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Into the federal vortex

Lost in the welter of news about bank runs and the plans to allay them is the looming insolvency—to be sure, a technical, hypothetical insolvency—of the Federal Reserve. At the current rate of operating loss, the Fed will be fresh out of capital by April Fools' Day (thank you, Alex J. Pollock). Earning an average of 2.1% on its loans and securities while paying in excess of 4.5% to its depositors and reverse-repo counterparties, the central bank could hardly not go broke, if the law allowed it. But symbolism is above the law, and the Fed's ramshackle financial position is the mirror to the breakdown of the Ph.D. standard of monetary management.

In this social democracy, money wants to be easy and credit profuse. Dollars may not vote, but the people who hold them have expressed themselves in not one election cycle but over the long sweep of years. Accommodating the popular will, the institutions of money and credit have adapted in ways to promote unstable prices, illiquid banks and erratic financial judgments. In declaring that the only progress in banking he could identify was the invention of the automatic teller machine, Paul Volcker was saying that financial evolution works in reverse.

So it's everybody's fault, including your grandparents', that the failure of a handful of regional banks is forcing a pivot in monetary policy from not quite tight (see the prior issue of *Grant's*) to what is beginning to look like accommodation again. The about-face is all the more striking because, with the unveiling of the Bank Term Funding Program, the Fed is bailing out its previous bailout. It's lending against the par value of bonds and mortgages that don't trade near par. They don't trade near par because their too-high prices were eviscerated in 2022. Their too-high prices were eviscerated because of the inflation that the central bankers helped to foment and, indeed, fan. Thus, one intervention begets another.

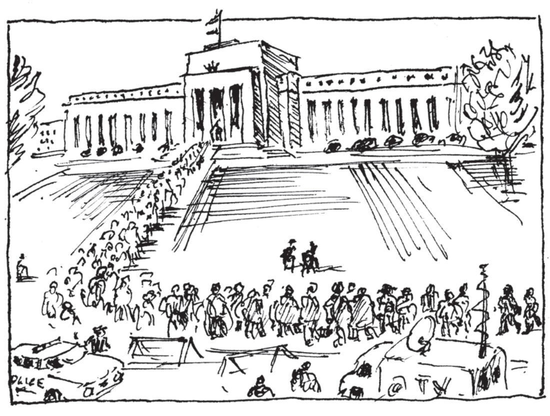
It speaks multilingual volumes about the fragility of the world's banking arrangements that the Swiss National Bank, which posted a $143 billion loss in 2022, felt it necessary to facilitate the acquisition of Credit Suisse Group AG, which last year suffered a mere $7.9 billion loss, by UBS Group AG, a tie-up so urgently imperative that the relevant banking regulators dispensed with the customary nicety of seeking the permission of the respective shareholders.

It's the clustering of these monetary- and interest rate–related pileups (we skip over, for now, the looming troubles in the dysfunctional Japanese bond market) that points to a universal monetary design error. Or, perhaps, not an error but the long succession of choices by ourselves and generations preceding. And what we, the people have chosen, is "to rest the value of money on political authority." The memorable quoted words are those of Bray Hammond, author of *Banks and Politics in America from the Revolution to the Civil War* (1957). Hammond here refers to the United States, but just about every member state of the United Nations has arrived at the same monetary destination.

Having chosen the paper fork in the road, citizens and their governments have lived with the consequences, including the pleasant ones, such as sweet bull markets, foreshortened business-cycle downturns and a normally positively-sloped yield curve. There are adverse consequences, too, including a propensity for inflation (of consumer prices, asset prices or both), heavy central bank regulation, intermittent financial repression (especially of interest rates), monetary nationalism, financial fragility, the socialization of credit risk and the heavy accumulation of sovereign debt.

A prerequisite to a system in which the value of money rests on political authority is that the value of the paper dollar must float. It must be undefined and uncollateralized, secured by nothing but the good intentions of the issuing government. Unfixed exchange rates are, indeed, the sine qua non of a paper-money regime. They afford the central bank maximum discretion to set interest rates and create credit through which to serve a purely domestic policy agenda.

In contrast, a system in which the value of money rests on the fixed



Anxious Federal Reserve depositors queue up to withdraw their funds.

(Continued from page 1)

value of precious metals constrains the central bankers, whose agenda cannot be purely domestic, because the free movement of money across national boundaries is at the heart of the regime. The domestic economy adjusts to the money, rather than the money to the domestic economy. Interestingly, before the institution of the Fed in 1913, interest rate volatility tended to express itself in money-market rates rather than bond yields. The yield curve was routinely inverted, which advantaged long-term investment over short-term speculation.

A 2012 survey of leading economists at a handful of top universities by the University of Chicago Booth School of Business found that exactly none of the respondents agreed with the proposition that a dollar defined as a weight of gold would serve the economic interests of the average American better than the discretionary monetary-policy regime currently in place. We might add that, under the gold standard, central banks employed few, if any, economists.

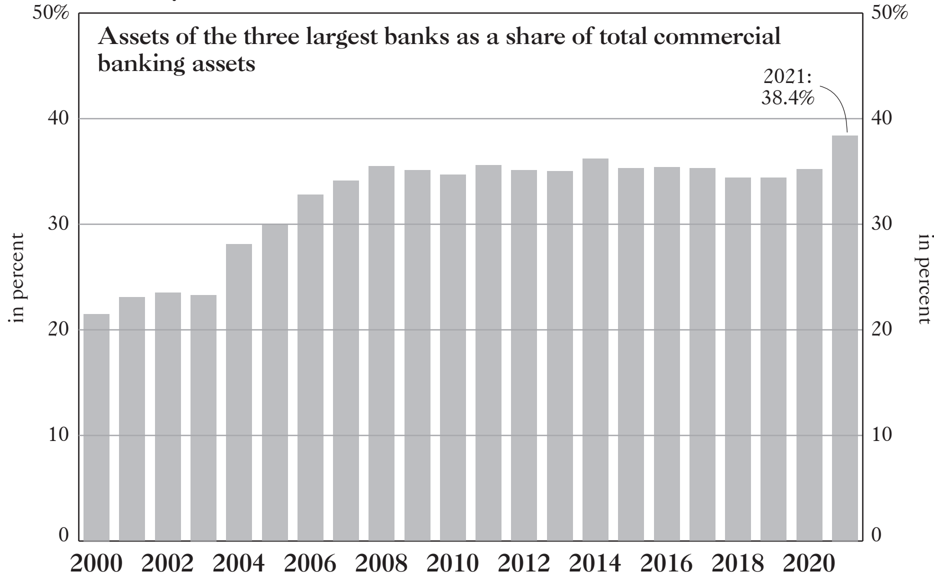
As we go to press, Treasury Secretary Janet Yellen is promising to intervene to support smaller banks if necessary while declaring that the banking system is hale and hearty. The source of the non sequitur is the reverse-evolutionary movement of money and banking over the past two centuries and, especially, since the 1930s.

No need to recite the timeline when a few short examples will tell the tale.

For starters, the capitalization of the Bank of New York at its founding in 1791: Leverage was capped at three times the paid-in capital, which capital was paid in gold and silver. So, a ratio of capital to liabilities of 33%. Silicon Valley Bank showed a year-end 2022 ratio of equity to liabilities of 7.5%.

A second example concerns the original, best-remembered but long-forgotten understanding of the nature of banking assets, the proper role of bank credit and the distinction between capital and credit. "Bank paper is not capital but credit," according to an unnamed authority in Kentucky around 1837. "Bank paper, being credit, the purity of which depends upon its always being met upon demand, is from its nature designed to circulate and exchange the annual and marketable products of industry; and is therefore an unfit subject for long loans and permanent investments." No mention here of inherently illiquid loans secured by venture capital startups or residential real estate mortgages.

