

FRIEDBERG'S

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Gold: Don't fade the breakout

A little over two months ago, we expressed some doubt about the immediacy of a push to new recovery highs. We reasoned that the resumption of the up-trend necessitated a weaker dollar and/or a complication in the imminent US war with Iraq and/or an acceleration of inflation. None of these appeared on the immediate horizon. Though extremely bullish for the long term (see our June 3 issue, "Why is gold leading the charge against the dollar?"), we felt that the market had gotten a bit ahead of itself (witness the extraordinary speculative interest in gold shares), and that a pause was in order. Also, our relatively bullish view on the dollar had colored our near-term expectancy. But, as is axiomatic of our trading world, neither bull markets nor bear markets wait for anyone.

In a few short days, bulls took a third stab in 7 months (and the fifth stab in three years) at the \$325/oz. Maginot Line and managed to overcome it. Precisely because we feared that bull markets don't wait for anyone, we advised in October to "wait for now or buy the (\$325/oz.) breakout."

The ingredients for an explosive move are all present. Open interest on the Comex has risen 40,000 contracts in recent days and is approaching record highs. With bullish speculators in control of the market, the heavy short position – commercials and professionals selling the top of the trading range – will be forced to pay up in a big way. War jitters will not make it easier.

More significant, as we discussed in our June issue, is the existence of a hedge book of approximately 3,000 tonnes, the equivalent of about 10 months of fabrication demand. Should hedge-lifting continue to accelerate (rumors have it that over 500 tonnes were repurchased in the past few months), we are likely to witness price-gapping, signaling the inability of the market to accommodate desperate producers.

Because rising prices lift spirits, investment demand, which had been totally absent for many years, is certain to grow. Though the merits of gold as an inflation hedge are questionable, especially when compared with inflation-linked, interest-bearing securities, its merits as a store of wealth in highly uncertain times are not. Ever-increasing controls over cash movements brought about by the war on terrorism and on drugs, war and the risks of freezing enemy balances, debt defaults, which thanks to Argentina and the IMF are likely to become more common, and even the vulnerability of fiat

Dedication

I would like to dedicate this issue to my father, of blessed memory, who unexpectedly passed away in his home on Monday, November 18. A banker and trader for most of his active life, even when running away from the Nazi persecutions, he was a master of the art of speculation. His sharp sense of knowing when to fade the street, his keen analytic skills, and above all, his thoroughgoing integrity served me as a model ever since, as a child, I began to walk with him.

He taught me all I know about markets, about people, and about making an honest living. He taught me to spend and to give. Proudly and firmly, he transmitted to me the faith of his forefathers. Finally, he spared no effort, financial or otherwise, for my continuing education.

There is little more a son can ask. May he rest in peace.

– Albert D. Friedberg

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Contributions by Albert D. Friedberg, Vincent DeCaen, Jeremy Fand, and Yakov Friedman.

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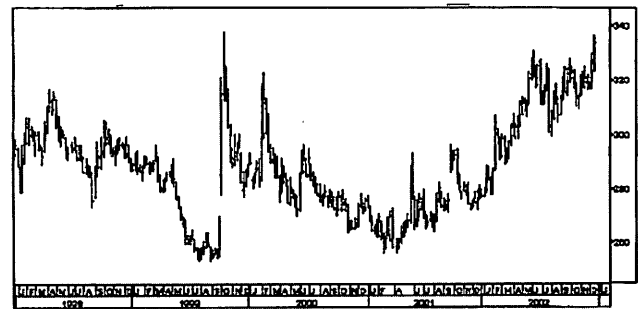
money to nuclear/chemical wars, are only some of the concerns that will begin to feed the bullish case for gold.

Despite higher prices, and perhaps dramatically higher prices, the plans designed by the leading Western central banks leading to full demonetization of gold are not likely to be changed (though, we should note, the US is not a signatory of the accord).

It remains to be seen, however, how China and some Asian countries that own sizeable dollar reserves react. Their initial reaction should not be long in coming. In the unlikely (?) event that they become buyers on the rise, prices are likely to soar well past historic highs, and a new gold standard will have arrived. Should they, on the other hand, shun the advance, the technically-driven sharp spike in gold prices will not be easily sustained. Prices should *settle* well above present levels but well below historic highs.

We advise full exposure via gold bullion, or preferably futures, and only selected exposure to un-hedged gold mining companies.

Chart 1 – Weekly gold



Courtesy Bloomberg

US DOLLAR

Finishing the year in trouble

By Jeremy Fand

The US dollar has had a bad year, following many years of strength, despite a growing US current account deficit, the stock market bubble bursting, and terrorist attacks. Finally starting to reflect a more balanced picture of the risks that it faces, the dollar has fallen past parity with the euro and is hovering in the ¥120-¥125, despite Japanese wishes for yen weakness. It is the combination of both cyclical and structural issues coinciding with a new era of investment uncertainty that has been, and may continue to be, toxic for the US dollar.

From about 1995 until early this year, the greenback had a relatively uninterrupted period of growing strength, as the US productivity miracle led to significant investment gains and strong economic performance. Even after the overexuberance of the “New Economy” was starting to be corrected, the dollar continued to rack up gains. The latter half of the '90s had so convinced people that the US economy represented unshakable stability, and that the US was always the best place to invest, that the US dollar still held strong even after the stock market bubble had burst and terrorists brought a new vulnerability to US soil.

Quick monetary policy action led by the US Federal Reserve Board may have kept the dollar out of trouble as this year started, but it is clear now that the assumptions of stability in the US economy and in investment returns was incorrect. It is this uncertainty that has been most toxic to the dollar of late.

The uncertainty of growing geopolitical risk as well as economic and political risks in the US has been most hurtful to the dollar. Indeed, the dollar has not served in its traditional “safe-haven” role for quite some time.

The imminent war with Iraq is at the top of the list of geopolitical risks to the dollar, as most of the world does not really back the US intentions. Indeed, with only the UK as a true partner in its war against Saddam Hussein, both the US dollar and the British pound have suffered weakness against the euro as the markets have reflected global negative sentiment towards the potential war. Negative sentiment towards

the US on the Iraq issue has also crimped foreign purchases of US bonds and equities and has left the dollar weaker.

The geopolitical risks are not limited only to a war with Iraq. US tensions also are on the rise with Iran and North Korea over nuclear power/weapons. The global investment community worries that the US can neither afford nor succeed in a role of global watchdog over terrorism and nuclear weapons.

With the US current-account deficit requiring significant investment inflow daily, the dollar cannot afford this negative sentiment. Flows have already been a negative for the dollar this year as stock market woes have left only bond flows to support the currency. While it turns out that US bonds were a good pick this year (as well as for the two previous years), it seems that only foreign US Treasury purchases have been saving the dollar from a plunge inspired by the current-account deficit.

