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We are Metro

On June 8, the editor of *Grant's* addressed the CFA Society of Washington, D.C. The text of his remarks follows.

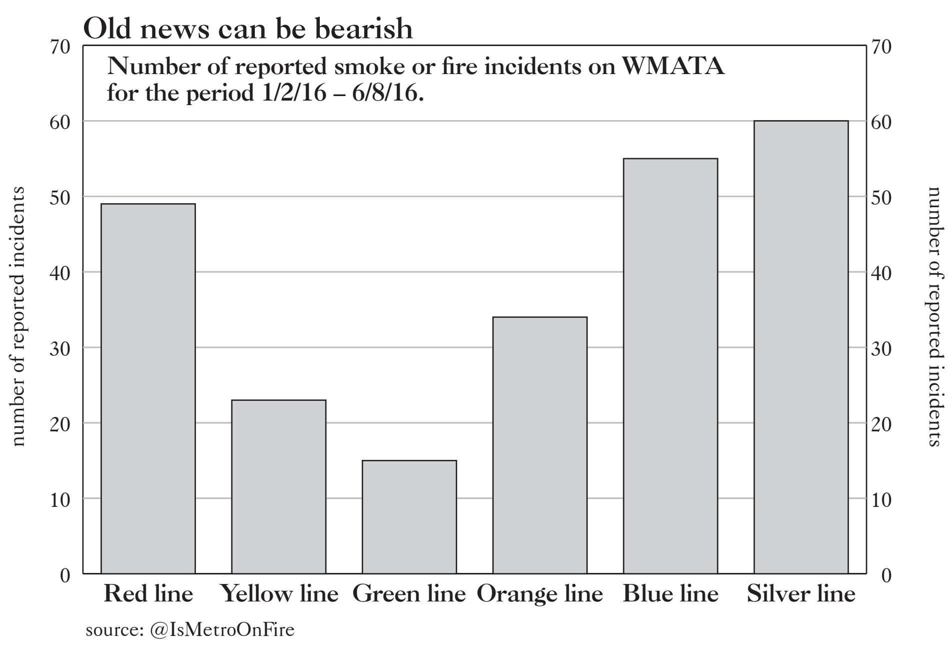
New Yorkers like me can't get enough of the serial calamities of the Washington, D.C., subway system. It makes us feel so much better about our own hole in the ground. We used to believe that riding cheek-to-cheek under the streets of the five boroughs was the worst customer experience in America. You've made us swallow that reverse civic pride. The New York subway may be dirty and overcrowded, but our operating snafus do not ordinarily rise to a level that requires the attention of the National Transportation Safety Board. Neither does New York have a consumer website exactly like the indispensable IsMetroOnFire.com.

My focus this evening is on what might be called the behavioral-finance aspect of the Metro situation. The crisis of the Washington Metropolitan Area Transit Authority was decades in the making. Everybody saw it coming. Still, it happened and, indeed, continues to unfold. I am going to propose that there are more than a few Metros in our financial lives. I would include, in a short list, doctored interest rates, overweening bank regulation, looming federal fiscal problems and China's toxic debt predicament. Old news, all of it. Yet problems do not go away just because we're tired of hearing about them. Metro is a 50-year-old bore. Still, it wreaks havoc.

Chartered Financial Analysts accept that markets are efficient. It's a doctrine that presupposes the efficiency of the humans who act in markets. But tell me, Washington CFAs: How does sentient man, and sentient woman, allow things to come to such a pass that the entire Metro—its 118 route miles, 91 passenger stations and 1,100 railcar fleet—could be taken off-line in March for 24 hours to attend to the maintenance capex that was left undone in full knowledge of the supervising authorities, the press and, indeed, of the massed federal safety establishment itself?

Ben S. Bernanke, the former Federal Reserve chairman turned blogger and capital-introduction professional, is wont to contend that "nobody" saw the oncoming disaster of the 2008 debt crisis. He is wrong about that. But, surely, everyone noticed the encroaching troubles of the Washington underground. You couldn't help yourself.

