GRANT'S

JAMES GRANT
EDITOR

Vacation delectation

To the readers of ***Grant's***:

The attached anthology of recent ***Grant's*** pieces is not only for you, but also for your friends—and co-workers, clients, classmates, shipmates, brothers-in-law and maids-of-honor, too. Please pass it along, with our compliments, to any and all prospective members of the greater ***Grant's*** family.

We resume publication with the issue dated Sept. 3.

Sincerely yours,

James Grant

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Up the capital structure

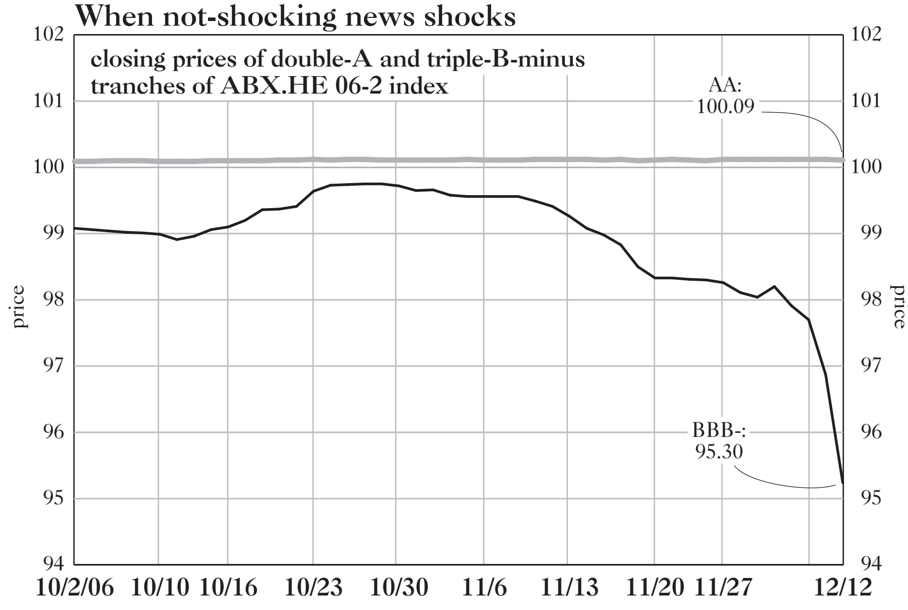
(December 15, 2006) The not very shocking news that low-rated tranches of poorly underwritten mortgages on depreciating houses are susceptible to loss has nonetheless managed to shock. The cost of insuring the lowliest such slice on the standard subprime reference index has climbed by 25% in seven short days, according to the guardians of the untransparent mortgage derivatives market. *Grant's* has had much to say about mortgage credit this year. Following is a speculation on 2007, if we have our timing right. In preview, we find that, under some not very adverse assumptions,even higher-rated mortgage structures are vulnerable to infestation by credit termites. Insurance on these supposedly safe and sound mortgage derivatives is available for a song.

We write not only for the well-staffed professional investor who could actually buy protection on the penthouse levels of an arcane mortgage index. Our intended audience is, equally, the curious investment amateur who ordinarily has no truck with tranches and derivatives but is always prepared to make an exception for a $1 trillion market. Our hypothetical layman should know that the experts, so-called, are almost as confused as he is. Certainly, they are of many minds. A few—a minority—believe that the troubles now unfolding at the margins of subprime are the leading edge of much deeper problems. We are in that camp. The majority contend that the derangement of the BBB-minus-rated tranches is a fluke. The broad market, they say, even the broad subprime market, is hale and hearty. Bear Stearns, the top mortgage-backed securities underwriter, is an exponent of this idea, as is Triad Guaranty (*Grant's*, June 16). Both are expanding their businesses as if the bear markets in mortgage debt and residential real estate were already over and done with—if, indeed, they ever really got under way.

The subprime arena is the Wal-Mart Nation of American leveraged finance. Like the Wal-Mart customer, it is a bellwether of financial disturbance. Perhaps, it's no accident that the giant retailer's sales have weakened as the cost of insuring low-rated subprime mortgage tranches against default has risen. But there is something about the sudden blight of delinquencies and foreclosures in the bottom of the 2006 mortgage barrel that doesn't quite add up. Yes, the median house price has fallen by 3.5%. But the jobless rate stands at only 4.5%. Nominal interest rates—even following 17 quarter-point jumps in the fed funds rate—remain low. The Russell 2000 Index the other day hit an all-time high. Blame for the distress at the fringes of subprime, we judge, cannot be laid at the feet of the U.S. economy. It should, rather, attach to the lenders and borrowers who piled debt on debt until the edifice sways even in a dead calm.

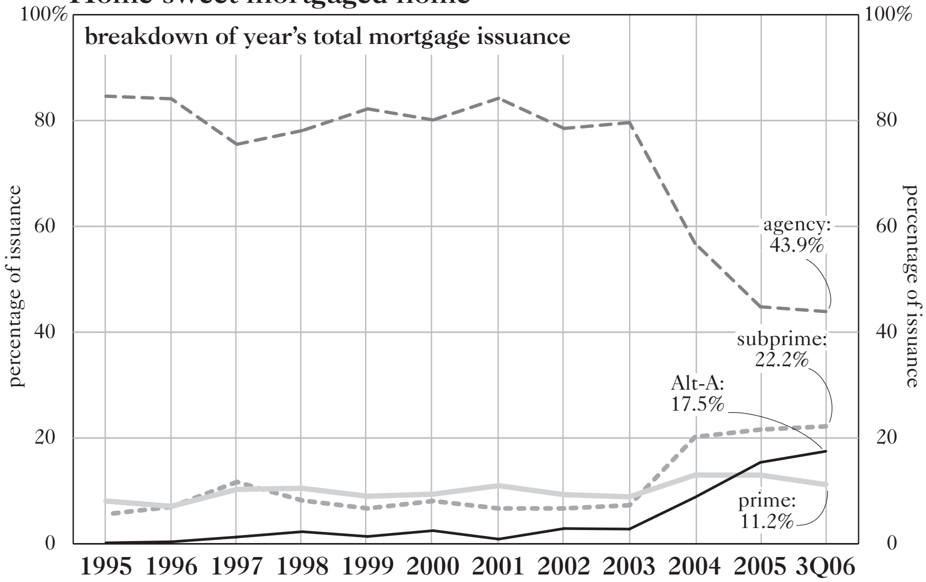
A common reaction to our descrip-

When not-shocking news shocks



source: Markit Group, CDS IndexCo.

Home sweet mortgaged home



source: UBS

tions of the elaborate design, and not especially generous yields, of asset-backed securities (ABS) is amazement: "Who buys this stuff?" *Grant's* readers want to know. Yield pigs the world over, is the answer. "Who creates and promotes it—and what would cause them to stop?" is another oft-heard question. The answer to that is Wall Street. Its mortgage mills create asset-backed securities like the kind featured on page one of the September 8 issue of *Grant's* ("Inside ACE Securities' HEL Trust, Series 2005-HE5"). And the same mills issue collateralized debt obligations, a.k.a. CDOs. It's the CDOs that dependably buy the lower-rated ABS tranches.

Constant readers will recall that CDOs are highly leveraged debt-acquisition machines (*Grant's*, June 2). So it is all important to the subprime market that new mortgage-packed CDOs continue to come tumbling down the Wall Street production lines as, indeed, they have been: According to the latest data, year-to-date CDO issuance totals $223.7 billion, no less than 89% higher than in the like period a year ago.

To sustain this pell-mell growth, the Street needs buyers, specifically buyers of CDO equity. The equity tranche is like the understander in a human pyramid. Without him, there can be no show. Upon a CDO's equity is loaded tranches of lower-rated ABS at a ratio of as much as 20:1.

Mortgage traders speak lovingly of "the CDO bid." It is mother's milk to the ABS market. Without it, fewer asset-backed structures could be built, and those that were would have to meet a much more conservative standard of design. The resulting pangs of credit withdrawal would certainly be felt in the residential real-estate market. So the musing of a knowledgeable salesman to whom colleague Dan Gertner spoke the other day is worth considering. "The CDO managers have certainly stepped back," said our source (so knowledgeable is he that he asks to go nameless). He explained that what is worrying the CDO managers has nothing to do with the macroeconomy. It is all about microeconomics, particularly a sudden paucity of buyers. "Clearly," our source went on, "the end buyer of this rubbish—whether it be the Middle East or, more likely, the Far East—has had second thoughts about home-equity loans and subprime in general. I think that is key. If you follow the money trail, it has implications for other asset markets as well." Perhaps, the flies on the wall at the upcoming talks between Chinese finance officials and Treasury Secretary Paulson will have the consideration to leak the gist of any concerns Chinese analysts harbor about the subprime market.

The $1 trillion size of the market should push it to the top of any international financial agenda. Through September 30, overall U.S. mortgage issuance totaled a little more than $1.5 trillion, according to UBS. Of this grand total, no less than 22.2%, or $342.4 billion, was subprime, i.e., speculative grade (meaning, generally, a FICO score of less than 620, 100 points lower than the national median). Another 17.5%, or $269.5 billion, was Alt-A, the class between speculative and prime. At 39.7% of year-to-date issuance, the sum total of subprime and Alt-A emissions thus begins to approach the 43.9% of the higher-quality mortgages that Fannie Mae and Freddie Mac are allowed to buy.

Credit quality in the U.S. residential mortgage market has been in a long-term downtrend, which is another way of saying that house prices and homeownership rates have been on a long-term uptrend. As recently as 1994, again according to UBS, subprime issuance amounted to just 5.6% of total mortgage issuance, with Alt-A amounting to only 0.2%. Fannie, Freddie, Ginnie et al. had the mortgage-securitization field virtually to themselves—and because they stamped their issuance with a federal guarantee (implied or actual), credit risk, from the investor's standpoint, was virtually nonexistent. "Since 1994," observes Gertner, the *Grant's* special vice president in charge of mortgage complexities, "agency-eligible mortgage issuance has grown by a factor of 2.5, subprime issuance by a factor of more than 19 times and Alt-A by a factor of more than 500 times."

The long vigil of the mortgage bears for signs that they have not been imagining things has ended with a succession of confidence-rattling news items. The first was the shuttering of Texas-based Sebring Capital Partners, a subprime and Alt-A originator, on December 1. Sebring, with 325 employees and 10 years of operating experience, was forced to turn off the lights after rising defaults left it without a banker. Ownit Mortgage Solutions, a California subprime lender founded in 2003, followed Sebring into the darkness on December 5. The *Los Angeles Times* quoted a valedictory Ownit press release that blamed Merrill Lynch for pulling the plug; Merrill held about 20% of Ownit's equity. Two days later, Fitch Ratings placed a subsidiary of AMC Mortgage Services under surveillance for possible downgrade, citing a plunge in origination volume, rising credit problems and a consequent knock to the profitability of the firm's servicing business. In remarks that bear on all subprime originators, the *L.A. Times* quoted John Bancroft, managing editor of *Inside Mortgage Finance*, as follows: "These are companies that depend almost exclusively on new loans for their earnings. That market grew rapidly in the last 10 years, but it couldn't last forever. Eventually, you reach just about every marginally qualified borrower you can."

That not one borrower was left behind is increasingly evident in the market for lower-rated subprime mortgage tranches. An index that references a particular subspecies of mortgage slices—the ABX.HE 06-2 BBB-minus—is the one that suddenly costs 25% more to insure against loss than it did at the end of November. Informants say that it is nearly impossible to buy credit protection on poorly performing tranches of the mortgage stack. Mr. Market, though sometimes slow on the uptake, does not have to be told twice that the fat's in the fire.

We will proceed to identify a few slices of fat that have not yet fallen off the griddle—colleague Gertner has spotted some excellent candidates for sale. First, though, a few helpful words of background.

"ABX" is the basic index designation, and that is simple enough. ABX.HE is a fuller designation, and it is wholly misleading. "HE" signifies home equity, but you may put that out of your mind. This is an index overwhelmingly of first liens; home-equity-type seconds may constitute no more than 10% of a given tranche. The basic index consists of an equal-weighted static pool of 20 credit default swaps, or CDS, that reference U.S. subprime mortgage securities. Have you tripped over the words "credit default swaps"? Pick yourself up and dust yourself off. In effect, CDS are insurance policies on credit risks. They may, therefore, be viewed as mirrors to the credit risk against which they offer protection.

The basic ABX.HE index contains five subindices, each of which tracks a different grade of mortgage credit quality. Which may lead you to wonder: "If all the mortgages are subprime, how can there be more than one rating category?" Yes, the mortgages that pack the various tranches are all subprime. But derivatives architects convert subprime into investment-grade by armoring the higher tranches with extra collateral. A triple-A-rated subprime tranche is one reinforced with enough mortgages to make it impervious—supposedly—to loss. Remember that, in all such structures, income cascades down from the top while losses infiltrate up from the bottom. The higher-rated tranches get paid first; the lower-rated ones bear the first loss.

The ABX.HE index series is a joint production of CDS IndexCo and Markit Group Ltd. CDS IndexCo is a consortium of 16 brokerage-house-cum-market-makers; Markit, which was founded in 2001, is a pricing, asset-valuation and risk-management data vendor. On the occasion of the launch of the first index series last January, Bradford S. Levy, a Goldman Sachs managing director and acting chairman of CDS IndexCo, explained what it was all about: "The CDS of [the] ABS market has grown at a rapid pace over the past six months, and we have seen increasing appetite among clients for a way to take a syn-

Termites gnaw

performance of the constituents of the ABX.HE AA 06-2 index

	—credit support—		—days delinquent—				real estate	total	months of
ABS deal	original	current	30	60	90	foreclosure	owned	distressed	seasoning
LBMLT 2006-1	14.15%	17.38%	4.56%	2.47%	3.00%	4.91%	1.09%	16.03%	9
CWL 2006-8	12.95	13.45	3.10	1.25	0.29	1.67	0.05	6.36	6
MSAC 2006-WMC2	12.45	12.57	3.66	2.21	1.40	2.37	0.00	9.64	6
ARSI 2006-W1	14.84	19.03	2.77	1.57	1.45	4.95	0.79	11.53	10
FFML 2006-FF4	13.35	15.33	2.80	1.04	0.69	2.64	0.60	7.77	7
ACE 2006-NC1	14.65	18.97	2.60	1.21	1.17	2.68	0.64	8.30	11
SVHE 2006-OPT5	15.13	16.35	3.26	1.26	0.68	1.28	0.00	6.48	5
SAIL 2006-4	10.90	12.33	4.06	2.24	0.76	2.70	0.04	9.80	6
GSAMP 2006-HE3	17.20	19.14	4.43	2.94	1.76	3.75	0.62	13.50	7
MLMI 2006-HE1	18.35	22.94	4.71	1.56	2.31	2.45	0.81	11.84	10
JPMAC 2006-FRE1	17.45	22.18	5.08	1.95	0.24	6.16	1.35	14.78	11
RASC 2006-KS3	14.90	16.88	3.83	1.84	1.22	3.59	0.57	11.05	8
RAMP 2006-NC2	12.95	15.22	3.70	1.72	0.81	5.24	0.70	12.17	6
HEAT 2006-4	12.90	14.73	3.53	1.90	1.02	2.38	0.05	8.88	5
BSABS 2006-HE3	16.65	20.01	4.03	2.46	2.70	4.63	0.24	14.06	9
MABS 2006-NC1	14.30	17.56	3.51	2.11	1.20	5.29	0.68	12.79	10
CARR 2006-NC1	16.40	19.95	2.92	1.12	1.18	3.46	0.30	8.98	9
SASC 2006-WF2	13.55	14.98	2.04	0.25	0.08	1.04	0.02	3.43	6
SABR 2006-OP1	11.40	16.02	2.48	0.49	1.12	2.88	0.40	7.37	11
MSC 2006-HE2	3.90	14.14	3.84	1.97	1.92	3.13	0.36	11.22	7
Average	14.42	16.96	3.55	1.68	1.25	3.36	0.47	10.30	8.0

thetic view on ABS. ABX is a direct response to that demand, and gives clients an efficient, standardized tool with which to quickly gain exposure to this asset class."

In short, here was a new derivative index to fill the supposedly crying need for a way to speculate on the value of stacks of subprime mortgage tranches. The first index series to be launched was the ABX.HE 06-1, and the mortgages from which it derives its value were originated in the second half of 2005. The next index made its appearance in July. This was the ABX.HE 06-2; the mortgages to which it refers were originated in the first half of 2006. The promoters say they intend to introduce a new series every six months.

The index that keeps getting its name in the paper is the July edition. What makes it notorious is the shockingly weak credit quality of the early-2006 subprime mortgage cohort. Not surprisingly, the weakest of the five constituent subindices is the lowest-rated one, the BBB-minus tranche. The aforementioned plunge of confidence in its creditworthiness translated into a spike in the cost of insuring it against loss to 380 basis points per annum from 300, all in the space of a week. No doubt the move was exaggerated by the usual depopulation of year-end trading desks.

The bad news is oddly uncontagious so far. Nothing like that loss has been registered in the higher-rated subindices of the same ABX. HE 06-2; the AA-rated tranche is little changed. Neither has the ABX.HE 06-1 index—which, to repeat, references the late-2005 subprime cohort—been dragged down. The BBB-minus tranche of the 06-1 index trades around par. The annual cost of insuring it against loss amounts to just 270 basis points, 110 fewer basis points of risk premium than assigned to the same tranche in the 06-2 subindex.

