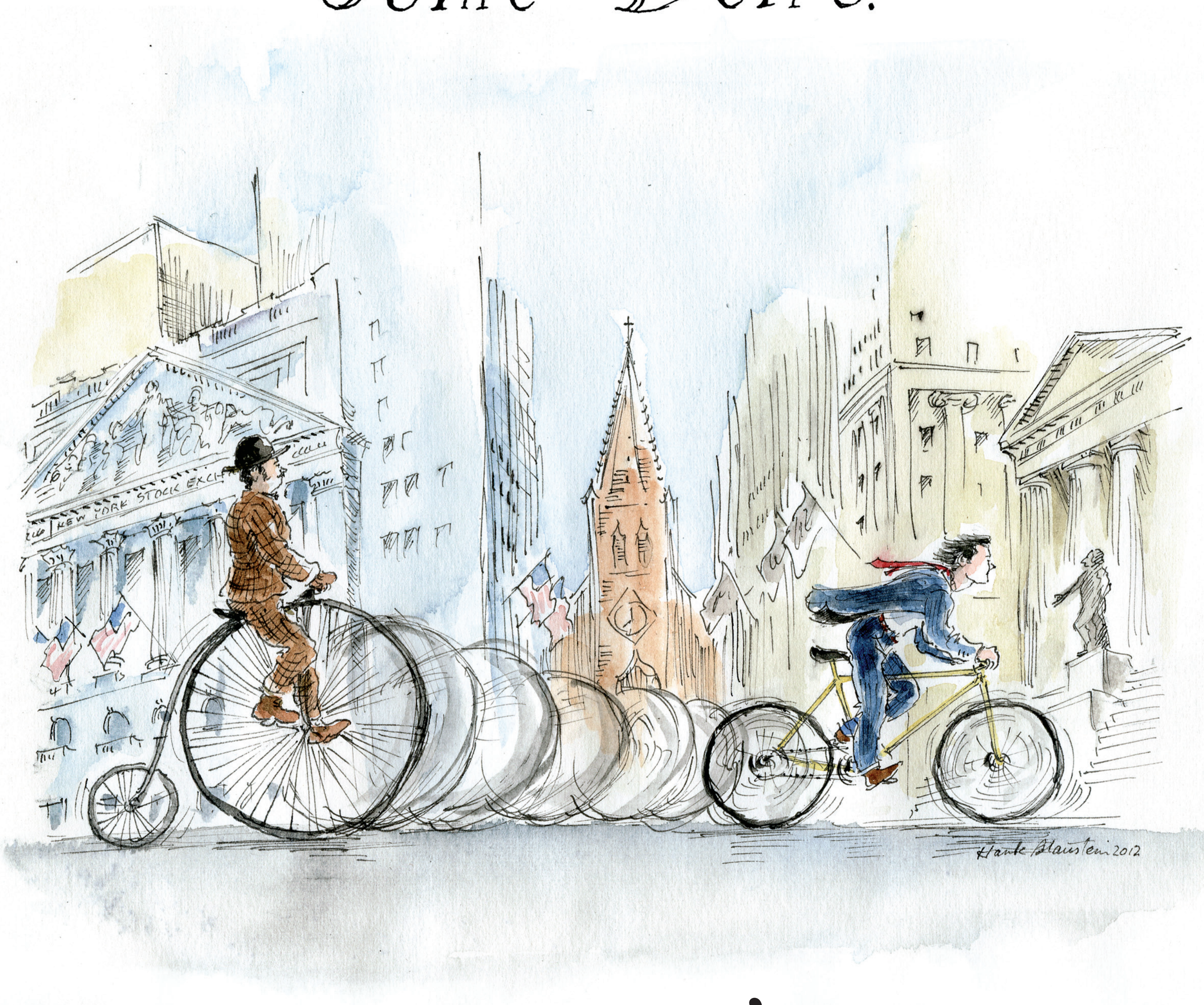
Some Cycles Change…

Some Don't.



GRANT'S

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A special invitation from James Grant, founder and editor.

Dear Investor,

I am about to praise my own publication to the skies—to tell you why so many successful investors find it indispensable and why you might, too. But before I get around to the sales pitch, let me tell you something of the back story.

I founded ***Grant's*** in 1983. I had been writing for *Barron's* before deciding to strike out on my own. In those early days, little did I realize how close I would literally come to striking out. Jimmy Rogers, the famed "Investment Biker," was my very first subscriber. Others did follow him, but—at first—not so many and not in so great a rush.

We began to make a name for ourselves the next year with a bullish call on the 30-year Treasury bond, then priced to yield 13%. From the present era of stunted interest rates, it is almost impossible to conceive of the bearishness on Wall Street toward these astounding bargains. Interest rates had been rising since 1946. Most investors, looking backwards, expected them to continue to rise.

Well, interest rates did not keep rising, but began falling and have continued to fall. Armed with perfect foresight, I could have borrowed enough money to buy enough Treasurys to endow a small college. But I did not have perfect foresight—did not then and do not have now. What I believe I have acquired, though, is a sense of the cycles of finance. I have come to see how perfectly good investments lose favor and become unreasonably cheap, while not intrinsically better assets tickle the market's fancy on their way to becoming outlandishly rich. I have long since become a confirmed contrarian.

The collection of ***Grant's*** articles you hold in your hand represents a fair sample of our work. You will find a 1994 essay on the coming commodity boom, a 1998 analysis of an unloved gold stock (they were all unloved, as gold was trading for $280 an ounce), a 2005 lament on the mispricing of European sovereign debt and a 2006 deconstruction of the faulty design of residential mortgage-backed securities. Each was prescient—and each, admittedly, was early. Let me just say that the readers of ***Grant's*** are not often surprised by what they read in the newspaper.

Grant's was among the very few to have seen the debt bubble of the 2000s for what it was and to have identified actionable strategies to profit by its certain collapse. And we were likewise among the few to have anticipated the explosive recovery in credit.

In every 12-page issue, you'll find some of the best securities analysis this side of Omaha, Neb.—as well as astute observations on interest rates, the credit markets and currencies (including the legacy currency, gold). In the way of the hedged investor, we look for securities to sell short as well as those to buy and hold.

If you would like to sample a complete issue before subscribing, just log on to our Web site at, **grantspub.com/0212J.** But please do subscribe. The past 29 years have been more than I ever dreamt of way back in 1983. But, I have every confidence that the next 29 will put them in the shade.

Sincerely yours,

Jim

James Grant

P.S. Subscribe by May 31, 2012 and I'll send you an autographed copy of either the recently published sixth edition of Graham and Dodd's classic "Security Analysis" or "Mr. Speaker! The Life and Times of Thomas B. Reed, The Man Who Broke the Fillibuster." Your choice. If those are already in your personal library, we offer instead, a reproduction of the classic ***Grant's*** cartoon, "By God, I remember when interest rates <u>were</u> interest rates." shown on the inside back cover.

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They ask for nothing

(January 27, 2012) Last week, the U.S. Treasury auctioned 10-year inflation-protected notes at a 0.046% negative real yield, while Her Majesty's Treasury issued four-year conventional notes at a 0.893% nominal yield. Twelve-month T-bills denominated in dollars and yen fetch 10 basis points and 12 basis points, respectively, while the German government, borrowing for the same 12 months in a currency that may or may not be around in the next 12 months, pays 13 basis points.

Nothing percent is the topic under review. The opportunities to earn nothing in securities denominated in unredeemable scrip, i.e., today's paper money, is one point of focus. The theory of investments returning nothing is another. The contribution of central banks to nothingness and the special case of zero-yielding Japan are others. In preview, *Grant's* is bearish on nothing, bullish on more than nothing.

Seekers after no return—except for the always welcome return of principal—don't have far to look. Money market funds are a rich mine of zero-percent opportunity. Whether it's government funds, prime funds or tax-exempt funds, the return on offer is one basis point or—at a stretch—two. According to the Money Fund Report, $2.692 trillion is self-incarcerated at those non-rates. For any who are unwilling to accept one or two basis points but still refuse to accept, for example, 351 basis points available on the common dividend of Johnson & Johnson, the U.S. Treasury yield curve presents many choices, including the two-year note priced to yield one-quarter of 1%. In times past, bond salesmen talked about how much a security yielded. Now they talk about how little.

"In this market environment, Treasurys prove to be of unprecedented value," the *Financial Times* quoted a sell-side analyst as saying on Friday. If "unprecedented" means what it seems to mean, the analyst makes a novel case. He is saying that a dozen basis points of return in 2012 trump more than a dozen full percentage points of return at the tail end of the great bond bear market of 1946-81.

"He says," said the *FT*, trying to explain, "Treasurys give investors an option at a time of great uncertainty by deferring an investment decision on the riskiest assets such as equities." Only consider the two-year note, the analyst himself continued: "Two years from now, we will find ourselves in a completely different market environment, in which banks, hedge funds and other participants play a different role, new security products are traded and relative value opportunities may exist in a currently unknown form and shape. Surviving until then is key. Treasurys help you do so."

"By God, I remember when interest rates were interest rates."

For ourselves, we repeat the wise words of the investor Joe Rosenberg, as quoted in the Dec. 5 *Barron's*: "You can have cheap equity prices or good news, but you can't have both at the same time." For the patient and not overly leveraged investor, trouble is a friend, provided it isn't cataclysmic. Do today's troubles qualify? Or are they the kind—troubles with a capital "T"—that will make prophets out of the nothing-percent bulls?

A century ago, Congress convened hearings to expose the concentration of financial power among the big New York City banks. Under questioning, one of the witnesses, George F. Baker, 72-year-old chairman of the eminently solvent and profitable First National Bank of New York, admitted that too many financial resources were probably controlled by too few private hands. However, he went on, "In good hands, I do not see that it would do any harm. If it got into bad hands, it would be very bad."

The interrogating lawyer, Samuel Untermyer, seized on that concession. "If it got into bad hands," he asked hopefully, "it would wreck the country?"

"Yes, but I do not believe it could get into bad hands," Baker replied. And presently he added, "I do not think bad hands could manage it. They could not retain the deposits nor the securities."

This was in 1912, two years before the Federal Reserve opened for business, 21 years before the founding of the Federal Deposit Insurance Corp.

(Continued on page 2)

(Continued from page 1)

and 59 years before the jettisoning of the last remnants of the gold standard. It was 70-odd years before the enunciation of the doctrine that some American banks are too big to fail.

In the world in which Baker and J.P. Morgan did business, "bad hands" couldn't successfully compete. Today, if employed by a too-big-to-fail bank, bad hands can flourish. Governmental dispensations like unchecked money printing and the zero-percent funds rate help them over the cyclical rough patches. However, to subsidize something is to get more of it. Subsidies to bad banking have materially increased the number of bad banks. These are the sunshine institutions, solvent in the booms, needy in the busts. In Europe, cyclically solvent banks must number in the hundreds.

You can infer as much by the enormous bulge in lending by the European Central Bank. When governments not led by Angela Merkel lost the market's confidence, so did the banks that owned those governments' notes and bonds. Standing on their own, the suspect institutions couldn't fund themselves. Tellingly, interbank lending virtually stopped—the bankers knew all about each other. The not-needy banks implemented their own nothing-percent trade by depositing excess cash in the ECB rather than risking it in the wholesale funding markets. As for the needy banks, to borrow Baker's phrase, "they could not retain the deposits nor the securities."

We Americans wake up dreading to hear the news from across the pond because Europe's crisis hits home. It's the crisis of the welfare state of credit. If the system of heavy public borrowing financed by fiat currencies and semi-socialized banking is doomed, what about us? It's our system too. Here, at least, the overused phrase "systemic crisis" is actually descriptive.

