GRANT'S

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EDITOR

Happy and Merry

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Sincerely yours,

James Grant

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On the systematic mispricing of debt

(May 15, 2015) How a $50 million loan to RadioShack turned into an $81 million gross impairment was the featured topic on the May 7 earnings call of Fidelity & Guaranty Life of Des Moines, Iowa (FGL on the Big Board). Stage one was that $50 million plain-vanilla credit, the company explained. Stage two involved a $63 million equity tranche in a collateralized loan obligation, of which a certain portion was invested in RadioShack debt—nothing vanilla here. Stage three concerned a $33 million investment in a reinsurance vehicle that also came equipped with RadioShack exposure.

Dialers-in listened as the chief financial officer, Dennis Vigneau, summed things up. "Following extensive evaluation analysis. . . ," said Vigneau, "the $50 million loan participation was impaired by $35 million, or 70%, to a fair value of $15 million. Next, the $63 million CLO investment, which was partially exposed to RadioShack, was impaired by $25 million, or approximately 40%, to a fair value of $38 million. And lastly, the $33 million preferred stock investment. . .was impaired by $21 million, or 64%, to a fair value of $12 million. In total, these impairments were $81 million gross. . . ."

Fidelity & Guaranty Life, an offshoot of the old U.S.F.&G., of Baltimore, is the firm that "helps middle-income Americans prepare for retirement," or so claim its copywriters. If so, the life insurer's investment department, with its RadioShack trifecta, itself needs help. Certainly, it gets none from the world's central banks—or, as far as that goes, from the post-1981 interest-rate zeitgeist.

Great bond bull markets don't come around all the time. There have been just three in America for the past 150 years—1865 to 1900, 1920 to 1946, and 1981 to the present. In the nature of things, bull markets end at extremes of valuation. In the case of bond bull markets (again, bearing in mind the limited sample size), ending points are also marked by the metallic scraping sounds of conservative fiduciaries searching for suitable income-producing investments in the bottoms of barrels.

This particular bull bond market, the post-1981 episode, is unique. It owes its extreme valuations, in good part, to radical monetary policy. In no previous modern interest-rate cycle did short-dated sovereign yields make their lows at less than zero or the 10-year Bund its low at just five basis points above zero. As for sensible-shoes Midwest fiduciaries harboring triple exposures in a credit that *The Onion*, for Pete's sake, marked as a goner as long ago as 2007 (*Grant's*, Feb. 20), that, too, is one for the record books.

The mispricing of biotech stocks or corn and soybeans is of no great consequence to finance at large. Interest rates are another matter. Universal prices, they discount future cash flows, calibrate risk and define investment hurdle rates. Interest rates are the traffic signals of a market economy. Ordinarily, some are amber, some are red and some are green. Since 2008, they have mainly been green.

Please find nearby a table that lays out the damage to government bondholders since the third week of April. As of midday Tuesday, it would have taken a dozen years of coupon income to compensate the owners of French and German 10-year notes for the mark-to-market losses they have borne in only a few weeks—losses, let it be noted, that have propelled yields, in the case of the French obligation, to just 98 basis points from a starting point of a mere 36 basis points. "There is a lot of soul-searching at the moment," an interest-rate strategist is quoted as saying in the May 8 *Financial Times*, "because a lot of people thought Bund yields were en route to minus 20 [basis points]." Minus 20 basis points for a 10-year obligation denominated in a fiat currency? Posterity, reading about this era in finance, may need some persuading to believe that what is purported to happen did actually happen, and to sentient human beings at that. It seems implausible even now, when we are living through it.

Just a little bear tap

			yield		price			
	maturity	coupon	4/20/15	5/11/15	4/20/15	5/11/15	change	years of coupon income lost
U.S.	2/15/2025	2.0%	1.89%	2.3%	100.977	97.391	(3.6)	1.8
U.S.	2/15/2045	2.5	2.56	3.06	98.695	89.031	(9.7)	3.9
France	5/25/2025	0.5	0.36	0.98	101.428	95.445	(6.0)	12.0
France	5/25/2045	3.25	0.95	1.79	159.938	133.785	(26.2)	8.0
Germany	2/15/2025	0.5	0.07	0.69	104.170	98.210	(6.0)	11.9
Germany	8/15/2046	2.5	0.46	1.32	159.228	130.003	(29.2)	11.7
U.K.	3/7/2025	5.0	1.57	2.01	131.305	126.465	(4.8)	1.0
U.K.	1/22/2045	3.5	2.33	2.66	125.055	117.220	(7.8)	2.2
Switzerland	7/24/2025	1.5	-0.19	0.08	117.468	114.428	(3.0)	2.0
Switzerland	1/6/2049	4.0	0.25	0.56	220.970	204.990	(16.0)	4.0

source: The Bloomberg

Except for manhandling by the central banks, Steven Kandarian, chairman of MetLife, is on record as suggesting that 10-year Treasury yields would trade at between 4% and 4 ½% ("based on the Fed's 2% inflation target and expectations for long-term economic growth," he wrote in the MetLife 2014 annual report). As it is, the Treasury 2s of 2025 are quoted at a hair less than 98 to yield 2.25%. A yield of 4 ½% implies a price not far from 80. Not much coupon protection there, either.

Which brings us back to Fidelity & Guaranty Life's triple stumble in RadioShack. As an isolated investment error, it would mean little. As a sign of the times, it would be much. "I guess," Brian Horey, president of Aurelian Partners, a long-short equity fund, tells colleague David Peligal, "you can think of it as the structural manifestation of the reach for yield. I have no idea how widespread the use of junk credits as reference entities for derivatives like these have become, but I'll note that, in this case at least, it is all well outside the Paul Volcker- and Elizabeth Warren-neutered banking system that so many obsess over today, and thus likely to be invisible from a regulatory standpoint. As such, it seems like quite potent fertilizer for a 'hoocoodanode' moment some quarters or years hence. If regulators have carried forward any scar tissue from the last cycle that can be put to use, that scar tissue should start to feel itchy upon review of FGL's RadioShack adventure."

The repricing of interest rates will be its own kind of adventure.

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Essence of China

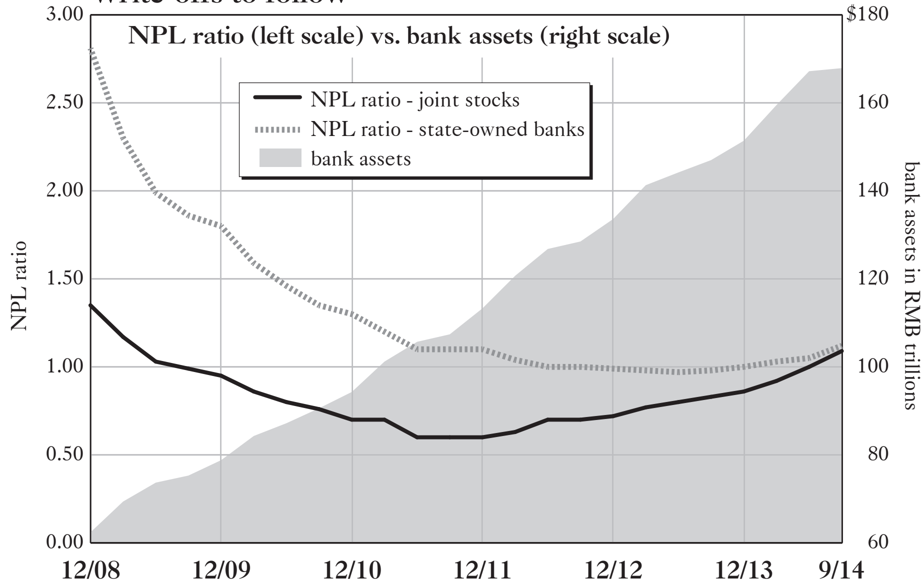
(February 6, 2015) China is a riddle wrapped in a mystery inside a phony press release, to adapt a line of Winston Churchill's. By official contention, the GDP of the People's Republic registered year-over-year growth of 7.3% in the fourth quarter. Yet, also in the fourth quarter and likewise measured year-over-year, profits at Chinese industrial companies tumbled by 5.8%. In December, the China Leading Index, which is derived from stock prices, credit spreads, a consumer expectations' survey, real estate investment and freight traffic, among other soundings, dropped to its lowest level since February 2009.

