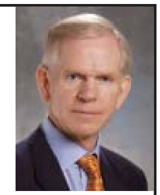
GMO

QUARTERLY LETTER

August 2011

Danger: Children at Play



Stop Press Addendum

Jeremy Grantham

My worst fears about the potential loss of confidence in our leaders, institutions, “and capitalism itself” are being realized. We have been digging this hole for a long time. We really must be serious in our attempts to resuscitate the “average hour worked” and the fortunes of the average worker. Walking across the Boston Common this morning, I came to realize that the unpalatable (to me) option of some debt forgiveness on mortgages looks increasingly to be necessary as well as the tax changes I discuss here.

To go further, if we mean to prosper long term, I am sure we need to act to make debt less attractive to everybody: it really is a snare and a delusion.

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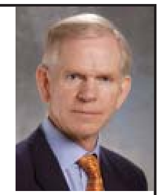


Jeremy Grantham

"Peace in our Time"[1] and the Art of Can-Kicking

Tough decision-making is never easy, and wishful thinking and trying to postpone the day of reckoning is always tempting. The British of the late 1930s probably hold the world record for wishful thinking, and the agreement signed in Munich in 1938 certainly provided the ugliest example of expensive can-kicking: Czechoslovakia was sold out to Hitler to, at best, buy a few months of peace. More recently, Japan has been the reigning world can-kicking champ for 20 consecutive years. But today Japan is suddenly being challenged by both the U.S. and the Euroblock. (The Brits, in contrast, with their draconian cost-cutting program at a time of acute economic weakness, look brave. Possibly recklessly conservative, and probably with rotten timing. But certainly very brave, Mr. Minister.)

Climbing the Greecey Pole

I am not an expert in euro finance by a wide margin. But I know one thing. Forget the debt for a second: the current uncompetitiveness of Greece, Ireland, Portugal, Spain, and Italy did not occur quickly. It took 10 long and obvious years. They had to work at it. The cure was always going to cause a lot of pain and threaten the well-being of the euro. So why didn't the bosses attempt to fix it early on when it would have been so much easier? There was no material squawking by the Germans or the ECB. In fact, the Germans back then were themselves busy weaseling on their own rules of good financial behavior. Along the way, the local bosses – just like Greenspan here – were cheerleaders for the disastrous behavior of excessive spending. Today these problems have become much tougher, but still the decisions are only half made and the cans get kicked and kicked again.

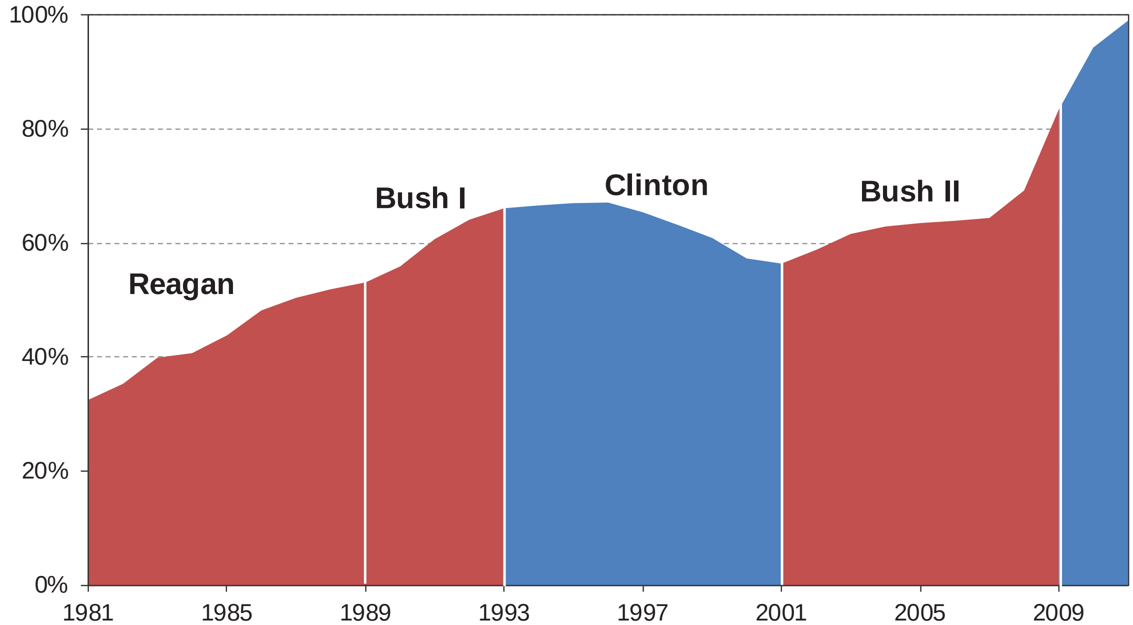
Also challenging strongly to assume the can-kicking title (having already snatched "The Most Dysfunctional Government" title from Argentina) is the United States. Exhibit 1 shows the build-up of U.S. gross national debt as a percentage of GDP. The shading shows the data by presidential term. The debt ratio rose rapidly under Reagan and Bush II and fell rapidly under Clinton. No doubt, there were extenuating circumstances for all of them: unnecessary wars, etc. (There certainly was for the current incumbent. By the way, where is the current incumbent? In any case, he definitely inherited a dreadful mess courtesy of Greenspan, Bernanke, Paulson, Bush II, Rubin, and an army of greedy corporate short-term profit maximizers.) To go with all of their other failings they were, above all, engaged in wishful thinking. For all of them there appeared to be no housing bubble, no need to regulate subprime, no fear of an extra million houses being built. But most importantly, there was no willingness to take preemptive and tough decisions. Everyone appeared to be hoping for the best. At the extreme there was Greenspan expecting responsible behavior from bankers! This is all old hat, but it is important to remember that most of the current problems for the U.S. stem from an earlier refusal to deal with the U.S. housing bubble at an early date.

