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Money's out of touch

Venezuelans are breaking off flakes of gold nuggets to carry on everyday commerce in the face of relentless monetary debasement, Bloomberg reports. "You can pay for everything with gold," the news service quotes a 20-year-old Venezuelan consumer, Jorge Pena, as marveling. Has Gen Z rediscovered the gold standard?

Not yet, though the poorest Venezuelans, deprived of both internet service and a functional currency, are reminding the rest of us about the tactile nature of real money. We write to propose that the "dematerialization" of wealth, a trend supposedly necessary, salutary and irreversible, is fast becoming another bubble. "React and adapt" is the executive summary of the prescription below.

You read in these very pages about *EtherRock #42* recently commanding a crypto price equivalent to $1.33 million, a value only slightly lower than that realized at auction by the bicorne hat Napoleon wore on his victorious progress through Poland in 1807. The buyer of the chapeau actually owns that tangible relic; the buyer of the non-fungible token owns nothing but bragging rights on the blockchain.

Even so, $1.33 million is a large sum, as "40 million percent," is a prodigious 12-month rate of appreciation. That was the year-to-date performance of the Shiba Inu crypto unit before Elon Musk took it down a notch last weekend by tweeting that he actually didn't own it. Shiba Inu is said to parody Dogecoin, which itself was conceived as a sendup of bitcoin. "With such memecoins, it's hard to speculate on the actual reasons for price movements, in all honesty," Vijay Ayyar, head of Asia-Pacific at crypto exchange Luno Pte., said Sunday in a message quoted by Bloomberg. However, "there are some interesting communities being built around them."

We all belong, willingly or not, to the worldwide "Paper Money Sans Interest Rates Financialization Community," which came into being in stages, starting in 1971, when the dollar was cut loose from what little remained of its gold moorings, and continued to expand in the era of zero-percent funding costs, which followed the 2007–09 financial crisis and persists to this day. With neither the discipline of a gold standard nor the coherence of market-determined interest rates, we investors operate in a state resembling zero gravity, where nothing is anchored and things that aren't nailed down go up.

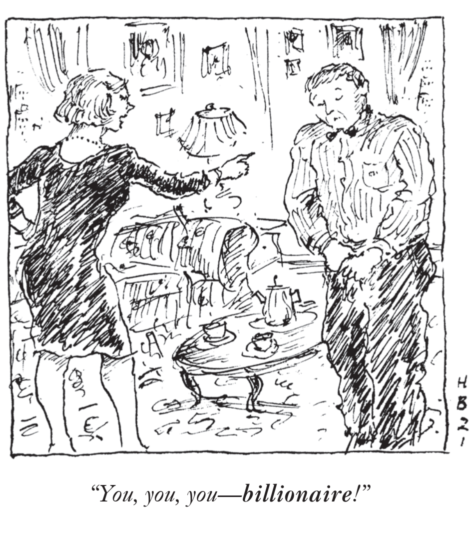
The speculative craze for intangible things—digital coins, NFTs, metaverse real estate—is not the least striking feature of financial weightlessness. You can trace the roots of investment Zero-G back to the paperwork crisis of the late 1960s, when Wall Street closed on Wednesday afternoons to dig out from the snowdrifts of uncashed checks and uncleared trades that threatened to suffocate it. The analogue infrastructure of the time, unable to process even 15 million shares a day, made necessary the formation of the predecessor to today's Depository Trust & Clearing Corp. of New York.

A half-century after that founding, the DTCC's success in building (and relentlessly improving) digital structures and procedures for settlement, storage and processing has facilitated a level of financial activity that no one could have dreamt of, even in the imagination-stretching era of the first moon landing. Reading the DTCC's annual report, we're not sure we can grasp it today.

Thus, in 2020, the Depository Trust processed securities valued at $2.33 quadrillion—that is, with a "q." It cleared an average of 173.4 million shares of stock a day, with an average daily value of $1.698 trillion. Over the 12 months of 2020, it settled securities transactions in the grand sum of $131 trillion.

"Cashless and contactless commerce" are the DTCC's watchwords, and it's a thorn in the side of the corporation's technicians that slightly less than 1% of the securities held in inventory—a mere $780 billion's worth—remains in physical form. "With concerted effort and the help of the transfer agent community," says Murray Pozmanter, head of the DTCC's clearing agency services and global operations, "we believe a realistic target in the next three years would be the full dematerialization of 98% of all physical stock certificates."

All hail the dematerialization of mortgage and stock certificates. No social



*"You, you, you—**billionaire!**"*

Satire of a sendup

source: CoinMarketCap.com

good came from the laborious physical clearing of bonds, stocks and cashier's checks. The absence of hard money and market-discovered interest rates is another matter. The seeming anachronism of the precious metals regulated the stock of money. Proper interest rates valued and rationed credit.

In the absence of these foundational financial elements, we operate in the Golconda that Philip Grant, esteemed editor of Almost Daily Grant's, described on Monday, as a world of unprecedented dividends payable to the promoters of innumerable leveraged buyouts ("private equity transactions" in 21st-century argot), supported by the issuance of never-before-seen volumes of junk bonds and leveraged loans.

It's the financialized state of things that Henry Maxey neatly characterizes as the "optimization of the economy around finance and asset prices" (see page 5). Optimal, in the cause of nourishing finance and supporting asset values, are ultralow interest rates and super-abundant credit. Such a structure is the source of unfathomable wealth, and of towering leverage, sky-scraping valuations and, to borrow a word from Hyman Minsky, "fragility" yet unmeasured.

Inflation is what the financialized investor most fears, and now that ogre has arrived, for how long nobody knows. It's the dematerialization of money itself that may prolong its unwelcome stay, as Jason Zweig of *The Wall Street Journal* noted in July: "Dozens of studies have shown that consumers using credit cards rather than cash are less likely to remember how much they spent, take less time deciding what to buy, are more willing to pay high prices and make a greater number of purchases. They also exert less self-control, buying more junk food, luxury goods and other impulsive items."

"Skin hunger," or "touch starvation"—the unanswered yearning for human contact—beset many during the pandemic, and perhaps there's an analogue in the world of money and investing. Just maybe the crypto adepts are feeling the need to touch the things they buy.

Tungsten cubes, colleague Evan Lorenz reliably informs us, have become the avocado toast of Gen Z, a form of conspicuous consumption that young partakers enjoy all the more for the derision it invites from the mocking old.

"In the latest phase of the quest to turn everything into an NFT," Vice Media reports, "crypto traders are now bidding to digitally own a 1,784 lb. cube of tungsten in Willowbrook, Ill. According to the terms of the sale, which will have the receipt posted to the blockchain for posterity, the 'owner' can have one supervised visit to the cube per year to touch or photograph it."

The quotation marks surrounding the word "owner" underscore that the concept of ownership, sacred in capitalism, doesn't pertain to NFTs. You may buy but not possess.

Anyway, it's a 14-inch cube of an ultra-dense metal, and Midwest Tungsten Service manufactured it. Right now, the highest bid is 47.76 ether, "currently equivalent to $201,295.23," Vice continues. "According to the listing, the only way to take physical possession of the cube will be to burn the NFT, meaning send it to a dead-end address so it can no longer be traded."

An aging goldbug may dream that Gen Z-ers (we mean, apart from the afore-quoted Jorge Pena) will conceive an interest in a metal even denser than tungsten. Nothing wrong with tungsten—as a light-bulb filament, it's nonpareil, but it's not going to protect you if the Federal Reserve, underestimating the fragility of the financial architecture, bungles the next tightening cycle or inadvertently drives people out of the dollar by slapping on yield-curve control.