Ping An Insurance Group Co. of China (2318 on the Hong Kong Stock Exchange) is one of two featured topics in the essay now unfolding. The financial system in which this important company has its cosmetically luminous being is the second. In preview, we're bearish on the stock and astonished anew at the system. China, the supposed once and future driver of world economic growth, remains a laboratory experiment in how much debt a society can bear without actually collapsing.

"You have to keep in mind that the GDP number is a bureaucratic target, not an analytic result," replies Anne Stevenson-Yang, the co-founder and director of research of Beijing-based J Capital, in response to the question: Why do China GDP data seem to have so little to do with reality? "The State-owned Assets Supervision and Administration Commission, the nominal owner of all the state-owned companies, makes its budgets with reference to the posted GDP target. Each industry has a number that is based on a correlation to historic GDP figures and you are given that formula and that is your production target for that year. If the premier were to say, 'Actually, growth is 3%,' then SASAC takes down all the targets and it becomes a self-fulfilling prophecy. You can't afford to do that."

Grant's isn't the only observer that missed the run-up in the Shanghai stock market last year. Plenty of Chinese wanted no part of it, either. Outbound flows of local currency have pushed the renminbi-dollar exchange rate to an eight-month low. Once upon a time, the People's Bank bought dollars—all told, $4 trillion of them—in order to tamp down the renminbi's value. Now it is selling dollars—$150 billion in the six months ended December—to support the renminbi's value. In buying dollars, the PBOC expanded the money supply. It is selling dollars, it is contracting the

Write-offs to follow



source: The Bloomberg

money supply. Is this the way modern communist functionaries minister to a sickly economy?

Pity the Red planners (or try to). The government lashes the renminbi's value to the dollar through an administered trading band. The dollar has been on an upside tear. Beijing would welcome stronger exports. It chafes at the collapsing yen and euro. But an explicit devaluation of the renminbi could touch off a spasm of capital flight. Likewise, an explicit gesture of monetary easing might have undesirable consequences in a country in which—as Charlene Chu observed at the Fall 2014 *Grant's* Conference—debt is twice as large, and is growing twice as fast as GDP.

The authorities have opted for a kind of stealth easing. On Nov. 21, they cut the minimum rate at which banks can lend to businesses to 5.6% from 6%. On Dec. 27, they redefined the word "deposits" in such a way as to permit a rise in the system-wide ratio of loans to deposits. The move will unleash rmb. 5.5 trillion ($880 billion) in new lending reckons Shanghai-headquartered Haitong Securities. Or will it?

"I've been wandering around to banks asking, 'Are you going to lend more?'" Stevenson-Yang tells colleague Evan Lorenz. "They all say no. When I ask why, a lot of the reason is because all of the borrowers have their collateral already double hypothecated. There is no more collateral in the market. What borrowers have been doing is taking, through agents, a piece of the promised loan to buy collateral. But that only works if you can overstate its value. The problem is that real collateral values are falling now and the math doesn't work anymore. There are some scams out there but, for the most part, it doesn't work."

Chu had observed that for six years following the 2008 global financial crisis, the Chinese government fostered annual increments of lending and borrowing equivalent to 35% to 45% of GDP. "That is an astonishing amount," she reminded the audience. "If you were to put that in U.S. terms, we're talking about roughly $5 trillion in credit being extended six years in a row."

As far removed as the *Grant's* aerie at 2 Wall St. may be from the seat of Chinese finance, we are prepared to hazard that the People's Republic has overdone it in the leverage department. We conjecture as much to start with by the low level of admitted Chinese non-performing loans. They should be rising: the rate of credit formation has been breakneck, the return on invested capital has presumably been falling, and deflationary forces have raised the real cost of debt. The fact that acknowledged slow loans are barely rising prompts an informed suspicion that Chinese creditors are extending and pretending—capitalizing interest costs, "ever-greening" dubious debts.

A second item of evidence in support of the proposition that the debt rivets are (or should be) popping is Beijing's new scheme to shift the cost of servicing local-government borrowing. By this time next year, if the Party planners get their way, $2 trillion-plus of local government IOUs will have been converted to low-yielding municipal bonds. Instead of bank debt yielding, say, 8%, there will be municipal bonds yielding, say, 4%. Sound impossible? "Actually, it is not that difficult," a Hong Kong analyst advises Lorenz. "All you do is go to a bank balance sheet, scratch out rmb. 150 billion from the loans and put rmb. 150 billion in 'low-risk' bonds in the investment book." Bad for the banks—net interest margins will shrink as bad debts expand—but good for the macroeconomic optics.

Corruption—or rather the authorities' belated drive against it—further complicates the Chinese credit situation. Thus, Kaisa Group Holdings, a Shenzhen developer, missed a rmb. 162.8 million interest payment on Jan. 8, even though it showed rmb. 9.6 billion in cash on June 30. It seems that the company's accounts have been frozen since its chairman resigned in December, reportedly over ties to an allegedly crooked former secretary of the Shenzhen Municipal Politics and Law Commission.

"As I get the story," Lorenz relates, "what's changed is that giving a bribe has become retroactively illegal. Formerly, it was only receiving a bribe that got you in trouble. I understand that the switch may help to account for the rise in outward money flows. The government has put the fear of God in business people."

So all is gloom and doom? Not at all. Insurance, for instance, is a hopeful beacon. China is among the most underinsured countries in Asia, as Credit Suisse analysts Arjan van Veen and Frances Feng observe. "The central government has outlined a blueprint to promote private retirement savings as well as greater use of private health care insurance by local governments," as Bernstein Research analysts Linda Sun-Mattison, Thomas Wang and Min Zhou point out.

All the better, then, for Ping An, China's No. 2 insurer in both life and property-casualty (though life insurance in China has more to do with savings than protection against actuarial risk). Bulls swear by a management team that they say eschews market share for a shareholder-friendly focus on earnings. "The bull case is really that it is the best insurance company in China," van Veen tells Lorenz. "It has the most professional sales force. It is the most innovative in trying new things. It is spending a lot of money on trying to sell insurance direct. In motor insurance, where it is number two, it was the first one—rather than sell through agents or car dealerships—it was the first to go direct with outbound call centers, Internet and inbound call, and now half of that business is direct. It still has a first-mover advantage on that as well."

In dollar terms, Ping An boasts a $100 billion market cap and a $628.8 billion balance sheet. It has 212,000 employees and uses 608,000 agents. It ranks 128th in *Fortune* magazine's tally of 500 of the world's "Leading Companies." Of the 27 analysts who follow Ping An common, 26 profess to be bullish on it. The stock trades at 16.9 times trailing net income and 2.6 times book; the dividend delivers a 1.1% yield.

A respected worldwide brand, an institutionally coveted investment Ping An may be. Still, to us, it is the epitome of what's wrong with 21st century Chinese finance. "Thus," Lorenz points out, "it's an insurer that is buying shares in developers, insurers, banks. It has a bank and its bank is among the most aggressive in using accounting games to hide non-performing loans. It has a trust bank, an investment bank and a guarantee business. It's paying fancy prices for 'trophy' properties in 'gateway' cities, including their recent acquisition of Tower Place in London for $482 million."

