

TEATRO SERIES - Risk and The Future of the Global Economy

The 3rd annual speakers series, held at Teatro Restaurant, Calgary Alberta, explores the key issues facing the economy.

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The Economy: Don't cheer yet

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The following is an edited transcript of David Rosenberg's speech at Teatro Restaurant. Mr. Rosenberg is chief economist at Gluskin Sheff and former chief economist with Merrill Lynch in New York City.

It is great to be back in Canada, at a great firm, Gluskin Sheff and Associates. It is especially great to be back at a very fortuitous period since we just opened up our gateway to the West. After about a quarter of a century working at big banks and forecasting in an ivory tower, and never understanding fully whether management or whether clients were really using my research, it has been a phenomenal experience.

But when you work in an entrepreneurial place where the CIO and the CEO are literally thirty feet away from each other, it certainly gives you a strong sense that you're having a much greater impact on the investment decision process, and that it really is a team effort. What I have brought to the table is a macro overlay on top of what

Gluskin Sheff has done successfully for 25 years, such as identify undervalued securities for investors.

Previously, I was at Merrill Lynch, as the chief economist out of New York. I signed on to Gluskin in March but Merrill asked me to stay on for three months for what they call garden leave. They don't really have that in Canada. Technically, I didn't have to serve out the garden leave, but in the name of good will I did. What Merrill wanted to do, in that three month period, was take me around the United States and have a last go, a last Rosie show, so to speak. One of the top sales guys in New York said, "Rosie, it'll be like Madonna." Well, I'm not Madonna, but nonetheless I did the tour.

One of the stops was a very large hedge fund in Chicago which shall remain nameless -- but you can guess who it is -- where there were about fifteen portfolio managers in the boardroom. The lead portfolio manager gets up, stops me, and says, "Rosenberg, we've got to know you in the past seven years and we appreciate your research. But I've got to interrupt you right now because it's your last time here and I've got to tell you how we really feel about you."

The portfolio manager says that I remind him of the story of the

grandfather. If you don't know it, the story is that the grandfather goes and visits his grandson on a Sunday afternoon. In the early evening he bids his adieu and drives into the sunset. About 15 minutes go by and the grandson turns on the radio and hears that there is a maniac driving on the wrong side of the I90 and he says, "Oh my God, that's where granddad is!" He calls his granddad on the cell phone and says, "Granddad, there's a lunatic driving on the wrong side of the I90." And the grandfather says, "Oh no, there's not one. There are hundreds and they're coming right at me."

So that's the story of my professional life -- that the consensus is always wrong and I'm always right. That's obviously not the case, but I like to feel that I've been successful at being an economist and a strategist and making forecasts. The reality is that you have to make your bets against the consensus. I was mentored by several great people in my professional life and the one thing that you learn over time -- whether you're a portfolio manager or a strategist or an analyst or an investor -- is that the consensus gets it wrong 80 percent of the time. Of course, that means the consensus gets it right 20 percent of the time.

Maybe this is the one year where the consensus gets it right.

Right now the consensus says there will be some sort of V-shaped recovery and that somehow nothing happened in the past two years, that there was no credit collapse, no asset deflation, and that the government has all the answers.

Frankly, I'm extremely skeptical. As advertised, I'm the chief economist and the chief strategist so I have a split personality. As the economist, you focus on the economy and you forecast growth. As a strategist, you have to take that forecast and then ascertain the extent to which that economic growth, best-case scenario, is either under-discounted or over-discounted in financial assets. That's really what I want to talk about today, because I'm not from the Brookings Institution, I'm not from the Conference Board, I'm not from the Bank of Canada. I am a financial market economist. I'm a Bay Street guy, a Wall Street guy. I'm here to talk about what the economics mean for your investments and about how to stay out of trouble.

