# David Rosenberg: Last Disinflationist Standing

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***Erik:*** Joining me now is David Rosenberg, founder of Rosenberg Research. Rosie, it's great to have you back on the show. Last time we spoke, it wasn't in vogue yet to be talking about inflation, only a few people were. You told us inflation was coming but don't be fooled. It's going to be transitory. Let's get an update. Is that still your view? And what is your outlook? Are you concerned at all about secular inflation?

***David:*** Well, the last part is easy to answer. So absolutely not at all concerned about secular inflation. And very interesting, I was asked those questions after Barack Obama got elected, and I got asked it again after Donald Trump got elected. And there are no new eras, one about Farrells Fabled 10 marker rules to remember. No new eras, there is no new inflation era despite what you hear. And I would just say that the fundamental forces in place for the past three decades that have ensured that inflation remained on a fundamental downtrend line were the three Ds. Demographics, Debt, and Disruptive technology. And it doesn't mean that we don't have gyrations around that trendline, we had a gigantic gyration around that trendline, you know, in the 2000s, when I was at Mother Merrill and oil prices if you remember went to $150 a barrel and inflation got to the same levels that they're at today and everybody believed back then that we were in some permanently new commodity supercycle inflation era. And I asked the question, how well did that turn out?

So I would say that, you know, for the time being, certainly, inflation is going to remain sticky because of the supply chain issues. People talk about booming demand. That to me is in the rearview mirror, I don't think we have booming demand anymore. And a lot of the durable goods purchases by the American consumer has already been facilitated if there's going to be strengthened spending, it'll come more on the services side, which is still lower today than it was before the pandemic. So speaking of the pandemic, that's really where the inflation is coming from. And it's principally from supply side issues that the Fed or any other central bank has little control over. But I don't believe for a second that supply chains are broken indefinitely. And I do believe that we are going to have a situation where you're seeing it in the commodity markets already where the goods inflation morphs into goods deflation a year from now that's not in the market.

And I guess if transitory to you is, you know, a few days, weeks, months or even quarters, then certainly it's not transitory if you go to the Webster's definition of transitory there's no timeline attached to it. And Jay Powell is thrown in the towel on this, I haven't. Because transitory to me means something that isn't permanent, or something that's short term. And in the overall scheme of things from a, from an economic history standpoint, we will not be talking about this as a major secular inflationary period, any more than we remember what happened in the mid 2000s. When we had that massive commodity supercycle, nobody seems to remember that, but we were talking about inflation back then, too. So I'm feeding the consensus narrative on this. I think the economy is going to slow precipitously next year because of the fiscal withdrawal. I think that God willing, we'll get through the pandemic without any more variants along the way, but that could be wishful thinking. But the supply chains will come back. Globalization is not dead. And we will go back to where we were before, which was an inflation environment. That'll be roughly 2%. I don't see that deviating.

***Erik:*** Now, I'm curious when you refer to Jay Powell throwing in the towel, were you referring to his comments in the course of testimony before the Congress on Tuesday of this week, same day that we're speaking and how do you interpret that? Why do you think the Fed made that statement?

***David:*** Well, look, it's not the first time we've seen Jay Powell pivot. It's called the Powell pivot for a reason because he was talking extremely hawkishly and actually raising rates in the fourth quarter 2018. And then the stock market collapses 20%. Some stocks are down 30-40%. The credit markets froze. We didn't have a high yield bond issue for a couple of months, and the yield curve flattened. And next thing you know, the Fed's cutting rates three times in 2019. I mean, you got to go back to the last few months in 2018. And rate cuts were nowhere on Jay Powell's mind, and yet 2019 in the context of coming off an epic trillion dollar tax cut by President Trump. We had three Fed rate cuts. So once again, we have a pivot I mean, when you go back to Jay Powell's speech that he gave at Jackson Hole in late August, you know, it wasn't a few years ago, he gave a bellwether speech on the fundamental forces driving inflation down. He seems to have abandoned that and I think because he's under a lot of pressure. He's under a lot of political pressure. And ultimately, you know, who is his boss? It's Congress, but he was reappointed by Biden and I believe he has some sort of political responsibility because the Fed is a political institution when push comes to shove. It is the construct of the Federal Reserve Act by Congress. So to say that the Fed has independence, I've always sort of chuckled at that.