So now (July 30), the U.S. – with a dysfunctional Congress – has to decide between two of the ugliest choices seen in a long time. Should they cut government expenditures and therefore cut aggregate demand at a time of a critically weak economy on the cusp, perhaps, of a double dip? Or should they do nothing and allow a technical default, compromising the integrity of the dollar and sending a powerful signal to the world that the U.S., at least for now,

1 "My good friends, this is the second time in our history that there has come back from Germany to Downing Street peace with honor. I believe it is peace in our time." Prime Minister Neville Chamberlain upon his return from Munich in September 1938 after he had met with Hitler and signed the Munich Pact, a treaty that he publicly represented as avoiding war.

Exhibit 1

U.S. Gross National Debt as % of GDP



Source: Office of Management and Budget   As of 6/30/11

is not a serious country and is probably past its prime. Ouch! Nobly trying to resolve this impasse, a small chunk of Republicans has seized the mantle of blackmailers and turned out to be very good at it. Certainly too good for President No-Show. Come to think of it, the choice was between technical default and looking like a Banana Republic and technical blackmail and looking like a Banana Republic! Just different bananas perhaps?

Update on "Seven Lean Years"

I wrote in early 2009[2] that "we probably do face a period that will look and feel painfully like seven lean years." And "I expect that, at least for the seven lean years and perhaps longer, the developed world will have to settle for about 2% real GDP growth (perhaps 2.25%) down from the 3.5% to which we used to aspire in the last 30 years ... It makes it very unlikely … that we will get back to the old highs in the stock market … anytime soon." And perhaps most seriously: "We have all lost some confidence in the quality of our economic and financial leadership, the efficiency of our institutions, and perhaps even in capitalism itself." (Emphasis added.)

So here we are more than two years later, at the one-third mark in the seven lean years. Profit margins, as we will see later, are far above what I expected then. But everything else is perhaps at least a little worse. First, when I talked about 2% growth I was talking about a reduction in our trend line growth. I did not intend to count from the dead low of the economic recession. In fact, I argued that of course there would be an economic bounce with all of the spare capacity and unemployment. Had we averaged 2% growth from 2007 until now, GDP would be up 7% today. It is actually just under dead flat. To make up this 7% shortfall in the remaining 3.5 years (December 2007 to December 2014) would take an extra 2% a year, that is, 4% annual real GDP growth. Given our current headwinds, this would seem to need a miracle. Even to average 1.5% growth for the seven years from 2007 to 2014 would take 3% a year growth, which seems at the upper end of a reasonable range. So, unfortunately, at the end of the first period (in hockey terminology), my dismal seven-lean-year forecast looks all too accurate and, perhaps, even optimistic. To this point, there has never been such a weak and slow recovery from a steep decline. The revised numbers show that at the 2009 low we had had by far the biggest drawdown in GDP (-5.1%) since the Great Depression. The reasons that I thought it would take at least seven years to get back to normal are still mostly in place. Some have modestly improved, but many are worse.

