Gluskin Sheff + Associates Inc.

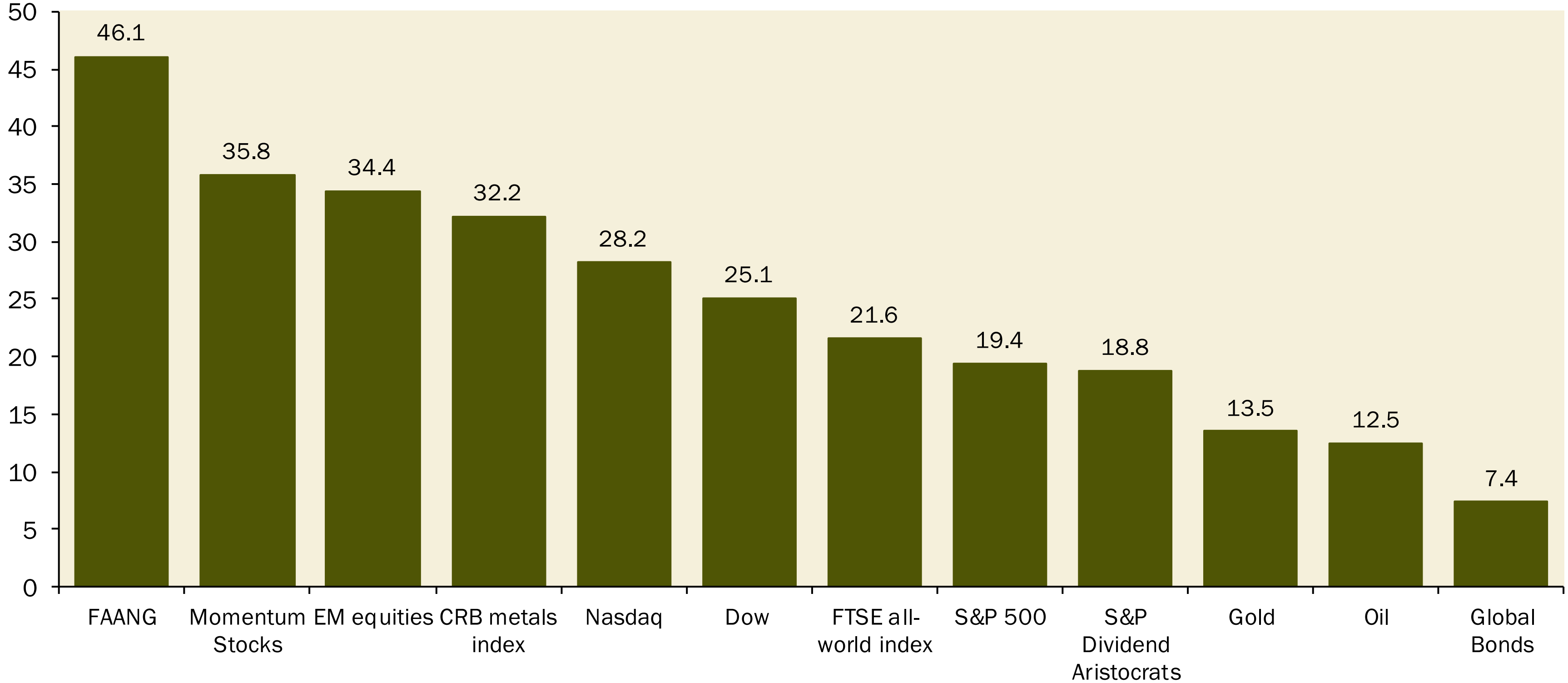
Year of the Dog: Will It Bark or Bite?
David A. Rosenberg

March 2018

EUPHORIA EVERYWHERE YOU LOOKED

2017 Price Returns

(percent change)



As of Jan. 26th, 2018: 304 trading days without a 3% drawdown in the S&P 500; 396 sessions without a 5% pull-back

Notes:
Source: Bloomberg, Gluskin Sheff

S&P 500 END-2018 CONSENSUS FORECAST

Firm	Strategist	2018 Close
Bank of America	Savita Subramanian	2,800
Bank of Montreal	Brian Belski	2,950
Canaccord	Tony Dwyer	3,100
Citigroup	Tobias Levkovich	2,800
Credit Suisse	Jonathan Golub	3,000
Deutsche Bank	Binky Chadha	2,850
Evercore ISI	Dennis DeBusschere	3,000
Goldman Sachs	David Kostin	2,850
HSBC	Ben Laidler	2,650
Jefferies	Sean Darby	2,855
JPMorgan	Dubravko Lakos-Bujas	3,000
Morgan Stanley	Mike Wilson	2,750
Oppenheimer	John Stoltzfus	3,000
Scotiabank	Vincent Delisle	2,750
Stifel	Barry Bannister	2,750
UBS	Keith Parker	2,900
Wells Fargo	Chris Harvey	2,863
Mean		2,875
Median		2,855
Max		3,100
Min		2,650

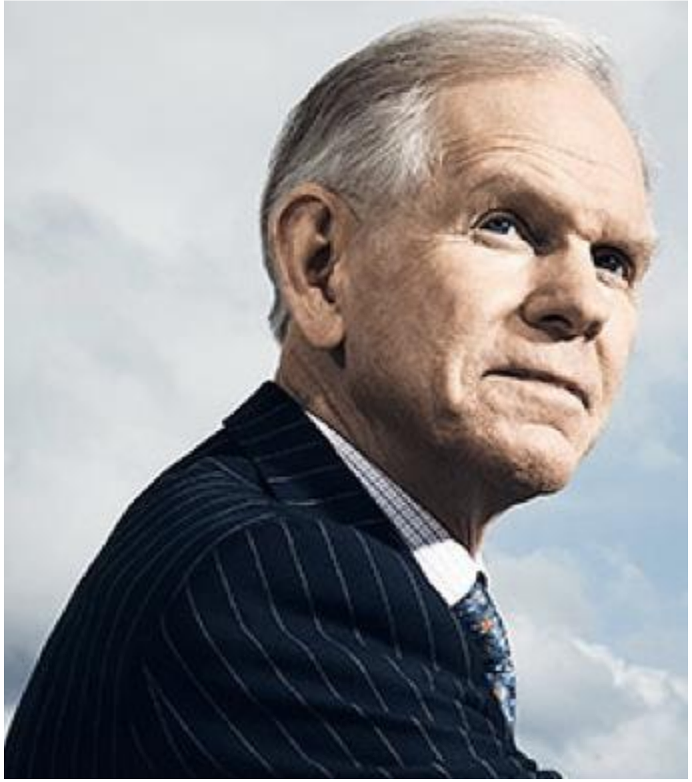
Notes:
Forecasts as of December 22, 2017
Source: Bloomberg, Gluskin Sheff

The S&P 500 hit 2,873 on January 26th!

ONE LAST MELT-UP!

I find myself in an interesting position for an investor from the value school. I recognize on one hand that this is one of the highest-priced markets in US history. ***On the other hand, as a historian of the great equity bubbles, I also recognize that we are currently showing signs of entering the blow-off or melt-up phase of this very long bull market****.*

— Jeremy Grantham, January 3rd, 2018

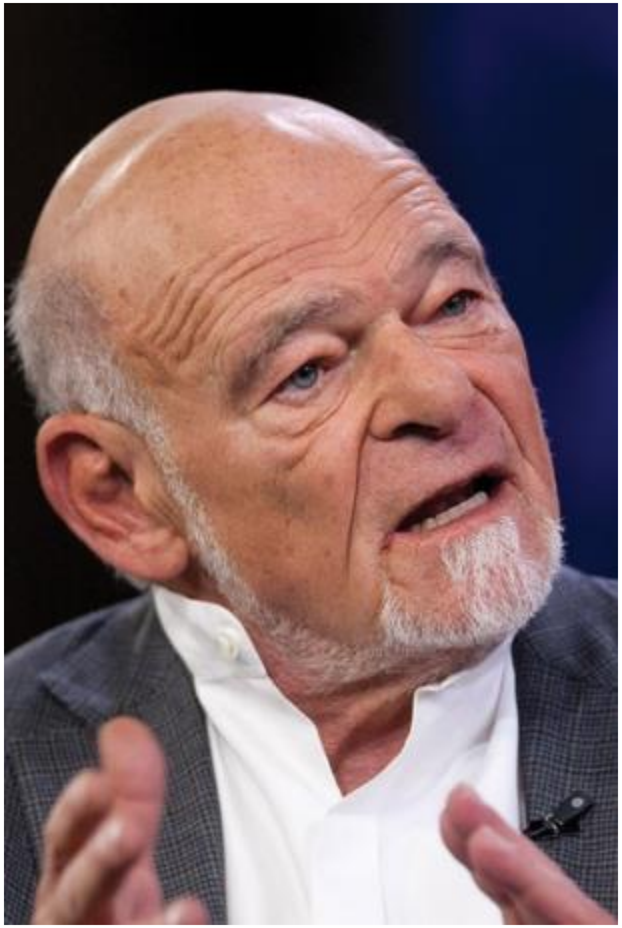


***Sees the potential for a final 60% surge over the next two years**

GO TO ZELL!

I think the current situation seems like irrational exuberance.

— Sam Zell, January 16th, 2018

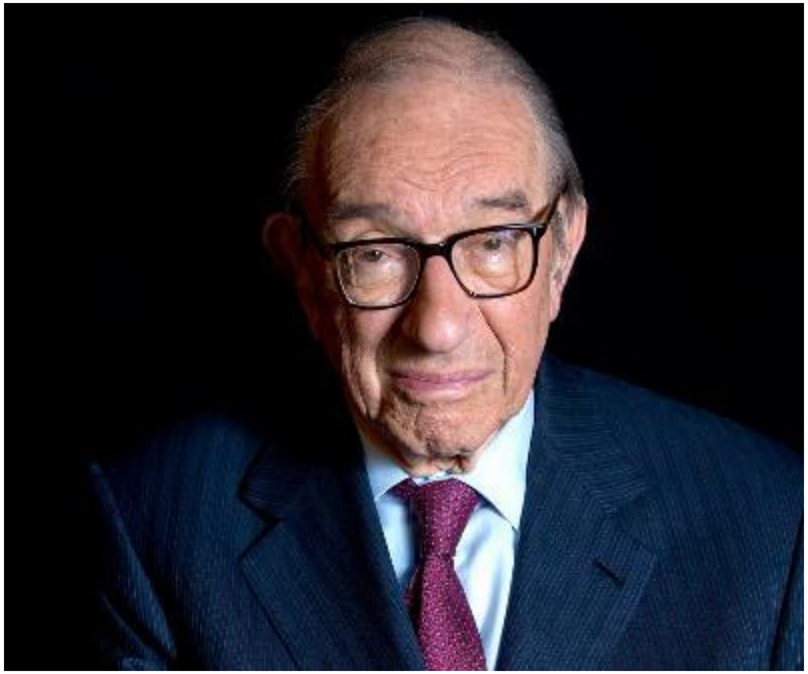


HOWARD MARKS: IT'S NOT DIFFERENT THIS TIME

"Most valuation parameters are either the richest ever or among the highest in history. In the past, levels like these were followed by downturns. Thus a decision to invest today has to rely on the belief that 'it's different this time'. I'm convinced the easy money has been made."

— January 23, 2018

HE KNOWS BUBBLES BETTER THAN ANYBODY



"There are two bubbles: We have a stock market bubble, and we have a bond market bubble…what's behind the bubble? Well the fact, that, essentially, we're beginning to run an ever-larger government deficit. As a share of GDP debt has been rising very significantly and we're just not paying enough attention to that."

— January 31, 2018

Notes:
Source: Alan Greenspan, Bloomberg TV, January 31, 2018

"WE ARE IN A BIG FAT UGLY BUBBLE"

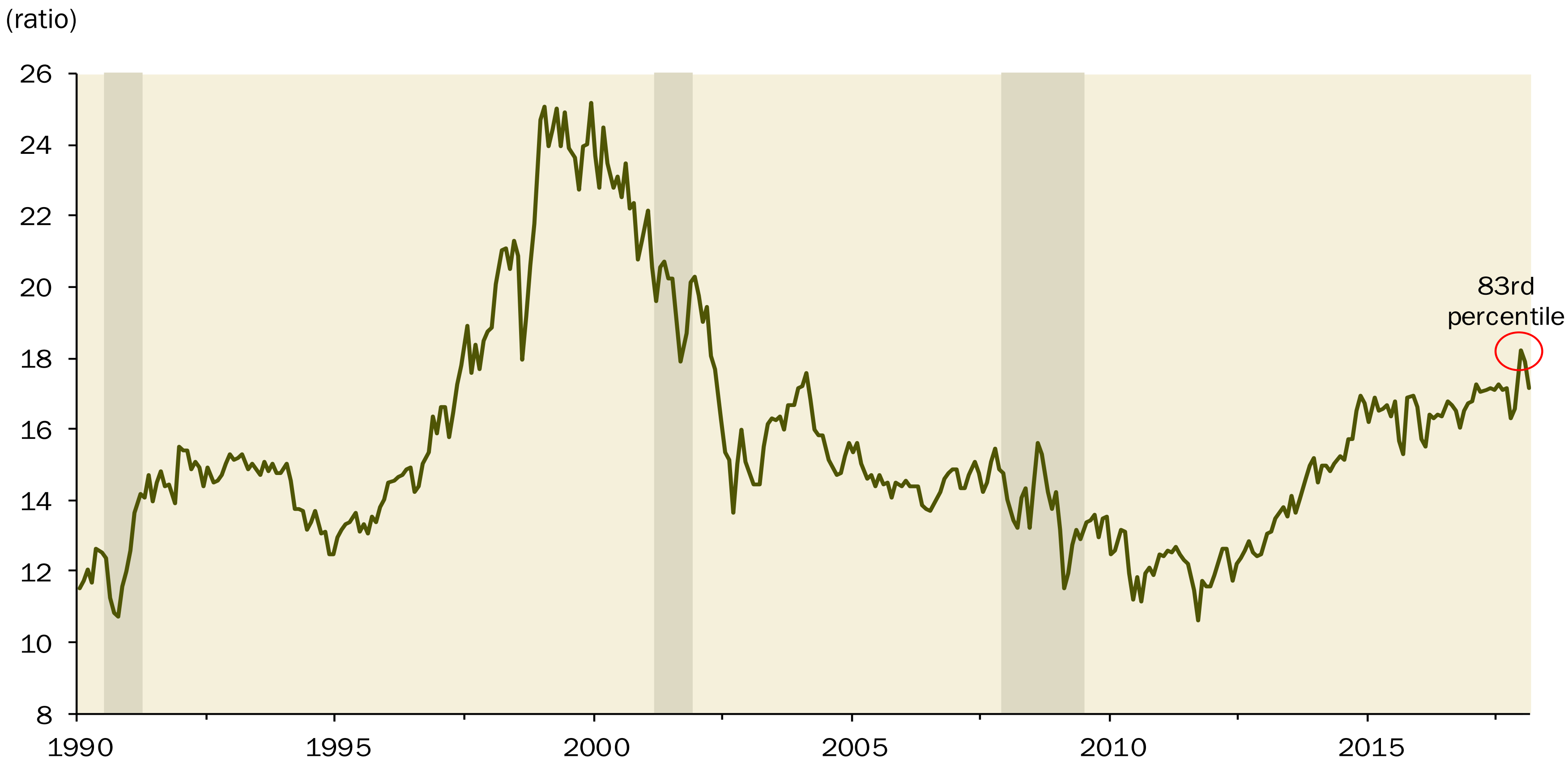
"Now look, we have the worst revival of an economy since the Great Depression. And believe me, we're in a bubble right now. And the only thing that looks good is the stock market but if you raise interest rates even a little bit, that's going to come crashing down. ***We are in a big fat ugly bubble, and we better be awfully careful.***"

Donald Trump
First U.S. Presidential Debate,
September 26, 2016

Dow on September 26th, 2016: 18,094

VALUATIONS ELEVATED NO MATTER THE METRIC

United States: S&P 500 Forward Price to Earnings Ratio



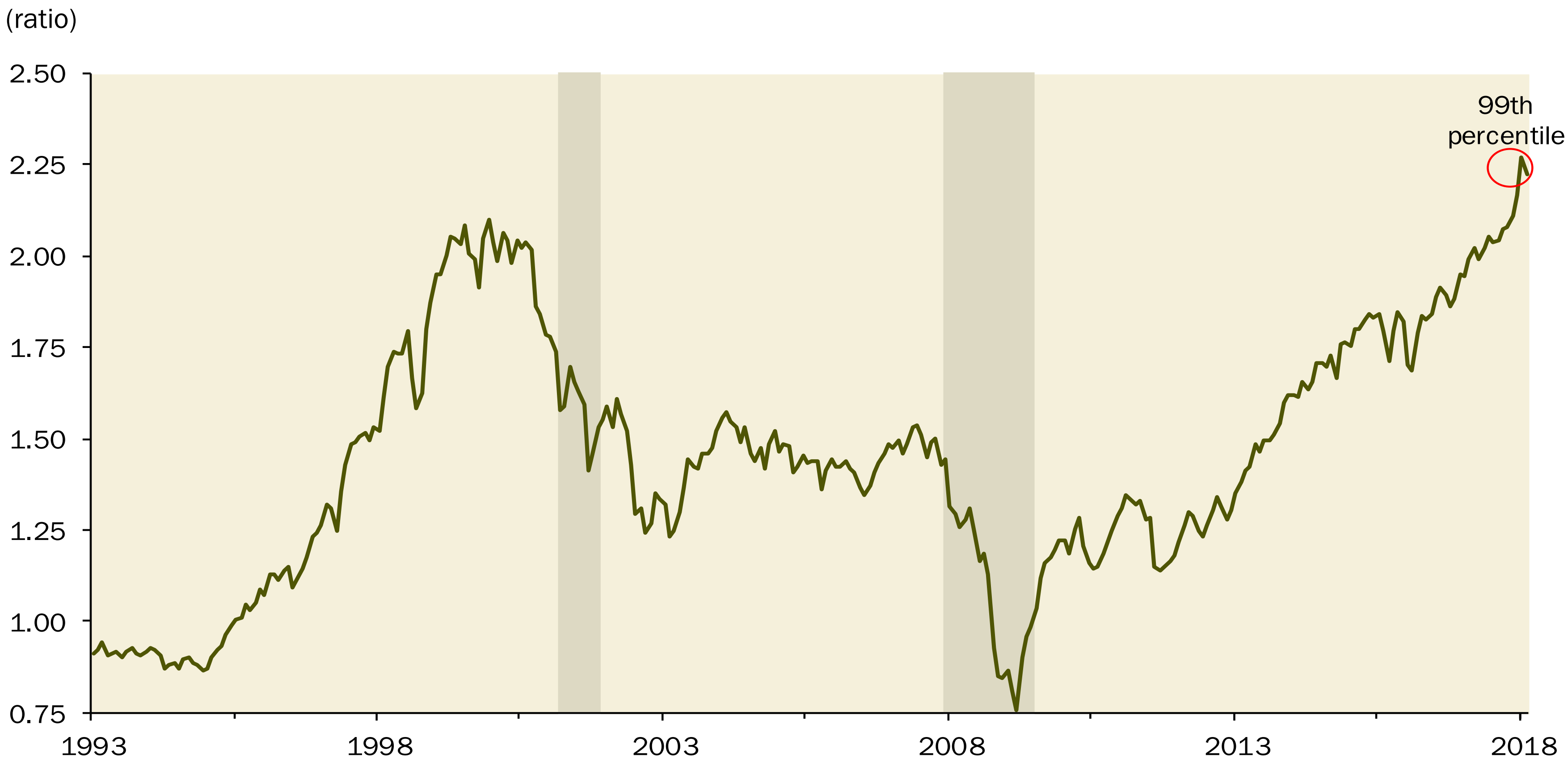
Notes:

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

TAKING OUT THE DOTCOM PEAK

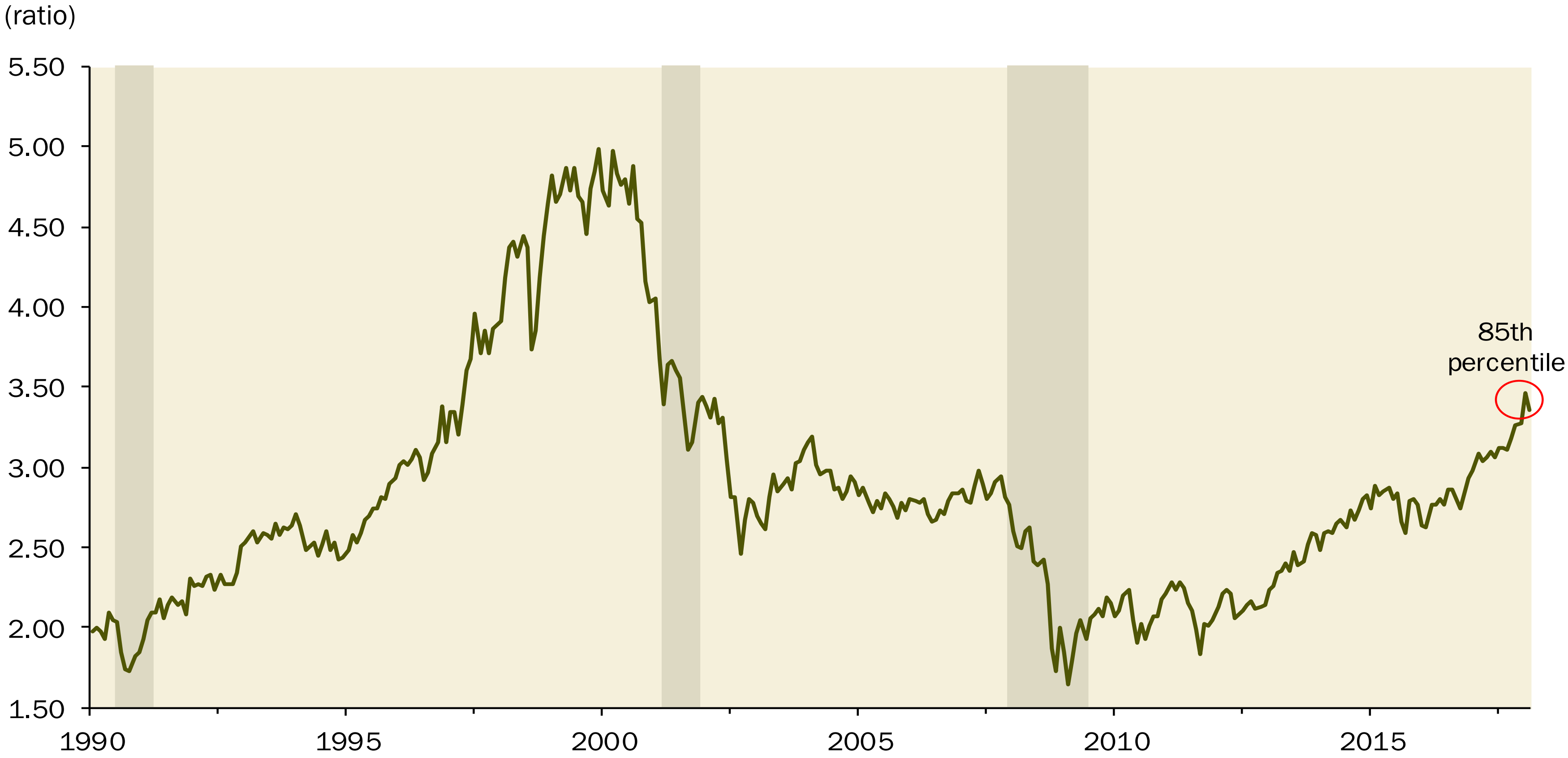
United States: S&P 500 Price to Sales Ratio



