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## listeningin

# Ho Ho Ho, Dollar Drop Has Mo'

*But Shorting Buck Not A Slam-Dunk, Albert Friedberg Warns*

*Albert Friedberg, the young fellow sketched below, knows the dollar, currencies, commodities, and of course, stocks and bonds. But international currency and commodities markets have been his special metier since 1972, when (still a mere child) he started Toronto's Friedberg Mercantile Group, now a \$1 billion-plus asset manager whose fund of funds, while heavily weighted to international fixed-income bets, has its fingers on the pulse of virtually every asset class extant. I know of no one better to turn to for enlightenment on currencies, and when I called Albert recently, he did not disappoint.*

**KMW**

**Suddenly all I'm hearing from "Con-the-sense-out-of-us-TV" (ConsensusTV, for short) is that the dollar is in a death spiral. But you just wrote an interesting rejoinder, warning that is "not a slam-dunk."**

There's a lot of talk—a lot of non-sense talk—as though certain things are proven "truths." Like, "a current account deficit of this size is unsustainable." Period. And if it's unsustainable, "the dollar *has* to go down."

**You don't accept as self-evident truth the notion that twin deficits are a very evil omen?**

"Twin" deficits make a great story. The fiscal one, the current account one. Calling them twins impresses and alarms. So does the "fact" that the U.S. needs to "find" \$2 billion a day before it opens its doors for business.

**You dispute that reality?**

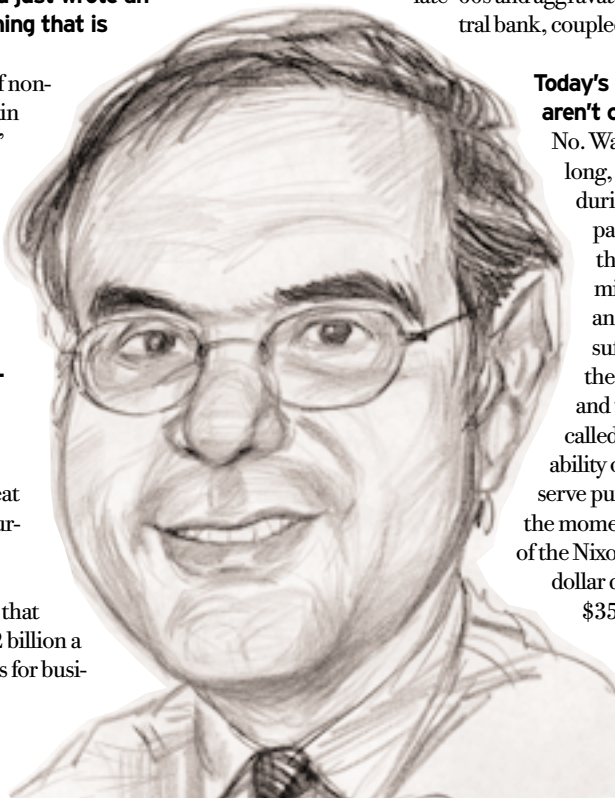
No. Just the *inevitability* of the outcomes the crowd suddenly expects. None of these problems has ever been proven to force a currency to depreciate—not in a situation when the borrower's currency was, at the same time, the world's monetary standard.

**I dimly recall the greenback collapsing during the 1970s, when we also ran big deficits—and the dollar was the reserve currency then, too.**

The circumstances weren't really the same. While we had a current account deficit and a fiscal deficit, everything else was not equal. Especially the relative economic performance of the major industrialized countries. Back then, the U.S. economy was also characterized by low productivity and high inflation, a process kick-started by Vietnam in the late '60s and aggravated by an extremely lax central bank, coupled with Watergate.

**Today's Wall Street's scandals aren't comparable?**

No. Watergate dragged on for too long, hobbled the U.S. economy during the '70s and produced a painful bout of stagflation. In the meantime, foreign economies, led by West Germany and Japan, grew smartly and suffered less inflation. It got to the point that the deutschmark and the Swiss franc came to be called "hard currencies," for the ability of their issuing banks to preserve purchasing power. But it was the momentous refusal, in early 1971, of the Nixon Administration to honor dollar debts in exchange for gold at \$35/oz., which really sent the dollar south. It had an electrifying effect on the minds of global investors. Suddenly the "default-prone" U.S. dollar, running up huge new debts



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**Jean M. Galvin**  
Season's Greetings Drawing  
**Victor Juhasz**  
Page 1 Illustration

daily and depreciating internally via accelerating inflation, was no match for the hard currencies of the post-war reconstructed dynamic economies. It was a simple matter of relativity: Investors could find better homes for their savings. As a result, the U.S. found it increasingly difficult to fund its balance of payments deficit. Despite repeated intervention and higher interest rates, the dollar continued to slide.

