



A Market for Contrarians

By Robert Huebscher

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When it comes to the caliber of investment-related speakers, few conferences can rival the one held last week in San Diego by Fortigent, the Maryland-based technology and research provider. This year's lineup, in addition to Steve Leuthold (see [here](#)), included Rob Arnott, Doug Kass and Joseph Galligan.

Those attendees hoping to leave buoyed by bullish forecasts found those hopes largely unfulfilled. While Leuthold opened the door with his prediction of a six-month rally, that door was closed, latched and locked shut by the other three speakers.

Truly successful investing demands a contrarian attitude; little can be gained by following the crowd's consensus. That's the closest thing to a silver lining to emerge from these three presentations. The bearish sentiment expressed by these three presenters was so all-encompassing that virtually any position in any asset class would qualify as a contrarian bet.

Rob Arnott: "Three-D"-fueled inflation

Arnott, the chairman and founder of California-based Research Affiliates, is also the creator and outspoken advocate of fundamental indexing. His firm is the sub-advisor to PIMCO's All Asset Fund (PASAX), an asset-allocation mutual fund.

The question Arnott addressed was how long-term investors can best achieve real (inflation-adjusted) returns in turbulent markets that are priced to provide lower-than-historical ("new normal") returns. The challenges that must be overcome, as Arnott has explained in a [white paper](#), are the three Ds: deficits, debt and demographics.

Deficits and their byproduct, debt, are escalating at a potentially uncontrollable rate, he said. Arnott presented data showing that commonly cited measures, such as federal deficits as a percentage of GDP, severely understate the leverage in the US economy.

Deficits were 10% of GDP last year – alarmingly above underlying GDP growth. Once you add in off-balance sheet debt, the picture worsens. Including GSE debt, the unfunded portion of Social Security and Medicare entitlements, and Medicare D (the prescription drug program), the number swells to 18% of GDP, well above historical levels.



Total public debt is 140% of GDP once you include state, local and GSE debt, not the 60-80% commonly cited. Only Japan, Lebanon, Zimbabwe have higher public debt, and our debt is almost twice as high as Greece's. Include corporate and household debt and unfunded entitlement programs and total debt surges to 840% of GDP.

"I defy you to show me anywhere there is deleveraging," Arnott said.

I strongly suspect some double-counting is embedded in those numbers, but Arnott's central point is dead-on. Taxing our way out of the hole created by that debt is unfeasible, and, absent a sustained surge in GDP growth, the default outcome will be inflation.

"Prepare for some breathtaking inflationary shocks in the coming years," Arnott warned. He believes our government's only option is to inflate its way out of its debt problems.

"Social Security and Medicare are a solemn promise that we made to ourselves, which we expect the next generation to keep," he said. But demographics are making that promise increasingly impossible to keep. Just eight years ago, there were 10 times as many people entering the workforce (ages 19-25) as new senior citizens. In 2023 that ratio will reverse; there will be 10 times as many new senior citizens each year as new workers.

How, then, should investors position themselves for Arnott's "three D" inflation? Nominal fixed income classes offer little hope, according to Arnott. Yields and spreads among convertible bonds, investment grade bonds, high-yield bonds, and emerging bonds are mostly unattractive, reflective of credit conditions prior to the financial crisis.

US stocks, on a capitalization-weighted basis, although they were cheap a year ago, are now overvalued, according to Arnott. Unsurprisingly, Arnott made a strong case for the attractiveness of fundamentally-indexed strategies going forward, which he said are now priced at a "remarkable levels relative to growth." The current market has been "propelled by a mountain of liquidity," leaving growth stocks overpriced and value stocks – especially deep value ones – grossly underpriced relative to growth stocks. Fundamental indexing is designed to profit from such situations, Arnott said.

Fundamental indexing has been a source of ongoing debate in the financial community, and those who choose not to follow this path can turn to Arnott's



other inflation-hedging recommendations: long/short funds, TIPS, commodities and REITs.

Arnott noted flaws in the each of those strategies. Commodities are currently expensive and should be bought “when they are trading down,” he said. REITs are similarly unattractively priced now because of an impending wave of foreclosures in commercial real estate, and TIPS suffer because of the imperfect tracking of the government’s CPI index relative to true inflation.

TIPS, he said, are the surest best, with the 20-year breakeven inflation rate now at 2.4%. Not a single member of the audience raised their hand when Arnott asked if they expected inflation to average less than that number over the ensuing 20 years.

Succinctly summarizing his outlook, Arnott said, “I dislike most asset classes right now.”

Doug Kass: Will the last great short-seller go long?

For many years, Doug Kass operated perhaps the only pure short-only hedge fund, Seabreeze Partners Short, only to close that fund in August of last year, when he opened a long-short fund, Seabreeze Partners Long/Short.

Given Kass’ inclination to position at least a portion of his funds bullishly, one might have expected to hear at least a tinge of optimism in his remarks.

Not so. The economy and the market face threats not fully reflected in current valuations, Kass said. “I continue to be short in this bull market,” he said.

Kass said that he called the March 2009 market bottom, based on price-to-book and normalized PE ratios that had reached “generational lows.” He doesn’t expect to see those lows again in our lifetimes. Now “animal spirits have responded to the liquidity of the Federal Reserve’s zero-interest-rate policy” and we are “not embarking on anything close to a bull market.”

