Gluskin Sheff + Associates Inc.

SEARCHING FOR CERTAINTY IN A SEA OF UNCERTAINTY

David A. Rosenberg

November 2011

WHAT, ME WORRY?

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 – i) sharp down, ii) reflexive rebound, and iii) 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

BULLISH SENTIMENT ENTRENCHED FOR 2011

Cover story: USA TODAY Investment Roundtable

In 2011, it's all about stocks

5 top experts agree: New year's looking great for stocks, not so great for bonds

By Robert Deutsch, USA TODAY

By Adam Shell
USA TODAY

NEW YORK — Five Wall Street heavyweights say it's time for individual investors to shun the perceived safety of bonds — and get over their fear of the U.S. stock market — so they can take advantage of what they predict will be a third straight year of solid gains for stocks in 2011.

The major theme from USA TODAY's 15th annual Investment Roundtable is that the bond market is looking riskier amid signs the economy is gaining traction. The five panelists say stocks, which get a boost from stronger growth, will post better returns than bonds in 2011. They are advising investors, many still leery two years after the financial crisis, to start shifting some investment dollars out of bonds and back into stocks.

"If you don't believe in a depression, and I don't," says BlackRock's chief equity strategist Bob Doll, "stocks will go up and bonds will go down in the next few years."

Adds David Bianco, chief U.S. equity strategist at Bank of America Merrill Lynch: "We're broadly bullish on U.S. equities. It's important for investors to get back into the asset class. Go buy mutual funds. Go buy index funds."

With the odds of a double-dip recession fading, assets perceived as safe, such as bonds, may be riskier than investors think. And "risk assets" like stocks may be better priced than they appear, says Abby Joseph Cohen, senior investment strategist for Goldman Sachs' Global Markets Institute.

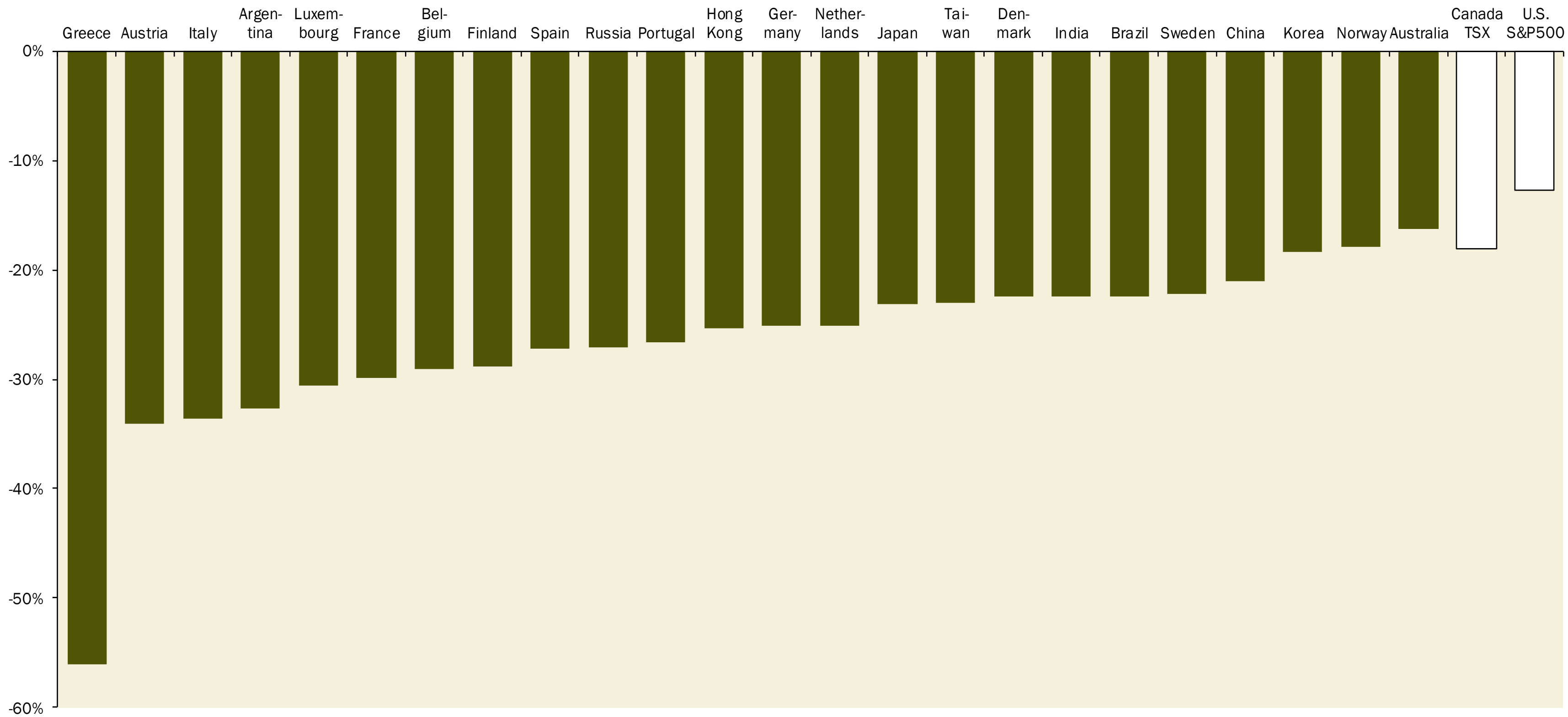
Each panelist predicted double-digit gains in 2011. Dan Chung, CEO and chief investment officer at Alger Funds, was the most optimistic, saying stocks could rise more than 20% sometime in 2011. Earnings will surprise to the upside, he says.

Richard Bernstein, CEO and chief investment officer of Richard Bernstein Advisors, says U.S. stocks "sort of have the

A SPREADING GLOBAL BEAR MARKET

Major Stock Markets

(percent change from the nearby peak)

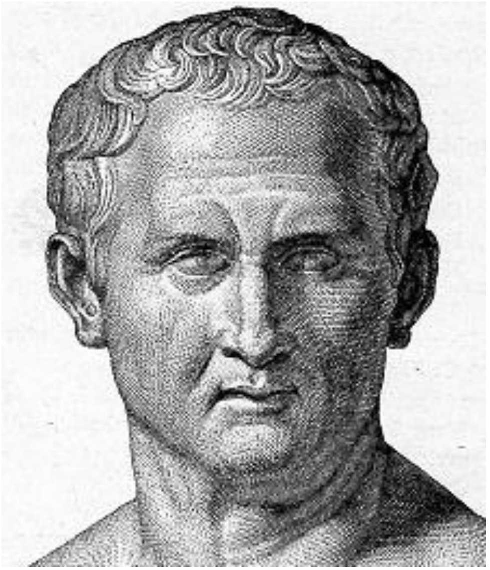


Note:
Source: Bloomberg

WHAT HAVE WE LEARNED IN 2,604 YEARS?

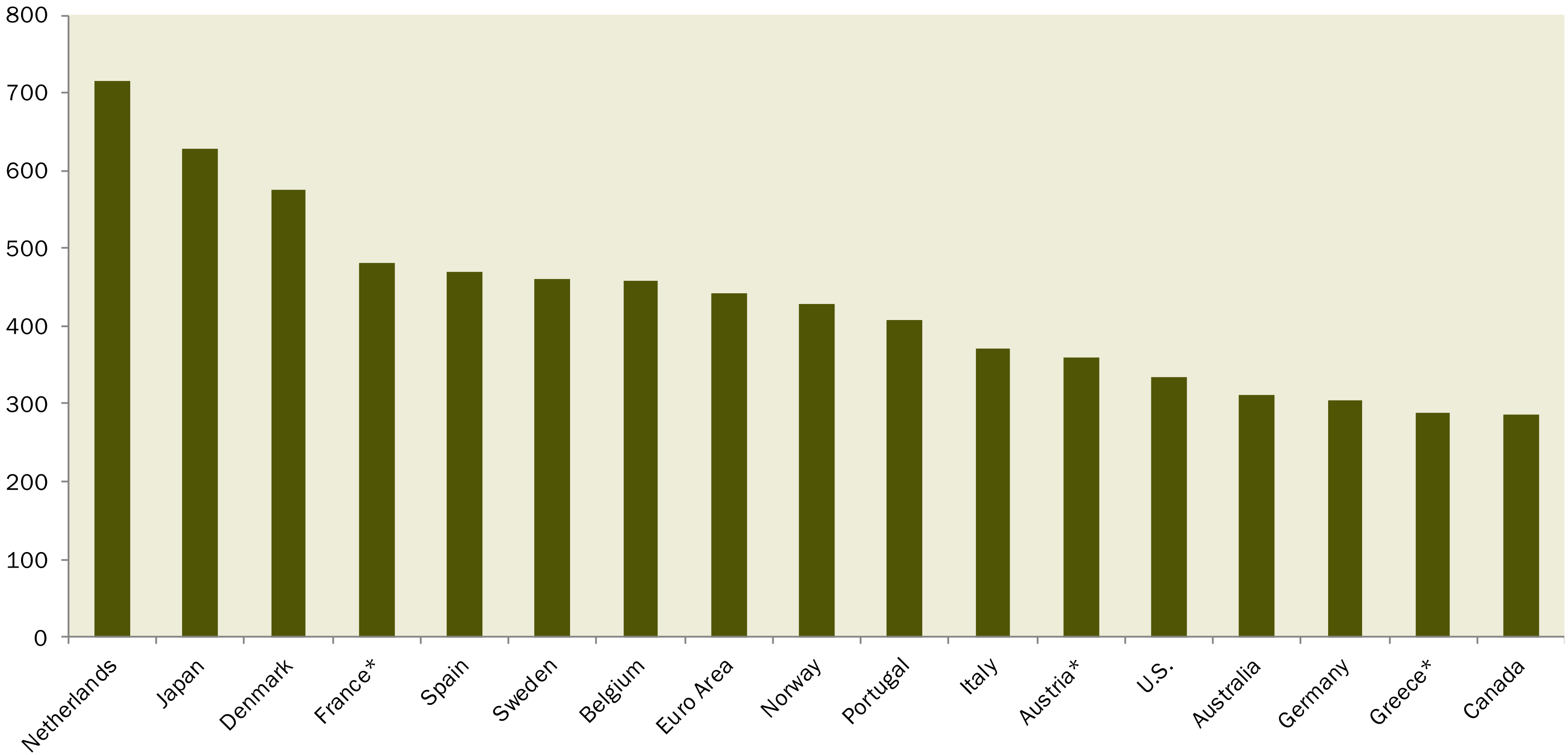
"The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance."

Cicero - 55 BC



TOO MUCH DEBT AT ALL LEVELS

Domestic Debt Outstanding as a % of adjusted GDP (Q2 2011)

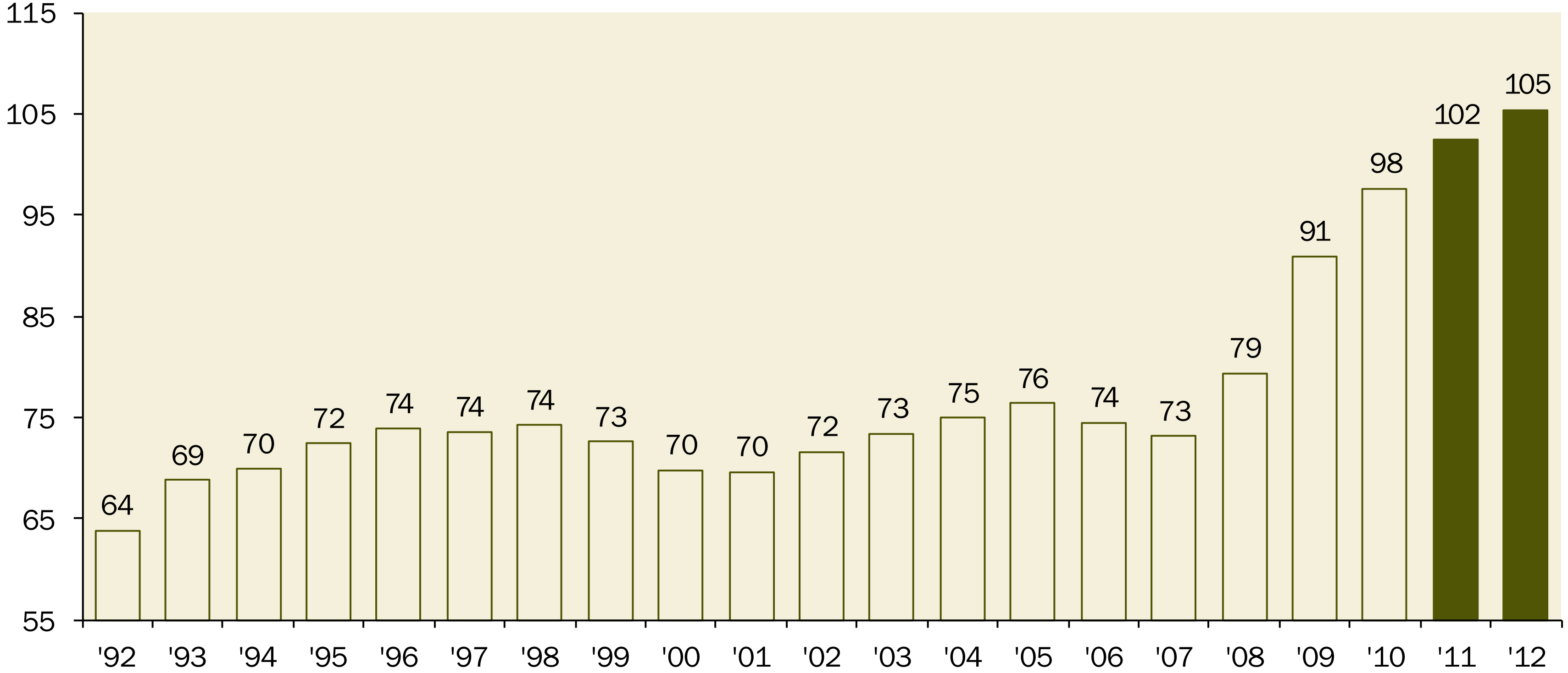


Note:
Source: Haver Analytics
** Last available data points for France and Austria are as of Q3 2010 and Greece is as of Q1 2011*

