FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

Friedberg Commodity Management Inc. Volume 23, No. 5 October 7, 2002

No brainer

For longer than we can remember, we have pounded the table with the idea that Treasuries linked to inflation (TIPS) were the single finest investment of the times. We are happy to say that time has, so far, proven us right.

The accompanying charts tell the story. Chart 4 depicts the price action – from March 2000 to the present – of the most liquid long-term bond, the 3.875% of 2029. For added effect, the starting date is conveniently fixed at the onset of the great bear market in stocks. Chart 2 shows the total return – price appreciation plus interest plus the inflation adjustment, in case you forgot – over the same period. Chart 1 shows the trajectory of real long-term interest rates, the unit of denomination of these bonds for those years. Clearly, the rise in prices accompanied a drop in real rates (a mathematical tautology and not a causative proposition). For an interesting perspective, Chart 1 shows the real yield on long-term UK (inflation-linked) gilts and on Canadian (real return) Treasuries.

So now what? Before we attempt the difficult task of guessing correctly twice in a row, we would like to make a number of observations. Many of our clients were a trusting bunch of investors, kind to boot, for not thinking us mad, and went along with purchasing these securities without really understanding why. They thought we liked TIPS because we were obsessed with the dangers of inflation. Yes we were, and still are, obsessed with the fear of inflation. But no, we did not buy them for that reason. Though we tried repeatedly to explain the reason, investors' lack of familiarity with the notion of real rates exposed our didactic weakness. We will now, again, make a second attempt to explain, because it bears importantly on our outlook for these securities.

The second observation: The investment in TIPS, anytime in the past three years, was highly counterintuitive. Treasuries, in general, were the lowest-yielding securities in the fixed-income universe. (They always are, of course, thanks to their risk-free status, but more so in the past few years as spreads against lower-quality paper widened and widened and continued to widen to record heights).

Yet in terms of total return, Treasuries (and especially TIPS) handily outperformed investment-grade corporates, junk bonds, and emerging market debt, which statically were richer by as much as 2,500 basis points (see Chart 2)! This outperformance represented one of the greatest ironies of financial history. By some wondrous mechanism, default fears so impacted prices of lesser-grade securities that they more than offset their extraordinary yield advantage. And, by the same token, these same fears made risk-free securities so attractive that price gains more than offset their meager static returns.

The moral of the story is that not everything is as it appears to be – or perhaps, what is obvious might be wrong.

Let us now go to the essence of the argument. Real risk-free interest rates are declining the world over for lack of interesting investment opportunities, for fear of lending (to exposed and vulnerable borrowers), and also for lack of visibility (ter-

In this issue

Contributions by Vincent deCaen, Jeremy Fand, Albert D. Friedberg, Yakov Friedman, and Christopher Mayer.

rorism, frequent changes of rules by policymakers, lack of respect for property rights, and so on). Elevated risk-free real rates of interest accompany economic booms, clear skies, confidence in the surroundings, and confidence in the future.

The last time we witnessed such a favorable environment was in the period from 1997 through 1999. Long-term risk-free real rates climbed to 4.3%, historic highs for a mature economy like the US. Admittedly, the seeds of the bust were already planted as far back as 1990-91 (with the bailout of the big New York city banks).

Still, the world at large was oblivious to the dangers. Nasdaq was on its way to 5,000. In early 2000, the investment climate began to change for the worse. Industrial overcapacity, excessive leverage, rising cost of government (can anyone remember the promise of fiscal surplus running into the next century?), fear of terrorism, the scent of war – all factors that tend to dampen the "animal spirit" of capitalists, to use the felicitous Keynesian metaphor.

Risk-free real rates are now at 2.7% in the US (and an attractive 3.25% in Canada). How much lower can they go? The UK may serve as a useful paradigm. Given their longer history with inflation-linked securities (going back to the early '80s), and thus their greater familiarity and understanding of them, one could argue that their pricing is more efficient.

What is more, measured at least by rates of unemployment and changes in that rate, the UK is "doing better" than the US at this time, operating closer, one would suspect, to full capacity. Yet, long-term risk-free rates are barely above 2%, having come up from as low as 1.8% during all of 2000 and part of 2001 (see Chart 1).

We feel quite certain that we are heading in that direction. In fact, we believe that conditions are such that we might even see 1.5% real rates. These targets, if achieved in the next 12 months, would translate into highly respectable total returns of 16% and 25% respectively.

Why TIPS and not nominal 30-year Treasuries? Here is where our obsession comes into play. We first ask ourselves how much we are giving up in yields by choosing inflation-linked securities over nominal ones. By comparing their yields, we arrive at what is commonly called the "break-even" – in our case 2.17%. In effect, if annual inflation rates over the next 30 years were to average less than this rate, we would have ended up leaving some money on the table for not choosing the richer nominal securities. If, on the other hand, annual inflation rates were to exceed 2.17%, we will have been vindicated, in retrospect, for having chosen inflation-linked securities.

Today, a rising chorus of deflationists argues that the break-even premium is too steep and that, in fact, we might easily move into deflation à la Japan. Why, they ask, ignore the higher yielding nominal bonds?

Our reply is simply that "we sleep better." For as long as elected officials run governments and for as long as maestros run central banks, we can be sure that inflation and not deflation will be the most serious danger facing industrial economies over the next 30 years.

It is true that Japan has been running a (quite mild) deflation over the past five years – not because it wants to but because it has not found, as yet, the best way to monetize its losses and to expand its money supply. Inflation has not reemerged for lack of wanting, but rather for lack of creativity and thanks to some age-old inhibitions.

One may rest assured that Japan will throw overboard its last inhibitions and find the way to inflate effectively as soon as its financial system absolutely approaches, or begins to topple into, the abyss.

Besides, the comparisons with Japan are spurious. On the eve of deflation (late 1992), Japan's money supply was *contracting* at a rate of 1.9% per annum compared with an *expansion* of 10.6% in present day USA, and Japan's central bank rate was 3.25% versus the Fed's 1.75% (on its way to 1.25%, we guess). And while Japan's banking system was slowly "freezing" (causing a contraction of lending that has persisted for a record-breaking 44 months) and unable to expand its balance sheet, the US banking system is coming off a quarter of record earnings, which at $23.4 billion, surpassed the previous record set only three months earlier by 7.8%.

While admittedly this situation may deteriorate, it is unlikely anytime soon to cause a clogging up of the engine of money growth, a stable and/or expanding deposit multiplier. Therefore, as long as the Fed can control the growth of the monetary aggregates via its control of the monetary base, we can be certain that Japan's experience – huge monetary base injections absorbed by mounting excess reserves and cash leakages – will not be repeated in the US.

Finally, TIPS prices reflect expectations. Deflation may indeed be *the order of the day*, but the market will surely not project this state of affairs for 30 years forward. In fact, given the Fed's deflation phobia, chances are good that the Fed will engineer a massive reflation after extrapolating negative inflation readings forward one or two months (if and when they occur).

Reflation prospects will raise inflationary expectations, but these expectations will not be *fully* reflected in nominal bonds – either because of a natural lag in adjusting to new conditions, or because of a reversion-to-the-mean mentality, or because of the market's inability to price real returns properly, allowing them to be "squeezed" to make room for the inflation premium.

