GRANT'S

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Case of the obstreperous interest rates

"Even if something can't go on forever, it may seem as if it can." This variation on the well-known Herb Stein epigram fairly describes America's ever looming, ever receding fiscal crisis. The federal budget deficit—6% or 7% of GDP for "as far as the eye can see"—is arithmetically unsustainable, all must agree. But sustain it we do.

Or, rather, sustain it we have. Observe, as we did two weeks ago, the congestion in the short-term funding markets. Note the telltale rise in sensitive market rates of interest above the Federal Reserve's administered policy rates. Mark, as Bloomberg reported on Nov. 12, that federal regulators are preparing to relax capital requirements to enable big banks to warehouse more government securities. And hear Roberto Perli, manager of the Fed's System Open Market Account, address the issue of money-market stringency at the annual U.S. Treasury Market Conference, also on Nov. 12:

> The share of repo transactions taking place at rates above [the interest rate called "interest on reserve balances," or IORB, now fixed at 3.90%] has reached levels seen in late 2018 and 2019. The share of interbank payments settled late in the day has also shifted to late 2018 and 2019 levels as banks have delayed payments, possibly to economize on reserves. And the share of borrowing in the federal funds market by domestic banks has increased as well, albeit less so.

Perli was as cool as a cucumber. Such sightings only confirmed that systemwide bank reserves are dwindling, as the Fed intended they should, he said. At $3.1 trillion, down from $4.2 trillion almost four years ago, reserve provisioning was no longer "abundant," as it had appeared to the New York Fed itself as recently as October. The word today—quantitatively undefined—is "ample." The central bank had planned the shift, made it happen and was now poised to end QT, a.k.a. "portfolio runoff," beginning Dec. 1. Pretty soon the Federal Reserve's balance sheet will begin to grow again.

"At some point," Perli said, "it will be appropriate to start increasing the size of the [System Open Market Account portfolio, the heart of the balance sheet]. The exact timing will depend on several factors, but, as President Williams said, given what we know today, we probably won't have to wait long."

The Williams to whom Perli referred is John Williams, president of the Federal Reserve Bank of New York. Williams summoned a meeting of the representatives of the primary dealers in attendance at the Treasury market meeting to urge them to borrow more money from the central bank's standing repo facility. Don't be shy, Williams urged in so many words. The Fed is selling the SRF as a safety valve with which to relieve the pressure on money-market rates—so, a kind of volatility-suppression facility. Until the *Financial Times* got wind of it last weekend, Williams's appeal to the dealers was hush-hush.

Could these signs and portents be the prelude to the resumption of QE, as the short-lived, shocking leap in money rates in September 2019 proved to be? Perli, seeming to anticipate the question, replied in the negative. "Of course," he said, "organic growth of the portfolio to accommodate a growing demand for Federal Reserve liabilities absolutely does not represent a change in the underlying stance of monetary policy."

We wonder. The supply of government securities must be greater than the demand for government securities at prevailing yields. If they were not, why the propagandizing of the dealers to toss more business to the SRF? Why the recurrent upside pressure on repo rates?

On form, latent volatility in money rates will not forever remain latent. The overburdened market will get a case of the hiccups or worse. If worse, the Fed will rush to its bedside to administer the customary home

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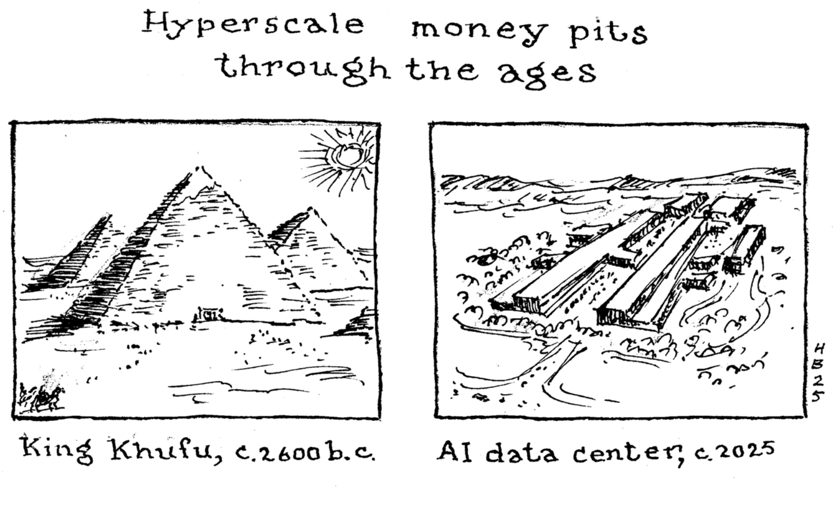
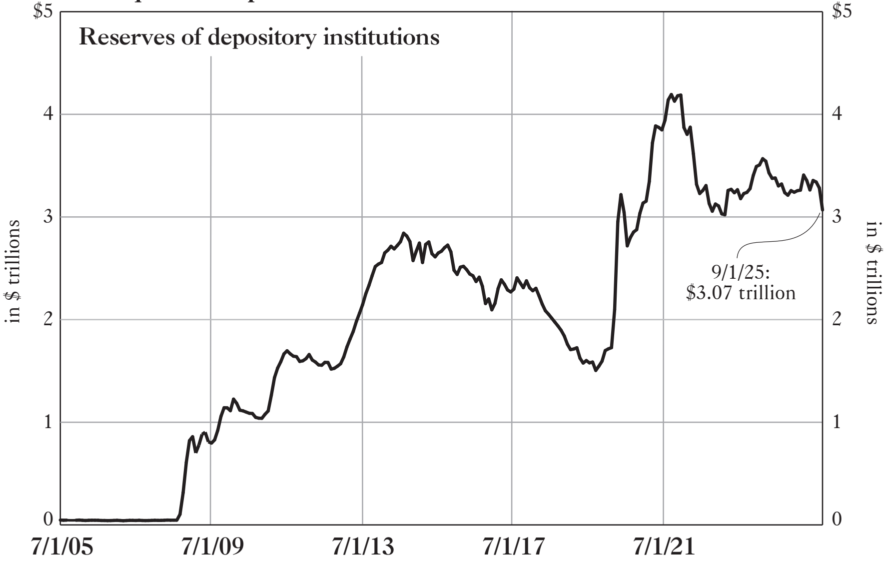


Not quite 'ample'?



source: Federal Reserve Board of Governors

remedy of bill-buying, note-buying and/or bond-buying. Pay no attention, it will tell the world. It's not what it looks like (for it looks a great deal like "QE by any other name," Part II). There have been tax payments. There was a government shutdown. A growing economy needs more debt and a touch—just a touch, mind you—more inflation. We are merely restoring "smooth market functioning."

This is the monetary dimension of the unmanageable public debt. In the short run, the problem presents in unruly money rates. In the long run, the pain points are demographics and entitlements. When the short run ends and the long run begins are the great known unknowns.

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Michael Faulkender, the former deputy secretary of the Treasury who made news in August by resigning his post less than five months after the Senate confirmed his nomination, delivered some timely remarks on the public credit at the Nov. 7 meeting of the Shadow Open Market Committee. Having served as a top aide to Secretary Steven Mnuchin in the first Trump administration (earning the Alexander Hamilton Award for his sterling work in the pandemic) and, according to *Politico*, played "a key role leading the transition team after the 2024 election," Faulkender is no ordinary ex-bureaucrat. Colleague James Robertson, Jr. was in the audience to hear him.

