GRANT'S

INTEREST RATE OBSERVER®

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'Hold still, little fish!'

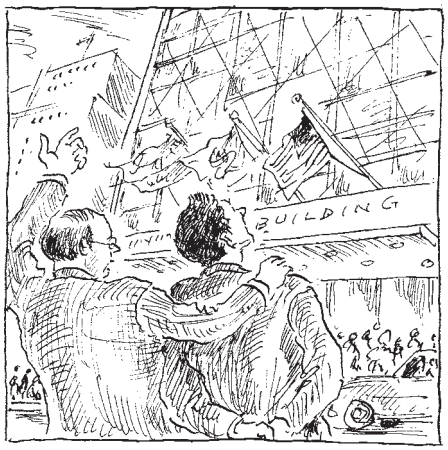
To top up the rate of inflation, the Federal Reserve has printed trillions of dollars and sawed the funds rate off at the knees. Though the unlettered masses may quail at such seemingly radical measures, our monetary mandarins are full of assurances. Even greater exertions at the printing press would be justified to achieve the appropriate rate of up-creep in the CPI, they say. Two percent a year would be splendid.

Now begins an essay on getting the thing you thought you wanted, but getting more of it than you bargained for. Inflation is that thing. The developed world has become numb to it. A Tuesday dispatch from Osaka by Agence France-Press did not get around to mentioning the scale of post-earthquake money printing by the Bank of Japan until the fourth paragraph. The sum is 39 trillion yen, the equivalent of $481 billion, the wire service reported. When the materialization of nearly a half-trillion dollars in a fortnight's time stops astounding the reporters, it's past time for a monetary reappraisal.

You listen to the Fed and you can't believe your ears. However, as balmy as its doctrines may sound to us, they surely will hit the ear of posterity as balmier. Especially will they amaze and astound the next generation of money managers in their attempts to understand what the knuckleheads of 2011 were thinking about when they swallowed the proposition that $3^1/_3$% was a fair rate of return on a 10-year government security denominated in the very currency the Fed was actively striving to cheapen.

Then, again, we suspect, if futurity will be dismayed, our monetary ancestors would be horrified. Specifically, the late, great president of the Federal Reserve Bank of Atlanta, Malcolm Bryan (1902-67), an exponent of the University of Chicago school of central banking, would be aghast. If accidental inflation was bad, Bryan believed, premeditated inflation was inexcusable. So, in October 1957, when the CPI showed year-over-year growth of as much as 3%, Bryan made a speech. It was a great speech, and its greatness was tarnished not at all by the fact that the central banker's warnings were 10 years premature. At *Grant's*, a decade is nothing.

His 2010 dissenting votes on the Federal Open Market Committee may have won Thomas M. Hoenig, the president of the Federal Reserve Bank of Kansas City, the gratitude of the critics of QE2. But Hoenig, 64, is uncomfortable in the role of public naysayer, and he's ventured only so far off the Federal Reserve reservation. Bryan figuratively journeyed all the way to Timbuktu.



"Some see a building, my boy. I see a cap rate."

You have to understand the context in which this slender, graying former college professor took his case to the people. In the mid-1950s, inflation was quiescent. Indeed, for 12 consecutive months, September 1954 to August 1955, the CPI had actually registered small year-over-year declines. This brush with "deflation" curiously caused no great alarm, though memories of the Great Depression were certainly still vivid. Not until summer 1956 did the measured rate of inflation return to 2%. Not stopping there, however, it jumped to 3% by December. Exponents of the theory of "creeping inflation" cheered it on. "Inflation may or may not cause the benefits," wrote one of these advocates, the Harvard economist Sumner Slichter, in the fall of 1957, "but in the present state of knowledge, it is an inseparable by-product of the processes that produce important benefits."

Bryan admitted not one benefit. In an address to the American Life Convention in Chicago, he denounced the inflationist nostrums on the grounds of economic theory, common sense and—especially—morality. Bryan made no apologies for his intolerance for even a dollop of calculated debasement. It was nothing but theft, he said.

We moderns forget what "price stability" actually meant: It meant stable prices. Not that the Fed could freeze the cost of living, Bryan acknowledged. Central bankers could work no such miracle. But neither could they sneak a slyly persistent rise in the cost of living past the open eyes of the American public.

It appears that William McChesney Martin, the incumbent Fed chairman,

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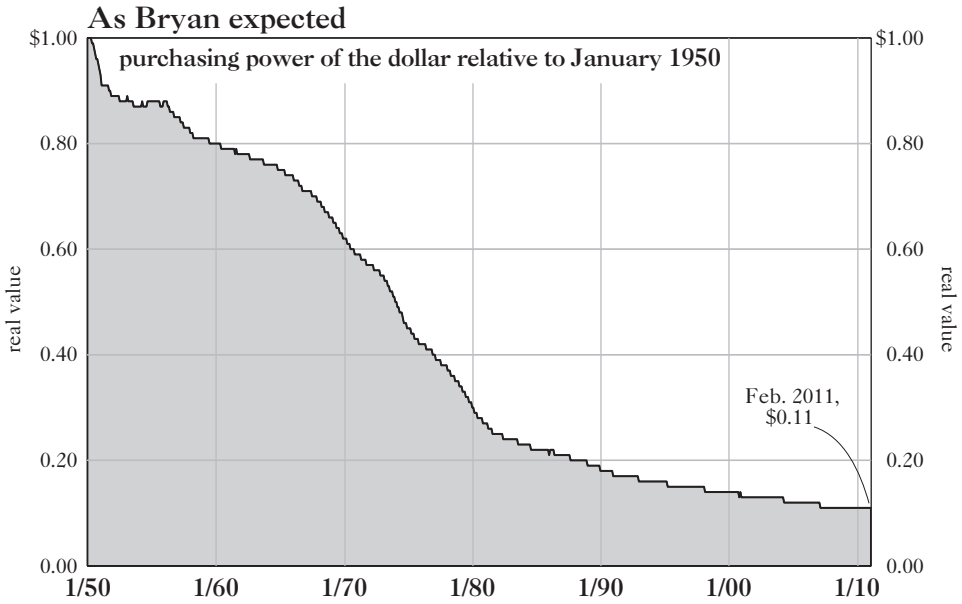
found Bryan a bit of a trial. The man from Atlanta was a harsh critic of the prevailing Federal Reserve operating method. That method centered on neither the funds rate nor the money supply. The open-market desk of the New York Fed rather targeted "free" reserves, i.e., excess reserves minus member-bank borrowings. The desk operated, as the phrase went, by "tone and feel." Monetarists, of whom Bryan was one, despaired of this method, tactile and intuitive as it was. Far better, they believed, to control the money supply directly. It was Bryan who devised the once ubiquitous "cones," whose megaphone-like projections defined the boundaries inside which a properly tempered money stock could be directed to grow. On the technical points of monetary control, Bryan and Martin could agree to disagree (the "dead hand of statistics," warned the chairman, should never dictate policy). However, one can imagine, it wasn't Bryan's monetarism that got under Martin's skin but rather the scourging tone of the Atlantan's public dissent.

"As an economist," the Kansas City Fed's Hoenig humbly declared in a speech in January, "I cannot be certain that my views are correct." Bryan was 100% certain, to borrow a phrase from Chairman Bernanke, that creeping inflation was as immoral as it was unworkable. He spoke to his American Life audience in a barely suppressed rage. It will be useful to quote his remarks at length, not only for their shock value and timeliness, both of which we rate high. The fiery words may also awaken the sleeping inflation-phobia that is an essential part of the mental equipment of the vigilant investor in every paper-money era. If, as and when today's 2% inflation world becomes a 4%, 5% or 6% inflation world, there won't be enough Kleenex to dry the tears of the bondholders.

