GRANT'S
INTEREST RATE OBSERVER

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Bearish on the biggest monoline

It's the U.S. government that insures the bank deposits and guarantees the mortgages and stands behind Fannie Mae and Freddie Mac and the Federal Home Loan Banks. And it is, of course, the government that, through Medicare and Medicaid, foots the bill for a high and rising portion of American health care. Laudable, to be sure. But who or what stands behind the government?

Now unfolding is a hard look at Uncle Sam, he of the generous spirit but not—despite appearances to the contrary—infinite resources. The analysis will range over the government's financial statements and, especially, the notes thereto. It will consider the tricky intersection between the Treasury's finances and the Federal Reserve's paper money. And it will attempt to tot up the costs of the credit guarantees that have turned the Treasury into a kind of gigantic Ambac (albeit one with a dollar-printing press on the premises). In preview, we are bearish on the triple-A-rated credit of the United States. Or, rather, we remain bearish, as we have never been bullish on it. In the early junk-bond era, we produced mock debt prospectuses for the Treasury as if the government were just another Drexel Burnham investment-banking client. The Bush administration's hastily contrived plan to rescue Fannie and Freddie from the condemning judgment of their respective stockholders and lenders is what prompts another look at America's public finances.

If ever there were a slowly developing risk—or, for some, opportunity—it is the one surrounding the deterioration of the government's credit. In the short term, the unified federal budget deficit is part of the elevator music of finance, familiar and forgettable. With rare episodes of relief—as in the second Clinton term—one year, one administration, seems very much like another. But the deficit is not the principal issue. New this cycle is the return of the uncouth chickens of socialized credit. Washington's long-implied commitment to make whole the creditors of the government-sponsored enterprises once seemed a risk in theory only. Suddenly, it's an imminent and material one. For the better part of 100 years, the risk of borrowing and lending has been migrating from private hands to public. Upon the condition of the federal credit increasingly depends the health of the private sector's credit. And upon both hinges the international standing of the dollar. In this case, as in so many others, the knee bone is connected to the thigh bone.

No goose was ever so golden as the U.S. economy, but that doesn't mean it's immortal. Generations of politicians have had their knives out for it.

"I was kidnapped by a short seller."

In the seven years of the Bush administration, growth in the government's financial obligations (both explicit and implicit) has compounded at 13% per annum, far in excess of the 5% compound growth of nominal GDP. In 2000, the government was on the hook for $29 trillion of guarantees, insurance obligations and projected future payments to Medicare and Social Security recipients. Seven years later, the grand total of such projected future obligations and payments was $67 trillion. Over that same span, nominal GDP grew to $13.8 trillion from $9.8 trillion. Insofar as the promises continue to pile up faster than the domestic resources with which to redeem them, the Treasury's creditors must be at some elevated level of risk. Needing money it can't easily get through taxation, the government must borrow it. Who will lend it, and at what cost? Possibly, the Federal Reserve will pitch in by printing up enough extra dollars to bridge the gap. It certainly knows how.

However, we check ourselves right there. The 1992 tract, "Bankruptcy 1995: The Coming Collapse of America and How to Stop It," by Harry E. Figgie, is an object lesson in the perils of forecasting with a preconceived idea. Figgie, an industrialist by trade and calamity howler by avocation, based his thesis on extrapolations of observed trends (many of which were identified by the federal commission headed by Peter Grace in the early 1980s) and projections of new, and still more alarming, ones. Interest rates would go right back up to the highs of 1981, Figgie believed. So reasoning, he projected that the unified federal bud-

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get deficit would reach $850 billion by 1995 (actual number: $164 billion), that the public debt would hit $13 trillion by the year 2000 (actual result: $5.7 trillion) and that the value of the dollar would collapse (hyperinflation, too, was a no-show). What Figgie did not predict was that the company he founded and led, Figgie International, would itself incur life-threatening debt problems, and that he, not the president of the United States, would be the CEO taking a sudden and unplanned retirement in 1994, one year before America (as it turned out) did not collapse.

Obligations of the U.S. government
(in $ billions)

	2000	2007	annual growth rates
Nominal GDP	$9,817	$13,841	5.0%
Public debt outstanding	5,662	9,229	7.2
Federal employee and veteran benefits	2,758	4,769	8.1
Expected expenditures for Social Security	3,845	6,763	8.4
Expected expenditures for Medicare	9,193	34,085	20.6
Ginnie Mae guarantees	603	428	-4.8
FHLB liabilities	622	1,218	10.1
Fannie and Freddie MBS and liabilities	3,345	6,537	10.0
FDIC insured deposits	3,055	4,293	5.0
	$29,083	$ 67,321	12.7%

"[T]here is a great deal of ruin in a nation," Adam Smith sagely remarked. Then, again, Smith didn't live to see the financial position of the United States described in summary form as $1.6 trillion of assets and $10.8 trillion of liabilities. Nor did he have the opportunity to read the just-released review of the government's fiscal-year 2007 finances produced by the Government Accountability Office, which contains that summary. The GAO asserts that the unfunded deficits in Medicare, Medicaid and Social Security are on track to sink the nation's finances. Long-term fiscal simulations "of what might happen to federal deficits and debt levels under varying policy assumptions . . . continue to show ever-increasing long-term deficits resulting in a federal debt level that ultimately spirals out of control," the agency concludes—a conclusion, incidentally, shared by the Bush Treasury.

The trouble with these claims is that they are as familiar as they are shocking. Besides which, the entitlement catastrophe is no incontrovertible fact but a disaster that looms closer or further away depending on the actuarial assumptions one uses to model and forecast it. Critical variables include the life expectancy of the American people, the rate of rise in medical costs, the pace of economic growth, the track of interest rates and the drift of federal tax policy. As to the latter, the Congressional Budget Office makes a purely clinical and nonpartisan pitch for much higher taxes over the next several decades. Only by taxing more and spending less, it contends, will the distant meteor of fiscal calamity be diverted from its collision course with the 50 states. Possibly. We ourselves doubt that (*a*) any such course will be chosen by America's elected representatives, and (*b*) if a much deeper federal bite were written into law, that it would, in fact, yield the bounty the CBO seems to expect.

Anyway, what has star-gazing ever availed a practical investor? Draw up a list of the "critical variables" of the next three or four decades, and chances are you will omit the variable that will trump all the others—as, for example, did the prophets of America's "secular stagnation" in the late 1930s, when they overlooked the small transaction called World War II, the baby boom that followed it and a generation or so of unparalleled national prosperity. The CBO's—and GAO's—projections run 75 years into the future. If actuarial forecasting is anything like economic forecasting, that might be 75 years too long for pinpoint macroeconomic accuracy. Yet, granting all that, it does seem as if the taxpayers, creditors and/or the dollar holders are in for a rude surprise at some not-so-distant future date.

The accretion of new federal obligations did not happen by accident. At every major congressional vote, lonely voices protested against the trend, though not once did their oratory roll the governmental snowball back uphill. "Such a guarantee as that," objected Sen. Robert J. Bulkley, an Ohio Democrat, to the proposed Federal Deposit Insurance Corp. in 1933, "would have made the Government pay substantially all losses which had been accumulated, whether by misfortune, by unwise judgment, or by sheer recklessness,

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and it might well have brought an intolerable burden upon the Federal Treasury." That was 75 years before IndyMac bit the dust.

