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Economic Commentary

Gluskin Sheff

MARKET MUSINGS & DATA DECIPHERING

Donuts with Dave

NORTHERN EXPOSURE

After a three-day business trip to California, we can safely say that the bullish Canadian economic and financial story is page C16 news. It is still nowhere close to the front page, which is good news for contrarians always on the lookout for when all the positives are priced in. But the story is very positive indeed and while still underappreciated, I can sense that it is gaining more and more believers state-side. Global capital inflows are already running at unprecedented levels and I would be looking for this to persist and likely take the Canadian dollar at least 20% higher in the next half-decade. Barring a Chinese economic reversal that causes a commodity collapse, what I would refer to as "tail risk", I seriously believe that this Canadian dollar forecast will prove to be conservative, not bold.

Let's assess the landscape.

First off, the loonie managed to cross above "par" against the greenback on December 28 for the first time in eight months. When the Canadian dollar made its run towards par three years ago, oil prices were heading for $145/barrel. Today we are barely north of $90, which tells you that this latest leg-up in the loonie is not merely a "petro currency" story. Global investors are putting an increasing premium on reserves in the ground but they also are allocating capital towards those regions of the world that offer a secure yield (like a 4% banking sector dividend yield or a 2-year note that commands a 90 basis points yield advantage over U.S. comparables), national balance sheets that are not just rated AAA but are in fact AAA, as well as governments that are right-of-center, at least on economic issues, and as such, focus on lowering top marginal income tax rates.

Second, the TSX closed the year with a 21% gain in USD terms, outpacing the 13% gain in the S&P 500 by 800 basis points. This marks seven of the past eight years in which the Canadian stock market outperformed the U.S. in common-currency terms (20% average annual returns compared with 5% for the S&P 500). This not only reflects the bank-commodity barbell (financials command 30% of Canada's market cap and resources take up nearly 50%) north of the border but also the fact that the Canadian dollar is in a clear secular uptrend (not just against the USD either). In fact, for U.S.-based investors, the Canadian dollar appreciation has actually provided more than half of the alpha in that total return differential since 2002. Being in the right currency, and one that is going up typically 4-5% annually, is akin to playing your golf game from the front tees.

Third, as I said above, the front end of the Government of Canada curve offers a nice 113 basis points premium over U.S. Treasuries. This helps attract global fixed-income fund managers looking to park cash and pick up some income. This positive spread basically reflects the fact that the Canadian economy is operating at a much higher level than is the case south of the border — an assertion underscored by the fact that on an apples-to-apples comparison, Canada's unemployment rate is 6.5% versus 9.4% stateside — an unprecedented gap.

I'll tell you something else that's unprecedented. The long Canada bond is now around 88 basis points below U.S. comparable levels. This is unprecedented and comes despite a policy rate that is 75 basis points higher in Canada, which tells you that, when adjusted for the gap in the "cost of carry", bond yields at the longest maturity are arguably 125 basis points lower in Canada than they are in the U.S.A. Think about that for a moment. What the markets are telling you is that Canada, the little brother to the north, is a much safer place to park your money from a fiscal balance sheet standpoint. Both countries are rated AAA by the major credit agencies, but the market has clearly discriminated which country has the more sound national balance sheet and more solid long-term economic prospects.

Moreover, the fact that the Canadian dollar is appreciating is only one part due to commodities. The other part is a more responsible fiscal policy. The U.S. government continues to pursue a profligate spend-and-borrow fiscal strategy that is not going to end up doing much more than mortgage economic growth from future generations. Dipping into Social Security so that people can have more pocket money to buy more gasoline imported from the Middle East and more electronic gadgets manufactured in emerging Asia hardly represents a very impressive long-term growth plan (like the 5-year ones they have in China). Though it does at least make the quarterly data-flow appear to be more buoyant than they actually are and will be able to fool investors for as long as the stimulus doesn't wear out. But as Herb Stein famously said, "anything that can't last forever, by definition, won't." And in the Year of the Rabbit, this may well end up being applied to the rabbits that reside in Ben Bernanke's hat … there may not be that many more that he will be able to pull out.

