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JAMES GRANT
EDITOR

Vacation delectation

To the readers, and —especially—potential readers, of ***Grant's***:

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We resume publication with the issue dated Sept. 16 (don't miss it!).

Sincerely yours,

James Grant

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Trudges, the nation's business

(November 27, 2015) Growth in manufacturing and trade sales sits not far from a 17-month low, growth in GDP stands at an 18-month low and growth in industrial production registers near a 72-month low. Economic cycles, interest rates and the dollar are the topics at hand. Skipping down to the bottom line, we speculate that the dollar will turn weaker as the Fed raises the funds rate in the teeth of a downshifting business cycle.

"Speculate" is the operative word, as the future is a book slammed shut. Especially do the thought processes of the voting members of the Federal Open Market Committee defy prognostication. Still, one must try to imagine the future, even if one can't predict it.

Thus, we reckon: The Federal Open Market Committee, meeting on Dec. 16, will lift the funds rate from zero. Having to choose between a loss of institutional face (how many times has it hinted that this time it will act?) and the mounting evidence of weakness in the segments of America's economy that produce and transport goods, Yellen et al. will chose face. Markets will register no immediate objection; they've had years to get used to the idea of a funds rate just a little higher than zero.

Trouble follows. The passing months will reveal that there is, again, no "liftoff," but rather a dwindling in the economic and financial vital signs. Mortified at what is looking more and more like an unforced policy error, the mandarins will return the funds rate to zero. In speeches, they will drop broad hints about some new round of experimental monetary measures. The dollar bulls, participants in what Bank of America Merrill Lynch last week identified as the world's "most crowded trade," will have already acted. They will have beaten the Fed to the punch by trading in their greenbacks for euros, Swissies and other alternatives (including the seemingly hopeless one that can be found in the Periodic Table). Worshippers of the paper calf will begin to reconsider their allegiance.

Few will envy the monetary deciders their Dec. 16 vote. The data are always ambiguous, and today's figures leave plenty of room for interpretation. Thus, the S&P 500 is up, but commodity prices are down. The headline jobless rate has fallen to 5%, while the U6 measure of unemployment and underemployment still stands at 9.8%. Year-over-year growth in average hourly earnings recently hit a 6¼-year high, but not for any good reason: Growth in hours has been falling faster than growth in pay.

Neither is the evidence in support of a call for an imminent recession exactly clear-cut. Focusing on the prospects for home construction, economists at the University of Michigan project that GDP growth next year will reach 2.6%, its highest in a decade. Steve Blitz, chief economist at ITG Investment Research, Inc., singles out strong weekday hotel rates as evidence of a thriving service sector.

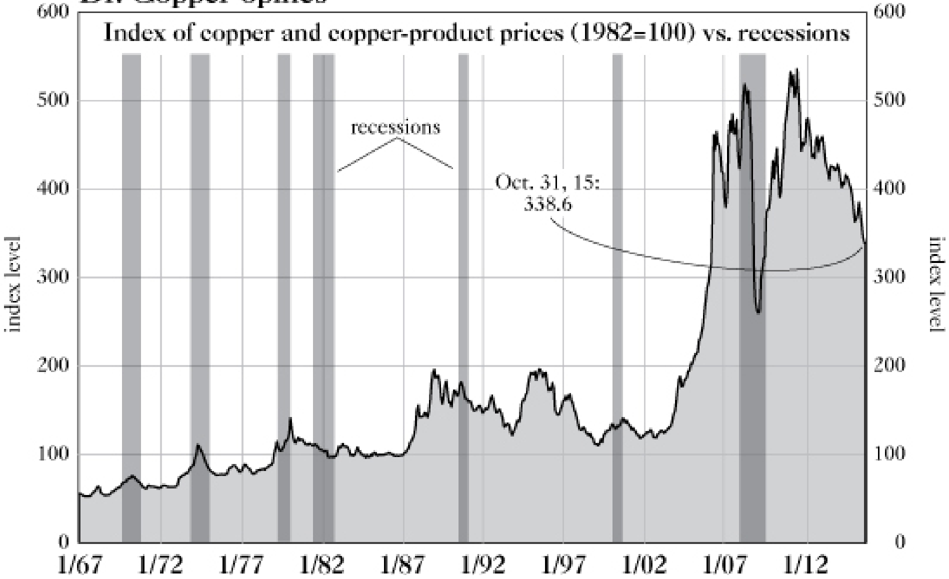
"OK, fine. So you look like a billion bucks."

And even if home-building and services fall short, a prophet of economic weakness must come to terms with the fact that oil-price spikes and a rising funds rate are the common antecedents to modern recessions. To contend that a downturn has begun in the absence of those time-tested auguries is akin to speaking the forbidden words, "It's different this time."

We'll say them anyway. It's always a little different, after all (every cyclical episode is distinctive), and novelties abound today. China is one such new force in the economic world; zero-percent (or lower) interest rates are another. Many cycles ago, the Wall Street thinker John Mendelson identified the price of copper as a bellwether of business activity. "Dr. Copper," Mendelson respectfully wrote, "the metal with a Ph.D. in economics." Chalk it up as something notable, if not unprecedented, that copper prices (and nickel prices, too) are plunging in what is still, officially, an expansion. The so-called new normal--booming asset markets, lackluster GDP growth, chronic underemployment--is another kind of novelty. So are the creatively disturbing inroads that digital technology continues to make on the conventional ways of doing things. ISIS and presidential politics constitute disturbances of another kind.

You might ask what the stock market is doing at these penthouse levels if a business-cycle downturn is beginning. The

Dr. Copper opines



source: Federal Reserve Bank of St. Louis

answer is that, by one school of thought, a bear market is already in progress.

We take our cue from an article of wisdom dispensed a century ago by William Peter Hamilton, longtime editor of The Wall Street Journal. It holds that you know that a bull stock market is in good trim when industrial stocks and railroad issues move synchronously. Let one portion of the market diverge from the other--the goods-producing end, for example, makes new highs while the transportation end languishes--and there's trouble, possibly a change, in what the adepts call the primary trend. By the light of the Dow Theory--or, rather, by some construers of the Dow Theory, for there is schism in technical analysis as there is in other departments of human thought--the primary trend is down. You know it because the May 19 peak in the Dow Industrials has gone unconfirmed by a subsequent new closing high in the Transportation Average (which put in its last new high almost exactly one year ago). Actually, you may not know it, since stock-market technicians sit below the salt in modern finance. We refer scoffing readers to "Transported by Mr. Dow" in the June 12 issue of Grant's, as well as to the discussion that resumes below.

The macroeconomic sightings so far related come courtesy of Lakshman Achuthan, chief operations officer of the Economic Cycle Research Institute, a producer of rigorous and thoughtful analyses of the macroeconomy. What ECRI says it sees is a rate of economic growth that is perilously close to no growth.

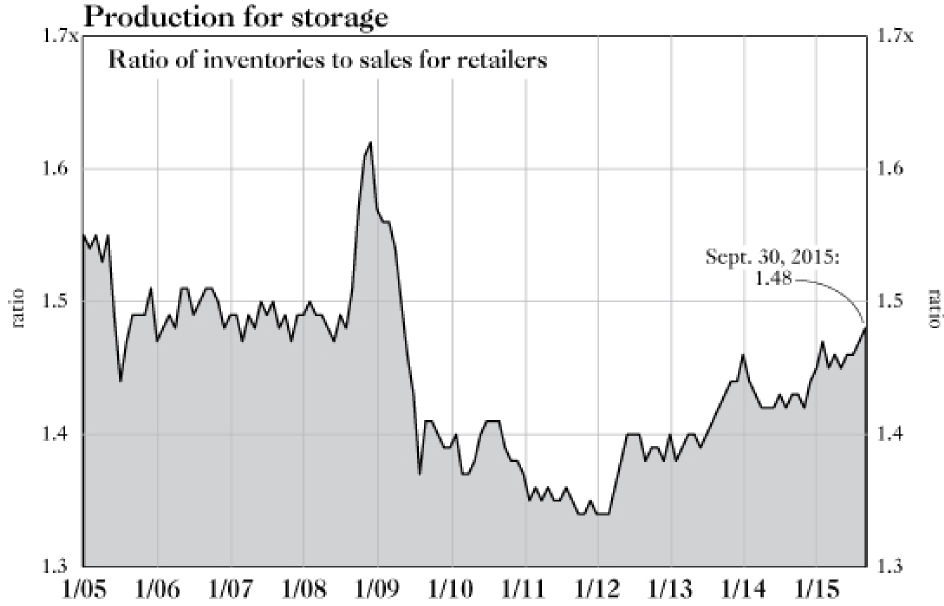
"What is very slow will get slower," Achuthan tells Grant's, "but in order to make a recession call, we need to see our leading indicators fall in a pronounced, pervasive and persistent way, and we don't have that yet. I'm not saying it won't come, but as of today [Nov. 16], I don't have that. . . . The forward-looking indicators, which correctly anticipated the slowdown we are experiencing, point to more slowing ahead of us. As to an outright recession, stay tuned. We need to see the levels of our indicators actually fall."

Achuthan can testify to just how fine is the line between recession and nonrecession. He had predicted that the final six months of 2012 would register contraction. The first estimate of GDP growth came in at 1½% (that is, at an annual rate of 1½%). The fifth revision to that initial estimate, unveiled in July, pushed down the measured rate of growth to a quarter of 1%, about as close to shrinkage as a positive growth figure can be.

The deceleration in GDP growth began 10 months ago, Achuthan continues. He says it's the 22nd such measured cyclical pause since 1948. It's a "moderately severe slowdown by 21st-century standards." The book on slowdowns, he goes on, is that half lead to recessions, half don't: "It's not over, so it's likely to get worse. How much worse is the $64,000 question." The readers of Grant's--the editor of Grant's--would like a little more certainty, of course. It is not to be had.

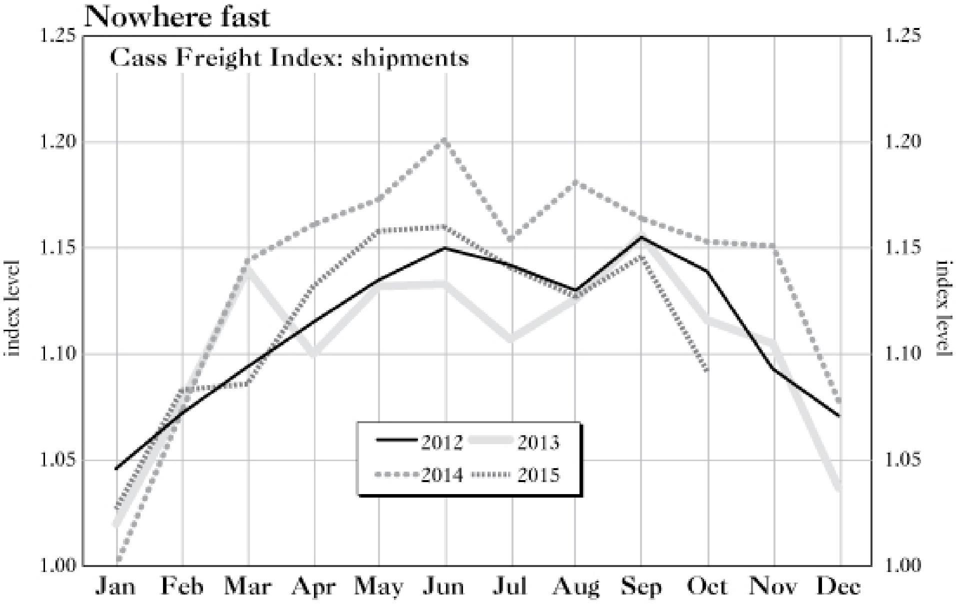
Profits may tell the tale. They're strong and rising, according to the comprehensive measure produced in the National Income and Product Accounts (NIPA). They're nothing of the kind, according to the narrower readings of the component companies in the S&P 500. Reuters observes that S&P 500 earnings are poised to record their first quarter of year-over-year shrinkage since the third quarter of 2009. "We can't think of any instances when the Fed was hiking during an [S&P 500 earnings] recession," the news service quotes Joseph Zidle, portfolio strategist at Richard Bernstein Advisors in New York, as saying. It's worth noting, we think, that while the NIPA and S&P 500 earnings

Production for storage



source: The Bloomberg

Nowhere fast



source: Cass Information Systems

data track closely over time, they can diverge in the short run, particularly during recessions. At the start of a slump, S&P net income falls much more sharply than NIPA profits do. And at the onset of recovery, S&P net income rises much faster than NIPA profits do.

