For the next 10 years

On Thursday, Nov. 15, a surprise autumn snowstorm plunged New York into chaos and recrimination. The National Weather Service—which each year makes more than 76 billion meteorological observations and issues 1.5 million forecasts and 50,000 warnings, has a $1 billion budget, employs 4,218 people and operates super computers with a combined processing power more than 10,000 times greater than that of the Dell on your desk—blew it.

At that, the weathermen ought to count themselves lucky that they don’t predict interest rates. Snowflakes may not fall where they’re supposed to, but they don’t willfully change course. Nor, by the simple act of observing weather patterns, does the NWS run the risk of altering them.

Financial forecasters would have better luck if interest rates were rain drops or temperature gradients instead of the quasi-living things they are. Prices, because they measure human behavior, do virtually have lives of their own. As for interest rates, they measure not only the supply of credit and the demand for credit, but also time preferences and inflation expectations and confidence in the money in which an IOU is denominated. Nor is that the most confounding part. Interest rates also measure the expectations for others’ expectations. Especially do they measure the expectations of the Federal Reserve, which, despite employing more than 22,000 people and mobilizing its own formidable computers, has no clearer view of the financial future than does the average off-duty meteorologist.

Since 1970, the Weather Service has materially improved the accuracy of its forecasting of Atlantic-basin tropical storms and hurricanes. No such progress is evident in the Fed’s forecasting of financial storms, although the central bank (as James Bianco observed at the Grant’s Fall Conference) has an unrivaled record in causing them.

All of which is preface to the declaration of our own expectations—the paid-up subscribers have a right to know them, errant though they must almost certainly be, given the difficulties just enumerated. “Up” is the long-term direction of interest rates, for next year and, perhaps, many years to come, we speculate.

The Grant’s house view holds that the bond bull market that began in 1981 ended in 2016. Since its intra-day low of 1.318% on Wednesday, July 6, 2016, the 10-year Treasury yield has more than doubled. If past is prologue, that key rate will push jaggedly but persistently higher.

That is, it will push persistently higher if the past has anything to say about the future. Interest rates have long tended to move in generation-length cycles, approximately corresponding to the tidal movements in prices. Thus, in America, bond yields moved higher from 1900 to 1920, as did the rate of inflation; over the two decades, an index of railroad-bond yields climbed to 5.81% from 3.89%. Rates then reversed course, also in tandem with prices, until 1946, after which began a new inflationary cycle that culminated in double-digit inflation and 15% bond yields.

In 1982 ensued a generation’s worth of disinflation and the lowest interest rates in 3,000 years. Now a new inflationary upswing is in progress, along with a spanking-new bond bear market, or so we venture.

Thus, the grand historical overlay. Of course, since nothing is predestined, the skeptical investor must weigh the evidence on both sides of the interest-rate argument, not forgetting that—again, on form—these secular trends won’t be hurried. As noted in these pages before, the 1946–81 bear bond market was in progress for 10 years before long-dated yields notched their first 100 basis-point rise.

What makes us bearish today is, first, the disarray of American fiscal policy and the consequences of radical monetary policy. Washington’s budget presents the market with a uniquely unfavorable supply situation. This fiscal year, the sum of expected Treasury issuance and projected Fed dispositions (in connection with the balance-sheet reduction program known as quantitative tightening) could reach $1.8 trillion, or 8.3% of forecast GDP, the highest in relation to national output since 1945 (Grant’s, Feb. 9). It gives pause that this offense against the bipartisan

(Continued on page 2)
doctrines of Presidents Grover Cleveland and Calvin Coolidge is occurring in a year of breakout economic growth and record-low unemployment. Given that, in a recession, the budget deficit can blow out by four percentage points from the deficit recorded in the year of the business-cyclical peak, government-securities issuance in the next slump could well reach the equivalent of 10% to 12% of GDP, a post-World War II high-water mark.

Ultra-low interest rates are the joker in the current interest-rate forecasting deck. You would have thought—we did erroneously think—that zero-percent funding costs and so-called quantitative easing would have instigated old-time inflation. What they rather instigated was bull markets. The kind of currency debasement that made the 1970s unforgettable has seemingly vanished, never to return. Is Jeff Bezos not at his post?, the bond bulls demand. Does the burden of debt not lay a dead hand on prices, therefore on yields? If a trifling rise in mortgage rates can stymie the housing market, how can even higher yields be sustained? And given that a 100 basis-point jump in the cost of funding the public debt would increase the dollar cost of federal debt service by $163 billion, won’t the Fed do all in its power to prevent a disorderly bear market? Besides, cast an eye on Japan: Sometimes low interest rates just stay and stay, outsized debt burdens notwithstanding.

We bond bears reply that, in America, high-strung asset prices are colliding with up-tempo business activity. Wage costs are rising in tandem with job openings. Thus, as Bloomberg reported on Monday: “The job openings rate for the durable-goods manufacturing industry reached 4% in October, a record in data back to 2000, according to figures issued Monday by the Labor Department.” Debt is, or can be, a dead hand, but America’s fingers are visibly flexing. Real, or inflation-adjusted, Treasury yields are negligible all the way out to 10 years. The bond bulls have fallen in love with the asset class that pays them next to nothing.

