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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

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DON'T KNOW MUCH ABOUT HISTORY…

Have a look at the front cover of the Economist (*The Rift*) and you'll see what I'm talking about. The world is splintering apart, and all commentators can discuss is how great the stock market has been doing…for two weeks! Does everyone spend their time looking up to, but not past, the tips of their noses? I don't think I have seen such a group of investors so complacent before, and so prone to denial and projection. It's incredible.

But then again, it is human nature. I think back to the late 1980s when the view built late in the decade was that the architects of Reaganomics had managed to kick the business cycle. But bubbles in commercial real estate in California, Texas and New England burst, and with lags, morphed into a credit crunch that took four years for the Fed and the Resolution Trust Corp to fix. Alan Greenspan was still talking about "headwinds" three years after that recession officially ended. Oh — did I mention a recession that nobody saw coming? Sound familiar?

In the summer of 1997, the Thai baht is devalued, the Emerging Market economies and asset prices go into a depressionary tailspin. Nothing much happens in the USA, even as commodity markets sank like a stone and the rest of the world went into disarray. Alan Greenspan actually had to temper the exuberance of the day by suggesting that the U.S. economy was not some "oasis" and boy, did he get heck for that by the good ol' boys club. Months later, after Asia hit Russia, and Russia defaulted, LTCM almost brought down JP Morgan. The S&P 500 collapsed 20% in the summer of 1998 and there was no bid in the corporate bond market for about six weeks. Liquidity went on a sabbatical. Unfortunately, we have 13 million people in the financial services industry giving advice today who have absolutely no idea what I'm talking about.

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The dotcoms that went bust were never supposed to generate a recession — even the Fed in early 2001 saw it as an inventory correction. But it turned into a deflationary shock to the entire technology capital stock, and the effects went global, as the likes of Nortel and Alcatel felt some serious heat. That recession was mild in magnitude but was a big one in terms of duration.

Of course, we then had the housing crisis in the last cycle. We were told by the pundits and central bankers and academics not to worry. House prices never go down on a national basis, right? And even if subprime mortgages collapse, they're such a small share of the market that the damage will be contained, right? And we will only have a soft landing, not a recession, because the Fed eased policy in time, right? And the rest of the world had decoupled from the USA and would emerge unscathed, right? Oh, that last one on 'decoupling' — what a sham.

And now we have so much of the same. Listen to what he does, not says. Take him seriously, not literally. America's trading partners don't play fair so tariffs are justified. Nobody will retaliate, doesn't the rest of the world know that the USA doesn't need them (an export share of 10%). Oh, and the impacts will be small, so don't worry — focus instead on the tax cuts.

The lumber duties have been a big squeeze on the homebuilders

The trade war has started. And it's not just the USA against China, but against the world — the EU, Japan, and Canada. There already are a myriad of domino effects taking place. Steel and aluminum prices have soared and this is exerting a depressing impact on U.S. manufacturing activity. Those who think the American economy is immune because of low direct export/GDP ratios miss the overriding issue that the metals sector is hugely sensitive to global export and import flows. Once downstream consumers begin to re-adjust their order books for lower sales, a whole chain reaction through the manufacturing sector takes hold. And for those who thought tariffs were a good thing for the U.S. economy, the lumber duties have been a big squeeze on the homebuilders, adding to costs and prices and undermining homeowner affordability.

The tariffs on washing machines earlier this year has caused runaway inflation in this particular area. In other areas, deflation has been the result, as weaker metals demand from the factory sector has caused a 15% plunge in copper prices in barely more than a month. The U.S. Chamber of Commerce already released a report concluding that *"tariffs that beget tariffs that beget more tariffs only lead to a trade war that will cost American jobs and economic growth."* Nomura published a study showing that a 10% hike in tariffs by the USA and China and Europe would shave global GDP by 1.4 percentage points — which everyone would feel in this race to the bottom. Japan, an innocent bystander here, sees a 10 basis point drop in economic growth for every 10% decline in USA auto sales through the trade channel — think of sales sagging three times that amount if the Trump team goes ahead with the next chapter here, which are tariffs on motor vehicles.

