



MACRO Voices

with hedge fund manager Erik Townsend

David Rosenberg: Stagflation is coming but not yet April 23rd 2020

Erik: Joining me now is [David Rosenberg](#), founder and president of [Rosenberg Research](#).

Now, most of you know Dave as the famous author of the “Breakfast with Dave” newsletter. He’s actually branched out and got some really exciting new products and services that he is starting to explore in his own new firm. So we’re going to talk about that at the end of the interview.

But, David, obviously we’ve got to start with, wow, these are amazing times that we’re in. I gotta tell you, I am just dumbfounded. It seems like maybe a little bit of common sense in the last couple of days has hit the stock market. But until then, it seemed like most people thought, okay, it’s all over now. We’re past peak infections. It’s time for new all-time highs in the stock market.

I think it’s crazy. But what do you see here? What’s the big picture? Is this really ending? Or is it only just beginning?

Dave: Well, look, I think that when you’re taking a look at the extreme daily moves that we’re seeing in the stock market, it is completely characteristic of a fundamental bear market, not the onset of a new bull market. I mean, we’ve had, just in the past 20 sessions, 18 of those the DOW moved in either direction by at least 200 points. It’s almost like we’ve become numb.

Today, if the DOW moves 400 points up or down, it’s completely ho-hum. But these are dramatic daily swings. It’s showing a market that is completely confused and I think caught in this tug of war between – I wouldn’t say a V-shaped recovery – really caught between knowing that we have a very deep and sharp recession on our hands but also the Fed coming in and doing what no other Fed has done before.

I mean, Jay Powell has made a mockery out of Ben Bernanke. That’s for sure. And taken on this role, not just as a liquidity backstop, but going into corporate credit, municipal bonds, and now into high-yield ETFs. And so the Fed is basically telling investors we are going to put a pervasive floor under the situation.

Now, I’m not saying that the Fed can stop a bear market in its tracks, but what the Fed can do is send a message that it is going to eliminate tail risk. And I think that is what caused this big what I’d say countertrend rally off the lows was a big part of that was the Fed.

And the shock and awe of that is over. And now we're heading back into a period where investors are realizing the deep recession is staring us in the face and the very little likelihood that we get very much of a recovery.

So it's really that tug of war: deep recession, unknown extent of recovery. And on the other side of that is this ongoing incredible support that the Fed is trying to provide the financial risk assets.

Erik: You know, it's amazing, David. The very first thing, the first public statement that I remember Jay Powell making after he took office, was to very authoritatively exclaim, look folks, the Fed is not in the business of bailing out asset markets. So get that through your heads. Well, I guess he didn't mean it or something.

I think you've perfectly summarized what's going on. And the big question it leaves me with is, okay, if we were talking about the old normal reality, we've been through recessions before. Financial history teaches us a lot about what to expect. You would expect the stock market to have only just begun a bear market and much lower numbers, new lows still to come.

But, wait a minute. As you just said, the Fed seems to be in the business of doing what they said they were not going to do, which is bailing out asset markets. They've already done what I think was both immoral and illegal in bailing out the junk bond market through the ETF.

Who's to say that stocks are not next? And I do think that's illegal. It was illegal to bail out HYG. They did that.

So what do you make of this? Do we apply the logic that eventually the fundamentals win out? Or is this more of a case of, hey, you wouldn't want to short the stock market no matter how bad you think the recession is going to be, because the Fed's probably going to put a floor under it?

Dave: Well, I guess that – anyway I'm not going to jump at Jay Powell's defense. I think that this was something that started more than 30 years ago, which is the extent of the powerful relationship now between the financial economy and the real economy. Or at least that's the perception at the Fed, whose models continue to believe in the wealth effect on spending. But that's essentially where they've taken their cue.

I'm not going to sit here and say that the Fed can stop a bear market in its tracks. And I don't think they'll be successful doing that. I think that what they're trying to do here is provide some semblance of confidence that tail risks are not going to be tolerated.

But can the Fed come in and buy equities? Well, they probably can. And they might, depending on how bad this gets. I mean, after all, high yield and the capital structure resides right next to the equity market. Who ever thought that they would actually move from their conditional role as a liquidity backstop towards being the savior of insolvency?