ZIRP and QE will eventually cause the checkout-counter variety of inflation, the bear case continues. There will be another financial crisis one day. It will be correctly seen, in part, as the evil fruit of ultra-low interest rates. Reaching for yield, people did, indeed, grasp it, in the shape of covenant-deficient leveraged loans (see page 4), overpriced junk bonds, near-junk investment-grade debt and the anticipated dividends from highly leveraged private-equity promotions.

The Fed will rush to the scene of the accident. Turning away from the real economy to save the paper one, it will cut such rates as there are to be cut. It may dust off QE, too, having first suspended QT.

The about-face will shake the confidence of all but the most dogged holders of fixed-income securities. Just how much confidence remains to be shaken is apparent in the fact that Emmanuel Macron’s France can still borrow at a 10-year yield of 71 basis points, no matter the yellow vests and tear gas. Or in another fact: According to Bloomberg, $7.6 trillion of bonds worldwide are priced to yield less than zero in nominal terms. The stewards of these trillions would rather invest at a certain loss than buy U.S. Treasury bills at 2.4% or gold bullion at zero percent.

Your editor lost confidence in modern central banking decades ago. Waiting for the non-Grant’s portion of the world to catch up, he has accumulated gold and gold-mining shares—he so declares by way of full disclosure. By coincidence, there happens to be just enough above-ground gold—almost exactly $7.6 trillion—to accommodate a swap for those $7.6 trillion in non-yielding securities. Something tells us that no such epochal asset exchange is in the cards. However, a rippling loss of confidence in paper money, and in the immense debts that the paper-money-spinning central banks have facilitated, could readily find expression in higher bond yields.

Such is our road map for what is surely not the foreseeable future. But we do know one thing for certain about the next decade. The fact on which we can positively bank is that Grant’s Interest Rate Observer will be making its offices at the Woolworth Building, the “Cathedral of Commerce,” 233 Broadway, Suite 2420, New York, New York 10279. It’s the very tower in which we started 35 years ago. At the age of 72, your editor has signed a 10-year lease. And people call him pessimistic?

After the boom

Residential real-estate prices are drooping in Canada and the United States and actually falling in the People’s Republic of China, greater London, metropolitan Stockholm and—especially—Australia. Now unfolding is a closer look at the action Down Under. In preview, we see in the Lucky Country the symptoms of post-boom deflation syndrome, a kind of macro-economic katzenjammer.

It’s been a storied boom, 27 years young as of Sept. 30, and we think we will not join, or perhaps the word is rejoin, the hapless prognosticators who have tried to call time on it. However,
crowding out the news of the latest cyclical milestone was the report that Australian banks rejected just under half of all mortgage applications in November, compared with a year-earlier rejection rate of just 5.2%.

Nothing that the Reserve Bank of Australia has recently done (its policy rate remains 1½%) can explain it. The problem rather seems to lie in what came before—in particular, the bank’s efforts to boost house prices to compensate for the slowdown in resource-related investment; between November 2011 and August 2016, the policy interest rate tumbled to the still prevailing 1½% from 4¾%. Perhaps taking their cue from the central bank, the commercial banks’ reflexive response to mortgage applications became a hearty “yes.”

Now—as the data wizards at Digital Finance Analytics have been able to show—the fallback word is “no.” Shamed by revelations of American-style lapses in bankerly due diligence, the Aussie lenders have belatedly reverted to prudence (Grant’s, June 15). They are actually said to be checking incomes, expenses, total debt and other such previously unexamined details. It can’t be entirely coincidental that, in November, average house prices in the five leading Australian markets fell by 5.6% while Sydney’s plunged by 8.1% and Melbourne’s by 5.8%. The latter two cities account for “approximately 55% of the value of Australia’s housing asset class,” according to CoreLogic’s head of research, Tim Lawless.

“The rise in mortgage rejections comes at a particularly difficult time for borrowers,” colleague Evan Lorenz relates. “At the end of 2015, nearly two-fifths of mortgages were interest-only (IOs). The typical Aussie IO starts amortizing after five years, at which point monthly payments increase by 30%–40%. The Reserve Bank estimates that around A$120 billion ($86.3 billion) of IOs will reset annually in 2018 through 2020. ‘About one-third of that won’t get refinanced,’ says Martin North, the principal of Digital Finance Analytics.”

The big four Aussie banks may not be lending, or at least not with their boomtime zeal, but that doesn’t mean that every channel of mortgage finance is closed: would-be borrowers are turning to a different class of lender. “To go to the peripheral lenders as opposed to the mainstream lenders, it will cost bor-rows more,” says Michael Schneider, lead portfolio manager of the soon-to-launch Firebell Australian Macro Fund. “The way I look at it is that it has as similar impact as a tightening in official interest rates—it is going to cost more.”