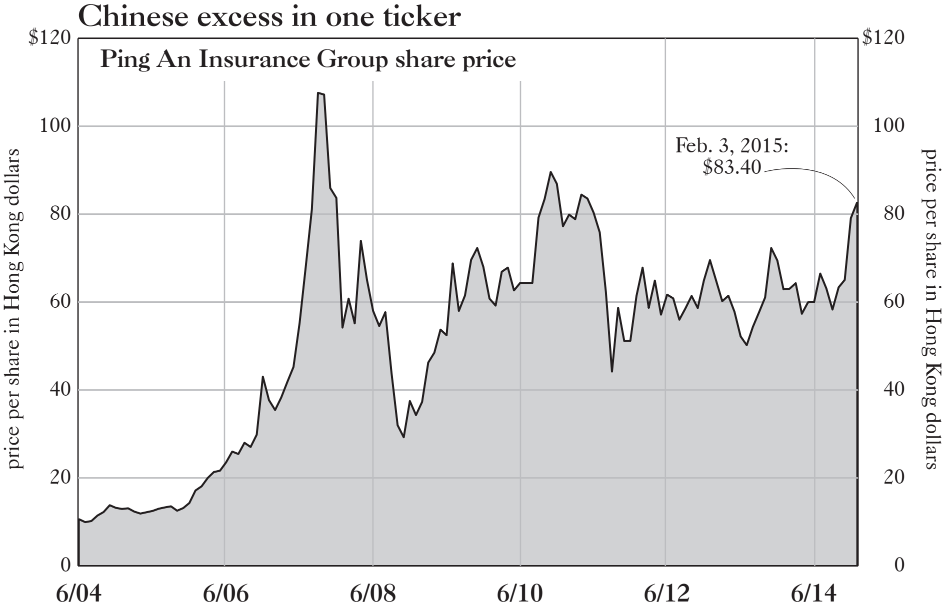
So Ping An is much more—or, at that, much less—than a well-regarded insurance company. In the first half of 2014, life insurance generated 36% of net income, P&C insurance 17%, banking 38%, securities underwriting and investment banking 2%, and trust management 3%. "Ping An strives to become the world's leading provider of personal financial services, establish a traditional business framework supported by the group's three pillars of business, namely insurance, banking and investment, and continue to promote the parallel growth of its traditional and non-traditional financial businesses," the corporate Web site modestly states. Remember Sandy Weill's concept of the financial supermarket? Ping An is that soup-to-nuts emporium.

The bank is the principal source of risk. Ping An acquired Shenzhen Development Bank through a series of share purchases beginning in 2009. Today, the parent holds a 59% equity stake in the rebranded and separately listed Ping An Bank Co. (000001 on the Shenzhen Exchange). As of the third quarter of 2014, Ping An Bank reported assets of rmb. 2.1 trillion, amounting to 56% of the parent's overall balance-sheet footings. Rmb. 127 billion in equity stands behind those banking assets, indicating a ratio of equity to assets of 5.9%. At last count, which was the third quarter's, non-performers amounted to just 0.98% of total loans and provisions were sufficient to cover 192% of those doubtful credits. On the face of things, then, credit quality would seem to present no insuperable problems. Then, again, this is the hyper-leveraged People's Republic. Besides, since 2009 the bank has compounded the size of its assets by an average of 25% a year. The pace of expansion does not suggest an over scrupulous attention to underwriting.

"I think Ping An Bank is possibly one of the worst banks in China," a Hong Kong-based observer who asks to go nameless ventures to Lorenz. "I find them an astounding institution. There is a loan category called 'overdue but not impaired.' It's exactly how it sounds. Ping An Bank and a lot of banks in China have taken that definition to a new extreme. The problem for the auditors is that the China Banking Regulatory Commission is not only supporting these accounting treatments, but is pushing back on the auditors trying to impair the loans." As of June 30, the "overdue but not impaired" category amounted to rmb. 21 billion, up from rmb. 1.4 billion at year-end 2011.

Not that the bank's problems are necessarily contained in the loan book. Loans, in fact, constitute only rmb. 1 trillion of the bank's rmb. 2.1 trillion of total assets. Another rmb. 0.9 trillion is deployed in interbank assets and in

Chinese excess in one ticker



source: The Bloomberg

what is blandly called "investments." In point of fact, not a few of these so-called investments in corporations and local governments are really loans, but they will never generate an NPL—not as long as they are ticketed "investments."

Our anonymous informant and we are far from the only skeptics with respect to Ping An Bank. The parent, too, has seemingly had a bone to pick with its problem child, to judge by the admission of Shao Ping, president of Ping An Bank, as quoted in the June 25, 2014, edition of *Caixin* magazine. Thus: "It has been common for branch banks to extend new loans to companies so they can repay old ones, but to do so in the future, they will have to get the headquarters' approval."

"When Ping An Group bought Shenzhen Development Bank, it was your classic failed merger," J Capital analyst Matthew Lowenstein tells Lorenz. "Ping An management has very much an insurance mentality, meaning they think costs should be low. They really didn't know how to run a bank. For well over two years after the merger, Ping An Bank had the highest turnover of middle management of any bank."

Neither do retail deposits tend to stick. Lacking that stable funding base, Ping An has turned to flightier liabilities—bank acceptance notes and corporate deposits, for instance. Only 17% of Ping An Bank's rmb. 1.5 billion in deposits are of the retail variety vs. 47% for Industrial & Commercial Bank of China Ltd., the largest bank in the People's Republic.

A would-be short seller may wonder why the beloved parent is a better target than the tempting bank subsidiary that trades under its own name. For one thing, the bank trades only on the mainland, whereas Ping An Insurance Group is listed in Hong Kong as well as on the mainland. Then, too, parent Ping An changes hands at more than twice the multiple of the banking sub. Besides, as Lorenz notes, "shorting Ping An Insurance gets you exposure not only to everything that Ping An Bank has both on and off its balance sheet, but also the parent's asset guarantor, its peer-to-peer lender and its trust company."

Perhaps, gentle reader, if you were the CEO of parent Ping An, you would sell the bank and be done with it. After all, the bank is the ball and chain that has caused the government to stick Ping An Insurance with the unwanted label "systemically important insurer." But sell to whom? Another Chinese bank? A clean Chinese bank? Where?

China's trust companies issue "wealth management products," or securities backed by claims on companies that, as often as not, don't qualify for a bank loan. Ping An Trust, one of the country's top trust companies, managed some rmb. 377 billion as of Sept. 30. It markets its WMPs to 29,000 high net worth individuals.

"Products" of all kinds carry with them some potential liability for the manufacturer. Who bears the cost of a defective wealth management product? Even if not bound by law to make restitution, a highly regarded issuer—Ping An, for instance—will look to its reputation in case of trouble. It happens that Ping An Trust last year issued a WMP in the sum of rmb. 2.5 billion to the now troubled Kaisa Group Holdings. On Jan. 20, Bloomberg cryptically reported the following: "Ping An Trust Co. established the two-tranche trust product on behalf of Kaisa in April last year, the people said, asking not to be identified because the details are private. The money on the largest portion comes due Jan. 21 and an as yet undisclosed third party will take it over so investors can be repaid their principal plus interest, the people said." It seems a fair guess that Ping An bailed out its investors. If so, the associated contingent liability was nowhere recorded on the balance sheet.

