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View from inside the belly of the beast

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But his bearishness nevertheless is shared by several other investment experts — though several in the group admittedly have been bearish for some time.

The pessimistic Dalio has been analysing the US and world economies and investment markets for decades and has designed his Bridgewater group's investment strategies around the need to cover even the worst eventualities.

While he is possibly no less bearish than Faber or Grantham, he is less well-known to the public — though his views are routinely sought by the authorities.

Bridgewater manages money for several of the world's central banks and Dalio was one of the hedge fund managers consulted by Ben Bernanke in August 2007 before the Federal Reserve Board dramatically cut rates to stem panic in the markets.

At the start of the year, Dalio said he believed the world was at the start of a large-scale secular shift in the financial and economic landscape, caused by the popping of the US debt bubble. And, in January he said, ''there is probably too much optimism about the degree to which [President Barack] Obama's stimulus will change the direction of the economy.''

By the start of February, Bridgewater concluded that several months of ''terrible economic growth numbers have made it pretty clear how bad the current growth story is, but the magnitude of the deflationary wave that is now baked in the cake for 2009 is still under-appreciated''.

Dalio says his guess for the likely turning point for sharemarkets is late this year ''or, more probably, some time in the first half of 2010 — at significantly lower prices''.

In direct response to the *AFR*'s question ''do you think markets can regain confidence without a clear solution to the heavy debt burdens?'' Dalio answers, succinctly: ''No.''

Faber, Grantham and Pimco chief Bill Gross all agree there can't be any recovery until the debt problems are resolved.

Grantham estimates a successful bail-out of the US economy might need halving the level of private debt to underlying assets — which could imply the need to get rid of between $US10 trillion ($15 trillion) and $US15 trillion of debt.

In his most recent commentary, Gross says economic recovery isn't possible until policy measures can stop the deflationary deleveraging under way and what he calls a mini-depression.

Gross says the only way to achieve this is to stop the decline in asset prices — and that this will need more than pumping liquidity into the banks and recapitalising them. But this involves what Gross call the ''shadow banks'' whose lending — via securitisation activities — has been faltering.

It is not so much that the Wall Street stockmarket needs to go back to levels of above 10,000 points on the Dow Jones average, he says. ''That would nice,'' he says for the millions of 401ks (retirement savings accounts), ''but it is not likely.''

Rather, Gross argues, the asset prices on which municipal bonds and commercial real estate and credit card receivables depend ''must stop going down if the real economy has any chance to revive by 2010''.

In the short term, Faber thinks the central banks' interventions — by printing money — has improved liquidity and, he says, ''markets could rally around 30 per cent from here''.

So, are investors looking for too quick a recovery? Yes, says Faber, ''but before we move lower, we could have a strong rebound''. But after a possible recovery to 1100 to 1150 points on the S&P, he thinks the market could then decline again — ''possibly to new lows''.

GMO's Grantham warns investors the markets could plumb new lows if only because ''markets love to overcorrect on the downside after major bubbles''.

But over the next seven years, GMO's long-term forecasts of asset returns are ahead of the average of the past 15 years and ''moderately above normal'', Grantham says.

He suggests investing in global equities ''slowly and carefully''.

Dalio agrees that if the markets surprise investors, it could be on the downside — at least for stocks. At the same time, there could be an upside surprise in gold prices, ''depending on how aggressive is the reflation''.

He suspects the most likely initial moves will be for stocks to fall and, later, for gold prices to rise. This is because ''the deflationary depression problems will probably be more powerful than the reflation until the problems become so great that the reflation overpowers''.

Grantham says in the long term, investors should be researching portfolios that would resist both inflationary problems and potential (US) dollar weakness — the two serious problems that might have to be faced as a result of flooding the global financial system with government bail-outs and debt.

Faber says he also is torn between the deflationary and inflationary scenario. He says the wealth destruction of the past 15 months is being opposed by Ben Bernanke's use of the printing press to generate higher spending and inflation.

Personally, he says, the fears of investors about a recession or a depression are not overdone. ''We may experience an even worse depression than in the 1930s,'' he says.

His investment strategy is diversification, with an emphasis on Asian markets and commodities where he thinks prices should be higher over the next five years. ''I am less certain about the US — certainly in inflation-adjusted terms,'' he says.

Brinson warns that financial markets are going through a permanent change in system-wide leveraging and says it is hard to find short-term bright spots.

He says there are too many uncertainties because both the depth and duration of the economic and financial market problems are extraordinarily complex.

Brinson says it is impossible to predict a turning point in the stockmarket. Share prices have declined substantially and the question of whether this decline is enough depends on the answer to those questions about the depth and duration of the downturn.

But, Brinson says, ''the markets will ultimately discount the severity and start to improve — before the real economies improve.''