Certainly, Schneider goes on, the builders and developers are having to pay up. “There is quite a vibrant mezzanine debt market in Australia right now, which is charging far higher interest rates,” he says. “I’ve been told by some lenders in that market that they are lending at rates up to 16% in the mezzanine market to developers.”

One of the troubles with prosperity (there aren’t so very many) is that uncorrected errors accumulate. “Take, for example,” Lorenz writes, “the ironically named Blue Sky Alternative Investments Ltd. (BLU on the Australian Securities Exchange), an alternative asset manager favoring private-equity-style investments, water rights and real estate in Australia and North America.”

On March 28, Blue Sky awakened to discover that it was the star of a 67-page analysis by Glaucus Research Group. The report alleged, among other things, that the 15% internal rate of return that Blue Sky claimed to have earned since its 2006 inception was a near impossibility. And, sure enough, Blue Sky, in calculating assets under management, had managed to lump in debt with equity, thus hugely inflating fee-earning assets. (America’s Beardstown Ladies, an Illinois investment club for women of a certain age, had made a similar mistake in the 1980s.) Since the unmasking, Blue Sky’s market capitalization has collapsed to A$74.6 million from A$885.6 million.

On Oct. 28 came a 176-page broadside by a different research organization, VGI Partners Pty. Ltd., criticizing Corporate Travel Management Ltd. (CTD on the Australian Securities Exchange), an online business-travel roll-up boasting an adjusted operating profit margin of 32% vs. 13% for peers in a highly competitive global industry. CTD had claimed a worldwide network of branch offices; the VGI analysts, traveling to visit them, found half of European and a quarter of U.S. offices to either not exist or to be unoccupied. CTD had bragged about its “patented” proprietary technology; the VGI analysts, combing government databases, couldn’t find the patents.

CTD issued a 14-page rebuttal (qualified with the warning, “For personal use only”), contesting some points, acknowledging others (certainly, it should “keep its website updated with its office locations”). It insisted, however, that it has earned margins that—for instance—its much bigger American rival, Egencia, a business-travel unit of Expedia Group, Inc., has not come close to matching.

The CTD share price, though down by 37% from a Sept. 4 peak, is nonetheless quoted at 29.1 times trailing earnings; the CTD market capitalization is still a formidable A$2.3 billion. Of the eight analysts who rate the company, six
say buy, none says sell. Twenty-seven consecutive fat years can make a bull out of just about anyone.

‘Really, just IOUs’

On the authority of Leon Black himself, the credit markets have achieved a state of bubbliness, the next-to-last stop in the expansion phase of the credit cycle. “The amount of covenantless debt is more than in 2007,” the co-founder of Apollo Global Management told the Goldman Sachs Financial Services Conference last week. “You have a thirst for yield that exists on a global basis. So there is true excess.”

Amen to that, we say. Suppressed interest rates and their crowd-pleasing corollaries, low default rates and high bond prices, have set the stage for panic, the final cyclical stop (after which, following an interlude of penitence, begins a new expansion). If the free-and-easy portion of the credit cycle is behind us, better days—at least, for the intrepid, value-seeking readers of Grant’s—may be at hand.

Credit is broadly at risk, we think, from investment-grade debentures to junk bonds to emerging-market debt to leveraged loans—perhaps especially loans, and still more particularly the exchange-traded funds that house those illiquid claims. Collateralized loan obligations, a.k.a. CLOs, are likewise in the cyclical cross hairs. Facts, figures and stratagems to follow.

Not the least of the troubles with floating-rate, senior, secured bank-like loans (the tradable kind incurred by speculative-grade business borrowers) is their appealing record. They shone in 2008 and led the credit pack in 2018. In a year when nothing seems to go up, leveraged loans have returned 2.5% to date, compared with -0.3% for junk bonds, -3.1% for emerging-market corporate bonds and -3.2% for U.S. investment-grade corporates.

Yet even that meager edge appears to be slipping away. On Dec. 11, the S&P/LSTA Leveraged Loan Index hit 95¾, a two-year low. The downtick may look inconsequential—the decline from the October reading of 98.7 is hardly a crash. Then, again, the well-informed leveraged-loan market usually doesn’t move without reason. Public companies report quarterly. Leveraged-loan borrowers report monthly—and those monthly reports, addressed to the creditors alone, are rich in detail, including internal financial projections. It’s to gain access to such fancy information that leveraged-loan asset managers have become sought-after acquisition targets for non-specialist money managers, Bloomberg reports; the acquirers want a peek at what the loan insiders are seeing. More likely, then, we judge, the recent softness in loan prices is an augury of something not bullish.

It’s nobody’s secret that the evisceration of covenant protection is among the loan market’s top risks (Grant’s, July 13). In the absence of the customary legal language forbidding the borrower from slathering on more debt, or from running up its fixed charges in relation to its earnings, creditors face a heightened likelihood of disappointment. Gone, in the cases of “covenant-lite” or—as Black put it—“covenant-less” loans, are the opportunities for midcourse corrections that covenant violations provided the creditors of yesteryear (and still provide the holders of fully armored loans today). You can hardly trip a covenant if none exists; and without the tripping, creditors are powerless to demand concessions from a borrower who’s running afoul of the interests of the senior claimants. “I’d like to say,” Peter Washkowitz, covenant analyst at Reorg Research, Inc., tells colleague Fabiano Santin, “that these debt documents are really kind of turning into IOUs at this point.”

