

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave – Free

Dear Readers,

This report was published last week for our paying subscribers. I'm pleased to now share it with all of you as a Free edition. Hope you enjoy reading it.

I WANT TO HOLD YOUR HAND

That's not Lennon or McCartney, it is Janet Yellen.

If you went to sleep at the start of the year and just woke up to see the S&P 500 up 1% on the year, you could be forgiven for thinking that you didn't miss very much – but we could have said much of the same for all of 2015, and yet there was no shortage of volatility, peaks and valleys, intermittent corrections, and sharp bear market rallies along the way.

The era of “buy and hold” is over; the near straight line up in the market really ended with the end of quantitative easing back in the Fall of 2014, and so adding alpha now means being nimble and quick.

It is a traders' market and it is likely to stay that way for some time yet.

Which brings me to the Fed, which seems to be front and center yet again. At least we know who the boss is and it is not any of the particularly hawkish District Fed presidents – like the four in the past couple of weeks who advocated a rate hike sooner rather than later.

It is now more obvious than ever that when Janet Yellen talks, people listen – as we saw in the initial bullish reaction to her speech in New York on last Tuesday and the follow-through on Wednesday, taking the major averages to the highs of the year.

But I think it is instructive to focus on the one sector that has stuck out like a sore thumb, which is the Banks as they are lower now than they were prior to Janet Yellen's dovish commentary – a Fed that is now on hold as far as the eye can see is not exactly good news for a part of the market begging for expanding net interest margins.

When we look back we will also see that rallies that do not have the Financials participate are rallies you can take to the dance but that you cannot necessarily take home.

FREE 2-WEEK TRIAL

Promo Code: Growth

Redeem from:

<http://research.gluskinsheff.com>

The era of “buy and hold” is over

When Janet Yellen talks, people listen

Rallies you can take to the dance but you cannot take home



I also have to say that it does make me feel a bit queasy to see *Yellen Rides to the Rescue of Markets* on the front page of the USA Today — I mean, seriously, we are seven years off the lows, with equity returns more than tripling over that span, and we still need to hire Janet Yellen as Mr. Market's hand-holder? Hard to believe but true.

Well, maybe this is not the best time to play philosopher and focus on what makes markets tick today, which obviously is the ongoing drip of financial heroin from central banks (in fact, it may not be Janet who is the boss as much as all the other major central banks like the Bank of Japan and European Central Bank, whose relentless easing initiatives have forced her to the sidelines indefinitely).

The reflation theme is being underscored by the softening in the U.S. dollar — after failing recently not once, but twice, at the 50-day moving average, the DXY dollar index just made a failed approach of the 200-day trend line and is now faltering quite badly — at a key technical juncture right now actually, and this was clearly one of Janet Yellen's goals (after all, she carefully isolated two sources of concern — China and Oil — and both can be remedied by what? Try a weaker U.S. dollar).

The reflation theme is being underscored by the softening in the U.S. dollar

The greenback has slipped 4% on a trade-weighted basis in March, and is on track for its second straight monthly setback — and the sharpest decline since September 2010.

To repeat, the vice on global liquidity from the super-strong dollar — the second most intense dollar bull market on record — which created more losers than winners in the process (what's that about "too much of a good thing", again?), has been broken.

All the major trend-lines are either flat or rolling over, so it is reasonably safe to say that the dollar bull market is over.

And consider this music to the ears of the U.S. manufacturing sector, dollar-denominated debt strained Emerging Markets, gold, industrial commodities, resource-based currencies — our beloved Canadian dollar broke through the C\$1.30 threshold as an example — and the weakening greenback is a key factor that will help ease foreign exchange pressures in China (as the yuan has been able to depreciate to 16-month lows on the trade-weighted index monitored by the PBOC).

Music to the ears of the U.S. manufacturing sector

So we have the fed fund futures market basically pricing out any residual probability of a rate hike at the next meeting (down from 10% recently) and a move by November is now being treated as a coin toss — in fact, odds of any move in 2016 got marked down 10 percentage points to 63% ... now that is called power from the pulpit).

The two words that Janet Yellen emphasized last Tuesday were "global" (11 references versus four at her February congressional testimony and just once in her last December speech, just ahead of the "you-know-



what” hitting the fan) and “uncertainty” (10 Tuesday from three in February and eight citations last December).

The Fed chief is more concerned about the downside risks to growth and inflation from the weakening pace overseas than before, that much is clear — and whenever a central banker is uncertain, rest assured that the only certainty is that he or she does nothing.

