The New York Times

SundayBusiness

SUNDAY, APRIL 17, 2011

STRATEGIES

The Wall of Worry Has Never Looked So High

By JEFF SOMMER

THE stock market has been climbing a wall of worry — that's an old Wall Street adage, and it has certainly rung true lately. Calamities abound and there have been setbacks, but the market has been climbing anyway.

Richard Bernstein, who was chief investment strategist for Merrill Lynch until April 2009, says he's never seen anything quite like it. "This cycle is the biggest wall of worry I have ever seen or will ever see in my entire career," he said last week, in the offices of the investment advisory firm he now runs in Manhattan.

The stock market's 80 percent rise since March 2009 has been one of the greatest bull runs in history, he says, and while the American economy has its problems, it is clearly strengthening and corporate profits are rising. Yet anxiety about the American market is profound, he says, and many investors have been avoiding American stocks, pouring money into emerging market stocks and bonds instead. That makes no sense to Mr. Bernstein, a longtime bear who turned resolutely bullish in July 2009.

"It seems no one wants to believe in the stock market in the United States," he said. "People don't accept that the American economy may actually be strengthening. And they go for emerging markets, which are wildly overpriced. What in the world is going on here?"

Even now, he says, many American investors are disillusioned. There has been too much pain from the financial crisis, a severe bear market and lingering recession. Traders are unusually skittish, and, as I wrote recently, markets globally have become increasingly synchronized and volatile, with "risk on, risk off" trades overwhelming all other approaches.

Investors are certainly nervous. But is this a very steep wall of worry — a classic barrier that will be surmounted as the bull market continues? Or is it something else — a vast universe of pain that will only get worse as a bear market takes hold? David A. Rosenberg, formerly chief economist at Merrill Lynch, takes the bleaker view.

Budget cuts and an end to quantitative easing threaten a recovery.

Now based in Toronto with Gluskin, Sheff, he agrees that equities in many emerging markets are overpriced. Still ferociously bearish, Mr. Rosenberg parts with his erstwhile colleague in much of the rest of his analysis. "I have great respect for Rich Bernstein, and I tip my hat to him for making that early bullish call," Mr. Rosenberg said. "But I think that people who are still bullish right now will be in for a very big surprise."

In a telephone conversation on Wednesday evening, Mr. Rosenberg said that the boom in the American stock market was largely caused by the "radically" expansionary monetary policy of the Federal Reserve. The Fed's current program of "quantitative easing" — its second bout of purchases of Treasuries and other securities, known as QE2 — is scheduled to end in June.

"There's no political support" for an extension, he said, but if the Fed ends its asset purchases, "it will be a very big deal — a bad one — for the equity markets." Furthermore, budget cutting at the state and local level is sucking air out of the economy, and that's likely to be accompanied by federal budget cuts, he said, with Republicans in Congress vying with President Obama to reverse the explosive growth in government debt over the last several years.

Mr. Rosenberg ticks off other "pernicious headwinds," including geopolitical risk in the Middle East and North Africa, "acute risk of sovereign debt default" in Europe, surging oil and food prices, the battered housing market and a very tepid economic recovery "that has needed to be propped up by the Fed. "

While Mr. Rosenberg's relentless bearishness is a minority view, many economists and strategists on Wall Street agree with aspects of it. A survey by Blue Chip Economic Indicators issued on April 10 found that economists on average had downgraded their estimates for real G.D.P. growth in the United States in 2011 to 2.9 percent, down from 3.1 percent only one month earlier. At the moment, they project growth of 3.2 percent for 2012. These are low numbers for an economy rebounding from a recession.

On the other hand, the consensus among Wall Street strategists is bullish: the Standard & Poor's 500-stock index will approach 1,500 within 12 months, according to a Bloomberg News analysis of price estimates for the index's underlying components. That would be about a 14 percent increase over its current level.

Corporate profits are buttressing these projections. The earnings season for the first quarter began last week, and Michael Thompson, an S.& P. managing director, says it will probably be the sixth consecutive quarter of double-digit earnings growth for S.& P. 500 companies. Wall Street analysts expect a 12.2 percent increase over the same quarter in 2010, according to S.& P.'s Capital IQ unit. Mr. Thompson said he was "guardedly optimistic," despite rising energy prices.

The richer price of oil over the last several months — it has declined a bit since April 8 — has actually had a positive effect on corporate earnings so far, said Kevin Gardiner, head of global investment strategy for Barclays Wealth. That's because energy companies, which have profited from the increase, account for a large share of major stock market indexes, while heavy users of energy are relatively small components.

Of course, if energy prices were to seriously crimp consumer spending — and derail the economic recovery — the implications would be very serious, Mr. Thompson said, but that isn't happening so far. In fact, he said, "consumer spending is actually very strong." Despite high unemployment in the United States, consumer discretionary companies are doing quite well, suggesting that spending by individuals is helping to propel a "self-sustaining" recovery, he said.

FOR his part, Mr. Bernstein readily concedes that on an "absolute" basis, the picture is hardly perfect, but he says the critical question for the markets is whether the trend is positive or negative. He's convinced that prospects for American companies are quite bright, and expects that investors will grudgingly climb that wall of worry, moving the markets higher. He advises embracing risk in the American market in a big way. For a global mutual fund he runs for Eaton Vance, he is placing large bets on small-cap growth stocks in the United States.

"They'll give you the best return when the market is going up," he said. "And I think it's going to go up."