GRANT'S

INTEREST RATE OBSERVER®

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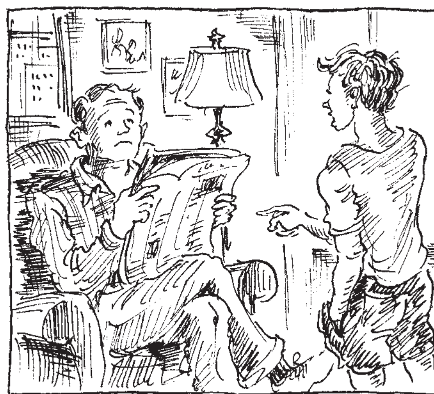
IBM makes bookends

Last month, Norfolk Southern borrowed $250 million for almost 100 years. It paid 5.95%. At about the same time, IBM borrowed $1.5 billion for three years. It paid 1%. Each transaction set modern-day yield records, on the low side, of course, and each bore witness to the raging bond fever—we do not say "bubble." A bubble is a bull market in which the user of the derogatory term has failed to participate. From the *Grant's* perspective, by this definition the fixed-income levitation of 2010 is bubblier than Perrier. But even the most prescient, fully invested bond bulls are bound to admit that they are risking more and more to earn less and less.

Following is a short treatise on tiny interest rates. We are bearish on them, not because we insist they can't go lower, but because the bonds to which the rates attach are denominated in untrustworthy pieces of paper. In the United States, according to Sidney Homer's "History of Interest Rates," the cost of borrowing has tended to rise and fall at generation-length intervals. Interest rates fell in the protracted deflation of the final quarter of the 19th century. They rose in the first 20 years of the 20th century. They fell from 1920 to 1946 and rose from 1946 to 1981. They have fallen since 1981. The 100-year Norfolk Southern bonds got us thinking about bear bond markets, the IBM three-year note about bond bull markets. We conclude that the interest-rate world of 2010 is the mirror image to that of 1979—when IBM set another kind of bond market record and Paul A. Volcker set about trying to quell inflation rather than restart it.

Posterity is forever rubbing its eyes at the follies of its ancestors. We expect that, 30 or 50 years from now, our descendants will be rubbing their eyes at the uncomprehending trust of the millennial creditor. While ground-hugging interest rates are nothing new under the sun, there is something historically novel about ultra-low rates set in a world of pure paper currencies. Your great, great grandfather accepted low rates—some even lower than ours—on the belief that the dollar was good as gold and would long so remain. Laboring under that misconception, as well as the related error that interest rates would remain low indefinitely, he bought up the Louisville & Nashville 3s, the American Gas & Electric gold 5s and the Manhattan Railway Co. second gold 4s, among innumerable other hundred-year issues. A specimen of a slightly longer-dated offering was the Elmira & Williamsport 5s of 2862. What became of that bond, we don't know, but the Elmira & Williamsport Railroad itself unpromisingly features on a Web site named abandonedrails.com. As for the dollar, it fetches not 1/20.67th of an ounce of gold, as it did when 100-year bonds were in style (this was in the late 1890s, during the J.P. Morgan era of railroad reorganization), but 1/1,230th of an ounce of gold and counting. The years have scarcely been kinder to the dollar than they have been to the Elmira & Williamsport.



"Yo, Dad, what's that thing you're reading?"

This publication's bond bearishness is wide-ranging and nondiscriminatory. We hold no brief for anything quoted at par or higher, though we keep an open mind on deeply discounted junk. Zero-coupon Treasurys—30-year Treasury strips—are a special case of a discounted high-grade bond. They are the bond bulls' shot-and-a-beer. Quoted Monday at a dollar price of $30.32, to yield 4.02%, they would rally to $40.72 if yields fell to 3.02% and to $54.73 if yields fell to 2.02%. Just a whiff of deflation, the bond bulls cackle, and they would be sitting on the set of "The Charlie Rose Show" explaining how they got so rich so suddenly in the face of the massed doubt of respectable Wall Street.

We ourselves look forward to expounding on the IBM 1s of 2013. In the 1s can be seen a bookend to $1 billion worth of IBM debentures that came to market in 1979 just as Paul Volcker was beginning to clean monetary house. Inflation was Public Enemy No. 1 at the time, and Volcker was determined to crush it. To that end, he convened a dramatic Saturday afternoon press conference on Oct. 6 to lay out the battle plan. Scribbling reporters took down the essentials: a strangulation policy toward bank reserves and much higher short-term interest rates.

The news came out of the blue, though it shouldn't have. The inflation rate was soaring and the dollar—cut loose from gold in 1971—was in a steep bear market. Taking Volcker at

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(Continued from page 1)

his word, one might have hoped that inflation would eventually recede, but not before interest rates exploded. The Sunday *New York Times* report on the Fed's press conference therefore set palms to moistening. Especially did it shake up the partners of the 227 participating firms in the IBM syndicate. The offering consisted of two $500 million tranches, a seven-year note, the 9½s of 1986, and a 25-year bond, the 9⅜s of 2004. Big Blue had never before issued public debt, and no American corporation had issued as much as $1 billion before in one placement. The triple-A-rated paper had come to market the Wednesday before the Saturday announcement. It sold slowly before the press conference (Salomon Brothers, the lead underwriter, had priced it right on top of the Treasury curve, in view of the scarcity and prestige of the issuer's name), not at all afterward. Released from syndicate, the notes and bonds tumbled a cool five points, at which price they yielded 10.66% for seven years, 9.99% for 25. Syndicate losses were rumored to be as high as $30 million—in any case, the most in Wall Street history.

Now, three decades later (where did the time go?), IBM has sold three-year notes, rated A1/A-plus, at 1%, and Ben Bernanke is fabricating bank reserves and pushing down interest rates, rather than the opposite. It's 1979 in a mirror. "Deflation" is the new monetary bogeyman, and the Fed is on a mission to conquer it. That is, the central bank is actively trying to do what Volcker endeavored to undo. And Wall Street is praying as fervently for Bernanke's success as it ever did for Volcker's.

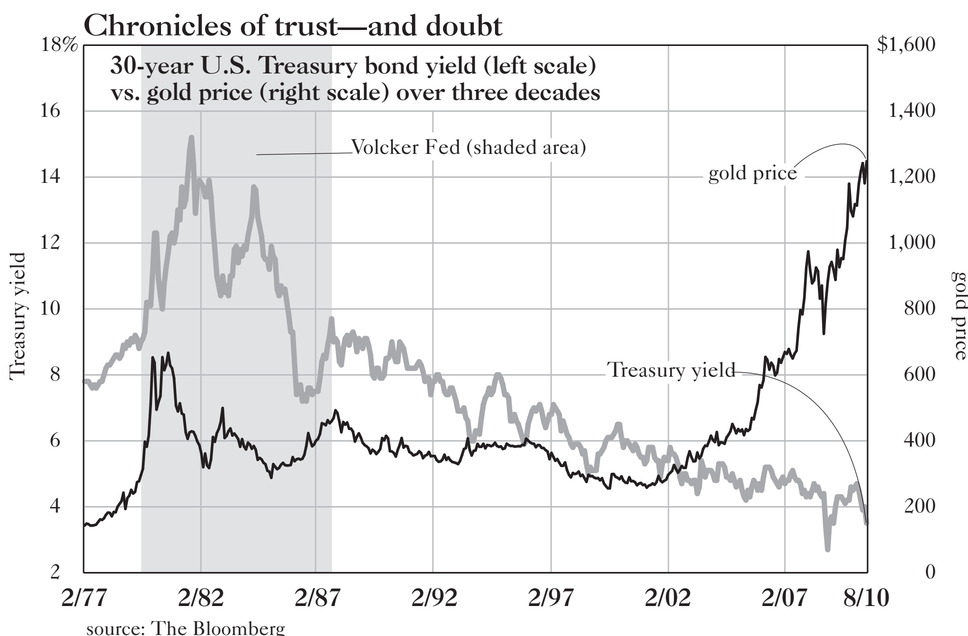
You hear it repeatedly said that, while a central bank can defeat inflation, it is powerless against its ugly twin—witness, the skeptics say, Japan's long and, to date, futile bout with sagging prices. De-leveraging will take years, they say. Perhaps, but what they say is often conditioned by what they see on the screens in front of their noses (Telerate in the 1970s, Bloomberg at the millennium). "Markets make opinions," quoth the sage.

