

**MARKET MUSINGS & DATA DECIPHERING**

# Breakfast with Dave

## WHILE YOU WERE SLEEPING

European bourses are up across the board and U.S. futures show a rebound, but the action in Asia has been broadly mixed and down outright in China and Hong Kong. We seem to remember that it was the Shanghai index that led the global equity market recovery in late 2008 and views we are seeing being espoused on the news wires that the U.S. and China have “decoupled” seem off base even if seemingly accurate for the here-and-now crowd.

Commodities are down, except for gold, which has recovered from six-week lows and the resource-based currencies have remained firm (New Zealand GDP in Q4 came in better than a 3% annual rate). The mighty U.S. dollar is off a tad so far today in a round of profit-taking (the move in the past few weeks look parabolic).

Bond markets overseas are following on the footsteps of the dramatic selloff in U.S. Treasuries yesterday (though to a lesser extent) — the bond market is really oversold at these levels.

The data overnight were sparse but mixed. We did get a pleasant surprise in the U.K. as retail sales jumped 2.1% MoM in February but this was skewed in part by the weather and VAT distortions, which crushed spending at the start of the year. Meanwhile, France printed an awful consumer spending number — down 1.2% in February (the consensus was +0.4%) and this took place on top of the 2.5% slide posted in January. The Euroland economy is in trouble and the news overnight that regional M3 is now contracting (-0.4%) will only serve to reinforce that view. Market-wise, we see that Starbucks has become a fan of the secular income theme as it doles out a dividend for the very first time.

## MARKET THOUGHTS

A good friend, and long-time reader, was kind enough to pass along these thoughts yesterday. Basically, the stars are starting to align for something really big to happen.

First, the Shanghai index peaked in August 2009 and had a secondary top in December 2009 (global demand slowing?). Many emerging markets are all negative year to date.

Second, gold peaked in the first week of December 2009 (and now breaking down) while the U.S. dollar index (the DXY) is breaking higher (Greece has not been resolved).

Third, TIPs (ETF) peaked the first week of December 2009 (and just broke to a new four month low).

## IN THIS ISSUE

- While you were sleeping — the data overnight were sparse but mixed; however, we did get a pleasant surprise in the U.K. retail sales results; commodities are down, except for gold
- Market thoughts — it seems that the stars are starting to align for something really big to happen
- Getting more overvalued — the latest Shiller data just came out and shows the normalized P/E ratio on the S&P 500 to be 21.3x. The long-run mean is 16.4x
- Getting more overbought — the Investor Intelligence poll shows that the share of bulls are now at 48.9%, up from 46.1% last week; the bear camp dwindled again, to 20.5% from 21.3%
- Payrolls about to surge... really?
- The U.S. housing market is rolling over again even with all the stimulus
- We are seeing Moderate growth in capex in Q1 for the U.S.
- Canadian economy on fire — the index of leading economic indicators advanced 0.8% MoM in February

Please see important disclosures at the end of this document.

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 meeting the needs of our clients by delivering strong, risk-adjusted returns together with the highest level of personalized client service. For more information or to subscribe to Gluskin Sheff economic reports, visit [www.gluskinsheff.com](http://www.gluskinsheff.com)

Fourth, commodity prices peaked in the first week of January and appear to be rolling over. Head-and-shoulders top from October 2009 peak?

Fifth, could we be in for a March peak in equities? The NYSE new high list peaked six trading days ago. Recall that a market correction followed in October of last year and January of 2010 following similar peak in new highs.

Sixth, despite signs of economic cooling in Q1 (around 2.5% growth and half the Q4 pace) and lower inflation expectations, the 10-year Treasury note yield is ratcheting up (in a destabilizing fashion) and devoid of any bearish economic data (for a range of technical/fund flow reasons as was the case in the summer of 2007 — we never said at the Grant's conference in New York that it was going to be a straight line down). But in technical lingo, it does look as though the yield is breaking out from a triangle since the December 31, 2009 yield peak — go back to that period in December and January, 3.85% on the 10-year Treasury-note served at least three times to be major technical support — a break of that this time around would mean some serious near-term trouble (the nearby high closing level was 3.98% back on June 10, 2009).