Rep. Charles A. Eaton (R., N.J.) sounded a similar note in 1935 about the new idea of a Social Security System. "It is simply one more step," declared Eaton, "towards sovietizing our distinctive American institutions, devitalizing the self-reliance and enterprise of our people, and mortgaging our future by a debt so mountainous that we will be in grave danger of repudiation or inflation."

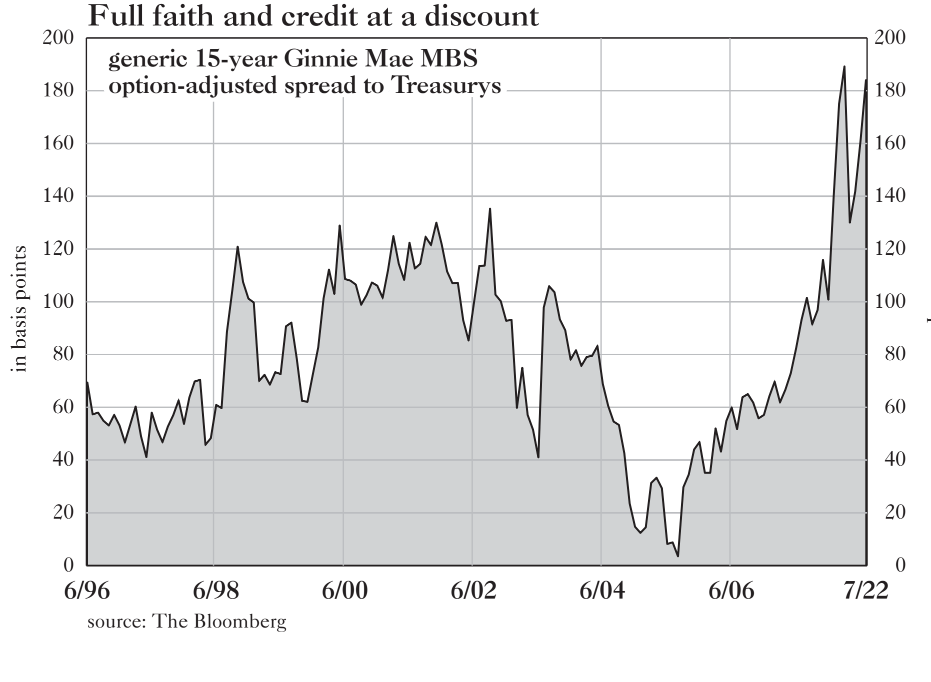
In the 1965 debate over proposed amendments to the Social Security Act that would institute Medicare and Medicaid, Sen. Carl T. Curtis (R., Neb.) took the rhetorical baton from Eaton. "To pay the medical bills and hospital bills of individuals over 65 who are well able to provide for themselves is not charity," insisted Curtis. "It is not needed. It is socialism. It moves the country in a direction which is not good for anyone, whether they be young or old. It charts a course from which there will be no turning back."

And today, in their critiques of the public finances, the GAO, the CBO and the Treasury Department are beginning to sound as if they were picking up where Curtis left off, or have even taken a page from Figgie. "Simply said," writes the Bush Treasury in a new, reader-friendly budget document entitled, "The Nation by the Numbers: A Citizen's Guide," "holding revenues constant, required Medicare, Medicaid, and Social Security spending and the related deficit financing costs will far exceed the Government's ability to pay. Projections show that by 2070, total Government expenditures are projected to be 50% of GDP [having reached but 44% of GDP in World War II, the standing record]. . . . And by 2080, expenditures are projected to approach 60% of GDP. This would cause dramatic increases in deficit spending, and consequently . . . Federal debt needed to finance them."

The current on-the-run 30-year Treasury bond matures in 2038, its successor in 2068. It's the grandson of today's long bond—the 6s, or maybe 26s, of 2098—that the descendants of today's bond traders will be buying and selling (especially selling, by the sound of things) when the storm reaches its projected maximum fury along about 72 years from now. But the observant creditor will not have to wait so long to feel the fiscal headwinds in his or her face. For instance, the ratio of working Americans to Social Security recipients is expected to dwindle to 2.1:1 in 2030 from 3.2:1 today, as an aging, potato-chip-eating population makes heavier and costlier demands on the semi-socialized American health-care system. Beginning in the 2020s, projects Moody's in a January report intended to confirm that the Treasury is, and remains, a triple-A credit, "without a cut in benefits spending for Medicare and Social Security, debt is projected to rise to very high levels. Thus, a combination of benefit reductions and tax increases may have to be enacted if the country's fiscal position is to avoid significant deterioration at that time." Under what appears the politically more reasonable of the CBO's two main fiscal scenarios, the 2030 federal budget deficit will balloon to a size equivalent to 10.1% of GDP, compared to 1.2% of GDP in 2007. "The spiraling costs of interest payments would result in clearly unsustainable levels of debt relatively quickly," the agency ventures in its December 2007 "Long-Term Budget Outlook"—barring, of course, the million and one contingencies, wrinkles and accidents that have confounded just about every long-range forecast ever made.

When might the projected entitlement crisis, now augmented by the crystallization of the costs of socialized credit risk, begin to crimp U.S. government securities prices and/or the dollar exchange rate? Possibly, they are already doing so. Yields on the GSE bonds haven't widened against Treasurys for no reason, of course. But what reason? It would be nice to have Mr. Market on the couch for a heart-to-heart. Is the gentleman worried about the Treasury's solvency or the market's illiquidity? Or is he merely addled by the credit crisis? At this writing, Ginnie Mae bonds are quoted at near-record-wide spreads to Treasurys: a generic 15-year GNMA mortgage-backed security is pitched 184 basis points over the Treasury curve on an option-adjusted basis, up from 3.5 basis points as recently as the summer of 2005 and from an average premium of 79 basis points since mid-1996. Long-time fixed-income investors look bug-eyed at these numbers, for Ginnie Mae is no government-sponsored enterprise but the government itself; its obligations are pari passu with the Treasury's bills, notes and bonds. GNMA spreads have blown out, pretty clearly, because of the disarrangement of most spreads in the 2007-08 credit fright, not because the U.S.

Full faith and credit at a discount



source: The Bloomberg

government is a double-A borrower impersonating a triple-A-rated one.

Then, there's the case of Fannie Mae. Compared to the Treasury's five-year note, Fannie's debentures are quoted at a post-1998 near-record-wide spread of 84 basis points. Plainly, the market is worried about something. But is that something the risk that the credit of the United States is (or will presently be) impaired, or that the 2007-08 debt predicament may not be resolved any time soon? We are going to guess that there is some of the former and much of the latter. Fannie and Freddie, between them, have borrowed $1.7 trillion. They own or guarantee $5.2 trillion of mortgages. They are institutions heavily encumbered with debt and highly leveraged to house prices. House prices—still—are falling. We leave it up to the always hopeful sell side of Wall Street to make the case that the chance of a significant impairment of the Treasury's financial position on account of a failure of one or both of the federally chartered mortgage behemoths is virtually nil. The chance, in fact, is small, but not insignificant. It is what used to be called in the junk-bond prospectuses a "risk factor."

