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Opportunists apply here

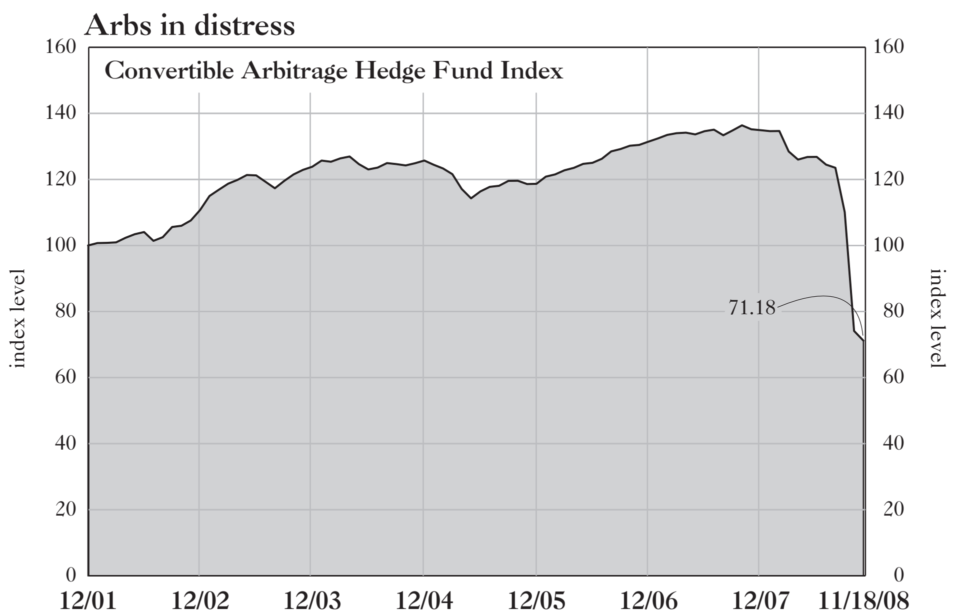
(November 28, 2008) In the 30 days to November 20, the Dow Jones Convertible Arbitrage Hedge Fund Index executed a power dive remarkable even in this season of nose-down price action: It fell at the annual rate of 93.7%. De-leveraging and deflation explain the general tenor of things in convertible bonds. But another, more particular source of distress is at work in that specialized market. Convertible arbitrageurs own convertible bonds—they and almost nobody else. From which it follows, observes John Barton, himself a convertibles practitioner, that if one such investor is "looking for the exit and in pain, they're all looking for the exit, and they're all in pain." To say nothing of *their* investors.

What manner of prices and yields the hastily exiting arbs are leaving behind them is the subject at hand, and Barton is our tour guide. Every market save the Treasury market is on sale (or lately has been), of course. But we are going to venture that none is so cheap—nor so disorganized nor demoralized—as the one in convertible bonds. Anomalies abound. Converts that present a better risk-reward proposition than junk bonds constitute one such example. Converts that stack up more favorably than the equity into which they are convertible make another.

As an introduction into the oddities of the convertible world, consider, first, the Medtronic 1.5s of April 2011 (Cusip 585055AL0). The borrowing company, founded in 1949, is the world's leading manufacturer of medical devices for the treatment of heart disease, spinal injuries and diabetes. The debt is rated A1/AA-minus. Medtronic has an equity market cap of $33.2 billion, total debt of $7.1 billion and total assets of $22.7 billion, of which $1.7 billion consists of cash and short-term investments. In the past 12 months, EBITDA (earnings before interest, taxes, depreciation and amortization) covered interest expense by 19.2 times ($5.02 billion over $261 million). Debt is 1.4 times EBITDA. Altogether, Medtronic is a strong candidate for not going out of business.

Yet, on October 28, the aforementioned Medtronic convert traded at 80.75, a price to yield 10.6%. It didn't stay there for long, though, and is quoted today at 90, a price to yield 6.1%. At the October low, the adjusted spread of the Medtronic issue to Treasurys was 1,600 basis points—i.e., adjusted for the value of the various options embedded in any convert, notably the opportunity to exchange the bond for common stock at the stipulated rate, in this case at a price of $55.96 a share. Given that the stock trades in the high 20s, the conversion feature is, for the time being, nugatory. But, observes Barton, 10% was the wrong yield on a double-A-rated bond, straight or convertible. At 80, the Medtronic 1½s were not just cheap, he says, or "stupid cheap." They were "absurd"—Barton's highest value accolade—indeed, absurd enough to have collected a new constituency of buyers to replace the retreating convertible arbs. The story of the redemption of the convertible market, when it's written, will be the story of the handoff of one bond

Arbs in distress



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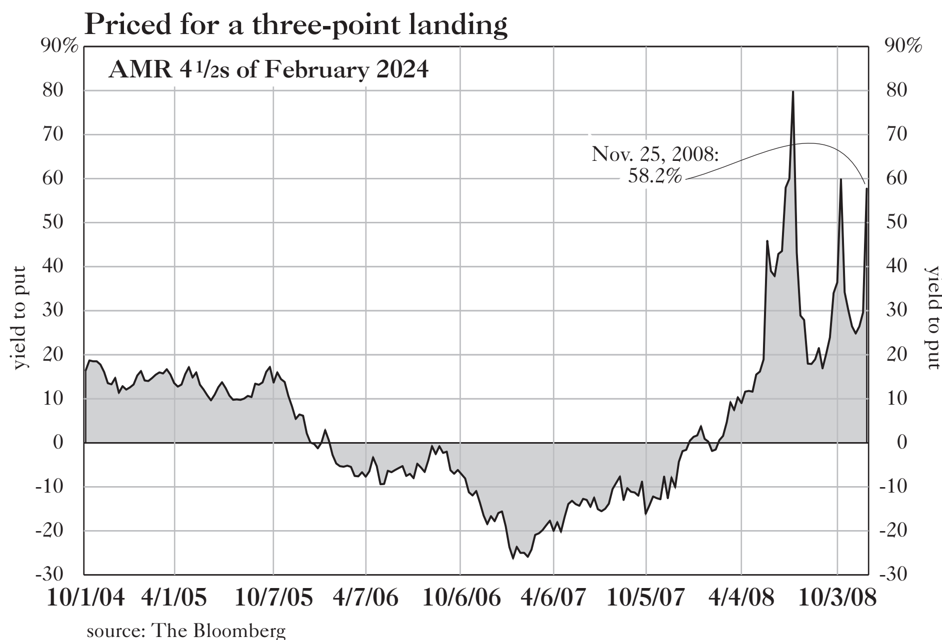


Priced for a three-point landing

source: The Bloomberg

after another to buyers outside the convertible universe—or, at least, outside that portion of the convertible universe that is suffering massive redemptions. Another thing, adds Barton, you have to pay cash. Leverage, which was there for the asking before the bust, is today unavailable. No mystery, then, that prices have fallen, or continue to fall.

Though the Medtronic issue has found a new home, the orphanage of unplaced and unwanted converts is filled to overflowing. Barton mentioned, for instance, the Lawson Software 2 1/8s of April 2012 (52078PAA0), quoted at 66.5 for a yield to maturity of 15.7% and an option-adjusted spread to Treasurys of 2,050 basis points. Lawson originates and sells the kind of software that a business customer would need to harmonize such administrative functions as billing, procurement, distribution and personnel. With a market cap of $612 million, total debt of $248 million and assets of $1.3 billion, of which $362 million consists of cash and equivalents, Lawson, too, seems a likely survivor. In the last 12 months, EBITDA covered interest expense 11.6 times ($95.7 million over $8.3 million); total debt to EBITDA stands at 2.5 times.

Like Medtronic's convertible issue, the Lawson bonds are priced as if they were straight debt. They are convertible into 83.2293 shares, or at a price of $12.02 a share—a far cry from the current quotation of $3.76 a share. However, Barton points out, the cry is not quite so far as it seems, because the Lawson convertible buyer is paying only 66.5 cents on the dollar, about two-thirds of face. Shave a third off the $12.02 conversion price, and you come up with $8. Above $8 a share, if Mr. Market has his wits about him, the Lawson convertible holder would participate tick for tick in share-price appreciation. "I would just look at it as a high-yield bond that happens to have a call that is not unreasonable," Barton comments. "The company's been spoken of in the past as a take-out candidate. You have a change-in-control put, so that would be a home run. And whatever the return on this thing really is going to be, it's not going to be 15%. It's going to be better. It's going to be better because you're not going to ride a 15% curve all the way out into 2012. At some point, either this will trade for a lower yield, or they'll get sold, or they'll recover, or something. And given the valuations you're coming in at, I think this compares really well to a lot of the stuff I am seeing in high yield. Certainly less leveraged. . . . If I were a high-yield guy, I would look at this and say, 'These guys have a variable cost structure; I'm coming in at a fraction of a reliable cash stream.'"

Or put yourself in the shoes of a stock investor, Barton proceeds, turning to Akamai Technologies, which claims to own and deploy "the world's largest distributed computing platform." Akamai, in Hawaiian, means "smart," and Akamai is smart enough to do the things it does without much debt; it has just $200 million vs. $301 million of cash and marketable securities, a stock-market capitalization of $1.9 billion and total assets of $1.8 billion. In the last 12 months, $300 million of EBITDA covered $3 million of interest expense 100 times over. The only debt happens to be a convertible issue, the 1s of December 2033 (00971TAE1), convertible into 64.7249 shares, or at a price of $15.45 a share. Down by 69% this year, the stock last traded at $11.35 a share.

Now, then, Barton mused, look at things as an equity holder might. The share price has collapsed. It is wonderfully volatile. At today's quotation, you're in the enterprise at 2.4 times sales, 6.0 times EBITDA. Buy the bond, on the other hand, and your valuation drastically improves: You're in at 0.25 times sales and 0.66 times EBITDA. "And what am I sacrificing for that?" Barton reflects. "Basically nothing. Conversion price is 15.45, but I'm paying 93.5, a yield to the December 2010 put of 4.4%. So I'm participating 100% in the appreciation of Akamai at prices greater than 14.45. Basically, I'm giving up the first three points of any stock-price upside. So for me to say that I want to own this stock and not this convertible bond, I need to make the argument that I want those three points relative to a stock that's down 50% in the past three months. And I want those three points so badly that I'll walk out from the safety of that bond to invest at six times EBITDA and over two times sales, rather than at 0.25 times sales and at 0.66 times EBITDA."

The more Barton thought about it, the more incredulous he became. "That's an insane relationship between the two," he went on. "Nobody owning those shares should not make the switch to the convert. Not to do it, you're taking on a huge amount of downside. In this market, can the shares still get cut in half? Sure."

In Barton's mind—and, as we listen to him talk, in ours, too—the 2008-model convert is as versatile as it is cheap. Why, he proceeds, some give good service as high-yield cash equivalents. "There are a bunch of short-dated converts with very high yields to maturity that are certainties. And the reason they trade where they do is because the yield is a function of very few points to the maturity. You're not getting a whole lot of points to the upside. If you need to raise cash, you don't care that you are selling something at a 20% to 30% yield that's a certainty if, in fact, you just need the cash."

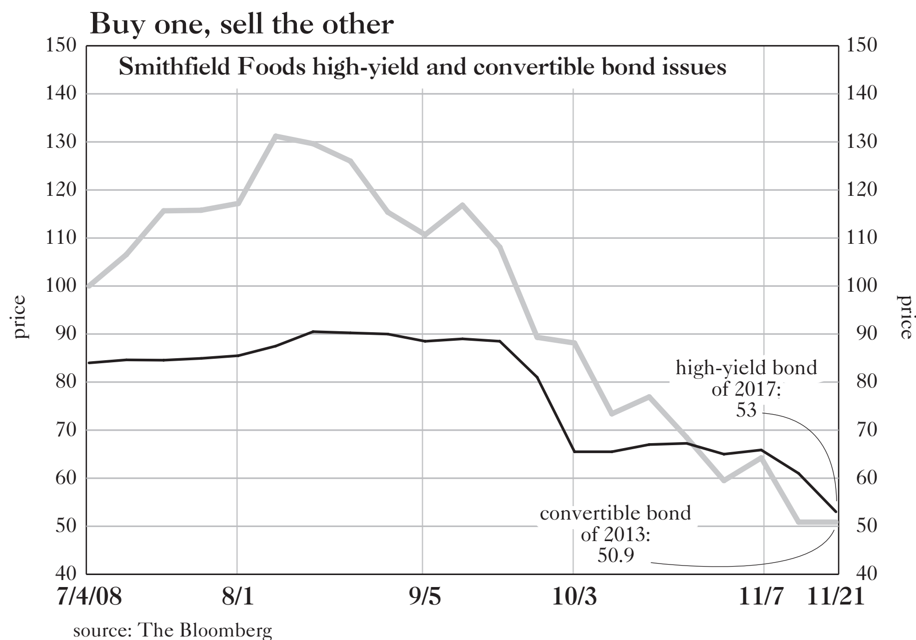
Comverse Technology, a globe-girdling software development company that got caught with its hand in the op-

tions-backdating cookie jar a few years back, is the issuer of one such attractive short-dated security. The issue, in the sum of $418 million, is the 0s of May 2023 (205862AM7), quoted at 94 and convertible into 55.6347 shares. The conversion price is $17.97, while the stock is quoted at $5.91. What lends sizzle to the situation is that the bond is putable on May 15, 2009, at par for a yield to put of 14%. Cash and cash equivalents of $1.3 billion (not counting $200 million of currently frozen auction-rate securities) could redeem the issue three times over. "It's inconceivable to me that they could burn through that much cash between now and May," Barton says. "This is virtually a T-bill. The reason you can get 14% essentially on cash here is that the guy who's selling it at 94 needs that cash and doesn't care that it's only six points til May. 'So what that I'm giving someone 12% to 13% total,' you say, 'I need the money.'"

AMR Corp.'s 4 1/2s of February 2024 (001765BB1) is another junk-grade T-bill surrogate. Whether airline traffic is falling even faster than the price of oil is a good question. But it may not be as pertinent as it seems at first glance. The AMR converts, all $324 million of them, are putable in February. Quoted at 90, they yield 58.2% to the put. It's true that AMR is loss-making ($1.8 billion in the past 12 months) and highly leveraged. It is also true that the 4 1/2s are the second maturing debt issue and that, as of September 30, there was $4.6 billion of cash and short-term investments on the balance sheet, 14.3 times the principal to be redeemed. AMR does have the option to redeem the bonds in stock, but it must give the bondholders 20 days notice (a convertible holder so informed could presumably hedge away some or all of the equity risk).

One casualty of the credit collapse is the art of capital-structure arbitrage. Its practitioners are in the business of observation and inference. When the logical and legally defined relationship among various corporate obligations moves out of line, they buy or sell to restore it to coherence. It is a sign of the times that so many of these relationships are broken and seemingly irreparable. The arbs watch in amazement as the debt markets randomly attach a higher value to a junior nickel than they do to a senior dime. Amazement turns to horror, however, when the anomaly persists—or when they are rendered powerless to set things right because the arbs' loyal investors have suddenly decided that the business of nickel selling and dime buying is a little too risky for their blood.

In the convertible market, one can buy converts and sell high-yield bonds of the same legal standing—they are pari passu with the converts—and, in the process, pick up points up front, increase one's yield to maturity and shorten one's duration. "The amount of money in the hands of guys who tie different markets together is usually pretty small, and right now those are the guys who aren't in a position to put capital into anything," Barton says. "So there have been some real disconnects between markets. And convert vs. high yield, or U.S. high yield vs. European high yield are where you see that."



source: The Bloomberg

Smithfield Foods, the nation's top pork producer, is the name behind one of these anomalies. One could, as Barton suggests, buy the Smithfield convertible 4s of June 2013 (832248AR9) while shorting the Smithfield straight 7 3/4s of July 2017 (832248AQ1). Both issues are rated BB-minus. The converts last traded at 50.9, a price to yield 21.3%, the straights at 53, a price to yield 19.1%. The trade delivers a pickup in points (2.1 up front) and in yield to maturity (220 basis points) and a shortening in duration compared to that of the straight issue alone. There is, however, negative carry of 375 basis points—the straights pay 7.75%, current, the converts 4%.