The Chinese have already radically cut their orders for U.S. soybeans this year (by 366,000 metric tons) and next (66,000 tons), and now this is wreaking havoc for Canadian farmers who are price takers on this score.

Even the Japanese are pursuing their own 'stealth' strategy of hitting back as they have reduced their exposure to U.S. Treasuries to the lowest level in seven years (to $1 trillion). This may be one reason the 2.8% floor on the 10-year T-note is so elevated, even during the so-called risk-off periods.

In Canada, a Nanos survey found that 72% of Canadians are now willing to boycott U.S.-made goods and 73% intend to cut back on their U.S. travel plans. Indeed, I shifted from my annual Spring trip from Napa to the Okanagan Valley, and may well forgo my upcoming plan to visit the Finger Lakes in favor of the Gaspé. Canada First, I tell you!

The trend towards isolationism, populism, xenophobia, and nationalism were already being established

Besides the trade war under way, we have a world that was already changing dramatically. The trend towards isolationism, populism, xenophobia, and nationalism were already being established. Brexit, and now followed by cabinet drama in the May government. What happened in the U.S. election. Italy. Eastern Europe, especially Poland snubbing at EU laws. Angela Merkel's precarious political situation. Turkey seemingly moving into a dictatorship with Erdogan's new sweeping powers and his penchant for unorthodox economic policies should make you nervous if you own any of the country's mountain of debt obligations. And look at the recent Mexican election — where the landslide winner (Obrador) campaigned on this slogan: *"The best foreign policy is domestic policy."*

This all seems more like a George Orwell novel than modern-day reality.

In terms of the greatest economic threat, which is this U.S.-China trade war, it's a matter of who blinks first. We have an American President who wants more than just a dramatically lower bilateral trade deficit or a solution to technological piracy (on this Mr. Trump is right), but rather a radical curbing in China's global influence. On the latter philosophical point, that just is not going to happen and Xi Jinping is in there for life so he doesn't have to blink. Mr. Trump does face more political constraints, but his vocal base and a Republican Party that has gone into hiding on issues such as fiscal conservatism and trade, appear to have the President feeling invincible. So he's not going to blink, either. But as we saw with the Cuban Missile Crisis more than five decades ago, only when someone blinks will the trade war end. This means we have to wait for Congress to start intervening (maybe the blunt criticism from Bob Corker is a start) or we will have to await the outcome of the midterm elections.

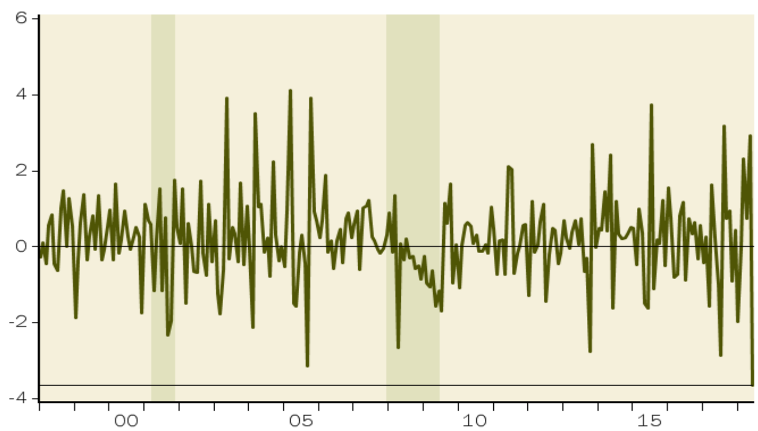
In the interim, avoid Industrials or any part of the global supply chain linked to trade. Think of how the reversal of globalization will lead to higher cost-push inflation, aggravating a situation already caused by super-tight labor markets and reflationary fiscal policy. This is more about being micro in the investment strategy — focusing on companies that have low price-demand elasticities who can easily pass on the cost increases, companies with low labor intensities, and companies with more domestic than foreign exposures. And all the while, finding ways to protect the portfolio from late-cycle inflationary pressures — via Financials, preferred shares, precious metals, Energy, TIPS and floating-rate notes.