In 1776, the year of the publication of "The Wealth of Nations," Adam Smith was familiar with a United States whose principal asset was the Declaration of Independence. Two hundred and thirty-two years later, the ideas expressed in that document may still constitute the greatest asset of the United States. But though Jefferson's words stand on their own without the support of a viable currency or a fertile tax base, the same cannot be said of the American state. Let us have an unsentimental look at how Leviathan manages its affairs.

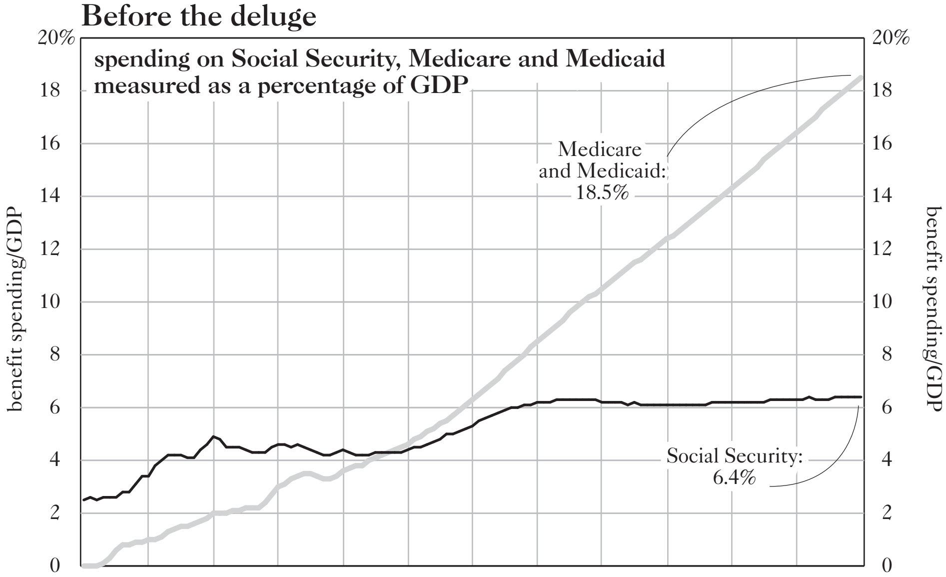
In fiscal 2007, for the 11th year in a row, the GAO refused to opine on the government's accrual-basis consolidated financial statements. Accounting chaos at the Defense Department is the first of three reasons it gives for withholding an unqualified opinion; irreconcilable differences in the intragovernmental accounts and "the federal government's ineffective process for preparing the consolidated financial statements" are the second and third. What the GAO does not include in that short list is the fact that $55 billion of the taxpayers' money went missing. Curious readers can find an account of the disappearance in Appendix II of the auditor's review of the government's 2007 finances (we ourselves, with our private-sector biases, might have displayed the story a little closer to the front of the document). "Although showing progress under OMB's continuing leadership," the text encouragingly begins, "agencies' fiscal year 2007 reporting under the Improper Payments Information Act of 2002. . .does not reflect the full scope of improper payments. For fiscal year 2007, Federal agencies' estimates of improper payments, based on available information, totaled about $55 billion. The increase from the prior year estimate of $41 billion was primarily attributable to a component of the Medicaid program reporting improper payments for the first time totaling about $13 billion for fiscal year 2007, which we regard as a positive step to improve transparency over the full magnitude of improper payments."

So more than $55 billion went astray. Even so, as the authorities may console themselves, there's generally more where that came from. Last year, the government took in a record $2.6 trillion, up 7.6% from 2006. If, as we contend, the federal credit is on the skids, it's not for a lack of income. Personal income tax receipts, which last year generated 76% of the government's top line, have grown at a compound annual rate of 2.9% during the Bush years. Corporate tax receipts, which accounted for 14% of the 2007 take, have grown at a compound rate of 8.7% over the same period. "Cash collections have increased by an average of $200 billion per year since 2003," the Treasury Department is happy to note, "contributing to a reduction of both the budget deficit and net operating cost." Revenue-wise, these are—or at least recently were—the good old days.

But the income statement isn't where the government's secrets are hidden. That repository of truth is, rather, the balance sheet, and especially the notes to that presentation. For it isn't the public debt that looms so large in 21st century disaster scenarios, but the prospective claims on the Social Security, Medicare and Medicaid systems.

What does the government own? What does it owe? Its most precious resource must be the economy of the United States, the greatest cash cow on earth. But this asset goes unrecorded on the balance sheet. More tangibly, the government owns 28% of the U.S. landmass, or 664 million acres, not including 19,000 square miles of near-shore coral reefs and open ocean. Neither do these holdings—national parks, national forests, wildlife refuges, fish hatcheries, etc.—appear on the balance sheet: "Stewardship land is land that the Government does not expect to use to meet its obligations," the Treasury

Before the deluge



source: Congressional Budget Office

explains. On the other hand, neither is Central Park land that the government of the city of New York expects to "use to meet its obligations." Back in the dark days of the city's financial crisis, however, Robert M. Bleiberg, the editor of *Barron's*, reasonably advised the city to sell it; City Hall declined. Come tomorrow's mighty fiscal crunch, we will see about the inviolability of the stewardship lands. By the same token, the government makes no estimate of the monetary value of the U.S. Constitution, the Library of Congress, the Washington Monument, Mount Rushmore and other "heritage" assets. For the time being, at least, they, too, are held to be unavailable for sale.

Property, plant and equipment in the sum of $691 billion is the largest line item on the asset side of the federal balance sheet. Inventories and related property, at $277 billion, is No. 2, followed by loans receivable, at $232 billion, and cash and other monetary assets, including gold, at $128 billion. Altogether, on September 30, the government showed assets in the amount of $1,581 billion. The number is hugely understated. Assign to stewardship lands a value of $1,000 an acre, and you come up with an extra $644 billion. Mark the federal gold to market (the government claims ownership of 261,498,900 ounces, which it carries at $42.222 an ounce for a grand total of $11 billion), and you find an extra $251 billion. Reach to the stars for a value of the heritage assets ("What am I bid for the U.S. Constitution?" the man from Sotheby's would playfully inquire of the auction-house crowd): Shall we say $100 billion? Add these things to the acknowledged $1,581 billion and the government's assets look a little more respectable.

It wouldn't matter, however. The rub is that the liabilities are not only far bigger than the assets; they also are growing much faster. The on-balance-sheet liabilities are really the least of them, but, for the record, they comprise $5,078 billion of federal debt held by the public and $4,769 billion of federal employee and veteran benefits payable. Environmental and disposal liabilities, at $342 billion, is the third-largest line item on the right side of the balance sheet. Far down the list is the estimated present cost of $1.2 trillion in federal loan guarantees—e.g., FHA and VA loans, Federal Family Education Loans—a mere $69 billion. On September 30, on-balance-sheet liabilities footed to $10,787 billion.