Is the subprime mortgage class of 2006 uniquely blighted? Were the underwriting standards prevailing during the first six months of the year uniquely slapdash? Or, are the remarkable losses borne on the unseasoned 2006 vintage simply the consequence of a bear market in house prices (and the preceding riot in easy credit) that sooner or later will corrupt the 2005 subprime mortgage crop as well? Our replies are, respectively, "no," "no," and "yes."

For evidence to support our affirmative response to question No. 3, we invoke the September 28 Merrill Lynch "Review of the ABS Markets." In it, the Thundering Herd's ABS research group posits that losses on recent subprime ABS issues could be big enough to eat well into the structures' mezzanine levels, i.e., a principal loss on the order of 6% to 8%. This could occur if house prices do no worse next year than move sideways. But the Merrill economics squad has forecast a house-price decline of up to 5%. In which case, the ABS researchers warn, losses in subprime asset-backed structures would spike into the double digits. Losses could infiltrate all the way up to the A-rated mortgage stack, the researchers speculate. Just as rising house prices tended to cover up affordability and solvency problems, so falling house prices would unmask them.

It goes without saying that these excellent analysts are groping in the dark. We all are. None of us, for example, can be sure how long it might take for delinquencies and foreclosures to translate into money losses. But some things are certain. With only a glance at the tote board, for example, we can know today's odds on tomorrow's possible outcomes. Specifically, the probability of a default on the AA tranche of the ABX.HE 06-2 subindex is reckoned to be close to zero. You can buy credit protection on the AA slice of subprime mortgage exposure for a mere 13.8 basis points. That is, the cost of insuring $10 million in notional value of the AA index will set you back a mere $13,800 a year. "Pretty cheap insurance," Gertner notes. "But is there any chance of getting paid?"

Gertner has made a study of the 20 ABS deals that constitute the ABX. HE 06-2 index. He pronounces their performance to be lamentable. After just eight months of seasoning on average, 10.3% of the constituent mortgages are delinquent, in foreclosure or classified as real estate owned. (The runt of the ABS litter, the Long Beach Mortgage Loan Trust 2006-1, shows 16% of the loans in one state of distress or another.) Now, credit support for the AA-rated tranches, at 17%, provides 6.7 percentage points of insulation against loss—and, of course, there's no telling when, or if, the loans now troubled would go irretrievably bad. But given the wretched performance of the collateral to date, the cost of insurance seems strikingly cheap. "Nor is a cash loss the only way to get paid," Gertner points out. "Spreads could widen—as the spreads on lower-rated tranches have already begun to do."

For the time being, the bear market in subprime credit is tightly focused on the lowest tranche of the 2006 index. It would, to repeat, cost you 380 basis points a year to insure it against credit loss. Better value, as Gertner points out, is protection on the BBB-minus tranche of the earlier index, the ABX.HE BBB-06-1. "If deterioration in subprime mortgage quality finds its way into the loans originated late in 2005, and I believe it will," Gertner winds up, "then the cost of insurance will only steepen."

As bull markets are said to climb a wall of worry, bear markets grow on a trellis of complacency. Is Mr. Market yawning? A good sign—for the mortgage bears.

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China channels 'Monkeybrains'

(July 10, 2009) Too much debt got us into this mess, and too much debt will see us out of it. Socialize the risk of a new cycle of open-throttle lending and cling to the monetary system that assures a repeat crisis. Such, approximately, is the global policy-making consensus. Central bankers and finance ministers have achieved an uncommon meeting of the minds. The cure for what ails us is the hair of the dog that bit us, they prescribe, though not in exactly those words.

It's no small thing that China is especially enamored of the shot-and-a-beer-for-breakfast approach. Nothing about China is small or insignificant nowadays, since the Chinese economy is actually growing. It might, indeed, account for 74% of worldwide GDP growth in the three years to 2010, the International Monetary Fund estimates. Since 2005, China has generated 73% of the global growth in oil consumption and 77% of the global growth in coal consumption. By the looks of things, it accounts for a fair share of the growth in worldwide luxury-car consumption, too:

FRANKFURT (Dow Jones)—BMW AG said Monday that sales at its core BMW brand in China were up 46% on the year in June at 8,033 cars, fueled by strong demand for its X5 and X6 models.

Sales in China for both the BMW and the compact Mini brand rose 44% on the year at 8,506 cars, a company spokesman said.

Now unfolding is a preview of the next, the future, credit collapse. Such methods as China is employing—a borrowing binge centrally planned and directed—will eventually come to grief, as the readers of *Grant's* know full well. Indeed, in money matters, nearly everything seems to come to grief sooner or later. However, it is equally true that, before the grief, comes the laughter and levitation. Massive injections of money and credit are always unsound. But for stocks, commodities and credit, they are bullish before they are bearish. In the fad for "quantitative easing," when might the laughter turn to tears? How to prepare for that inflection point? How to see it coming?

China is not alone in seeding bad loans right on top of the previous cycle's only partially harvested crop of desperate debts. Loan guarantees, commercial paper purchases and other forms of financial artificial respiration by the governments of the G-20 nations sum to the equivalent of 32% of last year's combined G-20 gross domestic product, the IMF estimates. That is on top of average fiscal stimulus equivalent to 5.5% of GDP. So the United States, implementing fiscal and monetary stimulus worth nearly 30% of GDP (*Grant's*, April 3), is not far out of the interventionist mainstream. China is in a class by itself.

In the 1930s, Western intellectuals persuaded themselves that the Soviet economic model was depression-proof. Today, not a few investors marvel at the vigor of the modified communist economic model of the People's Republic. Credit may contract in the United States, but it expands—nay, explodes—in China. "If the rumored new lending figures for June are accurate (for more, see Michael Pettis's blog at mpettis.com)," observes colleague Ian McCulley, "Chinese banks will have lent 7 trillion renminbi, or a little more than $1 trillion, in the first half of 2009, compared to Rmb4.9 trillion in all of 2008, Rmb3.6 trillion in 2007 and Rmb3.2 trillion in 2006. New lending was exceptionally strong in the first three months of this year. It tapered off a bit in April and May but appears to have roared back in June."

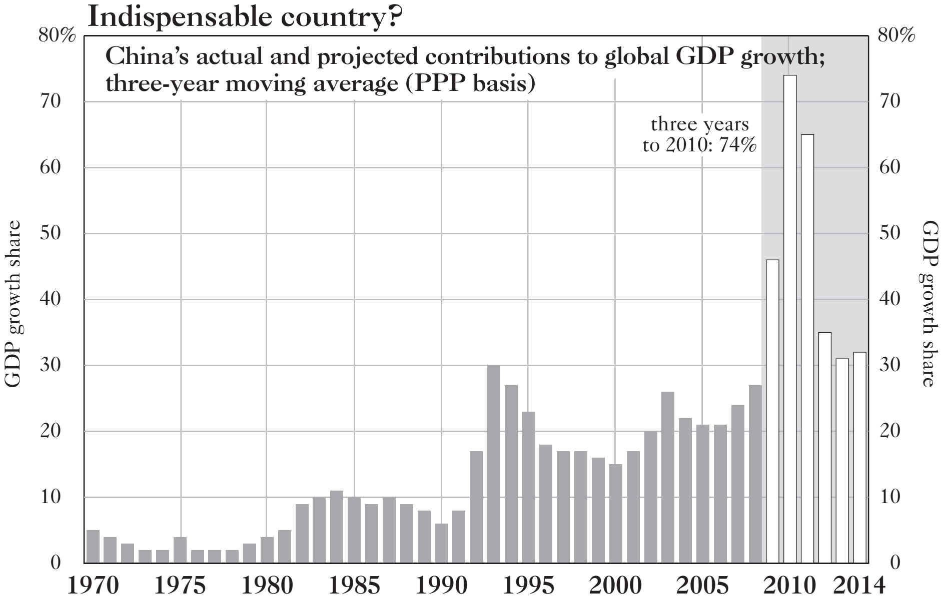
Complementary roars have issued from China's manufacturing industries and world commodity pits. Last week, the People's Republic purchasing managers' survey registered 53.2, its fourth consecutive month over the 50% mark that indicates economy-wide growth. The Shanghai A-share market jumped by 65% in the first half, to a level that fixes its value at 31 times trailing net income, up from 12.8 times at the October lows. Chinese M-2 was 25.7% larger in May than it was a year before. Chinese officialdom is targeting 8% GDP growth this year, while the World Bank predicts 7.2%, of which, the organization says, six full percentage points owe their existence to government stimulus. As between the 8% government forecast and the 7.2% non-government forecast, our money is on the government. Not only do the cadres print the money, but they also calculate the GDP. So, falling in with the Communist Party, we, too, predict 8% growth for 2009—barring an early explosion in the Chinese banking system.

New directives to Fannie Mae and Freddie Mac to refinance certain mortgages at up to 125% of appraised home value reaffirm the U.S. government's membership in the hair-of-the-dog bloc. But no credit-market intervention approaches the one being mounted in Beijing. For it, the world's commodity producers say daily prayers of thanksgiving, and their gratitude would truly be incalculable if only they knew how long the Chinese could keep it going. Absent Chinese stockpiling, where would commodity prices be? Without a functioning Chinese banking system, where would the world economy be?

A superb primer on the risks of China's go-for-broke lending drive was published by Fitch Ratings on May 20. Is it not passing strange, the agency asks, that Chinese lending is accelerating even as Chinese corporate profits are shrinking? "Ordinarily, falling corporate earnings are met with tightened lending, but in China, precisely the reverse is evident. . . ." You would expect—and Fitch does anticipate—that the borrowers of these trillions of renminbi are not so profitable as they were in the boom, and some will therefore struggle to service their debts.

Reading Fitch on China, we think of the author Mark Singer on Oklahoma. In China, Fitch explains, credit losses don't surface promptly on ac-

Indispensable country?



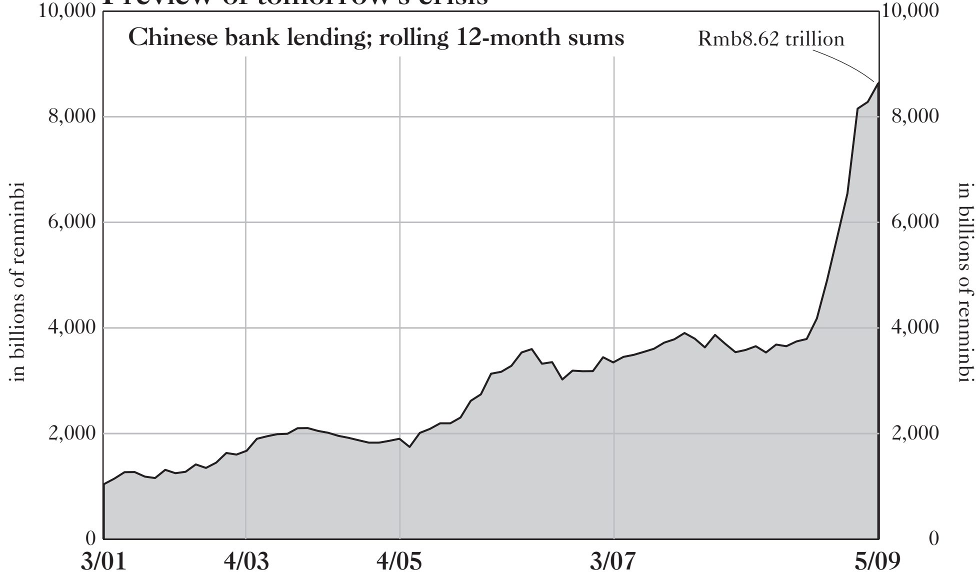
source: International Monetary Fund

count of "pervasive rolling over and maturity extension of loans when they fall due. This not only leads to under-capturing of NPLs and delayed credit costs, but also, by extension, inflated capital. Consequently, in the short to medium run, Chinese banks' performance may continue to hold up well as rapid loan growth drives up the denominator of NPL ratios and boosts profits via high volumes, but the medium-term risk of a deterioration in corporate portfolios is rising."

Neither did credit losses surface right away at the Penn Square Bank, Singer related in his 1985 tour de force, "Funny Money." Penn Square originated oil-patch loans at its headquarters in an Oklahoma City shopping center during the boom of the late 1970s and early 1980s. Interests in these credits it syndicated far and wide. An alert loan buyer might have taken a cautionary hint from Penn Square's super-fast growth and evident undercapitalization, if not from the nickname of its chief energy-lending officer—they called him "Monkeybrains." But the Continental Illinois National Bank & Trust Co., of Chicago, one of Penn Square's top loan participants, seemingly suspected nothing until the Oklahoma bank failed in 1982. When Continental Illinois itself became insolvent in 1984—pulled down, in part, by its Penn Square participations—a new chapter in the socialization of credit risk was opened. To save the Federal Deposit Insurance Fund, the government nationalized Continental, then the nation's seventh-largest bank, with assets of $41 billion. Pure and simple, it was too big to fail. Indeed, Comptroller of the Currency C. Todd Conover subsequently hinted, the 11 largest banks in the country were systemically irreplaceable. And so was born the too-big-to-fail doctrine. Whether or not it was an American invention, the policy today belongs to the world. China, in particular, has taken the idea and run with it.

Examining, first, the track of Chinese bank lending and, second, the trend in Chinese nonperforming loans, the seasoned reader will remember not only Monkeybrains but also Drexel Burnham Lambert. In the mid-to-late 1980s, the American junk-bond market combined breakneck growth with muted default

Preview of tomorrow's crisis



source: The Bloomberg

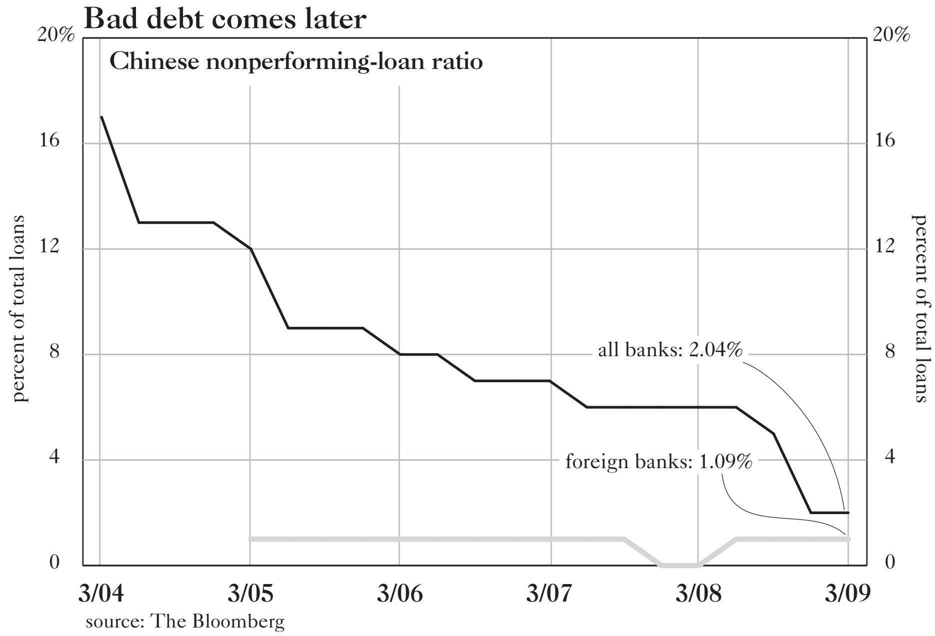
rates. The secret, fully revealed during the subsequent bear market, was that the default rates were a direct product of the issuance rates. Borrowers didn't default because of—to adapt the Fitch formulation to that earlier time—the "pervasive rolling over and maturity extension of bonds as they fell due." Drexel failed when the junk market did.

The idea that the government will finally pick up the pieces may or may not drive the typical mid-size American bank to risk-taking from which it would otherwise shrink. In China, however, there appears to be no doubt. "Prior to the global crisis," according to Fitch, "domestic [Chinese] credit conditions had been fairly tight; strict loan quotas had been put in place at the start of 2008 amid concerns about inflation, and [corporations] and banks were increasingly employing off-balance-sheet transactions to complete deals. However, since the rollout of the stimulus package [last November], the climate has dramatically changed. Projects that had been sidelined when quotas were tight have been put into action with the assumption that if problems arise, Beijing will likely step in with assistance."

If problems arise? As Fitch itself implies, the only question is when: Nonperforming loans at foreign banks in China, "which are generally believed to have stricter risk management and oversight and are less willing to roll over delinquent loans," are already on the rise. Chinese loan officers work to a quota. They take their direction from their branch managers, who report to the senior management, which answers to the board of directors—and the directors hang on the words of the People's Bank.

The trouble these days is that too many motivated loan officers are chasing too few creditworthy borrowers. Net interest margins at Chinese banks are tightening on account of the recession and the governmentally sponsored drive to lend their way to prosperity. So loan officers push all the harder. "For example," as Fitch explains, "a branch manager is given an annual profit target of Rmb35 million. If the average loan margin is 3.5%, he needs to lend Rmb1 billion to meet this goal. However, if the average margin declines to 2%, he now needs Rmb1.75 billion to meet the same objective. This is not the first time Chinese banks have faced a margin squeeze, but in the past the ability to raise credit volume was limited by quotas [i.e., central-bank-imposed quotas to restrict lending to combat inflation]. Now, in a quota-less environment, that restraint is gone."