MORE INFLATION BENEATH THE SURFACE THAN MEETS THE EYE

Headline CPI came in a touch softer than expected yesterday — rising +0.1% MoM (consensus: +0.2%), though the YoY rate was bang-on at +2.9% (a 6 ½ year high). Lower energy prices (-0.3%) were largely responsible, though core inflation was also relatively non-threatening at +0.16%. That said, the weakness here was attributable to just two sources — apparel (-0.9%) and lodging away from home (-3.7%) — both of which look unlikely to exert a similar drag next month. In fact, together these sources subtracted eight basis points from core CPI — that might not sound like much, but it made the difference between +0.24% and +0.16%.

CHART 1: LODGING AWAY FROM HOME

United States
(month-on-month percent change)



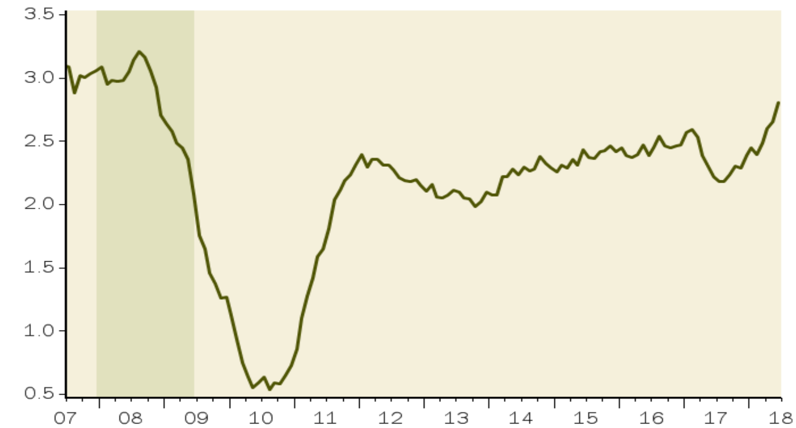
Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

There was more in the way of inflation than the headline would otherwise indicate

Providing confirmation that there was more in the way of inflation than the headline would otherwise indicate, the Cleveland Fed's median CPI measure rose a firm +0.23% on the month. As a result, this took the YoY trend to +2.80% from +2.65%, the highest level of the expansion. Note that research from the Fed has shown that *"the Median CPI provides a better signal of the inflation trend than either the all-items CPI or the CPI excluding food and energy."* It should therefore be no surprise that we see the balance of risks firmly tilted to the upside on the inflation front through the back half of the year.

CHART 2: CLEVELAND FED MEDIAN CPI

United States
(year-over-year percent change)



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

It was a very similar message from the trimmed-mean CPI which also rose +0.23%, the largest increase since January. This was enough to push the 12-month change to +2.17% from +2.02%, the fastest run-rate in 1 ½ years.

CHART 3: CLEVELAND FED TRIMMED-MEAN CPI

United States
(year-over-year percent change)

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

And, of course, beyond firming underlying measures of inflation, the tariffs already enacted and proposed by the U.S. administration will put further upward pressure on prices going forward. As an example of the

The tariffs already enacted and proposed will put further upward pressure

effect this already had, look to washing machines which have seen prices soar +16% (or a +34% annualized rate) since tariffs here were enacted back in January.

CHART 4: CPI: LAUNDRY EQUIPMENT

United States
(six-month annualized percent change)

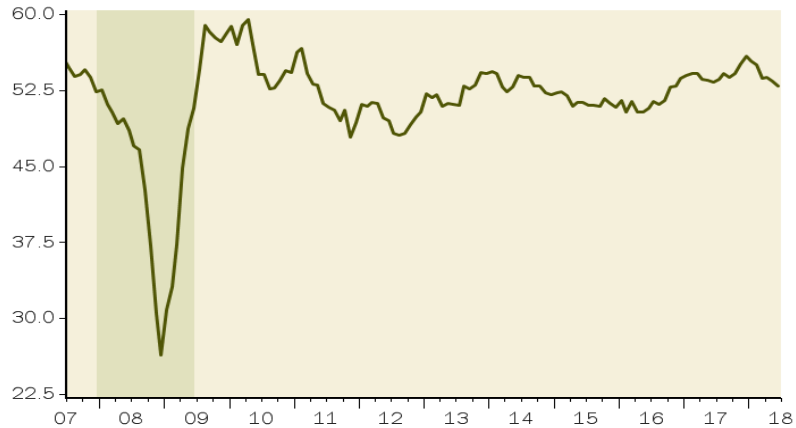
Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Make no mistake — tariffs are a tax on consumers, nothing more and nothing less, with clear negative implications for consumer spending given pinched real incomes. Time will tell how the trade turmoil will ultimately shake out, but we are taking up our forecast for inflation while concurrently taking down our forecast for growth. In other words, some whiffs of stagflation — something that is also starting to be signaled in JP Morgan's global manufacturing PMI where new orders fell to an 20-month low while prices rose to a seven-year high during June.

