

I Do Indeed Believe the US Market Will Revert Toward Its Old Means – Just Very Slowly

Jeremy Grantham

After a few misquotes and misunderstandings by journalists, overeager perhaps for a punchy headline and unwilling to invest time in my two long and quite possibly boring pieces on “[Not With a Bang But a Whimper](#),” I need to reply.

They have said, or implied, that I believe high prices are here permanently and that I also believe regression to the mean has ended. This is, of course, inaccurate, as readers of my quarterly letters know. I have suggested that although mean reversion in margins and price earnings ratios is still probable, the speed of regression has slowed way down and become sticky. This slowdown is because nearly all of the factors causing it are themselves unlikely to change fast. These include Fed policy including moral hazard, lower interest rates, an aging population, slower growth, and productivity; and increased political and monopoly power for corporations.

Because of this stickiness, I have suggested that regression of P/Es and profit share will take 20 years as opposed to the 7 years (the basis of GMO’s official 7-year forecast) that is more typical of the period 1900-1997 and that even then those measures will have only regressed back two-thirds of the way to the old normals.

What was quite surprising to me in this work, though, was how damaging even this reduced regression rate would be to the imputed returns of the S&P 500: 2.7% real per year for 20 years, a rate bound to break the hearts of many corporate and public pension fund officers. (It is also within a half a point a year of GMO’s standard 7-year forecast methodology when that is extended to 20 years, on the assumption of normal growth in years 8 to 20.)

Of course there will always be normal bear markets, and in two or three years this cycle is likely to die of old age (or lack of labor) and go into a recession. Both recessions and bear markets are normal, as are their recoveries. My key question is: If we have a bear market soon, even a severe one, will it recover to the new normal of 23x or the old normal of 15x? I believe the former. Let me remind you that that new 20-year era of higher prices was very severely stress-tested by the 50% decline from the 2000 Tech Bubble and the 50% decline in 2008-2009, perhaps the biggest foul-up of the financial system in modern times. Neither spectacular event was enough, apparently, to jolt the price trend back to its former lower level.

Further, the current market lacks most of the behavioral indicators of a true bubble. Rather, we should be braced for a long-drawn-out and painful flight path back toward the old ratios we know so well. As a value manager, I wish it were not so.

P.S.: A fully-fledged bubble in the US with full behavioral ecstasy can still occur. In today's changed environment, though, I think it would take a considerably higher level on the S&P 500. Now that's a seriously irritating thought! I suggest letting the evidence of bubble-type euphoria speak for itself, so when the local lunch places are touting stocks and not Red Sox replays, as they did in 1999 and no doubt would have done by radio in 1929, I'll let you know.

Also, please remember that this is my personal view, not GMO's official view. It is also described as ["A Thought Experiment."](#) My "near certainties" of 1999 and 2007 vintages are sadly lacking these days.

Jeremy Grantham. Mr. Grantham co-founded GMO in 1977 and is a member of GMO's Asset Allocation team, serving as the firm's chief investment strategist. He is a member of the GMO Board of Directors and has also served on the investment boards of several non-profit organizations. Prior to GMO's founding, Mr. Grantham was co-founder of Batterymarch Financial Management in 1969 where he recommended commercial indexing in 1971, one of several claims to being first. He began his investment career as an economist with Royal Dutch Shell. Mr. Grantham earned his undergraduate degree from the University of Sheffield (U.K.) and an M.B.A. from Harvard Business School.

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