China has its Sheila Bair as well as its Ben Bernanke, and the safety-and-soundness bureaucracy in March urged banks to set aside in reserve 150% of the par value of their bad debts, up from 120%. But the directive seems more in the way of a suggestion than a ukase. Certainly, the



stock market does not believe that the evil end to the new credit boom is yet in sight. In Hong Kong, the big three Chinese banks—Industrial & Commercial Bank of China, Bank of China and China Construction Bank—trade at price-to-book multiples of 2.5, 1.7 and 2.5, respectively.

We are as bearish on the multiples as we are on the stated book values. On the other hand, the stock market is as sanguine about Chinese bank stocks as economists are complacent about Chinese inflation. The late Milton Friedman handed us not so much a postulate as a divine law when he said that "[i]nflation is always and everywhere a monetary phenomenon." But a new generation of central bankers and economists is having its doubts. "Some worry that the rapid growth of money and credit will lead to inflation," the Beijing office of the World Bank advises in its June Quarterly Update. "However, with a lot of [spare] capacity in China and world-wide putting downward pressure on raw material prices unlikely to soar soon, substantial generalized price pressures seem unlikely any time soon." An asterisk at the end of that sentence leads the reader to a footnote in which the World Bank economists finish the argument: "The relationship between monetary aggregates and inflation is complex. That is why central banks in mature market economies have largely abandoned using money as a guiding variable for inflation projections, giving priority to output gaps."

So the economists give intellectual cover to the money printing. For the "mature market economies," we advise a return to the basics, starting with the very definitional threshold of the problem. Inflation is not "too much money chasing too few goods," but too much money, period. What the fatal, redundant increment of cash chooses to pursue varies from cycle to cycle. In pursuit, however, it never fails to distort something. Lately, the money has been chasing investment assets rather than goods and services. In Shanghai, it is chasing A-shares. Globally, this year, it has pushed up, or contributed to the pushing, of the prices of lead, copper and nickel by 75%, 71% and 50%, respectively. Who knows? Maybe the central banks have prevented some prices from falling further than they otherwise would have done. Central bankers, however, to generalize across the profession, refuse even to imagine the problem in these terms. They are content rather to assert that, owing to the prodigious gap between output and potential output in recession-wracked economies, their actions have instigated no inflation but have forestalled deflation. Self-congratulations ringing in their ears, they are prepared to crank the presses even faster when duty next calls. What's the harm in it? they seem to ask.

In fact, by cutting off interest rates at the knees, central banks punish thrift. Prolonging the lives of businesses that deserve to go out of business, they thwart the designs of the entrepreneurs who would, if they could, build something better. There's no end of mischief in quantitative easing. On the other hand, it's an ill monetary wind that blows no portfolio any good. Beijing has been lifting prices in resource markets. "The round of oil-field auctions in Baghdad last week," McCulley points out, "is a sign of things to come, as China National Petroleum Co. was part of a winning BP-led bid, while most other Western majors walked away complaining of unfair terms. (China National has a separate deal to develop other Iraqi fields.) Sinopec is buying Addax Petroleum, with reserves in West Africa and Iraq, in an $8.8 billion deal, and, according to *The Wall Street Journal*, is paying $16 per barrel of proven and probable reserves, more than triple the valuation of other deals in the region." Western companies may answer to their shareholders, but as an energy consultant put it to the *Financial Times* last week, "The Chinese companies are answering to politicians who have an aggressive strategy of resource capture."

The properly skeptical observer is in a quandary. China holds perhaps $1.5 trillion of low-yielding Treasurys and U.S. agency securities. You'd expect it to be edging out of two-year notes and Fannies and Freddies into resource investments, even if it had no doubts about the dollar. But it does have doubts, which it has taken to expressing in deeds as well as in words. On Monday, a Shanghai municipal government finance official called a press conference to announce the decision of three local companies to begin settling import and export contracts in renminbi rather than dollars. From offstage, a Singapore currency analyst declared, according to Bloomberg, "This is a first step on the long road towards that target of making the [renminbi] a global reserve currency. That's probably going to take five years or more."

It could be a long, hard road if China's Monkeybrains banking system follows the Penn Square-type trajectory, as we expect it will. Besides, Bloomberg News, in the very same dispatch, relates that the dollar's share of official vault space climbed to 65%, or $2.6 trillion, up 100 basis points on an admittedly incomplete sample set, in the first three months of the year. And it quotes He Yafei, China's deputy foreign minister, speaking in Rome on Sunday: "The dollar will maintain its role for 'many years to come.'"

So saying, He came to the root of the problem. The dollar's "role" in the world—its exalted status as a reserve currency—is what has facilitated the piling up of debts on one side of the Pacific and U.S. Treasury assets on the other. It is the dollar's role that has allowed the United States to consume much more than it produces and to finance the difference in the currency that it alone may lawfully print. China ships merchandise to us; we ship dollars to China. These dollars wind up at the doorstep of the People's Bank, which creates the renminbi with which to absorb them. And what does the bank do with its greenbacks? Why, it invests them in the securities of the U.S. government. Note, please, that the dollars might as well have never left home. Note also that their transit instigates credit creation in China, some of which, though not all, may be neutralized, or "sterilized," by the People's Bank. Under a proper gold standard, creditor countries gain reserves while debtor countries lose them. Built into that system is a balancing mechanism. New under the paper-money arrangements of recent decades is a kind of intrinsic imbalance. The major debtor country loses no reserves even as the debtor countries gain them.

Our Great Recession has restored a small measure of balance to the international financial traffic. U.S. imports have fallen further than U.S. exports, thus reducing the U.S. current-account deficit for the first quarter to $101.5 billion vs. the year-ago reading of $179 billion. The second-quarter shortfall was the smallest in absolute terms since the fourth quarter of 2001, and the smallest as a percentage of GDP—2.9%—since the first quarter of 1999. Yet, still, China accumulates dollar bills. "Despite a year-over-year drop in exports of 26.4%," McCulley notes, "and the American consumer's newfound taste for thrift, China has posted an $89 billion cumulative trade surplus through May, which is actually ahead of last year's record-setting pace."

A good-size portion of the Treasurys and agencies that America's creditor nations accumulate is held for safekeeping at the Federal Reserve Bank of New York. We track these custody holdings on pages six and seven of *Grant's*; the Fed discloses them every Thursday. Strange to relate, they have grown, not shrunk, in the past three months, at an annual rate of 27%.

All in all, the world is reverting to pre-crisis form. Central banks are monetizing dollars, subsidizing credit and socializing risks, and the People's Bank is outdoing all others in this direction. Certain it is that these unprecedented monetary maneuvers will come to a sorry and dramatic end. What we are struggling to divine is the timeline. Watch this space.

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Lift for Lufkin

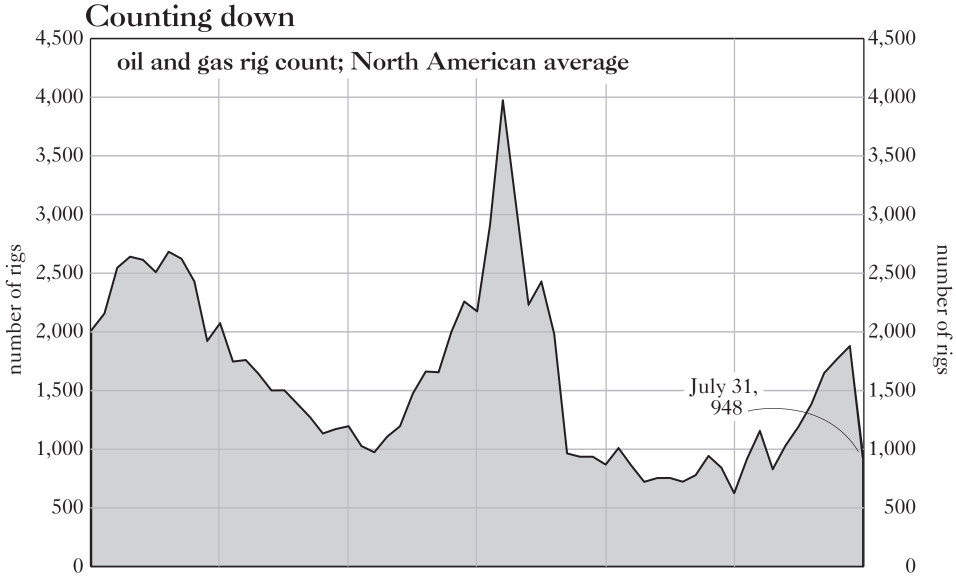
(August 7, 2009) It's not only we, the people, who are aging. Oil and gas fields, too, are getting gray around the temples. To erase unsightly blemishes and prolong productive life are yearnings that have launched many a profitable business. Following is a bullish analysis of Lufkin Industries (LUFK on the Nasdaq), a Just-for-Men-style vendor to the energy industry.

Lufkin, 107 years young, is a leader in the field of artificial lifting—its technology restores to aging wells what nature is gradually taking away. Its oil-field segment manufactures pumping units, or "horse's heads," as the roughnecks affectionately call them. Lufkin installs pumping units, services them and fine-tunes them with computer automation equipment.

A second Lufkin business segment, the power-transmission division, makes and services gearboxes for industrial applications. For energy-related work, it produces high-speed gearboxes. An exacting work is this, as the gearing runs at up to 4,500 revolutions per minute. For less demanding applications, there is a Lufkin line of low-speed gearboxes.

A little like the stock market itself, Lufkin's shares are neither very rich nor very cheap. They are quoted at 10.8 times earnings (and peak earnings, at that) and 20 times the average earnings of the past 10 years. They trade at 1.7 times book with a dividend yield of 2.1%. At $47 a share, the stock is half of its record-high price set almost 12 months ago. Revenues and net income peaked in the fourth quarter of 2008 at $230.6 million and $26.6 million, respectively. Second-quarter revenues and net income, at $123.7 million and $4.5 million, were

Counting down



source: Baker Hughes

Lufkin Industries
(in $ thousands, except per-share data)

	12 mos. to 6/30/09	2008	2007	2006
Sales	$702,513	$741,194	$555,806	$526,122
Cost of goods sold	(515,575)	(527,120)	(393,538)	(374,922)
SG&A	(75,256)	(71,974)	(57,582)	(50,752)
Other income (expenses)	(10,864)	(5,688)	4,772	1,474
Taxes	(36,180)	(48,387)	(37,673)	(30,650)
Net income	64,638	88,025	71,785	71,272
Earnings per share	4.35	5.92	4.92	4.83
Sales backlog	162,260	317,486	199,032	183,929
Cash and cash equivalents	86,300	107,756	95,748	57,797
Receivables	NA	139,144	90,696	90,585
Inventories	NA	128,627	92,914	85,630
Total assets	519,092	530,718	500,656	429,069
Current liabilities	NA	88,813	68,314	61,495
Long-term debt	2,300	—	—	—
Shareholders' equity	418,928	413,937	384,653	328,140
Share price	$47.06			
Dividend	2.1%			
Market cap	$699,349			
Price/book	1.7x			
Price/earnings	10.8			

down from year-earlier levels by 29% and 79%. They fell in a heap with the oil price and the rig count. One year ago, according to Baker Hughes, 1,951 rigs were at work in North America. There were just 876 in May. At last count, in July, there were 948.

"Compounding the fall in demand for our products," CEO John F. Glick told listeners-in on the July earnings call, "is the high level of inventory in our major customers' storage yards. Since customers purchased much of that inventory and put it in place in the second half of 2008 in anticipation of having a number of rigs under contract, the pace for drawing down that inventory will be slow. We believe it may take at least two more quarters for those inventories to be worked down, assuming the rig count remains roughly at current levels. Until that happens, new orders will remain well below those record levels we saw last year." To adjust, the front office reduced the oil-field manufacturing head count by 38% in Canada and by 68% in the United States.

Admittedly, the bull story may not be quite self-evident. Rather, we think, it's implicit in the profile of the world's waning oil fields. In the full bloom of youth, an oil or gas well may exhibit what the engineers call natural lift. Whether or not a well can use a Lufkin pumping unit depends on comparative fluid pressures. Pressure within the energy-bearing reservoir is one such variable. Pressure created by the column of oil or gas or water inside the well bore is another. This second kind of pressure is known as the hydraulic head. When the hydraulic head is greater than the pressure in the reservoir, the oil or gas can't get to the surface under its own power. It needs a lift, in the shape of a device to reduce the hydraulic head to some value lower than the pressure prevailing in the reservoir. Enter Lufkin.

"In an oil well," colleague Dan Gertner advises, "there are generally three fluids inside the well bore—natural gas, oil and water. A 100-foot column of gas exerts a force of about five pounds per square inch; a 100-foot column of oil exerts about 33.3 psi; and a 100-foot column of fresh water, about 43.3 psi. The bottom-hole pressure in a 10,000-foot well bore with 1,000 feet of gas, 4,500 feet of oil and 4,500 feet of water would, therefore, be 3,500 psi (1,000*0.05+4,500*0.333 +4,500*0.433). In order for the well to produce via natural lift, the reservoir pressure would need to be greater than 3,500 psi. If the reservoir pressure were, say, 4,000 psi, fluids would flow toward the well bore and make their way to the surface—no assistance required. If the reservoir pressure were only 3,000 psi, the column of fluid would need to be lifted artificially out of the well bore by a pump. New wells may or may not have sufficient pressure to produce naturally. But, as wells age, reservoir pressure declines and artificial lift becomes necessary."

Oil fields may age, but they only reluctantly retire. Twenty-four million barrels a day, or 35% of global production, flow from fields that began operations before 1970. It's a sign of the times that artificial lifting has become a hot topic even in the Middle East, where, proverbially, once upon a time, black gold gushed from a hole you just punched in the sand. The fifth Middle East Artificial Lift Forum, a three-day event held in Manama, Bahrain, in February, featured opening-day remarks by the host nation's minister of oil and gas. "Dr. Ali Mirza," said the press release, "stressed the important role played by artificial lift in crude oil production by pointing out that over 50% of the world's oil wells currently utilize some form of artificial lift technology. Citing the local situation, he added that more than 60% of oil wells in Bahrain also use these technologies, contributing about 50% of the kingdom's total oil production."

How does Lufkin, with a market cap of only $699 million, shine in the firmament of artificial lifting? Customer satisfaction surveys hold a clue. Thus, in 2007, Lufkin earned a kind of four-star honorable mention in the biennial Customer Satisfaction Survey published by EnergyPoint Research. Specifically, it won the maximum number of plaudits for companies that did not garner enough evaluations to be eligible for the primary rankings. In 2005, when it did so qualify, Lufkin ranked third in a field of 28.

"They are clearly a player in artificial lift," Doug Sheridan, managing partner of EnergyPoint Research, tells Gertner. "[T]hat is a pretty narrow area of expertise, so what happens is they have to live and die by their success with that product and service. So it has to be good. As opposed to an integrated service provider, like Schlumberger, [which] can really say, 'Well, we may be average in some areas, but we are really good in others, so we accept the average or below-average areas and look at us from an entire package.' A guy whose job is focused on trying to increase production at a well using artificial lift ends up being frustrated with some of the integrated providers. Lufkin does not suffer from that. As a matter of fact, they execute very well. They are very well regarded, not only in terms of sales, but also execution. One of the things that you see that is really important in this sector is after-sales support. Meaning, how did it work out? What do we need to do to make sure you get the results you were looking for? And what can we do to be accountable to you for what your expectations were for us?"

London-listed John Wood Group (with a market cap of $2.5 billion) and Weatherford International (valued at $13.3 billion on the Big Board) are Lufkin's principal investor-owned comps, and there's not much difference in valuation among the three. Lufkin's principal distinguishing financial feature is its balance sheet. As against $419 million in book equity, it has just $2.3 million in long-term debt. Wood and Weatherford show debt-to-equity ratios of 37.5% and 65.7%, respectively. Such debt as Lufkin has is not homegrown but imported. It was, specifically, affixed to International Lift Systems, a maker, installer and servicer of so-called plunger lift systems, which Lufkin acquired for $45 million in March—a month when not many other companies had the courage or wherewithal to shop for acquisitions. "They provide an entry for Lufkin into the offshore market for artificial lift wells," said the buyer's press release, "including deepwater plays, and they expand our reach into the artificial lift market."

We write in praise of Lufkin a little more than two months after Natco Group (*Grant's*, January 23) was scooped up by Cameron International at a 30% premium to the prevailing Natco share price. Gertner was the office Natco bull, and he has this to say, in closing, about Lufkin: "I view Lufkin much as I did Natco. Both companies have a narrow focus and highly satisfied customers (Natco was ranked fourth in the 2005 EnergyPoint survey), and both are positioned to capitalize on the engineering problems associated with the aging of the world's oil production. Like Natco, Lufkin has the financial strength to survive lean times. I have not seen Lufkin mentioned as a takeover candidate, but it would be a good fit with a larger oil-field service company. After all, none of these fields is getting any younger."