#### **It didn't turn until Volcker put his foot down.**

Right, eventually, the attempt to rein in domestic inflation brought about a drastic change in monetary policy. Interest rates soared, inflation was halted, and the dollar stabilized. The supply-side Reagan Administration provided a further fillip, and the first dollar bull market in more than a quarter century was born. Confidence had returned, but, more importantly, the dollar, except against the Japanese yen, was no longer viewed as an inferior repository of savings. European economies had begun to lose their erstwhile dynamism, and relative inflation, even in the land of the hard currencies, was no longer noticeably lower. Booming Japan, with its low inflation rate, became the darling of investors. Once again, it was a game of relativities. Eventually, repeated unsterilized interventions took Japan over the edge: The unsustainable boom burst, and a decade-and-a-half-long stagnation-cum-deflation took hold there.

#### **No argument, Japan and Europe have problems of their own—**

Significant ones. A revitalized U.S. economy is now competing with an anemic, ossified Europe and a struggling Japan. On OECD's reckoning, the U.S. economy grew 2.9% in 2003 versus 2.7% for Japan and 0.5% for the euro area. It expects the U.S. to grow 4.2% in 2004 versus only 1.8% in Japan and 1.8% in Euroland. On inflation rates, the U.S. (1.6%) showed a lower increase than the euro zone (1.9%) and a higher one than Japan (-2.5%). Next year, we are still expected to better Euroland and to narrow the difference with Japan. What's not to like about this for the U.S.?

#### **Well, those U.S. numbers look pretty anemic themselves, versus ones coming out of China and Asia.**

Sure, they are likely to continue outperforming the U.S. for years to come—from their much lower bases. Especially China and India. But relative growth differentials are *not* a sufficient condition to attract investors. Investors need liquid and attractive investment markets, too. Euroland and Japan enjoy good investment markets but suffer from relatively inferior economic performance. China, India, and

the rest of Asia enjoy superior economic growth but suffer from either relatively closed and controlled investment markets (China and India), or small and opaque ones. In short, they are not markets that can accommodate huge flows of capital. In fact, Asian central banks have shown an overwhelming preference for U.S. assets, and private Asian investors likely will do the same.

#### **Or maybe not. Won't our huge deficits lead to a big default premium on the dollar?**

It shouldn't. What is different here is that any other time in history that another country ran a large current account deficit, the strains began to show. You would have the central bank actively trying to defend the currency. You especially would see very large increases in interest rates to try to attract funds to cover the current account deficit. We have not seen that in the U.S.

#### **So be very thankful the dollar is the world's reserve currency?**

Yes, but my point is simple: One cannot focus on only one side of foreign exchange flows. *Trade flows are offset by investment flows.* If these flows return the trade flows to the same destination from whence they came—i.e., the U.S., for lack of better alternatives—the price effect on the dollar is minimal or nil. To the extent that some net investment flows move abroad—which has probably been happening in recent

months—the trade-weighted dollar does fall. Still, the limited-capacity Asian markets and the economically unattractive European and Japanese ones are no match for the depth, liquidity, and superior prospects (because of better growth, better productivity, superior labor mobility, superior transparency, and entrepreneurial spirit) of U.S. markets. It is only a matter of time before investment flows again overwhelm trade flows, and the dollar recovers.

#### **Time matters a lot in these markets.**

That, I concede. And the timing *could* be set back by a number of events:

- 1) If Iraq becomes ungovernable, the U.S. could be perceived as having entered another Vietnam. Investors drawn to make facile comparisons to the late '60s would sell dollars.
- 2) A second terrorist act of consequence on U.S. soil would probably lead to another dollar-selling episode. With time, of course, these fears would be seen as overblown, as 9/11 and the most recent Turkish experience have demonstrated. Safe-haven effects are short term in nature and do little to deflect long-term fundamentals. (Witness the steady deterioration of the Swiss franc vis à vis the euro so far this year, despite repeated terror-related rallies.)
- 3) A revaluation of the renminbi could lead to heavy dollar selling. In which case, the "psychology" could be right, but

the economics would certainly be incorrect.

