

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc.



Volume 22, No. 2 April 2, 2001

Be warned...a run on mutual funds threatens to accelerate the decline

Surely you must have heard in recent weeks that the stock market is or has reached a bottom and that stocks sell at "compelling valuations," especially the so-called value stocks. Be warned: The other shoe is yet to drop.

Bullish sentiment prompted us to issue a warning a few weeks ago that stock prices were "headed to new lows in a hurry" (see "We are going down again" in our Feb. 5 issue).

Very little if anything has since changed in this regard. Nasdaq, S&P 500, and the Dow Jones have dropped 36.2%, 14.3%, and 9.9%, respectively, and measured bullishness has fallen back some, hardly a sign of despair (see Charts 1 and 2).

Consumer, business, and investor expectations have been propped up by official assurances, especially from Fed officials, that the economy has not entered a recession and that faster growth was likely to return before the year was out. This is pure economic nonsense. The sooner the private sector begins to reckon realistically with the enormity of the \$5 trillion loss of wealth experienced thus far, the better. It does little good to sugar-coat what is already the worst collapse in earnings in a decade, to overlook the erosion of the paycheck caused by an insidious acceleration of inflation, and to brush aside the fact that the American private sector is running the worst financial deficit atop the worst balance sheet in its history.

A barely noticed phenomenon, however, may well trigger the next sharp selloff, changing the character of this bear market. We are referring to the fact that equity funds are experiencing the first outflows in over two years.

For now, the "leakage" is still minor, though it is being masked by otherwise strong seasonal patterns (the first quarter of the year is typically the strongest one, mostly a result of reinvestment programs associated with retirement plans). January 2001 showed inflows of \$25 billion, compared with \$40.9 billion one year earlier; February 2001 showed an *outflow* of \$3.1 billion, compared with an inflow of \$53.6 billion in February 2000; and March 2001 showed a preliminary (based on the Trim Tabs weekly survey) *outflow* of \$20.2 billion, compared with an inflow of \$39.3 billion in March 2000 (see Chart 3).

The significance of this leakage should not be overlooked. Though well down from the highs, a stock market beast weigh-

ing \$10.5 trillion (the value of the Wilshire Index, measuring total market capitalization) still requires a lot of feeding. The first-quarter downtrend and in particular the substantial (preliminary) March outflow – the largest monthly dollar outflow in mutual fund history – is ominous.

With corporate share buybacks at a standstill, the consequence of a precipitous fall in cash flows, mutual fund purchases must be counted on to absorb routine selling and selling linked to the exercising of corporate options. The stock market can ill afford persistent fund outflows.

Even more ominous is the possibility of a run on equity

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Contributions by Albert D. Friedberg, Steve H. Hanke, and Kathryn M. Welling.

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mutual funds, an event whose consequences could be as cataclysmic as the series of bank runs experienced at the depth of the Great Depression. In fact, an argument can be made that investors who redeem are acting rationally. The reason is simple: Liquidity in many sectors of the market is beginning to evaporate. Closing or settlement prices used by mutual funds to value many of their large holdings are becoming increasingly unrealistic. The notion of marked-to-market is already largely an illusion: There is hardly an equity fund that could possibly move into 100% cash at settlement prices within 48 hours.

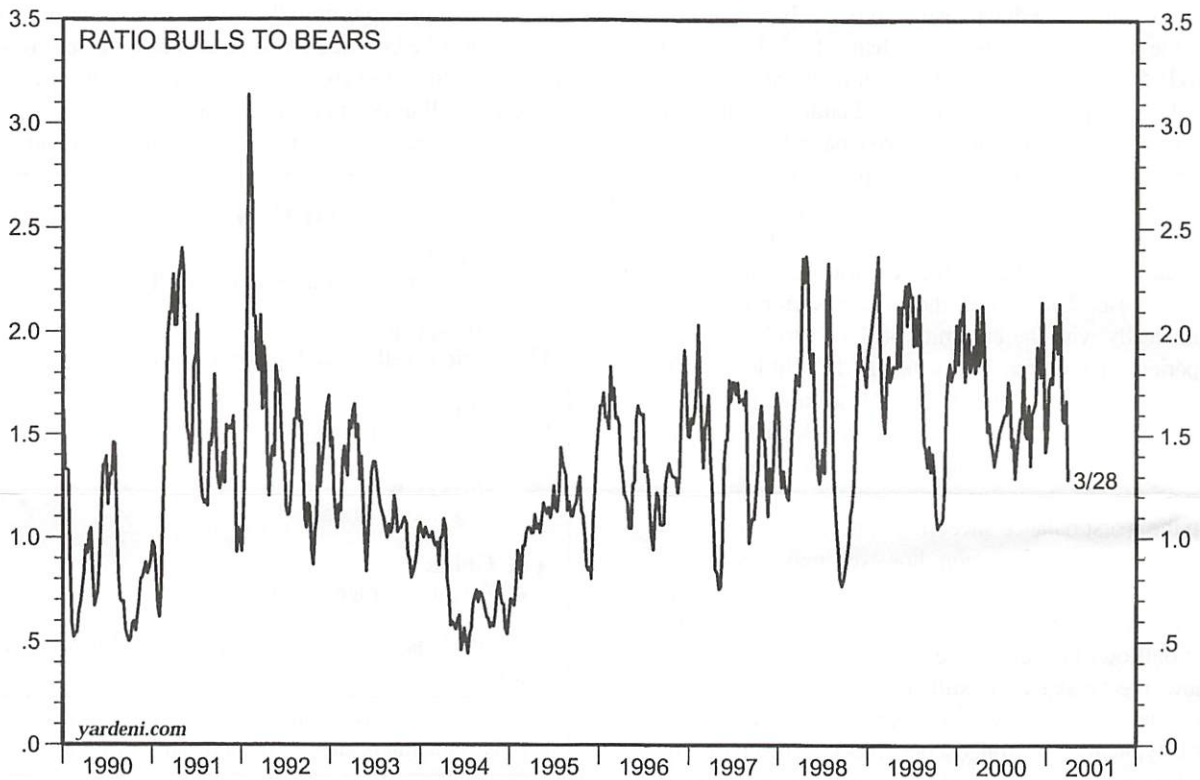
Further price declines accompanied by falling or modest volumes will give rise to perceptions that net asset values do not reflect market reality. Astute investors are beginning to realize that official net asset values are overstated and will want to cash out at those relatively favorable prices. Crumbling net asset values will draw a second group of investors who will have been made aware of the funds' difficulties in liquidating positions.

