# GRANT'S

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# 'Doesn't have to be a reason'

Millions of people can't predict baseball, and billions can't predict soccer. As for interest rates, commodity prices, exchange rates, politics, geopolitics, GDP growth, the weather and equities, the cream of Wall Street can't seem to predict them, either.

The topics at hand are sports and speculation. In each category of endeavor, humanity strains to know the future. In each endeavor, the earthlings come up short, algorithms and supercomputers and newfangled baseball stats notwithstanding. As Spain's early exit from the World Cup competition and the Tampa Bay Rays' (so far) lost baseball season have confounded the sports world, so the collapse of volatility and trading volumes have flummoxed the managers of the pools of capital called global macro funds. To anticipate the conclusion of this essay, *Grant's* is bullish on the big-picture, top-down speculators; their time is coming.

Not that we put much store in macroeconomic forecasting. Believe us, we've tried it. Interest rates, for instance. Up or down? You'd think it would be easy. Or baseball: "It's a round ball and a round bat, and you've got to hit it square," quoth Pete Rose. Simplicity itself. Still, interest rates stump the financial world, the Toronto Blue Jays astonish the baseball experts and Costa Rica, for Pete's sake, is making a run for the cup in the quadrennial planetary soccer tournament.

If one could predict even a single, simple thing, how pleasant life would be. We have given some thought to Major League Baseball. You'd suppose there's nothing very complex about America's national pastime. Nine men to a side. Nine innings in a game. One hundred sixty-two games in a season. See the ball, hit the ball.

Of course, the ball is coming at you at 92 or 94 miles an hour, and not in a straight line, either. There are injuries, slumps, crises of clubhouse karma. It isn't an easy sport to play, but—really—how hard a game could it be to handicap? We ask this rhetorical question because people you may know—maybe even you yourself—think nothing of laying down good money on contingent events much less straightforward than the collision of probabilities inherent in a nine-inning game.

"Major League Baseball has completed nearly half of its 2014 season," colleague Charley Grant observes, "and surprises already abound. The preseason consensus, as established at the end of March by 'over-under' bets laid down at Las Vegas sports books, identified the six strongest teams. Five of the six have so far disappointed. Thus, the Los Angeles Dodgers are on a pace to win 87 games this year (just multiply the current winning percentage by 162) instead of the 94 games that the wisdom of the gambling crowd had projected at the end of spring training; the Boston Red Sox, winners of the 2013 World Series, were supposed to win 87.5 games, the sports book consensus had it; if the rest of the season unfolds in the same fashion as the early going, Boston will win only 74 games."

The anguish of Red Sox Nation (and the punters who backed it) is as a mere sigh compared to the heartache of the devotees of the Tampa Bay Rays. Perennial contenders in recent years despite a fan base that can't seem to find its way to the ballpark and a virtually sub-poverty-line player payroll (at $77 million, smaller than every other team's but two), the Rays are on track to win not the 88.5 games expected of them but rather a catastrophic 64.

"The fall in the Rays' fortunes is astonishing to baseball fans and pundits alike," Grant continues. "In the past four seasons, the former laughingstock of the American League won 369

### Bear market in macro
#### annual returns since 2008

| | HFRI macro index | SPDR S&P 500 ETF Trust | Vanguard Total Bond Market Index Fund |
|---|---|---|---|
| 2008 | 4.8% | -36.7% | 5.0% |
| 2009 | 4.3 | 26.3 | 5.9 |
| 2010 | 8.1 | 15.1 | 6.4 |
| 2011 | -4.2 | 1.9 | 7.6 |
| 2012 | -0.1 | 15.9 | 4.0 |
| 2013 | -0.4 | 32.3 | -2.3 |
| compound annual growth rate: | 2.0 | 6.23 | 4.38 |

sources: Hedge Fund Research, Bloomberg

games, better than all but the Yankees (372 games), the Atlanta Braves and the Texas Rangers (each with 370). Certainly, the bargain-basement Rays didn't buy their success. Deft management and luck seem rather to account for it. What, then, accounts for this year's flop? Joe Maddon, the Rays' brainiac manager—'as eccentric as they come and as brilliant as anyone you'll meet,' warrants *USA Today*—is still at the helm. David Price, the Rays' star left-handed pitcher, is still on the mound. Evan Longoria, the Rays' power-hitting third baseman, is still at the plate. New on the Rays' payroll is a 77-year-old Seminole tribal elder, Bobby Henry. He drops by the ballpark to exorcize bad spirits."

