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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

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SECTORS AND THE BUSINESS CYCLE

There is so much angst over the run-up in mortgage rates, the impact on housing, and the subsequent effect on the overall economy. I continue to field so many comments on how the economy can manage to survive without a vibrant residential real estate market. The answer is simple. The economy invariably manages to grow in an economic cycle long after the housing market peaks. It has always been the case, and the current situation is no different.

We went back into the history books to carefully examine which sectors perform the best in the various points along the business cycle.

Inventory investment and housing are classic early cycle performers.

They tend to give up leadership in mid-cycle, when consumer spending and exports take over in terms of relative growth rates.

Capital spending (Machinery & Equipment) and nonresidential investment are classic late cycle sector outperformers.

I think we are heading into mid-cycle where consumer spending is going to take the baton from the housing market. This is currently being delayed by the lagged impact of the early year tax bite and the current round of sequestering, but next year we should begin to see the impact of gradually improving job market fundamentals spill into a pickup in consumer spending growth. This would not just be desirable — it would be natural. Exports should also take on a leadership role as the recession in Europe ebbs and Chinese growth stabilizes. The cyclical outlook in Japan is also constructive as the monetary and fiscal stimulus has to fully percolate but there is already evidence that the two-decade experience with deflation is drawing to a close.

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The next chapter would then involve capital spending and plant expansion, and capacity utilization rates and an increasingly obsolete private sector capital stock will trigger accelerating growth in business spending, likely by 2015 or perhaps even earlier. Profit growth is slowing and normally that would be an impediment, but there is ample cash on balance sheets and what businesses need is a less clouded policy outlook, which hopefully will be resolved in the coming year as we get a new Fed leader, greater clarity on monetary policy and some fiscal resolution ahead of or following the mid-term elections. That may be nothing but a hope and prayer, but more fundamentally, productivity growth has stagnated and the best way the corporate sector can reverse the eroding trend and protect margins at the same time will be to move more aggressively to upgrade their operations and facilities — we are coming off the weakest five-year period in the past six decades with regards to growth in capital formation. Perhaps the parting of the clouds in the euro area will serve to be the shot-in-the-arm that companies need to make a capital commitment to the real economy.

All that said, I really don't want to obscure the main point here, or delve too far into the future on that capex call. For the here and now and immediate future, no, I am not worried about the housing revival peaking out. There is no evidence that when this happens, the economy suddenly rolls over and plays dead. Quite the opposite. A peaking in the housing market right now would be perfectly normal — normal defined as the historical norm. Just look at the evidence:

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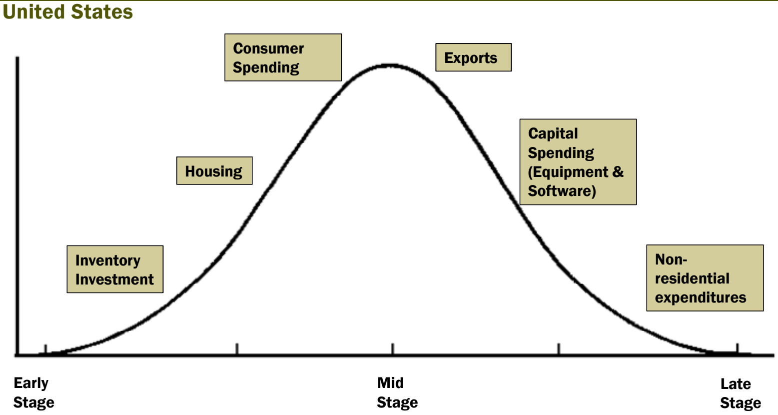
- Housing starts peaked at 2.27 million units on January 2006. The recession began in December 2007 or nearly two years later.
- Starts peaked December 1998 at 1.8 million, and the recession began on March 2001.
- Starts peaked February 1984 at 2.26 million, and the expansion did not end until July 1990. Is that early cycle enough for you?
- Starts peaked at 2.2 million in April 1978, and the recession did not start until January 1980.
- Starts also peaked in January 1972 at 2.49 million units, and the expansion lasted all the way to November 1973.

