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More on the banking mess

In August 1983, we republished a long-forgotten classic, *A World In Debt* by Freeman Tilden. In the prologue to the book, we mused about the debt crisis of the '80s and pointed our finger at the Fed for deviating from the early notion of merely providing liquidity — and at the FDIC for removing market discipline from the banking industry. Quoting some of the relevant passages, we wrote:

“...healthy constraints imposed upon *any* dynamic and honest banking system — concern about liquidity and solvency — were eliminated. The depositor could quite routinely lend his money to a commercial bank with the full knowledge that regardless of the bank's lending and investment acumen, his deposit would be quite safe; as good, in fact, as the full faith and credit of the U.S. government.

“A cursory reading of American banking history shows that commercial banks had to earn the trust of their depositors. The panic of 1907 was principally a crisis of liquidity, not solvency, that was eventually resolved by a combination of aggressive Treasury lending of specie and a two-month restriction on payments of deposits into currency... In fact, in pre-Federal Reserve days, banks were constrained from engaging in risky and speculative debt by the very threat of withdrawals; therefore, bank credit was, on the whole, of good quality.”

We then went on to describe the destabilizing efforts of the Federal Reserve and the FDIC in spite of their regulatory powers.

“...the proliferation of banks and the extraordinary expansion of bank credit far surpassed the regulatory capabilities of bank examiners, even if we believe they knew what to look for. Finally, assuming we could find enough capable regulators, we would still not be able to dictate a proper allocation and pricing policy for the dominant illiquid loans. *Only informed depositors, concerned about the safety of their deposits, could force lending institutions, by the mere threat of withdrawals, to liquidate or reduce certain types of loans, or charge higher spreads.*”

Our beef with deposit insurance did not end there. In six articles written between June 1984 and April 1987, we warned of a major banking crisis (the first article was titled “The progressive crumbling of the banking system”; the next was “The banking mess”) resulting from the rapid increases in the threshold of deposit insurance, last raised in 1980 to

\$100,000. At the time (June 10, 1984), we said “deregulation proceeded without an iota of countervailing discipline, except perhaps the sporadic visitation of an employee of the Office of the Comptroller of the Currency or the FDIC. Understaffed and unable to uncover fraudulent concealment of problem loans in time, the regulatory agencies began to witness a mounting number of failures — and an alarming drain on their resources.

“In fact, *and this should be elementary*, there is only one kind of discipline that could keep a system of 14,000 banks, and savings and loans honest: market discipline.”

Our prophetic warnings came true years later with the growing string of bank failures, capped by the famous Financial Corporation of America, which we chronicled and called one of the greatest swindles in US financial history.

As we wrote in the April 26, 1987 issue:

“The FSLIC has been unable to find a buyer for FCA: It simply does not have enough money to pay a potential acquirer

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With contributions by Albert D. Friedberg, Dr. Steve H. Hanke, Daniel A. Gordon, and Michael D. Hart.

for what is probably the most spectacular failure since Continental Illinois.

"Incredibly, the FSLIC has not forced FCA to shrink in size. Instead, *insured depositors* unaware and/or unconcerned with the plight of FCA have maintained and even increased their deposits.

"Regulators, afraid to bite the bullet, are prolonging the agony. Can anyone truly say that the US is not facing a banking disaster?"

The tragedy persists and the costs mount. The S&L crisis is likely to cost taxpayers upwards of \$200 billion — provided there is no recession in the '90s. With a recession, all bets are off.

The Wall Street Journal of Nov. 20 recounts the Lincoln

Savings \$2.5 billion scam. It's an absorbing and sad account of greed, influence, and corruption that is inherent to systems based on bureaucratic regulation and largesse.

We are republishing the article for two reasons: 1) so that more, thinking individuals begin to understand the insidiousness and destructiveness of government intervention in the marketplace; and 2) to describe the strange role of Alan Greenspan in the affair and the *possibility* that it may affect his job as Chairman of the Federal Reserve (at best, Dr. Greenspan showed an unusual degree of gullibility).

Forget bailouts and government regulations. Give us more market discipline. Phase out deposit insurance in excess of \$10,000. Or introduce a co-insurance scheme.

SPECIAL REPORT

The following article appeared in The Wall Street Journal, Nov. 20, 1989.

How Regulatory Error Led to the Disaster at Lincoln Savings

By Brooks Jackson

Staff Reporter of The Wall Street Journal

WASHINGTON—How could Washington have been so stupid?

The nation's top thrift-industry regulator saw Charles Keating Jr. as a "pillar of his community." So apparently did five U.S. senators, assorted House members, a White House chief of staff and even Alan Greenspan, currently chairman of the Federal Reserve Board.

But now the government contends that Mr. Keating, under the very noses of federal regulators, operated his Lincoln Savings & Loan Association as a massive scam that fleeced taxpayers of as much as \$2.5 billion. Rep. Charles Schumer, a New York Democrat on the Banking Committee, called him a "financial Blackbeard" at a congressional hearing.

With Mr. Keating scheduled to testify tomorrow in a Congressional investigation of the matter, many here see the Keating affair as much a scandal for Congress as for Keating: Public attention is focused mainly on the five senators who took \$1.4 million in donations arranged by Mr. Keating while pressing his case with regulators. But while much has been made of their intervention—which, in and of itself, was extraordinary—their actions alone can't account for the magnitude of this regulatory disaster. Instead, a systematic breakdown of government supervision pervaded the Lincoln Savings crisis. A detailed account—drawn from recent testimony, interviews and thousands of pages of previously secret government documents—portrays an often timid bureaucracy wrapped up in petty internal turf wars while the White House and Congress looked the other way.

Mistakes were committed from the outset. Regulators passed over a record of alleged banking abuses that might have prevented Mr. Keating from taking control of Lincoln in the first place. Examiners for years failed to spot a plot that

allegedly allowed him to illegally siphon off \$94 million from Lincoln.

Those who raised alarms were viewed by higher-ups as incompetents or zealots. Top-level regulators, meanwhile, put too much trust in outside auditors opinions that turned out to be highly questionable. Mr. Keating, threatening lawsuits at every turn, repeatedly faced down timorous officials in Washington. Even M. Danny Wall, the top thrift regulator, now concedes in an interview that he should have been more forceful in dealing with Lincoln.

For his part, Mr. Keating says he has been unfairly maligned by all the allegations. "It's all innuendo," says his spokesman, Bradley Boland. While the investigations continue, Mr. Keating is counterattacking with three separate lawsuits accusing the government of illegally seizing his business and of blackening his name with news leaks.

And indeed, what has come out so far isn't a pretty sight.

