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**May 25, 2018**
Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

# Weekly Buffet with Dave

*A summary of my top insights from this week*

IN THIS ISSUE

## SOME RANDOM MARKET THOUGHTS

**From the May 22nd edition of BWD**

- What perfect timing. Global equity funds took in $11.9 billion of net inflows last week, almost all of it to the USA (fourth week in a row of net intake and the largest in two months), just in time for the S&P 500 to incur its worst week in six via a 0.5% setback. For all the bullish chatter out there, what is striking is that while it normally takes a market in a 10% correction just 33 days to recoup the loss, this time it is taking well over that. Maybe a sign that the bull market is over and all we are seeing take hold is a classic topping formation.

- Think about it, the Fed is hiking rates. Bond yields are popping. Oil prices have been soaring — up another 18% this year alone. Think 1973-75. Think 1979-80. Think 1989-90. Think 1999-2000. And think 2006-07. And tell me a recession isn't coming our way before too long.

- Also think of the past when we had situations where the 10-year T-note yield ratcheted up 200 basis points or more (we're almost there): 1980-81, 1986-87, 1993-94, 1998-2000 and 2004-07. There is no get out of jail free card — we either ended up having a recession or, in the case of 1987, a huge equity market collapse. Or there's 1994 when we ended up having a crisis in Mexico and Orange County.

**There is no get out of jail free card — we either ended up having a recession or, in the case of 1987, a huge equity market collapse**

- And those weak Nordstrom same store sales figures — a microscopic +0.6% YoY pace — and reduced guidance, takes some of the sheen off the post-retail sales data euphoria.

- What about those state-level employment numbers the BLS released on Friday? The cumulative number was a mere +133k, not the +164k as per the NFP report. And only 8 states accounted for all the gain in what was a lousy regional diffusion index.

- The Fed is in its advanced stage of their prolonged tightening cycle. Historically, real GDP growth averages close to 5% at the time of the first rate hike and by the time it is over, the economy is running at roughly half that pace. Then with a lag that typically lasts around twelve months, recessions occur, rather unexpectedly, more than 80% of the time in the past.

- The bond-induced backup in interest rates is bound to bite. U.S. mortgage rates (on the 30-year fixed) rose another 6 basis points last week to a seven-year high of 4.61% — and up now 130 basis points from the 2012 cycle lows. Hence why the MBA mortgage purchase index has sagged for four weeks running. The number of homeowners who can now be eligible to benefit for refinancing has slipped below 2.3 million (46% share), which is the lowest in a decade. This is cash-flow negative, which is acting as an antidote to the tax cuts (total refi activity is poised to plunge 26% this year). And students are about to feel the bite as well, as undergrads are set to see a reset of their rates to 5.1% from 4.5% and to 6.6% from 6.0% for graduates.

- Bond yields did manage to see some relief on Friday but at 3.06% on the 10-year T-note, we now appear to be in the lower end of a new range. And this breakout has been split between real rates and inflation expectations — the latter reaching 2.2% and surely must be on the Fed's radar screen (how can the funds rate still be roughly 50 basis points below that?). And one can reasonably expect the pressures to build as the prior surge in raw material costs filter through. As per John Deere, which made pass-through a key feature of its earnings call (on full display on page B2 of the weekend WSJ). To wit: *"We do expect the pricing we're going to take for 2019 to be more than offsetting the inflation we're seeing."* The company's stock received a 5.8% boost on the news. We shall see if this causes a domino impact.

**One can reasonably expect the pressures to build as the prior surge in raw material costs filter through**

- Gold cannot seem to catch a break even as we have moved into a new stage of heightened geopolitical and trade uncertainty. The NAFTA talks missed their U.S.-imposed deadline — it's highly unlikely now we see a deal this year (see the weekend WSJ editorial on this file *A Looming NAFTA Debacle*). All of a sudden, there is less hugging and kissing among the two Koreas and the words have become less friendly between Pyongyang and the White House. The China-U.S. trade negotiations also seem to be faltering. All the while, the Nobel prize visions going through the minds of the hardcore Trump base are in the process of being dashed (maybe the Hamas leadership will be next in line?).

