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Pavlov's Bulls

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About 100 years ago, the Russian physiologist Ivan Pavlov noticed that when the feeding bell was rung, his dogs would salivate before they saw the actual food. They had been “conditioned.” And so it was with “The Great Stimulus” of 2008-09. The market’s players salivated long before they could see actual results. And the market roared up as it usually does. That was the main meal. But the tea-time bell for entering Year 3 of the Presidential Cycle was struck on October 1. Since 1964, “routine” Year 3 stimulus has helped drive the S&P up a remarkable 23% above any inflation. And this time, the tea has been spiced with QE2. Moral hazard was seen to be alive and well, and the dogs were raring to go. The market came out of its starting gate like a greyhound, and has already surged 13% (by January 12), leaving the average Year 3 in easy reach (+9%). The speculative stocks, as usual, were even better, with the Russell 2000 leaping almost 19%. We have all been well-trained market dogs, salivating on cue and behaving exactly as we are expected to. So much for free will!

Recent Predictions ...

From time to time, it is our practice to take a look at our predictive hits and misses in an important market phase. I’ll try to keep it brief: how did our prognostication skill stand up to Pavlov’s bulls? Well, to be blunt, brilliantly on general principle; we foretold its broad outline in my 1Q 2009 *Letter*¹ and warned repeatedly of the probable strength of Year 3. But we were quite disappointing in detail.

The Good News ...

For someone who has been mostly bearish for the last 20 years (of admittedly generally overpriced markets), I got this rally more or less right at the macro level. In my 1Q 2009 *Letter*, I wrote, “I am parting company with many of my bearish allies for a while ... we could easily get a prodigious response to the greatest monetary and fiscal stimulus by far in U.S. history ... we are likely to have a remarkable stock rally, far in excess of anything justified by either long-term or short-term economic fundamentals ... [to] way beyond fair value [then 880] to the 1000-1100 level or so before the end of the year.” As a consequence, in traditional balanced accounts, we moved from an all-time low of 38% in global equities in October 2008 to 62% in March 2009. (If only that had been 72%, though, as, in hindsight, it probably should have been.) In the same *Letter*, I said of the economy, “The current stimulus is so extensive globally that surely it will kick up the economies of at least some of the larger countries, including the U.S. and China, by late this year ...”

On one part of the fundamentals we were, in contrast, completely wrong. On the topic of potential problems, I wrote, “Not the least of these will be downward pressure on profit margins that for 20 years had benefited from rising asset prices sneaking through into margins.” Why I was so wrong, I cannot say, because I still don’t understand how the U.S. could have massive numbers of unused labor and industrial capacity yet still have peak profit margins. This has never happened before. In fact, before Greenspan, there was a powerful positive correlation between profit margins and capacity in the expected direction. It is one of the reasons that we in asset allocation strongly suspect the bedrock on which these fat profits rest. We still expect margins to regress to more normal levels.

¹ “The Last Hurrah and Seven Lean Years,” 1Q 2009 *Quarterly Letter*.

On the topic of resource prices, my long-term view was, and still is, very positive. Not that I don't expect occasional vicious setbacks – that is the nature of the beast. I wrote in my 2Q 2009 *Letter*, “We are simply running out of everything at a dangerous rate ... We must prepare ourselves for waves of higher resource prices and periods of shortages unlike anything we have faced outside of wartime conditions.”

In homage to the Fed's remarkable powers to move the market, I argued in successive quarters that the market's “line of least resistance” was up – to the 1500 range on the S&P by October 2011. That outlook held if the market and economy could survive smaller possibilities of double-dips. On fundamentals, I still believe that the economies of the developed world will settle down to growth rates that are adequate, but lower than in the past, and that we are pecking our way through my “Seven Lean Years.” We face a triple threat in this regard: 1) the loss of wealth from housing, commercial real estate, and still, to some extent, the stock market, which stranded debt and resulted in a negative wealth effect; 2) the slowing growth rate of the working-age population; and 3) increasing commodity prices and periods of scarcity, to which weather extremes will contribute. To judge the accuracy of this forecast will take a while, but it is clear from the early phases that this is the worst-ever recovery from a major economic downturn, especially in terms of job creation.

And the Bad News ...

We pointed out that quality stocks – the great franchise companies – were the cheapest stock group. Cheapness in any given year is often a frail reed to lean upon, and so it was in 2009 and again last year, resulting in about as bad a pasting for high quality as it has ever had. We have already confessed a few times to the crime of not being more open to the beauties of riskier stocks in a Fed-driven market. And in the name of value, we underperformed. Reviewing this experience, we feel that it would have been reasonable to have shifted to at least an increased percentage of risky investments after March 2009, because some of them, notably emerging market equities, did have estimates almost as high as quality. In fact, some were well within the range of our normal estimating error, although, of course, quality stocks were not only the least expensive, they were also the least risky, often a formidable combination. But even if we had made such a move at the lows, more extreme value discrepancies by early 2010 would have compelled us to move back to our present position – heavily overweight quality stocks – that we have carried for several years. Our sustained heavy overweight in quality stocks in 2009 was painful, intellectually and otherwise. Our pain in 2010 was more “business as usual,” waiting for the virtues of value to be revealed. The saving grace is that, although value is a weak force in any single year, it becomes a monster over several years. Like gravity, it slowly wears down the opposition.