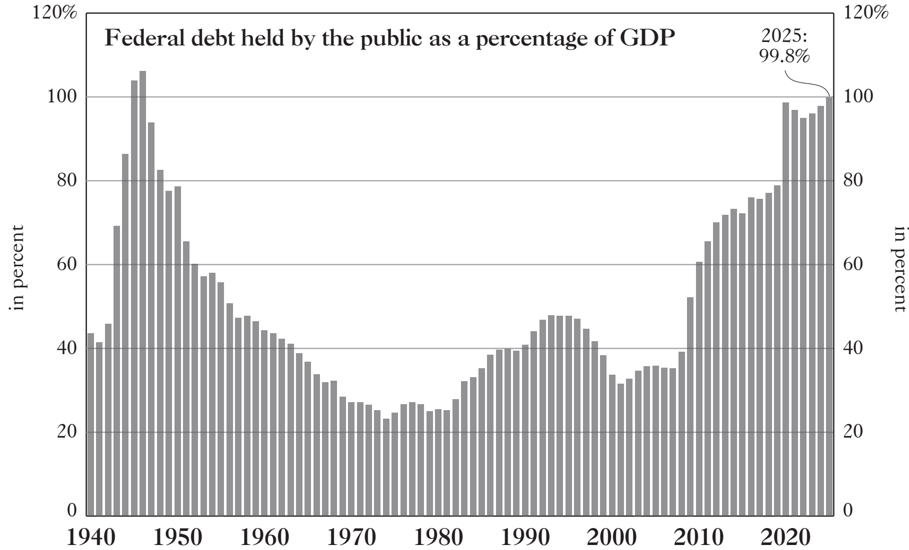
The former deputy secretary seemed to burn no political bridges (though, with Donald Trump, who's to say?), but he was not uncritical of the administration from which he had beaten such a hasty, second-term exit. As to the president's on-again, off-again tariff initiative, Faulkender rhetorically asked: Does the White House seek revenue, strategic advantage or negotiating leverage? He replied that nobody can tell. The president's top negotiators did not quite know what, "in the president's mind," success looked like. "I'm not sure there was real clarity, and it was just—you had to take different options to the president and see which ones he jumped on." At the limiting case, as Faulkender pointed out, "if you re-domesticate all manufacturing, if we no longer import anything, well, then you're not getting any revenue from the tariffs."

That confusion is the essence of the tariff case before the Supreme Court. The question is whether the executive branch, by single-handedly implementing such duties, has trespassed on Congress's exclusive constitutional prerogative to levy taxes on American citizens. "It's been suggested," Chief Justice John Roberts addressed Trump's solicitor general, John Sauer, during the Nov. 5 oral arguments, "that the tariffs are responsible for a significant reduction in our deficit. I would say that's raising revenue domestically."

Sauer, in the administration's defense, repeatedly argued that the money generated from the levies was "incidental." They were "regulatory tariffs" and not "revenue-raising ones," he said. So saying, he seemed to contradict the president's promotion of tariffs as a major tool with which to tackle the $37 trillion gross federal debt.

By the end of the hearing, the majority of justices seemed to share their chief's doubts, *The Wall Street Journal* reported, and betting markets today assign a 76% probability to an administration defeat, according to Polymarket, up from 41% in September.

Let's call it 100%



source: The White House

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Trump warned last Tuesday via Truth Social that the economic fallout from an adverse ruling would be "insurmountable" and come at a cost of more than $3 trillion in lost import revenue and investments. It was a figure that recalled the Congressional Budget Office's summertime estimate that the tariffs in place would cut primary deficits by $3.3 trillion and trim another $0.7 trillion in interest costs over the next decade. The combined $4 trillion in relief would nearly balance the CBO's projected $4.1 trillion price tag for the One Big Beautiful Bill.

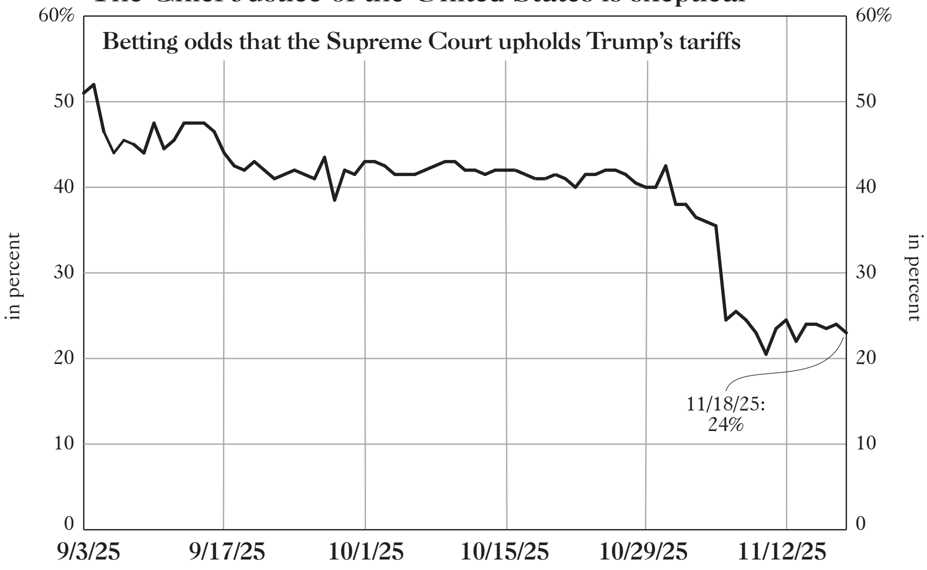
Of course, not all the projected tariff revenue would disappear under the gavel of a negative ruling. Some 25% of duties, largely the targeted ones unmentioned on Liberation Day, are not currently under judicial review. Executive privilege allows the president to replace some of those on the chopping block. And there is a stopgap, the so-called Section 122 powers of the Trade Act of 1974, which allows the president to impose tariffs of up to 15% for five months.

But much of those future tariff revenues, and more than the $100 billion already banked, could indeed vanish (never mind the administrative nightmare of remitting the duties already paid). An adverse ruling would force the administration to rebuild its tariff campaign industry by industry or country by country. Sweeping tariffs would be off the table. No longer could the administration argue that every industry is a national-security concern or that every nation is a predatory trading partner.

"Nor," Robertson notes, "is there any guarantee that the White House would earmark for spending reduction the tariff revenues that remain. Four days after the Court began its deliberations, Trump floated a tariff-funded 'dividend of at least $2,000 a person,' for all but high earners. Such a program, the Committee for a Responsible Federal Budget (CRFB) estimated, would cost $600 billion, or twice the amount of expected tariff revenue this year."

Bond markets have made few concessions to the risk of a tariff budget boomerang. Since the tariff case moved up to the Supreme Court on Aug. 29, the 30-year Treasury yield has declined by 18 basis points, to 4.8%. Nor has the bond market demanded concessions (as far as we can tell) from the threats

The Chief Justice of the United States is skeptical



source: Polymarket

to the integrity of the public credit presented by nonstop entitlement spending and dwindling population growth. Perhaps the 40-year bull bond market conditioned the world to ignore those secular forces.

"When I was assistant secretary," Faulkender told the Shadow Open Market gathering,

> I chaired a working group on Social Security and Medicare trustees' reports, because, as you may know, the secretary of the Treasury is the managing trustee. And the fundamental problems in those programs are demographic, not economic. There are two inputs into that report that matter more than anything else—birth rate and death rate. Everything else is secondary.
>
> A lot of people think that the baby boom was mostly in the late '40s. It actually was in the late '50s. It was the biggest part of the baby boom, and those folks are retiring now. Those are the folks in their mid-60s right now. Once they fully retire, Social Security spending is 6% of GDP. Medicare plus Medicaid is 7% and you have to add Medicaid because a lot of the people who end up in nursing homes end up having Medicaid. So 6% for Social Security, 7% for Medicare, 3% for interest on the debt and at least 3% for Pentagon spending, because the world's getting riskier and not safer.