  What is really troublesome is what's happening in the euro area at the moment. Specifically, the unstable political merger in Italy between the 5 Star Movement and the League who have pledged to walk away from pension reforms, structural changes to the economy, any commitment to fiscal improvement (including mandated deficit/GDP ratio), and are now pressuring the ECB to basically forgive the mountain of debt sitting on the central bank's balance sheet. It's been some time since we had the issue of the possible breakup of the monetary union back on the front pages — and Italy is a much bigger deal than Greece ever was. Yet another reason to see the euro remain on its relatively new weakening path.

**Italy is a much bigger deal than Greece ever was**

- We are seeing some real classic late-cycle market behavior. For all the talk about how the corporate tax cuts will boost the economy, the Up & Down Wall Street column in Barron's shows, that in actuality, capital spending among S&P 500 companies sagged 6.5% in the first quarter (though up from depressed year-ago levels by 21%....the number the bulls latch on to). With 94% of companies reporting, buybacks have come in at an incredible $178 billion. The last time we had something like this, you ask? Try the third quarter of 2007 ($172 billion), which is so late-cycle that the market peaked that very Summer-Fall. Buybacks have surged 42% from year-ago levels and the four-quarter sum is set to top $1 trillion (also including dividends) for the first time ever. Another unprecedented theme is dividends — 187 firms raised theirs and none cut, and this again is something we have never before witnessed.

  What else? Well, we have a monstrosity of a global M&A wave going on, totaling a massive $1.85 trillion year-to-date, a 67% surge from a year ago. This all tells you something very important — the tax cuts are disproportionately going into buybacks and dividend payouts, not capex, despite the narrative. This, along with the M&A craze, is strongly suggestive that companies do not see, and this is classically late-cycle, opportunities to grow their business organically. This is exactly the message contained in the vast majority of regional Fed surveys, showing a rolling-over in capital spending intentions, and the notable slide in NFIB business expansion plans in the latest poll. Again, what we have is a classic case of 'supply side' economics leading to a fiscal package with very little in the way of 'trickle down' dynamics, but was really aimed at padding the wallets of investors. In the process, all that has happened is exactly what happened under the Gipper, Clinton, George W., Obama and now Trump. Notice I don't include Bush 41? He got impaled by his own party for trying to contain an unstable fiscal situation, nowhere else in the world is 'tax' a dirty three-letter word. There is a further widening in what already is unprecedented gaps in wealth and income inequality. One has to wonder how this resonates with the 20% of Bernie supporters who voted for Donald Trump in 2016 (according to exit polls). It was this group, not the 'base', who made the difference.

**This is strongly suggestive that companies do not see opportunities to grow their business organically**

- That said, the all-in cash yield of around 5% on the S&P 500 via dividends and payouts, has allowed the stock market to stay where it is, as in out of full-fledged correction mode. At least so far in this topping process.

- The futures markets are now priced for 50% odds that the Fed hikes three more times this year, not just two. This will ensure the durability of the dollar rally, especially since the ECB is not yet even committed to ending QE anytime soon, let alone ever moving the needle on the -0.4% policy rate. This, in turn, will prove problematic for the EM space where it is now best to book profits.

- This is interesting — 59% of economists polled by the WSJ are calling for recession. But here's the catch — not till 2020. The surprise, from my lens, will be the timing (I see 2019), not the event.
- Much is being made of the small cap stock outperformance in that it reflects an alleged booming domestic economy. Or that these firms are benefitting from the deregulation thrust, lower tax rates, and escaping the damage from trade frictions and the stronger dollar. None of the above. The reality is that the small cap sector has a much higher health care orientation and this part of the market has surged alongside merger/takeover speculation. As in, the small-cap biotech space has soared 26% year-to-date whereas the large-cap comparable have risen by less than 1% — therein lies the story within the story.

