GMO

QUARTERLY LETTER

October 2010

Jeremy Grantham

NIGHT OF THE LIVING FED

something unbelievably terrifying

RUNAWAY COMMODITIES !

BANKS COME BACK TO LIFE !

HOMES DESTROYED !

FAMILIES EVICTED !

CURRENCY WARS !

Starring BEN BERNANKE

and Introducing JANET YELLEN

with Guest Appearance as Chief Zombie ALAN GREENSPAN

The Ruinous Cost of Fed Manipulation of Asset Prices

My diatribe against the Fed's policies of the last 15 years became, by degrees, rather long and complicated. So to make it easier to follow, a summary precedes the longer argument. (For an earlier attack on the Fed, see "Feet of Clay" in my 3Q 2002 *Quarterly Letter.*)

Purpose

If I were a benevolent dictator, I would strip the Fed of its obligation to worry about the economy and ask it to limit its meddling to attempting to manage inflation. Better yet, I would limit its activities to making sure that the economy had a suitable amount of liquidity to function normally. Further, I would force it to swear off manipulating asset prices through artificially low rates and asymmetric promises of help in tough times – the Greenspan/Bernanke put. It would be a better, simpler, and less dangerous world, although one much less exciting for us students of bubbles. Only by

hammering away at its giant past mistakes as well as its dangerous current policy can we hope to generate enough awareness by 2014: Bernanke's next scheduled reappointment hearing.

To Summarize

1) Long-term data suggests that higher debt levels are not correlated with higher GDP growth rates.

2) Therefore, lowering rates to encourage more debt is useless at the second derivative level.

3) Lower rates, however, certainly do encourage speculation in markets and produce higher-priced and therefore less rewarding investments, which tilt markets toward the speculative end. Sustained higher prices mislead consumers and budgets alike.

4) Our new Presidential Cycle data also shows no measurable economic benefits in Year 3, yet point to a striking market and speculative stock effect. This effect goes back to FDR, and is felt all around the world.

5) It seems certain that the Fed is aware that low rates and moral hazard encourage higher asset prices and increased speculation, and that higher asset prices have a beneficial short-term impact on the economy, mainly through the wealth effect. It is also probable that the Fed knows that the other direct effects of monetary policy on the economy are negligible.

6) It seems certain that the Fed uses this type of stimulus to help the recovery from even mild recessions, which might be healthier in the long-term for the economy to accept.

7) The Fed, both now and under Greenspan, expressed no concern with the later stages of investment bubbles. This sets up a much-increased probability of bubbles forming and breaking, always dangerous events. Even as much of the rest of the world expresses concern with asset bubbles, Bernanke expresses none. (Yellen to the rescue?)

8) The economic stimulus of higher asset prices, mild in the case of stocks and intense in the case of houses, is in any case all given back with interest as bubbles break and even overcorrect, causing intense financial and economic pain.

9) Persistently over-stimulated asset prices seduce states, municipalities, endowments, and pension funds into assuming unrealistic return assumptions, which can and have caused financial crises as asset prices revert back to replacement cost or below.

10) Artificially high asset prices also encourage misallocation of resources, as epitomized in the dotcom and fiber optic cable booms of 1999, and the overbuilding of houses from 2005 through 2007.

11) Housing is much more dangerous to mess with than stocks, as houses are more broadly owned, more easily borrowed against, and seen as a more stable asset. Consequently, the wealth effect is greater.

12) More importantly, house prices, unlike equities, have a direct effect on the economy by stimulating overbuilding. By 2007, overbuilding employed about 1 million additional, mostly lightly skilled, people, not counting the associated stimulus from housing-related purchases.

13) This increment of employment probably masked a structural increase in unemployment between 2002 and 2007, which was likely caused by global trade developments. With the housing bust, construction fell below normal and revealed this large increment in structural unemployment. Since these particular jobs may not come back, even in 10 years, this problem may call for retraining or special incentives.

14) Housing busts also help to partly freeze the movement of labor; people are reluctant to move if they have negative house equity. The lesson here is: Do not mess with housing!

15) Lower rates always transfer wealth from retirees (debt owners) to corporations (debt for expansion, theoretically) and the financial industry. This time, there are more retirees and the pain is greater, and corporations are notably avoiding capital spending and, therefore, the benefits are reduced. <u>It is likely that there is no net benefit to artificially low rates</u>.

16) Quantitative easing is likely to turn out to be an even more desperate maneuver than the typical low rate policy. Importantly, by increasing inflation fears, this easing has sent the dollar down and commodity prices up.

17) Weakening the dollar and being seen as certain to do that increases the chances of currency friction, which could spiral out of control.

18) In almost every respect, adhering to a policy of low rates, employing quantitative easing, deliberately stimulating asset prices, ignoring the consequences of bubbles breaking, and displaying a complete refusal to learn from experience has left Fed policy as a large net negative to the production of a healthy, stable economy with strong employment.

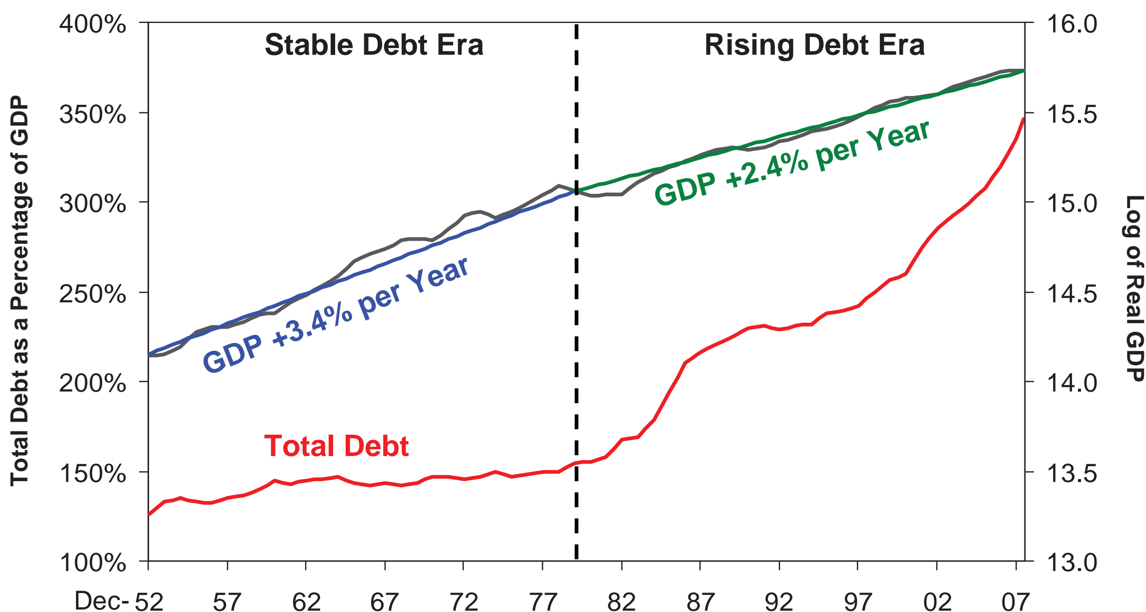
The Effect of Debt on Long-term Growth

My heretical view is that debt doesn't matter all that much to long-term growth rates. What I owe you, and you owe Fred, and Fred owes me is not very important; on the positive side, all it can do is move demand forward a few weeks and then give it back later. This is the paper world. It is, in an important sense, not the real world. In the real world, growth depends on real factors: the quality and quantity of education, work ethic, population profile, the quality and quantity of existing plant and equipment, business organization, the quality of public leadership (especially from the Fed in the U.S.), and the quality (not quantity) of existing regulations and the degree of enforcement. If you really want to worry about growth, you should be concerned about sliding education standards and an aging population. All of the real power of debt is negative: it can gum up the works in a liquidity/solvency crisis and freeze the economy for quite a while.

