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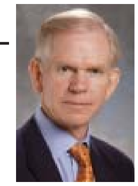

Obama and the Teflon Men, and Other Short Stories. Part 1.

Jeremy Grantham

With economies and financial markets, it seems that if you stare hard enough and long enough at the fog of battle, you occasionally get a glimpse of what may be going on when a favorable wind blows. This, for me, is decidedly not one of those occasions. It is obvious to all of us that these are momentous days in which government actions may well have make-or-break impact, but my confidence in government and leadership is at a low ebb. (Although I must admit my confidence has increased enormously in recent weeks in all areas outside of finance. Even in finance it has increased a little.) Economic advice for President Obama covers the waterfront, and even the near-consensus case for great stimulus is lacking in historical certainties or intellectual rigor. Everyone seems to be guessing at strategies and outcomes, knowing clearly that the best strategy would have been to have avoided getting into this pickle. The current disaster would have been easy to avoid by making a move against asset bubbles early in their lifecycle. It will, in contrast, be devilishly hard to get out of. But, we are deep in the pickle jar, and it seems likely that, in terms of economic pain, 2009 will be the worst year in the lives of the majority of Americans, Brits, and others. So break a leg, everyone!

It would be helpful at a time like this to have a Quarterly Letter that sounded convinced of something … anything. So I apologize for overtly tickling around the edges. I do not apologize, though, for pointing you to the best thing I have read in *The New York Times* in a very long time: the article by Lewis and Einhorn[1] does a great job of summarizing where we are and how we got here, as well as offering some helpful advice for the future. My contribution is to address a few peripheral topics that have accumulated over recent quarters as more important topics have dominated. Half of the mini topics are covered in this Letter, and the other half will be posted in a few weeks.

1. The Story So Far: Greed + Incompetence + A Belief in Market Efficiency = Disaster

Greed and reckless overconfidence on the part of almost everyone caused us to ignore risk to a degree that is probably unparalleled in breadth and depth in American history. Even more remarkable was the lack of insight and basic competence of our leadership, which led them to ignore this development, or worse, to encourage it. Ingenious new financial instruments certainly facilitated and exaggerated these weaknesses, but they were not the most potent ingredient in our toxic stew. That honor goes to the economic establishment for building over many decades a belief in rational expectations: reasonable, economically-induced behavior that would always guarantee approximately efficient markets. In their desire for mathematical order and elegant models, the economic establishment played down the inconveniently large role of bad behavior, career risk management, and flat-out bursts of irrationality. The dominant economic theorists so valued orderliness and rationality that they actually grew to believe it, and this false conviction became increasingly dangerous. It was why Greenspan and Bernanke were not sure that bubbles – outbursts of serious irrationality – could even exist. It was why Bernanke, who had studied the bubble of 1929, could still not see it as proof of irrationality and could still view the Depression (à la Milton Friedman) as a mere consequence of incredibly bad, easily avoidable policy measures. Of more recent importance, it was why Bernanke could dismiss a dangerous 100-year bubble in U.S. housing as being nonexistent. It was why Hyman Minsky was marginalized as an economist despite his brilliant insight of the "near inevitability" of periodic financial crises. It was why the suggestion in academic circles of stock market inefficiencies, let alone major dysfunctionality, was considered a heresy. It was why Burton Malkiel could rationalize the 1987 crash as being an efficient response to 12 or so triggers. These triggers, however, had a trivial weakness: seasoned portfolio managers at the time had never even heard of most of

[1] Michael Lewis and David Einhorn, "The End of the Financial World as We Know It," *The New York Times*, January 4, 2009. This article is available online at www.nytimes.com.

them. Never underestimate the power of a dominant academic idea to choke off competing ideas, and never underestimate the unwillingness of academics to change their views in the face of evidence. They have decades of their research and their academic standing to defend. The incredibly inaccurate efficient market theory was believed in totality by many of our financial leaders, and believed in part by almost all. It left our economic and governmental establishment sitting by confidently, even as a lethally dangerous combination of asset bubbles, lax controls, pernicious incentives, and wickedly complicated instruments led to our current plight. "Surely none of this could happen in a rational, efficient world," they seemed to be thinking. And the absolutely worst aspect of this belief set was that it led to a chronic underestimation of the dangers of asset bubbles breaking – the very severe loss of perceived wealth and the stranded debt that comes with a savage write-down of assets. Well, it's nice to get that off my chest once again!

