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Final last gasp?

When Britain's pound sterling was as good as gold, His Majesty's government thought itself fortunate to be able to borrow at 3% in perpetuity. That was in 1751. Now that the pound is as good as pixels, George Osborne, chancellor of the exchequer, has announced his intention to avail himself of the opportunity to refinance those ancient 3s at interest rates even lower than 3%.

Trying to comprehend the 21st century's affinity for digital wampum, on the one hand, and ultra-low bond yields on the other, monetary historians of the future will scratch their heads till their brains ache. They will conclude, as we do here and now, that the world was bond mad.

"Whither rates?" is the question of the hour. Lower and lower, says Van Hoisington, the great bond bull, with whom we spoke on Monday (Hoisington's fund was up 32.6% last year; over the past 10 years it has delivered 8.62% a year vs. 4.71% for the Barclays Capital U.S. Aggregate Bond Index). Lower and lower in a crescendo of panic, say we. More from Hoisington below.

"Economists don't forecast because they know," quipped John Kenneth Galbraith. "They forecast because they're asked." Each month, Bloomberg asks dozens of economists to forecast the 10-year Treasury yield over a six-month horizon. On Dec. 11, the date of the latest survey, 71 economists responded. Each and every one predicted higher yields. One hundred percent were bearish on bonds.

"One last gasp for Treasurys?" was the headline over the page one article in *Grant's* exactly one year ago. In it, we suggested that Treasurys might confound the bearish consensus (though only 86% of the economists were then bearish) with an unscripted rally.

With this sequel, "One final last gasp?" we come close to repeating ourselves. Treasurys will continue to rally in 2015, a move that will culminate in even higher prices and even lower yields. And that will be the end of the bond bull market that started on Oct. 1, 1981, say we (and not for the first time, let the record show).

Though we expect a blow-off rally in government securities, "bullish" on Treasurys we're not. Bulls want to own the objects of their desire. Your editor owns no Treasurys and wants none. He owns no sovereign bonds of any maturity. Long-dated Treasurys may be cheaper than foreign government securities of similar duration, and the United States may be John Winthrop's "city upon a hill." But the bonds of any government are promises to pay interest and principal in a currency that the issuing government either creates or (in the case of European borrowers) lends a hand in creating. As government-issued money tends to depreciate, so should—over time—the value of the government's promises.

One makes allowances for price and value. Even a goldbug could be bullish on 14% Treasurys (*Grant's*, July 16, 1984). By way of reciprocity, perhaps, even a bond bug might see the merits of gold today, given the fact that the virus of radical monetary policy is swimming in the global political bloodstream; what feats of money printing will the central bankers attempt next time? On Tuesday, the Swiss 3s of January 2018 were priced to yield minus 29.3 basis points. Principal continuously invested at that rate of return is halved in 236.2 years. So it has come to pass that sterile gold is a high-yielding asset.

On form, interest-rate markets are long-trending markets. In 19th century Britain, gilt yields fell for 80 years. In 20th century America, Treasury yields rose in the 35 years from 1946 to 1981. Yields have fallen in the 33 odd years since 1981. Well do we recall the blow-off phase of the great bond bear market. Though economists strained to

To duplicate 2014 returns, yields must plumb lower lows

bond	total return in 2014	2014 year-end y.t.m.	assumed year-end 2015 y.t.m.*
U.S. 10-year Treasury	10.6%	2.10%	1.17%
U.S. 30-year Treasury	28.9	2.73	1.60
German 10-year bund	14.9	0.38	-1.08
Mexican 100-year bond	21.7	5.32	4.58
10-year gilt	14.4	1.66	0.22

*to match 2014 performance
source: The Bloomberg

furnish reasons to explain why 15% was, after all, not so very high, given (for instance) the terrible Reagan fiscal prognosis, the real motive force in the bond market was panic. We wonder if the investment narrative spun today to explain the reasonableness of sub-1% yields on 10-year government notes will wear any better than the inflation-phobic yarns of the early 1980s.