The bond bulls have had it their way for most of the past 30 years, though few members of that farsighted cohort understood at the start of their long run to glory just how right they would be or how rich they could become if only they let compound interest do its work uninterrupted. It was a smooth ride only in retrospect. Divide an interest rate into 72; invested funds approximately double in that number of years. In 1981, a 14⅞% yield was there for the taking. Invest $16 million in a 30-year zero at 14⅞% and collect $1 billion at maturity. You could have looked it up. Few did, or having done so, called in an order. Harlan Batrus, a former partner of Lazard Freres, says that in trying to sell his clients on high-yield Treasurys, he invoked words attributed to Albert Einstein. "Compound interest is the Eighth Wonder of the World," the salesman quoted the mathematician. "Got a good laugh," Batrus recalls.

By 1981, the bond bears had been having their way for 35 years. Inflation was seen to be a "structural" problem in the face of which mere monetary policy was impotent. Besides, as your editor, then on the staff of *Barron's*, was wont to argue, interest rates wouldn't come down until the faith-based dollar was reconnected to its golden anchor. Between the administrations of Franklin D. Roosevelt and Richard M. Nixon, the dollar had been defined as 1/35th of an ounce of gold; by Nixon's order, on Aug. 15, 1971, it was redefined as a piece of paper, nothing else. How was Volcker to imbue such a thing with value? More persuasive than any argument was muscle memory. Bond prices had been going down; ergo, they would continue going down. Everyone who had called a bottom so far had been wrong.

So Volcker's vow to smite inflation by choking off monetary growth met with skepticism on Wall Street. On the Friday before the Saturday press conference, the 30-year Treasury was quoted at a price to yield 9.36%. Two years later, in October 1981, the yield was close to 15%, and—strangest of all—it revisited 13% as late as the spring of 1984, when the CPI was showing year-over-year gains of just 4% (Milton Friedman was only one of the high-prestige bond bears then talking down the market). So, yes, everyone knows that a determined central bank can defeat inflation by turning the screws. But not everyone knew it, or was prepared to believe it, when Volcker was running his real-life experiment in screw turning.

Which leads us to suspect that arguments about central bank impotence in the face of de-leveraging and structural unemployment will also, in their turn, be found wanting. We are not now arguing the macroeconomic merits of the case, only emphasizing the cyclical nature of markets and the fallibility of human judgment. The bond bulls demand to know what could stand between them and 2% yields (the Fed being on hold and inflation presumably dormant). A pro-growth political agenda forced on the Obama administration by its shocking losses in the November mid-term elections is one possibility. A flight from paper currencies in general or from the dollar in particular is another. In the banking week ended two Wednesdays ago, foreign central banks added $21.3 billion to their dollar-denominated securities portfolios, bringing their combined holdings to $3.2 tril-



source: The Bloomberg

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lion (see pages 6 and 7). Something is wrong with a monetary system in which these things are possible.

Luxuriating at Jackson Hole, Wyo., last weekend, central bankers listened to prophecies of intractable joblessness and structurally depressed growth. Bernanke, in eagerly awaited remarks to his colleagues and to the world, pledged to do what had to be done to forestall falling prices, perhaps by buying tens or hundreds of billions of dollars more of Treasurys and mortgages with money printed specially for the purpose. In 1979, the market doubted that Volcker had the courage of his convictions. It was a not unreasonable doubt—few knew who Volcker was. But Bernanke is a known quantity, and he has a very different remit. While Volcker set himself the difficult course of doing an unpopular thing, all Bernanke has to do is the popular one. The success of the Volcker program was measured in falling stock prices, that of the Bernanke stratagem in rising ones. "Helicopter Ben," the boys and girls on the bond desks started calling the then-Fed governor after his 2002 speech invoking Milton Friedman's image of dollar bills fluttering from Fed-chartered aircraft in the service of deflation suppression. The bond bulls say Bernanke wouldn't literally drop money from the skies. We say he would literally think about it.

So low are interest rates that the bond bulls need heaven on earth (i.e., their peculiar notion of heaven) to get paid. That they will be paid in something called dollars, we have no doubt. But what those dollars might buy, we have no idea. All in all, we take Bernanke at his word—and gold, too.

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Contrarians wanted

Adam Rowe writes:

"Safety, first," is the investor's audible motto, but "liquidity, please!" is his sotto voce cry. Having no conviction except that something isn't right, people seem to want assets that they can sell as easily as they can buy: Treasurys, blue-chip equities and gold, to name a few. What they don't want, observes Todd Tateo, paid-up subscriber and retired (at the tender age of 50) Florida real estate appraiser, is houses. Of them they have had quite enough. "Quality residential real estate is the only asset which is now totally out of favor," Tateo says. "[It's been] beaten down and out for three years, with some quality properties now available in some quality locations at 30 cents on the dollar."

Yours for $3.95 million—club membership not included.

In June, sales of new houses priced at $750,000 and up totaled fewer than 500. Ditto, July. How many fewer than 500 happens to be a state secret (at least, the Department of Housing and Urban Development, keeper of the data, refuses to divulge it). By comparison, 4,000 houses found buyers at $750,000 and up in July 2006. So has the market's thirst for liquidity made compelling bargains of those assets that conspicuously lack it? In the waning days of August, it only seemed natural to test this proposition on high-end, sun-drenched vacation properties.

To members of the value tribe who like to vacation as they invest, *Grant's* presents Fishers Island, a seven-by-one-mile stretch of land where the market for second homes is, as Chris Rafferty, a long-time resident puts it, "a little perverse." If Rafferty came to that adjective ruefully, he has his reasons. He owns 11.4 acres on the island. The property boasts a seven-bedroom house built in 1927 by Rafferty's great grandfather, Edwin Rice Jr., the second president of General Electric, and includes a private beach, a 120-foot dock, a guesthouse and an observatory with a refracting telescope—all of which can be had for $3.95 million. But, so far, no one will have it. Rafferty has been trying to sell for years.

Were such an offering situated in Southampton, N.Y., Rafferty could set the whole place on fire and still expect to sell it in a blink for a few times his current asking price. But on Fishers Island, $4 million is about as high a price tag as one is likely to find. Perched about four miles off the Connecticut coast at New London, the island lies midway between New York and Boston, an easy commute for residents in both cities. The Luce, du Pont and Firestone families have all owned homes on the island, and in the middle of the Great Depression, President Franklin D. Roosevelt stopped by long enough to catch 36 striped bass. The year-round population of 235 swells to around 2,000 in the summer season. There are about 600 houses on the island and a small inn.

