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Revenge of the invisible hand

"Data-dependent" the Federal Reserve might be, but interest rates depend on many things, as Ben S. Bernanke obliquely acknowledged at his already famous press conference last week. "Well, we—we were a little puzzled by that," said the chairman in response to a question about the surprising (to the Fed) leap in yields. "It was—it was bigger than can be explained, I think, by changes in the ultimate stock of asset purchases within reasonable ranges, so I think we have to conclude that there are other factors at work as well, including, again, some optimism about the economy, maybe some uncertainty arising."

Interest rates, causes and consequences, is the subject at hand. Subsidiary points of focus include monetary management and—a somewhat lengthier topic—monetary mismanagement. Our plan of action is to place today's turmoil in historical context: to review the dramatic events of recent weeks from the vantage point of an impeccably fair and temperate critic of the Ph.D. standard of monetary administration (that would be your editor), and, most important, to propose a course of investment action suitable for the occasion. Only last month, stocks and real estate and other income-producing assets were capitalized for a 2% 10-year Treasury yield. But if 2% was a fake rate of interest, the valuations deriving from 2% were likewise ersatz. The world is making adjustments.

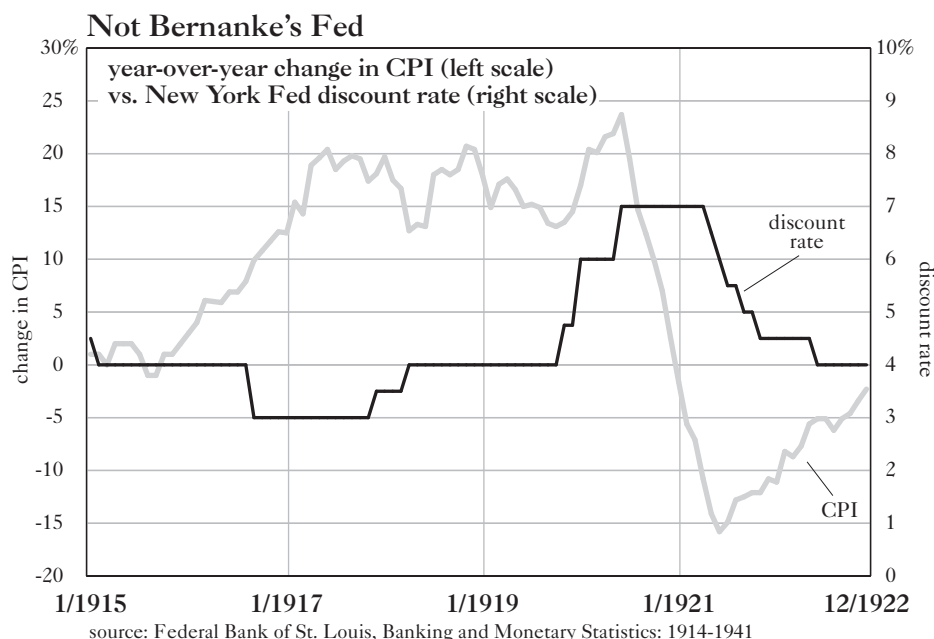
For the sake of his always fragile mental health, Mr. Market might recall a relevant precedent to today's

bond upheaval. The action occurred more than 90 years ago when the Federal Reserve, not old enough to know better, pulled the rug out from the inflated American economy. In so doing, the rookie central bank set in motion a short, sharp deflation, out of which sprung a great booming prosperity. The similarities between that episode and today's are instructive. More so are the differences. Understanding each may help a stunned investor to regain his or her bearings.

ZIRP, QE and Twist are many things, but they're not unprecedented. In 1917, President Woodrow Wilson's central bank entered into the now familiar business of suppressing market interest rates. Its purpose

was not to stimulate but to subsidize; the Treasury was borrowing billions to finance America's participation in World War I. While the government funded itself at an average of 3.12% in 1917, consumer prices climbed at upwards of 18%. The war stopped short on Nov. 11, 1918, but the subsidized borrowing continued.

There were the usual inflationary side effects of leverage, misdirected investment and speculation. The purchasing power of the dollar reciprocally plunged, though about this fact posterity may scratch its head. Was the United States not then on the gold standard? Yes, it was—in name. Was the dollar not convertible into gold at the option of the holder at the



statutory rate of \$20.67 to the ounce? Again, yes, but only in the law.

The spirit of the gold standard was subordinated to the exigencies of wartime finance. Most important, gold was prohibited from leaving the country (the free movement of money was the essence of prewar monetary arrangements). Then, too, citizens were enjoined not to exchange paper dollars for their gold equivalent. The word had gone out that hoarding bullion was unpatriotic. The gold standard was legally in place, but functionally suspended.

So American finance in 1918-19 anticipated modern finance. The Fed was captive to something besides the soundness of the dollar. And the dollar itself was, temporarily, for the duration of the emergency, in substance if not in name, a mere piece of paper. As briefly noted in these pages two weeks ago, Wall Street responded to artificially low interest rates, as Wall Street has done today, by pushing up asset prices. What bore no resemblance to anything seen today was the Fed's response to the evident excesses.

There was in 1919, however, no agonized indecision about the monetary "exit," no Reserve Bank presidents on opposite sides of the policy question duking it out on CNBC. The Fed passed through the door and didn't look back. Its exit strategy was the restoration of the spirit, as well as the letter, of the gold standard.

