Joseph, consigliere to the pharaoh, advised him that seven lean years were sure to follow the string of bountiful years that Egypt was then having. This shows an admirable belief in mean reversion, but unfortunately, the weather does not work that way. It, unlike markets, is almost completely random, so Joseph’s forecast was like predicting that after hitting seven reds on a roulette wheel, you are likely to get a run of blacks. This is absolutely how not to make predictions unless, like Joseph, you have divine assistance, which, frankly, in the prediction business is considered cheating. Now, however, and definitely without divine help but with masses of help from our political leaders, we probably do face a period that will look and feel painfully like seven lean years, and they will indeed be following about seven overstimulated very fat ones.

Probably the single biggest drag on the economy over the next several years will be a massive write-down in perceived wealth. In the United States, the total market value of housing, commercial real estate, and stocks was about $50 trillion at the peak and fell below $30 trillion at the low. This loss of $20 trillion to $23 trillion of perceived wealth in the United States alone (although it is not a drop in real wealth, which consists of a stock of educated workers, factories, trucks, etc.) is still enough to deliver a life-changing shock for hundreds of millions of people. No longer as rich as we thought—undersaved, underpensioned, and realizing it—we will enter a less indulgent world, if a more realistic one, in which life is to be lived more frugally. Collectively, we will save more, spend less, and waste less. It may not even be a less pleasant world when we get used to it, but for several years, it will cause a lot of readjustment problems. Not the least of these will be downward pressure on profit margins that for 20 years had benefited from rising asset prices sneaking through into margins.

Closely related to the direct wealth effect is the stranded debt effect. The original $50 trillion of perceived wealth supported $25 trillion of debt. Now, with the reduced and more realistic perception of wealth at $30 trillion combined with more prudent banking, this debt should be cut in half. This unwinding of $10 trillion to $12 trillion of debt is not, in my opinion, as important to consumer behavior as the effect of the loss of perceived wealth, but it is certainly more

Editor’s Note: This article is adapted, with permission, from “The Last Hurrah and Seven Lean Years” by Jeremy Grantham, GMO Quarterly Letter (May 2009).
important to the financial community. Critically, we will almost certainly need several years of economic growth, which will be used to pay down debt. In addition, we will need several years of moderately increased inflation to erode the value of debt, plus $4 trillion to $6 trillion of eventual debt write-offs in order to limp back to even a normal 50 percent ratio of debt to collateral. Seven years just might do it.

Another factor contending for worst long-term impact is the severe imbalance between overconsuming countries, largely the United States and the United Kingdom, and the overproducing countries, notably China, Germany, and Japan. The magnitudes of the imbalances and the degree to which they have become embedded over many years in their economies do not suggest an early or rapid cure. It will be hard enough to get Americans to save again; it will be harder still to convince the Chinese, and indeed the Germans and the Japanese too, that they really do not have to save as much. In China, in particular, they must first be convinced that there are some social safety nets.

A lesser factor will be digesting the much shrunken financial and housing sectors. Their growth had artificially and temporarily fattened profit margins as had the general growth in total debt of all kinds, which rose from $1.25 \times GDP$ to $3.1 \times$ in 25 years. The world we are now entering will, therefore, tend to have lower (more realistic) profit margins and lower GDP growth. I expect that, at least for the seven lean years and perhaps longer, the developed world will have to settle for about 2 percent real GDP growth (perhaps 2.25 percent) down from the 3.5 percent to which we used to aspire in the last 30 years. Together with all the readjustment problems and quite possibly with some accompanying higher inflation, this is likely to lead to an extended period of below-average P/Es. As I have often written, extended periods of above-average P/Es, particularly those ending in bubbles, are usually followed by extended periods of below-average P/Es. This is likely to be just such a period and as such historically quite normal. But normal or not, it makes it very unlikely with P/Es, profit margins, and GDP growth all lower than average that we will get back to the old highs in the stock market in real terms any time soon—at least not for the seven lean years, and perhaps considerably longer. To be honest, I believe that most of you readers are likely to be grandparents before you see a new inflation-adjusted high on the S&P 500 Index.

