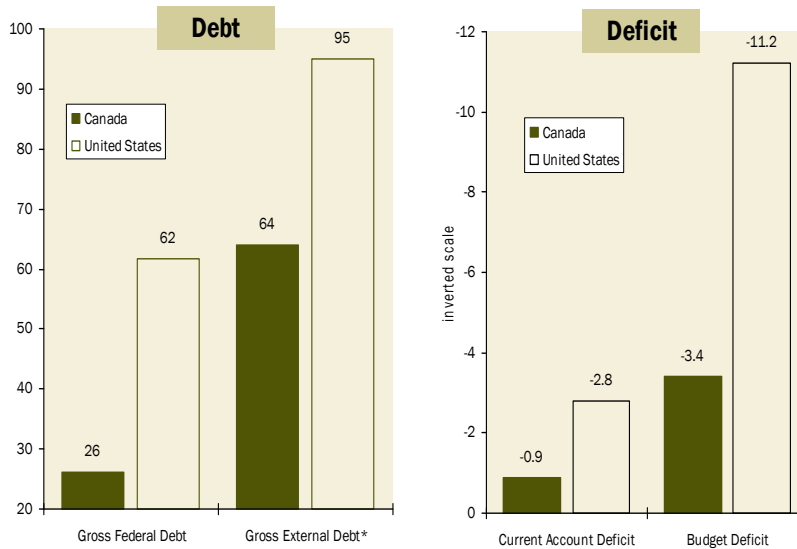
Source: Fox-Pitt Kelton (FPK), RBC Research, UBS Research, Mortgage Bankers Association

3. No Canadian bank failed, cut its dividend or had cap-in-hand to the federal government for capital.

In addition, Canada’s fiscal finances, in terms of debt and deficits to GDP ratios, are far lower than is the case stateside and this, in turn, implies that comparable tax rates are going to very likely move in Canada’s favour in coming years with more positive implications for the currency, growth potential and relative fair-value price-earnings multiples. Keep in mind as well, for the time being, the Canadian government is run by pro-market and pro-business Conservatives, while the U.S. is being governed by an Administration and Congress that some would cite as one of the more left-leaning combinations of the post WWII era.

CHART 16: CANADA IN BETTER SHAPE THAN THE U.S.

(as a percent of GDP, 2009 forecast)



*Using 1Q 2009 figures

Source: Haver Analytics, IMF forecast, Gluskin Sheff

The comparisons above were made in common currency terms because it is vital that investors who make the choice to invest in Canada or the United States understand that in any given year, going back three decades, half of the equity market return differential (in both directions) is accounted for by the move in the exchange rate. The secular bear market in the Canadian dollar from 1982 to 2000 cost a U.S. investor in the Canadian market an additional 10,000 basis points of underperformance. This of course, has all changed with the nine-year bull market in commodity markets and the concomitant improvement in Canada’s terms-of-trade.

While it is never a straight line, secular bull markets by definition have an upward sloping trend-line and cyclical spasms, even the sharp correction in the summer and fall of 2008, are noise around the trend line, as severe as these corrections can be, and should be treated no differently than the setback in the stock market in October 1987. In hindsight, that steep decline can barely be detected on a chart of the Dow today and how many knew back then that it was a correction in what was the fifth year of what turned out to be a secular 18-year bull phase?

THERE'S MORE TO THE CAD OUTPERFORMANCE THAN JUST COMMODITIES AND CANADA'S SUPERIOR FINANCIAL UNDERPINNINGS

But there is more to the bullish Canadian dollar outlook than just the outlook for commodities and Canada's superior financial underpinnings – both in the banking and government space. It comes down to the prospect that the U.S. dollar breaks down further in the coming year to new lows.

The trade-weighted DXY index is just a few basis points away from breaking below the September 22, 2008 low of 75.89 – so far it has hit a low of 76.05. A break below that level sets up the next test at just over the 70 level, which acted as a huge support in the opening months of 2008 (and is the low since coming off the era of fixed-exchanged rates in the early 1970s). This would be great news for gold, commodities, the resource-based currencies (such as the Canadian dollar), basic material stocks and U.S. large-cap stocks in areas like consumer staples, technology and health care where a large chunk of the revenue base is derived from overseas operations.

For Canadian sectors, large importers, such as retailers and wholesalers, see their input costs recede and margins expand when the Canadian dollar firms. Canada is not just a large exporter, but is also a very large importer so there are some winners when the CAD rallies.