The tale begins in February 1984, when state and federal regulators allowed Mr. Keating to buy Lincoln even though only 4½ years earlier he had been accused of fraud. In a 51-page complaint filed in U.S. District Court in Washington, the Securities and Exchange Commission said he and an associate authorized or permitted Provident Bank of Cincinnati, Ohio to make \$14 million in preferential loans to insiders—including Mr. Keating himself—often without collateral or the usual credit checks.

The SEC accused him of "untrue statements" and "fraud or deceit." Mr. Keating settled the charges by signing a consent decree without admitting or denying liability, an action he now says he regrets.

Nowadays a blemish like that would keep Mr. Keating

out of the S&L business, unless he could show why it shouldn't disqualify him. But in 1984 the rules were looser—and in any case, nobody in Washington seems to have noticed Alvin Smuzynski, an official at the Federal Home Loan Bank Board who handled Mr. Keating's application, says today he didn't know about the consent decree at the time. "It would have made a difference," he says.

Within days of getting control, Mr. Keating began to strip Lincoln of its conservative lending officers and internal auditors, even though he had told regulators he would keep them. He installed as board chairman his 28-year-old son, Charles Keating III, an Indiana University dropout who only a few years earlier had been working as a country club busboy.

Lincoln plunged—sometimes profitably—into high-risk speculation in currency futures, junk bonds, corporate stock, hotels and vast tracts of desert land in Arizona. It bought \$11.8 million in junk bonds of Circus Circus, the Las Vegas casino operation, and put \$132 million into stock of Gulf Broadcasting Co. during a takeover fight, according to government memos filed in U.S. District Court in Washington.

Why should that matter to federal regulators? Because Mr. Keating was playing with what was ultimately taxpayers' money: government-insured deposits.

With wild speculation sweeping the thrift industry, Edwin Gray, chairman of the Federal Home Loan Bank Board, became alarmed. He pushed through new regulations prohibiting federally insured thrifts from putting more than 10% of their assets into so-called direct investments—such as the 600-room luxury hotel that Mr. Keating had begun to erect near Phoenix, Ariz.

Mr. Keating declared war on the regulatory establishment. One of his first allies was Alan Greenspan, then president of the consulting firm Townsend, Greenspan & Co. and a former chairman of the president's Council of Economic Advisers. On Feb. 13, 1985, Mr. Greenspan wrote a letter supporting Mr. Keating's application for permission to put 40% of Lincoln's assets into direct investments. Mr. Greenspan praised Lincoln's new management as "seasoned and expert," with a "long and continuous record of outstanding success in making sound and profitable direct investments."

Unanticipated Problems

Mr. Greenspan also said that Mr. Keating and his team had "succeeded...in reviving an association" whose home mortgage portfolio had "been forcing large losses... pushing it nearer the brink of insolvency." In fact, Lincoln had made \$3 million in profits the year before Mr. Keating took control of it. Years later, after the thrift had collapsed, Mr. Greenspan said, "I never anticipated the types of problems Lincoln would ultimately create."

In his campaign to preserve direct investment, Mr. Keating also enlisted allies in Congress. Mr. Gray, the former Bank Board chairman, recalls being lobbied "very hard" against the rule by Rep. Chip Pashayan, a California Republican who later introduced a bill that would have overturned

the rule. At the time, a Pashayan aide was quoted by United Press International as saying the congressman personally introduced the bill without consulting his staff, at the behest of a lobbyist for Mr. Keating. Later Rep. Pashayan received \$26,000 in campaign contributions from Mr. Keating, his family and Lincoln officials. The congressman says the donations were at least partly motivated by his opposition to pornography, which Mr. Keating also strongly opposes.

Regulators denied Lincoln's request for exemption from the 10% direct-investment rule, and held tough when Lincoln appealed the decision. The Federal Savings and Loan Insurance Corp., which insured thrift deposits, simply couldn't take the risk, they determined. "Under new management, Lincoln has engaged in several serious regulatory violations," Norman Raiden, the Bank Board's general counsel, wrote in a memo released during Congressional hearings. He said these included overvaluing real estate and failing to get proper appraisals—"the same type of violations that have led to some of the worst failures in FSLIC's history."

Mr. Keating then tried a new tactic: removing his antagonist Mr. Gray by hiring him. He made the offer personally to Mr. Gray's chief of staff, Shannon Fairbanks, over breakfast at Washington's Four Seasons Hotel on Nov. 22, 1985. "There seems to be a problem in our ability to have our message heard" by regulators, she recalls him saying. He was offering to hire Mr. Gray to lobby against the very regulation he had put in place. Ms. Fairbanks says she cut off further discussion.

No Credit Checks

On March 12, 1986, federal regulators began a new examination of the thrift. Quickly, they found that Lincoln was making property loans in the millions without conducting appraisals. It also wasn't conducting elementary checks of the financial condition of the borrowers, the auditors found. "There's nothing to indicate they're doing anything but giving money to developers to do what they want," one regulator said in an interview.

But Mr. Keating wasn't going to take such attacks lying down. "Any attempts to take enforcement actions against Lincoln would be severely resisted," he said at a meeting with regulators, according to a government memo. Mr. Keating engaged platoons of lawyers—ultimately, 77 law firms in all. Two regulators would testify that Mr. Keating told them in 1987 he had spent \$50 million fighting regulators in San Francisco and Washington. For a time, Lincoln insisted that examiners route all their requests through a law firm in New York, 3,000 miles away.

Still, the examiners pressed ahead. In August they reported to Washington that among other violations, Lincoln had made \$600 million more in direct investments than the investment limits allowed.

Even at that, the examiners didn't question everything they should have. Lincoln was sending millions of dollars to its parent company, American Continental Corp., headed by Mr. Keating, to cover federal income taxes, even though the parent didn't have a federal income tax liability. Regulators

approved the arrangement, but now say it was illegal and that they approved it because of misrepresentations by Lincoln's lawyers. The issue is in litigation and the government has demanded that American Continental repay Lincoln. The amount of funds at stake totals \$94 million.

Mr. Keating was using the thrift to raise more than \$200 million for the parent company in another way: by selling subordinated debentures in American Continental, mostly to elderly people, through Lincoln's branch offices, where many of the buyers assumed that the securities were federally insured. Federal thrift regulators blithely gave blanket permission for American Continental to issue such debt. "We all must have been smoking dope," the Bank Board's Mr. Smuzynski said in a 1987 memo.

Taking Action

Even though the examiners failed to grasp the danger of Lincoln's transactions with its parent, regulators in the San Francisco district thought it was time to move in, for Lincoln was showing a pattern of risky investments and sloppy business practices.