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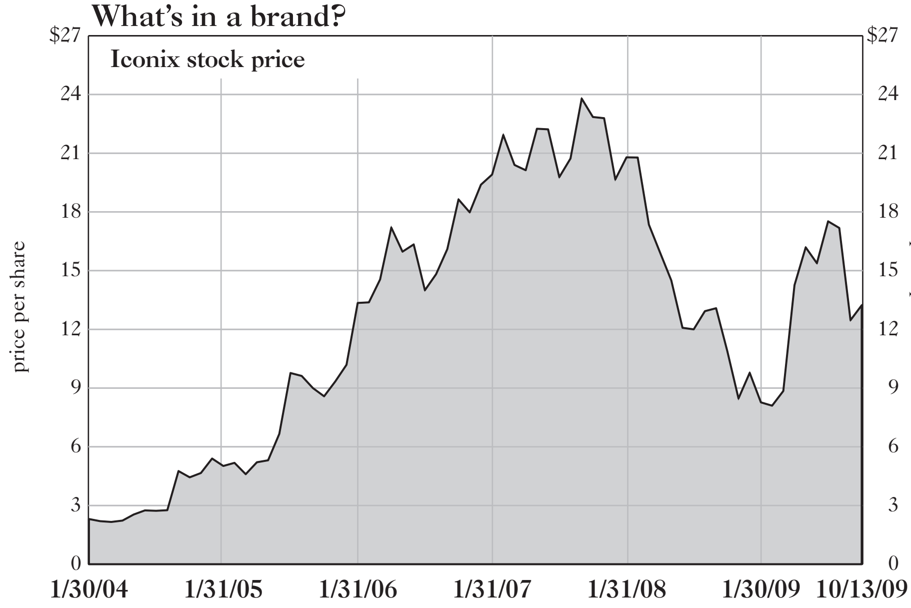
House of brands

(October 16, 2009) Into Mr. Market's quavering hands, the management of Iconix Brand Group (ICON on the Nasdaq) consigned a press release dated September 30. "The company," the text read, "is revising its full year 2009 revenue guidance to a range of approximately $215 million to $220 million from prior guidance of $223 million to $230 million." Actually, management added, the evident revenue miss represented a 5% revenue increase from the comparable period a year ago. But it was no good: The confession drilled the share price for 21%, wiping out $237 million of stock-market capitalization.

The burden of the following analysis is that Mr. Market was a little hasty. Iconix, which owns and licenses a portfolio of established consumer brands, may yet have a future, assuming the consumer does. About this contingency, admittedly, there are doubts. In a recent single edition of *The Wall Street Journal*—that of October 8—there's fully a week's worth of bad news. Thus, holiday spending will be 1% less than last year's, which was 3.4% lower than the prior year's, according to the National Retail Federation; this year's tally of retail-store closings (8,300 through September) is greater than all of last year's (6,900), according to the Federal Reserve; and 10.3% of retail space at U.S. shopping centers was vacant in the third quarter, up from 8.4% in the third quarter of 2008, according to Reis Inc.

Iconix, we are about to contend, is likely to ride out the slump and prosper in the upturn. What the company does for a living takes a little explaining. It buys intangible things—brands—and licenses others to sell them. It is the beau ideal of the "tangible-lite" business highlighted in the April 17 issue of *Grant's*. Brands may or may not endure, but at least they don't require painting, new software or retrofitting with new power trains. They are lighter than air. Some 77% of Iconix's assets are of this nature—goodwill, trademarks, etc.—which obviates the risks associated with inventories and manufacturing operations.

What's in a brand?



source: The Bloomberg

The tangible-lite business model is geared to producing high EBITDA margins (in the 70s in this case) and lots of cash. Management forecasts free cash flow this year of $125 million or so on revenues of $225 million or so. Of course, there are corresponding risks. Brands, like the ether, can go pfft, and there is only so much comfort in knowing that the company is quoted in the stock market at book value. By writing down its $1.2 billion of intangibles to zero, management would eliminate that book value 1.4 times over.

Iconix owns 18 brands with $8 billion in annual sales. The list is as follows: Candie's, Bongo, Badgley Mischka, Joe Boxer, Rampage, Mudd, London Fog, Mossimo, Ocean Pacific, Danskin, Rocawear, Cannon, Royal Velvet, Fieldcrest, Charisma, Starter, Waverly and Ed Hardy. These brands the company licenses to designers, manufacturers, distributors and retailers. Licensees pay a royalty based on net sales and a certain amount, in addition, for marketing and advertising. Brands may not literally rust, but they do grow stale (the average Iconix brand has been around for 52 years), and the company works to keep them fresh. Gisele Bundchen, Britney Spears, Brooke Shields and Tony Romo are among the celebrities who have sprinkled stardust on Iconix's wares.

Iconix may license a wholesale supplier to sell authorized products to stores within an approved channel of distribution. Or it may license a single retailer to sell a range of branded products within a certain geographical area. For instance, Kohl's has an exclusive license to sell the Candie's brand in the United States across two-dozen product categories. Similarly, Target has Mossimo and Wal-Mart has Ocean Pacific, Danskin and Starter. Direct-to-retail licenses accounted for 50.5% of Iconix's revenues in the first half of this year, almost double the year-ago volume. Retailers like holding the proprietary rights to a national brand without the risk of being undercut by a nearby competitor.

Brands don't come for free, as the growth in Iconix's balance sheet attests. Since year-end 2004, the company's share count has more than doubled, to 71 million from 28 million shares, and its debt has grown to $576 million from $25 million. Among these obligations are $240 million of convertible notes, the 1.875s of June 2012, unsecured and convertible at $27.56 a share. "Balancing that debt," observes colleague Dan Gertner, "is $500 million of guaranteed minimum royalty payments for current licenses, excluding any renewals, and $216 million of cash. Guaranteed minimum royalty payments are due regardless of the amount of sales. Such guaranteed payments have recently accounted for 70% of royalty payments. Besides Kohl's, Target and Wal-Mart, top licensees include K-Mart/Sears and Li & Fung. The expiration of the licenses is staggered over the next five years."

On the second-quarter conference call, Iconix management talked up its ambitions to make acquisitions and to expand overseas. "On the international front this quarter," said CEO Neil Cole, "we signed our third deal in China for our Rocawear brand. Between Rampage, London Fog and Rocawear, we epxect our brands to have well over 500 stores in China within the next three years. To reiterate our China strategy, we are targeting the masses. And rather than opening up a handful of stores in a few major cities, our partners anticipate opening up hundreds of stores in the densely populated non-major cities all over greater China." This sounded bullish, indeed, although Cole is not so personally bullish that he did not choose to sell 650,000 of his own shares in connection with a recent secondary offering (the sale leaves him with 2.6 million shares, or 3.6% of the outstanding; insiders collectively hold 7.1% of shares outstanding).

Iconix trades at 12 times its downwardly revised 2009 earnings estimate and 10.9 times the Street's 2010 forecast of $1.20 per diluted share, i.e., roughly half the multiples commanded by the larger retailers with which Iconix does business and roughly half, as well, of the valuations of such design houses as Polo Ralph Lauren and Guess? Inc. "The Iconix share price," Gertner winds up, "moves up grudgingly on good news and is thrown for a loop by bad news (witness the reaction to the slight revenue miss).

Iconix Brand Group
(in $ thousands, except per-share data)

	12 mos. to 6/30/09	2008	2007	2006
Licensing	$216,303	$216,761	$160,004	$80,694
SG&A	(70,423)	(73,816)	(44,254)	(24,527)
Other income (expenses)	(365)	(1,421)	6,039	(2,494)
Net interest	(30,151)	(32,598)	(25,512)	(13,837)
Taxes	(41,425)	(38,773)	(32,522)	(7,335)
Net income	73,939	70,153	63,755	32,501
Earnings per diluted share	1.14	1.15	1.04	0.72
Cash and restricted cash	216,057	83,145	68,458	68,458
Receivables	57,909	47,054	29,757	14,548
Prepaid advertising	13,406	14,375	5,397	2,704
Property and equipment	6,067	6,719	1,293	1,384
Goodwill	165,001	144,725	128,898	93,593
Trademarks and intangibles	1,056,966	1,060,460	1,038,201	467,688
Total assets	1,592,251	1,420,259	1,336,130	696,244
Current liabilities	74,051	103,193	76,410	35,705
Long-term debt	516,700	594,664	649,590	140,676
Shareholders' equity	864,539	613,526	527,920	465,457
Share price	$13.02			
Market cap	928,316			
Price/book	1.1x			
Price/earnings	11.5			

There are plenty of signs urging caution when it comes to the American consumer, but the stock seems to be priced for worry. Add the safety of a guaranteed royalty stream to a reasonable valuation, and a bullish investor may be allowed to contemplate the possibility of something going right."

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Warm thoughts on a cold metal

(February 19, 2010) Earnings season is almost over, but for GLD it never began. Not since the earth's crust cooled has the 79th element in the Periodic Table earned a dime. Yet that hasn't stopped SPDR Gold Trust, a.k.a. GLD, from becoming an institutionally recognized investment asset. Still, the question hangs in the air: What's an ounce worth?

Now begins a reappraisal of our Nov. 27 reconsideration. That essay, skeptical in tone, ran under the headline, "Cool thoughts on a molten metal." Its thesis was not that the gold price was too high (who knows how high is too high?), but rather that its rate of rise was too fast. The central banks of India, Mauritius and Sri Lanka had very publicly bought gold instead of U.S. Treasurys. The Indian government, first of the three out of the gate, had relieved the International Monetary Fund of 200 metric tons at an average price just below $1,050 to the ounce. China must be next in line, some bulls reasoned. Others took a simpler approach to the valuation problem. The charts looked good, they said.

Then the price stopped going up and started going down—and now we're bullish again. Our approach to the valuation question is different from the chart readers' but almost as simple. Gold is a monetary asset, we reason. It competes with other monetary assets, notably with paper currencies. And it competes, too, with credit, which is the promise to pay money. In Europe, especially, gold shines brighter every day next to the competition, either to the coin of the realm or to the sovereign obligations denominated in that coin.

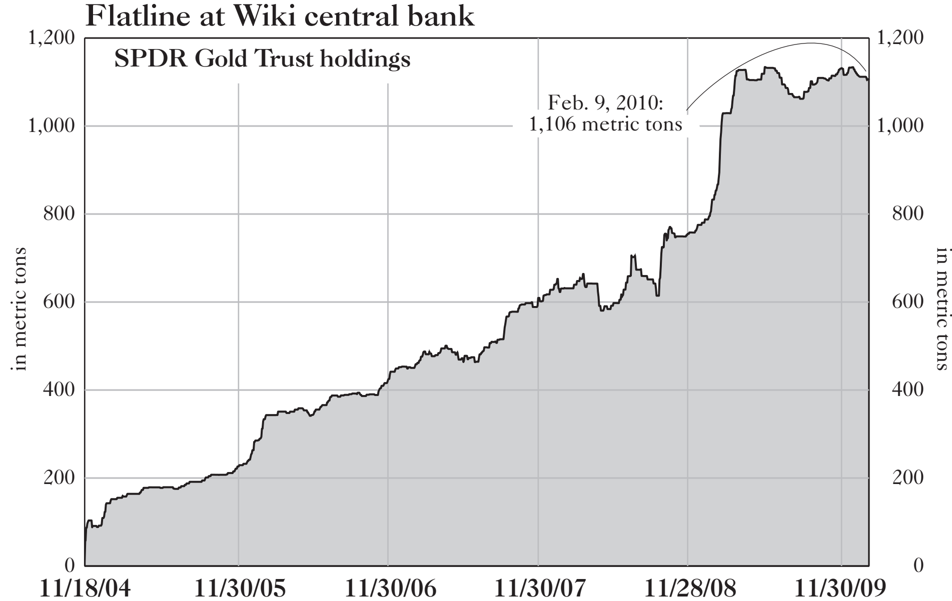
Money is intrinsically valuable, which sets it apart from credit, which may or may not be valuable. During the late crisis, people wanted $100 bills because they were worth $100. General Electric commercial paper, on the other hand, was worth par with a Treasury guarantee, a little less—perhaps a great deal less—without one. Way back when, under our beloved gold standard, monetary value was intrinsic in the money itself. Under the law, you could exchange dollars for gold, and gold for dollars, at a fixed rate. Growth in the world's monetary base was under the control of mining engineers as much as it was of bankers. The dollar was anchored and so, to a degree, was dollar-denominated credit. But not since 1971 has any currency been so endowed. Monetary value, rather, is conferred by governments under the direction of the kind of people who participate in the panel discussions at Davos, Switzerland. Gold may be hard to value, but you can tell it's worth something just by looking at it. The euro, too, is hard to value, but it is inherently worth nothing, absent a government to stand behind it.

By this line of argument, the crisis of the euro should be hugely bullish for the gold price, denominated either in dollars or euros. What could be better for bullion than trouble for the made-up European money that not only circulates on the Continent but also claims a 28% share of the world's central-bank vault space (compared with 62% for the U.S. dollar)? But the euro's weakness is the dollar's reciprocal strength, and an appreciating dollar exchange rate conventionally implies a depreciating dollar gold price. Then, again, not much about this juncture in world monetary affairs is conventional.

We say we are bullish, but we have no idea where the price is going. And neither do you, whoever you are. The gold price, it has sometimes seemed to us, is the reciprocal of the world's faith in the judgment of Ben S. Bernanke. The greater the trust, the lower the price, and vice versa. You would suppose, after all the blood, sweat and tears of the past three years, that the market would not trust the chairman of the Federal Open Market Committee further than it could throw him. Yet the gold price is not $3,000 but one-third of that. It makes you humble, if you happen to be in the soothsaying business. The dollar system will come a cropper, we believe, but it will evidently do so on its own schedule, not ours. Maybe the euro system will lead the way to chaos. The outer limit on the precision of our forecast is contained in the phrase, "We are bullish on gold."

The gold bull market is a decade old, but only recently has the Street begun to flatter the barbarous relic with research coverage. Trained to divine the net present value of a future stream of earnings, the analysts have cast around for a quantitative approach to a sack of Krugerrands. "Undaunted," colleague Ian McCulley notes, "the sell side, needing to fill pages with 'rigorous' analysis, has cooked up all manner of correlation and regression studies connecting the gold price to real interest rates, money supply, inflation, inflation expectations, investment demand and the dollar exchange rate. But no matter how hard the analysts try, gold still doesn't yield anything."

Flatline at Wiki central bank

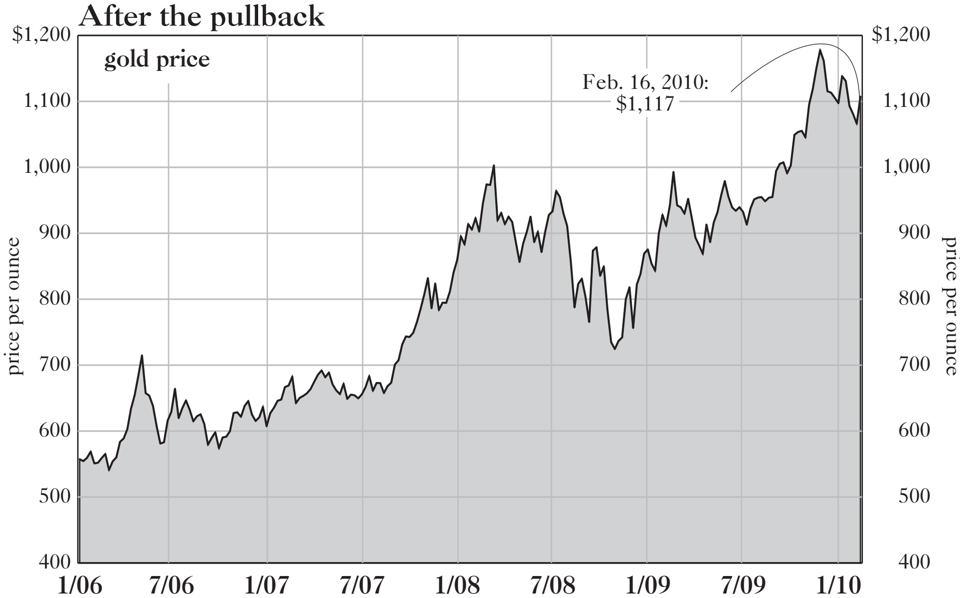


source: The World Gold Council

A recent report from one of the government-supported New York banks lays out the bearish case on the metal that used to line that institution's vaults in the days when it was independently solvent. The authors of the study—who, let the record show, were not the ones who ran the bank into the ground—argue that the gold market has lost a number of its bullish props. "Investors and speculators are the main driver of the gold price," they write. "There is no support at current prices from mine and scrap supply (which is rising), or fabrication demand (which is plummeting), in our view. U.S. dollar weakness and increased money supply has been the main driver of investment demand and speculative flows, we believe, and any strength in the U.S. dollar is the main risk to prices." And if the rising dollar exchange rate isn't bad enough, the bulls confront benign inflation, rising mine supply, a rhetorically stern Fed, a worrying swoon in U.S. monetary growth and an evident peaking in the level of gold reserves held in the London vaults of the SPDR Gold Trust.

"Wiki central bank," this publication has coined the GLD hoard. Even if no government has the courage of our convictions, any brokerage-house customer can choose to go on his or her own personal gold standard. And it seemed as if a people's gold standard were in the making during the pounding heart of the financial crisis.

