Financial author and behavioral analyst James Montier, as long-time WOWS readers know, has been a friend of this publication (or more precisely, your editor) since, well, at least one of us was a relative neophyte. One of the pre-eminent thinkers on modern finance, James these days hangs his hat (figuratively) at Boston’s Grantham, Mayo, Van Otterloo & Co., whose asset allocation team he joined in 2009, after a long, colorful and insightful stint as co-head of global strategy at Société Générale.

For the last year or so, James has been applying some of his formidable intellect to issues of monetary and fiscal policy. Why the former’s impact has so persistently been, well, limp. And why the latter just isn’t mentioned in polite company — even though, in James’ view, it could boost both a sagging economy and market.

Granted, its sheer contrariness alone makes fiscal policy nearly irresistible as a topic, to James. But listen in to our conversation and I suspect you, too, might give it another look.

Hi James. I hope you’re as comfortable as I am in the vanguard of the work-from-home economy.

James Montier: Oh yes, there are certain luxuries in life, aren’t there? And this is definitely one of them.

You’re even managing it while your children are young, which makes you even luckier — or smarter.

I know. It’s even better. I get to have breakfast with them and dinner with them and it just creates a certain nice work-life balance.

I’ll bet. So you’re still enjoying your gig with GMO?

Oh, very much so, yes. I think that I have found my spiritual home at GMO. It’s an interesting place with its own foibles but it’s certainly spiritually very closely aligned to the kinds of beliefs that I hold, therefore it’s a good home for me. But I do miss old Albert [Edwards, at Societe Generale, with whom James worked until 2010], of course.

I’m sure that his office has a pretty special dynamic, too.
Absolutely. Yes. Albert and I go back a long way and I do miss him — although he is my eldest daughter’s godfather, so I still get to see him occasionally.

So I would imagine. It has to be.

Albert is as bearish as ever, it seems. How about you?
As always. The one difference between he and I is I occasionally change my mind and I’m just not sure he will. Even in 2009, he was resistant. I turned bullish and he hadn’t, so that was fun. But I have to say, I think we’re aligned once again in the moment: it’s hard to get too excited about life here.

It isn’t easy when every day you wake up to discover that the market is figuring out a new way to pummel you. Exactly right. That’s exactly what it feels like. “Oh good, I’ll get out of bed,” and, “Oh no, I wish I hadn’t bothered.”

Right, even when the market bounces up a bit, the rallies feel all too evanescent —
Yes. My problem is that when I look at the world, I just don’t see any huge opportunities. When I look at the 7-year forecast — the engine of what we do here at GMO — I am just struck by the dearth of decent investment opportunities. There may be two things that are kind of interesting, but outside of that, most of the broad groups look still quite expensive. With that backdrop, it shouldn’t be a surprise that the markets are coming down.”

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Yet Jeremy’s latest quarterly commentary actually sounded a tad more optimistic than it had for a while —
Yes. But talk about coming from a very low base!

That’s true. My reaction was well, he relieved that the rest of the world finally has realized that valuations were as insane as he’d been saying for quite some time. It’s the joy of the contrarian when he’s no longer quite as contrarian as he used to be, right? It’s that, “Oh, thank God, I haven’t lost my mind” feeling. Because there is that in-between period you go through — when you’re just out there all lonely — and the rest of the world is doing its thing. You’re looking at the world and it doesn’t make any sense and you begin to question your own sanity.

Even if you understand behavioral economics —
Oh yes. The great issue with behavioral economics is it offers so many wonderful insights — but it does not protect you against being human. And there isn’t a way of de-programming yourself. There’s an expression in behavioral psychology which I kind of like, which is, “If you can’t de-bias then re-bias.”

Meaning?
I think too many people in the behavioral fields spend all of their time trying to de-bias rather than adopting a kind of nudge approach, if you will. In other words, if we know that people will make mistakes and errors in a predictable fashion, then we should try to turn that behavior to their own advantage.

In other words, try to guide their “mistakes” in useful directions?
Exactly. If you know you’re going to cling to random inputs — which is anchoring — rather than let it be market prices that you cling to, why not make it valuations? That seems like a lot more sensible of an anchor for behavior. So I think you
can nudge your behavior in better
directions. But as the late, great
Amos Tversky said, just because he
named all these behaviors didn’t mean
he didn’t suffer them. I think that is
the challenge for every one of us: We
are all human and therefore all sub-
ject to the pitfalls of behavior.

Indeed, I kept reading his long-
time partner Daniel
Kahneman’s book, hoping for a
miracle cure, but his message
is that’s not the way we’re
wired.
Right. “What you need to do is turn
around three times and then stand on
your head and you’ll be fine.” If only.
It would be lovely. But the only thing
you can do is try to build a process
that is behaviorally robust; that tries to
take on as many of those behavioral
biases as you can and defend your
approach to investing from them. But
it’s hard to do and it’s hard to stick to:
That’s the real crux of the thing. Ben
Graham pointed it out long ago. Don’t be led astray
by the follies of Wall Street and the fads and fan-
tasies of Wall Street. But it’s hard to do.

Quite evidently, or a lot more people would
have succeeded at it over the years.
It’s complicated by our favorite conceit, right, that
everybody is a long-term investor — right up until
that first point of poor performance — when sud-
ddenly they become short-term investors. So, “Oh
good, of course, I’m in for the long term. What the
hell happened last month?”

“Like, remember, it’s all about the long term and
understanding the valuations.”

“Oh Yes, that’s all great, but geez, you were down.
What happened?”

