GRANT'S

INTEREST RATE OBSERVER®

Vol. 31, No. 12a | Two Wall Street, New York, New York 10005 • www.grantspub.com | JUNE 14, 2013

On the authority of Bill Gross

The 32-year-old bull market in bonds is kaput, the founder of Pimco tweeted the other day. The implications of this seismic shift in interest rates (if such a shift has, in fact, occurred) is the subject at hand.

We hasten to add that nobody knows if the cycle has turned, nor is anyone likely to know for a while. Since the first round of so-called quantitative easing on Nov. 25, 2008, the yield on the 10-year Treasury note has climbed by 50 basis points on eight separate occasions, only to swoon again. As there have been so many false alarms (your editor having sounded more than his fair share of them), the burden of proof on the proposition that rates have reversed course properly falls to the bears.

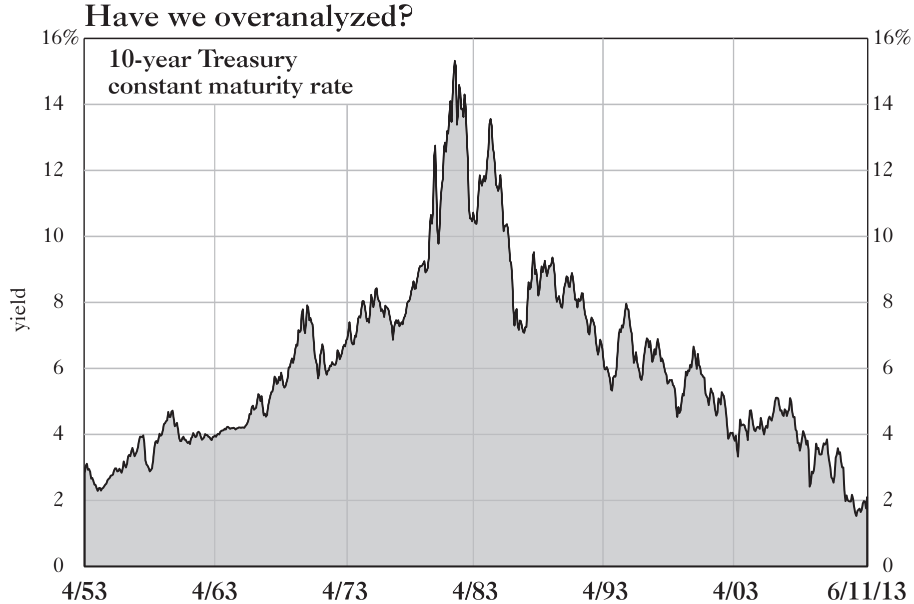
To be clear, *Grant's* is bearish on bonds. We hold that, whether or not interest rates have embarked on a generation-length upswing, fixed-income securities are unattractive at current prices and yields. Pure and simple, the risks—monetary, fiscal and other—outweigh the meager rewards. Readers of Homer's and Sylla's "History of Interest Rates," we observe that rates have tended to move in long-trending cycles. We observe, as well, that this tendency is not to be confused with a law of physics. Still, we conclude that a bear market in bonds might succeed the post-1981 bull market any year now. Which year that may be, we don't happen to know. Once we guessed it was 2001.

The bull case for bonds, simple and time-tested, holds that yields follow inflation and that central banks, try as they might, do not direct our economic destiny. The Federal Reserve doesn't control the rate of turnover of money, i.e., velocity of circulation. Nor does it control the relationship between the money supply (e.g., M-1 and M-2) and the monetary base, i.e., the money multiplier. The units of scrip that the Bank of Bernanke creates in such superabundance seem mostly to molder on the Fed's own balance sheet as excess (why not "excessive"?) reserves. Clinically, they are called excess reserves.

"As we look at the world," Van Hoisington, the great bond bull, tells *Grant's*, "it is dis-inflating, rather than inflating. Nominal GDP is waning rather than waxing." Ergo, the case for long-dated Treasurys is intact, he says. Though contrary opinion is not the reason he's bullish, Hoisington adds, he is beginning to doubt that anyone besides himself and his firm, Hoisington Investment Management, Austin, Texas, is actually bullish. "Pressure on us is incredible," he says.

