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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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Morning macro/market musings

- There is a lot riding on today's employment data in terms of whether the market tilts to 50 basis points from the Fed instead of just 25 basis points

Pushing on a string

- This is a theme we have been discussing in great length — after all, despite the more than 100 basis point decline in mortgage rates, housing activity remains sluggish

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MORNING MACRO/MARKET MUSINGS

HIGHLIGHTS

- Mixed end to the week for equities
- EM stocks dip 0.3%
- U.S. dollar regains a bid
- But gold hangs in well (not oil, mind you)
- Bond markets stabilize
- Global growth still on a downtrend
- Surprising plunge in German industrial orders
- Equity valuations skewed by buybacks
- Stock markets love “bad news”
- Stick with rate-sensitives and bonds/bullion barbell

COMMENTARY

It’s a mixed finish to the week. U.S. equity futures are slightly in the red column but remain near lofty highs for the S&P 500. European bourses are down 0.4% at the moment. Asia was mixed but overall with a slight upward bias — we saw modest gains in Thailand (+0.4%), Japan and China (+0.2% apiece) that was met with declines in Singapore (-0.2%) and India (-1.0%) and roughly flat performances in both Korea and Hong Kong. All in, Asia-Pac closed with a 0.1% dip and the EM equity complex was clipped 0.3%.

Bond yields are stable to up just a smidge. If this is where bond yields go at the bottom in unemployment and peak in the stock market, imagine where they go when these two variables reverse course. Treasury yields are still headed for their longest stretch of yield declines in a good seven years — and the Fed easing process hasn’t even started yet! There is a lot riding on today’s employment data in terms of whether the market tilts to 50 basis points from the Fed instead of just 25 basis points — the consensus is +160k (range of +100k to +220k). I’d take the under on that, seeing as 9 of the 12 surveys gleaned for June showed employment conditions softening in June. Remember how disappointing May was and we saw 6 of the 12 surveys for that month coming in weak. So it stands to reason, therefore…

The DXY U.S. dollar index has made a decent 16 pip move up to just below the 97 mark — the euro is softer and sits at its 100-day moving average at $1.1260, and dollar-yen is up to ¥108.0 from ¥107.8. Sterling receded 0.2% to $1.2554, more than a two-week low. The

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Canadian dollar, meanwhile, remains bid at C$1.3068, with the latest rounds of constructive data providing a tailwind and the large volume of speculative shorts being forced to cover their negative bets on the loonie. The move back to a trade surplus and the pick-up we are seeing in the Toronto real estate market — home sales in June up 10% YoY and the benchmark home price index up 3.6% — have to be viewed as sources of comfort to the Bank of Canada.

Gold is a tad softer (-0.1% to $1,414 per ounce) but is still on track for its longest weekly winning streak in eight years. Iron ore prices rolled over hard today from their supply-induced five-year highs (off 5% to $108.46 per metric ton, the worst setback in nearly five months). WTI was slammed as much as 1.7% overnight, but has pared its losses and is back to just under $57 per barrel as demand concerns are beginning to outweigh the OPEC+ pact and its extended supply curbs.

One can only imagine where equity markets would be without the world's central banks, led by the Fed, providing the 'nudge, nudge, wink, wink' that they have the backs of the investor class. The global data remain awful. Look at Germany, the land of negative yields right out to the 20-year maturity — industrial goods orders tanked 2.2% in May — ten times worse than the consensus estimate of -0.2% and dragging the YoY trend into recession terrain at -8.6%. This is the world's fourth largest economy. Industrial production in Sweden dipped 0.1% in May and we see that the YoY trend in once-hot Spain slowed to 1.4% from 1.8% in April.

BoJ officials overnight signaled more stimulative efforts ahead (is that even possible? The central bank now controls the JGB market and massive chunks of equity ETFs) as the incoming data, all of a sudden, have taken a turn for the worse. The BoJ's quarterly consumer sentiment survey for Q2 declined 5.8 points, to -25, the fourth straight erosion and this followed a 4.9 point slide in Q1. At the same time, the Bank's consumption activity index retreated 0.4% in May. And keep in mind that this is the world's third largest economy — and with Germany, home to the deepest negative interest rate environment. Nice to see how well these policies are working in terms of stimulating aggregate demand. South Korea, widely considered a window on the entire Asian economy, recently posted a horrible 13.5% YoY plunge in exports in June. And core inflation in Taiwan slowed to 0.5% YoY in June from 0.6%, in another sign of fledgling domestic demand growth.