Gilded, a start-up with ambitions to make gold "digital, mobile and usable," is in tune with the digital zeitgeist, to the point of hosting a private blockchain to record transactions and attesting that the gold in which it deals is "ethically sourced."

Ashraf Rizvi, an Iowa-nurtured Wharton School alumnus whose parents immigrated from India in the 1960s, described to colleague James Robertson, Jr., the thought process that led him to found, and now to lead, the latest entrant in the digital gold field.

"What if," the former forex derivatives trader mused, "I could marry the 21st-century technology of the blockchain, a mobile app and a smartphone and tie it directly to the physical commodity, or, in other words, give you access to real gold itself, where it becomes your title, your property?" And that is what he's building.

It won't be easy, as others have discovered. For one thing, U.S. regulators are more welcoming of crypto than they are of the proposed mobilization of gold for monetary purposes. For another, there's an ever-present business risk that growth in customer order flow will fall short of the rate required to pay the bills to support a 24/7 platform. Rizvi unveiled his project in India before the American rollout, but he's still in start-up mode.

One day—heroically assuming regulatory clearance—Gilded aspires to deliver "the functionality of money but be a better version of it." For now, a customer's options are limited to buying or selling gold and to holding those ounces in a Brink's vault in Zurich, Dubai, Singapore, New York, London or Sri City. In keeping with the bullish *Grant's* house view, Robertson chose to buy. Undaunted by buggy know-your-customer and anti-money-laundering protocols, he secured one gram at a price of $59.30, $2.58 over spot.

"Neither confetti nor balloons celebrated our purchase," Robertson reports, "but I received a picture of the Valcambi-refined gold bar we (fractionally) own, AZ8936, stored in a Brink's vault in Zurich."

To emphasize, the word is own, not "own."

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Buy now, pay later

Evan Lorenz writes:

Don't buy now

source: The Bloomberg

It's not every president whose exit upstages his successor's inauguration. Rarer still is the commander-in-chief who, after leaving office, returns to public life via the speculative asset class du jour. Donald Trump is that former POTUS as well as the namesake of Trump Media & Technology Group, which two Wednesdays ago announced a merger with Digital World Acquisition Corp., a blank-check company, sending shares up 493%.

The bull market in everything is giving everyone second chances. Except for a SoftBank Group Corp. bailout two years ago, WeWork would have come a cropper. Yet, on Oct. 21, the office-sharing avatar went public through a merger with BowX Acquisition Corp. The still unprofitable WeWork now commands a $9.8 billion market cap versus $2.7 billion in trailing sales.

All this recalls the software-like multiples that the besotted Mr. Market has chosen to hang on businesses that lack software-like margins. The Aug. 6 issue of *Grant's* examined three such overvalued specimens. New-age insurer Lemonade, Inc. has subsequently declined by 22.6% and Mister Car Wash, Inc. by 10.3%, while Affirm Holdings, Inc. (AFRM on the Nasdaq) has disobligingly shot to the moon, rallying by 126.1%.

Following is a review of our losing pick-not-to-click, as well as an examination of a pair of new IPOs, Warby Parker, Inc. (WRBY on the New York Stock Exchange) and European Wax Center, Inc. (EWCZ on the Nasdaq). In preview, we're bearish on the lot.

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Affirm is a giant in the buy-now-pay-later lending field, the millennial-approved alternative to credit cards. Think of BNPL as a form of reverse layaway: Rather than paying now and consuming later, customers consume now and pay later. Unlike layaway credit, BNPL loans charge interest (the cost of which the merchant may choose to defray). However, Affirm assesses no late fees, nor does it charge for missed payments ("we never profit from consumers' mistakes," the 10-K report would like you to know).

BNPL appeals to younger consumers who lack strong credit profiles and may give traditional credit cards the side eye. Looking at Affirm's past securitizations, it appears that its borrowers' FICO scores hover between subprime and the bottom end of prime (*Grant's*, Aug. 6).

Branching out from its core business, Affirm is adding a feature to allow the purchase and sale of cryptocurrencies; a program to fund the working capital of merchants who accept Affirm's BNPL payments; and a new Debit+ card, which will link to a customer's checking account and provide the option to toggle payments between checking and BNPL.

But none of these forays explains why the stock has more than doubled in the past two months. A more likely source of propulsion was Affirm's Aug. 27 announcement that Amazon.com, Inc. would feature the BNPL lender as a payment option.

Consider, first, however, what the Everything Store transaction is not. It's not the Bezos brainchild's first BNPL partnership—that was with Zip Co. Ltd. in Australia in 2019. Nor is it Amazon's first American BNPL experiment—the e-tailer already offers installment payment plans. Neither does the deal confer exclusivity, something that Affirm disclosed later, on its Sept. 9 earnings announcement.

What the Amazon deal does represent is top-line growth, much like the exclusive agreement that Affirm struck with Shopify, Inc. earlier this year. In consequence, the Street estimates a 40% bump in revenue to $1.2 billion in the fiscal year ending June 30, 2022 (and to $2.3 billion by June 30, 2024), from $870.5 million in fiscal 2021. But it is profitless growth, as analysts project red ink throughout the period.

This is a problem for a stock valued at 48.9 times enterprise value to sales, and Affirm acknowledged as much during its Sept. 28 investor day. When revenue growth slows to between 20% and 30% over an unspecified number of years, said the front office, adjusted operating margins will rise to between zero percent and 10% of sales, from an anticipated negative 11%–13% in fiscal

2022. Longer-term, management projected a margin surge to between 20% and 30% of sales due to a "slower rate of investment," as CFO Michael Lindford put it. (There is an asterisk here, however, as Affirm defines adjusted operating income as Ebitda plus stock compensation and other costs.)

In fact, none of the big, pure-play BNPL lenders like Klarna or Afterpay Ltd. is profitable. In a report last month, Fahed Kunwar, a partner at U.K. broker Redburn, aggregated the figures from the three largest BNPL lenders and found that, on average, the trio earns 4% of a loan's value in interest while paying 3.7% in interchange and network fees, card-processor costs, reserves for credit losses and borrowing expenses. It leaves a paltry 0.3% in gross profit. Those 30 basis points are all that remain to pay the advertising costs to attract new borrowers and to cover the general and administrative expenses in one of the most forgiving credit environments ever.

"[T]he banks analyst in me cannot help but note the pricing structure barely works even when assuming all-time low credit losses," Fahed added. "If these were raised to a through-cycle level, the economics of BNPL collapses." According to data from the Federal Deposit Insurance Corp., U.S. bank net charge-offs are the lowest as a percentage of loans outstanding since at least 1984 (*Grant's*, Oct. 15).

Bulls on Affirm look to markets like Sweden and Australia, where BNPL accounted for 25% and 14%, respectively, of online retail sales. However, Lisa Ellis, a partner at MoffettNathanson, LLC, cautions that there are specific reasons why BNPL has succeeded in those countries. For one, each has an outsize cohort of young consumers. For another, those consumers are much deeper in hock than their American counterparts are: U.S. household debt sums to 96% of income versus 200% in Sweden and 210% in Australia.

Nor are credit cards such a compelling consumer option in Sweden and Australia. In Sweden, regulators have thrown up barriers to revolving credit. In Australia, the government has ratcheted down credit-card interchange fees over the past two decades and shifted the cost of cards to consumers from merchants. Thus, the Australian consumer is looking at high costs and meager loyalty points.