"Long the convert, short the high yield, you're capturing the call in the convert," Barton explains. "You are profiting also from the prospective convergence to a similar yield between the two. You've got a 220 basis-point higher yield to maturity in a pari passu bond in the convert. So Smithfield Foods doesn't have to do anything. The stock can stay right where it is. If the convert yield falls and the straight yield rises, the arb is ahead of the game. And, also, you're picking up the put on the enterprise. If things really got bleak at Smithfield—they don't export pigs any more and the prior debt maturities have covenants that trip it up, any kind of bear scenario for Smithfield—in that case, these are pari passu claims and they would converge to the same percent of claim on the enterprise, and you're long the convert at 51 and short the high yield at 53."

So much for exotica. What about outright purchases? "What would I look for in convertible longs?" Barton mused. "I would look for convert longs where they are the only ones in the capital structure, the company is not likely to need the capital markets, I am being given a nice yield and a call that I might like, and I have got plenty of time to sit on it and not worry about it and wait for either the yield to diminish or the equity call to come through. But one way or another, it is going to be money good. . . . What I wouldn't want to own is convert behind high yield, behind bank debt in a high fixed-cost business that could turn into a cash user and might need the capital markets. Because that is a formula for a zero."

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Triple-A upgrade

(March 6, 2009) "They don't upgrade triple-As," a promoter quipped way back when. *They* may not, but we are about to. The top layers of ACE Securities Corp. Home Equity Trust, Series 2005-HE5, a subprime-mortgage-backed securities structure of boom-time vintage, we hereby crown quadruple-A, one notch better than the best.

Unlicensed by the SEC, *Grant's* doesn't rate often, but we rate with confidence when the urge comes over us. The A-1 and A-2C layers, or tranches, of the aforementioned contraption we make bold to liken to Treasury bills—T-bills, that is, priced to yield 9.9% and 11.3%, respectively, to fairly short maturities. It would be nice to buy them, or others like them, but the structured finance market is broadly off limits to us civilians (though a mutual fund we name below has exposure to mortgage matter of this kind). Thus, we write not principally in the how-to vein but in the gee-whiz vein. The story of the ACE structure is the story of the credit cycle in miniature. The bad news, you know about. Now comes a kind of good news.

Truer words were never spoken than the trader's adage, "There are no bad bonds, only bad prices." The ACE RMBS was a bad bond when it came into the world in August 2005. It never had a chance; society made it what it was. Yet it—specifically, in its penthouse strata—is a good bond today. At inception, in the foam of the credit bubble, it was priced too rich. Today, so we contend, it's too cheap.

Dan Gertner of this staff has been keeping tabs on the ACE structure since 2006, but new readers may need a primer. You may think of structures like this as banks without walls. On the asset side are mortgages, on the liability side, notes. The notes finance the mortgages. In typical asset-backed security fashion, the notes are clumped into tranches, of which there were 20. ACE came into the world in 2005 with assets and liabilities footing to $1.4 billion. Though the assets overwhelmingly were subprime, no less than 76% of the liabilities were rated triple-A.

The financial engineers assumed that house prices would never fall as they have, in fact, fallen. But that is not to say that the wunderkinder made no allowances for adversity. They overcollateralized the upper tranches, padding them with lower-rated mezzanine tranches. Let the junior slices absorb the first blows. Let the senior ones have first claim on cash flow. Insulate the bottom of the structure with equity ($11.5 million would do, they decided). Thus fitted and armored, the good ship ACE set sail.

Soon it was shipping water, for more than four-fifths of its mortgages were adjustable-rate and thus susceptible to what has come to be known as reset shock. Furthermore, 45.5% of the portfolio was sourced in the bubble states of California and Florida. By June 2007, a fifth of the loans were in trouble—60 days or more delinquent, in foreclosure or in repossession. Today, 53% are so dinged. The lower-rated tranches have taken the beating for which they were intended. Not counting the excess-interest reserve, four have been erased and a fifth is almost gone.

But give the engineers their due. No harm has yet come to the triple-A-rated tranches, and none is likely to. Americans are a restless people, even in bear markets. They refinance and pull up stakes, and more than a few go broke. And as they swap one mortgage for another (or, choosing to rent, for none at all), they cause such structures as this one to shrink. As often as not, the shrinkage leaves the senior securities stronger than they were on Day 1.

ACE today is reminiscent of a Thanksgiving turkey on the Friday after the Thursday, with just 1,597 loans, down from 7,712. Of the four original triple-A-rated tranches, only two remain, and they are melting away; the other two were paid down. Thus, the A-1 tranche stands at $24.4 million, down from $549 million, and the A-2C tranche at $27.7 million, down from $68.8 million. Smaller, the top-rated specimens are also safer.

As of the February remittance report, what remains of the ACE flotation looked like this:

—$328.2 million in balance-sheet footings;

—$188.2 million of delinquent or otherwise damaged mortgages;

—$140 million of current mortgages;

—$52.1 million of triple-A-rated liabilities, supported, or protected, by $276.1 million in subordinated liabilities.

Better than the best

ACE Series 2005-HE5 performance

	—principal balance—		—rating—		
	initial	current	initial	current	*Grant's*
A-1	$549,265,000	$24,367,853	Aaa/AAA	Aaa*/AAA	AAAA**
A-2A	333,119,000	paid off	Aaa/AAA	NR/WR	
A-2B	135,251,000	paid off	Aaa/AAA	NR/WR	
A-2C	68,780,000	27,713,617	Aaa/AAA	Aaa*/AAA	AAAA**
M-1	57,482,000	57,482,000	Aa1/AA+	Aa1*/AA+	BBB
M-2	53,171,000	53,171,000	Aa2/AA	Aa2*/AA	BBB
M-3	31,615,000	31,615,000	Aa3/AA	A2*/A	BBB
M-4	28,023,000	28,023,000	A1/AA-	A2*/A	BBB
M-5	25,149,000	25,149,000	A2/A+	Ba2*/CCC	BB
M-6	23,711,000	23,711,000	A3/A	Caa2*/CCC	CCC
M-7	19,400,000	19,400,000	Baa1/A-	C/CC	CC
M-8	17,963,000	17,963,000	Baa2/BBB+	C/CC	CC
M-9	15,808,000	15,808,000	Baa3/BBB	C/CC	CC
M-10	12,215,000	3,793,127	Ba1/BBB-	C/D	D
B-1	14,371,000	-	Ba2/BB+	C/D	D
B-2	25,149,000	-	NR/BB+	NR/D	D
B-3	15,089,000	-	NR/BB	NR/D	D
CE	11,496,688	-			
P	100	100			
R	0	0			
Total	$1,437,057,788	$328,196,697			

* downgrade watch
** as of March 2009
source: The Bloomberg

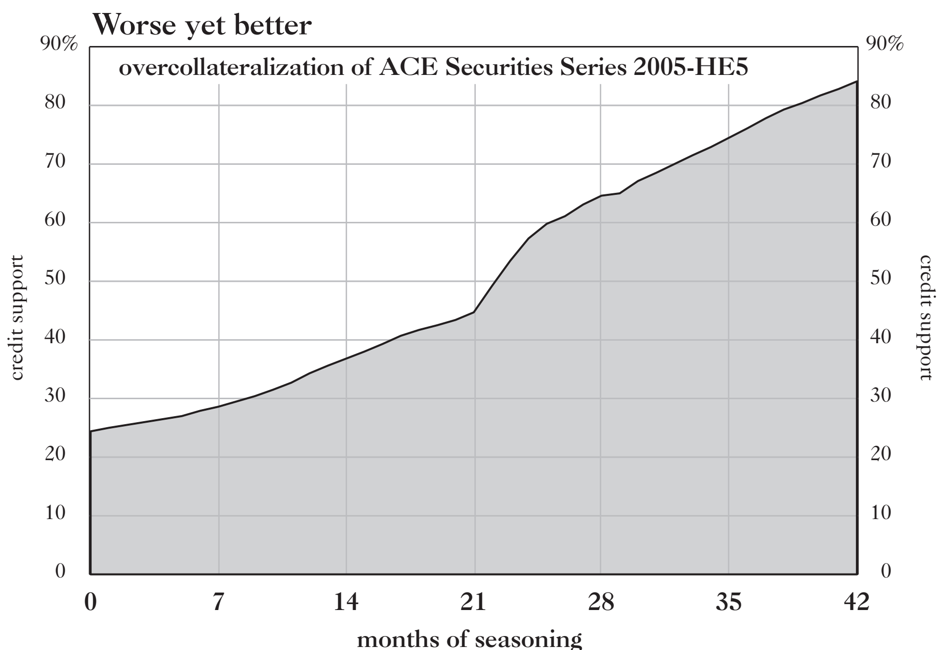
"Yes," Gertner allows, "the deal has performed horrendously. But it did what it was designed to do. It has protected the senior securities at the expense of the junior ones. The February bulletin contains the usual quotient of miserable news. But there is also the unexpected, positive fact that more principal was repaid to the top of the structure than was lost at the bottom. Specifically, the senior holders got $5.8 million, while the pawns lost $1.8 million."

Which brings us, at last, to our ratings decision. "Let us say," Gertner muses, "that 100% of the structure went through the complete liquidation cycle—from delinquency to foreclosure to repossession to the sheriff's auction. In order to impair the remaining triple-A (quadruple-A, by our lights) obligations, the loss severities would have to hit 84%. In the case of a $100,000 mortgage, just $16,000 would be salvaged at the hypothetical auction. The fact is, over the past 12 months realized loss severities have averaged 50.3%. I would say that the likelihood of the triple-A stack surviving without a loss is extremely high. Indeed, it's as close to certain as anything could be in these interesting times."

Prompting our unofficial upgrade was an official move in the opposite direction. Moody's last week placed the aforementioned tranches under surveillance for possible downgrade. They were caught in the dragnet of a much broader probable re-rating of 7,942 tranches of 2005-07-vintage RMBS with an original face value of $680 billion. Prompting the action, said Moody's, was its own upward revision of the ultimate likely loss on these securities. For instance, in the case of the class of 2006, it says it believes that 30% will be wiped out, double its estimate of January 2008.

Maybe, in the case of the ACE deal, Moody's simply lumped in the strong-as-steel triple-A-rated tranches with the rest. Perhaps, following close study, it will forgo downgrading them. Not much chance, however, of an upgrade to better-than-triple-A.

Quadruple-A securities aren't born. Rather, they are made. What makes them is the natural pay-down of senior tranches. Recall that, in an asset-backed security, income and principal trickle down from the top. When the trickling fills the pockets of a senior tranche, that tranche is retired, as were two of the original four triple-A tranches of the ACE security. If the top-rated tranches are repaid faster than the lower-rated ones are erased, credit quality at the top improves. The thicker the wall of protection around the senior-most claims, the more creditworthy those claims become—at the extreme, more creditworthy than triple-A.



Just how many quadruple-A tranches there might be is a matter of guesswork. Gertner has heard estimates, stemming from pay-downs in the 2005 and 2006 vintages, of between $25 billion and $50 billion. Metropolitan West Low Duration Bond Fund (MWLDX) is a likely beneficiary of the quadruple-A phenomenon. Senior non-agency RMBS constitute 40% of the fund's assets (corporate bonds make up 33% and agency RMBS 22%). In the past 12 months, the fund has lost 16% of its value, a fact we ascribe not to managerial error but to Mr. Market's imperfect understanding of the better-than-best non-agency opportunity. We expect the old gentleman will see the light.

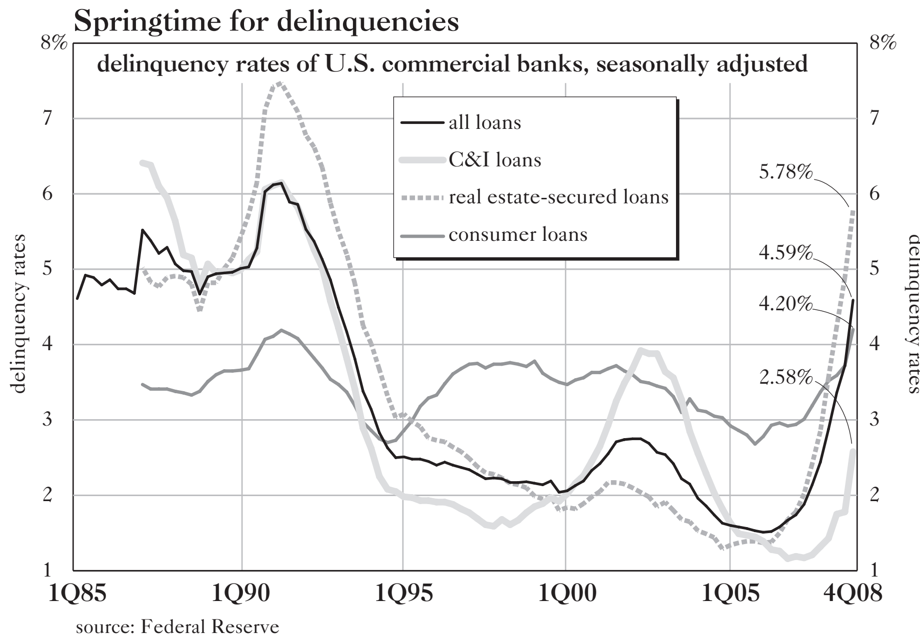
Options on recovery

(March 6, 2009) As to whether the world will survive, opinion is mixed. Some say yes and some say no, and others are on the fence. Neither is there any firm consensus concerning the nation's banks. Will even one remain in the private economy on the day the Great Recession expires? You can get an argument.

Now unfolding is an exploration into the crisis-related investment opportunity. We write, we hope, with a due sense of the gravity of the times. It's not just every cycle in which a certain Ayn Rand disciple and former Fed chairman plumps for nationalizing American banks. Then again, the bad news is not exactly news anymore. From its peak, the Keefe, Bruyette & Woods bank-stock index (BKX) has fallen by 82%, while the financial-stock component of the Standard & Poor's 500 Index weighs in at just 9.5% these days, down from 22.3% as recently as September 2006.

Yet, your editor is here to attest, if there is anything scarier than owning the stocks of banks, brokers and insurance companies during a credit liquidation, it's being short them during the post-crisis moon shot. Citi, for example, was an $8.50 stock in December 1991. Within two years, it was a $40 stock. Within six years, it was earning—almost—its intraday-low 1991 share price. The Bank of New Hampshire traded at $3.50 a share in September 1991, two weeks before the FDIC seized seven other Granite State institutions. In April 1996, it fetched $43.50.

Maybe today's basket cases will produce per-share earnings equal to today's share prices at some not-too-distant date. We don't rule it out. Neither do we dismiss the possibility that Sheila Bair will wind up controlling every bank in the BKX. But, born optimists, we at-



tach a higher probability to the former outcome than we do to the latter.

"High expenses for loan-loss provisions, sizable losses in trading accounts and large writedowns of goodwill and other assets all contributed to the industry's net loss," noted the FDIC in reporting that, in the final three months of 2008, insured financial institutions suffered their first quarterly loss since 1990. No surprise, then, that, despite the highest ratio of reserves to loans in 14 years, coverage ratios stand at 16-year lows, or that nonperforming loans climbed by 107% last year to reach 2.93% of overall loans, the highest in 17 years. Also came the report that the top-secret FDIC list of "problem" banks comprised 252 institutions controlling $159 billion of assets, compared to the year-earlier tally of 76 institutions controlling $22 billion of assets. Evidently, Citi is beyond problematical; it alone controls $1.9 trillion of assets. So what is the bullish-bearish-hopeful-confused investor to do?

