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January 18, 2010
Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

IN THIS ISSUE

- While you were sleeping — overseas equity markets mixed; signs of some risk aversion in the FX market; commodities are higher
- The good news must be priced in; what made Friday's action interesting wasn't just the triple digit decline in the Dow but what the response was to Intel's and JP Morgan's earnings releases
- Complacency still reigns — despite the memory of Dubai and the fiscal problems in Greece and Portugal, investors continue to seek yield irrespective of the risks
- Still bullish after all these years — The consensus is that everything is just going to be fine
- Tape and glue, that is what is holding the global economy and capital markets together
- Credit demands very weak (it's not just supply!)
- Sector pricing trends in the U.S. CPI report

WHILE YOU WERE SLEEPING

U.S. markets are closed for Martin Luther King Jr. Day so it is characteristically quiet, though it won't be beyond today given the long line-up of earnings results that lie ahead (especially in the banking space).

Equity markets are mixed: the MSCI Asia-Pac index is down 0.5% today; European markets, so far, are up by that amount. Oil prices are up for the first time in six sessions on Chinese comments that more imports are coming down the pike and supply-constrained statements out of OPEC. Gold is fractionally higher to start off the week. Credit spreads are starting to widen out amidst all of the supply indigestion year-to-date.

In the FX market, signs of some risk aversion seen in the better tone to the greenback and the fact that the Euro is trading at a one-week low. At the same time, concerns on the periphery are sending Greek bond yield spreads back out. The commodity-based Aussie dollar and New Zealand kiwi are both trading near their lowest level in two weeks and many of the emerging Asian currencies are softening. Korea's Finance Minister really rained on the parade by having the temerity to call into the question all the exuberance surrounding the economy's recovery from the deep slump.

No market-moving data to speak of and it is relatively calm this week from that perspective –– one key in Canada will be the Bank of Canada's policy statement tomorrow (9 a.m.) and the BoC policy report due out Thursday.

THE GOOD NEWS MUST BE PRICED IN

What made Friday's action interesting wasn't just the triple digit decline in the Dow on higher volume but what the response was to Intel's and JP Morgan's earnings releases; both are leaders in their space, both reported EPS that was 10x higher than a year ago, and both stocks finished the day sharply lower (and the SOX index closed the week down a hefty 6%).

There was a time, little more than nine months ago, that quarterly numbers like that would have sent their share prices sharply higher. The fact that their stock prices fell is a full testament to the view that the era of the 'green shoots' is officially over and after the most profound bear market rally in recorded history, what we have on our hands is a market that is more than just fully priced.

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It was easy to beat low-balled expectations in 2009 because investors are now becoming much more discriminating. So it wasn't just about the bottom-line earnings performance this time around. Questions now abound over Intel's ability to maintain record gross margins. The lack of revenue growth at JPM did not go unnoticed, and neither did the still-high level of loan loss provisioning on the consumer book. And generating profits from fixed-income trading, tax breaks and contained compensation growth also calls into question the sustainability of future profits — especially when it is so evident on the revenue line that there is minimal, if any, loan demand!

Emerging market bond spreads have collapsed in the past month; the average junk bond yield is at its lowest level since October 2007

COMPLACENCY STILL REIGNS

Despite the memory of Dubai and the fiscal problems in Greece and Portugal, investors continue to seek yield irrespective of the risks. Emerging market bond spreads have collapsed 50bps in the past month (and 500bps in the past year). The average junk bond yield, at 8.7%, is down 100bps in the past six weeks and at its lowest level since October 2007.

The VIX index may have endured a hiccup on Friday, but it remains near 19-month lows of 18.3. The recession has *de facto* been completely priced out, even though the former dean of the business cycle dating committee, Martin Feldstein, assured us a month ago that contraction phase is not necessarily completely over just because of two quarterly blips in real GDP.

Besides ,the giveback in the cyclical stocks to close out the week, and the fact that the S&P financials peaked back on October 14, there are several other non-confirming variables to the risk appetite in the credit market cited above.

