GRANT'S

INTEREST RATE OBSERVER®

Vol. 30, No. 11b | Two Wall Street, New York, New York 10005 • www.grantspub.com | JUNE 1, 2012

Bubble in safety

Just seven basis points more than zero was the yield on Germany's zero-coupon notes of June 2014 that came to market two Wednesdays ago. "That is symbolic of the desperate need for security in today's troubled times," a French bank's interest-rate analyst told Bloomberg. The times may be troubled (they often are) and people may be desperate (someone usually is), but that doesn't mean that low-yielding sovereign debt is the last word in safety and soundness.

Now under way is an exploration of the alternatives. The creditworthiness of highly regarded governments is one topic. A 30,000-foot survey of highly unpopular equities is another. And the intersection of sovereign credit with the euro kerfuffle is a third. In general, this publication is bullish on things certified to be unsafe, bearish on things certified to be safe (assuming always that the respective prices are right). In the meantime, we remain bullish on the time-tested haven that you can find in better-stocked bank vaults and safe-deposit boxes.

Claims on the governments of Switzerland, Germany, Japan and the United States are the favored investment ports in today's financial storms. In real terms, none yields much more than nothing while many yield less. Yes, a creditor of these sovereigns stands a good chance of receiving his money back at par—then again, the creditor had his money before he lent it. Besides, what will that money buy after the central banks get through printing more of it?

Before getting down to the overvaluation of the debts of the world's most-favored nations, we pause to note the overvaluation of the debts of one of the world's less-favored nations. Not so much less favored, in fact. That nation is the Republic of Lebanon, whose single-B-rated 8¼s of 2021 are quoted at 116.9, a price to yield 5.79%. For perspective, a single-B-rated American corporate offers 8.29%. Contemplating the ungenerous yield on Lebanese government debt, we think first not of geopolitical risk but of the post-1981 bond market. Interest rates have been falling for 31 years. Equities have been lost in space for a dozen or more years. Thursday's *Financial Times*'s teasing "Death of equities?" on its front page recites the facts that, in the United States, bond funds have attracted more money than stock funds every year since 2007, "with outright net redemptions from equity funds in each of the past five years." A concerned British actuary tells the paper that, concerning the lopsided investment-allocation preferences in place today, and likely to continue (in his view) for decades, "There are not enough bonds in the world."

So investors pay 117 cents on the dollar for Lebanese 8¼s. Lebanon does boast a growing labor force, it's true, and in that important detail it presents a happy contrast to Japan, Germany and Switzerland. However, neither Japan nor Germany nor Switzerland borders Syria. Then, too, Lebanon is running a 4% inflation rate, a current-account deficit of more than 14% of GDP (compared to 9.7% for Greece) and a ratio of government debt to GDP of 136.2%. Not unlike Germany, Lebanon tends to attract money when its neighbors quarrel. And its neighbors do quarrel. Why, then, do Lebanon's creditors not demand a higher rate of pay for the risks they take? One might well ask the same question of the creditors of the world's most prestigious sovereign borrowers—Germany, first and foremost.

Rated triple-A by every licensed ratings agency except Egan-Jones, Germany posts a budget deficit of just 1% of GDP (compared to America's 9.6%) and a ratio of total debt to GDP of only 81.5% (compared to America's 102.9%). The German unemployment rate stands at 6.8% vs. 10.9% for the 17-nation euro zone. In the past 10 years, the German economy has grown at an average annual rate

Sovereign yield curves

bonds	U.S.	U.K.	Germany	Switzerland	Japan	Lebanon
3-month	0.08%	0.32%	0.01%	—	0.11%	4.52%
2-year	0.29	0.29	0.04	-0.22%	0.10	3.92
5-year	0.77	0.76	0.43	0.01	0.21	4.98
10-year	1.74	1.78	1.36	0.61	0.85	5.93
30-year	2.85	3.09	1.93	0.98	1.80	—

source: The Bloomberg

Money magnets
(2011 figures in $ billions)

	GDP	gross debt to GDP	current account as % of GDP	govt. structural balance	avg. inflation	10-year bond yield
Germany	$ 3,577	81.5%	5.7%	-1.0%	2.5%	1.4%
U.S.	15,094	102.9	-3.1	-7.2	3.1	1.7
U.K.	2,418	82.5	-1.9	-6.3	4.5	1.8
Switzerland	636	48.6	14.0	0.2	0.2	0.6
Japan	5,869	229.8	2.0	-8.1	-0.3	0.9
Lebanon	39	136.2	-14.4	-12.2	5.0	5.9

source: International Monetary Fund

of 1.05%, compared to 0.63% for Japan and 1.73% for Switzerland. As for the German commitment to financial orthodoxy and fiscal austerity, Germany's monetary co-venturers can all too readily attest to it.

