Snack with Dave

THE LOST DECADE

Today’s U.S. nonfarm payroll report, when you consider how many barbiturates the government has supplied the economy, can only be described as horrible.

It’s not that for the first time in a long time the consensus missed the headline to the downside — looking for a flattish print versus the reported decline of 85,000 — but the details were very soft and a big problem emerged for the bond bears and Fed hawks, which is that the “gaps” in the labour market are widening. This, in a word, is “deflationary” in a world where governments have been reflating like crazy into a post-bubble credit collapse. It’s one thing to cushion the blow, but it is quite another to turn the tide. From top to bottom that message came across loud and clear. There will be those who blame the cold weather for the dismal tally, but for some reason that didn’t stop 11 million souls from buying a new car last month (though 20% of that was fleet-related).

Even as weak as the -85,000 headline print was, the details were even softer. What is critical, given that the payroll survey has a large company bias, is what the Household survey showed when measured in a similar fashion. The population and payroll concept adjust employment figure better measures what is occurring at the small company level where the trend in orders, output, sales and employment have been far less robust than has been the case for big businesses, which have greater access to credit and exposure to the global consumer. On this basis, employment showed a massive 465,000 decline in December and down exactly three million in the second half of the year.

Please see important disclosures at the end of this document.
In our view, this is the most accurate employment barometer in the current environment. Even adjusted for the inclement weather, which kept some people homebound last month, this metric still would have shown a massive decline in excess of 400,000. If this is what the beginning of a recovery looks like then we’d be keen on seeing what would happen if the economy were to double dip.

It’s not just the magnitude of the job declines but how widespread they are that is disturbing. The employment diffusion index fell to 40.0% from 42.4% in November. The manufacturing diffusion index came in at 39.8%, which belies the ballyhooed bounce in the ISM to a three-year high of 55%.

While there may have been some notable bright spots, such as financial services posting a payroll gain for the first time since July 2007, the fact that so many economic-sensitive sectors lost more jobs in December: construction (-53,000), durable goods manufacturing (-16,000), retail/wholesale (-28,000), transportation (-8,000), leisure/hospitality (-25,000), information services (-6,000) and real estate (-6,000). In other words, the segments of the employment pie that are sensitive to the business cycle actually cratered 142,000 last month, which flies in the face of the overwhelming view that this recession has really fully run its course.

In a sign that we, at the very least, are still finding a way to employ doctors, nurses and teachers, the health/education sector managed to eke out a 35,000 advance. Though even here the gains are a tad below the typical 40,000 monthly increases we were seeing during the boom years of the last cycle.

Once again, the growth bulls will point to the 47,000 rise in the ‘temp help’ segment of the payroll report — the fifth increase in as many months — as a constructive signpost but the problem here is that the only jobs that are being filled are in part-time positions. Full-time employment plunged 647,000 last month while part-time edged up by 66,000 — every one was because they could not find anything but part-time work.

So, while the jobless claims data have been signaling that the pace of firings has subsided sharply, the reality is that nobody is hiring, especially in the small business sector, and this was the primary concern the Fed highlighted in the set of minutes that was just released for the December Federal Open Market Committee (FOMC) meeting.

As we said above, labour market ‘gaps’ are widening; this is economist lingo that basically refers to the fact that slack in the jobs market is expanding, and this is why wage growth remains under relentless downward pressure. The unemployment rate stayed at 10% in December but it did so for a very bad reason. It was because the labour force plunged 661,000 in what was the sharpest decline in nearly 15 years. Without that dramatic disengagement from the jobs market on the part of the general public, the unemployment rate would have spiked to 10.4%.
In fact, the U6 measure of joblessness, which captures all the various degrees of unemployment and underemployment, rose to 17.3% from 17.2% and is flirting with the highest levels ever for this series.

**CHART 2: THE TRUE MEASURE OF JOBLESSNESS — U6 RATE AT 17.3%**

*Includes all marginally attached workers and those employed part-time for economic reasons*

Source: Haver Analytics, Gluskin Sheff

To add insult to injury, both the average (29.1 weeks) and median (20.5 weeks) duration of unemployment rose to new all-time highs in December; and the ranks of the unemployed who have been looking fruitlessly for a job for at least 27 weeks surged 229,000, or 3.9% MoM, also to a record high of 6.1 million (or 40% of the total jobless tally, yet another record). It is exactly this discouragement that has led to the participation rate sliding to its lowest level since August 1985.

