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Inflate your income

The cyclical stars are seemingly in alignment except for the dim star of inflation. Whither the long-awaited, out-of-left-field upside jolt in the CPI? Now in progress is a survey of the opportunities in—bonds.

Not just any bonds. The securities under the *Grant's* lens are floating-rate notes with coupons that reset quarterly and with prices that seem to afford the investor a margin of safety. We're bullish on them—in the understated manner appropriate to securities whose humble portfolio mission is to keep the investor out of trouble.

Some will say that miners and drillers and the things they extract from the earth deliver the best returns under inflationary conditions, and that may be so. Your editor has sold none of his spectacularly underperforming gold-mining equities or his long-slumbering gold bullion. Others will observe that there is more than one kind of inflation. A great inflation of financial assets in the context of a never-before-seen expansion of central-bank balance sheets is the inflation for which there is no track record. The combination of an elevated stock market and a wobbly bond market puts a premium on caution.

David Rosenberg, chief economist and strategist of the wealth-management firm Gluskin Sheff + Associates, Inc., has curated some data in support of the case for not going out on a limb. Thus, he shows, the ratio of household net worth to disposable income stands at 673%, above the 652% in 2007 and 612% in 1999. The ratio of financial assets to U.S. household assets is approaching 70%, a level only seen at the

peak of the dot-com bubble and the Nifty Fifty hurrah of the early 1970s. Equities as a percentage of U.S. financial assets stand at 36%, below the 40% reached before the 2000 tech crash but above the 34% of 2007.

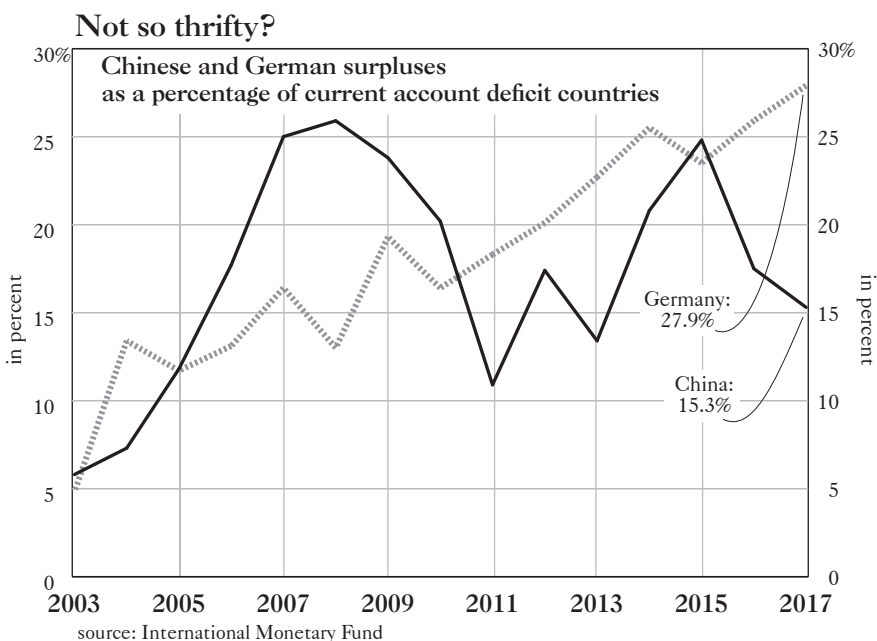
"The U.S. economy," Rosenberg advises, "has never before been so dependent on asset inflation for its success. . . . This surge in paper wealth has enabled the savings rate to decline to a decade low of sub-3%, a move that has made the difference between 3% and 1% growth in the real economy."

To which he appends: "This is not to say anything more than that the elastic band looks extremely stretched and . . . that we hit similar peaks in the past just ahead of a turning point, and right at a time when investor complacency

and bullish sentiment were around where these metrics are today."

Henry Kissinger's admonition concerning policy toward the Balkans comes to mind: "Anything you do is going to be wrong, including nothing." Investors can't do nothing—their money has to be in something, someplace. Not knowing the future, they must guess, especially about the great imponderable of interest rates.

Some contend that the economy is too leveraged to support rates much higher than the historically puny rates now in place. This publication believes that the post-1981 bond bull market died in the buying panic of July 2016 when the 10-year Treasury note traded at 1.36% (and when the dollar-equivalent volume of sovereign



debt quoted at negative nominal yields reached \$14 trillion). These are points of view, not certainties.

In support of the bond-bearish proposition, Vincent Deluard, global macro strategist at INTL FCBStone Financial, Inc., advises colleague Fabiano Santin, "You have a secular turn in rates going from a global-savings glut to a global-savings squeeze. That's because you had two countries that had very unique demographic structures and policy objectives that led them to be abnormally large savers."

As it is, the two paragons of thrift accommodate 43% of global borrowing (i.e., their current account surpluses are 43% of the world's current account deficit). Deluard has his theories about Chinese saving. Not believing much of anything that comes out of China, we pass by the People's Republic. As for Germany, it is becoming less stereotypically German, therefore less thrifty: "In the next five years there will be one million Germans a year retiring, and the country's demographic peculiarity is further eroding because 20% of Germans are of immigrant descent," says Deluard.

Right here in America, the bond bears rub their paws over tax reform. The new law, whether or not it augments the supply of federal debt, is creating an incentive for American corporations to repatriate funds at the low, low tax rate of 15.5%, vs. 35%. On Jan. 17, Bloomberg reported that an estimated \$3.1 trillion in corporate cash sits snoozing in bonds domiciled offshore. Based on recent filings, Apple, Inc., Microsoft Corp. and Alphabet, Inc. held \$500 billion in U.S. government and corporate fixed-income securities. Exchanging some of that paper for the cash with which to pay dividends or—just possibly—hire and invest could accomplish many things. It likely would not lift bond prices.