But I think what it comes down to – and this is why I'll cut him some slack – is that this was a manmade – to some extent – look, there's no doubt that we went into this – people say that there were no imbalances in the economy. Well, we went into this with balance sheets completely dilapidated, especially in the corporate sector.

But there are wide swathes, even in the household sector, of debt excesses that should have been controlled. There was talk about this after the fact. But I think that there is this collective guilt.

I mean, look at what's happening in Congress right now. For the first time, the Republicans and Democrats are fighting over how much more to add to any specific package like the PPP. You've got the president on board. You've got the Democrats and Republicans all fighting over how much bigger can we make this next fiscal assistance package.

Now, I say "assistance" because this isn't like FDR where we're going to have the New Deal to try and put idle people back to work.

What's happened here is that people have been told to stay home and not go to work. So I think there's a palpable sense of guilt at the government level – and that includes the Fed – that we've made this decision here to tell people you can't work anymore. You've got to stay home.

The risk is that they may be going way overboard here, whether it's on fiscal policy or certainly whether it's on Fed policy. But I think that there is just this collective guilt that we actually told people – this is actually – it wasn't even the virus. You can't even say that the virus, the coronavirus caused this recession.

It was the government's reaction that caused the recession. They could have done a whole bunch of things. But we went into basically national lockdown mode and everything that is considered non-essential, which is 70% of the economy, just basically shut down.

So I guess it's with that mindset that the public official, which Jay Powell is – the Fed is a construct of the Congress – and so that's why they're going into a realm that they've never done before, specifically because of the nature of this pernicious economic and financial downturn that was really caused by government decisions to begin with.

Erik: Let's talk more about the extent of the government response. Because something I've said before, and it sounds like we're in agreement on, is the coronavirus is a really big deal. But I think that the bigger risk is the government reaction to it.

And when you start spending \$2 trillion a week in fiscal stimulus, literally for a few weeks there was an unlimited amount of monetary stimulus, it seems to me like maybe this is the long-awaited catalyst that finally forces a secular shift to a secular inflationary rather than deflationary backdrop.

Am I on the right track there? And, if so, is that something that plays out in the next six months or the next six years? Or how does it work?

Dave: Well, let's first address what you said initially, which is about the gargantuan fiscal stimulus, which is – it is truly unprecedented.

But we're in a situation now where you've got some of these Wall Street economic houses calling for 40% down in second-quarter GDP at an annual rate, and without much of a recovery. Which we're not going to get. We'll get some, we could be on the precipice here of GDP being down close to 10% for the entire year. Which is almost what you had back in 1930-31.

And so, when you're talking about so far the stimulus, which seems incredible, I mean it's been well over \$2 trillion just on the fiscal side, which is about 10% of GDP, basically covers the hole that the recession has created.

So that's all the government has tried to do here is just fill a leaky boat. That's why it's not really traditional stimulus. It's just basically to keep households and businesses intact. They may have a lot more to do.

And then you've got to weigh in the fact that a lot of companies are going to be focused on two precious words called "working capital." And households will be building on their savings rates.

So a lot of this money coming into the system, into the private sector, a lot of that is not going to get spent in GDP, because their chunk is going to get saved. So it's not even clear, or the assistance that the government is providing is going to be enough to fill the economic hole. So we have to keep that in some perspective.

In terms of the very near term, there is no doubt that this is initially – and I mean for the next one or two years – this is going to be a deflationary shock of intense proportions. And it will be a deflationary shock that will linger on for the next (I'd say) one, two, or three years.

We're going to be left, most likely, with double-digit unemployment for an extended period of time. There will be tremendous excess capacity in the business sector. And so deflation, if you have a one- to three-year view, is what we're going to be left with.

If you're going beyond three years, I completely agree with you. I think there is going to be a time – we have to basically not extrapolate what's happening now beyond say three, four, five years into the future. I think that would be a mistake.

And I think you're quite right that what's going to happen here is that, at some point, demand will stabilize. We're not going to normalize. Nothing is going back to normal.

