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FYI: Bull Market or Bear Trap?

If you read *Barron's* this week, you may have come across this interview of Jeremy Grantham whose Boston firm runs $48 billion and has a well-deserved reputation for sound management. A client called our attention to the interview and asked for our thoughts on Grantham's basic theme that we are now experiencing a bear-market rally, with "A Sucker Punch Coming." We decided to do more than comment, going through the interview word-by-word, to make it clear why we believe this is a genuine bull market and why it will continue until unforeseeable political events intervene. As you will see, Grantham himself is not expecting a break in the market in the near term but sees one coming sometime in 2004. Our comments are in the underlined passages.

"Sucker Punch Coming:
Jeremy Grantham Says It's Only a Bear-Market Rally"

By Sandra Ward

Interview With Jeremy Grantham -- Clients of Grantham, Mayo, Van Otterloo & Co. have been gathering the past two weeks at the venerable investment firm's Boston headquarters for its annual assessment of the state of the world's markets. In other words, to hear "Jeremy's jeremiads." With 35 years experience under his belt and $48 billion under management at the firm he helped found, Grantham is well worth listening to. His foresight and fastidiousness are the stuff of legend, as is the firm's ability to deliver superior results across asset classes around the globe over the long haul. For Grantham's latest prophecies, please read on.

Barron's: New bull market? Bear market rally?

Grantham: The simple story is the market is overpriced and will go to a trendline P/E, which we now believe is 16 times based on research that shows earnings tend to be overstated over time because assets tend to be under depreciated during times of technological progress. Currently, the market is around 24 times trailing earnings, on a fairly generous earnings estimate. This is not just a bear market rally but the greatest sucker rally in history.

Q: There's nothing comparable?

A: Nothing in American history. In bear-market rallies, in the not-too-distant future, a new low is made. But the new low is only verified in hindsight. The normal characteristics of the leadership in a bear market rally flash back to the old leadership of the prior bubble.

That's not the case in a new bull market. In the three substantial, but not huge, rallies that occurred in 2000, 2001 and 2002, technology and growth stocks led the way, particularly flaky little companies. The scope of the speculation and the leadership of tech and the surviving Internet stocks are just not typical of a serious new bull market.

JW: *Initial comments by JG indicate his concerns arise from a higher than normal P/E average and current market leadership by stocks that led the previous Bull Market. These concerns appear to be based upon statistical and technical chart studies of historical experience, as contrasted with current political and economic conditions. Current market performance depends upon rational market consideration of present political/economic factors. These present factors indicate conditions favorable to the beginnings of a new Bull Market. On the fiscal policy side of economics, the recent supply-side tax cuts have brought into play the most favorable tax climate for the U.S. economy since 1966, with prospects for further improvement on the horizon. The proposed additional tax bill presently under the radar of most market analysts will repair the FSC subsidy problem by providing significant additional tax relief to business. As in 1982, tax relief of this nature may be sufficient alone to produce a Bull Market of substantial proportion. The tax relief has already restored strength to the economy on a scale that is reducing the projections of federal spending deficits. On the monetary policy side of economics, the economy and the markets are benefiting from the serious monetary reflation that has totally reversed the previous deflation pall. Broadly speaking, the market is not expensive relative to GDP-based NIPA profits, which we think is the best, most stringent measure of profits available.*

Q: But this one will?

A: It is the third year of a presidential cycle. The presidential cycle is enormously important. The presidential cycle for me starts in 1932. Before then, the whole idea of stimulus hadn't sunk in. Keynes explained the concept and in Franklin Delano Roosevelt he had a very interested listener.

From then on, administrations understood it is a good idea to stimulate the economy in year three, so that in year four unemployment -- and this is key -- is dropping. It's fine to have a strong economy, but it is unemployment that really drives the vote, our research shows. The third year in a presidential cycle is not just a bull market year, but one with a bubbly flavor to it where growth wins. It's the only year in the cycle that growth wins. The speculative stocks outperform the quality stocks and small caps do very well.