Could any decision have been less enlightened, more barbarous? Not to the sensibility of the 21st-century central banker. Critics of the gold standard condemn most of all its supposed rigidity. And they are right to the extent that the system allowed the Ben Bernankes of yesteryear only so much discretion. As long as the dollar was lawfully convertible into gold by someone at a fixed rate (as late as 1971, foreign governments enjoyed the right of convertibility at the rate of \$35 to the ounce), the Fed's hands were at least partially tied. QE, plainly, would have been a non-starter. An overstimulating central bank could spark a run on its government's gold reserve. And this was true in all phases of the business cycle. The Fed was no more a free agent at the bottom of a depression than it was at the top of a boom: Job No. 1 was to protect the gold parity of the currency.

Consider, then, the dilemma of the Fed and of the markets in 1919-20.

The war was over, but wartime inflation still roared. Imagine yourself in the shoes of a leveraged commodity and interest-rate speculator as he watched the gradual restoration of prewar monetary discipline (which, incidentally, occurred in tandem with the return of federal fiscal discipline). He liked the idea of sound money but not its consequences. He favored the restoration of good old-fashioned, non-inflationary finance, but not just yet.

So he observed uneasily in June 1919 as the Wilson administration suspended the wartime restrictions on the free movement of gold. Now free to go or stay, the monetary metal decided to go; there were greener and more stable pastures abroad. Here was an unwelcome contractionary development. And at about this time, the Fed regained its abridged freedom of action to raise its discount rate—or, more exactly, the freedom of the various Reserve Banks to raise their discount rates, for each set its own. No more was the central bank the financing arm of a warring state. It could, within the confines of its remit to protect the gold value of the currency, adjust America's borrowing costs.

The fathers of the Federal Reserve System saw to it that a Federal Reserve note was anchored by gold and other eligible collateral to a minimum of 40% of its face value. So in 1919, too, the Fed had a "mandate." And, in 1919, too, the Fed was "data-dependent," though the data on which it depended for policy guidance—gold and eligible collateral in hand, first and foremost—bore not one iota of resemblance to today's macroeconomic statistics. In fact, the very word "macroeconomic" was yet uncoined.

Up, then, went the various Fed discount rates—this was in November 1919—and down went the Dow Jones Industrial Average, the stock market easily comprehending how bearish was the end of an era of free and easy credit. As interest rates continued to rise, commodity prices began to fall, the Producer Price Index plunging by two-fifths from the 1920 top to the 1921 bottom. Yields on prime corporate bonds climbed to 5.56% from 4.71%. Between November 1919 and June 1920, the New York Fed lifted its discount rate on three different occasions by a total of 300 basis points—right in the teeth of a depression.

In pulling the rug out from under the speculators, the Fed also upended the farmers and industrialists who had overextended themselves on the mistaken assumption that prices would continue to rise. In suppressing interest rates, the central bank had distorted the structure of production and speculation alike. Tricked by the artificial prices and yields, General Motors rashly overexpanded as the forerunner to today's Citigroup rashly overlent (though, with Citi, to judge by subsequent history, its rashness might have been inbred).

Something like this dynamic is at work today, though without a preceding war-induced inflation. The normalization of interest rates—if, indeed, that is what's happening—may be a necessary step forward, but no one roots it on except, perhaps, the bears and various life insurance annuity departments.

What happened next in 1919 is something that today's central bankers have virtually taken a blood oath to prevent. Following the inflationary boom came a deflationary depression.

According to the dating methods of the National Bureau of Economic Research, the expansion peaked in January 1920 and the contraction troughed in July 1921. Out of a nonfarm labor force of 31.5 million, unemployment topped out at "between three million and five million," according to the none-too-exact official estimates. That was as precise as the figures got, though nobody doubted that joblessness was a severe and urgent problem. Still, the Fed tightened the screws, for the first and only time in its history setting a discount rate that was higher at the business cycle bottom than it had been at the expansionary peak.

To Chairman Bernanke, deflation is the evil most to be feared. To his functional predecessor in 1920, Benjamin Strong (who, though he headed the Federal Reserve Bank of New York, overshadowed the chairman of the Federal Reserve Board, W.P.G. Harding), deflation was a necessary corrective to the preceding inflation. A former comptroller of the currency, John Skelton Williams, assailed "the tragedy of artificial 'deflation'" and charged the Fed with gross and unforgivable malpractice. Modern historians, notably Milton Friedman, Anna Schwartz and Allan Meltzer, side with Williams.

Bernanke, too, is a Williams man. But many contemporaries defended the forced de-leveraging. Among these prototypical "austerians" was Benjamin Anderson, the excellent house economist at the Chase National Bank, at the head of which bank's successor sits Jamie Dimon today.

Late in 1921, after the business-cycle bottom was in, Anderson defended the new central bank before the St. Louis Chamber of Commerce. The depression was notable for the absence of a banking crisis, he pointed out. Somehow, despite titanic real yields (more than 8% nominal lending rates overlaid on collapsing wholesale prices), there was no panic. And though the economist could not have known, 1922 would bring a vibrant economic recovery.