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

MORE SIGNS OF EXCESSIVE VALUATIONS

United States: S&P 500 Price to Book Ratio



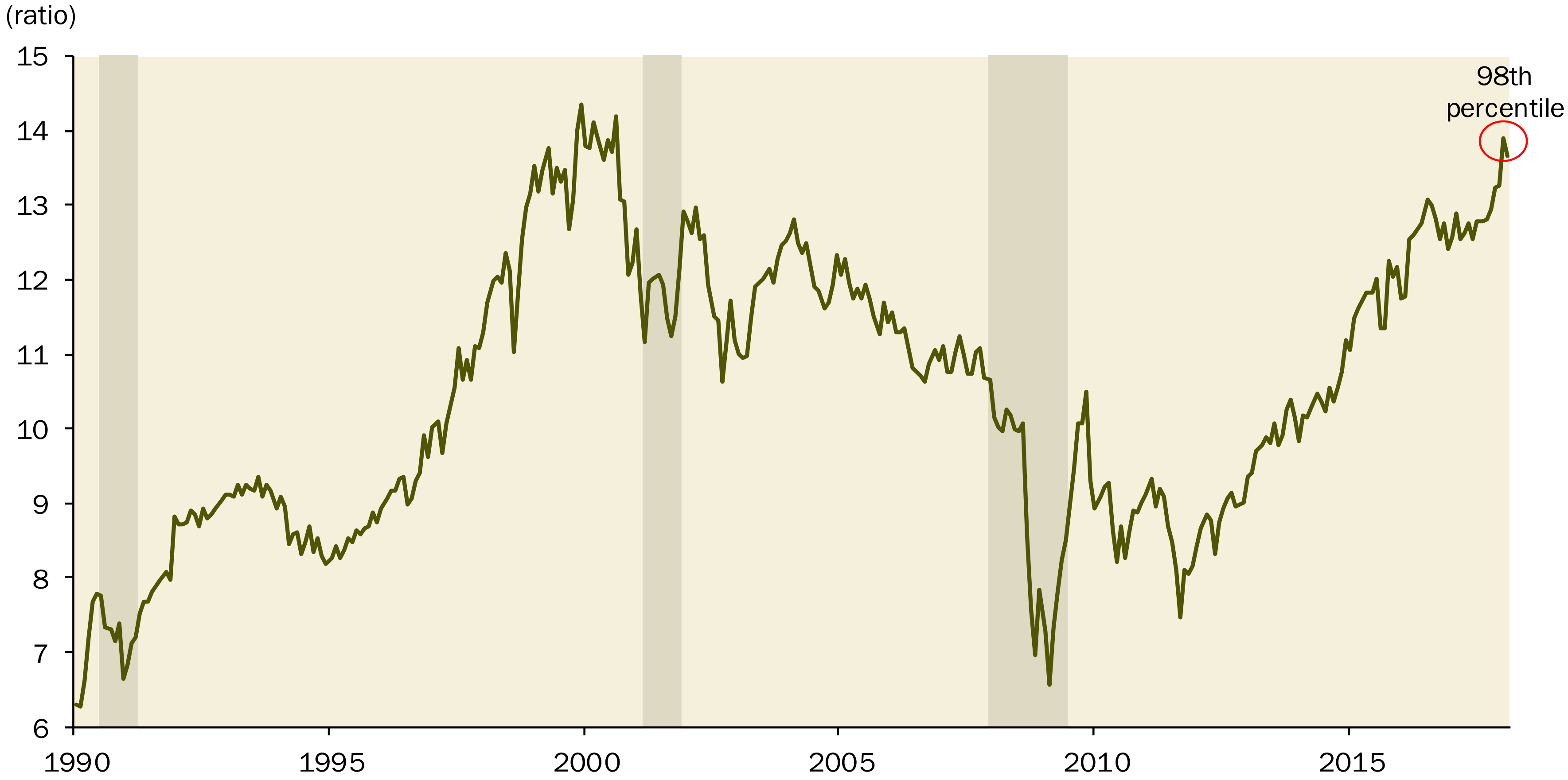
Notes:

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

MORE SIGNS OF EXCESSIVE VALUATIONS

United States: S&P 500 Enterprise Value to EBITDA Ratio



Notes:

Shaded regions represent periods of U.S. recession

Source: Bloomberg, Gluskin Sheff

PAYING MORE FOR SLOWER GROWTH!

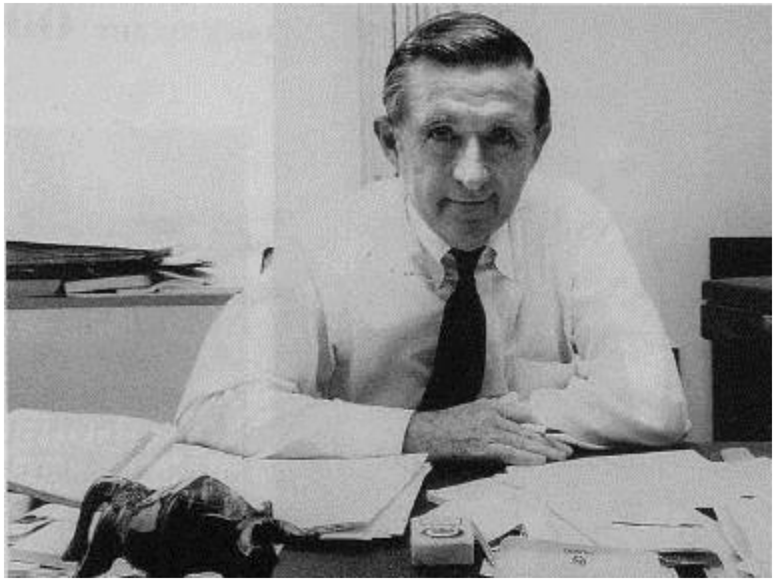
United States: Historical Bull Markets

(annualized percent change)

Trough Date	Peak Date	S&P 500	Nominal GDP	Real GDP	Months
13-Jun-49	15-Jul-57	17.3	7.3	4.6	97
22-Oct-57	3-Jan-62	15.4	5.4	3.8	51
26-Jun-62	29-Nov-68	12.0	7.7	5.0	77
26-May-70	11-Jan-73	23.3	10.0	5.1	32
3-Oct-74	28-Nov-80	14.1	10.8	3.2	73
12-Aug-82	16-Jul-90	17.5	7.6	4.2	95
11-Oct-90	24-Mar-00	19.0	5.6	3.5	113
9-Oct-02	9-Oct-07	15.0	5.8	2.9	60
9-Mar-09	16-Jan-18	17.3	3.6	2.1	106
Average		**16.8**	**7.1**	**3.8**	**78.2**
Median		**17.3**	**7.3**	**3.8**	**77.0**

Notes:
Source: Haver Analytics, Gluskin Sheff

BOB FARRELL'S 10 MARKET RULES TO REMEMBER

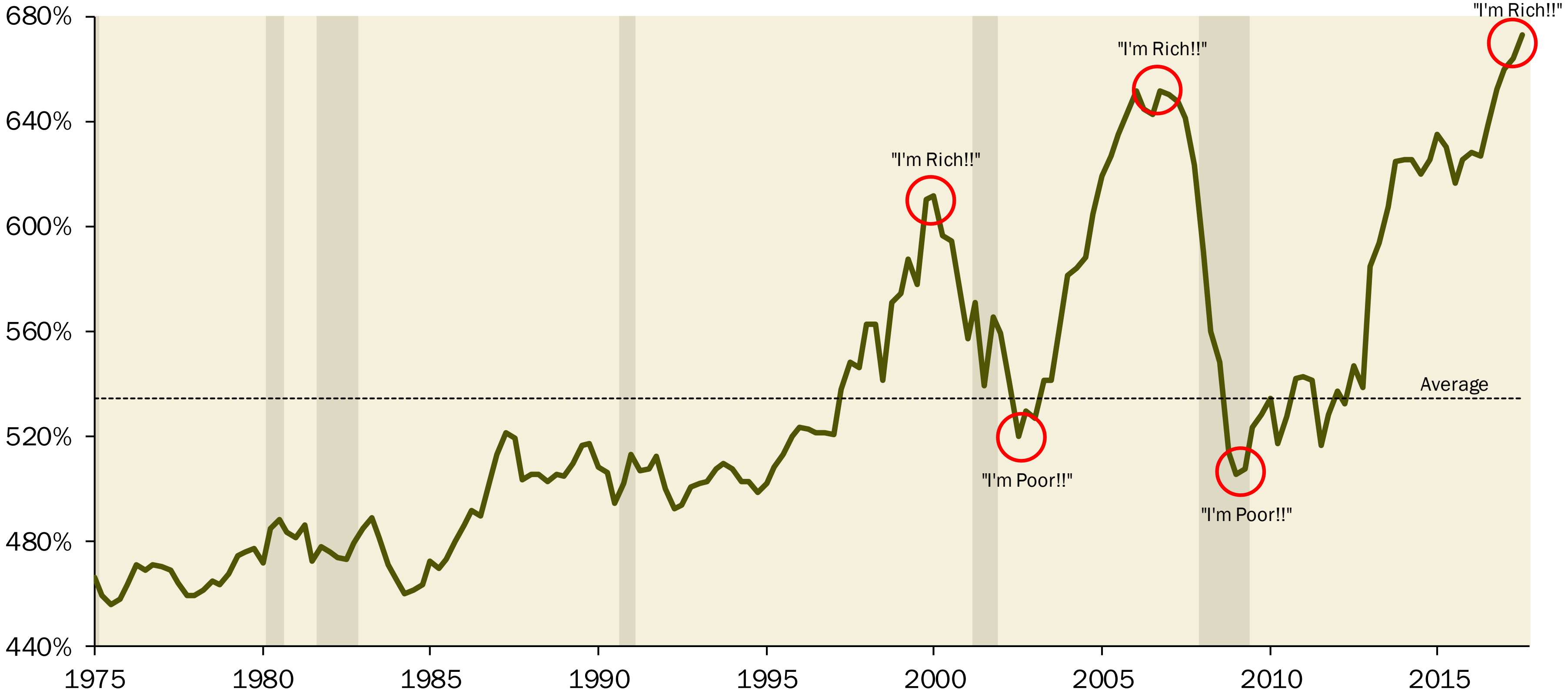


1. **Markets tend to return to the mean over time**
2. Excesses in one direction will lead to an opposite excess in the other direction
3. There are no new eras — excesses are never permanent
4. **Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways**
5. The public buys the most at the top and the least at the bottom
6. Fear and greed are stronger than long-term resolve
7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names
8. Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend
9. **When all the experts and forecasts agree — something else is going to happen**
10. Bull markets are more fun than bear markets

WHAT'S EVERY PEAK TYPICALLY FOLLOWED BY?

United States: Household Net Worth Share of Personal Disposable Income

(percentage)



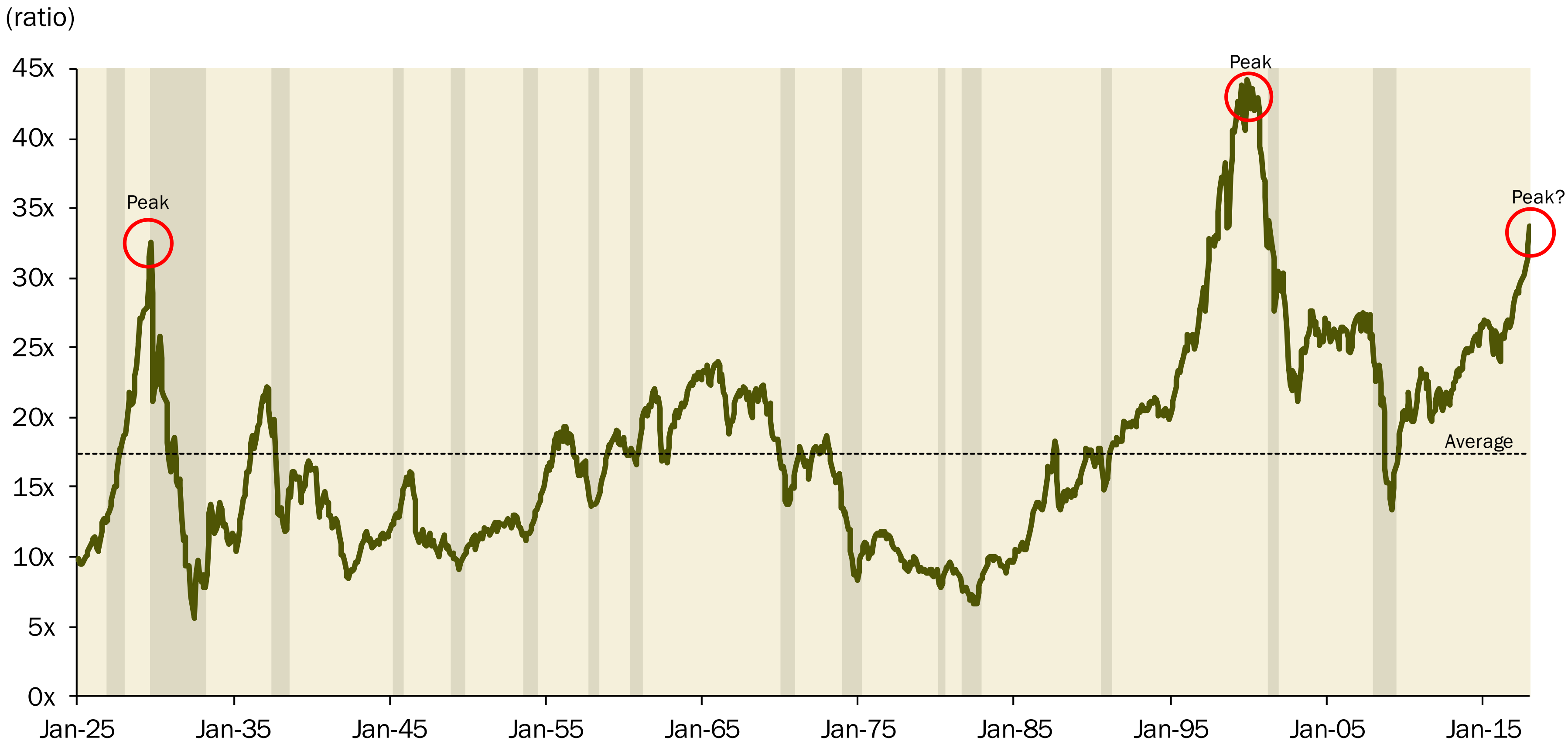
Notes:

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

THIRD MOST OVERVALUED STOCK MARKET

United States: Cyclically Adjusted Price-to-Earnings



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

SOME WARNINGS FROM THE SAN FRAN FED

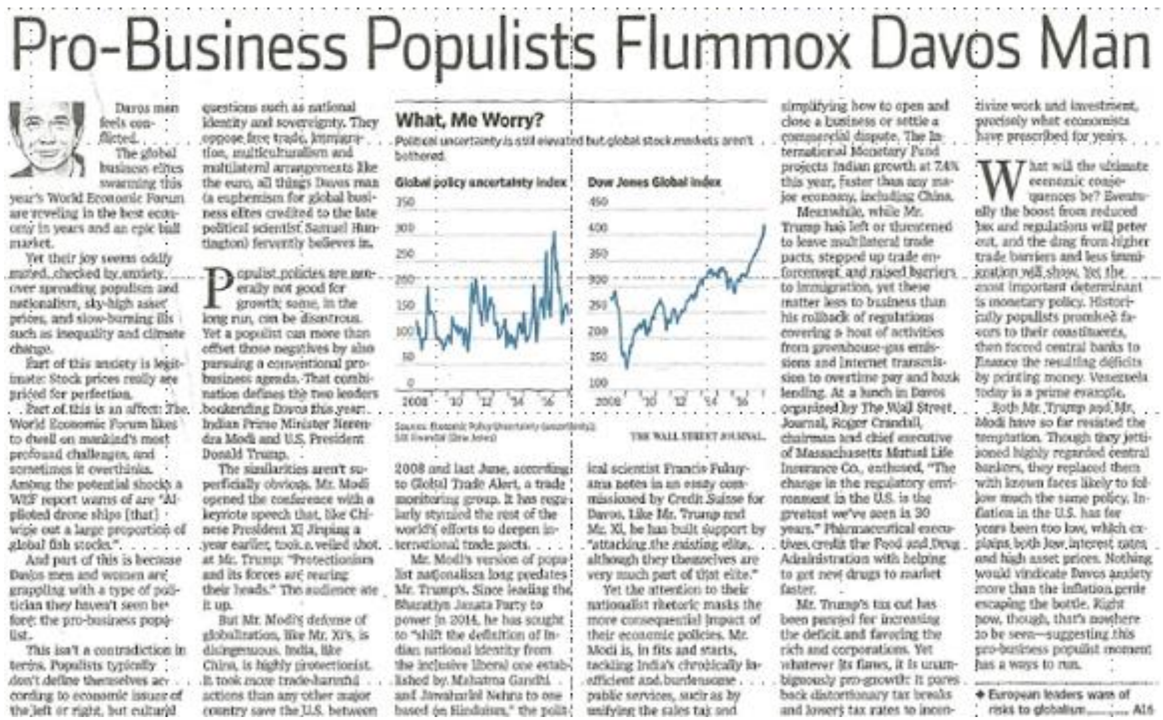
*"Current valuation ratios for households and businesses are high relative to historical benchmarks…**we find that the current price-to-earnings ratio predicts approximately zero growth in real equity prices over the next ten years.**"*

*"The net worth-to-income ratio — defined as household assets net of liabilities divided by personal disposable income — provides a valuation metric for a broad set of assets including debt, equity, and real estate weighted by the proportion in which they are being held by households. **Similar to the P/E ratio, this ratio tends to revert toward its historical average and does not remain at extreme values, either high or low, for prolonged periods.**"*

Notes:

Source: Valuation Ratios for Households and Businesses (January 8, 2018)

THE WALL STREET JOURNAL.



"What will the ultimate economic consequences be? Eventually the boost from reduced tax and regulations will peter out, and the drag from higher trade barriers and less immigration will show. <u>Yet the most important determinant is monetary policy</u>."