With the added issue of geopolitical concerns weighing on the global investors' minds, it seems unlikely that foreign interest in holding US dollars will pick up anytime soon. Indeed, as the year comes to a close, it is important to note that the dollar is displaying seasonal weakness resulting from a year-end slowing of cross-border capital flows to the US.

Looking at the US dollar index over the past 5 years shows that the dollar falls an average of 1.37% in December. While the USD index has already fallen more than that this December, continued weakness should be expected as flows continue to trickle off.

On a more positive note, the US dollar seasonal negatives in December have on average reversed strongly in January (rising on average 1.19% above the Dec. 1 valuation), similar to the “January Effect” often observed in the stock market. Critical to a US dollar positive January Effect in 2003, however, will be some relaxation of geopolitical tensions (a quick win against Iraq, for example) and a renewed foreign interest in putting money to work in the US (led perhaps by a strong US equity performance in January).

The relative performance of US assets will also be critical for the dollar. In this regard it is interesting to note that the return on US assets abroad averages about 4.5%, while the return on foreign assets in the US is just over 3%. As a result, the US has been able to maintain near balance in the income-servicing account, which has been offsetting the downside pressure on the dollar from the impact of the current-account imbalance. Nevertheless, the current-account issue is on more minds today than ever, and that fear alone has served a negative for the dollar.

The commonly held perception that the greenback is still overvalued given the size (and continued growth) of the current-account deficit has many economists and investors believing that only a still weaker US dollar is needed to correct the imbalance. It is this policy prescription that has many thinking that the Bush administration's US dollar policy has changed.

The recent changes to the Bush economic team are being seen as potentially bringing a further watering down of the "strong dollar" policy. The new Treasury Secretary, John Snow, has yet to comment formally on the dollar (his confirmation is not until January), but many fear that his industrial background will bias him towards a weaker dollar. Part of the recent dollar selloff is related to this, as many expect the "strong dollar" policy to change to a "sound" currency policy or a "strong economy" currency policy.

It is unlikely that the Bush administration wants to see the dollar fall any further, because it could take other US assets with it and distract from Bush's priorities of new fiscal policy initiatives and the global war on terrorism. It is therefore unlikely that dollar policy will change. Yet the market is uncertain about dollar policy going forward, and the earliest statements on dollar policy are not due for at least a month – leaving the policy issue as a dollar negative for now.

Questions about the US economy are also serving to undermine the US dollar. While the data out of the US have been mixed of late, there is plenty of evidence pointing to a gradual economic recovery over the course of 2003. The global uncertainty surrounding geopolitics, global investment, and US dollar policy, is negatively infecting views on the US economy. Many are concerned that the bursting of the bubble that started a few years ago has a long way to go. This bearishness has brought on discussions of deflation, a bursting of the housing bubble, monetary policy ineptitude, and traditional current account fears. While these issues are real concerns, the

strength of the US economy – especially relative to others – is a balancing factor.

A US economic performance that stands in sharp contrast to the economic woes of Europe and Japan may be enough to quell these fears and offer an attractive investment alternative to the global bears – allowing the US to attract enough foreign funding to live on with the current-account deficit. While this may prevent further declines, dollar strength is difficult to forecast unless the market gives the Fed's easing the benefit of the doubt (that is, live with negative carry), has faith in Bush's fiscal push, and grows comfortable that the US is doing a good job in its battle with terrorism.

Already, the interest rate markets are starting to show more optimism on the economy as rate expectations are climbing. In this regard, the negative carry of the dollar versus the euro may become less of a negative – as interest rate futures market expected-yield differentials between Euribor and Eurodollars have already narrowed significantly in recent weeks. Still, global equity markets need to stabilize and perform better before the carry issue becomes moot.

The weight of uncertainty is likely to continue to hurt the dollar, but the negatives now working against the dollar could balance out in the New Year. Continued positive economic data from the US relative to dire news coming from Europe and Japan are likely to be the best antidote to current dollar weakness.

Europe and Japan both risk financial disturbances that could also make the dollar look relatively attractive. In the case of Japan, the banking system is undergoing repair, while Europe is dealing with expansion issues at the same time as fiscal policy is under fire, with the stability pact being called into question.

The policy question regarding the new Bush economic team and the "strong dollar" policy will likely be clarified in the affirmative for the dollar in January. Also critical for the dollar's health will be a speedy conclusion to the issues surrounding a war with Iraq. The dollar may stabilize a bit higher if uncertainty diminishes in the New Year.

Expectation of a significantly stronger dollar in 2003, however, is difficult to imagine at this point, given the size of the current-account deficit and the strong doubt that the exuberance of the '90s will return anytime soon.

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

FOREIGN EXCHANGE

Hunting for yield

By Jeremy Fand

Participants in foreign exchange markets have a plethora of tools to help guide them when looking to pick the winning currencies, but the problem with these tools is that they don't all work at the same time. While the textbook teaches that a current account deficit of the size that the US has been running should be detrimental to the currency, the US dollar was able to strengthen considerably even though the deficit built up for years.

Similarly, growth differentials or interest rate differentials should add up as factors that determine a currency's relative value, but these measures have not been very good predictors of currency markets in recent years. Indeed, the granddaddy of all currency theories – purchasing power parity (PPP) – has had a notably bad track record in predicting currency movements from year to year.

While economists will argue that many of these theories of currency determination work in the very long run, the currency market investor has learned by experience that these themes sometimes work, but often do not. Of most interest to currency markets in the past two years has been the interplay of interest rates and currencies.

In 2001, the Fed's dramatic interest rate cuts have forced a decline in US short-term interest rates to 2% from 6.5%. This sent the US/Europe short-term interest rate differential plunging from about 150 basis points (bp) in favor of the dollar to about 150 bp in favor of the euro.

Despite this dramatic change in interest rate differentials, the dollar remained on a strengthening path. While currency market traders were throwing out their economics textbooks, the positive carry of the euro versus the dollar was starting to get attention. After the terrorist attacks of Sept. 11, 2001, the risk environment in global markets changed dramatically. Not only was the global equity market already in the process of declining, but asset allocators were already building up preferences for bonds over equities.

The risks of a global economic recession combined with rising risk aversion put bonds in favor as 2002 began. It is this preference for fixed income that also brought back that key interest rate differential to the determination of currency value.

Currency investors often think about which currencies to overweight or underweight by looking at a combination of signals coming from four general areas: economic valuation; yield; technical trend; and flow/sentiment.

- Economic valuations come in the form of growth differentials, current account balances, and PPP, among others.
- The yield measure is the most straightforward of the four because it is a simple look at which currency offers a better carry.
- Flow and sentiment indicators can sometimes be a by-product of economic fundamentals, but look specifically at cross-border flows and sentiment measures to judge relative value.
- Technical trend refers to momentum and other aspects of charting.

