Meet the affable bear who expects the S&P to tumble to 20-year lows

By **Sue Chang**
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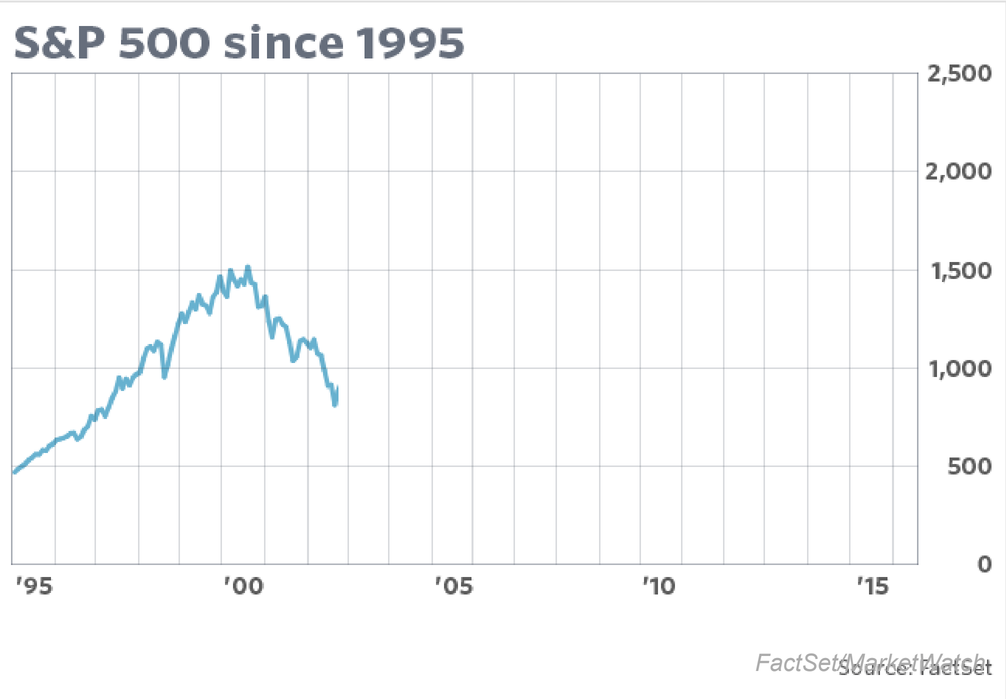
'The longer central banks interfere, the worse the crash'

If you're buying stocks today, says noted permabear Albert Edwards, you need a psychiatric evaluation.

Edwards, global strategist at Société Générale **GLE, -0.16%** told MarketWatch in an early September interview that the stock market, bolstered by easy money, has valuations at "nosebleed" levels even as labor costs are rising and corporate profits are falling. That, he says, points toward a U.S. economy on the brink of recession — and an S&P 500 **SPX, +0.53%** set to plummet to 550, a level not seen in more than two decades, in response.



