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JAMES GRANT
EDITOR

Vacation delectation

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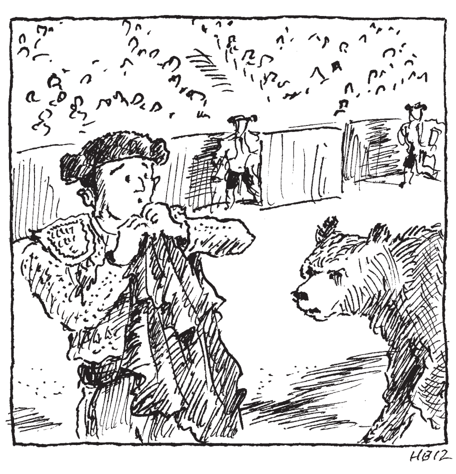
Bubble in safety

(June 1, 2012) Just seven basis points more than zero was the yield on Germany's zero-coupon notes of June 2014 that came to market two Wednesdays ago. "That is symbolic of the desperate need for security in today's troubled times," a French bank's interest-rate analyst told Bloomberg. The times may be troubled (they often are) and people may be desperate (someone usually is), but that doesn't mean that low-yielding sovereign debt is the last word in safety and soundness.

Now under way is an exploration of the alternatives. The creditworthiness of highly regarded governments is one topic. A 30,000-foot survey of highly unpopular equities is another. And the intersection of sovereign credit with the euro kerfuffle is a third. In general, this publication is bullish on things certified to be unsafe, bearish on things certified to be safe (assuming always that the respective prices are right). In the meantime, we remain bullish on the time-tested haven that you can find in better-stocked bank vaults and safe-deposit boxes.

Claims on the governments of Switzerland, Germany, Japan and the United States are the favored investment ports in today's financial storms. In real terms, none yields much more than nothing while many yield less. Yes, a creditor of these sovereigns stands a good chance of receiving his money back at par—then again, the creditor had his money before he lent it. Besides, what will that money buy after the central banks get through printing more of it?

Before getting down to the overvaluation of the debts of the world's most-favored nations, we pause to note the overvaluation of the debts of one of the world's less-favored nations. Not so much less favored, in fact. That nation is the Republic of Lebanon, whose single-B-rated 8¼s of 2021 are quoted at 116.9, a price to yield 5.79%. For perspective, a single-B-rated American corporate offers 8.29%. Contemplating the ungenerous yield on Lebanese government debt, we think first not of geopolitical risk but of the post-1981 bond market. Interest rates have been falling for 31 years. Equities have been lost in space for a dozen or more years. Thursday's *Financial Times*'s teasing "Death of equities?" on its front page recites the facts that, in the United States, bond funds have attracted more money than stock funds every year since 2007, "with outright net redemptions from equity funds in each of the past five years." A concerned British actuary tells the paper that, concerning the lopsided investment-allocation preferences in place today, and likely to continue (in his view) for decades, "There are not enough bonds in the world."



So investors pay 117 cents on the dollar for Lebanese 8¼s. Lebanon does boast a growing labor force, it's true, and in that important detail it presents a happy contrast to Japan, Germany and Switzerland. However, neither Japan nor Germany nor Switzerland borders Syria. Then, too, Lebanon is running a 4% inflation rate, a current-account deficit of more than 14% of GDP (compared to 9.7% for Greece) and a ratio of government debt to GDP of 136.2%. Not unlike Germany, Lebanon tends to attract money when its neighbors quarrel. And its neighbors do quarrel. Why, then, do Lebanon's creditors not demand a higher rate of pay for the risks they take? One might well ask the same question of the creditors of the world's most prestigious sovereign borrowers—Germany, first and foremost.

Rated triple-A by every licensed ratings agency except Egan-Jones, Germany posts a budget deficit of just 1% of GDP (compared to America's 9.6%) and a ratio of total debt to GDP of only 81.5% (compared to America's 102.9%). The German unemployment rate stands at 6.8% vs. 10.9% for the 17-nation euro zone. In the past 10 years, the German economy has grown at an average annual rate of 1.05%, compared to 0.63% for Japan and 1.73% for Switzerland. As for the German commitment to financial orthodoxy and fiscal austerity, Germa-

Sovereign yield curves

bonds	U.S.	U.K.	Germany	Switzerland	Japan	Lebanon
3-month	0.08%	0.32%	0.01%	—	0.11%	4.52%
2-year	0.29	0.29	0.04	-0.22%	0.10	3.92
5-year	0.77	0.76	0.43	0.01	0.21	4.98
10-year	1.74	1.78	1.36	0.61	0.85	5.93
30-year	2.85	3.09	1.93	0.98	1.80	—

source: The Bloomberg

ny's monetary co-venturers can all too readily attest to it.

But these virtues (if virtues they all be) pertain to the past. A set of euro-related risks clouds the future. The fact is that Germany has massive exposure, actual and contingent, to the so-called European periphery. The market can't help but know it, though it seems to avert its eyes. Perhaps we humans need to believe that somewhere exists a safe haven. Anyway, for now, Germany is Europe's chosen bolt hole. It's the Japan or United States—or Lebanon—of the Continent.

We don't gainsay Germany's economic prowess. What we do question is the risk-and-reward proposition presented by Germany's debt. Negligible nominal yields armor the fearful investor against no contingency except the one from which most of the rest of mankind seems also to be fleeing. The "bull market in fear" that Christopher Cole identified in the previous issue of *Grant's* is stamped on sovereign yield curves.

Germany constitutes a special case of misperception, in our opinion. Virtually, as we see the situation, Germany is the euro and the euro is Germany. Some 60% of German exports never left the European Union in 2010, according to the World Trade Organization, while exports contributed 51% of German GDP in the first quarter of 2012, according to German government data. "Germany is no more 'decoupled' from the euro zone's economic crisis than the world was from the 2007-08 American housing crisis," observes colleague Evan Lorenz.

Neither are German commercial banks decoupled from Europe—on the contrary. As of year-end 2011, according to the Bank for International Settlements, German lenders held claims of $13 billion on Greece, $95 billion on Ireland, $30 billion on Portugal, $146 billion on Spain and $134 billion on Italy, for a rounded grand total of $419 billion, or €323 billion.

Then there's the money that the German government has to defend the euro. Such commitments—promised but yet undrawn—include €22 billion for the first Greek bailout, €211 billion for the European Financial Stability Facility, €190 billion for the European Stability Mechanism, €12 billion for the European Financial Stabilization Mechanism and €40 billion for the Securities Markets Program. They sum to €475 billion, or 18% of German GDP, note Credit Suisse analysts Christian Schwarz and Matthias Klein.

Perhaps most significant of all these risks is Germany's growing exposure to peripheral credit via the European interbank payment system. The Trans-European Automated Real-Time Gross Settlement Express Transfer System is the proper name from which the acronym Target2 is tortured. Every day, an average of €2.385 trillion courses through the Target2 channels, i.e., the equivalent of the entire Continental GDP every four days. Target2—the technological successor, in 2007, to Target 1.0—was designed to serve as an advanced electronic payments superhighway. What it has become instead is an infernal flight-capital financing machine.

Basic to an understanding of the European financial crisis is the fact that a member state of the European Monetary Union need not apply for assistance to meet a capital outflow. Target2 provides it automatically and in central-bank funds.

Say that you, a Greek importer, place an order with a German manufacturer. The Bank of Greece is the institution that ships the relevant number of euros to Germany. The bank of the German exporter earns a credit with the Bundesbank, while the Bundesbank has a claim on the European Central Bank. Synchronously, the importer's Greek bank has a debit with the Bank of Greece, which in turn has a debit with the ECB.

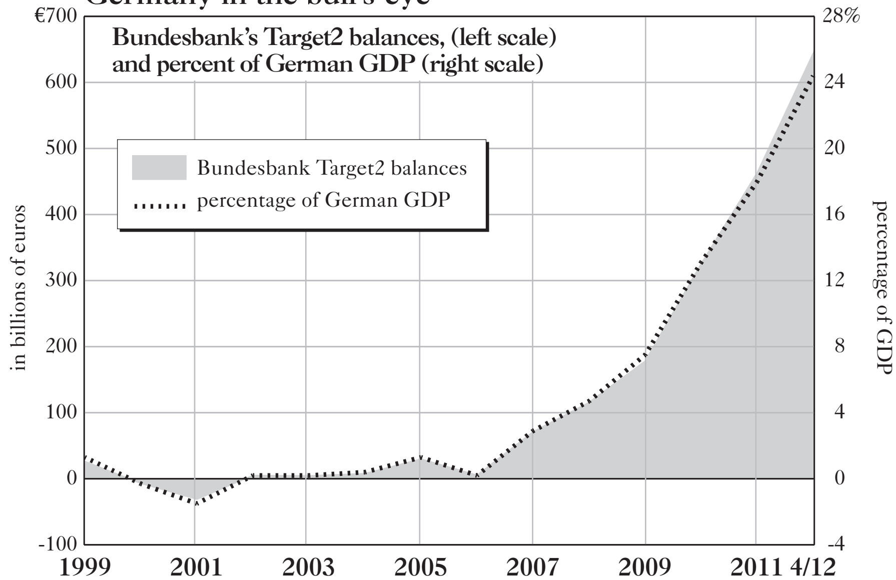
The European central bankers who dreamt up the Target system anticipated no outsize imbalances. They assumed that credits and debits would net to zero in the normal course of trade, which, until 2007, they usually did. But come the financial crisis the system no longer neatly balanced. As Greeks, Irish, Portuguese, Spaniards and Italians lost confidence in their domestic banks, they began moving funds to Germany. This capital flight Target2 noisily accommodated, just as it accommodates imbalances in ordinary commercial dealings. You see no sign of the shift on the ECB balance sheet, as intra-system debits and credits between the member central banks approximately offset each other (*Grant's*, Nov. 18). The evidence is, rather, to be found on the balance sheets of the national central banks. Up and up go Germany's claims on the PIIGs; up and up go the PIIGs' debits to the Bundesbank. The Bundesbank's claims on the various pe-

Money magnets
(2011 figures in $ billions)

	GDP	gross debt to GDP	current account as % of GDP	govt. structural balance	avg. inflation	10-year bond yield
Germany	$ 3,577	81.5%	5.7%	-1.0%	2.5%	1.4%
U.S.	15,094	102.9	-3.1	-7.2	3.1	1.7
U.K.	2,418	82.5	-1.9	-6.3	4.5	1.8
Switzerland	636	48.6	14.0	0.2	0.2	0.6
Japan	5,869	229.8	2.0	-8.1	-0.3	0.9
Lebanon	39	136.2	-14.4	-12.2	5.0	5.9

source: International Monetary Fund

Germany in the bull's-eye



source: Bundesbank

ripheral central banks zoomed to €644 billion in April from next to nothing in 2006. The latest reading represents almost a quarter of German GDP.

While under law the Bundesbank is at risk only to the extent of 27% of the ECB's losses (that number corresponds to the Bundesbank's share of the ECB's paid-in capital), it's an interesting question who would pick up the tab if the Bank of Greece, the Central Bank of Ireland, and/or the Banca d'Italia were unable to shoulder their share of the losses. And it is worthwhile pondering how large the Bundesbank's exposure might become if today's slow-motion run on the commercial banks of the periphery turned into a headlong sprint. One could imagine a sudden lurch higher in the Bundesbank's claims on those countries least able to honor them. "Please note," advises Ben Powell of Barclays Capital in a May 21 bulletin, "that as deposits flow out of Greek and Spanish banks and into 'safe' German banks, this has the odd effect of meaning that Germany is *more* exposed to the periphery nation. And this is accelerating."

Veterans of the mortgage-backed securities crack-up may be thinking along the lines of William Porter, a Credit Suisse managing director of investment-grade research in London. Think of the euro zone credit structure as a kind of asset-backed security, Porter suggests. That is, if you can bear it, think of Europe as a collateralized debt obligation. You will recall—or maybe you've blocked it out—that a CDO is a piece of financial architecture. The assets that support the structure pay out income to a hierarchy of liabilities, or tranches. Income trickles down from the top of the structure, losses worm their way up from the bottom. If the assets supporting the CDO are money good, everyone gets paid. If, however, the assets are defective, there are losses to apportion, and the equity holders take the first knock. Not until the equity is erased do the senior creditors lose a dime.

Many are the ways in which Europe conforms to this stylized CDO. "The assets are the taxing and bor-

Money repellants
growth rate

company	div. yield	P/E	EV/ EBITDA	10-year CAGR sales	10-year CAGR EPS	10-year CAGR dividends
Wal-Mart	2.4%	14.7x	7.5x	8.2	11.3	17.6%
Nestle SA	3.5	18.6	12.2	-0.1	5.6	11.8
BASF SE	4.3	9.7	5.7	8.5	—	14.4
Metka SA	13.2	2.4	2.0	23.6	29.8	22.3

source: The Bloomberg

rowing powers of the governments—the government net present values, if you like—of these various countries," Porter tells Lorenz. "You can therefore construct a CDO and simplify the tranches accordingly or just let the market rank the tranches for you." But there is, as Porter notes, a vital difference between an actual CDO and the conceptual European version. Not once that we know of was a super-senior tranche dragged into a position of having to subsidize an equity tranche. But Germany is committed to doing just that. Risk of loss in the euro zone is becoming increasingly "correlated," as the quants say, or "socialized," as the political scientists would put it. In a proper CDO, the equity tranches have no moral or financial claim on their investment-grade betters. In Europe, the pain has been, and will be, shared—to just how great an extent only time will tell. From which observation Porter makes a grand strategic leap: Buy the high-yielding obligations of the countries that Germany will likely bail out, he counsels. Sell—positively do not buy—Germany.

Well, you might ask, what about Portugal? The Portuguese 10-year note is priced to yield 11.4%, compared to 1.4% for the German 10-year note. Portugal's gross debt amounted to 106.8% of Portuguese GDP in 2011, and the IMF projects a bump up to 112.4% in 2012. Compare and contrast Germany, with a current ratio of debt to GDP of 81.5% but with prospective future rates of debt to GDP considerably higher should worse come to worse in the euro zone.

"Right now," says Porter, "Portugal looks very attractive to us against a short further up in the 'capital structure,' either Germany, if you are really swinging for the fences, or Italy or France, potentially, as well." The euro's political guardians will move heaven and earth to convince the world that Greece is the exception, not the rule, the argument goes. Portuguese bonds will accordingly rally, as the cost of a Portuguese bailout is explicitly borne and socialized. Bunds will accordingly depreciate, as the market comes face-to-face with the fact that Germany is the principal socializer.