While the currency investor would prefer to invest when all four valuations are pointing in the same direction, those occurrences are rare. Looking back at the past year, the search for carry has been the dominant force in driving currency valuations.

A simple forex investment strategy if one is interested only in capturing carry would be to buy the three highest-yielding major currencies versus the three lowest-yielding currencies, and hold them for the year.

A good amount of research has been done on these types of strategies, but the conclusion is that carry works only when carry is hot (Deutsche Bank conducts an ongoing study of this

type of strategy). It turns out that 2002 has been a good year for carry as global market uncertainty saw investors looking for the security of fixed income.

While 2003 feels like it may go that way too, a return to strong growth in the US compared with severe weakness in Europe and Japan could throw that off, with growth differentials coming back into vogue. That said, a strategy of investing in the three highest yielders versus the three lowest yielders did very well in 2002.

With December results still pending, all but two months in 2002 (late summer) had this strategy producing positive returns. Indeed, in the 11 months of 2002, this strategy yielded a return in excess of 15%.

The currency mix also remained basically constant all year. Norway, New Zealand, and Australia were the high yielders at the start of the year, while the US, Switzerland, and Japan were the low yielders – and have all remained so as of the time of this writing. The high yielders in this simple experiment did suffer some setback in June and July, but soon regained ground. It appears that they were simply overbought.

While the summer setback of this strategy could be written off to that "technical" factor, the other reason that the high yielders did not do well for some time was that the king of the low yielders (the Japanese yen) had a bout of significant strength.

If this yield-hunting forex strategy had simply been carried out for the four biggest currencies, the high yielders (British pound and euro) did significantly outperform the low yielders (Japanese yen and US dollar).

The perennial low-yielding currencies are the Japanese yen and the Swiss franc, with short-term rates effectively zero in Japan and just over 0.5% in Switzerland. Of note, however, is that 2002 saw the US dollar become a low yielder.

In looking back at the weakness of the dollar this year, the yield preference for the pound or the euro over the dollar has made simple sense. The dollar movement versus the yen this year has been erratic and clearly not a function of interest rate differentials. But the notable rise of the euro versus both the dollar and the yen seems hard to explain in any other way than to look at the euro's positive carry.

While an interest rate differential/carry-trading strategy seemed to have worked in the past year, the potential recovery in the US and the chance that equities might come back into favor could derail the profitability of such a strategy in 2003. Most critical to this strategy is that bouts of risk aversion seem to be accompanied by investors looking to park their money in relatively safe, but high yielding, currencies.

For the rest of the year, and into the early part of 2003, that may be the best forex strategy while uncertainty surrounding the global economy and geopolitics continues to run high.

MONETARY POLICY

Central banks guarantee inflation

In a high profile speech delivered before the National Economists Club in Washington on Nov. 21, Dr. Ben Bernanke, the newest addition to the Federal Reserve Board, had this to say:

"I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States

and, moreover, that the US central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief..

"Indeed, under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other

agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero...

"But the US government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost..."

"By increasing the number of US dollars in circulation, or even by credibly threatening to do so, the US government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services..."

"We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

Bernanke acknowledges that monetary policy can affect prices and thus that monetarism is alive and well. As Milton Friedman once put it, "inflation is always and everywhere a

monetary phenomenon." If so, it is strange that Bernanke does not show any concern for the fact that broad measures of money have been growing since the mid-'90s at a far faster pace than during the earlier half of the decade (see Chart 2), a pace that will certainly guarantee inflation rates that are higher than those seen in the first half of the past decade.

While consumer price inflation is being held down because of cheap imports and productivity gains in manufacturing, service prices continue to gallop ahead at 3% to 4% per annum. More worryingly, commodity prices have been firming up (see Chart 3), despite soft economic conditions, and housing and land prices are rising at multiples of consumer price increases.

In the face of an inflationist central bank, as Bernanke put it, talk of sustained deflation is nonsensical. Fixed-income portfolios should continue to privilege highest-quality, inflation-linked securities.

Chart 2 – M2

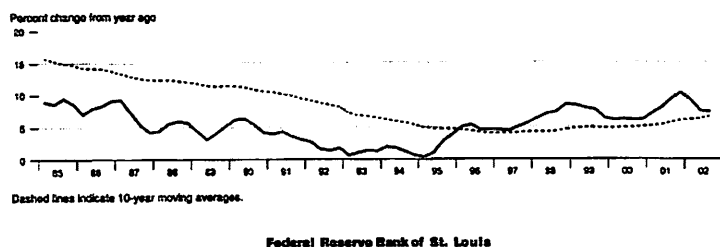
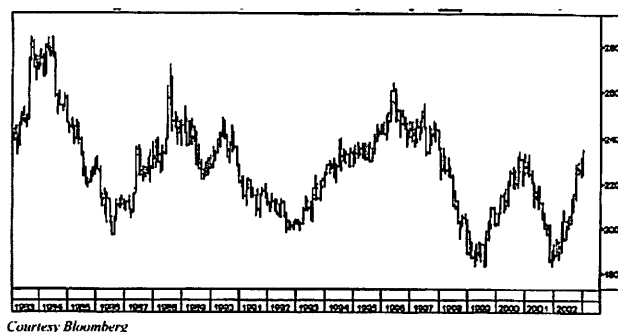


Chart 3 – CRB Index, monthly



JAPAN

Austrian economics and the Japanese quagmire

By Vincent DeCaen

The postwar Japanese colossus, much like the mighty Soviet colossus, came crashing to earth anno mirabilis 1989. Both American rivals have now been surviving on life-support for over a decade, and perhaps pundits might be forgiven periodic paroxysms of *Schadenfreude* – *Nought remains/But vindictiveness here amid the strong, ...* . And yet, if early twentieth-century European experience be any guide, "pulling the plug" on these patients might have dire consequences: We cannot afford a virtual Versailles.

Economic collapse is back on the agenda. The dreaded D-words are current once more: "deflation" and "depression." Evaluating macroeconomic analyses and anti-depression policies is serious business again. Furthermore, the standard nostras of the orthodox supersensors of classical economics, postwar Keynesianism succeeded in recent decades by Friedman's monetarism, have *prima facie* failed in Japan and elsewhere. Or as Keynes once put it, we apparently scheme on "sandy and false foundations."

Benjamin Powell, writing from George Mason University, Virginia, offers a timely critique of orthodox anti-recession policy from an Austrian-School perspective in his article "Explaining Japan's Recession," in the *Quarterly Journal of Austrian Economics* 5.2 (2002), pp. 35-50. Powell briefly

reviews Keynesian and monetarist diagnoses of the Japanese predicament and their economic prescriptions; and he concludes that their policies have "completely" failed.