'Our system of credit is concentrated'



source: The World Bank

Our third example addresses the ticklish question of who bears the cost of failure, human frailty (and the precarious design of fractional reserve banking) assuring that there will be failures, no matter the monetary system in place. In the absence of federal deposit insurance, a New Deal innovation, it was the owners of bank shares who got a capital call if the nationally chartered institution in which they held a fractional interest became impaired or insolvent. "Double liability" was the name of this legal structure, and a 2021 scholarly appraisal of its record, posted on the website of the Office of the Comptroller of the Currency, gives it high marks.

"The available data on OCC receiverships from 1865 to 1937," write Roger Tufts and Graham Tufts, "certainly indicate that double liability assessment played an important part in mitigating the losses borne by depositors and in the voluntary liquidation of still-solvent banks. Though Sen. Sherman overstated the case, when, in debating the 1864 amendments, he asserted that a double liability regime 'will make it ample beyond all danger,' his unrealized optimism only partially detracts from the overall positive evaluation of the policy in lessening depositor losses."

The double-liability approach met its match with the Federal Deposit Insurance Corp., the doctrine that some banks are too big to fail and the contemporary trial balloon that even small banks must not be allowed to succumb to their depositors' panic or their management's errors. We wonder how differently the equity-holding senior managements of Silicon Valley Bank and First Republic Bank might have steered their institutions in the knowledge that, if all went pear-shaped, they had more to lose than the value of their stock options.

In his successful campaign for the presidency in 1912, Woodrow Wilson denounced the concentration of private banking assets and pledged to bust the so-called Money Trust. "The great monopoly in this country is the money monopoly," said candidate Wilson. "So long as that exists, our old variety and freedom and individual energy of development are out of the question. A great industrial nation is controlled by its system of credit. Our system of credit is concentrated."

Wilson meant the likes of J.P. Morgan & Co.; First National Bank of New York; National City Bank of New York (the latter two now consolidated under the Citigroup banner); Lee, Higginson & Co. of Boston and New York; Kidder, Peabody & Co. (which vanished into the maw of General Electric) and Kuhn, Loeb & Co. (devoured by Lehman Brothers). A century plus 11 years later, American private banking assets are arguably just as concentrated, even cartelized, while uninsured depositors, fleeing small- and medium-size institutions, are contributing to further concentration and cartelization by abandoning banks altogether for the undoubted safety of government-only money funds, which face, as their counterparty, the Federal Reserve. They bring their cash to the Fed or to an agent of the Fed; and the Fed or that agent sells them (for 24 hours only) its bills and notes at the aforementioned yield of 4½% or better. In at par, out at par, with no credit risk: How could any saver, any corporate chief financial officer, refuse that value proposition now?

Only last month, the Bank for International Settlements, the central banks' own Swiss bank, issued a monograph intended to lay to rest concerns over the splashes of red ink on the income statements of its leading affiliates (including the central banks of Australia, Belgium, England, Japan, the Netherlands, New Zealand, Sweden and the United States). "Why are central banks reporting losses?" posed the title page: "Does it matter?"

As the "why" question answers itself, it's on to the second question. Echoing previous analyses of the Brookings Institution and the Fed itself, the BIS holds that "the usual concept of solvency does not apply." Taking a narrow view of the question, one can hardly argue. For the past dozen years, the Treasury has indemnified the Federal Reserve against operating loss.

For any who care to track the figures at home, simply dial up the Fed's weekly balance sheet, the form H.4.1, issued on Thursdays at 4:30 P.M. Eastern time. Now, cast your eyes on the bottom line, labeled "Other liabilities and accrued dividends," which is where the Fed journals its losses to the Treasury. As of March 15, this item showed negative $34.4 billion, compared with negative $30.5 billion one week before. If you net this against the Fed's $42.5 billion in total capital, our central bank shows capital of just $8.1 billion. To put that $8.1 billion into perspective, the Fed showed assets, recently swollen by the new Bank Term Funding Program, of more than $8.6 trillion. On a mark, therefore, the central bank of the United States, as of March 15, 2023, was leveraged 1,068:1.

It doesn't matter, according to the BIS, since a central bank "can, in principle, issue more currency to meet domestic currency obligations, and face no regulatory capital minimum precisely because of their unique purpose." And for the same reasons, these charmed institutions can "successfully operate without capital and withstand extended periods of losses and negative equity."

"Central banks are public institutions," the apologia closes, "but there is broad consensus on the need for their independence to pursue price and financial stability mandates without interference from governments, whose priorities can conflict with these mandates."

Just how independent of the Treasury is the Fed, and the Fed of the Treasury, is for the reader to decide. (Reader G.M. Rouzee asks, "Any chance the Justice Dept. will investigate the merger of the Fed and the Treasury?") It's the Treasury that plugs the Fed's operating losses. And it's the Fed that, in service to the Treasury, is lending the FDIC the funds it needs to meet the failures of Silicon Valley Bank and Signature Bank. Except for the Fed's intercession, observes Paul H. Kupiec, senior fellow at the American Enterprise Institute, in the March 20 issue of *The Hill*, the Treasury would have had to do the borrowing in the market, on the government's books and with the attendant risk of crashing the federal debt ceiling.

The world's experience with gold and silver can be measured in millennia, but that with the money that "rests on political authority" in less than a century. The technical, hypothetical insolvency of the Federal Reserve is a warning against complacency.

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So, we were early

From the July 11, 2014 edition of *Grant's*, concerning those combustible AT1 securities now in the news:

> CoCos, indeed, pose potential risks to the whole world of leveraged finance, we think. Conversions or write-downs, when they're finally forced, won't take place under wraps. The news will start a highly focused reassessment of the creditworthiness of the stricken CoCo issuer or issuers.
>
> Providers of short-dated liabilities—certificates of deposit, uninsured deposits, commercial paper—are likely to arrive at the same conclusion more or less simultaneously. They may reason: "As long as we're earning nothing in this zero-percent world, let's earn that zero where we stand a better chance of recovering our principal than we can from this bank, or these banks, with the contingent convertible bonds that have suddenly turned into equity."

Or, we might have added, something even less than equity.

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Zero-days option

On the other hand, what's wrong with being early? The risk of missing out on the next levitation in stocks and bonds is front of mind for a brace of bold-faced names on Wall Street, Bloomberg reported on Tuesday. The likes of Franklin Templeton, Invesco and JPMorgan Asset Management are preparing for a return to a "higher for longer" asset-price regime, anticipating that a dovish central bank pivot will spell bullish tidings for such Covid-era winners as technology stocks, long-duration bonds and private credit.

Time is of the essence, when the worm turns: "If you miss the start of the rally, you miss the bulk of the returns," Wylie Tollette, chief investment officer of Franklin Templeton Investment Solutions, told Bloomberg. "It's very difficult to catch up if you miss the first week or two. Sometimes it's just days."

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Apathy in a panic

Running for their money as if for their lives, frightened depositors passed a small cohort of ambling pedestrians. These are the gold bugs, who, alone among the participants in the current monetary footrace, seem not to have broken a sweat.