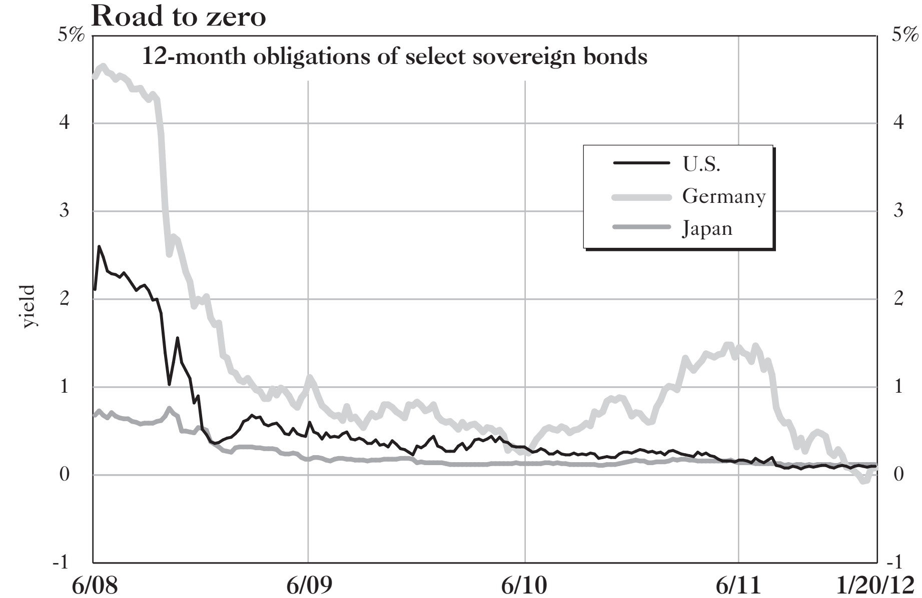
In December, the ECB extended €489 billion in three-year loans to more than 500 European banks against an encyclopedic list of eligible collateral. "Long-term refinancing options"—LTROs to the cognoscenti—is the name of this massive monetary initiative. On Jan. 20, the ECB's balance sheet footed to €2.706 trillion, up by 37% from a year ago. Over the past three months, the assets of the ECB have been growing at an annual rate of 90%.

Italian banks availed themselves of the ECB's accommodation more than the banks of any other euro-zone nation, and Monte dei Pacshi di Siena was the most eager Italian borrower of them all, based on its takings as a percentage of 2012-13 funding requirements. According to an excellent new Morgan Stanley study of the situation ("Don't underestimate the impact of the LTROs," dated Jan. 18), MPS secured 100% of this year's financing and most of next year's, €10 billion altogether. "The oldest surviving bank in the world," as management characterizes the 540-year-old institution, survived the Great Recession with the help of a €1.9 billion infusion from the Italian government. It may be said that MPS is not (and possibly never was) a purely capitalist institution, its founding charter providing for loans to "poor or miserable or needy persons." Yet it may also be said that any crisis that can rock the oldest surviving bank to its ancient foundations tells you something about the quality of banking in the era in which the crisis occurred.

LTRO isn't, and couldn't be, the cure for our manifold sins and suffering. A taker-upper of a three-year loan from the ECB pays just 1%, it's true, while short-dated Greek debt fetches as much as 392%. But the borrowing bank is under no regulatory obligation to commit its ECB-dispensed funds to purchase Greek, Italian or French debt. "Even if the banks do find the 'carry trade' enticing at the February three-year LTRO," write the Morgan Stanley analysts, "they will have little incentive to buy bonds beyond a three-year average maturity (e.g. could include some five years in the mix but unlikely 10 years). It also leaves open an intriguing question of who will buy euro sovereign bonds beyond the 'sugar highs' of the December and February three-year LTROs. It may mean beyond February more bearish trades should be put back on in the sovereign curves. We still expect that the ECB will cut the Refi rate by a further 50 basis points during the spring; and will probably need to step in during the summer with full-blown QE (direct buying of government and corporate debt). It may be that a Greek restructuring calls for a quicker need to backstop Italy and Spain with greater vigour."

However, in the absence of the Bakers and the Morgans and the gold standard under which they operated, someone had to do something. In 2012, Morgan Stanley estimates, €470 billion of senior unsecured debt falls due. In no economy is a systemwide banking collapse a mere footnote. In Europe, where 80% of the credit is drawn from banks, the authorities would move heaven and earth to forestall such a disaster. The relatively undeveloped state of the capital markets (and the absolutely impoverished state of the labor market, with the euro zone unemployment rate standing at 10.3%) make imperative a clear and functioning "bank lending channel," as the cognoscenti also say. Next month comes a second round of LTROs, which may

Road to zero



source: The Bloomberg

And more where that came from

source: European Central Bank

elicit borrowings of €400 billion or more, possibly much more.

Note, please, the matter-of-fact tone of the just-quoted Morgan forecast concerning a radical acceleration in the ECB's already muscular rate of credit creation. Clearly, the ECB is a misunderstood institution. Though politicians complain about its alleged reluctance to go all-in on monetary ease, the ECB has actually pursued through other means the kinds of policies identified with the Fed and the Bank of England. Eschewing QE, it has instead performed LTROs. It has created the purchasing power with which the Continent's used-up commercial banks can buy sovereign debt, rather than—as would occur under QE—the central bank buying that debt outright. But the effect is the same. New liquidity and new credit are brought into the world but without—a key point—a corresponding increase in new goods and new services.

Taking as it does a conservative, shall we call it, approach to money and banking, this publication sometimes glides too easily over mainstream 21st-century doctrine. In the matter of central bank policy, the view of many an established and thoughtful practitioner is that the Ben Bernankes and Mario Draghis should keep printing, that no harm will come if they do but that great harm may result if they don't, that harm taking the shape of a deflationary depression.

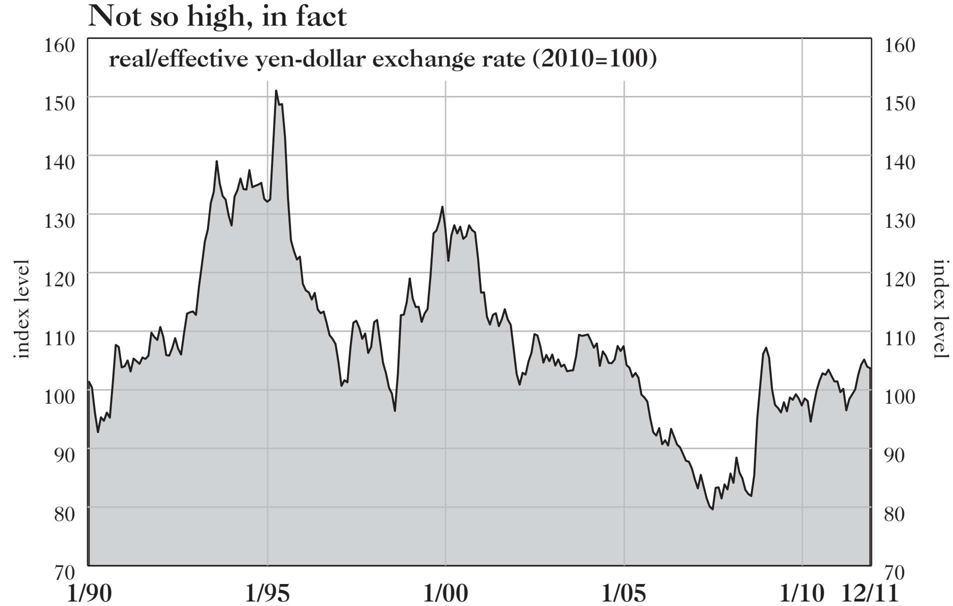
Willem Buiter, chief economist of Citigroup, is one of these modern thought leaders. "Potentially infinite money creation is clearly inflationary," Buiter, a former member of the Bank of England's Monetary Policy Committee, acknowledges in a Sept. 9 report, "but as we have argued before, even the non-inflationary loss absorption of the ECB/Eurosystem—assuming that its money creation will not exceed the level consistent with the ECB's price stability mandate—is likely in the range of €3 trillion. Since we take the ECB's commitment to price stability seriously, we regard these €3 trillion rather than infinity as the right constraint on the institution's potential contribution to the resolution of the euro area's sovereign and banking crises."

Since that writing, the ECB has created €620 billion. And without alarming the economics department of Citigroup, the Bank of Draghi may materialize 2.4 trillion more euros. Insofar as the Citi economists speak for the others—and Citi is usually not in the vanguard of radical opinion—the ECB might only have begun to print. We reason that the looming euro zone liquidity crisis is over for the time being. The euro zone banks will get both funding and forbearance. There will be more than enough euros to go around.

Reasoning in this fashion, we conclude that the nothing-percent trade is yesterday's big idea. As the world comes to accept that a euro zone banking crisis is off the menu of immediate risks, there could be a shift, if not a stampede, into assets yielding more than nothing. We thus restate our preference for cheap equities over the non-yielding alternative. Cheap gold-mining equities seem especially attractive, given the habitual central bank response to meeting crises with new emissions of paper.

It may not be easy persuading the bulls on nothing that something is, in fact, more remunerative, even safer. Japanese sovereign debt, a mainstay of the worldwide stock of non-yielding assets, came in for a downgrade to double-A-plus from triple-A by

Not so high, in fact



source: Bank of Japan

the domestic ratings agency, Rating and Investment Information, on Dec. 21. But the announcement made no waves in the immense placid sea of nominal-yielding JGBs. "Noise," was the reaction to the demotion by the Nomura chief investment strategist. Now comes word that, as of Sept. 30, ownership of Japanese debt by non-Japanese residents stood at a record ¥75.7 trillion, or $974 billion, much of which, according to the *Financial Times*, was in the form of zero-percent-yielding T-bills. "[I]t is understandable," the *FT* reported, "that foreign money-market funds would seek shelter in a market where bids are almost always at least twice the amount offered, and where the views of credit rating agencies seem to have no effect on prices."

It is not so blindingly understandable to anyone who appraises the value of short-dated Japanese paper based on Japan's ratio of debt to GDP (an estimated 233% last year, as against 100% for the United States and 83% for Germany), never mind by nonexistent nominal Japanese yields or by the unfavorable trend in the Japanese current account. But the stockpiling of yen-denominated scrip becomes more than comprehensible to a bull on the Japanese currency—notably, to a yen bull who happens to be a Japan bear.

One investor who fits this unusual description is Hugh Hendry, chief investment officer of Eclectica Asset Management, London. Having made its mercantilist bed, Hendry contends, Japan must now lie in it. For almost a half century, the Japanese private sector has been accumulating non-yen assets. Today, it holds a pile of non-yen claims equivalent to a year's Japanese GDP or more, i.e., on the order of at least $5.9 trillion. And handy it is in times of trouble—say, in the wake of the Lehman bankruptcy, or of last year's tsunami and earthquake. However, the very act of repatriating dollars or euros tends to elevate the yen exchange rate, which is exactly the opposite of what Japan's exporters want. It's an exquisitely ironic problem, Hendry relates: the more foreign exchange the private sector brings home, the more the yen tends to appreciate, and the less price-competitive the very same private sector becomes.

At 77.7 yen to the dollar, Hendry proceeds, the currency only seems uncomfortably high. In fact, it traded near that level in April 1995 after the Kobe earthquake. If the exchange rate had merely reflected Japan's superior inflation record from that day to this, yen/dollar would be quoted in the 50s today. And it will, Hendry predicts, finally trade in the 50s or 60s, at which crisis level the lights will go out in Japanese industry.

But, in response to the implosion of Japanese automaking, steelmaking and chemical manufacturing, the lights will go on at the Bank of Japan. Only at such an acute level of exchange-rate-induced pain, Hendry says, will the Japanese authorities show the world how QE is really done. Then, and only then, will the bear market in the Japanese currency and in the Japanese bond market begin in earnest.

And perhaps, at that interesting juncture, the nothing-to-maturity trade will finally and definitively turn unprofitable.