You know? Everybody just asks, “How dare you?”
“What are you doing there?” The consultants and
everybody else — everybody’s looking at quarterly
performance, sending their reports, all these kinds
of things. It’s all bias to make everybody so
obsessed about the short-term noise rather than the
long-term fundamentals.

Despite tons of evidence that it’s counter-
productive, people keep doing it.
Exactly.

I guess it’s at least job security for con-
sultants and analysts.
I suppose. I remember — possibly the only time
that Alan Greenspan and I have ever agreed about
anything — he once pointed out that changes in
human behavior were glacial, and I was like, “Yes,
exactly, and that’s why we’ll continue to do what we
do.” It does create a great sense of job security.

So what’s your take on what the markets
are trying to tell us here — beyond
January’s wake up call — or have you been
too deeply immersed in a new book project
to hazard a guess?
No, no — though I do have to write one more book
at some stage because I realized not all that long
ago that I have two daughters and only one of them
has a book dedicated to her. So the younger of the
two is going to require me to write another book at
some stage and dedicate it to her. But I have not
yet embarked on that particular project.

I have, instead, been thinking a lot about what’s
happening in the world we live in — it’s really
interesting to me that the valuations are still so
unappealing and yet people — up until the begin-
ning of this year — were willing to just ignore that.
It’s never obvious to me what the trigger is: The
proximate trigger always seems to change. But the
one inescapable element is that when you see
assets priced for perfection — and broadly speaking, that is what we were facing, certainly, at the end of last year — then it doesn’t take a lot to lead to quite radical reassessments of the backdrop. And I would argue that, if we’re not quite at perfection any more, we’re still pricing in quite good times in many respects. Now, maybe some people blame the Fed for triggering the retreat — but I have no idea — and I don’t actually think it matters.

**It doesn’t?**

One of the beautiful things about being a value guy is you don’t have to predict, you just have to react. It’s nice if you can predict — it gives you a sense of intellectual satisfaction — but you don’t actually have to do it in order to do your job. To do your job, you can sit there and say, “Okay, today I’m going to come in and look at different assets and see if they’re cheaper than they were yesterday. If they are, do I want to own some?” The luxury of the reactive approach is one of the benefits that valuation-based investing gives.

I suppose that’s true. “All” you have do is quite enough research to convince you what you think something is worth.

That’s right. Sir John Templeton used to talk a lot about how he did all of his research on days when there was nothing happening. That way, he knew that when he calculated intrinsic value, he could just keep that information ready and updated, so that when the markets moved and times were turbulent, he would be able to invest — because he’d already done the work and could say, “Well, look, this thing is now well below my estimate of intrinsic value.” It was an interesting pre-commitment strategy. I mentioned the need for a behaviorally robust process, and well, that’s a really good example of exactly that, in real time.

**Templeton was about as contrarian as they come. As you noted, the consensus seems to be blaming the Fed for a scant increase interest rates in December.**

Yes, like 25 basis points matters to anybody in the real world — unless you’re running leverage. If you were leveraged to the hilt, yes, I get it. Every basis point matters at extreme levels of leverage. But to the rest of us, that rate rise really should not have mattered, right?

So if that was the proximate trigger, I suspect some people will blame the Fed. But the reality is that the markets were damned expensive before they started raising rates — in part, probably because of the Fed’s behavior. I do not think the Fed is blameless in all this. But not quite in the way people are saying.

**How then?**

People are — or the market, at least — is behaving like a sort of sugar-addicted kid whose parents have suddenly said, “Well, we don’t think it’s a good idea that you gorge on sweets all day long” — despite previously having opened packets and packets of candy for them. That sort of seems to be how the Fed has behaved.

**Not to mention every other central bank. And they’re persisting to do it —**

Oh, absolutely. I mean, people are going to love the Japanese for going for negative rates. But what I don’t get about negative interest rates — to me, they are just a tax on a bank [and its customers, if they’re passed on], pure and simple. And the one thing I know about tax increases is that they are not generally held to be stimulatory. Yet somehow imposing a new tax on banks — and don’t get me wrong, I have no problem imposing taxes on banks, I suspect they deserve it — I don’t quite understand how that’s meant to generate a huge stimulatory boost to the economy. But I’m obviously just rather stupid.

Join the club. How is raising their costs going to stimulate them to lend more, when they didn’t want to lend in the first place?

Yes, good question. It wasn’t like they were falling over themselves to lend here. It’s like they’re sitting on huge amounts of excess reserves and we’re now going to tax those excess reserves. Oh, dear, what’s going to happen? Well, they’ll pass that tax increase on to their customers. So you’ll just end up with the generalized Switzerland problem. Mortgage rates have actually risen there, since they’ve had negative interest rates, because the banks have just passed that additional cost on in mortgage rates, because they won’t charge a negative deposit rate to their customers.

And they’ve got to make it up somewhere. Exactly. They’re like, “Well, we can’t charge negative deposit rates, so we’ll put it onto the mortgage rates because they’re a pretty captive market and can’t do a lot about it.” How any of that is meant to be wonderfully stimulatory is completely beyond me. But then again, I’m not a central banker, so I’m not privy to such brain power. Or the lack thereof, perhaps. I don’t know.

I’d thank God, daily that I’m not an economist, if I were you!
Yes. I saw a headline the other day saying, “Yellen now saying Fed behavior now dependent on whether the market turmoil continued.” I thought, “Oh good, she’s now firmly in the Bernanke/Greenspan group — panicking every time the market goes down a bit.”

It’s called being “data-dependent.”
As if that’s the role of the central bank — not to upset anyone. It is bemusing the way that central banks see their role as not wanting to upset anybody.

