GRANT'S
INTEREST RATE OBSERVER®
Vol. 33, No. 08b Two Wall Street, New York, New York 10005 • www.grantspub.com APRIL 17, 2015

Radical negative one

David Einhorn, long-short equity investor par excellence, led off the *Grant's* spring conference with a long idea (AerCap) and a short-sale idea (athenahealth). He prefaced those stock picks with a grand tour of interest rates, such as they are. "I remain of the view," said the founder and president of Greenlight Capital, "that higher rates will surprise by improving the economy on Main Street even though it is quite possible they would create some turbulence on Wall Street, as most equities are now highly priced and a select group are in a bubble."

What has the ground-hugging, post-2007 yield curve contributed to the cause of national prosperity? Less than nothing, Einhorn reasoned. The Fed had counted on the "wealth effect" to boost consumption and to raise up economic growth. Though the stock market has tripled over the past six years, growth is stuck at 2%.

"Low interest rates make workers save more," Einhorn proposed, "as they can't anticipate earning safe income on savings. They also make retirees spend less, as they have less current and future income and need to stretch savings over their remaining lives. Both dynamics create less spending and a slower recovery."

Did interest rates fall, or did someone push them? Some contend—a blogger named Bernanke is especially persistent—that rates are low because the rate of return on capital is low. Inflation expectations, too, sit at ground zero. Central bankers may influence nominal money market interest rates, he keeps saying, but they don't control real long-term yields.

Einhorn admitted that the recent commodity-price spill had taken him by surprise. "It has turned out," he said, "that over several years, sharply rising commodity prices and low interest rates created a boom in investment and excess supply in everything from iron ore to oil. Lackluster demand has failed to keep up with this growing supply and, ironically, it turns out that the loose monetary policy put in place by central bankers to fight deflation has, in fact, contributed to it."

In the case of $3 trillion of European and Japanese sovereign debt, yields don't hug the ground but rather burrow beneath it. "Logically," our speaker continued, "interest rates should always be positive. People should prefer a dollar today to something less than a dollar in the future. If you have a dollar, you can literally avoid negative rates by sticking it under the mattress. Tempur-Sealy may be a long. Negative rates are like the square root of negative one: they exist in theory but no one is supposed to be able to see them."

You do wonder, Einhorn mused, who's investing at yields of less than zero. A short-term trader might buy with the expectation of flipping his position to the European Central Bank, which has pledged to buy bonds at yields as low as its minus 0.2% deposit rate. "I think the more interesting question is why do long-term investors who bought sovereign bonds for the income continue to hold them at negative yields? Why not sell and capture all the future income and then some today? Why continue to take duration risk, liquidity risk and even credit risk without any compensation?"

Regulation is the reason. Negative yields surprised the governments as much as they did investors. Bankers husband sovereign debt, even at vanishing yields, to satisfy the new "macroprudential" banking rules. To pass regulatory muster, bankers are making the most curious demands on their customers. For instance:

—to switch unwanted deposits into securities that the bank can hold in custody;
—to take out loans to buy government securities;
—to transact through off-balance sheet derivatives such as swaps;
—to replace physical positions with synthetic look-alikes, collateralized by government securities.

"None of these changes make banks safer or benefit the customers," our speaker went on. "They raise costs, reduce liquidity and add leverage and counterparty risk." As banks begin to charge the public for the privilege of making a deposit, customer satisfaction, too, will become a casualty of the new regulatory climate.

"There's a limit to this, of course," Einhorn said. "At some point banks will decide it's cheaper to hold physical currency in their vaults than it is to maintain excess deposits at central banks. Correspondingly, customers can decide they would rather hold cash than pay for the privilege of depositing money. We are paying attention to a possible transition from banks rejecting customers to customers rejecting banks."

As with banks, so with insurance companies. Under "Solvency II," a

European Union directive intended to harmonize insurance regulation across the Continent, government bonds carry a lower capital charge than cash. It doesn't matter if the yields are positive or negative; sovereign debt is judged to be inherently safer than money. Thus, if it sold a negatively yielding debt to hold cash, a European insurance company would incur a capital charge. The persistence of negative yields on longer-dated European debt may be a paradox, Einhorn pointed out, but—once you understand the regulatory arrangements—it's hardly a surprise.

"Monetary policy and regulations have combined like a failed chemistry experiment to create a potentially destructive force that should not exist outside of fiction," Einhorn concluded the macro portion of his talk. "I think this adds to the ultimate attraction of holding gold instead of green."

On, then, to AerCap Holdings NV, the Ireland-headquartered, New York Stock Exchange-listed aircraft lessor (the ticker is AER). No less than 40% of the global airline fleet is leased today, up from 2% in 1980, said Einhorn: "Many emerging-market airlines lack good access to capital markets and bank financing. Leasing allows them to finance fleet growth. Other airlines lease to access newer planes without taking residual value risk."

AerCap has compounded its book value per share by 19.6% per annum since the company's November 2006 public listing, said Einhorn. It earns not quite 7% on assets and more than twice that much on equity. It takes pains to manage credit risk, proof of which is that, from 2007 through the credit crisis and into 2013, annual defaults averaged just 2.5%. Annual losses were still lower, averaging only 0.2%.

Opportunism is another strong suit. Thus, when AIG decided to sell ILFC, its trouble-plagued aircraft leasing subsidiary in 2013, AerCap had the will and the way to buy the cast-off at a 16% discount to its appraised fleet value and at less than half of its adjusted book value.

Yes, the share price has advanced, Einhorn said, but the P/E multiple—8.8 times the 2015 estimate—has barely budged: "All told, in an expensive market this appears to be a cheap stock."

Einhorn's analysis of athenahealth (ATHN on the Nasdaq) took the form of an update from the short pitch he had delivered at the Ira Sohn conference last May. "We called athena a bubble stock because its shares had gone parabolic even as its fundamentals deteriorated," said Einhorn. "At the time of Sohn, even though the stock had rolled over, it still traded at more than 100 times forward earnings that are adjusted to ignore stock compensation expense."

"Athena," Einhorn went on, "has a long history of deteriorating earnings estimates. Over the last year, estimates have continued to decline [the share price is little changed]. This is true for both GAAP and adjusted earnings. On a GAAP basis, EPS has declined over the last three years, and the company currently operates at a loss."

"Like many companies," Einhorn continued, "athena has learned that if Wall Street counts cash compensation but not stock comp, it may as well pay its people in as much stock as possible."

But look at this, said our speaker, displaying an excerpt from the athena cash-flow statement: "athena wants everyone to back out the stock compensation because it is a 'non-cash' expense. Yet, it pays out cash taxes as part of its stock compensation scheme. At $28 million, that's more than the company's entire free cash flow."

The colorful Jonathan S. Bush, CEO of athenahealth, starred in a number of video clips that Einhorn played. They brought down the house.

•