

## GLUSKIN SHEFF MARKET OVERVIEW & PORTFOLIO COMMENTARY

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### MARKET COMMENTARY

It is always difficult to predict the future, but right now, many investors are caught in the moment and are being told “not to fight the tape” and simply play the momentum game. They do not see that the current rebound in the U.S. economy is a statistical mirage orchestrated by record amounts of monetary and fiscal stimulus that are simply unsustainable and actually risk precipitating a very unstable financial and economic backdrop in the coming years.

As we see it, the rally in the U.S. equity market of the last 12 months is reminiscent of the 1930 snapback, and remember that the S&P 500 went on to hit new lows in subsequent years and the next secular bull market did not start until 1954. Back then, as is the case now, all the bullish pundits and “tape watchers” were ridiculing the cautious folks. Just have a read of the Depression Diary of Benjamin Roth. You will see how much giddiness there was over the bear market rally and accompanying sentiment that the worst was over. On July 31, 1931, he entered this into his journal: “Magazines and newspapers are full of articles telling people to buy stocks, real estate etc. at bargain prices.” He said this during the “reflexive rebound” in the equity market; there was still 35% to go on the downside before the triple waterfall bear market was complete. On March 6, 1933, he lamented: “When I started in 1930 to jot down the happenings during the depression I had no idea it would last as long and I did not think I would require more than one small notebook. Now after 3½ years of the worst depression we have ever seen, the end is not in sight.” As it turned out, to everyone’s surprise (except those who kept their eyes on the forest, not the trees), the lows were still more than a year away. Deleveraging cycles take years to play out, even with massive doses of government intervention.

It is very important not to get caught up in the euphoria in the business media and the mania in the financial markets. The most dangerous thing anyone can do right now is extrapolate the stimulus-led bounce of the past year into the future. As was the case back then, investors who succeeded are not the ones who believe they are able to play the flashy bear market rallies but rather the ones who opt for strategies that minimize volatility and optimize risk-adjusted returns. Income, whether it be from paper assets (bonds, dividends) or hard assets (oil and gas royalties, REITs), is going to emerge as king in an environment where the primary trend is deflation, which is indeed the case as the post-bubble contraction in private sector credit continues unabated.

### EQUITY STRATEGY

North American equity markets continued to climb during the first quarter of 2010: the S&P/TSX Total Return Index and the S&P 500 Total Return Index (CAD) rose 3.1% and 1.9%, respectively, over the quarter. The price of oil rose by approximately 3.3% and the price of copper rose by about 5.7% during the quarter while the Canadian dollar almost reached parity with the U.S. dollar, rising by 3.5% to US\$0.9844. While the Canadian dollar may be moderately overvalued in the short run, we feel that it remains in a secular uptrend. In spite of its continued outperformance, we still favour the superior fundamentals of most Canadian equities over those of the U.S.

We continue to advocate balanced and relatively defensive asset mixes across asset classes and thus, lower than normal exposure to equities. That said, we were able to take advantage of the January-to-February correction in the equity markets to re-invest a meaningful portion of the cash balances in many of our

equity portfolios by adding to existing holdings or initiating new ones. Most of our equity portfolios exhibit a “barbell approach”; that is, they have significant exposure to commodity-oriented businesses reflecting our continued belief in the secular bull market for many commodities; and, significant positions in stable, slower-growth businesses that pay attractive dividends or distributions. The “barbell” characteristics of many of our portfolios reflect both our “top-down” strategic view of the investing environment, as well as our “bottom up” fundamental approach to equity investing and the individual businesses that we choose to invest in.

#### **FIXED INCOME AND CREDIT ALTERNATIVE STRATEGY**

The debt market has moved its focus away from corporate credit risk and on to sovereign risk. Leverage throughout the financial system and the economy has been transferred from the private sector to the public sector through enormous bailouts and stimulus spending. Governments must now term out short-term debt and raise huge sums of money to finance their deficits. In a perverse reversal of circumstances, governments, not corporations, are now the entities potentially facing a disruption in liquidity. A toxic combination of increased expenditure and limited cost cutting combined with too high a debt load have increased risk premium for governments with high borrowing needs.

The appetite in Canada for fixed income securities continues to be robust with \$21 billion of issuance in the first quarter of 2010, roughly double the amount during the same period in 2009. Interest rates have started to climb higher and appear to be moving higher for the foreseeable future. Recent Canadian economic statistics and the pending end to the Bank of Canada’s pledge of an accommodative monetary policy suggest there is a reasonable probability that short-term rates will rise after June 2010.

All of our bond portfolios are positioned with a duration bias that is short and conservative. The funds should react defensively to a drift up in interest rates. Given the short duration of our funds, we would view a material increase in interest rates this year as an opportunity to extend the term on some percentage of our portfolios to take advantage of higher rates. We continue to be very constructive on credit as corporate fundamentals continue to improve.