"Ping An," according to Bernstein Research, "is likely on the hook in case of underlying investment defaults in Ping An Trust and Ping An Banks' WMP products. Insurance operations continue to grow, but a reliance on re-insurance for capital management, expansion into credit and guarantee insurance, and investment into high-yield assets leave the company more vulnerable than its peers."

"Numbers are sparse for some of Ping An's other businesses," Lorenz goes on. "Figures for Lufax, Ping An's consumer-to-consumer lending business (think Lending Club in Mandarin), aren't broken out in Ping An's filings. We know the business is growing fast—the 2014 semi-annual report says that Lufax's transaction volumes grew by nearly 10 times in the first half of 2014 from the first half of 2013. In September, Ping An announced that Lufax would finance down payments for home buyers on such liberal terms as to allow prospective buyers to put down not one red renminbi. We don't know how many assets in toto that Ping An's creditor guarantor subsidiaries stand behind, but we do know they guarantee all of the loans in Lufax."

Certainly, Ping An is diversified, but it is the diversification of error. "They can shift assets from this pocket to this pocket and another pocket without ever recording a write-down or without ever having a truly neutral party agreeing on a price," as Lowenstein says. "Ping An has all this dross and bad assets both on and off balance sheet that will just never get written down. Beyond that, they are the poster child for lending into property, mining, and pie-in-the-sky infrastructure projects. They are worse than most banks."

In China, that's no compliment.

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To outsmart a snowstorm

(February 6, 2015) In auto finance, smaller down payments and longer repayment terms are the new-new things. Equally, in a cyclical world, they are the old-old things. "We've seen this movie before, we know how it ends, and it's not pretty," said Tom Webb, chief economist at Manheim Consulting, at an event before the North American International Auto Show, according to a Jan. 21 Bloomberg dispatch. "But I say that it has longer to run, and we have already paid the price of admission. So we might as well stay to the end. You just keep your eyes on the exit door."

The not-so-foreseeable future, junk bonds and subprime finance are the subjects at hand. Or, should we say "non-prime" finance? In reviving the pre-2008 craft of refashioning less-than-stellar-quality mortgage loans into marketable securities, today's investment bankers, for some reason, shy away from the word "subprime" (thank you, Jody Shenn). Anyway, there's a gleam in the eye of the American creditor.

The Tom Webb quote of 2015 calls to mind the Chuck Prince quote of 2007. "As long as the music's playing you've got to get up and dance," said the CEO of the pre-nationalized Citigroup just when he shouldn't have said it.

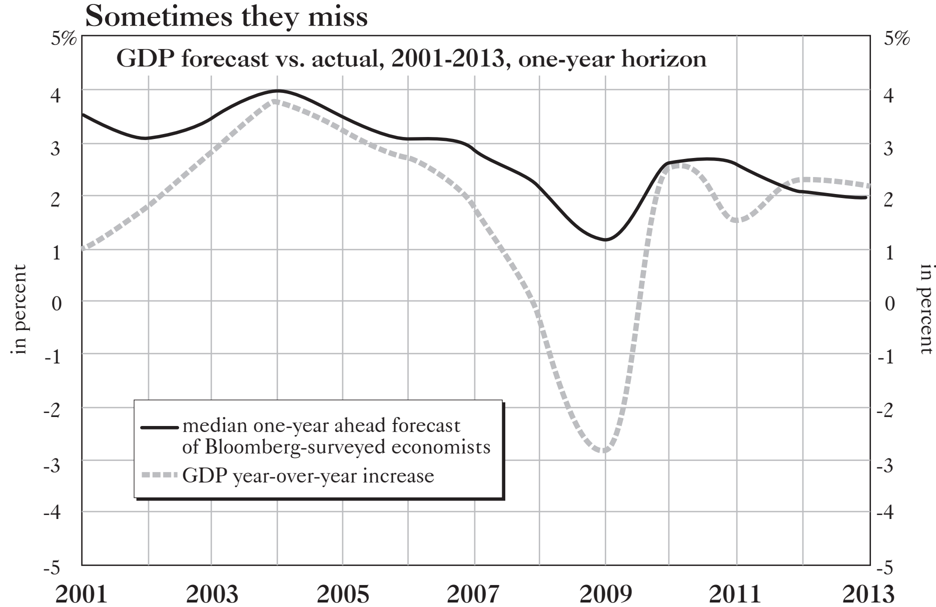
From time to time, this publication judges a certain stock or bond or market to be either overvalued or undervalued. And it sometimes happens that said overvalued or undervalued security or market seems to take no notice but keeps on going in the wrong direction. If Prince, hewing to the early *Grant's* line on subprime finance, had decided to withdraw from the residential mortgage business in 2005, he would have lost his job. He would have lost it just as surely as he actually did lose it by not hewing to the early *Grant's* line. History might have judged him prescient had he made a principled stand against subprime finance two years before the top, but he would still be unemployed.

Humility before the financial future seems especially well advised in the wake of the Jan. 27 blizzard that wasn't. The forecasters were late to detect what was initially billed as the greatest snowstorm in the history of New York. They were late to call it a dud. If weather predictions are fraught with error, how much more so must be financial predictions? Snowflakes, unlike investors, don't confound the forecasters by trying to second-guess Mario Draghi or change their minds on account of something they saw on CNBC.

Perhaps we mortals would be better advised to spend less time forecasting the future and more time observing how Mr. Market is casting his odds on the future. Were the dozens of economists whom Bloomberg polled in December perfectly unanimous in projecting a rise in interest rates in 2015? They certainly were (*Grant's*, Jan. 9). Their unanimity, while it can't be said to have caused the January upside panic in the bond market, evidently presaged it. As we go to press on Feb. 3, the euro-denominated Nestle unsecured 0.75s of Oct. 17, 2016, change hands at 101.283. It's a price to yield minus 0.006%, which happens to be more than 300 basis points less than the Nestle dividend yield. Meanwhile, in Denmark, Nordea Kredit is trying to recalibrate its back-office systems to accommodate negative mortgage interest rates. As Google renders the relevant Danish news bulletin: "Lise Nytoft Bergmann says that there is no cause for concern and that the new situation can be handled, 'but sometimes we have to use duct tape and paste.'"

Maybe the Danes could spare some duct tape for America's speculative-grade bond market. "Could defaults exceed expectations?" asks Marty Fridson in a characteristically thoughtful new analysis issued through S&P Capital LCD. "Yes, indeed," he replies

Sometimes they miss



sources: The Bloomberg, Economagic

in so many words, "and by a factor of three to four."

As his text, the chief investment officer of Lehmann Livian Fridson Advisors takes a half-dozen, published sell-side forecasts for GDP growth and junk-bond default rates for the year in progress. Not one of the GDP predictions comes in at less than 2.9%; not one of the default predictions comes in at more than 3.5%. For perspective, 4.7% is the long-term average default rate, according to Moody's. For further perspective, the last calendar year to produce GDP growth as fast as 3% was 2005.

Default rates show little correlation with economic growth in the neighborhood of 3%, Fridson observes. Weaker levels of business activity are a different story—or they used to be. Prior to 2008, measured growth of between zero percent and 2% was associated with a junk-bond default rate in excess of 7%. In the wake of the 2001 tech wreck, GDP growth came in at 1%, junk bond defaults at 11.21%.

Something changed then. In 2007, GDP eked out growth of less than 2%, yet the default rate scarcely measured 1%. Likewise in 2011: Growth was less than 2%; so, too, was the default rate.

A superabundance of liquidity forestalled defaults, Fridson reasons. Companies that would have missed an interest payment except for easy money didn't miss. The Federal Reserve wouldn't let them.