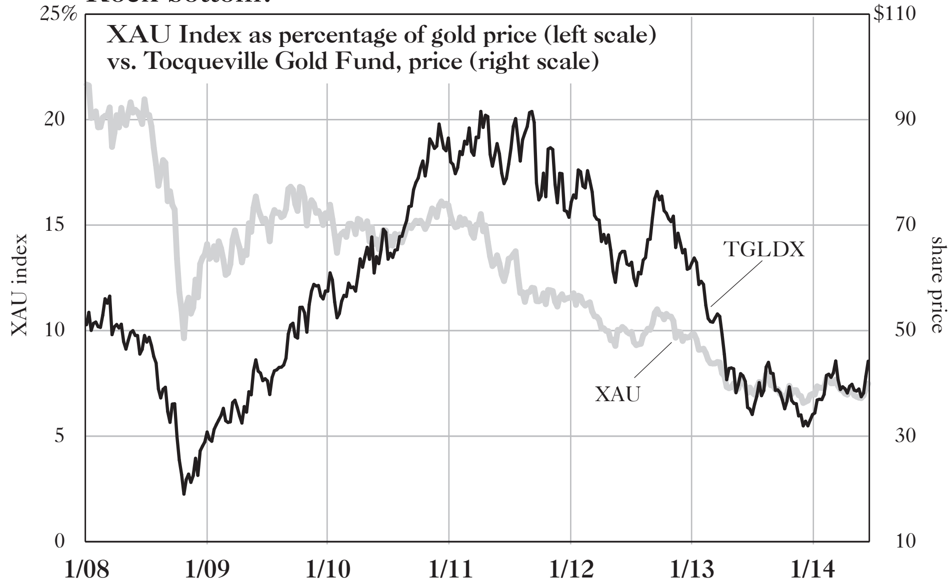
Maybe the Rays and the Red Sox and the Dodgers will finally pay off, though the form favors the house, not the gamblers. Interestingly, the development of a sophisticated quantitative template for baseball analysis ("sabermetrics") has benefited the patrons of the Las Vegas sports books not much more than the improvement in software-driven trading methods has assisted the global macro hedge funds.

Grant Brisbee, a writer for the sports Web site SB Nation, was one of the baseball authorities who predicted great things from Tampa Bay this year. "[T]he Rays," he judged at the close of spring training, "are the best team in the American League" (he reciprocally identified the Toronto Blue Jays, current leaders of the Rays' division of the AL, as among the worst).

In a follow-up post on June 13, Brisbee meditated on what had gone wrong. Injuries, underperformance from established players and bad luck all played their part. Then, again, the humbled forecaster added, "this happens to a team every year. The 2013 Giants, the 2012 Phillies, the 2011 Twins. This year, it's the Rays' turn. There doesn't have to be a reason for it. They just got snared up in the things we're awful at predicting." Or, to quote another baseball man on another occasion, "I've seen year after year brilliant men buying low and selling high—for a while successfully—and then going broke because they thought they understood why a certain investment had to perform in accordance with their personal logic."

John Henry spoke those words in 2000 when he was the owner of the Florida Marlins as well as the eponymous chief of John W. Henry & Co. In his day job, trading the futures markets, Henry had $2 billion under management in 1999. By late the next year, he was down to $1 billion. In December 2000, *Barron's* published a kind of obituary of the managed futures business—in the very quarter in which Henry was on his way to generating a return of 39.2%.

**Rock bottom?**



source: The Bloomberg

A June 13 *Wall Street Journal* article recited the woes of macro money-makers of Henry's caliber (who famously traded in his Marlins for the supposedly cursed Boston Red Sox; under Henry's ownership the Bostonians have won three World Series). None of the featured parties—Caxton Associates, Tudor Investment Corp., Moore Capital Management—can seemingly earn a dime any more, the story related. On the evidence of the 2008-to-date results of the HFRI macro index, the entire asset class has lost its way. On average from 2008 through 2013, the S&P 500 has outperformed the macro hedge fund universe by 423 basis points per annum; over the same span, the Vanguard Total Return Bond Market Index Fund has bested the Paul Tudor Joneses, Louis Bacons and Kyle Basses by an average of 238 basis points per annum.

"And why not?" is a thought that jumps first to mind. The successful macro investor must anticipate changes in things usually un-anticipatable: interest rates, exchange rates, GDP growth, etc., not to mention the human reaction to the movements in those magnitudes. But suppose that prediction weren't impossible, only just about impossible. Even then, the top-down, big-picture speculator would confront daunting levels of competition. In 1992, the year George Soros won his duel with the Bank of England, there were fewer than 1,000 hedge funds walking the earth. Today, there are more than 8,000. "It's possible that there are simply too many fish in the ocean," judges Howard Kapiloff, managing editor at *Hedge Fund Alert*.