But these virtues (if virtues they all be) pertain to the past. A set of euro-related risks clouds the future. The fact is that Germany has massive exposure, actual and contingent, to the so-called European periphery. The market can't help but know it, though it seems to avert its eyes. Perhaps we humans need to believe that somewhere exists a safe haven. Anyway, for now, Germany is Europe's chosen bolt hole. It's the Japan or United States—or Lebanon—of the Continent.

We don't gainsay Germany's economic prowess. What we do question is the risk-and-reward proposition presented by Germany's debt. Negligible nominal yields armor the fearful investor against no contingency except the one from which most of the rest of mankind seems also to be fleeing. The "bull market in fear" that Christopher Cole identified in the previous issue of *Grant's* is stamped on sovereign yield curves.

Germany constitutes a special case of misperception, in our opinion. Virtually, as we see the situation, Germany is the euro and the euro is Germany. Some 60% of German exports never left the European Union in 2010, according to the World Trade Organization, while exports contributed 51% of German GDP in the first quarter of 2012, according to German government data. "Germany is no more 'decoupled' from the euro zone's economic crisis than the world was from the 2007-08 American housing crisis," observes colleague Evan Lorenz.

Neither are German commercial banks decoupled from Europe—on the contrary. As of year-end 2011, according to the Bank for International Settlements, German lenders held claims of $13 billion on Greece, $95 billion on Ireland, $30 billion on Portugal, $146 billion on Spain and $134 billion on Italy, for a rounded grand total of $419 billion, or €323 billion.

Then there's the money that the German government has to defend the euro. Such commitments—promised but yet undrawn—include €22 billion for the first Greek bailout, €211 billion for the European Financial Stability Facility, €190 billion for the European Stability Mechanism, €12 billion for the European Financial Stabilization Mechanism and €40 billion for the Securities Markets Program. They sum to €475 billion, or 18% of German GDP, note Credit Suisse analysts Christian Schwarz and Matthias Klein.

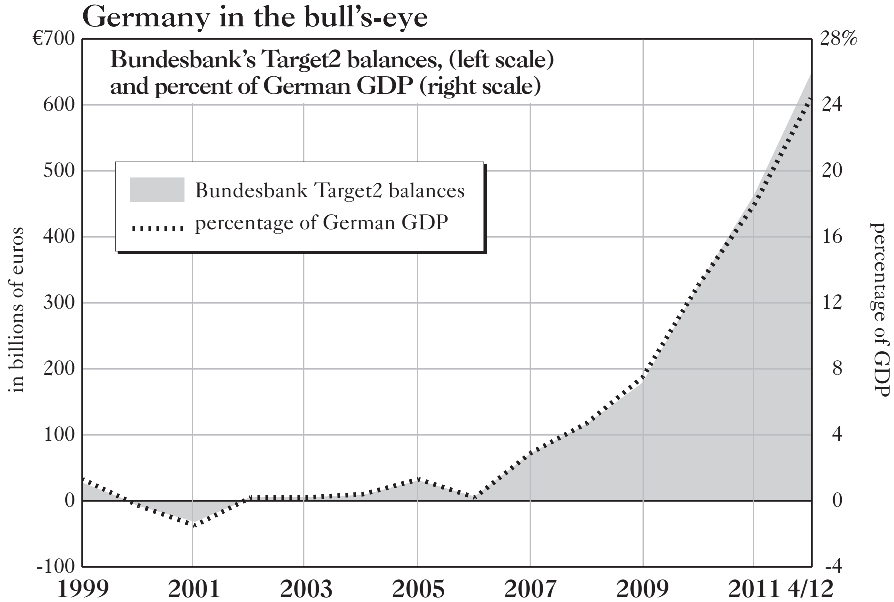
Perhaps most significant of all these risks is Germany's growing exposure to peripheral credit via the European interbank payment system. The Trans-European Automated Real-Time Gross Settlement Express Transfer System is the proper name from which the acronym Target2 is tortured. Every day, an average of €2.385 trillion courses through the Target2 channels, i.e., the equivalent of the entire Continental GDP every four days. Target2—the technological successor, in 2007, to Target 1.0—was designed to serve as an advanced electronic payments superhighway. What it has become instead is an infernal flight-capital financing machine.

Basic to an understanding of the European financial crisis is the fact that a member state of the European Monetary Union need not apply for assistance to meet a capital outflow. Target2 provides it automatically and in central-bank funds.

Say that you, a Greek importer, place an order with a German manufacturer. The Bank of Greece is the institution that ships the relevant number of euros to Germany. The bank of the German exporter earns a credit with the Bundesbank, while the Bundesbank has a claim on the European Central Bank. Synchronously, the importer's Greek bank has a debit with the Bank of Greece, which in turn has a debit with the ECB.

