Byron Wien Reflects on His List of Surprises
By Laurence B. Siegel
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Byron Wien is a senior managing director and vice chairman of Blackstone Advisory Partners, the largest alternative investment firm in the world with $140 billion under management. He spent 21 years at Morgan Stanley as its chief U.S. strategist and later as a senior strategist. He has been in the investment business since 1965 and has written over 1,000 essays on various aspects of investing.

Larry Siegel interviewed Wien on August 31, 2011.

The recent market panic has been very hard to interpret. The apparent problem is that governments are struggling to pay their debts, yet investors have rushed to sell equities to buy government debt. What is behind this behavior? Is it rational? And can we make money by doing the opposite — for example, selling Treasury bonds to buy equities?

I'm in the camp that we are in the process of making a bottom here. Bonds are very expensive, and stocks are cheap. Maybe the market can go lower, because – as we have all experienced during our careers – the market is not totally rational. But the reason that Treasury yields are so low is that people are risk averse, and they are parking their money in Treasury securities. They don't intend to be there long, but they want to earn some yield while they are waiting for their risk appetites to improve.

So the reality is not as bad as the market is saying it is.

I hope you are right. Moving on to Fed policy, Ben Bernanke finally said something sensible last week about economic stimulus, in my opinion. Instead of promising endless stimulus going forward, he warned of the dangers of unlimited stimulus and forecasted a normal economy. These forecasts evoke the well-known non-consensus forecasts which you disseminate in your annual “Ten Surprises” essay, a Byron Wien tradition since 1986. Last December, you forecasted 1,500 on the S&P and the unemployment rate below 9% by the end of this year. Are those forecasts still realistic? And what do you think of Bernanke’s new position? Does he fail to recognize the seriousness of our economic problems?

Bernanke very clearly recognizes the problem. My 1,500 forecast was probably too ambitious, but I believe the market will be higher at year-end than it was at the beginning of the year. So this is likely to be an up year. It is almost there now, almost at breakeven now. Maybe 1,400 is the goal. The unemployment rate will be lower, below 9%. I thought it
would be in the low 8s, maybe the high 7s by the beginning of the year, and it won’t get there.

There are several ways to view the apparent failure of the past few years’ stimulus: that it was not enough and we should do more, that it didn’t stimulate anything and we shouldn’t have done it at all, or that it saved us from a much worse outcome and was about right. Where do you come out on this spectrum?

First of all, President Obama set his priorities incorrectly. He put health care reform above jobs. At the time that he was elected and had a mandate from the people and a victory of 53% to 47%, so he should have pushed jobs. Instead he pushed healthcare, which caused him to lose political capital. It didn’t do much for the economy and may have even been a negative for the economy.

The stimulus program of $787 billion enacted in April 2009 did some good. It was adequate, but most of it went to state and local governments to keep teachers and police on the payroll. There was no clear job creation focus, and that was the weakness of the program.

Do you think that government spending can ever actually stimulate job creation, or is it more like robbing Peter to pay Paul?

It can do some good, but you need to enact policy measures too. You need to relieve regulation. You need to provide tax incentives. But government spending can be a positive.

We have been hearing from various commentators that the recent contraction was not a typical business-cycle or Fed-driven recession with a quick recovery at the end, but a once- or twice-in-a-century deleveraging that takes much longer to work out. Are there are two types of recessions? Is the recent one fundamentally different from the previous three? Are we in a depression?

Ray Dalio of Bridgewater has been saying this, as well as Kenneth Rogoff and Carmen Reinhart, the authors of the financial history book *This Time is Different*.

Deleveraging is a legitimate issue. There are a lot of people adhering to the concept that we’ve got too much leverage in the system and, until we clean it out, we are not going to grow again. I subscribe to that view to some extent, but that doesn't mean that we can’t have growth and deal with the overleveraging over a long period of time.

It is unlikely that the developed world is going to grow faster than 3% any time in the next five years, and the growth rate may be close to 2%. But the developing world is growing faster, and that is going to help world growth. So I am not optimistic about strong growth in the developed world, but it doesn’t have to be as bad as it is right now.
Does your low-growth forecast for the developed world mean it's just hard to grow an economy that produces income at a rate of $50,000 per capita per year? Have we reached a cap?

We are a mature economy. As you point out, we have a high standard of living, probably the highest in the world. It is very expensive to maintain it. We have a democracy. We have half of the people in the country not paying taxes but receiving entitlements. We have Congressmen and women elected every two years, and the people who vote for them tend to be people who get things from them. So we have a broken system where the government provides entitlements that it can't afford. That dynamic limits our growth.

How can we break the cycle?

We aren't going to create jobs without spending some public sector money. The best way to do that is through an infrastructure program. Our infrastructure is aging and in need of refurbishment. A significant portion of the unemployed are construction workers who have the skills to do that work. So that's one thing we have to do.

We have to increase taxes. The Boehner-Obama plan of $3 of spending cuts per $1 of revenue increases – the so-called “grand bargain” – was a good idea. We can increase taxes on wealthier Americans. I don't know whether $250,000 or $500,000 is the proper cutoff point, but we can raise some taxes.

We have to cut expenses. There is a tremendous amount of waste in Medicare. I would raise the Social Security retirement age. I would withdraw troops from Afghanistan and Iraq.