The zero-interest-rate policy is like steroids, with a finite benefit that eventually takes its toll, irreparably damaging the credibility its proponents, Kass said, adding that it creates unrealistic future expectations in the capital markets.

“Well before zero-interest rates are abandoned, growth concerns will crystallize and stocks will suffer,” Kass said, and “investors will fail to react in time.”

Kass’ corollary concern is the US consumer, which he called the Achilles heel of the US economy. He expects unemployment to remain elevated at levels far



higher than consensus forecasts, leading to lower-than-expected consumption, business expenditures and profits.

“It’s different this time,” he said, admitting that he was “acutely aware” of the risks of making that statement. The difference, he said, stems from deleveraging, as the economy transforms from one where consumer debt grew faster than income to one where the reverse is true.

In past business cycles, Kass said corporations have driven consumer income and consumption through a process described by Say’s Law. In previous cycles, however, the consumer was in better health. Consumer frugality, globalization, wage deflation and consumer leverage are all factors that distinguish this business cycle from previous ones, and the implication, according to Kass, is that consumers must drive recovery, not businesses.

Add to this a host of “non-traditional headwinds” that Kass described. The economy will be vulnerable to aftershocks of the credit crisis, Kass said. The securitization markets, for example, still lie dormant. Housing recovery will be muted and the economy lacks a viable substitute. Commercial real estate has “only begun to enter a cyclical decline,” Kass said. Kass said municipalities, which have historically provided economic stability, are in “broad disrepair.”

“A very negative attitude toward wealth has emerged,” he said, which will lead to higher sales and income taxes – P/E deflators – to appease the “populist administration.”

“The most important cloud is that the more productive American industry is and the greater the perception that corporations are taking a larger piece of the profit pie from the American consumer, the more that will be asked of corporations and the wealthy,” Kass said. Although he is a Democrat and a former Nader Raider, Kass said investors face a “growing wave of populism” and current policy is not investment-friendly.

Joseph Galligan: The case for residential mortgages

When Jeff Gundlach founded his new firm DoubleLine, a key member of his ex-TCW team to join him was Joseph Galligan. The two have worked together for over 20 years.

As DoubleLine prepares to open its new fund, Galligan attempted to make the case for allocation to residential mortgages, specifically those securitized in the agency and non-agency markets, where Gundlach’s team has demonstrated expertise and success.



Prices are up 30-50% on non-agency mortgages since their lows in March, Galligan said. Yields over that time frame decreased from 18-20% to 8-9%, using aggressive loss-adjustment assumptions, he said. Agency mortgages are now priced to yield 4.5%. Galligan thinks that non-agencies are cheap relative to agencies, and expects spreads to go from 300-400 to 100 basis points “over time.”

Galligan’s presentation, however, mostly served mostly to illuminate the continuing deterioration in the US housing market and its ramifications for mortgage-backed investors. “Things are not getting better,” Galligan said. Residential housing inventories are oversupplied at a level two years above historical averages. That supply-demand imbalance can only lead to further erosion in home values and its consequences – delinquencies and foreclosures.

Data on delinquencies, Galligan showed, support this forecast. Whether one looks at prime, Alt-A, subprime or option-ARM mortgages, the pattern is the same: defaults and delinquencies are rising without any indication of peaking or reaching a plateau. Moreover, the gap between these two measures is significant.

For the market to stabilize these two numbers need to intersect. Ideally delinquencies need to decrease, but Galligan said there is “no sign that is happening.”

Galligan cited a “universal consensus” that the agency market is overvalued, due primarily to the Fed having been an active buyer in that market. That Fed program is scheduled to end in March, at which point Galligan expects spread to widen by at least 30 basis points. Galligan thinks that the day is near, and said the residential housing market is in the “seventh inning” of its crisis.

Eight to 10 million homes will be sold out of foreclosure and “we have barely scratched the surface” on that front, Galligan said, adding that the housing crisis will not end, and home prices will not stabilize, until that happens.

Loan modification programs are not working, because they are not decreasing the principal outstanding and economic conditions and unemployment have worsened.

Perhaps the only good news in this market is that loss severities have come down somewhat, he said, although that may be due to the process by which banks are liquidating their loans, through initiatives such as “short sales.”

The commercial real estate market, where Gundlach’s team admittedly has less expertise, is only in the second inning of its crisis, Galligan said. This year will be



the “year of reckoning” for that market, as lender and borrowers scramble to rewrite contracts on hundreds of billions of dollars of maturing debt.

Galligan believes banks still have \$1 trillion of bad assets on their books. The Fed’s zero-interest rate policy is allowing banks to earn an extra \$300 billion per year as they earn their way out of their problems. “Everyone understands the game that is being played,” he said. Meanwhile, banks are not lending and not originating new loans.

When I asked Galligan for his forecast for interest rates over the next decade, he said he is “tremendously concerned with what is going on” and “it will be very inflationary and rates will be a lot higher,” despite a short-term bias toward deflation.

The big question – perhaps the only question – for long-term investors in this market, therefore, is whether sector and security selection skills will be sufficient to overcome rising interest rates and accompanying value erosion.

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