David Rosenberg: The Bond Bullion Barbell

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Erik: Joining me now is [Rosenberg Research] founder David Rosenberg. Rosie, it's great to get you back on the show. Last time I had you on, the message was: hey, the bear market is probably not over, the final low is probably not in. And the people who are celebrating that it's all unicorns and roses from here probably have the message wrong. I still want to believe that's true. But gosh, look at this S&P chart. What do you make of this?

David: Well, I think that it has to be said that we have not made a new high for the S&P500. Despite all the efforts and achievements by The Magnificent Seven, it's been almost two years now that we last had a peak in the broad market. So I find it fanciful, when people say to me that we have entered into a new bull market, I think that we have just been range trading for the better part of the year. We know that when you look at the S&P500 equal weight index, which really is a proxy for the average stock, or the median stock, it's done diddly squat all year long. I mean, all the heavy lifting has been in the mid cap tech stocks. And this remains one of the most concentrated markets we've had in our hands since the late 1990s, with the.com and broad technology craze. So I would say that there's no evidence, notwithstanding the fact that we've had a nice seasonal, short covering rally that the bear market is over, I think that we've really just been sitting on a shelf. And the market seems to believe that we're going to be in a prolonged soft landing, because we've been in one all year long. So I think that the big surprise, especially for a market that's pressing up against the 19 Ford multiple, that the recession that was delayed was not derailed. And I think that you're going to be finding in the next four quarters, these earnings estimates that you could say have helped underpin the market are going to be ripe for a sequence of declining expectations on the earning side. So the bottom line here is that, what is still not priced in, really that any asset class, maybe it's starting to filter into the oil market. What more important price is there than the oil price? Which is telling you a story, I think of the demand side, So I think that the bear market is still here. We've had intermittent rallies in the context of what is still a bear market, and the answer is no, especially if we get a recession, which I believe is the base case, I think that the ultimate low still lie ahead.

Erik: I tend to agree with you. But just to take the other side of the argument, since that's my job as a journalist, one of the things that the bulls seem to be celebrating is this narrative where they're saying, okay, look, we're past the moment of peak rates, the fight against inflation is over, the Fed's got it under control. We've seen peak rates, and everything's going to get better from here. And so far, as I can tell, all of that is based on exactly one CPI print coming in a whopping 0.1% below consensus expectations. So I'm not quite sure why all the hopeium. But that's the narrative. What do you think about peak rates? Is that really true? Is inflation under control? And if inflation is under control, is it because the Fed succeeded? Or is it just because maybe a hard landing is coming and inflation is coming off as a natural function?

David: Well, I think it's all the above. There's no doubt that in the pause period, that really goes from the last rate hike to the first rate cut, generally produces in everything rally, you get rallies in equities, you get rallies in fixed income, you get rallies and commodities. And so nothing here is really that surprising, that you get this rate relief induced rally. And we've been seeing that now for, I call it the past several weeks, maybe the past couple of months. I think that inflation is yesterday's story. And I think inflation has already come down dramatically from over 9% to barely over 3%. There's only been four other times in history when inflation fell this far this fast. And actually, in those four other periods, it coincided or led to an economic recession. So there's a bunch of things that have happened on the inflation side. On the beneficial side, of course, have been the restoration of global supply chains and we've seen the labor force participation rate pick up, productivity has been improving. So a lot of a bottlenecks on the supply side that helped create those conditions for 9% plus inflation in the summer 2022, those conditions on the supply side have largely faded away.

On the demand side, you're seeing two things happening, you're seeing the fading of the fiscal stimulus and the impact that that had on demand. And at the same time, the likely impact of the Fed tightening, which also is having an impact on demand, and we haven't seen the full impacts there yet. I think that for people that look at the inflation side as a reason to be bullish on equities, what I can say is that you can argue that inflation coming down should mean that interest rates come down. And that should be very good news for an expansion in the market multiple. But you see, it's not as if we're coming at this with the multiple at normal levels. I mean, you're talking about a price earnings multiple pressing against 19, when historically the multipolar is close to the 15, or 16. So I don't really think that if you're bullish on equities, you want to be making your bullish bet on further multiple expansion of where we are today. If we were at a normal multiple, I would be more constructive in the market. And the next thing is, what does declining inflation mean? It means that prices, price change is slowing down. And the price change slowing down means that revenues ,most of the items in the CPI, and then the producer price index, that reflects some company's revenue stream. So you can't have it both ways. In ordinary times with a normal market multiple, declining inflation, declining interest rates would lead to an expansion of the multiple. But I started to think that that's going to happen from current levels, they're just too inflated as they are.