"It is misleading to talk about the business cycle in explaining present conditions," Anderson told his hosts. "It is not an ordinary cycle we have been through, but rather something partaking of the nature of a cyclone. The gold dollar has a remorseless way of taking vengeance on those who treat it disrespectfully, and when the abnormal forces which had generated and maintained the boom began to slacken, the speculators who had gambled on a 'permanently higher price level' had to face a day of reckoning."

In so many words, Anderson maintained that the price mechanism—Adam Smith's invisible hand—was, and ought to be, the regulator of employment and production. And it would regulate by the uncompromising yardstick of a dollar "remorselessly" defined in gold value. Employers and employees would have to adjust themselves to the dollar, because the dollar was not going to adjust itself to them.

Now it's the dollar that adjusts. And the dollar—being uncollateralized and costing nothing to produce—would seem to be eminently adjustable. No more is the Fed bound by the restraints of gold or eligible collateral, only by the "data," and it isn't really bound by them, either. Its constraint, if constraint it be, is rather the way it chooses to interpret the data. "The Federal Reserve has fallen short of meeting its employment and inflation objectives," William C. Dudley, president of the Federal Reserve Bank of New York, said in Basel, Switzerland, the other day, advancing his own inter-

pretation of the data. "This suggests that with the benefit of hindsight, U.S. monetary policy, though aggressive by historic standards, was not sufficiently accommodative relative to the state of the economy." If the Ben Strong Fed was "fettered" by gold, the Ben Bernanke Fed is pretty completely unfettered. Nowadays, "cyclones"—to use Anderson's term—bring forth not deflation but money printing.

For all the changes that 90-odd years have wrought, interest rates are still the prices by which investors measure evident risk and prospective reward. From which it follows that repressing, manhandling or otherwise manipulating interest rates is fraught with risk. The 1920 Fed, seeming to acknowledge that fact, chose to tighten even in the face of falling prices. The 2013 Fed, now seeming also to acknowledge the same fact, says it may tighten. Or, rather, that it will likely not lift its funds rate until 2015 and that it may or may not choose to reduce the gait of its money printing by 2014. The economy will sooner or later outgrow its need for monetary nostrums, Bernanke assured the press the other day, but when is a matter of judgment, not the calendar.

Now comes a test of wills as much as of ideas or policies. In 1920-21, the Fed appeared deaf to its critics (though Chairman Harding did throw a punch at former Comptroller Williams during a heated moment in a congressional hearing). Paul A. Volcker hardly flinched in the early 1980s. But a succession of market interventions in the next 30 years has almost institutionalized flinching. In 2013, the Fed seems to do nothing but listen, its principal critic bring none other than Mr. Market. The question before the house is whether the Fed has the courage of even the mild convictions its chairman conditionally expressed two Wednesdays ago.

Under Alan Greenspan, the Fed's reflexive intervention to stop panics before they started took the name, "Greenspan put." And now there's a Bernanke put, still more explicit than the Greenspan model because the Fed is overtly putting the speculative cart in front of the economic horse. It is, or has been, attempting to revivify the economy by boosting asset prices. This technique, doing business as the "portfolio balance channel," is supposed to raise real activity by lifting speculative

activity. Enrich the people with brokerage accounts, and they, in turn, will consume more and, ultimately, finance more. You wonder if, having sponsored the bull markets, the FOMC doesn't feel a responsibility to sustain them.

If so, the central bankers have their work cut out for them. Since mid-May, observes subscriber Gary Bialis, the price of the five-year Treasury note has tumbled by some \$3,000 per \$100,000 face amount, or by more than three times the \$830 in interest that the note had been priced to deliver before the world changed. Relative to income, Bialis speculates, it might be the greatest price decline in modern fixed-income annals.

Stocks, junk bonds, closed-end bond funds, gold, emerging markets' debt, emerging markets' currencies and commodities: All have gone through the wringer, of course. From the trenches on Friday came a telegraphic hair-raising report about the liquidation in municipal securities:

"The last 4 trading sessions has seen high grade 10y tax-exempts trading 75 bps wider than Monday and some bidsides have been off as much as 100 bp. Many factors are contributing: fund outflows, huge size BWICs [Bids Wanted in Competition] from fund groups that are receiving very poor bids, big forward new issue calendar, month-end/quarter-end, etc. No real buyer has popped up yet. Have seen some Crossover action early in the day bidding down 40-50 bps from the night before and getting hit. Insurance companies will come in and nibble at these higher rates but nothing substantial. We are unclear what will stop the sell-off."

What stopped the deflationary liquidation of 1920-21 was the price mechanism. Investors returned—gold and consumers returned, too—when things got cheap enough. And in this era also, some things will certainly get cheap enough. Whether or not the 10-year Treasury, quoted at around 2.6% on Monday afternoon in New York, is cheap enough, it may be over-sold enough; not since February 1980, according to Bialis (whose technical commentary concerning the five-year Treasury ornamented the May 31 issue of *Grant's*) has a government security at the 10-year point in the yield curve been more oversold.

This, of course, is an observation for

the short term. For the longer term, we ask: Will the Bernanke Fed, or, for that matter, the Zhou People's Bank of China or the Carney Bank of England be prepared to wait for the invisible hand to do its constructive work before intervening to head off the crisis they thought they had smothered five years ago? We speculate not.