"The idea that creeping inflation is first inevitable, then necessary to the successful management of our economic affairs, and finally desirable—for economic growth, among other things—is nowadays preached with evangelical zeal," Bryan led off in Chicago almost 54 years ago. The zealots almost seemed to promise that "slow-burning" inflation would contain communism and preserve democracy. "Maybe it is not unforgivably sardonic," Bryan went on, "to anticipate presently the solemn assurance that a little chronic inflation will assist us in warding off the Asiatic flu. . . ."



source: Federal Reserve Bank of St. Louis

Bryan brushed away the argument that even the losers in inflation would gain something—i.e., the rise in the value of their assets and the reciprocal fall in the value of their liabilities would somehow make things right. "[W]e should all be clear on one point," he said, "a connived-at or complaisant depreciation of money cannot be covered with the cloak of respectability simply by demonstrating that the loss to the victims is not quite so much as might at first be supposed. Respectability for the doctrine cannot be attained by such easy, statistical means.

"After all," he went on, "there is such a thing as principle. We are not amused by the occasional newspaper stories that tell us of the footpad who sets upon the citizen, strips him of his clothes, his watch, his wallet, and then, in a gallant gesture in leaving, turns and tosses him a fiver, saying 'Here, Buddy, get yourself a cab home!' We are not impressed when, later on, the defense enters the plea that the theft was not X but X-5 and, besides, the poor devil did not lose everything: he still had his shoes and his underwear. We all know that the requirements of moral respectability are a lot more exacting.

"Actually, of course," this senior officer of the Federal Reserve System proceeded, "the loss to the victims of a contrived or tolerated inflation, whether of 2, 3 or 4 percent per year—the exact dosage has not yet been proclaimed—is and must be enormous. You may start your calculations in this country with about $800 billion of gross public and private creditor and debtor relationships—not, incidentally, the whole of money-payable contracts. You can apply the percentage you choose, make offsets and other corrections to your heart's content, and, though you may slice the victims thin, you cannot slice their losses thin."

At this writing, debt in the United States totals $52.6 trillion. At a 2% rate of debasement, $1.053 trillion a year would silently creep from the creditor's account to the debtors'. You'd think the lenders would make a fuss, but the bond vigilantes are mum. Maybe they shouted themselves hoarse in the credit crisis.

Bryan said a great deal more along these lines. It was nothing less than a sermon against the morality of the Federal Reserve's policies. "If," the preacher went on to say, "a policy of active or permissive inflation is to be a fact, then we can rescue the shreds of our self-respect only by announcing the policy. That is the least of the canons of decency that should prevail. We should have the decency to say to the money saver, 'Hold still, little fish! All we intend to do is gut you.'"

Possibly, if he were alive today, Bryan would be mollified by Bernanke's candor. For the chairman does, after all, announce his intentions. "Low rates of resource utilization in the

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SOLD OUT

GRANT'S

Spring 2011 Conference

Tuesday, March 29, 2011

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The Plaza Hotel
1 W. 58th Street, Manhattan

8:30 a.m	Registration and Continental breakfast
9:00	***Seth Klarman,*** "A sound investment approach for precarious times."
9:35	***Jim Bianco,*** "Is QE2 the new EBITDA?"
10:10	Break
10:25	***Mark Doyle,*** "Muni bond insurers: Back from the ashes?"
11:00	***Joshua Friedman,***"Is it safe? Investing in a world of complacency and complexity."
11:35	Break
11:50	Luncheon
12:40 p.m.	Luncheon speaker: ***Conrad Black,***"The travails and prospects of the newspaper."
1:15	Break
1:30	***Randy Smith,*** "Distressed opportunities in old media."
2:05	***Steven Eisman,*** "World in turmoil—an equity long."
2:40	Break
2:55	***Michael Harkins,*** "Embrace reason; shun theories."
3:30	***James Grant & Lewis E. Lehrman,*** "Money: past, present and future."
4:15 - 5:15	Reception and Jazz music by The Toby Williams Group

United States are creating disinflationary pressures," Bernanke told an audience of central bankers in Frankfurt in November. "[V]arious measures of underlying inflation have been trending downward and are currently around 1%, which is below the rate of 2% or a bit less that most FOMC participants judge as being most consistent with the Federal Reserve's policy objectives in the long run. With inflation expectations stable, and with levels of resource slack expected to remain high, inflation trends are expected to be subdued for some time." Thus, in a mere half-century, "creeping inflation" has gone from a purist's anathema to an overt policy.

Around the Fed, people rolled their eyes at Bryan's views. The recently retired president of the New York Fed, Allan Sproul, asserted in 1959 to a former colleague, Robert Roosa, that they were "a legacy of a fundamentalist religious slant as bent and twisted by the University of Chicago, but it is also a consequence of his having had no experience in a money market."

Bryan, however, was practitioner enough to understand why creeping inflation would ultimately fail. As prices convey information, the wrong prices would convey misinformation. "The contention that a steady, annual, but indefinite deterioration of money will not adversely affect the quality of judgment in the economic community is about as logical as would be the belief that a steady, annual, but indefinite depreciation of the tape measure would not adversely affect the quality of judgment in carpenters, cabinetmakers and their customers," he said. "We would be much closer to the truth, I think, if we held that, in the one case, economic society would find itself equipped with some exceedingly curious cabinet work and carpentry and that, in the other, economic society would find itself equipped with a good deal of exceedingly curious and unprofitable capital commitments."

So Bryan said his piece. He did not predict that the then-prevailing 3% inflation rate would accelerate to 4%, 5% or more, or that the Bretton Woods monetary system (of which, as a member of the American delegation, he had done his part to create) was doomed. Then, again, he wasn't exactly bullish, either. So it did not enhance his reputation for prophecy when the 3% inflation rate of 1957 subsided into the annual rates of less than 2% in 1958 and every other year until his retirement in 1965. He died in 1967.

Not until 1969, two years after his death, did the year-over-year rise in the CPI push through 5% on its way to the moon. Nor did Bryan live to see the breakdown of dollar-gold convertibility (though the signs were there to be read even in 1967) or the unveiling of the monetary establishment's answer for the perceived lack of "liquidity" on what proved to be the eve of the Great Inflation of the 1970s. This wonderful invention was the SDR, or special drawing right.

The present moment in monetary affairs is like no other we have ever heard or read about or seen with our own eyes. Bryan would appreciate it, we think. Our Great Recession should have been the occasion of a great deleveraging. However, since the start of the crisis, total debt has increased, not shrunk, to $52.6 trillion in the fourth quarter of 2010 from $52.4 trillion at the end of 2008. The CPI did register eight consecutive months of year-over-year declines beginning in March 2009, but it's back now to creeping above the zero-percent line.

The world over, observes Frank Byrd, director of research at Fielder Management and a speaker on inflation at the fall 2010 *Grant's* Conference, "money supply and velocity of money are growing faster than output." Recall, he says, the national income identity: money times velocity of money equals output times price, i.e., MV equals PY. "There's only one way for this equation to balance," he—and we, too—conclude, "and that's with a higher 'P.' That is why we are seeing global inflation."

Bryan was early, but what's the fault in that?

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'Core' inflation

"The corner of Main and Main" is the proverbial address of the trophy, or "core," office building. At this incomparable intersection, investors settle for cash-on-cash returns lower than they could earn even a block or two distant. Not that they complain. They are mortally certain that for the right building—one supported by the right, open-throttle monetary policy—there will always be a willing buyer.