Because real rates are determined in the far larger, more liquid, nominal market (our own working hypothesis), the "squeeze" in real rates will be translated, via arbitrage, to the more explicit inflation-linked securities (TIPS), with the result that real rates will fall and prices will rise.

In sum, we *are* prepared to accept forecasts of real rates that are based, as we said, on investment climate. That they are going lower is, in our opinion, a no-brainer. We are *not*, however, prepared to take on the *extra* uncertainty entailed in a forecast of future inflation, reflected in the inflation premium (equivalent to the break-even) that nominal securities carry.

One last point. Can the Fed affect real yields? Or, more directly, if the Fed raised rates, would real rates be affected negatively, i.e., will they rise?

This difficult question deserves a rather complex answer. It depends.

a) If the Fed equivocates and, by raising rates, sends the economy into a tailspin, then real rates are certain to resume their downtrend after a very brief upward flurry.

b) If, the Fed raises rates in response to rising inflationary expectations, then these same rising expectations will, via the mechanism described above, cause real rates to fall, which, in turn, will cause TIPS to rise, provided the Fed has raised rates a little less than the rise in inflationary expectations.

c) If, however, the Fed raises rates faster than the rise in inflationary expectations, then real rates will rise, and TIPS will fall (probably because nominal bonds adjust faster and more effectively to interest rate adjustments than to changes in inflationary expectations).

Thus, we have identified one, and only one, circumstance by which the Fed could cause TIPS to fall – that is, when the Fed is pre-emptive and moves aggressively to rein in the (phantom) of inflation. It happened in 1994 (but there were no TIPS around at the time to test our hypothesis) and again from mid-1999 to mid-2000, when the Fed raised rates to 6.00% from 4.5% (admittedly, well above the change in expected inflation). The rise in rates wilted TIPS, and real yields climbed by 50 basis points (model "c" above). Interestingly, real yield began to back off in early 2000, *while the Fed was still raising rates*, responding perhaps to the prospective bursting of the bubble (model "a" above, dramatized by the asset bubble and subsequent bust).

Other than a Fed-engineered rise in rates discussed above, real yields, as we have seen, can rise in the midst of an economic boom. Because present day fiat monetary systems are prone to undershoot – i.e., keep rates too low – a risk may arise that, thanks to excessive stimulus, a new boom will be born.

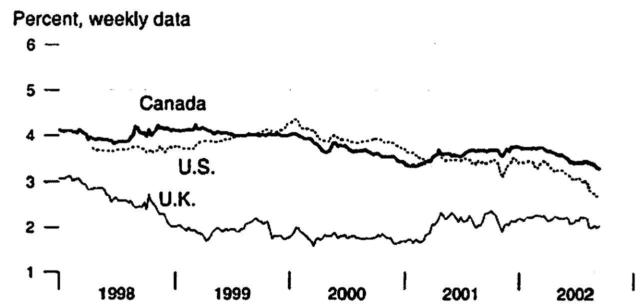
This is a risk, but, in our opinion, a small risk. More likely, excessive stimulus will end up in the accelerated growth of nominal gross domestic product and inflation. The result will be stagflation, and very low real yields.

The reason: Besides the effects discussed earlier, accelerating inflation makes for very poor visibility, for illusory gains, and for confiscatory taxes. Stagnation makes for poor investment prospects and low demand for credit. In the '70s, the last period of stagflation, real rates were thought (there were no TIPS) to be *negative* (though more likely, rates were mildly positive if we ignore current inflation rates and instead factor in reversion-to-the-mean expectations).

Understandably, prospects for stagflation make us very, very bullish. We conclude that but for very few exceptions (the booms of the '20s and the '90s, mostly the product of new technology and dreams), fiat money systems are likely to keep real yields low and falling.

Buying TIPS is still a no brainer.

Chart 1 – Inflation-Indexed 30-Year Bonds



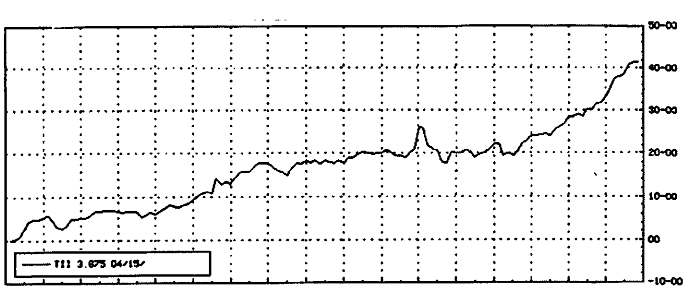
Courtesy Federal Reserve Bank of St Louis

Chart 2 – Total Return

Bond / Index	March 2000 - Oct. 2002	Year to Date
US TII 3.875% April 15, 2029 (TIP)	41.14%	17.37%
Merrill Lynch US Treasury 10 yr. +	39.34%	15.99%
Merrill Lynch US Corporate Long Term	27.91%	6.37%
Merrill Lynch High Yield	-9.14%	-8.50%
Merrill Lynch Global Emerging Market	8.66%	1.03%
Canada 4% Dec. 1, 2031 (TIP)*	13.10%	12.28%

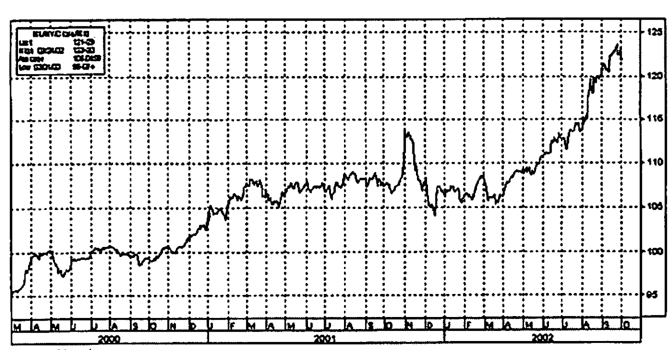
Adjusted in US dollars

Chart 3 – Cumulative Total Return US Treasury Inflation-Indexed Treasuries 3.875% of 2029



No dividends on coupons
Courtesy Bloomberg

Chart 4 – US Treasury Inflation-Indexed Treasuries of 2029



Courtesy Bloomberg

MONETARY POLICY

Short notes on commodities, currencies, gold and stocks

Our outlook for commodities is unequivocally bullish

The reason is simply that the Fed is maintaining a dangerously excessive expansionary monetary policy. In effect, after a brief deceleration in growth, the broad monetary aggregates have resumed their near double-digit pace. A recent Federal Reserve of St. Louis publication (*Monetary Trends*, September 2002) concluded that "a Taylor rule for monetary policy would suggest that the Federal Open Market Committee's (FOMC) federal funds' rate should be close to 3% [*it is 1.75% now – Editor*], assuming an FOMC inflation target of 2%."

The Fed is "cheating" in the hope of cushioning a developing financial crisis and averting a potential second recession. The "letting-the-air-out-of-the-stock-market-tire-slowly" policy is buying an enormous housing bubble, a commodity explosion, and a much greater financial crisis down the road.