Discounts are not easily measured in such a specialized market—as a general rule, when a house does not have or need an address, one should not try to discern its value from an index. Relative values are nevertheless apparent on Fishers Island, though not in ways that would make for a compelling PowerPoint presentation. Consider, for instance, a 4,000-square-foot Cape Cod-style house at the east end of the island. The back doors open up on a considerable hill that slopes gently down to the ocean, allowing for a wide-open view of the Connecticut shore and the water in between. The 5.59-acre property sold for $1.7 million last September. Jim Reid, a realtor on the island, told *Grant's* that in a healthy market the house would easily have sold for $2.25 million. Taxes on the property are approximately $17,000, and one could reasonably hope to earn $50,000 by renting it out over the entire summer.

And how might one expect to spend such a summer? Aside from a single pub and a modest community center, two clubs are the only social venues on the island. The Fishers Island Club boasts a course that *Golf Magazine* has ranked ninth in the country. But—and here's the rub—both clubs are private, and residency does not confer membership. Reid feels compelled to divulge that point to any prospective buyer at the outset. "Great," the unwary buyer may say, "they don't let losers in. We'll introduce ourselves, show them the charming kiddos and that

will be that." In fact, this line of thinking has made distressed sellers out of more than a few, though with no financial setbacks, as many new residents of the small island community find that the correlation between ownership and membership is infuriatingly weak. It is hard to enjoy an island getaway when your neighbors have essentially declared, by formal vote, that you and yours simply won't do, especially if you happen to be a golfer. "Money doesn't determine whether a person fits in the Fisher picture," a resident told a *New York Times* reporter in 1967, adding ominously, "People have to like you." Little seems to have changed. "I don't want to make it sound snobby," Reid said of the clubs, involuntarily conveying just that impression.

Those put off by such a harrowing social challenge might consider Marco Island, a waterfront community a half-hour from Naples, Florida, where, under the softening influence of constant sunshine and Jimmy Buffett tunes, New England snobbery is as foreign as New England snow. The area also boasts the highest per-capita ratio of golf courses in the country, so there's no danger of being completely barred from the local links. Marco offers long, white-sand beaches, two luxury resorts and a few high-rise condos. The year-round population of 16,000 nearly doubles during the winter season. Todd Tateo was our guide through the neighborhood, and it was his frontline view that inspired this inquiry. Asked if the market he described is new to his 25 years of experience, Tateo did not hesitate. "Absolutely," he said. "I think it's new for everybody with a pulse's experience." Though house prices managed the unprecedented feat of becoming almost universally overvalued, they have been far less uniform in falling back to earth. Residential real estate markets have once again become idiosyncratic.

On Marco Island, Tateo relates, the value-laden niche begins in the mid-six figures and ends around a million dollars. The market for truly lavish oceanfront homes has been surprisingly unaffected by the Great Recession. Just like everyone else, those in the market for a multi-million-dollar winter home may have seen their net worth take a tumble over the last few years. Unlike everyone else, however, they do not necessarily need to adjust their lifestyle accordingly. Meanwhile, those selling such properties are often uniquely able to wait for the right bid. In Port Royal, a high-end community in Naples, houses stayed on the market for an average of 327 days in 2009, more than double the 2005 average. On the other hand, those shopping for houses priced at six figures and below are likely to borrow, and record-low interest rates are helping to keep that end of the market up. Between these two extremes are houses for people who once flooded Marco Island—aging, upper middle-class baby boomers with healthy retirement accounts. The properties to which they once flocked are now experiencing a rare moment of neglect.

"Here, for example," Tateo relates, directing our attention to a house at 456 Parkhouse Court, "is a property in the area where I live. It's what we call 'a direct access waterfront property,' meaning you don't have any bridges and you can get to the Gulf in about 15 minutes in a boat." The house features all the amenities you would expect in a place like Naples—a private dock, electric boat lift and a private study adjoining the master bedroom. In 2007, the three-bedroom house sold for $1.47 million. Now in foreclosure, it's available for $356,000. Tateo estimates that one could easily rent the house for $18,000 a year. After the $5,500 annual tax bill and general upkeep costs, the property could earn a yield of about 3%. Not an absolute bargain to be sure, but a relative steal for anyone who prefers boating to Treasurys.

As another illustration, Tateo presented a two-story, Mediterranean-style house at 450 Gray Court. Also a direct access waterfront property, this house includes an electric boat and Jet Ski lift, and a balcony overlooking a palm-tree-shaded backyard with a pool, barbeque and spa. Built in 2000, the house sold for $1.4 million in 2007. Now in foreclosure, it's available for $881,900. After taxes and maintenance, one can expect the house to earn about $20,000 a year. Credit is readily available for those who can put 20% down. Those who see financing as a problem, Tateo relates, are confusing the ability to borrow with the inclination. "For a new buyer with cash, coming into a place [and] saying here's my 20% down, we'll get you a loan in two days," he says.

That these new prices represent a discount rather than a return to rationality is a prediction more than a calculation. Florida has a knack for turning empty fields into sunny housing communities. In some of these, prices have fallen and there is no reason to think they will rise again. Recovery will bring new communities just like them, raising the per-capita golf-course ratio still higher while also assuring that the values in the older developments nearby never return to their bubbly highs. But, Tateo points out, waterfront properties are different. "The regulatory system is such that you cannot create a new waterfront community." So with places like Marco Island, "you're buying something for less than what it would cost to create it. And on top of that, you cannot create it anymore."

In the meantime, liquidity, liquidity, liquidity is the mantra of the day, and the next wave of Florida residents are delaying retirement and heading back to work. The for-sale signs on view in Tateo's neighborhood seem like "a lonely trade, indeed," he concludes, "something only a delusional value investor could love."

Finally, for the contrarian seeking a real estate investment that will have friends and family questioning his sanity, rather than just his sense of timing, there is that perennially dying city, Detroit. Reasons given for the city's endless decline are outnumbered only by its vacant houses. The 2010 census is expected to show

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that approximately 150,000 of the city's 900,000 residents have left since 2000. Then there are those who consider even the prediction that Detroit will end up a ghost town as being too optimistic. After stories of white flight and black flight from the city had been exhausted, *The Detroit News* published a story headlined, "The Flight of the Dead," about the number of corpses disinterred and taken from the city by families of the deceased. "For about every 1,000 living human beings who leave Detroit, one dead human being follows," the paper estimated in 2008. For value investors, however, even the gloomiest market becomes appealing at the right discounted price. The gloom is certainly there; indeed, it's almost pathological. So how are the prices?

Keeping this tour focused on the high end of the market, we looked to Indian Village, one of Detroit's oldest and most picturesque neighborhoods, for an answer. At 1470 Iroquois St. sits a nine-bedroom, 6,000 square-foot house selling for $449,000. Built in 1912, the red-brick, Georgian-style house has been well maintained and is just minutes from downtown Detroit and two blocks from the Detroit River. Annual taxes come to $6,951. In just about any other city, such a structure would command seven figures. Still, in Detroit proper, one could hardly ask for a better location. A few doors down, Julie Wilson, a local realtor, told *Grant's* that a nearly identical house sold for $1.2 million before the market soured. The community has an effective neighborhood association that has kept both crime and blight at bay. Meanwhile, vigorous efforts to develop and gentrify downtown Detroit, which were yielding promising results before the recession, could only benefit the historic residential neighborhood nearby. Asked about the more general Indian Village market, Wilson was enthusiastic. "It's turned around, thank goodness," she said. "I'm so busy, it's not even funny.… We have more buyers than houses right now." So why, we asked, has the house at 1470 Iroquois St., which is selling for less than half of what a similar property nearby commanded only a few years ago, been sitting on the market since last October? Wilson dismissed the comparison. "We may never see the market turn around to where it was in our lifetime," she said. An encouragingly pessimistic sentiment, we judge, especially from someone describing a recovery in a market that has not seen anything like a boom in over a generation.

