GRANT'S

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JAMES GRANT
EDITOR

Merry and Happy

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Lower the debt ceiling

(January 11, 2013) Like a well-fed teenager, the national debt keeps growing and growing. On Dec. 31, it bumped its head against the statutory ceiling that never seems to contain it. That would be \$16.394 trillion, or the cash equivalent of 360.7 million pounds of \$100 bills. We write in support of the ceiling.

Reciprocally, we write against the debt. At prevailing pygmy interest rates, we are bearish on the bonds of which it consists. We oppose, too, the sneaky nomenclature of American public finance, including the title affixed to the Department of the Debt. Inasmuch as the Treasury holds no net treasure, Timothy Geithner's agency should be properly and frankly rebranded. And we oppose the monetary legerdemain by which so much of the debt is financed, notably the nonstop bond buying of the Department of Money Printing. This is the bureau known officially—another misnomer—as America's "central bank."

The operating procedures of the departments of Debt and Money Printing didn't come from nowhere. They sprang from the heads of learned economists. As imbibed by somewhat less learned politicians and journalists, the economists' ideas were reduced to bite-size, destructive, policy-ready form, e.g., "We owe it to ourselves," and "America issues the world's reserve currency, so what's the harm?" and "A family has to balance its budget but a nation is different."

The first debt ceiling was enacted in 1917 after the United States entered World War I. It authorized the sale of long-dated 4% bonds in the sum of \$7.5 billion; the 1917 gross national product amounted to \$60 billion. (For perspective, today's \$16 trillion-plus debt ceiling stacks up against a \$15.7 trillion GDP.) It was no good omen that the Senate passed the 1917 act without a dissenting vote in "record time," according to *The New York Times*. The next year Congress enacted an interest-rate ceiling that prohibited the sale of any U.S. Treasury bond with any coupon greater than 4¼%.

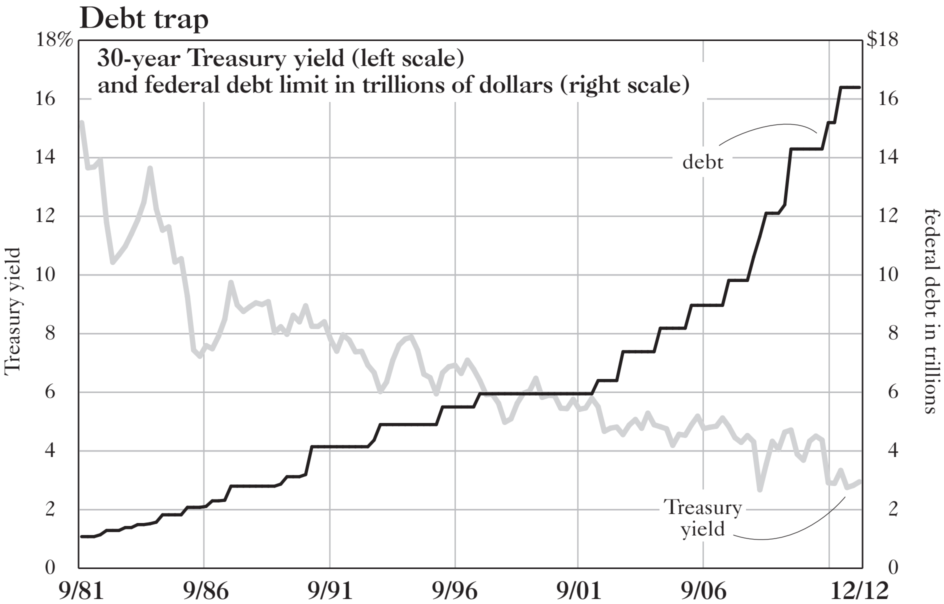
"Since 1917," observes colleague Charley Grant, "the ceiling has been raised 107 times. Expressed as a compound annual rate of growth, the debt ceiling has risen by 8.4%, the nominal GDP by 6%. Twenty-nine more years on this track and the debt ceiling would be double the size of GDP."

"There is a great deal of ruin in a nation," said Adam Smith to calm the apprehensions of an 18th-century worrywart. Just how correct was the author of "The Wealth of Nations" may be seen in the fact that the United States has been able to continue to fund itself despite not one but two defaults over the past 80 years: in 1933, when the dollar was devalued to one-thirty-fifth of an ounce of gold from a little more than one-twentieth of an ounce, and in 1971 when the government stopped exchanging dollars for gold at any rate. J.P. Morgan, too, had a point when he admonished that a bear on America would certainly go broke.

"I'd advise you to stop shorting Amazon."

But neither Smith nor Morgan lived to see the pure paper dollar or today's routine immense peacetime budget deficits. Nor did they live to see the triumph of the ideas of the economists who neglected to consider the temptations inherent in the reserve-currency gimmick. "Borrow what you like, America," in effect, the architects of the post-1971 monetary arrangements proposed, "you can pay your bills, foreign and domestic, in the currency that only you may lawfully print. Now, just don't go printing too much." A nation of saints might resist the urge to overdo it. As for us mortals, the debt ceiling speaks for itself. Perhaps, observing affairs from the economic and financial wing of the kingdom of heaven, Smith and Morgan are just as worried as *Grant's* is.

In fiscal and monetary thought, there is the modern era and the premodern era. The modern era is the age of heavy public indebtedness and paper money; we're in it. The ancient era, the age of minimum in-



sources: The Bloomberg, Office of Management and Budget

debtedness and a convertible currency, is the one that your professor dismissed with a smile in Economics 101. *Grant's* stands for a modern adaptation of ancient thinking.

"The creation in time of peace of a debt likely to become permanent is an evil for which there is no equivalent," said President Martin Van Buren, speaking for the ancients, in his third annual message to Congress in 1839.

"As the sole manufacturer of dollars, whose debt is denominated in dollars, the U.S. government can never become insolvent, i.e., unable to pay its bills," write Brett W. Fawley and Luciana Juvenal, economists at the Federal Reserve Bank of St. Louis, on behalf of the moderns. "In this sense, the government is not dependent on credit markets to remain operational. Moreover, there will always be a market for U.S. government debt at home because the U.S. government has the only means of creating risk-free dollar-denominated assets. . . ."

The Van Buren approach has the longer pedigree, the better grounding in history and the surer claim to horse sense. The St. Louis approach, although ahistorical and actually a little bit crazy, is the doctrine of the Ph.D.s.

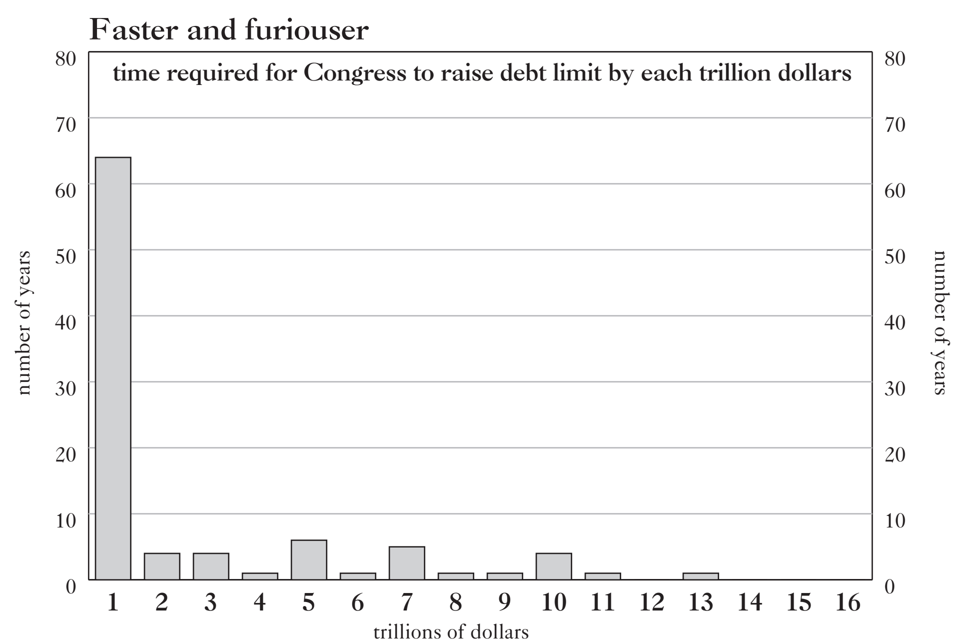
The prejudice against peacetime borrowing persisted through the 1920s. It lingered into the 1930s—Franklin D. Roosevelt himself aspired to balance the budget—and made a brief return appearance after the close of World War II. On June 3, 1946, the Senate passed by unanimous consent a bill to reduce the federal debt limit to $275 billion from $300 billion. "Widely viewed in Congress as a definite step toward the end of deficit financing by the Government," said *The New York Times* of the measure in which the House concurred and which the president, Harry S. Truman, signed.

The Iraq and Afghan wars have, of course, been fought on the cuff. Not so the Korean War; in the early 1950s, the debt ceiling went unraised. "Because the [war] was mostly financed by higher taxes rather than by increased debt," says the Congressional Research Service's new history of the debt ceiling, "the limit remained at $275 billion until 1954." Not until March 1962 did the debt limit again reach $300 billion, where it had originally been set in 1945.

Meanwhile, the rate of inflation was creeping higher, pressuring bond prices. The Eisenhower administration was stymied by the aforementioned 1918 law that capped long-dated Treasury coupons at $4\frac{1}{4}$%. The administration of John F. Kennedy, however, was not so inhibited. Shortly after the 1961 inauguration, the president's brother, Attorney General Robert F. Kennedy, ruled that the interest-rate cap did not bar the issuance of a $4\frac{1}{4}$% bond priced at a discount to par, and, therefore, at a yield higher than $4\frac{1}{4}$%.

The *New York Times* report of this legal innovation is more than a little timely amid urgings (including that by former House Speaker Nancy Pelosi) that President Obama do an end run around Congress and raise the debt ceiling by executive order.

"That was not a new finding," said the *Times* account of the attorney general's ruling. "The Eisenhower administration found the same thing—that it was legally possible to get around the ceiling. The Eisenhower administration did not try this, however, because it didn't think it could get away with it. Interest rates were already high in 1959. They were a hot political issue. The Democrats were in control of Congress. In short, the 'climate' for



source: Office of Management and Budget

cutting legal corners was most unfavorable, so President Eisenhower asked Congress for specific permission. Congress refused."

The law hadn't changed, in short, the *Times* noted. "What has changed is the occupancy of the White House."

It can't be pure coincidence that growth in the public debt accelerated following the 1971 default. The United States had, since the first Roosevelt administration, borrowed dollars convertible into one-thirty-fifth of an ounce of gold. When Nixon redefined the currency as an uncollateralized piece of paper instead of a convertible one—thereby defaulting on debts denominated in gold dollars—the debt ceiling stood at around $400 billion. Over the next 10 years, Congress ratcheted up the limit to $1 trillion—that is, as Andrew H. Tisch pointed out in a June 26 op-ed essay in *The Wall Street Journal*, a sum that, paid out in $100 bills, would weigh 22 million pounds. (The anodyne word "trillion" is a kind of verbal narcotic that lulls the people into a false sense of comprehension, Tisch suggested.)

And as the par value of the outstanding debt approached $1 trillion, long-dated Treasury yields pushed through 15%. As a matter of fact, the first trillion-dollar debt ceiling authorization and the all-time record high in government bond rates occurred within 24 hours of each other.

"Bond Prices Continue Weak, as Treasury Pays Record 15.78% on 20-Year Offering," said the headline over the Oct. 1, 1981, *Wall Street Journal* bond dispatch. "A Debt of $1 Trillion: Its Effect on Economy," said the headline over the Oct. 1, 1981, *New York Times* report on the looming American fiscal milestone. "The bond market still is very uneasy about the economic policies of the Reagan administration and the large planned budget deficits," said John O. Wilson, a senior vice president of Bank of America, to the *Journal*'s Tom Herman. It was possible to infer that soaring debt caused flyaway bond yields.

It was an erroneous inference, but one that briefly troubled the national conscience. Blaming 15% interest rates on the deficit (a mere 2.6% of GDP in fiscal 1981, in fact), politicians resolved to do better. "We've only balanced the budget once in the last 20 years," declared President Ronald Reagan in a televised address to the nation. "One trillion dollars of debt—if we as a nation needed a warning, let that be it."

Whether or not America needed a warning, it declined to heed one. "Many governments have come to power upon a platform of economy—but never twice," observes Freeman Tilden in his quirky and wonderful book, "A World in Debt" (1935). "We often hear that a politician is equipped with a 'mandate' from his constituents toward economy in government. What this really means is that he is directed by his electors to urge other politicians—similarly instructed—to spend less, so that *his* district can spend more. As this leads to an impasse, the way out is clear. Each votes as much as possible. In politics, the word 'economy' refers to something *somebody else* has done, or has not done, or is to be required to do or not to do."

Especially do Tilden's words apply to a country equipped with a magic credit card. What credit card might this be? Why, the one economists know as the reserve-currency "privilege." We rather call it a bane, as the ability to pay one's foreign debts in one's own currency constitutes an irresistible temptation to overspend and overborrow. Especially is this so when one's creditors—e.g., the People's Republic of China—facilitate the buildup of American debts in their own mercantilist interest. When gold was the world's money, there were no "privileges"; one nation's currency was as

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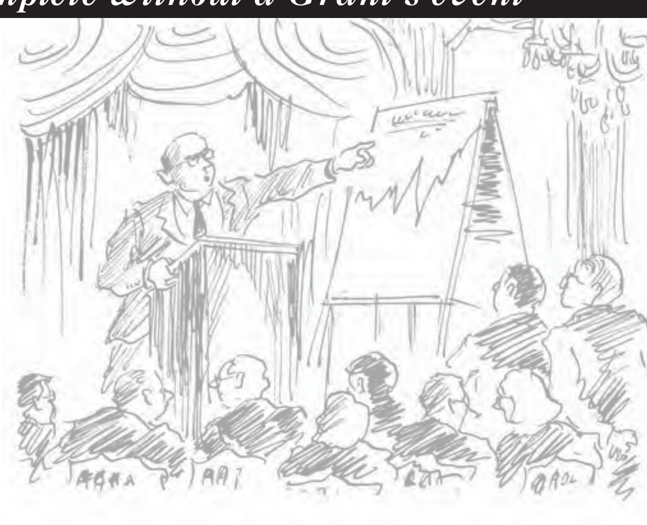

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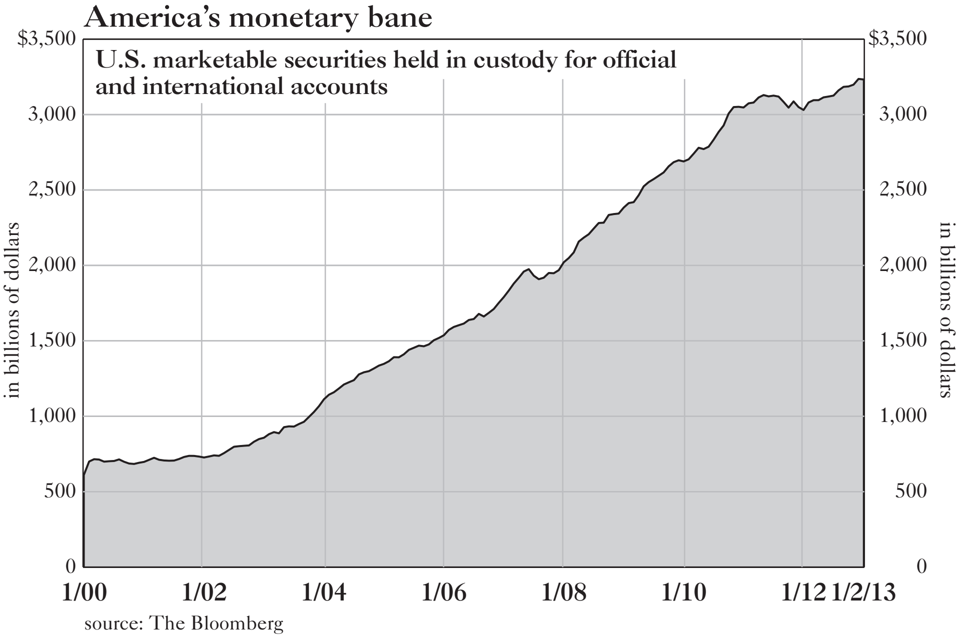


good as another's.

