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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

IN THIS ISSUE

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WHILE YOU WERE SLEEPING

Call it a modest risk-on mood to start the week.

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European bourses snapped a three-day losing streak with gains so far today of around 0.6% — albeit on weaker volumes — on the back of some better than expected German business sentiment data for July (the Ifo index did slip to 108.3 from 108.7 in July, but the consensus was looking for 107.5. Be that as it may, the key "expectations" component slid to 102.2 from 103.1.

Equities in Emerging Markets received support from news out of Turkey that the government is moving to promote stability and growth with a multi-billion dollar infrastructure package — the Borsa Istanbul 100 index rallied 3.1% after last week's 13% post-coup-attempt plunge (steepest slide since 2008).

Even with dollar-yen rising a touch to ¥106.3, the Nikkei closed essentially unchanged, but for the most part, Asia was fractionally in the green column — Korea's Kospi, Hong Kong's Hang Seng, and China's Shanghai all up 0.1%. The Sensex emerged as the star performer with a 1% pop.

The DXY U.S. dollar index is off close to 15 pips to 97.3, but only after having taken out all the major averages in the rally of the past month. Tough resistance ahead at the 98 level, however.

Despite this softer dollar tone today, the CRB Commodity Price Index has continued to flounder, for all the talk of coming reflation, and after breaking below the 50-day moving average, is now about to slice below the 100-day trend-line.

Gold and oil are off their nearby peaks and the failure of bullion to move higher on a day when the greenback is flat on its back suggests that fatigue has set in here (likely just a brief respite).

Not just that, but it also looks as though the bounce we saw of late in the Baltic Dry Shipping Index is showing signs of sputtering.

The soft macro data of late and this commodity slippage has shown through in the performance of the Canadian dollar, which is back to $1.3170 and seemingly in its way towards a test of the 200-day moving average of $1.33 — not much to support the loonie on a near-term basis and what we need to see is more vigor in the non-energy export and manufacturing data.

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Bond yields are inching higher as equity prices firm up —10-year sovereign yields in Europe are up anywhere from two-to-four basis points and that is a big move in today's uber-lower rate environment.

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The 10-year Treasury-note yield at 1.58% is now pressing up against its 50-day moving average and a break here would set up a test of the 100-day moving average at 1.73%.

Note that the bond market is so strong that the 10-year could trade all the way back up to 1.9% and that would not violate any of the major trend-lines which remain in a downward trajectory (with respect to yield).

The 10-year Japanese Government bond yield fell 1.5 basis points today to -25 bps and this is likely to act as an anchor for the government bond markets everywhere — so there is a cap here for where Treasury yields can go when both German and Japanese yields trade below the zero line.

After all, the average spread between the 10-year T-note and JGB yields over the past five years is around 150 basis points; and it is 100 basis points for the U.S.-German rates gap — so I would not rule out another run at the recent lows in U.S. bond yields when the time is ripe.

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Either that, or these yields abroad gap up. This is probably less likely since the BOJ and ECB are still full-square involved in the QE game and simply will not allow for the tightening in financial conditions that would occur alongside a rise in long-term interest rates.

As for equities, resilience would certainly be an appropriate description of investor behavior of late.

Nerves of steel.

After all, we have emerged from a May recession scare with the payroll data to the June Brexit vote to more acts of global terror to an increasingly rancorous U.S. election campaign to fears of Italian bank insolvency to Turkey's heightened instability to a renewed weakening of the yuan to the oil price rolling over (what happened to that positive correlation?) and now to more talk of how the Fed is going to prep us for a rate hike at Wednesday's meeting (the dog that barked).

Imagine that only half of polled voters say that Mrs. Clinton is prepared to be president while two-thirds indicate that Mr. Trump isn't ready for the job, either… what a choice!

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This leaked email scandal confirmed Bernie Sanders' claims that the system is rigged and this plays right into Donald Trump's hands; but at the same time how does the GOP candidate manage to get away with claims that he will wage war against terrorists but at the same time retrench from the global scene; how does he get away with protecting jobs by ripping up the same free-trade agreements that give American consumers everyday low pricing, from the less expensive and lower value-added goods produced abroad?

There was a time late last year and early last year when any or all of these factors would have sent the stock market reeling. Yet here we are still flirting near the high for the S&P 500.

