MACRO Voices
with hedge fund manager Erik Townsend

David Rosenberg: The Bear Market Bottom is Not In

April 20th, 2023

Erik: Joining me now is Rosenberg Research founder David Rosenberg. Rosie, it's great to have you back on the show. It's been way too long. Let's start with the big picture. We're climbing away here with what some people think, is a recovery to maybe new all time highs in the stock market. I'm skeptical myself, how do you see this market? What lies ahead?

David: Well, we have a long way to go to get back to those early 2022 highs. So that is a bit of a stretch. I think that the markets, whether it's the equity market, or whether it's the credit market, has gone into pricing a soft landing. So I think that they more or less bought into the Jim Bullard view from the Fed, that all is good, the business cycle has been repealed, there is no recession. And the green light is there to bid up the forward multiple back almost to 19 earnings. So this is a very expensive stock market right now and it's priced for Goldilocks. So all of a sudden, recession apparently is off the table and investors are embracing the soft landing once again.

Erik: I have a feeling David, that you are not quite as sold on this idea as some others are that it's all uphill from here. What's your outlook and what do you see on the horizon?

David: Well, I'm seeing the tea leaves as being that a recession is actually already starting this quarter. And you could see that being built in from the negative retail sales volumes numbers that we've had in February and March, the negative reading in March industrial production, the labor market is mixed. The headline Nonfarm Payroll numbers have continued to be positive. But at the same time, the leading indicators of employment, such as temp agency jobs, they're coming down. And you know, historically that when the headhunters are chopping heads, the rest of us aren't usually that far behind. The workweek is a classic leading indicator of employment because companies tend to cut hours before they cut their staff. And the workweek is in a notable downtrend. That gets very little play in the work week, by the way, is one of the components of the Conference Board's index of leading economic indicators. And of course, initial jobless claims have all of a sudden started to ratchet up, they are up 50,000 from the cycle lows. And if you go back the last time we were up 50,000, from the cycle low before the pandemic was heading into January 2008, when the recession was just starting, and yet the consensus back then was that we were in a soft landing so much like the sentiment that we're seeing right now. I guess my fundamental view is this. I come from the school of Albert Einstein, although I'm not a physicist, but Einstein famously said that the power of compound interest is the eighth wonder of the world. So I've always believed that interest rates matter in both

directions. It's interesting that when the Fed is cutting interest rates and steepening of the yield curve, everybody is talking about recovery in a bull market, when the Fed embarks on the most aggressive tightening cycle since 1981, and inverts the yield curve, well we can just somehow ignore that.

But the cycle is the cycle, the rate cycle, the market cycle, the economic cycle, they are these pivotal forces, the sine waves that intersect over time. So I would just say to the people that disagree with my view, which they're well entitled to, a lot of people do. That you defacto are acknowledging that not only is it different this time, but that the business cycle has somehow been repealed. I don't believe that business cycle has been repealed. I believe interest rates matter. I believe that there is tremendous value in information from the yield curve. But it tends to lead by roughly 10 to 12 months and the yield curve started inverting for good last July. So do the math. And it's telling you that the recession should be arriving on time, basically the quarter that we're in right now. So that's my big picture view. I think that at this stage looking at where credit spreads are looking at the big backup recently and 10-year treasury note yields and the two year note pricing in another rate hike in early May. And now we're sort of building towards another one after that in June, just the more the Fed has to do now, the more they'll have to cut rates down the road. But suffice it to say that an economy that is driven by credit, and now we not only have the cost of credit, having gone up substantially in the past year, this is the most aggressive tightening cycle since the Volcker years of the early 80s. We now a lot of question marks over the availability of credit, the access to credit in the aftermath of not one but three bank failures last month, and there's going to be more chapters to be written. Even though the authorities, the Fed have managed to backstop deposits and prevent a contagion. What they will not be able to do is stop the banking sector from focusing on their balance sheets, focusing on their capital, and restricting their access to credit which is going to have a layered impact on the downside towards the economy in the next several quarters. That development is only now just starting.