Interest rates discount the value of future profits. The stock market anticipates whether those profits will materialize. When Charles Dow compiled the first-ever stock index, the Dow Jones Railroad Average, in 1884, he couldn't have anticipated the coming of the service economy, the computer, e-commerce, Amazon or Uber. Nor could have Hamilton, writing a generation later. What each man, Hamilton especially, intuited was that goods, once produced, must be moved, lest they pile up in a warehouse. So a new upside (or downside) record on the production side of the stock market is of no predictive value unless confirmed by a new upside (or downside) record on the transportation side.

"When they fail to [confirm]," as we quoted Louise Yamada, eponym of Louise Yamada Technical Research Advisors, as saying in Grant's in June, "often a market correction is being signaled. The confirmation, or non-confirmation, often takes place over months. The last major divergence took place in the 2007 top, as the Transports moved to a new high but the Dow failed to confirm. In 1999, the DJIA moved to a new high and the Transports diverged, as is happening now. Each occurrence progressed to a market setback."

The story is much the same today, Yamada relates: "Strong rallies in weak markets have often proved bull traps. Strong rallies initiating bull markets carry dynamic positive statistics, which are not visible today." By the light of Dow Theory, this is a bear market, Yamada tells colleague David Peligal. Stocks have been rising "on poor indicator readings so there is no indication that the topping process is being reversed."

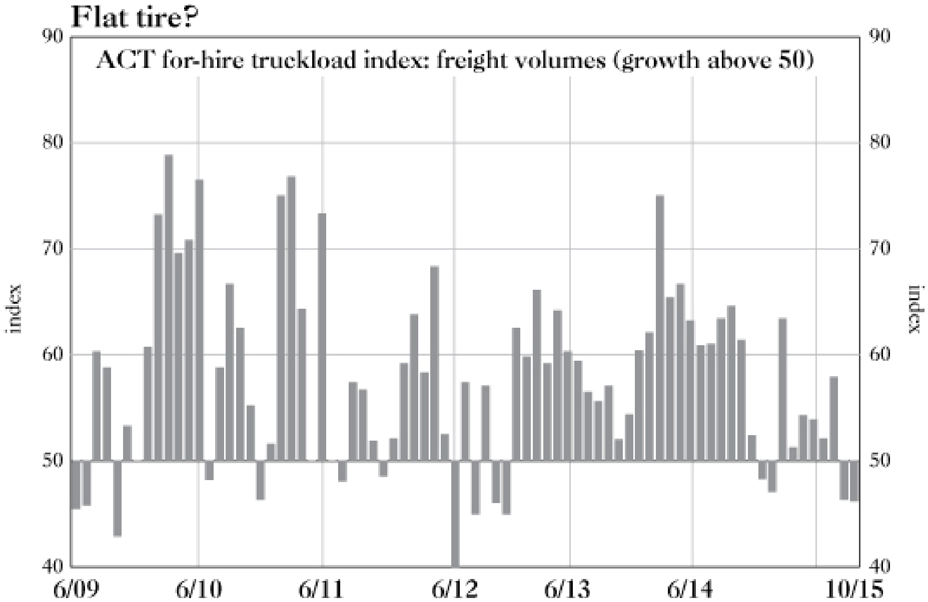
In June, Yamada had observed that "a top is not a place, it's a process." Where are we now in the speculative journey? Peligal asked.

"We don't know," the technician replied. "But we could argue that we have been in this process since mid-2014, when you actually had that mid-October dip that took you down to 1,820 in the S&P 500. And now, we've come down and tested that level again. So you're failing to put in place a series of higher highs and higher lows. You're going sideways, basically."

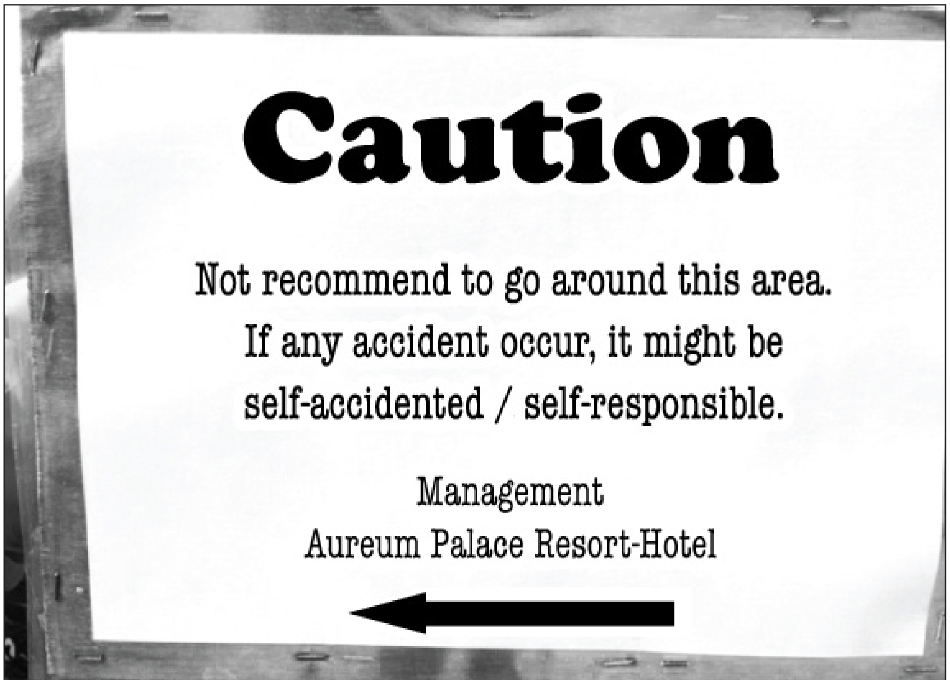
Oppenheimer & Co. points out that only 33% of NYSE stocks are above their 200-day moving average, meaning that many stocks (including not a few of Grant's favorite value plays) are in their own bear markets. This ties into market breadth, or the lack thereof. It's no front-page news that a few high-growth, consumer-facing technology companies (e.g., Amazon, Google, Facebook) have accounted for most of the S&P 500's gain this year. "Hedge funds continue to favor the small list of mega cap stocks that have driven a vast majority of the S&P 500 return YTD," Goldman Sachs relates in its Nov. 20 "Hedge Fund Trend Monitor." "Ten S&P 500 stocks have accounted for more than 100% of the index-level return in 2015. Seven of the top 10 contributors are also members of our Hedge Fund VIP list."

The reason to dwell on a century-old interpretation of the movement of a pair of technically deficient (price-weighted, not market-cap-weighted) equity indices is because the stock market may reset expectations for the dollar and monetary policy. To emphasize, we

Flat tire?



source: ACT Research Co. LLC



Investment words to live by.

are star-gazing. Even the best of us do. The late, great Richard Russell, author of the "Dow Theory Letters," who died on Saturday at the age of 91, wrote in what stands as a predictive valedictory that "market analysis has now become central bank analysis. All the old methods of analyzing markets have given way to deciphering what the Fed or ECB will do next. I've talked about the pattern of the Dow Jones Averages ever since 1958. Based on the action of the two averages now, I'd say that the market is headed higher." So, no, there is no clarity, only the dueling of ideas.

And, to be sure, of facts, including the ones concerning the business of moving goods to market. The number of freight shipments, rail and truck, dropped by 5.3% in October, measured year-over-year, according to the Cass Freight Index. "The freight shipment index," the data compilers relate, "now sits at its lowest October level since 2011. This month's decline was much sharper than in recent years and can be directly correlated to falling imports and exports as well as decreased domestic manufacturing levels. Burdened by bloated inventories, and under the shadow of a possible interest-rate increase by the Federal Reserve, businesses cut back on new orders placed in the last three or four months. This is resulting in lower import volumes, less freight to move and faltering industrial production. With the dollar still strengthening, export growth decelerated in the third quarter."

The Cass narrative is the standard one nowadays, Peligal reports. Thus, October freight volumes aboard Class 8 trucks (the behemoths) were the lowest since December 2012, according to an index compiled by ACT Research. And it was the first October to register a year-over-year decline since the survey was initiated in 2009. "Anecdotally," says Kenny Vieth, ACT's president and senior analyst, "we are hearing that shippers are coming into the market early for bids, which underscores the softening in the supply-demand dynamic as they look to take advantage of current weakness."

And so by sea: "America's busiest ports are sending a warning about the U.S. economy," The Wall Street Journal reported on Nov. 15. "For the first time in at least a decade, imports fell in both September and October at each of the three busiest U.S. seaports."

Union Pacific Corp. (UNP on the New York Stock Exchange) opens another window on the not-so-vibrant American economy. "Volumes at the railroad are down by 5% in the year to date," Peligal says. "At a Nov. 11 investor conference, UNP's chief financial officer, Rob Knight, elaborated thus: 'This softness has continued into the fourth quarter with car loadings down about 8% right now. With the exception of automotive, which continues to be strong [give credit where it's due, in this case to Fed-facilitated EZ finance--ed.], we are seeing declines in all other lines of our business.' In agricultural products, fourth-quarter volumes to date have fallen by 2% from the year-ago period; chemicals are down by 5%, intermodal by 8%, industrial products by 15% and coal by 17%. Cars and trucks are higher by 7%."

Vacationing in Myanmar, paid-up subscriber Preston Hutchings snapped the picture of a sign, below, that the management of his hotel had posted to steer tourists away from some hazard or other. The investment applications of the charming phrase "self-accidented/self-responsible" are obvious.

Our monetary affairs are self-accidented since we the people are self-responsible for them. We the Wall Street people have bet heavily not only on a higher funds rate but also on a lower euro exchange rate. Grant's is proposing that the higher funds rate will prove transitory and that the dollar exchange rate, in company with the U.S. stock market, will pull back.

On Monday, the Dollar Index topped 100 for the second time this year (not since early 2003 has it held that level for very long). Also on Monday, the Markit Flash U.S. Manufacturing Purchasing Managers' Index for November fell to 52.6, down a point and a half from October and the lowest reading in 25 months. Markit chief economist Chris Williamson connected the dots: "Domestic demand appears to be holding up well, but the sluggish global economy and strong dollar continue to act as dampeners on firms' order-book growth. Export orders showed a renewed decline, dropping for the first time in three months."

We are betting against, among others, Goldman Sachs, which predicts that the FOMC will "raise the funds rate by 100 basis points next year, or one hike per quarter--a fair amount above the 55–60 basis points pace priced into the bond market."

We are betting, too, against the stock market's typical early-year strength and against the many fixed-"income" investors who, self-accidentingly, have pushed the yields of $2 trillions' worth of European sovereign debt to less than zero. If we're right on currencies and economic growth (or the lack of it), the long-dollar/short-euro bets will fail to pay off.

Monday brought the Markit Flash Eurozone Manufacturing PMI for November, which reached a 19-month high. The text that accompanied the data referenced a three-month high in the growth in manufacturing output and the biggest gain in order books since April 2014. "Factory headcounts also rose at a faster rate as firms raised capacity in line with the improved demand environment," Markit reported. Maybe the high dollar and the low euro have already completed their missions.

Harping on gold for the past four fruitless years, it is we who have self-accidented. Still, we shall continue to harp, seeing in this (for now) widow- and widower-making metal a liquid and time-tested alternative to such instruments as the German two-year note, now priced to deliver minus 39 basis points.

Hear Bill Dudley, president of the Federal Reserve Bank of New York, declaim on the path of monetary policy (he said it last December): "With respect to 'how fast' the normalization process will proceed, that depends on two factors--how the economy evolves, and how financial-market conditions respond to movements in the federal funds-rate target. Financial-market conditions mainly include, but are not necessarily limited to, the level of short- and long-term interest rates, credit spreads and availability, equity prices and the foreign-exchange value of the dollar."

Considerations of institutional dignity will serve up a 25-basis-points funds rate next month. Economic and financial reality will force a redo next year. We are speculating, naturally.

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Sell Donald Trump

(December 14, 1987) Crash or no crash, the personal stock

of Donald J. Trump, the New York real-estate celebrity, is up. Up is Trump's favorite direction. He proposes to build the world's tallest building. For flying, he owns a Super Puma jet helicopter and a Boeing 727. For weekend cruising, it's the yacht Nabila, which belonged to the previously opulent Adnan Khashoggi. On land, he rides in limousines. A new "Trump" line of superstretch limo produced by a Bronx manufacturer was named for—who else?

