

All Of The Huge Threats Facing The Economy Summarized In One Paragraph

The best articulator of the bear case, [David Rosenberg of Gluskin-Sheff](#), summarizes all of the risks facing the market in one paragraph:

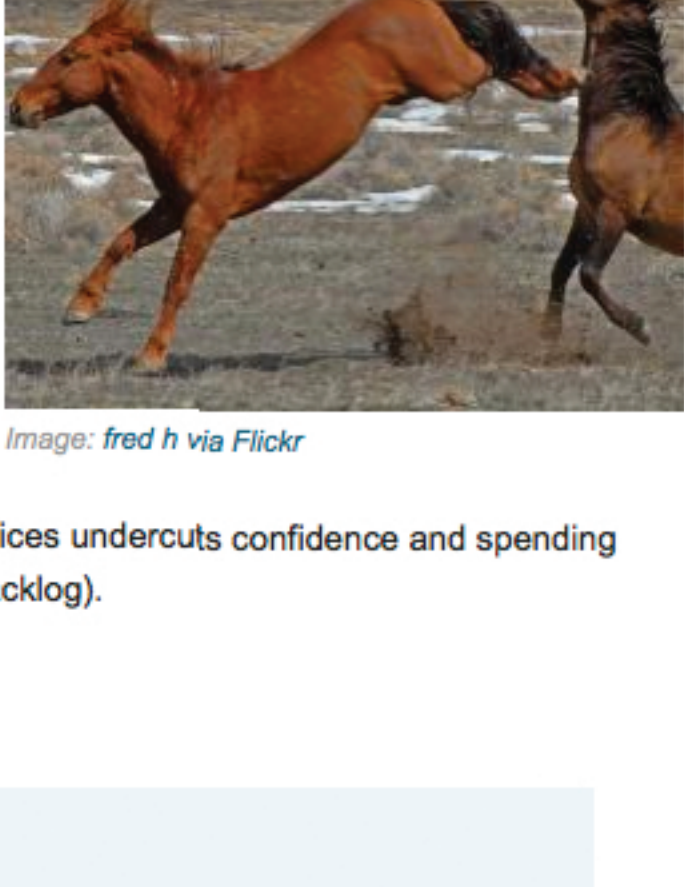


Image: fred h via Flickr

Market sentiment is as overly optimistic now as it was pessimistic at the July- August lows. Eurozone fiscal deflationary shock. Anti-inflation policy restraint in emerging Asia. Widespread cutbacks at the state and [local government](#) level. Debt ceiling issue triggers major rounds of market volatility. Tax breaks that are temporary tend to have marginal economic impact with few multiplier impacts, hence GDP revisions will likely be to the downside post-Q1. Another downleg in home prices undercuts confidence and spending (with around two years' supply of total vacant inventory backlog).

Got that?

China is overheating



Image: Inhabitat.com

rapidly beyond productivity gains and a huge credit bubble could well burst sometime within the next 1-2 years. There is dramatic excess capacity — highlighted by the 40%-plus ratio of fixed investment to GDP. So, there is a strong chance that China undergoes a significant, though likely brief, economic adjustment by 2012, which could interrupt, at some point, our secular bullish call on commodities. Just something to consider."

Source: [Gluskin-Sheff](#)

