GRANT'S
INTEREST RATE OBSERVER®
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What they wish for

How posterity will rate Mario Draghi and the monetary world he lives in is for posterity alone to judge. As for us, we can't make heads or tails of him or it. We understand the patterns of his speech but not the logic of his deeds. Especially are we stumped by his announced determination to steer the fortunes of the continent of Europe according to the squiggles of something called the "five-year, five-year euro inflation swap rate."

If you are still with us, the five-year, five-year swap rate is meant to express the market's clearest vision of the average level of inflation starting in five years' time—i.e., for the half-decade beginning in 2019. In Europe, the market for inflation swaps is thought to be deeper and more informative than the market for inflation-linked bonds.

Draghi tipped his hand during the speech he gave in August at the Federal Reserve conclave at Jackson Hole, Wyo. Observing that "[i]nflation has been on a downward path from around 2.5% in the summer of 2012 to 0.4% most recently," he allowed that transitory factors might explain the observed deceleration. The euro had been strong, the euro-area economy had been weak, etc. "I have said in principle," Draghi went on, "most of these effects should in the end wash out because most of them are temporary in nature—though not all of them. But I also said if this period of low inflation were to last for a prolonged period of time the risk to price stability would increase."

Which led him to his punch line: "Over the month of August financial markets have indicated that inflation expectations exhibited significant declines at all horizons. The five-year, five-year swap declined by 15 basis points to just below 2%—this is the metric that we usually use for defining medium-term inflation."

Why, exactly, an inflation rate (or a projected, or imagined inflation rate) of slightly less than 2% is too low, the ECB chief didn't say. The world over, central bankers have set their faces against a too thorough scourging of inflation. It's strange to reflect how ardently their predecessors in the 1970s prayed for just that result.

As to the inflation forecast ostensibly embedded in the swaps market, curious minds will ask how any mortal being, swaps trader or not, can accurately divine distant events. We now imagine a scene in the boardroom of a German bank in the early summer of 1914. The Great War has not yet begun, and the mark is still as good as gold. The chairman of the board polls his fellow directors about the financial outlook. "Anyone have a guess about the rate of inflation eight years hence?" he inquires. No one has a clue, naturally. And not one voice pipes up to foretell that the German cost-of-living index, then set at 1, would hit 218,000 million come November 1923. As Adam Fergusson relates in his superb, *When Money Dies*, the mark went "from worthless to very worthless."

"I'm not a teller. I'm with the government. Why are you withdrawing $50?"

Draghi worries lest the euro go from hard to very hard. As it is, the single currency buys too much, holds its value too faithfully, he says in so many words. It punishes exporters (though it helps importers). In this curious line of reasoning, he gets no argument from financial opinion makers on either side of the Atlantic. Chins wagged on receipt of Tuesday's news that euro-area inflation for September came in at the annual rate of 0.3%, the lowest in five years. Bloomberg quoted Christopher Matthies, an economist at Sparkasse Suedholstein in Neumuenster, Germany, on the meaning—the peril—of low inflation. It's "a sign of incredible weakness of economic activity in the euro zone," the economist opined. "It's looking bleak right now, and I don't see any short-term relief." What does the ECB propose to do about this incipient deflationary calamity?

Something, we know, because Draghi said so in Jackson Hole. His five-year inflation indicator on Tuesday registered 1.93%, near its recent lows. Like every enlightened 21st-century central banker, the president of the ECB wants nothing to do with the "fetters" of gold. His preferred monetary North Star is, rather, the consensus of speculative opinion concerning the remote future.

Perhaps, as we see the situation,

(Continued on page 2)

(Continued from page 1)

Draghi no more credits the wisdom of the inflation swaps market than he would a post-cocktail hour straw poll at the average CFA forecast dinner. The virtue of the five-year contrivance is that it sounds objective. It breathes the aura of quantitative finance that stops the uninitiated from asking too many questions. "Mr. Draghi is creating a dynamic which empowers him," Huw Pill, European economist for Goldman Sachs, was quoted as saying in a Sept. 24 *Financial Times* dispatch. "He could be backed into a corner but we know that he is at his most powerful when backed into a corner."

A glance at the tabular material at the center of this publication suggests how stark is the divergence between policy at the ECB, on the one hand, and that at the Federal Reserve and Bank of Japan, on the other. Whereas the former has been reeling in money, the latter have been conjuring it. Over the past 12 months, the assets of the ECB have fallen by 14.4%. Over the same 12 months, the assets of the Fed have climbed by 20.5%, those of the BoJ by 34%. Having pared its benchmark policy rate to 0.05% and its deposit rate to minus 0.2%, the ECB is champing at the bit to balloon its balance sheet; Draghi makes no bones about it.

Easier said than done, of course, when euro-area businesses are loath to borrow and euro-area banks are reluctant to lend. Enter, then, the prospect of full-blown quantitative easing. By this is meant the wholesale purchase of European government securities by the ECB with euros that the ECB cooks up for the purpose. And enter, as well, the not so subtle monetary-policy ploy of talking down one's currency. Draghi has done more than a bit of this already.

He has plenty of company in the craft of rhetorically powered currency depreciation. The Japanese are past masters at it, and you have been reading about the Swiss. "[A] negative interest rate is in our arsenal of instruments," Thomas Jordan, president of the Swiss National Bank, warned on Monday. "We don't exclude any measure to meet our mandate of price stability." On Sept. 25, Graeme Wheeler, chief of the Reserve Bank of New Zealand, called the resurgent kiwi/U.S. dollar local exchange rate "unjustified and unsustainable." The Reserve Bank of Australia has entered similar protests against the strength of the Aussie dollar. South Korea has been complaining about the falling yen, or, reciprocally, the rising won. Russia and Brazil are taking action against the rising dollar, or reciprocally, the plunging ruble and real. Scrip has lost its bearings.

We are going to try to put words in posterity's mouth, after all. Our financial descendants will learn about the interconnected cults of debt and central banking. They will smile at the celebrity of the Draghis and Yellens and marvel at the gullibility of the creditors who bought long-dated claims denominated in currencies that government computers mass-produced. History will say that the central bankers got a great deal more debasement than they bargained for, a bad thing. It will say that the debtors owed a great deal less, in real terms, as a result of the central bankers' boneheaded hubris, a good thing. A kind of Hollywood ending after all.