Donald Trump, 41 years old, by all accounts is nearly perfect. He is "six feet-something tall" (People) and photogenic. He is the owner of Trump Tower, which, among real-estate people, is mentioned in the same breath as another one-time family business, Rockefeller Center. Trump himself calls it, "the best piece of real estate in the world, in the most incredible city in the world." He has called the Mayor of New York a "moron"—and lived to tell the tale. When New York City government bungled the job of restoring the Wollman ice-skating rink, Trump in to finish it, on time and within budget. He and his wife Ivana, a model and skier and a current socialite and business-woman, have three children. If one of the children should happen to call the office, that child is put right through—no questions asked. "In 10 years," says Ivana, "Donald is going to be 51 years old. How many casinos can you own? How many buildings can you build? Eventually, Donald's going to look at some other business. Maybe it's politics. Maybe it's something else. I never say never."

Although the mayor and Trump get on like Iran and Iraq, the developer has managed to ingratiate himself with national political leaders. He has taken out full-page advertisements. in The New York Times (at about $35,000 a page) to advance his views on foreign policy. He has flown to Moscow. "I like the people, and the people like me," he says, sounding a little proprietary about the people. He won't be running for President this year, though: "It's so hard to just drop everything to do something like that."

Although Trump contends that he doesn't like "doing press," he is chronically landing on the cover of magazines.Business Week, the New York Times Magazine and People have done him. New York almost canonized him. Trump has done himself, too, in Trump: The Art of the Deal, newly published by Random House. "I don't do it for money," Chapter One leads off. "I've got enough, much more than I'll ever need. I do it to do it. Deals are my art form." Elsewhere Trump contends, "The point is that you can't be too greedy." Also he writes, "I like thinking big. I always have." It is an affecting story of an often misunderstood business genius. The book has gone to a 25% discount from the $19.95 list price at Waldenbooks.

"He is this year's phenomenon," People said, "a 41-year-old member of a species on the verge of extinction: He is a Tycoon."

It is possible that no individual in America is more overbought, personally,than Trump, It is one thing to call Edward Koch a "moron" and get away with it, or to patronize your father in your autobiography ("I had loftier dreams and visions," writes Donald, comparing himself to Fred). It is another to get your face on the cover of People and and manage to hold on to your money. "Whom the gods would destroy, they first make merry,": a friend quipped. Trump was the roaring 1980s in person. And now that the roaring has subsided, what will become of him? If New York City real estate should happen to sink, what will happen to the man who owns so much of it? Is it possible that publicity, the scourge of fortunes and breaker of luck, will be any kinder to Trump than it was to the investorturned-literary-celebrity, George Soros?

Our curiosity was reduced to a few basic questions: Is Trump the type of tycoon with money or the type without? Does he personally go in for leverage? To what extent does his net worth depend on the quoted prices of illiquid assets? More broadly still: Will any real-estate fortune be secure in the coming credit difficulties? Seeking the answers, we read the Trump oeuvre: press clippings, public financial statements, autobiography, back issues of W and "Suzy" columns. We asked around town. Taking nothing for granted, we ordered up a Dun & Bradstreet report on the Trump Organization. The results were inconclusive:

EMPLOYEES: 4,200, including officers; 100 employed here.

FACILITIES: Rents 5,000 sq. ft. in multistory steel building in good condition. Premises neat [i.e., "the best piece of real estate in the world, in the most incredible city in the world"].

LOCATION: Central business district on a main street [i.e., Fifth Avenue].

BRANCHES: Subject operates a casino [he has two and is building a third] in Atlantic City, N.J.

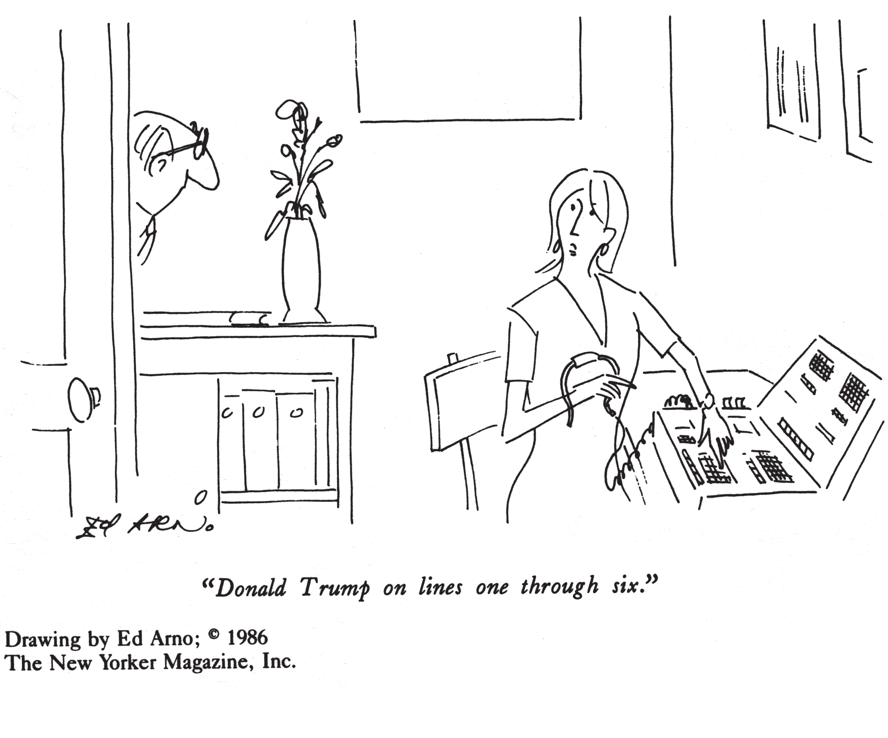
D&B did not specifically address the question of whether Trump has any money or whether it is all spinach. Business Week had ventured $3 billion, seeing Forbes an estimate of $850 million and raising it a couple of billion, but the Business Week estimate appeared before the crash and before the tycoon took a controlling position in Resorts International with its vast sinkhole, the unfinished Taj Mahal casino in Atlantic City.

Furthermore, the magazine spoke before the publication of Trump: The Art of the Deal, and the author's specific guidelines for interpreting Trump, i.e.:

> The final key to the way I promote is bravado. I play to people's fantasies. People may not always think big themselves, but theycan still get excited by those who do. That's why a little hyperbole never hurts. People want to believe that something is the biggest and the greatest and the most spectacular. I call it truthful hyperbole. It's an innocent form of exaggeration—and a very effective form of promotion.

Maybe he was only exaggerating, but Trump divulged that $320 million seemed like a lot of money to him as recently as 1985. That was the year he purchased Hilton's Atlantic City hotel, which, he says, was the biggest bet of his life. He borrowed the money from Manufacturers Hanover, incidentally —got the president on the phone and got the money "just like that. It goes to show you the value of credibility. In return, I did something I'd never done before. I personally guaranteed the loan."

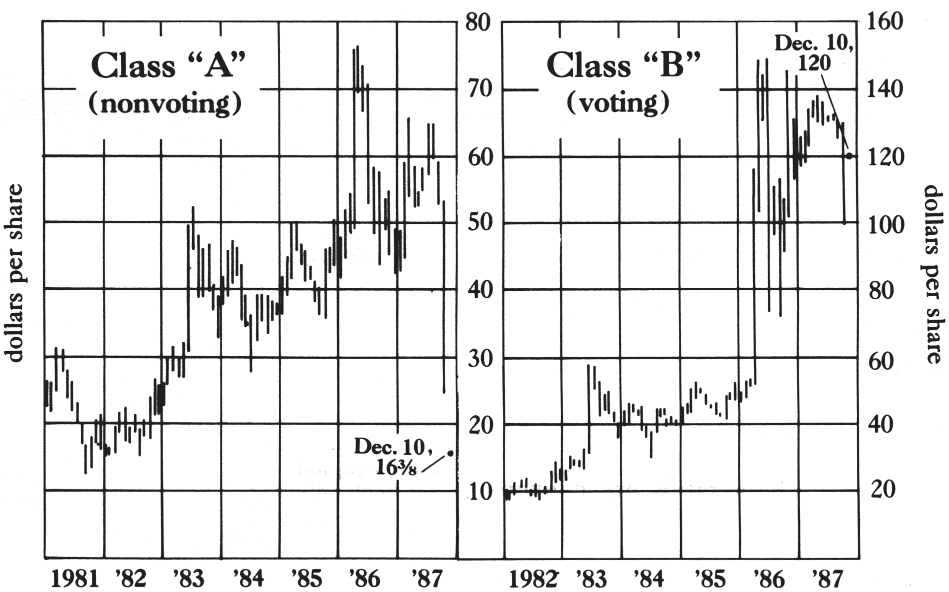
That's the rub with Trump: not knowing how many chits he has out. The tycoon has raised $600 million in junk-grade debt for his two Atlantic City casinos: $250 million in Trump Plaza Funding mortgage bonds (the 12-7/8s of 1998), $226.8 million in Trump's Castle Funding first mortgage bonds (the 13-3/4s of 1997) and $125 mil-lion in another Trump's Castle Funding first mortgage bond issue (the 7s of 1999). As for Trump himself, our intelligence has it that he is, in fact, loaded. More than that, our informants say, he is probably liquid. "He's big time, he really is," said a real-estate friend who has an appreciation of liquidity. The source likens him to Samuel LeFrak, the New York City developer, though a notch below Trammell Crow, the national developer. Trump has tended to work with money partners—the Equitable Life Assurance Society, for instance, or his anonymous junk-bond buyers—rather than on his own credit. Barring a lurch toward recklessness, our informant



"Donald Trump on lines one through six."

Drawing by Ed Arno; © 1986
The New Yorker Magazine, Inc.

Resorts International rolls the dice



source: M.C. Horsey & Co.

contended, Trump is almost a shoe-in to die rich.

Resorts International, the casino and hotel operator, may not reverse that bullish prognosis, but it does not enhance it, either. On the face of things—an impression corroborated by the action of Resorts' common—the company is struggling. Trump paid $100 million or so for control of the voting "B" stock last summer. Since that purchase, the Resorts story has been Wollman Rink in reverse, with massive overruns and snafus at the giant Taj Mahal casino/hotel complex. A year ago, the cost of the project was estimated to be $550 million. In the June 10-Q, it was put at $800 million. In the brand-new September "Q," it was bumped up to $930 million. The latest Q discloses plans to issue $100 million of convertible bonds and up to $450 million of secured indebtedness, all junk grade. That would push the volume of high-yield issuance by Trump-controlled companies to over $1.5 billion, or 1% of the entire public junk market, an impressive figure even for a man who has gotten off the line, "I want the best, whatever it takes."

If the money does get raised, the Q also noted, Resorts would show $1.2 billion of long-term debt. It would show just $109 million of equity. "The Company's ability to service that amount of debt will depend, to a significant extent, upon the future profitability of the Taj Mahal," Resorts adds, which will be no mean feat. Even if you happen to be the moderately leveraged house, Atlantic City has become a harder place in which to make a buck. In the September quarter, city-wide gaming capacity was up by 12.7%, while gaming revenues were up by only 9.7%. Trump Plaza, for instance, managed to score an 18.7% gain in gaming revenues in the September period thanks to expanded parking and the opening of some new "super suites." But, as the financials also disclose, competition raised gaming costs by almost $8 million, or 32%. The document summed up the troubles in one neat sentence: "Market capacity has outstripped market growth."

As might be expected, Trump has not left his flanks entirely unprotected in this campaign. Resorts and Trump's very own Trump Hotel Corp. recently signed a comprehensive services agreement (thank you, Forbes). Among its other features, the contract guarantees Trump a fee equal to 3% of the post-July 21 construction costs of the $930 million (and counting) Taj Mahal. That is, the more it costs, the more Trump stands to earn. We wanted to ask Resorts about that, and we wrote down a question to put to the financial v.p.: "Is there any limit—any cap—to what the Trump Hotel Corp. could earn through cost overruns at Taj Mahal? If not, doesn't Trump, considering he paid only $100 million for his stock, have a vested interest in delay? At the very least, aren't his interests and the company's sharply at variance?"