The European central bankers who dreamt up the Target system antici-

Germany in the bull's-eye



source: Bundesbank

Money repellants
growth rate

company	div. yield	P/E	EV/ EBITDA	10-year CAGR sales	EPS	dividends
Wal-Mart	2.4%	14.7x	7.5x	8.2	11.3	17.6%
Nestle SA	3.5	18.6	12.2	-0.1	5.6	11.8
BASF SE	4.3	9.7	5.7	8.5	—	14.4
Metka SA	13.2	2.4	2.0	23.6	29.8	22.3

source: The Bloomberg

pated no outsize imbalances. They assumed that credits and debits would net to zero in the normal course of trade, which, until 2007, they usually did. But come the financial crisis the system no longer neatly balanced. As Greeks, Irish, Portuguese, Spaniards and Italians lost confidence in their domestic banks, they began moving funds to Germany. This capital flight Target2 noisily accommodated, just as it accommodates imbalances in ordinary commercial dealings. You see no sign of the shift on the ECB balance sheet, as intrasystem debits and credits between the member central banks approximately offset each other (*Grant's*, Nov. 18). The evidence is, rather, to be found on the balance sheets of the national central banks. Up and up go Germany's claims on the PIIGs; up and up go the PIIGs' debits to the Bundesbank. The Bundesbank's claims on the various peripheral central banks zoomed to €644 billion in April from next to nothing in 2006. The latest reading represents almost a quarter of German GDP.

While under law the Bundesbank is at risk only to the extent of 27% of the ECB's losses (that number corresponds to the Bundesbank's share of the ECB's paid-in capital), it's an interesting question who would pick up the tab if the Bank of Greece, the Central Bank of Ireland, and/or the Banca d'Italia were unable to shoulder their share of the losses. And it is worthwhile pondering how large the Bundesbank's exposure might become if today's slow-motion run on the commercial banks of the periphery turned into a headlong sprint. One could imagine a sudden lurch higher in the Bundesbank's claims on those countries least able to honor them. "Please note," advises Ben Powell of Barclays Capital in a May 21 bulletin, "that as deposits flow out of Greek and Spanish banks and into 'safe' German banks, this has the odd effect of meaning that Germany is *more* exposed to the periphery nation. And this is accelerating."

Veterans of the mortgage-backed securities crack-up may be thinking along the lines of William Porter, a Credit Suisse managing director of investment-grade research in London. Think of the euro zone credit structure as a kind of asset-backed security, Porter suggests. That is, if you can bear it, think of Europe as a collateralized debt obligation. You will recall—or maybe you've blocked it out—that a CDO is a piece of financial architecture. The assets that support the structure pay out income to a hierarchy of liabilities, or tranches. Income trickles down from the top of the structure, losses worm their way up from the bottom. If the assets supporting the CDO are money good, everyone gets paid. If, however, the assets are defective, there are losses to apportion, and the equity holders take the first knock. Not until the equity is erased do the senior creditors lose a dime.

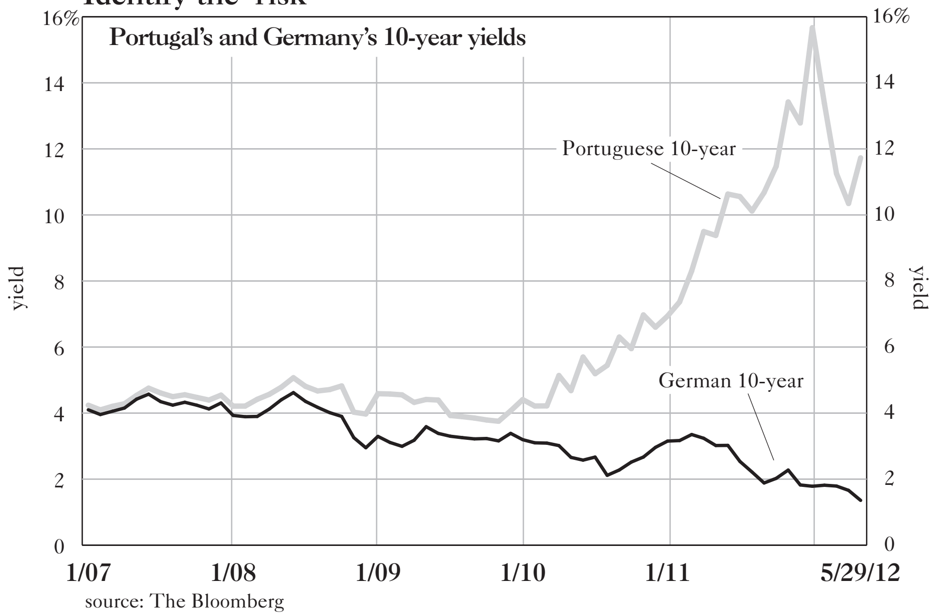
Many are the ways in which Europe conforms to this stylized CDO. "The assets are the taxing and borrowing powers of the governments—the government net present values, if you like—of these various countries," Porter tells Lorenz. "You can therefore construct a CDO and simplify the tranches accordingly or just let the market rank the tranches for you." But there is, as Porter notes, a vital difference between an actual CDO and the conceptual European version. Not once that we know of was a super-senior tranche dragged into a position of having to subsidize an equity tranche. But Germany is committed to doing just that. Risk of loss in the euro zone is becoming increasingly "correlated," as the quants say, or "socialized," as the political scientists would put it. In a proper CDO, the equity tranches have no moral or financial claim on their investment-grade betters. In Europe, the pain has been, and will be, shared—to just how great an extent only time will tell. From which observation Porter makes a grand strategic leap: Buy the high-yielding obligations of the countries that Germany will likely bail out, he counsels. Sell—positively do not buy—Germany.

