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Market of the absurd

In the closing scenes of the bear bond market of 1946-81, despairing bulls cracked open Sidney Homer's "History of Interest Rates." Surely, they reasoned, nothing in markets is ever really new. There must be some guidance, some consolation in history. Actually, 15%—the then-quoted, long Treasury bond yield—was unprecedented.

The essay in progress concerns the mirror image of 1981. Today's stunted interest rates, though not exactly unprecedented, are rare and remarkable. The world over, creditors are living on the equivalent of birdseed. Investors who once disdained sky-high yields today settle for crumbs. What were they thinking a generation ago? What are they thinking today?

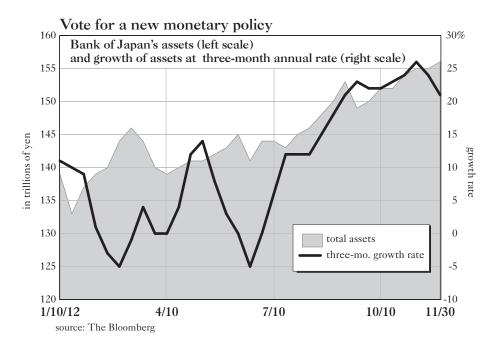
The thoughts, in fact, run in parallel. Central bankers are harmless, said the bond bears in 1981; in a social democracy, inflation is ineradicable. Central bankers are harmless, charge the bond bulls of 2012; in an overleveraged economy, inflation is unachievable. So is growth, they have lately begun to insist. As for us, we hold a candle for both growth and inflation—and, in consequence, for our long anticipated, long overdue bond bear market.

Markets live by the ideas that stock the noggins of the fully credentialed professional investors. "The new normal"—meaning, essentially, "Don't get your hopes up, Mr. or Ms. America, because growth is hostage to debt, and stocks are cooked"—is one such ubiquitous notion. Implicit is a call to action. Call your Pimco representative without delay. Buy bonds. Earn almost as much as the measured rate of inflation. Sleep tight.

In August, Robert J. Gordon, professor of economics at Northwestern University, took up the theme in a National Bureau of Economic Research working paper entitled, "Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds." As might be inferred, the answer to the question posed in the title is "yes." We've seen the best of growth in America for what may be a very long time, say the year 2100, the professor believes. "There was virtually no growth before 1750," Gordon writes, "and there is no guarantee that growth will continue indefinitely. . . . [T]he rapid progress made over the past 250 years could turn out to be a unique episode in human history."

The first industrial revolution, 1750-1830, brought forth the steam engine, cotton spinning and the railroad. The second industrial revolution, 1870-1900, delivered electricity, the internal combustion engine and flush toilets. The third industrial revolution, 1960 to approximately the peak of the Nasdaq Stock Market in 2000, is responsible for digital technology in all its permutations.

Inventions bestow their gifts over time, Gordon continues. The benefits of indoor plumbing, air conditioning or jet air travel contributed to growth for a certain number of years. But then they stopped. It's not as though we don't continue to benefit from the ingenuity of Thomas A. Edison or



Henry Ford and whoever it was who invented the shower head. But their contributions to material progress eventually stop producing the incremental unit of GDP.

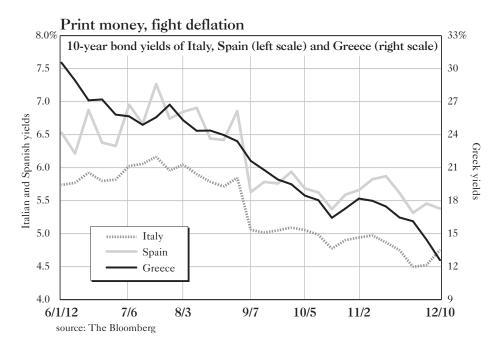
More than 100 years elapsed before the transformative power of the first and second industrial revolutions ran their course, Gordon proposes. But digital innovation has nothing like that staying power. It flares then it fades. Besides, the significance of the innovations of industrial revolution No. 3 pale in comparison to those of the first two upheavals. Electric lights and central heating transformed the way we live and work. In a very different league are the products that diffuse the entire body of human knowledge in ways never before imagined. They please and amuse and improve, but, he insists—though many will argue they do not transform.