But I think in this case, he's really changed abruptly and I would say no doubt that the inflation situation has proven to have been more cumbersome than even I would have thought or anybody for that matter. But usually, a central bank chair person has a very big picture view, and doesn't allow a few weekly or monthly wiggles in the data. gyrations around the trendline is what I call them, influence your view. I mean, if you remember, go back to Alan Greenspan, back in the 1990s. He was steadfast in the view that we were in a situation of rapid technology, the internet, and that productivity was going to keep inflation low with strong growth. And he didn't feel he had to raise interest rates. And he didn't, and he was right. But he didn't let monthly or quarterly wiggles influence his fundamental view. And I'm finding right now that Jay Powell seems to have been pushed off his fundamental view, it's hard to believe that so much has happened to push them off a fundamental view as much as what's happened in the past couple of months. But let's take a look at what's happened the past couple of months and I'm not talking about inflation. I'm talking about Joe Biden's approval rating has fallen through the floor. And Biden is getting blamed for a lot of this inflation. Most of it actually is beyond his control. Some of it is within his control. But that's because he chose to undergo a massive fiscal stimulus package back in March, at a time when the economy was reopening. And that exacerbated the inflationary situation.

But you see, Biden needs to have Powell sound very tough on inflation right now. He needs that to help his credibility, and to show the public that the government is going to be fighting inflation, since the view is that the reason why Biden's popularity is so low is because of this inflation run up. And of course, you know, it's not really called inflation. It's called *screwflation*, because most of the things that are going up in price the most are the things that hit the low and middle income households the hardest, and especially when you consider food and energy, and the most visible items in the CPI. So I think a lot of this is politics, in my opinion, and why Powell all of a sudden has taken a more hawkish course, I would still be very surprised. Unless this latest variant turns out to be a flash in the pan that the Fed they they may go ahead with the taper. But I have a tough time believing they're hiking interest rates three or four times next year.

***Erik:*** That was actually going to be my next question, because Jay Powell did allude to accelerating the pace of tapering and several hikes in 2022. So do you think that was just political posturing doesn't really mean it?

***David:*** No, I think there's a, a real push within the FOMC to speed up the taper. And they should have actually done that already. I mean, the Bank of Canada north of the border has already ended their QE, the Fed decided to do it in stages. The QE had little impact on the economy. And when you go to the last cycle, under Bernanke, the QE had little impact on the economy. Its impact really is on financial assets. So all the Fed has done is just made fat cats richer by stimulating financial asset inflation. And you could actually argue housing inflation. So that's the problem. The problem here is that the Fed should have started tapering earlier. And frankly, you know, let them taper. They're still buying mortgage backed securities for what reason? Home prices are up 20% year over year. Want to be homeowner households who are renting have been crowded out of the market, because of the insanity on pricing and part of that is because of QE. And the Fed once again, has created a fairly large equity bubble as well. Because even when you normalize for interest rates, the price earnings multiple is so inflated, I mean, you have a cape P/E of 40, which has only happened 2% of the time in the past In the past 130 years. It's a got five standard deviation event.

And so the Fed has once again created as they've done so many times in the past, they created the conditions for a bubble that now has to deflate. The sooner they do that, the better. But when we're talking about taper, that's one thing that's about financial assets, that's about the Fed has your back. And that's not going to be around for investors anymore. rate hikes are something different. Rate hikes will have a meaningful impact on Main Street, which is why I don't think that we'll see the rate hike expectations priced into the treasury curve coming to fruition. And you're starting to see already, just in the past several days, those rate hike expectations coming out of the market, I just think that there's more to go. In fact, I don't even think the Fed will be raising rates at all next year. And it won't be because they don't want to, it's because they don't think the economy will give them the cover to do that. And tremendous opportunity in the rates market, Eurodollar futures, Fed fund contracts, the Treasury curve, anything that's priced for what the market thinks the Fed is going to do next year. That's really what you want to buy.

***Erik:*** Let's talk about what this means for the stock market. Because normally, if we're talking about disinflation, we're talking about an economy that's going to be in trouble. You know, these are all stock market down kind of signals. But lately, it seems like perhaps due to Fed supplied liquidity, the stock market seems to have this ability to just melt up through almost anything. Is that going to turn around? Are we going to see a meaningful correction or even a cyclical bear market here?

