CONSUELO MACK | WEALTHTRACK

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On this week's Consuelo Mack WEALTHTRACK: A different investment world. Financial Thought Leader, James Grant, Editor of Grant's Interest Rate Observer declares the 35 year bull market over and sees few opportunities to replace it.

James Grant
Editor
Grant's Interest Rate Observer

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CONSUELO MACK: On this week's WEALTHTRACK, are you prepared for the biggest investment change in nearly two generations? Financial thought leader, historian and bond expert James Grant says we better be. He explains why, next on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello, and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. We have been living in an extraordinary era, one not experienced in five thousand years of recorded history. Most of us didn't even know it and have come to believe it is the norm.
I am referring to the level of interest rates. One of my favorite charts of all time shows the history of short and long term interest rates since 3000 BC. It illustrates that in the last couple of years we saw the lowest interest rates in five millennia.

A more familiar story is illustrated by this chart, showing what yields on ten-year U.S. treasuries have done since 1900. It gives us a much shorter time horizon, but still a picture of how dramatic the fall in rates has been over the last three plus decades. This week's guest believes the era of record low rates is finally over. He is the first to admit he has thought that for several years, but today he is even more convinced that the death knell is sounding and that the implications for markets and investors is profound. He is financial thought leader James Grant, the founder and editor of *Grant's Interest Rate Observer*, a twice monthly analysis of all things credit related. It casts a wide net including analysis, commentary and history of the bond, stock, real estate, and currency markets and continuously tracks central bank finances and policy. It is a must read for many top professional investors.

Grant is a financial historian and prolific author. His most recent book is: ***The Forgotten Depression: 1921: The Crash That Cured Itself***. Grant has been a vocal critic of the unprecedented stimulus policies implemented by central banks all over the world, particularly by the fed, and is alarmed by the high levels of debt accumulated by governments, especially since the financial crisis. In a recent *Grant's* he cited one example of the havoc rising interest rates could create in the U.S. alone.

"The government today pays net interest expense of $240 billion at an average interest rate of 1.8%. At 5%, it would pay $681 billion, $441 billion more than today and $77 billion more than the fiscal 2016 defense budget."

CONSUELO MACK: Reason enough to worry. I asked Grant what gives him the confidence to emphatically state that the 35 year bull market in bonds is indeed over.

JAMES GRANT: I'm not sure if confidence is the word. I have been thinking along these lines for many years, and if I sound as if I'm confident it's perhaps because of repetition. This is a working hypothesis, but sooner or later these things do end. The story of interest rates, oddly enough, is a story of generation plus length cycles. Stocks don't work this way. Commodities don't work this way, but interest rates for some reason or other have worked this way for going on 200 years. These cycles sometimes last 20 years; sometimes 30 years. In the case of the Gilt Edge British Securities in the 19th century, the cycle lasted for about 80 years, but I do think that we have reached the end of this particularly... it's a glorious ending in a glorious bull market in bonds.

CONSUELO MACK: Why? Where's the evidence? What's telling you that?

JAMES GRANT: Well, I work back from the proposition that you are investing at this point with almost a guaranteed loss. In the backdrop or not so deep in the background is the nature of contemporary money. It is an X or an O in somebody's cloud or hard drive. It's these things, these dollars, these euros, this renminbi are created as if by magic somebody taps a computer screen, and without effort the sum appears on somebody else's computer screen. That's money. Is money no longer a thing? No. It is a concept increasingly. It is an instrument of public policy. Money is what the authorities would make it to be rather than that thing which you can touch, gold, silver, what have you which was money for eons. So that's one fact in the background. Perhaps a more relevant fact for most investors is the utter absence of value. At the peak of the lunacy in 2016, upwards of 14 trillion of sovereign debt, principally European, was priced to deliver a yield of less than nothing, nominal yield of less than nothing. Now in the long history of markets, you are hard-pressed to find that particular value proposition, and our mutual friend, Dick Sylla, the author of the page-turner called *A History of Interest Rates*, if he were here he would attest to the fact that never once in 5,000 years or the recorded annals of interest rates has this occurred, had an important number of bonds been priced at this ridiculous level. So when there is no...

CONSUELO MACK: So if there’s a top...