From the start a half-century ago, the system lacked a dedicated funding source. For its annual operating subsidies and capital infusions, WMATA goes hat-in-hand to its so-called partners: the District of Columbia, the State of Maryland and the Commonwealth of Virginia. The U.S. Government Accountability Office raised an eyebrow about this precarious arrangement as long ago as 1979. An oversight panel harped on the lack of assured financing (in which Metro is unique among the nation's urban passenger-transportation systems) in 2005. Quoth the panelists: "After a quarter century, Metro is succeeding beyond expectations in ridership, has become an



integral part of the region and yet it is literally falling apart."

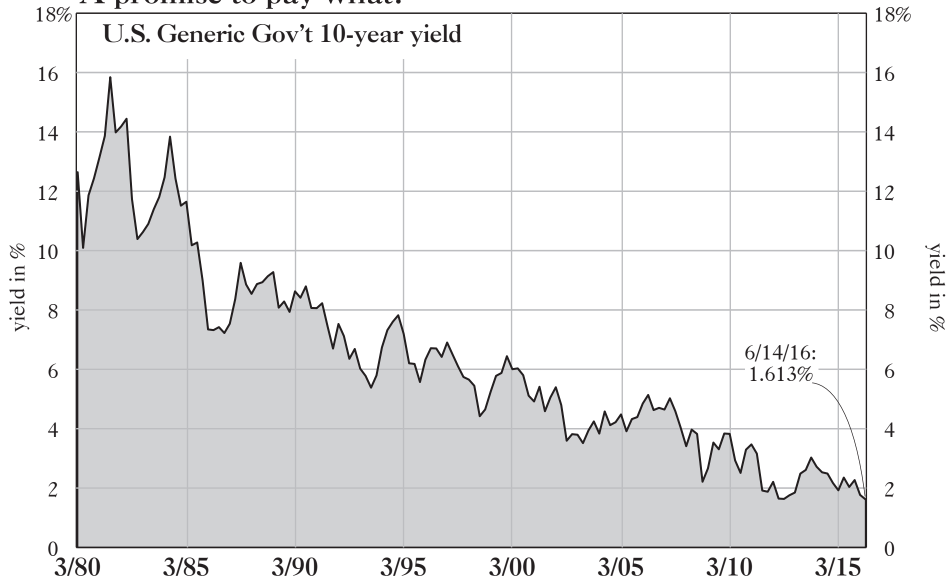
An institutional orphan, Metro lacks an essential capitalistic constituency. It has no owners—I mean no owners who know that they own it. Now, if the mere presence of owners guaranteed good stewardship, Valeant Pharmaceuticals would not be a $25 stock. Sometimes owners, transfixed by a levitating share price, forget that they own a business, not just a winking figure on a Bloomberg screen. Still, better distracted owners than none at all, as Metro demonstrates. I call your attention to the aftermath of the fatal Jan. 12, 2015, track fire near L'Enfant Plaza. NTSB investigated, as it did on 13 occasions over the previous 33 years. The cumulation of these episodes showed—here, I quote NTSB board member Robert L. Sumwalt—that "WMATA, historically speaking, has had a severe learning disability. Quite simply, they have not been willing to learn from prior events."

Urgent problems, unaddressed, hiding in plain sight: We have them on Wall Street, too. Do you ever stop to wonder what your children, looking back as adults at the year 2016, will find most perplexing about us and our investment world? It's a useful way to exercise the financial imagination. I'm pretty sure that the list of perplexities will start with interest rates.

Only 35 years ago, long-dated Treasurys were priced to yield 15%. Today, more than $10 trillion of sovereign debt is priced to deliver less than zero percent (including, as of just the other day, the German government yield curve, out to 10 years). Another $36 billion of corporate debt yields less than nothing, according to the *Financial Times*. Toyota Finance Corp. almost augmented that sum on Tuesday, June 7, when it issued ¥20 billion ($186 million) of three-year notes to yield 0.001%. As for Metro's own 4s of July 1, 2019, rated A2/AA-minus, you earn the lordly, tax-exempt yield of 87 basis points.

You know what a bond is. It's a promise to pay money. But do you know what money is? It's becoming a little murky. The textbooks say that money is a unit of account, a store of value, a medium of exchange. But surely the nature of money has changed. What has changed it is the demonstrated ability of the world's leading central bankers simply to materialize it. Since 2007, they have tapped $10.5 trillion into existence—have summoned it into being with a few light keystrokes on their computers.