These are historic times, we are certain. Chancellor Osborne's press release last month held out hopes for the prospective refunding of the perpetual 2 ½% securities issued in the fall of 1946 by the Socialist Chancellor Hugh Dalton. Cheap money was the cry on both sides of the Atlantic at the time. At Dalton's death in 1962, his eponymous 2 1/2s changed hands on a 6% basis. At the bottom in 1974-75, they had sold down to an 18% basis. "Daltons," those loss-producing pieces of paper were derisively called. The chancellor himself bought some; he died poor.

What's a fair yield for long-dated Treasurys? We put the question to Hoisington, who has held long bonds through thick and thin—mostly through thick—since October 1990, when they fetched 8 ¾%.

He replied with the proposition that inflation expectations are key. Look around the world, he said. You see a half-dozen countries whose 30-year debt trades at less than 2%—Denmark, Switzerland (0.541%), Japan and Belgium among them. "Their credits are in many cases much worse than ours. So you would argue that it's not the credit quality, but it's the fact that they have very low inflation and maybe some idiosyncrasies in those countries."

"So with that as a start," Hoisington went on, "what is the appropriate level for long-term rates in the United States? If the general trend which started in 2011 of lower commodity prices continues to be under downward pressure because of excess global capacity, then you would presume that U.S. prices would tend to have downward pressure as well. And you would assume that the stronger dollar, as everybody tries to get out of the muck around the world by devaluing their currencies against the dollar and the dollar continuing to appreciate, would put further downward pressure on prices. So we have a global phenomenon that is probably more impactful on the United States than in the past, and it seems to me to be pointed in the direction of downward pressure on prices. Whether that ends ultimately in 'deflation' is unknown, but certainly the prospect of a rapid rise in inflation seems, for the time being, not on the horizon."

In other words, "lower" is still the prevailing direction. Hoisington demurred on the notion that digital technology was a force for everyday low prices. Debt, however, he said, certainly weighs on prices: "We believe the fact that over-indebtedness of the United States and the world is contributing to the lack of global demand, because people have borrowed and spent, and that means they can't spend that money in the future, they have to try to repay it. And that's at all levels—corporate, individual, governments—and that is sort of an overarching restraint on economic activity. And the wonderful thing is that the Federal Reserve and other central banks can do nothing about it."

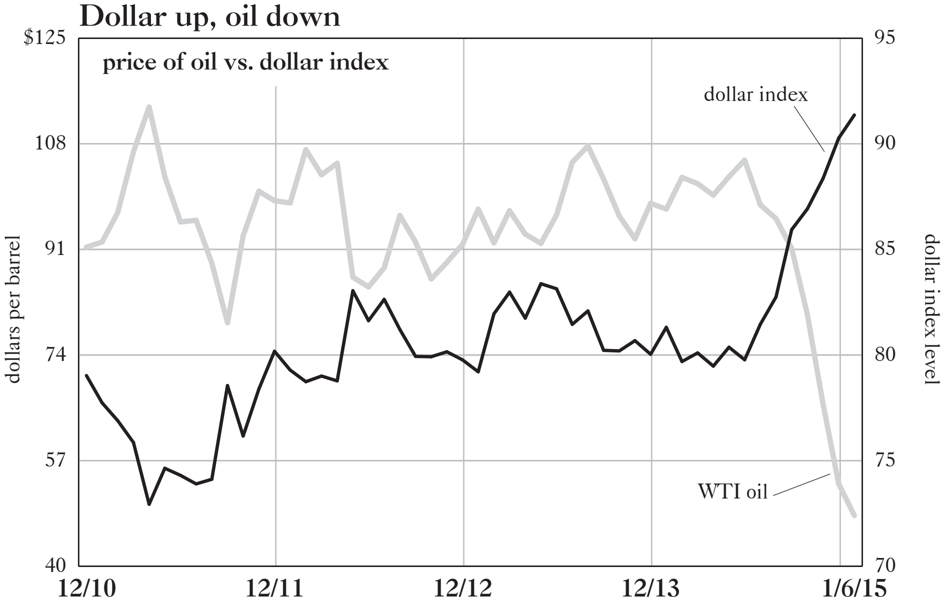
So more credit formation—induced by zero-percent borrowing costs—is not the way forward? we asked, leading the witness. "More debt is of course not the answer," Hoisington replied, "because it just brings forward consumption and makes it worse later, so they might be able to have a transitory improvement, but not a permanent improvement. The fact is, it seems to me, that the evidence in Japan and here in the United States that the effort to buy securities to help the system was counterproductive, and we would suppose if the ECB were unintelligent enough to try their own, that it would be equally unproductive. Somebody pointed out that almost all maturities are close to five years and they don't really have much long paper, so if they did do it, they'd be buying five-year notes, which are zero anyway. Or less than zero."

