GRANT'S

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EDITOR

Happy and Merry

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

This compilation of recent articles, our annual Grant's Holiday e-issue, is for you—and for your friends, 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.

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Sincerely yours,

James Grant

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Ready-mixed short sale

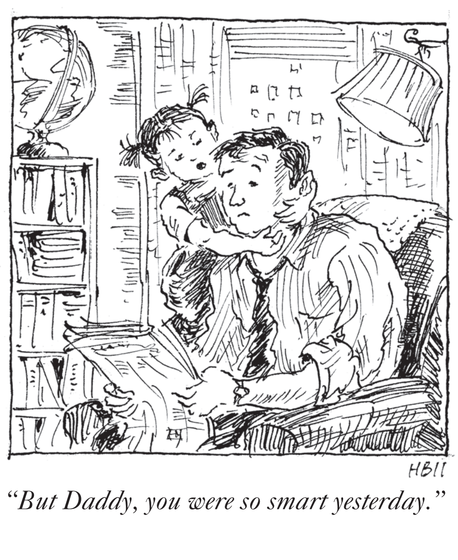
(October 21, 2011) China's empty apartment towers, redundant bridges and untraversed highways wouldn't exist without concrete—or without the concrete pumps, concrete mixing plants and concrete placing booms that deliver the ready mix where, in so many instances, it actually isn't needed. Changsha Zoomlion Heavy Industry Science & Technology Development Co., the No. 2 maker of concrete-related and general construction machinery in the People's Republic, is the subject under discussion. In preview, *Grant's* is bearish on it.

You, gentle reader, may doubt you need a short-sale candidate situated 7,649 miles west of the New York Stock Exchange, especially one whose price has the ill grace to tumble before *Grant's* goes to press. However, you won't regret knowing more about what makes the world's No. 2 economy tick, or—as we see the situation—not tick. Zoomlion (1157 on the Hong Kong Stock Exchange) is more than a major corporation and a large and liquid stock. It is also a kind of macroeconomic laboratory specimen.

Founded in 1992, the company has boomed in tandem with the investment-charged Chinese economy, its sales climbing at the compound annual rate of 65% since the word go. As seen from Capitol Hill in Washington, D.C., the People's Republic is a mercantilist export machine, but the 2010 GDP data tell a different story. Fixed-asset investment contributed 49%, net exports 4%.

Investment may be necessary, but it isn't always productive. To decide how to invest, and how not, capitalists depend on interest rates, the prices that balance the supply of savings with the demand for savings. Capitalism being honored more in the breach than in the observance, however, the free play of interest rates is frequently subordinated to government directives. On this score, distortions abound even in the nominally free-market United States. In the People's Republic, where the government fixes interest rates, sets lending quotas and directs capital to politically favored economic sectors, it's often unclear which are the distortions and which is the reality.

Zoomlion, which is 20.6% state-owned, can be said to operate in the service of distorted reality. Beijing's hell-bent-for-election drive to build, modernize and grow has created an insatiable demand for the picks and shovels of the modern infrastructure industry. Concrete-making equipment is Zoomlion's forte, contributing 46% of first-half 2011 sales. Cranes come next, at 34%, followed by sanitation equipment, 5%, road-working gear, 4%, and earth-moving, material-handling and other miscellany, plus 3% from "financing activities." Domestic sales contributed all but 5% of 2010 corporate revenue; Zoomlion is mainly a homebody.


"But Daddy, you were so smart yesterday."

At a glance, you wonder what the bears are talking about. Zoomlion grows like a Chinese skyline, and its balance sheet shows Rmb 1.3 billion in net cash. Its shares change hands at just 7.8 times the 2011 earnings estimate. None of this displeases the sell side. Of the 22 analysts who have an opinion, 16 say "buy," six "hold" and none "sell." For 2012, the analytical consensus anticipates 24% growth in net income on a 26% jump in sales.

We rest our bearish case on the fact that the bullish story is coming apart at the seams. Final demand is wilting and real estate prices are falling, yet Zoomlion continues to report breakneck growth. The key to this mystery seems to lie with the Zoomlion balance sheet and with management's approach to revenue recognition. The company is financing more and more of what its customers buy, and inventories are crowding dealers' lots.

Bulls, needless to say, have a different take on the subject. Consider, just for instance, they say, the inspiring prospects of building-site mechanization. In 2009, just 40% of Chinese concrete was machine-mixed, as opposed to 78% in Japan and 84% in the United

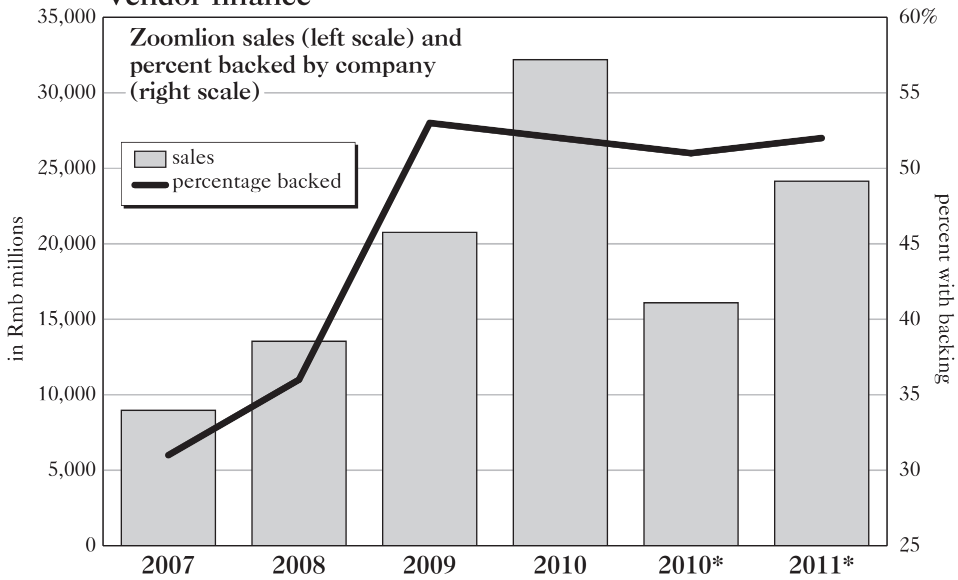
States. Certainly, the bulls contend, the difference will narrow, fattening Zoomlion's revenues as it does. However, observes our own analyst, Evan Lorenz: "Much of the narrowing has already occurred, and some won't happen for years. Thus, revenues of Zoomlion's concrete-related business soared by 97% in 2010 and by 58% in the first half of 2011. Adding in the rest of the industry's sales and those expected for the balance of the year, you see that the 2011 concrete-mechanization rate in China may be closer to 64% than the 40% reckoned for 2009. Yes, it's below the American rate, but it should be. China's per-capita GDP is one-ninth the size of America's."

Undebatable is the slowdown in Zoomlion's end markets. The CEO of Caterpillar gave testament to this fact in July, the president and chief operating officer of Cummins Inc. on Sept. 13. "In China," the man from Cummins, Norman Thomas Linebarger, told visiting analysts, "truck and construction markets have clearly come off as a result of the end of stimulus spending that the Chinese government put in back in '08 and the tight money policy they've been implementing." Concerning the monetary situation, it's a pretty good sign that money is tight when corporate debtors go into hiding to escape their unlicensed creditors, as hundreds of Chinese executives have done, according to reports from Reuters, Bloomberg and *Caixin*.

"Since about March this year," Frank Manfredi, the publisher of *Machinery Outlook*, tells Lorenz, "the machinery markets in China have dropped pretty rapidly—they're down about 30% to 40% compared to a year ago. And most people think that the numbers that were reported in 2010 were unsustainable anyway." Another expert source, OTR Global, concurs, in shorthand style: "Sources said 3Q11 sales decreased an average of 18%-23% yy, marking the first time new equipment sales were down yy since OTR Global initiated coverage in Sept. 2009," the firm said in a Sept. 29 bulletin. To move metal in hard times, the research shops agree, Chinese manufacturers are cutting prices and lowering the financing bar.

Which raises the question previously posed: How can Zoomlion continue to report zooming sales when its

Vendor finance



*first-half results
sources: company reports, *Grant's* estimates

end markets are stagnant or shrinking? The answer takes this form: In 2007, just 4% of Zoomlion's sales were company-financed. Through the first nine months of 2010, 32% were so assisted. On June 30, finance receivables totaled Rmb 18.4 billion, up 28% in the previous 12 months. "Zoomlion's competitors also discovered the rocket fuel of customer financing," Lorenz relates. "Their trade receivables, too, are bulging, albeit from a smaller base. As of June 30, XCMG Construction Machinery Co. posted receivables of Rmb 9.8 billion, up 187% year-over-year; Sany Heavy Industry Co. showed receivables of Rmb 13.4 billion, up 65% year-over-year."

Then, too, we conjecture, Zoomlion is stretching the maturities of its leases, perhaps to 72 months from the 24 or 48 months it vaguely acknowledges. We do not conjecture lightly. The longer the lease, the more uncertain the residual value of the machine at expiry. An inflated residual value in a lease document means easier terms for the lessee, and the likelihood of a future loss for the lessor. Because Zoomlion did not crank up its leasing effort until 2008, management has not yet had the educational experience of managing a lease book through a full credit cycle. (Aside from inexact indications of the lease durations, the front office discloses no information about underwriting assumptions. Nor did it return our telephone calls and e-mails.)

"In addition to underwriting loans with its own balance sheet," Lorenz continues, "Zoomlion guarantees its customers' loans and leases with third-party lenders. Such off-balance-sheet guarantees have climbed to Rmb 10.4 billion as of June 30 from Rmb 7.3 billion at year-end 2010 and Rmb 3.4 billion at year-end 2009. Combining company-financed sales and leases with sales under financial guarantees, Zoomlion backstopped 52% of sales in the first nine months of 2010, up from 31% in 2007. The company no longer breaks out how its customers fund purchases. As for June 30, total company exposure to customer loans and guarantees amounted to Rmb 28.8 billion, compared to stated cash and equivalents of Rmb 20 billion."

Zoomlion isn't alone in continuing to grow in contravention of bearish reports on the ground. Compared to Zoomlion's 50% rise in sales in the first six months, XCMG reported a bump of 48%, Sany a spurt of 79%. We suspect that the protocols of revenue recognition go some way to explain the fireworks. Zoomlion, like its competitors, books the sale of a machine when a dealer takes it into inventory. Overcrowded dealer lots therefore point to a problem in economic coordination. And, indeed, OTR Global, reporting high and rising dealer stocks, quotes an unnamed Zoomlion dealer in corroboration of this suspicion: "Zoomlion is also doing OK because of its financing policy. They allow customers to get equipment with only 100,000 yuan [$15,600] down payment." The quotation calls to mind a report last month in the Peoria *Journal Star* that Caterpillar dealers in China are raffling off Mercedes-Benzes. Buy an excavator, win a car, the pitch goes. Gamblers, however, not getting into the spirit of the promotion, have been buying excavators only to return them when they don't win the car. Maybe this year's big machinery sales are only the cutting edge of next year's poor machinery sales.

"Zoomlion publishes a most eccentric set of financials," relates Lorenz, who has been poring through them. "The company reports many line items down to the penny, a level of precision unparalleled in the West. But just as important is what it doesn't report. Caterpillar, Volvo and other household corporate names segregate, for reporting purposes, finance operations from manufacturing ones. Not Zoomlion. It lumps them together, reducing the curious analyst to conjecture. As for us, we conjecture that the finance operations are likely running at a loss, thus subsidizing the manufacturing business—though for how long, we can't tell.

"Important line items that help investors determine the health of the company flit into and out of existence," Lorenz goes on. "After disclosing how customers paid through sales for the first three quarters of 2010, the company suddenly ceased reporting those data altogether. Maybe the inconsistency has something to do with a May 2010 change in auditors (in came Baker Tilly China, out went Beijing ZhongXi Certified Public Accountants Co.). Or take such seemingly simple items as the change in earnings per share. In full-year annual reports, that figure is sometimes calculated before other comprehensive income (change in fair value of securities, exchange differences, etc.). In other years, it is calculated after. Some important information, like the geographic breakout of sales, is disclosed only on an annual basis. International sales are, in large part, from Zoomlion's September 2008 purchase of Compagnia Italiana Forme Acciaio SpA (CIFA). Curiously, international sales declined by 14% in 2010, which may show problems at CIFA—Zoomlion still holds Rmb 1.7 billion in goodwill from this acquisition. If sales do not pick up, Zoomlion may have to write down goodwill.

"Not to complain," Lorenz continues his complaint, "but English-speaking investors may feel especially shortchanged. Scroll through the Hong Kong Stock Exchange news sector for ticker 1157. You'll find many links that simply say, 'An announcement has just been published by the issuer in the Chinese section of this website, a corresponding version of which may or may not be published in this section.' To save you, the readers of *Grant's*, the trouble, the corresponding English version is, in fact, not published. You know that the Chinese investor has been told something, but not quite what.

"Possibly, the most puzzling lines on the company's financials are those indicating that, while days inventory stood at 118 days, days payable amounted to 260 days. In other words, this company that appears to flatter its own top line with aggressive vendor-finance techniques is itself the beneficiary of indulgences from its own vendors. Compare and contrast Zoomlion's larger rival, Sany," Lorenz winds up, "which shows days payable at 75 at year-end 2010. Should Zoomlion's days payable fall to 75, the aforementioned net cash balance would shrink by Rmb 16.4 billion to net debt of Rmb 15.1 billion."

If all else fails, the real estate and construction-equipment bulls allow themselves to hope that the government will ride to the rescue. How would China hum without them? As we read the news, however, it sounds as if the government is not inclined to saddle up this time. Thus, from the Sept. 29 *FT*: "In interviews with the *Financial Times*, two officials said that tightening measures over the past year had been aimed at choking off credit flows to poorly managed developers in China's unruly housing market." Quoth one of the higher-ups: "If a couple of real estate companies fail because of bad management practices, then they should fail. The banks who lent to them should be punished through higher non-performing loans. As long as that doesn't become a big systemic crisis, that's fine."

If that is, indeed, the new party line, much would be different for Zoomlion, the most levered of the equipment makers in China's infrastructure markets. Perhaps the head office is already trying to tamp down expectations. An Oct. 11 press release projected third-quarter earnings of Rmb 0.16 to 0.18 per share, up 7% to 20% from Rmb 0.15 per share in the third quarter of 2010. It was a marked deceleration from the 74% increase to Rmb 0.60 posted in the first half of 2011. No estimate of sales or operating earnings was forthcoming. Chinese- and English-language speakers found themselves on an equal informational footing. Not for the first time, both were in the dark.

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Opportunism Inc.

(October 7, 2011) It's not much of a world, but it's the only world we have. And if it doesn't end—let's just suppose—it will pay to own something besides U.S. Treasurys again. We write in anticipation.

Blackstone (BX on the New York Stock Exchange), the fast-growing purveyor of so-called alternative assets, is a dividend play with an embedded call on prosperity. Prosperity being a distant memory, BX trades where other financial stocks do, i.e., lower. Yet, though Mr. Market seems to hate the firm that Stephen A. Schwarzman built, the Blackstone clientele keep throwing money at it.

Founded in 1985, Blackstone went public in June 2007 at the very top of the market. The price was $31 a share. It was a Chinese investor—Beijing Wonderful Investments—that took down the largest portion of the equity, for which the promoters expressed their gratitude with a specially discounted price of just $29.61 a share. BX today trades at $11.91.