A bull market with no global corporate pricing power…fascinating. But this attests to the power of microscopic (and negative) interest rates, which distorts valuations to the point that they can go parabolic. Stock markets are not telling you things are fine with the global economy — the data speak for itself. Stock markets are only telling you that discounting

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future earnings streams at today's level of interest rates takes you into an orbit that we have rarely seen before, at least in recorded history.

Back to the data. The global manufacturing PMI is in contraction mode for the first time since the 2012 double-dip recession fear period and is down 6.6% on a YoY basis. Today's U.S. jobs data will be interesting to see whether May's depressed figure was the real deal or whether the labor market is operating on an island all on its own. The Household survey has actually flagged a year-to-date employment contraction of nearly 200k — this receives precious little attention — and all of the loss is in full-time positions. Not to mention the granddaddy of all leading job market indicators, which is aggregate hours worked for production and non-supervisory workers which peaked in…January.

As for the USA, I still hear "where's the recession?" I keep responding with "you're not scratching the surface." What is that old refrain about if it walks like duck and quacks like a duck, then guess what it is? Look at the updated YoY trends in these high-frequency economic indicators (and you can decide if it's a duck):

- Container port shipments (Long Beach): -16.6%
- Global semiconductor sales: -14.6%
- Intermodal railroad traffic: -7.4%
- Coal production: -6.3%
- Cass freight shipping index: -6.0%
- Lumber production: -5.6%
- Electricity output: -3.7%
- Railway carloadings: -3.5%
- Corrugated paper production: -3.3%

My vote is with the duck. But make no mistake, the equity market is begging for a horrible nonfarm payroll report today because that would solidify expectations for a 50 basis point rate cut at the end of the month. The stock market has ceased to be an economic indicator a long time ago — it is now an asset class that has become addicted to policy stimulus. Look at what happened a month ago when we got that woeful employment report for May — the S&P 500 jumped more than 1% and the Dow leapt 263 points. Look at the monthly real GDP data and there has been no growth at all since February and yet the S&P 500 has rallied 17%. That's all you have to know — we are in a phase where 'bad news is good news' and where the bullish case for equities is all about the Fed (and its overseas counterparts).

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Meanwhile, two of our major macro themes for 2019 received a major shot in the arm on page 19 of the FT — these being the inevitable unwind of the unsustainable corporate debt bubble and the commensurate pullback in business capital spending. See *Wall Street Fund Managers Are Fretting Over 'Toxic' Loans* and *Tariff Woes and Fears for Global Growth Prompt Boards to Rein In Spending*. The global market for leveraged loans is now a massive $2.2 trillion and Moody's estimates that 80% of this debt is ranked as "covenant lite", which makes a mockery of the 25% share prior to the 2008 financial crisis. Stripping out add-backs, and the ratio of total-debt-to-EBITDA stands at 7x. No wonder the Fed, BoE and IMF have been sounding alarm bells in recent months over the risks emanating from this excess.

At the same time, Morgan Stanley's index of U.S. capital spending plans just dropped to a two-year low and S&P Global now estimates that capex growth is poised to weaken this year to 3% from 11% in 2018. But equity investors need not worry, of course, since this means more money for buybacks, which totaled a record $806 billion in 2018 and the first quarter of this year showed no let up at $205 billion. Strip out this share shrinkage effect, and the S&P 500 today would be sitting closer to 2,100 than 2,900. Another consequence of this extended ultra-low interest rate environment. There is also no other way that the stock market can make new highs in the face of a three quarter earnings recession — never mind that nobody was calling for this at the end of 2018. Then again, the Fed was signaling two more rate hikes back then and 'autopilot' on QT, and now we have Powell taking about rate cuts coming soon and an end to the balance sheet reduction in three months' time. Page B1 of the WSJ has it completely right — *Stocks Power On, Feeding Off Rates*.

Even so, the most sensible advice is located on page B6 of the Globe & Mail — *Stocks are Soaring, But Investors Should Keep Playing Defense*. I continue to see this as a call to play 'bond proxies' in the stock market, which means Telecom, Utilities, Real Estate and Pipelines. Step up in quality. Focus on strong balance sheets. Preference for liquidity. Dividend growth is just as important as dividend yield in this shrinking interest rate landscape. Gold has broken out of a six-year trading band and for the right reasons.

The four things we do know with certainty is that…

- Both inflation and interest rates have peaked for the cycle
- Central banks are turning from hawks to doves
- Downside global growth risks are rising
- Valuations in the equity market have been massively inflated by zero-negative interest rates

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- Economic, trade and geopolitical uncertainties are elevated

Rate-sensitive stocks and the bond/bullion barbell make imminent sense in this backdrop.