We need not tell you the rest. With the speed of the Internet, fund troubles will become public. The leakage can very quickly turn into a flood. As posited earlier, the character of the bear market will change. No longer will value investors find refuge in non-tech and modestly priced securities: Safe stocks will be dumped overboard along with speculative ones, value along growth, small caps along with big caps. *The only qualification will be liquidity: If it can be sold, it will be sold.*

This nightmarish scenario is, in our opinion, highly probable. All that has to occur is a continuation of outflows in April and May. Equity funds' low cash ratios will be hard put to accommodate continuous net redemptions without forcing more liquidation.

Prudent investors are warned. Aggressive ones can continue to sell short, focusing on the more liquid issues. In effect, those will be the first ones to bear the brunt of indiscriminate liquidation.

Chart 1 – ISI Institutional Equity Managers Survey



* Source: Investor Intelligence

Chart 2 - Ratio Bulls to Bears

Bullish/Bearish 0=Bearish 100=Bullish
4 Wk.Avg. Mar 20 56.8

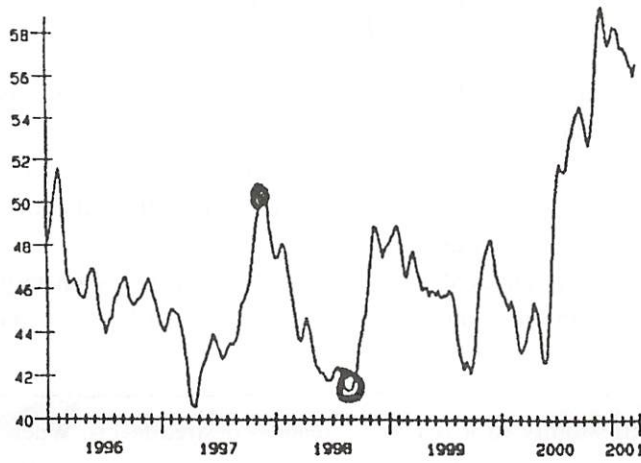


Chart 3 - Net Equity Mutual Fund Sales

NET EQUITY MUTUAL FUND SALES

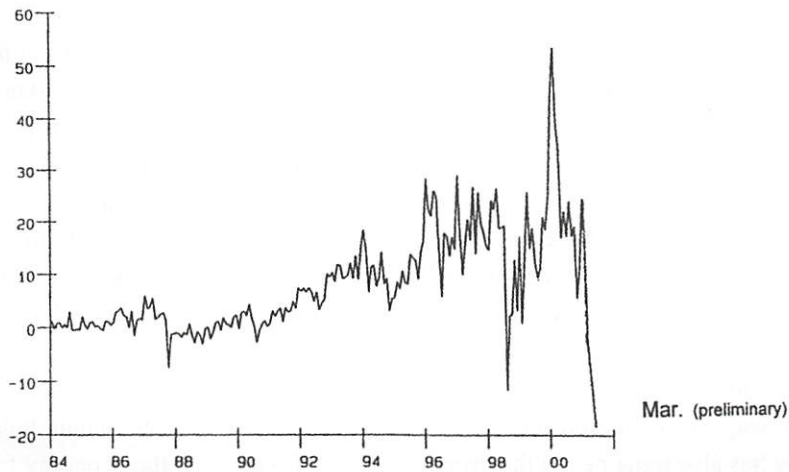
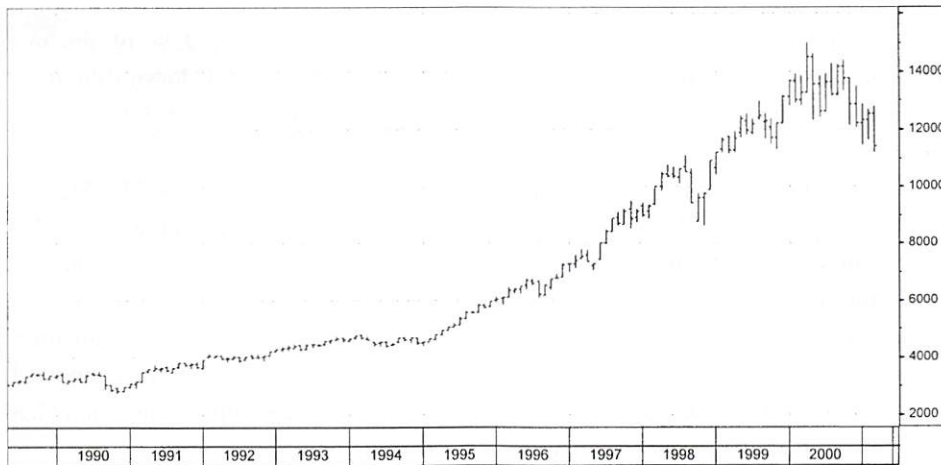