Thus, on May 1, 1987, the San Francisco office sent Washington a 285-page document recommending that the Bank Board seize Lincoln and appoint the FSLIC to run it. At about the same time, regulators asked the Federal Bureau of Investigation to look into possible criminal actions by Lincoln officials: some undated documents had been created, the regulators believed, to make it appear that Lincoln had conducted proper investment analyses before plunging into junk-bond investments.

Washington, however, didn't act. Lincoln remained in business. Mr. Keating remained in control. And losses—all of them ultimately financed by the taxpayers—began piling up.

Why? Could the "Keating Five" have kept him afloat for those two years?

Certainly, Mr. Keating exercised great influence in Washington. Mr. Gray, the former Bank Board chief, recalls that on March 6, 1987 Sen. Donald Riegle, a Michigan Democrat who now heads the Senate Banking Committee, said his colleagues from Arizona were unhappy about the handling of Lincoln. Then, on April 2, Mr. Gray met for about an hour with the two Arizona senators, Democrat Dennis DeConcini and Republican John McCain, as well as with Democratic Sens. John Glenn of Ohio and Alan Cranston of California. Mr. Gray testified that Sen. DeConcini seemed to speak for the rest. "He said he and the other senators were there on behalf of their friend at Lincoln Savings," Mr. Gray recalled.

On April 9 four top regulators from San Francisco met for more than two hours with Sens. DeConcini, McCain, Glenn and Riegle, and, for only a moment, with Sen. Cranston. According to extensive notes taken by William Black, one of the San Francisco officials, Sen. DeConcini complained about the direct-investment rule. Sen. McCain complained that the examiners were being too tough in evaluating Lincoln's real-estate holdings. Sen. Glenn urged regulators to quit drawing out their investigation. Sen. Riegle insisted, "These people saved

a failing thrift," repeating Mr. Keating's inaccurate claim.

But the regulators weren't moved. James Cirona, the top San Francisco official, told the senators, "This is a ticking time bomb." Michael Patriarca, another top official, told the senators, "I've never seen any bank or S&L that's anything like this."

If the intervention by the Keating Five came to no result, then what of Mr. Keating's clout with the White House?

Mr. Keating boasted of lobbying Chief of Staff Donald Regan to get a business associate, Georgia businessman Lee Henkel, appointed to the Bank Board in November 1986. But Mr. Henkel and others say Mr. Keating exaggerated his role. In any case the appointment did him little good. Mr. Henkel did propose a modification of the direct-investment rule that would have benefited Lincoln, but the modification wasn't adopted and Mr. Henkel's action provoked such an uproar that he resigned from the board amid an FBI investigation. The Justice Department declined to prosecute him after a two-year review of his case.

It is true that the White House passively allowed the Lincoln fiasco and the larger thrift-industry crisis to run out of control, but apparently without much prompting from Mr. Keating. For a time in 1986 the White House allowed two vacancies on the three-member Bank Board to go unfilled, leaving Mr. Gray powerless to act.

The most important player in Mr. Keating's continued control of Lincoln was M. Danny Wall, who succeeded Mr. Gray as chairman of the Bank Board in 1987. When Mr. Wall assumed his position he found the staff bickering over how to proceed, and Lincoln pressing a lawsuit that claimed regulators had been leaking damaging information about the examination to news organizations.

Complicating matters further, Rosemary Stewart, head of the office of enforcement in Washington, had a long-running feud with the San Francisco staff, which she suspected of committing the leaks. She also argued that San Francisco hadn't produced enough evidence to make a seizure of Lincoln, or even a cease-and-desist order, stand up in court. Ms. Stewart was lined up against the chief of regulation and supervision, William Robertson, who told Mr. Wall in a July 30, 1987, that Lincoln ought to be put into receivership. Within days, Mr. Wall told Mr. Robertson he would be replaced.

Mr. Wall moved slowly. On Sept. 24, 1987, he met personally with Mr. Keating. "He was a businessman that appeared to be very successful. He appeared to be a pillar of his community," Mr. Wall recalls. He says he also found his business style "freewheeling" and recalls thinking that he was "not a person who belongs in the thrift business."

Mr. Keating put on his tough exterior, saying he would refuse to allow any more San Francisco examiners into Lincoln without a court order. Washington then effectively stripped San Francisco of its authority over Lincoln, according to testimony by Mr. Black.

No examiners called on Lincoln for the next 10 months. "Lincoln dropped into a regulatory black hole," Mr. Black says.

Mr. Wall promised Mr. Keating his Washington staff would review San Francisco's handling of Lincoln. Months of wrangling ensued, during which Lincoln complained of an additional news leak and asked to be relieved permanently of San Francisco's supervision.

Meanwhile, some in Washington continued to press for strong action. But while Mr. Robertson had urged a receivership for Lincoln, his successor, Darrel Dochow, urged caution. He and Mr. Wall say they were swayed in part by the fact that Lincoln was reporting a healthy net worth and that it had received clean reports for 1986 and 1987 from its independent auditor, Arthur Young & Co. (later merged into what is now Ernst & Young).

Arthur Young would later resign the account in a messy public dispute over Mr. Keating's insistence of booking millions in profits from some questionable transactions. Mr. Keating also hired the Arthur Young partner, Jack Atchison, who had headed the 1986 and 1987 audits, for a salary of near \$1 million a year. Mr. Atchison recently invoked his Fifth Amendment privilege against possible self-incrimination when the House Banking Committee asked him to testify about the affair.

Mr. Dochow remained cautious even though his staff was telling him that Lincoln was going under. Kevin O'Connell, an aide assigned to the Lincoln case early in 1987, said in a recent interview, "When I came here I said, 'This shop is going to fail.'" Another of Mr. Dochow's aides, Mr. Smuzynski, told Mr. Dochow in an Oct. 16, 1987, memo that Lincoln "presents excessive risk" and "is operating in an unsafe and unsound manner."

But Mr. Dochow remained optimistic. "Darrel thought that Lincoln could be saved," Ms. Stewart, the enforcement chief, recalls.

Ultimately, Mr. Wall signed a negotiated "memorandum of understanding" with Lincoln, bowing to Mr. Keating's demands that he be removed from San Francisco's jurisdiction. Board member Lawrence White dissented in the 2-1 vote approving the move. "San Francisco was on the right track," he said earlier this year.

Indeed, a new audit team, recruited from other districts, last October concluded that Lincoln's problems were even worse than San Francisco had initially reported.

Among other things, they said the thrift was generating phony profits through a complex series of sales of barren desert land. An accounting firm hired by the regulators, Kenneth Leventhal & Co., looked at 15 transactions accounting for \$135 million in pre-tax income—half of what Lincoln had booked since Mr. Keating acquired it—and concluded that none of the profits should have been allowed. "Seldom in our experience have we encountered a more egregious example of the misapplication of generally accepted accounting principles," Leventhal said.