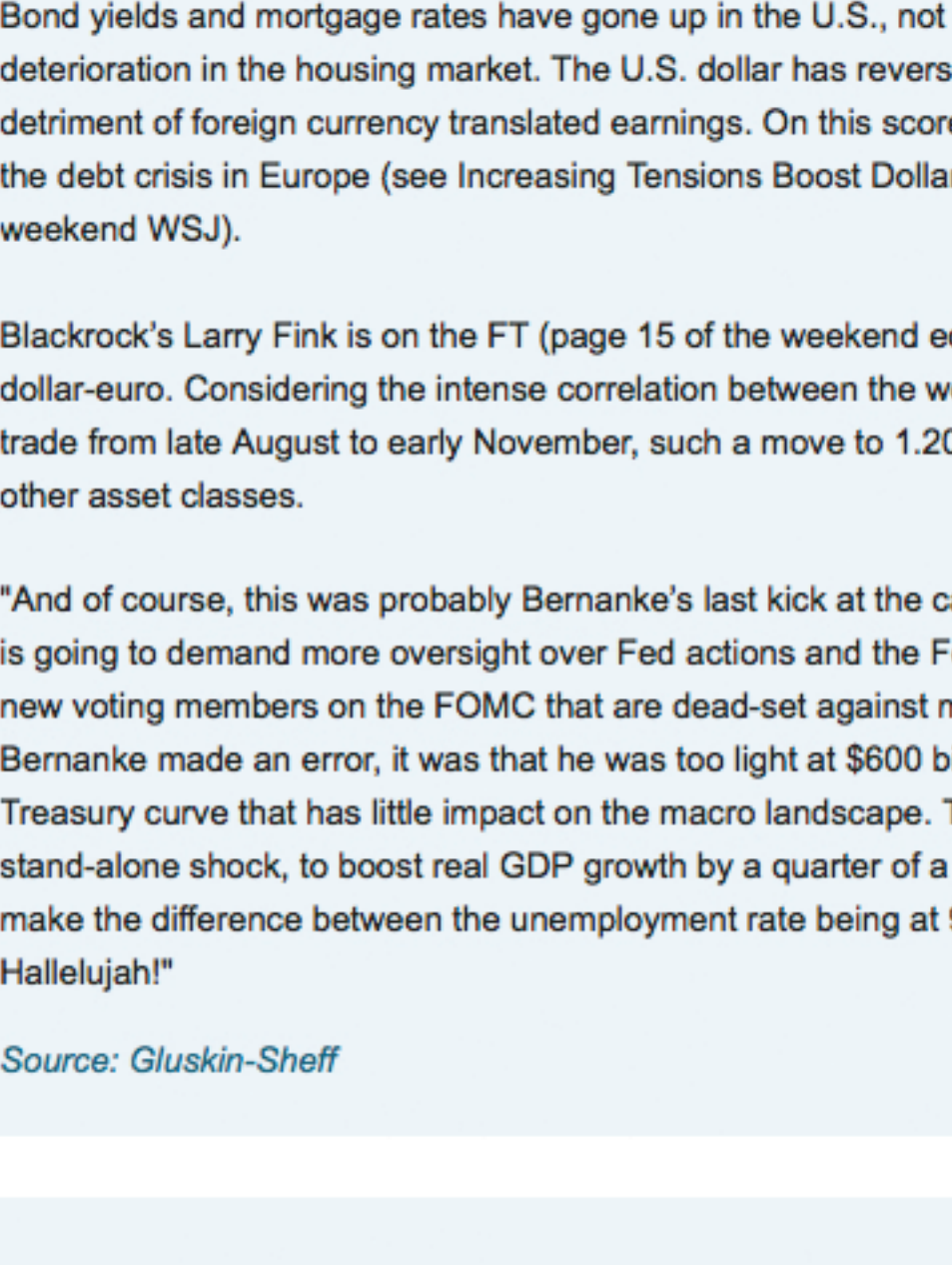
"China is overheating and more policy tightening will likely be needed. When government officials begin discussing price controls, you know the situation is serious. The bottom line is that conventional Street research is probably way off in the consensus view that the inflation pickup is confined to food. Wages are rising

