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EDITOR

Vacation delectation

To the readers (and potential readers) of ***Grant's***:

The attached anthology of ***Grant's*** pieces, both ancient and modern, 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. 9.

Sincerely yours,

James Grant

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The slowest asset

(April 24, 1992) In Houston, office rents are falling again, fully a decade after the Texas energy business stopped inflating and began deflating. Rents continue to fall in New York, too, and Citibank is reportedly trying to sell the mortgage it holds on 40 Wall St. at a distress price. The amount that Citi is owed on the 70-story building, once a holding of the late, great Ferdinand Marcos, is $80 million. The amount that it is willing to accept in payment, according to Crain's New York Business, is $20 million, or $20 a square foot. A source of ours relates that the offered side of the market is, in fact, lower; a spokeswoman for Citicorp declines to provide a number. If the cost of refurbishing the building to attract an institutional clientele is anything like $100 million (as Crain's reports), the building's true, economic value might well be less than zero. It would certainly be low enough to rattle the downtown real estate community.

Real estate is an admittedly slow and illiquid asset, but it isn't in every postwar cycle that tall buildings collapse on the heads of the billionaires who own them. Recently, David Shulman of Salomon Brothers predicted that the slump in commercial real estate may last, in some regions, until the end of the decade and that it will be 12 years before the national office vacancy rate returns to 5% from about 20% today. To equity investors who have become accustomed to measuring bear markets in terms of days, weeks or months, such a thing is almost beyond imagining.

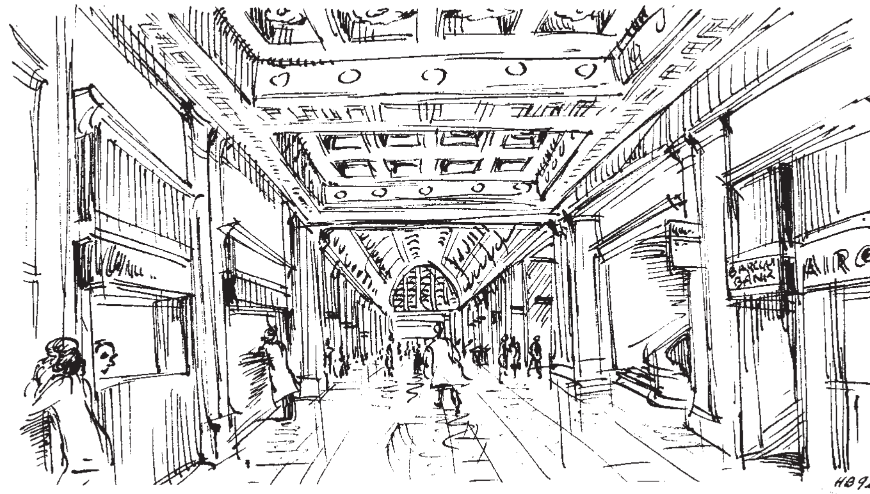
Precedent is on Shulman's side, however, and the documentary evidence is available at the New York Public Library. One instructive story is that of the Equitable Building, 120 Broadway, a still-magnificent Wall Street skyscraper built in 1914-15. We've been reading up on the Equitable's past to try to reach a clearer understanding of the future. What we want to know is whether the realestate-related credit cycle is over or ending, or, as Shulman and others suggest, still unfolding. The answer to that question is easy: It is still unfolding. H. Dale Hemmerdinger, a reader and New York City property owner, contends that years of misery lie ahead as long-term leases are replaced by new, lower-cost leases. "Costs are front-end loaded," Hemmerdinger says. "Even if the market turns tomorrow (which it won't), it will take me a long time to get rid of my free rent, of my $30 to $50 work letters, and I've got to get my rents up. In the meantime, my costs are still going up.. . . What Olympia & York is looking for is a short-term solution. I don't know how that works."

The period selected for this investigation was the last glacial, deflationary bear market in New York City real estate, that of the 1930s. We skipped the 1970s bear market because it was an inflationary downturn, one that featured rising commodity prices and expanding bank credit. In the Depression era, occupancy rates and interest rates fell, and chastened lenders hung back from committing new funds. It has been a little like that in the 1990s, too. What is most interesting about the Equitable story, however, is what happened in the long succession of disinflationary years between the alleged return of prosperity in 1933 and the U.S. entry into World War II in 1941. The company stumped through the Depression only to seek bankruptcy protection at a time of relative prosperity. For those who like to use the stock market as a leading indicator of business activity, the failure occurred some nine years after the Dow Jones Industrial Average made its all-time low.

We are relating this story because it helps to convey a sense of the rhythm of a deflationary liquidation. It is slow motion, like a family reunion. If past is prologue, lessons from the 1930s may also apply to the 1990s (with certain modifications, of course, allowing for the mature welfare state, the full paper monetary standard and the possibility that the federal government may yet engineer a new inflation). For instance, construction activity will not make the hoped-for contribution to the next business expansion, real- estate losses will continue to weigh on banks and life insurance companies, and the patience of newspaper readers will be sorely tested. Like the man who came to dinner, Paul Reichmann might move onto the pages of The Wall Street Journal indefinitely. He and his lenders and their lawyers may carp and cavil and negotiate into the next millennium (but — to strike a bullish note — not into the one after that).

The best reason to study the Equitable Building is that the Equitable Office Building Corp. was once an investor-owned company, and its financial history is available in Moody's Banks ?Finance. The original Equitable Building burned to the ground in 1912 on the same Broadway site, and Coleman DuPont came up from Delaware to organize a corporation to put up a bigger and better successor building. No visitor to 120 Broadway is likely to quibble with management's appraisal (c. 1915) that the building, originally housing 1.2 million square feet, is "among the great business structures of this hemisphere." It was so great, in fact — 40 stories rising straight up from the building line without a single setback — that theshadows it cast on lower Manhattan galvanized a political movement to restrict the construction of anything so overpowering in the future. The Equitable Life Assurance Society of the United States gave DuPont a longterm, $20.5 million mortgage, one of the largest ever written up until that time. The interest rate was 41/2%.

It is impossible to appreciate the Equitable story without a proper respect for the building's gleaming place in the Wall Street skyline. "Emphatically, and unequivocably," said the original sales brochure, perhaps reflecting market conditions as well as management's sense of decency, "we will not make to one tenant, regardless of his size or his importance or his desirability, any concession which is denied to others." The capitalization of the Equitable Office Building Corp. was conservative, and the tenants were grade A. The fact that 41/2% eventually became an unmanageable rate of interest is a useful lesson in the relativity of nominal yields and the changeableness of rents. What seems low may later appear high, even oppressive; and, of course, vice versa.



The lobby of the Equitable Building. If only beauty could be capitalized.

The moral of the Equitable story is that a decline and fall takes time. In the roiled credit markets of 1930 and 1931; the Equitable Office Building Corp. 5s of 1952 were still quoted in the low 90s and mid 80s. In the nightmare year of 1931 — marked not only by a global liquidity crisis but also by a rash of real-estate foreclosures by New York savings banks and life insurance companies — the company showed a profit and comfortably covered its fixed charges; rental income was almost $6 million, or $5 a rentable square foot. After expenses, depreciation and taxes, net earnings totaled $2.4 million. Cash on hand totaled $1.5 million. Altogether, it must have seemed to the Equitable's creditors as if the Depression were happening to somebody else.

In 1932, rental income dropped by less than 5%, earnings per share by a little more than 10%. The common dividend was cut to $2.50 a share from the old $3 rate, but at least there was a dividend. So far, so good.

If the phrase "world coming to an end" has ever pertained to the resilient American economy, it was descriptive in 1933. Rental incomes plummeted, and 25% of the mortgage investments of the major U.S. life insurance companies wound up in default. In that harrowing year, the Equitable Office Building Corp. was able to earn $1.4 million, or $1.54 a share, a testament to the quality of the tenancy and the long terms of the leases.

Inevitably, of course, leases came up for renewal. Some tenants did renew (others moved out and still others went bankrupt) and the new leases were signed at low, Depression-era rates. In 1933, rentals fell to an average of $4.16 a square foot. In 1934, they averaged $3.66 a square foot. Operating expenses and real-estate taxes happened to drop in 1934, but the capital expenditure program went on. Hoping to save on energy costs — the price of oil had vaulted by 71% in the first year of the Roosevelt recovery — management converted the building's oil-fired steam generating plant to anthracite coal power. Earnings in 1934 just topped the $1 million mark, or $1.25 a share, representing less than half of the 1931 rate. In the summer of 1934, the common dividend was omitted. It was reinstated at a lower rate in 1936: a false harbinger of recovery, it turned out.

The worst of the Depression was over, but rental income continued to fall as high-cost, 1920s leases were annually converted into low-cost, 1930s leases. (For 1920s and 1930s, of course, read 1980s and 1990s, respectively.) By 1936, the building's rental income amounted to just $2.68 a square foot, down by 46% from the levels prevailing in 1930. The Equitable Building's vacancy rate in the mid 1930s hovered around 15%. For perspective, the 1992 vacancy rate stands at 15.8%. Counting space available for sublease, it would amount to 20.5%. (We leave it to the real-estate scholars to determine the underlying cause of the decline of rents in lower Manhattan in the 1930s.

Was it the still-weak national economy or overbuilding in the boom? Our bet is on the first hypothesis. In the 1920s, no self- respecting New York bank made real-estate loans.)

Periodically, but without great success, management petitioned the city for tax relief. The corporation paid $807,533 in real-estate taxes in 1935. It paid $788,800 in 1937 but $846,800 in 1939. War broke out in Europe in September 1939, and America became a haven for frightened money. It might have seemed to the average Wall Street investment strategist that a rally in rental income was imminent. But the building realized only $2.41 a square foot, on average, in 1939, and reported a net loss of $14,685, or two cents a share, its first annual deficit of the decade. It just barely covered fixed charges.

The company fell short in 1940, and again in 1941; management gave up the ghost eight months before Pearl Harbor. "The [bankruptcy] petition said that, although the company would not be able to meet its current obligations as they fall due, it has an income and assets sufficient to make possible an equitable reorganization," Moody's reported.

The same slow, dream-like pace of activity continued during the reorganization proceedings — another cautionary precedent for today's lenders.

Committees were formed, plans submitted and meetings held. Paul J. Isaac, the reader who inspired this piece, tells a story about one such proceeding. He says that he got the anecdote from his father. An arbitrageur named Lou Green, of the firm of Stryker & Brown, was questioned by an SEC examiner, Isaac relates. Asked what class of security holder he represented, Green did not reply "the debenture holders," "the senior mortgage holder" or "the preferred." What he said was, "the short interest in the common." Wartime prosperity notwithstanding, the vacancy rate in early 1942 was almost 14%. On July 10, 1942, Federal Judge J.C. Knox approved the purchase of a $16 million war and bombardment insurance policy for $16,000 a year. Rents and margins were down: The net loss grew.

As for the Equitable reorganization proceeding, it was conducted without undue haste. Competing plans of reorganization were submitted, and at least once the U.S. Circuit Court of Appeals reversed Judge Knox. By the time the final plan was confirmed, in October 1948, fees and allowances to the trustees and attorneys had piled up to $792,521. In November 1947, the building got a new, 25-year mortgage from the John Hancock Mutual Life Insurance Co. In place of the overbearing 41/2% interest rate was a reasonable 3.7% interest rate (which would later increase to 33/4%). The downward adjustment was just in time for the start of the long postwar rise in interest rates and also, of course, in rental rates. Still, the rent roll in December 1948 had returned only to an average of $3.47 a square foot, lower than the average for 1934.

Scrolling ahead a half century, to 1992, the Equitable Building is owned and managed by Silverstein Properties. A fund managed by J.P. Morgan Investment Management holds a participating mortgage on the property (entitling the creditors to a share of the cash flow). The lobby is still splendid, and the rentable area of the building is now put at 1.9 million square feet, an increase of 58% since the 1930s. According to a broker, the reasons for this miraculous growth relate, first, to the expandable definition of a square foot under New York law and, second, to the general tendency of potato chip bags to hold fewer chips every year. He implied that space inflation was in the air. As noted, the vacancy rate, not counting available sublease space, is 15%. One big tenant nowadays is the office of the New York State Attorney General; another is the law firm of Lester Schwab, Katz & Dwyer. The defunct Crossland Savings Bank occupies ground-floor space. Brokers say that deals can be struck at an effective rent of less than $22 a square foot over a 10-year lease for a 10,000-square-foot space. The number includes a work letter to finance construction and a certain amount of free rent. Neither Morgan nor Silverstein would comment on the economics of the building, but the numbers can only be bleak and — in view of the weakness of rents and the long-term nature of big-city leases — getting bleaker.

At a meeting of the New York Real Estate Board the other day, Larry A. Silverstein, head of Silverstein Properties, explained the real-estate profitand-loss dilemma, and the April 15 Real Estate Weekly gave this account:

> Silverstein said the real problem is that commercial rents are so low — the deals are not economically viable for the owners. He said operating expenses amount to $7 and $8 per square foot, real estate taxes are running from $7 to $11 per square foot, tenant work letters are at $5 per square foot and $1 is going for leasing expenses. This adds up to $21 per square foot before debt service, he said.
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> Postwar building debt service averages $25 per square foot so Silverstein said owners need to see $46 per square foot just to break even. "In a $30 market," he said. "it's hard to see a profit and impossible not to incur a loss." In fact, he added, "There is no profit and the question is the magnitude of the loss."

In other words, losses loom indefinitely. If $21 per square foot is the average operating cost of a building before interest expense, it's a cinch that the owner of the Equitable Building is showing no profit after paying its lenders. "Quality projects in the end will become profitable," a vice president of Olympia & York Properties (Oregon) assured the Portland Business Journal recently. "It's just a matter of time." Based on the history of the Equitable Building, we would amend that claim. In a deflation, even quality projects will become unprofitable. It's inevitable.

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The future is Italy

(February 12, 1993) Italy is the Roman Colosseum of borrowing and the catacombs of taxation and the Appian Way of compound interest. It has a public debt that is larger, and more gross, than its gross domestic product. Interest on its public debt amounts to more than 10% of its GDP. Italy is not the world's third largest economy - it is No. 7, according to the International Monetary Fund - but it does have the world's third-largest government bond market. The Italian bond screen, Mercato Telematico dei Titoli di Stato, displays 94 issues. Things have come to such a pretty pass that the Italian who recently said, "The state can no longer guarantee everything to everybody," was the Socialist prime minister, Giuliano Amato, himself.

Mathematically, the growth of a

Italy leads, America follows
(in billions of dollars)[1]

	U.S.[2]		Italy[3]	
	1992	5-yr. growth rate	1991	5-yr. growth rate
GDP	$5,868.6	5.7%	$1,139.5	13.6%
Receipts	1,091.6	5.0%	517.6	16.0%
Outlays	1,381.8	6.6%	639.5	15.0%
Deficit	(290.2)	14.1%	(121.9)	11.6%
Gross interest payments	199.4	7.6%	118.9	18.0%
Gross public debt	4,002.7	11.3%	1,196.3	17.6%

government budgetary ratios— historical

	U.S.	Italy
Receipts/gross interest	5.47 x	4.35 x
Gross interest/GDP	3.4%	10.4%
Gross public debt/GDP	68.2%	105.0%
Gross interest/deficit	68.7%	97.5%

government budgetary ratios — projected[4]

	U.S.	Italy
five years forward		
Receipts/gross interest	4.86 x	3.98 x
Gross interest/GDP	3.7%	12.7%
Gross public debt/GDP	88.3%	125.0%
Gross interest/deficit	51.1%	129.3%
10 years forward		
Receipts/gross interest	4.32 x	3.65 x
Gross interest/GDP	4.1%	15.4%
Gross public debt/GDP	114.3%	148.8%
Gross interest/deficit	37.9%	171.4%

[1] conversion reflects average market exchange rate for the period; source: IMF's International Financial Statistics
[2] latest data as of end of fiscal 1992
[3] latest data as of end of fiscal 1991
[4] straight-line projections of government budgetary ratios applying historical five-year compound annual growth rates

country's borrowing may not indefinitely exceed the growth of a country's output. Yet, for a decade (or more) in Italy it has.