Indifference to the first derivative of the world's legacy monetary asset either marks a large shift in generational preference or a commanding investment opportunity. While not absolutely ruling out the former possibility, *Grant's* favors the latter. This publication is—or, more accurately, remains—bullish on gold and gold-mining equities, including Agnico Eagle Mines Ltd. and Equinox Gold Corp. (AEM and EQX, respectively; both on the Big Board) and the Sprott Gold Equity Fund and First Eagle Gold Fund.

source: The Bloomberg

Gold, say we, is not so much an inflation hedge as an investment in monetary disorder. The rising CPI itself has proven a paradoxically mixed blessing. Yes, inflation is monetary disorder writ large, but it's a type of disorder that was accompanied by a strong dollar-exchange rate, rising interest rates and, for the gold miners, rising production costs. Bank runs, a weakening dollar-exchange rate and tumbling nominal yields go far to explaining the metal's almost (as we type) $2,000-per-ounce price.

As usual, someone does buy the stuff. Gold offtake jumped to 4,741 metric tons (or "tonnes") last year, an 18% increase over 2021, according to the World Gold Council, nearly matching the 2011 record demand. Central bank purchases reached 1,136 tonnes, the highest on record going back to at least 1950. Turkey and the People's Republic of China paced the buying.

Even so, gold-mine equities have barely responded, as the ratio of the price of gold to the Philadelphia Gold and Silver Index sits at 0.06, one-third the post-1983 average and just 0.02 above the post-2015 record low.

John Hathaway, managing partner at Sprott, Inc., tells colleague James Robertson, Jr. that the industry trades at an enterprise value to forward Ebitda multiple of six to seven times, also near the recent low. At that, says Hathaway, it's a conservative estimate based on stale gold prices. If a sustained period of $2,000 gold is in the cards, "which I don't believe is a crazy thought," he goes on, "there's a huge amount of leverage in just about every name you can think of."

The miners and streamers themselves, at least, are paying attention. Triple Flag Precious Metals Corp., for instance, completed its takeover of Maverix Metals, Inc. in January (*Grant's* Nov. 25, 2022), paying 1.1 times net asset value, while, just last month, B2Gold Corp. agreed to buy Sabina Gold & Silver Corp. at a ratio of price to net asset value of 0.5, and Newmont Corp. has bid $17 billion for its former Australian subsidiary, Newcrest Mining Ltd.

The trouble with inflation is that the miners, too, are susceptible to it. As the costs of energy, chemicals and, most crucially, labor have soared, margins have reciprocally compressed, though relief may be in store. "The interesting thing that happened in the second half of the year going from Q3 to Q4," Greg Smith, CEO of Equinox, told conference-call listeners on Feb. 22, "is we actually did not see much by way of cost increases. In fact, cost stayed overall relatively flat.... It looks like costs have peaked sometime in Q3."

. . .

In 1957, Agnico Eagle christened itself Ag-Ni-Co, a mashup of the periodic table's designations for silver, nickel and cobalt, though Au alone would suffice today. AEM stands as both the world's third-largest investor-owned gold producer—many regard it as best-in-class among the majors—and an exemplar of the low estate of mining equities. As to the share price, suffice it to say that, since the January high, the gold price has gone up by 2% and AEM has declined by 12%, the latter being a direct result of a 5.6% rise in the company's all-in-sustaining costs, to $1,090 an ounce, in 2022.

Growth is the Agnico watchword. A player in the M&A wave, the company completed its merger with Kirkland Lake, Inc. last year, adding the largest Canadian gold mine, Detour Lake (*Grant's*, June 29, 2018), and Fosterville, the biggest gold mine in the Australian state of Victoria, to its portfolio in an all-stock deal.

On Nov. 4, 2022, Agnico, in partnership with Pan American Silver Corp., launched a successful bid for Yamana Gold, Inc. at an all-in valuation of $4.8 billion, a 23% premium over the prior day's closing Yamana share price. Agnico will pay $1 billion in cash and $1.5 billion in stock for Yamana's Canadian assets. Pan American will pay $2.3 billion in stock for Yamana's remaining mines, which are situated in Latin America. Agnico is set to receive exploration properties and full ownership of the Malartic mine, in Quebec, which produces 700,000-plus ounces a year and of which Agnico had previously owned half. The transaction is expected to close this month.

All but two of Agnico Eagle's mines are grounded in North America, and neither of these exceptions, in Finland and Australia, would seem to present inordinate political risk. However, as Thomas Kertsos, portfolio manager of First Eagle Gold Fund, tells Robertson, that's not to say they're riskless.

In Finland, regulators first approved an expansion permit for the Kittilä mine, then (by Agnico's telling) thought better of it, reducing production to 1.6 million tonnes from an expected 2 million tonnes until a higher Finnish court examines the case later this year. In Australia, regulatory authorities ordered a 25% cut in production in Agnico's Fosterville mine on account of "noisy" ventilation, even though, as Fred Hickey, of *High-Tech Strategist* fame, points out, the fans emit noise at a frequency below the level of human hearing. Perhaps some dingoes filed a complaint.

Despite those political speed bumps,

Snapshot of indifference

source: The Bloomberg

Agnico Eagle "is the one major gold miner that's proven to be a consistent grower (in basically a non-growth group)," Hickey relates by email. "No. 1 Newmont has been stuck for some time around 6 million ounces of gold a year and No. 2 Barrick's 2022 production sunk to a 22-year low (note that I own all three of those stocks)."

With full ownership of the Malartic property, Agnico will have two mines projected to produce more than 700,000 ounces per annum until 2040. Yamana's Canadian assets are within spitting range of the five mines Agnico already operates in Quebec, including Detour Lake.

Agnico's gold production rose to 3.13 million ounces in 2022 from 2.1 million ounces in 2021 with the added production from Yamana's assets yet to come. The company's gold mineral reserves increased 9% to 48.7 million ounces last year and are expected to rise further when the Yamana acquisition closes.

Agnico has cut its debt by more than half, to $649 million from $1.5 billion at the start of 2020, putting its ratio of net debt to Ebitda at 0.29. And unlike Barrick Gold Corp. or Newmont, Agnico did not reduce its dividend last quarter, delivering a 3.2% yield for its shareholders. The shares trade at 9.5 times trailing 12-month Ebitda and at 1.1 times net asset value.

On Feb. 22, after reporting earnings, Agnico CEO Ammar Al-Joundi bought 8,200 shares at an average price of $62.17. Over the past six months, insiders have been net buyers of 56,267 shares. Analysts on Wall Street and Bay Street are likewise bullish with 15 buy recommendations, one hold and zero sells.

...

For investors looking for a bit more leverage on the gold trade, there are mid-cap producers in the bargain bin. Equinox, for instance, operates seven mines in North America and Brazil. The stock has traded down 47% in the last 12 months and sells for 5.5 times trailing Ebitda and 0.68 times NAV.

Equinox is a mid-cap miner with a big backlog of organic expansions that would rank it foremost among intermediate producers if development proceeds as planned—rarely a given in the mining business. The company drew 532,319 ounces of gold from the ground last year at an all-in sustaining cost of $1,622 per ounce. Projected to produce an additional 400,000 ounces a year, the Greenstone mine in Ontario, Canada, is 70% complete and largely on budget, according to management.

Equinox shares Agnico's problems, but in spades. Its costs are higher, its political landscape riskier and its production delays more prevalent. Just last year, nearly every mine met some trouble that reduced output—too much rain, a strike at an explosives supplier, permitting delays, production ramping-up more slowly than expected, leaching issues. Altogether, production missed guidance by 20%.