You have imagined yourself in the place of a Harding-era speculator in government securities. Now please put yourself in the seat of Chairman Bernanke. You, Bernanke, a scholar of the Great Depression, have staked your reputation on fending off deflationary Armageddon. You are a little sensitive about the word "helicopter," and you would like to hear less grumbling on the sidelines from Paul A. Volcker. Still, you do not underestimate the gravity of a potential worldwide interest-rate crisis. It would be deeply embarrassing to reverse course now—indeed, you ask yourself, what course would these petulant markets *have* me reverse? The harmless bit about maybe, one day, not buying \$85 billion of securities every month? But personal dignity is not your paramount concern as you near what may very well be the end of your term at the Fed. You pick up a phone reluctantly, but still you dial. "Hello? Is this Jon Hilsenrath? The chairman here. We at the Fed have reconsidered a few things. . . ." Meanwhile, the monthly purchases—effected with dollars that didn't exist until the Fed conjured them on its magic computer keyboard—continue unchecked.

The scenario of retreat from tapering, or even from the expressed thought of eventually tapering, is our favored scenario, but our preference does not necessarily improve the odds on its happening. There are many other scenarios to consider, naturally. For instance, the interest-rate genie might irretrievably have escaped from the bottle. It's all very well for the Fed to predict a strengthening economy (the Fed usually does, after all). But higher rates are the fact, prosperity is the hope and, at that, a hope diminished by the turbulent action in bonds, stocks, mortgages, commodities and currencies.

In the meantime, there's money to be invested. The present moment is hard enough to parse. How does a value-seeking and risk-averse investor think about the future?

We make three different approaches

to the subject. They entail mortgage real estate investment trusts, emerging markets (specifically, a pair of richly valued South American banks) and gold-mining equities, the unspeakable.

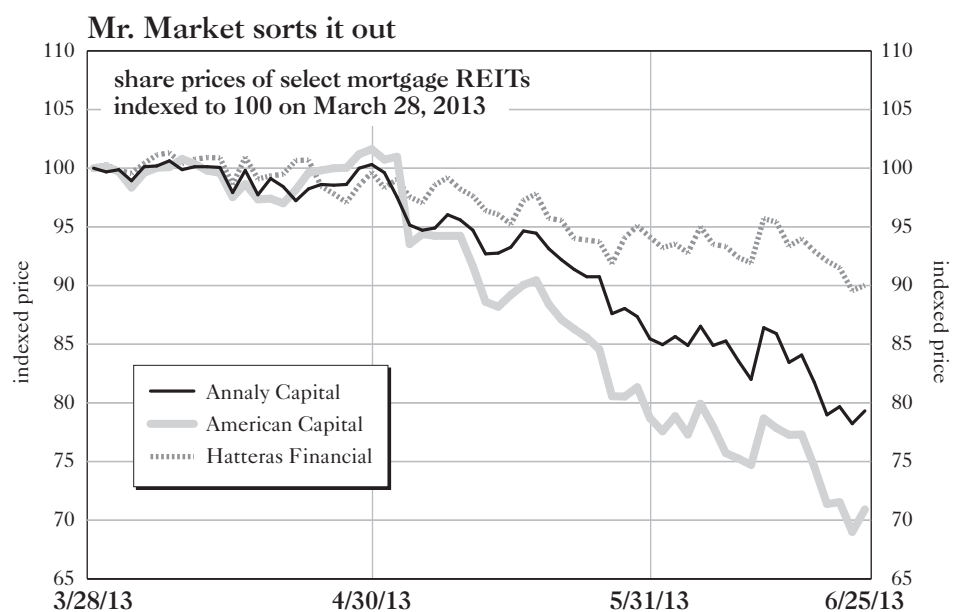
Friday, the final business day of the quarter, is judgment day for the mortgage REITs. It's the day they mark their portfolios to market to determine second-quarter book value. The extent of the markdowns will partly depend on the vicissitudes of a single day's trading.

"Brutal" would be a gentle characterization of the quarter. As compared to share prices prevailing on March 31, American Capital Agency Corp. (AGNC on the Nasdaq) has fallen by 29% and Annaly Capital Management (NLY on the New York Stock Exchange) by 20%. Before the Fed intimated that it might not be buying mortgages and Treasuries forever, AGNC was paying a quarterly dividend of \$1.25 a share, Annaly a quarterly dividend of \$0.45 a share. One week ago, each company slashed its payout, AGNC to \$1.05, NLY to \$0.40. The steady Eddie of the mortgage REIT family, Hatteras Financial Corp. (HTS on the Big Board), which mainly owns adjustable-rate mortgages, says it will not only continue to pay at the rate of \$0.70 a share but may also purchase as many as 10 million shares of HTS in the open market, of which not quite 100 million are outstanding.

As the cost of a dollar of income went up and up, so did the value of what the mortgage REITs had to offer. They were the right stocks in the right place at the right time. But the glimmering of the possibility of a close to the yield famine has changed matters. As the cost of a dollar of income has fallen, so have the REIT stocks. The question before the house is whether they have become cheap enough to attract the seasoned taker of a businessman's risk. Our answer is, "Yes, approximately."

Mortgage REITs, as constant readers know, resemble S&Ls but without the tellers and drive-thru windows and deposit insurance. They are leveraged. They own mortgage-backed securities, which they hedge with options, interest rate swaps, and/or with short sales of Treasuries. Good for the REITs and their shareholders are steep yield curves, low funding costs and stable bond prices. What the tumult of the past two weeks has begun to deliver is a steep yield curve.