Erik: Let's talk a little bit more about interest rates. Last time that we spoke to you, you said that the peak was in for inflation seems pretty clear that it at least with respect to the the pandemic induced inflation that has peaked now. But is there a new secular inflation trend that we need to be worried about or are we headed back down below 2%?

David: Well, you know, we won't know the secular story for years or decades, because by definition, secular means long term. And a lot of that has to do with the view that there are shortages of everything. Shortages of material, shortages of labor, and that the world is deglobalizing. And there may be truth to that, we just don't know. That's going way out into the future. I think that that story on secular or structural inflation is way overdone. By the way, we were hearing the same thing after Donald Trump got elected in 2016. That blowing a hole to the fiscal deficit through a trillion dollar tax cut, and restricting immigrant labor was going to create the conditions for secondary inflation. We heard that back seven years ago, somehow it never materialized. So I guess I adhere to one of Bob Farrells 10 market rules to remember that there are no new eras, excesses are never permanent. And so I think that, you know, the situation with inflation is that the inflation is not the CRB Index, it is not the S&P500. It's glacial, it took a

long time for inflation to go from where it was to 9% in June of last year, it'll take time for inflation to go down. Inflation is a process, it doesn't fall like a stone, it doesn't do a bungee jump, and everybody is just so impatient about getting down towards 2%. It's going to take a while to get down towards 2% The way the CPI is constructed. But I think that inflation as you said, it has peaked, it is coming down. It's like a race for an economist very exciting race between watching paint dry and grass grow. But I think that inflation is going to be coming down. I think it's going to be coming down in the good side. And you're seeing that in the broad commodity indices over the course of the past several months. You're seeing it in freight rates and transportation costs. What is still frustrating in the CPI data is the rental components, which is 30% of the index. So as rents go, so we'll inflation. And there are these three year distributive lags and the rental component. So a lot of the rental inflation, which is stubbornly high is still reflecting leases that were being signed, you know, two or three years ago, when there was no supply and rental rates were going up, but that will come out of the data. Eventually, perhaps as soon as the second half of this year, the one thing I will tell you and of course today, we just got the housing stock data for March. When you're taking a look, for example, at multiple units under construction, they're at a record high. They're up 60% over the course of the past year, and they're running about 960,000 in annual rate. These are units under construction in the rental industry. So there's a massive pipeline of new units coming on stream at a time when the nationwide, apartment vacancy rates already gone from roughly 4% to 7%. And you're seeing in real time rents have been either deflating or disinflating. That hasn't shown up on the CPI data yet. And when it does, I think people will be surprised and this might be more of a story for next year, how low inflation is going to go. So I'm in the camp that thinks that secular inflation that's a wait and see. That's a show me situation. We've heard it before. But I think that if you have a 12 month view, inflation is going to be coming down quite significantly.

Erik: David the last time or maybe it was the time before that when I spoke to you, you emphasized don't give up on gold and at that point, we were plumbing $1,600 or something. Needless to say that was a good call. But now that we're back up approaching all time highs in gold still over $2,000 As I'm speaking right now, are we done here? So we already have the big bull market in gold or is it just getting started?

David: Well, the chart looks great right now. You could argue, if you're into the technicals that it's overbought on a near term basis. But I think the fundamentals for gold are going to remain very positive. Now, you got to consider that the two most important determinants fundamentally for gold are real interest rates, and the dollar and the Fed as continued to raise rates, saying they're going to raise rates again in early May. And now the swaps market is pricing in about a 25% chance that they go ahead and move again in June. And so this is what gold has done in that environment. The dollar has weakened, but hasn't yet broken down. We are soon on the precipice of seeing the 50-day and the 100-day moving averages converge, that would be a bearish technical signpost for the greenback. So there's two things that are gonna happen in the next several months that make me very excited about gold, I think the Fed is going to be stopped in its tracks. I think the data will force the Fed to stop in its tracks and then the market is going to go ahead and price in even more rate cuts into 2024. On top of that, because the ECB is playing catch up to the Fed, the BOJ has even done anything yet, a lot of the central banks

will still be tightening monetary policy at a time when the Feds on hold, and then pivoting towards easing monetary policy. And the most important determinant of currencies are relative interest rate differentials, which are going to work against the US dollar. So the future if we can define the future, not secular, let's take it a year at a time. Hopefully, you'll have be back on before the next 12 months. But let's just say if you said you're going to give you a 12 month view, gold's going to go to new highs, and not based on anything other than lower real rates, and a weaker US dollar. And those are the only ingredients you need to be bullish on gold.

