

**MARKET MUSINGS & DATA DECIPHERING**

# Breakfast with Dave

## WHILE YOU WERE SLEEPING

Global equity markets were able to shrug off some adverse earnings news after the close — Europe now up 10 days in a row; Asia is up right across the board; U.S. futures flashing more green. Government bonds are trading defensively. The U.S. dollar is soft and along with that we see continued firming in the commodity sector. On the data front, a mixed bag overall but still with a positive tilt — French consumer spending was down in July but the German Ifo business sentiment index jumped to 87.3 from 85.9 (consensus was at 86.5). The combined manufacturing and service sector PMI for the continent improved too — to 46.8 from 44.6 in June (contracting at a slower rate — the definition of a green shoot). These numbers followed the closely-watched Belgian business sentiment survey, which came in at -22.8 from -23.6 in June and this is viewed as a terrific leading indicator. News that U.K. GDP contracted twice as much as expected in 2Q (-0.8%) received scant attention.

Perhaps the best leading indicator of global equities is China — it peaked in 2007 ahead of the pack and then bottomed in late 2008 a full four months ahead of the U.S. trough. In addition, the Shanghai index leads the CRB by two months and with an 80%+ historical correlation. There is no doubt that China's fiscal stimulus is percolating and that the economy has turned higher, but the equity market there has surged 85% so far this year, so how much is priced in at this point is a concern. It looks like speculative fervor is back — the volume of credit that has flowed into the economy this year has amounted to one-third of GDP. Not only that, individual investors opened 484,799 accounts in China last week — the most since January 2008 and five times as many that were opened last January. This may be one sign of ... irrational exuberance.

## CHART 1: BUBBLE 2.0?

China: Shanghai Index



Source: Haver Analytics, Gluskin Sheff

## IN THIS ISSUE

- Is the Obama team sanctioning a weaker dollar?
- The equity markets have clearly broken out in terms of price. But is it real or not?
- In our opinion, the odds of a consumer-led 4Q relapse are very high
- Inventory rebuild story overdone
- The economic data out of the U.S. remain, well ... weak

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### IS THE OBAMA TEAM SANCTIONING A WEAKER DOLLAR?

The DXY is starting to break down, and the moving averages are moving down across the board. Meanwhile, the commodity complex and the commodity-based currencies are on fire. The Kiwi is at a nine-month high; the Rand at an 11-month high and the Loonie at a seven-week high. Meanwhile we saw sugar, wheat, corn, cotton and gold all rally significantly yesterday. As we said before, the last policy shoe to drop, which may be dropping already, is the dollar.

Speaking of the Obama team and this may be one reason why equity market sentiment has been improving – the President is facing opposition in both houses of Congress to the health care overhaul in terms of getting legislation over the next month. This is a pretty big deal and there does seem to be an inverse correlation to how the equity market has performed of late and the President's approval ratings in the recent polls.

### SOME MARKET THOUGHTS

If you need signs of complacency, just look at the VIX index, which has sagged all the way to 23.4 from over 30.0 two short weeks ago. And, if you need signs of delusion, just look at the fact that even in the face of a 49% plunge in earnings, UPS still managed to rally 2.3% yesterday.

We would have to say that we look at UPS, the world's largest package delivery company, as a major artery in the global economy. It ships products that span all aspects of manufacturing and financial services, so it is extremely broadly based in terms of its representation in world GDP. As a result, it is very difficult to reconcile what the company did and what it had to say with the widespread view that a major inventory cycle is somehow kicking in; unless all the shipping action is taking place at FedEx (which we know from last month's statement is hardly the case – sales down 20%). UPS guidance was downbeat, with the company saying that shipments will remain "significantly below" last year's levels and sharply cutting its EPS forecasts for 3Q (to 45 - 55 cents from 60 cents), and as is the case with so many other companies, revenues sagged 17%. There is still no top-line growth. Look at Microsoft – the largest software company in the world – it posted a 29% drop in profit and sales (this isn't enough to offset the earlier Intel news?). Amazon.com, the world's largest internet retailer, posted a decline in profits and below-target sales despite its aggressive price discounting strategy (the stock still rallied nearly 6.0%). Bonds sell off (Treasury announced \$115 billion of new supply for next week, above the expected \$112-113 billion) but as they do, the real yield rises because deflation pressures are still intensifying in the real world – look at McDonald's, which posted a 7.0% YoY revenue falloff.