In the United States, the $4 trillion gross public debt represents about two-thirds of the nearly $6 trillion GDP. Between 1987 and 1992, the U.S. GDP grew by 5.7% a year, whereas the U.S. public debt grew by 11.3% a year. If those rates persisted, the debt would hit the $8 trillion mark, overtaking GDP, in 1999. An American may ask of his own country, as well as of Italy: How much longer?

The lesson of Italy is sobering and hopeful, all at once. It is most hopeful that Italia is still on the map. Unless he or she is taxed and regulated by New York City, is a veteran of the U.S. armed forces, is employed by the Tennessee Valley Authority or can remember the Hundred Days of the Roosevelt administration or the more imperial moments of the Great Society, an American may not understand the voracity of the Italian state. In Italy, government spending represents 56% of GDP. In America, federal government spending ("investment," in the argot of the Clinton administration) represents 24% of GDP. Still, in New York and Rome, life goes on.

We turn to Italy because, barring change, it is America's fiscal destination, and there are questions to answer: What damage has this vast debt done? Is there such a thing as a point of budgetary no return? If so, has Italy reached it? What are the prospects for the Italian stock market and also, not least, for a reader's lira- denominated speculation, the IMI Bank International's 13-year zero- coupon bonds? Finally, what does the Italian dilemma suggest about America's financial future?

On to the first question: Is a huge public debt clearly and unambiguously bearish? In the United States, where a rising debt has been accompanied by falling interest rates and a flyaway stock market, many would answer, "No." However, in Italy, we believe, there is no one who would not answer, "Yes." The greater concern in Italy stems not only from the greater mass of its debt, but also from a more virulent case of statism. If in America "entitlements" are the root cause of the growth of the public debt, in Italy what's to blame is the very structure of things.

In any case, Italian real interest rates are among the highest in Europe, the Milan stock exchange is stunted in size and price and the Italian government's own credit rating is not a reproachless AAA but a diminished Aa3. Italian borrowers were virtually barred from the syndicated European loan market last summer when Efim, the state industrial holding company, went into liquidation. Much to the dismay of the bank creditors, who had assumed that a loan to an arm of the state was a loan to the state itself, the Italian treasury declined to pay. Then, in November, the government reconsidered and now the Euromarket has begun to accommodate Italian borrowers again. And now Ilva, the Italian state's loss-making steel company, is threatening to become Efim2. It is hard to conceive of such a run of bad luck befalling a purely solvent country.

In public life as well as in business, too much debt can be stifling. The proof of this maxim is that Italy is now running a taut fiscal policy in a time of economic stagnation. We can be sure that if the Amato government had lira to spend, it would spend them. Then, too, as you will remember, Italy abandoned the European Rate Mechanism during last September's currency crisis; to reenter, which is the government's stated top economic ambition, the public debt must be brought in line with the national income.

But how? As this piece was composed in lower Manhattan, we do not pretend to grasp every single nuance. One such imponderable is the resilience of the Italian economy, in which transactions occur aboveground, underground and underworld. Italians are legendary savers and famous tax evaders. Surely, therefore, the denominator of the Italian debt-to-GDP ratio must be chronically understated.

Also under the heading of "life goes on," Italy has rolled financial rocks uphill before. Great problems have elicited audacious, sometimes larcenous solutions, as in the wake of the tripling of the public debt between 1862 and 1877. Shepard B. Clough, in "The Economic History of Modern Italy," records that the government seized and sold Church properties "which were not used for religious purposes," sold state property (a little like the RTC), privatized state railroads and instituted the Corso Forzoso, a declaration that the paper money of the banks of issue was no longer convertible into gold. This last gambit, at least, is unavailable to the Amato government, as all the world is now on a full paper monetary standard. (By the way, the lira-denominated gold price, shown nearby, must be counted a disappointment to those who are pinning their principal hopes for a gold bull market on the fiscal deterioration of the U.S. Treasury. Until last fall's lira devaluation, gold, in terms of lira, mainly went down.)

Giuseppe Volpi, Benito Mussolini's finance minister in 1926, met still another fiscal crisis by forcing the holders of five- and seven-year Italian bonds, which the Treasury could no longer easily redeem, to exchange them for longer-term consolidated 5s at a price of 87/a. This "Littorio" loan lengthened the maturity of the public debt, but not without arousing what Clough describes, perhaps with understatement, as "considerable resentment."

In the Depression, Il Duce created Istituto Mobilare Italiano (IMI) and Istituto per la Ricostruzione Industriale (IRI), a pair of Hoover- and Roosevelt-style public corporations that grew and grew, in debt and political influence if not in efficiency, and survive until this very day. America would look more like Italy if the Reconstruction Finance Corp. were still buying preferred stock in U.S. banks, or if the Civilian Conservation Corps were still planting trees. As it is, the Agriculture Department brings a little bit of Tuscany to Washington, D.C.

Statism in Italy is the man who stayed for dinner, and the fiscal crisis is therefore also a political and social crisis. Running up debts, the government has simultaneously run down the nation's capacity to service them.

To turn the tide, the Amato government, just seven months old, has proposed a vigorous privatization campaign, the creation of a private pension system and an increase in the retirement age (to 65 from 60 for men and, chivalrously, to 60 from 55 for women). Last summer, the government made history by abolishing the scala mobile, the allegedly eternal postwar Italian institution for indexing wages to inflation. Besides the lira's undignified exit from the European Rate Mechanism, the autumn also brought labor riots.

An American observer, at least, can take heart in the relative simplicity of his own country's debt predicament. In the United States, it is Bill Clinton vs. the laws of compound interest. In Italy, it is Amato vs. the laws of compound interest compounded again by the state enterprise system. In America, there is nothing quite like IRI, not even the former military- industrial complex. In Italy, the something-for-nothing political constituency is large, far-flung and ill- tempered, more so even than in America.

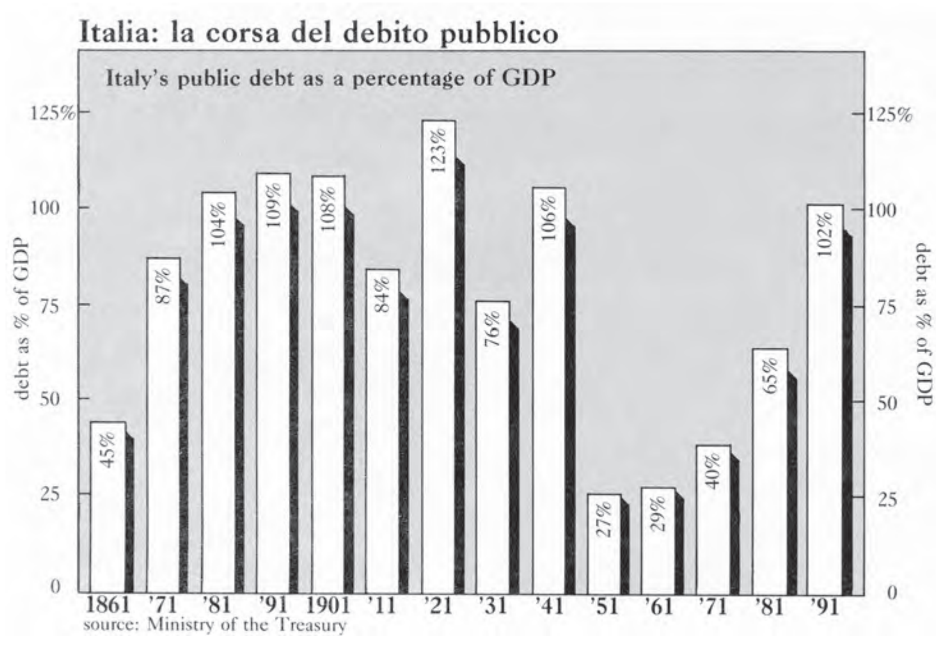
The first impression gained by a week's long-distance study of Italian finance is that reform would be very bullish indeed. Erich Stock, manager of the Italy Fund, tells Grant's: "You can imagine what the U.S. market would look like if there were no pension funds. You can imagine what the Italian market will look like once there are pension funds." The second impression is that such a great reform hangs by a thread. Thus, a wire-service dispatch last Friday, only a little more alarming than average:

ROME (Feb. 5) UPI — Prime Minister Giuliano Amato's seven-month-old government defeated a no-confidence motion in the Chamber of Deputies Friday, averting a crisis that his supporters feared could have plunged Italy into chaos.

The four parties of Amato's coalition stuck solidly together to defeat the no-confidence motion presented by the former Communist Party by 321 votes to 255, with eight abstentions in the 630-seat lower house of Parliament.

If Amato, a 54-year-old Socialist, had lost the vote he would have had to resign his coalition of Christian Democrats, Socialists, Social Democrats and Liberals....The government is Italy's 51st since World War II and was put together after a three-month crisis that followed parliamentary elections in April 1992, in which the traditional coalition parties suffered heavy losses.

Not plunging into chaos is good, but not coming close to plunging into chaos would be better. To the holder of Italian debt, it would be infinitely better, because the upside of seven-year Italian Certificati di Credito del Tesoro is a very finite 11/2%, after the 12A% withholding tax. The downside, in political terms, would be a victory by Achille Occhetto, leader of the former Communist Party, now renamed the Democratic Party of the Left. It is



unlikely, from everything one reads, that Occhetto sees the pension-fund issue just the same way that the equity bulls do.

As long as the Warsaw Pact was in place, Italy's non-communists could make common political cause. Now that the Soviet threat has disappeared, the politicians have lost their cohesion. In some cases, they (and their businessmen co-dependents) have lost their freedom: About 100 people have been arrested on bribery charges. The scandal, which has been unfolding for months, has afforded the public a grim new look under the rock of Italian statism.

The bulls hope that reform is forced on Italy, both by the impossible arithmetic of its own compounding debt and by the terms of a pending, eight billion Ecu loan (the equivalent of about $9.5 billion) from the European Community. To take down the full amount of the loan, observes Daniel Schultz, head of research of IMI in London, Italy must contain the growth of the public debt. If all goes well, the debt will peak as a percentage of GDP in 1994 or 1995.

Italy was able to borrow to the tune of 105% of GDP because its population lent to the government. They lent because of their own prodigious savings rate, and also because currency controls denied them an overseas alternative. But controls came off two years ago, and the momentum toward financial integration may now be irreversible. Nowadays, the government must compete for the people's capital.

The question is: Will the government also allow the people to compete for their own prosperity? Ed Vulliamy, recently writing in the Manchester, England, Guardian, observed that Amato's program is the first to attempt an assault on the fiscal beachhead "by cutting spending rather than by raising income."

For a time in the 1980s, Italy was the fastest-growing of the four big European economies, but the boom also fed the state, as Vulliamy elaborates: "Italy spent on its massive state apparatus and bloated bureaucracy, with which the ruling cliques bought political power. Civil servants could retire at 35 and take a second job on pension. The public utility and health agencies were — and remain — cesspits of corruption. Italy spent lavishly, to little return, on the dinosaur of its industrial public sector, feeding money into the IRI, the state industrial colossus, and other state enterprises; again, principally, in order to keep the regime in power."

The fiscal crisis has foreclosed a repeat of that idyll, and monetary reforms have reduced the probability of a state-sponsored inflation. As long ago as 1981, the Bank of Italy was relieved of its formal obligation to serve as the buyer of last resort of the treasury's debt, and in 1987 the commercial banking system was similarly unburdened of its bond-buying duties. A year ago, the governor of the Bank of Italy was given the right to set key interest rates without the treasury's approval. Most important, until last fall's departure of the lira from the ERM, Italian monetary policy in effect was subordinated to German monetary policy. For all these reasons, the Italian inflation rate has fallen to 4/2% from 6/2% over the past two years.

Lately, Italian interest rates have joined in the decline of other European rates. The Bank of Italy's discount rate has fallen to 11/2% from 12%, and the Banca Commerciale Italiana's prime rate is down to 12/4% from 13/2%. Last Friday, following the Bundesbank, the Bank of Italy reduced the proportion of funds that Italian commercial banks must set aside against their deposit liabilities (to a still-astounding 17.5% from 22.5%; Italy's reserve requirements were, and remain, the highest in Europe). To reduce reserve requirements is traditionally one of the most bullish things a central bank can do for equities.

"Traditionally," an Italian analyst said last week, "investors have preferred short-term bonds, because with long-term bonds there was little chance that the government would have the money to pay the yields when they came due. Now BTP bonds are favored; they are five- or 10- year bonds. The government is looking to lengthen the maturity of the bonds because it's finding it more and more difficult to refinance the short- term bonds."

The average length of the United States public debt is five years, 11 months, and falling. The average length of the Italian public debt is about three years, down from about four years as recently as 1987, but up from the bill-length maturities that the treasury was forced to issue in the bad old inflationary days of 1975.

In highly leveraged backward countries, debts are "rescheduled." As Italy is a highly leveraged industrialized country, however, its debts must be "refunded." The question is: Can it refund them?

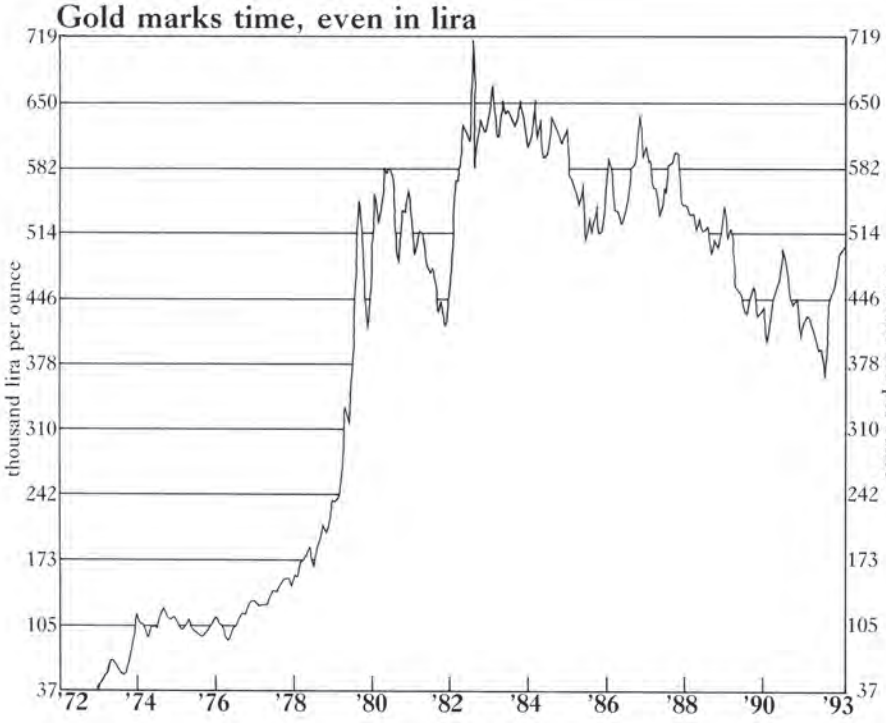
Barring a change in the rate of growth in borrowing, the government must inevitably fail, although when is a matter of guesswork. The table contains some projections for the next five and 10 years, based on the palpably

unrealistic assumption that nothing changes. In 10 years' time, as you can see, the U.S. debt would be bigger than Italy's is today, as a measure of GDP, although the burden of servicing it would be far lighter. Italy would be still deeper in the hole, but who is to say that 149% on the debt-to-GDP scale would spell oblivion? Certainly, though, it would not be bullish.