On this topic, take another look at Exhibit 1, my personal favorite. What a powerful and noble experiment! We tripled debt to GDP ratio over 28 years, and yet GDP growth slowed! And it slowed increasingly, especially after 2000. The 3.4% trend line had been intact for over 100 years, from 1880 to 1982. From this data it is possible to hope that the decline in GDP would have been even worse if we had not been wallowing in debt. But I believe it probably suggests that there is no long-term connection between debt and GDP growth. After all, the last 10 to 15 years have revealed some great reasons for GDP growth to be stronger than average, not weaker: the growth rate of emerging countries helped along by the collapse of communism and the moderate de-bureaucratization of India, the ensuing explosion of world trade, and a claimed surge in productivity from the rapid developments of the internet and cell phone technology

Exhibit 1

Debt Does Not Create Growth!



Source: Federal Reserve, Global Financial Data As of 6/30/08

in particular. Given the above, there is little or no room for higher debt levels to provide a net benefit to economic growth. Therefore, artificially low interest rates must also be of insignificant help to long-term growth, for its main role in stimulating growth is to encourage more debt. After all, a lower rate hurts the lenders exactly as much as it helps the borrowers. The debt expansion, though, was great for financial industry profits: more debt instruments to put together, to sell, and to maintain. Not to mention all of those debt officers to pay for and charge for, and all of that increased debt for investment managers to manage. Thus, the role of finance grew far beyond its point of usefulness. (See "Finance Goes Rogue" in last quarter's *Letter*.)

The Effect of Subsidized Rates and the Economy on Financial Markets

But subsidized debt – debt at manipulated rates – in contrast to normal debt at market clearing prices, has a large, profound, and dangerously distorting effect on market prices. The Presidential Cycle, which I have often talked about, shows most clearly how hard it is to move the real economy with low rates and moral hazard, and how easy it is to influence speculation and market prices. Table 1 shows the data for growth in GDP and employment in Year 3 of the Cycle: it is completely normal, not above average at all.

The economic response to the extra market move of 18.5% in Year 3 occurs in Year 4, just when it is needed politically. It shows a reasonable 0.6% increase in GDP, a 0.5% gain in consumption, and a 0.3% drop in unemployment. This last item, by the way, is the only thing we have ever found that actually moves the vote. This 0.6% effect for GDP, though, is almost exactly what could be expected from the wealth effect on its own, leaving no room in the data for Fed stimulus (or fiscal stimulus, for that matter) to have had any other economic effect in Year 4. This can be tested by looking at all of the best 12-month market moves, excluding Year 3s, which have a cut-off just 3.5 percentage points per year better than the Year 3 performance (22% versus 18.5% above average). These moves are followed by an extra 0.8% GDP the following year – a very similar relationship to that between Years 3 and 4. It is reasonable to conclude from this data that the Fed was able to move the market a lot in Year 3, but that the wealth effect associated with these moves was the only effect on fundamental growth. As a footnote, we can conclude that the stock market wealth effect here works out to about 3% of increased wealth, which is compatible with most academic studies. (Please note that this 3% number includes one cycle of house price wealth effect over the 50 years, and so is moderately overstated.)

In contrast, Exhibit 2 reminds us of the remarkably large effect that low rates and the Greenspan-Bernanke put have on speculation in Year 3, both in raising the broad market and, not surprisingly, on lifting the speculative quarter of the market even more. Exhibit 3 reminds us of the substantial Fed effect all around the world. Never fight the Fed about market prices or underestimate its global reach. The U.K. stock market has been more responsive to the U.S.'s Year 3 stimulus than the U.S. market has itself. It shows Britain in its true colors: half a hedge fund and half the 51st state. How humiliating!

Table 1

Presidential Cycle Effects on Real Economy: None in Year 3, Some in Year 4

The Year 3 Effect Moves Market but not Economy	
Year 3 Compared to Average	
Average Change in Unemployment	+0.15 %
Average Real GDP Growth	-0.3 %
Average Real Personal Consumption Growth	-0.2 %
Average Stock Market Real Return	+17.6 %
Average Change in Fed Funds	-0.56 %

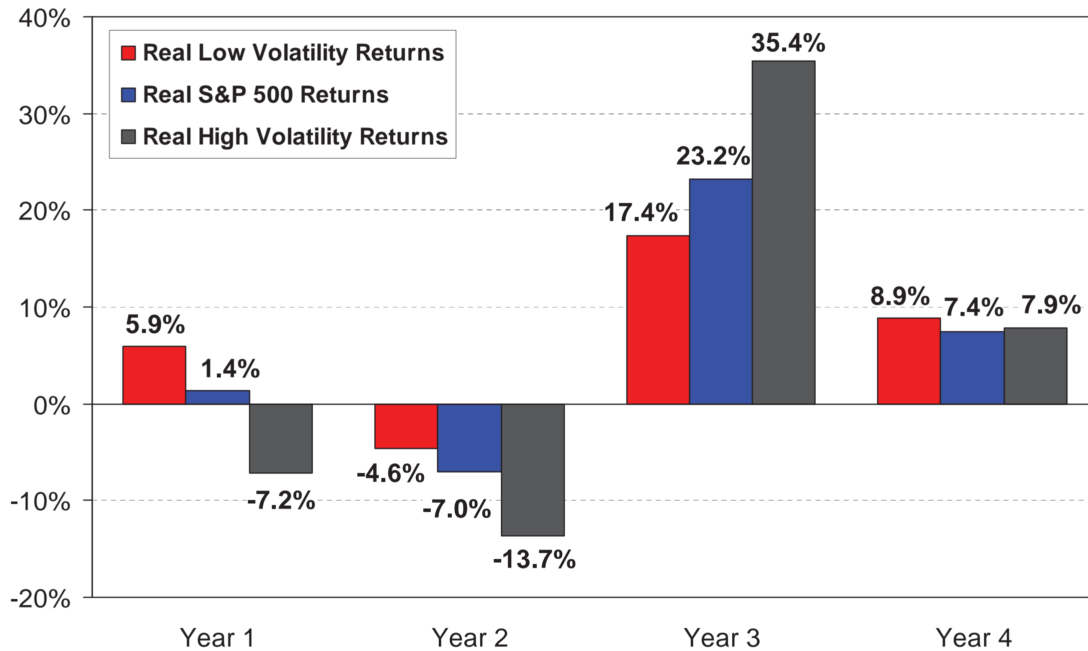
Year 3 Stock Moves Affect Year 4 Economy	
Year 4 Compared to Average	
Average Change in Unemployment	-0.26 %
Average Real GDP Growth	+0.6 %
Average Real Personal Consumption Growth	+0.5 %
Average Stock Market Real Return	+1.7 %
Average Change in Fed Funds	+0.26 %

Source: S&P, BLS, Federal Reserve Data from 1/1/64 to 12/31/07

Exhibit 2

WOW … (It's Year 3 Market Moves that Affect Year 4 Economy)