2 Jeremy Grantham, "The Last Hurrah and Seven Lean Years," 1Q Letter, 2009.

"Seven Lean Years:" The Plus Side

- The growth rates and general economic well-being and resilience of emerging economies, especially China and India, have been nothing short of remarkable. Collectively they have resisted the financial crisis far better than expected, with only 17% of global government debt outstanding, compared to fully one-half of global GDP! They bounced back much faster economically and have basically supplied a lifeline to the developed world that has admittedly been grabbed more solidly by some – Germany in particular – than others.
- The scale of both the Chinese trade surplus and the U.S. trade deficit has declined: hopefully this is a down payment on a long-term project aimed at more sustainable trade relationships.
- There is a U.S. personal savings rate once again. It has jumped to 5% from 1% (first announced as negative but much later revised). This causes some short-term problems for everyone by reducing immediate demand, but in the long term dis-saving was not even close to a long-term equilibrium. Perhaps the current 5% savings rate will be just enough to muddle through, although it leaves retirement funds severely malnourished after a decade of little or no savings.
- Corporate profits are a bonanza that would allow in principle for substantially increased hiring and a consequent stimulus to GDP. President Hoover bitterly railed at senior businessmen in 1930 and 1931 for sitting on their cash. President Obama would have felt sympathetic. Corporations today are doing very little hiring despite unusually high cash reserves.

"Seven Lean Years:" The Negative Side

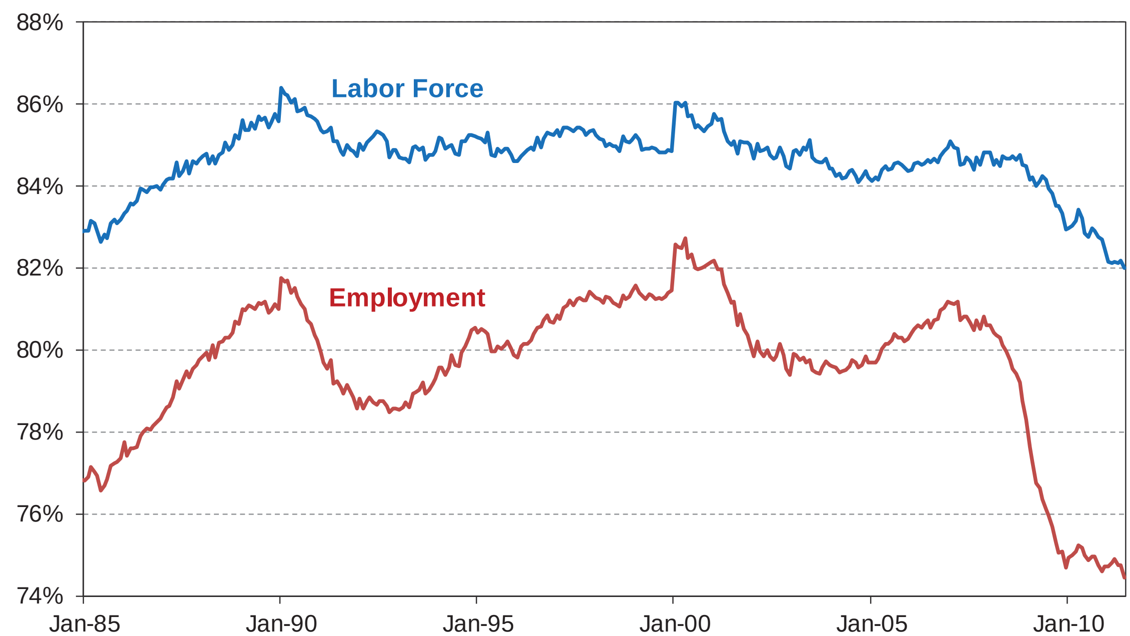
- Where to start? The disillusionment with institutions and "even capitalism itself" has increased, particularly disillusionment with Congress, whose dysfunctionality would be laughable if the stakes were not so high. This depresses animal spirits, which dampens the current recovery, and some of this effect (which for some of us reaches mild despair) might linger for years, persistently making growth a little more difficult than would normally be expected given all other economic inputs.
- Resource prices are even higher than I expected partly because China's growth has continued to be strong and partly because truly atrocious weather has continued for longer than I expected, even though I was counting on much-increased climate instability in the long run as the direct result of climate warming.
- Predictably, the developed world ages, the percentage increase in new workers declines, pensions and health benefits bloom, and balanced budgets clearly become mathematically impossible without either substantial reneging on commitments or tax increases or both. Any other pretense is beyond wishful thinking or weak math skills. It is either childish or gross and cynical politics: that is to say, even worse politics than usual. It is certainly kicking an enormous can down the road. The lower GDP forecasts inherent in the seven-lean-year environment would guarantee, if they materialize, much higher U.S. deficits than currently forecast.
- The overhang of a housing bust remains and will remain for years. The illusion that we had of great housing wealth was shattered. The extra housing stock must be absorbed. The extra 4% to 5% of home ownership that resulted from sustained overstimulation must revert to its economically justified level. The good news is that it is at least halfway there. It simply has to keep painfully plugging along for a few more years. House prices are unlikely to roar back because, with houses, "once bitten, twice shy" really does apply. In any case, home builders can produce decent houses at current prices and, in the long run, these lower prices are far more satisfactory for the critical new buyers, whose well-being we tend to forget in the heat of battle. (See Australia today where a typical young couple in Sydney cannot buy an average house.)