THE WORLD IS AWASH IN DEBT

OECD: Gross General Government Debt-to-GDP Ratio

(percent of nominal GDP)

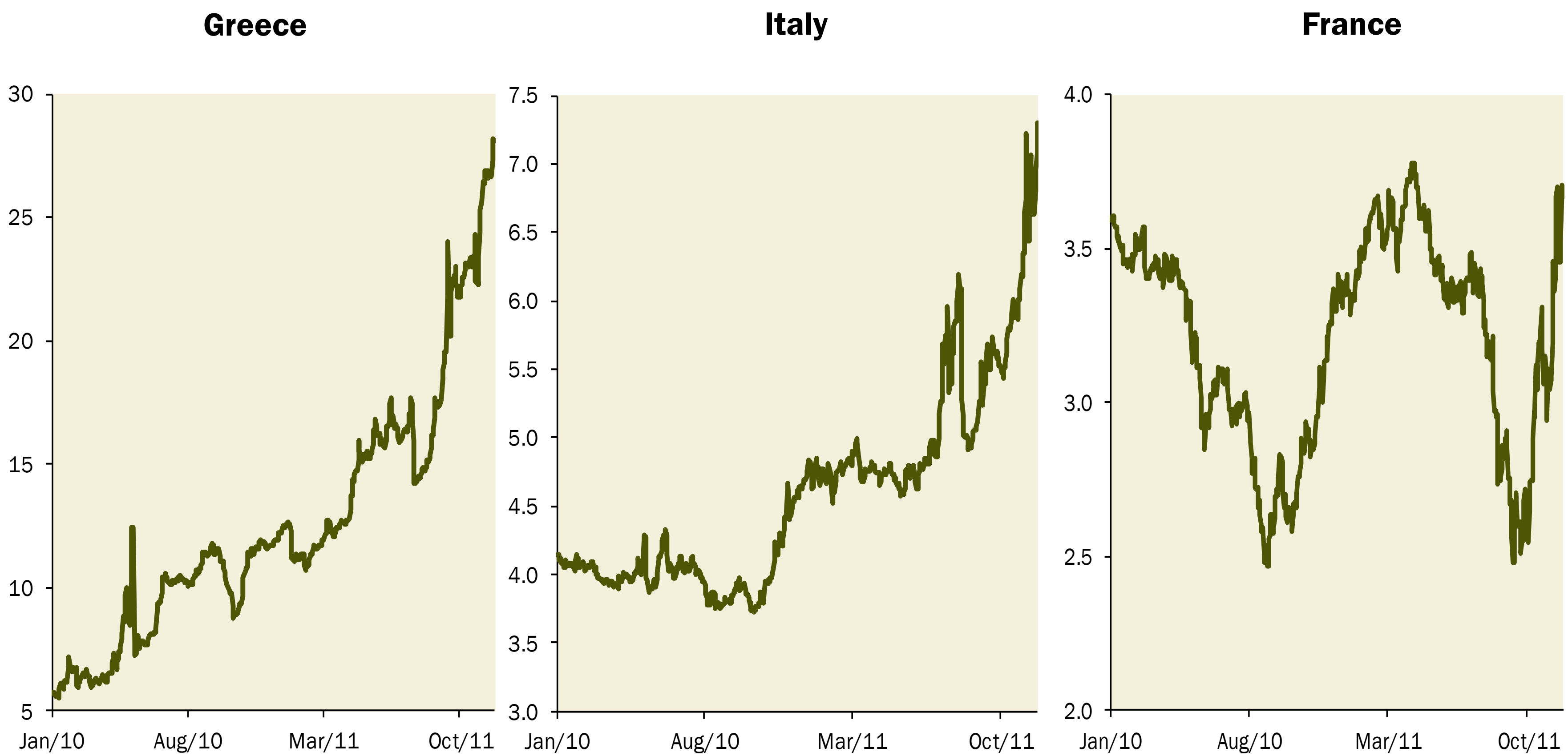


Notes:
Shaded bars represent OECD estimates
Source: OECD

CONTAGION SPREADING

10-Year Government Bond Yield

(percent)



Note:
Source: Bloomberg

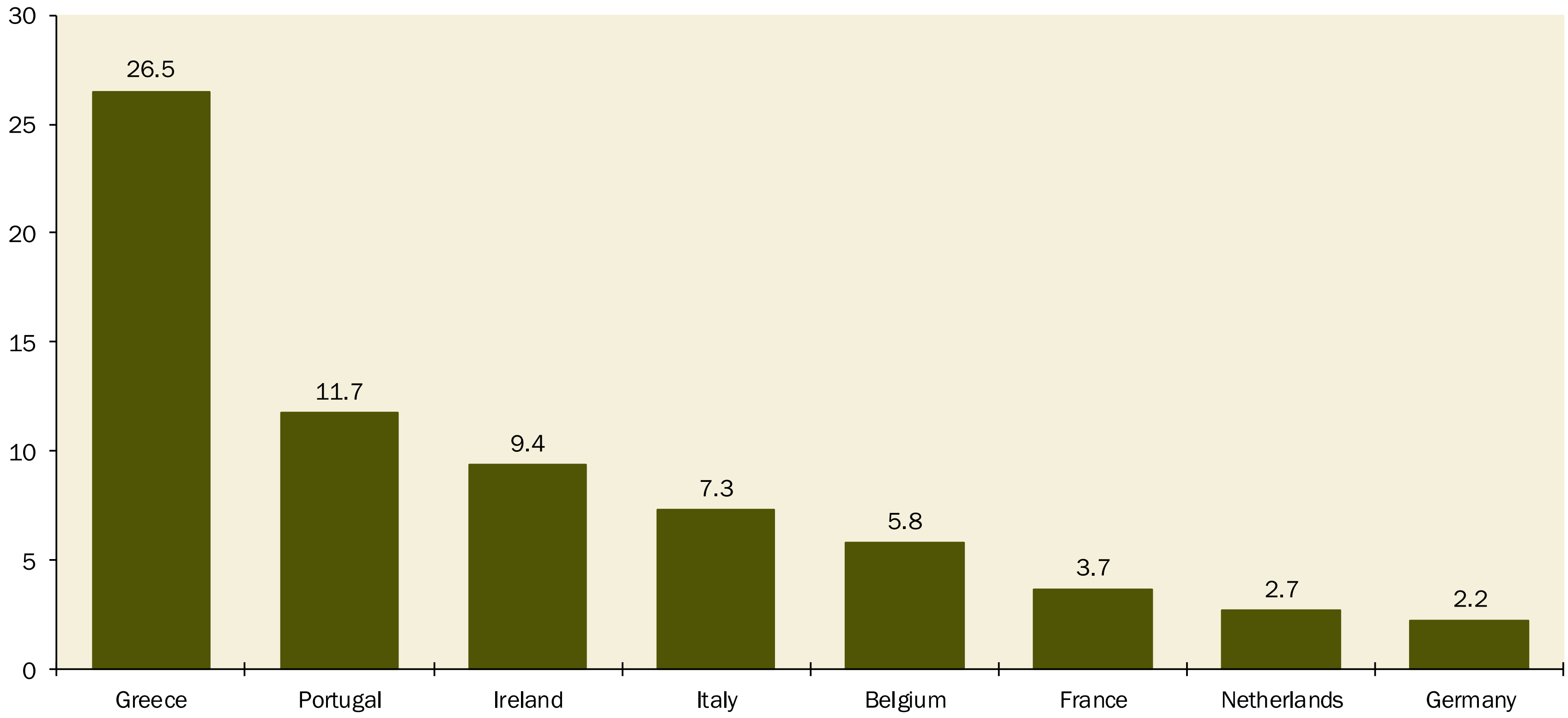
IS THIS REALLY THE END?

Note:
Source: The Economist, November 26, 2011

INTEREST RATES DIVERGE IN THE EUROZONE TO THE PRE-EMU LEVELS

Current 10-Year Government Bond Yield

(percent)

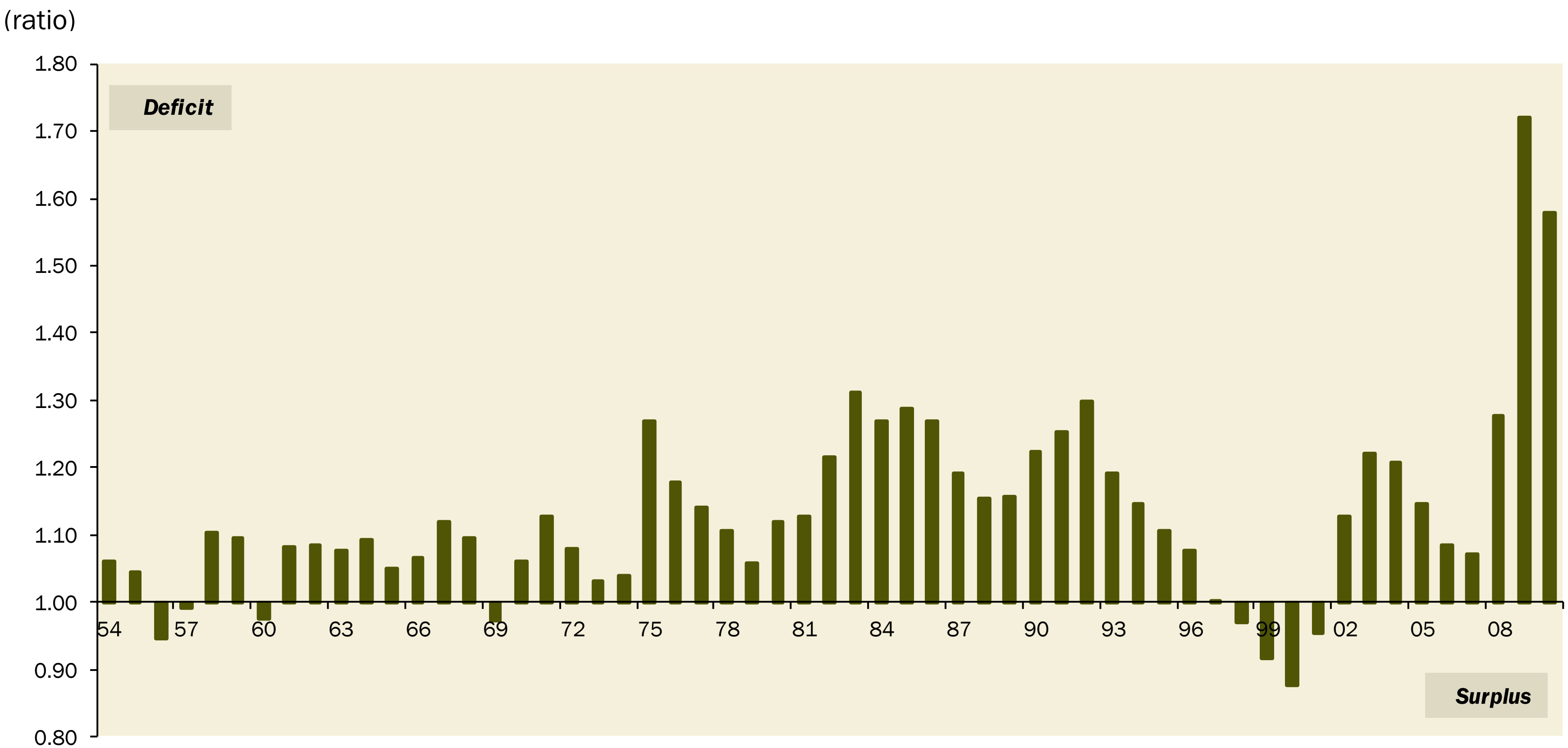


Note:
Source: Bloomberg


FEDERAL RESERVE NOTE
THE UNITED STATES OF AMERICA
F 54207307 R
ONE DOLLAR
DARYL CAGLE

U.S. GOVERNMENT SPENDING $1.60 FOR EVERY $1.00 IN REVENUE

United States: Net Outlays/Net Receipts

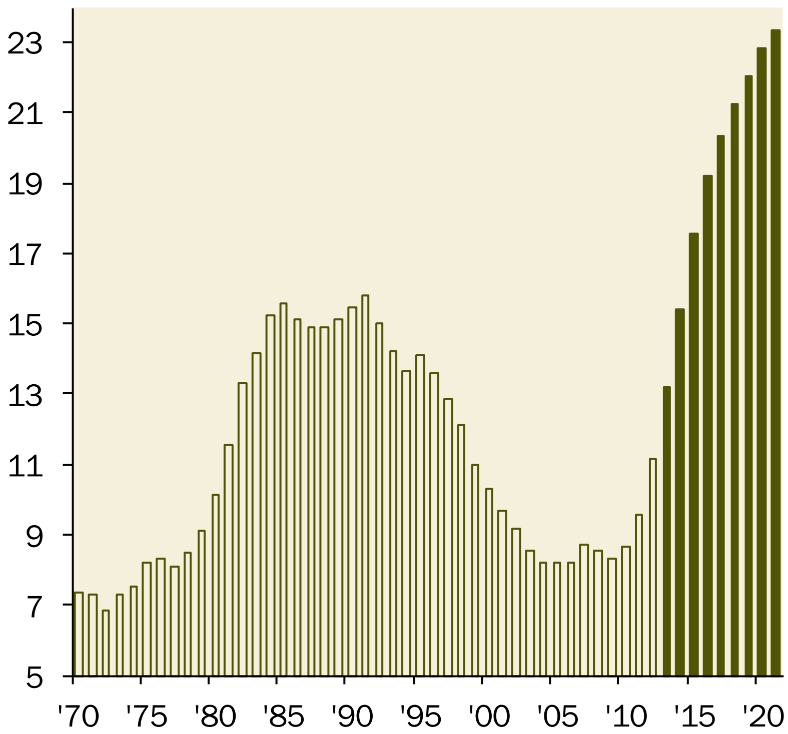


Note:
Source: U.S. Treasury

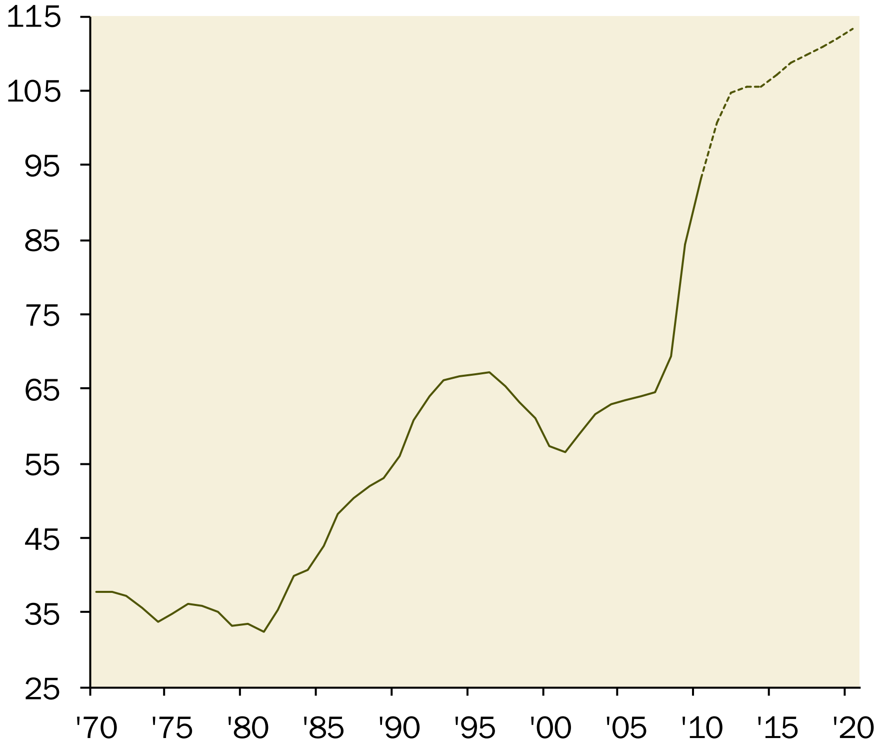
A CHALLENGING ENVIRONMENT FOR THE FEDERAL GOVERNMENT

United States: Government Finances (percent)