2. Lost Illusions: The Loss of Perceived Wealth and Stranded Debt

During the market's rise, I wrote about the fallacy of paper wealth, particularly as it applied to houses. At three times the price, they were obviously still the very same houses. How could we kid ourselves that we were suddenly rich and didn't need to save for our pensions when we were sitting in the very same buildings we bought in 1974? With "wealth" built on such false premises, it is not surprising that we come to grief from time to time. But the good news is that, as we move back down to earlier prices, they are still the same houses. We have not lost wealth, but just the illusion of wealth. Illusions tend not to have very long-lasting effects, but they obviously can and do have very powerful short- and even intermediate-term effects. This particular illusion, which applied to stocks, real estate, art, and almost everything else, was grand indeed, and it directly over-stimulated consumption and indirectly over-stimulated imports. In the process, it suppressed both savings and investments of our own locally generated income. (Although there was plenty of foreign investment into the U.S. to fill the gap, which has its own long-term complications.)

Now the illusion of wealth has been lost, with formidably negative effects on animal spirits. My hero, Keynes, emphasized the importance of shifts in animal spirits in economics, and explained how shifts in such spirits could ruin the most carefully calculated investment decisions. At times like this, animal spirits need nurturing. Obama's election will help, at least for a while; talking up the power of stimulus will help (whether or not the power is really there), and avuncular, optimistic advice from influential figures will not go amiss.

But let us look for a minute at the extent of the loss in perceived wealth that is the main shock to our economic system. If in real terms we assume write-downs of 50% in U.S. equities, 35% in U.S. housing, and 35% to 40% in commercial real estate, we will have had a total loss of about $20 trillion of perceived wealth from a peak total of about $50 trillion. This relates to a GDP of about $13 trillion, the annual value of all U.S. produced goods and services. These write-downs not only mean that we perceive ourselves as shockingly poorer, they also dramatically increase our real debt ratios. Prudent debt issuance is based on two factors: income and collateral. Like a good old-fashioned mortgage issuer, we want the debt we issue to be no more than 80% of the conservative asset value, and lower would be better. We also want the income of the borrower to be sufficient to pay the interest with a safety margin and, ideally, to be enough to amortize the principal slowly. On this basis, the National Private Asset Base (to coin a phrase) of $50 trillion supported about $25 trillion of private debt, corporate and individual. Given that almost half of us have small or no mortgages, this 50% ratio seems dangerously high. But now the asset values have fallen back to $30 trillion, whereas the debt remains at $25 trillion, give or take the miserly $1 trillion we have written down so far. If we would like the same asset coverage of 50% that we had a year ago, we could support only $15 trillion or so of total debt. The remaining $10 trillion of debt would have been stranded as the tide went out! What is worse is that credit standards have of course tightened, so newly conservative lenders now assume the obvious: that 50% was too high, and that 40% loan to collateral value or even less would be more appropriate. As always, now that it's raining, bankers want back the umbrellas they lent us. At 40% of $30 trillion, ideal debt levels would be $12 trillion or so, almost exactly half of where they actually are today! It is obvious that the scale of write-downs that we have been reading about in recent months of $1 trillion to $2 trillion will not move our system anywhere near back to a healthy balance. To be successful, we really need to halve the level of private debt as a fraction of the underlying asset values. This implies that by hook or by crook, somewhere between $10 trillion and $15 trillion of debt will have to disappear. Given where we are today, there are only three ways to restore a balance between current private debt levels and our reduced, but much more realistic, asset values: we can bite the bullet and drastically write down debt (which, so far, seems unappealing to the authorities); we can, like Japan did, let the very long passage of time wear down debt levels as we save more and restore our consumer balance sheets; or we can inflate the heck out of our debt and reduce its real value. (In the interest of completeness I should mention that there can <u>sometimes</u> be a fourth possible way: to somehow re-inflate aggregate asset prices way above fair value again. After the tech bubble of 2000 Greenspan found a second major asset class ready and waiting – real estate – on which to work his wicked ways. This time there is no new major asset class available and, although Homo sapiens may not be very quick learners, we do not appear eager to burn our fingers twice on the very same stove. As a society, we apparently need 15 to 20 years to forget our last burn. With so many financial and economic problems reverberating around the world and with animal spirits so crushed, re-inflating equity or real estate prices way above fair value again in the next few years seems a forlorn hope if indeed it is possible at all.)

