GMO

QUARTERLY LETTER

December 2011

The Shortest Quarterly Letter Ever

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I've been having one of those quarters where everything that can get in the way of writing and thinking does, notably our client conferences and unexpected travel requirements. Like many, I find it hard enough to write at the best of times. So sorry for the delay. But rather than skip a quarter, I thought I'd make a simple list of points that I'm thinking about.

Notes to Myself

- I have no particular insight into the problems plaguing the eurozone, but I can recognize a terrifying situation when I see one. The appropriate response is surely to be more cautious than usual.
- Sadly, I feel increasingly vindicated by my "seven lean years" forecast of 2½ years ago. The U.S., and to some extent the world, will not easily recover from the current level of debt overhang, the loss of perceived asset values, and the gross financial incompetence on a scale hitherto undreamed of.
- Separate from the "seven lean years" syndrome, the U.S. and the developed world have permanently slowed in their GDP growth. This is mostly the result of slowing population growth, an aging profile, and an overcommitment to the old, which leaves inadequate resources for growth. Also contributing to the slowdown, particularly in the U.S. and the U.K., is inadequate long-term savings. As I write, the U.S. personal savings rate has fallen once again below 4%.
- In addition, and sorry to harp on this, the U.S. in particular has rapidly acquired relative deficiencies over the last 20 years that will hamper the effective functioning and growth of its economy. Relative to other developed countries, and an increasing number of developing countries, we are sliding in some key areas that threaten loss of competitiveness:
  - Notably depleted infrastructure
  - Marked fall-off in the effectiveness of education and training
  - Much decreased effectiveness of government, particularly in its ability or even willingness to concern itself with long-term issues.
- Meriting a separate, special point are the drastic declines in both U.S. income equality – the U.S. has become quite quickly one of the least equal societies – and in the stickiness of economic position from one generation to another. We have gone from having been notably upwardly mobile during the Eisenhower era to having fallen behind other developed countries today, even the U.K.! The net result of these factors is a growing feeling of social injustice, a weakening of social cohesiveness, and, possibly, a decrease in work ethic. A healthy growth rate becomes more difficult.
- I also believe that having an economy in which the average worker makes little or no economic progress slowly erodes economic balance, leaving us (as mentioned last quarter) with strong sales of BMWs and other premium goods, and weak and erratic sales of what might be called ordinary goods, resulting in weaker and more unstable

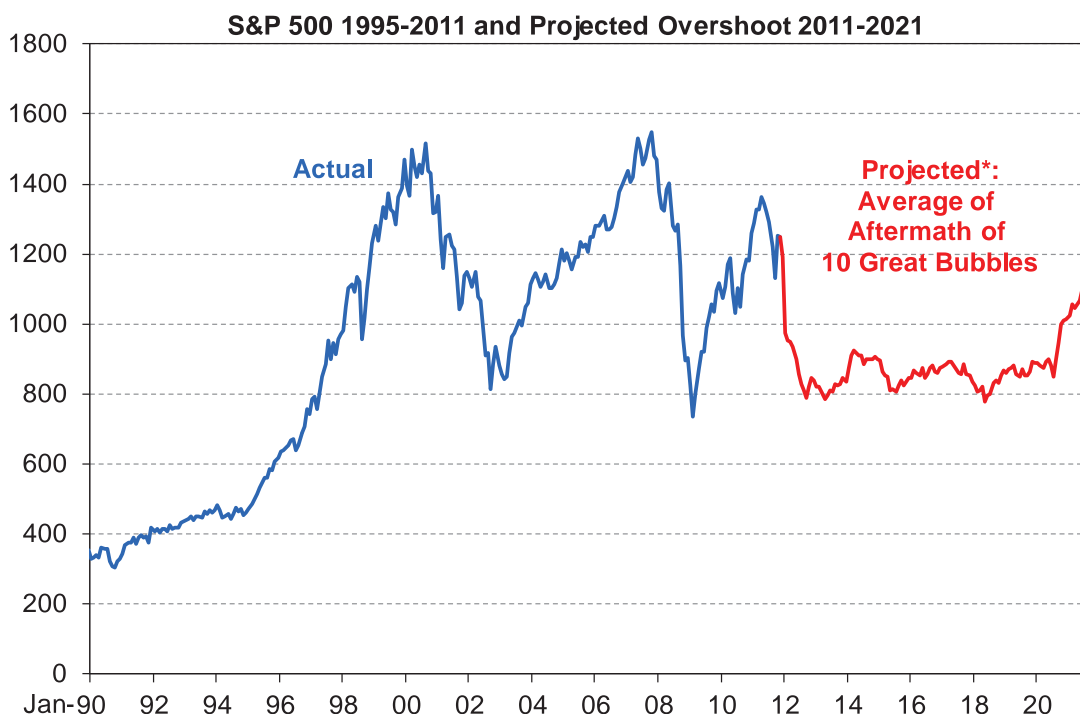
growth. Sales are erratic because, with little or no income progress, buying surges by the "middle class" depend increasingly on shifts in confidence and a willingness to go into debt.