If there is hope, we think, it is that the Socialist Amato is able to follow the liberalizing example of the Argentine president, Carlos Menem. In the 1930s, Mussolini inspired the Argentine dictator Juan Domingo PerOn, Evita's husband, with his feats of state socialism. Later on, PerOn inspired Menem. It is only fair that now, in rolling back the state, Menem should inspire Amato.

Coming into power, notes Carolina Guevara-Lightcap of this staff, who was born and raised in Argentina, Menem made the capitalists despair. On taking office, however, he threw over the unions, embraced the rhetoric of enterprise and surrounded himself with right-of-center advisers. "The results surprised everybody," she says, "and many cried treason, but Argentina started on its way to recovery. Through November last year, the public sector showed a net profit from privatizations of some $3.4 billion, about $403 million more than the IMF minimum. In 1991, the economy grew by 8/2%; in 1992, by more than 7%." Why can't Italy do the same?

Gold marks time, even in lira



We mentioned the lira-denominated, zero-coupon issue of IMI Bank International. A subscriber, who bought an odd lot, describes his position: "I own a billion lira [i.e., at current exchange rates, about $660,500 worth]. "I don't get them now. I get them in 2006. To be exact, on June 13, 2006." Compare and contrast with a zero-coupon U.S. Treasury issue of the same maturity, he suggests. The American issue is priced at 40 cents on the dollar to yield 7.2%. The lira issue is priced at 20 cents on the dollar to yield 12.9%. The lira exchange rate would have to go to 3,000 from last Tuesday's 1,500 or so before the Treasury issue would outperform the IMI issue, other things being the same. Other things may not be the same, of course, because IMI Bank International is under review for a possible downgrade by Moody's (it has been on watch since November). It is rated Aa3. The Treasury is not without risk, as the Clinton administration may be demonstrating right now, but it is backed by the Bureau of Engraving and Printing and the Internal Revenue Service and the Federal Reserve Board.

"Every time I shave," our reader continues, "I make a point of saying, `We're not going to pay it back.' " He is referring to the U.S. public debt. The lira is just another paper emission of another social democracy, he admits, but capital invested in lira is compounding more briskly than capital invested in dollars.

For our part, we would prefer Italian stocks to Italian bonds if we could only see through the brick wall of Italian politics. If Amato is going to succeed, the Milan market is going to excel, because the success of the government must imply the overhaul of the pension system and the privatization of state assets. According to Stock, the Italian market as a whole is valued at 19.7 times 1993 earnings. Excluding the richly priced insurance companies, however, it is valued at 15.5 times 1993 earnings.

Amato may or may not succeed, but he is fighting the good fight, and the Italian bourse is down by more than

40% from its 1986 high. President Clinton may or may not succeed, but he seems to be fighting the wrong fight, and the American equities markets stand at new highs. As Amato has demolished the scala mobile, Clinton has hinted at raising the minimum wage. Italy may yet show us that there is no such thing as a fiscal point of no return, and America may prove that too much public debt is not in fact a standing bull argument for financial assets. A benevolent observer will purchase a rooting interest in the Italy Fund and remember Amato in his prayers.

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Emulate Henry Singleton

(February 24, 2003) Something went haywire with American capitalism in the 1990s, and we think we know what it was. There weren't enough Henry E. Singletons to go around. In truth, there was only one Singleton, and he died in 1999. He could read a book a day and play chess blindfolded. He made pioneering contributions to the development of inertial navigation systems. He habitually bought low and sold high. The study of such a protean thinker and doer is always worthwhile. Especially is it valuable today, a time when the phrase "great capitalist" has almost become an oxymoron.

Singleton, longtime chief executive of Teledyne Inc., was one of the greatest of modern American capitalists. Warren Buffett, quoted in John Train's "The Money Masters," published in 1980, virtually crowned him king. "Buffett," Train reported, "considers that Henry Singleton of Teledyne has the best operating and capital deployment record in American business."

A recent conversation with Leon Cooperman, the former Goldman Sachs partner turned portfolio manager (he's the managing general partner of Omega Partners), was the genesis of this essay. It happened in this fashion: Cooperman was flaying a certain corporate management for having repurchased its shares at a high price only to reissue new shares at a low price. He said that this was exactly the kind of thing that Singleton never did, and he lamented how little is known today of Singleton's achievements as a capital deployer, value appraiser and P/E-multiple arbitrageur. Then he reached in his file and produced a reprint of a critical *Business Week* cover story on Teledyne. Among the alleged missteps for which Singleton was attacked was his heavy purchase of common stocks. The cover date was May 31, 1982, 10 weeks before the blastoff of the intergalactic bull market.

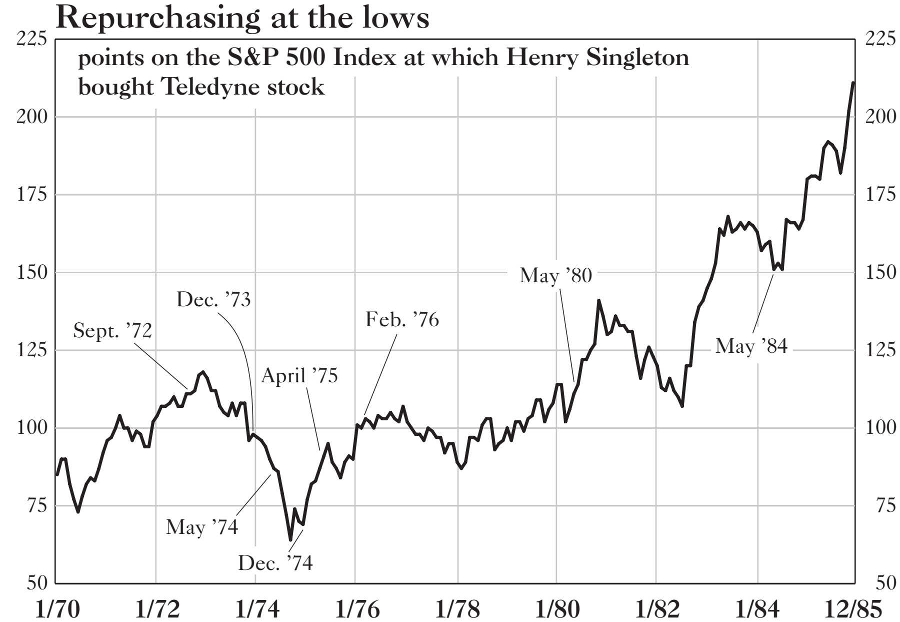
The wonder of Singleton's life and works is the subject under consideration—admittedly, a biographical subject, as opposed to a market-moving one. We chose it because Singleton's genius encompassed the ability to make lemonade out of lemons, a skill especially valuable now that lemons are so thick underfoot.

Singleton was born in 1916 on a small farm in Haslet, Texas. He began his college education at the U.S. Naval Academy but finished it at M.I.T., earning three degrees in electrical engineering: bachelor's and master's degrees in 1940, and a doctorate in 1950. In 1939, he won the William Lowell Putnam Intercollegiate Mathematics Competition Award. In World War II, he served in the Office of Strategic Services. At Litton Industries, in the early 1950s, he began his fast climb up the corporate ladder: by 1957, he was a divisional director of engineering. In 1960, with George Kozmetsky, he founded Teledyne.

Anyone who was not reading *The Wall Street Journal* in the 1960s and 1970s missed the most instructive phase of Singleton's career. When the Teledyne share price was flying, as it was in the 1960s, the master used it as a currency with which to make acquisitions. He made about 130. Many managements have performed this trick; Singleton, however, had another: When the cycle turned and Teledyne shares were sinking, he repurchased them. Between 1972 and 1984, he tendered eight times, reducing the share count (from high to low) by some 90%. Many managements have subsequently performed the share-repurchase trick, too, but few have matched the Singleton record, either in terms of market timing or fair play. Singleton repurchased stock when the price was down, not when it was up (in the 1990s, such icons as GE, IBM, AOL Time Warner, Cendant and, of course, Tyco, paid up—and up). He took no options awards, according to Cooperman, and he sold not one of his own shares. Most pertinently to the current discussion of "corporate governance," he didn't sell when the company was buying (another popular form of managerial self-enrichment in the 1990s).

The press called him "enigmatic" because he pursued policies that, until the mists of the market lifted, appeared inexplicable. For example, at the end of the titanic 1968-74 bear market, he identified bonds as the "high-risk asset" and stocks as the low-risk asset. Accordingly, he directed the Teledyne insurance companies to avoid the former and accumulate the latter. To most

Repurchasing at the lows



source: The Bloomberg, Leon Cooperman

people, stocks were riskier, the proof of which was the havoc they had wreaked on their unlucky holders during the long liquidation.

Some were vexed that, for years on end, Teledyne paid no dividend. The master reasoned that the marginal dollar of corporate cash was more productive on the company's books than in the shareholders' pockets, and he was surely correct in that judgment. Teledyne's stable of companies (many in defense-related lines, others in specialty metals, offshore drilling, insurance and finance, electronics and consumer products, including Water-Pik) generated consistently high margins and high returns on equity and on assets.

Singleton made his mistakes, and Teledyne's portfolio companies made theirs. A catalog of some of these errors, as well as not a few triumphs misclassified as errors, appeared in the *Business Week* story. We linger over this 21-year-old piece of journalism because it illustrates an eternal truth of markets, especially of markets stretched to extreme valuations. The truth is that, at such cyclical junctures, doing the wrong thing looks like the right thing, and vice versa. In the spring of 1982, few business strategies appeared more wrongheaded to the majority of onlookers than buying the ears off the stock market.

On the *BW* cover, the handsome Singleton was portrayed as Icarus in a business suit, flying on frail wings of share certificates and dollar bills. The article conceded that the master had done a pretty fair job for the shareholders, and it acknowledged that the share repurchases had worked out satisfactorily—to date. They had, in fact, boosted per-share earnings "and also enabled Singleton, who held on to his own Teledyne shares, to amass 7.8% of the company's stock." He was the company's largest shareholder and its founding and indispensable brain.

Yet the magazine was not quite satisfied, for it perceived that Singleton had lost his way. For starters, it accused him of having no business plan. And he seemed not to have one. He believed, as he later explained at a Teledyne annual meeting, in engaging an uncertain world with a flexible mind: "I know a lot of people have very strong and definite plans that they've worked out on all kinds of things, but we're subject to a tremendous number of outside influences and the vast majority of them cannot be predicted. So my idea is to stay flexible." To the *BW* reporter he explained himself more simply: "My only plan is to keep coming to work every day" and "I like to steer the boat each day rather than plan ahead way into the future."

This improvisational grand design the magazine saw as the "milking" of tried-and-true operating businesses and the diverting of funds to allow the chairman to "play" the stock market. A *BW* reader could imagine Singleton as a kind of Nero watching Rome burn while talking on the phone with his broker. He didn't invest in businesses, the magazine suggested, only in pieces of paper. He either managed too little (as with the supposedly aging and outmoded operating companies) or too much (as with the insurance businesses, where, according to *BW*, he managed to no great effect). His reserve was "icy."

Singleton's disdain for the press was complete and thoroughgoing: The *BW* article just rolled off his back. It puzzled him that his friend Cooperman would bother to draft a nine-page rebuttal, complete with statistical exhibits. Why go to the trouble? Cooperman, who has fire where Singleton had ice, wanted the magazine to know that, during the acquisitive 1960s, Teledyne's sales and net income had climbed to about $1.3 billion and $58.1 million, respectively, from "essentially zero," and that during the non-acquisitive 1970s, profit growth had actually accelerated (with net income of the 100%-owned operating businesses rising sixfold).

As for those share repurchases, Cooperman underscored an achievement that appears even more laudable from the post-bubble perspective than it did at the time. "Just as Dr. Singleton recognized [that] he had an unusually attractive stock to trade with in the 1960s," wrote Cooperman, "he developed the belief that the company's shares were undervalued in the 1970s. In the period 1971-1980, you correctly point out that the company repurchased approximately 75% of its shares. What you did not point out is that despite the stock's 32% drop from its all-time high reached in mid-1981 to the time of your article, the stock price remains well above the highest price paid by the company (and multiples above the average price paid) in this ten-year period." And what Cooperman did not point out was that none of these repurchases was earmarked for the mopping up of shares issued to management. He did not point that out, probably, because the infamous abuses of options issuance still lay in the future.

Business Week, however, was right when it observed that nothing lasts forever and that Singleton couldn't manage indefinitely. In 1989, he formally relinquished operating control of the company he founded (and, by then, owned 13.2% of). Even then it was obvious that the 1990s were not going to be Teledyne's decade. Appended to *The Wall Street Journal's* report on Singleton's withdrawal from operations was this disapproving note: "The company hasn't said in the past what it plans to do. It doesn't address analyst groups or grant many interviews. Teledyne's news releases and stockholder reports are models of brevity. Some securities analysts have given up following the company because they can't get enough information." Imagination cannot conjure a picture of Singleton on CNBC.

The dismantling of Teledyne began in 1990 with the spin-off of the Unitrin insurance unit (later came the sale of Argonaut, another insurance subsidiary). Singleton resigned the chairmanship in 1991, at the age of 74. Presently, the financial results slipped, the defense businesses were enveloped in scandal and Teledyne itself was stalked as a takeover candidate. Surveying the troubles that came crowding in on the company after the master's departure (and—unhappily for the defense industry—after the fall of the Berlin Wall), *Forbes* magazine remarked: "For many years Henry Singleton disproved the argument that conglomerates don't work. But it turns out Teledyne was more of a tribute to Singleton than to the concept."

In retirement, Singleton raised cattle and became one of the country's biggest landowners. He played tournament chess. "Most recently," according to a tribute published shortly after his death (of brain cancer, at age 82), he devoted much time to computers, programming algorithms and creating a fine computer game of backgammon. . . ."

To those not attuned to the nuances of corporate finance, Singleton's contribution appeared mainly to concern the technique of share repurchases. Thus (as an obituary in the *Los Angeles Times* had it), Teledyne was the forerunner to the white-hot growth stocks of the Clinton bubble, including Tyco International and Cendant. Singleton knew better. To Cooperman, just before he died, the old conglomerateur confided his apprehension. Too many companies were doing these stock buybacks, he said. There must be something wrong with them.

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There ought to be deflation

(January 14. 2005) Fly now for half price—no restrictions! Take 30% off that top-of-the-line cashmere jacket, which, by the way, looks smashing on you. And may we show you, sir or madam, our special no money-down, zero-percent financing options on any vehicle in stock? Undercoating and rubber floor mats are yours with the compliments of the sales manager.