In November, the percentage of credits showing a bare minimum of covenant protection, taken as a percentage of all leveraged loans issued by American borrowers, reached the unprecedented level of 79%. However, in view of persistently good credit experience, investors let the fact roll off their backs. In November, the loan-default rate reached a 13-month low of 1.61% on the afore-cited S&P/LSTA index. Including bonds, Moody’s calculates, the speculative-grade default rate for the 12 months ended Oct. 30 stood at 3.2% vs. a long-term average of 4.7% and a projected forward rate for the 12 months ending Oct. 30, 2019 of 2.3%. Then why worry?

We know a few reasons, including an interesting interest-rate wrinkle. CLOs, which hold 52% of broadly syndicated loans, are coming under margin pressure (Grant’s, Sept. 7). As you know, a CLO is a business on a balance sheet. To generate income, it holds leveraged loans. To finance those loans, it issues debt. Such debt rests on a thin wedge of equity. Both the interest it earns and the interest it pays reference the London interbank offered rate, though not identical maturities of that rate. A typical CLO earns interest based on one-month Libor; it pays interest based on three-month Libor. The difference is of no importance when the two rates align. But they don’t align today, as the three-month rate is quoted 18 basis points over the one-month rate. Hence the interest on the margins of the CLO managers: Instead of a 178 basis-point net interest margin, the average CLO is looking at a
140 basis-point margin, near a post-2008 low, according to Wells Fargo Securities, LLC. Things have come to such a pass that, in October, the Loan Syndication and Trading Association (LSTA) prayed for relief from the Volcker Rule to allow a CLO to diversify away from loans to bonds. All of which intensifies the friction surrounding the regulatory push to drop Libor in place of a new rate (which is another story for another time). Suffice it to say that, because CLOs are not so prosperous as they were to be, they are not such eager bidders for loans as they formerly were.

Late credit-cycle sightings abound. Thus, October brought a $540 million three-year-note issue from HC2 Holdings, Inc., a conglomerate with interests in undersea-cable servicing, structural steel, broadcasting, telecom, life sciences, insurance, energy and—to complete the corporate theme of miscellany—“other.” Led by Philip A. Falcone, HC2 is chronically unprofitable, with a share price ($3) and debt ratings (Caa1/ single-B-minus) to match that record.

“Only 1% of HC2’s assets are available to support the notes,” Santin observes. “As to the ratio of debt to earnings before interest, tax, depreciation and amortization, it stands at 15.5 times as conventionally calculated, and at half that much for any who would play the game of ‘EBITDA add-backs’—inflating that already dubious, non-GAAP metric with so-called pro forma cost savings, projected synergies, etc.”

Give HC2 this much: Its notes credit boasts maintenance covenants requiring minimum liquidity of $200 million, a minimum interest coverage ratio of 1.5 times and a maximum leverage ratio of 4.25 times debt to EBITDA. So far, so good.

However, in 2017, before its McDermott tie-up, CB&I incurred charges of $870 million related to immense cost overruns on a pair of gas-turbine projects and on another pair of LNG-terminal projects. How to account for these financial and operational bruises? Here the narrative takes a slightly technical turn (readers impatient for the how-to-short-narrative takes a slightly technical turn: (Continued on page 8)
Bring in the unicorns

Credit Creation

Business activity is cooling. You can see it in commercial and industrial loans, and in money aggregates, whose growth has slowed to a virtual standstill (see table to the right). You may have also noticed a trend in economic releases: disappointment. The Citi Economic Surprise Index for the United States, which measures how economic data stack up against expectations, has declined to negative 7.1 from a 2018 high of positive 80.7 on Jan. 4.

Before a car rolls out of a General Motors Co. factory or Whirlpool Corp. assembles a washer, manufacturers have to buy resins, pigments and other chemical inputs. The American Chemistry Council tracks this and more with its Chemical Activity Barometer (CAB). The year-over-year change in the CAB dropped sharply to 1.4% in November from an average of 4.1% in the first nine months of the year.

The Street is belatedly getting the message. Analysts have cut estimates for 2019 profit growth for the companies comprising the S&P 500 to 8.2% from 10.2% two months ago.

Cue the unicorn stampede. Last week, Uber Technologies, Inc. and Lyft, Inc. filed confidential paperwork with the Securities and Exchange Commission for their respective initial public offerings. The ride-hail outfits join the ranks of highly valued private...
companies such as Palantir Technologies, Inc., Slack Technologies, Inc. and Airbnb, Inc. with plans to go public next year. Uber has dubbed its IPO plans “Project Liberty,” according to The Wall Street Journal, “a sly reference to the thousands of employees and investors who have waited years to sell their full stake in the company for a profit.”