After the pullback

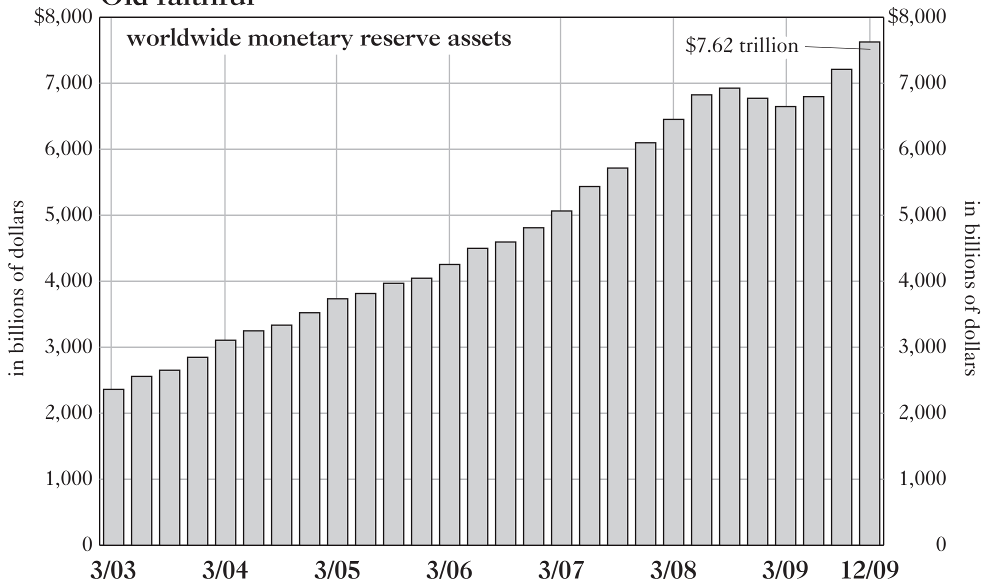


source: The Bloomberg

On the day the Fed bailed out AIG, Sept. 16, 2008, GLD held 614 metric tons; by March 2009, the stockpile had nearly doubled, to 1,127 metric tons. In dollar terms, it more than doubled in those six months, to $33 billion from $15 billion. But, lately, there has been stagnation, or shrinkage: to 1,106 metric tons at last report from a peak of 1,134 metric tons in June 2009. In point of fact, the GLD vaults have relinquished relatively little bullion compared to losses in previous bouts of gold-price weakness (thus, from March to May 2008, they surrendered 12%, compared to just 2.4% from June 2009 to this point in 2010). However, the analysts whose work we have been quoting see the vault as half empty, not half full. Investors, they contend, "are no longer concerned with counterparty risk and collapse of financial systems, but continue to want exposure [to] gold as a U.S. dollar hedge, inflation hedge and interest-rate hedge."

While we can't speak for all investors, we can speak for ourselves. We buy gold as an investment in monetary disorder. Fractional-reserve banking systems are historically prone to runs and deflationary contraction. Paper-money systems are inherently prone to inflation. Our modern financiers have created something new under the sun. They have devised a paper-money-cum-fractional-reserve-banking-system (with yet another credit structure, also highly leveraged, lurking in the shadows) that is prone to inflation and deflation at one and the same time. The greatest generation? In devising infernal financial machines, we're the one.

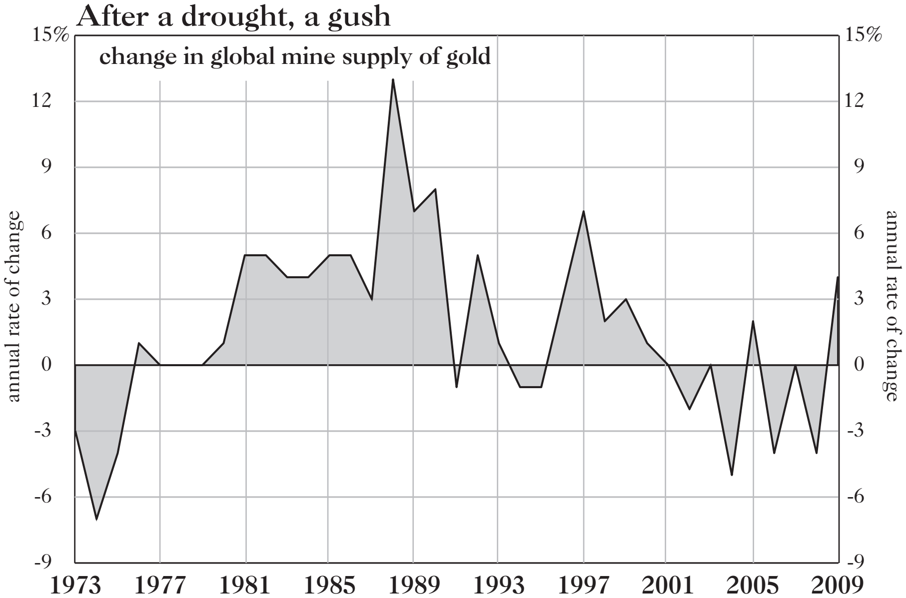
Old faithful



source: The Bloomberg

The United States properly takes top honors for frenzied finance, but Europe is no slouch, either. "The real problem on the Continent," McCulley relates, "is not so much the ability of France and Germany to backstop the debt of some of the weaker euro-zone sovereigns, but, rather, whether France and Germany can backstop the various exposures that their banks have accumulated. According to third-quarter data from the Bank for International Settlements, German banks have exposures of $43 billion to Greece, $47 billion to Portugal, $240 billion to Spain, $193 billion to Ireland and $209 billion to Italy. French banks have exposures of $79 billion to Greece, $36 billion to Portugal, $185 billion to Spain, $69 billion to Ireland and $489 billion to Italy. For comparison, the German banks have $625 billion of capital, the French banks, $620 billion. As a percentage of GDP, German banks' exposure to the weaker euro-zone members amounts to 22%; for the French banks, the equivalent figure is 32%. Of course, one could calculate the exposures of Citi and J.P. Morgan to California. The point is that throughout this crisis, governments have moved an ever-growing body of liabilities to public-sector balance sheets from private ones. At some point, there isn't much more debt you can pile on already over-burdened national treasuries. The burden might eventually have to fall on central banks, which—unlike gold miners—can create money on a computer keyboard."

After a drought, a gush



source: U.S. Geological Survey

Many a discouraged gold bull is tapping his or her foot for the return of last autumn's thrilling season of central bank gold buying. Two weeks ago, when the price fell within $20 of the $1,042-to-$1,049-an-ounce range that India had paid the IMF, Andy Smith, analyst at Bache Commodities Ltd., London, raised a question: If the price broke lower, would the Indian authorities buy more? "If they don't," he replied in anticipation, "then November's purchase was more a trade than an expression of long-term intent."

So far, the gold price has forced neither India's hand nor China's. Chinese monetary authorities own 1,054 metric tons of the shiny, not-dollar monetary asset, worth $37 billion at today's prices, or 1.5% of overall foreign-exchange holdings of $2.4 trillion. So the People's Republic of China and *Grant's Interest Rate Observer* are once more at loggerheads. We are betting heavily on fractures in the world's dollar-centric paper currency system. China, on the other hand, is betting rather more heavily on stability. Then, again to judge by the recent 13-F filing of China Investment Corp., a sovereign wealth fund under the wing of the State Council, the Chinese may be reconsidering. The filing disclosed ownership of 1.45 million shares of GLD and noted further that 42% of the portfolio is invested in metals stocks.

To our mind, however, central bank buying of gold is not the world monetary authorities' main contribution to a higher gold price. Rather, they do their part just by going to work in the morning—by targeting interest rates or inflation rates or implementing what is euphemistically known as quantitative easing. Global mine supply rose by 4% in 2009, and large North American-headquartered miners are expected to boost output at a compound annual rate of 2.6% until 2016, according to data from Deutsche Bank. Compared to the 1%-per-year rate of decline in global supply since 2000, Deutsche is forecasting a veritable gusher. But no geological monetary asset has ever gushed like the paper or electronic kind. Thus, worldwide foreign exchange reserves, which consist mainly of dollars, are currently showing year-over-year growth of 16%.

Cheering, too, are signs that the gold bulls are on the defensive. At the frothy November peak, out-of-the-money gold calls were three times more expensive than out-of-the-money puts. Months of discouraging price action has bled away much of that premium. "Indeed," McCulley ends up, "now the equivalent out-of-the-money calls trade at less than two times the price of puts. The 'volatility skew,' as the options adepts express the foregoing concept, is the flattest, or most favorable towards call buyers, since the fall of 2008. It can't be said that the options market is exactly bearish on gold, at least compared to the S&P 500, where June SPY puts struck at 25% out of the money are some 15 times more expensive than equivalent calls. But the gold options market is definitely less frothy than it has been in a while. Even John Paulson's new gold fund apparently raised only $90 million, a huge whiff from the whisper number."

We don't whisper but speak out loud: Expecting monetary turmoil, we're bullish on the legacy monetary asset.

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Goodbye, good Lufkin

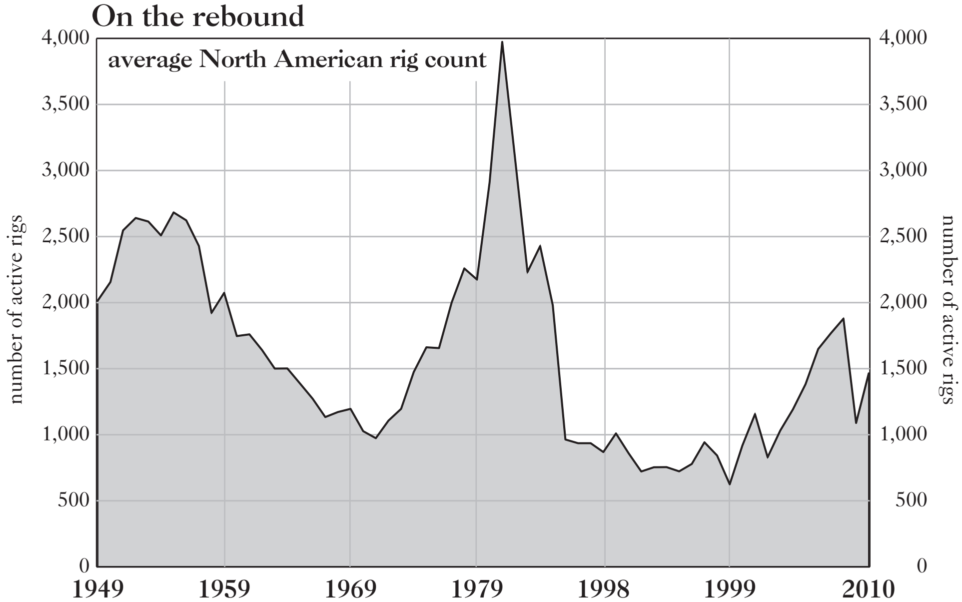
(April 14, 2010) "A little like the stock market itself," said we of Lufkin Industries in the issue of *Grant's* dated Aug. 7, 2009, "Lufkin's shares are neither very rich nor very cheap." Update: Lufkin's shares are very rich. While this fact does not necessarily make them an imperative sale, it does—by the lights of Graham and Dodd—transform them from an investment into a speculation.

These days, every thinking investor—Lufkin bull or not—wrestles with the treetop valuations widely in place. Treasurys at today's levels, for instance, constitute a speculation on a certain kind of economy, not an investment. The yield is too low to afford a margin of safety. So, too, with Lufkin. At 58.3 times trailing net income and 2.9 times book (and at a yield of just 1.2%), the shares are a speculation on higher oil prices and/or on the continued growth in the population of aging, lower-quality oil fields. If the economy collapses in a deflationary heap, or if the oil price revisits $150, you'll be glad you hung on to your long bonds and LUFK.

Texas-based Lufkin, 108 years old, makes equipment to boost the performance of superannuated oil wells. It produces and services gas lift and plunger equipment as well as horse's heads, a.k.a. pumping units. Separately, it manufactures and services gearboxes for industrial applications, including high-speed units for energy-related operations. High speed really means "high," i.e., more than 4,500 revolutions per minute. Oilfield equipment accounts for 70% of revenues, power-transmission devices for the rest.

Lufkin and its shareholders thrive on high oil prices, economic growth—and dissipating oil deposits. Whether or not the so-called peak oil thesis is on the mark, it's music to the ears of the Lufkin bulls. No coincidence that only one month separated the 2008 oil-price high ($147.27 a barrel, in July 2008) from the Lufkin share-price peak ($95.23, in late August). And it

On the rebound



source: Baker Hughes

was around that time that the domestic rotary-rig count hit 2,031, the most since early 1985. The financial crisis cut all three data—share price, oil price, rig count—down to size, but all have recovered from the 2009 lows, LUFK bouncing especially high.

Thus, while the share price is only 10% below its all-time high, the oil price and rig count are 27.1% and 27.9%, respectively, below their levels of August 2008. "And as far as Lufkin goes," colleague Dan Gertner points out, "margins, prices received and order backlogs have yet to rescale the lofty heights of 2007-08." Gross margins in the oil-field segment were 20.6% in the fourth quarter, an improvement from 15% in the third but significantly below the 28.9% posted in the fourth quarter of 2008. On a consolidated basis, gross margins for the fourth quarter were 20.8% vs. 30.5% a year ago and 21% in the third quarter of 2009. Listening to the February earnings call, you can hear the analysts trying to coax the right encouraging words from a somewhat reluctant front office. They were not wholly successful. In response to a leading question about margins, for example, CEO John F. Glick replied that the expected pickup in utilization rates might restore one-third of the lost margin. "But I think there's still going to be pricing pressure out there that will keep us from getting back to the level we saw in '08."

Prices received in the oil-field segment of the business, said Glick in response to another question, have fallen by 15% to 20%, and in some cases as much as 25%, from the boom-time highs. Concerning the companywide order backlog, it stood at $140.3 million at year-end 2009, up by $6.4 million from the third quarter, but down by $177 million, or 55%, from year-end 2008.

"Last August," Gertner observes, "Lufkin was trading at 10.8 times near-peak earnings and at 1.7 times book (and at a yield of 2.1%). After an 82% price levitation, today's valuations might be characterized as stretched. A believer in higher oil prices stemming from a growing contribution to world oil production from lower-quality and aging fields (count me in this group) would assume that margins, prices and backlogs will return to the high-cotton days of 2007 and 2008. But the Lufkin share price appears to have internalized that possibility already. It trades at 14.5 times all-time peak earnings, compared to 7.9 times last August, and 35.3 times the average earnings of the past 10 years, compared to 20 times last August."

Lufkin is a top-flight company, all right—and now with valuations to match.

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Three-dollar tale

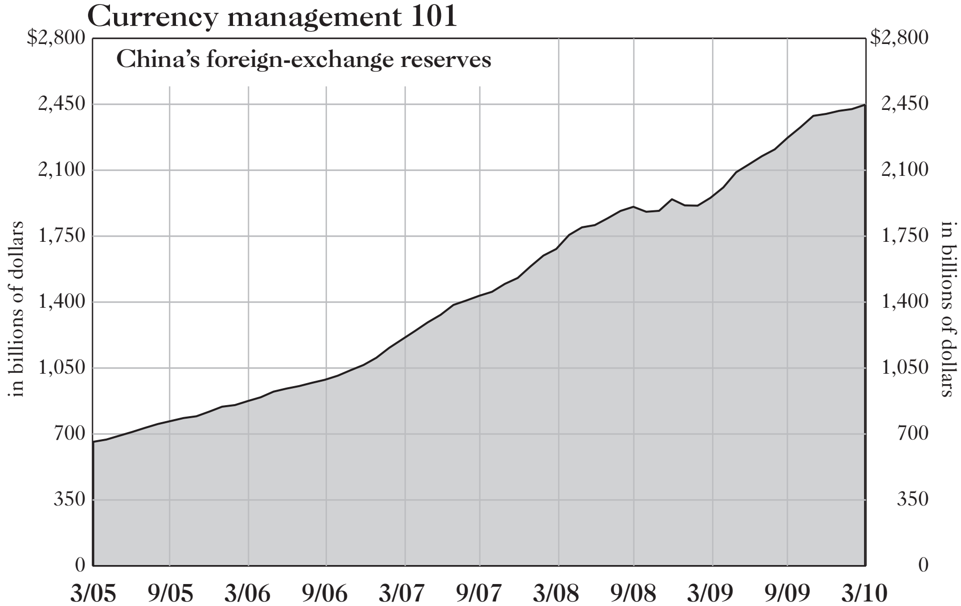
(April 30, 2010) The readers of *Grant's* already know what the Federal Open Market Committee said on Wednesday. The editor of *Grant's* happens to know in advance what the FOMC *didn't* say. "Recognizing its responsibilities as the steward of the world's principal reserve currency," it certainly didn't say, "the committee has voted to raise the funds rate to 3% from 0% to 0.25% to relieve the inflationary pressures building in those Asian economies whose currencies are linked to the dollar." Probably, the thought never crossed its mind.

Now unfolding is a report on those pressures and a speculation on what they mean. In preview, we expect the Singapore dollar to appreciate and the Hong Kong dollar to appreciate—or, just possibly, to depreciate. Holding a certain kind of currency option, one would be paid in either case. In general, we are bullish on Asian currencies in terms of the U.S. dollar, and we are bullish on gold, the legacy monetary asset that nowadays doubles as an option on monetary upheaval, in terms of all currencies. On monetary tumult, we are especially bullish.