Inflation is the topic at hand, specifically the kind of inflation that takes the pleasant form of a bull market. Borne aloft on monetary helium, asset values have climbed these past two years. Particularly have prices risen for high-multiple growth stocks, prime Iowa corn ground and the glitziest coastal office towers. In the post-2009 real estate recovery, core properties have appreciated by almost 35%, according to Green Street Advisors. The share price of CB Richard Ellis (CBG on the New York Stock Exchange), the world's top commercial real estate services firm, has likewise taken flight. Eventually, however, interest rates must rise. Come the day of reckoning, cap rates, too, will likely spurt. How to

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prepare for this disruptive eventuality is the question before the house.

The time-honored way to prepare for a bear market is to ride the preceding bull market; you'll be rich enough not to care about the subsequent drawdown. Sometimes, of course, one forgets to mount, in which case defensive measures are advisable. Standing on the sidelines with one's hands in one's pockets, trying not to mope, is hard enough when cash yields a respectable return. It is well nigh impossible when the real return on money market instruments is less than zero. We don't mean to complain, but facts are facts.

In his December appearance on "60 Minutes," Ben Bernanke memorably insisted that he was "100%" confident of his ability to claw back the myriad dollar bills he has caused to be materialized since the start of the financial crisis. With only a little less than 100% confidence, we say the chairman will be just as surprised by the next inflation as he was by the recent crisis. The future was invented to astonish us, central bankers included.

For an instructive case study in the glories of the recent past and the risks of the immediate future, look no further than Ellis. Since *Grant's* blessed the stock in the issue dated Nov. 13, 2009, CBG has rallied to $27 a share from $11. And more than the share price jumped. Between 2009 and 2010, revenue rose to $5.1 billion from $4.2 billion and EBITDA (earnings before interest, taxes, depreciation and amortization) to $647.5 million from $372.1 million. Per diluted share, the company earned 12 cents in 2009 and 63 cents in 2010 after the horrific loss of $4.81 in 2008. For 2011 and 2012, the consensus of analytical guesswork points to EPS of $1.09 and $1.49, respectively.

Ellis engages in property and facilities management, leasing, sales, appraisal and valuation, investment management, brokerage and development. It is the No. 1 vendor in most of its product lines and 70% larger, measured by revenue, than its largest competitor, Jones Lang LaSalle. In 2005, a very good year, Ellis carried net debt of a mere $128 million. In 2006, a better year, Ellis bought property manager Trammell Crow, along with its debt, for $2.2 billion. By 2008, a terrible year, Ellis was juggling net debt of $1.95 billion. Management's subsequent negotiation of a forgiving new debt amortization and maturity schedule is what is known in Washington, D.C., as "kicking the can down the road." As applied to Ellis in the crisis of 2008-09, however, the pertinent phrase is "timely crisis management." Anyway, the company survived and today shows manageable net debt of $943 million. Anticipated EBITDA in 2011 would cover $180 million of projected interest expense by a factor of 4.6.

"The 2010 recovery," quoth Ellis in its just-published 10-K report, "was characterized by a slowly decreasing vacancy rate, stabilizing rental rates, a broadening of credit availability and increasing property sales and leasing activity. These recovery trends appeared to gain momentum in the last quarter of 2010, but market activity generally remained well below levels experienced in 2006 and 2007." Spreading its wings after a long two years of folding them, Ellis last month disclosed far-advanced plans to buy the majority of the real estate investment management division of Netherlands-based ING Group N.V. for $940 million in cash (net of transaction/integration costs and the purchase of certain co-investment positions). At a glance, notes colleague David Peligal, the purchase appears both reasonably valued (10.5 times EBITDA, within the nine times to 12 times range typically seen in such transactions over the past 10 years) and strategically promising (Ellis's management clients are mainly American, ING's European).

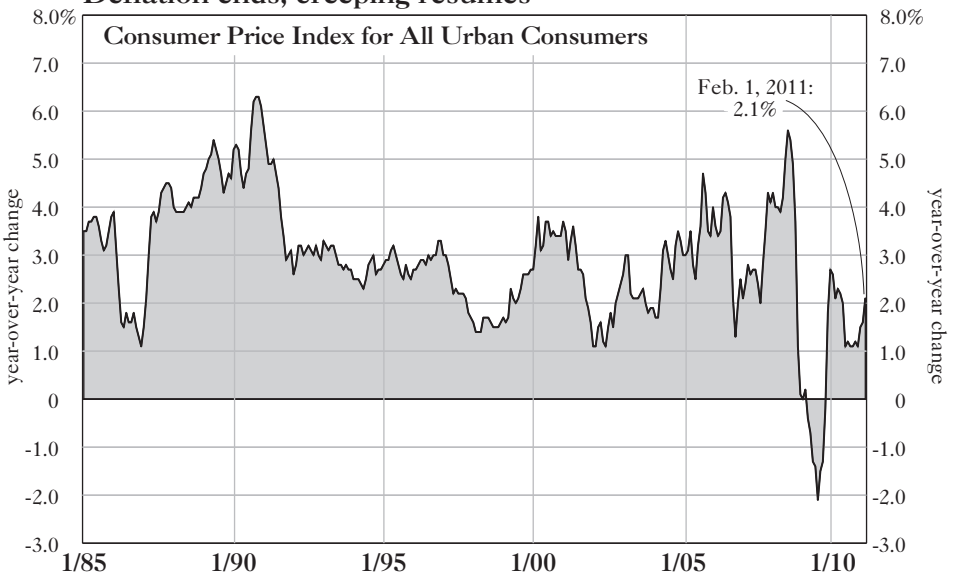
As for the narrow quality of the U.S. real estate recovery, Ellis CEO Brett White tells Peligal that it's nothing out of the ordinary. As a rule, the core segment leads the broader market higher in the boom that follows the bust. Unusual today is the gulf between the vanguard and the rearguard, he observes. Institutional investors want trophies almost to the exclusion of the less shiny, higher-yielding buildings collectively denoted as non-core. As for the non-institutional investor, he or she has become a cipher, so scarce is financing on the friendly old terms.

"If you're not an institution right now," says White, "you really aren't a participant in the market today because you can't get traditional property-level financing. The financing that's available today—if you and I were looking to buy a $35 million Class A, suburban, two- or three-story office building in a good market—Stamford, Raleigh, etc.—you and I are looking at a deal that will probably trade in the 7% to 8% range. Notwithstanding what the banks would like us to hear from them, the financing available would be something like 50% to 60% loan-to-value, full recourse with exceptionally stringent underwriting criteria. Really tough underwriting criteria."