JAMES GRANT: When there is no value, when there is less than no value, when the money in which these promises to pay is denominated is itself kind of a postmodern concept as opposed to a thing, a store (Inaudible). When these stars come into alignment, I say “phooey,” which is a technical term meaning “not for me, thank you very much.” By way of postscript, I have been saying this for a while.

CONSUELO MACK: You and many others.

JAMES GRANT: Now it’s really true, Consuelo.

CONSUELO MACK: (Laughter) Exactly. Kind of was the key the negative interest rates, kind of the height of absurdity like... ?

JAMES GRANT: That was enough for me.

CONSUELO MACK: Or the depth of absurdity. I don't know.

JAMES GRANT: That was enough for me.

CONSUELO MACK: But these things could take time.

JAMES GRANT: There was an impulse. There was an almost irresistible urge on the part of so many people to buy what was plainly objectively, from the perspective of the figurative man from Mars, a losing proposition. They had to have it. That kind of an impulsive investing is a (Inaudible). We know it’s not the bottom. Right? It seems to me that it very nicely fits into my conception of a top. No value know-how, and almost certain loss. That to me is a persuasive set of propositions for a market top.

CONSUELO MACK: But we could skirt along the top. Right?

JAMES GRANT: We could.

CONSUELO MACK: For a number of years.

JAMES GRANT: Well, there’s a precedent for that.

CONSUELO MACK: Tell me what the precedent is as a financial historian that you are.

JAMES GRANT: Well, I watched the last time this happened. There was a bull market in bonds, meaning a long trend of falling interest rates, of rising bond prices that began in 1920, and it ended in April of 1946. Now I was not there for the exact low in yields. I was born in July, but my mother told me what happened (Laughs) in May and June, and bond yields scraped bottom at 2.12 or thereabouts, call it two and a quarter, and it took them ten years to get to three and a quarter, ten years.

CONSUELO MACK: Wow.

JAMES GRANT: So if someone had been around watching our show in 1946, a grainy black and white picture on one of three channels available then and they heard some guy, I would have been very young of course. (Laughter)

CONSUELO MACK: The child prodigy that you were not.

JAMES GRANT: Talking about interest rates bottoming.

CONSUELO MACK: Infancy.

JAMES GRANT: They would have been paid not to worry. However, the way, the path that rates took then was governed in good part by the Federal Reserve, which continued to suppress them overtly until 1951. Also the world was looking back at the Great Depression and looking back at the...

CONSUELO MACK: So the Fed was doing that even then.

JAMES GRANT: Oh, yes. It had begun in the early years of the war, and it persisted until 1951. There were explicit pegs for bonds and for Treasury bills. Now the pegs are slightly less overt.

CONSUELO MACK: So the role of the Fed then in this, so I mean can we assume that this?

JAMES GRANT: No. Whatever it is: no. (Laughs)

CONSUELO MACK: Can we assume anything? That it’s not going to be a sudden severe ratcheting up of interest rates.

JAMES GRANT: Consuelo, you can assume exactly nothing, and in general that’s good advice on Wall Street, because there’s so much we don’t know – like about the future, everything – but in this case it seems to me it is extra important, this caution about presuming to know the future, if only because of our new president. He is tail risk so to speak on two legs. He says anything, tweets anything. He might do anything. He probably won’t do anything, but the range of possibilities is rather mind-boggling, some of them very, very good for financial assets, some of them really, really bad. For instance, it’s possible that he will actually implement the thing that he was talking about on the campaign trail. He might...

CONSUELO MACK: Which one? (Laughs)

JAMES GRANT: Well, there were a few. Weren’t there?

CONSUELO MACK: Yes, there were quite a few.

JAMES GRANT: He might say that no job is leaving the country and it could be that corporate America knuckles under to this. It could be that he is going to impose substantial penalties on imports. It might be that he’s going to, I don't know, build the wall. Build the darn wall.

CONSUELO MACK: So all of which would be...

JAMES GRANT: This would be part and parcel perhaps of the anticipated although by no means specified yet details of this reflation, this program of big spending, this program of government activism. It might be that he appoints some compliant person to be his Fed chairman who is going to suppress interest rates in the face of perhaps a rising dollar exchange rate perhaps.