Not to mention Gordon's buffeting "headwinds"—slowing population growth, rising inequality, the Web-induced leveling of the global commercial playing field, high tuition costs and ignorant students, taxes and environmental regulations, and burdensome debts.

Get it out of your head, the Gordon essay counsels, that progress is constant and accelerating. It is intermittent and—as at this moment—decelerating. For ages, nobody moved faster than "the hoof or the sail." Then came the railroad in 1830 and, finally, the Boeing 707 in 1958, a soaring curve of speed and convenience. But that's when forward motion stopped: "[I]n fact, airplanes fly slower now than in 1958 because of the need to conserve fuel."

We forget how lucky we are, the professor proceeds. It was 500 years before the living standards of the year 1300 improved by a factor of two, while to double the standard again, starting in 1800, took but 100 years. The standard of living of 1929 doubled in a mere 28 years—by 1957, people were living twice as well as they had in the year of the Crash, the Great Depression and World War II notwithstanding. Progress thereupon downshifted. The next doubling, to 1988, took 31 years, Gordon claims, at which point the historian becomes a prophet: To double the living standard of 2007 will require 93 years, he pronounces.

During the techno-bubble of the late 1990s, Gordon was a brave de-



bunker of the extravagant claims of the prophets of the "new economy" (see, for instance, "The great productivity delusion," Grant's, March 31, 2000). Not only was he correct, but also contrary. And while he may be correct today, which we happen to doubt, he is anything but contrary. Stock prices peaked five years ago, bond yields 31 years ago. Monday's Financial Times reports that "assets in fixed-income hedge funds are poised to overtake those in equity trading strategies for the first time in the history of the \$2 trillion industry." Tuesday's Wall Street Journal reports that the public is out of the market.

Europe is evidently in recession, America peers down from its fiscal cliff and Japan hasn't been heard from in 25 years. Jeremy Grantham, the voice of Boston money manager GMO, has produced a deeply gloomy analysis entitled, "On the Road to Zero Growth." Capital formation is slowing, population growth is shrinking, resource costs are rising, climate is changing and real growth is faltering, he proposes. We may survive, or we may not. GDP growth in the developed world, "and particularly in the U.S.," has fallen, "and will continue to do so in the future," writes Grantham, not just predicting but underlining his prediction, as if to say, "It's really going to happen!" Unless we misread the sentimental tea leaves, "growth is dead" has become safe institutional doctrine.

As it was, of course, in the 1930s and

early 1940s. Yet, as Gordon notes, living standards between 1929 and 1957 were on their way to doubling. Surely, few living witnesses to this uplift realized it was happening. Bearishness is always in flower in depressions, so Alvin Hansen, apostle of John Maynard Keynes and professor of economics at Harvard University, stood before a sympathetic audience as he delivered the president's address at the 51st meeting of the American Economic Association in Detroit in 1938. It was entitled, "Economic Progress and Declining Population Growth."

Bond yields had been falling for 18 years, and the stock market had just crashed—again. The prosperity of the 1920s must have seemed like a fantastic dream. "We are passing, so to speak," Hansen told his colleagues, "over a divide which separates the great era of growth and expansion of the nineteenth century from an era which no man, unwilling to embark on pure conjecture, can as yet characterize with clarity or precision. We are moving swiftly out of the order in which those of our generation were brought up, into no one knows what."

But Hansen knew, or thought he did. The key was population growth. It had collapsed to half the rate of the 1920s, "and the best forecasts indicate a decline to a third in the decade which we are about to enter." Yet the "best" forecasts missed one small upcoming event—the baby boom (see *Grant's*, Feb. 10).