In this note, we also take the opportunity to devote some thought to Keynesian and monetarist theory in the context of an ailing Japan. We then turn to the papers by Powell and Keeler and consider Austrian analysis of the Japanese business cycle and their standard prescription: *laissez faire!*

1. JMK and aggregate demand

Demand-side economics concentrates on the collapsing Japanese *aggregate demand*. Assuming consumption remains reasonably stable, such collapsing demand can be the result only of *declining investment*. Because of "sticky" prices and wages, equilibrium is not inevitable – especially at full employment. Moreover, Keynesians are an impatient lot, unwilling to fiddle indefinitely while Rome burns and then rises from the ashes. The government must intervene, therefore, both to boost investment via aggregate demand and to stave off revolutionary rumblings. Fiscal measures include cutting taxes and increasing government outlays.

Powell reminds us that despite 10(!) fiscal stimulus packages totaling more than ¥100 trillion, increasing government

“on-budget” debt to more than 100% of gross domestic product, Japan is still mired in recession. It should follow that Keynesianism is a failure.

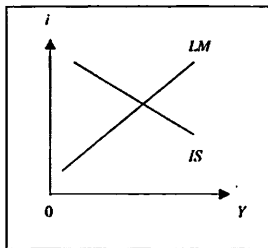
Logic choppers might spot the fallacy of “denying the antecedent” here. Those of a gloomy disposition might argue that it was only the massive stimulus of mobilizing for total war that was enough to jumpstart the global economy of the 1930s and that nowhere near that sort of stimulus has yet been applied. But regardless, there still is a standard Keynesian escape clause: the possibility of a “liquidity trap,” in which shifting the “LM curve” has no effect on aggregate demand. This situation is often described as “pushing on a string” – that is, the “string” of monetary policy.

2. On liquidity traps and monetary strings

It may be useful here to go into the theory of a “liquidity trap” in a little detail, to see how monetary policy could be viewed as “pushing on a string,” given the buzz in the media. To understand a liquidity trap, we must recall the two basic Keynesian relations between incomes (or, output) and interest rates.

Let us begin with a simple picture offered by Hicks in his classic 1937 paper. Label the Cartesian coordinates as follows. Along the x-axis plot Y (incomes, or output); and along the y-axis plot i (interest rates). Label an upward sloping curve LM and a downward sloping curve IS , intersecting, like Marshall’s supply and demand curves, at an optimum interest rate as shown in the Figure 1.

Figure 1 - Optimum interest rate

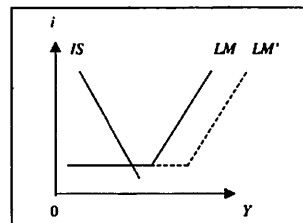


The positively sloped “monetary” LM curve indicates those values (Y,i) at which the money supply (M) and the demand for money (or liquidity preference, L) are balanced in equilibrium. This curve dictates that incomes and interest rates must rise or fall in lock-step to maintain equilibrium. Crucially, rising incomes induce a demand for liquidity, which in turn must be met by rising interest rates.

The negatively sloped “fiscal” IS curve shows how the interest rate is inversely related to aggregate demand via incomes: Coordinates (Y,i) on this curve indicate combinations at which aggregate demand equals incomes (and investment (I) equals savings (S), hence IS curve). From this second curve, we learn that higher outputs obtain at lower interest rates and vice versa.

Notice, however, that this textbook version, with steady slopes that typically intersect in the middle of the chart, fails to provide for a liquidity trap. The required twist, suggested by Hicks et al in the 1930s, is the problematic nature of the LM curve as it approaches the limit of 0% interest rates. Approaching this limit under “depression conditions,” it was speculated, the LM curve bends sharply to the horizontal below a certain threshold (Keynes suggested a threshold of 2%) as indicated in the following diagram.

Figure 2 - Approaching the limit



Why should this apparently innocuous change at the extreme matter? After all, no central banker in their right mind would drive rates below 2% heading towards 0%. Sir Alan Greenspan knows what he’s doing, so why worry?

But just for our own edification, let’s try to picture this imaginary situation: Let us imagine the IS curve strikes the LM curve at the horizontal extreme. Imagine further that Sir Alan is printing greenbacks, shifting the curve to LM' . Why does this have no effect? The monetary expansion is met by an infinitely elastic demand for liquidity – which is how the horizontal portion of the curve is interpreted. Shifting the LM curve has no effect on interest rates or output. It is like pushing on a string. The infinite demand for cash soaks up the extra money, as it were: Hence, liquidity trap.

Note in passing that we have already looked at liquidity demand in trying to understand, from a monetarist perspective, why the soaring American money supply has not (as yet!) triggered a 1970s-style stagflation. We thought that persistent demands for liquidity might be decreasing the velocity variable (V) in the monetarist equation $MV = PT$ versus the monetarist assumption of stable velocity. Decreasing velocity would offset the increasing money supply (M). See further, “On the specter of stagflation,” in our March issue.

The suggested response to this IS-LM quandary is to have governments lend directly to business (instead of trying to create liquidity indirectly via the banking system). But as Powell notes, the Japanese already do this through FILP (Fiscal Investment and Loan Programme). The details need not detain us, but it is important to note that the funds are lent “off-budget.” Thus, if this debt were included, the total debt might exceed 200% of GDP. (See further our survey on Japan, “Dogs and demons: A revisionist tells tales of Japan,” in our July issue, where we quoted the estimate of 150% of GDP.)

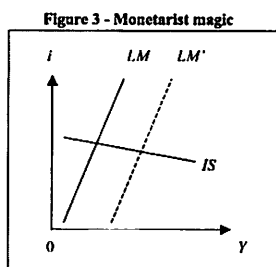
The MIT neo-Keynesian, Paul Krugman, recognizes these impediments to implementing orthodox remedies. In a flurry of papers, newspaper articles, and the brief monograph *The Return of Depression Economics* (2000) he advocates “unconventional monetary expansion,” which brings us now to monetarist theory.

3. Monetarist money magic

Krugman, together with the monetarists (especially the think-tank variety), advocate increasing money growth by having the Bank of Japan (BoJ) aggressively purchase long-term bonds (corporate and especially Japanese-government) and foreign exchange. And then, *hocus pocus*, deflation will come to an end, and recovery will bloom everywhere in Eldorado.

How so? For Milton Friedman and colleagues, inflation is, always and everywhere, a monetary phenomenon. A money supply that outpaces economic growth results in inflation. Contrariwise, it is argued that a rapidly contracting money supply results in 1930s-style deflation (see further, Friedman and

Schwartz's *The Great Contraction, 1929-1933* [Princeton, 1965]). Therefore, assuming a steep LM curve and an almost flat IS curve, one need only pump up the growth rate of the money supply and...*presto!* Figure 3. (Friedman, by the way, has recommended a steady 3%-4% growth rate of the money supply.)



