



**MARKET MUSINGS & DATA DECIPHERING**

---

# Breakfast with Dave (Free Report - PDF)

**This Special Report was included in a previous edition of *Breakfast with Dave*. We are pleased to share it with all of our readers today as a Free Edition. Enjoy!**

**IN THIS ISSUE**

**Sectors and the business cycle**

**Click to read on ...**

*Gift certificates available, email [research@gluskinsheff.com](mailto:research@gluskinsheff.com) for more information*

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms.

Founded in 1984 and focused on serving 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.

For more information or to subscribe to Gluskin Sheff economic reports, visit [www.gluskinsheff.com](http://www.gluskinsheff.com).



## 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.

---

**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**

---

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:

---

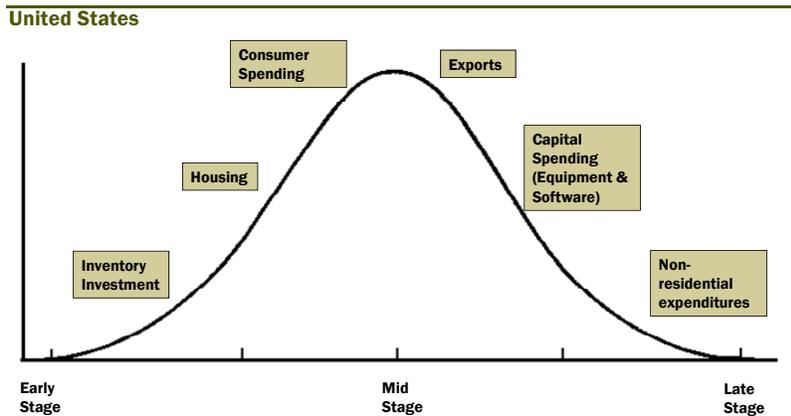
**I am not worried about the housing revival peaking out. There is no evidence that when this happens, the economy suddenly rolls over and plays dead. Quite the opposite**

---

- 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**



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).

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

---

**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**

---



---

**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**

---



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

## OVERVIEW OF THEMES AND STRATEGIES

THEME	STRATEGY/IDEA	SECTOR/ASSET CLASS
<b>Redeployment of Capital</b>	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
<b>Income Orientation</b>	Focus on reliable dividend <u>growth</u> 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 <u>grow</u> dividends
<b>Financials</b>	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
<b>Canadian credit</b>	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
<b>Energy Infrastructure</b>	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
<b>Auto Recovery</b>	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
<b>European Domestic Demand Plays</b>	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
<b>Mobility/ Connectivity and IT Infrastructure</b>	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
<b>Non-Cyclical</b>	Focus on special situations that are not correlated with the economic cycle.	Defense-aerospace Healthcare Dollar/Discount stores



---

<b>Capital Preservation</b>	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
<b>Other</b>	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

# 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<sup>1</sup>

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

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

*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.*

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

*For further information, please contact [research@gluskinsheff.com](mailto: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.

## IMPORTANT DISCLOSURES

Copyright 2013 Gluskin Sheff + Associates Inc. ("Gluskin Sheff"). All rights reserved.

This report may provide information, commentary and discussion of issues relating to the state of the economy and the capital markets. All opinions, projections and estimates constitute the judgment of the author as of the date of the report and are subject to change without notice. Gluskin Sheff is under no obligation to update this report and readers should therefore assume that Gluskin Sheff will not update any fact, circumstance or opinion contained in this report.

The content of this report is provided for discussion purposes only. Any forward looking statements or forecasts included in the content are based on assumptions derived from historical results and trends. Actual results may vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts when making any investment decision, and no investment decisions should be made based on the content of this report.

This report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and particular needs of any specific person. Under no circumstances does any information represent a recommendation to buy or sell securities or any other asset, or otherwise constitute investment advice. Investors should seek financial advice regarding the appropriateness of investing in specific securities or financial instruments and implementing investment strategies discussed or recommended in this report.

Gluskin Sheff may own, buy, or sell, on behalf of its clients, securities of issuers that may be discussed in or impacted by this report. As a result, readers should be aware that Gluskin Sheff may have a conflict of interest that could affect the objectivity of this report. Gluskin Sheff portfolio managers may hold different views from those expressed in this report and they are not obligated to follow the investments or strategies recommended by this report.

This report should not be regarded by recipients as a substitute for the exercise of their own judgment and readers are encouraged to seek independent, third-party research on any companies discussed or impacted by this report.

