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The next issue of
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will be published
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listeningin

Gimme Credit—Not!

Too Much Of A Good Thing Has Been Created Outside Banking System

Doug Noland is a financial markets strategist at **David W. Tice & Associates**, Dallas—and, no surprise for someone working for the publisher of the *Behind the Numbers* institutional research service and proprietor of the *Prudent Bear Mutual Fund*—a bear. What's interesting is why. While the Soaring 'Nineties' explosion in asset values has left analysts of far longer experience dumbfounded and searching for explanations, Doug has spent most of his decade in the business applying his training as a CPA and MBA to tracking down what he's convinced is the source of our good fortune. His conclusions?

Read on. But be warned: They're the perfect antidote for too much holiday cheer.

KMW

Your analysis isn't exactly mainstream—

There certainly are very few people discussing the massive credit and money creation that's going on in the system. If anything, the story line—at least

until the Fed started its Y2K liquidity injections—was that money growth had slowed this year. But that misses the point: 1998 will go down in history as one of the years of greatest credit excess—and this year's numbers will be very similar, despite a little slow-down earlier in the year in money supply growth.

Back up for a second and explain where you're coming from.

I started studying the credit system in the U.S. back in 1990, while working for a hedge fund in San Francisco. I was fascinated by the S&L bailout, and by the Fed's aggressive accommodation in the early

'90s—it was very much a quiet bailout of the whole U.S. banking system. One thing led to another. You had the massive leveraging of the hedge funds, feasting on the carry trade, in 1993. When the Fed eventually raised rates in 1994, we had a stealth bear market in stocks, which was nothing compared with the worst bear market in decades in the bond market. A near debacle when David Askin's fund went bust,

then Orange County. And Mexico's massive deleveraging. The derivative blowups with Procter & Gamble Co. (PG) and the whole list of others. Those were scary times and I was watching very carefully, trying to understand how we were going to get the U.S. financial system safely through a massive deleveraging. Then I noticed that **Fannie Mae**, **Freddie Mac** and the Federal Home Loan Bank System aggressively began expanding their balance sheets during

"The three GSEs, over the last 21 months, have increased their assets by \$521 billion, while the Fed has grown its own assets by only about \$70 billion."

1994. These "government-sponsored enterprises" (GSEs) were basically allowing a shift of leverage from the speculators onto their balance sheets, which helped the system keep going, despite considerable stress. Then in 1995, after the Mexican bailout, it appeared that the system was again flush with liquidity. Money supply took off—and the financial markets certainly followed. Happy days were here again. Well, I was hooked on trying to puzzle out just what dynamics were behind the turnaround—the stock market's rise and the rapid acceleration in credit growth. The answer that I've gradually pieced together is that a whole series of changes in the financial system have

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together fostered massive credit creation outside of the banking system. Not only by Fannie and Freddie, but by a whole slew of companies Wall Street created to lend money—in the sub-prime auto area, in credit cards, home equity. All these new companies were out borrowing money, and lending money, securitizing their assets and extending more credit. So were the finance arms of major corporations, the GE Credits and GMACs of the world. All the pieces of the puzzle came together in the early '90s to create an almost entirely new credit system.

Virtually eclipsing the Fed and the banks, you're implying?

Absolutely. No doubt about it. The numbers are staggering. Agency securities in the marketplace—that is, paper issued by Freddie, Fannie and the Federal Home Loan Bank—now total some \$3.6 trillion, up 64% from \$2.2 trillion at the end of '94. My contention is that all of these additional securities are involved in creating credit. Generally, in the mortgage area, but that liquidity spills over into financial markets everywhere. The numbers are huge, especially when contrasted with bank credit, which has barely grown over this span. Yet the folks—including most economists—who focus narrowly on bank credit and narrowly defined money supply growth see no excesses. My point is today's world is about *credit* not *cash*. We go to the store and use a credit card to buy something, or to buy online. That credit card could be a bank card, or a debit card. It could be issued by a non-bank. That loan could end up on a bank's balance sheet. Or as an asset-backed security outside of bank credit. It doesn't matter. It's credit. And that's what's driving the boom. What Henry Kaufman calls "unguarded credit." And excesses can certainly be seen if you look at annual net additions to financial sector borrowings, which grew from just over \$400 billion at the end of 1994 to \$1.2 trillion at the end of the first quarter, or at securities issuance by the GSEs. As of the end of the third quarter, total assets of Fannie, Freddie and the FHLB were \$1.45 trillion, up 134% from \$618 billion at the end of 1994.

Doesn't that just mean they've been financing mortgages, like they're supposed to?

