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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

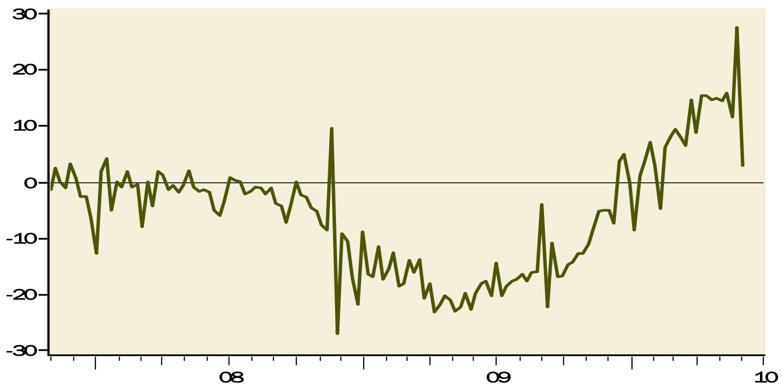
Breakfast Lite with Dave

TRAFFIC COMES TO A STOP

There has been a sudden and sharp turndown in railway car loadings in the latest data that came out for the week of June 5th — the YoY trend is down to a four-month low. The data is not seasonally adjusted so it is difficult to compare levels but the 13-week rate of change is now running at a -25% annual rate, which is unusually weak for this time of year. Remember — this metric is closely linked to the only to areas of the economy that have been major contributors to the recovery: Exports and inventories. In fact, over the past three quarters, every basis point of GDP growth has come from these two areas.

CHART 1: A SUDDEN HALT IN RAILROAD TRAFFIC

United States: Railroad Traffic
(year-over-year percent change)



Source: Haver Analytics, Gluskin Sheff

FED ON HOLD FOR A LONG, LONG TIME

"Many predict that the economy will take years to return to full employment and that inflation will remain very low. If so, it seems likely that the Fed's exit from the current accommodative stance of monetary policy will take a significant period of time."

That was the conclusion from the just-published San Francisco Fed newsletter – titled *The Fed's Exit Strategy for Monetary Policy*. Indeed, when you go to the rule-of-thumb that reveals statistically the relationship between the funds rate, inflation and the output gap, we estimate that the equilibrium policy rate right now is -5%. Yet it is 0.25% and we have many a Fed bank president clamouring for rate hikes. And remember, bonds do not go into bear markets unless either the Fed is tightening monetary policy or threatening to do so.

IN TODAY'S ISSUE OF BREAKFAST WITH DAVE

- While you were sleeping: global equity markets are higher today ignoring yesterday's negative action in the U.S.; however, the latest round of news and economic data are not exactly conducive for risk-taking
- Railroad traffic comes to a stop: there has been a sudden and sharp turndown in railway car-loadings; could this be a sign that industrial active in the U.S. has peaked?
- The Dow-Gold relationship
- The Fed could be on hold for a long, long time
- A call to arms — part II: I strongly believe that escalating global economic imbalances have dramatically increased the vulnerability of the global recovery
- Yet another soft Canadian data point: auto sales tumbled another 4.7% MoM in April

A CALL TO ARMS — PART II

In case it wasn't made clear before, I strongly believe that escalating global economic imbalances have dramatically increased the vulnerability of the global recovery. The chances of a growth relapse in the second half of the year are higher than the equity market, and to a lesser extent the credit market, have priced in. Treasuries seem to be the asset class that most closely shares by cautious views. Anyone with a pro-cyclical bent has to answer for why it is that the yield at mid-point on the coupon curve is barely above 2%, a year after a whippy rally in equities and commodities and what appeared to be a sizeable policy-induced GDP jump off the bottom.

I strongly believe that escalating global economic imbalances have dramatically increased the vulnerability of the global recovery …

The answer is that the U.S. economy is susceptible to a growth relapse, with all deference to the various purchasing managers' reports, which for portfolio managers, should be treated as coincident indicators (equities historically have done far better the year after ISM comes off the 30 level than the years after the 60 milestone is reached, just as an example). A variety of recent consumer-related reports, including the May employment and retail sales releases, have been sub-par and are posing appropriate questions as to whether the recovery will be V-shaped. That mortgage applications for new home purchases have plunged 40% in the past five weeks to a 13-year low despite a 25bps decline in mortgage rates is, to be polite, disconcerting.

… and so the chances of a growth relapse in the second half of the year are higher than the equity market, and to a lesser extent the credit market, have priced in

When the VIX plunged to 15x in early spring, it reflected a widespread view that the green shoots of 2009 would be extended into a sustainable growth phase into the future. Given the massive government intervention across the planet, it can hardly come as a surprise that economic activity began to recover exactly a year ago. The recovery in international trade and the reversal of the inventory cycle's contributed to a "V-like" recovery initially and fostered optimism that global economies were well on their way to a sustained recovery. Meanwhile, real final sales have all but stagnated in per capita terms in what has turned out to be a subdued rebound in demand. Not a good assumption then; and not one now — especially with the growth rate in the ECRI weekly leading index now at -3.5% in early June.

YET ANOTHER SOFT CANADIAN DATA POINT

Canadian auto sales fell 4.7% MoM in April, after falling by a similar amount in March. Admittedly, this isn't new news as industry data were signaling the decline. What was new in the report, however, was Statistic Canada's preliminary estimate for May, suggesting that sales will be flat on a month-over-month basis.

Canadian auto sales stalled in April, falling 4.7% MoM and are expected to be flat in May

Auto sales are very much a second-tier economic indicator but the trends are troubling and is adds to the growing list of weak Q2 data — trade, housing starts and resale starts. We are tracking 3.3% QoQ at an annual rate GDP growth, below consensus estimates of 3.6% (the Bank's at 3.8%) and we continue to think that the risks are to the downside.

Gluskin Sheff

Gluskin Sheff at a Glance

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$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $11.7 million[2] on March 31, 2010 versus $5.7 million for the S&P/TSX Total Return Index over the same period.

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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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For further information, please contact questions@gluskinsheff.com

Notes:

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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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