Each of the three realistic possibilities listed above would be extremely painful, each is loaded with uncertainties, and even the quickest of them would take several years. Our path this time is likely to involve a hybrid approach: we will <u>certainly</u> take some painful debt liquidations; this crisis will <u>almost certainly</u> take far longer than normal to play out; and <u>probably</u>, before a new equilibrium is reached, we will see inflation rates that are well above normal.

It would be convenient if we could reach safety without having our global economy come to a complete standstill for a few years; without a wave of <u>very</u> high inflation and, ideally, without a dollar crisis or a trade war. All of them, unfortunately, are what a quant would call "non-trivial possibilities." Traveling happily certainly has its virtues, but in these dangerous times it is probably better to be braced at least for the right order of magnitude problem that we face.

This is a good time to look at the Japanese crisis of 1989 to present since, along with the Great Depression, it is probably one of the two most relevant examples for today's problems. The Japanese had an even bigger problem in write-downs of "wealth" than we have now. They had to write down perceived wealth by an amount equal to a stunning three times GDP! Even in 1929, we had to write off amounts equal to only three quarters of a year's GDP, as the stock markets then were less developed and housing was decidedly pre-McMansion. This time in the U.S., however, we must write down perceived wealth or capital by almost precisely one and a half times GDP, worse than the Depression but happily much less than Japan.

In this context, do not kid yourself that the Japanese did a terrible job in extricating themselves. Even the Japanese often express dismay at the costs they have paid due to their heroic level of public spending. I believe that this primarily reflects their original failure to realize how deep their hole was. It can also be admitted that their program, while <u>probably</u> right in concept, was not highly efficient. Bridges to nowhere have not been as stimulating or productive long term as a focus on energy conservation and oil and coal replacement technologies would have been. It was often said that the Japanese should have bitten the bullet as the U.S. did in its S&L crisis, taking a quick hit rather than dragging out the pain. How superficial and self-congratulatory those comments seem now. Faced with our own credit crisis, we discover there is no easy cure – the bullet turns out to be a grenade, which doesn't fit as easily into the mouth. At about 4 to 1, the Japanese corporate sector went into the 1989 crunch with much higher leverage than the U.S. had ever seen. Remember too that their stock market, at 65 times earnings, was over three times our market's recent highs and their land was at several multiples of ours. In 1989, Tokyo's land per square foot was around ten times the value of Manhattan's! So they had higher write-offs conflicting with much higher corporate leverage. If they had rapidly marked their assets to market, the entire corporate Japan Inc. would have been under water. And since we know that around a quarter of Japan's market – their Sonys and Toyotas – was solvent, we can deduce that the remaining three-quarters was shockingly under water, using the types of rules we are attempting to apply to ourselves now. As the years passed, a few Japanese companies failed, but the great mass in the middle painfully clawed their way back to solvency. Somehow or other, Japan absorbed the greatest deleveraging in human history without incurring a severe depression. I can only hope we do as well!

