David Rosenberg Says the Bulls Are in Fantasyland

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by Dorothy Hinchcliff

This article is based on a presentation from John Mauldin's 2020 Virtual Strategic Investment Conference, which is being held from May 11 to 21. To register for this conference, click here. The Strategic Investment Conference was just approved by CIMA and CFP for 14 hours of continuing education credits.

David Rosenberg bluntly told attendees Monday at John Mauldin's Virtual Strategic Investment Conference 2020 that the stock rallies in recent weeks ignore reality and don't recognize that the United States is likely entering a depression, facing double-digit unemployment for at least three years, secular changes in consumer spending and saving, and deflation followed by stagflation.

"Right now I would classify the equity market as exhibiting a level of hubris that is as amusing as it is disconcerting," said the Toronto-based Rosenberg, who in January started his own economic consulting firm, Rosenberg Research & Associates, after working a decade as chief economist and strategist at Gluskin Sheff & Associates.

We are in "The Great Repression," and the downside risks brought on by the COVID-19 pandemic are not being factored in by a lot of people, he said. "Seriously, fully 80% of the stock market rally since the end of March has taken place on the days of the seven-worst readings on initial jobless claims of all time," Rosenberg noted. "It's surreal that we got that huge rally on Friday following the payroll figure."

The U.S. Labor Department reported Friday, May 8, that 20.5 million nonfarm payroll jobs were lost in April, catapulting unemployment to 14.7%. But Rosenberg maintained the loss was actually 27 million jobs. "When you account for the big drop in the participation rate and the errors that people made in classifying themselves erroneously that they're still employed when they're actually not, the real unemployment rate is currently over 20%, as if the reported 14.7% rate isn't horrific enough. … We're likely going to see another five to 10 million jobs lost in May, and the unemployment rate will probably test 30%, which we last saw in 1933."

Real GDP may drop at a 50% annual rate in the second quarter, he told listeners. "Like I said, the hole we have to dig out from is just getting bigger, and the economic math is daunting, because to recoup a 50% plunge in GDP means it has to then surge 100% to make up for that deep loss."

It's also possible a "fiscal cliff" will be created when the government ends the income replacement programs currently helping laid-off workers and small businesses, he continued. "Keep in mind that this is no FDR New Deal stimulus, when we built the Golden Gate Bridge, the Hoover Dam, the Lincoln Tunnel, and Route 66. This is not fiscal stimulus with any future multiplier impact or payback; it's simply government-assisted life support."

Rosenberg reeled off statistic after statistic that he used to illustrate how pundits are seriously underestimating the permanent economic damage in the United States that's already been done. Other examples: The labor force participation rate dropped from 62.7% in March to 60.2% in April, which is the lowest it's been since February 1972; and the total number of employed people who didn't even bother to get classified as unemployed, but just actually vacated the labor force altogether, skyrocketed by 3.6 million.

"The problem I have is that it's pure fantasy to think that normalized earnings are not going to be seriously dented by the likely permanent loss of some 10 million workers in the future from what the baseline was prior to the crisis, which means lost labor income of roughly $1 trillion. Since it is an economy where 70% of GDP is derived from consumer spending, I just have a really tough time wrapping my head around the concept that the long-term trend line for corporate profits is miraculously going to be left unscathed," Rosenberg said.

He added his firm's research shows "the adjusted normalized P/E multiple currently sits at 20, residing in the top 10% evaluation extremes of all time. So, far too rich for my taste."

Current low interest rates are foreshadowing a prolonged deflationary output gap, which is bad for profit margins, Rosenberg said. The end of the recession, or depression, brought on by COVID-19 is completely contingent on an effective vaccine or treatment being developed, which could take months or even years.

An economic recovery is definitely not contingent on reopening the economy, he emphasized, because that won't guarantee demand. People are still going to be afraid to get on planes and go out to eat. "As it stands, the U.S. Chamber of Commerce said that 25% of small businesses have already shut down and 40% have enough working capital on hand to last another two weeks, and that's it. The AARP reports that 53% of American households have no emergency savings, so I don't think they're heading on a cyclical spending spree anytime soon."

Rosenberg stressed it will not be business as usual, as the bulls will try to convince people, and the best the U.S. can hope for any time soon is a partial recovery.

"So even as the stock market is telling you that it is all figured out, I can assure you, what we face at this very moment is a highly uncertain economic future, and unfortunately, most of the longer-term risks are to the downside, not the upside. We are in a depression, not a recession. It's a depression. I didn't say the Great Depression; it's a depression," Rosenberg stressed. "And I think the dynamics of a depression are different than they are in a recession, because depressions invoke a secular change in behavior. Classic business cycle recessions are forgotten about within a year after they end. At a minimum, depressions entail a prolonged period of weak economic growth, widespread excess capacity, deflationary pressure and a wave of bankruptcies.