And on the other hand, you have to say, what does this rapid decline in inflation mean for pricing power, and pricing power is correlated with revenues, and profitability. So that's where you got this, breaking the link in the bullish argument over the inflation. The inflation had been signaling, had been signaling and the improvement that we've been seeing on the supply side, the next leg is what we're going to be seeing on the demand side. And that's going to feed right into what I said at the onset, which is lower profits, not higher profits. I mean, the consensus thinks we're going to have 10% profit growth next year. And I see that as a virtual impossibility.

And what the inflation numbers are telling you is that pricing power in the corporate sector is receding. And that is not anywhere close to being fully priced into the stock market.

Erik: On the fixed income side, one of the messages we're hearing from the bulls at least is, okay, look, buy duration and buy it and size, peak rates is behind us. You can't go wrong buying bonds, just by duration backup to leverage struck. Well, what could go wrong in that story?

David: I'm not really sure what can go wrong unless somehow, out of thin air, we're going to recreate a new inflationary environment. That is certainly not going to be happening in the next year. But if you can dream up a scenario where inflation stages of the miraculous comeback, that would definitely kibosh the bond rally that we've been seeing, over the course of the past, say, four to six weeks. If we get some sudden growth reacceleration, that would also cause yields to back up, certainly would cause these expectations, the Fed rate cuts to come out of the market, but you have to ask yourself the question, what's the catalyst for that? What is the catalyst for a real acceleration of economic growth? I will see it at least for the next year.

Now, we can talk about bond supply and fiscal policy. But the reality is that that's all well known. Everybody knows about bond supply. Everybody knows about the structural deficits. So that's not really a surprise. So we'd have to really get it from what is it that matters most for the Treasury market, economic growth, inflation, and Fed policy. And we have a situation where Fed policy is already extraordinarily tight. The Fed funds rate is almost 300 basis points above the Feds own estimate of neutral and we have a simultaneous contraction in the money supply and bank credit, which I think is inherently deflationary, not just disinflationary. So somehow out of all this, out of contraction and money supply, out of the pullback we're seeing in bank credit, we'd have to somehow see this downward momentum. And it's not just one month, a downward momentum in the trajectory of inflation has been breathtaking. I said before, only four other times, has inflation come down from a peak, not even Paul Volcker saw this. And so those would be the conditions that would cause me to turn bond bearish, a reacceleration and growth, we have to identify what that catalyst is going to be. I just don't see it. It ultimately will come from more stimulative policy, either here or abroad.

And what is going to stop this downward trend? In inflation, when you consider that we haven't even seen the full impact of the rental deflation, the deflation in the multifamily housing market in real time has yet to really translate into the CPI numbers. That's going to be a big story for next year. And a third of the CPI is residential rents, and 40% of the core residential rents. And if you can build me a story that we're going to have declining vacancy rates and a resumption of an upward trend in rental rates, well, that will cause me to go back to the drawing board. That's going to exert a downward pole of significance on headline and core inflation in the coming year. And don't forget that there are important spin offs through the entire cost structure from what's happened with the oil price. Now remember, that when the Saudis extended the output cuts, and then we had the onset of the war in the Middle East, the mantra amongst the oil gurus, I mean, the people that only get paid to forecast the oil price, were telling us we're going to be getting to $100-$120 a barrel. We're at $75 a barrel. I mean, we have, oil is in a bear market. Oil is back at a bear market, it's more than 20% below where it was at the end of September. And that's going to have all sorts of spin off impacts on headline and core inflation for the next several months. And we have to ask ourselves the question, again, this comes down to the economy, and it comes down to demand and then connect the dots to the ELA, for corporate profits. Why is it that oil prices are going down right now? Given the constructive supply? Oh, look, it's because demand, global demand is contracting. I was actually stunned at the latest data that came out for US consumer spending to see that over the past year, volume consumption in the United States of gasoline and motor fuel is down more than 2%, for a nation that has about 140 million drivers. So what does it mean for the economy when people are only filling up their cars with half a tank of gas? What does that tell you about the state of demand? So I'm not surprised at what the bond markets doing. I'm not even, frankly, really surprised by what the stock market's doing, because so much of the stock market is psychological and momentum. And now you've got the Santa year-end rally, and everybody's got FOMO on the brain. So it's not always fundamental. When it comes to the stock market. There's just so much psychology and emotion that's involved. But for the bond market, I can see exactly what's happening. They're responding to what they're seeing in real time, to key aspects of the demand side of the economy.