Although Japanese corporations were in much worse credit shape than ours are now, the reverse is true for consumers. Japanese individuals went into the 1989 event with a very high savings rate and very high accumulated savings. In contrast, our households go into our crunch borrowed to the hilt (or beyond) and painfully under-saved. So our job is to nurture our average people in the street and somehow restore the quality of their balance sheets, just as Japan (admittedly taking 15 uncomfortable years) did for its corporations.

To finish this section on an optimistic note (my civic duty), it is worth remembering that real wealth lies not in debt but in educated people, laws, and work ethic, as well as in the quality and quantity of fixed assets and the effectiveness of corporate organization. We, like Japan, are not proposing to destroy any of these assets. We, like Japan, have just tripped on make-believe assets and we now have to deal with chronic deleveraging and bruised animal spirits. When we have dealt with this crisis, all of our assets will still be sitting around waiting to be fully used once again. It is helpful to consider that after the Depression, the U.S. GDP got back on its original trendline <u>as if the Depression had never occurred</u>.

Also remember that although your portfolio is down 40%, just as you own the same house, you still control the same number of shares and hence the same fraction of long-term wealth that you had before. You simply over-estimated your wealth before, believing that the companies you owned had quickly become twice as valuable. With an individual stock, this is rarely the case; on a broad market level, it is never the case. The good news is that with the market at half price, you now have much more powerful dollars. For consumption purposes, a dollar is always a dollar. Investment dollars, in contrast, are weak dollars in badly over-priced markets but powerful dollars in cheap markets. Today, investment dollars are a whole lot more powerful than they used to be. (In fact, to encourage business, we will make a special January sale on our own investment management services: we will manage the same number of global equity shares as last year for 40% less! Hurry, hurry, limited supply!)

3. Obama and the Teflon Men

I am naturally a contrarian and a nitpicker, so I found myself becoming a Republican in the Clinton era and a real pinko in the Bush era. But after exulting in Obama's election, I couldn't even reach his inauguration before finding fault! As an environmentalist, I am delighted that he has surrounded himself with the very top talent. I, for one, find Hillary Clinton an exciting choice to head the State Department. But in the critical financial arena, he appears to have brought in Rubinesque retreads, "yes men," or both, <u>none</u> of whom appeared to have seen the most obvious developing bubbles in the history of finance.

One can only admire Bob Rubin's ability to retain influence and have his protégés in powerful positions. Rubin is the guy who was last seen exhorting Citibank to take more leverage and keep swinging. No, come to think of it, he was last seen paying a visit to Hank Paulson, his relatively recent underling at Goldman Sachs. He pleaded with his old chum, with brilliant success, for an unprecedented bailout. He was part of the establishment that failed to express early, loud concerns over slipping financial standards, and in fact helped to create an environment where prudence was a career risk and CEOs felt obliged to keep dancing.

His man Summers has proven he has some bite. Because he has written often for the *Financial Times* we at least know his public stance on matters financial. Well, let's put it this way: he runs no risk of being on any of the many lists of people who gave clear warnings of potential financial disaster. And dozens did. Summers was emphatically not a whistleblower. He did not rail against falling financial standards. What he did, with his allies Greenspan and Rubin, was beat back a heroic attempt in late 1998 by Brooksley Born, then boss of the CFTC in Chicago, to supervise OTC derivatives. They held her off, presumably in the Greenspanian spirit of "the less regulation, the better."

Obama appointed Gary Gensler to lead the CFTC. Gensler has a good reputation, but was hired into Treasury by … you've guessed it … Robert Rubin.

And as for Tim Geithner! The FOMC minutes are available, so at least we know what he added to Greenspan's and Bernanke's meetings. Over the Greenspan years, there were a few cautionary words from other members – a very, very few from a rather spineless group – and we know from the records how they were greeted. A typically precise response from Greenspan was: "So, this seems like a good time to break for coffee," or words to that effect. And we can study Geithner's objections to the Fed's long journey down the primrose path, but our study period will not be a long one, for he questioned nothing! He was, if anything, a cheerleader, and wrote in support of the new era of "Great Moderation." He, however, was not picked by Rubin. No, he was picked by Summers, who was picked by Rubin. These guys are very, very loyal!