"Asset markets, as I see them, still don't reflect the economic depression. This sort of V-shaped revenue recovery, which I think you can tell, I believe is nothing more than pure fantasy. The best-case outcome is an L-shaped or I would say a backward J-shape recovery, and I repeat, that is the best-case scenario. That's what I would call a slow, jobless recovery, and only made possible by continued and constant support from gaping fiscal deficits and Fed liquidity, and I don't believe that a 20-multiple unnormalized earnings, based on my calculations, can be sustained in that unstable future."

Rosenberg expects a retesting of the lows in the stock market. When looking at all the possible outcomes, the absolute best-case scenario would be a post-lockdown bounce that ends the deepest part of a recession, and the best case after that would be a painfully, slow recovery.

The 2.5% productivity decline in the first quarter announced last week received scant media attention, he said. "I would say consider that to be the thin edge of the wedge. Then think of a future with massive public deficits, debts, government intervention and regulation, and a world of reduced globalization and more localized supply chains, and an end to just-in time inventories."

He added it's "crystal clear" that rescue packages will be paid for not by labor but by capital, bringing higher tax rates on capital gains and corporate income. "The current surge in the deficit is not about shovels in the ground with some hope of future multiplier effects on the economy," he said. "It is simply a transfer from some future taxpayer to today's households and businesses, who are out of work and for some reason had no cash, no savings no liquidity to even get through even a few months of shutdown for public health and safety purposes. That says a lot right there."

He added increased taxes financed the spending that helped the U.S. get out of the Great Depression in the 1930s. The corporate income tax from 1929 to 1939 rose from 11% to 19%, capital gains tax rates went up from 12.5% to 22.5% and personal income tax rates jumped from 24% to 62%, Rosenberg said.

"Think about this too. FDR, despite whatever you want to think about him from a fiscal policy standpoint, or anything else: He never ran a fiscal deficit greater than 7.5% of GDP during the Great Depression, and we are at least going to double that today. By 1938, five years after the New Deal was unveiled, the federal government was back in fiscal balance. The government debt-to-GDP ratio peaked that year in 1938, at 43%, half of what it is today. Why? because taxes actually back then were not a dirty five-letter word. There was a concept known among the upper classes called shared sacrifice. And there was productivity and revenue payback from that stimulus, as opposed to today's income transfer."

Many economists believe that the surge in the personal saving rate from 8% in February of this year to 13% in March represents some powder for future spending, but Rosenberg sees such saving rates as the "new normal."

"According to President Trump," Rosenberg said "we apparently had the greatest jobs boom of all time. And indeed, we went into this crisis with a 50-year low unemployment rate of 3.5%, and even with that, half of the household sector didn't even have enough liquidity to make it through three months, if God forbid, they lost their job. Well, you can kiss that mentality goodbye. So even if the rose-colored glass crowd is right and recovery starts in earnest with no relapse by the third quarter, we can't ignore the secular changes that are coming our way: changes to how people approach their cash positions, their spending and their balance sheets."

A San Francisco Fed report that was recently published looked at the longer-run economic consequences of 15 pandemics from the 14th century on. The major finding shows a secular shift toward greater precautionary savings and a decline in investment demand, exerting a lasting downward impact on interest rates, and that's why negative bond yields can't be ruled out, says Rosenberg. The report concluded that following a pandemic, the natural rate of interest declines for decades, reaching its nadir about 20 years later, he said.

Rosenberg noted some investments that may be good bets, given the profound influences from the COVID-19 pandemic on the way we live and how we conduct ourselves in our personal and commercial lives. "For example, working from home is certainly going to be a more dominant force, with obvious negative implications for commercial real estate, but positive implications for internet infrastructure, hardware and video conferencing," he said. "There's going to be a sharp reduction in travel to work, travel in general, that means fewer cars on the road, so all the ESG reasons to avoid energy before will now be accentuated. And nothing here is very good news for the auto sector, not to mention office REITs. But they're going to be bullish themes that emerge from this too, as I've outlined. We're going into an era of elevated personal savings rates where people are going to focus on what they need, not what they want."

Another theme that might benefit investors is to focus on stable dividends. Rosenberg expects dividends to become scarce and a reliable payout growth will be more important than dividend yield.

One of Rosenberg's key investment themes is to invest in physical gold, which he says is a very good hedge against the instability that would be brought on by the extremes of deflation and inflation. "If there is deflation and interest rates remain low or go negative, the opportunity cost of holding gold is nil. Then if there's inflation, gold will do well as a store of value."

He argued a strong case can be made over three or five years that stagflation will emerge as a secular theme coming from the pandemic crisis, once demand stabilizes. "Which means dusting off the 1970s playbook might not be a bad thing to thing to at least to start to think about. Either way, physical gold comes out a winner."

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