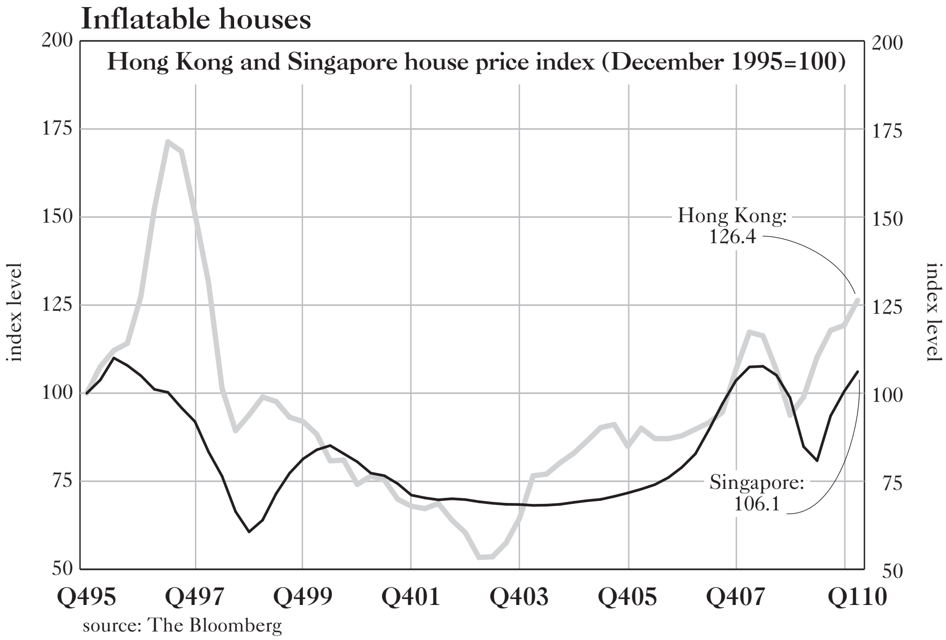
Though widely separated by distance, the two dollars, Hong Kong's and Singapore's, are linked by the rules and conventions of the reserve-currency system. At the beating heart of the system is a certain North American power unto which is given the right to print the world's main money in such quantities as it finds convenient to its own purposes. Because other countries choose to counter these monetary emissions with more printing of their own, the financial world is susceptible to alternating cycles of inflation and deflation. As best as can be ascertained, the world today is celebrating its deliverance from deflation by embarking on a new inflation. Pleasantly, the initial symptoms of the new cycle are taking the form of higher prices for stocks, bonds and real estate. The monetary mechanics of these ebbs and flows are well known to constant readers. For late arrivals, a short refresher course follows.

Living large, the United States pays its bills in the green money that only it may lawfully print. America's foreign vendors exchange those pieces of paper for local currency at the first opportunity. If you were the CFO of

Currency management 101



source: The Bloomberg



the Shanghai Garden Hose & Lawn Ornament Corp., what would you do with a wad of Ben Franklins? You need renminbi. It's in the course of that exchange, dollars for renminbi, that the inflationary impulse begins to throb.

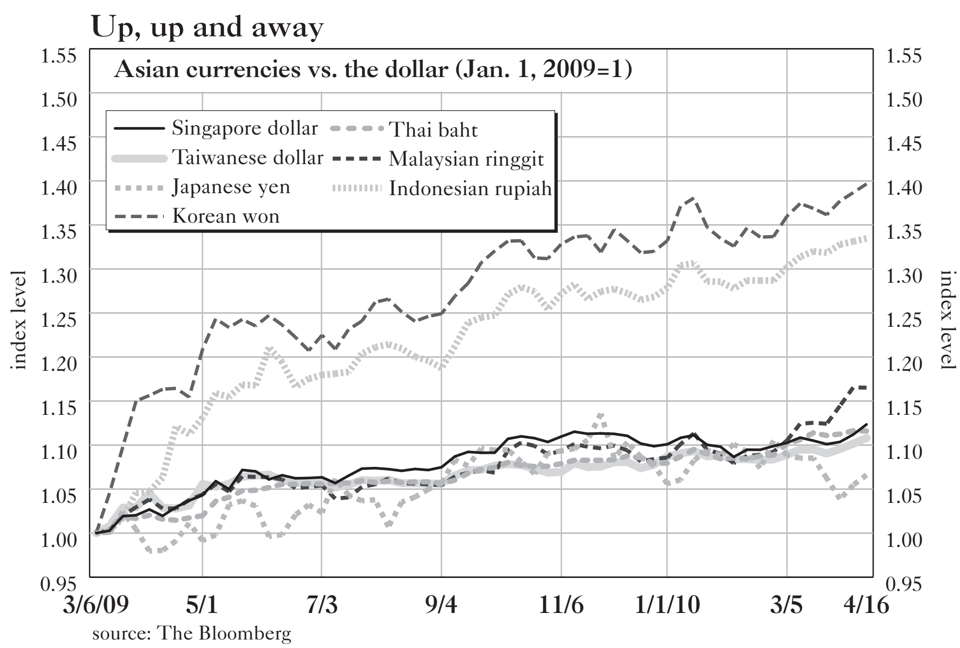
As likely as not, the dollars in which America's vendors are paid wind up in the vaults of the local central bank—for instance, the People's Bank of China. Though China's is an authoritarian government, the PBOC does not just commandeer the businessmen's greenbacks. Rather, it buys them with renminbi, which it gets in the same way the Fed gets dollars. It prints them.

What the People's Bank does with its newly acquired dollars constitutes another jolt of monetary electricity. It invests them in U.S. Treasury and agency securities. It might not choose to invest in U.S. securities so readily if the United States paid its bills in gold. But we do not. We pay in our own special money, which our obliging Asian creditors return to us in the shape of dollar-denominated investments. It's as if the dollars never left home. Meanwhile, the newly printed renminbi circulate in China (less whatever portion of that currency the central bank chooses to neutralize, or "sterilize," through open-market operations). So the Chinese money supply grows and the American money supply doesn't shrink. Asset prices climb on both sides of the world. We, the American people, have our cake and eat it, too.

No schematic diagram of transpacific monetary flows can capture every detail. You may object, for instance, that although America collectively imports more than it exports, no small part of those imports is essentially American, being produced in Asia by U.S. multinationals. The problem, if there is one, you may therefore conclude, lies not with American consumers but with macroeconomic statisticians. They can't keep up with the fast-changing global economy.

But it takes no special insight into intracorporate accounting to see that something is wrong with our bubble-propagating monetary system. Its main blemish is obvious (that is, its main non-euro-related blemish). It is the fact that Asian central banks find it necessary to keep stuffing their vaults with dollars. They buy them because, absent such purchases, the dollar would weaken. Or, to say the same thing, Asian currencies would appreciate. At year-end 2007, China held forex reserves on the order of \$1.5 trillion. One year later, its hoard totaled \$1.9 trillion. At last report, which was at the end of March, it amounted to \$2.4 trillion. Such is the pattern throughout Asia, relates the Asia Development Bank. During the panic of 2008, the pace of dollar buying tailed off. But it picked up in the second quarter of 2009, "and the regional stock of foreign exchange has become even higher than before the crisis. . . . This trend suggests a high degree of exchange rate management in the region."

Mark well the previous sentence. Asian central banks and their governments buy dollars to please themselves. They buy them to manage the value of their currencies against the dollar and, therefore, the competitiveness of their exports denominated in dollars. If America consumes much more than it produces, its Asian creditors willingly produce much more than they consume. The tightly grouped appreciation of a half dozen



Asian currencies, the Singapore dollar included, is the expression of these facts in the foreign exchange market.

Conferring our highest monetary accolade on the Singapore dollar, we have pronounced it one of the least bad paper currencies (e.g., *Grant's*, April 16, 2009). Forex traders rubbed their eyes last week as the city-state disclosed that first-quarter GDP bounded higher by 13.1%, measured year-over-year, or by 32.1% measured sequentially, quarter to quarter, at an annualized rate. With an open economy heavily engaged in trade, Singapore manages its monetary policy not with interest rates but with a composite foreign exchange rate. The Sing dollar's nominal effective exchange rate, a.k.a. "S$NEER," is that trade-weighted rate, and in the wake of the stupendous GDP news, the Monetary Authority of Singapore disclosed that it would allow S$NEER to creep higher. As an immediate effect of this policy, the Sing dollar gained 1.4% on the greenback. It's only the start, we believe.

Before the MAS' disclosure on April 14, zero-percent appreciation was the policy. Coupled with an overnight interest rate of just 0.1%, the city-state's monetary policy was fabulously accommodative. Consequently fabulous in their turn were local monetary growth, the local residential real-estate market and a host of local economic indicators that, like the new GDP data, look for all the world like typos.

Thus, relates colleague Ian McCulley, "M-1 shows year-over-year growth of 17.5%, M-2 of 9.8% and domestic credit of 8%. Forex reserves, which stand at $196 billion—immense for an economy with a $177 billion GDP—have climbed by 16% in the past 12 months. While these numbers don't exactly rise to the level of China's, they are notable for a financial and trading center that suffered a 10% GDP decline in the recession. Especially striking is the resumption of bank lending, something that Europe and the United States have been unable to achieve. In the past 12 months, Singaporean loans have risen by 5% and overall banking assets by 8%. Stock-market margin loans pace lending growth, up by 78% year-over-year, a period in which the Singapore stock market rose by 61%. Residential mortgage loans show 16.5% growth in the 12 months, during which time an index of house and residential property prices increased by 25%."

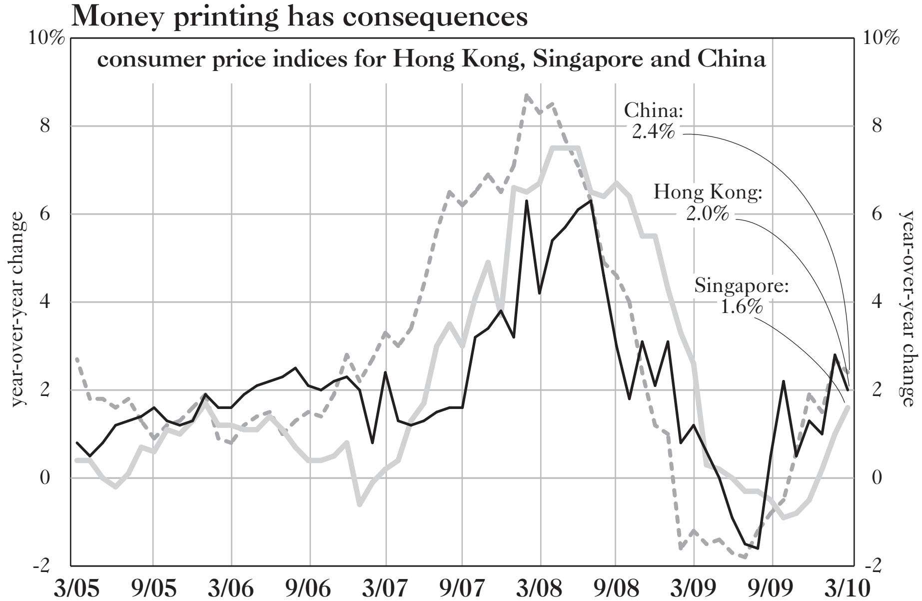
In Singapore, as, indeed, throughout Asia, prophets of a V-shaped, rip-roaring recovery look like geniuses. Top to bottom, 2008-09, the city-state's exports fell by 42% and its imports by 41%. But collapse has given way to resurgence, with container traffic showing 16% year-over-year growth in the first quarter. Over the past 12 months, non-oil exports have soared by 27%, tech exports by 39% and industrial production by 43%. "With the Q1 expansion," observes the MAS, "the Singapore economy has now fully recovered the output lost during the recession, and economic activity in a broad range of industries has exceeded its peak. As a result, the economy's output gap turned positive in Q1 2010."

That means, the MAS estimates, the Singapore economy is humming fast enough to risk overheating. Specifically, it is growing fast enough to tax the existing structure of production to the point of generating a rising rate of inflation. Let us assume that the diagnostics are on the beam. In the face of this inflationary red light, the little-city-that-could continues to maintain that 10 basis-point money rate that it willingly (now, perhaps, reluctantly) imports from the United States.

In the 12 months to March, Singapore's consumer prices were higher by just 1.6%. However, since inflation takes many forms, there is only so much consolation to be taken from that fact. "Interest rates are low enough that nearly any size mortgage can be made to seem affordable," McCulley reports. "I went to the United Overseas Bank's Web site to play with the calculator that lets you see how much you can afford to borrow based on your income. I plugged in S$8,000 a month—the equivalent of US$5,800. I indicated that I had no debt (i.e., no non-mortgage debt) and chose a 35-year repayment term. The maximum amount I could borrow was S$800,000, which means the bank is comfortable making a mortgage loan exceeding eight times my indicated annual gross income. Even in the United States, back in the roaring mid-2000s, a ratio like that would have made a WaMu lending officer blink. What makes this stretch 'affordable' is that the bank is charging an interest rate of roughly 125 to 150 basis points over the three-month swap rate, or less than 2% all-in, for a monthly payment of only S$2,500 a month—until rates go up, of course."

Then, again, McCulley relates, unusual are loan-to-value ratios above 80%, and the ratio of household debt to GDP, at 72%, is well below the peak reading of 95% set in 2003. Besides, this is Singapore, where the government bosses the citizenry

Money printing has consequences



source: The Bloomberg

in ways unimaginable even to the busybody mayor of New York City. But rules and regulations—such as prohibiting the sale of certain kinds of apartments until the owners have occupied them for three years—can stem only so much of the monetary torrent. Visible even from Wall Street is a glaring disparity between the invisible bank rate and the white-hot economy. If the FOMC on Wednesday astounded the world by saying what we previously insisted it would never say in a million years, Singapore's monetary problems would be well on their way to a solution. But because the chances of that are, let us say, remote, the MAS must weigh other options. If the local economy continues to thrive and if the Fed refuses to budge, Singapore will have little choice but to put its dollar on a faster track of appreciation.

In exchange-rate policy, Asia is split between countries that cast their monetary lot with the U.S. dollar and those that have chosen to keep some distance from it. Thus, since March 2009, the South Korean won has appreciated against the greenback by 40% and the Indonesian rupiah by 34%. These currencies are, however, outliers. The Sing dollar, ahead by just 10%, is more typical of the region's exchange-rate experience. Most Asian currencies have crept, rather than zoomed, higher, because the relevant monetary authorities have suppressed their rise by exchanging dollars for the local monetary product. The Sing dollar, as the accompanying graph points up, is part of an exchange-rate grouping that includes the yen, Taiwanese dollar, Thai baht and Malaysian ringgit. Each has appreciated against the dollar on the order of 10% since March of last year.

Which brings us to the Hong Kong dollar, in which we believe we have identified a speculation high on potential and low on risk. As you know, under the currency-board system in place in the former Crown colony since 1983, the Hong Kong Monetary Authority backs each one of its dollars with one of Ben Bernanke's. For all intents and purposes, the Hong Kong and American currencies are interchangeable.

Is that system an anachronism? Hong Kong, after all, is today a "special administrative region" of the People's Republic. Like mainland China, of which it is a political and economic appendage, Hong Kong references the value of its currency to the dollar. The difference is that China, by dint of its tightly controlled capital account, does not import, in toto, the policy of the Federal Reserve.

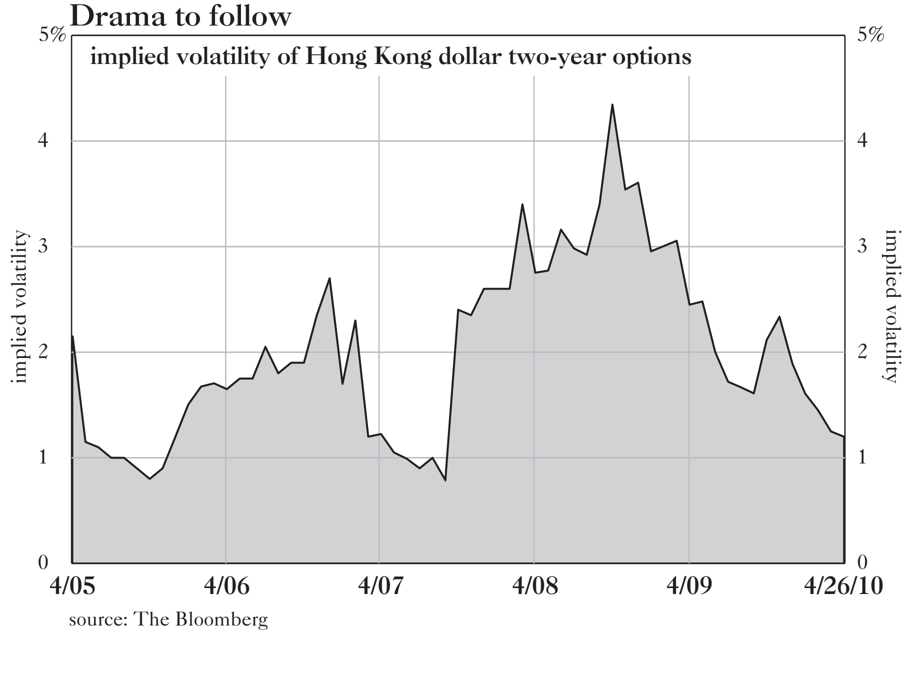
Hong Kong's dilemma is, therefore, greater and more pressing than Singapore's. Like Singapore, Hong Kong is not a natural candidate for a zero-percent funds rate. Earlier this month, Dow Jones Newswires quoted Mark McCombe, chief executive of HSBC in Hong Kong, as saying that local economic growth is accelerating and that first-quarter GDP growth, due for unveiling on May 14, will likely come in at 8% (in calendar 2009, it contracted by 2.7%). In the past 12 months, Hong Kong M-1 has grown by 36% and its mortgage loans by 12.2%. Foreign exchange reserves—read "dollars"—are higher by 39%. Property prices are on fire, up 6% so far this year after a 27% gain in 2009, reaching their highest level since the 1997-98 Asian financial meltdown. Yet, on account of the zero-percent fed funds rate, the Hong Kong wholesale funding rate is also approximately zero percent—just what a boomtown needs.

