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This credit crisis has a long way to run

Barron's interview with Jeremy Grantham, Chairman of GMO

One of the grandest of thinkers and most eloquent of oracles, Jeremy Grantham has long been the voice of reason in an industry prone to excesses and embellishment. By taking the long view, blending quantitative strategies and technical analysis with sound and experienced judgment, Grantham, chairman of Boston-based GMO, consistently uncovers with his team the best values among a wide range of global asset classes.

The payoff is outstanding performance and risk management. In return, clients have entrusted the firm with about \$150 billion. As the man who warned early of a worldwide bubble forming, we turned to him as that bubble has started bursting.

Barron's: *You, along with George Soros, have called this the worst financial crisis we've had in the post-war era.*

Grantham: This is much more global than, say, the savings-and-loan crisis was. The world is obviously much more globalized than at any time since the late 19th century and much more interrelated in almost every way, certainly financially. To have the leading economy and the reserve currency having a major-league credit crisis would by itself make it more important than earlier ones.

Secondly, this occurred at a time of what I believe is the first global bubble in pretty well all asset prices, so there is a much greater degree of broad-based vulnerability. Then it is a question of degree, and how carried away the sloppy lending was: It was very carried away. Not just in the design of needlessly complicated instruments, but in the enthusiasm -- recklessness one might say -- with which they were sold.

Can these bubbles burst if the Fed is easing the way they are?

Well, this is an amazing little tidbit. People think the Federal Reserve can stop a bear market because they can throw money at it and lower interest rates. It is even more certain we can collectively stop a bear market if some fiscal stimulus is thrown in. To which I say, 'Oh, you mean like 2000 and 2002?' -- when they threw what I call the greatest stimulus in American history, an unparalleled series of interest-rate cuts, cumulating in two, almost three, years of negative real returns, real interest rates coupled with a really substantial tax cut, which would never have happened without 9/11.

The combination would have gotten the dead to walk, and it stopped the bear market eventually. But the Standard & Poor's 500 was down 50% and the Nasdaq -- which was all anyone talked about back then -- went down 78%. And a puny five to six years later, people are saying there is not going to be a

bear market because the Fed is going to lower rates and because the government is going to have a stimulus package. But we have just been there, done that, and we had a nice bear market.

What about places to hide?

That isn't something we can laugh off. Last time, there were plenty of opportunities: Bonds were cheap and TIPS (Treasury-inflation protective securities) were brilliant; real estate was cheap and REITs were brilliant. Even within equities, emerging markets were much cheaper than US equities, and within US equities, value stocks were only a little expensive and small-caps were only a little expensive and small-cap value was actually a little bit cheap. So you could really hide and could reasonably expect to make money, which we did in each of the three years of the bear market.

Since then, all those areas appear to have read the book on mean-reversion. Ten years would be a perfectly normal period of time to go from a peak of a great bubble [like the one in 2000], based on the history of bubbles and their aftermath, to the low. I have long thought that 2010 would be when we hit the biggest discount to fair value. Trend-line value on the S&P, by the way, in 2010 is 1100. (The S&P 500 traded at 1334 late last week.)

What should we expect from the market between now and 2010?

In the fourth year of a presidential cycle, where you have a lame-duck president, the typical pattern of S&P 500 performance has been something like 10% below the normal long-term average (a 5.2% gain, inflation-adjusted), and worse if it is an overpriced market. A first year is never very pleasant: They average about 3% below normal. If they are overpriced, they do four points worse than that.

But if the party in power changes, first years tend to be eight points below normal. The following year is ugly, too. The average year two, since 1932, has been 10 points below normal and, if the market is overpriced, 15 points below normal. This is unpleasant. By a nice coincidence, those averages suggest the market will decline to 1100 in 2010, which is exactly the number we get to from a completely different technique -- building it from the grass roots through fundamental value. We do that by taking average corporate-profit margins, actually a generous average, assigning a normal market price/earnings ratio, and that gives you 1100 in 2010. This year, next year and the year after will all be uncomfortable years. One of them might be up, but my guess is it won't be up by much.

What exactly will make them more uncomfortable?

Profit margins, the great prop to the market, surprisingly defied the laws of gravity for three years in the developed world and, particularly, in the emerging world and even in Japan. That was because the global economy was stronger than any corporation counted on and, in the US, consumption was always higher and our savings rate was always lower than any corporate

economist would have suggested, going into negative territory. But there are a few near certainties in this business -- not many, but a few -- and one of them is that abnormally high profit margins will go back to normal. The timing is unfortunately shrouded in fog. The other near certainty is that house prices will go back to a normal multiple of family income. In the end, we, the people, have to be able to afford the houses and they are affordable at something around 2.8 times family income. When they peak in Boston at 6 times and nationally at 3.9 times, you know you are in for tough times.

Incidentally, it was late in '06 when [Fed Chairman Benjamin] Bernanke said he thought the high prices of homes in the US merely reflected a strong US economy. Was he not looking at the data? Did he not measure long-term house prices? Had he not seen how they ebbed and flowed as a multiple of family income, which they do here and in the U.K. and everywhere else? And with it being so obviously a bubble, how could he have said that?

He was taking his cue from Alan Greenspan, who said we should all be taking out adjustable-rate mortgages.

Greenspan and Bernanke have taken a hands-off approach for two consecutive great bubbles, first in TMT -- telecommunications, media and technology -- and second, in housing. A hands-off approach is a polite way of saying they facilitated this. And what is the point of a 125-basis-point rate reduction, other than to provide reinforcement for the people who borrow short and lend long? From bankers who have committed every crime you could possibly accuse a banker of, to hedge funds who borrow short, leverage, and invest long in the stock market -- that's who really benefits from the interest-rate reduction. The economy, broadly defined, does not.