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Where the analysts aren't

Long experience suggests that markets are just as efficient as the analysts and investors who operate in them. Take away the analysts, and markets are even less efficient than that. Thoughts running in this vein, the *Grant's* team rummaged Bloomberg for public companies with slight to nonexistent coverage—two analysts at the most. We believe we've found some mispriced securities.

The accompanying table compares the universe of sparsely covered stocks with the thoroughly investigated (and plumbed and ventilated) Standard & Poor's 500. Criteria for inclusion in the *Grant's* Analytical Equity Orphanage include a market cap greater than $75 million and a profitable operating experience during the Great Recession (i.e., positive average EBIT margins between 2007-09). Our orphanage contains 403 companies. Compared to the unweighted S&P 500, the *Grant's* names include fewer financials (3% vs. 15%), more industrials (20% vs. 12%) and more consumer cyclicals (16% vs. 13%).

"Is There Life After Loss of Analytical Coverage?" is the title of a draft paper intended for publication in *The Accounting Review*. "Yes," the authors—Simona Mola of Arizona State University, P. Raghavendra Rau of the University of Cambridge and Ajay Khorana of Citigroup—conclude. "[I]n the years after loss of analyst coverage," they write, "sample firms experience a decrease in trading volume, stock liquidity and institutional ownership, while operating

(Continued on page 8)

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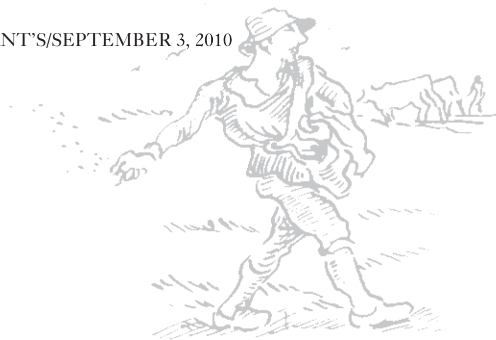


CREDIT CREATION

FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

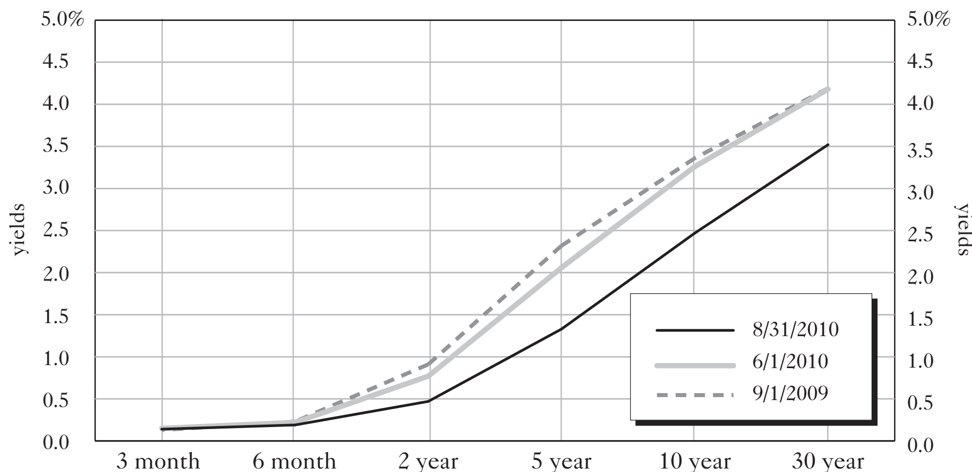
	Aug. 25, 2010	Aug. 18, 2010	Aug. 26, 2009
The Fed buys and sells securities...			
Securities held outright	$2,051,160	$2,052,150	$1,478,941
Held under repurchase agreements	0	0	0
and lends...			
Borrowings—net	57,879	61,909	327,069
and expands or contracts its other assets...			
Maiden Lane, float and other assets	185,106	188,448	242,852
The grand total of all its assets is:			
FEDERAL RESERVE BANK CREDIT	$2,294,145	$2,302,507	$2,048,862
Foreign central banks also buy, or monetize, governments:			
Foreign central bank holdings of Treasurys and agencies	$3,197,200	$3,175,927	$2,824,622

BANK OF ENGLAND BALANCE SHEET*
(in millions of pounds)

	August 2010	July 2010	August 2009
Loans	£21,817	£23,167	£53,100
Securities	13,718	13,605	13,276
Other assets	214,383	215,380	153,876
Total assets	£249,918	£252,152	£220,252

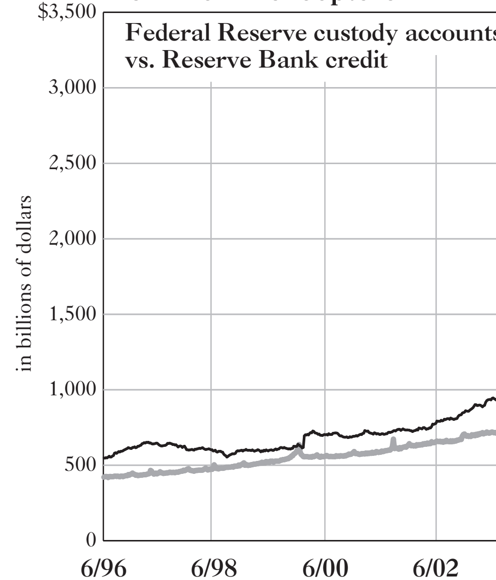
*totals may not add due to rounding

MOVEMENT OF THE YIELD CURVE



source: The Bloomberg

As if from helicopters



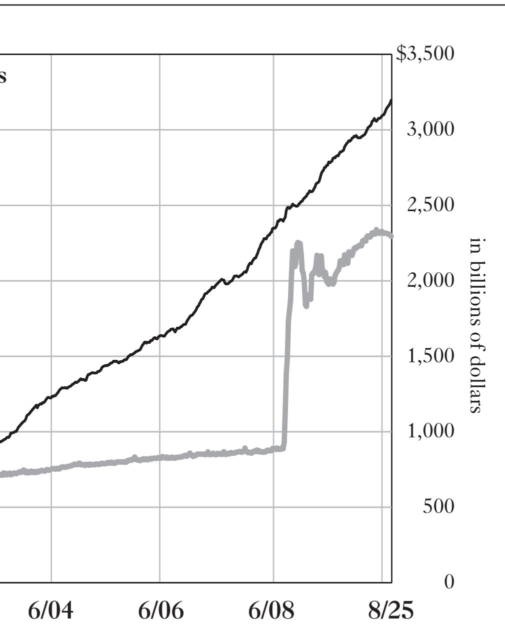
source: The Bloomberg

What's th

You have to wonder if the Deflationary Dirge of Disaster, the tune at the top of the forecasting charts this summer, isn't one of the policy makers' own compositions. We think, first, of zero interest rates. Money is moving more slowly these days. It ambles rather than hustles, for which James S. Tisch has an explanation. "The check didn't clear because it is still in my drawer," the CEO of Loews Corp. has written to a friend who was wondering why the check he had mailed to Tisch had gone so long uncashed. "And my excuse is that with interest rates of zero, I wanted you to earn no interest on the funds rather than me!" Maybe, Tisch ventures, money would step a little livelier if interest rates were a little higher.