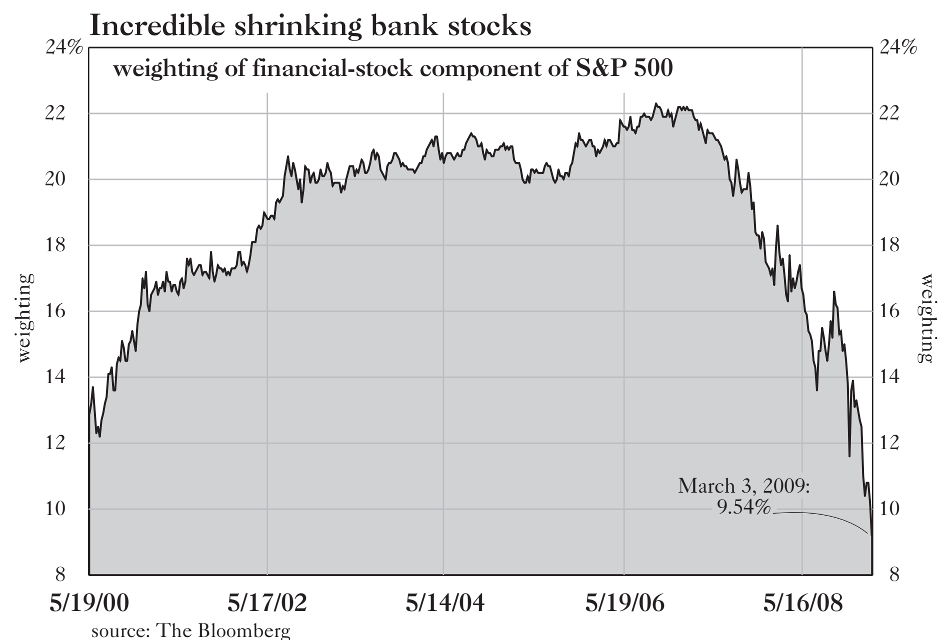
An options strategy, perhaps. Pick an assortment of banks of varying degrees of survivability. Buy call options at strike prices double the current price, with maturities clustered in early to mid-2011. The reason not to do any such thing is that options tick like time bombs. The reason to stop one's ears to the ticking is the likelihood that the cycle will turn within 24 months and financial stocks will lead the way up, with the book-entry share certificates themselves crying hallelujah as they go.

Clairvoyants, seeing into the future, naturally do their bank-stock investing at the bottom. Fearless because they are all-knowing, they buy the junior-most security of the shakiest survivors, the stocks that go up the fastest and farthest. For the rest of us, lacking perfect foresight, we might consider options on the shares of a cross-section of financials, three or so, let us say, from each of the three departments of the financial triage ward: ambulatory, salvageable and doubtful.

BB&T Corp. (BBT on the Big Board) fills the bill of a Ward 1 candidate. The 12th-largest financial-services holding company, Winston-Salem-based BB&T conducts a diversified business—brokerage, capital markets and insurance, besides basic banking—in the American southeast, including formerly bubbly Florida. Nonperforming loans, at 1.34% of total assets, are, so far, manageable, though $8 billion of home builders' loans ("residential acquisition, development and construction loans") and $11.5 billion in commercial real-estate loans may yet break out in hives.

BB&T performed the astounding trick of turning a fourth-quarter and full-year 2008 profit (of 51 cents and $2.71 cents per share, respectively). It lent more in the fourth quarter than it did in the third, and more in 2008 than it did in 2007. Net cash interest margins fattened by two basis points in the fourth quarter compared to the third, and by 22 basis points compared to the fourth quarter of 2007. Net interest income, before provisions for bad debts, jumped by 7.5% from the 2007 fourth quarter. BB&T did issue $3.1 billion of preferred stock to the U.S. Treasury toward the end of last year in connection with the TARP, but it seems that it didn't have to. With $8 billion of tangible common equity against $152 billion in assets, the bank is sitting in the capitalization catbird's seat—barring, of course, another year or two worth of seismic jolts in credit and business activity.

But, one must consider, what about the other possibility? How would it be



Option basket
(in $ billions)

	ticker	mkt. cap	total assets	5-yr. comp. asset growth	non-perf. to total assets	allw. for loan losses to nonperf. loans	tgbl. comm. equity-to-assets	price to tgbl. book value
PNC Financial	PNC	$10.6	$291	33.67%	0.74%	236%	2.90%	1.23x
BB&T Corp.	BBT	8.6	152	10.94	1.34	110	5.30	1.07
Goldman Sachs	GS	41.6	885	16.99	NA	NA	4.82	0.97
Morgan Stanley	MS	19.5	659	1.80	NA	NA	4.33	0.68
Key Bank	KEY	3.2	104	4.24	1.41	147	5.95	0.52
Comerica	CMA	2.1	68	5.11	1.46	84	7.21	0.43
Regions Financial	RF	2.4	146	24.66	1.18	141	5.23	0.33

source: company filings

for BB&T if all this World War II-grade fiscal stimulus and Weimar-caliber credit creation "succeeded"? Even as it is, according to CEO Kelly S. King, speaking on the fourth-quarter conference call, the market is coming BB&T's way. Customers have come knocking, for one thing. They seem to like a solvent bank. "[I]f you see something that says they can't get a loan, give them my number," King invited the listeners-in.

Then, too, King went on, the collapse of the shadow banking system has done a world of good. "I'm very, very pleased with what is going on with regard to restoring pricing discipline," the CEO stated. "We had an interesting thing for the last 20, 25 years. We disintermediated the banking industry as a huge amount of loans left the banking system and went through securitization into various conduits and other investment areas, which caused two things to happen. One is we lost the volume and put enormous pricing pressure on loans, because a lot of these investors didn't have the capital and reserve requirements that we do. And so I started making loans 36 years ago, and over that period of time, we've lost about 300 basis points on the same kind of loans. We haven't gotten it all back yet. It will take a little while, but on the larger-size credits, we've already seen a 100-plus basis-point improvement just in the last three or four months. We're beginning to install floors on credits because absolute rates are so low, and there is a lot of receptivity to that in the market."

PNC, too, is the kind of bank to which nervous, safety-seeking customers have been flying—transaction deposits climbed by $5.9 billion, or 10%, in the fourth quarter—and we place it, side by side with BB&T, in the first department of the *Grant's* triage clinic. On the February earnings call, James E. Rohr, PNC's chairman and CEO, sounded as cheerful as Barack Obama used to before he took office. "We've been open for business throughout this period by adhering to our business model and leveraging our success at building long-term relationships with our clients, and by allocating capital based upon risk-adjusted returns, we've delivered significant value to the shareholders over time."

So far as the dividend is concerned, there will be 85% less of it, PNC disclosed on Monday, suggesting it was the regulators' idea. Up til then, the Pittsburgh-based super-regional had been on the offensive. At the end of December, it doubled its customer base by swallowing Cleveland's National City Bank for $5.6 billion of stock and an odd lot of cash. The combined entity shows $291 billion in assets, $175 billion in loans and $193 billion in deposits. It has a 33% ownership stake in BlackRock, a capital-markets business and a custody business. Nonperformers stand at 74 basis points of total assets, and the allowance for bad loans covers 236% of known duds. National City was choking on bad loans, home-equity credits among others, and PNC was able to mark some of these assets as low as 42 cents on the dollar.

Come the turn, shareholders will thank CEO Rohr for his courage and foresight in buying low. Pending that happy event, however, they will have to live with the possibility that Rohr did not, in fact, buy low, but rather, like so many others on Wall Street, mistook a calamity for a business cycle. As the regulators count capital, PNC is amply covered, with a so-called Tier 1 ratio of capital (equity and preferred) to assets of 9.7%. But the market puts no more stock in the bank regulators these days than it does in the ratings agencies, and the market is focused on tangible common equity. Preferred doesn't count. "Owing to the National City acquisition," colleague Ian McCulley observes, "PNC has a tangible common equity ratio of just 2.9%. Asked on last month's call if another capital raise is in the offing, management was noncommittal. (PNC is one of the few banks that could raise private capital.)" Rohr reaffirmed at a conference on Tuesday that there is no plan to raise common equity.

The *Grant's* triage ward sorts its patients by price-to-book ratios. Goldman Sachs (GS) and Morgan Stanley (MS), unloved though they may be in Washington, D.C., are welcome here, in Ward 2, the salvageables, reserved for shares quoted at a discount, though not a gaping one, to book. The Fed's open-handed lending has quieted fears about the pair's liquidity, and disaster has thinned out the competition. In 2008, each shed some of the excess pounds accumulated during the bubble years. Morgan Stanley, for instance, shrank its balance sheet by 37%, to $659 billion. True, for the time being, neither will be raking in billions from highly leveraged proprietary trading. But wider spreads will allow for profitable dealing even on lower leverage. Though the equity advisory business is likely to be as quiet this year as a 2009 off-site, there's work to be had in restruc-

turing and debt underwriting—and in asset management. In the 12 months to November 30, Goldman's asset-management business, which includes prime brokerage, generated $3 billion in pretax earnings on period-end assets of $779 billion, down just 10%. Morgan Stanley's asset arm performed no such feat, showing a $1.8 billion pretax loss after write-downs. The wealth-management business did generate $1.2 billion in pretax earnings, however, and the Morgan Stanley-Smith Barney merger holds promise for the next up cycle. Before it took Smith Barney off the trembling hands of Citigroup, Morgan had 8,400 brokers superintending $546 billion in client assets. Bigger now than Bank of America, which famously bought Merrill Lynch, the new Morgan Stanley will field 20,000 brokers overseeing $1.7 trillion in client assets.

So much for Ward 2. We now come to the institutions about which Mr. Market entertains a reasonable doubt. The likes of Comerica (CMA), Key Bank (KEY) and Regions Financial (RF), among many others, trade at steep discounts to book. They are officially doubtful. Yet, despite their well-aired troubles, each shows a relatively high amount of tangible equity and reserves in relation to nonperforming loans. A word about Regions: With its shrinking net interest income, its immense 2008 net loss ($5.8 billion, owing to a $6 billion write-down of goodwill) and its heavy exposure to residential real estate and construction loans in Georgia and Florida, the bank would appear to have what the early Americans called a churchyard cough. But the insiders, or some of them, seem deaf to it. Over the past six months, they have bought 227,000 shares and sold none.

A glance at the balance sheet conveys no sense of the depth of the bank's admitted problems. Assets foot to $146 billion and shareholders' equity to $16.8 billion, of which $7.3 billion is tangible. Nonperforming assets account for 1.2% of total assets, and loan-loss reserves represent 141% of nonperforming loans. However, on the January call, management warned that 9% of the loan portfolio was "distressed." Residential homebuilder loans amount to $4.4 billion, home-equity loans to $16.1 billion and a portfolio of third-party-originated consumer loans (RVs, autos, boats) to $3.9 billion. Management has been more aggressive than most at charging off bad loans, and nonperforming assets actually ticked lower in the fourth quarter.

Then, again, the loan book would be worth $15 billion less than the value at which it is carried if it were marked to market, the recently filed 10-K report discloses. True, under U.S. generally accepted accounting principles, the loan book is not marked to market, but the common stock is. On Tuesday, it was quoted at a ratio to tangible book value of just 0.33%. It seems fair to conclude that good news is not exactly built in.

Alternatively, rather than buying calls on a self-selected basket of potential crisis survivors, McCulley points out, one could use the Financial Select Sector SPDR Fund (XLF). "You can buy call options that expire in January 2011 with a strike of $15 for 65 cents a piece," he winds up. "XLF was last quoted at $7, and come the turn, the sector could easily double. It's happened before."

Sold to you, Uncle Sam

(April 3, 2009) What marks our Great Recession for greatness is neither the loss of jobs nor the shrinkage in GDP, but the immensity of the federal response to those afflictions. The scale of the government's intervention is much more than unprecedented. Before 2008, it was unimaginable.

Now unfolding is an examination of the chain of events that has taken us to this, the kitchen-sink phase of U.S. counter-cyclical policy. The narrative prompts a question: If it's taking this much to revive today's economy (which, as of now, remains unrevived), what kind of a jolt might be necessary to succor tomorrow's? An even bigger shock, we surmise, if tomorrow's economy is no less encumbered than today's. But it is almost certain to be more encumbered, since the active ingredient of the Bush-Obama palliative is credit formation, the very hair of the dog that bit us. Skipping down to the bottom line, we renew our doubts as to the staying power of paper currencies and to the creditworthiness of the governments that print them.

To try to exorcise the Great Depression, President Herbert Hoover deployed fiscal and monetary stimulus equivalent to 8.3% of gross domestic product (i.e., GDP for 1933, the year the Depression officially ended). To banish the demons of 2008-9, successive administrations have spent, or encouraged to be printed, the equivalent to 28.9% of GDP. A macroeconomist from Mars, judging by these data alone, would never guess how much more severe was that depression than this recession. The decline in real GDP from August 1929 to March 1933 amounted to 27%; that from December 2007 to date, just 1.8% ("just 1.8%" is the phrase to use if one is still employed). So for a slump 1/15th as severe as the Depression, our 21st century economy doctors have administered a course of treatment more than three times as costly.

Since John Maynard Keynes walked the earth, economists have plumped for deficit spending and money printing to combat recessions. Different schools of thought have recommended more of one and less of the other, but only the most radical prescribed anything like today's mega-dose: a combination of fiscal and monetary stimulus equivalent to more than a quarter of GDP, not counting wholesale federal guarantees of money-market mutual funds, bank deposits, bank bonds and sundry direct guarantees of the balance sheets of such begging behemoths as Citigroup and Bank of America.

"This crisis did not come about because we issued too little money but because we created economic growth with too much money, and it was not sustainable," Angela Merkel, the German chancellor, was quoted as saying in last weekend's *Financial Times*. And she added, seeming to address Barack Obama and Timothy Geithner directly, "If we want to learn from that, the answer is not to repeat the mistakes of the past." We would go further than Merkel by misquoting Santayana, to wit, "Those who cannot remember the past are condemned to keep piling on the 'stimulus' and the 'quantitative easing' and the 'TARPs' and the 'TALFs' and the like until the dollars thereby expended are worth only the cost of producing them, which is just about nothing."

To make sense of the outpouring of federal stimulus initiatives, an observer requires a scorecard and a primer. You are now reading a primer

on the modern precedents. The National Bureau of Economic Research identifies 10 postwar recessions before this one. On average, from peak to trough, they lasted for 10 months and registered a 1.8% decline in inflation-adjusted GDP. The government attacked the average slump with an average fiscal stimulus of 2.6% of GDP and an average monetary stimulus of 0.3% of GDP, for a combined countercyclical lift of 2.9%. As the table shows, this recession of ours is not so severe by GDP shrinkage alone. It is, however, off the postwar charts in financial dislocation as well as in federal intervention. And we expect that, some day, it will prove to be a record-setter in the unintended consequences of the government policies it called forth.

A word on method: We measure fiscal policy by the cumulative change in what is known as the fiscal balance, i.e., in the federal budget deficit as a percentage of GDP. We measure monetary policy by the cumulative change in the Federal Reserve's balance sheet. For an index number of the government's overall exertions over the course of a recession, we add the fiscal and monetary changes. The measurements are indicative only, but then, again, they have the virtue of simplicity.