It’s always been thus — or at least, for a long time.
William McChesney Martin was a little bit different when he was Fed Chairman [1951-1970]. But it has been a long time since his tenure at the Fed, and certainly in the Greenspan-onward era, central banks have become scared of upsetting anybody — particularly the market. That’s why, in large part, I think they’re at least complicit in the asset pricing structure that we’ve ended up with.

The over-valuation? Why?
Because they’ve essentially encouraged unbridled risk-taking in a foolhardy attempt to stimulate the economy through a lousy, non-existent wealth effect.

Why don’t you tell me what you really feel? Non-existent?
It’s just staggering that the mental models the central bankers operate with are so at odds with simple empirical evidence. It’s just — I know economists are reasonably ungrounded in reality, but really, this seems to me to be one of the dangers of letting them run central banks. This kind of, “Oh, we don’t care about the real world, our model says there should be a wealth effect,” does seem slightly dubious to me. Yet it’s the modus operandi that they’ve been pursuing. And then they wonder why assets are all expensive.

Believing they can model — and control — the real world is a sort of ultimate hubris. Especially when they ignore the shadow economy, shadow finance —
Absolutely. They don’t even have control over the bits where they’re the regulator, which is really terrifying. It’s the ultimate example of regulatory capture — the way that the financiers have managed to take over central banking. It’s quite staggering.

Then they wonder that they don’t understand the shadow system! Well, it’s not that hard. Just think of lots of people doing daft things and you’ve pretty much described any shadow financial system.

Doing daft things?
That’s a saying my grandmother would just have tossed out in desperation.

Maybe we need to nominate your granny to one of the central banks.
Oh good Lord, no. Talk about not being of sound mind and body. She’s definitely not up to running a central bank. But at 95 years of age, I think that’s acceptable: she’s earned the right to rest now.

I would hope. But she sounds more sensible than a lot of central bankers.
That is one of the huge advantages that getting older brings — that wealth of experience. I realized that not so long ago when I was giving a speech to a group of investment consultants and I happened to say “TMT” — meaning, technology, media and telecoms, as I — and probably you — recall very well. But as I looked around the room, I realized that none of them had the foggiest idea what I was talking about. They were all still in short trousers while that boom and bust was unfolding. I was just like, “Good God, it really wasn’t that long ago.” It still feels like only yesterday to me. But somehow they — they’ve not really forgotten — because they weren’t there — but they’ve never learned about it, either. That sort of youthfulness really stands out. It’s amazing how little age and experience counts for — and yet how useful it actually is.

You’ll get no argument from me on that score. I saw a statistic recently, I can’t quote it accurately so I won’t, but the upshot was that the majority of people working as portfolio managers today were still in high school — or even younger — when the tech bubble imploded.
That’s right, yes. There’s a similar stat that somebody used, showing that the majority of bond traders have never seen an interest rate rise. Isn’t that just astonishing? Or maybe it’s just depressing. It’s a realization along the lines of thinking that you’re still one of the youngest in the office and then suddenly looking around and seeing that you’re the second-oldest person there. “When did I become the grumpy old fart in the corner?”

Sad, but true. I may still feel like I’m 25, but anyone who meets me knows differently —
Right. But that’s actually to your personal advantage. As a society, we really are doomed to keep repeating the same mistakes, because we don’t learn. People in general are very bad at learning from vicarious experience. You can go and read
that wonderful book, “Manias, Panics and Crashes” by Charles Kindleberger — or Eddie Chancellor’s “Devil Take the Hindmost” — either of those are wonderful stories of the nature and types of bubbles that we see. Yet people don’t read them and internalize their lessons — or at least they only read them in the wake of a crash. And there’s Hyman Minsky’s work, too. There’s an enormous amount of stuff you can draw on, but people are just blissfully ignorant of it because it isn’t something they experienced their particular life period.

It’s depressing. History is what happened then, to them. And has nothing to do with me.

Yes. But if you do take the time to study market history, it’s pretty scary — You come away thinking the world is far from riskless. That it doesn’t take a lot for things to go wrong. What’s more, there are patterns that are reasonably predictable in the general scheme of things that tend to end badly. Yet people don’t seem to want to recognize that. Strangely enough, they’d rather delude themselves that all is fine and dandy in the garden — right up until someday they wake up and say, “Oh, no, we don’t understand what’s going on in China,” or, “Oh, it looks like there’s a lot of capital flight.” “Mmmm, the Fed has raised rates, oh dear,” and suddenly there’s an enormous re-pricing of assets.

Meanwhile, the price of oil is dropping below $30 a barrel — spooking investors even though most of the world benefits from cheaper oil.

Yes, surely lower oil prices mean generally lower costs for most people. It’s bad news if you’re an oil producer, I get that, but if you are a consumer — which is probably most people — it’s not such a tragedy. Yes, it’s very peculiar, the obsession with lower oil prices, and I have no idea how sustainable it is. Somebody the other day asked me how I would go about valuing oil stocks, and were they cheap or not? Their hypothesis was that they should use the futures curve to do that analysis.

You sound skeptical.

I am, very. I said, “No, no, no. I can’t accept the futures curve because I don’t believe there’s any information in the futures curve.” When oil was $80 a barrel, the futures curve was still saying it was going to $100 a barrel. And now that it’s at $30 a barrel, the curve implies that in five years, it’s going to be $60. I mean, clearly it has no idea, no predictive power over oil prices at all.

So cheap oil hasn’t driven the energy stocks down to tempting prices?