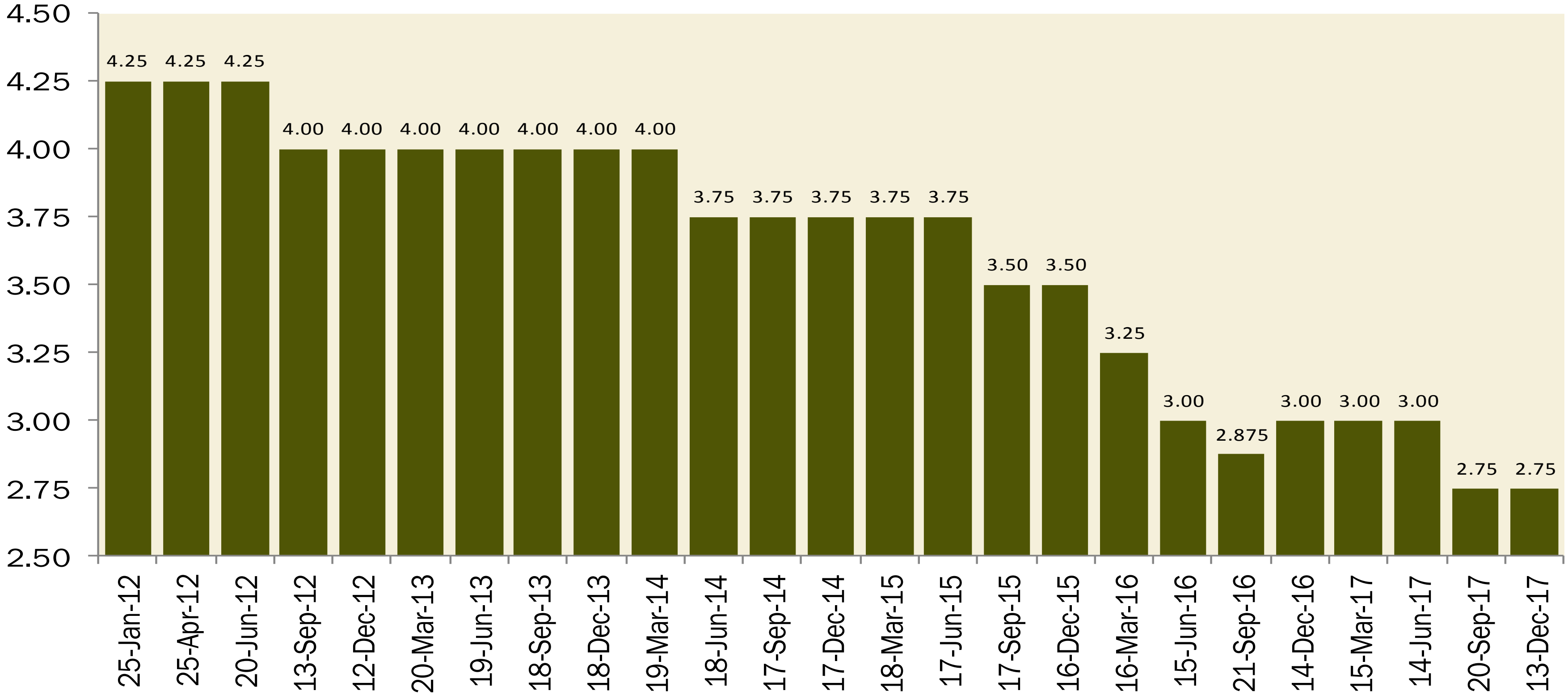
Notes:

Source: Wall Street Journal (January 25, 2018)

THE FED HAS SLICED ITS NEUTRAL POLICY RATE FORECAST

United States: Median FOMC Terminal Funds Rate Forecast

(percent)



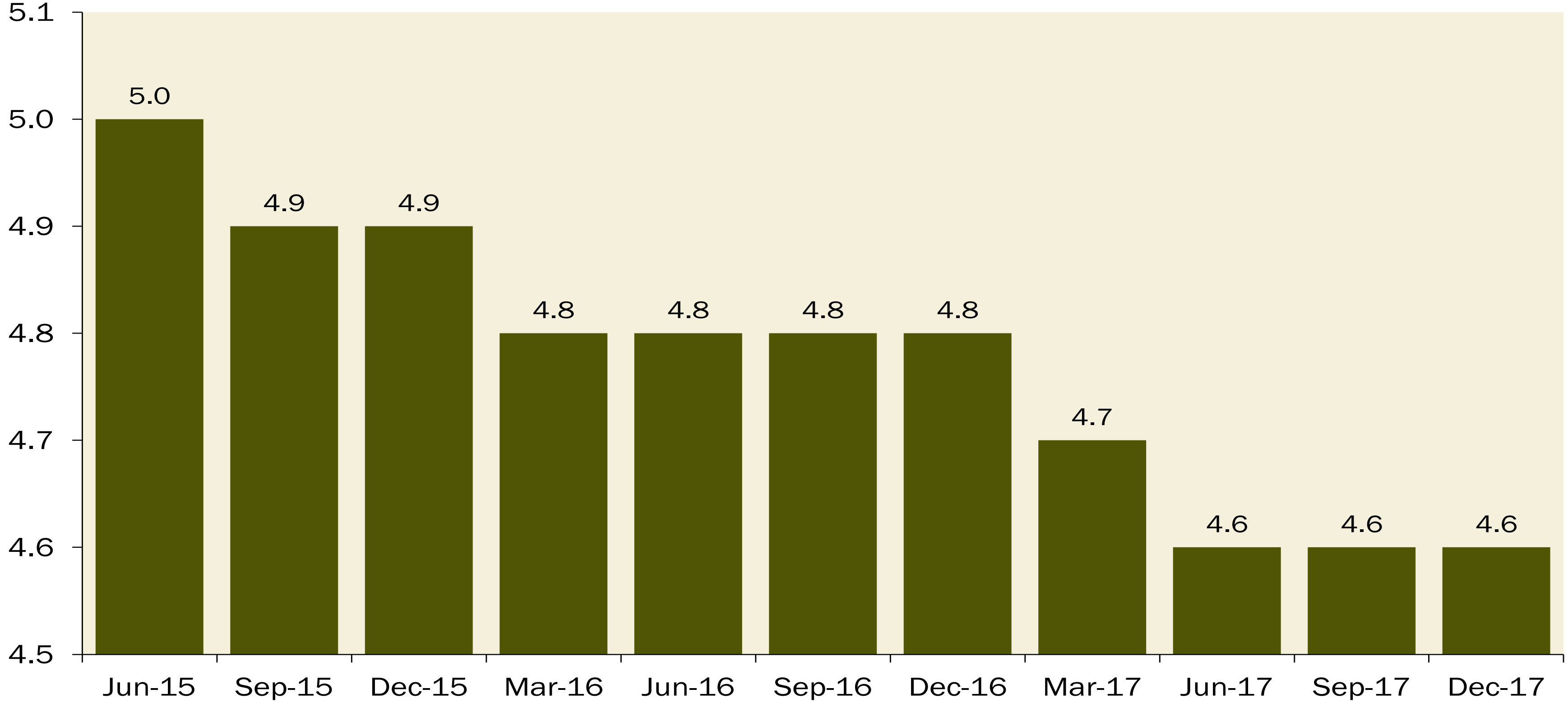
Notes:

Source: Federal Reserve, Gluskin Sheff

FED HAS TAKEN DOWN ITS NAIRU ESTIMATE OVER TIME AS WELL

United States: FOMC Full Employment Forecast

(percent)

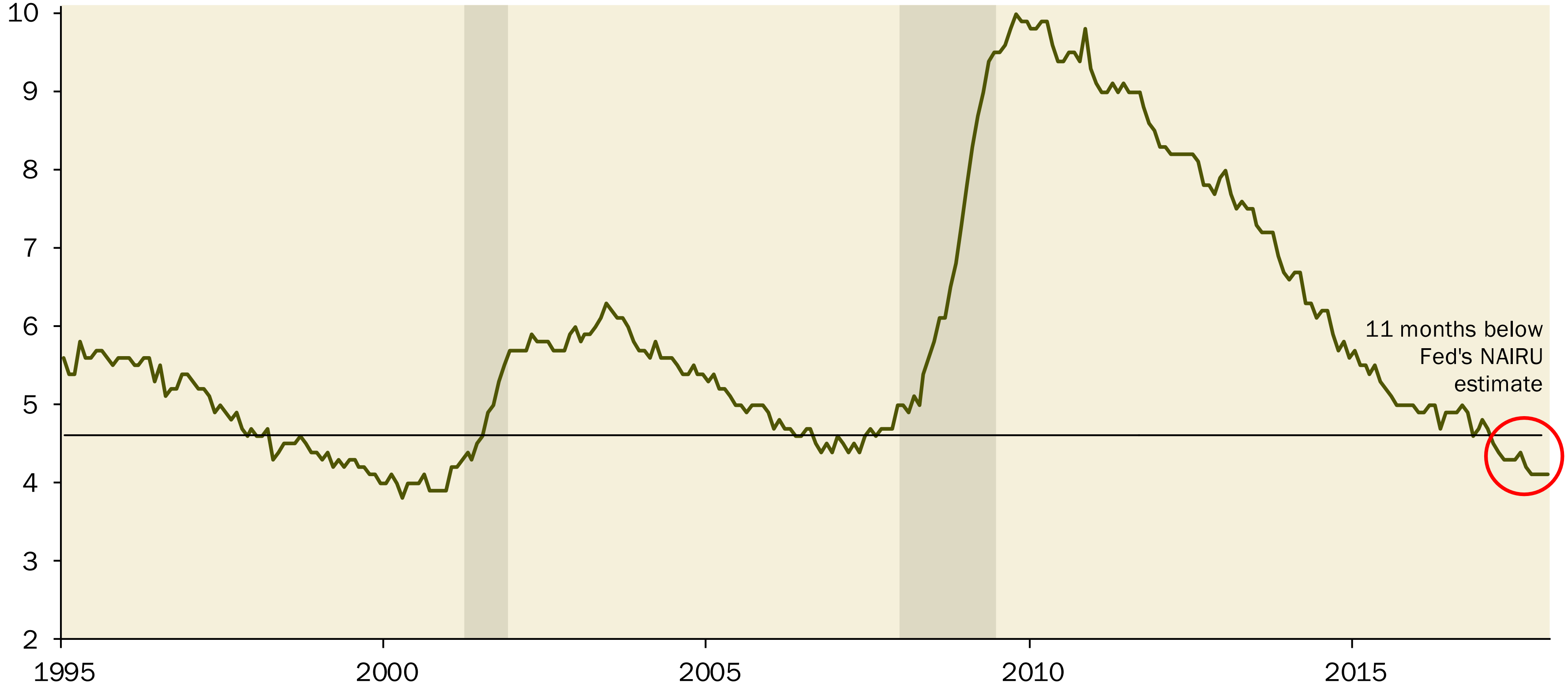


Notes:
Source: Federal Reserve, Gluskin Sheff

LITTLE (IF ANY) SLACK LEFT IN THE LABOR FORCE

United States: Unemployment Rate

(percent)



Notes:

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

IS 2% CORE INFLATION REALLY PRICE STABILITY?

***CHAIRMAN GREENSPAN**. Price stability is that state in which expected changes in the general price level do not effectively alter business or household decisions.*

***MS. YELLEN**. Could you please put a number on that?*

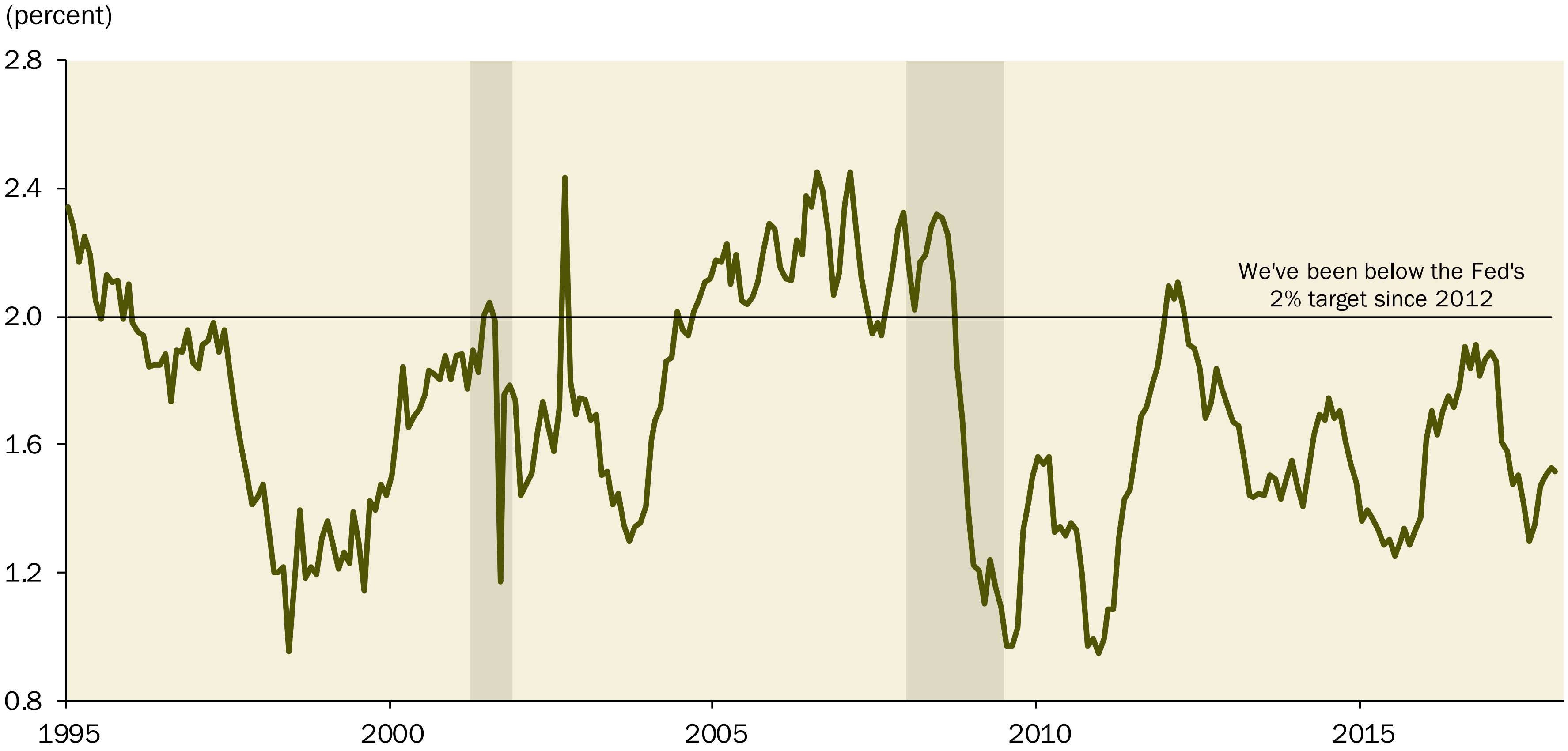
***CHAIRMAN GREENSPAN**. <u>I would say the number is zero</u>, if inflation is properly measured.*

-July 3rd, 1996

Notes:
Source: Meeting of the FOMC (July 2-3, 1996)

AN EVER-ELUSIVE 2% TARGET

United States: Core PCE

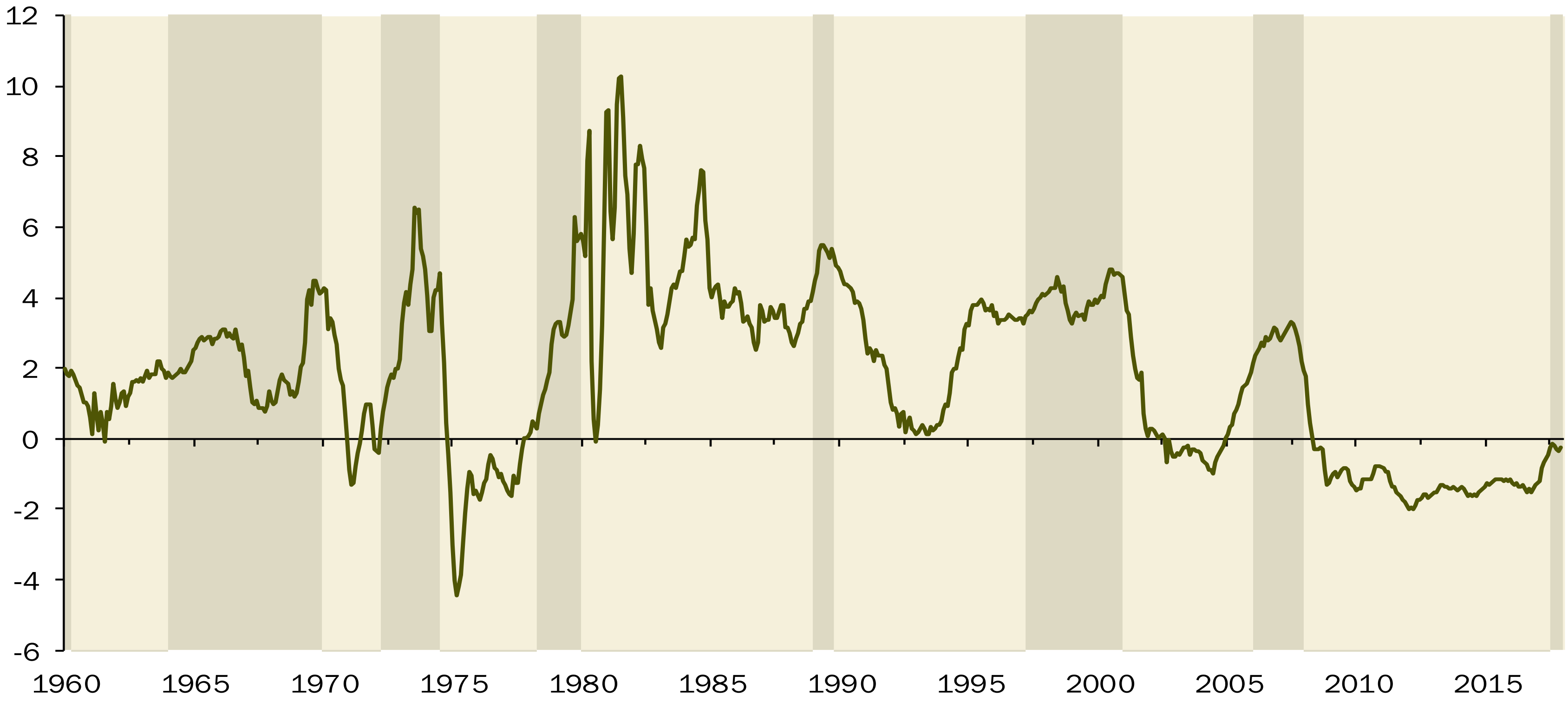


Notes:
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

NEGATIVE REAL FUNDS RATE AT FULL EMPLOYMENT??

United States: Real Federal Funds Rate

(percent)



Notes:

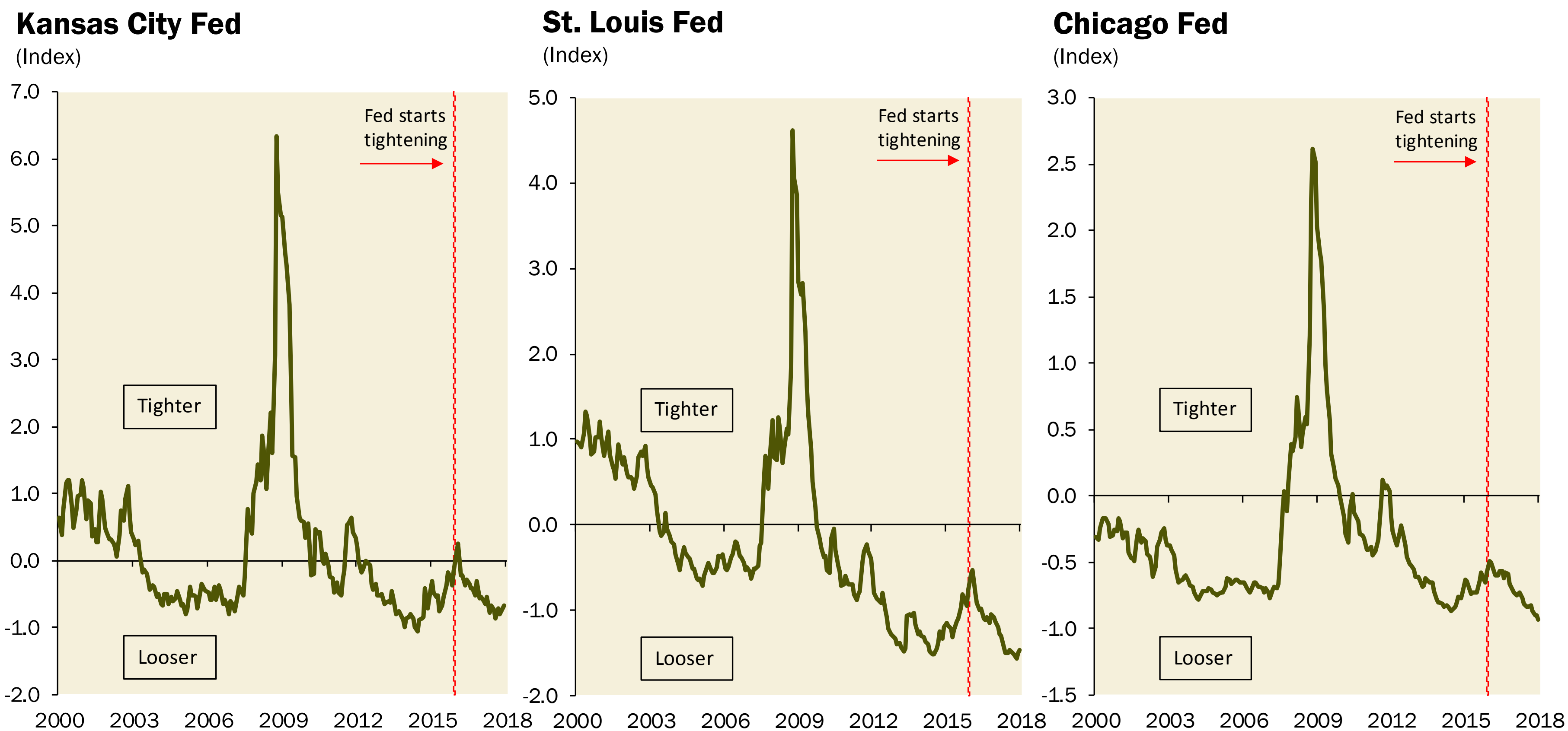
Real fed funds rate = nominal fed funds rate less core PCE inflation

Shaded regions represent periods where the output gap has closed

Source: Haver Analytics, Gluskin Sheff

EASIER FINANCIAL CONDITIONS DESPITE FED TIGHTENING!

United States: Financial Conditions (Positive = Tighter)



Notes:
Source: Haver Analytics, Gluskin Sheff

THE WALL STREET JOURNAL.

CAPITAL ACCOUNT | By Greg Ip

For Fed, Stock Boom Brings Bubble Déjà Vu

Any central banker watching the stock market today should get a queasy sense of déjà vu.

A housing boom preceded the last recession. A tech stock bubble ushered in its forerunner.

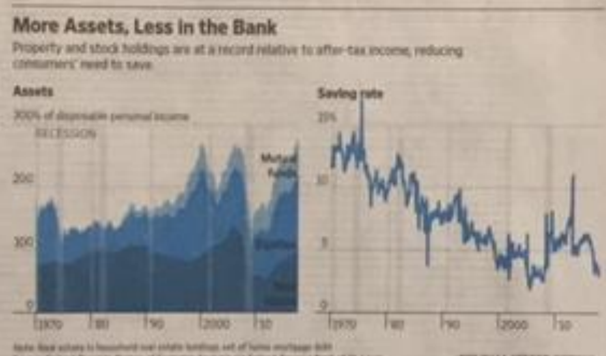
Today, stock and property prices are once again setting records, in absolute terms and relative to household incomes. That may leave the Federal Reserve and Jerome Powell, nominated to succeed Janet Yellen as Fed chair next month, confronting some agonizing trade-offs in the next year or two: What if low inflation calls for low interest rates but those low interest rates make an eventual, destructive asset bust more likely? Should he lean against an incipient bubble by raising rates faster now, or plan to mop up the mess if assets collapse later?

loan losses and is more closely regulated. Credit growth isn't excessive.

Stock price-to-earnings ratios are by some measures the highest since 1999, but today's are more justifiable. In 1999, government bonds yielded 6%; today, they yield 2.6%, which makes them a less appealing alternative to stocks. Moreover, even if stocks fell, that wouldn't necessarily destabilize the financial system.

"When we look at other indicators of financial stability risks, there's nothing flashing red there, or possibly even orange," Ms. Yellen said in December.

Yet it doesn't take a crisis for an asset bust to hurt. The 1990s tech stock run-up fueled a surge in investment and spending via higher wealth and easier financing conditions. When the bubble burst in 2001, that surge reversed, dragging the economy down. The damage was contained because the Fed



personal saving rate below 3%, the lowest since 2007. Both spending and stocks have gotten an added kick from the recent tax cut.

