GMO

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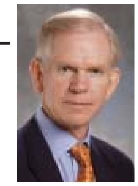

The Last Hurrah and Seven Lean Years

Jeremy Grantham

The Loss of "Near Certainties" in Investing

First, let me lament the loss of near certainties in investing. The financial and economic collapse that I described as "the most widely predicted surprise in the history of finance" about 18 months ago is behind us. More precisely, we believed that bubbles had formed in global profit margins, risk premiums, and U.S. and U.K. housing prices, and that all three were "near certainties" to break, with severe consequences for the economic and financial system. All have thoroughly burst and are in their overcorrection phase with the single exception of U.K. house prices, which I'm confident will do their duty. Normally there are, of course, no near certainties in investing. Life is not meant to be that easy. Asset allocators have been blessed in the last 10 years with a large collection of extraordinary outliers. As my favorite quote by Mandelbrot (1983) says, "Even though economics is a very old subject, it has not truly come to grips with the main difficulty, which is the inordinate practical importance of a few extreme events." If this last 10 years did not prove him right, nothing will. Since 1988, we have been offered 8 or 10 2-sigma events. (A 2-sigma event is our definition of an important bubble or bust.) All of these events were bubbles, and all behaved themselves by bursting. Now, sadly, there are probably none. Government bonds are the one serious candidate. In our opinion, they are badly overpriced but probably not by enough to justify the bubble title. Global equity markets are still cheap, but in major markets are nowhere near 2-sigma, 40-year bust levels. Some small-scale 2-sigma bargains may exist in the fixed income markets in rate differentials, but need skillful analysis and knowledge to disentangle from value traps. And, they are a very far cry from, say, the opportunities offered by buying credit default swaps at a handful of basis points on overleveraged financials in early 2007. So, all in all, welcome back to the age of guesswork.

The Last Hurrah

One reason I am parting company with many of my bearish allies for a while is my familiarity with the Presidential Cycle and, critically, what it has taught us about the power of stimulus and moral hazard to move the stock market many multiples of their modest effects on the real economy. These lessons seem to me to be particularly relevant today.

This Presidential Cycle effect is dismissed as an artifact by the great majority of financial academics, but they have a stalwart record of dismissing any data that implies even modest market inefficiency, and this effect implies great dollops of inefficiency. Simply summarized: since 1932, in the third year of the Presidential Cycle, the average S&P 500 return (from October 1 to October 1) is 22 percentage points ahead of the average of years one and two! And this is statistical noise? Year three is the time when, driven by politics, financial stimulus and moral hazard are applied so that the economy – particularly increases in employment – can be a little stronger in the run-up to the election in year four. In years one and two, in contrast, the system is tightened in order to leave some room for re-stimulus in the next year three (except during Greenspan's era, when he basically could never stop stimulating and so periodically upset the applecart). It is all pretty understandable. All we have to believe is that politicians like to be reelected and that completely independent Fed chairmen like to play ball with politicians. (Volcker of course, unlike the others, was never a ball player.) There have been no serious bear markets in year three, and many in years one and two.

In our search for what actually caused this magnificently large effect, we have been unable to find more than a very modest tendency for rates or money supply to increase above trend in year three. From this historical lack of rapid monetary expansion, we make two guesses. First, we assume that stock markets are far more sensitive to financial stimulus than is the battleship GDP. The liquidity and other financial encouragement required to move the battleship a degree or two is apparently enough to have a very material effect on stocks. Stocks are simply much more sensitive to stimulus than the economy. The second guess is that the Fed's moral hazard is far more important than we realize, and is far more effective at moving markets than the modest financial adjustments. The implied promise to bail out speculators in years three and four if anything goes wrong, but to leave them hanging in years one and two (again, Greenspan excepted), is what drives this. Never underestimate the power of the Fed (or the Fed's willingness to deny its own influence when it suits). The best proof of this power has always been that the U.K. has shown a bigger year three jump on our Presidential Cycle than the U.S. has since 1932! Europe and even distant Japan also show a pronounced sympathy with the U.S. cycle.

Which brings us to this present case. Forget the traditional Presidential Cycle effect for the time being: Greenspan ruined it by overstimulating again in 2005 and 2006. <u>Just bear our two principles in mind</u>. If the stock market is many times more sensitive to financial stimulus in the short term than the economy is, then we could easily get a prodigious response to the greatest monetary and fiscal stimulus <u>by far</u> in U.S. history. Second, if you don't think there is a special, one-off, super colossal dose of moral hazard out there today, you are sadly uninformed. The moral hazard in play today is of a massively larger order than any we have ever seen. (But given how strangely selective the moral hazard or bailouts have been, it is enough to make those susceptible to conspiracy theories think in terms of a financial mafia led by You-Know-Who. Too much seems to depend on which friends you have.)