Canada is experiencing very similar modest rates of economic growth like the U.S. but not on the back of quantitative easing and not at the risk of blowing a hole through the government balance sheet. And while the plus 20% of GDP that is exported to the U.S.A. will forever be challenged by the choppy U.S. recovery and the strengthening Canadian dollar, the other 80% share of the economy is doing just fine, thank you very much, and on the back of a very impressive boom in capital spending which has carried the baton handed off from the once hot housing market. Household debt in Canada is clearly problematic, but for now, completely serviceable. At the national level, as far as we know, Canada is the only G7 country with a credible federal government plan to balance the books over the next five years and at the same time promote domestic competitiveness via a schedule of sliding top marginal corporate tax rates, which just fell to 16.5% from 18% (federal rate), and is on track to slip to 15% by 2012. By way of comparison, top federal rates on profits are 35% in the U.S.A. and Japan, and 25% on average in Europe.

Our proprietary models say the Canadian dollar is overvalued, as they have for some time, but these are only models and what they don't include are intangibles — such as a comparatively intelligent and affordable set of fiscal and monetary policies.

And while this is purely anecdotal, I gave a presentation in Los Angeles yesterday for a boardroom full of senior executives seeking investment ideas. Only two of the large group had any exposure to Canada, but the interest turned out to be so palpable that I never had time to go through the other parts of the presentation. Then again, by not getting to the U.S. and European segments of my chart deck, for the first time in years, I finally gave a sermon that left the room in cheers rather than in tears.

And it felt good!

Enjoy this set of charts, which unlike the last two days, don't have to be turned upside down to spin a positive story.

THE CANADIAN RENAISSANCE

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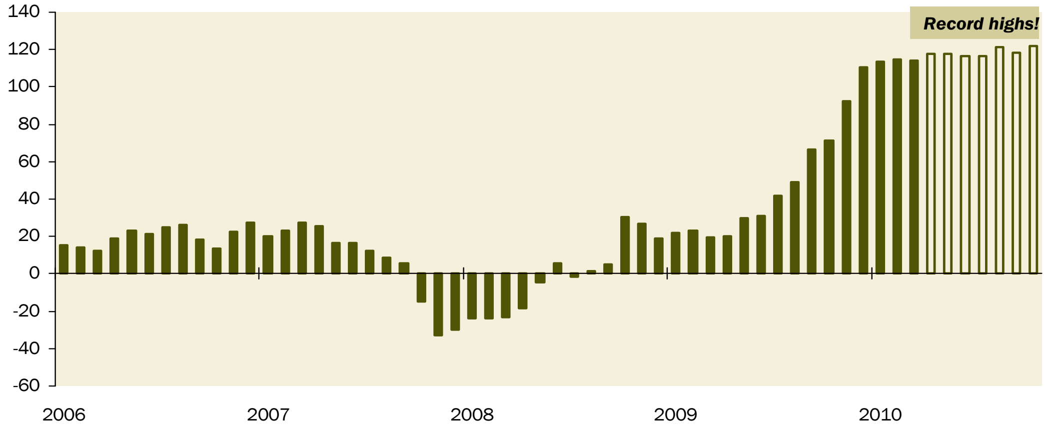
CHART 1: FOREIGN INVESTORS REDISCOVER CANADA

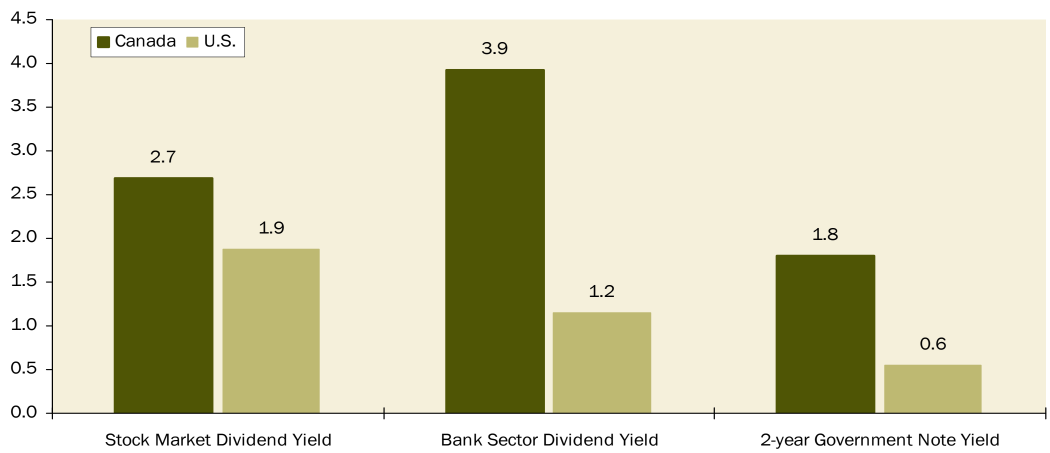
Canada: Net Foreign Purchases of Canadian Stocks and Bonds
(12-month total, C$ billions)