What these government-sponsored enterprises basically do is issue IOUs to borrow in the capital markets, at times largely from the money markets, and use the proceeds to buy financial assets, mostly mortgage paper, which appear as assets on their balance sheets. It's a simple transaction. But when the GSEs buy mortgages, the money remains within the financial system, so it can filter back into the money markets, back into the capital markets—and then Freddie and Fannie and the FHLB can again borrow it in exchange for still more IOUs. It amounts, in essence, to an infinite multiplier. So their balance sheets today show those \$1.45 trillion in combined assets offset with huge liabilities, but very little in the way of combined equity. Fannie and Freddie have combined reserves for future bad debt losses that

total only \$1.6 billion—on assets that are 1,000 times that. What's more, the three GSEs, over the last 21 months, have increased their combined assets by \$521 billion, while the Federal Reserve has grown its own assets—something that monetarists watch like hawks—by only about \$70 billion.

You're hinting most economists are missing the boat on credit excesses because they're concentrating on the narrow money supply in the belief that only banks create credit—

Right. Everyone believes it's inflationary if the Fed creates money. They also believe that Fannie and Freddie are just financial intermediaries, taking funds from one person and giving them to another. What they are missing is that these agencies create credit in the system by issuing debt instruments in exchange for existing money stock, which they then use to buy financial assets. So that money literally just spins around the system and, with electronic transfers, instantly creates credit and liquidity in the financial markets. What's more, these GSEs are not burdened with reserve requirements, like the banks, but do enjoy the implied guarantee of the government on their debt, so even in the most dire market environments, they have virtually unlimited access to the capital markets. Which they've used very aggressively at times. That's one of the dynamics here: Whenever the markets become less-than-liquid, the agencies act aggressively to balloon their balance sheets, buying mortgages and buying back mortgaged-backed securities, essentially reliquifying the system. That's what went on in the fall of 1998, when we were in the midst of a severe financial crisis. Freddie and Fannie in particular ballooned their balance sheets, basically took mortgage portfolios off the hands of leveraged speculators—the Long-Term Capital Managements and Wall Street firms—that would have been in severe trouble if they had not come in as a buyer of last resort.

We heard the Fed was the hero, lowering rates.

That only affected the price of credit, not its availability. What's generally not appreciated is that in the Fall of '98, in the midst of credit spreads widening dramatically, mortgage rates actually fell. In a way, Freddie and Fannie incited a historic refinancing boom. Almost overnight households throughout America went to their local mortgage broker to refinance. So suddenly Fannie and Freddie had an easy opportunity to accumulate lots of refinanced mortgages. And, not coincidentally, to provide liquidity to the holders in the old mortgages, who largely were leveraged speculators. It worked like magic. The GSEs had unlimited access to borrowings from money market funds and used those funds to take old mortgages off the hands of speculators.

It worked. So what's your problem?

Only that the GSEs were borrowing *short-term* because, in the midst of a crisis of confidence, everyone was very hesitant to lend long. And they were

using those funds to buy *long-term* assets. They pulled it off by explaining that they were buying derivatives to hedge themselves. Keep in mind, Fannie Mae bought \$188 billion worth of mortgages last year at an average yield of 6.61%. Freddie Mac bought \$288 billion. What's happened since? Mortgage rates were recently quoted at 7.7%.

You're saying they're holding lots of underwater assets?

Someone is hugely underwater on this mountain of mortgages Fannie and Freddie bought last year. They let household America refinance their mortgages at artificially low rates. Now, Freddie and Fannie together own \$500 billion worth of derivatives, which they bought to hedge against a rise in rates and so they claim to have very little interest rate exposure. But if so, whoever wrote those derivatives contracts is underwater. Someone has huge losses because the household sector has been a huge winner in the mortgage game over the past 18 months.

Fannie and Freddie's brokers will tell you they've hedged themselves in turn.

Derivatives are a zero-sum game. While some may claim that the Street can just short the securities and eliminate any exposure, the numbers are just too big. It's almost like the market trying to hedge itself, which is impossible. Individual risks may be hedged, but not whole markets. Likewise, you can't really hedge \$500 billion worth of mortgages. Someone has losses on those derivatives. Which puts us in an interesting situation today, with the economy so overheated and the Fed increasingly seen as behind the curve. We might see the Fed having to tighten aggressively early next year—and, if so, problems with derivatives could grow exponentially.

Only if it happens too quickly for dynamic adjustment. And if bond investors don't perversely welcome a hike. So why worry?

To begin with, there's that implied government guarantee on the agencies' debt. Almost \$1.5 trillion of it that the taxpayer could be on the hook for. That is almost a minor issue, however, compared with the fact that this massive and unprecedented credit creation is truly the fuel behind asset bubbles in the stock market and real estate that are hugely distorting the financial system, the economy and the market pricing mechanism itself. Down the road, when this credit bubble is pierced, we'll be left with an economy that's so maladjusted it'll probably take decades to set it right.