Rates may be rising because:

- Of added supply concerns from Obamacare;
- Sovereign credit quality;
- Heightened fears over a looming trade spat with China (if the Treasury accuses China of being a 'currency manipulator' next month);
- Hedging related to the most recent huge wave of corporate bond issuance;
- Swap rates have also become unhinged (they traded at an unprecedented 8bp discount to 10-year Treasuries yesterday) ....

... but yields are NOT rising from inflation (in fact deflation signs are re-appearing again). Hence, real yields are on the rise ... not typically what an equity bull would like to see with real growth now softening. Rising real rates as real growth slows means it is time to get more defensive, not more cyclical (especially with small-cap stocks up nearly 10% year-to-date, doubling the performance of the large-caps. This will not be sustained as the global and domestic economies cool off through the balance of the year.)

Bottom line: Stronger U.S. dollar. Rising bond yields. Lower commodity prices. Slower growth. And the stock market is flirting at post-crisis highs. Bond yields are rising temporarily and this will very likely prove to be a good buying opportunity; however, over the near-term, higher yield activity may well persist and the question is how the equity market is going to handle this backup in market rates. Recall that the 10-year yield had a March to June 2007 spike of 90bps before the rate and credit collapse took hold in the back half of 2007! Could it be that history is rhyming again? The March-June period has been seasonally weak for the Treasury market in five of the past six years.

---

**Rising real rates as real growth slows means it is time to get more defensive, not more cyclical**

---

Add to all that is the further extra intrigue of the S&P 500 having just 'celebrated' the 10<sup>th</sup> anniversary of the first bubble peak reached in 2000. As painful as it is for the bulls to see, the equity market is still down 23.5 % from those March 2000 highs, not to mention still in the red by 25.4% from the record high posted in October 2007. The Nasdaq is still a Japanese-like 53% shy of its 2000 all-time high.

#### GETTING MORE OVERVALUED

The latest Shiller data just came out and shows the normalized P/E ratio on the S&P 500 to be 21.3x. The long-run mean is 16.4x, so if you are buying the market today, you are buying it a 30% premium to what was considered to be normal in the past. Some claim that P/E multiples deserve to be high seeing as bond yields and inflation are so low. But even here, when we go back and capture other such periods of low rates and low inflation, the Shiller multiple averages out to be 16x. So, even adjusting for this, the market is overvalued by more than 30% benchmarked against historical norms.

#### GETTING MORE OVERBOUGHT

The Investor Intelligence poll was just updated and shows ... the share of bulls are now at 48.9%, up from 46.1% last week; the bear camp dwindled again, to 20.5% from 21.3%. Even those expecting a correction (did we really have one in January?) are throwing in the towel – down to 30.6% from 32.6%. The bull/bear spread widened for the sixth time in as many weeks – a contrary negative but we have been saying that for a while now and Mr. Market has not exactly been cooperating.

#### PAYROLLS ABOUT TO SURGE. REALLY?

We are hearing estimates of March employment near +300k on a weather rebound and Census hiring. Meanwhile, we just heard from Paychex (provides HR services to small businesses) and their quarterly earnings report and we printed part of the press release below (from the CEO):

*“For the third straight quarter, our key indicators have shown stabilization and, exclusive of certain items, we have slightly exceeded our earnings goals throughout fiscal 2010. Achieving our revenue goals has proven more difficult due to the adverse impact the economic headwinds have had on new client sales and client retention. Our client base declined 2.1% since May 31, 2009. The selling season was a difficult one as our new sales units for the nine months were down 6% from last year, primarily due to declines in new business formation and fewer companies moving to outsourcing. Client retention, while less favorable than normal, began to show some improvement as clients lost during the first nine months were 5% below the same period a year ago, with a slight improvement in these losses as a percentage of the beginning of the fiscal year client base. On a positive note, checks per client remained stable with a 2.2% reduction over the same period last year, compared to 3.7% and 5.0% for the second and first quarters of fiscal 2010. We are hopeful that the checks per client are an indicator of better times ahead.”*