To duplicate the brilliant returns of 2014, 30-year Treasury yields would have to fall to 1.60%, 10-year gilt yields to 0.22%. "From a market standpoint," Hoisington commented, "with the Bloomberg survey continuing to show 100% of the economists forecasting higher rates for the umpteenth consecutive month, you have to assume the positions are still pointed towards people expecting higher rates, and for that reason the first part of this year could see really much lower interest-rate levels than anyone thinks possible, because of positioning in my opinion."

Assets under management at his firm ended the year at $6 billion, Hoisington related. Though it's a new high, clients are hardly breaking down the doors to get in: "Everybody still thinks rates are going up, and this would be a stupid time to invest in 30-year bonds."

Business activity is weaker than the Fed seems to know or to acknowledge, Hoisington went on: "We think this year will be slower than last year in terms of growth, and nominal growth will be noticeably slower. Real growth will be slightly slower. So when we see that, if the Fed were to raise rates in a weakening environment, which is what they would be doing, I think bond rates would rally...." And if the economy sur-

Dollar up, oil down



source: The Bloomberg

You pay them

source: The Bloomberg

prises to the upside? Even then, Hoisington said, the long end of the yield curve would probably rally: "It would be the last hurrah for a moment."

Our ears perking up at the phrase "last hurrah," we mentioned some of the signs of panic and—in the case of the proposed British refunding—of historic optimism we see. Is it possible that the market has overdone it?

"If you look back in United States history, our charts going back to 1870, the market spent a few years below 2%, but not much and not by much," Hoisington replied. "And so having 30-year rates below 2% seems to me to be excess. We're not there yet, but in a very short period of time we could be."

And if that were to come to pass, the collapsing energy markets would bear a good share of the blame (or, from the bond bulls' vantage point, credit). People understandably focus on the bulge in supply, said Hoisington; they should not overlook the evident crack in demand. "The demand curve can shift out and take these oil prices even lower than they are today, in our judgment," he went on. "And we think that has an enormous impact on economic activity. In 1986, 1985, we had oil go in round numbers from $40 to $10, maybe a little below that. We actually had a mini recession. I think they may have revised that away but we had one quarter down in 1986. So we think the drop in oil prices is a clear negative to the United States economy this year. The high-paying jobs were in the oil sector. We know that about one-third of the increase in capital spending over the last four years was due to oil, but there was a knock-on effect, so we figure instead of 30%, it's roughly 45% of the increase in capital spending was due directly or indirectly to this oil boom. So we think there's a major adjustment economically from this downtick in oil prices in the United States—it is going to be enormously disappointing over the next six to nine months."

Hoisington wound up on a note of prospective—underscore the word "prospective"—bond-bearishness: "If you get the right set of policies, things can turn around in a hurry," he said. "And people forget this. We've had this sort of pendulum swing towards overregulation, constraining small banks from lending, being anti-business, and it's possible the pendulum starts to swing the other way, and business has been lackluster for so long that, in my judgment, a shift in regulatory policy and tax policies could create a substantial boom by the private sector in the U.S. and therefore around the world. So I'm not overly pessimistic, but for the time being, we have anti-growth policies in place."

