

## My Breakfast with Dave

By Robert Huebscher

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A month ago, one of the most closely followed market observers, Gluskin Sheff's David Rosenberg, moved his *Breakfast with Dave* commentaries behind a pay-wall, ending an era of free access to his insights. Last Friday, however, he presented his views publicly to an audience of 500 advisors and investors, your author included.

The inflation-versus-deflation debate was Rosenberg's topic. His verdict was that deflation will dominate.

Rosenberg spoke at the Strategic Investment Conference in San Diego, which was sponsored by Altegris Investments and John Mauldin.

Rosenberg began by asking those in the audience whether they believed that inflation would lessen in the coming year. Almost no hands went up, mirroring recent consumer opinion polls that found only seven percent of Americans expect inflation to abate this year.

He then cited Bob Farrell's rule number nine: When all the experts and forecasts agree – something else is going to happen.

"We are our own best contrary indicator," he said. Rosenberg showed the cover of *Time* magazine from July 2008. It proclaimed that inflation was back, following a month when the CPI rose 5%.

Over the next year deflation set in, and the net change in the CPI was -1.0%.

Let's look at the reasons behind Rosenberg's forecast of deflation – a forecast that agrees with that of Gary Shilling, who also spoke at the conference and whose views are presented [here](#).

### Observed inflation is a temporary phenomenon

The Conference Board conducts regular polls of consumer forecasts for inflation and, according to Rosenberg, its data reinforce the contrarian role of public opinion. Ninety percent of the time when inflation forecasts were above 5%, inflation declined from its then-current value over the following year.

Today, inflation forecasts are over 6%, yet actual CPI inflation is roughly 2%.



Headline inflation is picking up, Rosenberg said. But that has happened before. Inflation peaked at 5.5% in 2008, and the bond market did not fall apart, he said.

“For now, bonds are a very good place to be,” he said.

Core inflation has also picked up, Rosenberg said, but, he asked, “In your heart of hearts you’ve got to ask yourself a question: What is the sustainability of the inflationary process?”

Rosenberg said the current inflationary spasms will be temporary. Most consumers, he said, focus on oil prices because they are so visible. “How can there not be inflation with \$115 oil?” they ask. But Rosenberg noted that consumers had similar inflation forecasts last year, when oil was at \$80/barrel. Inflation is actually lower now than it was with \$80 oil.

Rosenberg said that inflation is a “process” and oil prices are a “level.” Essentially, consumers will adjust their spending patterns in response to changes in oil prices, but it will take a sustained increase in prices of a commodity such as oil to produce inflation.

Indeed, Rosenberg said the current spike in oil prices is actually deflationary, because the shift in consumer spending patterns will cause other prices to decline. He called the rise in oil prices a “deflationary tax” on consumers.

Speculators are driving oil prices higher, Rosenberg said. Speculative long positions are three times what they were when oil peaked three years ago. That reinforces his contention that high oil prices will not persist, once speculators reverse their positions.

Nor is Rosenberg concerned about inflation in other commodities. He said that “goods inflation” is now almost 4%, and that might temporarily go as high as 6%. That will have only a modest impact on inflation, though, since the US is a “mature service-sector economy,” he said, and commodity prices play a small role in inflation.

And Rosenberg is not worried about inflation in rents, which are a large portion of the CPI. Though homeownership rates have declined and have put upward pressure on rents in recent years, he expects rent inflation will be temporary. Many homes are being bought through foreclosure by speculators whose goal is to rent them out, he explained, which will eventually depress rental prices.

Housing prices will decline another 20% or 30%, Rosenberg said, further increasing the likelihood of deflation.



## **But what about wages?**

Unit labor costs have historically had an 80% correlation with inflation, and those costs are declining. As long as that trend persists – and it will at least as long as there is high unemployment – there is little chance of inflation.

Rosenberg dismissed arguments that suggest that labor costs could rise as they did in the highly inflationary 1970s. “Capitalism didn’t work back then,” he said. “We were heavily regulated, heavily unionized, and we were just trying to get through the GATT for global free trade flows.” Productivity stagnated, he said, and wages rose through COLA adjustments.

High unemployment will keep inflation in check, according to Rosenberg. One in seven Americans are either unemployed or underemployed, he said. “If inflation doesn’t get into the wage process, it is going to get stopped in its tracks, like it did in 2008, 2004, 1999, and 1993.”

Rosenberg called the unemployment situation an “unmitigated disaster.”

Rosenberg attributed much of the recent decrease in unemployment to declines in the labor force participation rate, as fewer people are seeking jobs.

The waning power of unions will put further downward pressure on wages. The public sector makes up 15% of the economy, the second largest component after consumer spending. Rosenberg noted that even Democrat controlled states, such as Massachusetts, are now pressuring public unions for concessions.

## **Investment implications**

“I couldn’t care less if Bernanke prints \$500 trillion,” Rosenberg said of quantitative easing. “If it doesn’t get re-circulated in the economy, it is not going to create any inflation; and it is still sitting on bank balance sheets.”

Household credit is still contracting, he said. Banks are willing to lend money, but the demand for credit doesn’t exist. Consumers are more focused on paying down debt, according to Rosenberg.

The closest parallel to the current plight of the US economy is that of Japan over the last two decades. Both countries experienced a bubble in housing and credit, followed by the bursting of both. Both central banks cut interest rates to zero and dramatically increased their balance sheets. Japan has been in a deflationary environment for most of the last two decades, and that could be the fate of the US, according to Rosenberg.



Rosenberg said too many investors suffer from “numerical microphobia” – the fear of small numbers, in this case bond yields.

He said the 10-year Treasury yields (now at 3.3%) will stay between 2% and 4%, and the next big move in bond yields – about 50 to 75 basis points – “is probably going to be down.”

If Japan is the cautionary tale, then investors could look forward to the 1.2% yield now offered by Japanese government bonds, he said. Even Swiss government bonds are now at 2.0%, and German bonds were close to 2.0% before the ECB signaled that it would begin raising rates.

“I think we will see 2% before we see 4%,” Rosenberg said.

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