"If you read the article on page B18 of the weekend WSJ, you will see that the real canary in the coal mine is Belgium (Belgium Is the One In Eurozone to Watch). CDS spreads there have been on the rise since late summer and 10-year yield spreads relative to Germany have widened out to 100 basis points. This has shades of 1997 when nobody ever thought the problems in Thailand could ever reach large countries such as Korea. "Spain is another — the bond yields of this untouchable have been rising steadily since the beginning of November and 10-year spreads off Frankfurt have ballooned to a record 260bps. And while seen as the most robust of the Eurozone basket cases, it has an unemployment rate of over 20% and a banking system over-exposed to deflated real estate values. The country has yet to fully meet its 2010 funding needs and as such the upcoming Spanish bond auctions on December 2 and 16 will likely be key flashpoints. When you have a prime minister, as Spain's Zapatero did the other day, issue a threat like this: "I should warn those investors who are short selling Spain that they are going to be wrong and will go against their own interests", then you know that you are in for a showdown. Oh ... shades of September 1992 when despite all the bluster out of the U.K. government, it was the markets that won the day ("Black Wednesday") as the British pound was forced out of the ERM (and George Soros made over \$1 billion by not paying attention to any warnings from politicians)."

Source: [Gluskin-Sheff](#)

"The European debt crisis. If the contagion reaches Spain, it would likely be game over for the euro. The Spanish bond market is behaving similar to the Irish market around the time of the Greece bailout. The fact that the rating agencies downgraded Ireland after it succumbed to EU pressure to tap the stabilization fund is hardly a constructive

QE is creating uncertainty



cites how Barclay's research team are "fans" of the new Bernanke "put" and how "it is unusual for the world's most powerful central bank to provide such a clear signal that it wants the prices of risky assets [read stocks] to go up." They conclude "risks for stocks seem tilted to the upside." So, the reason to be bullish on stocks is because of Federal Reserve manipulation. Nice. We can now officially take the word "free" out of "free markets". Bond yields and mortgage rates have gone up in the U.S., not down, despite further deterioration in the housing market. The U.S. dollar has reversed course and is rising to the detriment of foreign currency translated earnings. On this score, QE2 is clearly no match for the debt crisis in Europe (see Increasing Tensions Boost Dollar's Allure on page B11 of the weekend WSJ).

"It is too early to judge whether it is a success or a failure. If the aim was to kick-start the equity market, then all we can say is that so far all QE2 has done is help bring the S&P 500 to the high end of a broad 1,000-1,200 band, which has been prevailing for 14 months now. Henry Sender's column on page 15 of the weekend FT is well worth a read — she

Blackrock's Larry Fink is on the FT (page 15 of the weekend edition) calling for 1.20 dollar-euro. Considering the intense correlation between the weak greenback and the risk-on trade from late August to early November, such a move to 1.20 could set off a few fireworks in other asset classes.

"And of course, this was probably Bernanke's last kick at the can seeing as the new Congress is going to demand more oversight over Fed actions and the Fed itself is going to have three new voting members on the FOMC that are dead-set against more balance sheet expansion. If Bernanke made an error, it was that he was too light at \$600 billion and targeted a part of the Treasury curve that has little impact on the macro landscape. This is going to help, as a stand-alone shock, to boost real GDP growth by a quarter of a percentage point next year and make the difference between the unemployment rate being at 9.4% instead of 9.6%. Hallelujah!"

Source: [Gluskin-Sheff](#)

