David Rosenberg: Too much debt spells lower future growth and inflation

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Erik: Joining me now is David Rosenberg, founder and president of Rosenberg Research.

David, it seems like pretty clearly there's a light at the end of the pandemic tunnel. At some point in 2021, we're probably going to have widespread use of a vaccine that hopefully will bring this thing to an end.

So I want to talk about, first, between now and the end of the tunnel it seems like a lot of stuff is getting worse on the pandemic front, at least in the immediate term. Cases and deaths and hospitalizations are up right now. On the other hand, the vaccine is coming.

So how do we reconcile those things? Do we think the market's already looking past what's going to happen in the next six months toward the light at the end of the tunnel?

David: Well, I think that the market is looking maybe past the next three months. If you believe the experts, they are going to start to rule out these vaccines any time now and that every American will hopefully – if these positive results from the drug makers have any validity to them, we could be talking about the second half of next year everybody who wants to be inoculated will become inoculated.

And so that's why the markets have looked through the raging pandemic and now we're back to new highs, practically, in hospitalizations. Deaths are going up, although they're lower than they were during the spring. But still problematic. The sorts of numbers from a health crisis standpoint that would have caused the markets to go into a tizzy just six-seven months ago when you consider these new restrictions and curbs that are spreading out across the country.

But you're quite right, the markets are looking at that flicker of light because six-seven months ago nobody was entertaining the thought that we'd get a vaccine, or get vaccines plural, as early as we're going to. It really is a modern-day medical miracle.

I think the markets are pricing that in. I think they're pricing in that once we get a certain critical mass there is going to be a huge unleashing of pent-up demand.

And parts of the economy that we haven't been partaking in, either willingly or out of force – so whether that means hotels, motels, theme parks, entertainment, travel, tourism, restaurants, bars – so all that will see in maybe the second or third quarter, third or fourth quarter of next year, we're going to get a couple of quarters of boom-like economic conditions.

And that's what the market is focused on right now.

The question I've been asking is what does life look like past the tunnel. Because the tunnel has shortened. There is no doubt that there is a flicker of light at the end of that tunnel. That's what's been driving the markets, in the past several weeks in particular, but at some point along that tunnel.

And, as I said, it is a shorter tunnel now.

What is life going to look like beyond that tunnel? Because at some point the markets are going to have to confront that reality. And that reality is going to look quite a bit different than a couple of quarters of unleashed pent-up demand because of six months of exceptional growth.

Equities look ahead. They are by definition a long-duration asset. At some point, we have to come to grips with what the world is going to look like, what the economy is going to look like past that unleashing of the pent-up demand. And I think it's going to be much like we had in the previous 10 years.

And people say to me, ugh, I can't wait to go back to the old normal. Remember that old normal was low growth, low inflation, and low interest rates for a variety of structural reasons that haven't gone away because of the pandemic and the fight against the pandemic. In fact, the structural impediments to growth have been accentuated through this period.

And so when we talk about the old normal as being low inflation, low growth, and low interest rates, I think that growth, interest rates, and inflation will be even lower once we get past the end of that tunnel. And then we'll have a different repricing in the financial markets against that backdrop.

Erik: That's very interesting. We've had several guests telling us, okay, look, they're going to do so much monetary accommodation because of this situation that it just has to lead to a situation of secular inflation.

Sounds like you're on the opposite side of that – a return to deflation, even more deflation.

David: Well, it's like déjà vu all over again. These are probably the same people that were telling you in 2010 to be braced for a decade of inflation because, of course, the Fed was embarking on quantitative easing and we had that initial boost in the fiscal deficit from the Obama fiscal package on infrastructure.

Of course we coupled that with the Trump tax cuts. We finished the last cycle with a trillion-dollar deficit at a time of full employment. And yet, what was inflation? Basically 2.

And so I think that we could have a future of inflation down the road. Who knows what this – you know, we have Janet Yellen, a former Fed chief take over at the Treasury. Last time we had that happen was William Miller in the late 1970s. Well, I guess when we connect some dots between something happening that's going to draw the Fed and the fiscal authorities that much closer together, we have to keep an open mind.

But we do have a massive gap between demand and supply. The pandemic was both a supply shock and a demand shock, but the hit to demand was a lot bigger.

And so I think it's going to take several years. And it would take years of exceptional growth in demand before aggregate supply and aggregate demand meet at a point that's going to generate sustainable inflation.

So I think that it's certainly a narrative. It was a narrative for most of the past cycle that we're going to get the big inflation. But it never materialized.