The U.S. government, like a kind of composite of General Motors and Ambac, is an enterprise overloaded with health-care obligations and financial liabilities. Health care blocks out the sun. The GAO, though it refused to opine on the federal finances as a whole in 2007, did render an unqualified opinion on the Statement of Social Insurance ("a significant accomplishment for the federal government," adds the agency in a little intramural pat on the back). "This statement shows," says the GAO, "that projected sched-

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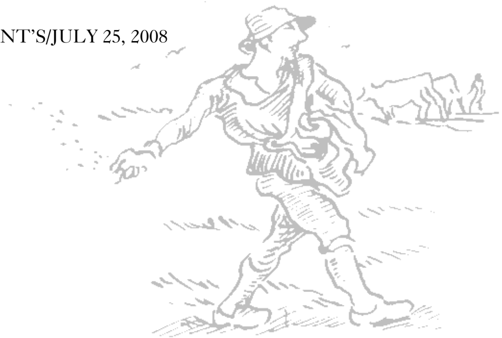


CREDIT CREATION

FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

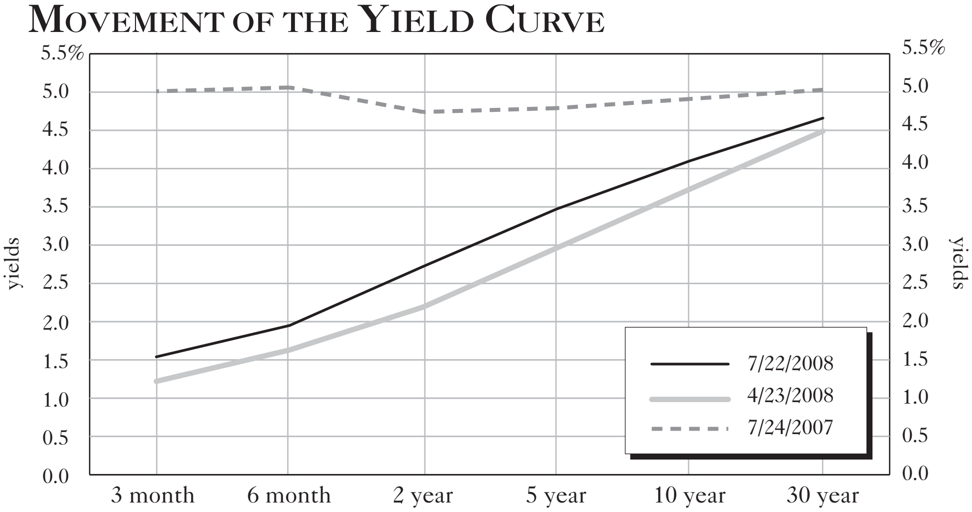
	July 16, 2008	July 9, 2008	July 18, 2007
The Fed buys and sells securities…			
Gross securities held	$367,861	$365,568	$768,104
Held under repurchase agreements	111,143	113,357	22,536
Net securities held	479,004	478,925	790,640
and lends…			
Borrowings—net	164,301	163,014	360
and expands or contracts its other assets…			
Float and other assets	245,113	245,927	62,856
The grand total of all its assets is:			
FEDERAL RESERVE BANK CREDIT	$888,418	$887,866	$853,856
Foreign central banks also buy, or monetize, governments:			
Foreign central bank holdings of Treasurys and agencies	$2,347,973	$2,350,038	$1,996,019

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

	July 2008	June 2008	July 2007
Gold	€208,946	€209,353	€172,141
Cash and securities	386,667	390,672	329,133
Loans	455,051	483,006	465,667
Other assets	376,684	379,679	245,643
Total	1,427,348	1,462,710	1,212,584

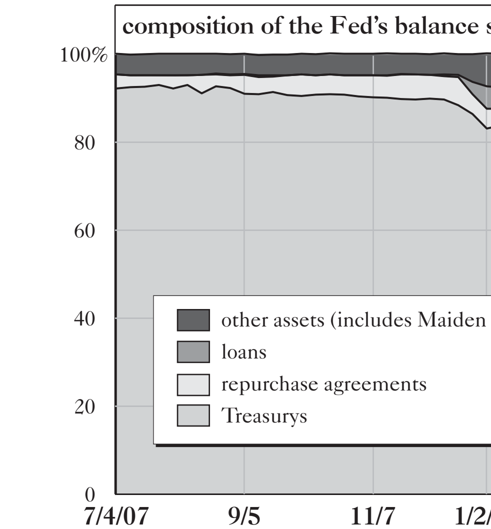
*totals may not add due to rounding

MOVEMENT OF THE YIELD CURVE



source: The Bloomberg

What supports the dollar



source: Federal Reserve

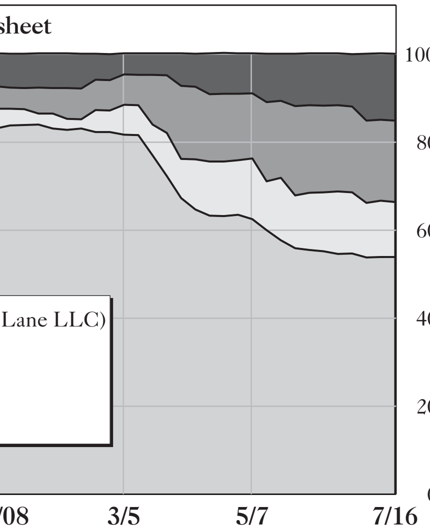
One for t

The credit crisis has claimed many a victim. That the Federal Reserve would be among them must count as one of the strangest, and most unsettling, turns of the cycle. Up until about a year ago, the central bank had a balance sheet as simple as it was safe: government securities on the left-hand side, greenbacks on the right. Now, as colleague Ian McCulley relates, "it's a mishmash of acronym-laden lending facilities, not to mention a fully consolidated $29 billion portfolio of asset-backed securities.

"Maiden Lane LLC, to give that ABS portfolio its proper name, is only the latest in a line of Fed gambits to repair the banking system," McCulley goes on. "Last December was unveiled the Term Auction Facility, which has subsequently grown to $150 billion. In mid-March came the Term Securities Lending Facility and the Primary Dealer Credit Facility. All told, loans to financial institutions currently make up 18% of assets vs. nil a year ago. Maiden Lane LLC adds another 3% of mystery meat, while repurchase agreements have grown from 3% to 13%.

"What has gone more or less unnoticed is the $65 billion-odd increase in 'other assets,' to $106 billion. That's 12% of the balance sheet right there. Drawn foreign-currency swap lines with other central banks is the line item's

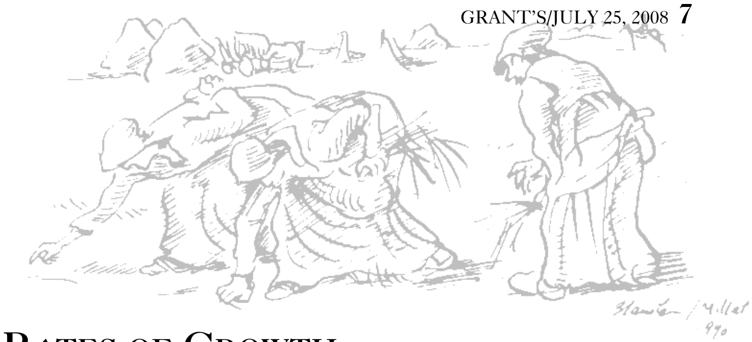
• Cause & Effect



the team

main component. At the beginning of May, the Fed increased its swap lines with the European Central Bank and the Swiss National Bank to $50 billion and $12 billion, respectively. Considering the travails of UBS and other European banks, it's no surprise that these facilities appear to be getting a workout. Given the interconnectedness of the global financial system, the Fed may reason that it can't afford not to help out the Europeans.