We write to identify investments suitable to a time of rising interest rates, as well as to compare the present alignment of financial, technical and macroeconomic forces with those prevailing in 1899 and 1946, the opening years of the previous two modern secular bear bond markets. In service of this grand plan will come a discussion of real estate valuation and a look at a particular warrant on a particular bank stock. And we will speculate on the tempo of the rise in interest rates, whenever

Have we overanalyzed?



source: Federal Reserve Bank of St. Louis it comes. We believe we have found a wrinkle that will quicken the pace at which rates rise (when they do eventually rise). In the 1946-1981 interest-rate up cycle, it was 10 years before the long-dated Treasury rose by even 100 basis points. There'll be no such dawdling next time around, unless we've missed our mark.

"What's different?" is never a bad analytical question. It seems especially pertinent to a speculative analysis of interest-rate cycles. Three or four things make the present moment in interest rates different from the settings in which rates began their previous long journeys higher. Leverage is one. The nature of money is a second. The art and practice of central banking is a third. The complexity of finance is yet another. One could go on.

Though this generation hardly invented leverage, it has pioneered in the techniques of abusing it. To boost the sale of Liberty Bonds and Victory Bonds in 1918 and 1919, the Federal Reserve (still wet behind the ears) and the Treasury promoted the "borrow to buy" investment method. Banks lent the funds with which patriotic Americans invested in government securities. Later, when money-market interest rates spiked and bond prices fell, the patriots sold at a loss. Professional investors—the young Benjamin Graham was one—descended to pick up the pieces. From these small beginnings (if they were, in fact, the beginnings), leveraged bond speculation has come into its own.

In 1946, when long-dated Treasurys made their low in yield for what would prove to be a full generation, domestic nonfinancial debt amounted to 153% of American output. Today, domestic nonfinancial debt foots to 254% of American output. "The fact that you actually have higher debt levels is perversely contributing to a long-term secular shift downward pressure on interest rates and inflation," Howard L. Simons, strategist at Bianco Research, observes.

But the mass of debt is perhaps not so interesting as its composition. Once upon a time, depository institutions did most of the lending. Now, the financial markets do. In 1946, domestic financial debt was a rounding error of 1.3% of GDP. Today, it amounts to 87% of GDP (and was as much as 123% in the first quarter of 2009). The meaning of which? James Aitken, eponymous head of Aitken Advisors, has the insight that in such a financial system as today's, "collateral is money." That is, such collateral as Treasury securities is the necessary lubricant for lending and borrowing. Rising bond prices, therefore, facilitate the flow of credit. Falling bond prices, presumably, inhibit it. Complex feedback loops between the Treasury market and the rest of the financial economy is one of the hallmarks of the present day. "What will start as volatility in U.S. Treasury bonds will end up transmuting to other asset classes," Christopher Cole, founder and portfolio manager of Artemis Vega Fund, tells colleague Evan Lorenz.