Presidential Cycle 1964-2007

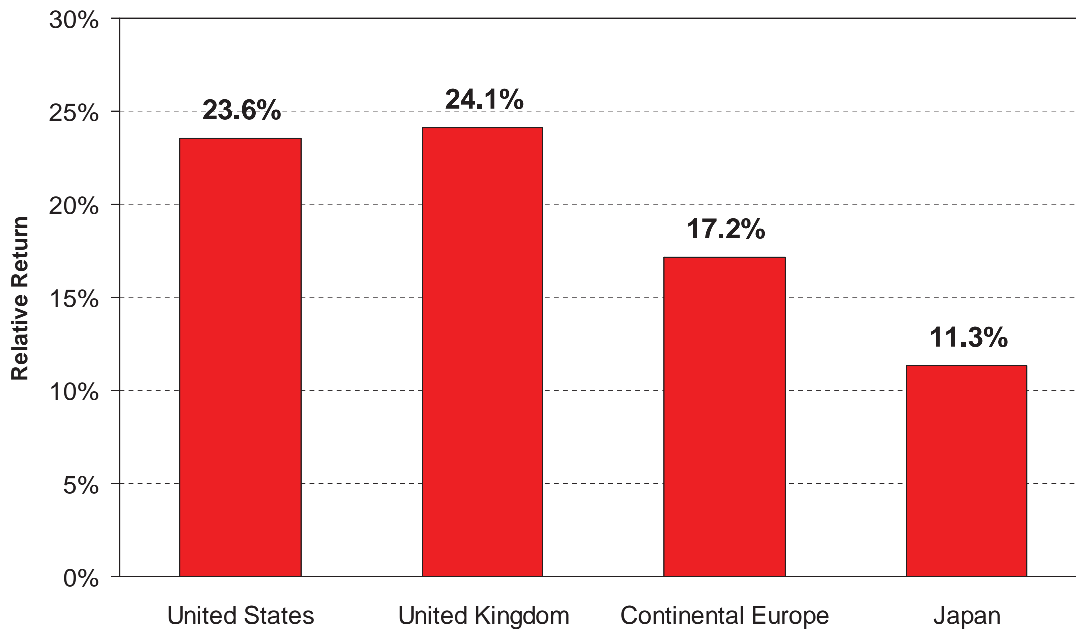


Source: Global Financial Data, GMO As of 12/31/07

Exhibit 3

Never Underestimate the Fed's Global Reach!

Third year of local markets relative to their average: 1964-2010



Source: Global Financial Data As of 9/30/10

Greenspan and Bernanke Learn How to Stimulate Stock Markets

Here the plot thickens, for I suspect that Greenspan and Bernanke know this: that their only decent tool to help the economy is to move the market. They know, as we have also deduced, that the market is far more sensitive to monetary factors than is the real economy. "Monetary policy works for the most part by influencing the prices and yields of

financial assets, which in turn affect economic decisions and thus the evolution of the economy" (Bernanke, May 2004, *American Economic Review*). If you believe this, then goosing the market deliberately is a useful short-term tool for getting traction in difficult economic times, such as those following a severe financial crash or even a normal cyclical contraction.

Unfortunately for us, as the economy recovers and the artificially stimulated market gets up a nice head of steam, the Greenspan-Bernanke team officially loses interest, emphatically and repeatedly denying any interest in, or responsibility for, curtailing their latest experiment in market manipulation. And manipulation is exactly what it is. They express uncertainty that a bubble could even exist. Who am I, argued Greenspan, to disagree with the opinions "of tens of thousands of well informed investors?" They both imply or state outright that markets are overwhelmingly efficient, yet they themselves manipulate the prices to help in the recovery from a recession! How are we to interpret these contradictions? As distortions of their true beliefs, or as sloppy thinking revealed? Whichever it is, we have discovered twice in a decade, and may discover again in a year or two, that this asymmetric policy of stimulating stock moves by setting artificially low rates and then leaving the bull markets, when overstimulated, to bubble over, is dangerous. It is probably the most dangerous thing to inflict on a peacetime economy with two possible exceptions – runaway inflation and a housing bubble. So, not only have these two Fed bosses been almost criminally inept in ignoring stock bubbles, they have also deliberately instigated them as a policy tool! Since we continue to be at Bernanke's mercy and Greenspan's spirit is still alive and well, could things be much worse?

Messing with Housing Is More Dangerous than Messing with Stocks

Well, yes, they could be worse. For the same technique that encourages equity markets (and especially speculation) also encourages housing prices. The housing market is much, much more dangerous to mess with than stocks, as is clearly illustrated by the Greenspan-instigated remarkable and disastrous housing bubble of 2002-06. Housing is always likely to have a larger effect on consumption than stocks for many reasons: for one, higher house prices used to feel permanent, while those for stocks were uncertain. Borrowing against house values has always been more appealing for other reasons: it is easier and usually cheaper to withdraw equity or increase leverage, and is not subject to margin calls. This housing cycle, of course, was exceptional in that borrowing against increased house values was rendered effortless and was actively encouraged by parts of the financial industry. The latter was done with such "success" that at the very peak of the first-ever housing bubble in the U.S., with prices up 60% in four years and 100% in seven years, borrowing against house values reached a record 50% of the total new inflated value. Rising house prices were initially a potent boost to the economy, but later became a lethal weapon. It was just possible that the housing bubble was incidental to the deliberate attempt by Greenspan to encourage higher stock prices, and it may have been unexpected, but the evidence suggests otherwise. As early as 2001, Greenspan was practically bragging about the help that rising house prices was delivering to the wounded economy. Yet, to further confuse the issues, while Greenspan later began to see "extreme speculation" in some housing markets, Bernanke remained unconvinced, claiming not to see a problem even as house prices in 2006 hit the 100-year flood level. "It largely reflects the strong U.S. economy." That was it. And, after all, not to worry, for "U.S. house prices have never declined." Thus, with a closed mind, he seemed to completely ignore the extreme sensitivity of the economy to housing, and this mistake brought us, and most of the developed world, to our knees. It was a direct outcome of a policy that is clearly still in place.

House prices may often not be susceptible to manipulation. Low interest rates may not be enough: they may stimulate hedge fund managers to speculate in stocks, but most ordinary homeowners are not interested in speculating. To stir up enough speculators to move house prices, we needed a series of changes, starting with increasing the percentage of the population that could buy a house. This took ingenuity on two fronts: overstating income and reducing down payment requirements, ideally to nil. This took extremely sloppy loan standards and virtually no data verification. This, in turn, took a warped incentive program that offered great rewards for quantity rather than quality, and a corporation overeager, with aggressive accounting, to book profits immediately. It also needed a much larger, and therefore new, market in which to place these low-grade mortgages. This took ingenious new packages and tranches that made checking the details nearly impossible, even if one wanted to. It took, critically, the Fed Manipulated Prices to drive

global rates down. Even more importantly, it needed the global risk premium for everything to hit world record low levels so that suddenly formerly staid European, and even Asian, institutions were reaching for risk to get a few basis points more interest. Such an environment is possible only if there exists an institution with a truly global reach and a commitment to drive asset prices up. In the U.S. Fed, under the Greenspan-Bernanke regime, just such an institution was ready and willing.

The Wealth Effect of Housing

The effects of house price increases on consumption have been hard to measure. First, prior to 2000, nationwide house prices had never risen materially, so there is no good historical data. Second, if such a rise stimulates a surge in home building and an accelerated turnover of houses, it is impossible to separate this direct stimulus from the wealth effect. But based on a sample of one in the U.S. and a few overseas, we can conclude that the stimulus effect from a house price rise is somewhat greater than for stocks if the boom is not accompanied by a house building surge (as in the U.K. and Australia), and far greater if there is such a surge (as in Ireland, Spain, and the U.S.). The direct effect for stocks and houses is usually calculated as being between 2.5% and 5%, meaning that up to 5% of the new wealth is used for increased spending in the next several years. (Our research suggests the lower end of the range.) The increased facilities to withdraw capital from housing in the U.S. almost certainly made it a bigger effect than normal, and one that was more rapidly delivered.