"But the strangest thing, as we continually harp, is that, despite the Fed's efforts, Reserve Bank credit—the sum of the Fed's earning assets—is growing by only 3.7%, year-over-year. The slight acceleration in growth from 1.5% in mid-May could indicate that the Fed has decided to put its back a little more into the work of re-liquefying the banking system. In any case, even the new, slightly less anemic growth rate would seem to be insufficient to the scale of problems. Credit is contracting despite the ultra-low funds rate (low on its face, negative when adjusted for inflation). Commercial bank credit, i.e., loans and securities, fell on a three-month annualized basis in June, the first decline since 2003 and the largest since the late 1940s. If the trend continues, the Fed may have to respond even more creatively to the credit crisis." •



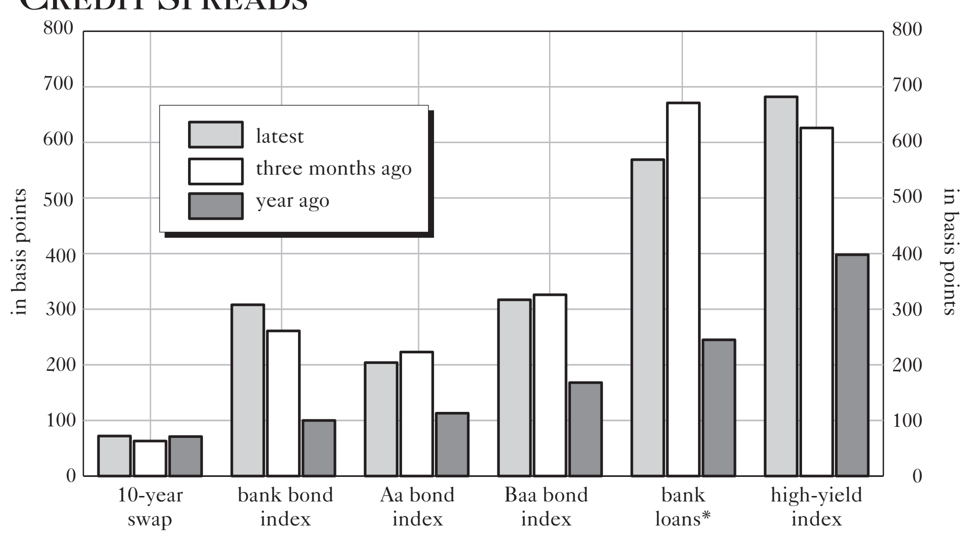
Annualized Rates of Growth
(latest data, weekly or monthly, in percent)

	3 months	6 months	12 months
Federal Reserve Bank credit	5.5%	2.3%	3.7%
Foreign central bank holdings of gov'ts.	30.6	29.6	18.4
European Central Bank assets	23.8	11.1	21.9
Commercial and industrial loans (June)	6.6	9.7	19.4
Commercial bank credit (June)	–5.3	3.2	9.2
Currency	5.4	1.0	1.8
M-1	1.8	1.5	0.4
M-2	4.8	7.5	6.3
Money zero maturity	4.3	16.0	15.2

Reflation/Deflation Watch

	Latest Week	Prior Week	Year Ago
Moody's Industrial Metals Index	1,870.77	1,968.63	2,163.76
Silver	$18.20	$18.82	$13.29
Oil	$128.88	$145.08	$75.05
Soybeans	$14.70	$16.16	$8.51
Rogers Int'l Commodity Index	5,396	5,702	3,726
Gold (London p.m. fix)	$959.75	$962.75	$666.75
CRB raw industrial spot index	492.60	501.28	484.68
ECRI Future Inflation Gauge	(June) 115.2	(May) 116.6	(June) 121.2
Factory capacity utilization rate	(June) 79.9%	(May) 79.6%	(June) 81.0%

Credit Spreads



*spread over three-month Libor
sources: The Bloomberg, Standard & Poor's LCD

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uled benefits exceed earmarked revenues by approximately $41 trillion in present value terms for the next 75-year period." To that $41 trillion, add reported liabilities as well as implicit commitments and contingencies and you get $53 trillion in overall "fiscal exposures," a number that grew by $2 trillion in the 12 short months of fiscal 2007.

In this forest of big numbers, ordinary financial dilemmas stand no taller than the average fern. Thus, the $14.1 billion hole in which the Pension Benefit Guaranty Corp. is buried is no small thing—except in relation to the government's unfunded entitlement guarantees, or, for that matter, to the $55 billion that went astray in 2007. The Federal Deposit Insurance Corp., reeling from the failure of IndyMac, is expected to raise its assessment rate on insured deposits in order to top off the bank insurance fund. The numbers involved—a loss to the FDIC of between $4 billion and $8 billion—is, again, anything but tiny, except in relation to the present value of the projected social insurance deficit. Fannie and Freddie, with their combined exposure of $5.2 trillion of mortgages (through outright ownership or guarantees), are one of the few federal risks that can stand an even cursory comparison to the nation's future doctors' bills. Or, rather—once again, to emphasize—a bureaucracy's best guess of the present value of health-care expense 75 years out into the not-quite-transparent future.

We take the projections seriously, however, for two reasons. First, they fit into the hypothesis we favor that a secular bear bond market began five years ago, when the 10-year Treasury touched 3.1%. Second, the idea of a building crisis in the finances of the United States also fits into the *Grant's* house view that this is a testing time for paper currencies, the dollar not least. The partial socialization of credit risk, though not so fiscally important as the partial socialization of health care, is coming out of the shade and into the full glare of worldwide attention.

The hypothetical quasi-nationalization of Fannie and Freddie took the form of a July 13 press release issued under the name of Treasury Secretary Henry M. Paulson. It said this: "GSE debt is held by financial institutions around the world. Its continued strength is important to maintaining confidence and stability in our financial system and our financial markets." Global financial institutions (read central banks) own so much GSE debt because they have absorbed so many dollars. They own those dollars—at least $2.3 trillion, according to a tally on the Fed's balance sheet—because they have chosen to finance and facilitate the long-running U.S. current-account deficit. America's creditors don't bury the dollars they receive in exchange for the goods and services they sell to American consumers; rather, they invest them. At least $984 billion was parked in federal agency debt in the banking week ended July 16.

"The United States' 'AAA' rating," opined Fitch Ratings in May, "reflects its high standards of living. . . ; its high-value added, well-diversified economy; and the resilience and flexibility of its markets. Together with policy responsiveness, these attributes have helped the US to enjoy a decade of low and stable inflation (2.6% on average over 1998-2007) and low output volatility. . . . The US's 'AAA' rating is further underpinned by its strong international bargaining power and the stability and effectiveness of its political, civil and social institutions, which facilitate the pursuit of prosperity." Not to mention, as Fitch goes on to add, "the dollar's status as the world's dominant reserve currency."