So by analogy to the normal Presidential Cycle effect, driven by stimulus and moral hazard, we are <u>likely</u> to have a remarkable stock rally, far in excess of anything justified by <u>either long-term or short-term</u> economic fundamentals. My guess is that the S&P 500 is quite likely to run for a while, way beyond fair value (880 on our revised data), to the 1000-1100 level or so before the end of the year. (For the record, I presented this case six weeks ago in Europe at 725 on the S&P, but was sadly distracted in my quarterly letter writing by a trip to Bhutan. Poor thing. I won't complain, though, since my "Reinvesting When Terrified" was posted on the day the market hit its low. You win some and you lose some.)

The market always anticipates an economic recovery and, sometimes, it must be admitted, there are several false moves ("suckers' rallies") before the recovery takes place. The current stimulus is so extensive globally that surely it will kick up the economies of at least some of the larger countries, including the U.S. and China, by late this year or early next year. (This seems about 80% probable to me, anyway.) Anticipating this, we should expect a stock market recovery – which normally leads economic recovery by six months, plus or minus two – sometime between two months ago and, say, August, which the astute reader will realize implies that this rally may already be it. This was part of the logic behind my March posting, "Reinvesting When Terrified": the uncertainties of the economy are so great that when the uncertainties of the stock market's anticipation are laid on top of them, you simply must have big ranges of outcomes and hedge your bets. Unless you have extreme luck or divine guidance, you will never catch the low. Alternatively, there is still time – just – for another freefall leg, but time is running out. Investor confidence is still fragile, and should we get a series of particularly shocking data points, which, in the unique position we find ourselves is quite possible (say, one out of three), then confidence could crack one more time and the market could go to a new low before the major anticipatory rally I'm describing. (This would make the current rally a short-term head fake.) In a rally to 1000 or so, the normal commercial bullish bias of the market will of course reassert itself, and everyone and his dog will be claiming it as the next major multi-year bull market. <u>But such an event</u> – <u>a true lasting bull market</u> – <u>is most unlikely</u>. A large rally here is far more likely to prove a last hurrah … a codicil on the great bullishness we have had since the early 90s or, even in some respects, since the early 80s. The rally, if it occurs, will set us up for a long, drawn-out disappointment not only in the economy, but also in the stock markets of the developed world.

Bulls vs. Bears

Resolute bears will point out (as we have) that the low of other major market breaks has been far lower than this one, and they would be correct. Compared to our revised fair value estimate of 880 for the S&P and its current recent devilish low of 666, the bottoms of other important comparative bear markets were much more impressive. On a similar basis, the low in 1921 – the post WWI depression – was about 300; the U.K. in 1974 was at the current S&P equivalent of about 300. In 1982 and 1974, the lows in the U.S. were equal to about 450. Of our six best comparable examples, only in Japan, three years into the market crash, was the market still above 880 equivalent. Admittedly, I don't yet know enough about 1921, but as for the others, I could offer good reasons why their lower levels might be understandable. One group (the U.K. and the U.S. in 1974 and the U.S. in 1982) had very high interest rates providing formidable short-term competition with stocks. (In the long term, the Fed Model logic is simply false, but in the short term – up to a year – it does work for behavioral reasons.) These markets also had very high inflation, which in the short to intermediate term has a compelling explanatory power for P/E ratios. To keep it simple, high inflation rates typically come with lower than average P/Es and vice versa. A third factor in all three cases was a crisis in oil supply and the accompanying much higher oil prices. So without these extra negative factors, the current market seems unlikely to overcorrect below fair value quite as badly as these prior bear markets have.

The other two setbacks that we consider most useful for comparison purposes – 1932 in the U.S. and Japan in 1990 – were quite different. Both came with low rates and deflationary pressures, and each had extremely serious economic setbacks, with the wheels falling off the economic machine, a condition that certainly does apply this time. On the other hand, in neither case did they receive massive international stimulus. In Japan, the authorities delivered reluctant piecemeal stimulus. Interestingly, they now strongly warn against other countries copying their strategy, which they now deem an expensive failure, both in terms of growth and time. In 1932 the stimulus in the U.S. was on-again/off-again, on a trial and error basis, and usually with some elements offsetting others so that the stimulus program is judged to have been a partial or even substantial failure. In comparison, the response to today's crises is the first time that there has been even an attempt at a coordinated global policy. In some cases, including that of the U.S., the degree of stimulus far exceeds any previous efforts. It has also been initiated quite quickly despite the criticisms. So the effect of the stimulus might well kick up in time to clip off the last stage of the bear market, and this is what I think will happen.