At the same time, there are clear contradictions:

A host of other major market averages have not confirmed the peak. The ValueLine geometric and arithmetic indices, Russell 2000, NYSE composite and the Nasdaq have not joined the S&P 500 and Dow Jones Industrial Average into record territory.

The VIX, sentiment surveys and put/call option volumes all smack of complacency if not a return to greed, and yet the latest Bank of America Merrill Lynch poll shows that portfolio managers are sitting on the most cash (5.8% of asset) since November 2001.

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While almost 80% of S&P 500 companies are beating on the bottom-lines so far this reporting season — this week is a very active one on this score with nearly 200 companies posting results — barely half are surpassing top-line revenue estimates.

So many bulls also salivating over the most recent retail sales report and economists were quick to raise their forecasts for consumer spending.

This begs the question as to why it is that Wells Fargo added $150 million to its loan-loss reserves in Q2 and Capital One boosted its reserves for its credit card business by a hefty $290 million if the American consumer was in such great shape (JP Morgan also added $250 million of reserves for looming credit card losses too)?

Here's the rub:

- Default rates on general purpose credit cards rose to 3.11% in June from 2.88% a year ago — climbing now after five straight years of decline.
- Auto loan delinquency rates are now up to 0.91% from 0.85% a year ago.
- According to a New York Fed survey, 13.3% of households will likely miss at least a debt payment in Q3, that is up from 11.5% in March and the highest in two years.
- If there was one theme this far from the U.S. Banks in this reporting season, it is that they are starting to tighten up their credit scoring for borrowers with lower FICO scores (as in, sub-700).

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And while there was very good news out of some bellwethers like Microsoft and Qualcomm last week that propelled the tech sector to a 2% equity price advance, at the same time we saw some major global players such as Honeywell and G.E. issue some downbeat guidance — the former cutting its revenue forecasts and the later describing the overall business climate as “a volatile and slow growth economy”. And there sure was quite a bit of caution over the PC outlook in that Intel conference call last week.

Core retail sales have managed to rise 0.5% back-to-back and yet University of Michigan consumer confidence index in July was down to a three-month low and the second weakest it has been since last September. Go figure.

The amount of excitement over the Citigroup’s economic surprise index is palpable, and yet over the past month we have seen the Atlanta Fed trim its Q2 real GDP growth estimate by 30 basis points to a 2.4% annual rate.

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If the outlook is so constructive, then it also begs the question as to why U.S. companies are hoarding more cash now than at any point since 2011. Have a look at *U.S. Groups Hoard Cash as Uncertainty Grows and Earnings Expectations Dim* on page 13 of today’s FT.

Confusion reigns and contradictions abound. We have a mixed and muddle economic picture but the narrative now is of accelerating growth and Wall Street strategy talk of reflation trades ahead.

We had a Brexit vote but Theresa May has already said there will be no trigger this year.

Donald Trump gets a lot of play and there is a growing chorus saying he will win despite his ability to ignore the facts (see *The Fight of Hillary’s Life* on page 9 of the FT), come up well short on policy specifics and pledge to reduce America’s global influence as he attempts to make America great again … that seems to be quite the case of cognitive dissonance (a retreat from the WTO — seriously?) and yet the four models collected by the NYT puts Hillary’s odds of winning at 71% (it is about electoral college votes, not popular vote — just ask Al Gore).

But for now the investment community is playing the markets from the long side. From my lens, the bounce up in the past month is the mirror image of the slide that took hold after the Brexit vote.

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In a word, overdone. Chasing market performance at the current price-to-earnings multiple, even with a tip of the hat to ultra-low discount rates, is akin to chasing nickels and dimes in front of a steamroller.

FROM SIRP TO CHIRP?

The economy seems to have sprung into summer with the latest readings on sales, production, employment, housing starts with turnover activity surpassing expectations.

The economy seems to have sprung into summer

The earnings season is coming in better than anticipated as well.

Second quarter real GDP growth looks set to come in around a 2½% annual rate and survey data for the early part of Q3 are holding steady.

There also is some chirping in the marketplace that conditions on both the macro and markets front will encourage the Fed to soon start setting us up for a possible rate hike in September.

While I am skeptical, one must always tip the hat to the other side of the debate and keep an open mind at all times. Nobody got rich from being inflexible and stubborn.