Agreed: The United States has been a triple-A credit, and the dollar has been the world's top monetary brand. But, by definition, there's only one way to go from the loftiest peak, and that direction is down. We are not apocalyptic, still less, unpatriotic. We are, however, bearish on the public credit and on the Treasury's debt securities.

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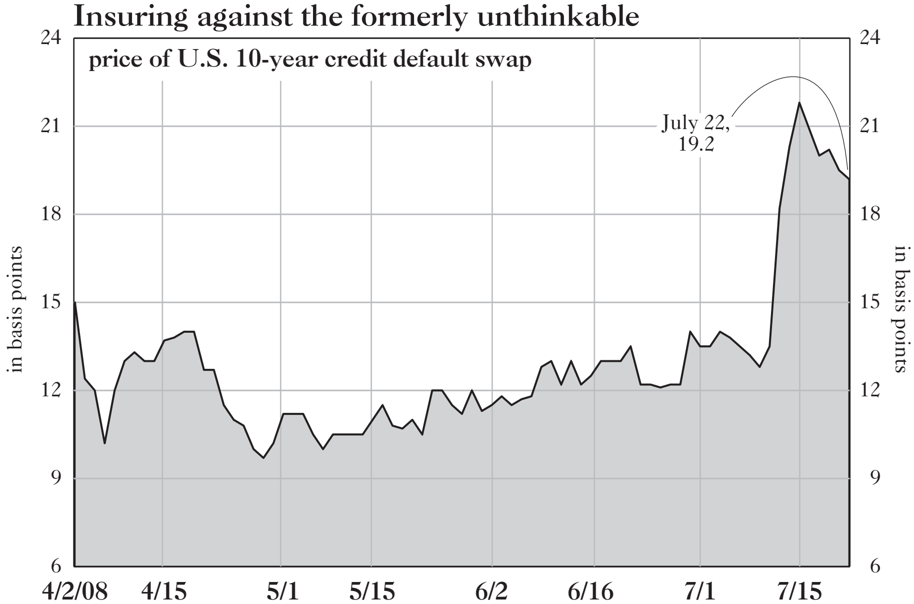
Insuring against the formerly unthinkable



source: The Bloomberg

No bottom, no fish

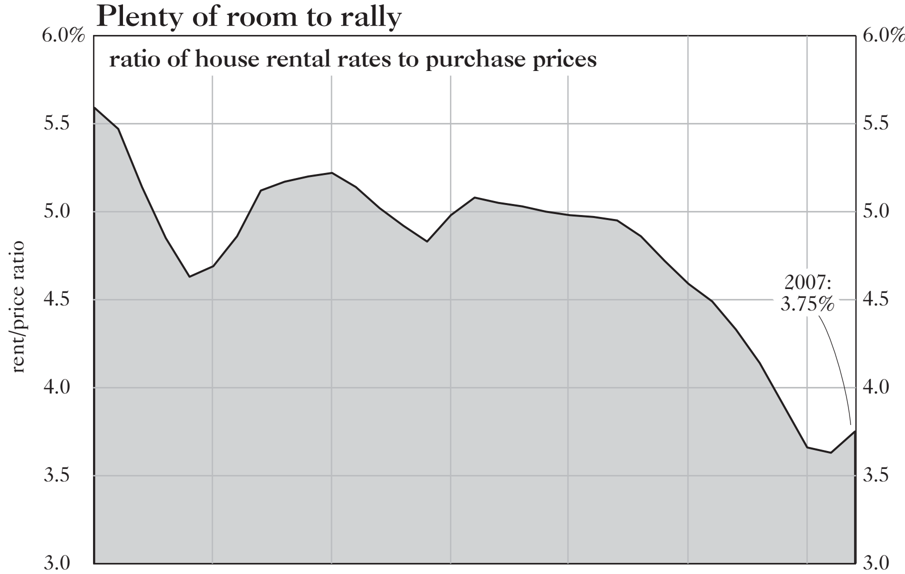
Bank stocks have rallied but not the mortgage-backed securities that dragged them down in the first place. A new-low list of MBS prices, if such existed, would certainly fill many of the new, downsized pages of our leading daily newspapers.

House prices only go up, the market seemed to believe just last year. Now it apparently is convinced that they only go down. Just 12 months ago, supposedly knowledgeable fixed-income investors were prepared to accept yields of 50 basis points over Libor for investing in senior tranches of residential mortgage-backed securities (RMBS). Now, most of these same people refuse to touch senior claims at yields from the mid-teens to the low 20s. Never mind that the higher yields are grounded in assumptions on loss severities at which sophisticates would have openly scoffed when house prices were levitating.

Houses are the underlying asset, and the future value of that asset is the abiding unknown. How low is low? Knowing the answer, even to a first approximation, a bottom-fishing investor in RMBS might have the courage to buy more as the market moves against him—even while ingesting the news that Fortress Investment Group is down by 30% in its lightly leveraged mortgage salvage fund, as *The Wall Street Journal* reported the other day. According to the Case-Shiller composite 20-city index, house prices peaked in July 2006 and have fallen 17.8% through April; May data are due next week.

"On the assumption," colleague Dan Gertner ventures, "that a house is an income-producing asset, not an ATM, it would follow that the value of that asset depends on the yield it produces." So a comparison between today's rental yields and yesteryear's is pertinent. Happily, such a study was unveiled in May by Morris A. Davis at the University of Wisconsin-Madison School of Business. "What Moves Housing Markets: A Variance Decomposition of the Rent-Price Ratio," by Davis et al, deconstructs a rent-to-price ratio back to 1975. It uses data from the Office of Federal Housing Enterprise Oversight and the Bureau of Labor Statistics.

Plenty of room to rally



source: University of Wisconsin-Madison School of Business

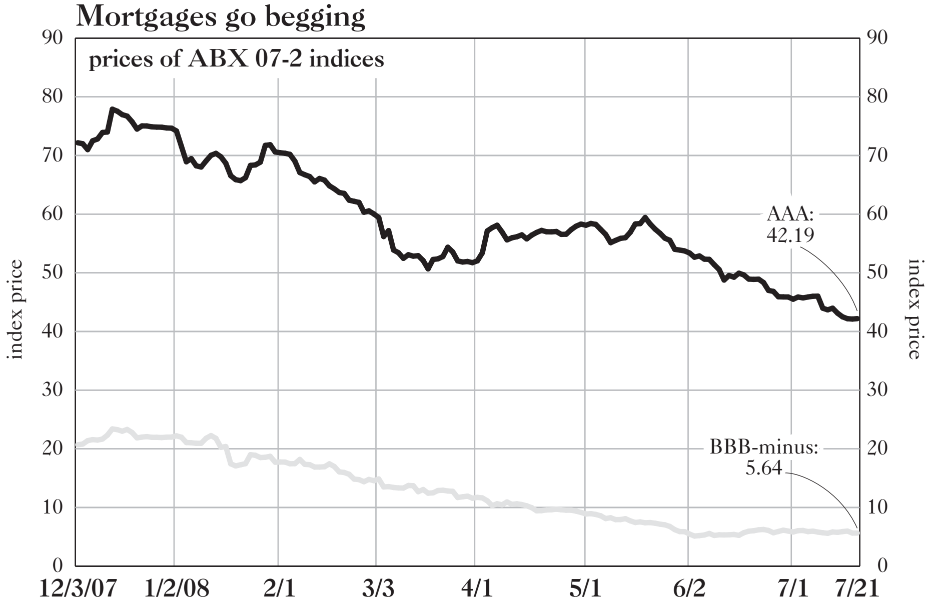
"Houses yielded 4.8% between 1975 and 2007," Gertner relates. "The yield hovered near 5% between 1975 and 1996. It traced a decline to 3.6% in the 10 years to 2006, before it recovered to 3.8% in 2007. Let's say that the rent-to-price ratio is mean-reverting. It can therefore return to its long-term average in one of three ways: rents can increase, house prices can fall or a combination of the two. And that can happen slowly or quickly.