The world is a cornucopia. Thanks to the infernal machine of American debt finance, the Internet and the economic emergence of China and India, among other millennial economic forces, goods are superabundant. More and more services, too, are globally traded, therefore cheaper than they would be in the absence of international competition. Yet the measured rate of inflation in the United States is positive, not negative, as it was in so many prior eras of free trade and technological progress. Following is a meditation on the meaning of this fact and some thoughts on what to do about it.

From George Washington until the A-bomb, prices alternately rose and fell. They rose in wartime and fell in peacetime. As Alan Greenspan himself has pointed out, the American price level registered little net change between 1800 and 1929. Four years after the Crash, the Roosevelt administration put the gold standard, or what was left of it, out of its misery. In 1946, the Truman administration passed an act to mandate full employment. In effect, inflation became the law of the land. "In the two decades following the abandonment of the gold standard in 1933," Greenspan noted not long ago, "the consumer price index in the United States nearly doubled. And, in the four decades after that, prices quintupled. Monetary policy, unleashed from the constraint of gold convertibility, had allowed a persistent overissuance of money." That is, Greenspan added, until now.

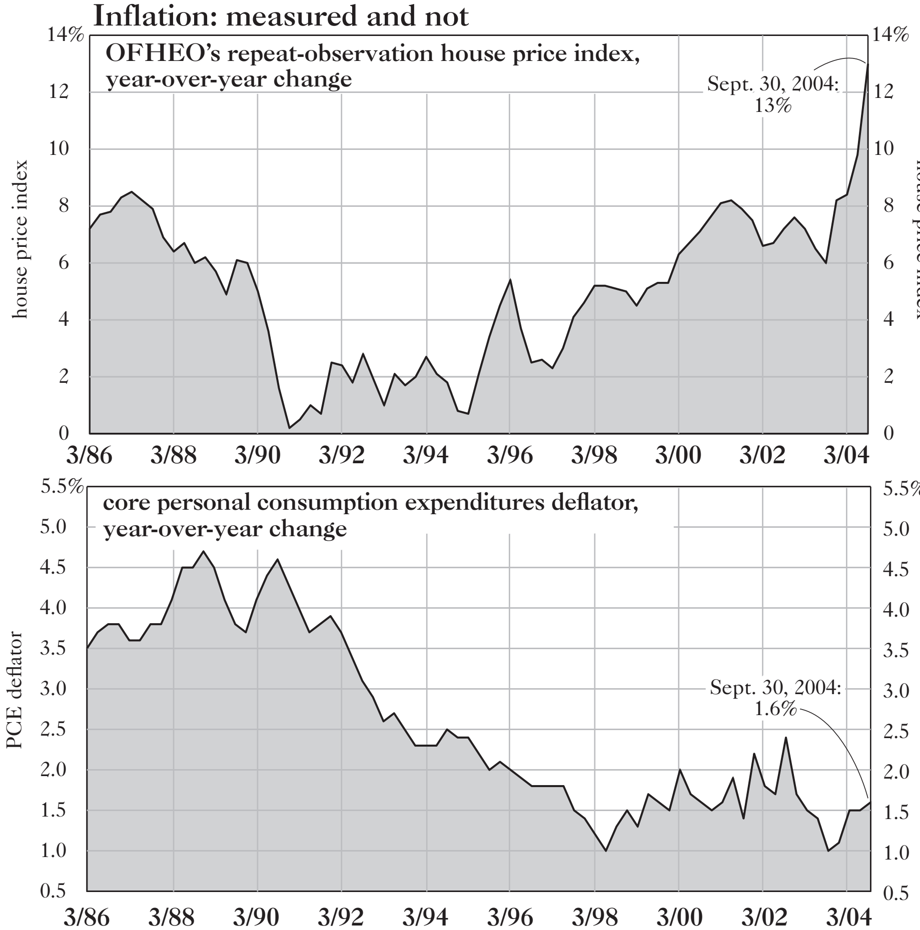
The chairman was holding forth in December 2002, a time when—so his colleagues and he insisted—the U.S. confronted a meaningful risk of falling prices. To forestall this supposed crisis, the Fed pushed down the funds rate to a 46-year low. The object of this policy was to restore the familiar postwar lift to the American price level. Oddly, the public registered no protest, though, as consumers, Americans love a bargain. Economists had drummed it into their heads that falling prices were bad for growth, bad for employment, bad for debtors and, not least, bad for the way the Fed conducts monetary policy. Let the central bank guide the price level gently higher, the call went out.

Which, by appearances, the central bank has done. Supposedly, the great Greenspan has implemented a perfect measure of monetary stimulus. He has averted deflation while steering clear of what the bond market might regard as a worrying rate of inflation.

At least, so say the members of the loosely organized Greenspan for Mount Rushmore Committee. *Grant's* has an alternative view, which requires a short definitional preface. What inflation is not, we believe, is "too many dollars chasing too few goods." Pure and simple, it is "too many dollars." What the redundant dollars chase is unpredictable. In recent months, they have chased stocks, commodities, euros, junk bonds, emerging-market debt and houses. On Wall Street, such inflationary episodes take the name "bull markets." They are always welcome. When, on the other hand, the surplus dollars chase skirts (or sweaters or automobiles or medical care), that phenomenon is called "inflation." It is usually unwelcome.

Deflation is not quite the opposite of inflation. We would define deflation as too few dollars chasing too

Inflation: measured and not



source: The Bloomberg

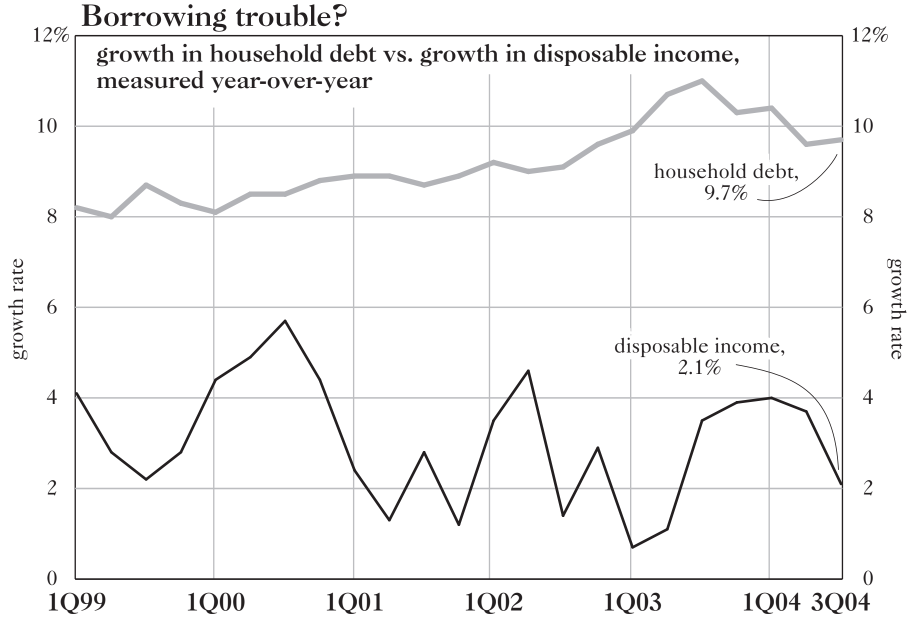
much debt. Dollars extinguish debt; too few dollars in relation to the stock of debt is the precondition for what, these days, is euphemistically called a "credit event." A second-order effect of a credit event is falling prices. Prices fall because, in a big enough credit event, business activity stops cold. In the absence of liquid markets, cash is king. But we would not throw around the term "deflation" to describe every episode of weak or falling prices. If prices fall because the global supply curve has shifted downward and to the right, we would call that circumstance "falling prices." "Deflation," to us, means "debt deflation."

Pending the worldwide acceptance of these ideas (which we have borrowed from economists long dead), we will accommodate our views to the world's. This means we will not pedantically enclose the conventionally employed words inflation and deflation with quotation marks. But the world is doing itself no favors by so narrowly defining inflation and by so carelessly crying deflation.

The Fed is, of course, a prime perpetrator of sloppy thought, loath to acknowledge that inflation is anything other than an unacceptable rate of rise in its favored inflation index. This index is the personal consumption expenditure deflator, excluding such minor and discretionary items as food and energy. It is not that the Maestro has refused to acknowledge that the world's cup of goods and services runneth over. In so many words, he has conceded that the global supply curve has shifted in the direction of plenty. But, as far as we know, he has not followed this observation where it logically leads. If everything else were left the same, the measured inflation rate might, by now, be negative. We emphasize "might," as the cornucopia effect of greater, and cheaper, global supply is offset to a degree by the depreciating dollar exchange rate. However, we are certain that, except for heavy Fed intervention, the measured rate of inflation would be lower than it is now. So, too, the "unmeasured" rate of inflation, by which we mean house prices, credit spreads and other such markers of asset valuation.

We are prepared to wager that the Maestro knows more than he lets on about the true nature of inflation and deflation and about the tendency of

Borrowing trouble?



source: Federal Reserve Board

the U.S. price level to subside in a world so generously supplied as this one. And we are equally prepared to wager that he has some appreciation of how highly leveraged are American families and businesses. In relation to income, the stock of debt has been rising for decades. If the price level reversed course and declined, uncounted net debtors would struggle to stay solvent. Falling prices, even if they were not caused by a credit event, could easily provoke one (in which, for example, trillion-dollar government-sponsored enterprises just might have to call in their chits to the Treasury).

Small wonder, then, that everything has not been left the same. The Fed, warning about the dire consequences of the "zero bound" (by which it means a federal funds rate stuck at zero percent) and invoking the specter of Japanese stagnation, or worse, assumed a radically easy monetary stance in 2001. It has taken five tightening moves to bring the funds rate back to 2¼%, at which point it is still 75 basis points lower than what passed for an ultra-low funds rate during the 1992-93 easing cycle. The late Daniel Patrick Moynihan spoke of "defining deviancy down." The Fed has been redefining accommodation down. It has been pushing low interest rates lower and lower.

The interest-rate stimulus administered by the Fed in 2001-03 showered wealth on the homeowners who refinanced their mortgages not once but over and over, extracting equity as they went. But as interest rates have stopped falling, the shower is over. So it goes with monetary palliatives. Friedrich von Hayek, winner of the Nobel Prize in economics, touched on the risks of credit creation in a speech as he accepted the prize 20 years ago. Beware the nostrum of printing money to boost aggregate demand, he warned. Such a policy is, of course, inflationary, but the problem goes deeper than that. Money printing distorts prices and wages, the traffic signals of a market economy. Responding to the wrong signals—spending on red and saving on green—people take the wrong jobs and capital flows into the wrong channels. All were misled by the wrong prices, or, in the past couple of years, by the wrong interest rates.

Said Hayek: "The continuous injection of additional amounts of money at points of the economic system where it creates a temporary demand which must cease when the increase of money stops or slows down, together with the expectation of a continuing rise in prices, draws labor and other resources into employments which can last only so long as the increase of the quantity of money continues at the same rate—or perhaps even only so long as it continues to accelerate at a given rate. What this policy has produced is not so much a level of employment that could not have been brought about in other ways, as a distribution of employment which cannot be indefinitely maintained and which after some time can be maintained only by a rate of inflation which would rapidly lead to a disorganization of all economic activity."

Hayek spoke of injecting money "at points of the economic system," and it is in these favored niches that prosperity temporarily smiles (until the money printing or the interest-rate slashing comes to a stop and throws the process into reverse). To an investor, still more to a speculator, "temporarily" is the magic word. Could the Nobel laureate not be a little more specific? We must try to fill in the blanks ourselves. One notes, for example, reading the January 5 *Wall Street Journal*, that "With Market Hot, More People Now Have Third Homes." Rising interest rates must sooner or later cause the marginal third-home owner to become a two-home, or a one-home or even a no-home owner. One would suppose that a similar chain reaction is going to take place in other highly leveraged sectors of the U.S. economy. Which might they be? The FOMC itself, in a much-quoted passage in the just-released minutes of the December 14 meeting, serves up a helpful list. "Some participants," the text relates, "believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets evidenced by quite narrow credit spreads, a pickup in initial public offerings, an upturn in mergers-and-acquisition activity and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums."

In a provocative letter to the editor of the *Financial Times* last weekend, Ann E. Berg, a former director of the Chicago Board of Trade, offered a Hayekian coda to the discussion of the U.S. trade deficit. To correct the huge and growing gap between what this country consumes and what it produces, the market has focused almost entirely on the dollar exchange rate. "I have yet to see a single analyst suggest the trade imbalance could be solved by a general contraction of consumer credit—something that would surely correct the import/export imbalance," Berg writes. "For 25 years, U.S. consumers have enjoyed increasingly easy credit due primarily to a declining interest rate environment."

But, as Berg goes on, in addition to falling interest rates, the American shopper has gained from the growth and resourcefulness of Wall Street in processing, packaging and distributing debt. The advent of futures and options, of swaps and securitizations has facilitated American borrowing "and lined consumer pockets with several hundred billion dollars over the past few years, particularly with the turning of unsecured credit card debt into asset-backed security agreements (home equity loans)." Conveniently for the United States, the "emerging" economies are better at producing and saving than at banking and consuming. Rising U.S. interest rates will likely slow the pace of borrowing, therefore of consumption in this country. However, as Berg notes, for the time being, consumer debt continues to rise faster than consumer incomes. And it is this fact that "will cause some creditors to demand higher risk premiums due to the greater default probabilities of borrowers. Anecdotal evidence suggests that some credit card issuers are demanding significant increases in monthly minimum payments. Further dollar depreciation helping spur export growth is therefore only one solution to the current account deficit. A tighter credit environment forcing a leaner consumer might prove an equally likely resolution, however unwelcome." However un-American.

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Snoopy deploys capital

(April 8, 2005) MetLife, once upon a time known as the Metropolitan Life Insurance Co., sold its self-branded, 58-story New York City office tower last week (the one that starred in "Godzilla") for $1.7 billion. On $83 million in projected annual net operating income, that's a 4.9% yield, or cap rate, a remarkably low number even for this sky-scraping real estate market. It is, in fact, just remarkable enough to inspire a meditation on the risks presented by low interest rates and rampant overvaluation.

Question: How does one invest in an era of low rates? Answer: One invests poorly, because the available investment options are themselves often impoverished. MetLife, the nation's soon-to-be No. 1 life insurance company (pending completion of its acquisition of the Travelers), has survived each and every interest-rate cycle of the past 137 years. Just how remarkable is this achievement becomes apparent when one considers that every investor is a prisoner of the times in which he lives. Yields are what they are. Valuations are what they are. And, belief systems are what they are. A half-century ago, the Met earned rates of return that, adjusted for inflation, taxes and expenses, could not have been much greater than zero. Seeking safety—"security of principal"—it bought bonds yielding 3% or 4%, while disdaining equities yielding more than bonds. It accepted uncritically the ultra-conservative 1950s' investment-belief system.

Looking back on 2005 from the perspective of 2055, what will posterity say about us? Will it shake its know-it-all head over our own errors and omissions? Of course it will. At the top of the list of millennial shortcomings will be: uncritical acceptance of an ultra-progressive and optimistic investment-belief system (e.g., "stocks excel in the long run, because they always have excelled in the long run") and the headlong purchase of low-yielding bonds denominated in the leading unstable currencies. Posterity won't believe that we didn't see the breakdown of the post-1971 monetary system as it was unfolding before our eyes, or that we imputed to the Federal Open Market Committee powers of judgment and preknowledge given to no mortal human. "What were they thinking about?" one member of posterity will sadly remark to another.