Chart 4 - (TMW) Wilshire Index



JAPAN

The anatomy of a Japanese bull

By Steve H. Hanke

Before General Douglas MacArthur began his brilliant counter-offensive against the Japanese – one that would eventually bring victory to the Allies in the Pacific – he warned his officers, “Never let a Jap attack you. When the Japanese soldier has a coordinated plan of attack, he works smoothly.” He went on to say, “When he is attacked – when he doesn’t know what is coming – it isn’t the same.” Indeed, the Japanese were vulnerable when on the defensive, precisely because of their rigidity and lack of imagination. The General compared this inflexibility to a fist that cannot loosen its grip once it has seized onto something.

With the General’s insights in mind, it is not hard to imagine how he devised what was one of the most brilliant military strategies in history. Instead of confronting the Japanese troops that were dug in on fortified Pacific islands, the General surprised his opponents time and again by simply leapfrogging them.

This brings me to the Japanese economy and economic policy. When the bubble economy collapsed in 1990, the Japanese cognoscenti were surprised and were put on the defensive. Indeed, they couldn’t imagine the negative fallout from the bursting bubble. Consequently, they have staged a rigid defense. Fiscal policy has remained a clenched fist, clenched around the Keynesian notion that you could stimulate your way out of a slump by deficit spending. Monetary policy has also remained in the grip of a clenched fist. The Bank of Japan has targeted interest rates. And those rates have always been too high in light of the collapse in the demand for credit. This has required the BOJ to drain reserves from the banks, thus reducing the loanable funds in the financial system. Consequently, the most widely used measure of money, M2 plus CDs, has grown at very low rates since 1990, creating deflation.

The loose fiscal stance, which became looser and looser with each stimulus package, reduced confidence in the credibility of the government’s economic game plan. This reduced the fiscal multipliers. Indeed, as I have argued before, the fiscal multipliers associated with the last few stimulus packages were negative. Therefore, instead of stimulating the economy, those packages actually slowed things down. To put it another way, Japan was

engaging in a very loose fiscal policy and a very tight monetary policy. And when fiscal and monetary policies move in opposite directions, monetary policy dominates. It’s no wonder, then, that the economy never could get on track.

Another purely monetary analysis – one based on the Cambridge cash balance approach – also sheds light on what has been going on in Japan. Normally during deflation, the value of real cash balances grows and eventually reaches desired levels. When that point is reached, people start consuming and investing in assets that are priced at “low” attractive levels. Deflation, then, works to eventually kick start the economy and spur real growth.

This virtuous deflationary process, working on real cash balance levels, doesn’t always work according to plan, however. The length of time required for deflationary forces to work on real balances and to put the economy back on its potential real growth path can be attenuated. This can occur if confidence keeps falling because of the collateral damage caused by the deflation – bankruptcies, eroded asset values, consequent problems with bank profits and balance sheets, etc. If confidence deteriorates, then the desired level of real cash balances keeps increasing and the gap between desired and actual cash balances is not closed. As a result, people continue to pile up cash hoards. And when people hold cash, they don’t consume. Consequently, the economy fails to pick up steam.

It appears that this vicious-cycle scenario has been occurring in Japan. Evidence of cash hoarding is abundant. Japanese have substituted cash for deposits at a rapid rate. Consequently, 93% of the monetary base is cash (something the BOJ doesn’t control directly). Therefore, we have a situation in which the monetary base grows relatively rapidly as a result of cash hoarding and the broader measures of money – like M2 plus CDs – grows at a much slower rate. Furthermore, in Japan, the ratio of cash holdings (M2 plus CDs) to nominal GDP, the so-called Cambridge K (the reciprocal of money velocity), continues to rise. Indeed, it is at an all-time high. Moreover, the Cambridge K’s recent rise is unusual, because it is more the result of a decline in nominal GDP than an increase in nominal money.

If fiscal and monetary policies were the only thing that have been in the “grip” and headed in the wrong direction, it would be bad enough. A third set of policies has also been in a state of paralysis, namely that many enterprises are walking dead. Indeed, the Japanese banks have engaged in an extreme exercise of forbearance. This has allowed many enterprises to stay on artificial life support. In addition, it has left the banks with loads of non-performing loans. The avoidance of bankruptcy has left huge chunks of the economy in limbo, creating mere idle resources.

While the Japanese have been on the defensive and in the grip of a three-pronged set of ill-conceived economic policies, foreigners have been on the offensive. Much as General MacArthur did, they have leapfrogged the Japanese and gained important footholds in the Japanese auto and investment banking industries.

* * * * *

After more than a decade, this gripping state of affairs might be changing for the better. I emphasize the word “might” simply because the political scene in Japan remains clouded, at best. First, fiscal stimulus packages might have played their last act. A hint of this was given by Finance Minister Kiichi Miyazawa in mid-March, when he blurted out something very un-Japanese. Indeed, he stunned the financial markets when he described Japan’s finances as being in a “catastrophic situation” and urged fiscal restraint. Even though he later apologized for such a frank statement, it all suggests that some fiscal tightening is in the cards. This is exactly one necessary condition that must be satisfied to set things right.