Or maybe the ocean itself has changed. Certainly, it lacks the tides, riptides and swells of yesteryear. The still waters owe a great deal to what the policy makers are pleased to call "financial repression." While there's nothing new in interest-rate control (the Fed fixed rates all along the yield curve between 1942 and 1951), the mobilization of the stock market in the cause of economic growth is something new. According to the June 16 *Financial Times*, a report issued by the Official Monetary and Financial Institutions Forum finds that public sector institutions (including central banks, public pension funds, sovereign wealth funds) own capital markets' investments valued at $29.1 trillion. "We are now invested in large-, mid- and small-cap stocks in developed markets worldwide," the OMFIF quoted Swiss National Bank Chairman Thomas Jordan as saying. And the Swiss are supposed to be the conservative ones.

Macro Man, the witty and anonymous blogger, fielded an e-mail from this publication asking what was wrong with the global macro asset class. He replied that the business model incorporates the assumption of meaningful interest-rate differentials. It's hard to make a living when the major currencies all yield approximately nothing.

Then, too, Macro Man went on, top-down speculation thrives on interest rates pitched either too high or too low, or on exchange rates nudged in the wrong direction; "policy error," too, is an integral part of the macro business model. "More policy dynamism, including rate hikes from the Fed, the Bank of England, and possibly others" are what's needed to improve the speculative odds, our source contended. "The last real epochal monetary policy shift, in Japan, demonstrated that macro can make money when the authorities move."

Of course, the authorities have already moved heaven and earth. They have printed the most money in the shortest elapsed time in the history of inflation. They have systematically overridden the price mechanism. They have raised up stock prices as they have pushed down interest rates. They have collapsed credit spreads and suppressed volatility. The unintended consequences of these actions will hand the trend-following macro cohort the opportunity of a career.

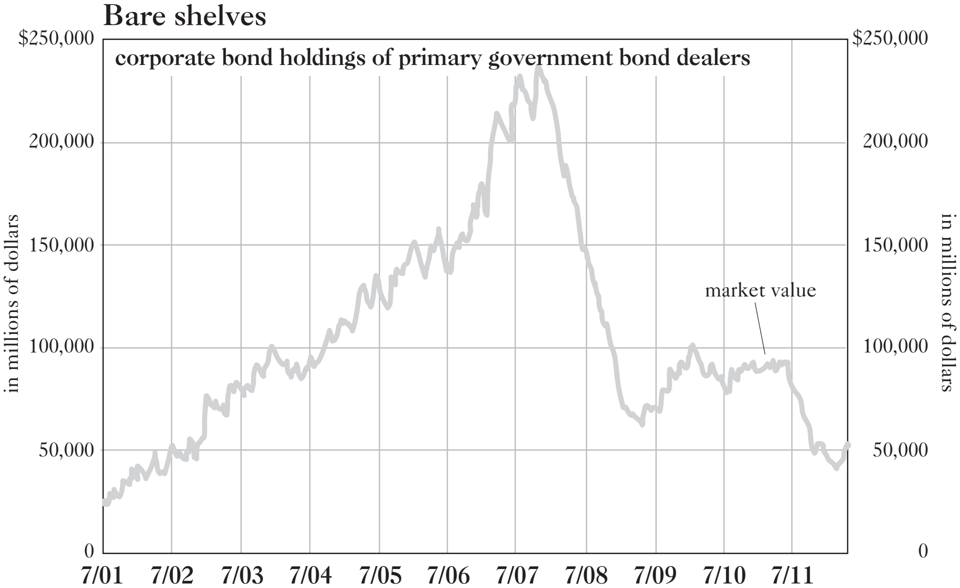
That, at least, is our expectation. The collective voice of the bond market could hardly disagree more. To infer from the pricing of inflation-linked Treasurys, the market projects a 10-year average rate of consumer price inflation of only 2.28%. Monday's *Wall Street Journal*, which reported that fact, quoted a number of authorities to the effect that the only kind of inflation that awaits us is the kind that the central bankers mean to generate.

Under the headline, "In Yellen We Trust Is Bond Mantra as Inflation Dismissed," the Monday Bloomberg wire sounded an even more emphatic version of the same theme. The bulletin quoted the stewards of hundreds of billions of dollars in support of the central banks and against the fretful, worried well. "The bond vigilantes have all been quieted," said Priya Misra, head of U.S. rates strategy at Bank of America, one of the serene ones. "The idea that just the act of printing money gets you inflation has been debunked."