Erik: Going back to your view on equities, it seems to me the VIX is at a pretty darn low level right now, there's also a pretty significant bullish option skew. So puts are cheap right now. I would think given the view you're describing, if there's a Santa Claus Rally, probably the way to fade that is to be buying puts on the cheap. Would you agree with that? And is that a strategy you're recommending?

David: 100% agree, I mean, the VIX, you know, below 13 is a one in six event and you can see that degree of complacency coinciding with all the survey data right now the investors intelligence, whole investors intelligence, that seems like an oxymoron, but you have now more than two bulls for every bear in the AAII poll, the American Association of Independent of individual investors, the same thing to bulls for every bear. So you got sentiment, is at an extreme low level, the CNN fear greed index is now flirting with extreme greed. In just over a month, it's swung dramatically. But like I said, that's the stock market for you. And you have excessive sentiment and excessive valuations. And right now, downside insurance is dirt cheap. And I would completely agree with you that if you're looking at those pricing output options, they actually look very attractive right now.

Erik: Going back to the oil side, in the data that you follow, is it possible to tune out the growth of electric vehicles so that we could see whether or not this reducing demand for motor fuels is really coming from economic weakness versus potentially just a shift to electric vehicles?

David: Well, that shift is taking place, at really a gradual pace. It's not going to explain electric vehicle, by the way, look, the EV consumption has really disappointed all the bullish projections that were out there. And in recent years, they fallen well short of estimates. But you see, that's really… more you could argue a longer term factor that could suppress the price of oil 100%. It is not an explanation for how, in the span of less than two months, the price has plunged more than 20%. That's not electric vehicles, it cannot possibly have an impact like that over a short period of time.

Erik: Let's turn now to the market impacts of the changing geopolitical situation. Because just a couple of months ago, we had a narrative that kind of went, okay, unconditional support for Ukraine forever until the war is won, that seems to have changed to Zelensky, time to negotiate. we're done supporting you. The Israel/Gaza war that broke out and as you said, had everybody afraid of oil prices going to $150? Well, oil prices have gone the other way. We now see there's been an extension to the ceasefire. Seems like maybe things are starting to calm down a little bit. I was originally thinking that would be a real escalation there as soon as this ceasefire was over, but it seems like they're extending it. So I'm not sure what to make of that. And then there's the question of whether or not a Taiwan invasion from China is still a significant risk on the near horizon. How do you see all of this? And how do you interpret the geopolitical impacts on markets?

David: Well, you know, it's always very difficult to invest around geopolitics. And as we saw, with this move down in oil, because you'll always think the first thing you think about with geopolitical risks, is that a premium gets built in the oil price, especially when it is about the Middle East. That didn't happen this time. So if you turn bullish on oil, because all the experts told you that you should as a geopolitical hedge, that hasn't worked out so well. I can only say that the world is in a trouble place, I guess we could argue it always is. But it is now several deviations away from any norm that we've been accustomed to over the course of the past three decades. You know, the only way that I could see that you really want to play this from your portfolio, is it having exposure to aerospace defense stocks, and cybersecurity and the like. I think that there is going to be a secular bull market globally in defense stocks, because government budgets aimed at bolstering defense expenditures, the military budgets, they're going up around the world, even a former pacifist countries, like Japan, for example, radically bumping up its military budget, and we're seeing that globally. So that I think is an investable theme that transcends the business cycle.