A Canadian housing bust

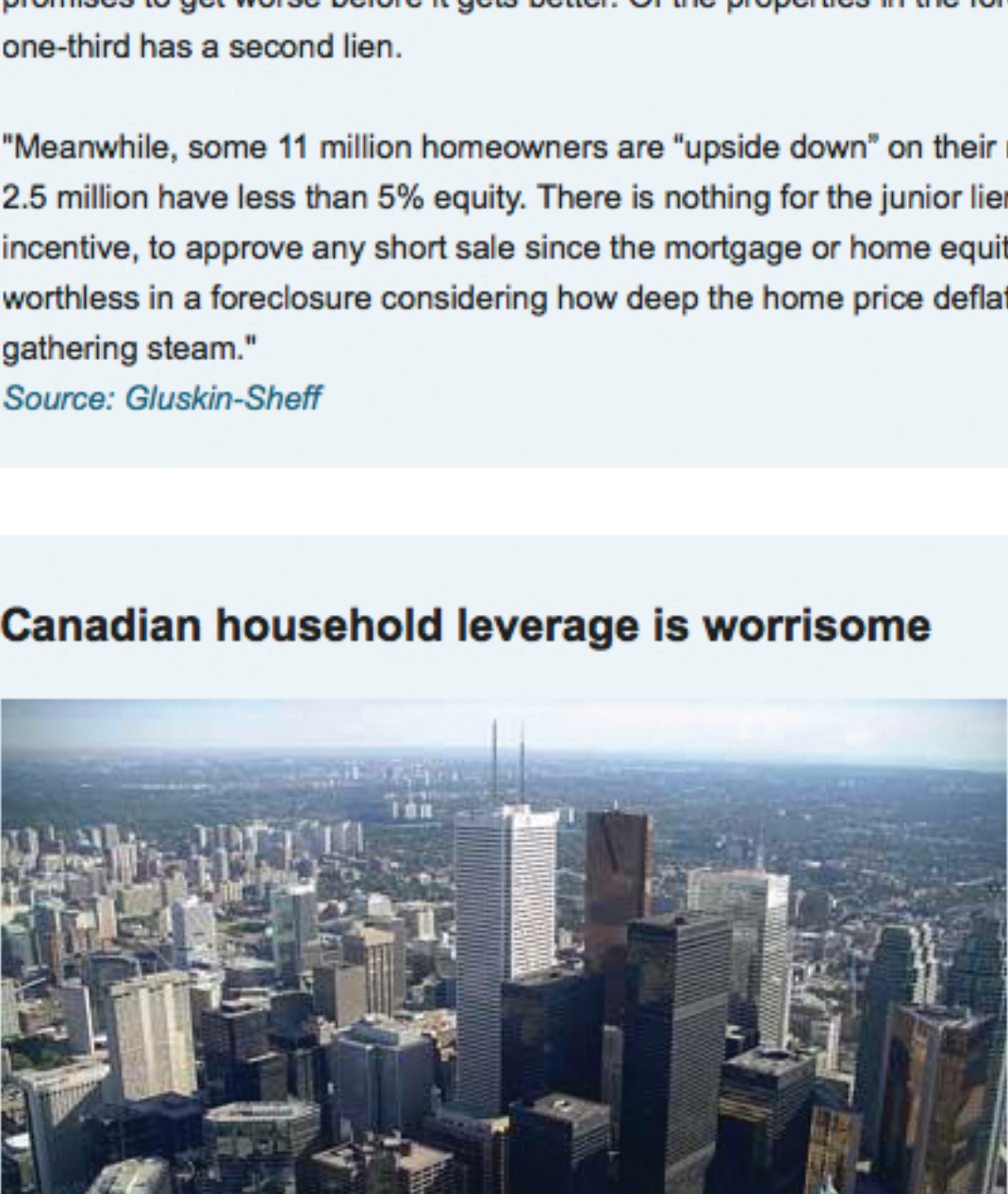


Image: JamesZ_Flickr via Flickr

especially if the Bank of Canada follows the market and resumes in its rate-hiking program early next year. As it stands, the Teranet-National Bank House Price Index (HPI) deflated 1.1% in September — the first decline since the depths of despair in April 2009. Some cause for pause."

"We remain concerned that Canada experienced some sort of housing bubble in 2009 and into 2010. We are worried about looming default risks but have been pleasantly surprised by the fact that the real estate market has eased, rather than busted. Be that as it may, a more pernicious turn down in real estate values cannot be ruled out,

Source: [Gluskin-Sheff](#)