Source: Statistics Canada, Gluskin Sheff

CHART 2: CANADA OFFERS A YIELD PREMIUM

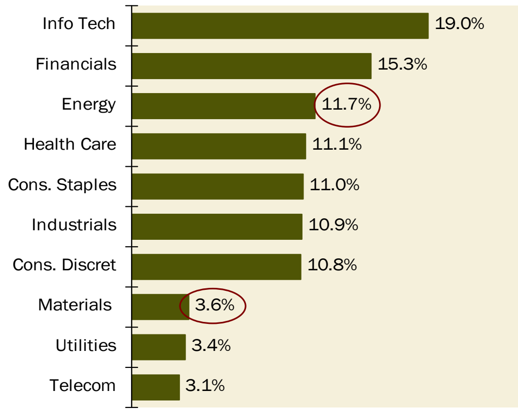
(percent)



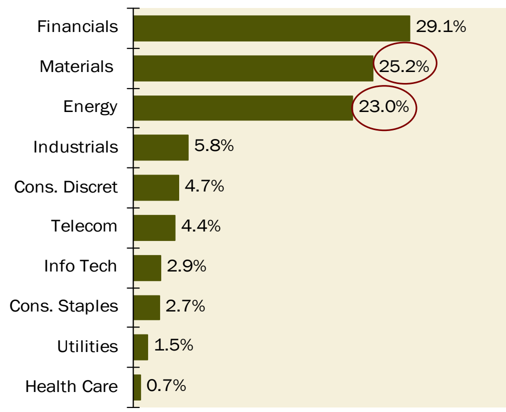
Source: Haver Analytics, Bloomberg, Gluskin Sheff

CHART 3: CANADIAN MARKET GEARED MORE TOWARDS BASIC MATERIALS

S&P 500 Composite Index
(percent, as of December 31, 2010)



TSX Composite Index
(percent, as of December 31, 2010)



Source: Bloomberg

CHART 4: HAS CANADA BEEN RE-RATED?

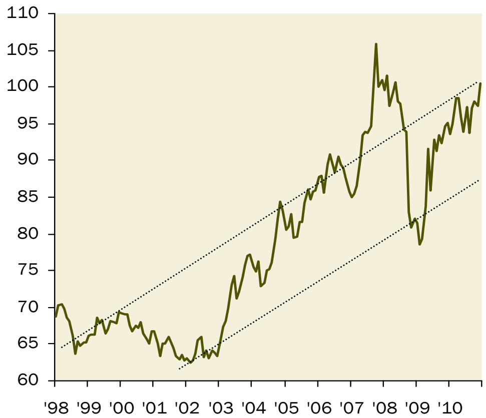
Canada: Canadian Dollar
(US$/C$)

Source: Haver Analytics, Gluskin Sheff

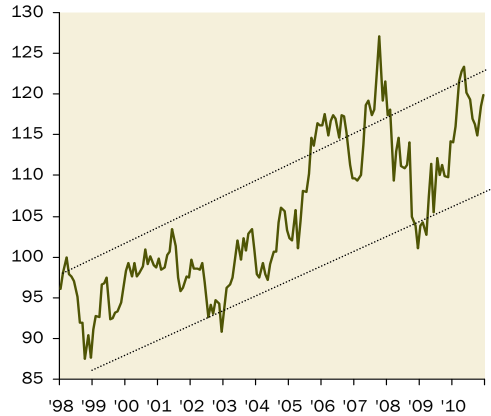
CHART 5: CANADIAN DOLLAR NOT JUST A USD STORY

Canadian Dollar

Against the U.S. Dollar
(US$/C¢)



Versus Six Major Currencies excluding USD*
(1992 = 100)



**A weighted average of bilateral exchange rates for the Canadian dollar against the currencies of Canada's major trading partners*
The six foreign currencies in the basket are the U.S. dollar, the Euro, the Japanese Yen, the U.K. Pound, the Chinese Yuan, and the Mexican Peso.
Source: Haver Analytics, Gluskin Sheff