"Assuming that 4.8% is the correct yield and that only the denominator adjusts," Gertner goes on, "house prices would have to decline by 21.8% from 2007 levels (the rental-price series stops at the end of 2007). Much of this adjustment has already taken place. In the first four months of 2008, the Case-Shiller index fell by 8.2%. To bring the rent-to-price ratio back to its long-term average would require a further price decline of 14.8%. Certainly a painful adjustment, but one significantly smaller than the draconian decline that some investors we know are building into their worst-case scenarios."

One such salvage buyer came to the phone this week. "It is not clear that they were wrong," he remarked of Fortress. "It is very clear that they were early. . . . My sense is that there is a growing significant opportunity. And what colors the opportunity is that most people either don't have the expertise to play or are seeing other things elsewhere they would prefer to do, or are fighting fires and don't have any available buying power themselves or even margin to reduce leverage. So they can't play or are trying to call the bottom. All of which suggests that it is a wonderful time to play. But none of which stops you from bleeding every day."

A footnote on ancient history: In the 1940 edition of "Security Analysis," Benjamin Graham and David Dodd posit that "under ordinary circumstances," a $10,000 American house would have a rental value of $1,200 a year, for a pretax yield of 12%. To put today's American residential real

Mortgages go begging



source: Markit

estate market on a 12% basis, prices would have to fall by another 66% from April levels. Type in "house prices" and "worst since the Great Depression" for a Google search, and you get 557 hits. Flash: This is no Great Depression.

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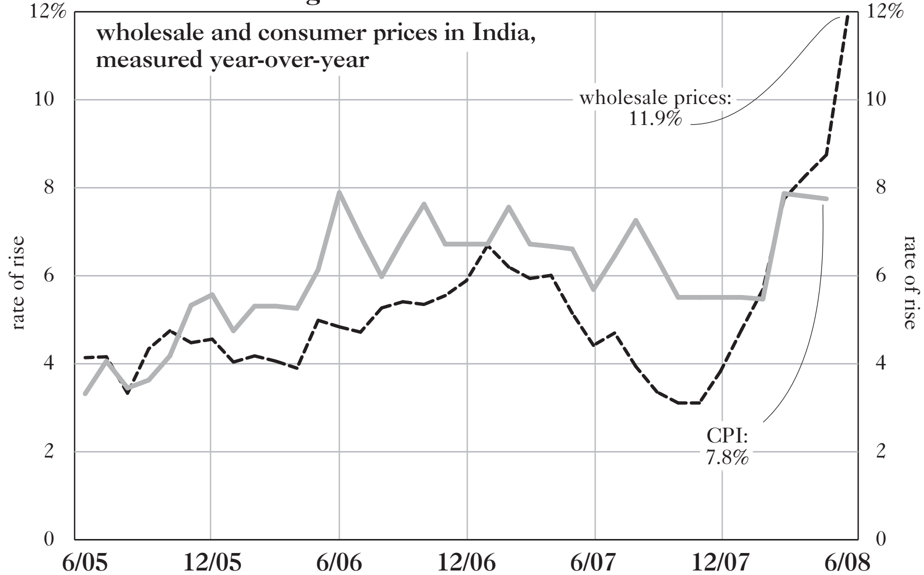
Remember India?

With the Indian stock market and currency down by 30.5% and 8.5%, respectively, in the year to date, investors are rewriting one of the world's great growth stories. Provisional new title: "Get me out."

Back when the world's biggest democracy could do no wrong—say, in December—most were happy to close their eyes to India's warts. Infrastructure, politics and government finances were problems, of course, and the financial system—to put it charitably—was a work in progress. Yet, the bulls regarded these flaws as the setting in which the gemstone of India's future shone the brighter.

Now the former optimists watch queasily as the rupee and the Sensex race, together, in the wrong direction (with such notable countertrend rallies as occurred Tuesday). India, they now perceive, as they could not comprehend before, has an inflation problem, an unmanageable oil bill, a widening trade deficit and a government that survived, but barely, a vote of no confidence this week. *Grant's*, however, chooses the bullish side of the argument.

Inflation takes flight



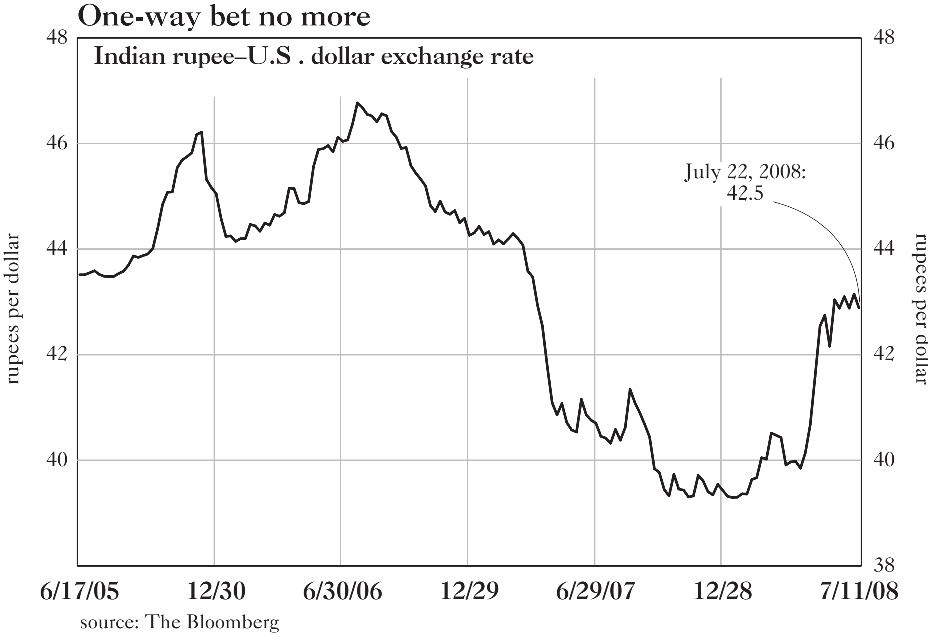
source: The Bloomberg

"So," colleague Ian McCulley relates, "Indian CPI is rising at 7.75%, while the higher-frequency wholesale price index is printing at almost 12%. M-3 is increasing by 21%, year-over-year, commercial bank credit by 26%. The local bond market, perennially sleepy given the mandate that banks hold a certain percentage of their assets in Indian government securities, has sold off dramatically since May. As a result, long-term yields have climbed to 9.1% from 7.8%. Meanwhile, growth is slowing and the Reserve Bank of India is under pressure from the government not to go too far in cracking down. A full-scale rupee sell-off, however, was not supposed to be part of the script."