If we are looking for any further drawn-out negatives, I suspect we could add the more touchy-feely factor of confidence. We have all lost some confidence in the quality of our economic and financial leadership, the efficiency of our institutions, and perhaps even in the effectiveness of capitalism itself, and with plenty of reason. This lack of confidence will not make it easier for animal spirits to recover. This does not mean necessarily that we have not already seen the low, for, in my opinion, it is almost 50/50 that we have. It is more likely to mean a long, boring period when making fortunes is harder and investors value safety and steady gains more than razzle dazzle. (The flaky, speculative nature of the current rally thus bears none of the characteristics that I would expect from a longer-term market recovery.)
The VL Recovery

So, we are used to the idea of a preferred V recovery and the dreaded L-shaped recovery that we associate with Japan. We are also familiar with a U-shaped recovery, and even a double-dip like 1980 and 1982—the W recovery. Well, what I am proposing could be known as a VL recovery (or very long), in which the stimulus causes a fairly quick but superficial recovery, followed by a second decline, followed, in turn, by a long, drawn-out period of subnormal growth as the basic underlying economic and financial problems are corrected.

An Amateur’s Assessment of the Stimulus Program

On the confidence topic, it would be a start if we could all believe in the effectiveness of our stimulus program, but it is not easy. The situation today is that an unprecedented amount of stimulus is being thrown at our problems, and it is being thrown on a global basis. Some hurlers, like the United States, are more prodigal than others, and some, like the Germans (whose only imaginative stimulus is a scrapping bonus, not surprisingly reserved for their beloved cars) are more frugal. But in total, the effort is unrivaled in history. The bad news comes in two bits: First, no one really knows if generous bailouts are a good idea in the long run; and second, no one really knows that even if they are indeed a good idea, whether this current stimulus is enough. What most people, including me, agree on is that the problems we face are unprecedented both in global reach and in the breadth of financial assets that are affected, which is to say everything.

My own personal and speculative take on this is that the stimulus program will have a positive effect on all countries, and in some cases, this will be enough to kick GDP growth back into positive territory quite soon for the most fortunate, in which group I include the United States.

It is ironic, by the way, that the United States would be less hurt than most given that Pied Piper Greenspan led all of us global rats into the river. And, yes, in this case the maestro (well named) had an orchestra pit filled with U.S. Treasury and Fed officials (especially the New York Fed) and such a large supporting cast of dancing CEOs of financial firms and their reckless board chums that even Cecil B. DeMille would have found them sufficient. So, we in the United States developed almost single-handedly the tech bubble of the late 1990s and then engineered a U.S. housing bubble and a flood of excess dollars that almost guaranteed that global assets would follow suit. Yet, unfairly or not, the United States has some considerable advantages in this mess we created. First, we have an unusually low percentage of our labor force in manufacturing and export-oriented companies, which will be the most immediately affected by the global downturn, unlike in Germany and China, to name two. Second, the dollar plays an important role that may cushion U.S. pain by allowing U.S. authorities the flexibility to make their own rules, whereas such other countries as Spain and Ireland have most decisions heavily constrained.
More profoundly, the United States is in a position where necessary sacrifices will simply be less painful. We affluent in the United States will have to buy two fewer teddy bears for our already spoiled four-year-olds. The third television set will be postponed as will the second or third car. We will have to settle for a slimmed down financial industry and fewer deal-oriented lawyers. Woe is us. China, in contrast, will close teddy bear factories and send its workers back to marginal or submarginal jobs in the countryside. That is the real world, and it delivers real pain. Even worse, in some ways, is that the Germans (and to a lesser extent the Japanese) make and sell the equipment that builds the teddy bear factories, no more of which will be needed for a long while. That, too, is real pain. To add to these advantages—at least in the short term—the United States is pouring on more stimulus than anyone else.

So, for the United States at least I have considerable confidence that GDP growth will kick back into positive territory (+0.8 percent) by late 2009 or early 2010. This, I concede, is a consensus view but one that comes with a significant caveat: I believe that there is a decent chance, say 20 percent, that we still badly underestimate the downward momentum of short-term economic forces. We know we are perfectly capable of doing this because as recently as November 2008 the “authorities” (such as the IMF) estimated a +0.5 percent GDP growth rate for the developed world in 2009, and it is now at −4 percent! Not bad . . . a 1 percent reduction per month where a 0.1 percent change per month for four months would normally be considered a landslide.