Securities and other financial instruments discussed in this report are not insured and are not deposits or other obligations of any insured depository institution. Investments in general and, derivatives, in particular, involve numerous risks, including, among others, market risk, counterparty default risk and liquidity risk. No security, financial instrument or derivative is suitable for all investors. In some cases, securities and other financial instruments may be difficult to value or sell and reliable information about the value or risks related to the security or financial instrument may be difficult to obtain. Investors should note that income from such securities and other financial instruments, if any, may fluctuate and that the price or value of such securities and instruments may rise or fall and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance.

Foreign currency rates of exchange may adversely affect the value, price or income of any security or financial instrument mentioned in this report. Investors in such securities and instruments effectively assume currency risk.

Any information relating to the tax status of financial instruments discussed herein is not intended to provide tax advice or to be used by anyone to provide tax advice. Investors are urged to seek tax advice based on their particular circumstances from an independent tax professional.

Individuals identified as economists in this report do not function as research analysts. Under U.S. law, reports prepared by them are not research reports under applicable U.S. rules and regulations.

In accordance with rules established by the U.K. Financial Services Authority, macroeconomic analysis is considered investment research.

Materials prepared by Gluskin Sheff research personnel are based on public information. Facts and views presented in this material have not been reviewed by, and may not reflect information known to, professionals in other business areas of Gluskin Sheff.

To the extent this report discusses any legal proceeding or issues, it has not been prepared as nor is it intended to express any legal conclusion, opinion or advice. Investors should consult their own legal advisers as to issues of law relating to the subject matter of this report. Gluskin Sheff research personnel's knowledge of legal proceedings in which any Gluskin Sheff entity and/or its directors, officers and employees may be plaintiffs, defendants, co-defendants or co-plaintiffs with or involving companies mentioned in this report is based on public information. Facts and views presented in this material that relate to any such proceedings have not been reviewed by, discussed with, and may not reflect information known to, professionals in other business areas of Gluskin Sheff in connection with the legal proceedings or matters relevant to such proceedings.

The information herein (other than disclosure information relating to Gluskin Sheff and its affiliates) was obtained from various sources and Gluskin Sheff does not guarantee its accuracy. This report may contain links to third-party websites. Gluskin Sheff is not responsible for the content of any third-party website or any linked content contained in a third-party website. Content contained on such third-party websites is not part of this report and is not incorporated by reference into this report. The inclusion of a link in this report does not imply any endorsement by or any affiliation with Gluskin Sheff.

Gluskin Sheff reports are distributed simultaneously to internal and client websites and other portals by Gluskin Sheff and are not publicly available materials. Any unauthorized use or disclosure is prohibited.

### TERMS AND CONDITIONS OF USE

*Your receipt and use of this report is governed by the Terms and Conditions of Use which may be viewed at [www.gluskinsheff.com/terms.aspx](http://www.gluskinsheff.com/terms.aspx)*

*This report is prepared for the exclusive use of Gluskin Sheff clients, subscribers to this report and other individuals who Gluskin Sheff has determined should receive this report. This report may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Gluskin Sheff.*

**YOU AGREE YOU ARE USING THIS REPORT AND THE GLUSKIN SHEFF SUBSCRIPTION SERVICES AT YOUR OWN RISK AND LIABILITY. NEITHER GLUSKIN SHEFF, NOR ANY DIRECTOR, OFFICER, EMPLOYEE OR AGENT OF GLUSKIN SHEFF, ACCEPTS ANY LIABILITY WHATSOEVER FOR ANY DIRECT, INDIRECT, CONSEQUENTIAL, MORAL, INCIDENTAL, COLLATERAL OR SPECIAL DAMAGES OR LOSSES OF ANY KIND, INCLUDING, WITHOUT LIMITATION, THOSE DAMAGES ARISING FROM ANY DECISION MADE OR ACTION TAKEN BY YOU IN RELIANCE ON THE CONTENT OF THIS REPORT, OR THOSE DAMAGES RESULTING FROM LOSS OF USE, DATA OR PROFITS, WHETHER FROM THE USE OF OR INABILITY TO USE ANY CONTENT OR SOFTWARE OBTAINED FROM THIRD PARTIES REQUIRED TO OBTAIN ACCESS TO THE CONTENT, OR ANY OTHER CAUSE, EVEN IF GLUSKIN SHEFF IS ADVISED OF THE POSSIBILITY OF SUCH DAMAGES OR LOSSES AND EVEN IF CAUSED BY ANY ACT, OMISSION OR NEGLIGENCE OF GLUSKIN SHEFF OR ITS DIRECTORS, OFFICERS, EMPLOYEES OR AGENTS AND EVEN IF ANY OF THEM HAS BEEN APPRISED OF THE LIKELIHOOD OF SUCH DAMAGES OCCURRING.**

If you have received this report in error, or no longer wish to receive this report, you may ask to have your contact information removed from our distribution list by emailing [research@gluskinsheff.com](mailto:research@gluskinsheff.com).