David Rosenberg: Global Economy Still Deteriorating

September 19th 2019

Erik: Joining me now is Gluskin Sheff's chief economist David Rosenberg. David prepared an excellent slide deck.

I'm sure many of you are familiar with "Breakfast with Dave," perhaps the longest-standing and one of the best-known paid subscription newsletters in the industry. Most of the slides in the deck come from "Breakfast with Dave" and it's a really excellent deck, so I recommend that you download it.

Registered users will find the download link in your Research Roundup email. If you're not registered yet, just go to our home page and look for the red button that says Looking for the Downloads? next to David's picture.

David, it's great to have you back on the program. Last time that we had you on, you told us a story of an ending or late-stage economic cycle and deteriorating economic conditions. As I perused your slide deck, it looks like those conditions are maybe even getting worse.

So give us an update on what some of the major things are that people will find in the slide deck and what you're watching in terms of economic signals.

David: I think that the theme really is about elevated if not unprecedented levels of trade and policy uncertainty that has frozen business capital spending in time across the planet.

I know that the temptation is to talk about how resilient the US consumer is, and I understand that. But the US consumer is not immune to a pullback in US business spending. There's just lags. And the US economy is not immune to what's happening to the world around it, which is one of the themes that Jay Powell talked about in yesterday's post-meeting press conference.

So we have elevated levels of uncertainty.

It's caused this massive pullback in capital spending. I actually estimate that business spending globally on a median basis across 27 countries that I monitor is negative 5% at an annual rate year-to-date.

And that is really what is providing knock-on effects in terms of global economic activity. And of course at a time when global supply chains are in retreat and global trade and investment flows are contracting for the first time in a decade.

And, as I said before, I think that the temptation is to look at the stock market near its highs and to look at the latest round of GDP data and conclude that all is going to be well on this side of the planet.

I'm just not so sure about that, as we see countries like Germany, the UK, and Italy – three of the top four economies in Europe – teetering on the brink and seeming to me to be heading towards some form of economic recession. Dramatic slowing taking place in China, and other parts of Asia clearly are slowing down.

I mean, when you get a situation where a hot spot like India now has auto sales domestically down more than 40% year-over-year in August – and that until recently was the strongest component of global GDP – you know things are cooling off and cooling off dramatically.

So, if anything, the forecast I was running with at the beginning of the year has probably come into fruition at this stage even more than I thought it was going to.

Erik: Well, I think you've got it exactly right, David.

And I think that your current slide deck really does an excellent job of providing hard evidence to substantiate that the kind of bearish call that you made, I think it was upwards of a year ago (not the last interview that we had, but two interviews back when you started talking about this outlook). I think you've been spot on. You've got it right.

But the crazy thing is, even though most stock markets around the world have been selling off, we're almost at new all-time highs on the S&P.

What's going on here? Is this because everybody is expecting more accommodation from the Fed? Or why is it that the S&P seems to have this immunity from the economy, unlike any other market?

David: A big part of this – because, let's face facts, we are into three quarters in a row of negative earnings growth, even in the S&P 500. This wasn't supposed to happen.

I'm looking at the third quarter estimates right now. They are roughly minus 4% year-over-year. When we started the year back in January, the consensus was plus 4% for Q3. It's now negative 4%. And that's the third quarter in a row of decline. So you'd be tempted to think, what is going on here?

We are actually in a profits recession. Nobody seems to talk about it very much. And yet the stock market as a whole certainly is gravitating towards the highs.

But look at the sectors that have really been leading this thing for the most part: telecom, services, utilities, real estate. The rates are up 26% year-to-date over the past 12 months. So that is something to keep in mind is that it's been really a defensive rate-sensitive rally back towards the highs.

And a lot of the cyclicals that have lagged behind, I would tip my hat to the growth stocks. I mean, companies like Microsoft as an example.

You know, you always have to have a theme. You mentioned about being bearish. There's parts of the market I'm bullish on. Certainly I've been bullish on bonds.

But in terms of the thematic in the equity market – because there is always a theme you use to advise people to invest around – you don't have to buy the entire market and I don't advise buying equity TFs.

I believe in ideas and thematics and providing unique insights. And I think that what we have on our hands is a classic, call it Adam Smith–David Ricardian scarcity value on our hands. You want to own what's scarce globally. And what is scarce globally is yield and what is scarce globally is economic activity.