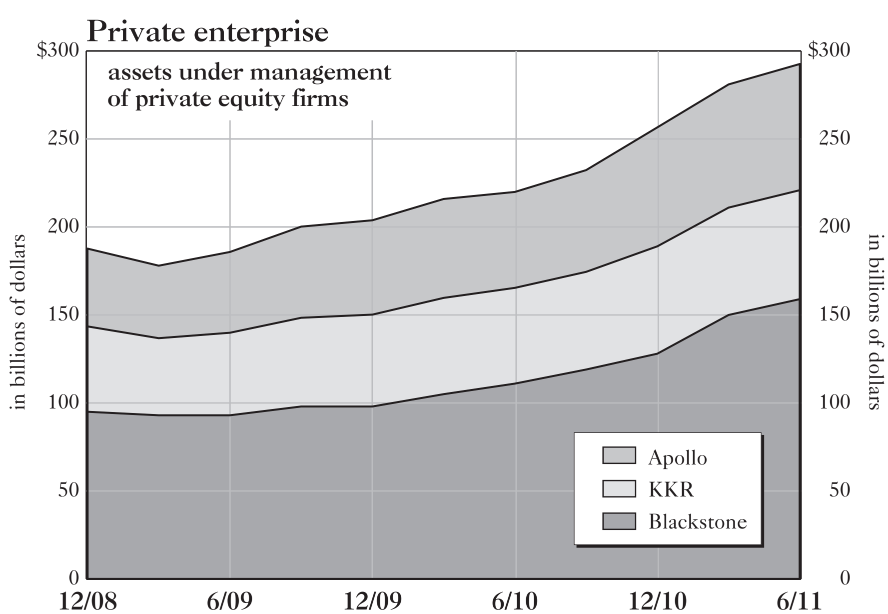
All along, Blackstone has suffered from what the investor-relations profession would call a problem of perception. For instance, contrary to supposition, the firm is not mainly a private-equity shop. Of its almost $160 billion of assets under management, private equity accounts for not quite 30%. The rest is apportioned among hedge funds, credit investments and—the crown jewel—real estate. Then, too, Blackstone is neither highly leveraged nor habitually unprofitable, appearances of its GAAP financials notwithstanding. In fact, there's net cash on the balance sheet, and the second quarter showed strong earnings, even according to GAAP.

Still, it's no misperception that Blackstone has its hands full. Its marks to market are plunging, and the president of the United States has a tax-reform agenda. Facing off against the hedge-fund population of Greenwich, Conn., the administration is demanding an end to the favorable treatment of carried interest in the federal tax code. Such a revision would hit the taxable Blackstone investor, to be sure, though not Blackstone's reported net income. Neither would it touch Blackstone's dividend. Recession presents yet another business risk, but Blackstone, at the end of the second quarter, had $31.4 billion of uninvested cash to deploy. Taking one thing with another, we believe that the rewards outweigh the risks.

Strategically, Blackstone seems to be in the right place at the right time. Institutional investors are huffing and puffing to deliver the returns they rashly promised the actuaries. Eight percent seemed a modest enough hurdle rate in 2007. Today, it looks well-nigh unattainable, hence the stampede to alternatives—i.e., alternatives to depreciating equities and manic Treasurys. Credit is one such alternative. Blackstone, in these post-Dodd-Frank times, is an alternative bank, lending against the kind of collateral that others won't touch—CLOs, whole loans, etc.—though they were happy enough to accept it during the credit bubble.

Blackstone is the beneficiary of a related mass movement to investment-management simplicity. The CalPERS of the world have many general-partnership relationships to attend to. They want fewer. Here, too, the advantage goes to Blackstone, which, like other big publicly traded alternative managers, offers a kind of one-stop shopping.

"Look at Blackstone," says a man who, preferring anonymity, has done more than look—he's bought the stock. "Pre-recession, they had $70 billion of assets under management. Today, it's about $160 billion of AUM. And this has been a horrendous fund-raising environment for your typical fund. It's not just Blackstone—most of these guys, the public alternative asset managers, have taken in additional



source: company reports

money. Apollo and KKR have grown as well.

"This is an unloved category, for sure. They basically debuted at the top. They created the top. They disappointed people right out of the box. They fell under their high-water marks and, basically, because of the recession, the economics of the business have been obscured ever since. But, in addition, they're complicated entities. They're limited partnerships—and GAAP accounting requires two things that make them a particularly tough read."

Indeed, chimes in David Peligal, the *Grant's* analyst on the case, "You read the SEC, GAAP-compliant financials of Blackstone and its peers, and you have the sudden urge to read something else. For instance, to quote from the Blackstone 10-K, 'We expect to record significant net losses for a number of years as a result of the amortization of finite-lived intangible assets and non-cash equity-based compensation.' Translation: The pre-IPO partners in Blackstone got stock in the IPO. The stock is vested over a period of five or so years. Ergo, the value of those awards are recognized year by year. But this is an accounting fiction. The partners owned the business before it went public. They own 60% of the shares today. In the IPO, they just exchanged private shares for public ones.

"Then," Peligal goes on, "there's the GAAP mandate to consolidate, or partially consolidate, the debt of the companies in which Blackstone invests on Blackstone's own balance sheet. Let's say that Blackstone has a 1% equity holding in a collateralized loan obligation. Onto the Blackstone balance sheet goes 100% of the economics of that CLO, debt included. Pick up the latest Blackstone 10-Q and you may conclude that loans payable total $9.3 billion. In fact—substantively—they total only $1.03 billion. Run a screen, as a short seller might, for companies both leveraged and unprofitable. There's Blackstone."

To remove these GAAP-induced distortions, Blackstone reports "economic net income," i.e., pretax income excluding IPO-related amortization charges and both revenues and expenses from Blackstone-managed funds. However, be warned: Not even this favored metric traces the neat upward progression so beloved by institutional investors. Blackstone earned $2.42 billion of ENI in its coming-out year of 2007. It showed a $1.33 billion loss in 2008 and a $723.8 million gain in 2009. Last year brought a $1.58 billion gain, which the first half of this year—up by $1.47 billion—almost matched. A glance at the Bloomberg terminal, however, suggests that no such repeat performance is indicated for the second half of 2011.

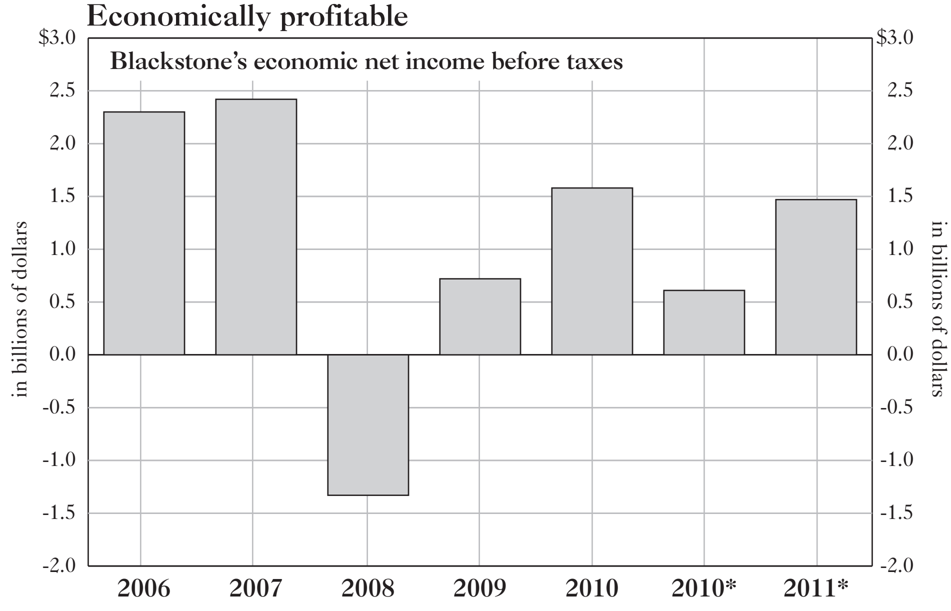
"From a bottoms-up standpoint," our friend, the Blackstone bull, says, "we see $4 a share of cash and co-investments. The stock today is at $11.91 a share [it was at $12.50 when we spoke to him]. It's a long way from the IPO price, even though AUM and, presumably, the earnings' power of the business has more than doubled since the IPO." So, the analysis proceeds, subtract $4 of net cash and co-investments from the share price. What do you get for the residual $7 and change, i.e., the portion of the share price representing a claim on the business itself? You get a dividend—to start with, 50 cents a share in annual distributable income after all expenses at the current rate. This is the income stream derived from Blackstone's management fees, which are drawn on capital contractually committed for 10 years. "It's not at the whim of the market," our informant points out. "It's actually a much better anchored flow. We could arguably justify the price based on the way other money-management firms—like T. Rowe Price or Eaton Vance or Franklin—are valued. But then, in addition to this sector, and with Blackstone in particular, you have an enormous carried interest potential."

"Potential" is the word, as "carried interest" is pay for results. It's contingent. "Currently," Peligal explains, "Blackstone has fee-earning assets under management of $35.8 billion in private equity and $27.9 billion in real estate, and it's raising more in both categories. Some of the existing funds are below their high-water marks—no incentive fee is payable until values return to the stipulated minimum marks. Nevertheless, let's figure out what the company could earn in a proper bull market.

"Once the newest real-estate fund is closed," Peligal continues, "fee-earning assets under private equity and real estate might total $75 billion. Assume that Blackstone generated gross returns of 30% on that $75 billion. And assume that incentive fees averaged 20%. Subtract the firm's performance compensation of 40%. The pretax payout would reach $2.7 billion, or $2.45 a share. These are big assumptions, of course. And it might just be that there is no bull market in our immediate future. But because Blackstone is raising money, the top end of the earnings range could be as high, or even higher than, our supposed $2.45 a share. And if the markets don't recover and performance fees add up to zero, you still earn the 50 to perhaps 60 cents a share in dividend income."

Certainly, the Blackstone front office knows the arithmetic. Schwarzman himself earns no bonus; his cash compensation is $350,000 a year. He already has his name on the New York Public

Economically profitable



*first-half results
source: company reports

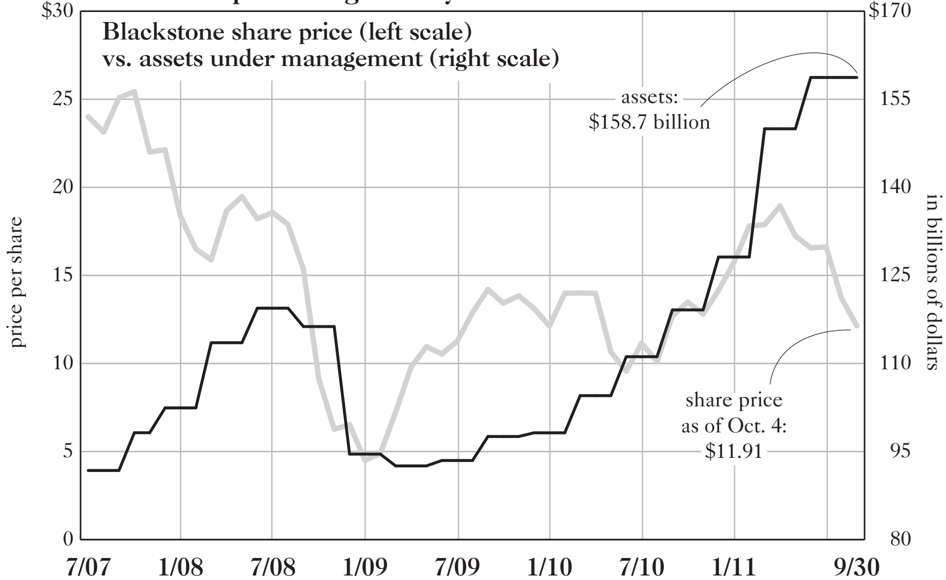
Library. To be able to bestow another benefaction of that grand scale, he'll have to make the shareholders rich, too, as he goes along.

Naturally, the firm requires no small degree of cooperation from the gods. Possibly, the gods will be uncooperative. The latest private-equity fund to get fully invested, BCP V (December 2005 to January 2011) has delivered a net internal rate of return to date of only 2%, a far cry from the 20% to 40% returns achieved earlier. Then, again, Blackstone is already busy funding private-equity number VI, a giant, as Schwarzman told dialers-in on the July 21 earnings call. "The fund is now over $16 billion in size," the CEO said, "making it the largest fund raised in the industry over the last three years and likely will be the largest for the next year or two or three years, as well."

Blackstone's hedge-fund segment shows what kind of growth the firm has enjoyed and what may yet be possible. The division managed just $500 million in 2001, while today it has $40.6 billion—$5 billion came in during the first half of 2011 alone. Out of the rest of the $158.7 billion under management on June 30, private equity accounted for $46.7 billion, real estate $37.6 billion, credit $33.8 billion, while—as noted—$31.4 billion lay fallow.

"We bought it last year at 10 bucks and we were selling at 19 when the sky was pretty blue earlier this year," our friend, the bull, relates of his BX investment. "Now we've loaded all the way back up again—it's a lot cheaper at 12 today than it was a year ago, just on the basis of the increase in earnings power from the AUM raise. But we sort of wonder to ourselves: 'Where are we wrong on this?' I think, to some extent, the risks are clearly present with the economy. Secondarily, it's exposed to the equity markets, because a lot of people look at this entity and say, 'The only way you're going to dispose of your investments and get any value is from the equity-market IPOs.' And that's true for the private-equity business. It's not true for the other two-thirds of the business, so we think that's one material misperception. But another exposure is the health of the credit markets. If the credit markets are rocky, they can't always line up credit for their investments. Our view on that would be actually [that] white-hot credit markets are terrible, in fact

Clients keep sending money



source: The Bloomberg

worse than the current conditions, because it means anybody with a pulse can take out money, and they tend to bid things up aggressively and that creates bubbles. So today's conditions are actually much better for Blackstone than the white-hot credit market that was prevailing."

For a case study in the uses of adversity, look no further than the Blackstone real-estate group. You may remember shaking your head at its $39 billion purchase of Equity Office Properties early in 2007—a top, surely, you might have sensed (as indeed it was). Blackstone, too, seemed to agree, as it nimbly peeled off salable pieces of Sam Zell's portfolio before the cycle turned. Today, in similarly contra-cyclical fashion, Blackstone's managers are buying what others are selling—earlier this year, for instance, the U.S. shopping centers of Melbourne-based Centro Properties Group for $9 billion.

With just 23.7% of firm-wide assets, the Blackstone real-estate division delivered 55.6% of first-half economic net income. Beyond its own skill and resources—perhaps, in money terms, three to four times' greater than that of the next largest entrant—the company owes a shout-out to its vanquished competitors. In the early and mid-2000s, no big bank could seem to hold up its facade unless it employed maximum leverage to buy real estate at the minimum available cap rate. Come the Great Recession, the bank funds sold and, almost without exception, fled. Today, in a market pocked with opportunity—which is to say, fear and distress—Blackstone has money to act.

It's a buyer's market all right. Valuation disparities between so-called core and non-core assets are some of the widest in memory. Banks are shrinking (and quaking), the commercial mortgage-backed securities market is largely shut and, to top it all off, the Europeans are coming. Only now are the European banks starting to sell their real estate assets, according to a Peligal informant.

As in the bond and stock markets, "safety"—without much regard to price or value—is the watchword in real estate. The properties in greatest demand are the ones that most closely resemble the risk-reward characteristics of U.S. Treasury securities, say, a long-leased Washington, D.C., office building priced to a 4.5% cap rate. Dented assets, never mind broken ones, go begging.