Anticipating Gordon, Hansen foresaw no tailwinds, only the winds at his face. The vanished frontier was one such. In the 19th century, the push into new places called forth half of new capital formation. But, said Hansen, "[t]hese outlets for new investment are rapidly being closed." India? China? Russia? Think again, he said. They offer "relatively meager investment opportunities. At all events, no one is likely to challenge the statement that foreign investment will in the next 50 years play an incomparably smaller role than was the case in the nineteenth century."

Neither would invention save the day, Hansen went on. "[W]hile technology can facilitate the opening of new territory, it cannot create a new world or make the old one bigger than it is. And while the advance of science, by reducing the death rate, was a major cause of the vast nineteenth century increase in population, no important further gains in this direction can possibly offset the prevailing low birth rate."

So "secular stagnation" was on the long-term agenda, the Harvard professor preached: "sick recoveries which die in their infancy and depressions which feed on themselves and leave a hard and seemingly immovable core of unemployment." Except, that is, for the seminal prosperity, beginning at the close of World War II, which failed to appear in the would-be futurist's field of vision.

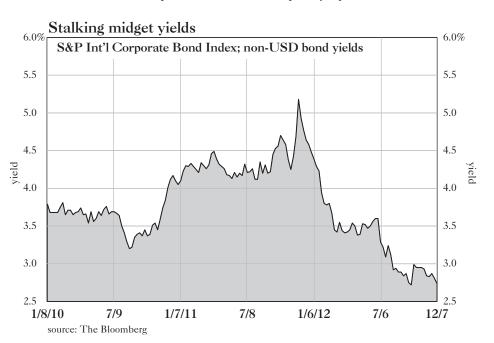
Gordon could be right or he could be wrong. Maybe, suggests colleague Evan Lorenz, the shale gas boom will restore American manufacturing dominance. Or, perhaps, "that glaring marker of income inequality, low wage growth for the middle class, is making America's labor force globally competitive. Witness the recently announced relocations of Apple and Lenovo factories to the United States from the formerly low-cost precincts of China." Then, too, Lorenz points out, Americans have been paying down their debts even while citizens of other countries-widely assumed to be the prudent countries-have been running them up. "Did you know, for instance," Lorenz inquires, "that the ratio of debt to disposable income in America fell to 107.9% in the third quarter of 2012 from a peak of 129.4% in the third quarter of 2007? Meanwhile, Canadian and Swedish consumers carry debt-to-income ratios of 163.4% (as of June 30) and 170.7% (as of year-end 2011), respectively. Not to forget house prices: America's, having collapsed, appear to be on the upswing. Canada's are only starting to break. In November, year-over-year sales fell by 16% in Toronto and 28.6% in Vancouver."

Imagination is what a prophet needs lots of. We sometimes wonder if investors should read more science fiction and less economics. Thinking about Gordon's low opinion of the economic payoff of digital technology, we are put in mind of the diametrically opposite view expressed by, among many others, the mathematician and science fiction writer, Vernor Vinge. In remarks delivered in 1993 at the Vision-21 Symposium sponsored by NASA (a setting we judge to be at least as likely to elicit actionable investment ideas as a meeting of the American Economic Association), Vinge discussed the coming of artificial superhuman intelligence. "I argue...," he said, "that we are on the edge of change comparable to the rise of human life on earth." Added Vinge, "I'll be surprised if this event occurs before 2005 or after 2030."

We have a feeling—and the merest feeling it is—that Vinge, even adjusted for hyperbole, has a better view into the potential of computer technology than Gordon has. From a somewhat more solid footing, we observe that a kind of comprehensive

bearishness is baked into the cake of world interest rates. Neither inflation nor growth will prompt a rise, Mr. Market is saying. Yes, the Bank of Bernanke will carry out its plan to buy bonds and mortgages. And, yes, central bankers the world over areas Bloomberg reported on Monday-"arguing about how far they can look beyond their price mandates and focus instead on economic growth, employment or financial stability when inflation threats are either not pressing or deemed to be passing. This marks a shift from three decades in which central bankers battled inflation, an enemy they understood so well that most made it their singular emphasis in the 1990s." Which, for many, leaves bonds (though not for GMO, let the record show). And what is a bond? It is evidence of indebtedness, denominated in the very fiat currency that our central bankers are working so hard to depreciate.

