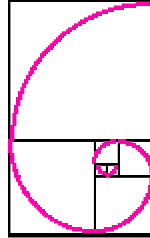


Sand Spring Advisors LLC

To Greenspan from Kasriel: Farewell Soon?

by,

Barclay T. Leib

November 25, 2001

Corrective moves are never our favorite to forecast. As readers know, the month of October and early November have seen us to temporarily lose our roadmap, so to speak, as to the length and magnitude of Wall Street's recent virulent equity rally. It seems almost mind-boggling that the equity market is net higher than it was on September 10th. And yet technically we can still point to strong resistance (as we did in our November 20th Chart du Jour) not that far away at 10,120.90 on the Down Jones Industrial Average. Fundamentally, there is little argument that the economy is too over-leveraged as unemployment steps ever higher.

What's been going on here?

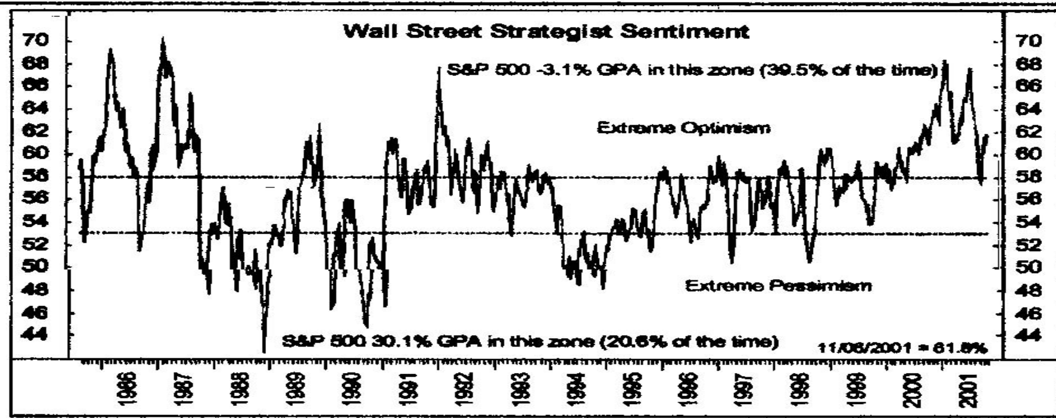
According to Liquidity Trim Tabs, a publication that tracks fund flows, it appears now that some $45 billion went sloshing out of equities in late September, only to come sloshing right back into equities in early November on a traditional pension fund manager "re-balancing" act versus appreciated bond holdings. This process is called "portfolio optimization" and Wall Street firms all have their own quant groups egging mutual funds, pension funds, foundations, and insurance clients to follow the computer's advice: When bonds yields get as low as they recently did vis a vis equity prices, it's traditionally been appropriate for money managers to re-jigger respective holdings of each. (The investment banks earn greater commissions and dealing spread revenue in the process, of course.)

But this is anything but a normal economy. So we wonder if the computers will perhaps be premature here. Technically at least, we continue to believe that the September 21st V-shaped equity bottom will be retested into early February. This may or may not be a massive move below prior lows – perhaps it will just be a failed 5th wave down or a B-wave within a larger A-B-C corrective period – but we do think that there will be a period of distinct disappointment as good news potentially wanes from Afghanistan in the early winter months, and still dismal corporate profits hit home on equity valuations still priced far too close to perfection.

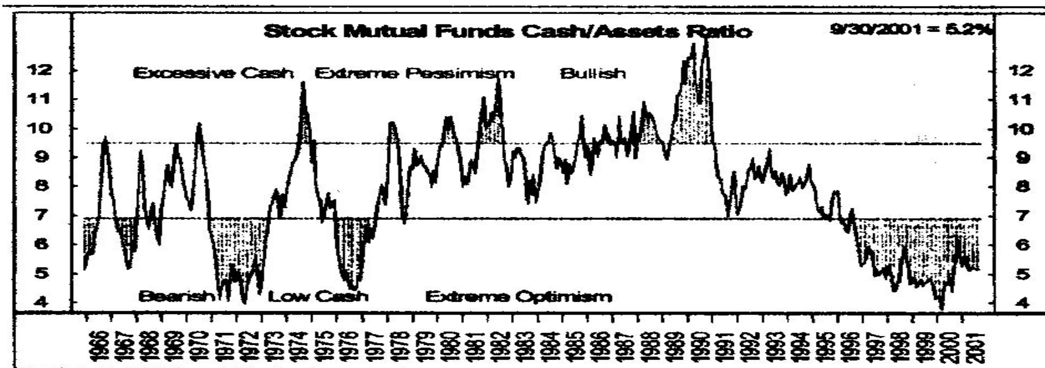
As Sir John Templeton told an interviewer in early October: "The market is still much too high in relation to basic earnings power. When you get into a bear market, the bottom is not just back to normal.

If you've been far above normal, then the bear market carries you far below normal. We're nowhere near the end of the bear market yet." And keep in mind he said that before the recent silly upside froth.

More recently, Morgan Stanley's Barton Biggs pointed to some interesting charts from Ned Davis Research. The first of these charts shows sentiment statistics still bullish and complacent, and the second shows very low mutual fund cash levels sitting on the sidelines – a dangerous combo to say the least.

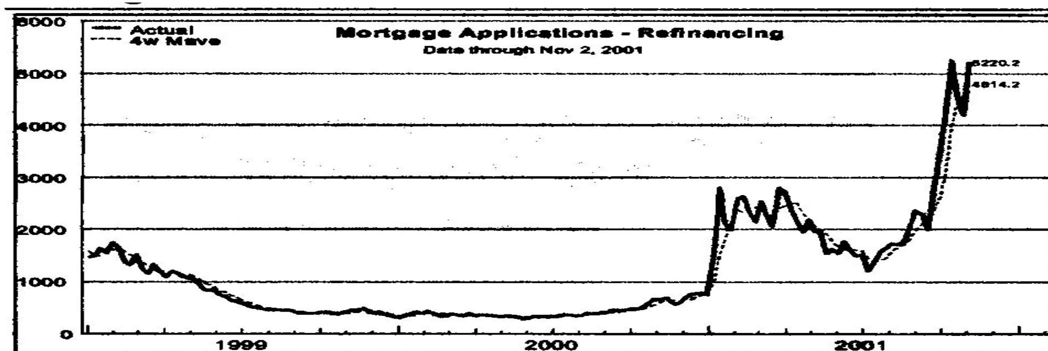


Source: Ned Davis Research



Source: Ned Davis Research, Investment Company Institute

With time, of course, all the recent money supply growth provided by the Fed this year may still show its impact. The recent new "Operation Twist" by the U.S. Treasury to retire 30-year bonds from issuance has also served to create an instant boom in mortgage refinancing. We recently reached the point where 90% of all fixed-income mortgages that exist in the loan pool can be refinanced, and on a trillion dollars of outstandings, for every 50 basis points that get refinanced down, consumers will save $5 billion in revenue each year.