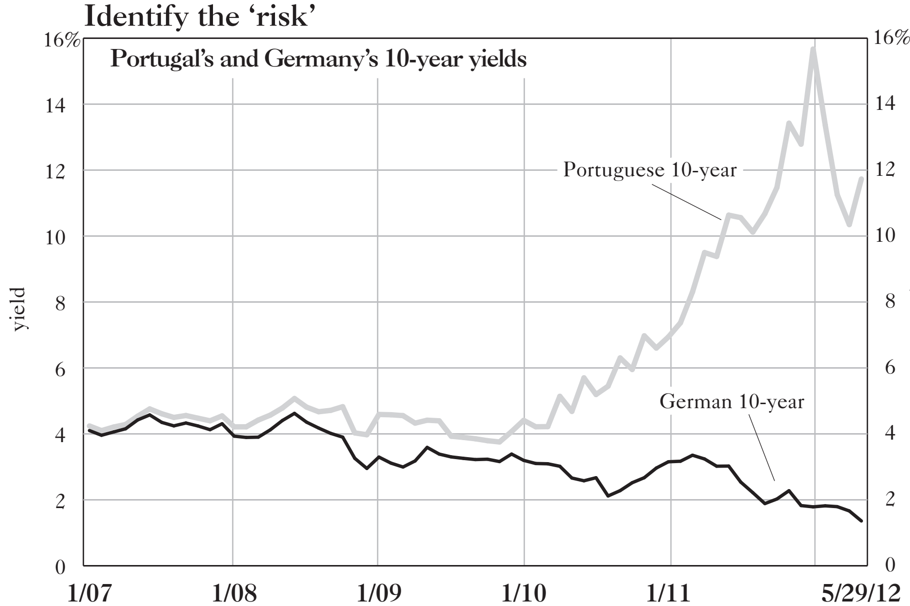
We take Porter's point but prefer another kind of junior claim—the real-life shares of growing and profitable operating companies. Naturally, we like them cheap. For instance, the common shares of BASF, the giant diversified German chemical company, we prefer over the conceptual equity of Portuguese sovereign debt (conceptually situated at the bottom of our imaginary euro CDO). Riding the cycle, BASF common will never be confused with a government security. Earnings per share dropped by 63% between 2007 and 2009, and they rebounded by 338% between 2010 and 2011. Financial leverage exaggerates the cyclical thrills and chills: net of cash, the company owes €9.4 billion, or €10.23 per share, on the current €57.74 share price. But growth there has been: over the past 11 years, sales, earnings and dividends have compounded at annual rates of 7%, 19% and 9%, respectively (2001 delivered a net loss). Today, the shares change hands at 9.7 times earnings and 5.7 times enterprise value to earnings before interest, taxes, depreciation and amortization. They yield 4.3%; the 10-year German bund yields 1.36%.

By the same token, we favor Wal-Mart over the 10-year Treasury, and Nestle over the 10-year Swiss government note. Wal-Mart, which yields 2.4%, and Nestle, which fetches 3.5%, have shown the ability to grow and adapt in economies both good and indifferent. Neither stock would repay its owners in a deflationary collapse, but neither, perhaps, would the 10-year Swiss note. Disaster would seem to be very largely priced into its 0.61% yield to maturity already.

We do not make light of the very real risks of a euro-induced slump or of a Continent-wide panic out of non-German bank deposits. Nor, we expect, does the ECB discount those risks. In the face of depression or panic, the bank of Mario Draghi would surely run the presses. In such a setting, it would be nice to have some gold.

The issue of *Grant's* dated February 24 featured a bullish analysis of a Greek engineering company called

Identify the 'risk'



source: The Bloomberg

Metka. As you may recall, Metka produces turnkey natural-gas power plants. Over the past decade, the company's sales, earnings and dividends have grown at annual rates of 23.6%, 29.8% and 22.3%, respectively. Though domiciled in Greece, Metka booked 82% of first-quarter sales and 91% of first-quarter earnings in foreign parts—work in Syria, let the record show, contributed 49% of first-quarter revenue. In February, the shares fetched €5.81 apiece. Today, on the eve of fateful Greek elections, they're quoted at €5.69, a price representing 2.4 times trailing net income and two times enterprise value to EBITDA.

The world has much to fear, we readily allow. However, it seems to us, not the least of these perils are the alleged safe havens themselves.

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Made in China

(May 18, 2012) According to China's National Bureau of Statistics, nominal Chinese GDP, sparked by a 20.9% surge in urban fixed-asset investment, grew at a year-over-year rate of 12.1% in the first quarter. Yet, according to China's heavy construction machinery trade group, sales of excavators, loaders, bulldozers, etc., plunged at year-over-year rates of 27% to 48% in the same quarter—and in the same China. A fair-minded observer, blending macro and micro sightings, might thus conclude that the economy of the People's Republic lacks coherence as well as forward propulsion.

Now unfolding is a reappraisal of the credit-swollen Chinese enterprise taken from three different vantage points. Construction-equipment manufacturer Zoomlion is the first, the Australian dollar is the second and the Canadian dollar is the third. They make a worrying triptych, in our opinion. In preview, we remain bearish on the People's Republic and its manifold derivatives.

Zoomlion Heavy Industry Science & Technology Co. (1157 on the Hong Kong Stock Exchange) featured in these columns last year as a miniature of China's debt-addled industrial economy (*Grant's*, Oct. 21). If you missed that analysis, you would have no reason to doubt that a precipitous fall in construction-equipment sales wouldn't make some dent in the fortunes of a $7.2 billion-revenue construction-equipment manufacturer. But Zoomlion managed to report an 8% jump in first-quarter revenues, paced by a 40%-plus jump in concrete-machinery sales.

Hats off to Jefferies & Co. analysts Julian Bu and Zhi Aik Yeo for their May 2 note on this curious triumph. They observe that Zoomlion is selling a lot of equipment in markets where customers would seem not to need it. One such hot spot is Jiangsu Province, which accounts for 15% of national concrete volumes. In Jiangsu, utilization rates on concrete-related machinery fell to 36% in 2011 from 47% in 2010. Then, too, the analysts observe, developers and local governments are notoriously slow-pay. A would-be buyer of a Zoomlion concrete placing boom or truck-mounted concrete mixer might very well be short of funds.

Which, however, turns out to be no insuperable problem in the short run. Zoomlion offers its machines for nothing down and with E-Z terms postdelivery. "[M]ost importantly," the Jefferies team points out, "the new machines bought on credit are further used as collateral to obtain loans from banks." So a self-propelled concrete truck, for instance, is actually a kind of mobile bank-credit procurer. True, such equipment might be judged redundant by conventional lights. But to those conversant with Chinese financial practices, they are essential cash-management tools. "Many of the unneeded machines are put either in a warehouse or simply outside covered with canvas," the analysts write. "We heard that 50%-60% of the concrete machines sold by Zoomlion in 1Q haven't been started."

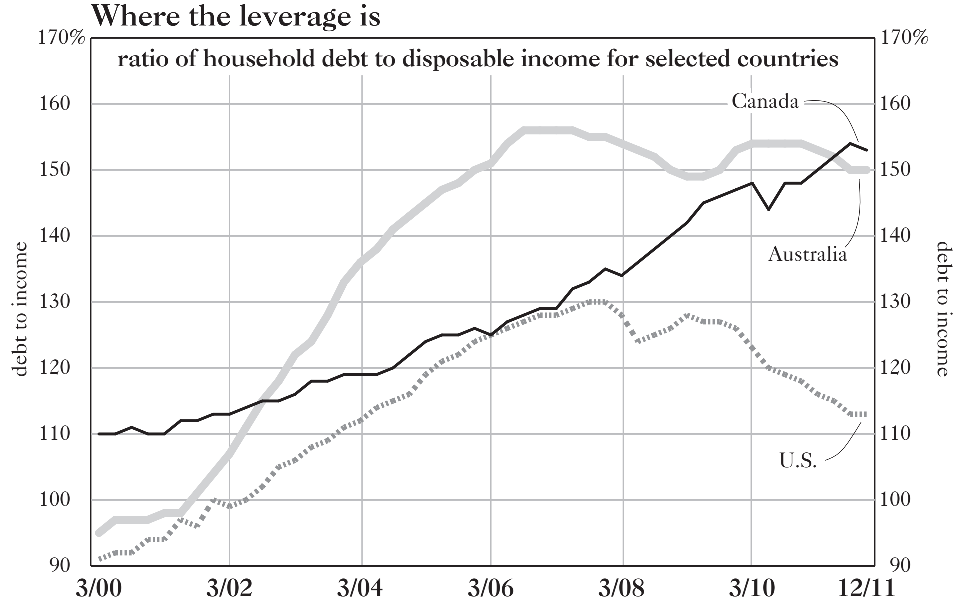
Of course, this can go on only so long. When a customer finally defaults, Zoomlion sends a repo man to secure its collateral—though if the equipment happens to be engaged in a public project, the government may order it unsecured. Reports the April 30 *South China Morning Post*: "Mainland [China] developers' financial health has raised warning bells, as most of the top 30 listed players record negative cash flows and post debt ratios exceeding the last big downturn in 2008."

How to hedge against the faltering Zoomlion economy? Currencies are one possibility—though, of course, a risky one. We have our eye on the Aussie and Canadian dollars.

"What do you call a credit bubble built on a commodity bull market built on a much bigger Chinese credit bubble?" inquires Société Générale analyst Dylan Grice in an April 25 research note. "Leveraged leverage? A CDO squared? No, it's Australia."

Australia has become a kind of Chinese appendage. Mining investment is the dynamo Down Under, Philip Lowe, deputy governor of the Reserve Bank of Australia, noted in a March 7 talk to the Australian Industry Group: "Over the next few years, mining sec-

Where the leverage is



sources: Reserve Bank of Australia, the Bloomberg tor investment will reach new highs as a share of GDP, and is likely to account for around 40% of total business investment," he said.

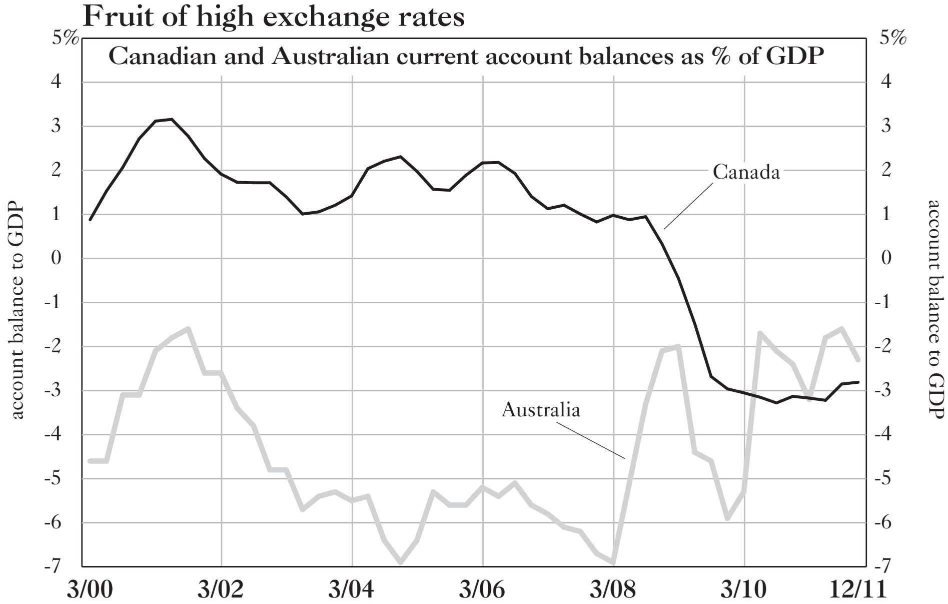
The Chinese boom has put Australia through its paces. Since the modern era of paper currencies and floating exchange rates began in 1971, the Aussie dollar has commanded an average of 88 American cents. At year-end 2000, before China got rolling, it bought 56 cents. When, on Monday, it bought fewer than 100 cents, observers gasped (it had been quoted at 110 cents as recently as last July), but even 99 cents is high in the long-term scheme of things.

The elevated Aussie dollar is more than a mirror to the goings-on in the People's Republic. It is also the cause of a rolling redistribution of economic energy inside the $1.5 trillion Australian economy. Manufacturing is down and out (the country consistently imports more goods and services than it exports), and tourism, too, has suffered. Capital flows have become a force to reckon with. Three-quarters of Australia's government debt is held by nonresidents, while Australian banks fund only 64% of their assets from local deposits or equity.

"The decade-long investment boom in the natural resources sector combined with a two-decade-long economic expansion (Australia last suffered a recession in 1991) has led to a significant increase in debt and asset prices," colleague Evan Lorenz notes. "The ratio of debt to disposable income for Australian households rose to 149.6% in December 2011 from 96.8% in December 2000. For comparison, debt to disposable income in the United States stands at 112.7%. Aussie house prices are high enough to land the country near the bottom of the international scale of housing affordability."

If we are right that Zoomlion is no anomaly but a window on the Chinese credit structure, the Aussie dollar would be at risk. It might be anyway. On May 2, Alberto Calderon, chief executive of BHP Billiton's aluminum, nickel and corporate development groups, told a Sydney investment audience that the pace of his company's investment in Australia was going to slow on account of rising costs and growing uncertainty about China. Next day, Rio Tinto CEO Tom Albanese echoed Calderon: "Coal is an increasingly difficult business in Australia," he said, indicating that the pace of Rio Tinto's Australian investment would also decelerate.

Fruit of high exchange rates



source: The Bloomberg

"I've been speaking with a few engineering consultants in Australia," Adrian Hart, senior manager of BIS Shrapnel, a Sydney market research firm, tells Lorenz by phone. "They tell me that when they scope out costs now for some of these big mining projects, such as for coal loaders or things like that, typically costs are double what they were five years ago."

But let us say, Hart proceeds, that China continues to generate 8% growth—that things do go according to the five-year plan. "I have quite serious concerns about the middle of the decade when a lot of the construction boom related to mining will have peaked and should begin declining significantly thereafter. I don't see the same scale of projects yet lining up to sort of match what we are seeing right now." If, indeed, things are so good they can hardly get better, it follows that engineering construction firms like Monadelphous Group (*Grant's*, Jan. 13), which trades at 15.9 times expected fiscal 2012 net income ending in June, may be quoted at peak earnings.

And perhaps we have seen peak interest rates. On May 1, the Reserve Bank of Australia trimmed its target cash rate by 50 basis points, to 3.75%. Not the least of the props under the Australian dollar has been the RBA's nominal rates, unusually (for today's world) pitched above zero.

Canada, too, is dining at the great Chinese restaurant. Seven percent of Canada's exports are consigned to the People's Republic, and Chinese is the third most-spoken language in Canada, behind English and French. And as Canada and China have grown closer together, so has Canada come to resemble Australia.

House prices are high and rising in Canada as they are Down Under. Canadian manufacturing exports are in the doldrums, just as Australia's are. And the Canadian dollar exchange rate is historically elevated, just like Australia's.