It isn't a stretch to see all those factors switching

in spending. In such a world, getting interest rates correct could achieve both low, stable inflation and sustainably low unemployment, which economists dubbed the "divine coincidence."

they concluded no: pre-emptively pricking bubbles seemed much riskier than letting them burst of their own accord. They are less dogmatic now. Though officials' first choice is to use regula-

bility concerns and asset prices. In a 2016 study, Federal Reserve Bank of Boston President Eric Rosengren and two co-authors counted how often words such as "bubble," "bust," "crisis" and "volatility" appeared in transcripts of monetary-policy discussions at Fed meetings. They found that such worries tended to move interest rates more than mere considerations of inflation and unemployment could justify, although the influence was stronger when rates were falling than rising.

Mr. Powell largely agrees with his predecessors that monetary policy should be a last resort for dealing with financial excess. Yet his bar doesn't appear to be as high. When Mr. Powell joined the Fed in 2012, he told colleagues he worried that the Fed's bond-buying program could fuel risk-taking down the road, according to meeting transcripts released last week.

Notes:
Source: The Wall Street Journal (January 11, 2018)

WHAT EVER HAPPENED TO TAKING THE PUNCH BOWL AWAY?

*…**The Federal Reserve, as one writer put it, after the recent increase in the discount rate, is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up**…Nowadays, there is perhaps a tendency to exaggerate the effectiveness of monetary policy in both directions. Recently, opinion has been voiced that the country's main danger comes from a roseate belief that monetary policy, backed by flexible tax and debt management policies and aided by a host of built-in stabilizers, has completely conquered the problem of major economic fluctuations and relegated them to ancient history. This, of course, is not so because we are dealing with human beings and human nature.*

— William McChesney Martin, October 19th, 1955

*Inflation was 0.4% the day of this speech; 2.2% a year later

THE START OF THE 'GREENSPAN PUT'

"I still do not believe we are out of the woods on the market; I don't think all of the yield spreads have gotten back to where they were. All objective measures of stock market levels suggest that, if anything, we are still above normal and that we are vulnerable to a significant decline. ***Consequently, even though under normal circumstances I would say that in this type of environment we probably should be in something of a tightening mode, if rates go up under these conditions I suspect the stock market would go down, and I'm fearful of the extent of that particular decline****."*

— December 16, 1987

*"****What's concerning me is that there is a vulnerability out there which is continuing to heal but is not healed yet****. And I'm basically concerned, in a way which in fact Governor Seger raised, that* ***if we were to indicate that we were tightening, the shock to the markets I think would break the stock market and create some real problems****. "*

— February 10, 1988

Notes:

Source: Meeting of the FOMC (December 15-16, 1987); Meeting of the FOMC (February 9-10, 1988)

FOLLOWED BY THE ‘BERNANKE PUT’ (WHAT HE SAID THE DAY AFTER QE2)

“Stock prices rose and long-term interest rates fell when investors began to anticipate the most recent action. Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. ***And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending****. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion.”*

— November 4, 2010

Notes:
Source: What the Fed did and why: supporting the recovery and sustaining price stability; Washington Post (November 4, 2010)

THE 'YELLEN PUT' HAD AN EVEN HIGHER STRIKE PRICE!

"…*We also face the serious risk that inflation, which we currently forecast to run below our target, could decline further over time, raising real interest rates and thereby making it yet more difficult for monetary policy to provide meaningful stimulus.* ***Under such circumstances, there is an important benefit from conveying that <u>we do not intend to take the punch bowl away</u> just as the party is getting going.*** *Frankly, I worried at the time of our September meeting that our open-ended purchase program would be interpreted by markets as tepid support for accommodation. Instead, just the opposite occurred. By linking our purchases to significant improvements in the outlook for the labor market, and coupling this commitment with the statement that we intend to keep rates low as the economic recovery strengthens,* ***we communicated that <u>we will at least keep refilling the punch bowl until the guests have all arrived</u>, and will not remove it prematurely before the party is well under way****…"*

— December 12, 2012

Notes:
Source: Meeting of the FOMC (December 11-12, 2012)

JANET DIDN'T EVEN SEE ORANGE AS THE MARKET WAS SOARING TO THE HIGHS

"I think when we look at other indicators of financial stability risks, there is nothing flashing red there or possibly even orange."

-December 13th, 2017

	Dec. 2017	20-year Avg.
Trailing P/E	22.2x	19.5x
Forward P/E	18.3x	16.3x
High Yield Spreads	364 basis points	582 bps

Notes:
Source: FOMC Press Conference (December 13, 2017)

The Economics of the Fed Put

Anna Cieslak (Duke University) and Annette Vissing-Jorgensen (University of California Berkeley)

*In summary, the Fed pays attention directly to the stock market rather than merely to variables correlated with the stock market…. **these facts are consistent with the view that the stock market is a causal factor influencing Fed policy making**.*

*Our textual analysis suggests that **the Fed’s focus on the stock market is driven a lot by its concern about the effect of stock market declines have on consumption**, with a relatively smaller weight put on other GDP components.*

*Discussions of stock market conditions by the FOMC attendees are most frequently cast in the context of consumption, **with the consumption-wealth effect highlighted as one of the main channels through which the stock market affects the economy**.*

This result confirms the Fed thinking causally about the stock market as a driver of the economy and the Fed updating its expectations of future economic conditions accordingly. At a time when it has come under criticism for focusing too much on asset prices it would be useful for the Fed to lay out whether it believes the stock market should have an independent impact on the target beyond its effects on Fed growth and inflation expectations.

Notes:
Source: The Economics of the Fed Put (December, 2016)

POWELL CAUTIOUS ON RISK-TAKING

	Oct. 2012	Apr. 2015	Today
Trailing P/E	14.5x	18.8x	21.9x
Forward P/E	12.7x	16.9x	17.0x
High Yield Spreads	554 bps	459 bps	365 bps

*“**I think we are actually at a point of encouraging risk-taking, and that should give us pause**. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but that they have every incentive to take more risk, and they are doing so.”*

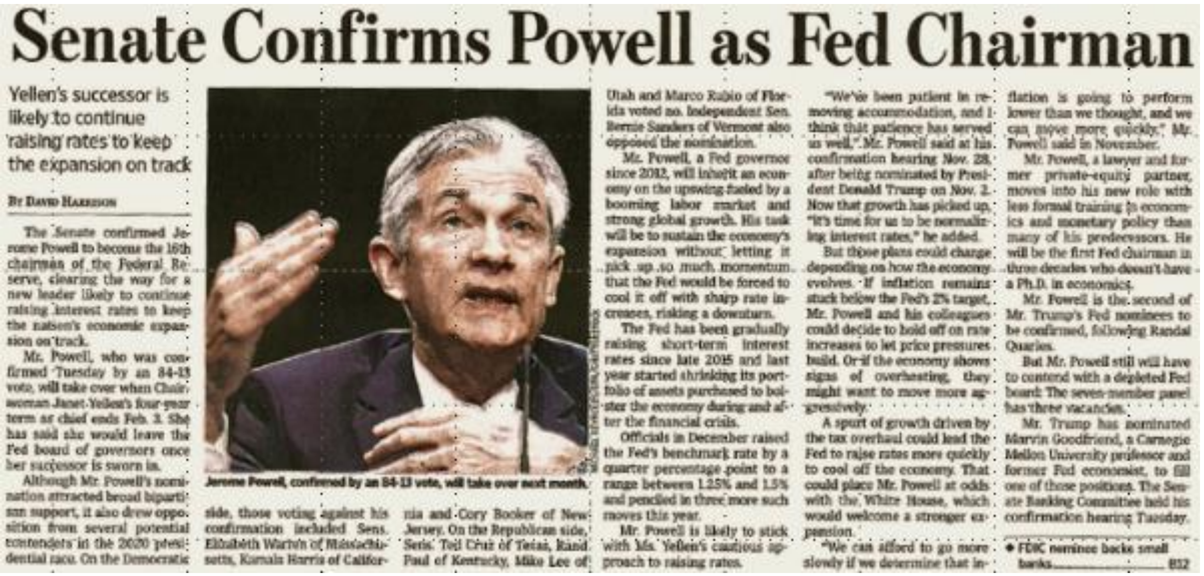
-October 24, 2012

*“Overly accommodative monetary policy also poses risks. First, the economy could overheat, and rising inflation could require the Committee to raise rates faster, which--if overdone--could produce a damaging recession. **For now, I would be more concerned with a second risk, which is that more-accommodative policy could lead to frothy financial conditions and eventually undermine financial stability**. While I do not see a troubling buildup of these risks today, tighter monetary policy might eventually be necessary if such risks do appear.”*

-April 8, 2015

Notes:
Source: Meeting of the FOMC (October 23-24, 2012), Speech at the C. Peter McColough Series (April 8, 2015)

THE WALL STREET JOURNAL.



Senate Confirms Powell as Fed Chairman

Yellen's successor is likely to continue raising rates to keep the expansion on track

By David Harrison

The Senate confirmed Jerome Powell to become the 16th chairman of the Federal Reserve, clearing the way for a new leader likely to continue raising interest rates to keep the nation's economic expansion on track.

Mr. Powell, who was confirmed Tuesday by an 84-13 vote, will take over when Chairwoman Janet Yellen's four-year term as chief ends Feb. 3. She has said she would leave the Fed board of governors once her successor is sworn in.

Although Mr. Powell's nomination attracted broad bipartisan support, it also drew opposition from several potential contenders in the 2020 presidential race. On the Democratic side, those voting against his confirmation included Sens. Elizabeth Warren of Massachusetts, Kamala Harris of California and Cory Booker of New Jersey. On the Republican side, Sens. Ted Cruz of Texas, Rand Paul of Kentucky, Mike Lee of Utah and Marco Rubio of Florida voted no. Independent Sen. Bernie Sanders of Vermont also opposed the nomination.

Mr. Powell, a Fed governor since 2012, will inherit an economy on the upswing fueled by a booming labor market and strong global growth. His task will be to sustain the economy's expansion without letting it pick up so much momentum that the Fed would be forced to cool it off with sharp rate increases, risking a downturn.

The Fed has been gradually raising short-term interest rates since late 2015 and last year started shrinking its portfolio of assets purchased to bolster the economy during and after the financial crisis.

Officials in December raised the Fed's benchmark rate by a quarter percentage point to a range between 1.25% and 1.5% and penciled in three more such moves this year.

Mr. Powell is likely to stick with Ms. Yellen's cautious approach to raising rates.

"We've been patient in removing accommodation, and I think that patience has served us well," Mr. Powell said at his confirmation hearing Nov. 28, after being nominated by President Donald Trump on Nov. 2. Now that growth has picked up, "it's time for us to be normalizing interest rates," he added.

But those plans could change depending on how the economy evolves. If inflation remains stuck below the Fed's 2% target, Mr. Powell and his colleagues could decide to hold off on rate increases to let price pressures build. Or if the economy shows signs of overheating, they might want to move more aggressively.

A spurt of growth driven by the tax overhaul could lead the Fed to raise rates more quickly to cool off the economy. That could place Mr. Powell at odds with the White House, which would welcome a stronger expansion.

"We can afford to go more slowly if we determine that inflation is going to perform lower than we thought, and we can move more quickly," Mr. Powell said in November.

Mr. Powell, a lawyer and former private-equity partner, moves into his new role with less formal training in economics and monetary policy than many of his predecessors. He will be the first Fed chairman in three decades who doesn't have a Ph.D. in economics.

Mr. Powell is the second of Mr. Trump's Fed nominees to be confirmed, following Randal Quarles.

But Mr. Powell still will have to contend with a depleted Fed board: The seven-member panel has three vacancies.

Mr. Trump has nominated Marvin Goodfriend, a Carnegie Mellon University professor and former Fed economist, to fill one of those positions. The Senate Banking Committee held his confirmation hearing Tuesday.

Jerome Powell, confirmed by an 84-13 vote, will take over next month.

◆ FDIC nominee backs small banks B12

***"We've been patient in removing accommodation, and I think that patience has served us well**, Mr. Powell said at his confirmation hearing Nov. 28, after being nominated by President Donald Trump on Nov. 2. Now that growth has picked up, **"it's time for us to be normalizing interest rates" he added**"*

Notes:

Source: Wall Street Journal (January 24, 2018)

A BRAND NEW FED (AND MORE HAWKISH!)

2017 (Start)	2018
Brainard (Dove)	Barkin (Unknown)
Dudley (Moderate)	Bostic (Moderate)
Evans (Dove)	Brainard (Dove?)
Fischer (Moderate)	Dudley (Retiring)
Harker (Moderate)	Goodfriend (Hawk)
Kaplan (Dove)	Mester (Hawk)
Kashkari (Dove)	Powell (Moderate)
Powell (Moderate)	Quarles (Hawk)
Tarullo (Moderate)	Williams (Hawk)
Yellen (Moderate)	Yellen (Retiring)

- No hawks, four doves
- Four hawks, one dove

EVEN THE FED DOVES SEE THE IMBALANCES THEY CREATED

“***Finally, a low neutral rate environment may also be associated with a heightened risk of asset price bubbles, which could exacerbate the tradeoff for monetary policy between achieving the traditional dual-mandate goals and preventing the kinds of imbalances that could contribute to financial instability****. Standard asset-valuation models suggest that a persistently low neutral rate, depending on the factors driving it, could lead to higher ratios of asset prices to underlying income flows--for example, higher ratios of prices to earnings for stocks or higher prices of buildings relative to rents.* ***If asset markets were highly efficient and participants had excellent foresight, this would not necessarily lead to imbalances. However, to the extent that financial markets extrapolate price movements, markets may not transition smoothly to asset valuations that reflect underlying fundamentals but may instead evidence periods of overshooting****. Such forces may have played a role in both the stock market boom that ended in the bust of 2001 and the house price bubble that burst in 2007-09.”*

— October 12, 2017

Notes:
Source: Rethinking Monetary Policy in a New Normal (October 12, 2017)

THE WALL STREET JOURNAL.

Stocks Are Headed for a Fall

By Martin Feldstein

Year after year, the stock market has roared ahead, driven by the Federal Reserve's excessively easy monetary policy. The result is a fragile financial situation—and potentially a steep drop somewhere up ahead.

To deal with the Great Recession, the Fed cut interest rates to a historic low. The short-term federal-funds rate hit 0.15% in January 2009 and stayed there until the end of 2015. In a strategy aimed at reducing long-term rates, the Fed under then-Chairman Ben Bernanke promised to keep short-term rates close to zero until the economy fully recovered. The Fed also began buying long-term bonds and mortgage-backed securities, more than quintupling its balance sheet from nearly $900 billion in 2008 to $4.4 trillion now.

The Fed is playing catch-up. As interest rates and inflation rise, asset prices will revert to earlier norms.

Mr. Bernanke explained that this "unconventional" monetary policy was designed to encourage an asset-substitution effect. Investors would shift out of bonds and into equities and real estate. The resulting rise in household wealth would push up consumer spending and strengthen the economic recovery.

The strategy eventually worked as Mr. Bernanke had predicted. The value of equities owned by households increased 47% between 2011 and 2013, and overall household net worth rose nearly $30 trillion in 2013 alone. The S&P 500 stock index gained more than 200% in the seven years from 2009 to the month before the 2016 election. By now the total increase is more than 300%.

Stock prices rose much faster than profits did. The price/earnings ratio for the S&P 500 is now 26.8, higher than at any time in the 100 years before 1998 and 70% above its historical average. Although some of the market's recent surge reflects improved expectations since the 2016 election, the P/E ratio just before the election was already 49% higher than its historical average.

The high price of stocks reflects the very low returns available on fixed-income securities. Though the federal-funds rate has been raised since 2015, its real value is still negative. The 2.5% yield on 10-year Treasury bonds approximately equals expected inflation over the next decade, implying a real yield of zero. Historically the real yield on 10-year Treasurys was about 2%.

When interest rates rise back to normal levels, share prices are also likely to revert to previous norms. If the P/E ratio declines to its historical average, the implied fall in the market would reduce the value of household equities held directly and through mutual funds by $10 trillion. If every dollar of decline in household wealth reduces annual consumer spending by 4 cents, as experience suggests, spending would fall by $400 billion, or more than 2% of gross domestic product. The drop in equity prices would also raise the cost of equity capital, reducing business investment and further depressing GDP.

What about interest rates on bonds? I see four different reasons for a coming increase.

First, the Fed is raising the short-term rate and will continue to do so at least until its favored inflation measure, the price of personal consumption expenditures or PCE, moves from its current 1.8% to the stated target of 2%. Higher short rates will cause long rates to rise even if the slope of the yield curve does not increase.

Second, the Fed is cutting its balance sheet by reducing its holdings of Treasury bonds, pushing up the interest rate needed to get the market to absorb the greater suppl of securities.

Third, the federal governmen deficit of 3.5% of GDP means Wash ington will borrow some $700 billio this year. The Congressional Budg Office forecasts that the deficit w grow to more than 5% of GDP ov the next decade under current la That would push America's debt-t GDP ratio from 77% now to 97% 2027. This is probably too optim tic. Spending on defense and disc tionary programs is shrinking a share of GDP, and the need to verse this trend means the defic and debt will be even greater th current law suggests. Buyers of t increased U.S. debt will requir higher interest rate.

Fourth, easy monetary policy produced an overly tight labor m ket that is beginning to push up flation. The consumer price in rose 2.1% over the past 12 mon and there is an increased risk th some point inflation will shoot ward. The expectation of rapid i tion will cause long-term rate rise even before that faster infla occurs.

In short, an excessively easy m etary policy has led to overvalue uities and a precarious financial ation. The Fed should have st raising the fed-funds rate se years ago, reducing the incenti investors to reach for yield and up equity prices. Since it didn't the Fed now faces the difficult lenge of trying simultaneous contain inflation and reduce t cess asset prices—without p the economy into recession.

Mr. Feldstein, chairman Council of Economic Advisers President Reagan, is a profe Harvard and a member of th nal's board of contributors.

*"In short, an excessively easy monetary policy has led to overvalued equities and a precarious financial situation. **The Fed should have started raising the fed-funds rate several years ago, reducing the incentive for investors to reach for yield and drive up equity prices.** Since it didn't do so, the Fed now faces the difficult challenge of trying simultaneously to contain inflation and reduce the excess asset prices – without pushing the economy into recession."*

Notes:

Source: The Wall Street Journal (January 17, 2018)

THE WALL STREET JOURNAL.

REVIEW & OUTLOOK

The Tax-Reform Stock Rally

Animal spirits are unleashed, but watch the Fed's great unwinding.

Equity markets took a mild breather on Tuesday afternoon after another morning rally, pausing on what has been a remarkable runup so far in 2018, following eye-popping gains since Election Day in 2016 and throughout 2017. The latest gains look like a tax-reform rally, though it will pay to be mindful that markets inevitably correct, often hard.

We've been hosting an op-ed debate on stock prices, and last week financial consultant Donald Luskin made his case for the running of the bulls as expected corporate earnings are adjusted upward due to tax reform. Harvard economist Martin Feldstein makes the case for caution nearby, arguing that equity prices are fated to fall as the Federal Reserve reverses its long period of asset purchases and low interest rates, and inflation makes a comeback. Both men could be right, depending on your investment time frame.

The bullish case is based on expectations of capitalized profits, which have risen smartly with the cut in corporate tax rates. The higher after-tax returns flow into higher asset values, all else being equal. The surprise is that stocks have kept rising this year, with the S&P 500 up some 4%. This suggests that many investors underestimated the possibility of pro-growth tax reform passing last year, and now they are catching up to the implications.

The harder question is whether rising stocks are also a harbinger of faster growth in the real economy. Business sentiment, from the Business Roundtable to the National Federation of Independent Business, is as bullish as we can recall. Business Roundtable chief Jamie Dimon, also CEO of J.P. Morgan, captured the mood last week when he said "animal spirits" have been unleashed.

He cited tax reform and "proper smart regulation," while the global economy is also growing in sync for a change. With investors willing to take more risks, emerging markets are seeing capital inflows as are Japan and Europe. This greater appetite may explain why the U.S. dollar has been relatively weak despite signs of better U.S. policy and faster growth. Maybe investors feel a reduced need to park money in the safety of dollar assets or Treasurys.

But don't forget Mr. Feldstein's warning about the Fe[d] and its great monetary unwinding. Former Fed Chairman Ben Bernanke justified quantitative easin[g] (QE) as a tool to drive investors into riskier assets, including stocks, which would create [a] "wealth effect" to spur the real economy. H[e] succeeded on asset prices but failed on growt[h] which didn't accelerate until better tax an[d] regulatory policies arrived. But if QE lifte[d] stocks as it expanded, will the reverse happe[n] as it unwinds?

It's certainly possible, and students of fina[n]cial history know that sooner or later rising i[n]terest rates will weigh on stock prices. This [is] another way of saying that the biggest thre[at] to growth and financial markets—Dona[ld] Trump's trade agenda or a Speaker Pel[osi] aside—may be the Federal Reserve as it [re]verses Mr. Bernanke's experiment. Mr. Be[r]nanke has already taken a half dozen victo[ry] laps, but they'll have been premature if the [un]winding leads to asset selloffs that create fin[an]cial disruption and a recession.

All of which underscores the importance [of] timing of the GOP tax reform. The current [ex]pansion is already historically long, if also [his]torically weak, and it has needed a second w[ind]. Businesses have had plenty of capital, at h[ome] and abroad, but they had been reluctant to [de]ploy it given the uncertainty of how and w[hat] the Obama regulators and taxers might st[rike] next. Donald Trump's deregulators hav[e re]moved the fear of arbitrary political pu[nish]ment, and now tax reform is raising the ex[pec]tations of returns on investment.