A double dip in US housing

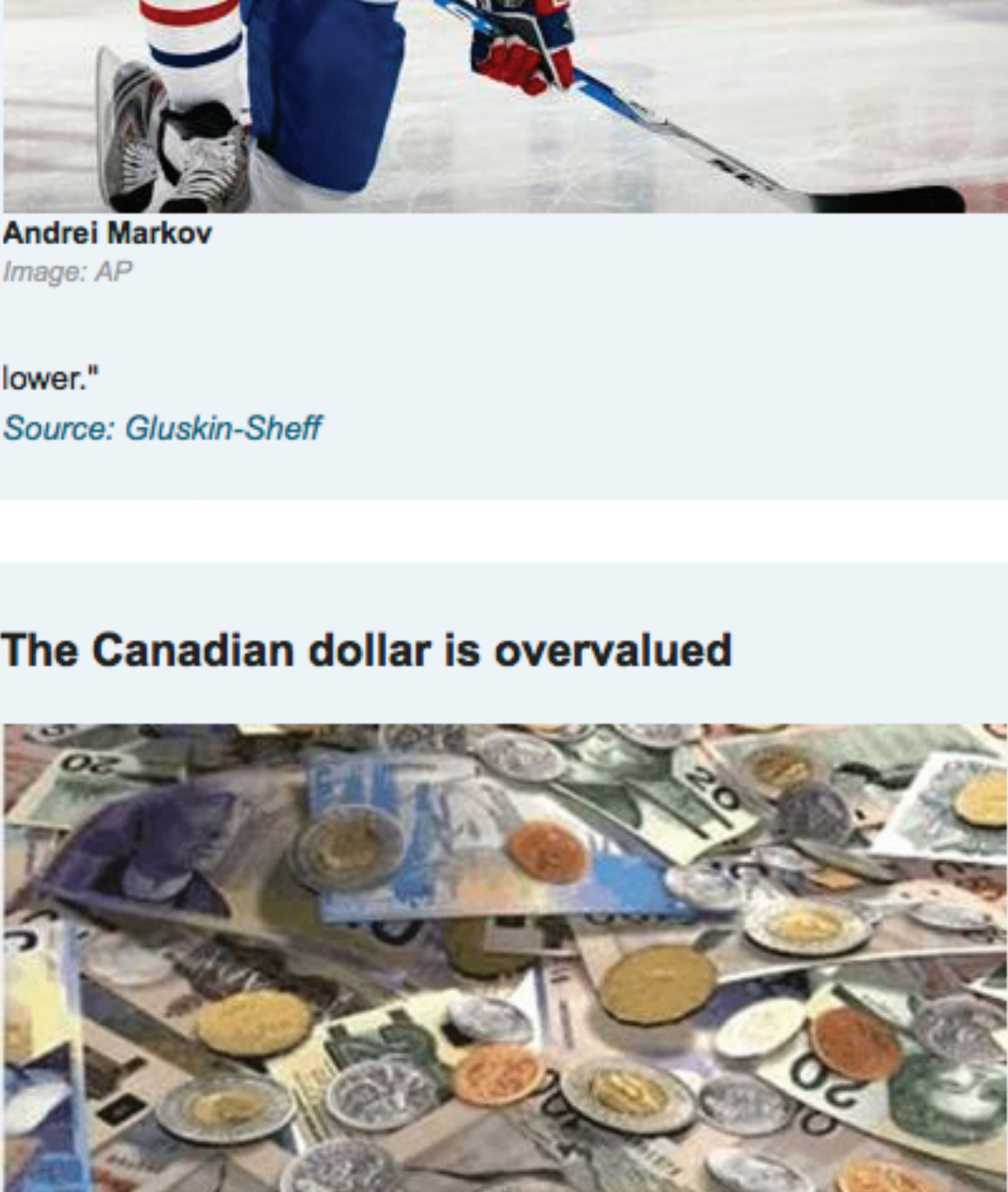


Image: trulia

cited in the press, which instead focuses myopically on Black Friday shopping, and possibly missing a very big story here.