(In this respect, George Soros' reflexivity can come into play: a false dawn can alter the eventual outcome as it chews up time. For example, in June 1932 market players saw illusory light at the end of the tunnel. In two months, the market rose almost vertically, climbing 110%! For four more months it held the gain and then, confronted with continued unrelieved bad news, sank steadily for six months so that one year after the rally began it was up only 35%. But this is the key: by then – a year later – <u>there really was</u> light at the end of the tunnel and the market rose again, 130% in eight months. And this time it did not give it back. If investors had jumped into a time machine back in June of 1932 and had been able to see how bad things would look in 9 to 12 months, it seems nearly certain the market would have gone lower. In this way, one or two false hopes can protect against lows that a more realistic view would cause. And I think it is likely to do so this time. Although the economy is likely to kick up in the next 12 months (although far from a near certainty) and be anticipated by the stock market, I believe it is likely that the longer-term health of the economy will be exaggerated. In time – perhaps a year into the recovery – the economy will slow once again and stay disappointingly below the standards to which we have become accustomed over the last several decades.)

But for this current market setback, it seems reasonable that we would do less badly than all of these previous worst cases. We are not trying to be bullish and we have no reputation as bulls, but – for a second ignoring the current rally, which is so sharp as to bear out my warnings of March – three months ago we at GMO collectively considered that a range of 550-650 for the S&P was about right for the low this time.

Reinvesting When Not Quite Terrified

My March note suggested that it is psychologically very difficult to reinvest any cash once a crash in the market and the economy has really frightened you. The antidote is to have a simple battle plan of determining levels at which to reinvest and to stick to it absolutely. We could call that Plan A. It is ideal for dealing with a market meltdown, which should be any asset allocator's dream: to be able to make wonderfully cheap investments. Investors, though, also need a Plan B for investing if the market bounces back up but stays either cheap – that is to say below fair value, currently at 880 on the S&P in our view – or close enough that investors can still expect a decent return that is far in excess of cash. Our Plan B is to move our equity investments up to neutral weight steadily over 9 to 12 months. Since we were fortunate enough to trigger a second major investment at 740 on the S&P eight weeks ago (executed six weeks ago) we are now only 2% underweight. So for us, that requires investing only a fraction of one percent a month. But for those formerly in rigor mortis who were left behind and are now praying for a pull-back, this steady investing process is critical. You have missed some great investment opportunities, and now you have a psychological commitment to another major fall to add to any intellectual reasons you may have had. The market may well oblige by coming down sharply again in the near future, and I for one continue to believe there is still about a 1 in 3 chance it will do so. There is also perhaps a 1 in 5 chance that the market will come down much further in the future to a new low, but if it does not and it continues to rise, extended praying may not make you as much money as you would like.

Plan C gets to be a particularly speculative prospect, and that is what to do if the market, fueled by liquidity and hopes from the stimulus program and the usual morally hazardous promises from the Fed, soars way over fair value, say to the 1000 to 1100 range, which I begin to think is quite likely by the end of the year, whether or not there is another near-term fall. But to keep things simple, we will discuss what to do for Plan C if and when we get there.

Where GMO's Asset Allocation Stands in All This

In traditional asset allocation accounts, we hit an all-time low of 39% global equities against a theoretical minimum of 45% due to the speed of the decline last October. In October and November we invested a double tranche of 16%, and at 740, as already mentioned, we invested another 7.5%, leaving us then 4% underweight equities with two more 7% tranches lined up to go at lower prices. We would have preferred a lower low to trigger at least one more trade, and we would much prefer a new low going forward, especially one in the next two or three months. We prefer it so intensely that we hope it is not impacting our assessment of the future odds. Our second choice is for a new low, say, late next year after our longer-term head fake to over 1000 has been washed away by the longer-term economic and financial problems. Strangely, therefore, if a lot of the thinking in this letter is simply wrong and far too bullish, we will be in a good position to benefit by reinvesting the rest of our reserves at wonderfully cheap prices. It is seldom that one wants to be wrong! For sensible long-term investors, what can possibly be better than investing at great prices? Every percent of our 23% invested so far has been done at 7-year forecasted returns of over 10% real. We would just like to do some more. So should you.

