Jeremy Grantham: US Stocks are Expensive and Bonds are Disgusting

By Robert Huebscher
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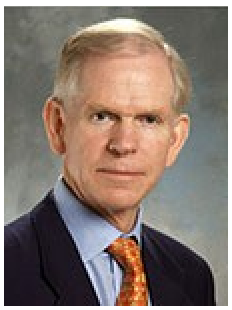

Jeremy Grantham, who has consistently identified overpricing in the US equity markets – he flagged both the Dot Com bubble and the irrational pricing that preceded the financial crisis, for instance – said last week that US stocks are "a little expensive" and bonds are "disgusting." But his sternest warning to investors concerned the longer-term threat posed by global resource constraints.

Abnormally high corporate profits are the primary reason for Grantham's contention that stocks are overvalued. Reversion to the mean is the core expectation that undergirds his firm's investment philosophy, and when profit margins revert to their historical averages, he argued, investors will suffer weak returns.

Grantham is the co-founder and chief investment strategist of Grantham Mayo van Otterloo (GMO), the Boston-based asset manager. His was one of the keynote presentations at last week's Morningstar Investment Conference, held in Chicago.

I'll discuss Grantham's concerns about natural resources – he devoted most of his talk to that subject – but first let's look at his assessment of valuations in global capital markets.

I'll conclude with some very specific advice from Grantham on how investors can make money.

The problems with stocks and bonds

Followers of Grantham – and our readers – are familiar with GMO's investment process, which is based on a faithful reliance that certain key variables that drive stock prices – such as P/E ratios, revenue growth and profit margins – will reliably revert to their means.

GMO regularly publishes its forecast for market returns, which it projects over a seven-year time horizon. It "ruthlessly normalizes" earnings, Grantham said, assuming they will return to their historical averages by the time seven years have passed.

Abnormally high earnings will lead to disappointing US equity returns, Grantham said.

"The great majority think US equities are reasonably cheap," he said, "but we don't, because we want them to be priced to normal earnings."

Mason Hawkins, the chairman and CEO of Memphis-based Southeastern Asset Management, spoke the previous day and articulated the opposing view: Margins and earnings are neither at peak or temporarily elevated levels. He said margins are higher in the US (but not globally) because we have exported lower returning businesses to other countries, such as those that are manufacturing-based, and have kept the higher returning ones, in industries such as technology and pharmaceuticals. Additionally, he said many US-based firms have significant overseas subsidiaries. Often they own less than 50% of them and account for them on an equity basis, where income but not sales is consolidated. That has artificially pushed up earnings, he said, but not temporarily.

Grantham conceded that high profit margins in the context of high unemployment is “truly weird” and has never occurred before. But he also said that GMO’s research has revealed that rising government debt is often accompanied by higher profit margins (although he did not say whether this was globally or just for the US, or over what time period).

He said that the stock market “wants to be nervous” and has priced equities accordingly, “but only because it quite incorrectly gives full credit to today’s earnings.”

I asked Grantham whether central banks and government fiscal policies are working to slow or stop the regression to the mean upon which GMO’s investment philosophy relies. He said those factors contributed to poor results from many noted and talented value managers, including some who had exemplary track records for over a decade. He acknowledged that the Fed policy has allowed “changes to the laws of nature” and wasn’t sure whether those changes are temporary or permanent. But he did not say whether GMO had changed its investment approach as a result.

Among US equities, Grantham said the best returns are likely to come from high-quality blue-chip stocks, for which GMO forecasts an inflation-adjusted annual return of 4.8%. But, he said, “you would lose a ton in US small-cap.” International large- and small-cap stocks and emerging equities are at fair price, he said.

Grantham said that investors face short-term risks in emerging markets, and that China’s economy may slow down. But globally diversified investors should expect “pretty decent” returns equal to their historical averages over a seven-year horizon, according to Grantham.

The “real problem” among asset classes is bonds, Grantham said. Their overvaluation is the result of Fed policies that have artificially depressed real interest rates. “They do it to encourage you to get so fed up with parking your money at minus one that you will move it into the equity market,” he said. “The more you do it, the more seductive it becomes.”

GMO has refused to be seduced. “It makes it so expensive to have the dry powder that you know you should have in the face of the euro, China, and the debt overhang, which are pretty big problems,” Grantham said.

GMO is the uncontested expert on bubbles, having studied and mathematically analyzed over 330 of them. Although bonds are horribly priced, Grantham said they are not in a bubble. To earn that distinction, he said there would need to be "wildness," with IPOs and exuberant, excited investors. Indeed, he said the bond market is in an "anti-bubble," marked by fear and nervousness.

The constraint on global growth

Grantham is a noted environmentalist, and his quarterly letters often address the subject of the constraints on global economic growth posed by shortages of natural resources (see, for example, here). His talk last week was largely devoted to this subject – which has been a theme for Grantham and GMO for the last decade.

The potential for running out of resources is going to play a "big role in everybody's life from now on, particularly in the poor countries," he said. We may avoid devastating consequences in the next 20 or 30 years, he said, but commodity prices will be erratic and, over the long run, rising, according to Grantham.

Grantham's key assertion is that the increase in commodity prices over the last decade is a paradigm shift, not a temporary bubble. Until 10 years ago, average commodity prices had declined over the previous 100 years by 70% on an inflation-adjusted basis. But since then, an equal-weighted basket of 33 commodities tripled in price. (He noted that a study by McKinsey found similar results with a market-weighted basket of commodities.)

"That has never happened in the history of psychological equity bubbles," he said.