***David:*** Well, you know the market has received three major tailwinds since coming off the lows in March of 2020. It had a dramatic monetary tailwind, and then it had a dramatic fiscal tailwind. And then it had a dramatic vaccine tailwind. I mean, nobody thought early on that we would ever see a vaccine within five years. And of course, we have to pay attention to the fact that the pandemic is not in the rearview mirror. But we do have vaccines, the medical science is staying ahead of this or staying in line with it. And not withstanding what's happening right now. We have to believe that we did ultimately get through Delta, we'll get through this. But it's going to be a problem. I think, from an uncertainty and volatility standpoint, for the next several months. I don't tend to base my investment advice based on events. As we're seeing right now with this latest variant. I just stick to the fundamentals.

And so what do I see next year? I'm not saying we're going to have a recession, but you don't need to have a recession to have a significant pullback in the stock market. Just go back, as I said before, to the fourth quarter of 2018, there was no recession. That was no walk in the park. And in fact, you had three years in that great cycle from 2009 to 2019. There were three years where the stock market really didn't make you any money. It doesn't go up every year. You know, the problem I have is that there's this expectation now that it will go up every year just because of what happened, you know, coming off the pandemic lows. That's not the way the world works. My big concern is valuations. And people will always say well, but valuations are not a timing tool and they're not a timing tool. But I never advertised to anybody that I was a market timer. This starting point on the multiple is a huge constraint on future returns. In fact, when you're over 40, on the cape multiple, and it doesn't mean you go into recession. It's just about classic Bob Farrell rule number one mean reversion.

In the 2% of the time in the past 130 years that the multiple was this high, the one year, three year, and five year returns for the S&P 500 we're negative and that's all I'm saying. So I don't have a recession forecast next year, I just have a situation where we have an unusually expensive stock market, there's a lot priced in, and there is a risk that the Fed is going to make a policy mistake. And the only way you can justify equity valuations as to where they are right now is through interest rates. But even more to the point when you normalize. When you normalize interest rates. And you look at equity valuations. We're still 15% overvalued. You know, it used to be people said, oh well, we can justify these multiples because look where interest rates are. That was true 9 or 12 months ago. We've way superseded that. So I'm very concerned about what's priced in. I see all the classic signs of a bubble. I see it in leverage. We have marched in debt up more than 40% in the past year, heading to a trillion dollars for the first time. I mentioned the valuations. Sentiment is off the charts. market positioning. I mean, you go to the latest big money, barons poll of portfolio managers, they are all in 68% asset mix in favor of the equity market, it really doesn't get much bigger than that. And then we have portfolio managers when you go to the ICI data sitting on 2% cash ratios, razor thin. And, of course, we got the data from Bank of America just the other day showing that through so far this year, there's been $900 billion of money flowing into equity ETFs, and mutual funds, which is as much as what's been collected in the past 19 years combined.

So you also have massive, if not unprecedented retail participation. These are all the classic signs of a bubble, whether it's sentiment, market positioning, valuation, leverage. And so notwithstanding the economic environment, I am actually pretty worried that anything that causes a mean reversion trade is going to push us into a steep correction. And I think there's a good chance that it'll happen next year. And my big concern, because I don't have a big inflation view, but the Fed seems to have moved in that direction, they start to move rates up then we're in a whole new situation altogether. So the monetary tailwinds that caused people to buy every dip because the Fed had your back. Well, my theme is that the Fed doesn't have your back next year. And we're not going to get fiscal stimulus next year. It's not happening. In fact, the amount of fiscal withdrawal next year is going to be roughly two and a half percentage points of GDP. And yet I don't see that in many forecasters' numbers for next year. How's the economy held in? We had the the amount of fiscal stimulus this year gave the economy a 5% boost. Now, we're going to get some of that infrastructure next year. But it's not going to be enough to offset what's happening in the vacuum from fiscal policy is going to be a huge drag next year, nobody talks about it. So the fiscal tailwinds are over, the monetary tailwinds are over, it doesn't look like the pandemic is over. And so, I think that for next year, it's going to be a little problematic. The big risk to me if you're gonna ask me what the big risk is, and there are numerous risks is that the Fed pulls a classic policy misstep, and decides to follow the market and follow the pressure in the media and start to raise interest rates.

