

Much more pain to come, says fund manager

GMO's Grantham argues that expecting write-downs of \$1 trillion to \$2 trillion massively underestimates the problem

By Sam Mamudi, MarketWatch

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NEW YORK (MarketWatch) -- Investors hoping to see an economic improvement in 2009 may be in for a rude awakening if one fund manager is to be believed.

Jeremy Grantham, chairman at value shop GMO, said that he thinks there will be far more write-downs than is currently assumed, and that to reach the necessary debt levels the U.S. will suffer some serious pain.

“To be successful, we really need to halve the level of private debt as a fraction of the underlying asset values,” said Grantham. “This implies that by hook or by crook, somewhere between \$10 trillion and \$15 trillion of debt will have to disappear.”

Grantham calculated his figure by assuming write-downs of 50% in equities, 35% in housing, and 35% to 40% in commercial real estate, amounting to a loss of about \$20 trillion of perceived wealth from a peak of about \$50 trillion. He then estimates private debt -- corporate and individual -- to be about 50% of that peak level. In straitened times, he said, debt will be lent at closer to a 40% level, meaning that today's \$30 trillion in wealth will lead to ideal private debt levels of \$12 trillion.

Grantham believes that there are only three ways to bring private debt levels down in relation to reduced asset values: drastically write down debt, inflate the debt to reduce its real value or adopt the Japanese model of long-term saving.

“Each of the three realistic possibilities...would be extremely painful, each is loaded with uncertainties and even the quickest of them would take years,” said Grantham.

Grantham predicted a hybrid solution. “We will certainly take some painful debt liquidations; this crisis will almost certainly take far longer than normal to play out; and probably, before a new equilibrium is reached, we will see inflation rates that are well above normal.”

Grantham also defended Japan's actions since 1989, adding, “Somehow or other, Japan absorbed the greatest deleveraging in human history without incurring a severe depression.” But he pointed out that while Japanese corporations had worse credit positions than U.S. firms do today, Japanese individuals were in better shape compared to today's U.S. consumer.

“So our job is to nurture our average people in the street and somehow restore the quality of their balance sheets, just as Japan (admittedly taking 15 uncomfortable years) did for its corporations,” said Grantham.

Despite his feelings about the broader economy, Grantham sees value in the markets. He recommends investors “slowly and carefully” invest cash into stocks, with a preference for high-quality U.S. blue chips and emerging markets stocks.

“But be prepared for a decline to new lows this year or next, for that would be the most likely historical pattern, as markets love to overcorrect on the downside after major bubbles,” he warned. “Six hundred or below on the S&P 500 would be a more typical low than the 750 we reached for one day.”

Grantham added that risk “finally” seems attractively priced in fixed-income, and suggests going short long government bonds.

“As for commodities, who knows?” he said, before adding, “In currencies, we know even less.”

Past performance is not indicative of future results. The risk of loss exists in futures trading.