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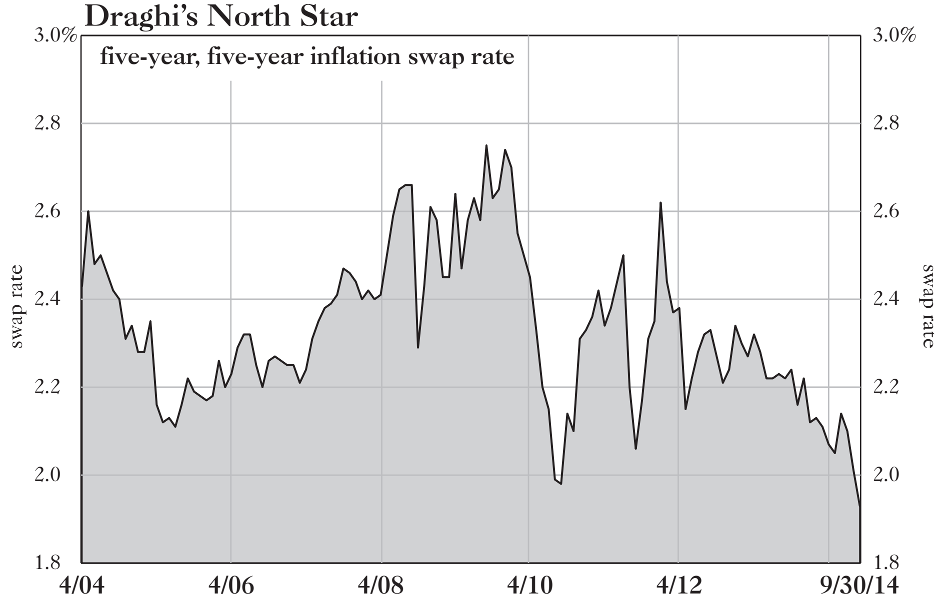
Draghi's North Star



source: The Bloomberg

Yield on sale

Interest rate risk and credit risk compete for pride of place on the worry list of thoughtful income-seekers. Where to turn for a fighting chance to earn 8% or 9% per annum? Business development companies, familiarly known as BDCs, are the subject at hand. To jump the analytical gun, we're bullish on two and bearish on two.

BDCs are non-bank lenders. They are lightly leveraged, as the 1940 Investment Company Act requires them to be. The pair on which we're keen has a demonstrated proficiency in lending to small and medium-sized business. Income is what many need nowadays. Here is a way to procure it with moderate risk.

Ares Capital Corp. (ARCC on the Nasdaq) and Golub Capital BDC Inc. (GBDC on Nasdaq) are our two featured exhibits. Ares, which went public 10 years ago, sailed through the financial crisis with loan losses that put America's big banks to shame. The share price, we hasten to add, didn't sail but sank before recovering; in the heat of crisis, not many paused to distinguish between babies and bath water (*Grant's*, Oct. 19, 2013). Golub, which began its career as a public company only in 2010, likewise posted strong credit results in 2007-09 while operating as a private company (*Grant's*, Nov. 2, 2012). The BDCs have stumped along well enough in this time of suppressed interest rates. They would likely prosper in a time of rising interest rates.

What makes BDCs newly topical is their valuation. Compared to a 7% rise in the S&P 500 this year, Ares and Golub have notched share-price declines of 9% and 17%, respectively. Yield compression—the great scavenger hunt for income—is one reason for this underperformance. The anomalies of index investing is a second.

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Some months back, the keepers of the S&P 500 and of the Russell indices gave the BDCs the boot. Inasmuch as passive index funds owned 10% of the industry's public float, the BDC shareholder base was literally decimated.

The index-keepers had no substantive gripe against the likes of Ares and Golub. The issue rather centered on the optics of financial reporting. The index-fund purveyors chafed at having to record the BDCs' management expenses as their own (as the SEC required under the so-called acquired fund-fee expense rules). "So, for example," Greg Mason, managing director of specialty finance at Keefe, Bruyette & Woods, advises colleague Evan Lorenz, "if Vanguard charges a 15 basis-point fee and they invest 1% of the index funds in BDCs, which have all-in costs of 4% of assets, Vanguard would have to add four basis points to its fund expenses. It would, therefore, have to report a management fee of 19 basis points. While four basis points seems like a tiny amount, it's a huge increase on a percentage basis."

Thanks in part to this technical dislocation, Ares now trades at a 2% discount to book vs. a 8% premium at the end of 2013; Golub trades at a 3% premium vs. a 25% premium (see the afore-cited *Grant's* of Dec. 13 for a lamentation on the higher valuations that were in force late last year). Ares and Golub are priced for dividend yields of 9.4% and 8%, respectively. In fact, BDCs in general look cheap. "Historically, the BDCs have traded around 76% of the forward P/E multiple of the S&P 500," Mason relates. "If you do the same math for the banks, the bank industry has also traded at about a 75-80% P/E of the S&P 500. Today, the BDCs are at 67%. We are trading almost a 10% discount on a relative P/E basis to the S&P 500."

Technical reasons alone, as mentioned, do not explain all the share-price weakness. The same yield famine that drove the junk-bond market to crazy heights has also distorted the pricing in middle-market lending. "Middle-market debt as an asset class is clearly not as attractive today as it was three years ago," says David B. Golub, eponym and CEO of Golub Capital. "In middle-market lending, we are insulated from but not immune to changes in liquid credit markets. In the last