Source: Mortgage Bankers Association

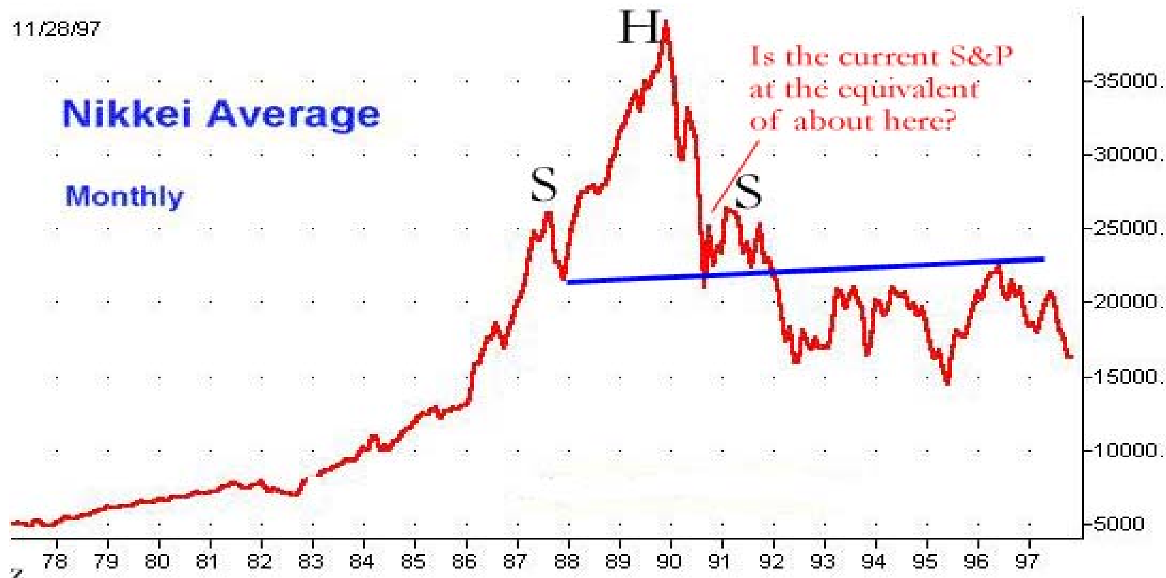
Refinancing paper work being what it is, one can expect approximately 8 weeks to transpire before some of this saved money from refinancing actually starts trickling into household hands, but when it does finally start to arrive, it should set us up nicely for a February 2002-November 2002 "false" yet impressive 8.3-month rally. As already witnessed by suddenly booming car sales at 0% interest costs, you can be sure that when consumers see a free handout on home financing or otherwise, they will be sure to avail themselves of it.

But this is likely to be a last gasp splurge of debt on top of debt. It can last awhile, but not forever.

So technically, bringing this all into real-time, put us in the camp of being short term bearish on the S&P 500 and Dow Jones, but not necessarily intermediate-term bearish beyond February. The market may simply experience a failed fifth wave (or B-Wave) spike down in the Dec-Jan period, but then between February and November of 2002, the market could actually appear quite healthy for an 8.3 month run. America still believes in holding equities for the long term. The problem is that this complacency still sits atop too much debt and a yet-to-be-popped property market bubble. Refinancings will give America a temporary surge in cash liquidity, but the still anemic pace of New Housing Starts suggests that the underlying economy is slowly running out of gas.

If a February-November rally period does ensue, eventually of course the Fed will feel impelled -- for any number of reasons -- to tap on the brakes. The trigger for such an action could come from a plethora of directions-- a poorly performing U.S. dollar, rising inflation stats, or a revolting U.S. Treasury market. It doesn't really matter. What does matter is that it is only at this latter time that one will truly want to watch out below in both property and equity markets. In between now and then, we see a significant "zig" down, followed by an equally significant "zag" back up. Perhaps the chart below of the S&P 500 shows our overall view the best. Is that a potential huge Head and Shoulders top in the making?

Now compare the current S&P picture above to an old glimpse of the Japanese Nikkei index on its way lower in the early-1990's. Could it be that the S&P 500 has just entered an equivalent region that existed for the Nikkei – a chop-zone that eventually formed the second shoulder of a huge Head and Shoulders top in that market? To us the two patterns look reasonably similar.



But rather than focus too much on what our own beliefs are at this time (Remember, we have been "cold" for a bit here, so please treat our views as no more than a broad roadmap), we thought that we would take this moment to discuss exactly how the U.S. economy actually got into its current situation.

Was the 2000-2001 tech-wreck in the NASDAQ something unavoidable that just happened on its own? Or did the Fed somehow have an inadvertent hand in creating the bubble?

For this purpose, there is no better analyst than Paul Kasriel, Chief Economist of the Northern Trust Company. In my mind, Kasriel's neo-Austrian economic views of America's current economic situation are dead on, and a good fundamental backstop to our own technical work. We recently sat down with Kasriel for a private interview after a speech he made at the fall *Grant's Investors* Conference.

Readers not acquainted with his work can find periodic analysis from him free on the web at: http://www.northerntrust.com/library/econ_research/weekly/index.html

Kasriel to Greenspan: Retire Soon or Risk Being another Willie Mays

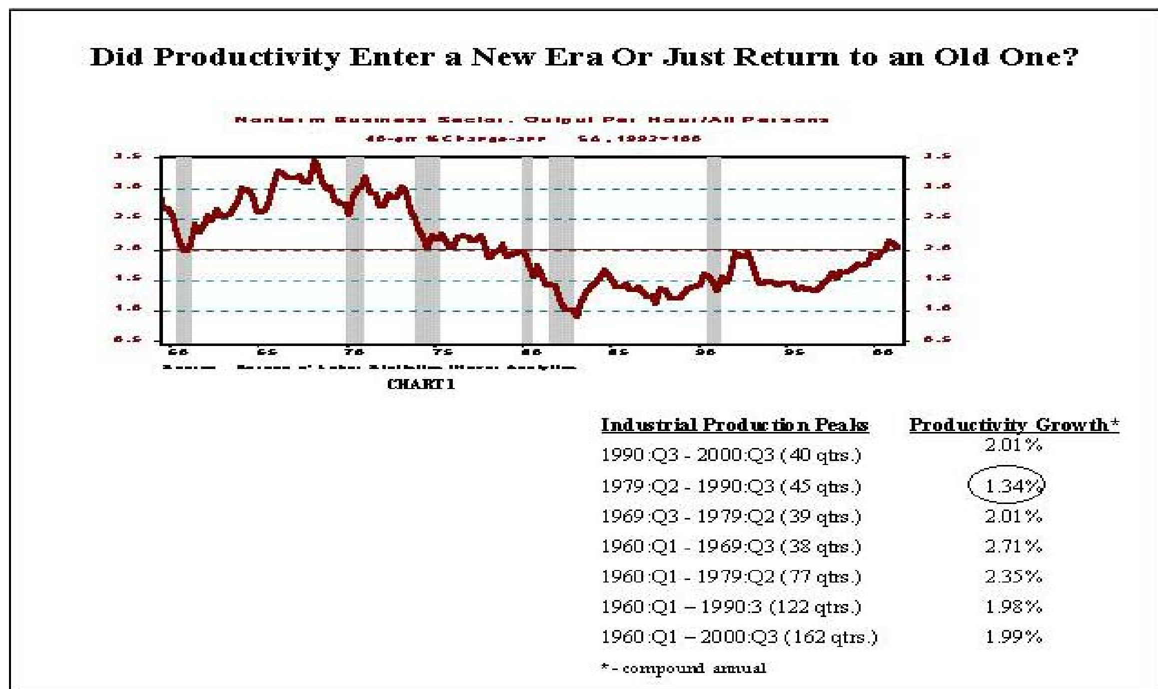
Paul Kasriel, holder of a Masters degree in economics from Indiana University, toiled for several years at the beginning of his career in the economics research department of the Chicago Federal Reserve. But it is easy to see why he didn't stay there: He's far too outspoken. Indeed, despite currently being the Chief Economist of Northern Trust, he is rarely invited these days to Fed functions, and is downright disrespectful of Alan Greenspan.

In his recent *Grant's* Conference speech entitled "Greenspan – Maestro or Music Man?" Kasriel basically argued that Greenspan has no clue about the economy, and is largely to blame for the creation of the 1999 tech bubble.