SECULAR DECLINE IN THE U.S. DOLLAR

We are just coming off the second anniversary of the credit crunch, when the two Bear Stearns hedge funds went belly up and the inter-bank lending market completely froze up. When you consider how dramatic the policy response has been between a funds rate going from 5.25% to effectively zero, the Fed's balance sheet ballooning from \$800 billion to \$2.0 trillion, and the fiscal deficit surging from 2.0% relative to GDP to 12.0%, it is amazing that the U.S. dollar has only managed to drop to the low end of a trading range of the past couple of years. One would think that it would have depreciated much more profoundly considering the massive shifts in other policy variables.

Now, don't think for a second that the U.S. dollar is not viewed as a policy lever. Sanctioning a depreciation is just a more surreptitious form of trade protectionism, which the U.S. government recently showed is a direction it is willing to follow via those 35% tariffs on Chinese-made tires.

There is more to our bullish CAD outlook than just commodities and Canada's solid financial sector ...

... The U.S. dollar also plays a role and it is in a secular bear market, we believe

We are just coming off the 2nd anniversary of the credit crunch in the U.S. ...

... And the only thing that has not changed is the U.S. dollar

Imagine if you could build a tariff wall for all manufacturers – especially since the U.S. has the lowest share of industrial exports to GDP in the G7. Well, that is what a U.S. dollar depreciation would accomplish.

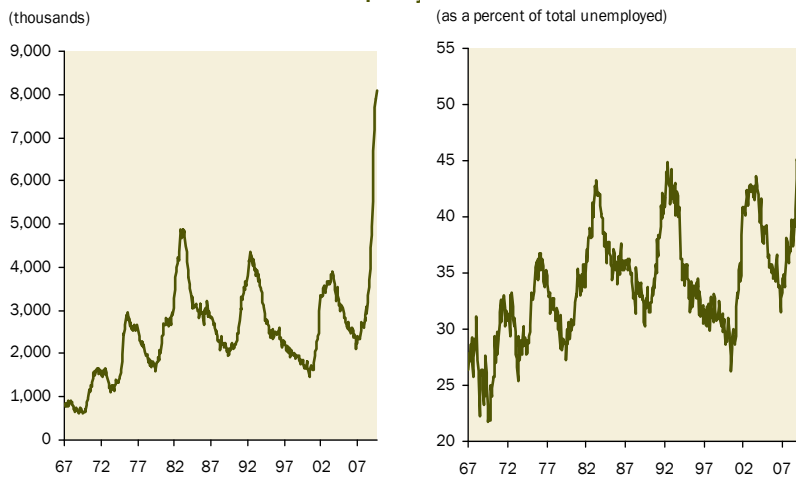
THE MOTHER OF ALL JOBLESS RECOVERIES

The key behind the bearish U.S. dollar outlook is the unemployment rate, believe it or not, and the implications of seeing it hit new highs in a mid-term election year. The unemployment rate may be a lagging indicator for the economists and a coincident indicator for the credit strategists, but for a politician, it is a perfect coincident indicator – especially for incumbents seeking re-election. There are lots we do not know about the future and the error term around any forecast is far wider than it has been in the past. Just take a look at the massive range in the Federal Open Market Committee’s real GDP growth forecast for 2010 – from as low as 0.8%, to as high as 4.0%. In a \$14 trillion economy that gap is not exactly trivial. But what caught our eye was the unemployment rate projection – 8.5% to 10.6% is the range of forecasts. So, there is someone at the Fed who sees a 10.6% unemployment rate, which would put it within striking distance of the 10.8% peak reached in November-December 1982.

The jobless rate may be a lagging indicator for economist, but for a politician, it’s a perfect coincident indicator

CHART 17: PERMANENT JOB LOSERS SURGE TO RECORD HIGHS

United States: Job Losers Not on Temporary Layoff



Source: Haver Analytics, Gluskin Sheff

We think there is a non-trivial chance that we actually see the unemployment rate hit new post-WWII highs next year, and it comes down to how businesses managed their payrolls during this economic downturn. While more than six million jobs have been lost, what that number masks are the near nine million people who saw their full-time positions eliminated. There were three million who were pushed into part-time work, and in fact, there are now a record nine million Americans working part-time because of the weak economy, which is a 55% increase from a year ago.

CHART 18: MORE PEOPLE ARE NOW WORKING PART-TIME FOR ECONOMIC REASONS THAN EVER BEFORE

United States: Nonfarm Workers: Working Part-Time for Economic Reasons



Source: Haver Analytics, Gluskin Sheff

Against this backdrop of a growing part-time workforce, the private workweek was cut more than 2% this down-cycle to a record low 33.0 hours – the labour market equivalent of a further 2 million job losses.