So there are two takeaways here. If we did peak this time at one million units back in March, it will have been the lowest peak ever (back to the 1950s) and by about half. Second, as you can see from the lags, the next recession does not begin, on average, for nearly three years after the peak in housing starts. There is more to life — and the economy — than this 3% chunk of GDP.

CHART 1: THE BUSINESS CYCLE

United States



Source: Gluskin Sheff

Housing always peaks early in the business cycle. The lag between the peak in housing and the peak in the economic cycle is typically 40 months, not three months. And if the peak was one million in housing starts last March, it will be the first time that has ever happened (and I do understand that the world is different post-crisis as it relates to credit availability and demographics). The two lowest peaks ever in U.S. housing starts were 1.8 million units in the mid-1960s and the late 1990s. So it is unclear that one million was the peak this time around, and higher mortgage rates have to be viewed in the context of improving job market conditions. And even if one million was the peak, the time lag between the peak in the residential sector and the next recession is just far too long for me to fret about right now. Inflation, the yield curve, the unemployment rate and housing all scream early-cycle to me, though the stock market, the boom/bust ratio, productivity and capacity utilization rates in industry suggest mid to late cycle. So I do acknowledge that it is not 100% clear as to where we are in the business cycle right now — but the yield curve tends to win out and is so steep that it would be bizarre to be talking about the expansion being long in the tooth at the current time (though the equity market looks fully priced to say the least).

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There is also tremendous angst following the 13.4% slide in new home sales for July (data out on Friday). The bottom line is that about the only piece of data out there that is more notoriously volatile is the monthly durable goods orders report (the numbers just came out for July and were quite a bit softer than expected but did come off significant strength during the Spring) — in fact, no fewer than 10 times in the past 10 years have we seen a month that saw new home sales dive double-digits — consider it an annual event. Now I am not downplaying the recent softening in the housing market here — but again, like housing starts, sales tend to peak in the early part of the cycle — and generally four years before the expansion dies. If you thought that the last cycle was going to be aborted, for example, after home sales peaked in July 2005 (again, in response to a 130bp backup in mortgage rates from the lows), you would have missed out on another 2½ years of positive cyclical momentum (and a good two years before the most optimal time to re-extend duration).

In fact, while we seem to be in the mid-cycle segment of the economic cycle, sector rotation within the equity market suggests we are later in the investment cycle. What we did was assess relative sector performance across the market in up-phases — what leads and lags in the first 20% of the equity bull market (early), next 20% (early-mid), the next 20% (mid), the next 20% (late-mid) and the final 20% (late). As you can see from the table below, late-cycle tends to see Tech, Materials, Industrials and Consumer Discretionary near the top, and the rate-sensitive Telecom, Utilities and Financials lagging behind — which is almost precisely the backdrop of the action we have seen over the past

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month. It would not be that unusual to have the market in the later stage, and the broad economy in the mid stage, since it is the S&P 500 that leads GDP, not the other the way around.

CHART 2: SECTOR PERFORMANCE IN DIFFERENT STAGES OF BULL MARKETS

United States

		Stage of Bull Market				
		1st	2nd	3rd	4th	5th
Sector ranking	1	Cons. Discret.	Telecom	Financials	Healthcare	Info Tech
	2	Info Tech	Industrials	Healthcare	Cons. Staples	Oil & Gas
	3	Materials	Utilities	Cons. Staples	Financials	Industrials
	4	Industrials	Cons. Staples	Oil & Gas	Telecom	Materials
	5	Financials	Oil & Gas	Industrials	Utilities	Cons. Discret.
	6	Cons. Staples	Financials	Telecom	Cons. Discret.	Healthcare
	7	Oil & Gas	Cons. Discret.	Info Tech	Oil & Gas	Cons. Staples
	8	Healthcare	Materials	Materials	Industrials	Telecom
	9	Utilities	Healthcare	Cons. Discret.	Materials	Financials
	10	Telecom	Info Tech	Utilities	Info Tech	Utilities

**Sector data from DataStream which go back to 1973*

Source: DataStream, Standard and Poor's, Bloomberg, Haver Analytics, Gluskin Sheff

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OVERVIEW OF THEMES AND STRATEGIES