In terms of background, and as a starter, Kasriel quickly waltzes through some of Greenspan's finer past accomplishments. First there was the 1974 Whip Inflation Now campaign (complete with little WIN buttons) that Greenspan helped spearhead for President Gerald Ford, but did so just as the economy had already whipped inflation (at least temporarily) and was mired in a very deep recession. Then of course there was the endorsement of the Keating S&L organization that Greenspan vociferously made in

the early 1980s, only to subsequently see Mr. Keating become a convicted felon. Then nine years ago Greenspan inadvertently followed a tight money policy through the 1990-91 recession without knowing that he was doing so. And then in 1998-99 we saw Greenspan follow an over-expansionist monetary policy having swallowed the argument that the U.S. economy, courtesy of high tech, was a wonder of new productivity.

This is where Kasriel starts to lay into Greenspan with some substance, showing charts of productivity growth over various stretches of time. Looking at the slide below, Kasriel states "2% seems to be a growth number that we can point to that has occurred over long periods of time, with just one outlying period of lower productivity growth in the 1979-1990 period. It does not appear that we have recently entered a new era of productivity growth, but more that we have simply returned toward our long-term mean."

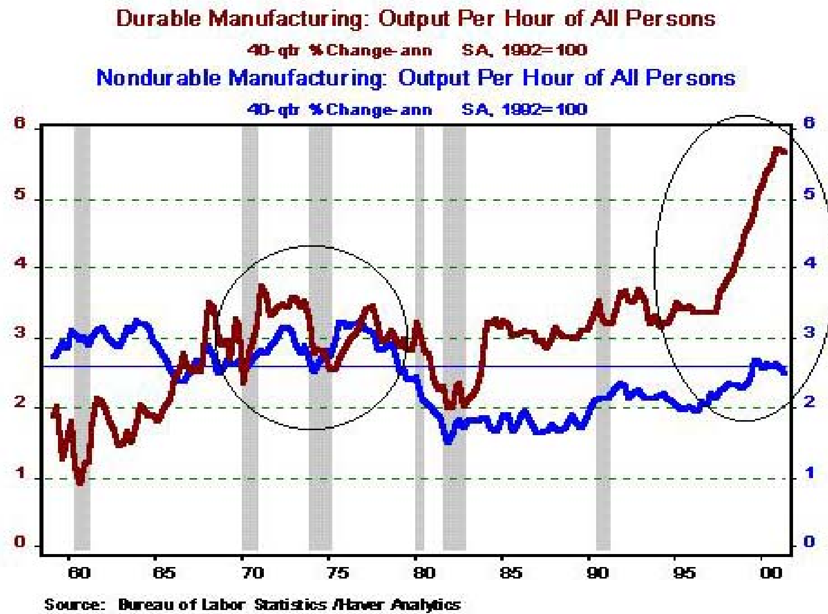


Industrial Production Peaks	Productivity Growth*
1990:Q3 - 2000:Q3 (40 qtrs.)	2.01%
1979:Q2 - 1990:Q3 (45 qtrs.)	1.34%
1969:Q3 - 1979:Q2 (39 qtrs.)	2.01%
1960:Q1 - 1969:Q3 (38 qtrs.)	2.71%
1960:Q1 - 1979:Q2 (77 qtrs.)	2.35%
1960:Q1 – 1990:3 (122 qtrs.)	1.98%
1960:Q1 – 2000:Q3 (162 qtrs.)	1.99%

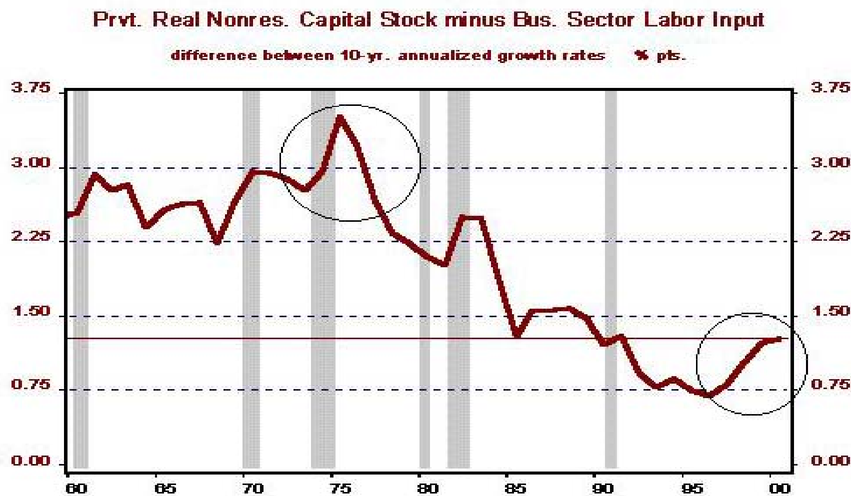
*- compound annual

Now, according to Kasriel, some argue that these statistics must be flawed because productivity growth in manufacturing has consistently shown up far higher than overall productivity growth. As a potential cause of this, some believe that economists cannot measure service-sector productivity growth particularly well. Kasriel concedes to this point a bit, with a self-deprecating quip: "In my sector at least -- the economics service sector – I can attest to huge productivity growth. When I joined the Northern Trust over 15 years ago, it took three senior economists, together with three research associates, about two weeks to come out with an inaccurate economic forecast. With this little laptop, I can now pretty much do that all by myself in one day."

But the service sector aside, Kasriel still points to a sharp difference between the productivity growth in durable manufacturing (that has been very high) with non-durable manufacturing productivity growth (that has not been very high). He then concludes that this difference has come not so much from the spread of technology but from the actual production in the tech sector. In other words, computers cost far less today than they once did, but there is still some debate as to the growth of productivity from the use of computers. In Kasriel's mind, this takes a little bit of the edge off of Greenspan's notion of a "New Economy" productivity spurt.

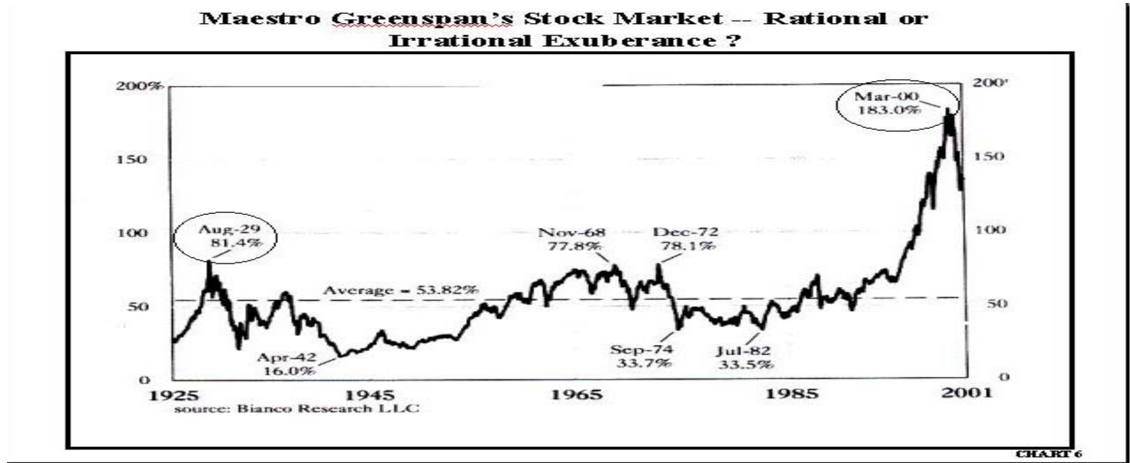


Kasriel goes on to show that while many people, including Greenspan, believe that we have experienced a huge growth in the capital-to-labor ratio over the last 10-years, actual statistics do not bear this out. There is lot of hype about the new era, but the data simply does not justify this hype.