### Why is that?

By lowering the trade-weighted dollar, a Chinese revaluation would take pressure off other currencies. In time, the market would return to its fundamentals. My worry list could go on. Still, short of an event that would *permanently and negatively* affect U.S. investment standing vis à vis the rest of the world, the dollar *will* recover and possibly move to new highs.

### You're actually a bull on the buck?

Absolutely, *long-term*. A better-integrated world, where investment flows move towards the most attractive destinations, is becoming a major plus for the U.S. dollar, provided its economic and financial lead is preserved. Investment flows, rather than trade flows, should continue to be the main determinants of forex prices. All this bearish dollar talk based on twin deficits, ruinous debt, and eventual default is definitely grist for the mill of momentum players. But it is poor economics.

### Point to something better—

Well, for example, on the basis of its relative inflation experience over the past decade, the yen also is a bit undervalued. It is not unrealistic to think of a 15%-20% lower dollar/yen rate. To get there, though, the Japanese must first realistically address their banking problems and their inefficient use of capital—which are partly brought about by low interest rates. Then, with a healthier and stronger economy the BoJ would allow the yen to appreciate.

### Yet the twin deficits in the U.S. don't give you pause?

My take is that what's happening with those deficits is not stressful. But are they sustainable, ultimately? I don't know. It's *possible* that the world *wants* to own a lot of U.S. assets. It's a cliché, almost, that the dollars we spend on imports get recycled back, mostly via investments in the U.S. Treasuries market. But it's possible for part not to come back, putting pressure on Treasuries. In fact, that's obviously what is happening at the margin because the dollar *is* under some pressure. But you cannot say the pressure is strong. The U.S. has had very little problem, really, attracting money. But if you let this thing continue—it builds momentum. And Mo' has an effect; it does build upon itself, psychologically. Especially because more and more hedge funds are drawn to momentum—and hedge funds today are major—and very leveraged—players. Besides, it's not hard to do billion-dollar transactions in foreign exchange markets. You don't need a lot of money. Leverage is very available. We have a very accommodative central bank. As does the rest of the world, generally.

### So the dollar's slide *does* have momentum—

And we have a lot of momentum players today. A lot of technical traders. Most of the currency market today is ruled by technical traders, rather than fundamental, discretionary traders. So it's hard to know just how far it will overshoot. But it will overshoot. Just like it overshoot on the upside.

I've seen some charts of the dollar lately that look mighty sick.



Exactly, which tend to bring in more momentum players. Then, too, we also have a few unusual things happening. The Bank of Japan is intervening continuously here—

### Yet is only managing *to slow* the yen's rise.

Then we have this weird situation where the euro gains on almost everything else, because the euro is 1) the most liquid currency, after the yen, and 2) the one that doesn't have an implicit threat of intervention. So if you want to *play*, the plaything is the *euro*. But if you look at the euro *from a value point of view*, European economies are in a horrible stagnation, with very high unemployment, and serious fiscal problems that show how little credibility EMU really has. Their lack of growth is being compounded by the euro's big gain against the dollar, which in some sense is choking future growth. Yet momentum traders are driving that currency higher, for no other reason than that they don't like the dollar and they need a football to play with that is liquid and free of intervention. Only a little of the hedge fund activity is spilling over to the Canadian, Australian and New Zealand commodity currencies, where fundamentals are much better, simply because they can't easily do billion-dollar transactions in those markets.