CONSUELO MACK: Which we’re seeing now, a rising dollar.

JAMES GRANT: It might just be that these imagined policies or projected policies of our new president will be very, very bad for bonds, in which case the road map we have from the last occasion seven years ago of a ten-year rise from two and a quarter to three and a quarter, it could be that’s all out the window. It might be it’s no longer germane. What might be happening is a very sudden rise in interest rates. We don’t know. **The past is interesting certainly, and it reminds us what is possible, but it doesn’t define what is possible.**

CONSUELO MACK: But to invest you’ve got to have some sort of a working scenario.

JAMES GRANT: You do. You do. You do indeed.

CONSUELO MACK: So here we are holding trillions of dollars' worth of bonds in personal accounts, and it wasn't until this past year that investors stopped buying bonds and started selling bonds and actually putting money more into the stock market. So kind of what's your working thesis? I mean what do we do in a situation like this with all of our bonds?

JAMES GRANT: I think the way to think about this first and foremost is the value available in these bonds and the alternatives available in other income-producing vehicles. So last time I looked, the ten-year Treasury was trading at about two and a half percent, which is approximately the rate of inflation that many of us feel in our own lives, not exactly because these things are all rather subjective, but about. I would say that barring a new whiff of deflation and weakness in business activity, that two and a half percent is not a really compelling invitation to invest. I would say the same for junk bonds, many of which begin with a yield number five, and munis which three and four. I mean this is, as we say in the city of New York: "Meh," meaning quite ordinary and I think not...

CONSUELO MACK: So not attractive enough.

JAMES GRANT: Not attractive and certainly lacking what the ancients would call a margin of safety. Now from that let's go to what the stock market can deliver in the way of interest income. Well, there are mortgage real estate investment trusts that are priced to yield something like 11 percent. Many of them are trading below book value which sounds good, and it is good except if short interest rates do go up. There will be a squeeze between what the mortgage REITs pay to borrow and what they earn on their mortgages. And those yields will go down and the stock prices themselves will go down. So those are the yields and those are the risks. There are business development companies that offer you a floating rate of interest, but they are priced richly, some of them, the better ones, well over book value again.

CONSUELO MACK: Because investors have already recognized their attractiveness, and in a rising rate environment you want floating rates.

JAMES GRANT: Correct, and similarly with floating rate bank debt. Senior claims on leverage, corporate capital structure is pretty safe. They are priced to yield about four percent. Again it's okay. May I enter one candidate for consideration?

CONSUELO MACK: Yes, certainly.

JAMES GRANT: It's a company called Parkway, PKY. It yields nothing at the moment. It is a brand new real estate investment trust that owns properties. All of its property is in Houston. Now Houston is a disaster area.

CONSUELO MACK: Because of the fallout in energy prices.

JAMES GRANT: So much of the office space in Houston is vacant, and one would expect that this would be, on its face, a really dubious investment. The value proposition is that it's relatively cheap, and it's at ten times or so funds from operations. The average multiple in the worlds of REITs is something like 17 times.

CONSUELO MACK: You feel that Parkway, your analysis from *Grant's Interest Rate Observer* is that Parkway can survive. It's resilient enough (Overlap/Inaudible).

JAMES GRANT: It can survive, and if energy prices, if this reflation idea comes to fruition and if energy prices go up, suddenly this outfit which has not very much debt has a lot of flexibility in the way it might purchase cheap properties in Houston. This could be a really interesting valued stock. Now it's a speculation, and the yield if one were to surface, the directors might choose to pay you a yield of say three percent which is not anything like the yields available in mortgage real estate investment trusts, but I think and we think at Grant's that the upside is kind of interesting. It is very speculative but...

CONSUELO MACK: So that would be your one investment for a long-term diversified portfolio? It's Parkway?

JAMES GRANT: Yes, yes. I think in a world of very, very unattractive alternatives, I think this one is pretty interesting on its own merits, not necessarily only in regard to what is out there to compete with it.

CONSUELO MACK: So Jim, what that tells me is of the paucity of investment opportunities out there for income.

JAMES GRANT: Well, as I see them. Yes.

