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Boring Fair Price!

Jeremy Grantham

Waiting for Markets to be Silly Again

A year is certainly a long time in markets, and so is a quarter. A year ago, equities globally – and everything else for that matter – were very overpriced, particularly if they were risky. A quarter ago, in mid March, prices everywhere were cheap. Now they have all – or almost all – converged for a few unusual moments at fair value. A year ago, it was very easy to know what to be: a risk avoider. It was not so easy reinvesting when terrified, but most of us knew that we should have been doing more. But today? It's difficult to be inspired at fair value.

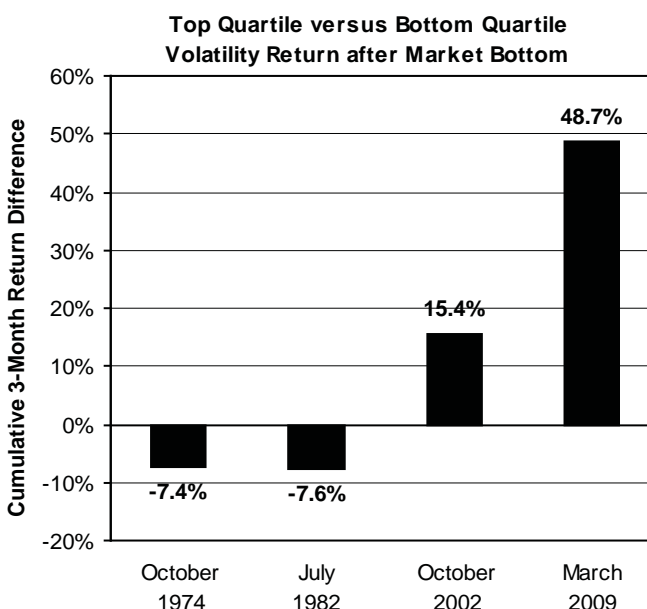
Since early March, the market has had the type of strong speculative rally that often follows extreme declines. The danger of a breathtaking rally is that it leaves those few investors who raised considerable cash waiting for a pullback and psychologically invested in the case for a new bear market leg. This was covered in our mid-March posting, "Reinvesting When Terrified." That theme was developed a few weeks later for me when the penny dropped: the extreme stimulus and moral hazard of recent quarters resembled the stimulative third year of a Presidential Cycle. Indeed, it seems to have turned this usually restrictive Year One into a giant Year Three effect. The market in Year Three typically outperforms its average by 12 percentage points predicated on much less desperation exhibited by the authorities than we had this year. A notionally independent Fed has to be at least somewhat discreet in its friendly support of an existing administration in Year Three. While in Zurich on April 1 (you get what you pay for on April 1), under the impact of that penny dropping, I told *Finanz und Wirtschaft* that "Der S&P 500 Index kann rasch auf 1100 steigen." That is, the S&P could move rapidly to 1100. I actually remember saying that the move could be between 1000 and 1100, but journalists hate wasting space. In a belated quarterly letter a few weeks after that, I tried to make the point that such a rally had absolutely nothing to do with the logic

of long-term fundamentals, but was merely a response to great stimulus and great implied promises.

Well, this time once again, enough risk takers were found to get the job done, and the market rose to 950, with presumably at least a decent shot (say, 50/50) at rising over 1000 in the next two to three quarters.

In addition to making the sharpest upward move since 1938, the market had a record speculative bias, as shown in Exhibits 1 and 2. On this topic I failed badly to emphasize enough one aspect of the analogy to the third year of the Presidential Cycle: it is usually extremely speculative. Where the S&P outperforms normal by 12 percentage points in Year Three, the most volatile quarter of the market outperforms by 21%! This is a lot of money in a year. Exhibit 1 shows the gap between high and low

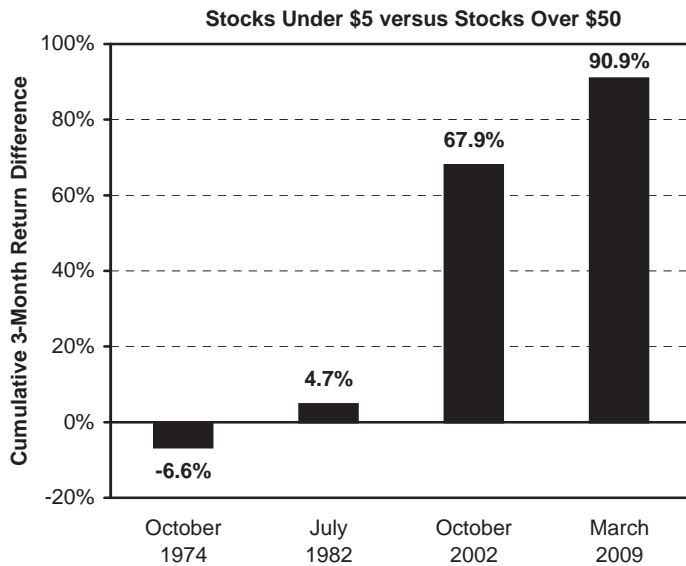
Exhibit 1 Speculative Rallies I



Note: The universe for the above data is the top 1000 U.S. stocks by market cap.