The only way you could really make a solid case for oil companies is to say, “Are they profitable based on today’s oil price?” Then build me a case that states your price is reasonable.

But when you hear people talking about oil prices, they often start talking about marginal costs. The problem there is that the marginal cost of production moves with the oil price. It isn’t an anchor for the oil price. So, at $120 a barrel, guess what, tar sands are suddenly profitable and so the marginal cost of extraction moves up to $80 or $90 a barrel because, well, they’re getting $120 and that’s $30 or $40 of nice profit for them. But suddenly down at $30 a barrel, nobody in their right mind is going to be playing with tar sands.

So the idea that marginal costs somehow provide an underpinning to price I think is dangerous in a lot of cases. I don’t claim to know anything about the oil price, but I do know that — it’s always interesting that when any commodity goes up, the story is always about restricted supply and then when it comes down, it’s about a lack of demand.

You’ve noticed that, have you?

You know it. And it’s just incredible how often you see that dynamic play out. “Oh, guess what? It’s all about supply” — on the way up. Then suddenly, “Oh, my goodness, China is selling and it’s not going to need so much,” and it’s all about demand on the way back down. So I’m like, “It wasn’t that hard to see.”

The trouble with a lot of those supply and demand stories is just that. They’re stories, right? They’re true at every price. I don’t know what percentage actually reflects their reality, but you can make the same arguments at 60 bucks, 80 bucks and 120 bucks. It’s far from obvious that we can actually price that stuff particularly well.

The price history of almost any commodity tells you that: They’re volatile, they fluctuate, they go from one extreme to the other. Absolutely. It is the nature of commodities, right? They’re unstable, I mean just look at the microeconomics — at their cobweb models with supply being determined by prices from a year ago or a couple of years ago, depending on the lead time. You know there’s going to be instability in the pricing structure of those kinds of assets. Therefore you’ve got to be very, very careful when you construct a cash flow based around that because it’s going to be so sensitive to what you assume.
That’s the last thing most investors want to hear — they much prefer a nice, clean formula — however dubious.
Yes, I think that’s true of lots of people in lots of places. Philosophically, it’s interesting that there are people who think that if they just work hard enough, the truth is out there — and they will uncover it. But then there are people who, like me, think there is just so much fundamental uncertainty around so much stuff that you really can’t be sure about very much at all.

I used to joke when I gave speeches that I’m not even sure that I exist. For all I know, I could be a brain in a jar. Now admittedly, if this is how I choose to spend my time, my brain needs to get a life. But it is possible that I don’t exist, right? This could all just be a figment of my rather over-active imagination.

You missed a calling in Sci-Fi —
But you have to admit it is strange how people so much want certainty in a world in which there’s so little of it. Though it’s not all that surprising, I suspect. If one thinks about a lot of human activities, a quest for certainty and the desire for certainty are behind an awful lot of it — religion — to just give you one really good example — albeit a reasonably controversial one.

Have you been paying attention to the Republican primaries in this country? Go on, if you dare!
I was just going to point out that their creation myths and so forth are terribly good at making people feel certain about things in the face of what is overwhelming uncertainty.

Not to mention bolstering their inclination to avoid change if they can —
Yes, absolutely. My wife will tell you, though, that I am amazingly change-resistant. She’s worked out that the only way to change anything in the house is to change it when I’m not there. Let me come home, let me moan about it for two weeks and then, after that, I’ll finally agree that actually it was a really good idea — and claim it was probably my idea in the first place.

Men! At any rate, the world is looking even more uncertain than usual here. Is there anything for perennially optimistic investors to grab hold of?
There are a couple of areas — and I literally mean “a couple” of areas, sadly. We’re down to only two things that are piquing our interest at the moment. One is emerging markets, in particular, value stocks within emerging markets.

It’s interesting, I saw a chart in one of the Bank of America/Merrill Lynch surveys recently, showing the percentage of asset allocators who like and loathe emerging markets — and the net balance has never been more negative. Everybody just loathes emerging markets, which naturally — as a contrarian — gets me all excited and piques my interest. I thought, “This is my bread and butter. This is the stuff I live for.”

But when you start looking at it, you’re like, “Actually, there is a lot of hair on this. And it is quite scary.”

Obviously, because something is frightening the herd away from it.
But I think as long as you acknowledge that, there is certainly some opportunity in some of the emerging markets. You just have to size your positions correctly and also acknowledge that the scale of the opportunities is simply not enormous. It isn’t a once-in-a-lifetime opportunity.

How would you characterize it, then?
When we look at our forecasts, emerging value — now it ought to be trading at a little bit more than fair value — but let’s say at the end of last year, it was at least around fair value on our measures. Which is to say, it was likely to be generating, on a prospective basis, around about 8% per annum in real terms for the next seven years.

So it wasn’t pound-the-table cheap, but compared to the alternatives, it wasn’t bad?
Precisely. In a normal world, you would look at that and go, “Okay, it’s fair. And so I should probably own some.” But it isn’t mortgage-the-house cheap, nor is it “re-mortgage the house, and sell the granny and put the kids’ college funds in it — this is a humdinger of an opportunity.” It’s just simply, “fair.”

The tragedy is that the rest of the opportunities are so depressingly bad that it looks like one of those home-run opportunities. So you have to keep reminding yourself that fair is just that. It’s okay. It’s not great, but it’s not a disaster. So you’ll probably want to own some.