Now, I imagine if we end up monetizing the debt and the Fed loses control of the monetary base and velocity stops going down, you can build a case where inflation is going to come back sooner rather than later.

But the point I'm making is this: What were the fundamental forces at play that led to this what we call secular stagnation?

We did have a form of secular stagnation, despite what the stock market did, because we had the biggest debt for equity stock on corp balance sheets in history as companies issued debt to buy back their stock to the point where the share count of the S&P 500 last cycle went down to a 20-year low.

So you can provide the illusion of some marvelous earning cycle because the share count goes down.

But, you see, it was the weakest economic expansion on record. We had tremendous monetary accommodation. I mean, the Fed, even when the Fed was raising rates, what did it get to? 2-1/2% of the funds rate?

We haven't had such a low level of the funds rate at a peak since the 1930s. At the lowest point, the Fed could not even get its balance sheet below $4 trillion.

The Fed's balance sheet at the tightest point of Fed policy in the last cycle was five times bigger than the balance sheet had been historically. And the funds rate got to 2-1/2%. The Fed wanted to go to 3% in the fourth quarter of 2018 and it couldn't even do that. Then we had the Powell pivot.

What's all that telling you? What's it telling you, really, about the fundamentals of the economy? Leave the stock market aside. The stock market is not the economy.

What does it mean about the economy that the Fed – you had Jay Powell coming in in January of 2018 telling you we're going to normalize interest rates and they couldn't even get within 50 basis points of what Powell's own definition of normal was back then? (Of course, the Fed has adjusted that estimate ever since.)

It's telling you that we have too much debt. We have too much debt. We are choking on this debt.

Now, of course you can argue that all the debt greased the wheels for ending the recession very quickly in February and March and April. All of that is true. But now we are living with total debt to GDP – government, business, and household – that's almost 400%. We've never had this condition before.

And that's going to be a huge tourniquet on growth going forward. People say – well especially the MMT-ers – and the people advocating massive government say, well, just bring it on because we can finance this with such low interest rates.

It's like when homeowners tell me they take out a mortgage, they say, boy, why am I still paying the bank every month? Because I was told interest rates are zero.

Yeah, yeah, yeah, yeah, but you still have to pay off the principle. You still have to pay off the principle. And paying off the principle of a gigantic unprecedented peace-time economy. And that's going to take a chunk out of economic growth for a long period of time.

So you see these factors of massive indebtedness, a huge constraint in aggregate demand. That's gotten worse through the pandemic. This is what the markets might not see right now because they are focused on the light at the end of the tunnel.

We get out of the tunnel, how do we resolve these massive deficits and debts? How do you really forecast an era of accelerating growth?

There's people out there that are saying, oh, this is going to be like the Roaring Twenties. We came off the Spanish Flu of 1918 into 1919 – not only did we have a different demographic base, a much younger demographic base, but the government basically didn't do much to prevent the pandemic. It was a different society back then, a different culture.

But the reality is that ended up just developing herd immunity without the government doing anything. We didn't have massive government debts and deficits to deal with the situation in 1918 and 1919.

So that left the government the opportunity through the 1920s, with a strong government balance sheet, to do what? Cut taxes. We had massive tax reduction in the 1920s.

Now, I don't know how this is going to play out, because the US population just basically voted against tax increases up-ballot and down-ballot. There is no room to cut spending on the discretionary side.

We have tremendous demographic pressures on fiscal finances. So maybe the answer is going to be we'll just monetize our way out of the debts. And if that happens, I'll probably have to change my inflation call. But I'll actually wait for that to happen.

I mean, that would be called the big bazooka. Outright debt monetization. That would be huge. And maybe Janet Yellen being at the helm means it's going to happen sooner rather than later. But that's just being speculative right now.

What we know is that we come out of the pandemic with really three things that are problematic that were made for us. Massive debts. Aging demographics.

The pandemic didn't change aging demographics being a powerful deflationary force on the economy and a powerful force that weighs against aggregate demand growth because older people don't tend to spend as much as younger people do.

And then on top of that, the gaping income and wealth inequalities which got worse, got worse, still unresolved. And every academic and scholarly report has shown that extreme income inequality is actually a detriment to economic growth.

So I don't know. The structural factors that brought us low inflation, low growth, low rates, unexpectedly – I mean, we had a lot of very bright people who are experts on the fixed income market telling us that bond yields in the last cycle were supposed to get to 5-6%.

People were saying that after Donald Trump got elected that he was going to unleash the animal spirit and we were going to get tremendous reflationary tax policy. And that bond yields were going to go through the roof.

What was the roof? 3%? So, you see it's a complicated outlook.