Source: GMO

Exhibit 2 Speculative Rallies II



Note: The universe for the above data is the top 1000 U.S. stocks by market cap.

Source: GMO

volatile stocks in each of the most impressive market recoveries in recent decades, and Exhibit 2 shows the gap between stocks under \$5 and over \$50, which has a very good record as a risk proxy. This current move clearly looks like the record holder! And the rally did indeed leave institutional investors feeling left behind. In an informal survey at a recent meeting of 150 or so institutions, those admitting to feeling nervous about underexposure to risk outnumbered those feeling too aggressive by a neat 10 to 1! This also suggests how a speculative rally can keep going longer than reasonable investors expect.

We at GMO, while we were really quite good in re-entering the market, perhaps under-responded to the probabilities of a particularly risky rally. As value purists (at least most of the time), we were very constrained by the fact that we still measured U.S. quality blue chips as the highest return global equities even at the very low. This was in complete contrast to the situation at the low in 2002, where the best values were in risky emerging markets and small caps, and we simply had to follow our value noses to really participate in, even outperform, a strong rally. For any approach, some market stages cooperate and some try to really mess with you. We came very close to getting the point this time but still missed it, although all the pain can and very well may be recovered. One of the encouraging things about investing is that you only have to be partly right: in our typical global balanced accounts, for example,

we fell last year with an average of 42% global equity and we rose off the low with an average of 62%.

On its way up from 666, the S&P flashed through its fair value of about 880 on our best estimates (our estimate of fair value has decreased slightly again due to write-downs of book value, among other factors). The market's overshoot to 950 caused our seven-year forecast for the S&P to drop to 4.8% real compared with its 5.7% estimate at fair price. After 20 years of more or less permanent overpricing of the S&P, we get five months of underpricing. There is no justice in life! Well, at least not for the apparent handful of us who welcome the opportunity to invest at bargain prices! There is more happiness, it seems, for the armies of investors who prefer the temporary endorphin rush that comes with a rising market, even if it's overpriced.

In March and April, I wrote about Plan A: you must force yourself to invest in a cheap market even when you are terrified by rapidly falling prices, as I admit I was to some extent. I also suggested Plan B: if you missed the earlier lows, you must grit your teeth and phase slowly into a cheap market. You can't gamble that it will oblige you by another low, and historical analogies with earlier, much lower market lows are fraught with genuine differences. Now it is time for Plan C.

Plan C: What to do if the Market Overruns

Given our view that we are in for seven lean years in which the market will be looking for an excuse to be cheap, we recommend taking some risk units off the table, including becoming underweight in equities – between 1000 and 1100 on the S&P, if it gets there this year. Around 880 you should continue to move slowly to fair value, twiddle your thumbs, and wait to see what happens. Boring! Otherwise, it is time to focus on the lesser issues: which types of equities are cheaper or more expensive than the market. This leads us back once again to the bet on quality stocks.

The Quality Bet

The easy winner of the cheapest equity sub-category contest is still high quality U.S. blue chips. They were really trashed on a relative basis by the second quarter rally in junk. I understand a rally in junk after the record decline, but this was excessive and based apparently on unrealistic hopes for a strong, sustained economic recovery. Such a recovery seems most unlikely, whereas a temporary, weaker recovery appeared very likely three

months ago as the substantial size of the stimulus package was revealed. The latter scenario still seems probable. Our original estimate for the timing of some economic recovery to occur late this year or early next year still stands. Without an unexpectedly strong improvement in the economy, it is hard to see high quality stocks losing much more ground, given their extreme value gap over junky stocks – more than an 11 percentage point spread per year on our seven-year forecast! If our numbers are correct, long quality (or long quality and short junk) is substantially the most outlying bet available today in all global equities. (Let me admit here, once again, that there is always more subjectivity and, hence, doubt in measuring “quality” as a sector than there is in, say, large caps versus small caps. But we have been estimating quality this way for 30 years and think we have a good record in doing so.)