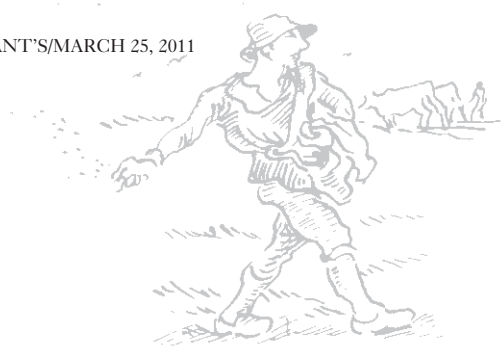
So "easy money" is easy for the happy few who don't need it, hard to come by for the many who do. "For 80% of the buyers out there in this asset class,"

(Continued on page 8)

Deflation ends, creeping resumes



source: Federal Reserve Bank of St. Louis



Credit Creation

Federal Reserve Balance Sheet
(in millions of dollars)

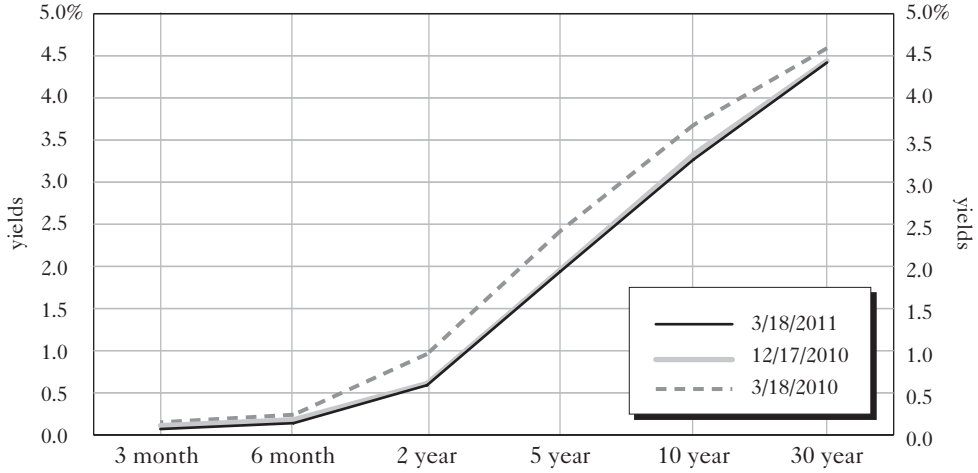
	March 16, 2011	March 9, 2011	March 17, 2010
The Fed buys and sells securities…			
Securities held outright	$2,365,018	$2,345,021	$2,011,499
Held under repurchase agreements	0	0	0
and lends…			
Borrowings—net	20,050	20,311	88,730
and expands or contracts its other assets…			
Maiden Lane, float and other assets	183,156	181,357	192,232
The grand total of all its assets is:			
Federal Reserve Bank credit	$2,568,224	$2,546,689	$2,292,461
Foreign central banks also buy, or monetize, governments:			
Foreign central bank holdings of Treasurys and agencies	$3,401,266	$3,396,735	$2,996,693

European Central Bank Balance Sheet*
(in millions of euros)

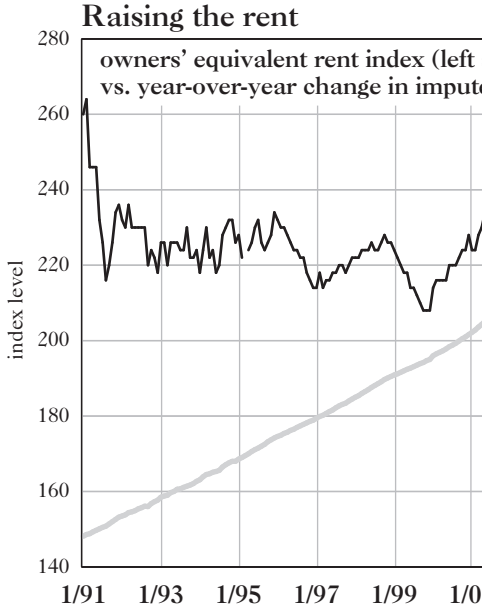
	March 2011	Feb. 2011	March 2010
Gold	€367,433	€367,433	€266,919
Cash and securities	834,012	828,007	648,950
Loans	443,483	458,415	725,409
Other assets	295,450	298,423	253,620
Total	€1,940,378	€1,952,278	€1,894,898

*totals may not add due to rounding

Movement of the Yield Curve



source: The Bloomberg



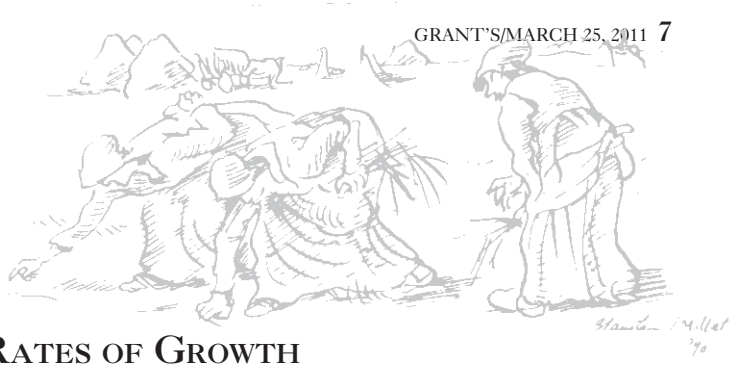
source: Bureau of Labor Statistics

Deflation in beer,

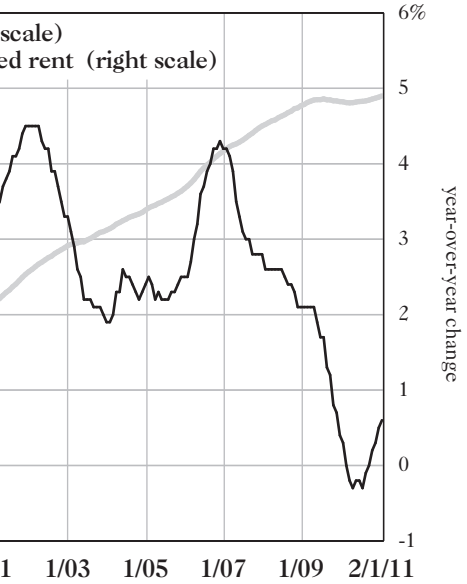
Bearish British inflation news on Tuesday left the 10-year gilt with a princely real yield of minus 0.8%. Then, again, U.K. alcohol prices did tumble by a monthly record of 1.1%. Bond traders seem to have focused on the segment of the price report most meaningful to them.

Like the gilt market, the Bank of England's Monetary Policy Committee has been a picture of steely British resolve. A policy rate of 0.5% is perfectly suitable cojoined to an inflation rate of 4.4% when—as the committeemen found—"some spare capacity would persist throughout the forecast period." The observation sounds persuasive. Certainly, the MPC finds it so. However, as Lakshman Achuthan, co-founder of the Economic Cycle Research Institute, reminds colleague Evan Lorenz, "the output gap has never worked as a forecasting tool." Anyway, wage rates in China, the Manchester of the 21st century, are said to be surging.

As for the FOMC, it finds (or perhaps hopes) that "longer-term inflation expectations have remained stable," its own bulging balance sheet, the run-up in commodity prices and the rise in TIPS break-even rates notwithstanding. Where inflation expectations have assuredly not remained stable is that vast region called "outside the United States." In February,



• Cause & Effect



inflation in rents

inflation registered 6% in Brazil, 9.5% in Russia and 4.9% in China; in January, India recorded 9.3%. Meanwhile, German inflation rates have progressed since November in the following sequence: 1.5%, 1.7%, 2.0% and 2.1%. "If you were just saying what is going on with world inflation," Achuthan relates, "it is probably in a cyclical upswing."

A quirk of American inflation statistics is that imputed rent carries a 40% weighting in the CPI, ex-food and energy. One would suppose that the rash of mortgage-induced bankruptcies would be deflationary. Perhaps not, suggests Martin Cohen, co-CEO of Cohen & Steers. "If you've declared personal bankruptcy," Cohen points out, "it is difficult, if not impossible, to get a mortgage. We are running at about a 1.5 million personal bankruptcy clip for the last two or three years, and expectations are the same for this year and next [there are 112.5 million households in the country]. So if you just look at that, you have many millions of Americans who can't buy a house, are renters by necessity. . . . I think the world has underestimated the pool of renters, and it is not a discretionary decision any more."