An arbitrageur who used to own Resorts "A" said that he sold out his stock on the hunch that Trump was not so much on the side of Resorts as on the side of Trump. Some fine print in the Resorts September "Q" raises the same point. It notes that Donald Trump, the chairman of Resorts, controls two other Atlantic City casinos in which Resorts has no interest:

> Because the Trump Casinos compete directly with other Atlantic City casino/hotels, including Resorts International Casino Hotel, and will compete with the Taj Mahal. . . potential conflicts of interest may be deemed to exist by reason of access to information, business opportunities or otherwise.

"Never underestimate the man who overestimates himself," Warren Buffett is supposed to have said. Sell Trump short—but with close stops only.

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Driving the automo-bezzle

(April 8, 2016) Last year marked the sixth consecutive year of rising American light-vehicle sales. Could 2016 make a seventh? If so, never mind the record books. You'd have to turn to the history books. "The last time there were at least seven consecutive years," Jesse Snyder, opinion-page editor of *Automotive News*, tells *Grant's*, "was the streak that started in 1909 when the Model T was introduced."

Now in progress is a skeptical note on the quality of Detroit's arithmetic. In preview, we find it wanting. We suspect that it may likewise prove to be top-making.

Embezzlers are busy in all times and cycles. What ordinarily brings their work to the attention of the police are the circumstances of the down cycle. Undetected embezzlement had no name until John Kenneth Galbraith invented one. He called it the "bezzle."

The author of *The Great Crash* elaborated on his coinage: "In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks."

To read Jesse Snyder in the *Automotive News* of March 21 is to suspect that the automo-bezzle is growing. The editor quoted with approval some remarks by the CEO of AutoNation, Mike Jackson, about the industry's growing dependence on incentives and leasing to maintain a volume of sales "that really isn't there."

"I share his concern," Snyder went on, "and I would add long-term auto loans and heavy fleet volume to the mix. But what really alarms me? Reporting as 'sold' new vehicles that stay on the lot as service loaners, rentals, demos or 'executive' cars. Vehicles quickly resold as used at big discounts, with little or no mileage."

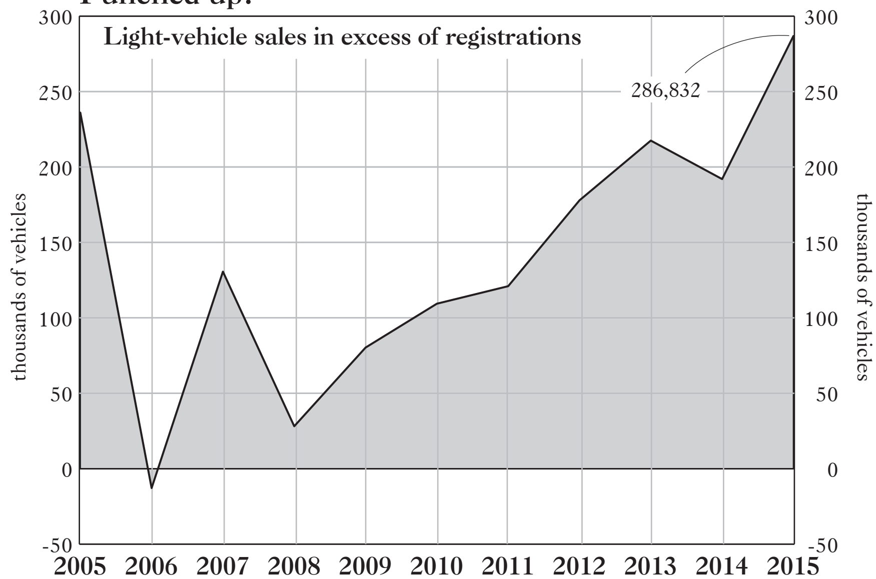
If these tricks of the trade were not a little familiar, they would have no name. "Punching" is the adepts' term for them. While there's no telling exactly how prevalent they are, you can get some idea by comparing the disparity between sales and registrations. Between 2005 and 2014, Snyder reported, the difference averaged 128,000 per annum: "But in 2015, that jumped to 286,832. That's a lot of, ahem, service loaners."

We called the editor to draw him out. Snyder graciously came to the phone and lingered awhile. "Somebody moving 1,000 new cars a year, they're going to have some service loaners, and you want them to have late-model cars," Snyder told colleague Alex Hess. "It's just, when is it excessive?"

Is car-punching endemic? Probably not, Snyder replied: "We're still trying to get our arms around it, on the pervasiveness, and we've talked to an awful lot of people in the industry. This is largely anecdotal at this point, rather than systemic. We're working on it, and we may find there is more."

What prompts the cheating? To start with, Snyder answered, there's pressure to hit sales targets. Then there's a "stair-step" incentive structure: "If you sell 80 vehicles, over and above everything else, [the manufacturer will give you] $100 per car that you've sold this month . . . if you make 100, [you earn] $200 per car. If you make 110 or 120, [they] give you $300 for every car you've sold."

Punched up?



sources: Automotive News Data Center, IHS Automotive

Jackson's reference to a sales volume "that really isn't there" set our own editorial antennae to quivering. The 17.4 million new cars and trucks that rolled off dealer lots in 2015—either sold or leased, with a heavy new emphasis on leasing—constitute an all-time calendar-year record. The latest headline numbers might have suggested that 2016 is on course for something even better. Thus, in the three months through March, light-vehicle sales climbed by 3.4%.

The headlines were more hopeful than the text beneath them. In an April 4 memo, Goldman Sachs analysts Patrick Archambault, David Tamberrino, Stefan Burgstaller and Jay Yang called attention to some un-bullish details: "Overall vehicle unit sales . . . fell 4.4% when adjusted for selling days (27 in 2016 vs. 25 in 2015)." They noted, too, that at a seasonally adjusted annualized rate, March sales came in at 16.6 million, vs. a year-to-date, seasonally adjusted run rate of 17.2 million. Should they hold pace, vehicle sales would fall slightly short of last year's fabulous totals.

That the best of the cycle is likely in the rearview mirror is not the hottest new idea of the spring season, admittedly; Mr. Market today assigns price multiples of 4.9 times 2016 earnings for Fiat Chrysler Automobiles, and 5.4 times and 6.5 times the same for General Motors Co. and Ford Motor Co. The Center for Automotive Research is out with a set of downside scenarios in which sales dip by 12% and 33%, respectively, in 2018.

Of course, no amount of punching could produce the sales gust that low gasoline prices and even lower borrowing costs have delivered. Dollar-denominated interest rates on a 48-month car loan have fallen in each of the past eight years, to 4.0% in 2015 from 7.6% in 2007. The Goldman auto analysts point out that low rates and extended maturities largely served to neutralize the 21.8% rise in average selling prices that the automakers pushed through between January 2009 and September 2015. This shift was accompanied by an ever-rising share of new-car buyers who rely on financing, and a drop in consumer credit scores, according to data from Experian for the fourth quarter of 2015.

Not that the evident outbreak of punching is without its own message. "This kind of stuff goes on to some degree when there is more pressure on manufacturers, and on the individual managers within each manufacturer, to do this," says Snyder. "Before things go bad, [the manufacturers tell themselves] 'I want one more big score.' If I'm going use a stock-market analogy: One more summer in the Hamptons before the recession hits."

Once a car has been punched, that "sale" must be replaced next year, lest growth be seen to stop. And therein lies the trouble: What happens when these "sales" cannot be replaced? Does the dealer punch more vehicles, and more, until finally the truth peeps out?

And what happens when they take away the "punch" bowl?

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Paper tigers

(May 21, 1999) A new high in the prestige of modern central banks was recorded two Fridays ago when Britain waylaid the gold market. Without warning, Her Majesty's government announced the sale of more than half of the U.K. gold reserve, formerly called "treasure." Instead of selling the currency, however, Mr. Market chose to sell the collateral behind it. The Bank of England, protector and defender of the pound, should have blushed: The plunge in the bullion price was the most extravagantly undeserved compliment it has ever received.

The world's oldest currency, sterling has, in this century, also been among the most perishable. It has depreciated in terms of both gold and British domestic prices, without let or hindrance, to borrow from Kipling. That the world should now be prepared to forgive the Bank of England is testament not only to the strength of the global bull bond market, but also to the blessed forgetfulness of the human species, even the monied portion of the species. It is testament, too, to deflation, or more exactly, we think, to the fear of it. In Japan, where the action in bank stocks suggests that a death-dealing financial collapse has been avoided, the two-year note today yields seven basis points (repeat: seven).

To accommodate those readers who have threatened to cancel their subscriptions over the continued unprofitable subtext of gold-bugism in these pages, we will not ourselves make the obvious and necessary point about the relative constancy of the value of bullion, or about the cycles of fashion in monetary assets, or about the tendency of managed currencies down through time to self-immolate. Rather, we will quote other noted authorities on these matters (any complaints, address to them). Thus, Christopher Fildes in the May 15 issue of The Spectator: "As late as 1931, a pound note was as good as a gold sovereign. Today's price for a sovereign is £41, so what was a dead heat is now a race won by a distance."

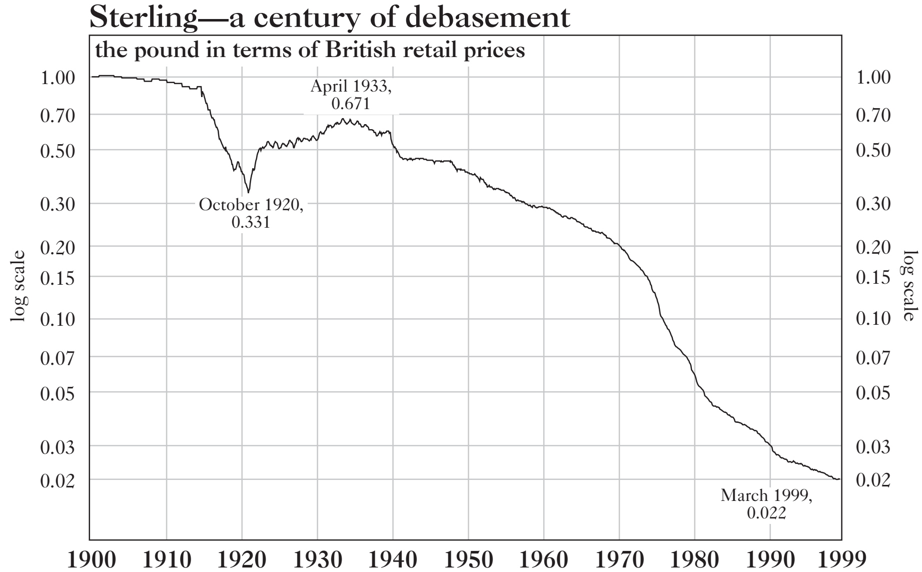
And Harry Bingham, of Van Eck Institutional Advisors in New York, in a recent concise history of the currency that is not called "sterling" for nothing: "Britain's Isaac Newton defined the British pound in terms of gold and silver almost 300 years ago. At the time, the pound was stated to be worth one-fourth of an ounce of gold and a pound of sterling silver. . . . Except for an interruption during the wars with Napoleon [and a century later, the war against the kaiser], the pound maintained its parity with gold and silver until 1931, when Britain formally refused to redeem pound notes for gold. Today, the pound is worth 1/170th of an ounce of gold and less than one-third of an ounce, not a pound, of silver, and this for the only paper currency that has survived for as long as 300 years."

Gold has borne its share of abuse during the almost 20-year bear market, but few indignities can match the market's demonstrated preference today for currencies of no particular pedigree, which includes nearly all of them. Either British social democracy has turned over a new leaf, or Mr. Market—having for so long pushed paper assets in one direction and gold in the opposite direction—is preparing to change his mind. We cling to the latter hypothesis, although we have taken to heart the observation of a reader who said that gold will move when it is good and ready to, not when we tell it to.

Still, we can't help but comment on the poor quality of the competition for gold that the central banks are fielding. As for the pound, nobody who has read its history will be able to take it seriously in 1999, a year that happens to mark the 50th anniversary of its epic devaluation in 1949 and the 35th anniversary of the British payments crisis of 1964. The latter episode, which anticipated the sterling devaluation of 1967 (which is not to be confused with the float-cum-devaluation of 1972 or the float-cum-devaluation of 1992), was the one that inspired an economics minister in the first government of Harold Wilson to fasten the blame for Britain's currency troubles on the "gnomes of Zurich." Putting the nation's gold where their mouth was, the Laborites in 1966 proceeded to sell gold at the then-prevailing $35-per-ounce price. By 1972, Britain had ditched 1,356 tons, more than half of its stash.