The question is which?
It’s really comes down more to sizing your exposure — and it’s a very mixed bag. I was looking at emerging value recently and what’s interesting about it is that there isn’t any particularly consistent theme that makes them cheap stocks — which is both good and bad.
Sounds like a lot of idiosyncratic research is required. So what’s good and bad about it?
I think there is both merit and demerit to the fact that no obvious theme is making them cheap. The merit is exactly that — you can build a nice diversified basket of stocks that nobody else likes. And that is kind of a juicy opportunity to a contrarian.

On the other hand, sometimes it’s easier to make the argument that the world has just gone mad when you can discern a theme. When you were standing on the other side of the TMT bubble, saying, “The rest of the world is just insane,” it was an easier (even if widely reviled) argument to make. Here, it’s harder to do that in emerging value stocks. All you can say is, “Okay this disparate group of stocks — Korean chaebols, Russian energy companies, even some Chinese stocks — actually are looking fairly interesting. As long as you’re very careful — and you don’t buy banks — there are some interesting opportunities in emerging markets in some places.

China, really?
Well, what strikes me is that there isn’t a consistent value theme really discernible in the emerging markets, unless it’s tied to China. In fact, China is probably the one thing that unifies almost any emerging market exposure these days. China has been such an incredibly dominant force in the growth that emerging markets have recorded over the last 15 years or so. So when we’ve looked at values, pretty much across all the emerging markets — possibly with the exceptions of Russia and India (Russia being cheap here, India not being particularly cheap here) — almost everything else interesting is China-related to a large extent.

Yet China’s slowing economy is the source of a lot of market angst — fears that the growth engine will implode.
The China situation is interesting. Edward Chancellor, my former GMO colleague, has obviously warned significantly of a bubble in China, and one of my other colleagues and I did some work over the course of last year looking at China from a different perspective, and then confirming Edward’s conclusion. The different framing we used led us to exactly the same conclusion: There was a huge investment bubble going on in China that was really showing up in housing.

There is a massive structural imbalance in the Chinese economy. People talk a lot about that, usually saying things like, “Oh, well, it’s easy to rebalance. You just need to get more consumption.”

But I am like, “I’m really not sure about that. I get that you need to rebalance, I’m just not entirely sure it’s easy.” As far as I can remember, there isn’t any historical example of a country rebalancing painless-ly. South Korea didn’t manage it, Japan didn’t manage it, the U.S. didn’t manage it, the U.K. didn’t manage it. None of us. And none of us were the size of China.

So you see what’s going on in China as more than growing pains, or cyclical readjustments?
It’s quite intriguing that this time around, people are yet again saying, “Oh, don’t worry. China will be able to rebalance painlessly.” I’m really not quite so convinced.

Why not? Just because of its size?
I think one of the aspects to China that people haven’t really considered enough is the inequality issue. China has rampant inequality, which is not a surprise to anybody —

More billionaires than the U.S., reportedly —
But in order to rebalance, what it really needs is reasonably broad-based wage growth, and that is not necessarily in the interest of those who have benefitted from the policies that have led to that inequality.

No kidding —
It’s hard to think that a lot of the people who have benefitted from and done well under China’s policies of the last 15 years or so would necessarily turn around and say, “Oh, yes, we absolutely think you need to get rural wage growth up and a broad swath of the economy to actually rebalance.” So there are some significant hurdles to China rebalancing its economy.

But now, as ever, that doesn’t mean you don’t want to own some Chinese stocks. It comes down to what are they pricing in?

The Chinese market is certainly a lot lower than it was — not just early last summer, but even at the end of last year. Is it starting to price in enough hurdles?
Well, I did some analysis of emerging value stocks there; looked at what their growth expectations were — and at what growth was required at least to make today’s prices reasonable. They had to grow at about one percent per annum for the next seven years, in terms of earnings, in order to make today’s valuations of those stocks fair.
That sounds rather doable.
Right, that doesn’t sound like a lot. One percent is pretty low. At least that was my initial reaction, too. But then I decided that I’d better check and see what emerging value stocks had actually delivered, just to make sure. And it turns out that they delivered about 1.7% per annum over the last 15 years.

And 1.0% versus 1.7% is again pretty consistent with what the standard GMO forecast is showing. So these things are only fair, right? They’re not cheap — or not meaningfully cheap. They’re cheap relative to everything else, including the rest of the EM, but they’re not cheap in any hugely, massively, absolute sense, and I think one has to reflect that in the allocation.

Okay, you also mentioned finding something other than the emerging market value sector a mite intriguing here?
The other thing that we’ve been looking at more recently is high yield — with the explosions and ructions in high yield, it has begun to get interesting to us. One of the beautiful aspects of being a long-term investor is the fact that you can provide liquidity when liquidity is absent. And if ever there were a market where liquidity is absent, it appears to the high yield market — and in corporate bonds in general — but in high-yields in particular.

The spreads have definitely widened — as it has finally dawned on investors why companies were willing to offer high coupons on their paper —
It’s stunning how appalling liquidity is in that particular market. So we’re cautiously starting to build some positions in high yields, because we think that — absent a Great Depression-like outcome — you will probably get a decent-ish real return on corporate bonds — from high yields, at least — from these kinds of levels. And that should hold, even if we see a pretty nasty default cycle, such as that seen in the wake of the TMT bubble bursting — a real wipeout event would obviously require something like the Great Depression.

Well, there’s no shortage of scare stories suggesting that we’re again threatening to skate on the edge of the abyss.
But I think the 2008 crisis at least hinted, to some extent, that the risk of a Great Depression kind of outcome has at least been mitigated by things like automatic stabilizers — the way fiscal policy actually works — and that probably is a risk worth underwriting. Again, at a reasonably small size, and by building the position slowly over time — because as we know there is nothing that stops cheap assets from getting cheaper still.