The first postwar slump, November 1948 through October 1949, must have gratified the Truman administration with its brevity and meekness. It lasted for 11 months and dug a 1.7% hole in real GDP. In American experience, deflationary depressions had followed major wars. The post-Appomattox slump measured 32 months, a pair of post-World War I depressions a total of 25 months. The 1946 Employment Act had made it the government's business to foster the circumstances in which all could find work. Mass unemployment was a thing of the past, President Harry S. Truman vowed as he signed the legislation into law.

Nowadays, no edition of *The Wall Street Journal* is complete without news of some new federal initiative to control, suppress, humiliate or rein in Wall Street. Finance was still more comprehensively regimented in Truman's term. The Federal Reserve, subordinated to the Treasury, pegged the government yield curve at levels not so different from today's. Since the Depression and its aftermath were still fresh in memory, lenders and borrowers walked on eggshells. As for the Truman recession, the administration attacked it with fiscal policy. Federal outlays had been on a steep decline since the end of World War II. In 1945, the final year of conflict, government had spent $93 billion. In 1948, it spent just $30 billion, which generated a budget surplus equivalent to 4.5% of GDP. Counter-cyclical spending revved up in 1949 and again in 1950, the year of the outbreak of war in Korea, when the budget was in deficit to the tune of 1% of GDP. This swing to deficit from surplus represented a 5.5% shift in the fiscal balance.

And what did the Fed contribute to the anti-recession cause? Remarkably, it tightened. Interest rates stayed low but did not go lower (in fact, in 1948, the Fed raised its discount rate to 2% from 1.5% and did not see any reason for lowering it, slump or no slump). M1, consisting of currency and checking accounts, peaked at $113.4 billion in January 1948 and steadily dwindled to $110.9 billion by October 1949, the month of the trough. Reserve Bank credit, i.e., the Fed's earning assets, fell by a quarter, to $18 billion, over the course of the downturn. Yet—Ben S. Bernanke, please copy—the republic survived and the recession ended. Altogether, giving effect to the Fed's tightening and the budget's swing to deficit from surplus, the combined fiscal and monetary stimulus amounted to 3.3% of GDP.

We hold in our hands an archaeological relic, a *Washington Post* editorial taking Truman to task for his "advocacy of deficit financing as a method of overcoming the downturn in economic activity." The needful thing, declares *The Post*, is "a revival of business and banker enterprise," not the shoring up of already-adequate consumer purchasing power. "A Government spending program that will add to the size of an already huge Federal debt and tend to shake confidence in the credit standing of the Government is not the way to provide investment initiative," this astounding document continues. "It is the way, on the contrary, to retard it. We do not believe that Congress, or for that matter the American people, can be converted to a belief in deficit financing as an easy road to future prosperity and full employment." The date was July 12, 1949.

The Post changed and so did the world, but not immediately. In 1954, a slump of moderate severity ran its course with no federal assistance whatsoever. Miraculously, the economy recovered all by itself. Nominal GDP peaked at $382 billion in the second quarter of 1953 and fell to $375.3 billion in the first quarter of 1954, a 1.7% decline, or 2.7% in real terms. Half way into the recession, the Fed did reduce its discount

What government did—and didn't do

				—stimulus as % of GDP—		
peak	trough	length (months)	decline in real GDP	monetary	fiscal	combined
August-29	March-33	43	27.0%	3.4%	4.9%	8.3%
May-37	June-38	13	3.4	0.0	2.2	2.2
November-48	October-49	11	1.7	-2.2	5.5	3.3
July-53	May-54	10	2.7	0.0	-1.4	-1.4
August-57	April-58	8	3.2	0.0	3.2	3.2
April-60	February-61	10	1.0	0.7	1.0	1.7
December-69	November-70	11	0.2	0.3	2.4	2.7
November-73	March-75	16	3.1	0.9	3.1	4.0
January-80	July-80	6	2.2	0.4	1.1	1.5
July-81	November-82	16	2.6	0.3	3.5	2.8
July-90	March-91	8	1.3	1.0	1.8	2.8
March-01	November-01	8	0.2	1.3	5.9	7.2
December-07		15	1.8	18.0*	11.9*	29.9*

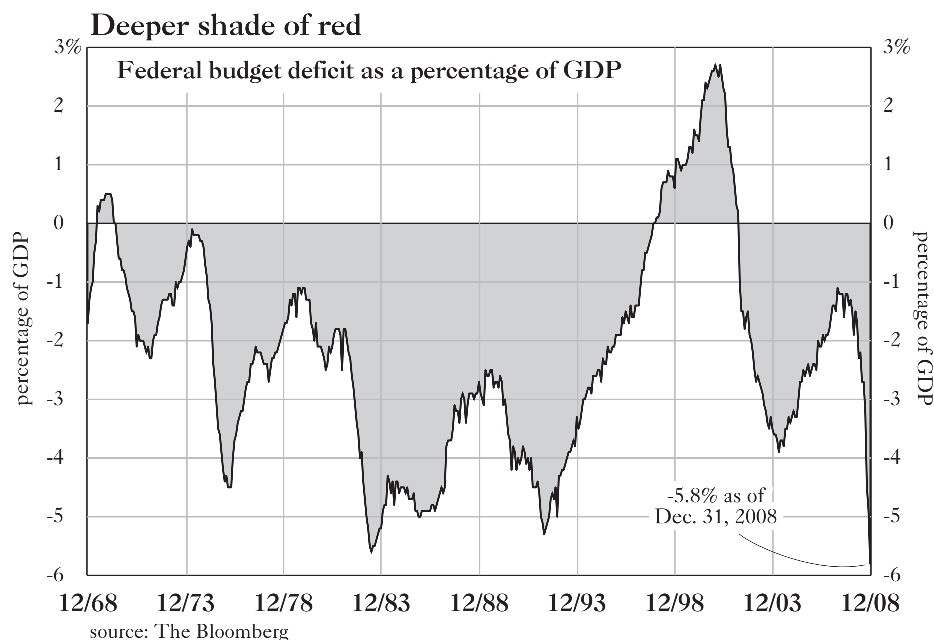
*estimated

sources: Federal Reserve, Congressional Budget Office

rate by one-quarter of 1%, to 1.75%; and two months later, it lopped off another 25 basis points. But so far from "quantitative easing" was the policy of that time that Reserve Bank credit stood stock still. If monetary policy was neutral, fiscal policy was positively contractionary, though war and peace confuse the question of intent. A falloff in federal spending followed the truce in Korea, with the budget deficit narrowing from 1.7% of GDP in 1953 to 0.3% in 1954. The combined fiscal and monetary stimulus was therefore minus 1.4%. The Eisenhower administration, taxed by its critics for inaction in the face of a 5% unemployment rate, insisted it was doing everything it could and should do. "[The administration]," *The Washington Post* judged in August 1954, "has genuflected to an excessive degree before the idol of the balanced budget. . . ." Maybe Ike took his cue from the 1949 editorials.

What accounts for the regenerative qualities of the economy of yesteryear? Favorable demographics might explain part of the resiliency—the baby boom was then bouncing. Financial conservatism, too, might have contributed to the capacity for self-healing—overall indebtedness amounted to just 142% of GDP in 1954, compared to 370% today. So distant was that time that General Motors was still a member in good standing of the American private sector, and its debt was rated triple-A. "Wall Street," in the early 1950s, was still licking its wounds from the early 1930s. It could not have crashed because, doing a dull business at sea level, it couldn't have hurt itself very much even if it had jumped out a window.

The Eisenhower economy did, however, absorb one hard knock. The eight-month recession beginning in August 1957 featured a 3.2% drop in real GDP, one of the steepest of the postwar era. To cure the patient, the administration allowed the budget to swing from a 1957 surplus equivalent to 0.7% of GDP to a 1959 deficit equivalent to 2.5% of GDP. The Federal Reserve cut its discount rate, in four steps to 2 1/4%, at economic low ebb in April 1958, but it allowed no growth in the size of its balance sheet. In mid-recession, Vice President Richard M. Nixon pledged that, while the administration was mindful of the risks of inflation (the CPI was then showing a year-over-year rise of 3.5%), the government was nonetheless "firmly committed to the principle that the Federal Government must take whatever action is necessary to stop the economic downturn and stimulate the recovery of the recession."



source: The Bloomberg

Little did the then-vice president know how much action would prove to be "necessary" within a few short decades—or how critical a part he himself would play in making it so. What greased the ways for radical federal action was the breakdown of age-old inhibitions in the early 1970s. First to fall was the partnership form of organization on Wall Street. Second was the gold-anchored dollar.

Over the general partner of every partnership hangs a sword of Damocles. Let the partnership fail, and the GP is at risk for everything he or she owns. When Donaldson, Lufkin & Jenrette went public in 1970, exchanging limited liability for the unlimited kind, a new chapter in financial risk taking was opened. Would that it had quickly closed. With a little more fear of God, and a little less "value at risk" (as one of the failed gods of quantitative risk management is known), the debt bubble might not have become the blob that ate the world economy. As for the dollar, the Nixon administration redefined it, on Aug. 15, 1971, as a piece of paper of no intrinsic value instead of the 1/35th of an ounce of fine gold it had been since Roosevelt's time. The transformation worked magic. The number of dollars in the world proliferated wonderfully, just as Chancellor Merkel noted to the *Financial Times*.

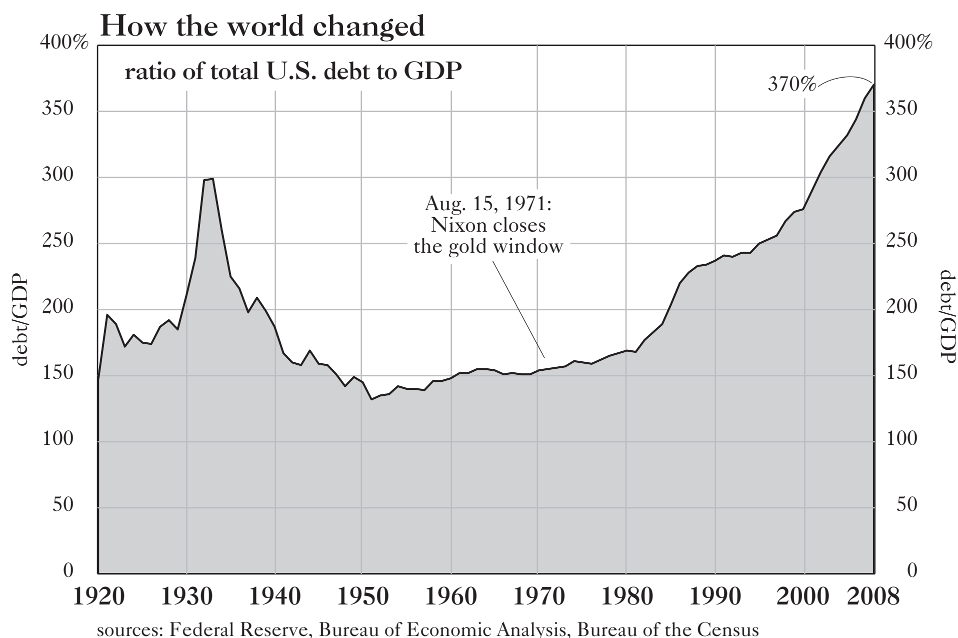
Taboos kept falling, for instance, the convention that big banks should set a good example for little banks by not going broke, and that the world's reserve-currency issuer should set a good example for lesser nations by being a net creditor, as Britain had been during the long reign of the pound. In 1984, the FDIC forestalled the bankruptcy of the Continental Illinois National Bank & Trust Co., the nation's eighth-largest bank, and so doing established the principle that some banks were "too big to fail." In 1988, Thomas Gale Moore, a member of the President's Council of Economic Advisers under Ronald Reagan, shrugged off the news that the United States had become a net debtor. "We can pay off anybody by running a printing press, frankly," Moore was quoted by the Dow Jones newswires as saying in reference to America's privileged status as the only official fabricator of dollar bills, "so it's not clear to me how bad [the transition to net debtor status] is."

But we run ahead of our story. The recession of the mid-1970s was scary enough to elicit the now-familiar phrase "not since the Great Depression. . . . " In one critical particular, at least, however, the comparison was inapt, for nominal GDP kept climb-

ing from the peak of the cycle, in November 1973, to the trough, in March 1975. Of course, the inflated dollars in which nominal GDP was counted flattered the true state of things. In real terms, from peak to trough, GDP dropped by 3.1%. "[T]he outlook is approaching a situation that is somewhat desperate. . . ," George Perry, a Brookings Institution economist, warned the House Budget Committee at what turned out to the trough. "We are now staring at what is likely to be called the first postwar depression." And what should the government do about it? "For the near term, we should be pulling out all the stops. . . . It is hard to put a limit on what we could do [to stimulate the economy] and still be helpful." So the Federal Reserve printed money, lifting Reserve Bank credit by 17% over the course of the cycle, while administration spent money. In 1975, federal outlays jumped by an astonishing 23.4%. The combined fiscal and monetary stimulus was equivalent to 4% of GDP.

The recessions beginning in 1980, 1982 and 1990 called forth the conventional fiscal and monetary medicines in the more-or-less standard postwar dosages, but the decade featured a novel upswing in lending and borrowing. When Ronald Reagan took the oath of office in January 1981, debt summed to 169% of GDP. On the occasion of George H.W. Bush's inauguration in January 1989, the ratio stood at 233%. At the start of Bill Clinton's first and second terms, it was 240% and 253%, respectively. And by the time that George W. Bush gave way to Barack Obama, it had reached the aforementioned 370%.

As early as the 1990-91 recession, economists wondered if the nation were not too heavily indebted to allow full scope to federal anti-recession projects. "Since the government failed during the prosperous 1980s to run budget surpluses, or even achieve balance," Robert D. Hershey Jr. of *The New York Times* wrote in January 1991, "it lacks the wherewithal to pump up a deflated economy. A long-feared prospect is thus at hand: a recession that hits when fiscal policy is already immobilized." Hershey's concerns were premature—the Bush administration succeeded in producing a fiscal pick-me-up equivalent to



1.8% of GDP—but not ill-founded. The Federal Reserve fretted that monetary stimulus was losing its potency. Elderly readers will recall that the policymakers of the early 1990s dealt with many of the same problems that bedevil today's mandarins, from a big-city banking crisis to a real-estate slump (though, back then, the blight was mainly concentrated in commercial structures). To put things right, the Greenspan Fed reduced the funds rate to 3%. Many gasped twice: Not only at how low it was but also at what little effect this remarkably stimulating rate of interest seemed to have. What was going on? Governor Wayne Angell demanded of his colleagues on the Federal Open Market Committee. "Since we have watched the Fed funds rate come down from 9.9% to 3%—that's 690 basis points—and it has had less than the intended effect upon credit and upon spending, then it seems very appropriate for us to look again at this model."

This was in October 1992. A decade later, in the throes of the first recession of the 21st century, the central bankers were pushing even harder, with still less evident effect, though all too few had the wit to wonder what was wrong with their approach. "While it took a 3% funds rate in 1992 to resolve the banking crisis and spur economic growth," colleague Ian McCulley points out, "in the millennial recession, the funds rate got all the way down to 1%, even though the latter recession was much milder than the former and did not come with the unwelcome baggage of a banking crisis." In a November 2002 meeting of the FOMC, Chairman Alan Greenspan, then in his clairvoyant phase, urged that the committee not stint on the money printing. It would always be possible to tighten, he said, but "I don't think we could adjust all that easily if we were to fail to move and the economy began to deteriorate and we were looking into a deep deflationary hole."