JW: *The presidential election cycle stimulus theory is definitely from the Keynesian school of economic theory, and that is the economic theory that has been practiced in most, but not all, previous election cycles since 1936. This current cycle is different. The 2001 tax cuts were largely Keynesian in design and effect; i.e., immediate demand-side stimulus. The 2003 tax cuts had both an immediate component and lasting changes in the nature of significant reductions of tax rates applicable to capital gains and dividends, as well as depreciation expensing. These latter reforms are classic supply-side, designed and enacted largely by the expertise and influence of Bill Thomas, chairman of the Ways and Means Committee in the House, with some help from the new economic team in the White House. The supply-side improvements in incentives for* *production (the after-tax return on capital is improved by 40%) are expected to have lasting effects as a foundation for the new Bull Market, not just a "hot shot" for the presidential year.*

Q: How does this third year stack up against those in the past?

A: This is a classic third year. The absolute return, minus inflation, is 17% in the third year and believe it or not that is exactly where we are, up 17%. Growth outperforms its normal relationship to value by 5% and that is exactly where it is today, to the penny. Small cap does very nicely and this time has done twice as well because it has benefited from another kicker.

While there isn't a very strong connection between the economy and the stock market, there is one very useful connection: In the 12 months, sometimes 24 depending on conditions, but always 12 following a low in the economy, small caps do very well. Low quality or junk does spectacularly.

What we found, too, is that the third year is fairly indifferent to value. Years one, two and four are reasonably sensitive to value. In year three, it doesn't matter whether the market is cheap, expensive or in between, the market goes up. In 1999, the most expansive year in American history up to that point, the market went straight through the roof, like a pea bouncing off a tank.

JW: *Rather than rely on historical statistics and chart patterns to identify market sectors that will lead or lag under current political/economic conditions, Polyconomics weights each sector according to the influences and pressures indicated by the Supply Side Economic Model. At this time, we remain bullish on the commodity-based economy and think that monetary reflation paired with powerful supply-side tax cuts will continue to boost the outlook for growth. Heavy equipment, manufacturing, agriculture, metals, mining, forest products and transportation continue to be standout sectors. Conversely, cable and healthcare, two areas at the end of the regulatory whip, continue to rank near the bottom of our model. Also at the bottom of our model is the oil services sector, which we think will suffer from the evolution of a lower oil price.*

Q: What should we expect in year four?

A: Year four is neutral. The market comes in on average, small cap is about average, junk still wins -- a little echo effect -- and surprisingly value comes back and typically has the best year on average in the cycle. Value matters.

This is, of course, a glorious heaven-sent opportunity to take advantage of the rally and reposition portfolios. This is a very important rally and it will probably last through the year and may easily carry over into one or more quarters next year.

But next year is much more up for grabs. It is a very expensive market and that will be a drag. We still have very low capacity-utilization and all the problems of excess spending that went on. We have the problem of debt.

JW: *These comments by Grantham indicate he thinks this is not such a sucker rally that investors should be out of it entirely at this time, but that they should be in it until next year and then be nimble in getting out. At this time, there is no event identifiable on the horizon that would cause such a market reversal next year.*

By and large, the market is rationally priced, but we favor certain sectors as indicated above for reasons we detail at greater length in our in-depth research reports.

Q: How critical is the question of debt?

A: What is unique to this cycle is debt has not declined. It has, in fact, risen dramatically at the government level, quite dramatically at the corporate level, dramatically at the foreign level and very substantially and steadily at the consumer level. This is not a good picture.

Normally, it rises in bad times and falls in recoveries. This time it has not. This is a long way from today, but 2005 and 2006 will be a much clearer call than most years.

JW: *Debt is not bad in and of itself. Low interest rates have allowed debtors to refinance at much lower rates, thus lowering their debt service expenses. This may be bad or good, depending upon the soundness of the investment decision being financed. Since we presume a rational market, we think the size of the debt at present is not an overriding concern in the economy and could actually assist in propelling growth if favorable political/economic policy conditions continue to prevail.*

Q: How is that?

A: They will be painful years. A black hole.

Q: Why do you say that?