Interest Payments as a Share of Total Revenue



Debt as a share of GDP



Notes:

Shaded bars and dotted lines represent estimates (interest payments/total revenue estimates by Gluskin Sheff and debt/GDP estimates by the OMB)

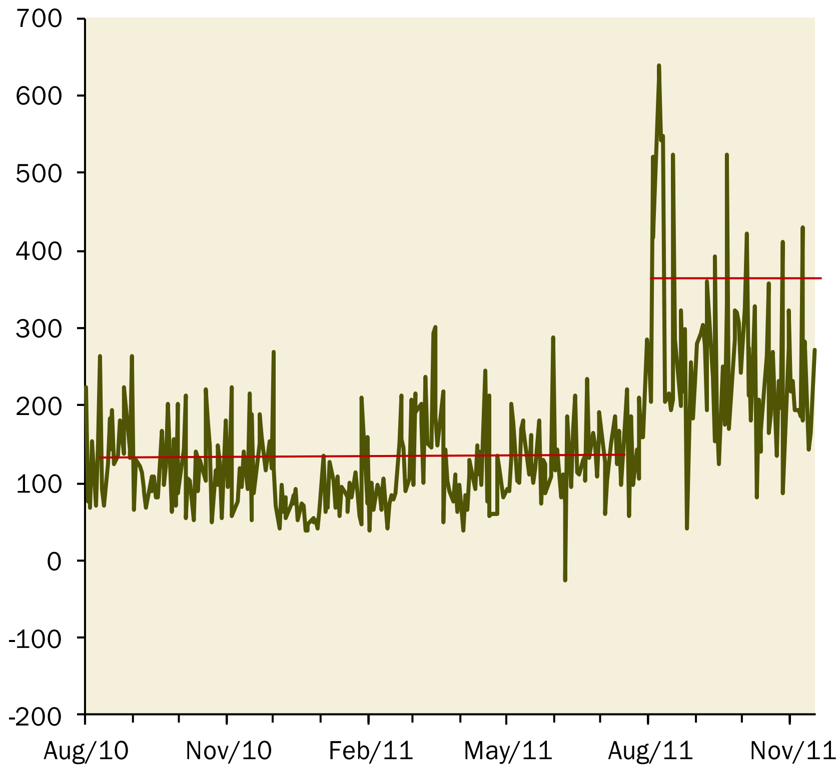
Source: OECD, U.S. Office of Management and Budget (OMB)

VOLATILITY IS THE NEW NORMAL

United States

VIX Index

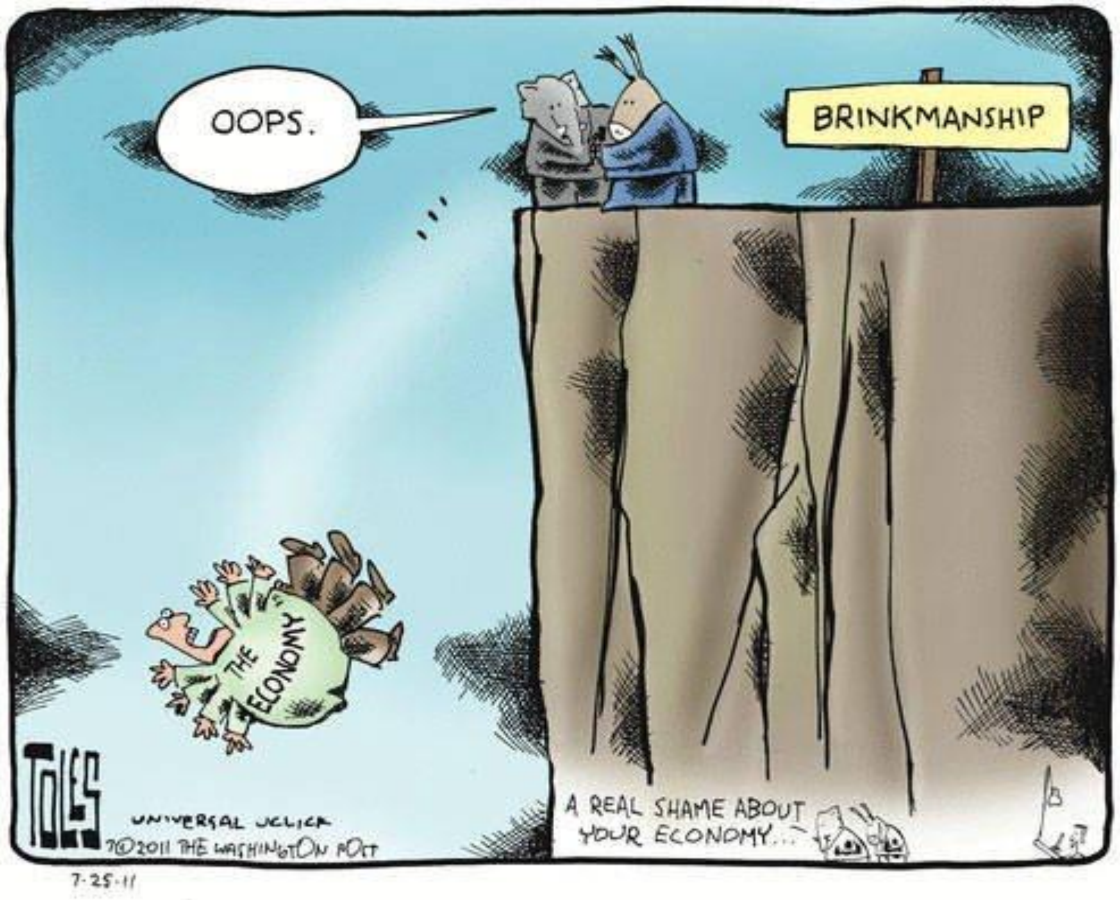
Dow Jones Index: Intraday High minus Low



Note:

Source: Wall Street Journal, Haver Analytics

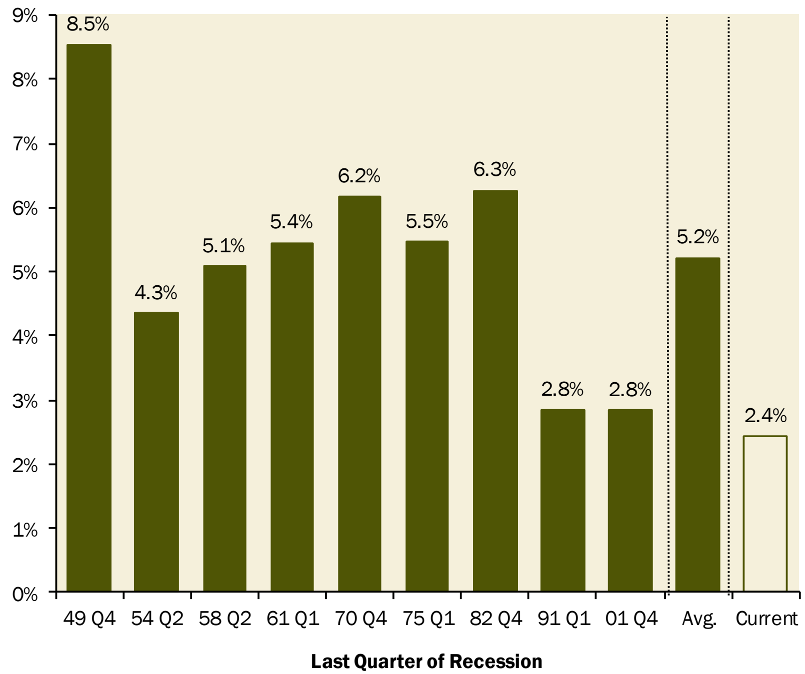
THE PEAK IN GROWTH IS BEHIND US



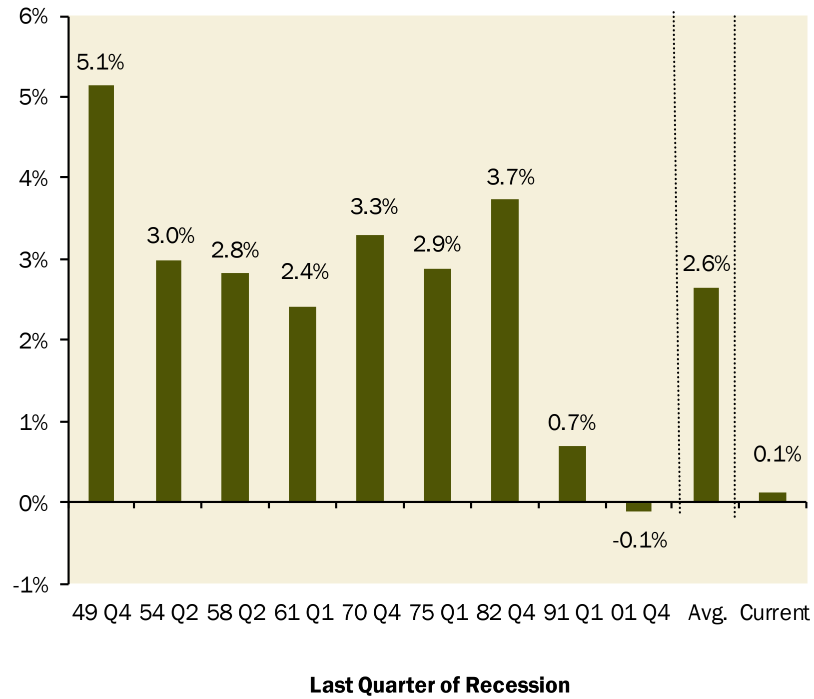
SO FAR, A SUB-PAR U.S. ECONOMIC RECOVERY

United States

Real GDP Two Years After A Recession Ends
(annualized percent change)



Employment Two Years After A Recession Ends
(annualized percent change)



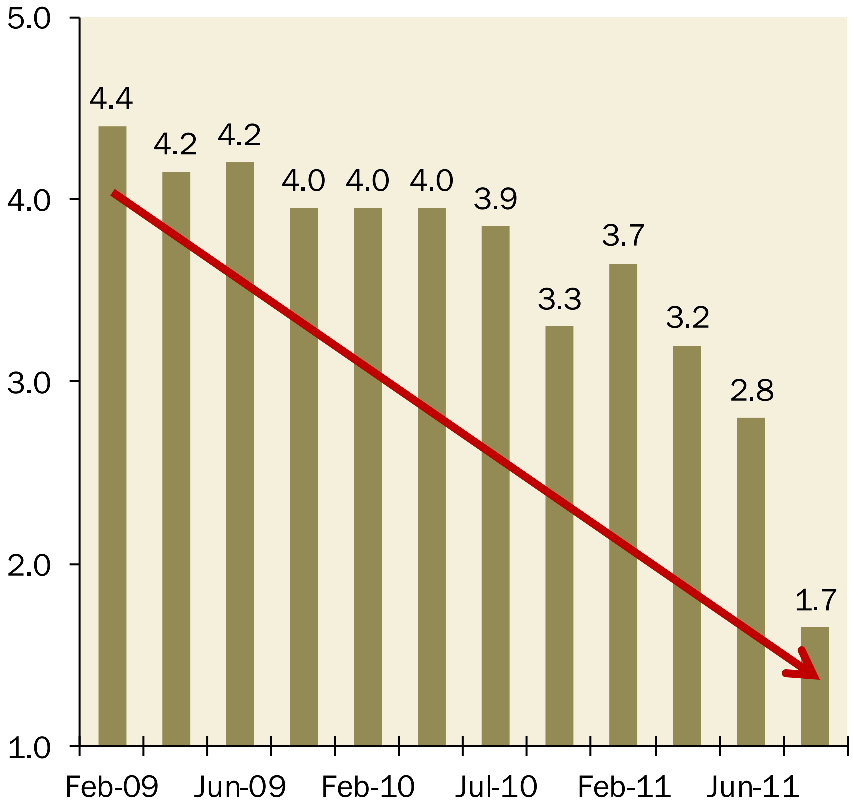
Note:

Source: Bureau of Economic Analysis, Bureau of Labour Statistics

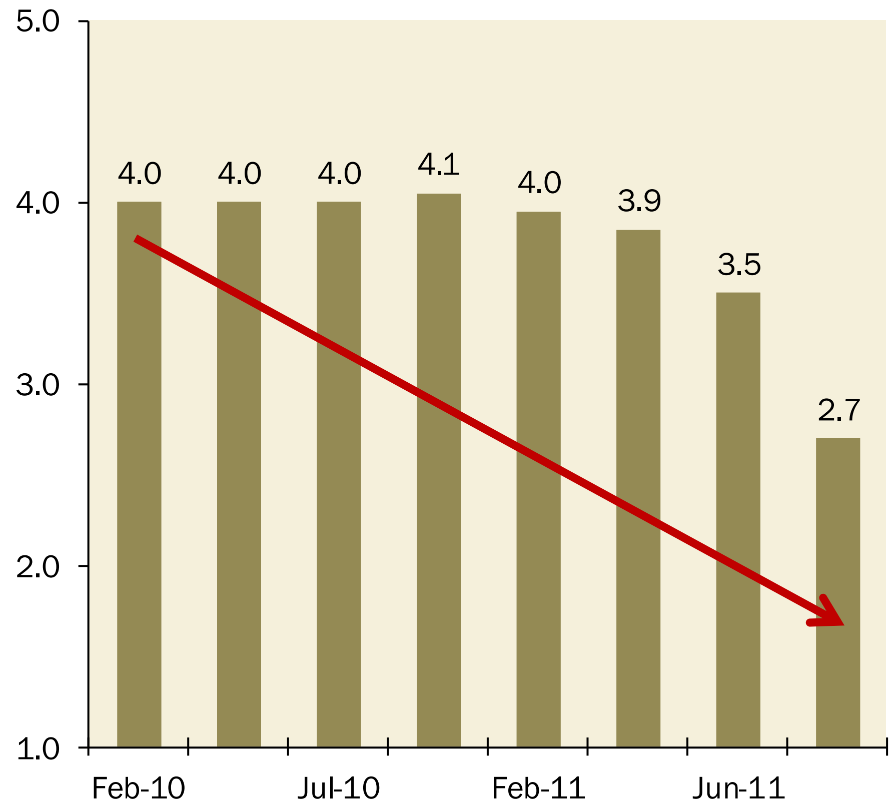
THE (SLIDING) EVOLUTION OF THE FED'S GDP FORECAST

United States: Federal Reserve GDP Forecast

2011



2012

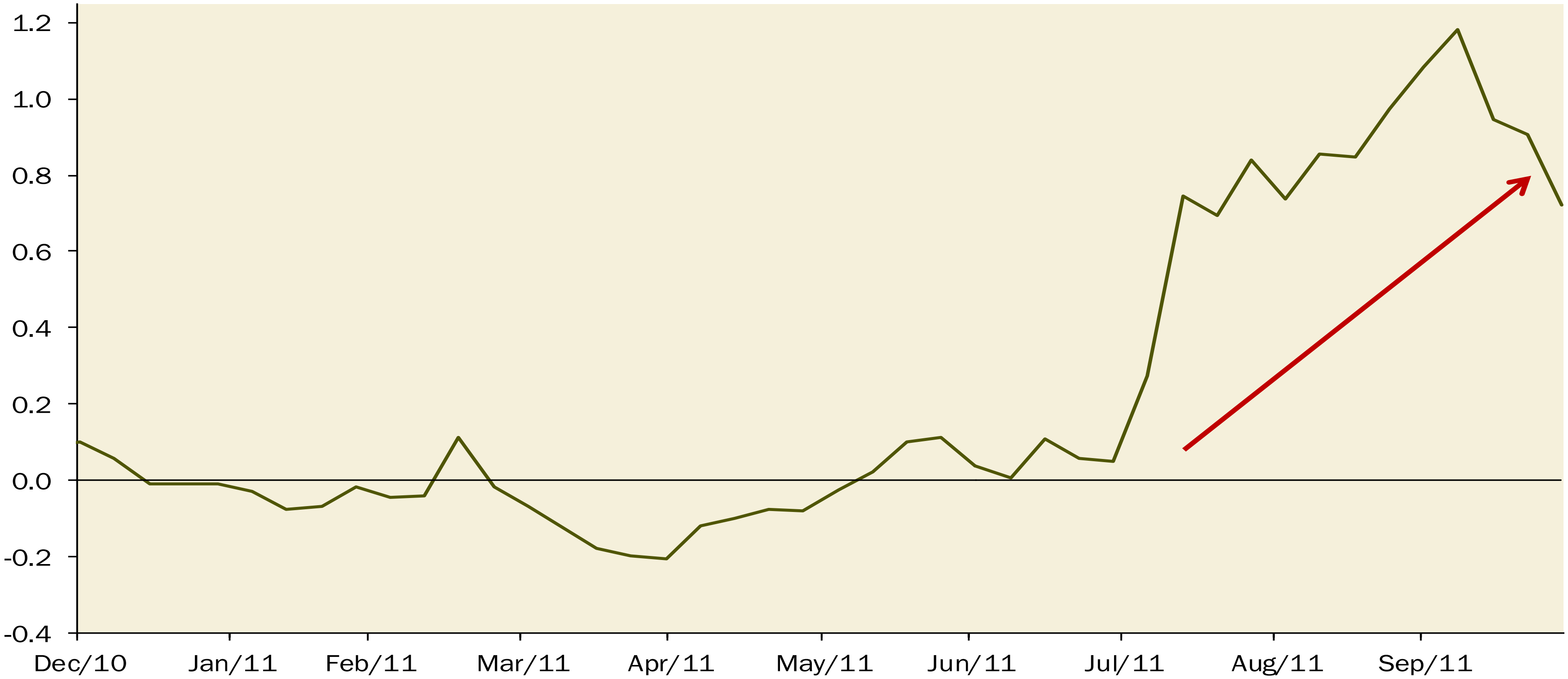


Note:
Source: Bloomberg

FINANCIAL CONDITIONS HAVE TIGHTENED SUBSTANTIALLY

United States: St. Louis Financial Stress Index

(above 0 = above average financial stress)

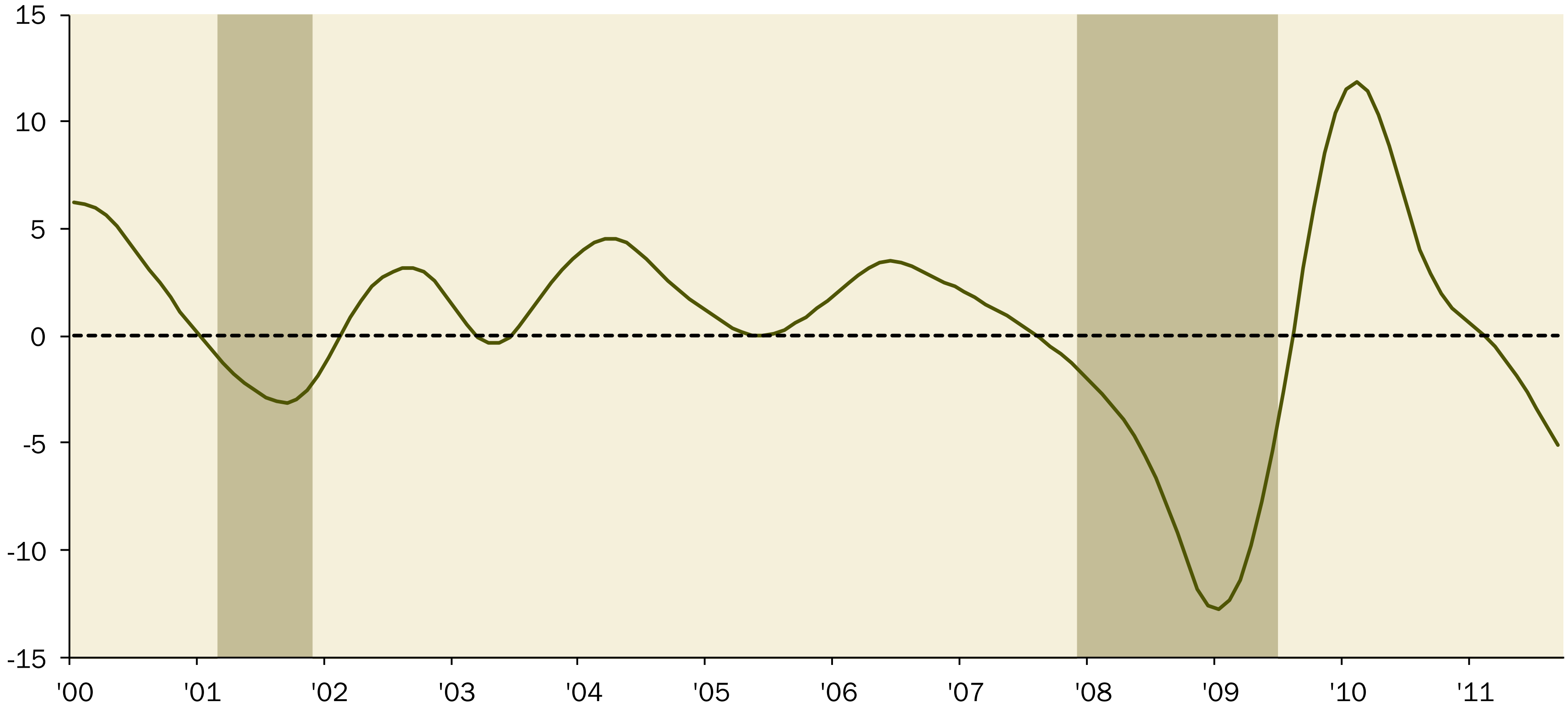


Note:
Source: Federal Reserve Bank of St. Louis

EURO AREA HEADING FOR RECESSION

Euro Area: Leading Indicator

(year-over-year percent change)

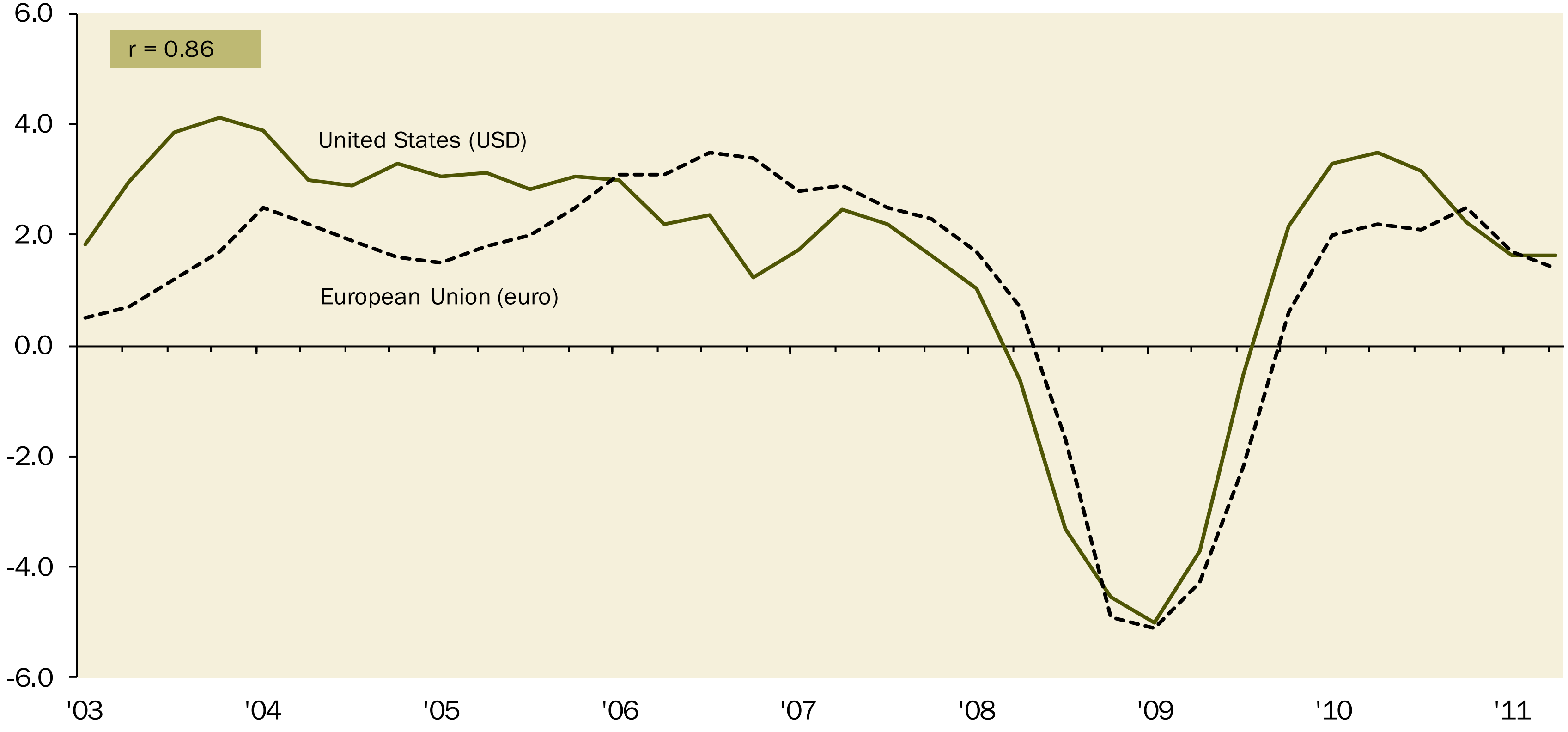


Note:
Shaded regions represent periods of U.S. recession
Source: OECD, Haver Analytics

THERE IS NO DECOUPLING

Real GDP Growth

(year-over-year percent change)