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How the bond vigilantes got fat

(December 2, 2011) Failure of a German government debt auction on the Wednesday before Thanksgiving launched a thousand tweets. Ah, said the bold ones who presume to speak for Mr. Market: The vigilantes will work their will on the Germans as they have already done on the Italians, Spaniards and Greeks. Avenging creditors will restore good order to public finances of Europe.

We write to correct that interpretation as well as to offer an alternative. In fact, the record persuades us, what the "vigilantes" want isn't old -time religion but low, low funding costs. Balanced government budgets are what they are heard to demand, but quantitative easing and Operation Twist are what they actually desire. Very heaven, for the 21st-century vigilante, is a central bank-pegged bond yield overlaid on a purely nominal money market rate. Perfection itself is a central bank chief who drops broad, periodic hints (in private, of course) about the future direction of interest-rate policy, as, indeed, *The Wall Street Journal* last week revealed that Chairman Bernanke is wont to do.

This publication's expectation remains the same: the bondholders will come to rue the very things for which they now agitate. Leverage will bury the speculators. That will happen all of a sudden on a date nobody knows. Inflation will—at a more deliberate pace—lay low the investors.

If memory serves (which it does about once every three weeks), the economist Ed Yardeni coined the phrase "bond vigilantes" in the mid-1980s. Recall, please, that the bond-holding constituency had been through the mill. Between 1946 and 1981, long-dated Treasury yields had climbed to 15% from 2.1%. To not a few investors, 6% had seemed a well-nigh irresistible rate of return; this was in the year 1969. When, 12 years later, the market reached the snow-capped summit of 15%, even the remnant of surviving bulls was gasping for breath.

Looking backwards, one can see that the bear market ended in 1981; it's an historical fact. In 1981, however, squinting forward with about 35 unhelpful years of bearish memories to try to put aside, one couldn't be sure, and the bond bulls walked on tiptoe. Who could positively warrant that a new inflation might not come along to push yields to even higher record elevations? Not even Paul Volcker himself could satisfy the doubters. It was at this juncture—call it 1985, with the long bond still yielding 11%—that the vigilantes bared their teeth.

Never again would they submit to being robbed through the agency of a great inflation, they vowed. Never again would they allow the Treasury to borrow at inflation-adjusted interest rates of less than zero. At the first sign of fiscal or monetary backsliding, they would lift real yields to heights that would stop the economy cold. The politicians, begging for mercy, would make the appropriate policy adjustments. Such was the vigilantes' creed.

Occupy Wall Street should have been alive to see it, because the vigilantes did—briefly—have the establishment paying obeisance. James Carville, adviser to President Bill Clinton, famously quipped that, if reincarnation were possible, he would come back as the bond market, because he would then hold the whip. But time passed, yields plunged and the vigilantes forgot—or they retired on their bond bull market earnings and played golf. By early 1993, the 30-year Treasury fetched a mere 6.82%, even as the federal deficit swelled to 3.9% of GDP. Compare and contrast the year 1981, when yields were twice as high even as the deficit was just two-thirds as large. The cartoon on this page, reprinted from the issue of *Grant's* dated Jan. 29, 1993, depicts the beginning of the transformation of the one-time guardians of sound money and fiscal integrity into today's easygoing yield slurpers.

Remarkably, in the United States—impossibly from the vantage point of the original bond vigilantes—the federal budget deficit is coming in at upwards of 10% of GDP while real yields are negative. As against a 3.5% year-over-year rise in the October CPI, the 30-year U.S. Treasury bond fetches less than 3%. In the U.K., a 5% inflation rate compares to a 3.04% 30-year rate. In the wake of last week's failed German auction, 10-year gilts traded through bunds. Astoundingly, debasement-prone Britain has become a port in a monetary storm.

Of course, you will hear, there are extenuating circumstances. An historically weak currency may prove a better short-term bet than a possibly doomed currency. The risk of a debt-induced deflation is more immediate than the threat of a persistent, significant inflation, no matter what the CPI may currently read, the bond bulls say. At the kind of inflation prevailing in Switzerland, for instance—that would be minus 10 basis points—inflationphobes would grasp at Treasurys the way Black Friday shoppers lunged for $2 Wal-Mart waffle irons.

Those who wait for the storied vigilantes of yesteryear have so far waited in vain. The fixed-income hooligans who disrupted the German auction weren't proper vigilantes, Seattle money manager Bill Fleckenstein observes. They, or their cross-channel brethren, bought gilts even as they sold bunds. "No more inflation!" cried the vigilantes of yore. "Anything but deflation!" cry the vigilantes of 2011.

Muscular monetary ease is the way to the heart of today's creditors. Thus, the Swiss National Bank's campaign to cheapen the franc against the euro has coincided not with a sell-off in Swiss government securities but with a stiff little rally.

The central bankers of Zurich made a clean breast of their intentions in September. They would, they said, permit no export-killing strength in the Swiss franc but would enforce a rate of 1.2 francs to the euro (vs. the 1.03 quoted before the intervention). In a Sept. 6 press release, the SNB said it was "aiming for a substantial and sustained weakening of the Swiss franc. . . ." It would enforce this rate, the SNB went on, "with the utmost determination and is prepared to buy foreign currency in unlimited quantities. . . . If the economic outlook and deflationary risks so require, the SNB will take further measures." In July, before the central bank promised to print enough francs to suppress the franc against the euro, the Swiss 10-year note fetched 1.36%. Today it's quoted at 0.88%.

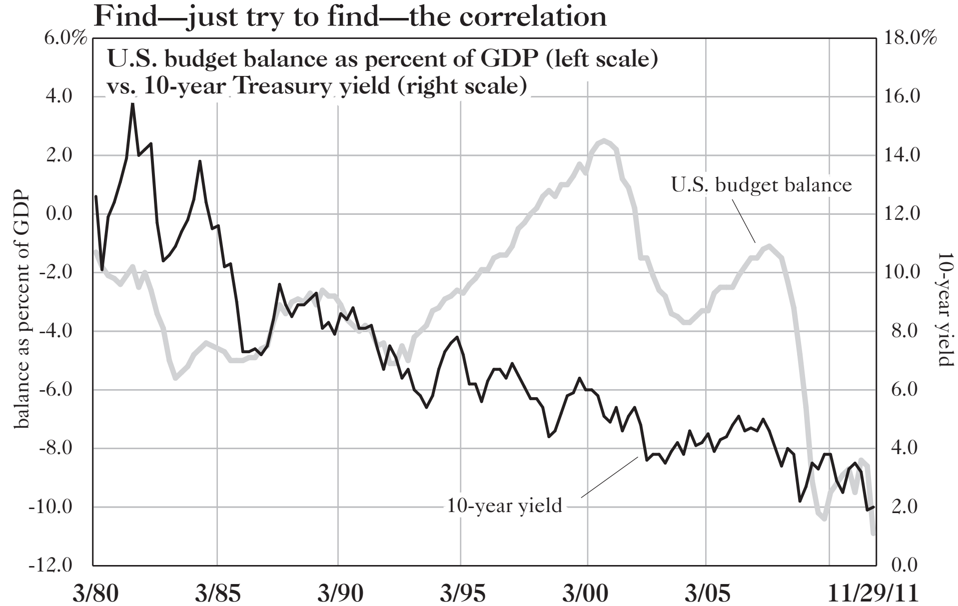
Debasement has been the one-word story line of the sterling-denominated debt markets since Britain left the gold standard in 1931. However, with the raging crisis on the Continent, the past is either forgiven or forgotten. Today's narrative is that of a central bank determined to keep deflation at bay—even in an environment of 5% inflation.

"Make no mistake," said Adam Posen, a member of the Monetary Policy Committee of the Bank of England in a Sept. 13 speech, "the right thing to do now is for the Bank of England and the other G-7 central banks to engage in further monetary stimulus. If anything, it is past time for us to do so. The economic outlook has turned out to be as grim as forecasts based on historical evidence predicted it would be, given the nature of the recession, the fiscal consolidations underway, and the simultaneity of similar problems across the western world. Sustained high inflation is not a threat in such an environment, and in fact the inflation that we have suffered due to temporary factors in the U.K. is about to peak. If we do not undertake the stimulative policy that the outlook calls for, then our economies and our people will suffer avoidable and potentially lasting damage."

So far, the gilt market is putty in the central bank's press-cranking hands. When, on March 3, 2009, the Bank of England undertook its first adventure in quantitative easing, 10-year gilts fetched 3.36% as against a year-over-year inflation rate of 2.9%. Today, four QE installments later, the 10-year is quoted at 2.23%.

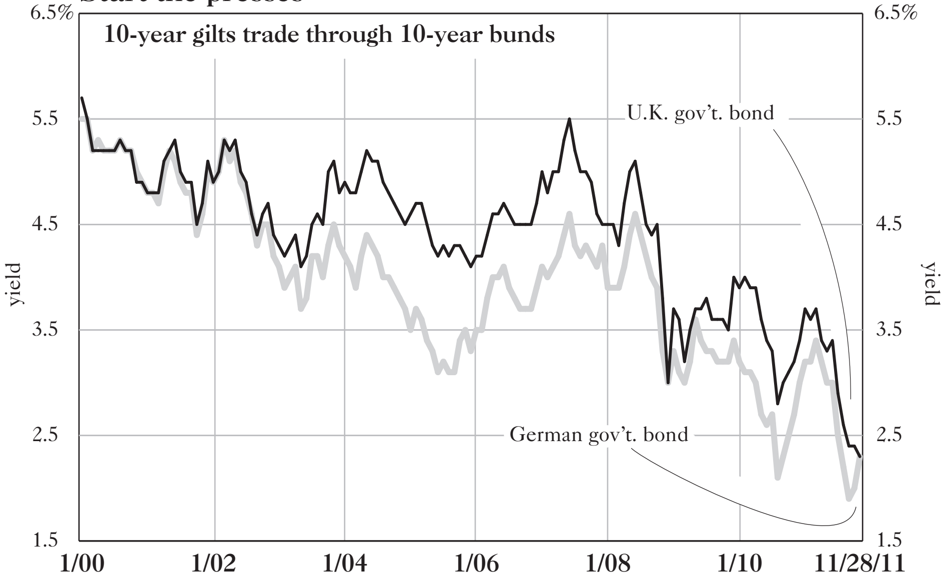
Our central bankers are neither arrogant nor unaware (well, most of them). They've heard about the 1970s, even if they weren't of money-printing age in that inflationary decade. "We have to accept," the SNB acknowledged as it vowed to print francs, "the fact that the costs associated with [the radical new policy] might be very high." And in remarks the other day, Martin Weale, another member of the Bank of England's Monetary Policy Committee, observed that gilt yields have fallen

Find—just try to find—the correlation



source: The Bloomberg, Office of Management and Budget

Start the presses



source: The Bloomberg

to levels not seen since the close of World War II, i.e., at the start of what proved to be a 35-year bond bear market. "Indeed," said Weale, referring to the long-dated British sovereign bonds, locally known as "stock," that impoverished a generation of British savers, "with the price of 4% Consols above par and the price of $3\frac{1}{2}$% War Stock . . . only just below par, it is hard not to wonder whether these venerable stocks themselves will be casualties of our current circumstances."

What Weale is describing is what the investor Paul J. Isaac has called "return-free risk." Ground-hugging yields afford no margin of safety, yet still they tumble, rising public deficits and swelling central bank balance sheets notwithstanding. There is, of course, a notable exception to the trend to lower sovereign debt yields, and that exception is the euro zone.

To listen to the market and the politicians (all except the German ones), the simple solution is interest-rate fixing, the socialization of banking risk and QE. The old vigilantes would strain to believe it, but yesterday's sin has become today's virtue. What nearly everyone seems to think is what Tuesday's *Wall Street Journal* asserted, namely, "The European Central Bank has showed no signs of abandoning its conservative approach to buying government bonds in recent days." The truth is that the ECB appears "conservative" only in comparison to the policies implemented by the Federal Reserve, the Swiss National Bank and the Bank of England. It has, since year-end 2010, expanded its footings by 21%, to €2.4 trillion. Over the past three months, its balance sheet has grown at an annual rate of 77%. "We are aware," the new ECB president, Mario Draghi, told an audience in Frankfurt on Nov. 18, "of the current difficulties for banks due to the stress on sovereign bonds, the tightness of the funding markets and the scarcity of eligible collateral."