If the garden-variety MBS is a kind of options bomb, volatile and explosive, the fault rests with the entitled American mortgagor. On the one hand, let interest rates fall, and he or she rushes to refinance. On the other, let interest rates climb, and he or she sits tight. In the first case, the mortgagee loses an appreciating asset (it is called away). In the second case, the mortgagee is stuck with a depreciating asset (it stays in the portfolio where it isn't wanted). Thanks a lot, Mr. and Mrs. America.



"They make nice presentations and put in good charts in their handouts and how things should turn out, but I want to get a sense of how it actually worked in this environment before I jump in," so a wise hand in mortgage REIT investing summed up his current approach in conversation with colleague Evan Lorenz on Monday. Our investor, who asks to go unnamed, was referring to, among other things, interest-rate hedges. Granted, there's no such thing as a perfect hedge, but just how imperfect are the ones in place at the likes of AGNC, NLY and HTS?

Necessarily, there are cracks between which the shareholders' money can and does fall. While a conscientious risk manager can protect against adverse movements in interest rates, he or she cannot so easily hedge against "basis" risk. By basis is meant the relationship between MBS, on the one hand, and the instruments employed to hedge those MBS, on the other. Since the end of the first quarter, the yield on Fannie Mae 3s has jumped by 0.99%, while the yield on the 10-year Treasury has risen by 0.76%. The difference, those 22 basis points, spells loss for some REIT investors.

Consider, Lorenz suggests, the case of AGNC. "It holds a portfolio of primarily fixed securities (92% of the total) and had hedges with a notional value equal to 73% of the investment portfolio at quarter's end," he relates. "Rising yields lift the value of the hedges while deflating the value of the MBS. As of March 31, AGNC lever-

aged each dollar of equity with \$8.10 of debt. That is, for every 1% drop in the value of its earning assets, AGNC's equity would fall by 9.1%. Assuming that hedges worked perfectly (hah!), AGNC would lose only 1.3% on the aforementioned 3% Fannie Mae bond on account of the rise in rates. But after taking the change in basis, or spread relationship, into account, the loss would be 3.3%. Factor in leverage, which was so pleasing on the upside, and the ding to book value could be 29.9%. Underscore, please, 'could.' AGNC's portfolio consists of more than Fannie Mae 3s, of course, and AGNC's management may have managed leverage or hedges in ways that could mitigate or magnify losses over the quarter. So while the AGNC share price has dropped by 29% since March 31, book value might have fallen by that much or more."

"Spreads are wider," Gary Kain, president and chief investment officer of AGNC, tells *Grant's*, "prepayment fears are dropping. The yield curve is steeper. We are seeing a lot more banks come in and be a bigger factor versus where they were earlier. When we piece that all together, it makes for a pretty good total return environment both in terms of stated earnings and much tamer prepayments, even though prepayments weren't that big of a deal for us."

We at *Grant's* wish to commend Mr. Market on his discernment in valuing AGNC, NLY and HTS. Encompassing leverage and portfolio composition,

it seems to us, the stocks are just about where they ought to be (barring, of course, an outright, terminal collapse of the bond market).

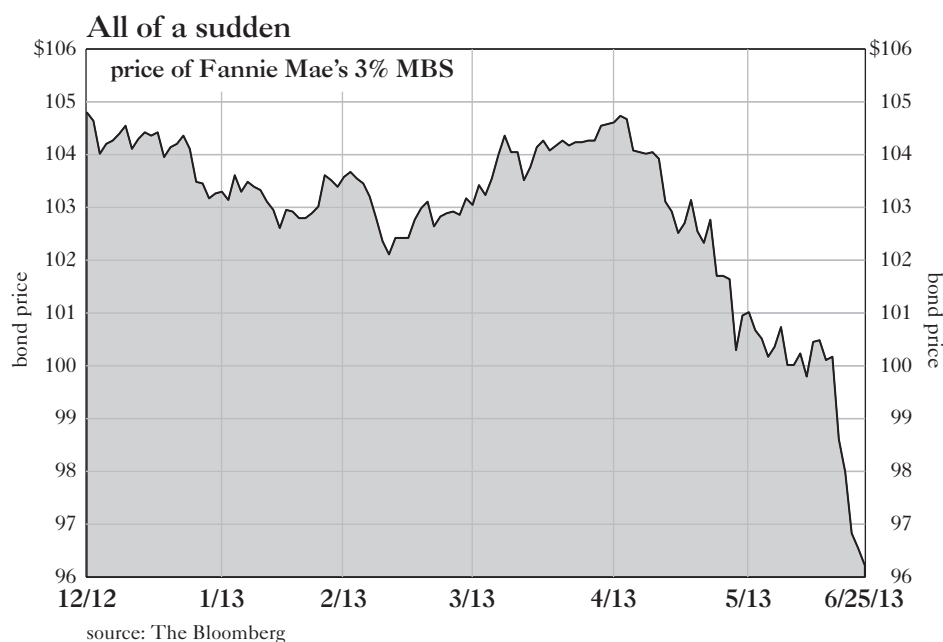
In the issue of *Grant's* dated May 17, we asked and answered a question: "The best balance between risk and reward at the current iffy juncture? We'll take Hatteras." So would we today, though any persuaded that interest rates are headed down again would probably favor AGNC or NLY.