---

**The latest Shiller  
normalized P/E ratio on  
the S&P 500 is 21.3x –  
the long-run mean is 16.4x**

---



**HOUSING ROLLING OVER EVEN WITH ALL THE STIMULUS**

First, we got the existing home sales data for February and they edged down again, by 0.6% MoM, and “no” – it was not due to the blizzards (sales actually rose in the Northeast and Midwest). Also keep in mind that these are closings – so no reason why they should have been impacted by the weather at all.

This is a new downward trend in sales turnover because it was the third decline in a row and we are now all the way back to the depressed levels of June 2009, at just over five million units annualized. Without the tax credits, which expire at the end of April (we shall see about that – Arnold is already moving to extend the goodies in the Golden State) we would have seen an even weaker figure because first-time homebuyers made up 42% of the sales tally last month. Repeat buyers are hibernating, comprising 39% of the sales pace, down from 43% in January

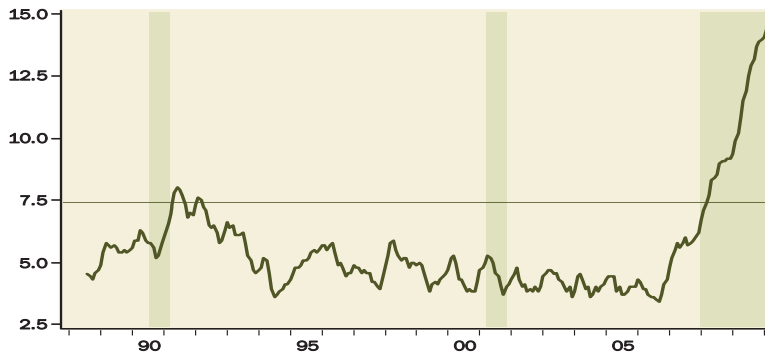
What was truly disturbing were the inventory data – listings up almost 10% to their highest level since last September – taking the backlog to a six-month high of 8.6 months’ supply (from 7.8 in January), which is materially above the 5-6 months that generally characterizes a balanced market.

We are back to a classic buyers’ market, which means that we are in for another round of residential real estate price deflation. Indeed, average resale prices dropped 0.8% last month and are down in seven of the past eight months – the Case-Shiller home price index is probably not too far behind (recall that the FHFA house price index has declined in each of the past two months).

Look Chart 2 – it is now taking homebuilders 14.4 months (median) to locate a buyer upon completion of a unit. Talk about a lack of demand! The bottom line is that nobody wants a mortgage and there are now a record 4.5 million apartment units across the U.S.A. sitting vacant with a “For Rent” sign on the door (that number rarely moved above three million in the 1990s).

**CHART 1: TAKING THE HOMEBUILDERS  
A RECORD 14.4 MONTHS TO FIND A BUYER**

**United States: New Single-Family Homes: Median Number of Months for Sale**  
(months)



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

---

**We got the existing home sales data for February and they edged down again, by 0.6% MoM, and “no” – it was not due to the blizzards**

---

Second, the new home sales numbers were pathetic, and it is amazing given what is happening regarding the data that the homebuilder stocks have been outperformers this year. Then again, nobody ever gave Mr. Market kudos for sophistication.

As is the case with the resale housing market, we are back on the primary trend, which is down – sales off now in six of the seven months, with the latest 2.2% MoM setback taking the level to a record low 308,000 units at an annual rate (and that was with a 21% MoM pop in the West region). But consider all of the resources that the government has expended to resurrect motherhood and yet new sales hit an all-time low in February – breaking 6.2% below the recent trough. That is truly scary.