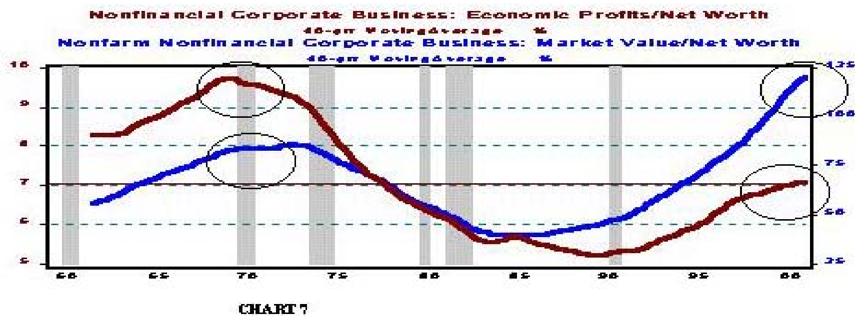
Other multifactor productivity measures also show no huge growth in productivity. So in Kasriel's mind, Greenspan's original reliance on productivity growth as the driver of our economic boom simply does not show up in any of the data.

Kasriel then goes on to show how total market capitalization of the U.S. market versus GDP saw stocks reached 183% of GDP in March 2000 as compared only to an 81% peak in August 1929. This suggests to Kasriel that we have indeed experienced the biggest stock market bubble ever.



But was the bubble justified perhaps by a growth in profits? To answer this question, Kasriel looks at corporate profits (as defined by the Commerce Department based on IRS data), relative to book value of corporate net worth. There he sees what one might expect – a steady trudge higher in recent years, but no exceptional divergences over the past 10-years. But when he looks at total market capitalization to the same book value of net worth, it's practically off the charts. In other words, equity market cap relative to book value was admittedly cheap in the mid-70's, but way overvalued today.

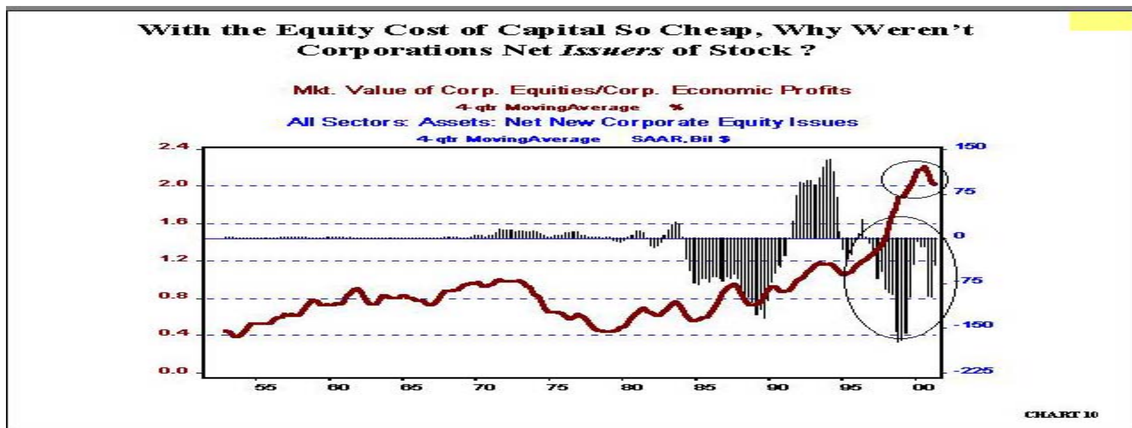
Profits as a percentage of net worth are also currently lower than in the 1960's, so one can't even explain away this gap by the argument that we are undercounting corporate assets when economists fail to include intellectual property rights such as a company's people, patents, etc. If these "soft assets" were so valuable, then profits as a percentage of net worth should be higher today than two decades ago, and they are not.

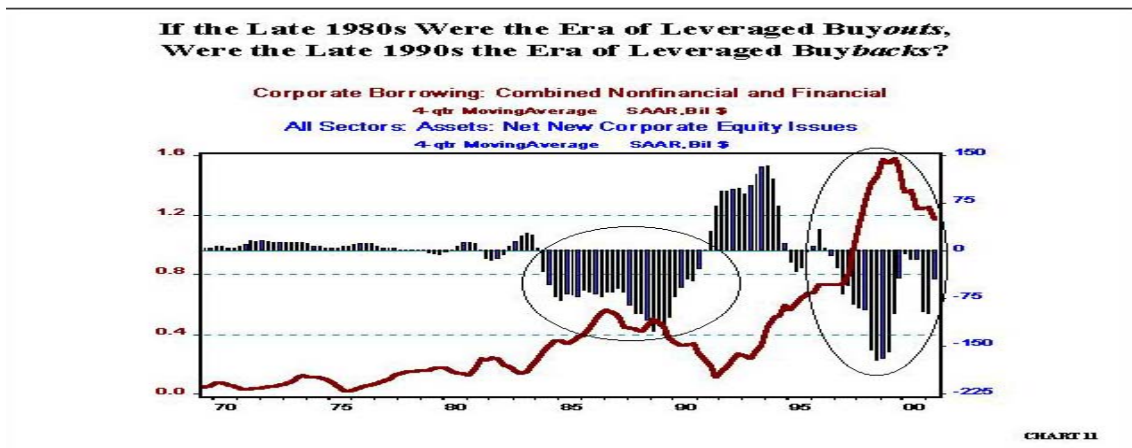


Industrial Production Peaks	Nonfinancial Corporations Market Cap/Net Worth*	Economic Profits as a % of Net Worth*
1990:Q3 - 2000:Q3 (40 qtrs.)	115.4	7.04%
1979:Q2 - 1990:Q3 (45 qtrs.)	45.9	5.24%
1969:Q3 - 1979:Q2 (39 qtrs.)	58.2	6.58%
1960:Q1 - 1969:Q3 (38 qtrs.)	84.3	9.79%
1960:Q1 - 1979:Q2 (77 qtrs.)	71.1	8.16%
1960:Q1 – 1990:Q3 (122 qtrs.)	61.8	7.08%
1960:Q1 – 2000:Q3 (162 qtrs.)	75.0	7.07%

* - average

Kasriel also questions why -- if the cost of equity capital was so cheap in the late 1990's -- corporations weren't in the aggregate net issuers of stock during this period? What they were actually doing, of course, was floating a lot of debt to buy back their stock, to in turn make their earnings look better. This occurred on a net basis even despite the dilutive issuance of insider stock options at the same time. Kasriel argues that in many ways this was similar to the leveraged buy-outs of the 1980's, only that the events of the 1990s took place at significantly higher P/E ratios than in the former period, and was executed by companies themselves via leveraged "buy backs."

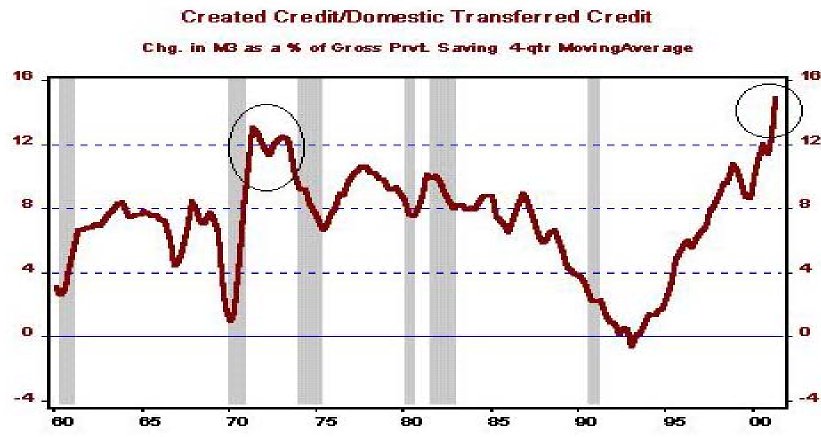




"Now remember," Kasriel advises, "Greenspan said, 'Who am I to tell if there is a bubble?" Then Greenspan went on to say that "Even if this does turn out to be a bubble, we can handle it – having learned many lessons from from the 1920's and the recent Japanese experience." Clearly the jury is still out on this latter assertion in Kasriel's mind and ours.