As of May, the ECB's list of eligible collateral comprised 28,708 securities with a value at year-end 2010 some 50% greater than the 2010 GDP of the 17-nation euro zone. Since May, the eligible list has expanded to 29,350 names. Question: Would it not be simpler to publish an ineligible list? Then, again, as noted in these pages one issue ago, each of the 17 national euro-zone banks is free to lend against any collateral it wishes. No system-wide disclosure of such so-called Emergency Liquidity Assistance operations is available, though two of the more opaque line items on the ECB balance sheet—"other claims on euro area credit institutions denominated in euros" and "other assets"—have risen by €106.3 billion to €430.6 billion since the end of last year.

Once upon a time, the Bank of Italy might have engineered a decline in Italian government yields by tightening policy. Now, to listen to the hubbub of the new vigilantes, the ECB must save the Italian bond market by creating still greater volumes of euros. Heeding its critics, President Draghi will materialize this money from the very same thin air from which Chairman Bernanke plucks dollars and Governor King conjures pounds sterling. For ourselves, we hew to the doctrine that the place in which you find real money is a mine.

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Billions buy beans

(January 14, 1994) It has not gone unnoticed in bondland that the Chinese and the Indians and the Russians outnumber the Americans, that Chinese wages are lower than the developed world's wages or that the Third World is growing faster than the first. The consequence of these facts is alleged to be an even purer state of financial prosperity in the developed world in coming fiscal quarters: fatter corporate profits, lower interest rates and a leaner and more grateful and even more anxious American work force.

For ourselves, we have been wondering if the bulls haven't overlooked one important detail. The most vital fact about the newly employed industrial masses of the Third World, we think, is not that they are paid less than the average North Carolinian (much less, there can be no doubt: The new minimum wage set to take effect in Shanghai next July amounts to the princely sum of 10 cents an hour). It is that they are employed at all. Finally earning a nonagricultural wage, millions of people will consume more protein. They may buy extra cotton shirts, environmentally incorrect packaged foods and air conditioning. In the former U.S.S.R., in the wintertime, they may acquire heat.

In short, we have been thinking, the economic enfranchisement of hitherto undernourished, underclothed and underhoused people constitutes not merely a threat to the Western world's relatively high wages. It also holds a potential stimulus to the prices of raw materials.

Raw material prices are at low ebb, last year's rally in the Commodity Research Bureau index notwithstanding. The bear market in things has been under way for decades, and the long-term trend in inflation-adjusted, non-energy commodity prices is actually a negative number: minus 1.5% a year, according to calculations by the World Bank. The 1993 data have not been compiled, but the discount of 1992 prices to the long-term price trend, reports a World Bank consultant, E. Mick Riordan, is the greatest since the late 1940s.

Other sightings suggest similar conclusions. Thus, for instance, at yearend the Goldman Sachs Commodity Index was valued at 13% below the weighted cost of producing the component commodities (about half of which are energy-related). According to Ravi Bulchandani, a Goldman Sachs commodity analyst, the discount, index price to estimated index benchmark costs, is one of the steepest on record.

As for the grain-laden CRB index, over the past two decades it has gone approximately nowhere, even in nominal terms. In real terms, of course, it has gone to hell on an elevator. From the late 1950s to the early 1970s, the CRB traded around 100. In 1973, it went to 200, and in 1980 it went to 300 (in point of fact to 337.60). On Monday, it was closing in on 225 but from the wrong direction, i.e., from 226. The 1993 rally- from 200 to a little more than 225 - was therefore, when viewed over the longer term, the merest tick.

For a dozen years or so, commodity prices ha-'e been the mirror image of bond prices. It has been the destiny of things to fall, investors understandably have come to believe, and of securities (almost any securities) to rise. Even the commodities that do go up do not impress old hands. Cocoa, for example, has staged a rally to about $1,100 a ton from about $900 a ton last summer. It is a hefty move in percentage terms but a nonevent in historical ones. On a spike in 1977, cocoa was quoted at more than $4,900 a ton; for one shining moment in 1954, it fetched $1,423 a ton. In the 20th century, 40 years is a long time for the price of anything to make a round-trip.

Even the most bullish holder of the U.S. five-year note may therefore entertain a qualm about this long-running commodity bear market. Given that Third World stock markets have been levitating and Third World economic growth has been accelerating, shouldn't Third World aggregate demand keep on rising? To put a finer point on the same question: What would happen to the aluminum market if one billion Chinese learned to drink Coca-Cola?

John Crawford of this staff has projected some utopian possibilities. If China and India had drawn down as much aluminum last year as Taiwan did, per capita, for example, they would have consumed 28 million tons.

To put that in perspective, estimated worldwide aluminum production in 1993 amounted to 15 million metric tons. Even more strikingly bullish results pertain for copper (43 million metric tons of hypothetical consumption vs. nine million metric tons of estimated actual production) and zinc (18 million metric tons of hypothetical consumption vs. 5.4 million tons of estimated production). In soybeans, parity with per capita Taiwan consumption would have lifted combined Indian and Chinese ingestion to 195 million metric tons. Estimated worldwide production, in contrast, was 117 million metric tons. Incidentally, actual average Chinese and Indian soybean consumption, 1989-91, is put at 11.6 million metric tons.

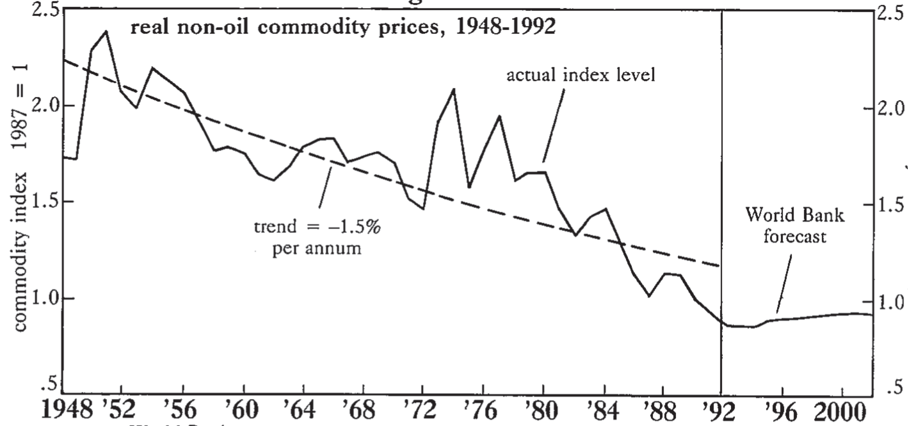
We extrapolate only to exercise the imagination. Concerning the objections that it took Taiwan 40 years to become Taiwan, that nothing like this kind of projected growth in commodity demand could happen in any meaningful investment horizon or that any number of bumps and detours are inevitable along the road to development, we strongly concur.

It is a truism that prices of renewableresources tend to revert to the cost of production. It is another law of the commodity pits that, thanks to strides in technology, production costs tend to fall. And as for the dream of a vast Chinese market, it has been dreamt by every American merchant since John Hancock.

The issue therefore is whether the prospective step-up in demand from the developing world is sizable enough to matter. Will the growth in demand outstrip the rise in available supply in a time of depressed commodity prices, thereby tending to set the stage for new bull markets? Yes, we happen to believe. Or, will growth in worldwide productive capacity - or even the red uction in worldwide waste and spoilage - overwhelm demand? Yes, said the experts with whom Grant's consulted. Even the ones who professed to be bullish on commodity prices actually sounded bearish.

At this very moment, anybody can compile a long list of reasons why Chinese growth is doomed: inflation is rampant, austerity is on the minds of the political rulers and scarcely hidden trade disputes may burst out into the open. The Hong Kong stock market may explode. Be that as it may, the world's poor have been getting richer for a long time. Vol. 1, No. 1 of Market:Basket, "The newsletter of global purchasing power," Ithaca, N.Y., published the accompanying graph, which depicts long-term trends in per capita GOP. The projections are not so much forecasts as scenarios, the editors caution, and they disclose the assumptions that support them: U.S. growth will continue to moderate; Japanese growth will converge on U.S. growth; and -

The bear market in things marches on

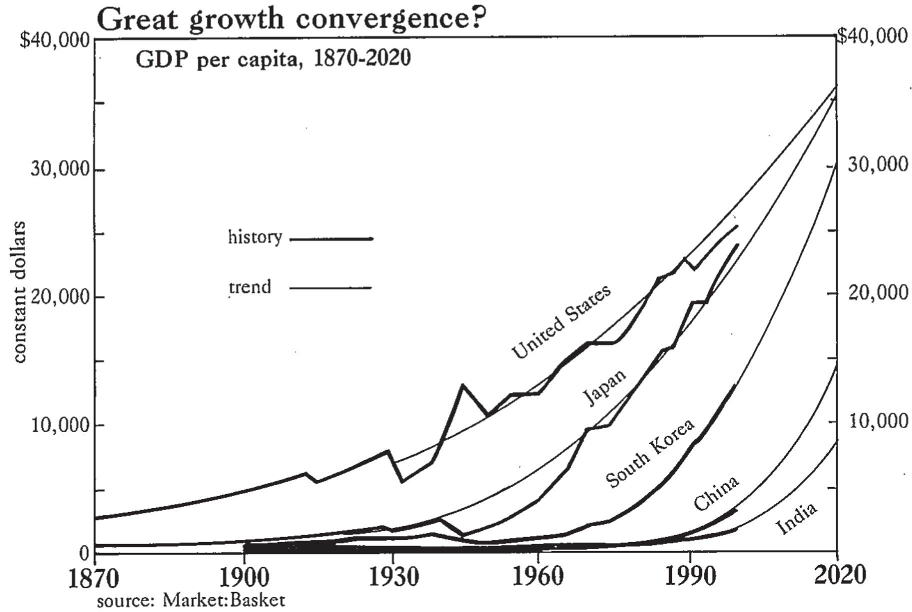


source: World Bank

most importantly - "China, and ultimately India, will follow fast growth curves similar to those patterned earlier by Japan and Korea. This growth will bring those huge economies into developed country status."

The basic demographic facts are startling and exciting, even to the people who have already heard about them. For every 100 persons living on the earth in 1990, five were American, five were from the former U.S.S.R., 10 were European (six of whom belonged to the European Community), 22 were Chinese and 16 were Indian. In 1990, the world's working population totaled 2.3 billion people, of whom 75% resided in developing countries. The developing-country portion has been steadily gaining. From 65% of the global labor force in 1950, it rose to 72% in 1980 and 75% in 1990. It is projected to rise to 78% by 2000 and 84% by 2025. "Developing countries will contribute about 97% of the increase in the world labor force between 1990 and 2025, while they account for 93% of total population growth," write David E. Bloom and Adi Brender in "Labor and the Emerging World Economy" (in the October 1993 edition of Population Bulletin). None of these facts has stopped the presses lately. China's per capita income has been growing by 6% a year since the late 1970s; coincidentally, commodity prices have also been falling since the late 1970s. Even so, for all the progress in India and China, those two populations, which constitute 38% of the world's citizenry, do not get enough to eat. According to USDA tabulations, India's estimated protein intake amounts to 36% of America's; China's, to 42%. "Empirical analysis," comments the USDA, lending a hand to common sense, "has shown that household income growth not only results in increases in food budgets, but is also often accompanied by changes in the types of foods selected by consumers. Consumers' diets tend to shift from heavy reliance on 'starchy staples' ... towards those containing more animal products, fats, oils, sugar, finer grains, as well as more highly processed foods." In other words, towards soybeans (among other edible and tradable things).