On Sept. 26, Equity One, a Florida-based property owner and developer, announced the sale of 36 shopping centers, comprising 3.9 million square feet and situated mainly in Atlanta, Tampa and Orlando, to a Blackstone real-estate partnership. In the 12 months through June 30, the centers generated net operating income of $35.4 million, the press release said. Divided by the $473.1 million purchase price, you get a net operating yield of 7.5% before leverage, not bad for this low-return world. Says a party to the transaction: "And they're grocery-anchored shopping centers—so it's hard to disintermediate either the supermarket or the pizza guy through the Internet."

In the 12 months through June 30, Blackstone expanded its assets under management by 43%, whereas, in the 12 months through Tuesday, the share price has fallen by 5%. From these facts, we conjecture that the customers are satisfied but the market is out of sorts. Maybe the customers know best.

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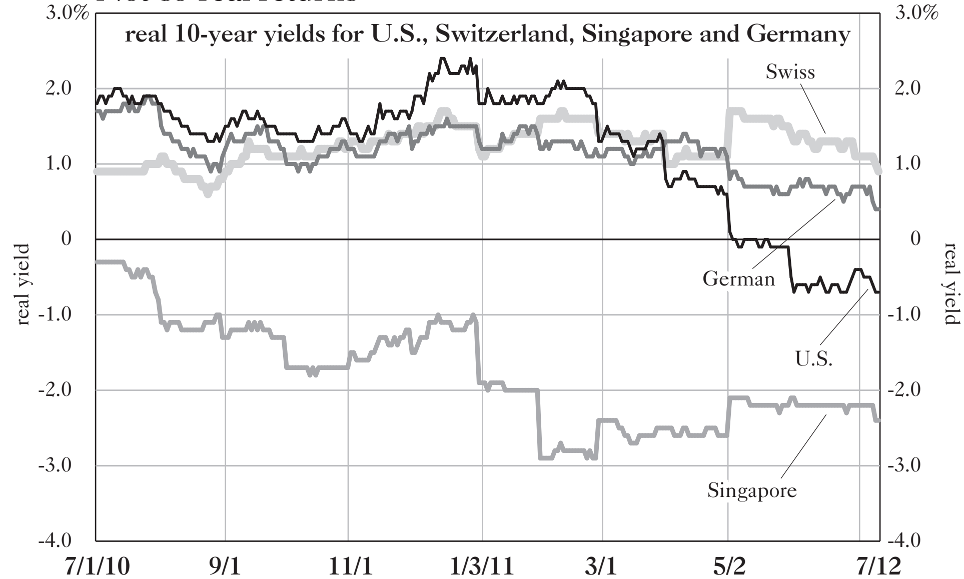
The pending dollar rally

(July 15, 2011) Against the Swiss franc on Monday, the euro made an all-time low. Against the U.S. dollar, however, it scored a 17-week—mind you, not a 17–month—low. All the world knows what's wrong with the euro. But what's wrong with the dollar?

The flight to the dollar that hasn't occurred is the subject at hand. You'd think that monied Europeans—following along with us in America as EU functionaries try to explain away the inevitable Greek default, or to squelch the ratings agencies for having the temerity to downgrade Portugal, or to "stress-test" the European banks—would be doing enough precautionary dollar buying to push down the euro-dollar exchange rate well below $1.40. They have not so far, but nothing would surprise us less. "If not now, when?" to borrow a phrase from the federal-debt-crisis-negotiator-in-chief.

Not-so-real returns



source: The Bloomberg

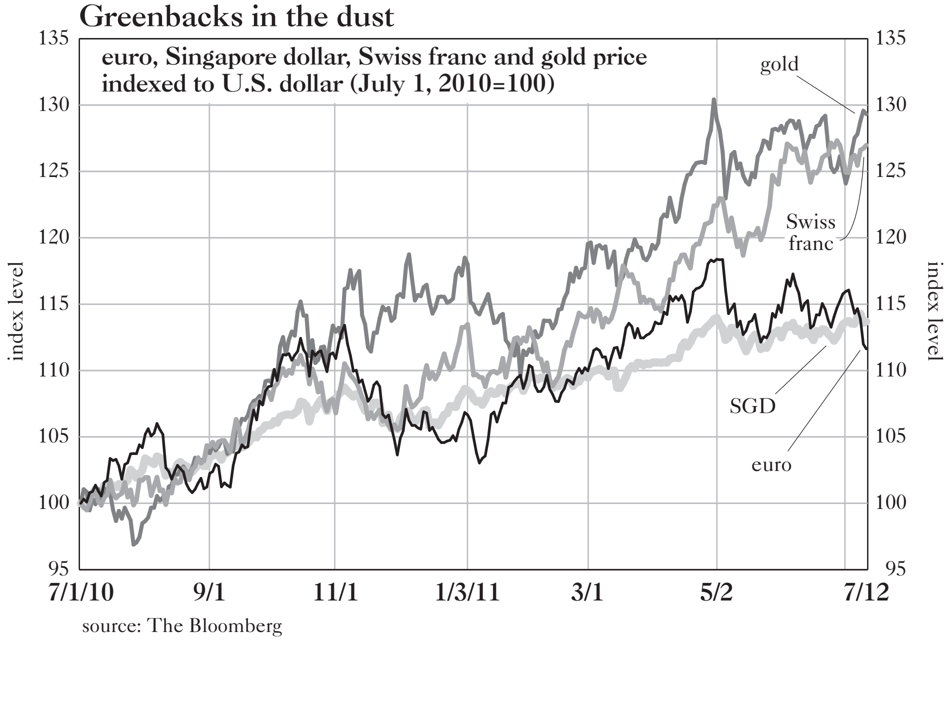
Only a year ago, the greenback jumped when the world sneezed. In the seven months to early June 2010, the U.S. Dollar Index climbed by 19%. It was a period during which the world awoke to the problems of post-classical Greece—as five-year Greek credit default swaps bulged to 801 basis points from 193 basis points—and came to terms with the passing, on March 31, of QE1. The springtime air was presently rent with anxious talk about a new recession. The dollar was a port in that squall, just as it had been during the post-Lehman storm.

"Not lately, though," as colleague Evan Lorenz observes. "Since the start of 2011, the Dollar Index has fallen by 4% and is down by 14% from its June 7, 2010, high. Other safe-haven currencies have continued to appreciate, the Swiss franc and the Singapore dollar rising 13% and 5%, respectively, against the greenback this year, each setting record highs. Remarkably—amazingly—the euro itself has rallied by 4.3% against the dollar."

Markets sometimes get a bee in their bonnets. So frazzled, they fix on one consideration in the determination of a clearing price to the exclusion of others seemingly just as relevant. In the foreign exchange markets, interest rate differentials are one such preoccupation; national debt, purchasing power, GDP growth and geopolitics are others. Geopolitics, at least, we can eliminate from consideration as a factor in explaining the absence of a monetary flight to the dollar from the euro. Switzerland and Singapore, to which capital is flying, don't have the H-bomb. Gold is a pacifist.

Interest-rate differentials, then? These days, in developed economies, they are differentials without differences. The negative real yield on the Singapore government's 10-year bond is, in fact, greater than that on the U.S. 10-year note (minus 2.4% vs. minus 72 basis points). You can earn a 1% real yield by venturing 10 years out on the Swiss yield curve, at which rate you would double your money in 70 years,

Greenbacks in the dust



source: The Bloomberg

but you'd probably lose patience. Gold yields not much less than Libor.

A Graham and Dodd devotee might home in on value, or "purchasing power parity," as it's known in the currency markets. Again, not much help. According to *The Economist*'s Big Mac Index, which calculates PPP for exactly one basket of goods, the Swissie was 83% overvalued and the euro 29% overvalued vs. the dollar at year-end 2010. So the euro, though objectively overvalued and possibly doomed, is up marginally on the year against the dollar. It makes you think.

What about debt? Singapore has a strong dollar with a 97% ratio of debt to GDP; the United States has a weak dollar with a 92% ratio of debt to GDP. Switzerland has a strong franc with a 55% ratio of debt to GDP. As for the Netherlands, with a 64% debt-to-GDP ratio, and Italy, with a 119% debt-to-GDP ratio, they belong to a confederation of nations that shows a raio of debt to GDP of 75%. Still, Italy has a fiscal problem.

Perhaps the reserve-currency curse is finally catching up with the greenback, as it did so long ago with the pound sterling. Not promptly settling accounts with its Asian creditors, this country has built up stupendous deficits, fiscal and otherwise. The IMF compares the nations of the world in terms of their external financial positions. Its criterion is "the current account balance," which is the sum of the trade account, the income account (i.e., income from loans and investments) and the secondary income account (i.e., transfer payments). By this standard, the dollar is making heavy weather of it. Thus, in 2010, according to the IMF, the United States ran a current account balance deficit equivalent to 3.2% of GDP. In contrast, Switzerland ran a 14.2% CAB surplus, Singapore a 22.2% CAB surplus. The European Monetary Union countries essentially broke even, with Luxembourg, for instance, earning a 7.7% surplus and Greece logging a 10.4% deficit.

This publication, which stands for the gold standard, is perennially bearish on the monetary and banking arrangements of the modern world. Yet, climbing down from that lofty perch of disapproval, we try to distinguish between one variant on unsound practice and another. In that vein, we prefer the American form of error to the European kind. The talks in Washington, D.C., over the federal debt ceiling, for instance, we regard as political posturing. The underlying fiscal problem is real enough, and worrying, too, but the crisis is artificial. Not so the flailing efforts of the once and future chieftains of the European Central Bank, Jean-Claude Trichet and Mario Draghi, to beat back the European banking-cum-fiscal-cum monetary contagion. Now *there* is a crisis.

Gold is our favorite monetary medium. As between the dollar and the euro, we prefer the dollar. If the dollar should execute a crisis-induced U-turn against the single currency, we expect that gold would shudder, buckle and then recover to make new highs. The barbarous relic, at least, is mute. The central bankers and finance ministers and banking regulators can never seem to stop talking.

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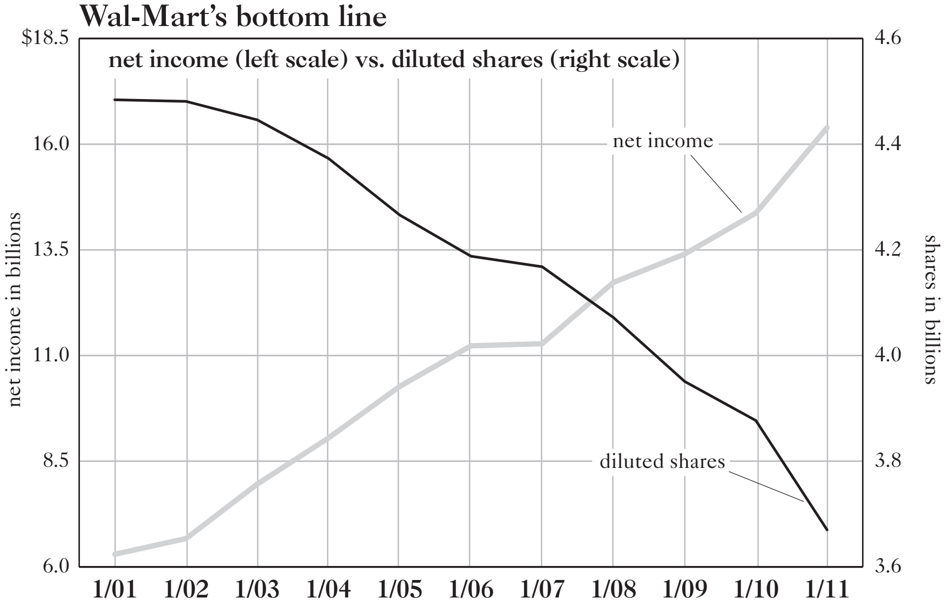
Phil Fisher meets Benjamin Graham

(July 1, 2011) To the bond bulls, it matters not that the U.S. government is on the cusp of technical default, that the CPI has risen by 3.6% over the past 12 months or that—the elevated pace of inflation notwithstanding—the zero-percent funds rate is likely to persist "for an extended period." These facts are inconsequential. All you have to know, they say, is that Greece is on the verge of a more-than-technical default, that the euro is more precarious than the dollar, and that the so-called global reflation trade hangs by the thin thread of the People's Republic of China. Thus, the argument goes, the 10-year Treasury—quoted at all of 2.8% on Monday morning—is just as rich as it ought to be.

Now begins a comparison of the government bond yield with the Wal-Mart dividend yield, and more. We compare things that grow—e.g., the Wal-Mart dividend—with things that don't—e.g., the coupon attached to the U.S. 3 1/8s of May 15, 2021. We appraise the investment merit of Wal-Mart alongside the retailer's majority-owned Mexican subsidiary, and we size up both of those entities in relation to Costco, America's No. 2 retailer by market cap. In preview, we're partial to Wal-Mart.

Comparing the enterprise that Sam Walton founded with the enterprise that Sam Adams, John Adams and Thomas Jefferson founded isn't so farfetched as it might first appear. Though each is a wonder of the age and each is a cornucopia, each happens to be stuck in a growth slump. America is looking over her shoulder at the fast-rising Asian economies, Wal-Mart at Costco. Happily, however, there is nothing to compare in the matter of fiscal rectitude. The

Wal-Mart's bottom line



source: The Bloomberg

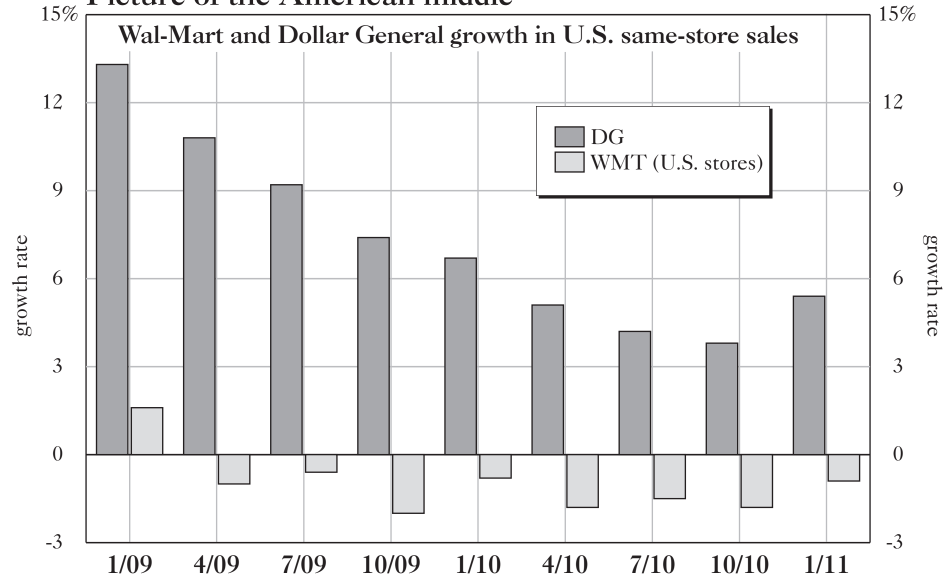
famously cash flow-negative U.S. government may command (for now) a triple-A credit rating, but the famously cash flow-positive retailer earns its double-A. At the three-year point on the yield curve, the Treasury is paying 0.67% to borrow, Wal-Mart 1 5/8%. Objectively, the Treasury is the weaker credit, but Wal-Mart has no Bernanke.