Unless maybe we get a vaccine. And maybe in the next few years that's going to happen. Or

we'll have the herd immunity and we'll just all burn through it.

But at some point what's going to happen is that the supply side is going to overtake the demand side. Demand will stabilize. But the supply side is what's going to get crunched really hard here.

We're talking about the implications that this is going to have on capital investment, the implications this is going to have on productivity and labor productivity.

When you consider the future, we'll be wearing masks, there will still be some form of social distancing at work, taking people's temperature as they go into the office or into the workplace. This is all detrimental to productivity.

That alone is inflationary, from a supply side standpoint.

And then you layer on what everything is going to mean in the future from a globalization standpoint, that supply chains will become more localized. The concept of just-in-time inventories, which was a great cost killer, is going to have to be reevaluated.

And I can see a future now where some of these trends were already starting with these trade conflicts in the past 18 months. But we're going to see a world that's going to be completely different. The trend towards populism, nationalism, isolationism, and protectionism, and (dare I say) socialism, is going to most likely – if you actually read the history books – is going to be on an accelerating trend.

That means that the world is going to be shrinking in a lot of respects from a supply-side standpoint. And that is going to be cost push inflationary at a time when demand is no longer imploding.

When I look at where the aggregate supply aggregate demand curves are going to be looking like beyond, say, three years, you're 100% right. We will come out of this – I would say – actually, I wouldn't call it inflation, I'm going to call it a return to stagflation.

And I think if you have more than a three-year horizon, that has to be on your mind right now.

Erik: Let's talk a little bit more about how this plays out. Because I agree with you. What we've got a setup for now with the coronavirus and the impact it has on the economy right now, it's all very deflationary.

But the cat's out of the bag.

We know that the central banks, not just the Fed but around the world, are going to just go crazy conjuring more money out of thin air. And I predict if you look back at this podcast five years from now, people would laugh and say, listen to these guys. They're acting like single-digit

trillions is a big deal in a policy announcement. It will probably be bigger than that by then.

But the thing is, at some point it has to be – I guess it depends on your definitions – if you don't want to call it inflationary, let's say it has to debase the value of fiat currency.

So is gold the big winner? I mean, how do we navigate this period if we know something different is coming but it starts with deflation but it doesn't stay deflation forever? What is the investment strategy that gets you through this storm?

Dave: Well, I think that you'd want to own the areas of the market that are classic inflation hedges.

Again, we're going past the next one, two, three years of deflationary pressure, so I think gold would fit in very well. Precious metals in general. Commodities. I would say real estate, especially farmland. Especially when you consider coming out of this situation realizing the impact this has had on the food supply chain.

So farmland, real estate, commodities, precious metals, TIPS. I think that consumer staples will be a good place to be, probably health care. You can actually concoct a portfolio that will be a great hedge against that inflationary future. The one thing that will happen is that the last thing you'll want to be in is going to be cash, because that will erode in real terms.

But I would tend to agree with you that gold would be – notwithstanding the fact that gold has maybe not performed as well as us bulls on bullion would have liked to have seen, the reality big picture is that it's still up 11% year-to-date. So it's still been one of the better performing, obviously, asset classes so far in 2020. But I do think that gold and precious metals in general will be good places to be in this environment.

Erik: So it sounds like you're not concerned. Obviously the next two or three years you think is going to be a big deflationary shock. In normal times, when they're not printing trillions of dollars a week, I would say that's a good time to get out of gold.

I think we probably agree that it's a good time to stay in gold right now. Maybe we'll get a selloff. But most likely the money printing will outweigh whatever downward deflationary pressure exists.

Are we on the same page?

Dave: Well, look, I still think that gold is an effective hedge, even in a deflationary environment. Because when you're in a deflationary environment, with private sector debts as high as they are, it creates a destabilizing cycle of defaults and delinquencies.

Now, 100% true that the Fed has provided a backstop for these fallen angels post- March 22. But I've got news for you: The Fed is not going to be bailing everybody out. We are going to be

seeing delinquencies and defaults, and there will be recurring rounds of instability.

So gold is not just an inflation hedge. That's what everybody thinks, and they're right. But gold is also a hedge against recurring rounds of instability.