"Core" CPI reached 1.1% in February, nearly double the October rate of 0.6%. It "acts well," the traders would say.

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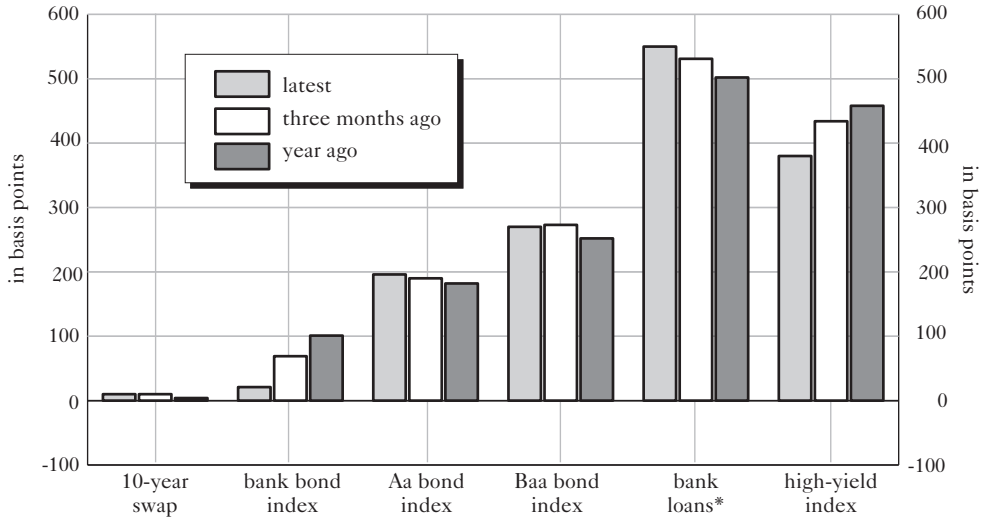
Annualized Rates of Growth
(latest data, weekly or monthly, in percent)

	3 months	6 months	12 months
Federal Reserve Bank credit	42.1%	21.1%	11.9%
Foreign central bank holdings of gov'ts.	6.2	12.1	14.3
European Central Bank	2.5	-2.0	3.0
Commercial and industrial loans (Feb.)	6.1	1.0	-1.7
Commercial bank credit (Feb.)	-4.4	-2.1	2.8
Primary dealer repurchase agreements	-2.5	0.2	8.4
Asset-backed commercial paper	-6.1	-22.2	-12.8
Currency	9.2	10.4	7.0
M-1	13.0	13.3	9.6
M-2	4.6	5.2	4.1
Money zero maturity	2.7	5.1	3.1

Reflation/Deflation Watch

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	9,029.17	9,154.96	11,255.50
Moody's Industrial Metals Index	2,459.28	2,368.01	1,962.13
Silver	$35.06	$35.94	$17.42
Oil	$101.07	$101.16	$82.20
Soybeans	$13.63	$13.35	$9.60
Rogers Int'l Commodity Index	4,118	4,169	3,232
Gold (London p.m. fix)	$1,420.00	$1,411.50	$1,122.75
CRB raw industrial spot index	618.02	612.60	503.52
ECRI Future Inflation Gauge	(Feb.) 102.1	(Jan.) 101.9	(Feb.) 99.5
Factory capacity utilization rate	(Feb.) 76.3%	(Jan.) 76.4%	(Feb.) 72.4%
CUSIP requests	(Feb.) 1,573	(Jan.) 1,439	(Feb.) 1,357

Credit Spreads



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

(Continued from page 5)

White proceeds, "what that really means is that there is no financing and/or they will have to go out and buy very expensive bridge financing or mezz financing—and most aren't. That's another dynamic that drives the capital to 'core,' because only institutions can play in this market and institutions—most of them don't need financing."

And what do the core-besotted institutional buyers have to say for themselves? White was recently out on the road on a non-promotional listening tour. "'Look, Brett,'" he relates the institutions' pitch to him, "'I'm buying into the asset class at the trough of the cycle, at cyclical low rents, into a market where there is no supply coming into the marketplace and it will take you folks' (talking to me) 'five years to get the supply into the marketplace, if then.' There hasn't been speculative financing in the marketplace for years—way pre- this cycle."

Unleveraged, cash-on-cash returns are, therefore, all over the lot in commercial real estate these days—that is, when there are cash returns to capitalize. As empty buildings generate no income, they are valued, so to speak, by the pound. Thus, reports Mike Millett, a surviving Atlanta real estate developer (*and* paid-up *Grant's* subscriber), BellSouth's mostly empty former 20-story headquarters on Peachtree Street changed hands last fall at $70 a square foot. "Replacement cost," observes Millett, "should anyone be demented enough to try, would be about $300 per square foot, all in." According to Bloomberg, two-thirds of the 3.6 million square feet of new office space constructed in Atlanta between 2008 and the first quarter of 2010 sits vacant. It, too, would be valued by the pound.

However, for the sleekest core assets in the principal world financial centers, investors are settling for cap rates of between 4% and 5%, which match the low yields—in some cases driving through them—of the champagne and confetti era of 2006-07. As for generic non-core assets, according to Mike Kirby, Green Street's director of research, you are looking at an approximate midpoint of 8%, and perhaps as little as 5% if there's a compelling story, or as much as 12% for the dog that "should never have been built." Thus, call the spread between cap rates on core and non-core assets 300 basis points, Kirby continues, as wide a gap as he has ever known.

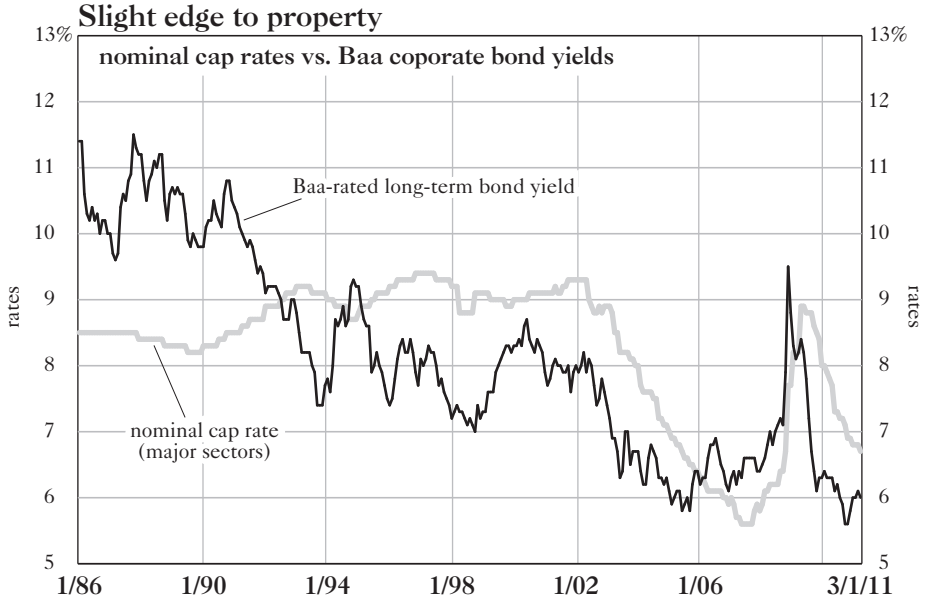
The commercial mortgage-backed securities market, that fixture of boom-era property finance, has been sorely missed. "What is unusual this time," Kirby continues, "is the complete debacle in the CMBS market. It went from $200 billion per year of originations to zero. The CMBS product is what was used to finance an awful lot of the B-grade stuff in the secondary and tertiary locales. That's such a shock to the system."