A: Housecleaning needs to be done, whether a new administration or old, and we have got a really dirty house. There is debt everywhere, and there are problems that have not been addressed, only postponed, by this administration and the Federal Reserve. In addition, we have a horrifically overpriced market. It is the third most expensive year ever recorded.

JW: *Rather than join the chorus of naysayers regarding the debt burden, we think that debt could become even less of a concern going forward. If the reflation we are experiencing now morphs into inflation, the inflation would reduce the real value of debt, thereby reducing leverage automatically.*

Q: What should investors do?

A: There are fewer places to hide than any time in my 35-year career.

Bonds are not horrific, but they are vulnerable to someone deciding the way to get rid of all this debt is to inflate. TIPS (Treasury inflation-protected securities) are okay, but fairly priced. The returns at these levels are not terrible but neither are they satisfactory.

In stocks, value has come in and won't be too much help on the downside, nothing like 2000-2001. Same with small cap. Small cap has done brilliantly all the way down and all the way up this year. Small cap is not cheap in the U.S. Do not expect it to provide any material help on the downside; it may even underperform.

JW: *In this answer, we now come to Grantham's recommendations on what to do today, against the backdrop of his theoretical framework. As for the black holes he predicts for 2005 and 2006, we would* *guess he is back in the presidential cycle theory that a President takes the medicine early in his term so the economy is on an upswing as the term ends. We can't predict that far out, not knowing who the President will be in 2005 and who his advisors will be. But unless there is a geopolitical bolt from the blue, there should be less pressure to take medicine in a way that would produce black holes with no place to hide.]*

A: Housing prices have continued to rise to a multiple of income that is dangerously high. The next time at bat, you really have to count on the housing market coming down, not disastrously, but if the S&P comes down through 700, which is our estimate of fair value, it will very likely be accompanied by at least a modest decline in housing.

All the reasons that propped it up will have flowed through the system. It would be hard to imagine a two-year decline in the market that was coincident with a continued climb in real estate. Real estate is getting very expensive and quite unaffordable, and when rates rise that will make it much more so.

JW: *During the out-going Clinton administration, the tax treatment of capital gains on real estate used as the primary residence was changed to exempt the first $500,000. This was essentially a relinquishment of at least $2 TRILLION by the federal treasury to homeowners, and it has helped to propel the prices of residential housing. This goes a long way towards explaining the real estate performance that Grantham sees as unexplainable. We also must point out that higher nominal income would accompany almost every scenario for higher interest rates. This would work against the doomsday scenario.*

A: Meanwhile, REITs [real-estate investment trusts] went up in 2000-'01-'02 when the U.S. market went down. Then we have a 20% rally in the S&P this year and REITs are six or seven points ahead. Since we spoke last year, REITs are up 33.4% to the S&P's 23.9%, almost 10 points ahead.

Q: Why the outperformance? Aren't REITs out of favor now that other dividend-paying stocks receive a tax advantage?

A: Of all the questions I find hard to answer, that is No. 1. I can give you plausible B.S. but I don't know why REITs have done so well. They changed the tax on dividends, but not for REITs, and therefore other high-dividend stocks should surely handsomely outperform REITs. Yet REITs, without the tax advantage, are far ahead of other high-yield stocks. Go figure.

Everyone knows the fundamentals of office space are terrible and apartment rents have fallen and vacancy rates are up. We've had three years of brilliant outperformance in the worst bear market since 1974, and still REITs are outperforming. I don't get it, except underneath it all there is still a big gap between the expected return from REITs and the S&P. We are down to about a 4.5% estimate in REITs from 8.1% a year ago. Now 4.5% is not enough, but it is a lot better than about negative 1% a year, which we expect from the S&P.

JW: *Nice to see here JG says he doesn't know why real estate is doing so well.*

Q: Are you still anti blue-chip?

A: I'm anti blue-chips in terms of absolute return. In terms of relative return, one of the places to hide in the U.S. market will be quality stocks. Quality stocks, whether large-cap, or small- or mid-cap, provide noncontroversial, straightforward return on equity, stability of profits and balance-sheet strength. Meat and potatoes. Those characteristics have underperformed continuously all year. This has been a junk year by every parameter.