The Stimulus to Home Building from Rising Prices

What makes a rise in house prices so dangerous, however, is that it can cause a great surge in home building. Recently in the U.S., home construction rose to 1 million more houses per year than trend line average. As far as we can tell, this increase led directly to a 1.5% jump in the workforce. With the related surge in realtors, mortgage brokers, and bankers, let's say that number is closer to 2%. There was also the extra stimulus that more rapid house turnover delivered for household furnishings and appliances. A formidable total.

We can deduce that without this burst of extra employment from increased home building activity, unemployment between 2003 and 2007 would have been even higher. It is a reasonable deduction that the beginnings of a structural problem with the population of mid- and lower-skilled workers would have been revealed had it not been for the abnormal level of house building. The "jobless recovery" would have been seen back then as a crisis.

When the housing boom inevitably ended, all of these temporary advantages were given back with interest. House construction dropped to just above half normal, delivering almost by definition a greater than 2% increment to unemployment. The bad news is that the jobs related to abnormally high house building will not, of course, reappear for some time, perhaps not for 10 or 20 years. Or even longer. Completely new jobs must be found for this small army of the housing-related unemployed.

To make a bad situation worse, the housing bust has badly reduced the free flow of labor across state lines, which is now at the lowest percentage ever recorded. Labor mobility is particularly necessary when unemployment is as high as it is now. But with positive equity in houses suddenly having turned into negative equity, and with some hope (justified or not) that housing prices may recover, many of the unemployed and others will simply not move.

Inflated Asset Prices Cause Faulty Budgeting

Compared to the huge effect that higher house prices had on the economy from 2001 to 2006, the effect of rising stock prices was probably quite mild. But together, they had a powerful destabilizing effect on tax revenues, first inflating them and then crushing them as prices fell. The Federal government, with its unique right to print money, could counter this effect and smooth it out, albeit at the cost of adding to other longer-term problems. But state and local governments were left – and remain today – high and dry. Their loss of capital gains on equities coincides with a much more drastic loss of property taxes, which has the added sting that property values take several years to catch down to new lower price levels.

States and municipalities thus made the painful mistake common to pension funds and endowments: they became acclimatized to the taxes on higher asset prices over so long a period that they assumed them to be a new high plateau. They basically built these higher prices into their budgets. Similarly, endowments did not calculate payouts based on the fair value of assets; they merely "normalized," using the average of the last five abnormally high years. In the same way, pension funds did not materially adjust their target returns downward. These (at around 8% nominal) would be at the outer boundaries of reasonable, even if we were dealing with a decade with above-average inflation, combined with a reasonable or below average P/E, say, as occurred in the '70s and '80s. But since 1995, we have been dealing with below-average inflation and persistently above-average P/Es, which is to say, lower imputed returns. Absolutely no adjustments have been made.

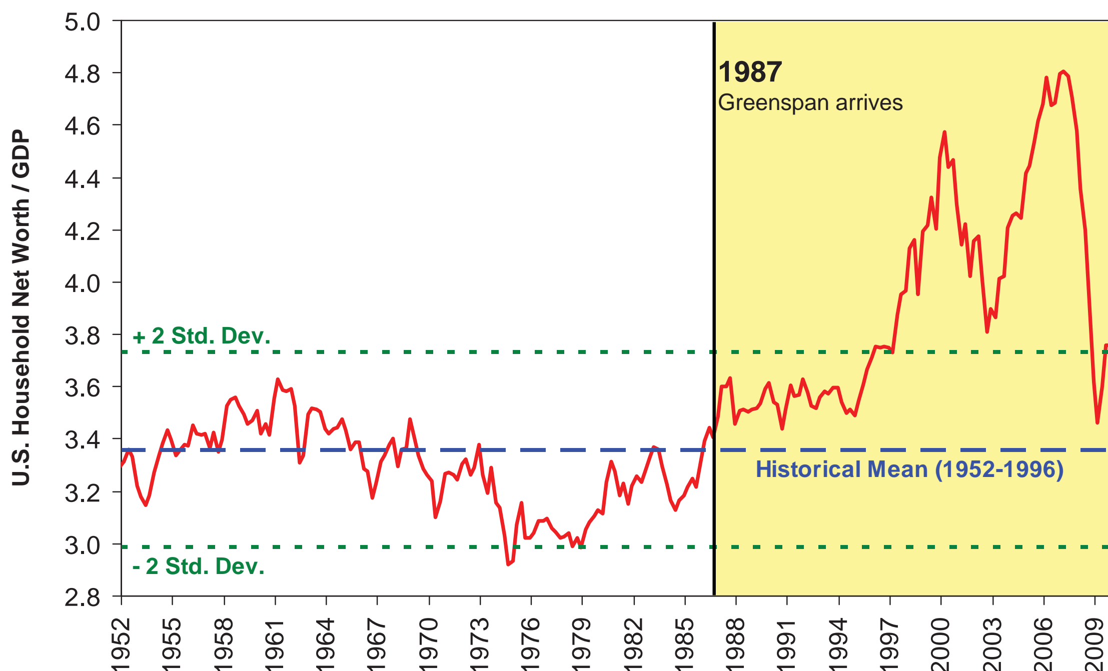
Abnormally High Profit Margins Also Misled

Compounding this problem, which for endowments has already resulted in severe cuts and for pension funds is a looming disaster, is a third factor that is even easier to miss: above-average profit margins. For long-term budgetary purposes and for establishing fair value for global equities, variations in profit margins are an even more potent variable – and very variable indeed – than are P/E ratios or inflation. The '70s had margins well below average and the '80s were average, but since 1995, we have lived in an above-average profit margin world as well as an above-average P/E world. But the fact that this environment has persisted for 15 years most emphatically does not make it normal. It just guarantees that most models and almost all committees will accept it as normal. And we have had some rude shocks on the P/E front, coming down from 35 times in the U.S. market to less than half that in a decade, which, not surprisingly, is a decade that has delivered negative returns. The second shoe to drop is likely to be a similar effect on profit margins. In this way, pension funds, endowments, states, and municipalities have all become collateral damage to a Fed policy that resulted in abnormally high asset prices. But these higher prices were, regrettably, not permanent.

The Fed "Succeeds": Higher Asset Prices

Exhibit 4

Fed "Success": The Greenspan-Bernanke Era of Overpriced Markets

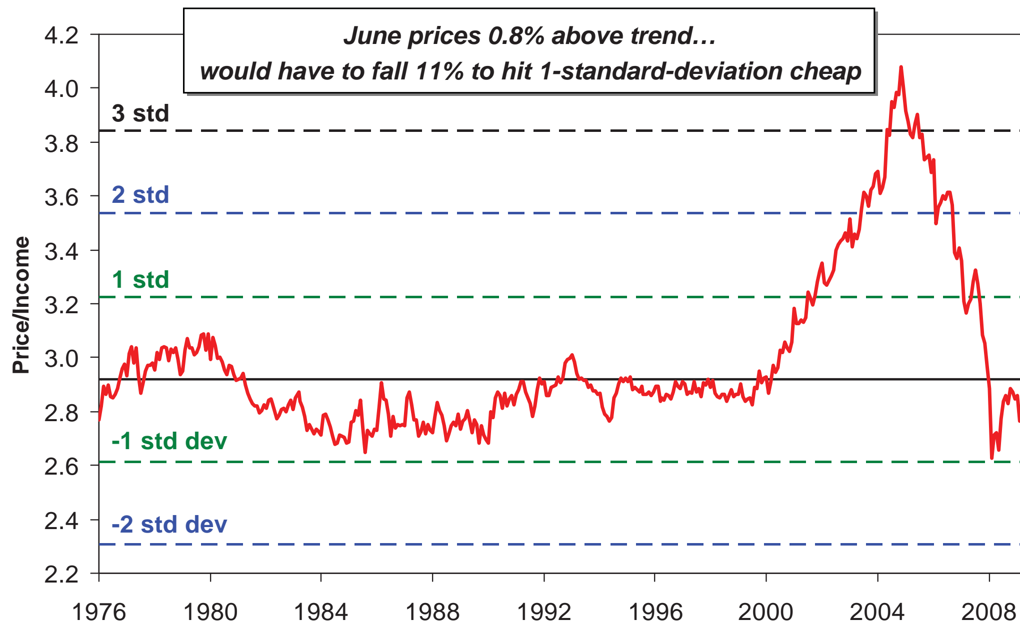


Source: Federal Reserve, BEA As of 6/30/10

Exhibit 5

Fed "Success": Blood Out of a Stone – The Fed Provides the First Housing Bubble in History