So I would still say that there's going to be different facets of gold, different characteristics. So you still want to have a good chunk of it in your portfolio. Of course a good chunk is very personal. It's all contingent on what your comfort level is historically. Some people would be happy with 20% gold, some people happy with 5% gold. It's always benchmarked against what's your comfort zone and how much of it have you owned historically.

But we talked about a lot of other things ahead of going into the stagflation, which is the growing global instability we're going to be seeing coming out of this.

So I would say that, outside of inflation, you value gold at one divided by T, where T is trust, or perhaps the inverse of uncertainty. And the future is very uncertain.

And what makes gold so alluring is not just because it is this shiny malleable metal that goes back thousands of years, it's that it's about the only thing whose production function is stable at about 1% per year. That's the one thing that you can take to the bank, is the gold production function.

Now, maybe we can't predict what the demand of India or China or what the Russian central bank is going to be doing. Maybe you've got these central banks like Russia being massively negatively impacted on its balance of payments because of what's happening with oil, so they sell gold to cover their debt service payments. To me, that's all just very temporary and is a buying opportunity.

But gold at its head has a stable production function. And in a world where the production of money, where the production of almost everything has so many question marks in front of it that you want to own gold just for the stability aspect of it.

Erik: Let's talk about bond yields next. If we're expecting deflation for the next two or three years, the normal argument would be, okay, duration risk still makes lots of sense. Let's expect lower Treasury yields.

But as we get to the zero-bound on the US 10-year, is that just another number on the way to negative yields? Or is there really a zero lower limit there that we have to rethink the strategy on bond yields?

Dave: Well, nothing arithmetically says that the 10-year Treasury yields can't go negative, anymore than you would say, theoretically or practically that we couldn't have negative 10-year yields in Japan or wide swabs of Europe.

And so nothing stops, really, if we go into a deflationary experience, if we go into an experience where the term premium starts to price in a Fed policy that shifts to negative interest rates. Remember that the Fed no longer just talks about – they don't talk about the zero bound anymore. They talk about the lower band.

You've had other central banks, by the way, talking more openly about negative interest rates. And I'm not saying that's what the Fed is going to do. But all that has to happen is that the bond market starts to price that in.

And in the context of a deflationary environment and a huge savings glut in the private sector that they can't rule out the 10-year note going below zero. There is nothing magical about it. It all depends on the constituents of what makes up a nominal yield, the real rate inflation expectations and the term premiums.

So can you go negative? Yes you can. Are there other opportunities there right now in the fixed marketplace to focus on where you probably have to take on a little more risk but to get some yield.

I say this in the context of that you still want to have Treasuries in your portfolio, much like you want to have gold in your portfolio. At least you will get some sort of positive yield right now, if not much.

But I would say the municipal bond markets, we're not going to get through this situation, we are not going to get through a recession if state and local governments are not made whole. They are a huge chunk of GDP – outside of the consumer, the biggest chunk.

The Fed's already told you we're going to backstop this group. I'd hazard to say that the federal government would come to the aid of any state and local that was on the precipice of financial difficulty. So I'd say that the muni market looks relatively attractive to me.

I'd say, within the corporate credit market, would I be buying high yields? No. Would I be buying triple-C distressed credit? No.

But there are parts of the investment-grade universe, whether it's (I'd say) single-A high credit or (I would say) triple-B high credit, that you can formulate a strategy in the corporate market, pick up some yield in areas where you have some confidence where default risk is low. Even in a recessionary environment.

And so I'd say that there are some pockets outside of Treasuries in the fixed-income space that are worth looking at right now.

Erik: What does all of this mean for emerging markets? Obviously, some of them are going to get hit harder because they don't have the medical resources that developed nations have. What's the fallout after or during the rest of the coronavirus crisis going to mean for emerging

market equities?

Dave: Well, you know there are so many correlations here that you have to run. And understanding that the emerging market space is like talking about health care, or you're talking about hospital services, biotech, pharma.

And the emerging market space is also very heterogeneous. So you certainly don't want to be long any emerging market country right now that, for example, is a big oil exporter. I don't think you'd be really fawning over Indonesia right now.