CANADIAN BANKS ARE RATED NUMBER 1

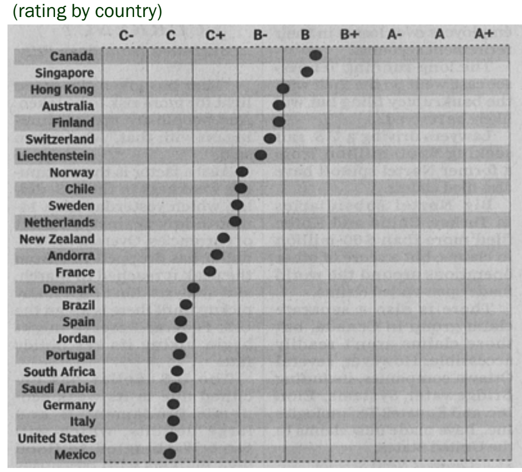
World Economic Forum, Global Competitiveness Report 2010-11

Banks ranked on a scale from 1 (may need government bailout) to 7 (sound)

Rank	Country	Score
1	**Canada**	**6.7**
2	New Zealand	6.6
3	Australia	6.5
4	Lebanon	6.5
5	Chile	6.5
6	South Africa	6.5
7	Panama	6.4
8	Hong Kong	6.4
9	Singapore	6.3
10	Malta	6.3
111	**United States**	**4.4**

Moody's Report, September 2009

Average Bank Financial Strength
(rating by country)



Source: World Economic Forum, Global Competitiveness Report 2010-11, National Post ("Moody's Rates Canada's Banks Tops", October 9, 2009)

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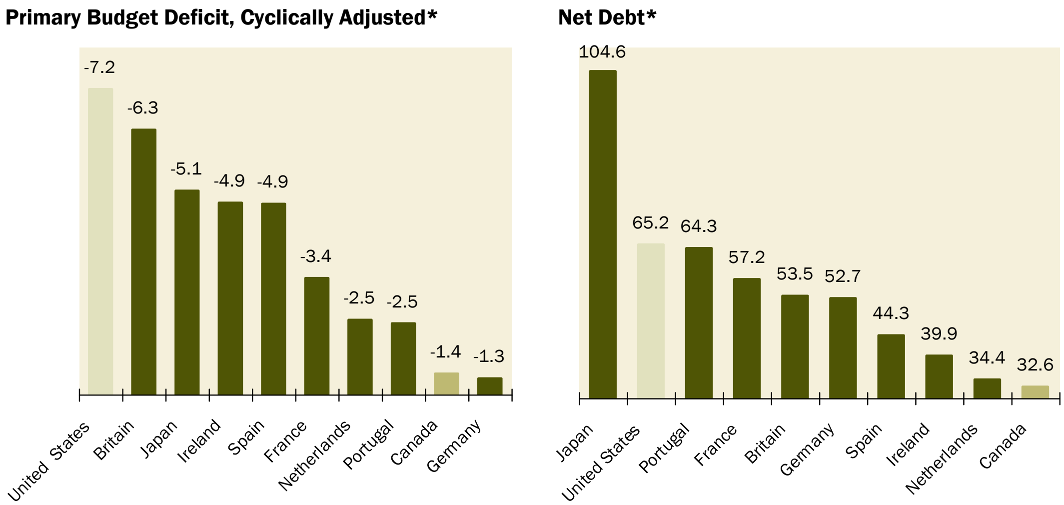
CHART 6: CANADA, ONE OF THE FEW COUNTRIES WITH AN AAA BALANCE SHEET

As a percent of GDP, 2010 Estimate



**General government.*

Source: Organization for Economic Cooperation and Development

CHART 7: CANADA, U.S. FISCAL PROJECTION COMPARISON

		2010	2011	2012	2013	2014
Deficit	*Canada*	-3.1	-1.6	-1.0	-0.5	-0.1
(percent of GDP*)	*U.S.*	-9.2	-6.5	-4.1	-3.2	-2.7
Real GDP	*Canada*	2.6	3.2	3.0	2.8	2.6
(annual percent change)	*U.S.*	2.2	1.9	4.6	4.8	3.9
3-month Bill Yield	*Canada*	0.7	2.4	3.8	4.3	4.4
(percent)	*U.S.*	0.2	0.7	1.9	3.0	3.9
10-yr Treasury Yield	*Canada*	3.7	4.3	4.9	5.2	5.3
(percent)	*U.S.*	3.6	3.9	4.2	4.5	4.9