Having lost $1.07 billion in the third quarter, Uber is not on track to show positive earnings before a prospective 2019 offering. So, to boost the odds it gets a good price, the company is angling to get bigger. Already an investor in the dockless-scooter company Lime, Uber has held talks in recent weeks to acquire Lime and/or competitor Bird Rides, Inc. according to the Journal. The dockless-scooter business may, in fact, be rougher than the cutthroat ride-hailing business. More than 200 of Scoot Networks’ 650 scooters, for instance, were destroyed or stolen within two weeks of the company’s October launch in San Francisco.

Perhaps the IPO window has already closed. Moderna, Inc., a money-losing biotech company, went public last Friday at an initial price of $23 per share, valuing the company at $7.6 billion. By the end of its first day of trading, shares had sold off by 19%.
in the private-equity world—see the enlivening sagas of retailers J. Crew Group, Inc. and PetSmart, Inc. (Grant’s, July 13 and Sept. 21).

On Sept. 18, Marble Ridge Capital, the creditor with the boxing gloves, wrote to Neiman’s board of directors alleging that the distributions may have constituted “intentional and constructive fraudulent transfers,” triggering a default under the indentures of senior notes due 2021. Marble Ridge further contended that, prior to the transfers, the borrower was nearly 10 times leveraged, which is to say, insolvent.

Neiman Marcus, snubbing Marble Ridge, has started to restructure negotiations with a select group of lenders owning a “material portion” of the senior notes due in 2021 and the secured credit facility. To the secured lenders, in return for their assent, management is offering additional liens, seniority on unencumbered ground leases, a 25 basis-point boost in their interest rate. To the unsecured lenders, management is dangling the offer to repurchase, at par, $250 million of senior notes (trading at 50 cents on the dollar), in exchange for more truculent and less privileged lenders—Marble Ridge, for instance—they would get nothing, not even the recourse to which they were entitled under the (for now) functionally dead-letter debt agreements.

Perhaps,” Santin speculates, “Marble Ridge—as well as other less ‘material’ creditors of Neiman Marcus—will finally be shut out of the clubby restructuring group. If so, they will surely not be the last to be so marginalized. Passive investors, too, may one day find themselves on the outside looking in. And if disaster ever did strike the passive investing vehicles, the less liquid kind would not be the last to feel it. Retail funds and ETFs make up 16% of the leveraged-loan investor base, while they represent close to 40% of the high-yield bond market, according to Bank of America Merrill Lynch. The Invesco Senior Loan ETF (BKLN on NYSE Arca), with $6 billion of assets, and the iShares iBoxx High Yield Corporate Bond ETF (HYG on NYSE Arca), holding $13.8 billion, constitute Exhibits A and B.”

Adam Schwartz, paid-up subscriber and founder and chief investment officer of Black Bear Value Partners, L.P., a two-year-old fund managing mainly his own money, is using long-dated put options to short ETFs holding speculative-grade debt. “The primary thing,” Schwartz tells Santin, “is that you have a lot more debt, a lot lower expectations for defaults because that has been the case for the last five years with rates being low. You have spreads near all-time tights, and you have covenants that are nonexistent. Lenders don’t really totally understand that they have very little in the way of protection.”

The work of redeeming and creating shares in ETFs is performed by so-called authorized participants—the APs exchange ETF shares for the underlying securities, and securities for shares; it is their arbitrage that’s intended to keep share price and asset value aligned. What puzzles Schwartz is the contradiction between the liquidity of the ETF shares, on the one hand, and the substantive illiquidity of the ETF assets, on the other. Junk bonds do trade, even if by appointment. Loans, too, trade by appointment, though even less frequently than bonds, and settlement routinely takes a week or more. Bond ETFs, at least, can count on APs to try to keep asset values and share prices in sync. No such mechanism exists for loans—the market isn’t deep enough to allow it.

“I can’t understand for the life of me, and no one has explained to me, where [the APs] are going to sell those cash bonds and what happens if the liquidity in the cash bond market gets strained,” says Schwartz. “What I can see happening is this: People think that they have a very liquid instrument that is backed by very illiquid assets, and for the time being it is fine and works okay and the markets usually work. But if there is a large amount of selling at the ETF level which requires a large amount of unit redemptions at the issuer AP level, the APs are going to require a larger and larger discount to NAV and that in turn is going to create more panic and selling by the investors. Which, in turn, leads to more selling and the need for liquidity by the AP.” Schwartz is saying that he’s short across the spectrum from high yield to leveraged loans, emerging markets and investment grade.

A bearish bet against emerging-market bonds may also be worth consideration. You can implement it against the iShares J.P. Morgan USD Emerging Markets Bond ETF (EMB on the Nasdaq), which holds $14.9 billion of the kind of assets you wouldn’t choose for your mother’s portfolio. “If you look at the holdings list for EMB, in the top 11 you have 1MDB, which is caught up in the middle of all this fraud stuff; you have Iraq, which is a war-torn nation; you have Ecuador, which in 2015 paid a bond on time for the first time in its 180-year history,” Zach Truesdell, co-founder and portfolio manager of Matador Global, tells Santin. “And the yield on the EMB is 4.8%, and its spread to Treasurys is at its narrowest...”
ever.” Like Schwartz, Truesdell says he prefers to operate with long-dated puts rather than shorting the stock outright.