Erik: I'm fascinated by your emphasis on those being the only ingredients you need. A lot of people are starting to focus again on this dedollarization story with more and more central banks around the world questioning whether or not they're completely committed to US dollar denominated reserve assets. Is that part of this or is what's driving gold have nothing to do with dedollarization?

David: I don't really think right now, it has a lot to do with it. And I think that's again, another scare tactic that yes, you're finding, you know, whether it's Russia-Saudi Arabia, Russia-Brazil, China beginning to form some sort of currency bloc, where they are reducing their reliance on the US dollar. But the reality is that the dollar share of reserves globally and the US share of global trade globally has been going down for a considerable period of time. And that stuff you're mentioning was happening when the dollar was in a raging bull market last year. So that doesn't really factor into it. You know, I just said that, you know, when you're trying to model, you know, gold. Those two important variables, real rates and the dollar, you can actually run a model based on those two. Look, there's other things happening right now, I don't know so much about the, you know, what you talked about the dedollarization. You know, maybe that's accelerating probably true. You know, the fallout from the US government freezing those Russian reserves, less trust in you know, then again, all the US government did was punish bad behavior. Be that as it may. It comes down to a trust issue. That might be true as well. I'm not so sure that's really what's behind the move in gold. The move in gold is really the first move has been because the market, even though it's pricing in May and June, the markets realized that the Fed is very close to the end game on raising rates. That removes a major albatross across the neck of the gold price. And then the next will be to cut interest rates. And that isn't even fully priced in for the end of the year, couple of cuts priced in I don't think nearly enough. And I think the US dollar is going to go down. You know we can build the horror story of dedollarization and all these countries around the world ganging up against the US dollar. Okay, if that's your story, run with it. Maybe that's a cherry on the cake for the gold view. But I'm just saying, what is staring me in the face fundamentally lower real rates, lower US dollar. I suppose that if I was going to be looking at anything globally, that is supportive. It's that global central banks are diversifying more into gold. And that's also because they have deep pockets. And that's also something that investors should be comforted on. And if we see a near term pullback on technical reasons, because it is near term overbought, it is going to be a great buying opportunity.

Erik: Let's talk about China. To what extent does China's recovery factor into the overall global macro outlook? Some people are saying, you know, the China recovery is going to make all the difference in the world. Other people are saying it's not that important.

David: Well, that's a great question. You know, we had data today, for China, their march retail sales numbers were huge. Their industrial production numbers are very weak. So the bottom line, and of course, all you have to do is just look at the latest IMF forecast, the global economy is cooling off with or without China. And that impact is having a downward pull on the manufacturing sector in China. And plus, they're still working their way through their debt and the bursting of their property bubble, which thankfully, looks to be running its course. But it's still not a source of support for the economy. Is the China reopening enough to produce a boom for the global economy? I think it's just very selective sector wise. I think it's obvious that the reopening of the Chinese economy is going to be a big boost to travel and tourism within Asia itself. So you could say, is that bullish for airlines? Sure. Is it bullish for jet fuel? Sure. What does it mean, for the average Joe or Jane in the United States? Well, not that much. You could draw a line and connect some dots between Chinese now being able to go and visit Europe and go shopping in Europe and buy all those, you know, Gucci bags, and all the high end luxury goods that Chinese consumers like to buy, so you can formulate some sort of equity strategy out of it. I think you're gonna get a near term left obviously, from the services side. But, you know, what impact is it going to have on the production side, and we're not seeing much of a lift there at all? I think a lot of that is because the global economy is fragile, and a softening. And so you're seeing this dichotomy right now between the service sector in China, which is lifting off, and the goods producing side, which remains fundamentally weak. So I think it actually comes down to call it a fractionally positive boost for global GDP. I think it's a much probably bigger regional impact on cross border, trade and tourism flows within Asia itself. That's where the action would be if you're going to turn this into a bullish story. It's really an intra trade tourism travel story within the continent.

