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Breakfast with Dave

WHILE YOU WERE SLEEPING

Some decent follow-through this morning from yesterday's positive U.S. market action that took the NASDAQ and S&P 500 to fresh all-time highs.

The Euro STOXX 600 is up 1.1% thus far and the U.K.'s FTSE 100 has inched ahead by 0.2%.

In Asia, we had solid gains in Japan (+1.4%), Hong Kong (+0.4%), India (+1.2%), Taiwan (+0.3%), Shanghai (+0.2%) and Korea (+0.1%).

The Materials group is leading the way today — iron-ore futures have spiked 1% to the highest level in nearly two years (on reports of heavy Chinese buying, and in recent days, the PBOC has been pumping a record amount of liquidity, more than is seasonally needed, into the money market).

All in, the MSCI All-Country World index climbed to its best level since June 2015.

Japan's outperformance was aided and abetted by a stable yen at ¥113.6 and the news that Japan snapped a 14-month run of slipping exports in December (outbound shipments to China hit a record high).

Investors are shrugging their shoulders at Donald Trump putting words into action

Investors, overall, are shrugging their shoulders at Donald Trump putting words into action when it comes to foreign trade (see *Remaking Global Trade Brings New Order* on page A6 of the WSJ), and over this new brand of capitalism which is pressuring companies to invest where the new president wants them to (at home).

Have a look at the brilliant op-ed column on this file on page A15 of the WSJ (*Corporate America Taken Hostage*) — Trump's free-markets move to revive two oil-pipeline projects (Keystone and Dakota Access) involves a mix of anti-free trade protectionism as their construction must only involve U.S.-made steel ("America First" means everyone else gets to be tied for last).

And when one reads *Executives Stay Mum on Trump Profit Rise* on page B1 of the WSJ, you come to a quick resolution as to how the market overall is breathing in a whole lot of "animal spirits" here — the business community seems to be a tad more circumspect than the investment community is, at the present time.

Bonds remain in moderate selloff mode — up from one to three basis points abroad and the yield on the 10-year U.S. Treasury note has found the 50-day moving average of 2.41% tough to break below (now trading at 2.48%). Some pressure out to the longer end of the curves being accentuated by heavier supply coming out of Europe, and at the mid-part of the Treasury curve too.

Some of the more positive earnings releases, like D.R. Horton yesterday, are at play here as well, benefitting stocks at the expense of bonds. To be sure, the article that found its way to the front page of today's New York Times — *Federal Debt Projected to Grow by Nearly $10 Trillion Over Next Decade* likely raised some eyebrows as well.

In FX-land, the DXY U.S. dollar index is down 25 pips to 100.1 and gold is off a bit too despite this softer underbelly to the U.S. dollar (down $5 per ounce to $1,203).

Much of the move in the currency market has been centered in the U.K. pound which rallied as much as 0.5% to $1.2585 against the dollar, the highest it has been since December 14th, as investors remain hopeful that some sort of non-acrimonious new deal can be inked with the European Union

The Aussie is also softer against the greenback to $0.7560 (and the bond market one of few where yields are declining) in response to some easing in inflation there (the CPI rose 0.5% QoQ in Q4 versus expectations of 0.7%).

Not just this, but headlines such as *Pricing War Takes Toll on Verizon* on page B3 of the WSJ, and I simply cannot get too excited over the prospect of any meaningful or sustainable inflation run up, with all deference to commodity markets and Trump-onomics.

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Ditto for Johnson & Johnson, which missed on its quarterly revenue target and issued soft guidance for the year — in a signpost of how intense competitive pressures globally will simply not allow for an inflationary cycle to persist. The one we have on our hands right now is mixed, uneven, and premised largely on depressed year-ago effects when oil prices were on the floor (the WTI crude price, as an aside, is seeing a four-day winning streak end on the back of surprisingly high API inventory data (off 0.9% currently to $52.70 per barrel).