One can imagine, but not exactly quantify or schedule, a complex eddy of market forces in the years to come: rising incomes propelling rising de-



mand, met by (or not quite met by, as we happen to think) rising supply in both agricultural and industrial products. The issue is whether a world so long accustomed to falling commodity prices will easily adjust to the possibility of a change. The consensus of expert opinion, as noted, is that it can and wilL

According to Donald O. Mitchell, senior economist, the World Bank: "The quasi-collapse in the former Soviet Union and Eastern Europe is going to take such pressure off the system, for at least the next decade, that we're in a basic commodity surplus period for probably the rest of this decade and maybe the next decade." Whereas these countries were formerly big food importers, they will become significant exporters. "So that's such a shift that it offsets what will be some fairly significant increases in the developing countries. So the bottom line is that there will be no pressure on commodity prices."

And from Rip Landes, USDA economist: "We have a hard time seeing the combination of events that lead to higher commodity prices, at least in the long term. In the short term, anything can happen. We believe pretty strongly, I'd say, that it'll be pretty much no problem for world agricultural supplies to expand adequately to meet projected demand without raising those commodity prices."

The World Bank, in fact, is on record with what it calls a bullish forecast but which any reputable brokerage firm would suppress as a very close thing to a "sell" recommendation. "Global Economic Prospects and the Developing Countries," published last spring, ventures that, between 1993 and 2002, "the prices of primary commodities are expected to be approximately stable in real terms, ending the downward trend of the past 20 years." The authors predict a rally in coffee and cocoa prices and a leveling- off of inflation-adjusted oil prices. Some food prices may work higher but the "prices of other commodities are unlikely to show any sustained recovery in real terms." They wind up this tepidly optimistic exercise with the unanswerable assertion that "commodity prices can be expected to remain volatile."

Interestingly, no assumptions about rising demand from the developing world underlie the bank's conclusions. They are, rather, based on hopes for the industrialized world (as well as on the assumption that production growth in such perennial crops as coffee and cocoa will continue to decline as the result of chronic bear markets). Perhaps the authors reason that the life cycle of an agricultural bull market is too short to be affected by a secular rise in Chinese protein consumption, or by a potential rise in Russian cocoa off-take. Or perhaps they believe, with the USDA, that there is more than enough arable ground, tractors, subsidies and working farmers to feed anyone in the world who can pay the price - a price that is very likely to be identical to that of the previous sale in almost any market.

For ourselves, we were bullish on things before we began this study of the developing world. Now, after absorbing the data and weighing the market sentiment, we are still more optimistic. Commodity prices are very low. Incomes are still very low but rising. Existing stocks of soybeans and coarse grains are strikingly low in relation to current usage. There can be no telling when hoped-for secular forces may collide with cyclical forces, which (as far as we can see) are bullish already. Perhaps, however, there is enough electricity in the air to set off a bullish spark.

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Destination: Big Board

(July 31, 1998) If all goes according to plan, the shares of a big, new, dividend-paying South African multinational will shortly begin to trade on the New York Stock Exchange. Strictly by the numbers—operating costs, earnings, debt, dividends, etc.—there would seem to be nothing not to like about this enterprise. Similarly, by the rhetoric: Management says exactly those things that managements are expected to say in 1998, up to and including the phrase "to multi-task workers in teams, through appropriate training interventions" (MBAs will understand). There is one fly in the ointment, however: The new company is in the gold business.

Anglogold Ltd., indeed, is the world's biggest gold producer and the owner of the world's biggest proven and probable gold reserves. Larger than Newmont Gold Co. (the second biggest producer), Gold Fields Ltd. (No. 3) and Barrick Gold Corp. (No. 4), it's the product of the consolidation of eight previously distinct South African mines owned by Anglo American Corp., including Vaal Reefs and Western Deep Levels (the subjects of a bullish review in *Grant's* last November 21). On Wall Street nowadays, consolidations, or "roll-ups," are all the rage. For the bull-market sportsman, there is even a publicly traded consolidation blind pool (ticker symbol: BUYR). It is tempting to speculate how much excitement a consolidation of these properties might have generated if they mined some other monetary asset besides gold—dollar bills, just to throw out an idea. As it is, Anglogold is valued at the equivalent of 2.3 times book value and at a trailing 12-month price-earnings ratio of 13.9. Lumping its minor debts together with its stock-market capitalization yields an "enterprise value," and the ratio of this enterprise value to cash flow (defined as earnings before interest and taxes) amounts to 10.7. The stock yields about 5.2%.

We turn to Anglogold, first and foremost, because a world currency crisis continues to unfold. It's just gold's luck that the currency not in crisis nowadays is the U.S. dollar. As equity investors have piled into Coca-Cola and its ilk, so have currency traders bought the Coca-Cola of monetary brands. However, we think, although the actual Coca-Cola Co. may be said to be an inherently strong business franchise, the dollar cannot be said to be an inherently strong currency. There is nothing inherent about it. The dollar, rather, is a currency that periodically exhibits relative strength and relative weakness. Nor is relative strength necessarily an unalloyed blessing when it does appear. The U.S. trade deficit is at a record in this congressional election year. Were the shrinkage of net exports to become a political issue, it is not hard to imagine the Clinton administration undertaking to move up the starting date of the next dollar bear market through some intervention. Thus, paradoxically, the dollar becomes a riskier store of value the higher its exchange rate, just as Coca-Cola becomes a riskier investment the higher its price (in relation to its earnings).

Last week, in what could prove a bellwether trade-policy event, the U.S. Commerce Department found that stainless steel rod that was sold in this country even before the Asian currency crisis had, in fact, been "dumped," not sold. It punished the offending Japanese and South Korean exporters by slapping stiff tariffs on them. Tariffs, being bad for the free flow of merchandise across national borders, must also be bad for the free flow of money. Maybe, the punitive tariffs levied against the Asian steelmakers were purely defensive on the part of the United States and ought not to be viewed as the start of anything. However, an outbreak of protectionism would certainly be bad for the dollar exchange rate. Thus, it would be correspondingly good for the dollar's competitors, including (as we continue to think) the ancient, shiny one.

Fundamentally, Anglogold constitutes a long-term play on a con-

North America vs. South Africa—Anglogold measures up[1]

	Anglogold	Barrick Gold	Newmont Gold
Annual production (mil.)	6.5oz.	3.1 oz.	4.0 oz.
Reserves (mil.)	140.0	50.3	52.7
Resources (mil.)	414.0	70.5	71.6
Cash costs per oz.	$249	$176	$184
Total costs per oz.	275	244	249
Current shares outstanding (mil.)	97.6	375.7	166.9
Market cap./reserves	$28.80	$131.60	$67.70
Enterprise value/cash flow[2]	10.7x	18.9x	13.9x
P/E ratio	13.9	NA	69.9
Dividend yield	5.2%	1.0%	0.6%

[1]most recently available data

[2]enterprise value defined as market cap. plus book debt; cash flow is earnings before interest and taxes

source: The Bloomberg

tingent and unpredictable event: the unraveling of the post-Bretton Woods monetary system. Yet, recalling that a rose is sometimes just a rose, we emphasize that the company is also an investment with some unusual attributes: good management, an imminent change in its trading venue and a high sensitivity to the gold price. As a rule in North America, a gold mine can be viewed as an option on the gold price that also happens to be an operating business (and an expensively valued operating business at that). Anglogold is an attractively valued operating business that also happens to be an option. Although wrong about the gold price to date, and vexed, your editor is confident that the bear market will end during his lifetime. To help the readers of *Grant's* to quantify this prediction, he is 52 years old and in good health. Also, to declare an interest, he owns Anglogold.

If you do, too, perhaps you're wondering where it's been to, and who sent it away. In late June, Anglogold's listing was moved from the Nasdaq Stock Market to the pink sheets. It might as well have been moved to Easter Island. On June 29, trading in the shares was inaugurated in Johannesburg, London, Brussels and Paris. Yet, in the United States, no quote is available except through a dealer. The company blames this peculiar and arbitrary disaster on the SEC. Asked if it was willing to take the fall, the SEC said it was not: A spokesman for the agency said that it had not done anything to cause the delisting.

Whatever its source, the blackout constitutes a useful reminder of the fact that another branch of the U.S. government has long been on the outs with Anglo American. De Beers, which has been charged by the Justice Depart-ment with restraining free trade, is a 38%-owner of Anglo American, and Anglo American is a 50.4%-owner of Anglogold. It is Anglogold's expectation that this old-time controversy will have no bearing on Anglogold's standing as a soon-to-be-listed New York Stock Exchange company. (The date is August 5, says the Big Board.) In any case, what may soon become the most liquid and institutionally accessible overseas gold investment has been invisible all summer long.

Fortunately, Anglogold has been better at near-term financial results than at investor relations. Despite the gold bear market, earnings for the six months ended June 30 showed an 82% jump, to \$163.5 million, or \$1.68 a share. There was a drop in cash operating costs, to \$247 an ounce in the six months from \$292 an ounce a year earlier.

The South African rand turned weaker against the dollar in May and broke decisively in June. The Anglogold share price promptly rallied (as rumor had it, the currency crisis erupted as the stock began its listing exile). As the South African mining companies incur rand-denominated costs but earn dollar-denominated revenues, a rand bear market is just what the doctor ordered (providing, of course, that it stops short of inflationary chaos in the home country).

"Because of very high margins," Bobby Godsell, the CEO of Anglogold, recently observed in an interview with the *Financial Times*, "the South African gold industry had become more of an engineering project than a business. It was about moving ground, it was about producing gold, consuming electricity and employing people." The fall of the gold price forced a revamping, and the collapse of apartheid helped to facilitate the necessary organizational adjustments. Thus, in the past five years, the head count at Anglogold has been nearly halved, to 85,000.

"Go to the average South African gold mine manager five years ago," Godsell went on, "ask him how much rock he moved, how much gold he produced, ask him about the grade and he will have these numbers in his head. Ask him about the profit or the dividend and he won't have them. That's the difference between a business and an engineering project. So we said: 'Guys, we don't care if we're the biggest gold miner in the world. We want to be the most profitable.'"

Indisputably, Anglogold has the most production: between 6.5 million and 7 million ounces a year, vs. roughly 4 million for the runner-up Newmont Gold. And, it owns the biggest body of proven and probable reserves: about 140 million ounces (not counting another 144 million ounces that, although classified merely as "mineable resources," may constitute the reserves of the future). Barrick and Newmont each control—very approximately—around 50 million ounces.

What Anglogold also owns is its share of the valuation legacy of the local mining industry. As a rule, the South African properties have traded at a discount to the leading North Americans. Political risk explains part of this penalty; the higher cost structures of the deep-level mines explains another; the relative obscurity and illiquidity of the shares explains still another. (Concerning political risk, Blake D. Hartill, a Florida-based gold analyst, makes a worthwhile point. Certainly, he points out, South Africa is not Nevada, Newmont Gold's principal home turf. "However, he goes on, "it should be recognized that Newmont has major investments in Indonesia, Peru and Uzbekistan.")

Reefs, Western Deeps, Elandsrand et al. had their own individual dividend policies and geological profiles. John Brimelow, director of international equities at Donald & Co. Securities, and a longtime analyst of South African mining properties, says that he wishes they had never lost them. However, he allows, "The fact of the matter is, it's an enormous ore body. And it's in operation. And if the gold price goes up, or if the rand continues to go down, or both, it'll crank out some money."

Brimelow contends that the motive behind the consolidation was to ape the promotional success of the giant North Americans. James Duncan, Anglogold's corporate communications contact, contends right back again that the reason for the new creation was to improve the stockholders' returns. And the means to the end of heightened profitability was the attainment of three "core objectives": (1) "restore the South African operations to an acceptable level of global competitiveness"; (2) "have some kind of a counter to the diminishing ore reserve problem in South Africa"; and (3) "come up with an investment vehicle that investors would be happier with."