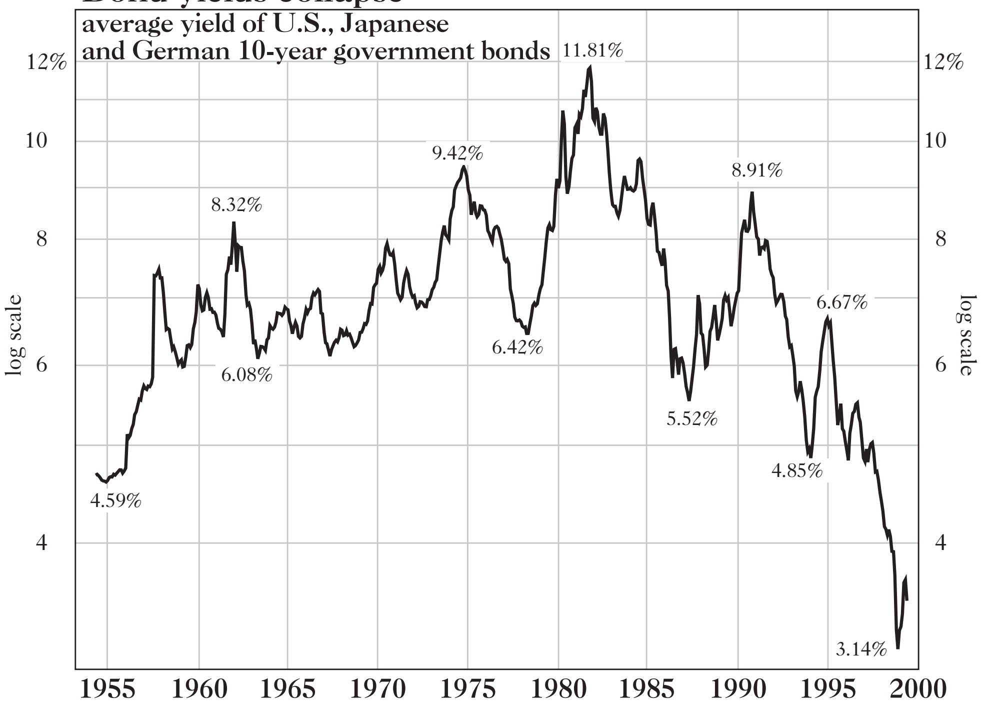
Now, not only do the Laborites, or rather the New Laborites, hate gold, but so do the gnomes and, indeed, the non-gnomes (these days, we do not exclude most gold bulls from the gold-hating majority—even we have our limits). The outer darkness into which the ancient monetary metal has been cast is illuminating, nevertheless. New lows in bullion are as much a sign of the times as are new highs in Japanese government debt instruments (last week's one-year bill auction was more than 13 times oversubscribed; priced at 0.049%, the securities rallied all the way to 0.035%, thereby demonstrating momentum if not what is known as "value"). Bullion and bonds, we think, together constitute a grade-A historical anomaly. The juxtaposition should force people in markets to confront the

Sterling—a century of debasement



Prepared for *Grant's Interest Rate Observer* by Topline Investment Graphics

Bond yields collapse



Prepared for *Grant's Interest Rate Observer* by Topline Investment Graphics

cyclically recurring question: "Is it really different this time?" This much, at least, is different: With the marginalization of the euro (not predicted here) and the weakness of the yen, the dollar has become the world's only universally acceptable monetary asset. It's Coke without Pepsi, a position never before obtained by a currency that can be duplicated at next to no cost on a high-speed printing press. (Arguably, sterling was just as important in its heyday as gold is today. Then, again, look what happened to sterling.)

It is hardly out of character for the Bank of England to show gold the gate. Our older readers may remember when, late in the Napoleonic era, the bank dragged its feet on the resumption of a gold-backed pound (was it really only 190 years ago?!). Down through the centuries, central banks have struggled with the dual mission of running a sound monetary policy and earning their keep. In formal gold-based monetary systems, of which none survive, gold not only collateralized the currency but also tempered the growth in bank credit. Both functions have been sorely missed on occasion in the post-gold era, although the lack of a regulator on bank-credit expansion has proven an excellent facilitator of bull markets. Still, the ingots yielded no income (by definition, they couldn't, any more than a $10 bill can; they were money, i.e., "cash"). Even central bankers who believed in the gold standard sometimes wished their vaults held fewer ingots and more interest-bearing securities.

What's new about the present day, therefore, is not that the official stewards of the golden ingots would like to sell, but that their plans for doing so elicit so little opposition. Essentially, the preference for currencies over bullion in 1999 is unconditional; interest rates no longer seem to figure into the monetary-asset demand calculation very much. It is, of course, the mirror image of 1980, when the panicked demand for gold was itself unconditional. Then, as you may remember, no interest rate was deemed high enough to turn back the tide of inflation. (Is any Japanese interest rate deemed low enough to check deflation? Not to judge by the yen-denominated yield curve.)

If central bankers were scorned 20 years ago, they are lionized today, even when a particular government makes no secret of its determination to cause its currency to depreciate (as the British and the Swiss have done) or when the modern history of a particular currency is really the history of debasement (as is the post-1931 history of sterling). It's true that the Bank of Japan has come in for concerted criticism, and perhaps the reason for the collapse of Japanese interest rates is not so much trust in the BoJ as it is doubt that the bank will ever be able to effect an economic recovery. Still, someone must have faith in the integrity of the currency—enough, at least, to accept a 11/4% yield over the next 10 years.

The first of what is promised to be a series of British gold auctions is set for July. Barring a U.S.-led collapse in bond prices, the interest rates at which the Bank of England will reinvest the proceeds of the sale will be among the lowest of the past half-century (yields

Sell gold? Buy pounds? Good luck

Prepared for *Grant's Interest Rate Observer* by Topline Investment Graphics in the accompanying graph are calculated as a blended 10-year government yield on the yen, the mark and the U.S. dollar). The Japanese two-year note, as mentioned, yields all of seven one-hundredths of one percentage point, before tax. For ourselves, bearing in mind that the doubling time of money invested at seven basis points is only slightly less than a millennium (990.5 years), we can't see the appeal. Safety? Not very likely in the event the Bank of Japan ever considers a rise in the overnight call rate. As a point of perspective, a gold ingot lent for three months yields just under 1.25%; indeed, as of Monday every gold lease rate out to 12 months was greater than every Japanese government bond yield out to 10 years.

By comparison, it's true, the German 10-year bond yield is almost full-bodied, at 4.11%, and the U.S. rate is positively towering, at 5.66%. Yet, over the sweep of the past quarter century, these yields, too, must be reckoned low. As for gold, the only thing one can say is that there is really nothing to say. Having made new lows, it's been written down and written off. (An investor friend relates that he recently bought 250,000 gold calls struck at $500 for five years at a cost of $2 each. Given that the forward gold price is approximately $370, he observed, the calls are essentially free. Oil can go up 80% or so in less than a year, he reflects, but to take the options market at face value, no way can gold go up 30% in five years.)

Following a debasement of the pound by Edward VI in 1549, there was a peasant revolt in Norfolk, Devon and Cornwall. After years of inflationary war finance, in 1810 there were parliamentary hearings into the cause of the alarming loss of the paper pound's purchasing power. And when, at the turn of the 20th century, cheap silver was offered up in competition to the gold-based pound, there was a Gold Standard Defence Association to stand up for the British creditor class.

No such resistance to the course of action announced by the British Treasury is evident today when, to many observers, the clear and present monetary danger is deflation rather than the opposite. Even a little currency appreciation is deemed to be too much (from the time last fall that the Bank of England began to cut its base rate, the trade-weighted sterling index has appreciated by 4.6%). Or, perhaps, the market is looking through immediate events to future British membership in the European Monetary Union, at which point the pound would cease to exist and Britain would share in the European Central Bank's monetary reserves. Certainly, to judge by the shape of the British government yield curve, some such story is making the rounds. Every market rate on the sterling curve is lower than the 51/4% short-term lending rate. The global bond markets are beginning to meld the British curve into Europe's.

But, for now, Britain is still Britain, and sterling is still sterling, and the pound's strength against the puny euro has set off alarm bells within the British commercial and monetary establishments. These concerns came to light in a remarkable report on the day of the gold sale bombshell. "The Bank of England, the U.K. central bank," the Financial Times story led off, "yesterday signalled growing concern over the pound's continued resilience, saying it would cut interest rates again if the currency remained strong."

The fourth paragraph got to the essential monetary issue: "The Bank said that if the pound did not fall, inflation could undershoot the targeted annual rate of 2.5%. 'Depending on other developments in the economy, there might, therefore, need to be further easing of interest rates in order to keep inflation on track,' it said."

Certainly, this is not the one and only official view of British monetary policy. The deputy governor of the Bank of England, Mervyn King, made hawkish sounds on Monday. However, the main fact, we think, is that sterling's depreciation is predestined; the only issue is the rate of decay.

In the wake of the British gold sale announcement, Haruko Fukuda, chief executive of the World Gold Council, a not disinterested party in the transaction, charged, "We at the World Gold Council have been told by HM Treasury that it was emphatically a political decision." Then, again, most monetary policy decisions are. In the circumstances, the choice of holding low-yielding currencies and selling $275 gold is more than trust. It is an act of faith.

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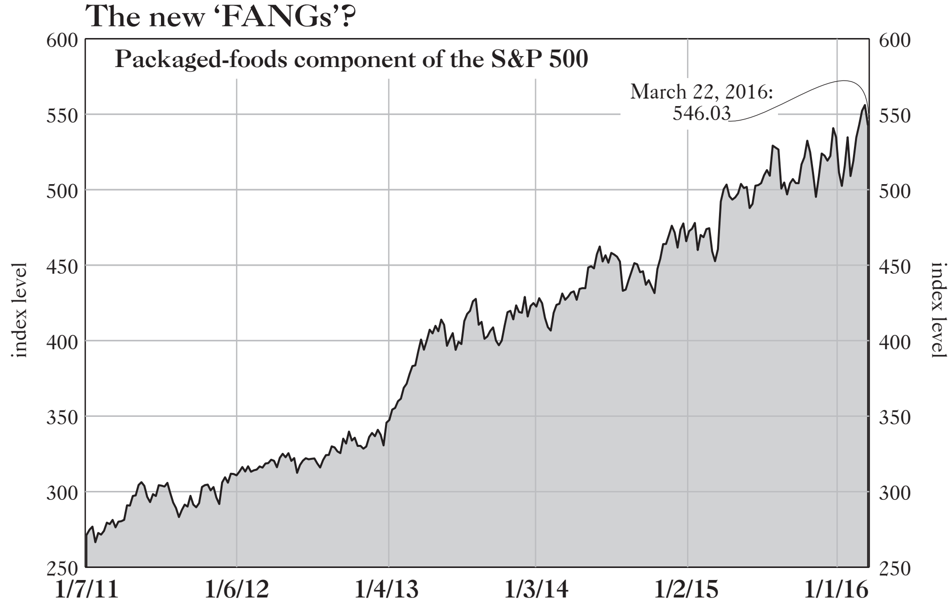
Sell Big Food

(March 25, 2016) In the physical world, some things are inherently safe, others inherently not. Daisies and dynamite, for example. There are fewer such clear distinctions to be drawn in the world of investing. Bonds are inherently senior to stock in a corporate capital structure, but "bonds," as an asset class, may or may not be riskier than "stocks," as an asset class. If risk is defined as the odds on the permanent impairment of capital, time and value decide.

Which brings us to Warren Buffett's favorite consumer packaged-foods company, to our former favorite canned-soup company and to "safety," as the Wall Street meme-makers define that

The new 'FANGs'?



source: The Bloomberg

elastic concept. In preview, *Grant's* is bearish on Kraft Heinz Co. (KHC on the Nasdaq), on Campbell Soup Co. (CPB on the New York Stock Exchange) and, yes, even on safety, as defined; mispriced investments are inherently risky, we are about to contend.