Moreover, similar to existing home sales, inventories are piling up again despite how far the builders have taken starts down to ... ostensibly not enough. The new housing inventory rose 1.3% – the second increase in a row, to 9.2 months' supply from 8.9 in January (the long-run average is 6.2 months). Housing, at least, is entering into a double dip. In the second half of the year, we shall see if the sector ends up yet again playing its classic role as leading indicator.

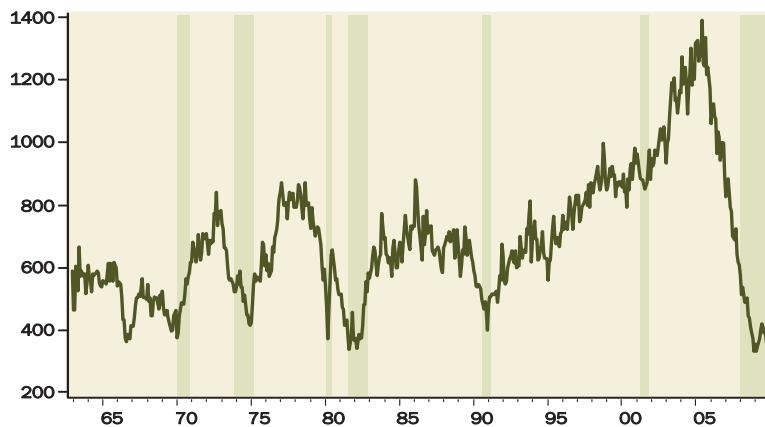
---

**Consider all of the resources that the government has expended to resurrect housing and yet new sales hit an all-time low in February – breaking 6.2% below the recent trough ... That is truly scary**

---

**CHART 2: NEW RECORD LOW**

**United States: New Single-Family Home Sales**  
(thousand units at an annual rate)



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

The bottom line is that the U.S. housing market is still in a mess fully three years after the collapse. If government policies worked, then it is hardly evident – perhaps at best cushioning the blow but not preventing it from happening. Consider the following:

- The slide in housing has shaved \$7 trillion from national residential real estate wealth since the third quarter of 2006.
- There are an estimated 5 million Americans still in the foreclosure process.

- There are still 11.3 million homeowners who are “upside down” on their mortgage. The average “under water” mortgage borrower is in the hole to the tune of \$70,700 (see front page article of the USA Today) in Q4, up from \$69,700 in Q3.
- The unsold housing inventory, when accurately measured, is close to 21 months’ supply. There are over 18 million residential housing units sitting empty right now across the country, and the areas under the most severe pressure are Nevada, Arizona, Florida, Michigan and California (“only” 25% of the country).

We are not the only ones who see the prospect of another leg down in home prices. The banks seem to have given up any hope that we would see a rebound at any time on the horizon, which explains for example why it is that BoA is now more fully engaged in principal writedowns and expect to see other lenders follow suit. It is the right thing to do. It will speed up the process of price discovery at the expense of revealing just how much more downward price pressure there is going to be in the market for residential real estate.

Never before have new home sales gone on to make a new cycle low after a recession ends – until now. In fact, in practically every other cycle, housing is the first sector to bottom and lead the economy out of the downturn. This time around, it has been the federal government – bailouts and repeated stimulus – and a production bounce as inventories get realigned with a sales environment that may be weak but never went into the abyss.

That said, without the traditional credit-sensitive sectors leading the economy into the upturn, as has traditionally been the case, then it is hard to believe we are going to see a sustainable recovery. Already we are seeing capital spending slowdown as companies opt for cash and liquidity as opposed to new investments and the export story is going to grow old very soon with Europe moving back into recession and equity markets in Asia pointing to a moderation in growth there as well. Not to mention what the stronger U.S. dollar is going to do in terms of a competitive roadblock for U.S. producers.