On the heels of Minister Miyazawa’s irreverent statement, the BOJ issued, on March 19, a statement, “New Procedures for Money Market Operations and Monetary Easing.” This is a truly revolutionary document. Most importantly, it relegates interest rate targeting to the dust bin, something we have said must occur if there is to be any monetary easing. The BOJ also said it would target inflation and aim at stable prices, a CPI target of zero. Since the CPI in Japan overstates inflation, the target still implies some deflation, however. To accomplish this, the BOJ will increase its “current accounts,” and the JGBs on its balance sheet. All this is good news, because it should

close the gap between actual and desired real cash balances. Once that happens, people will reduce their propensity to hoard cash and start to spend more of their incomes.

The last paragraph of the BOJ statement is worth reproducing, because it suggests that there has been a deal struck between the BOJ and the government, one that addresses the problems of the walking dead and the banks’ non-performing loans. If this happens, the relative prices of assets will be allowed to be altered and the idle resource problem will start to be corrected. Here’s what the BOJ’s statement has to say about this all-important third leg of Japanese policy:

In order to make this monetary easing fully effective in restoring Japan’s economy on a sustainable growth path, progress in structural reforms with respect to the financial system, e.g., resolution of the non-performing asset problem, as well as in the area of economy and industry is essential. Structural reform may be accompanied by painful adjustments. Without such adjustments, however, neither improvement in productivity nor sustainable economic growth can be obtained. The Bank of Japan strongly hopes that decisive actions be taken to address fundamental problems both with a clear support of the nation for structural reform and under a strong leadership of the government of Japan.

Japan appears to be finally switching from defense to offense. All three of the Japanese policies we have been critical of in the past – fiscal, monetary, and structural adjustment – either have or appear to have been changed and put on courses that we would deem to be correct. It is probably premature to call a bull in Japanese equities. But if more clarification on the intentions in the fiscal and structural adjustment areas occurs, we would do so. And if that should occur, watch out for the yen/dollar rate. Capital inflows would once again start moving into Japan and the yen would find a bottom and strengthen.

Steve H. Hanke is a Professor of Applied Economics at The Johns Hopkins University, a regular columnist of Forbes magazine, and Chairman of the Friedberg Mercantile Group, Inc., of New York.

OBSERVER

Insider selling and another horror story

Guess what? Insiders have stepped up the pace of selling even as the market was getting "more reasonably priced." *Vickers Weekly Insider* reports that its sell/buy ratio currently stands at 2.89, "firmly in negative sentiment territory." They add that "insider trading activity this week leaves not even a hint of any slackening in share disposition among corporate executives and directors. This is a relatively strong signal that a robust recovery in the broad indices should not be anticipated anytime soon."

Speaking about corporate insiders, why did Cendant Corp. award Henry R. Silverton, the New York franchising and marketing concern's chairman and chief executive, a

bonus of \$4.6 million (up from last year's \$4.3 million) and raise his salary to \$3.04 million (up from \$2.9 million)? Should he not take full responsibility for acquiring CUC International, a fraudulently-run company that saw Cendant's stock drop to \$14 today from a high of \$41 in 1998, wiping out in the process a stunning \$20 billion in shareholder value?

In view of the above, how can he be allowed to exercise options for a gain of \$129.1 million and still be granted a further 3 million options during 2000? Can rational investors own shares of this company? What are we to do with the postulate of market rationality?

EURO

Don't stand in front of a freight train

The interview in the following article spells out the commonly-accepted "reasons" for the euro's disappointing performance. Needless to say, we cannot concur with those reasons but neither should we stand in front of a

freight train, even if we think that it is headed in the wrong direction.

Sooner or later, when hope is lost on the ashes of the stock market, the US dollar will stumble.

Chart 5 – (EUR) "Euro"



INTERVIEW**Stagflation ahead?**

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Albert Friedberg thinks, and invests, globally, and makes no bones about zipping in and out of mega-positions in currencies and commodities as economic and market conditions dictate. Timing, to use a currently unfashionable phrase, is a skill that has served his Friedberg Mercantile Group, a Toronto-based broker and trader in currencies in commodities and hedge fund group, exceedingly well for better than two decades. So has Albert's keenly perceptive and unceasing surveillance of global economic and monetary trends. Both his trader's instincts and scholarly erudition are also critical to the way Albert runs his firm's (relatively small) equity portfolios, several of which have lately topped performance charts, north of the border – largely on the strength of his short positions. Which is a tip-off on his current outlook. The good news? The purgative will effect a cure.

– Kathryn M. Welling, Editor and Publisher, welling@weeden

I know you haven't been surprised by the market's swoon.

Right. We are definitely moving into a fairly pronounced, in our view, global contraction. It's starting to have its effects slowly around the globe. It's slow, but it's happening. And our view has long been that the Fed is responsible or all this, for feeding the craze with cheap money, cheap credit.

Not to mention, upping the moral hazard by bailing out everybody in line?