PUSHING ON A STRING

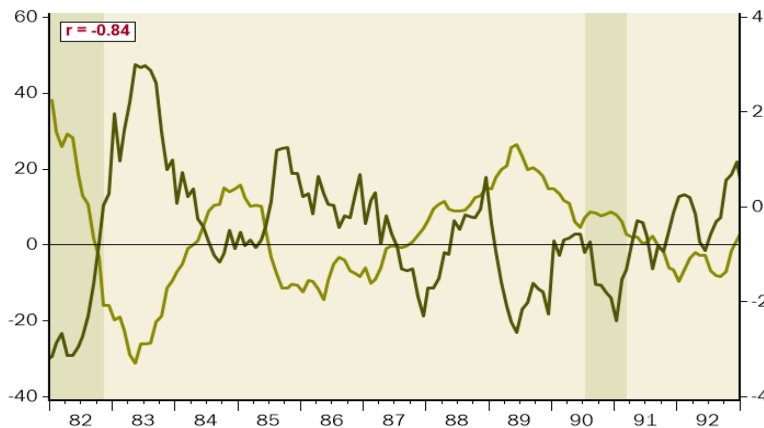
This is a theme we have been discussing in great length. After all, despite the more than 100 basis point decline in mortgage rates, housing activity remains sluggish. Normally, we would have expected this to incite a demand pick-up, but this has not been the case. This attests to bloated debt levels as well as a reduced sensitivity to further rate declines given their already low starting point.

We decided to go back and examine the data in order to quantify this development. Our approach was to look at four key housing metrics — building permits, housing starts, new home sales, and existing home sales — and compare their relationship with changes in mortgage rates. Unsurprisingly, what we found was that mortgage rate declines (increases) tend to coincide with stronger (weaker) housing activity. From an affordability standpoint, this is exactly what one would expect.

Sure enough, the relationship between the YoY change in mortgage rates and the housing data has declined meaningfully over time. For example, the 10-year rolling correlation of existing home sales and interest rates has declined from -0.84 in 1992 to -0.53 in 2002 to -0.43 at the peak of the housing bubble in 2006 to -0.24 currently.

CHART 1: 10-YEAR CORRELATION: 1982 TO 1992

United States
(existing home sales; YoY % change; dark-green line; LHS)
(mortgage rates; YoY change; light-green line RHS)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

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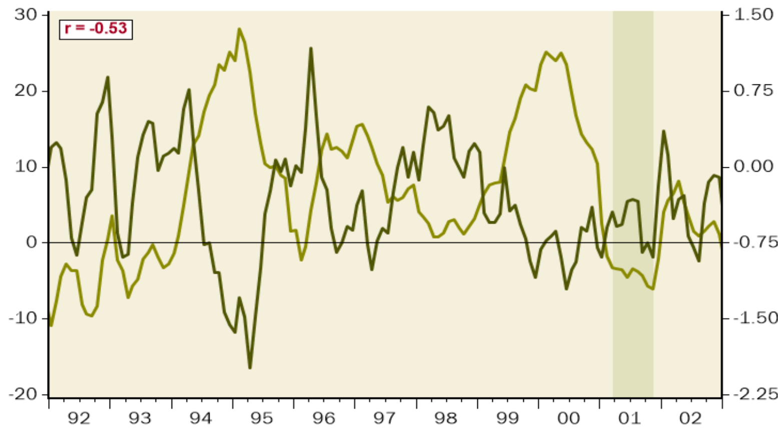
CHART 2: 10-YEAR CORRELATION: 1992 TO 2002

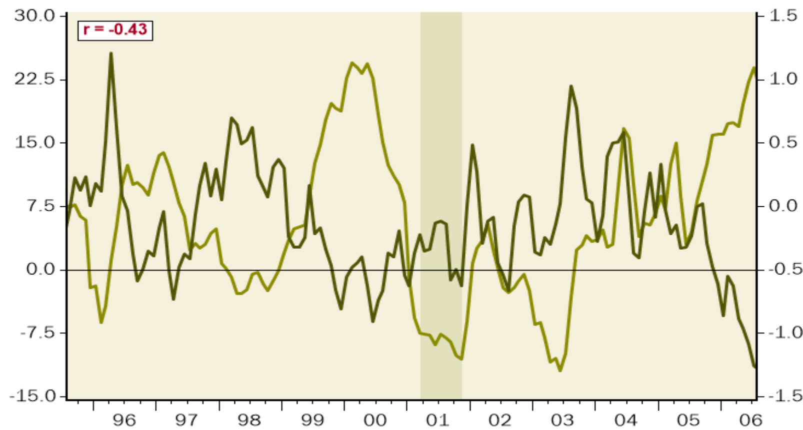
United States
(existing home sales; YoY % change; dark-green line; LHS)
(mortgage rates; YoY change; light-green line RHS)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

