Jeremy Grantham: The Market Bubble Will Burst in Weeks or Months

October 22, 2020

by Robert Huebscher

Jeremy Grantham has made a science of studying asset bubbles, correctly predicting the path of the Japanese, dot-com and housing overvaluations. Today's bubble in U.S. equities is unlike any other, he says, but it will burst in months, if not weeks.

Grantham is the co-founder and chief investment strategist of Grantham, Mayo, & van Otterloo (GMO), a Boston-based asset management firm. He was interviewed via webinar on October 21 by Alex Shahidi, who is a managing partner and co-chief investment officer at Evoke Wealth and ARIS Consulting, a Los Angeles-based asset manager, as part of its master speaker series.

"We are in a bubble," Grantham said, "but it is unlike any other." The excessive bubbles of history took a great economic situation and extrapolated it into the future, based on an assumption that today's perfect conditions will continue.

But doing that today leads to the opposite of a bubble, Grantham said, given that P/E ratios are at the highest 15% of their historical values despite the dismal economy.

Everything is overpriced, he said, but there is no way to say when they will peak. To call that peak, it is useful to look for signs of "crazy" behavior.

"That was not lacking in the rally off the COVID low," he said. That was a late-stage rally with a rapid surge in prices. Another sign of craziness is the flood of interest in special-purpose acquisition companies (SPACs), which he said are based on the proposition to, "give me your money and trust me that I will do something useful with it."

"That is a real testimonial to the speculative nature of the market." He added that the same is true with the valuations of Hertz and Tesla, the latter of which he called a great company but an unjustifiable stock at today's price.

"The stories are everywhere and are what you need for a bubble to break." But, he said, that is an indicator but does not offer certainty that we are close to the break.

It could be weeks or months, he said.

"You cannot be as certain as in prior bubbles," Grantham said. Those bubbles were due for near-certain collapses.

"My bet is that reality will catch up with the high P/Es."

According to Grantham, a high P/E is an intrinsically dangerous and risky situation that relies on investor confidence. "If you break confidence and are way overpriced, you are looking at substantial declines."

Grantham runs a family foundation that is focused on green-energy investments, where much of his time, energy and passion is focused. But he studies the market intensely. The interview was focused on climate change and the capital markets, as well as the intersection of the two.

Overcoming the existential threat from climate change

Rising sea levels present an existential threat to a large percentage of the global population.

Over the next century, Grantham predicted that countries in Africa will be destabilized, and “big chunks” of the Indian subcontinent will be devastated. We will go from 1.5% of the planet being uninhabitable to 17%, mostly near the equator. Two billion people, primarily in Bangladesh, Pakistan and India will lose their homes. Overall, five out of the nine billion people on Earth will be threatened, he said.

That will lead to immigration and pressure on Europe, which will become a big geopolitical risk and a “real threat to the well-being of society,” he said.

But humans are completely capable of handling it “easily,” Grantham said. Yet, in real life, we don’t “behave well.” Those who understand and accept the threat of climate change need to do everything in their power to use their influence, through political and media advocacy, for example. “You can never do too much,” Grantham said.

In 2007, he wrote a paper about climate change. Since then, it was clear to him there would be trouble for oil stocks. Oil has gone from 25% of the market capitalization of the S&P 500 in 1982 to 2.5%, which he said was the biggest loss of value in the history of the major groups of the index. Yet he acknowledged that he could never predict when that collapse would happen.

“But you were on wrong side of history if you owned oil,” he said. He called that a great demonstration of the “long-term, slow burn” of an industry. “That is what the rest of climate change looks like now.”

It will go in bursts and will be at times faster than you think, Grantham said.

“We will win,” he said. “The question is whether the world will still be worth living in.”

He said he has been dragged into politics. A Democratic administration will embrace deficit as well as green spending, he said, which he said would be great. “That will give a shock to the economic system that will drive us out of the dreary slow growth rates of the last two decades.”

The developed world has been losing its growth and edge, he said. As long as inflation is not gathering steam, we need a massive, sustained global stimulus.

“What an opportunity to have a win-win,” Grantham said.

Grantham is a big fan of venture capital, especially investments in green technology, where much of his foundation is focused. He said he prefers “creating new values from ground zero,” rather than trading bid-up assets.