Our outlook for the US dollar has become decidedly more bullish

For one thing, the easier monetary policy will buy *near-term* economic "strength." The same goes for its expanding fiscal deficit, war or no war. For another, the Eurozone, rigidified by the continuing growth of the welfare state and anti-growth labor legislation, will need huge doses of fiscal stimulus to pick itself up. This is not likely to happen: Fiscal policy is in a straight-jacket, as countries have started to exceed their Maastricht-agreed deficit guidelines, and monetary policy is constrained by a faster-than-desired growth in M3. (For more details, see Jeremy Fand's article, which follows).

The Southeast Asian mini-boom is withering for lack of serious economic reform, and Japan is still struggling to implement urgent banking reform. Finally, as the recent events are showing, no power in the world is likely to stand in the way of President Bush's single-minded and decisive crusade to rid the world of Saddam Hussein and other petty and dangerous tyrants. When the guns of October (or November?) resonate in the Middle East, they should also no doubt rout the dollar bears.

You can bet on more sovereign debt defaults now that the International Monetary Fund bankruptcy proposal has been given the official blessing. "Sovereign Chapter 11," as some have called the proposal, is likely to become effective sometime in 2003. Just in time, we think, for Brazil to rid itself of the debt albatross. Some judicious economists have observed that instead of slowing the spread of defaults, the measures would punish investors without fixing the situation that created the default in the first place – corruption, populist policies, and lack of respect for property rights.

By not including any enforceable penalties for governments that screw up – in contrast to private company Chapter 11 proceedings – they will create an unwanted moral hazard issue. Consequently, there would be no incentives whatsoever for these governments, or their successors, to reform.

For our part, this is just as well. Private lenders, the only kind of lenders that should exist, will become more cautious in their lending practices. Official (and highly distorting) subsidized lending will cease; governments will follow more prudent practices as the rug is pulled from under the politicos' feet.

Let the first salvo of a less statist world economic order begin with Lula!

Gold is still not out of the woods

A breakout above $325/ounce may require either a weaker dollar (unlikely for now), and/or a major complication in the coming US military campaign in Iraq (possible but not probable), and/or an acceleration of inflation (in the offing, but not tomorrow). Wait for now, or buy the breakout.

Stocks are still headed considerably lower

While corporate profits are still headed higher, they are not moving up fast enough to overcome the drag of excessive valuations. Moreover, discounted models that use Treasury rates (the Fed model) – and that justify present multiples – in the face of widening corporate spreads are analytically untenable.

Sentiment indicators are far from evidencing any sort of capitulation: Our Merrill Lynch friends report that Rich Bernstein's sell-side indicator (i.e., brokerage-firm strategists' suggestions) broke to a 10-month high of 69.9% at the end of September from 68.2% at end of August – *the sixth most bullish reading on record!*

Another interesting proxy of sentiment is the level of mutual fund reserves. At 4.5% (and perhaps lower this month), they are approaching the lowest levels on record, more a sign of a top than a sign of a bottom of the market. Of course, this bullishness is understandable; just as bull markets climb a wall of worry, bear markets slide a wall of optimism. Corollary: In a bear market, sell good news!

Please note, however, that the *public* has begun to take this bear market more seriously. August saw a further mutual fund outflow, this one of only $6 billion after July's massive $52 billion. Significantly, the outflows took place in the face of a rising market, the first sign that retail fatigue has set in. As we go to press, September outflows are estimated around $13 billion. Lest you believe that the numbers are still modest in relation to fund assets of $3 trillion, keep in mind that cash reserves are no greater than $120-$150 billion, hardly adequate to handle a stepped-up rate of redemptions without necessitating further liquidation.

EURO/US DOLLAR

Stuck in a range, but for how long?

By Jeremy Fand

The euro has been stuck in a broad range between US$0.96 and $1.00 for over two months now as the mix of influences on the currency pair has yielded no conclusive directional impetus outside of that range.

The key determinants of euro/US dollar are still mixed, but the factors that could take the currency pair outside of that range are becoming clear. The accompanying table lists those factors, organized into four categories that differentiate disciplines to currency determination.

While this table shows some relative balance in forces pulling on euro/US dollar – and thus the current range-trading environment – the factors that could cause a break to either side are clear. The outcome of the Iraq situation, the health of the stock market, and the path of the US economy are all key.

While not a clear call yet, I am leaning towards a US dollar-positive outcome, because I expect the Iraq war issue to come and go quickly and cleanly, and I expect that the US economy to surprise markets by more resilience than most expect.

While equities could still have another big leg down while waiting for this clarity, I think that the relative US outperformance vs. Europe on both equity returns and the economy will insulate the dollar. I continue to look to sell euro/US dollar near the top of the recent range.

Japan's troubles

Japanese data provide little guidance: The Bank of Japan's quarterly tankan survey of business sentiment showed a modest rise, to –14 from –18, which was widely expected. The survey illustrates that the economy appears to be crawling back from the dead – many of the diffusion indexes are at five- or six-quarter highs. The negative signs in front are still a concern, because growth is still not solid.

Finance minister says hands off foreign exchange: While the empowerment of Financial Services Minister Heizo

Key Determinants of euro/US dollar

€/US$ positive	€/US$ negative
Fundamentals	
Fears of a double dip in the US continue. Even with positive growth, many worry that growth is slowing and cannot support the twin deficits.	Growth differentials favor the. While not strong, the US economy looks like it is growing at about 3% vs. 0% in Europe.
Weak equity markets could precipitate a US current account crisis.	Equity return differentials still favor the US – i.e., US equities are down, but not as much as in Europe.
Weak US corporate profits and continuing scandals are pushing on the Dow – which is driving global equities lower. Earnings warnings rising too.	Fed might ease, while ECB holds. ECB's 2 pillars are above target. Rate cut risks ECB credibility, but risks growth in standing pat.
Interest rate differentials favor the euro.	Higher oil prices in run-up to war on Iraq hurts the euro.
Technicals	
Daily charts show stochastics gaining bullish momentum. The break above 0.9870 - 0.9875 is constructive, but must hold. A break of the 0.9990 high is required to cancel the range trading signal completion of the 3-wave corrective move down from 1.02.	Weekly indicators remain €/US$ bearish. This could be undermined by the dailies that would push on waning momentum. Market positioning might be a bit long of euro, which could feel real pain if the bottom of the range is taken out.
Flow	
Longer-term investors still like the euro as a hedge against rising risk aversion and current account fears of declining Dow.	Flows continue to ward off the current account crisis. US Treasury data indicate continuing purchases, even in the face of declining Dow.
	Banks report that preference for US dollar over euro equity is trending.
Politics	
Loosening of European fiscal policy could help to offset weak economy, but one size can't fit all.	Broken Stability Pact reduces confidence in EMU. Politics in Europe is shaky (Schroeder wins by slim margin in Germany). Pace of reform will slow.
War against Iraq raises risk-aversion. Lack of support from Europe is troubling for US dollar.	A quick victory in a war on Iraq would likely propel the US dollar higher.
Weak dollar policy. Many believe that a weak dollar is the only way to turn the global economy around. Does the US Treasury agree?	Nice Treaty vote on October 19 could yield a blow to sentiment towards EMU.