So you want to own income, because it's scarce. And you want to own growth, because it's scarce.

So the growth component – and Microsoft is the poster child for growth stocks in the US with strong balance sheets, stable cash flows, and so the growth/income theme. What I would say is the (call it) being long utilities and being long the areas, say, of technology that have growth characteristics are very good places to be.

On top of that, I think that what's obvious to me is that central banks globally are in easing mode. The Fed is not done. And that's going to continue to anchor interest rates across the yield curve at very low levels.

So I think that the rate sensitives, as expensive as they are, will continue to be places of refuge in a troubled and I would say deflationary global economic backdrop.

Erik: There was an event last week which some people think was very significant, where you had a day where the index didn't really move that much but under the covers, if you will, there was a massive dislocation in a single day – and I think it was the biggest ever in a single day – between value and growth. And some people are describing that as the tidal wave below the surface, maybe a foreshadow of evil things to come in the stock market.

How much legitimacy do you read into that view? What do you think of that sudden dislocation that occurred?

David: It's interesting that we call it a sudden development.

A lot of that is because tax day for companies in the United States is September 15. So you did have this situation where companies prepare for this by pulling the cash they need and putting it into money market funds. And so now that that tax day has passed, that cash was taken out of the market. And what it did temporarily was create a supply squeeze of dollars.

And the reality is that this isn't like 10 years ago where you had this situation happen and there would be a pull market and it really coincided with a breaking of the buck and the money market and hedge funds being closed down.

There's really none of that. You didn't see any big implosion in financial stocks or in other risk asset classes.

Jay Powell addressed this at length yesterday after the FOMC meeting. And the reality is that the Fed now, after months of allowing its balance sheets to be reduced, is now switching course, letting the Treasuries and mortgage bonds that it had bought following the financial crisis, to roll off.

You could argue [it] accentuated the reserve squeeze that we had in the past couple of days. But now the Fed is full-square pumping those reserves back into the system.

So I'm not convinced that the short-term funding stress that we had in the past couple of days is something that you could forecast as foreshadowing anything nefarious. I've got other reasons to be cautious on the outlook right now. This isn't one of them.

Erik: Since you brought it up, let's talk about the FOMC statement. And particularly, although a lot of people have predicted a return to quantitative easing at some point, I think this is the first time the Fed actually admitted that that was a possibility formally.

What do you make of that announcement? Do you think that there is any particular news here? Or is this just to be expected?

David: What Powell really said in the Q&A was, what would happen in the doomsday scenario if we fall into the recession that the Fed is telling you they don't expect to happen? It was all very situational. And he did say that we would go back into aggressive quantitative easing.

Interestingly enough, although a lot of the Fed's district banks have done a lot of research in the past year on negative interest rates, he seemed to downplay that idea as being a strategy the Fed would follow.

But the reality is that he said that QE is on the table if things go awry in terms of the economic outlook. And the question really is, do they start it before or after they move the funds rate back down towards zero? But I still see that as a stronger possibility and all the more so in the aftermath of what Draghi announced last week.

Erik: You mentioned the bond market. So let's come back to that. We've seen a backing up in yields. We've got almost to 2% on the 10-year Treasury after being down to – I forget what the low was – 1.40-something %.

Is this a change in direction? Is this a trend reversal? Or is this just a correction? And, if it's a correction, is it time to be buying bond here?

David: It was probably the fourth mini-correction that we've had since the 10-year Treasury note yield peaked at around 3.3% in November of last year. Nothing in the markets moves in a straight line. This is almost a straight line from 3.3% all the way down to almost 1.4%. We almost retested the post-Brexit July 2016 lows on the 10-year note at a time when the cost of overnight funds was materially higher. I mean, that is a pretty big event.

To look at this backup in yields, which to me was a hiccup and a spasm and overdue, has to be viewed in the context that we're still down 140 basis points or 150 basis points from where we were in the fall of 2018.

So, you can look at the trend line. And you can also look at the noise around the trend line. This spasm from what you would say was an overbought interim low, and took place alongside (I think) a revival of inflation and growth expectations, and coincided (for example) with that resurrection of the value-over-growth trade – which, again, I think was more temporary – but this was basically more technical in nature than anything else.