The central banks have, in fact, "printed" a mighty asset inflation. We believe that they have also seeded an inflation of the conventional kind. One can't be dogmatic, though neither should one be impatient.

The rate of CPI inflation, measured at 2.1% year-over-year, up from 1.5% in March, is running hotter than it has since October 2012. Inflation-adjusted Treasury yields are accordingly negative as far out on the curve as five years. And the Fed, though committed to tapering its purchases of bonds and mortgage-backed securities, continues to materialize new money. At last count, it was producing dollars at the historically blistering year-over-year rate of 27.4%.

**Bare shelves**




source: Oliver Randall at Emory University

Chairman Yellen insists that unemployed resources—people chiefly—will forestall a new inflation. We deny the evidence for the claim. Conduct your own statistical investigation. Measure the correlation between inflation, on the one hand (as calculated by the year-over-year change in the CPI), against the output gap on the other (measured as the premium or discount of real GDP to real potential GDP). Measure these things at quarterly rates from the first quarter of 1949 through the first quarter of 2014. See if you don't come up with the same underwhelming correlation as we do: negative 0.29.

Inflation is always and everywhere a psychological phenomenon, not a mechanical one. Money loses its value when people lose their confidence in the money, or in the government that prints it. Is the world's confidence in the management of the United States growing weaker or stronger? This is a judgment call, to be sure; we say "weaker."

"There doesn't have to be a reason for it," Grant Brisbee's observation on the swoon of the Tampa Bay Rays, is a phrase that, on Wall Street, connotes "model risk." The bright lights in the algorithm-writing departments of the big macro funds may have thought of thousands of relevant causative agents for the markets they try to model. Sometimes, the factor they miss turns out to be the dispositive one.

An observation: People lodge an almost religious faith in the institution of radical central banking. We so infer not only from words but also from deeds. Despite last week's spasmodic rally in gold and related equities (including Detour Gold Corp., featured here two weeks ago), mining shares in relation to the gold price are near the lows. The Philadelphia Stock Exchange Gold and Silver Index, a.k.a. XAU, stands (crouches) at 7.5% of the gold price, a slight improvement over the December nadir (6.5%) but a far cry from the post-2008 median reading of 13.1%. Then, again, you didn't need the XAU/gold ratio to intuit that the miners are out of favor. On June 12, Reuters reported that the owner of a tiny Canadian gold mine was prepared to sell his property for Bitcoin.

How might a *Grant's*-reading contrarian exploit this evident imbalance in speculative sentiment? Perhaps with the purchase of shares in the Tocqueville Gold Fund (in which your editor invested shortly after misspelling the name of the then new venture around the time of its June 1998 launch). Now with $1.5 billion under management, down from $3 billion in 2011, Tocqueville lost 23% per annum during the wilderness years 2011-13. In 2014 to date, the fund has returned 34%. In the past 10 years, it has returned 6.53% a year, while the XAU dwindled at the rate of 0.13% a year. If Wall Street's most illustrious bond bulls are wrong about the Fed, it follows that the management of the TGLDX, led by our friend John Hathaway, will be right. Our money's on him.

Observation No. 2: The illiquid corporate bond market would be ill equipped to cope with a sell-off. By the looks of a graph created by Oliver Randall, professor of finance at Emory University, for presentation at the 2013 All Georgia Finance Conference, holdings of corporate securities by the Fed's 22 primary securities dealers have fallen by some 87% from the 2007 highs. Secondary market trading in all cash bonds in American markets, at $720 billion a day, is lower by 30% than the $1,036 billion a day recorded in 2008, according to Nikolaos Panigirtzoglou, managing director of global market strategy at J.P. Morgan, writing in Monday's *FT* Alphaville.

How might a do-it-yourself global macro investor respond to these interesting facts? A matched pair of ETFs exist to go long and short, respectively, the corporate bond index designated the iShares iBoxx $ Liquid Investment Grade Index; their tickers are LQD on the long side and IGS on the short side. LQD has $17.7 billion under its wing, IGS only $3 million (with an "m").

LQD is priced to yield 3.42%, which towering figure it achieves only by climbing out on both the duration and credit curves. As to the latter, observes colleague Evan Lorenz, "45.7% of the LQD portfolio is rated single-A, 39.6% triple-B. On average since 1997, single-A-rated corporates have traded at a yield premium to Treasurys of 143 basis points; today, they're quoted at a mere 82 basis-point premium to Treasurys. If spreads were to widen by 61 basis points, i.e., return to the long-term average, LQD's portfolio would depreciate by 4.68% (0.61% times the 7.68 duration), or by more than a full year's coupon."

Don't give up, you masters of the universe; the central bankers, if nobody else, are on your side.

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