*All years are calendar years unless otherwise noted. *Fiscal Year*

Source: Canadian Department of Finance, U.S. Congressional Budget Office

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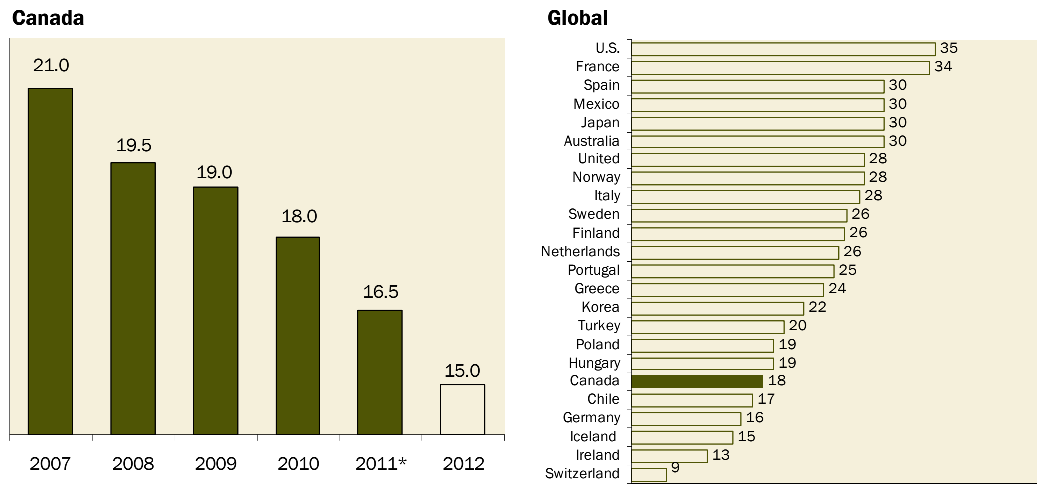
CHART 8: CANADA BECOMING MORE TAX COMPETITIVE

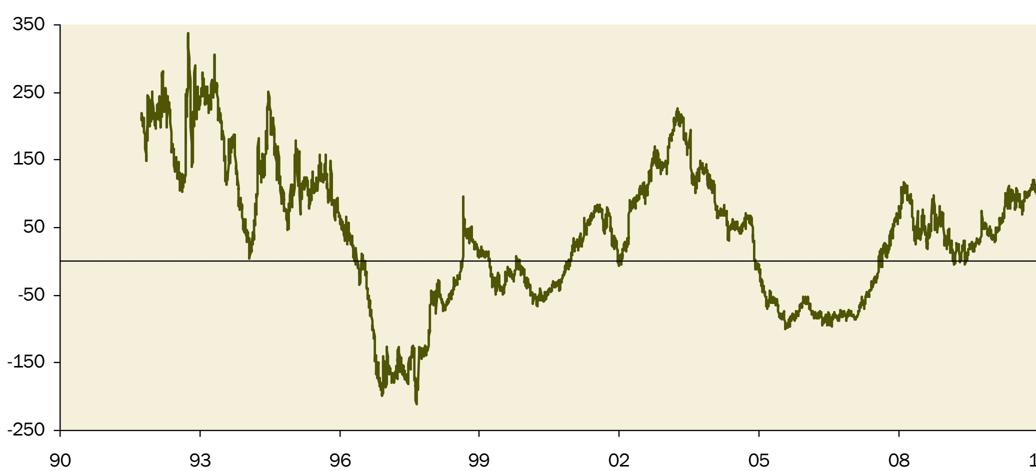
Corporate Tax Rate
(percent)



**Took effect on January 1, 2011. Reduce to 15.0% will take effect on January 1, 2012*
Source: Canadian Revenue Agency, OECD

CHART 9: SHORT END OF CANADIAN YIELD CURVE REFLECTS ECONOMIC STRENGTH …

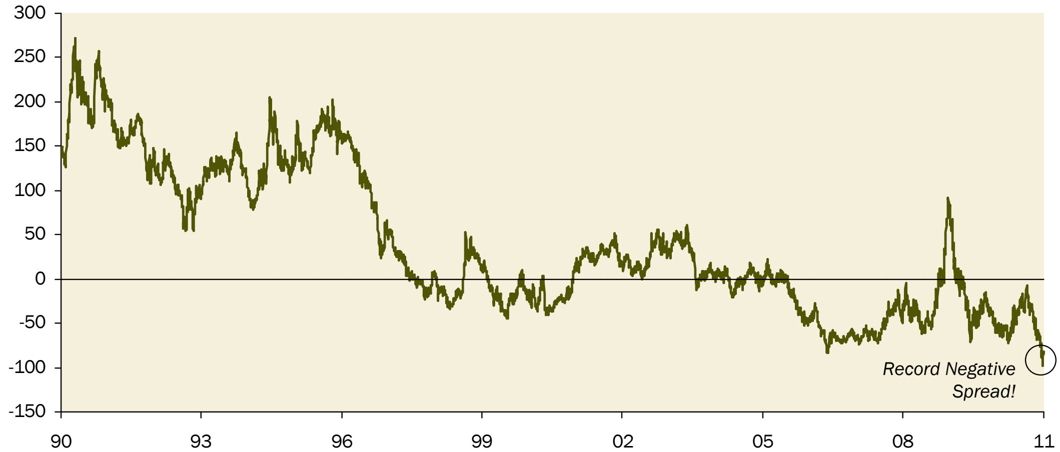
Canada minus U.S. 2-Year Government Note Spread
(basis points)