CHART 19: HOURS WORKED STILL AT A RECORD LOW

United States: Total Private Average Weekly Hours Worked (hours)



Source: Statistics Canada, Census Bureau, Gluskin Sheff

What does all this mean? It means that when the economy does begin to recover, when we finally get to the other side of the mountain, companies are going to raise their labour input first by lifting the workweek from its record low. Just to get back to the pre-recession level of 33.8 hours would be equivalent to hiring three million workers. And, the record number of people working part-time against their will are going to be pushed back into full-time, which will be great news for them, but not so great news for the 125,000 - 150,000 new entrants into the labour market every month. They won't have it so easy because employers are going to tap their existing under-utilized resources first since that is common sense. Also keep in mind that there are at least four million jobs in retail, financial, construction and manufacturing jobs lost this cycle that are likely not coming back. In fact, the number of unemployed who were let go for permanent reasons as opposed to temporary layoff rose by more than five million this cycle. This compares to the 1.2 million increase in the 2001 tech-led recession and in the 1990-91 housing-led recession (when Ross Perot talked about the sucking sound of jobs into Mexico).

In other words, the unemployment rate could well stay on an upward trajectory for the next few years. As we said, 10.8% would be a headline-grabber because that is the post-WWII high, and what we do know with certainty is that 2010 is special because it is a mid-term election year. The last Democratic president with an ambitious health care plan was Bill Clinton and if you recall, his party was crushed in the 1994 mid-term elections and his agenda was derailed by Newt Gingrich's 'Contract with America'. We are convinced that President Obama is well aware of this, and more than likely well aware that a record unemployment rate (at least in the 'modern era') could well be a political hot potato for any incumbent, and it is debatable whether a year from now he will be able to continue to deflect the jobless rate problem onto W.

WILL THE GOVERNMENT USE THE USD AS PART OF ITS POLICY ARSENAL

As we said above, the U.S. government has practically exhausted all of its policy options ... except for one; the U.S. dollar. It is the only policy tool that has not budged one iota since the crisis erupted two years ago. As we mull this over, we recall all too well this great book that a client referred us to a few years back and it was Robert Rubin's autobiography – *"In An Uncertain World"*. What we learned (as did the client and whoever else has read it) was obvious – the United States will always do what is in its best interest. Full stop.

TABLE 3: CELEBRATING THE 2ND ANNIVERSARY OF THE CREDIT CRUNCH – EVERYTHING HAS CHANGED EXCEPT FOR THE U.S. DOLLAR

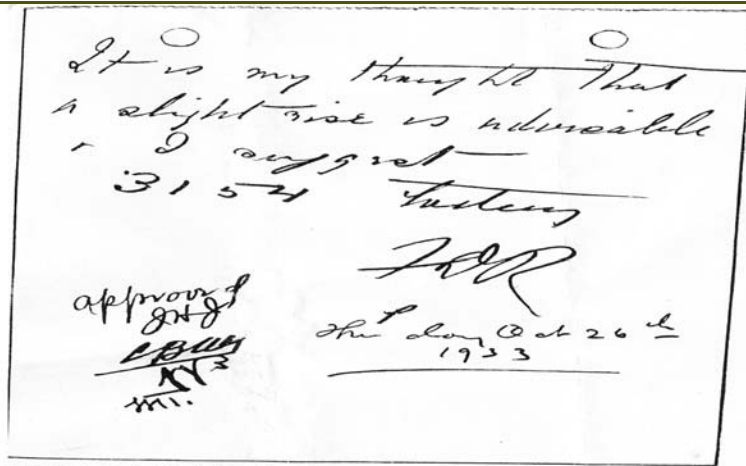
United States	Level of Economic and Financial Indicator	
Economic and Financial Indicator	Two-years ago	Current
Fed funds rate	5.25%	0%
30-year fixed rate mortgage	6.75%	5.00%
Fed balance sheet	\$850 billion	\$2.0 trillion
Fiscal deficit-to-GDP ratio	2.00%	13.00%
Broad Trade Weighted U.S. Dollar	102.8	103

Source: Haver Analytics, Gluskin Sheff

We think there is a non-trivial chance that we actually see the unemployment rate hit new post-WWII highs next year

In addition to knowing it is a mid-term election year in 2010, we also know that we have a President who has, step by step, been taking feathers out of FDR's cap in dealing with this modern day depression. The one item that has yet to be utilized is U.S. dollar depreciation, and if memory serves us correctly, FDR snuffed out the worst part of the Great Depression when he unilaterally devalued the dollar relative to the gold price in 1933 by 60% (ultimately fixing the price of gold at \$35/oz in 1935).