It's not all about return. It's also about the amount of risk you're willing to take on to reach that return. I'll tell you right now that we've come off a credit collapse and an asset deflation of historical proportions. I don't remember a time in my professional life where the range of possible outcomes -- and I will keep an open mind as we all

should -- both in the markets and in the economy is as wide as it is today.

Let's assess what is going on. What is the stock market telling us? In any given asset class, at any given point in time, the market is telling us something about the economy. It has to -- whether inadvertently or not. So let's go back to when I was at Merrill, at the peak in 2007, when all you were hearing about was global excess liquidity. It was all good.

Yes, there were problems in housing but Bernanke assured us that those problems in sub-prime were going to remain contained. Remember that? That goes right up there with Chamberlain's "peace in our time." In October of 2007, the S&P was sitting at 50 and 65, and when you ran the simulations, which is what you have to do as an economist and a strategist, the market was pricing in over five percent GDP growth. So if you were buying the market, in October of 2007, ipso facto, you had a five percent GDP growth forecast in your mind. But in the next year we got zero and the year after that we got negative. And then you got a big bad bear market for a whole host of reasons.

Now, let's talk about these March lows - the 666 lows, the diabolical devilish lows. Everyone talks about how the market got down to this egregiously oversold low, but I don't know if it really did. Profits went down 60 percent, so why shouldn't the market have gone down 60 percent? At the lows in March, the Armageddon lows, the stock market was pricing in negative two and a half percent GDP. When we close the books in the United States on 2009, by the way, that is exactly what we are going to see -- negative two and a half percent. I would actually argue that instead of getting dramatically oversold, the stock market priced in reality at those lows.

Fast forward to today, and we've had a 60 percent rally in the S&P 500. Now let's take it at face value that the stock market does bottom out before the recession ends -- and we'll be charitable and say that the recession has ended -- but by the time the recession ends the stock market is usually up 20 percent. It's not up 60 percent. By the time you're up 60 percent you're not debating in which month the recession ended, you're into the third year of the economic expansion.

Think about it. We've lost three million jobs. I guess employment doesn't matter anymore for the economy. We have lost more jobs since the market bottomed in March than we lost in the entire 2001

recession. I can't wrap my head around it except to know that this is a market that is devoid of fundamentals. You go back to the last cycle in which the market bottomed out, in October 2002, and by the time we were up 60 percent it was the fall of 2005. The economy was humming at such a rate the fed was halfway through its tightening cycle.

When I run our simulations, what is the market telling me? It's telling me that we're pricing in five percent GDP growth for the coming year. We're back to the same valuation very quickly and back to the same pricing and growth we had in the fall of 2007. This is not to suggest that we're going to have the same sort of market collapse. But I am saying that if you're going to buy the market today you should be comfortable with the view that we're going to have a V-shaped recovery. We're going to come out of this credit collapse, the government has all the answers, and we're going to get five percent growth in the coming year.

Now, you might wonder why Gluskin Sheff wanted to hire me -- I'm so bearish. Why would they want me, unless they wanted to give me a mop and a pail? But the reality is that there are many different strategies that we can deploy: credit arbitrage, different fixed income, hedge fund strategies. And it is actually very exciting, because you

know what? I'm a closet bull. I can find the needles in the haystack. When people see me on TV they call me bearish, because according to CNBC and FOX and BNN there's only one market and that's the stock market. There's no currency market, there's no commodity market, there's no fixed income market. People are going to judge you on whether you're a bull or a bear. They're going to judge you on the S&P 500. I don't really think that's fair but I can live with that.

In fact, I have not been bearish on equities in ten years. The reality is that the Dow first crossed 10,000 on March 29, 1999. And here we are just recently back above 10,000. We've crossed 10,000 29 times. That's more times than the Yankees have won the World Series, but over that time period bonds have returned 80 percent, commodities have returned 60 percent, and look what gold has done.

As for the here and now, I think we'll chug along at one and a half to two and a half percent GDP. There was a time, believe it or not, that would have been considered unbelievably bullish, but I know today when the market is pricing five percent that is not bullish. Certainly, Gluskin Sheff wouldn't have hired me to tell people to put their money in a mattress.