Takenaka and recent remarks by Vice Minister for International Affairs Haruhiko Kuroda leave the distinct impression that a weak yen policy is still on the top of the list for fixing Japan, Finance Minister Masajuro Shiokawa took a step to diffuse that thought. In a recent interview with foreign news, he said, "I wouldn't welcome tampering with foreign exchange as a measure against deflation. I think that foreign exchange should be left to natural forces."

Yet the finance minister's remarks also reveal a desire to see steps towards more easing (read monetization) by the BoJ, which I am sure he understands would be yen-negative. The point is that the government won't put the cart before the horse, but if the yen weakens, officials won't mind as long as it is a result of prudent policy action.

In recent days it has become clear that the Japanese government has been pushed by the BoJ to action, but does not know what to do. An undercurrent of bias towards a weak currency is likely to keep US dollar/Japanese yen rising in coming weeks – barring a collapse of the dollar against the other majors.

Jeremy Fand writes a weekly foreign exchange comment for the research section of our Website: www.friedberg.com.

MONETARY POLICY

The beginning of the end for central banking? Unfortunately, not just yet

The painful and lengthy bear market is forcing a much-needed revision of the role and responsibilities of Mr. Greenspan and his colleagues for the previous boom. Mr. Greenspan has already had to defend his actions on a number of recent occasions. His basic defense: The Fed could not have been certain that, indeed, an irrational state of affairs was driving asset markets (despite his much publicized "irrational exuberance" exclamation in late 1996) and that a bubble had gripped the US stock markets.

We beg to disagree and believe that we are entitled to do so in view of our comments at the time. As far back as July 19, 1995, we stated in our publication, "Our view has been even more radical [*than Milton Friedman's assertion that it was a mistake for the Fed to conduct monetary policy by targeting the federal funds rate – Editor*]. Governments have no business running money. Government interference in monetary matters has brought us only grief...And now courtesy of the Fed, the once-in-a-generation stock market frenzy that will end, just as surely as night follows day, with the destruction of hundreds and billions of dollars of savings."

On June 29, 1997, we ran an article entitled "Seventy years later – the same dilemma," in which we reviewed the monetary policy dilemma in the years and months leading to the stock market crash of 1929. We suggested that a similar dilemma was now in the making. We said, "...our own conclusions – based on the few monetary indicators that we reviewed [*slope of yield curve, rates of monetary growth – Editor*] are that the Fed of the '90s bears more culpability than the Fed of the '20s. Staying the course is no option. In 1997 the economy is growing at a satisfactory pace, inflation is moderate, yet the stock market is gripped by one of the greatest financial manias in history. By following an excessively easy money policy, Greenspan's Fed has stoked the fires of speculation more than any group of central bankers in American history."

Not a moment too soon, the tempo of this revisionism is rising. It may not change our legislators' mind about the benefits of central banking, but it is a beginning.

CRUDE OIL

Who's afraid of rising oil prices?

By Vincent DeCaen

It is human nature to assume causation – and to reject coincidence, when confronting co-occurrence. A rogue comet happens to appear just before the outbreak of a devastating plague: *post hoc, ergo propter hoc*. Women's hemlines rise and fall with the major market indices. Or how about the one about sunspots...? We swim in an ocean of coincidence.

Or how about rising oil prices and stagflation...? Everyone *knows* that the oil prices produced stagflation, right? But were we to accept the argumentation of Barsky and Kilian (2000, 2001) – and I think we must – the exogenous oil shocks of 1973-74 and 1978-79 were *not* the cause of the raging stagflation of the 1970s. However, according to them, neither was the co-occurrence of spiking oil prices and stagflation a coincidence. Rather, so they cogently argue, both stemmed from a common source: the *unprecedented monetary expansion* following the collapse of the Bretton Woods monetary regime.

The chattering classes raised the specter of 1970s-style stagflation in the wake of supply cuts by the Organization of Petroleum Exporting Countries (Opec) in the spring of 1999, and the chorus has continued on and off to the present: Rising oil prices produce double-digit inflation, or so conventional wisdom insists. Yet the perfect storm of 1970s-style stagflation is on the horizon, however – but for different reasons, were we to accept the monetarist arguments of Barsky and Kilian. (For that matter, so are rising commodity prices.) Quite simply, according to them, stagflation is a direct function of launching the American monetary supply into the stratosphere (see following table for encapsulation). Faithful readers will remember our flagging of the monetary growth and concomitant stagflationary threat in our March 24, 2002, issue. We go into somewhat more detail in what follows.

Period	Money Growth Rate (US M_2)
1970s	9.63%
1990s	3.92%
1Q95-3Q02	6.71%
3Q00-3Q02	8.30%

1.1. Oil behaves like a commodity (because it is a commodity)

Barsky and Kilian (2000, 2001) emphasize what ought to be immediately obvious: Oil is a commodity and so behaves like a commodity, responding to supply and demand pressures. Supply is a function of Opec (read "Saudi") production and the attempts of non-Opec countries (read "Russian Federation") to capture market share. Demand is a function of global economic activity as well as prospects for future supply and demand. Period. Straight out of the first chapter of every introductory economics textbook.

Thinking past the Iraqi standoff (and despite oil breaking the $30 barrier), we would argue that oil should find a price level below $10/barrel [see our Dec. 3, 2001, issue: "Oil: The coming (sooner or later) price war"]. Opec producers were faced with a choice between raising revenues and raising production. They chose to curtail oil production to boost revenues, thereby enticing non-Opec producers to try and grab market share. We argue that sooner or later, Opec will be forced to boost production to recapture market share from the high-cost producers (let alone a post-conflict Iraq sitting on over 10% of world reserves). Because we estimate marginal costs of production at less than $10/barrel, we can be sure the looming price war will drive oil prices below $10. The real question is the timing of such a price war.

Note: The current divergence between oil prices and the value of oil-company stocks tends to confirm the grim prospects for oil producers when the war premium is eliminated. Slowing global economic activity must equal falling demand and falling prices.

1.2. Inflation is a monetary phenomenon

Recall the Friedmanesque mantra that inflation is, always and everywhere, a *monetary phenomenon*. The following recipe for disaster was developed by Barsky and Kilian with a liberal helping of that mantra.

First, toss together a simple money-demand equation with a price equation (but make sure that prices incorporate a lagged or *sluggish* reaction to monetary-policy shifts). Next, add a pinch of Fed inflation targeting. Stylize and parameterize to taste. Bake until commodity prices bubble and stagflation is golden brown on top.

Assuming the crucial "sluggish inflation," stagflation must be the endgame of the Fed's current expansion of the money supply. Assuming the Fed's go-stop approach to inflation (important but not essential for this model), we should see the effect of feedback: an increasing amplitude of output fluctuations and a dampening of variations in inflation. Regardless, exogenous oil shocks are *not* required to generate stagflation within this framework.

1.3. Four supplementary arguments

Barsky and Kilian supplement their analysis of the 1970s stagflation with four additional arguments. We will briefly consider these below.