  Although we at GMO believe U.S. housing is at least back to trend prices and probably slightly below, we must admit that a multi-year sustained overrun on the downside has normally followed the breaking of a major bubble like the one just witnessed. Other than this historical observation, however, we know of no way to usefully guess at how deep and how long an overcorrection might be.

- Personal income progress is very modest. Productivity has been very high – remarkably so compared to the rest of the developed world average – but the U.S. continues its odd and long history of flowing all economic gains to corporations and the very rich and basically none to the average hour worked. Therefore, it should come as no surprise that we are facing weak demand. For 30 years to the year 2000, consumers compensated for their lack of progress in hourly wages partly by working harder and longer and in greater numbers (i.e., a higher participation rate) and partly by borrowing. But in the 10 years after 2000, the participation rate in the workforce has dropped dramatically (see Exhibit 2) and hours worked per person has flattened so that the only way for individuals to grow their consumption more recently was by borrowing even more and, to some extent, by speculating in housing. Rising house prices provided the (apparently) real backing for more debt and, even where that backing did not exist, the ingenuity (and, we must admit, greed) of the financial system still supplied the debt. And all of that has gone. And since creating and destroying illusions seems a wretched way to proceed, we can hope (non-mortgage brokers anyway) that it does not return. Today the artificial sugar-coating of increasing debt has been removed and we must live with the reality that an average hour's work has not received a material increase for 40 years (see Exhibit 3). Without increased debt and without gains in hourly wages, how can there be sustained broad gains in consumption? Only Chanel suits, Hermes scarves, BMWs, and their ilk have very strong sales, and these top-end items are just too small a fraction to carry the day. If we want to dig out of our current morass, don't we have to change this equation and isn't the most direct way of doing this to divide the pie more evenly? That would mean lower income and sales taxes for the bottom 75% of earners and higher taxes for the top 10%! We have allowed the vagaries of globalization and the plentiful supply of cheap Chinese labor to determine our income distribution, which has become steadily steeper, to the point where we have become one of the least egalitarian developed societies. Wouldn't it be better for us to decide deliberately and by ourselves that income distribution which creates the best balance of social justice and incentive to work? I am not suggesting that we become some goody two-shoes Scandinavian country. But how about going back to the levels of income equality that existed under the Presidency of that notable Pinko, Dwight Eisenhower (see Exhibit 4). And don't think for a second that this more equal income distribution somehow interfered with economic growth: the 50s and 60s were the heyday of sustained U.S. economic gains.