"It (Lincoln) created profits by making loans. Many of the loans were bad. Lincoln was manufacturing profits by giving money away." Most of the questionable transactions were completed while Mr. Wall and his deputies anguished over whether to move in.

"One of the things you can say in hindsight is that action should have been taken more promptly," Mr. Wall acknowledges. If he had it to do over again, he adds, he would have sent San Francisco examiners back into this institution despite Mr. Keating's threats to sue. "I would have forced the issue in the courts, and blamed the courts if they delayed us," he says.

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THE ECONOMY

Buyouts and productivity

Since our October evaluation of the economy, the Bureau of Labor Statistics has released data on productivity for the third quarter of 1989 and revisions for previous quarters. These data are an integral part of our supply-side spreads. Chart 1 shows the spreads through 1989:3. It is clear that a downshift in spreads occurred from 1989:2 to 1989:3. This means that firms have less of an incentive to increase output now than they did in the second quarter.

The narrowing of spreads is accounted for, in large part, by decreases in productivity growth rates. For the economy-wide spreads, year-over-year productivity dropped from 1.3% in 1989:2 to 0.9% in 1989:3, a 31% decrease, and for manufacturing, year-over-year productivity dropped from 3.2% to 2.4% in the same periods. These declines not only reduced the output-side of the spreads but also increased the unit labor cost, or input-side of the spreads. This caused the spreads to narrow.

If this weren't enough, Mr. Warren T. Brookes, a nationally syndicated economics columnist, has brought a recent Commerce Department study to our attention. This study gives us concern about the future course of productivity, and thus our spreads. We turn to a review of this study, "The Effects of Leveraged Buyouts on Productivity," and its implications for the future course of the economy.

The Commerce Department study is a detailed examination of all of the 1,100 manufacturing plants that were involved in buyouts between 1981 and 1986. Total-factor productivity (TFP) growth in these plants was compared with other plants in the same industry. Chart 2 summarizes the results for leveraged buyouts (LBOs) and management buyouts (MBOs). The productivity differences between buyouts (LBOs and MBOs) and non-buyouts in the same industry, when evaluated on a before and after buyout basis, were significant.

In the years before the buyouts, the LBO plants' productivity exceeded the non-buyout plants' in the same industry by 1.2% on average, and the MBO plants' productivity exceeded the non-buyouts' in the same industry by 3.0% on average. After the LBOs and MBOs took place, the productivity gap between the buyout and non-buyout plants widened to 2.9% and 7.5% on average for the LBOs and the MBOs, respectively.

The more than doubling of the productivity gap between buyout and non-buyout plants in the same industry was accomplished because the new owners were saddled with heavy debt loads. This made them tough-minded about costs and waste. Indeed, the study concluded that two factors contributed to the jump in productivity (the widening productivity gap) for the buyout plants: "(1) Increased intensity of effort by labor and more generally increased utilization of all employee input, due to increased sensitivity of the financial rewards (and penalties) to their performance; and (2) reduction in the proportion of resources misallocated to inefficient activities due... to a more intensive monitoring of managers by investors."

Implications

1. Buyouts make firms lean and mean. Hence, buyouts have contributed greatly to the nation's productivity growth in the 1980s.
2. As with any other economic activity, the most attractive buyouts are accomplished first, and then less attractive buyouts are pursued. Hence, the pool of attractive buyouts is

much smaller and of lower quality than it was when the buyout activity began. The market has begun to detect this fact.

3. If this weren't enough, the economy is beginning to slow. This will make the economics of buyouts even less attractive.

4. With the buyout era coming to a close, one of the factors that has contributed greatly to the nation's productivity will be eliminated.

5. Hence, without a new motivator for productivity, cost control (unit labor costs) will be more difficult to obtain, and there will continue to be squeeze pressures on the supply-side spreads.

On the issue of a new motivator for productivity, we add a pessimistic note. Indeed, the buyout firms have become lean and mean so that they can generate more cash flow to service their heavy debt commitments. However, firms in the buyout sector of the economy cannot be counted on to make investments in new plant and equipment, which are required to generate long-run productivity increases. This conclusion holds because these firms have already committed their newfound cash flows to debt service. Without the ability to generate more newfound cash flows, particularly in a slow-growth environment, or to borrow more money, the buyout sector will not be in a position to contribute a new long-run motivator for productivity growth. This motivator will have to come from another sector of the economy.

6. With such squeeze pressure on the spreads, robust economic growth will not be forthcoming.

— Dr. Steve H. Hanke

Chart 1
Supply-Side Spreads (Rates of Change)

Period	Economy-Wide	Manufacturing
85 1	1.8%	6.9%
2	1.4	9.5
3	2.7	7.5
4	2.0	7.9
86 1	4.7%	7.3%
2	3.5	3.7
3	2.0	3.7
4	3.1	3.4
87 1	0.0%	5.7%
2	1.8	8.5
3	4.1	9.7
4	3.8	9.6
88 1	5.8%	7.1%
2	2.6	5.1
3	2.5	5.8
4	2.8	5.7
89 1	0.6%	6.7%
2	2.4%	7.6%
3	1.2%	5.1%

Notes 1) Rates of Change are calculated on a year-over-year basis.
2) Supply-side spreads (=) percent change in productivity (+) percent change in prices (-) percent change in unit labor costs.

Chart 2
Buyout vs. Non-Buyout Companies
(Total Factor Productivity)

Years Before or After Buyout	LBO Gain in Productivity (%)	MBO Gain in Productivity (%)
3 years before	1.3	1.9
2 years before	1.3	2.2
1 year before	1.1	4.9
Buyout year	2.2	2.7
1 year after	3.5	7.2
2 years after	2.3	7.7

INTEREST RATES/US DOLLAR

The good news is already out

The Fed, aware of the slowing economy, has been lowering its Fed funds target rate in fairly rapid steps of one-quarter point. The latest "easing" move brings the Fed rate to 8¼%. The impact on the Adjusted Monetary Base has been hard to detect, as it shows an eight-week annual rate of growth of 1.8%, and a year-over-year pace of 2.7%. M1 and M2, however, have shown a stronger reaction, with eight-week increases of 8.9% and 8.3% annualized. Shifting of deposits from troubled S&Ls to commercial banks, however, may have been the primary reason for these changes. A broader measure, M3, continues to grow at a *very modest 3.9% year-over-year rate* (see Chart 3).