Erik: David, let's go back to the stock market outlook, you expressed a fair amount of skepticism earlier. Do you think the bottom is in for the S&P at $3,500 or do we still have new lows to come once we get into the recession that you're talking about?

David: Well, I think the only way that you could believe that the lows from last October are going to hold is if we managed to come out of this without a recession. And the market right now is telling you that David Rosenberg is wrong. And the soft landing crowd is correct. If you believe in the soft landing, then maybe you're even right, maybe we go to new highs. I don't think that's going to happen. I think that a recession is staring us in the face. So if you're true to your view, and at any moment in time, all the stock market is every single second, millisecond, minute, hour. The stock market is just the product of two numbers, its earnings and the multiple. And so if we get a recession, a classic plain vanilla recession, mild recession would still mean a 20% hit to earnings, which then takes you to something close to call it $185 EPS, then the question is what's the recession multiple? Well, a recession multiple is not 19 times forward earnings where we are right now. Recession multiple is closer to 16. So if you do the arithmetic on recession, multiple and recession earnings, I hate to say it, but you're down towards to 3000

on the S&P500. And I'm not that good that I could isolate what day that's going to happen except to say that is the endpoint for the bear market, and I'm hoping the sooner the better, because I'd like to turn bullish again. But that's where I would say that we'll go to in a recession that right now is not remotely priced in. I'll tell you right now that a recession was never fully priced in. And now we've gone from not just remotely pricing in a recession, to fully pricing in a soft landing and that's pretty dangerous. Because like I said before, if you're chasing this market at this point at these multiples, your belief system is that we have turned, we have repealed the laws of the business cycle. So I'm still bearish on equities.

We are in a significant bear market rally right now, over a month ago, we were talking about a new leg down because it was happening in the banking sector. But there's still more chapters to be written on this. We have not seen all the policy lags from what the Fed has done in terms of the rate hikes. The economy responds to rate hikes with lags that are fairly long, we haven't seen the full impact yet. So I think that when the recession becomes a reality in investors minds, and look how long it took, it took a long time in 1990 for the markets to recognize recession. Look how long it took in 2007-2008. You know, we'd be having the same conversation after Bear Stearns got swallowed up by JP Morgan in March of 08 and the market took off after that and we'd be having this discussion. You'd be asking me at that point, if we hit the lows. I'm pretty sure when I was at Merrill, I'd say no, I'm pretty sure we haven't. So I think that's really what the story here is. Where is your multiple? Where's your earnings number? And when you consider 16, multiple classic recession trough 19 right now... okay. And we're not even halfway through the earnings downturn, and earnings have turned lower. So I think when reality sets in, when Wily Coyote looks down, the market is going to go down to new lows, we're going to break, we're not just going to test the October lows of last year, we're gonna go through them.

Erik: Okay, so we've got a fairly bearish outlook based on what I'll call the recession model of the market, which is, where do we stand right now in the economic growth and recession cycle, but there's also a credit cycle. So let's talk about that next. Should we be concerned still, that this Silicon Valley Bank and then Credit Suisse, you know, are we in the beginning of a new 2008-like credit crisis, which is about credit? Or is that pretty much over now and wound down with what we've seen with Silicon Valley Bank and the other scares that we've had so far?