## CANADA RETAIL SALES: NICE CLOSE TO A WEAK QUARTER

**From the May 22nd edition of BWD**

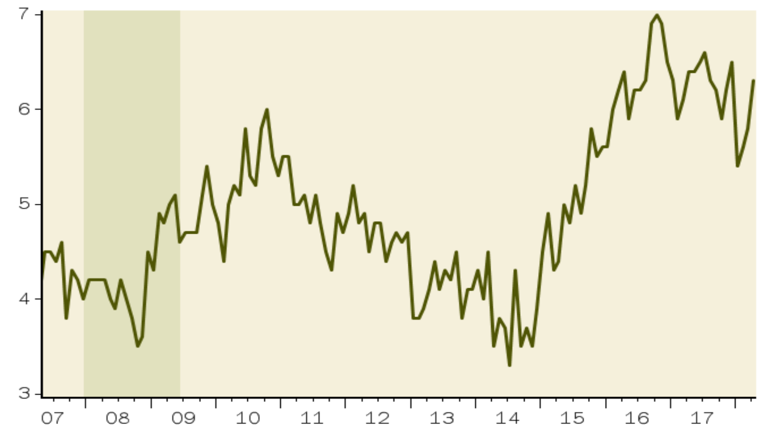
Canadian retail sales came in above expectations in March — firming +0.6% sequentially (double the consensus expectation) and February was revised up by a tenth to +0.5% as well. However, excluding autos, sales were much weaker than forecast — falling 0.2% (economists were looking for a +0.5% gain) as weakness in gasoline prices weighed.

In terms of the breadth of the report, six of 11 subsectors and seven of 10 provinces reported gains. Strength in furniture & home furnishings (+3.9%), autos (+3.0%) and clothing (+2.5%) offset weakness in electronics (-2.4%), gasoline stations (-1.9%) and food & beverages (-1.2%). Regionally, Quebec (+1.3%) and Ontario (+0.6%) led the way while Saskatchewan (-1.8%) was a drag. In fact, the latter has seen sales contract 6.4% over the past year as the province still reels from the prior oil price detonation.

**The latter has seen sales contract 6.4% over the past year**

**CHART 1: SASKATCHEWAN UNEMPLOYMENT RATE**

**Canada**
(percent)



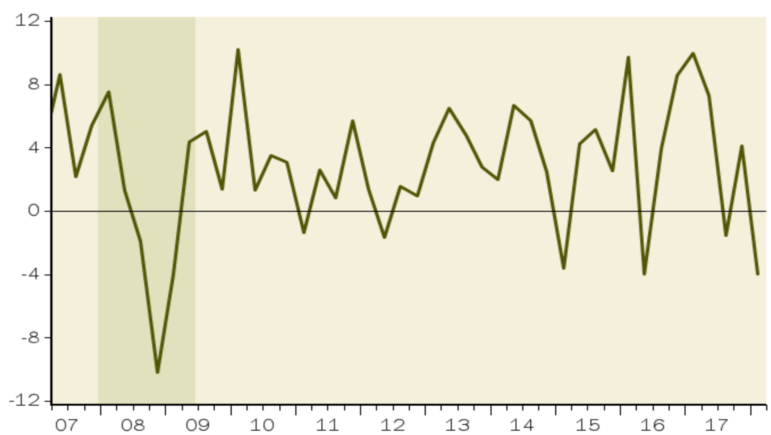

*Shaded region represents period of U.S. recession*
*Source: Haver Analytics, Gluskin Sheff*

All that said, what matters for GDP is volumes and the news on this front was encouraging as real retail sales advanced a healthy +0.8% on the month (best gain since last October). But even with the strong close to the quarter, sales volumes were down a hefty 4.0% (annualized) in Q1, reflecting some payback for unsustainable strength during 2017.