CONSUELO MACK: If this is kind of all you can come up with. (Laughs)

JAMES GRANT: I've tried, Consuelo.

CONSUELO MACK: A new weed in Houston. Okay, but really.

JAMES GRANT: To me this is the state of financial markets worldwide. My experience is that the best opportunities are prevalent when nobody likes the market in question. 2009 was (Inaudible). The smell of gunpowder or whatever it was.

CONSUELO MACK: (Laughs) Or the blood in the streets, the whatever.

JAMES GRANT: So I am of the value tribe, and I'm not satisfied until you can see a margin of safety, and until you can see investment value that is protected through price, of course through...

CONSUELO MACK: So let me go back to the fixed income markets, though, because one of the issues that you follow at Grant's a great deal is the indebtedness that we have in this country.

JAMES GRANT: The average interest rate since the inception of America or the American Republic was about six percent. That is what the basic kind of prime rate-ish kind of interest rate has been. What is certainly beneath the average of our interest rate experience is the current cost of the debt, 1.8, and I couldn't help but notice that during the campaign nobody said nothing (Laughs) about this.

CONSUELO MACK: About the national debt.

JAMES GRANT: Every other topic of interest was covered. Sex tapes, e-mails, all the (Laughter)...

CONSUELO MACK: Really pertinent (Laughter) developments.

JAMES GRANT: But nobody said a word at least on the main presidential basis about our fiscal position, which either means it is truly irrelevant and Mr. Market in his wisdom has chosen to look through it, waiting for the time 50 years from now, say, in which it will actually matter, or that it's truly significant and that we all better be paying attention. My call is the latter one. It seems to me that these numbers are truly worrying, and people say, well, the reason that rates will not go to five percent is because they can't. Look. If they did, we'd be paying debt service equivalent to the defense budget and that would be impossible. I say right. It would be inexpedient (Laughs) if rates went to five. That's different from impossible. (Laughs)

CONSUELO MACK: What's going to happen as far as the Fed's role? Again we don't know who Trump is going to nominate. I mean he's got several FOMC positions that he's going to...

JAMES GRANT: There's two now. Two now and perhaps there if somebody ups and quits.

CONSUELO MACK: You feel that the Fed is way too involved in the economy and way too heavy-handed as it is. So how much does that matter?

JAMES GRANT: Well, it matters a great deal. My suspicion is that Mr. Trump will appoint a rather compliant Fed chairman who will facilitate the program that he envisions for the restoration of greatness in America. He wants to build damns and highways and sewers. Well, this will take money. As he well knows as a real estate guy, it will take low financing costs. So my suspicion is that he will deliver to the Fed somebody who is very much like the people we have known at the Fed. However, there is the other Mr. Trump who talked once or twice in the campaign in New Hampshire I guess somebody asked him about the gold standard. He said, "Boy that would be terrific." We haven't got enough gold but we do, but there is a part of this. He furnishes everything he owns with gold plate as you know. So those of us who through conviction or through other... those of us who believe in the gold standard, who believe in a currency that is grounded in something besides the good intentions of the monetary scholars who run the central bank take some heart in this, but I think that the prevailing sentiment of the Trump administration will be one for easy money.

CONSUELO MACK: Speaking of gold, you've been a proponent of the gold standard for many years, but also you personally own gold.

JAMES GRANT: I do. The past few years have not been very pleasant, but I do and I have what they say in the trade "high conviction," and I say this because gold is on its face not an investment. You can't quantify its earning power. It has no earning power, a little like bitcoin which is quickly overtaking it in price to the humiliation of us gold bugs. But gold to me is an investment to this extent. It is a hedge against monetary disorder famously, but because monetary disorder is visible, prevalent and, in my perception, growing, I review gold as an investment in monetary disorder. It's an investment in the incoherence of these mathematical models that did such a great job, Consuelo, of anticipating the sorrows of 2008. It is an investment in the controlled anarchy of floating or no-so floating exchange rates. There is the ticking time bomb of leverage in the corporate and banking worlds, which leverage is fostered in part by the Fed's and other central banks' suppression of interest rates and ease of borrowing. So I wish that gold had not been such a dud since 2012, but I still hold it and have been adding to it because I believe that its time will come as the consequences of our monetary disorder come to the fore. As of now people think, oh, they got away with it. They have materialized $10 trillion in digital scrip. They have manipulated interest rates. They have jimmied up stock and real estate values. They have...