Mary Schapiro, appointed to head the SEC, has been greeted with great enthusiasm by the financial industry precisely because she has been a great supporter of the industry's financial well-being during her career, which has included positions at the SEC and the CFTC. She is seen as one who poses no threat by way of introducing nasty, inconvenient new regulations. Where is Brooksley Born when we need her? (In the interest of space, this anti-Schapiro section is brief. To help out, on January 15, there was a detailed criticism of her for being a softy in *The Wall Street Journal*, of all newspapers. Bush would have been proud to hire her!)

What a missed opportunity this all is. Obama was given a mandate that could have included some serious bottom kicking. We could have quickly taken quite a few steps down the long road leading to a credible financial system deserving of respect. The time to do that was now. Many readers will object that these are all bright – even very bright – people. And so they are. But our financial ship is not doing a passable imitation of sinking because of a lack of intelligence. What was lacking was the backbone to publicly resist the establishment's greedy joyride of risk-taking and sloppy standards. Even more important, perhaps, was the breadth of vision that was missing. There was plenty of intelligence, just not too much wisdom. So it would be very encouraging if there were someone included in Obama's appointments who had actually blown the whistle on the spiraling Ponzi scheme that our leveraged financial system had become (which is why the Madoff fiasco is such a fitting capstone to our troubles). If only there were someone with real toughness who could do unpopular things. Someone, say, like Volcker. Oh, wait a minute. Didn't he get a job? Or was that only a game to get obstreperous characters like me on board with the program? Unfortunately, I have a sneaking misgiving that Volcker was indeed window dressing for the Presidential campaign. Dollars to donuts he has not been pestered around the clock for advice so far. And I'll tell you one thing. You don't have to know him well to know that he'll resign within a year if they don't get serious. Since he is the only person on the team proven to have the right credentials – a preference for high standards of financial integrity and the backbone to push through unpopular but necessary actions – it would be a real shame to lose him entirely.

4. Disillusionment

The single word that probably best summarizes all of our feelings toward this last, truly miserable year is "disillusionment." We have all been, I believe, serially shocked by the lack of competence and misguided philosophy of our top officials, who for years encouraged rather than discouraged the bad tendencies in our financial system. We have been amazed at the third-rate job done by the leaders of our great financial firms, above all by their lack of moral fiber in restricting what could best be described as an orgy of moneymaking at any price. As stockholders, we also know we did little to put on the brakes; as individual clients and home buyers, we also did our bit to make it easy for greed to win out. We were willing gulls in an age of gullibility. Madoff has done historians a good turn by making it so clear that we were looking to make our 1.5% fees rather than looking to do hard analysis, and that collectively, even when we were suspicious, we were trying not to rock the boat. And, most significantly, our regulators were happy to leave no stone turned!

But it was worse than merely a decay of financial integrity. 2008 capped in incompetence what I am sure will be remembered as the most incompetent eight years of government in modern times, and a contender even if we include ancient times. Over an even longer period, as Paul Krugman would say, we tore up the social contract; through tax changes favoring the rich, we aided and abetted the strong global economic forces that already tended to concentrate wealth in the hands of the already rich. It was an uncharitable, unsympathetic, and avaricious era in which the cult of the individual trumped overall society, and the drive for wealth and the luxuries of life took precedence over more worthwhile and longer-lasting values. Most of our society got richer in the last 20 years, but there is not a hint of research that suggests we got happier, and plenty that suggests the reverse. In the process, we took some giant steps toward ruining the planet and had to live with the sight of many wealthy firms funding expensive PR programs that attempted to obscure the science and suggest that coal is clean and all is well. In short, we messed up on a very broad front, and last year was when it became impossible not to see it. If you ended the year without becoming disillusioned, you were not paying attention.