Headline U.S. consumer inflation is now +2.1% YoY. The peak in the 2002 to 2007 cycle was 4.7%. In the 1990s cycle the peak was 5.0%. In the 1980s anti-inflation cycle, it was 5.4%.

So if we peak at 3.7% YoY or lower this time around (which seems more than likely), this will go down as one of the lowest cycle-highs for the inflation rate ever recorded.

The core CPI trend at +2.2% YoY should be put into the same perspective — the peak in the last cycle was +2.9% and in the 1980s and 1990s the peaks barely topped 5%. The highest peak before the 1970s inflation outbreak was 2.7% in the late 1950s.

So that 2.2% rate offers up some important color here. As is the case with bond yields — and why the secular theme has not been broken — the lows in both inflation (core and total) and in market rates, are getting lower and lower in each progressive cycle.

To repeat: what makes this cycle the same as the most recent others, is that the peaks in inflation (as are the lows) are getting lower, despite eight years of radical global efforts to turn the tide.

The peaks in inflation are getting lower, despite eight years of radical global efforts to turn the tide

The equity rally and bond market slippage has taken hold today even though the key piece of data that came out (German Ifo for January) disappointed. The index of German business sentiment dropped to 109.8 from the near-three-year high of 111.0 posted in December and at the same time fell short of consensus views (111.3) — notably, the "expectations" component slipped to 103.2 from 105.5 in December.

The INSEE index of French manufacturing stayed at 106 in January but the service sector gauge fell to 102 from 106.

All of a sudden, the streak of relatively hot economic data has come to an end.

THE "GREAT DIVIDE"

We continue to see this great divide between the bullish survey "animal spirits" reports and the lukewarm actual "hard" incoming data flow.

We continue to see this great divide between the survey reports and the actual "hard" data

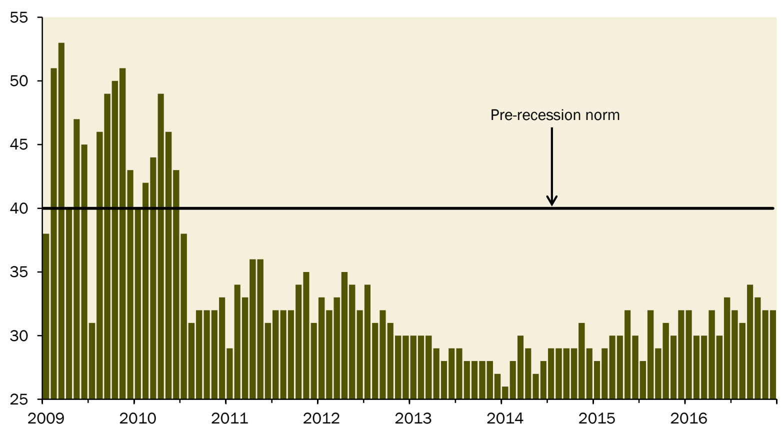
Yesterday's data flow showed another miss on an actual activity indicator — existing home sales down 2.8% MoM to 5.49 million annualized units, undershooting expectations for a smaller decline to 5.52 million — and better-than-anticipated results on two surveys — the Richmond Fed's manufacturing index rose up to a 10-month high of +12 from +8 in December, ahead of consensus of +7; the Markit version of the U.S. manufacturing PMI surprised to the high-side, up to its best level since March 2015 at 55.1 from 54.3 in December and exceeding consensus calls for 54.5.

The modestly larger-than-expected pullback in resale housing activity to close out 2016 (note that existing home sales totalled 5.441 million units in 2016 as a whole, up 4.0% from 2015 and the best annual performance since 2006) reflected broad-based declines across market segments — sales of single-family homes (-1.8% to a three-month low) and condos & co-ops (-10.3% to reverse the bulk of November's 13.3% bounce) both moderated, and activity declined in the Northeast (-6.2%), South (-4.8%) and Midwest (-3.8%) while holding steady in the South.