Exhibit 2

U.S. Civilian Employment and Labor Force, as % of Population Aged 20-64

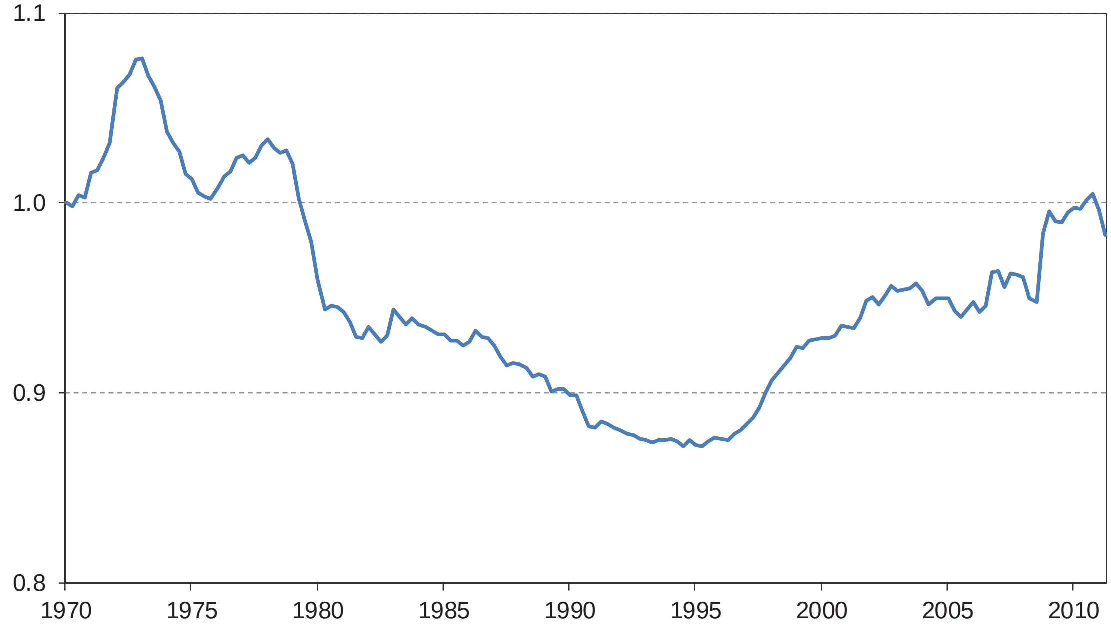


Source: Conference Board, U.S. Census, Bureau of Labor Statistics   As of 6/30/11

Exhibit 3

U.S. Real Average Hourly Earnings Index, Q1 1970 = 1

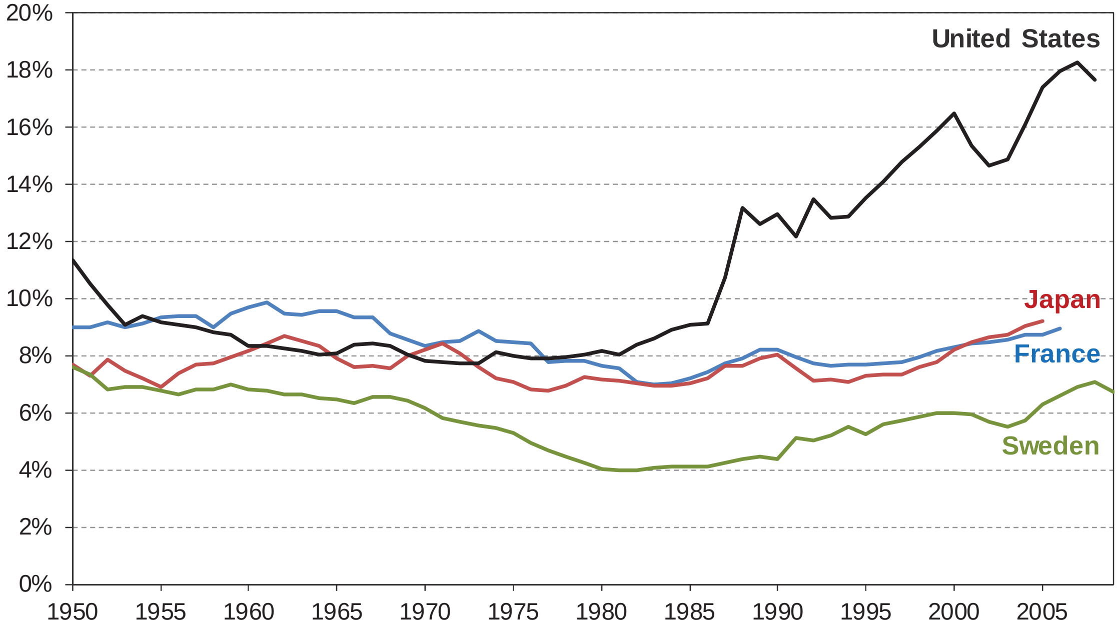
Down over 40 years!