The fundamentals have also worked against quality, with lower quality companies and small caps posting better earnings. They typically respond better to Fed-type stimulus. But like other components of value, profit margins always move remorselessly back to their long-term averages, or almost always.

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So, where are we now? Although “quality” stocks are very cheap and small caps are very expensive (as are lower quality companies), we are in Year 3 of the Presidential Cycle, when risk – particularly high volatility, but including all of its risky cousins – typically does well and quality does poorly. Not exactly what we need! The mitigating feature once again is an extreme value discrepancy in our favor, but this never matters less than it does in a Year 3. This is the age-old value manager's dilemma: we can more or less depend on quality winning over several years, but it may well underperform for a few more quarters. We have always felt we should lean more heavily on the longer-term higher confidence.

As a simple rule, the market will tend to rise as long as short rates are kept low. This seems likely to be the case for eight more months and, therefore, we have to be prepared for the market to rise and to have a risky bias. As such, we have been looking at the previous equity bubbles for, if the S&P rises to 1500, it would officially be the latest in the series of true bubbles. All of the famous bubbles broke, but only after short rates had started to rise, sometimes for quite a while. We have only found a couple of unimportant two-sigma 40-year bubbles that broke in the midst of

declining rates, and that was nearly 50 years ago. The very famous, very large bubbles also often give another type of warning. Probably knowing they are dancing close to the cliff and yet reluctant to stop, late in bubbles investors often migrate to safer stocks, and risky stocks betray their high betas by underperforming. We can get into the details another time, but suffice it to say that there are usually warnings, sometimes several, before a bubble breaks. Overvaluation must be present to define a bubble, but it is not a useful warning in and of itself.

I fear that rising resource prices could cause serious inflation in some emerging countries this year. In theory, this could stop the progress of the bubble that is forming in U.S. equities. In practice, it is unlikely to stop our market until our rates have at least started to rise. Given the whiffs of deflation still lingering from lost asset values, the continued weak housing market, weak employment, and very contained labor costs, an inflationary scare in the U.S. seems a ways off.

Commodities, Weather, and Markets

Climate and weather are hard to separate. My recommendation is to ignore everything that is not off the charts and in the book of new records. The hottest days ever recorded were all over the place last year, with 2010 equaling 2005 as the warmest year globally on record. Russian heat and Pakistani floods, both records, were clearly related in the eyes of climatologists. Perhaps most remarkable, though, is what has been happening in Australia: after seven years of fierce drought, an area the size of Germany and France is several feet under water. This is so out of the range of experience that it has been described as “a flood of biblical proportions.” More to the investment point: Russian heat affects wheat prices and Australian floods interfere with both mining and crops. Weather-induced disappointment in crop yield seems to be becoming commonplace. This pattern of weather extremes is exactly what is predicted by the scientific establishment. Snow on Capitol Hill, although cannon fodder for some truly dopey and ill-informed Congressmen, is also perfectly compatible. Weather instability will always be the most immediately obvious side effect of global warming.

One last story, which is far from hard science, but to me at least intriguing; I support research being done by the New England Aquarium on the right whale (so called because it was just perfect for catching, killing, and turning into whale oil). We had lunch with the right whale expert one month ago – hot off the press! – and were informed of a new development. Three hundred and fifty or so right whales (out of the remaining population of some 500, down from at least hundreds of thousands), have always shown up in late summer for several weeks of feeding in the Bay of Fundy. This year, for the first time in the 30 years of the study, they were “no shows.” Calling up and down the coast, they were able to locate only 100 of them (all known by sight as individuals; none of which stayed more than a day or two anywhere). It is hoped that their food supply had simply moved to another location. The cause for this is unknown and may take years to be very confident of, but the most likely candidate is that extra cold fresh water run-off from melting ice, mainly Greenland, had shifted currents or interfered in other ways with the location of their food. If indeed the cause were accelerated run-off, then this would be completely compatible with another long-established hypothesis: that extra cold fresh water from Greenland might cool the Gulf Stream, the great conveyor of heat to Great Britain and Northern Europe. If this were in fact the case, then London would wake up and find itself feeling a lot more like Montreal – on the same latitude – than it is used to, producing, for example, the winter there that all travelers are reading about today.

You read it here first, and conservative scientists will perhaps be writing it up in a learned journal in two or more years. It is, though, a wonderfully simple example of how a warm winter in the Northern ice might have destabilized systems, ultimately resulting in a frigid Northern Europe.