As for 2015, the economists are unanimously bullish on business activity. At least, the lowest forecast vouchsafed by the 84 participants in the Bloomberg 2015 economics poll was 1.9%. It isn't just the Fed whose GDP predictions tend to err on the high side; the Bloomberg respondents, too, persistently overshoot. Fridson observes that on three occasions in the past 13 years, the Bloomberg pollees overestimated GDP by 2.5 percentage points or more: The errant years were 2000, 2007, and 2008.

What if, Fridson muses, growth surprises to the downside again this year? And what if—for whatever reason—the old correlation between default rates and business activity reasserts itself? It isn't likely to happen, he allows. Still, he concludes: "It is worthwhile to remember that a proper forecast includes not only the base case which grabs the headlines, but also an optimistic and a pessimistic case. A default rate substantially higher than the consensus base case is part of the distribution, even if in the tail."

If debt pulls future consumption into the present, super-abundant liquidity pushes present defaults into the future. Come the next intersection of tight money and slow growth, restructuring lawyers and distressed-debt investors will have the *Forbes* 400 list mainly to themselves.

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House of mirrors

(January 23, 2015) Gary Friedman, chairman and CEO of Restoration Hardware Holdings, is seated on a high-backed beige chair, looking into the camera and speaking over a track of New Age (or is it Minimalist?) piano music. "There's a saying in our business that people buy with their eyes," says Friedman, tanned and fashionably stubbled, in a video which the company distributed last month in conjunction with third-quarter earnings. "That our first response is visual and everything else is secondary. That you can't sell what you can't see. That what we see shapes our perception of what we believe."

As for *Grant's*, what we see in Restoration Hardware (RH on the New York Stock Exchange) is an accident waiting to happen. What we believe is that the equity of this greatest of recent retail success stories is about to slip and fall. As ultra-low interest rates have facilitated RH's bloated inventories and grandiose building plans, the aggrieved bulls (when they do become aggrieved) can take their complaints, or some of them, to Janet Yellen.

The bulls will stop and stare. RH is the only known retailer to achieve the feat of four consecutive years of 25% growth in comparable-brand revenue. The stock, which doubled in 2013 and was up by 43% in 2014, is quoted at 30 times forecast 2016 earnings, a forecast into which is built a 28% jump in profit. "While still in the early stages of building RH into the leading luxury home brand," Friedman writes in the third-quarter earnings release, "we see a clear path to $4 billion to $5 billion in North American sales, mid-teens operating margin and significant free cash flow." For perspective, the company is currently producing $2 billion in annual revenue, a 9% operating margin and negative free cash flow.

No reader of Susan Berfield's superb profile of Friedman in the Feb. 27, 2014, issue of Bloomberg *Businessweek* will underestimate Restoration's business leader, curator-in-chief and guiding light. Friedman started in retailing in the Gap stockrooms in 1977; in a flash he was the company's youngest and most gung-ho store manager, answering to the peppy nickname Gary Gap. Today, he wears a woven brown bracelet on which you can read the word "Believe." And in the aforementioned video clip, he allows the viewer to compare him to Steve Jobs, Mickey Drexler (his retailing mentor), and Albert Einstein. CEO since 2001, Friedman has overseen the company's fall from grace in the Great Recession, its subsequent sale to a private equity group in which Friedman himself participated (in June 2008), and an IPO flawlessly timed to

ride the wave of the housing recovery (in November 2012), a ride materially enriched by Friedman's own shrewd eye for design. Affirms Drexler: "He basically took a moribund business and made it a relevant business." Relevant, yes, and for the investors—not least for Friedman, owner of 5.9% of RH shares—hugely profitable.

The Corte Madera, Calif.-based retailer is a design and housewares cornucopia. It sells—catering especially to the high-end consumer—furniture, lighting, textiles, bathware, household decorations ("décor"), outdoor and garden apparatus, tableware and children's furnishings. It operates 59 conventional-size stores, which it calls "Galleries," and in which it says it feels cooped up; a half-dozen immense stores of tomorrow, which it calls "Full Line Design Galleries"; three "Baby & Child Galleries," 18 outlet stores, and the occasional pop-up location at which the deluxe retailer is prepared to let down its high-end hair and hold a garage sale, like the one advertised in the banner ad shown nearby. The grand design is to replace the Galleries with Full Line Design Galleries, to expand product assortments, add new product categories—and, of course, to continue publishing catalogues so lush and back-breakingly heavy that they draw protests from UPS drivers.

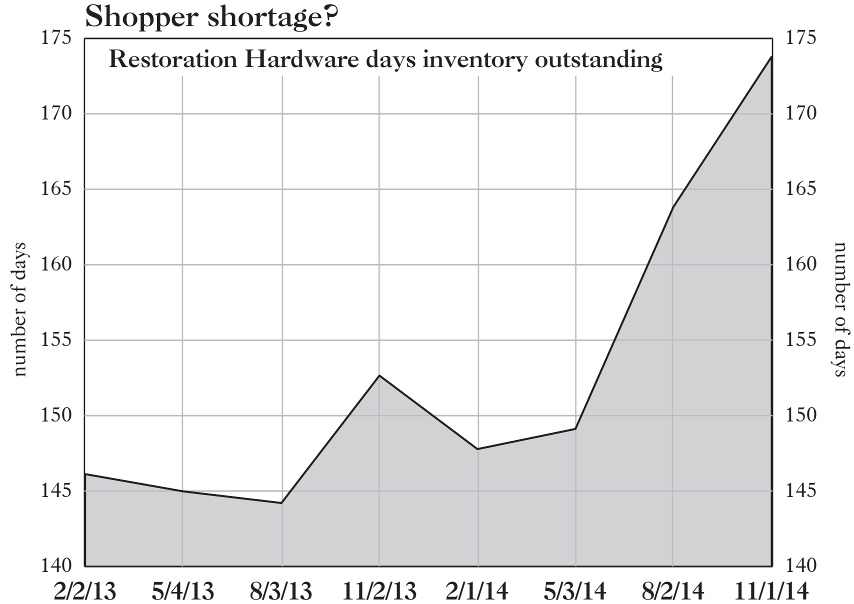
And how does the company propose to realize this vision, in particular the projected 600 basis-point improvement in operating margin? Returning to the videotape, we watch Karen Boone, RH's chief financial officer, explain: "We believe we have the world's largest collection of luxury home furnishings under one brand trapped in undersized 7,000 square-foot legacy stores," says Boone. "And the key to unlocking the value of our company is to transform our real es-

Restoration Hardware Holdings, Inc.
(in thousands of dollars, except per-share data)

	12 months to 11/1/2014	2/1/14	2/2/13	1/28/12	1/29/11	1/30/10
Net revenues	$1,756,389	$1,550,961	$1,193,046	$958,084	$772,752	$625,685
Cost of goods sold	1,108,781	994,081	756,597	601,735	501,132	412,629
Selling, general and admin. expenses	498,947	502,029	505,485	329,506	274,836	238,889
Income (loss) from operations	148,661	54,851	(69,036)	26,843	(3,216)	(25,833)
Interest expense	(13,149)	(5,733)	(5,776)	(5,134)	(3,150)	(3,241)
Income (loss) before income taxes	135,512	49,118	(74,812)	21,709	(6,366)	(29,074)
Income tax expense (benefit)	60,393	30,923	(62,023)	1,121	685	(423)
Net income (loss)	75,119	18,195	(12,789)	20,588	(7,051)	(28,651)
Adjusted net income (loss)	89,173	69,101	37,739	26,451	3,025	(18,483)
Cash and cash equivalents	157,127	13,389	8,354	8,512	13,364	13,186
Merchandise inventories	610,497	453,845	353,329	245,876	206,406	149,026
Net property and equipment	331,988	214,909	111,406	83,558	76,450	62,192
Total assets	1,452,323	1,025,103	789,613	586,810	501,991	431,528
Total debt (including current portion)	282,669	87,621	87,029	131,040	116,995	61,652
Comparable brand revenue growth	19%	31%	28%	26%	26%	-10%
Asset turnover	1.56	1.71	1.73	1.76	1.66	1.45
Income from operations /interest expense	11.3	9.6	(12.0)	5.2	(1.0)	(8.0)
Capital expenditures	105,936	93,868	49,058	25,593	39,907	2,024

source: company filings, the Bloomberg

Shopper shortage?



