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Revenge of the reciprocal

Finance is nothing if not symmetrical. There are assets, and there are liabilities. There is demand, and there is supply. For every policy yin, there is a policy yang. The unscripted consequences of post-2007 monetary intervention is the subject at hand.

We conclude, skipping right down to the bottom line, that radical policy is here to stay. We so judge because the Fed's newfound M.O.—ostensibly a bulwark against financial instability—is itself inherently destabilizing. Look no further than the life insurance business, the oil market or the pricing of "high-yield" debt. One episode of QE tends to set up a clamor for another, and then another. Besides, the mandarins demand, what's the harm? Where's the inflation?

A crack-up, say, in the European life insurance industry (brought about by Mario Draghi's vanishing interest rates) or a bankruptcy-inducing plunge in some oversupplied commodity market (instigated by producer access to ultra-cheap finance), would surely spark new rounds of aggressive central bank action. It would make no difference that the not-so-remote cause of the trouble was monetary policy itself. The Fed's functional dual mandate has become that of arsonist and fireman.

The central bank, though it is well aware of the existence of financial liabilities, never seems to mention them. Asset inflation is what the banks of Bernanke and Yellen set out to achieve. Unavoidably, they also achieved liability inflation, its reciprocal.

Like assets, liabilities have values, even if we customarily think of those values as burdens. The lower the discount rate, the greater the liability. The greater the liability, the more collateral it takes to satisfy the contractual commitment to pay savers, annuitants and pensioners, observes Sean McShea, president of Ryan Labs Asset Management. A simple example will illustrate. At a 6% yield, $1 million in principal will earn you $60,000 a year. At a 3% yield, you'll need $2 million to provide the same income. "The rising cost of retirement" is another way of saying "the rising value of liabilities."

The bull market in liabilities is the source of the bear market in life insurance. "Germany's life assurers: the next crisis?" was the headline over the April 21 *Financial Times* report on the gathering clouds over *Lebensversicherungsgesellschaften*, as a thrifty burgher would call the indigenous life business. Some 90 German life insurance companies with €900 billion of assets under management are panting for the interest rates that Mario Draghi's Europe does not provide. (On Tuesday, Bloomberg flashed news that an issue of securitized Spanish business loans had stopped paying interest because Euribor, the euro-denominated three-month interbank offered rate, had dropped below zero to minus 0.005%.)

"[G]uaranteed rates far outstrip today's meager investment returns," the *FT* reports of the German life companies. "Although new policy guarantees are capped by law at 1.25%, the long tail of policies—which typically extend for 30 years—means average guarantees are still running at 3.2%. Compare that with the 0.14% yield on 10-year bunds, and the tension becomes obvious."

The tension is pan-European. According to the IMF's new report on financial stability, or rather the lack of it, "more than half of European life insurers are guaranteeing an investment return to policyholders that exceeds the yield on the local 10-year government bond, thereby incurring undesirable negative investment spreads."

Which points to a "high and rising risk of distress" among mid-size companies, the IMF analysis continues. The failure of one could trigger a loss of confidence among many, "if the failure is believed to reflect a generalized problem. . . . The high and rising interconnectedness of the insurance industry and the wider EU financial system is another source of potential spillovers. The industry has a portfolio of €4.4 trillion in EU credit. Furthermore, insurers are traditionally closely linked to banks through liquidity swaps and bank bond holdings. . . . A large mark-to-market shock could force life insurers into asset reallocations and sales that could engulf the financial system." No surprise, then, that income-seekers have pushed half of euro-denominated BB-rated bonds—the highest rank of speculative grade, but still junk—to yields of less than 2%, according to the April 13 edition of the *Financial Times*.

The bull market in liabilities is raging on both sides of the Atlantic. In 2014, the defined benefit pension plans of the 100 biggest American corporations lost actuarial ground despite an average 9.2% gain in their average assets, according to the annual tally by *Pensions & Investments*. Liabilities gained more value than assets did, owing to a drop in the assumed average discount rate to 4.05% from 4.82% in 2013. People are living longer, too, but—as a matter of causation in the liabilities world—QE easily

trumps the revised mortality tables.

Radically easy money was supposed to expand aggregate demand by making the holders of assets feel richer. So stimulated, this vanguard of consumption would ostensibly spend until the economy achieved "escape velocity."