### You're implying the dollar's bearish momentum can't last because it flies in the face of the fundamentals?

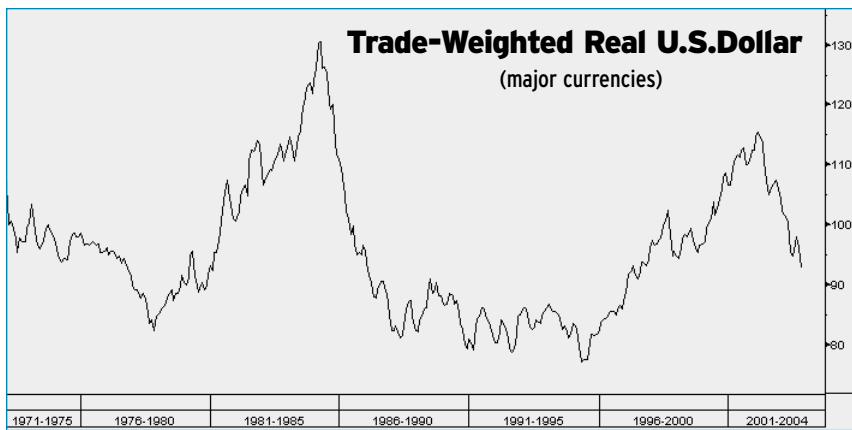
Put it this way: The sustainability or unsustainability of the current account deficit is *not* a matter of history or of statistics. It depends, in each case, *on who is running the current account deficit*. If Brazil or Argentina runs a deficit, *they have to earn those dollars*—and it's unsustainable, especially if their debt starts to rise above 50%-60% of GDP.

### But the U.S. is not Brazil or Argentina.

Exactly. The U.S. *doesn't have to earn money to repay creditors*. The U.S. just has to be a good place to invest money.

Key: What Charts Are These?

1: GE  
2: MSFT  
3: 3M  
4: X  
5: TXN vs. NDX (thin line) &  
SPX (blue)



And because it issues the reserve currency, it can *print* that money, if it wants to. It does not have what's known as the transfer problem. Granted, if printing dollars results in higher inflation, the dollar will depreciate. Still, higher interest rates *should* compensate investors for that depreciation. *In real terms, the dollar need not depreciate.* So the dollar bears' first premise is faulty. It may be that the U.S. can become more and more indebted over time; that what ever looks high will become higher later; that the U.S. can afford to borrow money because it is highly productive. I have a problem with the bears' second premise, too. I find it doubtful that a drop in the dollar can redress the basic issue, which is the imbalance in trade. There's little evidence that a 15% or 20% currency adjustment will make an enormous difference there. The numbers in the studies are all over the place. The academics can't agree on whether there is strong or weak elasticity in the balance of trade. Almost all do agree, though, that the income effect is much greater than the price effect.

#### You lost me there.

I mean, is the U.S. growing faster than the rest of the world? If it is, then it is absorbing imports at a much faster rate and the "income effect" on the trade deficit is much greater, than "the price effect," of U.S. goods being a little cheaper than European goods, for instance. But it's not so clear that the balance of trade statistics provide any realis-

tic picture of what is happening in this very complex world. In fact, international trade is exceedingly hard to measure. It may very well be that a lot of currency speculation is being based on statistics that aren't very meaningful anymore, given that so much is produced abroad. It really comes down to traders talking about the trend—and then justifying the trend by claiming that the U.S. is running an unsustainable current account deficit. But we see very few signs of stress. The U.S. has been able to take this devaluation, so far, without any problem in its money capital or bond markets. It's been orderly. What's more, the dollar's direction may start to change as soon as perceptions change just a little. After all, the U.S. is growing faster, and has the potential to keep growing faster than any other country except China. And neither the Chinese nor the Indians are really competing with the U.S. for capital. There is no way that you can invest \$20-\$30-\$40 billion a month, there. If you think you can, good luck to you, because you will probably lose all your money! The U.S. may have Enron and IPO favoritism and sloppy fund oversight, but they're part of having a big capital market. It is still the most transparent and best place in the world to invest, in terms of growth prospects. Sooner or later, that will be reflected in the currency.

#### Which brings me back to asking, when?

One way the downside momentum could be stalled is through what used to be called a concerted intervention. The Japanese or European central banks decide, "We've had enough. This is killing us." So they make a joint public statement and intervene in large amounts. Concerted interventions, when they're not carried out by just one country, *do work*—unlike what Japan has been attempting, alone. But concerted interventions are rare events, happening only when a number of central banks, including the Fed, manage to agree. So rare that they change market psychology; can break the back of momentum. That's when you'd see all the momentum players rushing to unwind positions and bring the market back to a level that makes more sense. But, so far, the Europeans have not said anything. So as a trader, I would not stand in the way of this momentum trade.

