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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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DEMAND IS ANEMIC

The perception that we have a strong U.S. economy on our hands runs pretty deep, even if it is clear that the pace of GDP growth is cooling off from where it was in the fourth quarter when a Fed-led wealth effect induced a decline in the personal savings rate to induce spending. Yes, chain store sales beat estimates in March but largely due to food and gas, and partly clothing, but the reality is that chain store sales represent just 16% of total consumer spending despite all the attention they receive. And yes, employment is doing a bit better but not enough to generate income growth that will offset the rise in consumer prices, at least for the time being. And if GDP growth is cooling off and GDP growth is moderating that *ipso facto*, productivity gains must be in the process declining and this is not constructive at all for profit margins.

At least there is someone else out there with a very large brain who would agree with the assessment of there still being a soft economic underbelly, and we would highly recommend a look at the article by Christina Romer (who is brilliant) on page 5 of the Sunday NYT business section (*This Jobless Rate Isn't the New Normal*). The column totally blows away the notion that the lingering high level of unemployment is due to structural as opposed to cyclical factors. Her prescription may be debatable, but her diagnosis is beyond reproach. To wit:

> *"Fortunately, there is a more compelling explanation. Strong evidence suggests that the natural rate of unemployment actually hasn't risen very much. Instead, the elevated unemployment rate appears to reflect mainly cyclical factors, particularly a lingering shortfall in consumer spending and business investment … most of our high unemployment is still the consequence of low demand. Consumers remain hesitant to spend because unemployment and debt are high. Companies are unwilling or unable to invest because customers are few and credit is still tight."*

What a great macro environment in which to be adding cyclicality, risk, and beta to the portfolio, don't you think?

(Yes, I'm being sarcastic).

SERIOUSLY, FOLKS …

What is really hard to square is the VIX index at 18 in the face of all the turmoil globally. Just a month ago, the volatility gauge was sitting at close to 22, and it seems to have come down ever since at a much faster rate than would be warranted by the geopolitical news around the planet. Just a read of the Saturday New York Times was enough to make even the hardiest souls among us gag, at least a little:

- *Portugal Next in Debt Trap* (front page — it's truly amazing. There really is no "bailout". There is just a new set of loans being provided by the EU and IMF with high interest rates attached and a brutal set of fiscal requirements which will only put the country that much deeper into a debt deflationary spiral (see *Portugal's Bailout to Require Deep Cuts*). Also, the ECB is tightening policy because these European demagogues believe higher interest rates will bring back oil production in Libya and encourage more wheat plantings in Kansas. This is truly Alice in Wonderland stuff, and yes, Spain with its extremely weak banking sector is next in line (they are loaded up not just with dubious real estate debt but also boatloads of Portuguese government bonds). Yet there are buyers for the euro at 1.43, which is truly astounding, and they are likely the same ones that lined up to buy QQQs in the winter of 2000 and CDOs in the spring of 2007).

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- *Worries Grow as Experts Argue About Nuclear Dangers at Japan Plant* (page A4 … this will exert even more upward pressure on global food prices).
- *Once the Darling of Egypt's Revolt, the Military is Under Scrutiny* (page A4 as well … read the first sentence and see what the United States did in terms of allowing Mubarak to be replaced, of course with an eye towards democracy: *"A blogger was jailed recently for insulting the military. Human rights advocates say that thousands of people have been arrested and tried before military courts in the last two months. Protestors have been tortured and female activists subjected to so-called virginity tests"*. Also have a look at *Egypt Protests Swell Against Military* on page A11 of the weekend WSJ. Tell me, does the U.S. really have a strategy in the region?).
- *Nigeria: 14 Die in Election Attacks* (page A5 … another reason to believe the geopolitical risk premium in oil can only expand).
- *NATO Expresses Regret Over Mistaken Airstrike on Libyan Rebels* (page A8 … it's pretty clear that forecasts a few weeks ago of Gaddafi's demise were just a tad premature. Libyan oil production is not coming back for a long time but practically every oil analysts is saying that this is already in the "price").
- *Students in Iran Demonstrate in Support of Bahrain's Shiites* (page A9 — if the resistance efforts in Bahrain were to ever succeed, we would undoubtedly see oil prices make even newer highs, but it goes without saying for the freedom-fighting United States of America democracy stops at the eastern border with Saudi Arabia. Also see *Bahrain Divisions Grow, Fanning Fears* on page A11 of the weekend WSJ).

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- *Dozens of Protests Across Syria Are Said to Be Largest and Bloodiest to Date,* on page A9 of the weekend WSJ; just another sign that the whole region is in upheaval.