And the answer to your question is, yes, I think the backup in yields across the curve offers a very nice buying opportunity. The bond market right now is barely priced, believe it or not, 50/50 for the Fed to move again this year. There's two more meetings.

There is no such thing as a sure thing in this business. I've been doing this for 35 year, I'm humble enough to know that. But in the area of forecasting that is the next best thing to a sure thing, I think that the Fed will be cutting rates probably at both meetings.

That may well steepen the curve. But the whole curve is going to move down. And I still think there is a lot of capital gains to be made in the Treasury markets in the next several months.

Erik: So it sounds like you think that we are headed for a new low in yield below that epic number from July of 2016 – I think it was 1.35% or 1.36% on the 10-year.

David: I think that by the time the cycle is over, I think the funds rate will be back towards the zero-bound. And I think that the 10-year note will be gravitating towards where the 10-year UK gilt is. There's an incredible correlation. Maybe it's because ultimately we all came from Britain and we speak the same language.

But the strong correlation between the gilt market and the Treasury market – I have a tough time believing that gilt yields in the current backdrop are going to move up towards where yields are in the US. I think that US yields will move down towards where they are in the UK. I'm not focused on negative yields in France or Germany or Japan.

I don't think we're going to get to negative interest rates in the United States. And, actually, I don't need that in my forecast to tell people that bonds are going to be a very good place to be from a total return perspective.

But the answer to your question is, yes, I think that – we already had a situation, by the way, where the long bond yield, the 30-year, did make a new all-time low just a few weeks ago when it broke below 2%. And I think that the 10-year note will make a new low this cycle, absolutely.

Erik: If we step way back out to the really big picture – as you just said, the 30-year just made an all-time new low – all-time forever, in all of recorded financial history. By some accounts, we're at a 5,000-year low in interest rates. That could be a pretty ominous sign of where we really stand economically.

What do you make of the really big picture of, boy, why are interest rates so darned low?

David: There's a variety of reasons why they're low.

A lot of it you can assess towards demographics and technology and other secular forces, excessive debt loads around the world. These sort of secular structural forces that have prevented inflation from coming back, despite all the efforts by all the fiscal policy makers and monetary officials. We never did manage to create much of an inflation cycle this time, despite all the efforts that were thrown at it.

I'm amazed at the number of people that say, oh, well, the decline in yields this year has to do with, well, aggressive pension fund rebalancing or the machinations and incursions of central banks. That's not the reason for the decline this year.

You could argue that's one of the reasons why yields are low. You can point to all the aggressive movements to add assets and bonds to central bank balance sheets.

But, come on, the Fed has been out of the QE game for years. The ECB, up until last meeting, was out of it for months. The UK hasn't been involved in QE for a long time.

It's nothing about central banks.

What happened this year that I think is important to note – and this is what I started off talking about at the beginning of this show – we've had a collapse in business investment globally for a variety of reasons. And interest rates, ultimately, equilibrate two very powerful curves that you learn about in Economics 101 – which is investment and savings.

And what happened this year is we had a collapse in capital spending from the business sector in relation to desired savings. And the rapid decline in interest rates had to equilibrate those two curves.

So we're really just back to the classic Ben Bernanke (quote) savings glut that he lamented about back in 2006, but for a different reason. Because this isn't just about excess global savings coming out of China. This is about a deficiency of capital investment globally.

And if you go the Fed's statement yesterday, what does the Fed talk about? They did mention the consumer is hanging in just fine, for now. But they talked principally about what is happening in the business sector, which is a leading indicator.

So that, to me, is what the story is. The story is excess savings over investment. Or, alternatively, deficient investment relative to savings. And that is the only possible academic explanation as to why bond yields melted as much as they did in the past 12 months.

Erik: Let's talk about the US dollar next. The dollar index has been in a steady but slow grind higher since the end of June. And the trade-weighted dollar index recently made an all-time high.

What's going on here? Is this set to continue? And what's driving it?

David: You have a situation where, for example, the first central bank out of the gates to announce a return to QE was the ECB. This is Mario Draghi's last hurrah. So that certainly was a factor. The expectation into that was a factor that undercut the euro.

We have a situation in the UK where hard Brexit is not out of the realm of possibilities. And now you just had another – we thought we were finished with the soap operas with Theresa May. And then we have the extension of the soap opera in the UK – and nobody does it better than the Brits, that's for sure – with all the shenanigans of Boris Johnson. So there is this more elongated period of uncertainty as it relates to the UK.