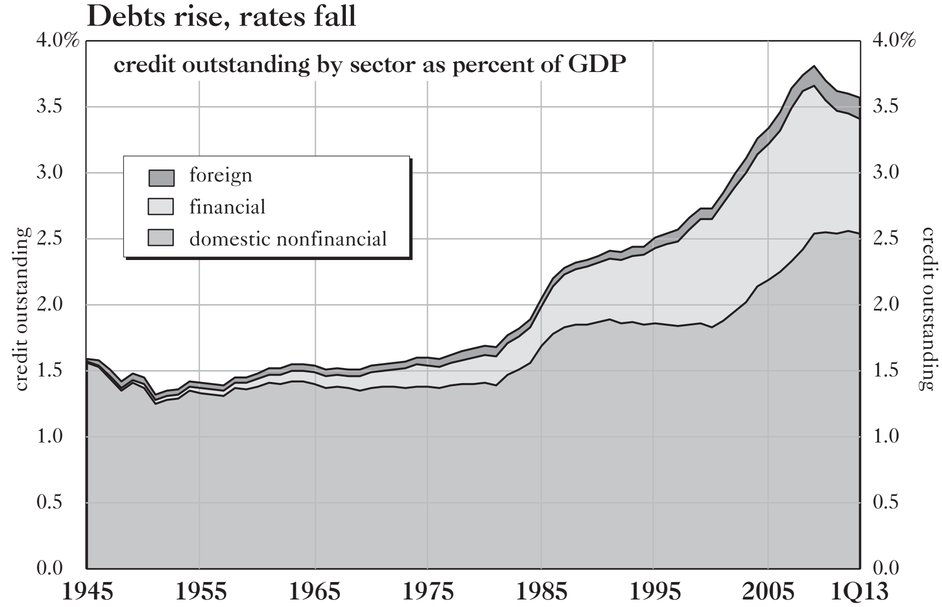
On Monday, Bloomberg reported that swaps traders, to comply with regulations requiring that derivatives trades be settled in clearinghouses, must come up with $800 billion to $4.6 trillion in high-grade collateral, Treasurys foremost. "This is going to be a new, very powerful engine that drives demand for Treasurys, so you have to expect it will impact yields," Bloomberg quoted a New York derivatives strategist, Ted Leveroni, of the firm of Omgeo LLC, as saying. "There are lots of firms out there—I know because they've told me—that are concerned about having the available collateral."

Let us only say that there are cross-currents. While the Dodd-Frank rules that drive over-the-counter derivatives trades to clearinghouses will evidently increase the demand for top-rated collateral, those rules also presumably will reduce the odds on a deflation-inducing collapse in the $633 trillion derivatives markets (that's the Bank for International Settlements' estimate). Such a calamity would seemingly be bullish for government securities. Averting that calamity? Seemingly less bullish for government securities.

Your head spins trying to sort out the bond-friendly from the bond-unfriendly implications of hypothetical events entailing figures reckoned in the trillions. A fundamental contention of the bond bulls is that debt smothers inflation and growth; ergo, the more debt, the lower the cost of debt. You would have lost money doubting the truth of this paradox. At the dawn of the 1981-to-date bull bond market, federal debt in the hands of the public totaled $789.4 billion, representing 25.8% of GDP. In fiscal 2013, federal debt in the hands of the public is estimated to sum to $12.4 trillion, representing 76.6% of GDP. In 1981, the Treasury paid a weighted interest rate of 9.2%. Today, an evidently much less creditworthy Treasury is paying a weighted interest rate of 1.9%. Could it be that we are all overanalyzing the interest-rate situation? Could it be that rates, as manipulated by our masters in Washington, are simply too low?

Moving on: In the face of this constricting indebtedness, the monetary authorities naturally take countermeasures. To lift the pall of debt, they buy Treasurys and mortgages and crisis-era miscellany

Debts rise, rates fall



source: Federal Reserve

with newly conjured dollars. A perhaps unintended consequence of these massive purchases is that the Treasury market is thinner and more volatile than it has been and would otherwise be. "It used to be you could buy $500 million in 30-year Treasurys without moving the market," Dan Fuss, vice chairman of Loomis, Sayles & Co. and manager of that firm's flagship Loomis Sayles Bond Fund, tells Lorenz. "Now it's $50 million." Are you as confused as we are? Good. We'll grope in the dark together.

We ultimately build our case against low-yield bonds (and, equally, against "high"-yield ones) on the foundation of value and risk. The world's central banks are embarked on a grand improvisation that may succeed for a time or may not. If it does succeed—that is, in keeping the economy off the rocks and the "core" rate of inflation under wraps—bondholders will receive their principal, somewhat the worse for wear even at measured rates of inflation of between 1% and 2% per annum, and earn their miserable coupon besides.

But why should we be so sure that the rate of turnover of money will not recover? Or because banks have been content to rest on their oars (thereby not dipping into the ocean of excess reserves) that they will continue to do so? Or, indeed, how can we know that "inflation is always and everywhere a monetary phenomenon"? Could it not, this once, be a fiscal phenomenon? Is it so farfetched to imagine the world losing confidence in the Congress of the United States and, in a flash of fiscal insight, selling dollars? Mostly, how can we be so sure that the Federal Reserve that got us into this mess will competently lead us to safety?