"This is Harold. My core boiding."

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You are full of holiday cheer!

Consider that today, all across the country, we're building expensive homes, shopping malls, casinos, hotels, health spas and and cinemas in the real economy, plus internet sites and enough broadband capacity to last a lifetime. The whole economy is now propelling itself with a mentality of permanent prosperity and increasing wealth.

Don't you want to be a millionaire, too?

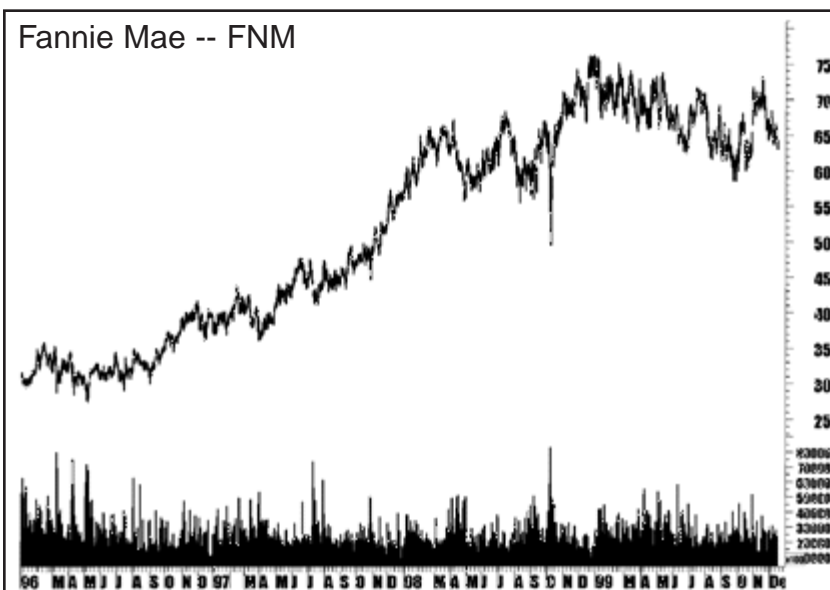
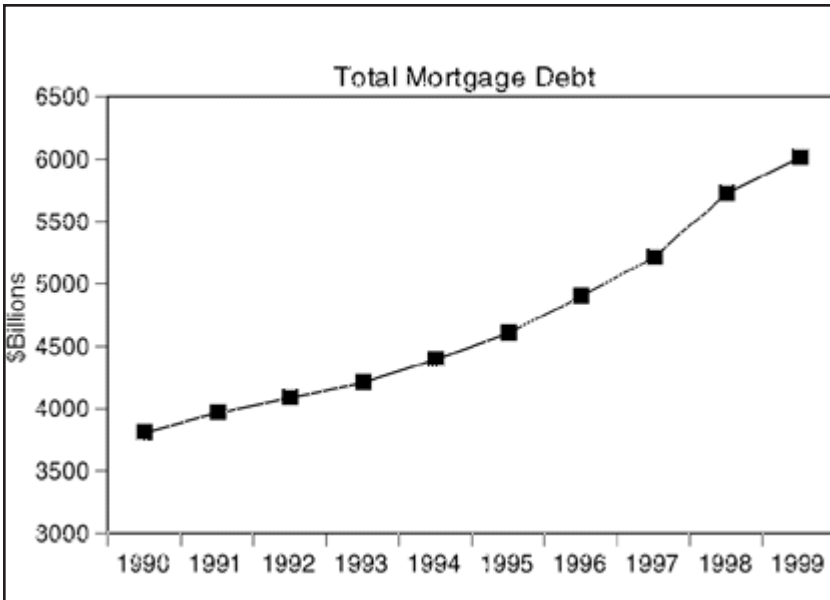
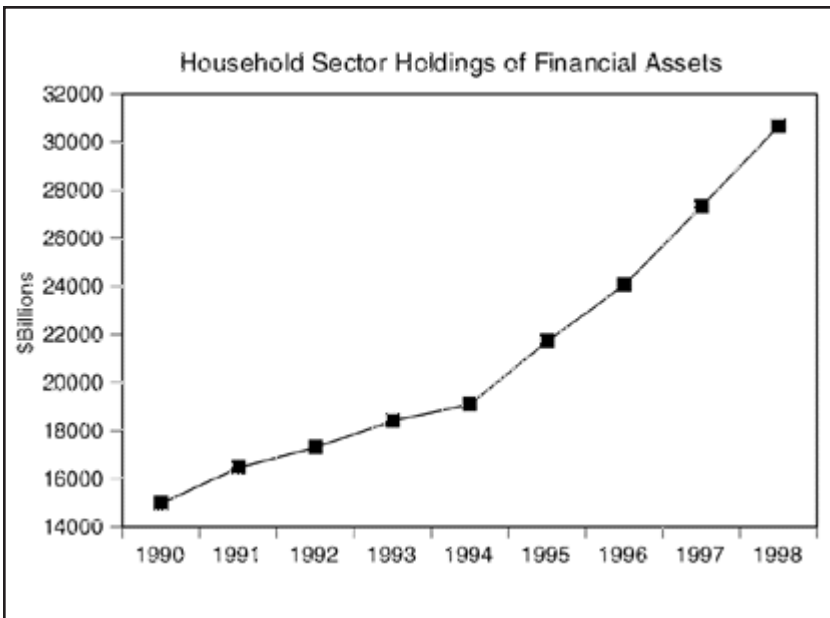
Well, as long as we increase wealth, the economy works fine. But if you all of a sudden have a stock market retreat and real estate prices decline—we'll have big problems. Almost our entire economy is based on consumption, when what we really need is to be able to produce goods and services so that we can pay off debts to our foreign lenders, etc.