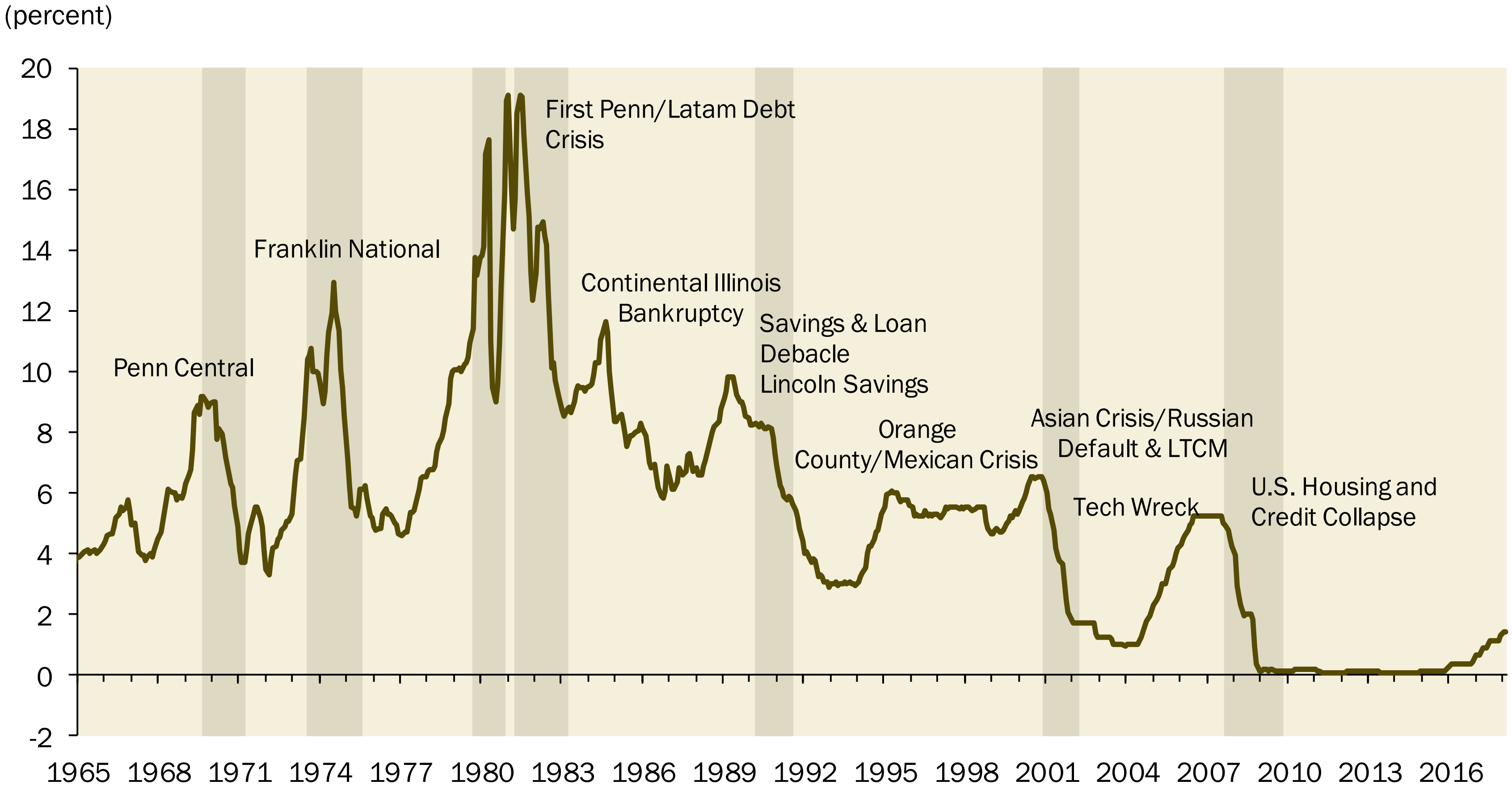
This is the cause for economic optimism [and] bullish equities, but keep in mind that [we've] never lived through a monetary-policy re[versal] like the one that is coming.

"This is the cause for economic optimism, and bullish equities, ***but keep in mind that we've never lived through a monetary-policy reversal like the one that is coming.****"*

Notes:
Source: The Wall Street Journal (January 17, 2018)

FED TIGHTENING CYCLES AND FINANCIAL EVENTS

United States: Federal Funds Rate



Notes:

Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

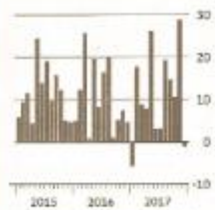
LATE-CYCLE EROSION IN CREDIT QUALITY

FINANCIAL TIMES

Big buyers of US corporate paper show signs of pulling back

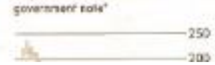
International investors shed corporate bonds in December

Purchases and sales of US corporate bonds by non-US investors ($bn)



US credit returns eroded by rising hedging costs

Relative value for buying a US corporate bond over a local government note*



Lending

US consumers struggle to repay credit card debt

ALISTAIR GRAY — NEW YORK

Overdue US credit card debt has reached a seven-year high, underlining the difficulties faced by many consumers in spite of the strong performance of the economy.

Banking sector data show consumers were at least three months behind repayments or considered otherwise distressed on $11.9bn of credit card debt at the turn of the year, a rise of 11.5 per cent during the fourth quarter.

More Americans are also falling behind on their mortgages, for which problematic debt levels rose 5.2 per cent over the same period to $56.7bn.

In contrast, the level of commercial and industrial loans that banks deemed to be problematic dropped 8.5 per cent to $18.1bn.

Top bankers shrug off concerns about the increasing losses, arguing they are to be expected after a post-crisis recovery in lending. The credit card charge-off rate rose from 3.46 per cent in the previous quarter to 3.77 per cent but remains far short of crisis-era levels.

Gordon Smith, JPMorgan Chase's retail banking chief, told investors yesterday that he was "very encouraged" by the health of his customer base. "The absolute level of losses on any basis is still exceptionally strong," he said.

However, Torsten Slok, chief international economist at Deutsche Bank, said investors were increasingly questioning US consumer wellbeing. Household wealth and unemployment metrics were solid but poorer families had failed to benefit from inflated asset

Notes:
Source: Financial Times (March 1, 2018)

BAIR-ISH!

BARRON'S


The Seeds of Another Financial Crisis

by Reshma Kapadia

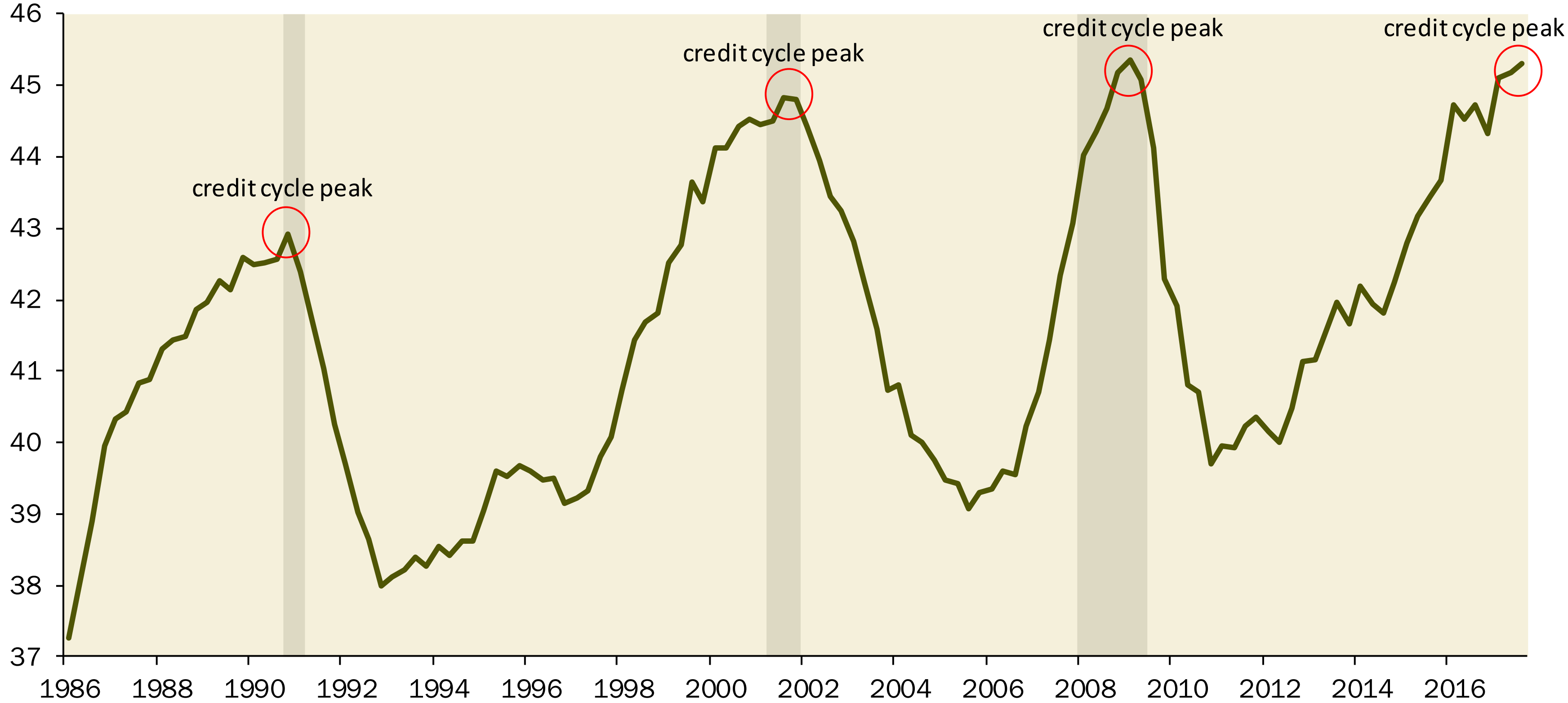
I'd keep an eye on credit-card debt. Subprime auto has been a problem for a couple years, and valuations on loans used to finance leveraged buyouts are high. Any type of secured lending backed by an asset that is overvalued should be a concern. That is what happened with housing. ***Corporate debt also has not gotten as much attention as it should****. It is market-funded, rather than bank-funded, but the banks still have exposure. Then there's cyber-risk. It took us so long to get around to the reforms postcrisis that we got a little behind on systemic cyber-risk, but regulators are very focused on it now.*

Notes:
Source: Barron's (March 5, 2018)

CORPORATE BALANCE SHEETS ARE NOT IN GOOD SHAPE!

United States: Corporate Debt-to-GDP

(percent)



Notes:

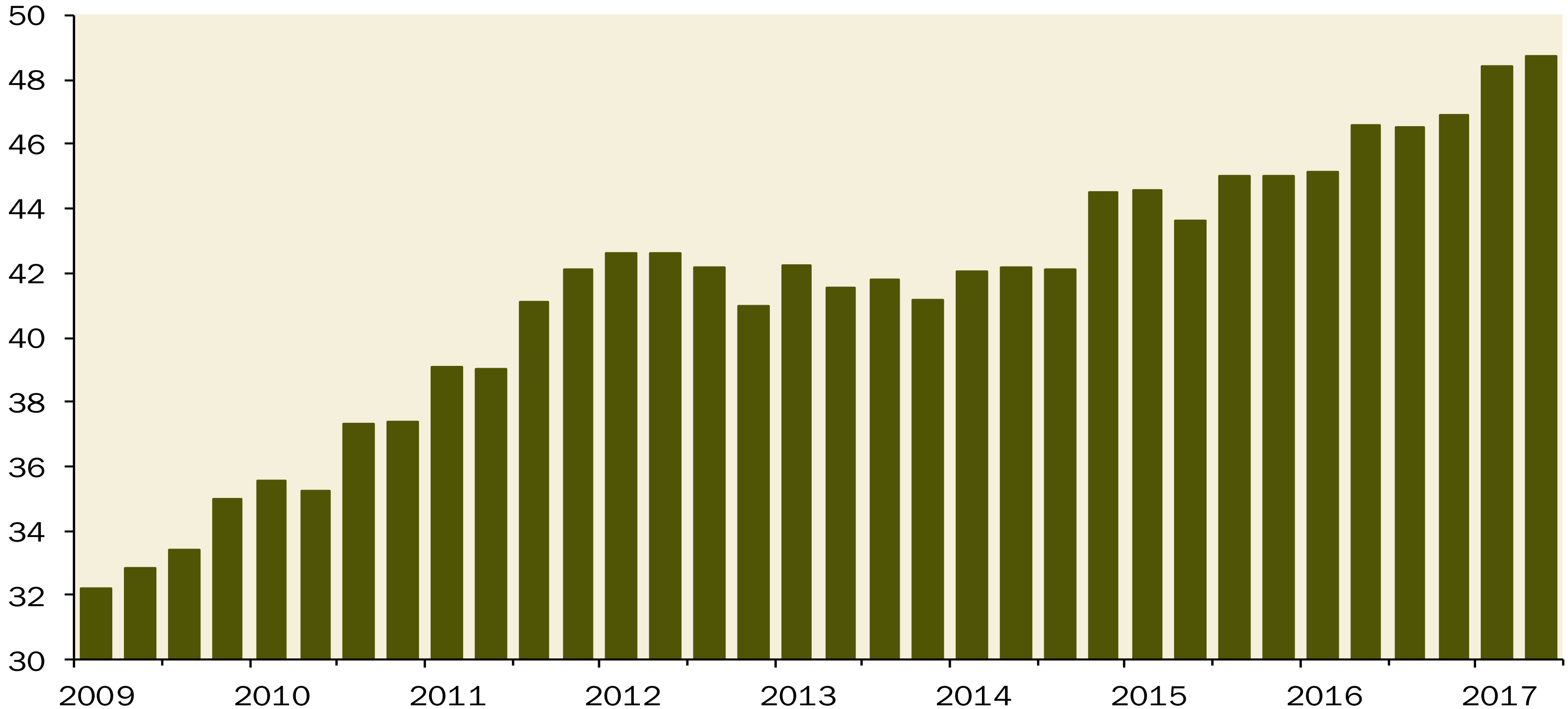
Shaded regions represent periods of U.S. recession

Source: Haver Analytics, Gluskin Sheff

NEARLY HALF OF INVESTMENT-GRADE COMPANIES ARE RATED BBB

United States: BBB Share of Investment-Grade Bonds

(percent)

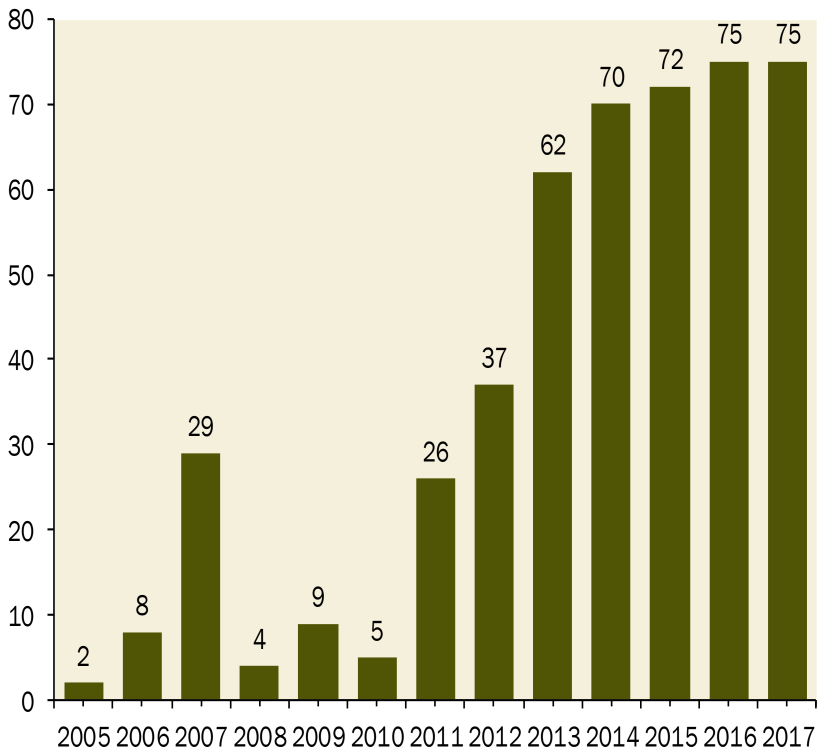


Notes:
Source: Bloomberg, Gluskin Sheff

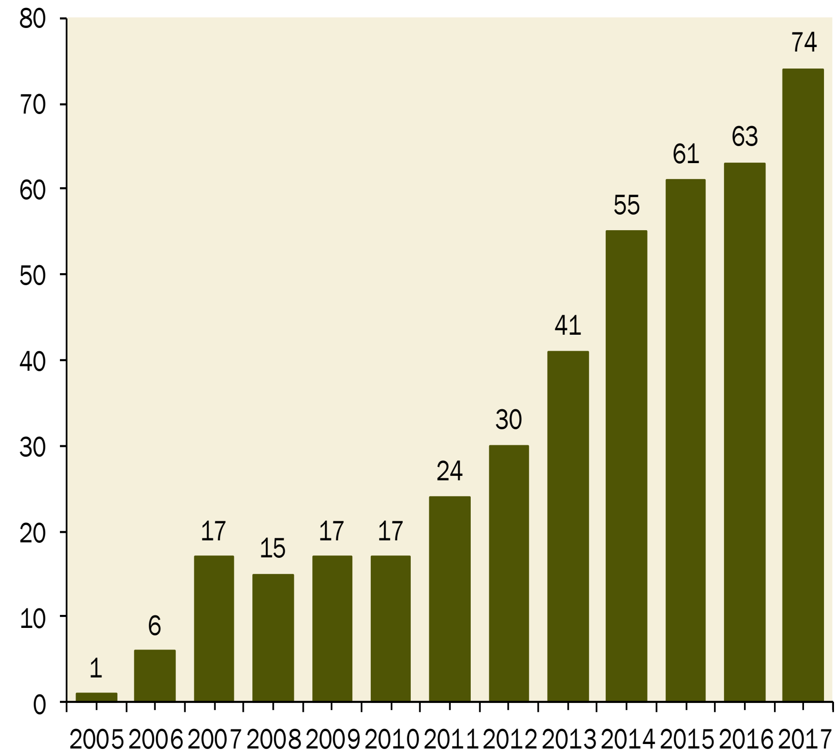
CORPORATE BOND INVESTORS HAVE LITTLE PROTECTION

United States: Covenant-Lite Loans

% of Total Issuance



% of Leveraged Loans Outstanding



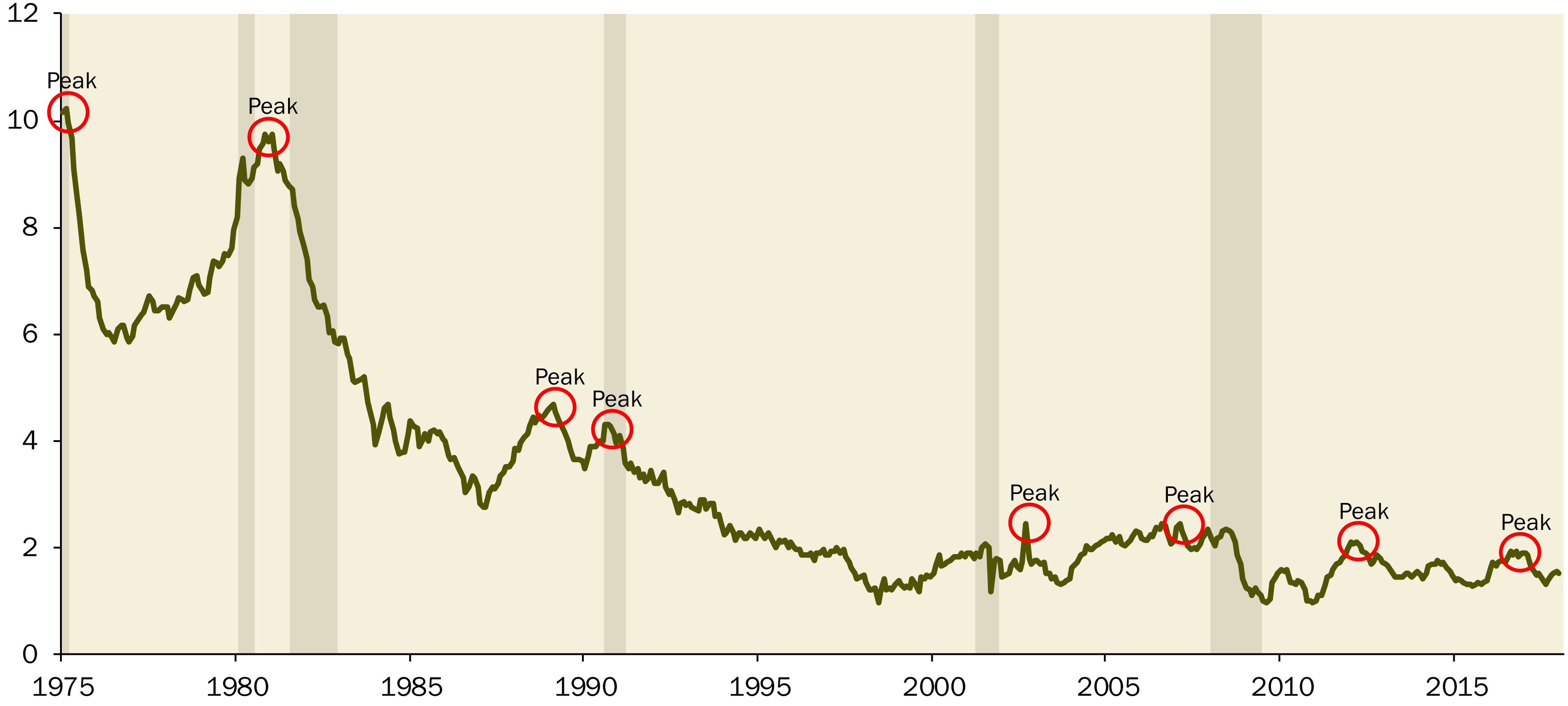
Notes:

Source: Bank of America Merrill Lynch, S&P LCD, Guggenheim Investments

CORE PCE INFLATION PEAKING LOWER AND LOWER

United States: Core PCE

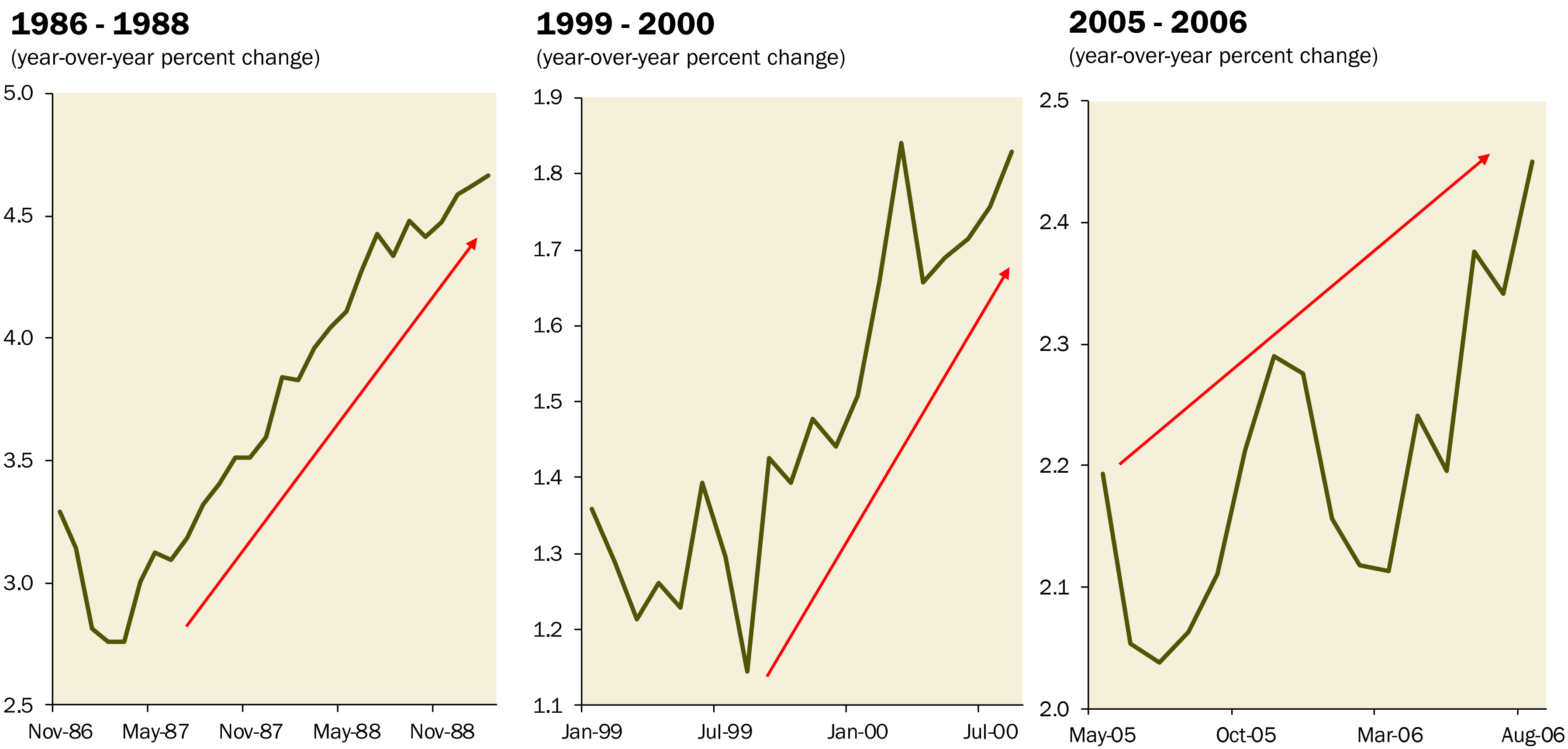
(year-over-year percent change)



Notes:
Source: Haver Analytics, Gluskin Sheff

SECULAR DISINFLATION, PUNCTUATED BY CYCLICAL INFLATION

United States: Core PCE

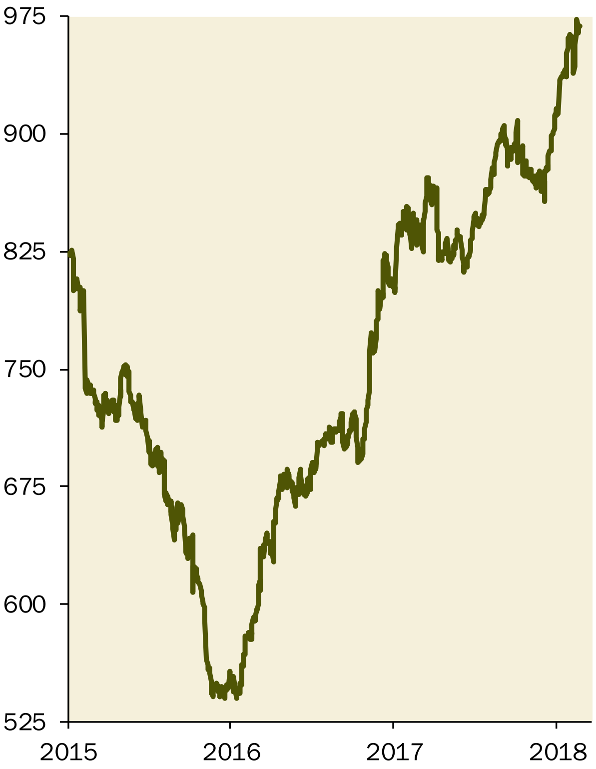


Notes:
Source: Haver Analytics, Gluskin Sheff

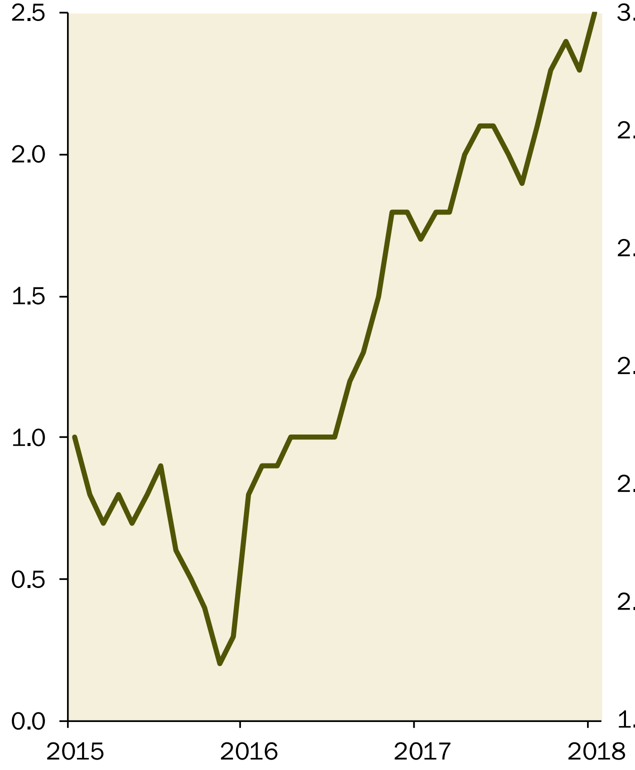
CYCLICAL PRESSURES BUILD

United States

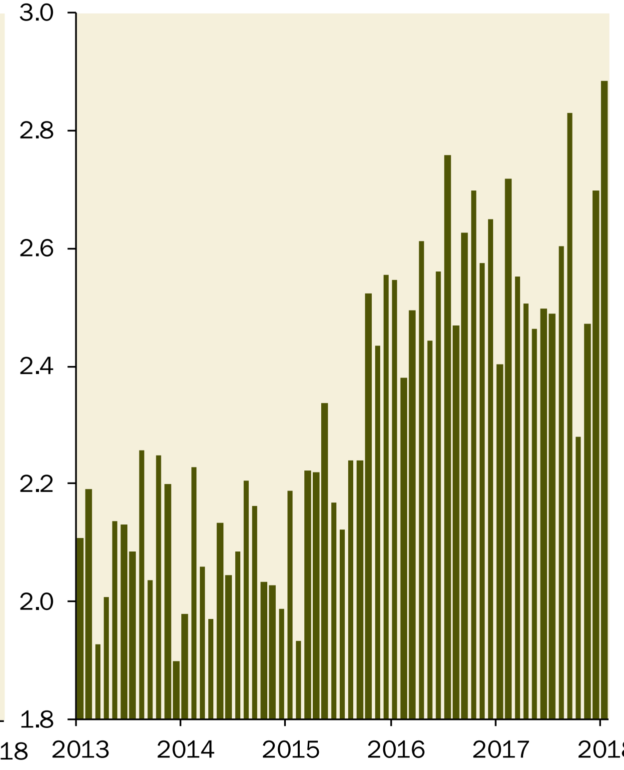
CRB Metals Index
(index)



PPI less food, energy, and trade
(year-over-year percent change)



Average Hourly Earnings
(year-over-year percent change)



Notes:
Source: Haver Analytics, Gluskin Sheff

A RETURN TO LARGE FISCAL DEFICITS

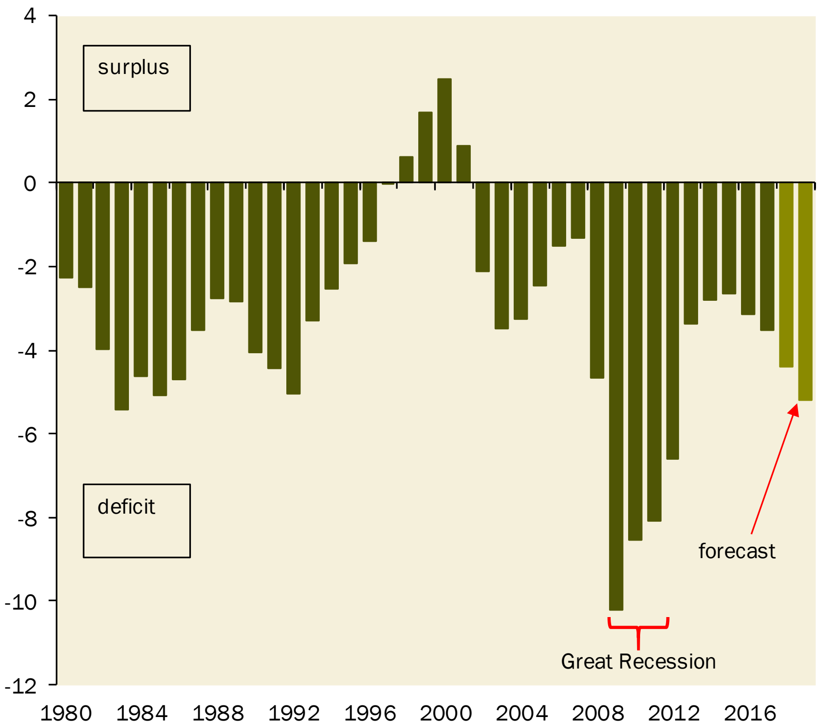
Notes:

Source: WSJ, The New York Times (February 7, 8, 9, 12, 13, 16, 2018)

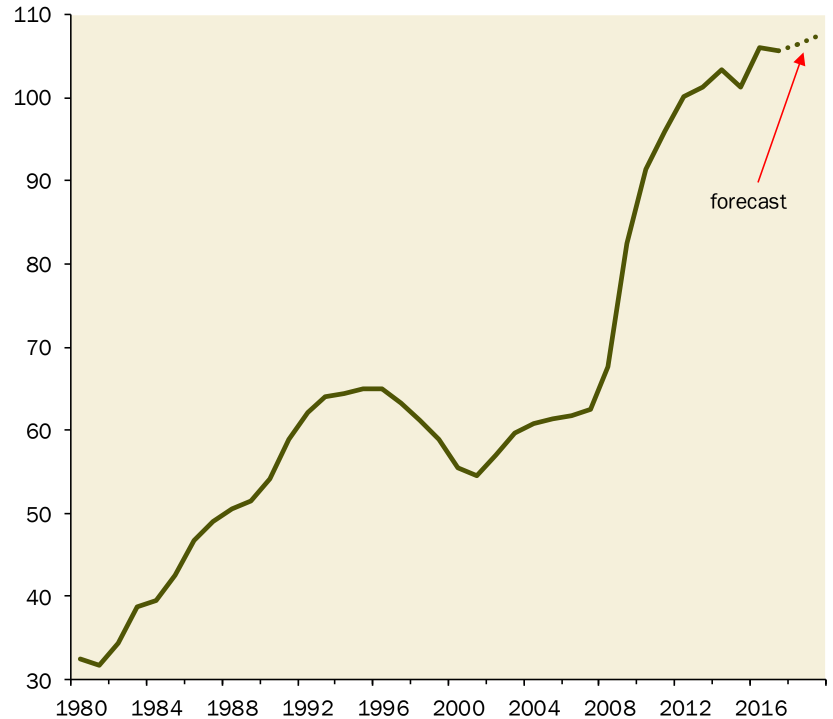
TRILLION-DOLLAR DEFICITS (TWO TRILLION??) LIE AHEAD

United States

Federal Deficit: Percent of GDP



Federal Debt: Percent of GDP



Notes:
Source: Haver Analytics, Gluskin Sheff

REGIME CHANGE IN TRADE POLICY TOO

U.S. trade deficit rose to nine-year high in December

Exports of goods increase
per cent to US$137.5-billior
December, the highest level s
October, 2014. Exports of ca
goods hit a record high, lifte
civilian aircraft and indus
machines.

There were also gains
exports of industrial sup
and materials. Petrol
exports increased to their h
est level since August, 2014.

Exports are being boosted
strengthening global econom

A weakening dollar is
making U.S.-made goods m
competitive on the internati
market.

Trump Threatens Allies With a 'Reciprocal Tax'

By ANA SWANSON

WASHINGTON — President Trump said on Monday that the United States would soon announce a "reciprocal tax" on countries that take advantage of the United States on trade, including countries to raise their own tariffs on American products as a punishment. To substantially raise its tariffs, the United States would most likely have to leave the W.T.O. — a prospect that could damage the American economy

Trade deficit reality starts to bite for Trump

The White House is slowly discovering the limitations of US policy

One way of viewing Donald Trump's administration is as an extremely expensive education in economics for the president and his leading officials.

Mr Trump came to office arguing that the US's trade deficit — both in aggregate with the rest of the world, and bilaterally with individual coun-
at America was
e by its trading
; a liberal trade
ariffs and other
rts, notably in
rowth and jobs

set an exact deadline" for eliminating the US imbalance with China.

This represents, one hopes, another step in the process of the White House backing away from the more extreme positions it has taken on trade. Mr Trump has already reneged on promises to name China as a currency manipulator and impose tariffs offsetting the renminbi's undervaluation.

The actions the administration has taken, although unwise, have yet to be disastrous. Mr Trump has insisted on a renegotiation of the North American

Trade data will irk Trump — wrongly

Simplistic idea driving policy

Kevin Carmichael
National Business Columnist

Most economists say th
gap between imports and ex
ports doesn't matter much.

Trade flows are deter
mined mostly by deman
and transportation links.

The U.S. runs deficits be
cause it buys a lot and save
little, and because globaliza
tion has reduced the cost o

U.S.-China Trade Gap Swells to Record Level

By ANA SWANSON

WASHINGTON — The United States trade deficit with China climbed to its highest level on record in 2017, a trend that could prompt the Trump administration toward tougher trade actions in the coming months.

The gap between Chinese goods imported to the United States and American goods exported to China rose to $375.2 billion last

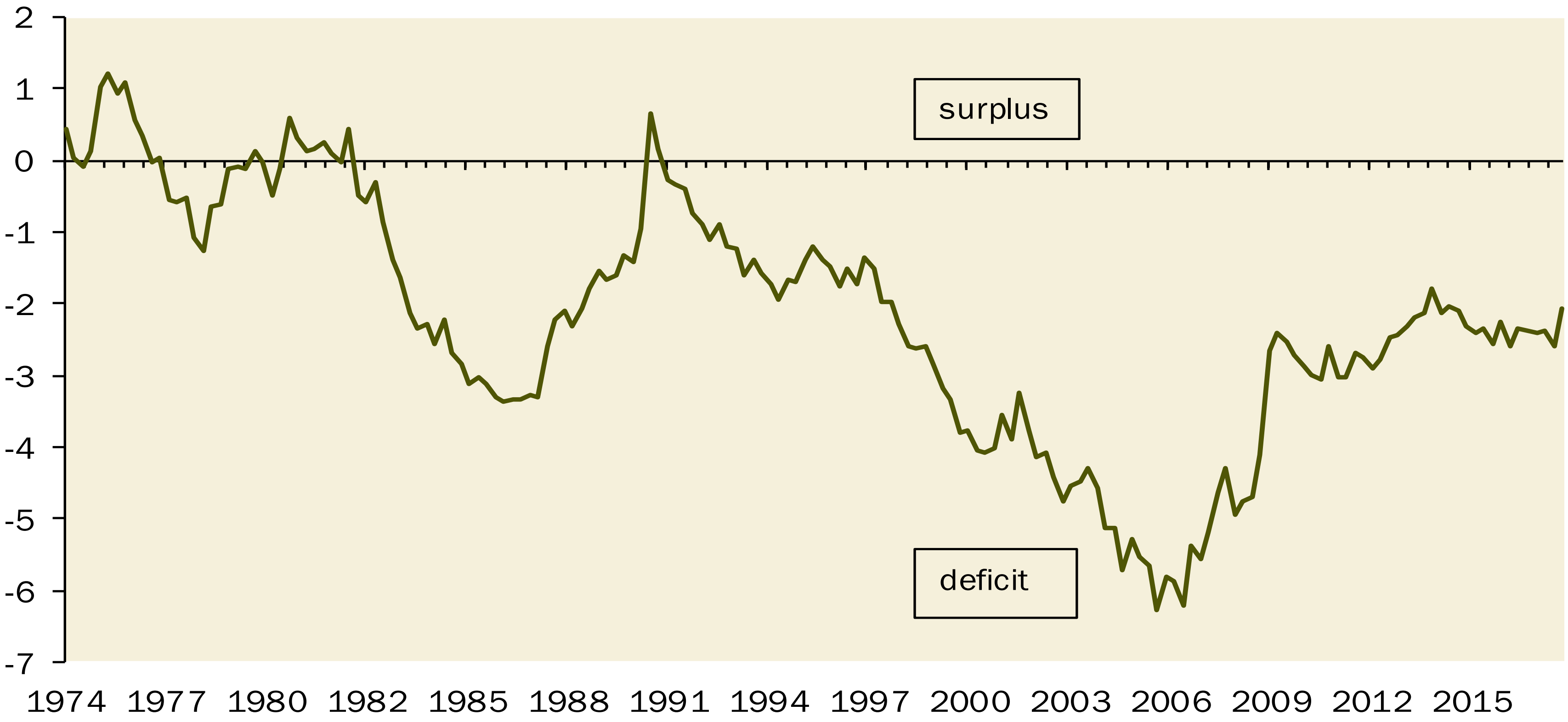
economic advisers to the Trump campaign, proposed that President Trump would eliminate the $500 billion United States trade deficit, generating enough tax revenue to largely offset the cost of the president's tax plan. During the campaign, Mr. Navarro, now director of the White House National Trade Council, said that the administration's trade plans would allow it to eliminate trade deficit "within a year or two."

Notes:
Source: The New York Times, Financial Post, Financial Times, Globe & Mail (February 7, 8, 13, 2018)

THE TRUMP TEAM PROTECTIONISTS TO ELIMINATE THE TRADE DEFICIT

United States: Current Account Deficit

(percent of GDP)

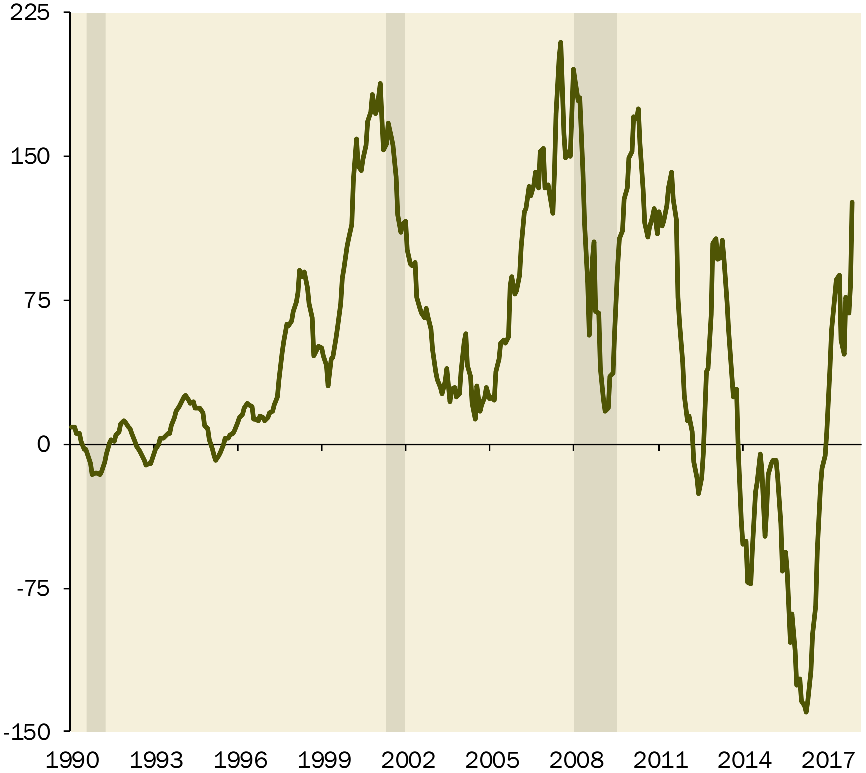


Notes:
Source: Haver Analytics, Gluskin Sheff

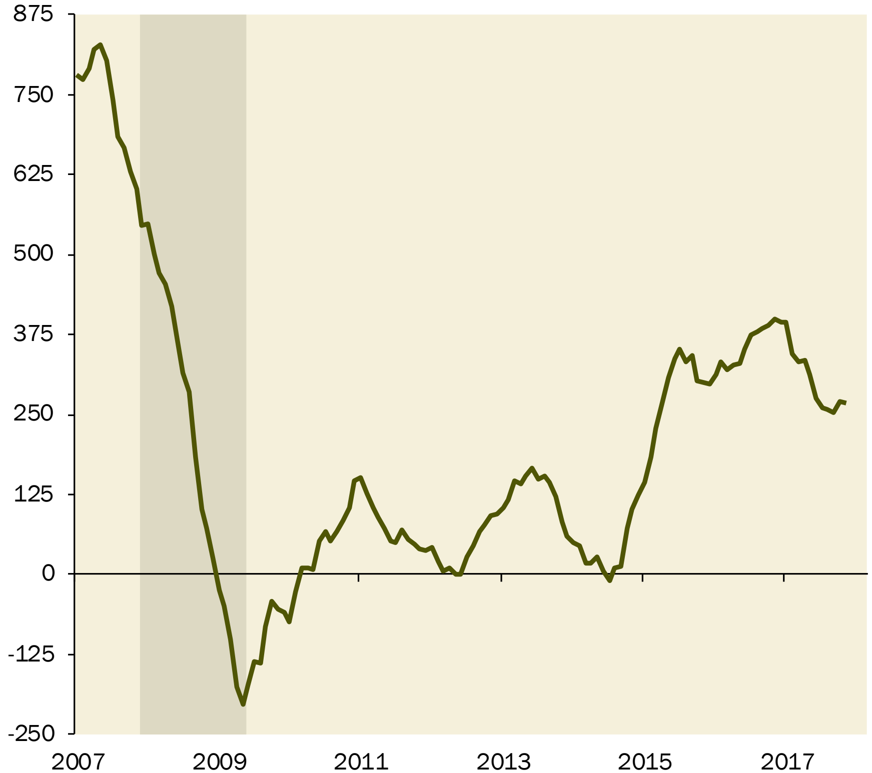
FLIP SIDE OF THE TRADE DEFICIT IS THE CAPITAL ACCOUNT SURPLUS!