Hatteras CEO Michael R. Hough tells *Grant's*, "I've been saying for a while that I'd love to see a higher yield on the 10-year—not necessarily for the marks—but because it would be good for the adjustable-rate mortgage market in particular. Prepayments would slow with the steeper yield curve and ARM origination as a percentage of total originations would pick up. That would be good for our assets and for putting capital to work. I don't think I wanted it to happen this quickly in an illiquid market. Wherever it settles in, I think we will have a steeper yield curve, which we always welcome."

It's as sound a doctrine in finance as it is in obstetrics that the knee bone is connected to the thighbone. Distorted American interest rates make their intoxicating presence known the world over. China's manic lending and borrowing have consequences well outside the People's Republic. The connective tissues stretch even to South America.

As short-sale candidates, we present the No. 1 bank in Colombia, Bancolombia SA (CIB on the New York Stock Exchange), and the No. 1 bank in Peru, Credicorp Ltd. (BAP, also on the Big Board). At a glance, you wouldn't necessarily jump to a bearish conclusion about either one. Equity as a percentage of assets amounts to 9.7% for Bancolombia and 11.1% for Credicorp (compared to 8.7% for JPMorgan, for instance); allowances for loan losses cover rising levels of non-performers by 255% at Bancolombia and 131% at Credicorp.

Then, too, neither Colombia nor Peru has attained that advanced stage of economic development in which everyone is in hock. "You have 25% loans to GDP in Peru and around 30% to 35% loans to GDP in Colombia,"



says Francisco Pereyra, a Raymond James financial analyst. "That's compared with 80% with Latin American countries like Chile, and 120% to 140% for more developed countries. So you have a lot of room for expansion, and mainly in the consumer and small and medium enterprise portfolios."

But the foreground of this story is more attractive than the background. Both home countries, Colombia and Peru, have ridden the coattails of the China-led commodity cycle. Both are reliant on exports (they contribute 24% and 41% of the respective countries' GDP). Both run current account deficits, i.e., both buy more from the world than the world does from them. Capital imports finance the difference. But, a question: What happens when the suppliers of capital, properly spooked by the deterioration in China, as well as by rising interest rates, decide to withhold their capital? In that case—it is, in fact, today's case—a deficit-running country must export more or import less. "No easy thing," as Lorenz notes, "as commodity prices have fallen and China's economy has downshifted. It becomes mathematically difficult to export a greater value of goods. So the adjustment falls on imports and on the foreign exchange rate. Year-to-date, the Colombian peso and the Peruvian sol have fallen by 8.2% and 8.4%, respectively, against the dollar. Here's a financial double negative: First, a falling demand for goods implies a shrinking demand for

credit. Second, earnings, when translated into dollars, are reduced."

Bienville Capital Management, whose insight we borrow, is short the equity of both banks. "What's happened over the last couple of years," says Bienville's Mark Bower, "is that growth has been strong, but it has been increasingly financed by outside capital flows, mainly emerging markets' bond funds here that are just chasing yield. . . . We think if those capital flows reverse or even just slow down, and commodity price pressure keeps building, liquidity will have to go away and growth will have to slow."

Even before the 10-year U.S. Treasury yield took up mountain climbing, economic growth was slowing. In the first quarter, Colombian GDP growth registered an annual rate of 2.8%, down from 4% in 2012 and 6.6% in 2011. The Peruvian GDP expanded at an annual rate of 4.8% in the first quarter, down from 6.3% in 2012 and 6.9% in 2011.

What has not stopped growing are the banks. "Credicorp has 25% to 30% year-over-year expansion in expenses," Pereyra relates. "They plan to double the size of the bank by 2016 in the number of branches, and you know that the maturity of reaching the break-even of those branches and everything takes time." As for Bancolombia, it expects to close on a February purchase of HSBC Holdings' Panama branch for a cash consideration of \$2.1 billion (with a concomitant reduction, by an

estimated three percentage points, in its Tier 1 capital level).

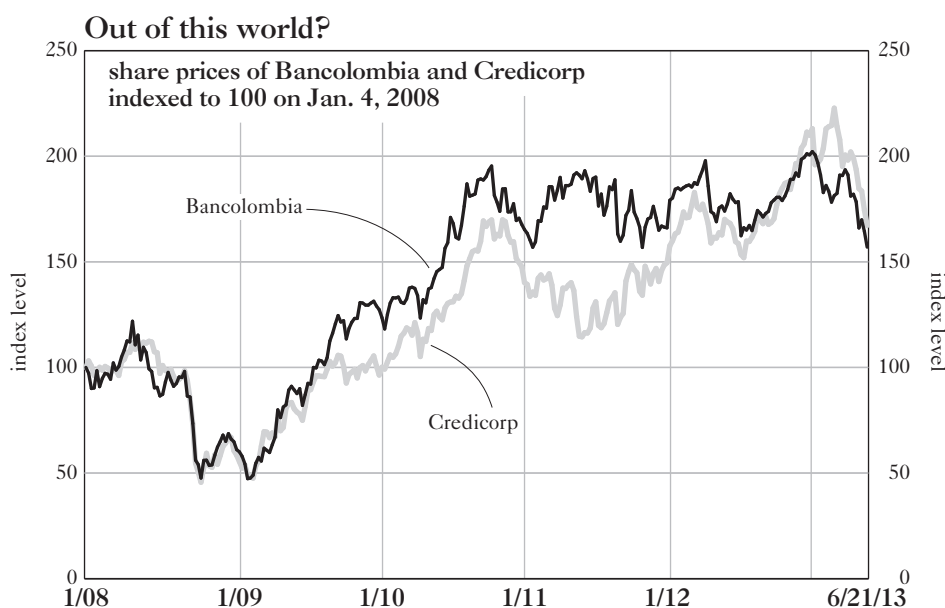
While Bancolombia's share price has fallen by 18% and Credicorp's by 15% in the year to date, neither would seem to be discounting the kind of world in which interest rates can double in less than a month. Thus Bancolombia is quoted at 189% of book and 12.8 times trailing net income; the shares yield 3%. Credicorp trades at 238% of book value and 12.6 times earnings; it pays a dividend yield of 2.1%. Each, all things considered, dwells closer to heaven than it deserves to.