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**The U.S. dollar is breaking down; are we starting to see the last policy shoe drop?**

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And what's this? American Express, the hottest stock in the Dow this year, posting a 48% plunge in net income. How does one square the pervasive belief that the credit crunch is over with that statistic? Friends, this is a faith-based rally, pure and simple. And, as powerful as it is, this rally to new post-Lehman highs is being driven primarily by the technicals. Momentum is extremely strong at this time, and this often exerts a self-perpetuating move in the market, and in both directions. As we saw in March, the negative momentum ends once the selling pressure is exhausted. At that time, signs that Armageddon was not in fact setting in, helped to underpin the move off the lows. In the current trading environment, this rally ends with the reverse – buying power subsides and evidence mounts that either the recession does not end this quarter or that any recovery is aborted (as we saw unfold in 2002 under very similar market circumstances).

Liquidity is also no impediment to the market at this time, though we do see that the Fed is now allowing its balance sheet to shrink and the once red-hot growth in the monetary base has now completely stagnated. Our concern is with valuation to some extent, as the market (and the consensus) is discounting an earnings stream (\$75 on S&P 500 operating EPS) for 2010 that we do not believe will occur much before 2012. To a greater extent, we are worried about the fundamental macroeconomic outlook over the medium-term. History shows that post-bubble credit collapses are followed by years of economic fragility, recurring deflation pressure and lingering double-dip recession risks.

Be that as it may, the equity markets have clearly broken out in terms of price. The question is: Is it real or not. Or is it just the C-wave (final leg) of a bear market rally. Volume would indicate that it remains a bear market rally as would the fundamentals as we witness stocks rallying even in the face of what has been a mixed earnings season at best (despite the CNBC hype) and continuing deflationary signs of negative revenue growth across a wide swath of industries.

Earnings may be beating low-balled estimates for the majority of S&P 500 companies, but there is no questioning the fact that we are also seeing a sustained decline in revenues. Weak top-line growth is being driven by weak employment trends and by persistent social trend towards frugality, which is still in its early stages. Social changes by their very nature do not occur over months or quarters but over years. And in our many recent visits south of the border, the strategy of long-term investors even in the face of this elongated bear market rally and volatility has been to focus on income orientation and capital preservation. We feel that it is extremely important to understand the degree of the volatility and to consider the extent of the switch in market sentiment that has taken hold now in just the last two weeks.

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**AMEX's net income plunged 48%; how can the credit crunch be over with a statistic like this?**

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To reiterate — what we are still witnessing is a trading opportunity rather than a fundamental shift in the outlook. We must take into account what the risks are going to be once the buying momentum is lost. Over the near-term, it is obviously prudent to tighten stops and at the same time have a very careful eye on entry levels, but the medium-term and longer-term trends still suggest that we are in cyclical spurt in what remains a secular bear market.

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**The odds of a consumer-led fourth quarter relapse are very high, in our opinion**

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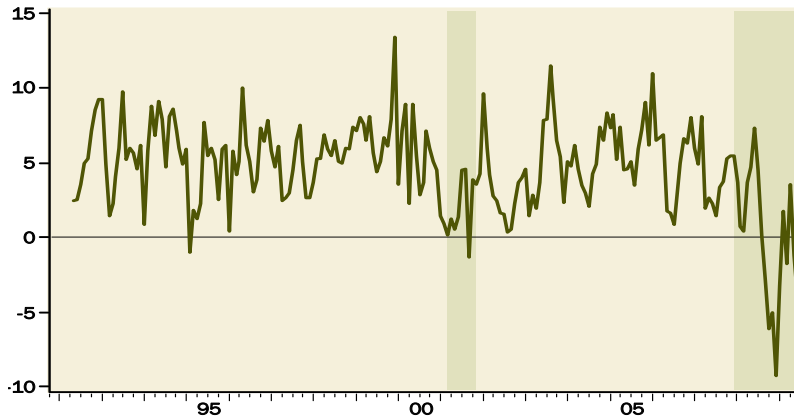
Much is being made of the looming inventory cycle and how far production has fallen below demand. We also heard this in late 2001 and early 2002 and in fact, there was a spurt in real GDP growth in the first half of '02 when inventories added an average of two-percentage points to headline growth, accounting for 80% of the total pickup in the economy. But there has never — ever — been an inventory cycle that was sustained without the front-end support of final sales growth. And the aborted inventory story of 2002 was exactly that as sales and GDP growth both converged at zero by year-end — new lows in the equity market were not far behind. Admittedly, this last leg of the bear market rally has been huge, taking the S&P up an impressive 8.0% over the past month, even in the face of mixed economic and earnings news. And as Mr. Market, that malevolent beast, tests our resolve, we remind ourselves that in the month leading up to the all-time high of 1,565 on October 9<sup>th</sup>, 2007, the S&P 500 was also up 8.0%, also in the face of a mixed data landscape. The lesson here is that it could be dangerous to extrapolate the short squeeze of the high-beta stocks into future price performance.