JW: *Not such bad advice. But we would add that sectors positioned to take advantage of the monetary reflation now underway should outperform other "blue chip" sectors. The commodity producers and heavy manufacturers – the so-called "smokestack" industries – were hurt early and hard during the 1997-2001 deflation, but will be among the first to register outsize gains.*

A: The net effect is that quality is already pretty cheap. If this bear-market rally continues for quite a long time, then quality will become about as cheap or cheaper than it has ever been. In the event the market goes another leg down, accompanied perhaps by some measures aimed at the overleverage in the system, quality could be a terrific defense against huge declines. Quality stocks will still go down, unfortunately. But they will provide real resistance to big declines. They will be pretty heroic as will REITs on a relative basis. That's the important idea in the U.S. But the real play, of course continues to be foreign and emerging stocks and bonds.

JW: *Here is a new topic: emerging stocks and bonds.*

Q: Still?

A: The dollar has probably not seen its low. Even though we don't score it as cheap on traditional purchasing-power parity, we have a strong suspicion it will continue down because of the trade gap. Now the place to hide in relative terms is in foreign stocks, emerging markets and, paradoxically, high-quality U.S. and, if you insist, REITs.

The problem is, what do you do in absolute terms? Foreign is no longer cheap. It is a little expensive. The best you can say for it is if you are going into the second leg of a major bear market, it is better to go with the sectors that are only a little expensive. They will go down in sympathy with the U.S. but I think they will go down substantially less and the currency kicker will make a big difference.

The only one that may buck the trend is emerging markets. Emerging may actually go up in a fairly serious decline. We've been saying this for a long time and last year the S&P was down 22% and emerging was minus 2%. It almost made it; it almost did the impossible. Emerging is still absolutely a bit cheap. It is the only equity category that is absolutely a little cheap. Its profit margins are improving. Its GDPs are improving. If there is no out-of-left field crisis in, say, China -- and "if" should be underlined two or three times -- they are in better shape than they have been for years in terms of financials and currencies.

JW: *Broadly speaking, we would agree.*

Q: Are you mostly focused on emerging Asia?

A: No. We like Brazil a lot. We like Argentina. We like Eastern Europe. We don't like Korea. It is picking and choosing. But emerging is the only category that might actually go up.

I am intrigued, too, by the growing interest in emerging equity. We are seeing fairly massive increases in institutional interest in emerging markets. And that is a market where a little bit goes a long way. If this speculative phase in the U.S. market were to continue for as long as nine months from today, I wouldn't be surprised if emerging markets didn't go up another 40%. It has got everything lined up for it. If the market here fades quicker than that, then it won't happen, but it still might do pretty well.

JW: *Well, okay, but would JG say the emerging markets will grow like Topsy if the US stock market collapses? This is what we mean when we say JG has lots of bright ideas, but he is not getting them together in a cohesive whole.*

Q: What are your views on China?

A: It is working out very well, for the time being. Their imports are growing faster than their exports. Their imports are up 40% year over year. Mind-boggling. Chinese imports represent almost one-third of the increase in imports globally. A country with an official GDP that puts it No. 7 or 8 in the world is accounting for 30% or so of all the growth in global importing. Stunning beyond belief. If it keeps rolling a lot of things are going to change in the world.

One of the interesting things is commodity prices. I always make a big fuss that there are only two commodity prices that have risen in the long run: fish and forestry.

What do they have in common? They started as free goods. When you start free and move to cultivation, that is known in the trade as an infinite increasing cost. Okay, it is an exaggeration but at least it makes the point that you can have a long, steady increase in price. Fish and forestry have risen and everything else has gone down in price.

It doesn't matter whether it is oil or soybeans, they have all gone down in real terms. And they've gone down because even those that have marginal increases in costs, such as oil, have had their productivity clock in a little higher than the rising marginal costs of extraction. It doesn't have to be that way, it just happens to be that way.

If China keeps up its growth rate, productivity -- which will not change just because China is growing rapidly -- will come in below the increasing marginal costs of extraction, and those commodities will tend to have a rising real price. Even though they haven't for a hundred years, they will have real price increases. If you push resources at the rate China is doing now, we are going to live in a world where commodity prices rise.