1.3.1. Go-and-stop monetary policy

First, the actual go-stop performance of the Fed in the early 1970s is consistent with the inflation observed. With reference to the Bernanke-Mihov (overall monetary policy based on the Fed Funds rate) and Boschen-Mills (narrative evidence – primarily policy pronouncements) indices, Barsky and Kilian show that monetary policy was strongly expansionary from mid-1970 to the end of 1972, but sharply contractionary in early 1973 in response to inflation, crucially well before the first oil shock in late 1973. Faced with recession in 1974, the Fed again unleashed the money supply through to 1977. They claim that the behavior of these two indices is a better explanation of the bouts of recession during this period. (See Chart 5 for the Bernanke-Mihov index.)

1.3.2. Worldwide changes in liquidity

Second, stagflation was associated with the worldwide swings in liquidity. They show that explosions in worldwide money growth in 1971-72 and again in 1975-77 precede the two major bouts of stagflation in 1973-74 and 1979-80. They also compare the pattern in US liquidity and find the spikes in money growth preceding the peaks of inflation in 1974 and 1980. (They also point to periods of abnormally low interest rates as indicators of excess liquidity.)

1.3.3. Other industrial commodity prices

Barsky and Kilian draw attention to the sharp and generalized price increases in industrial commodities, beginning as early as 1972. They argue that the increases are too across-the-board to reflect shocks in any given market; rather, the increases reflect increasing demand for commodities in response to global liquidity (see previous section 1.3.2.). In passing, they note that oil prices showed "sluggish adjustment" relative to other commodities. They suggest such sluggishness was a function of long-term contracts vs. a regular spot market. (See Chart 6 for commodity prices vs. oil.)

1.3.4. Business cycle indicators

Fourth, they show that a recession was indicated long before October 1973, consistent with their monetary explanation. Indices of consumer confidence and of leading indicators (Chart 7) peaked in January 1973, concurrent with the Fed's switch to a contractionary policy.

1.4. Conclusion

Americans of Sir Alan's generation are still haunted by the ghosts of the 1930s as well as the 1970s: They are still fighting yesterday's battles. The Fed will do anything to head off contraction, even cranking up the printing presses and unleashing the money supply. And while we dream at night of endless lines at the gas pumps, we are oblivious to the threats of the real-estate and credit bubbles that we are creating.

In summary, we highlight the two major points of the

Barsky and Kilian offerings. First, oil prices have their own rhyme and reason. Crucially, rising oil prices are not the cause of stagflation. Second, unchecked money-supply growth is the cause of stagflation. Considering the current double-digit monetary growth rates (see also the encapsulation above), we wonder if the stage has not been set for a repeat of the stagflation suffered during the 1970s.

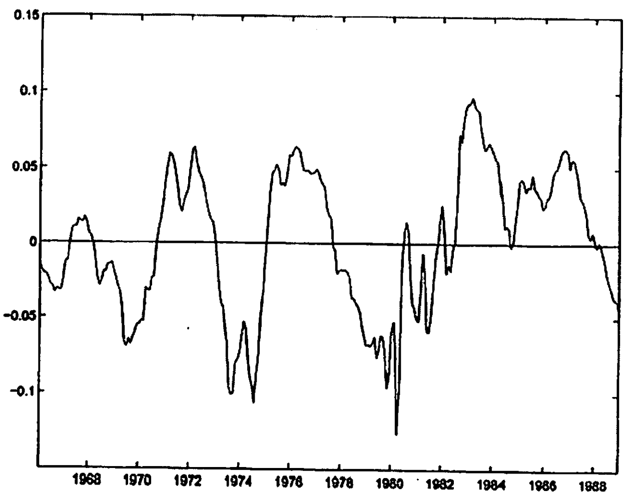
Perhaps the monetarists will have the last laugh.

Bibliography

Barsky, Robert B. barsky@umich.edu, and Lutz Kilian. 2000. "A Monetary Explanation of the Great Stagflation of the 1970s." *NBER Working Paper Series* no. 7547.

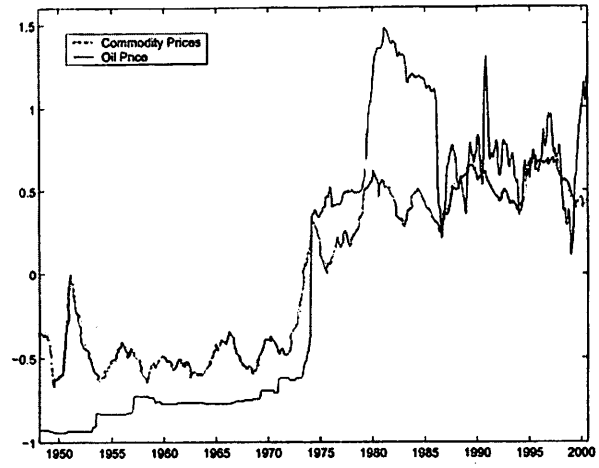
Barsky, Robert B., and Lutz Kilian. 2001. "Do We Really Know That Oil Caused the Great Stagflation? A Monetary Alternative." *NBER Working Paper Series* no. 8389.

Chart 5 – Indicator of Overall Monetary Policy Stance, 1966.1-1988.12



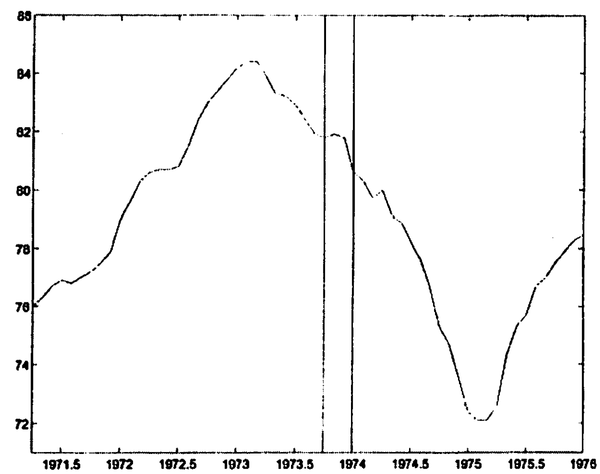
Courtesy B. Bernanke and I. Mihov

Chart 6 – Nominal Price Indices for Crude Oil and for Industrial Commodities, 1948.1-2000.7



Source: All data are logged and demeaned. The commodity price index excludes oil and food. The index shown is an index for industrial commodity prices (DRI code: PSCMAT). Virtually identical plots are obtained using an index for sensitive materials (DRI code: PSM99Q).

Chart 7 – Index of Leading Economic Indicators



Sources: DRI

MONETARY POLICY

The imaginary evils of deflation

By Christopher Mayer

Deflation is popularly defined as a general fall in prices; it is the opposite of what most people generally think of as inflation. It is most commonly associated with the Depression and with the recent economic woes in Japan.

Perhaps as a result of this common association, or perhaps as a result of a more general weakness in the clarity of economic thought, deflation is often seen as something that brings calamitous consequences and as something that must be prevented.

One of the more surprising recent business best-sellers is a book titled *Conquer the Crash*, by Robert Prechter. It is surprising because the public does not often take to being told that disaster is around the corner. Optimism is the far sweeter fruit, more often indulged upon whether the facts justify it or not. Be that as it may, Prechter's book calls for a deflationary depression and paints a rather dire picture of financial distress.