Post-1971, Canada's dollar has fetched an average of 83 American cents, but vibrant Canadian commodity exports and a rush of inbound Chinese investment (*Grant's*, May 20, 2011) have pushed the loonie to 100 cents.

"What became clear to me," Vijai Mohan, portfolio manager at Hyphen Fund Management, tells Lorenz, "especially when you go look at old research reports, which I love to do, the Canadian dollar wasn't called a commodity currency 10 years ago—it was just the Canadian dollar. Yet today it has morphed into this leveraged investment play that is basically all things emerging markets and global growth. That's part of what has driven the Canadian dollar to an extreme.

"The Canadian dollar, to me, is what should be a classically mean-reverting relationship," continues

Mohan, who says he is short the loonie. "Seventy-five percent of Canadian exports go to the United States, and Canada, although they would disagree vehemently, is essentially part of the United States. [Note to Canadian readers: Alternatively, the United States is essentially a part of Canada—ed.] It shouldn't be all that different. However, the currency itself is near an all-time wide relative to the U.S. dollar. I found that fact very interesting. Digging deeper into all of the main factors that matter, whether it's purchasing power parity, current account deficits, the weird things happening in the real estate market, inflation differentials—these things are at historic wides."

As for interest rates, three-month Libor stands at 1.35% in Canada, 4.18% in Australia and 0.47% in America. By the law of interest rate parity, as every CFA charter holder knows, the Canadian and Aussie dollars should depreciate against the greenback. For ourselves, we draw our principal bearish conviction on the Aussie and Canadian dollars not from interest rates but direct from Zoomlion. We continue to believe that China is less than it seems.

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Not so fast, Warren Buffett

(March 9, 2012) "Productive" assets are the ones to buy, counsels the chairman of Berkshire Hathaway, low- or non-yielding assets the kind to shun. Who could quibble? Why, this publication. We now commence an argument with the second-richest man in America (we have no problem with Bill Gates).

"Procreative" is the word that Warren Buffett uses to extol the earning assets of which he approves—businesses, farms, real estate. Other kinds of assets, e.g., money-market instruments, fixed-income securities and "tulip," both ancient or modern, he broadly rejects. The latter, he contends in the new, must-read Berkshire annual, are the "assets that will never produce anything, but that are purchased in the buyer's hope that someone else—who also knows that the assets will be forever unproductive—will pay more for them in the future."

For Buffett, Coca-Cola is a prime example of the procreative investment, gold the archetypical other. For us, we submit that the chairman has failed to take proper account of today's unique monetary backdrop. Interest rates are uncommonly low, worldwide monetary policy unprecedentedly easy. No institution under the sun is so procreative as the quantitatively easing central bank. Faster than even the best business can spin cash flow, the Federal Reserve can materialize scrip. What to do about this novel fact is one of the foremost investment questions of our time.

Never was a goldphobe more alert to the reasons to own the very metal he mocks than the Sage of Omaha. "Even in the U.S.," Buffett observes, "where the wish for a stable currency is strong, the dollar has fallen a staggering 86% in value since 1965, when I took over management of Berkshire. It takes no less than $7 today to buy what $1 did at that time. . . . '[I]n God We Trust' may be imprinted on our currency, but the hand that activates our government's printing press has been all too human."

So then, how can the holder of wealth insure against continued overcranking? Buffett, of all people, should have something to say on the subject. Not only has he excelled as an investor (since 1965, Berkshire's book value has grown at a compound annual rate of 19.8%), but also as an insurance underwriter. Thus, the Berkshire insurance division has produced an underwriting profit for nine years running. For comparison, State Farm, the biggest American insurance company, has borne an underwriting loss in eight of the past 11 years. So when one of America's all-time great appraisers of risk holds forth about the risk to the currency, one should lend an ear.

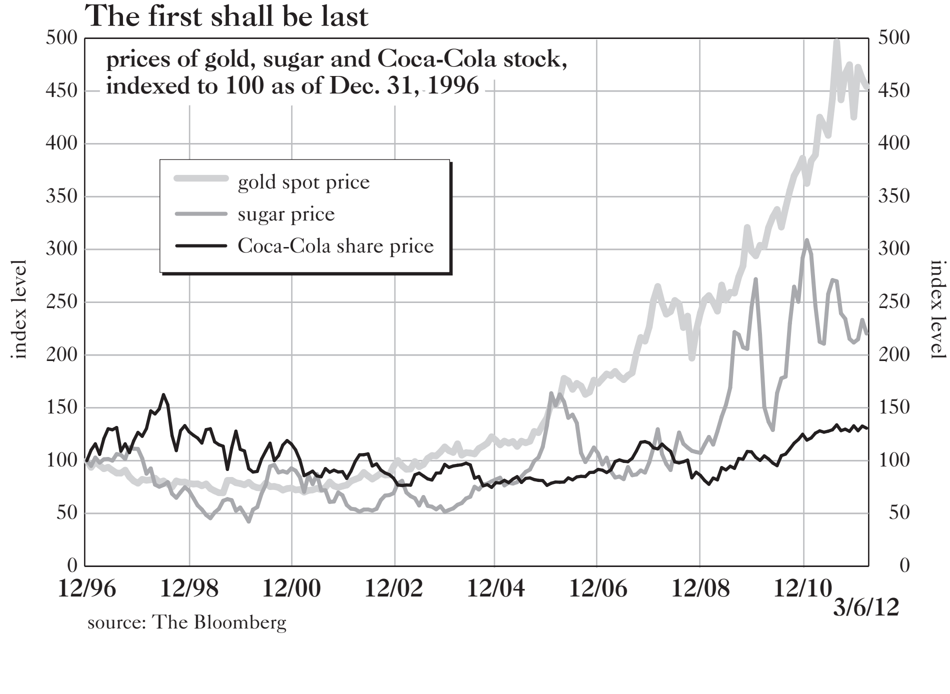
We have listened carefully, and pondered respectfully. And our response is: Come again? For Buffett, paper money is a short sale, but gold is no haven, only jewelry. Fearful people buy it because they believe that still more fearful people will ultimately pay an even higher price to take it off their hands. "Meanwhile," Buffett concludes—and he is correct about this—"if you own one ounce of gold for an eternity, you will still own one ounce at its end."

So, then, according to the second-richest man and best investor and leading appraiser of risk in the 50 states and all the territories, Coca-Cola and farmland and Exxon and income-producing real estate and suchlike are the only things to own in these times of ultra-low interest rates and rapid-fire money printing. Let us see about that.

That *Grant's* has a soft spot for the barbarous relic is well known. But only the most venerable and retentive subscriber will remember our in-depth analysis of Coke. Sell it, we said.

The date was Oct. 11, 1996. The stock market was on the boil, and Coca-Cola was valued more richly than it had ever been since its 1919 IPO. At $49\frac{3}{4}$ a share, it was quoted at 39 times

The first shall be last



source: The Bloomberg

earnings. Not only was that the highest multiple on record, but also the highest valuation premium to the S&P 500 on record. Roberto C. Goizueta, Coke's hard-charging CEO—Buffett could hardly say enough nice things about him—spoke of "our virtually *infinite* opportunity for growth." The company measured its potential in terms of the liquids it did not yet supply toward mankind's average daily requirement of 64 fluid ounces. Inasmuch as Coke furnished less than two ounces of that intake, there were 62 to go. To express its vision of the opportunity it was doing everything in its power to grasp, management deployed the infinity symbol. It was, it said, an "unregistered trademark."

Clearly, Coke had reached a state of temporal perfection. In the 12 months to June 30, 1996, it returned 19.4% on assets and 54.1% on equity. Not for 10 years had the senior debt of the Coca-Cola Co. been rated triple-A, but no one could call the balance sheet over-leveraged. Long-term debt stood at just 16% of capital, and EBIT—i.e., earnings before interest and taxes—covered fixed charges by a factor of 17. *Fortune*'s "Most Admired Corporation" of 1996 had, in the 12 months to June 30, generated a 62% gross margin and a 17% net margin. Was any price too high to pay for an enterprise that came as close as any to duplicating the economics of the Federal Reserve?

Management thought not. "Is there ever a time you wouldn't consider buying your own stock?" the front office queried itself in the 1995 annual report, and replied: "Yes, whenever securities laws say we can't. Otherwise, we've yet to encounter a time when we felt our stock wasn't a long-term investment bargain for us."

Yet, we noted in our 1996 essay, though Coca-Cola had always been a marvelous business, it was not a consistently marvelous stock. In January 1974, at the peak of the so-called Nifty Fifty market (the half-a-hundred favored companies exhibiting characteristics that supposedly made them valuation-proof), Coke had commanded a price-earnings multiple of 36.9 times. What followed were the great inflation and a decade—for Coke as for many other one-decision favorites—in the equity wilderness. From 1973 to 1983, revenues vaulted to $6.8 billion from $2.1 billion and earnings to $559 million from $215 million. "However," as *Grant's* noted, "the price of a share of Coke would fail to match its January 1974 high until the summer of 1984, two years after the beginning of the intergalactic bull market and the company's near-simultaneous uncorking of Diet Coke."

Buffett had climbed aboard in 1988, buying 14,172,500 shares for $592.5 million and paying a multiple of 14.7 times 1998 earnings. To the Berkshire shareholders, he made a wry confession: "This Coca-Cola investment provides yet another example of the incredible speed with which your chairman responds to investment opportunities, no matter how obscure or well-disguised they may be. I believe I had my first Coca-Cola in 1935 or 1936." However, between the fourth quarter of 1988 and the fourth quarter of 1996, Coke delivered a total return of 961.3% against that of 220.5% for the S&P 500.

Plainly, as procreative assets went, Coke was it. Then, again, there was nobody who didn't seem to know it. There was, indeed, we thought at the time, nobody who didn't seem to believe that the stock market was the stairway to heaven. Two months after we published, Alan Greenspan delivered his famous "irrational exuberance" speech (the Maestro wasn't bearish for long, only until he began to absorb the abuse that his somewhat halting expression of skepticism about the stock market brought down on his head). Were things not looking a little toppy?

While throwing stones at the Coca-Cola share price, we quoted a few lines from Paul Fussell's memoir, "Doing Battle." In describing a series of botched night patrols in which he participated in France as a junior infantry officer during World War II, Fussell had much to say about the nature of risk. "I was learning," wrote the for-

Coca-Cola over the years
(in $ millions)

	full-year			
	2011	2006	2001	1996
Net operating revenues	$46,542	$24,088	$17,545	$18,673
Cost of goods sold	18,216	8,164	6,044	6,738
Gross profit	28,326	15,924	11,501	11,935
Gross profit margin	60.9%	66.1%	65.6%	63.5%
Earnings before interest and taxes (EBIT)	$10,154	$6,308	$5,352	$3,915
EBITDA minus capex	9,188	5,839	5,386	3,558
Free cash flow	6,554	4,550	3,341	2,473
Interest expense	417	220	289	286
Net income	8,572	5,080	3,969	3,492
Net income margin	18.4%	21.1%	22.6%	18.7%
Current assets	25,497	8,441	7,171	5,910
Total assets	79,974	29,963	22,417	16,161
Current liabilities	24,283	8,890	8,429	7,406
Short and long-term debt	28,569	4,582	5,118	4,513
Equity	31,921	16,920	11,316	6,156
Shares outstanding (millions)	2,263	2,318	2,486	2,481
Price-to-sales	3.4x	4.7x	6.7x	7.0x
Price-to-earnings	18.2	20.4	29.5	40.8
Price-to-book	5.0	6.6	10.3	21.21
Return on assets	11.2%	17.1%	18.3%	22.4%
Return on equity	27.2	30.5	38.4	60.5
EBIT/interest expense	24.4x	28.7x	18.5x	13.6x
Debt/total capitalization	47.2%	21.3%	31.1%	42.3%
Dividend yield	2.69	2.57	1.53	0.95

source: company reports, the Bloomberg

mer lieutenant, "from these mortal-farcical events about the eternal presence in human affairs of accident and contingency, as well as the fatuity of optimism at any time or place. All planning was not just likely to recoil ironically; it was almost certain to do so. Human beings were clearly not like machines. They were mysterious congeries of twisted will and error, misapprehensions and misrepresentation, and the expected could not be expected of them."

The Street expected continued great things of Coke, many preceding years of greatness notwithstanding. "Coca-Cola a Buy Despite High P/E," ventured Standard & Poor's in "The Outlook" (a brilliant medium-term call, as it turned out). Let us say, we proposed, that Coca-Cola's earnings grow at the same rate for the next 10 years as the 18% they were expected to grow in the following 12 months, i.e., calendar 1997. That would put net income at $18.3 billion in 2006. Capitalized at the same 39 times multiple, Coke would command a 2006 stock-market cap of $713 billion.

These things did not, in fact, come to pass. Over the 10 years to 2006, Coke's compound earnings growth worked out not to 18% per annum but to 3.8%. Net income in 2006 totaled not $18.3 billion but $5.1 billion. The company's year-end 2006 stock market cap worked out not to $713 billion but $112 billion.

Seemingly valued for a perfect world, Coke had to make do with the fact of imperfection. Human beings, conforming to the Fussell script, sometimes disappointed. For instance, Goizueta's handpicked successor, M. Douglas Ivester, resigned 30 months after his appointment. By 2001, the company was ratcheting down its expectations for growth in unit volume to 5% or 6% a year from 7% or 8%, and in its earnings per share to 11% to 12% from 15%.

The Internet bubble burst. Not intending to seed another excess with which to replace the dot-com boom, the Fed did exactly that by pressing its funds rate down to 1%. Up went house prices. Late in 2002, then Fed governor Ben S. Bernanke, in a speech heard round the world, observed that, if need be in a fiat money system, the Federal Reserve could drop currency out of helicopter doors.

In the 2011 Berkshire letter, Buffett approvingly quotes the business adage, "Buy commodities, sell brands." "It has produced enormous and sustained profits for Coca-Cola since 1886 and Wrigley since 1891," the chairman writes. "On a smaller scale, we have enjoyed good fortune with this approach at See's Candy since we purchased it 40 years ago."

However, for one reason or another—not least the muscular money printing of the world's central banks—commodity prices have been in the ascendant. In a comparative measure of total returns in the 15 years since 1996, the S&P 500 has delivered 119.9%, the Goldman Sachs Commodity Index 207.9%.

The Coca-Cola formula is the darkest and deepest of corporate secrets, but anyone with taste buds knows there's a sweetener in it somewhere. In 1996, a pound of raw cane sugar fetched 11 cents. Fifteen years on, at year-end 2011, the same non-procreative pound was quoted at 23 cents. The fact is that, from year-end 1996 through year-end 2011, the hypothetical continuous holder of the generic sugar futures contract earned a compound annual return of 5.13%, while a stockholder in the utterly non-generic Coca-Cola Co. had to settle for a compound annual return of 3.99%. In 1996, some of the best business advice on offer (Jimmy Rogers had the call) was "Buy commodities, period."