The market has already discounted a whopping 100-basis-points drop in Fed Funds by March '90, as three-month T-bills trade at 6.51% versus a present 7.54%, while three-month Eurodollar rates are expected to fall to 7.68% from the present 8.31% (implying a wider Ted spread in March '90 than the one prevailing currently). With such expectations, it becomes difficult to make money *betting* on lower rates.

Furthermore, the external value of the US dollar has become extremely sensitive to the increased rate differential

developing between the US and the ECC, particularly West Germany. As recently as last April, three-month Euro-DM rates were 6.25%, while three-month Eurodollar rates traded at 10% for a differential in favor of the US dollar of 375 basis points. At the time, the exchange rate was around 1.86 DM/\$. On Friday, three-month Euro-DM rates traded at 8.12%, just 20 basis points less than equivalent Eurodollar rates. As a result, the DM had risen to 1.7975 DM/\$.

The implications are clear: The Fed has little room to maneuver if it wants to avoid a sharp dollar fall — despite the continuing improvement in the current account and the continuing attractiveness of US assets.

STRATEGY: *The trading implications are quite clear: 1) It no longer pays to "bet the ranch" on lower interest rates. When and if they come, they will disappoint the T-bill, Eurodollar, and T-bond bulls. Liquidate long calls in T-bills and T-bonds, accepting profits. 2) It no longer pays to stay long US dollar, even if only against the yen; cross trading has proven to be much more rewarding (see the September and October issues). Hedge up any outright yen short positions with either DM or SF.*

Chart 3

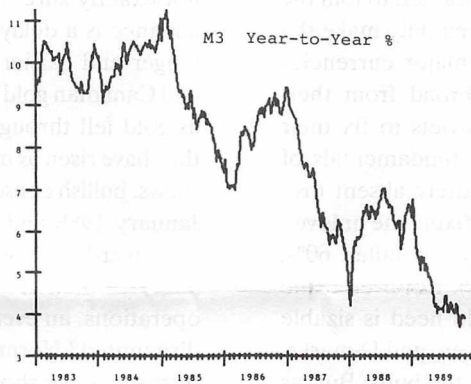


Chart 6

Dec. Swiss francs/Dec. Japanese yen

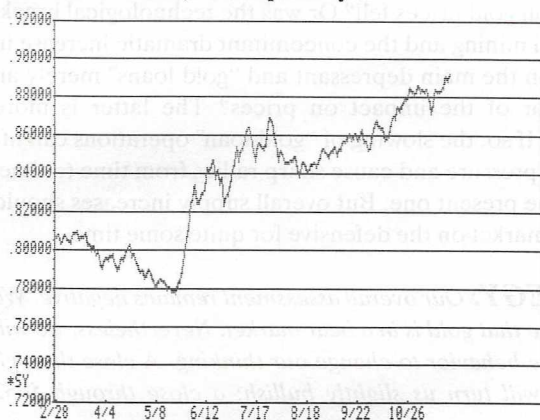


Chart 7

Dec. DM/Dec. Japanese yen



GOLD**Just a bear market rally?**

It seems that we do not bother reading our own script. In the July 23 issue of *FC&CC*, in an article entitled "Is gold bottoming?", we suggested that "gold prices are probing for an early bottom." We advanced three tell-tale signs: 1) strong relative action *vis à vis* silver (see Chart 8; price action from end of March to end of July); 2) strong relative action *vis à vis* the CRB index (or own preferred spread; see Chart 9); and 3) the fact that the "gold-loan" story was wearing thin with clear indications that its pace was slowing dramatically.

Ironically, we concluded that "it is much too early, we believe, to make a bullish case. The US dollar is strong and inflation is clearly on the wane. Nevertheless, we are becoming *more attentive* (did we really?) to the possibilities of an early bottoming action and have changed our odds to 50/50 from 75/25 on the chances of a move below \$300/oz."

Complacently, we retained the short gold/long CRB positions without ever paying attention to the technical build-up in strength. The double bottom around \$360/oz. and the slowing downside momentum can be linked to a large accumulation of dry leaves: It waits to be ignited and turn into a devastating fire.

The gold market was ignited by well-intentioned but fantastic (as in fantasy) dream of a Soviet plan to make the ruble gold-convertible. If the Soviets truly wanted to join the civilized world's monetary system, they need only make the ruble freely convertible into any and all major currencies while continuing to earn hard dollars abroad from their bullion sales. It would be folly for the Soviets to fix their currency in a floating universe while the fundamentals of economic reform and liberalization are sorely absent (ask capitalistic Argentina how well it has done fixing the unloved austral; in four short weeks the currency has fallen 60%, causing in the process huge reserve losses). But even if the Soviets attempted to do so, all they would need is sizable international reserves made up of dollars, yen, and D-marks.

Gold is merely a gleam in the eyes of the bulls. But, as we noted earlier, gold had built up an "incendiary" condition and needed very little to be set off.

Our best guess, thus far, is that gold is experiencing a bear market rally that is likely to fall short of the peak registered in the run up of \$437/oz. late last year. A *close* above \$437 would turn us mildly bullish, while a *close* above \$452 would dispel our last doubts regarding the onset of a bull market.

We do not believe, however, that this will happen. Why? simply because the main ingredients of a bull market, easy money and *accelerating inflation*, are missing. Furthermore, bull/bear commodity cycles go from overvaluation (where producer profits are unusually high) to undervaluation (where producers, using a British expression, make losses). As yet, major gold producers have not reported losses. An alterna-

tive explanation, i.e., that we never left the bull cycle (and thus gold need not swing to undervaluation) and the two-year decline from \$500/oz. is merely a correction in a ongoing bull market, is possible though improbable.

Finally, and most importantly, past bull markets in gold always began well past the *trough* of a US recession — let alone the onset of one. This was true in late 1971, 1977, and 1983. By all accounts (see "Buyouts and productivity" in this issue), we seem to be a great deal closer to the beginning of a US recession than *past* the end of one.

Just as the technical condition of the market was ripe for a substantial advance — an oversold and lethargic market refusing to give much more ground — the technical condition of the market, at this time, gives every reason to believe that a reversal is imminent. Implied volatilities have advanced from 12½% to 21% (the highest in two years); bullish consensus has risen to 72%, the highest reading in nearly two years, and the media have prominently displayed increasing space and importance to the recent advance. None of these indicators have reached "extreme" readings (although Friday's \$8/oz. rise has not, as yet, been "measured"), but one should become attentive to "topping" action in the next few days.

Here's an interesting point to consider, although we are not exactly sure of the implications: Bullion's skyrocketing advance is a delayed reaction, strangely enough, to a much longer and earlier increase in bullish sentiment. Major US and Canadian gold mining shares bottomed out *last December* as gold fell through \$400/oz. for the first time. Since then, they have risen as much as 100%. At the same time, as Chart 10 shows, bullish consensus also bottomed out in December 1987/January 1988 and despite continuing falling bullion prices, an upward trend was established in the bullish consensus.