source: The Bloomberg

tate. Our next-generation galleries will present six to eight times the product assortment of our legacy galleries and we expect retail sales to increase two to four times in each market as we continue to expand our product offering into new categories and businesses." Even allowing for delays in construction, Goldman Sachs says that it expects RH to end calendar 2015 with 30% more square feet than it started with. Visions of $6 per-share earning power—say by the year 2018—are dancing in the bulls' heads. And if a skeptic counters with the observation that Friedman has presided over more money-losing years than profitable ones since he took charge in 2001, the enthusiasts have a ready-made reply. That fact is true but irrelevant, they will say. And right as rain they have been.

Still, it's a curious boom over which Friedman has presided. For instance, observes colleague David Peligal, fixed assets expanded in line with sales during the four magical years of blistering revenue growth, 2011-14. Which is to say that "asset turnover" was flat. "The reason that people care about comparable sales growth is that it represents a directional indicator of operating leverage," he points out. "There's not much operating leverage when assets grow right along with sales. By the numbers, net property and equipment jumped to $332 million in November 2014 from $93.7 million in October 2012. One could say Friedman & Co. were spending like drunken sailors even before the Full Line Design Gallery push started in earnest. So as they begin aggressively to grow square footage as store sizes increase from 7,000 square feet to something as high as 60,000 square feet, there will be ample opportunity for things to go wrong. Bulls are assuming that the plan will go off without a hitch."

Friedman admits to no doubts. "We've created spaces that blur the lines between residential and retail, indoors and outdoors, physical and digital," he tells his video audience. "We've created spaces where guests [sic] who visit our new homes [sic] are saying, 'I want to live here.' I've been in retail almost 40 years, and I've never heard anyone say they wanted to live in a retail store—until now. Most retail stores are archaic windowless boxes that lack any sense of humanity. There is no fresh air or natural light. Plants die in a typical retail store. And if we are building those, I too would be worried about the threat of online. But we don't build retail stores. We are creating inspiring spaces with garden courtyards and rooftop parks with reflecting pools, trickling fountains, and fireplaces."

About a year from now, if the analysts know what they're talking about, RH will be reporting 12-month sales of $2.24 billion and $3 per share in earnings—as noted, implying increases of 20% and 28%, respectively, in revenue and net income. Restoration is clearly taking market share. Unclear is how much share there is to take. The home furnishings' industry is fragmented and sleepy. It rang up sales of $91.2 billion in 2000; it did all of $101.4 billion in 2013, making for compound annual growth over that span of years of just 0.8%. Williams-Sonoma, a $7 billion market cap company, thinks it has a 4% market share. With such brands as Pottery Barn and West Elm, the company is projected to generate $5 billion of revenue in the fiscal year ended January 2016, up from about $4.7 billion this year. Williams-Sonoma's stock trades at 21 times the projected consensus earnings estimate for the fiscal year ending January 2016; the dividend yield is 1.7%. Restoration, as noted, trades at 30 times; it pays no dividend.

"I contacted a retail-focused portfolio manager I know and asked him about RH," Peligal writes. "He was short the stock and wanted his identity to be kept under wraps. He felt the biggest risk was not the stock's borrow, as the rate is low even though 28% of the float is short, but rather the timing of the short. The risk for a short-seller is that Friedman keeps executing. So when RH reported last month that comparable brand revenues increased 22% year-over-year, the stock jumped as many shorts covered. Yes, the company is currently doing well, he allowed, but the building boom presents an opportunity (as a bear would define opportunity). New stores tend to cannibalize existing stores—in other words, not all the expected business would be incremental. Furthermore, massive stores only work if a large portion of the neighborhood is shopping in them."

Speaking for himself, our anonymous short-seller continues: "In general, this is a tough business. One of the reasons furniture companies have never really grown to more than say $2 billion in sales is that it's just not a great economic return. It's harder to grow a business that doesn't have a great economic return versus something like Facebook. That's why there is nobody dramatically bigger than they are. So the financial aspects of this square footage growth, I think, are questionable. Another issue is the size of the stores. So their stores, on average, have been smaller, but they're talking about opening these 50,000 or 60,000 square-foot meccas—like in Atlanta or West Hollywood. In my experience, the only large store formats that work are ones that have mass-market appeal. So Wal-Mart, Target, even Best Buy. Best Buy did well at 25,000 to 30,000 square feet. Best Buy did not do well at 45,000 square feet. So the idea that you're go-

ing to appeal to a high-end customer—and I'll give them credit for doing a good job merchandising-wise, and building the brand in a way that appeals to the upper-end customer—it's hard to fill a huge store with upper-end customers because, frankly, there is not as many of them. The other related fact is that people in those neighborhoods don't want to all have the same furniture."

The furniture wouldn't have to be the same, to judge by the bulge in RH inventories. The company seems to carry everything and anything (as long as its color is tastefully muted). Third-quarter results showed a 36.2% jump in stocks on hand from the year-earlier period. The number of days required to sell those goods—i.e., "days of inventory outstanding"—rose to 173 for the third quarter from 163 in the second quarter and from 152 in the third quarter one year earlier. Friedman registered no concern on the Dec. 10 conference call. "If you're growing the business horizontally," he told dialers-in, "there's no way your inventory growth is going to keep up with your sales growth or you are going to under-optimize the business. You have to—from an inventory point of view, you really have to be looking ahead. You can't just be looking at today."

We conjecture that ZIRP is responsible for a general breakdown in managerial discipline. Late last year, Restoration amended and expanded its senior secured revolving credit facility. Instead of $600 million, it can now borrow $800 million. Instead of paying Libor plus 1.75% to Libor plus 2.25%, it can now pay Libor plus 1.25% to Libor plus 1.75%. In June, the company issued $350 million of convertible notes in a private offering. The interest rate attached to the coupon on those securities was zero, and with the proceeds of the financing, RH paid down its bank debt. As money is free, ambition can be boundless. By "stimulating" aggregate demand via ultra-low interest rates, the Fed is also necessarily stimulating aggregate supply. More aggregate supply is a force for lower prices (absent a corresponding uptake in demand), which is another word for "deflation," which is a trigger for additional monetary easing. More easing, other things being the same, means lower cap rates and higher stock prices. Higher stock prices mean more high-end consumption. More high-end consumption means higher multiples for the equity of high-end retailers. For RH, these are the good old days.

"I feel like he is running this business with the assumption that we'll never have another recession," our short-seller remarks. "They have so much inventory, it could get real ugly, real fast. And this inventory doesn't get better with age." Whatever the timing of the next recession, the past week has brought downbeat news on U.S. retail sales and disappointing guidance by Tiffany, Richemont, Best Buy and KB Home. Houston was the site of Restoration's first built-from-scratch design gallery. When it opened in November 2011, a barrel of WTI crude oil fetched $100; now the price is $46. We suspect that the prototypical RH shopper, in or out of Houston, is less sensitive to gasoline prices than to stock and bond and real estate prices.