We are not sure what the appropriate label is for a market that has managed to shrug off four consecutive months of negative core retail sales in the face of what was the most pronounced fiscal stimulus in modern history. Over that period, core retail sales fell at a 4.2% annual rate, and going into the second half of the year, there is no more cash-flow support from Uncle Sam at a time when a rising unemployment rate has already taken organic personal income down by a record 1.9% year-over-year (in nominal, not real terms). The odds of a consumer-led fourth quarter relapse are very high, in our opinion. And, as for all this talk about inventory rebuilding, all we can say is that outside of the auto sector, I/S ratios have barely budged from their cycle highs so we just don't see that the restocking story is broadly based enough to have enough legs to make a difference beyond the current quarter's motor vehicle production rebound. It's going to be known as pop, snap, and crackle.

Remember what Ben Bernanke had to say at this week's congressional testimony: *"Despite these positive signs, the rate of job loss remains high and the unemployment rate has continued its steep rise. Job insecurity, together with declines in home values and tight credit, is likely to limit gains in consumer spending."* And without the consumer, there can be no sustained inventory cycle.

**CHART 2: CONSUMER HAS ALREADY DOUBLE-DIPPED SINCE MARCH**

**United States: Retail Sales excluding Autos, Gasoline and Building Materials**  
(four-month percent change at an annual rate)



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

**INVENTORY REBUILD STORY OVERDONE**

Moreover, it is extremely difficult to get overly excited about a sustained inventory bounce when (i) containerboard and paper box prices are deflating; (ii) the Dow transports index is sputtering in relative strength terms; (iii) UPS package volumes in June were down 4.7% YoY, compared with -3.9% in March and -2.1% in December; (iv) total railway carloadings, as of July 18<sup>th</sup>, were 18.8% below last year’s levels and those levels represented an economy that was already eight months in recession.

That said, the Bank of Canada declared the end of the recession yesterday and changed its real GDP growth forecast to a +1.3% annual rate for 2Q from its -1.0% forecast before. And that’s with an 87 cent dollar assumption too! We are left supposing that inventories are going to be the story, perhaps coupled with pent-up housing demand and fiscal stimulus, but weak employment trends are bound to hold down the consumer and an overvalued exchange rate, along with moribund domestic demand south of the border, are not going to do very much for the export sector.

Here is what the Bank of Canada had to say in its Monetary Policy Report yesterday:

*“Global economic activity appears to be nearing its trough, and there are increasing signs that activity has begun to expand in many countries in response to monetary and fiscal policy stimulus and measures to stabilize the global financial system.”*

But remember, this is just a view – it may or may not actually happen. In fact, so far this cycle, most central bank forecasts of the economy and inflation have been way off the mark. Remember this from the June 2008 Bank of Canada meeting?

*“...the balance of risks to the Bank’s April projection for inflation in Canada has shifted slightly to the upside. Although the composition of U.S. growth has not been favourable for demand for Canadian goods and services, overall, global growth has been stronger and commodity prices have been sharply higher than expected. At the same time, many of the downside risks to inflation identified in the April MPR have eased, while the evolution of credit conditions has been in line with expectations. The risk remains that potential growth will be weaker than assumed.”*

Nice call.

As an aside, Alan Blinder writes an op-ed on page A15 of the WSJ titled *The Economy Has Hit Bottom* and even suggests we could be in for a few quarters of 3–4% growth, which is largely statistical in nature as housing stops subtracting from headline GDP and inventory liquidation subsides. In the final analysis, there is no sustained recovery in the absence of a revival in consumer spending and that is the wild card in the outlook.