United States

Net Foreign Purchases of U.S. Stocks
($ Billions)



Net Foreign Purchases of U.S. Bonds
($ Billions)



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

THE U.S. DOLLAR IS LOOKING PRETTY SICK THESE DAYS

United States: Nominal Trade Weighted U.S. Dollar vs. Major Currencies

Notes:
Source: Haver Analytics, Gluskin Sheff

MNUCHIN TALKS DOWN AN ALREADY WEAK U.S. DOLLAR

"Obviously a weaker dollar is good for us as it relates to trade and opportunities"

— January 24, 2018

Notes:
Source: Steven Mnuchin, Davos Economic Forum, January 24, 2018

ALL MNUCHIN DID WAS TOW THE TRUMP LINE

*“**I think our dollar is getting too strong, and partially that’s my fault because people have confidence in me**. But that’s hurting—that will hurt ultimately…Look, there’s some very good things about a strong dollar, but usually speaking the best thing about it is that it sounds good…**It’s very, very hard to compete when you have a strong dollar and other countries are devaluing their currency.**”*

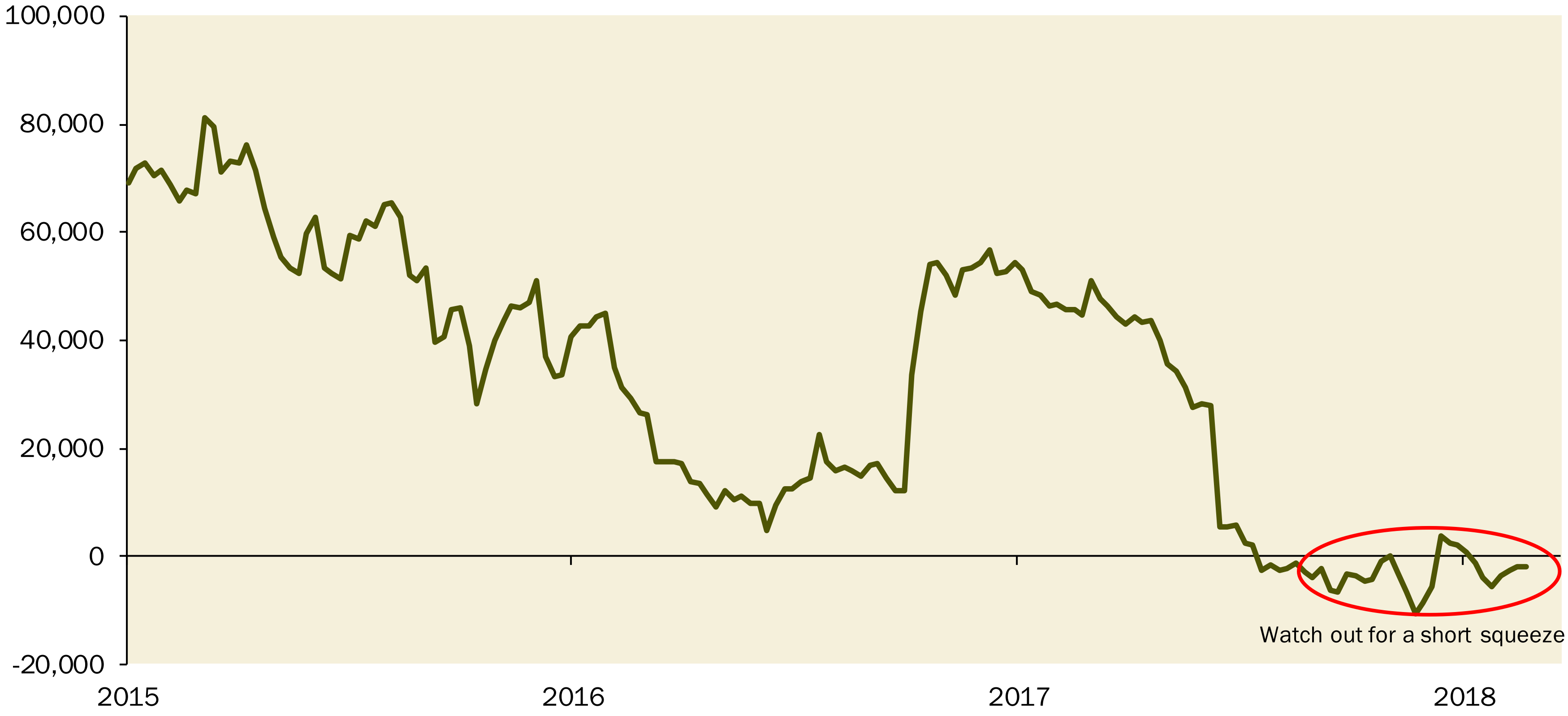
— April 12, 2017

Notes:
Source: Donald Trump, WSJ Interview, April 12, 2017

ONE RISK; THE NEGATIVE USD VIEW IS A CROWDED TRADE

United States: CFTC Positioning on the U.S. Dollar

(number of contracts; >0 denotes net long)

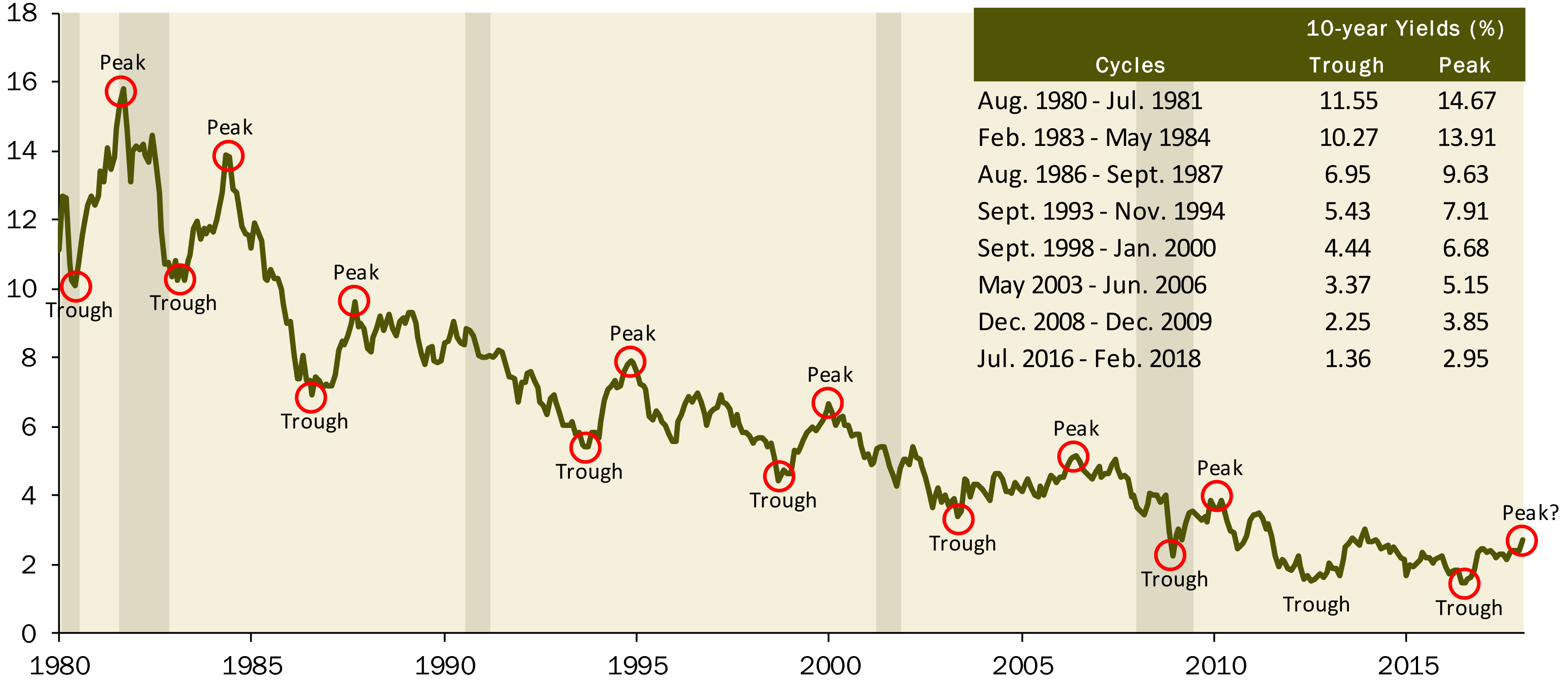


Notes:
Source: Haver Analytics, Gluskin Sheff

WE HAVEN'T BROKEN OUT OF THE DOWNTREND JUST YET

United States: 10-year Treasury Note Yield

(percent)

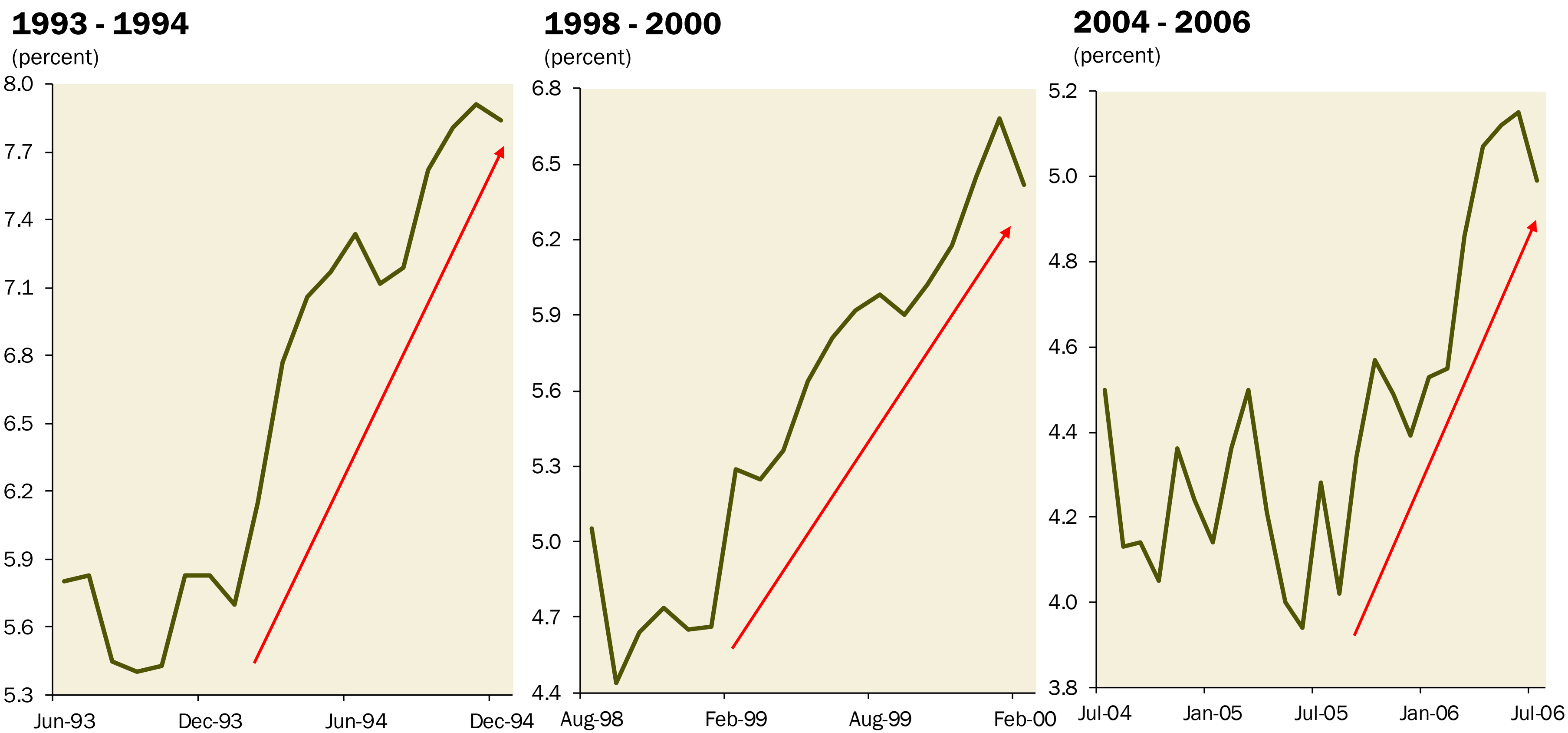


Cycles	10-year Yields (%) Trough	Peak
Aug. 1980 - Jul. 1981	11.55	14.67
Feb. 1983 - May 1984	10.27	13.91
Aug. 1986 - Sept. 1987	6.95	9.63
Sept. 1993 - Nov. 1994	5.43	7.91
Sept. 1998 - Jan. 2000	4.44	6.68
May 2003 - Jun. 2006	3.37	5.15
Dec. 2008 - Dec. 2009	2.25	3.85
Jul. 2016 - Feb. 2018	1.36	2.95

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

BOND MARKET CORRECTIONS OCCUR DESPITE SECULAR DEMAND

United States: 10-year Treasury Note Yield



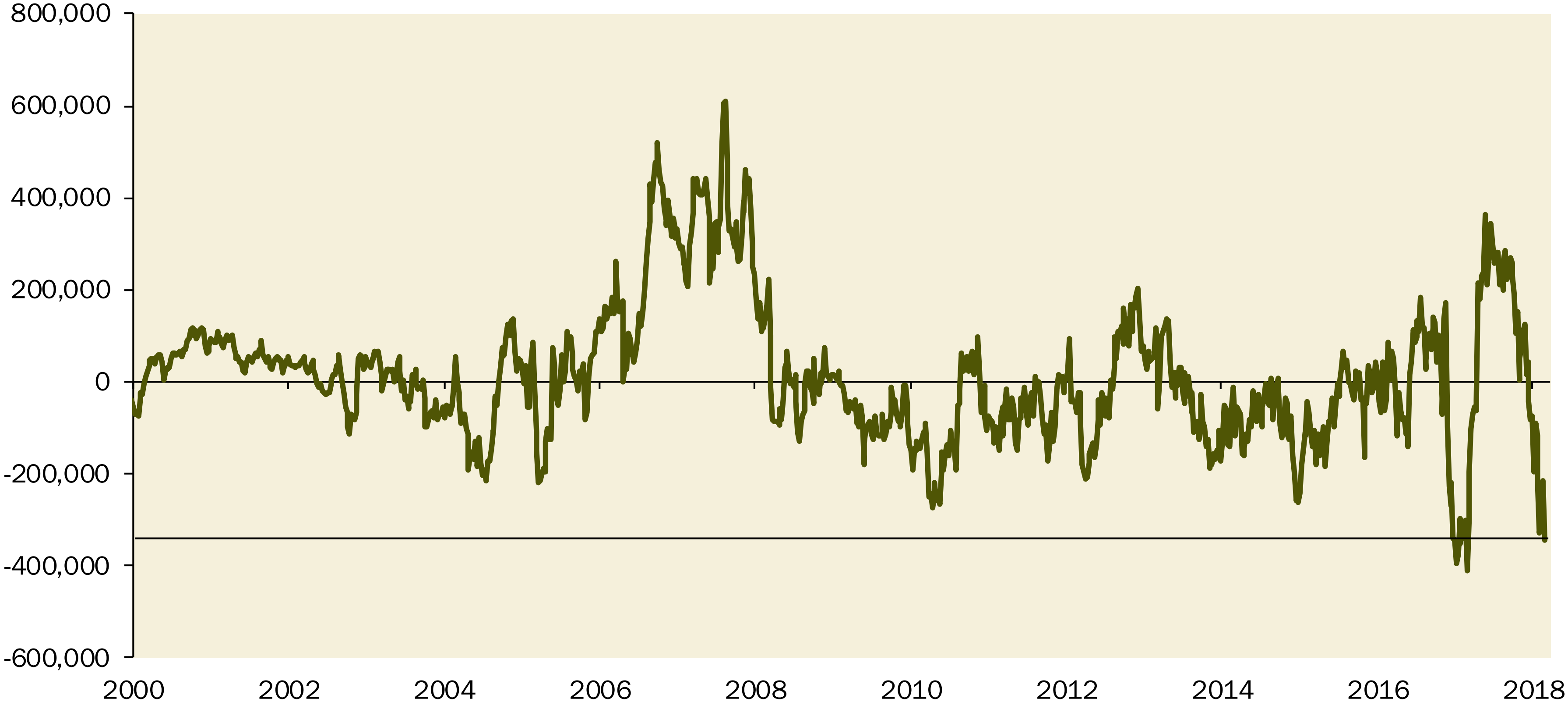
- Bond market corrections occur; can last up to 2 years and see 10-year note yields rise 200 bps

Notes:
Source: Haver Analytics, Gluskin Sheff

SECOND LARGEST SPECULATIVE NET SHORT POSITION EVER ON THE 10-YR T-NOTE

United States: CFTC Positioning on U.S. Treasury 10-year Note

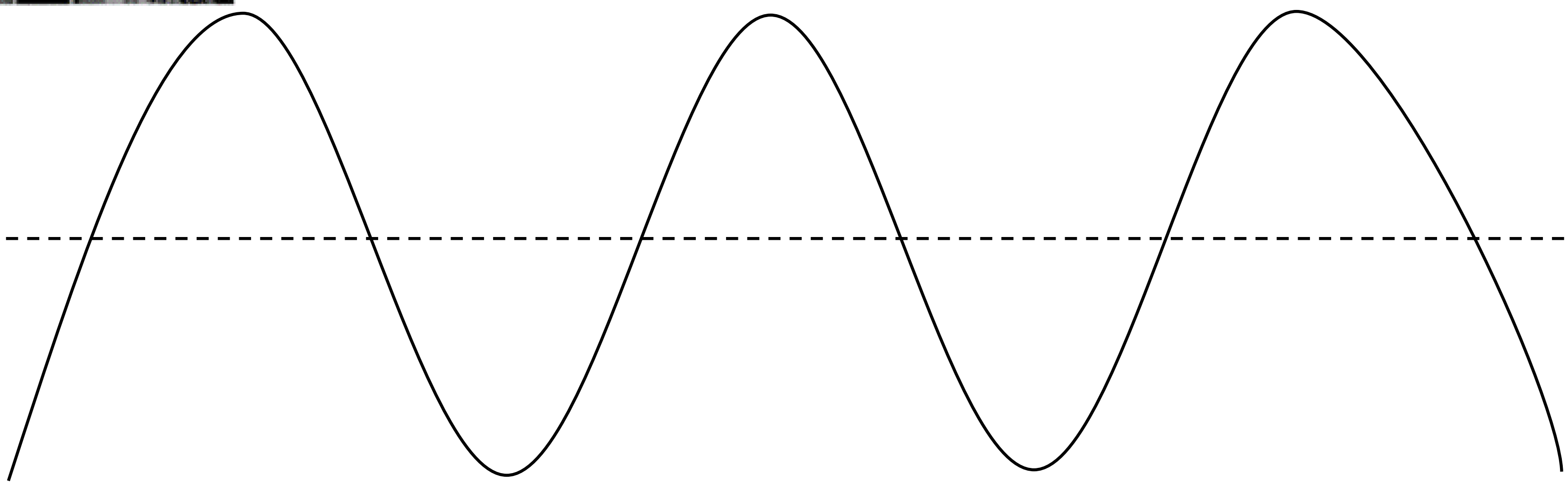
(number of contracts; >0 denotes net long)



Notes:
Source: Haver Analytics, Gluskin Sheff

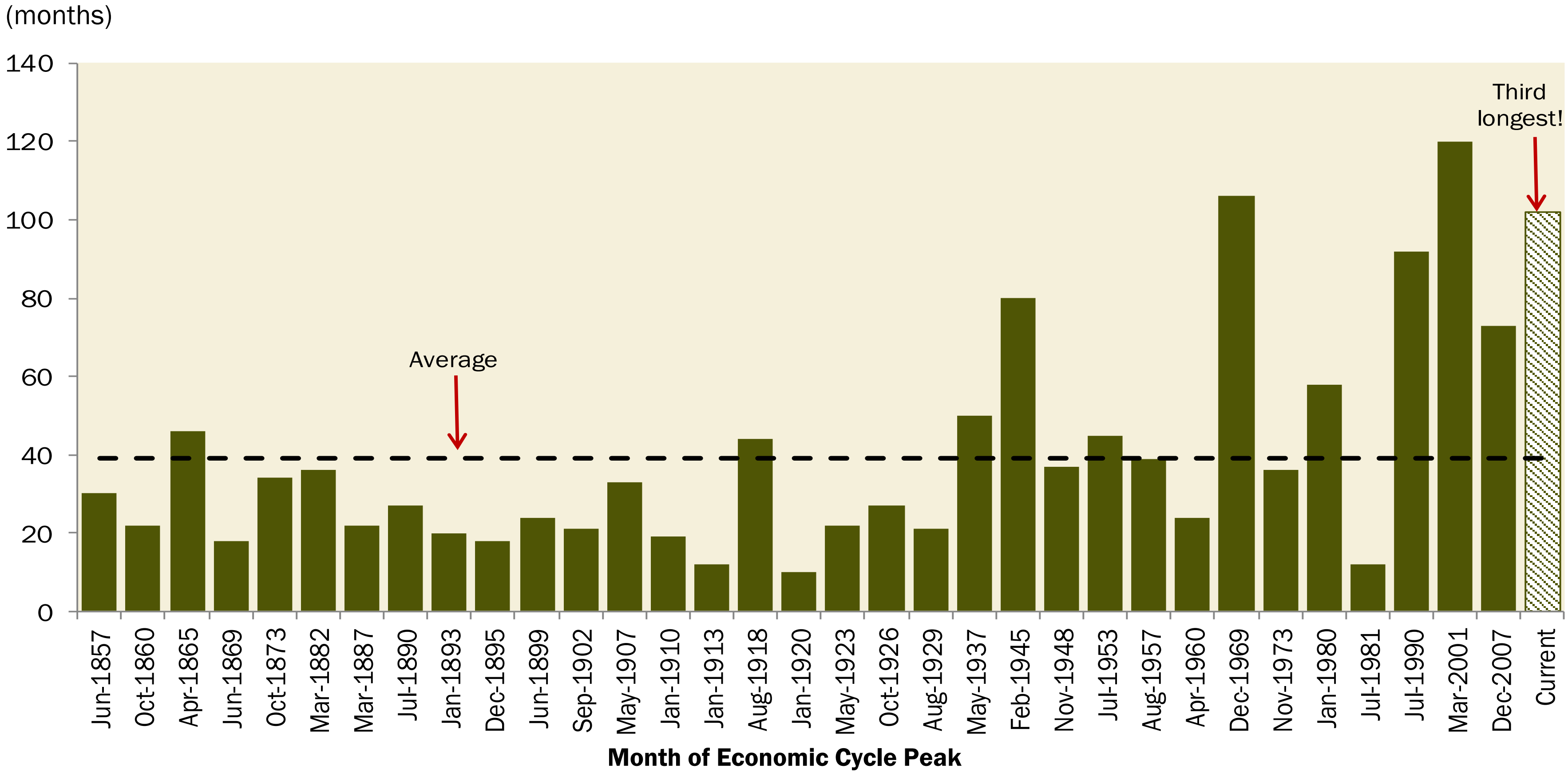
"If something cannot go on forever, it will stop."