So I think that that's got a bulk large energy exposure. I think that countries that ended up not spending as much blowing their brains out on solving the coronavirus deserve a look. There are countries that actually got ahead of this very quickly that ultimately won't have to spend as much fiscal and future taxpayer resources to fund the largess.

So you could be looking at places like Taiwan or Korea or Singapore, notwithstanding the fact that Singapore has had another wave. The amount of money that a lot of these countries are spending to deal with the situation is far less a share of GDP than in the United States.

So I'd say that there are some parts of emerging Asia that are attractive, both their equity market and their fixed income market. I just named a few.

Latin America is a little more dicey, just because of the exposure either to oil or to commodities, which will be part of this near-term deflationary environment that we're in. So I can't say that I'm overly bullish on Latin America. Maybe there's parts of Asia that look interesting.

The big wild card is going to be what happens to global supply chains that benefited not just China but also a good chunk of emerging Asia. That's really the unknown, the extent to which global supply chains that generated manufacturing capacity in a lot of these emerging markets end up coming back into the confines of the US economy. That's, again, a really big unknown.

So the emerging markets right now, I'd say more like the capital markets in general, you've got to be extremely selective.

Erik: A lot of people have speculated that once the crisis is over there's going to be newfound hostility and tension between the US and China. A lot of Americans feel like China withheld critical information that could have allowed other countries to get through the crisis much more easily. Now, regardless of whether or not that's actually true, the perception exists and potentially leads to more tension between these two superpowers.

What are the implications of that economically if there is a breakdown between the US and China from a trade relations standpoint?

Dave: Well, look, I think that in the US this distrust of China is one of the few things the Republicans and the Democrats can agree on. Outside of how much money can we spend to put a floor under the economy, China is certainly something that they both agree on.

And it's not just the US. It's really the world. The world is going to view China with an even more skeptical lens – and I'm being charitable when I say that – than they did previously.

So it's going to make any future trade deals with China that much more difficult. And it's going to, I think, impart what I said earlier, generally speaking, which is a world economy that is going to grow further apart than grow further together. When you consider that it's – when you think of the world economy today, it's really the US and it's China.

So what I think happens here is that we have relations that were already frayed that will become more separated over time. And that will have other implications as well. It will force China maybe into other alliances. But their problem is going to be that other countries are going to view China much the same as the US does.

So then the question becomes, after China joining WTO almost two decades ago and there's a lot of people around that are in the financial business that have only known what the world is like in the bi-powerful world when you have China and you have the United States.

And now we have a situation in the past 20 years, where China grew more into the global economic sphere and now it's going to end up potentially becoming less a part of that global economic sphere.

So you can almost view this as a start – and maybe it was starting with these trade frictions anyway – maybe this just reinforces something that was just starting post-Trump presidency, which is an economic cold war. And not just between China and the United States but now between China and the rest of the world.

By the way, one of the reasons why gold will fit in well – or gold stocks, physical gold, because of the hedge against – but will also be a potential of global political instability coming out of this in the future.

Erik: I want to shift gears now and give our listeners the inside story on the launch of Rosenberg Research. Most of our listeners know you, David, as the “Breakfast with Dave” guy. And certainly, for anyone who is not familiar, “Breakfast with Dave” is probably the most well respected daily newsletter that has existed in the industry for decades now.

You've been through, I think, three or four different jobs. It seems like any firm that can get you on their team, if they can be the host of “Breakfast with Dave,” it's always worth it to them because your letter is just so highly respected.

It seems like you had a pretty cushy job, first with the position of being chief economist at

Merrill and then moving on to Gluskin Sheff in the private wealth management area.

You just went and took on a whole bunch of extra work, launching Rosenberg Research. What's going on? What led to this? What's driving you to launch your own firm and go to the next level with your work?

Dave: Well, the benefit of the previous 10 years at my former employer was that I was able to market my research to outside clients. And I had over 2,000 clients in 40 different countries around the world, split evenly pretty well between individual investors and institutions. And I just decided in the past year that maybe it was time just to hang out my own shingle, not have to be part of pitching product in a either buy-side shop or sell-side shop, really just concentrate on unbiased research.