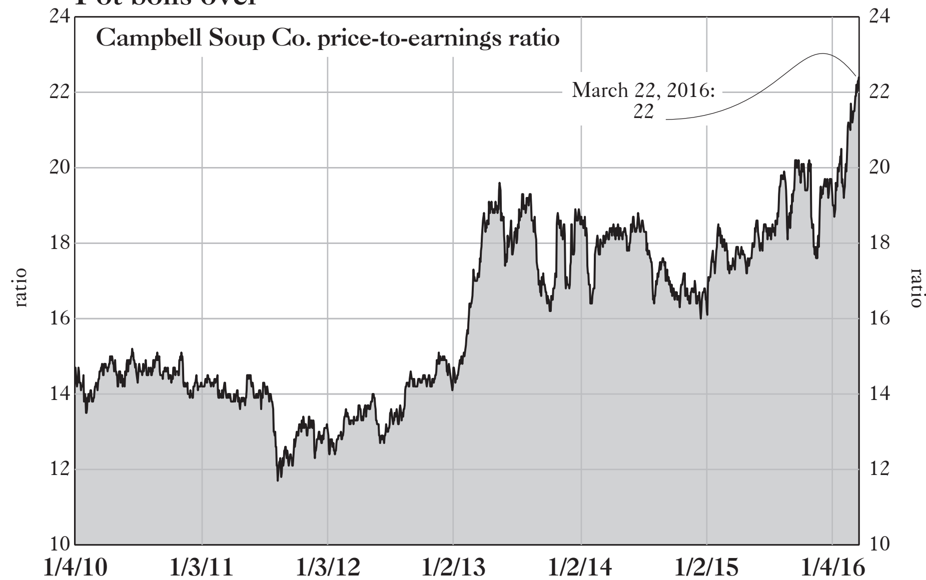
To judge by their assigned equity valuations, packaged-foods companies must be cycle-proof, even consumer-proof. Five years ago the dozen companies constituting the packaged-foods segment of the S&P 500 traded at an average of 15.6 times trailing net income. Today, they command an average of 24.8 times. There will always be Heinz ketchup, Campbell's soup and Kraft macaroni and cheese, the argument seems to run. The companies that make them may not deliver much topline growth, but, allegedly—Old Man River-fashion—they'll just keep rolling along.

You can be sure that the market isn't valuing the favored dozen on revenue growth. In the latest reported quarter, Hormel Foods Corp., producer of, inter alia, Spam and Skippy peanut butter, divulged a 4% drop in sales. Post Holdings, Inc. (Grape-Nuts, Honey Bunches of Oats) suffered a 4.2% decline in sales, excluding the benefits of acquisitions, and Kraft Heinz (Velveeta, Oscar Mayer) admitted to a 5% plunge in sales (pro forma the acquisition of Kraft Foods). "They are literally shrinking," Mathew T. Klody, managing partner of MCN Capital Management, Chicago, marvels to colleague Evan Lorenz, "and the market is paying 25 to 30 times earnings for them. If you look at these stocks, it looks like the FANG stocks [Facebook, Amazon, Netflix, Google] of six months ago. They've gone up parabolically."

Americans may be buying the stocks. They are not—as they have done in the past—buying the products. Health and wellness are today's on-trend watch words. They are not the first characteristics that spring to mind when contemplating the comfort foods of Kraft, Hormel, Heinz et al. Big Food still dominates the supermarket's center aisles. The trouble is that crowds are forming around the perimeter, where the kale is.

Newfangled foods—free-range, organic, gluten-free, farm-to-table, non-GMO and fresh, above all—are the drivers of sales growth today, John J. Baumgartner, the Wells Fargo Securities LLC analyst who covers packaged-foods companies, advises Lorenz. "I think the retailers are recognizing that the reason

Pot boils over



source: The Bloomberg

that they lost traffic in the couple of years following the recession to places like Trader Joe's and Whole Foods is because they didn't merchandise as much natural and organic," Baumgartner explains. "As they recognized that and are ramping up their merchandising of natural and organic in a traditional grocery environment, it is putting traditional food in a bit more of a bind."

Untraditional is the millennial cohort's disdain for once revered brands. According to a recent survey by Mintel Group, almost half of Americans between the ages of 29 and 38 regard the Big Food companies with mistrust. Value is rather the young person's shopping mantra.

In 1986, Grant's published a profile of the independently thoughtful investor Bill Tehan. A one-time goldbug, Tehan had become a kind of food-bug. Disinflation was fattening the margins of the Hersheys and Heinzes and Kelloggs, and he was bullish on the group. How skinny were those margins, in comparison to today's, may bear a moment's reflection. In 1985, Campbell was earning 9.2% on sales, half of today's rate; Heinz was earning 12.1%, compared with 16.5% in 2015 and a projected 28.9% for 2017.

The low valuation of the food stocks in the wake of the Great Recession had little to do with business fundamentals. The affliction known in these pages as "2008-on-the-brain" was rather the source of knockdown P/E multiples. Anxious investors demanded government securities, not equities. The issue of *Grant's* dated Oct. 7, 2011 proposed a 10-year total-return contest between the common equity of Campbell Soup Co. and the then-current 10-year Treasury note. Our money was on CPB.

Here was a valuation story—ergo, by our definition, a safety story. Campbell traded at 12.9 times earnings and delivered a 3.6% dividend yield. The Treasury 2 1/8s of Aug. 15, 2021 traded at 102.66, a price to yield 1.83%. Suppose that Campbell's earnings and dividend stood still for the next 10 years, we proposed. At year 10, an investor would have earned a decade's worth of dividend payments, producing a 36% all-in return. Over the same period, a holder of the Treasury note would be just 18.3% to the good. It followed that, in order to achieve a break-even return with the 10-year note, the Campbell share price would have to decline. It would have to decline by 17%, or 1.9% a year for 10 years, in fact, to reduce it to parity with the government security.

So far, so good for the soup maker. In the past five years, Campbell has generated a 110% return, including dividends; the 10-year note has delivered 9.7%. Campbell's earnings per share has grown by 13.6%, and its revenues by 3.6%, while the share count has fallen by 3.4%. The quarterly dividend has been lifted to $0.312 from $0.29. Net debt has pushed higher, to $3.5 billion from $2.6 billion, as the debt rating has drifted lower, to triple-B-plus from single-A.

But nothing that Campbell did contributed more to the trajectory of its

share price than what Mr. Market did for it. From 12.9 times earnings in 2011, the multiple leapt to 22 times today. That sprouting P/E ratio has served up the bulk of the return.

Maybe the time has come for P/E contraction. In the quarter ended Jan. 31, total company volumes (including the likes of V8 and Pepperidge Farm) showed a year-over-year decline of 2%, while dollar-denominated revenues, also measured year-over-year, were flat. (Sales of soup actually fell by 4% year-over-year.) The way forward is cost-cutting, management and Wall Street now concur. The upshot is a consensus projection for operating income of $1.5 billion in fiscal 2017 (ends July 31), up from $1.2 billion in fiscal 2014. To hear the analysts tell it, operating margins will spurt to 18.5% of sales in fiscal 2017 from 14.4% in fiscal 2014. Who needs growth in sales or market share when you have forecasts?

For ourselves, we elect to cut short our 10-year bet, crowning ourselves and Campbell the winner and Treasurys the loser. We note that the Campbell insiders have sold a net 289,010 shares over the past year for proceeds of $16.3 million. No soup for them; no soup for us.

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On, now, to Kraft Heinz, a grand specimen of the platform company, or roll-up, on which James H. Litinsky so profitably expounded at the *Grant's* fall conference (see the Oct. 30 issue). Certainly, 3G Capital, Inc. and Berkshire Hathaway, Inc. have been merrily rolling along. In 2013, they acquired HJ Heinz Co. for $27.4 billion in cash. Two years later, their acquisition vehicle bought Kraft Food Group, Inc. for $55.4 billion in cash and stock. Today, KHC is the largest American food manufacturer by market capitalization, at $93 billion. Mondelez International, Inc. is a distant second, at $63 billion.

For Litinsky, "platform" was a term of disparagement; not for KHC. "The Kraft Heinz Company," the investor-relations home page dilates, "a platform for performance. This historic transaction unites two powerful businesses and iconic brands, and provides a platform for leadership in the food industry, both domestically and internationally."

In the fiscal year ended Jan. 3, the combined entities of Kraft and Heinz produced $27.4 billion of sales to retailers worldwide. The United States and Canada contributed 79% of the total, Europe 9% and parts unknown 12%. You know the brands: Kraft, Oscar Mayer, Heinz, Planters, Velveeta, Philadelphia, Lunchables, Maxwell House, Capri Sun, Ore-Ida, Kool-Aid, Jell-O. Undisclosed is what each brand contributes to the corporate whole.

"Kraft Heinz's brands are ubiquitous," Lorenz observes. "On-trend, they are not. Yes, Oscar Mayer does produce a 'natural' line of lunch meats, but sugary drinks (Kool-Aid, Country Time), high-fat condiments (Cool Whip, Miracle Whip), sugary condiments (Heinz ketchup) and processed cheeses (Kraft, Velveeta) are the corporate workhorses. The price that you, the investor, pay for this conflation of chow is 34.9 times adjusted, pro forma 2015 earnings per share and 25.8 times the 2016 estimate. As for 2017, it's yours for just 20.2 times."

With revenues on the dwindle, management is promising $1.5 billion in cost reductions, or $1.23 for each of the company's 1.2 billion shares. According to Kraft Heinz, workforce reduction, overhead savings—3G's famous "zero-based budgeting"—and manufacturing and supply-chain efficiencies will deliver the savings by the end of 2017.

"As with Campbell Soup," Lorenz points out, "the Street has dutifully penciled in those projected savings and more into forward estimates. Operating income (of the pro forma kind) footed to $4.5 billion for the combined Kraft Heinz in 2015. Actual operating is expected to grow to $7.8 billion by 2017. This is despite an expected contraction in sales, to $27 billion from $27.4 billion over that span. Based on shrinking sales and expectations of growing profits, Street estimates imply that Kraft Heinz's operating margin will expand to 28.9% in 2017, from 16.5% (pro forma) in 2015."

"Of the dozen packaged-food companies in the S&P 500, only one, Mondelez, has an operating margin as high as the Street is betting that Kraft Heinz will achieve by 2017," Lorenz continues. "It's unlikely, though, that Kraft Heinz can follow Mondelez into the promised land of super-profitability. On Oct. 1, 2012, Mondelez (then Kraft Foods, Inc.) spun off its low-margin grocery businesses into a new company. This company, confusingly, bore the name Kraft Foods Group, Inc. In other words, Mondelez is a cherry-picked portfolio of higher growth and higher margin products. The operating margin for the other 11 packaged-goods companies in the S&P 500 averages 12.3% of trailing-12-month sales."

Bulls pin their hopes on something called "trade spend optimization" (when the busy financiers say "spend," what they mean is "spending"). This will take a little explaining. The revenues that the likes of Heinz Kraft report are net sales. Gross sales can be 20% higher than net. Undisclosed marketing expense accounts for the difference.

Trade promotions have their origin in the 1971 Nixon price controls. In an attempt to get one step ahead of the government, packaged-food companies padded their selling prices. It was insulation they could use when the federal price-control ax fell. When that threat receded, the cannier food companies retained the gross-to-net spread as a kind of piggy bank. Ever since, they've used it to secure desirable shelf space or better placement in weekly advertising circulars.

It's an expensive stratagem. Compare and contrast a 1% reduction in trade promotions with a 1% increase in sales volumes. The former is much more efficient than the latter. By cutting trade promotions, you effectively increase prices; a dollar thus saved contributes a dollar to operating income. In contrast, a 1% increase in volumes boosts operating profit only by the assumed operating margin, say 29%. Wishing that trade promotions would go away, Wall Street's optimists are prone to assume that they will.

You can't assume away the debt. The roll-up of Kraft into Heinz left the food behemoth with $28.9 billion of net borrowings. Based on management's estimate of pro forma, adjusted EBITDA for the full year 2015, net debt to EBITDA totaled 4.3 times; the Street projects a 2016 decline to 3.9 times. In the fourth quarter, which included a full three months of the combined Kraft and Heinz results, operating income covered interest expense by 4.8 times.

Even if Kraft Heinz refinances a big slug of its 9% preferred stock in June, the shoe of leverage will continue to pinch (the company's triple-B-minus debt rating is just this side of junk). The clamoring bulls demand that management materialize $3.1 billion in free cash flow in 2016. The stockholders demand that 3G and Berkshire honor their pre-merger commitment to maintain (and, if possible, boost) the 55-cent-per-quarter dividend. So far, so faithful—the dividend now stands at 57½ cents a share—but that payout is costing the company $2.8 billion a year, or 91% of this year's estimated free cash flow.