The system absorbed a happier kind of jolt three weeks ago when Blackstone disclosed that it was paying $9.4 billion for the distinctly non-core U.S. shopping center assets of Centro Properties Group of Australia. While no hard valuation data have been disclosed, Kirby reckons that Blackstone paid full price (a 1.3% discount to Centro's calculation of book value) for the very kind of assets that have gone begging so far in this cycle. And to view the glass of financing as half full, the fact is that reluctant lenders don't finance new capacity. "There's no one building any malls today in the United States of America," Jerry Gershman, founding partner and chairman of Gershman Brown Crowley, an Indianapolis-based developer, reminds Peligal. "That business is over with for some time. And no one is going to build a 900,000 square-foot lifestyle center out in Hamilton County [Ind.]. We built it already."

A Chicago investor we know (who asks to remain anonymous) reports that about three weeks ago, a fully leased, single-tenant office building in Milwaukee changed hands at an $8^1/_2$% cap rate, which translates into estimated replacement cost of $165 to $175 per square foot. In Chicago, our source speculates, the same property would have fetched a $6^1/_4$% to $6^1/_2$% cap rate. "Cap rates in the Midwest and in second- and third-tier markets are now benefiting as buyers get priced out of the coasts," he said. He predicted that the valuation spread between the most favored, most liquid markets and all the other markets has "got" to narrow: "It can't be 300 basis points. Historically, it hasn't been that wide." The Milwaukee sale, our source added, was the first of its kind in a year.

Possibly, Kirby speculates of the Centro deal, it is the start of something, since—so he judges—"the CMBS market is rebuilding. You have just as many banks back in the business now as you had in 2007. Anybody in that business thinks it's going to be a $40 billion or $50 billion business this year, and next year you got to add a lot to that. That is all but assured of coming back in a pretty big way." And when it does come back, he added, the better kind of non-core asset will find a bid.

Mr. Market himself could devise no more favorable set of monetary conditions than those in place today. Still trying to ward off the specter of the 1930s, the Fed suppresses money-market interest rates. Still trusting the Fed, the bond market makes no protest of that aggressive policy. Groping for yield, in-



source: Green Street Advisors, Moody's Investor Services

come-starved savers push down yields on junk bonds and tradable bank debt. Resurgent commodity markets presage a new inflation but the official price indices remain benign.

How long perfection will reign is anyone's guess, but we rule out eternity. Certainly, even a modest jump in inflation—to a plausible and persistent 3% or 4%, say, from the present readings of 1% or 2%—would end the idyll of 4% to 5% core cap rates. Investors in top-flight buildings at current valuations imagine they are buying a bond, Ellis's White relates, a kind of "real-estate bond" without credit risk. In the kind of buildings they're buying, there's no rollover risk, the institutions have determined, because there will always be a steady supply of aspiring tenants. "These are the deals," White explains, "where an institution is going in and saying, 'I'm going to park $500 million here. I'm satisfied with a 4.5% cash-on-cash yield there. And I'd be pretty happy if I left my money there for the next 10 years."

However, what if the next 10 years look nothing like the past 10? In fact, with respect to interest rates, what if the next 10 years look nothing like the past 30? From 1981 to date, rates have mainly fallen. Inflation, which spiked in the 1970s, subsided in the early 1980s and thereafter lay dormant. But let us imagine that inflation jumps out of its box and interest rates reverse course and climb. What then?

One valuation technique favored by Green Street is to compare the average cap rate on a broad index of commercial structures with the Baa corporate bond yield. At today's readings, real estate looks only faintly attractive, Kirby relates. Whereas the bond fetches 6%, property is quoted at 6.8% to 7.8% after adjustments for anticipated growth. "The 180 basis-point gap between the projected IRR and the Baa is 40 basis points wider than the 140 basis-point average for this figure since 1986," Kirby points out. "If you just revert to the mean, it says that real estate has another 5% to 10% upside." And the downside? Holding cap rates constant, a rise in Baa yields of just 40 basis points would erase the property market's current valuation edge. "So there is clearly risk," Kirby observes. "When we think about it, we're just trying to price real estate relative to bonds. Which should do better, real estate or bonds? . . .[I]t could be they're both overpriced."

Miniature nominal interest rates distort all valuations. When we opined on the shares of CB Richard Ellis in November 2009, they were quoted at 22 times the 2010 estimate of 50 cents a share (13 cents light, as it turned out). However, margins were depressed and the CBG valuation was no richer than that of Jones Lang, Ellis's less heavily encumbered competitor. Insiders were buying. These days, Ellis is quoted at 25.1 times the 2011 estimate, 18.4 times the guess for 2012 (compared to 19.2 times and 16.0 times, respectively, for Jones Lang). Margins are fatter than they were in 2009—on an EBITDA basis, 12.7% vs. 8.9%—but the message from the insiders is cautionary.

"Ellis's directors," Peligal relates, "many of whom have a private equity background, have been recent sellers. Board member Frederic Vincent Malek sold 50,000 shares in the first two weeks of March at prices ranging from $25.90 to $27.22. Board member Gary Wilson exercised options and sold 8,847 shares at $26.90 on March 14. Raymond Wirta, vice chairman, exercised options and sold 900,000 shares from March 4 to March 11 at prices ranging from $25.29 to $27. And on Feb. 28, White himself exercised some options and sold 174,381 shares at prices ranging from $24.78 to $24.86."

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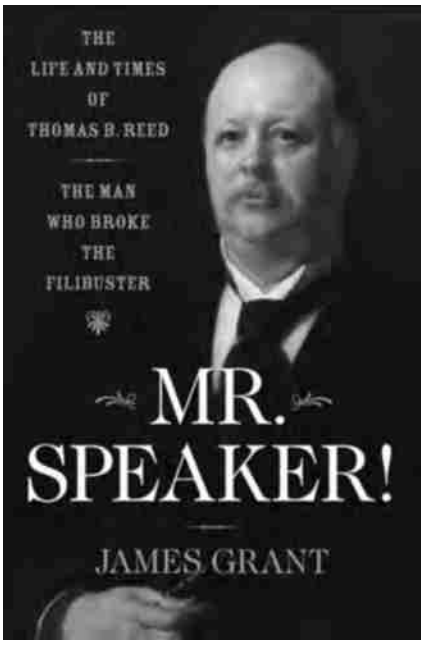

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How to interpret these dispositions? No married man, or, for that matter, married woman, will fail to see the matter sympathetically. "I think," White explains, "when an executive's compensation is one-third or one-half in stock, the idea that they should never sell is silly." On a personal note, he adds, "when the stock broke $3 going the wrong way, I sat down with my wife and we talked about what was left, which wasn't much. I promised my wife that we would take some off the table if it ever got back to what I thought was a range where some value was there."

Sound advice, it seems to us. A bet on the persistence of today's alignment of bullish forces is, after all, a bet on the prescience of the Federal Open Market Committee. We'll take our chances at the racetrack.