"All the stops," George Perry's policy prescription for the 1973-75 recession, seemed exactly to characterize the federal exertions during the eight-month downturn beginning in March 2001. Fiscal and monetary intervention in the combined sum of 7.2% of GDP, was the most muscular since the Great Depression. Insofar as that 1% funds rate was instrumental in blowing up the debt bubble, however, the intervention only postponed the evil day.

Its coming, in 2007, found the federal budget in deficit in the amount of 1.2% of GDP, the smallest since 2001. Next year came the flood. Outlays grew by 9.1%, fastest since 1990, while receipts plunged by 1.7%, yielding a shortfall equivalent to 3.2% of GDP. It was only temporarily shocking. In 2009, federal spending is expected to jump by as much as 34% and receipts to tumble by 14.5%. On the basis of the Obama administration's proposed

budget—not the most pessimistic document in Washington—the CBO projects a deficit of 13.1% of GDP in 2009 and 9.6% of GDP in 2010.

As for the Fed, since December 2007 it has conjured more than one trillion new dollars into existence. "Quantitative easing," the three-dollar phrase for heavy money printing, promises at least two trillions more. At this writing, the Fed's balance sheet foots to $2.1 trillion. As recently as December 2007, it totaled $874 billion. Inasmuch as the Fed has the authority to absorb $1.25 trillion more of agency-issued mortgage-backed securities, $200 billion more of agency debentures and $300 billion more of Treasurys, not to mention as much as $1 trillion for the new Term Asset-Backed Securities Loan Facility, or TALF, the balance sheet of the very near future will easily top $3 trillion. "Just counting the projected decline in the U.S. fiscal balance and the actions the Fed has already taken," McCulley points out, "you get intervention equivalent to between 18.7% and 19.9% of GDP. Adding the authorized increase in the size of the Fed's balance sheet over the next year gets you to 28% to 30% of GDP."

However, this heretofore unimagined 28% to 30% of GDP is just for starters. One must also consider the new federal guarantees, including: $1.8 trillion to backstop the commercial paper market, $540 billion for the Money Market Investor Funding Facility, $3 trillion for the soon-to-expire blanket guarantee of money-market mutual funds, $700 billion for expansion of deposit guarantee coverage to $250,000 per depositor, $1 trillion for ensuring the debt of sundry financial institutions and a further $450 billion for additional guarantees. Nor must one forget the Fed's thoughtful guarantee of more than $400 billion of assets on the overstretched balance sheets of Citigroup and Bank of America. The new Public-Private Investment Program could add an additional $1 trillion. All told, such guarantees and backstops sum to $8.9 trillion at face value, representing an additional 63% of GDP. "So in total dollars," McCulley winds up, "the government's response to this crisis could be equivalent to GDP—all of it."

Counting these hypothetical outlays, the federal response to the Great Recession would be 12 times greater than that to the Great Depression. "It is utterly impossible to keep up with the things that happen in Washington," Frank Kent, a political columnist for the *Baltimore Sun*, wrote in March 1934, one year into the New Deal. "One project follows another so rapidly that they baffle the hardiest mind. . . . . The whole business has become fantastic. The activities are on so many fronts, the experiments so numerous, varied and vast that confusion reigns and many on the inside are as perplexed as those looking on."

It's strange to reflect how relatively small was the intervention that occasioned so much bafflement, confusion and perplexity. Maybe Kent wondered what the government would ever do for an encore. So do we.

'Solid across the void'

(May 15, 2009) Legg Mason Inc. is the city of Buffalo, or maybe the Baltimore Orioles, or perhaps *The New York Times* of the asset-management industry, a once-thriving enterprise now fallen on evil days. Since 2007, the year Legg management found all about structured investment vehicles and—*and*—decided to sign a 15-year lease on its very own 24-story Baltimore office tower, assets under the company's management have fallen by 34.7% and its share price by 80%. We hold no view on the recuperative powers of Buffalo, the Orioles, or the *Times*, but we are bullish on Legg, now free and clear of its SIV difficulties and delivered from the near-term threat of insolvency. For a much higher LM share price, no stock-market miracle is necessary, only a snapback in corporate operating margins.

We focus here on Legg, the nation's No. 2 publicly traded, freestanding asset manager by assets, but our bigger interest is the investment-management business. Is the mutual-fund business model kaput? Not yet, we judge. One of the bear arguments against companies like Legg is that management fees will fall. Well, they have been falling since the early 1980s and may well continue to fall, but it won't be news if they do. The bears say that assets won't come back after this terrible bear market, not much of which was anticipated by Legg's storied investment professionals. But inflows and outflows forever follow investment performance. Come the next bull market, the money will be flowing back again, with no hard feelings. ETFs? They stand to garner more investable assets, but the threat to mutual funds from that quarter seems overblown. For all the talk and trumpets, ETFs constitute only 5.5% of mutual fund assets. In the year-to-date, the average technology mutual fund has returned 18.3%, twice the rise in the Nasdaq, while the average large-cap-blend mutual fund has returned 3.1%, nearly twice the rise in the S&P 500. Are not quite five months of exceptional returns proof that active managers have finally found a way to earn their keep? No such belief is priced into the relevant share prices.

Especially is it not priced into the slumped-over Legg Mason share price. The outlier among investor-owned asset managers, Legg is quoted, on an enterprise value-to-AUM basis, at 77 basis points, compared to 116 for AllianceBernstein, 138 for Blackrock, 175 for Invesco, 288 for Eaton Vance, 289 for Franklin Resources and 348 for

Asset-manager comps
(in $ millions)

	mkt. cap	P/E ratio	P/B ratio	oper. margin	assets under mgt.	AUM y/y chg.	EV/ AUM
Blackrock	$18,650	29.6x	1.6x	27%	$1,283,000	-6%	1.38%
Legg Mason	2,741	NM	0.6	-7	632,000	-33	0.77
AllianceBernstein	5,319	7.0	3.3	6	435,000	-44	1.16
Franklin Resources	14,472	15.7	2.1	24	421,000	-34	2.89
Invesco	5,843	12.2	1.0	11	367,600	-26	1.75
T. Rowe Price	9,963	25.7	4.0	29	268,800	-29	3.48
Eaton Vance	3,209	19.6	12.1	25	119,300	-21	2.88

Legg's Baltimore neighbor, T. Rowe Price. What ails Legg is a thrice-told tale. The company absorbed a $2.9 billion loss on the $10 billion of SIV-issued commercial paper that found a host in its money-market mutual funds. Investment assets fled—$77 billion in the December quarter, $44 billion in the three months to March 31—and operating margins collapsed. Legg calculates that, excluding the items it trusts are unusual, it generated $69 million of operating income in the March quarter, good for a pro forma operating margin of 11.2%. In the boom, based on generally accepted accounting principles, Legg consistently produced operating margins in the mid-20s (the GAAP figure for March was minus 7%). For Legg's top management, it is either a goad to effort or a cause to drink that some of its peers, even in this bear market, are still earning operating margins in the mid-20s.

So cost cutting is de rigueur throughout the Legg Mason organization: at the fixed-income shop, Western Asset Management, which manages $472 billion of the company's $632 billion of assets; at ClearBridge, the second-largest division, which manages the equity funds in the Legg Mason Partners-branded fund family; and at Brandywine, Permal Group, Royce & Associates and Batterymarch. It's the equity side that gets the attention—especially, in recent years, the brickbats—but stocks constitute just 20% of the asset mix. It's 57% bonds and 23% money markets.

On the May earnings call—Legg, Japan-style, has a March 31 fiscal year-end—the new CEO was expounding on cost control. Management had sliced 22% from its operating budget, and it had identified enough additional fat to lop off 27% "on a run-rate basis" by September 30, related Mark R. Fetting. Head count was down by 13% since September. Such data, however, elicited no "great quarter, guys!" huzzahs from the dialers-in. With revenues down by 42%, realized cost savings of 22% impress only so much.

No more calculated to raise investors' spirits was the loss, in the March period, of another $44 billion of AUM. As one analyst put it, the outflows were the "worst in the group in the quarter despite performance that was in line with the group, especially on the equity side." Indeed, the lately derided (formerly celebrated) Bill Miller has the Legg Mason Value Trust up by 9.06% in the year-to-date, which is good for 76th percentile performance honors. Western Asset's numbers, notably terrible in 2008, are also on the upswing. "While it may take time for the pipeline for some of their flagship strategies to grow meaningfully again," the Legg Mason IR department advises colleague Ian McCulley, "we continue to see new mandates in those and other strategies, such as Western's TIPS product and some international products."

Time does fly. Legg went public only in 1983 with a $27 million IPO that doubled shareholders' equity. Miller's fund, pre-Miller, had assets of less than $30 million. Today, after a mediocre year in 2007 and a debacle in 2008, it has $3.5 billion. By any reasonable standard, what's amazing about Legg is not how much it has lost, but how far it's come.

And management, oblivious to the gathering debt storm, almost lost it all. That the $10 billion SIV problem did not, after all, sink a company with March 31 equity of $4.45 billion speaks as much to good fortune as it does to managerial acuity. After laying the SIV crisis to rest, Legg has $1.1 billion of cash (an expected tax refund will add $500 million more), $3.2 billion in debt and $9.32 billion in total assets. The debt consists of a $550 million term loan, $1.25 billion in 2.5% convertible notes and $1.125 billion in equity unit hybrids. The nearest debt maturity is 2011.

Having passed through the shadow of the valley of death, management seems determined to find the sunshine of safety. Last week, it chopped the quarterly dividend to three cents a share from 24 cents, its $1.1 billion of cash notwithstanding. An analyst on the call asked why. "[T]he market may be a leading indicator," Fetting replied,

Legg Mason Inc.
(in $ millions, except per-share data)

	12 mos. to 12/31/08	3/31/08	3/31/07	3/31/06	3/31/05
Operating revenues	$ 3,809	$ 4,634	$ 4,344	$ 2,645	$ 1,571
Operating expenses	4,296	3,584	3,315	1,965	1,082
Operating income	(487)	1,050	1,028	680	489
Other income (expense)	(2,379)	(606)	15	36	(18)
Tax provision	(986)	176	398	276	175
Minority interests	—	—	—	(6)	—
Income from cont. operations	(1,879)	267	646	434	295
Net gain on sale	—	—	1	710	113
Net income	(1,879)	267	647	1,144	408
Earnings per share	(13.36)	1.86	4.58	9.50	3.95
Cash	1,563	1,464	1,184	1,023	795
Current assets	4,199	4,686	2,392	2,127	6,552
Goodwill and intangibles	5,259	6,646	6,858	6,797	1,447
Total assets	10,136	11,830	9,604	9,302	8,219
Short-term debt	509	932	5	120	103
Current liabilities	2,030	2,739	1,312	1,598	4,939
Long-term debt	2,967	1,826	1,108	1,166	708
Total liabilities	5,315	5,210	3,063	3,452	5,926
Shareholders' equity	4,821	6,620	6,541	5,850	2,293
Cash from operations	571	964	905	545	366
Assets under mgt. (billions)	698	950	969	868	375
Shares outstanding (millions)	141				
Price per share	$19.20				
Market capitalization	2,741				
Price/earnings	NM				
Price/book	0.62x				

"and it may or may not be a bear-market bounce, or whatever. But we want to be solid across the void and preserving cash for that, I think, is actually the right thing for the long-term interest of the shareholders. It could be, if we are pleasantly surprised, that we'd have an opportunity to revisit and take a look at other ways we could bring capital back to the shareholders." Fetting added that the bear market had served up some "interesting" acquisition possibilities.

"The trend toward consolidation and increased size in the business is long running," McCulley observes. "The Investment Co. Institute calculates that the number of firms in the fund business shrank by 12% during this decade. But the need for wounded global banks to improve capital ratios should lead to a new wave of asset-manager transactions. Thus, Barclays is selling iShares, the ETF operator, for £3 billion to CVC Capital Partners, or—perhaps—to a higher bidder. iShares generated £658 million of revenue and £288 million of operating profit in 2008, providing a 43.7% operating margin. The business manages £226 billion in assets, indicating that CVC's bid values the business at 132 basis points of AUM, about the same as AllianceBernstein (and, of course, much higher than Legg's 77 basis points). According to Bloomberg News, Bank of America's Columbia Management fund business has attracted bids that value it closer to Legg Mason than to Legg's more prosperous peers, say, a price equivalent to 60 to 100 basis points of AUM. Anyway, these indications of interest suggest that the public markets are prepared to value asset managers more highly than the private market does."

With Charles Schwab's recent announcement that it plans to create its own line of ETFs, inquiring minds will wonder if actively managed mutual funds, like the rotary-dial telephone, are not one of the great ideas of yesteryear. In the year to March 31, ETF assets fell by 15.6%, to $482 billion, while mutual fund assets fell by 21.2%, to $9.25 trillion ($5.4 trillion excluding money market funds). Equity mutual funds, which manage a grand total of $3.3 trillion, relinquished 43% of their assets in 2008, and redemptions from those funds are on track to shrink AUM by 30% in 2009.

As noted above, however, ETFs still claim just 5.5% of total mutual fund assets, while ETF costs are starting to rise. Whereas the management fee on the plain-vanilla SPY is just 9.5 basis points, the investment-grade bond fund, LQD, charges 15 basis points, and the junk bond fund, HYG, gets 50. EWZ, the iShares Brazil fund, will set you back 63 basis points, while some of the new double- and triple-levered ETFs—a brand new way to lose money—get nearly 100 basis points.

"Ultimately," McCulley winds up, "the Legg Mason investment thesis is that there is nothing fundamentally wrong with the asset-management business model and that, when the bear market ends, the company should benefit. The same is true for the entire group, but Legg is particularly beaten down. Analysts expect the company to produce operating margins of 13.4% and earn 95 cents a share in the fiscal year to March 2010. It wouldn't take much in the way of better-than-expected asset growth or margin improvement to earn closer to $1.50 or $2 a share in the next couple of years. With the same business mix, the company earned $4.58 a share in the year to March 2007. Make no mistake, this stock is something of a warrant on better financial-asset returns in the future. More likely, however, after a quarter or two of positive earnings, the market will realize that Legg should not be valued like a distressed bank but, rather, like its asset-manager peers."

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*year-over-year through March 2009
source: Investment Co. Institute

Horrible? Certainly. Bearish? Not necessarily.

(June 12, 2009) Not even rising joblessness, plunging Treasury prices and the widening prevalence of negative equity entirely exhaust the list of reasons to despair for American residential real estate. A third wave of losses, set to soak the heretofore high-and-dry prime borrower, is supposedly crashing over the market. "We're right in the middle of this third wave," Mark Zandi, chief economist at Moody's Economy.com, told *The New York Times* last month, "and it's intensifying. That loss of jobs and loss of overtime hours and being forced from a full-time to part-time job is resulting in defaults. They're coast to coast."

Residential mortgages and house prices are the subjects at hand. In preview, we are selectively bullish on the first and expectant toward the second. Regrettably, the easily accessible public plays on recovery in "toxic" mortgage-backed securities have moved out of bargain-hunting range. Mr. Market, reliably fickle, may just decide to move them back again, though we would not spin out the following essay on that hope alone. Rather, we reappraise the state of American residential mortgage finance because so much seems to depend on it.

"Bullish," admittedly, isn't the first word that springs to the minds of readers of the everyday mortgage news. For instance, first-quarter delinquency rates climbed across the board, even for prime borrowers. Sequentially, they were up by 19.8% (to 6.06% from 5.06%) and by 63.3% from the year-ago level (to 6.06% from 3.71%). The inventory of foreclosed houses financed by prime mortgages climbed by 32.5% sequentially (to 2.49% of prime mortgages surveyed from 1.88%) and by 104.1% from the year-ago level (to 2.49% of that mortgage universe from 1.22%).