Chartered Financial Analysts may object that there can be no true comparison between the apple of a government bond and the orange of a common stock, and the two assets are, indeed, dissimilar. But all life is choice, and all investment is arbitrage. Professional asset managers may find themselves slotted in a one-asset career specialty, but, ultimately, even they must choose between one kind of claim and another. Will it be bonds or stocks, Secretary Timothy Geithner or CEO Mike Duke?

Wal-Mart was a $50 stock, more or less, when *Grant's* last addressed it in the issue dated Dec. 10. In truth, Wal-Mart has been a $50 stock for the past 10 years. Earnings have gone up but the multiple at which the earnings are capitalized has collapsed. Management has made its share of mistakes—including, recently, a failed attempt at rewriting the merchandising strategy—but the share price isn't its fault. Mr. Market has got it into his head that Wal-Mart can't and won't grow, that it will continue to lose market share and that—if share repurchases continue at the current torrid rate—the Walton family, returning to majority ownership, will somehow freeze out the public. On each point, we demur.

The story of Wal-Mart's lost decade in the stock market is easily told. In the fiscal year ended Jan. 31, 2001, earnings per share were $1.40 on sales of $42.67 per share, and there were 4.48 billion shares outstanding. Ten years later, in the fiscal year ended Jan. 31, 2011, earnings per share were $4.47 on sales per share of $114.95, and there were 3.67 billion shares outstanding. A decade ago, Wal-Mart commanded a trailing P/E multiple as high as 41.7 times; today it trades at 11.7 times. Granted, growth is all to the good; no value investor is against it. What are you willing to pay for it is, rather, the question before the house. And what

Picture of the American middle



source: company reports

is growth? Do you count the raw dollars of sales and earnings? Or the raw dollars divided by the share count? By the first method, Wal-Mart looks as if it were sleepwalking. By the second, it almost resembles Apple. Concerning the per-share WMT, Phil Fisher, the growth-stock guru, could find common ground with Benjamin Graham, the value guru.

Tom Gayner, chief investment officer of Markel Corp. and a sizable holder of Wal-Mart, quips that during the 2007-09 bear market, the typical money manager went through three phases in his Wal-Mart experience. First, he invested in Wal-Mart, then he shopped at Wal-Mart and finally he worked for Wal-Mart. In 2011, however, it's the Wal-Mart customer base that's down on its luck.

"American consumers are in the early stages of an unprecedented retrenchment," Stephen Roach, the Morgan Stanley economist turned Yale professor, wrote in the *Financial Times* a couple of weeks ago. "In the 13 quarters since the beginning of 2008, inflation-adjusted annualized growth in consumption has averaged just 0.5%. Never before in the post-war era have U.S. consumers been this weak for this long." Monday brought news of a second consecutive drop in inflation-adjusted personal consumption expenditures.

The tale is told in the very prosperity of Dollar General Corp. (DG on the Big Board), the 21st century's five-and-dime. Last year, Dollar General generated $13 billion in sales and same-store sales growth of 4.9% by selling a quarter of its merchandise for $1 or less. Compared to Dollar General, Wal-Mart fairly blots out the sun with 2.1 million employees and fiscal 2011 revenues of $421.8 billion. Net sales at the Bentonville, Ark., giant grew by 3.4% last year, but in the 50 states, same-store sales actually shrank by 0.6% (and have shrunk for eight consecutive quarters). Fiscal year 2009, with its 7.3% top-line growth and domestic same-store sales growth of 3.5%, seems, for the Wal-Mart shareholder, like a long lost golden era.

So Wal-Mart goes for growth outside the 50 states. With last month's $2.4 billion purchase of a 51% stake in South African-based Massmart Holdings, sub-Saharan Africa moved into the corporate sphere of influence. Of Wal-Mart's 9,198 stores, 4,774 are situated outside the United States, including 1,773 in Mexico. Wal-Mart de Mexico SAB de CV, the 65%-owned Mexican subsidiary (Bloomberg ticker: WALMEXV MM), shot the lights out in the 2000s, even in unprosperous 2009, when same-store sales climbed by 3% despite a 2.2% fall in nominal Mexican GDP. In the 10 years to 2010, Walmex sales and earnings per share sped along at compound annual rates of 16.7% and 19.1%, respectively. But Mexican growth, too, has decelerated. In the first five months of 2011, Walmex sales were ahead by 9.1%, comparable-store sales by 2.3%. In the first five months of 2010, by contrast, the company logged growth of 20.6% and 3.3%, respectively.

What has not subsided so far is the Walmex price-earnings ratio. At 26.6 times the current year's estimate, it is double the parent's multiple and only slightly higher than the lordly 24.1 times at which Costco trades. Is growth—measured in dollars or pesos without reference to the share count—so precious as that? Is Costco so superior to Wal-Mart in what is nowadays known as the customer experience? Let's find out.

Please note, observes colleague David Peligal, that Wal-Mart has delivered the goods that equity investors would seem most to prize. Thus, in the 10 years to Jan. 31, 2011, Wal-Mart's sales and earnings per share compounded by 10.4% and 12.3% per annum, respectively. "You look at the Costco stock chart," Peligal goes on, "and you assume that COST generated much faster growth, but not so. In the 10 years through 2010, Costco's sales and earnings per share compounded by 10% and 8% per annum, respectively. Costco does have its statistical advantages, even on a per-share basis; in 2010, its sales per share, at $175, were more than 50% higher than Wal-Mart's. But in the past 10 years, Wal-Mart has boosted its dividend by 18% a year. Costco, which initiated a payout in 2004, has boosted its dividend by 13% a year."

Costco is a magnificent merchandising machine, to be sure. But is it so much more magnificent than Wal-Mart? *Grant's* set out on a voyage of discovery to New Jersey's big-box country. We inspected a Wal-Mart in Secaucus at 11 a.m. and a Costco in Clifton at lunchtime. We talked to customers and gaped at the staggering mounds of golf clubs, automatic garage-door installation gear, engagement rings, hamburger meat and sunscreen (the piles being especially notable at Costco, which eschews the nicer forms of presentation). We talked to Wal-Mart fans and Costco fans, and satisfied ourselves of the essential truth of the proposition (sworn to by Eric Whitehead, your editor's right-hand man) that you really can't get out of Costco without spending at least $100. So it's Costco for sheer volume—you can find what you need in quantities three times larger than you need—but for the targeted purchase of the item you want in the size you can actually use, go to Wal-Mart.

Admittedly, Costco has the sizzle (and at lunchtime, the denser population of shoppers). To us, it seemed a little sad that Wal-Mart had to hire Will Smith, the comic actor, to be its paid friend and facilitator at the June 3 annual meeting. In fact, the actual star of that proceeding was the Wal-Mart board of directors, which authorized the repurchase of $15 billion of stock, renewing the prior year's authorization of $15 billion, of which all but $2 billion was spent.

The aforementioned Gayner reflected on the implication of these buybacks in which Wal-Mart has bought in 445 million shares over the past eight quarters. "Today," he observed, "the market cap is roughly $190 billion. So we're saying that the whole pie, steady state, is worth $190 billion. So my joking math is that, in 15 years at the current rate, the share count will be one. Instead of cutting that pie into roughly 3.5 billion shares outstanding, $190 billion will be cut into one slice. So that one slice will be worth $190 billion. If we're going to make 20% on our money between now and then, what is the net present value of $190 billion for 15 years? I think it's about $12 billion. I kept doing the math to make sure it was really right—to make sure the zeroes were right—and it is. It appears that the price chart is going to be 50, 50, 50, 50, etc., and then $12 billion—if the stock does nothing. I suspect that we will not reach that end point, but we don't really have to. You can cut it in half, cut it in half again, then cut it in half again—whatever margin of safety you want—but it sure seems like it's worth a lot more than $50 on that path."

As for the United States of America on the eve of the Fourth of July weekend, we love this country. As to its securities, however, someone else can have them.

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The risk down under

(June 3, 2011) There was "fake cash recorded on the books," the chairman of Longtop Financial Technologies, the New York Stock Exchange-listed Chinese financial software company, belatedly admitted to a partner of Deloitte Touche Tohmatsu, because there had been "fake revenue in the past." Scales fell from the auditor's eyes as Deloitte Touche's attempts to confirm the existence of Longtop's bank deposits met with resistance, then with obstruction and, finally, with threats to the Deloitte auditing staff. Trusting investors were gobstopped. For six years running, Deloitte had blessed Longtop's financials with a clean opinion. As recently as November, the market had valued the company—with its comforting Big Board ticker, LFT—at $2.4 billion. Fidelity, Putnam and Janus owned the shares, trading in which was suspended on May 16 at a closing price of $18.93. When trading resumes, the opening price will likely be closer to the funds rate.

Now under way is an investigation into the relationship between financial misinformation and the modern monetary system—and between Australia and its No. 1 trading partner, the People's Republic of China. Arithmetic is the point of contention between ourselves and Beijing. *Grant's* supports plain, unvarnished numbers. We like our interest rates straight and unmanipulated (not the kind the Federal Reserve serves up, to be sure). Likewise, we prefer authentic inflation rates, exchange rates, coal prices and electricity tariffs. The Chinese Communist Party takes an alternative approach. It shows a distinct aversion to unprocessed facts. In the People's Republic, the price system is subordinated to party rule. We are bearish on China.

In 2011, that is a large and comprehensive announcement. To be properly bearish on China, one must be similarly bearish on the things connected with the vast Chinese enterprise. Recently, Jeremy Grantham, the public brain of GMO in Boston, compiled a list of commodities for which China accounts for an outsize share of global demand. The world's No. 2 economy, generating 9.4% of world GDP, buys 53.2% of the world's cement, 47.7% of its iron ore, 46.9% of its coal, 45.4% of its steel and so on down the line, with receding but still substantial shares of lead, zinc, aluminum, copper and nickel. Among edible items, according to Grantham, China buys 46.4% of the pork, 37.2% of the eggs, 28.1% of the rice and 24.6% of the soybeans.

So a bear on China must confront the implications of his bearishness. The cessation of Chinese growth would turn down the economic and financial lights in places as geographically far removed from the People's Republic as the United States, Brazil, New Zealand and—as noted—Australia. It would deflate the so-called reflation trade, the dimensions of which would become fully apparent only after it ended. China's Ponzi-like banking system, sustained by the misbegotten reserve currency system, is the reed on which leans a fair portion of world enterprise—including, for instance, the art world, as illustrated in the March sale of a Chinese vase for $18 million that Sotheby's had conservatively appraised at $800 to $1,200.

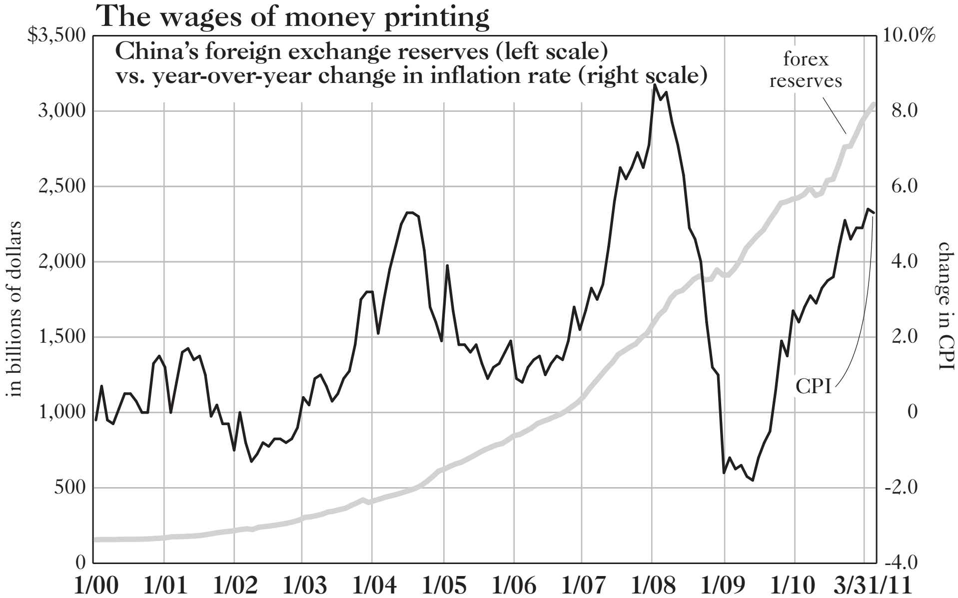
Because we are bearish on China, we are bearish on the Australian dollar, quoted near a 30-year high against the greenback. Reciprocally, we are bullish on an Australian winemaker that would thrive with a cheaper currency. You may say that if China steps in front of a bus, people will be drinking water, not wine, but we say they will be drinking wine, and lots of it.

It caught our eye, in reading Floyd Norris's account of the Longtop scandal in *The New York Times* on Friday, that Deloitte didn't just take Longtop's word on the size of its liquid assets, but tried to verify the deposits with Longtop's bankers. It seems the bankers were in the habit of fibbing. If so, as Norris quoted John Hempton, chief investment officer at Bronte Capital, an Australian hedge fund that was forehandedly short Longtop shares, "the Chinese banks were in on the fraud, at least on the branch level. This is no longer a story about Longtop, and it is not a story about Deloitte. Given the centrality of Chinese banks to the global economy, it's a story much bigger than Deloitte or Longtop."

The infernal machine of the world monetary system we take to be that bigger story. It's the reserve currency system in toto. The word "reserve" connotes the dollar's role as a favored asset on the balance sheets of America's Asian creditors, especially China. What does the dollar have to do with China's falling-down banks? The connective tissue is familiar enough to constant readers. Recall, please, that we Americans send dollars west to finance our perpetual trade deficit. These dollars, the Asian central banks buy with their very own currency, printed specially for the purpose. Having bought the George Washingtons, the portfolio managers do not bury them but, rather, invest them in dollar-denominated assets. So the dollars fly home again. We Americans can have our cake and eat it, too.

In times past, a deficit country like the United States lost real monetary wealth, e.g., gold, to its creditors. The loss set in train a deflation of prices and wages and thereby an improved competitive position. By the same token, a surplus country like China gained real monetary wealth. The acquisition produced an inflation of prices and wages

The wages of money printing



source: The Bloomberg

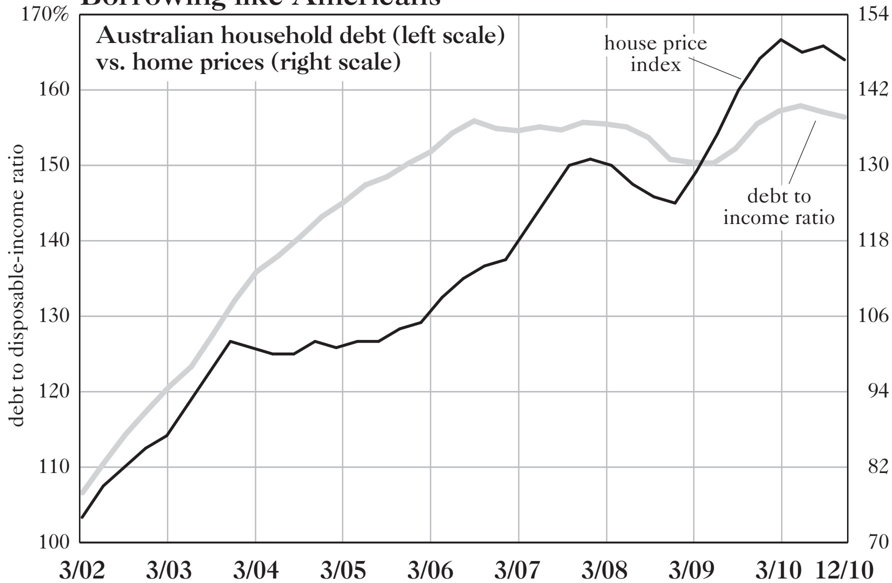
and thereby a diminished competitive position. Something like balance in international accounts was thus achieved and maintained. Prosperity there was, too, in that faraway time (the true-blue gold standard didn't survive World War I). The central banks didn't directly aim at it. Growth and employment were, rather, the co-products of sound money.