But I would say that the fundamental secular forces that are almost Japanese-like in nature that led us to slow growth, low inflation, ultra-low interest rates are going to be at least at much in force (if not more so), barring some other shock.

And maybe the shock is going to the debt monetization shock.

I don't know what else is going to happen. The demographics, how can it turn around? We're not going to have a baby boom in time to turn aggregate demand around to create the forces of inflation.

And the debt burden, to me, is the biggest deflationary force globally. We've all turned into Japan.

So people that talk about the inflation and the reflation and all these other things, you should pan from the past three decades as your template as to how far that's going to go.

So, barring some unforeseen shock on the demand side, or if we all just turn into isolationists and populists and nationalists, and we all turn inward and globalization goes into permanent reversal, that would really be an inflationary impulse on the supply side.

Exactly where is the inflation going to come from that it didn't come from in the previous 10 years?

Erik: David, I appreciate your comment that the stock market is not the economy. And everything you're saying about the economy is very insightful. But, obviously, our listeners have an interest in the stock market.

Now, if we went to the old, old normal, the 20th-century old normal, the things that you're saying would naturally lead to a bearish outlook for stocks. But, needless to say, the last 10 years it seems like the rules are different.

So where do you see the stock market performing in the face of all of this?

David: Well, look, it's a – the stock market has done far better than I ever would have thought that it could do. And there is no doubt that we've had tremendous policy stimulus and we've had great, amazing vaccine news, light at the end of the tunnel.

But, you know, when you're looking at the Shiller, the smooth, what is called the CAPE, the cyclically adjusted price earnings multiple, which is really the best way to look at the market because it looks at the multiples over 10-year periods, and the stock market by definition is a long-duration asset class.

And the PE multiple on the CAPE is 32. You've actually broken above the pre-plunge peak of 30 points that happened in February.

So who is to say that the market can't go higher and higher here? But it's getting into nosebleed valuation territory.

Now, people say to me, meh, valuations don't matter, focus on momentum. That's fine. You know, there's momentum, there is the technicals, there's the fund flows off the charts. There's four bulls for every bear, when you are taking a look at the broad surveys.

The bears have been beaten into submission. Sentiment is off the charts.

But, really, what does a 32 PE multiple on a 10-year scrolled earnings backdrop tell you? It tells you that really you're expecting real return.

And the equity market for the future is basically close to zero. Those returns have been harvested, you know. We've had over a 6-point multiple expansion just as the market bottomed in March. That doesn't happen every single day, even off fundamental lows.

And so the market is too sensitive for my liking. But then, again, it is a stock market and it is a market of stocks and it is a market of ideas.

So I would say that, firstly, if you do believe in the vaccine trade and that things will, if they don't go back to normal go back to quasi-normal, there are a lot of items in the value proposition that would have some upside potential for the next few months.

You can point to the airlines, you can point to casinos, you can point to hotels, you could point to mall REITs, in fact residential REITs, aerospace defense.

There is a lot – there are many segments of the market that can still close the gap where even if they closed half the gap to where they were trading in February, could make it 10-20%.

Some of these sectors, like autos and even the restaurants, have already gone back to those levels. So there is still some opportunity in those value stocks. I should add the banks as well, as being areas that could have some catchup potential here.

But I would say that in the future what I would want to focus on is I'd want to focus on investing around – you know, the classic works of David Ricardo and Adam Smith – and focus your investments on what is scarce globally.

So I would basically be focusing on scarcity value. That means I want to focus on growth, I want to focus on growth stocks. But growth stocks that have utility-like characteristics but also are well priced.

And most of them are still too expensive, so I'll wait for the valuations to return to normal. But growth is scarce, therefore own growth at a reasonable price.

Yield is scarce. I mean, look, we're talking about a world where $17 trillion of bonds trade with a negative yield. We have a situation where the Greek 2-year bond yield is negative and the Green 5-year bond yield is three basis points away from being negative.

Think about that. Greece, a junk bond, is trading with a negative yield at the front end of its curve. It's incredible. That's the investing world that we're in. We're in a world where high yield trades at 4.9%.

How are you supposed to be doing any reasonable capital asset pricing model?

How are you supposed to be really calculating what your hurdle rate is on your business when you have central banks buying corporate credit and high-yield bonds to the point where you've driven such a big wedge between what is reality and what is true fundamental risk reward?

So we do know that that's probably not going to end. We have about 30% of the global bond market trades with a negative yield. Yield is scarce. So you want to own yield. So dividend yield, dividend growth.