Our other perennial favorite – emerging market equities – has had an amazing recovery, all things considered, and is no doubt also vulnerable to a reassessment of how quickly the global economy is recovering. Deciphering the strength of the Chinese economy will also play a major role in formulating our view of any future relative strength of emerging. My colleague, Edward Chancellor, strongly suspects that the Chinese economy is dangerously unbalanced and very likely to come unhinged in the next few quarters, surprising the pants off investors. On the other hand, the strong longer-term case that I outlined in “The Emerging Emerging Bubble” 15 months ago seems intact. I suggested then that emerging equities would

sell within five years or so at a distinct P/E premium to celebrate their obviously superior GDP growth compared with that of an aging developed world. Emerging market equities are already selling at a modest premium to EAFE and the higher quality half of the U.S. equity market.

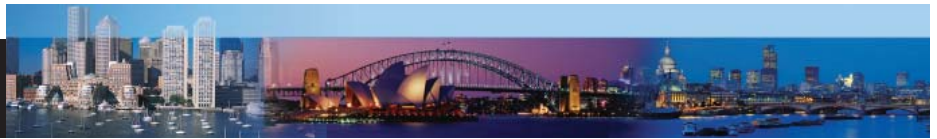
Being pro-emerging yet anti-China is a dilemma for us; we are working to resolve it. Meanwhile, emerging equities, like most risky asset components, are moderately overpriced. We in asset allocation may, however, push our luck in emerging – particularly ex-China emerging – using inertia to reduce our current modest overweight. If we do this, it will be out of respect for the high probability that emerging equities will sustain and increase their overpriced level relative to the rest of the world.

Caveats

What we specialize in at GMO, not surprisingly perhaps, is doing the easy job: we wait for extreme situations and predict that they will become normal once again. When markets sell at normal prices, life for us becomes much harder, perhaps 10 times harder. Predicting movements away from rational prices in an irrational world should not be easy, and indeed it is not. Our one and only effort at predicting a bubble – in emerging markets – is likely to stay just that. Only U.S. quality feels (and measures) to us like a real outlier. As for the rest, if you feel yourself becoming overconfident about anything, take a cold shower and start again. Just be patient. In our strange markets, you usually don’t have to wait too long for something really bizarre to show up.

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Initial Report: Running Out Of Resources

Jeremy Grantham

Getting Used to Lower Growth and Higher Prices

As the economy sorts itself out from the recent financial turmoil, we are very likely to have lower growth rates for quite a few years. We described the reasons for this last quarter: writing down excessive loans and curtailing expenditures as we realize we are not as rich as we thought.

Economic expansion will also be held back by the decreasing growth of available man hours. Since 2000, this growth has declined to below 1% per year from an average of 1.62% for the prior 50 years. Over the next 30 years, it is almost certain to continue to decline to about 0.5%, ignoring the temporary cyclical bounce in employment that we will get as the current severe recession ends.

Behind these two issues, however, lurks another longer-term and more important factor affecting future growth, and that is the increasing limitations on resources: we are simply running out of everything at a dangerous rate. We apparently have trouble processing numeric issues of this kind, and this missing faculty will cause considerable grief. We do not understand the implications of exponential or compound growth rates: the main implication being that they are impossible to sustain.

No better example of resource limitation in the face of both denial and strong efforts can be found than U.S. oil production. As is well known, we have been on the steep downslope of production since 1974 despite our best attempts to “Drill, baby, drill!” The largest oil discovery in the Gulf in the last 20 years will keep our engines running for a mere 41 days. Nothing we do can reverse the decline, and drilling our reserves faster has been described as “oil independence through more rapid exhaustion of our reserves!” Coal reserves of the highest quality – anthracite – are basically mined out everywhere, and the second choice – bituminous coal – has probably

also passed its peak. All attempts to maintain the growth of total hydrocarbon output must now depend on subbituminous coal, lignite (which is a little bit better than burning rock, but not much), and tar sands, which are themselves increasingly energy- and water-intensive to exploit.

Modern agriculture has been described as a way of turning hydrocarbons into food. Without cheap energy – a single gallon of gas is the energy equivalent of 100 hours of old-fashioned labor – the world would certainly have trouble producing half of the current food supply, and that fraction could be substantially less. Hydrocarbons are not only critical to farm equipment and food distribution over very large distances, but also play a dominant role in fertilizer production. With sparse hydrocarbon usage, American agriculture would have to be totally and painfully restructured away from very large scale monoculture. Hydrocarbons are very efficient in the use of manpower but surprisingly inefficient with everything else, including output per acre and output per unit of energy.

All metals are facing the same depletion problem as hydrocarbons. Where 30 tons of copper ore once produced a ton of copper, it now takes 500 tons of ore! And with every extra ton of ore required, the energy intensity also rises. Several specialized metals critically important as catalysts are past their peak production. Water resources, so necessary for agricultural growth, are under incredible economic pressure, and are simultaneously diminishing in absolute terms.