**CHART 3: INVENTORY-TO-SALES RATIO IN MANUFACTURING – RE-STOCKING AHEAD?**

**United States: Manufacturing Inventory-to-Sales Ratio**  
(ratio)



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

#### CHART 4: Manufacturing Inventory-to-Sales Ratio Excluding Autos

##### United States

(ratio)



Shaded region represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

#### THE DATA REMAIN, WELL .... WEAK

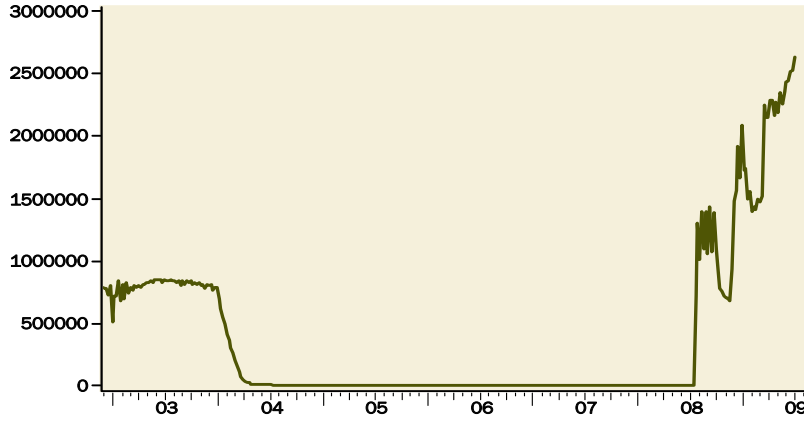
It has become fashionable to treat the jobless claims data as 'green shoots' since they are no longer making new peaks. That much is true. But at 554,000 (the level for the July 18<sup>th</sup> week), claims are consistent with nonfarm payroll losses of between 300,000 and 400,000, which are huge whether assessed straight-up or as a share of the population. Now, there is much being made of the fact that continuing claims are starting to come down — down 88k to 6.225k in the July 11<sup>th</sup> week and this followed the 591k plunge the week before. But in reality, what is happening is that people have been on unemployment insurance for so long that their benefits have expired. Check out the benefit exhaustion rate, which just hit a record 50%. What people are doing is rolling onto the various extended benefit programs, which surge by over 170k in the latest week.

Oh yes, and the home sales data, which certainly did put some oomph into the homebuilding stocks. So the bottom has been put in with regard to resales. Well, one would expect that outcome eventually given how attractive affordability is. But the upturn is so lackluster that it is really difficult to get excited. Since bottoming in November 2008, sales are now up 7.7% (and keep in mind that nearly 1-in-3 of these sales are foreclosure activity). Go back to all the other cycles and check out, by this time, what the 'normal' rebound is from the trough. Try 20%. This is what you would otherwise call a slow-motion recovery. The fact that the unsold inventory receded to 9.4 months' supply in June from 9.8 months' was indeed good news, but keep in mind that the home price deflation story only ends once this metric dips below 8 months' supply.



**CHART 5: MORE AND MORE AMERICANS ARE CLAIMING EUC**

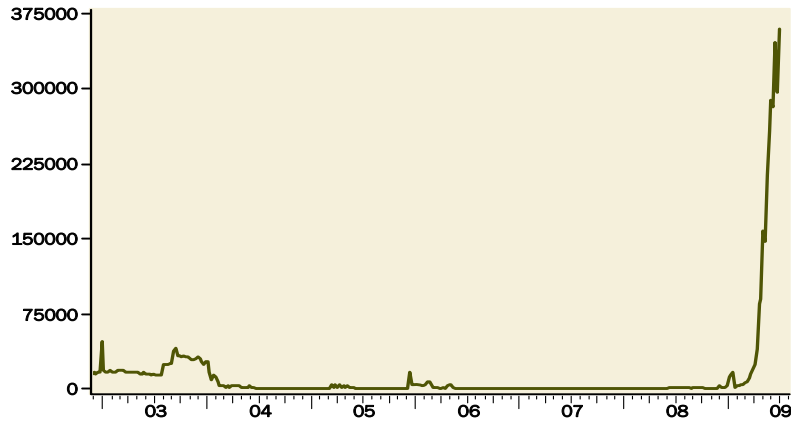
**United States: Persons Claiming Benefits Emergency Unemployment Comp (EUC)**  
(number)



Source: Haver Analytics, Gluskin Sheff

**CHART 6: ONCE EUC IS EXHAUSTED, THEY GO INTO EXTENDED BENEFITS**

**United States: Persons Claiming Benefits Extended Benefits**  
(number)



Source: Haver Analytics, Gluskin Sheff

# Gluskin Sheff at a Glance

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## 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).<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 \$8.7 million<sup>2</sup> on June 30, 2009 versus \$4.8 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 \$10.1 million USD<sup>2</sup> on June 30, 2009 versus \$7.5 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.

*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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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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