Resource Limitation Note

For my money, resource problems exacerbated by weather instability will be our biggest and most complicated investment problem for years to come. How should we prepare for it? First, we should all transfer more of our intellectual resources to the problem. Yes, we have already recommended forestry, agricultural land, and “stuff in the ground.” It would be nice to back this up with more detail. To this end, we are starting to look more closely at

commodity cycles, both historically and currently. We will report back from time to time.

By the way, the good news is that our long-term bubble study, started in 1998, has become a monster. Formerly a study of the handfuls of famous, accepted investment bubbles, we are now well into a statistically rigorous review of primary, secondary, and possibly even tertiary bubbles, and now count a stunning 320 completed bubbles. For now, we do not intend to make our complete review generally available, but we will review some interesting “average” bubble behavior in a few months.

So, we do know some useful stuff about commodities. The complicating point is that in the recent few years, commodities seem to be making a paradigm shift. If this is so, it will be the most important paradigm shift to date. The bad news is that paradigm shifts cannot, by definition, be described well using history. It is all about judgment. Now there's a real problem.

Looking Forward

- Be prepared for a strong market and continued outperformance of everything risky.
- But be aware that you are living on borrowed time as a bull; on our data, the market is worth about 910 on the S&P 500, substantially less than current levels, and most risky components are even more overpriced.
- The speed with which you should pull back from the market as it advances into dangerously overpriced territory this year is more of an art than a science, but by October 1 you should probably be thinking much more conservatively.
- As before, in our opinion, U.S. quality stocks are the least overpriced equities.
- To make money in emerging markets from this point, animal spirits have to stay strong and not much can go wrong. This is possibly the last chapter in a 12-year love affair. Emerging equities seem to be in the early stages of the “Emerging, Emerging Bubble” that, 3½ years ago, I suggested would occur. How far a bubble expands is always anyone's guess, but from now on, we must be more careful.
- For those of us in Asset Allocation, currencies are presently too iffy to choose between. Occasionally, in our opinion, one or more get far out of line. This is not one of those occasions.
- Resource stocks, as in “stuff in the ground,” are likely to be fine investments for the very long term. But short term, they can really ruin a quarter, and they have certainly moved a lot recently.
- We think forestry is still a good, safe, long-term play. Good agricultural land is as well.
- What to watch out for: commodity price rises in the next few months could be so large that governmental policies in emerging countries might just stop the global equity bull market. My guess, though, is that this is not the case in the U.S. just yet.

Things that Really Matter in 2011 and Beyond (in one person's view) for Investments and Real Life

- Resources running out, putting strong but intermittent pressure on commodity prices
- Global warming causing destabilized weather patterns, adding to agricultural price pressures
- Declining American educational standards relative to competitors
- Extraordinary income disparities and a lack of progress of American hourly wages
- Everything else.

Postscript

I was recently asked by a colleague on the GMO Board how I decide what to write about. Well, I'm most decidedly not trying to comment on all-important, or even all-interesting, topics. Readers are often surprised – quite reasonably, I might add – at what I avoid.

I have always tried to focus on the handful of issues about which I know a decent amount. This has been overwhelmingly about identifying hugely mispriced major sectors or asset classes among equities. This developed over the years into a study of bubbles and busts. As we built up our data and analysis, my (and our) knowledge and comfort zone extended to similar outlier events in other asset classes, including currencies, commodities, bonds, and some real estate markets. The rule, though, was not to stick our necks out unless the pricing is truly extreme for these non-equity price series, a policy that has given us, touch wood, a good safety margin. In equities, we have been a little braver and sometimes paid a high price for being early. But we missed very few, if any, major mispricings.

Second, we have studied all other equity market tendencies over the decades, from the sublime to (I confess) the ridiculous. Thus, Presidential Cycles and January Rules were considered fair game for research, along with theories for valuing everything and studying the effects of momentum and other factors on pricing behavior. In the end, for equities, this became a pretty inclusive question: how do markets work? Outside of equities or bubbles, I do not usually consider my understanding sufficient to justify my commenting seriously. Although I do occasionally.

Most other opinions I've offered have had this body of data as their source. For example, my strong views on the Fed hinged on their obvious missing of the significance and dangers of allowing asset bubbles to form and also, to a lesser degree, on our knowledge of the Year 3 Presidential effect, which they cause.

On some very rare occasions, I feel that I have some insight into a very small part of the general economic or financial picture, usually based on what I see as common sense as opposed to detailed knowledge. In general though, I feel that many investment pros make the mistake of thinking of themselves as economists or banking experts. Their feel for markets is often excellent, and should be enough to keep them happy.

This is my view, anyway, and it leads me to avoid comment (or serious comment, anyway) on any number of interesting and important issues. Such areas of avoidance today would include inflation versus deflation, how precisely to extricate ourselves from high debt without causing inflation, interest rates in general, credit in particular, subtleties of currency, any banking nuance, politics, health care, desirable trade policy, tax policy, etc., etc. So please don't think I believe it's unimportant if I ignore an issue. I don't.

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