That makes 19% in all, Faulkender observed, "and I haven't funded the rest of the government." For reference, the entire federal budget in the just-ended fiscal year absorbed 23% of GDP. "So it's mathematically impossible to get our fiscal situation under control by never touching Social Security, Medicare and Medicaid." He continued:

> You cannot get there. We are already trying to squeeze as much as possible out of everything other than those five things. If you're going to have a homeland security department, if you're going to have embassies around the world, if you are going to have an agriculture department, if you're going to have law enforcement, we are going to have to spend money elsewhere. But we've already got 19% of GDP going to those five things.

Which leaves taxes. "How much more revenue can we get?" mused Faulkender, who for not quite two months last spring served as acting commissioner of the Internal Revenue Service (one of five, including the current incumbent, Scott Bessent, to fill that post in the second Trump administration). He went on:

> So where is the peak on the Laffer Curve? That's the economic question and a political question. Will the political economy allow you to actually have the middle class and the upper-middle class pay for that with tax? So yes, we just extended the [Tax Cut and Jobs Act of 2017]. They're permanent. But remember, even the Biden administration didn't want to raise

taxes for everybody below $400,000. So there was already this consensus that the upper-middle class also was not going to see a tax increase.

So maybe we could get another 1% of GDP out of the wealthy. But if you're taking everyone below $400,000 off the table, there's not a lot more revenue to be had. You can bring in a little bit from the president's tariff policies. But spending can't stay at the 23%, 24%, 25% of GDP. It's got to come down.

Plain and simple, contended Faulkender, now a chaired professor of finance at the Robert H. Smith School of Business at the University of Maryland, there isn't the political will to address it. "We can't even get both parties to agree that the debt is even a problem," he said. "The Democrats think we're going to just tax our way out of it. The Republicans think we're just going to grow our way out of it. Again, the demography piece is just too big for either one of those to fix Social Security.

"I think everybody needs to understand that you cannot touch Social Security inside of reconciliation. Under the Budget Act that created the reconciliation process, it explicitly immunizes the Social Security Act. You cannot modify it."

What's the answer? "So then," Faulkender concluded, "the question is going to be, What is finally going to force Congress to deal with something that they all consider the third rail and don't want to touch? It's going to be a failed bond-market auction."

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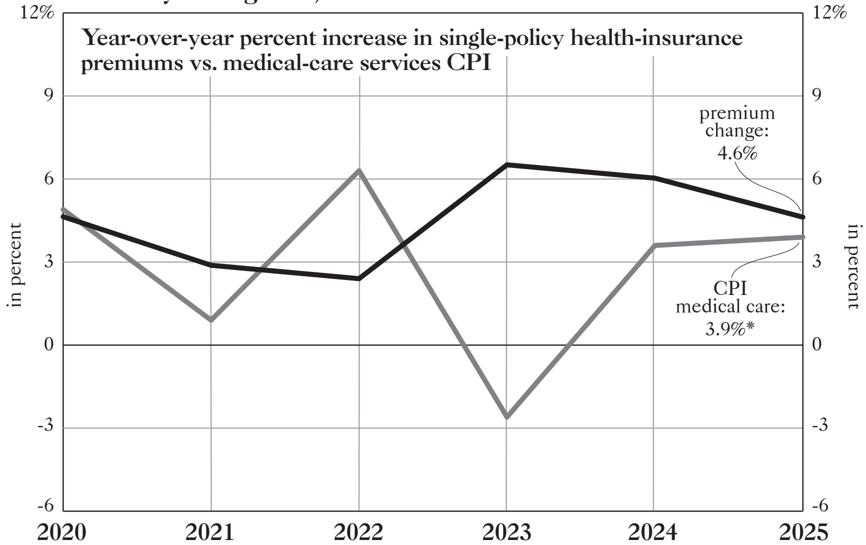
Inside the CPI

Joel Wallenberg writes:

There is no October CPI report, but there were November off-year elections, and the results were uncontestable. "Affordability," the new inflation, won in a landslide (in a negative kind of way). Price controls and socialism rode the coattails of affordability to victory down-ballot.

Now that the government, along with its pretty darn honest statistics mills, is up and running again, we look ahead to the next few months of inflation reports. In preview, we expect more upticks than downticks along with one potentially electrifying bullish surprise.

Check your figures, BLS



* As of September 2025.

sources: Kaiser Family Foundation, Bureau of Labor Statistics

"It would not be accurate to say that we are flying blind," the president of the Kansas City Fed, Jeffrey Schmid, told the 2025 Energy Conference in Denver last Friday. His dissent against the Federal Open Market Committee's latest rate cut, he said, was well informed by data sources in his bank's own district (even though the Bureau of Labor Statistics was shuttered). Such sources expressed "continued concern over the pace of price increases," and tariffs were only part of the picture. "I hear concerns about rising health-care costs and insurance premiums," Schmid continued, "and I hear a lot about electricity. Overall, the message is that inflation is too high."

Rising health-care costs not least. The average single-policy health-insurance premium jumped by 4.6% per person from 2024 to 2025, according to the Kaiser Family Foundation survey of employer-sponsored health insurance. Premiums have risen by 4% per year on average over the past decade, including a 6.5% leap in 2023. One can find line items in CPI for automotive insurance and home insurance in CPI (up 3.1% and 7.5% year over year through September, respectively), but one will not find a line item called "health-insurance premiums."

The CPI calculation does not price these directly, but rather estimates the medical benefits paid out and distributes them among the various "medical care" subcategories. A residual index, based on the retained earnings of health insurers, is captured by the sub-component actually named "health insurance." The overall medical-care services index in September's CPI, up by 3.9% year over year, does not quite represent the observed rise in premium prices, nor does "medical-care commodities," up by 0.7%. Neither does the "health insurance" sub-component do justice to the premium increase, though it is closer, at 4.2% year over year.

As for that 6.5% lurch higher in premiums in 2023, the CPI entirely missed it: The medical-care index registered only a 2.9% increase from January 2022 through December 2023, and the "health-insurance" sub-component of CPI showed a 27.1% *decrease* year over year through December 2023. (The CPI did register a 6.3% increase in September 2022 for medical-care services, which does not appear in the readings for other months.)

The 24 million Americans (7% of the population) enrolled in plans through the Affordable Care Act (ACA) Marketplace can expect to suffer a 26% surge in premiums in 2026, according to a Kaiser Family Foundation report. However, if Congress does not extend the enhanced premium tax credits for the 22 million ACA enrollees who enjoy such subsidies, that cohort's health-insurance premiums will shoot higher by an average of 114% next year. Lower-income enrollees (i.e., those making $22,000 or less annually) will move from paying no health insurance to paying 2.1%–3.6% of their earnings for coverage, and the higher rung of enrollees (i.e., those making $55,000–$65,000) will pay 10% of their incomes in health insurance in 2026, from 7.3% in 2025.

President Schmid is as right about electricity as he is about health care, and price increases are accelerating. Year over year through August 2025, residential electricity prices rose 6.1% and average household bills by 9.6%, according to the National Energy Assistance Directors Association. More worryingly, electricity prices climbed by 10.5% between January and August alone (16.2% annualized), and NEADA projects a 10.2% year-over-year jump in electric heating prices for this winter. The official CPI electricity component agrees with NEADA's year-over-year electricity price figure (not the electricity bill figure), but it undercounts the 2025 increase: From January through August, the CPI registered only a non-seasonally adjusted 8% rise. Data dependence, if that data is intra-annual CPI, has its limits.