But outside of that, whether or not Israel starts again, and Gaza, which we don't know how that's going to play out, so far, this has just been a few days of the hostage release. But I recommend to the people that are on the call, to not formulate your investment decisions based on geopolitics. It's not really something you can invest around, I would only say and I was saying this before, you know what happened on October 7th was that global military budgets are on the rise. That's where a lot of spending is happening. And that gives this sector earnings visibility. That has nothing to do with whether we go into recession or not. So that's the only real natural play on everything we’re talking about right now. I mean, we've been talking about Taiwan for many years. And we know the threat. We know that the US has a red line when it comes to Taiwan. But I wouldn't be, there's too much, too many other investable themes right now that we can concentrate on with more certainty than to be talking about how do we reallocate our asset mix or our sector orientation because of the geopolitics. I would just say that the natural way to do it, is by making sure that within your equity portfolio, you have exposure to aerospace defense, and maybe not just in the US, although they have the best companies, but globally.

Erik: Are there any other themes you want to mention that you do favor?

David: Well, we talked about earlier about long duration bonds. And that's my highest conviction trade for the coming year. And I would just say that, if we can accept the legendary Bob Farrells rule number one, on market mean reversion as gospel, then what I can offer is that mean reverting things like the super stretched homeowner affordability ratio, housing is more unaffordable in the United States today than it was at the peak of the bubble, back in the mid 2000s. If you mean revert the homeowner affordability ratio, which is a mean reverting series, if you mean revert the razor thin equity risk premium, which is a mean reverting series, if you mean revert the inverted yield curve itself to the norm of the past two decades, you do the math on this. And it will require an ultimate move down in the Fed Funds rates to or below 2%. The 10-year treasury note below 3%. Keeping in mind that I'm not talking about going to some pre COVID situation. Before COVID, the 10-year note was sitting below 2%. But I think that the conditions are there for the 10-year Treasury in the next 12 months to get to 3% or lower. And the long bond would then come down to 3.5% or more than 100 basis points below where we are today. Now if I'm right on this, and here, I'm not even talking about other things like where's inflation going, I'll get into that in a second. But I'm talking about mean reverting critical ratios that are mean reverting series. And every single path is blazed with a return to lower interest rates not to zero, but to much lower than we are today. And if I'm right on what the long bond is going to do, the 30-year treasury bond, because of the price convexity, the total return in the next year is going to be 25%. People don't realize, people say to me all the time, who would want to buy a bond and hold on to it for 10 years or 30 years? Well, I don't know who buys a stock and holds on to it for 10 or 30 years. I mean, the equity market also is a long duration animal but people are buying stocks with a one year view ,three year view, sometimes a one week or one month view. If you have a one year perspective, I think that the chances that, now remember keeping in mind that this will be the third consecutive year where the Treasury market delivered a negative total return, negative total return for three straight years is unheard of. But as Herbert Stein famously said, anything that can't last forever, by definition, it won’t, and the bear market and bonds is not going to last forever. And I would say that for the stock market to match that potential return on the long bond, the S&P would have to finish 2024, north of 5600 or 23 P multiple. And I don't think that's going to happen.

So I think the long bonds is going to be a great place to be. And I even say that after applying a premium for fiscal policy risks, and namely what we all talk about, which is the increasingly structural nature to the deficits and the debts. Even with that, because there's such a strong cyclical component to market interest rates, that I think that the long bonds gets to 3.5, the 10-yr gets a 2.5. And my message here is that all roads are going to lead to a reversal of this bond bear market in the coming year and I think in fairly spectacular fashion. And when I trace out what rents are going to be doing, if you get the rents right, you're going to get the inflation story right, because it's so dominant in the CPI data. We map out how residential rents in the CPI are going to follow what's already happening in real time, because rents in real time have already deflated for months in a row, that gets reflected in the CPI with a lag. And then we're going to trace through what the producer price index is telling us because that leads the CPI. And you have a situation where at the back end of the production curve, and for semi processing goods, the core indices are running negative on a year over year basis. And then we've got attack on what the implications are of this downdraft in oil, which is going to have an enormous impact going forward on transportation costs. So we map all this out. And I think that by this time next year, inflation is going to be somewhere between 0% and 1%. And there's no way that the economy is going to be able to withstand nominal yields this high with inflation that low and the Fed will respond, and it'll be too late as it normally is.