As an aside, the Chicago Fed’s National Activity Index worsened in February too – to -0.64 from -0.04 (this index contains 85 variables!). What was the level when the recession began in December 2007? Try -0.63. Nice recovery.

Look at the consumption/housing subindex (see Chart 3) and tell us what sort of V-shaped recovery we have going on. The equity market needs a reality check in a major way – this is 75% of GDP we are talking about that is still flirting with record lows. No traction at all.

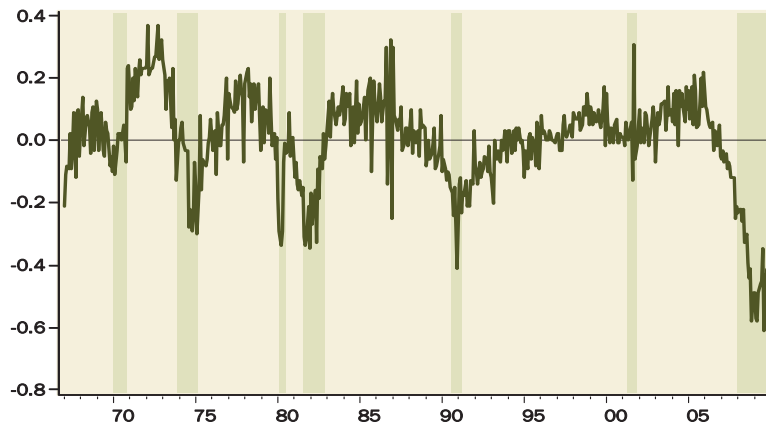
---

**We are not the only ones who see the prospect of another leg down in home prices. The banks seem to have given up any hope that we would see a rebound at any time on the horizon**

---

**CHART 3: WHERE IS THE “V”?**

**United States: Federal Reserve Bank of Chicago National Activity Index: Personal Consumption and Housing**  
 (positive number = growth above trend)



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

**MODERATE GROWTH IN CAPEX**

The key in yesterday’s U.S. durables report from a GDP perspective were the core capex numbers – nondefense capital goods excluding aircraft. While the numbers were modestly positive, they fell well short of offsetting the deep losses incurred in January. These orders were up 1.1% MoM last month versus the 3.9% slide in January; and the core shipments (nondefense capital goods) data showed a tepid 0.3% MoM gain, which barely dented the 4.4% January plunge. It looks like the incentive-led 18% bounce in capital spending in Q4 was a one-off wonder and that we could see a big capex slowing this quarter to low-single digits. Yes, that is correct – core capex shipments are running at a +2.2% annual rate so far in Q1 versus nearly 9% in Q4; core orders are actually running modestly negative through Q1 and we have not seen this occur since the detonation in the first quarter of 2009).

Inventories will contribute again and there is also moderate growth built into the consumer but it looks like real GDP is going to slow to below a 3% annual rate this quarter. So far in this post-recession recovery, real final sales have only managed to rebound at a 2% annual rate despite all the gobs of government stimulus as this goes down as one of the poorest bounces on record. To put it into perspective, real final sales, by now, are usually rising at a 5% annual rate at this point of other cycles, not 2% – and those 5% growth rebounds did not require nearly as much future taxpayer support.



### **CANADIAN ECONOMY ON FIRE**

The index of leading indicators came out for Canada the other day and the closely-watched smoothed index advanced 0.8% last month after a 0.7% increase in January. All but one component was up – in stark contrast to the declining breadth in the U.S. comparable. Housing components were robust.

On a year-over-year basis, the smoothed index is running at 5.8%, the strongest since March 2005. The unsmoothed is up at a 11.3% YoY pace, that's the strongest since September 1997. So, it looks like real GDP in Q1 will come very close to the ripping 5% pace in Q4 and Q2 is looking solid as well. There was no blarney from Carney yesterday – both the pace of activity and inflation is running faster than the Bank had been thinking and the BoC Governor did a good job yesterday at hinting that a June rate hike is not out of the question barring a significant reversal in the CPI data when the March and April data come out. The commitment to stand pat through mid-year, we were reminded yesterday, was always "conditional".