CHART 20: FDR's MEMO IN 1933 TO DEVALUE THE U.S. DOLLAR



The initials on F. D. R.'s gold chit are those of R. F. C. Directors Jesse H. Jones, Carroll B. Merriam, John F. Blaine, Frederic H. Taber.

Source: Jones, Jesse H. "Fifty Billion Dollars: My Thirteen Years with the RFC," 1932-1945 (1951)

We're not sure that President Obama is going to re-price the dollar price of gold, but the catalyst for a weak-dollar policy may lie in further expansion of the Fed's balance sheet and *de facto* printing of excess greenbacks, which may well have been the *quid pro quo* for Mr. Bernanke's reappointment. (Just a few months ago, the White House had reportedly published a short list of possible replacements for the Fed Chairman, but we will only find out in the memoirs how much horse trading went on behind closed doors. But suffice it to say that a President that is becoming actively involved in the New York governorship race is quite capable of doing all it takes to ensure a desirable political outcome.)

THE U.S. UNEMPLOYMENT RATE COULD HIT 10.8% BY YEAR END

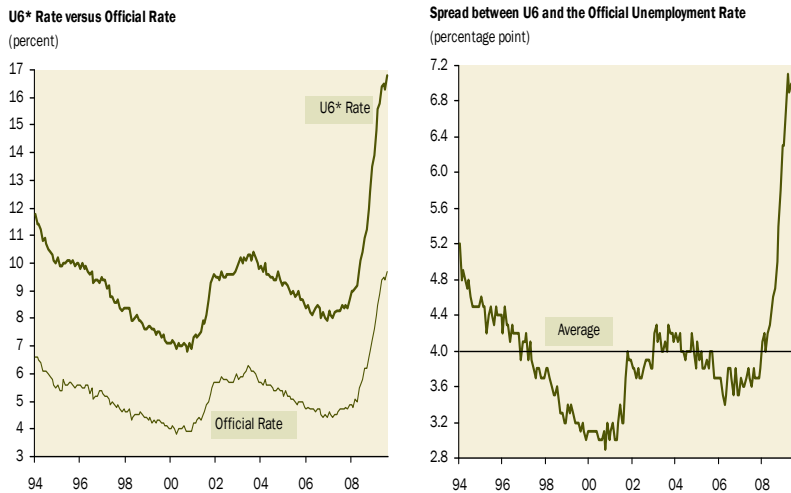
Most folks frankly do not know what goes into the unemployment rate but they do know that it is a lot like their golf score. When it goes up, it's not a good thing. We have a combination next year of politics mixed with the prospect of a new post-WWII high in the unemployment rate. The Chart 21 below shows, we do have one measure of the unemployment rate already at 17%, and it is the U6 measure, which provides the most inclusive definition of the labour force, including the shift to part-time work.

The official rate that makes it into the headline news is at 9.7% (highest since mid-1983). As we said above, when employers start to feel the need to add to labour input, they are likely to start by boosting hours and moving the record number of part-timers out of furlough and back into full-time. However, the typical 100k-150k new entrants to the labour force every month are likely going to find it difficult to find a job and hence the unemployment rate will continue to drift higher even as the recovery takes hold. Remember, the last recession ended in November 2001 and yet the unemployment rate did not peak until June 2003 – a year-and-a-half later. The critical difference is that there was no election for incumbent politicians to fret over.

The historical gap between the U6 jobless rate and the official measure is four percentage points, but today it is at a record seven percentage points. As this spread mean reverts, as the U6 heads down and the headline rate moves up, it could easily meet in the unhappy middle of 4 percentage points, which would mean ... the possibility of a 13% peak in the unemployment rate. Sounds bizarre, but then again, who was calling for a zero funds rate two years ago?

CHART 21: RECORD LEVEL OF SLACK IN THE LABOUR MARKET

United States: Unemployment Rates



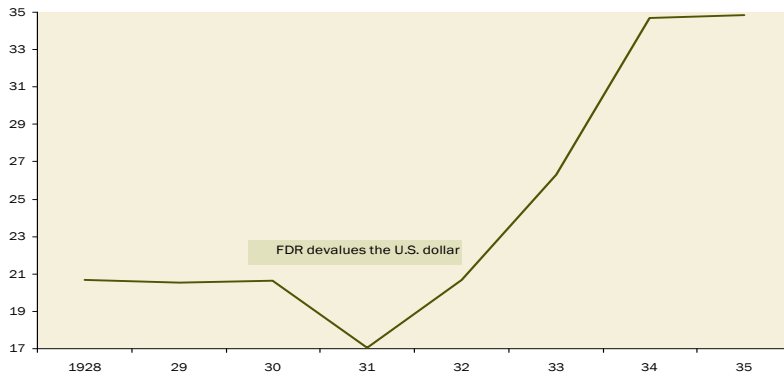
**Includes all marginally attached workers and those employed part-time for economic reasons
Source: Haver Analytics, Gluskin Sheff*