Was bullion "forced" lower by the unusual "gold loan" operations, an event that was well understood and, perhaps, discounted? Normally, this is a bullish development, and in retrospect, we should have been more attentive. But does it have long-term bullish implications? Were "gold loans" the *only* reason gold prices fell? Or was the technological breakthrough in mining and the concomitant dramatic increase in production the main depressant and "gold loans" merely an accelerator of the impact on prices? The latter is more probable. If so, the slowing of "gold loan" operations can lift downside pressure and cause sharp rallies from time to time, such as the present one. But overall supply increases should keep the market on the defensive for quite some time.

STRATEGY: *Our overall assessment remains negative. We still believe that gold is in a bear market. Nevertheless, we will allow price behavior to change our thinking. A close through \$437/oz. will turn us slightly bullish; a close through \$452*

will convince us that the bull market that began in 1983 is alive and well.

Stopped out of the long CRB/short gold spread, with overall good profits. Stand aside.

Chart 8 - Dec. Gold/Dec. Silver

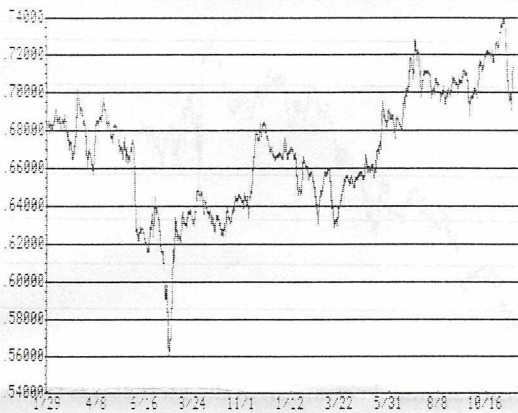


Chart 9 - CRB/Gold

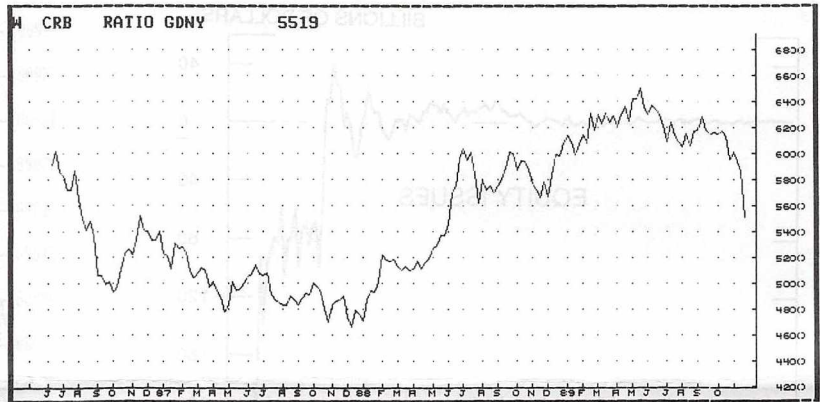


Chart 10

GOLD & THE BULLISH CONSENSUS

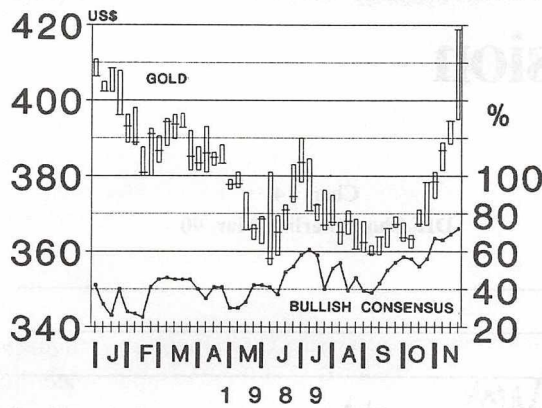


Chart 11 - Comex Gold



STOCK INDEXES

Prelude to decline

While fundamentals continue to point to a massive profit squeeze ahead (as productivity falters and unit labor costs soar), and as night follows day, a recession, the market responds positively although not enthusiastically to the prospect of lower interest rates. Stock prices remain locked in a 330 to 350 trading range, basis the S&P 500, but breadth is very poor, and new lows still exceed new highs by a respectable margin. Furthermore, the lack of any announced "deals" in recent weeks makes it all but certain that the "deal era" and its virtuous effects of removing supply and propping up prices is, for all practical purposes, over (see Chart 12).

An enormous potential supply of stock lies in wait in the coming years, one that threatens to keep stock prices down for longer than we would like to think. How will it come to market? Primarily through recapitalizations and Chapter 11s,

which will convert billions of dollars of debt back into stock, an ironic end to the leveraging of America. Already, some of the largest failed LBOs, Southmark, Resorts International, Revco, Southland, and so on, have announced or are close to announcing, plans that will involve the issuance of billions of dollars worth of new stock. This is merely the beginning. In another stock-for-debt swap, better-off leveraged corporations will resort to issuing convertible bonds to refinance high-yield obligations. That was the route taken by the likes of Turner Broadcasting, Kaufman and Broad, etc. Here, again, the supply of stock will mount, unleashing a reversal of the virtuous circle of the '80s.

STRATEGY: Maintain long put positions. The present consolidation is a prelude to another decline and not the base for a new advance.

Chart 12

Net funds raised by Non-financial Corporations

Annually, 1950-51; Seasonally adjusted annual rates, quarterly, 1952-90

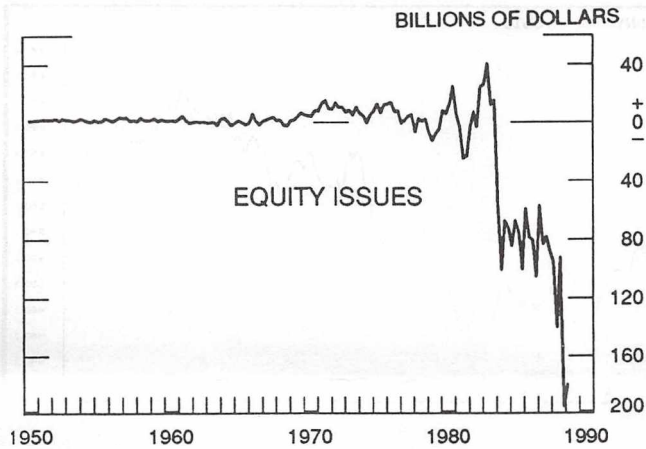


Chart 13

CME S&P 500 Index



LONDON 3-MONTH DEPOSIT RATES

Into the recession

The evidence is mounting that the UK has indeed entered a recession, as we have pointed out in past issues.

