



## **Richard Bernstein: The Antidote to Pessimism**

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For an antidote to the bearish sentiment coming from David Rosenberg, look at Richard Bernstein. In contrast to Rosenberg's vision of Japan's lost decade, Bernstein expects the S&P to outperform emerging markets, at least in the near term.

Until a couple of years ago, Rosenberg and Bernstein were colleagues at Merrill Lynch. They remain close friends, though Rosenberg is now with Gluskin Sheff in Canada, and Bernstein is the founder and CEO of Richard Bernstein Advisors, based in New York.

Bernstein spoke last week at a forum hosted by the Maryland-based investment consulting and technology provider Fortigent, LLC.

Investors are "way too bearish on the US," Bernstein said, "and they are a little too optimistic about emerging market stocks."

I'll discuss Bernstein's favored asset classes for the coming year, but first let's look at where he thinks the US economic recovery and markets stand.

### **Four phases of bull markets**

Bernstein believes that bull markets go through four phases, according to Bernstein:

- Denial, when investors say "it can't happen."
- Acceptance, when they come to realize that "maybe this is really happening" and start to believe they should have more in the market.
- A "brave new world" of outperformance that will never end.
- A bear market that brings the bull market ends to an end.

US equities are somewhere between phases one and two – between denial and acceptance, Bernstein said. Moreover, he said the economic recovery in the US is "much more normal" than most believe. The economy is almost exactly tracing out the path of the GDP during the recovery from the last two recessions – in 1990 and 2001. In fact, he said, the 2001 recovery was weaker than the current one.

"We have just had a perfectly normal recovery of corporate profits," he said, "and a perfectly normal recovery of the stock market."



The strength of corporate profits is being neglected by the media and by investors. Few are aware, according to Bernstein, that 70% of US companies are now reporting positive earnings surprises. Cost-cutting doesn't explain this, he said, because 54% of those companies are reporting positive revenue surprises.

"This is unfathomable," he said. "People can't believe this is actually happening and that the US economy is improving."

Bernstein largely dismissed concerns that rising interest rates would dampen the recovery. He said we are entering the middle phase of the economic cycle (not to be confused with the phases of bull markets). US production is increasing, he said, as is capacity utilization. It is normal for long-term interest rates to move up at that time.

By contrast, Bernstein said, fundamentals in emerging markets are deteriorating. He noted that 40% of emerging market companies in the same reporting period reported negative earnings surprises. "Expectations are so high in the emerging markets that we can now no longer meet those expectations," he said.

Emerging markets are between phases three and four, according to Bernstein, approaching the onset of a bear market. He said few investors are aware that the S&P has outperformed the BRIC indices over the last three years.

Bernstein looks at 15 leading indicators of the US economy, and he said "every single one is both very strong and getting stronger, or medium and getting stronger."

That statement goes to the heart of Bernstein's optimism. Markets do not move on absolutes of good and bad, he said. They move on "better or worse." "That is why the stock market has gone up in the US in the last 12 months," he said, "because the economy has gotten better. It's that simple."

Incidentally, Bernstein said this philosophy is what distinguishes his approach from that of his former colleague Rosenberg, who believes that markets are driven by absolutes of "good or bad."

### **A contrarian discipline**

Bernstein is a self-professed contrarian. His approach is to find markets where there is a shortage of capital and to be the "sole lender in a sea of borrowers." "If there are 100 borrowers and one lender," he said, "that one lender is going to do really well."

He gave two examples of shortages of capital that led to exceptional returns for investors. The first was in the emerging markets in 1998, following the Asian crisis. At that time, emerging market debt was trading at 1,300 to 1,400 basis points over Treasury bonds. Emerging market debt had hit "rock bottom," he said, "and nobody was looking at it."



The second opportunity was in March of 2000, during the dot-com bubble, when Bernstein recommended that investors shun Silicon Valley stocks and reallocate to energy sector.

In both cases, investors would have been well-served following Bernstein's recommendations.

Today, small-cap companies face a shortage of capital, according to Bernstein. Small caps were the strongest performers in the US markets in 2010, and Bernstein expects that to continue in 2011. Historically, he said the difference between outperformance in small-versus large-cap stocks boils down to one question: Will profitability will be stronger over the ensuing 12 months. If so, as Bernstein predicts, small-caps will outperform.

Emerging markets have excess capital. Bernstein said he is seeing waves of IPO and secondary market offerings in those equity markets, a clear indication that they are not cheap. He was also bearish on emerging market debt, which is said is essentially a play on the strength of the US dollar for those investors who prefer not to speculate directly in the currency markets.

Bernstein sub-advises for an Eaton Vance mutual fund, and he said he now has a 65% allocation to the US, including a 25% allocation to US small-caps. A mere 2% is allocated to emerging markets.

The energy sector also looks attractive now to Bernstein, given the increases in production he is seeing in the US economy. He cautioned, however, that his biggest fear – and the one factor that could derail his forecast – would be gasoline prices rising disproportionately to wages and salaries.

"It is not the economy is that we care about," Bernstein said. "It is the valuation of the assets and the stocks that represent those assets. We have a situation where in the US valuations are pretty conservative."

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