**CHART 3: DURATION OF UNEMPLOYMENT AT A RECORD HIGH**

Source: Haver Analytics, Gluskin Sheff
The so-called ‘employment rate’ — the ratio of employment to population — fell 58.2% from 58.5% in November and the cycle peak of 63.4% in 2007. This is extremely significant because what it means is that it would take an expansion in employment of 20 million over the next five years just to get back to those old cycle highs. But here’s the problem — the country has never before managed to come close to creating that number of jobs over a half-decade period, so what the future holds is one of ongoing deflationary labour market pressure as far as the eye can see.
We started the decade with a national payroll level of 130.8 million. We finished the decade practically unchanged at 130.9 million. Meanwhile, the total pool of available labour rose from 146 million to 159 million. In other words, we have the same number of jobs today as we did a decade ago, and yet we also have 13 million more people competing for them. It was more than just a lost decade for the equity market. It was a lost decade for the labour market. Today’s report validated the Fed’s concern over the outlook for employment, which dominated the FOMC minutes released earlier in the week. Those pundits calling for an early exit from the central bank’s accommodative stance may have some reconsidering to do.

No doubt that we are seeing modestly positive growth in the economy and that the pace of job declines is moderating. We won’t quibble with the rose-coloured glass crowd on that. But the extent of any improvement has to be viewed in the perspective of the vast amount of fiscal and monetary resources that have been deployed to-date to try and bring the economy out of its malaise. If indeed the economy is fully out of recession then that first quarter of positive growth normally is 7.0% at an annual rate, not the pathetic 2.2% rate posted for the third quarter. And, considering that the Fed began to ease monetary policy back in the summer of 2007, what is normal typically 2½ years after the first rate cut is that real GDP is humming along at a 5.0% annual rate and employment isn’t declining at a slower rate but is booming. The fact that that the private domestic demand is still so stagnant following the greatest experiment with fiscal and monetary ease in recorded history, we have to admit, leaves us more than just a tad worried over the macro outlook and beyond.

CANADA BETTER BUT NOT BY MUCH

The Canadian employment number also came in below expected, at -2,600 in December versus consensus forecast of +20,000. The question really is why the consensus was expecting an increase today since Statistics Canada reported a month ago that we created 79,100 jobs in November. History shows that we stand to see more than a 50-50 chance of a serious let-down (flat to negative print) after a surge like we saw the month before. So, consider what we saw in December as a mild retracement — a blip in a very mild employment uptrend. In the past four months, the Canadian economy has managed to generate 64,000 or nearly a +1.0% annual rate (though this trend is -1.0% south of the border). That is the overriding story.

That said, as a stand alone report, the details were softish.

- 92% of the loss was in full-time.
- Manufacturing shed 9,700 and transports down 23,900 which portend an upcoming poor round of shipments and export data — this could act as a near-term restraint over the CAD.
- The labour force participation rate edged down to 67.1% from 67.2% (the unemployment rate was unchanged at 8.5%).
The workweek did bounce 1.5% MoM, but this is a volatile number and (i) followed two months of decline, and (ii) was screwy since it was up in services but negative in goods-producing where the data are more reliable.

The median duration of unemployment edged up in December, to 18.0 weeks from 17.8 in November and 13.0 a year ago. As in the U.S.A., it is taking longer to find a job.

Average hourly earnings were up 0.1% MoM and average weekly earnings were down 0.1% MoM, so the bottom line for the Bank of Canada here is that wage pressures are non-existent.

Sectors that have been the growth leaders over the past 3-6 months have been construction, financials, tech, retail, and health care.

