

Grantham: the Bear Grows

Is it 1929 all over again? Maybe not, but the market oracle sees no quick end to the pain

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June 17, 2008 at 6:40 AM EDT

Renowned value investor Jeremy Grantham knows an investment bubble when he sees one coming, and always steers well clear of the risks - sometimes at great initial cost. At the height of the Internet stock bubble in the 1990s, GMO, the Boston-based institutional money manager he founded, lost about 45 per cent of its funds under management when investors sought out firms with sexier strategies. Of course, his sound analysis and risk assessments were vindicated and his clients eventually were rewarded handsomely.

By 2006, Mr. Grantham, whose firm manages about \$145-billion (U.S.), including \$2.8-billion from Canadian pension funds and other institutions, was warning of the coming implosion of the global credit market. And he has seen nothing since that cataclysmic event last year to convince him the worst might be over.

You draw comparisons between what's happening today and the start of the Great Depression.

We're in that 1929-30 window, where we've had a shock to the system. But the secondary effects - less consumption, lower profit margins, lower GDP, lower employment, lower global trade - are beginning to work through the system. They're steadfastly ignored because they're still quite slight. It takes a year, 18 months [or] even longer for some of these effects to show up.

So no short, shallow downturn, then?

It's very hard to torture the economics, to think that you can squeeze liquidity, take a hit to your biggest capital asset, housing, mark it down 15 per cent and then maybe another 15 per cent, in an overleveraged society, without having a sustained negative effect that would last two or three years. Which I'm sure it will.

Yet the stock market doesn't seem to agree. Investors are treating this as a short-term problem that will soon be fixed.

They [equity players] hate anything negative. And that's grown along with the moral hazard and the credit crisis. They have almost a pathological aversion to honest, negative opinion, which in itself is a sad state of affairs. But what the market never gets are the long lags.

You have said that by pulling out all the stops to prevent a recession, governments actually end up slowing the economy more in the long run.

I think you can argue logically there has to be some movement of assets into weaker hands, and, therefore, some loss of aggregate efficiency vis-à-vis the rest of the world, and, in all probability, a modest loss of growth rate. That certainly tallies with the data.

If the economy limps along, barely above recession levels, don't people come to expect this condition to last a long time?

Yes. The real divide comes when the recession is sharp enough to wash away the people who were relatively weak at their game or were caught out taking much too much risk and too much leverage. And the next time, there wouldn't be those weak sisters. It comes back to the health of the financial system. The whole economy becomes a little less vigorous if it's constantly propped up this way.

And what do you think finally persuades the equity markets?

The fundamental data. It may not be next month, because people systematically make a mistake on how to treat the weak [U.S.] dollar, which affects the 45-per-cent earnings of the S&P [500] that come from overseas.

Can you give us an example of how profits are being misread?

If the dollar goes down 18 per cent against the euro, then all your profits in Germany are marked up by 18 per cent. Bang, simple as that. Let's say you have 6-per-cent natural growth and an 18-per-cent markup. You have a 24-per-cent earnings increase from your German subsidiary. The next year, the 6 [per cent] may only have gone down to 4, but the dollar has rallied ... and your growth has gone to zero.

You have also been extremely critical of America's love affair with debt.

The [U.S.] debt-to-GDP ratio went sideways for 50 years and the economy was growing handsomely. Then the debt level tripled in 25 years [since 1982] and the growth rate slowed. So this beautiful faith we have that increasing debt will cure all problems is a complete hoax. Growth is about the level of capital spending and saving, education, technology, R&D and all those good things. It's not about what I owe you and you owe me.

Let's move on to a favourite Canadian topic: commodities. Are we looking at a bubble that will go the way of credit or U.S. housing or a real sea change?

It's not a nice simple bubble of the kind that I love and would like to stake a lot on. And the reason is that in the long run, the paradigm has shifted. Raw materials in a world of China and India and so on will never be quite the same tame things that they were from a price point of view for the previous 50 years. Throwing in speculators who like to invest in commodities to get diversification, and two years of almost perfect global economic conditions have set commodity prices on an incredible roll.

It sounds as if a *but* is coming.

They may be quite vulnerable on a tactical, short-term basis. If I'm right in my general thesis that we're underestimating the pain, then they will probably take a fairly sharp short-term hit. But they'll be back, as Schwarzenegger would be saying.

Are there other opportunities for people who want to stay invested?

There isn't a healthy risk/return ratio around in the equity markets. What I would personally do is look for the greatest vulnerabilities, under anticipated. I'd be looking to make money either by going short or, at the most aggressive, long short. I'd go long emerging [markets] and long high-quality U.S. stocks, and short the U.S. junky [small-cap] stocks. That can do perfectly fine over the next several years.