And what about our advice, "sell Coke"? Let us just say that nobody had to rush out to implement the idea. Coca-Cola, though it had never been more richly valued than it was when we wrote, proceeded to become still more richly valued. The share price peaked at $87.93 on July 14, 1998, up 77% from our Oct. 11, 1996, call, the trailing P/E ratio leaping to 57 from 39. In the new Berkshire annual, Buffett calls gold a "bubble." For ourselves, we would call modern central banking a "bubble." Anyway, Coke at 57 times earnings exhibited more than a few bubble-like symptoms. A decade and a half later, the price has still not regained those oxygen-free heights.

By this time, relates Alice Schroeder in her 2008 biography, "The Snowball: Warren Buffett and the Business of Life," Berkshire's stake in Coke had multiplied 14-fold, to $13 billion, "and [Buffett] had gone so far as to declare the company an 'inevitable' to his shareholders, as if it were a stock he would never sell. He reasoned that Coca-Cola would send more swallows down more throats in each passing decade 'for an investing lifetime,' which made it about as close to immortal, for a brand, as you could get. Berkshire now owned more than eight percent of the company. Coca-Cola stock was trading as high as forty times its estimated 2000 earnings—a multiple that said investors believed the stock would keep rising by at least 20 percent a year. But to do that, it would have to increase earnings twenty-five percent a year for five years—impossible. It would have to almost triple sales, to a number nearly as large as the entire soft-drink market in 1999—again impossible. No amount of bottler sales or accounting finagles could produce results like that. Buffett knew it. Nevertheless, he did not sell his Coca-Cola stock."

As to why not, "the reason was partly inertia," Schroeder continues. After all, "Buffett liked to say he made most of his money by 'sitting on his ass.' Like the investors who kept their GEICO stock when it fell to $2 a share, inertia had protected him from many mistakes—both of commission and omission. He also owned too much Coke to sell without creating a major headache. The symbolism of Warren Buffett—the "world's greatest investor" and a board member—dumping Coca-Cola stock would be unmistakable." Besides, there would be taxes to pay on the realized gains. Then, too, by not selling, Buffett saved himself the job of deciding when, if ever, to repurchase.

Maybe now would be the time to buy if he had ever sold. Sixteen years ago, we characterized Coke, only half-facetiously, as "the corporate equivalent of Mount Rushmore, the hot dog, the Bureau of Engraving and Printing and Muhammad Ali, all rolled into one." It remains so today. Employing 146,000 people, it operates in 200 countries and boasts no fewer than 15 brands that generate annual revenues of $1 billion or more. Coke, Sprite, Fanta and Diet Coke, its top four brands, exceed total annual revenues of $10 billion. Of the $35 billion of growth in the total retail value of worldwide ready-to-drink sales in 2011, Coke captured no less than 40%.

The present-day Coca-Cola value proposition represents a boundless improvement over the one on offer in 1996. At $68.76 apiece, the shares are quoted at 17.9 times trailing net income and 16.9 times the 2012 estimate. And the indicated $2.04 per-share 2012 payout points to a dividend yield of 2.97%, well in excess of the utterly non-procreative 2% yield on the 10-year Treasury note. Banking on perfection in 1996, CEO Goizueta strove for 20% earnings growth, which his successors did not attain. Banking on something less than perfection in a very different world, today's CEO, Muhtar Kent, seems to be aiming for growth at less than half that rate, which, in 2011, he topped (EPS growth coming in at 10% before abnormal items). If Coke is not a compelling absolute investment, it is a fetching relative one. It is, moreover, as the accompanying table points up, a most terrific business.

Concerning gold, Buffett does have a point. Unlike Coke, it generates no earnings and pays no dividend. Yet, since 1996, its value—denominated in the Greenspan/Bernanke dollar—has appreciated more than two-and-a-half times faster than that of Coke, dividends included. But gold, contrary to the Buffett formulation, is no investment but rather money, and money is, by definition, sterile. In our view, the gold price is a mirror to the world's faith in the procedures of the stewards of fiat currencies. As more money holders come to doubt the words and deeds of the paper wizards, the gold price tends to push higher. Buffett maintains that gold is the refuge of the "fearful." It is, in part. And it is, in part, the refuge of the momentum seeker, just as Coke was way back when. More substantially, gold is the refuge of the wary. The constructively anxious gold bug will ask germane questions. For instance, what if QE spins out of control? What if the inflation rate gets out of hand? How can I preserve purchasing power sufficient to allow me to buy oodles of Coke at the next bear-market bottom?

Earning nothing, gold is impossible to value. It is, indeed, a speculation, but a well-founded speculation on the not-bright future of the kind of money that, with a push from the Federal Reserve, just seems to drop out of the sky.

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Zero-coupon trees

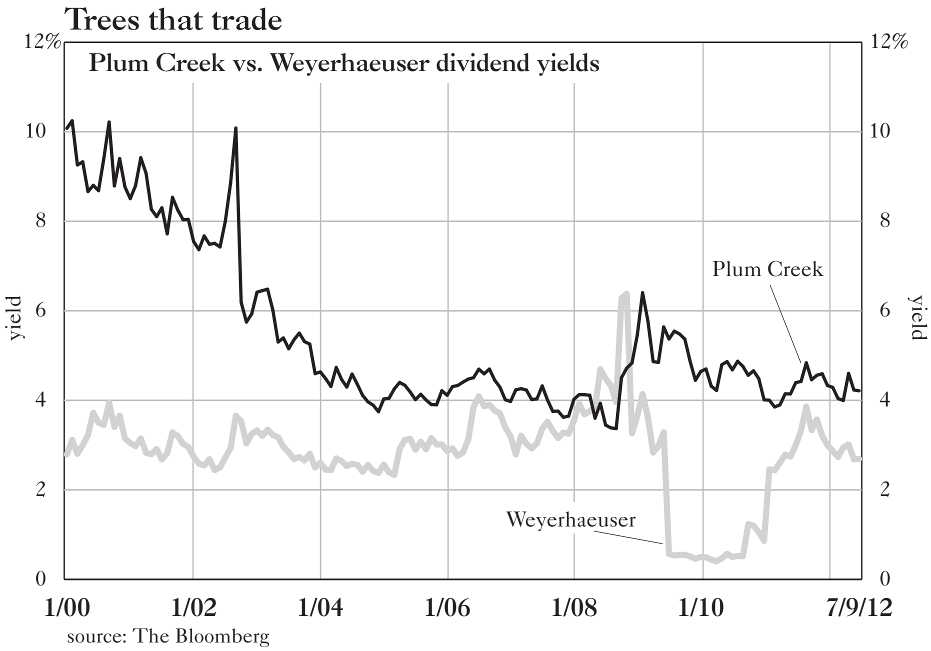
(July 13, 2012) Twenty-five or thirty dollars of banking assets for every dollar of banking equity hardly raised an eyebrow on the eve of the crisis of 2008. But while Wall Street has now disavowed extreme leverage, foresters practice it as a matter of course. Dig a hole, plant a seedling and wait 25 or 30 years. Minimum effort yields maximum results—leverage of a nonfinancial kind.

Now unfolding is a survey of the field of timber investment, especially investment in hardwoods and, specifically, investment in the noble black walnut. You plant—maximizing sunlight, your rows run north to south—you fertilize, spray, mow, prune and harvest. Or, your heirs and assigns harvest. The fast-growing, genetically modified black walnut seedling that cost you $5 may finally command $800 to $1,000 of 2012 buying power—or some very different sum of money, nature being as fickle as the Fed. The journey from seedling to veneer log is the subject at hand.

Some would prefer that, if the subject must be trees, the focus should rather be on generic, easy-to-buy, plain-vanilla, institutionally acceptable timber REITs. Certainly, they are less bother. Trees stand up or get blown over; they contract or resist disease—there's no predicting which. Hardwoods demand a generation-length holding period and pay no dividend until the man with the chainsaw shows up. They are absolutely illiquid and may or may not be in popular demand or in short supply when the time comes to fell them. So you may be wondering: What is this particular asset doing in the pages of a family interest-rate journal?

Reason No. 1 is that a tree is a store of value, a tangible, or "real," asset. A black walnut is as real as the next species of tree, but it may also remind you of a zero-coupon bond. As with a zero, you clip no coupons prior to maturity, therefore bear no reinvestment risk. The essential value is the principal value, not counting the land underneath the tree trunks. In the early 1980s, long-dated, zero-coupon Treasurys were offered at pennies on the dollar. Like hybridized black walnuts, they had a 30-year life. At a purchase price of $20 per $1,000 of face value, they delivered a compound rate of return of almost 14%. There's no telling if a stand of hardwood will deliver anything like that return. But it's a cinch today that the bond won't.

Barring fire and flood and a visitation of thousand cankers disease, your phototrophic asset will grow up and out, finally attaining a height of, say, 65 to 90 feet and a trunk diameter of 16 inches.



The finest specimens produce veneer, which, in strips as fine as one-one hundredth of an inch, is used in furniture making. You will also find black walnut in railroad ties, palettes, flooring, pulpwood chips and gun stocks.

The second reason we take up the cause of the *Juglans nigra* is that the idea is so winningly contrary. It's the kind of idea that not one professional investor in 500 will be able to implement. The value proposition takes this form: Lock up your capital—the cost of land as well as that of seedlings, taxes, labor, etc.—to reap an uncertain reward in the year 2040. Even if an investment consultant allowed the idea to come before an investment committee, and even if by some miracle the proposition did get waved through, the valuation department of that hypothetical open-minded endowment (or trust fund or pension fund) would soon be at wits' end trying to quantify the change in the net present value of a stand of timber on account of an average quarter-inch of growth in trunk diameter. Truly, black-walnut farming ticks not one institutional box.

The third reason for this unconventional topic requires a confession. Your editor and his wife own a farm in Upstate New York. Formerly young, we have had to begin thinking about futurity: How to pass along a certain number of dollars to one's descendants not named Uncle Sam? It used to be said that throwing a fastball past Ted Williams was like sneaking a lamb chop by a wolf. Moving money past the wolves of the Federal Reserve and the Internal Revenue Service is no easier. So when a friend mentioned black walnut trees—just the thing, he said, for the taxable investor with a truly long-term horizon—he had a receptive audience.

Investors, like the rest of humanity, are prone to pick the path of least resistance. And the path of least resistance for the timber-minded investor is probably not a limited partnership interest in a hardwood plantation—still less a personal adventure in silviculture. Rather, he or she will likely just buy Potlatch, Plum Creek, Rayonier and/or Weyerhaeuser.

To give them their due, the timber REITs are liquid, but that, at least to us, is the beginning and end of their investment appeal. On average, they yield 3.3% and trade at a slight discount to estimated net asset value, though at a full 24.2 times trailing FAD, or funds available for distribution—i.e., free cash flow after capital spending, according to Stifel Nicolaus. Most of the REITs change hands at ratios of price to earnings and price to book reminiscent of tech stocks in 1999. By no valuation method are they cheap.

Valuation is one problem, the REITs' principal stock in trade another. What they mainly produce is softwood, a building material. And when houses go unbuilt, such trees as pine, cedar, fir and spruce go unharvested. "Wall of wood" is a phrase you may have heard. It connotes the looming, post-housing-bubble oversupply of lumber. "Inflation hedge" is a phrase you have certainly heard. In the context of timber investing, it is meant to invoke the supposedly impregnable defenses against the Federal Reserve that a generic timber investment erects. But does it?

Let us say, Chip Dillon, analyst at Vertical Research Partners, proposes to colleague David Peligal, that the inflation-phobes have their day in the sun and the CPI jumps by 5% in 2013, compared to 2% in 2012. In such a setting, the price of oil might well appreciate—say, by 10%. Even wages might go up. But—and here's the rub—mortgage rates, too, would shoot higher, perhaps to 6½% or 7% from less than 4% today. In that case, the monthly payment on a new house would almost double, never mind the price of the house itself. Given even a modicum of price elasticity, the demand for new houses—ergo for new lumber—would buckle. Land prices, too, would tumble, the sale of timberland to real estate developers providing a meaningful source of return for the typical plantation owner. "Bottom line," contends Dillon, "in 2012-15, buying timberland in the U.S. will not prove an effective inflation hedge."

As Dillon also notes, however, there's more than one kind of timber. Wholly different than commodity softwoods are the relatively scarce hardwoods—oak, maple, black cherry, ash and black walnut, among them. "Even with the housing downturn and the weak dollar," says Bob Saul, director of domestic forestry investments at GMO's Renewable Resources division, "you've seen export of these logs and this lumber remain relatively stable, and … in our GMO portfolios, we've seen the prices of pine fall off more than 40%. We've seen prices for sugar maple, oak and black walnut—if you blend all of those together—actually appreciate over the same period, not by a whole lot but by a few percentage points. So it's a different type of wood than commodity softwoods."

Saul, a 1980 alumnus of Amherst College, not only oversees GMO's timber investments but also manages his own. He farms 68 acres in Amherst, Mass., 27 acres in neighboring Hadley and a 120-acre plantation in Westmoreland, N.H., about an hour-and-15-minute drive from Amherst. He planted the oldest of his trees in 1992, the newest in 2012. On his Hadley property, he's spaced the rows of black walnuts 13 feet apart and has planted a tree in those rows every six feet. The trees, though they grow as far north as southern Ontario, have slender, droopy leaves that lend them a tropical air. Looking out over the neatly regimented plantings, you have a feeling you have wandered onto the set of "Jurassic Park."

For this, the operational portion of his life in silviculture, Saul dresses in shorts, low-cut hiking shoes and a John Deere cap. He has a wiry build, a square jaw and work-worn hands. Two Thursdays ago, he chose to complete his farm ensemble with a blue tennis shirt emblazoned, "GMO Renewable Resources." If he looks as if he's training for a marathon, he says he isn't because his knees wouldn't hear of it. By Saul's count, they have helped him plant 70,000 seedlings.

Saul's training in forestry has come on the job. In college, he studied English, and at Harvard's Kennedy School, he studied public policy. Master's degree in hand, he became a furniture retailer. Learning all he cared to about the profitless economics of owning and managing five stores, he got into property management. An underemployed father of two—he married a fellow Amherst student, Katie Fretwell, in 1982—he came to GMO with a proposition to farm hardwoods. "We don't like your business plan but we do like you," is Saul's account of his entry into the world of high-powered Boston money management. This was when the tech-stock fever was raging, and GMO Renewable Resources was managing $35 million. Today, it looks after $4 billion.

"Forestry is not that hard," says Saul in a mock stage whisper when asked about his lack of arboreal credentials. A Brooklyn-dwelling visitor to the Saul properties is tempted to correct his host, saying, "Forestry is not that hard *if* you know what you're doing." Clearly, raising trees—the straight and healthy kind that command top veneer prices—is no job for the uninitiated. A good forester, like a good farmer, is part mechanic, part agronomist and part entrepreneur. He or she must also be, like a good investor, part fatalist. Mortals propose but the gods dispose.