- I despair that this country and its government have failed to take at all seriously the most important and the most dangerous issues: depleting resources, development of a comprehensive energy policy, and, yes, global warming. Wake up dudes!
- Sitting on planes over the last several weeks with nothing to do but read and think, I found myself worrying increasingly about the 1% and the 99% and the appearance we give of having become a plutocracy, and a rather mean-spirited one at that. And, one backed by a similarly mean-spirited majority on the Supreme Court. (I will try to post a letter addressed to the "Occupy … Everywhere" folks shortly.)
- Since the spring, the equity markets have been absolutely bombarded by bad news. This news is complicated and inter-related: how one factor, say, "Greek default," or "China stumbles," interacts with others such as double-dipping economies and generalized financial crises is just about impossible to know. One can only make more or less blind guesses. Looking out a year, the overall picture seems so much worse than the generally benign forecast of 4% global growth from the IMF. The probabilities of bad outcomes are not as high for us today as they were in early 2008 when, I'm pleased to say, as predictors, they looked nearly certain to us. But the possibility of extremely bad and long-lasting problems looks as bad to me now as it ever has.
- Yet the S&P 500, unlike other global equities, has hung in and staged rallies whenever the bad news has eased. Why? Well, 15 years ago, Ben Inker and I designed a model to explain (not predict) the ebbs and flows of the P/E ratio. It had a surprisingly high explanatory power. We found that everything that made investors feel comfortable worked. That is to say, it was a behavioral model. Fundamentals like growth rates did not work. The two (out of three) most important drivers were profit margins and inflation. Well, today we have (remarkably, even weirdly) record profit margins. And by historical standards, stable and low inflation. Because of this, the P/E level that one would normally expect to have in these conditions has been way in the top 5% since 1925, but today's market (not to mention the lows of September) is well below the explained level. It's depressed by a very obvious reason: the cloud of negatives, which generally and surprisingly have historically had very little effect individually on the market, but apparently do depress "comfort" when gathered into an army of negatives. So, whenever the negative news cools down for a week or so, the market tries to get back to its "normal" level, which is about 20% higher. (P.S. the "normal" level is based on a behavioral explanation. It is absolutely not justified by long-term value, which hinges on boring discount rates and long-term sustainable growth or, even more fundamentally, on "replacement cost" or Tobin's Q.)
- Profit margins dominate the P/E equation above, so that the market is unlikely to come down even to fair value, about 975-1000 on the S&P in our view, and stay there until profit margins decline. And the longer you look at these record and still-rising margins and compare them to the miserable unemployment and substantial spare capacity, the stranger these high margins look. They will come down to more normal levels eventually, of course, and when they do they will bring the market down with them. Probably by then, some of the negatives mentioned above will have resolved themselves. If not, then the market could decline a lot and test my "no market for young men" thesis that follows.
- **"No Market for Young Men."** Historians would notice that all major equity bubbles (like those in the U.S. in 1929 and 1965 and in Japan in 1989) broke way below trend line values and stayed there for years. Greenspan, neurotic about slight economic declines while at the same time coasting on Volcker's good work, introduced an era of effective overstimulation of markets that resulted in 20 years of overpriced markets and abnormally high profit margins. In this, Greenspan has been aided by Bernanke, his acolyte, who has continued his dangerous policy. The first of the two great bubbles that broke on their watch did not reach trend at all in 2002, and the second, in 2009 – known by us as the first truly global bubble – took only three months to recover to trend. This pattern is unique. Now, with wounded balance sheets, perhaps the arsenal is empty and the next bust may well be like the old days. GMO has looked at the 10 biggest bubbles of the pre-2000 era and has calculated that it

typically takes 14 years to recover to the old trend. An important point here is that almost no current investors have experienced this more typical 1970's-type market setback. When one of these old fashioned but typical declines occurs, professional investors, conditioned by our more recent ephemeral bear markets, will have a permanent built-in expectation of an imminent recovery that will not come. For the record, Exhibit 1 shows what the S&P 500 might look like from today if it followed the average flight path of the 10 burst bubbles described above. Not very pretty.