Source: U.S. Federal Reserve Board, Bank of Canada

CHART 10: … THE LONG END REFLECTS A SOLID BALANCE SHEET

Canada minus U.S. Government Long Bond Spread
(basis points)

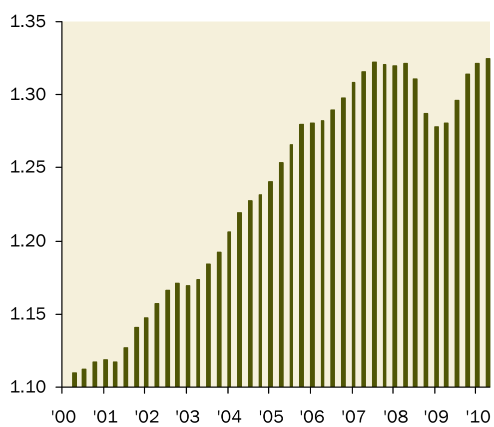


Source: U.S. Federal Reserve Board, Bank of Canada

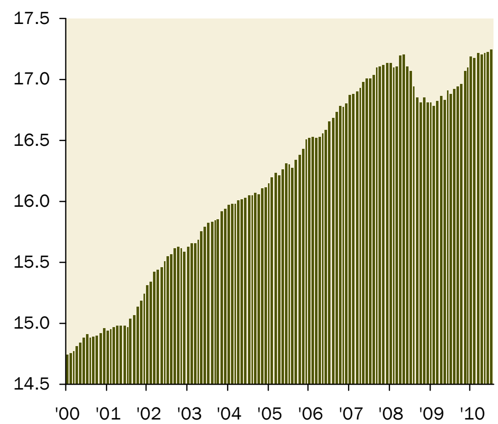
CHART 11: TWIN PEAKS – LEVEL OF BOTH REAL GDP AND EMPLOYMENT BACK TO ALL TIME HIGHS

Canada

Real GDP
(C$ trillion, 2002)



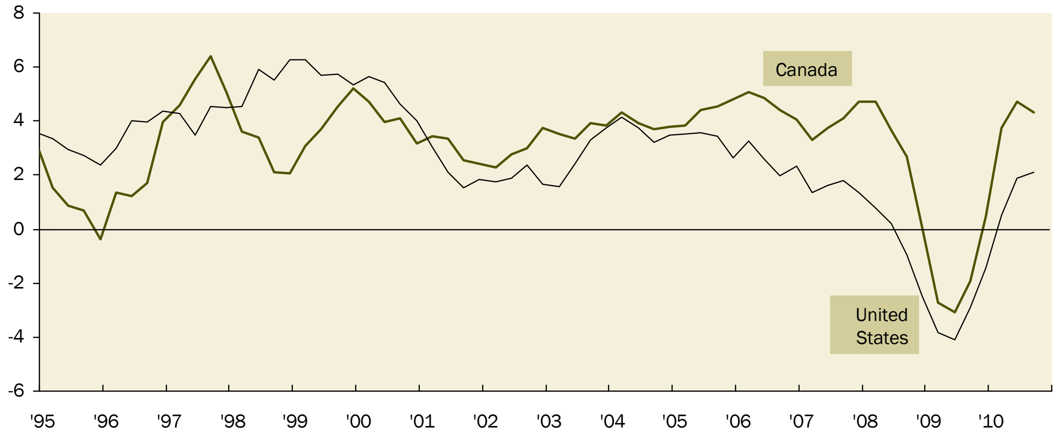
Employment
(millions)