That was the message from Yellen’s speech. Rate risk is off the table, but the reasons for it — a lack of growth visibility — are why investors did not bid up stocks even more yesterday despite her overtly dovish tone.

I don’t think it can be lost on investors that the Fed is less of a sustainable positive force for the equity markets at current stretched valuations.

The market price-to-earnings multiple is two points above its historical fair-value. In other words, the market is priced for operating earnings per share of \$140 for the coming 12 months whereas the consensus among bottom up analysts has not budged from roughly \$120.

Somehow and some time that bridge is going to close, and if it closes in price action that would shave 100 points off today’s level of the S&P 500.

So *caveat emptor* (let the buyer beware) in playing this Fed relief rally.

Not just that, but we are still very clearly in an earnings recession and the quality of earnings is deteriorating at the fastest pace since the Great Recession, seven years ago.

The trailing price-to-earnings multiple on reported (un-scrubbed) earnings is 23.5x, a high for the cycle. Up until the latest quarter, the range had been 13x (in the third quarter of 2011 when it was time to buy) and 21.7x in the second quarter of 2015 (when it was time to lighten up).

The gap between reported and operating multiples has widened to 320 basis points from 190 basis points a year ago and the widest since the third quarter of 2009.

So it isn’t just a lack of quantity, but a lack of quality in terms of the profit picture. Not a pretty one, either.

In that vein, it was interesting to see the sector performance on Tuesday in the S&P 500 (even as all 10 advanced, there was a wide dispersion) — Materials (+0.4%) and Industrials (+0.5%) actually underperformed, and it was the defensive rate-sensitives that topped the leaderboard (Utilities +1.4%; Telecom +1.1%; Health Care rallied 1.2%).

Whenever a central banker is uncertain, rest assured that the only certainty is that he or she does nothing

Quality of earnings is deteriorating at the fastest pace since the Great Recession



It was an interesting response.

Yellen pushed against rate hike expectations which means a persistent search for yield by investors. She said "*caution is especially warranted*" which means she is downbeat on growth.

So the fact that the segments of the market with the highest yields and the lowest correlations with the economy advanced the most — along with having toes in the asset class that the Fed wants to rally the most, so as to improve financial conditions as an antidote to the weakening pace of overseas activity.

But investors with three-to-five year time horizons would be advised to heed the message that we have a Fed that is adopting a strategy that differs from the dual mandate of full employment (which we have) and price stability (which we also have).

We do have a reflation, or even mild stagflation, theme on our hands for those driving by looking through the front window as opposed to the rear view mirror.

This should be constructive for hard assets like basic materials and real estate — and one reason why I like the Canadian dollar because it is a currency play on a reflationary future.

Janet Yellen will continue to hold policy rates negative in real terms as far as the eye can see even with core CPI inflation at 2.3% and rising, core PCE at 1.7% and rising, unemployment south of 5% (and for those who truly are employable, that rate is between 2% and 2½% depending on the measure).

Money and credit growth is running close to a 10% annual rate (on a 13-week rate of change basis) so deflation or lowflation are frankly a bit of a red herring.

It is not evident to the naked eye just yet, but just as the Fed sowed the seeds in the second half of the 1960s for the unexpected stagflationary experience of the 1970s, something very similar is taking hold this time around.

In sum, this Fed rally has a short shelf life absent a reacceleration in global growth in both the economy and earnings.

So this will remain broadly what it has been — more of an idiosyncratic market of special situations and creative ideas than one of merely playing the major averages and hoping for the best which worked so well from March 2009 to May 2015 (the lack of participation by the Financials remains a concern to me). This is especially the case for "growth stocks" seeing as the Nasdaq 100 has fallen short of getting past resistance so far at its major trendlines.

Yellen pushed against rate hike expectations which means a persistent search for yield by investors

Janet Yellen will continue to hold policy rates negative in real terms as far as the eye can see



Now, make no mistake — I am not saying we are in a bear market, but we don't seem to be in a bull market, either. We are in a stagnant or purgatory market where nimble security selection and sector rotation rules the roost.

The S&P 500 peaked intraday on May 20th 2015 at 2,134 and bottomed on Feb 11th 2016 at 1,810; the tighter band is 2,100 on the upside and 1,900 on the downside.

But as we saw in 2015, if you were in the “right” sectors (always so evident in hindsight) like Health Care, the Consumer and Tech, your total return was close to 7%-plus in what was basically a flat market.