CONSUELO MACK: They being the Fed.

JAMES GRANT: They the central banks collectively and it feels great. They did it. They should have done it before because it is without cost. That is the implicit storyline, but I don't believe it. (Laughs) I think these things do have cost, and I think the cost will be forthcoming.

CONSUELO MACK: So we've had guests on who talk about gold in a portfolio being ballast in a portfolio and being a store of value and that it's basically a non-correlated asset, so when things go bad, gold holds its value.

JAMES GRANT: I don't disagree with that.

CONSUELO MACK: But you're talking about it being something more. I mean when do you, Jim Grant? I mean have there been times when you've actually sold gold when it's...?

JAMES GRANT: I'm glad you asked because I sold some when it got to the point at which I first bought it. (Laughter)

CONSUELO MACK: Oh, great.

JAMES GRANT: I bought it in the year 18 ... no. (Laughter) It was like 1980, and I queued up at a storefront on Wall Street with the innocents not then realizing as now one realizes with the wisdom of years you never stand in line to buy an investment, Consuelo. You always buy it when there's no queue. (Laughs) So I bought some gold. It must have been the peak at 850 or something, and I rue the day where I bought like two Krugerrands, so I feel like such a dope as the years wore on. I came to see how interest rates matter, and how valuation matters and how gold is a seasonal or is a cyclical...

CONSUELO MACK: Commodity.

JAMES GRANT: Well, it's money.

CONSUELO MACK: But it's more than that. It's money.

JAMES GRANT: Anyway, I came to see the errors of my rookie ways, and I vowed that if it ever got to back to 850 I would sell some, so I sold a little bit as a symbol as to remind myself of the idiocy of... well, I don't want to say child of what 30 or something. (Laughs)

CONSUELO MACK: But it gives you a sense of security? I mean is that what it is?

JAMES GRANT: Yes, yes. It is.

CONSUELO MACK: Then at some point someone, perhaps your children or your grandchildren, will take your stash of gold when it's worth a fortune and...

JAMES GRANT: You're right. It's not an eternal asset, but it is an asset for a season. So we live in this world I say of monetary anarchy, and in such a world it seems to me... I'm not going to say one ought to own gold. I'm going to say that I own a little bit of it, more than a little bit for myself, and I'm quite comfortable in holding it. Sometimes I wish that it would do better for me, but that's different than for me losing my conviction about what it's for. Gold is money in a world in which money is being debased and in which it is being trivialized through its ease of materialization on computer keypads. In this world I think that gold will come back into its own. Gold is not exactly out of fashion, but it's sufficiently out of fashion to have reduced the price relative to many other claims on investors' intention. So I own it and am happy to do so.

CONSUELO MACK: We'll leave it there. Jim Grant, thank you so much for joining us on *WEALTHTRACK*.

JAMES GRANT: You are so welcome, Consuelo. Nice to be here.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's action point is: **<u>It's Time To Avoid Leveraged Investments.</u>** If interest rates have in fact finally bottomed governments and companies with lots of debt will have to pay more, possibly a lot more to service that debt. Case in point is the figure we cited from Jim Grant earlier. If interest rates the treasury pays on its debt go up from the current 1.8% average to a not abnormal 5%, the yearly interest bill would nearly triple to a staggering $681 billion. Any heavily indebted company or government is facing higher bills and more scrutiny from lenders as rates rise even modestly. It's time to avoid debt laden investments and favor credit worthy ones.

I hope you can join us next week for our exclusive interview with another financial thought leader: Bank of America Merrill lynch's chief investment strategist, Michael Hartnett will discuss the major investment changes occurring around the world and what they mean for investors. Meanwhile, to hear about Jim Grant's latest project, a biography of Walter Bageot, one of the most influential financial and political journalists of the 19th century, click on the extra feature on our website. Also thank you for contacting us on Facebook and Twitter. It might take us some time but we will respond to each and every one of you. Have a great weekend and make the week ahead a profitable and a productive one.