Time will tell how the trade turmoil will ultimately shake out

CHART 5: NEW ORDERS

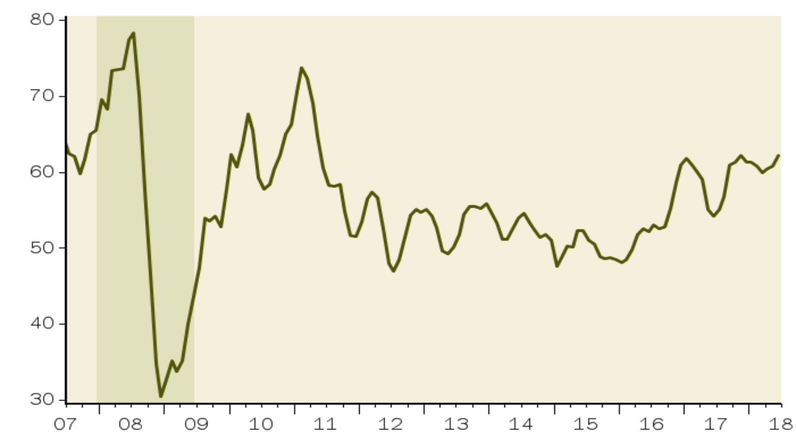
United States: ***JP Morgan Global Manufacturing PMI***
(index; >50 denotes expansion)



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

CHART 6: INPUT PRICES

United States: ***JP Morgan Global Manufacturing PMI***
(index; >50 denotes expansion)



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

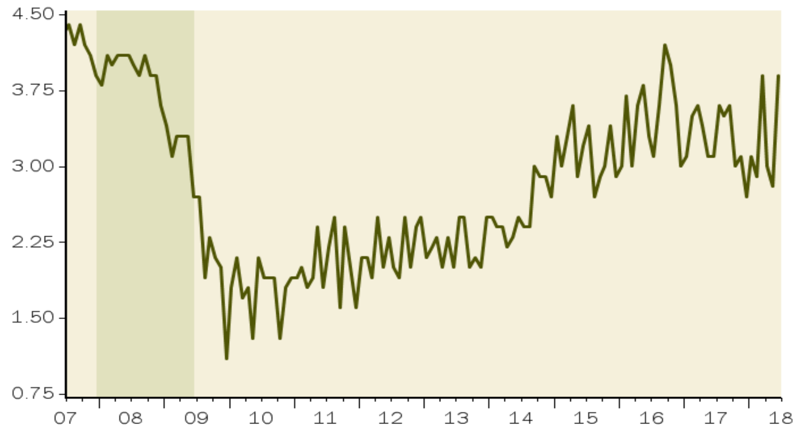
ARE WAGES STRONGER THAN BROADCAST?

Earnings growth may well have been tame in last Friday's NFP report, but the Atlanta Fed wage tracker painted quite a different picture for the month. In fact, the 'non-smoothed' indicator jumped to +3.9% from +2.8% in May, tied for a 20-month high.