The freak Halloween snowstorm that ravaged New England last year cut a swath through the Saul property. "In two hours," says the proprietor, "I lost 10% of my net worth." Hardest hit were the oaks and ash that had held onto their leaves. On them, the heavy, unseasonable snow piled up until—crack! Down came the branches. Entirely unscathed was Saul's principal asset, his black walnuts. Having cleverly shed their leaves, they gave the snow no purchase. At that, the October 2011 blow-down in Amherst seems mild compared to the October 2008 blow-down on Wall Street.

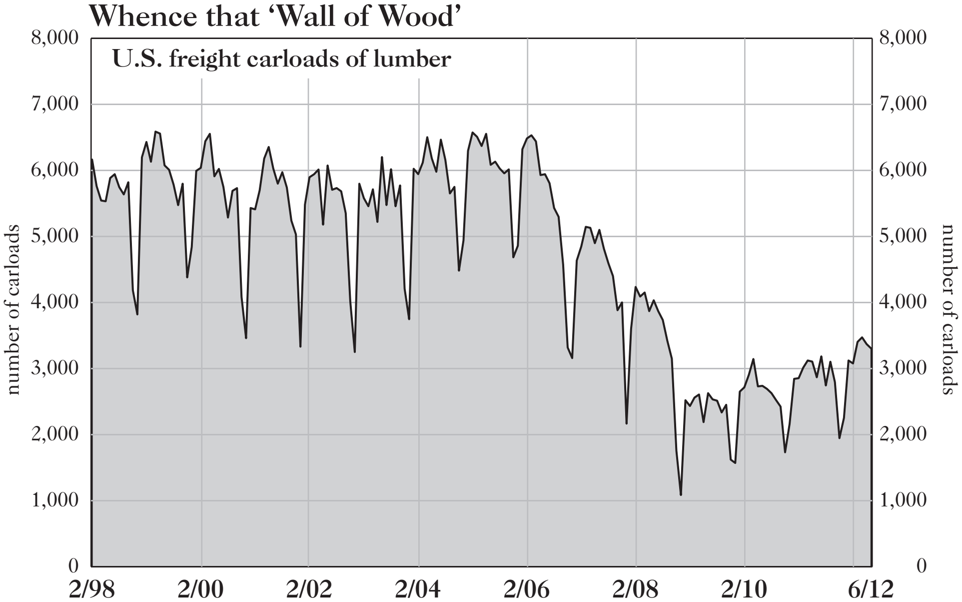
"I love trees," says Saul, unsentimentally. "Trees are good nutrient foragers," he says. And he adds that he admires them for their toughness. But he doesn't mind harvesting, and he doesn't mind culling them. He'll shave the weaklings but he'll also fell the giants, which take more than their fair share of sunlight from their later-developing cohorts. Walking around his New Hampshire plantation, Saul talks about his trees as a beef farmer might about his steers. "This guy," he says, pointing to a twig in the ground, "don't ask me why he failed, but he did." And concerning another specimen—better than the runt but still of less than prime quality: "Best you can hope for, a No. 1 sawlog." And of another: "This guy—we'll likely prune him and cut off his head."

One of the things about the black walnut that Saul loves is how little human effort is required to produce a prime specimen. Figure, he says, three minutes to plant and 12 minutes—all in—for trimming, mowing and weeding. That's 15 minutes—20 minutes, tops—over the full 25- to 30-year life. It's one of the greatest feats of leverage a human being can perform, Saul marvels: One quarter-hour to create a living, lucrative, beautiful, long duration asset. He goes on in this vein for a while longer, remarking, for instance, on how a black walnut will fight for space, how it will prevail over weeds and rummage for food. Then he stops himself. "That's about as poetic as I'm going to get," he says.

About the black walnut, it's easier to be poetic than prosaic. The truth is, there's no easy way to invest. Then, again, that is an essential part of the investment appeal. The barriers to entry are as high as the reluctance of nearly anyone to commit to a 30-year holding period. But say that you are that kind of long-range thinker. A "qualified" investor, you have identified a hardwood investment partnership in which to put money (on condition of a long lockup and no liquidity). Or you have decided to emulate Saul in your own backyard, farmette or farm. Whichever you choose, you'll have to know the basics.

To start with, not just any land will do. Well-drained land is the ticket, with a water table that rises no nearer to the surface than 16 inches even after a long, soaking rain. The cost of land is another constraint. Cheaper is better than dearer, as timberland-price appreciation may contribute 20% to one's total return. Tree growth is, naturally, the principal driver of value. And it would be nice if the walnut-tree bull market kept rolling (as the nearby graph points up, prices for sawlogs and veneer logs have made persistent, if sometimes volatile, upside progress since the second Eisenhower administration). Anyway, black walnuts need sun, as well as room to put down roots. "Soils with

Whence that 'Wall of Wood'



sources: The Bloomberg, Association of American Railroads acid clayey subsoils should be avoided," cautions the USDA, "as should soils with coarse sand or gravel layers or bedrock within 2.5 feet of the surface."

But let's say that the land-price bubble has passed you by, the ground on which you or your general partner will plant has abundant sunlight and enough (but not too much) moisture. What then?

"Roughly speaking," says Saul, "you are going to spend 50% of your money on land and 50% of your money on trees and maintaining those trees…. [B]lack walnuts are ideally suited for this kind of investment for two reasons: One, they're very fast-growing; two, they're very valuable. There are two things that are not quite apparent to the layman. Black walnuts grow very well in crowded circumstances like plantations. Not all valuable hardwood species are that way. Black walnuts don't mind competing for water and nutrients and sun when they're crowded by other trees. They also have been hybridized. Purdue University has done a lot of work to take fast-growing trees and high-quality trees that grow high-quality wood, and trees that grow straight and kind of hybridize them into a single cloned genome, and you can get those trees from a couple of nurseries that specialize in them and have purchased those licenses from Purdue."

Not many species have been scientifically enhanced in this manner, Saul goes on. And not many species can thrive in plantations. "Those are two very important characteristics," he says. "For example, sugar maple, also a high-value species, you try to grow sugar maples on top of one another, forget it. They develop all kinds of disease. They start to wilt, they get very unhappy when they can't spread their branches out."

Saul says he likes the way black walnuts point toward the sun, searching for light, not just growing straight up in the air like some conifer on autopilot. Walnuts have heads on their shoulders. But, he cautions, those heads have to be cropped.

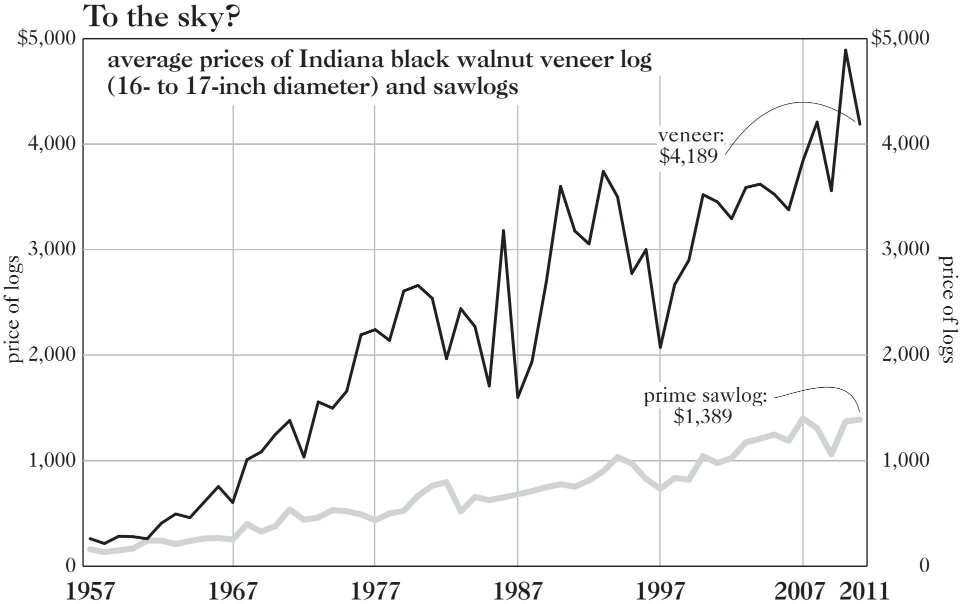
"The issue is," he says, "you've got to keep up with pruning, and pruning is an art, not a science. You face each tree like you face a painting. You have to take a different approach to each tree because even though they are clones, even though they come from the same genetic material, they manifest their genetics differently, almost tree by tree. So some trees you need to cut off their head to allow them to coppice, which is where you end up with a bud that takes the lead on the tree and starts to go straight. Some trees don't have good leadership, they don't have an apical bug that leads the charge and causes the tree to grow straight. Sometimes the tree will want to branch out and create an almost star shape at the top. If you come across a tree like that, you have to lop off the top so you get apical dominance coming from a single bud, so you have a much straighter trunk. Other trees go into a V, and you have to cut out that V or else water gets into the V and you get rot in the V. So you really have to keep your tree growing straight. They want to grow straight because they're phototrophic. They like to grow towards the sun, but they get off to a pretty rocky start."

The most intense pruning takes place in years three, four and five, Saul continues. In the first two years, most of the growth takes place underground, in the roots. "You don't see a lot of action up above," he continues, "but, boy, after two years if you try to take one of these babies out of the ground, it's just not going to happen. The roots have really developed, and once the roots start to develop, that's where most of the photosynthetic energy is going—then it starts to go up."

Time flies with trees as it does with children, and it's now year 10. "So you've been good about your pruning," Saul goes on, "you've got a stocking level. There are two schools of thought on this. One I call the precious tree approach, where you plant 160 trees per acre and that's it, and you take care of each one like it was your own child. You make sure it's propped up with a pole, you haven't planted too many trees so there's plenty of room, and the tree tends to grow up and out. So you have to be very attentive about pruning, and it's also prone to wind damage because it's out there on its own.

"Then there's my approach, which is to spend a lot more money up front—I also have to tell you, the aesthetics are much better and the aesthetics matter to me—and you plant 400 trees per acre. What that does is it gives you a stand to work with. Four hundred trees per acre, after five years you're probably left with only 300, 320 trees per acre, because some trees just suck. So you remove those trees—they're just getting in the way, they're never going to amount to anything, to use a phrase we all know. So you need a larger stand even though you're putting in more money upfront, so you end up with a lot of trees to choose from. Now, the benefit … is that as these trees grow taller, and you can get, probably, of your 300 trees per acre at year 10, you can get almost 275 of those to grow big enough so you can harvest them as saw logs or veneer logs. If you think about this acre with the 300 trees on it … after 10, 12, 14 years, now it's going to start throwing off a deferred dividend, because you're going to be able to thin. This part is counterintuitive; if you write any of this part, you'll get letters to the editor saying: 'This is anti-silvicultural-best-management practices!' But what you'll end up

To the sky?



source: Purdue University Cooperative Extension Service doing is harvesting your biggest trees that are also getting in the way of the other trees, so you're essentially releasing those trees. Now, in a natural forest, you do it in reverse. You take out your low-grade trees and let your big honker trees grow to maturity and higher values."

Insofar as the price of black walnut rises faster than the rate of inflation, an investor has snatched his money past the quivering jaws of the Federal Reserve. And to the extent that the tax laws continue to favor timber investments, he or she stands a fighting chance with the IRS as well. "You deplete or you shelter your income by what you paid for the trees upfront," Saul explains. "You're running down that part of the asset, and so you're left with exposure only to the capital appreciation in the value of the trees and in the growth of the trees. In a hardwood plantation, because you're starting from scratch and all of those expenses—cost of trees, cost of labor, cost of equipment—all that stuff is capitalized. By the time you've made your first several harvests, all of that capitalization plus the depletion shelters, virtually all of those early harvest revenues—now that means your later harvest revenues will be fully exposed to long-term capital gains tax. But, still, it's long-term capital gains tax."

In the early 1980s, zero-coupon, long-dated Treasurys were priced to deliver an unconditional low-teens return. Today, zero-coupon, long-dated black-walnut trees are priced to deliver an indeterminate, highly conditional return. We may guess—fiddle with assumptions about interest rates and timber demand and supply and veneer-log prices—but we can't know. For us, we are prepared to guess that, in the absence of hard money, hardwoods will prove a rewarding investment.

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Gas-fired income

(May 4, 2012) Irrepressible yields may not be available until the Federal Open Market Committee disbands, but Boardwalk Pipeline Partners (BWP on the New York Stock Exchange), a master limited partnership in the business of transporting and storing natural gas, perhaps comes as close as any public security to delivering Fed-resistant income. The shares—not to be confused with Treasury bills, by any means—are priced to yield 7.7%.

Boardwalk is the principal topic under discussion, gas is a secondary topic and Westshore Terminals (WTE. UN on the Toronto Exchange), a Canadian income play, is a tertiary topic. We like Boardwalk as an income vehicle, gas as a commodity (though our bullish view is wholly derived from expert testimony and personal hunch) and Westshore as a foil to Boardwalk.

Boardwalk is the owner of three interstate natural gas pipeline systems that transport 7.3 billion cubic feet of gas a day, or 11% of American daily gas consumption. The trio includes Gulf Crossing Pipeline, Gulf South Pipeline and Texas Gas Transmission, and they reach 14,300 miles and can store 185.6 billion cubic feet of gas. The longest of the three, Gulf South Pipeline, spans 7,600 miles through Texas, Louisiana, Mississippi, Alabama and Florida.

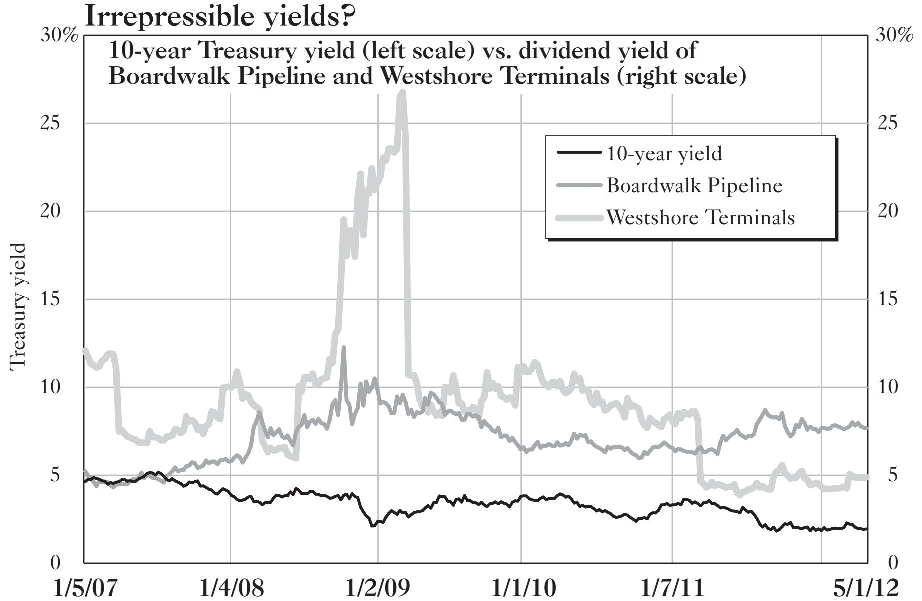
In most of its operations, Boardwalk is a regulated utility. The Federal Energy Regulatory Commission tells it how much it can charge for transmission and storage. Some pockets of the business are unregulated—notably Boardwalk Field Services, a new subsidiary involved in gas gathering and processing. Field Services is building assets in the Pennsylvania-centered Marcellus shale formation. But 96% of Boardwalk's income is derived from long-term contracts in its mainly regulated business lines. As of the end of 2011, the average remaining life of such contracts was six years.