MetLife has been selling real estate to finance its recent $11.5 billion purchase of Citigroup's insurance assets (besides the MetLife building at 42nd Street, it sold its former New York City headquarters at 1 Madison Ave.). The Citi businesses, valued at 1.54 times book and 12.8 times 2004 earnings, did not come dirt cheap, except in comparison to the valuation of the buildings. "The company is capitalizing on a Manhattan market where top office buildings now sell for more than $700 a square foot after rarely touching $500 before 2002. . . ," Bloomberg News noted. "Think about it," Rob Speyer, a managing director of Tischman Speyer, one of the buyers of the MetLife Building, told *The New York Times*. "It's the opportunity of a lifetime. To buy one of New York City's iconic properties is an opportunity we just leapt at."

Today, at a 4.9% cap rate, one could buy an iconic building or some not-quite-iconic bonds. Which would you prefer? Bonds have no windows to wash, walls to paint, carpets to vacuum, tenants to litigate with or governments to pay property taxes to. On the other hand, the building wouldn't be subject to early call if interest rates fell. Then, again, each stream of income—rentals and coupon payments—is denominated in dollars, of which the world is very long. And if interest rates, and/or the inflation rate, were to climb? Depending on the timing of lease expirations, the building's new management could raise rents. Bondholders could reinvest their coupon income at higher and higher yields. And in the absence of an adverse credit event, they would receive 100 cents on the dollar (whatever a "dollar" happened to be) at maturity.

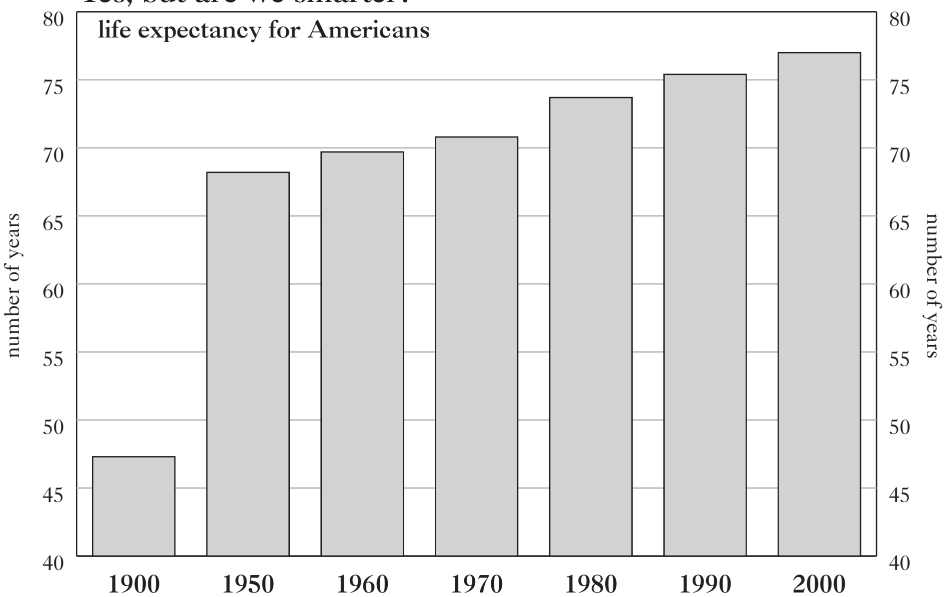
But neither the building nor the bonds provide the margin of safety that value-seeking investors demand. On the contrary, both asset classes command some of the fanciest valuations in memory. Only last year, MetLife's real estate and real estate joint ventures yielded 11.6%, or more than twice the cap rate to which the buyers of the MetLife Building said "I do" last week. Does overvaluation alone assure a disappointing total return? Emphatically, yes. We consign our judgment in confidence to the *Grant's* time capsule.

It is easier to sift through the past than to speculate about the future—easier and often more remunerative. Economic cycles wax and wane. Ditto, skirt lengths, necktie widths and geopolitical alignments. But low nominal interest rates present the same basic investment challenge to a deployer of capital whether the president be Dwight D. Eisenhower or George W. Bush. Famously, compound interest is the eighth wonder of the world, but some rates of interest are more wondrous than others. Invest $100 at 4% a year for 50 years, compounded twice a year, and you wind up with $724.46. Invest $100 at 8% for 50 years, compounded in the same fashion, and you get $5,050.49. To borrow from Sophie Tucker

MetLife—the more things change. . .
(invesment portfolio, in $ millions)

	—1955— total	—1955— percent of portfolio	—2004— total	—2004— percent of portfolio
Government bonds	$1,766	12.7%	$ 30,310	12.7%
Corporate bonds	7,298	52.4	101,853	42.6
Equities	156	1.1	5,114	2.1
Mortgages (includes MBS)	3,170	22.8	77,006	32.2
Real estate	518	3.7	4,329	1.8
Other assets	1,026	7.4	20,677	8.6
Total	$13,934	100%	$239,289	100%

Yes, but are we smarter?



source: Centers for Disease Control

(1884-1966), the Met has invested at high interest rates, and it has invested at low interest rates, and high interest rates are better. High real interest rates are especially better. Low rates are undesirable not only for what they fail to deliver in investment return, but also for the temptations they present to prudent people to invest imprudently.

The financial hand dealt to the parents and grandparents of present-day *Grant's* readers featured (besides midget bond yields) high marginal tax rates, cheap equities, unleveraged capital structures, regimented investment markets and deep-rooted insecurity. Many Americans feared the resumption of the Great Depression or the onset of World War III, or both. Rare is the individual who can imagine a different set of circumstances than those that surround him. Rarer still is the organization that can imagine them. "Imagination is not a gift usually associated with bureaucracies," wrote the 9/11 Commission. "Insight for the future is . . . not easy to apply in practice," the commission also noted. "It is hardest to mount a major effort while a problem still seems minor. Once the danger has fully materialized, evident to all, mobilizing action is easier—but it then may be too late." Here, though the commission believed it was discussing national security, it could have been ruminating on the art of investing.

Constant readers know that interest-rate markets are long-trending markets; complete cycles, low rates to high rates back to low rates again, can span a generation or more. According to Sidney Homer's "A History of Interest Rates," a bull bond market began in 1920, with corporate yields at 5 1/4%, and ended in 1946, with corporate yields at 2 1/2%. The ensuing bear market got off to a slow start. Indeed, so measured was the rise in rates (which were still under the thumb of the Fed and Treasury) that hardly anyone noticed the change in trend. Yields stayed low into the early 1960s. Who expected that this greatest of bond bear markets would culminate in a great inflation and, in 1981, a 15% long Treasury yield? Not the investment committee of the Metropolitan Life Insurance Co.

"As ever," the Met addressed its policyholders in the 1955 annual report, "the prime consideration of the Company's investment policy is safety of principal, combined with a reasonable return, and consideration of regional and national interests." What passed for "reasonable" in 1955 was 3.48% before tax. Last year, the portfolio achieved 6.53% pretax.

In 1955, the Met was a mutual company, meaning the policyholders owned it, even if they couldn't control it. It had $13.9 billion in assets, by which measure it was the biggest company in America (not just the biggest insurance company, but the biggest of any kind). It insured 38.3 million people, one person in five in the 48 states and Canada, and it employed 50,000. It had no mandate to maximize earnings, or, for that matter, anything else. Rather, it sought to protect principal and contribute to the national economic agenda: defense in wartime; prosperity in peacetime. Compare the mandate of the de-mutualized, profit-maximizing, capital-markets savvy MetLife of 2005: "The company's primary investment objective is to optimize, net of income taxes, risk-adjusted investment income and risk-adjusted total return while ensuring that assets and liabilities are managed on a cash flow and duration basis."

Today's MetLife, a holding company, deploys billions of dollars in corporate assets "to build shareholder value"; as it acquires the Travelers Insurance Co., it sells Manhattan real estate. It insures 46 million people worldwide and employs 54,000. In 1955, the Met's surplus amounted to 6.4% of its total liabilities; in 2004, the MetLife insurance subsidiary had surplus in the amount of 3.7% of total liabilities. "We know that people across the globe are under-insured, under-saved and, in the case of the baby-boom generation, in need of retirement solutions that will guarantee income," declares management in the new, approved language of globalization. The Met of yesteryear was in business to serve the policyholders and the country (and, of course, its own officers and employees), not a self-selected core of stockholders. Even if the Eisenhower-era company had decided to change "its methodology of allocating capital to its business segments from Risk-Based Capital ('RBC') to Economic Capital," as the contemporary Met just did, management probably wouldn't have felt the need to disclose the fact in the annual report. The millennial MetLife, with its battalions of quants, CFAs and MBAs, not only hedges its interest-rate and currency risk with derivatives, and spices its bond portfolio with junk, but also discloses these facts in the standard regulatory format.

But despite these epochal changes, asset allocation today is little different than it was in 1955. Now as then, the emphasis is on corporate bonds, an asset class subject to early call, event risk and credit risk. Corporates constitute 43% of the investment portfolio, as compared to 52% in 1955. Mortgages and mortgage-backed securities make up 32% of the portfolio, as opposed to 22.8% in 1955. Today, as in 1955, government securities account for exactly 12.7% of the portfolio. Now as then, equities figure only marginally in the asset mix. Ditto, real estate. And now, as then, "alternative" assets—timber, hedge funds, convertible-bond arbitrage, etc.—seem to figure hardly at all. The millennial MetLife does go in for foreign securities, as the 1955-edition Met may not have (31% of the 2004 corporate portfolio was foreign). But they are only so foreign: the company has no unhedged currency exposure.

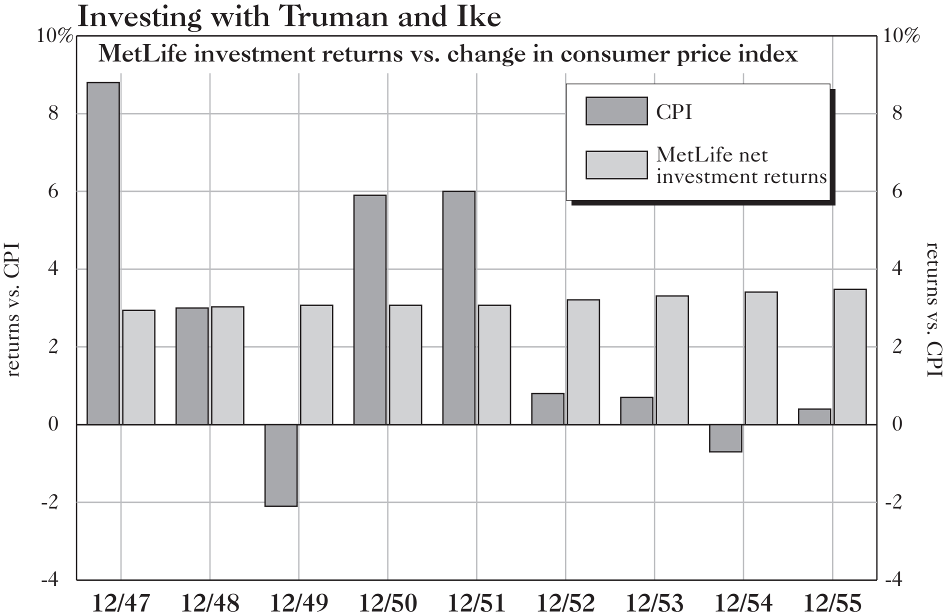
In the past half-century, life expectancy in the United States has climbed to 77 years from 68.2 years. "From a demographics standpoint," states the 2004 MetLife annual, "the bulk of the United States population is moving from an asset accumulation phase to an asset distribution phase. People within 10 years of retirement hold significant assets. With continually lengthening life spans and unstructured asset distribution, the company believes many of these people may outlive their retirement savings and/or long-term care. As a result, the company expects that the demand for retirement payout solutions with guarantees will increase dramatically over the next decade."

Fifty years ago, Americans were still briskly accumulating. Certainly, Metropolitan Life was accumulating assets. In 1955, it enjoyed $6.5 billion of new premium income, an astounding 33% jump over 1954. How to invest these massive inflows?

The guiding light of a seven-man investment committee in the early 1950s was an octogenarian. Frederick H. Ecker had been with the company since 1883. Possibly, he was still young at heart. But he had been president during the 1930s, when the delinquency of 58% of the company's agricultural loans resulted in the repossession of two million acres of farmland (the Met had its own "Department of Agriculture"). Reputedly a shrewd investor for his personal account, Ecker tried nothing fancy with the policyholders' savings. "Safety of principal must be the primary consideration of life insurance funds," declared the president, Charles G. Taylor, for emphasis.

Noble words! But what kept principal safe? There was precious little safety to be had in the asset markets in which the Met chose to invest. From the close of World War II through the early 1950s, the company's investment returns barely kept up with (or actually lagged behind) the measured rate of inflation. And that measured rate was flattered by price controls.

Investing with Truman and Ike



sources: MetLife annuals, the Bloomberg

To earn a return greater than the microscopic prevailing bond yields, the Met, late in the 1930s, stepped up its investments in apartment buildings. It built, among other big projects, the Parkfairfax in Alexandria, Va., the Parkmerced in San Francisco and Peter Cooper Village and Stuyvesant Town in Manhattan. But it could find no economic relief even in bricks and mortar. Inflation pushed up building costs and rent controls capped income. In the 1948 annual report, management wistfully recalled the 5¼% rates it had earned late in the 1920s: "If the interest rate earned last year had been the same as in 1928, it would have meant about $182 million more in income, which would have enabled the company to pay substantially higher dividends to policyholders." That year, the company earned a grand total of 3.03%, which—to look on the bright side, which the Met always tried to do—was up by nine whole basis points from 1947.

Interest rates were flat on their backs—but so, too, were common stocks. Here is a paradox for the modern portfolio theorist to ponder. In 1951, long-dated Treasurys fetched 2.6%—but the S&P 500 threw off a dividend yield of 6.1% and an earnings yield of 10.9%. We mention 1951 because that was the year the New York State Insurance Department revised its draconian investment rules to allow life companies some exposure to common stocks. Did the Met avail itself of this opportunity? "We have no intention of acquiring common stocks," president Taylor told *The Wall Street Journal* in 1952, having taken a year to think it over.

Fast-forward four years, to the press conference at which a new Met president presented the 1955 financial results. A reporter asked if the company had changed its mind about stocks. Frederic W. Ecker, the son of the eminent Ecker, said, "No." For one thing, the law didn't allow the purchase of enough stocks to make a meaningful impact on the investment results. For another, the market really wasn't cheap any more (in 1954, the Dow had finally pushed above the old 1929 highs). As he spoke, the dividend yield on the S&P was a mere 104 basis points higher than the long-term, triple-A-rated corporate bond yield. But even if the company had

Then and now

	1955	2005
Aaa-rated corporates	3.04%	5.40%
Baa-rated corporates	3.53	6.14
Long-term governments	2.84	4.44
S&P yield	4.08	2.04
Price/earnings ratio	11.46x	19.59x

sources: Federal Reserve, the Bloomberg

been allowed to buy enough stock to matter, it wouldn't have. The market might go down.