Source: Statistics Canada

CHART 12: DOMESTIC ECONOMIC GROWTH IN CANADA ALMOST DOUBLE THE U.S. TREND

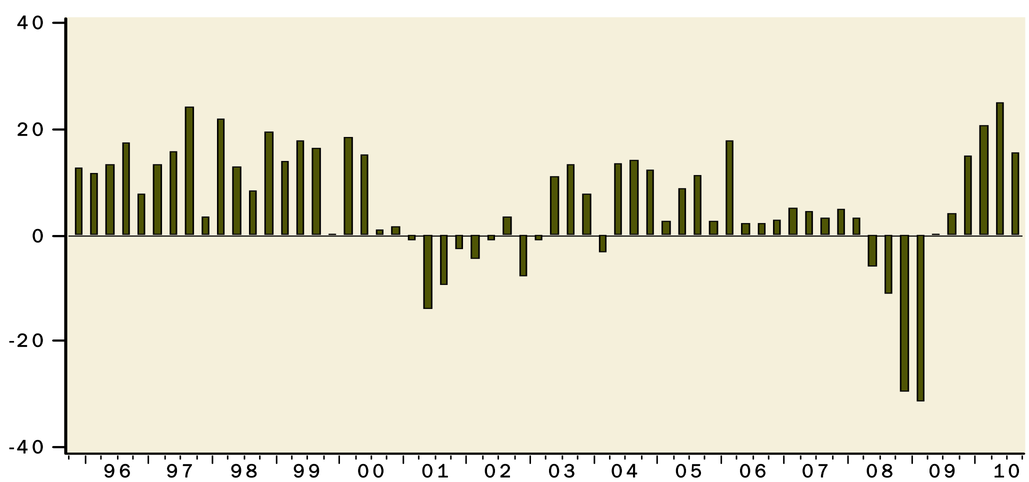
Final Domestic Demand
(year-over-year percent change)



Source: Statistics Canada, U.S. Bureau of Economic Analysis

CHART 13: BUSINESS SPENDING UP FOUR QUARTERS IN A ROW — STRONGEST INCREASES IN 13 YEARS

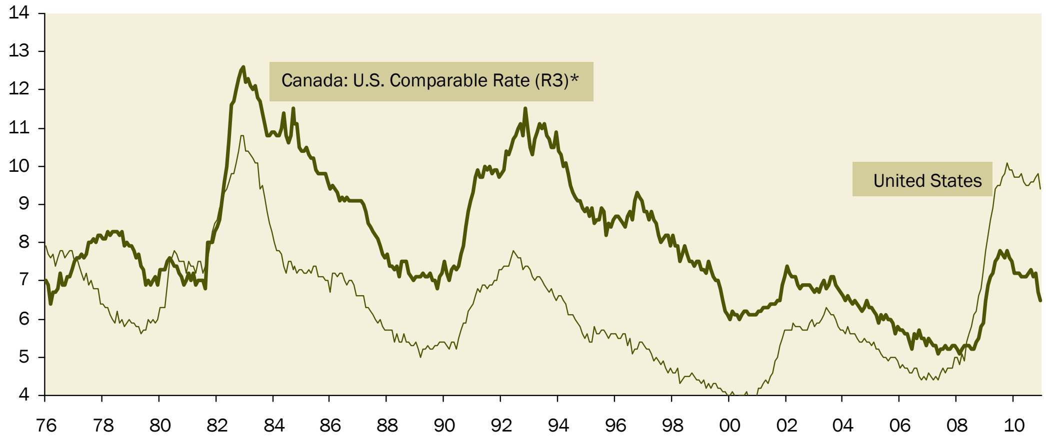
Canada: Real Business Investment in Machinery & Equipment
(quarter-over-quarter percent change at an annual rate)



Source: Statistics Canada

CHART 14: CANADA'S JOBLESS RATE IS NOW SIGNIFICANTLY LOWER THAN THE U.S. RATE …

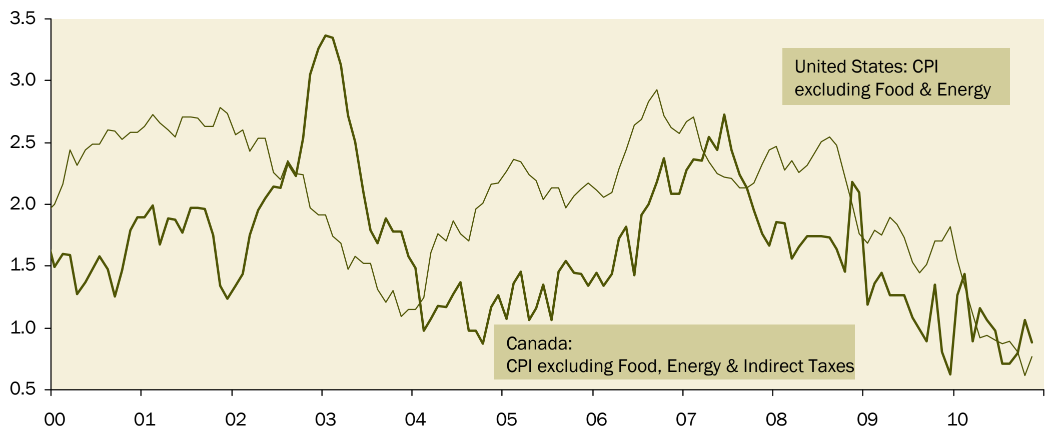
Unemployment Rate
(percent)