"Renewed housing deflation in the United States. The problem of excess supply has improved enough to forestall another down-leg in national home prices. Median new home prices have collapsed at nearly a 30% annual rate over the past four months and resale values in the existing home market are down almost 20%. Nowhere was this fact

"There are in excess of six million unsold vacant residential units overhanging the market, including the shadow inventory. Short sales activity is being hampered by the refusal of banks to write down second mortgages (see page A5 of the weekend WSJ for more) and this promises to get worse before it gets better. Of the properties in the foreclosure process, about one-third has a second lien.

"Meanwhile, some 11 million homeowners are "upside down" on their mortgage and another 2.5 million have less than 5% equity. There is nothing for the junior lien holder, in term of incentive, to approve any short sale since the mortgage or home equity loan would basically be worthless in a foreclosure considering how deep the home price deflation has been — and now gathering steam."

Source: [Gluskin-Sheff](#)

Canadian household leverage is worrisome



Image: AP

concern for the consumer spending outlook."

Source: [Gluskin-Sheff](#)

"Canadian household leverage — debt ratios are as high as they were in the U.S.A. at the peak in relation to income (the debt/asset ratio for now looks better here). This is a longer-term concern, especially if interest rates were to be raised further in the future. I see this is a very big intermediate-term

The weak Canadian economy

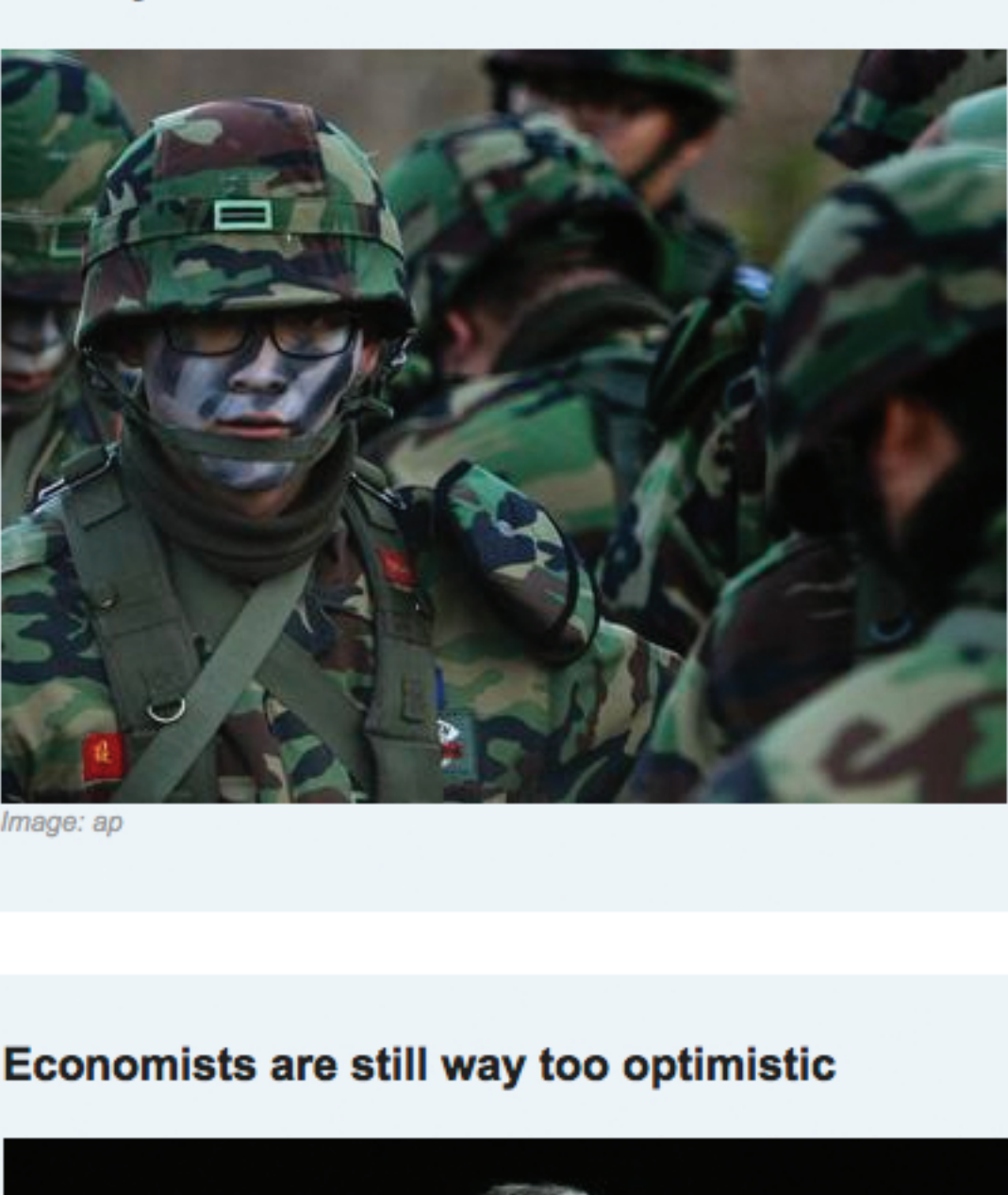