GRANT'S®

Fall 2014 Conference

Tuesday, October 21, 2014

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The Plaza Hotel

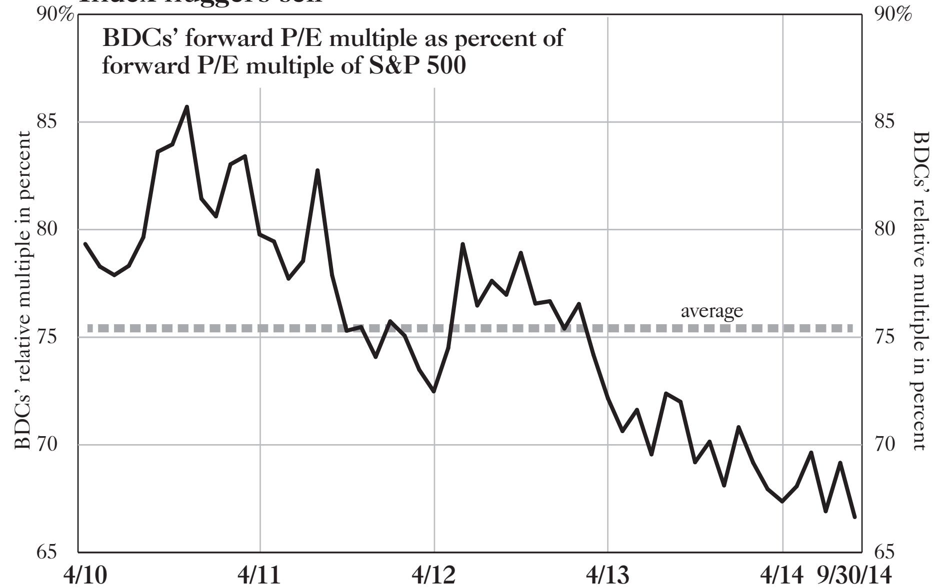
1 W. 58th Street, Manhattan

8:30 a.m.	Registration and continental breakfast
8:55	Opening remarks
9:00	Pariahs' panel: Long ideas in Argentina and Russia. ***Cullen Thompson and Ian Hague***
9:40	***Charlene Chu***, "Crash, boom or muddle? Casting China's future."
10:20	Break
10:35	***Ken Langone***, "Investments I love."
11:15	***Bob Diamond***, "The new merchant bank: Africa and beyond."
11:55	Break
12:10 p.m.	Luncheon
1:05	Luncheon speaker: ***Martin Lipton***, "Activist interventions and the destruction of long-term value."
1:45	Break
2:00	***Bill Ackman*** in conversation with ***Jim Grant***
2:40	***Bruce Greenwald***, "The 21st century: macroeconomics, government policy and the evolution of business value (with examples)."
3:20	Break
3:35	***Simon Mikhailovich***, "The oldest idea whose time has come... again."
4:15	***James Grant***, "This monetary moment."
4:55 – 6:15	Reception—Music by Toby Williams

several years, terms in middle-market lending have gotten more favorable for borrowers. We've seen that in the form of some decrease in spreads and some increase in typical leverage levels."

The cyclical pendulum is starting to favor the lenders again. Certainly, they're getting back some of their own in the public markets. Junk-bond yields made their lows in the third week of June with a 5.16% reading on the BofA Merrill Lynch U.S. High Yield Index. At last report, the index had shot back up to 6.55%. After reaching a high of $175.1 billion at the end of March, funds invested in retail bank-loan funds had declined to $163.7 billion in August (September data are due in mid-October). Ares and Golub each tell Lorenz that the selling squalls in public markets have led to stabilization in the yields in the private, non-traded market for small-business debt.

Index huggers sell



source: Keefe, Bruyette & Woods

Still, a "stabilized" yield in the year 2014 is anything but a generous one. The typical BDC is borrowing at 5% and lending at 9%, a spread that affords little margin for underwriting error. How does Ares, for instance, protect against credit losses that could take a debilitating bite out of its top and bottom lines? Lending more in a senior capacity, less in a junior one, says Kipp deVeer, newly appointed CEO (he was previously president of the firm and has worked at Ares since its inception; Michael J. Arougheti, the former CEO, remains on the board as co-chairman).

"We've been in this part of the cycle before," deVeer tells Lorenz. "It's a recognition of the experience of the team here that providing credit is an inherently cyclical business. Unfortunately, most people get it wrong—they see the market environment that we are in today with strong deal flow, pretty good fundamental performance, and limited to no defaults in portfolio companies, and they say, 'This is a good time to be pumping capital out. There doesn't seem to be any risk.'

"Since we tend to hold everything we invest in for three to five years, we look to invest in cycle durable assets," deVeer goes on. "We are also an opportunistic, relative value investor throughout business cycles. So it's not about what the environment is like today or what it has been like for the last few years, which has been pretty good and has been an easy time to invest money. It's about what it will be like over the next five years."

As of June 30, Ares managed an $8.6 billion portfolio, of which 44% was apportioned to first-lien, senior secured loans, 16% to second-lien senior secured loans, 5% to senior subordinated debt, 3% to preferred equity and 8% to common equity. The remaining 24% of assets was deployed through a joint venture with GE Capital Corp. and GE Global Sponsor Finance LLC; the j.v. is called the Senior Secured Loan Program. While the SSLP makes senior secured loans, Ares is the junior claimant; to that degree, therefore, the SSLP's assets, from the Ares perspective, are subordinated (which subordination lends an extra fillip of leverage to Ares' balance sheet).

Including the SSLP, the interest rate attached to 81% of Ares' loans is floating. At the end of the second quarter, nonperformers amounted to 1.2% of Ares' assets (which matches the lows of 2007). Debt less cash amounts to 64% of stockholders' equity.

Golub Capital takes what it calls a "one-stop," or "unitranche" approach to lending. Its preferred position in the capital structure of its investees is that of the one and only creditor. In effect, it holds both the senior *and* the subordinated claim, all in the same loan.

"Junior debt providers get paid two premiums: the first is for taking junior credit risk, for being junior in the capital structure," Golub tells Lorenz.

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"The second premium they get paid is for taking the risk that there will be some conflict between senior creditors and junior creditors; the senior creditors may take some action that is good for the senior creditors but bad for the junior creditors. In a 'one-stop' we get paid for that second risk—but we are not taking it. Because we are both the senior and the junior debt, we are able to work with the company and the sponsor to come up with a plan from a remediation standpoint that is good for both positions, not one position over the other. To date, our default rate on one-stops has actually been lower than our default rate on traditional senior loans."

A fraction of Ares' size, Golub Capital, as of June 30, managed $1.5 billion, of which 65% was committed to one-stop loans, 22% to senior secured loans, 6% to second-lien loans, 3% to equity, and 1% in subordinated debt. Another 3% was consigned to a joint venture with the RGA Reinsurance Co. Fully 96% of Golub's portfolio was in floating-rate claims. Nonperformers amounted to a mere 0.02% of quarter-end assets.

Lorenz asked Golub if this essentially flawless credit record betrayed an unprofitable excess of caution. Could it be that Golub Capital is taking too little credit risk for the stockholders' own good? "Excellent question," Golub replied. "Arguably, it means we have been too cautious, but such judgments require more time to steep. Clearly it reflects strength in the portfolio. We are pleased with the positioning of the portfolio." As to June 30 balance-sheet leverage, Golub Capital borrowed 83 cents, net of cash, for every dollar of equity.

"Ultra-easy money isn't all bad for the BDCs," Lorenz points out. "Yields are shrunken on both sides of the balance sheet. Both Ares and Golub have seized the opportunity to extend—to 'term out'—the duration of their borrowings. Thus, Ares has no debt maturities until 2016; Golub's first maturity is in 2018. 'Over the past several years, we have extended the duration of our liabilities, which average about seven to eight years vs. a three- to four-year duration on our assets,' deVeer says. 'What really created a lot of market issues in the last downturn was forced selling by participants due to liability mismanagement. We have put ourselves in a better financial position, as have many others, which we believe could lead to more stability.'"