In our state of diminished data, private reports such as CoStar Realty Information, Inc.'s recent multifamily outlook provide a glimmer of hope for the Stephen Mirans of this world. CoStar now projects a 0.1% annual rent decline for the final quarter of this year, down from its previous estimate of a 1.5% increase. Nevertheless, renters are not out of the woods, as surplus demand is on the way: CoStar expects renter demand to begin outpacing supply this quarter, for the first time since 2021, and for apartment deliveries to decrease by 55% in 2026. The report does not expect rents to continue to decline, even in the case of economic weakness, noting that "the undersupplied U.S. housing market is likely to help sustain multifamily demand by keeping renters priced out of homes, as it did during the pandemic and the Great Recession."

A data-dependent market, however, might be tempted to over-interpret temporarily cooling rents, provided that they materialize. With rent and owners' equivalent rent together making up 33.7% of the CPI calculation, a year-over-year 0.1% slip in these categories would reduce overall CPI by 0.03%. Such an amount does not sound like much, but it would knock more than a third off of CPI inflation, all else being equal, making annual inflation through November and December look very close to 2% (the surprise we mentioned above). That could very well turn the head of Mr. Market and of the FOMC that pays that gentleman court.

The portion of this change that would be traceable to the 26.2%-weighted owners' equivalent rent is perhaps more than a little misleading. Rents may fall, but the costs involved in owning and maintaining a home typically do not. This fact can easily be gleaned from other components of the September CPI, such as the 4.8% year-over-year rise in water- and waste-disposal costs, the aforementioned 7.5% uptick in home-insurance costs and the 13.9% increase in gardening costs.

An Oct. 30 research report by Dan Pan, economist at Standard Chartered plc, and Steve Englander, head of Global G10 FX Research and North America Macro Strategy at Standard Chartered, makes the point about owners' equivalent rent in no uncertain terms, stating that homeownership costs "barely change unless the mortgage terms change." Observe, they say, the absence of a significant statistical relationship between the shelter CPI component and consumer inflation expectations, which are known to generally run above CPI inflation. Thus, the University of Michigan Survey of Consumers reports a preliminary November year-ahead inflation expectation of 4.7%, up from October's 4.6%. (This number has remained above 4% since February.)

Another source of misperception, according to Pan & Englander, is the so-called hedonic, or quality, adjustment to rent and owners' equivalent rent. The BLS considers improvements in the quality of certain items to constitute deflation, including housing amenities, and so adjusts the prices of those CPI components downwards. This causes CPI to underestimate inflation, and overestimate deflation, vis-à-vis the prices that consumers actually pay. By precisely how much, we cannot say: Dan Pan tells me via email that the exact magnitude cannot be ascertained, because it is not reported. (A CPI economist confirms that the BLS does not disclose specific quality adjustments for specific CPI reports.) Pan & Englander find that the CPI is separated into quality-adjusted components and non-adjusted components and that only the latter significantly track consumer-inflation surveys.

"Our results suggest," Steve Englander says to me electronically, "that the BLS measure of rents doesn't have the impact on inflation expectations that would be expected given its weight." The consumers aren't necessarily wrong, particularly where owners' equivalent rent is concerned. As more and more technology becomes embedded in everyday items, including ones a homeowner may need to install to maintain a home, Pan & Englander say we can expect more such quality adjustments in the future. As anyone whose boiler has broken down in the dead of winter can testify, the new boiler is probably a much better model than the old, but it was also the only option on the table.

Even Donald Trump is concerned about "affordability," to judge by his announcement last Friday that certain agricultural imports would no longer be subject to the infamous "reciprocal tariffs." His move belies the White House press release of Nov. 10 claiming that "inflation has been tamed," based on a DoorDash, Inc. study of select items from their delivery marketplace. The presser comes complete with a cartoonish chart that asserts, "Grocery prices on breakfast items has [sic] dropped." Brazilian beef, for instance, will no longer be subject to the 10% reciprocal tariff, though it will still be subject to the 40% tariff on Brazil that Trump instituted in July, as the *Financial Times* reported on Nov. 14. (September's CPI registered a 14.7% year-over-year increase in the price of beef and veal.) Bananas, another item now excluded, showed a 6.9% year-over-year price increase in September, but rising import prices do not explain it. In fact, as Tracy Alloway notes in Bloomberg's "Odd Lots" newsletter, there has been a 26% decline in the import price of bananas since last September.

Clearly, keeping prices from rising is one thing, and getting them to fall is another. At that, the Federal Reserve, the fount of affordability, continues to target a 2% rate of rise (or is it 3%?). You wonder whose side it's on.

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(Continued on page 8)

CREDIT CREATION

FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

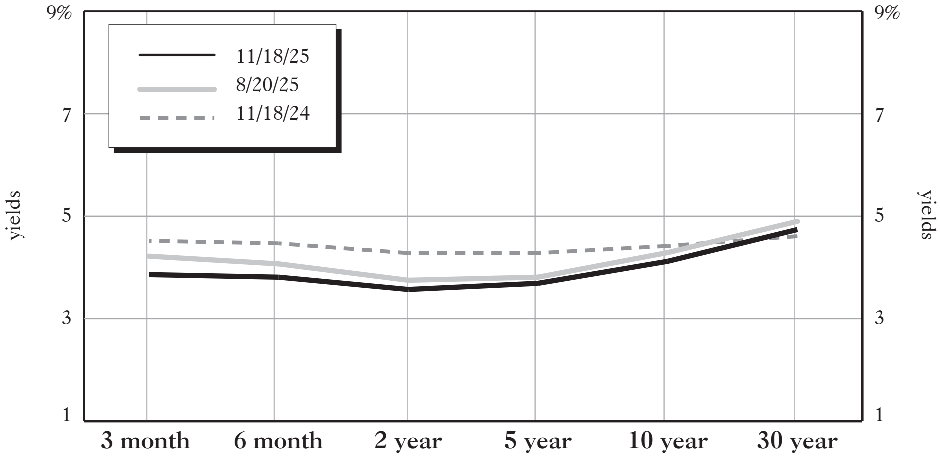
	Nov. 12, 2025	Nov. 5, 2025	Nov. 13, 2024
The Fed buys and sells securities…			
Securities held outright	$6,265,216	$6,265,501	$6,608,382
Held under repurchase agreements	1,723	26,308	1
and lends…			
Borrowings—net	6,758	7,494	2,241
and expands or contracts its other assets…			
Maiden Lane, float and other assets	254,826	251,928	320,925
The grand total of all its assets is:			
Federal Reserve Bank credit	6,528,523	6,551,231	6,931,549
Foreign central banks also buy, or monetize, governments:			
Foreign central-bank holdings of Treasurys and agencies	$3,064,484	$3,088,644	$3,328,205

EUROPEAN CENTRAL BANK BALANCE SHEET*
(in millions of euros)

	Nov. 14, 2025	Oct. 17, 2025	Nov. 15, 2024
Gold	€1,128,570	€1,128,546	€819,979
Cash and securities	4,698,780	4,736,745	5,163,764
Loans	19,861	19,220	49,195
Other assets	310,457	307,854	350,059
Total assets:	€6,157,668	€6,192,365	€6,382,997

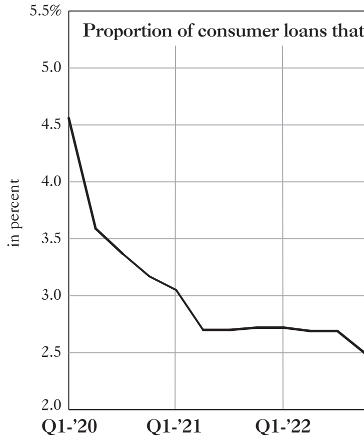
** Totals may not add due to rounding.*

MOVEMENT OF THE YIELD CURVE



source: The Bloomberg

Let the creditors wait



source: Federal Reserve Bank of New York

Mr. Market up in

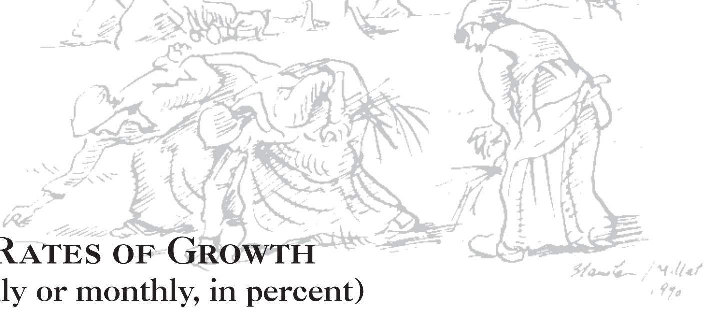
Evan Lorenz writes:

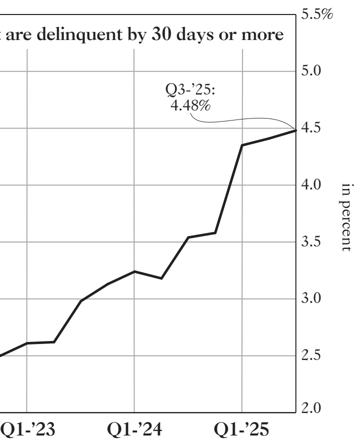
This earnings season is one for the record books. Based on the 463 companies that have reported third-quarter results, the S&P 500 is on pace to report year-over-year earnings growth of 14.7% and net profit margins of 13.1%, the highest pitch of profitability since FactSet Research Systems, Inc. began tracking the series in 2009. Chief executives forecast more fair weather, as mentions of "economic slowdown" and other recession synonyms on conference calls have dwindled to their lowest levels since 2007, according to Bloomberg.

Investors are understandably ebullient. According to the November BofA Global Fund Manager Survey, respondents are the most overweight stocks since February, i.e., before this year's trade ruckus began, while cash levels have fallen to 3.7%, a threshold that has been matched only 19 other times since 2002. Just 6% of respondents expect a hard economic landing.

Are the respondents assuming that Blue-Chip America will continue to cut or pass through costs, including the ones embedded in President Donald Trump's tariffs? If so, they might remember that one person's cost is another person's income. American companies announced 153,074 job cuts last month, nearly triple the number logged in the same month last year and the most for any October since 2003. Not surprisingly, the University of Michigan's consumer-sentiment index slipped

• Cause & Effect





n the driver's seat

by 3.3 points in November, to 50.3, only 0.3 points above the series's lowest reading of 50, carved out in June 2022.

And it's not just auto lenders like Tricolor that are defaulting on their debts. The proportion of subprime borrowers 60 or more days past due on their car loans rose to 6.65% last month, the most since Fitch Ratings began tracking the series in 1994. Overall, 4.5% of all consumer loans were 30-plus days past due in the third quarter, the largest crop of delinquencies since the first quarter of 2020, when lockdowns commenced, according to the New York Fed.

While little seems to link Wall Street exuberance to the struggles on Main Street, there is economic reflexivity at play. According to Moody's Analytics, the top 10% of households by income accounted for 49.2% of all spending in the second quarter, a record high since at least 1989, and this comfortable cohort takes its cues from frothy (or, at least, previously frothy) markets.

McDonald's Corp. is a case in point: In the third quarter, the burger chain's U.S. same-store sales rose 2.4% year over year, despite a double-digit decline in visits from lower-income consumers and a nearly reciprocal percentage increase in traffic from affluent ones.

If losses in the stock and crypto markets cause top earners to tighten their belts, look out below. It's Mr. Market's economy.

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Annualized Rates of Growth
(latest data, weekly or monthly, in percent)

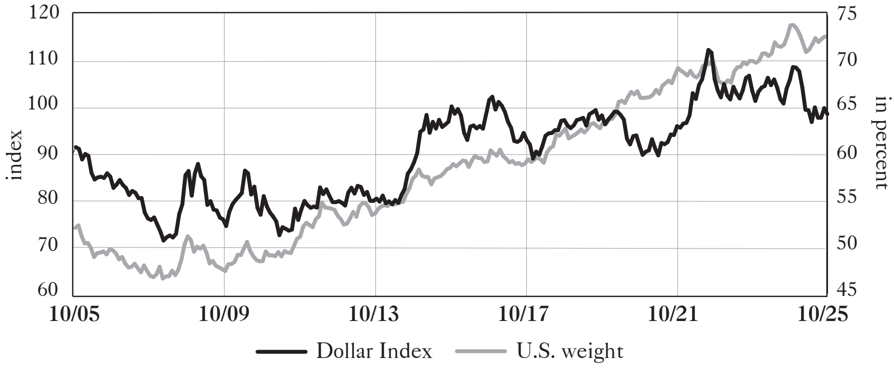
	3 months	6 months	12 months
Federal Reserve Bank credit	-3.4%	-3.8%	-6.1%
Foreign central-bank holdings of gov'ts	-16.7	-11.7	-7.5
European Central Bank assets	4.5	-4.4	-3.6
Commercial and industrial loans (Oct.)	3.1	1.7	-3.2
Commercial bank credit (Oct.)	5.2	5.5	4.9
Asset-backed commercial paper	7.8	8.5	18.1
Currency	3.1	3.3	2.6
M-1 (Sept.)	6.0	4.8	4.7
M-2 (Sept.)	7.2	6.1	4.9

Reflation/Deflation Watch

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	18,451.35	18,118.42	15,198.35
Moody's Industrial Metals Index	3,297.56	3,263.40	2,932.96
Silver	$50.69	$48.14	$30.57
Oil	$60.09	$59.75	$68.70
Soybeans	$11.25	$11.17	$9.88
Rogers Int'l Commodity Index	4,140.22	4,100.10	3,754.76
Gold (London p.m. fix)	$4,071.10	$3,994.10	$2,567.30
CRB raw industrial spot index	576.49	572.93	540.51
ECRI Future Inflation Gauge	(Oct.) 108.5	(Sept.) 108.0	(Oct.) 111.6
Factory capacity utilization rate	(Aug.) 77.4	(July) 77.4	(Aug.) 77.9
CUSIP requests	(Oct.) 4,120	(Sept.) 4,030	(Oct.) 3,848
Fed's reverse repo facility (billions)	1.56	4.90	172.40
Grant's Bitcoin Treasury Index*	78.38	100.41	96.04

*Index=100 as of 6/27/2025

American Dominance
Dollar Index (left scale) vs. weight of U.S. stocks in the MSCI World Index (right scale)



(Continued from page 5)

Credit cycle play

Evan Lorenz writes:

In the first nine months of the year, creditors have taken over 45 p.e.-sponsored companies, the fastest pace in at least six years and more than double the count in 2024, according to Lincoln International. "You will probably see more sponsors throwing in the keys and saying, 'Take it over,'" Roy Kahn, the global co-head of Lincoln's valuations and opinions group, warned last week.

You've got the keys. Now what? Hire a restructuring adviser, of course (what you, the lender, don't know about running a business could probably fill a book). In preview, *Grant's* is bullish on FTI Consulting, Inc. (FCN on the New York Stock Exchange), one of the largest restructuring consulting firms in the world.

Former U.S. Naval Academy professor Dan Luczak and his business partner, Joseph Reynolds, Jr., founded Forensic Technologies International in 1982. To provide lawyers in complex court cases with expert witnesses and comprehensible computer models was the business model. Early case work included the Hunt brothers' attempt to corner the silver market in 1980 and the O.J. Simpson murder trial in 1994–95.

The 2002 the Sarbanes-Oxley Act was manna from heaven. In obedience to the stipulation of the law that audit firms could no longer engage in consulting work for their own clients, PricewaterhouseCoopers put up its U.S. restructuring unit for sale. FTI, as Forensic Technologies by then had rebranded itself, was the lucky buyer, paying just $250 million. This was in 2002, when the acquiree was generating Ebitda of $45 million per year.