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Sincerely yours,

James Grant, Editor
August 19, 2015

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Not such a lock

(February 6, 2015) A wave of identity theft and computer-borne financial fraud has hoisted LifeLock—LOCK on the New York Stock Exchange—into the elite ranks of American growth stocks. "Elite" is no part of the LifeLock corporate story, *Grant's* is about to contend. On the company whose CEO famously paraded his own Social Security number in front of the TV cameras just to dare bad actors to steal it (which the taunted thieves actually proceeded to do), this publication is bearish.

Anxiety is LifeLock's stock in trade. If North Korea (let us say) can hack Sony Pictures Entertainment, and if JP Morgan Chase, Home Depot and Target are likewise vulnerable to digital intruders, which ordinary citizen is safe? Some 3.5 million Americans, deciding that they, at least, are unsafe, have signed on. In the 12 months through Sept. 30, LifeLock's revenues jumped by 30% from the year- earlier period. From 2007 through 2013, compound annual growth in the LifeLock top line amounted to no less than 64%; results for the final quarter and full-year 2014 are due on Feb. 10.

Between five and 15 million Americans are annually hacked, according to estimates by Forrester Research and the Department of Justice. "Let's assume," Richard Davis Jr., analyst with Canaccord Genuity, muses with colleague Evan Lorenz, "the only people who have any interest in this product is someone who actually had their identity hacked. So, that's seven million people per year. With LifeLock's churn, which is about 18%, they have to land about 1.2 million of that seven million, so they have to get 17% of those people in that narrowly defined universe of people who had their identities hacked. If that's all they won, a 17% win rate is not that bad. It's not like they need 50% to 60%."

The argument appears to have carried the day with all but one of the nine analysts who follow the company. The shares are valued at 28.9 times trailing net income and 22.7 times the 2015 estimate. Cash per share works out to $2.55; the balance sheet is debt-free. Not since going public in October 2012 has management produced a disappointing quarter. Boldface names—Goldman Sachs, Bessemer Venture Partners, Kleiner Perkins Caufield & Byers—furnished venture capital. Tom Ridge, former head of the Department of Homeland Security, sits on the board of directors.

What, exactly, does LifeLock deliver? Less than the "comprehensive identity theft protection" that it claims. The standard LifeLock protection plan, which sells for $9.99 a month, buys you notification if a credit card account (or mortgage or mobile phone application) is opened in your name. It promises assistance in canceling lost or stolen credit cards. It guards against attempts to tamper with your address. It scans Web sites for signs that someone is filching your vital data, and it blocks pre-approved credit card offers and offers a $1 million service guarantee in case of fraud. For the customer who wants to know if a registered sex offender has moved into his neighborhood or who demands instant notification of major corporate data breaches, higher and costlier levels of service are available. Except for a small enterprise division that verifies customer bona fides for corporate clients, consumer protection is LifeLock's beating heart.

You might suppose that the anti-identity theft industry is thriving. In fact, annual average top-line growth over the past five years amounted to just 0.5%, according to Sarah Kahn, analyst at IBISWorld. Revenue at the only other public company focused on identity-theft protection—Intersections Inc. (INTX on the Nasdaq)—slipped to $262 million in the 12 months ended Sept. 30, 2014, from $373 million in calendar 2011. Intersections markets through banks, where it has collided with the Consumer Financial Protection Bureau. LifeLock has had no such difficulty issuing ads to the hack-wary public.

Many a business in the Internet age has foundered in failing to compete with services that someone, somewhere can deliver for free. Perhaps such a fateful encounter awaits LifeLock. "Consumers can request their credit reports once

"Fiat, boys! I found fiat!"

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