Good businesses in their own right, Ares and Golub shine the brighter in comparison with a pair of BDCs under the stewardship of Fifth Street Asset Management. Fifth Street Finance Corp. (FSC on the Nasdaq) is the first of these uncomely siblings; Fifth Street Senior Floating Rate Corp. (FSFR, also on Nasdaq) is the second.

The Fifth Street entities, like Ares and Golub, are governed by a legally distinct external manager. It's an arrangement that presents a weak-willed overseer with the temptation to subordinate the stockholders' interests to his own. "I've often said this in the context of our new equity issuances that they have to be good for new investors, old investors and the manager or we shouldn't do them," remarked David Golub on his Aug. 7 earnings call.

By the Golub score-keeping method, Fifth Street management not infrequently bats one-for-three. In September last year, as you may recall (*Grant's*, Dec. 13), Fifth Street Finance issued 17.64 million new shares at $10.31. The market seemed to interpret the sale as a vote of confidence; would a conscientious management raise equity with 11 days left in the quarter if there were anything in the offing except good news? The market misjudged its man. On Nov. 25, Leonard M. Tannenbaum, CEO of Fifth Street Finance, announced a dividend cut. Today, FSC trades at $9.18 per share, a 5% discount to book.

Organized as regulated investment companies, BDCs must pay out in dividends at least 90% of their earnings. Retaining so little income, they tend not to generate significant growth in book value. The shareholders get the profits—and pay taxes on them.

Which is not to say, though, that good BDCs generate no growth—or that the bad ones don't generate losses. Accomplished managements boost net worth in two ways. They avoid credit mistakes. And, they harvest such equity co-investments or warrants as they might have seeded along the way. Thus, over the course of its 10 years as a public BDC, Ares has managed to boost its book value per share to $16.52 from $13.85. Over the four years ended June 30, Golub managed to raise its book value per share to $15.44 from $14.67. As for Fifth Street Finance, from its debut as a public company in the first quarter of 2008 through the June quarter of 2014, Tannenbaum managed to shrink its book value per share to $9.71 from $14.12.

The other Fifth Street fund, Fifth Street Senior Floating Rate Corp., has proved not much more rewarding to the outside investors. FSFR came public on July 11, 2013. The IPO fell flat: just 6.67 million shares were taken up at a price of $15 per share. So small were the proceeds—just $100 million—that Fifth Street Asset Management, the external manager, announced that it would cover the $5.7 million in underwriting expenses. FSFR's opening-day pop was to the down side, and on no subsequent day has the share price topped book value per share.

Fast forward one year. Would the stockholders Tannenbaum petitioned in the 2014 proxy permit the sale of stock at a discount to book value? By early July, the votes were in. Incredibly, the owners voted "aye"; book value was now $15.13 a share.

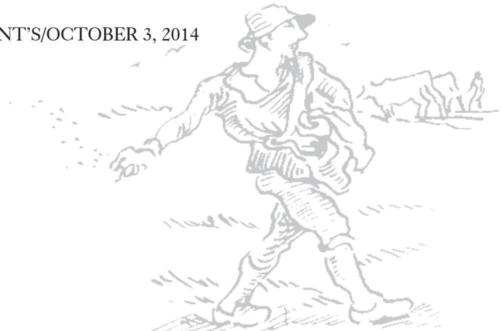
Fifth Street wasted no time with the equity drop. On Aug. 14, it sold 22.8 million shares at a price of $12.91. Which is to say, it expanded the share count by 242% through raising equity at a 14.7% discount to stated NAV. This time, Fifth Street Asset Management did not swallow the underwriting fees; the $17.7 million in charges resulted in net proceeds per share of $12.14 for FSFR. Today, the stock trades at $11.82 a share.

(Continued on page 8)

"Scary smart."

Bruce Greenwald, Columbia University professor and consultant to Arnhold and S. Bleichroeder, will demonstrate the intellectual and analytical range that has won him the rarely conferred Wall Street accolade, scary smart.

Oct. 21 at *The* Grant's Conference



Credit Creation

Federal Reserve Balance Sheet
(in millions of dollars)

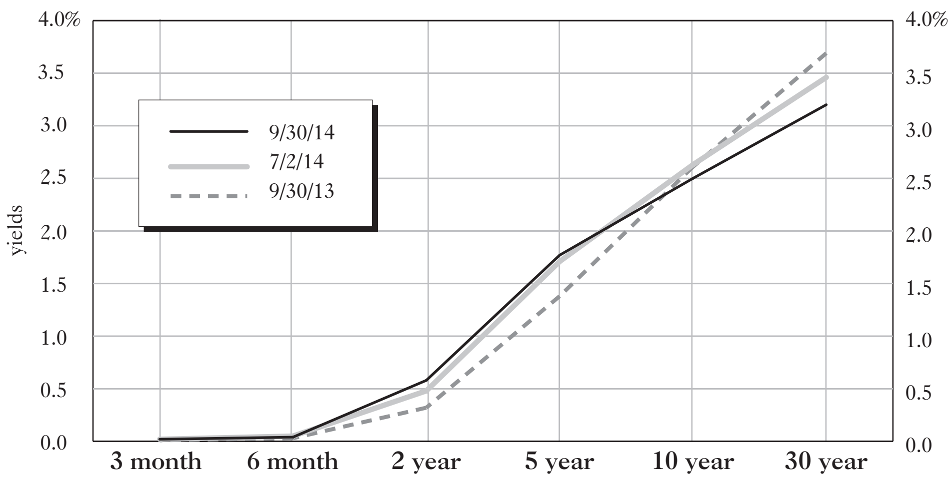
	Sept. 24, 2014	Sept. 17, 2014	Sept. 25, 2013
The Fed buys and sells securities…			
Securities held outright	$4,195,219	$4,186,546	$3,470,384
Held under repurchase agreements	0	0	0
and lends…			
Borrowings—net	330	302	272
and expands or contracts its other assets…			
Maiden Lane, float and other assets	222,184	220,767	224,359
The grand total of all its assets is:			
Federal Reserve Bank credit	$4,417,733	$4,407,615	$3,695,015
Foreign central banks also buy, or monetize, governments:			
Foreign central bank holdings of Treasurys and agencies	$3,359,602	$3,347,141	$3,289,073