One may conjecture that, as Affirm's American customers get older and build their credit scores, they may pick up the credit-card habit. "From a consumer share-of-wallet perspective," Ellis tells me, "my view is that BNPL will likely remain a fairly specialized model. In the United States, consumers have very broad and sophisticated access to credit, and they love it. Most people love their credit card rewards and all of the programs around them."

And this is before the competition stiffens. On Sept. 28, Mastercard, Inc. rolled out a BNPL offering that allows any card issuer in its network to offer the buy-now-pay-later option. Visa, Inc. is testing a pilot BNPL program with select lenders now and plans to welcome all issuers to its network later. PayPal Holdings, Inc., which had 403 million customers as of June 30, is also ramping up its installment-payment options; management says it funded $1.5 billion's worth of BNPL loans in the second quarter, up from $1 billion in the first. For comparison, Affirm, which counts 7.1 million customers, processed $2.5 billion in the June quarter.

Of the 13 analysts who cover the stock, 8 say buy and only one says sell. Insiders have neither bought nor sold shares since we went to press in August.

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Read enough prospectuses, and you learn something—for instance, that most aspiring investor-owned corporations show less than $1.07 billion in trailing revenues, the threshold to qualify as an "emerging growth company." So designated, a fledgling public company need provide only two years of audited financial statements, rather than three. It is likewise absolved (for a period of up to five years) from the usual obligation of attesting to the rigor of its internal financial controls. Multiple share classes with disparate voting rights, through which insiders keep managerial control, are another common feature of the new IPO breed.

A case in point is spectacles vendor Warby Parker, which on Sept. 29 completed a direct listing for its class-A stock (which confers one vote per share) while insiders retain class-B shares (10 votes). In the risk-factors segment of its S-1 report, Warby admits to material weaknesses in internal controls for, among other items, "processes to enforce segregation of duties, prevent and detect errors, support timely reconciliation of certain key accounts, and enable review of manual journal entries."

Inspiration struck Warby co-founder Dave Gilboa in 2008, when he lost his phone and eyeglasses on a backpacking trip through Southeast Asia. He couldn't fathom why the replacement specs, derived from a "technology that has been around for 800 years," as he's said on many occasions, cost as much as a replacement phone.

In 2010, Gilboa, along with fellow Wharton School classmates Neil Blumenthal, Andrew Hunt and Jeffrey Raider, founded Warby Parker, which offers prescription glasses (frames plus lenses) starting at $95 on its website and in its 145 physical stores. Organized as a public benefit corporation, WRBY donates a pair of glasses for each pair it sells.

Covid-19 was a boon to the online-focused retailer. Sales grew by 6.3% in the plague year, and revenue growth accelerated to 53% in the first half of 2021. Warby Parker ships up to five frames for free so that online shoppers can see how they look in different styles before they buy. This makes online sales costlier than those in actual stores. As the pandemic boosted the proportion of online business, operating losses bulged to $55.6 million in 2020 from $1.7 million in 2019.

Now the company is focused on expanding its store base, with a goal of opening 30 to 35 new shops in 2021. "If we look at most of our large competitors, they have thousands of retail stores across the U.S.," Gilboa told investors on Sept. 13. "So that just underscores the massive opportunity we have."

In other words, Warby Parker hopes to become a moderately profitable physical retailer from a currently unprofitable online merchant. *Grant's* has nothing against the strategy, but we do question WRBY's price tag of 12.6 times enterprise value to sales. Walmart, Inc., a famously profitable brick-and-mortar retailer, trades at 0.8 times EV to sales. Four of the seven analysts who cover the stock say buy, and none says sell.

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European Wax Center is another characteristic new arrival. Here there are two share classes, A and B, each with identical voting rights, but rather than cementing the founders' control the point of the dual classes appears to be to limit the tax liabilities of management and private equity sponsor General Atlantic, L.P. Another emerging growth company, EWCZ has not even tested its internal controls.

Brothers Joshua and David Coba founded the company in 2004 with a single location in Aventura, Fla. As the name implies, EWCZ is in the hair-removal line. Over the past 17 years, it has established 815 locations, of which franchisees operated all but five, and it's these franchisees who furnish the bulk of the corporate revenue. Product sales generated 55% of second-quarter sales, royalty and marketing fees, another 39%; company-operated stores chipped in the balance.

Franchisors enjoy high multiples because royalty streams hold up across the economic cycle—after all, bulls observe, it's the franchisees who bear the operating risks. But pandemics are another matter. Covid-19 hit in-store waxing hard, shrinking same-store sales across European Wax clinics by 36% and reducing Ebitda to $20 million from $34 million. Nevertheless, the Street likes the fact that "Wax Pass" loyalty memberships generate three-fifths of system-wide sales and has labeled the stock a "services-as-a-service" company, a play on the highly valued "software-as-a-service" sector.

EWCZ sizes the U.S. waxing market at $18 billion, but Jefferies, LLC estimates the in-home component of that market at fully $12 billion. In the first half of 2021, system-wide sales at European Wax annualized to $751 million, or 12.5% of the out-of-home market. Management says it can expand the store count to 3,000 units, but as mature stores generate $1 million in sales, that implies $3 billion in overall sales, or one-half of the current addressable market.

Nor is waxing a buzzy new product category. According to EWCZ, there are 10,000 independent waxing boutiques in the United States and another 100,000 wax-equipped salons. To hit its targeted 3,000 stores, the out-of-home waxing market would have to grow by 50% or more, or European Wax would have to take substantial market share from existing competitors, or some combination thereof. As to expanding the overall market, CEO David Berg notes that 95% of clients are women, so convincing men to wax is an untapped market. Who's first, fellas?

EWCZ isn't the only depilatory specialist tapping the capital markets. On Oct. 15, Milan Laser, Inc., which manages 132 clinics, filed a registration statement with the Securities and Exchange Commission to go public. While laser hair removal is more expensive than waxing, it is also permanent. Thus, to the extent Milan is successful, it will shrink the available market for European Wax. Milan's S-1 statement anticipates the building of 1,000 laser clinics over the next 15 years.

Nevertheless, European Wax trades at 12.8 times enterprise value to sales and 33.5 times Ebitda. (Because of the Covid-19 impact last year, our figures annualize first-half figures.) Of the nine analysts who cover the stock, seven say buy. There's not a seller in the lot.

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Green's the color

"Climate change," Will Thomson, founder and managing partner of Massif Capital, LLC, told the in-person *Grant's* audience at the Plaza Hotel and the myriad viewing remotely, "is the environmental cost associated with a necessary economic decision." And how might a concerned investor contribute to a greener future? *Not* by investing in the kind of ESG funds that stock themselves with the securities of companies that have nothing to do with carbon emissions, hauling in upwards of $100 billion this year in the process.

To build an "impactful" portfolio, our speaker proceeded, one must commit to industries and businesses that are transitioning away from their old brown selves. Steel makers, cement companies, electrical utilities and paper and pulp manufacturers figure on Thomson's list: "The old economy must become the new economy, and the management teams in these industries know it and are moving to innovate."

Make no mistake, Thomson continued, "there is no environmental impact-free future. The dirty little secret no one tells you is that the carbon-free economy is not free of environmental impact. The impact is just different. Your Tesla requires the mining of 90,000 pounds of material to extract the necessary ore for one 1,000-pound battery. We are not getting rid of environmental impact; we are changing the impact we are having."