Seven Lean Years

For the biblical record, 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, really is 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 incompetent leadership, 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 the massive write-down in perceived wealth that I described briefly last quarter. In the U.S., 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-$23 trillion of perceived wealth in the U.S. alone (although it is not a drop in real wealth, which is comprised of a stock of educated workers and modern plants, etc.) is still enough to deliver a life-changing shock for hundreds of millions of people. No longer as rich as we thought – under-saved, under-pensioned, 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-$12 trillion of debt is not, in my opinion, as important as the loss of the direct wealth effect on consumer behavior, but it is certainly more 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-$6 trillion of eventual debt write-offs in order to limp back to even a normal 50% 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 U.S. and the U.K., 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 don't 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 1.25x GDP to 3.1x 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% real GDP growth (perhaps 2.25%) down from the 3.5% 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 anytime 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.

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 haven't 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 where 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're used to the idea of a preferred V recovery and the dreaded L-shaped recovery that we associate with Japan. We're also familiar with a U-shaped recovery, and even a double-dip like 1980 and 1982, the W recovery. Well, what I'm 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 sub-normal 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 U.S., are more prodigal than others, and some, like the Germans, whose only imaginative stimulus – 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 <u>really</u> knows, if they are indeed a good idea, whether this current stimulus is enough. What most of us, 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 U.S.

It is ironic, by the way, that the U.S. would be less hurt than most given that Pied Piper Greenspan led all of us global rats off the cliff. And, yes, in this case the Maestro (well named) had an orchestra pit filled with Treasury and Fed officials (especially the NY 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 U.S. 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 U.S. 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 that will be the most immediately affected by the global downturn, unlike 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 where other countries such as Spain and Ireland have most decisions heavily constrained. More profoundly, the U.S. is in a position where necessary sacrifices will simply be less painful. We in the U.S. 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, on the other hand, will close teddy bear factories, and send its workers back to marginal or sub-marginal jobs in the countryside. That is the real world, and it delivers real pain. Even worse, in some ways 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 U.S. is pouring on more stimulus than anyone else.

So for the U.S. at least I have considerable confidence that the GDP will kick back into positive territory (+0.8) by late this year or early next year. 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%, that we still badly underestimate the downward momentum of short-term economic forces. We know we are perfectly capable of doing this since as recently as last November the "authorities" like the IMF estimated a +0.5% GDP for the developed world in 2009 and it is now at –4%! Not bad … a 1% reduction per month where a 0.1% 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 (if that is not an oxymoron these days) or on 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 U.S., 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 doesn't seem like a probable long-term answer. 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. So they may have done 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 1919-21 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 had full employment by 1935 when we – Americans and Brits – still had 15% 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 U.S.

Germany and Japan sprang back from the ashes after

World War II, but are we sure that this doesn't say more about remarkable economic resilience than it does about stimulus? On the stimulus side it certainly had the Marshall Plan, the very high point of enlightened and generous American foreign aid. On the other hand, surprisingly, the U.K. received more Marshall aid than the Germans, 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. <u>They are not such delicate flowers that we need to protect every foolish bank or be faced with wrack and ruin</u>. 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 approach of a more rapid liquidation. Month by month we are voting for desperate life support systems – at the tax payers' 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 never 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 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 don't have to deal with Congress.

Let me end this section by emphasizing once again the difference between real wealth and the real economy on one hand, and illusionary wealth and debt on the other. If we had let all the reckless bankers go out of business, we would not have blown up our houses or our factories, or carted off our machine tools to Russia, nor would we 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 learned for a generation or two, and assets would be in stronger, more efficient hands. <u>Debt is accounting, not reality</u>. 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.

Appendix

Just for Fun: One Strategist's List of (Hopefully Well-informed) Guesses

	Probabilities
Branch #1:	
The economies of the U.S. and some other leading countries kick up by late this year or early next year	**.80**
In which case:	
▪ Chances of a new low in the next three months	**.333** and rapidly declining
▪ Chances of a new low late next year or beyond as the painful longer-term truth dawns	**.167**
▪ Therefore, chances we have already seen the low	**.50**
Branch #2:	
The global economies prove to be so weak that they do not start to recover until late next year after a series of disappointments	**.20**
In which case:	
▪ Chances of a new low this year or next	**.80**
▪ Chances that somehow hope triumphs over disappointment	**.20**

Aggregate probabilities of a new low:

$$\left.\begin{array}{l}\text{Branch 1: } .50 \times .80 = .40 \\ \text{Branch 2: } .80 \times .20 = .16\end{array}\right\} = \mathbf{.56}$$

Branches 1 and 2:	
▪ Chances that this is the start of a lasting bull market destined to take us to new highs within three or four years (after inflation)	**.15!**
▪ Therefore, chances we face a long, drawn-out period to reach a new high (up to 20 years)	**.85**