

David Rosenberg - Bullish on Stocks

May 5, 2015

by Robert Huebscher



The consensus narrative is negative for the economy and U.S. equity markets. But according to David Rosenberg, that is wrong. A recession is three years away, he said, and even if the Fed raises rates, equities will perform strongly this year.

Rosenberg is the chief economist and strategist at Gluskin Sheff, a Toronto-based wealth management firm. Prior to joining the firm in 2009, he was the chief economist at Merrill Lynch. He spoke on May 30 at the Strategic Investment Conference in San Diego, hosted by Altegris and John Mauldin.

Investors are not giving sufficient respect to the prolonged length of the current recovery, he said. He titled his talk the “Rodney Dangerfield Cycle.” Unless a recession hits, according to Rosenberg, equities will do well.

“There is no such thing as a bear market that is not connected to a recession,” Rosenberg said.

“Equities will be the best returning asset class,” he predicted, adding that stocks will outperform bonds in 2015.

I last reported on Rosenberg in March of 2014, when he said there would be two more years of economic growth. He forecast 5% to 7% returns on equities for last year, about half of the market’s actual performance. However, he incorrectly predicted that bonds would perform poorly in 2014.

Rosenberg explained why he was wrong then about bonds. But, first, let’s look at why he thinks the current recovery “gets no respect.”

The unappreciated recovery

Rosenberg acknowledged that the current recovery has been the weakest cycle of all-time, with GDP growth averaging 2.2%, including the just-released data from the first quarter of this year.

“What the cycle has lacked in magnitude,” he said, “it has made up in duration.”

This is now the sixth longest expansion since the Civil War. It will rival or exceed the longest – that of the 1990s – according to Rosenberg.

There has been no “boom and bust,” he said, and the volatility of quarterly GDP data has been half of its historical average and the second lowest of all-time.

Rosenberg speculated that part of the reason for slow growth is structural, due to unfavorable demographics. The working-age population grew at the slowest rate last year since 1954. Fertility is at the lowest rate since 1909. Greater regulation and technological progress may also be at play, he said.

“Despite how sluggish this recovery has been, this cycle is going to last quite a long time,” he stated.

The current equity bull market has not been driven purely by quantitative easing (QE) and Fed policy, Rosenberg said. “It is rewarding the length of the recovery.”

According to Rosenberg, this is the first time we are ever this far into the expansion and still have an output gap of 2%. Normally the gap is closed and the Fed is raising rates.

Don’t fear the Fed

“There’s lot of things to worry about,” Rosenberg said, “but the Fed is not one of them.”

“It’s not the first rate hike that is the problem. No cycle ended at first, second or third rate hike,” he said.

“The big concern is the last hike, not the first one.”

We are 69 months into the cycle and Fed hasn't raised rates, according to Rosenberg. Historically, we are 35% into the bull market when the Fed starts to raise rates.

No bull market or economic cycle ends “on its own,” he said. “It ends in a liquidity cycle when the Fed tightens so dramatically that it inverts the yield curve.” All 11 post-war cycles all ended the same way, Rosenberg said. “This one will too, but it might not be until 2018.”

Rosenberg cited three historical examples to back up this claim. Bernanke raised rates in June 2006, but the market didn't collapse for another 12 to 18 months. Prior to that, Greenspan's last rate hike was in May 2000, six months before the dot-com crash unfolded. The Fed hiked rates in May 1989, but the bull market continued well into 1990.

The U.S. was never brought into a recession by another country, Rosenberg said, in response to a question about whether weakness in China could halt the recovery. China has an output gap and is rebalancing, he said. But consumer spending there is growing, and he predicted that “a new bull market on consumer services” will unfold in China. Although the commodity boom is over, Rosenberg said, China can slow down and it will not have a deleterious impact on the US.

The impact of cheap oil and a strong dollar is unambiguously positive, he said. Low oil prices benefit consumers, especially if perceived as permanent. Likewise, a strong dollar has been positively correlated with GDP growth over the long term.

Is there a profit recession?

Rosenberg dispelled the notion that U.S. corporations are facing a profit recession. S&P profits are declining, he said, but the decline is isolated in the energy sector, which is down 60%.

He noted that in the mid-1980s, there was a 70% plunge in oil prices, a strong dollar and seven quarters of negative earnings-per-share. But stocks were up 34%. A similar scenario occurred during the Asian crisis, a decade later, with similar results.

“The stock market is a long-duration animal and will look through things that are transitory,” Rosenberg said.

Wrong on bonds

Rosenberg admitted that he was wrong to be bearish on bonds last year. He had expected slower growth in the economy. But focusing on the correlation of bonds to economy was wrong as well. The correct correlation was to the yield of the German Bund, he said, which has been driven down by the European central bank's QE. That has driven investors to the Treasury market.

Now, he said, there also are very strong flow-of-funds effects. Five years ago, when things were terrible, Rosenberg did not expect our fiscal situation to improve such that the deficit would be 2.5% of GDP. It's not just a result of low interest rates. He said that revenue growth is at 8.5%. Net borrowing by the Treasury is now \$500 billion, versus \$740 billion last year.

On top of this, several types of institutions are buying bonds, virtually irrespective of their prices, he said. Regulatory changes drove commercial banks to purchase \$150 billion of Treasury bonds last year, about 25% of what was issued. Rosenberg called this “absolutely amazing.”

Pension funds bought another \$350 billion of Treasury bonds last year, he noted, and insurance companies and central banks added to their Treasury holdings.

Those “non-price sensitive entities” used to be 40% of the Treasury market, Rosenberg said; now it is 100%.

The result is a short supply of Treasury bonds that has pushed prices higher.

Valuations and inflation

Despite the supply-demand dynamics in the Treasury market, Rosenberg doesn't recommend that investors hold any bonds, unless one has a “proven view of deflation.”

But deflation is unlikely, he said. Core inflation is running close to 2% and is “more than meets the eye.” Inflation will be in our future, he said, but not in the next 12-24 months. “The central banks will ultimately

get what they want,” he predicted, at which point a hard-asset cycle will be upon us.

Bonds are for speculators, he said, not for income.

According to Rosenberg, for 10-year Treasury to generate a 14% return (what the S&P returned in 2014), it would have to go to 50 basis points.

If you want income, go to the stock market, Rosenberg advised. He likes CISCO with a 3% yield and Apple and MSFT with approximately 2% yields.

Four investment quadrants

Rosenberg provided a two-by-two matrix of scenarios, based on whether the Fed is tightening or easing and whether the economy is expanding or contracting. For each quadrant, he provided the historical return on the S&P 500:

-2%	+11%
Recession and Easing	Expansion and Easing
-34%	+8%
Recession and Tightening	Expansion and Tightening

Avoid what is on the left, he said, when the Fed is tightening and economy is in recession. That is when investors should “start to bail.”