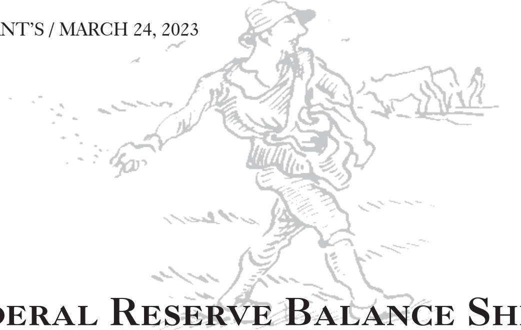
Will Thomson, managing partner and portfolio manager of Massif Capital, LLC, who owns a position in Equinox, says he doesn't fault management for last year's string of operational mishaps, but rather blames the vicissitudes of the mining industry.

"You've got a fantastic management team," Thomson sums up the case for Equinox, "and great ownership with plenty of experience and background in building mines. And over the next couple of years as they turn on Greenstone and they finish up some additional

(Continued on page 8)

Cream of the miner crop

source: The Bloomberg



Credit Creation

Federal Reserve Balance Sheet
(in millions of dollars)

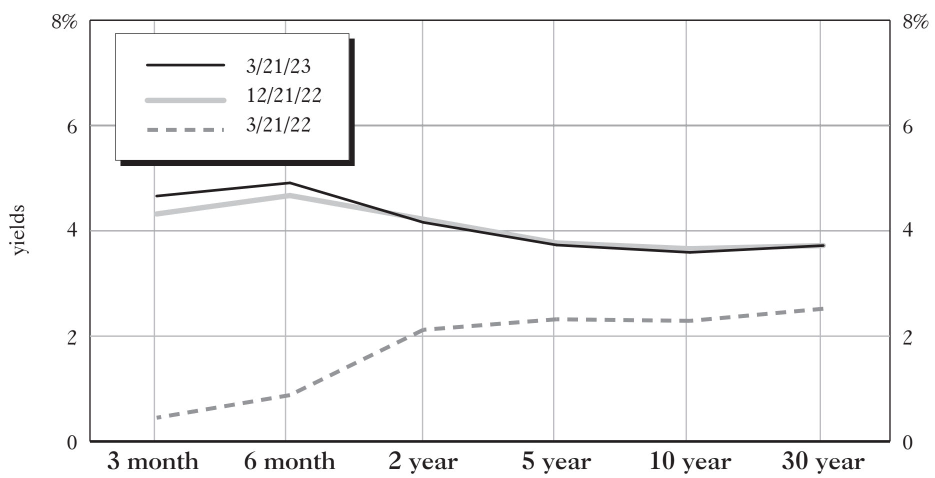
	March 15, 2023	March 8, 2023	March 16, 2022
The Fed buys and sells securities…			
Securities held outright	$7,947,058	$7,948,213	$8,468,693
Held under repurchase agreements	32	2	0
and lends…			
Borrowings—net	84,960	4,435	2,442
and expands or contracts its other assets…			
Maiden Lane, float and other assets	414,942	352,199	424,334
The grand total of all its assets is:			
Federal Reserve Bank credit	8,446,992	8,304,849	8,895,469
Foreign central banks also buy, or monetize, governments:			
Foreign central-bank holdings of Treasurys and agencies	$3,362,175	$3,360,015	$3,434,801

European Central Bank Balance Sheet*
(in millions of euros)

	March 17, 2023	Feb. 17, 2023	March 18, 2022
Gold	€592,983	€593,004	€559,476
Cash and securities	5,705,825	5,710,188	5,626,848
Loans	1,221,927	1,258,778	2,201,272
Other assets	311,124	311,612	312,440
Total assets:	€7,831,859	€7,873,582	€8,700,036

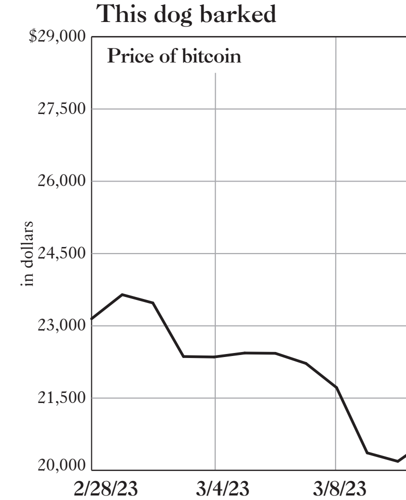
** Totals may not add due to rounding.*

Movement of the Yield Curve



source: The Bloomberg

This dog barked



source: CoinMarketCap.com

Dogs that a

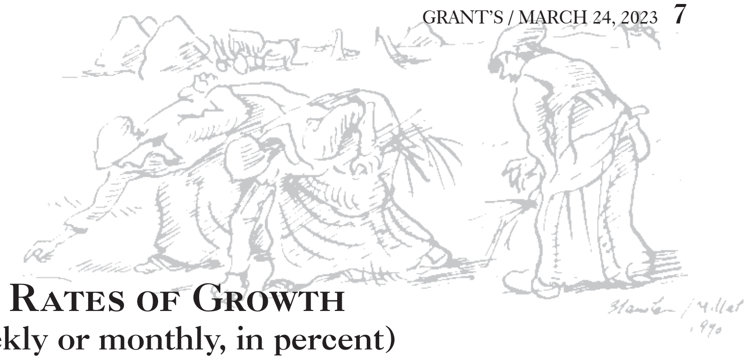
Evan Lorenz writes:

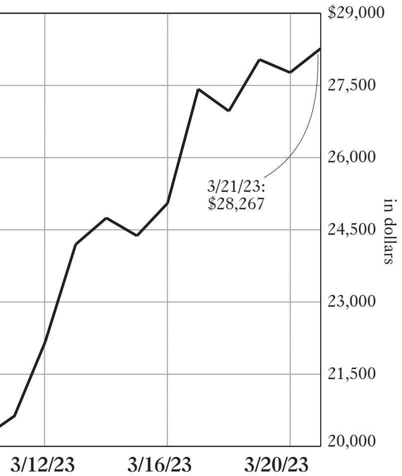
In the past two weeks, three American banks and one Swiss mega-lender either failed or were taken over. This has led to predictable knock-on effects, such as Treasury bill yields plummeting as investors pile into the perceived safety of government paper, investment banks like JPMorgan Chase & Co. canceling sales of junk-rated debt and the Federal Reserve rolling out the latest in its alphabet soup of emergency facilities, this time the Bank Term Funding Program.

However, what didn't happen after the quartet of bankrupt banks is perhaps more remarkable than what did. Interest rate volatility, as measured by the ICE BofAML MOVE Index, shot to 198.7 on March 15, the highest level outside of the housing bust. Yet the share prices of mortgage real-estate investment trusts, which leverage pools of residential mortgage–backed securities via the repo market and are highly sensitive to changes in rates, barely budged (note the placid action in AGNC Investment Corp.'s common and preferred stocks).

Signature Bank and Silvergate Capital Corp., two of the U.S. bank failures, were key cogs in the crypto-ecosystem. Both created blockchain-powered transfer networks that allowed crypto exchanges and traders to exchange fiat currencies 24 hours a day, seven days a week. With both banks gone, it's unclear how the

• Cause & Effect





didn't bark

crypto sector will replace those round-the-clock fiat payment networks. Yet, since Silvergate announced that it would liquidate operations on March 8, the aggregate market capitalization of cryptocurrencies has increased to $1.2 trillion from $1 trillion.

The price of the S&P 500 was volatile over the past two weeks, with daily changes ranging between positive 1.76% and negative 1.85%. However, it has not been as volatile as some pundits feared. Approximately two-fifths of all stock options are of the mayfly variety, i.e., with zero days to expiry (0DTE). Earlier this month, a team of JPMorgan Chase & Co. analysts warned that 0DTE options could turn a 5% intraday plunge in the S&P 500 into a 25% wipeout as options traders and dealers unwound positions en masse. One thinks of the 20.5% on Black Monday in 1987—though not of anything that happened last week.