One could, and many do, signal a commitment to environmental purity by buying Alphabet, Facebook, etc., but "greenifying a portfolio by avoiding the worst sectors does not lead to a reduction in emissions," Thomson said. "The key issue is not how to restrict investment in carbon-emitting industries but rather how to make sure these industries invest in technology and innovation that allows them to produce goods and services without emitting greenhouse-gas emissions."

Thomson identified RWE A.G., which once was Europe's largest coal-powered utility and now is one of its top producers of carbon-free electricity, as an example of constructive greenifying, along with a selection of companies that make the component materials for solar panels and wind farms.

"Building a single 100-megawatt wind farm," Thomson told the audience, "requires 30,000 tons of iron ore, 50,000 tons of concrete and 900 tons of nonrecyclable plastic. A 100-megawatt solar development requires cement, steel, aluminum and glass 150% greater than that of the wind farm."

Thomson identified Siemens Energy, A.G. as a premier play on the burgeoning growth in turbines, substations, hydrogen electrolyzers and other such essential energy-infrastructure items.

Our speaker advised the *Grant's* faithful to pay no heed to inherently backward-looking ESG scores. Besides, the "number and quality of green patents is roughly inversely correlated with ESG scores. Apple produces no innovations with meaningful environmental impact, but Exxon Mobil does."

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End of the optimal

What if inflation proves both transitory *and* problematic? In other words, volatile? At the *Grant's* event, building on his analysis in the March 5 issue of this

(Continued on page 8)

CREDIT CREATION •

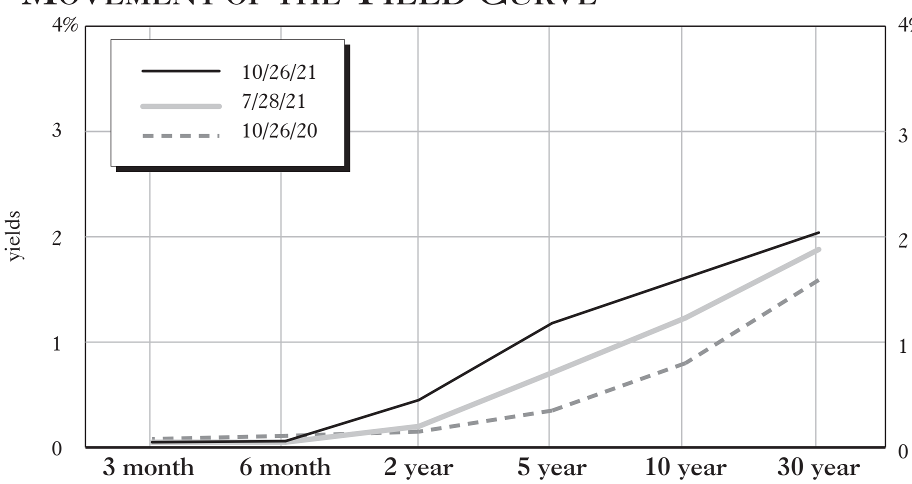
FEDERAL RESERVE BALANCE SHEET
(in millions of dollars)

	Oct. 20, 2021	Oct. 13, 2021	Oct. 21, 2020
The Fed buys and sells securities…			
Securities held outright	$8,038,175	$7,952,726	$6,533,450
Held under repurchase agreements	0	0	1,000
and lends…			
Borrowings—net	484	383	2,813
and expands or contracts its other assets…			
Maiden Lane, float and other assets	478,750	478,986	573,602
The grand total of all its assets is:			
Federal Reserve Bank credit	8,517,409	8,432,095	7,110,865
Foreign central banks also buy, or monetize, governments:			
Foreign central-bank holdings of Treasurys and agencies	$3,481,652	$3,482,919	$3,402,789

PEOPLE'S BANK OF CHINA BALANCE SHEET
(in billions of renminbi)

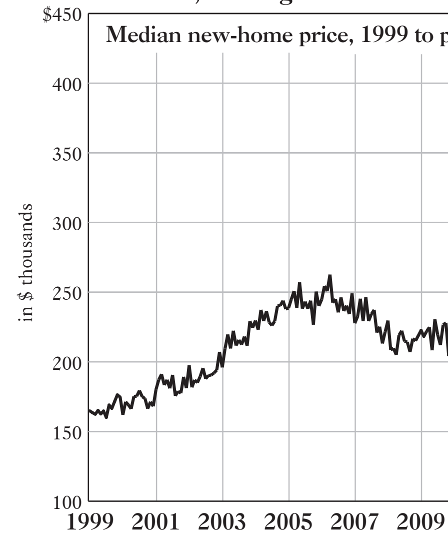
	Sept. 2021	Aug. 2021	Sept. 2020
Foreign exchange and other foreign assets	RMB 22,037	RMB 22,040	RMB 21,551
Gold	286	286	286
Claims on domestic economy	15,188	14,019	13,382
Other assets	1,689	1,607	1,290
Its assets total:	RMB 39,200	RMB 37,951	RMB 36,508

MOVEMENT OF THE YIELD CURVE



source: The Bloomberg

Too fast, too high?



source: The Bloomberg

Inflation c

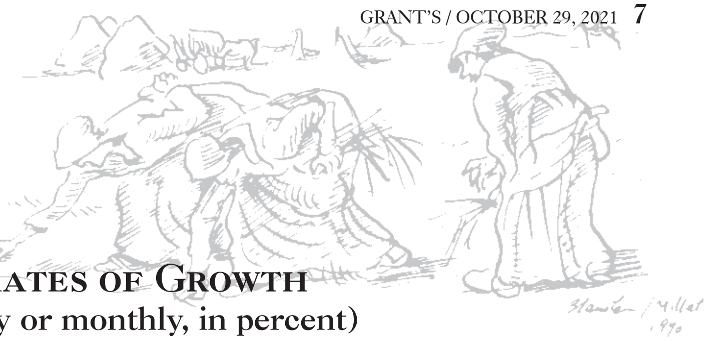
Evan Lorenz writes:

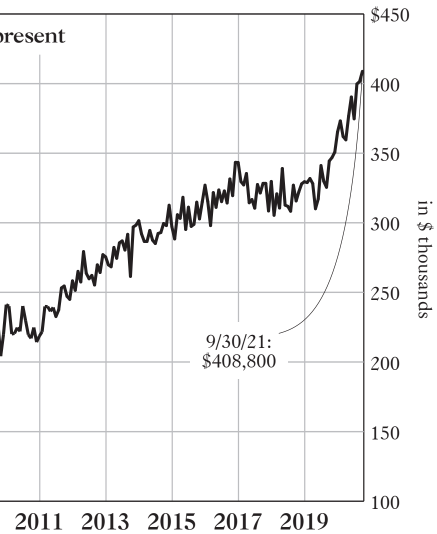
The U.S. housing market is still on the boil, with prices of newly completed units soaring 18.7% year over year to $408,800 in September. "[S]trong demand has continued through the first few weeks of October," PulteGroup, Inc. CEO Ryan Marshall advised on the Oct. 26 earnings call, adding that "our divisions continue to manage or outright restrict sales pace to better match sales with our current production."

As most purchases are financed, the cost to buy a home is a function of both price and interest rates. To take a stab at that cost, we assume that the typical household makes a 20% down payment and borrows the balance. So, in our model, down payments have increased by the aforementioned 18.7% to $81,760 from $68,880 last year. Since September 2020, the average 30-year mortgage rate has climbed to 3.27% from 3.08%. This would imply that the average monthly mortgage payment is up by *22%* year over year, to $1,427 from $1,174, compared to a 4.6% year-over-year rise in wages over the same period.