The global competitiveness mission has centered on labor reform—overhauling the caste-ridden structures that were part and parcel of the old, apartheid-era regime—as well as on geological technique. This latter initiative has boiled down to the mining method called "high-grading," i.e., reducing costs by mining a better, richer grade of ore. Thus, in the six months ended last June, the Anglogold ore generated 0.226 ounces of gold per ton; in the year-ago period, the yield was 0.187 ounces per ton.

As for productivity, goals have been set for each mine, some based on value (i.e., grams of gold produced per employee), others on volume (i.e., square meters of ore moved per employee). The company has more and more linked compensation to output, rather than simply to showing up for work. And the management has taken to calling its mines "factories," hoping in that way to instill the gospel of productivity. A labor-relations breakthrough was achieved last year, according to Duncan, when workers earned a 10% raise in exchange for a predetermined increase in output. "We got the gold," Duncan tells colleague Joshua Kahn, "and our employees got their wage increase. That was very much a landmark for us." The sum total of these changes, managerial and geological, shines through in the decline in cash costs per ton (as noted, to $247 per ounce in the latest six months vs. $292).

Concerning the second grand objective, the replacement of expended reserves, Anglogold has been on the lookout close to home. "We have found a number of opportunities to 'take down farm fences,'" Godsell & Co. told a gold conference in Zurich last spring, "our expression for liberating ounces held captive in the ground by the rather peculiar, historical delineation of South African mineral rights by farm fences on the surface." Farther afield, the company is looking for gold in east, central and west Africa, and it is negotiating to buy the gold assets of Minorco S.A.

Which leads us to the third strategic objective, the creation of the ideal gold-mining investment. Possibly, such a thing is a contradiction in terms, the ideal gold investment having for many years been the short sale of bullion at almost any price. Certainly, it is a contentious objective, as the ideal gold investment depends in part on the level of conviction of the gold investor. About 18 months ago, Anglogold embarked on a kind of international investor-relations road tour. "And overwhelmingly," relates Duncan, "the message that we got back is, 'Give us one robust gold counter [i.e., share] that offers us growth and dividend flow rather than this miscellany of shares with differing profiles.'"

By the sound of it, the focus groups did not consist of goldbugs, whose idea of a robust gold "counter" is slightly different from that of the sizable population of non-goldbugs. For instance, a goldbug would regret the sale by Anglogold of some of its marginal, or low-yielding, mining properties in a way that a non-goldbug would not. To a goldbug, who holds out the hope of a much higher gold price *in his lifetime*, today's marginal dirt is likely to become tomorrow's profitable deposit. Be that as it may, one may ponder: If the gold business could be made to resemble the Internet business, why would anyone want a gold mine to pay a dividend? And if the gold business can never resemble the Internet business, what should the skeptical investor pay for growth? Necessarily, a gold mine is a wasting asset, and a collection of gold mines is a wasting business. Anglogold, if it continued to produce seven million ounces a year, and if it acquired no new reserves, would exhaust itself by 2018.

"The way I view it," says Harry Bingham, of Van Eck Associates, an observer so seasoned that he can actually remember the last gold bull market, "none of these major companies should be considered growth companies." Spurts in the rate of global gold production there have been (e.g., in the 1980s), and individual growth companies, there have been. However, as Bingham points out, the gold industry is not a growth industry. Nor should it be: It's the tendency of production to grow at a slow and steady rate that imparts to gold its unique monetary characteristics. The reason that it has served as money at all is because its value was relatively unaffected by short-term blips in supply. "Commodities are used for consumption," Bingham observes. "Unlike other commodities, gold is really produced for accumulation."

Still, as noted in our analysis last November, companies like Vaal Reefs somehow managed to achieve a functional immortality. That is not to say, however, that life extension comes for free. On average, breakeven costs are higher in South Africa than they are in North America; the South African mines are therefore more leveraged to the gold price than are the Barricks of the world. On the other hand, on average, South African mines are less leveraged in their balance sheets than are their North American cousins. Anglogold, specifically, has debt in the sum of $228.9 million, or 7.7% of capital. If you accept, as Bingham does and we do, the axiom that growth and gold are antithetical, it follows that one ought not to be paying much for growth in the share price. And the management of one's gold mining company ought not to be skimping on the dividends in the name of future production.

"I think all these companies should be paying out. . .a significant portion of their earnings in dividends," says Bingham, "which the South Africans do, because you are dealing with a wasting asset. The other theory is just a greater fool theory. If they don't pay dividends and just use all the earnings to develop new mines, that means they'll probably never pay dividends. So you'll never get anything out of it."

"Anglogold," Bingham went on, "probably won't pay out as much as they did before the mergers because now they are able to do some exploration beyond their lease areas. That's okay with me as long as it doesn't go to an extreme. I would think they'll continue to pay out more than half of their earnings."

What are the risks (apart from the possibility, never far from the gold bull's mind nowadays, of the bullion price returning to $35 an ounce)? "The negative is, it's South Africa," Bingham replies. And yet, the political change so much anticipated a decade ago has, by and large, occurred, he notes. "We've had the change," Bingham points out, "which didn't turn out to be as radical as it was expected to be. The ANC [African National Congress] claimed to be a socialist organization. In fact, their initial program was to nationalize the mines. Then they were going to nationalize the mineral rights. They haven't done either one of those.

In fact, if anything, they have been kinder to business than the old government. For example, allowing these mergers—that was never allowed in the past."

Finally, is Anglogold bullish or bearish on the thing it produces? It may not be as bullish as Bingham, Brimelow or *Grant's*. However, to judge by the size and structure of its hedge book, it isn't bearish. Thus, forward sales at June 30 amounted to $281 million, or the equivalent of less than 5% of proven and probable reserves. As noted last issue, there are mines (Kahn identified one in Australia) that have sold more than 100% of their reserves forward. And most of Anglogold's sales are short term. Therefore, if the price of gold should ever go up again—we rule out nothing in these pages—so will the shares of the world's biggest gold company.

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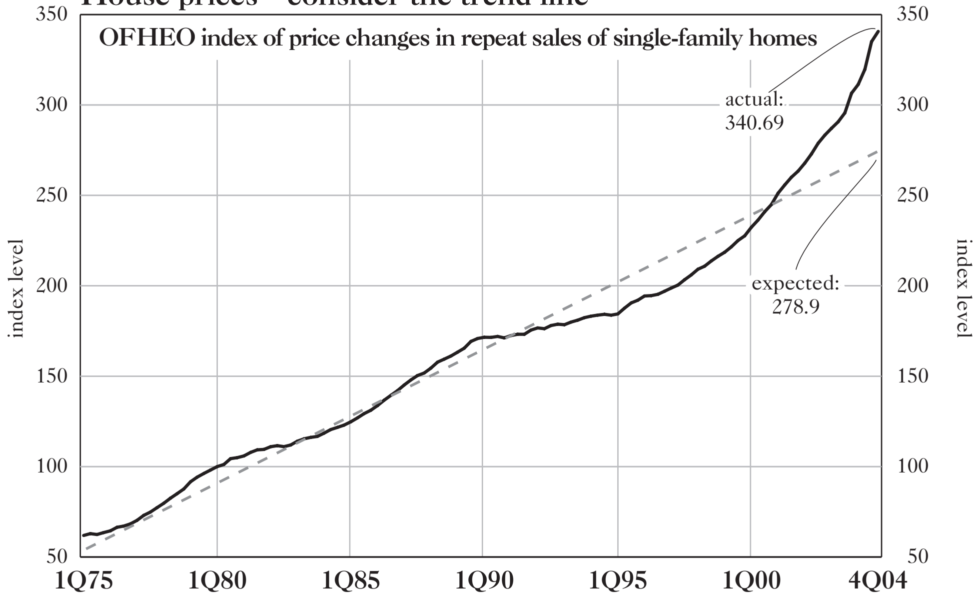
The 29th bubble

(June 3, 2005) "We don't perceive that there is a national bubble," Alan Greenspan, speaking about house prices, advised the Economic Club of New York the other day, "but it's hard not to see . . . that there are a lot of local bubbles." For what might be the first time in his life, the Maestro thereby staked out a genuinely contrary investment position. These days, bearishness on house prices has become an Approved Institutional Opinion, much like bullishness on almost everything else.

Following is a new contribution to the negative literature. We do not mean to be repetitive, or—worse yet—banal, and we believe we are not. One proof we offer is the title of an essay by the real-estate authority we are about to quote. It is: "Growth of Dolphins, *Coryphaena Hippurus and C. Equiselis*, in Hawaiian Waters as Determined by Daily Increments on Otoliths" (Fishery Bulletin, U.S. Department of Commerce, Vol. 84, 1986). Which other expert on U.S. house prices could make an even remotely similar claim? The author's view, and ours, is that, in residential real estate from Miami to Seattle, "bubble" is the word.

It's not a word just to toss around.

House prices—consider the trend line

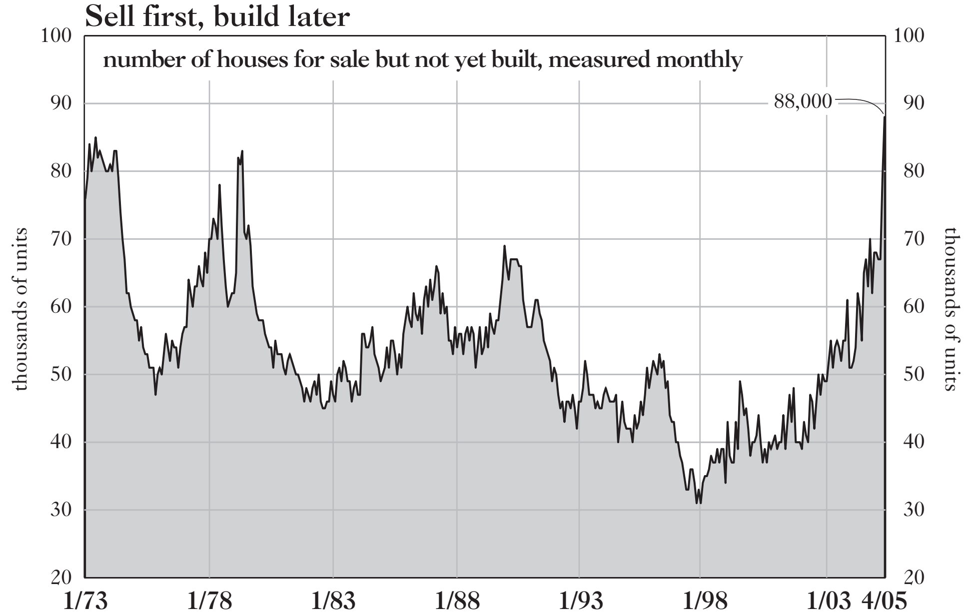


source: Office of Federal Housing Enterprise Oversight

A bubble market is one that goes way, way up, then comes way, way down. And house prices have gone way, way up—in April, the median existing home price showed a year-over-year gain of 15%. But they have not come way, way down. Indeed, the national average has not registered a broad-based decline in living memory. Since the 1930s, sideways is as bad as a bear market in American residential real estate has gotten (though there have been some ferocious localized declines). "[H]istory is definitive," pronounced the *American Banker* in a May 23 article on interest-only mortgages, "The national average price of a home may remain relatively flat for a number of years, but it doesn't fall." Let's see about that.

If the 2005 U.S. residential real estate market were in a bubble, and if prices did not subsequently fall, that would constitute a first. A bubble is a defined phenomenon; not just any frothy market makes the grade. According to the analysts at GMO, Boston, a bubble is a two standard deviation event, and they have identified

Sell first, build later



source: U.S. Census Bureau

only 28 of them since the Coolidge bull stock market.