Then there are the normally volatile stocks. In the table at right, our index of 10 high-beta stocks, i.e., equities that gyrate more than the overall S&P 500 (see the issue dated Feb. 10), rallied by 9.1% in the week ended March 17. This is despite the fact that spreads on high-yield bonds rose by 106 basis points to 5.15% since March 8, which is negative news for junk-rated borrowers in our gauge like Carvana Co. and MicroStrategy, Inc.

It was, or is so far, a remarkably well-contained banking crisis. •

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

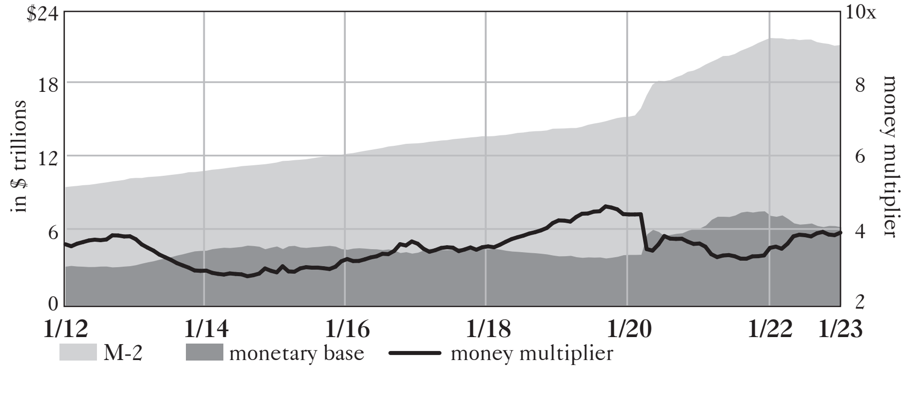
	3 months	6 months	12 months
Federal Reserve Bank credit	-9.2%	-9.7%	-5.9%
Foreign central-bank holdings of gov'ts	5.9	-2.0	-2.7
European Central Bank assets	-29.5	-19.9	-9.7
Commercial and industrial loans (Feb.)	1.8	7.2	13.2
Commercial bank credit (Feb.)	4.2	3.0	5.4
Asset-backed commercial paper	2.5	5.7	9.2
Currency	1.5	2.2	2.5
M-1 (Jan.)	-9.0	-8.4	-4.5
M-2 (Jan.)	-3.0	-3.4	-1.7

Reflation/Deflation Watch

	Latest week	Prior week	Year ago
FTSE Xinhua 600 Banks Index	12,643.29	12,538.24	13,943.31
Moody's Industrial Metals Index	2,824.24	2,886.94	3,841.23
Silver	$22.46	$20.51	$25.62
Oil	$66.74	$76.68	$102.98
Soybeans	$14.77	$15.07	$16.69
Rogers Int'l Commodity Index	3,478.80	3,603.47	4,023.15
Gold (London p.m. fix)	$1,962.10	$1,861.25	$1,949.65
CRB raw industrial spot index	554.29	558.68	669.32
ECRI Future Inflation Gauge	(Feb.) 112.3	(Jan.) 112.4	(Feb.) 125.2
Factory capacity utilization rate	(Feb.) 78.0	(Jan.) 78.0	(Feb.) 79.4
CUSIP requests	(Feb.) 2,643	(Jan.) 2,479	(Feb.) 2,655
Fed's reverse repo facility (billions)	2,106.17	2,188.38	1,715.15
Grant's High Beta Index*	134.60	123.40	719.70

*Index=100 as of 12/30/2022

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



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brownfield expansion at some of their existing assets, they will move from 600,000 ounces a year to a million, maybe a million plus with declining all-in sustaining costs. They will be as they have been for the last couple of years, basically the fastest-growing gold miner in the world in terms of production.…We view it as a $12 stock [compared with $4.35 on Tuesday]."

Equinox, another position in the Sprott Gold Equity Fund, is, according to Hathaway, an "ultra-cheap mid-cap that is highly leveraged to a better gold price and price environment."

Insiders, too, are bullish, having bought a net 386,381 shares over the past six months, though the Street is of many minds, with three buys, four holds and two sells. Ross Beaty, founder and chairman of Pan American Silver and chairman of Equinox, bought 262,500 shares on Nov. 4, 2022 at an average price of $4.06.

Expanding its Castle Mountain mine in California, Equinox expects to add 218,000 ounces a year to a complex that pulled only 23,227 ounces out of the ground in 2022. After completion of the project, management expects company-wide AISC costs to drop to less than $950 per ounce from $1,699. The difference between expectations and results may explain why the stock trades at a 32% discount to net asset value.

"The royalty and streaming segment of the gold industry offers a safer haven for those who think costs will only continue to rise," Robertson points out. "With shoestring operating budgets and low headcounts, the coupon-clippers of the gold market provide some insulation against production delays and rising operational costs. The market leader, Franco-Nevada Corp., operates without an ounce of debt on its balance sheet. While royalty and streamers offer a margin of safety, it's the miners themselves that boast operating leverage to the gold price.

"Investors who wish to take a portfolio approach have a few options," Robertson continues. "They may consider the Sprott Gold Equity Fund, which invests 65% of its $838 million assets under management in gold stocks. Top positions include i-80 Gold Corp. (5.35%), Osisko Mining, Inc. (4.79%) and Agnico Eagle (4.72%). Other than a 14% position in gold bullion itself, the fund holds smaller miners of other species, including a 6% stake in MAG Silver Corp. Retail investors pay 1.41% in management fees while institutional investors pay 1.12%; there are no sales charges. Since inception in June 1998, the investor class has returned 8% annualized net of expenses, including reinvested dividends.

"Another option is the $2.1 billion First Eagle Gold Fund, which allocates 80% of its AUM in gold equities. Major positions include the streamer Wheaton Precious Metals Corp. (12.73%), Newmont (9.88%) and Barrick (7.06%). The First Eagle fund charges a 1.2% management fee and a sales load for investments under $1 million of between 5% (less than $25,000) and 1.5% ($500,000 to $1 million). The fund delivered a 5.2% annualized total return net of expenses and sales load since its inception in 1993."

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Buildings sans banks

Evan Lorenz writes:

Where, and what, would commercial real estate be without bank credit? On current form, we just may find out. Meantime, in preview, we survey the sources of real estate lending, acknowledge a losing call on JBG Smith Properties (JBGS), cover our analytical short on SL Green Realty Corp. (SLG; both on the New York Stock Exchange), revisit the Trump Building at 40 Wall Street—and spotlight an inside-baseball way to participate in the bear market in office properties.

The spigot of credit was already slowing to a trickle before the Federal Deposit Insurance Corp. took possession of SVB Financial Group and New York regulators euthanized Signature Bank. In the Federal Reserve's Senior Loan Officer Opinion Survey for January, 54.8% of respondents reported tightening standards on loans secured by nonfarm, nonresidential properties, a degree of constraint typically seen during recessions.

"For high-quality offices with investment-grade tenants, the CMBS [commercial mortgage-backed securities] market is still open," Samuel Ashner, a managing director at Winthrop Capital Partners, tells me. "You can also finance a class-B building today that has long-duration leases. But if it doesn't and if it is a transitional play [i.e., a building in need of capital improvements], then you don't have access to the CMBS market."