There's a troubling circularity about post-2007's "unconventional policies." You don't just do a little QE, it turns out; you have to keep going. Writing in the London *Daily Telegraph* on Tuesday, Ambrose Evans-Pritchard reported that Italy will "likely" need a bailout within six months, as rising bond yields imperil the solvency of highly leveraged Italian companies. In evidence, Evans-Pritchard quotes a confidential client note from a Mediobanca analyst: "Time is running out fast. The Italian macro situation has not improved over the last quarter, rather the contrary. Some 160 large corporates in Italy are now in special crisis administration."

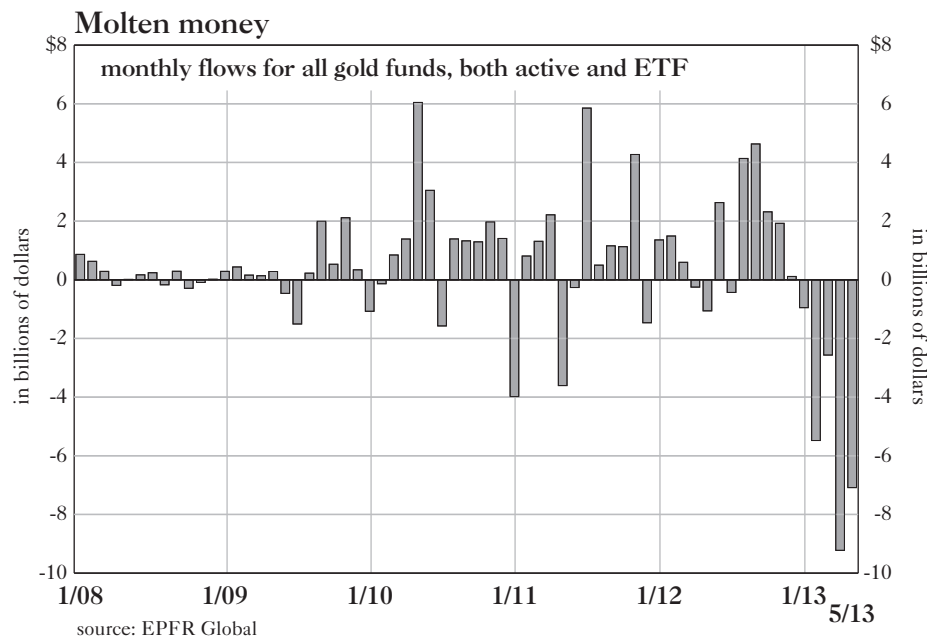
"Monetary policy works, at least in part, by providing incentives to households and businesses to bring forward spending from the future to the present," according to Mervyn King, who this week departs as governor of the Bank of England. "But that reduces spending plans tomorrow. And when tomorrow arrives, an even larger stimulus is required to bring forward yet more spending from the future. As time passes, larger and larger doses of stimulus are required."

And what if, as we believe, QE and ZIRP do not stimulate but, on the contrary, depress? Then greater and greater doses would do greater and greater harm until they shattered the market's confidence both in paper money and in the people who can't seem to stop printing it.

Neither your fondest hopes nor worst fears usually come true, Joe Rosenberg, chief of speculation at Loews Corp., is wont to say. But central bankers are doing things they've never done before. They may succeed or they may not. All



source: The Bloomberg



can acknowledge that there is a broad range of possible outcomes, including, for the gold buyer, his fondest hopes and, for the holder of dollar bills, his worst fears, namely, in both cases, a big fat monetary crisis. Possibly, therefore, the gold bull market is poised to resume. It would comport with the perversity of markets if a proper washout—testing the sincerity of even the truest believers—preceded a truly delicious payday.

Anyway, *Grant's* continues to carry a torch for the metal that nowadays goes down on bad news, good news and no news (though it does go sideways on Saturdays, which is a blessing). And while gold has fallen by 24% this year, the typical gold stock has dropped by twice that much. On cable TV, talking heads seem locked in competition to register the strongest bearish view of the metal or the stocks. In real life, investors yank money from the funds. Through May 31, withdrawals from gold funds, actively managed and ETF, totaled \$25.3 billion. To put this flight into context, 2008—a year almost as wretched for gold, and certainly more wretched for everything else—delivered a net inflow of \$1.8 billion.