He said he has never seen more opportunity in venture capital, as long as one is diversified. Green venture capital will have a very high return, he said, in areas like wind, solar and electric cars.

It is going to take tens of trillions of dollars to “green” our economy, Grantham said, and we must do it.

The impact of fiscal and monetary responses

Grantham was generally supportive of the fiscal and monetary responses to the pandemic. But he made careful distinctions between the two and their long-term impact.

Central banks, the Fed, and fiscal policy are globally supporting the market, he said, providing an “enormous” push.

“This is very effective to raise stock prices.”

But U.S. equities are priced higher than a year ago, when the economy was in decent shape. Meanwhile, everyone is extending the period during which the pandemic will last.

Monetary and fiscal spending must be separated, Grantham said. Under Fed Chairperson Alan Greenspan, the U.S. debt started to rise rapidly, leading to the eventual quadrupling of the debt-to-GDP ratio. Over that time, growth has slowed, but Grantham said the causal relationship is not clear.

Government spending must be used as long as inflation is low, he said.

Grantham is not intimidated by leverage, only by interest-cost coverage. The entire corporate system is in “pretty good shape” on that basis, he said, as are sovereigns.

“Do not let conservative politicians and some economists persuade you that debt is a bone crusher,” he said. “It is not.”

With respect to response to the virus, monetary policy has been ineffective and fiscal policies have been timid. Grantham said it is much better to push hard on government spending, which we have been doing.

The election has the potential for increase in green government spending and, on a 10-year basis, jump start the developed world. Without that, we face 1% to 1.25% growth.

“Bring on the left-wing Democrats,” he said. “Let’s make sure it is done right. I don’t mind a little inflation. It doesn’t threaten the economy; it threatens PEs.”

He said the market is very vulnerable to profit margins and the “hint” of inflation. But the economy is very durable, even if it were to face 5% or 6% inflation.

Instead, Grantham said we are gently sliding into deflation. He has never called inflation a major risk over last 20 years and won’t be in the future. But, he said, for first time we can “talk about the potential for it to come back.” Fiscal spending can reasonably lead to inflation. We should expect raw materials and food to be scarce, but it will take a long time to work through to wages because wage deflation has been persistent and the power of unions has been eroded.

Investment strategy

Grantham recommended avoiding U.S. equities in favor of emerging markets. For those inclined to favor the U.S., he prefers deep-value stocks.

Those deep-value stocks are somewhat attractively priced, he said, following an extreme year that drove growth stocks to bubble territory. But it is best to avoid the U.S. entirely.

“The certainties we used to have no longer exist,” Grantham said. We have seen the most massive move against value in history. Value is not as dependable and useful a weapon as it was prior to 2007. But now the parameters that measure the “cheapness” of value have been pushed to extremes.

The best value metric is dividend-discount model, according to Grantham, because it gives full credit for intellectual property. It is why he bought Microsoft early on and held it until late 1999. It sold at many multiples of book, he said, but had a high, stable return. Amazon and Alphabet, even allowing for their returns, are still overpriced based on that model.

“We are going to have a very big reversal in favor of value sooner or later,” he said.

The FAANGS are worthy of study, he said. Grantham has never seen as concentrated a group of disruptive, fast moving companies that were built on intellectual capital. But they have been bid up and even the best companies can be overpriced.

Don’t short them, he said, “but own as few U.S. equities as you can.”

If you insist on investing in the U.S., he recommends green venture capital.

GMO’s seven-year forecast calls for negative real returns for virtually all asset classes.

“But you only need one big asset class to get rich,” Grantham said.

That asset class is emerging markets, which are guaranteed to grow fast, he said. It consists of 26 countries and covers every industry you could want – at 10-times earnings.

He favors China, which will get 30% of world’s growth, and India, Russia and Brazil. Collectively they will be a much bigger part of world GDP, according to Grantham.

“A bet on emerging markets is a bet on the future against the past,” he said. “The only thing interesting outside of that are the FAANGs, but more so intellectually than financially.”

Grantham said he is sympathetic to the lack of opportunity in this low-yield environment, “but the market doesn’t care about that.”

“Your desperation is your own matter.”