Median house price/median family income



Source: National Association of Realtors, U.S. Census Bureau, GMO *As of 6/30/10*

Effects of Engineered Higher Asset Prices

By the 21st century, the pernicious practice of asset price manipulation had become baked into the pie. It guaranteed that stocks would be overpriced most of the time and that the persistent overpricing would move the average higher, while not, of course, changing fair value – replacement cost – at all. Investors would receive lowered dividends and a lower compound return. This distorted high average has been like the deliberately misplaced signal lanterns, which the Cornish, in the stormy west of England, used to lure ships onto the rocks for plunder. Individuals, as well as institutions, were fooled into believing that the market signals were real, that they truly were rich. They acted accordingly, spending too much or saving too little, all the while receiving less than usual from their overpriced holdings. Especially in the boom periods, capital was substantially misallocated, with billions being raised for worthless dotcom companies and massive overcommitment to fiber optic cable. Even worse was the excessive percentage of GDP spent on the overbuilding of homes – basically, a nonproductive asset. Apparently, much of our leadership believed in the permanence of those higher asset prices (either believed or cynically played the game and miscalculated). Regrettably, the perpetrators, in this case the Fed, did not get any plunder, but ended up with a ruined balance sheet. Any plunder to be had from the booms and busts went, of course, to the more nimble members of the financial community!

This most unfortunate matter of asset price manipulation does not merely change politics and economics. It is also desperately important to those of us in the stock market, and we must make sense of it. We have mentioned lower returns and scrambled budgeting. More disturbingly for investment professionals, it changes the normal workings of capitalism and the market. Weaker companies need more debt. Artificially low rates that are engineered by the Fed mean that leverage is less of a burden and survival is easier. Similarly, the Great Bailout allowed many companies that normally would have failed and been absorbed by the stronger or more prudent ones to survive. If we look at the time frame since 2001, it is composed of two periods of negative interest rates with a bailout in between. This whole era has been artificially favorable to marginal companies and leveraged companies, partly at the expense of conservative, un-leveraged blue chips. The great companies look less excellent on a relative basis, and they have missed opportunities

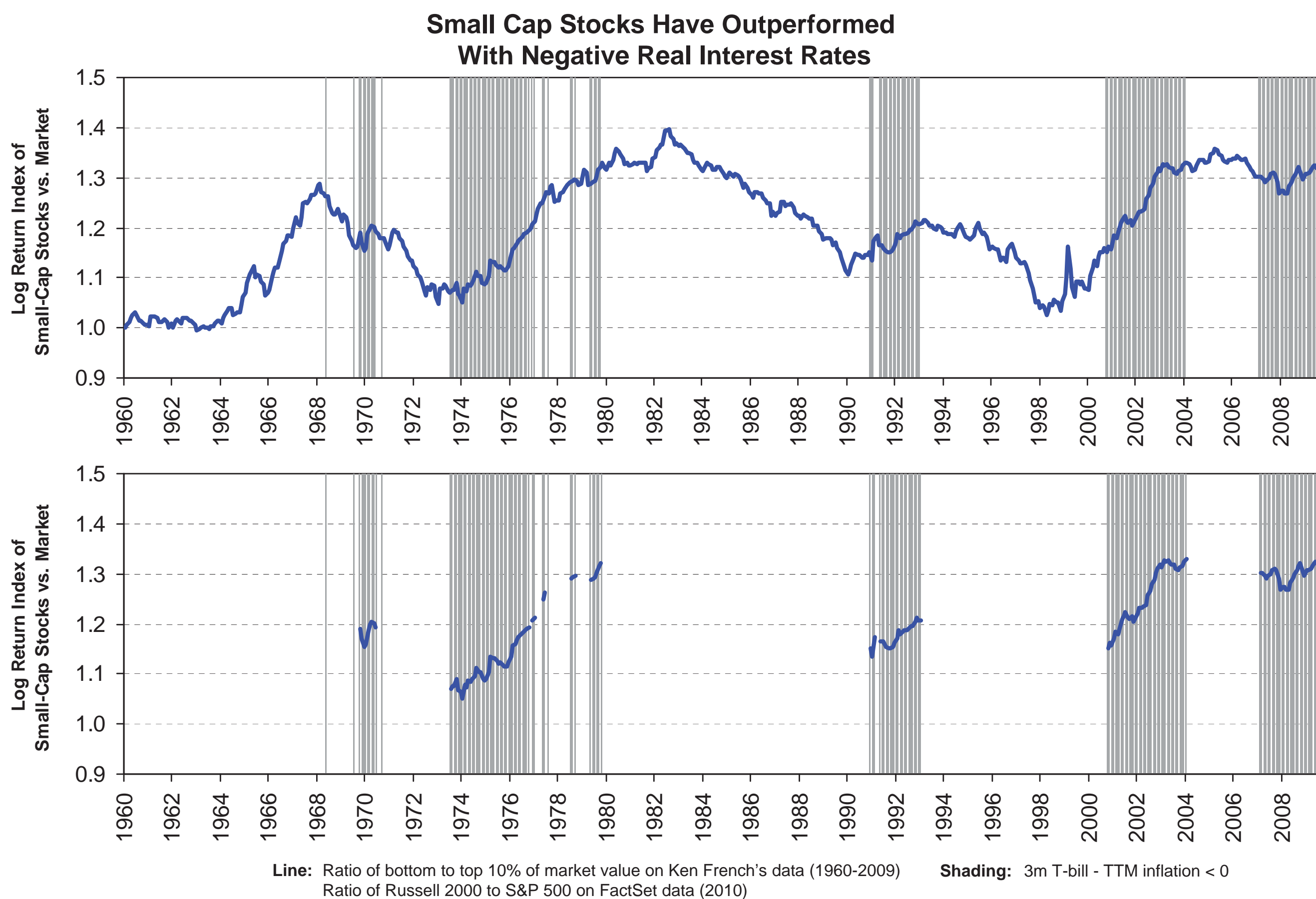
for picking up failing companies that they would normally have acquired at attractive prices. To see how sensitive more marginal companies are to this effect, we took a look at the effect of negative real short-term rates on the performance of the small stocks (as representatives of more marginal companies) relative to the S&P 500. Exhibit 6 shows the results in an emphatic way: 100% of those four major and several minor periods of negative real rates show outperformance for the small stock group. With the Fed begging speculators to borrow at negative rates, it should not be surprising that they do, and that these speculative investments are not typically the Coca-Colas of the world. Because of this effect, it is also probable that the regression rate of profitability, particularly for weaker companies, has slowed. This change, in turn, seems to have caused value models to work less effectively since 2001 than was the case for the prior 50 years.