The one thing I do know, however, is that the baby boomers are still going to be craving cash flow streams, and no matter what, the equity market is still likely to remain the conduit for income. But that doesn't mean being stuck in Safety and Income at a Reasonable Price (as Utilities, Telecom and Staples) which has worked out well during the last 12-to-18 months of sluggish economic growth.

If, in fact, the economic backdrop is improving, then the most effective strategy will morph into Cyclicals Having Income at a Reasonable Price or CHIRP.

Defensive sectors are not the only areas of the equity market that maintain decent yields above what the long bond delivers with sustainable dividend growth as well.

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There is a long list to consider that includes steel, electrical equipment, construction machinery, autos & auto parts, regional banks, telecom equipment, diversified chemicals, paper & packaging, the rails, advertising, and residential & commercial REITS which round out a diversified group that will not be left out of the party. The traditional defensive sectors may be ripe for a correction as long as this growing chorus of economists is prescient that the economy is in fact showing a pulse here.

Master Limited Partnerships with an average yield of over 7% will also be a beneficiary — as a signpost of this investor hunger for income flows, consider this asset class is up nearly 70% from the mid-February lows — page M9 of Barron's quotes some followers as seeing 40% upside over the next two years.

WILL THE CONSUMER STEP ON THE GAS?

The huge inventory bulge in gasoline has sent prices at the pump tumbling in 39 of the past 40 days, shaving 20 cents off the nationwide price to $2.19 per gallon over this time to the lowest level for this time of year since 2004.

Prices are now down 57 cents a gallon from year-ago levels and that translates into nearly $80 billion of freed-up cash flow for the U.S. household sector.

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The question is how much ends up getting saved, used to pay down debt, and/or put into retail sector cash registers? The types of discretionary spending that tends to benefit from whatever gets spent are small luxury goods and services — entertainment, restaurants, electronics, books/sporting goods and the like.

THE CASE FOR GOLD

This is more of a post-election story but at this point, it seems that whoever takes the White House will be pursuing left-leaning policies.

Both Donald Trump and Hillary Clinton have become anti-free traders, with the latter doing a complete about-face on the matter, having been pushed there by Bernie Sanders and Elizabeth Warren.

They will both pursue fiscal stimulus, with Mr. Trump likely to really provide some juice, and while he will need Paul Ryan's help, keep in mind that the House Speaker and Michael Pence are good buddies and likely will be able to cobble together a growth-boosting budget package.

It looks like whoever wins the election will pursue fiscal stimulus

I recommend having a look at page A2 of today's WSJ — *Debate over Borrowing Sees Change in Tone* (also have a look at the op-ed on page A11 — *Clinton Won the Battle, Sanders the War*).

The reason why Donald Trump may have an edge in this election is because, at the margin, the U.S. voter is strategic in nature and realizes what is at stake is not just the next four years but actually the next fifteen years — as in, the appointment of a Supreme Court judge that will tip the current 4-4 balance (following Former Associate Justice Antonin Scalia's death in February of this year).

It seems as a certainty now that the Senate reverts to Democrat rule and voters will not likely wish to see Hillary appoint, and the new Senate confirm, a judge on the Supreme Court that will tilt it to a liberal plurality for the first time in five decades.

It will not be just one judge, but likely two more looking at how a couple are set to turn 80.

Rare is the time that a president in one term will have such an opportunity. If it weren't for the high odds that the Senate turns Democrat again, I wouldn't be thinking that Trump would win the election, especially given his lack of knowledge on the policy front.

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He has one other tailwind — he leads 55-to-33 percent in the uneducated white voting population, and that is no small group of people.

Meanwhile, Mr. Trump, in addition to wanting to reverse the course towards globalization, is keenly running on a series of isolationistic, xenophobic, and nationalistic policies.

He was gleeful over the Brexit vote, congratulated Erdogan on his strong-arm tactics following the failed coup, and seems to be in awe of Putin.

He seems willing to cut back on NATO involvement and will be withdrawing from the traditional U.S. role as being the world's policeman (extending what Obama had already begun).

All of this points to the likelihood of a more troubled world, not a less troubled world. Reversing free trade may save jobs, but at the expense of higher prices. Protectionism will lead to cost push inflation. Fiscal stimulus will help fuel better aggregate demand growth. This should all be a very powerful tonic for this resumption of the bull market in gold.

The heightened uncertainty that would surround a Trump presidency, even if he ends up proving to be an enormous success should he win the election, will undoubtedly be the icing on the cake for the gold price.

