GMO

OTHER COMMENTARY

NOW IS THE TIME TO BE CONTRARIAN

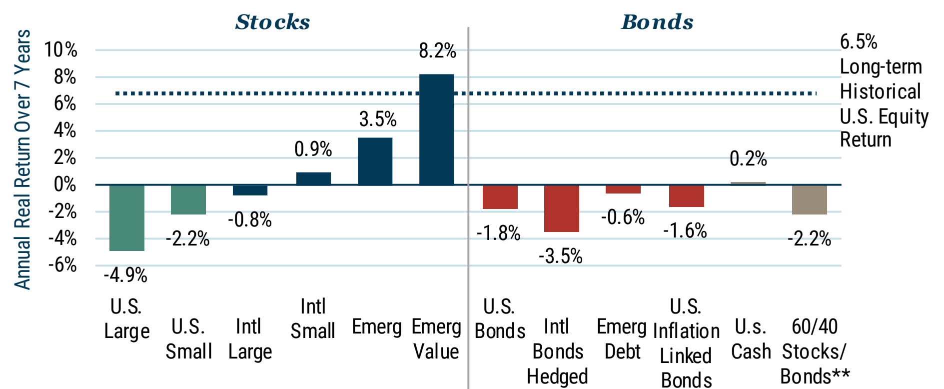
Peter Chiappinelli | January 2020

The good news first. The fourth quarter was an amazing capstone to a risk-on year. Virtually all risk assets rallied impressively: U.S., non-U.S., and Emerging stocks, growth, value, large, and small. Certain pockets in the equity markets posted double-digit returns in the quarter alone. Credit markets, such as High Yield and Emerging Market Debt, rallied. You name it, and it was up.

Now for the bad news. Much of 2019's impressive run-up for U.S. large cap equities was based not upon fundamentals but upon P/E multiple expansion. Profit margins, in fact, declined substantially in the fourth quarter, yet the "Ps" kept rising. And this expansion was on the back of what was already an expensive market. We ended 2019 with the Cyclically Adjusted Price to Earnings (CAPE) for the S&P 500 at 31, putting it at extreme levels, well past the bubble levels of 2007 and within whispering distance of October 1929.

Back to the good news, however. The rest of the world, particularly value stocks in Emerging equities, are trading at substantial, near historic, discounts to the U.S. So, there is money to be made, good money in fact, as our 7-year forecast for Emerging Value stocks is over 8% real, with possible additional returns coming from their cheap currencies. But it gets better. Value stocks across the planet, in fact, are also trading at substantial discounts to their Growth brethren. We are also quite constructive on our alternatives portfolio, which can further exploit these valuation differences without taking beta or duration risk.

7-YEAR ASSET CLASS REAL RETURN FORECASTS*



As of 12/31/19 | Source: GMO

*The chart represents local, real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forwardlooking statements. U.S. inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

**60% MSCI ACWI / 40% U.S. Bonds

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Mr. Chiappinelli is a member of GMO's Asset Allocation team. Prior to joining GMO in 2010, he was an institutional portfolio manager on the asset allocation team at Pyramis Global Advisors, a subsidiary of Fidelity Investments. Previously, he was the director of institutional investment strategy and research at Putnam Investments. Mr. Chiappinelli earned his MBA from The Wharton School at the University of Pennsylvania and his B.A. from Carleton College. He is a CAIA charterholder, and was the founding President of the CAIA Boston chapter. He is a CFA charterholder.

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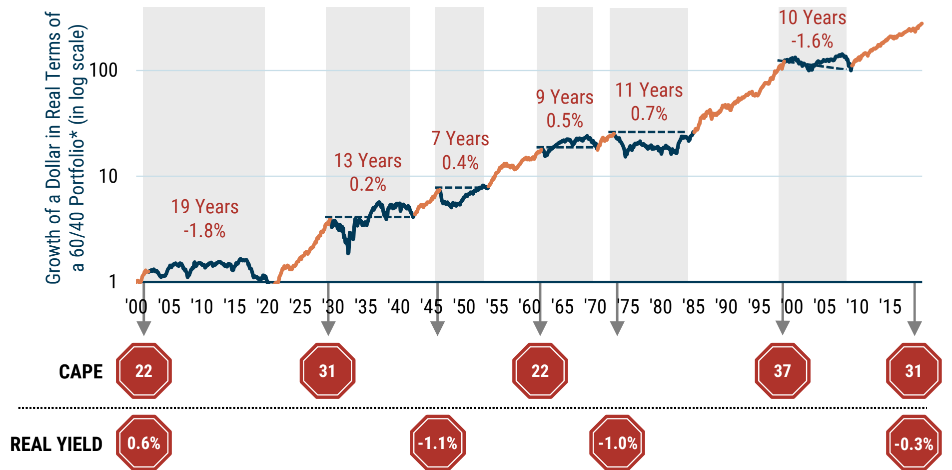
The last time we saw this wide a "spread" in expected returns between a traditional 60/40 portfolio and a non-traditional one was back in the late 90s, and we all know what happened from there. The traditional 60/40 portfolio went on to have a "Lost Decade," making essentially no money, in real terms, for ten years. Starting in late 1999, the 60/40 portfolio delivered a cumulative real return over the next ten years of -3.9%. Ouch. (As an important aside, GMO's flagship balanced strategy delivered a cumulative real return of +86.0% over the same time frame). Sadly, as the chart below points out, Lost Decades have happened with alarming and surprising frequency, all preceded by expensive stocks or expensive bonds. Today, both are expensive.

In fact, the amazing run-up of the traditional 60/40 portfolio over this year and this decade can mean only one thing to this valuation-sensitive, i.e. contrarian investor: now is the time to be moving away from 60/40.

60/40: "LOST DECADES" ARE MORE COMMON THAN YOU THINK



As of 12/31/19 | Sources: Bloomberg, Global Financial Data (early history), Factset (S&P500 returns and CPI), J.P. Morgan (J.P. Morgan GBI United States Traded), Shiller data; real yields are the yield on the 10-Year U.S. Treasury minus the 12 month trailing CPI.
*60% U.S. Equities (S&P 500), 40% U.S. Bonds (U.S. Treasuries) rebalanced monthly.