Physicists rightfully smile at the pretensions of Wall Street's quants. But, in the matter of bubbles, the financial analysts may have discovered an actual law of nature. In 27 of the 28 cases, according to GMO, sky-high prices eventually returned to earth, frequently making a small crater as they landed. The one known outlier is the 28th and current bubble, the S&P 500, which would have to fall to about 750 to revert to the mean (it closed Tuesday at 1,192). "Have to fall," in fact, is not quite accurate. By trading sideways for a decade or so, the S&P might revert to trend with a whimper, not a bang. So, the question that should absorb us all: Are U.S. house prices in that kind of a market?

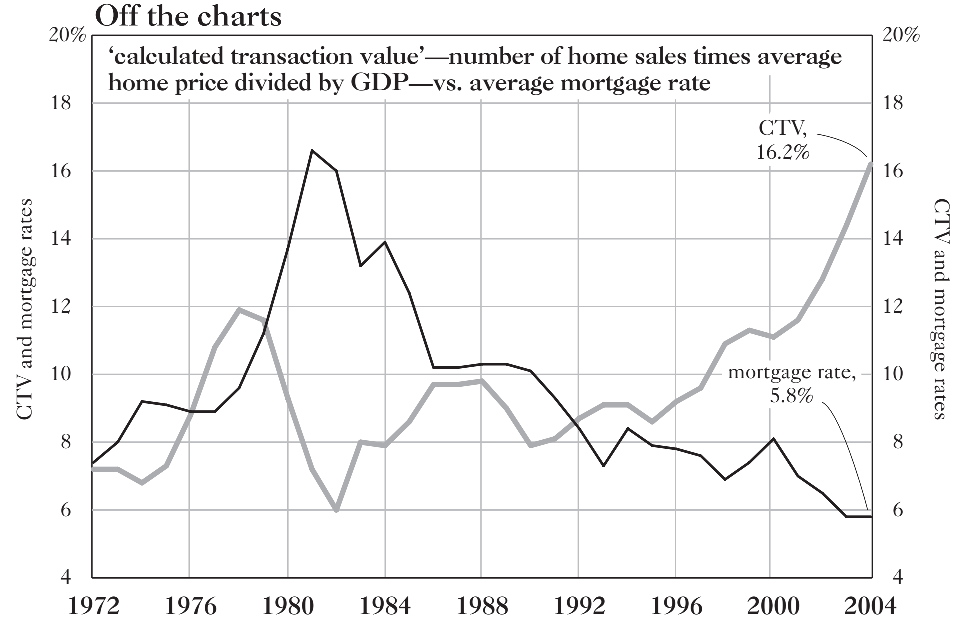
We base our affirmative reply on mWe base our affirmative reply on many things, including the proliferation of no-money-down and interest-only mortgages; the soaring growth in the volume of new houses for sale, which houses do not yet happen to exist; and the growing imbalance between rising supply and sated demand. As for the second and third items on the list, students should consult a May 25 report by Francois Trahan et al. of Bear Stearns, "REIT All About It: A Bubble Looming in Real Estate?" Trahan's thesis is that 2005 is a uniquely risky juncture in real estate. Never before have homeowners been so leveraged; and never before has the residential market been so speculative. And, yes, he's bearish on REITs.

Which brings us to the centerpiece of the investment case against houses. R. King Burch, the originator of the forthcoming analysis, is a paid-up subscriber in Honolulu. As might be inferred from the title of the scientific essay quoted above, he was trained as a marine biologist, but made a career switch to real estate (he was intrigued to discover in business school that investment mathematics resemble the math used to express the dynamics of fish populations). He participated in the Japanese-financed Hawaiian property bubble of 1988-90, worked on hotel deals in Florida in the 1990s and wrote—among other real-estate-relevant works—"The Internal Contradictions of Hotel Real Estate Investment Trusts" (*Real Estate Review*, Fall 1997). Today, he consults and invests for himself in Hawaii. Either house prices are in a bubble, Burch advises, or, if not that, "at least something very different from the usual home buying activity that goes on in the U.S. economy."

We believe that Burch has proven the bubble case, with all it implies for a future slump in the prices of the roofs over our heads. Like many another eureka, this one is calculated to make the reader say, "Now why didn't I think of that?" To draw a bead on U.S. real estate activity, Burch suggests, just take price times volume: Multiply the number of home sales by the average home price. Now divide that value by GDP. The answer expresses the intensity of house fever. Call this measure, as Burch does, the "calculated transaction value," or CTV. Now examine the findings, 1970 to date, plotted nearby. Do you spy a bubble?

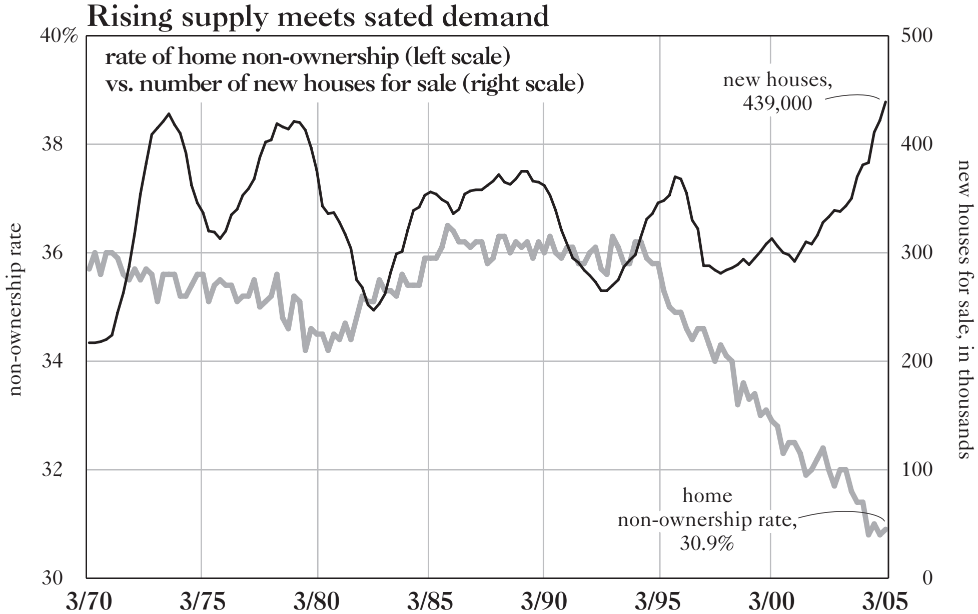
For 35 years, 1970 to 2005, the annual CTV—price times volume, both of existing and new houses—averaged just under 9.2% of GDP. "However," Burch relates, "the data show two periods with remark-

Off the charts



sources: R. King Burch, Freddie Mac

Rising supply meets sated demand



source: The Bloomberg

able divergences from this mean. The first such period occurred in the inflation-led housing frenzy of the late 1970s, when transactions jumped from early-decade values of around 7% and peaked at nearly 12% in 1978. However, a nudge from Paul Volcker and 16% mortgage rates sent it plummeting back down to 6% of GDP by 1982." Significantly, Burch goes on, the decline was owing not to any fall in average prices, but to a 50% plunge in the number of sales: "Housing transactions then spent the next 15 years ranging from about 8% of GDP to just under 10% of GDP."

The breakout year for the current house-price boom is 1998. Except for a small stumble in 2000, the CTV has made a succession of new highs. It reached 16.2% in 2004, "a proportion," notes Burch, "that is 73%, and 2.95 standard deviations, greater than the average for the last 35 years." Not stopping there, it touched 17.2% at the end of the first quarter of this year, a level 85%, and 3.4 standard deviations, greater than the average for the past 35 1/4 years. If house prices are not a bubble, house transactions certainly are. Does your brother-in-law, the real estate broker, owe you money? Now is the time to collect.

One might suppose that low mortgage rates are a sufficient condition for bubbling house prices. Burch finds otherwise: "A simple regression shows that average annual interest rates on conventional loans explain only about 30% of housing activity expressed as a percentage of GDP." Only consider 2004: CTV soared as mortgage rates stayed the same. Nor is the driving force behind the real estate bull market elevated income growth. Since 2000, growth in nominal wages and salaries has averaged 2.7% a year (5.9 percentage points lower than annual average growth since 2000 in the median price of an existing house).

What has driven the boom is rather the accessibility of dollars. For this monetary superabundance, the revolution in securitized mortgage finance, specifically the post-2000 lift-off in MBS activity, deserves thanks. Comments Burch: "The relatively recent advent and growth of an international market in mortgage-backed securities, whose buyers are neither especially knowledgeable of, nor concerned with, the credit and collateral of the borrower trumps the claim, valid in quaint earlier times when a neighborhood lender made and held local loans, that real estate markets are local." And while you're at it, thank the so-called carry trade (the tactic of borrowing at a low rate and investing at a higher, longer-term rate) and the shape of the yield curve (short rates conveniently below longer ones).

In times past, the home buyer had to apply for a loan. Now, the lenders almost apply to him, whoever he is. Can you fog a mirror? But wait, Burch cautions. A subprime-grade borrower availing himself of a no-money-down, interest-only mortgage confronts daunting arithmetic. Besides mortgage expense—call it 5% a year—the buyer must bear the cost of property taxes, upkeep and utilities—call that 2 1/2% a year. And say, at the end of year one, he decides to sell. He must pay a sales commission and other closing costs—call that 6.5% of the purchase price. Just to break even, therefore, our buyer-speculator requires 15% in price appreciation (calculated as [1.00 + 0.05 + 0.025/0.935]).

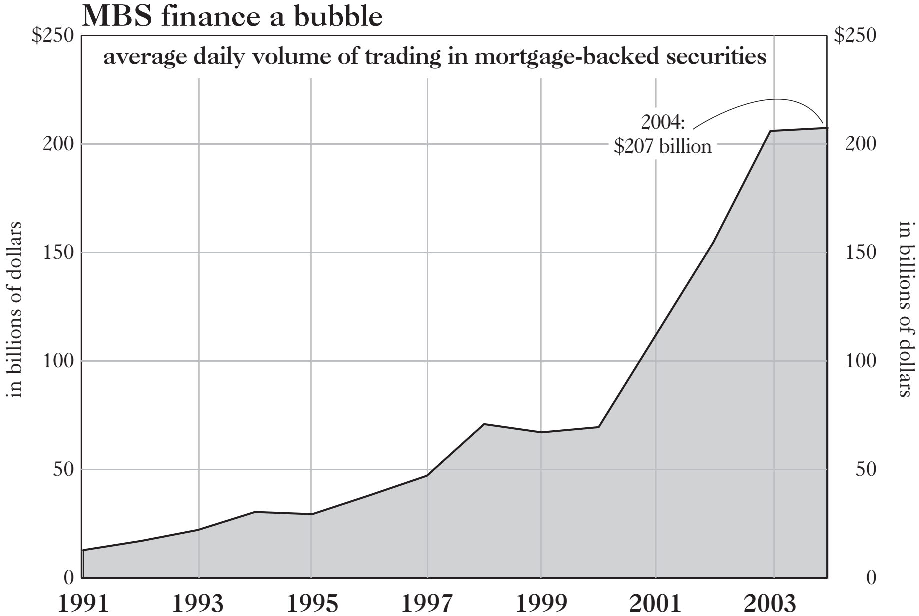
'Club Med'

deficits and debts measured as a percentage of GDP

	Greece		Italy		Portugal	
	deficit	debt	deficit	debt	deficit	debt
1994	-9.4%	107.9%	-9.3%	124.8%	-6.6%	62.1%
1995	-10.2	108.7	-7.6	124.3	-4.5	64.3
1996	-7.4	111.3	-7.1	123.1	-4.0	62.9
1997	-4.0	108.2	-2.7	120.5	-3.0	59.1
1998	-2.5	105.8	-2.8	116.7	-2.6	55.0
1999	-1.8	105.2	-1.7	115.5	-2.8	54.3
2000	-4.1	114.0	-0.6	111.2	-2.8	53.3
2001	-3.6	114.8	-3.0	110.7	-4.4	55.9
2002	-4.1	112.2	-2.6	108.0	-2.7	58.5
2003	-5.2	109.3	-3.1	106.3	-2.9	60.1
2004	-6.1	110.5	-3.1	105.8	-2.9	61.9
2005e*	-4.5	110.5	-3.6	105.6	-6.8	66.2

*European Commission forecasts
source: Eurostat

MBS finance a bubble



sources: R. King Burch, Bondmarkets.com

"Home prices and financing cannot continuously diverge from the buyer's ability to pay," Burch winds up. "Even the most aggressive MBS investors must eventually balk at funding towering home prices when the buyer has no 'skin' in the game. Since mortgage rates have, generally, stopped declining, I would bet (in fact, I have bet, by purchasing put options on home builders) that the game has already peaked." And the flatter the yield curve becomes, the tighter the lender's margins and the greater his risk.