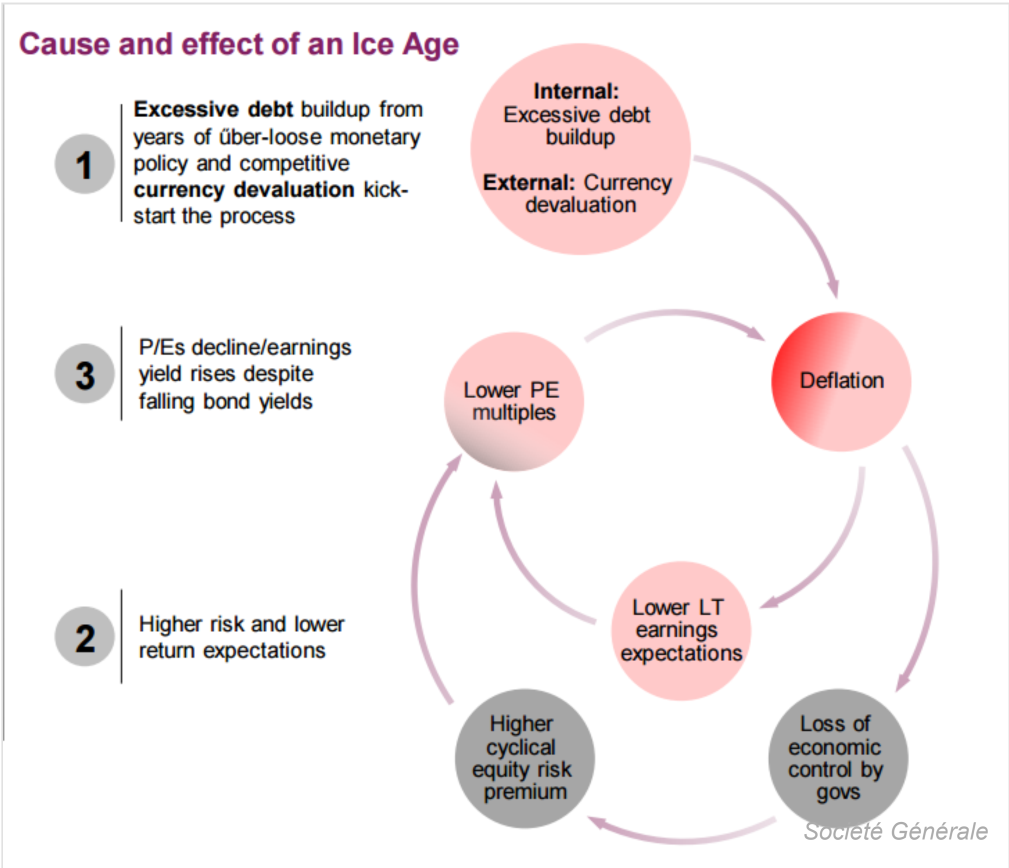
FactSet/MarketWatch

> *“I want to come out into the light. I want to turn bullish.”*
>
> Albert Edwards, global strategist at Société Générale

At the core of his forecast is the belief that the economy goes in cycles — or, as he says, that “recessions come along with regular monotony.”

“This is the weakest recovery on record in the U.S.,” said Edwards, who is based in London. “Everything you expect to see at the end of an [economic] cycle is apparent.”

Edwards is known for his 1996 “Ice Age” thesis, in which he envisioned a world going to hell in a deflationary handbasket as inflation becomes elusive and growth sputters. In other words, price-to-earnings ratios will fall as governments lose the ability to control economic cycles and developed countries lose the fight against deflation.



The theory underpins his argument that if the Federal Reserve raises interest rates, a deep recession in the U.S. will result, dragging the rest of the world over the cliff. Edwards believes that investors flocking to U.S. stocks will be devastated in a market correction — a stark contrast to the general consensus that they currently offer investors the best bang for their buck.

“It is madness, what we are seeing,” said Edwards. The coming crash, he said, “will be horrific compared with what we’ve seen so far.”

Being a bear ‘isn't a pleasant place’

While Edwards' projections are dire, he comes across as an affable man who tries not to take himself too seriously. He prefers sandals to designer suits and shoes, and he often peppers his reports with self-deprecating jokes, personal photos, and humorous anecdotes. In a 2009 analysis, he used his own vasectomy to express the pain he anticipated for investors.

"I suppose I should have been a bit more vocal when I was asked if a trainee doctor could perform the procedure — albeit supervised by the head of the clinic," he wrote. "But I felt in safe hands and nodded. What could go wrong? Well, about two minutes into the procedure I realized maybe quite a bit [could go wrong]. I can still hear the words of clinic boss to the trainee — 'Oh dear, I wouldn't have made that cut there, if I was you!'"

Edwards said he received more feedback from male readers on that note than any other he has published.

Société Générale

His cachet as a strategist has grown during his four decades in the industry, a journey that took him from the Bank of England to the pinnacle of beardom. The conferences he hosts each January, which have come to be known as "bearfests," attract hundreds.

But Edwards — and his downcast outlook for markets — has his detractors. "I've observed some very lively comments about my parentage in the comments sections of articles [about me]," he said. Being a bear, he said in June, is "not a pleasant place. People either don't speak to you or send you abusive emails."

His statements have at times landed him in hot water. Two decades ago he was banned from Malaysia for referring to then-Prime Minister Mahathir Mohamad's policies as "Noddynomics," a reference to a wooden puppet from Enid Blyton's children's books whose naiveté lands him in trouble.