#### You're a bull, but won't put your money where your mouth is? How is Friedberg Mercantile positioned?

First of all, while we do trade currencies, a much larger part of what we do involves a fund of funds program that mainly trades international bonds. Of course, part of the total return on international bonds has to do with the currency you pick. The rest, with the movement in interest rates. Anyway, we have now cut back almost completely on foreign exposure in our international bond portfolios. We used to have Canadian exposure and a little Central European exposure. We're down to only 15% of our total bond portfolios now in foreign currencies. These portfolios don't trade rapidly and we don't want to incur too much slippage going in and out of positions. Then, too, from the point of view of "value," there's almost none left in the foreign currency arena. We like Turkey a little bit, and Poland and Hungary because they have very nice growth prospects and high interest rates. I don't see any value in euros, yen, certainly not in Swiss francs, that's a

## Trading Ideas

### Vietnam And The Markets

What happened to the markets during the Vietnam War. We went from 16,000 troops in '63 to a peak of 550,000 in 1969. From '63 to January 1973, the markets roared only to crash to a painful low in '74/'75.

More important is what happened to the purchasing power of the US\$. From '58 to '68 the CPI as reported by the Government (caveat emptor) grew by 20%. From '65 to '75, LBJ and Nixon, guns, butter and the closing of the gold window in 1973, the CPI grew by 70%.

Relating this to the present situation, we have a war, record deficits with more to come (i.e. Medicare drugs) and benign neglect of the dollar. I would be surprised if the decline of the purchasing power of the US\$ over the next five years averages less than 5% compounded. Just to stay even after taxes and a little expenditure on the family, one would have to earn 10% compounded.

Which is no mean feat for mere mortals.

**Robert Feibusch**

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## Growth Rates of Output

Compounded annual rates  
(Output: Real GNP or Real GDP)

1963-1973	
Germany	4.7
Japan	10.4
United States	4.0

Source: *International Economic Condition, July 1980, The Federal Reserve Bank of St. Louis*

**"A simple matter  
of relativity:  
Where do investors  
find better homes  
for their savings?"**

## Per Capita Real GDP Growth Rates At PPP Exchange Rates (1982\$)

	1974-1980	1980-1986
<b>Germany</b>	2.49	-0.83
<b>Japan</b>	3.36	1.37
<b>United States</b>	1.35	1.98

Purchasing power parity (PPP) is the estimated exchange rate at which the currencies of two different countries would purchase the same bundle of goods and services in either country. Throughout the floating exchange rate era, which began in 1973, exchange rates have not conformed to PPP. For example, in 1986, the average PPP exchange rate for the Japanese yen was 223 per dollar compared to the actual market rate of 168. Similarly, PPPs for the German DM and United Kingdom sterling were, respectively, 2.48 and 0.57 per dollar compared with actual rates of 2.17 and 0.68. These deviations from PPP—24.2% for the yen, 12.5% for the DM and 19.3% for sterling—imply that international comparisons of real income and the growth of real income using market exchange rates are biased. Valid comparisons can be made only by comparing output and growth rates at PPP. (*International Economic Condition, Aug. 1987, The Federal Reserve Bank of St. Louis*)

totally stagnating economy. By the same token, you don't go short euros on a value basis; that's standing in front of a moving train. Maybe, when there are signs the momentum is overdone—perhaps very large increases in open interest in the Chicago markets, or lopsided surveys of market participants, you can take a leap and short the euro, but it's difficult to time. It's best to wait for something that breaks the back of the rally. You won't catch the absolute peak in the euro that way, but you won't get skinned alive. Because we're talking about a market that needs something dramatic to break its momentum. We are talking about psychology, *not* talking about value here. For now, the greenback is being pushed down by momentum feeding on itself. But sooner or later, they'll need new stories to feed the bear.

### Where *should* the dollar be trading?

It's hard to say. These are not precise numbers. They are very vague—undefined ranges—that are compatible with flows of goods, services and capital. If I say that somewhere between 90 and 120 or 130 on the dollar/euro is an acceptable range, I'm not trying to be vague. Look at my long-term chart [page 4] of the real, trade-weighted dollar. It shows the currency's response to everything in the last 30-plus years: Big dollar crises, dollar strength, the Reagan period and the Plaza accord. Through it all, the dollar has fluctuated over a fairly wide range without much of a trend. So in real terms, it seems to be well-priced *anywhere in that range*. Besides, no one can pick a precise level because capital flows are much more important today than trade flows. It's conceivable, if you were dealing only with trade flows and had an enormous and very sophisticated econometric computer, that you could calculate a level that would equalize trade balances. But after all that, you still wouldn't know exactly where the dollar *should* trade, because of the overwhelming importance of capital flows. Which can be just as happy or just as unhappy with the buck at 130 as at 90. It all depends on growth prospects, long-run productivity and profit potential. So I can't specify a level for the dollar. Just its range, in real terms. We are somewhere in the middle of those extremes now. But there *should* be an upward secular trend in the dollar in the world we live in.