I have an exhibit that shows the 30 years prior to 1982 when the debt-to-gross domestic product ratio was completely flat at 1.2 times. Total debt is defined as government debt, personal debt, corporate debt and financial debt. Then in the 25 years after 1982, the flat line goes up at a 45 degrees angle from 1.2 times to 3.1 times GDP. Massive. In the first 30 years, when debt is flat, annual GDP growth is its usual battleship, growing at 3.5% and hardly twitching. After the massive increase in debt, GDP, far from accelerating, grew at 3%. So debt in the aggregate does not drive the economy. The economy is driven by education, man-hours worked, capital investment and technology. It is not driven by what I owe you and you owe me.

So the Fed's actions won't stave off a slowdown?

Since when did the thought of an economic slowdown induce such hysteria? That was a response to the decline in global markets. It was aimed at the stock market. It was aimed at banking disorder and banking profits. It doesn't have that much of a powerful effect on the economy. If it had any more profound effect, there would be a positive relationship between debt increasing and GDP growth, and there is none.

But it is driving down the dollar.

It drives down the dollar, which is inflationary, and, eventually, it could be seriously inflationary.

I understand you are most concerned with further fallout in the private-equity arena?

Yes. I have yet to meet a private-equity firm that put into its spreadsheet the assumption that system-wide profit margins could decline by 20% to 30%. They have taken the current, abnormally high profit margins as a given and then determined to improve them by, let's say, 15% and assume everything works out pretty well.

But if the base declines by 20%, even if they end up improving margins by 15%, they are going backwards. And if they pay the 25% premium up front, which was normal, and if they leverage 4-to-1, which was normal, then they almost precisely wipe out all of the clients' money, all of the 20% in equity and if, perish the thought, they don't add 15%, but add perhaps zero to 5%, then they do more than wipe out the equity, they leave the underlying debt in ragged disarray. That is the next shoe to drop on the credit side.

Where else does this housing crisis lead us?

It has a lot to go. It still has to drop 20% to 25% to reach more normal levels, or if you prefer, it could wait five years for income to catch up, barring no big recessions. With the housing market gone, people turned to credit cards and with economic times slowing down -- whether there's a recession or not -- consumers are going to slow down a lot, are slowing down or have slowed down a lot.

What about the dollar?

Currency is a real problem, I've got to admit. There was a time not that many years ago when we had a huge high-confidence bet against the dollar. It was technically overpriced, and we were running a huge trade deficit. Now, it is technically substantially cheap. But we are running an even bigger deficit. It is a conundrum. I don't think it should be a major, major bet. We are reasonably happy owning emerging currencies as a packet against the dollar for a several-year time horizon. I'm not particularly happy owning a packet of other developed currencies against the dollar.

Personally, I'm long the yen, the Singapore dollar and the Swiss franc. I'm certainly not long the pound: shorting the pound is a better bet than shorting the dollar.

What other bets would you take here?

My favorite bet on Jan. 1 and today, for that matter, is going long very-high-quality US blue chips with 50% of my dough, and long emerging markets for 50%, and shorting the Russell 2000 for 100%, or a complete hedge. In that

bet, I'm long value because both of those components are cheaper than the Russell 2000. I'm long liquidity on average. I'm long momentum on average.

What about growth stocks? Isn't there value there?

Growth stocks are expensive, but not quite as expensive as value stocks or low-growth stocks. Quality stocks are expensive but substantially less so than anything else. Emerging is expensive, but less so than anything less, and the fundamentals are so much superior to the rest of the world. Everything is expensive. All we are trying to do is extract some relative money, or by going short, actually make some real money.

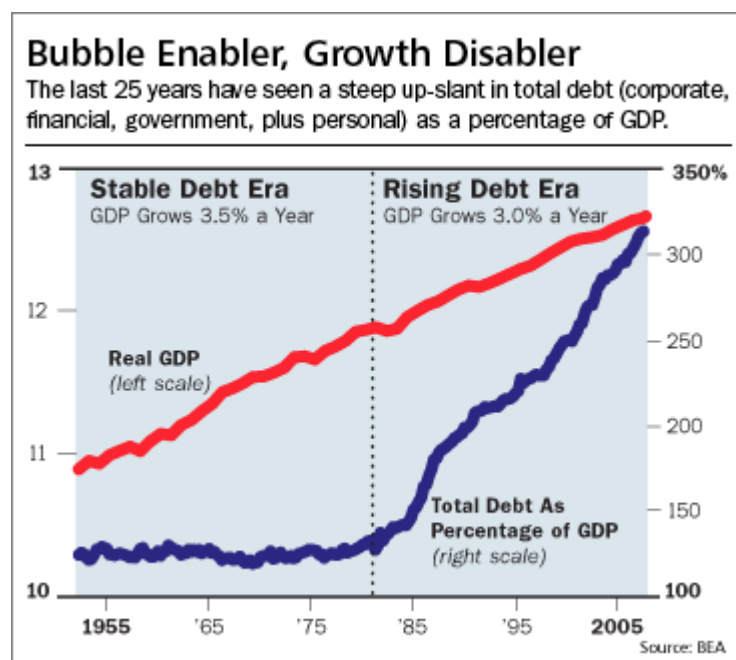
But how do you define quality these days?

We always defined high-quality companies as those with high and stable returns and low debt. Recently, we had to override, and exclude several banks from that list. Whether you like it or not, you have got to treat banks separately.

What about the deal market, will that provide any lift to stocks? Microsoft's bid for Yahoo! hasn't done much for the market.

You might say that is a company in serious trouble being acquired by a company that is worried, maybe desperate. And that doesn't sound like a very strong deal to anybody.

Fascinating as always, Jeremy. Thank you.



Source: Sandra Ward, [Barron's](#), February 11, 2008.