Retail sales, by volume were lower in October than they were in the first quarter of this year. For the third consecutive month, the trade balance improved, aided by a drop in the volume of imports of more than 4%. The current account deficit, at £1.54 billion was lower than the market expectation of a £1.7 billion shortfall. The collapse in consumer spending should accelerate this trend over coming months.

The next set of economic statistics, due out in two to three weeks, should convince the Bank to engineer a cautious and slow decline in rates, in one-half percentage point steps. Care will be taken not to frighten the forex market; therefore, the move will take place at times of Sterling strength. It is clear, however, that the Thatcher government has adopted Dr. Walter's views and has given up targeting Sterling. Thus, the Bank will give first priority to the domestic situation and allow rates to fall gently regardless of the impact on Sterling.

STRATEGY: Remain long March '90 Deposit Rates. Profit potential is substantial.

Chart 14

DIF Short Sterling Mar. 90



POTPOURRI

Sugar and Canuck buck

Sugar has been closed out, as per Hotline Update of November 22; stand aside for reentry advice. Canadian dollar looks higher, short term, thanks to widening interest rate differen-

tials; maintain long puts but hold back from increasing positions as yet.

FRIEDBERG CAPITAL MARKETS

Pacific Scientific: good results

Pacific Scientific 7¾% debentures, due 15/6/03.

First recommended FC&CC April 16, 1989 Update:

For the recently-released third quarter report (Sept. 29/89), Pacific Scientific reported:

Earnings in the third quarter of 1989 continued their upward trend as previously projected. Eliminating extraordinary gains and the 11-cent first-quarter gain from the sale of product lines, the earnings per common share during the first three quarters of 1989 have been as follows:

	Profit (Loss)
First Quarter	(\$.05) per share
Second Quarter	\$.05 per share
Third Quarter	\$.18 per share

Consolidated orders for the first nine months of 1989 were up 30% as compared to the prior year (excluding discontinued product lines) and orders are at an annualized revenue figure of \$196 million. Year-to-date shipments have been at an annualized rate of \$164 million. This difference in order and delivery rates has resulted in an increase in backlog to its current level of \$106 million. It is expected that the current fourth quarter will begin to show a higher rate of sales growth.

**Chart 16
Foreign Currency Bonds**

Date: November 24, 1989
We offer the following bonds subject to change without prior notice:
Min. a/c US\$5000.

ISSUER/INT. DATE/COUPON	BID	OFFER	CURRENT ANNUAL YIELD TO INT.	LAST PAY DATE
CANADIAN DOLLAR DEBENTURED BONDS				
GOVERNMENT OF CANADA (semi annual) 01/02/90 13 1/4%	99.92	- 100.22	Money Market	01/08/89-01/02/90
NEW ZEALAND DOLLAR DEBENTURED BONDS				
TORONTO DOMINION BANK 02/04/90 15% RSP eligible	100 1/4-	101 1/4	12.71%	02/04/89-02/04/90
TOURIST HOTEL (N.Z.) 04/06/93 zero coupon	62 1/4-	63 1/4	13.91%	matures 04/06/93
AUSTRALIAN DOLLAR DEBENTURED BONDS				
COMMONWEALTH BANK OF AUSTRALIA 01/07/94 14%	97 7/8-			01/07/89-01/07/90
WORLD BANK 15/03/93 12 3/4% RSP eligible	96	- 96 3/4	13.98%	15/03/89-15/03/90
CAN. IMP. BANK OF COMMERCE 13/03/91 13% RSP eligible	95 1/4-	96	16.50%	13/03/89-13/03/90
DANISH KRONER DEBENTURED BONDS				
STOCKHOLM 10/11/91 10 5/8%	98 5/8-	99 5/8	10.83%	10/11/88-10/11/89
BRITISH POUND DEBENTURED BONDS				
KGM of SWEDEN 14/4/93 9 3/8%	90 7/8-	91 5/8	12.51%	14/04/89-14/04/90
DEUTSCHE MARK DEBENTURED BONDS				
QUEBEC HYDRO 5 1/2% 1/5/96RSP eligible	88 1/8-	89 1/8	7.70%	01/05/89-01/05/90
SWISS FRANC DEBENTURED BONDS				
GOVT. OF AUSTRALIA 30/10/98 5%	90 1/4-	91	6.35%	30/10/89-30/10/90
JAPANESE YEN DEBENTURED BONDS				
GOVT. OF CANADA 23/7/93 5 5/8% RSP eligible	98.55	- 99.30	5.83%	23/07/89-23/07/90
U.S. DOLLAR DEBENTURED FIXED COUPON BONDS				
PACIFIC SCIENTIFIC 7 3/4% 15/06/03(semi) CV \$538 p/ah	70 1/2-			15/06/89-15/12/89
SUNRISE MEDICAL INC. 7.25% 26/6/96 CV \$517 5/8 p/ah	80	- 83	10.99%	26/06/89-26/06/90
ALLIANT COMPUTER 7.25% 15/05/12(semi) CV \$539.75 p/ah	46	- 48	16.31%	15/05/89-15/11/90
COOPER CO'S. 10 5/8% 01/03/05(semi) CV \$527.45 p/ah call in 1995 \$100	64	- 66	17.60%	01/09/89-01/03/90
COEUR D'ALENE SA 10/06/02 CV \$526.55 p/ah call in 1990 \$ 103	90 1/2-	92 1/2	6.91%	10/06/89-10/06/90
DICEON ELECTRONICS 5.5% 1/3/12 (semi) CV \$539.50 p/ah	43 1/2-	45 1/2	13.50%	01/09/89-01/03/90
U.S. DEBENTURED ZERO COUPON BONDS				
KINGDOM OF DENMARK 6/8/98	49 1/8-	49 7/8	8.34%	matures -06/08/98
U.S. DOLLAR DEBENTURED FIXED RATE BONDS				
ALBERTA 7 3/8% 9/12/91 RSP eligible	98	- 98 3/4	8.06%	09/12/88-09/12/89
SOUTHMARK CORP. 10 7/8% 1/11/89 (semi) U.S. DOLLAR DEBENTURED FLOATING RATE BONDS				
UNITED KINGDOM 24/9/96 3 mo LIBID-1/8 (qly)	99.21	- 100.91	8 13/16%	28/09/89-28/12/89
REPUBLIC OF ITALY 30/4/93 3 mo LIBID(qly)	99.25	- 99.65	8 5/8%	31/10/89-31/01/90
REPUBLIC OF PORTUGAL 8/12/93 6 mo LIBOR +5 B.P.(semi)	99.98	- 100.28	9.3%	08/06/89-08/12/89
BANCO CENTRAL DE BRAZIL 15/10/99 6 mo LIBOR +13/16 (semi)	59 1/4-	61 1/4	9.5%	16/10/89-17/04/90
** Yield to maturity			21.47%	*amortized: 1/4 of principal paid semi-annually starting 1993.
BANCO CENTRAL DE CHILE 20/1/94 12 mo LIBOR+ 13/16 (annual)	60 1/4-	62 1/4	10 11/16%	
** current yield			**	20/01/89-20/01/90