Powell reminds us, however, that such a policy (purchasing foreign exchange, government bonds, etc.) was actually implemented in mid-1997 through mid-1998. Not only did this implementation fail to jumpstart the economy but Japan actually experienced its two most negative years of economic growth.

Maybe the negative numbers were a coincidence? Maybe this failure indicates more about BoJ incompetence than the power of monetarism? Regardless, the failure might suggest that Friedman has become another “defunct economist”. We should note in passing that the Japanese banks’ response to the policy was to *increase liquidity* (see above, on “liquidity trap”).

4. Aristotle and Austrian metaphysics

The Austrian school begins, appropriately, at the beginning with *first principles* (for example, democracy is incompatible with private property: see further Hans-Hermann Hoppe, *Democracy: The God that Failed* [2001]). No fuss with scientific method: The analogy with physics is false. No aggregation headaches: Methodological individualism forecloses on macroeconomics. No econometrics: Subjectivist concepts do not lend themselves to empirical analysis. Just nineteenth-century microeconomics.

None of that old-fashioned nonsense. Nope. Just Aristotelian metaphysics. *Ontology trumps epistemology*. Toss out Descartes and Leibnitz, Hume and Kant, and get right back to medieval Scholasticism. Austrian onto-theological certainty at long last, no matter what those postmoderns say.

What was old is new again, and the once-defunct Austrian School rises anew. Of interest to us is the Austrian view of the trade cycle (or, “business cycle,” as the Americans prefer), which is garnering attention at certain think-tanks. As Powell explains, in a free market, consumer “time preferences” are assumed to align perfectly with the “structure of production” via price “signals” (note, on this view, command economies cannot function because there are no “prices”). A self-equilibrating, perpetual-motion machine. However, the slightest intervention in this utopian market (read, “pointy-headed government bureaucrats”) will cause *misalignment*.

Thus it was in September 1985 that the Japanese reduced the discount rate (Plaza Accord). Given the price stability at the time, monetary expansion could introduce an unsustainable boom only by *artificially* lowering interest rates (note here the assumption of a natural market rate). The low interest rates sent the wrong “signal” to the markets, causing *malinvestment* and overconsumption. Such distortion could be sustained only by monetary inflation. And when the oxygen was cut off, the

flames of the boom were snuffed out.

Our gentle readers may be forgiven for wondering what difference there is between monetarist and Austrian analysis. There is one big difference, however. The monetarists, like the Keynesians, suggest a regime of plenty of bed rest and lots of liquids for the ailing patient, whereas, the wild-eyed Austrians suggest just “pulling the plug” on the life-support. Because the problem, on the Austrian view, is *malinvestment*, the cure must be *liquidation of all malinvestments*. Only in this way will capital and labor be reallocated. Furthermore, the government must get out of the way – drastically cut taxes, halting all expenditures (except for enhanced police and military?), etc.: the (in)famous night watchman of liberal theory.

5. Keeler on Capital investments

Keeler’s article, “Empirical Evidence on the Austrian Business Cycle Theory,” *Review of Austrian Economics* 14.4 (2001), pp. 331-351, offers further clarification of Austrian theory and analysis. Saving and investing automatically balance at a Wicksellian “natural” interest rate. However, a monetary shock creates excess lendable funds that drive the interest rate below its “natural” level. Agents incorrectly perceive that the natural rate has fallen, and they set off a business expansion. To summarize, the Austrian cycle can begin only with a monetary shock via *relative price changes*.

If all this sounds vaguely familiar, just wait. Keeler, as an Austrian, views investment “differently” – remember, no aggregation. Capital is heterogeneous, and so must be *disaggregated*. If we differentiate across types of capital, we observe sectors that are more or less capitalistic or capital-intensive. With the false signal of artificially low interest rates, there is a change in the allocation in investment and, cumulatively, in the structure of the capital stock. Austrian theory says that capital-intensive investments increase relative to less capital-intensive. These sectoral shifts also ensure that capital is excessively and inefficiently allocated.

Powell draws the conclusion for Japan. “If the Austrian business cycle theory describes Japan’s recession, the boom’s largest malinvestments will have taken place in capital-intensive industries, in the earlier stages of production. During the recession, the greatest contractions should occur in these industries, if the Austrian business cycle theory applies” (p. 47). Powell then walks us through a capital-intensivity scale, as it were, with sector growth rates by year (reproduced in Table 1). He concludes that the growth rates are “precisely in the order Austrian theory would predict” (p. 48). Thus Japanese sectoral shifts are consistent with Austrian cyclical theory.

Table 1 - Japan: Industry Gross Domestic Product Growth Rate

	Mining	Manufacturing	Wholesale & Retail	Services
1990	23.2	6.8	8.5	7.2
1991	-2.7	5.3	6.1	5.7
1992	-1.8	-1.4	1.2	4.8
1993	-4.4	-4.0	-2.3	3.4
1994	-15.5	-1.3	-0.4	0.9
1995	-0.4	1.6	4.3	2.2
1996	0.7	2.2	2.4	5.2
1997	-6.6	1.9	3.9	3.8
1998	-8.3	-5.0	-4.0	4.0
1999	-9.6	-2.6	-4.4	0.5

(It does not take an Austrian song-and-dance on interest rates to explain such behavior. It has been long understood, in Keynesian perspective, that demand is magnified up the capital

food-chain: otherwise, the *accelerator*. A minor increase in demand for toasters and hairdryers, for example, rapidly cascades into major demands for big-ticket machinery, etc.)

6. Conclusion

As Powell concludes, the Austrian liquidation solution has not yet been tried (or more accurately, *non-solution*). In the infamous words of Andrew Mellon: "liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate...purge the rottenness out of the system." Liquidate it all. The solution, then, to a boom is a good old-fashioned Austro-Hungarian *bust*, a Viennese waltz with creative destruction – or, in the more clinical vocabulary of Powell, "allow the market process to realign the structure of production to match consumer preferences"

(p. 49). Or, simply the mercantilist battle cry of the eighteenth-century Vincent de Gournay, "*laissez faire, laissez passer*."

Why not? After all, there is the empirical evidence from the sectoral shifts in Japanese investment allocation...

Still, the Japanese keep toying with liquidation, even though proposals have consistently been swatted down by the LDP "cronies." The most recent reform package, "Comprehensive Measures for Accelerating Reform" (Oct 30), is disappointing in this respect – to be charitable. Countermeasures do include a lukewarm attack on the banks' "deferred tax assets," it is true (maybe a third of shareholder equity), but the various measures really amount to little in terms of liquidation.

We should reasonably conclude that Takenaka and colleagues cannot deliver much more given Japanese *Realpolitik*.