A Trump presidency would be the icing on the cake for the gold price

MORE ON THE DIVIDEND THEME

As per my note last week on how investors are buying bonds for price and equities for yield, I couldn't help but notice how liquidity and expanding options are being improved to play the SIRP theme.

Like, for example, this move to make REITS their own specific sector. Or, as a valued and loyal subscriber made me aware of — as to how the ETF structure has been and will continue to profoundly change the nature of dividend investing, and trigger a further shift from bonds to dividend stocks in dividend ETFs.

The thought process goes like this.

In the past, portfolio investors would buy a selection of high dividend stocks, a few Utilities, Energy shares, Telco's, drug makers and Banks.

Each of the names had its own industry and individual fundamentals.

For instance, Utility stocks have a high price-to-earnings ratio compared to history right now, two standard deviations above the norm, in fact.

The Energy industry has an uncertain future as the Saudis and shale producers flood the market with new supply as sources of competition accelerate (as in solar).

Banks face intense competition forces from new rival technologies (Fintech) and reregulation (and now Trump calls to revive Glass-Steagall) that impede earnings visibility.

Banks face intense competition forces from new rival technologies

So each industry is risky in its own right, but a little diversification can go a long way.

I mean, look at a dividend ETF like the popular DVY. It's been around for some time now — at least a decade.

It contains 95 stocks which as a group have increased dividends with high frequency, and again, as a diversified group, have strong earnings streams that cover current dividends and offer promise of future payout growth. The group in a dividend ETF offers a better alternative than a fixed interest income alternative, risk for reward, and we doubt that is going to change any time soon.

The buying of dividend ETFs by investors appreciating its group dynamic will in turn trigger incremental significant buying activity in the underlying stocks in the future.

This is a strategy with more legs. This is not a new theme to be sure, but it is not yet an overextended bubble story, either. Keep in mind that some investors in these funds are in it for the long-term (and not just soon-to-be retiree's looking for a source of income).

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So it is reasonable to be wary of Utility stocks trading at nearly-20x price-to-earnings multiples with just single-digit profit growth potential. However, if these ETF investors experience growing dividends from the underlying companies, and they are long-term focused in nature, it is likely that they re-invest these dividends, adding further incremental buying to the underlying shares.

So far this year, DVY is up 17.5% with a three-year compound annual growth rate of 13.6%. It looks expensive with a price-to-earnings multiple of 20x, but it has a beta of 0.65x and a yield of 3¼% which is 110 basis points above the S&P 500 yield and 165 basis points north of the 10-year note yield.

And it isn't just invested in Utilities and Consumer Staples but a nice mix of most sectors. Take a look at the top ten holdings:

Top 10 Holdings

1. CME Group (Financial)
2. Chevron (Energy)
3. Entergy (Utility)
4. Kimberly Clark (Consumer Staple)
5. Lockheed Martin (Industrial)
6. McDonalds (Consumer Discretionary)
7. Nextera Energy (Utility)
8. ONEOK (Energy)
9. Philip Morris International (Consumer Staple)
10. Sempra Energy (Utility)

(Source: BlackRock Inc.; as at July 21st 2016)

I have to add one group we do favor, with interest rates so low, and investors craving stability along with income flows, are the REITS on both sides of the border.

It isn't hard to find a 4% yield in this sector and in aggregate they are up 15% in price year-to-date. Remember — this too is a low beta sector and a nice refuge in a volatile, and now toppy, stock market.

Another sign of how the equity yield theme is working is to put your global hat on.

Everyone focuses on the S&P 500, but there is another index out there that has hit record highs and it is New Zealand's S&P/NZX 50. While you may or may not want the commodity exposure it has, the yield is certainly attractive — bordering on 4% (and this follows a 23% price advance in the past twelve months).

Everyone focuses on the S&P 500, but there is another index out there that has hit record highs, the S&P/NZX 50

This has grabbed worldwide attention — to such an extent, in fact, that more than one-third of the New Zealand stock market is now owned by foreign investors.

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 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, 2016, the Firm managed assets of $8.3 billion.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and is 21% 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 industry 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.

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$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $5.5 million[2] on June 30, 2016 versus $2.7 million for the S&P/TSX Total Return Index[3] over the same period.

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.

IMPORTANT DISCLOSURES