At-the-money puts dated Jan. 21, 2021 against BKLN (quoted at $22.37) at the strike price of $22.00 are offered at $2.45. Out-of-the-money puts against the HYG at a strike price of $80 (quoted at $83.04) ending on Jan. 17, 2020 are offered at $4.30. Puts on EMB (trading at $104.14), with a strike price of $96.00 and an expiration of Dec. 20, 2019, can be had at $2.25.

“I don’t know if this happens,” says Schwartz. “This is a bet where if I think I’m right, then I want to make a lot and if I’m wrong, then I lose a little. It is very hard to predict what has been virtually a 25-year cycle of easy money. What that means when the government stops buying bonds, when the ECB stops buying bonds, when China stops buying our bonds, I don’t know. Anyone who says they know, please give them my phone number, because I don’t know. It is very uncertain.”

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**Year-end review**

“Ignorance, madam, sheer ignorance,” forthrightly replied Samuel Johnson to a critic who asked him to explain how he could have erred in defining the word “pastern” in his famous dictionary (it is not, as he wrote, the knee of a horse, but a portion of the leg closer to the hoof).

Registered subscribers will find an annotated list of our 2018 investment ideas, longs and shorts, profitable and otherwise, on the Grant’s website (just type www.GrantsPub.com/2018performance). Evan Lorenz and Fabiano Santin have done more than identify hits and misses. In many cases, their notes describe what went right or wrong and how the Grant’s outlook has changed, if at all.

In general, our shorts have fared better than our longs—small consolation, we understand, for the majority of our readers who would no sooner sell short a bond or stock than cross the Brooklyn-Queens Expressway while blindfolded. Let Mr. Bear do his work, and we will happily emphasize the long side of the market. Meantime, we will continue to call them as we see them—after all, the paid-up subscribers expect nothing less.

As for interest rates, we said “higher,” and higher they have gone (see the issues of Dec. 15, 2007 and Feb. 9, 2018). Concerning gold, we similarly said “higher,” but lower—a little—it has gone. Then, again, against the 4.4% fall in gold in the year to date, bitcoin has tumbled by 76.7%. It’s a moral victory, to be sure (again, see the Dec. 15, 2017 issue), but, to adapt a line from President Trump, we like the ones that go up.

**Governmental leaf blowers**

“It looks like there’s liquidity,” Zhiwei Ren, portfolio manager at Penn Mutual Asset Management, tells The Wall Street Journal, “but once you try to catch it, it goes away.”

Perhaps it was ever thus. Let the selling cascade, and the market-makers can’t hear the jingling telephones (or their digital equivalents). And that was before Dodd-Frank and the intercontinental regulatory crackdown.

The governmental assault on market liquidity is the topic under discussion. In preview, we contend that attempts to shield regulated financial institutions from harm have succeeded in shifting risk but not eliminating it. If the banks are less vulnerable, the financial markets are more so. A tweet, an interview and a speech set the journalistic wheels in motion.

“In recent years,” Deutsche Bank A.G. tweeted on Nov. 29 following a police raid on the head office to search for evidence of complicity in money-laundering, “we have proven that we fully cooperate with the authorities—and we will continue to do so.” To judge by the clear implication that 75% of Deutsche Bank’s book value is worthless (the price-to-book ratio of the largest German bank is 0.25), institutional submission to the will of the authorities may have become the core competence of the $1.6 trillion behemoth.

A week after the police dropped in, DB’s front office ruled that employees must secure company consent to trade ETFs (they must already request permission to buy or sell individual stocks). We draw no connection between the raid and the rule except to observe that “compliance,” in all its forms, is nowadays the dominating presence in big, cartelized
As for Deutsche Bank, news reports over the weekend fanned speculation of a state-sponsored merger with the partially nationalized Commerzbank (the government acquired a 15% stake in a 2009 bailout).

The regulators are up in the driver’s seat worldwide. Here in America, the managing director of one of the Federal Reserve’s primary dealers tells colleague Evan Lorenz what it’s like to do business these days. “What’s been happening over the last, say, two years,” our (necessarily unnamed) source relates, “is the way regulators have been fining dealers. . . . The power of compliance people internally has grown because the regulations have been so worry about incurring the wrath of regulators, incurring additional fines. The level of fines are undefined and typically set to be punitive. If you get on the wrong side of the regulators’ cross hairs, you are at risk of getting a fine of many multiples of whatever you made in that business.”

A year or so ago, the CEO of a Nordic bank was quoted as saying, approximately, “The point of banking can’t just be to prevent bank failures.” Oh, yes it can. In New York, our source relates, it’s come to the point that dotting i’s and crossing t’s is taking precedence over serving clients.