5. Small Arguments with Two Heroes

First, Warren Buffett. At about 950 on the S&P on October 16, he announced that he was a personal buyer of U.S. stocks because they were cheap and their prices reflected widespread fear. This is not typical for him, but he certainly did it in 1974. When he said it back then, every stock in our portfolio at Batterymarch yielded almost 10%! The portfolio P/E was below 7.5x. Even with hindsight, if you value the market in 1974 using our current methodology, it was very much cheaper than it is today at 950, which is what we calculate as almost precisely fair value.

His recent announcement made the market seem so much more exciting than boring old fair value. So what are the possibilities? Was he performing a civic duty? Certainly, animal spirits are a critical component of any recovery, so encouragement to take risk from an authoritative source makes perfect sense. Does he believe that 1974-type cheapness can never return, or is very unlikely in this particular case? If that were the argument, we would disagree; we suspect that cheaper prices are not just possible but probable, although admittedly far from certain. Has he perhaps a tactical market timing model that produces his obvious excitement, despite these ordinary values? Most unlikely, given his style. Or are our numbers wrong? Perish the thought! In any case, it is all an interesting conundrum.

Second, Nassim Taleb and the Black Swan logic, which I have previously admired in public. Taleb is completely dismissive – in a way only he can be – of any near certainties. He implies that we have just suffered from an outlier event crashing up against standard risk modeling that only assumes that events will occur in an approximately normal way. He argues that modeling the 95% or 99% normal range in Value at Risk (VaR) misses the whole point: that the real game is played out in the final 1%. It's hard to disagree with this criticism of VaR, but is it relevant in this case? Was the recent breaking of our credit and asset bubbles a totally unpredictable outlier?

We believe that we live in a world where bubbles routinely form and where there are – in complete contrast to Nassim Taleb's belief – some near certainties. One is that bubbles will break. Bernanke should not have said, "U.S. house prices have never declined," thus implying that they never would. He should have said, "Never before has a three-sigma, 1 in 100, U.S. housing bubble occurred, and be advised that all such analogous bubbles in other asset classes and in housing in other countries have always burst." (Robert Shiller for the Fed! He would have said almost exactly that.) The bursting of the U.S. and U.K. housing bubbles, the profit margins, and the risk premium in global asset prices were all "near certainties." This was a White Swan, a particularly White Swan. Taleb's work will no doubt be correct when we have a genuine Black Swan, but this was most definitely not it. (Okay, Nassim. I can hear you thinking: this guy Grantham is a complete loser who has obviously missed my entire point.)

Recent Recommendations and Performance

Well, we got it about as right over the past few years as we're ever going to. "Avoid all risk." "Don't be too proud to own cash." "Let the other guys be brave." "Expect at least one major bank to fail (July 2007)." "Many financial companies will approach technical insolvency (January 2008)." Expect 50% of hedge funds to disappear and, after a lag, expect a major crisis in private equity where 2006 and 2007 investments should approach zero in value. More fundamentally, we called for persistent, below-estimate growth in economies, especially in China and the U.K. and, most particularly, we expected falling profit margins globally. These views were perhaps best captured in our belief that risk-taking was at the heart of the bubble, and that risk premiums were nearly certain to rise significantly. And, of course, house prices would fall and cause considerable trouble. If we had implemented as well as we got the big picture right, we would have had a year from heaven – at least from that part of heaven reserved for institutional managers: relative heaven. In fact, we did a mixed job in implementation: some very good, some bad, and some in-between but, all in all, we had a good year.

Re-introducing the Very First of Our 7-year Forecasts: Bullish Again!

For many years, we used a 10-year forecast for asset class returns. In January 2002, we made our first 7-year forecast, dated December 31, 2001. We moved from 10 to 7 years because research proved that it was closer to the average time for financial series to mean revert. The data is shown in Table 1.

As you can see, despite being called "perma bears," we overestimated the returns for global equities, except for emerging, where we were more or less spot on. Government debt – not surprisingly, given our crisis – also moderately outperformed our estimate.

