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OFF THE SHELF

A Bear Saw Around the Corner

By STEPHEN KOTKIN

THE long economic boom passed many people by, but the bust has nailed nearly everyone. The carnage has also made a clairvoyant of James Grant, the founder of Grant’s Interest Rate Observer and a perennial market bear.

In “Mr. Market Miscalculates” (Axios, $22), Mr. Grant serves up an edifying anthology of his previously published — and prescient — editorials and speeches from his much-read industry publication. Read them now and weep.

Counteracting the uncanny amnesia of the financial world, the bookish Mr. Grant has a wonderful habit of revisiting forgotten or classic works like “Lombard Street” by Walter Bagehot (1873), which defended the necessity of bailout loans by the Bank of England. Mr. Grant disagrees.

His longstanding, consistent, contrarian views are bracing; his prose, fluid and witty. (Subprime lending is dubbed “not one borrower left behind.”) “Great booms,” he wrote in 1999, “produce large abuses, which usually do not seem abusive until after the up cycle ends.” Happy 2009!

In 1999, Mr. Grant also rightly noted that “there is one set of rules for bull markets, and another for bear markets.” Unfortunately, the regulations needed during boom times are instituted only during the downturns.

Lucid essays from well before the 2008 meltdown captured the toxicity of the mortgage market and the investments known as collateralized debt obligations (stacks of debt). Other writings celebrated Karl B. Hill, an unconventional banker who muses that it would be convenient if all the McMansions built with financial flows from Asia could now be exported to improve America’s foreign trade balance. (The alternative is for the Asian holders of American debt to move into the houses and employ the insolvent nominal homeowners as household staff.)

We’ve been here before. Technology stocks, Mr. Grant writes in the anthology’s foreword, were absurdly overvalued in early 2000, just before the tech bubble burst, “but, then again, they were only a little less overvalued in 1999 and 1998.” Ditto for 1997, and 1996. “I myself,” he adds, “thought the market was a little overvalued in 1992.”

Had investors followed Mr. Grant’s advice in any of the years before the tech crash, they would have forgone huge gains that kept piling up in defiance of his doomsday predictions. It takes a strong person to
leave a lot of easy money on the table, quarter after quarter.

More recently, Mr. Grant correctly predicted that securitized mortgages would implode — but in 2005, and again in 2006, which turned out to be gloriously profitable years for those who were in the game.

“When the music stops, in terms of liquidity, things will be complicated,” said Charles O. Prince III, the former Citigroup chief executive, in the summer of 2007. “But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”

Another key to the fiasco, Mr. Grant shows, is the widespread disinclination to accept, let alone seek out, information that contradicts one’s views. “As a rule,” he wrote in 2002, “investors see what they want to see.” This applies to many of his own subscribers, who paid for analysis that they ignored.

Therein lies the allure of the irrational Mr. Market, a character invented in the 1930s by the father of value investing, Benjamin Graham (whose disciples include Warren E. Buffett). Modern portfolio theory now generally holds that outsmarting the markets is impossible, making it advisable to invest in index funds.

But Mr. Grant follows Graham in insisting that Mr. Market’s herd behavior — “price is never an object; he just wants in, or he wants out” — creates opportunity for a disciplined investor to find stocks selling at a discount to a company’s intrinsic value.

In gauging the troubles of the American International Group, the big insurer, Mr. Grant proved no better than regulators, and issued a mea culpa. Still, he contends that mispricing opportunities are always at hand. “Panicked investors,” he wrote in 2007, before the recent sell-offs, “will care no more about value than the euphoric ones did.” But here’s the paradox of successful “value investing”: it’s possible, if at all, only because few practice it.

Mr. Grant’s targets have been many, but none more so than the Federal Reserve. During the height of Alan Greenspan’s maestro acclaim, Mr. Grant made the case against him, then took up the cudgel against his successor, Ben S. Bernanke. He accused them of inflating bubbles and of fighting what Mr. Grant sees as the false bogeyman of deflation.

Beyond the tilting, though, one question begs an answer: Is it possible to have robust growth without the follow-on crises? Essentially, Mr. Grant answers, no.

Capitalism, like invention, is disruptive, he has observed many times, while arguing that past efforts to ensure future safety have only increased long-term instability. That’s because well-meaning protections against “systemic risk” — even government insurance for bank deposits — encourage recklessness. Such was the backdrop to the financial engineering that computers made possible.

IN addition, as Mr. Grant sees it, the world went to hell after 1971, when the United States abandoned the gold standard. “Gold not only collateralized the currency but also tempered the growth in bank credit,” he admonished in 1999 — and, it seems, every year, before and since.
Unhitching economic growth from the vicissitudes of mining freed the Fed to issue endless liquidity to prop American employment and G.D.P. But cheap credit meant that investors, already egged on by Uncle Sam’s implied backstop guarantees, became flush with gambling money.

Mr. Grant is dead right about the long-run tendency of central banks to debase their own paper currencies, but permanently returning the dollar to a gold standard is no more practicable than reducing the government’s size to 19th-century levels. Still, as he warned in 2002, “very low interest rates often ignite booms, but even ultralow interest rates may not fix busts.” Live by the Fed's pump-priming, die by the Fed’s pump-priming.