This year — again a year that looks flat but has actually been a wild roller-coaster ride — being in the right sectors (bond proxies like Utilities and Telecom barbelled with softer-dollar proxies like Materials, Industrials and Consumer Staples) and again, the returns again have been a touch better than 7% thus far (and that is not annualized!).

From my lens, we have rallied too hard and too fast off the February lows and I don't expect this Fed induced rally to have a lot of legs.

A two-multiple point forward price-to-earnings multiple expansion in barely over a month does not happen too often.

We have enjoyed a great run back up to the top of the range and at a time when the Q1 earnings season is going to prove to be very challenging.

At the same time, sentiment is no longer a tailwind — complacency has set in, perhaps a tad too much of it. Market Vane Consensus Bullish equity sentiment was at 47% a month ago is at 56% today and the VIX back below 14x is hardly a green light to add more to positions.

And the fact that the two best performing sectors so far this year are Telecom (+15.3%) and Utilities (+13.9%) and among the worst are Financials (-5.4%) and Consumer Discretionary (+1.3%) is not a very favorable pro-cyclical mix and attests to a generally defensive tone in an otherwise range-trading market.

As for the economy, it was nice to see the upward revision to fourth quarter GDP growth to 1.4% at an annual rate from 1.0%, and the initial print of 0.7%, but the tracking for the current quarter is now just +0.6% and this would then make it 10 of the 27 quarters since the recession ended where growth came in south of 1½% — so that is over 35% of the time we have been mired below 1½%, double what is normal in a typical expansion.

I am not calling for recession, but I see many economists hanging on to their one-in-four probabilities for the coming six-to-12 months (Wells

The S&P 500 peaked intraday on May 20th 2015 at 2,134 and bottomed on Feb 11th 2016 at 1,810

Sentiment is no longer a tailwind



Fargo the latest) which just doesn't jive with a forward price-to-earnings multiple some two points above the norm, and using GAAP earnings, that spread is even more acute.

This is a market desperately searching for a theme — very much an idiosyncratic, stock-specific, and special situation (idea)-driven, not to mention dominated more by the technicals than is typically the case.

Ultimately, what we pay for as equity investors is for profits, and while the overall economy is not in recession, profits are, and the national accounts data from the Bureau of Economic Analysis last Friday showed pre-tax earnings dropping at a 7.8% annual rate in Q4, the biggest decline since the first quarter of 2011.

This followed a 1.6% decline the prior quarter — down in four of the past six, actually — and this dragged the annual trend down to -11.5% YoY, the lowest since the "Great Recession".

Profit margins are now being squeezed big-time — compressing to 12.7% in Q4 from 14.2% in Q3 and 15.1% a year ago (profits as a share of gross domestic income came in at 7.5% in Q4, far off the Q2 2013 peak of 10%).

Again, while it is true that the economy is not in recession, capital spending sure is, ditto for net exports, and so what is hanging the thread together is the consumer and housing and even here, we are seeing a loss of some momentum in recent months.

So there is limited visibility on earnings or the economy, that was Janet Yellen's macro message Tuesday, and then we have to assess the political risks that surround us globally.

Look at the world around us.

In a word, instability. In two words: no leadership.

We have a horrible primary season on our hands stateside as the candidate's trip over themselves claiming to be the greatest anti-free-trader and anti-Wall Street crusaders.

Populism at its best.

The two frontrunners — Hillary and The Donald — have the highest unfavorable ratings. She is being pushed to the left, and let's face it, The Donald is a loose cannon and is totally unpredictable.

Elsewhere, President Obama has all but checked out, which became pretty clear with his truly lame response to last week's terror attacks in Brussels.

Doesn't jive with a forward price-to-earnings multiple some two points above the norm

In a word, instability — in two words: no leadership



U.K. Prime Minister David Cameron is in deep trouble with this Brexit vote and the separation crowd now has a modest lead in the polls and no doubt the tragic events at the heart of the European Union will only embolden this group.

Angela Merkel's fortunes have faded with their refugee policy, as the German state elections reveal her growing vulnerability.

Iran is back testing missiles and nobody outside of Bibi Netanyahu seems to be paying any attention.

Putin is dictating foreign policy in the Middle East and appears in the process to have successfully stabilized the Assad regime.

**Putin is dictating foreign
policy in the Middle East**

There is also the tense political backdrop in Brazil (largest economy in South America) — which adds more to the global political uncertainty theme.

Secessionist forces in Spain are alive and well.

Italy is in the midst of a Banking crisis.

In France, Prime Minister Francois Holland is now backing away from labor market reforms.