JAPAN

Resolving Japan's economic woes

By Vincent DeCaen

When CNBC runs a series on Japan's economic woes, you can assume two things: We are *well* into the crisis (old news); and policy wonks are hard at work behind the scenes (chatting up policy directions). In one respect, then, Anil Kashyap's analytical review, "Sorting out Japan's financial crisis," *Economic Perspectives* [Federal Reserve Bank of Chicago] 26.4 (4Q/2002), pp. 42-55, adds one more voice to the growing chorus. On the other hand, the paper is clear, concise, and offers a few important insights that we will highlight in the following summary of this article.

In brief, Japan is experiencing an economic catastrophe that in some respects is worse than the '30s. Japan is without a functioning system of financial intermediation: banks; insurance companies; state-run financial agencies. But we've known this for over a decade.

Kashyap's central message is that "[t]he overarching principle is that Japan's banks, insurance companies, and government financial agencies all suffer from *different problems* and require different solutions. But all three sectors are connected, and a *failure to tackle concurrently the problems of all three promises to doom any reform plan*" (p. 41, italics added). Further, taxpayers face a clean-up bill, at the lower bound, of 24% of GDP (compare America's S&L crisis at less than 1%!). And delaying reform only adds to the costs.

We know that economic growth is "anemic." Kashyap emphasizes that while the implosion of 1990 can be blamed for triggering the downward slide, it cannot be blamed for its continuation after more than a decade. Recapitalizing banks does nothing to address the dire straits of borrowers.

In addition there is the declining aggregate price level. Deflation squeezes profits and increases inflation-adjusted debt burdens. Kashyap also points out, crucially, that it also makes it difficult to spot the deadbeats or "zombies." At 0% they can make payments indefinitely; the trouble is exposed only when the principal comes due.

1. Banking sector

Fiscal 1993 was the last time the banking sector recorded a net operating profit. Losses recorded since 1992 total 16.5% of current GDP, and the bleeding is expected to continue for

the foreseeable future. Kashyap outlines three problems facing this sector.

The most obvious is that the banks are not generating enough revenue to offset funding and operating costs. Lending operations are not profitable. Labor costs, while declining, are still high by international standards. Finally, the banks underinvested in information technology through the 1990s, raising long-term costs and reducing efficiency – like deferred maintenance, this cannot be put off indefinitely.

Second, the comparative advantage of the Japanese banks is limited. Japan's banks are world leaders in few if any product lines. They consistently enter new markets late and are slow to offer innovative products. Some of the blame could in the past be fixed on regulation, but currently there is little excuse.

Third and finally, the banking sector faces stiff competition from state-run financial institutions. The (in)famous postal savings system is an enormous challenge. The housing loan system accounts for 40% of all home mortgages. Even worse, such public institutions are extremely *popular* with the voting public, and weaning them from market-distorting institutions is a daunting challenge for any politician.

Thus, Kashyap concludes that solvency is not so much the issue as the need for bank restructuring. Even so, what are the real costs of recapitalization? Who knows? Under-reporting is a central issue. Yet even *reported* bad-loan provisions are in the neighborhood of 40%-60% (compare this with 160% in the US!). Analysts estimate that losses are more than *four times* those reported (and this does not net out collateral and reserves).

In addition, there are serious questions about *the rest* of the balance sheets. Of all of the problems, Kashyap singles out "double-gearing" – ailing banks and insurance companies own each other's shares, and as a result look so much better on paper.

In short, "the private sector analysts are unanimously of the view that *the banks are bankrupt*" (p. 40, italics added).

2. Insurance sector

Even though most insurers are mutual (and therefore not publicly traded), their health is "intimately connected" with the publicly traded banks. The insurance sector owns at least 10% of the major banks.

The problems are similar to those of the banks: exposure to the stock market; competition with government-subsidized institutions (the postal system life-insurance program covers about one third of Japan); etc. Fortunately, on the bad-loan front, the insurance companies are in better shape. Maybe 2% of their loans are bad, and their provisions are at 70% of reserves.

The real problem in this sector, however, is the excessively optimistic estimates of future returns. As of 1992, annuities have returned 5.5%. As a result, "negative carry" – the spread between returns and current rates – is a serious problem. Then there is the related regulatory mess. By international standards, solvency margins below 200% spell trouble. While it is estimated that 3 of the big 10 insurers are below 200%, the industry is reporting in excess of 400% (3/2002) – and the three deadbeats in excess of 490%!

3. Government-subsidized sector

Here there is poorer disclosure, and assets tend to be obligations on other government institutions. The additional problem is that funds thrown in this direction are funds that could help the banks and insurance companies.

More than anything else, this sector is a victim of Japanese accounting practices. Past losses remain on the books as assets. Loan losses exceed reserves. There is no deprecia-

tion on physical assets. Assets – for example, land bought in the go-go 1980s – are valued at the original purchase price, not the current, severely depressed price. The list continues... .

4. Prescription: concurrent resolution

Kashyap underlines the government's problem: Different sectors are ailing for different reasons. Because the three sectors are so intimately related, measures must address all *concurrently*.

How will politicians react? Deferred liabilities for the public are at least one quarter of GDP – and mounting. Any restructuring entails massive closures and even more massive job losses. While government agencies are unprofitable, they are widely popular with the voting public. Meanwhile, half-measures keep the zombies alive and burning capital.

Kashyap points out that government measures amount to an indirect unemployment compensation plan. In the long run, it should follow, it would be much cheaper to pull the plug now and compensate the unemployed directly. It is time to formulate such a two-pronged plan of "large-scale, comprehensive intervention." Until Koizumi, Takenaka, *et al* formulate and implement such a plan, we can expect the slow, downward dance of death to continue.

We're not holding our breath. Regardless, the short side of most (regional) banks, as we have been clamoring for years, is a no-brainer.

STOCK BEAT

Retail updates and floating opportunity

By Yakov Friedman

It never rains but it pours. In our Oct. 7 article we continued to follow the sad saga of the Great Atlantic & Pacific Tea Company. With the stock trading just above \$8, we indicated that we expected a further decline as the market continued to digest the steady flow of bad news. We were not disappointed.

The past two months have seen the company announce a freeze on hiring and salary increases before releasing very poor quarterly results, which included a writedown of more than \$3 a share. Analysts finally came around and dropped all their buy recommendations, while admitting that the company is not likely to post a profit for some time.

Moody's Investor Services announced another downgrade in A&P's ratings. With the sector's fundamentals still showing no signs of improvement and the company's operations in disarray, we were not surprised to learn of the next bombshell. The newly recruited COO, part of the great "turnaround story," stepped down, and the man who ran the only successful division of the company, up here in the Great White North, was called on to save the operations south of the border.