Of course, interest rates continue to creep up on the back of elevated inflation, and housing will fuel further rises in the consumer-price index next year even if home prices plateau (*Grant's*, July 9).

• Cause & Effect





omes home

Shelter makes up 32.6% of the CPI, and the surveys that the Bureau of Labor Statistics uses to gauge that housing component have lagged the recent frothy price action. Case in point: The August inflation report showed only a 3.2% year-over-year advance in shelter costs. Housing prices are unlikely to rest, at least to judge from PulteGroup's Tuesday call, which highlighted shortages in labor and in key supplies such as windows, appliances and paint in addition to the robust demand environment.

As a result, the Fed funds futures market has priced in two rate hikes next year. If we add 0.5% to our mortgage model, the average monthly cost to finance a home rises to $1,518, or 29% above the September 2020 level; if house prices leap by 10% with the same rate assumptions, the monthly cost would rise to $1,670, or 42% above the year-ago level.

At some point, buyers will get priced out of the market, which may lead to a correction. This will slow construction, drag down economic growth, as well as dent the results of private funds raised in recent quarters to buy single-family residential properties and publicly traded companies that flip homes, such as Zillow Group, Inc. and Opendoor Technologies, Inc.

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

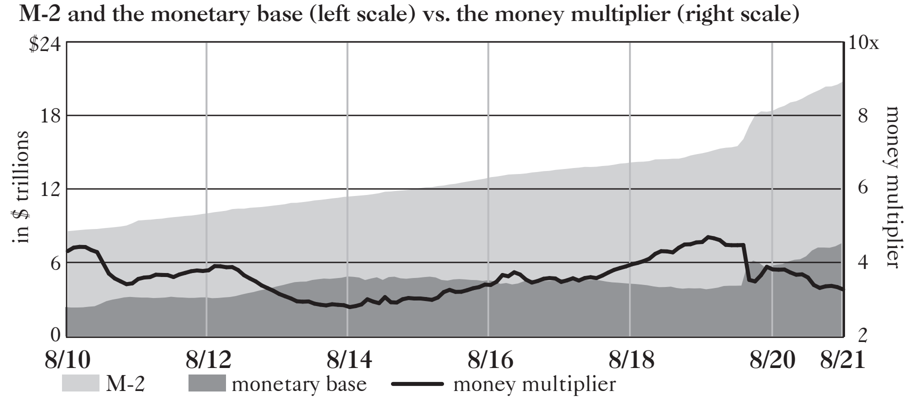
	3 months	6 months	12 months
Federal Reserve Bank credit	19.2%	20.7%	19.9%
Foreign central-bank holdings of gov'ts	-5.2	-4.1	2.1
People's Bank of China assets	2.2	4.9	4.6
Commercial and industrial loans (Sept.)	-8.6	-12.0	-12.0
Commercial bank credit (Sept.)	6.9	6.7	6.3
Asset-backed commercial paper	16.2	23.7	11.8
Currency	2.9	4.8	8.0
M-1 (Aug.)	10.5	14.5	16.5
M-2 (Aug.)	8.6	11.8	13.2

Reflation/Deflation Watch

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	15,509.41	15,278.10	14,710.06
Moody's Industrial Metals Index	3,169.25	2,955.64	1,978.68
Silver	$24.45	$23.35	$24.71
Oil	$83.76	$82.28	$40.64
Soybeans	$12.21	$12.18	$10.74
Rogers Int'l Commodity Index	3,263.05	3,263.97	2,037.01
Gold (London p.m. fix)	$1,808.25	$1,772.65	$1,900.95
CRB raw industrial spot index	645.49	649.56	472.10
ECRI Future Inflation Gauge	(Sept.) 122.6	(Aug.) 122.8	(Sept.) 94.3
Factory capacity utilization rate	(Sept.) 75.2	(Aug.) 76.2	(Sept.) 72.1
CUSIP requests	(Sept.) 2,495	(Sept.) 2,295	(Sept.) 2,495
Fed's reverse repo facility (billions)	1,403.02	1,462.30	0.0
Grant's SPAC Index*	101.99	104.67	104.50

*Index=100 as of 8/17/2020

Effectiveness of the Monetary Policy
M-2 and the monetary base (left scale) vs. the money multiplier (right scale)



(Continued from page 5)

publication, Henry Maxey, chief investment officer of Ruffer, LLP, made a persuasive case for that very outcome.

Central bankers assume that equilibrium is the place to which a pandemic-distorted, supply-shocked economy will come to rest once the human herd is immune. Actually not, Maxey contended, quoting Claudio Borio of the Bank for International Settlements (who had himself borrowed from the Swedish economist Knut Wicksell, 1851–1926). In today's "pure credit" economy, there is no such equilibrium.

"Financialization"—the "optimization of the economy around finance and asset prices"—is the fruit of American ZIRP and QE. "Leapfrogging industrial development" is the consequence of Chinese mercantilism.

In both countries, ultralow interest rates have made finance something grotesque. In China, banks sit atop $52 trillion in assets, more than twice what U.S. banks manage, while, in America, "the Fed now openly targets financial conditions, but most of the stimulus appears to get lost in transmission, trapped inside finance." (For proof, just look at the $1.4 trillion resting comfortably in the Fed's reverse repo facility.)

Not every dollar's trapped, however. America's new big-spending fiscal agenda complements the Fed's current $120 billion-a-month bond-buying program even as businesses reset their supply chains in the spirit of "just in case" rather than "just in time."

Bond bulls contend that the encumbered U.S. economy is inflation-proof. Certainly, Maxey acknowledged, the American financial architecture is inflation-intolerant. Only consider that investment-grade corporate-credit duration stands at an all-time high of 8.7 years and "modeled equity duration" at 55 years, second highest on record, behind only the 2000 frenzy.

Factor tiny interest rates and quiescent inflation into the so-called efficient frontier of investment assets, Maxey noted, and investors choose more risk for higher returns: "At a 5% risk-free rate, they allocate around 57% to risky assets; at a zero-percent rate, they allocate around 70% to risky assets." But higher and more volatile inflation negates the benefits of diversification—no "optimal portfolio" beat cash in the 1970s.

So what to do? A portfolio heavy in commodities, inflation-linked bonds, etc. could outrun the consumer-price index. "The problem is, inflation volatility could be with us for some time, and when inflation is on a downswing, your portfolio will follow on speed," Maxey noted. "What you need is a hedged fund.... You will need to be active. Sadly, no static, passive portfolio will do the job. You will need hedges. You might even have to pay for them. Sometimes you'll have lots of cash when the option value of cash is high. And avoid trying to optimize. It's a 'just-in-case' world now."

•

Your best ideas

"When you see something demonstrably superior rejected by 99% of people, it kind of looks like madness," proposed Bryan R. Lawrence, founder of Oakcliff Capital, L.P.

"Concentrated value investing," he says, is that superior something. It means "having the courage of your convictions to have even a single 5% position" and an annual portfolio turnover rate of less than 30%.

"One estimate," said Lawrence, himself a successful, 17-year practitioner of the concentrated value art, "is that just 1% of global publicly traded equities out there is managed using a concentrated value strategy—or about $800 billion. And, interestingly, of that $800 billion, about 40% is managed by Warren Buffett."

For this, our speaker blamed volatility—not the familiar VIX variety, but the kind you can derive by comparing 52-week highs with 52-week lows. So defined, for the S&P 500 and the Russell 2000 between 2000 and 2020, median volatility varied between 40% and 60%; it spiked to almost 200% in the high-stress moments of 2008 and 2020.