You're preaching economic Calvinism in the internet age? Why worry about paying off foreign creditors as long as we can take a company with \$34 million in revenues and \$24 million in losses—not to mention little prospect of ever morphing those losses to profits—and catapult it to a \$10 billion market cap overnight?

That's indicative of the bubble. M3 money supply is now at \$6.4 trillion, having grown \$2 trillion over the last five weeks. Everybody thinks we're rich; that there's plenty of money to fund any business that wants capital. We can have a million web sites.

Why not, as long as there's no price inflation?

Well, the old Austrian School economists were very clear on this. In their view, any credit creation beyond savings is pure excess—in other words, credit



inflation. You're just creating securities. They argue that if you have credit inflation, it will manifest itself in one of three ways: Either in consumer price inflation (in goods and services); in asset price inflation; or in trade deficits. It makes sense. If you create extra money, it's going to be spent somewhere. You can buy a new car with it. You can buy stocks. Or you can buy a foreign car. The old Austrians also argued that consumer price inflation was the *least dangerous* of the three outcomes. Because all the central bank had to do was tighten and slow things down. But they warned that if you let inflation spill into the asset markets and into trade deficits, it would over time lead to a bubble of higher asset prices encouraging more consumption, which distorted your investment cycle, and led to a massive trade deficit. Jeopardizing your entire economy and financial system. Because your dysfunctional economy would have little ability to repay foreign debts. That's exactly what we see today. We're having a great consumption party. A great asset bubble. But when it is pierced, the hangover, in terms of debts to foreigners, will be measured in trillions.

What did a bunch of old Austrian economists know about the internet age?

They knew about credit, which has been with us forever, and going through cycles forever. We've had booms and busts throughout financial history. The old Austrians were very critical of the credit excesses in the late '20s, especially in New York—and were proven correct. Were someone like Joseph Schumpeter, whom a lot of bulls like to quote, alive today, he'd be (like the rest of us) very excited by all the new technology. But he'd also warn that new technologies were also a factor in inciting greater credit excesses in the late '20s. Today's internet boom comes at a time when money and credit were already growing exponentially, so it feeds the fire in a new era of excesses, both financial and economic. In the '20s, it was the automobile. The whole world aggressively built up auto manufacturing capacity. People thought, "We're going to have cars forever." Well, they were right. We still do. But we also had the Great Depression. Truly profound new technologies, in terms of increasing productivity, were developed during the '20s. It's debatable whether, great as it is, the internet has increased human productivity as much. Face it, the web is a consumer's tool; it's very difficult for a business to make a return on investment in web services. And, like I said, this consumption-driven economy doesn't need more consumption. The game of trading securities for goods is not sustainable. Our foreign trading partners are eventually going to want to settle these claims for something other than paper. To think that we can continue to run \$25-\$30 billion a month trade deficits as far as the eye can see is silly.

Not as long as we maintain confidence in the greenback.