A typical bubble is characterized by a once-in-44-years event, Grantham said, and once-in-100- or once-in-200-years events (as was the case with Japanese real estate 20 years ago) can be classified as bubbles. But the increase in iron ore prices is a once-in-2.2 million-years event; coal price increases represent a once-in-48,000-years event; and the increase in corn prices is a once-in-14,000-years event.

"This must be something else," Grantham said. He thinks that something else is the global population, which could be on its way to nine billion.

"It is the pressure of people," he said. "It's going to be extremely ugly."

China is the biggest contributor to population-induced consumption. In 2011, it used 53% of all cement, 48% of all iron ore and 40% of all coal produced worldwide. "These are spectacular numbers," he said, "and it's putting a horrible pressure on the world's resources."

Consumption in other countries, including South Korea and Japan, has grown at a rate similar to that of China's, but these countries did so with far smaller populations.

Energy, metals and food

Grantham divided resource problems into three categories.

The first two can be addressed, he said. We can have enough energy if we are "sensible" and start building solar- and wind-powered smart electrical grids. And if we "recycle like mad," we will have enough metals to last for hundreds of years, although ultimately he said those supplies will be exhausted.

"But the one that is immediately pressing is food," he said. "We are losing the ability to distribute and feed the poor countries."

Declining agricultural productivity is the main culprit. Grantham said that we now use five times as much fertilizer per acre as we did in 1960 – and in China that figure is 10 times as much. Over-fertilization is ruining the environment, polluting waterways and yielding a diminishing return, according to Grantham.

Land productivity, on a global basis, is growing at 1.2% – too slowly to keep pace with population growth.

Animal feed shortages are particularly problematic, he said. The Chinese diet has become increasingly dependent on beef and pork, and China imports most of the soybeans it needs to feed its livestock. As a result, North and South American farmers have more acreage under soy today then they have under wheat. "These are stunning changes, with great implications," Grantham said.

The most productive wheat growers – including the UK, Germany and France – have not increased production over the last decade. Japan, the most productive rice grower, has had flat output for the last 15 years, he said.

Agriculture is limited by four inputs: soil, water, fertilizer (phosphorus, potassium and potash), and nitrogen. Soil – arable land – is being depleted at 1% annually, which Grantham said is 10- to 100-times faster than it is naturally replaced.

Water is a huge problem for a lot of countries but not for the US, according to Grantham. Issues with water usage, he said, tend to stem from "incompetence" – growing rice in deserts, for instance, or pricing water too cheaply.

Fertilizer ingredients stand out as a crisis, Grantham said. About 95% of phosphorus supplies are in Morocco, and that concentration represents an extreme risk, according to

Grantham. “These are the kind of problems we don't talk about because they are inconvenient and they threaten long-term growth of the system,” he said.

Climate change has contributed to declines in agricultural output, Grantham said. Hotter temperatures and more volatile weather have all taken their toll.

Already, even some advanced economies are struggling to feed their populations. Grantham said that the average Indian diet was only 2,100 calories in 1982, and today it is down to 1,900. He said that India faces serious malnutrition problems, as do a lot of Africa, Southeast Asia and Pakistan.

Grantham faulted the US for its ethanol subsidies. The corn for one tank of ethanol in an SUV would feed an Indian person for a year, he said.

The net result of constrained resources is that global economic growth will decelerate. The US will benefit from its natural gas reserves, at least over the short- and medium-term, but it will be hard pressed to grow at more than 2.2% annually. The rest of the world will be less fortunate, growing at 1.7% to 1.8%.

But for the last 100 years the America grew at 3.4%. “Now we are talking about 2%,” he said. “This is a huge decline.”

How to make money

Against the backdrop of his sobering assessment of the world’s resource problems, Grantham offered some specific and practical investment advice.

First, he said, investors must recognize that two forces guide investor behavior. One is a bullish bias that pervades normal market conditions. The second – quite separately – is that investors like to stay in the pack, even if the pack is hurtling downwards.

Investors adjust to those biases in order to preserve their careers and, he said, behave so as to never be wrong on their own. That proclivity was first identified by Keynes 80 years ago, and it remains true today. The way most investors try to win, according to Grantham, is to be a little bit “quicker and slicker the draw,” through more effective strategy execution and more accurate market anticipation.

“And if you are very smart, you anticipate what other people anticipate,” he said.

The desire not to be wrong on one’s own creates an enormous momentum and drives prices away from fair value, Grantham said. “It dominates our industry and how we behave.”

The way to counteract that fact is to invest methodically (using GMO's reversion-to-the-mean process across asset classes) and for the long term, according to Grantham.

Grantham has illustrated the value of a long-term focus in how he invests his sister's pension fund, a subject he has covered in his quarterly letters. He considers his sister's assets to be permanent capital; he has no career risk, since his sister will not fire him as the manager. He has managed it since 1968, and over the last 10 years his returns have exceeded those of Harvard and Yale.

Grantham said that the advantage he has with his sister's account is that he doesn't over-manage it. Sometimes he makes adjustments twice a year, but once a year is more normal. Everyone in the audience, he said, and everyone in the institutional world, over-manages money for very good career risk reasons. "We want to be seen busy and earning our keep," he said.

The returns on Grantham's sister's assets are not measured against any benchmark, and that, he said, contributes to their strong performance. As a manager, the risk that Grantham focuses on is the protection of capital, not on metrics such as the Sharpe or information ratios.

Grantham said that this style of low-turnover, permanent-capital investing produces returns that are 100 to 200 basis points a year greater than GMO's funds that have their performance measured against a benchmark. In today's low-return, low-growth environment, it is remarkable that so few have embraced this philosophy.