Issuance of CMBS fell by no less than 72%, calculated year over year, in the first two months of 2023, to $3 billion. As $92 billion of nonbank office debt is falling due this year, more than a few office buildings may be unable to refinance their debts.

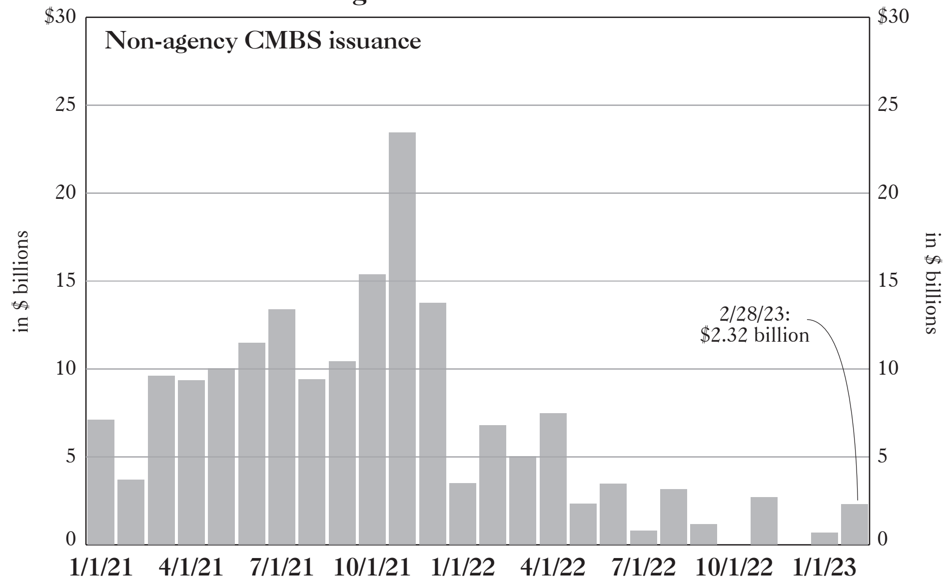
The first-order effect of bank runs is to discourage bank lending. Signature, the 10th-largest bank lender for commercial real estate in the United States, has a $35.2 billion CRE portfolio. It is (or was) the third-largest CRE bank in New York City and the No. 1 New York lender in middle-market loans of less than $100 million. According to Maverick Real Estate Partners, some 46% of Signature's CRE book consists of loans against rent-"stabilized" multifamily buildings, the value of which has been "absolutely crushed" since 2019. It will be interesting to see what happens now that New York Community Bancorp has taken over some of those Signature assets.

SVB crystallized the problems of the regional banks, many of which are sitting on unrealized mark-to-market losses in their held-to-maturity securities portfolios (*Grant's*, Jan. 27). This has led to depositors decamping from regional banks to money-market mutual funds, Treasury securities themselves and the too-big-to-fail institutions. As to the latter, Bank of America Corp. reported an influx of $15 billion in the first three business days following SVB's failure.

The flight to safety has disrupted wider financing markets, too. The ICE BofAML MOVE Index, which measures volatility in the Treasury market, shot to 198.7 on March 15, the highest level outside of the 2008–09 financial crisis, from 129 before SVB Bank was seized by regulators. The sheer violence of the price action has caused such issuers of asset-backed securities as Fannie Mae, Automotive Rentals, Inc. and Santander Consumer USA to pull planned sales.

In a bid to protect small- to medium-size lenders, the Federal Reserve initiated the Bank Term Funding Program on March 12. The facility offers banks one year of financing against the par value of pledged Treasury, agency debt or mortgage-backed securities. Helpful as far as it goes, the BTFP charges the one-year overnight index swap rate plus a spread of 10 basis points, or an all-in cost of 4.8%—which happens to

Real estate credit tightens



source: The Securities Industry and Financial Markets Association

be 30 basis points more than the return on bank earning assets in the fourth quarter.

As the Fed was slow to hike policy interest rates, so have banks been dragging their feet in boosting deposit rates. The recent outrush of uninsured deposits will likely speed up that response, though it won't come without a cost. Such disintermediation will eviscerate banks' net interest margins, stiffen the terms of lending and probably, therefore, reduce the volume of new credit. CRE markets will especially feel the pinch.

For all intents and purposes, community banks are real estate banks. Thirteen mega-banks with assets over $250 billion may account for 55.5% of U.S. bank assets, and may, virtually, be arms of the government, but the banks below that threshold funded 76% of loans backed by commercial real estate.

Lending terms were already tightening before the bank blowups. "The three-month rolling loan-to-value ratio in March of last year on 39 deals was 63.2%," Stephen Buschbom, research director at Trepp, Inc., tells me about the terms in the CMBS market. "For the 12 deals issued over the three months through February, the LTV stood at 53.7%."

This change in terms is harsher than it may sound. Take an office building one year ago with a hypothetical value of $100, and say it was carrying $63.20 of debt. Over the past 12 months, the value of the building would have declined by 25%, according to Green Street, which pushed the loan-to-value ratio of the building to 84%—that is, $63.20 of debt divided by the new $75 valuation.

Now assume that the owner must refinance. His $100 building is worth $75. And his lenders will advance only 53.7% of that diminished value, or $40.28. Our owner must therefore come up with an extra $22.92—the difference between what he could have borrowed a year ago, i.e., $63.20, and what he can borrow today, i.e., $40.28. That $22.92 increment happens to be almost twice the $11.80 of equity that the owner had showed before the refinancing.

Green Street reports that institutional-quality commercial property values fell by 15% over the past 12 months. Results varied by asset type: Hotels held their own compared with drawdowns of 19% for malls and 21% for apartment buildings, but offices, off 25%, led to the downside.

The past year's deteriorations, both in loan-to-value ratios and in value itself, go far to explain why even presumably well-financed borrowers have been telling their lenders, "Take my building, it's yours." Thus, Blackstone, Inc. advised a CMBS trustee last week that it's stopped servicing $325 million in mortgage debt on a group of 10 office buildings in Las Vegas. Other operators, including RXR Realty, LLC, Pacific Investment Management Co. and Brookfield Corp., have similarly returned keys.

Not even 40 Wall Street, "one of the great real estate deals of all time," as the Trump Organization modestly describes its 1995 purchase of the lower Manhattan skyscraper, has been spared the buffeting. The issue of *Grant's* dated Feb. 24 noted the deterioration in the building's financial vital signs since 2015: a halving in the debt service coverage ratio, to 1.00 from 2.13, on the back of a slump in occupancy, to 83% from 94%.

What we neglected to mention is that Trump leases the land on which the building stands and that the ground lease payments, which totaled $1.65 million in 2015, will ratchet up to $2.55 million this year and to $2.8 million in 2028.