So there is a lot that we could do to save money, and we can raise more revenues. We have to do all these things simultaneously, but I am not convinced there is an appetite in Congress for getting them done.

I am going to move onto investment advice and viewpoints. As I noted earlier, you are well known for your annual list of 10 surprise forecasts. Looking back no more than a couple of years, which forecasts are you the most proud of, and which were furthest off the mark?

The best forecast I've had recently was on gold, where I've been bullish for quite a few years now. That certainly worked out well. The worst forecast was on interest rates, where I thought that the deficits we were running would push the 10-year Treasury yield up to 5%.

Clearly I've been wrong on that one. I misjudged the amount of fear in the world and the fact that so much money would migrate into U.S. Treasury securities for protection.
When you make these forecasts, what is your inspiration or process?

I hold two or three lunches for major investors in the eastern Long Island area, people who have weekend homes out in the Hamptons. I invited 90 people to three lunches this year. I host one, a venture capitalist hosts one and George Soros hosts one. Of the 90 people invited, 80 came. You would know most of them by name. That's where the process starts.

I then find out what the consensus is and pick 10 things I want to argue against. That goes on from September through December, and by the end I've narrowed the list down to maybe 25 different things. During the last couple of weeks of the year, I cut it down to 10. But it is a laborious process, because I carry them in my head all year long.

And, as you say, the world is at least somewhat aware of them. So, when I get them right, I get a certain amount of praise. But when I get some of them wrong, I get a lot of criticism. I've never gotten more than nine right. Two years ago, in 2009, I did get nine right. But until then I had never gotten more than seven right, and I have been doing this since 1986.

I don't do it to keep score. I do it to stretch my own thinking and the thinking of our clients.

With Treasury rates at or near an all-time low, some investors are reaching for yield in the following ways: high-yield bonds, leveraged bank loan funds, preferred stocks, REITs and high-dividend portfolios of equities. Which of these, if any, do you think is an effective or timely strategy, and what are the risks involved?

I don't think we are going to have a recession, so therefore I like leveraged loans and lower-quality high yield bonds, because the default rate that is priced in to these securities is too high. I also like dividend-paying stocks but not necessarily the highest dividend-paying stocks. Brand-name multinationals in the United States and Europe are very attractive now. So, looking for yield is a sensible approach. And I would look for it in both the high-yield end of the bond market and in equities.

I tend to see the silver lining in every cloud, and in the real estate crash the silver lining is particularly evident. Housing is affordable again – in some places extremely affordable, with mortgage payment-to-income ratios at or near record lows. If you think individual investors should start gaining an exposure to real estate again, how should they do it — through REITs, through a mortgage-backed securities (MBS) fund, through direct purchases of property? What is your general view on real estate?

I am very positive on commercial real estate because there wasn't a lot of office building construction in the last cycle. We have a very large real estate operation at Blackstone. It operates all over the world in all kinds of properties, and it is one of the strongest areas at the firm.
Hotels are very good. Offices in places such as New York, San Francisco, Washington and a few other cities are very good – not every city, but those cities and a few others.

To implement a real estate strategy, you can invest in real estate funds. You can invest in certain REITs. Mortgage-backed securities (MBS) funds are attractive. And you can buy buildings directly if you are an institutional investor and have the resources to do it. Individual investors are more limited in what they can do, because single residential properties are very undiversified and costly to manage. For individuals, I would recommend MBS funds and high-quality (Class A) office REITs.

If you don’t mind the conversation taking a more speculative turn, I have been researching the effects that the end of the global population explosion will have on the very long-term future of investors. (World population is expected to peak between 2050 and 2075 and then begin to decline.) Ben Wattenberg first brought up this issue in his book *Fewer*. Most authors who have looked into this question are bearish on the investment markets, because they see limited growth opportunities in a world without an expanding population. My preliminary results, however, are bullish, because a very large number of previously poor people are going to be able to consume at first world and near-first world standards. What is your view on this question and how you think about it?

You are looking at it correctly. Look at China. China is trying to control its population, and their standard of living is rising.

The most important economic story in the world today is the rising standard of living in the developing world. You don’t need an expanding population to have growth. You just need to be improving the quality of life for the existing population, and that is what is going on in India, China and many other places in the developing world.

**What scenarios do you fear most for the economy and the markets?**

There is plenty to worry about. I am very worried about a breakdown in Europe as a result of sovereign debt default or restructuring – a meltdown in the European banking system similar to the potential meltdown we had in the United States because of subprime lending. So that is my big worry in Europe.

In the United States, I am worried that we will slip back into recession because Obama will be ineffective in getting any stimulus through. Congress is trying to make him look bad, and the American people are the victims of that effort.

I'm worried about resumption of the Arab Spring. The overthrow of Mubarak and Gadhafi was based on the fact that younger people in those countries didn't have sufficient economic opportunity. Now the dictators are gone, and the opportunities haven't appeared.
I'm worried that there will be a second wave of unrest, one that will destabilize the oil supply and possibly lead to much higher prices, which will put us closer to recession.

I'm worried about China. I'm worried that the banking system is fragile there, and there has been overbuilding of high-end real estate. Growth may slow there, and that is a particularly big worry because China is the engine of growth for the world.

And of course there is always worry about another terrorist attack, either in the developed or developing world. So there's plenty to worry about.

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