### Why?

Based on politics as well as economics. The U.S. remains extremely adaptable to technological changes. Very much a creator, innovator. Politically, in a world where showing strength is important—if you can do it prudently and at the right time, there's no place else to go but the U.S. The U.S. is by any measure the strongest country in the world. European countries have shown—the word appeasement comes to mind. They are being influenced by very large Muslim minorities. The Korean problem doesn't go away.

### We can't "police the world."

That's true. And the bears say that the U.S. is overextended, that there's a limit to imperial power. It *is* possible to overextend your resources. But it is more a question of signals than of muscle. More than anything, the U.S. during the Clinton Administration did not give the proper signals. You don't need to have the military fighting five different wars. You *need* to show that you believe in something and that you will fight for it. If you do it once or twice, you can undo some of the damage inflicted since Vietnam. The U.S. will not need to back up its leadership with arms often, *if* it's perceived as willing to judiciously use its power. So I expect a more sustained upward trend in the dollar, combined with the surge in productivity.

### You actually believe the productivity stats?

The numbers are probably exaggerated a little. But even guys who were skeptical, are coming around to conceding that indeed there has been a much-greater-than-anticipated (and much stronger than we've experienced in recent history) surge in productivity. It probably has to do with the fact that it has taken time—I am still not using a computer, I use paper. But maybe even I, five years from now, will start using a Palm. Clearly, it takes time for people to learn to use technology in the best possible ways. Which is possibly why we are seeing such a surge in productivity now.

### There is a learning curve, no doubt. But those statistics don't account, for instance, for the massive dent it puts in my productivity when something goes wrong with my computer.

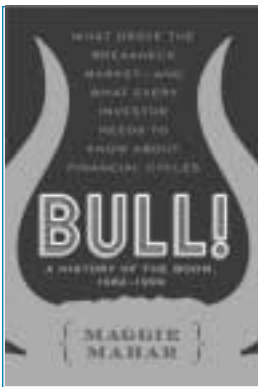
Just like they never measure, either, that you actually work longer hours than you used to, because your laptop is always available, even at home. There's no such thing anymore as leaving the office at 5 or 6 pm. It may be that, adjusted by hours worked, our productivity is *not* that high. But the increases in the statistic are undeniable. Surging productivity isn't necessarily bullish for corporate profits, however, because it competes away profits. But it is *very good for the consumer*.

### The ones who manage to stay gainfully employed—

Right, but the economy *is* producing jobs. 5.9% unemployment. I remember when that was an *objective*—in the 1960s. Officials thought that would be incredibly low. So we have a low unemployment rate in historical terms. Just very high expectations; because everybody is nostalgic for 4.5%. The truth is that the economy is producing jobs more and more efficiently.

### We strayed from the topic before. You still haven't told me what currency positions your traders have on.

In our currency program, our traders are currently long yen. As I said, of all the currencies, only the yen is probably "worth" in very qualified terms, something like 10-15% more. Because Japan has had deflation for so many



## Trading Ideas

**Gift Idea:** Maggie Mahar (full disclosure) is a former colleague at *Barron's* who left the fold a few years before I decamped to start W@W.

Other than a brief detour as a columnist for Bloomberg, she's been using her time well indeed, on the evidence of "Bull," her recent book, published by Harper Business.

Thoroughly researched with the cooperation of the some of the Street's most prominent skeptics, Engagingly and breezily written, "Bull" illuminates the origins and tracks the course of the late great bubble market. Along the way, Maggie paints colorful portraits of many of the era's leading men and ladies, as well as of not a few of the just plain folks who were swept up in the herd's rampage.

The upshot: "Bull" is lively social history with an attitude. A thoughtful holiday gift for anyone, market pro or Uncle George, still wondering what hit 'em, and whether it can be avoided in the future.