If theory said one thing, practice has revealed another. It's a world—to quote page one of Saturday's *Wall Street Journal*—"awash in too much of almost everything." Here was another kind of stimulus, no less effective because the central bankers didn't plan for it.

Oil, cotton, iron ore, labor and capital are all in surplus, the *Journal* reports, "a glut that presents several challenges as policy makers struggle to stoke demand." Like traffic and weather, or love and marriage, demand and supply are nearly inseparable. In trying to boost demand, the central bankers have inadvertently fired up production. Energy is Exhibit A.

Over the past decade, observes the new edition of Deutsche Bank's annual study of junk bond defaults, energy was the fastest-growing segment, both of America's economy and America's capital markets. "Energy issuers," according to the DB analysts, "now represent the single largest sector in the U.S. high-yield market, the second largest in U.S. investment-grade (after financials) and the third largest in U.S. equities." Without money both cheap and abundant, it is hard to imagine the shale revolution taking the shape it did—nor the price of oil taking the kind of pratfall it has.

Now, a low oil price may be a gift to humanity. A collapsing oil price in the context of a leveraged oil industry is another matter. So, too, is a collapsing oil price in the context of an idée fixe that "deflation" is a peril that must be met with aggressive reflationary action. Said action can't help but distort some of the prices that the mandarins didn't think to include in their macroeconomic modeling. More distortion, and greater instability lead to more intervention, i.e., to still more distortion and instability.

"The current state of plenty is confounding on many fronts," the *Journal* story continues. "The surfeit of commodities depresses prices and stokes concerns of deflation. Global wealth—estimated by Credit Suisse at around $263 trillion, more than double the $117 trillion in 2000—represents a vast supply of savings and capital, helping to hold down interest rates, undermining the power of monetary policy."

We wonder how much of this bruited cornucopia is "capital" and how much is debt. Capital is savings, or consumption deferred; you don't have to pay it back. Credit is like a library book; you must return it by the due date. As to the "power of monetary policy," we judge that it's just as potent as ever. The rub is the results it achieves. They're not always the ones the policy makers intended.

If the makers of QE meant to seed a bull market in junk bonds, they've outdone themselves. Jim Reid, Deutsche Bank's high-yield strategist, relates that so far as the 2010-14 cohort of high-yield debt is concerned, defaults are the lowest since the start of modern record-keeping in 1983. Practically (this is *Grant's* talking now), companies aren't defaulting because the market, priced as it is, won't let them, though the market may soon have to reconsider. At $50 per barrel oil or less, the DB analysts reckon, each and every high-yield oil and gas issuer rated single-B and below will register negative free cash flow.

The paucity of defaults is, to our mind, no badge of honor but another proof of policy gone wrong. In the capitalist forest, old growth must perish to let the new growth find the sunlight (without which the denizens of the forest soon find themselves speaking Japanese). Besides, businesses that survive solely by the indulgence of their creditors aren't destined to prosper once easy money becomes hard to get.

The Federal Reserve Bank of Boston has published a new paper which takes the view that the Fed ought not to abandon QE but keep it handy for the next cycle of distress. "The author's view," concludes author Michelle L. Barnes, a Johns Hopkins Ph.D. and senior economist in the bank's research department, "is that balance sheet tools in practice have led to benefits not available from using the federal funds rate tool alone, particularly because none of the feared costs from using these newer tools have yet materialized." Be patient, we would counsel in this context; "feared costs" can take their own sweet time to materialize (as Paul Singer was quoted as saying in these pages two weeks ago).

"To add value to society," Barnes proceeds, "the best action that the Fed can undertake is to do what is needed to execute appropriate policy, however that end is reached. Foregoing the use of potentially valuable policy tools because such tools are unconventional and the full cost and benefits as yet unknown seems to miss the point entirely. . . ."

Radical improvisation works, the economists cry. Let us therefore have more of it. And there will be more—on this, at least, *Grant's* and the Ph.D.s see eye to eye.

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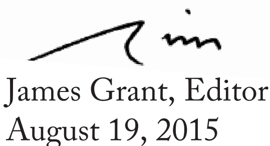

James Grant, Editor
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Not such a lock

(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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