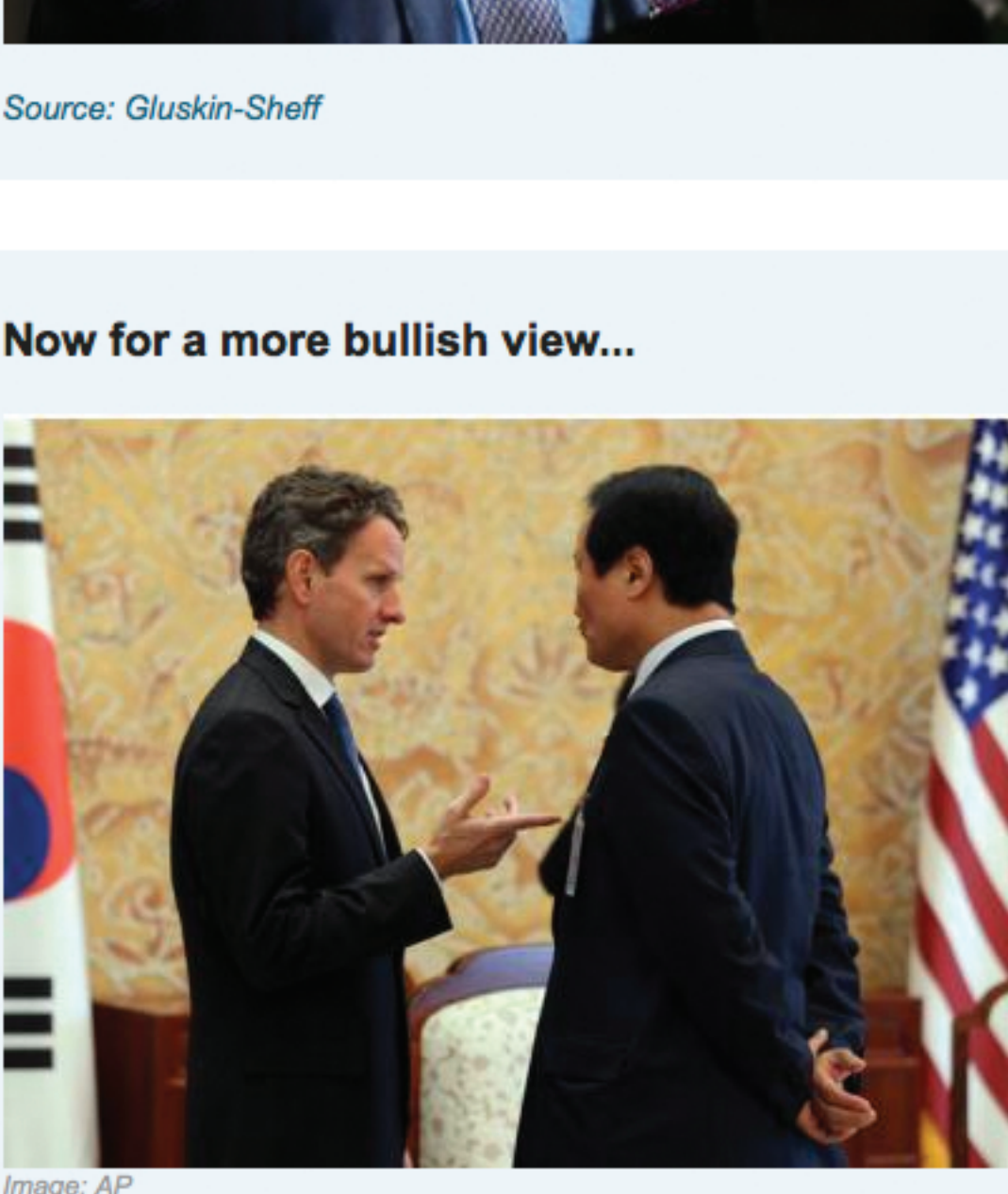
Image: AP

lower."

Source: [Gluskin-Sheff](#)

"Lack of productivity growth in Canada. This is a key source of debate — but we contend that the U.S. data are overstated and the Canadian data are understated. How can we be a productivity laggard when we have practically the same underlying inflation rate as the U.S.A. with a comparable unemployment rate that is nearly three-percentage points

The Canadian dollar is overvalued



dampening domestic export competitiveness — Canada's record current account deficit attests to that view."

Source: [Gluskin-Sheff](#)

"The Canadian dollar. In our view, it is still overvalued by a nickel even with the recent firming in the commodity complex, though strong international capital inflows are providing a very firm floor under the loonie. That said, the Canadian dollar is impeding growth in the local manufacturing sector and clearly

Major austerity on the state and local level

Image: Flickr / Dotdoubledot

consumer, this is the second largest spender in the U.S. economy. Have a look at The Mortgage Parallel on page 78 of The Economist."

Source: [Gluskin-Sheff](#)

"The dramatic retrenchment at the state/local government sector south of the border and the negative feedback effects on domestic demand. This is the one critical source of downside risk for the U.S. economy in 2011, which could easily result in 1.5-2.0 percentage points of withdrawal from GDP growth. Outside of the

Currency wars...

"The perception a month ago was that Bernanke was aimed at debasing the U.S. dollar. Some emerging market countries have already slapped on quasi capital controls. China still refuses to allow its currency to float more freely. Japan has intervened to reverse the yen's strength, with some moderate success.