And what do the city fathers have to say about this combustible state of affairs? "The rise in property prices since last year," John Tsang, Hong Kong's financial secretary, told lawmakers on April 21, "is largely attributable to an environment with extremely low interest rates, abundant liquidity and a relatively low supply of flats coinciding together." Tsang called this alignment of the stars an anomaly. "As the global economy recovers," he went on, "countries around the world will start exiting from their measures against the financial tsunami. Liquidity will be withdrawn and interest rates will reverse to a more normal level." Tsang may so hope, but the western-most Federal Reserve district is San Francisco. Exactly no part of the Fed's councils is concerned with the overheating of foreign economies that choose to import American-made interest rates.

Echoing his counterparts in Singapore, Tsang sought to cut the intoxicating power of minuscule interest rates with cautionary words. "I appeal to citizens and small investors who would like to buy a flat," he said, "to carefully assess the impact of future interest rate hikes on their ability to repay their mortgages. . . . Small investors should assess their own capabilities and future incomes, including the stability of their jobs, before making what is possibly the biggest investment decision of their lives." Still and all, Bank of China Hong Kong is advertising floating-rate mortgages at loan-to-value ratios of up to 95%.

No FOMC hawk is more impatient than Tsang to get on with the job of

Drama to follow



source: The Bloomberg

"removing excess stimulus." What to do? The unthinkable is one possibility. By abandoning the dollar peg, Tsang could raise local interest rates, thereby getting a jump on the next inflation before it has had a chance to get out of control—if that time has not already passed.

In the prior issue of *Grant's*, we allowed ourselves to speculate that the renminbi/dollar exchange rate might as easily move to the downside as to the upside. But let us say, for argument's sake, that the conventional view is correct. We'll assume that an upward revision is in the cards. What, then, for the Hong Kong dollar? A reciprocal upward adjustment? An end to the beloved currency board?

"The possibility of a change in currency regimes," McCulley notes, "is something to consider, especially given the clear focus the authorities in the government and monetary board have placed on preventing bubbles in Hong Kong. Even better is that the market thinks there is no chance of fundamental change. U.S. dollar/Hong Kong dollar volatility on currency options is within a hair's breadth of all-time lows. You can buy two-year calls struck 10% out of the money for 17 basis points (going out five years will cost you 47 basis points). Or, taking an agnostic view of the direction of change, you could buy a strangle with strikes set 10% out of the money on either side, up or down, two years out for 33 basis points. HSBC and Barclays, among others, make markets in Hong Kong dollar options. With prices so cheap, you could make money simply from an increase in implied volatility, perhaps as a result of a Chinese revaluation or—to return to thoughts outside the box—devaluation."

On Wednesday, the FOMC will utter its pronouncements as if it were setting interest rates for the 50 states alone. The truth is that it makes monetary policy for most of Asia. That Asia is booming isn't exactly the Fed's problem. But it could be the currency speculator's opportunity.

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Profitably wasting away

(June 11, 2010) Some managements suffer a bear market in silence, but not the front office of PDL BioPharma (PDLI on the Nasdaq). It would like you to know that, unlike the typical biotech company, PDLI earns a profit, pays a dividend and refuses to invest in R&D. "Also, frankly," CEO John McLaughlin remarked at a JMP Securities research conference last month, "if somebody wants to make an attractive offer for the company, it's for sale."

Now resumes the bullish analysis begun in the issue of *Grant's* dated July 24, 2009. "High-yield equity" was the headline over the first installment, and the sentiment was right as far as it went. From that day til this, PDLI paid out $2.67 a share in dividends. Unfortunately, in the same 11 months, the share price dropped to $5.08 from $8. No, come to think of it, not "unfortunately." From the Graham and Dodd vantage point, a good investment has become cheaper. The word is "fortunately."

Make no mistake: It's the destiny of PDLI to become much cheaper. The company's business is managing and licensing a patent portfolio. Since the patents expire in 2013 and 2014, the company, along with its share price, will finally dry up and blow away. What might happen on the road to extinction is the question before the house.

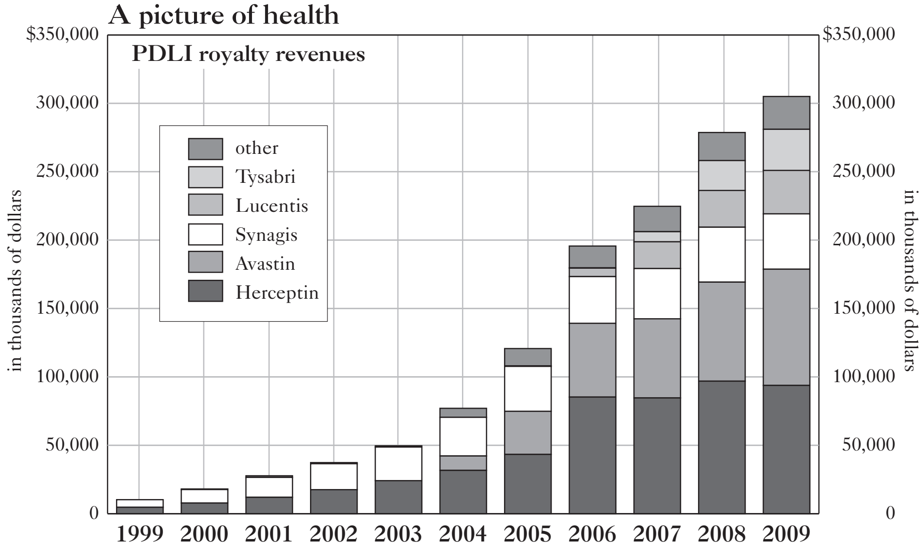
PDLI got its start in 1986 as Protein Design Labs, "a biopharmaceutical company focused on discovering, developing and commercializing innovative therapies for severe or life-threatening illnesses." And those things it did do. It was issued seven patents between 1996 and 2000, covering the humanization of antibodies. The "Queen et al." patents they are called after Dr. Cary L. Queen, from whose brain they principally sprang. Certain rights under those patents are what PDLI licenses to biotechnology and pharmaceutical companies. The business model is simplicity itself: In come the royalty payments; out go the dividends.

The science behind the royalty income is a little more complex. Antibodies are the company's stock in trade. An antibody is a protein found in blood and bodily fluids that combats invading bacteria and viruses. In the laboratory, scientists can create antibodies by injecting tumor cells into mice. The object of the exercise is to produce mission-specific antibodies, e.g., ones that attack cancer cells. Because the mouse-bred antibodies are tailor-made for mice, they must be adapted for use in people, i.e., "humanized." Which is where the PDLI patents come in.

The humanized antibodies are used in therapies for the treatment of cancer, blindness, multiple sclerosis and rheumatoid arthritis. They are embedded in seven marketed drugs (see the nearby table) and in drugs undergoing Phase 3 trials for the treatment of Alzheimer's and Type 1 diabetes.

The PDLI investment story could be a case study in the attention span of markets. An April 29 disclosure of flat revenue in the first quarter, measured year-over-year, was the

A picture of health



source: company

apparent catalyst for a 22% drop in the share price. Revenues were flat because PDLI has stopped receiving royalty income for Synagis, an infectious-disease-preventing drug manufactured by MedImmune. The royalty income stopped because MedImmune, which had been dutifully paying PDLI and its predecessor for 10 years, decided to contest the patent. "Nobody could have seen this coming," the now-standard line spoken by the great and the good of American finance to excuse themselves for culpability in the debt collapse, cannot reasonably be invoked in the case of the PDLI revenue miss. Management itself warned about it on the 2009 first-quarter conference call (*Grant's*, July 24). The real news in PDLI's first-quarter financials was its 35% year-over-year increase in revenues apart from Synagis.

Colleague Dan Gertner (who, let the record show, owns the stock) has updated the earnings model he produced last summer. "The major inputs are the same," he relates: "royalties/license-agreement revenues, general and administrative expenses, interest expenses, taxes and dividends. I made my projections out to 2015, the year after the last of the patents expire. I assumed 5% annual growth in G&A expense and a 35% federal tax rate (in Nevada, where the company is domiciled, there is no corporate income tax). I assumed that the company will repurchase its debt—two convertible bonds outstanding worth $344 million that it has been buying in the open market and a $300 million securitization outstanding—over the next three years, thereby reducing and finally eliminating interest expense. And I assumed that dividends were paid with two tactical objectives in view: first, to build up enough cash to pay down debt, and, second, to return cash to shareholders in a timely manner (i.e., to avoid building a cash mountain).

"The major driver of PDLI's results is revenue growth," Gertner continues. "In the past four years, royalties and license-agreement revenues have grown by 26% a year. For my base case, I assumed no revenue growth in 2010 on account of the aforementioned MedImmune dispute. And I assumed that revenues in 2015 will be one-quarter of 2014 revenues, since the company is paid with a one quarter lag. Thus, drug sales in the fourth quarter of 2014 would generate royalty income in the first quarter of 2015."

To earn back today's share price in dividend payments alone, Gertner finds, revenues would have to grow by an annual rate of 5.6%, or less than one-sixth of the year-over-year growth shown in the first quarter, ex-Synagis. A second table indicates the interplay between revenue growth and expected rates of return. Thus, with a 15% annual increase in PDLI's top line, an investor would earn a 11% return on his or her dwindling principal, dwindling because PDLI, like a gold mine, is a wasting asset. Top-line growth of 25% would generate an annual return of 19%.

"[T]he most important of our patents expire in December of 2014," said CEO McLaughlin at the conference last month, "but, in fact, we anticipate we will get paid longer than that period of time, and the reason for that is, under patent law, you are paid for product that is made or sold. So if our product is sold after the patent expiry, but made prior to it, we get paid." To cook up a bulk batch of antibodies requires five months. Quality-tested and frozen, the material is held in inventory. No just-in-time for the consumers of this commodity; they typically keep 12 to 24 months' worth on hand. It's therefore not unreasonable to expect that PDLI will continue to receive royalties through 2015 and into 2016. Gertner's base case makes no allowances for this possible source of out-year dividends.

Another potential source of pleasant surprise is the demonstrated growth in the sale of Genentech drugs from which PDLI draws royalty income. Measured at annual rates over

PLDI royalties

product	licensee	status	indications
Avastin	Roche	approved	colorectal cancer
			lung cancer
			metastatic breast cancer
			glioblastoma
			metastatic renal cell
		Phase 3	ovarian cancer
			gastric
			prostate cancer
			adjuvant settings
Herceptin	Roche	approved	breast HER2+ cancer
			HER2+ stomach
			and gastro-esophageal cancers
Trastuzumab-DM1	Roche	Phase 2 and Phase 3	Breast HER2+ cancer
Lucentis	Roche	approved	macular degeneration
		Phase 3	vein occlusion
			macular edema
Xolair	Roche	approved	moderate-severe asthma
		label expansion	pediatric asthma
Tysabri	Elan	approved	multiple sclerosis
Actemra	Roche/Chugai	approved	rheumatoid arthritis
Mylotarg	Wyeth	approved	acute myeloid leukemia
Bapineuzumab	Elan/J&J/Pfizer	Phase 3	Alzheimer's disease
Solanezumab	Eli Lilly	Phase 3	Alzheimer's disease
Teplizumab	Eli Lilly	Phase 3	newly diagnosed Type 1 diabetes
Synagis	MedImmune	approved	in legal dispute

the past three years, revenues are up by 38.2% for Avastin, 20.8% for Herceptin, 132% for Lucentis and 23.2% for Xolair. With Genentech, PDLI has struck a tiered royalty agreement for products sold or manufactured in the United States. The rate is 3% for the first $1.5 billion in sales, declining to 1% for sales over $4 billion. However, for products sold and manufactured outside the 50 states, Genentech pays a flat 3% rate. Happily, for PDLI and its shareholders, the foreign-made and sold share of Genentech products jumped to 19% in the first quarter from 7% in the first quarter of 2009 and from 12% for the full 12 months of 2009. Hopeful, too, is the fact that Roche Holding AG, Genentech's parent, is building plants in Singapore and Germany. Concerning the growth in the overseas portion of Genentech's sales, Cris Larson, PDLI's chief financial officer, tells Gertner, "I will say that the trend is continuing and from everything that we can tell, it will continue."

Besides the applications for which the drugs have been accepted, one or more may be approved for new applications. Thus, Avastin is in Phase 3 trials for four new cancer indications. Lucentis is in Phase 3 trials for two different eye diseases. Phase 3 trials for new Alzheimer's drugs are under way under the aegis of Elan/J&J/Pfizer and Eli Lilly. Results are expected in 2012. The Alzheimer's drugs have blockbuster potential, Larson reckons. Royalties—to make that speculative leap—would be less than 5% of sales. Based on the indications of experimental success, the sponsoring companies would build inventories of some of the antibodies covered by PDLI royalty agreements. "The good news, again," Larson advises Gertner, "as they build inventory, we will continue to get royalty after the patents expire, because of the inventory in the freezer." In the expectation of heavy sales—assuming the kind of success that one can't reasonably assume—the customers would not stint on inventory building. In that happy case, PDLI's financial extinction could be pushed back a couple of years. Phase 2 results were positive for the Alzheimer's drug produced by the Elan/J&J/Pfizer consortium. Results featured a 9% reduction in amyloid-beta, or plaque, deposits for treated patients vs. a 15% increase in plaque deposits for placebo-administered patients.

What else might go right? Or, to ask the question in the CFA-approved fashion, how many other free options might be embedded in that $5.08 share price? One is the potential for a revenue-generating resolution in the MedImmune affair. Before PDLI, MedImmune had dealt with three other licensors on Synagis (i.e., Genentech, Celltech and Centocor/J&J). It sued each of them for one reason or another and settled each case, either on the courthouse steps or on appeal. Maybe it will settle with PDLI.

Altogether, from where we sit, the risk/return calculus over the next four years is little changed from last summer. The downside is a mid-to-high single-digit return, the upside something along the lines of 30%. A kind of gold mine, perhaps.

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Potential PDLI returns

annual revenue growth	break-even discount rate
0%	-6%
6	0
10	6
15	11
20	15
25	19
30	23

source: *Grant's* estimates

Mobile payout

(June 25, 2010) To the list of big-cap stocks that may produce a better return than the obligations of America's mega-cap government, we hereby add Vodafone Group Plc, the London-based mobile telecom giant. Vodafone is a globe-girdling blue chip that happens to gird a little too much of the euro zone for the stock market's liking. For that reason and others, the shares (listed in London, VOD LN, and in New York via an ADR, VOD US) are quoted at nine times earnings and at a ratio of enterprise value to earnings before interest, taxes, depreciation and amortization of 7.3; they yield 5.8%.

We say "they yield" without meaning to imply that there is anything firm, settled or contractual about the dividend rate. It's contingent on forces too numerous to imagine, let alone mention, even if the chairman of the Vodafone board, Sir John Bond, writing in the new annual report, did go on record saying, "The Board is . . . targeting to maintain growth in dividends per share at no less than 7% per annum for the next three years." You don't hear Timothy Geithner making that kind of pledge. The Treasury's principal aspiration, as a matter of fact, appears to be that the U.S. dollar should command fewer and fewer units of the Chinese renminbi.

Though Vodafone operates in Western Europe, Eastern Europe, Africa, the Middle East, Asia and North America (by dint of its 45% ownership of Verizon Wireless), it's old Europe that furnishes 67% of its £44 billion top line and 74% of its £15 billion EBITDA. Germany, contributing 18% of companywide revenue and 21% of EBITDA, is the No. 1 market. Italy is No. 2, followed by Spain and the United Kingdom. As investors do not need to be reminded, these are not the world's growth meccas (nor are the Netherlands, Greece, Portugal, Albania and Malta, in which Vodafone also operates). European-generated revenue did grow by 0.8% in the fiscal year ended March 31. However, before the flattering effects of currency movements and other nonoperating factors, it fell by 4.1%, with Spain and the U.K. leading the downside charge. But—a mitigating fact—the rate of decline in the European business moderated as the year wore on, to 2% in the fourth quarter from 5.4% in the second.