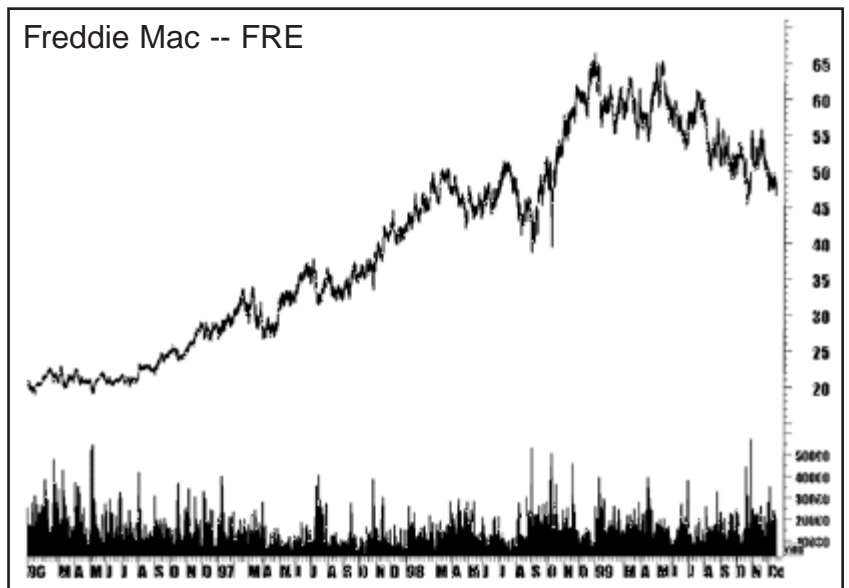
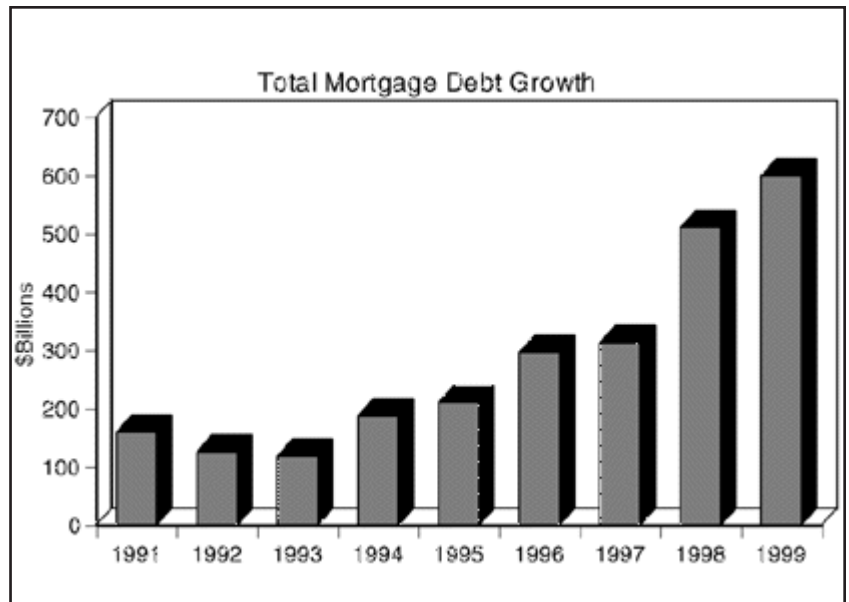
Just this week in the *Financial Times*, there was a story talking about the Hong Kong Monetary Authority looking to buy more euros because they're worried about the U.S. bubble. We see more and more Asian countries looking to form some type of regional currency block. The Japanese are definitely taking a harder line, knowing full well that we have a huge bubble here. The European central bankers—it's almost like they're trying to get their houses in order knowing the U.S. is very vulnerable. To assert that foreign investors will always want U.S. paper is ridiculous. Especially after seeing the instability in the global financial system over the last decade. You can easily argue that the global financial system breeds booms and busts: Japan, Mexico, Southeast Asia...

Yet every time, the safe haven has been the U.S. The Fed has ridden to the rescue.

No doubt that as the world's reserve currency, we've been afforded the opportunity to have our credit excesses not be as problematic as they were for a lot of other countries. But that has allowed us to perpetuate them. I would argue that what we've done over the last almost two years is allow such reckless credit growth that our financial system has spun out of control. So there's no way around a dollar crisis, going forward. One that, unlike the others, won't result in a flight into the dollar, because it will be centered in Wall Street and in the currency. We won't be able to just blatantly create more credit to pay for all the problems. Which changes the whole game.

If not into the dollar, where?

The rush at that point will be to get *out* of the dollar. The panic will be to sell, not to buy. I would argue that the unappreciated secret now is that a lot of dollar buying has been by the leveraged speculating community, which, it is estimated, controls \$350 billion of assets. My guess is that it's the hedge funds that have huge, long positions in dollar. Some playing the dollar, others, just as a way to play the U.S. stock market bubble. The big surprise going forward could be a market crisis that sparks a collapse of credit within the hedge fund community—and that will be manifested as a crisis in the dollar, not to mention stocks and the credit market. Look what happened last Fall, when stocks got in trouble and all the liquidity drained out of U.S. credit markets—the dollar basically collapsed against the yen. That was an early signal of what is to come; of how the dollar is tied directly in with this big bubble of speculation in the U.S. The yen today is at 102. In July, '98 it was at 146. Today, God only knows how much hot money has been borrowed in Switzerland and throughout Europe to play NASDAQ. And when speculation is based on huge leverage, there's very little tolerance for pain. If the hedge fund community starts to lose money, they *have* to contract because they're so heavily leveraged. And if they all, for whatever reason, head for the exits together, I don't know where



"Fannie and Freddie are swimming hard just to tread water."

the liquidity comes from to allow them to unwind their trades. There are huge derivative positions and paper profits that will not be easily converted to cash.