The Atlanta Fed wage tracker painted quite a different picture for the month

CHART 7: ATLANTA FED WAGE GROWTH TRACKER

United States
(year-over-year percent change)



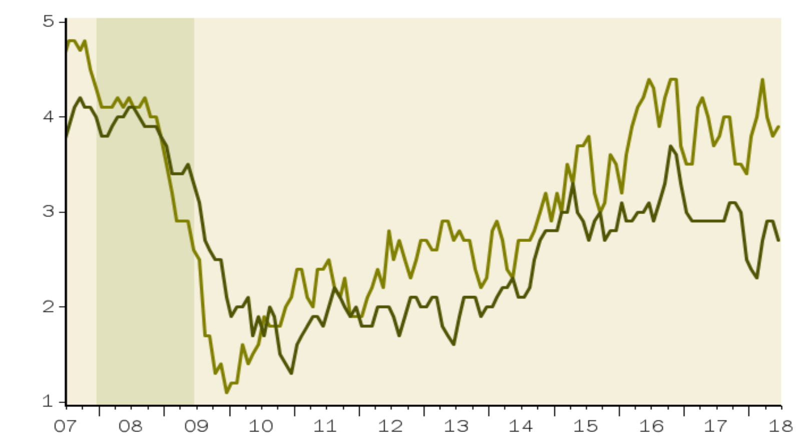
Shaded region represents period of U.S. recession
Source: Haver Analytics, Gluskin Sheff

On a smoothed (three-month moving average) basis, 'job stayers' are seeing earnings growth of +2.7% YoY. Not horrible, but considerably below the +3.9% trend for 'job switchers'. This is why the acceleration in the quit rate (as per the latest JOLTS data) foreshadows a wage pick-up — more people are now leaving for greener pastures (a higher paying salary).

More people are now leaving for greener pastures

CHART 8: BETTER WAGE GROWTH FOR JOB HOPPERS

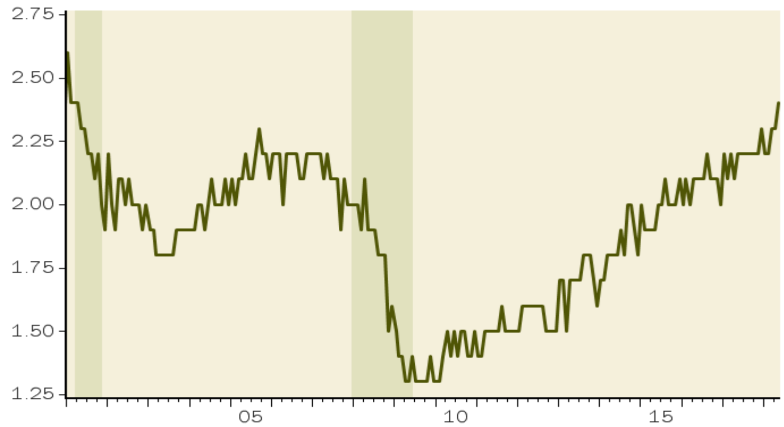
United States
(job switchers wage growth; light-green line; year-over-year percent change)
(job stayers wage growth; dark-green line; year-over-year percent change)



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

CHART 9: QUIT RATE

United States
(percent)



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

That said, one reason why earnings growth has remained relatively subdued throughout the cycle is because there is still a high percentage of individuals (14.1%) that have experienced no change whatsoever. This is well above levels during the prior two expansions and likely indicative of a more deeply engrained sense of job insecurity (automation, globalization, etc.).

Likely indicative of a more deeply engrained sense of job insecurity

CHART 10: INDIVIDUALS WITH NO WAGE CHANGE

United States
(percent)

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

Nonetheless, the bottom line is that we are seeing a cyclical uptick in wages even as secular factors (and scars from the prior crisis) have limited just how robust this improvement has been.

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$1 million invested in our flagship GS+A Premium Income Portfolio in 2001 (its inception date) would have grown to approximately $6.3 million[2] on April 30, 2018 versus $3.1 million for the S&P/TSX Total Return Index[3] over the same period.

For further information, please contact: research@gluskinsheff.com

Notes:

1. Past returns are not necessarily indicative of future performance. Rates of return are those of the composite of segregated Premium Income portfolios and are presented net of fees and expenses and assume reinvestment of all income. Portfolios with significant client restrictions which would potentially achieve returns that are not reflective of the manager's portfolio returns are excluded from the composite. Returns of the pooled fund versions of the GS+A Premium Income portfolio are not included in the composite.
2. Investment amounts are presented to reflect the actual return of the composite of segregated Premium Income portfolios and are presented net of fees and expenses.
3. The S&P/TSX Total Return Index calculation is based on the securities included in the S&P/TSX Composite and includes dividends and rights distributions. This index includes only Canadian securities.

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