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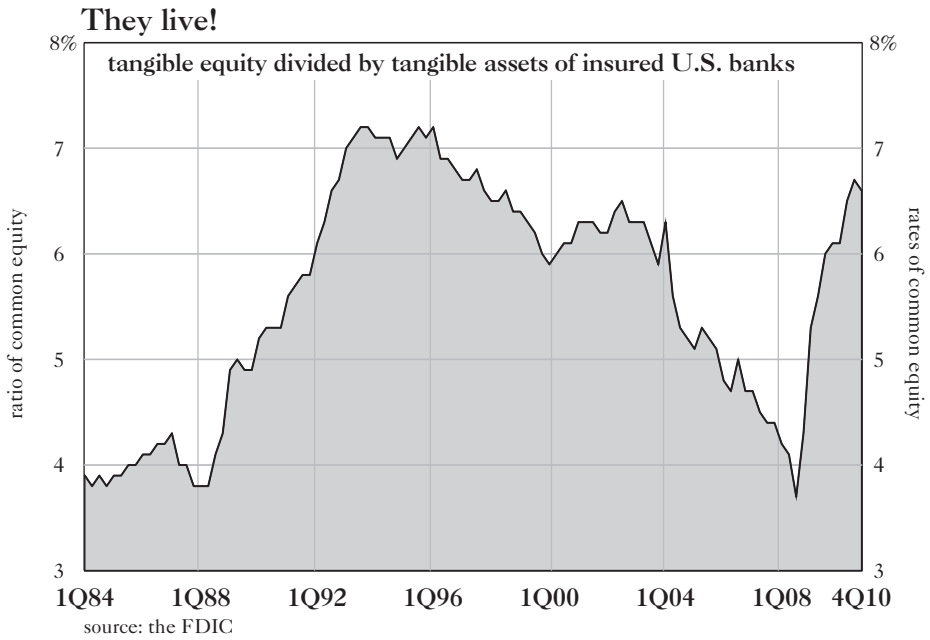


Buy the predators

It fell to Sheila Bair to remind the bankers how low they have sunk in the public's esteem. In a new Pew Research poll, the FDIC chairman noted at the March 16 Government Relations Summit of the American Bankers Association, only 22% of respondents rated banks positively. Even Congress—Congress!—stood higher in the public's estimation. As for the estimation of the world's investors, that's a different story. To anticipate, there are reasons for optimism.

The FDIC itself has the bullish facts and figures. Since the end of the world-as-we-knew-it in 2008-09, the quantity and quality of bank capital alike have rebounded. Indeed, the ratio of tangible equity to tangible assets at America's insured banks stood at 6.6% in the fourth quarter, higher than the average of 5.6% registered over the 1984-2010 span. At the peak of the boom in 2007, tangible equity to tangible assets weighed in at just 4.4%.

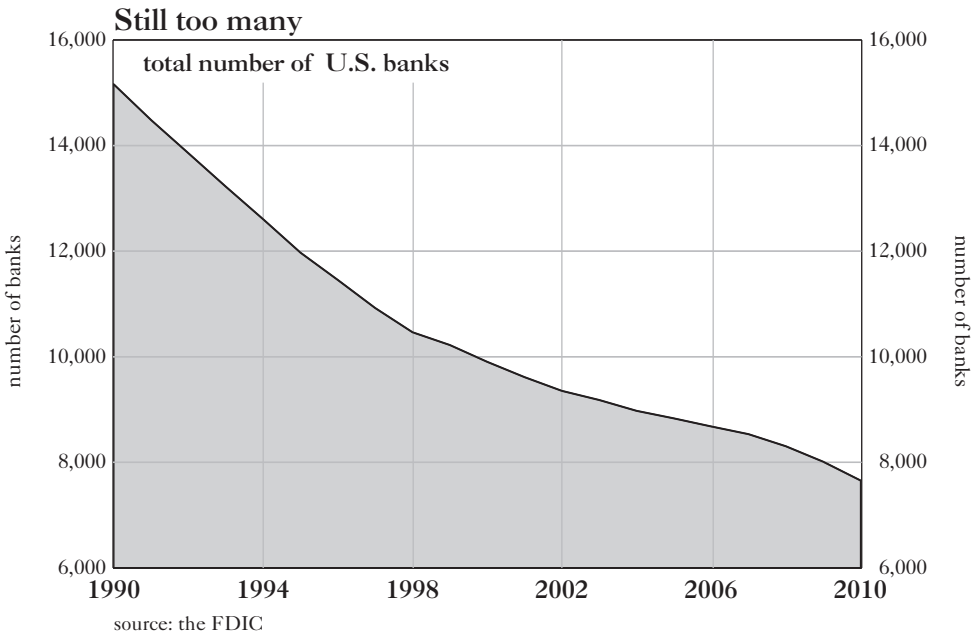
"I think that we are a lot further along than most would have anticipated at this stage of the game," Matthew Kelley, managing director of the financial institutions group at Sterne Agee, tells colleague Evan Lorenz. "There has been more capital raised. Equity valuations have improved much faster and by a much larger degree than anticipated, and that has allowed institutions to raise capital along the way, to exit TARP faster."

It doesn't hurt the profitability of the disesteemed banks that, thanks to the Fed, they are paying their depositors peanuts. Fourth-quarter net income of $21.7 billion was the second-highest quarterly haul reported since the second quarter of 2007, while the fourth quarter's net interest margin of 3.71% actually surpassed the 3.33% registered in the second quarter of 2007. There are, however, lingering effects of the credit debacle, with loss provisions representing 19.3% of net operating revenue in the fourth quarter, compared to 7.2% in the second quarter of 2007. Still, noncurrent loans and leases have declined to 4.87% of outstandings from a peak of 5.43% of outstandings in the fourth quarter of 2009; of course, they are up from 0.91% in the second quarter of 2007, when next to nobody defaulted because money was there for the taking. If the Fed stays easy and the bones of credit continue to knit, bank earnings may soon set new records. Won't the public love the bankers then?

"It does feel like the system is working the way we would hope it would work," Ivan Q. Zinn, founding partner at Atalaya Capital Management, tells Lorenz. Atalaya, with a half-billion dollars under management, specializes in illiquid credit assets. To Zinn and his firm, the Great Recession was a kind of paradise. At the start of the proceedings, he relates, only money center banks, with their more diversified revenue bases and anxious friends in Washington, were willing and able to sell assets. Today, the regionals, too, are coming clean and taking their marks (and lumps).

"Anyone who has been doing extend and pretend has seen the light," avows Kevin J. Lynch, CEO of Oritani Bank (*Grant's*, Nov. 26, 2010). "They've had a 'come to Jesus' moment with the regulators coming and saying, 'Let's take another look at that loan you've extended.'" Regulators, he says, are actually enforcing the rules that restrict property lending to a portion of bank capital—commercial real estate lending to 300% and construction and development lending to 100%. Push above those limits and you won't be allowed to grow. As if to atone for previous sins of omission, the authorities are on the warpath today. Consider, for instance, suggests Lynch, an upcoming Financial Accounting Standards Board rule revision that will increase the number of loans that fall under the rubric of troubled debt restructuring. "Until that loan is paid off, your books will reflect a troubled debt restructuring," he says. "It's something that ends up flagged on your financial statements until the loan is paid off in full."

Once upon a time, America's secret strength was its ability to admit error, reprice it, liquidate it and go on to new triumphs—and, necessarily, new errors. While the recent massive federal



source: the FDIC

interventions have rather muddied the story line, a certain essence of American exceptionalism remains.

Zinn contrasts what is happening in the United States today with his experiences in Europe. "I ran around continental Europe a number of years ago, likewise trying to buy opportunistic credit investments, very similar to what we'd be trying to buy today," he relates. "Regardless of how many meetings I had inside Commerzbank, couldn't convince them to sell anything. They never sold anything, at least anything that was really relevant. I look at the German banking system as one reasonable example where I've had some experiences where we thought there would be opportunity. It was never nearly as attractive as we thought the Basel II restrictions would require.