No doubt other interesting effects will fan out from that. With China increasing its imports by 40% and its exports something like 35% this year, what effect does that have on shipping? They're growing faster than they can build ships. Shipping rates have gone through the roof. China may push the whole infrastructure of shipbuilding pretty hard. It may take a few years to gear up to build enough ships to keep up with the incremental effect. Now if the rest of the world slows down a bit, that will mitigate the pressures enormously.

JW: *China is a big deal, which Polyconomics has been saying since 1978. Why? Its leadership now understands the kind of economics practiced by the Chinese Diaspora in Hong Kong, Singapore and Taiwan, and they understand monetary policy. This goes back to the 1946-47 inflation that brought Mao Tse-tung and the Communists to power. Remember Marx favored a gold standard. China will not float the yuan. Even if it unfixes from the dollar, it will fix to a commodity standard, gold or a small basket of commodities that are sensitive to inflationary impulses.]*

Q: So, how do you feel about the loss of manufacturing jobs in the U.S. to China?

A: There are only 14 million manufacturing jobs, down from 17 million four years ago. How many of those 14 for technical reasons are always going to be in America? Say 8 million. So between now and forever you are going to lose another 6 million jobs. You just lost 3 million in the last four years. It is really seriously hard to get too excited in a population of 250 million about the eventual loss of an incremental 6 million jobs.

The huge pain of the economy going from 80% manufacturing in 1900 is behind us. That is really bullish. There are plenty of countries where this is a serious factor, but for the U.K. and the U.S., the two most advanced in this way, what used to be bad news has become the good news. The U.K. and the U.S. are service-driven economies.

Q: What about the migration of services jobs at this point?

A: Migrating service jobs is much more complicated. You certainly wouldn't want them to go too fast because that is the area where we are growing and that's where our comparative advantage always has been.

But in the end, global trade benefits everybody. It may also hurt some people, but net-net, it increases the total wealth of the majority of people and so it will go on. We should welcome it. But it is tough if you are the computer programmer who just lost his job to someone in Mumbai.

Q: And so are you investing in commodities?

A: Commodities will probably be a nice place to hide and well worth looking at. We have been considering doing a real-asset fund using stocks. We probably will not, but we are working on it just to have an extra weapon to consider according to the circumstances.

A fund we will probably do is a quality stock fund. A lot of our funds are tied to benchmarks and there is a limit to how much they can tilt to high-quality stocks or should. A quality fund will allow us to target quality stocks more emphatically.

JW: *This is another good insight, looking into commodities, but there is no theoretical underpinning. Our guess is that Grantham's service is as good as it is because he has people on his team who are better thinkers and analysts that Grantham may himself be. In other words, the broader intellectual portfolio at Grantham may be greater than the sum of its parts. Our own theoretical underpinning for commodity prices is the gold* *price. The most reliable method for determining where commodities should be priced at any given time is to calculate where they stand relative to their historical ratio with gold (i.e., more expensive or cheaper), rather than their historical price in dollars. It is dangerous to assume that the price of any commodity would revert to its historical average against the dollar, for the simple reason that the value of the dollar is always moving, and sometimes moving by a great deal.*

Q: *Thanks, Jeremy.*

JW: *In summary: It is of course possible that political decisions will be made in Washington in the next six months that will bring about a bear market. But at the moment, the forces pushing up the value of the nation's capital stock are easily outweighing those dragging it down. The spring tax cuts give us the lowest combination of taxes on capital in 40 years and the legislation before Congress to replace the Foreign Sales Corp makes the environment for capital formation even more favorable. At the same time, the monetary deflation that dragged on the markets and economy in the first two years of the Bush Administration now is behind us, with gold at $380 indicating a very mild inflation. The big risks remain geopolitical, but even there, things are going so badly for the President in the Middle East that his hands have been tied on future adventures against the axis of evil. Barron's should invite Grantham back in six months and ask for a new assessment. He may simply push his doomsday model forward and again advise that for the near term things look okay.*

Jude Wanniski (with Michael Darda, Steve Anderson and Wayne Jett).