And when you look at relative rates of growth, they're slowing more overseas than they are in the United States. I think there will be a lagged impact here at home.

But when you're taking a look at the problem spots in the world, it really is more overseas. And you look at the euro and the UK, they comprise a big chunk of the trade-weighted index. So that's a big part of it.

I think that the Fed will start to play catchup with these other central banks, so I think that the days of this bull market in the US dollar are pretty well behind us. I wouldn't be chasing nickels in front of the steamroller.

I think most of this bull market of the US dollar is behind us because I think that the interest rate differentials and the policy gap between the US and the rest of the world is going to start to close for the next year or two.

So I have a more, shall we say, circumspect or even, I'd say, negative view on the US dollar right now relative to a lot of the other currencies in the world that have already been making these policy adjustments.

Erik: Since the last time we had you on the program, we've seen a really big breakout in gold beyond $1,350 which was the resistance level for a good solid five years. And we've seen a very decisive breakout – maybe the beginnings of a retracement now, but still looking pretty strong.

What do you expect for gold here?

David: I'm very bullish on gold. Precious metals in general, gold in particular. And a lot of it has to do with what the trend in interest rates is. We had this incredible statistic just a few weeks ago where $17 trillion or a third of the global bond market carried a negative yield. I don't expect that condition is going to go away.

And gold has this phenomenal inverse correlation to the general level of interest rates, especially real interest rates. So I think that gold is going to continue to benefit from this bond yield landscape that I think is semi-permanent. I don't think this is going away any time soon.

Gold is also valued, when you think about it from a psychological standpoint, 1/T where T=trust. And there's just not a lot of trust right now when it comes to overall policy or geopolitics.

I mean, we have this situation in the UK as an example.

We have, really, a clouded political outlook in the US when you look at what could happen in the November 2020 elections. We have a situation where trade policy is muddled. And whether or not we get some sort of interim tentative deal to save the president's election prospects, the reality is that China and the US are locked into a prolonged economic war. That creates its own level of uncertainty.

And we've just got layered on top of that the geopolitical risks of the security of what we thought was invincible, which is the Saudi's oil infrastructure. And nobody should have an illusion that Tehran, who apparently has its thumbprints all over this attack, that something like this won't happen again.

And gold and oil tend to have a positive correlation as well.

You know they say that – or Mark Twain said – there's lies, damned lies, and statistics. I think that he was referring to economists when he said that.

But charts don't lie. And the chart of gold is incredibly bullish. The chart of gold – I mean, I look at the chart of gold, you could be looking at the chart of the S&P 500 in the early 1980s.

Gold has just put in a six-year basing period where it retested and retested and retested, all successfully – a six-year basing period. It's a long enough sample size. And now it has broken out. And not just broken out on the charts, broken out in every single currency, not just in US dollars.

And when gold breaks out in every currency term, that's telling you that this is a bona fide, legitimate, and I would say secular bull market in bullion that's going to go to new record highs in the next couple of years that will surprise a lot of people.

Erik: Now, some people are saying that the real bargain here is silver, because silver has lagged. First of all, even before this breakout occurred, we had a near-record level on the gold/silver ratio. So silver was already pretty cheap relative to gold. And then, as gold has broken out, silver on a percentage basis has not followed as much.

Is silver the bargain here? Or is there a reason to favor gold over silver still?

David: Well I do believe in mean reversion trades. So I would, follow in that gold/silver ratio where gold certainly had room to rally.

The reason why I'm more bullish on gold and less so on silver on a relative basis is because silver has many more industrial applications and it's much more cyclical. So if we're going into a global economic slowdown or downturn – and here we are today with the OECD cutting its global growth forecast again to below 3%, the lowest it's been since the Great Recession in fact – then the more cyclical the commodity the less I want to be long.

And silver relative to gold has more economic-sensitive characteristics. So I would say that, for the time being, big picture, I still like gold relative to silver – notwithstanding the catchup silver had to make looking at that mean reversion trade you were just talking about.

Erik: And the other thing you mentioned just a minute ago was the attacks on the Saudi oil facility where it seems like Iran's probably going to be accountable for this.

What could this mean in terms of Russia and China are really, really big important players in the global economy and it seems like they maybe are going to come to the aid or act as allies to Iran?