Today's transpacific monetary traffic achieves nothing like balance. On the contrary, deficits pile up on one side, surpluses on the other. Economists and central bankers may pour out their denunciations of this lopsidedness—you can see it, with respect to China, in the accompanying graph of Chinese reserve accumulation—but the criticisms fall on deaf ears. Asian mercantilists like their piles of Treasurys, American consumers their mounds of stuff. It's a curious thing about 21st-century monetary policy, but its practitioners follow no hard-and-fast rules. Some do target inflation—the European Central Bank and the Bank of England, for example—meaning they aim to achieve it (just a little, mind you). But most shoot for prosperity, the thing itself. To fire up growth, they push around interest rates, crank the presses and raise up stock prices. To the millennial sensibility, it seems the obvious approach; if we want something, let us go after it hammer and tongs.

However, achieving better living through monetary means is harder than it looks. Capital misallocation is a common unintended consequence of modern-day monetary policy. Press interest rates to the floor and house prices, for instance, may reach the sky before they tumble back to earth. And to mitigate the busts that are part and parcel of the booms, central banks inadvertently give cover to scoundrels. Bear markets unmask imposters; otherwise, Ponzi schemes can grow to systemic proportions. In China, in the matter of Longtop and Deloitte, we wonder if we are seeing the tip of a gigantic Madoffian iceberg.

The Chinese credit system, as described in the prior two issues of *Grant's*, is only a blunter variant on the now orthodox monetary policy techniques of the capitalist West. As you will recall, the Chinese Communist Party treats the state-owned banks not as commercial enterprises but as instruments of national policy. The centrally directed lending sprees inevitably yield up undigestible masses of nonperforming

Borrowing like Americans



sources: Reserve Bank of Australia, Australian Bureau of Statistics

ers, but officials see that as no great inconvenience. Bankers pack up the slow loans in so-called asset management companies. Time—and growth—will cure all is the party mantra.

The United States wasn't born rich, the China bulls never miss an opportunity to interject. During the formative years of American industrial growth, European creditors despaired at America's penchant for bankruptcy, fraud and outright theft. In the 1870s, observing the corrupt financing of the first transcontinental railroad and listening to U.S. Grant arraign his good-government critics—"morbidly honest," the president called them—the foreigners probably wondered what they had got themselves into.

But not even in that time of industrial growing pains did Washington, D.C., take command of the banking system to funnel credit to state-owned enterprises in order to achieve the planners' goal of 8% GDP growth. Neither did Gilded Age politicians resort to exchange-rate suppression to boost American exports (though they did not scruple to lay on heavy tariffs to stymie imports). We are bearish on China not because many companies are corrupt—17 state-owned enterprises have lately misreported financial data, China's National Audit Office disclosed last week—but because many prices are. Manipulate enough prices and before you know it, the bullet trains, sans passengers, are streaking from empty city to empty city past idle steel mills and untenanted shopping malls. Longtop and its bankers might have done what they allegedly did even in the golden age of hard money and solvent banking, but the monetary and financial arrangements in place in China would tempt a saint.

We believe they are debauching Australia, which, in your editor's opinion, doesn't deserve it. Australian house prices may be bubbly, and the Australian consumer overleveraged, and the high Australian dollar starving innocent Australian exporters, but the world's No. 13 economy has achieved feats that should leave American policymakers wide-eyed. We are not now referring to the astounding fact that Australia has borne not one year of GDP shrinkage since 1991. The odd slump is salutary, we believe. Without it, cyclical excesses go uncorrected. Nothing is so unstable as stability, as Hyman Minsky approximately postulated. To applaud a 20-year recession drought is to subscribe to the unlikely proposition that Australia has gone 20 years without overdoing it.

However, our admiration for Australian interest rates is unbounded. In the first place, you can actually see them with the naked eye. In the second place, they go up as well as down. To ward off the demons of 2008-09, the Reserve Bank dropped its cash target rate to 3% from $7\frac{1}{4}$% between March 2008 and April 2009. In America, monetary experts can't seem to stop wringing their hands over the Fed's projected "exit strategy." In Australia, the Reserve Bank simply raised the rate, to the current level of $4\frac{3}{4}$%.

Looking at Australia's economy,

you couldn't tell there was a worldwide recession. In the plague years of 2008 and 2009, Australian real GDP grew by 2.6% and 1.3%, respectively, thanks in no small part to its proximity to China. It was a most favorable comparison to rates of growth of zero percent and minus 2.6% registered in the United States. Neither—looking at the Reserve Bank's balance sheet—could you tell that the world almost came to an end. For reference, the Federal Reserve has bloated its footings by 211% since year-end 2007. Over the same period, the Reserve Bank's assets declined by 9.4%. The Australian central bank did, in fact, expand aggressively in 2008, but it subsequently took out what it had put in—and then some. Since November 2008, it has sawed its balance sheet in half. Striking, too, is the nature and quality of the Reserve Bank's assets. Fully half consists of gold and foreign exchange, with the balance in Australian government debt (11%), other Australian dollar-denominated securities (37%) and other assets (2%).

On the down side, Australia is a direct beneficiary of the corrupting symbiosis of America's dollar and China's renminbi. China is booming not solely on account of the suppressed renminbi exchange rate, but it's the cheap currency, perhaps, that imparts the manic and inflationary cast to China's growth spurt. Whatever the case may be, Australia is—for now—most profitably situated in the Chinese vortex.

"China," relates colleague Evan Lorenz, "accounted for 25.3% of Australian exports in 2010. But Australia's actual export dependency on China may actually be greater. Japan, which accounts for 18.9% of Australia's exports, and South Korea, which takes 8.8%, are also large exporters to China. You would expect that Australia, with its huge mineral resources, would be an export-dependent economy. But net exports contributed a mere 1.1% to GDP in 2010. In fact, Australia ran trade deficits in 77% of the calendar quarters since 2000."

In the Texas real estate boom of the late 1980s, buildings went up to house the real estate appraisers, developers, architects, engineers and bankers, the people who—as the visionaries reckoned—would be required to construct still more shiny new office towers in Dallas and Houston to accommodate the projected marvelous growth that the real estate boom had set in motion. Not until the great comeuppance did the survivors realize they had been capitalizing a boom on a boom.

So, too, today—it seems to us and others—in Australia. "The two key export earners for Australia are iron ore and coal, and the prices of these commodities have increased tremendously because of China over the past five years," Brian Redican, senior economist at Macquarie Group, advises Lorenz. "The way that this is impacting the economy is not exports per se, but, rather, in mining investment. BHP and Rio Tinto are flush with funds and are expanding facilities, and this has been a major impact on the economy. If you look at mining investment as a share of GDP, it has increased from 1% to 3%, and companies plan for that to double."

Not to worry, bulls counsel. Yes, they acknowledge, commodity prices and investment in commodity extraction stand at 100-year highs as a percentage of Australian GDP. And, yes, in the next two years, Australia will record the highest rate of investment, measured as a percentage of GDP, in at least a half century. But even if China should hit a cyclical speed bump, much of that investment would go forward. Liquefied natural gas projects are conceived on a 20- to 40-year time horizon. Calculations for iron ore investment are similarly farsighted. The big mining companies have committed billions of dollars—Aussie or U.S., it doesn't make much difference at current exchange rates—to these investments, and they will not be easily discouraged.

At the end of April, 94 projects were in an advanced stage of development, with a record outlay of A$173.5 billion, or 13% of 2010 GDP, up from 9% in 2009, finds the Australian Bureau of Agricultural and Resources Economics and Sciences in a May report. "This represents a 31% increase from October 2010," the agency says. "New capital expenditure in the mining industry is estimated to be $55.5 billion in 2010-11, 53% higher than 2009-10. Based on industry intentions from the December quarter 2010, Australian Bureau of Statistics survey data indicate capital expenditure in the mining sector in 2011-12 may be around $73.7 billion."

China is setting universal records in the investment intensity of its economic growth. In 2009, fixed-asset investment amounted to 48% of GDP, up from 35% in 2000. In the United States, fixed-asset investment was just 12% of GDP in 2010 (a more current figure than China's), a decline from 18% in 2000. With respect to investment intensity, the No. 13 economy looks more like China than the United States. In 2010, Australia registered fixed-asset investment worth 27.4% of GDP, up from 24.7% in 2000.

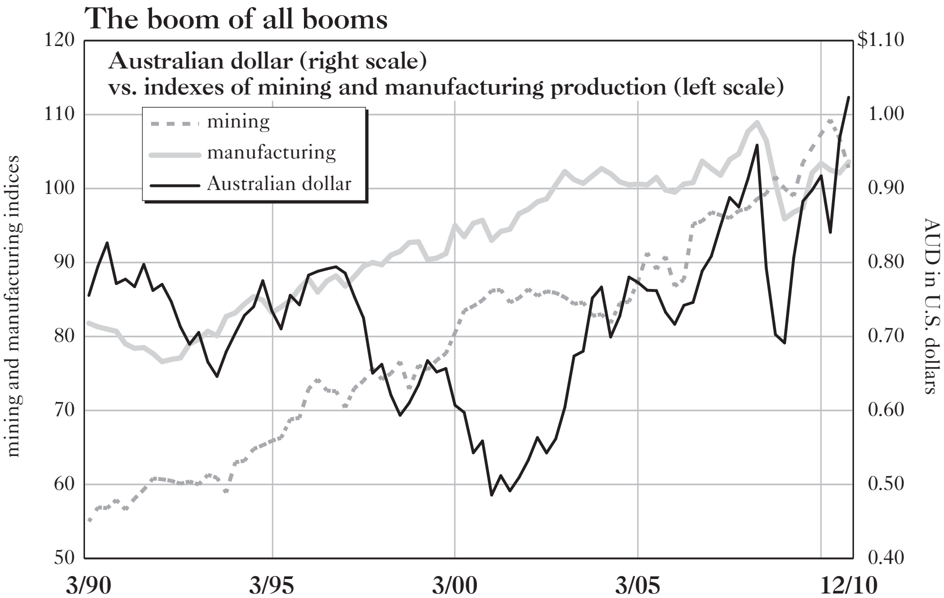
Sitting where the Aussies sit, nothing could seem more reasonable. Unreasonable to them is the skepticism of the people on the other side of the world who fail to grasp the significance of the transformation of India and China. Suddenly, two billion people demand—and have the wherewithal to buy—the coal and iron ore in which the West so signally failed to invest in the decade of the 1990s.

Advanced mineral and energy capital expenditure projects (in A$ billions)

	value of projects*	GDP	value as % of GDP
2002	A$17 billion	A$784 billion	2%
2003	21	833	3
2004	23	895	3
2005	34	966	4
2006	43	1,041	4
2007	71	1,137	6
2008	80	1,241	6
2009	110	1,248	9
2010	174	1,344	13

*April of following year

sources: Australian Bureau of Agricultural and Resource Economics and Sciences, IMF



sources: The Bloomberg, Australian Bureau of Statistics

"[I]f," Reserve Bank Gov. Glenn Stevens told a Victoria University audience in February, "China and India maintain, on average, their recent rates of 'catch-up' to the productivity and living standards of the high income countries, and if they follow roughly the same pattern of steel intensity of production as seen in the past in other economies, a strong pace of increase in demand for resources will likely persist for some time yet." Booms do go boom, Stevens acknowledged, but he noted that "[t]he current boom looks bigger than any other since [the founding of the Commonwealth of Australia in 1901] at least." It would, Stevens added, "be rather extreme to assume that the rise of China and India is a short-run flash-in-the-pan phenomenon."

Amen, says Warren Hogan, chief economist of the Australia & New Zealand Banking Group: "Cyclical issues in China I don't get too concerned about, because the amount of capital committed by large miners won't stop if China slows down for a year or two, which I think is a low probability event."

There is, too, in Australia a shrug of the shoulders regarding the calculated misinformation of China's state-manipulated prices. Australia's own economy in the 1960s and 1970s was a model of resource misallocation, you will hear. The exchange rate was fixed, wages were inflexible, tariffs were high, the financial sector was bound hand and foot. In short, the argument goes, it was a system that anticipated China's. Notice, however, say the bulls, that Australia removed those obstacles to the workings of the price mechanism without a social or economic breakdown.

Concerning China, we are dead certain of its errors, highly uncertain as to when the consequences of those errors might validate a short sale of China or its myriad proxies. Michael Pettis, professor of finance at the Guanghua School of Management, Peking University, who has done so much to expose the weaknesses in China's banking and credit structure, posed a question in the May 23 edition of his newsletter: "[A]re debt levels in China currently unsustainable?" he asks, then answers: "Probably not. I think China has at least four or five more years of this kind of debt build-up before it hits the debt limit. Why do I think this? Unfortunately, I have no reason beyond intuition, especially since neither I nor anyone else truly knows the amount of debt in the system."

What Pettis doesn't know, neither do we. As for our intuition, we see an ominous near-term convergence of events in China's developing power crisis. For an electricity shortage that is crimping production, drought gets the blame, but price control is the real cause. Though the Chinese government fixes electricity rates, the world sets coal prices. "Fast-growing China has long experienced periodic power shortages, especially in winter and summer when weather demands boost demand for heating and cooling," the Associated Press reports from Shanghai. "But the problems this year stem mainly from a failure of government-controlled electricity rates to keep pace with costs paid by utilities for the coal that fuels about three-quarters of the country's electrical generation."

"According to the power plants," relates a May 26 dispatch from Xinhua News Agency, the government's own, "the cost of generating one [kilowatt hour] of electricity has already exceeded the price they sell to grid companies, so the more electricity they generate, the more money they lose." Might that explain why China Southern Power Grid Co., the People's Republic's No. 2 electricity distributor, turned up at the top of the list of 17 state-owned enterprises that the government's own auditor last week charged with cooking the books?

Meanwhile, Global Sticks is coming home. The Canadian maker of wooden ice-pop sticks is moving to Thunder Bay, Ontario, from Dalian, China. China may have lower wage costs, notes *The Toronto Globe & Mail*, which broke the story last week, but "[w]hen the power goes off, it suddenly doesn't matter if your labor is expensive. . . . Chinese power prices have gone up as little as 1/10 of the rise in world oil prices."

Heavy-duty money printing, wild and wooly lending, exchange-rate suppression, a closed capital account and price control—not the ideal combination of macroeconomic policies for a healthy and growing economy. They are, however, the policies dear to the heart of the Chinese overlords. Nemeses there will surely be, though on the gods' own timetable. How to prepare for what may prove to be more than a bump in the road of China's long economic march?

Of short-sale candidates, there is no shortage. One could pick on Vale, Rio Tinto or BHP. One could sell the public seaborne shippers, the commodity of your choice (not gold, however, we think), or even Sotheby's. Alternatively, one could sell the Australian dollar. As things stand, admittedly, it's fairly valued. The value of Australia's exports in relation to the value of Australia's imports stands at a 140-year high. The economy is near full employment. An epic investment boom is under way. The $1.07-to-the-greenback exchange rate is, therefore, the Reserve Bank's best friend. A much lower exchange rate would present the central bank with the necessity of raising Australian interest rates, which—in conjunction with elevated Australian house prices—are high enough to hold down the percentage of first-time home buyers to 16% as of the April report, down from 21.7% of total buyers in the decade of the 1990s and 28.5% in May 2009 (when the government was bending over backwards to help).