What people don't realize is that I've been bullish on corporate bonds, where you line up on the better part of the capital structure and they're better priced. Equities carry too much risk. Corporate bonds, on the other hand, have been a wonderful place to be. The corporate bond spreads have come in to below 300 basis points. A lot of the so-called low-hanging fruit is over. The easy money has been made. But in terms of deciding on the asset mix, corporate bonds remain the better place to be.

Why is that? Once again, when we run our models what we find is that corporate bonds are no longer priced for minus ten percent growth. They're priced for about two to two and half percent growth, which was roughly my forecast.

When you run the arithmetic, what is interesting is that when you go back to those Armageddon lows, if the equity market was pricing in the world in which the corporate bond market was pricing, the S&P would not have bottomed at 666. It would have bottomed at 325. Fast forward to today and the question is where should the S&P be if the corporate bond market is right? Do we get two percent growth next year? And the answer is 875 on the S&P. That is not far off from what Jeremy Grantham was saying a few weeks ago.

Six months ago that would have been wildly bullish. Today it is over 20 percent correction. But how much risk do you want to take on? From my standpoint, either the prices catch down to the fundamentals or the fundamentals have to catch up to the prices.

So no matter how you slice it or dice it corporate bonds are a good place to be. And this is from the big bad bear. It's a matter of not being bullish or bearish. It's a matter of being realistic and of being sober in this business of money management, because you are the custodians of peoples' wealth. You have to treat your role with respect and understand what the downside is. If I'm going to express a certain cyclical view and I don't have a double dip view and you want to be extremely defensive, corporate bonds are still a very good place to be.

I said before that there's a whole range of outcomes and a lot of uncertainties, but we have to talk about this: within the uncertainties what are some of the certainties out? This is going to feed through again to how you want your investments to be positioned. For example, when I go back to the equity market it's a 60 percent rally. I was not calling for a 60 percent rally. These rallies will come and go. I know historically, a 60 percent rally in the stock market in a six-month

span is actually more symbolic of a secular bear market.

I know what a secular bull market looks like. I know in 1982 we had the onset of a secular bull market and I know what that looks like. The equity culture is dead. In 1979 Business Week had a front cover that announced the death of equities. People did not want to talk about equities. It was not even hatred. It was total ambivalence.

So let's say what this is not. This is not the start of some phenomenal new secular bull market. As far as I'm concerned, this is a very flashy cyclical bear market and I've got news for you: Japan had four of these in the 1990s, so maybe this is the first in four installments of a 60 percent rally. And maybe we will see a new low in the next several years. It's possible.

What else? In the spirit of uncertainty, what is there we can say with certainty? When I was in school, I was the sort of kid who did all the easy questions first when I had an exam to write. So let's talk about what we know. What we know with 100 percent certainty is that next year is an election year in the United States, a midterm election year, and midterm election years matter a great deal, especially to a new president.

We saw what happened to Bill Clinton in 1994 when Newt Gingrich and the Republicans swept the House and the Senate. This could end up affecting the presidency for the next six years, not that it did Clinton any damage when all was said and done. But he never did get through a lot of the legislation that he thought he was going to get through. So we know that exactly a year from now there is going to be a midterm election of significance for Barack Obama.

What else do we know? I know with probably 98 percent certainty that the unemployment rate in the United States is going to hit a new post-World War II high. We are at ten point two percent right now. I have a sneaking suspicion that in the next few months we are going to break to a new high. The number that matters the most is ten point eight percent. At ten point eight percent we break above the 1982 post-World War II high. And then it is no longer George Bush's recession. It becomes Barack Obama's recession.

To a politician, the unemployment rate is the most emotionally charged statistic out there. It is a forward looking indicator on your own longevity. And most people don't even know what goes into the unemployment rate but they know it's like their golf score -- when it

goes up it is not a good thing. And we're going to break about ten point eight percent and that is going to be a disaster for the president.

