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A Mid-Year Bull vs. Bear Investing Smackdown

By **GREGORY ZUCKERMAN**

Investors are dazed and more than a bit confused. The first week of July was the best week for stocks this year; the previous week was the second worst of 2010. Bears and bulls are torn about the direction of earnings and the global economy, the health of consumers and how attractive stocks are.

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To get a better understanding of where the market is headed and what investors should look out for, we called on two thoughtful investors, David Rosenberg, chief economist and strategist at Gluskin Sheff & Associates, a noted bear, and James Paulsen, chief investment strategist at Wells Capital Management, a leader of the bull camp.

Q: Where is the market headed the rest of this year and over the next 12 to 18 months?

PAULSEN (the Bull): Investor optimism, which got ahead of itself in early spring, has been checked, considerable liquid asset holdings are on the sidelines and concerns about a potential double-dip recession seem overblown. Recently the dividend yield on the Dow Jones Industrial Average rose above the 10-year Treasury-bond yield for

the first time in decades, and the price/earnings multiple on year-end estimates has declined to about 13.

With interest rates and oil prices down, earnings still rising and policy officials showing no inclination of taking the punch bowl, the upside potential for stocks is encouraging.

ROSENBERG (the Bear): The market is not cheap. By the end of secular bear markets, stocks trade no higher than P/E multiples of 10 and at least a 5% dividend yield. We very likely have quite a long way to go on the downside.

The market moves in cycles -- 16- to 18-year cycles, in fact. This secular down-phase began in 2000. The best we can say is that we are probably 60% of the way into it. In a secular bear market, rallies are to be rented, not owned. We're in a primary bear market, not unlike what we endured from 1966 to 1982. Back then, the principal cause was inflation; this time, it's deflationary debt deleveraging.

Within the next 12 to 18 months, I can see the Standard & Poor's 500-stock index breaking back below 900 [it's currently at almost 1100]. A substantial test of the March 2009 lows cannot be ruled out.

Q: What should investors keep an eye on?

PAULSEN: The job market will likely determine conditions in the stock market during the balance of this year. Either job growth will soon accelerate or concerns about a double-dip recession or a crawling recovery will overwhelm stocks.

ROSENBERG: The economic recovery phase is behind us. The boost to growth from the inventory bounce has run its course and the stimulative effects of fiscal policy will diminish amid a public backlash against increases in government debt. That constrains the government's ability to try to fine-tune the economy.

Even if we manage to avert a double-dip recession, the chances of a growth relapse in the second half of the year are higher than the equity market assumes. The U.S. unemployment rate will stay near double-digit terrain, and inflation and interest rates will remain low.

A market priced for peak earnings in 2011 could be in for some pretty big disappointment. We'll see that with guidance from companies when second-quarter results stream out in the next few weeks.

Q: What should investors do with their portfolios?

PAULSEN: We recommend sectors most sensitive to the economic cycle, such as junk bonds and energy, materials, technology and financial shares, which have been left for dead. Now that China is done tightening, the emerging-market story may regain prominence. Cash offering zero returns (with today's ultra-low interest rates) and relatively "risk-free" 10-year Treasury bonds at a 3% yield don't offer much. Defensive economic sectors like health care are relatively overvalued. We like small-cap stocks and industrial stocks longer term, but both also seem a bit overvalued.

ROSENBERG: My primary theme has been SIRP -- "safety and income at a reasonable price." Yield works in a deleveraging deflationary cycle. The median age

of the boomer population is almost 55, there is very strong demographic demand for income and with bonds comprising just 6% of the household asset mix. So appetite for yield will expand.

Within the equity market, squeeze as much income out of a portfolio as possible -- a reliance on reliable dividend yield and dividend growth makes perfect sense. Gold makes up a mere 0.05% of global household net worth, so small incremental allocations into bullion or gold-type investments can exert a dramatic impact. And central banks, selling during the higher interest rate times of the 1980s and 1990s, now are reallocating their reserves toward gold, especially in Asia.

Q: What makes you most enthused about the investing environment?

PAULSEN: If 2000 was the era of "irrational exuberance," today must be the era of "irrational pessimism." Too many are too pessimistic and are greatly underappreciating potential investment returns.

ROSENBERG: We are entering into a period of stable consumer prices that should last at least for a generation. This will help prevent erosion in real household incomes.

Q: What could happen that would turn you into a bear/bull?

PAULSEN: I could become a bear again if the massive policy stimulus introduced during this crisis prove too highly inflationary. That could raise bond yields, force more extreme Fed tightening and lead to a collapse in stock P/E multiples.

ROSENBERG: Signs that the debt deleveraging cycle has run its course. A new "killer app" or major technological breakthrough. A sustained decline in oil. Structural economic reforms in the world's "surplus saving" countries like China, India and Germany that stimulate their domestic consumer spending. Progress toward working our way though the repair process of the balance sheets of domestic households and businesses.

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