**INVESTOR COMPLACENCY RUNNING HIGH**

- According to Investors Intelligence, there are now three times as many bulls as there are bears. Almost everyone is a performance chaser.
- Market Vane sentiment on equities has firmed to 57%, higher than it was in September 2007 when the market was beginning to crest. We didn’t see a number this strong in the last cycle until September 2003 when the recession was already two year’s behind us. By way of comparison, at the March lows, it was sitting at 32.
- Not one of the 12 seers polled by Bloomberg sees a down-market for 2010. The median increase in the S&P 500 is +11%.
- The VIX is down to 19, right where it was at the market peaks back in October 2007.
- The S&P 500 dividend yield is back below 2% for the first time in over two years.
- Corporate bond spreads and CDS credit default swaps have collapsed to levels not seen since two years ago.
- Based on the Shiller normalized P/E ratio, which is based on the 10-year trend in real corporate earnings, the S&P 500 is trading with a 20x multiple versus the long-run average (back to 1881) of 16x. This market, in other words, is more overvalued now (25%) than it was in heading into October 1987. To be sure, the average ‘overvaluation gap’ at a market peak is 50% so the argument can certainly be made that the market can go even higher from here until it rolls over. That may well be the case. But investors should be aware that at this stage, they are buying into a very expensive market and the ability to time the exit strategy is more than just an art. Those buying stocks in hopes of catching a classic blow-off to a bubble peak — remember, this market is already 25% overvalued based on the most tried, tested and true valuation metric.
CHART 6: SHILLER’S P/E RATIO SIGNALS THAT STOCKS ARE MODERATELY OVERVALUED

United States: Shiller’s Cyclically-Adjusted Price-to-Earnings Ratio*

*Robert Shiller’s measure of the price-to-earnings ratio for the S&P 500 uses the 10-year average of as reported earnings. Both earnings and prices are inflation-adjusted.

Source: Robert Shiller ("Irrational Exuberance"), Gluskin Sheff

MORE COMMENTS ON MARKET VALUATION

We should add here that on a Shiller real 10-year “normalized” earnings basis, the S&P 500 is now trading at 20x, which is 25% above the historical average of 16x. This is the same level of overvaluation heading into October 1987, though at the bubble peak in October 2007, the overvaluation gap was 70%. At the average of prior market peaks, the extent of the overvaluation is 50%. We are not saying that equities as an asset class is in a bubble but they certainly have moved to an overvalued extreme.

Moreover, as we have pointed out recently, what is “normal” is that every percentage point of nominal GDP growth translates into 2.5 percentage points of profits growth. Most economic forecasters see nominal GDP growth at 4% for this year. But strategists see, on average, 36% profit growth. But that 4% growth in nominal GDP is only enough to boost profits by 10%, if the normal relationship holds up. To see such low nominal growth and such strong profit growth is a 1-in-50 event. Maybe the economist and strategist at the Wall Street research houses should sit down with each other.

We are labeled as being “bearish” because we see profit growth coming in at +10% for the coming year. That is hardly bearish. On average, profits in any given year typically rise 7%. The challenge is what is currently being discounted. Market participants seem to agree that we will see something close to $77 of operating EPS this year. It is fascinating that this precisely what the consensus view was this time last year for 2009, and what we will get is something close to $56. Nice call.
All the consensus seemed to do is just fast-forward that projection into 2010 — what skated the market onside last year was the surge in the P/E multiple that occurred alongside a halving of the VIX index to 20 ...is it going to go 10 in 2010?. That would be a 36% increase from the 2009 level.

Never before — never — have we seen a 4% nominal GDP performance translate into anything remotely close to a 30% earnings profile, let alone a figure higher than that. There was a time when our forecast of $62 on operating EPS would have been viewed as wildly bullish but that was at least six months ago. But you know a lot of good news is priced into the equity market when an 11% profit growth forecast is considered as being outright negative.
Gluskin Sheff at a Glance

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Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 65% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

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

We offer a diverse platform of investment strategies (Canadian and U.S. equities, Alternative and Fixed Income) and investment styles (Value, Growth and Income).

The minimum investment required to establish a client relationship with the Firm is $3 million for Canadian investors and $5 million for U.S. & International investors.

PERFORMANCE
$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to $15.5 million on September 30, 2009 versus $9.7 million for the S&P/TSX Total Return Index over the same period.

$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to $11.2 million USD on September 30, 2009 versus $8.7 million USD for the S&P 500 Total Return Index over the same period.

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We have a strong history of insightful bottom-up security selection based on fundamental analysis.

For long equities, we look for companies with a history of long-term growth and stability, a proven track record, shareholder-minded management and a share price below our estimate of intrinsic value. We look for the opposite in equities that we sell short.

For corporate bonds, we look for issuers with a margin of safety for the payment of interest and principal, and yields which are attractive relative to the assessed credit risks involved.

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Our success has often been linked to our long history of investing in under-followed and under-appreciated small and mid cap companies both in Canada and the U.S.

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In terms of asset mix and portfolio construction, we offer a unique marriage between our bottom-up security-specific fundamental analysis and our top-down macroeconomic view.

Notes:
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2. Returns are based on the composite of segregated Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.
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