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

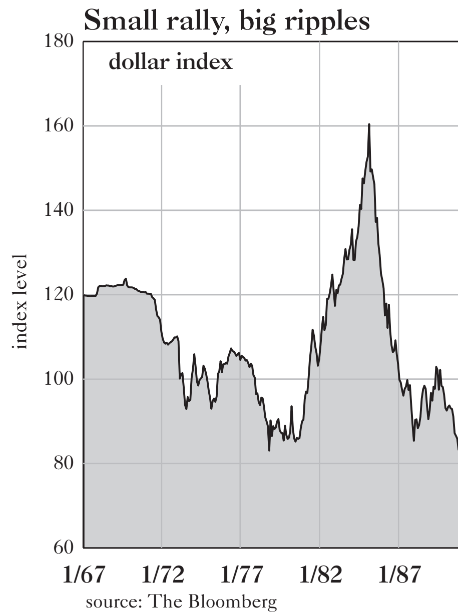
	Sept. 26, 2014	Aug. 29, 2014	Sept. 27, 2013
Gold	€334,434	€334,433	€319,969
Cash and securities	950,234	943,848	1,005,699
Loans	520,227	517,578	767,304
Other assets	233,340	242,857	245,072
Total	€2,038,235	€2,038,716	€2,338,044

*totals may not add due to rounding

Movement of the Yield Curve



source: The Bloomberg



source: The Bloomberg

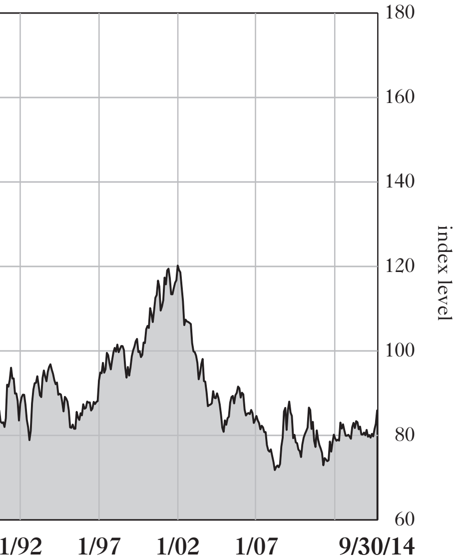
The dollar's stre

"[T]he status of the U.S. dollar as a reserve currency seems, if anything, more secure now than in 2006," said the IMF in its World Economic Outlook on Tuesday. Mr. Market wouldn't disagree. Over the past three months, the U.S. Dollar index has rallied by 7.7%. In September alone, the greenback sent a host of Asian currencies—the Korean won, the Philippine peso, the Taiwan dollar and the Malaysian ringgit—to their steepest monthly declines in two years.

"Export powerhouses like South Korea and Japan, you would think, should be booming," observes colleague Evan Lorenz. "They aren't. On Tuesday, Korea disclosed a 2.8% year-over-year decline in industrial production for August. This was against expectations of a 2% gain. Korean companies complain that the weak yen is hurting their exports—it's depreciated against the dollar more than the won has. Perhaps, but Japanese industrial activity was also weak in August. It sank by 2.9% against the year-ago period; forecasters had expected a decline of only 1.1%."

Blame debt, counsel a quartet of economists in the 16th annual Geneva Report, which was released on Monday. There's been no worldwide deleveraging, the four contend: "Indeed, according to our assessment, the ratio of global total debt excluding financials over GDP. . . has kept increasing at an unabated pace and

• Cause & Effect



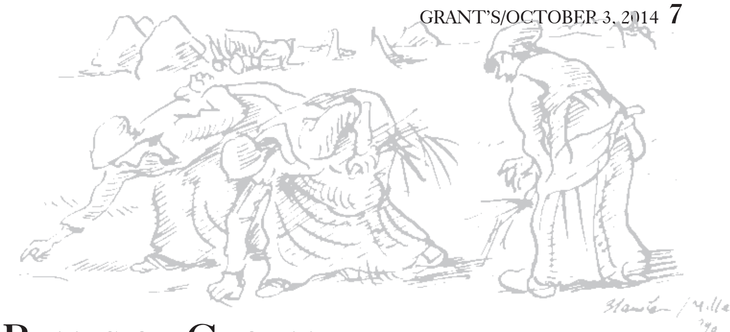
ength saps Asia's

breaking new highs: up 38 percentage points since 2008 to 212%."

Only the names of the obligors have changed, the Geneva authors argue. Before 2008, it was the American-led developed countries that borrowed to excess. In this, the post-crisis era, the emerging economies led by China have seized the baton of leverage. These pages have often contended that China is reaching the end of its financial tether. To that point, Chinese steel consumption fell in August for the first time since the year 2000. A measure of the steel makers' distress is that they've taken to hawking their rebar online, through Alibaba (imagine U.S. Steel's wares turning up on eBay).

Over the past 10 years, according to a new Morgan Stanley report, foreign debt in developing Asian countries has jumped to $2.5 trillion from $300 billion. It's a fact that provides context for the Asian Development Bank's new warning to "prepare for possibly tighter liquidity as United States quantitative easing is expected to end in October."

"The Morgan Stanley analysts forecast that a surge in the dollar index to 92 by next year will create the same strain as the dollar shock of 1997," Lorenz winds up. "You wouldn't have guessed it just by looking at the graph. Then, again, the graph takes no account of the buildup of leverage. Leverage does magnify mistakes." •



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

	3 months	6 months	12 months
Federal Reserve Bank credit	8.2%	11.9%	20.5%
Foreign central bank holdings of gov'ts.	4.9	4.8	1.8
European Central Bank	-18.5	-13.7	-14.4
Commercial and industrial loans (Aug.)	13.8	12.8	11.8
Commercial bank credit (Aug.)	8.4	8.2	6.0
Asset-backed commercial paper	-18.3	7.0	-10.3
Currency	3.6	4.7	7.0
M-1	4.1	6.9	11.0
M-2	5.8	6.2	6.6
Money zero maturity	5.4	5.3	6.0

Reflation/Deflation Watch

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	8,571.41	8,669.98	8,936.01
Moody's Industrial Metals Index	1,927.71	1,953.37	1,832.81
Silver	$17.54	$17.84	$21.77
Oil	$93.54	$92.41	$103.03
Soybeans	$9.10	$9.57	$13.17
Rogers Int'l Commodity Index	3,297.97	3,343.32	3,586.49
Gold (London p.m. fix)	$1,213.75	$1,219.75	$1,333.00
CRB raw industrial spot index	512.42	516.95	519.63
ECRI Future Inflation Gauge	(Aug.) 106.9	(July) 106.9	100.0
Factory capacity utilization rate	(Aug.) 78.8	(July) 79.1	(Aug.) 77.8
CUSIP requests	(Aug.) 1,764	(July) 1,873	(Aug.) 1,673
Fed's reverse repo facility (billions)	$172.96	$169.52	
Grant's Story Stock Index*	109.27	113.36	135.46
*Index=100 as of 7/31/2013			
Grant's Never-Never Index**	200.95	208.54	193.07
**Index=100 as of 1/4/2013			