Actually, you had the Treasury, the Fed and the IMF all working to bail out the Mexicos and the Southeast Asias, the Russias, and LTCM. On top of that signal (that they were prepared to bail everybody who made a bad investment), you had free, or at least very easy money, very easy credit during those last 5 years, a very powerful combination. It created a huge bull market, then the wealth effect took over and you had people spending money, household savings. Everybody knows the story. Household savings went down from like something like 8% to a negative number. Now that the whole thing is starting to collapse. We feel very strongly that the wealth effect will go in reverse. That household savings will begin to increase. Of course, that overspending was the other side of the coin of the current account deficit in the U.S. That will change too, as people begin to save more, spend less. But the process will be very painful and could be very prolonged,

depending on what policy moves are taken. The initial signs are not good because the Fed is trying to manage it and slow it down. By lowering rates and increasing debt, they're trying to do the same thing that they did for 5 years. Basically the Fed still thinks that by making credit easier, they can prolong the expansion or at least turn this thing around. In other words, they have not diagnosed the problem properly, in our view. Increasing credit at this stage of the game is not going to make a big difference. It may prolong the slowdown, that's all, by not allowing the economy to come down enough.

You mean it may fuel speculation, but it's unlikely to convince a company already awash in excess capacity to add more?

That's right. It's not an inventory problem. There aren't people waiting to build more factories or things. In good Austrian economics terms, resources have been misallocated because of the cheapness of credit in both the stock and credit markets. So you're not going to solve our problems by making money cheaper again. You're just going to make it worse.

By adding inflation to the mix?

Sure. This very long period of an above-average rate of growth in money eventually does have an inflationary impact. We have not gotten away from the relationship between money growth and inflation. All studies indicate that in the long run, inflation is a function of money supply growth. We are having a very, very slow uptick, but an uptick nonetheless in the rate of inflation.

Could that be good news, as a counterbalance to the deflationary forces at work?

I don't look at it that way. I don't see deflation, per se, as evil. You've had periods in American history, and in world history, where you had *mild* deflation with rising rates of growth.

Doesn't it depend on what's deflating, assets or prices?

Exactly, exactly. When a bubble bursts, you have a deflation of the bubble and that's the deflation in asset prices. But generally speaking, if you have inflation, you're shrinking real income and by shrinking real income further, you com-

pound the recessionary effect, the contractionary impact of the bursting of the bubble. So inflation at this point of the game is going to compound the problem.

Create the worst of all possible worlds?

Inflating prices and deflating assets and, of course, contracting real economic growth. There you are with "stagflation" or even worse. Stagflation presumes stagnation plus inflation. We could have a real economic contraction (2%, 3%, 4% of GNP) *plus* a rate of inflation that will eat further into incomes. So you have a loss of income via unemployment. You have a loss of income via the shrinkage of the purchasing power of wages. And that's a serious problem that the Fed has not given any attention. They keep dismissing it. And they keep taking things out of their measures of inflation. They say, look at "core inflation" and then they take tobacco out of that, too. Even so, we are running a rate of inflation that's relatively high. Just the core alone is probably running between 2.6% and 3% a year. That's pretty severe for a central bank that is supposed to keep "price stability," which is 0-2%, at worst. So 3% is bad.

It doesn't sound all that alarming to folks who remember the 1970s.

3% is not so bad if you look at it as the number 3. The problem is that it eats away real income. When it does that, it will be reflected in the shrinkage of purchasing power – making the contraction all the worse. So we have a combination of wealth contraction or shrinkage, via the asset implosion, an attack on income via inflation, an attack on income via further layoffs. All the makings of a prolonged slump that can be pretty deep if policy is directed to trying to contain it. The best thing that the Fed can do at the moment is say, "You know what, we're not going to manage this thing. Let it fall and let those who have to fall with it. At least that will reverse some of those bad moral hazard signals we've given in the past. If the market has to go down, it has to go down. We'll go through a recession. There's nothing that we can do about it." There were excesses built up for the last 5 years. It wasn't that productivity increases were so enormous. There was a lot of speculation too. My feeling is that they're in a very tight spot. The combination that we have in front of us is deadly. We have falling assets, falling wealth, a consumer caught off-guard, a consumer caught overbought, in a sense. Now seeing his wealth diminishing. A reversion to more normal savings rates and an attack on income via inflation that is slow, corrosive. But it's there. Real incomes are shrinking. Those things make for a fairly prolonged and deep recession in my view.

Consumers so far have been hanging tough–

They've been resilient and willing to spend but it's only a matter of time. There is a kind of denial that people are in. Mostly it's the fault of officialdom. People believe that things will turn around because the Fed will create the conditions for a V-type of a rebound. Fed officials have talked about it. Not just Greenspan. They are fueling hope – and that hope is not good. Because it will prolong the adjustment. People are just not willing to adjust. They say, "In the past, when there were dips, the Fed came in and turned the thing around and it's going to happen now." If you talk to people who have lost as much as 70% of the value of their stocks, they *still* say that this thing can turn around and so there's no need to make any adjustments. What's happening here is that the losses haven't sunk in yet. And that's the fault of the same people who gave us 5 years of a boom. They believe that they can control the boom, they can manage this decline and they can make it turn. And the public has bought it. That's also one of the reasons corporations haven't yet begun aggressive campaigns of laying off people. They also believe that in the second half of the year, things will turn around. The wrong signals are being given. Instead of, "Look, guys, you went to a party. It was a phenomenal party. You got drunk and now I can't simply sober you up. You've got to sleep it off," the Fed is saying and the government is saying and even the multinational bodies like the IMF and the OECD are saying, "It's a just a slowdown."

Here's your keys. Have a quick cup of coffee and hop back in your car.