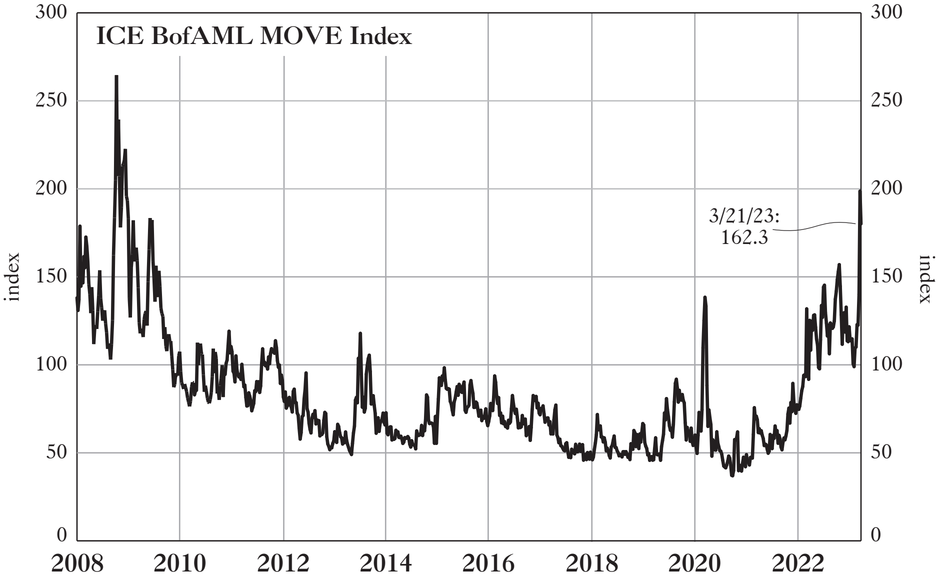
The arithmetic leaves scant margin for error. Thus, in 2022, 40 Wall produced $9.8 million in net cash flow (i.e., net operating income minus capex) and incurred an identical $9.8 million in debt-servicing costs. Other things being equal, then, this year's scheduled increase in ground lease payments, of $231,500, will throw the building into the red. It would take some doing for the lenders behind the 2025 mortgage not to throw the Trump Building, or its keys, into the hands of the majority owners of the ground lease, the German Hinneberg family.

A good thing for Trump, then, as he chronicled in *Never Give Up*, his titanic 2008 all-time best-selling comeback saga, that he "got along very well" with the Hinnebergs. "They realized that after a string of losers who had owned the building, I had the integrity of their spectacular property first and foremost in my mind." Maybe, then, it will remain great and brimful of integrity.

Taxing authorities, too, jockey for their fair share of real estate–generated income. Starting April 1, for instance, the City of Los Angeles will apply a 4% tax on building sales that exceed $5 million in value and a 5.5% tax on those surpassing $10 million in value. Notably, these taxes are due even if a building is sold at a loss and are incremental to other city assessments.

Just where might the needy building owner turn for an infusion of liquidity? "As an example," Seth Weissman, founder and president of Urban Standard Capital, tells me, "we're working on a deal now in Manhattan, where the borrower has $500,000 in net operating income. The existing

It moved



source: The Bloomberg

bank loan is around $9 million." While they paid $13 million for the property, "the best quote they have is for $6 million."

The borrower thinks that the NOI will increase, thanks to his improvements, Weissman goes on, so he's approached Urban Standard for a second-lien loan. Weissman says he's happy to accommodate, though only at rates of between 15% and 20%. In general, Weissman continues, private funds like his charge rates 300 basis points higher than a bank's.

Financial tumult is driving customers to his door, Weissman tells me: "I don't know how many phone calls I've gotten since Thursday," i.e., the day before SVB was seized. "It's not just borrowers who were Signature clients, but also regional bank clients who have loans scheduled to close in the next 30 to 90 days. They are asking, 'Does this loan close? Is somebody going to show up at that closing table?' They've got seven-figure deposits that are committed, and they are highly concerned."

Working from home, another non-transitory adverse trend, means that businesses are making do with fewer square feet of office space, strong job growth notwithstanding. According to real-estate software developer CommercialEdge, the nationwide office vacancy rate increased to 16.6% in January, up 80 basis points from the same month last year. Indeed, given that many businesses are offering unused space in the sublet market, the real vacancy rate is likely higher.

Shorter leases, a feature of the lockdown years of 2020 and 2021, point to an elevated level of space to relet this year and in 2024, Trepp relays. It goes without saying that a recession would further complicate matters.

. . .

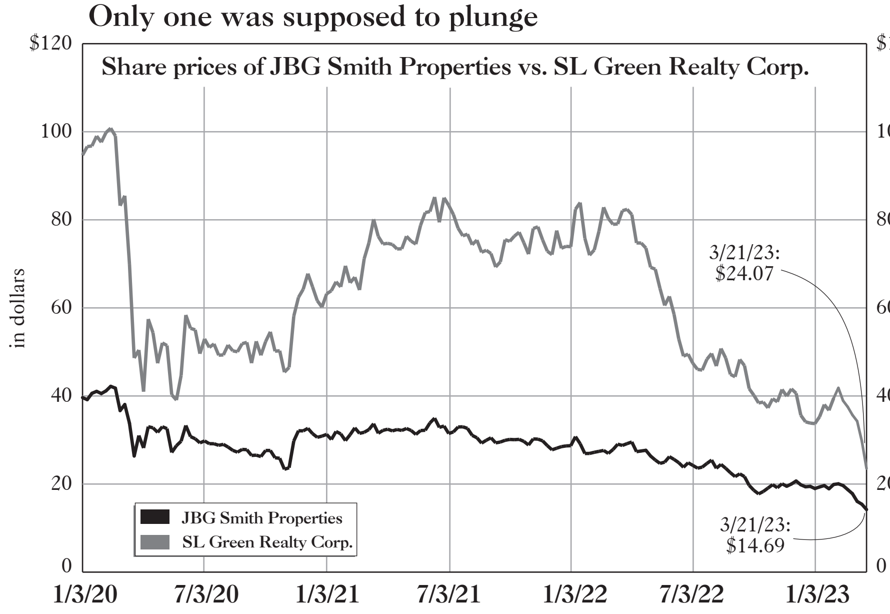
Altogether, it's been tough sledding for JBG Smith Properties and SL Green. Constant readers may recall that JBG Smith was the company selected to build Amazon.com, Inc.'s second headquarters in Arlington, Va. (*Grant's*, July 9, 2021). As of Dec. 31, 2022, Smith managed a portfolio of 51 buildings, encompassing 8.4 million square feet of office, retail and apartment space, and was working on a development pipeline that would cover 9.7 million square feet. In 2022, commercial properties accounted for 65.4% of net operating income and multifamily, 33.1% (leaving an "other" residual of 1.5%).

To date, Amazon is living up to its side of the bargain. Despite laying off 18,000 corporate workers worldwide, the Everything Store has added 8,000 workers in JBGS's backyard and is expected to move those employees into Metropolitan Park, a 2.1 million square-foot office complex developed by JGBS, this summer.

Unfortunately, the good news ends there. Simultaneously with the planned move into Met Park, Amazon is slated to vacate 387,000 square feet of other JBG Smith real estate. Then, too, Amazon says it's indefinitely pausing construction on PenPlace, the second and larger phase of its headquarters buildout that includes a double-helix, glass-encased building and plazas and pathways lined with indigenous mid-Atlantic flora. Separately, and also unhelpfully, two non-Amazon tenants with 112,000 square feet of office space have given notice of their intention not to renew this year.

As a result of these difficulties and

Only one was supposed to plunge



source: The Bloomberg

a balance sheet that shows net debt of 8.6 times trailing Ebitda, Smith is in cash-preservation mode. "JBGS continues to hold off on new development starts given elevated construction costs that have yet to moderate, and the REIT alluded to new investments (e.g., acquisitions, development starts) being largely dependent on its ability to execute additional dispositions," a Feb. 21 Green Street note summarizes.

Since our bullish piece in 2021, JGBS has delivered a total loss of 50.8% versus a 5.9% decline in the S&P 500 (both figures include reinvested dividends). Even so, at 12.2 times price to estimated 2023 funds from operations, the company is valued closer to multifamily REITs like AvalonBay Communities, Inc. and Equity Residential (which trade at an average of 15.4 times this year's estimate) than to office REITs like Vornado Realty Trust and Boston Properties, Inc. (6.5 times). And these valuation disparities exist even though JBG sources two-thirds of its NOI from offices. Bullish on JGBS, therefore, we no longer are.