Constant readers know well the flight path of dollars both west and east across the Pacific. Buying more from China than China buys from the United States, American consumers ship dollars to their Chinese vendors. The vendors sell the dollars to the People's Bank, which exchanges them for newly created renminbi. And what else would the People's Bank do with its hundreds of billions of greenbacks except to invest them? And—seeking to suppress the value of the renminbi to enhance China's exports—the People's Bank doesn't exchange its dollars for an alternative currency but rather invests them in U.S. Treasurys or federally guaranteed mortgages. Running up its debts (and at generation-low interest rates, too), America never winces: Never has it hurt so little to borrow so much. As a matter of definition, the public debt is deferred taxes, pure and simple. As a fact of political life, the emphasis goes on the word "deferred" rather than on the word "taxes."

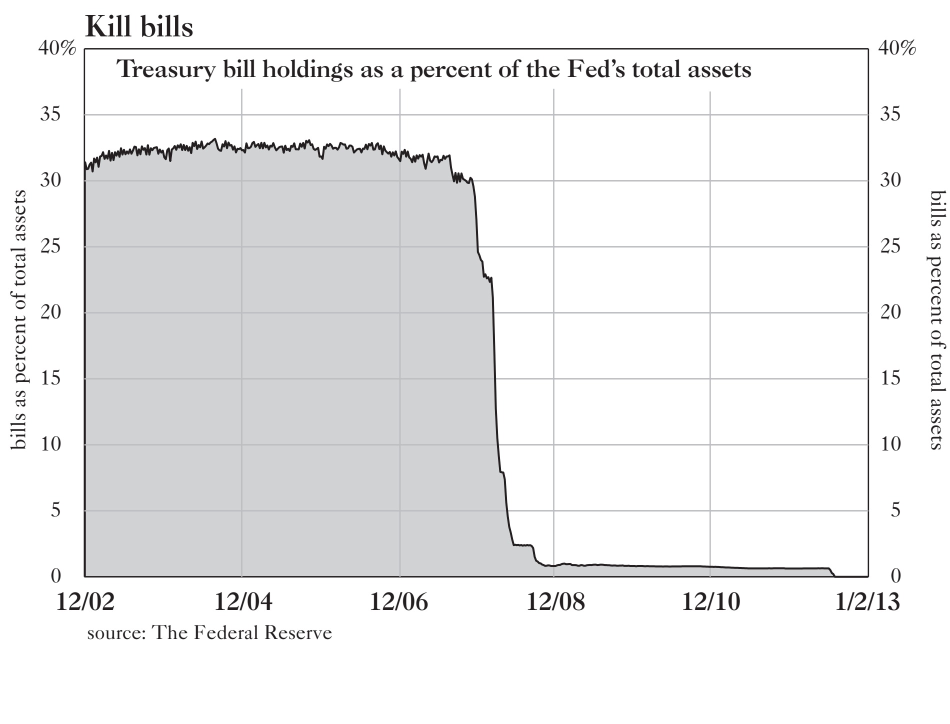
Since Oct. 1, 1981, long-dated Treasury yields have plunged to 3% from 15%, whereas the gross public debt has zoomed to $16 trillion from $1 trillion. The compound rate of growth in the debt has outstripped the compound rate of growth in federal receipts by a factor of two to one.

"Although it took 64 years for the debt limit to be raised to $1 trillion," Grant observes, "it took just four more years to double: Congress voted to increase the ceiling to $2.079 trillion in December 1985. The bill passed the House, 271-154, and the Senate, 61-31. Contained in the bill was a mandate to balance the federal budget by fiscal year 1991, with the now familiar provision for automatic spending cuts across the board should deficit reduction targets fail to be met. The federal budget deficit in 1991 totaled $269.2 billion, or 4.5% of GDP.

"Skipping ahead," Grant continues, "George W. Bush left the presidency in January 2009 with a debt limit of $11.315 trillion, a 90.2% increase over the ceiling of $5.95 trillion he inherited. He presided over seven separate boosts in the statutory borrowing capacity, which the Democrats duly protested. 'During this administration,' Sen. Max Baucus (D., Mont.), top Democrat on the Senate Finance Committee, declared in March 2006, 'America's debt, that is, the total of the deficits, has increased by $3 trillion. That's a 40% increase in the entire federal debt accrued by our country in its entire history.' This time, the Senate voted by a margin of 52-48 to raise the ceiling.

"When the vote was taken on March 20, 2006, a young and popular Democratic senator from Illinois voted against the debt-ceiling increase (to $8.97 trillion from $8.18 trillion) and took the opportunity to lecture the administration on the state of American public finance. 'The fact that we are here today to debate raising America's debt limit is a sign of leadership failure,' Sen. Barack Obama complained. 'It is a sign that the U.S. government can't pay its own bills. It is a sign that we now depend on ongoing financial assistance from foreign countries to finance our government's reckless fiscal policies.'"

As the senator spoke, foreign governments and their obedient central banks owned at least $1.59 trillion of U.S. government and federal agency securities. As of Jan. 2, the same overseas institutions owned at least $3.23



trillion of U.S. government and federal agency securities. The apolitical truth is that the cause of this dependency lies in the nature of the world's monetary arrangements. With the reserve-currency bane, America possesses the dubious gift of amassing "deficits without tears" in the words of the late, great French economist, Jacques Rueff.

"At this moment of writing," wrote Tilden in 1935, "nearly all the small nations—and all the great ones—are solvent only by rhetorical courtesy, or by the growing difficulty, in a hysterical world, of deciding what constitutes bankruptcy." In 2013, the split-rated United States is a solvent credit (the market says so), but a deteriorating one.

Most of the historical checks on public borrowing have, of course, fallen away. Keynes's theories have displaced Martin Van Buren's convictions, while the paper dollar has shoved aside the golden one. Willing mercantilist creditors and the great bull bond market complete the circle of seduction. The debt ceiling is one of the few remaining inhibitions on the running up of the federal debt.

It would do the quality of debate a world of good if someone would move to reduce the ceiling, not to raise it. Granted, such a demarche could prove embarrassing if the proposing politician had ever taken an alternative position. "I think it's important that the outcome—based on the outcome of the vote, as I mentioned, the full faith and credit was not in doubt—the full faith and credit of our government and the economy was not in doubt." So stammered the White House press secretary, Robert Gibbs, in January 2011 when he was asked to explain the apparent inconsistency between the positions taken on the debt question by the former Sen. Obama and the current President Obama.

And what reasons might a hypothetical congressman from, say, the imaginary district of Wall Street give to support a cause so apparently quixotic as a reduction—just a small, newsworthy, symbolic reduction—in the statutory debt limit? He might observe that the Fed is buying $85 billion of bonds a month, or $1.02 trillion at an annual rate, which represents more than 100% of the OMB-projected fiscal 2013 budget deficit; it is a fact out of

Net interest expense in 2012 at varying average interest rates (in $ billions)

Average interest rate	2.1%	3.0%	4.0%	5.0%	6.0%	7.0%	9.2%
Net interest expense	$224.8	$325.6	$434.1	$542.7	$651.2	$759.7	$998.5
Share of 2012 federal recs.	9.2%	13.3%	17.7%	22.2%	26.6%	31.0%	40.8%

sources: Office of Management and Budget, the Treasury Department

the pages of Andrew Dickson White's "Fiat Money Inflation in France." He could say that, although conventional inflation might seem a remote danger, the consequences of the worldwide experiment in monetary force-feeding will probably be inflationary and that, in the way of the world, they are likely to materialize unexpectedly.

Continuing, the member from Wall Street might point out that the Fed, as a consequence of "Operation Twist," is fresh out of Treasury bills and is loaded to the gunwales with long-dated assets, including $1.35 trillion of bonds that mature in more than 10 years and $867 billion of notes that fall due in more than five years but in fewer than 11 years. Have you ever heard, he would quiz his colleagues, of the Fed's "bills-only" policy? In the Eisenhower era, the central bank refrained from buying coupons lest it distort the structure of interest rates. Now it buys coupons precisely in order to manipulate the structure of interest rates. Anyway, in a bond bear market, the Fed would find it inconvenient to sell (and the taxpayers would find it irksome to absorb the central bank's trading losses).

For the benefit of new arrivals, the congressman could review the futile history of attempts to contain the deficit through improved oversight (e.g., the 1974 founding of the Congressional Budget Office) or through force of law (e.g., the 1985 Gramm-Rudman-Hollings Balanced Budget Act, the 1990 Budget Enforcement Act or the 2011 Budget Control Act). What is oversight, or even law, when set against the combined power of easy money and the reserve-currency bane?

Quoting from a recent blog post of the former chief economist of Northern Trust Co., Paul Kasriel, the member from Wall Street could shed some welcome light on the pickle in which the contending parties find themselves. One party wants higher taxes, the other lower spending. Each professes to seek reduced deficits and a slower rate of rise in the public debt. But neither seems to reckon with the consequences of the recently exacted American Taxpayer Relief Act, the law that made permanent the Bush 43-era tax cuts for all but the hated 1%. If the Congressional Budget Office is on the beam, the not-so-grand fiscal compromise will reduce federal income tax revenues by $3.75 trillion (82.5 million pounds of C-notes) in the 10 years to 2022, compared to the revenues that would have been booked in absence of the law. It seems an odd way to bring about the professed bipartisan determination to effect a $4 trillion reduction in the debt over the next 10 years.

Then, too, our man from Wall Street—an authority on interest rates, as it happens—would not fail to remind his colleagues about the fateful financial year of 1981. As the debt ceiling passed $1 trillion and bond yields pierced 15%, an economic consultant named Alan Greenspan was quoted in *The New York Times* on the troubling arithmetic of ultra-high interest rates. "In a technical sense, the interest payments are the most uncontrollable part of the budget," said Greenspan. "You can change the entitlements by Congressional legislation [just try it—ed.], but you cannot change the level of national debt."

On an average net debt of $750.7 billion in the fiscal years 1980 and 1981 (i.e., debt in the hands of the public, excluding the portion held in government accounts), the Treasury bore net interest expense of $68.8 billion; the average interest rate was 9.2%. Compare and contrast the present day. On an average net debt of $10.853 trillion in fiscal years 2011 and 2012, the Treasury bore net interest expense of $224.8 billion; the average interest rate was 2.1%. Had the average rate been 4%, the government would have spent more than 90% as much on interest outlays than it actually did on Medicare.

The congressman would close his speech on behalf of a symbolically reduced debt ceiling with another borrowing from the Kasriel post. In the past 10 years to fiscal 2012, compound annual growth in federal receipts worked out to 2.8%, that in federal outlays 5.8%. Inasmuch as the growth in receipts was much below the historical median (which, since 1967, had been 6.75% a year), one might—just for argument's sake—say that the country had an income problem. But that is in the past. It will imminently have a much bigger spending problem as the entitled Americans of the baby boom generation claim what is lawfully theirs. Too bad about the $3.75 trillion in receipts that won't be received.

Imagine such a fiscal impossibility, the representative from Wall Street says. And imagine such a monetary temptation: Will our money-conjuring central bank not find it irresistible to bridge the gap between insufficient federal receipts and extravagant federal promises?

Get the debt under control, our conceptual politician thunders. Get the Fed under control and address the underlying monetary problem. Alternatively, he advises his legislative colleagues, quit public life to take up a career as a bond trader—on the short side, chiefly, of course.

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A personal message for Larry Summers

(November 29, 2013) I thought I heard a wistful tone in your voice as you delivered your widely YouTubed remarks at the IMF Annual Research Conference on Nov. 8. In particular, I detected a note of regret when you began a sentence with the phrase, "Were I a member of the official sector. . . ." Believe me, I know what it's like to be excluded from the official sector. Out of the blue in 2011, Ron Paul announced that I would be his Fed chairman if he won the presidency. Well, he didn't win, and I'm still editing *Grant's*. So here we are together, disappointed non-central bankers. I expect you feel the same kinship toward me as I do toward you.

Anyway, I'm presuming on our shared experience to write you about your IMF speech. Blood brother to blood brother, it was enough to curl the hair of a normal non-economist. How to restore America's once and future economic vitality? Why, you said—or allowed the audience to infer you meant—that the government must borrow more, spend more, print more, because even zero is too high an interest rate for the world in which we live, a world of "secular stagnation," you called it. And to think, as between you and Janet Yellen, you were supposed to be the reasonable one.

I did love the part of your speech where you compared a financial crisis to a power failure. The lights go off, the grid goes dark and the economy stops cold. In response to which, as you conjectured, "There would be a set of economists who would sit around explaining that electricity was only 4% of the economy and so if you lost 80% of electricity you couldn't possibly have lost more than 3% of the economy! And there would be people in Minnesota and Chicago writing that paper!" It was good to hear the knowing laughter you raised in that audience of economists. Wisdom begins with self-awareness.

Allow me to observe, my fellow non-Fed chairman, that you seem not to admit the possibility that what ails American enterprise is the institution that neither one of us is running. I am going to say that ZIRP, QE and Twist have so distorted current and prospective rates of return that entrepreneurs are stymied rather than stimulated. Biotech stocks are going up a percent a day. Credit spreads have collapsed. Pieces of middlebrow contemporary art fetch $100 million at Christie's.

You seem to welcome these orbiting asset values. As you put it to the audience, "It has been demonstrated, less conclusively but presumptively, that when short-term interest rates are zero, monetary policy can affect a constellation of other asset prices in ways that support demand. . . ." But, if you don't mind my asking, what kind of demand and for how long?

I don't have to tell you that real American median income was lower last year than it was in 1989, that student debt tops $1 trillion (more than auto loans, credit-card loans and home-equity balances combined) and that companies that cater to the middle class are treading water, if not slipping under it. Target Corp., Wal-Mart and Gap are reporting essentially flat same-store sales.

Casual dining is an especially instructive disaster area: From 2006 through 2012, same-store sales at Red Lobster, LongHorn Steakhouse and the Olive Garden fell a cumulative 13.8%, 8.9% and 6.2%, respectively, according to a J.P. Morgan research note dated Oct. 8. Because, over the same span, inflation increased by 16.7%, real same-store sales at the aforementioned chains dropped by a quarter. Darden

Too bad about the customers

source: The Bloomberg

Restaurants (DRI on the New York Stock Exchange), which owns those outlets and derives 88% of its revenue from them, earned 11.4% on assets in fiscal 2006 but only 6.4% on assets in fiscal 2013, ended May.

And here's the kicker: The stock market loves Darden. It loves it for its financial engineering. It wasn't the food that generated growth in earnings per share of 5.4% a year between 2006 and 2013. The secret to this feat was growth in debt; net borrowings were up by 22.2% a year over the same span. Now the shares change hands at 18.7 times earnings and 9.6 times enterprise value (market cap plus net debt) to EBITDA (earnings before interest, taxes, depreciation and amortization). It's almost as rich a valuation as the ones that made the peak of the 2007 private-equity boom.

My friend John Hamburger, president of *Restaurant Finance Monitor*, sponsored his annual restaurant finance conference in Las Vegas this month. And do you know what he reported to his subscribers about that event? He told them that among the attendees were the "largest number of restaurant lenders, investors and restaurant operators on hand in our 24-year history." And he added, "While we're more than happy to take credit for superior organizing skills, a big shout-out goes to the Bernanke-Yellen credit palooza. . . ." It can't be a good sign that working Americans can hardly afford to eat at the restaurants on which the bankers and promoters continue to extract fees and to heap leverage.

I think I can guess what you're going to say, because you said it at the IMF meeting. You're going to say that Ben Bernanke's Stakhanovite feats of money conjuring very likely saved the world from having to reprise the years 1929-33. You can't prove it, and I can't disprove it. But why this harking to the Great Depression and only the Great Depression? You'd think it was the only cyclical event in American history.