Deflation worries are gathering more and more attention. *The Wall Street Journal* recently ran a piece titled "Deflation Fears Make a Comeback," in which it noted the fall in prices of selected goods but warned that "if deflation spreads into other segments of the economy, it could turn into a major problem." Assuming a connection, the article mentioned financial hardships during the Great Depression and in Japan.

Not only is deflation seen as something that is harmful, but it is also viewed as something that must be prevented. Naturally, the Fed is envisioned as the institution that should do the job. A recent Fed paper titled "Preventing Deflation:

Lessons from Japan's Experience in the 1990s" takes it for granted that the Fed ought to take measures to avoid deflation.

There is something about monetary phenomena that make them a particularly misunderstood aspect of economic life. Deflation is no exception. There seems to be little understanding as to what it is, what causes it, and whether or not it is something that should be prevented.

Professor Joseph Salerno has done us all a favor with a well-written paper titled "An Austrian Taxonomy of Deflation" that makes it much easier to answer these questions and cut through the muddle of media hype and distortion.

The effects of deflation, like the quality of drinking water, cannot be considered without regard to its source. According to Salerno's taxonomy, there are four basic causes of deflation.

The first is *growth deflation*, which stems from increases in efficiency and productivity. Assuming the supply and demand for dollars is unchanged, an increase in the quantity of goods produced will result in falling prices. In other words, the same amount of dollars can now purchase more goods. The common example of this deflation is to look at the falling prices for technological goods. The computing power a consumer can purchase for a dollar today is much greater than what could be purchased even a few years ago.

Growth deflation should be the prevailing trend in a healthy progressing economy. It is only because of years of rampant money supply growth, endemic under a fiat currency system, that inflation has become the accepted norm. As Salerno notes, "throughout the nineteenth century and up until the First World War, a mild deflationary trend prevailed in the industrialized nations as rapid growth in the supplies of goods outpaced the gradual growth in money supply that occurred under the classical gold standard."

Growth deflation, then, is by no means harmful. It is the natural product of voluntary exchanges and the ever-increasing productivity that has become the hallmark of market economics even among it detractors.

The second type of deflation under Salerno's taxonomy is *cash-building deflation*, which occurs when the demand for money increases. All other things being equal, an increase in the demand for cash will raise the price (i.e., the purchasing power) of the currency. Increased purchasing power implies a fall in prices.

Hence, this deflation, too, is a result of that action taken by free individuals to meet certain needs – the need for the additional security gained by holding more cash, for example. If one remembers that the ultimate basis for economic action is to satisfy human wants and needs, it is hard to imagine why cash-building deflation (called "hoarding" by its critics) is thought to be malign. From the perspective of the consumer doing the cash-holding, it is obviously not a bad thing. Clearly, a want or need is being satisfied.

Then there is *bank credit deflation*, which comes from the contraction of the money supply. Salerno writes that "the most familiar is a decline in the supply of money that results from a collapse or contraction of fractional-reserve banks that are called upon by their depositors en masse to redeem their notes and demand deposits in cash during financial crises." The effect of such a collapse, holding other factors constant, is to increase the purchasing power of money.

Bank credit deflation, Salerno asserts, "has a salutary effect on the economy and enhances the welfare of market participants....Bank credit deflation is a benign and purgative market adjustment process." Obviously, you cannot have a bank credit deflation without first having bank credit inflation. It is the inflation that creates all the malinvestments and excesses of the boom. Bank credit deflation is a force that works to correct those errors so the economy can profitably grow again. Despite the beneficial effect of bank runs and credit deflation in helping to check credit inflation, it is hard to imagine any widespread bank failures given the hyper-interventionist government we live with today and the ease with which money can be created.

While the money supply did contract during the Great Depression, Salerno notes that the stabilization policies of the Hoover and Roosevelt administrations "prevented the deflationary adjustment process from operating to effect the reallocation of resources demanded by property owners." These attempts only hindered the recovery and worsened the depression.

Finally, there is confiscatory deflation, which is the only kind of deflation that is unequivocally bad for market participants. It is also the kind of deflation that is usually overlooked. Confiscatory deflation is forced deflation brought on by the exercise of political power.

The most recent example of this is the debacle that occurred in Argentina, when the government attempted to prop up the ailing peso (a victim of soaring money supply growth) by preventing or limiting the ability of Argentines to make withdrawals on their bank accounts. By preventing withdrawals, it was hoped that the bankrupt banking system could be saved – at the expense of millions of Argentines' savings!

The events that followed are still fresh in our memory: riots, loss of life, property damage, the forced resignation of Argentina's president – in short, chaos. Confiscatory deflation, in addition to being an act of outright thievery by a government, also is tremendously harmful to the market's participants. It blocks them from meeting their wants and needs.

Given this framework for understanding deflation, how likely is it that the US economy will experience the sort of widespread deflation that worries so many observers? Salerno believes that there is little chance of that. Given the slow growth or recession expected in 2002, there would seem to be little risk of growth deflation for a while. Salerno cites some evidence of cash-building deflation, but this, he says, tends to be a short-term phenomenon. Looking at the money supply, there is the expansionary monetary policy of the Fed, coupled with the fact that "there is no evidence that Americans are losing confidence in the banking system." Again, given the hyper-interventionist government of today, it is hard to imagine widespread bank failure, however beneficial the effects of such failures might be.

Salerno concludes that "an existing or imminent deflation in the US is chimera conjured up by those unfamiliar with sound, Austrian monetary theory." Whether or not a widespread deflation does hit the US economy, given the analysis summarized here and assuming it is not of the confiscatory variety, it is certainly not something to fear or prevent. *[Posted September 11, 2002]*

Christopher Mayer is a commercial lender for Provident Bank in the suburbs of Washington, DC.

STOCK BEAT

Looking back...and ahead

By Yakov Friedman

It's certainly easier to document a good call than to make a good prediction. In our July 29 issue, we reviewed the warning signs and red flags coming from the Great Atlantic & Pacific Tea Company, which led us to take a short position on the company. Since that time, the company finally admitted that it was facing severe competitive pressures, something we had assumed based on competitors' disclosures and the company's declining sales. A greater degree of openness pervaded its conference call until the time that management indicated that it could give no guidance for the rest of the year. It became obvious that the earlier call by analysts of 85¢ per share was nothing more than a pipe dream, proving that our skepticism was well placed.

Further confirmation of monkey business, incompetence, or a supreme desire to be squeaky clean (your pick – you know *our* take) came in the *two* subsequent amendments to the delayed 10K filing. This was followed by the surprise dismissal of Deloitte & Touche, when the firm's long-time auditors advised the management of deficiencies in its accounting systems. The revelation of Deloitte's concern came in an unannounced 8K filing that raised more questions than answers. The story goes on.

The analysts have become slightly more conservative in their assessment of the company and its prospects and Moody's has placed it on negative credit watch from its already lowly junk status. Amazingly, even after a drop of a further 40% since our last article, the stock still trades at over 15 times expected (guessed) earnings for this year. We are in an environment of disappointing earnings reports, which has become epidemic in the supermarket industry.