. . .

SL Green, Manhattan's largest office landlord, boasts interests in 61 buildings totaling 33.1 million square feet, 87% of which are in New York's most densely populated though geographically smallest borough. Despite the office sector's well-ventilated troubles, Green managed to report a 3.3% rise in same-store net operating income, calculated year over year, in the fourth quarter. That all is not well, however, is apparent in the 4.7% decline in rental rates for leases signed in the fourth quarter. Deflating rents mean that earnings will dwindle as tenants renew.

Green's balance sheet is the most leveraged in the office REIT sector, with net debt footing to 15.7 times trailing Ebitda as of Dec. 31, 2022 versus 9.9 times for Vornado and 7.7 times for Boston Properties. Management, not unaware of this fact, has laid out a target to sell around $2.25 billion's worth of properties this year, with proceeds earmarked for debt reduction. Signature's failure will make it harder to deliver on that goal.

Mitigating this familiar litany of woe is the upcoming auction of a casino license for New York City by the New York Gaming Facility Location Board. If SL Green emerges as the winner, it will plan to convert—with its joint-venture partner, Caesars Entertainment, Inc.—a Green-owned office building at 1515 Broadway into Caesars Palace Times Square. The corporate duo anticipate that the new casino will have 250,000 square feet of gaming space and 950 hotel rooms.

Since we had our say in the issue dated March 19, 2021, SLG has delivered a 62.9% loss versus a 5.5% gain for the S&P 500, both including reinvested dividends. However, the shares are cheap at 4.4 times estimated 2023 funds from operations against an average of 6.5 times for office REIT peers Vornado and Boston Properties. If Green does win the casino license, it could prove a cash and share-price gusher. Bearish, therefore, we no longer are.

. . .

Yes, office values have plummeted by 25% from their high last year, "but we're expecting office values to go down anywhere between 40% and 60% from peak for your class-B office space," Daniel McNamara, the founder and chief investment officer of Polpo Capital Management, LLC, tells me. "There's a lot of properties that have floating-rate debt," he continued. "Obviously, interest rates have exploded, and many can't afford that interest expense anymore."

To execute the trade, Polpo has bought credit default swaps on CMBX indexes, i.e., gauges tied to CMBS production from specific years. McNamara is targeting CMBX Series 13 through 15, i.e., commercial mortgage-backed securities that were sold between 2019 and 2021. "We short the most leveraged tranche in CMBX, which is the double-B security," at a cost of approximately 5% per year.

The CMBX indexes are blunt instruments, mixing as they do loans collateralized by multiple property types within multiple geographies. "It's not as easy as just saying, 'Oh, I want to do a specific short on just San Francisco,'" McNamara says. "You are looking holistically, you're trying to decide, 'Alright, what is my best short here? Okay, I may get some San Francisco exposure, but I may also have to take some Miami exposure.'

"Given the diversification in CMBS conduit deals, we don't view this trade as similar to the Big Short in 2008 ABX, where many tranches went to zero," McNamara continues. "Instead it's a much more nuanced trade to identify these deals and tranches with the most exposure to lower-quality office. We view the office short in CMBX today as similar to the [2019–20] CMBX 6 Mall short, but [think it] will play out over a longer period of time given offices' longer-term leases."

Nor is this trade for everyone. It requires what is known in the trade as an "ISDA"—a signed International Swaps and Derivatives Association master agreement. However, for the professional investor, there's approximately $30 billion in market depth in CMBX to execute the strategy, according to McNamara.

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Dogs that didn't bark

Evan Lorenz writes:

In the past two weeks, three American banks and one Swiss mega-lender either failed or were taken over. This has led to predictable knock-on effects, such as Treasury bill yields plummeting as investors pile into the perceived safety of government paper, investment banks like JPMorgan Chase & Co. canceling sales of junk-rated debt and the Federal Reserve rolling out the latest in its alphabet soup of emergency facilities, this time the Bank Term Funding Program.

However, what didn't happen after the quartet of bankrupt banks is perhaps more remarkable than what did. Interest rate volatility, as measured by the ICE BofAML MOVE Index, shot to 198.7 on March 15, the highest level outside of the housing bust. Yet the share prices of mortgage real-estate investment trusts, which leverage pools of residential mortgage–backed securities via the repo market and are highly sensitive to changes in rates, barely budged (note the placid action in AGNC Investment Corp.'s common and preferred stocks).

Signature Bank and Silvergate Capital Corp., two of the U.S. bank failures, were key cogs in the crypto-ecosystem. Both created blockchain-powered transfer networks that allowed crypto exchanges and traders to exchange fiat currencies 24 hours a day, seven days a week. With both banks gone, it's unclear how the crypto sector will replace those round-the-clock fiat payment networks. Yet, since Silvergate announced that it would liquidate operations on March 8, the aggregate market capitalization of cryptocurrencies has increased to $1.2 trillion from $1 trillion.

The price of the S&P 500 was volatile over the past two weeks, with daily changes ranging between positive 1.76% and negative 1.85%. However, it has not been as volatile as some pundits feared. Approximately two-fifths of all stock options are of the mayfly variety, i.e., with zero days to expiry (0DTE). Earlier this month, a team of JPMorgan Chase & Co. analysts warned that 0DTE options could turn a 5% intraday plunge in the S&P 500 into a 25% wipeout as options traders and dealers unwound positions en masse. One thinks of the 20.5% on Black Monday in 1987—though not of anything that happened last week.

Then there are the normally volatile stocks. In the table at right, our index of 10 high-beta stocks, i.e., equities that gyrate more than the overall S&P 500 (see the issue dated Feb. 10), rallied by 9.1% in the week ended March 17. This is despite the fact that spreads on high-yield bonds rose by 106 basis points to 5.15% since March 8, which is negative news for junk-rated borrowers in our gauge like Carvana Co. and MicroStrategy, Inc.

It was, or is so far, a remarkably well-contained banking crisis.

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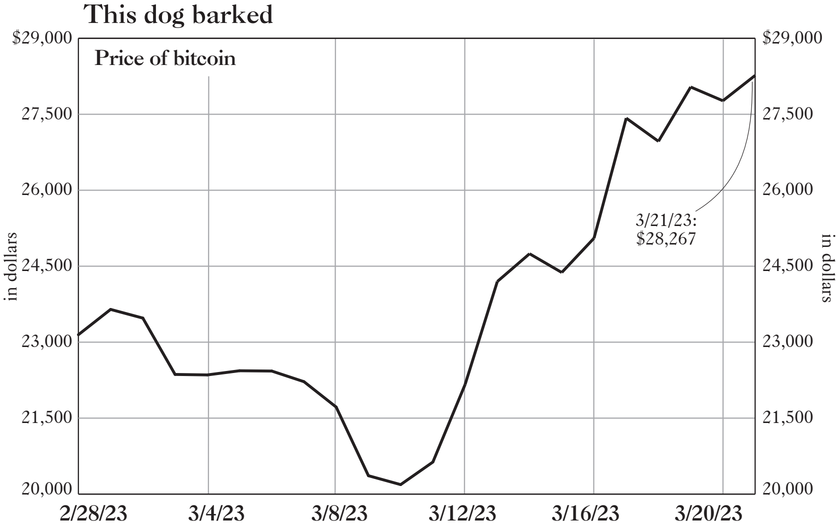
This dog barked



source: CoinMarketCap.com