**Seasonally adjusted by Haver Analytics*
Source: Statistics Canada, U.S. Bureau of Labor Statistics, Haver Analytics

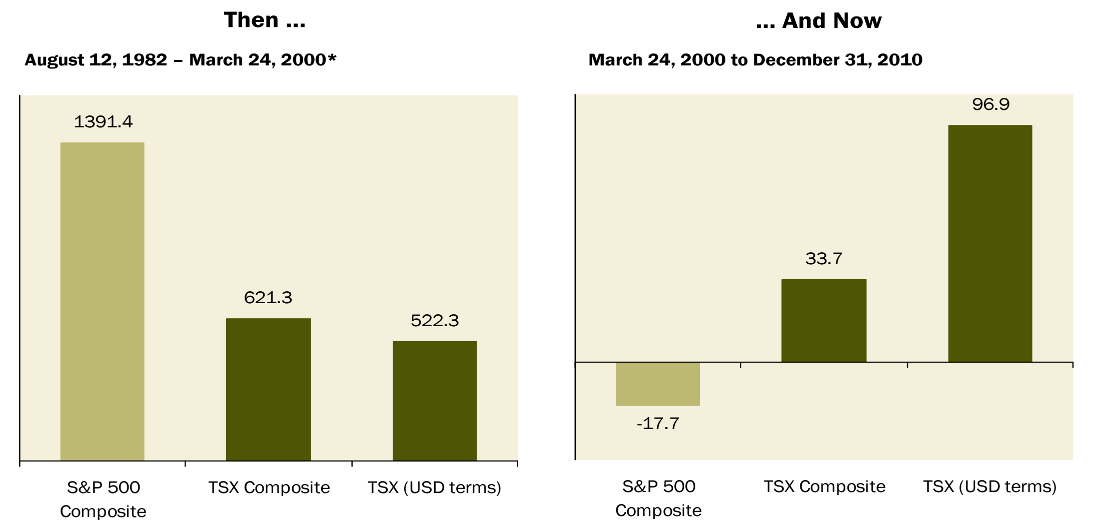
CHART 15: … YET CORE INFLATION RATES ARE ROUGHLY SIMILAR

Core Inflation Rates
(year-over-year percent change)



Source: Statistics Canada, U.S. Bureau of Labor Statistics

CHART 16: HALFWAY THROUGH THE CANADIAN STOCK MARKET OUTPERFORMANCE



**Dates reflect the trough (August 12, 1982) and the peak (March 24, 2000) in the S&P 500 Composite Index*
Source: Bloomberg, Haver Analytics

Gluskin Sheff

Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and focused primarily on high net worth private clients, we are dedicated to the prudent stewardship of our clients' wealth through the delivery of strong, risk-adjusted investment returns together with the highest level of personalized client service.

OVERVIEW

As of September 30, 2010, the Firm managed assets of $5.8 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 49% 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).[1]

The minimum investment required to establish a client relationship with the Firm is $3 million.

PERFORMANCE

$1 million invested in our Canadian Equity Portfolio in 1991 (its inception date) would have grown to $9.1 million[2] on September 30, 2010 versus $5.9 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 $11.8 million USD[2] on September 30, 2010 versus $9.6 million USD for the S&P 500 Total Return Index over the same period.

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We have strong and stable portfolio management, research and client service teams. Aside from recent additions, our Portfolio Managers have been with the Firm for a minimum of ten years and we have attracted "best in class" talent at all levels. Our performance results are those of the team in place.

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.

We assemble concentrated portfolios - our top ten holdings typically represent between 25% to 45% of a portfolio. In this way, clients benefit from the ideas in which we have the highest conviction.

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.

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For further information, please contact questions@gluskinsheff.com

Notes:

Unless otherwise noted, all values are in Canadian dollars.

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