First, take note that the oil price finished the week down almost 6% last week, and it was on the back of a modest cut in the demand forecast by the IEA. That does not sound very cyclically-bullish from our lens. The FX market is taking on a more defensive posture as well, and we see that in the 2% firming of the Japanese Yen against both the U.S. dollar and the Euro (and 1.8% against the commodity currencies).

Remember too that Alcoa started last week with its earnings report that shed some initial concern over the reporting season long before Intel and JP Morgan; China's policy tightening is a reminder that inflation is starting to become a concern in emerging Asia, which is never a particular pro-growth development; Japan reported a collapse in its latest core machinery orders data; it looks like Germany is doing little better than flat GDP growth for the current quarter and there are all sorts of question marks over the U.S.A too after the latest slate of distinctly non green-shooty payroll, retail sales, production and consumer confidence data.

If all we have to hang our hats onto is a 30,000 job surge in Australia, then we are in for a pretty rocky time … and to think that the Fed and the Treasury believe they can start withdrawing their support for the housing and mortgage market after March, it will be interesting to see. As it is, conditions are soft enough to have encouraged Goldman Sachs to cut its outlook for Toll Brothers as the week drew to a close.

The consensus is that everything is just going to be fine and that we should expect nothing more than a second-half economic slowdown. If there is a sharper turndown the monetary and fiscal spigots will be turned on even harder

STILL BULLISH AFTER ALL THESE YEARS

The emerging consensus is that everything is just going to be fine and that we should expect nothing more than a second-half economic slowdown, and that if there is a sharper turndown the monetary and fiscal spigots will be turned on even harder. The market is seen no worse than fair-value. Treasuries remain the enemy. This tone was highly evident in the Barron's Roundtable, and we offer a few snippets below:

Felix Zulauf: *"Cyclical forces are bullish … the market probably has 10% upside from here… my next recommendation is to short government bonds."*

Abby Joseph Cohen: *"We think global growth won't be too bad in 2010 … we're forecasting S&P 500 earnings of $75 to $76 this year and $90 next year."*

Fred Hickey: *"The stock market will likely be up this year, unless the dollar collapses."*

Scott Black: *"I figure S&P 500 earnings will be closer to $66, which puts the market at 17.3 times earnings, about the historic norm."*

Oscar Schafer: *"Liquidity and another stimulus package will keep the market up."*

Marc Faber: *"The S&P 500 won't revisit the March 2009 low of 666 in nominal terms ever again."*

Meryl Witmer: *"Fifteen times earnings seems about right for the market, and earnings could grow a little this year … fair value isn't so different from where the market is now."*

Archie MacAllastar: *"I'm an optimist, I expect the S&P to earn $75 to $80 this year. Public participation will increase."*

Mario Gabelli: *"You'll be up 5% to 10% in the first half of the year … interest rates at some point will top 4%."*

Scott Black: *"The underpinnings of the economy aren't quite as bleak as everyone thinks."*

TAPE AND GLUE

That is what is holding the global economy and capital markets together – not just dramatic monetary easing but the fact that G20 governments have managed to spend $2.2 trillion to restore growth. But this is clearly unsustainable – the downside of this government binge is that the hangover is going to prove extremely painful for years to come. That the equity market has yet to realize this does not make this assertion any less relevant. For a truly sobering view on the outlook, have a read of the usually bullish editorial in the current edition of BusinessWeek – *After the Stimulus Binge, A Debt Hangover* on page 14.

Credit demands still very weak; according to a poll by the Atlanta Fed, only 1 in 4 of the business sector is borrowing funds to finance economic activity

CREDIT DEMANDS VERY WEAK (IT'S NOT JUST SUPPLY!)

The Atlanta Fed conducted a survey that was written on its 'macro blog' by John Robertson, Vice President in the Atlanta Fed's research department. The survey was striking.