We led off this article with the concession that bears on houses are thick on the ground. But how many of these doubters have taken bearish action? Your house-owning editor has not. The bearish Francois Trahan (co-author of the Bear Stearns report) advises against precipitous action: "[T]here's no need to rush for the exits just yet; i.e., real estate, unlike stocks, is a slow-moving asset and none of this will unfold overnight." And from one of the top Wall Street research houses comes this optimistic article of pessimism: "[H]ousing is in a bubble, but [eminent economist's name withheld] places us in the seventh inning with plenty of upside potential." As long as interest rates stay moored, what's the rush?

But maybe the immediate risk to house prices lies not with interest rates but with lending standards, or the shape of the yield curve. Recall, as does Paul Kasriel, director of economic research at Northern Trust Co., the May 16 "guidance" from a brace of federal regulatory agencies to the nation's mortgage makers. The points of risk singled out by the bureaucrats are the very ones that have empowered the marginal home buyer to stretch to buy the marginal home (they include interest-only loans, high loan-to-value loans, low—or no—documentation loans and proliferating home-equity loans). A friend observes that the Fed resisted entreaties late in the 1990s to tighten margin requirements to deflate the stock-market bubble. Not literally deaf to its critics, the Fed—and the other leading federal banking regulators—might just be trying to take some of the helium out of today's bubble in house prices. It's no easy thing to deflate just a little bit. Good luck, *federales*!

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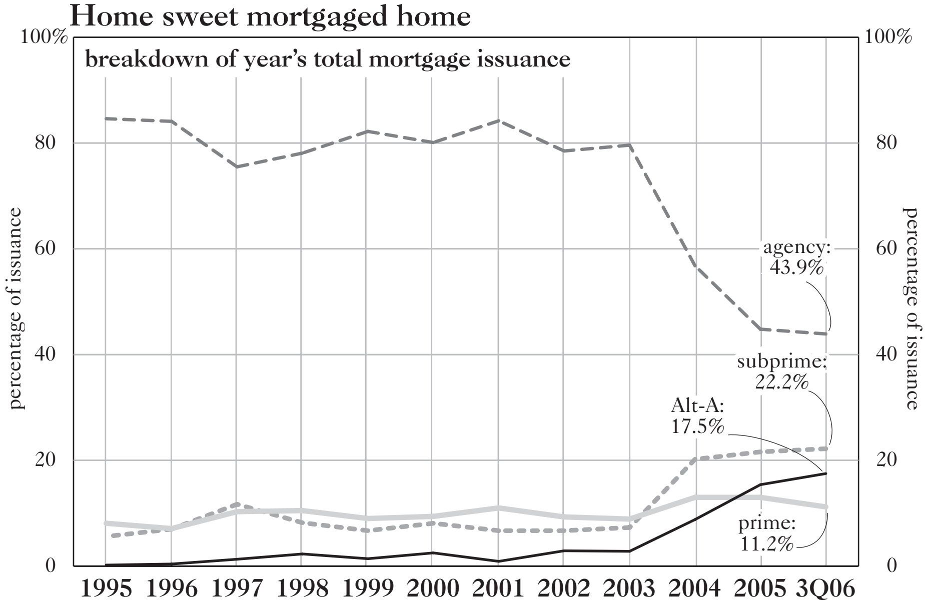
Up the capital structure

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

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

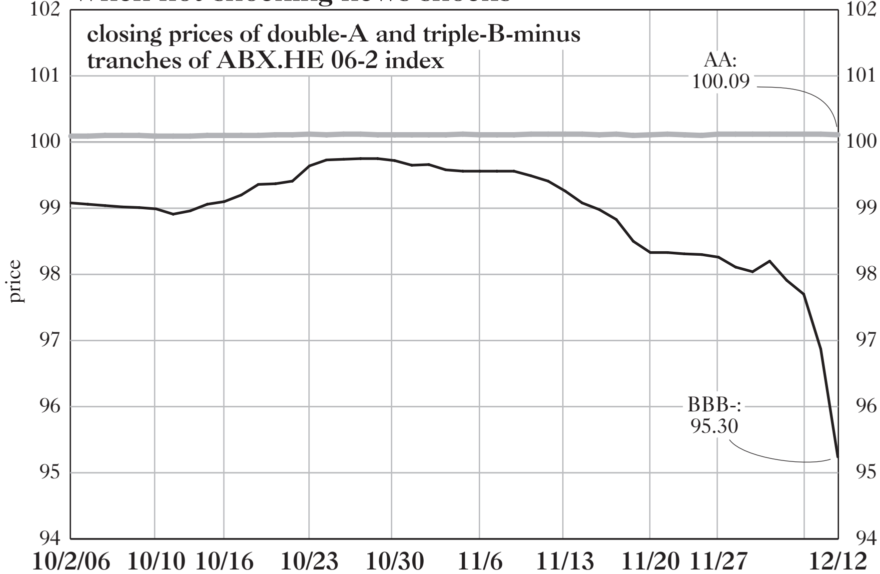
The subprime arena is the Wal-Mart Nation of American leveraged finance. Like the Wal-Mart customer, it is a bellwether of financial disturbance. Perhaps, it's no accident that the giant retailer's sales have weakened as the cost of insuring low-rated subprime mortgage tranches against default has risen.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

Home sweet mortgaged home



source: UBS

When not-shocking news shocks



source: Markit Group, CDS IndexCo.

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

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

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

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

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

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

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

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

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

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

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

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

In short, here was a new derivative index to fill the supposedly crying need for a way to speculate on the value of stacks of subprime mortgage tranches. The first index series to be launched was the ABX.HE 06-1, and the mortgages from which it derives its value were origi-

Termites gnaw

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

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

nated in the second half of 2005. The next index made its appearance in July. This was the ABX.HE 06-2; the mortgages to which it refers were originated in the first half of 2006. The promoters say they intend to introduce a new series every six months.

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

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

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

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

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

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

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

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

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Ready-mixed short sale

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

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

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

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

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

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

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

Bulls, needless to say, have a different take on the subject. Consider, just for instance, they say, the inspiring prospects of building-site mechanization. In 2009, just 40% of Chinese concrete was machine-mixed, as opposed to 78% in Japan and 84% in the United States. Certainly, the bulls contend, the difference will narrow, fattening Zoomlion's revenues as it does. However, observes our own analyst, Evan Lorenz: "Much of the narrowing has already occurred, and some won't happen for years. Thus, revenues of Zoomlion's concrete-related business soared by 97% in 2010 and by 58% in the first half of 2011. Adding in the rest of the industry's sales and those expected for the balance of the year, you see that the 2011 concrete-mechanization rate in China may be closer to 64% than the 40% reckoned for 2009. Yes, it's below the American rate, but it should be. China's per-capita GDP is one-ninth the size of America's."

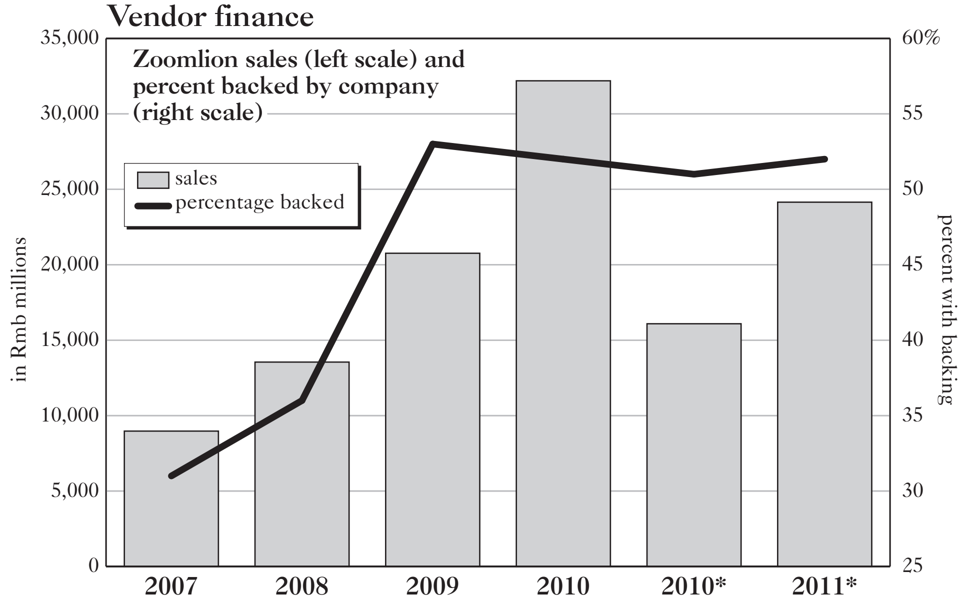
Undebatable is the slowdown in Zoomlion's end markets. The CEO of Caterpillar gave testament to this fact in July, the president and chief operating officer of Cummins Inc. on Sept. 13. "In China," the man from Cummins, Norman Thomas Linebarger, told visiting analysts, "truck and construction markets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

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

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

Then, too, we conjecture, Zoomlion is stretching the maturities of its leases, perhaps to 72 months from the 24 or 48 months it vaguely acknowledges. We do not conjecture lightly. The longer the lease, the more uncertain the residual value of the machine at expiry.

Vendor finance



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

An inflated residual value in a lease document means easier terms for the lessee, and the likelihood of a future loss for the lessor. Because Zoomlion did not crank up its leasing effort until 2008, management has not yet had the educational experience of managing a lease book through a full credit cycle. (Aside from inexact indications of the lease durations, the front office discloses no information about underwriting assumptions. Nor did it return our telephone calls and e-mails.)

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

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

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

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

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

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

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

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

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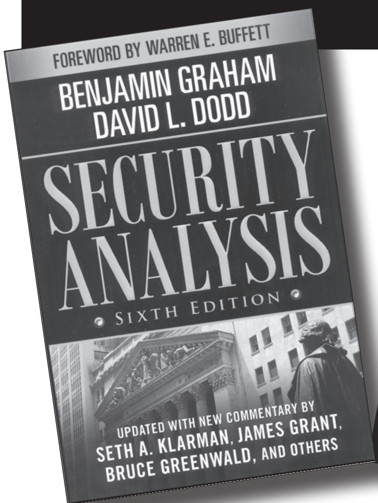

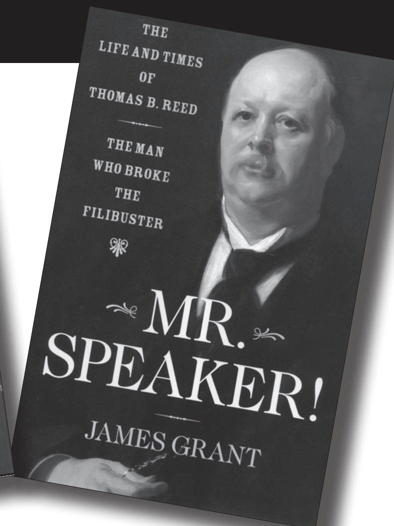

"By God, I remember when interest rates were interest rates."

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