What the jury is not out on is that Greenspan had a significant hand in promoting this leveraged buy-back mentality, basically by setting the cost of credit too low for too long. If one may remember, Greenspan eventually argued that if productivity gains were real (although they really weren't that real as explained above), then productivity was also the reason the economy eventually overheated – driving the stock market higher – and creating a wealth effect that people were buying all these things. But Kasriel believes it is very difficult to have a wealth effect unless the Central Bank is aiding and abetting the crime – targeting low rates while there is an increased demand for credit.

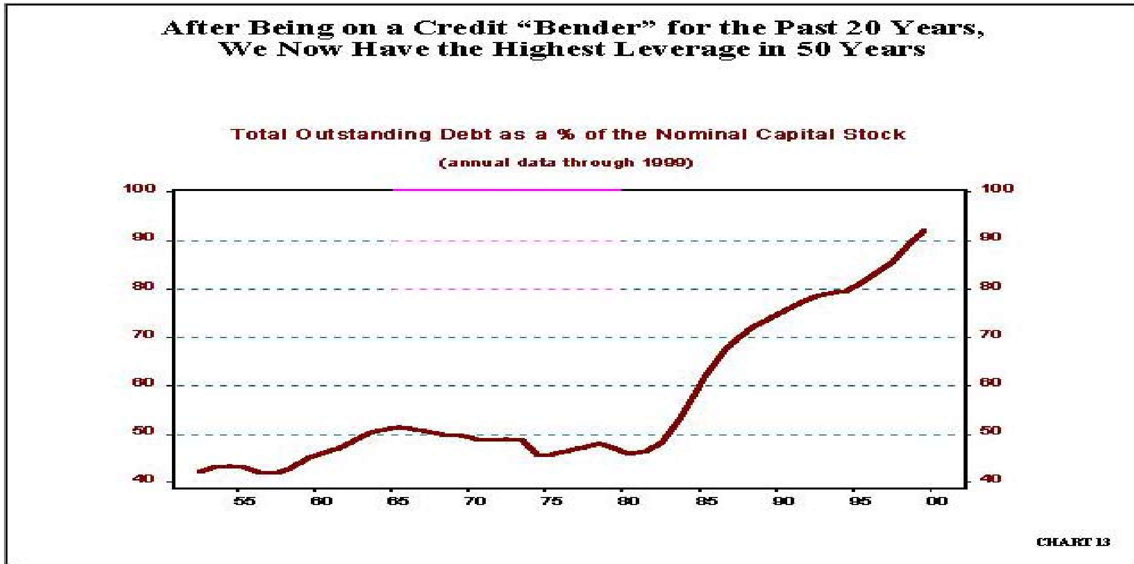
How can one measure how much Fed "created credit" was behind the bubble as opposed to simple "transfer credit" where one individual or corporation foregoes current consumption to lend funds to another individual? Specifically here, Kasriel looks at the change in M3 money supply as a percentage of gross private savings, and hits his punch line. Kasriel observes, "Lo and behold we have the highest ratio of Fed created credit relative to transfer credit in the last 40 years."



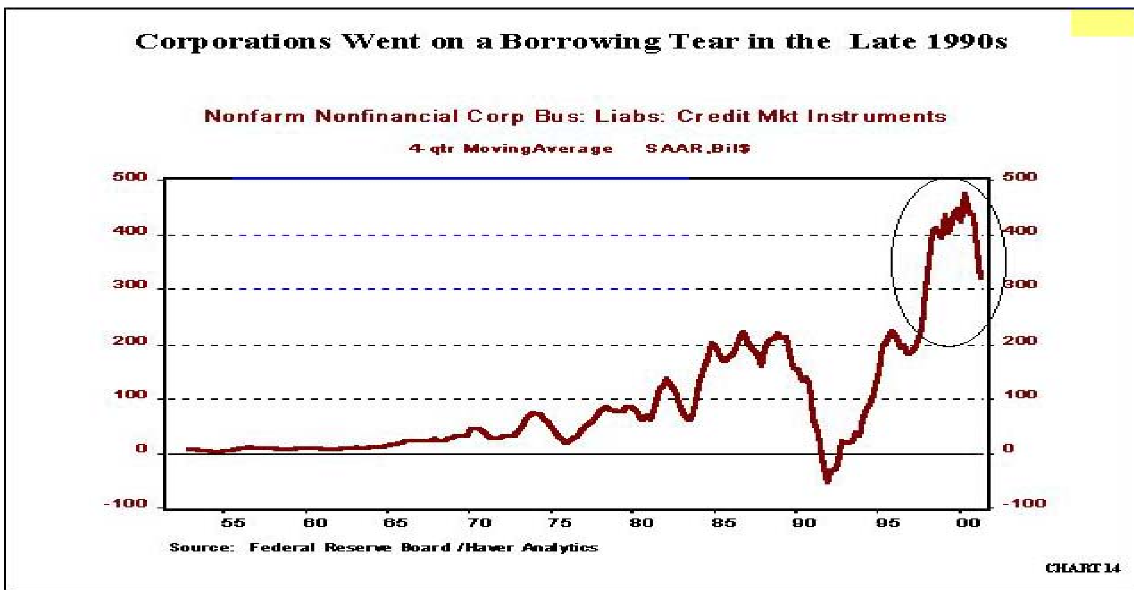
Thus, circa early 2000, Alan Greenspan was complaining about the productivity induced wealth effect overheating the economy, while it was really Alan Greenspan himself who had directly overheated the economy. In short…

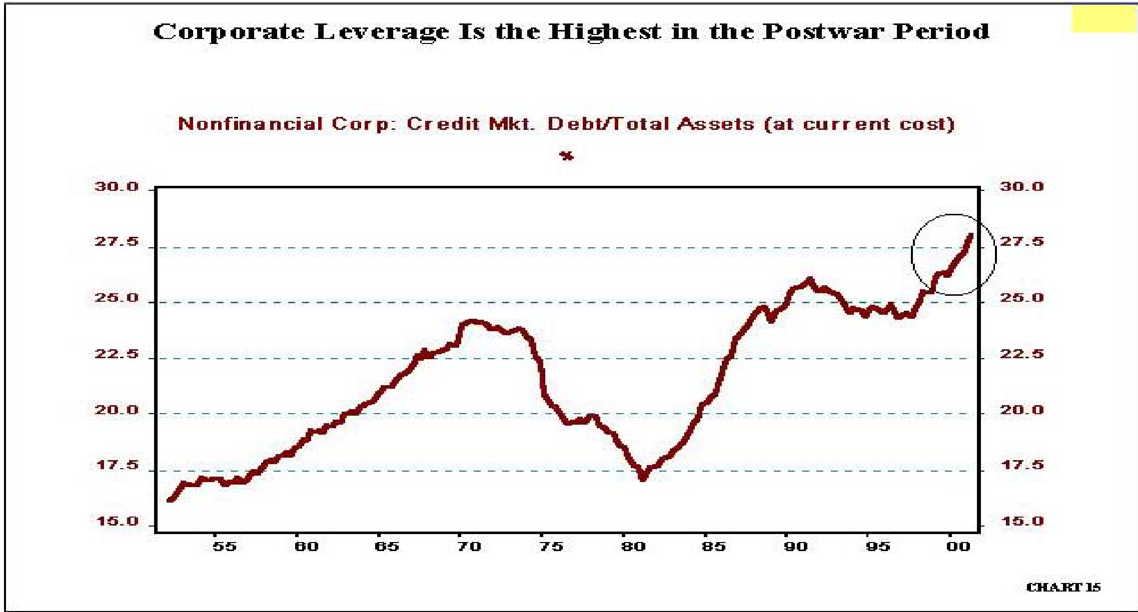
Kasriel specifically sees Greenspan as having moved furthest off course in late 1998 post the Long Term Capital situation. "I know in times of stress, the market has an increased demand for liquidity, and it's the Fed job to meet that demand," admits Kasriel. "But in that 1998 instance, the Fed actively drove interest rates lower between Fed meetings. By the third aggressive rate cut, this was a bit much. It created the whole "moral hazard" issue and the misplaced belief by many that the Fed is always an ultimate backstop to over-leveraged investments."