David: Well, let me answer maybe the middle question first, which is that no, it's not 08 or 09. Lightning doesn't strike twice. And the large banks are in fine shape. They have capital buffers, strong liquidity. And they're so heavily supervised and regulated and monitored today that the big banks in the US look like the big banks in Canada. So they're fine. You know, we do have a situation with the small banks, regional banks, and the small banks aren't so small anymore. And they are loaded up the wazoo with commercial real estate debt, which is the you know, last cycle was residential mortgages, the cycle before that was dotcom. This cycle, the bubbles in commercial real estate, and now you're seeing vacancy rates above 18%, rents coming down, price is imploding, and defaults are on the rise. So the next shoe to drop is commercial real estate. And although practically every bank has large exposures, the big exposures are on at the small banks. But the small banks have taken up over the past decade, an ever greater share of outstanding credit in the economy, because for so long, the big banks were penalized. And so

that's where the problem is. It's not going 08-09. But, you know, I don't think we have to draw that comparison. What we have to do is just become rational thinkers. Let's put aside the catastrophe scenario, which I don't think it's going to happen. I think what's likely to happen that will still have important downside economic impacts, is that the banks are doing what they're doing already. They're going to be raising the loan loss provisioning, and they're going to be restricting access to credit, maybe not to their most creditworthy borrowers, but almost everybody else who is not that credit worthy. And remember that recessions always operate at the margin. Small changes in a big economy, the level of GDP is always huge, even in recessions. Recessions are about rate to change. And I think that coming off, what was a massive increase in interest rates, which is going to have a continued impact on debt servicing costs for the economy. Now, keep in mind that a lot of the run up in the debt servicing costs from the Fed, were absorbed for much of the past year, from the lingering impacts of all the fiscal stimulus and all those checks that were sent out, you know, back in the winter and spring of 2021. That's already basically done. So the full impact of what the Feds done is going to come into fuller view, at the same time that the banks are going to be constricting credit.

I think that if we were to draw some sort of, you know, probability curve of outcomes. I don't think we're going to have a massive, you know 08-09 event, I don't think it's going to be I mean, outside of commercial real estate, that's a big problem. But it's not enough to create something that you would call a great financial crisis or the Great Recession, everybody likes to draw the comparisons to 08 or 09, that was a one in century event. So maybe we'll wait another century. However, the situation that evolve with Silicon Valley Bank, is a reminder to the banking sector writ large, that their capital is precious, and they're going to most likely be tightening their credit standards, which they were doing, by the way, even before this crisis took hold, this is going to cause the banks to become that much more circumspect. So I think we're going to go through a variation of what we had back, say in the early 90s, coming out of the savings and loan debacle, which by the way, no big bank failed, there was no massive contagion, although we shuttered a third of the Savings Loan industry, but it had an impact on credit creation. And we had a three quarter recession wasn't the end of the world, the Fed took the funds rate from 9 and 7/8th down to 3%, we had a workout period because there wasn't much of a recovery after that three quarter recession. But by the mid 1990s, Netscape goes public, we have the internet, and we're off to the races again. So we're not going to be talking about Silicon Valley Bank, or we're not going to be talking about anything we're talking about today 2, 3, 4 years down the road. But there is going to be a near term impact, at least over the next year in terms of a construction of bank credit coming out of this, that's going to add downside risks to the economy. That much we can almost say with certainty.

Erik: We spoke about precious metals earlier. Let's talk about commodities more broadly. We're seeing a lot of interest in copper, in battery metals, a lot of people are putting big commodity bets on around energy transition. Is this part of a secular trend? Is it just a fad? Where are commodities headed from here?

David: No, it's not a fad and I think that, you know, what you're seeing already, you know, even during whatever period we had, where there was all this recession talk, commodity prices came