I myself have been thinking about the depression of 1920-21. Measured from peak to trough, this bump in the road featured drops of 31.6% in industrial production, 46.6% in stock prices and 40.8% in wholesale prices. The collapse in wholesale prices was reckoned the most violent in American annals up until that time. No reliable data exist on unemployment, but contemporary guesswork put the figure in the teens. And do you know how the administrations of Woodrow Wilson and Warren G. Harding met this calamity? They balanced the budget and, through the Federal Reserve, raised—not lowered—interest rates. They made no attempt to prop up wages or prices but let them find their own level (the Fed was, in fact, promoting deflation). After which, a vibrant and job-filled recovery began and the 1920s proverbially roared. Say, I happen to have written a short book on the 1920-21 depression that Simon & Schuster is going to publish next year. The working title is, "Triumph of the Invisible Hand." May I count on you for a blurb?

We can all agree that the American economy is in a kind of trance. You pin the blame—the immediate blame—on the government, saying, or again implying, that it hasn't done nearly enough. "Imagine," you said at the IMF, "a situation where natural and equilibrium interest rates have fallen significantly below zero." In such a situation, you broadly hint, QE forever would be just what the doctor ordered.

Maybe you've seen John B. Taylor's critique of your speech. In rebuttal, that eminent Stanford economist says there's no need to imagine the cause of our long-lingering non-recovery. The Affordable Care Act, Dodd-Frank and the 2013 payroll-tax hike are staring us right in the face. I happen to agree with Taylor. But I'm beginning to wonder if the supposed science of macroeconomics isn't just politics dressed up in algebra.

One more thing: On camera with Bloomberg TV on Nov. 21, you seemed awfully sure of yourself that history would vindicate today's radical monetary measures. "On the question of whether the Fed stepping up and providing liquidity when no one else would was the right thing to do, I think historians are going to judge that about 98 to 2," were your exact words.

Concerning what future historians might or might not say, you should really treat yourself to the YouTube clip of former President George W. Bush bantering with Jay Leno. Bush is saying that he's been reading some recently published books about George Washington. "If they're still writing biographies of the first guy," drawls W. in his funny-humble way, "the 43rd guy doesn't have to worry about it."

Isn't that charming?

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Well-marked book

(December 14, 2012) iStar Financial (SFI on the New York Stock Exchange) lives and breathes. This seemingly minor claim to fame is no small accolade for a real estate finance business that borrowed to buy at the top of the market in 2007. But, like Marley's ghost, iStar really does exist, and *Grant's* is bullish on it.

Let us only say that there are warts. The income statement is a fright, the directors vote no dividend and management won't come to the phone (at least, not to talk to us). The $6 billion balance sheet, though less encumbered than it used to be, is still leveraged, and nonperforming loans are still a drag on earnings. The CEO, Jay Sugarman, 50, earned $25.9 million in 2011, a figure that puts him in the running for a new title that the staff of *Grant's* has teased from the Bloomberg data base. This is the title: "recipient of the highest total compensation as a percentage of the market cap of the company that the CEO leads."

iStar, which is organized as a real estate investment trust, opened for business in 1993, went public in 1998 and—skipping ahead a full decade—purchased the commercial and construction loan portfolio of the Fremont, Calif., General Bank in July 2007 at the opening gun of the great debt contraction. Over the next 16 months, the SFI share price, too, did some contracting, to $1 from $45. Then, on March 16, 2009, iStar negotiated a $1 billion secured term loan from its bankers. The clouds parted, the sun shone and Sugarman exhaled.

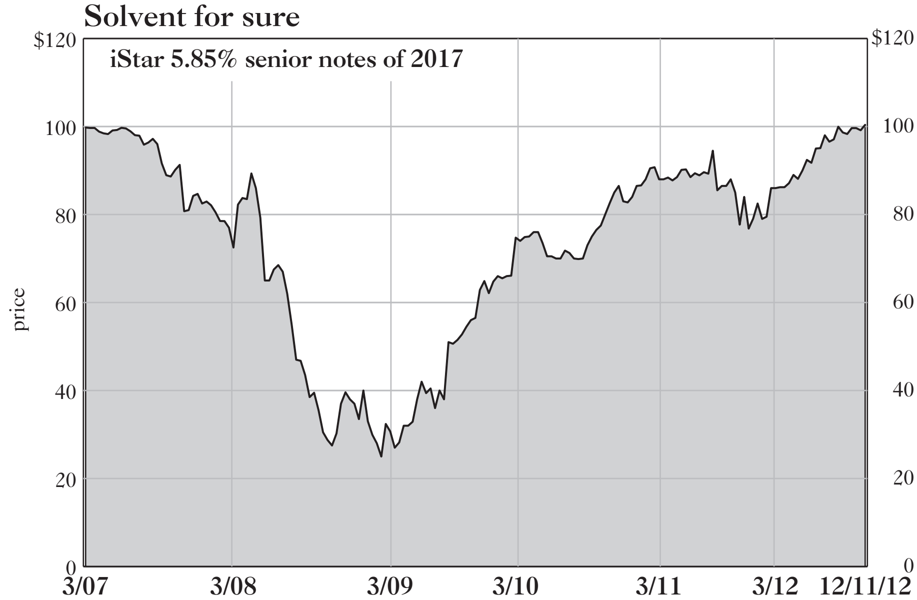
"Its funding base secured," relates colleague David Peligal, "iStar showed its mettle by buying back boatloads of stock at huge discounts to book and hundreds of millions of dollars of debt at meaningful discounts to par. Before the crisis broke, there were 131 million iStar shares outstanding. Today, there are 83.6 million, at $7.88 each. After shooting itself in the foot with the Fremont purchase, iStar smartly managed its liabilities during the crisis. There aren't too many financials, especially credit-focused ones, that had both the will and the way to shrink their share counts." Except for management's coolness under fire—to be sure, fire it had partly trained on itself—the iStar book value per share would certainly be lower than the $10.23 one can simplistically calculate today: $1.4 billion of book equity minus $545 million for the preferreds divided by 83.6 million of outstanding common shares.

Lending is iStar's main operating business. Real estate developers are its principal customers, and they borrow from $20 million to $150 million for periods of three to 10 years. Whole loans, loan participations and debt securities stock the iStar portfolio.

Sometimes the borrowers bite off more than they can service or repay, which opens the door to a second business line. iStar acquires properties, or shells of half-completed properties, through foreclosure, deed in lieu of foreclosure, or in satisfaction of nonperforming loans. These buildings, and this land, are mainly what make us bullish.

A third line of business is the net-lease assets division—leasing a finished property to a single creditworthy corporate tenant. There are miscellaneous investments besides, including a 24.2% stake in LNR Property, a mortgage special servicer.

Solvent for sure



source: The Bloomberg

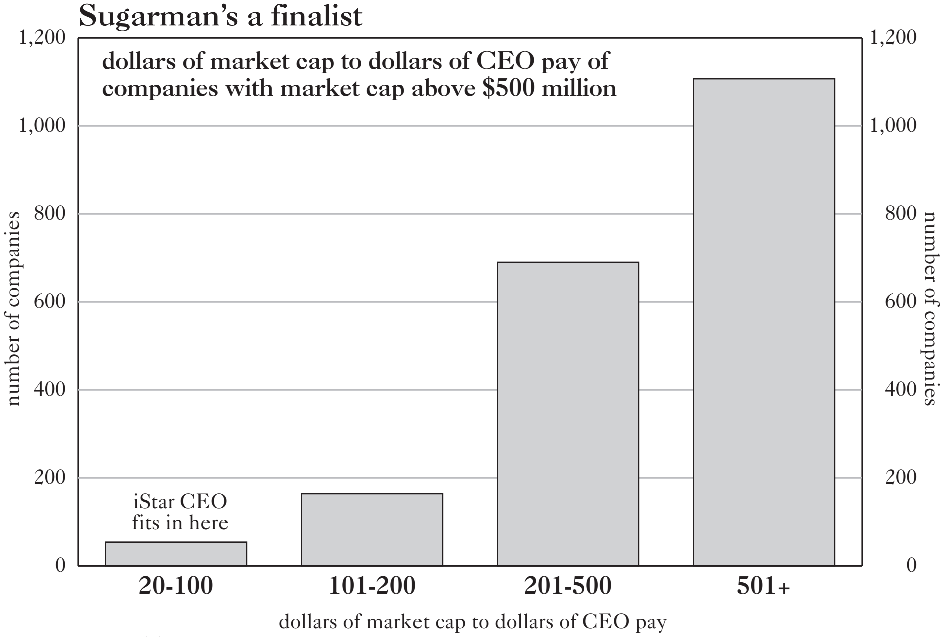
Chief sources of revenue for iStar are interest income and lease income, but neither is adequate to deliver a net profit. Losses before earnings from equity-method investments and other items totaled $288.4 million in the first nine months of 2012, better than the $1.34 billion recognized in 2009, but a loss nonetheless. "Apple," Peligal remarks, "the company is not."

"It is not a 'beat-and-raise' story," Peligal continues, "nor a 'my-estimates-are-higher-than-the-Street's' story. It's not even a 'I-think-they're-going-to-make-a-lot-of-money-on-a-GAAP-income-basis' kind of story. They're going to lose money over the next few quarters, and it wouldn't be surprising if book value fell a little bit during that time."

iStar is rather the story of asset values still hidden but—perhaps with an assist from Chairman Ben Bernanke—ultimately to be realized on a $900 million land portfolio that is going to be sold to home builders over the next 12 to 36 months, and on a $400 million condominium portfolio that is in the process of being sold, unit by deluxe unit, to wealthy home buyers. The value proposition we judge to be compelling, but instant gratification plays no part in it.

Land—the company's high-quality acres destined for master-planned communities or for waterfront development—was a topic on the third-quarter conference call. "The managed land portfolio," Sugarman told dialers-in, ". . .can be broken down a few different ways, but one simple way is to group them according to when they will begin production. Our current portfolio has 10% of assets by book value already in production, and we anticipate having approximately 60% by book value to be in production by the end of 2014. The remainder are expected

Sugarman's a finalist



source: The Bloomberg

to begin production between 2015 and 2017. This portfolio should be a strong contributor to future earnings, though not until a majority of the projects are in full selling mode and will remain both cash flow and earnings negative until then."

The company's condominium exposure consists of $264 million in performing loans, $65 million in nonperforming loans and—the stuff with the upside potential, we judge—$389 million in "other real estate owned." The iStar OREO portfolio features such sanctuaries for the one-tenth of 1% of American earners as 10 Rittenhouse Square in Philadelphia (an unfinished, 6,900-square-foot space will cost you $7 million, not that you should even blink) and Ocean House in South Beach in Miami, Fla. Both projects are said to be more than 70% sold. "Two years ago," relates Peligal, "there was a lot of doubt about iStar's condo portfolio. Today, there is not."

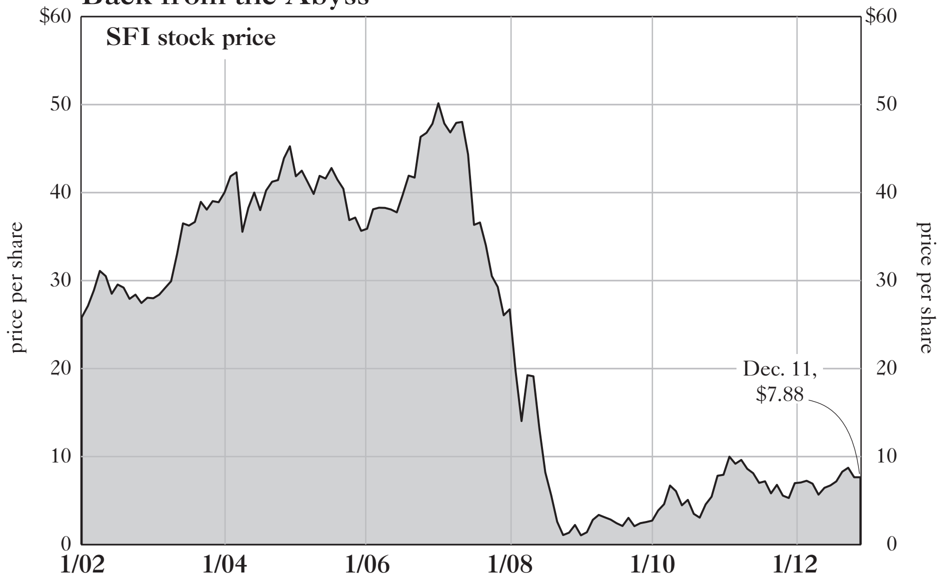
The process by which a lender by trade becomes an owner and developer begins with someone's miscalculation. "Let's say," says Peligal, "iStar lent to a condominium developer, the developer couldn't pay and iStar repossessed the collateral. The project is stalled, so iStar must complete it. The lobby needs work, the fixtures are uninstalled, whatever. Money goes out of iStar's door to salvage—and to improve and enhance—the value of the project. The expenses go on and on—for security guards, maintenance, utilities. As long as these outlays continue, the condo will remain an eyesore on iStar's income statement. But it's not a terrible assumption to make that the dollars they're investing today are going to allow them to sell the building for a 30% gain compared to where it is marked on the balance sheet."

But this assumption is one that an investor will have to make him- or herself. Goldman Sachs may mark its assets to market, but iStar does something else. It estimates what an asset might be worth in the future, but discounts that value by what the asset might fetch today. Fair value accounting—the kind that iStar, a finance company, employs—defers the recognition of any accretion in value of repossessed collateral until the moment of sale or leasing. "The bottom line," notes Peligal, "is that it takes a very long time for these assets to generate what looks like GAAP earnings. But we could potentially see $100 million to $150 million in gains thrown off from the stable of repossessed condos in the next 18 months."

Ori Uziel, a big iStar owner and—*and*—a paid-up subscriber to *Grant's*, tells Peligal that what the iStar doubters miss is the quality of the iStar assets. "Most people don't know the tracts of land we're talking about," Uziel says. "If you do know what tracts of land we're talking about, you should be encouraged, but it's a long-tailed process. . . . For an investor to invest here, you have to realize that book value is worth more than what is stated in the 10-Q. This is because the credit tenant lease assets are worth more than book, the condos are worth more than book, their stake in LNR is worth more than book, etc. There is probably not much loss content on the loans, although some people point to mezzanine loans in Europe as potentially a problem. But it's not very much. What you're left with is a big bet on residential land and the potential to restart the lending business. Almost all the land is single-family residential and it's marked at about, according to my calculations, 40 to 45 cents on the dollar vs. peak prices. Some of it is less than that, some of it is more than that. They just sold a piece of property in Hollywood, Calif., to Kilroy Realty for basically the peak market price. iStar actually had it on its books for that price and it was the piece of land I was most worried about. This is because it was sold for $15 million in 2003 and then $66 million in 2006. iStar had it on its books for $64.5 million, and they just sold it for $65 million. Those are the numbers. The market is marking down a well-marked book."

10 Rittenhouse Square, Philadelphia—an iStar trophy

Back from the Abyss



source: The Bloomberg

With the Oct. 15 closing on a new $1.82 billion credit facility, iStar secured a lower cost of capital and a more forgiving debt-maturity schedule. Next year, $1 billion of debt falls due, then essentially nothing until 2017. Moody's bestowed its approval on the autumn financing by raising its iStar debt rating to B2 from B3. On the third-quarter call, Sugarman said that some additional reduction in corporate leverage—now running at the top of the company's expressed 2.0:1 to 2.5:1 preferred range—"is probably prudent."

Incidentally, in fairness to Sugarman, the stockholders themselves voted to bestow the $23.4 million of multiyear stock awards that formed the principal source of his $25.9 million jackpot in 2011. But in fairness to us, his sympathetic analysts, there's nothing to do but guess about the reason, or reasons, behind his sale of 188,175 shares of iStar at the end of November. We are going to guess that the use of proceeds was to fund his professional soccer team, the Philadelphia Union, which, at 10-18-6, failed to make the Major League Soccer playoffs this year. Even contending teams cost money. Sometimes non-contending teams cost more.