The bulls may not yet be selling RH, but the insiders are. Thus, on Dec. 17, the afore-quoted Karen Boone—she appeared in the film clip—exercised and sold 8,000 shares of RH at a price of $95.28; she directly holds zero shares. Carlos Alberini, an RH director and Friedman's former co-CEO and soulmate (see the Businessweek story), sold 40,000 shares on Jan. 6 and 7 at prices ranging from $90.61 to $93.87 through a 10b(5)-1 plan. He continues to hold 532,855 shares, of which he owns 333,441 directly. Alberini, who left tens of millions of dollars on the table in unvested options to become chairman of the board and CEO of Lucky Brand one year ago (as RH common was extending its climb), was quoted as saying in a December 2013 Restoration Hardware press release that he plans "to remain a significant shareholder." Then there's Tommy Mottola, another RH director who, in his day job at Sony Music helped to develop the careers of Hall & Oates and Celine Dion; Mottola sold 163,733 shares on Dec. 12 at prices ranging from $93.31 to $98.21. Restoration's chief operating officer, Kenneth Dunaj, sold 20,280 shares on Dec. 11 through a 10b(5)-1 plan at a price of $93.54. His remaining directly held holdings are zero.

"Using RH as a way to be long U.S. consumption and housing for the past two years, the bulls absolutely nailed this one," Peligal winds up. "But things change—markets, styles, expectations, business conditions. Perhaps 2015 will be kinder to the bears."

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Final last gasp?

(January 9, 2015) When Britain's pound sterling was as good as gold, His Majesty's government thought itself fortunate to be able to borrow at 3% in perpetuity. That was in 1751. Now that the pound is as good as pixels, George Osborne, chancellor of the exchequer, has announced his intention to avail himself of the opportunity to refinance those ancient 3s at interest rates even lower than 3%.

Trying to comprehend the 21st century's affinity for digital wampum, on the one hand, and ultra-low bond yields on the other, monetary historians of the future will scratch their heads till their brains ache. They will conclude, as we do here and now, that the world was bond mad.

"Whither rates?" is the question of the hour. Lower and lower, says Van Hoisington, the great bond bull, with whom we spoke on Monday (Hoisington's fund was up 32.6% last year; over the past 10 years it has delivered 8.62% a year vs. 4.71% for the Barclays Capital U.S. Aggregate Bond Index). Lower and lower in a crescendo of panic, say we. More from Hoisington below.

"Economists don't forecast because they know," quipped John Kenneth Galbraith. "They forecast because they're asked." Each month, Bloomberg asks dozens of economists to forecast the 10-year Treasury yield over a six-month horizon. On Dec. 11, the date of the latest survey, 71 economists responded. Each and every one predicted higher yields. One hundred percent were bearish on bonds.

"One last gasp for Treasurys?" was the headline over the page one article in *Grant's* exactly one year ago. In it, we suggested that Treasurys might confound the bearish consensus (though only 86% of the economists were then bearish) with an unscripted rally.

With this sequel, "One final last gasp?" we come close to repeating ourselves. Treasurys will continue to rally in 2015, a move that will culminate in even higher prices and even lower yields. And that will be the end of the bond bull market that started on Oct. 1, 1981, say we (and not for the first time, let the record show).

Though we expect a blow-off rally in government securities, "bullish" on Treasurys we're not. Bulls want to own

To duplicate 2014 returns, yields must plumb lower lows

bond	total return in 2014	2014 year-end y.t.m.	assumed year-end 2015 y.t.m.*
U.S. 10-year Treasury	10.6%	2.10%	1.17%
U.S. 30-year Treasury	28.9	2.73	1.60
German 10-year bund	14.9	0.38	-1.08
Mexican 100-year bond	21.7	5.32	4.58
10-year gilt	14.4	1.66	0.22

*to match 2014 performance
source: The Bloomberg

the objects of their desire. Your editor owns no Treasurys and wants none. He owns no sovereign bonds of any maturity. Long-dated Treasurys may be cheaper than foreign government securities of similar duration, and the United States may be John Winthrop's "city upon a hill." But the bonds of any government are promises to pay interest and principal in a currency that the issuing government either creates or (in the case of European borrowers) lends a hand in creating. As government-issued money tends to depreciate, so should—over time—the value of the government's promises.

One makes allowances for price and value. Even a goldbug could be bullish on 14% Treasurys (*Grant's*, July 16, 1984). By way of reciprocity, perhaps, even a bond bug might see the merits of gold today, given the fact that the virus of radical monetary policy is swimming in the global political bloodstream; what feats of money printing will the central bankers attempt next time? On Tuesday, the Swiss 3s of January 2018 were priced to yield minus 29.3 basis points. Principal continuously invested at that rate of return is halved in 236.2 years. So it has come to pass that sterile gold is a high-yielding asset.

On form, interest-rate markets are long-trending markets. In 19th century Britain, gilt yields fell for 80 years. In 20th century America, Treasury yields rose in the 35 years from 1946 to 1981. Yields have fallen in the 33 odd years since 1981. Well do we recall the blow-off phase of the great bond bear market. Though economists strained to furnish reasons to explain why 15% was, after all, not so very high, given (for instance) the terrible Reagan fiscal prognosis, the real motive force in the bond market was panic. We wonder if the investment narrative spun today to explain the reasonableness of sub-1% yields on 10-year government notes will wear any better than the inflation-phobic yarns of the early 1980s.

These are historic times, we are certain. Chancellor Osborne's press release last month held out hopes for the prospective refunding of the perpetual 2 ½% securities issued in the fall of 1946 by the Socialist Chancellor Hugh Dalton. Cheap money was the cry on both sides of the Atlantic at the time. At Dalton's death in 1962, his eponymous 2 1/2s changed hands on a 6% basis. At the bottom in 1974-75, they had sold down to an 18% basis. "Daltons," those loss-producing pieces of paper were derisively called. The chancellor himself bought some; he died poor.

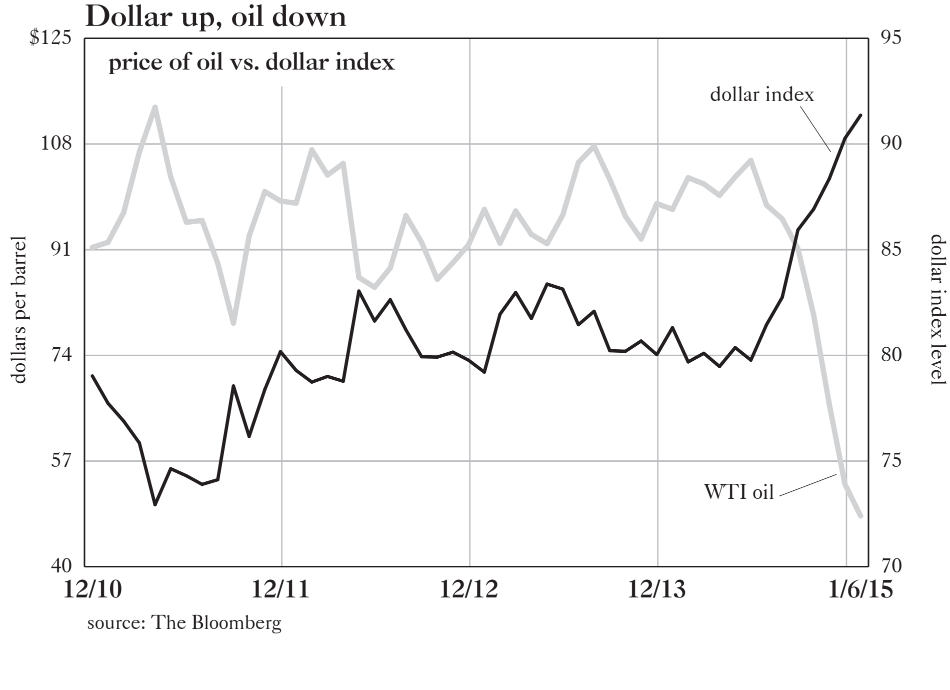
What's a fair yield for long-dated Treasurys? We put the question to Hoisington, who has held long bonds through thick and thin—mostly through thick—since October 1990, when they fetched 8 ¾%.