Then, there's the persistently high rate of U.S. unemployment, proof—so the argument goes—of the insurmountable difficulties of an economy trying to shed its boom-time layers of unproductive debt. Or maybe not. On the op-ed page of Monday's *Wall Street Journal*, economist Robert Barro contended that the labor-market culprit is the administration's extension of jobless benefits to 99 weeks from 26. Barro's analysis was elegant and persuasive, though not so incisive as the headline over his essay: "The Folly of Subsidizing Unemployment," it said.

• Cause & Effect



e hurry?

The worldwide system of paper-money printing is the source of another, even more potent set of distortions. Consuming much more than it produces, this country discharges its debts in dollars. Having no use for dollars, their recipients, America's Asian creditors, sell them for local currency, which their local central banks duly print. The dollars, meanwhile, go winging their way back to America in exchange for Treasurys and agency securities. So far, so sweet: Everybody seems to win. Asian asset markets levitate, and Treasury yields collapse. But the sheer volume of dollars emitted, Treasurys purchased and Asian currencies printed should make even the most sanguine bond bull stop and stare.

Treasurys and agencies held in custody at the Fed for the account of foreign central banks first topped $1 trillion on Nov. 5, 2003. They reached $2 trillion on July 25, 2007, and $3 trillion on March 24, 2010. Between mid-1996 and the close of 2001, growth in these holdings basically tracked the rise in nominal American GDP, i.e., up by 5.4% a year. Since then, however, they have shot up at the compound annual rate of 18.6%. In one week alone—it was last week—custody holdings jumped by $21.3 billion. What do they say about too much of a good thing? •

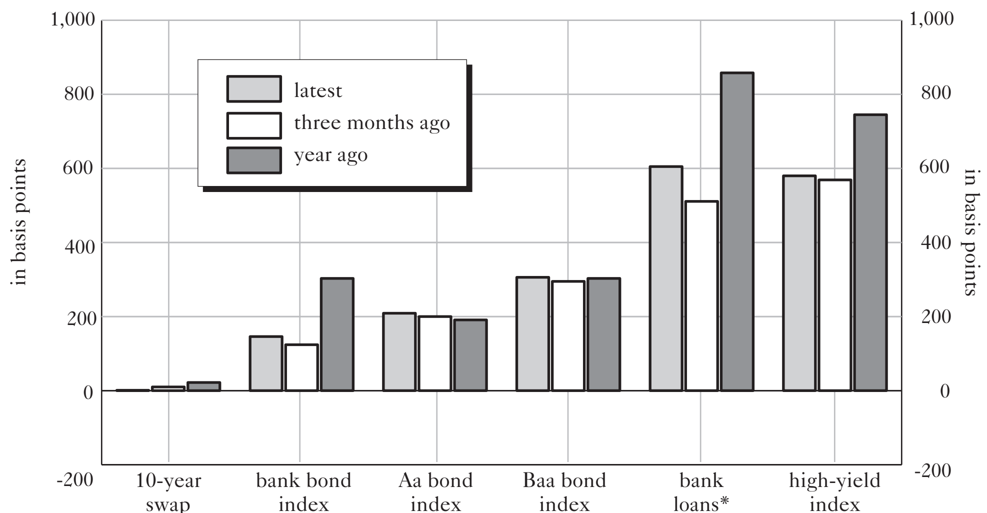
Annualized Rates of Growth
(latest data, weekly or monthly, in percent)

	3 months	6 months	12 months
Federal Reserve Bank credit	-2.3%	6.0%	15.0%
Foreign central bank holdings of gov'ts.	14.4	15.2	13.0
Bank of England assets	1.6	2.2	8.0
Commercial and industrial loans (July.)	-7.4	-8.6	-17.3
Commercial bank credit (July	-4.4	4.7	-1.1
Primary dealer repurchase agreements	0.2	7.9	4.3
Asset-backed commercial paper	3.6	4.2	-6.6
Currency	4.0	4.9	3.9
M-1	3.0	3.5	4.7
M-2	4.1	2.2	2.0
Money zero maturity	3.7	-1.0	3.7

Reflation/Deflation Watch

	Latest Week	Prior Week	Year Ago
FTSE Xinhua 600 Banks Index	9,289.97	9,558.00	10,578.10
Moody's Industrial Metals Index	1,899.70	1,909.13	1,614.37
Silver	$19.04	$17.99	$14.22
Oil	$75.17	$73.46	$72.49
Soybeans	$10.22	$10.09	$11.14
Rogers Int'l Commodity Index	3,100	3,135	2,967
Gold (London p.m. fix)	$1,235.00	$1,223.50	$943.00
CRB raw industrial spot index	503.34	500.16	444.38
ECRI Future Inflation Gauge	(July) 96.1	(June) 96.4	(July) 84.5
Factory capacity utilization rate	(July) 74.8%	(June) 74.1%	(July) 69.2%
CUSIP requests	(Aug.) 1,603	(July) 1,656	(Aug.) 1,285

Credit Spreads



*spread over three-month Libor
sources: The Bloomberg, Standard & Poor's LCD

(Continued from page 5)

prospects are similar to their covered peers." Value investors may have suspected as much.

Orphan No. 1 is John B. Sanfilippo & Son (JBSS on the Nasdaq), a leading processor of edible nuts, not the wing kind. The company deals in peanuts, cashews, walnuts, almonds and mixed nuts—and now, with its May acquisition of Orchard Valley Harvest, in dried fruits, too. There's no mistaking JBSS for one of the high-yielding blue chips that recently featured in these pages. The eponymous Sanfilippo family controls the company with 52.3% of the voting rights. The public float comprises just eight million shares at $12.80 apiece, for a $135 million market cap.

Profitable these days, JBSS showed losses in fiscal years 2006 and 2007, when the Atkins diet made nuts de rigueur but short crops drove up their prices. The company wound up buying some very expensive nuts. Long and—as it turned out—wrong, management also chose an inauspicious time to lay out the funds needed to build a new processing plant. Its debt covenants breached, the company was obliged to restructure. Gross margins plunged to the neighborhood of 6% and 7%, less than half of what had previously passed for normal. The share price broke to the single digits from $23, and analysts stopped calling. Not one is on the case today.

In fiscal 2009, while Wall Street's back was turned, JBSS generated a gross margin of 13.1% and earned $6.9 million, or 65 cents a share. In fiscal 2010, with Wall Street's eyes still averted, the company generated a gross margin of 16.9% and earned $14.4 million, or $1.34 a share. Over the two years, debt declined and stockholders' equity increased, such that, today, the stock trades at 86% of its $14.93 tangible book value per share. "Some of the issues that we had in 2006 and 2007—mainly that was commodity-driven—scared them off," CFO Michael Valentine tells *Grant's* of the vanishing analytical cohort. "When I talk to some of the analysts that cover similar companies in our industry, they'd like to see some consistency in our results . . . so it's easier to predict what we're going to do. We returned to profitability last year. This year, we pretty much returned to normal margins. I think they would like to see a couple of years of that."

Wall Street's disappearing act can explain only so much of JBSS's statistical cheapness. As noted, from a governance perspective, the company is essentially the Sanfilippo family's to do with as it pleases. Then, too, JBSS is less protected against commodity-price vicissitudes than are its consumer-focused rivals, e.g., Ralcorp Holdings (RAH on the Big Board) and Diamond Foods (DMND on the Nasdaq). Of this perceived vulnerability, management is well aware, and it says it's working to fix it—for instance, by maintaining a 12-person research and development staff to develop new high-margin products.