"Suppose," reported *The National Underwriter*, paraphrasing Ecker, "only 10% were in stocks—and there were a 40% drop in the stock market, as had happened several times in the last half century, it would probably come close to wiping out the company's surplus. Moreover, if at a time when the stock market was falling apart the news should get around that life companies' surpluses were being virtually destroyed it would not be a very good thing for public confidence. These violent fluctuations, Mr. Ecker indicated, are implicit in the nature of common stocks."

And what characteristics were implicit in senior securities? Ecker acknowledged only one: safety. A clairvoyant would have seen that bonds, as then valued, were only apparently safe, because yields would keep rising until Sept. 30, 1981. But clairvoyants either don't need jobs or can't hold them. Especially are they unsuitable candidates for work in the investment department of the big insurance companies. The "climate of conformity" that the authors of the new Robb-Silberman report on U.S. intelligence bemoaned in the CIA and allied agencies is just as prevalent in the world of institutional investing. Bonds? "Perfectly sound, long-term investments," the investment committees broadly judge. Look at the past quarter-century: Interest rates fell, inflation became quiescent, the dollar achieved worldwide acceptance as a reserve currency. Why must any of that change?

To finance World War II on the cheap, the U.S. Treasury and Federal Reserve suppressed interest rates. Fifty years later, to mitigate the damage from the bursting stock-market bubble, the Fed suppressed interest rates again. The first manipulative episode visited huge losses on bondholders. We expect that the second episode will deal sizable losses to holders of the same kinds of securities. Fifty years ago, refugees from the fixed-income markets found value in equities. Today, there's no such haven (now that every known member of Mensa International is running a hedge fund, investment opportunities are increasingly scarce, both across markets and time zones). The Met deserves a salute for the nimbleness of its real estate sales. And it deserves commiseration on the immensity of its bond portfolio. In filing future complaints about the company's lamentable investment performance (which the present dearth of investment value all but guarantees), policyholders should not forget to copy the Federal Open Market Committee.

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'Boats for all' —a cautionary tale

(April 30, 2010) For this confident nation, disaster is a call to arms. "Never again," we vow, even before the dust has settled. To prevent a recurrence of whatever it was that took us by the scruff of the neck, we summon experts, glean facts, issue bipartisan reports and legislate—not necessarily in that order.

So it is with the great financial upheaval. And so it was in a long-ago maritime disaster. The subject at hand is what the capsizing of the S.S. Eastland in the Chicago River in 1915 has to teach about the contemporary drive to risk-proof the American financial system.

"We shouldn't put in place a regulatory regime that overly reacts and, as a result, significantly dampens our capacity to have the most vibrant capital and credit markets in the world," Sen. Judd Gregg, a New Hampshire Republican, was quoted as saying on Monday. Without choosing up political sides, a student of the Eastland sinking may judge that Gregg has a point. The intended consequences of government regulation are frequently less potent than the unintended ones.

From both sides of the congressional aisle today come measures to protect the economy against Wall Street malpractice. The representatives and senators would, among other things, implement a "Volcker rule" (no proprietary trading by federally insured depositories) and a kind of Tobin tax (leveraged speculators should pay a toll, just as motorists do). A bipartisan bill, according to Tuesday's *New York Times*, would "authorize the government to shut down a financial institution deemed to pose a threat to the stability of the system, using a $50 billion fund financed by big banks to help the failed company meet financial commitments while it is being wound down." Derivatives activity would be curtailed or eliminated. A new federal consumer protection agency would interpose itself between borrowers and lenders, breathing heavily down the necks of the latter. Your editor, too, has a big idea, a proposal to adapt the Brazilian convention of holding senior bank directors and senior officers personally liable for the solvency of the institutions in which they are interested. This particular notion seems not to be getting much traction in Washington. (Visit the *Grant's* home page for a link to his *Washington Post* op-ed column of April 23.)

Concerning the Eastland, an eyewitness said it rolled over at dockside "as though it were a whale going to take a nap," shortly before its planned departure to a picnic site in Michigan City, Ind. The vessel was loaded with holiday-bound workers of the Western Electric Co., 2,752 in all, the maximum allowed under newly revised regulations; 844 passengers and crew were killed.

It was the Titanic disaster of April 14, 1912, that set in train those regulatory revisions. Or, rather, concludes an historian of the Eastland, it was "the world's response" to the Titanic disaster that activated the regulatory changes that led to the horror in Chicago three years later. "That response was, perhaps inevitably, highly emotional, and, in retrospect, excessive," writes George Hilton, an emeritus professor of economics at UCLA, in his history, "Eastland: Legacy of the Titanic" (Stanford University Press, 1997). "More important, that response was poorly related to the cause of the disaster."

Hilton contends that a shortage of lifeboats wasn't responsible for the deaths of 829 passengers and 694 crew of the pride and joy of the White Star Line. Blame rather attaches to a poorly designed rudder and center screw and an unfortunate series of commands from the bridge in the moments following the collision with the iceberg.

Embarked on the Titanic were 2,228 persons, of whom only 705 were saved; the ship's lifeboats could have accommodated 1,178. The owners had not skimped on lifeboats—there were more seats than existing regulations required. So rose the demand for new regulations, Hilton relates, and "Boats for all" became the worldwide rallying cry of maritime reform.

"Actually," the author observes, "the probability of a ship's hitting an iceberg did not differ after the Titanic disaster from what it had been before—1 in 1,000,000, in the evaluation of the Titanic's underwriters in writing her insurance contract. Such a suggestion would have been highly unpopular, however—about as unpopular as the comment that most ships run no risk of hitting icebergs at all. Similarly, it went unremarked in popular discussion that many marine disasters are of such a character that no boats can be launched."

No matter. International conferees, meeting in 1914, drafted the "Fundamental Principle" that there must be a lifeboat seat for every passenger and crew member. Congress responded with the La Follette Seamen's Act of 1915, which, in the spirit of the Fundamental Principle, required boats and life rafts for all hands. The law was passed over the prescient objections of, among others, A.A. Schantz, general manager of the Detroit & Cleveland Navigation Co. Regulations intended for the high seas would likely backfire on the Great Lakes, Schantz testified before the Senate Commerce Committee.

"The boats now operated could not comply with the requirements of the bill," Schantz said, "on account of the light draft and the construction of the cabins and upper works. The extra weight of lifeboats and rafts would make them top-heavy and unseaworthy, and in our judgment, we believe some of them would turn turtle if you attempted to navigate them with this additional weight on the upper decks."

The Eastland was notoriously top-heavy before the addition of three lifeboats and six rafts to quiet the "Boats for all" outcry. The extra weight evidently pushed it to do exactly what Schantz had predicted that some Great Lakes vessel would eventually do. Nor was Schantz alone. An editorial in the trade magazine *Marine Journal* rebuked Congress for writing "Boats for all" (or, more exactly, "Boats or life rafts for all") into the statute books. The Titanic disaster, the magazine editorialized in the issue dated July 24, 1915, which happened to be the very day the Eastland foundered, ". . .should never have caused the irreparable damage that it has to the marine industry through the inimical measures that Congress and the Administration have favored."

So unlikely was a repeat of the Titanic sinking, Hilton suggests, that it warranted no regulatory response. As for the debt debacle of 2007-09, a recurrence is not just probable. Because the incentives that caused it are still in place, another such crisis is virtually certain. Still and all, the story of the Eastland is a powerful reminder that politicians and regulators don't always get what they want. Sometimes, in fact, they get the opposite.

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The whys and wherefores of QE3

(April 22, 2011) For the institutional elite of American finance, money is literally free. Federal funds change hands at 10 basis points, the one-month Treasury bill at two basis points. In the repurchase, or repo, market, the lending rate on general collateral stands at five basis points, that on certain named, or "special," collateral at less than zero percent. The dollar exchange rate sits near record lows, the dollar-denominated gold price at a nominal high. In a functioning free-market economy, money is no more free for the taking than are neckties or movie tickets. Yet, almost 30% of the respondents to a poll conducted by UBS a few weeks back said they anticipate a third round of so-called quantitative easing. Maybe our economy isn't so functional or so free.

QE3 is the subject at hand, a topic as speculative as it is timely. In preview, we count ourselves among the expectant 30%. To its congressionally directed dual mandate—stable prices and full employment—the Bernanke Fed has unilaterally added a third. It has undertaken to make the markets rise. The chairman himself has more than once taken credit for the post-2008 bull market (on one such occasion in January, he reminded the CNBC audience how far the Russell 2000 had come under Fed ministrations). Could he therefore stand idly by in the face of a new bear market? Byron Wien, vice chairman of Blackstone Advisory Services, went on record the other day predicting a summer swoon in stocks following the scheduled winding down of QE2 in June. Let us say that Wien is right, and that, furthermore, drooping stocks are accompanied by sagging house prices and a weakening labor market. Bernanke was hard put to explain why he chose to let Lehman go while acting to save Bear Stearns. He would be harder put to explain why he chose to implement QE1 and QE2 but, in another hour of need, refused to launch QE3.

A different Fed—a *Grant's* Fed or a Hoisington Fed, for instance—would cease and desist quantitative easing this very minute. Van R. Hoisington, eponymous chief of Hoisington Investment Management Co., Austin, Texas, is out with a new critique of the Bernanke program. "If the objectives of Quantitative Easing 2 (QE2) were to: a) raise interest rates; b) slow economic growth; c) encourage speculation and d) eviscerate the standard of living of the average American family," his colleagues and he write in their first-quarter report, "then it has been enormously successful." The third point, especially, speaks to the prospects of QE3, we think. Sooner or later, gravity turns speculative markets into investment markets. When this transformation next occurs, the Fed will confront the need to bail out the innocents it had previously bailed in. Hence, QE3.

The first phase of Federal Reserve dollar conjuring began in November 2008, and it didn't stop until March 2010. Over those 16 months, the Fed's balance sheet grew by 5.8%, as the S&P 500 jumped by 36.4% and the dollar-denominated gold price by 35.1%. As for the nation's economic pulse, it slightly quickened. Best of all, observe the Fed's apologists, there was no reprise of the Great Depression. On those terms, QE1 was a rousing success.

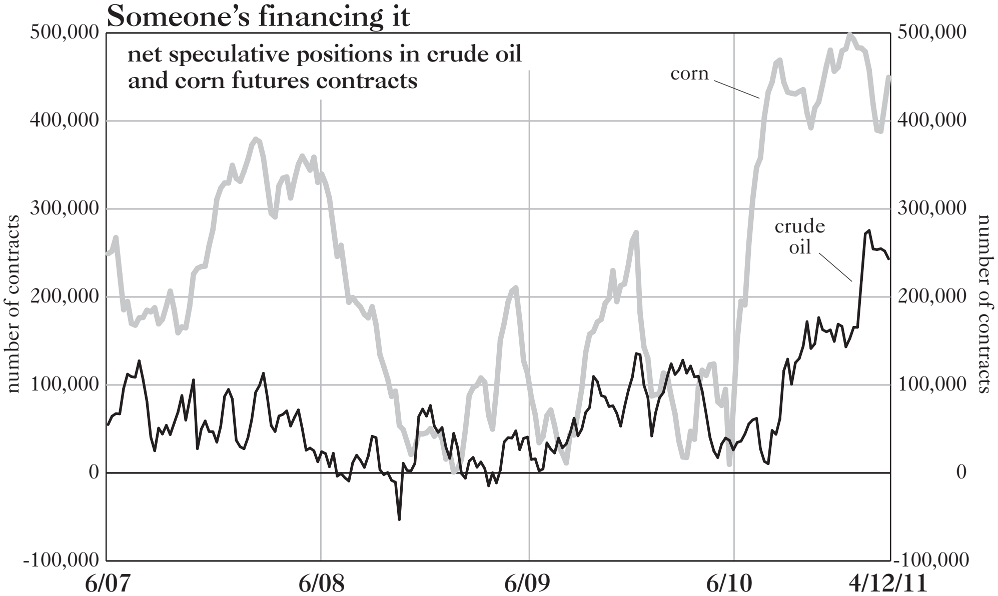
We say "dollar conjuring"; some will object that "conjuring" is what modern central banks do. The Fed and its ilk purchase earning assets with money they create for the very purpose. However, QE is no ordinary conjuring trick. In the 10 years ended in 1951, the Fed pegged the three-month Treasury bill rate at three-eighths of 1% and the long bond rate at 2½%. But the Ben Bernankes of their day, Marriner Eccles and William McChesney Martin, were only doing their duty as they saw that duty. They pegged interest rates to facilitate wartime borrowing (and, after the war, to prevent the kind of jump in interest rates that had shocked the novice Liberty Bond buyers after World War I). Eccles, in particular, seemed to have it in for bull stock markets. He cut short one in 1937, another in 1946. Besides, in those days there were forms to respect. As the dollar was lawfully defined as a weight of gold ($35 to the ounce), one could conjure only so many pieces of green paper.

The Martin Fed exulted in its newfound independence from the Treasury after the famous 1951 Fed-Treasury Accord. The Bernanke Fed appears to be exulting, still, in its independence from the gold standard, the last vestige of which ended in 1971, 40 years ago this summer. Like its World War II-era predecessor, the 2011 Fed is pegging money-market interest rates at close to zero. Unlike the Martin Fed, however, the Bank of Bernanke has set out to manipulate America's risk appetite. It means to herd the public into stocks and corporate bonds and out of government securities, so speeding financial and economic recovery. "The portfolio balance channel" is the clinical name for this monetary mind game.

Successful though it was at cheapening the dollar in terms of stocks and gold, QE1 failed to deliver vibrant growth or full employment. Besides, the Fed had chosen to pursue its policy by buying mortgage-backed securities. Perversely, the still-weak economy gave long-term interest rates a downside push. Lower mortgage rates meant a faster gait of mortgage refinancing, which meant that the Fed's MBS portfolio began an unplanned and, from the vantage point of monetary management, disadvantageous shrinkage. At the annual Federal Reserve cookout and barbeque in Jackson Hole, Wyo., on Aug. 27, 2010, Bernanke sketched the outlines of what turned out to be QE2.

"[A]s the pace of economic growth has slowed somewhat," the chairman explained, "longer-term interest rates have fallen and mortgage

Someone's financing it



source: The Bloomberg

refinancing activity has picked up. Increased refinancing has in turn led the Fed's holding of agency MBS to run off more quickly than previously anticipated. Although mortgage prepayment rates are difficult to predict, under the assumption that mortgage rates remain near current levels, we estimated that an additional $400 billion or so of MBS and agency debt currently in the Fed's portfolio could be repaid by the end of 2011.

"At their most recent meeting," Bernanke continued, now all but drawing a picture, "FOMC participants observed that allowing the Federal Reserve's balance sheet to shrink in this way at a time when the outlook had weakened somewhat was inconsistent with the Committee's intention to provide monetary accommodation necessary to support the recovery." A month later, David Tepper, chief of Appaloosa Management, was on CNBC correctly anticipating that, unless the economy picked up, the Fed would re-launch QE. "Then what's going to do well?" he rhetorically asked. "In the near term, everything." And so it came to pass.