***Erik:*** Let's talk about commodities. The secular inflation crowd is saying, hey, it's a new commodity supercycle because of the inflation, and it's set to continue. I'm guessing, since you don't share the inflation view that you're probably see commodities is kind of rich to value here?

***David:*** Well, I think that there are you can point to really a handful of commodities that, you know, are gonna, we'll have a second bull market related to the greening of the world, and electric vehicles, and the like. But, you know, I'm taking a look just now, you know, people are talking about inflation about commodities. I mean, there's some, I mean, if you want to go, you know, if you want to focus on, you know, maybe want to focus on copper, or natural gas, or hydrogen, or those sorts of things, and we've actually constructed an index of secular commodities. There are a handful, but I'm just looking at the day that and everybody's talking about commodity inflation. Meanwhile, from the recent peaks, iron ore is down 60%, lumber is down 50%, steel prices are down 25%, soybeans are down 25%, Corn is down 20% and all of a sudden oil is down 20% and the base metals in the aggregate are down. 12%. And then people come back and say, oh, well, you know, well, you know, lumbers down 50% but only after rising, you know, 100% and I say well do the math on that, because usually you go up 100% And then you're down 50% you're back to where you were. That's exactly what's happened. It's called bear market math. If you go down 100%, you're at zero. And I got people saying, oh well, but you're saying we're down 50% when we were before up 100%. Yeah, exactly!

***Erik:*** I won't comment on the ability of people in the finance business to understand arithmetic but your point is well taken, sir.

***David:*** So what, but commodities are rolling over. I mean, up until the last couple of days, the dollar had been strengthening. Of course the dollar has given it up a little bit because of these receding Fed tightening expectations for next year. But I've seen look, the thing about goods inflation, nothing's permanent here. And it just moves on a cycle. I think this time next year, the 40% of the CPI called goods is going to be negative, it ain't going to be positive. Service sector will be a little stickier admittedly. There's going to be all sorts of crosscurrents. But the thing is that the dominant impact on the service sector side is, of course, imputed rents and actual rents. And that's going to be problematic for my view for the next few months. But I'm looking at the data. And this is the reality of a free market enterprise economy is that high prices will attract supply. And maybe this is something that has nothing to do with global supply chains. And nor should it but I'm just noticing that when you take a look at multifamily building permits, housing starts, units under construction and completions, they're booming.

The number of rental units under construction right now in the United States is at the highest level in 45 years. And there's a lag here. But it's telling me that the supply response, in the second half of next year will be overwhelming. The vacancy rate will go back up, and rental rates will come back down. Just as the lagged impacts of what I just mentioned on commodities is going to filter through to the goods part of the CPI. I think inflation is going to melt in the second half of next year. Now for a lot of people that's just too long, because you know, we speak to those people today. They're so tempestuous, long term to them, is lunch tomorrow. But I'm saying that you have a lot of inflation priced into the bond curve. I mean, you got almost 3% inflation breakevens. In the five year treasury note, you got three to four rate hikes priced in for next year.

And based on my forecast on the economy and on inflation, none of that's going to happen. And that's why it tells me to be bullish on the Treasury market. And actually, for all the talk about what a horrible year this has been for the Treasury market, yields peaked at the end of March. It's actually been terrific ever since. Despite all the horrific inflation and all the bond bears out there as vocal as they could be. And we have almost a record net speculative short position on the CBOT and the 10-year note. It's incredible. And so what do you do for an encore? So I think we're going to go through a bull flattening, which has already started, and that tells me and as far as investing is concerned, but you want to be long the longest duration bond, the 30 year treasury. But I would also say that bond proxies should do well.

And I think within the equity market, if I'm long only equity, I want to be in defensive growth. I do not want to be in cyclicals. I think the consumer is going to fade next year, there's no pent up demand on the good side. And I think that if you are going to be in the equity market writ large, defensive growth, you know, that means it could be parts of technology, healthcare, consumer staples, and dare I say utilities. Utilities by the way, which are the most detested and under owned sector of the stock market. But that's because of its high correlation with the Treasury market. That's why everybody despises it so much because they despise the bond market. And they don't understand the bond market. But you're not buying the bond market for the coming year on yield, you're buying it on price. Because if I'm right on this narrative, the total return will be very significant, at least 10% at the long end of the curve.