On trades not cleared through a central counter-party, the Dodd–Frank Act requires banks to inform the client, before money changes hands, of the mid-point between the bid price and the asked price. “Our compliance guys have taken the opinion that it is not good enough to show them a two-way price and say 7 to 7 ¼ and assume the guy can calculate 7 ⅛ is the mid,” our informant explains. “You actually have to label ‘mid is 7 ¼’ and you can’t [just] label it ‘mid is 7 ⅛.’ You have to label it ‘DFA mid is 7 ⅛.’

“That is what they want us to do,” he continues. “They sit here, and they audit us. They will come up with, ‘These three trades don’t appear to have ‘Dodd–Frank mid’ on them,’ and say, ‘Can you dig up the communication?’

Of course this trade is from a month ago, so the guy on my desk, instead of covering his client, is spending the last hour looking through his chats and his emails to determine what the conversation was around this transaction.”

Box-ticking costs money, of course. And to save the money with which to tick—for instance, the boxes concerning money laundering and the rules laying down the mandate to “know your customer”—banks have been jetisoning marginal clients. Thus, in early 2015, JPMorgan Chase & Co. set out to lose around $100 billion in institutional deposits—the depositors were too small to pass muster. Our source relates that his bank has culled customers who failed to generate a certain threshold of interest-rate-related trading income. Still, they were customers.

The scourge of “e-learning” is another reason for even high-level financial-services employees to dread the office. Pre-crisis, it was enough for a would-be sales representative to achieve a passing grade on the Financial Industry Regulatory Authority Series 7 exam. Now even old hands must complete dozens of hours-long courses—on local banking rules, the Dodd–Frank Act, etc.—and pass numerous bespoke quizzes. “The anti-money-laundering unit I’ve done so many times I have it memorized,” our source confides. “I’m not a dumb guy. I have to do it each year. It is insulting.”

Primary dealers, barred from trading for their own account (the Volcker Rule) and beset by rules requiring more capital (the Supplemental Leverage Ratio) and more high-quality, liquid assets (Liquidity Coverage Ratio), have stepped back from market-making. Filling the breach are such high-speed proprietary firms as Virtu Financial, Inc.

Federal Reserve Governor Lael Brainard, in a speech the other day at the Federal Reserve Bank of New York, said that, in the 12 months through July, such prop firms accounted for 21% of trading in Treasurys and made up the majority of trading on interdealer platforms. How did they do it?

“Proprietary trading firms trade for their own account rather than that of a client, which places them outside of FINRA’s jurisdiction and many other forms of oversight,” Brainard said.

Are we better off or worse off on account of it? Grant, for argument’s sake, that the Dodd-and-Franked banks are safer than they were before 2008. Is the bond market similarly improved? Brainard offered reasons to doubt it: “The pattern of a spike in trading volumes followed by a persistent decline in market depth has been characteristically of three recent market turmoil episodes: 1) the Treasury flash rally on October 15, 2014; 2) the flash crash in the British pound on October 7, 2016; and 3) the spike in the VIX on February 5, 2018.”

Her presentation included a graph of intraday Treasury trading volume during the VIX tumult in the first week in February. After the volatility spike of Feb. 5, trading volume in Treasury securities was sawed in half. In difficult markets, traders (high- or low-frequency) still have trouble picking up the phone.

Naturally, the biggest banks are the ones that can afford to comply with burgeoning federal regulations. Thus have the Washington rule-makers succeeded in digging an even deeper moat around the too-big-to-fail institutions. Until 2017, exactly two firms, Bank of New York Mellon Corp. and JPMorgan, administered the tri-party repo market.
In 2017, Morgan exited, leaving Alexander Hamilton’s 18th-century start-up as the sole intermediary in the $2 trillion funding market.

“Pushing trades onto central counterparties (CCPs), which require maintenance margin as trades decline in value, was thought of as a way to prevent the near failure of American International Group, Inc.” Lorenz observes. “So Dodd–Frank has nudged more trading on CCPS. This is much to the benefit of CME Group, Inc., the biggest CCP in Treasury futures. On Nov. 2, CME acquired Nex Group plc, the biggest dealer-to-dealer exchange in Treasurys. The transaction, said the press release, makes CME ‘the leading global markets company across futures, cash and OTC’ trading.”

Under the incentives created by federal regulation, risk is concentrated in fewer and fewer closely regulated firms. It will be instructive to see, during the next crisis, if the governmentally blessed survivors can contribute to functioning markets.

As leaf blowers disperse leaves but do not remove them, so financial regulators shift risk but do not destroy it. At least, you can see the leaves.

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*Tropical-storm warning*

Fabiano Santin writes:

Optimism reigns supreme in Brazil following the election of extreme right-wing president Jair Bolsonaro. Since Sept. 6, when then-candidate Bolsonaro was stabbed and his electoral lead cemented, the Ibovespa Index has been up by 20% in U.S. dollar terms. Investors, however, aren’t pinning their hopes on Bolsonaro so much as on Paulo Guedes, his University of Chicago-educated finance minister.

As national solvency is contingent on a pension reform, the question before the house is whether Bolsonaro and Guedes can pull it off. Anything can happen, perhaps especially in Brazil, but new political complications certainly do not help.