"Unquestionably," continues Sir John, "this has been the most difficult economic environment in which your company has ever operated. Against this background, I am very pleased to report that the group delivered an adjusted operating profit of £11.5 billion (down 2.5%) and generated £7.2 billion of free cash flow (up 26.5%). . . . The telecommunications sector as a whole has seen declining revenue through this period, but we have not seen the extremely steep declines in revenue experienced by some other sectors of the economy—mobile communications remain an essential element in most people's lives."

Not so long ago, even a Great Recession might not have slowed the cell phone business' meteoric growth. But now that most people in most countries have a phone seemingly growing out of their ears, the macro economy comes more into play, as does regulatory policy, especially in India. Vodafone bought its way into India with its $10.7 billion purchase of Hutchison Telecom International's Indian subsidiary in 2007. It was a hearty price, as we said at the time (*Grant's*, Oct. 19, 2007), though—as Vodafone must have reasoned—the growth opportunity was hearty, too. And so it turned

Vodafone Group Plc
(in millions of British pounds, except per-share data)

	Year ended 3/31/10	3/31/09	3/31/08	3/31/07
Revenue	£44,472	£41,017	£35,478	£31,104
Cost of sales	(29,439)	(25,842)	(21,890)	(18,725)
Gross profit	15,033	15,175	13,588	12,379
Selling and distribution expenses	(2,981)	(2,738)	(2,511)	(2,136)
Administrative expenses	(5,328)	(4,771)	(3,878)	(3,437)
Share of result in associates	4,742	4,091	2,876	2,728
Impairment losses, net	(2,100)	(5,900)	-	(11,600)
Other income and expense	114	–	(28)	502
Operating profit	9,480	5,857	10,047	(1,564)
Nonoperating income and expense	(10)	(44)	254	4
Investment income	716	795	714	789
Financing costs	(1,512)	(2,419)	(2,014)	(1,612)
Profit before taxation	8,674	4,189	9,001	(2,383)
Income-tax expense	(56)	(1,109)	(2,245)	(2,423)
Profit for financial year	8,618	3,080	6,756	(5,297)
Minority interest	(27)	2	96	129
Profit to shareholders	8,645	3,078	6,660	(5,426)
Diluted earnings per share	16.36p	5.81p	12.50p	(9.84)p
Goodwill	£51,838	£53,958	£51,336	£40,567
Property, plant and equipment	20,642	19,250	16,735	13,444
Investments in associates	36,377	34,715	22,545	20,227
Non-current assets	142,766	139,670	118,546	96,804
Trade and other receivables	8,784	7,662	6,551	5,023
Cash and cash equivalents	4,423	4,878	1,699	7,481
Current assets	14,219	13,029	8,724	12,813
Total assets	156,985	152,699	127,270	109,617
Long-term borrowings	28,632	31,749	22,662	17,798
Non-current liabilities	37,559	39,975	28,826	23,378
Short-term borrowings	11,163	9,624	4,532	4,817
Trade and other payables	14,082	13,398	11,962	8,774
Current liabilities	28,616	27,947	21,973	18,946
Total liabilities	66,175	67,922	50,799	42,324
Shareholders' equity	90,381	86,162	78,043	67,067
Shares outstanding (millions)	52,663			
Price per share	£1.43			
Market cap	75,308.09			
Price/earnings	8.71x			
Price/book	0.83			

out to be. Post-acquisition, Vodafone's Indian subscriber population has increased to more than 100 million from 28 million. The trouble is that, under the Indian government's licensing policies, as many as 15 cell phone providers compete in the same Indian market. Thus, in the past year, while Vodafone's subscribers jumped by 60%, its Indian revenues were up by only 18%. Referring to the ferocious competition implied by those numbers, as well as to looming outlays for cap-ex, an analyst quoted by Bloomberg last month characterized Vodafone's Indian adventure as a "fiasco." Fiasco or not, Vodafone remains the No. 2 entrant in a country that is adding 20 million new subscribers a month and has only just crossed the 50% overall penetration mark, compared with 100% and more penetration in developed markets and 70% or less in most emerging markets. "Looking out over a longer time horizon," colleague Ian McCulley observes, "the current price war should eventually lead to weaker players exiting the field, leaving Vodafone's business in good shape. There are worse things in the world than being the No. 2 mobile provider in a 1.2 billion-person country growing GDP at 7% a year."

If India is not Vodafone's crown jewel, Verizon Wireless just might be. As noted, Vodafone owns 45% of the Verizon mobile provider (Verizon Communications, the parent, has the rest). For good reason, Verizon Wireless is an investor fan favorite. Its subscriber base is growing, its financial health is glowing and its average monthly revenue per user—no less than $50—is amazing. For perspective, Vodafone's German operations pull in $20 per user per month. So far iPhone-less, Verizon Wireless would shine even brighter were it to obtain that shiny new Apple toy.

"While Vodafone booked over £4 billion of operating income as a result of its 45% share in Verizon Wireless," McCulley notes, "it received dividends worth only £1 billion, roughly enough to cover its tax liabilities. It's Verizon's corporate policy to pay down debt with free cash flow, not return it to the shareholders. But there's only so much debt to repay. In the first quarter, the Verizon sub generated $4.8 billion in free cash flow, with which it paid down $3.2 billion of debt. As its outstanding obligation totals $23 billion, it would take only six or seven more quarters to extinguish it—if that were the goal. But it makes no sense to de-lever the company completely given its growing cash flow and healthy margins. From this line of thinking, it would follow that there could be action on the Verizon Wireless dividend within the next nine to 12 months. The market would likely begin to mark up the value of Vodafone's stake in the Verizon sub if Vodafone began to receive a regular cash distribution. Any M&A—Verizon Communications buying out Vodafone, a spin-out, a merger—would also likely lead to value realization for the Vodafone shareholders.

"Note, please," McCulley goes on, "that the 45% Verizon Wireless interest goes unreflected in Vodafone's EBITDA line and thus in that measure of valuation. As it is, Vodafone changes hands at 7.3 times enterprise value to EBITDA. Say that the Verizon sub could generate $25 billion of EBITDA this year. At a multiple of six, that would be worth $150 billion. Subtract $22 billion in net debt, and you're left with an equity value of $128 billion. Vodafone's share would be £39 billion. The implication of that number is that the rest of Vodafone's businesses trade at a 4.6 times multiple (and not the 7.3 multiple at which it does trade). If Verizon Wireless were valued higher, say, at an eight multiple, the rest of Vodafone's businesses would have to be valued at a 3.6 multiple. On a global basis, multiples have compressed in the past three years. Big mobile phone operators trade at between four and five times EBITDA in developed markets and at six or seven multiples in emerging ones. Still, an implied—and very hypothetical—multiple of three or so does seem cheap."

It will be said that big, dividend-paying brutes like Vodafone have cheapened in the stock market because, when the Bush tax cuts die their expected death in 2011, dividend income will be taxed as ordinary income, not at the current favored 15% rate. Those in today's top 39.6% federal bracket are, therefore, staring at a meaningful cut in dividend income. In the case of Vodafone, one's after-tax dividend return would drop to 3.6% from 4.9% (without regard to state income tax). Then, again, corporate managements are nothing if not adaptive. If dividend income holds less after-tax allure than capital gains, share buybacks might return front and center. Besides, Treasury coupon payments are already taxed as ordinary income and that hasn't slowed down the bond bulls. Tuesday's two-year note auction was hammered down at a yield of 0.74% (the coupon was five-eighths of 1%, the lowest on record). Whatever that yield amounts to after tax, it's lower than the payout that the board of Vodafone is striving so mightily to deliver.

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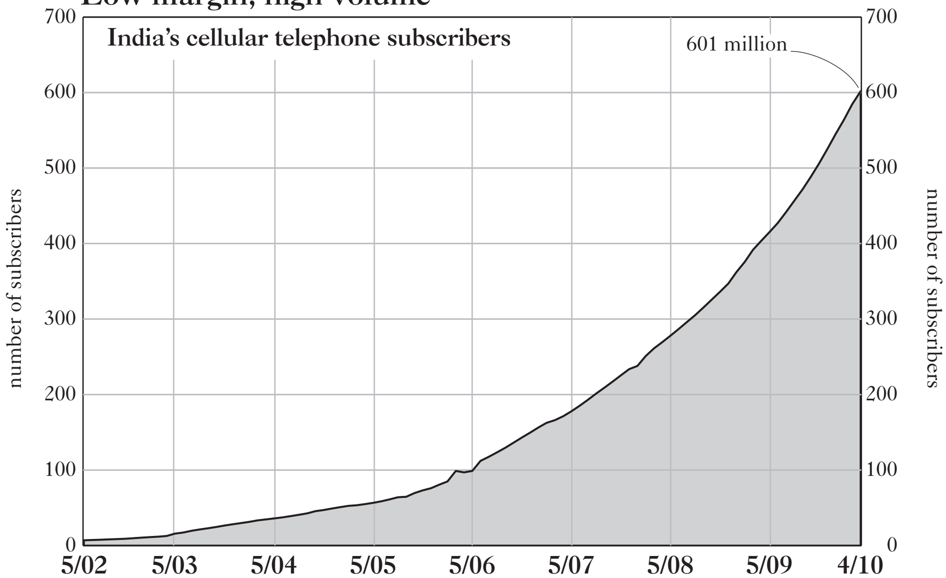
Low margin, high volume



source: The Bloomberg

For the long run

(July 9, 2010) "Nobody is going to buy cigarettes anymore," Nasir Ess, the owner of a Harlem deli, complained to the New York *Daily News* the other day about crazily spiraling tobacco taxes. "You can buy crack for $10." So saying, Ess put his finger on the investment conundrum of the cycle. "Safety first," your not-so-helpful investment adviser may admonish, but what's safe, and why? Bonds, stocks and gold are the items under consideration.

In 2003 or thereabouts, tax-exempt bonds secured by anticipated revenues from the Master Settlement Agreement (MSA) with Philip Morris and other tobacco companies seemed as safe as houses (houses were not then known to be unsafe). The cigarette companies had pledged to pay 46 states a king's ransom, perhaps as much as $200 billion over 25 years, depending on tobacco consumption, inflation and other imponderables. Eager to realize the present value of this anticipated windfall, Ohio, California and New Jersey, among other states, refashioned their claims on the MSA into bonds; $56 billion came to market. "[T]here was a widespread belief," as *The Bond Buyer* noted last week, "that demand for cigarettes was inelastic—meaning smokers were so hopelessly addicted that they would keep buying cigarettes even if prices rose."

If next decade's growth in book value and dividends match previous decade...

	price/book at current price	annual dividend	dividend yield at current price
Exxon Mobil	0.94x	$3.27	5.80%
Johnson & Johnson	1.02	6.83	11.60
United Technologies	1.05	6.24	9.72
Intel Corp.	1.63	5.69	29.84
3M Co.	1.89	3.72	4.81
Kraft Foods	1.14	7.55	27.27
General Dynamics	0.45	4.81	8.20
Kimberly-Clark	3.40	5.53	9.12
ConAgra Foods	1.17	0.77	3.33
Coca-Cola Co.	2.02	3.89	7.79

source: *Grant's* calculations

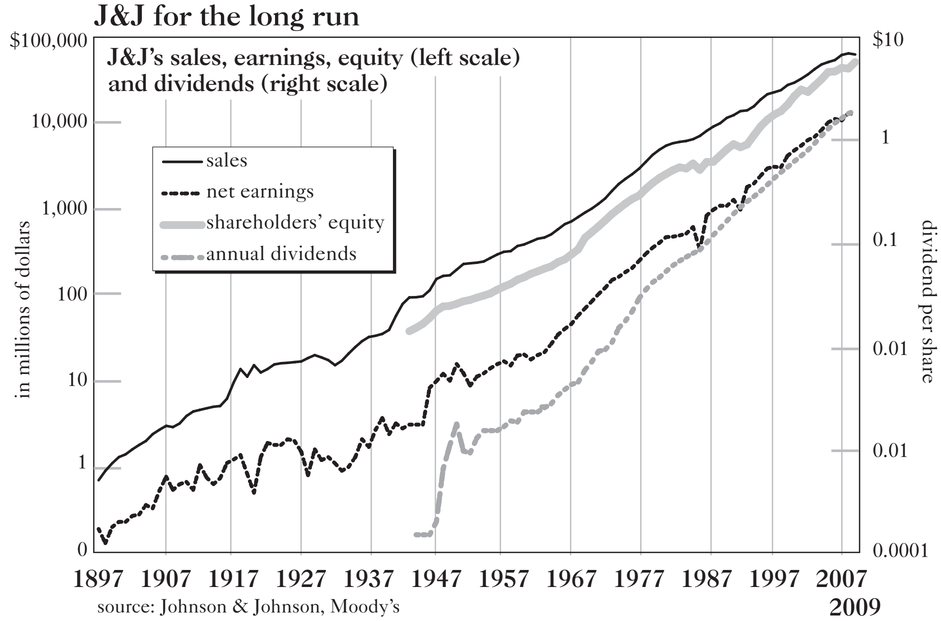
But the smokers' addiction to nicotine met its match in the states' addiction to taxing and spending. Excise taxes have risen to the point where smokers are buying cigarettes one at a time or doing without. In New York City, a loosie will set you back 75 cents, a legal pack by $13 and up, including $6.85 in taxes, of which $1.60 per pack was slapped on only last week. "Most of the bond structures they support were devised assuming modest declines in tobacco consumption over time and rising settlement payments," *The Bond Buyer* said. "That scenario is now in doubt, with cigarette consumption plunging 9.3% last year by one measure—about five times more than forecast."

No constant reader of *Grant's* needs to be reminded how rarely the light of prediction illuminates the darkness of the future. But if we can't predict, we can at least observe.

In recent issues, we have observed that the equities of well-financed, high-yielding U.S. multinationals are selling at some of the lowest valuations in years. Many outyield the 10-year Treasury note. You may object that a dividend yield is hostage to its volatile share price and that big, long-established, dividend-paying companies are forever reinventing themselves as shrinking, dividend-cutting corporate has-beens. Five years ago, what seemed a surer thing than AIG?

Let the record show, therefore, that there are no sure things. But there are cycles, and blue chip equities are in that phase of the cycle technically known as "the outs." A CFA will tell you that lower interest rates imply higher price-earnings multiples, not lower ones. That is so, doctrine has it, because lower interest rates, when used to discount future earnings, make that stream of income look larger than it would if a higher rate of interest were used to discount it. But, in recent years, P/Es have been falling in tandem with interest rates. It could be that this multiple compression presages lower profit margins, slower growth or a more punitive regulatory environment. Or it could be that sagging P/Es are simply the mirrors to a demoralized world. Or it might just be that the world is at last coming to realize that P/Es were previously too high. In any case, today's multiples,

J&J for the long run



source: Johnson & Johnson, Moody's

in comparison with decades of history, look low.

When *Grant's* served up Johnson & Johnson a couple of issues ago as an example of a blue chip bargain, we did not have at hand the statistical treasure trove that we subsequently discovered. Thus, from the company's founding in 1886 to 2009, sales increased to $61.9 billion from $0.1 million, or by 11.6% a year. Reported earnings, which began a decade later, mounted to $12.2 billion from $0.19 million, or by 10.4% a year. JNJ, which paid a maiden dividend in a split-adjusted sum of $0.00015 per share in 1944, the year it went public, paid $1.93 a share in 2009, a rate of growth from point A to point B of 15.7% per annum. Shareholders' equity grew to $50.6 billion in 2009 from $38 million in 1943, or by 11.5% per annum.

Johnson & Johnson, in fact, is the archetype of an increasingly familiar type, namely, the lightly leveraged, time-tested corporate giant that looks as if it has another couple of decades of life in it (at least) but is valued as if for trouble. Like many another blue chip, Johnson & Johnson's business has been running rings around its share price. Thus, since 2000, the company has seen annual growth in sales, net income and book value of 8.5%, 11.5% and 12.1%, respectively, while the dividend grew by 13.5% per annum. In contrast, the share price inched up by only 3.3% a year.

And how would it look in 2020, you may be wondering, if the next decade delivered business results identical to those of the 2000s while the share price stood still? We present the results nearby. Johnson & Johnson would be selling at a hair higher than book value and yielding 11.6%. To keep up with the projected internal compounding of JNJ's book value, the gold price would have to reach $3,777 an ounce from today's $1,200. To match the previous 10-year compounded growth in the book value of General Dynamics, to pick another example, the gold price would have to reach $4,897 an ounce.

And Treasurys? How might these darlings of our Age of Anxiety fare over the next 10 years? Could they keep up with JNJ's 12.1% per annum record of internal compounding? "At 3%," Gertner ventures, "it would be arithmetically impossible—unless, of course, one successfully traded in and out of the market. Just to get a 12.1% capital gain on the current, on-the-run 10-year note would require a plunge in the 10-year yield to 1.6%. Another year or two of 12.1% capital gains could be had, but before long the wall of zero percent would loom. Here is another way to think about it: Say that you bought a 3%, 10-year Treasury at par and that the 10-year yield immediately dropped to zero. Why would anyone pay more than $130 for that 10-year note? That is, for the privilege of receiving 10 years of $3-per-$100 coupons plus principal over the allotted decade, discounted at zero percent?"

Never say never, we say. Our all too fallible central bankers could easily send the gold price to heaven or the 10-year Treasury to the moon. But the world turns and Armageddon is usually a no-show. Cast-off blue chips, you have friends at *Grant's*.

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