— Herbert Stein's Law



THE U.S. CYCLE IS VERY LATE

United States: Duration of Economic Expansions



Notes:

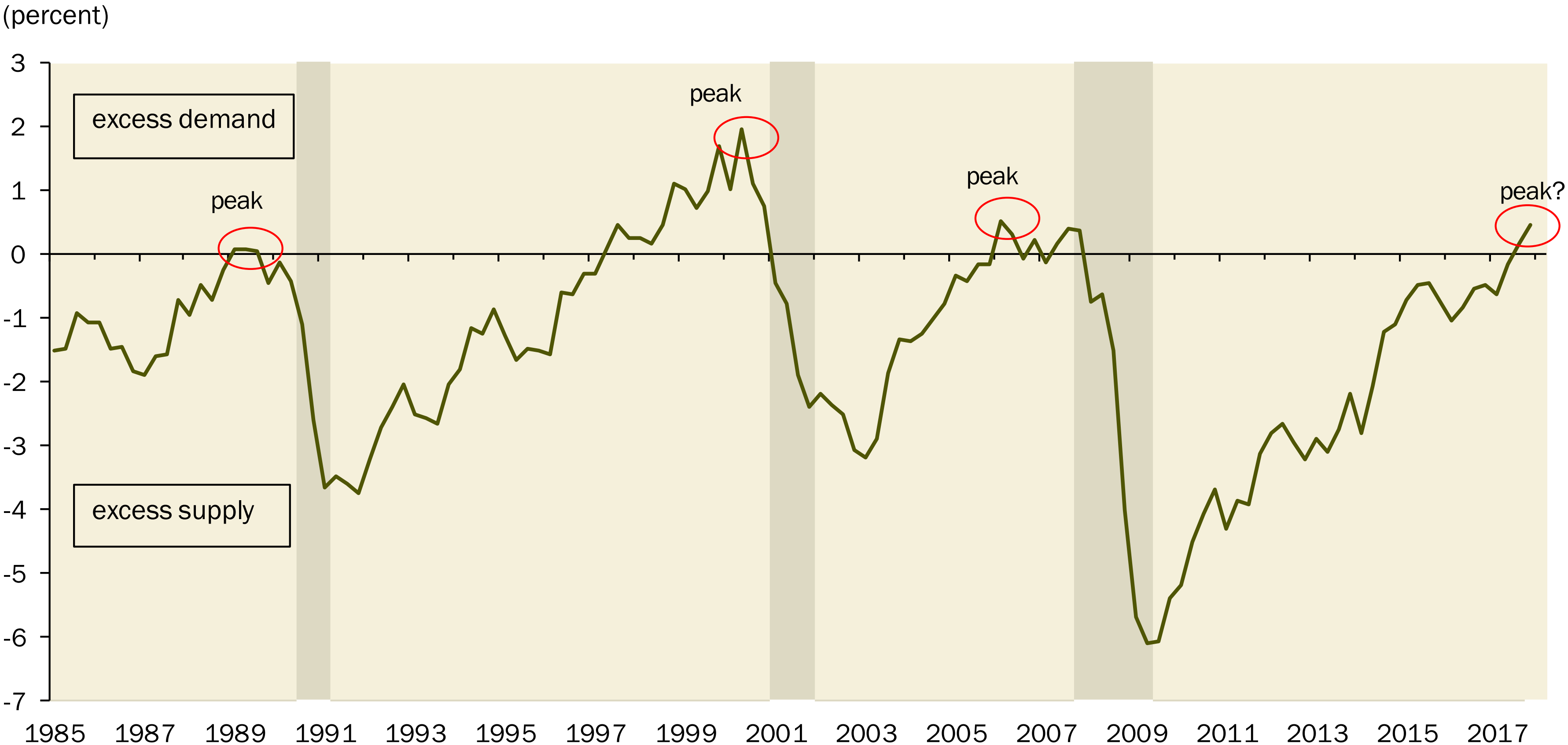
Source: National Bureau of Economic Research, Gluskin Sheff

THERE HAVE BEEN 13 FED HIKING CYCLES, 10 LANDED IN RECESSION!

First Hike	Last Hike	Result
October 1950	May 1953	**Recession**
October 1955	August 1957	**Recession**
September 1958	September 1959	**Recession**
December 1965	September 1966	Soft Landing
November 1967	June 1969	**Recession**
April 1972	September 1973	**Recession**
May 1977	March 1980	**Recession**
August 1980	December 1980	**Recession**
March 1983	August 1984	Soft Landing
January 1987	May 1989	**Recession**
February 1994	February 1995	Soft Landing
June 1999	May 2000	**Recession**
June 2004	June 2006	**Recession**
December 2015	???	???

NO SPARE CAPACITY = LATE CYCLE

United States: Output Gap



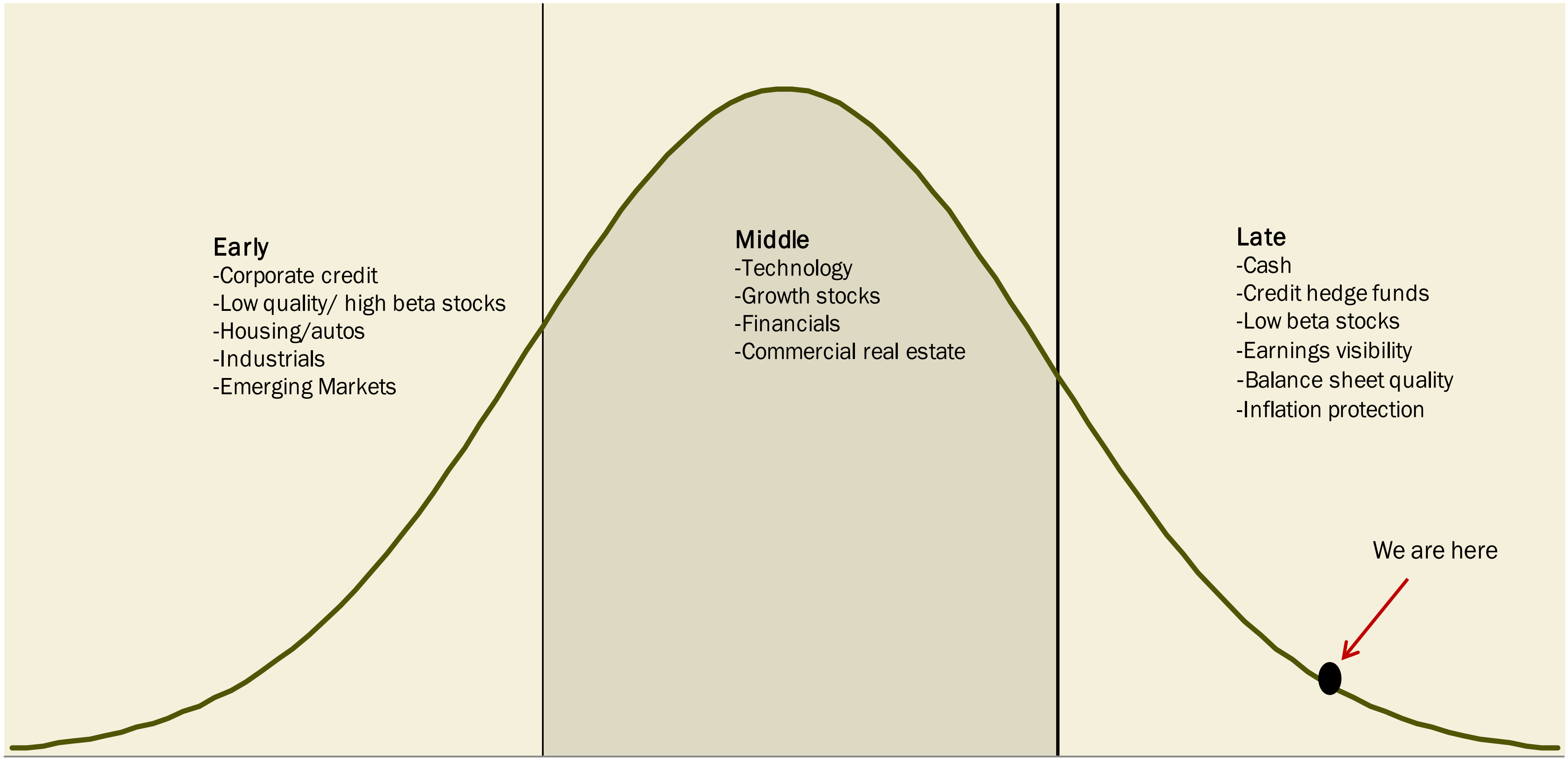
Notes:
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

14 OF 15 VARIABLES SUGGEST WE ARE PAST THE SEVENTH-INNING STRETCH

Variable	Average change in expansions (start to peak/trough)	This cycle	Percent of average recovered this cycle
Core CPI (bps)	82.0	60.0	**73.2%**
CRB Commodity Index (%)	37.0%	48.0%	**100.0%**
2s/10s Yield Curve (bps)	-183.0	-164.0	**89.6%**
Industry Capacity Utilization Rate (ppts)	9.0	12.5	**100.0%**
Unemployment Rate (ppts)	-2.9	-5.2	**100.0%**
Real GDP (ppts)	8.9	7.4	**83.1%**
Profit Margins (ppts)	3.9	5.6	**100.0%**
ISM Manufacturing (pts)	25.0	14.2	**56.8%**
Auto Sales (%)	56.0%	84.0%	**100.0%**
Housing Starts (%)	63.5%	127.0%	**100.0%**
Cyclical GDP Share (ppts)	3.2	3.7	**100.0%**
Trailing P/E Multiple (pts)	7.8	9.3	**100.0%**
High Yield Spread (bps)	-662.7	-785.1	**100.0%**
Employment-to-Population Ratio (ppts)	2.5	0.8	**32.3%**
Consumer Confidence (pts)	43.9	75.6	**100.0%**
Average			89.0%
Median			100.0%

Notes:
Source: Haver Analytics, Gluskin Sheff

AS THE CYCLE TURNS…SO SHOULD YOUR PORTFOLIO



Notes:
Source: Gluskin Sheff

THE FED WILL HAVE VERY LITTLE LEEWAY IN THE NEXT DOWNTURN

		Federal Funds Rate (%)		
Start	**End**	**Start Level**	**End Level**	**Delta**
Oct-57	May-58	3.50	0.57	-2.93
May-60	Jul-61	3.83	1.18	-2.65
Nov-66	Jul-67	5.74	3.79	-1.95
Feb-70	Feb-71	8.95	6.03	-2.92
Sep-71	Feb-72	5.53	3.30	-2.23
Jul-74	May-75	12.91	5.22	-7.69
Apr-80	Jul-80	17.43	9.01	-8.42
Jul-81	Dec-81	19.10	12.44	-6.66
Aug-84	Dec-84	11.50	8.13	-3.38
May-89	Sep-92	9.81	3.00	-6.81
Dec-00	Jun-03	6.50	1.00	-5.50
Aug-07	Dec-08	5.25	0.13	-5.13
Average		**9.17**	**4.48**	**-4.69**
Median		**7.73**	**3.55**	**-4.25**

Notes:
Source: Haver Analytics, Gluskin Sheff

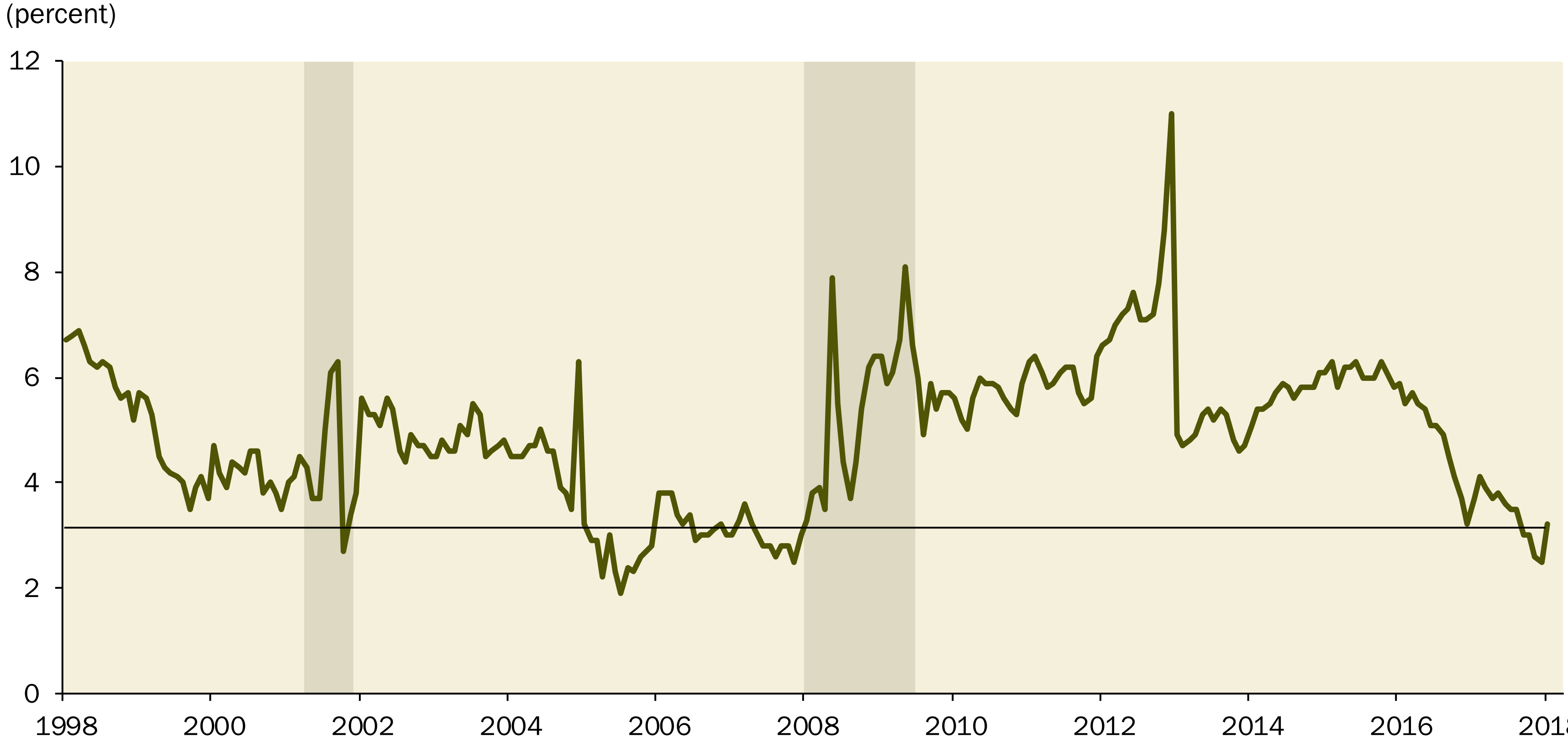
FISCAL POLICY WILL BE SERIOUSLY CONSTRAINED IN FIGHTING NEXT RECESSION

Cycle Peak	Deficit-to-GDP (%)	Year Following Recession	Deficit-to-GDP (%)	Delta (%)
1948	4.5	1950	-1.1	-5.6
1953	-1.7	1955	-0.7	1.0
1957	0.7	1959	-2.5	-3.2
1960	0.1	1962	-1.2	-1.3
1969	0.3	1971	-2.1	-2.4
1973	-1.1	1976	-4.1	-3.0
1980	-2.6	1983	-5.9	-3.3
1990	-3.7	1992	-4.5	-0.8
2001	1.2	2002	-1.5	-2.7
2007	-1.1	2010	-8.7	-7.6
Average	**-0.3**		**-3.2**	**-2.9**
Median	**-0.5**		**-2.3**	**-2.9**

Notes:
Source: Haver Analytics, Gluskin Sheff

PERSONAL SAVINGS RATE GETS DEPLETED ONCE AGAIN – CLASSIC LATE CYCLE

United States: Personal Savings Rate



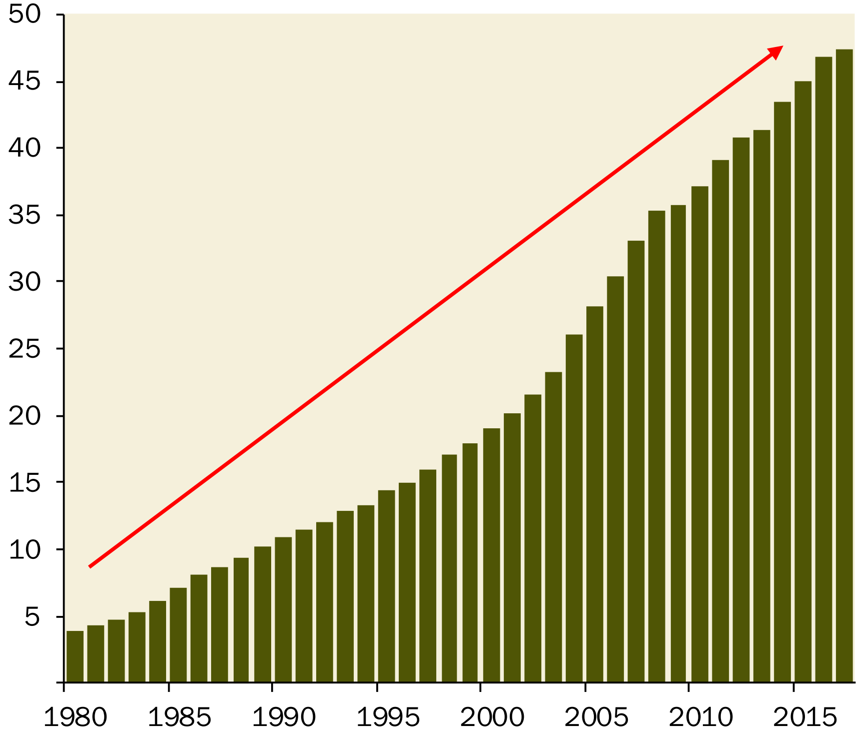
Notes:
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

WHERE WAS THE DELEVERAGING?

United States

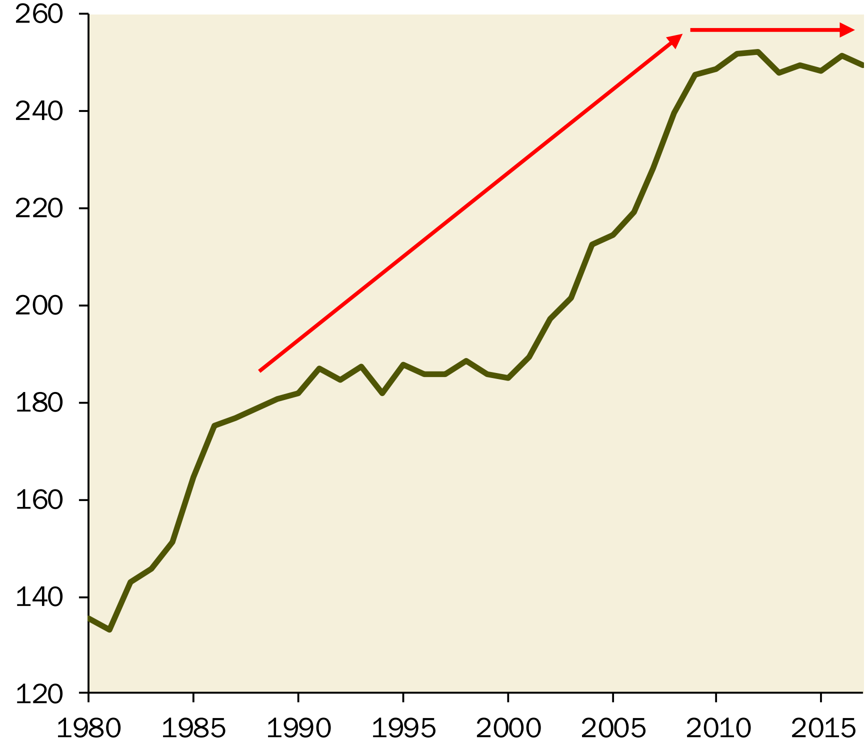
Total Debt

(U.S. Dollar Trillions)



Total Debt-to-GDP

(ratio)



Notes:

Source: BIS, Haver Analytics, Gluskin Sheff

THE END GAME IS THE DEBT JUBILEE

The Federal Reserve Board

Remarks by Governor Ben S. Bernanke

Before the National Economists Club, Washington, D.C.
November 21, 2002

Deflation: Making Sure "It" Doesn't Happen Here

Since World War II, inflation--the apparently inexorable rise in the prices of goods and services--has been the bane of central bankers. Economists of various stripes have argued that inflation is the inevitable result of (pick your favorite) the abandonment of metallic monetary standards, a lack of fiscal discipline, shocks to the price of oil and other commodities, struggles over the distribution of income, excessive money creation, self-confirming inflation expectations, an "inflation bias" in the policies of central banks, and still others. Despite widespread "inflation pessimism," however, during the 1980s and 1990s most industrial-country central banks were able to cage, if not entirely tame, the inflation dragon. Although a number of factors converged to make this happy outcome possible, an essential element was the heightened understanding by central bankers and, equally as important, by political leaders and the public at large of the very high costs of allowing the economy to stray too far from price stability.

Notes:
Source: Ben Bernanke, Deflation: Making Sure "It" Doesn't Happen Here (November 21, 2002)

DISCLAIMER

The information, opinions, and other materials contained in this presentation is the property of Gluskin Sheff + Associates Inc. and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by Gluskin Sheff + Associates Inc. based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.