"Volatile share prices mean volatile returns to people," Lawrence pointed out. Clients become fearful and fire their managers. Managers become fearful and hug their indices. Robots replace overdiversified humans, management fees fall—and investment returns flatten.

Lawrence didn't leave the Plaza stage before getting down to brass tacks. Basic Fit, N.V., an operator of low-cost gyms in France, the Benelux countries and Spain, was his featured investment idea:

"Low-cost gyms turn out to be really great businesses. They fulfill a couple of needs. One of them is social: You are much more likely to meet a date for Saturday night on the bike next to yours at a Basic Fit than you are pedaling at home alone on a Peloton. Also, low-cost gyms turn out to be winner-take-most businesses. If you build out a chain of low-cost gyms across a city or a country, you build a barrier to entry that makes it very difficult for new entrants to enter. We see this in several countries. And once the winner is established, cash flows are dramatic."

Lawrence observed that "in the United States, the winner is Planet Fitness. It's up 500% in the past five years. We believe Basic Fit is the winner in much of Europe, and the stock is cheap due to lingering concerns over the pandemic's closing of gyms. We think it has €3 a share of earning power once the current gyms mature, which takes about 2½ years. And if they can build the gyms they say they can build, we think it is trading not at 10 times what we paid for it, but at a single-digit multiple out in the future."

•

Lobbyist Jay Powell?

Jerome Powell would not intrude himself into the Senate's business of confirming a presidential nominee for the Federal Reserve Board—the chairman said so himself, in July 2019, while responding to a question about the gold standard during a hearing at the House of Representatives. Before dismissing out of hand the efficacy of dollar convertibility into gold at a fixed price, Powell denied that his remarks were aimed at a particular Fed nominee—Judy Shelton being that unnamed party. "[O]f course," he said, "I would not do that."

The New York Sun, in an Oct. 3 editorial, cited phone calls between the Fed chairman and key senators in the days leading up to the Senate confirmation vote on Nov. 17. On stage at the Plaza, Shelton was asked for her view of the matter. Did the chairman press his thumb on the senatorial scales?

"Maybe my name didn't come up," Shelton allowed, concerning those publicly logged calls. "I'll assume it didn't, because it would be improper, as Chairman Powell has acknowledged.... So I assume I wasn't part of that conversation. But I did notice."

What Shelton and the *Sun* noticed was Powell's telephonic busyness in the days leading up to the dramatic vote. The day before, on Nov. 16, Sen. Lamar Alexander (R., Tenn.) announced that he opposed the candidate but would not be in Washington to vote—news that, as *The Washington Post* reported, put the confirmation vote "on knife's edge."

Phone records show that Powell called four senators on the 16th, including Mitt Romney (R., Utah), at 6:15 P.M., and two on the day of the vote itself. Shelton told the *Grant's* audience that the Romney call especially piqued her interest: "It was late. I never saw [Powell] make a call that late in the evening.... And I thought, did he catch him at work? How did he reach him, and what was so important?"

On Nov. 17, Sen. Charles Grassley (R., Iowa), a Shelton supporter, announced that he, too, would miss the vote because he was self-quarantining. Would Romney care to observe the senatorial courtesy of pairing his nay vote with Grassley's lost yea? The 2012 GOP presidential candidate would not oblige, and Shelton wound up on the losing side of a 49–48 tally.

"Had Romney done that for Grassley," said Shelton at the *Grant's* event, "it would have been a tie, and Vice President Pence would have broken the tie in my favor, something he assured me of a few hours later."

"[O]n Dec. 8," the *Sun* observed, "in a rare lunch at the Fed's headquarters, Mr. Powell's schedule notes, the chairman did sit down with a guest—the soon-to-be former Senator from Tennessee, Lamar Alexander."

•

Bad behavior pandemic

Mike Wilkins, professional short seller, asked the *Grant's* audience, "Has everybody given up?" He meant regulators, the press, central bankers, investors—everyone who has, or ought to have, a stake in honest markets.

Co-founder of Kingsford Capital Management, LLC, Wilkins cited enough fraud, deceit and skullduggery to answer his own question with a resounding "yes." Even so, he took care, as one must do, not to step over the line.

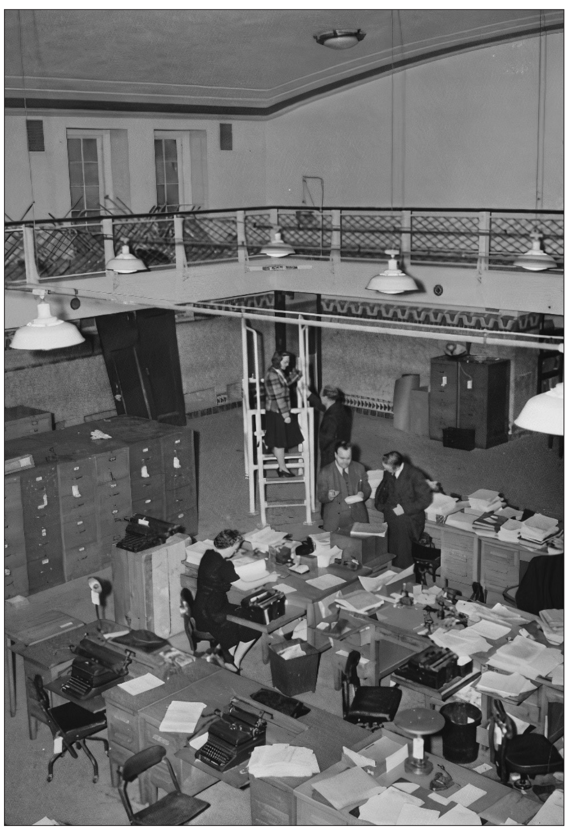
"Here's my disclaimer slide," he said. "[I]f you hear me use terms like crook, charlatan, racketeer—like weasel, bandit or goon—I do not mean them in their legal sense, but as good-natured ribbing. So if you know one of the people I'm about to mention, or if you are one of them, remember, these are for illustration only."

Wilkins, who has spent 26 years in the perilous business of selling high and buying low, focused on small biotech situations, but he had plenty to say, too, about regulation, or the lack of it. "I think the broken-windows theory of crime fits here," he said. "Broken-windows proposes that visible signs of petty crime lead to more substantial crime. So, make sure that you take care of the little things.

"Our regulators know that windows are being broken," Wilkins went on. "They just don't do anything about it. And I'll start with the Securities and Exchange Commission, the 'investors' advocate.' They're often scapegoated, and sometimes with good reason. They get to take Fridays off—I didn't know if you knew that, but they get to take Fridays off—and when Covid hit, they were the first federal agency that decided to work from home. They've never been seen as an important federal agency. In fact, during World War II, they were moved out of Washington altogether and literally housed at the bottom of a swimming pool in Philadelphia."

Even so, Wilkins dryly proceeded, the SEC is not entirely unaware, as witness the warning it issued in January during the meme-stock mania about the risks of mixing speculation with social media: "Of course, one of the risks is that they're not going to come bail you out. But after another month of insanity, the commission let you know that they 'proactively monitor for suspicious trading activity tied to stock promotions on social media.' They even took action and suspended some stocks. But all 15 stocks that they suspended were trading for pennies before the halt.

"Kingsford tried to remain optimistic," our short seller wound up. "The glass is one-sixth-full now. But there's an old saying—those who don't study history are condemned to repeat it. I'm here to tell you, so are those who do."