For further information and current prices please call:
FRIEDBERG CAPITAL MARKETS (416) 364-2700 F/HICHH

**Chart 15
Breakeven exchange rates for US\$ - based investor**

This analysis shows a "snapshot" of the relationship between interest rate differentials and rates of exchange. The breakeven rate measures how far the foreign currency has to devalue (for NZ\$, A\$, DKr) or revalue (for DM, SF, JY) before the interest rate advantage/disadvantage is overcome by currency depreciation/appreciation.

	U.S. \$	NEW ZEALAND \$	AUSTRALIAN \$	DEUTSCHEMARK	SWISS FRANC	JAPANESE YEN	DANISH KRONE
1 year	7.54%	Toronto Dominion 2/4/90 yields 12.71% (.560 NZ/US)					
2 year	7.60%		CIBC 13% 13/3/91 yields 16.50% (.669 A\$/US)				Stockholm 10% 10/11/91, yields 10.83% (7.42 US/Dkr)
4 year	7.64%	Tourist Hotel 0% 4/6/93, yields 13.9% (.468 NZ/US)				Canada 5% 23/7/93, yields 5.83% (133.99 US/JY)	
6 year	7.69%			Hydro Quebec 5½% 1/5/96 yields 7.70% (1.806 US/DM)			
9 year	7.75%				Australia 5% 30/10/98 yields 6.35% (1.434 US/SF)		
Spot Exchange Rate	N/A	.5875	.7839	1.804	1.613	143.4	7.006

**For example, in parentheses, since a US\$ based investor would receive 627 basis points (1391-764) by holding the Tourist NZ\$ bond, the NZ\$ can depreciate to .468 NZ/US from the present spot exchange rate of

.5875 NZ/US over the next 1 year for the NZ\$ investment to break even with current US\$ rates of interest. Assumes that bonds are held to maturity, and coupons are reinvested.

FOREX RATES & UPDATE

<i>Currency</i>	<i>Spot</i>	<i>3-Month</i>	<i>12-Month</i>	<i>Comments vis à vis US\$</i>	<i>Comments vis à vis DM (Spot DM: 1.8060)</i>
Australian dollar	.7830-.7840	.7645-.7660	.7195-.7230	Neutral	Neutral
Belgian franc	37.85-37.95	37.97-38.27	38.39-38.64	Neutral	Neutral
Danish krone	7.0100-7.0175	7.0720-7.1435	7.2200-7.2425	Neutral	Remain long
Dutch guilder	2.0370-2.0385	2.0373-2.0392	2.0437-2.0467	Neutral	Neutral
Greek drachma	164.25-164.30	169.25-174.30	177.75-197.80	Remain short	Remain short
Hong Kong dollar	7.8105-7.8115	7.8090-7.8115	7.8105-7.8315	Neutral	Neutral
Irish punt	1.4595-1.4610	1.4460-1.4500	1.4030-1.4105	Neutral	Neutral
Italian lira	1331-1332	1345-1347	1388-1394	Neutral	Neutral
Kuwaiti dinar	.29750-.29780	.29720-.29775	.29750-.29780	Neutral	Neutral
Malaysian ringgit	2.7020-2.7030	2.6850-2.6880	2.6590-2.6640	Neutral	Neutral
New Zealand dollar	.5875-.5890	.5720-.5745	.5570-.5605	Neutral	Neutral
Norwegian krone	6.8600-6.8675	6.9265-6.9370	7.1200-7.1400	Neutral	Neutral
Portugese escudo	156.55-156.65	159.60-160.40	168.95-172.25	Neutral	Neutral
Saudi Arabian riyal	3.7495-3.7505	3.7465-3.7495	3.7465-3.7495	Remain short	Remain short
Singapore dollar	1.9550-1.9560	1.9445-1.9465	1.9175-1.9285	Neutral	Neutral
Spanish peseta	115.70-115.80	117.55-117.75	123.15-123.45	Neutral	Neutral
Swedish krona	6.4150-6.4225	6.4710-6.4810	6.6760-6.6925	Neutral	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue.

Currency expected to firm against both currencies.

Currency expected to strengthen against US\$ and weaken against DM.

Currency expected to weaken against both major currencies.

Currency expected to weaken against US\$, but strengthen against DM.

Term used to liquidate short position but does not imply a new buy recommendation.

Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy	Buy
Buy	Sell
Sell	Sell
Sell	Buy

Cover

Liquidate

HOTLINE UPDATE

Tuesday, October 31:
Market Letter is in the mail.

Friday, November 3:
The market letter was mailed this week. An error crept into the letter on page 9 in the strategy section of the London 3 months deposit rates. It reads "each point represents 25 Pounds Sterling," it should read "each point represents 12.50 Pounds Sterling."

Tuesday, November 7:
No changes or new recommendations.

Friday, November 10:
No changes or new recommendations.

Flash update, Monday, November 13, 4:00 p.m.:
Buy March copper, at market, risking 112.00, close only.

Flash update, Wednesday, November 15, 9:45 a.m.:
On Monday, November 13, we suggested going long March copper with stops at 112.00, close only. Although yesterday's settlement of 112.00 was above the stop, you may still have been stopped out, since the closing range had a low of 111.90. If so, we advise reinstating long positions at market. Our revised stop is 111.50, close only.

Friday, November 17:
1. We were stopped out of long March copper positions at yesterday's close, as per our revised recommendations on Wednesday of a 111.50 stop, close only.
2. Raise stops in long March sugar positions to 1425, close only.

Tuesday, November 21:
No changes or new recommendations. However, there may be a flash update tomorrow between 11:00 a.m. and 12:00.

Flash update, Wednesday, November 22, 11:00 a.m.:
Liquidate long March sugar positions at market.

Friday, November 24:
1. As per Wednesday's flash update, you have liquidated long sugar positions at market. One new recommendation: Short Japanese yen positions should be hedged up with long March Swiss franc to the same dollar equivalent, the Swiss franc having a slightly lower contract value (62.25 vs 6999, basis March, basis today's close.)

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