China's leadership has lost credibility, Abenomics isn't working and the Modi revolution in India has largely fizzled.

And of course, terrorism is back on the front burner in Turkey, Brussels and Pakistan where the threat is building.

All of this uncertainty caps the upside in equities, even if the response thus far has been muted to say the least.

**All of this uncertainty caps
the upside in equities**

Concluding on the bond market, I am convinced that if it were not for the fact that 10-year Japanese Government bond yields were trading at -9 basis point and German bunds at +0.16% (on the back of rampant central bank intervention), the 10-year Treasury note yield would be closer to 4% right now rather than the 1.8% level we have on our hands today.

Never before has 1.8% on 10-year money looked so good, and even as deflation fears subside, we still have this bizarre situation (the creation of the central banks in fact) where average yields on the \$23 trillion of global sovereign bonds outstanding have just dropped below 0.7% for the first time in recorded history.

So as cautious as I am on equities, this "TINA" (There Is No Alternative) theme for the stock market is not going to go away either, and that is one reason I am not more negative than I am. Not when we have a 2.4%



S&P 500 dividend yield; fatter than the 10-year Treasury yield by a full 60 basis points.

In fact, we have reached a state where fully half of the U.S. stock market now trades at a yield premium to the 10-year Treasury note. Or here in Canada, where the TSX gives an investor over a 3% dividend yield right out of the gate and 4%-to-5% yields in stable sectors like Telecom, Utilities and Financials.

We are already seeing the early signs of inflation-protection in the very asset class that is most sensitive to the switch from deflation fears to inflation jubilation.

The purest form of this reflation theme is obvious in the recent behavior of Treasury Inflation-Protected Securities (TIPS), where breakeven levels – the market-based measure of inflation expectations – have jumped to their highs for the year at over 1.6% for the 10-year breakeven.

As I said at the top, this is a choppy year that doesn't look to offer much from the averages, but beneath the surface, what probably pays well are those stocks that few are willing to own – the unloved ones – and those that have blown up with a catalyst for change.

So as I search for a market theme, for the most part, it is simply about playing yield, earnings stability and low volatility – back to “Safety and Income at a Reasonable Price” (SIRP) strategies – on one end of the barbell and inflation protection on the other side of the barbell sounds like a reasonable strategy to me.

In terms of regional exposure, the country that has the most visibility right now is Canada, which has emerged as a bastion of political stability in a sea of global instability, and one of few countries where fiscal policy has grabbed the torch from monetary policy, which means that the Canadian dollar's switch from a flightless bird to a loon with wings likely has some durability.

Oil has taken a bit of a breather as it's had a nice run but the pipelines serve as a low beta way to play Energy, but with a near-5% dividend yield and 8% payout growth. The Canadian Banks have had a nice run but the yield of 4%-plus remains attractive and also a low-risk way to play the recovery in oil via reduced concerns over loan-loss provisioning.

Corporate credit also looks very good even after the nice recovery in recent weeks. High-Yield corporate bond yield spreads have come in 200 basis points to be sure, but there is still quite a bit of juice left in the orange.

Take note that in each year since 2009, when the Great Recession ended, we have seen at least one day when the High-Yield spread broke below 600 basis points and they currently sit near 700 basis points.

**Back to “Safety and Income
at a Reasonable Price”
(SIRP) strategies**

**Corporate credit also looks
very good even after the
nice recovery in recent
weeks**



Corporate credit is an area where you stand a good chance at current yield levels of say 8% for High-Yield debt and 4% for BBB-rated paper to generate equity-like returns in a safer part of the capital structure, in fact, in our own asset mix, the latest shift we have made is from stocks to corporate credit and regionally from Europe and the U.S. into Canada.

Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada’s pre-eminent wealth management firms. Founded in 1984 and serving high net worth private clients and institutional investors, we are dedicated to providing our clients with a world-class experience in the management of their wealth by delivering strong, risk-adjusted returns together with the highest level of personalized client service.

OVERVIEW

As of December 31, 2015, the Firm managed assets of \$8.3 billion.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and remains 27% 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 consistently pursued 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 among the largest clients of the Firm. Our clients are our partners, through performance-based fees that are earned only when pre-specified performance benchmarks for clients’ investments are exceeded.

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff’s management and employees are collectively among the largest clients of the Firm.

For further information, please contact:
research@gluskinsheff.com



IMPORTANT DISCLOSURES

Copyright 2015 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 research.gluskinsheff.com/epaper/helpandsupport.aspx?subpage=TermsOfUse

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.