Less than a year after that statement, the Asian financial crisis swept through the region. Malaysia saw its currency, the ringgit **USDMYR, +0.1162%** come under attack from speculators as its gross domestic product shrank 28% in one year to $72.18 billion in 1998, according to International Monetary Fund data. The Malaysian Embassy to the U.S. didn't respond to requests for comment.

Edwards, meanwhile, stands by his prophecies. He notes that equities have underperformed 10-year government bonds on a relative basis since the unveiling of the Ice Age.

“The only way a critic could say the Ice Age hasn't panned out is that the S&P has been flirting with all-time highs recently, whereas I have been a longstanding bear of equities,” he said in an email. “Bonds have done what I said in absolute terms and the Western economies have been more like Japan than anyone else predicted [with regard to] flirting with outright deflation. No one else was even contemplating these events 20 years ago.”

While he says he has always favored bonds over stocks, he says that conviction has further crystallized recently, leading him to suggest that he may “rethink” the Ice Age strategy. “I was not bullish enough on bonds,” he said.

“In the next recession, I expect U.S. 10-year [yield] to converge with Japan and European 10-year [yields] at around minus 1%.” The U.S. 10-year Treasury **TMUBMUSD10Y, -1.67%** was yielding 1.686%, while 10-year eurozone bonds were yielding 0.010% as of early Monday.

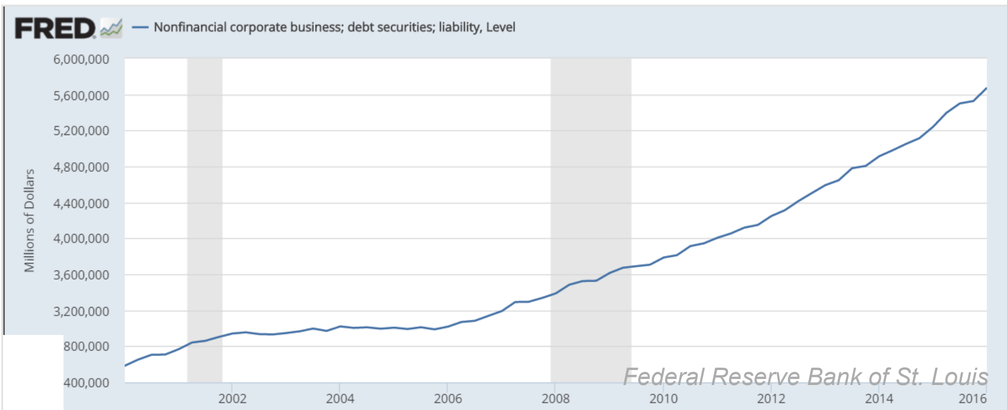
‘The longer central banks interfere, the worse the crash’

Today, Edwards reserves his scorn for central bankers, whom he blames for the precarious state of the economy and the markets. A big chunk of the bonds being offered in Europe and Japan are yielding less than zero as policy makers struggle to keep their economies on life support.

“Central banks can never prevent a recession,” Edwards told MarketWatch. “They can just delay it. The longer central banks interfere, the worse the crash.”

In the U.S., the Fed has pumped trillions into the markets via quantitative easing to stimulate the economy in the aftermath of the 2008 financial crisis. But that has only served to create another massive credit bubble — this time in the corporate sector.

Total corporate debt ballooned to $5.7 trillion in the first quarter of this year from $3.5 trillion in late 2008 when the Fed launched QE, St. Louis Fed data show.



As liabilities swell, Edwards says, investors will grow increasingly complacent that authorities will kick the can down the road — that is, until the Fed’s excesses come back to haunt them and the whole system implodes.

“The U.S. is one recession away from deflation,” said Edwards. “There is a grotesque amount of debt piled on the corporate sector, and when the chickens come home to roost, there will be massive bankruptcies.”