The Stimulus of the Fed Manipulation Must Always Be Repaid, Sometimes with Interest

The saddest truth about the Fed's system is that there can be, almost by definition, no long-term advantage from hiking the stock market, for, as we have always known and were so brutally reminded recently, bubbles break and the market snaps back to true value or replacement cost. Given the mysteries of momentum and professional investing, when coming down from a great height, markets are likely to develop such force that they overcorrect. Thus, all of the beneficial effects to the real economy caused by rising stock or house prices will be repaid with interest. And this will happen at a time of maximum vulnerability, like some version of Murphy's Law. What a pact with the devil! (Or is it between devils?)

Exhibit 6

Subsidized Rates Encourage Speculation



Source: FactSet As of 8/31/10

The Underestimated Costs of Lower Interest Rates

For all of us, unfortunately, there is still a further great disadvantage attached to the Fed Manipulated Prices. When rates are artificially low, income is moved away from savers, or holders of government and other debt, toward borrowers. Today, this means less income for retirees and near-retirees with conservative portfolios, and more profit opportunities for the financial industry; hedge funds can leverage cheaply and banks can borrow from the government and lend out at higher prices or even, perish the thought, pay out higher bonuses. This is the problem: there are more retirees and near-retirees now than ever before, and they tend to consume all of their investment income. With artificially low rates, their consumption really drops. The offsetting benefits, mainly shown in dramatically recovered financial profits despite low levels of economic activity, flow to a considerable degree to rich individuals with much lower propensities to consume. This trade-off might be worth it if the low rates also encouraged more corporate borrowing for capital investment, more hiring and, hence, more long-term growth. We know already that increased debt does not cause an increase in long-term GDP growth. We also know that this particular time, capital investment by corporations is so particularly weak as to be considered non-existent. The willingness to hire is also unprecedentedly low, so the costs of low rates are higher (more retirees) and the benefits (capital spending stimulus) are less than normal. Yet the normal effect of low interest rates can be seen to be minimal if indeed they exist; if they do exist, they come packaged in this very dangerous game of asset price stimulus involving booms and busts. In a number of years, after academic wheels have turned, I suspect this policy approach will be totally discredited. And the sooner, the better! In the meantime, as far as I can see in the data, it is probable that an engineered low interest rate policy has no net benefit at all, even in normal times. It is quite likely in these abnormal times that it even has a negative effect – it holds back economic recovery!

The Last Desperate Round: Quantitative Easing, Currency Wars, and Commodity Panics

And these are most decidedly not normal times. The unusual number of economic and financial problems has put extreme pressure on the Fed and the Administration to help the economy recover. The atypical disharmony in Congress, however, has made the Federal government dysfunctional, and almost nothing significant – good or bad – can be done. Standard fiscal stimulus at a level large enough to count now seems impossible, even in the face of an economy that is showing signs of sinking back as the original stimulus wears off. This, of course, puts an even bigger burden on the Fed and induces, it seems, a state of panic. Thus, the Fed falls back on its last resort – quantitative easing. This has been used so rarely that its outcome is generally recognized as uncertain. Perhaps the most certain, or least uncertain, is that the eventual outcome will be inflationary or, at best, that it will be inflationary unless precise and timely countersteps are taken. Knowing this, the entire financial world acts accordingly: the dollar goes into accelerated decline, over 5% down in the last few days (ending October 15) alone. Global commodities, frightened by dollar weakness in response to QE2, have gone on a rampage, at least temporarily, with the entire CRB commodity index up 2.5% for the single day of Friday, October 8. Unfortunately, bad weather and tightening supply conditions as emerging countries pick up economic speed have added to this wild panic. But most disturbing of all is the response of other countries to the dollar's decline. With the renminbi tied more or less to the dollar, the competitive pressure on China's main export rivals such as South Korea, Taiwan, and Japan has become immense, and the temptation for competitive devaluations, not surprisingly, is growing. Just remember, even as we fulminate against China – and they are pretty good villains in this part of the game – the dollar is underpriced in purchasing parity terms, and yet the U.S. government is far from having even a neutral position on the dollar. We are still obviously encouraging a further decline. This, unfortunately, makes our perhaps justified complaints against China seem hypocritical. Our ill-chosen program of ultra-cheap rates at all costs may end by creating a currency war. Thus, our current policy of QE2 is merely the last desperate step of an ineffective plan to stimulate the economy through higher asset prices regardless of any future costs. Continuing QE2 may be an original way of redoing the damage done by the old Smoot-Hawley Tariff hikes of 1930, which helped accelerate a drastic global decline in trade. We may not even need the efforts of some of our dopier Senators to recreate a more traditional tariff war. And all of this stems from the Fed and the failed idea that it can or should interfere with employment levels by interfering with asset prices.

Time Out: Let's Try To Empathize with the Fed

If you were a Fed boss and had, as one of your twin responsibilities, to look after employment, you would justifiably be panicking. The other responsibility – to look after inflation – is, in comparison, a piece of cake. So, what would you do? The only economic stimulus that seems to be available is the wealth effect, which is mild in the case of stocks, although very easy indeed to manipulate and more intense, as it turns out, in the case of house prices. And here is what the Fed bosses do: when they need help for the economy, they deliberately throw their resources, moral and otherwise, at the markets. It's all they can do. They then cross their fingers and hope for a quick and strong wealth and animal spirit effect. Thus, during 1991, the game began, and stocks were stimulated to recover from the 1991 recession. Why the dread of taking a normal recession set in I cannot guess, for the refusal to take mild recessions has been likened to a policy of not allowing forest fires. Such a policy weakens the resistance of the forest so that when the fire inevitably starts, it burns so hot that the trees die along with the undergrowth. The Fed's intervening to push up asset prices helps retain some weaker corporate players and creates steadily increasing moral hazard. And this is certainly the choice that was consistently made. The market gathered steam, and very probably helped the economy recover. Then, as momentum built, Greenspan swore off intervention after a second's hesitation in 1996 with his suggestion that the market might be showing "irrational exuberance." With that idea quickly abandoned and with a very unusual over-stimulation in 1997 and 1998, the market spiraled out of control and, at a remarkable record 35 times earnings, broke spectacularly in 2000. This, in turn, brought forth from the Fed an even greater dose of low rates and moral hazard, which very probably curtailed the market decline. It stopped, uniquely in the history of equity bubbles breaking, at just above trend line value in September 2002, when normally it would have overcorrected for several years and seriously depleted the market's animal spirits and, consequently, its enthusiasm to speculate. But this time, with negative real rates for well over two years, in 2003, 2004, and 2005, the stock market, the housing market, and <u>all risky assets</u> responded to create the first truly global bubble in risk taking, with the lowest risk premiums ever seen or even dreamed of: virtually non-existent. And the rest is history; although one, apparently, we are condemned to repeat, as, here we are, with risk taking bouncing back under the same old impetus.

Fiscal Stimulus Appears To Be the Only Option

I've always been sympathetic to the general idea of crowding out: that government spending displaces an equal and offsetting amount of private spending. But it is an academic argument and, although it may have a grain or two of truth, it smells of the typical recent tendency in economics: to be heavy on assumptions and light on common sense and the real world. This concept is known, after the British nineteenth century economist, as Ricardian Equivalence, but to be fair to Ricardo, there were no government statistics then, so everything had to be theoretical. The same relatively small group of taxpayers also owned most of the bonds, so one can see how Ricardo might have gotten there. But today, the government's hiring someone is absolutely not the same as a private company's hiring exactly the same person, for if the person is not hired, the government bears all of the costs of <u>unemployment</u> and the corporation none. This cost is not merely welfare, food stamps, and the loss of taxes federally and locally. It also includes the long-term cost to society of the unemployed losing their skills and becoming less employable. For lower-paid workers, these total costs may equal, on rough estimate, one-third to one-half of the cost of hiring them. In this situation, there is no equivalence. A hired worker who would otherwise be unemployed is simply a better bargain for the government. A more capitalist alternative would be to offer some or all of the government's savings as a subsidy to employers who hire lower-skilled workers. This has been tried and, at times of severe unemployment, seems to be effective.