Sales to first-time buyers accounted for 32% of the total, unchanged from either November or last December — this also matched the share of total sales for 2016 which was the highest since 2011 while my estimate for sales to first-time buyers (1.7 million) is the best tally since 2009.

CHART 1: FIRST-TIME HOMEBUYERS' SHARE OF EXISTING HOME SALES

United States
(percent)



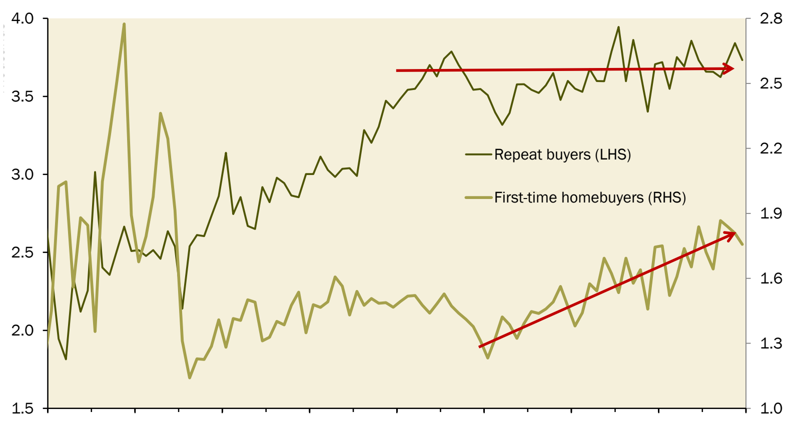
Source: National Association of Realtors, Gluskin Sheff

Sales to repeat buyers rose 1.5% in 2016 and reached the highest level since this data started being collected at the end of 2008, but the general trend has largely been sideways since 2013 — any "growth" in resale housing activity has largely been focused on the increased participation of the first-time homebuying cohort.

Any "growth" in resale housing activity has occurred from the first-time homebuying cohort

CHART 2: EXISTING HOME SALES BY TYPE OF BUYER

United States
(millions)



Source: National Association of Realtors, Haver Analytics, Gluskin Sheff

Given that the first-timers still are punching below their weight in terms of market share (the pre-recession norm was closer to 40%), that points to some lingering obstacles in the way of this crucial segment of the real estate market.

First-time homebuyers are still punching below their weight

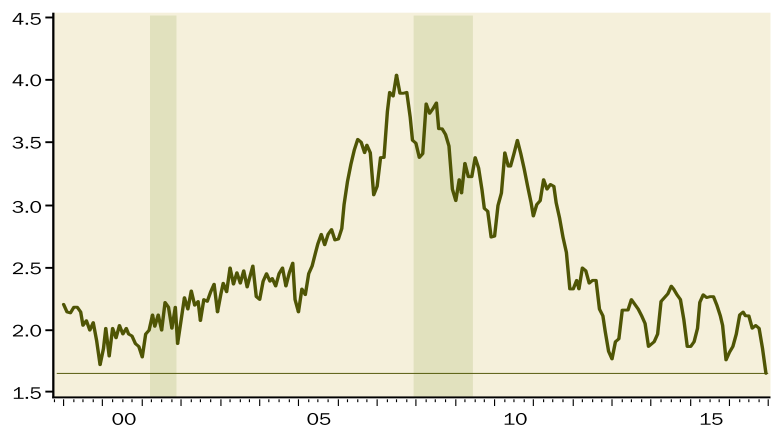
One of them, in addition to a tough jobs market, is this lingering crisis in student debt, and how stubbornly high delinquency rates negatively affect credit scores and ability to secure a mortgage (perhaps one reason why mortgage purchase applications are on a discernible downtrend).

As well, affordability conditions are worsening against an ever-decreasing supply of homes actually available for sales — the homes on the market plunged 10.8% in December (the third straight decline and fourth in the last five months) and touched an all-time low for the data back to 1999.