It found that over half the businesses polled sought to obtain a loan in the past six months. And over half of those who accessed credit did so to roll over an existing loan; and not for any business investment or working capital needs. So when you do the math – no calculator needed – what you see is that only 1 in 4 of the business sector is borrowing funds to finance economic activity. It also pays to note that 55% of the respondents were not seeking credit was due to a weak sales/revenue backdrop.

SECTOR PRICING TRENDS IN THE U.S. CPI REPORT

Food retailers are seeing the most rapid deflation in over 50 years. Intense competitive strains.

CHART 1: INTENSE COMPETITIVE STRAINS IN THE FOOD RETAILERS

United States: CPI: Food at Home
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

Restaurants are seeing their pricing power erode at a pace not seen since 1994 when the Fed was aggressively tightening policy.

CHART 2: RESTAURANTS SEEING PRICING POWER

United States: CPI: Food Away from Home
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

It's amazing that REITs enjoyed the year they did considering that **rents** are slowing at a record rate; posting sequential declines in each of the past six months.

CHART 3: RENT PRICES AT THEIR LOWEST RATE ON RECORD

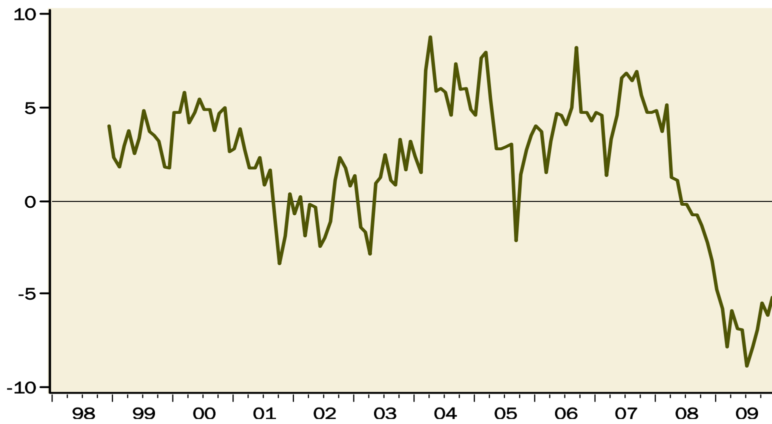
United States: CPI: Rent of Primary Residence
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

Hotels are seeing some second derivative improvement here – the YoY is still in deflation mode but sequential pricing has been positive for four of the past five months, including a 0.5% MoM gain in December.

CHART 4: HOTEL PRICES ARE STILL IN DEFLATION MODE

United States: CPI: Lodging Away from Home
(year-over-year percent change)

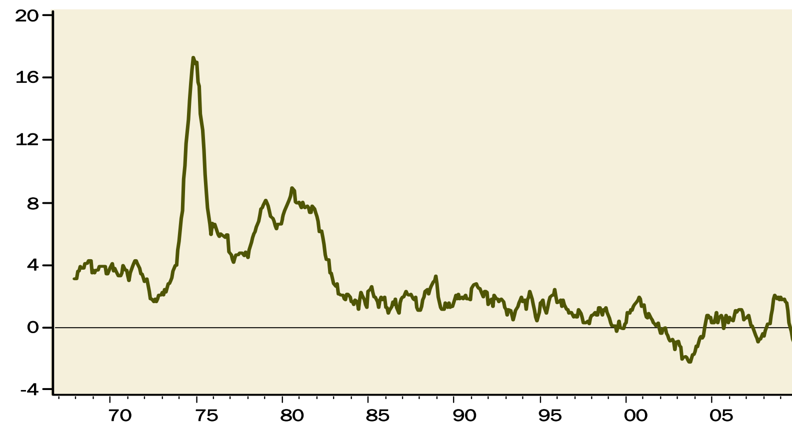


Source: Haver Analytics, Gluskin Sheff

Home improvement stores are seeing pricing decline at over a 1% YoY rate and there has been no sign of improvement in the month-to-month data either.