Current Recommendations

Slowly and carefully invest your cash reserves into global equities, preferring high quality U.S. blue chips and emerging market equities. Imputed 7-year returns are moderately above normal and much above the average of the last 15 years. But be prepared for a decline to new lows this year or next, for that would be the most likely historical pattern, as markets love to overcorrect on the downside after major bubbles. 600 or below on the S&P 500 would be a more typical low than the 750 we reached for one day.

Table 1

The 7-Year Forecast from 7 Years Ago: Bullish as Ever

Forecasts from December 31, 2001 vs. actual as of December 31, 2008

Asset Class	Estimated Rank	GMO 7-Yr Forecast Dec-01 (% Real Return/Yr)	Actual 7-Yr Return*	Actual Rank
Emerging Mkt Equities	1	9.4	9.9	1
U.S. REITs	2	9.1	3.1	7
Emerging Cntry Debt	3	6.8	6.4	3
Int'l Small Cap	4	5.2	4.9	4
U.S. TIPS	5	3.5	3.9	5
Lehman Aggregate	6	2.9	3.8	6
Foreign Bonds	7	2.6	7.4	2
U.S. Small Cap	8	2.2	-0.5	10
EAFE	9	2.2	1.0	8
U.S. T-Bills	10	2.1	0.2	9
S&P 500	11	-1.0	-3.9	11

The accuracy of these forecasts does not guarantee that current or future predictions will be accurate either with respect to the ranking of those asset classes over a 7-year period, the absolute levels of real return, or results over shorter periods. The accuracy of forecasted rankings in the asset class forecasts generally varies from period to period.

** Actual real index returns are for 12/31/01 to 12/31/08 period.*

Source: GMO

In fixed income, risk finally seems to be attractively priced, in that most risk spreads seem attractively wide. Long government bond rates, though, seem much too low. They reflect the short-term fears of economic weakness and the need for low short-term rates. We would be short long government bonds in appropriate accounts.

As for commodities, who knows? There were a few months where they looked like a high-confidence short, but now they are half-price or less, and are much lower-confidence bets.

In currencies, we know even less. It is easy to find currencies to dislike, and hard to find ones to like. There are no high-confidence bets, in our opinion.

For the long term, research should be directed into portfolios that would resist both inflationary problems and potential dollar weakness. These are the two serious problems that we may have to face as a consequence of flooding the global financial system with government bailouts and government debt.

Fearless Forecasts for the Long Term

Under the shock of massive deleveraging caused by the equally massive write-down of perceived global wealth, we expect the growth rate of GDP for the whole developed world to continue the slowing trend of the last 12 years as we outlined in April 2008. Since this recent shock overlaps with slowing population growth, it will soon be widely recognized that 2% real growth would be a realistic target for the G7, even after we recover from the current negative growth period. Emerging countries are, of course, a different story. They will probably recover more quickly, and will continue to grow at double (or better) the growth rate of developed countries. (See "The Emerging Emerging Bubble," April 2008.)

Footnote on the January Rule and the Presidential Cycle

In January 2008, I pointed out that the market had started the year with the worst five days ever recorded, and that the signal was "both impressive and bearish" in that down Januaries materially increase the probability of a down year. Well, that turned out to be a useful tidbit: "Worst-ever five days predict worst-ever year! Read all about it!" This year the five-day return was up a bit (saved by the last two hours), but the six-day return was down quite a bit. Ho hum.

The Presidential Cycle, as written about previously, has been completely ruined by Greenspan. He over-stimulated during the first two years, which are meant to be the time for tightening up, not only in 1997 and 1998, but also during this past cycle in 2005 and 2006. Both times this caused an extra-speculative surge in the typically stimulative Year 3s, in 1999 in the NASDAQ, and in 2007 in housing prices and ugly financial instruments. Both surges set off collapses during the critical election years, which are meant to be stable. In the coming Year 1 of the new cycle, we should be squeezing credit a little and tightening budgets so that we can re-stimulate in 2011 for the next election. What a joke! 2009 will be the greatest stimulus year ever, let alone in a normally restrictive year. So for the time being: Presidential Cycle – Rest In Peace!