ADVISOR PERSPECTIVES

Bubble Watch Update

November 18, 2014
by Jeremy Grantham
of GMO

The January Rule

As you may remember, the January Rule serves as a kind of barometer for the behavior of the market in the coming year. Historically, when January was down, the rest of the year had over twice the declines than one would expect randomly, far more mediocre months, and a very sub average return. But it is far from perfect and it had the unusual problem this year of bumping into the positive signal from the Presidential third year, which started for us on October 1. For the statistically-minded, or the trivia-minded, the four previous such conflicts between the January Rule and the Presidential Cycle were inconclusive but the simple rule would have been to end the January Rule enterprise on September 30. This year was flattish by then and the new Presidential Cycle has gotten off to a good start since September 30.

The Presidential Cycle

Regular readers know the score: +2.5% a month for the seven months from October 1 to April 30, in year three on average since 1932 (a total of +17%). This is now the 21st cycle. The odds of drawing 20 random 7-month returns this strong are just over 1 in 200 according to our 10 million trials. But 17 of the actual 20 historical experiences were up and the worst of the 3 downs was only -6.4%, so the odds of this consistency plus the high return would be much smaller. The remaining 5 months of the Presidential year have a good but not remarkable record, over .75% per month, but the killer here is that the remaining 36 months since 1932 averaged a measly +0.2% a month!

With the 7 months having returned over 10 times the average of the 36-month desert, it may seem like a nobrainer investment for those seven of us not intimidated by the obvious simplicity of the idea, but be advised that going into this particular cycle there appear to be more negatives than normal. (Though many of the previous 20 occurrences may well have seemed that way to investors at the time. Who knows?) The negatives this time include the ending of the Fed's bond purchase program. There is also talk of a rate increase early next year, given the recent recovery of the U.S. economy reflected in the improved employment report of early October (5.9% unemployed) and positive adjustments to the previous month's employment numbers. Other negatives include the potential for escalation of several minor but intractable wars and the recent Ebola outbreak.

Some would mention the very substantial overpricing of the U.S. market at the top of the list but, surprisingly, overpricing has had no material effect on third-year returns or the particularly sweet seven-month subset: an average of 17% for seven months becomes 19% if cheap and 15% if expensive. Big deal. Value, however, is very the other three quartiles are absolutely not worth having, all three together averaging almost exactly nil! More disturbing to me than the obvious overvaluation is the large and growing number of other negatives – technical and psychological – put together by Hussman and other market experts. Nevertheless, despite my nervousness I am still a believer that the Fed will engineer a fully-fledged bubble (S&P 500 over 2250) before a very serious decline.[1]

The Prudent Investor

As always, the prudent investor (unlike the political year three) should definitely recognize overvaluation, factor in regression to the mean, and calculate the longer-term returns that result from this process. More easily, such prudent investors can use our seven-year numbers, which have a decent long-term record measured when we have viewed markets as overpriced, as we believe they are today, and a better record measured in the periods after bubbles break. The other necessary ingredients to the investment mix are suitable measures of risk, and when these are added to estimated returns we believe efficient portfolios can be produced. On our data, with U.S. large cap equities offering negative returns (-1.5%) except for high quality stocks (+2.2%), with foreign developed and emerging equities overpriced (+3.7%), and with bonds and cash also very unattractive, investors have to twist and turn to find even a semi-respectable portfolio. It is a particularly tough process today with nowhere to hide and no very good investments compared to, say, the time around the 2000 bubble when there were several. My colleagues Ben Inker and James Montier have written in some detail about the problems of investing in these difficult times.[2] Designed to help your thinking about this topic, Exhibit 1 shows an example of a portfolio that might be used in a world that excludes private equity and venture capital, and for a client who can do without a benchmark and can settle for owning a (hopefully) sensible long-term efficient portfolio. Efficient, that is, in terms of trying to minimize risk per unit of estimated returns. As always, and particularly in this type of overpriced environment, there are no guarantees of success even if every GMO recommendation were to be implemented for, regrettably, we too are often imperfect.

My personal fond hope and expectation is still for a market that runs deep into bubble territory (which starts, as mentioned earlier, at 2250 on the S&P 500 on our data) before crashing as it always does. Hopefully by then, but depending on what the rest of the world's equities do, our holdings of global equities will be down to 20% or less. Usually the bubble excitement – which seems inevitably to be led by U.S. markets – starts about now, entering the sweet spot of the Presidential Cycle's year three, but occasionally, as you have probably discovered the hard way already, history can be a snare and not a help.

[1] In the interest of full disclosure, Grantham Foundation has tilted toward the Presidential Cycle by using out-of-the-money calls. But, caveat emptor.

[2] See Ben Inker, "Free Lunches and the Food Truck Revolution," July 2014 and James Montier, "The Purgatory of Low Returns," July 2013. Each of these publications is available with registration at www.gmo.com.