But the trade deficit was. In fact, India has run a trade deficit for most of its modern history. In the fiscal year to March, it imported $90 billion more than it exported, a larger shortfall than the ones recorded in fiscal 2007 or 2006 ($63 billion and $52 billion, respectively). The deficit has customarily been mitigated, even smothered, by what economists call "invisibles," the two biggest components of which are Indian exports of IT and software and remittances of Indian nationals back home. In the just-ended fiscal year, net remittances totaled $41 billion; software exports, $37 billion; and net income, minus $6 billion, for a grand total of $72 billion. That sum minus the merchandise trade deficit yielded a current account deficit of just $17 billion, or 1.5% of GDP.

Up until recently, capital inflows had put the trade deficit in the shade. Last fiscal year, for instance, net foreign direct investment totaled $15.5 billion, net portfolio investment, $29 billion, and net external borrowing by Indian companies, $22 billion. All together, net capital inflows came to

One-way bet no more



source: The Bloomberg

$108 billion, six times the current account deficit.

Nobody said that India's capital magnetism was a permanent fixture in global finance, and neither has it proven to be. "In the middle of a credit crisis and an economic slowdown," McCulley asks, "why should it have been? As recently as 2005-06, net capital inflows summed to just $25 billion, less than one-quarter of last year's total. Owing to the run-up in oil prices, the trade deficit widened to $10.7 billion in May. Annualize the May result and you have a $130 billion-a-year problem. Oil has subsequently risen in price, so the trade deficit has probably widened even further. It's doubtful that invisibles—those remittances and software exports—could offset it."

Nor, by the looks of things, are capital inflows going to be of much help, not with foreign investors abandoning ship. To date this year, $9 billion of foreign-held stocks and bonds have gone on the block, compared to net inflows of $5 billion over the same period in 2007. Circumstantial evidence, too, points to a slowing, or even a reversal, in other capital inflows. The Indian central bank, much like the central banks of other rising Asian financial powers, was, until recently, a heavy buyer of dollars. It accumulated them over the past five years to thwart, or at least to manage, the appreciation of the rupee against the greenback. But rumors surfaced a few weeks back that the Reserve Bank was actually selling dollars and buying rupees, in the vicinity of 43 to the dollar, to put a floor under the value of the Indian currency.

If we, the greater *Grant's* family, were running the Reserve Bank, we would want a stronger rupee. McCulley certainly does: "A weakening rupee only exacerbates the inflationary effect of imported commodity prices. But if oil stays where it is for the rest of the year, it's likely that capital inflows will continue to pick up again, and the rupee will begin to appreciate, especially if the Reserve Bank continues to raise interest rates. The rupee made its best showing in a while last week when the oil market fell out of bed. That the Reserve Bank has shown a willingness to intervene to support the currency, and that it has the capability to finance this year's current-account deficit in the absence of capital inflows, is also encouraging."

If you, too, are encouraged, there's a new exchange-traded fund that tracks the rupee-dollar exchange rate. WisdomTree sponsors it, the ticker is ICN and assets under management amount to only $10 million. The same sponsor has produced ETFs to track the movements of the Brazilian real (BZF) and the Chinese renminbi (CYB), as well; assets under management for the real and renminbi funds weigh in at $120 million and $300 million, respectively. The funds operate by purchasing non-deliverable forward contracts on their respective currencies and investing the collateral in dollar-denominated commercial paper rated A1. The long forward position and the long fixed-income position are meant to replicate, in synthetic fashion, the performance of the underlying currency, though there can be no guarantees, of course.

Grant's is bullish, but on what, exactly? On India, on its currency and on its equities for the long run. ICICI Bank, which has an ADR under the ticker IBN, is an example of the kind of opportunity that the bear market is surfacing. India's biggest private bank, and biggest private insurance company to boot, ICICI is on the receiving end of the central bank's anti-inflation drive. Higher interest rates mean slower loan growth, a bleaker earnings outlook, more nonperforming assets and widening credit spreads.

From 2 Wall Street, the *Grant's* line of sight on India and other markets, it's impossible to form an independent appraisal of ICICI's book of business. What we can observe, however, is that the shares were trading at four and five times book value last winter, when no one dreamt that an institution so fast-growing and strategically situated would be touched by America's credit problems. Now the bank is quoted at 1.7 times book. That this is the bottom—either of the world's troubles or of ICICI's—seems highly unlikely. But it seems less likely still that the bank, and the country in which it principally operates, will fail to come back strong when the cycle finally turns.

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We said it. Did you read it?

GRANT'S
INTEREST RATE OBSERVER

Sell the doppelganger

"Bank of the Yield Curve" was the moniker *Grant's* fastened on Commerce Bancorp as rising deposit rates proceeded to flatten its net interest margin. This was in the summer of 2005. Almost a year and a half later, Commerce has not come close to recovering its peak margins, let alone its world-beating earnings growth. But the bank founded and led by Vernon W. Hill II has produced results superb by any standards except the ones it set for itself (and frequently managed to surpass) during the high-cotton days of the early '00s.

The subject at hand isn't Commerce Bancorp, however. It is, rather, the Fort Lauderdale (Fla.)-headquartered bank that's doing its best to become Commerce Bancorp. BankAtlantic (BBX on the Big Board) mimics the Commerce-developed "banking as retailing" business model right down to the Commerce-evoking slogan, "Florida's Most Convenient Bank." Unlike the genuine article, however, the pale copy has failed to adapt to rising interest rates and a new, rate-shopping kind of depositor. Yet, curiously enough, Commerce is valued in the stock market as if it were the Darwinian loser, BankAtlantic as if it were the winner.

On the third-quarter conference call, BankAtlantic's chairman and CEO, Alan B. Levan, sounded a long lamentation. Like Commerce —exactly like Commerce, in fact— Levan's bank offers its depositors amenities in lieu of market interest rates. But BankAtlantic's customers seem increasingly reluctant to forgo 5%-plus CD yields in exchange for long-burning lights (the bank is open 80.5 hours a week), ubiquitous branches, bubbly tellers, coin-changing machines and a hockey stadium emblazoned BankAtlantic Center.

"The marketplace is more competitive and it's costing us more from a marketing standpoint to generate those accounts," said Levan. "Additionally, because of economy and environmental issues, we are losing some of the balances from our existing legacy accounts." (The "environment" to which he refers is the financial, not the natural, one.) Levan reiterated his faith in the Commerce Bancorp-cum-BankAtlantic business model, but he admitted: "Clearly, it is not working at the same level that it has been for the last five years. We're generating it on the front end; we're losing it on the back end."

Only last year, BankAtlantic was producing same-branch deposit growth in the 25% range (down from 35% or so in 2004). In the third quarter, growth dropped to 5.3%. Nonetheless, relates colleague Ian McCulley, "BankAtlantic is still spending tons of money . . . .

Read the full story at:
www.grantspub.com/doppelganger

— ***Grant's Interest Rate Observer***, **Dec. 15, 2006**

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