The all-in cost of foreclosure proceedings to creditors has also taken a leap. According to new data compiled by Fitch Ratings, loss severities across the credit gamut accelerated between June 2007 and April 2009—for subprime mortgages, to 73% from 40%; for Alt-A mortgages, to 55% from 19%; and for prime mortgages, to 43% from 14%.

In Street parlance, houses are the "underlying" in the residential mortgage market, and they are lying lower all the time. As of March, the S&P/Case-Shiller 20-city composite index was down by 18.7% in a year and by 32.2% since July 2006. Phoenix, with a peak-to-present decline of 53%, lost the most; Dallas, off by only 11.1%, the least. Not surprisingly, transaction volumes have plunged with house prices, while inventories have traced a course in the opposite direction. In April, according to the U.S. Census Bureau, new homes sold at a seasonally adjusted annual rate of 352,000, 0.3% higher than in March but 34% below the year-ago reading and 74.7% below the July 2005 peak of 1.4 million. The inventory of unsold, unlived-in houses stood, at last report, at 10.1 months (i.e., it would take 10.1 months to get rid of a house at the current sales pace), down from 12.4 months in January.

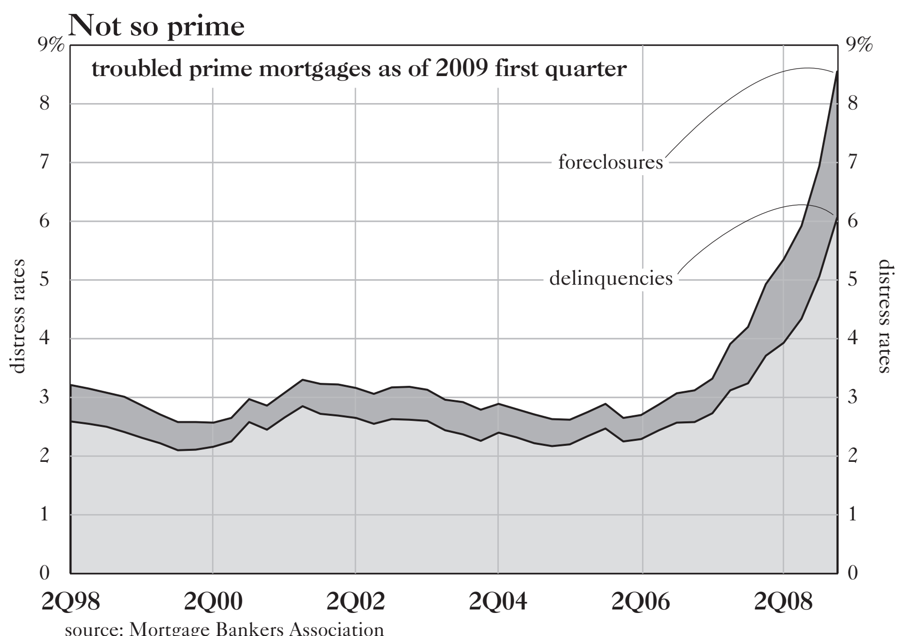
If you detected a small shaft of sunlight in the previous sentence, it wasn't your imagination. Falling prices are parting the clouds. Distressed property sales accounted for fully 45% of all used-house transactions in April, according to the National Association of Realtors. "After mostly retreating from the housing market after the bubble burst," *The Wall Street Journal* reported on May 20, "investors are returning in droves, hoping to take advantage of the distress. In many cases, realtors say, investors also are outbidding first-time home buyers and other would-be occupants because they often come to the table with all-cash offerings."

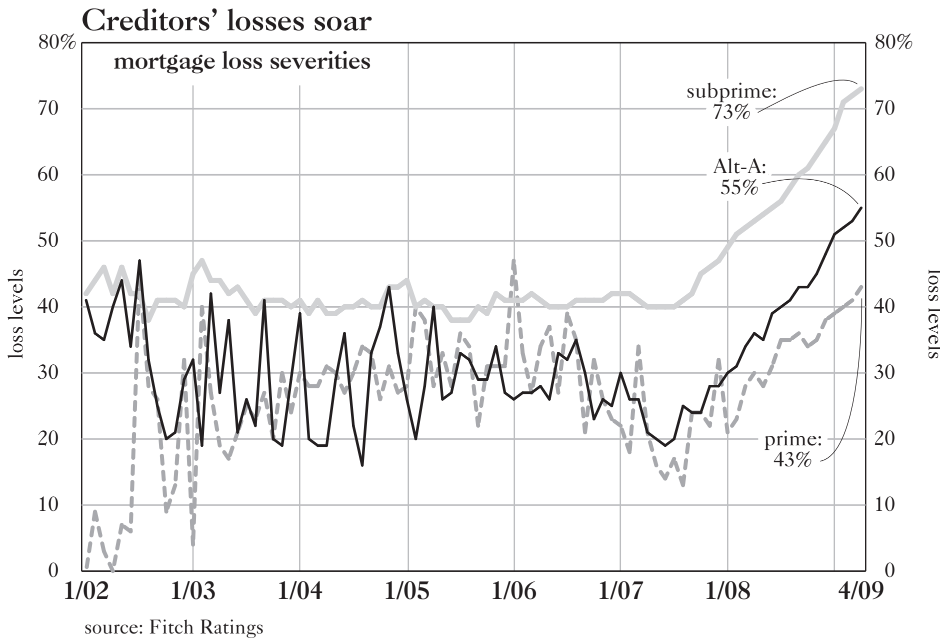
Colleague Dan Gertner, our first vice president for the mortgage mess, relates that house prices, having famously overshot to the upside, now seem to be overdoing it in the opposite direction. The basis for his conclusion is, in the first place, the analytical test developed by reader R. King Burch: Multiply the average house price (new and used) by the number of sales and divide by GDP to arrive at an intuitively attractive bubble-o-meter for residential real estate. Since 1970, the Burch Index, as it will henceforth be known, has averaged 9.8%, with a standard deviation of 2.9. It peaked at 18.3% in 2005, just shy of a three standard deviation from trend. The latest reading, 7.5% at the end of the first quarter, is a 0.8 standard deviation below the post-1970 mean. "The Burch Index," Gertner observes, "indicates that the housing correction has overshot to the downside."

Gertner invokes a second test of house-price value, the rent-to-price ratio monitored by Morris A. Davis of the University of Wisconsin-Madison School of Business. For donkeys' years, houses returned an average of 5%. The yield declined from 5.5% in 1960 to slightly less than 5% in 1999. Then it plunged to 3.1% in the first quarter of 2006. But now look: Owing to rising rents and falling house prices, the ratio is back to 5.1%. "Let us say," muses Gertner, "that 5% is the correct yield for a house and that the price-to-rent ratio overshoots by one standard deviation to 5.7%. Assume, too, that rents stay the same. In that case, the Case-Shiller index would have to register an additional decline of 9.9%, for a total drop, peak-to-trough, of 38.9%.

"A third test of house prices," Gertner proceeds, "is the National Association of Realtors' index of affordability. The index is set so that a reading of 100 means a family earning the median income would be able to afford a house offered at the median price. An index of 150 would mean that the family's income is 150% of the minimum amount required to afford a median-priced house (assuming a 20% down payment and principal and interest payment no greater than 25% of income). As of March, the index stood at a record 172.5, more than three standard deviations above its long-term average of 125."

Of course, things are never so bad that they can't get worse, and the bear market that follows a truly bubbly bull market often surprises the pure rationalist by how low it goes. So let us posit, suggests Gertner, that house prices overshoot to the downside by the same three standard deviations as they overshot to the upside (as measured by the rent-to-price ratio). In that case, they would register a further drop of 26.9% for an overall decline of 50.4%.





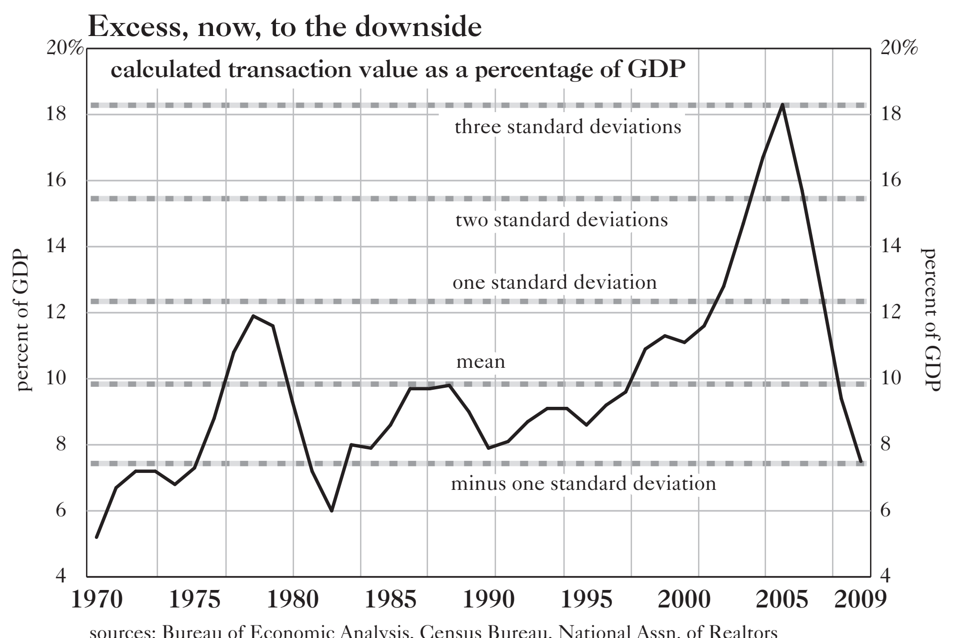
Nobody knows the future, but all can observe how markets discount it. In the case of the residential mortgage-backed securities market, collective expectations are as dire as the known facts. "A mortgage investor I know (he prefers to remain anonymous)," Gertner relates, "has built a data base of liquidated loans. In the past month, the average liquidated prime loan had an original loan-to-value ratio of 75% on a house priced at $750,000. So the loan was in the amount of $562,500. Notably, the price of the house at the time of liquidation had fallen not just by the Case-Shiller 20-city average (32.2% from the bull-market peak to date), but by 45%, to $412,500. It's notable but not surprising, inasmuch as foreclosures tend to cluster in weaker neighborhoods. Anyway, subtract the written-down value from the par amount of the loan, and you see that the creditors are in the hole by $150,000, or 26.7% of face. But the all-in loss severity is another 12 percentage points higher than that, such are the burdensome costs of foreclosure."

Daunting as these numbers are, they are nobody's secret. How is the RMBS market discounting them? In the case of a particular senior-most tranche of a certain prime RMBS, the market is figuratively laying in candles and canned goods. Beneath the tranche in question are five layers of credit protection amounting to 7.8% of the principal sum of the structure. This, the penthouse tranche, is quoted at 74 cents on the dollar to return an expected 10.3% over the life of the deal.

Our anonymous investor—it is he who expects the 10.3%—has modeled three sets of total-return outcomes corresponding to three different sets of assumptions. The most important of these assumptions are prepayment speeds, default rates and loss severities. Our investor's base case features prepayments decelerating to 4% from the 14% actually registered over the past three months, default rates accelerating to 3% annually from the current 1%, and loss severities immediately rising to 50%.

Even under a future as bleak as this one, our tranche, to repeat, is expected to deliver an annual return of 10.3%. Under a less severe set of assumptions (e.g., prepayment speeds doubling to 8%, default rates at 2% and loss severities of 40%), an investor would earn 12.2% a year. Of some comfort to us is the finding that even under a truly gruesome set of assumptions (e.g., prepayment speeds falling to 2% a year, defaults rising to 8% and loss severities climbing to 75%), an investor would earn a projected 2.8% per annum. Incidentally, at a 75% loss severity, a $750,000 house would be hammered down to $195,000.

We know of only two avenues by which a retail investor can participate in the residential mortgage-salvage movement. The first is Redwood Trust (RWT on the Big Board), featured in these pages on February 6. Redwood's management was lately out buying 2004 and earlier vintages of senior Alt-A RMBS and 2005 vintages of senior prime RMBS and junk-rated Alt-A RMBS. Studying the most recent 10-Q reports, we venture that management is paying 65 cents on the dollar for assets it regards as money-good. Impressive enough, but Redwood common is quoted at 1.6 times book and yields 6.6%. Perhaps Mr. Market would be so obliging as to mark it back down to book, or, say, to 1.2 times book at a minimum, in order to afford the value-minded investor a margin of safety?



Then there is Chimera Investment Corp. (CIM on the Big Board), a specialty finance company managed by a wholly owned subsidiary of Annaly Capital (to disclose an interest, Gertner and your editor are both Annaly investors). Chimera invests in RMBS, residential mortgage loans and other real estate-related securities. Its management is partial to Alt-A securities of 2006 and 2007 vintage, a part of the market that Redwood has avoided. A characteristic Chimera strategy is to pay 50 to 55 cents on the dollar for senior Alt-A bonds that, down the road, it expects to sell for 70 to 80 cents on the dollar, allowing for write-downs of 20 to 25 cents. Gertner asked Wellington Denahan-Norris, chief investment officer of Chimera, if the latest mortgage data on delinquencies had her spooked. "We expected it to be bad, and it continues to be bad. . . ," she replied. "We run some pretty draconian scenarios, and none of this is unexpected, and the bonds that we buy can withstand increases of much greater magnitude than we've experienced so far."

At 1.4 times book value and with a yield of 9.1%, Chimera, like Redwood, trades as if the market were confident of a happy outcome. We, too, expect good things, but we would be more comfortable investing if the market expected bad things. It will, too, sooner or later. Just wait.

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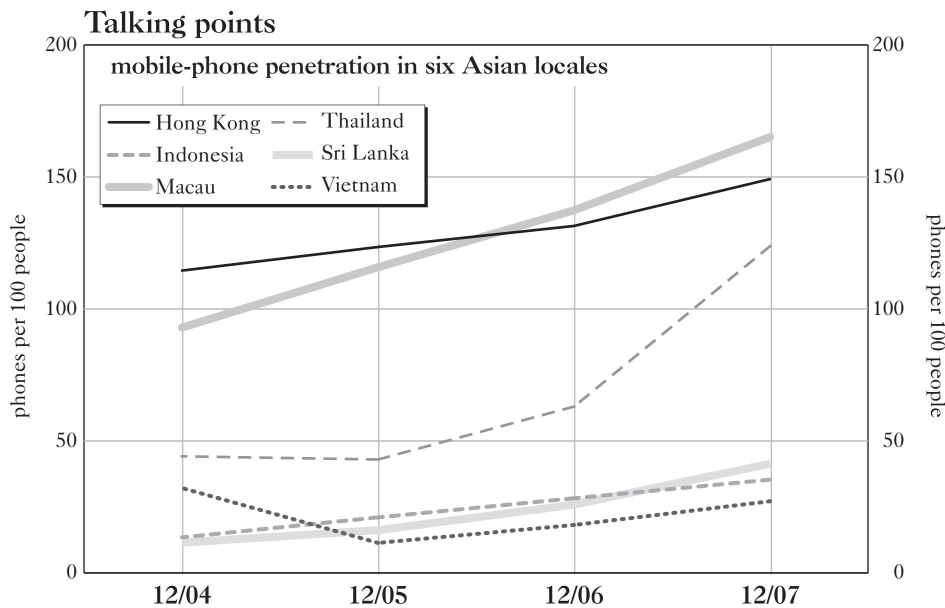
Cheaper talk

(May 29, 2009) If barely breaking even is the new hitting 'em out of the park, Hutchison Telecommunications International is almost a home run. Thanks to a surge this very week, the stock has returned a grand total of 7.1% since the bullish analysis so cunningly published in these pages on the eve of the plunge in global equities 19 months ago (*Grant's*, Oct. 19, 2007). We count ourselves lucky.