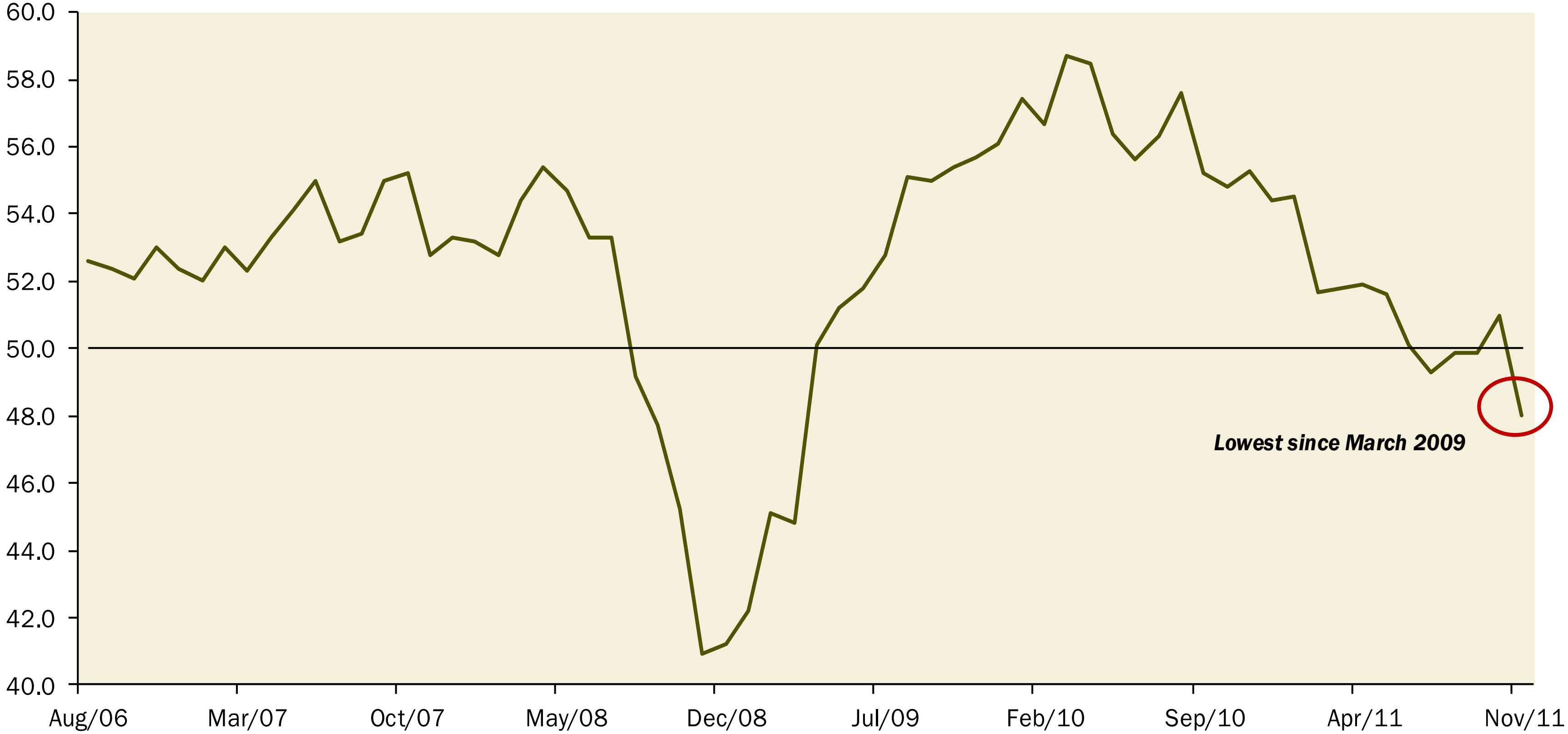


Note:
Source: Eurostat, BEA, Haver Analytics

HARD LANDING OR SOFT LANDING?

China: HSBC Manufacturing Purchasing Managers Index

(50+ = Expansion)



Note:
Source: Bloomberg

SAN FRANCISCO FED WEIGHS IN ON RECESSION DEBATE

FRBSF ECONOMIC LETTER
Future Recession Risks: An Update

By Travis J. Berge, Early Elias, and Oscar Jorda

On the yield curve:

"Historically, the interest spread between the federal funds rate and the yield on the 10-year U.S. Treasury bond had been one of the better predictors of turning points. But the extraordinary combination of the federal funds rate stuck near its zero lower bound and extremely low Treasury bond yields, reflecting uncertainty about European sovereign debt more than domestic fundamentals, have kept the spread unusually narrow. ***<u>We continue to view this signal as misleading in the current environment and have chosen to drop it from the update, just as we did in 2010.</u>****"*

On the economic outlook:

*"****<u>… the odds are greater than 50% that we will experience a recession sometime early in 2012.</u>*** *Because the international odds of recession are more imprecisely estimated, one must be careful with a strict interpretation of this result. But the message is clear. Prudence suggests that the fragile state of the U.S. economy would not easily withstand turbulence coming across the Atlantic. A European sovereign debt default may well sink the United States back into recession. However, if we navigate the storm through the second half of 2012, it appears that danger will recede rapidly in 2013."*

Note:
Source: November 14, 2011

CORRECTION IN AN EXPANDING ECONOMY OR A RECESSIONARY BEAR MARKET?

Correction in An Expanding Economy

- Examples: 1966,1987,1994 and 1998 (1987 was clearly much more intense, it was only so in magnitude, not duration)
- Duration: typically last little more than 3 months on average
- Magnitude: decline between 10-20%
- On average, real GDP growth was 4% SAAR during those selloffs
- In the most recent correction since April it was off 18% from the peak to trough

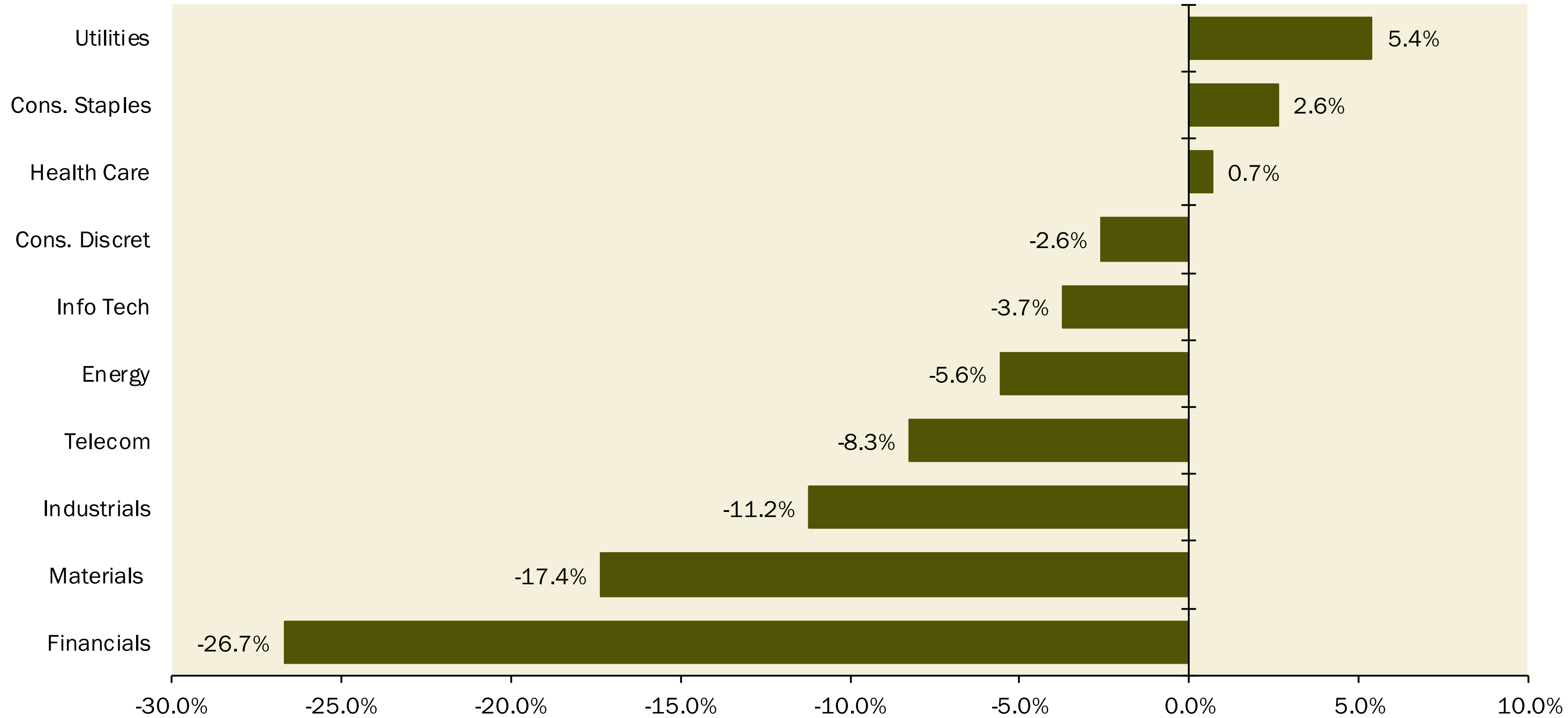
Recessionary Bear Market

- Duration: average is 16 months, median is 15 months and mode is 17 months
- Magnitude: decline typically as much as 20-40%
- But there have been several that have been extremely intense (57% in 2008-09, 49% in 2001-02 and 48% in 1973-74)
- GDP growth was about 0.8% SAAR in the lead-up to this selloff
- Only 27% of the bear market decline occurs prior to the first month of economic contraction

SURVIVAL KIT: LONG THE DEFENSIVES, SHORT THE FINANCIALS/CYCLICALS

United States: S&P 500 Year to Date Performance by Sector

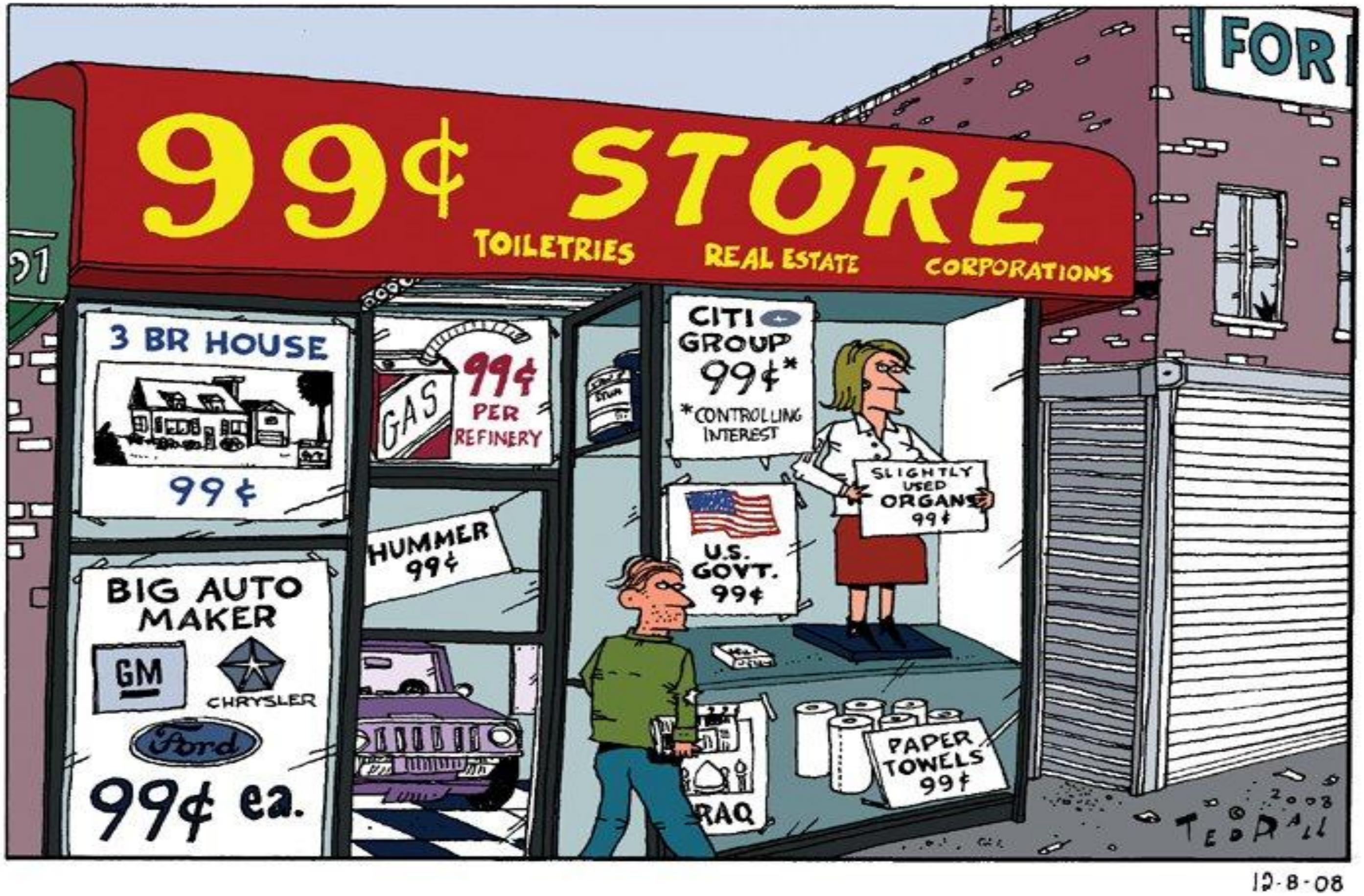
(percent, as of November 2011)



Note:

Source: Bloomberg

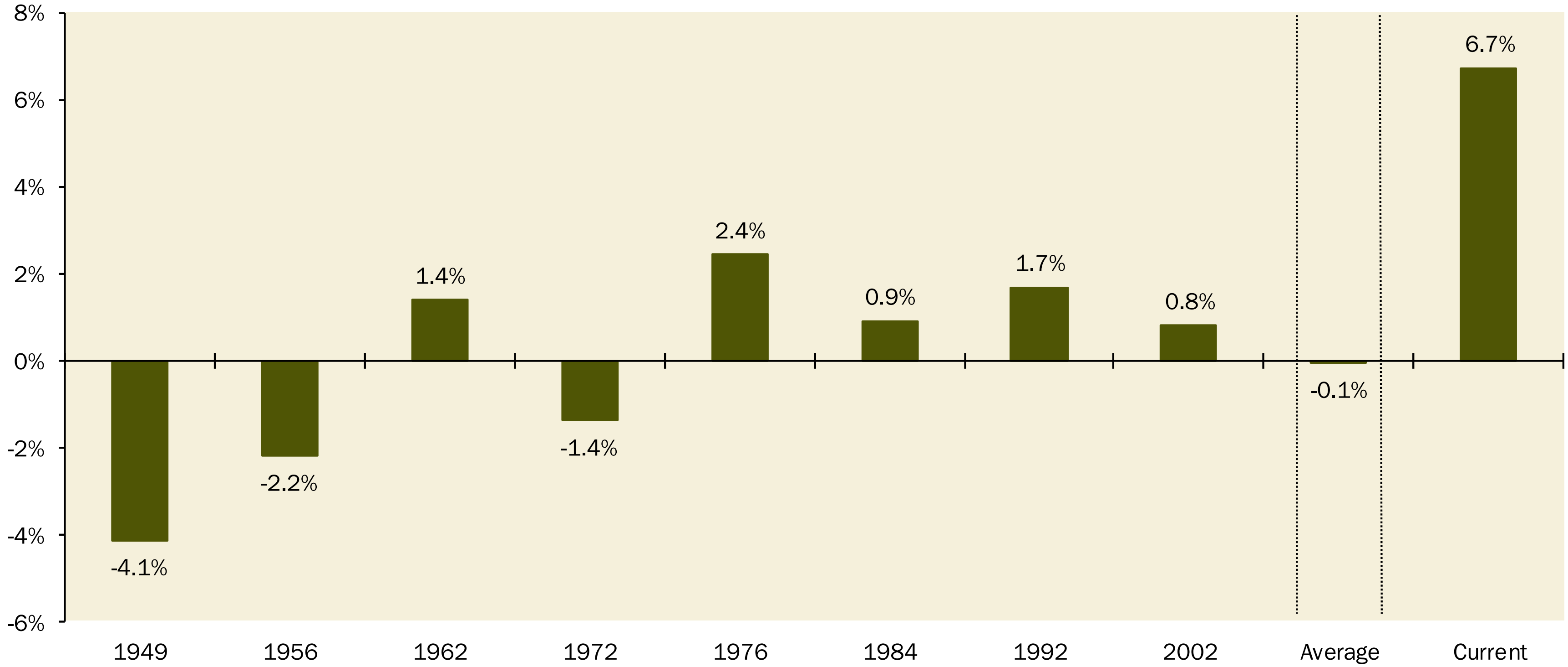
DEFLATION IS STILL THE UNDERLYING TREND



U.S. OUTPUT GAP HAS NEVER BEEN THIS WIDE AT THIS STAGE OF THE CYCLE

United States: Output Gap (potential GDP minus actual GDP)

(two-years after a recession ends, percent)



Note:

Source: Bureau of Economic Analysis, Congressional Budget Office

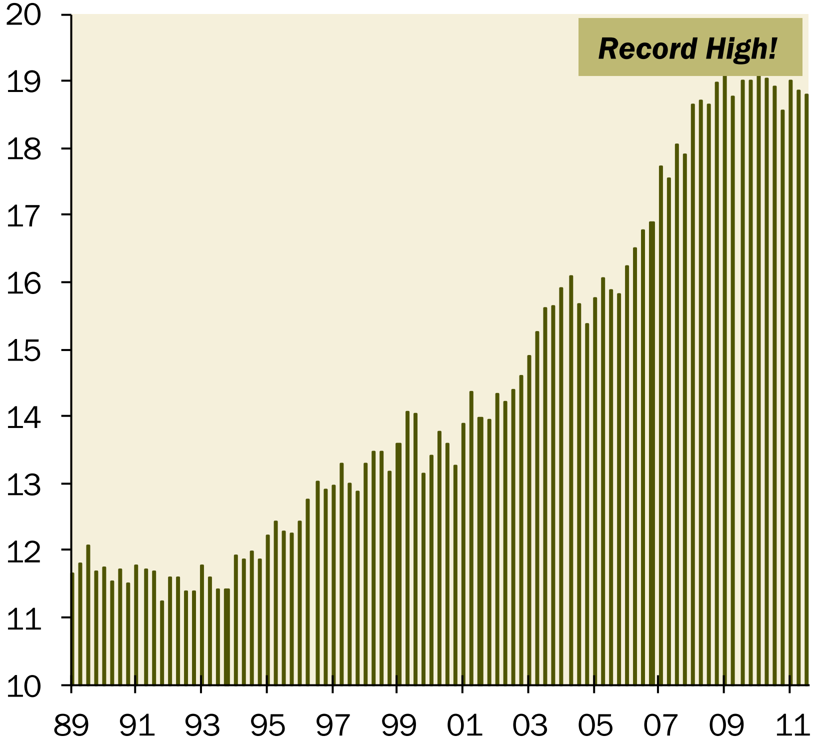

THE GOOD NEWS IS THAT PRICES ARE FALLING.


THE BAD NEWS IS THAT IT'S MY ASKING PRICE!
FOR SALE
$225 000
CARLSON

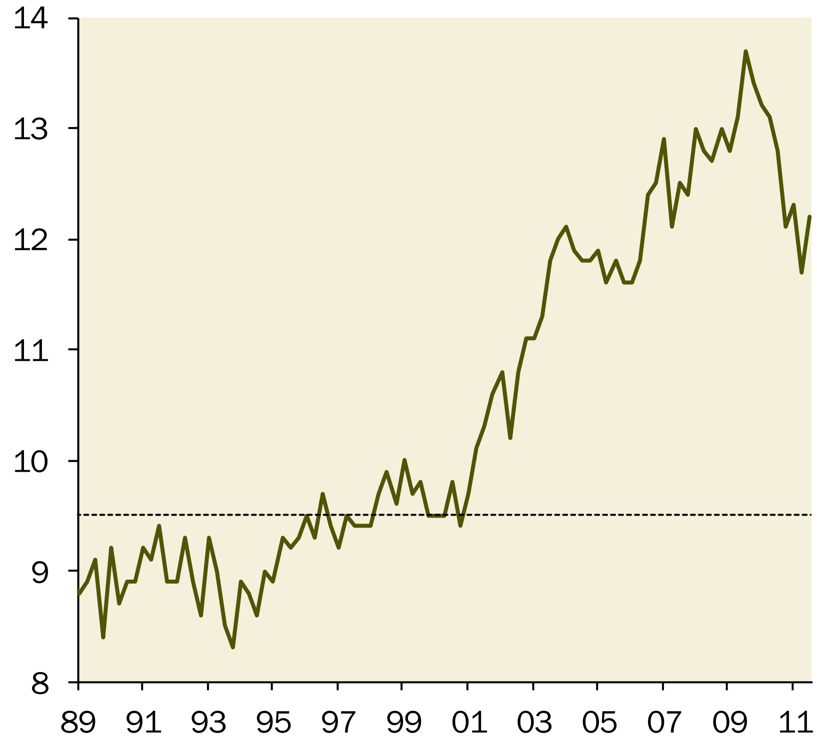
NEAR RECORD LEVEL OF VACANT RESIDENTIAL REAL ESTATE

United States

Total Vacant Housing Units
(million units)



Total Housing Vacancy Rate
(percent)



Note:
Source: Census Bureau

"Well, that's not going to help."

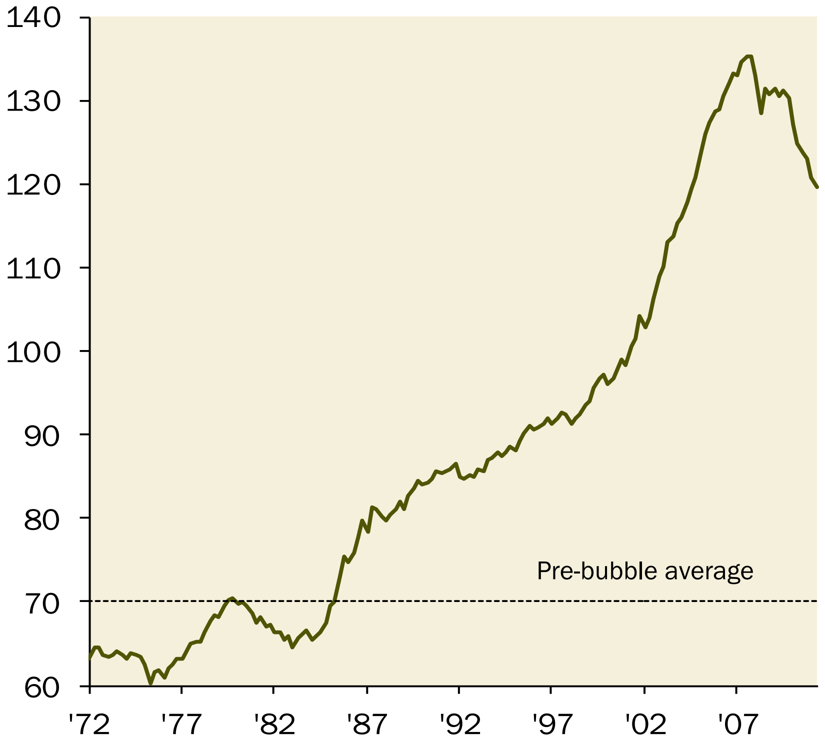
STILL MORE TO GO BEFORE THE HOUSEHOLD BALANCE SHEET IS REPAIRED

United States

(percent)

Household Debt-to-Asset Ratio

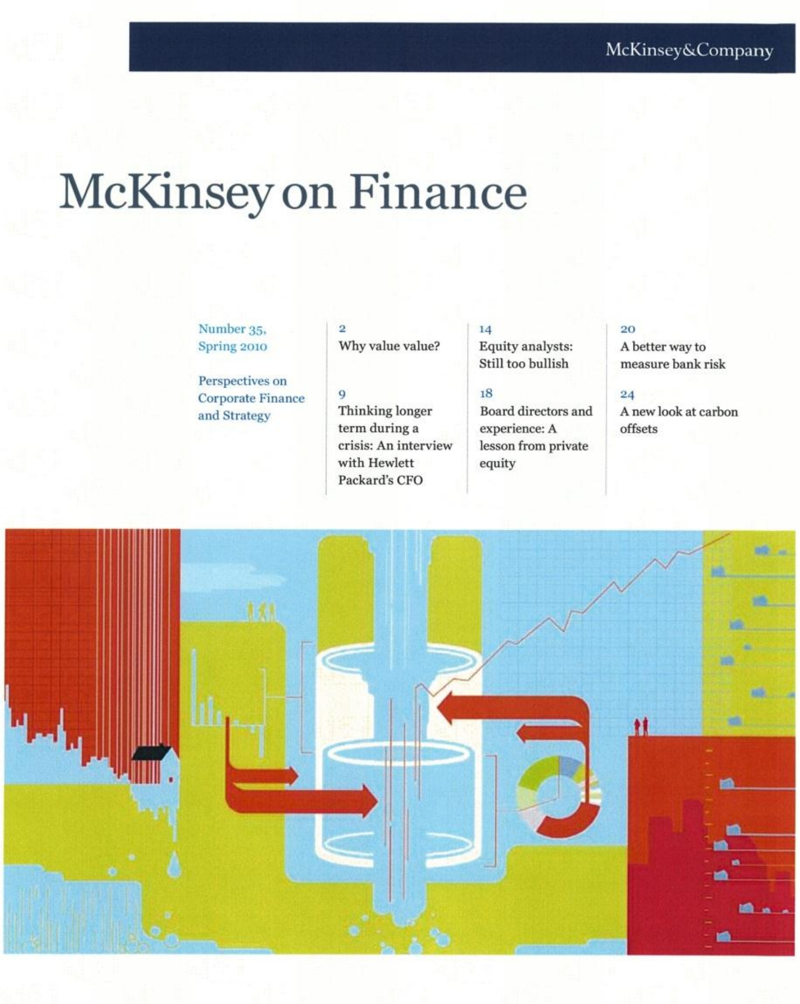
Household Debt-to-Income Ratio



Note:

Source: Federal Reserve Board

MCKINSEY ON FINANCE: PERSPECTIVE ON CORPORATE FINANCE & STRATEGY


McKinsey&Company

McKinsey on Finance

Number 35, Spring 2010

Perspectives on Corporate Finance and Strategy

2 Why value value?

9 Thinking longer term during a crisis: An interview with Hewlett Packard's CFO

14 Equity analysts: Still too bullish

18 Board directors and experience: A lesson from private equity

20 A better way to measure bank risk

24 A new look at carbon offsets

Findings from McKinsey & Company:

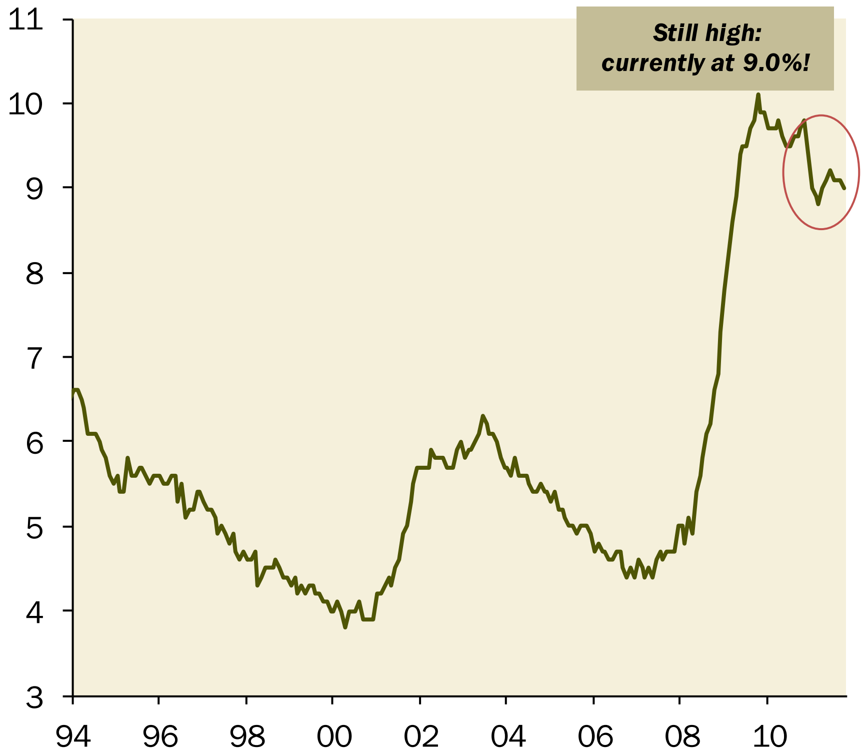
> *"While we cannot say for certain whether these sectors will deleverage, we do know that nearly every significant financial crisis in the post-World War II period was followed by a lengthy and painful period of deleveraging.* ***These episodes lasted on average six to seven years, with total debt as a percentage of GDP declining by roughly 25 percent. GDP contracted in the initial years of deleveraging but rebounded in the later years.*** *If history is a guide, therefore, we would expect a significant period of deleveraging to come, which will dampen GDP growth."*