"I think that part of it is," he goes on, "if you look at the German banking system, for example, vs. the U.S. banking system, yes, there's been a ton of subsidization effectively in the U.S. banking system over the last several years to keep stability. But the German banking system has lived on that for decades. The *Landesbanken* have lived on that system for many, many years and they don't know how to operate any other way. You shouldn't expect them to do anything other than operate the way they've operated in the past. I do think that the U.S. system is working with efficiency and in a capitalistic way that others have not been able to replicate."

For as far back as graybeards can remember, America has seemed to have too many banks and thrifts. Even after the culling that has halved the population since 1990, 7,657 institutions remain, including 884 with $390 billion in assets that probably shouldn't exist at all (the FDIC judges them to be imperiled). The answer? Consolidation. "When bank A acquires bank B," observes Michael MacDonald, managing director at Keefe, Bruyette & Woods, "it's going to take over bank B's bad assets at a mark-to-market that will enable the bank to sell them literally on the same day they close the acquisition of bank B."

Sy Jacobs, principal of Jacobs Asset Management, a.k.a. JAM Partners, who presciently forecast a bank consolidation wave at the *Grant's* spring event last year, has begun to change his tune in this respect. "Our thesis has kind of morphed, I would say, into a larger thesis that first started with the opportunity to buy failed banks and then, somewhere down the line, we recognized that the failed bank rollup was really a part of a larger consolidation," he tells Lorenz. "The U.S. commercial bank industry is going to consolidate—is starting to consolidate. Buying failed banks is going to be just a subset of that, just a small subset of that. There is going to be a lot more live-bank M&A than failed-bank M&A, and the failed bank was just the first chapter because it was the critical chapter of it. The FDIC didn't want there to be all of these zombie banks like there were in Japan, so they just had to address that first. But the broader consolidation would take more time to develop, and Act II would be much larger in volume than Act I."

Let us say, Jacobs continues, that the crisis is over and that balance sheets are indeed on the mend: "In such a world, the glaring hole is not a credit hole; it is a lack of growth and a higher expense base problem. That, to us, adds up to a massive consolidation coming where you have the bigger, healthier players needing to grow through M&A and the smaller players needing to sell. The size bar above which you need to afford the fixed costs and brain damage of being a regulated institution is now higher." While the cry for consolidation is almost as old as the American hills, new banks have continually sprouted to replace the ones absorbed in mergers and acquisitions. Result: too many banks. The new, post-crisis regulatory burden will exact a severe toll in the banking birth rate, Jacobs speculates, with potentially bullish long-term consequences. The banking business may become less crowded, more rational and, importantly, more profitable.

How to invest in anticipation of these changes? Counterintuitively. "Basically," Jacobs explains, "when you thought there was going to be a lot of M&A, you would automatically… figure out who was going to get bought. We think this time, and for the first time, it is almost the opposite. Those who are going to get bought are almost inherently unattractive and small. The real opportunity is to invest in the consolidators…. The opportunity for triples, quadruples, five and 10-baggers over the next five to 10 years is going to be the bank just above the size that feels it can survive and have expertise in consolidating banks and has made acquisitions in the past—you know, the $2 billion bank that wants to be a $10 billion bank or the $5 billion bank that wants to be a $20 billion bank—and can consolidate their market."

Jacobs says that his new strategy is still undergoing its shakedown cruise. However, even in this formative stage of development, the grand theme seems well established. To wit: This time around, invest in the predators, not the prey.

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Deflation in beer, inflation in rents

Bearish British inflation news on Tuesday left the 10-year gilt with a princely real yield of minus 0.8%. Then, again, U.K. alcohol prices did tumble by a monthly record of 1.1%. Bond traders seem to have focused on the segment of the price report most meaningful to them.

Like the gilt market, the Bank of England's Monetary Policy Committee has been a picture of steely British resolve. A policy rate of 0.5% is perfectly suitable cojoined to an inflation rate of 4.4% when—as the committeemen found—"some spare capacity would persist throughout the forecast period." The observation sounds persuasive. Certainly, the MPC finds it so. However, as Lakshman Achuthan, co-founder of the Economic Cycle Research Institute, reminds colleague Evan Lorenz, "the output gap has never worked as a forecasting tool." Anyway, wage rates in China, the Manchester of the 21st century, are said to be surging.

As for the FOMC, it finds (or perhaps hopes) that "longer-term inflation expectations have remained stable," its own bulging balance sheet, the run-up in commodity prices and the rise in TIPS break-even rates notwithstanding. Where inflation expectations have assuredly not remained stable is that vast region called "outside the United States." In February, inflation registered 6% in Brazil, 9.5% in Russia and 4.9% in China; in January, India recorded 9.3%. Meanwhile, German inflation rates have progressed since November in the following sequence: 1.5%, 1.7%, 2.0% and 2.1%. "If you were just saying what is going on with world inflation," Achuthan relates, "it is probably in a cyclical upswing."

A quirk of American inflation statistics is that imputed rent carries a 40% weighting in the CPI, ex-food and energy. One would suppose that the rash of mortgage-induced bankruptcies would be deflationary. Perhaps not, suggests Martin Cohen, co-CEO of Cohen & Steers. "If you've declared personal bankruptcy," Cohen points out, "it is difficult, if not impossible, to get a mortgage. We are running at about a 1.5 million personal bankruptcy clip for the last two or three years, and expectations are the same for this year and next [there are 112.5 million households in the country]. So if you just look at that, you have many millions of Americans who can't buy a house, are renters by necessity. . . . I think the world has underestimated the pool of renters, and it is not a discretionary decision any more."

"Core" CPI reached 1.1% in February, nearly double the October rate of 0.6%. It "acts well," the traders would say.

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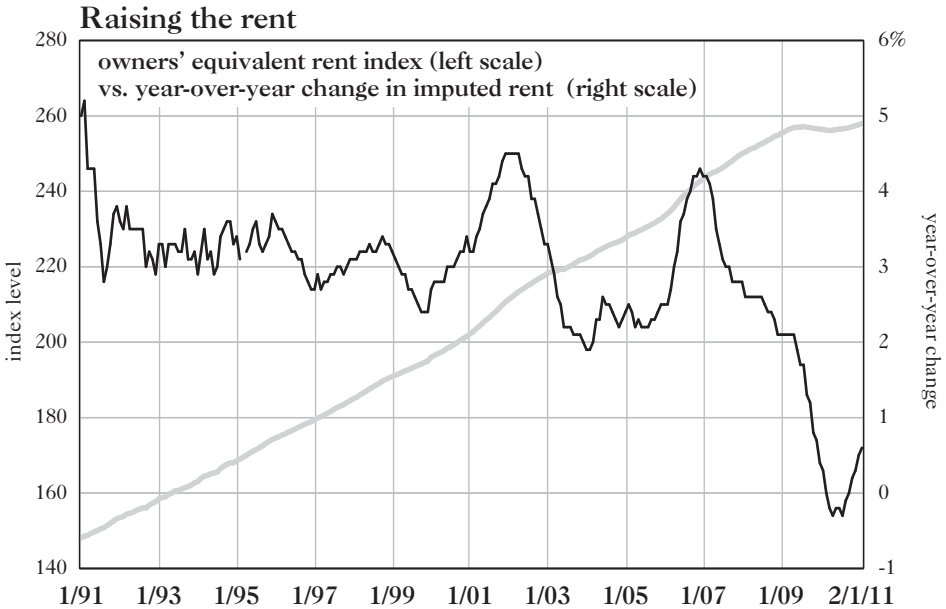

source: Bureau of Labor Statistics