I’m assuming you’re being just as selective in high yields as you are in emerging market stocks?
Absolutely, yes. One wouldn’t want to just dash out and buy the broad index. There are far more sensible ways of doing that. Securities selection — and asset allocation — always really have to work hand in hand to build a portfolio. One without the other is not very much use to anybody.

True enough. But you just uttered that awful phrase, “fiscal policy.” You even went so far as to write a report about it recently — and so far have lived to tell the tale. But why bring it up?
It’s just depressing. It’s like fiscal policy has become the dirty word in policy circles. Nobody can mention fiscal policy, or if they do — a Bernie Sanders or a Jeremy Corbyn — they suddenly get labeled as a socialists, or something equally evil. All fiscal policy is, after all, is using government spending and taxes to try to spur economic growth.

Fiscal policy has become the neglected step-sister of monetary policy, even though using monetary policy alone hasn’t exactly been working to spur growth.
To me, it goes back to some of the stuff we were talking about earlier — and to the obsession with monetary policy that everybody seems to have. Last year, I wrote a couple of notes called “The Idolatry of Interest Rates, Part 1 and Part 2” —

Which are really great reads, and still posted on GMO’s website to the discomfort of monetarists everywhere —
Well, what I was trying to get at in those pieces — one was about the finance aspects of interest rates and the other was about the economic aspects of interest rates — was that it just isn’t clear to me — despite the way people fixate on monetary policy these days — that interest rates have a particularly clear transmission mechanism into the real economy — beyond trying to encourage people to take on debt — which does not seem like the world’s most sustainable policy.

Gee, you think? Borrowing isn’t a sustainable route to happiness?
Anyway, as I was writing that stuff, I really began to think about fiscal policy and became awfully
bemused that today there’s this real kind of abject hatred of the use of fiscal policy. I really, for the life of me, cannot understand, why, from an economic point of view, it is so often reviled. But it generally seems to come down to an issue of politics: It’s ideological.

So after pretty much shredding the workings of monetary policy in your “Idolatry” pieces, you couldn’t resist taking on that other tenet of the sound money crowd in your latest GMO paper?

All I did was lay out—in that recent piece on fiscal policy (“Market Macro Myths: Debts, Deficits, and Delusions”)—many of the myths or fiscal fallacies that get thrown up when you mention fiscal policy. You can easily demonstrate them to be wrong.

And so you did.

Now, of course, demonstrating something to be logically flawed or wrong is not proof against it being adopted by anybody. But it is an interesting exercise to demonstrate that so many very smart people seem to actually hold beliefs about fiscal policy that I find quite logically flawed and just, strange.

Sure, you’re veering away from the world of logic, into religion—ideology.

Precisely. And arguing about that is quite fun, if you’re having a bottle of wine among friends, and not much fun, if you’re trying to actually influence the way the world works.

It’s actually surprising to me that people allow their ideology to go unchecked. I have always believed—and have tried to follow this belief, though not always successfully—that one should mark one’s beliefs to markets.

You don’t mean, by that, going with crowd, I’m pretty sure. So what do you mean?

I mean one should just occasionally look at what one holds to be self-evident and true—and actually see if there’s any empirical support for those beliefs—or logical support. If there isn’t, I think you’re on a fairly sticky wicket.

The Dalai Lama, I have always admired for this reason: He once said that if science can show that something that Buddhism says is incorrect, then Buddhism must change. I’ve always admired that extreme open-mindedness. Sadly, it does not seem that it is terribly prevalent.

That’s a fair observation.

I think it’s probably an understatement, but it will do!

You long ago told me that people tend to stick with their comfortable behavioral biases; they don’t suddenly get rational when the topic is economics.

Right, people tend to stick to their preconceived ideas—and it’s very hard to get people to shift from those preconceived ideas.

It doesn’t matter whether what you know isn’t so, you believe it is, so it is so—Exactly. Perception is reality. That’s why economics, like politics, isn’t science. Both are studies of human behavior; they’re on the social side of the curricula, not the hard-science side. When you study them, you are not dealing with things that are governed by physical laws and external forces. Your are dealing with things that governed entirely by people—and sadly they behave oddly under lots of different circumstances.

Now you’ve written that rejecting the use of fiscal policy is one of those odd behaviors. Have you converted any monetarists, that you know of?

I don’t think so. I think by and large the paper has been an abject failure. I did have an e-mail from one of the people that I listed as a staunch believer in sound money, which was vaguely amusing.

Because?

In a number of places, he actually said I was right. But then he decided in conclusion I was wrong—which was, in behavioral terms, interesting.

And when I presented my thoughts on fiscal policy as a speech at our client conference at the end of last year, I did get a lot of very nice feedback. But I also got some people saying it was the most frustrating
part of the day because they couldn’t understand it or because — it just seemed so wrong. So that was kind of fun.

But, as I said when I gave the speech, “If I don’t upset at least 25% of my audience, I really don’t think I have done a good job. My job is to provoke and to challenge.”

Still, I fear that the people who agree with what I wrote are the people who always agree. And the people who disagree will just dismiss me as a crank.

Surely, that can’t surprise you, given all the time you’ve devoted to studying human behavior —

No. So I guess that writing that note was proof that I’m an undying optimist at heart, which will surprise everybody who knows me — professionally, at least. There is a really good clinical study that says that there’s only one group of people who actually see the world the way it really is — and they are the clinically depressed. Which is, of course, why they are clinically depressed. The rest of us are happy and deluded.