Hopes for the 3G/Berkshire giant run high. Standard & Poor's all but promises a future ratings upgrade, and Goldman Sachs last week actually delivered one. Now KHC is a "conviction" buy, Goldman said, as distinct, presumably, from a "half-hearted, going-through-the-motions-just-for-a-shot-at-the-investment-banking-business" buy. "Investors, in our opinion," Goldman opines, "are underestimating KHC's earnings power that stems from improved pricing discipline, cost cuts, commodities and international-revenue synergies. We see a positive estimate-revision cycle ahead with further potential M&A offering incremental upside."

Goldman isn't alone in harping on mergers and acquisitions. Some speculate that General Mills, Inc. may be next on the Kraft Heinz menu. In any case, an anonymity-seeking bull tells Lorenz: "The addressable market or the addressable targets for Kraft is immense. We've sized it up to something around $1 trillion, in terms of enterprise value of potential targets they can go after and acquire. This is both public and private companies globally. It is $1 trillion and relative to Kraft's enterprise value of $122 billion; there is 10-X. There is an endless amount of pipeline for deals."

Bulls cast Kraft Heinz as a kind of armed missionary. The heathens can either convert voluntarily to zero-based budgeting and reduced trade promotions (thereby lifting both their margins and share prices), or they can undergo forced conversion at the not-so-gentle hands of 3G and Berkshire. To judge by the prevalence of 3G management jargon on recent Big Food conference calls—Campbell and ConAgra Foods, for instance, both spoke the new patois—the gospel of efficiency is making inroads.

Whether the converts stay converted is another matter, for the packaged-foods business was, and remains, dog-eat-dog. Kraft Heinz did try to economize on promotional spending in the UK recently. It stopped spending as it had customarily spent to push its branded soup. What it did not do, at the same time, was freshen the product or otherwise call new attention to it. It didn't take long for the competition to notice. A supermarket land grab ensued, at the expense of Kraft Heinz. Presumably, the humbled bully will be back again to reclaim its lost territory and market share. The point to mark is that the presumed counteroffensive will not come for free. Which leads us to conjecture that some portion of that allegedly certain $1.5 billion in promotional cost savings may not be saved after all. Businesses need sustenance, too.

"As the new health-and-wellness brands gain more distribution," Lorenz points out, "they likewise gain economies of scale that allow them to cut prices, and this they do over time (think Chobani, Kind Snacks and Naked Juice, among others). So, while existing packaged-food brands are trying to increase profits by cutting trade promotional dollars, the price gap is narrowing between established processed foods and on-trend, newer brands."

"My perspective, at least, is that what one company is talking about is usually what most of the other companies talk about," Rob Dickerson, the vice president and head of global packaged foods at Consumer Edge Research, an independent research boutique, remarks. "It changes every year. Right now it is trade optimization. Why weren't they talking about trade optimization three years ago? Three years ago they were trying to increase marketing and trade spend to increase volumes. That didn't work.

"Eventually you say," Dickerson proceeds, "'How do you generate higher profit margins to grow your profits?' You are just going down the line; what lever can we pull now? If these companies were growing volumes, would we be seeing as much discussion around trade promotions as we are? My theory is most likely we would not."

Investors have a lever to pull. It's the one marked "sell."

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Monetary regime change

(September 13, 2002) On August 30, at the annual monetary jamboree of the Kansas City Federal Reserve Bank in Jackson Hole, Wyo., Alan Greenspan washed his hands of responsibility for the bubble he said he could not have pricked even if he had noticed it floating above his desk on a string. "The struggle to understand developments in the economy and financial markets since the mid-1990s has been particularly challenging for monetary policy makers," declared the Maestro. "We were confronted with forces that none of us had personally experienced. Aside from the then recent experience of Japan, only history books and musty archives gave us clues to the appropriate stance for policy."

The chairman's Jackson Hole speech has been, will be and should be deplored as the worst kind of self-exculpating revisionism. However, it was a letter to the editor in Sunday's New York Times that hit the critical nail on the head.

"Mr. Greenspan is a human being," writes Victor A. Altshul, of New Haven, Conn., "subject to the same frailties as anyone else. Why should we expect him to be exempt from the universal tendency to rationalize one's errors and to distort the record to protect one's self-esteem? Shouldn't we instead be looking at our own complicity in investing so much power in one man?"

CEOs are celebrated not for who they are but for what they do. Until he presided over the great bull market, Greenspan did not give many outward signs of genius. But the higher stock prices went, the smarter he seemed to become. By late in the 1990s, he was heralded as a miracle worker. Indisputably, he was the only federal employee whose reputation for financial sagacity rivaled that of Jack Welch. Miracles being few and far between these past two years, Greenspan's reputation has begun to be marked down, if only by eighths and quarters. Welch's, last week, entered what looked like a secular bear market.

Following is a speculation on the outlines of a post-Greenspan monetary system. It is supported by some of the historical works that the chairman can read in the well-deserved retirement he should have taken starting in about 1996. We say "post-Greenspan" because, we believe, the Jackson Hole speech will raise the odds against his reappointment (his current term expires in 2004), speed the day of his departure and reduce his policy-making influence for as long as he remains in office. It would be no small thing if the chairman's myriad admirers decided that their idol had lost his touch. Although the Federal Reserve System employs 485 Ph.D. economists, only one is a living symbol of the dynamic U.S. economy. And now this one man says that he didn't know about the stock-market bubble, couldn't have known and, even if he had known, wouldn't have been able to make a move against it. It isn't a great advertisement for a monetary dictatorship.

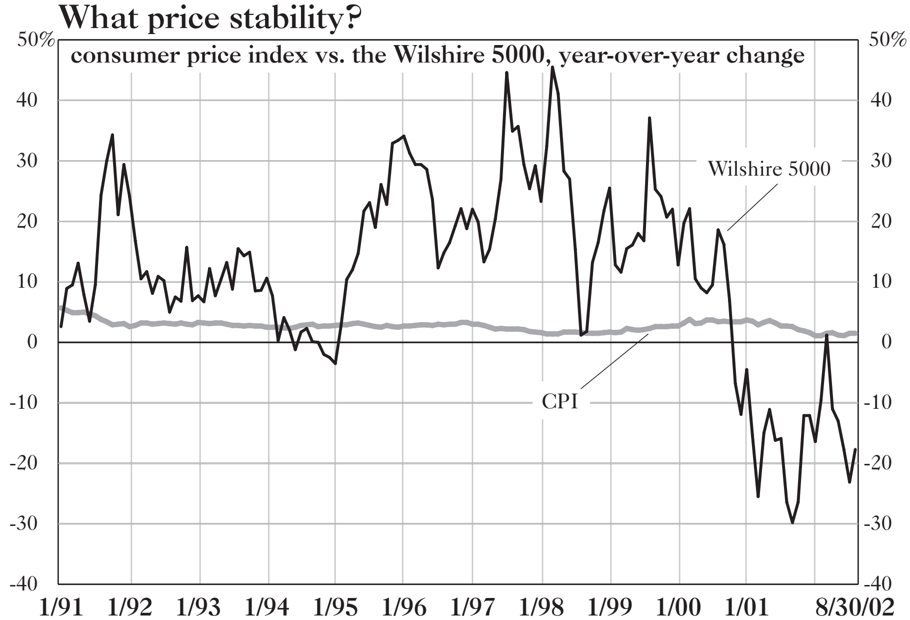
Monetary policy under Greenspan (as we may have touched on in the prior issue) consists of fixing an optimal funds rate. In better times, Greenspan's mysterious rate-setting method was deemed as great an American secret as the Coca-Cola formula. As recently as Aug. 2, 2001, David Wessel of The Wall Street Journal entered a page-one plea that the chairman share his secret lest the country suffer irreparable harm when nature finally called him to rest. To enforce this most perfect interest rate, the Fed creates the needed volume of credit. It "prints" money, as every trainee knows, by acquiring earning assets, mainly Treasury securities; it buys them with dollars that it creates for the very purpose.

Grant's monitors the growth of these assets to see how many dollars it takes to set and maintain the desired rate. To set an artificially low rate, the Fed pumps money into the market. To impose an artificially high rate, it withholds money from the market. (A rate that is neither artificially low nor artificially high is the rate that would balance the demand for savings with the supply of savings without central bank intervention.) The current, 13/4% funds rate has been maintained by prodigies of credit creation. As recently as July 17, growth in Fed credit was running on the order of 11.27%, measured year-over-year. Today, it's clocked at just 9.28%. It's noteworthy that the Fed is able to continue to impose a generationally low funds rate without deploying more and more credit (indeed, by deploying less). If the slower growth in credit supply reflects a faltering growth in credit demand, it may presage still lower money-market rates.

Only one of the troubles with bubbles is that, after they pop, ultra-low interest rates and extraordinary rates of credit expansion lose their stimulative potency.

What price stability?

consumer price index vs. the Wilshire 5000, year-over-year change



source: The Bloomberg

The rate of creation of new yen by the Bank of Japan stands at 26.1%, year-over-year, but this outpouring has yielded no appreciable reflationary results. It interests relatively few investors that the central bank of the world's second-largest economy is engaged in a monetary expansion of a scale suitable to one of the minor United Nations members. It would interest a great many more if the Fed were forced into the same exigencies. No one can know whether it will be or won't be. However, in January, the Federal Open Market Committee did discuss "unconventional policy measures" to deploy if "the economy were to deteriorate substantially in a period when nominal short-term interest rates were already at very low levels," according to the minutes of a meeting held on January 25-26.

The Founding Fathers, well remembering King George III, held the exercise of arbitrary authority in abhorrence. Their contemporary, stock-minded political descendants, however, have gladly tolerated the kind of arbitrary authority exercised by the Fed chairman. Willingly did this government of the people, by the people and for the people cede monetary power virtually to a committee of one. However, the more the economy labors and the lower stock prices fall, the worse this remarkable act of delegation will come to appear. The bear market will bring the question posed by letter-writer Altshul--why was so much power given to one man?--into the political mainstream.

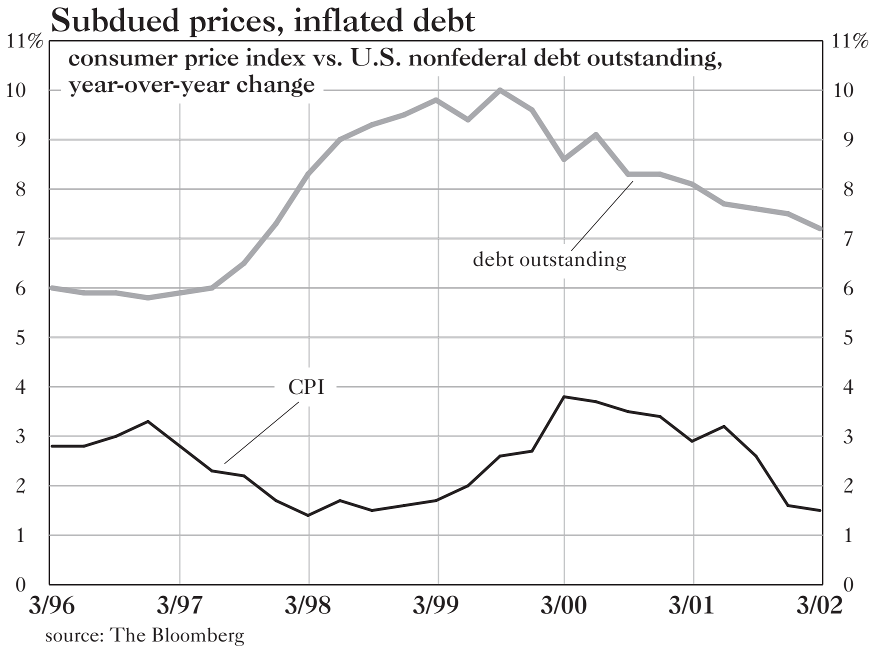
A survey of the dead authors not much read at the Federal Reserve supports an observation familiar to the readers of Grant's. This observation is that monetary systems are impermanent--one has succeeded another at intervals since the late 19th century. To their originators, each method of monetary organization was fit for the ages. But none lasted much longer than a generation. The system in place since 1971 is the worldwide paper-dollar system. In part, it's an "information standard," to borrow from retired Citibanker Walter Wriston, with interest rates and exchange rates mainly set by the market. But the federal funds rate, anchor rate of the dollar-denominated yield curve, is a government-issue rate, and the latent power to create massive amounts of credit (as at year-end 1999 and in September 2001) is a governmental power. As much as it might be an information standard, the current dollar system is just as much, or even more, a faith-in-government standard.