CHART 3: 10-YEAR CORRELATION: 1996 TO 2006 BUBBLE PEAK

United States
(existing home sales; YoY % change; dark-green line; LHS)
(mortgage rates; YoY change; light-green line RHS)



Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

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CHART 4: 10-YEAR ROLLING CORRELATION: 2009 TO CURRENT

United States
(existing home sales; YoY % change; dark-green line; LHS)
(mortgage rates; YoY change; light-green line RHS)

Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Taking this a step further, we discovered that a simple regression using the YoY change in mortgage rates did a pretty good job of explaining the variation in resales up until 2006 when the housing bubble burst. But since this time, the relationship has broken down quite significantly. We attribute this to two factors — first, excessive student debt, which has sharply restricted credit access for potential first time buyers. And second, the scars from the real estate deflation from the last cycle, which has exerted a powerful lingering effect on consumer attitudes towards homeownership, regardless of where the interest rate is residing.

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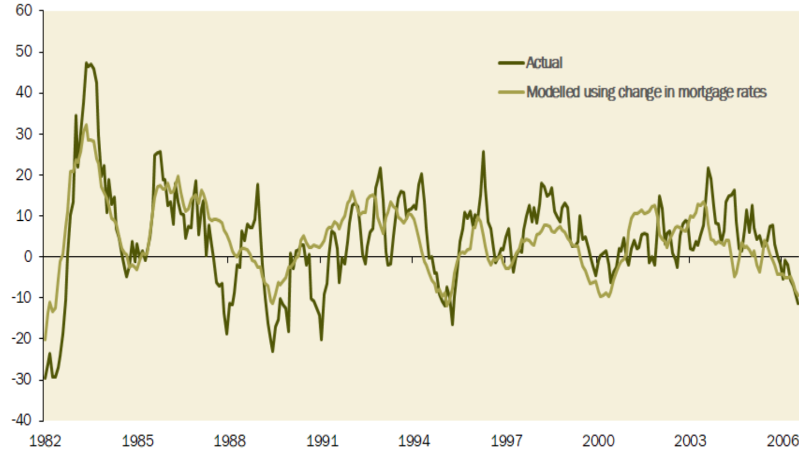
CHART 5: EXISTING HOME SALES VS. MORTGAGE RATES

United States
(YoY % change)



Source: Haver Analytics, Gluskin Sheff

In fact, based upon the historical relationship shown above, existing home sales 'should' be up about 8% YoY given the fall in mortgage rates instead of down fractionally (-0.8%). And it's a similar story for the other housing market variables — housing starts, building permits and new home sales should be up at least 10% relative to year-ago levels. This is exactly what we mean when we say the Fed is 'pushing on a string' — and a big reason why we continue to be bullish on high-quality long-duration bonds.

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OUR OFFERING

Investment Management:
A 35 year track record of goal-based investing over business cycles and a reputation for integrity.

Wealth Planning:
We help our clients understand the path of their finances through meaningful wealth planning.

The insights gained from these plans also help us manage our clients' investments more thoughtfully.

Events & Education:
Our team is sought after by prominent media outlets for their economic and market insights.

We also host exclusive events for our clients.

$8.3 billion
in assets under management as of March 31, 2019

13
investment strategies

WHY GLUSKIN SHEFF

Reputation & Trust:
Trusted by many of Canada's most established families to manage $8.3 billion of their assets.

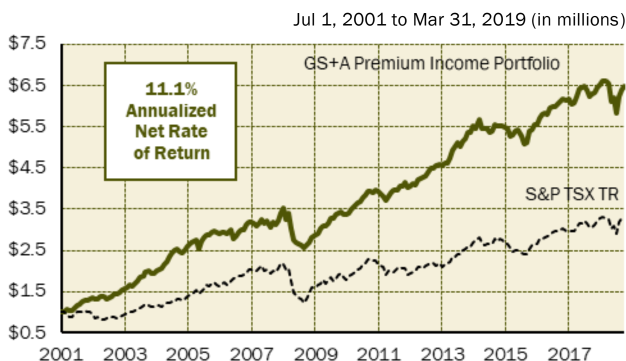
Experienced Team:
52 wealth management professionals across our client service and investment management teams.

Deep Relationships:
Validated by our yearly client survey, we are proud of our track record of client service.

Aligned Interests:
Invested with you: Our people invest a substantial portion of their own wealth in the same funds we use to build your portfolio.

Performance-based partnership: Our employees' compensation is tied to performance-based fees, which are earned only when we exceed pre-specified performance benchmarks for your investments.

Growth of One Million Dollars



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