This would be a dangerous situation with zero population growth; in fact it would guarantee that per capita growth would slow. Yet population growth in the last century has been the fastest in the history of man. The recent 100-year growth exceeded that of any 2000-year block in history. And in terms of absolute numbers added, the world’s

population has increased 2.5 times in my lifetime, from 2.5 billion to 6.5 billion.

It should be obvious from simple arithmetic that population growth is on a direct collision course with increasingly scarce resources. For millennia, food constraints held the world's population nearly constant. About 12,000 years ago, these constraints were altered significantly with the start of organized agriculture. Then, around 200 years ago, the so-called Agricultural Revolution – the introduction of science to farming – allowed for another doubling in output. All of this was dwarfed, however, by the harnessing of hydrocarbons – the sun's energy stored over hundreds of millions of years. This remarkable patrimony is now about half gone, and some time in the next 10 to 40 years, half of all of our resources will have been used or, stated another way, one last doubling will remain. We are looking at the last of 14 doublings in the past 250 years. We are, if you prefer, 13/14ths of the way through the game in exponential terms! At 1% growth in hydrocarbon consumption, which would be a dramatic reduction in the growth rates of the last 30 years, our reserves would last for merely one more generation. As we move through our remarkable and irreplaceable hydrocarbon reserves, the price will, of course, rise remorselessly to ration supplies. Hydrocarbons will increasingly be limited to their highest and best uses: (probably) petrochemical feed stocks and aviation fuels. The price rise, which for a while is quite likely to be parabolic – rising at an increasing rate rather than a steady rate – will have an immediate effect on the price of all agricultural products. Also affected will be the price of all metals, which too have become extremely energy-intensive, as has hydrocarbon production itself.

This transition away from carbon-based fuels could have been relatively painless on paper, but in real life our species has such a modest ability to deal with distant outcomes or to defer gratification that a bad ending is probably inevitable. We need, it seems, the shock of a Pearl Harbor to really gear up and make sacrifices. For the record, in 1977 President Carter pointed out that we were running out of oil and would need to make some "sacrifices." By "sacrifices," by the way, he did not mean real wartime-like sacrifices, but merely a time of settling for a lower rate in the increase of wealth. He noted quite accurately that in the 10 short years preceding 1977, our planet's population had used as much oil as in its whole previous history! (That is to say, it had doubled usage in 10 years, or had grown at 7% a year, which doesn't sound

so Draconian but, of course, is.) Carter urged us to fully insulate 80% of our houses in 10 years and to continue President Ford's auto fuel economy initiatives; following these recommendations would have actually freed us from the need to import any sensitive Middle Eastern oil! As a famous symbol, he had solar panels installed on the White House roof. Remarkably, this very un-American speech of his was well received by its audience but, unfortunately for him (and probably for us also), very little else he did was.

Carter was dispatched by President Reagan, who was admirable in many other ways in my opinion, but apparently had psychological problems when dealing with limits. In a display of brilliant politics and complete innumeracy, Reagan argued passionately and appealingly that the whole idea that our children were not entitled to a much richer life than their parents was un-American, sacrifice was unnecessary, Carter had overstated the case, and down came the solar panels. Thus, our sole effort at dealing with some foresight with the iron laws of limits was brushed aside, and the particularly egregious age of SUVs and increasing dependence on oil imports was ushered in.

Well, dear readers, happy thoughts and wishful thinking do not make it so; 30 precious years have passed, and there is now no safety margin. We must prepare ourselves for waves of higher resource prices and periods of shortages unlike anything we have faced outside of wartime conditions. In fact, I believe we are already several years into this painful transition but are still mostly invested in denying it. Everything within the investment business will be affected as well as everything outside of the business. GMO intends to make a sustained effort in this area to get ahead of the curve, and we will keep you posted.

As a parting note, let me point out that China is showing every sign of being a country ahead of the curve. There has been a whiff of panic – which I believe is justified – in China's last 5 years of behavior regarding resource limitations and possible mitigation through truly dramatic increases in alternatives, desperate attempts at resource acquisitions, and the fostering of special foreign relationships. Being more authoritarian may come with great long-term advantages in this field. It would be convenient if we could offset China's natural advantages with some of our own; for example, flexibility, a vigorous venture capital industry, and, above all, an enlightened government policy. A Carter-type statement of resolve

would be a good start, and would show a willingness to take a short-term political hit in the interest of a significant long-term advantage. I must confess to not holding my breath, but I am crossing my fingers. Do not allow

yourselves to be kidded by our usual optimism – this is the Real McCoy!

Have a good (if worried) summer!

Reading and Listening List

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Martenson, Chris. *The Crash Course*. 2009 <<http://www.chrismartenson.com>>.

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