***Erik:*** So the play there is price appreciation on the expectation of declining yields on the 30-year, how far down do you think the 30-year yield can go?

***David:*** Well, you know, we're already down to 180, if not mistaken. And I think the 10-year will get down to 1%. And I think that the long bond will get down to call it roughly 130-135.

***Erik:*** David, let's move on to precious metals, a subject that's near and dear to many of our listeners hearts. What do you see going on there?

***David:*** Well, I actually think that if there's going to be a year for gold, 2022 is going to be the year. For one, I think that a lot of these interest rate expectations that are priced in that have caused the US dollar to snap back in the past several months that's going to unwind. And so since gold is priced in US dollars, it's the perfect hedge against the US dollar. I think that's going to be a tailwind. On top of that, if I'm right that a lot of these rate expectations dissipate. Bond yields come down and we have to remember again that gold is inversely correlated to bond yields. Because the opportunity cost of holding gold goes down as bond yields go down. Well that's going to be another very important tailwind for gold. But there's a third one, which is what's happening on the geopolitical side. And we have to keep an eye on China more than ever, more than ever, especially with what's perceived to be a weak administration on foreign policy and Xi Jinping more powerful than he's ever been before. And we have to watch China and its ambitions, we have to watch what that means for Taiwan, which I think we'll see more in the news. And I don't think we'll go into a war with China. That's not going to happen in a classic sense, but economic warfare, cyber warfare, there's going to be that sort of a warfare, I think that tensions with China are going to accelerate.

And gold should once again be that classic geopolitical hedge. You could say to me, well, you know, wouldn't Bitcoin or crypto also serve that purpose? But you see the thing is that gold is a safe haven. And it does not have extraordinary volatility but crypto does. And so for all the people that talk about crypto in how you value it is really anybody's guess, it's really just a momentum gauge. That's all crypto is, it's a momentum gauge. It is the poster child of the risk-on trade. That's all crypto is. And so I think next year is going to be the inverse of the risk-on trade. I think that next year will be the risk-off trade. And I think that crypto and Bitcoin will have a tougher time of it next year, and of everything I said I talked about defensive growth, I talked about utilities, I talked about the Treasury Market, I talked about gold. Next year will be the year of mean reversion where safety valves come back into vogue or capital preservation, which has been lost among the investment masses. Capital preservation never goes out of style. But there's a belief that it has but it hasn't. That will be a theme next year. Safe haven investing, capital preservation, and the era that we've had unusually, and I think this is maybe the market gods have been testing our resolve and our discipline, but throwing caution to the wind, which has worked so well, in the past two years. I expect that that to will be mean reverting in 2022.

***Erik:*** David, with respect to crypto I personally agree with you. I think the fundamental argument for gold is better. But you know, there's a lot of people who disagree with us. What does that mean, just in terms of market share, it seems to me like one of the reasons gold hasn't performed so well here is that a lot of people who used to buy gold under these circumstances have decided that they think it makes more sense to buy crypto. When you see crypto maybe having a washout next year, does that mean that money flows into gold?

***David:*** I think that that will probably happen. I mean, there's other reasons why I'm bullish on gold, I am not in the higher interest rate camp. If I was I'd be bearish on gold and the lower bond yield camp, that view is now actually not just now, but the past little while been working out very well. I am not a bull on the US dollar and so that's going to be something that helps out. The Crypto call is just because for no other reason. It's just so highly correlated with the risk-on trade. So if I had a risk-on trade for next year, I'd have a high beta portfolio, I'd say sure. You know, go buy Bitcoin or go buy crypto, sure. But if I know anything about the crypto space and I'm not talking about the technology of it. I'm just saying you know, yeah, people are saying that we've been wrong and missed out on this other bubble. But, you know, it's still a currency. You know, it's not called. I mean, unless I'm wrong, correct me if I'm wrong, Erik it is called the crypto market? It's called cryptocurrency. It's currency. We're gonna make a killing on a currency. I don't know. I never heard anybody ever say to me, Hey, how do I make a killing on the Swiss franc or the Korean Won? Can you help me do that?