FTI today stands toe-to-toe with such advisory behemoths as Alvarez & Marsal Holdings, LLC and AlixPartners, LLP. All three represent both investors and debtors, though FTI is partial to the creditor side of the negotiating table, while Alvarez & Marsal and AlixPartners are more likely to be found on the debtor side. FTI has represented all top-100 law firms as well as 90 of the Fortune Global 100 corporations and 71 of the top-100 firms in the Private Equity International 300 list. "They're top-notch," James Sprayregen, vice chairman of global strategy and growth at Hilco Global, attests. "I've used them thousands of times over the years."

Corporate finance and restructuring, which brought in 40% of revenues in the 12 months ended Sept. 30, is the biggest of FTI's five business units. It serves up expert advisers on strategic, operational, financial and transactional matters in situations ranging from acquisitions to divestitures to corporate turnarounds. The forensic and litigation-consulting unit (20%) investigates and manages legal disputes, especially in the fields of construction and health care. The strategic communications division (10%) writes the press releases and crafts the messages that turn down the volume on corporate disasters.

Strictly from an earnings point of view, it might be better if there were three business divisions rather than five. Economic consulting (20%) is one problem child, technology (10%) another. The first analyzes complex issues surrounding M&A, antitrust, contractual claims and litigation. The second performs electronic discovery work and writes software to solve M&A, litigation and restructuring-related issues.

FTI has been through the mill lately. Its difficulties began in 2023 with the firing of Jonathan Orszag, co-founder of Compass Lexecon, LLC, a company that FTI acquired in 2006 and which forms the core of FTI's economic business. The dispute concerned profit-sharing and control. Thus spurned, Orszag founded a rival consulting firm, Econic Partners, LLC, in December 2024.

"It's been a disaster for FTI," George Livadas, founder of Upslope Capital Management, LLC, which holds a position in FTI, tells me. "He's brought over a bunch of people from FTI, so they lost some rainmakers, and they've had to pay the existing people more to stay."

Ebitda of the economic unit fell to a deficit of $4.6 million in the three months ended September from positive $35.2 million in the like period last year. In the same quarter, the technology division registered a 17.1% decline in Ebitda.

For a distress and bankruptcy advisory service, reports that high-yield default rates continue to hover around a moderate 5% belong under the heading of "news we could live without." However, as Victor Khosla, founder and CIO of Strategic Value Partners, LLC, noted at the *Grant's* fall conference (see the Oct. 10 issue), defaults aren't what they used to be. Most nowadays originate from so-called liability-management exercises (LMEs) rather than bankruptcies. The trouble, Sprayregen tells me, is that for FTI and firms like it, "those are very lawyer-driven types of events—more legal and financial engineering than operationally driven—and so there is less need for those kinds of firms."

On top of this, CFO Ajay Sabherwal announced his resignation on Aug. 12 to take the same role at OSTTRA, a p.e.-owned firm that provides such post-trade solutions as portfolio management, trade matching and confirmation. And if that weren't enough, investors have taken to worrying that artificial intelligence will render human-staffed advisory firms obsolete. Not surprisingly, FTI's share price has slumped by 30% from its highs 13 months ago.

Dark musings to one side, FTI in the third quarter showed 3.3% revenue growth, to $956.2 million, and earnings per share growth of 41%, to $2.60. Those top- and bottom-line figures are new high-water marks for the company. "This was a record quarter," CEO Steven Gunby crowed on the Oct. 23 earnings call. "I would call [it] spectacular and a set of results that, to me, was particularly gratifying given that we delivered these results in the face of major headwinds in two of our businesses and while continuing to invest in all our businesses."

In the third quarter, revenue growth in the corporate finance unit weighed in at 18.6%, in the forensic and litigation consulting unit at 15.4% and in the strategic communications unit at 7.4%, never mind the assorted troubles of fact and perception.

"The dirty little secret about LMEs is that 9 out of 10 fail," says Sprayregen, "but in the major leagues, if you strike out 7 of 10 times while hitting safely the other three you're in the Hall of Fame." Take Serta Simmons Bedding, LLC, for example. In 2020, the mattress maker conducted a liability-management exercise to secure more borrowing in a transaction that advantaged one set of creditors over another. So heinous was that gambit that creditors began demanding "Serta blockers"

Lots of paths to success

source: The Bloomberg

in future deals. But there is no karma blocker, and Serta filed for bankruptcy protection in 2023.

A manager of high-yield and private credit funds, who asks to go nameless, describes the situation as a pig in a python. "The problems in LMEs are building," our source says, "and you are going to need restructuring advisors." Notably, defaults are elevated despite continued economic growth. Credit problems would multiply in a recession.

"We're also seeing increased activity with commercial banks and other types of lenders as some recent alleged fraud has created pockets of stress," interim CFO Paul Linton told dialers-in on the Oct. 23 earnings call. "These are situations where our strong restructuring relationships and leading investigation position in [forensic and litigation consulting] means that our experts get more than our fair share of calls for the largest, most complex mandates." Such high-profile blow-ups as Tricolor and First Brands Group are creating more than just restructuring work.

AI will undoubtedly change how businesses operate, but it seems no death knell for consulting. "In general, all the things that FTI is doing are mission-critical and highly sensitive," Andrew Nicholas, who rates FTI a buy for William Blair, tells me. "And there's a huge difference between getting work 90% right and 100% right. Customers want people helping them through it. These are huge M&A transactions, huge court cases and huge bankruptcy proceedings."

The econ division is currently uneconomical, but nothing is forever in a cyclical business. Yes, the dearth of transactions has dashed hopes for a 2025 rebound, but M&A activity will eventually recover. And FTI's new econ rainmakers, though a drag on profits today, will build out their books of business and sooner or later justify their fancy paychecks—or else.

"Growth and earnings performance in 2025 has been masked by the turmoil within economic consulting, which we expect to find its bottom over the next couple quarters," Nicholas tells me. "Looking ahead to 2026 with easier comps on that side and an environment that is potentially setting up to be what I would refer to as a Goldilocks environment, where M&A is picking up and, at the same time, there's all this kind of disruption, whether it's technology-driven, whether it's interest rate–driven or whether it's the LMEs coming back for more. That's my bull case."

One can imagine an alternative bullish scenario. Busts and cyclical downturns generate more demand for restructuring advisors and, frequently, for litigation services and new communication strategies, too. FTI expanded its revenues by 17.4% in 2008, the year Lehman Brothers failed, and by 2.9% in 2020, during the lockdowns (both figures are adjusted for acquisitions). The growth in the plague year is all the more impressive given that many lenders allowed borrowers a Covid grace period before consigning them to default.

CEO Steven Gunby, age 67, took the helm in 2014 after serving as the global leader of transformations at the Boston Consulting Group. "FTI used to be a very siloed organization," Jack McPherson, president and portfolio manager of Aristotle Capital Boston, LLC, which holds a position in FTI, tells me. "He did a really good job of getting people to work together and refer business to other FTI divisions. I think it is a better business today than it was in the past."

Gunby is also doing something about the share price. In the year through mid-October, FTI spent $846.1 million repurchasing stock, shrinking the total share count by 14.1%, and it disclosed a new $500 million buyback authorization on the Oct. 23 earnings call. The next day, CEO Steven Gunby himself bought 7,500 shares at a net cost of $1.1 million, bringing his stake in FTI to 294,007 shares worth $48.5 million. This was Gunby's first open-market purchase since 2017.

Many companies make their share repurchases when the price is high and rising. FTI takes a radically different approach. It buys in the busts and accumulates cash in the booms. It ramped up buybacks in 2017; between Aug. 18, 2017 and Aug. 8, 2018, the share price soared by 155%. FTI also turbocharged repurchases in 2020; between Oct. 29, 2020 and Dec. 4, 2023, the stock leapt by 138%.