I'm talking to you up here in Canada. Look at the Canadian banks. Look at telecom. Look at selected REITs – I wouldn't say office REITs, but I'd say that assets that spin off a reliable income stream should be part of your portfolio.

So we can talk all day long about the market. But there are still some opportunities beneath the veneer of the market and it comes down to idea generation. So I'm talking about investing around scarcity.

I would argue, by the way, what else is scarce is safety. So you have to ask yourself the question, you know, as we're t talking about the equity market – and I know that a lot of listeners are all about the equity market – but the question really comes down to hopefully nobody is 100% anything.

But what is safe? What is safe in your asset mix?

And, you know, I always get guffaws – when I mention in the necessity of having a substantial portion of the portfolio in long-duration, high-quality bonds, I get derisions of laughter.

But, you see, the US long bond yield is 1.65%. And that is a giant in a world where 30-year German bunds are negative 15 basis points, JTBs are plus 60 basis points, UK yields plus 90 basis points.

Most of the world, if it's not negative, you're measuring your yields in basis points. At least in the US you can still measure it with a percent. So you own bonds in the portfolio to manage your risk.

So I say to all the listeners, ignore those pundits who say to dump your bonds because yields are too low. That is one of the most ridiculous statements I hear on a daily basis. They're low because, as a price, the bond market is telling you that we are heading into a future of ultra-low expected returns.

And that's the basic point I'm trying to make here is that Treasuries are a ballast and a stabilizer in the portfolio at all times.

People come and say to me well isn't there inflation risk and duration risk in Treasuries? Of course there is. But what makes Treasuries unique in everybody's portfolio is their payment safety characteristics. They are the only assets where security and certainty of payment is assured and guaranteed.

And I know the question was about the stock market, but the stock market does not have certainty of payment. The Treasury STRIP is the benchmark risk-free asset for funding actuary liabilities. It is the only investment vehicle with no default risk, no call risk, and hence no reinvestment risk. It's the only thing you can buy today where you know exactly how much money you're going to have 30 years from now.

And then I'd say that the fourth and final item that is scarce is called inexpensive assets, where you can find them. And everything right now in the United States and in many parts of the world are just too expensive, and partly because central banks have all but destroyed the equity risk premium.

But there are faraway places – I would daresay like China, Southeast Asia, where assets are cheap – the T multiples are in the low teens. And a region that's emerged, I'd have to say, in much better and financial shape coming out of the pandemic.

And I would say that China is destined to capture an ever larger share of global GDP in coming quarters and coming years. I don't think that's going to be reversible.

So I would conclude that the last item here in terms of scarcity is looking for inexpensive assets. And you can get that in many parts of the emerging market landscape, especially in Southeast Asia.

Erik: Now, you just made an excellent argument for Treasuries from a safety of repayment standpoint. But as far as expecting duration risk to be a long trade that's going to pay because of a secular move toward lower rates, we're already pretty much at the lower bound.

Do you think US Treasuries go negative on a 10-year yield at some point? Or do you just mean that we're staying here at zero, we're not going the other way?

David: No, I don't think yields are going to go negative in the US even though they've gone negative in many other jurisdictions. Germany is still a world-class economy. I mean, their long bond is negative 15 basis points. But it's hard to wrap that around anybody's head.

I don't really think we're going to negative yields in the United States.

And of course you can have those negative rates in Europe because you are backstopped by a central bank that de facto has embarked on policies of negative rates at the short end of the curve. I don't think we're going there. I think the Fed has already told you we're not going into negative rates.

But my point is this: My point is that it's not like you're going to make a huge amount of money in Treasuries. I do think that the most attractive part of the curve, looking at how steep it is right now, was really the long bond.

And we don't have Fed risk. The Fed has already told you they're not raising rates for at least the next three years. It's probably going to be even longer than that.

And I don't think we have much in the way of big inflation risk. I think people really have misunderstood how difficult it is going to be to generate the inflation. And it's going to be even tougher in my opinion than it was 10 years ago when people, again, were talking about big inflation.

So the point I'm making, though, is that there are times – like, take a look at what's happened. We have a 1.65% yield on the long bond after about a 70% run-up in the stock market. I don't think the stock market is running up another 70% from here.

I mean, 1.65% on the long bond – as Billy Joel would say, that's what you get for your money after the biggest risk-on reflation trades of all time – and we're at 1.65% yield on the long bond.

What happens if, God forbid, if the stock market stops going up?

So the point I'm making – I said it was a ballast and a source of stability in the portfolio. It's not like you're going to make gobs of money anymore in the bond market. I mean, if yields were to go down below 1% in the long end, yeah, you'll pick up a lot of price appreciation.