The forex picture would, we believe, change in a flash if China tripped or if Australia took an autonomous spill. "Australia," as Lorenz observes, "is an open economy, its $1.4 trillion GDP on a par with that of Texas. The rapid movement of capital in and out of the country registers strongly on the exchange rate. You don't have to turn over many pages of history to see dramatic movement. For example, the Australian unit fell by 39% against the greenback between July 15 and Oct. 27, 2008, a period during which the Commodity Research Bureau/Reuters U.S. Spot Raw Industrials Index plunged by 26%, Lehman Brothers filed for bankruptcy protection and world credit markets stopped in their tracks."

Of course, not every dislocation in finance is apocalyptic. Life goes on, the reserve currency system notwithstanding (though we sometimes wonder how). Maybe the Chinese mandarins will suffer not a proper depression but only a steep correction. Maybe the Aussie dollar will correct but not crash. But even such a marginal markdown in the Australian exchange rate would be as manna to the desperate Aussie exporters—for instance, the wine exporters.

Treasury Wine Estates (TWE on the Sydney bourse) bears the stigma of being "probably the most AUD-sensitive stock on the Australian market," according to a May 24 Bank of America Merrill Lynch research bulletin by David Errington and team. Treasury is a new stock—it began trading on May 10—but not a new company. Before acquiring its very own ticker, it was the wine group within Foster's (Foster's, as no American sports fan needs reminding, being "Australian for beer"). In explaining the spin-off to shareholders, Foster's gingerly touched on the wine business's lamentable earnings: "A formal sale process might result in the sale of TWE at a price that does not appropriately reflect its underlying value and future prospects," management said. Then, too, as independent investment adviser Grant Samuel & Associates observed in the March de-merger statement of TWE, "[t]he presence of the Wine business has arguably acted as a 'poison pill' for parties potentially interested in acquiring the Beer business, while parties interested only in the Wine business would be unlikely to contemplate an acquisition of all of Foster's."

Lindeman's, Penfolds, Rosemount, Wolf Blass and Beringer are Treasury's five main brands. To build them, and 45 others, BofA's Errington relates, Foster's spent more than A$8 billion over the past 10 years, "sparing no real cost to create a world leading asset base." Call it A$10 billion to A$12 billion in today's money, Errington goes on, as against the winemaker's current enterprise value of not much more than A$2 billion. TWE shows A$140 million in net debt vs. BofA's 2011 estimates of A$2.89 billion in equity and A$258 million in earnings before interest, taxes, depreciation and amortization.

For Treasury, which conducts 34% of its bottling operations outside the mother country (California, with 32%, is far and away the busiest foreign outpost), the Aussie dollar exchange rate is the villain of the piece. China is well and good as a wine market—management has high hopes for the Chinese palate—but the magnetic tug of the China trade on the Aussie dollar is the killer. In 2007, when the Australian currency was quoted at 78.7 cents to the greenback, TWE generated A$484.9 million in earnings before interest, taxes, depreciation and amortization. This year, with the Australian unit commanding 105 U.S. cents, the company is expected to generate no more than A$258 million in EBITDA.

According to a sampling of *Wine Spectator* reviews (no wine tastings allowed in the office during business hours), there's nothing wrong with Treasury Wine Estate's vintages that a more forgiving exchange rate wouldn't fix. If we're right about China, help is on the way.

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Raining REITs

(April 22, 2011) The previous issue of *Grant's* took note of a coming wave of mortgage real estate investment trust IPOs. The issue you hold in your hands (or that glows on your screen) takes stock of the newcomers while pausing to remember the REITs that came a cropper. In preview, the mortgage REIT Class of 2011 has much to learn. Someone must pay the tuition, but it doesn't have to be you, gentle reader.

Reasons for the crowded IPO calendar are many and obvious. The yield curve is steep, investors want income, mortgage managers want fees—and the administration wants out. The Treasury's February white paper on Fannie Mae and Freddie

Class of 2011
(in $ millions)

name	sponsor	date filed	fees	max. offer
AG Mortgage Investment Trust	Angelo, Gordon & Co.	4/5/11	1.5%	$345 mil.
American Capital Mortgage Investment	American Capital, LLC	3/31/11	1.5	500
Putnam Mortgage Opportunities	Putnam Investments, LLC	4/11/11	1.5	300
Apollo Residential Mortgage	Apollo Global Management, LLC	3/21/11	NA	300
Pimco REIT	Pimco	4/5/11	1.5*	600
Provident Mortgage Capital Associates	Provident Funding Associates, LP	3/8/11	1.5	300
TMAC Mortgage	TCW Investment Management	3/11/11	1.5	300
Western Asset Mortgage Capital	Legg Mason/Western Asset Mortgage	3/24/11	1.5	300

*20% incentive with 8% hurdle

Mac announced the government's intention to reduce its commanding role in mortgage finance. There's hardly room to enlarge it. Over the past three years, according to Redwood Trust, a REIT that is trying to reinstitute free enterprise in the mortgage field, the government has guaranteed nearly 90% of mortgage originations. Over the past 25 years, it has guaranteed an average of 51%.

To make the transition from all government to less government, the Treasury proposed that Fannie and Freddie raise the cost of the mortgage insurance they write, reduce the size of the loans they insure and shrink their portfolios by 10% per year. Just the raising of this immense trial balloon brought cheers from civilian mortgage managers. The removal—or, at least, reduction—of government subsidies promises more rational pricing, therefore better returns on invested capital.

Of course, the contemplated changes may be a long time coming—if, indeed, they ever arrive. But the promoters of the new REITs don't intend to wait. Eight new prospectuses are on file, and colleague Evan Lorenz has made a survey of them.

"The new REITs," Lorenz reports, "are adopting a hybrid model, which allows them to invest both in agency and non-agency securities. This makes sense if the future of the mortgage market will involve a reduced role for the government-sponsored enterprises. In this respect, the new offerings take after MFA Financial (MFA on the NYSE). American Capital Mortgage Investment Corp., Putnam and Pimco raise the hybrid ante by drawing commercial mortgage-backed securities into their potential universe of investments.

"Neither has it been lost on the filers or their investment bankers," Lorenz continues, "that running a mortgage REIT is highly remunerative. Nearly all the newcomers propose to charge a management fee of 1.5% of equity each year, well in excess of what a mutual fund typically commands. There are some honorable exceptions. Hatteras Financial (HTS on the NYSE), for example, is notable for scaling down its fees as its equity pool grows. The pending Pimco trust is notable in another way: It proposes a 20% performance fee for returns in excess of 8% on top of the 1.5% management fee."

As noted here two weeks ago, the REITs have never had it so good. The two-year to 10-year portion of the yield curve measures 271 basis points steep, more than double the 1.12% post-1990 average. Mortgages are devilishly hard assets to manage, loaded as they are with what the CFAs are pleased to call "optionality." The steepness of the yield curve, however, constitutes an almost irresistible temptation to give the mortgage business a try.

In the first quarter alone, the five largest mortgage REITs raised $5.3 billion in new capital via secondary offerings. The eight pending IPOs seek an initial $2.9 billion. The truth of the matter is that mortgage REITs are insatiable. They issue stock to go public. Then they issue stock to "gain scale." Then—scale attained—they issue more stock to rake in additional management fees. The reason the REITs, as an industry, trade not much higher than book is because book-plus-a-little is where they tend to issue more stock—and still more stock.

"All new filers will be externally managed," Lorenz observes. "The business acumen running each REIT will sit in a larger fund, e.g., TCW or Apollo, and that fund will collect the management fee. Externally managed REITs add another layer of potential misalignment between shareholders' and management's interests. And that is only one problem. The largest extant REITs change hands at an average of only 110% of net asset value. Investors in a new REIT give up a portion of the freshly raised funds to compensate the underwriters. That is, the public pays a premium for the privilege of investing in a blind pool on which accrues a management fee. 'If we are all trading at book value,' an executive at one of the established REITs remarks, 'I don't know how these deals are going to get done.'" We know. Money-market interest rates hovering near zero will smooth the way.

Some deals are done, others are undone. Carlyle Capital came undone in March 2008 when its lenders refused to continue to extend financing to a portfolio that was leveraged 32:1. (Memo to the Class of 2011: No leverage ratio over 31:1.) In mortgages, as in stocks or commodities or anything else, price is all important. While MFA and Chimera Investment Corp. (CIM on the NYSE) have made hay by investing in the private-label RMBS shaken loose by the Great Recession, the REITs that bought that paper at par, e.g., New Century and Novastar Financial, didn't survive the crisis to buy the dips.

While it's clear sailing, high cotton and full speed ahead today, it was not always thus. For instance, on June 30, 2004, the Fed began to tighten

Missing in action

name	inception	fail date	reason for disappearance
Luminent Mortgage	Dec. '03	Sept. '08	Chapter 11
Thornburg Mortgage	June '93	May '09	Chapter 11
Bimini Capital	Sept. '04	Oct. '07	NYSE suspends
KKR Financial Holdings	June '05	May '07	de-REIT, convert to LLC
Deerfield Capital	June '05	Nov. '08	de-REIT, convert to C corp.
Laser Mortgage Management	Nov. '97	May '02	NYSE suspends
Apex Mortgage Capital	Dec. '97	July '03	merged with AHM
American Home	Feb. '04	Aug. '07	Chapter 11
Anthracite Capital	March '98	March '10	Chapter 7
New Century Financial	June '97	April '07	Chapter 11
Carlyle Capital	July '07	March '08	defaulted on $16.6B
Novastar Financial	Oct. '97	Jan. '08	NYSE suspends
Sunset Financial	Dec. '03	April '06	merged with Alesco
HomeBanc	March '04	Aug. '07	Chapter 11
Crystal River Capital	July '06	Aug. '10	acq. by Brookfield Asset Mgt.
MortgageIT Holdings	July '04	Jan. '07	acquired by Deutsche Bank
Fieldstone Investment	Feb. '05	July '07	acquired by multiple entities
Hanover Capital Mortgage	June '97	Oct. '08	reverse takeover

sources: The Bloomberg, company filings

policy, raising the then 1% funds rate by 25 basis points. By year-end 2005, the yield curve began to invert. Annaly Capital Management (NLY on the NYSE), the largest and one of the best-run REITs, suffered a decline in book value per share to $9.48 in the second quarter of 2006 from $13.45 in the 2004 first quarter.

"I can't remember anything close," says Jeffrey Gundlach, CEO of DoubleLine Capital and former world-beating fixed-income manager at Trust Co. of the West, concerning the queue of projected mortgage REITs. "In the past, if there were three it was an event. Eight is unbelievable. I'm sitting here getting phone calls all the time from investment banks saying we should launch a REIT fund for you. The market's wide open. With reputation and the DoubleLine brand, you could raise billions of dollars. What's wrong with you? My answer is that I am too old to raise billions of dollars and go around the world saying 'I'm sorry,' which is what I think would end up happening."

The trouble boils down to the nature of the risks required to generate a competitive dividend yield—14% and up constitute today's benchmark. "Few, indeed," Gundlach goes on, "are the REITs that have done meaningful leverage that have really survived over a full cycle."

Prepayment risk is but one of the mortgage land mines. "Because," Gundlach explains, "you have a payment delay in getting your principal. They announce the prepayment the evening of the fourth business day of the month. But you don't actually get the money, in the case of Fannie Mae, until the 25th. And that gap in the middle is incredibly difficult to manage for a REIT because even though you have a receivable coming in on, say, the 25th, the margin clerk calls you on the fifth business day and. . . says, 'We need more collateral, because the factor on all of these securities has dropped with the prepay numbers that just came out.' He no longer has, say, $100 of collateral (under high prepay environments, you can get even 8% [of the underlying principal] paying off in a month; it can be that high). What they do is, they say, 'We have $92 in collateral, please send us the $8.'

"'I'll be happy to send it to you when I get it on the 25th,' you say. 'So I'll pledge you this IOU that comes wrapped in a government guarantee that comes due on the 25th.' The margin clerks do not accept that. What they say is, 'That's great, be happy to take that money when you get it, but we need the $8 now. And if we can't get the $8 now, we will liquidate your collateral pool in support of our loan.' You can actually go bankrupt on that in the REIT market. That's not happening now, but that did happen in 2002-03, and that happened a little bit in 1998.

"Most of these mortgage REITs that are starting, these 'newcos,' by their own prospectuses, disclose that they have no experience running a mortgage REIT," Gundlach winds up. "[T]hose that have no experience running a leveraged portfolio…will learn how to do it over the course of a couple of years, but you are going to make a couple of mistakes as you learn how to do it."

And therein lies the germ of a trade: long an existing REIT (e.g., MFA, Hatteras, Annaly), short a newco promising, but not yet delivering, a strategy comparable to that of the paired long. The fledglings labor under not one disadvantage but two. They bear the aforementioned underwriting fee, and they need time to put money to work to produce a dividend. Then, too, the management, being human, must be allowed to make some rookie mistakes. We forgive them in advance.

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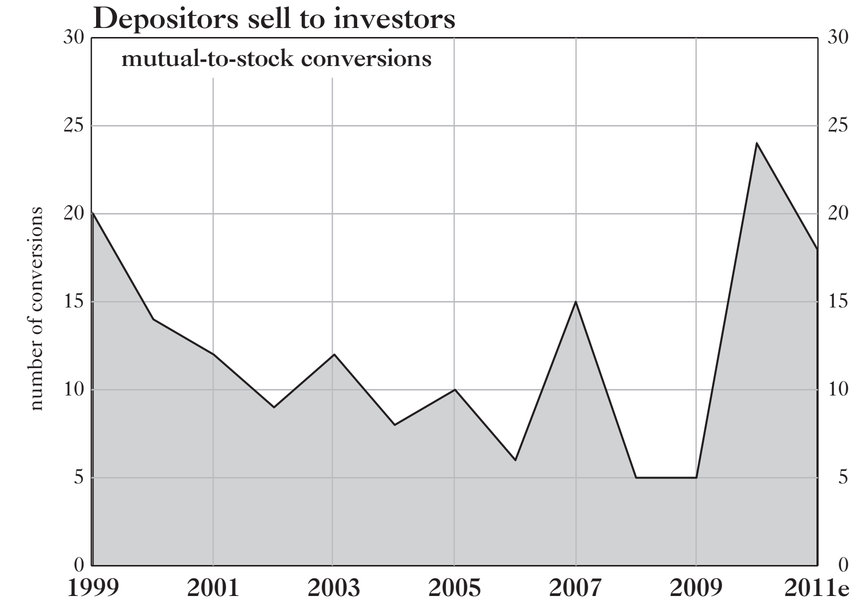
Nutmeg State conversion

(February 22, 2011) Mutual thrifts keep changing their spots. According to the February *SNL ThriftInvestor*, 24 savings institutions converted to investor ownership in 2010. Not since 1999 have so many depositor-owned banks and S&Ls gone public. At year-end, 18 more candidates came forward to convert, while 52 were in an earlier stage of IPO latency. The 52 are mutual holding companies. Having partially switched to investor ownership, they are laying plans to complete the transition. Twenty-two mutual holding companies change hands on major exchanges, another 30 in the pink sheets.

Grant's welcomes them (see the issues of Oct. 29, Nov. 12, Nov. 26 and Jan. 14). The typical mutual-to-stock candidate is under-managed—at least, from the profit-maximization point of view—and overcapitalized. It survived the debt disaster and sees opportuni-



source: *SNL ThriftInvestor*

ties in the post-disaster marketplace, including those implicit in the winding down of Fannie and Freddie. In some cases, a gray and long-serving management looks forward to monetizing the value of its stewardship by selling out when the time and price are right.