In any event, the debate has shifted from whether the Bank would tighten ahead of the Fed to whether it will start to go in June or July. A flatter yield curve cannot possibly be constructive news for the bank stocks, and at the same time will keep the fair-value line on the Canadian dollar on its secular upward path.

---

**Canada's index of leading economic indicators looking very robust**

---

# 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 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).<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 \$10.7 million<sup>2</sup> 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 USD<sup>2</sup> 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.

## 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.*

\$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to \$10.7 million<sup>2</sup> on December 31, 2009 versus \$5.5 million for the S&P/TSX Total Return Index over the same period.

*For further information, please contact [questions@gluskinsheff.com](mailto:questions@gluskinsheff.com)*

## IMPORTANT DISCLOSURES

Copyright 2010 Gluskin Sheff + Associates Inc. ("Gluskin Sheff"). All rights reserved. This report is prepared for the use of Gluskin Sheff clients and subscribers to this report and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Gluskin Sheff. Gluskin Sheff reports are distributed simultaneously to internal and client websites and other portals by Gluskin Sheff and are not publicly available materials. Any unauthorized use or disclosure is prohibited.

Gluskin Sheff may own, buy, or sell, on behalf of its clients, securities of issuers that may be discussed in or impacted by this report. As a result, readers should be aware that Gluskin Sheff may have a conflict of interest that could affect the objectivity of this report. This report should not be regarded by recipients as a substitute for the exercise of their own judgment and readers are encouraged to seek independent, third-party research on any companies covered in or impacted by this report.

Individuals identified as economists do not function as research analysts under U.S. law and reports prepared by them are not research reports under applicable U.S. rules and regulations. Macroeconomic analysis is considered investment research for purposes of distribution in the U.K. under the rules of the Financial Services Authority.

Neither the information nor any opinion expressed constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments (e.g., options, futures, warrants, and contracts for differences). This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this report.

Securities and other financial instruments discussed in this report, or recommended by Gluskin Sheff, are not insured by the Federal Deposit Insurance Corporation and are not deposits or other obligations of any insured depository institution. Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that price or value of such securities and instruments may rise or fall

and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Levels and basis for taxation may change.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report. Investors in such securities and instruments effectively assume currency risk.

Materials prepared by Gluskin Sheff research personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of Gluskin Sheff. To the extent this report discusses any legal proceeding or issues, it has not been prepared as nor is it intended to express any legal conclusion, opinion or advice. Investors should consult their own legal advisers as to issues of law relating to the subject matter of this report. Gluskin Sheff research personnel's knowledge of legal proceedings in which any Gluskin Sheff entity and/or its directors, officers and employees may be plaintiffs, defendants, co-defendants or co-plaintiffs with or involving companies mentioned in this report is based on public information. Facts and views presented in this material that relate to any such proceedings have not been reviewed by, discussed with, and may not reflect information known to, professionals in other business areas of Gluskin Sheff in connection with the legal proceedings or matters relevant to such proceedings.

Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

The information herein (other than disclosure information relating to Gluskin Sheff and its affiliates) was obtained from various sources and Gluskin Sheff does not guarantee its accuracy. This report may contain links to third-party websites. Gluskin Sheff is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this report and is not incorporated by reference into this report. The inclusion of a link in this report does not imply any endorsement by or any affiliation with Gluskin Sheff.

All opinions, projections and estimates constitute the judgment of the author as of the date of the report and are subject to change without notice. Prices also are subject to change without notice. Gluskin Sheff is under no obligation to update this report and readers should therefore assume that Gluskin Sheff will not update any fact, circumstance or opinion contained in this report.

Neither Gluskin Sheff nor any director, officer or employee of Gluskin Sheff accepts any liability whatsoever for any direct, indirect or consequential damages or losses arising from any use of this report or its contents.