**Even with the strong close to the quarter, sales volumes were down a hefty 4.0% (annualized) in Q1**

**CHART 2: RETAIL SALES VOLUMES**

**Canada**
(quarter-over-quarter annualized percent change)




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

Nonetheless, with the data available thus far, we are tracking a +0.2% gain in real GDP for March. Should this transpire, this would put growth at just under a 2% annualized clip for the quarter — about in-line with potential but above the BoC's prior +1.3% forecast. Still, the continued absence of upward pressure on the output gap should allow for the Bank to remain cautious on the rate hike front moving forward.

**The continued absence of upward pressure on the output gap should allow for the Bank to remain cautious**

## A NEUTRAL REPORT FOR THE BOC

**From the May 22nd edition of BWD**

Not much to move the needle either way in Canada's April inflation data. In their last policy statement, the BoC had characterized inflation — both headline and core — as *"close to 2 per cent"* which is a good way to characterize the readings this month. Indeed, headline CPI ticked down to +2.2% YoY from +2.3% (expectations were for an unchanged reading) while the Bank's preferred core measures held at an average of +2.0% for a third month running.

With the economy having basically grown at potential over the last three quarters, wages no longer pressing higher, and the CAD remaining range-bound, we don't see a clear impetus — beyond perhaps elevated commodity prices — to push consumer inflation higher in the near to intermediate term. This, in combination with continued trade uncertainty, a rolling over in the housing market, elevated consumer debt loads, and the importation of higher interest rates via the USA should keep the Bank on the sidelines for the time being. The OIS market is priced for just over two more rate hikes by year-end but it would seem to us that a whole lot has to go right for this to unfold. This means the CAD will continue to trade softly, though will obviously be sensitive to NAFTA headlines as they develop.

## WAIT A MINUTE!

**From the May 24th edition of BWD**

The FOMC minutes hinted clearly that another rate hike is coming in June, but they provided very little guidance thereafter. There seems to be a view building that the unemployment rate could continue to drift lower, but no need to panic since this will be occurring, most likely, via new entrants to the workforce. There was little concern cited over wage pressures, with the comment made that they are still confined to just a few sectors with binding capacity constraints and shortages. There was a lot of discussion on the need to emphasize the 'symmetry' of the 2% inflation objective, as if to signal to the markets that the Fed will not resist the expected move above target — and one key reason why investors read the minutes as being 'dovish'.

That said, the commentary below show the Fed is still bullish on the macro outlook, wage pressures are building, valuations and leverage are still excessive, but then acknowledges that monetary policy remains "accommodative". This is a bit of a surprising, if not disturbing, remark considering that there is no remaining slack in the economy. And the fact that inflation and inflation expectations, by some measures, already are exceeding what had long been the Fed's tolerance zone.

**This is a bit of a surprising, if not disturbing, remark considering that there is no remaining slack in the economy**

- *"They noted a number of economic fundamentals were currently* supporting continued above-trend economic growth; *these included a strong labor market, federal tax and spending policies, high levels of household and business confidence, favorable financial conditions, and strong economic growth abroad."*
- *"*Participants generally reported that their business contacts were optimistic about the economic outlook*. However, in a number of Districts, contacts expressed concern about the possible adverse effects of tariffs and trade restrictions, including the potential for postponing or pulling back on capital spending. Labor markets were generally strong, and contacts in a number of Districts reported shortages of workers in specific industries or occupations. In some cases, labor shortages were contributing to upward pressure on wages. In many Districts, business contacts experienced rising costs of nonlabor inputs, particularly trucking, rail, and shipping rates and prices of steel, aluminum, lumber, and petroleum-based commodities."*
- *"However, asset valuations across a range of markets and leverage in the nonfinancial corporate sector* remained elevated relative to historical norms*, leaving some borrowers vulnerable to unexpected negative shocks."*
- *"Overall, participants agreed that the* current stance of monetary policy remained accommodative*, supporting strong labor market conditions and a return to 2 percent inflation on a sustained basis."*

## HOME, HOME OFF THE RANGE

**From the May 24th edition of BWD**

In stark contrast to the ongoing bullish narrative, the U.S. housing market peaked long ago, and is in a prolonged process of rolling over under the weight of ever-eroding affordability. New home sales came in light in April, slipping 1.5% MoM to a 662k annual rate down from 672k in March, which was revised lower from 694k.