Speculation has particularly flourished, as the Hoisington-produced indictment notes. Thus, from the date of Bernanke 's Jackson Hole speech to the present, the S&P 500 has climbed by 23.3%, gasoline by 65.9% and the Goldman Sachs Commodity Index by 43.7%. Open interest is setting records in corn and crude oil. "Commodity and stock price movements are susceptible to a myriad of demand/supply factors that include cartels, war and weather," as Hoisington observes. "But the speculation created by QE2 suggests financial players are aiding and abetting the normal price movements." Gold and silver make exemplary cases in point. You can blame ethanol for the corn pop and revolution for the oil spike. The cause of the updraft in the precious metals would seem to begin and end with the world's central banks. Understandably, people have come to doubt paper currencies.

Before the Monday break, share-price volatility, as measured by the VIX index, stood at a post-2007 low, while New York Stock Exchange margin debt registered post-crisis highs. Of course, modern financial leverage takes many forms. One would expect zero-percent funding costs to facilitate ramp-ups in derivatives activity. And, indeed, ventures Rod McKnew, editor of "Beyond the Numbers," a professional bulletin on monetary matters, the invisible funds rate has done just that. The $1.4 trillion in excess reserves now apparently lying fallow at the Federal Reserve banks, he and we venture, are not quite inert. They finance something, even if we're not quite sure what.

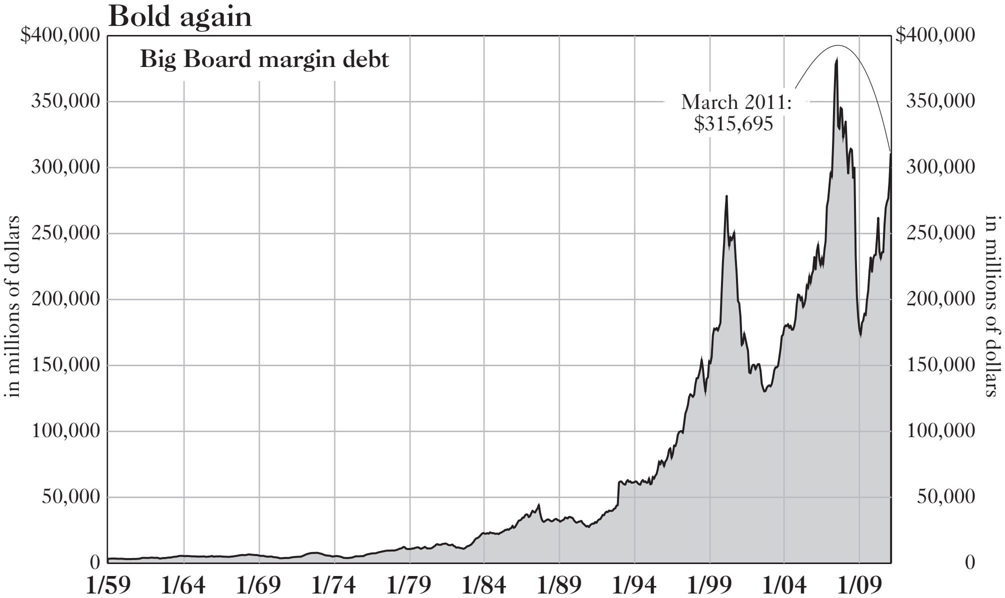
To the Dean Witter Distinguished Professor of Finance at the Graduate School of Business at Stanford University, Darrell Duffie, we posed this question: Can excess reserves serve as collateral for futures and derivatives transactions? "Yes," he replied. "Acceptable collateral is a matter of private contract, but reserve deposits [are] virtually always acceptable." It would be interesting to know the views of the Federal Reserve on this matter, but neither the Federal Reserve Bank of New York nor the Federal Reserve Board in Washington returned our calls. In any case, the piling up of these immense redundant balances is stimulatory in ways both seen and unseen.

Hoisington hates QE2, McKnew hates QE2 and we hate QE2. We will go further. The founders of the American central bank would hate it, too. The 1913 Federal Reserve Act was intended to prevent a recurrence of the Panic of 1907 by dispersing and decentralizing banking assets. At fateful, all-too-frequent intervals, the sponsors of the legislation believed, America's deposits wound up making mischief in the New York broker-loan market rather than financing enterprise and agriculture in the hinterland.

Rep. Carter Glass, Democrat of Virginia—the "father of the Fed," as history styles him—gave a talk in New York in October 1913 entitled, "The opposition to the Federal Reserve Bank Bill." In it, the chairman of the House Banking and Currency Committee tore the hide off the city bankers who would selfishly thwart progress. Glass was a gold-standard man with a populist's abhorrence of concentrated financial power.

"Under existing law," Glass declared, "we have permitted the banks to pyramid credit upon credit, and to call these credits reserves. It is a misnomer. They are not reserves, and when financial troubles come and country banks call for their money with which to pay their creditors, they find it invested in stock-gambling operations. There is suspension of payment and the whole system breaks down under the strain, causing widespread confusion and almost inconceivable damage. The avowed purpose of this bill," Glass continued, "is to cure this evil, to withdraw the reserve funds of the country from the congested money centers and to make them readily available for busi-

Bold again



source: The New York Stock Exchange

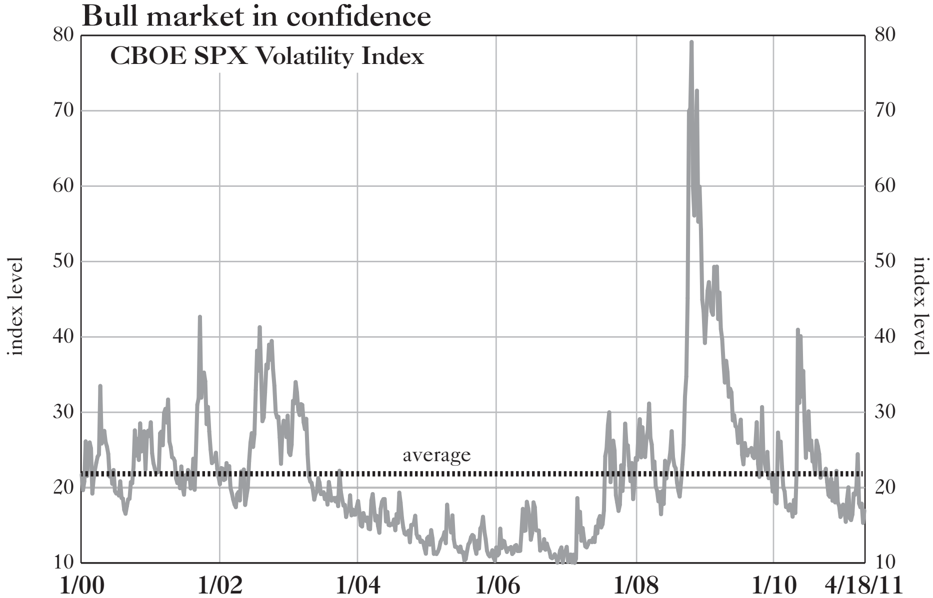
ness uses in the various sections of the country to which they belong."

This redistribution of deposits, Glass assured the audience, would occur only gradually. But the obstructionists wouldn't accept those assurances. "They do not want existing arrangements disturbed; they are willing to perpetuate a defective, unscientific system sanctioned by law but condemned by experience and bitterly offensive to the American people," Glass continued—"a system which everybody knows encourages and promotes the worst description of stock gambling."

Glass seemed not to know the word "investing"; for him, "gambling" was the all-purpose investment gerund. A worshipful admirer of Woodrow Wilson, the Virginian shared his president's conviction that the nation's banking resources were under the control of just a dozen willful men. Congress must break up this "money trust," as the Dimons, Blankfeins and Moynihans of 1912 were collectively stigmatized. Still, you could depend on Glass to stand up for old-time religion in the matter of the currency itself. It pleased the lawmaker just how many layers of protection insulated the new Federal Reserve notes. Gold, for one thing; self-liquidating commercial loans, for another; and the double liability of the stockholders of the national banks (and of the regional Federal Reserve banks, too), for a third. If, in those days, a nationally chartered bank became insolvent, the stockholders got a capital call. They deserved it, the lawmakers and judges of the time reasoned. After all, it was their bank that failed, not the government's.

Maybe the father of the Fed would deny paternity if he were returned to life to confront the consequences of his legislative achievement. Instead of Wilson's dozen willful men, the 2010 best-seller about financial concentration named a baker's dozen ("13 Bankers" was its title). Not much net progress seems to have been made toward the democratization of finance over a full century. In 1911, the 20 largest New York City banks controlled 43% of New York banking resources—but New York City controlled just 22% of the nation's. In a widely quoted speech a couple of months ago, Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, pointed out that, in 1999, the five largest American banking organizations controlled $2.3 trillion in assets, or 38% of the grand total. Now the top five—Bank of America, JP Morgan Chase, Citigroup, Wells Fargo and Goldman Sachs—control $8.5 trillion, or 52% of the sum. Woodrow Wilson never saw a money trust like the one brought about through the succession of crises ending in ever more radical federal interventions. As for the double-liability feature of the national banking system, it was erased in 1935.

Bull market in confidence



source: The Bloomberg

No monetary system protects against booms and busts. We humans can't seem to help ourselves. However, unchecked money printing in conjunction with the socialization of risk has brought this country to a more precarious position than Carter Glass ever dreamed of. And now, perversely enough, still greater feats of money printing likely await us. Good luck to the Fed—better luck to the rest of us!

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'Bonanza' was better

(August 12, 2011) In 1971, the world lost its semi-golden dollar. Last week, the United States lost its unqualified triple-A rating. In 1971, the gross public debt totaled $408 billion, or 37.8% of GDP. As of July 31, the gross public debt stood at $14.3 trillion, or 94.8% of GDP. Monetary cause and fiscal effect are the subjects at hand.

Cognizant of the world crisis, this publication will keep no reader guessing. The underlying cause of the downgrade, and of the fiscal predicament that led to the downgrade, is the post-1971-model dollar. While we don't claim that the paper dollar makes strong people weak, or that the gold dollar made weak people strong, we do claim that the paper dollar makes an unreasonable claim on the virtue of the ordinary politician. "Here," we voters and ratings agencies tell them, "balance the budget and pay down the debt, though if you would prefer not to do it, or to do it next year, or the year after that, you can finance your limitless borrowing at 2%. The predatory Asian mercantilists will be happy to accommodate you." Alexander Hamilton himself might have succumbed to the temptation. Fitting it is, therefore, that Standard & Poor's chose to downgrade the credit quality of the U.S. Treasury within 10 days of the 40th anniversary of the birth of a monetary system whose component currencies sink and surge like hailstones.

At 9 p.m. Eastern time on Sunday, Aug. 15, 1971, Americans gathered round the television to watch an episode of "Bonanza," the beloved, weekly horse opera. What they saw instead was President Richard M.

Nixon ordering a 90-day freeze of wages and prices, a 10% surtax on imports and the "temporary" suspension of the convertibility of the dollar into an ounce of gold at the $35 fixed rate. The disappointed "Bonanza" fans were taken aback. Was this the pro-business Republican whom they had voted for, or, for that matter, against? When markets opened on Monday, bond prices climbed and the Dow Jones Industrial Average registered the largest single-day gain in its history. Wall Street's broad grin prompted Leonard Silk, *The New York Times*' economics columnist, to wonder why Nixon had "waited so long to drop the ideology-ridden old game plan and to offer up his own new deal."

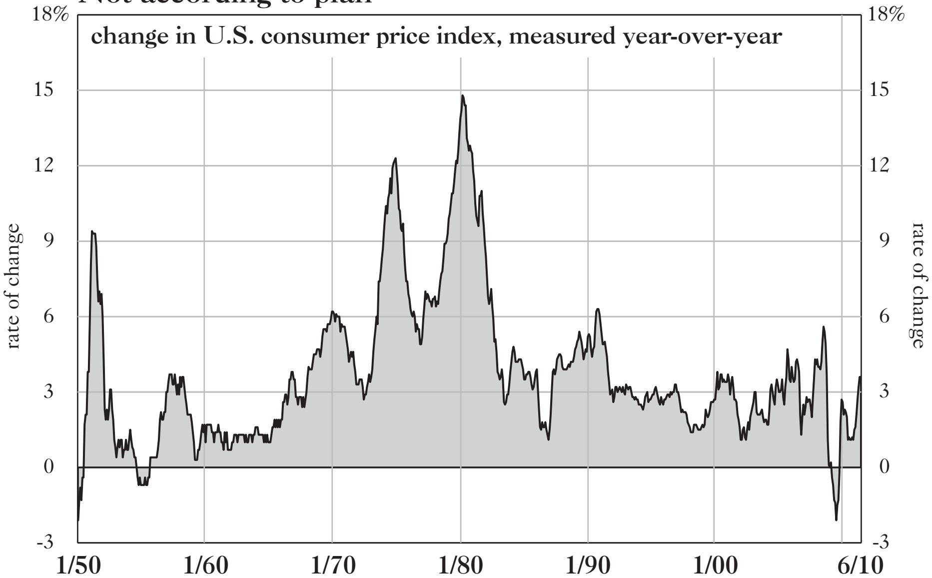
The world today confronts one kind of monetary crisis. Forty years ago, Nixon faced another. His was an inflation problem, with the CPI showing $4\frac{1}{2}\%$ year-over-year gains and the phrase "wage-price spiral" on editorial lips. Nowadays, there are signs of inflation and deflation alike. Beans in the teens and gold in the $1,700s coexist with zero-percent T-bill rates and upside-down residential mortgages.

The monetary differences then and now could hardly be starker. Nowadays, the dollar is undefined and uncollateralized. Then, under the international monetary rules hammered out at Bretton Woods, N.H., in 1944, a dollar was defined as 1/35th of an ounce of gold. Let an official foreign creditor demand gold in exchange for dollars, and the Treasury had to comply. The French, in particular, were keen to trade greenbacks for gold. The arithmetic of the American external position was, all agreed, untenable. Against some $50 billion of liquid dollar claims in the possession of America's overseas creditors, including $31 billion in official hands, the U.S. Treasury held just $10.5 billion in bullion. Either there were too many footloose dollars (the European position) or too many ungrateful, treacherous and venal Europeans (the American stance). In any case, something had to give. German hotel clerks were turning up their noses at dollar-denominated travelers' checks.

In 12 months' time, Nixon would be battling for a second term in the White House. If there were a moment for an economic call to arms, this seemed the one. So the president, returning the stare of the White House TV camera, laid out his economic program—part stimulus plan (investment tax credits, excise-tax reductions), part anti-inflation plan ("voluntary," in name only, wage-and-price controls) and part monetary bromide. As to the latter, Nixon said there could be no prosperity without a dollar made safe from the depredations of international speculators.

In this, we are reminded of the founding of the Federal Reserve in 1913. The progenitors vowed that the United States should never again suffer the costs and indignities of a panic such as that of 1907, when business ground to a halt for the simple want of cash. So Congress and the Wilson administration created an institution to provide an "elastic" currency. In the first 20 years of its existence, the Wilsonians' pride and joy presided over a torrid wartime inflation (1917-19), a frigid postwar deflation-cum-recession (1920-21) and, of course, the Great Depression (1929-33) along with a subsequent bear market (1937) calculated to break the spirits and fi-

Not according to plan



source: Federal Reserve Bank of St. Louis

nances of any who had managed to survive the Depression. After this chain of disasters, the Panic of 1907 started to look benign.