Boardwalk is a production of Loews Corp. (L on the Big Board), the Tisch-managed conglomerate. Loews bought Texas Gas Transmission in May 2003 and Gulf South Pipeline in December 2004. From those assets, it fashioned Boardwalk Pipeline Partners, taking the company public in November 2005. Today, Loews owns 59% of Boardwalk's shares through a limited partnership interest and 2% through a general partnership interest. The Loews presence gives Boardwalk—the senior debt of which is rated triple-B—a financially stable, A-plus-rated, shareholder-friendly long-term partner.

Stability is a good thing in the gas business these days, what with the price of the commodity recently scraping $2 per thousand cubic feet. It is an especially good thing for Boardwalk, which has $3.4 billion in net debt as against roughly the same amount in stockholders' equity and earnings before interest, taxes, depreciation and amortization of $652 million. Boardwalk's debt is fixed rate (all except $684 million from one bond and a revolving credit line), and it carried an average interest rate in 2011 of 5.78%.

Under the terms of its debt covenants, Boardwalk may show a ratio of net debt to EBITDA no higher than 5.0 times. At year-end, in fact,

Irrepressible yields?



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it showed 5.2, a permissible stretch, according to management. Allowances are made for future contractual income to be produced from new investments, it says. The company warrants that all was shipshape, covenant-wise, at year-end.

"Boardwalk increased its assets at a compound annual rate of 18.3% between year-end 2005 and year-end 2011," colleague Evan Lorenz relates, "as the partnership was able to capitalize on ever greater demand for transport and storage assets on the back of growing shale-gas production. Between 2006, the first full year the company paid distributions to limited partners, and 2011, distributions and revenues have increased by 9.7% and 13.4% a year, respectively. 'The Interstate Natural Gas Association of America anticipates that U.S. natural gas consumption in the power sector will increase to 14.8 [trillion cubic feet] in 2020 vs. 7.4 tcf in 2010,' JPMorgan analysts Jeremy Tonet, Tim Fisher and Alistair J. Meadows write in a Dec. 12 note. 'We expect that the significant ramp-up in shale-based production will overwhelm existing infrastructure, thereby providing attractive expansion opportunities for natgas [transportation and storage] MLPs.'" Of the three-dozen or so energy MLPs known to Bloomberg, Boardwalk ranks high in yield and middling in leverage.

Because all but 4% of Boardwalk's revenue is delivered via long-term contracts, short- and even medium-term fluctuations in the gas price are not so important to its ability to generate income. For the long term, Boardwalk would no doubt prefer a price high enough to keep its producers solvent, yet a price not so high as to induce electric utilities to burn coal instead of gas. As to the current shale-gas-powered bear market in gas, this too shall pass, according to Zev Abraham, managing partner at Resource Equity Insights. One of the troubles with shale—or, more particularly, the over-hyped version of shale now popular on Wall Street—is that there are not enough facts on which to base a solid judgment.

Much of the value in a well lies in so-called tail production, the gas extracted toward the end of the well's productive life. But, in the case of the shale plays, it is exactly this end-of-life yield about which little is known.

"There are some basins where evidence suggests wells are flattening out slightly below expectations and there is not enough history to know whether the production remains flat for as long as advertised," Abraham says. "The problem is that a slightly lower flattening or a continued, albeit very slight, decline can change the IRR on a well a lot. It can go from a good return to a lousy one pretty easily, and we just don't know what production is going to be and will not for a while."

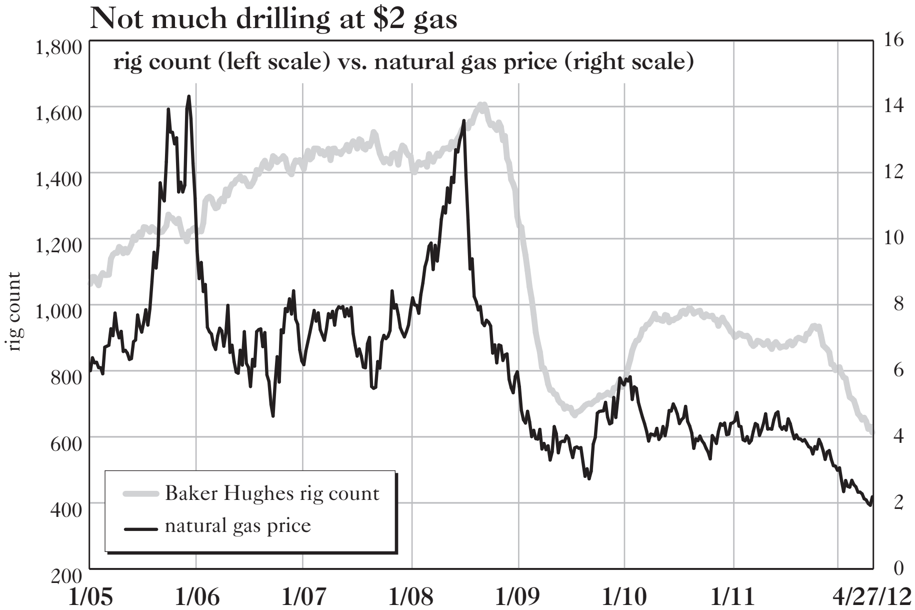
In other words, Abraham suggests, talk of a permanent low plateau in the price of natural gas is likely to be no more helpful than talk was, along about 1929, of a permanent high plateau in common stocks.

Lorenz asked Kenneth I. Siegel, chairman of Boardwalk and a senior vice president at Loews, what he worries about. Not much, Siegel replied. "We have a very significant portion of business locked in under long-term contracts. We've got good pipelines, we're well located, we've got growth opportunities, we've got a very strong management team. We have the financial flexibility to do interesting things when they present themselves. I'm pretty comfortable with where we are strategically."

Westshore Terminals operates the largest coal-loading facility on the west coast of the Americas on a man-made island at Roberts Bank, British Columbia. Like Boardwalk, Westshore has made hay from the shale-gas boom. Thermal coal, once the mainstay fuel for Canadian and American electric utilities, but increasingly displaced by cheap gas nowadays, still finds an eager market in Asia, especially in China.

As Boardwalk has a major shareholder in Loews, so Westshore has a principal investor in Jim Pattison, the third-richest man in Canada. Pattison and the stockholders see eye to eye on the subject of taxes: They are united in seeking to pay as little as possible. Pattison and the public are, however, perhaps a little less closely aligned in the matter of disclosure. If you are the kind of investor who needs to listen to a conference call, Westshore won't be for you. The company—or, rather, Westar, the company's external manager—holds none. As for income, Westshore is priced to yield 4.9%, a yield not so different from Boardwalk's when you consider that Westshore shows C$0.88 of net cash per share.

Westshore's business is through the roof—or the gunwales. There isn't enough capacity to handle the explosive Asian demand for coal. Westshore is, therefore, investing to



source: The Bloomberg

increase its annual export capacity to 33 million tons at the end of this year from the 27.3 million tons it shipped in 2011. Nor is Westshore alone. Ridley Terminals, a Canadian state-owned facility in Prince Rupert, is planning to double its 12 million-ton capacity by the end of 2014. Neptune Bulk Terminals, a three-berth operation handling coal, potash and fertilizer, shipped 5.2 million tons of coal in 2011 and plans to bulk up in order to be able to ship 12.5 million tons of coal in 2013.

Coal prices are up, volumes are up, margins are up. Walter Spracklin, an RBC analyst who follows Westshore, says that all systems are go. "I'm very comforted by the minimum volume requirements that the company has gotten," Spracklin tells Lorenz. "I like the significant supply-demand imbalance that exists right now to Westshore's favor for port access and loading capacity on the West Coast. Even in the event of a tempering in [metallurgical] coal demand, they know there is plenty of thermal coal to fill in that capacity, and it provides them very good economics. The dividend—we have it going up 25% this year and 25% again next year. The cash-flow generation that this company is putting out—very low capex program on a sustaining basis—means that, in our view, investors will be rewarded with significantly increasing dividends over the next few years."

If, however, you are as bearish on China as we are, you will not be so quick to jump in. Quoted at 14.3 times enterprise value to projected 2012 EBITDA, Westshore is valued for the Asian boom, not a Chinese bust. Our conclusion: Better a stroll on Boardwalk.

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Piece of my mind

(March 23, 2012) The Federal Reserve Bank of New York has invited some of its public critics to visit the bank to unburden themselves of their criticisms. On March 12, it was your editor's turn. The text of his remarks follows.

My friends and neighbors, I thank you for this opportunity. You know, we *are* friends and neighbors. *Grant's* makes its offices on Wall Street, overlooking Broadway, a 10-minute stroll from your imposing headquarters. For a spectacular vantage point on the next ticker-tape parade up Broadway, please drop by. We'll have the windows washed.

You say you would like to hear my complaints, and, on the one hand, I do have a few, while on the other, I can't help but feel slightly hypocritical in dressing you down. What passes for sound doctrine in 21st-century central banking—so-called financial repression, interest-rate manipulation, stock-price levitation and money printing under the frosted-glass term "quantitative easing"—presents us at *Grant's* with a nearly endless supply of good copy. Our symbiotic relationship with the Fed resembles that of Fox News with the Obama administration, or—in an earlier era—that of the *Chicago Tribune* with the Purple Gang. *Grant's* needs the Fed even if the Fed doesn't need *Grant's*.

In the not quite 100 years since the founding of your institution, America has exchanged central banking for a kind of central planning and the gold standard for what I will call the Ph.D. standard. I regret the changes and will propose reforms, or, I suppose, re-reforms, as my program is very much in accord with that of the founders of this institution. Have you ever read the Federal Reserve Act? The authorizing legislation projected a body "to provide for the establishment of the Federal Reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper and to establish a more effective supervision of banking in the United States, and for other purposes." By now can we identify the operative phrase? Of course: "for other purposes."

You are lucky, if I may say so, that I'm the one who's standing here and not the ghost of Sen. Carter Glass. One hesitates to speak for the dead, but I am reasonably sure that the Virginia Democrat, who regarded himself as the father of the Fed, would skewer you. He had an abhorrence of paper money and government debt. He didn't like Wall Street, either, and I'm going to guess that he wouldn't much care for the Fed raising up stock prices under the theory of the "portfolio balance channel."

It enflamed him that during congressional debate over the Federal Reserve Act, Elihu Root, Republican senator from New York, impugned the anticipated Federal Reserve notes as "fiat" currency. Fiat, indeed! Glass snorted. The nation was on the gold standard. It would remain on the gold standard, Glass had no reason to doubt. The projected notes of the Federal Reserve would—of course—be convertible into gold on demand at the fixed statutory rate of $20.67 per ounce. But more stood behind the notes than gold. They would be collateralized, as well, by sound commercial assets, by the issuing member bank and—a point to which I will return—by the so-called double liability of the issuing bank's stockholders.

If Glass had the stronger argument, Root had the clearer vision. One can think of the original Federal Reserve note as a kind of derivative. It derived its value chiefly from gold, into which it was lawfully exchangeable. Now that the Federal Reserve note is exchangeable into nothing except small change, it is a derivative without an underlier. Or, at a stretch, one might say it is a derivative that secures its value from the wisdom of Congress and the foresight and judgment of the monetary scholars at the Federal Reserve. Either way, we would seem to be in dangerous, uncharted waters.

As you prepare to mark the Fed's centenary, may I urge you to reflect on just how far you have wandered from the intentions of the founders? The institution they envisioned would operate passively, through the discount window. It would not create credit but rather liquefy the existing stock of credit by turning good-quality commercial bills into cash—temporarily. This it would do according to the demands of the seasons and the cycle. The Fed would respond to the community, not try to anticipate or lead it. It would not override the price mechanism—as today's Fed seems to do at every available opportunity—but yield to it.

My favorite exposition of the sound, original doctrines is a book entitled, "The Theory and Practice of Central Banking," by H. Parker Willis, first secretary of the Federal Reserve Board and Glass's right-hand man in the House of Representatives. Writing in the mid-1930s, Willis pointed out that the Fed fell into sin almost immediately after it opened for business in 1914. In 1917, after the United States entered the Great War, the Fed set about monetizing the Treasury's debt and suppressing the Treasury's borrowing costs. In the 1920s, after the recovery from the short but ugly depression of 1920-21, the Fed started to implement open-market operations to sterilize gold flows and steer a desired macroeconomic course.

"Central banks," wrote Willis, glaring at the innovators, "…will do wisely to lay aside their inexpert ventures in half-baked monetary theory, meretricious statistical measures of trade, and hasty grinding of the axes of speculative interests with their suggestion that by doing so they are achieving some sort of vague 'stabilization' that will, in the long run, be for the greater good."

Willis, who died in 1937, perhaps of a broken heart, would be no happier with you today than Glass would be—or I am. The search for "some sort of vague stabilization" in the 1930s has become a Federal Reserve obsession at the millennium. Ladies and gentlemen, such stability as might be imposed on a dynamic capitalist economy is the kind that eventually comes around to bite the stabilizer.

"Price stability" is a case in point. It is your mandate, or half of your mandate, I realize, but it does grievous harm, as defined. For reasons you never exactly spell out, you pledge to resist "deflation." You won't put up with it, you keep on saying—something about Japan's lost decade or the Great Depression. But you never say what deflation really is. Let me attempt a definition. Deflation is a derangement of debt, a symptom of which is falling prices. In a credit crisis, when inventories become unfinanceable, merchandise is thrown on the market and prices fall. That's deflation.

What deflation is not is a drop in prices caused by a technology-enhanced decline in the costs of production. That's called progress. Between 1875 and 1896, according to Milton Friedman and Anna Schwartz, the American price level subsided at the average rate of 1.7% a year. And why not? As technology was advancing, costs were tumbling. Long before Joseph Schumpeter coined the phrase "creative destruction," the American economist David A. Wells, writing in 1889, was explaining the consequences of disruptive innovation.