Courtesy of years of keeping the Fed funds rate below its true equilibrium level, Greenspan has thus left us with the most leveraged economy in the post war period, as shown by total debt as a percentage of total capital stock.

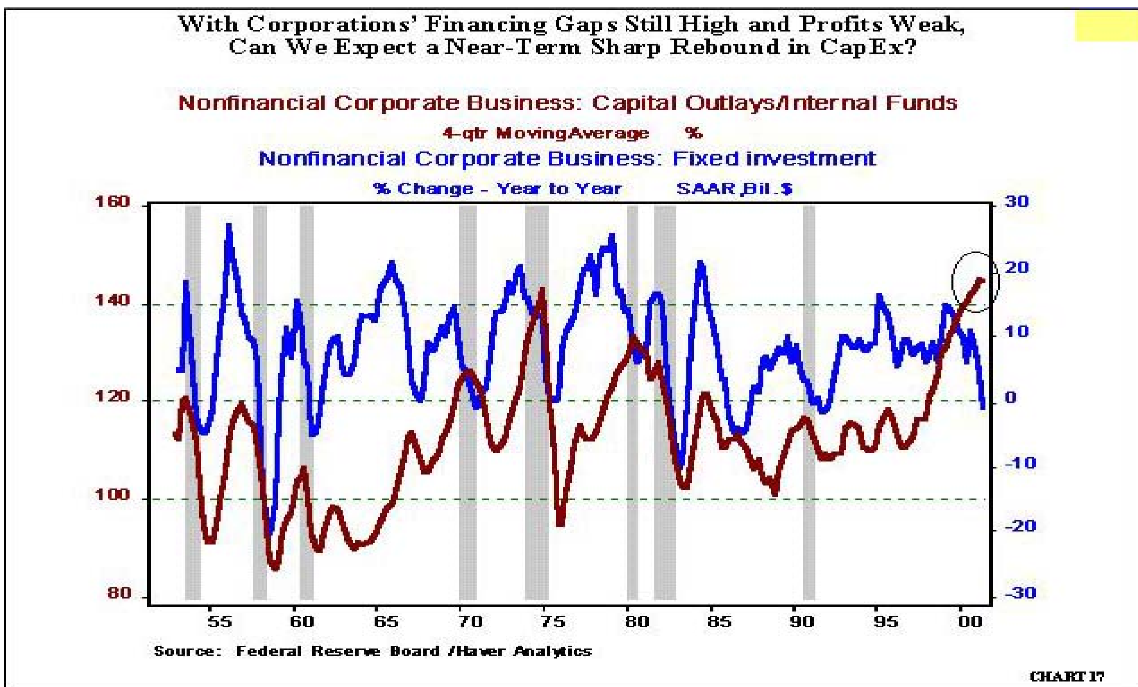


Corporations have been on a borrowing binge in the late 1990's.





This has led to higher default rates that are quickly approaching the highs of 1991, and as the chart below shows, has left corporations with no ability to do any significant capital spending at this time.



Households have also borrowed a tremendous amount, and while this may have been at acceptable levels as long as equity investments continued to appreciate, Kasriel is quick to point out: "When the capital gains go away -- as they already have started to -- the debt will stay. We've already suffered the sharpest decline in household net worth in the post-war era. Debt payments are becoming quite burdensome. Personal bankruptcy filings have soared."

Households Experienced a Record Drop in Net Worth in 2000

CHART 19

Interest Payments Appear to be Getting Burdensome, Indeed!

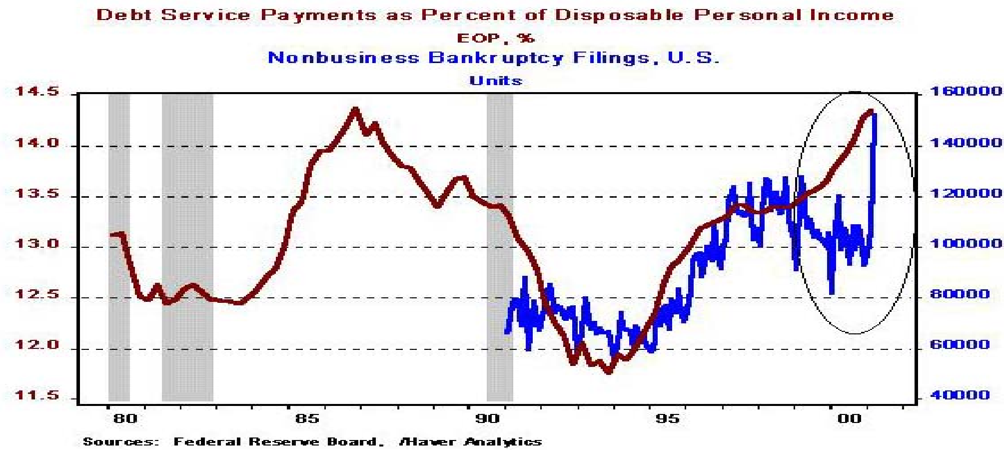


CHART 20

Kasriel believes that delinquency rates will continue to move up as the unemployment rate does so. Home mortgage foreclosures are currently going up despite the fact many banks are already “working” with borrowers who have fallen behind in debt payments. Households are very illiquid in terms of ready-cash and now that the rainy day has come, some may have to sell assets to survive.

With Expected Increases in the Unemployment Rate, Delinquency Rates Are Likely to Move Up to 1991 Levels