The surge in pension expenses is pushing the country’s general government gross debt to 88.4% of GDP by year-end, from 62.3% in 2014. That is the least of it. Brazil’s actuarial deficit (present value of projected pension liabilities less carrying assets) amounts to an additional 233% of GDP, thereby pushing combined indebtedness to no less than 321% of GDP. (For comparison, America’s actuarial deficit, combining the Social Security shortfall with state- and local-pension unfunded liabilities, is estimated to represent 99% of GDP.) As pension expenditures have hamstringed the government, Brazil’s recovery will be dependent on private investments, more specifically, on foreign private investment.

Pension reform requires a constitutional amendment, which, in turn, requires a three-fifths vote of Congress. Previous governments have tried and failed, in part because of historically heavy congressional representation of public workers that benefit the most from the pension system. Shrewd President Michel Temer had built support for a successful vote when, on the evening of May 17, 2017, bribery allegations against him emerged. Pension reform died, Temer’s re-election chances died and the real plunged by 9% on the following day, the currency’s largest move in 14 years.

Now come revelations about the incoming president which locals are aware of—and unconcerned about—but foreigners may not fully comprehend. Over the years I’ve seen plenty of evidence and allegations of corruption in Brazil that fade into oblivion, and this could well be the case. But the details are impossible to ignore because the all-important reform may end up costing Bolsonaro his political capital.

Bolsonaro, 63 years old and a 28-year veteran of the federal Chamber of Deputies, has sponsored 171 bills and enacted two. He has never built significant political alliances, and his aloofness, even after his election, could make it difficult to pass the reform. Corruption allegations would prove unwelcome.

Earlier this year came news questioning the rapid rise of the Bolsonaro family’s wealth, including that of three of his sons, who are also elected politicians in the state of Rio de Janeiro and in federal legislatures. To date, the clan mostly has skirted those concerns.

Last month, seven Rio de Janeiro state legislators, colleagues of the president’s eldest son, Flavio, 37, were arrested, accused of receiving bribe payments for political support of former governor Sergio Cabral, who has been in jail since November 2016.

On Dec. 6, Fabricio Queiroz, Flavio’s long-time driver and bodyguard, was flagged by a local watchdog for suspicious financial transactions, including a payment that ended at the bank account of the first lady (Bolsonaro’s third wife). The driver’s wife and two daughters have worked in different cabinets of the Bolsonaros. A less-than-satisfactory and delayed response ensued.

The suspicion is that Queiroz was responsible for a kickback scheme—seven other members of Flavio’s cabinet transacted with the driver—which may have been used for political campaigns or direct payments to the Bolsonaro family. It’s a “common, but illegal” practice in the legislative, according to the local press.

Anything’s possible, and not all of it’s bullish.

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Bring in the unicorns

Business activity is cooling. You can see it in commercial and industrial loans, and in money aggregates, whose growth has slowed to a virtual standstill (see table to the right). You may have also noticed a trend in economic releases: disappointment. The Citi Economic Surprise Index for the United States, which measures how economic data stack up against expectations, has declined to negative 7.1 from a 2018 high of positive 80.7 on Jan. 4.

Before a car rolls out of a General Motors Co. factory or Whirlpool Corp. assembles a washer, manufacturers have to buy resins, pigments and other chemical inputs. The American Chemistry Council tracks this and more with its Chemical Activity Barometer (CAB). The year-over-year change in the CAB dropped sharply to 1.4% in November from an average of 4.1% in the first nine months of the year.

The Street is belatedly getting the message. Analysts have cut estimates for 2019 profit growth for the companies comprising the S&P 500 to 8.2% from 10.2% two months ago.

Cue the unicorn stampede. Last week, Uber Technologies, Inc. and Lyft, Inc. filed confidential paperwork with the Securities and Exchange Commission for their respective initial public offerings. The ride-hail outfits join the ranks of highly valued private companies such as Palantir Technologies, Inc., Slack Technologies, Inc. and Airbnb, Inc. with plans to go public next year. Uber has dubbed its IPO plans “Project Liberty,” according to The Wall Street Journal, “a sly reference to the thousands of employees and investors who have waited years to sell their full stake in the company for a profit.”

Having lost $1.07 billion in the third quarter, Uber is not on track to show positive earnings before a prospective 2019 offering. So, to boost the odds it gets a good price, the company is angling to get bigger. Already an investor in the dockless-scooter company Lime, Uber has held talks in recent weeks to acquire Lime and/or competitor Bird Rides, Inc. according to the Journal. The dockless-scooter business may, in fact, be tougher than the cutthroat ride-hailing business. More than 200 of Scoot Networks’s 650 scooters, for instance, were destroyed or stolen within two weeks of the company’s October launch in San Francisco.

Perhaps the IPO window has already closed. Moderna, Inc., a money-losing biotech company, went public last Friday at an initial price of $23 per share, valuing the company at $7.6 billion. By the end of its first day of trading, shares had sold off by 19%.
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