Effectiveness of Monetary Policy

	August 2014	August 2009	August 2004
Monetary base ($ billions)	$4,075.0	$1,710.8	$757.2
M-2 ($ billions)	11,453.4	8,389.1	6,276.7
Money multiplier (M-2/monetary base)	2.81	4.90	8.29
Velocity of money (GDP/M-2)	1.51	1.71	1.94

Why the stockholders—management only holds a 2.3% stake in FSFR—voted as they did is a mystery. Why Tannenbaum would have chosen to finance on these disadvantageous terms is slightly less mysterious. Fifth Street Asset Management is in the process of going public through the auspices of Goldman Sachs and Credit Suisse, among others. According to the S-1 offering circular, the two Fifth Street siblings, FSC and FSFR, constitute 99% of Fifth Street Asset Management's assets under management. While FSFR's secondary offering was of no obvious benefit for existing shareholders and a dubious benefit to new shareholders (while they buy in below book value, they are investing in a management team that is willing to dilute investors and has destroyed book value through poor underwriting in Fifth Street Finance Corp.), it does stand to increase the fee-paying assets for Fifth Street Asset Management just in time for the impending IPO.

Too bad Fifth Street isn't in the baseball business. In baseball, going one-for-three is performance that puts you on the road to Cooperstown.

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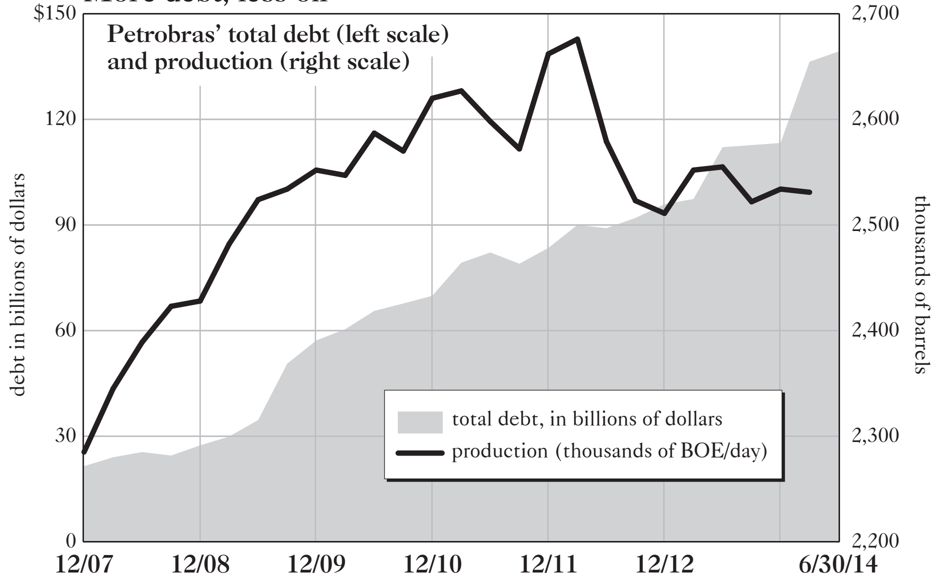
More debt, less oil



source: The Bloomberg, company reports

Bonds of debt

Monday's news that the business-baleful Brazilian president, Dilma Rousseff, had widened her lead in polls leading up to the first round of Brazil's 2014 presidential election on Oct. 5 sent the yields on Petrobras debt shooting higher. Petroleo Brasiliero SA (PETR4 in Sao Paolo, PBR in New York) is the world's most heavily encumbered energy company. Its net debts, in the sum of $110 billion, are ubiquitous. Are they also worrying? "Yes," we will presently get around to concluding.

Debt alone does not condemn the debtor, of course. The trouble with Petrobras is that its capacity to pay has receded almost as fast as its debts have multiplied. In 2007, which happens to be the latest full year in which the company earned positive free cash flow, earnings before interest and taxes covered interest expense by 12.7:1. By the second quarter of 2014, that telltale ratio had slipped to 2.2:1.

The Petrobras story comes in three parts, like a triptych: Credit, including interest rates; the Chicago caste to Brazilian politics; and liquidity, or lack thereof, in the world's corporate bond market. In preview, we judge that BBB-rated Petrobras is overdue for a downgrade, that Brazilian politics—which have accelerated both the buildup of Petrobras' debt and the build-down of its cash flow—may continue to poison the corporate well and that the illiquid state of the dollar-denominated corporate debt markets will deepen the losses of any who belatedly choose to sell Petrobras notes, bonds or tradable bank debt.

Altogether, the Petrobras story is one for this age of midget interest rates and raging yield hunger. A chronic burner of cash, the company was paying an average blended interest rate of just 5% on June 30. Even after the Monday sell-off, no dollar-denominated Petrobras bond was quoted at a yield of as much as 6.6%. At the 10-year point on the Petrobras yield curve, the quoted rate was 5.57%. What Petrobras ought to be paying to borrow is a question to which there can be no precise answer. Imprecisely, we venture, "more than it's paying now."

Like the U.S. Treasury, Petrobras chooses to borrow in dollars (69% of the company's debt is greenback-denominated, including dollar-linked local debt). Also like the Treasury, Petrobras is flattered by ultra-low dollar interest rates. There the comparison stops, however, as Petrobras can only earn dollars, not print them. Question No. 1 is whether it can earn enough of them. Question No. 1 (*a*)—it almost deserves to be question No. 1—is whether a Petrobras creditor is being adequately compensated for bearing the risk that the company can't earn enough of them.

Such risks seemed remote enough in 2010 when the Petrobras front office—virtually with a wave of its hand—raised $70 billion in the biggest equity offering of all time. This was in the full flush of the news of the discovery of the mighty Libra oil field, one of the great energy finds of the age. Counting up the seven or eight billion barrels of estimated new reserves that Libra would contribute to the company's grand total, Petrobras made bold to de-

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Cheap enough?

source: The Bloomberg

clare that its production would reach 5.4 million barrels of oil equivalent per day by 2015, so surpassing the output of Exxon-Mobil. "It wasn't in Frankfurt, it wasn't in New York, it was in our Sao Paulo exchange that we carried out the biggest capitalization in the history of capitalism," exulted President Luiz Inacio Lula de Silva at the time of the financing. Putting the taxpayers' money where his mouth was, Lula boosted the Brazilian government's stake in Petrobras to 48% from 40%. By 2011, the state's position topped 50%.

The national oil company proceeded to do the government's bidding. To maximize returns for the stockholders? Not the first order of business. The political objectives of Lula's successor, the aforementioned Dilma Rousseff, trumped mere earnings per share. Notably, in the name of controlling domestic inflation, the government directed the Petrobras refining division to sell imported diesel and gasoline at a loss.