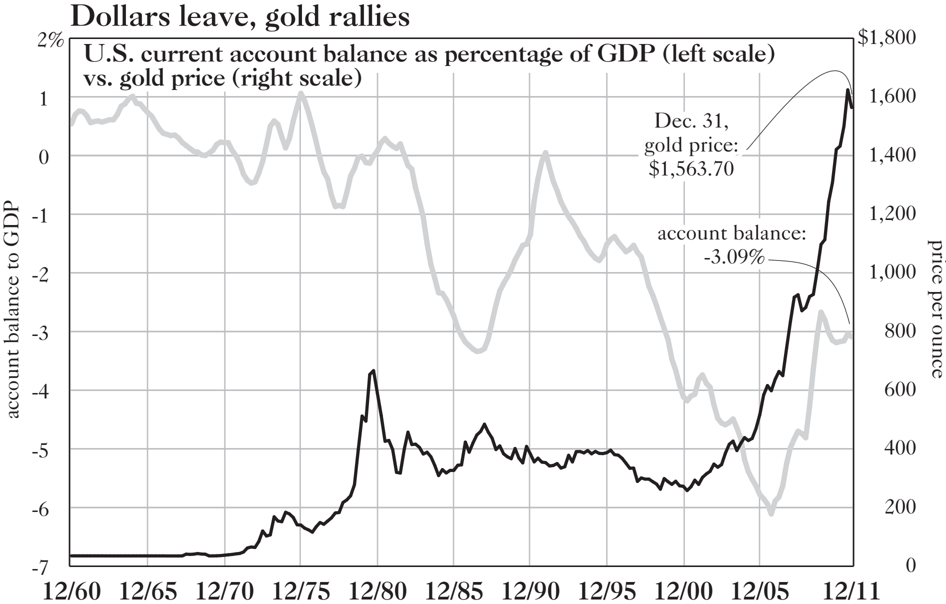
"In the last analysis," Wells proposes, "it will appear that there is no such thing as fixed capital; there is nothing useful that is very old except the precious metals, and life consists in the conversion of forces. The only capital which is of permanent value is immaterial—the experience of generations and the development of science."

Much the same sentiments, and much the same circumstances, apply today, but with a difference. Digital technology and a globalized labor force have brought down production costs. But, the central bankers declare, prices must not fall. On the contrary, they must rise by 2% a year. To engineer this up-creep, the Bernankes, the Kings, the Draghis—and yes, sadly, even the Dudleys—of the world monetize assets and push down interest rates. They do this to conquer deflation.

But note, please, that the suppression of interest rates and the conjuring of liquidity set in motion waves of speculative lending and borrowing. This artificially induced activity serves to lift the prices of a favored class of asset—houses, for instance, or Mitt Romney's portfolio of leveraged companies. And when the central bank-financed bubble bursts, credit contracts, leveraged businesses teeter, inventories are liquidated and prices weaken. In short, a process is set in motion resembling a real deflation, which then calls forth a new bout of monetary intervention. By trying to forestall an imagined deflation, the Federal Reserve comes perilously close to instigating the real thing.

The economist Hyman Minsky laid down the paradox that stability is itself destabilizing. I say that the pledge of a stable funds rate through the fourth quarter of 2014 is hugely destabilizing. Interest rates are prices. They convey informa-

Dollars leave, gold rallies



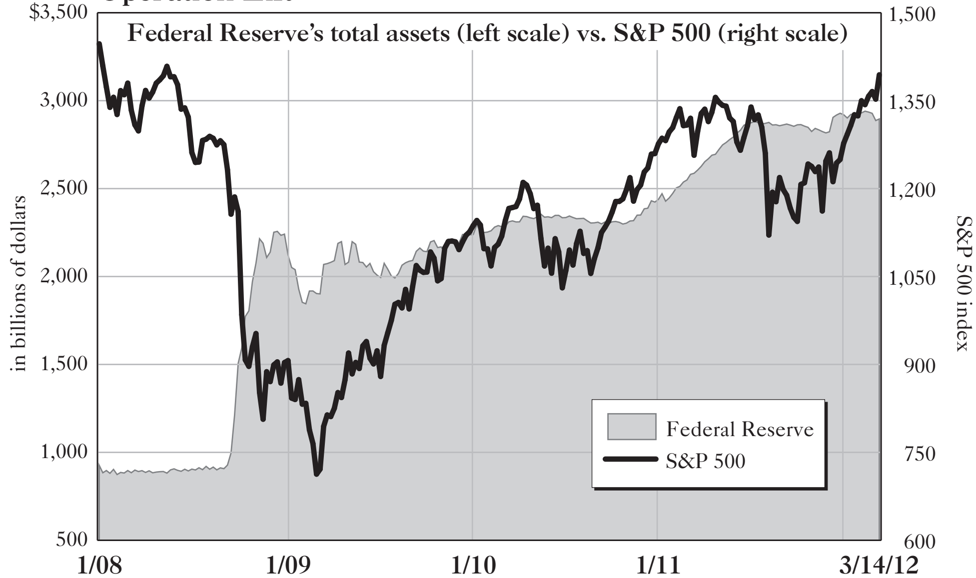
source: The Bloomberg

tion, or ought to. But the only information conveyed in a manipulated yield curve is what the Fed wants. Opportunists don't have to be told twice how to respond. They buy oil or gold or foreign exchange, not incidentally pushing the price of a gallon of gasoline at the pump to $4 and beyond. Another set of opportunists borrow short and lend long in the credit markets. Not especially caring about the risk of inflation over the long run, this speculative cohort will fund mortgages, junk bonds, Treasurys, what-have-you at zero percent in the short run. The opportunists, a.k.a. the 1 percent, will do fine. But what about the uncomprehending others?

I commend to the Federal Reserve Bank of New York Financial History Book Club (if it doesn't exist, please organize it at once) a volume by the British scholar and central banker, Charles Goodhart. Its title is "The New York Money Market and the Finance of Trade, 1900-1913." In the pre-Fed days with which the history deals, the call money rate dove and soared. There was no stability—and a good thing, Goodhart reasons. In a society predisposed to speculate, as America was and is, he writes, unpredictable spikes in borrowing rates kept the players more or less honest. "On the basis of its record," he writes of the Second Federal Reserve District before there was a Federal Reserve, "the financial system as constituted in the years 1900-1913 must be considered successful to an extent rarely equaled in the United States." And that not withstanding the Panic of 1907.

My reading of history accords with Goodhart's, though not with that of the Fed's front office. If Chairman Bernanke were in the room, I would respectfully ask him why this persistent harking back to the Great Depression? It is one cyclical episode, but there are many others. I myself draw more instruction from the depression of 1920-21, a slump as ugly and steep in its way as that of 1929-33, but with the simple and interesting difference that it ended. Top to bottom, spring 1920 to summer 1921, nominal GDP fell by 23.9%, wholesale prices by 40.8% and the CPI by 8.3%. Unemployment, as it was inexactly measured, topped out at about 14% from a pre-bust low of as little as 2%. And how did the administration of Warren G. Harding meet this macroeconomic calamity? Why, it balanced the budget, the president declaring in 1921, as the economy seemed to be falling apart, "There is not a menace in the world today like that of growing public indebtedness and mounting public expenditures." And the fledgling Fed, face to face with its first big slump, what did it do? Why, it tightened, pushing up short rates in mid-depression to as high as 8.13% from a business cycle peak of 6%. It was the one and only time in the history of this institution that money rates at the trough of a cycle were higher than rates at the peak, according to Allan Meltzer.

Operation Lift



source: The Bloomberg

But then something wonderful happened: Markets cleared, and a vibrant recovery began. There were plenty of bankruptcies and no few brickbats launched in the direction of the governor of the New York Fed, Benjamin Strong, for the deflation that cut an especially wide and devastating swath through the American farm economy. But in 1922, the first full year of recovery, the Fed's index of industrial production leapt by 27.3%. By 1923, the unemployment rate was back to 3.2%. The 1920s began to roar.

And do you know that the biggest nationally chartered bank to fail during this deflationary collapse was the First National Bank of Cleburne, Texas, with not quite $2.8 million of deposits? Even the forerunner to today's Citigroup remained solvent (though for Citi, even then it was a close-run thing, on account of an oversize exposure to deflating Cuban sugar values). No TARP, no starving the savers with zero-percent interest rates, no QE, no jimmying up the stock market, no federal "stimulus" of any kind. Yet—I repeat—the depression ended. To those today who demand ever more intervention to cure what ails us, I ask: Why did the depression of 1920-21 ever end? Given the policies with which the authorities treated it, why are we still not ensnared?

If you object to using the template of 1920-21 as a guide to 21st-century policy because, well, 1920 was a long time ago, I reply that 1929 was a long time ago, too. And if you persist in objecting because the lessons to be derived from the Harding depression are unthinkably at odds with the lessons so familiarly mined from the Hoover and Roosevelt depression, I reply that Harding's approach worked. The price mechanism is truer and enterprise hardier than the promoters of radical 21st-century intervention seem prepared to acknowledge.

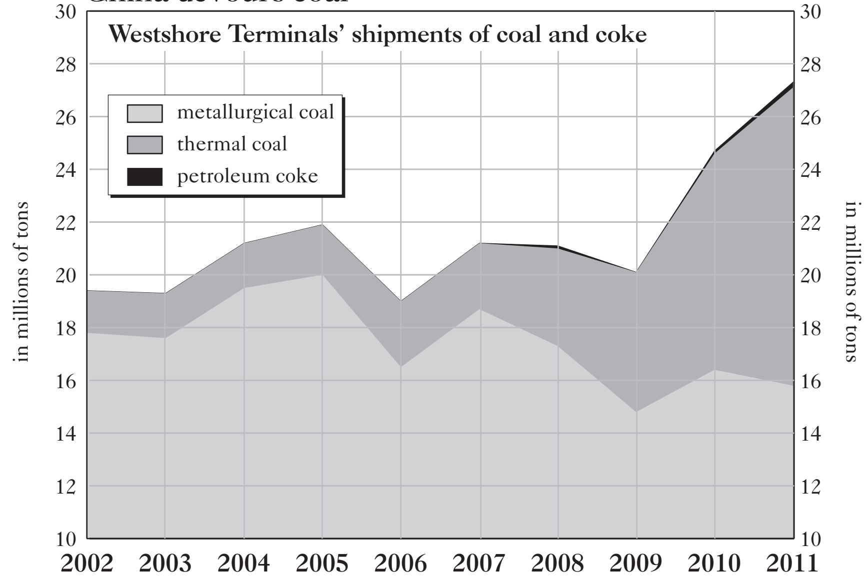
In notable contrast to the Harding method, today's policies seem not to be working. We legislate and regulate and intervene, but still the patient languishes. It's a worldwide failure of the institutions of money and credit. I see in the papers that Banca Monte dei Paschi di Siena is in the toils of a debt crisis. For the first time in over 500 years, the foundation that controls this ancient Italian institution may be forced to sell shares. We've all heard of hundred-year floods. We seem to be in a kind of 500-year debt flood.

Many now call for more regulation—more such institutions as the Treasury's brand-new Office of Financial Research, for instance. In the March 8 *Financial Times*, the columnist Gillian Tett appealed for more resources for the overwhelmed regulators. Inundated with information, she lamented, they can't keep up with the institutions they are supposed to be safeguarding. To me, the trouble is not that the regulators are ignorant. It's rather that the owners and managers are unaccountable.

Once upon a time—specifically, between the National Banking Act of 1863 and the Banking Act of 1935—the impairment or bankruptcy of a nationally chartered bank triggered a capital call. Not on the taxpayers, but on the stockholders. It was their bank, after all. Individual accountability in banking was the rule in the advanced economies. Hartley Withers, the editor of *The Economist* in the early 20th century, shook his head at the micromanagement of American banks by the Office of the Comptroller of the Currency—25% of their deposits had to be kept in cash, i.e., gold or money lawfully convertible into gold. The rules held. Yet New York had panics, London had none. Adjured Withers: "Good banking is produced not by good laws but by good bankers."

Well said, Withers! And what makes a good banker is more than skill. It is also the fear of God, or, more specifically, accountability for the solvency of the institution that he or she owns or manages. To

China devours coal



source: company reports

stay out of trouble, the general partners of Brown Brothers Harriman, Wall Street's oldest surviving general partnership, need no regulatory pep talk. Each partner is liable for the debts of the firm to the full extent of his or her net worth. My colleague Paul Isaac, who is with me today—he doubles as my food and beverage taster—has an intriguing suggestion for instilling the credit culture more deeply in our semi-socialized banking institutions.

We can't turn limited liability corporations into general partnerships. Nor could we easily reinstate the so-called double liability law on bank stockholders. But what we could and should do, Paul urges, is to claw back that portion of the compensation paid out by a failed bank in excess of 10 times the average wage in manufacturing for the seven full calendar years before the ruined bank hit the wall. Such a clawback would not be subject to averaging or offset one year to the next. And it would be payable in cash.

The idea, Paul explains, is twofold. First, to remove the government from the business of determining what is, or is not, risky—really, the government doesn't know. Second, to increase the personal risk of failure for senior management, but stopping short of the sword of Damocles of unlimited personal liability. If bankers are venal, why not harness that venality in the public interest? For the better part of 100 years, and especially in the past five, we have socialized the risks of high finance. All too often, the bankers who take risks don't themselves bear them. By all means, let the capitalists keep the upside. But let them bear their full share of the downside.

In March 2009, the *Financial Times* published a letter to the editor concerning the then novel subject of QE. "I can now understand the term 'quantitative easing,' wrote Gerald B. Hill of Stourbridge, West Midlands, "but . . . realize I can no longer understand the meaning of the word 'money.'"

There isn't time, in these brief remarks, to persuade you of the necessity of a return to the classical gold standard. I would need another 10 minutes, at least. But I anticipate some skepticism. Very well then, consider this fact: On March 27, 1973, not quite 39 years ago, the forerunner to today's G-20 solemnly agreed that the special drawing right, a.k.a. SDR, "will become the principal reserve asset and the role of gold and reserve currencies will be reduced." That was the establishment—i.e., you—talking. If a worldwide accord on the efficacy of the SDR is possible, all things are possible, including a return to the least imperfect international monetary standard that has ever worked.

Notice, I do not say the perfect monetary system or best monetary system ever dreamt up by a theoretical economist. The classical gold standard, 1879-1914, "with all its anomalies and exceptions . . . 'worked.'" The quoted words I draw from a book entitled, "The Rules of the Game: Reform and Evolution in the International Monetary System," by Kenneth W. Dam, a law professor and former provost of the University of Chicago. Dam's was a grudging admiration, a little like that of the New York Fed's own Arthur Bloomfield, whose 1959 monograph, "Monetary Policy under the International Gold Standard," was published by yourselves. No, Bloomfield points out, as does Dam, the classical gold standard was not quite automatic. But it was synchronous, it was self-correcting and it did deliver both national solvency and, over the long run, uncanny price stability. The banks were solvent, too, even the central banks, which, as Bloomfield noted, monetized no government debt.

