

## MARKET MUSINGS & DATA DECIPHERING

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# Toast with Dave

### IS U. S. GDP OVERSTATED?

We noticed an interesting piece of research on U.S. GDP from Goldman Sachs' Economics team that's worth highlighting. The team questions whether the official government GDP statistics capture how poorly small businesses (ie, sole proprietorships) are doing. The weakness in small business sentiment is seemingly at odds with the recent 3.5% Q3 GDP reading but may explain why the unemployment rate has continued to steadily increase. Part of the reason for small business weakness is that most don't have the same access to credit as larger firms and larger firms' output tends to be better captured in the GDP data. While sole proprietorships tend to be small they collectively account for a nontrivial 17% of the U.S. economy.

The Goldman team uses a couple of different statistical approaches to test their thesis. They use timely data from the National Federation of Independent Business (NFIB) confidence survey, which shows that despite a recent improvement, confidence remains exceptionally weak (in fact two standard deviations below long-run trends). The first model suggests that the NFIB survey is consistent with overall GDP growth of 2.5% to 3.0% – not the 3.5% reported. As well, they find that current NFIB readings are more in line with below-50 readings on the ISM manufacturing index versus the actual reading of 55.7.

The second approach has to do with revisions to the GDP data and their relationship to the NFIB. U.S. GDP goes through many revisions as more, and better, information becomes available with lags – historically preliminary numbers are revised down by almost 0.5 percentage point. This second model suggests that Q3 GDP could be revised down by as much as 1-2 percentage points.

### BUT IT'S NOT ALL ABOUT CREDIT FOR SMALL BUSINESSES

We've talked about the NFIB's small business optimism index, and we concluded that the current level of 89.1 in October was nothing to write home about. After reading through the actual press release from the NFIB, the conditions for small businesses are not very rosy and the "small business job machine is still in reverse." According to the press release, although it is nice for the Obama Administration to finally jump on the "small business bandwagon" by enhancing the Small Business Administration lending program, the main reason why these businesses are not hiring is not because of lack of financing, but because there are just no customers. Less than 1% of small firms have government sponsored loans and in the latest survey only 4% of the nearly 1,000 respondents said that credit was hard to come by. Indeed, the press release cited that *"the demand for credit is in short supply and failing to understand the more major problems facing small business leads to bad policy."*

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**Some believe that part of the reason why small businesses remain weak is because they don't have the same access to credit as large firms ...**

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**... But it's not all about credit for small firms; there weakness comes from the fact that there are no customers**

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The overall environment for small businesses is remains very depressed. Consider this comment from the NFIB press release:

*Overall, the small business job machine is still in reverse, due to continued declines in reported sales, rising labor costs, and a need to cut costs. Reported capital spending is at historic low levels, owners are still, on balance, reducing inventory stocks (only seven percent reported increases, 32 percent reported reductions) so orders to wholesale and manufacturing firms for new inventory are weak. Price cutting is rampant (though slowing) which combined with lower real sales continues to produce record reports of earnings declines, one reason capital spending remains low. Few firms report credit availability as a problem, though those who are borrowing report more difficulty and tougher terms than during the expansion. Events in Washington are not supportive of more optimism about the future – another reason not to spend or hire.*

#### **ERA OF FRUGALITY**

U.S. consumer shopping habits have changed on a semi-permanent basis. Yes, the government can step in time and again to distort human nature and try to reverse the rising trend in the personal savings rate, but left to their own devices, households are in a thrifty state. This came through loud and clear in the latest Deloitte survey, which showed that more than 25% of the 10,878 consumers polled say they have permanently altered their shopping patterns in view of the asset and credit collapse this cycle. And what did Wal-Mart Treasurer Charles Holley have to say yesterday in the aftermath of its earnings report? (Wal-Mart's sales were a puny +2.4% YoY off a depressed YoY basis, profits were underpinned by improved productivity and inventory management.) Here its (can you handle the truth?): *"The shopper has reset how he is spending money and that has affected retail in demand"*.

Moreover, getting frugal also means getting small – and in this new era, a most amazing thing is happening. Not only are consumers downsizing their auto purchases, but the size of the homes that are now being built is shrinking – see the front page of today's Wall Street Journal for evidence (*Builders Downsize The Dream Home*). Pure and simple – the days of impressing your friends with the winding staircase are gone.

#### **FED CAN'T RAISE RATES UNTIL AFTER 2011**

The reason – there is a wave of mortgage refinancings coming in the housing market for one, and not only that, but in the commercial space, there are 2.7 trillion of debt coming due through 2011 and another 1.5 trillion of leveraged loans (see page 24 of Thursday's FT). In other words, the default rate is going to rise even further and the Fed tightening policy would only aggravate that situation. In other words, the Fed is simply immobile for at least the next two years.

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**U.S. consumer shopping habits have changed on a semi-permanent basis**

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**The federal government can step in time and again to distort nature, but the reality is that the U.S. consumer is moving towards frugality**

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**In the U.S., a wave of mortgage refinancings will hit the market in the next two years; this is one reason why the Fed can't raise rates until after 2011**

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### MA AND PA KETTLE STILL LEANING TOWARDS INCOME

It is becoming increasingly obvious that the household sector, burnt twice by two bubbles seven years apart, are simply not biting this time. Once again, equity funds suffered a \$4.7 billion net outflow last week. At the same time, bond funds saw a \$7.5 billion inflow (on top of \$10.2 billion on the last week of October) and an additional \$358 million went into hybrids.

This appears to be a conscious effort by the general public to allocate their assets towards the fixed-income market, where they are underweight (as we have argued in the past). While the supply of bonds is clearly booming, guess what? So is the demand, which is why Treasuries and the like have managed to retain a constructive tone for much of the past six months. For more on this phenomenon, see *Treasury Hunger Remains Fierce* on page C12 of today's WSJ.

### STIMULUS, WHAT STIMULUS?

Fully nine states are in fiscal distress and only two have balanced budgets. States like Michigan are planning 20% budget cuts for the coming year. Indiana is planning a 10% spending cut in light of a 7.4% YoY revenue decline. How can the economy really be out of recession if government revenues are still deflating?

The states are filling around 40% of their fiscal gaps with the federal stimulus (so much for spending on "shovel ready" infrastructure projects). Even after the fiscal help from Washington, the state governments will still face a projected deficit of \$142 billion for 2011 (versus \$113 billion in 2010). All in, the restraint in the state and local government sector is estimated to drain a full percentage point from U.S. GDP growth in 2010 and more than fully offset the stimulative efforts from Washington. The U.S. economy is more likely to post growth of little more than 2% next year than the 5% currently being discounted by the equity market.

### DEFLATION, NOT INFLATION

There is no doubt that the government is massively reflation and there is little doubt that after socializing the private sector debt morass, the Fed is going to monetize the blow-up in the public sector balance sheet. But reflation will not turn into outright inflation until both the savings rate and unemployment rate both peak out and roll over on a sustained basis. The article on page A7 of the WSJ, in case you missed it, is a must-read (*Returning Workers Face Steep Pay Cuts*). There can be no inflation if wages (not to mention rents and credit) are deflating.

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**Despite the fiscal help from Washington D.C., the state and local governments will still face a projected deficit of \$142bn for 2011**

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# 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 September 30, 2009, the Firm managed assets of \$5.0 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 \$15.5 million<sup>2</sup> 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<sup>2</sup> on September 30, 2009 versus \$8.7 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, 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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