Markets might be able to regain their confidence without a clear solution to the heavy debt problems, he says, but they will be at lower valuations than were once the norm.

Over the longer term — say, five years — Brinson says he is bullish. ''Over this longer-term horizon and from these levels, markets should provide an appropriate risk adjusted return.''

Goldman Sachs's Abby Cohen is generally much less pessimistic. Although she admits the US is enmeshed in recession (which probably began more than a year ago) she now sees some signs that economic news ''is still bad but it is worsening more slowly''.

Her firm's forecasts are for the ugliest data to start improving around the middle of 2009 and for growth to resume in some parts of the economy later this year.

She says the pace of recovery may be ''modest and uneven'' but adds, ''the recession will end and a repeat of the 1930s is not expected''.

Unlike the Great Depression, Cohen says monetary policy has resulted in rapid and creative applications (including lending by the Fed and funding for the banking system).

In addition, fiscal policy has been adjusted much more quickly and unemployed workers have been given income and health-care coverage — a safety net that was not available in the 1930s.

Cohen says those looking for a recovery in financial markets need to look for properly functioning credit markets. Right now, she says, ''there are reasons to suggest, but not to prove, that the US financial markets are already past their worst''.

Recently, there have been signs of more favourable trends in the credit markets and now in equity markets, along with a notable reduction in volatility.

She says the S&P's volatility, which reached 85 per cent in the December quarter — more than four times its historical average — has since dropped by about half.

Based on Goldman Sachs's earnings forecasts (among the lowest of analysts), Cohen says the conservative numbers suggest the S&P index is trading below its fair value by the end of this year of around 1100 points.

Cheaper prices are not just possible but probable – although far from certain.
JEREMY GRANTHAM

Plus more from ...

Ray Dalio
Bridgewater Associates
'I'd have to go out to 10 to 15 years [before stock prices rise from current levels].'

Bill Gross Pimco
'[Asset prices] must stop going down if the real economy has any chance to revive by 2010.'

Jim Rogers
co-founder of Quantum fund
'The fundamentals for commodities are improved by what's happening. They're getting better, not worse. Prices are down, so that's a bullish opportunity.'

Anthony Bolton
Fidelity
'Commodity and mining shares were the main players of the last bull market and you don't find that what has led the last bull market leads the next one.'

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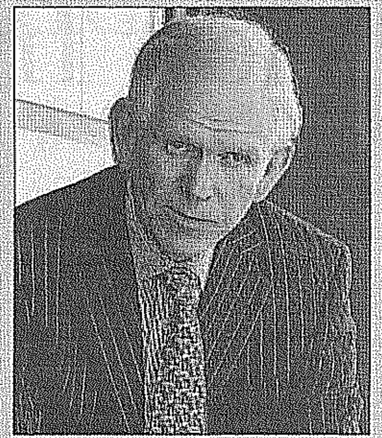

Jeremy Grantham

Fund managers and investors will all have to grapple with the issue of regret – no matter what they do in the stockmarket in coming months.

GMO's chairman Jeremy Grantham spelt out the dilemma in an interview with *Forbes* publisher, Steve Forbes, in late January.

Mr Grantham said GMO thought US share prices were the cheapest they had been for 20 years, although not as dramatically cheap as they were in 1982 or in 1974.

It was estimating real returns of 7.5 per cent a year over the next seven years for the US market.

But at the same time he said it was possible the US market could fall further, to around 600 points, on the S&P 500 Index (down 25 to 30 per cent from recent levels).

And Mr Grantham said he thought there was a good chance the market could go to a new low this year.

GMO's problem was it was still underweight equities, even though shares were reasonably cheap. ''Now what happens?'' he asked. ''If we throw in the client's money and it goes down – indeed, as I think it will – they will complain quite bitterly that we weren't smart. We thought it was going down, yet we threw their money in.

''So that's one kind of regret. The other kind is that we hang back and the market runs away.''

If that one-in-three chance came up, GMO's investors would still complain: ''You told us the market was cheap. You told us that you had these 9 per cent and 10 per cent real return opportunities – and you're still underweight and the market's back up 200 points. You're an idiot.''

Mr Grantham said there was no way to avoid some regret.

Investors would have to look at their own personal balance sheets and ask themselves how much pain they could stand, he said.

''If you absolutely can't stand a 20 per cent hit, you'd better carry quite a lot of cash because you're likely to get hit.'' The alternative was to be tough under stress, rather than try to avoid the downside risk.

''The worst situation that will befall probably quite a lot of people is that they exaggerate their toughness,'' Mr Grantham said.

''The market goes down 30 per cent and they panic, dump their stocks and never get back. That's the worst outcome.''

Barrie Dunstan