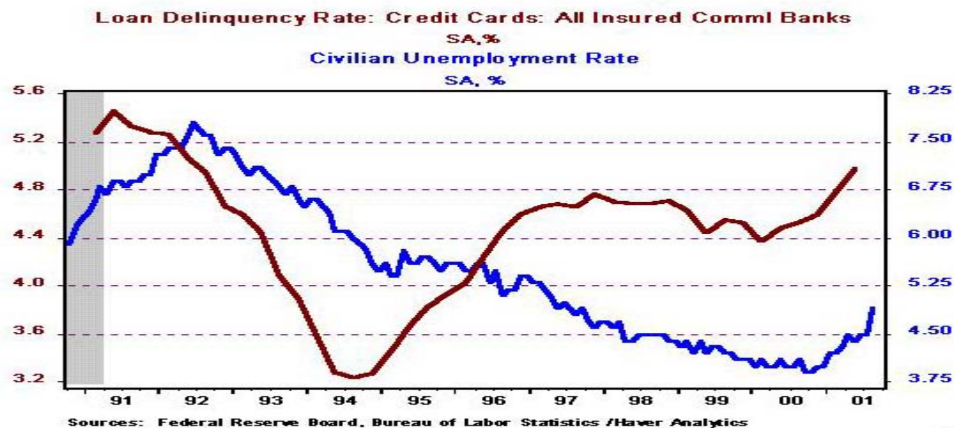
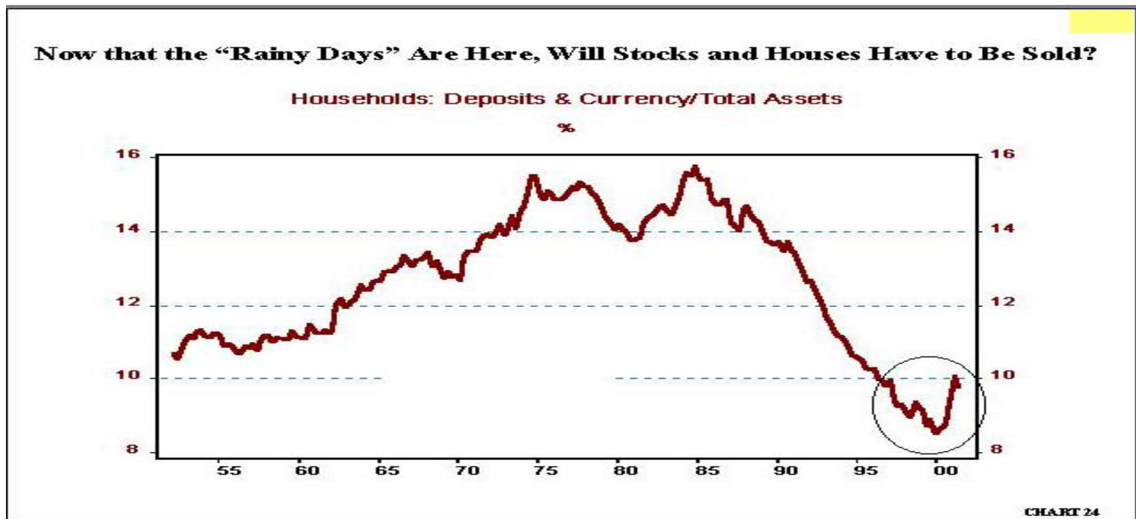
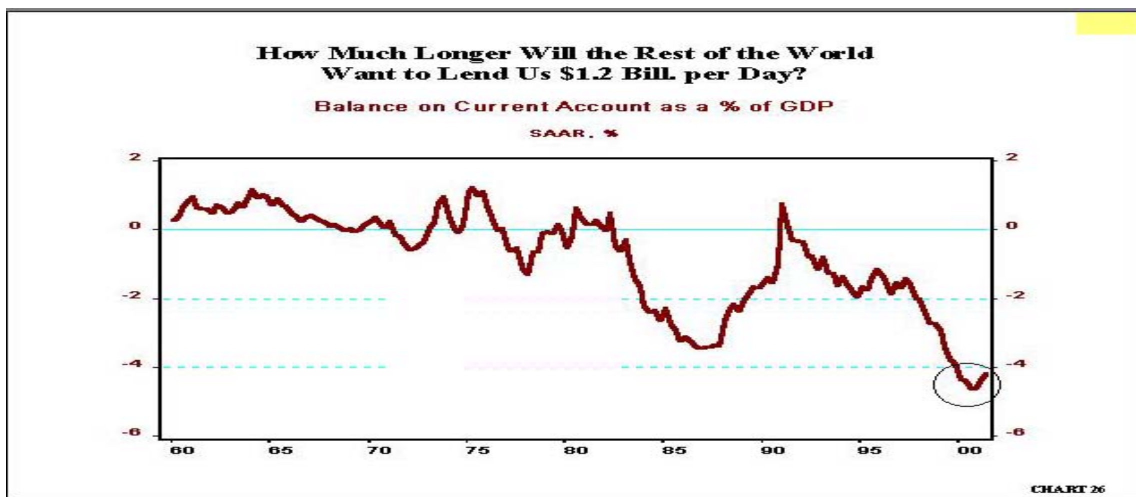


CHART 21



Lastly, Kasriel asks, "How long will the rest of the world be willing to lend us approximately $1.25 million a day that our current account deficit presently demands?"



All of this leads Kasriel to discuss one of his all-time favorite movies: the epic flic "Being There." In this film, a simpleton and slow-witted fellow named Chance (Chauncey) Gardener, played by Peter Sellers, is an actual gardener whose only education is obtained watching television. Sadly, he is displaced from his home when his master dies and he is forced to wander the streets of Washington D.C. until the President's wife accidentally takes him into the White House. He then soon finds himself appointed a chief economic advisor to the President for saying things like "In the spring, it will grow." Tongue in cheek, Kasriel now states "Alan Greenspan to some degree is very reminiscent of Chance the Gardener."

Kasriel also concludes by remembering how he watched Willie Mays play in his last game of his long baseball career. "Mays fell down in the outfield on a routine fly ball. It was really quite pathetic. Mays should have quit a few years before. Perhaps Mr. Greenspan should similarly avoid overstaying his welcome at this time. I think that he should and will use this last patch of an economic bounce to step down. Hopefully he is smart enough to at least do that."

It's All Not Pretty, but It Will Take Time To Play Out

As negative as all this sounds, Kasriel actually thinks the economy will show some recovery in the next two to three quarters. After all, at least in the short term, Greenspan has shot another strong dose of

M2 growth and now extra-low interest rates into the economy. But Kasriel also asks ominously: “If too rapid money growth was the cause of our current economic malady, how can another dose of it now be our lasting cure?” At best, it is likely to be another temporary delay tactic before the debt buildup of several decades finally comes home to roost.

In Kasriel’s words again: “When things do pick up again, and the Fed has to tap the breaks potentially toward the third quarter of next year, this could be the death blow to our current leverage build-up.” In other words, a credit bubble is there now, but it will need a catalyst and a bit more time to take it apart. The equity market was the first to fall, but the property market and residential mortgage market -- so central these days to the health of our entire financial system given the proliferation of GSE mortgage-backed paper throughout bank portfolios -- will only come truly undone on the next nudge higher in interest rates.

Greenspan can thus throw one last party for now, but if he is smart, he will be long gone by the next important PEI cycle date of November 7, 2002.

How to Play All of This?

For the anticipated initial move lower, and despite its recent irritating strength, we continue to be attracted to the short side of IBM. An extrapolated low near $74.50 would represent a more complete looking picture to this chart, and represents a level that is both a 38.2% retracement of the entire 1992-1999 up-move, together with a strong “fit” on our Fibonacci bands as pulled down from the 1999 highs. Since the spring of 2000, Dell has declined by 56%, Gateway has gone down over 90%, Hewlett-Packard is down 69%, and Compaq 78%. Given the magnitude of such moves, is it really correct to have IBM trading a scant 17% off its all-time high? Is Lou Gerstner really that much better at managing IBM’s affairs, or has he simply been more successful to hide IBM’s problems for longer? If we had one stock to short from here into our anticipated February market low, it would be IBM. Many financial skeletons linger in its closet that have yet to hit home with the average investor.

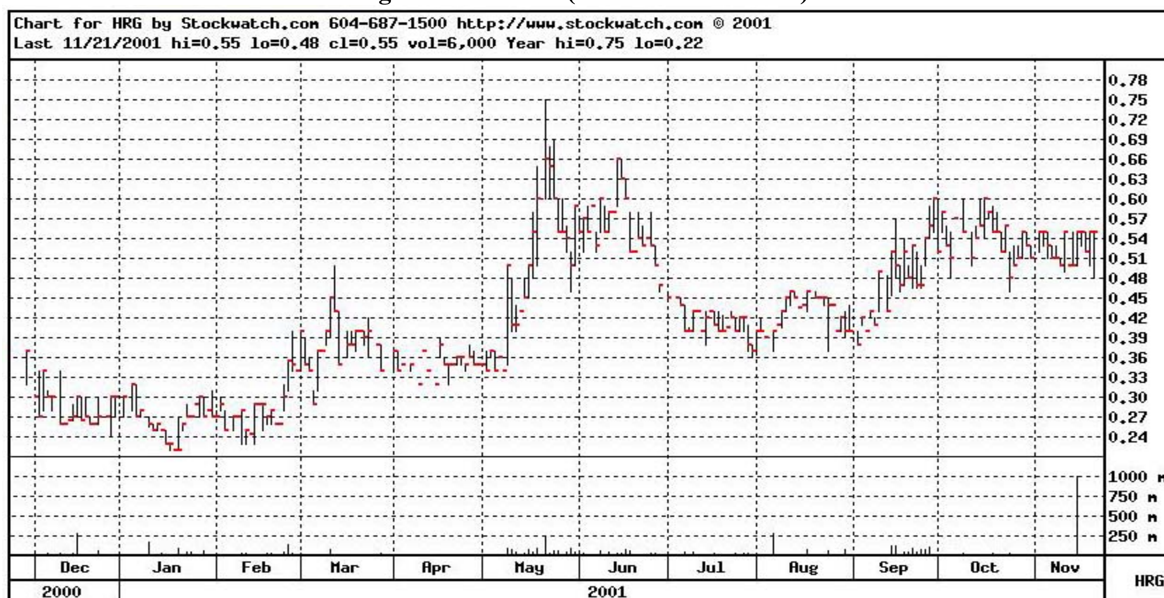
Also, rather than suggest a specific stop on any IBM shorts, let us simply suggest carefully watching the Dow Jones Industrials. If 10,120.90 on the DJIA gets intersected on a closing basis, this may be the best warning sign that something has gone awry with our other technical thoughts.