All this is well and good. We can spin a story of rising American tariffs, a resultant trade war, a tardy Fed and a big Treasury deficit lifting inflation and inflation expectations alike. For a gold bug, it is a peach of a story, but it does not address the question, "What would happen to bond prices if the stock market stepped in front of a bus?" Would Treasuries not prove a port in the storm as they did in crises past?

Contemplating the risk of inflation, on the one hand, and of not-inflation, on the other, we arrive at the intersection of debt and optionality. Consider, for those unwilling to take credit risk (except for the risk of a downgrade of the split-rated United States of America), the Treasury's floating-rate notes that debuted in 2014. The FRNs of October 2019 pay quarterly coupons based on the weekly average of 13-week bill auction rates. Their current yield to maturity is 1.43%, which is 60 basis points less than the yield on the two-year Treasury note. Then, again, the floaters would gain if bill rates rose, and the floor is at 0% in case those rates should happen to go negative.

Another alternative are the corporate-debt securities that pay floating-rate coupons based on a reference rate like Libor. Some are floating-rate, senior unsecured notes, others are preferred notes (therefore lower in the capital structure). They begin their lives with a relatively high coupon and later switch into floating on the first call date, typically a few years after issuance. The following securities boast relatively low duration and carry what we judge to be manageable credit risk.

- Single-A-rated Qualcomm, Inc. floating-rate, senior unsecured notes of January 2023, which reprice with a spread of 73 basis points above three-month Libor and are priced to yield 2.18%.

- Triple-B-plus-rated British American Tobacco plc floating-rate, senior unsecured notes of August 2022, which reprice with a spread of 88 basis points above three-month Libor and are priced to yield 2.07%.

- Triple-B-rated Becton, Dickinson and Co. floating-rate, senior unsecured notes of June 2022, which reprice with a spread of 103 basis points above three-month Libor and are priced to yield 2.42%.

- Triple-B-rated Wells Fargo & Company fixed-to-floating-rate preferred notes, which are callable on September 2023 at par (\$25 per share) and pay a quarterly coupon of 5.85% until the call date; after that date, they reset to three-month Libor plus 309 basis points. They trade at \$26.50 to yield 4.7% to call, or 5.5% in current yield.

- Triple-B-rated U.S. Bancorp fixed-to-floating rate preferred notes, which are callable on Feb. 16, 2018 at par (\$25 per share) and pay a quarterly coupon of 3½% until the call date; after that

date, they reset to three-month Libor plus 60 basis points. They trade at \$22.55 for a 4.1% current yield.

The iShares Floating Rate Bond ETF (FLOT on Cboe BZX) seeks to track the Bloomberg Barclays U.S. Floating Rate Note <5 Years Index, which comprises investment-grade floating-rate bonds (most paying interest off three-month Libor plus a spread) with maturities between one month and five years. The ETF holds \$6.7 billion in issuers rated triple-A (13.4%), double-A (21.8%), single-A (47%) and triple-B (17.4%). The yield is 2.02% with an effective duration of 0.14 years. The fund is managed by BlackRock Fund Advisors, which charges 20 basis points.

The SPDR Bloomberg Barclays Investment Grade Floating Rate ETF (FLRN on NYSE Arca), managed by State Street Global Advisors Funds Management, Inc., is another possibility. Its yield is 2.11%, its duration 0.13 years. "We view this as an efficient tool to provide income in a rising short-term-rate period," Matthew Bartolini, head of SPDR Americas Research at State Street Global Advisors, tells Santin. "We always like to compare it versus fixed rate. The [fund's] FRN maturity band is one to five years. So you look at how the performance has ebbed and flowed when the two-year [Treasury] rate increases. When the two-year rises, FRNs produce a positive return of around 26 basis points while the fixed-rate portion actually has a loss." The ETF holds \$1.7 billion in assets spread through investment-grade ratings: 11.4% in triple-A-rated issuers, 24% in double-A, 47.4% in single-A and 17.2% in triple-B. The total-expense ratio is 15 basis points.

For those with a need for, or tolerance of, credit risk, the PowerShares Variable Rate Preferred Portfolio ETF (VRP on NYSE Arca) tracks a basket of higher-yielding, more-speculative assets. The issuer typically pays a fixed dividend for 5 or 10 years, following which the security becomes callable or starts paying dividends based on the three-month Libor plus a spread. The PowerShares ETF holds \$1.9 billion in assets spread among somewhat lower ratings: triple-B (63%), double-B (30%), single-B (3%) and not-rated (3%). At least 90% of the fund is invested in preferred securities with variable

coupons. Current yield is 5.68%, the duration 3.8 years. Invesco PowerShares Capital Management LLC performs the management honors for a 50 basis-point total-expense ratio.

Or, for the institutional market, there's the Muzinich Low Duration Fund (supra institutional-shares ticker MZLSX, minimum initial investment of \$1 million), managed by Muzinich & Co., Inc. A "well-diversified portfolio of corporate bonds and senior loans, including floating-rate loans" consti-

tutes 80% of assets. Currency exposure—to euros, pound sterling and/or the Swiss franc—may reach 20% of assets. High-yield exposure may hit 40% of assets. Year-end rating skew was as follows: 60.2% triple-B, 16.8% double-B and 23% single-B. The fund yields 2.78% at 1.93 years duration. Total-expense fees are currently 50 basis points, but the Investment Advisor may raise them to 96 basis points starting on April 30, 2018.

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