I long ago decided that the right combination was to be clinical depressed at work and then happy and deluded when I came home in the evening. So far so good: it seems to be working.

What a frightfully rational approach to life!

Would you expect anything less from me?

Never! So let’s fearlessly dive into your cranky ideas about fiscal policy — like balanced budgets aren’t the end all and be all?

Well, in contrast to today’s dominant economic theology, which is “sound finance” — the belief that governments should seek to balance their budgets, I adhere to a school that takes a very different view of the role of government budget deficits, known as functional finance. It judges fiscal measures by how they work or function in the economy, instead of against any established doctrine about what is — or isn’t — sound policy.

So you devoted your latest paper to undermining beliefs that conventional monetarists hold to be self-evident.

Well, my view of the role of debt and deficits is definitely not mainstream, so I wanted to show that I’m not mad as a hatter by exposing a number of foundational “sound money” beliefs as the myths they are.

For instance, the belief that governments, just like households, can get into trouble by taking on too much debt?

Absolutely. That is, alas, one of the foundational misunderstandings of all believers in sound finance. Likely because it is so intuitive. Any economist can illustrate, using the sort of simple barter system example they love, that the over-accumulation of private sector debt creates problems. I utterly agree.

Where the sound finance theorists go wrong, however, is in indiscriminately extrapolating that finding into the realms of governments and deficits.

What do you mean?

First, we have to distinguish what sort of government we’re talking about. Is it monetarily sovereign — does it issue its own currency, have a floating exchange rate, issue debt in that currency? If so, like the U.S., the U.K., and Japan, it can in effect borrow from itself. Those that aren’t, like the Eurozone, aren’t quite as lucky.

But nations that do enjoy monetary sovereign status have the ability to create money and spend it — essentially out of thin air. Which means they can’t ever be forced into insolvency. If this sounds a little like Rumpelstiltskin spinning straw into gold — that is because it is. That is a benefit potentially available to monetarily sovereign nations.

But even the debt of a government that isn’t monetarily sovereign is still different from private debt.

How, other than the number of zeros usually attached?

The fact is that public debt, in macroeconomic accounting terms, is simply the inevitable counterpart of private saving. My paper runs through the economic formula that show that if the private sector wants to save more than it invests, then there must be a government debt and or a current account surplus. Indeed, if there were such a thing a closed economy (without foreign trade, etc.) then the government debt would exactly match any private sector savings surplus.

Spare me the math, please. I’ll accept that it’s an accounting identity.

Great, because that means it has to be true — and unsurprisingly, when we look at the data, that’s what we generally find. The private sector generally runs a surplus which is counterbalanced by the government’s fiscal deficits.

You used a chart [exhibit 1] showing that trouble arises when that isn’t the case.

Yes, you can see twice in the sample shown that
when the private sector has run significant deficits, the experience hasn’t ended well. The first was the TMT bubble, when start-up firms drove the private sector into deficit, and the second was the housing bubble, when households pushed the private sector into deficit. Both are examples of the dangers of debt accumulation by the private sector. However, the government sector has been accumulating debt over this whole period — with seeming impunity — contrary to the warnings of the sound finance crowd.

The reality is that once one truly understands that government deficits are just the other side of the coin to private sector savings, concepts like “the national debt” take on a different hue.

The numbers are still mind-numbingly huge. Yes, the U.S. national debt stood at $18.8 trillion, when last I checked. Who can ever imagine paying that back? But of course, it won’t be repaid. In fact, given the counterpart nature of the government deficit, the national debt could easily be relabeled “national savings.” And perhaps it should! That doesn’t sound nearly as scary.

You’re quite a spin-meisters. Still, regardless of label, isn’t printing money to finance government deficits inflationary? That’s another persistent sound money myth. Printing money doesn’t cause inflation, but the belief that it does seems to arise from the quantity theory of money.

You don’t believe in it, either? Well, the quantity theory of money simply says that all of the money in the economy, multiplied by the number of times it goes around, must be equal to the prices paid, times the volume of goods and services purchased. (MV = PY, for the algebraically inclined.) In other words, it says that expenditure equals income, which is nothing more than another identity.

Where does inflation come in? To turn that into a theory of inflation, you have to make some pretty unrealistic assumptions, like both velocity and output being fixed. If you do, the only free variables are money and prices — ergo, changes in money must cause changes in prices, according to conventional thinking.

You’re not buying it? Strangely enough, when you think about it, the prices paid times the volume of goods and services purchased side of the equation can also be thought of as the sum of consumption plus investment plus government spending plus the net of exports minus imports — in other words, as the definition of GDP. And what that says to me is that any of the components of GDP could cause inflation, not just government spending — if it raises output above the full-employment level.

So official deficits could cause inflation? Yes, it is certainly possible that running government deficits can create inflation — (if they push the economy beyond its limits), but so could any other element of GDP — consumption or investment). So there simply is nothing unique about government deficits from an inflationary point of view. And that’s another advantage, I think, of taking a functional approach to thinking about government deficits. It involves explicitly asking whether a particular deficit or surplus position helps us achieve our macroeconomic objectives — thinking about the consequences of our actions.

How does your theory stack up against the historical data? I used two examples of the history of deficits and inflation in exhibit 2 [nearby] in the paper, the U.S. and Japan. In neither case is there any evidence of a strong link between fiscal deficits and inflation. The only evidence of even a mild linkage I could find was...
in the U.S., around WWII, when it ran major deficits to support the war and inflation resulted from the shutdown in trade and then, ultimately, from the unleashing of pent-up demand when peace was re-established. But this tells us more about the impact of war (which is well-documented, anyway) than anything meaningful about the relationship between deficits and inflation.

