



## **David Rosenberg: “Searching for Certainty in a Sea of Uncertainty”**

By Katie Southwick  
February 21, 2012

David Rosenberg is known for his bearish outlook, and he has not yet seen anything in recent economic news that persuades him to change his tune. Contrary to prevailing “bullish complacency” and the widespread belief that central banking systems “have the answers to the ongoing global debt deleveraging cycle,” in the United States Rosenberg sees monumental deficits, flat growth, an underlying trend of deflation, and current fiscal policies that will limit future flexibility. In other words, trouble remains on the horizon.

Rosenberg, the chief economist for the Canadian money manager Gluskin Sheff, spoke at the Fortigent Winter Forum, held last week in Savannah, Georgia.

A key way Rosenberg differs from the optimists is in his belief that the current global deleveraging cycle is different than its predecessors. “This time around, we are seeing the biggest debt deleveraging in the global economy that we’ve ever seen before,” he said. “When you look at the global median debt-to-GDP ratio, it is up to 400% of total GDP.”

If Rosenberg is right, the full consequences of that deleveraging for the global economy still lie ahead.

### **Debt in the US and Europe**

In the US and Europe, the problematic debt lies with the government sector, with the total government debt-to-GDP ratio beyond levels we have seen in a long time. After entering a global recession, virtually every country in the world radically increased its government spending. Instead of raising taxes – and risk driving their economies deeper into recession – the governments “tapped into the debt markets,” either spending on infrastructure, extending unemployment benefits, or instituting tax cuts.

Now, three years into recovery, the US has “monumental” deficits, with the difference between government spending and government revenue reaching heights unseen since World War II, Rosenberg said. Over the next year, he predicted that the debt-to-GDP ratio will rise above 100%. “Once you have crossed over 90% ... you start to impair the private capital sector capital stock,” Rosenberg warned – presumably in reference to the research by Reinhart and Rogoff.

To measure the sustainability of government spending, Rosenberg looked at interest payments as a share of revenue. Over the next several years, this ratio will increase from 10% to 20%, “unless the problem is nipped in the bud quickly.” Given aging



demographics, healthcare needs, and current entitlement spending, Rosenberg predicted that interest payments as a percentage of revenues will double in the US, severely limiting the country's future fiscal flexibility.

Rosenberg holds a similar view on Europe, arguing that over the next few years we will see significant changes in the eurozone – which he called a “failed experiment” – as more and more countries hit a “debt wall.” The eurozone depends on having a single interest rate, but that will prove untenable, he explained. “They might have a single policy rate, but what drives most economies is the bond market, the ten-year yield,” Rosenberg said. “When you take a look at history, you will see that a monetary union not coupled with the fiscal union fails.” He predicted that Greece will default first and Portugal will default next, leaving Italy as a looming question mark.

If the euro is going to survive, Rosenberg said, German taxpayers will need to bail out the weaker members of the eurozone. If they do not, these smaller countries – which did not have the economic infrastructure to join the eurozone in the first place – will return to their local currencies. Rosenberg predicted that a new, stronger euro area would most likely emerge at the end of this process.

### **“Flat growth”**

Despite the fiscal problems he described, Rosenberg said that the US economy is experiencing some growth – a fact that is almost inevitable given the amount of stimulus the government has pumped into the economy. But rates of growth are below what they should be at this point in the recovery cycle, Rosenberg warned. Based on his projections, the economy should be growing at a rate of 5%; yet, current rates of growth average at 2.4% – a third of which are inventories and 1.8% of which are real final sales. When you average across the business cycle, Rosenberg argued, growth is tepid at best.

Despite massive government spending, the US has experienced the weakest employment and GDP cycles among post-war recoveries, he said. “The pace of growth is starting to weaken and economic forecasts are coming down.”

Rosenberg questioned the Fed's optimistic outlook on the US economy. With data from the fourth quarter indicating that Europe is re-entering recession, he said that US is headed in the same direction. “If you are going to tell me that Europe is going to go through a recession and we are going to remain unscathed, color me skeptical.” While he did not predict a “cataclysmic decline” for the US market, he does anticipate another year of flat growth and disappointing earnings.

Given scant earnings and weak growth, Rosenberg advised investors to “own companies in the sectors that have earnings visibility – not variability.” Approximately 25% of his money currently lies in the equity market, focused on stocks with low beta, high visibility, and strong balance sheets. “When you are coming off the lows like you were in 2009 –



and earnings become abundant, not scarce – that’s when you want to really to start owning the small caps and the high beta,” he said, but these days “that is not what you want to have in your portfolio, notwithstanding the fact that it has done well on the recovery.”

### **An underlying trend of deflation**

Rosenberg also argued that the US is facing a deflationary environment, evidenced by an output gap that he argues reflects excess capacity in the economy. Taking potential GDP and dividing it by actual GDP, the current output gap appears to be approximately 5.5% – representing \$800 billion in excess capacity.

This excess capacity extends throughout many sectors of the economy, including housing and employment. While housing has improved, there are still about 3 million excess single-family units and condominiums overhanging the market.

Employment follows a similar trend. Although the country is 5.5 million jobs shy of its peak pre-employment levels before the recession, this calculation does not account for a growing trend of underemployment – workers’ hours are being cut, even if they themselves are not fired. By using the U-6 employment rate, the number rises to 16%, meaning one of every six Americans is either unemployed or underemployed. Such widespread demand for more work exerts downward pressure on wages. The result, according to Rosenberg, is that, while the US may be experiencing “a job recovery,” the recovery remains “wageless.”

Ultimately, excess resources put downward pressure on prices, causing Rosenberg to favor bonds, especially long-term bonds. “The underlying trend in long-term rates is going to be down,” he said. “And I actually like the long bond; it’s the only place you can actually get yield.” He also likes corporate bonds, which he feels are well-priced and enjoy the strength of corporate balance sheets.

### **Investment advice during times of uncertainty**

Despite his bearish projections, Rosenberg said that there still ways to build wealth, When choosing investments in such a troubled environment, Rosenberg emphasizes scarcity value.

“You want to own what is scarce and what is in demand,” he said – and that, right now, is income. This is especially relevant for the “capital appreciation” demographic – a segment of the population between the ages of 25 and 49 who have demand for income and stable cash flows.

For Rosenberg, that means telling investors to focus on safe yields and take an “income orientation” to investing. “We are not just talking about Treasuries or corporate bonds,” he said. “We are talking about MLPs; we are talking about REITs.” Even hard assets work



well in uncertain environments, he added, pointing to alternative assets and precious metals. He recommended gold, as a good hedge against both his “bullish view on income” and the current deflationary environment.

Elsewhere, Rosenberg sees good investment opportunities in Canada, as Canadian banks “cheaped up a lot last year” – creating a stable banking sector, strong currency, and earning power. The Canadian government is “pro-capital, pro-business,” and not subject to the same political gridlock that deters similar policy changes in the United States. The Bank of Canada is one of the few central banks that is not printing money right now. Taken as a whole, Rosenberg argues that these factors make Canada a good alternative for the foreign market.

Despite whatever woes may lie ahead, Rosenberg concluded, “safety and income at a reasonable price still works.”

[www.advisorperspectives.com](http://www.advisorperspectives.com)

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