

David Rosenberg – I am not a Permabear

By Robert Huebscher

May 22, 2012



While most sell-side analysts are correctly classified as permabulls, Gluskin Sheff's David Rosenberg has been branded as the opposite – a permabear. He rejects that label. He recently said he's indeed bullish – on bonds and income – and has been so for quite a while.

Defending that label, Rosenberg asserted that his goal is the “holy grail” of risk-adjusted return. He defined risk in terms of capital preservation. “But when you talk about risk, you are labeled a permabear,” he said.

Rosenberg spoke on May 3 at the Strategic Investment Conference in San Diego, hosted by John Mauldin and Altegris Investments. Rosenberg is chief economist and chief strategist at Gluskin Sheff, a Canadian wealth manager. Rosenberg also [spoke](#) at that conference last year, when he offered the same investment advice.

Following his advice then would have been a good decision. During 2011, 30-year Treasury bonds earned 25% returns and the 30-year Treasury strip returned a remarkable 80%. Dow utilities – a sector Rosenberg recommended – calling them “bonds in drag” – were the top-performing stocks in the US market.

Rosenberg's now forecasts sustained deflation driven by a very weak economy, and he recommended increased allocations to Treasury, corporate and municipal bonds, as well as dividend-paying stocks.

I'll discuss Rosenberg's updated investment recommendations, but first let's look at his economic forecast for 2012 – which is much more bearish than his outlook last year.

Beware of a “big recession” in 2013

At this point following a recession, we are normally at the strongest stage in the business cycle, when the Fed should be raising rates, Rosenberg said. But that is not the case. A year ago, the forecast was for 3% GDP growth, but 2011 ended with a disappointing 1.5%.

Now, the underlying trend is 2% growth, Rosenberg said.

And the economy faces more peril. Rosenberg termed the 42 tax provisions that expire at the end of this year – including the Bush tax cuts – a “fiscal cliff.” That cliff represents a 4% drag on economic growth, which would translate to a 2% contraction in GDP.



“We will be in a big recession next year,” he said. “Whether or not the government will let that happen – I don’t know.”

He said there is “no possible way” that the government could implement a fiscal stimulus that would offset that contraction. Austerity is necessary, he said, “notwithstanding the pain it will cause.” Canada underwent such a program 20 years ago, he said, and its economy emerged much stronger.

Twice before – in 1960 and in 1969 – the US government experienced a fiscal cliff similar to what will happen at the end of this year, Rosenberg said. In both cases, a recession ensued.

“Don’t dismiss those odds,” he said. “The economy went into reverse.”

Rosenberg added that recessions most often happen in the first year of a presidential term, because presidents prefer to “get over with the bad news.”

With the economy operating below its potential, deflationary pressures will dominate, Rosenberg said. The output gap – the difference between the GDP at full potential and its current level – is approximately \$750 billion, which Rosenberg said is about the size of Florida’s economy.

Excess supply throughout the economy is depressing prices, according to Rosenberg. For example, he said that housing starts may have bottomed, but excess inventories will continue to depress prices on a national level.

Unemployment remains at “crisis” levels, he said, and the most appropriate measure of the labor pool is the U6 indicator, which at 16% is higher than during any prior post-War recession. More than six million people are working part time even though they want full-time jobs, which Rosenberg said is not reflected in the often-cited U3 unemployment numbers. Moreover, Rosenberg said wages and income are declining.

Deleveraging is continuing on a global basis, he said, and will continue for at least another three or four years.

“I don’t know how we are going to squeeze sustainable inflation out of that,” he said.

Where to put your money

At this time last year, significant inflation was perceived as likely, Rosenberg said. That never happened. The yield on the 10-year Treasury was 3.4%, and the consensus forecast was 4% for the end of 2011. It closed below 2%.



Rosenberg's forecast of continued deflation and low interest rates guided his investment recommendations.

Short-term rates near zero imply that the risk in the equity markets is high, he said. "That is the message from the market." The opposite was true in 1982, when yields were 13%, which he said signaled the onset of a secular bull market for stocks. "The outlook was right for capital appreciation."

The Fed has declared that it will keep short-term rates low at least through 2014. Rosenberg said he has built his entire investment strategy around that forecast and the elevated equity risk levels it implies. You don't need to be invested in cash, he said, but capital preservation must be the paramount goal.

Rosenberg noted that Fed policy, as expressed through overnight rates, has been the most important determinant of the overall level of interest rates. It has a 90% correlation to rates, greater than either inflation or budget deficits.

The yield curve is historically steep, with the 30-year yield 300 basis points greater than short-term yields. The implication, Rosenberg said, is that long-bond yields will go to 2%. "You can make a lot of money for your clients," he said.

"When it gets there, I will be a huge equity bull," he said, "but we have not yet done the full mean reversion."

Rosenberg singled out corporate bonds as an attractive asset class. He said balance sheets are strong, as corporate treasurers strengthened them since the onset of the financial crisis. Even though the economy hit "stall speed" in 2011, he said, the default rate on corporate bonds was only 2%; yet they are priced at "recession levels" of nearly 5%. Security selection is important, and he said that among the companies he looks for now, for example, are those rated BB, with A balance sheets.

"The message from the market is that income is scarce," he said, "and you want to own what is scarce."

Demographics are driving that scarcity. The baby-boomer generation is continuing to de-lever, he said, and will need income-producing assets after having suffered through the bursting of the dot-com and financial crisis bubbles. He said that bond and dividend-focused equity funds have benefited from new investments and demographics will ensure that trend in fund flows will continue.

"Don't debate whether to invest in stocks or bonds," Rosenberg advised, "because bonds are a contractual obligation and stocks are not."

"Bonds make sense," he said. "The bull market in bonds is not over."



www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
<http://www.advisorperspectives.com/subscribers/subscribe.php>