With almost all the bad news in the market, and the share prices holding above \$5.50 for three weeks, we took the opportunity to cover most of our positions. With competitors continuing to announce poor results, we anticipate continued difficulties for A&P. The shares showed some strength during the latter half of November in what we feel was a mix of short covering from a very large short position and speculative buying that we would prefer to call one last kick at the can.

Our funds still maintain a small short position in A&P, which,

barring further material developments, we believe we can cover under \$5. At the same time, we are placing a tight \$8 stop, just in case the Canadian executive can perform a miracle.

Walgreens Corp., after a brief hiccup in mid-October (which created a good selling opportunity for those looking to follow our suggestion), continued its decline. More importantly, it has begun to show weakness relative to the broader market (Chart 4), because it appears to be slowly losing its appeal as a "nothing-can-go-wrong" type of stock.

With relatively disappointing sales results over this quarter, there is much doubt as to whether the company will be able to maintain its previous torrid growth rate. The indications we documented have proven to be correct so far.

We will closely watch the early January earnings release and look for some more disclosure from the company as we reevaluate our position in the coming month.

New opportunity: Frontline Ltd.

Looking for new opportunities often involves bucking the trend. While perfect timing would certainly maximize a portfolio's return, it is almost always an exercise in futility to try and time putting on a position at the peak or trough of a security's move. Being ready to take action when a shift in market sentiment occurs often puts an investor on better footing than if the research occurs as a response to the stock's price movement.

While there always is a reason behind a significant change in the price of a stock, the key is to identify potential flaws in the market's reasoning and jump on the opportunity if the action starts to

give some credence to your view. Essentially, a watch list of potential investments can be developed, which, if closely monitored, can produce timely money making opportunities.

One such stock is **Frontline Ltd.**, a Bermuda-based company that maintains the largest fleet of tankers in the world. Its stock trades on the Oslo Exchange, and it has a market capitalization of 4.5 billion Norwegian krone (more than US\$635 million). It primarily delivers oil from the Middle East to the American coast.

The industry as a whole has taken an enormous hit as shipping rates fell by approximately 85% over a two-year period. Lower Opec production coupled with a shrinking demand significantly eroded the profits of all oil tanker companies over the period. Market nervousness surrounding Frontline's balance sheet and the falling tanker rates have pummeled the stock's price by about 75% from its high a year and a half ago. An analysis of these issues indicates that the market response was overdone. A good buying opportunity was created for a major player in an important market.

The relative share-price performance of Frontline over the past 18 months has been poor (Chart 5), because the benchmark Oslo Transportation Index is off less than 50% during this period. These results are not puzzling.

First, a few basic facts about the industry. There are three ways tankers are put to use: 1) Time charters commit the use of a specific ship to a customer for a specified amount of time (usually several years) for a predetermined amount of money; 2) vessel; and 3) voyage hires are done on a per trip basis, and their rates are determined by the highly volatile spot market.

Unlike many of its competitors, Frontline operates most of its fleet in the spot market. Thus, the company has a tremendous exposure to fluctuations in the spot shipping price (Chart 6). This exposure has resulted in much greater swings in its share value than that of other players in the industry.

The reduction in global crude oil production has lasted over a year since it reached its peak at the end of 2000. The lower demand for tankers to deliver the product drove the spot price for hiring tankers to historically low levels. This has resulted in a significant drop in the profits of marine transport companies, because they have seen ships sit idle or hired for low rates. Mercifully, the past two months have brought an upturn in rates, and it now appears that the market has finally bottomed out.

The heavy exposure to the spot market brings up the question of the company's ability to withstand lower rates and concern with its balance sheet. The cash position has been steadily declining as revenues dropped dramatically. Still, cash is a quite comfortable \$84 million. (The company has a cash covenant of \$70 million, but it is able to sell assets if push comes to shove).

The decision to pay out \$1.75 per share (about \$135 million) of dividends during the recent years of record revenues and profits might have been shortsighted, in hindsight. But it is indicative of management's desire to share its profits with its shareholders and let them decide what they would like to do with the money instead of appointing itself money manager and looking for new investment opportunities never contemplated by the original investor.

Finances

The company's debt is all bank debt, so it is a bit heartening to note that the head of the shipping division at Nordea Bank, one of Frontline's prime lenders, was recently quoted as claiming that

the analysts have been dramatizing the state of the company. While Frontline is in danger of breaching some of its debt covenants, the officer indicated that the importance of such an event has been exaggerated. The usual consequence of such an event is the renegotiating of the terms of the loans. As an example when some of the covenants were breached in 1999, the terms were renegotiated and the company went on to have a record year. Lenders are far more likely to be concerned with inept management than with a cyclical downturn. We should point out that the CEO and largest shareholder, John Fredrikson, is well regarded in the industry.

Although Frontline operates with substantial leverage, cash flow from operations has exceeded interest expense throughout the past several quarters of historically poor results. Additionally, the company recently announced that it has extended to 2005 its debt with its largest syndicate. Even if the recent recovery in rates is short lived, a nice cushion of time now exists for the company before it has to deal with significant payments.

Tanker supply

The 2000 boom in the industry produced a significant increase in orders for tankers. The lag time between order and delivery is about two years. As a result, there are a significant number of ships to be delivered over the next year or two. The demand for oil transport caused many firms to shelve plans to scrap ships. While these factors created more supply, which is bearish for the market, the number of tankers scrapped acts as a significant offset.

New regulations mandate the phasing out of vessels more than 25 years old. Fearnley's (a large Oslo-based outfit providing extensive research in the shipping industry) claims that at the end of 2001, more than 25% of the present fleet was over 20 years old – slightly less than the number of ships on order. Frontline is in a relatively good position in the industry, because it maintains a young fleet, with the oldest ship only 12 years old. It reports that it has only one ship slated for delivery in the next year, with an estimated equity investment of \$19 million.

Recent cutbacks in Opec production, and Iraq's self-imposed month-long removal from the world scene a while back, prompted a number of companies to proceed with the scrapping of ships that had been delayed because of the increased demand. The recent disaster off the coast of Spain is likely to spur operators of older single-hulled ships like the *Prestige* to scrap their older fleets before an outdated ship causes another spill. Approximately half of the world's tankers are single-hulled. Frontline's fleet is 70% double-hulled by tonnage – thus giving it another advantage over its competitors.

The political arena has seen fast-paced action in the past several weeks. The European Union's Transport Commissioner has proposed the mandated retirement of all tankers more than 23 old, a move that would not directly affect Frontline's new fleet but would reduce the number of ships vying for the same business. The Prime Minister of Greece, next in line for the EU Presidency, stated that he favors new stringent regulations and is already working towards them. The European governments have agreed to bar single-hull tankers from European ports pending an urgent study to confirm that enough double-hulled tankers exist to meet current demand.