Another thing, Valentine says: "[I]f you looked at our industrial channel as a percentage of our total sales in fiscal 2006, it was 22.7%. In fiscal 2010, the industrial channel was 13.9% as a percentage of our total sales. That's important because our sales in the industrial channel are generally fixed-price for about a year. Four years ago, we were entering into contracts long before we knew our costs. So when those customers wanted to buy, we weren't ready to sell. So quite a few of those customers dropped off. But the ones we retained—the Nestles and General Mills of the world—value what we have to offer. They're willing to pay more and also willing to buy from us when it's right for us, not necessarily when it's just right for them. That's taken a lot of commodity risk out of our business. We've stated that publicly many times, but analysts just want to see that in the results for a couple of years." By which time, perhaps, the share price might be a little higher than it is today.

What might JBSS earn? Sales for the past six years have been around $560 million. The Orchard Valley acquisition could lift the top line to $610 million. Assuming $61 million of operating expenses, $5 million of interest expense and a 14% gross margin, the company might earn $1.19 a share. With a 16% gross margin, it could earn $1.94 a share. Achieving these levels of profitability would value the stock at a price-earnings multiple of 10.8 times and 6.6 times earnings, respectively. If so, the investors themselves, not the analysts, would be the ones to congratulate management. "Great quarter, guys!" they could learn to say.

Orphans vs. S&P 500

	orphans	S&P 500
Avg. market cap	$323	$20,185
Maximum market cap	3,824	302,453
Minimum market cap	75	963
Median P/E	13.7x	14.9x
Median EV/EBIT	10.6	11.2
Median EV/EBITDA	7.1	8.1
Median P/B	1.5	2.1
Median dividend yield	3.2%	2.2%

source: The Bloomberg

Zion Oil & Gas (ZN on the Nasdaq) is another kind of analytical orphan. Here, one can see the analysts' point. A 10-year-old exploration-stage oil and gas company, Zion has produced gushers of stock and rights issues but not a drop of commercially viable oil. Moses told the Israelites that the Lord had made "oil out of the flinty rock," but an analyst (if there were an analyst) might by now be starting to wonder if the oil to which the Book of Deuteronomy referred was made from olives. Zion has no revenue, but it has a $106 million market cap. In the first six months of 2010, it consumed $16.2 million of cash. There is perhaps $15 million more cash in the till, while the board of directors has given management the green light to increase the share count to 50 million from 21.2 million. As it is, the shares are quoted at 2.9 times book value. If the company were to write off the remainder of its capitalized well expenses, book value would fall to $22 million from $36.4 million, while the price-to-book multiple would leap to 4.8 times. Among the stocks in the *Grant's* orphanage are a half dozen exploration and development companies that actually produce hydrocarbons (and that were, on average, profitable in the past three years). The average price-book ratio of this cohort is a mere 2.6 times. Since when is there a valuation penalty for making money?

Blount International (BLT on the Big Board), our final orphan offering, makes chains for chain saws. Headquartered in Portland, Ore., it commands more than half of worldwide sales in saw chains and guide bars. The advent of the disposal razor may have ruined the original razor/razor-blade business model, but the lucrative concept lives on at Blount. Over the past seven years, the company has returned an average of 15% to 20% a year on capital employed (i.e., net debt plus equity plus other long-term liabilities).

"We got some analyst coverage when Lehman bought the company in 1999 and then in 2004 [during the subsequent IPO]," Matt Clark, Blount's vice president for finance, tells *Grant's*. "We've been under the radar screen for too long, and we haven't been active in the capital

markets since 2004." The leveraged acquisition to which Clark refers saddled the company with debt, but it also delivered a future CEO. Joshua Collins is that man and the current incumbent. A Harvard alumnus and former Marine, Collins was among the investment bankers who effected, or perpetrated, the 1999 LBO. Collins's expressed ambition today—apart from paying down the still-substantial acquisition debt—is to use internally generated funds to expand Blount's EBITDA (earnings before interest, taxes, depreciation and amortization) to $180 million by 2014 from $87 million in 2009.

To that end, the front office is orchestrating a debt exchange (loans for public notes) and making an acquisition. SpeeCo, the North American market leader in log-splitting equipment, is that corporate accession. The grand plan is that SpeeCo's log splitters will make a lucrative product alliance with Blount's ubiquitous saw chains. "They're pretty close to being a monopoly in North America," Darian Elizondo, manager of Woodland International, the wholesale division of Bailey's Inc., Laytonville, Calif., tells a *Grant's* reporter of Blount's saw-chain dominance.

On its own, that fact would not necessarily bring joy to the face of a hypothetical Blount equity analyst. According to the Outdoor Power Equipment Institute, North American gas-powered chain saw sales fell by 15.6% in 2009 from 2008, and they have fallen by another 12% in the first seven months of 2010. Overseas, however, where Blount garners two-thirds of its revenue, the story is strength, especially in the developing world, where chain saws are displacing hand saws and axes and wood is cut for fuel, not principally for lumber. "People tend to overestimate the cyclical nature of our business," Blount CFO Cal Jenness tells *Grant's*. Whereas in developed economies, about 25% of roundwood production is used for fuel, with the remainder earmarked for higher uses (higher, at least, when people were still building houses), in emerging markets it's the other way around; perhaps 75% of the wood harvest goes into the fireplace.

That $180 million target nailed to the wall by CEO Collins may not be so easy to hit. Blount is watching its customer base consolidate and the Asian competition stiffen. But achieving $50 million of free cash flow—vs. $40 million in 2009 and $44 million in 2008—seems not so far a stretch. Divided by $555 million in equity-market capitalization, that would be a 9% free cash flow yield. Analysts, if there were more than one, might ask management some day about the possibility of the Obama administration promoting an energy policy featuring wood-based biomass. Would not, they could query management, such a development encourage a trend to "managed forestry" and, therefore, greater consumption of saw chains?

"Why, yes," management would reply on our imagined conference call. "We're glad you asked. . . ."

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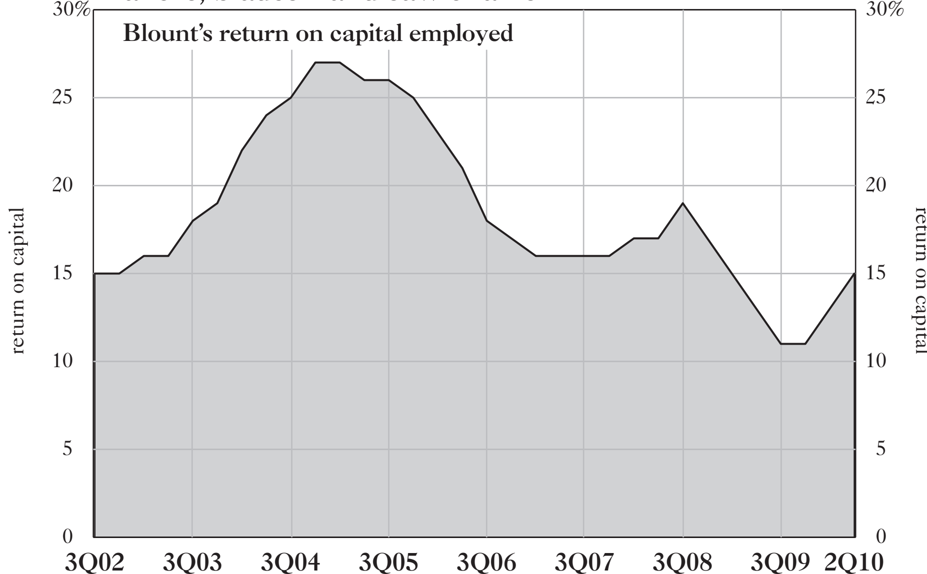