"One of the interesting things about iStar is how hard it is to get information from the company," Peligal winds up. "Maybe there's a reason. Maybe silence better serves the interest of a buyer of discounted shares (its own) or the developer of discounted land. Banks typically sell their foreclosed land. Not iStar, which has to spend money to develop its land. If that's the strategy, you wouldn't want your IR team putting out press releases telling the world how valuable the portfolio will be in 2015. Could this land be worth 50% more than where it's listed on the books now? It's possible. Could it be worth 100% more? Also possible.

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If you think about the numbers, there's potentially $5 a share to $10 a share of upside for the land portfolio, and probably only a few bucks of downside."

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Break ball in billiards

(April 19, 2013) In the game of eight ball, the first shot is the break shot, in which the lady or gent with the cue stick scatters 15 balls all over the felted table. "In order to do this," advises an online authority on the physics of billiards, "you must hit the cue ball with a certain force a certain distance away from the rack and at a certain angle."

Two weeks ago, Haruhiko Kuroda, newly installed governor of the Bank of Japan, set markets in motion with a powerfully struck break shot. Where the caroming monetary, interest-rate and volatility balls will come to rest is the subject at hand. The answer in preview: They will come to rest in places the central bankers haven't thought of.

Markets were prepared to hear about a ramping up of Japanese QE, but the new governor astounded them. He promised to double the size of the Japanese monetary base by the end of 2014, and to buy not only JGBs but also equity ETFs and real estate investment trusts—to buy what, on the scale of America's GDP, would amount to $190 billions' worth of assets each month, compared to the mere $85 billion per month that the Fed is putting away. With all of this, Kuroda redefined the term "radical ease." Compared to the Bank of Japan, the Federal Reserve now seems just moderately wild-haired. The BoJ has succeeded in out-Bernanke-ing even the chairman of the Fed.

Since Kuroda hefted his cue stick, bond yields have declined in the West, though they have risen in Japan. The yen has weakened and the Nikkei has lifted. These, perhaps with the exception of the action in JGBs (the 10-year rate has vaulted to 0.581% from 0.441%), are the consequences that Kuroda intended. Still to come are the consequences he didn't intend.

Many are the possibilities under the always interesting heading of "Things the Authorities Didn't Think of Before They Ran the Presses and Overrode the Price Mechanism." Already, the Bank of Japan has made its mark on bond yields. Presently, it may leave its calling card in China, where credit formation was already fast and furious before the yen exchange rate dipped, and in the volatility markets. But the nature of clacking and clicking billiard balls is that they go where they will. Kuroda-san has launched the world on a new financial adventure.

On one consequence, we can bank, however. By instigating another lurch higher in bond prices, Kuroda will, by that increment, devalue credit analysis. And by devaluing credit analysis, he will speed the day of the next crisis of lending and borrowing. By legitimizing a new, even more radical strain of QE, he will embolden others—the incoming governor of the Bank of England, Mark Carney, seems a likely candidate—to experiment with greater feats of money printing. Revolutions devour their children, even revolutions undertaken by the mild-mannered scholars of the global central-banking community.

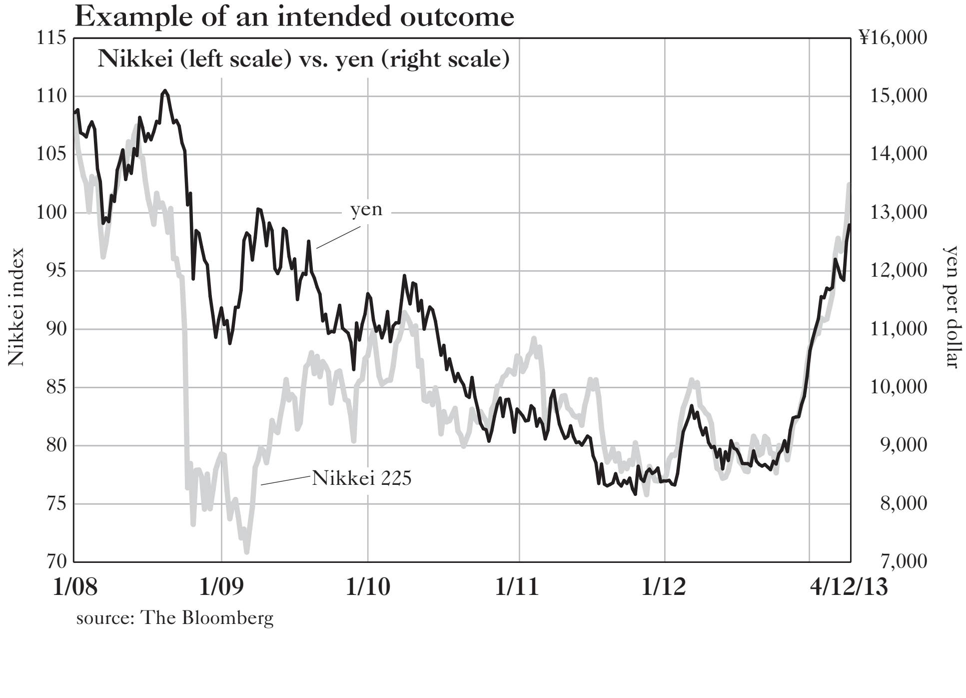
Surmising that yield-starved Japanese will snap up fixed-income securities denominated in non-yen currencies, speculators have taken anticipatory action. They have pushed zloty-denominated 10-year Polish government bonds down to 3.52%, peso-denominated Mexican government 10-year yields down to 4.72%, lei-denominated Romanian government seven-year yields down to 5.05%, and high-grade European corporate yields down to 2.31%. They have created such an alignment of the fixed-income stars that Ba2/BB-rated CNH Global N.V., the product of a 1999 merger between Case Corp. and New Holland N.V., was able last week to raise $600 million for five years at a yield of just 3⅝%.

On April 12, European Union finance ministers gave Portugal and Ireland seven-year extensions in which to repay their bailout loans. Preceding this act of purposeful charity, the split-rated European Financial Stability Facility paid a yield of just 0.956% to borrow €8 billion for five years. So great was the unslaked demand that the supra-national bailout fund could have raised €14 billion. "What once looked rich is no longer rich any more," the weekend *Financial Times* quoted Steven Major, head of fixed-income research at HSBC, as saying. "Say 'goodbye' to the yield floor."

And goodbye, too—at least in a temporary, cyclical way—to old-fashioned credit work. Uniformly tiny interest rates dull the effort to distinguish good investments from bad. At next-to-nothing percent, one credit looks much like another. The blurring of gradations in credit quality, owing to the undifferentiated flight into fixed-income securities, will do nothing to enhance the reasoned allocation of capital. On a positive note—we speak now as journalists—unreasoned capital allocation never fails to make for good copy.

According to *Money Fund Intelligence*,

Example of an intended outcome



source: The Bloomberg

U.S. prime money-market mutual funds raised their exposure to euro zone issuers to 20% of assets in February from 14% of assets in August. Assume that the relevant funds know their credits. But with yields on euro zone money-market instruments pinned at only a few basis points above zero, the difference between money-good and money-not-so-good is of little or no practical consequence. For a return of virtually nothing, what avails due diligence?

In the sovereign debt market, too, fund flows quash analysis. Last week, the European Commission issued a lengthy indictment of French public finance and French industrial competitiveness. Government debt is too high, the labor market is too rigid and taxes are too high, said the bill of particulars. French public-sector indebtedness represents "a vulnerability, not only for the country itself, but also for the euro area as a whole," the commissioners added. Yet, in the face of these risks, the yield on 10-year French sovereign debt has dwindled to 1.82%, about as low as it has ever been. A double-A-plus credit, France is under surveillance for downgrade by Moody's, Standard & Poor's and Fitch. It is not, however, as yet under surveillance by Mr. Market.

The clustering of sovereign bond yields in the neighborhood of nothing after tax and after inflation figured in some weekend brainstorming about the mobilization of European gold. Would it not be better to issue bonds against this national treasure rather than to sell it outright? You may recall that France issued bonds in 1973 secured by the national gold stock. Dubbed "Giscards," after the then-French president Valery Giscard d'Estaing, they featured in Tom Wolfe's novel, "Bonfire of the Vanities." Yet, as the "Lex" column of the *Financial Times* noted the other day, with interest rates pressed to the floor, the yields on gold-backed bonds might not be meaningfully lower than those attached to plain-vanilla securities denominated in paper currencies.

Even fewer basis points would remain for private consumption if the European Commission's mooted financial transactions tax were enacted, as it might very well be, effective Sept. 1. The tax—the FTT—would be levied at each stage of a financial transaction, according to *FT* columnist John Dizard: "So if a U.S. bank sells a French company bond to a U.K. insurer, and each, as is customary, uses a bond broker, the tax on the one transaction adds up to 60 basis points." At current rates of decline in Continental yields, there will hardly be 60 basis points left for the EU to seize.

Kuroda-san's break ball may ricochet around the monetary billiards table for many a moon. Chinese lending and borrowing were on a tear before the Japanese demarche. In the first quarter, the broadest measure of Chinese lending climbed by 6.16 trillion renminbi, or $1 trillion, the equivalent of 12% of 2012 GDP. How will Chinese finance officials answer the competitive threat presented by the suddenly cheaper yen and by the prospectively reflating Japanese economy? We will venture that China will respond by keeping up the torrid gait of credit growth. If the first-quarter rate persisted for the rest of the year, growth in credit—"total social financing"—in China in 2013 would amount to 47% of output, the most on record since at least 2002 and six percentage points ahead even of the emergency rate of infusion in 2009.

Prolonged periods of extreme monetary ease are good for journalists, governments and speculators, but not for savers and producers. We take this truth to be self-evident (although the IMF has lent its authority to the proposition in a new Global Financial Stability Report), and we accept as given that the central banks have no informed idea of what the money they conjure will finally do or to whom it will ultimately do it.

It isn't only the central bankers who can't predict the consequences of unprecedented actions. Most mortals can't. But we will take a guess. The Japanese initiative of April 4 will provoke other central banks to act, perhaps to cheapen their own currencies or to nip a nascent panic—Monday's,

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for example—in the bud. In so acting, the mandarins will scatter another rack of monetary billiard balls. Ultimately, the central banks themselves will drive thinking investors out of bonds and into assets the value of which does not depend on the stable value of money.

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Uncommonly preferred

(September 21, 2012) "If markets were efficient," inquires colleague David Peligal, "why would Hyundai Motor's second preferred securities (005387 KS on Bloomberg) trade at 32% of the price of Hyundai's common stock (005380 KS on Bloomberg) when, for all intents and purposes, the two securities are economically identical?" There happens to be no good reason. Now unfolding is a bullish exposé on a distant market inefficiency.

Mind you, South Korea does not exactly roll out the welcome mat for foreign value seekers. Professionals will find no insuperable barrier to buying Korean preferreds that trade at anomalous discounts to the corresponding common. And neither, for that matter, will the persistent retail investor. But to complete the required documentation will require some intercontinental e-mailing. You can't just call Charles Schwab.

The analysis now unfolding deals mainly, though not exclusively, with the eccentric market in Korean preferreds. Other topics include the nature of value, corporate governance, cultural differences in this supposed age of financial globalization and the importance (or non-importance) of catalysts, market liquidity and voting rights in the delivery of superior investment returns. Buy the persistently discounted, evidently catalyst-free Korean preferreds, even without hedging through a sale of the underlying common, is our conclusion.

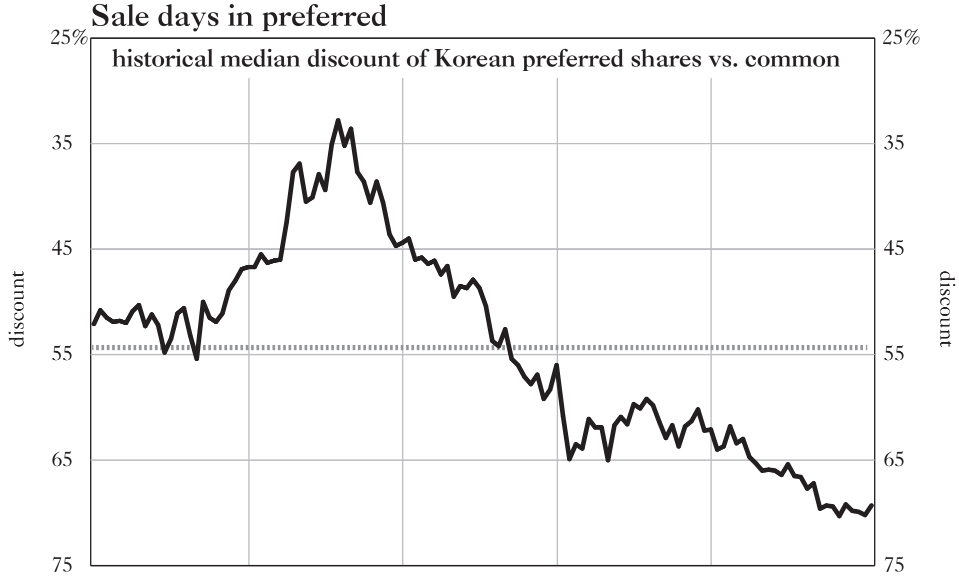
To begin at the beginning, 148 issues of Korean preferred are listed with a collective market cap of some $10 billion. While a portion of these issues are tiny and illiquid, others trade $10 million or more a day. None is listed in the MSCI Index, which means that, for the index-hugging, Korean-focused mutual funds, they might as well not exist.

"In Korea," Peligal explains, "the term 'preferred share' will appear as something of a misnomer to an investor in U.S. equities. While giving the holder full economic participation rights in the earnings stream of a business and a priority dividend, Korean preferred shares lack voting rights. One may therefore think of them as non-voting common shares. There's no question that voting rights have value, but how much of it? In Korea, the value of a vote is quite low. Investors willing to pay three times the price for a vote are paying a hefty price for a quiet vote in a country with *chaebols*, concentrated family ownership and a distinct lack of corporate activism."

Then, too, you can't buy and sell the preferreds as easily as you can the common. Besides, Korean common shares have delivered better returns than the corresponding preferreds over the past five to seven years. Furthermore, Korean managements (in general) seem in no hurry to help in closing a valuation gap that, according to a six-foot pile of CFA manuals, shouldn't even exist. Maybe the valuation anomaly wouldn't persist if more foreigners could read prospectuses written in Korean, but few can.

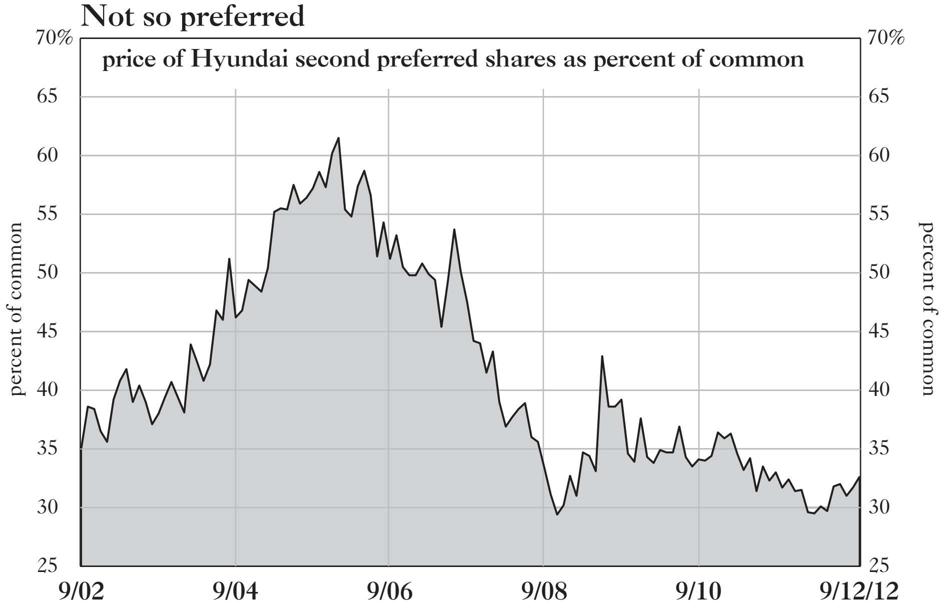
"But maybe," Peligal proceeds, "the sheer size of the discounts is reason enough to take the plunge. Let's go back to the Hyundai Motor example. That

Sale days in preferred



source: The Bloomberg

Not so preferred



source: The Bloomberg

second preferred issue (the automaker has three) is trading at 79,700 won and yields 2.3%. Hyundai common is trading at 248,500 won and yields 0.7%. Ergo, a 68% discount, about as steep a discount as any in the past 10 years. Historically, Korean preferreds have traded at an average discount of 54%; it's 69% today. In fact, the preferreds, on average, are as deeply discounted as they were during the 1997 Asian financial crisis. Remember, if a discount narrows to 60% from 70%, you don't make a 10% return. You make a 33% return."