According to Bloomberg data, close to 40 supertankers

have been scrapped or converted to other uses this year, about the same as last year. This rate of scrapping will balance the expected delivery of ships. Orders have tapered off as expected during the past year as rates sagged. With the long lag time before delivery and the presence of catalysts for increased scrapping, the scenario is set for the possibility of a return to tanker demand outpacing supply.

Moreover, a case can be made for increased traffic in oil production. First, oil stocks have been significantly depleted (Chart 7) from recent levels and are at the low end of the range of recent years. Secondly, weather patterns have a habit of averaging out over time – a normal winter should increase demand for oil. Finally, it should be noted that the supply of oil, while greatly variable on a monthly basis, has been in a general uptrend for some time (Chart 8).

Valuation

Frontline is trading significantly below book value of 147 Krone per share. Because there are very few non-tangible items on the balance sheet, its debt is considered well secured. Lenders are unlikely to panic and push the company into bankruptcy even if current weak conditions continue to persist, thus limiting the down side risk.

On a valuation basis, the Frontline is fairly cheap. It is trading at about 5 times its average earnings of the past 6 years, about 2.2 times its average EBITDA, and about 2.8 times average cash flow from operations. (All figures are based on a share price of Nok60).

Even with the poor results of the past year, its present market capitalization is less than 3 times trailing four-quarters EBITDA.

Insider transactions

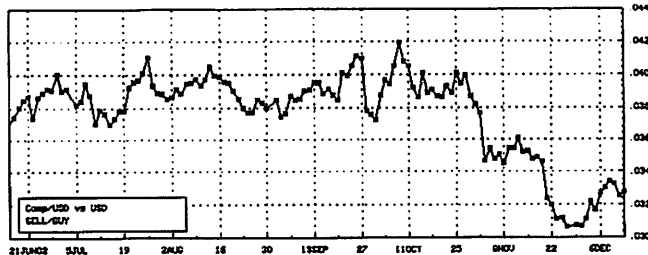
A positive signal can be drawn from the recent commitments made by a Vice-Chairman of the company to purchase over 60,000 shares. Fredrikson also added a quarter of a million shares to his holdings within the last several months. Although most of these transactions were done at lower levels than the stock is trading now, they do tell us something. These are not moves that would be expected if management felt that disaster was imminent. Indeed, management, which has been quite realistic and conservative in its calls for several quarters, appeared quite optimistic in its forecast to return to profitability that it made in the recently released quarterly earnings report.

Conclusion

A continuation of the turnaround in the oil transport market is not a certain thing. Yet it is a good possibility. That coupled with the market accepting that Frontline is not in such a precarious situation should move the stock higher. Buying the stock near its recent lows (Chart 9) should provide for a very decent risk/reward ratio.

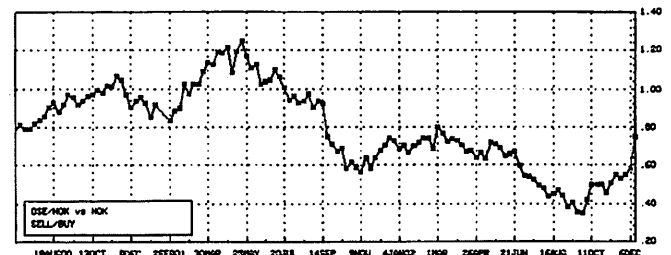
Disclosure: Our International Fund took a long position in Frontline in early December. Our hedge funds added to their short position in Walgreens in late November and early December and covered part of their GAP position in mid November.

Chart 4 – Walgreens Corp./S&P 500 historical price ratio



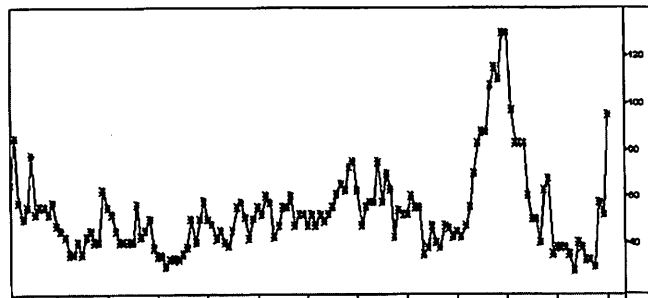
Courtesy Bloomberg

Chart 5 – Frontline Ltd./Oslo Exchange Transportation Index historical price ratio



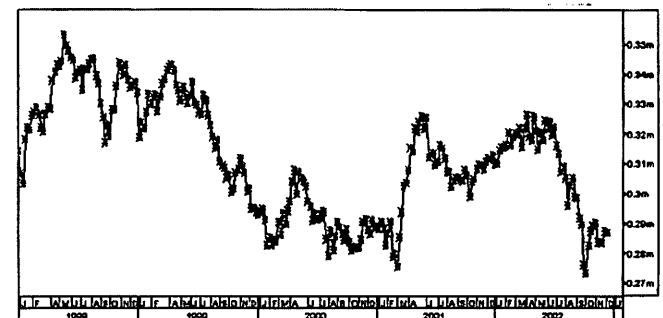
Courtesy Bloomberg

Chart 6 – Spot shipping price, monthly (Arabian Gulf to US Gulf Coast)



Courtesy Bloomberg

Chart 7 – US Crude oil stocks, weekly ('000 barrels)



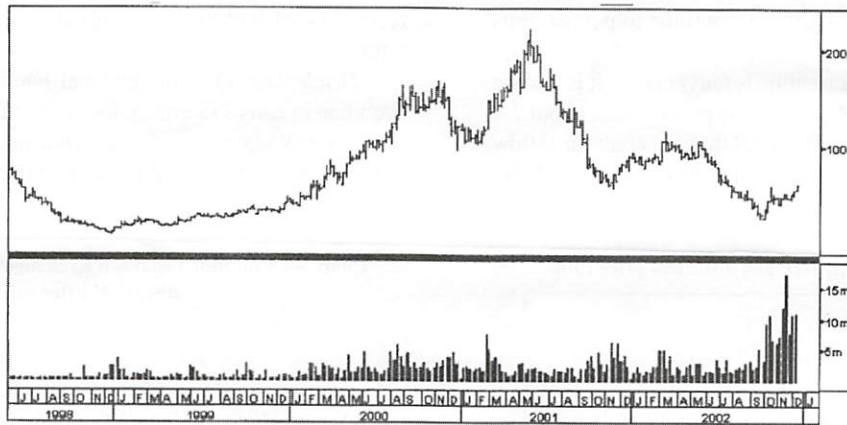
Courtesy Bloomberg

Chart 8 – Crude oil supply, monthly (barrels per day)



Courtesy Bloomberg

Chart 9 – Frontline Ltd. weekly share price and volume



Courtesy Bloomberg

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