A promise to pay what?



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Now some will say that the "money" thereby conjured isn't really money at all, because most of it lies inert on central-bank balance sheets. The apologists contend that the resulting yen, euros, Swiss francs or dollars exist only as bookkeeping entries in the cloud. The money, if you want to call it that, buys nothing except bonds (and a few stocks).

Well, that is no small exception. The central banks' bond-buying is the immediate source of the negative yields that will so confound posterity (and have already dumbfounded certain still living veterans of the last bond bear market). The central banks' stock-buying is another matter. You won't think about modern money the same way after I tell you about the Swiss central bank's equity portfolio.

Did you know that the Swiss National Bank files its own 13-F form, that it owns shares in 2,600 American companies, that its portfolio was worth $54.5 billion at last report and that it contained, among other items, 14.5 million shares of Apple, 11.6 million of Exxon-Mobil and 4.5 million of Wal-Mart?

The SNB creates money from the thin air—in its case, Alpine air. In this it is no different from the Fed. The Swiss create francs with which to buy euros in order to beat back unwanted strength in the franc. With those euros, it buys dollars, and with those dollars it buys American stocks. Which is to say it buys equity interests in real companies with money it whistles into being. I will call that something for nothing.

The SNB says it performs no security analysis but buys formulaically. Still, it does encourage me to see 3.9 million shares of Newmont Mining in the Swiss portfolio. Perhaps the gnomes harbor some atavistic suspicion of modern money-conjuring. Certainly, they should, and so should we all. Your children will think the better of you in 25 short years if you register some form of constructive disbelief in the discretionary monetary rule of former tenured college professors.

I mentioned overbearing bank regulation as the second item on my list of things at which posterity will roll its eyes. A couple of weeks ago, *The Wall Street Journal* published an article under the arresting headline "The Most Powerful Man in Banking." Now who could this titan be? Why, none other than a former law professor, Federal Reserve Governor Daniel Tarullo, head of the Fed's Committee on Bank Supervision. The potentate is quoted thus: "Has what we have done been effective? If we say, 'No,' then maybe we need to return and do more. And, intellectually, I am totally open to that."

One might call Tarullo the Janet Yellen of regulation, or Janet Yellen the Daniel Tarullo of interest rates. Each personifies the quasi nationalization—certainly, the cartelization—of millennial finance. Some will say that the bankers had it coming, but it is we, the people, who are paying for their sins. As our children might come to perceive, interest rates are prices, which are better discovered than administered; and banks are businesses, which a regulator might regulate but ought not, actually, to manage.

No. 3 on my list of problems which, like Metro, do not become less problematic simply on account of their being so well ventilated, is the federal finances. What is left to say about them? I recommend a recent analysis by Jeffrey Miron, who divides his time between Harvard University and the Cato Institute. "Fiscal Imbalance" is the title of his essay, which asks, simply, Are the government's financial policies sustainable? That is, in his words, "given the future expenditures implied by those policies and the projected revenues from all sources," can we keep doing what we're doing? And Miron concludes that the answer is "no." He compares the present value of future outlays (as those outlays are currently projected to grow) with the present value of future revenue (as those revenues are currently projected to grow). And he finds that the gap between the two—the measure of fiscal imbalance—is $120 trillion. Or it was, at last report in 2014. In this election year, it is getting no smaller.

The central problem is entitlements, especially health-care entitlements. At the very sound of the word "entitlement," informed Washingtonians will grimace. Adverse entitlement arithmetic is as tediously familiar as the story of the lapses in Metro capex. Still, as the looming summer disruptions in Washington subway service attest, familiarity ought not to breed complacency. *The Wall Street Journal*, chronicling the leftward lurch in the Democratic Party's policy agenda, quoted a Twitter exchange between Bernie Sanders and the now evidently quite certain Democratic candidate for president.

Sanders: "I urge Sec. Clinton to join me in saying loudly and clearly that we will never cut Social Security."

Hillary Clinton: "I won't cut Social Security. As always, I'll defend it, & I'll expand it. Enough false innuendos."

The Federal Reserve wants a higher rate of inflation. Neither Clinton nor Donald Trump seem to want a slower pace of government spending. As of today, the Treasury pays an average interest cost of 1.8%. Ruminating on these facts, I conclude that the Fed will eventually get the inflation it yearns for. Perhaps, it will get more.