Arbitrageurs might choose to go long the preferreds and short the underlying common. "Sticking with Hyundai," Peligal notes, "such a strategy would deliver an after-tax carry of 1.4%, although there are good reasons to buy the preferreds outright. So doing, one would not necessarily be trusting in the market to close an unreasonably (say we) wide discount, but rather in the tendency for good things to happen to cheap stocks."

"Korean preferreds," an anonymity-seeking, buy-side analyst informs Peligal, "are a bizarre exception to the phenomena we see with investors overpaying for yield without regard for NAV. It would seem prudent that Korean investors aren't reaching for yield. However, in this instance, it's actually incredibly imprudent, because an investor could basically buy the same economic claim at a much cheaper price. This behavior is so inconsistent with what we, as a fund, are seeing elsewhere in the world."

Unusual, too, are Korean preferred valuations in comparison with those of similar securities in other countries. Whether set against Indian differential voting-rights shares, Italian savings shares, Swiss participation certificates or German preferred shares, Korean discounts vis-à-vis the relevant common shares are in a league of their own.

There's no guarantee, of course, that cheap securities can't become cheaper (it happens all the time in Value Land). But, as discounts widen, other things being the same, yields increase. "Thus," Peligal observes, "if the Hyundai second preferred securities were to trade at a 90% discount, their yield would jump to roughly 8%. By comparison, short-dated Hyundai corporate debt—the 4s of 2017, for instance—are priced to yield less than 3%. The Korean government's two-year note fetches 2.87%, its 10-year note 3.08%."

"At a 60% discount," Peligal's afore-quoted informant says, "you might have said that it would never go to a 70% discount. But when we buy something cheap enough, our experience has been that we are more likely to be positively surprised than negatively surprised."

Armor Capital, a New York-headquartered hedge fund with $382 million under management, has had its share of pleasant preferred-induced surprises. Boris Zhilin, principal (and, let the record show, a paid-up subscriber to *Grant's*), says that two such issues have been in the fund's portfolio since the mid-2000s. They are Amorepacific Corp. (090435 KS on Bloomberg) and LG Household and Healthcare (051905 KS on Bloomberg), the former trading at six times, the latter nine times, Armor's estimate of 2013 earnings, and at discounts to the underlying common of 72% and 69%, respectively.

"One has to be happy with a return that comes from dividends and reinvestment decisions by management and not from people waking up and realizing, 'My God, these discounts are crazy,'" Zhilin says. "If people do come to this realization, great. But one shouldn't invest expecting that to happen. The other big takeaway is that high-quality businesses, the ones that tend to become intrinsically more valuable over time, are the best investments when it comes to deeply discounted preferred shares. These businesses turn time, as an investment parameter, from a potential detractor to a very helpful friend and ally. This allows one to earn attractive absolute returns, even in periods like the past five to seven years, when the multiples of many preferred shares contracted and the discount to the common shares widened."

Kyung Suk Choi is the man at Daewoo Securities who sets up brokerage accounts for foreign nationals. To fill out the necessary forms and secure an investment ID from the Korean financial authorities, e-mail him at kyungsuk.choi@dwsec.com. Or, if you can come to terms with the name, Boom Securities, affiliated with Monex Group, executes orders for American investors in Asian markets: https://baby.boom.com.hk/en/ is the Web address.

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Yellen on deck

(November 16, 2012) By reelecting President Barack Obama, the American people have very likely secured the reappointment of Federal Reserve Chairman Ben S. Bernanke. Or, if not Bernanke himself, then an intellectual doppelgänger. The Ph.D. standard won in a walk two Tuesdays ago, though it wasn't even on the ballot.

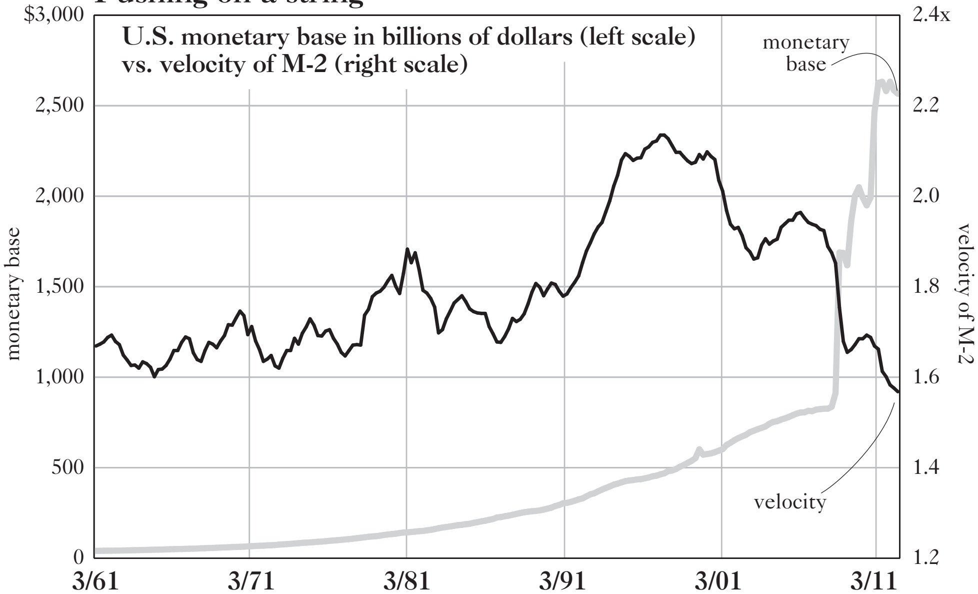
This back-door affirmation of professorial monetary management will eventually go down as the election's most important outcome. We say "eventually." Come the next collapsed asset bubble or the next roaring inflation, many will recall that they actually never did understand what the various distinguished former Ivy League economics department heads were talking about. Then, again, as will come to light, neither did the supposed experts.

Either the lessons of monetary history are moot or our mandarins are wrong. We write, in the first place, to support the latter hypothesis, and, second, to speculate anew on the consequences of QE, ZIRP, Operation Twist and modern central bank "communications" policy. Looking back at today's ultra-low interest rates, investors will think of the fable of the boiled frog and belatedly realize that they were the duped amphibians.

The "lessons of monetary history" is an admittedly vague and contentious term. But it's easy enough to show that paper currencies tend to lose their value, and that governments that borrow in paper currencies tend to overborrow. It is writ.

Unwritten is the timing of the denouement of the printing of boodles of money, though the sequence of sin and suffering makes a comeuppance of some kind inevitable. Sin comes first, always. If we suffered before we sinned, we wouldn't sin. If the pleasure and pain of monetary overstimulation were coterminous, there would be no inflation, no fast-climbing public debt and no exploding asset bubbles. The cost of overcranking the presses would be just as obvious, and just as immediate, as the thrill induced by the monetary pick-me-up. As it is, the pleasure

Pushing on a string



sources: Federal Reserve, Federal Reserve Bank of St. Louis

is immediate, the pain prospective. And if—as in the case of Chairman Bernanke's central bank—the materialization of new money perks up the prices of stocks, bonds and real estate, there is a general submission to the wisdom of the professors.

Don't worry, they say. There is plenty of slack in the product and labor markets. There is the need for continued de-leveraging. There is a shortfall in aggregate demand. There has been a collapse in the rate of monetary turnover, or velocity, as well as a breakdown in the linkage between central bank credit and commercial bank credit. There is, in consequence, no realistic chance that today's unconventional policy will be the source of tomorrow's inflation. Anyway, "inflationary expectations" are most satisfactorily anchored. And who anchored them? Why, the deep thinkers at the Fed assert, they themselves did.

If Chairman Ben S. Bernanke is the deep thinker-in-chief, the Fed's vice chairman, Janet Yellen, is his principal doppelgänger. She is as dependable a voice as there is on the Fed for radical experimentation—on Tuesday, she urged that the FOMC hold the funds rate at zero until the unemployment rate and the inflation rate meet with the mandarins' approval. Gold bulls should light a candle on her birthday, August 13, and pray that she rises to lead the Fed when it's time for the chairman to go. If Bernanke is good for, let us say, $3,000 an ounce in the bullion price, Yellen is a force for $4,000. If, at the close of Bernanke's term in January 2014, he chooses to step down, or is chosen to step down, she would be a strong contender to succeed him.

The holder of a Ph.D. in economics from Yale University, Yellen has every necessary credential to manage the pure paper monetary system. Chairman of the Council of Economic Advisers under Bill Clinton, a one-time Fed governor, a one-time president of the Federal Reserve Bank of San Francisco and a former professor at the Haas School of Business at the University of California at Berkeley, Yellen has taught, as well, at Harvard University and the London School of Economics. And while it is true that she was presented with the Adam Smith Award by the National Association for Business Economics, that honor should not be counted against her in the running to manage the institution that strives to manage the economy by manipulating the value of the currency. She has no slavish attachment to the price mechanism. On the contrary, she's foursquare for mandarin rule.

Neither will it hurt Yellen's chances when the time comes to pick a new chairman that the vice chairman is a company woman. "I will be the first to say that it is always difficult to get monetary policy just right," she acknowledged at the Commonwealth Club of California in June 2009, two years after the start of the financial panic that our central bank so signally failed to anticipate. "But the Fed's analytical prowess is top-notch and our forecasting record is second to none."

Which is not to say, however, that this possible nominee to lead the FOMC has no mind of her own. In a 2003 talk at the Federal Reserve

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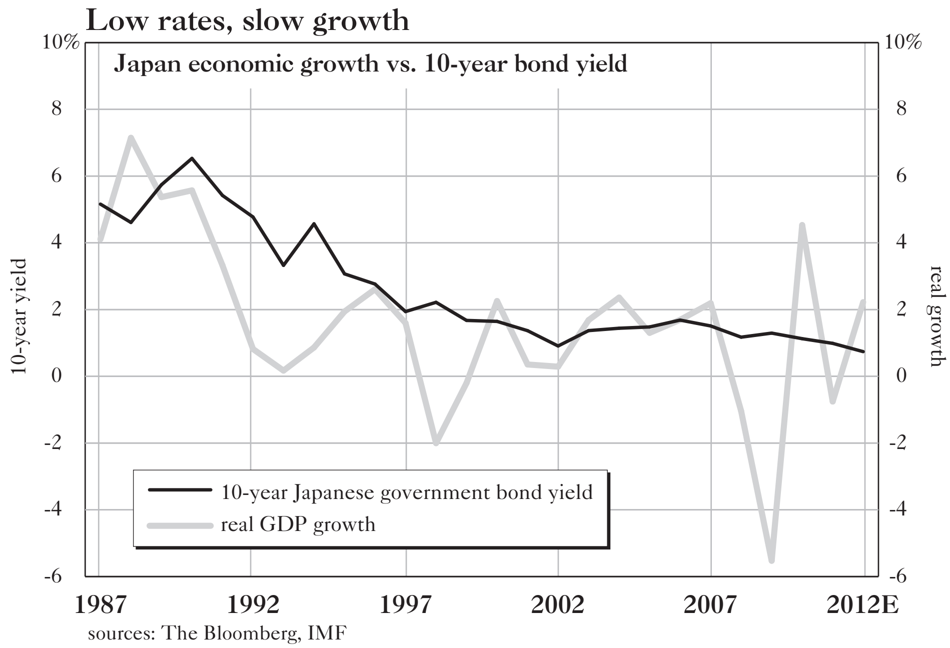
Bank of St. Louis, former Fed governor Laurence H. Meyer described a telltale exchange on how to define the fraught phrase, "price stability." The scene was Meyer's first FOMC meeting, in July 1996, and then-governor Janet Yellen was making the case for inflation targeting; she said she would aim for 2%. Chairman Greenspan replied that the Federal Reserve had a mandate to foster stable prices, not rising ones. Whereupon Yellen replied that the Fed also had a mandate to promote full employment. To hear her tell it, some increment of currency depreciation was a necessary lubricant for economic growth.

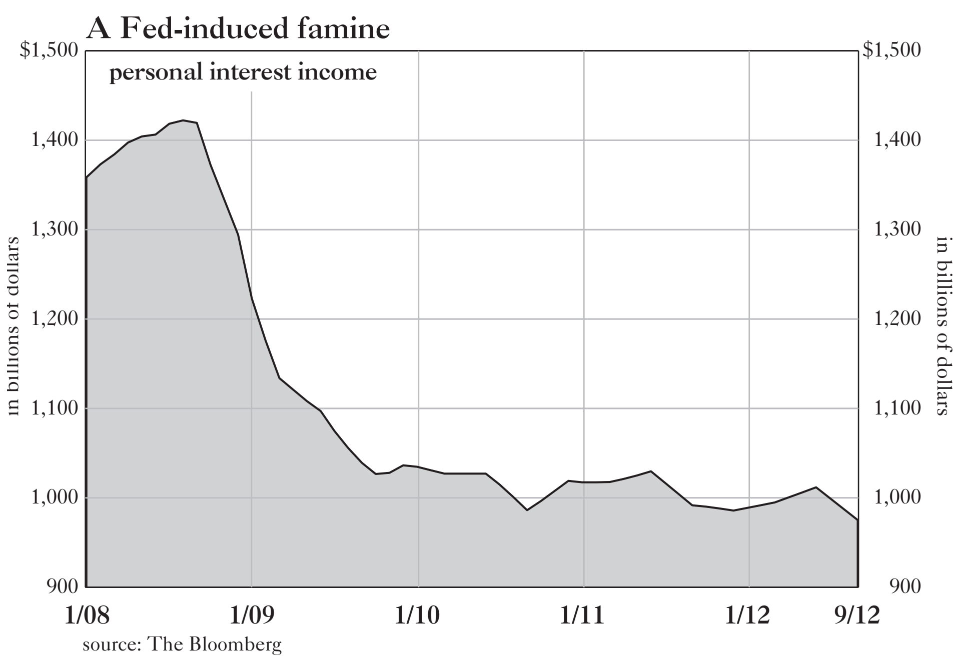
"Janet then seized the initiative," Meyer related, "asking the chairman to indicate how he would define price stability. Greenspan tried to get away with his vague definition. 'Price stability is the state in which expected changes in the general price level do not effectively alter business or household decisions.' But Yellen pressed him and asked if he could put a number on that. Remarkably, the chairman agreed, and said he preferred zero inflation, correctly measured. Janet asked him if he could settle for 2% incorrectly measured."

It was a rare flash of recorded wit for the vice chairman, but Greenspan had the better point. Measurement of inflation is inherently subjective. But even Greenspan's definition was too narrow. Changes in the measured price level these days are admittedly minor. They do not "effectively alter business or household decisions." But zero-percent interest rates are another matter. They have scrambled investment decision-making. They have changed the way firms and households think about risk, and they have warped the structure of the economy itself.



sources: The Bloomberg, IMF

Open before us is an essay in the July-September issue of the English journal, *World Economics*, entitled, "Too Loose for Comfort." Compare real interest rates with real income growth in the G-7 countries from 1950 and 2009, and you make an interesting discovery, write the authors, John C. Michaelson and Sébastien E.J. Walker. You find that falling interest rates are only so effective in nurturing growth; beyond a certain point, they seem to hinder it. Not that this observation proves anything, they hasten to add: maybe low growth "causes" low real interest rates, and not the other way around. "However," they go on, "we believe that there is a reasonable argument to be made to support the hypothesis that low (indeed, negative) real interest rates are impeding economic growth at present, at least in the U.S. and in the U.K. (euro-area countries currently face problems of a rather different nature)."



source: The Bloomberg

ZIRP and QE amount to central bank-led attacks on saving and savers, Michaelson and Walker continue. The famine in interest income has ground down "households and the beneficiaries of trusts, who have less income to spend; retirement accounts, which need replenishing to compensate for lower investment income; pension plans, which have to seek additional funding from their sponsors or from taxpayers; endowments, which have fewer resources available to support their missions; foundations, which have less funds to give; and companies with cash. These stresses also undermine the restoration of confidence, which is a key ingredient for recovery. Moreover, high earners in the financial sector, which benefits from an implicit subsidy (in the form of virtually interest-free loans), have a lower propensity to consume, as a proportion of their income, than less well-off households that have foregone income; this transfer is a drag on the economy, while increasing socially divisive wealth disparities."