AT LEAST I'M "OUT OF THE WOODS"!
ECONOMY
UNEMPLOYMENT
9/5 2009
DARKOW
CAGLECARTOONS.COM

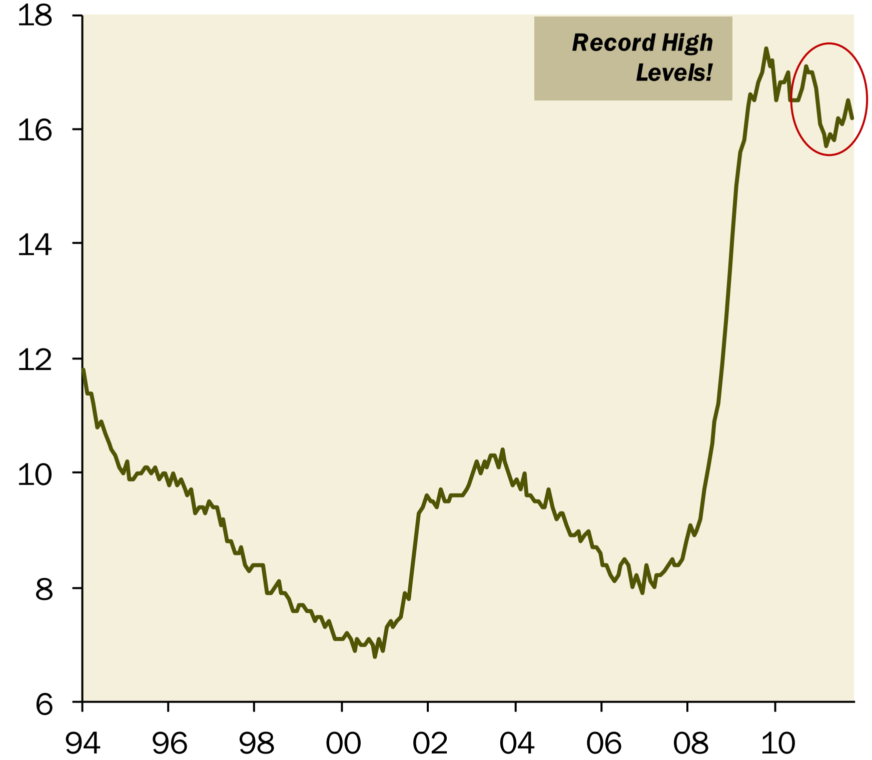
UNEMPLOYMENT STILL A MAJOR PROBLEM…

United States (percent)

Official Unemployment Rate



U6 Unemployment Rate*



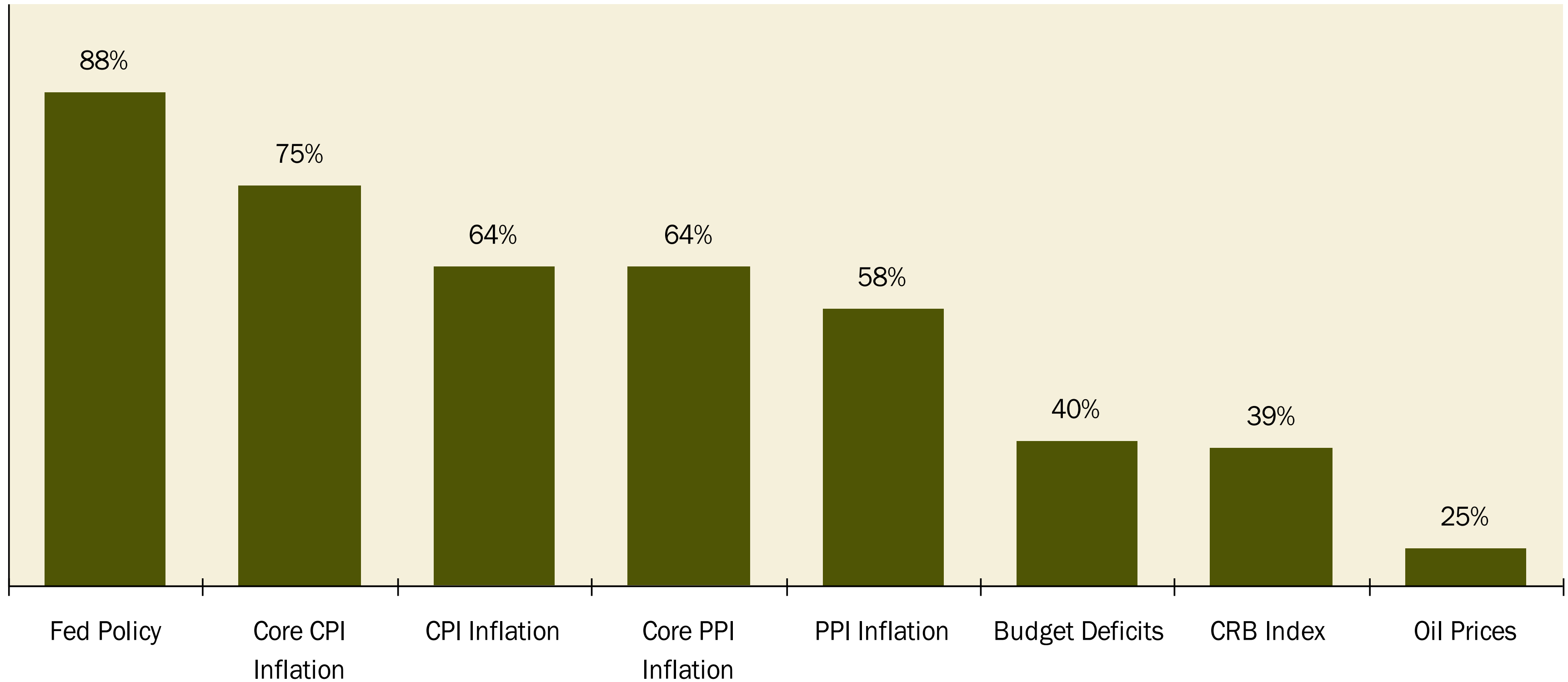
Notes:
*Includes all marginally attached workers and those employed part-time for economic reasons.
Source: Bureau of Labor Statistics, Federal Reserve


THE END IS NEAR
NUT-CASE.
UNFORTUNATELY, THAT'S MY FINANCIAL ADVISER.
STAHLER.

WHAT CORRELATES WITH BOND YIELDS

United States

(correlation: percent)



Note:
Source: Haver Analytics

NO U.S. RATE HIKE UNTIL MID-2013 … AT THE EARLIEST

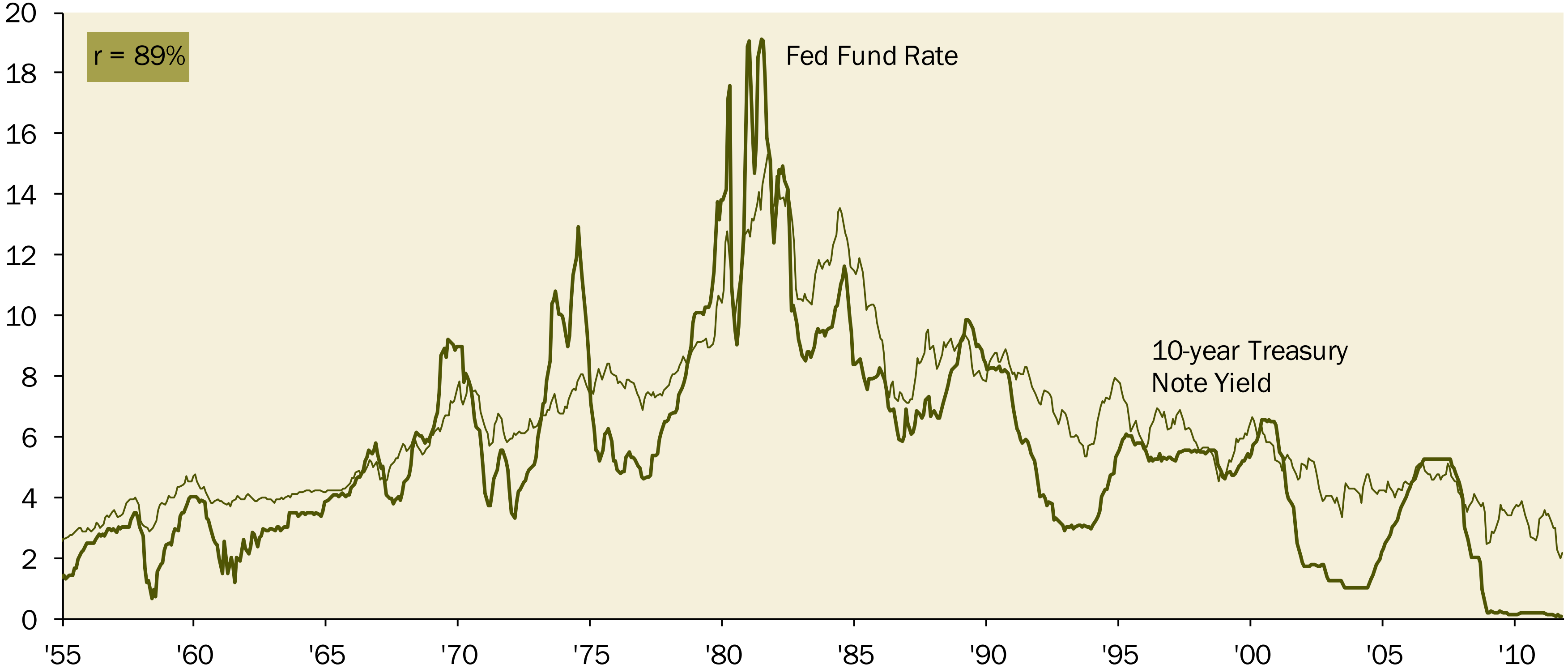
"*The Committee currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013.*"

— The FOMC Press Release, August 9, 2011

BOND YIELDS FOLLOW FED POLICY

United States

(percent)



Note:

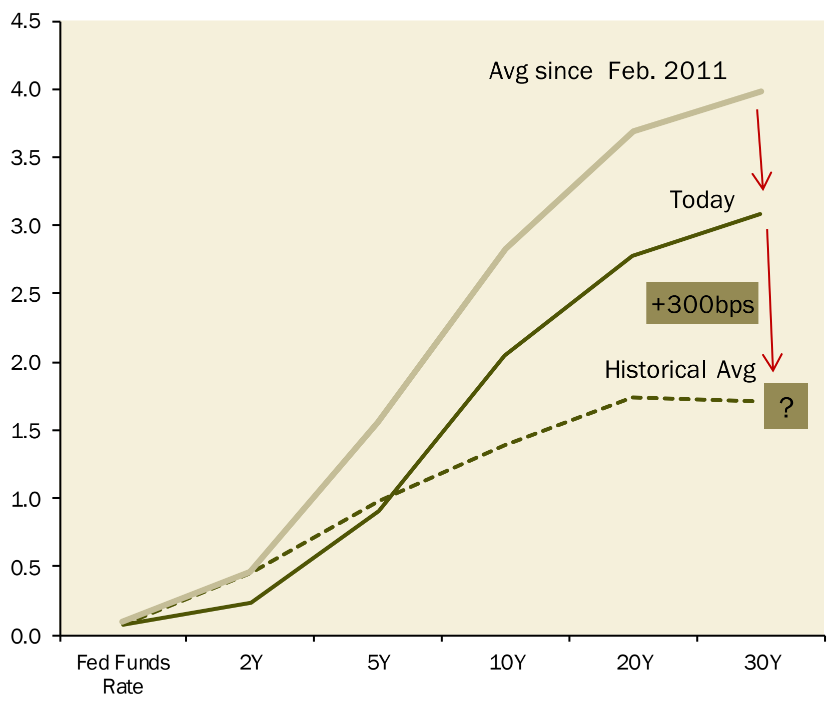
Source: Federal Reserve Board

A SUPER STEEP U.S. YIELD CURVE: HOW WILL IT FLATTEN?