PLENTY OF CROSS-CURRENTS IN THE EQUITY MARKET

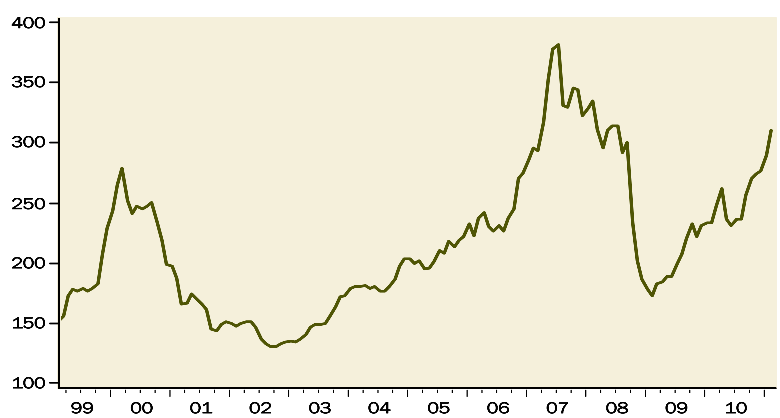
That is for sure. The small-cap S&P 600 and the Value Line arithmetic index both managed to hit new highs this past week. But we see in our trusty Barron's that the small caps now trade at a 17.5x P/E ratio (on forward earnings), which is the highest valuation since the wheels began to fall off, at least for a few months, in April 2010. Relative valuation of small caps to large caps is at the "highest level in decades".

But the reality is that the broad S&P 500 is still lower today than it was on February 11. Two months of nothing but volatility. The transports recently broke to a new high, but could not hold, and are down 3% since April 4 (see *Transport Will Set the Pace for the Running of S&P Bulls* on page 17 of the weekend FT). The financials are another huge "non-confirmation" — down 4% from the nearby high and unchanged from the start of the year. The ex-energy S&P 500 actually peaked back on February 18 and is down 1.5% since that time. For all the talk of how a bull market is being sustained over that time, you are up 3% if you own the energy index.

If there is one sure way to tell that the Fed has managed to create and nurture a speculative-led rally in the equity market, look no further than what is happening to investor-based leverage growth — it's exploding off the page. Yes that's right. Debit balances at margin accounts skyrocketed by $20.7 billion in February. Only four other times historically have we seen leverage rise so much so fast and both times it was during a manic phase — during the tech bubble of the late 1990s and the credit bubble just a short four-years ago.

CHART 1: MARGIN DEBT AT MANIC LEVELS

United States: Debt Balances in Margin Accounts at Broker/Dealers
(US$ billion)



Source: Haver Analytics, Gluskin Sheff

To put that $20.7 billion incremental leverage in one month into proper perspective, it represents a 7.2% jump, or an increase of no less than 129% at an annual rate. And, it's not just February -- the rising use of credit to buy stocks has zoomed ahead at a 64% annual rate in the past three months. If and when the market breaks, the problem in trying to contain the downside momentum is that there are no shorts left to cover, which actually helps as a shock absorber. The Fed has successfully cleaned out the short community, and the extent to which we see margins being called may very well accentuate any downside pressure … if it should come.

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Alcoa kicks off the earnings season as usual. Keep an eye on S&P 500 margins, which at 8.2% are now perilously close to the 8.6% bubble peak in the last cycle. The consensus is looking at double-digit sales growth this quarter (14% sales growth for the year hardly ever happens — last time was in 2000 when the economy was expanding at around a 6.5% annual rate in nominal terms). Throughout this dramatic stimulus-fuelled recovery the best we have done so far for any quarter, and we are clearly past the growth peak, was 4.8% at an annual rate.

As an aside, we really enjoyed reading the great debate on page B7 of the weekend WSJ between Robert Shiller and David Bianco — *Is the Market Overvalued?* We just love it when one analyst takes the work of someone else and then tweaks it to make it fit his *a priori* conclusions. Strip out this period here but leave in this period there and make a few adjustments and voila — the market is cheap. Give me a giant break. The fact that Jeremy Siegel, Mr. Dow 36,000 himself (his call, oh, only 13 years ago but a couple of bubble-busting episodes got in the way), backed Mr. Bianco just about says it all right there.

Key findings of IMF's report are that oil accounts for 33% of total global energy consumption. Of that, half is related to transportation. And China's share of total crude usage is 17% and growing

OIL PRICES OVERDONE NOW BUT LONG-TERM IT WILL HIT NEW RECORDS

The IMF released a report overnight concluding that oil prices have tremendous upside regardless of what happens in the geopolitics of the Middle East and North Africa (name of the report is *Oil Scarcity, Growth and Global Imbalances*). Key findings are that oil accounts for 33% of total global energy consumption. Of that, half is related to transportation. And China's share of total crude usage is 17% and growing.