CHART 5: HOME IMPROVEMENT STORES SEEING PRICING DECLINE

United States: CPI: Household Furnishings & Operation
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

Although **clothing stores** saw sales decline in December, prices actually managed to rise 0.4% sequentially and the YoY trend is actually firming to 2%.

CHART 6: YEAR-OVER-YEAR TREND IN APPAREL IS ACTUALLY FIRMING

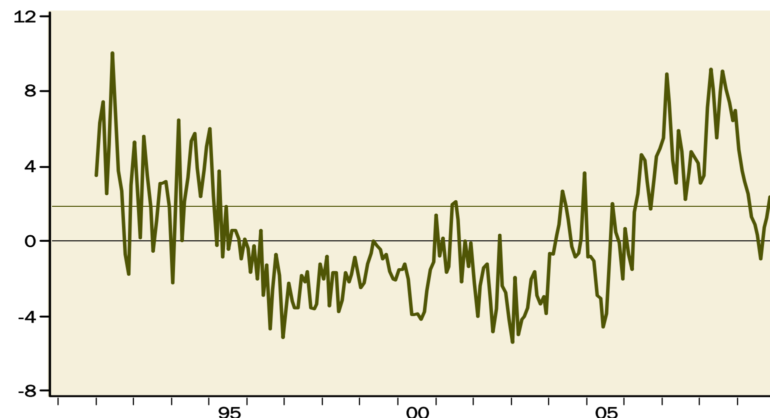
United States: CPI: Apparel
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

The deflation trend in **jewellery** pricing is over and a nascent uptrend is underway. Not sure how this fits in with the frugality theme – prices sequentially have risen for four months in a row. Perhaps a reflection of where Wall Street bonuses are going.

CHART 7: DEFLATION TREND IN JEWELLRY PRICING COULD BE OVER

United States: CPI: Watches & Jewellery
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

The last time the **auto sector** had 5%+ pricing on a YoY basis was January 1987. This is what better inventory management can do even in a permanently lower sales environment.

CHART 8: THIS IS WHAT BETTER INVENTORY MANAGEMENT CAN DO

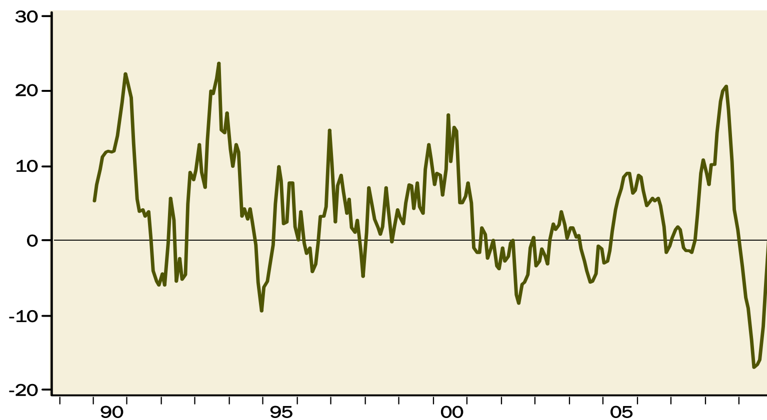
United States: CPI: New Vehicles
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

Airlines have now seen positive pricing for six months in a row (seasonally adjusted) and as the chart shows, back to positive terrain on a YoY basis.

CHART 9: AIRLINES NOW SEEING POSITIVE PRICING

United States: CPI: Airline Fares
(year-over-year percent change)