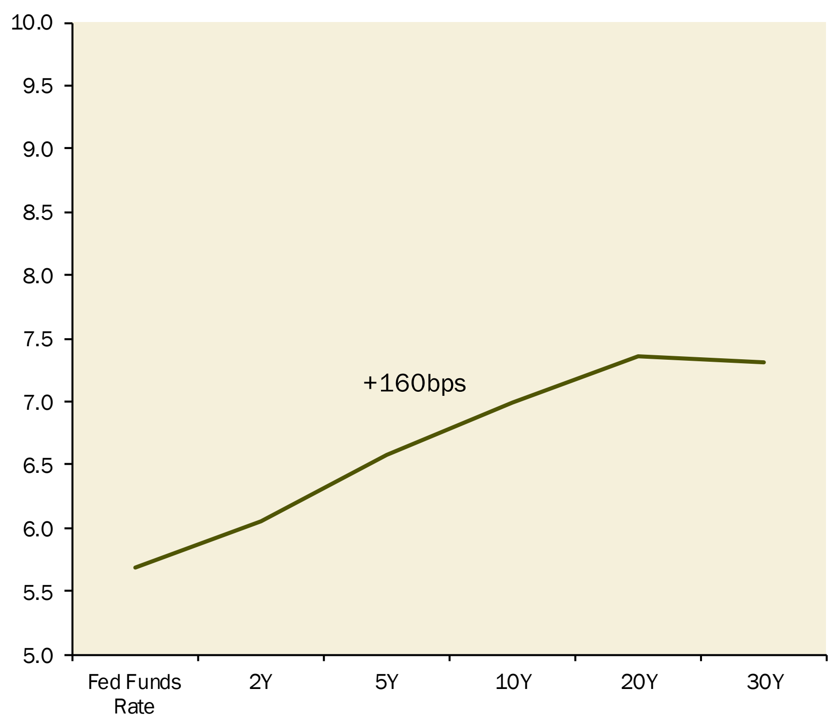
United States: Treasury Yield Curve

(percent)

Today (November 2011)



Average for Past 30 Years



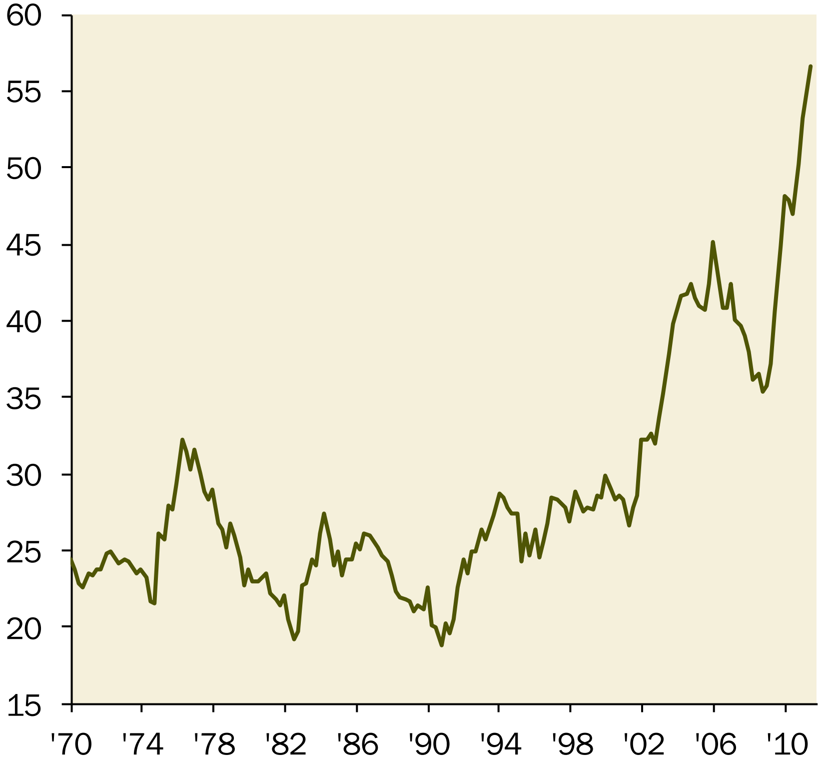
Note:

Source: Federal Reserve Board

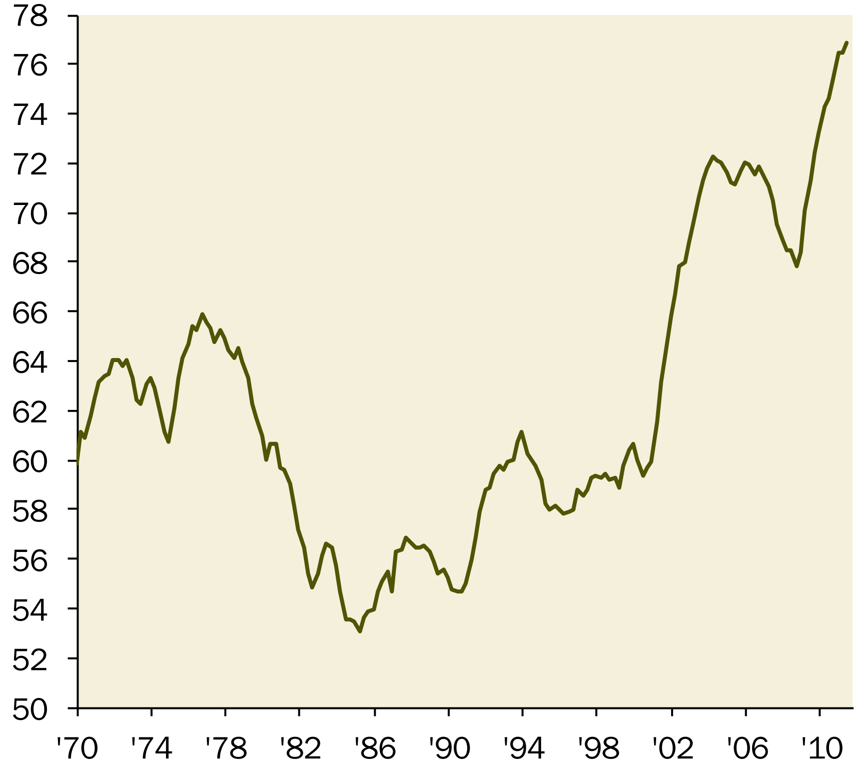
CORPORATE SECTOR FINANCES IN GOOD SHAPE

United States: Nonfarm Nonfinancial Corporate Business (percent)

Liquid Assets to Short-term Debt Ratio



Long-term Debt to Credit Market Debt Ratio

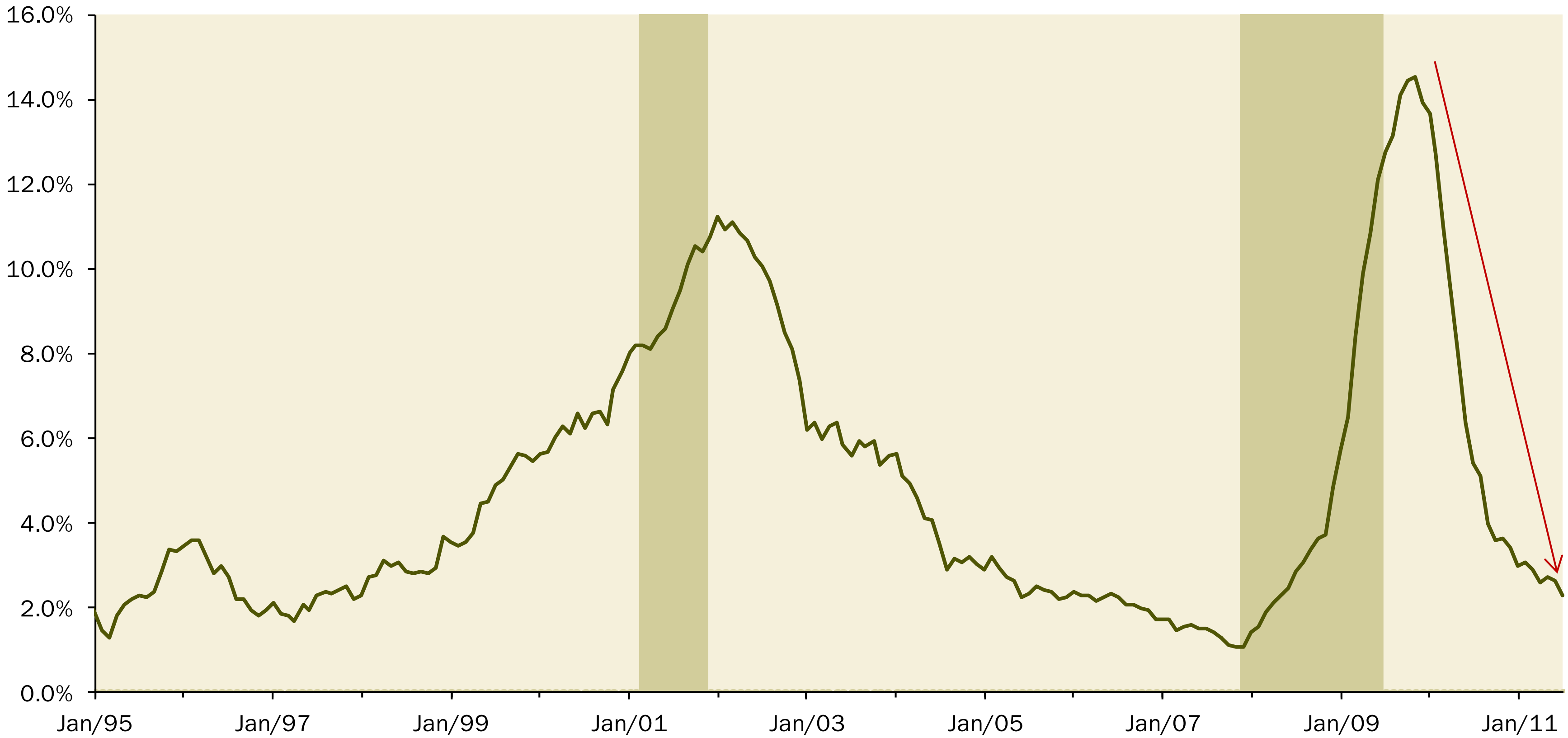


Note:
Source: Federal Reserve Board

CORPORATE DEFAULT RATES MATCH STRONG BALANCE SHEET FUNDAMENTALS

United States: High Yield Corporate Bond Default Rates

(percent)



Note:

Shaded regions represent periods of U.S. recession

Source: Barclays Capital

CORPORATE BOND SPREADS ARE WIDENING … BUYING OPPORTUNITY?

United States: Corporate Bond Spread

(basis points)

BBB-rated minus U.S. Treasury Master

BB-rated minus U.S. Treasury Master

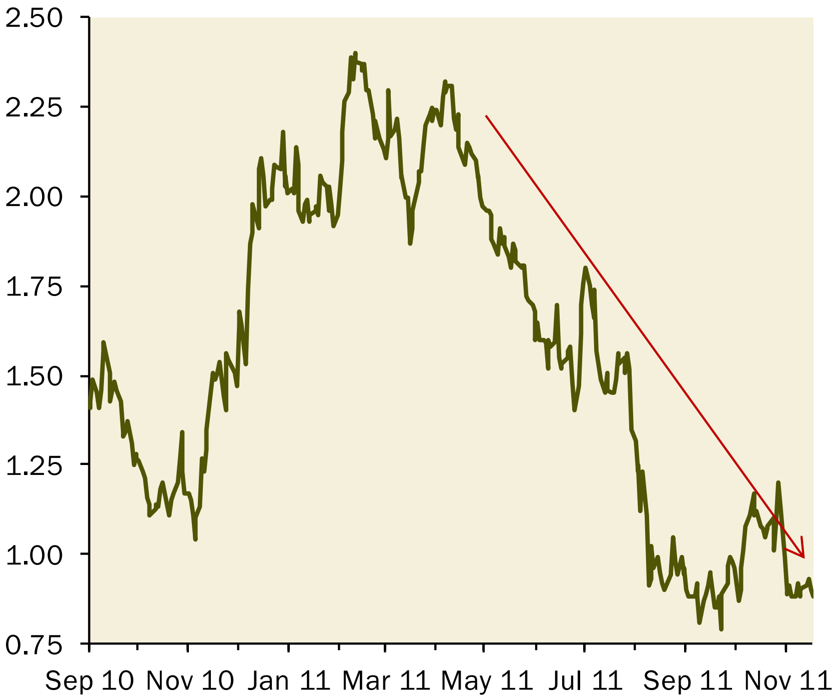
Note:

Source: Bank of America Merrill Lynch

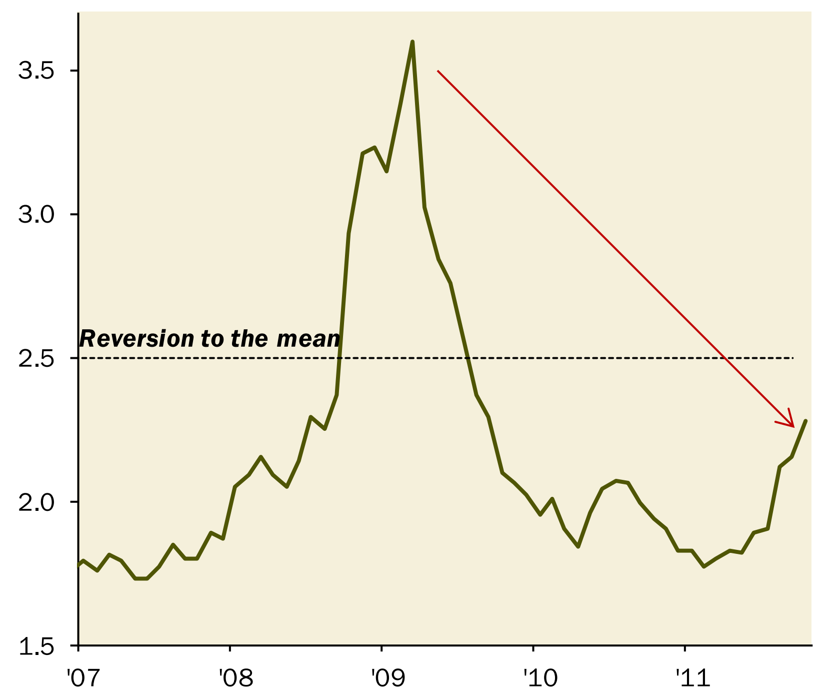
INCOME BECOMING A SCARCE COMMODITY

United States

Five-Year Treasury Note Yield
(percent)



S&P 500 Dividend Yield
(percent)



Note:
Source: Federal Reserve Board, Standard and Poor's

INVESTMENT STRATEGY: SAFETY AND INCOME AT A REASONABLE PRICE (S.I.R.P)

1. **Focus on safe yield:** High-quality corporates (non- cyclical, high cash reserves, minimal refinancing needs). Corporate balance sheets are in very good shape.
2. Equities: **focus on reliable dividend growth/yield; preferred shares ("income" orientation).**
3. Whether it be credit or equities, **focus on companies with low debt/equity ratios and high liquid asset ratios – balance sheet quality is even more important than usual.** Avoid highly leveraged companies.
4. **Even hard assets that provide an income stream work well in a deflationary environment** (ie, oil and gas royalties, REITs, etc…).
5. **Focus on sectors or companies with these micro characteristics:** low fixed costs, high variable cost, high barriers to entry/some sort of oligopolistic features, a relatively high level of demand inelasticity (utilities, staples, health care — these sectors are also unloved and under owned by institutional portfolio managers).
6. **Alternative assets:** allocate significant portion of asset mix to strategies that are not reliant on rising equity markets and where volatility can be used to advantage.
7. **Precious metals:** A hedge against the reflationary policies aimed at defusing deflationary risks — money printing, rolling currency depreciations, heightened trade frictions, and government procurement policies

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