First Connecticut Bancorp, holding company for Farmington Savings Bank, broadly conforms to demutualization type, and we therefore look kindly on it. To "look kindly" is an intermediate kind of investment posture, stronger than "hold" but weaker than "buy." In ardor, it resembles a kiss on the cheek. We go no further with Farmington because its problem loans have been growing faster than its loan portfolio. "The Year of Yes" was the theme of its 2009 annual report, which proudly flagged "record asset growth of $160.8 million." "Yes to growth," as the bank puts it, is laudable, especially when others are shrinking. But growth for the sake of growth is anathema for even a well-capitalized financial institution. What we don't know about First Connecticut—and won't be able to find out until the IPO has come and gone—is whether asset quality is, or is not, a problem with a capital "P."

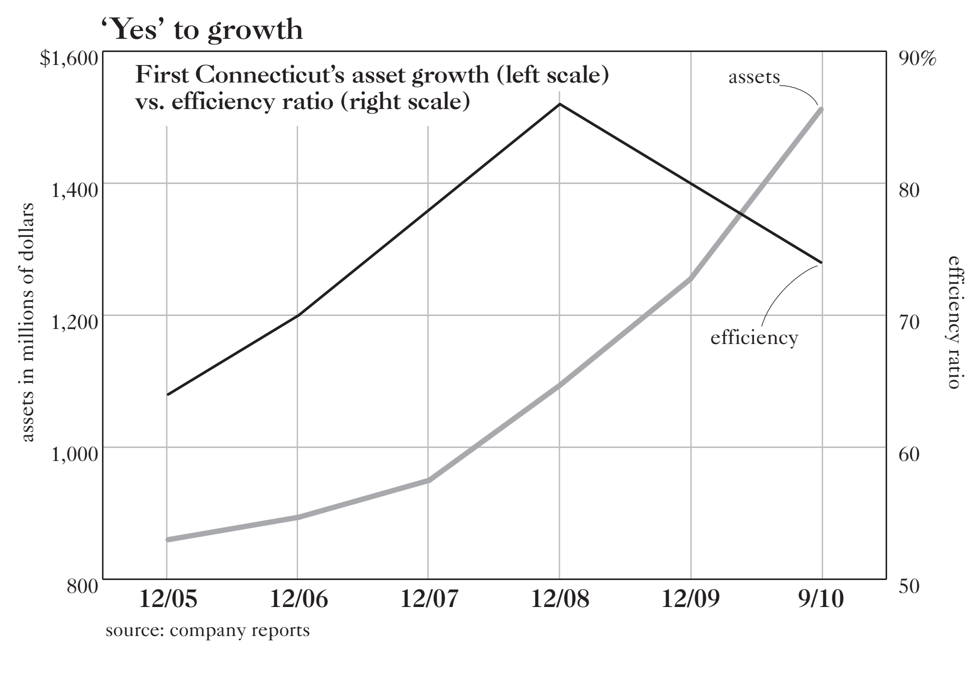
If, as expected, between 9.8 million and 15.2 million shares come to market next quarter at $10 apiece, you'll find them on Nasdaq under the ticker FBNK. The company would then command a market cap of between $102 million and $158 million, and the stock would be valued at between 55.8% and 68.8% of tangible book. Day traders will be interested to know that, according to SNL, 16 prior comparable thrift conversions—i.e., uncomplicated, "single-step" affairs—enjoyed average share price appreciation of 10% on the first day of trading.

Farmington was founded with initial deposits of $88.70 during the administration of Millard Fillmore. One hundred and sixty years later, under the administration of Barack Obama, the bank shows $1.2 billion in deposits and $1.5 billion in assets. It serves Hartford County with 15 branches and four limited-service offices. Real estate is what it lends against. Its loan portfolio is secured by residential real estate (41% of the total), commercial real estate (28%), construction liens (4%) and time-share interests (9%). Commercial loans and home-equity lines of credit constitute 10% and 7% of the portfolio, respectively. "Other" is the name of the residual.

At the December 2007 start of the big recession, Farmington had lots of tangible equity (equal to 9.4% of assets) and few nonperformers (0.39% of total loans). Capitalizing on that position of strength, management made hay. From the 12th month of 2007 to the ninth month of 2010, the balance sheet grew by 59%, to $1.5 billion. In March 2008, the current CEO, John J. Patrick Jr., joined the company, having previously headed the Connecticut operations of the former TD Banknorth. "I came from an organization where we took it from the 17th-largest bank in the state to the fifth-largest bank," Patrick tells colleague Evan Lorenz. "And so, there was an opportunity to be part of a growth story here."

Growth doesn't just happen, of course, and Farmington has been spending money on new systems, new people and new branches. Among the new hires is the former CFO of Rockville Financial (*Grant's*, Jan. 14). "We've built a platform here that's very scalable," Patrick says. "We've made investments in this company that you don't see in other mutuals."

You do see them, however, in the in-



source: company reports

come statement. On a trailing 12-month basis, non-interest expense has ballooned to \$40.8 million from \$24.2 million in 2007. In consequence, Farmington's efficiency ratio, a measure of non-interest expense to net-interest income plus non-interest income, has moved in the wrong direction, to as high as 85.6% in 2008 from 63.5% in 2005 (lower is better). Then, again, as Farmington has gained scale, the efficiency ratio has begun to come down, reaching 73.8% in the nine months ended Sept. 30.

"As part and parcel of rapid growth plus depressed earnings," Lorenz points out, "capital has not grown commensurately with assets. Today, Farmington's tangible equity totals just 6.5% of assets. A key reason the bank is flipping to a public charter is to raise the capital required for continued growth. Post the IPO, the bank will be comfortably capitalized with between 11.4% and 14% tangible equity to assets, opening it to the greatest investment risk for ex-mutuals: A cheap valuation and excess capital can lead even the most well-intentioned management teams to destroy value via acquisitions and empire building. Patrick is cognizant of the threat. 'We've had an organic growth strategy. We anticipate that we will continue organic growth as we continue to move forward,' he says. 'We don't expect to do anything to dilute tangible book value.' While Patrick, age 51, has stated no intention to buy, he may have an incentive to sell. His contract entitles him to a \$5.5 million payout should the bank be acquired.

"Rapid growth in any financial raises red flags," Lorenz concludes. "Farmington has grown assets at a compounded rate of 18% per year since December 2007. While nonperformers, at 1.8% of total loans, are no reason for alarm per se, they sit dramatically higher than the 0.39% level in 2007. Reserves, which amount to 1.57% of gross loans, may not be enough to cover losses if delinquencies continue to mount."

"Our whole management team has lived through the late 1980s and early 1990s with what happened here in New England," says Patrick in response to this observation. "None of us ever want to live through that again. . . . To grow for the sake of growth is not right for us. It has got to be the right kind of growth with the right asset quality."

Here's hoping.

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Also from the vault...

In the "everything old is new" category, we'd like to point a finger back six years to. . .

Inside baseball in Europe

(June 3, 2005) Since we prophesied that European sovereign debt yields would begin to de-converge (*Grant's*, March 11 and 25), Portugal has owned up to a shockingly big fiscal deficit, the Organization for Economic Cooperation and Development has revised upward its 2005 deficit forecasts for Greece and Italy (as well as for Portugal), and French voters have rejected the European Constitution. But spreads between the strongest and weakest European national borrowers have widened only a little.

Following is a progress report on an admittedly exotic speculation. Not just anyone can call up the Morgan Stanley derivatives desk and buy himself a basket of credit default swaps (CDS) on—for instance—Italy, Greece and Portugal, the so-called Club Med of the euro zone. But for those with the will and the way, no sweeter risk-reward proposition is available in all the credit markets, we judge.

Before monetary union, European governments borrowed each according to its ability, the weaker paying significantly more than Germany or France. For example, in 1995, Spanish and Italian 10-year notes fetched a yield premium of 525 and 600 basis points, respectively, over German bunds. Today, they're quoted at spreads of zero and 21 basis points, respectively.

Theory had it that, in a unified European economy, every sovereign borrower would be equally creditworthy. Each would be subject to the strictures of the stability and growth pact. All would share in the cohesive power of the single currency. And theory was borne out. Convergence—one of the longest-running and most lucrative fixed-income trades in years—came to pass.

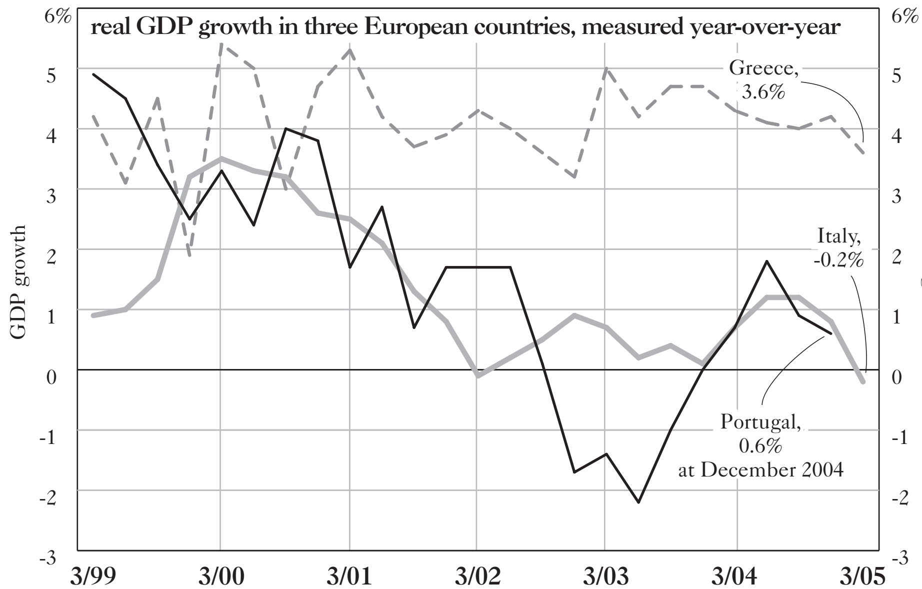
But centrifugal forces have overtaken unifying ones, and neither stability nor growth appears to be in Europe's immediate future. De-convergence may already be under way. Thus, since March 8, the premium of Italian to German 10-year yields has widened to the aforementioned 21 basis points from 10. Over the same span of weeks, the premium of Greek to German 10-year yields has widened to 24 basis points from seven. Portugal has no on-the-run 10-year note; but the premium of the Portuguese 4 3/8s of 2014 to the equivalent German bund has expanded to 10 basis points from five. In 1994, the occasion of another Portuguese fiscal crisis (though one less severe than today's), Lisbon was borrowing at a yield of 11.5%, 385 basis points over the German rate.

What price should the market exact on the free-riding profligates of western Europe? The *Daily Telegraph*, London, offers perspective. It points out that the sovereign credit spreads in Europe are smaller than the differences prevailing between the members of another federation, one much longer established than the EU (it contains 50 states and its capital is in Washington, D.C.). "Investors are assuming the ECB will continue to shield Club Med debt by treating it as identical to German debt in their refinancing activities," the *Telegraph* noted on May 28, "but already the Bank of England refuses to accept Greek bonds at par, and this political gamble overlooks the hardening mood in Paris, Berlin, Madrid and the Hague. [European Monetary Union's] architects always expected trouble, but counted on a 'beneficial crisis' that would help push Europe further towards full economic federalism. Jacques Delors even spoke of an inevitable 'debt union' binding Europe with indissoluble ties. This is now being put to the test. The high point of the European 'Project' may have passed when a clutch of ex-communist states joined the EU on May 1, 2004, each jealous of their newly won sovereignty."

As an aid to clear investment thinking, it sometimes helps to imagine selling the thing you plan to buy, or vice versa. We asked colleague Ian McCulley to paint us a picture of the re-convergence trade: What forces of politics or finance would make it profitable to sell credit insurance on Italy, Greece and Portugal? A weakened euro exchange rate might help, he ventured; it could help to stimulate export growth, therefore GDP growth, even in such economies as Italy's (which is shrinking), Portugal's (which is stagnating) or Greece's (which is growing, thanks to the stimulus afforded by the nonrecurring 2004 Olympics). A political backlash might hasten real economic reform and thereby institute a more prosperous Continental economy, McCulley goes on. And bond yields might continue to fall, "which would tend to compress the spread differences between the various sovereigns," he notes. "Investors could also become more sanguine about credit risk and push CDS spreads lower in all credit markets."

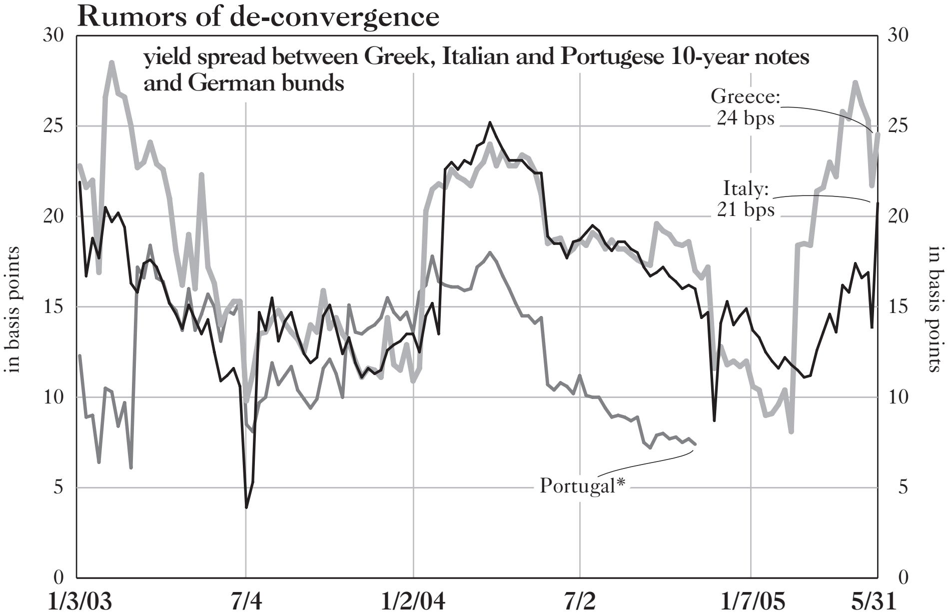
More likely, however, he and his editor judge, is that the weaker economies will get weaker, and that

Club dead



source: The Bloomberg

Rumors of de-convergence



*Portugal has no current 10-year bond
source: The Bloomberg

still-narrow credit spreads will widen. According to Viktor Hjort, Morgan Stanley credit derivatives and structured credit strategist, London, buying credit protection is much like buying a put. The most liquid contracts typically run for five years—if the cost of protection against default were 10 basis points, the CDS buyer would put up $10,000 a year on each $10 million face amount of CDS he bought. Some of these contracts trade more frequently than others, Hjort cautions. You can think of them as a deep, deep out-of-the-money option. Not so deep, we believe.