Oil demand has extremely low price elasticities, especially in the short to intermediate term; but oil demand has very high income elasticities, especially in the developing world. World production has stagnated since 2005; in the prior 25 years, growth averaged 1.8% annually. Barring a collapse in the global economy, even with assumptions about new technologies and whatever spare capacity is in the system today, even moderate rates of consumption growth will take the oil price up 75% in coming years.

IT ALL BOILS DOWN TO THE U.S. DOLLAR

With many other central banks raising rates (China, India, European Central Bank) or about to do so soon (Bank of England, Bank of Canada), and the Fed pledging to maintain an aggressive accommodative policy stance, at least so far, the U.S. dollar has all of a sudden emerged as a funding vehicle for the global carry trade. Together with the yen, these are the two currencies that are now the weak sisters in the world FX complex. What happens here is that large investors sell the dollar short and use the proceeds to put money in other higher-yielding assets in other currencies. This is why these quantitative easing programs are so reckless — they raise equity prices for the 20% of the elite that own stocks outright, but all risky assets are correlated so to believe that there are no knock-on effects elsewhere is totally naive.

For sure, there has been at least an indirect effect from QE, insofar as the program itself is designed to unleash investor animal spirits via emerging market currencies (hot money inflows) as well as commodities, which are in a secular bull market. However, as we saw in 2007 and part of 2008, commodity prices have deviated radically from their upward trend-line and this will likely sow the seeds of their demise again, the question is when, because nothing moves asymptotic indefinitely.

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There is an additional problem because the commodities we need to eat and drive are priced in U.S. dollars and with the U.S. dollar down to a 15-month low, and in no small part due to the Fed's posture, the QE programs have triggered a set of disturbing developments for families who are seeing their wages lag behind the surge in the gas and grocery bill. That the Fed does not see this does not matter — it never thought the housing bubble or tech mania were much of a dilemma either.

If there was a reward for futility, in fact, as far as Main Street is concerned, it would go to the Bernanke QE programs. What the "misery index" (the sum of the unemployment rate and the inflation rate) has done since QE2 is to rise 30bps and since the onset of QE1 it has surged well over 300bps.

So it all comes down to the U.S. dollar, which is at the precipice. Here is what the risk-on traders see — the nearby November 25, 2009 low on the DXY is 74.269 … we are now just a snick above 75. A break of that November 2009 low sets up the next critical stop at 70.698 on March 17, 2008 (a good 5-6% away).

Meanwhile, the bets against the dollar have already been made. Looking at the most recent Commitment of Traders (COT) report, there are now 11,642 net speculative short positions in the dollar, a huge swing from the 10,081 net longs just a short three months ago. Things can change in a big hurry. There are also net shorts of 67,564 contracts on the 10-year U.S. Treasury note and a net short position totaling 48,024 contracts on U.S. Treasury bonds ($100,000 face value for both), which is the largest since last July (only to then rally 40 basis points over the next four months). The speculators (non commercial accounts) also have 4,450 net short contracts out on the VIX index on the CBOE, which is historically quite a large bet against the resumption of any market volatility. All of this is traced back to the weakness in the dollar. It is why the net speculative longs in the euro, the Canadian dollar but even more so the Aussie dollar, gold and silver and especially oil (a net speculative long position today that is triple what it was when oil was heading towards $145/bbl three years ago).

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So all we need to start seeing is any catalyst to reverse the downtrend in the dollar. And it may just take a feather out of the BoE or ECB cap to do that, which would be just a little bit of hawkish talk out of the Fed. Once that happens, one would expect to see all the currencies and markets that have rallied in the past month and change begins to correct and the return to the "risk-off" trade likely to come back onto the front burner, at least for a while.

Just as we had fear at the lows last summer, the market is now totally gripped with greed. It is rather an amazing thing to watch risk assets rally in the face of such overwhelmingly risky news (as we cited above). To think that oil prices north of $110 a barrel at a time of subsiding fiscal and monetary relief is not going to put a serious dent into economic growth and earnings projections is just about as pie in the sky as it gets.

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We suggest that readers take a look at Friday's column by Gillian Tett (*ECB Rate Rise Will Spark New Debate About U.S. Tightening* on page 20 of Friday's FT), as well as the speech that Dallas FRB President Fisher delivered on Friday too (*"having done our job, I see many risks to the Fed overstaying its welcome … we at the Fed are near a tipping point"*). And Mr. Fisher is an FOMC voter this year, just as an FYI.