This is the wrong signal. It will dawn on people that the Fed lowering rates, the Fed increasing the money like crazy, like it's done in the past three months – if you look at the numbers, money supply is growing at a faster rate than we've had in 15 years. All that will do is aggravate inflation. And we've already seen some pretty eye-popping numbers.

PPI hasn't looked too bad –

I'm not talking PPI. I'm talking CPI. PPI is a little different because it is more sensitive to commodity prices and to the dollar. But domestic non-tradable inflation rates have been climbing, slowly but steadily, especially in the service sector, which is the largest component of CPI. And I don't see any easy way out of this. I think that the best that the government can do is try to avoid what the Japanese did, which was try desperately to hold their economy up for 10 years. I mean, the whole idea of tinkering with interest rates alone is a ridiculous concept – that they think they can actually find the *right* level of interest rates. That alone is stupid. Just basically don't do anything. Let the economy go

through a classic adjustment. A classic adjustment to over-capacity and a boom is to go through a bust. You have bankruptcies and you close all those factories and other buildings that are not worth what they were originally premised on. Just close them.

Ouch.

Let the prices go down, so that people will maybe at some price buy those things. Because in economics, it's always a function of price and that's it. That's how we will come out of it. We won't come out by trying to hold it up and making credit ever cheaper, and cheaper, inducing people to go in way over their heads and borrow more money.

There are those who argue that the Fed can't just stand aside. The economy, and the social fabric, couldn't stand the pain, especially because of the enormous derivatives exposures that were built up during the good times.

They really should do nothing. I mean, they've done too much already. That's the problem, keeping consumers and corporations from adjusting. Another problem can be observed in the perverse way the Fed's actions have affected the dollar. If you look, the dollar reacts *positively* to the Fed lowering rates. In the '70s or '80s, foreign exchange rates used to be a function of interest rate differentials between countries. So that if the U.S. had higher interest rates than Germany, the dollar would go up, or vice-versa. Right now, what the market does is, they hope that the Fed will lower the rates, and the more they lower rates, the *better* it is for the dollar. The idea being that lower rates can restimulate economic growth and restimulate the growth in asset prices. Lower rates were the drivers of the U.S.'s "prosperity." So if the Fed lowers rates, the dollar market says, "that's great." And if Europe doesn't lower rates, that's bad, because it sends Europe into a contraction, or it aggravates the contraction. Look at the way the market has reacted over the past few weeks, whenever Europe decides not to lower rates, it affects the euro negatively. And whenever there is hope that the Fed will cut rates by even more than anticipated, it makes the dollar look stronger. That's all part of that same stupidity: That the Fed can control the boom, the Fed can create the boom, and the Fed can contain now the boom from creating a real bust. It can *manage* it.

And why not? Central bankers have been elevated to deities – although Greenspan is slipping from his pedestal a bit.

A little bit, yes. But there it is. That's why it was so absurd to see the market hoping for even more aggressive

rate-cutting from the Fed. It's hard to convince someone to borrow more if he's already losing money on whatever he is doing. The only thing the Fed will accomplish by lowering rates is bringing on more inflation. Sooner or later, the acceleration in our money supply growth will be reflected in 4% and maybe 5% inflation rates. I find that to be terrible, because we don't demand a lot of the central bank: just to watch the value of our money – not to talk about productivity. Yet, suddenly they've become major experts, every one of them, in productivity. They expound on it. They talk about it. They make estimates. It's ridiculous. Since when does the central bank talk productivity? Central banks have to talk about the value of money. And maybe a little about liquidity in the banking system and about the solvency of the banks. I don't need the central bank to tell me about productivity and other economic measures that even academics don't have a very good handle on.

They can argue about it endlessly.

Right, we don't even know if productivity has really increased.

There s a professor at my alma mater who says the productivity miracle is bunk. Robert Gordon at Northwestern University.

That's right. Or maybe it's just a function of the economic cycle. When you have a booming economy, you do get a little bit of hyperactivity because you have big demand. But then, as the cycle begins to reverse, you'll see productivity collapse. Then what are they going to say? "Well, we have to lower rates anyway because the economy is slumping." No matter how you cut it, all the Fed did by focusing on productivity was justify easy money and easy credit, the cause and the root of all evil.

So what do you do as an investor?

We've been very heavily invested in U.S. Treasury inflation-indexed bonds, the TIPS. Because we feel that the real rate of interest has to go down as you move into a slump. We feel that the rate of inflation will rise slowly, so you get the best of both worlds by owning those bonds.

They've already had nice moves –

And after performing exceedingly well in the past 2-3 months, they will continue to perform well in this environment. You want to be short the U.S. dollar *at the right time* or trading it. We think that it's only a matter of time before the market realizes that lowering rates will not do very much for the U.S. economy. When that happens, I think you'll see the euro go very strongly higher.

Clearly the question is when?

I think the best entry point would be time it to the time that you see the market perception changing as to *what* the Fed can accomplish or cannot accomplish by lower rates, which could be very soon. There's no question that the euro has bottomed out against the dollar. We're not going to see 84 cents again. But there's still a pretty big trading range, somewhere between 90 and 94, and it may stay stuck there until you get to the next stage which is the realization that central banks really cannot do very much. They're not powerful enough to be able to affect government activities. So a steady as you go monetary policy (like the ECB is practicing now) is a much better asset than the wild, reactive type of policy that the Fed has implemented. When the market realizes that, you'll see a much faster drop of the dollar. Plus the fact that the market still believes that the U.S. economy will turn around, and quickly. That illusion has to be washed out. When people finally begin to say, "You know what, the economy isn't going to turn around so fast," the dollar will suffer quite badly.