Our benchmark supermarket index sports an average price-earnings multiple of 10 times this year's expected earnings and has come down about 13% over the same time frame. We maintain our short position, because we suspect that the market has not fully adjusted to the situation. The lesson? Never assume that an opportunity has passed because information has been made public.

A look ahead

While the broader market has been pummeled over the past six months, we continue to look for overpriced equities. One such company may be Walgreen Company (NYSE: WAG).

The large drug store chain has a market capitalization of over $32 billion and operates approximately 3,900 stores. It soon should become the largest operator of pharmacies by store count as it overtakes rival CVS. It already is number one in sales.

Despite these encouraging figures, the stock seems to be significantly overpriced. A comparison with its competitors bears this out. For a number of reasons CVS serves as the best comparison (Rite Aid is nearly bankrupt, and Eckerd does not release detailed results, because it is part of JC Penny). Although Walgreen has certainly reported better numbers than CVS in the recent past, the magnitude of the discrepancy in the respective stocks' prices demands scrutiny.

Valuation

A peek at the CVS story should help put Walgreen's performance in perspective. While CVS has had its share of slumping earnings in the second half of last year, the company's latest results indicate that it is currently on the mend. Recent action in the stock, however, tells a different story. The company posted its first quarterly net loss since 1997 in Q4 of 2001, as it took over $350 million in one-time restructuring charges.

The market's reaction to two disappointing quarters shows just how ruthless it can be when expectations are not met. CVS saw its share price drop by more than 60% from its high in early 2001 as its historically high rate of growth slowed and earnings collapsed. Since the turn of the year, CVS has met targets. Earnings are approaching previous levels while sales continue to rise. Still, the stock continues to get hammered, because management has not been persuasive enough to tell its turnaround story. More likely, the market has started valuing the company in a more realistic way.

Walgreen, on the other hand, shows few problems on the surface. Charting its reported earnings produces graphs so perfect one would think that they were geometrically designed. It reports quarter after quarter of record earnings and sales.

Still, with all the good news, we have a number of concerns. Higher selling expenses leading to smaller margins and lower than anticipated sales growth may be developing into real threats to the success of the company.

First, the company is one of the few surviving "pedestal" stocks in the retail sector. Equities that are priced for perfection are poised to fall the hardest. It is hard to take the near picture-perfect results at face value. Even the best management will run into difficult problems periodically. (Actually, a better indication of management's performance is how it deals with problems.)

Second, the company's expansion plans, though not exceedingly ambitious, may prove to be a source of trouble as focus placed on growth cannot help but come at the expense of full concentration on improving performance. Finally, the overwhelmingly optimistic tone of the company's press releases coupled with the absence of the customary analyst conference calls following earnings announcements make one wonder if things aren't too good to be true.

A hint that all might not be so rosy came on Sep. 30, with the release of the results from the final quarter of fiscal 2002. The tone of the earnings release was positive, as usual, but there were indications that the company is beginning to experience some difficulties. The company missed the analysts' average expectations by about 4%. While not a huge amount, it lent credence to our suspicions. Recent monthly sales figures imply that the same pressures we have seen in the broader retail sectors may finally be catching up to a company that Wall Street viewed as virtually infallible.

The problems that are beginning to emerge in Walgreen have been widespread in the retail industry over the greater part of the last year. While the drugstore business is very different from the grocery business, it is impossible to ignore the fact that in the retail food sector, price-earnings ratios for the larger players have fallen significantly this year – to near 10 from around 15.

Investors realize that slower paced increasing sales in this "never fail" industry have been accompanied with slipping margins as retailers try to draw customers who are finding lower priced alternatives. The name of the game for many of these large chains has shifted from increasing profits to maintaining market share.

The threat of Walmart may be less of a significant factor for pharmacies than it is for groceries, as prescriptions often need to be filled immediately. Additionally, one would be little inclined to make the excursion to a superstore location to make a one-item purchase – as is often the intention of the customer who enters a drug store. Still, it is difficult to believe that such a move isn't imminent within the drug store segment as well.

Indeed, Walgreen's earnings release of Sept. 30 indicated that the company is starting to have some difficulty maintaining margins. Sales, general and administrative costs increased by over 20 basis points as a percentage of sales (although gross margins improved owing to more generic drug sales). The disclosure that it will engage in more promotional activity implies that the management does not view the problems as a one-time blip but a real issue with which it has just started to deal.

The company stressed the improved performance on a yearly basis, but the latest quarter's numbers are probably more indicative of what is happening and what is in store for the firm. This is an industry that is becoming more competitive. Vendors are now selling to customers who are becoming increasingly conscious of their spending patterns. The ever-so-slightly cautious but generally optimistic tone in the company's release stands out in contrast to the ebullient tone displayed by management on earlier occasions. While Walgreen may display immunity to the overall climate because of the products it sells, we believe that cracks are starting to appear in the giant's armor.

On a strictly numerical valuation basis, the company looks grossly overpriced. Walgreen has been trading at a p/e multiple approaching 30 times expected 2002 earnings. Even after being hammered by close to 10% after its recent earnings miss, the stock still trades at over 27 times analysts' consensus. It trades at about 1.1 times trailing four quarter sales.

In comparison, CVS is currently trading at less about 14 times its expected earnings over the next four quarters and is priced at only 0.4 times trailing four quarter sales. Large grocery chains are trading at about 0.25 times sales and, as previously mentioned, have sunk to p/e levels of around 10.

One could easily argue that the lower ratios reflect a market that expects a downturn in profit. Why should Walgreen escape the fate of so many other retailers that have come down to more realistic valuations? Our guess is that it won't. Sooner or later the evidence will be at hand.

Walgreen doesn't provide its own earnings guidance. The analysts were unanimous in their response to the recent miss, though. The earnings expectations for the next fiscal year were cut by about 4% across the board. We're not so sure it's a good thing to be in agreement with them, but we tend to think that their error this time will prove to be in the conservativeness of their estimates of the problems facing Walgreen.

Growth

Walgreen continues to plan for extensive growth. Its latest prediction calls for 80% more stores in the next eight years, increasing its target to 7,000 stores by 2010 from the previous goal of 6,000. While Walgreen's aspirations may not be as grand as those held by other chains that ended in disaster, we would have preferred to see a more cautious tone adopted, not a more ambitious one.

Such aggressive plans for growth in an increasingly competitive environment seem wishful at best and possibly foolishly shortsighted. Large retailers such as The Gap have run into tremendous problems as overly aggressive expansion plans interfered with effective management of an existing store base. CVS, in contrast, has adopted a much more conservative growth policy.

The industry as a whole enjoys a good sales growth rate. Pharmacy sales have risen by about 10% over the past five years and the number of prescriptions dispensed nationwide grew at a 5% rate. There are many players vying for the new sales, and individual performance is key.