So how vulnerable do you figure Fannie and Freddie are?

This is all about perceptions. There's no concern in the marketplace that Fannie and Freddie have grown their combined balance sheets to almost a trillion dollars on only \$28 billion of equity. Keep in mind, too, that Freddie and Fannie have also guaranteed the timely payment of interest and principal on \$1.1 trillion of mortgage-backed securities, which are not on their balance sheets, but that their equity must support. Confidence is a shaky thing. One of these days, people may get concerned that if you combined Fannie, Freddie, **Lehman Bros.**,

Morgan Stanley, Merrill Lynch and Goldman Sachs, you'd have \$2 trillion of assets but only about \$75 billion of equity. That only works in a bull market. Now maybe the government will stand up and actually guarantee Fannie and Freddie's debt to keep this bubble going. But if rates start to move dramatically higher...our financial sector is so over-leveraged. It added \$1 trillion of new debt last year. Since the end of '94, it has added \$3.7 trillion, basically doubling the size of its borrowings. The GSEs are only about half of that total. It also includes the banks and players like **General Electric (GE)**, which, since the end of '94, has basically doubled its short-term liabilities. It's hard to make things, it's easy to leverage financial assets. We'll see, early next year, what the Fed does.

Do the numbers you just cited on financial sector debt reflect derivatives exposures?

No, derivatives are completely separate—and massive. But there is a strong correlation between the growth in derivative positions and the growth of credit. The problem is, we're on untested ground, with estimates of \$100 trillion in derivatives out there, at this point in the credit cycle. Wall Street does not have the equity to hedge Fannie's and Freddie's balance sheets. Their investment bankers have no choice but to try to lay off the exposure, either by shorting securities or trying to get someone else to take the risk.

Okay, but Fannie and Freddie buy mortgages, for gosh sakes. How safe can you get?

That's very difficult to get a handle on. But Americans, on average, have less equity in their homes now than they have had at any time since the 1930s. There are definitely people putting less down on new homes, choosing to keep their money in the stock market or elsewhere. Fannie and Freddie still claim low loan-to-value ratios. And real estate prices are rising. But just how important real estate asset inflation has been to this bubble isn't generally appreciat-

ed. In October, new home sales, in units, were reported 9% above October '98. Average prices were also up 9%. So transaction dollars (units times the average price) were up 18% year over year; 37% over the last two years. Then there are resales. Greenspan himself has estimated that the average capital gain on a home sale over the last five years has been \$25,000. That's about \$557.5 billion of capital gains—or cash extracted from real estate inflation. It's the real estate bubble that is really behind the majority of this credit explosion that has been feeding into the stock market. You can only convert all of these mortgages into AAA-rated paper because the government is involved. And as long as it's AAA-rated paper, there's not going to be any market self-regulation. Today, U.S. homeowners believe that they're getting rich by just watching the value of their homes go up. They borrow home equity. They buy stocks. They allow their debt to grow, all because of inflating asset prices. When asset prices turn the other way, the psychology will change dramatically.

Are you shorting Freddie and Fannie? Or going into bankruptcy law?

We certainly have an interest, though we're not short Fannie and Freddie today. The financial sector is an accident waiting to happen. These stocks sense it. They've stopped participating in the party. As long as Fannie and Freddie can continue to roll their short-term debt, everything stays fine. I would argue, however, that they also need to continue to grow aggressively to keep this credit game going. As soon as they slowed earlier this year, liquidity contracted throughout the credit market. Right now they're swimming hard just to tread water. They're growing their balance sheet 25%-30%, just to keep the prices of the mortgages from dropping dramatically.

What does all this mean to the money funds?

The money market funds have grown by almost \$1 trillion since the end of '94, rather neatly correlating with the growth in Fannie and Freddie's own balance sheets. Everyone thinks this is money. Well, it's not. It's IOU's from Freddie, Fannie, GE Capital, GMAC, etc. If people want that money back, the funds have to go to Freddie and Fannie and ask for it. Suppose they say, "We don't have any money. How about some mortgages?" The financial system is vulnerable. In just the past *12 weeks*, M3 money supply has grown by \$196 billion—almost as much as it did in the first *five years* of the decade. With this kind of money growth, things function splendidly. The stock market goes up. Credit spreads narrow. Interest rates drop. But as soon as money growth slows, the markets will be tested again. The corporate sector is borrowing like crazy. We have a negative savings rate. The third quarter current account deficit was a stunning \$90 billion, up from \$63 billion a year earlier. Something's got to give here. Either demand is going to falter, or interest rates are going a lot higher.