Against the euro, you mean?

Yes. Japan is an interesting case. Contrary to popular wisdom, Japan should want more *deflation*. I know what I'm going say sounds pretty crazy. Most people want to get Japan out of deflation. But Japan's problem is that it hasn't allowed its deflation to run its course.

No pain, no gain, again?

They've contained the deflation. Now why is that so important? Well, remember I said inflation is negative because it eats into consumers' real income. By the same token, deflation, when not accompanied by negative growth – when it's accompanied by flat or rising rates of growth – is very beneficial, because it increases your purchasing power. If you earn \$500 a week and prices are falling, you get to buy more goods with \$500 a week. That is bullish. And the way to increase people's purchasing power is to allow those corporations that are dead anyway (the deadbeats) and the banks that are dead (the deadbeats) to go under. Accelerate a little bit the deflation, accelerate the adjustment in prices, so that people's real incomes will grow and it will turn the economy around. Japan is getting closer to that because they've tried now for 10 years to prop it up, rather than let it fall. And all they've gained is a huge increase in debt. Japan is now one of the most indebted nations in the world *vis-à-vis* GDP. The economy continues to maybe increase 1/2% or 1% a year and in real terms, per capita, Japan has been in a decline for the past year. The other thing is that if prices continually erode 1% or 2% a year, you tend to postpone your purchases until

such time as you can get it cheaper. That holds back from spending. If, on the other hand, prices drop all at once by 10% or 15%, then you say to yourself, "We've had the drop. I can now safely buy." So a slowly-falling price level is negative for consumption because it lulls people into feeling that it will continue. What you need is for the price adjustment to take place quickly. Once that happens, people are more eager to take advantage of bargains. The price mechanism has to work unhindered. You cannot try to hold up, because by holding up prices, you are postponing the true adjustment. So the easy way out for Japan today would be for the central bank to keep producing low rates of money growth (about 2%, 2 1/2% a year) and just pull the plug on 70% of their banks and all those corporations that have made bad investments and are broke anyway. Let land prices come down. And let all this happen in a short time, six months. Then you'll see Japan's economy turn around in a big way. The Japanese have a lot of savings. They're very frugal people. When prices reach the proper level, I think you'll see a lot of buying and the economy will turn around. And if they do that, the yen will get very strong – go from 120 to 80 in a very short time.

But Japan is doing exactly the opposite of what you prescribe.

Printing money is going to create a serious, serious problem. JGBs will collapse and the banking system, which is loaded with JGBs, will collapse with it. That's all they need now. Not only will their loans be bad, but their portfolio investments will go bad. It'll be a disaster if they go ahead and print money in a big way, like they're talking now. The whole thing will just go up in fire.

You see inflation picking up here. Does that mean you're bullish on some commodities?

That's an interesting question. International commodities prices probably will not start going up in this cycle, yet. We think that they're going down, albeit only a little bit. I see the price of oil going down. The metals going down further. Because the industrial climate is deteriorating.

So lower demand, because of the economic contraction will overwhelm the effects of the inflationary monetary policy?

That's exactly what it is. What inflation is apparent is in the services sector. Especially in the large components of the service sector, like medical costs, and in wages. You saw, for instance, in the last month, a very sharp pickup in average earnings, 0.5%, that's a pretty big number. Nobody's talking about it. But you're not going to get a rise in the price of commodities as long as the economy is very weak. What you will

get instead is a continuous rise in service costs that will creep up, while the CPI, which is [mostly] commodity-based, will be restrained and maybe even show some slight negative ticks. You'll get drops in gasoline and heating oil and things of that sort. But the real risk is that when the economy finally turns (it may be 2-3 years from now), you will have built up so much liquidity in the system and brought the dollar down so far, that commodities prices will then turn and produce inflation in the goods side of the economy, compounding the inflationary problem in services.

Gee, glad I asked.

In addition, the U.S. is fairly fortunate that the dollar was strong because of the booming stock market. (Foreign investors bought dollars and that buying supported the dollar and held down the prices of imported goods.) The index of imported goods has been very weak, which has been very beneficial to the U.S. inflation rate. I don't call that "no inflation." I call that "repressed inflation." It's almost like a lady who is, pardon the expression, a little overweight and so wears a very tight corset. That's what the U.S. has done. The U.S. is actually inflating (and inflating in a big way), but the corset of the U.S. dollar has held import prices down. As the dollar begins to weaken, the corset opens up and the true flab will come out.

A lovely image.

Yes. But that, I think, is the reality. The very strong dollar has had a major influence on import prices, which, in turn, have had a major influence on consumer goods prices. So when the dollar turns, you will start getting imported inflation added onto the inflation on the services side, and you'll get a faster rate of inflation.

Are you optimistic about nothing?