So, too, as we will demonstrate, with the Nixon initiative—the "New Economic Policy," the administration called it. The 4½% rate of inflation in 1971 gave way at length to the 13½% inflation of 1980, and the moderately bad federal deficit of 2.1% of GDP yielded to the slightly more outsize deficits of the mid- and late-1970s (e.g., 2.7% of GDP in 1977 and 1978), to the jarringly larger deficits of the early 1980s (e.g., 6% of GDP in 1983, 4.8% of GDP in 1984) and to the grotesque deficits of 2009 to date (upwards of 10% of GDP). The convertible dollar checked political spendthrifts. The pure paper version gave them free reign. The convertible dollar resembled a national debit card. The pure paper dollar takes the form of a national credit card—and one, at least so far, with no forced reduction of outstanding balances. When you take the measure of the external financial position of the United States, the net debt and contingent liabilities of the U.S. government, and you consider the immensity of these numbers, you wonder what was so wrong with a 4½% inflation rate that Nixon had to turn the dollar into a thing that could be quantitatively eased.

We, of course, have the luxury of looking backwards. Nixon was looking forward to the 1972 election. What we know (colleague Charley Grant has dug up the facts) is that, in the 40 years since 1971, the federal budget has registered a deficit at least as large as 1% of GDP 85% of the time, whereas in the 40 years prior to 1971, the budget was in the red to the extent of at least 1% of GDP only 50% of the time—and those 40 years included the unprosperous 1930s and the war-torn 1940s. We know, too, that in the 40 years since 1971, the American current account has been in deficit 82.5% of the time, whereas in the 40 years preceding 1971, the current account was in deficit in not one single year. What Nixon knew was that a July 1971 Gallup poll had found 50% of respondents favoring a federal freeze on wages and prices, the most since the Korean War. Besides, 6% of the workforce was out of a job. America's slow but certain exit from Vietnam meant that two million veterans would need a place in the civilian economy, and hard on their heels would be 20 million baby boomers seeking jobs over the next decade.

To his national television audience of 40 years ago come Monday, Nixon expressed no satisfaction with the success of the post-World War II monetary regime during its heyday in the 1950s through the mid-1960s. Rather, he pointed to the devaluations and misalignments of the late 1960s. Still less did he tip his hat to the heyday of the classical gold standard, during which money could go where it was welcome and anyone, rich or not, could elect to exchange paper for gold and vice versa at a fixed and settled rate.

Bretton Woods resembled the classical system the way CliffsNotes' "Romeo and Juliet" resembles Shakespeare's "Romeo and Juliet." Under Bretton Woods, exchange rates were fixed, not floating, and the dollar was convertible at a fixed rate, if you happened to be a foreign central bank. But similarities to the pre-World War I system ended there. One forgets that the post-World War II economy was heavily regulated, from bank deposit rates (the Fed set them) to international capital mobility (it was discouraged) to the ownership of gold (President Eisenhower had signed a 1961 order forbidding Americans from owning gold in foreign countries, complementing a 1933 order signed by President Roosevelt forbidding Americans from owning gold at home). For Americans, the barbarous relic was a controlled substance, like cocaine.

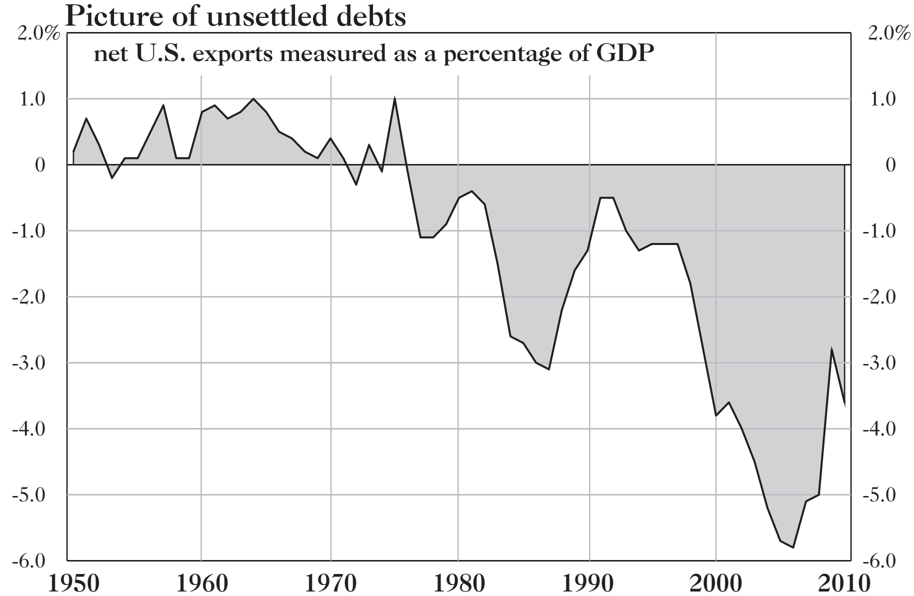
Neither did Nixon get into the monetary back story that Sunday evening, important though it was—and is. With the 1945 peace, America had the shattered world economy mainly to herself. However, in 1959 the United States registered a dramatic and unaccustomed reversal in trade, a surplus that was almost a deficit. And in 1960, in the London metal market, the gold price shot up to $40.50 an ounce—$5.50 higher than the official price—a vote of no-confidence in the resolution of the U.S. monetary and fiscal powers to control the emission of dollar bills. In response to this demonstration of doubt, the Federal Reserve should have raised its discount rate to draw gold back to the United States, thereby restoring the dollar to its gold parity, or, at least, it should have done so under the conventions of the true-blue gold standard. Instead, under the very different conventions of Bretton Woods, this country and its monetary allies established a slush fund, or "pool," to manipulate the gold price back to the desired range. And at first, the London Gold Pool succeeded. But it could not resist the dollar flood loosed by the Vietnam War. In 1968, the Gold Pool surrendered to the market forces that could no longer be manipulated. And now, on Aug. 15, 1971, Nixon was on the air castigating the speculators who, by buying gold, had effectively sold short the United States. "In the past seven years," the president said, "there's been an average of one international monetary crisis every year." He went on:

> Now who gains from these crises? Not the working man, not the investor, not the real producers of wealth. The gainers are the international money speculators: because they thrive on crises, they help to create them.
>
> In recent weeks, the speculators have been waging all-out war on the American dollar. The strength of a nation's currency is based on the strength of that nation's economy, and the American economy is by far the strongest in the world.
>
> Accordingly, I have directed the Secretary of the Treasury to take the action necessary to defend the dollar against the speculation.
>
> I directed Secretary [John] Connally to suspend temporarily the convertibility of the dollar into gold or other reserve assets except in amounts and conditions determined to be in the interest of monetary stability and in the best interests of the United States.

Nixon somewhat patronizingly assured the "Bonanza" fans that they would hardly notice the dollar devaluation if they bought American products and did their traveling in the 50 states, as the "overwhelming majority" of people did. As for the speculators, who cared? "[O]ur primary concern is with the American workers, and with their competition around the world," he said. Plans were afoot to establish "an urgently needed new international monetary system," and he vowed, "I am determined that the American dollar must never again be a hostage in the hands of international speculators."

So the world was sped along the road to unfixed exchange rates and unanchored currencies. A December 1971 conclave of the so-called G-10 at the Smithsonian Institution in Washington validated the cheapened gold value of the dollar ($38 to the ounce rather than $35) and thus granted the administration its wish for a cheaper currency—the better to export with, the argument went. "It is my great privilege to announce on behalf of the finance ministers and the other representatives of the 10 countries involved," Nixon declared at the close of that meeting, "the conclusion of the most significant monetary agreement in the history of the world."

Picture of unsettled debts



source: Bureau of Economic Analysis

The point almost survived the exaggeration. By drawing a line under the long American experience with collateralized money, Nixon had, indeed, done something epochal. From 1792 til 1971, with a long time-out for the Civil War and its aftermath, the dollar had been defined as a weight of metal. It had been convertible both externally and internally. Let us say that you owned a small bank in New England along about 1850. There was no national currency at the time, so you issued your own. But you could not issue too much, because your notes were convertible into gold coin at the statutory rate, then $20.67 to the ounce. Issue too much, and you risked a run (you would have had to wait 104 years for the birth of Sheila Bair).

And what would replace the quasi-gold-anchored Bretton Woods system? Special Drawing Rights—the newly minted "paper gold"—the Italians unhelpfully urged. Freely floating exchange rates, Milton Friedman proposed. Hear, hear! the editorial page of *The Wall Street Journal* seconded the great monetarist. "No Magic in Gold," the laudatory editorial was headed. As for the People's Republic of China, there was not so much as a shrug. "China's economy is mainly internal," *New York Times* columnist James Reston reported from Shanghai. "It is not particularly worried about world trade because it doesn't have much."

Its golden anchor lying on the floor of the monetary seabed, the good ship Dollar made way for the Port of Inflation, at which paper currencies had called since time immemorial. Paul A. Volcker put a stop to double-digit inflation but at the cost of double-digit unemployment. He could not put a stop to the rise in public borrowing, however. In the 10 years to 1971, the gross debt had climbed to $408 billion from $292 billion, or at a compound growth rate of 3.4%; it was a decade that encompassed both the Great Society and the war in Vietnam. In the subsequent 10 years to 1981, the gross debt jumped to $995 billion from $408 billion, or at a compound growth rate of 8.6%.

From the dawn of the Republic until the early 1970s, federal borrowing had surged in wartime and flattened in peacetime. Famously, in the 1920s, Secretary of the Treasury Andrew Mellon succeeded in paying down a portion of the debt incurred in World War I. From the optimistic vantage point of 1926, he predicted that the debt could be eliminated in its entirety by 1942 (he reckoned without Hitler). But there was no flattening of the growth curve in the immediate post-Vietnam era. Congress wasn't blind to it. Neither was it indifferent to the political and fiscal risks of failing to control it. So, in 1974, it created the Congressional Budget Office. Here, cheered *The New York Times* of the enabling legislation, was a law to "revolutionize procedures for considering the Federal budget and setting national priorities." It passed the Senate, 80-0.

As the fiscal conservatives were shaking hands with one another at the close of fiscal 1974, the debt amounted to $484 billion, or 33.6% of GDP. The budget deficit totaled $6.1 billion, 0.4% of GDP, not bad for a recession year (certainly, in comparison with recent recession years). Then, too, the nation had produced a small current account surplus. Were finances not on the mend?

They were not. Ten years later, the debt stood at $1.6 trillion, or 40.7% of GDP, and the deficit at $186 billion, or 4.8% of GDP. Enter now the dynamic Republican senator from Texas and former economics professor at Texas A&M, Phil Gramm. Seeking "to assure that we, as a nation, stop mortgaging the future of our children," Gramm brought forward a plan to enforce automatic spending reductions if the deficit poked through a predetermined level. Gramm-Rudman-Hollings, as his legislative brainchild was known, would create "a choke point on the growth of government," the principal sponsor explained. If all went according to plan, Gramm predicted, the deficit would be pared to zero by 1991. In fact, in 1991, a recession year, the deficit topped $269 billion, representing 4.5% of GDP. It is true that a key feature of G-R-H was found to be unconstitutional. But it wasn't the Supreme Court that neutralized the preceding great fiscal choke-point project, the Congressional Budget Office, or any of the well-intended but unsuccessful initiatives that followed G-R-H, a roll call that includes the Emergency Deficit Control Reaffirmation Act of 1987, the Budget Enforcement Act of 1990, the Balanced Budget Act of 1997, the Medicare, Medicaid and SCHIP [State Children's Health Insurance Program] Balanced Budget Refinement Act of 1999, or the Deficit Reduction Act of 2005. Nor could any have succeeded, as Lewis E. Lehrman, private investor and advocate of a new gold standard, contends. The source of the fiscal problem is the monetary problem. As long as the government keeps its magic credit card, it will borrow and spend as it has since Nixon took to the airwaves. And now comes the Budget Control Act of 2011, with its plea for the reduction of out-year spending and its creation of yet another new fiscal eye-in-the-sky, the Congressional Joint Select Committee on Deficit Reduction. We have seen it before.

You may object that, under President Clinton and with a paper dollar, the government did achieve three consecutive years of surpluses, 1999-2001. But the respite was brief, and the comeuppance hard. In the financially intoxicating year of 1999, President Clinton made bold to predict that the public debt—all of it—would be eliminated by 2015. He reckoned without the reserve currency.

In 1971, as Nixon prepared to shut the Treasury gold window on the fingers of the ungrateful French, liquid dollar obligations in the hands of foreign governments totaled just $31 billion. They top $2.7 trillion today, that being the sum of U.S. government securities held on behalf of America's foreign official creditors at the Federal Reserve Bank of New York. No such dollar mountain could have risen if, as under a properly functioning gold standard, debtors and creditors were bound to settle their accounts promptly in cash. As it is, China and America settle in credit—really, not at all.

Consuming much more than it produces, America remits boatloads of dollars to its Asian creditors, who immediately return them in the shape of investments in American securities. Sweet it has been, the reserve currency privilege—"deficits without tears," as the economist Jacques Rueff styled it—but the unprivileged are chafing. China was once happy to stockpile dollars in order to suppress its exchange rate. But now listen: Washington must "cure its addiction to debts" and "live within its means," said an official Chinese communiqué in the wake of the S&P downgrade of the Treasury's credit. "International supervision over the issue of U.S. dollars should be introduced, and a new stable and secured global reserve currency may also be an option to avert a catastrophe caused by any single country."

Mercantilists the Chinese may be, and predatory ones at that, and communists and knockers-off of Disney and Prada, to boot. But in raising the cry for a system of currencies that favors no single country, they have taken the first step on the road to monetary wisdom. There may be hope, after all.

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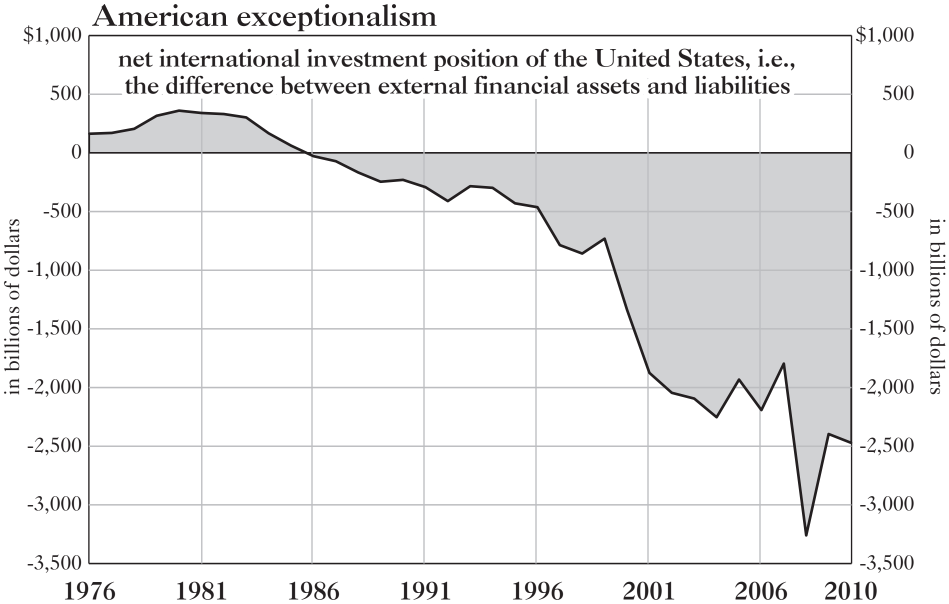
American exceptionalism



source: Bureau of Economic Analysis