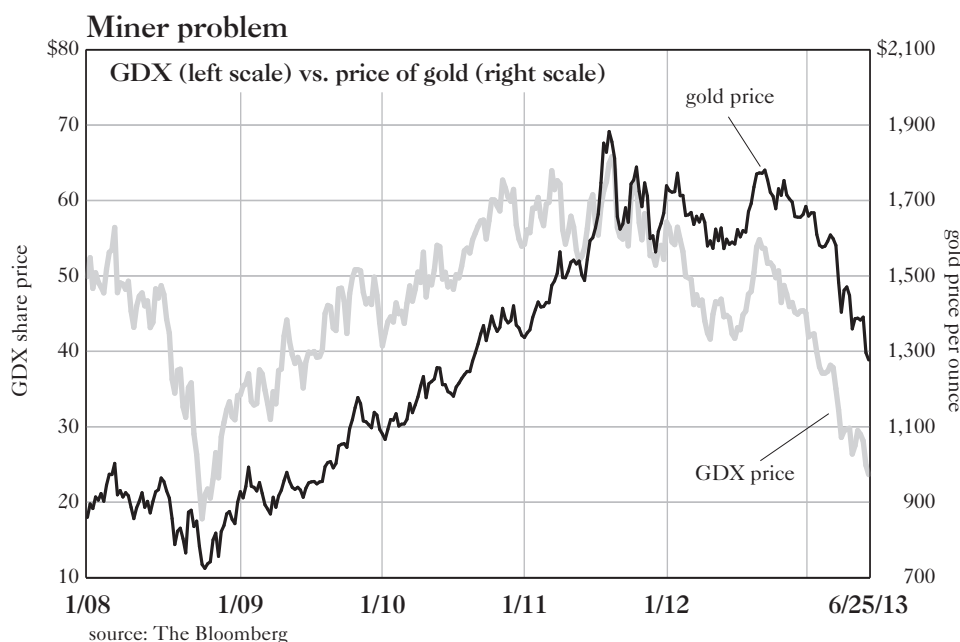
This publication holds that the gold price is the reciprocal of the world's faith in fiat currencies. Thus, the more you approve of Ben Bernanke's body of work, the more bearish you ought to be on gold, and vice versa. As we doubt the Fed, so we trust gold, recent price action to the contrary notwithstanding.

Price is the rub, of course. Gold is no more value-laden, as a Chartered Financial Analyst would use the word "value," at \$1,200 odd dollars per ounce than it was at \$1,900 odd dollars per ounce; it earns just as much and yields just as much, i.e., nothing. You can buy more gold with paper dollars today than you could before the big spill, but that fact actually seems to count against it.

What about the valuation of the mining shares? Indubitably, they are cheaper in nominal price, and they appear cheaper in terms of investment value. But, in the event the gold bull market is, in fact,

over, the appearance of value is illusory. And if, as we think, the bull market has merely been pausing to test and torment the faithful, valuation metrics are irrelevant. As measured by operating cash flow per share, for instance, the stocks have rarely, if ever, been cheaper, observes John Doody, editor of the *Gold Stock Analyst*. But, then, as Doody hastens to add, a falling gold price nullifies backward-looking valuation criteria (the gold price with which he performed his most recent calculations of operating cash flow per share was \$1,556 an ounce, not Tuesday's \$1,277 an ounce). If we are wrong about the Fed and QE and the Ph.D. standard, the gold stocks are probably not cheap enough.

Book value, then? Neither is that yardstick useful in a liquidation, notes colleague David Peligal. "As mining companies recalculate the value of their assets at lower gold prices, write-downs in book value are inevitable," he relates. "Indeed, they're already happening. Just the other day, Newcrest Mining Ltd. (NCM on the Australian Stock Exchange) took the biggest charge in gold-mining history, as much as A\$6 billion (\$5.5 billion) on properties it had bought when the buying seemed good. 'What was encouraged as a capital allocation decision in early 2012 is now seen as a bad decision,' Michael Elliott, sector leader for Ernst & Young's global mining practice, was quoted as saying by Bloomberg on Monday. 'It's a very unforgiving change in the sentiment of the market.'"



Nobody is more aware of that fact than John Hathaway, portfolio manager of the Tocqueville Gold Fund. "There's certainly no immediate market-price connection to price times cash flow, or price to NAV, or any of those things," he tells Peligal. "They don't help you on the downside. Any of them would show that the stocks are very cheap and you're paying nothing for any kind of upside in the gold price." But we knew that.

Founded in 1998, the Tocqueville Gold Fund has returned 10.9% an-

nually to the S&P's 7.6% over the past 10 years. But it has fallen by 46.4% in 2013. Compared to the 2011 high-water mark of \$2.9 billion, Hathaway manages assets of only \$1.3 billion. It's not that the investors are fleeing, he says—net redemptions this year are less than \$30 million. The problem is rather that the stocks are cratering.

Sentiment today is just as bad, or perhaps a shade blacker, than it was in 2008, when gold fell to earth along with most other tradable assets, or in 1998,

before the gold price had awakened from its long, post-Volcker slumber.

"When gold turns around," Hathaway winds up, "and I don't know when that is going to be, but it sure feels like all the signs . . . seem to be there, when gold turns higher, gold stocks do better. If gold goes up 10%, stocks should go up 20% to 30%. And that's always been the case. I think in 2009, off the bottom, I think we were up over 70%." Correct, and then some: In that recovery year, Hathaway's fund was up by 86.6%.



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