But if there is going to be an "event" that trips up the pro-risk trade, it will somehow end up involving a painful countertrend rally in the U.S. dollar.

STILL BULLISH ON THE LOONIE BUT RIPE FOR CORRECTION

Before we delve in, we are long-term Canadian dollar bulls, and we certainly do not think it has nearly the near-term downside potential that the Aussie has. The loonie is up 4% for the year and the Aussie 3%. The net speculative long position in the Canadian dollar on the CME is still high by historical standards, but has come down 20% from the recent highs, while the net speculative longs in the Aussie have surged to all-time highs.

So the hedge funds seemed to have taken down their long positions in the CAD just a tad and moved more aggressively into the Australian dollar. But you know, the harder they rally, the harder they fall. The cited reason for liking the Aussie is that it is more exposed to what is happening in China, but from our lens, sorry, the People's Bank of China is looking to take the edge off Chinese growth, which will come back to roost in the Australian net export accounts. The other cited reason is that Australia is rich in commodities, but it is Canada that is more strategically exposed to the most critical resource for the global business sector — energy.

All that said, the Canadian dollar is ripe for a near-term correction and one that will clear out more of the speculative longs who only see the loonie as a commodity play as opposed to representing a country possessing a true AAA-rated balance sheet.

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Remember, the Canadian dollar endured no fewer than five notable pullbacks in 2010, and yet it still finished the year with a 5.5% advance and appreciated the same amount against a basket of other currencies.

The domestic fundamentals are still very positive and the long-term trend in the CAD is still up and we see new all-time highs coming in the next 12-24 months. But the loonie will get caught up in a reversal in the greenback and we have to be braced for such an outcome, at least over the near-term. Yes, a month ago,

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we did see a modest 2½ -cent correction in the CAD, but like its predecessors in 2010, this was a short-lived window to go long loonies.

The odds that we see another setback, which will open up another buying opportunity, are high. After all, losing two-cents at any time within a year has occurred 100% of the time in the past three decades; but a temporary three-cent correction also happens about 80% of the time; almost half the time we see a four-cent interim pullback occur at least one time in any given year; and even a nickel slide happens about 25% of the time. So if you are looking to buy Canadian dollars, you don't have to be in any big hurry. History says there are better than even-odds at getting in at a better price but the recent lessons should be heeded that these corrections are short and sweet and the window of opportunity closes quite quickly.

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HYSTERIA OVER INFLATION

Once again, you could scarcely lift up a newspaper or magazine over the weekend and not read about inflation and how investors should protect their portfolios from the looming big inflation cycle. Didn't we hear all this in 2000, 2004 and again in 2008? How short the memories are. This dinosaur belief that commodities drive the inflation process goes dormant for a while but obviously never dies and then it's left to folks like us who see the forest past the trees to have to shut these people up.

Yes, we can see that bond yields have backed up from their recent lows. A good part of this does reflect the inflation expectation component but (i) we have seen this before and (ii) it is unlikely to be sustained. This doesn't mean that the 10-year Treasury note can't go all the way back and retest the 4% mark but if it does, as we saw last year at this time, it will sow the seeds of its own demise and that of the equity market as well.

Markets have a tendency to overshoot and that remains a risk in the bond market in terms of the trend in yields, but it is hard to fathom that commodities alone will drive inflation even higher without generating a much broader impact through the price system. But the United States is not an emerging market where goods make up the significant part of the spending bucket — services represent two-thirds of the pie and they have precious little to do with the price of oil and in fact look to be in a well-defined disinflationary downtrend.

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The Fed's policies may have elicited inflation in risk assets and commodities, but at the same time real wages are in decline so for the non-cyclical part of the family budget, demand destruction and deflation for this key segment of the economy is the end-result. Fully 100% of both QEs by the Fed merely was new money printing that ended up sitting idly on commercial bank balance sheets. Money velocity and the money multiplier are stagnant at best.

The latest bank data showed a $10 billion contraction in household credit over the past week and $25 billion over the past month. It is a slow bleed. And it remains a legitimate question as to how we end up with inflation as credit contracts. Not just in the consumer and housing sectors, but in the government sector too. The state and local government sectors have dramatically cut back on bond issuance this year and are cancelling capital projects in the process. We see on the front page of the weekend WSJ this headline — *Inflation Drives a Shift in Markets* and right above it is *Deadline Drama Over Budget*. Not only is household credit contracting, but the same is happening at the government level. This is deflationary, not inflationary, and once commodities settle down — they are volatile and self-correcting as we have seen in the past — all this talk of inflation is going to subside pretty quickly.

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Gluskin Sheff at a Glance

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For further information, please contact research@gluskinsheff.com

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