Exhibit 1

If the S&P Overcorrects Like the Average of 10 Great (pre-Greenspan) Equity Bubbles...



* Assuming 2.5% inflation

These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Actual results may differ materially from the forecasts above.

Source: Global Financial Data, GMO   Actual data as of 9/30/11

- Two quarters ago, I advised ducking and avoiding risk and called off the normal positive expectations for Year 3 of the Presidential Cycle; first, because we had already had a good return by April and second, because negatives were building up in a scary way. For this advice I have no regrets: "Discretion is the better part of historical valor." The Presidential Cycle this year was indeed very unusually poor (-2.7%) – the second worst since the start of the game in 1932 – finishing very near the lows for the year on September 30. (The Presidential Cycle is October 1 to October 1.)
- One quarter ago (end July), I said that if you could avoid low quality U.S. stocks, global equities were getting cheap; the average growth estimate for EAFE, Emerging, and U.S. High Quality was almost 7% real on our seven-year forecast. Back then we became net buyers of equities – actually, better described as nervous nibblers – for the first time since the spring of 2009.
- At the end of July, we remained a little underweight equities despite this decent 7% real return forecast because we allowed ourselves a very small adjustment for a fundamentally scary outlook: thus we were two points

underweight in equities instead of, perhaps, two points overweight. No regrets here either, for despite the strong rally in October, things are really, really scary. Aren't they? (And, more recently, stock markets are once again in disarray.)

- My longer-term advice in April was to stay ducked until either the equity markets get to be cheap or, for the speculatively inclined, until we enter the next Year 3 in October 2015, whichever comes first. This still looks like good general advice.
- Meanwhile GMO is having a better year. Our largest equity strategy, GMO Quality, is 9.1% ahead of the S&P year-to-date in an almost flat market (net, as of November 30)† and is well on its way to delivering a healthy positive absolute return. We would normally count on winning in this strategy in a big down year, but in a nearly flat year this difference is a testimonial to how risk-averse investors have been at the U.S. stock level. Better yet, U.S. High Quality stocks are, according to us, still relatively cheap.
- Our major asset allocation account (GMO Global Balanced Asset Allocation Strategy), helped along by this "Quality" effect, has done relatively well (though not great, +4.2% net against its benchmark year-to-date as of November 30)† despite the absence of longer duration U.S. treasuries, which have been tigers, and a moderate overweighting in emerging equities, which have definitely not. (Although the economic fundamentals and financial condition of emerging countries remain so much better than those of their developed counterparts, the world still fears their traditionally high beta – which can and has become a self-fulfilling belief – and the strong possibility of some weakness in China.)

Recommendations

- Avoid lower quality U.S. stocks but otherwise have a near normal weight in global equities.
- Tilt, where possible, to safety.
- Try to avoid duration risk in bonds. For the long term they are desperately unattractive. Don't be too proud (or short-term greedy) to have substantial cash reserves. Admittedly, this is the point where we at GMO try to be clever and do a little better than the minus 1% real from real cash – and, so far, with decent success.
- I like (personally) resources in the ground on a 10-year horizon, but I am nibbling in very slowly because, as per my Quarterly Letter on resources in April 2011, I fear a major short-term decline in commodities based on a combination of less bad weather – which has been bad, but indeed less bad – and economic weakness, especially in China. Prices have declined, often quite substantially, since that letter. However, I believe chances for further price declines in resources are still better than 50/50 as China and the world slow down for a while, and the weather becomes a bit more stable.

† The performance numbers are preliminary and subject to change. Final performance numbers are generally available 5-10 business days after month-end. Performance over other periods may differ significantly from that of the time period corresponding to these performance numbers. Performance data quoted represents past performance and is not predictive of future performance. Returns are presented after the deduction of management fees and incentive fees if applicable. Net returns include transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. A GIPS compliant presentation of composite is available at www.gmo.com. Actual fees are disclosed in Part II of GMO's Form ADV and are also available in each strategy's compliant presentation. The performance information contained herein is supplemental to the GIPS compliant presentation that was made available on GMO's website in April of 2011.

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