THEME	STRATEGY/IDEA	SECTOR/ASSET CLASS
Redeployment of Capital	Companies which have deployed or have capacity (and a track record) to deploy excess capital to generate risk-adjusted returns which exceeds their cost of capital.	Special situations
Income Orientation	Focus on reliable dividend growth and dividend yield; Being and staying ahead of the robust demographic (baby-boomers aging) shift towards income oriented investments. Safety and Income at a Reasonable Price (S.I.R.P.).	Income-oriented stocks with the ability to sustain and grow dividends
Financials	A focus on companies whose business model would benefit from a rising interest rate environment over the longer term; A steeper yield curve would also benefit banks as well; Focus on those that are at or near Basel III compliance, trade below book and will see NIM expansion from rising rates.	Insurance companies Banks
Canadian credit	Although Verizon is certainly a threat to the incumbent firms in Canada, we think this is a bigger equity/earnings risk and still feel comfortable with these companies from a credit perspective; Even when the credit markets were strong and spreads were moving materially tighter, deposit notes have been the major laggard in Canadian credit so far in 2013.	Credit of Canadian telecom companies Canadian bank deposit notes
Energy Infrastructure	There are mega-billions of dollars worth of projects awaiting approval in North America for the distribution of natural gas both for domestic consumption and export. The multi-year trend toward increasing gas consumption will benefit companies that have expertise in building natural gas infrastructure and liquefaction/gas-to-liquid technology.	Engineering & Construction companies specialized in natural gas infrastructure
Auto Recovery	The profitability leverage for the likes of Ford and GM is considerable when the global automotive industry begins to improve.	U.S. auto manufacturers Auto parts suppliers
European Domestic Demand Plays	The region is swinging back to positive growth for the first time in two years; We favour western European Telecom names on the back of "less bad" results. Expectations remain extremely low for this group.	European Financials, Industrials, Healthcare, Consumer Discretionary Western European Telecom Companies
Mobility/ Connectivity and IT Infrastructure	Focus on those firms that benefit from the secular trend surrounding the portability of data and increased consumer usage of smartphones/tablets; Identify and invest in firms that benefit from cloud-based strategies that allow customers to be more efficient and realize cost savings.	Technology firms Cellular carriers/Tower companies
Non-Cyclical	Focus on special situations that are not correlated with the economic cycle.	Defense-aerospace Healthcare Dollar/Discount stores

Capital Preservation	Lock in high-quality corporate bond spreads in non-cyclical sectors; Minimize volatility via alternative strategies such as long/short equity strategies.	Income-producing equities, preferreds and bonds Credit of Canadian Banks, Retailers, Insurance companies
Other	Invest in hard "strategic" assets; Focus on burgeoning middle class in emerging markets.	Commercial aerospace companies Emerging market consumer stocks

Updated: August 14, 2013
Source: Gluskin Sheff

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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 on high net worth private clients and institutional investors, 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.

OVERVIEW

As of June 30, 2013, the Firm managed assets of $6.2 billion. The minimum investment required to establish a client relationship with the Firm is $3 million.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and remains 46% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

LEADING

Our team is an exemplary group of investment professionals deep in talent, ideas and experience with the industry's top leaders in risk management and client service – all with the objective of providing strong risk-adjusted returns and the highest level of personalized client service.

INNOVATIVE

Throughout our history we have been Stubbornly unconventional™, consistently pursuing innovative approaches to wealth management for our clients. Today, we offer a diverse platform of investment strategies, including Canadian, U.S. and international equity strategies, alternative strategies and fixed income strategies.

PERSONAL

For Gluskin Sheff, delivering outstanding client service is as fundamental as delivering strong investment results. Our clients are unique, and so are their needs. This is why we offer customized investment plans to suit each client's specific objectives and risk profile.

Our success in developing lasting client relationships is founded on shared values, a thorough understanding of our clients' goals and a keen desire to earn their trust and confidence.

ALIGNED

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. Our clients are our partners, through performance-based fees that are earned only when pre-specified performance benchmarks for clients' investments are exceeded.

PROVEN[1]

$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $4.5 million[2] on June 30, 2013 versus $2.1 million for the S&P/TSX Total Return Index[3] over the same period.

Similarly, many of our other long-standing investment strategies have outperformed their relevant benchmarks.

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For further information, please contact research@gluskinsheff.com

Notes:

1. *Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.*
2. *Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.*
3. *The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.*

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