The real problem starts when direct governmental spending cuts into the always limited pool of skilled workers, or it is attempted when the pool of unemployed workers is only marginally above normal and the private sector has begun to hire. That is "crowding out." None of these conditions applies now. It is intuitively obvious, at least to me, that if fiscal spending were directed only: a) to lower-skilled workers, b) when there is clearly an abnormal level of unemployment, or c) when you hire them only to do jobs with a high return to society, that we will all come out ahead and there is no equivalence. Future debt commitments are paper; current useful jobs are real life. How can we possibly be better off when the unemployed who want to work are sitting idle and depressed, as their skills decay? Be serious! With a dreadfully deteriorated infrastructure and a desperate need for improvements in energy efficiency, there is certainly a

great potential supply of high societal returns waiting to be had on one hand, and an army of non-frictional unemployed ready to get to work on the other.

Political Consequences of the Fed's Boom and Bust Policy

Let me make a simple point for all of those who decry any and all governmental interference: in my opinion, capitalism has been manipulated far more, and more dangerously, by the last two Republican-appointed Fed bosses than everything else added together. It is naïve, if fashionable, to blame the rather lame current Administration for all of our problems. They inherited a cake already baked or, better, "half baked," and the master bakers were the current and former Fed bosses, and the underbaker (not quite an undertaker, but nearly) was Hank Paulson with his "contained" sub-prime crisis. Aided by Timothy Geithner at the New York Fed, they first did absolutely nothing for two years and then laid the groundwork for a bailout, the scale of which neither Democrats nor Republicans had ever dreamed! And of all of the many mistakes of the current Administration, the worst, in my opinion, are directly related to this fiasco: the inexplicable choice of Geithner, who was actually placed at the scene of the crime in New York and whose fingerprints were on the murder weapon, and the reappointment of ... gulp … Bernanke himself, about whose reappointment much juicy Republican criticism was made, all of it completely justified in my view. There may, however, be a small ray of hope. The recent Fed appointee, Vice Chair Janet Yellen, said not long ago, "Of course asset bubbles must be taken seriously!" She also said, "It is conceivable that accommodative monetary policy could provide tinder for a buildup of leverage and excessive risk taking." Yes, sir! Or rather, madam! A promising start. These sentiments, of course, are completely contrary to the oft-repeated policies of Greenspan and his chief acolyte, Bernanke. Perhaps she will slap some good sense into her boss on this issue.

The net effect of deliberately encouraging the start of asset bubbles – particularly in the case of housing – and then neglecting them and leaving them to burst, created the worst domestic and global recession since 1932. It exposed intractable, structural unemployment that had been building up. With a Congress totally at stalemate, this is a nearly impossible situation but one which, <u>as usual</u>, will be associated with the current Administration and therefore will cost dearly in votes. In 1970, England's Labour government was 7.5% ahead in the polls with just three weeks to go, but was ruined by England's favored and beloved World Cup team's losing to archrival Germany just four days before the election. Curses! It's better to be lucky. As to picking the right road to an economic recovery, the Irish punch line would be, "I don't think you can get there from here." It would all have been so much easier to prevent than to cure.

All This and Climate Change Too

I joked with my wife that I would end by saying that at least I couldn't blame the Fed for climate change. Ho, ho. Then I began to think: wait a minute, without the housing boom and bust and the stock boom and bust, we would not have had this chronic recession and intractable unemployment. This would then not have been blamed on Obama and, with less to worry about, he would not have been a "no show" on the climate debate, and we would probably have had a decent energy and climate bill. No kidding. So there you are: the Fed really is at the bottom of almost all of our problems.

Apologies

Since it is customary in polite society to apologize for causing distress, on behalf of the Fed, let me apologize for the extraordinary destructiveness of its policies for the last 15 years. Bernanke's version of an apology, delivered in January this year to the American Economic Association, was to claim that the Fed's monetary policy during the 2000-08 period was appropriate, and that there were no major failings, such as missing the housing bubble completely, that were worth mentioning. This stubbornness in the face of clear data is right up there with efficient market believers. And very impolite indeed.

Current Investing Questions

1) **Does this year being a Year 3 of the Presidential Cycle confuse the issue?**

   Yes. Exhibit 2 shows the extent of the problem. In Year 3, risky, highly volatile stocks have outperformed low risk

stocks by an astonishing average of 18% a year since 1964 (when good volatility data started). Also, to repeat a favorite statistic, the record says that 19 Year 3s have occurred since FDR with not one serious bear market – in fact, just one Year 3 was down, finishing at -2%. Who wants to bet on the 20th being different this time? Yet, if ever there were an argument for "this time is different," this is it, isn't it? This year, a Year 3 has been preceded by two abnormally stimulated years when, typically, the Fed works to cool the markets down in Years 1 and 2. This time, Years 1 and 2 were turned into a sort of massive Year 3 in which low rates and moral hazard added to the market's natural reflex to have a big rally after a major nerve-rattling decline. The market responded by rallying 82% in 13 months (to April 26, 2010), with risky stocks up by over 120%, both second only to the rally from the low of 1932. Also unique this time is the great bust of 2008 and the ensuing great bailout. How much difference do you want? Even so, I expect that the bottom line will come down to short rates. Surely they will stay low for the entire Year 3. And, if so, the "line of least resistance" is for the market to go up and for risk to flourish. In the last six months I've guessed on separate occasions that levels of 1400 or 1500 on the S&P 500 are reachable a year from now; this still seems a 50/50 bet. If we include more moderate market advantages, the total odds would be well over 50%. (I'm trying to wean myself from a recent dangerous habit of using precise probabilities.) Risks to this forecast are highlighted by some ugly near-term possibilities. The worst of these is that Senator Smoot and Representative Hawley, sponsors of the anti-trade bill of 1930, will pull a *Night of the Living Dead* and prepare a very dangerous opening salvo in the next global trade war. Indeed, today it feels as if there were an inexhaustible supply of politicians who would put their political/philosophical principles way ahead of global well being. As mentioned earlier, the Fed is also stirring up a hornet's nest on the currency side of this issue with its quantitative easing. There is also the definite possibility that we could slide back into a double dip, so we may get lucky and have a chance to buy cheaper stocks. But probably not yet. And, of course, if we get up to 1400 or 1500 on the S&P, we once again face the consequences of a badly overpriced market and overextended risk taking with six of my predicted seven lean years[1] still ahead. And this time the government's piggy-bank is empty. It is not a pleasant prospect.

2) Should we hold onto quality stocks?

For sensible long-term investors, the probable outcome of a further speculative rally as described above would be irritating and resolve testing. For good short-term momentum players, it may be heaven once again. Being (still) British, this is likely to be my n^{th} opportunity to show a stiff upper lip. There is, though, one quite friendly influence lurking around that may help us lovers of quality stocks. They are getting so cheap relative to the market that a wider range of buyers is finally noticing them. In the third quarter, in a market up a significant 12%, quality stocks held the market. To say the least, this has not been the law of nature recently: for the past eight years, quality stocks usually won in down quarters and usually lost badly in extreme up quarters. That the Fed Manipulation of Prices was still in force and that this was not a "risk off" quarter was proven by the continued outperformance of small caps and riskier stocks. So the better performance of quality stocks was clearly a bargain effect and not an anti-risk move. This may be grasping at straws, but if the expected speculative rally takes place in this Year 3 starting now, I believe that there is a decent chance, say one in three, that quality stocks are so cheap that they will "unexpectedly" hang in. And, after this next 12 months, the odds move in our favor, and I believe (once again speaking for myself) that high quality stocks should have an even bigger win over low quality than our GMO numbers suggest. I think it is probable that the remaining six of my seven lean years will wear down low quality, leveraged companies. Their margins, which are currently far above average, will end up far below average some time during this period, and their relative stock performance may well be horrific.