Just remember, for all its faults, there is no economic statistic that is quite as emotionally charged as the unemployment rate. Can anything really be ruled out for a country that always operates in its best interest – even if it may not be in everyone else’s best interest? Sanctioning a 10-20% dollar devaluation as a means to stimulate the domestic economy justified on the grounds that the U.S. has the lowest industrial export share of the G7 may not be too difficult a task since most Americans don’t really pay much attention to the dollar. (Ask them where the Dow is and that they can get to the decimal place without seeing a ticker board; U.S. dollar-euro is a different matter altogether – I can vouch for that, having worked there for nearly seven years.)

Canada had its currency go from 90 cents to 60 cents to bolster exports and crowd out imports and it wasn't long before it was posting record current account surpluses; and look at what happened to the balance-of-payments turnaround after the emerging Asia currencies plunged in the late 1990s. Mercantilism does at least pay off for a while, and was the case in the mid-1930s – remember that we have a president today who is the modern-day version of FDR. Back in the 1930s, devaluing the dollar did trigger a bump in inflation and turndown in the unemployment rate, at least for a couple of years.

CHART 22: IS DEVALUING THE USD THE NEXT STEP FOR THE ADMINISTRATION? FDR DEVALUES THE U.S. DOLLAR ...

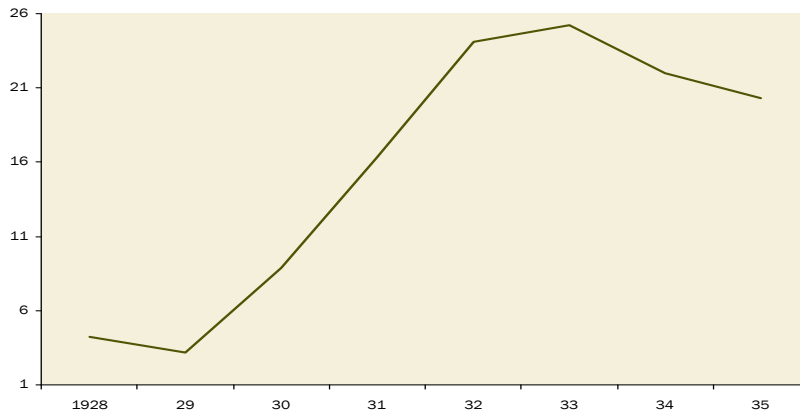
Unite States: U.S. Dollar Price of Gold (US\$/oz)



Source: Kitco.com, Gluskin Sheff

CHART 23: ... The Unemployment Rate Goes Down ...

Unite States: Unemployment Rate (percent)



Source: Haver Analytics, Gluskin Sheff

CHART 24: ... AND PRICES GO FROM DEFLATION TO INFLATION

United States: Consumer Price Index
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

HOW TO PROTECT THE PORTFOLIO IN A FALLING USD ENVIRONMENT

Remember, this is a premise. We are just conjecturing. But it is interesting that the dollar is the only financial metric that is at the same level today as it was two years ago, and we are of the view that the risks are high that the greenback will be on a significant downward path in the coming year. In addition, it does look as though Asia's secular growth dynamics are intact, and that is also critical to the constructive view on commodities and the Canadian dollar. With that in mind, investors should be thinking of how to hedge or protect the portfolio against this not-so-remote possibility, namely:

1. Commodities
2. Gold
3. Canadian dollar
4. Resource sectors of the stock market
5. U.S. sectors that have high foreign exposure (materials, tech, staples, health care)
6. Canadian sectors that benefit from lower import costs (consumer stocks) but lose export competitiveness (manufacturers)
7. Canadian bonds (a higher Canadian dollar will keep inflation low, hence reinforcing positive fixed-income returns)

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 June 30, 2009, the Firm managed assets of \$4.4 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).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 \$9.3 million² on August 31, 2009 versus \$5.1 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 \$10.8 million USD² on August 31, 2009 versus \$8.4 million USD for the S&P 500 Total Return Index over the same period.

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 30% to 40% 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, with the noted addition of David Rosenberg as Chief Economist & Strategist.

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For further information, please contact questions@gluskinsheff.com

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.
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