Then, too, the government seems not to have been overly punctilious in financial management. In March, the former head of Petrobras' refining division was arrested in connection with an investigation into alleged episodes of money laundering. Paulo Roberto Costa, who has copped to taking a bribe, accused a minister, three state governors, six senators and dozens of congressmen from the incumbent Workers' Party with scrubbing their own dollar bills ("Operation Car Wash," the case has come to be known). It happens, too, that Rousseff was chairman of Petrobras when, in 2006, the company bought a refinery in Pasadena, Texas, for a final consideration of $1.2 billion. Of that purchase price, Petrobras has already written off $500 million. In was in the process of buying the refinery that Costa admits to having his palm greased.

Contemplating Rousseff's political prospects, one naturally thinks of her sister in South American anticapitalist politics, Argentine President Cristina Fernandez de Kirchner. The difference between the two is that Fernandez is a lame duck, Rousseff a still quacking one. In Argentina, almost any political change will be for the better, or so we think (*Grant's*, Sept. 5). It's not so cut-and-dried in Brazil. Possibly, the country's economic management would improve even under a new Rousseff government. Then, again, as Lucas Aristizabal, the Fitch Ratings analyst who covers Petrobras tells colleague Charley Grant, more than the mere normalization of energy policy would be needed to put the company back in the black. A decision to allow the sale of fuel at non-subsidized prices, Aristizabal points out, would generate a boost to free cash flow on the order of $10 billion to $12 billion a year (free cash flow being defined as operating income minus capital expenditures). Petrobras is expected to burn more cash than that both this year and next. In 2013, it combusted $19 billion. Between 2008 and the close of this year, it will have torched some $80 billion.

So it can't be said that the Petrobras creditors have been caught unawares. Operational and financial difficulties have been piling up for years. "The promised riches of the Libra field have been very slow to develop," Grant relates. "Company-wide production averaged 2.4 million barrels of oil equivalent per day at the time of the triumphant 2010 financing. It averaged 2.6 million barrels of oil equivalent in the second quarter of 2014, not quite on track to overtake Exxon-Mobil. Should this figure hold up over the full year, production will have compounded at a rate of just 1.8% since 2007, when it stood at 2.3 million BOE."

The year 2007 marks a great divide for Petrobras, as it does for so many other corporations, governments and individuals. Since the eve of the Lehman collapse, Petrobras' annual capital expenditures have nearly doubled, to $40 billion from $21 billion. In 2007, the company's ratio of total debt to EBITDA was a svelte 0.8:1; now it weighs in at 5.3:1. At the end of 2007, debt accounted for 8.7% of the enterprise value of the firm—that is, to the sum of debt and stock market capitalization minus cash. Today, debt constitutes 64% of enterprise value, the 68% drop in the share price since October 2009 having materially contributed to the leveraging trend. In 2007, there were 68,931 employees. At the close of 2013, there were 86,111. Since 2007,

Off the banking grid

Where to keep the real money you've accumulated as a hedge against monetary debasement? Not in your neighborhood safe deposit box, as Simon Mikhailovich, principal of Tocqueville Bullion Reserve, will explain.

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EBITDA has grown at a compound annual rate of all of 1.1%.

To conserve cash, Petrobras eliminated the common dividend in 2012 and 2013 (it resumed payments in May at the rate of 48 cents per American Depository Receipt share). On Jan. 31, it again issued equity, $460 millions' worth, at a per-ADR price of $12.05; the 2010 offering came to market at a price of $34.49 per ADR. Nor has the company neglected the debt markets.

Investors operating in a world of ZIRP and QE were all too happy to lend, especially in the context of an emerging market, indeed, a "BRIC" growth story. At year-end 2007, gross debt on the Petrobras balance sheet footed to $21.9 billion; as of June 30, it stood at $139 billion, of which floating-rate obligations (revolver, term loans and floating-rate bonds) amounted to $68 billion. If the company does no more borrowing in 2014, growth of indebtedness over the seven years will have registered at the compound annual rate of 30%. It would be rash, though, to count Petrobras out of the fourth-quarter borrowing picture. In February, the Petrobras audit committee advised management to reduce debt—to which hint management responded by borrowing $8.5 billion in the next two weeks.

If sell-side estimates compiled by Bloomberg are on the beam, Petrobras will be burning much less cash come 2017; the consensus forecast is $837 million. One marvels at the confidence of the prognosticators. To venture any such prediction, they had to have guessed the oil price and the dollar/real exchange rate. They had to have taken a view on the composition of the next government and of the size of Brazilian energy-price subsidies. How could they know? How can anyone?

"Bondholders seem to share the sell side's optimism, or at least complacency, as do each of the three major rating agencies," Grant remarks. "Anyway, the looming Petrobras debt-maturity schedule has occasioned no scramble for the exits, either from the investors or the agencies. Maturities look manageable in the coming year, more difficult in the out years. Thus, $7.2 billion in principal falls due in 2015, while $12.7 billion matures in 2016, $8.7 billion in 2017 and a whopping $16 billion in 2018. These sums must either be paid or refinanced. As noted, 69% of the Petrobras debt is dollar-pay; 20% is denominated in reais, 8% in euros, 2% in pounds sterling and 1% in yen."

If we remember our Graham and Dodd, bond selection is, or ought to be, a "negative" art. Inasmuch as the upside to buying a bond at par is the return of one's funds with interest, an investor's first priority must be safety. In the high-grade, full-price wing of the bond market, as the masters pointed out, there are no three-baggers.

The equity opportunity is, of course, different. The aforementioned $10-$12 billion in free cash flow improvement from a hypothetical policy normalization would be the sweetest of fodder for the bulls. The major oil deposits haven't disappeared—Petrobras has 13 billion barrels. Oil prices have fallen; they may recover. Besides, Petrobras enjoys a near monopoly on domestic sales in Brazil. If those immense capital outlays finally start to bear fruit, the equity holder may just have bought a turnaround story—for the industry as well as the company—for nine times the 2014 earnings estimate and 7.8 times the 2015 forecast. Add in a 3.4% dividend yield that should improve in the bull scenario, and you can make a case for the stock.