After accounting for the recent buybacks, FTI's balance sheet showed $364 million in net debt, a sum equal to 0.8 times trailing Ebitda, as of Sept. 30. It's not much leverage, but a great deal more than the net cash position of $386.3 million posted at Sept. 30, 2024. The rating agencies position FTI on the cusp between investment-grade and junk (Ba1/triple-B-minus).

The shares trade at 17.1 times the estimate for 2026 earnings, which compares to an average price-earnings multiple of 24 times in the five years ended 2024. Despite FTI's $5 billion market cap, only three analysts on the Street follow the stock; one says buy, none says sell. With short interest footing to 4.2% of the equity float, the bears, too, seem disengaged. Insiders have sold a net 2,689 shares over the past 12 months for net proceeds of $513,991.

"You've had a temporary step up in investments you've had to make in talent," McPherson sums up the state of play, "but you are going to absorb that and leverage those investments over the next 12–24 months. So the returns on the business will improve, earnings will improve and cash flow will improve.

"To me, there's no reason that FTI can't get back to its historic valuation," McPherson adds. "If you get a surge in bankruptcies and restructuring activity, then you've got potential for even more upside."

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Way faraway values

"In January 2024, the Hang Seng was down approximately 50% from its peak six years earlier," says itinerant value-seeker Dan Rupp, "and stocks traded at generational-low multiples." Taking that cue, *Grant's* talked up a trio of Chinese bargains. You may remember the headline over the analysis: "Commie value play" (see the issue dated Feb. 16, 2024.) Now that the Hang Seng is 58.7% higher, it's on to the next opportunity.

In preview, we find much to like in PT Hanjaya Mandala Sampoerna Tbk, the largest cigarette maker in Indonesia, and a pair of Philippine retailers, Puregold Price Club, Inc. and Philippine Seven Corp.*

Rupp is the founder of Parkway Capital, Ltd. and the man who brought us the German-listed stock line of Chinese appliance-maker Haier Smart Home Co. (690D on Frankfurt) in the issue of *Grant's* just cited. Since that date, Haier has generated a 121.7% gain, blowing away the 35.2% return on the S&P 500 over the same span (both figures are in U.S. dollars and include reinvested dividends).

Prior to launching Parkway in January 2024, Rupp spent 17 years working at Overlook Investments Ltd., an Asian-focused investment fund, including a culminating stint as director of research. Taking a page from Overlook, the Parkway M.O. is to "buy growth at a discount," with a goal to build a portfolio that has a higher return on equity than the S&P 500 but with "significantly less leverage," as Rupp puts it.

So far, so good. The 29 positions in Parkway's portfolio are on track to generate a 21.7% ROE this year versus 18.9% for the S&P 500. And the Parkway portfolio achieves this with a net cash position equal to 8.4% of equity versus a net debt position of 43% for America's blue-chip average. Of course, exotic markets come with risks of their own.

Out of the bargain bin

source: The Bloomberg

You'd expect that the share price of Sampoerna (HMSP on Jakarta) would be on the wing. The median age of the Indonesian populace is 30 years, nine years younger than America's. GDP per capita has risen by 49% in dollar terms, to $5,026, in the decade ended 2025, according to the International Monetary Fund. Some 87% of the population is Muslim. Indonesians may not drink, but 37% of them (the adults, we mean) do smoke. Kretek, a blend of tobacco and cloves, is the national favorite. Sampoerna holds a 31% share of the cigarette market.

There is much to like in corporate governance and capital allocation, too. Sampoerna is 92.4% owned by Philip Morris International, Inc. and pays out 100% of earnings in dividends. As of Sept. 30, Sampoerna's balance sheet showed a net cash position of 5.1 trillion rupiah ($247 million).

Yet the Sampoerna share price has plunged by 88% in dollar terms since Jan. 23, 2018, a collapse attributable to the national tobacco tax, which climbed (and climbed) between 2016 and 2024 at the annual compound rate of 12.5%. There is a Laffer curve in even normally price-inelastic goods like cigarettes, Rupp, who holds a position in Sampoerna, tells deputy editor Evan Lorenz. "The government created an illegal cigarette industry."

And an industry that pays no taxes. Now that Sri Mulyani Indrawati, the finance minister whose heavy hand laid on the tobacco imposts, is out of office, her successor is holding tax rates steady this year and next. "Officials note that additional hikes would further widen the price gap between legal and illegal products and crackdowns are gaining traction," with 816 million illicit cigarettes seized in the year to date, Sucor Sekuritas analyst Giovanus Marcell Lie, who rates Sampoerna a buy, wrote in an Oct. 22 report.

"I was in Bali a few months ago, and I spoke to a bartender who was smoking," Rupp recounts. "I asked him about the illegal cigarettes and about Marlboros [a Sampoerna brand], his preference. He said that when he was out of work he was smoking illegals, but he said he just felt worse. Like, the next day he'd wake up with a cough or a sore throat. He said that when he switched back to Marlboros, he would wake up feeling better. Of course, that's a sample size of one.

"I assume that if they don't raise taxes, we can get to earnings of around 80 rupiah next year," Rupp speculates. "So, 80 on an 825 stock is a 9.7% dividend yield, but that dividend won't get paid until May 2027. The dividend for May 2026 will be this year's earnings, which will be around 50, which gets you to around a 6% yield."

. . .

The Philippine retailers are each a play on rapidly changing consumer preferences. "In Southeast Asia, there is a legacy component of traditional retail, think of it as mom-and-pop shops or wet markets," Rupp says. "Younger people like to shop in air-conditioned, well-lit convenience stores, supermarkets and shopping malls, but half of retail is still done in traditional channels. The median age in the Philippines is 26 years old."

Philippine stocks have sat out the year-to-date levitation in most financial assets. Since the start of 2025, the MSCI World Index, which tracks developed markets, is up 16.2% while the MSCI Emerging Markets gauge is up 29%. Over the same span, the Philippines Stock Exchange Index has slumped by 10.7% (all in dollar terms). As a result, the Philippine market trades at 9.4 times trailing earnings versus the 16 multiple that the MSCI EM Index commands.

Puregold (PGOLD in the Philippines) is the second-largest grocer in the archipelagic nation after SM Retail, Inc. As of June 30, the company operated 513 Puregold supermarkets, which cater to low- and middle-income customers, and 31 S&R price-club stores, which resemble Costco and serve the well-to-do. (S&R takes its name from Sol and Robert Price, who founded Price Club in the United States.) Despite the smaller store count, the larger S&R shops generated 47% of company-wide Ebitda in the first half of 2025.

To gauge its position in Philippine retail, Parkway compared the prices of common grocery items at Puregold and S&R markets versus the rest of the retailing field. In nearly every product, the home teams' shops either posted the lowest price or matched the lowest price. In fact, Puregold supermarkets sell bulk goods to mom-and-pop retail shops. As the company continues to build out its distribution infrastructure, Puregold's cost advantage relative to its smaller peers should continue to grow.

"There are several tailwinds to the Puregold growth story," Rupp addressed his Parkway investors in the third-quarter letter.

Both formats have ample room to expand their footprint. The company should be able to grow store count at least 5% annually as they expand into tier 2 and 3 cities. While not a meaningful contributor yet, they bought a mini-mart franchise—Puremart—in December 2024 from the Co family for about $10 million. While I am usually skeptical of related-party transactions, the 153 stores were purchased at book value [about $65,000 per store] and the transaction seems fair to beneficial to Puregold. I also think there is asymmetric upside as they integrate Puremart into the existing Puregold logistics network.