Now unfolding is a reappraisal of Hutchison and its new spin-off in the broader context of the emerging-markets telecom business. In preview, we believe we see opportunity.

You may recall that Hutchison Telecom International (HTX on the Big Board) was a kind of telephone omelet. Its ingredients consisted of mobile services in Hong Kong and Macau, a landline service in Hong Kong and mobile operations in Indonesia, Thailand, Sri Lanka, Vietnam and Israel. Once upon a time, there was a crown jewel in India, too. Selling the Indian subsidiary to Vodafone in 2007 for the fanciest of prices—the equivalent of $860 per subscriber—management pleased the followers of Graham and Dodd at the cost of alienating the members of the cult of growth. You know which sect has more adherents.



So the track of the share price flattened. Paying a fat, special dividend in December didn't help it. Would the spin-off of the dowager, dividend-paying Hong Kong and Macau operations do the trick? We'll soon see. Management effected this very dismemberment on May 14. So Hutchison Telecom International today comprises the volatile, growth-targeting, emerging-markets businesses, while the spin-off, called Hutchison Telecommunications Hong Kong Holdings, consists of the aforementioned Hong Kong and Macao assets. "Hutchison Telecom is a growth stock, and HTHKH is a yield-driven security," Dennis Lui, CEO of Hutchison Telecom, told dialers-in to the March earnings call.

Before delving deeper into the investment questions, a word on the family tree. Hutchison Wampoa, the shipping, ports and real estate conglomerate controlled by Li Ka-shing, owns 60.4% of both companies. That portion of the spin-off not controlled by Li changes hands in Hong Kong under the ticker 215 HK. U.S. holders of Hutchison Telecom received American Depository Receipts for their interest in HTHKH, and these ADRs trade—intermittently—under the ticker HTHKY. Volume in the American scrip is less than $500,000 a day.

We wonder if Dennis Lui's capsule summary of the differences between Hutchison and its spin-off does the spin-off full justice. HTHKH controls 47% of the 3G market in Hong Kong and 33% of the overall wireless market in Macao. It has an advanced fiber-to-the-building network in Hong Kong and the largest fiber capacity into mainland China. Its fixed-line business is on the move, too. "Growth has actually been pretty robust for what is supposed to be a boring company," colleague Ian McCulley observes (let the record show that he owns Hutchison and its spin-off as well as other cellphone names), "with the top line expanding at a compound rate of 10.9% from 2006 through 2008 and operating income at a 22.1% compound rate over the same period. That's even more impressive given that the market is what the analysts call 'saturated'; there are 1.6 and 1.7 cell phones per capita in Hong Kong and Macao, respectively."

Of course, growth will be harder to come by now that Hong Kong is confronting what the analysts call "challenges." With real wage growth stalled, GDP shrinking (perhaps by 3.5% this year) and property prices

Selected emerging-markets mobile phone operators
(in $ millions)

name	symbol	mkt. cap.	enterprise value	est. P/E	millions of subscribers	EV per subscriber
MTN Group	MTN SJ	$28,155	$34,929	11.9x	98	$356
Bharti Airtel	BHARTI IN	30,550	31,617	14.9	100	316
Orascom Telecom	ORTE EY	5,713	10,918	12.1	78	140
Turkcell	TCELL TI	11,303	9,049	7.8	36	251
Millicom International	MICC	6,211	7,660	10.6	34	221
PT Excelcomindo Pratama	EXCL IJ	900	2,787	13.5	25	107
Hutchison Telecommunications Int'l	HTX	1,020	1,870*	73.6	10	186

*pro forma the spin-off
sources: The Bloomberg, company filings

falling, consumers may think long and hard before splurging on that new iPhone. Some such adversity must be discounted in the HTHKH share price already. Larger and slower-growing PCCW, Hong Kong's old monopoly fixed-line and mobile provider, is the relevant HTHKH comp. PCCW trades at 12 times trailing net income, HTHKH at 11 times. PCCW shows a ratio of debt to earnings before interest, taxes, depreciation and amortization of 4.2:1, HTHKH of 1.9:1. If, as the management of HTHKH has indicated, the dividend payout will amount to as much as 75% of net income, the shares this year may yield 6% to 7%. Then, too, HTHKH is a spin-off, therefore an analytical orphan. Who knows what good things might happen to the valuation if and when the brokers discover the company's existence?

The previously quoted CEO of Hutchison Telecom International calls the emerging-markets business, the one he now leads, the "growth" telecom company. "Our operations in Indonesia and Vietnam," Lui has said, "form the key impetus for growth. We expect the Indonesian operation to be EBITDA positive within 2010 and our Vietnamese operation is ready to launch its new GSM service [it began in April]."

Hutchison Telecom International is not, in fact, a pure play on emerging-markets telephony. Remaining after the Hong Kong and Macao spin-off is the 51% stake in Partner Communications of Israel. "As a developed market company," McCulley observes, "the No. 2 mobile company in Israel, with a 31% market share, Partner would almost seem to fit better with

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the spun-off Hong Kong and Macao assets than with the high-risk/high-growth emerging-markets assets. Anyway, you don't have to wonder about Partner's operations or valuation. A stub interest representing the minority interest not owned by Hutchison Telecom trades in Israel and on the New York Stock Exchange (where it takes the form of ADRs). The shares are valued at nine times earnings with a 9% dividend yield and with a free-cash-flow yield in excess of 10%. It would not be surprising if Hutchison decided to monetize the Partner stake if and when Vietnam and Indonesia begin to come into their own."

At a glance, one might suppose that Hutchison Telecom is a bargain within a bargain. Its enterprise value amounts to $1.475 billion ($1.02 billion in equity market cap plus net debt of $455 million, ignoring the minority interest), while the 51% stake in Partner Communications alone is worth $1.341 billion. Evidently, the investor gets an option on the Indonesian, Vietnamese, Thai and Sri Lankan businesses for a mere $134 million. However, though it is cheap, it is not quite that cheap. As McCulley observes, another $900 million of debt is about to be incurred to finance cap-ex in Vietnam and Indonesia. "So on a forward basis, enterprise value is going to be significantly higher," he relates. "On the other hand, if any of the operations in emerging countries turn into the kind of home run that the famed Indian business did, or, perhaps more accurately, if a wide-eyed buyer appears, there could be substantial upside in the shares."

Enterprise value per subscriber is another way to look at cell-phone businesses like these. Hutchison Telecom has a close comp in PT Excelcomindo Pratama, the No. 3 Indonesian carrier with 25 million customers. Having registered a first-quarter loss and disclosed plans to finance cap-ex with a new share sale, Excelcomindo trades at an enterprise value of $107 per subscriber, half or less than half of the typical emerging-markets valuation. Millicom International, which has 33.6 million subscribers in 16 countries in Latin America, Africa and Asia, commands $221 per subscriber, while the MTN Group, with 98 million customers throughout Africa and the Middle East, trades at $356 per subscriber. And Hutchison? Back out the 51% Partner stake, which, as noted, is publicly traded and worth about $1.3 billion, and allocate subscribers on a pro-rata basis (i.e., Hutchison owns 65% of the Indonesian operation, so it gets 65% of the subs). Do this exercise, and you find that the market is valuing the customers outside Israel at a little under $28 each—but on the way to $213 each once that $900 million is borrowed.

"The valuations of emerging-markets telecoms have collapsed, and not without reason," McCulley notes. "In the first quarter, according to Reuters, worldwide cell-phone sales contracted at the fastest rate in the industry's brief history, showing a year-over-year decline in volumes of between 13% and 16%. There is also the issue of how much low-hanging fruit has been picked. The International Telecommunications Union estimates that, at the end of 2008, there were 4.1 billion mobile-phone subscribers worldwide (one individual with two phones is counted as two subscribers). In this decade, the customer count has grown by no less than 24% a year. The 4.1 billion grand total compares to 1.3 billion fixed-line telephones and 1.5 billion Internet users. Even some of the poorest countries in Africa have penetration rates over 40%."

Millicom, one of the great Paul Isaac stocks (*Grant's*, March 12, 2004), is a case in point. The Luxembourg-based company (MICC on the Nasdaq), fetched $125 a share in December 2007. After rallying by 27% to date this year, the price is $57. As recently as early 2008, subscriber growth was trucking along at almost 60% per annum. In the first quarter, it was a mere 29%. Analysts expect flat earnings in 2009, with growth resuming in 2010. The balance sheet shows $729 million in cash against $2.219 billion in debt, and the ratio of net debt to run-rate EBITDA is less than one. Thanks to rising EBITDA margins (and rising EBITDA) coupled with a reduction in cap-ex, Millicom has reached a milestone of sorts: This year, for the first time ever, it expects to generate free cash flow.

If you haven't looked in a while, you wouldn't recognize today's telecom valuations. Millicom trades at 11 times, far higher than the 5.5 times at which it was quoted in the autumnal panic but worlds away from the 40 times it fetched at the beginning of 2007. Nor does Millicom's valuation fall far outside the emerging-markets telecom norm.

"If you believe," McCulley winds up, that for many emerging markets this is a severe recession—that and not an endless debt crisis—then mobile phone operators are a way to get exposure to growth in domestic demand in the developing world. As for the Hutchison properties, the reasonably valued and cash-generative Hong Kong and Macao business seems more attractive than the rump HTX business. While there is nice optionality in monetizing the public Partner stake embedded in the latter, you can currently buy competitors like Millicom that have better market shares and are actually profitable at what are historically cheap valuations."

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China channels 'Monkeybrains'

(July 10, 2009) Too much debt got us into this mess, and too much debt will see us out of it. Socialize the risk of a new cycle of open-throttle lending and cling to the monetary system that assures a repeat crisis. Such, approximately, is the global policy-making consensus. Central bankers and finance ministers have achieved an uncommon meeting of the minds. The cure for what ails us is the hair of the dog that bit us, they prescribe, though not in exactly those words.

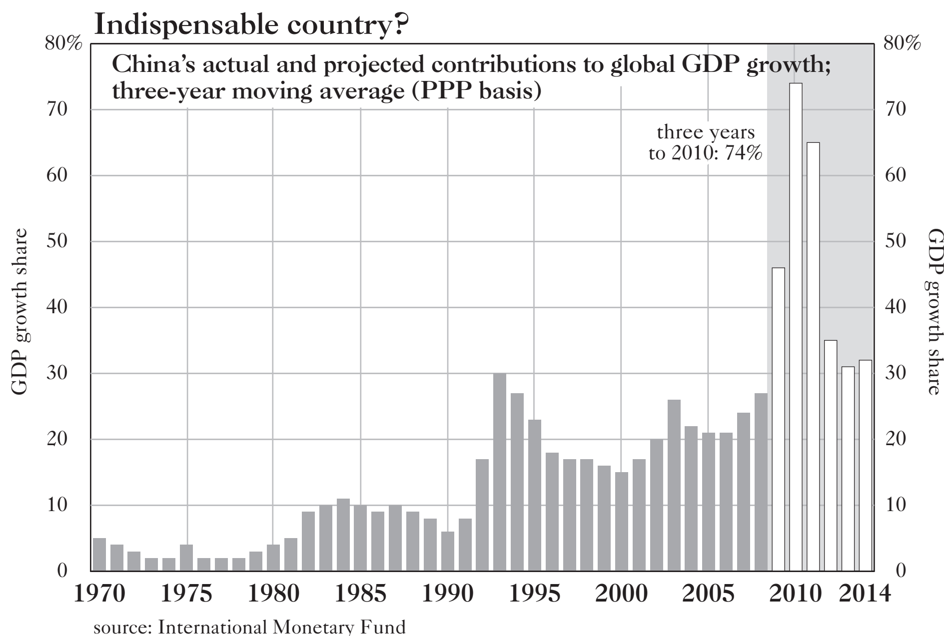
It's no small thing that China is especially enamored of the shot-and-a-beer-for-breakfast approach. Nothing about China is small or insignificant nowadays, since the Chinese economy is actually growing. It might, indeed, account for 74% of worldwide GDP growth in the three years to 2010, the International Monetary Fund estimates. Since 2005, China has generated 73% of the global growth in oil consumption and 77% of the global growth in coal consumption. By the looks of things, it accounts for a fair share of the growth in worldwide luxury-car consumption, too:

FRANKFURT (Dow Jones)—BMW AG said Monday that sales at its core BMW brand in China were up 46% on the year in June at 8,033 cars,

fueled by strong demand for its X5 and X6 models.

Sales in China for both the BMW and the compact Mini brand rose 44% on the year at 8,506 cars, a company spokesman said.

Now unfolding is a preview of the next, the future, credit collapse. Such methods as China is employing—a borrowing binge centrally planned and directed—will eventually come to grief, as the readers of *Grant's* know full well. Indeed, in money matters, nearly everything seems to come to grief sooner or later. However, it is equally true that, before the grief, comes the laughter and levitation. Massive injections of money and credit are always unsound. But for stocks, commodities and credit, they are bullish before they are bearish. In the fad for "quantitative easing," when might the laughter turn to tears? How to prepare for that inflection point? How to see it coming?



China is not alone in seeding bad loans right on top of the previous cycle's only partially harvested crop of desperate debts. Loan guarantees, commercial paper purchases and other forms of financial artificial respiration by the governments of the G-20 nations sum to the equivalent of 32% of last year's combined G-20 gross domestic product, the IMF estimates. That is on top of average fiscal stimulus equivalent to 5.5% of GDP. So the United States, implementing fiscal and monetary stimulus worth nearly 30% of GDP (*Grant's*, April 3), is not far out of the interventionist mainstream. China is in a class by itself.

In the 1930s, Western intellectuals persuaded themselves that the Soviet economic model was depression-proof. Today, not a few investors marvel at the vigor of the modified communist economic model of the People's Republic. Credit may contract in the United States, but it expands—nay, explodes—in China. "If the rumored new lending figures for June are accurate (for more, see Michael Pettis's blog at mpettis.com)," observes colleague Ian McCulley, "Chinese banks will have lent 7 trillion renminbi, or a little more than $1 trillion, in the first half of 2009, compared to Rmb4.9 trillion in all of 2008, Rmb3.6 trillion in 2007 and Rmb3.2 trillion in 2006. New lending was exceptionally strong in the first three months of this year. It tapered off a bit in April and May but appears to have roared back in June."

Complementary roars have issued from China's manufacturing industries and world commodity pits. Last week, the People's Republic purchasing managers' survey registered 53.2, its fourth consecutive month over the 50% mark that indicates economy-wide growth. The Shanghai A-share market jumped by 65% in the first half, to a level that fixes its value at 31 times trailing net income, up from 12.8 times at the October lows. Chinese M-2 was 25.7% larger in May than it was a year before. Chinese officialdom is targeting 8% GDP growth this year, while the World Bank predicts 7.2%, of which, the organization says, six full percentage points owe their existence to government stimulus. As between the 8% government forecast and the 7.2% non-government forecast, our money is on the government. Not only do the cadres print the money, but they also calculate the GDP. So, falling in with the Communist Party, we, too, predict 8% growth for 2009—barring an early explosion in the Chinese banking system.

New directives to Fannie Mae and Freddie Mac to refinance certain mortgages at up to 125% of appraised home value reaffirm the U.S. government's membership in the hair-of-the-dog bloc. But no credit-market intervention approaches the one being mounted in Beijing. For it, the world's commodity producers say daily prayers of thanksgiving, and their gratitude would truly be incalculable if only they knew how long the Chinese could keep it going. Absent Chinese stockpiling, where would commodity prices be? Without a functioning Chinese banking system, where would the world economy be?