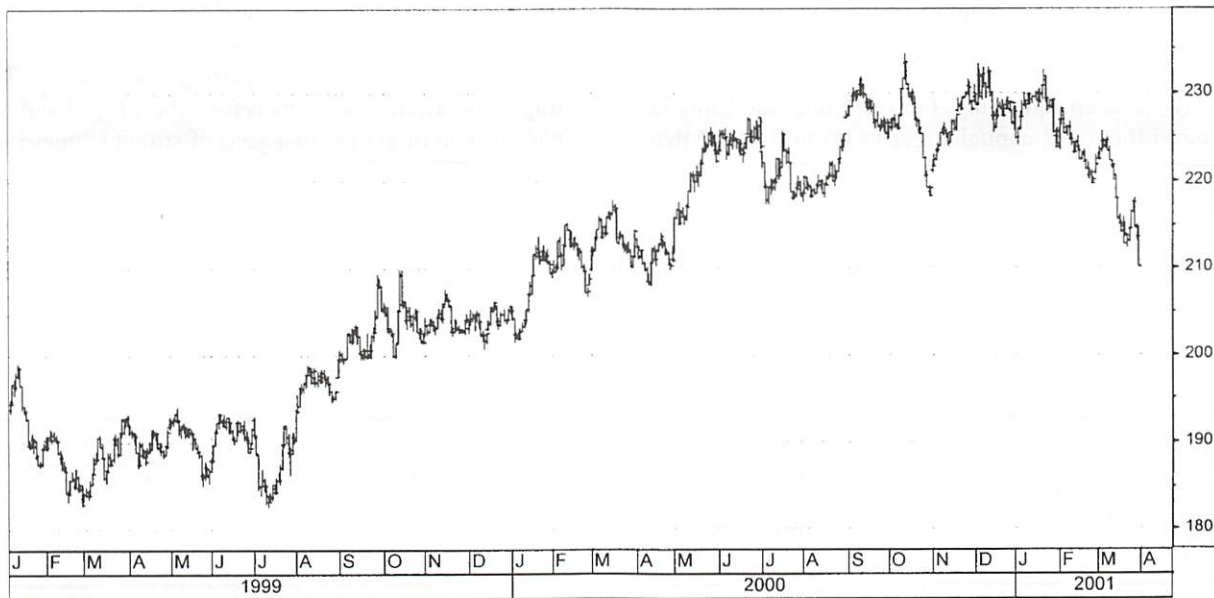
I'm very bearish on the global economy. We are heading towards the worst of all worlds. Economic contraction. Inflation. So it's up to the policy makers. Let's hope the officials begin to think better and begin to understand what really causes problems, and then maybe they'll know what to do.

And in the meantime, you're buying TIPS and shorting stocks?

We've been heavily long the TIPS and shorting stocks, as trades, so any shorts I'd mention, I might cover tomorrow. But in general, I think there's still room to short things like **IBM or Wal-Mart**. You don't necessarily have to short all or only the techs.

Thanks, Al.

Chart 6 – (CRY) "CRB Index"



CHINA**A real arbitrage opportunity***By Steve H. Hanke*

In China, a company can issue three types of shares – A, B, and H – and these can have wholly different valuations. How can this be? After all, the law of one price asserts that when you have three perfect substitutes, they must all trade at the same price.

The catch was, until February 26, these three types of shares weren't perfect substitutes. The "A shares" were yuan-denominated, and only Chinese nationals were allowed to invest in them. The "B shares" were an illiquid category that was reserved for foreigners, with those in Shanghai being denominated in US dollars and those in Shenzhen traded in Hong Kong dollars. That was the theory. In practice, 80% of the B shares listed in Shanghai and 60% of those trading in Shenzhen were held by Chinese nationals who had set up illegal overseas accounts. The "H shares" were listed in Hong Kong.

On February 26, all this changed. Chinese nationals are now allowed to trade B shares that are denominated in hard currency. So if you are a Chinese national with US or Hong Kong dollars, you can open an account and trade B shares. With the B shares trading at a 75% discount to the A shares, the Chinese nationals realized this for was it was, a true arbitrage opportunity. Or should I say a money pump? They literally stampeded to their branch banks to open hard currency accounts so that they could purchase B shares.

Not surprisingly, the B shares have soared since then by 88%. Even though the B share discount has narrowed to 52% from 75%, there is still plenty of juice in this lemon, if I may use that term.

What is more, the integration of the Chinese markets is here to stay. So keep squeezing. For one thing, the Chinese have allowed this legal capital flight to occur – recall that

there are strict capital controls in China – because the Chinese want to release upward pressure on their currency. Secondly, the Chinese want to integrate their equity markets so that they can start allocating China's savings, which are about 40% of GDP, more efficiently. Thirdly, China believes the integration of stock markets will reduce the cost of capital for Chinese enterprises and eventually force better corporate governance on Chinese companies. And lastly, the Chinese want to privatize some of their State-Owned Enterprise dinosaurs, and for that, a bull market is just what the doctor ordered. Until that B share discount is wiped out, stay on this raging bull.

And while riding the bull, don't get spooked by the fact that both Asian and world growth projections are coming down, as indicated by the regular revisions of these figures. Although China allows convertibility on current account transactions, draconian capital controls are in place on the capital account. These controls have allowed the Chinese economy to remain "sealed off" from the shocks thrown up by the global economy.

In addition, the Chinese disconnect imposed by capital controls has allowed the Chinese to pursue their own monetary and fiscal policies, while ignoring what is going on in the rest of the world. To hit its growth target of 8% annual GDP growth, China has retained an accommodative monetary policy for some time. In addition, it has continued to loosen fiscal policy over the last four years, resulting in a record-setting deficit. On March 16, Premier Zhu Rongji – rightly for the time being – dismissed concerns that China's fiscal stimulus spending is getting out of hand. The arbitrage opportunity will, therefore, be played out with the background of yet another year of strong Chinese growth.

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