Yes, the stewards of the Ph.D. standard will reply, but look at Japan. Yes, rejoin Michaelson and Walker, let's do look at Japan. Herewith is their reading of the sorry Japanese story, in bullet points:

- The economy does not respond to ultra-low rates.
- Policymakers view the problem as inadequate demand (as households, companies and public-sector bodies tighten their belts).
- In response, the central government borrows more at ultra-low rates, with the aim of stimulating the economy.
- Borrowed funds go towards politically directed activities with little economic benefit, and funds withdrawn from the economy in both taxes and borrowing further destroy demand.
- This leads to even more government borrowing to fund "stimulus" spending.
- The government cannot afford to pay a higher rate of interest on the debt it has accumulated, leaving the central bank reluctant to raise rates for fear of bankrupting the government.

An artificially low cost of capital exacts another cost, observes Jesper Koll, head of equity research at J.P. Morgan in Tokyo. This cost is the extra lease on life that E-Z financing accords to failing older businesses. They should leave this world, but they can't, or won't, because their creditors keep infusing them with subsidized credit. Imagine a forest in which the big trees never die. It would be nice for the old timber, but fatal for the seedlings that can't find sunlight. That forest is Japan, Koll says. Could it become America?

No, Yellen et al. would likely reply. The monetary mandarins don't give much thought to the unintended consequences of their own mathematically calibrated policies. They deny that ZIRP accelerates the downward spiral of our federal finances. They refuse to accept that the reserve-currency privilege constitutes an ever-present temptation for America to overborrow. They seem deaf to objections that ultra-low interest rates may be perpetuating the national economic half-sleep, rather than cutting it short. Lacking the once-burned speculator's respect for Mr. Market, they seem to believe that the old gentleman is theirs to command.

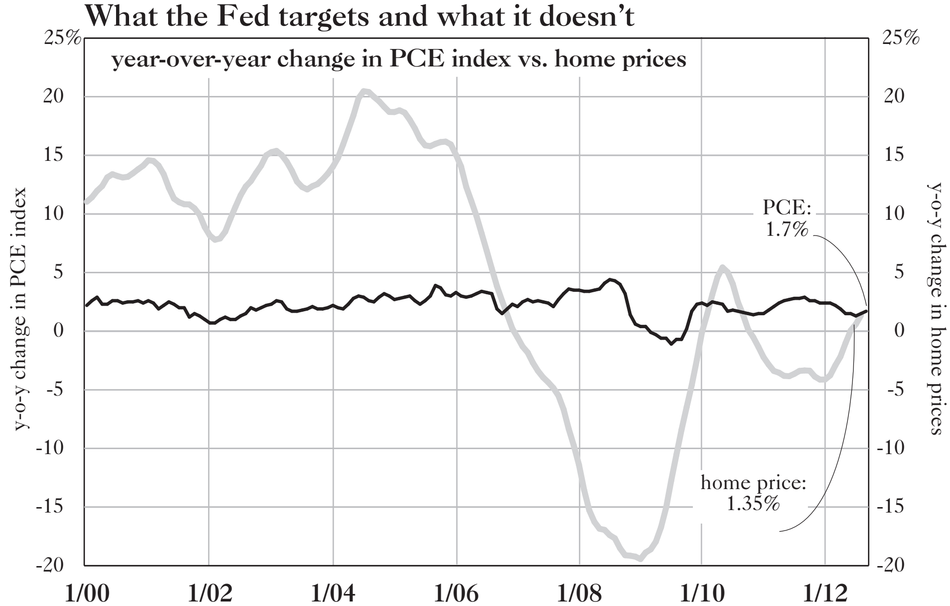
If you listen to them talk to each other, you would likely not comprehend. But you could hardly fail to pick up on their supreme professional self-confidence. Addressing her fellow economists in Boston in June, Yellen lapsed into shoptalk. Concerning the "optimal control" path of the federal funds rate, she said, the Fed employs an econometric model—the "FRB/US" model. "Such a path is chosen to minimize the value of a specific 'loss function' conditional on a baseline forecast of economic conditions," she said. "The loss function attempts to quantify the social costs resulting from deviations of inflation from the Committee's longer-run goal and from deviations of unemployment from its longer-run normal rate." A footnote was appended to the end of this sentence, and here is what the footnote said:

"Under this approach, the central bank's plans are assumed to be completely transparent and credible to the public. *In particular, both the policymaker and private agents are assumed to act as if they have perfect foresight about the evolution of the economy, including the future path of monetary policy, in that they ignore the possibility of unanticipated future shocks to the economy.* This assumption of 'certainty equivalence' is commonly used but is not an intrinsic feature of optimal control techniques. Indeed, the fully optimal policy under uncertainty involves the specification of a complete set of state-contingent policy paths."

What can one conclude from these non-English sentences, especially the one that we have printed in italics? We conclude that a Chairman Yellen would be unprepared for the possibility of unscripted outcomes. Like the incumbent chairman, she has spent her entire career with fiat money. And like the chairman, she seems to have given no serious thought to the thousands of years of monetary history that preceded the post-1971 worldwide experiment in nonconvertible currencies. If, for Yellen, monetary history isn't bunk, it is evidently extraneous. She would hardly flinch—we would bet a Krugerrand on it—if the gold price tripled.

In the aforementioned speech in Boston, Yellen discounted concerns that the Fed would bungle its "exit" from its posture of extreme, radical, unprecedented and heretofore unimagined accommodation. "The FOMC," she said, "has tested a variety of tools to ensure that we will be able to raise short-term interest rates when needed while gradually return-

What the Fed targets and what it doesn't



source: The Bloomberg

ing the portfolio to a more normal size and composition."

She addressed the cost of living in the same soothing vein. Really, there is nothing to worry about: "[I]nflation," she said, "abstracting from the transitory effects of movements in oil prices, has been running near 2% over the past two years, and I expect it to remain at or below the Federal Open Market Committee's 2% objective for the foreseeable future." The vice chairman did hasten to add that nothing is certain and that she could be mistaken. But surprises, if surprises there be, will likely be on the downside, she said, necessitating very easy money for a very long time to come.

Perhaps no one now living (certainly, no one now working on Wall Street) recalls the furious debates over Federal Reserve operating methods as the central bank began operations during World War I. The Ben Bernanke of that time, a man named W.P.G. Harding, resisted demands that the Fed target the price level—for there was pressure from the start to do just that—and he explained his reasoning in his 1925 memoir, "The Formative Period of the Federal Reserve System (During the World Crisis)." It wasn't at all clear, said Harding, that such a feat was technically possible—prices responded to changes in the discount rate, then the Fed's principal monetary lever, with long and variable lags. Then, too, the very act of trying to control the price level through interest-rate manipulation "would put the [Federal Reserve] Board in the attitude of assuming to be the arbiter of prices, and that then an advance or reduction in rates would reflect the Board's opinion that prices were too high or too low, as the case may be, and proclaim its intention to attempt to rectify them. The question then arises, would the country be willing to commit so important a question as the fixing of a proper price level to any board or commission? Any announcement by the Federal Reserve Board of a purpose to control prices by means of discount rates would, in my opinion, lead to the destruction of the Federal Reserve System."

Harding was wrong on both points, a 21st-century central banker would likely contend. The econometrically empowered Federal Reserve can plainly hold the inflation rate at the desired 2% marker, he or she would reply (just look at the recent record). And as to the political advisability of an unelected committee of civil servants overriding the price level, why who's complaining?

The presidential election was more than a triumph for Barack Obama. It was likewise a victory for an approach to monetary management that puts the economics professoriat at the controls of a fiat-currency regime. Here's a bubble that the Fed's "macroprudential" sleuths will never warn you against—the bubble in modern-day central banking.

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Tropical storm

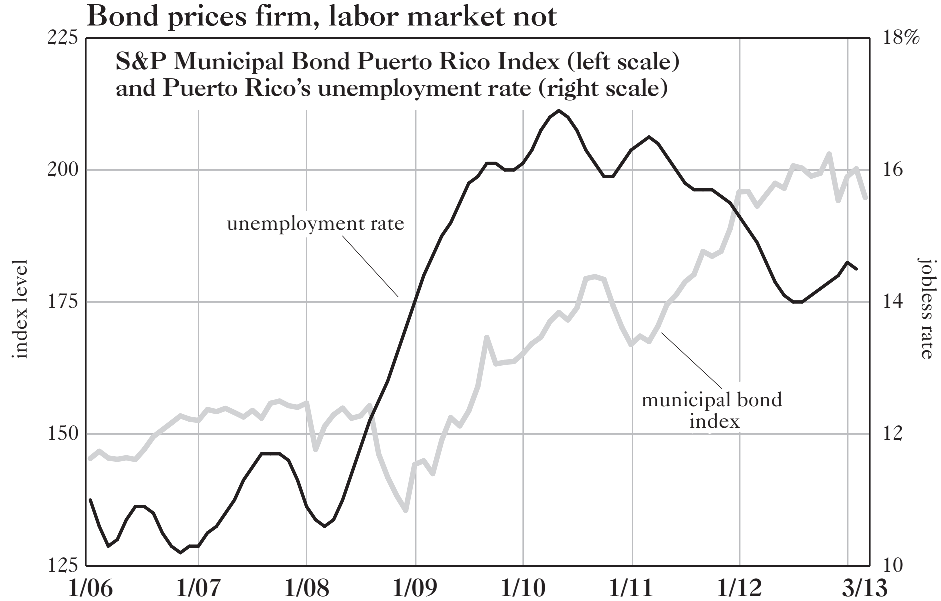
(April 5, 2013) In the municipal bond market, eyes today are locked on the city of Stockton, Calif., which is in bankruptcy proceedings, or on the state of Illinois, which perhaps deserves to be. We write to urge a refocusing. A timelier object of investor concern is the Commonwealth of Puerto Rico. Here is a disaster long ago made but—somehow—forever new and worse.

For the aspiring short seller, there's a catch, however. The market in which Puerto Rico's debt is quoted does not respond to stimuli. Unlike the markets in corporate debt or equities, it does not react to news. It hardly trades at all, observes Joe Mysak, editor at *Bloomberg Daily Brief, Municipal Market,* and perhaps the greatest living authority on tax-exempt securities. Munis trade for the first 30 days of their existence and then vanish into lockboxes and portfolios. From "heaven," as the adepts refer to these resting places, the bonds re-emerge upon maturity. "It's in many ways an inert asset class," Mysak says.

Puerto Rico, rated one notch above investment grade, may yet give that proposition a proper test. Moody's last May disclosed that the island has gross, tax-supported debt on the order of $58 billion, more than any state except California ($102 billion) and New York ($63 billion). In another claim to fame, the commonwealth boasts net tax-supported debt equivalent to 88.6% of 2011 personal income, almost 10 times that of runner-up Hawaii (9.6%) and almost 15 times that of perennial whipping boys Illinois and California (6% each). You wonder where Puerto Rico would be if Washington, D.C., did not contribute a third of its annual budget.

In fairness, the commonwealth ran a smaller budget deficit last year than it did the year before. But that fact, plus the weather and the politicians' access to the federal money hose, largely exhausts the island's defenses. Unemployment stands at 14.5% (better than the 2010 peak of 16.9% but worse than the 2006 trough of 10.2%), while the special entity created after a 2006 financial crisis to

Bond prices firm, labor market not



source: The Bloomberg

restore the government's finances has almost exhausted its own $15 billion borrowing authority. If there were a tournament to decide the most miserably managed government in the country, Puerto Rico would enter as the top seed.

And what makes the Puerto Rican financial hole so much deeper and darker, say, than the ones the Land of Lincoln or the "Empire" State have dug for themselves? Pension malpractice could alone explain the disparity. "Puerto Rico's main pension plan, the Employees Retirement Service (ERS), which serves about 250,000 past and present workers, showed a funding ratio of just 6% as of June 30, 2011," relates colleague Charley Grant. "What is a funding ratio? Divide the value of a plan's assets by the present value of its obligations. To put a 6% ratio in context, the five Illinois pension plans, deservedly the subjects of scorn and handwringing, show a funded ratio of about 40%.

"It's true that the Illinois pension plans assume a quite generous 8% discount rate," Grant continues, "and the funded ratio would be significantly lower if the Springfield actuaries used the 3.75% rate assumed by all but one of the regional Federal Reserve banks. Puerto Rico assumes 6.4%. Regardless of discount-rate assumptions, though, Illinois is not projected to exhaust its pension assets for at least seven years, according to Sean McShea, president of Ryan Labs Asset Management. California's projected depletion of pension assets is decades away. As for Puerto Rico, relates the commonwealth's Government Development Bank, the ERS will exhaust its plan assets by June 30, 2014. On the same authority, the unfunded liability of the ERS represents more than half the commonwealth's $64 billion GDP. Whereas membership of CalPERS and CalSTRS comprises about 6.6% of California's population, Puerto Rico's two plans (the teachers' plan included) cover 9% of the Puerto Rican population."

Only by the skin of its teeth is the commonwealth an investment-grade credit. In reducing its rating to Baa3 from Baa1 in December, Moody's had a few things to say about the quality of the island's pension management. "In addition to low asset levels," the agency noted, "ERS commingles the assets of both its defined benefit [after the closing of the defined benefit plan in 1999, new entrants into the workforce were enrolled in a defined contribution plan] and defined contribution members, meaning future D.C. payouts must be paid by ERS. No corresponding liabilities for these eventual payouts have been disclosed."

No argument, then, that Puerto Rico is a weak credit. But there is a market for tax shelters, Uncle Sam is generous to a fault, and the newly installed governor (in a disputed election), Alejandro García Padilla, pledges to enact a springtime pension reform (no details just yet). So the Puerto Rico 5$\frac{1}{4}$s of July 2023 (callable at par in July 2022) change hands at 101.72 to yield 5.03%, 161 basis points higher than a comparable 10-year Illinois G.O., which Moody's rates A2.

Taste as much as science determines what is adequate compensation for risk-taking. We judge that Puerto Rican debtholders are inadequately compensated (though they seem not to mind). If the market is indeed complacent, why does it not speak up for itself? Economists at the Federal Reserve Bank of Cleveland took a crack at the answer in a February essay entitled, "Do Public Pension Obligations Affect State Funding Costs?" "No," they conclude. Just perhaps, the authors venture, "investors might conclude that . . . while the risk-adjusted returns offered by municipal bonds may be negative, these returns might still exceed the returns on other investments in the low interest-rate environment. In other words, in an environment of depressed yields, municipal bonds are the least bad investment."

Which would make Puerto Rican G.O.s the most bad of the least bad. The tax-exempt market should be careful when it finally does wake up. It might fall out of bed.

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Short Koons, long Lincoln

(September 6, 2013) "What should I hang on the wall to show that I'm rich?" New answers to an old question will be provided in November at the New York auction-house sales. Sotheby's has already promised works by Cy Twombly (1928-2011), John Chamberlain (1927-2011) and Barnett Newman (1905-1970). If the forthcoming Newman fetches anything like what the springtime Newman commanded, there could be a run on paint, brushes

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and canvas. On May 14, an unknown buyer (the seller was Microsoft co-founder Paul Allen) paid $43.8 million for Newman's "Onement VI," which the abstract expressionist produced in 1953.

