Albert Edwards and Dylan Grice: Bearish Forecasts from Two Top Strategists

By Robert Huebscher
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It's been nearly 18 years since Albert Edwards forecast an "ice age" in which bonds would outperform equities. He's been right until just recently, when cumulative returns on the two classes converged. But Edwards insists that his thesis is still accurate – deflation will be the force to propel bonds over stocks, he says. Dylan Grice, meanwhile, warns that the markets operate on an unstable equilibrium that could devolve into apocalyptic conditions.


Albert Edwards

The two spoke at Societe Generale's annual research conference in London on Jan. 14. Edwards is the firm's global strategist. Grice is the director of research at Edelweiss Holdings, a Zurich-based investment manager. Prior to that, Grice worked alongside Edwards at Societe Generale.

"We are one recession, one slip away from outright deflation, both in the euro zone and in the U.S.," Edwards said. That would adversely affect equities, he said.


Dylan Grice

If that message wasn't sufficiently foreboding, Grice warned of a societal breakdown that would be far more disruptive.

The financial markets measure trust through yield, according to Grice. Investors should not be lulled into assuming today's record-low yields (in both equities and bonds) imply similarly low degrees of risk. That is incongruous with current political developments, he said.

"It is wrong. It is the last hurrah," Grice said. "This is not just an economic but a social phenomenon."

Beware a deflationary bust

Edwards cited a number of indicators indicative of impending deflation.

"Actual inflation is crumbling away downwards," he said. Both core and headline inflation – including measures of food and energy – are trending lower in the U.S. and the euro zone, according to Edwards. He claimed that the European Central Bank is not worried about this and, in fact, might believe deflation would help Spain or Italy become more competitive. Edwards said this line of reasoning was "ludicrous," given the debt burdens those two countries bear.

Weakness in the U.S. labor markets is another indicator. Edwards cited a recent commentary by PIMCO's Bill Gross, who wrote that household employment, which has been a reliable leading indicator of non-farm payrolls, has been very weak for the last year – running at a pace of approximately 100,000 new jobs per month.

Economists' projections for inflation have trended down steadily over the last year, according to data Edwards presented. But in the U.S., economists continue to expect inflation above 2%, which he said is seriously disconnected from the data.

Edwards sarcastically remarked that he knows there is a deflation problem when, in his own country, the Bank of England was able to hit its inflation target of 2% for the first time in almost four years. But investors remain confident in the central banks' ability to avert deflation, which Edwards said explains why markets have not priced in this scenario.

Japan will pay a key role in the oncoming deflation, according to Edwards. "Japan is fiscally bust and they have no option but to print, print and print," he said. That will weaken the yen, and Japan will export its deflation to the rest of the world.

Other Asian exporters – Edwards mentioned Korea and Thailand – will be forced to weaken their currencies, pushing more deflation into the developed markets. A similar phenomenon occurred in 1995-97, according to Edwards, when Japan's weakening of the yen triggered the Asian crisis.

"You will see waves of deflation coming into the U.S. and the euro zone at a time when profits are already stagnant or slightly falling," he said. That will pressure companies based in the developed markets.

Corporate cutbacks are the key risk of a recession, he said. Cuts in investment and inventories will be a precursor to falling profits and headcount reductions.

Odds of a recession are increasing, Edwards said, as the current recovery nears its sixth anniversary. He said the median length of economic recoveries has been only 36 months. Our minds are "polluted," he said, because the last three cycles were lengthened due to central bank intervention. Profits, labor costs and productivity in the U.S. have been a "big fat zero," Edwards said. "That is all associated with a cycle which is already long in the tooth."

Indeed, Edwards said that sentiment regarding inflation could trigger lower equity prices. Inflation expectations are firmly anchored between 1.5% and 2.5%, he said, and if inflation drops below 1.5%, "you can get a massive equity market reaction."

That sentiment has been reinforced by the market's belief that central banks will ease at the first hint of deflation, Edwards said, and that will buoy the prices of "risk assets." But Edwards said one of the most important developments in 2013 was that commodity prices fell, despite the third round of quantitative easing (QE).