So it's tremendous optionality because of the volatility. But to me, you know, it's, you know, Bitcoin is really for somebody my opinion with ice in their veins and a certain risk profile. I would never recommend it to my clients because you see, my clients have a certain focus that I can help them with, which is called capital preservation. How does Bitcoin help you with that? It moves in and out of bull and bear markets every two months, but next year, if we're gonna say, go take a few weeks or a few months, we know how volatile it is. I would be very surprised if bitcoin makes you money next year. But I wouldn't be surprised if gold does.

***Erik:*** Speaking of currencies, let's talk a little bit more about the US dollar because as you said, I agree with you that the risk of escalation geopolitically between China and the United States is very significant. And by the way, China has the more sophisticated and more advanced hypersonic weapons as far as I can tell. So I think this is a really interesting time. What does that mean for the US dollar?

***David:*** Well, I think that, you know, to me, the most important determinant of currencies, ultimately, are relative interest rate differentials. And so I would say that, because I believe that the Fed is not going to be doing anything next year, and I know that raises a lot of eyebrows, but only because of what the markets have suddenly priced in the past little while, I think the dollar is going to come under pressure. Now, I think that if you're talking about which individual currencies, well, in a risk off environment, which I think we're going to have next year, it will be currencies like the Swiss franc, and like the Japanese Yen that you probably want to have in the portfolio. The currencies that are most cyclical are going to have the toughest time and that would include the Canadian dollar, the New Zealand Dollar, the Australian Dollar, the Norwegian Krona, the South African Rand, the commodity currencies next year, I think you're gonna have a pretty rough year. So, you know, when you take a look at the US dollar, there's some areas where it might do better against, but against the Yen and perhaps even against the Euro against Sterling, I think that it's going to struggle on. Those are the dominant components of the trade-weighted index.

***Erik:*** Well, David, I can't thank you enough for a terrific interview. But before I let you go, tell us a little bit more about what you do at Rosenberg Research. You were with a private wealth firm a few years ago. You've branched off, you've got your own firm, tell us what it's about?

***David:*** Sure. Well, you know, first and foremost, we do offer a free one month trial. And I urge everybody in the call to come on our website, just Google Rosenberg Research. And you'll see the button right there on the front page for the free trial. And I guess, you know, what is it that we do? Well, you know, we cover the world in terms of investment strategy, and economics and always, you know, basically detective work, that's what we do. It's really, always searching for what the consensus isn't looking at. That's what we want to be looking at. What isn't priced in? What should we be focused on that we're not focusing on? So I like to think that, you know, we're here to do people's homework for them from a macro and investment sense.

You know, I would just say that I spent 25 years on the sell side, the seven years in New York at Merrill. Come to Toronto to work at Gluskin Sheff, a boutique mutual fund for 11 years. And I could have started this business when I left New York to come back to Toronto in 2009. But I knew that I wanted to have more well rounded experience. And I wanted to try out what is the buy side like. I've been on the sell side my whole life and so to spend 11 years in my role as a financial economist and Market Strategist to spend every day with portfolio managers made me think about probabilities. It made me think about risks. And it made me think about how to look at risk-adjusted expected returns across the asset classes. It was really, I probably learned more my time at Gluskin Sheff on the buy side than I did in my previous 25 years on the sell side about how to be disciplined in your approach.

And so, you know, I just decided great timing six weeks before COVID to start Rosenberg Research, but it's really worked out seamlessly. We're still working remotely. But an answer to the question. You know, I knew that when I was at Merrill Lynch and people would send me competitors material. It didn't cut it for me. And when I got to Gluskin Sheff, and I was a consumer of everybody on Wall Street's research, it all sounded the same to me, just all sounded the same. And in a very, I gotta say, a very bullish bias. And I understand that people want to hear a bullish story. And when you're on the sell side, you have to! You have to sell a positive story at nearly all times. So I just decided I've got the opportunity now, to become Rosy unplugged. And people to have I just feel there's a dearth of analysis out there, that is truly unbiased and that's what I believe I have filled in that void in the marketplace with my new firm.

***Erik:*** Well, I can't recommend Breakfast with Dave and your other publications strongly enough so listeners be sure to check out that free offer. Patrick Cerensa and I will be back as MacroVoices continues right after this message from our sponsor.