For us, we're on the lookout for the anti-Paul Volcker of this interest-rate cycle. We have our eyes peeled for the central banker or bankers who will lay low the menace of not-rising prices. Many are the contenders. In China, in the three months to October, so a knowledgeable mainland observer advises, broad credit financing jumped to an annual rate of 40% of GDP, the highest since the first half of 2009. In support of this money-materializing drive, the People's Bank has boosted net liquidity injections into the market



to the tune of 1.95 trillion renminbi (\$313 billion).

Famously, Japanese government bonds yield next to nothing, because Japan is locked in the supposed purgatory of not-rising prices. At the 10-year maturity, JGBs return a nominal 0.69%, a princely return, say the bulls, given the dwindling Japanese price level (down 0.4%, year-over-year, in October). But the Japanese go to the polls on Dec. 16 to elect a new parliament and—perhaps—a new monetary policy. Front-runner Shinzo Abe, president of the Liberal Democratic Party, is foursquare for reflation. He demands that the Bank of Japan print yen until the rate of rise in consumer prices touches 2%. It is a familiar demand, of course, but we should not be blasé.

"The Bank of Japan," Lorenz relates, "seems to be bending to political pressure. Assets at the bank grew by 21.4% at an annual rate in the three months to Nov. 30 after having contracted by 5% on the same basis as recently as June 20. In anticipation that the BoJ will print and print, but that the printing will cause no consequential inflation, the Japanese yield curve has attained its flattest profile since 1993."

Also in contention for the anti-Volcker laurels is the European Central Bank, whose muscular interventions have succeeded in reducing the quoted yields on the sovereign debt of the EU's peripheral problem children. Thus, Spanish yields have tumbled to 5.42% from a 2012 high of 7.62%, Italian yields to 4.71% from 7.16% and Greek ones to 12.68% from 37.10%. If the market is shelving its fears of deflationary debt collapse, it may focus instead on the risk of a new inflation (thank you, Bill Fleckenstein).

Demoralized was investment morale in 1938. Desperate is the mindset of fixed-income investors in 2012. In search of income, they are looking under rocks. They venture far and wide—to BB-rated Turkey, for instance, which on Dec. 5 raised \$1 billion of 29-year, dollar-denominated debt at a price to yield 4.352%, an interest cost just 158 basis points below that paid by the split-rated U.S. Treasury. In the local currency market, the Turkish 10-year note is priced to yield 6.58%, only slightly higher than the 6.37% Turkish inflation rate. Turkish banks have issued \$12 billion of international debt this year, more than twice the amount laid off in 2011 and topping, even, the \$7.1 billion raised by the government, according to Bloomberg. "And a good thing, too," Lorenz notes, "as Turkey is running a current account deficit equivalent to 7.5% of forecast 2012 GDP. Collectively since year-end 2009, Turkish banks have expanded their loan book by 94%, their deposits by 49%. International funding is more than desirable; they really have to have it."

And let us not forget Mongolia, a BB-minus-rated credit, which tapped the ravenous market for 10-year bonds in the sum of \$1.5 billion, equivalent to almost 20% of Mongolian GDP, in a two-part issue on Nov. 28. "Over the past 22 years," Lorenz notes, "Ulan Bator has had recourse to the IMF on five separate occasions. But not this time. It called on Mr. Market and wound up paying 5½. Ireland is paying 4.62%."

Then there is Iceland, whose Islandsbanki, the state-sponsored successor to the shattered Glitnir Bank, is preparing to return to the international debt market, or how about Baa-rated Amazon, which last month sold \$750 million of three-year notes at a price to yield 0.65%, with Moody's cautioning that the online retailer's 12-month EBIT of \$531 million was the lowest since 2006.

What are the world's creditors thinking about bonds? What they thought in 1981—but in reverse. They will rue it.

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