For the bonds? The upside, even for the conscientious fiduciary, comes down to keeping up with the debt indices and climbing the mutual-fund performance rankings. It is the job of *Grant's* to deplore the Fed. It is the job of the professional fixed-income investor to generate income (heaven help them). He or she may therefore browse among the following: Dollar bonds issued by the Mexican state oil firm, Petroleos Mexicanos, rated BBB+ and maturing in 2045, to yield 5.45%; dollar debt of triple-C rated YPF SA, the Argentine oil company, maturing in 2024 to yield 8.29% (the bonds pay an 8.75% coupon and trade at a premium); Gazprom dollar bonds maturing in 2034 to yield 6.9% and Rosneft dollar bonds maturing in 2022 to yield 6.6%; and dollar bonds issued by B-rated Venezuelan state oil firm PDVSA yield in excess of 15% (Nicolas Maduro being thereby revealed as a greater menace to the world's creditors than even Vladimir Putin). As absolute investment opportunities, this publication will pass on the lot.

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Petrobras bond trading volume—second quarter 2014

coupon	maturity	par outstanding ($ millions)	trading volume ($ millions)	as percent of outstanding
3.875%	2016	$2,500	$131	5.2%
7.875	2019	2,750	412	14.9
5.75	2019	2,500	531	20.4
4.375	2023	3,500	761	21.7
5.375	2021	5,250	1,394	26.6
6.25	2024	2,500	1,271	50.8

sources: Trade Association for the Emerging Markets, the Bloomberg

Relative values are a different matter. By standard credit metrics, Petrobras appears not merely to be absolutely unattractive but also relatively overvalued. Thus, by Bloomberg's calculations, the Brazilian state oil champion showed a ratio of debt to EBITDA of 5.3:1 at the end of the second quarter. It's more leverage than other state-controlled and/or despot-tainted energy businesses present. Pemex's ratio was 1.12:1, Rosneft's 1.84:1, Gazprom's (at the end of the first quarter) 0.95:1, and YPF's 1.41:1.

Interest-coverage data show a similar pattern. As noted in the case of Petrobras, EBIT was sufficient to pay interest expense by 2.2 times over in the second quarter. It's a lower ratio of interest coverage than that of YPF (3.0 times) Pemex (12.2 times), Rosneft (just under 10 times), Gazprom (21 times) and even PDVSA (11.1 times in 2013). Not that the coverage data are always dispositive. Thus, the cost of protecting against non-payment over the next 10 years in the credit-default swap market will run you 318 basis points for Petrobras, 171 basis points for Pemex, 347 basis points for Gazprom and 1,600 basis points for Venezuela's pride and joy, the possibly imminently defaulting PDVSA.

Certainly, Petrobras is a paragon of good governance and balance-sheet strength in comparison to its Venezuelan counterpart, but as an absolute value, it makes you want to reach for your copy of "Security Analysis." As we write, the Petrobras 5 3/8s of 2021 are quoted at 102 and change to yield 4.95%. One year ago, they fetched 5.98%; in 2012, at some manic risk-on moment, they were priced to deliver just 3.25%. Mr. Market, have you been thinking this through?

Liquidity is the final panel of the Petrobras triptych. According to second-quarter survey data compiled by the Trade Association for the Emerging Markets (EMTA), Brazilian dollar debt trades more frequently than the dollar-denominated securities of any country monitored by EMTA besides Mexico. "Not that that is necessarily saying much," Grant observes. "The Petrobras 3 7/8s of January 2016, a $2.5 billion issue that came to market in 2011, is a case in point. Just $131 million of par value traded on the secondary market in the April-June period, equivalent to 5.2% of the outstanding (which may include some double-counting between survey participants). The nearby table tells all that the EMTA survey uncovered on Petrobras. A careless glance down the far-right column would seem to suggest that, really, liquidity in the more popular Petrobras issues flows like water from a tap. Please note, however, that volume as a percentage of the outstanding issue is registered over the course of a calendar quarter."

The Petrobras 6 1/4s of 2024 count as one of the most actively traded corporate issues in the market. Last Wednesday, in fact, according to Finra's TRACE market aggregation system, the 6 1/4s ranked No. 5 in frequency of trading, comparing favorably to bonds issued by the likes of AT&T and Verizon. Past trading data are, of course, no guarantee of future liquidity. To borrow from Christopher Whalen, senior managing director at Kroll Bond Rating Agency, "Liquidity is something you really can't measure. You either have it or you don't. If they pick up the phone, you have liquidity. If they don't, you don't."

That the phone may one day ring off the hook—say, on the day after the agencies get around to demoting Petrobras to speculative-grade status—is the burden of a new, must-read report from Blackrock entitled, "Corporate Bond Market Structure: The Time for Reform is Now." "[T]he secondary trading environment for corporate bonds today is broken, and the extent of the breakage is masked by the current environment of low interest rates and low volatility, coupled with the positive impact of QE on credit markets," the Blackrock authors warn. "The current environment also breeds complacency—for issuers and investors alike. . . . A less-friendly market environment will expose the underlying structure as broken, with the potential for even lower liquidity and sharp, discontinuous price deterioration."

Such a scenario would be very heaven for value seekers, of course. Who might these people be? The kind who, almost by definition, owned no Petrobras.

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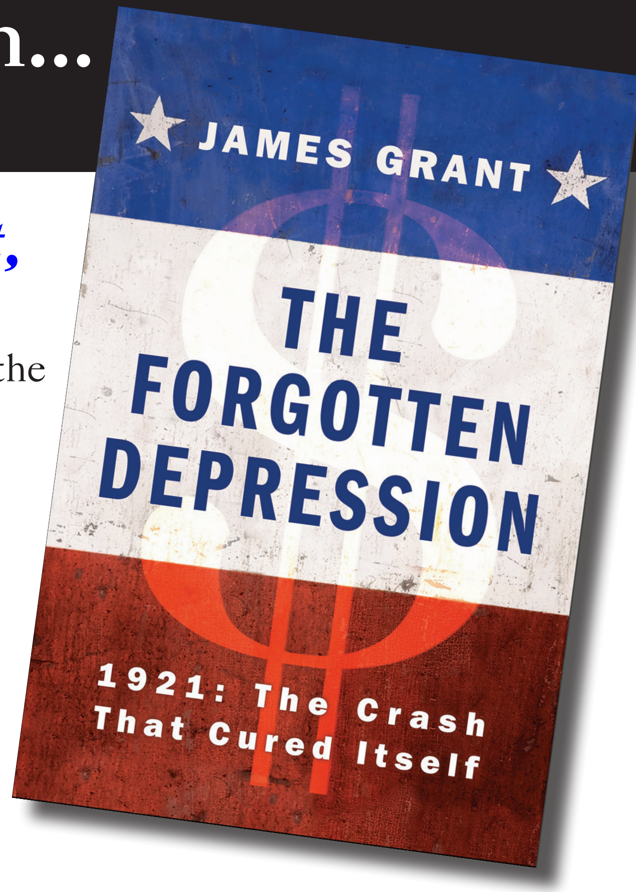

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