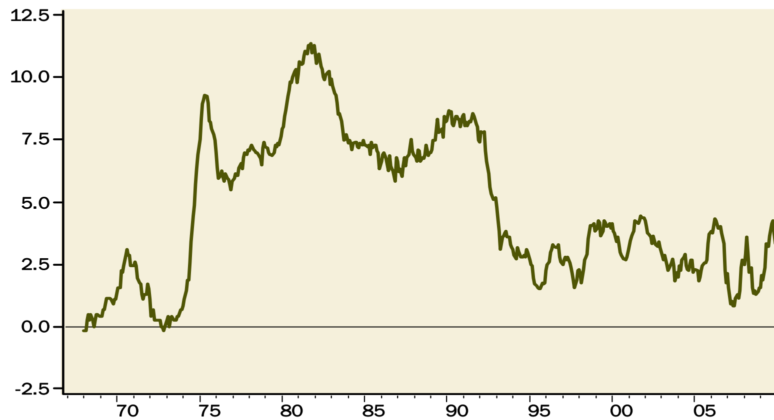


Source: Haver Analytics, Gluskin Sheff

Drug prices at the retail level actually fell 0.1% MoM in December and the YoY trend is stagnating. But we know that the pharmacies enjoyed strong sales from last Thursday's sales report so either they are seeing better volumes or stronger demand in other product lines.

CHART 10: DRUG PRICES AT THE RETAIL LEVEL HOLDING IN

United States: CPI: Medical Care Commodities
(year-over-year percent change)

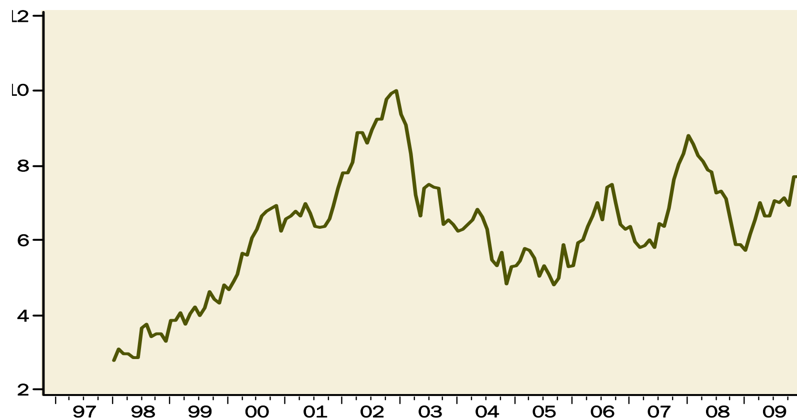


Source: Haver Analytics, Gluskin Sheff

Hospital services: No sector has pricing power like the HMOs – bordering on +8% on a YoY basis.

CHART 11: NO SECTOR HAS PRICING POWER LIKE THE HMOs

United States: CPI: Hospital Services
(year-over-year percent change)

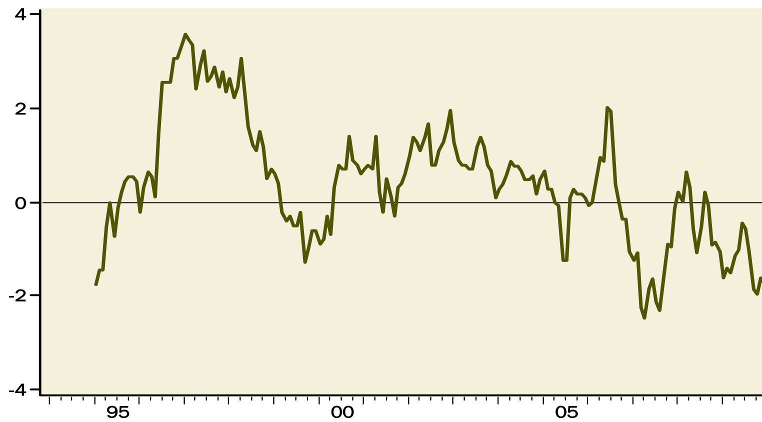


Source: Haver Analytics, Gluskin Sheff

Video and audio stores remain in pervasive deflation mode – the games are great and selling but consumers are fickle and price conscious on discretionary items like these, as the Fed's Beige Book just told us. Inventory management is critical to preserving margins in this space.

CHART 12: VIDEO/AUDIO STORES REMAIN IN DEFLATION MODE

United States: CPI: Video & Audio
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

Retailers who sell **toys** remain under severe deflationary pressure – prices have actually declined now for nine months in a row.