(A couple of short excerpts, Maggie's takes on Henry Blodget and Jean-Marie Eveillard, are included in this issue's digital version, on the website.)

years. I don't have a problem with that position, but I don't own it myself. My own inclination at the moment is to trade mostly crosses, which have more value—though they may not be showing more profits at the moment. I am bearish on the Swiss franc, vis a vis the euro, for instance. But rather than shorting the Swiss and going long the euro, I have substituted some of the Central European currencies that I mentioned earlier for the euro leg of the cross. So I am long growth and short stagnation, with points in my favor. I also like the Turkish lira; they finally are doing things right. This government seems to have better control and better public support—

### **Ironically, that's probably what has made Turkey a terrorist target.**

Right. To try to destabilize them. Because Turkey is starting to be a model for what the Mideast should look like. Their inflation rate is coming down nicely. They're fixing their banking problems; doing some privatizations. But most important, the political fragmentation that used to define Turkey, you just don't see today. The IMF loves what they are doing—not, mind you, that the IMF loving what *any* country is doing is necessarily a great endorsement—but for now, Turkey is getting credits and money and that is working for them. Other than that, in currencies, I'm not doing anything. I just don't see value trades.

### **Then let's switch to commodities. They've been spectacular—so much so that I wonder if they haven't gotten overdone, but Jim Rogers tells me it ain't so.**

No, the commodity area is justifiably doing well. We have a strong economic recovery around the world. It's pretty synchronous, That is putting some pressure on resources. The world has lived with relatively lower levels of inventories in recent years than it used to, as a response to three things: Interest rates were high, so people learned to economize on resources, technology came along to allow you to run down inventories (just in time inventory management) and the bandwagon effect. Because prices were so low for so many years, a lot of middlemen and users were persuaded to live with lower inventories. But now that is becoming a bullish factor for many commodities. In the grains, for instance, we have very low inventories around the world. In the metals, Chinese buying has been pretty spectacular, so copper and lead and zinc and tin and all these commodities have had a nice move. But mind you, *if you adjust them for real prices*, none of them are anywhere near where they were 20 or 30 years ago.

### **At the top of their own bubble, you mean?**

Right, but adjusted for inflation, 90-95 cent copper in current dollars isn't even a shadow of its price back in the 1970s. Maybe it's at a third of the highs it reached in the 1960s and 1970s. And these are just normal reactions in the commodities markets, given world economic recovery. China has been a big factor in the oil market, too. Plus, you've had a few disruptions: Venezuela, Jordan, and Iraq. So what has been happening to prices makes sense.

### **Aren't they due for a breather?**

Perhaps. But the economic recovery still seems to be picking up steam, so it's not unreasonable for commodities to go higher on the whole.

### **Isn't it worrisome that China has been building stockpiles, and might suddenly pull in its horns, because its economy is overheating?**

China's economy *is* overheating, and that is an ever-present danger to these markets. But there isn't any real evidence that it has been stockpiling commodities. In fact, in some cases, like in corn, also in cotton, they've run down old stockpiles. They are trying to live with more reasonable inventories. We don't have evidence of speculative inventory build-ups in China. The Chinese *are* trying to slow down their economy. But they are *not* really doing a great job at it. They haven't raised interest rates, credit is *not* scarce. Rates are still in the low 3% area. You can't slow down an economy growing credit at 20%-25% a year with 3% interest rates.

### **Not normally. But it's not a capitalist society. They have other ways—**

True, the Chinese are *not* capitalists—but they are going to have take stronger credit measures to slow the economy. There is already some inflation coming into the system now, where they used to have deflation. I don't see China slowing down *yet*, though, and with the rest of the world is still picking up steam, many commodities should do well.

### **You must have favorites here.**

One is gold, which isn't necessarily that tied to industrial activity but does have some very interesting fundamentals—some having to do with the fact that two of the major bearish factors that weighed on it are basically out of the way. One was disorderly selling on the part of the central banks, which drove the market to its \$250-\$260 lows. The so-called Washington agreement did a lot to stabilize the market. In it, the central banks said, "We want to demonetize, but we're going to do it in an orderly fashion, for our good as sellers, and for the market's." The agreement covered the sale of 400 tonnes a year, and will probably be renewed next year with a little increase, maybe to 500 or 600 tonnes a year. But the point is that the market no longer feels it's fighting a phantom, it can discount central bank sales. The other big change is that the mining companies were selling forward, a practice that was depressing prices. They had built up huge books of forward sales; The average was three years' of total world gold production. Then gold prices started rising and investors in gold shares began expressing a strong preference for *unhedged* producers, so they could capture the commodity play. Which produced a new fashion in mining company management—unwinding hedges. The last producer to finally admit that they will do that is the great **American Barrick** [ABX], the one that initiated the whole hedging process. In any event, the lifting of gold hedges is providing a bullish undertone to the market, just the opposite of when forward sales put bearish pressure on gold

prices. Then, too, gold has very bullish fundamentals because the gap between actual fabrication and demand is large. When it can't be filled well by mining company selling and central bank selling, the natural tendency is for the price to rise.