source: The Bloomberg

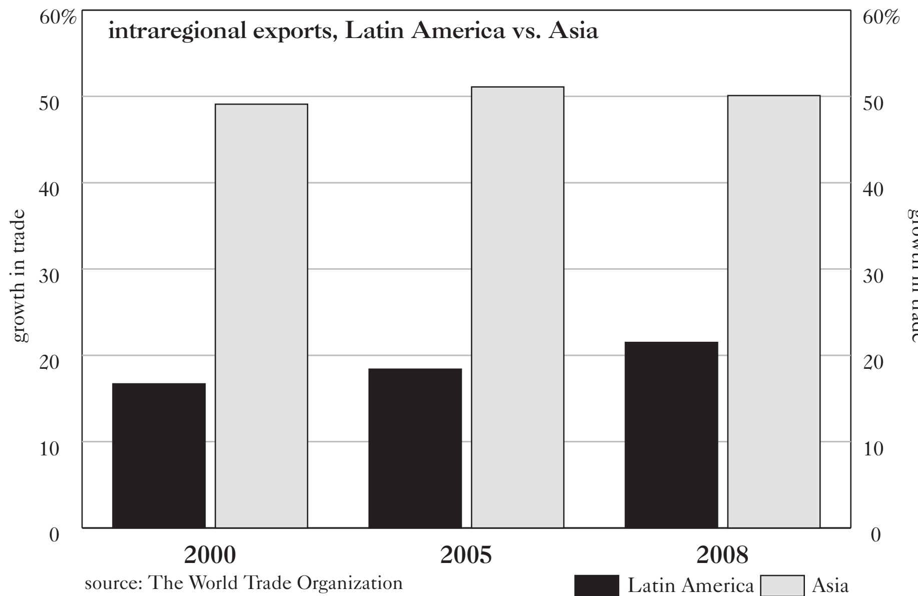
Rush hour in La Paz

Bladex, the Latin American trade-finance bank, has a sideline in speculation. Since 2006, a bank-owned hedge fund has compounded money at an annual rate of 9.2% while the S&P 500 has compounded in reverse. But in the second quarter, the managers of the asset-management division of Banco Latinoamericano de Comercio Exterior, S.A., zigged when they should have zagged, their miscue all but erasing three months of strong operating income. Gratitude for favors past is as rare on Wall Street as it is in politics or baseball. So investors made no allowance for the fact that the fund was profitable in 2008 or that it has basically shot out the lights since its inception four years ago. On the second-quarter conference call, you could almost hear the analysts banging their heads on their desks.

Bladex is the subject at hand—that and value traps (which Bladex isn't) and the South and Central American economies, which curiously refuse to take their cue from the gloomy North American Goliath, but rather continue to grow. Word from San Pedro Sula, Honduras, is that you can't find a parking spot at the shopping center.

As for Bladex, the stock price of which goes down and sideways more easily than it goes up, we remain bullish. Valuation is the main attraction, as it's been through the years (see, for instance, *Grant's*, March 20, 2009, and March 21, 2008). The shares trade at two-thirds of book value, at nine times trailing net income and seven times the 2011 estimate; the dividend yield is 4.7%. Just as unusual as the valuation is the business strategy. North of the Rio Grande, banks are trying not to shrink. Bladex, in happy contrast, is expanding its loan book in a fast-growing regional economy. It is—in a word rarely heard in the 50 states—"re-leveraging." And it's in a strong position to profit by the accelerating growth in regional trade within South America.

Altogether, Bladex is an odd duck. With its $467 million market cap and New York Stock Exchange ticker, BLX, it looks like a conventional public company. But its pint size, business focus and quasi-public purpose make it unlike the other regional banks against which an investor might draw a comparison (Banco de Chile, a representa-



tive of which sits on Bladex's board, commands a price/book multiple of 4.2:1, altogether out of Bladex's league). Then, too, the public holders of 27.6 million Class E Bladex shares don't elect the board of directors; rather, the holders of 8.9 million Class A and Class B supermajority shares do. Among these privileged investors are the central banks of Argentina, Brazil, Colombia, Peru, Paraguay, Ecuador and Chile (the Korea Exchange Bank has somehow been admitted to the supermajority club, too). So no matter how cheap the E shares trade, no takeover bid will be forthcoming. Bladex, a kind of Latin American government-sponsored enterprise (albeit a profitable and indisputably solvent one), isn't for sale.

Casting an eye over the Bladex financials, you may imagine yourself transported back to the long-ago days before the Federal Reserve. Like many a commercial bank of the pre-1913 era in American finance, Bladex is heavily armored with equity capital. Its Tier 1 capital (chiefly common equity) amounts to 23.4% of assets, almost 20 percentage points higher than the FDIC-stipulated minimum. Panama, in which the company is headquartered, famously has a canal. But, its dollarized economy has no central bank. TARP-less and Fed-less, Bladex takes precautions.

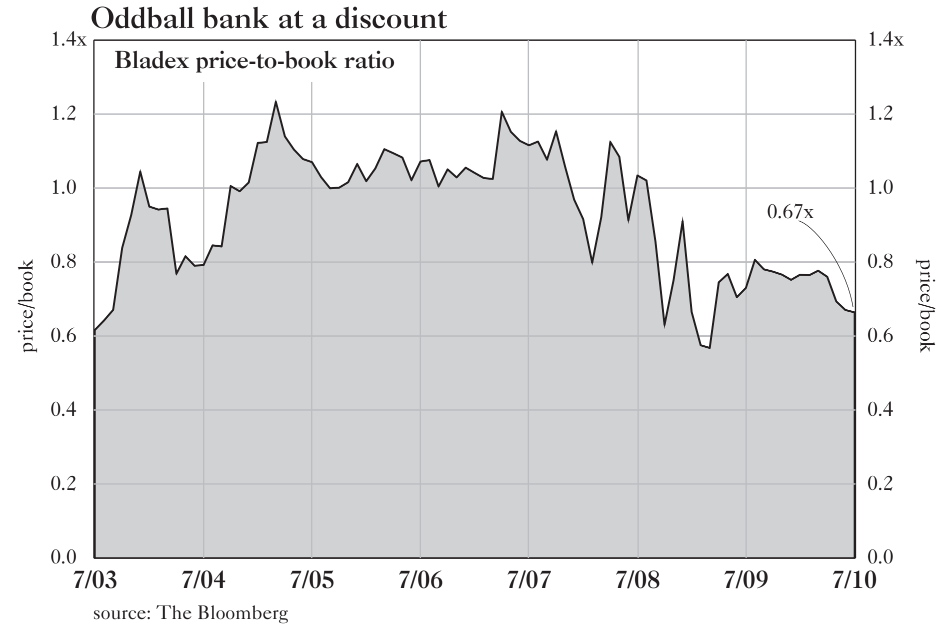
It has, for instance, diversified the sources of its funding over the past couple of years, moving away from wholesale sources to greater use of deposits (now 42% of the mix) and medium and long-term borrowings (now 41%). Extreme conservatism has its costs as well as its rewards. A super-size cushion of equity implies a tendency toward a low return on equity. Management's announced ambition is to achieve ROEs in the mid-teens, through asset growth and re-leveraging. But what it did achieve, in 2009 and in the first six months of 2010, were returns of 8.6% and 3.5%, respectively.