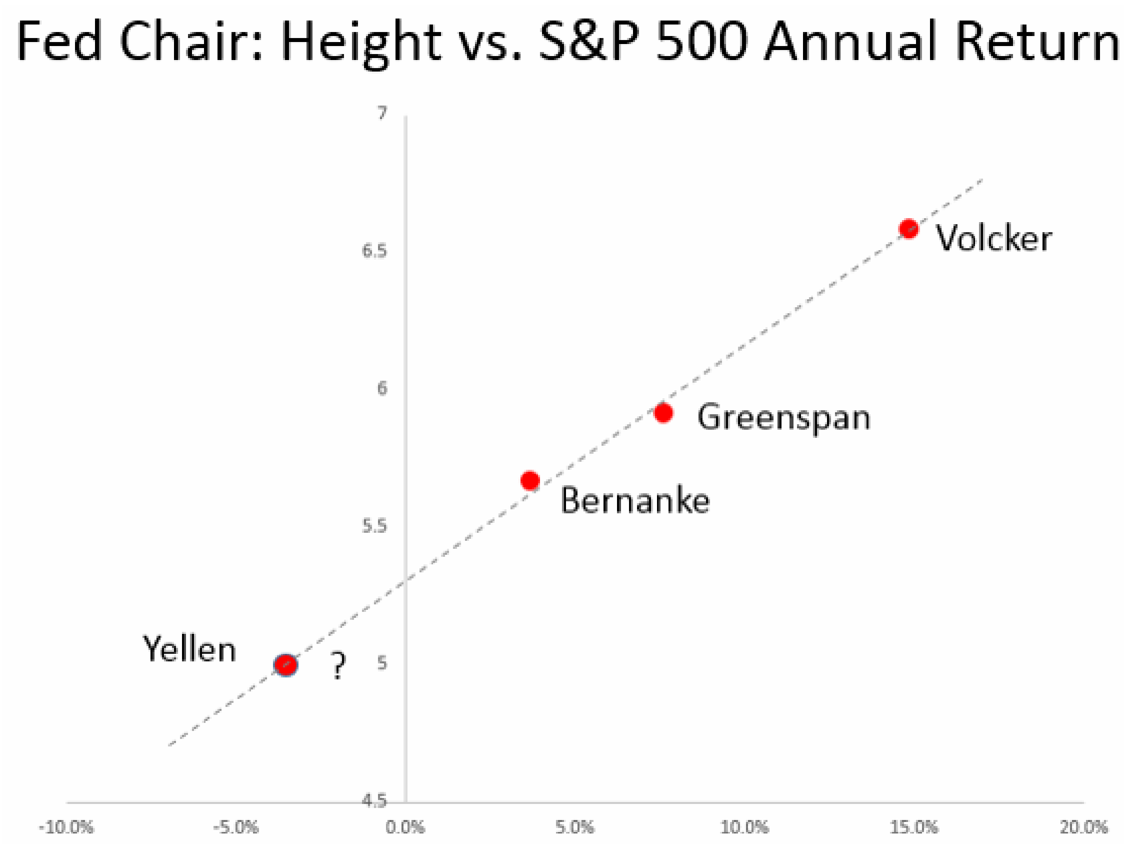
"It is wrong to assume that equities will always go up if there is a QE4 or QE5," Edwards said.

Fundamentals drive equities, Edwards said, and the current secular bear market can "break" easily. He cited a number of measures – including Shiller's CAPE and Tobin's Q – that indicate overvaluation. "I would expect in the next recession to bottom at about 7.5-times trough earnings," he said. "That is why I still remain so bearish."

"If you invest at very expensive valuations you are condemned to poor long-term returns," he said.

Even though his ice age thesis is imperiled by the recent convergence of cumulative equity and bond returns, Edwards – citing research by John Hussman – warned that a few years of equity gains can be easily wiped out in a few months of bad performance.

Edwards offered a final omen of poor prospective market performance – the appointment of Janet Yellen. Tongue-in-cheek, he showed what he considers a "guaranteed" relationship between market returns and the height of Fed chairpersons:



Edwards' pick for Fed chairman would have been Magic Johnson, who at 6'10" would have assured good long-term performance.

The market's prisoner's dilemma

Grice's presentation was slightly ethereal, but he distilled his abstract concepts into a forecast for the market and global economies that would unsettle even those with the most bearish outlook.

"Without trust, there are no markets," Grice began his exposition into the relationship between trust, cooperation, government policies and the scarcity of capital. Devaluing money – through policies such as QE – plays games with trust and threatens the sanctity of markets, Grice said.

To demonstrate what QE does, Grice asked the audience to imagine that a politician wants to spend money on the economy. Raising taxes is unpopular, unlike QE, which Grice said "increases the real purchasing power in the economy." But QE isn't free. It benefits those "closest to the printing presses," Grice said – for example, banks and companies that get funds for infrastructure projects. Workers are one-step removed from this "silent and insidious redistribution," he said. The benefits of QE decline as recipients get further away from the printing press.

QE creates an unsettled environment in which those in the "back of the line" blame those in the front, according to Grice. "It sets society against itself," he said. Keynes observed this effect during the Weimar inflation in Germany in the 1920s.

"We've conquered CPI inflation but created asset price and debt inflation in its place," Grice said.

Inflation – whichever form it takes – is not just a narrow economic phenomenon, Grice said. It causes societal discontent. Grice cited examples: The Salem witch trials coincided with a period of high inflation, and inflation during the Roman Empire led to persecution of Christians.

"Devaluing money devalues trust," he said.

Trust is a byproduct of cooperation among market participants. Grice next explored the psychology that drives individuals to work together cooperatively.