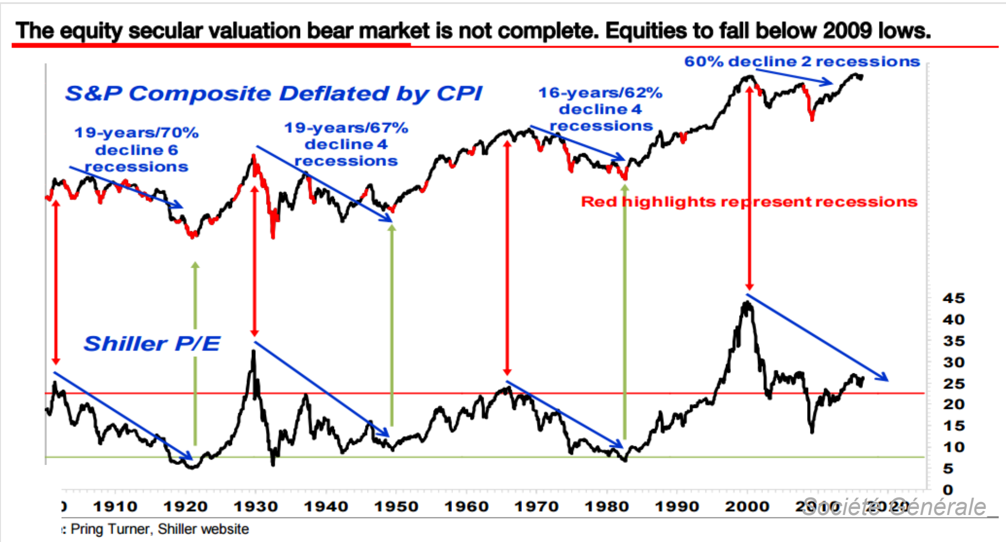
Edwards believes the chaos and subsequent collapse in asset prices will force policy makers to adopt negative interest rates in the U.S. and deploy helicopter money, pushing the Fed-funds rate — the rate at which banks lend to each other — to minus 3%. It is currently at 0.40%.

His predictions can appear counterintuitive at a time when U.S. stocks have recently scaled record highs and the Fed prepares to raise interest rates. But those indicators of relative economic health are a mirage, he believes.

The U.S. and China are both vulnerable

Edwards argues that the U.S. stock market has been stuck in a secular bear market — a long-term trend that typically ends when cyclically-adjusted valuation measures hit bottom — since March 2009, when the S&P 500 was trading at 666. The multiple he cites, the Shiller P/E ratio, bottomed out at 13.3 times in March 2009, well above the 7 times multiple consistent with a bear market.

As he illustrates in the chart below, the three previous U.S. bear markets took a minimum of four recessions to play out. “We have only suffered two since the peak of the bubble in 2000,” he said.



Edwards expects valuations to crash from their current 26 times multiple. For this market to work off its current bloat, he says, the Shiller P/E needs to correct to a 7 times multiple, which would require a 75% plunge in the S&P 500 to 550.

It isn’t just the U.S. that is vulnerable, according to Edwards. China, the world’s second-largest economy, is on a similarly precarious footing.

Growth in China faltered recently in line with slower global growth. The authorities have responded by weakening the yuan **USDCNY, +0.0810%** and pumping enormous amount of liquidity into the economy—prompting fears that China’s debt-fueled expansion is untenable.

“China is the Sword of Damocles hanging over us all,” he said, who warned that the bursting of China’s credit bubble will make the U.S. subprime crisis look like a “tea party.”

Read: SocGen claims China is only months away from burning through its currency reserves

Prominent market watchers are divided on China’s future. Andy Xie, an independent economist based in Shanghai, recently told MarketWatch that the country “is riding a tiger and is terrified of a crash. So it keeps pumping cash into the economy. It is difficult to see how China can avoid a crisis.”

Others, including Templeton Emerging Markets Group executive chairman, Mark Mobius, believe China’s current woes are emblematic of the painful process the country must go through as it becomes a more mature economy.

Albert Edwards /Mrs. Albert Edwards

Edwards included this photo in his September 2012 report to illustrate that the equity market will soon take a “bath.”

November will mark 20 years since Edwards put forth his bearish vision of the financial world. He believes the end of the Ice Age is near and he plans to make another — more upbeat — call when the recession ends.

“Nothing will give me more pleasure than to see this over,” he said. “I want to come out into the light. I want to turn bullish.”