The visible hallmark of the classical gold standard was, of course, gold—to every currency holder was given the option of exchanging metal for paper, or paper for metal, at a fixed, statutory rate. Exchange rates were fixed, and I mean fixed. "It is quite remarkable," Dam writes, "that from 1879 to 1914, in a period considerably longer than from 1945 to the demise of Bretton Woods in 1971, there were no changes of parities between the United States, Britain, France, Germany—not to speak of a number of smaller European countries." The fruits of this fixedness were many and sweet. Among them, again to quote Dam, "a flow of private foreign investment on a scale the world had never seen, and, relative to other economic aggregates, was never to see again." Incidentally, the source of my purchased copy of "Rules of the Game" was the library of the Federal Reserve Bank of Atlanta. Apparently, President Lockhart isn't preparing, as I am—as, may I suggest, as you should be—for the coming of classical gold standard, Part II. By way of preparation, I commend to you a new book by my friend Lew Lehrman, "The True Gold Standard: A Monetary Reform Plan without Official Reserve Currencies: How We Get from Here to There."

It's a little rich, my extolling gold to an institution that sits on 216 million troy ounces of the stuff. Valued at $42.222 per ounce, the hoard in your basement is worth $9.1 billion. Incidentally, the official price was quoted in SDRs, $35 to the ounce—now there's a quixotic choice for you. In 2008, when your in-house publication, "The Key to the Gold Vault," was published, the market value was $194 billion. Today, the market value is $359 billion, which is encouraging only if you personally happen to be long gold bullion. Otherwise, it strikes me as a pretty severe condemnation of modern central banking.

And what would I do if, following the inauguration of Ron Paul, I were sitting in the chairman's office? I would do what I could to begin the normalization of interest rates. I would invite the *Wall Street Journal*'s Jon Hilsenrath to lunch to let him know that the Fed is now well over its deflation phobia and has put aside its Atlas complex. "It's capitalism for us, Jon," I would say. Next I would call President Dudley. "Bill," I would say, pleasantly, "we're not exactly leading from the front in the regulatory drive to reduce the ratio of assets to equity at the big American financial institutions. Do you have to be leveraged 89:1?" Finally, I would redirect the efforts of the brainiacs at the Federal Reserve Board research division. "Ladies and gentlemen," I would say, "enough with 'Bayesian Analysis of Stochastic Volatility Models with Levy Jumps: Application to Risk Analysis.' How much better it would please me if you wrote to the subject, 'Command and Control No More: A Gold Standard for the 21st Century.'" Finally, my pièce de résistance, I would commission, staff and ceremonially open the Fed's first Office of Unintended Consequences.

Let me thank you once more for the honor that your invitation does me. Concerning little *Grant's* and the big Fed, I will quote in parting the opening sentences of an editorial that appeared in a provincial Irish newspaper in the fateful year 1914. It read: "We give this solemn warning to Kaiser Wilhelm*: *The Skibbereen Eagle* has its eye on you."

*On further review, the editorial appeared in *The Skibbereen Eagle*'s pages in 1899. The *Eagle* directed its warning towards the Czar of Russia.

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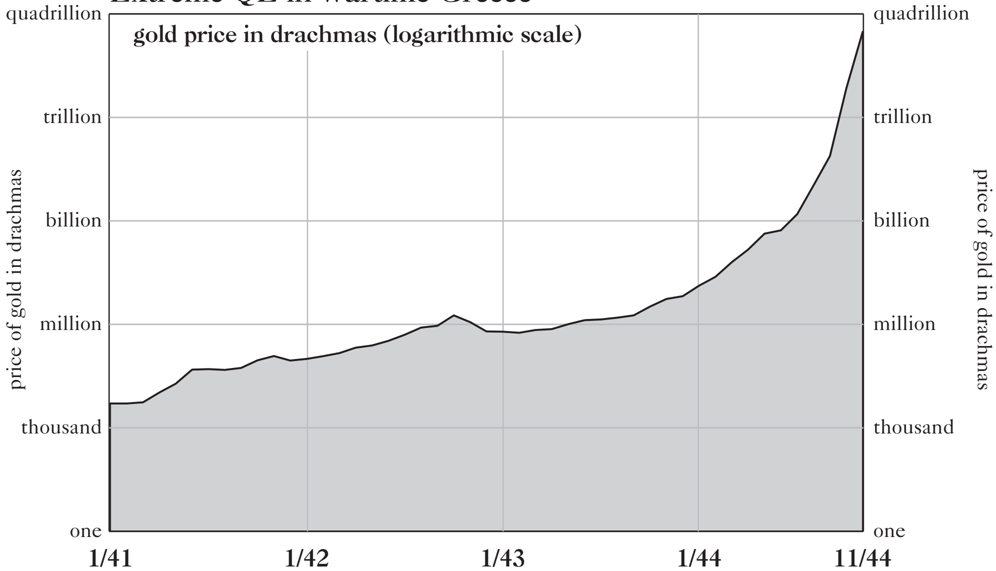
Greek monetary back story

(February 24, 2012) "Statements and assurances from Greece are no longer taken at face value," a German economics professor, Wolfram Schrettl, has remarked. "Who will ensure afterward that Greece continues to stand by what Greece is agreeing to now?" the German finance minister, Wolfgang Schäuble, has demanded.

Such expressions of German disdain ignite a special kind of fury in Greece. While 21st-century Greek fiscal and financial management may leave a little something to be desired, the record of German monetary stewardship in the Hellenic Republic is supremely worse. During Nazi occupation in World War II, Greece suffered famine, pestilence, wholesale killings and hyperinflation. The last-named plague is the topic at hand.

Let bygones be bygones, they say, and well they might say it in Europe, the land of ancient enmities. However, there can be no understanding the present-day Greek sensitivity to its high and mighty creditors without a rudimentary knowledge of the German-inflicted catastrophes of 1941-44. Nor can there be a full and proper appreciation of the risks inherent in paper money without a basic grounding in such abominations as the occupation-era Greek drachma or, for that matter, the post-occupation drachma—for the liberated Greek central bank took up where the German-corrupted central bank left off. Fiat currency can't seem to help itself. The insubstantial monetary material sooner or later goes up in smoke, no matter whose hand cranks the presses. These days, of course, the cranking hand is a technocratic one. "Quantitative easing" is the anodyne phrase. Yet in peace as in war, gold is the preferred refuge from state-imposed paper currency.

Extreme QE in wartime Greece



source: Mazower, Mark: "Inside Hitler's Greece: the Experience of Occupation, 1941-1944"

According to Mark Mazower's scholarly history, "Inside Hitler's Greece: The Experience of Occupation, 1941-44," between 250,000 and 300,000 Greeks died from famine at the hands of the German overlords. "In reality," Mazower writes, "there was no deliberate German plan of extermination." The extermination that did occur was rather the result of the calculated destruction of the Greek economy and the stripping of the Greek larder for the Axis armies, the German one in particular. "Who is Mr. Schäuble to revile Greece?" the 82-year-old president of Greece, Karolos Papoulias, demanded last week in response to the German finance minister's slighting comments about the country for which a teenaged Papoulias fought in World War II.

Famine was a certain, if not deliberately sought, consequence of German occupation policy, but there was nothing accidental about the destruction of the drachma. The German-controlled Bank of Greece printed up the national currency as the need arose. In the opening months of 1941, before the Germans (and the Italians and Bulgarians) came to stay, a British sovereign was worth 1,200 drachmas. As the Germans cleared out, in November 1944, blowing up railroad tunnels, rolling stock, harbors and such as they left, a sovereign commanded 71 trillion drachmas.

A sovereign is a gold coin weighing not quite one-quarter ounce—to be exact, 0.23542 troy ounce. When Britain was on the gold standard, a sovereign was worth one pound sterling, and it circulated as the people's money. It was a popular coin in Greece, too, as Britain and Greece had joined monetary forces in 1928. Three years later, Britain went off the gold standard, and in 1932, Greece and Britain ended their so-called stabilization relationship. Cut loose from gold, the paper pound began its long descent in purchasing power measured in gold. However, from the Greek vantage point, paper sterling was a better anchor for the drachma than no anchor at all, and in 1936 the Greeks re-lashed their currency to Britain's, at the rate of 548 drachmas to the pound.

Fast-forward now to the outbreak of war in Europe in 1939. As the pound came under new inflationary pressure, so did the drachma. In Athens, the cost of living was accelerating well before Hitler mounted his attack on Greece in April 1941. In 14 months of neutrality, prices in the Greek capital had jumped by 15%.

Nowadays, Germany is the national face of monetary and fiscal rectitude. It wore a different face in wartime Greece, though the German army of occupation did observe some of the basic commercial forms. "Rather than requisition all required goods and facilities," write Dimitrios Delivanis and William C. Cleveland in their "Greek Monetary Developments, 1939-1948," "the occupation armies usually preferred to pay with newly created currency."

The German visitation lasted for $3\frac{1}{2}$ years, but the real monetary damage was done in the first 18 months. In April 1941, an index of the cost of living in Athens registered 116. In October 1942, the same index stood at 15,192, a gain—if that's the word—of almost 13,000%, or an average monthly rate of rise of 722%, according to Delivanis and Cleveland. It didn't help the price picture that the Greek economy was crippled or that the Germans were making off with whatever wasn't nailed down to aid the Axis war effort. What, especially, didn't help the price picture was the breakneck growth in the local money supply, up roughly 10-fold between May 31, 1941, and Oct. 31, 1942, or the fact that, in 1942-43, newly printed drachmas financed 81% of public expenditures.

During this first act in the play of the death of the drachma, the currency's domestic purchasing power fell by 99.34%, its external purchasing power—expressed in terms of the gold sovereign—by 99.73%. These facts we commend to the 21^{st}-century gold bulls on those discouraging days when the eternal monetary metal seems to trade as a proxy for the euro. It isn't the euro, after all, but almost the opposite. It is money, the genuine article.

"It must be concluded," write Delivanis and Cleveland, "that the almost complete collapse of the value of the drachma, both internally and externally, was largely the result of enemy exploitation. The enemy occupation authority seized all stocks of commodities that were discovered, exploited for its own benefit the productive facilities and capital equipment of the country, confiscated and exported as much as possible of the current production, and extorted, as occupation costs, payments equivalent to 7,674 million prewar drachmas between May 1, 1941, and March 31, 1942, 2,287 million prewar drachmas between April 1, 1942, and Oct. 31, 1942."

No bear market is complete without a trick rally, an Act II, and the terminal decline in the Greek currency was no exception. News of the Allied victory at El-Alamein in October-November 1942 caused a rush out of gold into scrip. A sovereign had fetched 37,144 drachmas before the battle that Churchill famously characterized as not the end of the war, nor even the beginning of the end of the war, but, "perhaps, the end of the beginning." By February 1943, it took just 14,180 drachmas to buy a sovereign—as it turned out, not a bad entry point for the final move up to an average of 71 trillion.

Act III of the eradication of the drachma resembled Act I but with the addition of many more commas and zeros to all the significant currency and inflation data. Hopes of early deliverance from the Nazi occupation dashed, Greeks resigned themselves to the likelihood of a replay of the Weimar inflation of 1922-23, an earlier episode of German-directed monetary chaos. As noted, the Athens cost-of-living index stood at 116 on the eve of the German occupation. It registered 76,171 in November 1943 and 18,850,000,000,000 in the first 10 days of November 1944.

"During the final period of the enemy occupation of Greece," the Delivanis and Cleveland account continues, "the index of note issue by the Bank of Greece rose to fantastic heights. During the period of 18 months and 10 days [i.e., May 1943 til Nov. 10, 1944], the index increased in magnitude 11,214,823 times, i.e., from 7,368 to the value of 82,630,830,289. The total increase in the period was 1,121,482,300%, representing an average monthly increase of more than 62 million percent as compared with the average monthly increase of 60% during the first period of enemy occupation from May 1941 to October 1942, and the average monthly increase of only 22.5% during the succeeding period from November 1942 to April 1943. The tremendous expansion of the note issue was caused by the growth of public expenditures, principally on account of the enemy occupation and by the cumulative, self-reinforcing effects of monetary inflation." Toward the end of the German stewardship, the Bank of Greece printed 99% of the receipts of the Greek treasury.

Gold and foreign bank notes were the de facto coin of the realm. The British Middle Eastern forces funneled an estimated 700,000 sovereigns to Greek guerillas. And the Germans, in a vain attempt to tamp down the raging inflation rate, sold gold in exchange for drachmas—as many as 1,300,000 sovereigns in 1943 and 1944. It was the bright idea of the head of the German economic mission to Greece, Hermann Neubacher, to drop sovereigns on the Greek market to try to buck up the drachma. "Astonished Greek businessmen started to question, should we be buying gold, or selling it ourselves?" relates Michael Palairet in his history, "The Four Ends of the Greek Hyperinflation, 1941-1946." "Buying gold" turned out to be the correct answer.

At a glance, the Greek hyperinflation would seem a pale copy of the Weimar episode. The size of the drachma money supply as the Germans scuttled home in 1944 was a mere 826,308,303-fold greater than the size of the money stock in the year before the outbreak of war in 1939. As for Weimar, marks in circulation in 1923 were 3,250,000,000-fold greater than the German money stock in the 12 months preceding the outbreak of war in 1914. However, note Delivanis and Cleveland, the Greek catastrophe was six years in the making as against nine for the German one. Besides, they say, as the curtain fell on the Greek tragedy, only one-third of Greeks were still transacting in the worthless national scrip, whereas, up to the bitter end, nine-tenths of the German population continued to use marks.

It can't be said that Greek monetary management represented much of an improvement over the German kind. Having seen off the enemy, the Greek authorities proceeded to print money—new drachmas—with the note issue climbing to 25,762 million from 126 million. The gold bull market and the cost of living in Athens both resumed their upward course. As for the Greek treasury, now crippled by a ferocious civil war, it liberally availed itself of the fruits of the central bank's printing press. ("Early during the occupation," Palairet writes, "the German authorities tried to get the Greek government to reform its system of tax collection, but wrote off the effort, such as it was, as unavailing.")

Sixty-odd years later, the monetary scenery is transformed. A peaceful Europe is united, more or less, under a single currency. A single central bank aims for a rate of inflation in the neighborhood of 2%—no scientific notation required to calculate the rate of currency debasement these days.

However, in the all-important realm of monetary ideas, not so much has changed. Today, as in the war, government-controlled central banks print up the money with which to finance, directly or indirectly, burgeoning fiscal deficits. Today, as in the war, governments have recourse to "financial repression," e.g., zero-percent funding costs and QE. And today, as in the war, investors with eyes to see are busily exchanging fiat currencies for tangible stores of value. *Plus ça change*, as they say in Athens.

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