Source: OECD Main Economic Indicators, IMF International Financial Statistics   As of 6/30/11

Exhibit 4

Income Share of Top 1% as Percentage of Total Income



Source: World Top Incomes Database   As of 12/31/09

- The problems with average workers and their limited progress in income is not just about raw income after tax. They have been neglected in many other ways: excellent basic education is now the exception rather than the rule by international standards, and post high school training and retraining is also sadly lacking compared to best practices. Pensions also, as we'll see, have gone backwards. It is a very broad as well as a very depressing picture.

- It's not just that there is no increased debt to help consumption: individuals must also make an effort to increase savings and pay down existing household debt. This had peaked at 130% of income in 2007 and was clearly unsustainably high. It has been moderately reduced in the last three years, mostly by write-downs of the debt, but also by taking on less new debt. Net new debt was unprecedentedly negative for two years until two months ago when it moved up to just +1%. Loss of housing values has revealed how almost everybody has under saved for 20 years.
- The rapid abandonment of formerly widespread defined benefit pension funds puts further pressure on lower and middle income families. 401(k) and defined contribution plans are desperately poor substitutes for defined benefit corporate plans, in which corporations guaranteed a percentage of retirement salaries. These traditional plans were remarkably generous and represented a high point in corporate responsibility to employees. The management of these over their first 20 years became highly professional, in my opinion, and cost effective. Management by the individual retirees themselves is, in contrast, typically very high cost and, of course, disastrously amateurish.
- Economic policy making has been stuck between half-hearted Keynesian stimulus, mostly chosen, apparently, to avoid projects with a high social return on investment, and ill-timed "Austrian" cut-backs. Clearly, this mishmash has not been effective at job creation. Conversely, we were great at job destruction: no other country laid off workers with such panic. Where Dutch and German companies, among others, tried to protect their workers' social capital by limiting firing, we protected short-term profits.
- If we continue to drift around rudderless, if we don't develop some real leadership soon, then seven lean years may be the least of it. When I was five years old there was a globe on my grandparents' landing. The British Empire and Commonwealth bits were in red. You have no idea how red the globe was ... India, Pakistan, Bangladesh, Burma, Malaysia, Africa from Egypt to South Africa, and so on. It was undeniably the largest Empire by far in history, both geographically and in population. And 20 years later it was gone. Too many wars, sloppy and sometimes very unenlightened management, not enough money in the till, and, simply, a changing world. So, been there, done that. I mention this not as a comparison between the British Empire and the U.S. and certainly not to defend imperialism, but merely to show how quickly things can change. It would be a shame to see my adopted country also fall away from a leadership position in which it has been a working demonstration not just of entrepreneurial drive and effective government, but also of social justice and international leadership and assistance. A model to which reasonable people could aspire.