3) How far can emerging equities go?

I have been showing late-career tendencies to wander off the reservation of pure historical value. The "Emerging Emerging Bubble" thesis of 2½ years ago (1Q 2008 *Quarterly Letter*) is in splendid shape. The idea is that within a few more years, emerging equities will sell at a substantial premium P/E because their much higher GDP growth

1 "The Last Hurrah and Seven Lean Years," 1Q 2009 *Quarterly Letter*.

(6% compared to 2%) will give a powerful impression of greater value. Everyone and his dog are now overweight emerging equities, and most stated intentions are to go higher and higher. Emerging markets are admittedly fully priced, but they still sell at a decent discount to the 75% of the S&P 500 that are not quality stocks – a particularly strange quirk in a strange market. With their high commodity exposure, their strong finances, and their strong GDP growth especially, I believe that they will sell at a premium to the S&P, perhaps a big one. How much of this premium to go for depends on an investor's commitment to pure value relative to the weight that is placed on behavioralism – the way investors really behave versus the way they should behave. This gives us quite a wide range for investing in emerging that might be considered reasonable. GMO will make its own decision on how "friendly" to be toward emerging market equities as a category. You must make yours.

4) What to do about raw materials?

The "running out of everything" thesis that I dropped into a black hole a little over a year ago (2Q 2009 *Quarterly Letter*) is creeping out of its hole (helped by the Fed's mooted QE2), and at least the idea of generalized shortages is heard now and then. The last two weeks (October 3-17) have been truly remarkable for commodity prices: on October 8 alone, the entire commodity index was up 2.5%! Tin, for example, is at an all-time high (in nominal prices, I admit) and, more importantly, "Doctor Copper" is almost back to its 2008 high, which was then four times its previous level. Imagine what this means: in a developed world with 9% unemployment and masses of spare capacity, commodities are acting much too strong for this to be simply a normal response to a rather anemic cyclical recovery. I really believe that we are in a new world in which we are running out of resources … a world that only China truly gets. (For the record, I singled out rare earths in my 2Q 2009 *Letter*.) Some of these stocks have quadrupled in price, and at least one has tentupled! That would have been great for one of those "best ideas" dinners, where relevance to a large pool of money doesn't matter, since it's impossible to play rare earths in any size. My personal advice (i.e., how I invest my sister's pension fund, etc.) is to give the benefit of any doubts for very long-horizon (20 years) investments to resources in the ground, agricultural land, and, above all, forestry. Resource stocks, though, have really run, and a serious price decline caused by, say, China's stumbling, would of course make for a much better entry point. On a seven-year horizon, GMO is enthusiastic only for forestry, which has, in so many ways, more certainty to it than most investments: the sun shines, the trees grow.

5) Should we buy overpriced stocks when bonds are even worse?

We plan to write more substantively on this topic in the near future, but for now the short answer is that bond prices are currently manipulated, and are yielding less than any market clearing price would suggest. They absolutely do not reflect the substantial fears in many quarters about inflation in the long term. Even in less manipulated times, bond prices can be quite silly for the usual behavioral reasons, as demonstrated most clearly by the 15% yield on the 30-year Treasury in 1982! Bonds are thus emphatically not a reasonable yardstick for measuring value in stocks. We use the long-term returns for stocks to decide what their fair value is. They are currently overpriced. Bonds are even less attractive. Yet, remember that in a strongly mean-reverting world, you need to be careful about enthusiastically buying the less ugly of two overpriced investments. Cash has an option value: on the chance that stocks or bonds or, better yet, both, decline, the investor will need resources from which to buy.

6) Religious wars (or, Should we buy gold?)

Everyone asks about gold. This is the irony: just as Jim Grant tells us (correctly) that we all have faith-based paper currencies backed by nothing, it is equally fair to say that gold is a faith-based metal. It pays no dividend, cannot be eaten, and is mostly used for nothing more useful than jewelry. I would say that anything of which 75% sits idly and expensively in bank vaults is, as a measure of value, only one step up from the Polynesian islands that attached value to certain well-known large rocks that were traded. But only one step up. I own some personally, but really more for amusement and speculation than for serious investing. It may well work and it may not. In the longer run, I believe that resources in the ground, forestry, agriculture, common stocks, and even real estate are more certain to resist any inflation or paper currency crisis than is gold.

Very Brief Recommendations

1) Emphasize U.S. quality companies, which are still cheap in an overpriced world.
2) Moderately overweight emerging market equities.
3) Moderately underweight the balance of global equities.
4) Heavily underweight lower quality U.S. companies.
5) Carry extra cash reserves for a volatile market with insecure fundamentals.
6) For the very long term (20 years) overweight resources, particularly if they have a sharp decline. (This is my personal view rather than that of GMO, which on this topic is agnostic.)

Postscript: Australian and U.K. Housing

I happily concede that the U.K. and Australian housing events are not your usual bubbles. Australia, though, does pass one bubble test spectacularly: we have always found that pointing out a bubble – particularly a housing bubble – is very upsetting. After all, almost everyone has a house and, not surprisingly, likes the idea that its recent doubling in value accurately reflects its doubling in service provided, e.g., it keeps the rain out better than it used to, etc. Just kidding. So, the house is the same. Perhaps the quality of the land has changed? In any case, Australians violently object to the idea that their houses, which have doubled in value in 8 years and quadrupled in 21, are in a bubble.

The U.K. and Australia are different partly because neither had a big increase in house construction. That is to say that the normal capitalist response of supply to higher prices failed. Such failure usually represents some form of government intervention. In Australia, for example, the national government sets the immigration policy, which has encouraged boatloads of immigration, while the local governments refuse to encourage offsetting home construction. There has also been an unprecedentedly long period of economic boom in Australia, and the terms of trade have moved in its favor. And, let's not forget the $22,000 subsidy for new buyers. But does anyone think that bubbles occur without a cause? They always need two catalysts: a near-perfect economic situation and accommodating monetary conditions. The problem is that we live in a mean-reverting world where all of these things eventually change. The key question to ask is: Can a new cohort of young buyers afford to buy starter houses in your city at normal mortgage rates and normal down payment conditions? If not, the game is over and we are just waiting for the ref to blow the whistle. In Australia's case, the timing and speed of the decline is very uncertain, but the outcome is inevitable. For example, the average buyer in Sydney has to pay at least 7.5 times income for the average house, and estimates range as high as 9 times. With current mortgage rates at 7.5%, this means that the average buyer would have to chew up 56% of total income (7.5 x 7.5), and the new buyer even more. Good luck to them! In the U.K., which also has floating rate mortgages and, in this case, artificially low ones, the crunch for new buyers will come when mortgage rates rise to normal. But even now, with desperately low rates, the percentage of new buyers is down. Several of these factors, which do not apply to equities, make for aberrant bubbles, and clearly the Australian and U.K. housing markets fit the bill. In comparison, the U.S. and Irish housing bubbles behaved themselves. So let's see what happens and not get too excited. After all, these may be the first of 34 bubbles not to break back to long-term trend. There may be paradigm shifts. Oil looks like one, but oil is a depleting resource. If we could just start depleting Australian land, all might work out well.

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