But to get back to the point. The stimulus program is not based on either persuasive economic theory or solid historical studies: There are simply too few examples and absolutely no controlled experiments, so we are reduced to guesswork. Almost everyone has had the thought that if overconsumption and excessive debt have caused our problems in the United States, then pushing rates so low that they practically beg us to borrow and consume some more seems an odd cure. We acknowledge that a stiff whiskey can get the drunk to stagger to his feet and make it a few blocks, but it does not seem like a successful long-term strategy to cure him of drunkenness. Yet we all override this thought by saying that because a great majority of dignified economists, although they all disagree on the details, seem to think stimulus is necessary, surely they must collectively have it right. However, we in the investment business are blessed by an example that allows us to keep an open mind. The widespread acceptance of rational expectations and the efficient market hypothesis has taught us never to underestimate the ability of the economics establishment to get an idea brutally and expensively wrong. They may have done so this time. It may indeed be a better long-term solution to accept a more punishing decline and let foolish overleveraged banks go under together with weak players in other industries. Surely assets would flow to stronger hands with beneficial long-term effects. Indeed, the quick 1922 recovery from the precipitous decline of 1919–1921 was so profound that the “roaring twenties” suppressed the memory of that earlier depression.
So, what do we really know about the merits of stimulus programs? We do know that National Socialist Germany claimed full employment by 1935 when we—Americans and Brits—still had 15 percent unemployment. They did this as far as one can tell by direct government expenditures: by building autobahns, “people’s cars” (VWs), and the odd battleship. We also know that wartime preparations finally and absolutely cured the recalcitrant depression in the United States. Germany and Japan sprang back from the ashes after World War II, but are we sure that this does not say more about remarkable economic resilience than it does about stimulus? On the one hand, the stimulus side certainly had the Marshall Plan, the very high point of enlightened and generous American foreign aid. On the other hand, surprisingly, the United Kingdom received more Marshall Aid than the Germans did, who had far more damage to their infrastructure. So, perhaps it is indeed more about resilience and work ethic than stimulus. We know that in 15 years, with a semi-flattened industrial sector, the Germans had flashed past the Brits and even the neutral Swedes for that matter. The U.S. economy was also back on its long-term growth trend in 1945 as if the depression and the war had never occurred. So, we know a lot about the powerful resilience of economies. *They are not such delicate flowers that we need to protect every foolish bank or be faced with wrack and ruin.* Current stimulus seems to be more about timing. We are unwilling to take a very sharp economic downturn even if such a downturn makes a quick, healthy recovery more likely. Rather, we seem to be making a desperate attempt to make the setback shallower, perhaps at the expense of a longer recovery period. What is likely to happen in the near term always has far more political influence than what may happen in the longer term. So, we have been more decisively selecting the Japanese route rather than the 1921 or the S&L (savings and loan) approach of a more rapid liquidation. Month by month we are voting for desperate life support systems—at the taxpayers’ expense—for zombie banks and industrial companies that have been technically bankrupted by years of excess and almost criminally bad management.

I do think I know one thing, however. If a government invests directly, drawing employment from a large pool of the unemployed, and only invests in projects with a high societal return on investment—such as hiring workers with well-stocked tool belts to install insulation, or repair bridges and transmission lines, or lay track to accommodate a respectably fast train from Boston to Washington (yes!)—it seems nearly certain that such a government will not have to regret it. Keeping banks, bankers, or even extra auto workers in business seems, in comparison, far more questionable—so questionable in fact that it must be justified by politics, not economics. We should particularly not allow ourselves to be intimidated by the financial mafia into believing that all of the failing financial companies—or very nearly all—had to be defended at all costs. To take the equivalent dough that was spent on propping up, say, Goldman Sachs or related entities like AIG that were necessary to Goldman’s well being, as well as the many other incompetent banks,
and spending it instead on really useful, high-return infrastructure and energy conservation and oil and coal replacement projects would seem like a real bargain for society. Yes, we would certainly have had a very painful temporary economic hit from financial and other bankruptcies if we had decided to let them go, but given the proven resilience of economies, it would still have seemed a better long-term bet. But, as I said, this is all just speculative theory, and I do not have to deal with the U.S. Congress.

Let me end this essay by emphasizing once again the difference between real wealth and the real economy on the one hand and illusory wealth and debt on the other. If we had let all the reckless bankers go out of business, our houses and our factories would not have blown up, our machine tools would not have been carted off to Russia, and we would not have machine gunned any of our educated workforce, even our bankers! When the smoke had cleared, those with money would have bought up the bankrupt assets at cents on the dollar, and we would have had a sharp recovery in the economy. Moral hazard would have been crushed, lessons would have been learned for a generation or two, and assets would be in stronger, more efficient hands. Debt is accounting, not reality. Real economies are much more resilient than they are given credit for. We allow ourselves to be terrified by the “financial-industrial complex,” as Eisenhower might have said, much to their advantage and to our cost.

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