Merry Christmas to you, too, Doug. And thanks.

streetbeat

Rebirth?

Dave Talbot has been following healthcare stocks, well, since long before most of today's web investors were born. But don't get the idea he's just an old fogey. Dave's hedge fund, **HealthReform Opportunities LP**, specializes in the small health care-related internet stocks and biotechs that he sees leading the next revival of investor interest in the sector. Which he expects to kick in next year as the newbies are snapped up by industry giants anxious to restock their product pipelines—and, not coincidentally, to beat the clock on a last pooling acquisition or two.

He called last week to bring us up-to-date on one such outfit, **Claimsnet.com**, (CLAI) a Texas-based ASP, which is netizen-speak for an “application service provider”—or one of the next big things on the web. In Claimsnet.com's case, the service provided is, quite literally, just what the doctor ordered. More specifically, Dave says, it is the only pure internet system for processing medical claims and related documents, like statements and eligibility forms. Its web-based flexibility and online forms editing engine are designed to vastly lower the cost to doctors' and their staffs, in time and money, of dealing with mountains of reimbursement paperwork. Dave, in case you haven't guessed, is partial to Claimsnet, and just a wee frustrated that it hasn't attracted nearly the ink nor investment banking support that has flocked to its larger rival, Healtheon. While Claimsnet, back in April, came at the same IPO price as Healtheon, \$8 (albeit it on half as many shares), it hasn't fared nearly as well in the aftermarket. After a brief spurt to 19 and a fraction, Claimsnet sank to 4 before rebounding lately to 10 or so.

The recent revival of some investor interest in the stock apparently stems from the announcement, in mid-November, of a deal the ASP struck to license its technology to and do software development work for health care giant **McKesson HBOC**. And, insists Dave, Claimsnet's second wind has barely just begun. “McKesson's entry into the cyber revolution is a very big deal.” One that, Dave is betting, “the rest of the analytical community will follow me in recognizing six months from now” And one that will prove to be transforming, not just for Claimsnet, but for the much larger, if still-troubled, McKesson HBOC. “The analysts who are recommending **Healtheon** today are then going to be recommending McKesson HBOC.”

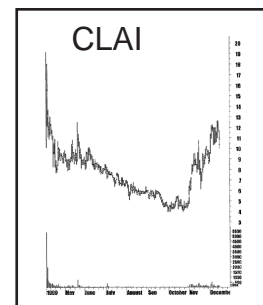
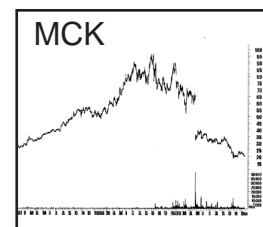
What caught our ear, we must admit, wasn't especially Claimsnet. Now, Dave may be exactly right about its potential, especially in this market. And maybe it *is* a failure of imagination on our part. But we can't help ourselves. The best we can be is agnostic on a company—even an ASP—trading at about 5 times revenues, one that, pre the McKesson deal, was on track to lose about \$8.5 million this year on

sales of about \$300,000. To be sure, it stands to collect a one-time development fee from the drug wholesaler, as well as licensing, subscription and transaction fees. And it's certainly free to sell its services elsewhere. On the other hand, McKesson HBOC likely could have picked up the whole shebang in the market a month ago for less than half its current quote, yet decided that a licensing deal would do just fine, thank you very much. McKesson HBOC did so, moreover, even as it was snapping up another ASP, privately held Abaton.com, which provides web-based software to help medical practices manage other information flow headaches, such as lab reports, medical charts and prescriptions.

Nope, what caught our ear were Dave's predictions that McKesson HBOC's deals with the two ASPs are but the first in a series of moves that will vault not just its troubled information technology unit, but every part of the pharmaceutical and medical products distribution giant, to the forefront of the e-commerce revolution in healthcare. Dave grants, of course, that MCK currently is accorded little respect. Even forgetting the accounting irregularities subsequently discovered at HBOC, he says, McKesson's 1998 acquisition of HBOC was scarcely a masterstroke. It paid top dollar for a practice management software business based on old-fashioned and expensive legacy software for mainframes. Nonetheless, Dave points out, McKesson did acquire something of value in the ill-starred deal: “a hell of a client list, and a hell of a sales force.” Now, it's working on giving them something to sell that's internet-based, “where the growth is going to be,” he avers. “If you're going to be selling pharmaceuticals to a doctor, you might as well as sell him claims processing capabilities, too. Especially if he doesn't have to buy a lot of technology. All he has to do is dial up ClaimsNet.com. The entire drug wholesaling side of McKesson is going to be selling claims processing (and other healthcare management services) over the internet.”