Grice likened market dynamics to the prisoner's dilemma, a core topic of study in game theory. In this hypothetical setting, two prisoners are separately interrogated for a crime they are accused of committing. If both cooperate (and remain silent), each receives a modest payoff. But if one of them accuses the second and the second remains silent, the former gets a large payoff. If they both defect, or accuse the other, each receives a modest penalty.

The dynamics of the prisoner's dilemma are complex, and Grice described some of the research into the problem. For example, one researcher created a tournament in which a group of scientists were invited to submit algorithms describing what a prisoner should do, assuming the game were played repeatedly and the goal was to maximize one's long-term payoff. The best strategy turned out to be "tit-for-tat:" One should continue to cooperate as long as the other player cooperated on the previous round. But if the other player defected on the previous round, then one should defect.

While it is optimal for both players to continue to cooperate, it is not a stable equilibrium. The temptation to defect is too great, and one defection can trigger an endless cycle of retaliation. Ultimately, the dominant strategy is to defect.

As Grice described, further research shows a better strategy than tit-for-tat – "generous tit-for-tat." Here, players also cooperate if their opponents have cooperated. But if their opponent defect, they cooperate or defect, based on a predetermined probability. Generous tit-for-tat results in a longer-lasting equilibrium than tit-for-tat, but it too ultimately regresses into a cycle of defection. The incentives are too great to overcome.

Martin Novak, one of the scientists who performed this research, remarked, "In all my work on the evolution of cooperation, it is always the same story – cooperation is never here to stay. Cooperation prevails for some time. Then the system breaks down and you have to rebuild it. … This is far away from the typical economist notion of equilibrium. There is no equilibrium."

Likewise, economies and markets operate in cycles of seemingly stable equilibria, only to be punctuated by catastrophes. For example, Grice cited Carmen Reinhart and Ken Rogoff's research, which showed that countries tend to be fairly solvent, except for periodic spikes in sovereign defaults (following the industrial revolution in the 1830s, following the Civil War in the 1880s, during the Depression in the 1930s and following the oil crisis and high inflation in the 1980s). Similarly, inflation has generally been tame, except for spikes in the 1920s, 1940s and 1980s.

High debt levels and inflation both represent a breakdown in trust that has fostered non-cooperative behavior and disunity in the past.

Grice sees the potential for such a crisis today in sovereign debt levels, which he said are unacceptably high once off-balance sheet liabilities, like health-care costs and pension liabilities, are considered. Those represent promises that cannot be kept, he said.

Behavioral finance research has shown that individuals experience disproportionately more unhappiness from losses than they do happiness from gains. Grice said that QE will be more painful when it is unwound through monetary tightening – but his overarching message was not merely "painful."

"This cycle has turned," he said. Global politics and economics are highly fragile.

Signs of peril

Grice pointed to a number of ominous warning signs. The Occupy movement in the U.S. was an early indication of trouble, and it was followed problems in the euro zone and tensions between Japan and Asia. Each of those episodes was preceded by credit inflation closely tied to central bank policies.

The use of trade-protection and capital-control measures has been on the rise in the last four years – signifying a lack of cooperation, according to International Monetary Fund data Grice presented.

Grice said he is “scared” by the politics in Japan, which has shown non-cooperative tendencies in connection with its territorial disputes with China. Grice showed a picture of Prime Minister Abe in a fighter plan with the number 731 inscribed on the side.

That was not a random number, according to Grice. It was the number of the notorious squadron that performed biological experiments on the Chinese during World War II. To have a picture like that, Grice said, would be “like Angela Merkel in a jet with a Swastika on its side. It was deliberate and a clear sign of provocation.”

Other indicators have been even more blatant. Grice quoted Taro Aso, Japan’s deputy premier and finance minister, who said in August, “We should proceed quietly. One day people realized that the Weimar constitution had changed into the Nazi constitution. No one had noticed. Why don’t we learn from that approach?”

There is a shortage of capital due to overspending and under-saving, according to Grice. The financial crisis in 2008 was the first revelation of this scarcity. Ultimately the price of capital must reflect the scarcity of capital – through higher yields.

Those ascribing to Grice’s dour outlook should hold a very defensive portfolio, he said. Cash should be held in gold to provide “optionality.”

“Gold is the oldest and purest form of capital,” he said. “If I’m right, the potential for gold is to explode.”

Investments should be centered on necessities, natural (not government-created) monopolies and capital-efficient businesses – fertilizers and miners were Grice’s two examples – that produce goods that will be needed if trust breaks down. Grice agreed with something that Warren Buffett has preached: The best inflation hedge is businesses that don't consume a lot of capital.

Grice acknowledged that things might turn out better – even a lot better – than he fears. Investors should hold a portion of their portfolio, he said, in out-of-the-money call options, in case equity markets surprise to the upside.