That will produce short ideas and long ideas and not just always having to have a bullish bias. Which I found, actually, being on the buy side for so long, I managed to see all the research coming from all my competitors on Wall Street and Bay Street.

I'm not going to say that anybody is necessarily biased, but the reality is that when you work for an employer, when you work for another shop, especially a shop that is in the business of selling financial products, there is some pressure to toe the party line.

And so I decided – and this is something that I always resisted, by the way – but I just want to spend 100% of my time not pitching product, and I want to spend 100% of my time building a team, which I've done, and formulating research that's going to be helpful to clients in the financial services industry and investors to connect the dots between the economy and the markets and come up with a coherent and cogent financial plan.

So that's what I want to spend all my time doing. And so that's why I endeavored on this, was so that I can call the shots. I can direct the traffic. But I also can spend 100% of my time 24/7, with my team, producing the research that I think is most important.

Erik: Now, back in the day, the research in question was really the "Breakfast with Dave" newsletter. But it's grown to more than that now.

So what are you offering through Rosenberg Research beyond the "Breakfast with Dave" newsletter?

Dave: Well, the "Breakfast with Dave" newsletter is what people on the outside always saw. There was a tremendous amount of other work that I would be doing – spending time with salespeople, with traders, and with portfolio managers internally. So the company I worked for over the years were invariably my primary client. And that makes perfect sense.

And now my primary clients are my subscribers.

So I can provide just a much larger set of products and services now. It's not just "Breakfast with Dave". "Breakfast with Dave" was what always the outside world saw. They didn't see what I was doing day to day inside the walls of the company I was working for. It was a lot more than that.

And what I do outside of "Breakfast with Dave" is one of the services that my clients can get. It involves conversations over the phone. It involves podcasts. It involves doing special reports. We've done probably four special reports already on the coronavirus and the implications near term, medium term, long term on how to invest.

So special projects, the "Breakfast with Dave," when something in the middle of the day – it could be any time, it could be the Fed does something, it could be that the Treasury did something – I write about it and I send it off to my clients right away. I didn't do that before. I would do that internally, but I didn't do it externally. Now I do that externally.

And, of course, I mentioned podcasts. But a lot of what I do, like I'm doing with you right now, is verbal interaction. And I didn't do a lot of that back in my previous incarnations. But I do that now.

So if you go on the website rosenbergresearch.com, you'll see all the different products and services that are being offered. But it transcends just "Breakfast with Dave." "Breakfast with Dave" is still what I would call the Big Mac, but there's a lot of other side issues that I'm offering right now alongside that.

Erik: David, let's stay focused on the Big Mac, or "Breakfast with Dave," just for one more minute. Because with your previous employer, it was possible for people to get a one-week trial with that.

We were able to negotiate for MacroVoices listeners to get a full month free trial to "Breakfast with Dave." How about extending that offer again and giving our MacroVoices listeners a chance to get a one-month trial?

Dave: Absolutely. One-month trial. And, by the way, not just for "Breakfast with Dave." You can have a one-month trial for everything that I do in a given month.

And so that – I do an early morning with Dave, which is the first thoughts in my head when I get up in the morning. It's a few pages of just my random thoughts. And then "Breakfast with Dave" comes out shortly thereafter.

But you'll also, if you come on, you'll get my podcast. You'll get special reports – could be in a specific country. You mentioned emerging markets. We did a whole report on emerging markets a few weeks ago. This is the sort of stuff I was not doing previously.

So you can actually come on, get a one-month trial of the whole smorgasbord. And I would love

to get as many people signed up as possible, because the operative goal here, from my lens, is to have influence and be impactful and helpful for people that have to actually put money to work in the markets.

I'm actually here to help guide you and limit the prospect of making a mistake. But also doing what I've done over the course of my 35-year career, which is always looking around the bend. It's all about mitigating your risk.

So that's the mindset that I have and I would love to have as many people as possible come on the website and for a full month look at the whole product of services that are being offered.

Erik: Listeners, you can sign up for that free one-month trial, which I highly recommend, at rosenbergresearch.com. I also strongly recommend following David on Twitter. That's [@EconguyRosie](https://twitter.com/EconguyRosie) on Twitter.

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