But I think that my strongest conviction call is for the yield curve to resume its more normal shape. That's really at the essence here, is that we've had an inverted yield curve since the summer of 2022. And we only have a yield curve inversion, because it's very abnormal, when you think of the time theory of money, the time value of money, the yield curve is possibly sloped 85% of the time, we are in an abnormal situation, when it comes to something so important as the shape of the yield curve. So how will the yield curve un-invert, mean revert back to its more normal positive shape? Now, it could do it if long term rates were to backup. But as you said earlier, where's this growth reacceleration going to come from? And where is this new upward trend and inflation going to come from? I don't see it. So it either re-steepens to its positive slope led by the back end of the curve, which I think is a low odds bet. Or it will mean revert because of the cycle. And every single Fed tightening cycle, historically, was followed by a pause, followed by an easing cycle. And every easing cycle was then followed by a pause and then followed by tightening cycle, it's just the cycle. And the Fed will cut rates, short term rates will fall much faster than long term interest rates. But because of the convexity and price appreciation, which will dominate the total return in the long bond, just getting down 100 basis points, think of that math, just getting down to 100 basis points and long bond gives you a 25% total return. That's the math people should focus on. And that I think will be the best returning asset class next year. And it's already starting.

Erik: Let's talk about commodities generally, in the month or two, as you said, we've really taken a big hit on crude oil. I noticed Dr. Copper is actually going the other direction. We just retested the 200-day moving average last week. So is there a new bull market in commodities as some people are saying and why is copper at such strong odds with crude oil, if we think the effect that's happening to crude oil is recession driven?

David: Well, I mean, the rebound on copper came after a very significant correction, as you could say, with lumber and a lot of other the commodities that we're looking at. So they got dramatically oversold, and they've snapped back. And I think a lot of it is technical in nature. And a lot of it is short covering in nature. There is nothing happening on the global demand scene that should cause you to be bullish right now on commodities. Now, we know that for many of the commodities, we've gone through many years of a lack of capital investment, we know that there is actually a very strongly supportive supply curve for most commodities. But it's the demand side you can't forecast a price with just one curve. And global demand is weakening. So am I a buyer of commodities? Am I a buyer into this rally that we've seen in some of the base metals, or even lumber? How could you look at the wholesale number that came out October, home sales tanked, you had a big downward revision in September, housing demand in United States is going down. And you've got economies in the UK which are flat. Germany looks headed for economic contraction, which is going to have an impact on the entire EU. Japan just posted a net quarterly GDP reading, we know that the Chinese economy is not performing well at all. And still in a debt morass and the property sector depression that doesn't seem to be bottoming out. And we're past peak growth in the US. And I sense that the fiscal stimulus, which helped extend the cycle is now in the rearview mirror. And all the policy lags from the Fed still haven't played out. And the Fed is going to be slow to cut rates, they shouldn't be cutting them, but they might not cut them until we're well into the spring, or maybe early summer of next year. They will be deliberately late, because they're like the groundhog skirt of a stone shadow, having missed the big inflation from the summer 2022. So I don't see the, you know, unless you're gonna say, well, the US dollar is going to weaken, which it has. And that might be one of the reasons that these commodities have done a little bit better, is that the US dollar is off the boil. And that much is true, and these commodities are priced in US dollars. But I think that we're going into a global recession. And I don't remember in my lifetime or before that, commodities were a place you want to be parking your investments. In the context of a global recession, commodities, when push comes to shove, are a torque on global GDP. And I don't think that's going to be a constructive story for 2024, quite the opposite.

Erik: I hear you on commodities generally, I just want to check in though, because in previous interviews, you said don't give up on gold. Is gold an exception because of its monetary function?