Money management, for all the exasperated attention it garnered on the second-quarter call, isn't really what the bank does for a living. The chief corporate occupation is banking. Bladex lends to commercial banks (32% of June 30 assets) and to importers and exporters (54% of those loans and leases). Unusually, from the 2010 North American perspective, its loan book is growing, not shrinking. Between the third quarter of 2009 and the second quarter of 2010, footings jumped to $2.96 billion from $2.5 billion. Growth is the watchword in the Bladex executive suite, analysts dialing in to the second-quarter call were given to understand. Management talked up its plans to acquire a factoring business. CEO Jaime Rivera outlined plans to ramp up the bank's presence in the fast-growing trade among and between the economies of South and Central America (as distinct from the trade between those economies and the United States, Europe or Asia). New this cycle, said Rivera, is the blossoming of intraregional Latin American commerce.

Bladex was most recently featured in these pages in March 2009, when the world was feeling even sorrier for itself than it does today. International trade was contracting, either because of, or concurrently with, the withdrawal of trade finance. We proposed that Bladex, with its unimpaired balance sheet and stout regional presence, would emerge from the crisis not only in one piece, but also with fatter margins and a bigger trade-finance market share. And so it came to pass. Lending margins averaged 262 basis points in 2009, up from 168 basis points in 2008. "Competition is less than it has been in years," Rivera remarked on the latest quarterly call. "Margins, while off their record levels of a year ago, remain relatively steady at levels above historical standards."

Last Thursday, *The New York Times* reported that America's too-big-to-fail financial institutions continue to trade for their own accounts, the so-called Volcker Rule notwithstanding. Bladex makes no pretense. The Bladex Capital Growth Fund, a wholly owned subsidiary, manages $153 million of the bank's own money (23% of June 30 equity capital) and not quite $40 million of other people's. Headquartered in Manhattan, far from the Panama City home office, the fund does business on the standard Park Avenue terms, charging a 2% management fee along with 20% of the upside, if any. What it does not do is invest. At least, it does not do what your father, not to mention *his* father, would recognize as investing. Rather, the fund trades currencies, credit, equity indices (not stocks themselves), credit derivatives and interest rate swaps. It uses, as it explains, a "multi-dimensional approach" in which it implements "directional, short term and relative value" strategies. Does Bladex have any more business juggling derivatives than Steve Cohen, of Greenwich, Conn., for example, would have establishing a Peruvian import-export facility? *Grant's* is among the many who raised no objections to the Bladex fund while it was making money. "Maybe it will shine again in 2009," we made bold to venture two Marches ago, after its triumphant 2008, "and maybe it won't." Shine it did in 2009, up 10.5%. But the trade-finance lending business has begun to shine brighter.

Analysts on the second-quarter call fretted about the fund. "I want the unadulterated exposure to your commercial capabilities because your franchise there is so strong," one addressed Rivera. "And if I wanted the other type



of exposure that you're adding through the asset management group, I could find that presumably in other ways." "A hiccup, an extraordinary hiccup," Rivera called the trading loss. On a subsequent call with *Grant's*, the CEO had this to say: "As you can imagine, we don't want to continue running the risk of a repeat of last quarter's impact on our core operations. So you can expect us to do something about it—as we generally have. But we tend to take our time when reacting. Every time we've rushed into decisions in the past, we've regretted it."

Meanwhile, for all the despondency about the American economy, it's onward and upward in Bladex's backyard. "We keep thinking to ourselves, maybe the guys north of the Rio Grande are right," Rivera tells *Grant's*. "But that is not my impression . . . having spoken to businessmen, banks . . . and actually having seen what is going on. For instance, if you think the growth in Brazil is somewhat of a bubble, all you need to do is travel to the interior of the state of Sao Paulo, only about an hour and a half away from the city. You'll be amazed—at least I was, and it was only a couple of years since I was there last—by the amount of investment, the number of new factories, the wealth being created, the technology in the new factories, the high-quality housing, etc. And . . . people are becoming employed again. We find it difficult to get good people. Good people are in high demand throughout the region and they are difficult to find."

In the dark days of early 2009, credit risk appeared to be the bank's top worry. But the Latin American economy, so far from double dipping, has proceeded to enter a kind of boom. Thus, at mid-2010, Bladex's non-accrual loans footed to the not-so-grand sum of $45.3 million, or 1.5% of the commercial portfolio, while the allowance for loan losses stood at $81.3 million.

"If the U.S. slows down," Rivera concludes, "it will definitely impact Mexico. Fortunately, Mexico is not that well integrated into the economy of the rest of the region. There is now enough intraregional trade and enough local market—that is the other element that did not exist until a few years ago. In just about every country in the region, the poor are less poor than they were in the past. The middle class—in most countries—has more purchasing power. Throughout the region, the poor and rich have a lot less debt than OECD countries. Local markets—in most countries—including smaller ones like Honduras, are doing relatively well. You go to a shopping center in San Pedro Sula and you'll have difficulty parking. Same thing happens in La Paz. There are traffic jams in La Paz. I'm actually trying to prove that people in the U.S. and Europe are right, but I haven't come up with a reason to doubt my own eyes."

As to "value traps": A value trap is a statistically cheap security that will never go up because the entity that issues it is irremediably defective. Bladex can be flummoxing, but it isn't dysfunctional.

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Banco Latinoamericano de Comercio Exterior
(in $ millions, except per-share data)

	12 mos. to 6/30/10	12/31/09	12/31/08	12/31/07
Net interest income	$66	$65	$78	$71
Reversal (provision) for loan losses	0	(18)	19	(12)
Trading gains	(3)	38	0	24
Other income (expenses)	(1)	2	(9)	1
Operating expenses	(39)	(38)	(40)	(37)
Net income	39	55	55	72
Earnings per share	1.07	1.50	1.51	1.99
Loans, net	3,015	2,779	2,619	3,732
Total assets	4,412	3,879	4,363	4,699
Deposits	1,507	1,256	1,169	1,462
Short-term borrowings	434	328	739	1,221
Long-term debt and borrowings	1,370	1,390	1,205	1,010
Total liabilities	3,699	3,168	3,784	4,086
Shareholders' equity	673	676	574	612
Net interest margin	1.69%	1.62%	1.55%	1.73%
Nonaccruing loans to total loans	1.50	1.82	0.00	0.00
Return on average equity	3.50	8.60	8.99	11.91
Tier 1 capital to risk-weighted assets	23.40	25.80	20.40	21.20
Leverage ratio	6.6x	5.7x	7.6x	7.7x
Price per share	$12.69			
Shares outstanding (millions)	36.8			
Market capitalization	$467			
Price/earnings	11.8x			
Price/book	0.69			

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What's the hurry?

You have to wonder if the Deflationary Dirge of Disaster, the tune at the top of the forecasting charts this summer, isn't one of the policy makers' own compositions. We think, first, of zero interest rates. Money is moving more slowly these days. It ambles rather than hustles, for which James S. Tisch has an explanation. "The check didn't clear because it is still in my drawer," the CEO of Loews Corp. has written to a friend who was wondering why the check he had mailed to Tisch had gone so long uncashed. "And my excuse is that with interest rates of zero, I wanted you to earn no interest on the funds rather than me!" Maybe, Tisch ventures, money would step a little livelier if interest rates were a little higher.

Then, there's the persistently high rate of U.S. unemployment, proof—so the argument goes—of the insurmountable difficulties of an economy trying to shed its boom-time layers of unproductive debt. Or maybe not. On the op-ed page of Monday's *Wall Street Journal*, economist Robert Barro contended that the labor-market culprit is the administration's extension of jobless benefits to 99 weeks from 26. Barro's analysis was elegant and persuasive, though not so incisive as the headline over his essay: "The Folly of Subsidizing Unemployment," it said.

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