Now under way is an excursion into the broad intersection of money, art and vanity—and history, central banking and fashion, too. We write to call attention not only to the profusion of dollars, but also to a paradox of value. Works by contemporary artists of no proven reputational endurance can bring an arm, a leg and a torso. Yet rare American historical documents—also suitable for Veblenesque display—frequently go begging. Sell Newman, we say, and Jeff Koons, too; buy the Founding Fathers, and—as far as that goes—Abraham Lincoln.

"Contemporary art" is as great and undifferentiated a field as "contemporary stocks and bonds." It encompasses images and structures that, for the most part, are non-representational. They tease, please or perplex, but they do not necessarily explain themselves. There are exceptions. At Christie's November auction, hotelier Steve Wynn paid $33.7 million for Jeff Koons's "Tulips," a three-ton, stainless-steel sculpture constructed between 1995 and 2004 that actually looks a little like tulips. And Koons's "New Hoover Celebrity IV"—four vacuum cleaners in an acrylic case set off by fluorescent lighting—executed in 1981-86 does certainly look like vacuum cleaners. It *is* vacuum cleaners. Up for sale at the Sotheby's contemporary show in May, the work was supposed to fetch between $10 million and $15 million.

While "New Hoover" didn't sell, it did raise questions. In 1956 debuted a funny musical work by Malcolm Arnold scored for three vacuum cleaners, a floor polisher and full orchestra. "A Grand, Grand Festival Overture" is still performed—the vacuum cleaners and the floor polisher never fail to delight—but nobody ever took it so seriously as the sum of $15 million. You begin to wonder about the meaning of money.

Koons, who was born in 1955, is happily still with us. Jean-Michel Basquiat, who was born in 1960, did not live to see his painting "Dustheads" get hammered down at Christie's on May 15 for $48.8 million, with commission. The title of the work is taken from the street slang for abusers of the drug called angel dust. The picture shows a pair of figures with distorted human features drawn in an hallucinating confusion of color. "Accentuated by the dark background," adds the Christie's catalogue, "the sheer vibrancy of the reds, yellows, oranges, greens and blues of 'Dustheads' explodes like fireworks against the night sky."

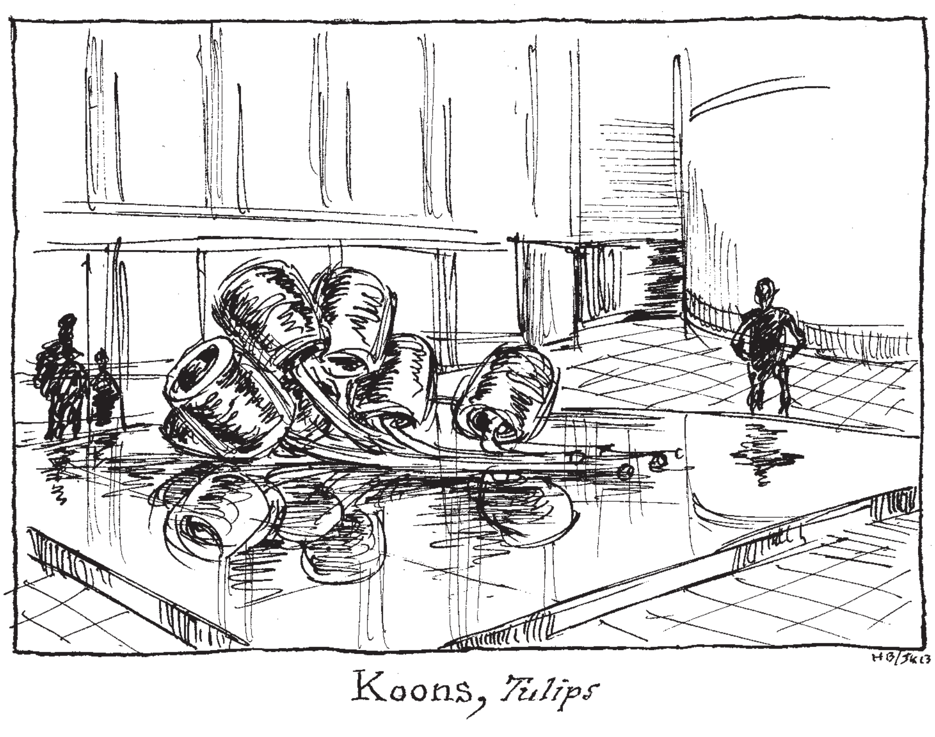
However, to repeat, the painting commanded $48.8 million. Is the market so sure that posterity will attach as high a premium on the name Basquiat as this generation does? How can anyone know?

"At the present moment," Richard Hurowitz, CEO of Octavian Advisers and an art collector to boot, tells colleague Charley Grant, "enormous prices are being paid for artists who, I think it is fair to say, have not yet proven to be a part of the historical canon. As time goes by, fewer and fewer artists in a generation have the staying power amongst museums, scholars and serious collectors, and not every generation produces the same number of super talents. Certain moments—the Renaissance, the advent of modernism—are just more fertile grounds for genius."

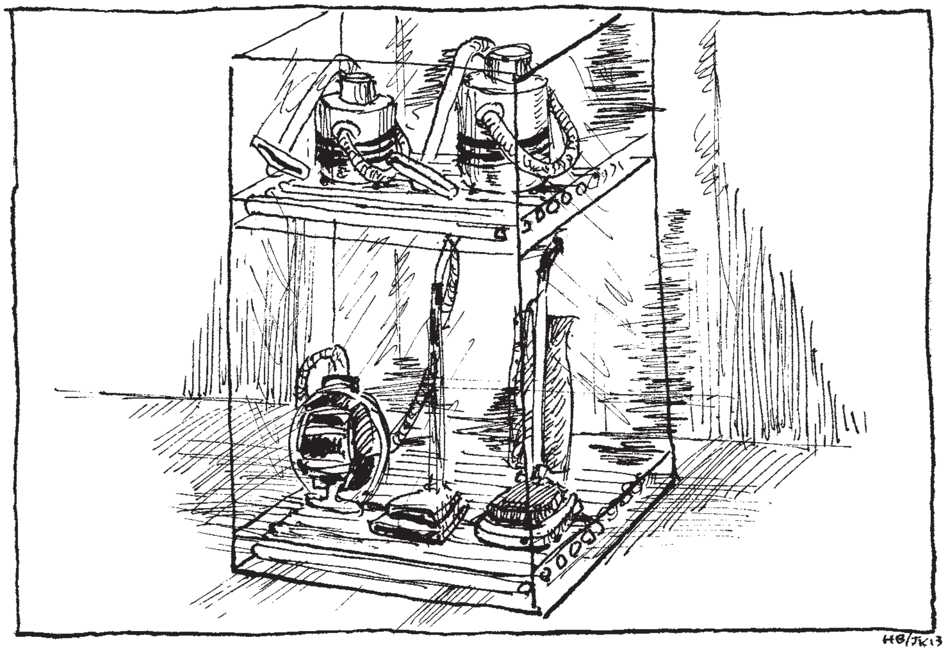
Modern art is valued in terms of modern money. The cost of producing Koons's "New Hoover" would perhaps run no higher than $150,000 were it created today, Grant reckons (that would include rent, labor, the vacuum cleaners themselves, glass case, on-board fluorescent lighting, other materials and maybe health-care premiums for the staff). "Or could buyers have been deterred by the fear of easy imitation?" *The New York Times* asked in a postmortem of the failed auction. "After all, how do you differentiate between a vacuum cleaner offered as a genuine Koons, and another that is just, well, a vacuum cleaner?"

Similar questions arise with regard to the aforementioned Newman painting, "Onement VI." To the untrained eye, it looks like a dark blue rectangle with a light blue line down the middle. "To be strictly accurate," the *Times* corrects the philistine, "the blue is not just blue. It is toned, darkening slightly here, lightening up slightly there. Buyers these days love minimalist abstraction that does not require prolonged inspection, particularly when it makes its impact felt from far away." The financial impact—that $43.8 million sale price—though impressive, has so far failed to land Barnett Newman on the Blouin Art Sales Index list of the top 10 best-selling artists of 2013. Occupying tenth place are works by the American painter Mark Rothko (1903-70), which have realized just under $106 million in the year to date. Andy Warhol (1928-1987) sits atop the leaderboard with aggregate sales of $585 million.

Opaque and lumpy, the art market is as hard to parse as a late Newman or early Damien Hirst. Thus, Sotheby's reported a 10% year-over-year decline in aggregate auction sales in 2012—but the number of items sold at auction with



Koons, *Tulips*



Koons, *New Hoover Celebrity IV*

a hammer price in excess of $1 million actually declined by 19%. Still and all, there are unmistakable signs that "art"—as a necessarily murkily defined investment asset class—is in a kind of boom.

"We see gallery expansions in London," Jonathan Binstock, senior art adviser for Citi Art Advisory, tells Grant, "we're seeing British galleries extend into New York, we're seeing Western galleries expand into Hong Kong. These are galleries that used to make their fortunes on the secondary market reselling trophies, and now they're making their fortunes on the primary market selling fresh studio works of art, where the gallery shares in the proceeds of the sales. The point is that instead of making 10% or 20% on a commission sale, galleries are probably making in the neighborhood of 50%, more or less, on a sale, and pretty big sales."

Bubble hunters at the Federal Reserve will be interested to learn that Amazon.com, too, has entered the gallery business. Amazon Art gives customers access to 40,000 works from more than 4,500 artists via 150 galleries and dealers. Paintings now available via Bezos & Co. at prices of more than $1 million include Norman Rockwell's (1894-1978) "Willie Gillis: Package from Home" (1941) for $4.85 million, and Warhol's "Hamburger Michel" (1980) for $1.45 million.

"But," adds Grant, "for clinching evidence that the bull market has achieved speculative lift-off, only know that the rapper Shawn Carter, a.k.a. Jay-Z, added a track called 'Picasso Baby' to his summertime album, 'Magna Carta . . . Holy Grail.'" The lyrics tell of Jay-Z's artistic awakening:

> It ain't hard to tell
> I'm the new Jean Michel
> Surrounded by Warhols
> My whole team ball
> Twin Buggatis outside the Art Basel
> I just wanna live the life colossal
> Leonardo Da Vinci flows
> Riccardo Tisci Givenchy clothes
> See me thrown at the Met
> . . .
> House like the Louvre or the Tate Modern
> Because I be going ape at the auction
> Oh what a feeling

So strong, so universal, is that come hither auction-house feeling that a certain number of patrons have come to feel that they can no longer wait for the traditional spring and autumn sales. "In response to the growing demand from our clients to transact continuously—not just in the traditional sales seasons—we plan to host five selling exhibitions per year," Cheyenne Westphal, Sotheby's European head of contemporary art, said in a statement on Monday. Coming attractions include a show by the 20th-century German Joseph Beuys, an artist heralded by critics for, among other works, his 1965 "shamanistic" performance piece, "How to Explain Pictures to a Dead Hare."

How might one explain the upswing in contemporary art to a living economist? Miniature interest rates have reduced the opportunity cost of investing in any kind of non-yielding asset. Also, for the American buyer, the rise in the 2013 dividend tax rate, to 20% from 15%, has reduced the relative tax disadvantage of gains earned on collectibles, which the government shears at the rate of 28%. To which Hurowitz adds, "The influx of buyers from emerging markets such as Russia, China and the Middle East has been a big factor in the high end of the market. The Chinese contemporary market went from almost nothing to bubble proportions very quickly, and Hong Kong has become an important location in short order. The air is quite thin at the top of the market, and the number of people who are willing and able to pay $50 million for a work of contemporary art is likely measured in the double digits."

It's a sign of the times that Qatar, that tiny rich oil field of a country, has chosen to spend its monumental wealth on art. "We are revising ourselves through our cultural institutions and cultural development," the director of the buying program, 30-year-old, Duke University-educated Sheika al Mayassa, said in a 2010 TED talk. "Art becomes a very important part of our national identity." All kinds of art: in 2011, Qatar is said to have paid the highest price for any work of art when it purchased one of the paintings in the Paul Cézanne "Card Players" series for $250 million (or $125 million for each of the two Aix-en-Provence peasants seated, cards in hand, at a café table). This was a work of the 1890s, but Qatar has an eye for the modern, too; it paid $70 million for Rothko's 1950 work "White Center" in 2007.

Admittedly, Qatar is an unlikely bidder for rare American historical documents, but what about the modern art-besotted American collector? He or she would be amazed at how far even the Bernanke dollar goes in the subdued auctions of works by Hamilton, Lincoln and Jefferson. For instance, on June 25 at the Robert A. Siegel Auction Galleries in New York, the LBO titan David Rubenstein picked up a copy of the first newspaper printing of the Declaration of Independence; he paid $632,500. It was, announced the gallery, a "record price for any historic newspaper," but what would you rather have on your wall, "When in the course of human events" or a deep shade of blue?

The American historical documents' market hasn't been the same since the Forbes estate unloaded its treasures in a pair of sales in 2002. While the rarest and most precious items do command fancy prices—Bill Gates reportedly paid $23 million in a recent private sale for a first edition of the Declaration of Independence—other books, broadsides and letters go for a few dozen pounds' worth of a Koons stainless-steel construction.

Consider, for instance, President Lincoln's 1862 letter to the reluctant George B. McClellan prodding the general to battle: "Is it your purpose," an exasperated Lincoln demanded, "not to go into action?" The letter fetched $81,250 at a June sale at Christie's.

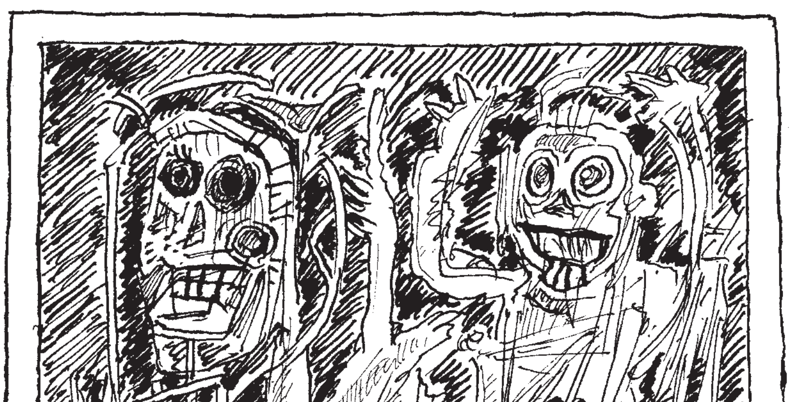
Or another: The official printing, signed by Thomas Jefferson, of Hamilton's 1790 Assumption Act, the law authorizing the federal government to issue United States securities in exchange for the debts of the states. It sold for $112,500 at Sotheby's on June 4.

Or this: Hamilton's 1789 Report on the Public Credit, also on the block at Sotheby's on June 4. It could have been yours for a dollar more than the winning bid of $40,625.

Or, finally, a first edition of Jefferson's Manual for U.S. Senate Procedure, annotated and inscribed by Jefferson to a friend in Virginia. It sold last year at Heritage Auctions for $115,000.

Cézanne, *The Card Players*

Like any other market, the art market is cyclical, and public taste is forever fickle. As Cynthia Saltzman relates in her 2008 history, "Old Masters, New World: America's Raid on Europe's Great Pictures," no less a financier than J.P. Morgan was caught up in the fashionable frenzy for English portraits at the turn of the 20th century. He paid £30,000, or the equivalent of almost $150,000, for Thomas Gainsborough's "Georgiana, Duchess of Devonshire," in 1901. The price was three times what Sir William Agnew had spent for the same work in 1876. It was not the best investment, Saltzman reports: "Prices of English portraits continued strong through the 1920s (with Gainsborough's 'Blue Boy' selling in 1921 for $148,000 to Samuel Huntington) and then collapsed with the Crash and never recovered," she says. "A pair of portraits by Joshua Reynolds that sold for £16,000 in 1926 came up at auction in 1941 and the bidding rose to only £400 (they were bought in)."