As of Sept. 30, Puregold's balance sheet showed a net cash balance of 4 billion pesos ($67.4 million). Despite its long-term growth opportunities and the absence of debt, Puregold trades at 9.9 times estimated 2025 earnings and offers a prospective 4.7% dividend yield.

. . .

Seven Corp. (SEVN in the Philippines) is the operator of the 7-Eleven convenience store brand in the Philippines. It's controlled by Taiwanese conglomerate Uni-President Enterprises Corp., which also operates the 7-Eleven brand in Taiwan, via a 56% shareholding. As of Sept. 30, Seven Corp. managed 4,366 Philippine convenience stores, with franchisees operating 47% of those shops.

The Philippine c-store operator's stock has sold off by 40.2% this year in dollar terms. Four consecutive quarters of negative same-store sales, including a 3.9% year-over-year contraction in the third quarter, are the culprits. Consumers are tightening their belts, and the government is cracking down on imported vape products. The vapes delivered only a small percentage of Seven Corp.'s overall sales, but the consumers who no longer visit 7-Elevens for their nicotine fixes also don't ring the cash register for non-vapes.

These are only short-term impediments, Rupp contends, and the company has plenty of room to grow. Seven Corp. has a big presence in Luzon, the largest island in the Philippines, but "if you go a bit south, you have the Visayas Islands, and the Visayas have relatively few convenience stores," Rupp continues. "Seven Corp. has done a good job of building distribution centers, and these are going to be hubs. They have a plan to add something like 500 stores per year, and they can do this for the next five years easily."

After the company is done lapping the change in the vape rules, same-store sales should recover. The combination of store expansion plus positive store productivity should result in double-digit top-line growth, while increased scale and a pivot to higher-margin product categories, such as ready-to-eat food and beauty products, should lift margins, Rupp adds.

As with the other two value candidates, Seven Corp.'s balance sheet showed a net cash balance of 5.8 billion pesos, or $97.9 million, as of Sept. 30. Unlike the aforementioned duo, the 7-Eleven operator trades at a relatively rich multiple, 15.8 times estimated 2025 earnings. As a multiple of guesstimated 2027 earnings, the valuation shrinks to 12.7 times.

"Seven is a fantastic combination of a great business, a proven management and a long runway for growth at a fair valuation," says our friend Rupp, international value hunter.

* Readers interested in these names can trade all three through Charles Schwab Corp.; they may be directed to the broker's global investing-services trading team to place an order.

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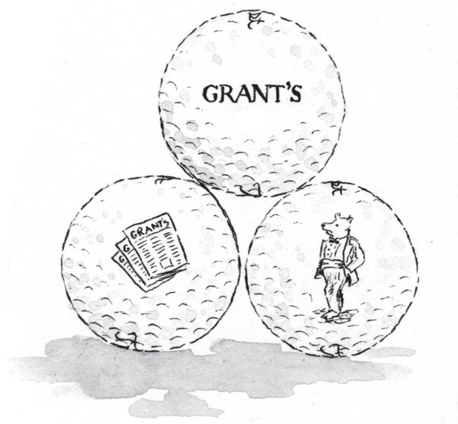

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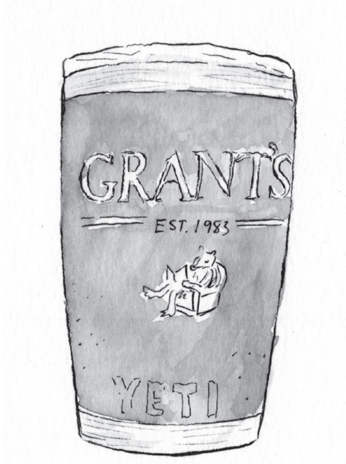

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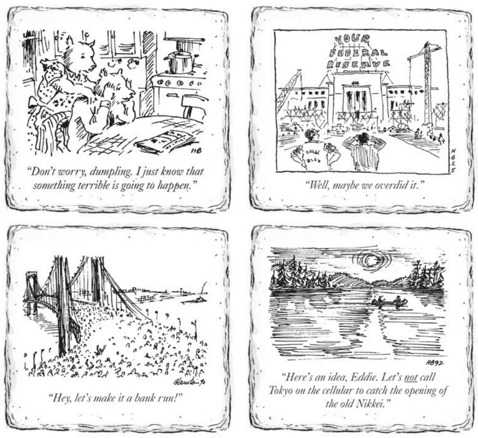

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Mr. Market up in the driver's seat

Evan Lorenz writes:

This earnings season is one for the record books. Based on the 463 companies that have reported third-quarter results, the S&P 500 is on pace to report year-over-year earnings growth of 14.7% and net profit margins of 13.1%, the highest pitch of profitability since FactSet Research Systems, Inc. began tracking the series in 2009. Chief executives forecast more fair weather, as mentions of "economic slowdown" and other recession synonyms on conference calls have dwindled to their lowest levels since 2007, according to Bloomberg.

Investors are understandably ebullient. According to the November BofA Global Fund Manager Survey, respondents are the most overweight stocks since February, i.e., before this year's trade ruckus began, while cash levels have fallen to 3.7%, a threshold that has been matched only 19 other times since 2002. Just 6% of respondents expect a hard economic landing.

Are the respondents assuming that Blue-Chip America will continue to cut or pass through costs, including the ones embedded in President Donald Trump's tariffs? If so, they might remember that one person's cost is another person's income. American companies announced 153,074 job cuts last month, nearly triple the number logged in the same month last year and the most for any October since 2003. Not surprisingly, the University of Michigan's consumer-sentiment index slipped by 3.3 points in November, to 50.3, only 0.3 points above the series's lowest reading of 50, carved out in June 2022.

And it's not just auto lenders like Tricolor that are defaulting on their debts. The proportion of subprime borrowers 60 or more days past due on their car loans rose to 6.65% last month, the most since Fitch Ratings began tracking the series in 1994. Overall, 4.5% of all consumer loans were 30-plus days past due in the third quarter, the largest crop of delinquencies since the first quarter of 2020, when lockdowns commenced, according to the New York Fed.

While little seems to link Wall Street exuberance to the struggles on Main Street, there is economic reflexivity at play. According to Moody's Analytics, the top 10% of households by income accounted for 49.2% of all spending in the second quarter, a record high since at least 1989, and this comfortable cohort takes its cues from frothy (or, at least, previously frothy) markets.

McDonald's Corp. is a case in point: In the third quarter, the burger chain's U.S. same-store sales rose 2.4% year over year, despite a double-digit decline in visits from lower-income consumers and a nearly reciprocal percentage increase in traffic from affluent ones.

If losses in the stock and crypto markets cause top earners to tighten their belts, look out below. It's Mr. Market's economy.

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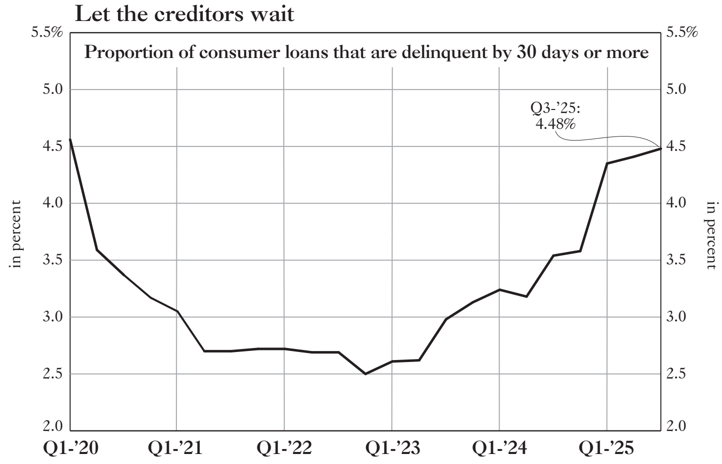
Let the creditors wait



source: Federal Reserve Bank of New York

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