Freakishly High Corporate Profits

Looking at corporate profit margins, one could argue the same for them – that they do not seem to be connected to economic reality. A sub average economic recovery, threatening to become painfully sub average, has not stopped corporate profits from quickly rising to a level that is about as high as they have ever gotten. The average worker, with flat wages for decades and with 16% to 18% of the workforce either out of work (9%), discouraged to look for work (4%), or forced to work only part-time (5%), must feel as if he (or she) is in a depression (see Exhibit 2). It looks likely to take several years before normal employment is reached. Corporations are spending on capital equipment but are doing little in the way of domestic recruiting. Profit margins in the financial system were protected, along with bonuses, which in some cases set records last year despite the undeniable fact that these were the guys who helped bring the Western world to its knees. Ah, justice! There never was – and perhaps, with luck, never will be again – such a terrible comparison between the economic well-being of corporations and their officers and the economic ill-being of their ordinary employees. My colleague Ben Inker has written (as has Andrew Smithers in London) that, other things being equal, corporate profits will rise when government debt has risen. And, boy, has it risen! A more intuitive variant of this is that normally when you lay off everyone and cut your costs, your profits rise, if you do it alone. But when you all do it together, everyone's top line drops and you collectively cycle downwards. Here though, for a while anyway, a great surge in government spending made up the difference on the top line, making for the temporary best of all possible worlds for corporate profits, an outcome that I must admit I never saw as even a faint possibility. It belongs, however, to the growing family of can-kicking maneuvers: when the government debt ratio inevitably falls, or even as it rises at a <u>decelerating rate</u>, it will put offsetting pressure on margins. As individuals continue to restrict their spending and as commodity prices stay high, other pressures on profits also intensify. <u>Lower margins are the great threat to market performance, even more so than the above long-term average P/Es</u>. [Memo: the very long-term normal trailing P/E is about 15. We use 16 in our calculations because we're friendly. Those who use much higher numbers are looking at the shorter time periods, when the Greenspan-Bernanke regime created a long period of artificially above-normal stock prices. Be warned!]

Recent Predictions: Looking Promising

For a year I had personally been taking more risk than justified by our seven-year forecast. I had done so, respecting the awesome (and awful) power of the Fed to move stock prices when it wants to. And it certainly wanted to. Bernanke bragged about its success in raising stock prices to prove the point. But, with Libya et al., Japan wobbles, and resource prices, I felt the game was just getting too risky. So, last quarter I suggested it was time to finally fight the Fed and take less risk, a recommendation that I feel much better about today than three weeks ago when the market was unchanged.

Since then I realize that I had underestimated the risks of both the Greek (or better: the Mediterranean) debt problem and the U.S. debt limit. Both of these additional problems introduce a plentiful supply of new risks. So my advice for the last two months of the Presidential Third Year (typically the short seller's nightmare) is to continue to keep your head down. And, more to the point, <u>keep it down for the foreseeable future</u>. Maybe you can pop up again for some risk taking in the next Year 3! Of course, everything changes if the market pulls an '09 and gets down to fair value. And we're 10% closer to fair value than when I originally sat down to write this.

Market Tone Continues to Shift to Quality

Better yet for GMO and my predictions, the general drift to quality that began in April continued on a global basis. GMO's Quality Strategy today[3] is 4% ahead of the S&P with the Russell 2000, a crude proxy for the enemy, down 2.5% for a 6.5% spread. (It had been 5% the other way in early April, so this is not an insignificant move!) Quality-adjusted-value measures have also done much better in recent months. This perhaps is even better news for us and similar managers, for quality-adjusted-value has done poorly for quite a few years, with the notable exception of 2008 and early 2009. The return on the S&P is still ahead today by about 0.5%. For quality stocks to be winning more or less globally in an up year (and they were also winning two weeks ago with the market return up over 6%) makes it increasingly likely that we have been in a classic late bull market rally as described in earlier quarterlies. (In 1929, 1972, 1987 pre-crash, and the 12 months to September 2000, high quality stocks outperformed in the last leg of major bull markets.)

The bottom line is that we are glad to have cut back on risk-taking and we are very glad to see quality working. I am sufficiently impressed by the power of the Fed and low rates to influence stock prices, however, that I still think it's quite likely that the market will renew its fight to stay up for a few more months and, if the negative flow of data eases up for a minute, it will even rise. Three weeks ago when one looked at the long, long list of real fundamental problems one could only wonder (admiringly, or not, depending on your portfolio disposition) at how well the global markets, especially the U.S. market, had done. What a terrible mistake it always is to expect stock markets to reflect economic reality in the short term. Especially in Year 3 of the Presidential Cycle! But three weeks, as they say, is a long time in investing. Now the realities of the world suddenly loom much larger. The market has this always disturbing habit of ignoring the obvious and ignoring it some more, until, in the blink of an eye, it doesn't.

3 Return data in this section is YTD as of August 2, 2011 and is net of fees. As of 6/30/2011, the GMO Quality Strategy has returned +26.8% (1-year), +5.2% (3-year), and +4.1% (5-year) net of fees.

What to Buy?