**The U.S. housing market peaked long ago, and is in a prolonged process of rolling over**

**CHART 3: NEW SINGLE FAMILY HOUSES SOLD**

**United States**
(thousands of units; SAAR)


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

**CHART 4: NEW SINGLE FAMILY HOUSES SOLD**

**United States**
(thousands of units; SAAR)

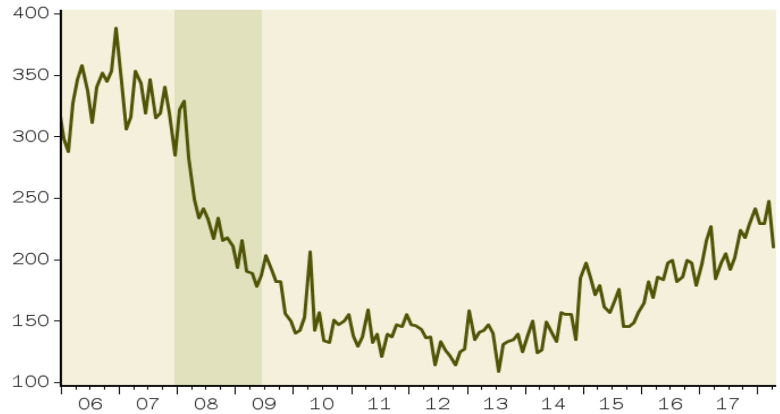

*Shaded region represents period of U.S. recession*
*Source: Haver Analytics, Gluskin Sheff*

The headline didn't do justice to the weakness behind the surface. Sales of completed homes sank 15% to 210k units, the lowest since August of last year. This is not good news from an excess inventory standpoint, and we did see the backlog ease up in April back to 5.4 months' supply from 5.3 months in March.

**This is not good news from an excess inventory standpoint**

**CHART 5: NEW SINGLE FAMILY HOUSES SOLD: COMPLETED**

**United States**
(thousands of units; SAAR)




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

Sales of homes that are currently under construction fell 5.3% to a four-month low of 231k. So as bad as the headline number was, it would have been far worse if buying "on spec" hadn't boomed 22% to 221k — this is what sales of "units not started" did last month. Who knows, maybe they never do get started.

**As bad as the headline number was, it would have been far worse if buying "on spec" hadn't boomed**

**CHART 6: NEW SINGLE FAMILY HOUSES SOLD: NOT STARTED**

**United States**
(thousands of units; SAAR)


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

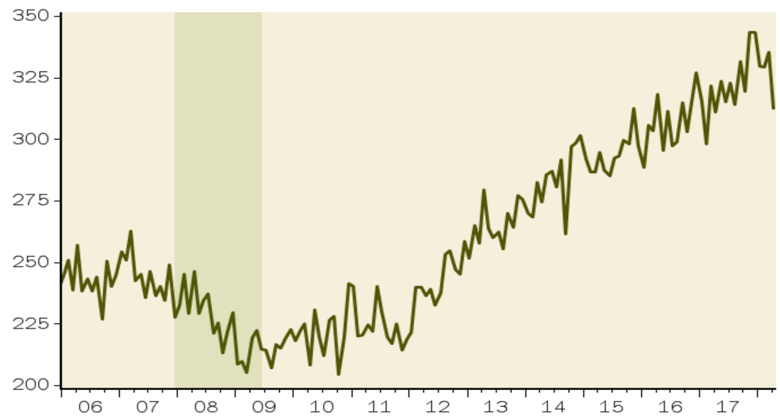
Interestingly, the moderating demand growth showed up in the median new home price data, which showed a 6.9% MoM decline — the steepest setback since May 2016 and the fourth decline in the past five months.