Australia just stated that it is contemplating reviews of foreign investments into its rural economy and food products sector. This follows the Canadian government ruling over the Potash file. President Obama failed to secure a trade accord with Korea last month too. So the trends toward globalization not only has stalled but may be reversing and this means: (i) government procurement, (ii) disruptions of global supply chains, and (iii) possibly trade wars. All of this is very positive in terms of establishing a floor under resource prices and should also add some lustre to precious metals as a hedge against any resulting "cost-push" inflation pressure."

Source: [Gluskin-Sheff](#)

Military skirmishes in Korea

Image: ap

"The two Koreas as an example but the situation will also test China-U.S. foreign relations as Beijing tells America to butt out. In recent months, China has been making strides to deepen its economic and strategic relationship with North Korea despite American objections."

Source: [Gluskin-Sheff](#)

Economists are still way too optimistic

Source: [Gluskin-Sheff](#)

"It does not seem to me that economists have fully taken into account the drag from the fiscal side of things in the U.S. and in the Euro region. Global GDP consensus has been at 4.2% for several months. Interestingly, the BoC took down their 4% view to 3.5% last month — so they could be ahead of the pack."

Now for a more bullish view...

Image: AP

See why [Tim Geithner has been vindicated](#) for his "Welcome To The Recovery" op-ed >