The SEC finds its level

(Courtesy of the New York World-Telegram and Sun Newspaper Photograph Collection, Library of Congress)

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Sic transit gloria

No, said Rob Arnott, founder and chairman of Research Affiliates, LLC, you have not missed the value-stock renaissance (it's in progress), and, no, mega-cap index funds are not the one-decision investments they're sometimes cracked up to be.

As to the second point, Arnott flashed a picture of the world's 10 largest companies by market cap, at intervals of 10 years, starting in 1980. "In 1980," he led off, "every last one of them was a U.S. stock. Half of them were energy stocks. That's the oil bubble. How many of these world-straddling colossi were still in the top 10, 10 years later? Two: IBM and Exxon.

"All right, that brings us to

1990. Eight of the 10 largest market-cap companies now are not in the United States. They're Japanese. Half of those are banks—the Japan bubble. How many are still on the list 10 years later? Two: NTT and Exxon Mobil."

On, then, to 2000, the height of the tech bubble: "Half of the names on the list are either tech or telecom. How many were still there 10 years later? Three: Microsoft, Walmart and Exxon."

Next up was 2010: "There's no bubble evident. There is broad industry diversification, broad geographical diversification, a very wide-ranging roster of names. Cool! That means there's going to be more survivors, right? Nope. Microsoft and Apple. That's it.

"Which brings us to today. Nine of the 10 largest market-cap companies on the planet can be viewed as tech stocks. I say 'can be viewed.' Amazon's categorized as a retailer. Tesla's categorized as an automaker. But their competitive advantage is tech. So, the most concentrated list in history: How many will still be on the list 10 years from now? If history is a guide, seven or eight of them will be gone from the list in 10 years; eight or nine of them will underperform. And those are your largest holdings if you're an index-fund investor, your largest holdings. So it's a cautionary note on the index craze."

As to the value-versus-growth debate, Arnott pointed out that, by the admittedly imperfect measure of price-to-book value, growth stocks are more expensive in relation to value stocks than they were in the sock-puppet era of 2000 (11 times versus 10 times).

"We know the aftermath," our speaker concluded. "Value came roaring back after the tech bubble. Value beat growth by well over 100 percentage points over the subsequent seven years." He said it's on its way to roaring back again.

•

What's old is cheap

James Rasteh, founding partner of Coast Capital, LLC, sang the praises of European investments in general and of FirstGroup plc, the second-largest public transport company in the Western world, in particular.

Not since the 1792 founding of the New York Stock Exchange have U.S. companies traded at a greater premium to their European counterparts than they do today, our speaker said. If 28–30 times earnings is the valuation norm in America, 16 times is standard in Europe.

"A lot of people think that's because the United States has a greater proportion of rapidly growing companies and tech companies," Rasteh went on. "But that just isn't true. If you adjust for industrial exposure, you find that European industries still trade at a minimum of a 20% discount to their U.S. counterparts.

"Minority investors across much of Europe," Rasteh continued, "have much greater rights afforded to them than they do here in the United States, where we have poison pills and staggered boards. We just don't have that in Europe. And very often, it's easier, and you need a smaller portion of the outstanding shares of a company to call an [extraordinary general meeting]. So it happens to be a great place for an event-driven and, on occasion, active fund like ours to invest in.

"And here are some other interesting things about Europe," our speaker proceeded. "Since 1996, when I began my career, the number of publicly listed companies in the United States has declined by almost 50%. So the universe of investable companies is much less rich than it was back then. In Europe, however, the universe of investable companies has expanded by 43%."

Regulatory overreach, too, redounds to the investor's benefit in Europe, Rasteh proposed. MiFID II, the set of rules intended to purify investment research by "unbundling" it from brokerage services, has rather purified it by making it scarce. "So, the average company in Europe currently has less than half the number of analysts covering it than the average company does here in the States. Clearly, a much less efficient set of markets to invest into, which for us is really great.

"And," Rasteh added, "it's important to note that private equity has really wised up to this. The amount of private equity capital, as a percentage of European publicly listed market cap, is notably greater—to the tune of 25%—than it is here in the United States. And the average premium that we've seen in deals, particularly in the U.K., is about 47%."

•

Everyman's rate hedge

Harley Bassman, a top Wall Street bond quant who came out of retirement to help individual investors hedge against the risk of rising interest rates, opened with a bang.

"The Fed," he declared, "recognized that there are only two ways out of a debt crisis—either default or inflate, with the caveat that inflation is simply a slow-motion default."

Clicker in hand, Bassman turned to the glories, costs and consequences of lawn-level interest rates. They've lifted the stock market, especially the half-dozen famous super-growth tech issues, tranquilized the bond market and, following 2008, engorged the top 1% of the American people with envy-inducing wealth. Not in every credit cycle do inflation-adjusted junk bond yields plunge below zero, Bassman added, but they've done it in this cycle—a post-1947 first.

"What's the wrong price?" Bassman rhetorically asked, and he gingerly suggested that a 1.6% yield on the 10-year Treasury in a time of 5%-plus measured consumer-price inflation might be ill-considered. Certainly, a reversal of the 40-year bull bond market would be inexpedient for anyone planning to retire on a conventional 60-40 stock-bond portfolio.

"I'm not saying [interest rates] will go up," Bassman, managing partner of Simplify Asset Management, Inc., told the *Grant's* audience, "although I think they will. But I'm not saying that. I'm saying, if they do, we have a problem. I want insurance on that. Can I buy a really cheap insurance policy on that?"

"Yes," was the answer.

"What we did," Bassman went on, "was we created an ETF that is called PFIX. It is listed and trades right now. We took $25 of a 5-year Treasury, and the rest is in a 7-year option on the 20-year rate. And that's it. There's no management. There's no adjustment. You can model it on Bloomberg. It's just that simple.

"And if new money comes in, like today, I'll go and buy a 4½-year Treasury and I'll buy a 6½-year option. As rates move higher, it goes up. As rates go down, it goes down in price."

PFIX, which came public at $50—"basically, the top of the market"—changed hands at $42 as

Seabridge excels

source: The Bloomberg

Bassman spoke. "We issued it on the day of the CPI in May. *Ay yai yai*, it was bad timing."

Which, however, for anyone in need of a hedge, is not now the point. "How I weight this," Bassman proceeded, "is, if you've got a million dollars of interest rate risk, you buy $50,000 of this product—not shares, the product."

So $1 million of face value of the AT&T 6.30s of 2038, for instance, quoted at 136, could be hedged with $75,000 of PFIX shares. "It costs like 43 basis points to carry this hedge. It's nothing."

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Exception to the rule

You buy gold stocks expecting a premium return to the metal itself, said Rudi P. Fronk, co-founder and CEO of Seabridge Gold, Inc., but shares of the companies whose managements seem unable to allocate capital or replace the reserves they dig up from the earth have mainly failed to match—have mainly not come close to matching—the 500% gain in the bullion price since 2000.

Fronk took a swipe at big Barrick Gold Corp. ("best assets + best people = best returns," its website boasts), whose share price is quoted today at just about where it was in 2000, and the little, equity-hungry junior miners alike. "Serial diluters," he called the latter, "issuing share after share after share without offsetting that dilution with accretion of value." Nor are the majors, in the matter of dilution, much better.