Well, you might ask, what about Portugal? The Portuguese 10-year note is priced to yield 11.4%, compared to 1.4% for the German 10-year note. Portugal's gross debt amounted to 106.8% of Portuguese GDP in 2011, and the IMF projects a bump up to 112.4% in 2012. Compare and contrast Germany, with a current ratio of debt to GDP of 81.5% but with prospective future rates of debt to GDP considerably higher should worse come to worse in the euro zone.

"Right now," says Porter, "Portugal looks very attractive to us against a short further up in the 'capital structure,' either Germany, if you are really swinging for the fences, or Italy or France, potentially, as well." The euro's political guardians will move heaven and earth to convince the world that Greece is the exception, not the rule, the argument goes. Portuguese bonds will accordingly rally, as the cost of a Portuguese bailout is explicitly borne and socialized. Bunds will accordingly depreciate, as the market comes face-to-face with the fact that Germany is the principal socializer.

We take Porter's point but prefer another kind of junior claim—the real-life shares of growing and profitable operating companies. Naturally, we like them cheap. For instance, the common shares of BASF, the giant diversified German chemical company, we prefer over the conceptual equity of Portuguese sovereign debt (conceptually situated at the bottom of our imaginary euro CDO). Riding the cycle, BASF common will never be confused with a government security. Earnings per share dropped by 63% between 2007 and 2009, and they rebounded by 338% between 2010 and 2011. Financial leverage exaggerates the cyclical thrills and chills: net of cash, the company owes €9.4 billion, or €10.23 per share, on the current €57.74 share price. But growth there has been: over the past

Identify the 'risk'



source: The Bloomberg

11 years, sales, earnings and dividends have compounded at annual rates of 7%, 19% and 9%, respectively (2001 delivered a net loss). Today, the shares change hands at 9.7 times earnings and 5.7 times enterprise value to earnings before interest, taxes, depreciation and amortization. They yield 4.3%; the 10-year German bund yields 1.36%.

By the same token, we favor Wal-Mart over the 10-year Treasury, and Nestle over the 10-year Swiss government note. Wal-Mart, which yields 2.4%, and Nestle, which fetches 3.5%, have shown the ability to grow and adapt in economies both good and indifferent. Neither stock would repay its owners in a deflationary collapse, but neither, perhaps, would the 10-year Swiss note. Disaster would seem to be very largely priced into its 0.61% yield to maturity already.

We do not make light of the very real risks of a euro-induced slump or of a Continent-wide panic out of non-German bank deposits. Nor, we expect, does the ECB discount those risks. In the face of depression or panic, the bank of Mario Draghi would surely run the presses. In such a setting, it would be nice to have some gold.

The issue of *Grant's* dated February 24 featured a bullish analysis of a Greek engineering company called Metka. As you may recall, Metka produces turnkey natural-gas power plants. Over the past decade, the company's sales, earnings and dividends have grown at annual rates of 23.6%, 29.8% and 22.3%, respectively. Though domiciled in Greece, Metka booked 82% of first-quarter sales and 91% of first-quarter earnings in foreign parts—work in Syria, let the record show, contributed 49% of first-quarter revenue. In February, the shares fetched €5.81 apiece. Today, on the eve of fateful Greek elections, they're quoted at €5.69, a price representing 2.4 times trailing net income and two times enterprise value to EBITDA.

The world has much to fear, we readily allow. However, it seems to us, not the least of these perils are the alleged safe havens themselves.

•