While CVS lagged in sales growth over 2001, the first half of this year has produced year-over-year increases in sales of 10% – up from 8.5% in Q4 of 2001. This figure is quite impressive in light of the store closings that have taken place since the beginning of the year. The increase in sales came from about 3% fewer stores, giving an adjusted increase closer to 12%, approaching the 13.5% adjusted increase to the same period last year (when the stock peaked at over $62). In comparison, Walgreen increased sales by 16.3% on a store increase of 10%, for an adjusted growth of less than 6%. New stores typically take several years to make money. Even so, these figures may indicate that the quality of stores currently maintained by CVS is superior to those held by Walgreen.

Equally as significant, CVS's same-store front store sales, which have a greater profit margin, increased by 3.6% during the first 8 months of the year – up from 3.1% in Q4. Over the same time period, Walgreen's same-store front store sales are up only 3.3%. Although Walgreen admittedly significantly outpaces CVS in overall sales growth, CVS's performance (and Walgreen's underperformance) in the higher margin areas cannot go unnoticed.

Walgreen prides itself on its record of growth and on the course of continued expansion that it has charted for itself. The rapid increase in store base has required significant capital expenditures. More than $1 billion was spent in the last fiscal year, and a similar amount is budgeted for 2003.

Cash flow has been adequate to meet these demands so far. It is not so clear that that will continue to be the case. The slippage in margins is likely to reduce the amount of cash available to meet the company's targets. Cutting into dividends is never an easy option. Walgreen's dividend is not large (less than 0.5%, even after the recent fall in the stock price). Investors would not take lightly to a decrease in their minimal dividend.

Transparency

It has become almost a given that large listed companies follow their earnings announcements with a conference call. These provide a forum for a frank discussion with management and typically are a source of valuable information that is not provided in the prepared press release. Even hearing the tone of the answers and noting the questions that the respondents skirt or evade provides insightful information for investors.

Typically, the most boring part of these calls is the first couple minutes, when a company spokesman reads from a prepared statement that is almost always a synopsis of the information already released in print. Walgreen follows its earning reports with access to a prerecorded "webcast" that mimics that boring first part of the call. There is no opportunity to hear the management respond to any queries.

Thankfully management has not gone into hibernation yet, and members are available for interviews. Even so, the amount of information that is provided is no match for the subtle hints that can be gleaned from the give and take with analysts.

The lack of earnings guidance from those who know best is also bothersome. One wonders why management is unwilling to provide accurate forecasts of the company's performance.

Although the company's SEC filings are on the skimpy side relative to some other large firms, its financial data are released in an eye-pleasing format. The easily digested, no-headache formula is certainly attractive for investors. It is almost like buying a product because of the pretty packaging. The wrapping, however, is not necessarily an indication of the quality of goods inside.

Walgreen prides itself on having "virtually no debt." On a strict balance-sheet basis this fact can not be disputed. The few hundred million dollars of short-term debt that was on the company's books a year ago has been repaid. Long-term borrowings do not exist, though the company reported $3.6 billion of total liabilities on its balance sheet (of course, in their eyes this is not debt, just liabilities. We still have not figured out the distinction between the two). The problem is that this number is not a true representation of the amount of money it has committed itself to pay. It fails to account for the off-balance-sheet obligations that are disclosed in the annual report.

Like virtually all retailers, the company maintains operating leases that are not included in the financial statements. In its fiscal 2001 10K filing, the company indicated that it had more than $13 billion in long-term lease obligations. While the practice may be the common, the amount is large, especially relative to the $6.2 billion book value of the company. The number is even more significant given the popular perception that the company carries "no debt." How else do you describe a non-cancelable obligation? Thus, Walgreen's reported $3.6 billion of liabilities is likely more than $10 billion (the exact amount would vary, depending on what discount rate you want to apply to the future lease payments). CVS has less than $9 billion in commitments on its operating leases and reported $4.1 billion of liabilities. Which company really has more debt?

Bottom line

Despite the drawbacks we have highlighted here, Walgreen is, on the books, a well-run company. Yet it has been priced for perfection. In recent price action, the market has begun to realize that prospects may not fully justify the high multiples awarded to the stock.

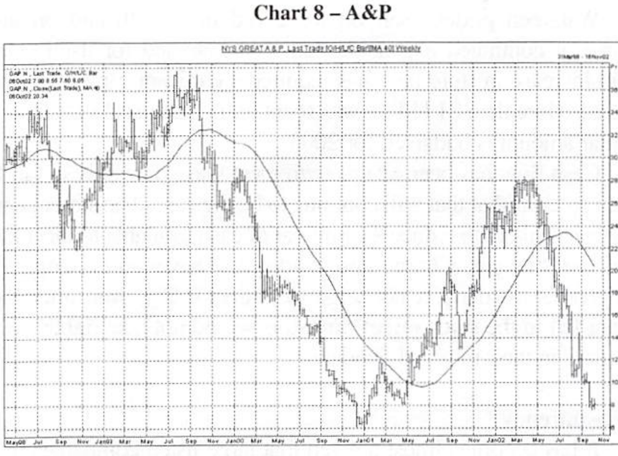
Over the past month, four different executives collectively sold more than 45,000 shares of their own company's stock, and the CEO sold 7,500. This should not go unnoticed. Though the number of shares sold may not be huge and may be option-related, such concentrated selling by those in the know has not occurred in some time and should cause concern to investors.

The recent slippage from its highs of $40 per share to a level around $32 culminating in the market's response to its Q4 earnings may scare some bears into thinking that they have missed the move. We don't believe that this is the case at all. During the drop in Walgreen's value, the broader market also fell significantly. A deeper, relative correction has yet to come. As we witnessed with A&P, significant falls in prices often signal more bad news to come.

Disclosure: Our funds and proprietary funds took a short position in Walgreen in early May.

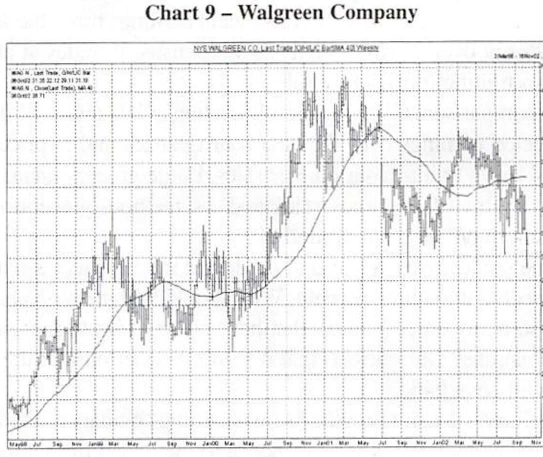
Yakov Friedman is an analyst at Friedberg Mercantile Group.

Chart 8 – A&P



Courtesy Bloomberg

Chart 9 – Walgreen Company



Courtesy Bloomberg

Friedberg's Commodity & Currency Comments (ISSN 0229-4559) is published by Friedberg Commodity Management Inc., P.O. Box 866, Suite 250, BCE Place, 181 Bay Street, Toronto, Ontario, M5J 2T3.

Subscription Enquiries for
Friedberg's Commodity & Currency Comments
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

Managed Accounts
All enquiries concerning managed accounts should be directed to:

In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 364-2700

For U.S. Persons
Friedberg Mercantile Group, Inc.
Suite 250, BCE Place
181 Bay Street
Toronto, Ontario, Canada M5J 2T3
1-800-461-2700