"The lifeblood of the gold industry are the reserves that we have in the ground," Fronk went on. "The share price of a company is theoretically based on the discounted cash flow of what future operations will bring from mining those reserves, less corporate G&A, less capex spent on projects, less exploration dollars divided by the number of shares outstanding." Since 2007, Barrick's reserves have fallen by 46%, Newmont's by 28%. Newcrest Mining Ltd. and Agnico Eagle Mines Ltd., noted Fronk, are successful outliers in the reserve replacement department.

And there is another shining exception, he did not forget to mention. Seabridge itself is that anomaly, whose share price has leapt by more than 7,500% since October 1999, whose gold reserves per common share rank tops among North American–listed gold producers and whose CEO—our speaker himself—has committed 95% of his family's wealth to the company he leads.

Fronk put in a bullish word, too, for NovaGold Resources, Inc. (lots of reserves and a low share count) and for John Hathaway's Sprott Gold Fund, formerly called Tocqueville (Seabridge constitutes 0.65% of its portfolio).

"Finally," said Fronk, "I would totally stay away from gold ETFs." Seabridge happens to be a component stock of the GDXJ, and was formerly a constituent of the GDX. "I can tell you firsthand that whoever's managing those ETFs never speaks to management or does any due diligence on what they own.

"And then," he continued, "if you're running a company that does well in the marketplace, and your shares outperform others in the index, on the next rebalancing you will get sold down, because you're too big of a component in the index. And what they'll do is take the proceeds from selling their winners down and buy more of their losers. If that's not a recipe for destroying value, I don't know what is."

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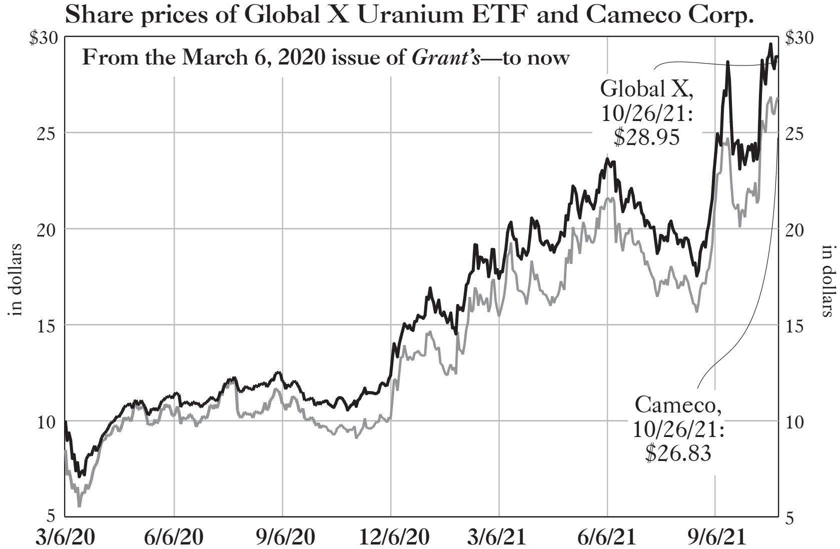
We said it. Did you read it?

Just because nuclear power leaves no carbon footprint doesn't mean it can hitch a ride on the ESG rocketship. On the contrary, the share price of Cameco Corp., the world's No. 2 uranium miner, can't even keep up with Treasury bills, let alone the S&P 500 and still less with the ESG-box-ticker Ormat Technologies, Inc.... Following is a reaffirmation of the bullish case for uranium in general and Cameco in particular, along with a few kind words for Uranium Participation Corp. (URPTF in the pink sheets), which buys and holds uranium itself, and Global X Uranium ETF, an investor in uranium miners and manufacturers of nuclear components (URA on the NYSE Arca).

—"Enrichment potential," *Grant's*, Vol. 38, No. 5 (March 6, 2020)

Share prices of Global X Uranium ETF and Cameco Corp.



source: The Bloomberg

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Inflation comes home

Evan Lorenz writes:

The U.S. housing market is still on the boil, with prices of newly completed units soaring 18.7% year over year to $408,800 in September. "[S]trong demand has continued through the first few weeks of October," PulteGroup, Inc. CEO Ryan Marshall advised on the Oct. 26 earnings call, adding that "our divisions continue to manage or outright restrict sales pace to better match sales with our current production."

As most purchases are financed, the cost to buy a home is a function of both price and interest rates. To take a stab at that cost, we assume that the typical household makes a 20% down payment and borrows the balance. So, in our model, down payments have increased by the aforementioned 18.7% to $81,760 from $68,880 last year. Since September 2020, the average 30-year mortgage rate has climbed to 3.27% from 3.08%. This would imply that the average monthly mortgage payment is up by 22% year over year, to $1,427 from $1,174, compared to a 4.6% year-over-year rise in wages over the same period.

Of course, interest rates continue to creep up on the back of elevated inflation, and housing will fuel further rises in the consumer-price index next year even if home prices plateau (*Grant's*, July 9). Shelter makes up 32.6% of the CPI, and the surveys that the Bureau of Labor Statistics uses to gauge that housing component have lagged the recent frothy price action. Case in point: The August inflation report showed only a 3.2% year-over-year advance in shelter costs. Housing prices are unlikely to rest, at least to judge from PulteGroup's Tuesday call, which highlighted shortages in labor and in key supplies such as windows, appliances and paint in addition to the robust demand environment.

As a result, the Fed funds futures market has priced in two rate hikes next year. If we add 0.5% to our mortgage model, the average monthly cost to finance a home rises to $1,518, or 29% above the September 2020 level; if house prices leap by 10% with the same rate assumptions, the monthly cost would rise to $1,670, or 42% above the year-ago level.

At some point, buyers will get priced out of the market, which may lead to a correction. This will slow construction, drag down economic growth, as well as dent the results of private funds raised in recent quarters to buy single-family residential properties and publicly traded companies that flip homes, such as Zillow Group, Inc. and Opendoor Technologies, Inc.

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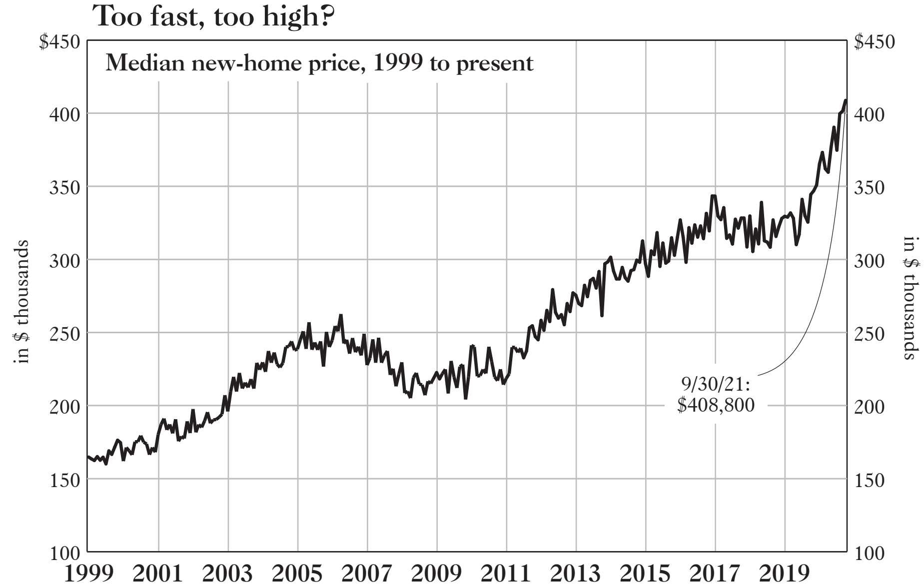
Too fast, too high?



source: The Bloomberg