Well do we recall the persuasive arguments the bond bears of 1980-84 arrayed against long-dated Treasurys at the end of a 35-year bear market. The orphaned "certificates of confiscation" found few takers even at yields of 12%, 13%, 14% and 15%. In 1900, the best and the brightest were unanimous in the view that interest rates would remain at 3% and not wind up where they did, in fact, wind up 20 years later, at 5% or thereabouts (see *Grant's*, June 1, 2012). Symmetrically, the bond bulls made a very pretty case for themselves in the spring of 1946. Among other things, they pointed out, the supply of new Treasurys was dwindling, and the Federal Reserve was a buyer of all bonds necessary to hold long yields at 2½% or less. And on each point, they happened to be correct (see *Grant's*, Jan. 28, 2011). But sometimes—no, make that frequently —events surprise you.

Banks with TARP warrants

	price	price/ book	price/ earn	div. yield	—warrant— price	—warrant— strike	expiry
Citigroup Inc.	$49.95	80%	12.0	0.1%	$0.75	$106.10	1/4/19
Bank of America Corp.	13.12	65	15.0	0.3	5.57	13.30	1/16/19
American International Group	44.92	67	12.5	0.0	18.29	45.00	1/19/21
JPMorgan Chase & Co.	53.49	103	9.0	2.8	15.18	42.42	10/28/18
Wells Fargo & Co.	40.66	146	11.4	3.0	13.19	34.01	10/28/18
PNC Financial Services Group	71.75	105	11.3	2.5	13.93	67.33	12/31/18
Capital One Financial Corp.	61.46	87	10.2	2.0	23.48	42.13	11/14/18

source: The Bloomberg

If America is truly in the coils of debt, what explains the recovery in residential real estate, the perpendicular bull market in office towers or the levitation of farmland values? How to square a supposedly constricting debt problem with the recent record highs in junk bond prices and the return of 2007-era structures in leveraged finance? At the least, there's enough uncertainty about the future to consider the possibility that the big arrow in the yield chart is finally pointing up.

The form on bond bear markets is that they are slow off the mark. In the first 20 years of the 1946-81 episode, long-dated Treasury yields rose by less than 250 basis points, to 4.55% from 2.1%. Yet during that span, the real GDP produced compound annual growth (as most inexactly measured) of almost 4%, while the Standard & Poor's 500 Index rose at a compound annual rate of 9.2% (only prices, without reinvested dividends). No national income data worth the paper they're printed on exist for the 21 years of the earlier bond bear market. But that cycle, too, featured wonderful growth as well as a pox of war-induced inflation following the outbreak of European hostilities in 1914. Prime corporate yields were quoted at 3¼% in 1899. They first reached 4¼% at the close of 1913. That bear market, too, took its own sweet time getting started.

What about the tempo of the next bear market? Faster out of the blocks, we speculate, and not necessarily because the Fed will be selling some of its massive holdings. To nonbelievers like ourselves in the allure of 2% coupons, the abiding mystery of ultra-low yields is why anyone wants them. Thanks to a man who asks that his name not get into the papers, we have chanced upon an idea.

The bond market is not irrational, our friend proposes. Thoughtful people must see something in it. And what they see, he suggests, is a hedge against a downdraft in stock prices. Until just recently, when the stock market went down, Treasury prices went up. To protect against a bear stock market, one could buy S&P puts—or, alternatively, 10-year Treasurys. The Treasurys, at least, pay interest.

"As you and I both know," our friend writes, "Treasurys and stocks are certainly NOT always negatively correlated to each other. In the early phases of an inflationary cycle, I would expect both stocks and bonds to react negatively (certainly when the Fed is hiking). In such a case, duration risk is a negative trait, Treasury beta moves to positive territory, and I would expect a rather hasty retreat for long Treasurys towards, or even past, their mean numbers, i.e., in yields above their mean inflation spreads." For the 10-year note, call that 200 basis points over the measured rate of inflation.