The YoY price trend has gone from +10.5% in February to +4.3% in March to now a mere +0.4% as of April. This also reflects a move afoot towards more moderately-priced homes (the return of frugality?) as the share of homes priced below $300k jumped to a thirteen-month high of 47% from 41% in March.

**This also reflects a move afoot towards more moderately-priced homes (the return of frugality?)**

**CHART 7: NEW SINGLE FAMILY HOUSES: MEDIAN SALES PRICE**

**United States**
(thousands of dollars)




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

And the moderating demand story also showed through in the length of time it took the builders to make the sale upon completion — 3.8 months in April compared to 3.7 months a year ago.

There seems to be little in the way of any evidence suggesting that the April showers turned to May flowers, because mortgage applications slumped 2% in the May 18th week. They are lower today than they were in mid-January and are down or flat in each of the past five weeks — during which they have literally collapsed at a 46% annual rate!

## MORE WEAK HOUSING NEWS

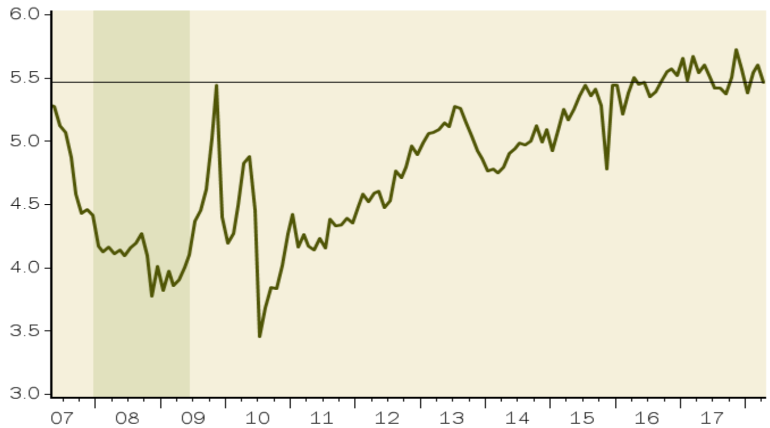
### From the May 25th edition of BWD

Another disappointing housing data point, this time coming courtesy of the April existing home sales release. Resales retreated 2.5% during the month (consensus was looking for a smaller 0.9% falloff) and are now down 1.4% from year-ago levels. In fact, at 5.46 million annualized units, sales are lower now than they were in April 2016! Not just that, but the breadth of the report was weak too, as not a single region recorded a gain.

**The breadth of the report was weak too, as not a single region recorded a gain**

**CHART 8: EXISTING HOME SALES**

**United States**
(millions of units)




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

There is little doubt that the supply backdrop remains particularly challenging with unsold inventory representing just 4.0 months of supply at the current sales pace (down from 4.2 months a year ago and the lowest level on record for the month of April). However, the demand side of the equation is also being pressured as affordability conditions are worsening further. Indeed, 30-year mortgage rates have now risen to their highest level (4.47%) since September 2013 and have increased for seven months running. Of course, this is occurring in the context of home prices (+5.3% YoY) continuing to run well in excess of the pace of income growth, which helps to explain why first-time buyers represented a miniscule 33% of all transactions in April (a ‘normal’ market would see something closer to 40% to 50%).

**The demand side of the equation is also being pressured as affordability conditions are worsening further**

**CHART 9: 30-YEAR FIXED RATE MORTGAGES**

**United States**
(percent)


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

Although existing home sales aren't the most timely indicator (since they are only counted after the transaction closes), the weekly mortgage application data tell us that we shouldn't expect April showers to turn into May flowers. The critical purchases index has retreated for four weeks running, over which time it has collapsed at a -53.5% annualized pace.

**The weekly mortgage application data tell us that we shouldn't expect April showers to turn into May flowers**

# 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 March 31, 2018, the Firm managed assets of $9.0 billion.

Gluskin Sheff is a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) and remains 17% 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.

*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.*

$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $6.3 million[2] on April 30, 2018 versus $3.1 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