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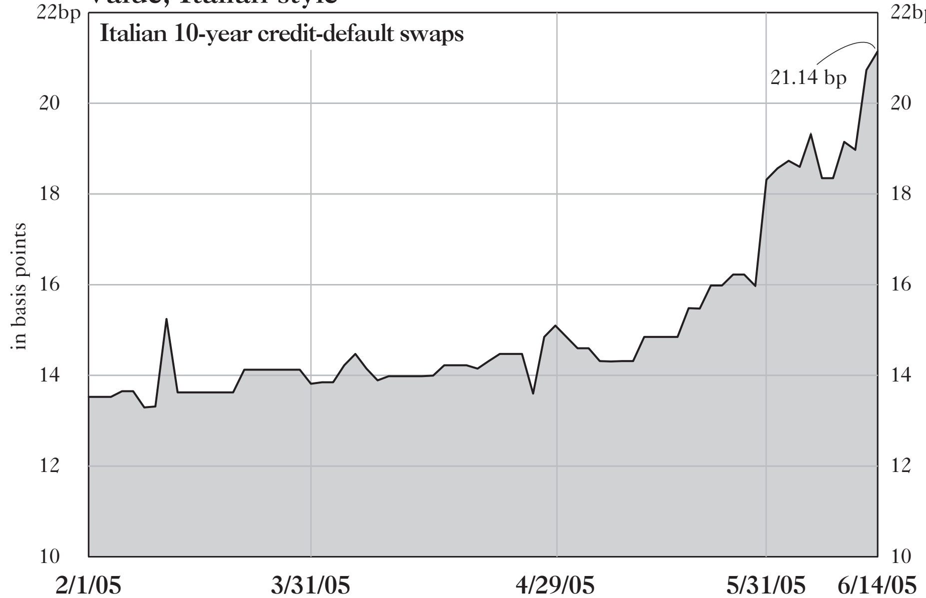
Bring back the lira

(June 17, 2005) On June 8, the government of Italy issued €2 billion of floating-rate, 15-year debt at an initial yield of only 2.75%, an interest rate worthy of the proverbially triple-A-rated Roman Empire under Caesar Augustus. Except, today's Italy is in recession, the only economy in the G-7 so blighted. And the European Union last week began procedures to discipline the Italian government for exceeding EU and euro-zone limits on budgetary deficits. In this respect, too, Italy stands alone (not in its open flaunting of the EU fiscal rules, for it is only doing what France and Germany do, but in being singled out for official condemnation).

Value, Italian style



source: The Bloomberg

What to do? The solution proposed by a trio of ministers in the government of Silvio Berlusconi is to trade in the euro for the previously unlamented lira. "Does sterling have no economic foundation because it is outside the euro?" demanded one of the ministerial champions of the discarded Italian currency. "Is Denmark living in absolute poverty because it is outside the euro? Are Swedes poor because they are outside the euro?" The politicians promise to fill in the details on June 19.

The odds on the recommissioning of the lira do seem long. Berlusconi himself rejects the idea (even as he winks at it), and a poll released Saturday shows that nine out of 10 Italians are opposed to it. On the other hand, in a November poll, 64% of Italians said they had either "a lot" or "some" trouble "handling" the euro, according to the *Financial Times*, "the highest level in the 12-nation eurozone." (If the euro has taken some getting used to in Italy, it might be because the single currency lacks the garlands of commas and zeros that had bedecked the devaluation-prone lira.)

To mainstream Italian politicians, the lira-restoration project is an embarrassment and an abomination. In anguish, they cry out to their countrymen: Are you nostalgic for the old sky-high inflation rates? For the old towering interest rates? For the serial monetary and fiscal crises? It is not to be taken seriously. "Talk of an implosion of the eurozone has . . . left most serious analysts cold," the *FT* recently pronounced. "Goldman Sachs, for example, put the likelihood of the collapse of monetary union this decade at 1%."

The bond market is priced for approximately those odds. Thus, on May 30, the day after the French voted down the proposed European Constitution, the government of

Euro-denominated gold price jumps

source: The Bloomberg

Italy was able to sell €2.5 billion of three-year notes at a yield of 2.3%, and another €2.5 billion of 10-year notes at a yield of 3.5%. Whatever else was running through investors' heads as they reached for their checkbooks to trade today's euros for tomorrow's presumptive euros (and at such fancy yields), it was not: "We investors require a margin of safety not only against the known risks but also against the increasingly worrisome possibility that the real risks we face are today unknown, at least to 'serious' analysts."

For last month's 14.5% drawdown in its Credit Fund, GLG Partners, Europe's biggest hedge-fund management company, has blamed the downgrades of General Motors and Ford, events so improbable that their occurrence produced an "eight standard deviation move," as GLG put it. Yet, is it only our imagination or do outlying events not seem to occur most frequently and devastatingly to leveraged investors operating without a margin of safety in overvalued markets?

In the euro zone, bond prices are driven these days mainly by expectations of easier monetary policy and weaker business activity. The results are as noted: generationally low yields, even for the fiscally unrepentant government of Italy. And because Italy is still a member of the euro zone, and because its bonds are still in the relevant bond indices, fiduciaries invest in Italian debt merely because it exists.

All the while, the price of credit insurance on Italian sovereign debt continues to widen, even as the euro-dollar exchange rate continues to weaken (*Grant's*, March 11). We deem the Italian credit-default swaps, at 21 basis points and change, to represent good value, still (alas, these instruments are available only to institutional-size investors). And we deem Italian sovereign debt—and that of Greece and Portugal—to represent rare and extreme anti-value.

"Serious" analysts will rue the day they discounted the centrifugal forces now unleashed in Europe, in our opinion. On the cover of the June 2 issue of the German magazine *Stern* is the headline, "Have we choked on the euro?" Inside is a report that, according to a new poll, 56% of Germans want their beloved deutsche marks back. In Germany nowadays, relates our German-speaking colleague, Susan Lhota, people say "teuro," not euro. The "t" signifies *teuer*, meaning expensive.

We judge that Europe wants cheaper money. And, we predict, it will get it.

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Unthinkable euro thoughts

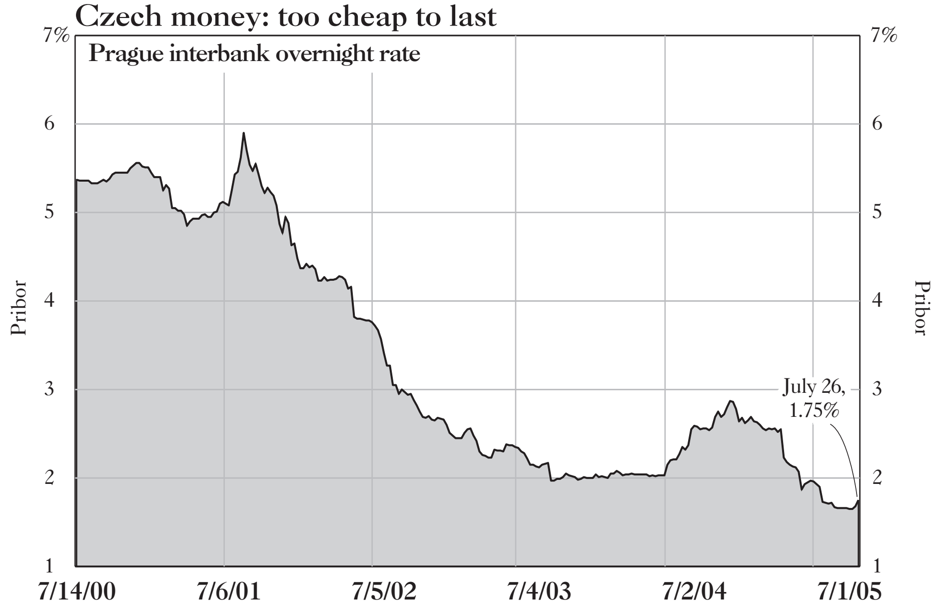
(July 29, 2005) From across the Atlantic come new and unsanctioned notions about European finance. First is that interest rates are too low, especially in the Czech Republic. Second is that seemingly comical calls to reinstate the lira in fact point to a serious risk of the euro zone breaking up into its 12 quarrelsome components and cutting short the grand experiment of the single currency.

Interest rates first. Did you know that the Czech overnight rate is just 1.75%? That it is 25 basis points below the European Central Bank's policy rate, even though Czech mortgage growth is ripping along at 56%? That the Czech stock market is up by 21% this year and that Czech GDP is growing by 4.5%? All true, observes an anonymous European reader, who suggests a trade to profit from a return to normal-size interest rates in the liberated Eastern European state. The strategy: Swap a fixed-rate cash flow for a floating-rate cash flow. Specifically, lock in the two-year Czech swap rate, at 2.24%, and receive the six-month Czech money rate (the Prague interbank overnight rate, or Pribor) at 1.75%. The fixed-rate side of the swap pays annually, the floating-rate side, semiannually.

So positioned, a trader initially suffers 49 basis points of negative carry. However, a 50 basis-point tightening by the Czech National Bank would propel him or her (slightly) into the black. To listen to our unnamed adviser, that half percentage point would be only the start. Czech interest rates have no business being as low as they are, and would not be except for a 2002 deflation scare. And though no inflation scare is in the immediate offing, expectations center around a 2% or 2½% rate of rise in consumer prices. "Retail sales growth keeps surprising on the upside," our man winds up. "Which is not surprising considering this is a country where people didn't have everything. Now they are getting a color television, a car, a refrigerator." But the existing, too-low, unsustainable and fluky 1.75% overnight rate was expected to stand following a July 28 meeting of Czech monetary policy makers.

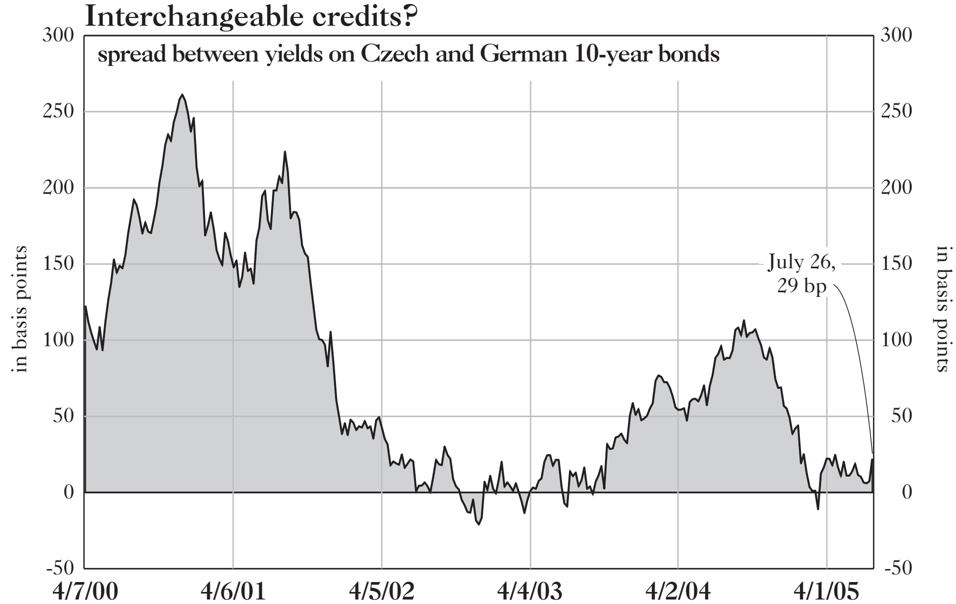
One of the many oddities about Czech crown-denominated interest rates is that the Czech Republic is expected to enter the euro zone in 2010 (along with Poland, Hungary

Czech money: too cheap to last



source: The Bloomberg

Interchangeable credits?



source: The Bloomberg

and Slovakia). You might suppose that, in view of the risks associated with any complex human endeavor, the market would not be assigning this one a zero-percent probability of misfiring. But it is: Czech interest rates are pitched below euro-denominated ones all the way out to five years.

Which brings us to the future of the single currency. A new report from Smithers & Co., London, concludes that it might not have one, or, at least, not a very long one. This radically bearish prognosis is the fruit of a carefully reasoned argument. "The fate of the Eurozone will be decided by the performance of its weakest link," the report proposes. Let one nation secede and devalue, and others would, by force of competitive pressure, be led to do the same. Before you know it, the world would be back to lira, francs, marks, punts, etc.

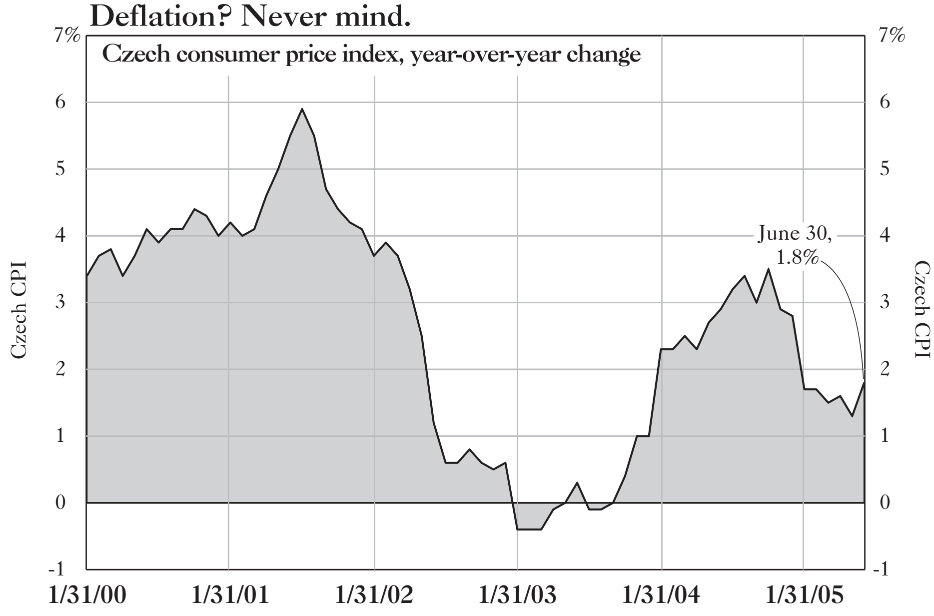
Why might a nation, even a weak one, leave the fold of a peaceful and united Europe? An inability to adapt and an incapacity to innovate are two good reasons. Imagine a country with an aging population, an uncompetitive manufacturing sector, an ineffective government and an inflexible labor market. Imagine Italy.

The Smithers argument stands on logic, it seems to us. What doubles its power is that it equally stands on historical precedent. In the 1930s, a group of European countries banded together to resist the devaluation of the British pound and the U.S. dollar. These countries—the so-called Gold Bloc, including France, Italy, Belgium, The Netherlands and Switzerland—left it to the Anglo Saxons to destroy themselves with paper money. They would stay the course with gold. At first, the Gold Bloc flourished, write the eponymous Andrew Smithers and his colleague Oliver Grant, a fellow of St. Anthony's College, Oxford. For the member countries, the Depression was not so devastating as for their neighbors. However, from 1933 onwards, the Gold Bloc lost ground to the devaluing countries. Belgium, in particular, found it hard to compete against the prices quoted in cheap pounds, and it left the bloc in 1935. "[T]he Belgian defection weakened the credibility of the Bloc as a whole," write Smithers and Grant, "and in turn exposed other members to competition from Belgian exports which were now cheaper. Further defections followed and the Bloc effectively came to an end in 1936."

All of which bears on the seemingly mirthful speculation about a return of the lira. "In the case of the Eurozone," the report warns, "the defection of even a single member is likely to be fatal for the system. If Italy, for example, were to withdraw, this would expose other countries to Italian competition, especially as this would almost certainly be accompanied by a large devaluation of the reinstated lira. Other vulnerable economies would come under pressure; perhaps Spain or Portugal would be the next to go. And so on, until the whole system had crumbled."

Italy entered the euro zone at what some now regard as an adversely high exchange rate. The Czech Republic is determined to enter at an advantageously low one. Hence the 1.75% overnight central bank rate—the artificial, inflationary and unsustainable 1.75% overnight central bank rate, we would say.

Deflation? Never mind.



source: The Bloomberg