Would this potentially derail the whole China/US trade negotiations? And what could the potential consequences be?

David: That's really difficult to say. I mean, there's a lot of different cards, especially that China could play. Not just geopolitically but also through the currency, through business practices. You've already seen a dramatic pullback in Chinese tourists into the US. Just ask anybody who works at Tiffany's about that.

But getting into the weeds of geopolitical responses based on this and alliances between Russian and China, that's really very hard to handicap.

What you could really say is that, when it comes to Russia, certainly if we're in a period where there is a geopolitical risk premium, an exogenous risk premium in the oil price that causes it to be elevated, and you like to dip your toes in emerging markets, Russia is probably going to be a very good place to focus on in that respect.

Erik: And finally, we have a lot of Canadian listeners. As a Canadian yourself, I know you follow the Canadian economy more than most economists do. Give us the Canadian outlook.

What do you expect for Canada that's at all different from what you've described for the United States and the rest of the world?

David: Well, I'm pretty concerned about Canada, to tell you the truth. I know that the reputation is that we're one of the better-growing economies in the industrialized world.

A lot of that is an illusion just based on the fact that we had a couple of years ago a big downdraft in economic activity because of what was happening in Alberta and the oil patch. So a lot of the improvement you've seen in Canada has just been a statistical, almost arithmetic knee-jerk bounce just based on the fact that the oil patch isn't imploding anymore.

More to the point, the Canadian GDP is running about 1-1/2% year-over-year. And 100% of that growth has come from population. That's mostly because Canada is running the most ambitious and aggressive immigration policy of any country in the OECD and certainly in Canada's history.

So when you look at Canadian GDP on a real per capita basis, it's been slack in the past year. The reason why the Canadian dollar has been weakening – even with the Fed cutting interest rates and the Bank of Canada on hold, even with the pickup geopolitically in the oil price, the Canadian dollar now is struggling at around a 1.33 mark, which is the 200 day moving average – is because there's been no productivity growth in Canada in the past 12 months.

And we have a chronic current account deficit. And these are just structural undermining factors for the Canadian currency.

We have an election coming up in a few weeks. Both the Liberals and the Conservatives are opting for deficit-financed fiscal stimulus. I'm not so sure that that's really the answer to whatever ails Canada.

And maybe there is no direct response. But the reality is that Canada, ultimately – like is the case in Australia, New Zealand, Korea, Taiwan, Singapore – Canada is really a torque on global GDP growth, given that it's a small open economy.

And, insofar as the OECD just again took another stab and knife at its global growth forecast, which was squarely to the downside, the higher the risks are to the Canadian economy over the course of the next year.

Erik: Dave I can't thank you enough for a fantastic interview. I want to come back to "Breakfast with Dave." Now, it's hard to believe that anyone listening isn't already familiar with this because it's probably the best-known paid subscription newsletter that's daily (as opposed to weekly or monthly) in the marketplace. But for anyone who's not familiar, please give them the executive summary.

What is "Breakfast with Dave" all about? What is its history? What would people expect to find there?

David: I've been writing this daily newsletter since 1998. I started it at the Bank of Montreal, I took it to Merrill [Lynch] Canada, then to New York when I was chief economist to the mothership. And then I brought it to Gluskin Sheff 10 years ago. So I've been doing this really for over two decades.

It is a daily distillation of my macro and market views and basically an ongoing attempt to take the economic data points, connect the dots, and attach a market call to them. If you're going to be an economist in the markets, your responsibility for investors is to help them make investment decisions. And that's what I do in this piece every single day.

Erik: Now, the "Breakfast with Dave" newsletter, there is a free version of it. But it's really just bullet points giving you an overview of what you missed. To get the whole thing, the good stuff if you will, it's kind of hard to get a free trial of more than a week or so.

But, because Patrick has a fantastic relationship with Marcel Aulls there at Gluskin Sheff, just for MacroVoices listeners you can get a complimentary one-month trial. They don't give that to anybody else, as far as I know.

In order to do that, though – it's not set up on their website because they don't do that for anybody else – you've got to write Marcel Aulls – mauls@gluskinsheff.com. That email address is also in your slide deck, which you can find the download link for in your Research Roundup email. It's on Page 36.

David, I can't think you enough. We look forward to getting you back on the program for another interview in few months.

Meanwhile, Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.