He replied with the proposition that inflation expectations are key. Look around the world, he said. You see a half-dozen countries whose 30-year debt trades at less than 2%—Denmark, Switzerland (0.541%), Japan and Belgium among them. "Their credits are in many cases much worse than ours. So you would argue that it's not the credit quality, but it's the fact that they have very low inflation and maybe some idiosyncrasies in those countries."

"So with that as a start," Hoisington went on, "what is the appropriate level for long-term rates in the United States? If the general trend which started in 2011 of lower commodity prices continues to be under downward pressure because of excess global capacity, then you would presume that U.S. prices would tend to have downward pressure as well. And you would assume that the stronger dollar, as everybody tries to get out of the muck around the world by devaluing their currencies against the dollar and the dollar continuing to appreciate, would put further downward pressure on prices. So we have a global phenomenon that is probably more impactful on the United States than in the past, and it seems to me to be pointed in the direction of downward pressure on prices. Whether that ends ultimately in 'deflation' is unknown, but certainly the prospect of a rapid rise in inflation seems, for the time being, not on the horizon."

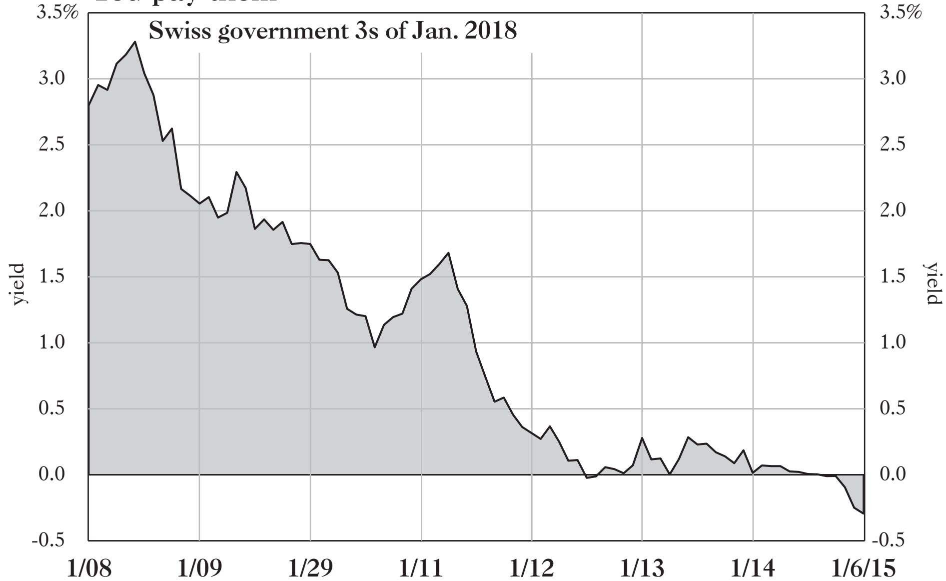
In other words, "lower" is still the prevailing direction. Hoisington demurred on the notion that digital technology was

Dollar up, oil down



source: The Bloomberg

You pay them



source: The Bloomberg

a force for everyday low prices. Debt, however, he said, certainly weighs on prices: "We believe the fact that over-indebtedness of the United States and the world is contributing to the lack of global demand, because people have borrowed and spent, and that means they can't spend that money in the future, they have to try to repay it. And that's at all levels—corporate, individual, governments—and that is sort of an overarching restraint on economic activity. And the wonderful thing is that the Federal Reserve and other central banks can do nothing about it."

So more credit formation—induced by zero-percent borrowing costs—is not the way forward? we asked, leading the witness. "More debt is of course not the answer," Hoisington replied, "because it just brings forward consumption and makes it worse later, so they might be able to have a transitory improvement, but not a permanent improvement. The fact is, it seems to me, that the evidence in Japan and here in the United States that the effort to buy securities to help the system was counterproductive, and we would suppose if the ECB were unintelligent enough to try their own, that it would be equally unproductive. Somebody pointed out that almost all maturities are close to five years and they don't really have much long paper, so if they did do it, they'd be buying five-year notes, which are zero anyway. Or less than zero."

To duplicate the brilliant returns of 2014, 30-year Treasury yields would have to fall to 1.60%, 10-year gilt yields to 0.22%. "From a market standpoint," Hoisington commented, "with the Bloomberg survey continuing to show 100% of the economists forecasting higher rates for the umpteenth consecutive month, you have to assume the positions are still pointed towards people expecting higher rates, and for that reason the first part of this year could see really much lower interest-rate levels than anyone thinks possible, because of positioning in my opinion."

Assets under management at his firm ended the year at $6 billion, Hoisington related. Though it's a new high, clients are hardly breaking down the doors to get in: "Everybody still thinks rates are going up, and this would be a stupid time to invest in 30-year bonds."

Business activity is weaker than the Fed seems to know or to acknowledge, Hoisington went on: "We think this year will be slower than last year in terms of growth, and nominal growth will be noticeably slower. Real growth will be slightly slower. So when we see that, if the Fed were to raise rates in a weakening environment, which is what they would be doing, I think bond rates would rally…." And if the economy surprises to the upside? Even then, Hoisington said, the long end of the yield curve would probably rally: "It would be the last hurrah for a moment."

Our ears perking up at the phrase "last hurrah," we mentioned some of the signs of panic and—in the case of the proposed British refunding—of historic optimism we see. Is it possible that the market has overdone it?

"If you look back in United States history, our charts going back to 1870, the market spent a few years below 2%, but not much and not by much," Hoisington replied. "And so having 30-year rates below 2% seems to me to be excess. We're not there yet, but in a very short period of time we could be."

And if that were to come to pass, the collapsing energy markets would bear a good share of the blame (or, from the bond bulls' vantage point, credit). People understandably focus on the bulge in supply, said Hoisington; they should not overlook the evident crack in demand. "The demand curve can shift out and take these oil prices even lower than they are today, in our judgment," he went on. "And we think that has an enormous impact on economic activity. In 1986, 1985, we had oil go in round numbers from $40 to $10, maybe a little below that. We actually had a mini recession. I think they may have revised that away but we had one quarter down in 1986. So we think the drop in oil prices is a clear negative to the United States economy this year. The high-paying jobs were in the oil sector. We know that about one-third of the increase in capital spending over the last four years was due to oil, but there was a knock-on effect, so we figure instead of 30%, it's roughly 45% of the increase in capital spending was due directly or indirectly to this oil boom. So we think there's a major adjustment economically from this downtick in oil prices in the United States—it is going to be enormously disappointing over the next six to nine months."

Hoisington wound up on a note of prospective—underscore the word "prospective"—bond-bearishness: "If you get the right set of policies, things can turn around in a hurry," he said. "And people forget this. We've had this sort of pendulum swing towards overregulation, constraining small banks from lending, being anti-business, and it's possible the pendulum starts to swing the other way, and business has been lackluster for so long that, in my judgment, a shift in regulatory policy and tax policies could create a substantial boom by the private sector in the U.S. and therefore around the world. So I'm not overly pessimistic, but for the time being, we have anti-growth policies in place."

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