David: Yes, I think that gold has fewer cyclical properties. And also is going to be a natural beneficiary of two things. Because you always have to pay attention to what the correlations are to any specific commodity or any specific equity or asset class. And there's two things that are going to play a role in gold breaking out, and it actually is breaking out, which is declining real interest rates, and a weaker US dollar. And I think that's all you really have to know. And if you take a look at gold this year, in any other currency terms, it's behaving very well. And I would say that even in the period where the US dollar was performing very strongly, the gold price was actually hanging in very well. So I think that, it comes down to the comment before when I said, well, you can't really invest around geopolitics. But gold, generally speaking, is a hedge against uncertainty, period. But I put that number three, I think that moving past the peak in interest rates is very important, because the opportunity cost of holding gold is the coupon that you're going to get in the fixed income market. And so that opportunity cost is now going in the other direction. And it looks as though the bull market in the US dollar is in the rearview mirror. And those are the two reasons why I'm sticking with gold. And actually, it's my second highest conviction trade, which is why the theme for 2024 is going to be the bond bullion barbell, which actually in the past few weeks, belatedly is starting to work very well. And I think that will be a very nice complement to the portfolio, exposure to gold and exposure to long duration, high quality bonds.

Erik: The one other commodity that I say that seems exceptional, at least in terms of what the price charts are doing is uranium, what's going on there? Is it telling us that there's going to be a full on renaissance in nuclear energy?

David: Well, you know, I've heard that for so long, I'd like to believe it. And I think that it should be playing a part in the clean energy revolution. Of course, there's always going to be political posturing against uranium. But I do think, if you asked me, is uranium in a secular bull market, I think that it is and I wouldn't be recommending exposure there as well.

Erik: Well, David, I can't thank you enough for a terrific interview. But before I let you go, I want to talk about not just the Breakfast with David newsletter, which you're very, very famous for, for I don't know how many decades now. But also, you used to be working under other asset managers, you founded your own firm, which takes you out of that pressure to always be bullish. Tell us a little bit more about the other services that you've added at Rosenberg Research. And also, in past interviews, you've given our listeners a deal on the newsletter. If that's available, we'd sure appreciate that as well.

David: Absolutely. So anybody who's on the call will get a 30 day free trial for everything we do. And, you know, we produce daily research weekly, monthly. And Breakfast with Dave is the flagship that really contains everything that you need to know, to get through your day, every single day. So it provides you with information. And it provides you with analysis. And it's a combination of small picture and big picture. And it takes the economics and weaves it into investment advice every single day. On top of that, we do special reports. So we'll write on a lot of things. We're talking about sector shifts in inflation, interest rates, countries, China, India, Mexico, and we also touch on what's happening on industry. So it's not just about stocks, bonds, or cash, and where do I invest around the yield curve, what are your favorite sectors, but we really dig deep in our special reports into what is lying around the band, and much of what we're thinking about in the next three, five and 10 years.

So we cover the nitty gritty and get into the weeds, but we also look at the world from 10,000 feet up in the air. And I would say that for investors, in particular, we publish a monthly asset allocation document called The Strategizer, where we actually have recommendations and scorecards on every stock market on the planet, we drill down with a sector level. It's got a bond duration model, how you should be investing around corporate credit. It has a commodity model and an FX model. And we rolled it all into a dynamic asset mix recommendation that we update every single month. So that's called The Strategizer. And I would say actually, although I've been doing Breakfast with Dave, since 1998, The Strategizer, I started Rosenberg Research in early 2020. That is basically caught up ,I would say that that's tied, is the flagship right now is the monthly Strategizer. And the next one for December is going to be coming out just the next several days. So yeah, absolutely. And we also do our own periodic webcast. We do a couple of those a month. So the other thing I would just mention is that for people that are clients of mine, they get access to me. So we have an Information box, I probably spend 20% of my day, answering client questions on everything, as arcane as shifts in parts of the Fed balance sheet, to what's happening in China. To my view on the US dollar and gold and everything we're talking about right now. I spend 20% of my day getting back to my clients on their questions. So that's an additional service that we offer.

Erik: Well, folks, you can't go wrong with a 30 day free trial. You'll find a link in your research roundup email in order to take advantage of that. Patrick Ceresna, Nick Galarnyk and I will be back as MacroVoices continues right here at macrovoices.com.