down, but not nearly to the levels that we had in the past. You know, when we had similar, you know, economic malaise. It's hard to sit here and say, yeah, be all bulled up on commodities as we go into recession. So on a near term basis, I'm not bullish on commodities, because there is a structural supply curve that's very positive for oil, and for the entire commodity sector and the greening of the world, and, you know, electric vehicles expanding. And so there's this natural demand that didn't used to be there for the commodity sector. That much is true. And of course, it's a sector that's been starved of capital, and supply constrained for so long that you have this very what in economics, we would call an inelastic supply curve. So that's very supportive for the price. There's also the demand aspect of it. And if we go into a recession, which by the way, the IMF pretty well told us that if we're not heading into a recession, we're heading into something close to a recession. Even with a very powerfully positive supportive supply curve, I think the demand will take commodities lower. However, if you have that sector view, secular view, let's define that, let's say it's 3, 5-10 year view, commodities are probably going to be in a bull market for an extended period of time. And I think actually, once we get past a recession in the recovery mode, and then we have the demand bumping against the inelastic supply curve, commodity prices are probably going to go up quite a bit. Now, you'll say to me, but how does that fit into your, you know, low inflation view? Well, because there's a whole lot of other things that are going to be happening at the same time. And keep in mind that, you know, we're going to be going through a considerable period of time rents are going to be deflating. The same rents that spent the last two years inflating and juicing up the CPI are going to mean revert in the other direction, and I think have more of an overwhelming impact on the inflation picture. Because remember, 60% of the CPI is services, not goods. It's true that we eat. It's true that we buy furniture and clothing and appliances, and we drive. Only 40% of the CPI is in goods, 60% in services, and guess what dominates the services, housing and house prices... what are they doing? Going down. Residential rents in real time... What are they doing? They're going down. And that process is going to go on for the next couple of years. And that's going to have a dominating impact what's happening on the good side. But if you're asked me about commodity inflation, you know, once we get past the worst point of the economic cycle, yeah, I'll write reports on that the prices are going to go up rather significantly.

Erik: Well David, I can't thank you enough for another terrific interview. But before I let you go, I want to talk a little bit about Breakfast with Dave, the newsletter that you've been known for, literally for decades, since your Bank of Montreal days back more years ago than probably either one of us wants to admit to remember. It's changed a bit though, since you formed Rosenberg Research, you don't have this have to be bullish all the time bias being held over your head. And that's changed the services or broaden to the services that you offer. So tell us a little bit more about what's on offer at Rosenbergresearch.com.

David: Yeah, look that's a fair comment. You know, we're always looking for ideas, and opportunities to put money to work. So the work we do look, we span all geographies. And we span all the asset classes. And we have investment recommendations. And on top of breakfast with Dave, we have a monthly asset allocation model called strategizer that we publish every single month. So people that say, well he's a one trick pony. It's always either or two, I guess. It's always about bonds or it's about bullion, the bond-bullion barbell for the alliteration. But we

actually have a slate of ideas that we're always talking about. And so Breakfast with Dave, yeah it's not what it used to be, it's actually more because it's chalk full of ideas and new ways of looking at the world and looking at the markets. So it's a little thicker than it used to be. More quantitative than it used to be, more model driven. And that's because as you said before, you're right, I'm not linked to an institution. I'm not on the buy side of the sell side. The only thing I have to sell, and what people could buy is basically my view or I should say our collective view, because what's really changed is I have a whole team behind me. And a good chunk of that team are terrific quantitative model-oriented individuals. And the name of the game is to help investors make decisions. So you know, thanks for the plug. Breakfast with Dave is still the flagship, but I'll just tell you what's changed at Rosenberg Research, Is that our monthly strategizer, asset allocation investor publication now rivals Breakfast with Dave in terms of client demand. That's something that just happened in the past couple of months.

Erik: Dave, I know you've been kind enough again as you said, it all starts with Breakfast with Dave and you've offered our macrovoices listeners a free trial. Please tell us a little bit more about what they can find there is a link in the Research Roundup email, but for anyone who's listening who's not subscribed to Research Roundup, please tell them where they need to go in order to take advantage of this offer as well.

David: Great. Just come to the website and information at Rosenbergresearch.com and it'll take you right to the website and you can log in there.

Erik: Okay and at the website, rosenbergresearch.com there's a free trial for the Breakfast with Dave newsletter.

David: Free trial for every viewer of today's show.

Erik: Fantastic Dave! We look forward to getting you back on the show in a few months for another update. Patrick Ceresna, Nick Galarnyk, and I will be back as macrovoices continues right here at macrovoices.com