What is he going to do about it? He is going to do everything he can, he and Larry Summers -- with Bernanke's help -- are going to try and squeeze every last basis point out of GDP growth. If you didn't notice, they're saving a lot of the infrastructure spending for next year -- next year is the big year from a political standpoint. What's next? What's the next policy tool? It's obvious. It's the U.S. dollar. The administration is treating the U.S. dollar with benign neglect. Just as Bob Rubin had a strong dollar policy in the 1990s -- only because it was going to benefit the U.S. economy -- and now we're in a totally opposite part of the cycle and with a totally different administration with a totally different view of the U.S. dollar.

So I think an administration that just raised tariffs by 35 percent on Chinese-made tires and 20 percent on Chinese-made steel pipe will decide there is no better way to promote exports than by sanctioning a weaker dollar. That is going to be the principal way the U.S. is going to try and generate economic growth next year. And this has a whole bunch of implications -- this is not sustainable. There is a fiscal train wreck in the United States.

How is it going to play out? Are they going to default? The United States is not going to default on its debt. They're not Argentina. They don't have foreign currency liability. So will the United States raise taxes? Tax is a dirty three letter word in the United States. I lived there -- I know that. Will they cut spending? Sure. Where?

What's left is reflation. And they have the right central bank to do it. They've got "Helicopter Ben," Ben Bernanke. Nominal GDP in the United States has not risen in two years and you have this guy Helicopter Ben who has printed two trillion dollars of currency. That's what it's all about.

I'm going to finish off by talking about Canada. Canada is really in a sweet spot. I think that we do have a very fragile economic situation in the United States -- maybe even globally. It's hard to know how this is going to play out, there is just so much tape and glue holding the banking system together in the United States and underpinning the U.S. economy, and we know what the U.S. economy means for the Canadian economy.

The Canadian stock market is also very sensitive to what is

happening in Asia, because we have three times the exposure to commodities than they have in the S&P 500. Commodities, which used to be an albatross, are now in a secular bull market. In other words, we are going to stand out in North America in terms of being a relatively high commodity exporter.

And if you take a look at the banks, over thirty percent of our indexes are in the banks. That is double what it is in the United States. And look what happened this cycle: we had a housing bubble and the housing bubble burst. But no Canadian bank went cap in hand to the government for its survival, no Canadian bank failed. No Canadian bank has cut its dividends since 1992. That's rather remarkable. In fact, both the OECD and Moody's just put out reports which ranked Canadian banks as being the most stable in the world.

Still, we have some problems. Manufacturers are going to have to deal with a rising Canadian dollar. There is not much we can do about that. It's going to create winner and losers. Retailers will be winners, wholesalers will be losers. It's going to allow Mark Carney to keep interest rates at low levels for longer, which should be good news for housing. I know that when the Canadian dollar is at 60 cents we hate it, and when it's at 95 cents we hate it, but the Canadian dollar is

going up for good reasons. We have more financial stability here.

Sure, Flaherty is running a deficit, three to four percent of GDP. That's sustainable, and even with that the debt ratio is coming down. In the United States, the deficits are ten percent and growing and the debt ratio is going up. How are they going to pay for that? Ultimately, they're going to pay for it by reflating, as I said before.

And as I also said, it is going to create winners and it is going to create losers -- but believe me, a stronger Canadian dollar is a good thing. It means our standard of living is going to be going up. It means our purchasing power in the global marketplace is going to be going up. If you look at the data coming in from Statistics Canada, the capital flows coming into the Canadian marketplace are at a record high.

So my sense is that a strong Canadian dollar is something we should embrace. And that's coming from the big bad bear, Dave Rosenberg. But you know what they say: in the land of the blind the one-eyed man is king, and Canada is the one-eyed man. On that relatively bullish note, I'll open it up to questions.