- For those with a long horizon, I am sure well-managed forestry and farmland will outperform the average of all global assets.
- I think it is likely that resources in the ground, hydrocarbons, metals, and fertilizer will also win on a 10-year horizon. I am not certain, though, because of the remarkable gains in so many of these in the last five years. I would put the odds at 2 to 1. As mentioned last quarter, many commodities have the potential for very sharp declines in the short term. If that occurs, then the odds would, of course, rise.
- On a regular time horizon, I would continue to overweight quality stocks, which may well be on a roll. They are not priced to make a fortune, but they are priced to give approximately 4.5% to 5% real return, which I think is acceptable for low-risk assets. They have also delivered dependable downside – risk off – relative performance for several years, which is a characteristic generally in short supply.
- Emerging markets are hard to evaluate because they are clearly going through many phases of development in a real hurry. So what is normal profitability? Probably not the old levels. They are moving toward developed status and probably toward our developed world's level of profitability. (Yes, James Montier, that would be a change and, therefore, I admit, far from certain.) In a global financial crisis it is also important to remember that their cumulative foreign reserves are remarkable, twice that of the developed countries. But, all things considered, I believe they will outperform other non-high-quality equities for the next seven years and are likely to produce a semi-respectable return for a risky group of about 4% to 5% a year real.
- We at GMO also believe that Japan is likely to "regress," in the mathematical sense, toward levels of profitability that would be considered normal in other developed countries. We expect the progress to be very slow and uneven. If it does not happen at all, then Japanese stocks are priced like the average of all other developed equities, or a bit cheaper. If, however, by some chance margins improve quite fast, then Japanese stocks will likely be the best performing stocks around and could hit double-digit real returns for seven years. Japan's remarkable resilience in the face of electricity shortages gives some inkling of what they are capable of. How quickly we have forgotten their obvious talents of 20 years ago. Can all of those talents really be lost forever?
- As for the rest of global equities, they range from unattractive (August 2) to very unattractive. The S&P 500, for example, is worth no more than 950 on our estimates.
- In general, risk avoidance looks like a good idea. Cash – despite its manipulated low rate, deliberately designed to make us reach for risk – should be seen as a safe haven replete with important optionality: dry powder to take advantage of possible opportunities.
- As mentioned in previous quarterlies, <u>the main long-term risk</u> is that after two massive bubbles and two equally massive resurrection programs, the Fed may be out of ammunition. Should more building blocks fall (government bond downgrade and further market declines have missed my deadline) and a serious global double-dip develop, then the pattern of market behavior this time may be more historically typical. That is, instead of quickly recovering, markets will become cheap and <u>stay below long-term averages for several years</u> as was the case pre-Greenspan. Twenty years is a long time, so most investors think that dipping to fair value for a minute and bouncing is normal. It is, in fact, highly aberrant historically. Markets staying down and washing away a whole generation's false expectations, high animal spirits, and excessive risk-taking – <u>that</u> would be normal. In the long run, a prolonged period of lower priced assets would lead to a much-improved, less risky, and less bubble-prone environment. In short, a more manageable world. It would also mean much higher returns from investing at lower prices. Long-term benefits from short-term pain. Just the kind of trade-off that the children in charge now would never make deliberately. But it may well happen anyway.

Stop Press

At the close on August 8, a slightly cheap equity portfolio could be put together comprised of U.S. high quality, emerging markets, Japan, Italy, and European growth stocks. On our data, the imputed 7-year return of the package today would be about 6.5% real!* Quality stocks, especially in the U.S. but almost everywhere, continue to handsomely outperform. Regrettably, this means that they have declined very considerably less than the indices. In its asset allocation accounts, GMO is modestly underweight equities, partly because of the desperately unattractive yields on fixed income. We are now very modest buyers for the first time since mid 2009.

Performance data quoted represents past performance and is not predictive of future performance. Returns are presented after the deduction of a model advisory fee, transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. Actual fees paid by accounts within the composite may be higher or lower than the model advisory fee used. A GIPS compliant presentation of composite performance has preceded this presentation in the past 12 months or accompanies this presentation, and is also available at www.gmo.com. Actual fees are disclosed in Part II of GMO's Form ADV and are also available in each strategy's compliant presentation.

*The forecast provided above is based on the reasonable beliefs of GMO and is not a guarantee of future performance. Actual results may differ materially.

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