Okay, but surely big fiscal deficits lead to high interest rates — squeezing the private sector?
That’s also mainstream thinking, but it’s also a myth. The model used to back such claims in conventional textbooks is known as the loanable funds theory, and I even provided an illustration of it, exhibit 3, in my paper. According to this model, the natural rate of interest is determined by the interaction of the supply and demand for funds, and can be neatly diagrammed.

Which is probably reason enough for you to dismiss it —
Possibly, but there are so many others. The model, in brief, holds that national savings are comprised of the sum of private and public saving. So an increasing budget deficit reduces overall savings, pushing the supply of loanable funds down — but it somehow doesn’t influence demand for funds, thus resulting in rising interest rates.

As I’ve written many times, I just don’t find this model a useful way to look at the world. It is riddled with flaws that make it unusable, to my mind. I’ll spare you from listing all of them here — suffice it to say that my biggest issue with the loanable funds model is that it presumes that savings must precede investment.

But you do have to save capital before investing it.
Do you? Not today. That thinking is reasonable if you’re an individual in a society based on one commodity. But modern monetary-based economies no longer require savings to precede investment. If you want to invest, you can go to the bank and ask for a loan. The bank decides whether to lend, but it isn’t constrained by deposits or reserves. It makes loans first, then worries about how to ensure regulatory compliance, afterwards.

So you’re saying budget deficits don’t push up interest rates?
Actually, they do the opposite. And to show that in my paper, I provided an illustration taken from one of the few living economists I deeply respect, Bill Mitchell, the “progressive” Australian economics professor and prominent proponent of what’s known as Modern Monetary Theory.

Clearly, his model is more complex —
And the real world is a lot messier than the loanable funds model! Essentially, when a government runs a fiscal deficit, it creates more money than it receives (by definition). Then that money is used to buy goods and services, requiring the central bank to transfer money from the government account to the reserve accounts of whatever private banks the sellers of those goods and services happen to use. Which creates excess reserves at those banks, and — since no bank willingly sits on excess reserves — that additional supply of money gets lent out in the interbank market. Which has the effect — pay attention here...
Looking at them, neither budget deficits nor high debt levels seem to be associated with higher interest rates at all — which probably shouldn’t be all that surprising, given that weak economic growth is likely to cause both high deficits and low rates!

Okay, but what of the worry that the levels of debt we’re piling up are simply unsustainable?
First of all, just what does “sustainable” mean? If you take Ben Bernanke’s fairly standard definition: “a sustainable path ensures that debt relative to national income is at least stable,” at face value, it basically comes down to whether the real interest rate is higher or lower than the real growth rate. If so, one can model the dynamics of debt to GDP over time to see if today’s values for those variables lead to a stable path. Exhibit 6 plugs in those values for the U.S. and Japan and reveals that both positions are “sustainable.” But it also includes a picture of Greece, circa 2009, just to illustrate what “unsustainable” looks like. But there are at least a couple of big problems with this kind of analysis.

Do tell —
The biggest is that it assumes nothing ever changes. Is it reasonable to assume (as the Japanese chart does) that real rates and real growth there will stay the same for the next 750 years? Beyond the obvious (when you think about them) pitfalls of extrapolation, there’s another problem with the issue of sustainability as defined by Mr. Bernanke. Central banks set interest rates for the nations we are talking about (monetary sovereigns) so they should pretty much be able to ensure that real rates are below real growth. The obvious issue for Greece, portrayed in its chart, is that it is neither monetarily nor fiscally sovereign.

I suppose you have an answer too, to that favorite line of politicians who love to thunder against wanton deficit spending — that it imposes an unfair burden on our children and grandchildren?
I just don’t see debt as an intergenerational issue.

That should be comforting to your progeny!
Look, if there’s one prediction I’m fairly confident in making, it is that at some point in the future, everyone alive today will be dead. At that point, the bonds that make up the government’s debt will be held entirely by our children and grandchildren. That debt will, of course, be an asset for those who own those bonds (just as it is today), as well as a governmental liability. Now, there may be some distributional issues if all of those bonds are owned by, say, the grandchildren of Warren Buffett and Bill Gates. But these will be intragenerational issues, not intergener-
away from policy makers’ obsession with monetary policy might also help generate a return to more normal world, from a valuation perspective.

What makes you say that?

Looking at the elevated valuation [exhibit 8] that the U.S. market has experienced since Greenspan took the helm of the Fed in 1987 tells me that while obsessing on monetary policy didn’t have much impact on the real economy (except via the debt channel, encouraging consumers to leverage up), it did seem to what investors’ risk appetites.

Well, to come full circle, they’ve been forcibly cooled this year –

And as a contrarian, obviously I find the markets much more interesting when they are clinically depressed. Value investors, I’ve been heard to say, are the financial equivalent of masochists: we actually get excited when things go wrong and the markets go down. Right now, though, we’re in that terrible in-between period, when markets are not yet attractive enough to make me excited. But at least they’re moving in a direction that makes me more excited than I was, let’s say, three or four months ago. The more depressed the rest of the world gets the happier I become. It is a definite inverse behavioral function. Oaktree Capital’s Howard Marks always talks about the markets’ pendulum of the swings from irrational exuberance to the depths of despair — I think being a contrarian anchored to valuation makes it easier to withstand both of those extremes. And even in the worst of times, you can help yourself cope to some extent by buying things that you think will still make sense, even if the world does go to hell.

All you’ve got to do is find them! Thanks, James.