Naturally, persistently rising interest rates would hurt some and help others. But they would disorient nearly everyone. Three decades and more of mostly falling yields have instilled deeply rooted habits and expectations. For instance, they have inculcated the notion that the cost of income is, and forever will be, going up. Come a bond bear market, the cost of income would fall, along with the prices of yield-generating securities. A preview to this feature of the new world order—if the world has really changed—is the sell-off in the shares of the mortgage real estate investment trusts, especially American

Capital Agency (AGNC) and Annaly Capital Management (NLY), the two largest such REITs, down by 26% and 16%, respectively, since April 29. Shares in Hatteras Financial Corp. (HTS), better positioned for a bear market, have fallen by only 6% (*Grant's*, May 17).

In roughly the same span of time, junk-bond yields have climbed by 20%, "super-safe" 10-year Treasury yields by 31% and never-actually-very-safe Turkish sovereign yields by 30%. And did you know, analyst Paul Macrae Montgomery relates, that on an intraday basis from April 4 to May 23, JGB yields spiked to 1% from 33 basis points, a leap of 200%?

"For bonds to go down, someone has got to sell them," Harley Bassman, managing director of convexity products at Credit Suisse, tells Lorenz. "The question is, you sell them to buy what? Isn't that the problem here? I'm not sure what you're selling them to buy. This is the residual problem with QE: at some point, there are few financial assets of value to buy. Maybe money goes to real estate or hard assets or goes into cash and you wait."

One approach is to steer clear of the beneficiaries of falling rates. "Core" commercial real estate has profited hugely by the decline. At cap rates of 3½% or 4%, shiny midtown office towers in the so-called gateway cities are priced for perfection. Rising cap rates would introduce a costly element of imperfection—unless rising rental income compensated for higher cap rates. Consider, proposes the Third Avenue Real Estate Value Fund in its first-quarter letter, that "a property that generates $12 million of cash flow would be valued at $200 million using a 6% cap rate. At a 6.5% cap rate, the value would be only $184.6 million—a 7.7% decrease. The property would have to generate an additional $1 million of cash flow (an 8.3% increase) to offset the impact of a higher cap rate." Leverage, of course, enlarges the problem.

Can you, gentle reader, imagine a world in which landlords can actually put through 8.3% rental increases? The picture doesn't come easily into focus. But at generational turning points, the world usually seemed fixed in place. While a contrary remnant of investors was bullish on bonds at the 1981 peak in yields, probably not one foresaw ZIRP and all that's come with it. Imagination is a much underrated investment aptitude.

Letting ourselves go, we will try to imagine a state of things in which short rates (not just bond yields) are rising and net interest margins are expanding. In such a world, bankers would be tap dancing to work in the morning. People would have forgotten about the warrants that the TARP recipients had to sell to the Treasury and that the Treasury subsequently chose to sell into the market. But the warrants, presumably, would be appreciating.

"These are long-dated call options and they are very cheap values in our view, because not only are the fundamentals of the bank business quite challenged but also volatility is quite low," Ryan Dobratz, co-portfolio manager of the aforementioned Third Avenue Real Estate Value Fund, tells Lorenz. "We bought into these at valuations that we thought would produce very attractive returns, 15%-plus just in the base case, and should the banks actually increase their net interest margins in a rising rate environment and start producing better returns on their equity capital and be rewarded with high book multiples and stock prices, you can make some serious money on these TARP warrants."

PNC Financial Services Group (PNC on the Big Board) is one of the names Dobratz mentioned (for others, please consult the nearby table). Priced at $13.93, the warrants entitle their holders to buy PNC common stock at a price of $67.33 from now until Dec. 31, 2018. The shares currently trade at $71.75, which represents 105% of the underlying bank's book value and 11.3 times its net income. PNC, as Lorenz notes, had what might be called a "good" Great Recession. Its nonperforming assets peaked at a manageable 2.34% of assets in 2009 and stand today at 1.24%. The warrants have an implied volatility of 23.2%, slightly higher than the CBOE's VIX Index's long-term average of 20.1%.

It can't be said that the PNC insiders have been buying. On the contrary, they have been substantially selling. Maybe they see problems that outsiders don't. Or maybe they don't know an imaginable, potential, possible and conceivable new bond bear market when it's staring them right in the face.

•