We checked in with McKesson Wednesday and found the company spokesman a mite more circumspect than Dave, as befits an industry behemoth with new, scandal-chastened management still operating under legal clouds that probably won't clear, at the earliest, until this time next year. Also found a company that sees no compelling reason, as of yet, to share the details of changes in its strategic direction with rivals. Yet we came away with the clear impression that this web thing is no mere dalliance on McKesson's part. And that it encompasses not only its information management side, but its drug and medical surgical product distribution arms, as well, that will use it to make themselves ever more indispensable to clients.

Now that's intriguing. Especially in a \$30 billion company with a beaten-down stock trading at only about one-fifth of sales and at roughly 12 times estimates for fiscal 2001.



tradingideas

High Tech, Low Multiple

A pretty savvy, albeit shy, investor we know called a few weeks back excited about an obscure tech stock. And no, that's not an oxymoron, even in this superheated environment for web darlings. This one has no dot.com tacked onto the tail end of its moniker, nor has it been peeled off of some slower-growing household name. It's domiciled, moreover, about as far as a company can get from Silicon Valley—psychically, if not geographically—on the outskirts of Cleveland.

If that didn't get some contrarian juices flowing, the subsequent action in the stock has: it has dropped from around 20 to below 17. Why, who can say, except perhaps that it was due a breather, having climbed quietly but fairly steadily from a low under 5 late last year—and recently having bested a record 19 1/2 set back in '96.

The company, we'll keep you in suspense no longer, is Big Board-listed Keithley Instruments (KEI), a maker of precision scientific measurement instruments. Its oscilloscopes and such have been fixtures in academic and commercial laboratories practically since Keithley's founding, back in 1946, by the father of its current chairman and CEO. But before you yawn, be advised: today's Keithley is scarcely the sort of cobweb-encrusted entity that's of value only to the founder's heirs.

The 500-plus folks who toil for Keithley in suburban Aurora, Ohio and its outposts in considerably more exotic corners of the globe are entirely in tune with the ethos of the ether. They don't sell instruments anymore. They "provide solutions to high-growth sectors of the electronics industry." Indeed, its customer list reads like a tech Who's Who: IBM, Motorola, Texas Instruments, Nokia, Qualcomm, Ericsson, and on and on. Keithley supplies precision testers, PC plug-in boards and the software needed to use them—for process monitoring, production testing and basic research. It also makes parametric test systems to monitor quality control during semiconductor production.

Quite simply, high-tech manufacturers can't do without the sort of stuff Keithley turns out. Cell phone makers, for example, need Keithley's tremendously precise software-based battery testers to make sure that the voltages put out by their ever-smaller power units don't vary—an increasingly critical concern because voltage

instability instantly translates into frequency changes that can garble or drop calls.

After hitting a rough patch in fiscal '98, brought on by the downturn in Asia and recession in the semiconductor industry, Keithley has redoubled its efforts in its fast-growing semiconductor and cell phone markets, which now account for 35%-40% of the firm's revenues. Its stated objective: faster growth, fatter margins. That Keithley, with roughly \$120 million in annual sales, goes nose to nose with **Hewlett-Packard** spinoff **Agilent** (A) in those markets is noteworthy, if a little scary. That it generally splits those competitive markets 40%-60% with Agilent and seems to be taking market share from the \$8 billion-plus instrumentation monster is, well, inspiring.

Our friend, who has lived and breathed both technology and the stock market for decades, can't help but be impressed, too, that Keithley sports a healthy balance sheet, with current assets better than twice current liabilities and barely a speck of long-term debt. It doesn't hurt either, in his admittedly quaint view, that Keithley pays a dividend, and has been using some of its prodigious cash stream to buyback shares.

But what really gets our friend excited about Keithley is the growth he discerns in its results, after stripping out "extraneous" items like extraordinary gains and charges from its restructuring, interest income and year-to-year changes in its tax rate. Also after adjusting his per-share numbers for the full potential dilution in the total outstanding (7.6 million). (If you're getting an idea he's a stickler for details, you're right on.)

We'll spare you the gory details: On this most conservative basis, he says, Keithley's "realistic actual operating earnings" climbed a cool 80% from 55 cents a share in fiscal '98 to 99 cents a share in the year ended September. (The company reported \$1.08 vs. 55 cents.) Near as our pal can tell, Agilent has increased has increased its operating profits over that span by roughly the same order of magnitude. So it galls him that the newly public shares of Keithley's rival are trading at 75 times trailing earnings versus about 17 times for Keithley. But he also smells opportunity in Keithley, which he (again, quite conservatively) bets could post operating net of \$1.40 a share in fiscal 2000—and, just maybe, get noticed.

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