But that's not what I'm talking about. I was talking about that one of the scarce resources globally is safety. And the Treasury market, there is nothing safer than that.

And so I would say that, at a minimum, in your portfolio if, God forbid, we ever get another crash in equities again – and I know most people think that can never possibly happen – your bonds will be your source of stability. Your total return in your portfolio will not go down with the stock market.

That's what I'm talking about. It's an insurance policy.

And, again, we have to take a look at what the Rates market is telling you about the future. And this is the signal. You have to take a look. Not just do I buy a bond at these levels? Why would I buy a bond at these levels?

The Rates market is telling every investor on this call that we are heading into a future of ultra-low expected returns across every asset class.

That's a sign. You have to take a look at what interest rates are telling you about as a price signal about the future of expected returns. And they are extremely low.

Which is why you're going to have to get your hands dirty, go beneath the veneer, either start to go into other markets globally that are cheap or go into some thematics or sectors in the stock market that still have some upside potential.

But as an asset class on its own, the 1.65% yield on the long bond is very similar to what the message is from a 32 CAPE multiple on the stock market. Future returns have been ground down to very low single digits.

That's the story.

Erik: Now, I can just feel the gold bugs screaming out in their sleep saying, wait a minute David, the whole argument in favor of Treasuries is either the yield that they pay or the expectations that you have, that duration risk is going to buy you price appreciation.

You're saying expect neither one of those.

If that's the case, why in the world would you want Treasuries over gold, which at least gives you a negative real yield hedge?

David: As I said before, you can buy gold. I am bullish on gold. But, as we have seen in the past couple of months, the Russians have been selling gold in the open market to replenish their foreign exchange reserves that were depleted by the earlier slide in oil prices.

If I own the long bond, I don't have to worry about what the Russians are going to do with regards to their gold export policy. I don't have to worry about what the dowry season in India is going to look like from a demand standpoint.

Don't get me wrong. I like gold for similar characteristics.

But the reality, as we've seen just in the past couple of months, is that gold prices can go down. No matter how bullish I might be on the gold price, I can't give you an iron-clad guarantee as to on what you're going to get back in 10, 20, or 30 years.

What I'm saying is that, in a world where safety and certainty of payment is not assured and guaranteed, the market that gives you that is the Treasury market.

I said before, what is it that you're going to pay for a security that is the only thing in the world that is triple A that you can buy today where you know exactly how much money you will have 30 years from now?

So in an uncertain world – and it's going to be an uncertain world – I know we have perceived certainty over vaccines. I would say it is certainty. It's a matter of timing. A lot of uncertainty over what the world is going to look like once we get past the flicker of light at the end of the tunnel.

And so I'm not going to say that you want to have 100% of your portfolio in Treasuries. I don't believe in zero and I don't believe in 100.

I've been in the business long enough to know that you don't put all your eggs in one basket and there actually is no such thing as a sure thing – except for this: that the Treasury STRIP is the only thing you can buy where you know exactly how much money you will have 30 years from now.

Erik: David, before we let you go, I want to make sure our listeners are aware you used to work for a private wealth management firm. For the entire year of 2020, you've been out on your own with Rosenberg Research, a new firm.

Where does that leave – the *Breakfast with Dave* newsletter is probably one of the most famous pieces of writing in the industry. Do you also have other products? And what business are you in at Rosenberg Research? Tell us a little bit more about it.

David: Going out on my own has given me the opportunity to provide a whole array of products and services. *Breakfast with Dave* is still the flagship.

But I do another very quick daily before *Breakfast with Dave*. We do a gamut of stuff for reports. We've done one on the US political situation. We've done one on practically every asset class: the outlook for China, 10-year growth outlooks for the major countries around the world, the inflation/deflation debate, demographics.

And I have a crack team behind me too. This is the best economics and strategy team. After being here 35 years in the business I have a crack team and we're putting out unique innovated and thought-provoking research that ultimately always ends with an investment conclusion as to either how to make money or save money by how we see the world unfolding.

So you're right, *Breakfast with Dave* is a flagship. But we're producing a whole array of different publications and webinars. So whether it's verbal or whether it's written, you can have as much access to us as you possibly want.

I invite everybody to go on the Rosenberg Research website. Just Google Rosenberg Research. And we have a one-month free trial so you can kick our tires and check it out.

I started in this business in the mid-1980s and I feel like a kid in a candy store. It's actually the most gratifying thing that I've ever done in my professional career, starting this business back in January.

Erik: Well, David, we look forward to getting you back on MacroVoices for another update in a few months. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.