It wasn't faith in an impersonal government, or in the rules laid down by government, that brought CNBC into American homes and taverns in the late 1990s. Rather, it was faith in the capacities of government masterminds. At the peak of their renown, Alan Greenspan and Robert Rubin seemed to work with tomorrow's edition of The Wall Street Journal always open before them. And now, instead of Rubin at Treasury, there is Paul O'Neill, a man who seems not to have read yesterday's paper. And there is Greenspan, who in Jackson Hole revealed a faulty memory and a guilty conscience.

The text of his speech is available on the Federal Reserve Board's Web site (http://federalreserve.gov/boarddocs/speeches/2002/) and it deserves a careful reading--or, rather, repeated careful readings, as the student will hardly believe it the first time through. Here is the history of the 1990s according to Greenspan, a decade in which "greater economic stability" fostered risk taking, and in which earnings prospects improved as the pace of innovation accelerated. Responding to these stimuli, stock prices rose. "The associated decline in the cost of equity capital spurred a pronounced rise in capital investment and productivity growth that broadened impressively in the latter years of the 1990s," the Jackson Hole audience heard him say. "Stock prices rose further, responding to the growing optimism about greater stability, strengthening investment, and faster productivity growth." Regrettably, they rose too far, but there was no way, except in retrospect, to have known that. Indeed, even the March 2000 highs might not have been too high "if all of the drop in equity premiums had resulted from a permanent reduction in cyclical volatility. . . ." And, of course, "productivity growth" was a gift almost beyond measure.

Greenspan disputed that a rise in margin requirements would have deflated the bloated market, forgetting that he himself had acknowledged the need to address the "stock market bubble problem" in the Sept. 24, 1996, meeting of the FOMC: "I guarantee you that if you want to get rid of the bubble, whatever it is, that will do it," the transcript of the meeting quotes him as saying (http://federalreserve. gov/fomc/#calendars). "My concern is that I am not sure what else it will do."

Greenspan's shortcomings as a memoirist in his Jackson Hole address are matched by his failings as an economic theorist. He perpetuates popular nostrums about productivity growth, "price stability" and interest-rate policy. For example, he offers no insight into the unintended consequences of suppressing market interest rates. He implies (though it is possible to infer from Bob Woodward's "Maestro" that he doesn't really believe it) that gains in productivity are registered automatically in profits, rather than in wages or prices, or in a combination of the three. He fails to mention that "price stability" can, and on many occasions in the past has, led to bull stock markets that elicited enough redundant capital investment to distort the economy in which they spread their joy. And he declines to address the risk that the very prestige of a popular central banker tends to cause investors to forget themselves and push up asset prices to the heights that all come to regret. The propensity to regret is especially keen if the prestigious central banker in question blesses the bubble both in word and deed.



A month before the Jackson Hole festivities, the BIS published a working paper by Claudio Borio and Philip Lowe that anticipated the subjects Greenspan discussed on August 30. The BIS, of course, is the Bank for International Settlements, the central bankers' central bank, and an unlikely source of criticism of the only central banker up for knighthood this fall. Yet the BIS authors come down hard on the side of doing what Greenspan didn't do, incidentally anticipating (and refuting) the reasons Greenspan presents for not doing it. The more successful a central bank in smiting the conventional kind of inflation, write Borio and Lowe, the greater the risk of an outbreak of the unconventional kind (i.e., a bubble). "Failure to respond to these imbalances," the two contend, "either using monetary policy or another policy instrument, may ultimately increase the risk of both financial instability and subsequently deflation (during the period in which the imbalances are unwound)."

Not once in his Jackson Hole recitation did Greenspan concede that his repeated interventions to prolong the up cycle had misdirected capital and hurt the owners of it (not to mention the people who work for the owners of it and the children of all the foregoing). The BIS authors clinically refer to the risks presented by "asymmetric" policies, i.e., cutting rates to rescue the market but never raising them to slow it down. It will speed the close of the Greenspan era when the public reflects on how lopsided was this asymmetry. Grant the chairman, for argument's sake, the prudence of intervening in the wake of the Long-Term Capital Management explosion in October 1998. Give him the benefit of the doubt about the stupendous infusion of credit with which the Fed prepared the nation to meet the crisis of the computer clocks at year-end 1999. And allow him the justice of the argument that in a deregulated world, the manipulation of margin requirements is a gesture certain to fail. Grant every point, and still it is not possible to explain away the fact that Greenspan sounded more like a broker than a central banker in his speeches and congressional testimony in the mid- and late 1990s. He was a greater seducer than any big-money analyst, in fact, because the public could see that he spoke from the heart. He wasn't in the bonus pool.

A week or so after the Jackson Hole speech found Stephen Cecchetti on the op-ed page of the Financial Times with a most becoming mea culpa. Cecchetti, currently professor of economics at Ohio State University, was director of research at the Federal Reserve Bank of New York in Wall Street's all-you-can-eat years, 1997-99. He reviews the damage inflicted by the bubble, from underfunded pension funds to distorted GDP statistics to the slight over-ordering of telecommunications equipment and computers. "Add all of this together," writes Cecchetti, "and the cost is several percent of U.S. GDP and still counting. When faced with the potential for output losses of this size, central bankers usually work fast to try to minimize the damage. So why, when faced with strong evidence of a bubble, do they react so differently, claiming that there is nothing they can do? The response is surprising." Having acknowledged that a move to withdraw the punch bowl was in order, the economist admirably closes, "I cannot claim this would have worked and did not push for it at the time--but I certainly should have."

The BIS essay almost diffidently makes the case for a "paradigm shift" in central banking. It urges an acceptance of the fact that asset inflation is a source of economic distortion, therefore a problem suitable for central bankers. Years ago in the pages of Grant's, colleague Gert von der Linde recalled Greenspan's own very neat definition of inflation. It was approximately this: Inflation is a rate of rise in prices sufficient to cause a change in human behavior. And von der Linde pointed out that the stock market bubble had caused millions of people to do things they had never thought of doing before it happened--for example, not working for a living.

We predict that the reaction against Greenspan will take the form of a rejection of policy making through intuition. In times past, many believed that the chairman could look into the future and improve it before it happened. How he did this was never clear, but it was not for the layman to understand. Proof that it was possible to do was that he was doing it (or so his acolytes insisted).

How far the reaction against the Greenspan intuition will go will depend on how much post-bubble suffering is left to endure. If more than a little, as we expect, the Fed might be obliged to introduce a set of more or less explicit operating rules. It has done so before--for example, from interest-rate targeting to money-supply targeting in 1979 and back to interest-rate targeting from money-supply targeting in 1982. The Fed could shoot at an inflation target--higher than zero, probably, if the post-bubble adjustment proves long, drawn-out and deflationary. The chairman's successor might announce the setting of a watch against the next distorting episode of asset price inflation. The history of monetary policy is an everlasting tale of the frying pan and the fire. The search for price stability has oftentimes led to financial instability (e.g., in the United States in the 1920s and 1990s and in Japan in the 1980s). And though we cannot now recall a central bank that directly targeted asset prices, we have every confidence that such a policy would eventually lead to price inflation. Why? Because money turned away from stocks or real estate would bid up the prices of the items measured in cost-of-living indices.

As dress on Wall Street has become more casual, so have the monetary arrangements. In less than a century, the gold standard and swallowtail coats have given way to Greenspan and open-neck shirts. Possibly, in both money and clothes, a reaction against the long-running trend is today in place. If so, before long analysts in neckties will be trying to decipher the intentions of a new, buttoned-up and rule-bound FOMC.

In the meantime, there will be monetary-policy separation anxiety to bear. Greenspan is a Washington fixture and his mumbles about the mysteries of finance have brought comfort to many, especially to those who don't quite follow him. Since he first reported for government duty in 1974, the nation has had many more successes than failures. He himself has been hailed as a saint and a clairvoyant. Now it develops that he is neither, but only a fellow in a business suit trying to hold his job and not look bad. The chairman is revealed to be a government worker who, perhaps, unlike some of his lay colleagues, did not think it odd that companies with no revenues commanded multibillion-dollar stock-market capitalizations or that bicycle messengers made their rounds with beepers to alert them to the news of publicly announced stock splits (in the bubble, stock splits were regarded as very bullish). Possibly, the up-creeping gold price is nothing more than a war tocsin. However, to us, it is more plausibly a measure of the market's unease over approaching changes in the personnel and operating methods of the Federal Reserve. Even we, bearish on the chairman though we are, must admit that his successor might be worse. In any case, changes are in store for the institution of the dollar.

Many will doubt that any wrenching discontinuity is possible, much less probable. But the financial history of the past 100 years is the story of just such jarring change. To the skeptics, we commend a few lines of reminiscence about the 1920s by the wonderful German economist Wilhelm Röpke, taken from his "Crises and Cycles," which appeared in 1936. "With production and trade increasing month by month throughout the world, the moment actually seemed in sight when social problems would be solved by prosperity for all. . . ," Röpke wrote.

"Thinking back to those 'gay twenties,' we cannot help but be inclined to regard them as one of the most remarkable and astonishing periods in modern history. Probably economic history has never before beheld such a speed, or such a scale of material progress and improvement in the technique of production and organization. It is a curious token of human fickleness that ten years later men are simply wallowing in abuse of that period and are decrying its spirit almost as a strange abomination, an attitude which is all the more curious and even tragic as this total reversal of atmosphere is one of the main reasons for the persistence of the present depression."

The trouble with not knowing history is not that one is condemned to repeat it. As history is cyclical, the only alternative to not repeating it is not being around for the privilege. The trouble is rather that the history-deprived person meets a surprise at every cyclical bend in the road. He or she lives in a childlike state of wonderment. It was thus that the chairman seems to have confronted the computer revolution (astounding!), the attendant gains in measured productivity growth (unprecedented!) and the persistence of stable consumer prices (most gratifying!). He could see the dawn of the New Economy.

And he did, too, as others have seen before him, because the economy is always new and always old. In 1902, R.E. May, a German theorist, was warning about the blessings and risks of productivity growth--"to enable producers to sell their growing output promptly prices must be reduced and wages must be raised in proportion as the supply of goods increases," said May. What he wanted was what the 20th century partially delivered, namely an equitable division of the spoils of productivity growth between wages and profits.

May is quoted in the summa of the dean of American business cycle theorists, Wesley Clair Mitchell. "Business Cycles," published in the very year the Federal Reserve was founded, 1913, reveal Mitchell to be an optimist, but for a set of reasons that will make posterity smile. Nothing like the tulip mania or the South Sea bubble would likely be seen again, Mitchell concluded, because speculative excess was being wrung out of Wall Street. The agent of this progress was enlightened regulation. "By a combination of various agencies such as public regulation of the prospectuses of new companies," the economist asserted 20 years before the creation of the SEC, "legislation supported by efficient administration against fraudulent promotion, more rigid requirements on the part of stock exchanges regarding the securities admitted to official lists, more efficient agencies for giving investors information, and more conservative policy on the part of the banks toward speculative booms, we have learned to avoid certain of the rashest errors committed by earlier generations." This particular section Mitchell entitled "Man's Mastery over the Workings of the Money Economy."

Not one to read history or even to hire someone to do it for him (not one Ph.D. in history draws a Fed paycheck), Greenspan may not be familiar with a masterly 1937 work by C.A. Phillips, T.F. McManus and R.W. Nelson, "Banking and the Business Cycle." In it, Phillips et al. produce a thorough monetary postmortem of the boom and bust of the 1920s and 1930s. And in so doing, they provide a detailed preview of the ups and downs of the millennial New Economy. In the earlier period, as in the later, the source of the bust was the boom. ("The only cause of depression is prosperity," wrote Clement Juglar, a French theorist, many years before.) Then, as now, the Fed achieved stable goods prices only to foment flyaway asset prices. And then, as now, credit expanded at a rate "vastly in excess of the needs of trade and industry."

"The new excess credit," wrote the Phillips team, "was in considerable measure directed into channels divorced from the normal nonspeculative operations of production and commerce, and found expression in the rise of prices in the stock market, in the real estate market and in wage rates. Federal Reserve control activities, primarily directed at stabilization of the price level, produced the speculative and investment booms, with the attendant disequilibrium between investment and saving, and thereby may be considered a generating cause of our recent plight. Investment inflation ended in depression."

Nowadays, investment inflation doesn't end in depression. With the chairman, it ends in confusion. There's some progress in that, we have to admit.

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