China is the last, but far from the least, of the Metro-like disasters that hide in plain sight from the world's investors. Information, and the freedom to act on it, is the first of China's problems. Fast-proliferating debt is the second.

Xi Jinping, the Chinese president, is a Mao-worshiping micro-manager, so it's no surprise that liberty is on the wane in the People's Republic. Nor is it exactly front-page news that China is wedded to a debt-intensive growth stratagem. Still, the rate of expansion in lending and borrowing is astounding. In the first quarter alone, the Chinese banking system created new renminbi equivalent to $1 trillion. For perspective, China's GDP is $10.5 trillion. For additional perspective, American students and their federal enablers needed more than a decade to expand student debt outstanding by $1 trillion.

What should worry us, though, is not the mere volume of Chinese credit. It's the way in which these funds are being deployed that threatens to rock everyone's boat. Less and less do they find their way into the workaday economy. More and more are they earmarked for speculation. If you have not yet seen it, please read the May 29 Bloomberg dispatch headed "China Default Chain Reaction Threatens Products Worth 35% of GDP."

The "products" to which the enigmatic headline refers are so-called wealth-management products. These are short-dated investment pools with aggregate assets of $3.6 trillion. Yield is the selling point. With the one-year deposit rate pitched at 1.5%, the WMPs fetch between 3% and 5%. They invest in everything under the sun, mostly bonds and what are suggestively called "non-standard credit assets." The story quotes (as did we, in a recent issue of *Grant's*), the excellent Charlene Chu, a partner at Autonomous Research: "We're starting to see layers of liabilities built upon the same underlying assets, much like we did with subprime asset-backed securities, collateralized-debt obligations and CDOs-squared in the U.S." Do you wonder how investors get their money back? Reports Bloomberg: "The most common source of funds for repayment of WMPs is the issuance of new WMPs." Did someone say Ponzi? Yes, as a matter of fact, Xiao Gang did. He said it in 2012 when he was chairman of Bank of China Ltd. China is an accident waiting to happen, *Grant's* has long said. Recalling the multi-decade arc of the decline and fall of Metro, we try not to be impatient for the vindication of that opinion.

Opportunity, too, can hide in plain sight, where it usually is disguised as trouble. I think, for instance, of equities in the early 1950s (the Dow Jones Industrial Average had not made a new high since 1929), of Treasuries in the early 1980s ("certificates of confiscation," even the worn-out bond bulls called them) or of credit in early 2009. If I have dwelled overlong on risks this evening, it's because I believe that the distortions wrought by ultra-low interest rates have infected every asset class and not a few asset managers.

In 19th-century Britain, Walter Bagehot, famed Victorian author and editor, warned against the speculative consequences of ground-hugging gilt yields. "John Bull can stand anything," Bagehot said, "but he can't stand 2%." I believe he meant positive 2%.

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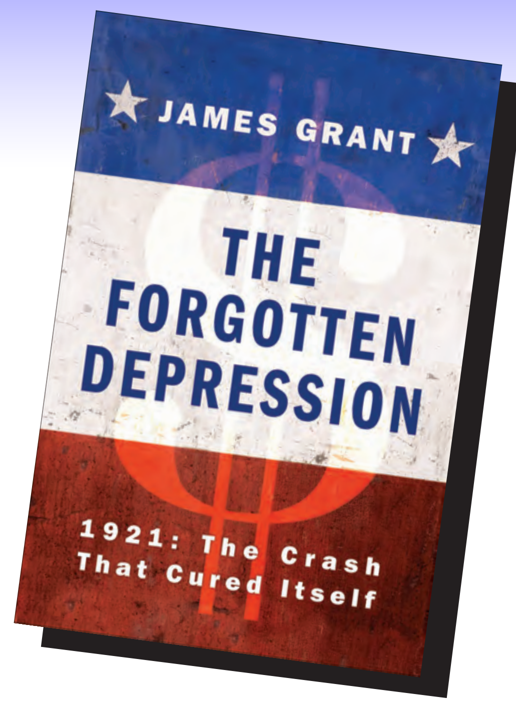

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