Affordability conditions are worsening against an ever-decreasing supply of homes available for sale

CHART 3: EXISTING HOMES AVAILABLE FOR SALES

United States
(millions)

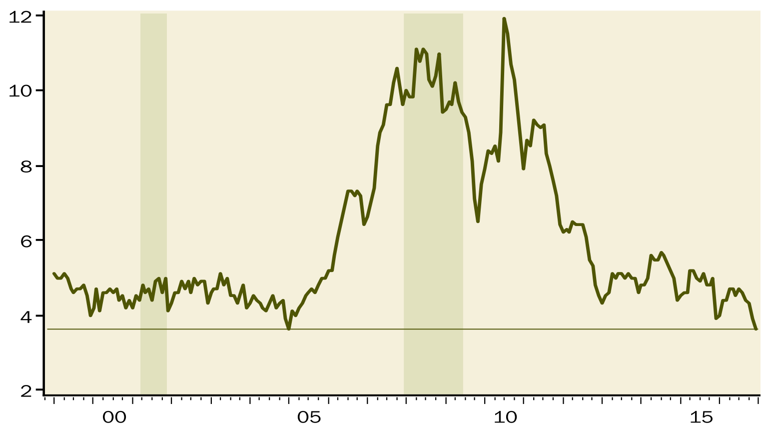


Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

The months' supply measure of inventories plunged to a record-low matching 3.6 months to close out 2016, from 3.9 in November and 4.3 in October. A thin level of inventory is one of the factors holding back housing market activity, that is for sure.

CHART 4: MONTHS' SUPPLY OF EXISTING HOMES FOR SALE

United States
(months)



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

Affordability pressures have the biggest impact on first-time buyers

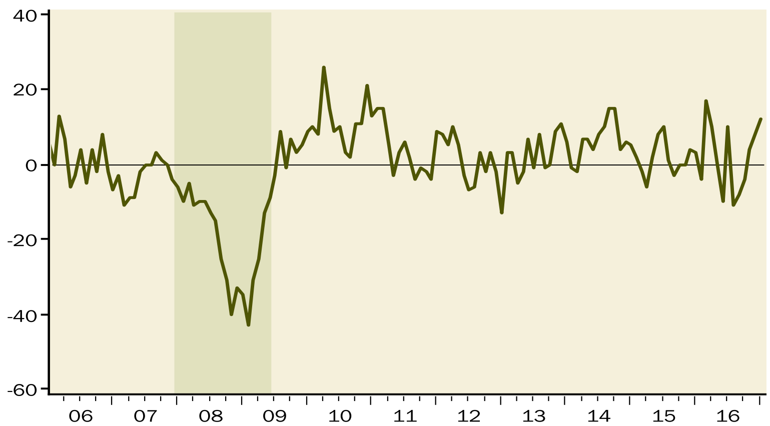
Affordability pressures have the biggest impact of restraining first-time buyers given that they typically have less capital to work with and find themselves among the first to be priced out of a bidding war. In the absence of an increased supply of housing (particularly at the lower-end of the pricing spectrum), there is fairly limited potential for the upside scope to really materialize in earnest.

This dearth of supply is underpinning home price appreciation (median sales prices were up 4.0% YoY) while rising mortgage rates are also pushing carrying costs up in tandem (the 30-year conventional fixed mortgage rate breached 4% in December for the first time in a year and a half).

In terms of the survey data, the Richmond Fed's factory survey's activity gauge bounced to a 10-month high of +12 from +8 in December (consensus was for +7), but that surge wasn't quite echoed in the ISM-adjusted version of the measure, though it remains very firm at 55.6 (was 55.7 in December, which marked a nine-month high).

CHART 5: RICHMOND FED MANUFACTURING INDEX

United States
(index; >0 denotes expansion)



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

The three regional Fed factory surveys that we currently have in hand (Richmond, Philly, New York) are pointing to a notable further improvement in the national-level ISM manufacturing index for January, which is something that the preliminary read of the Markit version of that data for January also showed.

It is worth repeating, though, that this significant uptick in sentiment has yet to actually show up in the "hard" factory activity data.

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Gluskin Sheff

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