CHART 13: TOYS UNDER SEVERE DEFLATIONARY PRESSURE

United States: CPI: Toys
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

Movie theatres may be filling the seats but pricing power is slipping as the chart below illustrates.

CHART 14: MOVIE THEATRES MAY BE FILLING THE SEATS, BUT PRICING POWER IS SLIPPING

United States: CPI: Admissions to Movies, Theatres & Concerts
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

Book stores are starting to see their price leadership fade.

CHART 15: BOOK STORES SEEING THEIR PRICE LEADERSHIP FADE

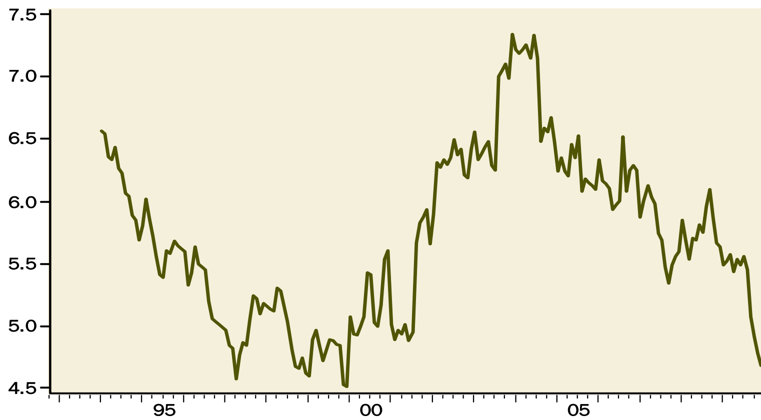
United States: CPI: Recreational Reading Materials
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

Education in the past was infallible because it was viewed as a noncyclical but in a credit collapse, nothing is recession-proof. This disinflationary trend is acute to say the least as tuitions come under pressure.

CHART 16: TUITION COMES UPDER PRESSURE

United States: CPI: Education
(year-over-year percent change)

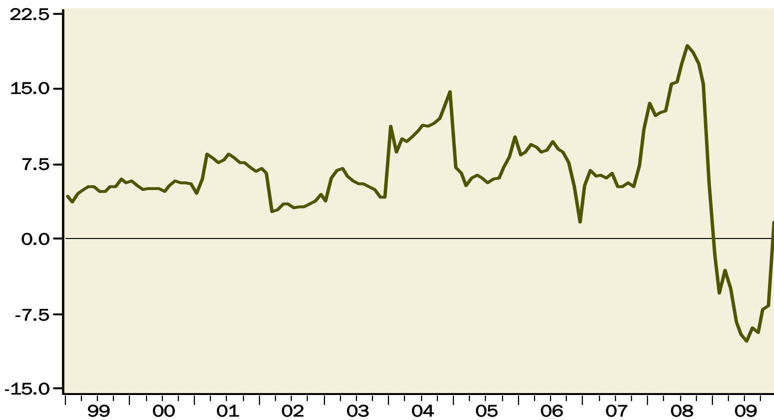


Source: Haver Analytics, Gluskin Sheff

Big hook-up in **delivery services** pricing, as UPS just signalled.

CHART 17: BIG HOOK UP IN DELIVERY PRICING

United States: CPI: Delivery Services
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

Telephone services still seeing positive pricing, but the trend here is not our friend. It hasn't been running as low as 1% in a good three years.

CHART 18: STILL SOME PRICING POWER, BUT THE TRENDS IS NOT OUR FRIEND

United States: CPI: Telephone Services
(year-over-year percent change)

Source: Haver Analytics, Gluskin Sheff

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Gluskin Sheff at a Glance

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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 $15.5 million[2] on September 30, 2009 versus $9.7 million for the S&P/TSX Total Return Index over the same period.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $11.2 million USD[2] on September 30, 2009 versus $8.7 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 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.

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2. *Returns are based on the composite of segregated Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.*

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