Basquiat, *Dustheads*

Today's contemporary art market is broader than it used to be, and the pool of would-be acquirers is certainly bigger and richer than ever before. But the values? We say they have never been more precarious. "You can overpay for a Cézanne, but it won't ever go to zero," Hurowitz observes. The same can't be said for such aesthetic experiments as Hirst's "The Physical Impossibility of Death in the Mind of Someone Living," which happens to be a shark floating in a tank of formaldehyde. How many millions of dollars Steven A. Cohen paid for this production in 2004 is unknown. What posterity may pay is still more problematic.

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Memo to Morgan Stanley

(September 20, 2013) On the occasion of the fifth anniversary of the 2008 financial upheaval, the CEO of Morgan Stanley, James P. Gorman, told the TV cameras, "I would say the probability of it happening again in our lifetime is as close to zero as I can imagine." We write to dispute that contention. Gorman, a youthful 55 years old, will—we trust—live to see many a new crisis. To guess the nature of those disturbances is the subject at hand.

New highs on the S&P 500 provide no obviously relevant backdrop to speculation about risk. Neither does the happy new conjecture about a Janet Yellen Fed nor Verizon Communications' triumphant $49 billion bond sale last week, the biggest corporate placement of all time. To compare the droopy gold market with the suddenly buoyant bond market is to conclude that, for Mr. Market's money, the risks of unscripted troubles in money or credit are "close to zero," as Gorman put it.

Comparing today's Morgan Stanley with its hyper-leveraged, pre-crisis predecessor could lead one to a similar conclusion. In a page-one essay in 2006, *Grant's* singled out Gorman's firm, then under the leadership of John Mack, as the era's paragon of excessive leverage and uncompensated risk-taking. "Over the cliff with Morgan Stanley" was the headline (see the issue of Oct. 20, 2006). By year-end 2007, Morgan Stanley was leveraged 38:1. By 2009, it was a ward of the state. Now the rehabilitated Morgan Stanley is leveraged 14:1. We were about to write "only" 14:1, but we will withhold that modifier until a cycle or two has slid by.

Gorman has built the new Morgan Stanley on the conviction that stockbroking is safer than proprietary trading—and so it would be if only the public would buy some stock. Risk is so much clearer after the fact. It wasn't as if, in 2007, Morgan Stanley intended to enter the federal TARP ward. It was only doing with its balance sheet what others were doing with their balance sheets.

Few financial truths are unconditionally true. Safety and soundness are the post-crisis regulatory watchwords, but safety is not intrinsic in any asset class. Treasurys are safe at a price, but not at any price. The 2s of Feb. 15, 2023, which came to market seven months ago at around par, are quoted these days at 93. That seven-point markdown in price is equal to $3^1/_2$ years of coupon income.

We go to press not knowing if the Fed will or won't taper. But who's to say that tapering is the main risk? Maybe the debt-ceiling drama will overtake it. As it is, Treasurys are collateral par excellence. But would they so remain in the event of even a "technical" default resulting from a political impasse over the debt limit? Don't be so sure, gentle reader, whoever you are. Few foresaw how quickly a Lehman Brothers failure would metastasize. Today, many mistrust banks and money-market funds alike. Harboring those doubts, they own (or lend against) U.S. governments. A debt-ceiling crisis could test the faith of the world's money holders in the intrinsic value of federal IOUs, denominated, as they are, in the dollar, a currency of no intrinsic value that the Federal Reserve runs off on a kind of copying machine.

More telling about the post-crisis Morgan Stanley than even its new, retail-oriented business model (no more wheeling and dealing allowed), are the 50 government regulators who've taken up daytime residence on the premises. According to *The Wall Street Journal*, Gorman was on the phone to his predecessor the other day when Mack advised him, "Your number one client is the government." "Mr. Gorman," the *Journal*'s account continued, "who was visiting Washington that day, agreed."

If the government is the No. 1 client, it is no less the No. 1 rule maker and rate setter. It defines what's risky, its agents enforce those risk-mitigation standards and its central bank fixes the interest rate at which asset prices are capitalized. Since the financial crisis, price discovery has more and more given way to price administration.

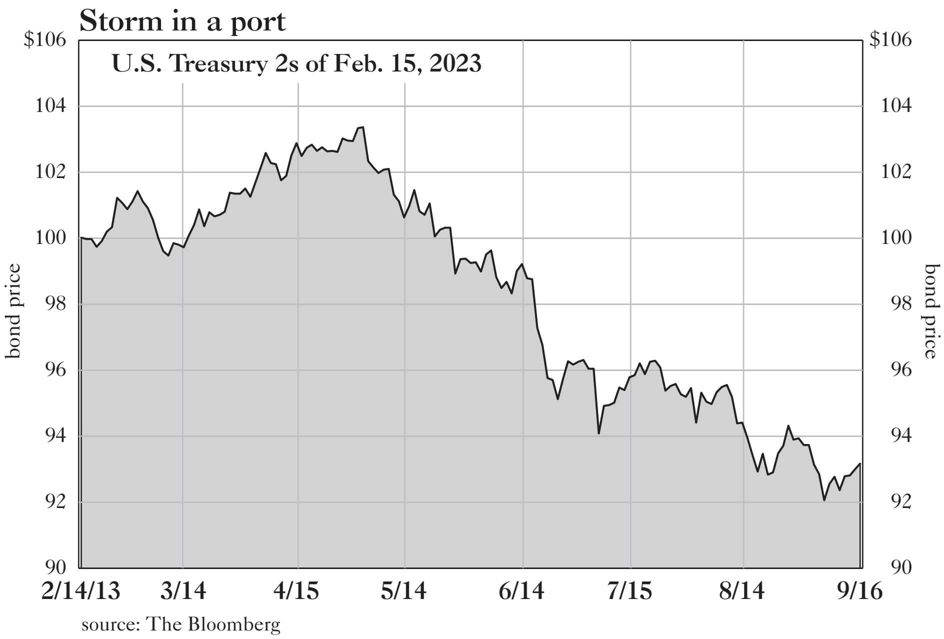
Risk is protean. Like rising floodwater, it conquers man-made defenses. You think you've stacked the sand bags high enough but the water seeps in underneath. Value-at-risk, the sandbag pile of the last cycle, calculates the potential for loss on a given portfolio over a defined interval of time for a given confidence level. But, as many an unemployed risk manager can today attest, past results are no guarantee of future losses—and the odds on loss that VaR computes are drawn from a narrow slit of historical experience. Anyway, VaR or no VaR, 2008 happened.

Enter, now, the government, or rather the government in force, with a new kind of sandbag. Though there's nothing very new about regulation—the Office of the Comptroller of the Currency, the oldest of the federal financial regulatory agencies, has been around since 1863—today's regulators have a new remit. They not only oversee firm structure and managerial choice, but they also, and more significantly, influence and direct asset prices. The trouble is that the asset-manipulation business directly collides with the rule-making and enforcement mission. Ultra-low interest rates corrupt decision making because they distort values.

And just because the new Morgan Stanley no longer takes the risks that the late, lamented Morgan Stanley did doesn't mean that nobody else is taking them. (Only one of the troubles of 2008-09, of course, was that while Morgan Stanley took the risks, the public finally bore them.) "Some amount of risk has gone away because some ac-

Over the cliff—and back

source: The Bloomberg



tivities are not being undertaken anymore," Brady Dougan, CEO of Credit Suisse, told the *Financial Times* last week. "But also, a fair amount of risk has been transferred to other parts of the system, like shadow banking, insurance companies, pension funds or retail investors."

It's a fact, according to the Bank for International Settlements, that the too-big-to-fail banks no longer control most of the trading in interest-rate and foreign-exchange derivatives; at the April tally, for the first time, smaller banks, hedge funds and non-bank financial institutions did. "Perhaps regulation, not unlike derivatives, redistributes rather than eliminates risk," observes colleague Charley Grant.

Then, again, booms and busts are the way of humanity, or at least of leveraged humanity. "The lesson from history is clear: asset price bubbles and crashes are here to stay," declared John Williams, president of the Federal Reserve Bank of San Francisco, in Sept. 9 remarks. "They appear to be a consequence of human nature. And the events of the past decade demonstrate the enormous human costs of asset price bubbles and crashes."

Next up, we say, will be a living demonstration of the enormous human costs of market intervention to prevent asset-price bubbles and crashes. In particular, the allied policies of zero-percent interest rates and quantitative easing will catalyze troubles all along the yield curve, from money-market instruments to long-dated bonds.

In the Sept. 11 testimony of Alex J. Pollock of the American Enterprise Institute before a congressional panel on the topic of the Fed's looming 100th birthday is a quotation attributed to former Sen. Jim Bunning (R., Ky.). "How can you regulate systemic risk when you *are* the systemic risk?" the senator supposedly asked former Fed Chairman Alan Greenspan.

A dozen leading bankers, organized as the Federal Advisory Council, seemed to channel Bunning in their quarterly meeting with the Fed's Board of Governors on May 17. The advisers warned about the perils of low interest rates. They noted that Federal Reserve purchases of mortgage-backed securities absorbed more than 70% of gross mortgage-backed issuance, "causing price distortion and volatility in the MBS market."

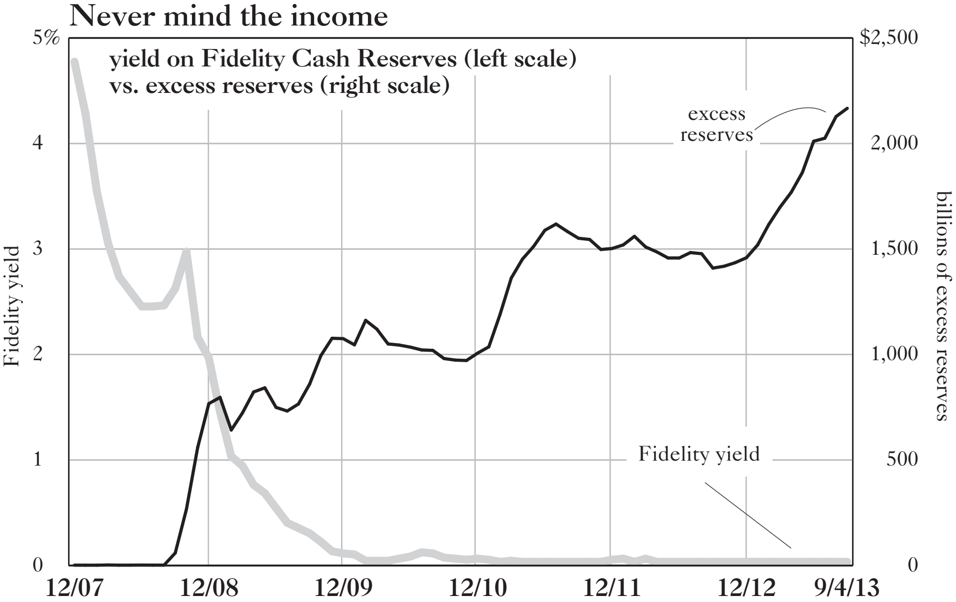
"Many are concerned about the Fed's significant presence in the market," the minutes continued. "They have underweighted MBS in favor of corporate, municipal and emerging-market bonds. There is also a concern about the possibility of an outbreak of inflation, although current inflation risk is not considered unmanageable, and of an unsustainable bubble in equity and fixed-income markets given current prices." Among the dozen worrywarts was the CEO of Morgan Stanley.

The Federal Advisory Council could have met all day and all night before running out of complaints about ZIRP, in your editor's opinion. By pressing money-market interest rates to zero, the Fed has eliminated credit differentiation at the short end of the yield curve. For would-be issuers of commercial paper, the ZIRP-paralyzed credit judgment is binary: 18 basis points, plus or minus four basis points, is the cost of borrowing, whether you happen to be Toyota Motor Corp. (Aa3/AA-minus) or J.P. Morgan Chase (A2/A) or a credit in between. Let us say you are Handelsbanken of Sweden. Your credit ratings are identical to Toyota's, but you show some concerning vulnerabilities, including an elevated loan-to-deposit ratio (267%, meaning that you must fund in the credit markets), and exposure to a bubbly real estate market. According to the Aug. 29 issue of *The Economist*, Swedish house prices are 32% higher than they ought to be in relation to rents (by the same method of appraisal, American houses are back to fair value).

What does a credit analyst do when credit doesn't matter? The conscientious Robert Litterst, portfolio manager of the $120.4 billion Fidelity Cash Reserves, puts in an honest day's work. He tries to add value by "maintaining a long weighted average maturity" and by "investing in floating rate securities issued by banks of very high quality, and by investing in securities issued by firms that were favorably regarded by Fidelity's research team," as he advises his shareholders. In the six months to May 31, he bought "very short-maturity" obligations of banks in the "core" of the euro zone, including France, Germany and the Netherlands. And the fruit of this diligent labor? A seven-day yield of 0.01%—at which rate, before tax, one's money would double in 6,932 years.

As much as any other department of Wall Street, the money-fund business has felt the full, asphyxiating weight of post-crisis regulation. As the Fed maintains ZIRP, the Securities and Exchange Commission has imposed new rules on the maximum weighted-average maturity of a money fund's assets (no longer than 60 days, down from 90 days) and is proposing new regulations as to the fraught question of net asset values: Should they remain at a constant $1, or should they float? As you'd expect, money-fund management is not much more lucrative than money-fund investment. Except for the parent's subsidies, Fidelity Cash Reserves would have yielded a minus 0.08% on May 31, not the princely

Never mind the income



source: The Bloomberg, Federal Reserve

0.01% it did deliver.

Self-awareness is not the government's strong suit. Through successive quantitative easings, the Fed has produced so many redundant dollars that most American banks have no need to borrow in the short-term wholesale market. So money funds must lend to borrowers who do need accommodation, including the likes of Handelsbanken and the German, French and Dutch banks in which Litterst finds merit if not yield.

But ZIRP does not exhaust the Federal Reserve's arsenal of monetary blunderbusses. In its July deliberations, the Federal Open Market Committee weighed deployment of "a fixed-rate, full allotment overnight reverse repurchase facility as an additional tool for managing money market interest rates." In other words, the Fed would lend its $3.4 trillion securities portfolio in exchange for cash. The interest rate that the Bank of Bernanke, or of Yellen, or of Geithner, Kohn, Ferguson or some other, would pay on such transactions would set the floor for short-term lending.

"After all," colleague Evan Lorenz points out, "why would Fidelity lend to Handelsbanken at 21 basis points for 30 days if the Fed offered, say, 25 or 30 basis points on overnight borrowings? This would be a boon to money funds, which would see a floor on their yields, but it might come as a shock to mortgage REITs and other short-term borrowers."

But what this mouthful of an intervention technique also promises is another giant step toward the federalization of finance. One forgets how excessive are today's excess reserves. As recently as December 2007, bank-controlled funds over and above the minimum required to satisfy the Fed's reserve requirements totaled $1.8 billion. Today, such balances stand at $2.2 trillion. Naturally, this mountain of redundant cash, which is held on deposit at the Federal Reserve banks, robs the market in federal funds of its function and the federal funds rate of its meaning. Before 2008, the Fed would buy or sell securities to move the funds rate down or up. But since 2008, the crisis-driven Fed has flinched from selling securities—certainly, nobody under consideration to succeed Ben Bernanke is contemplating the sale of the $2.2 trillion in assets that correspond on the Fed's balance sheet to $2.2 trillion in deposit liabilities. So to regain a measure of control over the money market, the Fed started paying interest on those inert balances in October 2008; one-quarter of 1% is the going rate.

This contemplated monetary Statue of Liberty play—the "fixed-rate, full-allotment overnight reverse repurchase agreement facility"—would constitute a deeper and more pervasive intervention by the Fed into market rates than any up till now. It would make the central bank an even more complete arbiter of money-market interest rates and credit. And insofar as the rates that the Fed chose to enforce were lower than the rates that otherwise prevail, there would be more misdirected investment than error-prone humans would incur on their own.

This publication, while always yielding to Mr. Market, respectfully reminds that sometimes-distracted gentleman that today's investors are the guinea pigs in a worldwide experiment in money printing and interest-rate control. We acknowledge the intoxicating first-order effects of a radically expansive (and simultaneously repressive) monetary policy. The wrinkle is that the people who orchestrate the first-order effects never warn you about the side effects.

Then, again, maybe that's where *Grant's* comes in.

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