A superb primer on the risks of China's go-for-broke lending drive was published by Fitch Ratings on May 20. Is it not passing strange, the agency asks, that Chinese lending is accelerating even as Chinese corporate profits are shrinking? "Ordinarily, falling corporate earnings are met with tightened lending, but in China, precisely the reverse is evident. . . ." You would expect—and Fitch does anticipate—that the borrowers of these trillions of renminbi are not so profitable as they were in the boom, and some will therefore struggle to service their debts.

Reading Fitch on China, we think of the author Mark Singer on Oklahoma. In China, Fitch explains, credit losses don't surface promptly on account of "pervasive rolling over and maturity extension of loans when they fall due. This not only leads to under-capturing of NPLs and delayed credit costs, but also, by extension, inflated capital. Consequently, in the short to medium run, Chinese banks' performance may continue to hold up well as rapid loan growth drives up the denominator of NPL ratios and boosts profits via high volumes, but the me-

dium-term risk of a deterioration in corporate portfolios is rising."

Neither did credit losses surface right away at the Penn Square Bank, Singer related in his 1985 tour de force, "Funny Money." Penn Square originated oil-patch loans at its headquarters in an Oklahoma City shopping center during the boom of the late 1970s and early 1980s. Interests in these credits it syndicated far and wide. An alert loan buyer might have taken a cautionary hint from Penn Square's super-fast growth and evident undercapitalization, if not from the nickname of its chief energy-lending officer—they called him "Monkeybrains." But the Continental Illinois National Bank & Trust Co., of Chicago, one of Penn Square's top loan participants, seemingly suspected nothing until the Oklahoma bank failed in 1982. When Continental Illinois itself became insolvent in 1984—pulled down, in part, by its Penn Square participations—a new chapter in the socialization of credit risk was opened. To save the Federal Deposit Insurance Fund, the government nationalized Continental, then the nation's seventh-largest bank, with assets of $41 billion. Pure and simple, it was too big to fail. Indeed, Comptroller of the Currency C. Todd Conover subsequently hinted, the 11 largest banks in the country were systemically irreplaceable. And so was born the too-big-to-fail doctrine. Whether or not it was an American invention, the policy today belongs to the world. China, in particular, has taken the idea and run with it.

Examining, first, the track of Chinese bank lending and, second, the trend in Chinese nonperforming loans, the seasoned reader will remember not only Monkeybrains but also Drexel Burnham Lambert. In the mid-to-late 1980s, the American junk-bond market combined breakneck growth with muted default rates. The secret, fully revealed during the subsequent bear market, was that the default rates were a direct product of the issuance rates. Borrowers didn't default because of—to adapt the Fitch formulation to that earlier time—the "pervasive rolling over and maturity extension of bonds as they fell due." Drexel failed when the junk market did.

The idea that the government will finally pick up the pieces may or may not drive the typical mid-size American bank to risk-taking from which it would otherwise shrink. In China, however, there appears to be no doubt. "Prior to the global crisis," according to Fitch, "domestic [Chinese] credit conditions had been fairly tight; strict loan quotas had been put in place at the start of 2008 amid concerns about inflation, and [corporations] and banks were increasingly employing off-balance-sheet transactions to complete deals. However, since the rollout of the stimulus package [last November], the climate has dramatically changed. Projects that had been sidelined when quotas were tight have been put into action with the assumption that if problems arise, Beijing will likely step in with assistance."

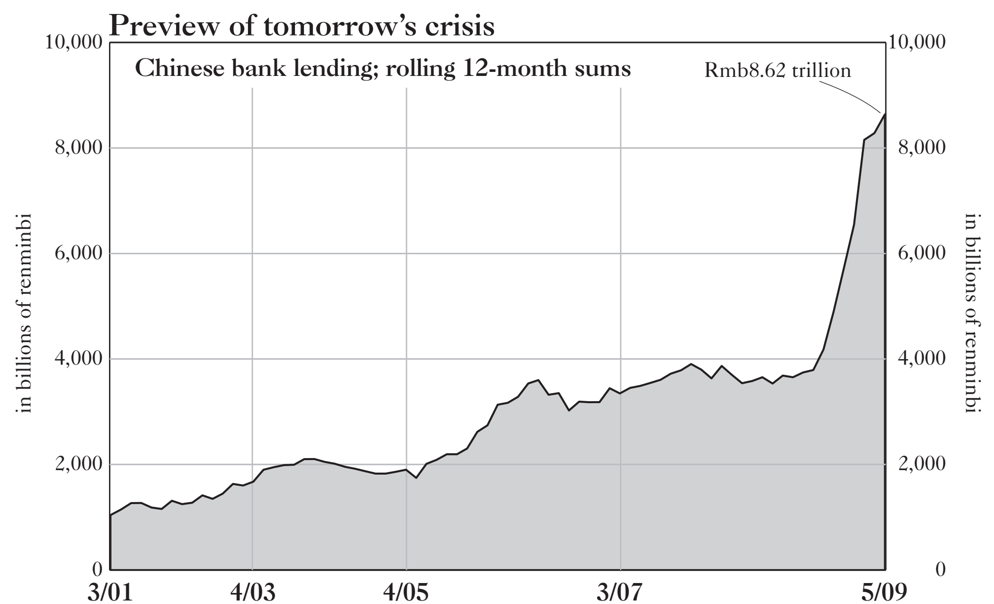
If problems arise? As Fitch itself implies, the only question is when: Nonperforming loans at foreign banks in China, "which are generally believed to have stricter risk management and oversight and are less willing to roll over delinquent loans," are already on the rise. Chinese loan officers work to a quota. They take their direction from their branch managers, who report to the senior management, which answers to the board of directors—and the directors hang on the words of the People's Bank.

The trouble these days is that too many motivated loan officers are chasing too few creditworthy borrowers. Net interest margins at Chinese banks are tightening on account of the recession and the governmentally sponsored drive to lend their way to prosperity. So loan officers push all the harder. "For example," as Fitch explains, "a branch manager is given an annual profit target of Rmb35 million. If the average loan margin is 3.5%, he needs to lend Rmb1 billion to meet this goal. However, if the average margin declines to 2%, he now needs Rmb1.75 billion to meet the same objective. This is not the first time Chinese banks have faced a margin squeeze, but in the past the ability to raise credit volume was limited by quotas [i.e., central-bank-imposed quotas to restrict lending to combat inflation]. Now, in a quota-less environment, that restraint is gone."

China has its Sheila Bair as well as its Ben Bernanke, and the safety-and-soundness bureaucracy in March urged banks to set aside in reserve 150% of the par value of their bad debts, up from 120%. But the directive seems more in the way of a suggestion than a ukase. Certainly, the stock market does not believe that the evil end to the new credit boom is yet in sight. In Hong Kong, the big three Chinese banks—Industrial & Commercial Bank of China, Bank of China and China Construction Bank—trade at price-to-book multiples of 2.5, 1.7 and 2.5, respectively.

We are as bearish on the multiples as we are on the stated book values. On the other hand, the stock market is as sanguine about Chinese bank stocks as economists are complacent about Chinese inflation. The late Mil-

Preview of tomorrow's crisis



source: The Bloomberg

ton Friedman handed us not so much a postulate as a divine law when he said that "[i]nflation is always and everywhere a monetary phenomenon." But a new generation of central bankers and economists is having its doubts. "Some worry that the rapid growth of money and credit will lead to inflation," the Beijing office of the World Bank advises in its June Quarterly Update. "However, with a lot of [spare] capacity in China and world-wide putting downward pressure on raw material prices unlikely to soar soon, substantial generalized price pressures seem unlikely any time soon." An asterisk at the end of that sentence leads the reader to a footnote in which the World Bank economists finish the argument: "The relationship between monetary aggregates and inflation is complex. That is why central banks in mature market economies have largely abandoned using money as a guiding variable for inflation projections, giving priority to output gaps."

So the economists give intellectual cover to the money printing. For the "mature market economies," we advise a return to the basics, starting with the very definitional threshold of the problem. Inflation is not "too much money chasing too few goods," but too much money, period. What the fatal, redundant increment of cash chooses to pursue varies from cycle to cycle. In pursuit, however, it never fails to distort something. Lately, the money has been chasing investment assets rather than goods and services. In Shanghai, it is chasing A-shares. Globally, this year, it has pushed up, or contributed to the pushing, of the prices of lead, copper and nickel by 75%, 71% and 50%, respectively. Who knows? Maybe the central banks have prevented some prices from falling further than they otherwise would have done. Central bankers, however, to generalize across the profession, refuse even to imagine the problem in these terms. They are content rather to assert that, owing to the prodigious gap between output and potential output in recession-wracked economies, their actions have instigated no inflation but have forestalled deflation. Self-congratulations ringing in their ears, they are prepared to crank the presses even faster when duty next calls. What's the harm in it? they seem to ask.

In fact, by cutting off interest rates at the knees, central banks punish thrift. Prolonging the lives of businesses that deserve to go out of business, they thwart the designs of the entrepreneurs who would, if they could, build something better. There's no end of mischief in quantitative easing. On the other hand, it's an ill monetary wind that blows no portfolio any good. Beijing has been lifting prices in resource markets. "The round of oil-field auctions in Baghdad last week," McCulley points out, "is a sign of things to come, as China National Petroleum Co. was part of a winning BP-led bid, while most other Western majors walked away complaining of unfair terms. (China National has a separate deal to develop other Iraqi fields.) Sinopec is buying Addax Petroleum, with reserves in West Africa and Iraq, in an $8.8 billion deal, and, according to *The Wall Street Journal*, is paying $16 per barrel of proven and probable reserves, more than triple the valuation of other deals in the region." Western companies may answer to their shareholders, but as an energy consultant put it to the *Financial Times* last week, "The Chinese companies are answering to politicians who have an aggressive strategy of resource capture."

The properly skeptical observer is in a quandary. China holds perhaps $1.5 trillion of low-yielding Treasurys and U.S. agency securities. You'd ex-

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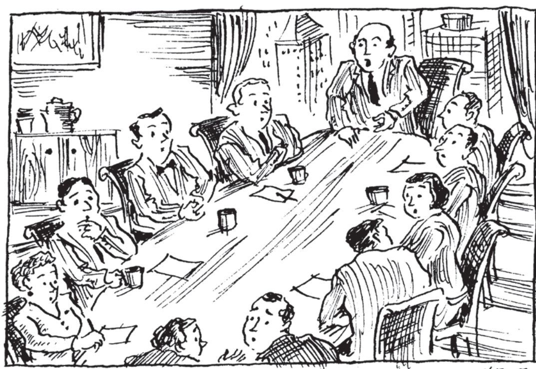

"I understand we own $1 billion of CDOs. Question: What's a CDO?"

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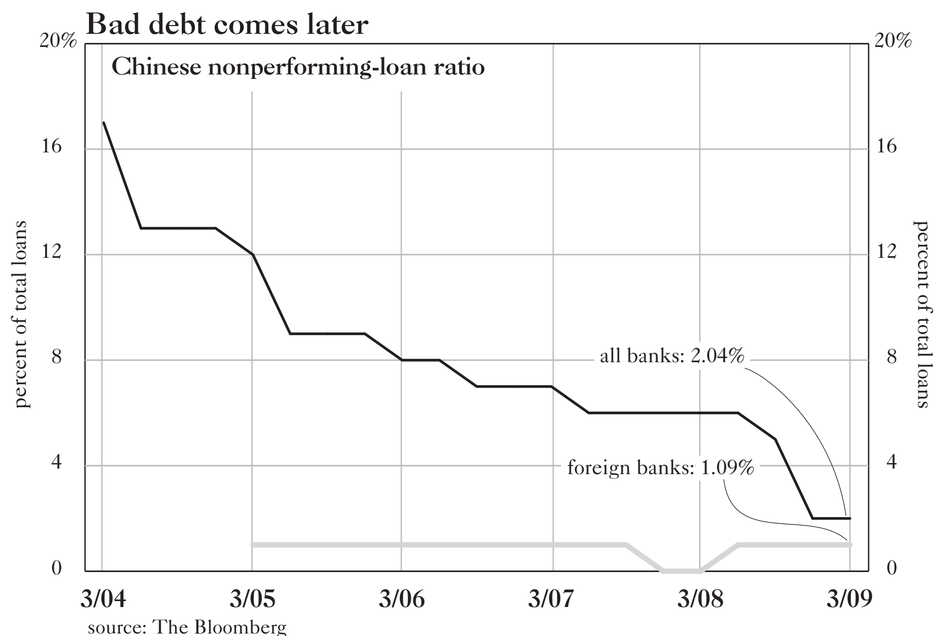
pect it to be edging out of two-year notes and Fannies and Freddies into resource investments, even if it had no doubts about the dollar. But it does have doubts, which it has taken to expressing in deeds as well as in words. On Monday, a Shanghai municipal government finance official called a press conference to announce the decision of three local companies to begin settling import and export contracts in renminbi rather than dollars. From offstage, a Singapore currency analyst declared, according to Bloomberg, "This is a first step on the long road towards that target of making the [renminbi] a global reserve currency. That's probably going to take five years or more."

It could be a long, hard road if China's Monkeybrains banking system follows the Penn Square-type trajectory, as we expect it will. Besides, Bloomberg News, in the very same dispatch, relates that the dollar's share of official vault space climbed to 65%, or $2.6 trillion, up 100 basis points on an admittedly incomplete sample set, in the first three months of the year. And it quotes He Yafei, China's deputy foreign minister, speaking in Rome on Sunday: "The dollar will maintain its role for 'many years to come.'"

So saying, He came to the root of the problem. The dollar's "role" in the world—its exalted status as a reserve currency—is what has facilitated the piling up of debts on one side of the Pacific and U.S. Treasury assets on the other. It is the dollar's role that has allowed the United States to consume much more than it produces and to finance the difference in the currency that it alone may lawfully print. China ships merchandise to us; we ship dollars to China. These dollars wind up at the doorstep of the People's Bank, which creates the renminbi with which to absorb them. And what does the bank do with its greenbacks? Why, it invests them in the securities of the U.S. government. Note, please, that the dollars might as well have never left home. Note also that their transit instigates credit creation in China, some of which, though not all, may be neutralized, or "sterilized," by the People's Bank. Under a proper gold standard, creditor countries gain reserves while debtor countries lose them. Built into that system is a balancing mechanism. New under the paper-money arrangements of recent decades is a kind of intrinsic imbalance. The major debtor country loses no reserves even as the debtor countries gain them.



source: The Bloomberg

Our Great Recession has restored a small measure of balance to the international financial traffic. U.S. imports have fallen further than U.S. exports, thus reducing the U.S. current-account deficit for the first quarter to $101.5 billion vs. the year-ago reading of $179 billion. The second-quarter shortfall was the smallest in absolute terms since the fourth quarter of 2001, and the smallest as a percentage of GDP—2.9%—since the first quarter of 1999. Yet, still, China accumulates dollar bills. "Despite a year-over-year drop in exports of 26.4%," McCulley notes, "and the American consumer's newfound taste for thrift, China has posted an $89 billion cumulative trade surplus through May, which is actually ahead of last year's record-setting pace."

A good-size portion of the Treasurys and agencies that America's creditor nations accumulate is held for safekeeping at the Federal Reserve Bank of New York. We track these custody holdings on pages six and seven of *Grant's*; the Fed discloses them every Thursday. Strange to relate, they have grown, not shrunk, in the past three months, at an annual rate of 27%.

All in all, the world is reverting to pre-crisis form. Central banks are monetizing dollars, subsidizing credit and socializing risks, and the People's Bank is outdoing all others in this direction. Certain it is that these unprecedented monetary maneuvers will come to a sorry and dramatic end. What we are struggling to divine is the timeline. Watch this space.

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EDITOR

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