On another front, to date we have had little satisfaction on our view that gold mining stocks should start to perk higher. Indeed, even though gold sector stocks have been relative market out-performers in 2001, given how downtrodden many of these stocks previously were, the bounce has not exactly been impressive or impulsive looking to date. Indeed at present we linger just above our previously proposed $272 stop-level basis December Comex Gold.

But with Fed currently "pushing on a string," actively encouraging the re-kindling of inflation so as to avoid at all costs the "liquidity trap" of Japan's economy, musn't gold finally perk to life? We continue to think so, at least into the November 2002 window of time.

In this space, and in addition to our previously espoused position in Trizec Hahn ABX convertible bonds (see the summer's piece "Eclectic Longs"), we recently added to our gold holdings via the Tocqueville Gold Fund, as well as one small Canadian micro-cap stock, High River Gold Mines. (HRG – Toronto, HRIVF – U.S.) that trades at approximately .55 cents Canadian, or .34 U.S. cents.

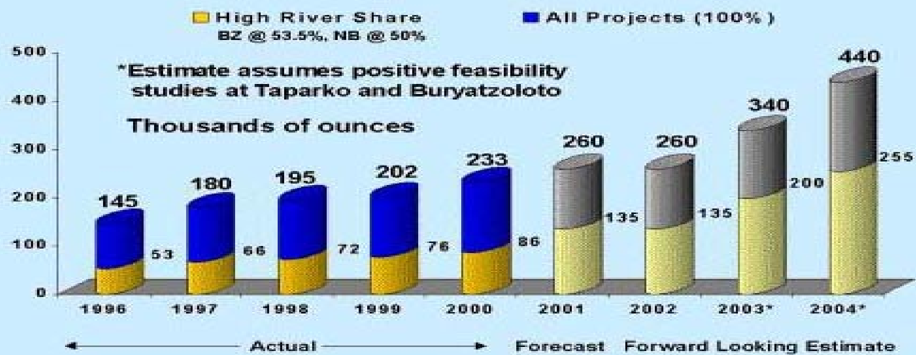
High River Gold – (in Canadian dollars)



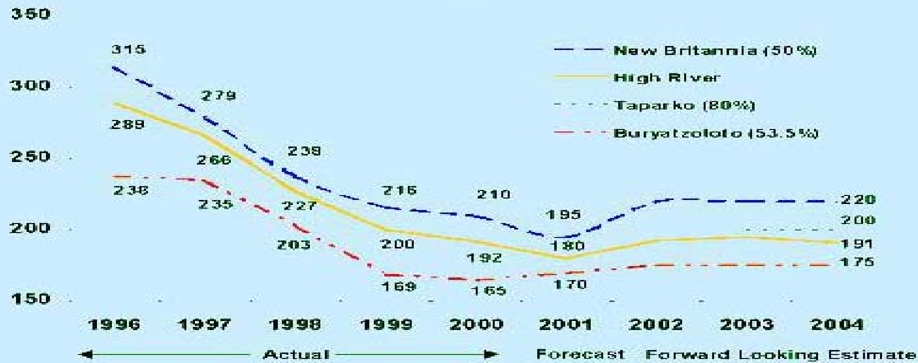
High River has producing properties in Manitoba, Canada and in Soviet Siberia, as well as a property in Burkino Faso, West Africa that is in feasibility study stage. The Soviet property, named JSC Buryatzoloto, is the third largest gold mine in Russia, and has PriceWaterhouseCoopers audited financial reports consistent with international financial standards. This Soviet company also has strong equity and debt investment from the European Bank for Reconstruction and Development (EBRD), one of the largest lenders to Russia. The EBRD holds two seats on the Buryatzoloto board, and has stated that it considers Buryatzoloto as one of its most successful Russian investments to which it would be prepared to add.

High River's share of the total proven and probable reserves from these three mining ventures together currently stand at approximately 7.2 million ounces (as updated from the end-2000 chart of Reserves below), and these reserves are projected to grow over time. Given an average cost of production near $200 an ounce, a spot $273 gold price, and fully diluted HRG shares outstanding of 58 million, you are looking at a company with a total market capitalization of just $19.7 million, capable in the future of producing profits to the tune of $525 million. Indeed, production at the Russian mine increased 52% in the first 6 months of 2001 as the cost of production moved steadily lower. Financially, High River is a company currently turning cash flow positive, and has solid financial backing from Canadian investment banker Sprott Securities that recently took a 10% equity stake in the company via a private placement offering. (Yes, there has been a bit of share dilution from this offering, but we feel it is toward a good end.)

Gold Reserves/Resources/Potential
(as at Dec 31/2000)
High River Share
BZ @ 53.5%, NB @ 50%, TP @ 80%
All Projects (100%)
Millions of ounces
20
15
10
5
0
2.1
1.1
5.1
3.0
9.9
5.5
17.0
9.6
Reserves
Resources
Potential
Total



Annual Gold Production
High River Share
BZ @ 53.5%, NB @ 50%
All Projects (100%)
*Estimate assumes positive feasibility studies at Taparko and Buryatzoloto
Thousands of ounces
500
400
300
200
100
0
145
53
180
66
195
72
202
76
233
86
260
135
260
135
340
200
440
255
1996
1997
1998
1999
2000
2001
2002
2003*
2004*
Actual
Forecast
Forward Looking Estimate



Total Cash Costs
(Cash Operating Costs + Production Taxes + Royalties)
(US $ per ounce)
350
300
250
200
150
New Britannia (50%)
High River
Taparko (80%)
Buryatzoloto (53.5%)
315
279
238
215
210
195
220
289
266
227
200
192
180
191
236
235
203
169
165
170
175
200
1996
1997
1998
1999
2000
2001
2002
2003
2004
Actual
Forecast
Forward Looking Estimate

Moreover, there is a catalyst that should begin to reveal to the public High River's true value. Because High River recently increased its ownership of the Soviet mining enterprise to 53% from 43%, the company will shortly be able to report Buryatzoloto's operating results on a financially consolidated basis together with the rest of High River's earnings. We expect that this, together with rising production levels, will push High River's earnings from its current small loss per share, into outright profitability early next year.

HRG is also a company primarily valued and traded in Canadian dollars, so at the current extreme Canadian dollar rate near $1.60, it may perhaps represent an even better long-term value to U.S. dollar investors looking to pick up Canadian assets on the cheap.

Anyway, for those interested in further information about High River, this may be found at their website: http://www.hrg.ca. I offer it here simply as another micro-cap eclectic security that piques my curiosity and satisfies my desire to find solid underlying intrinsic value.

Given High River's potential 20%+ annual earnings growth, it certainly beats IBM's growth potential hands down. For those who care to take a close look, IBM's cash flow from operations has experienced no growth for over five-years, while over the same period, it has only been able to muster single digit annual revenue growth from operations. And yet this company trades for over 10x its book value?

As Paul Kasriel is quick to point out: "Not every bubble has popped yet."

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Send us your comments at information@Sandspring.com.

AN IMPORTANT DISCLOSURE

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