#### **Until it brings investment sellers out of the woodwork.**

That is quite a way off. We are quite bullish on gold. Sure, from time to time, we will see reactions, but the bull market in gold could run for maybe two years from here, it has considerable upside.

#### **From your mouth to God's ear. Full disclosure: I own a little physical gold, a few gold fund shares.**

The new ETF that will be listed on the NYSE should give gold a further boost, making it easier for people to own it. Increasing investment demand for gold is something we have not seen for many years. There was actual disinvestment, in fact. People were unloading their investments in gold. But as gold's price has risen, that has reversed. It's starting to generate some momentum. Gold has done very well now, in relation to the stock market, in relation to the bond market. Suddenly it's become a new "asset class." You know what the definition of an asset class is, don't you?

#### **"Anything that goes up."**

So now gold is an important asset class and you're going to see disinvestment turning into investment in a big way. That is when prices can go anywhere. The upward momentum in gold is far more justifiable today on its own fundamentals than is the downward momentum in the dollar.

#### **Is there a 1-to-1 correlation there?**

Not necessarily. More and more you will see gold gain against currencies. It has already done better than the euro and the yen over the last year or so. It will do better because it has real fundamentals. The truth is that there is not a lot of gold in central bank vaults any more. If you excluded the U.S. and France (countries unlikely to sell their gold) central bank holdings were no more than three or four years worth of demand, I calculated a couple of years ago. By now, they're less. On the other hand, Asian countries that are accumulating a lot of dollars, like China are not likely to necessarily follow the West's lead on demonetization; might even accumulate some gold. They have very little. Imagine how exciting it could be if the Chinese decided tomorrow to put 10% of their reserves in gold—that would be a lot of gold.

#### **Come on Albert, now you sound like a classic stock shill.**

Exactly, it's a nice story. It's the pizzazz that you can create. They have given indications that they like gold, but we don't know. Surveying other commodities, one *has* to be bearish on oil longer term, especially in real terms. The price of oil has been dropping for 25 or 30 years in real terms; that will continue.

#### **Why?**

Because worldwide demand growth is very slow and because we keep finding more oil than we ever thought we had. Also because the Russians are now a major force in oil and will continue to increase their production dramatically. Nonetheless, near-term, the economic recovery is so strong that it's exerting upward pressure on prices, as have production interruptions in politically unstable lands. Iraq has still not been able to get back to pre-war production levels, but they say they will in the next three months. What's interesting is that amid these problems, OPEC's share of total world oil production continues to drop—because they are trying to maintain prices. In other words, OPEC has shouldered the burden of keeping nominal oil prices high.

#### **By cutting their own production.**

And that means cutting their own production.

#### **Which didn't bother them when they could assume ever-rising prices for their wasting oil assets.**

A very bad assumption. The question is at what point will OPEC's Gulf producers (because almost everybody else is producing at capacity) with their very low marginal production costs and the capability of increasing production rapidly, no longer be willing to defend prices at the expense of revenue? Especially with Russia taking over spot No. 1 in production, My bet is we see OPEC breaking up before long, or at least proclaiming, "We've accommodated the oil market for too long, it's cost us a lot of money, we're going to stop." That's why the real price of oil has to go down: a price war is inevitable. You're only going to see those fissures on the next economic downturn, not now while economic growth is supporting oil's price. But I wouldn't go long the oil market, long-term. There's no value there, except for a very short-term trade.

#### **It is a depleting asset—**

I discount that completely, we've been "running out of oil" for 70 years; we keep finding more. And one day we'll make breakthroughs in alternative energy sources. And the price of oil will collapse like whale oil in the 19th Century. There are better ways to play the economic recovery theme—base metals, gold and some grains, which have very tight inventory positions.

#### **Such as?**

It looks like we'll have to import soybeans, for example, to meet demand before the new crop comes in. The end-of-crop inventory number is actually calculated by the USDA, based on its supply and demand forecasts, to make sure there's always an acceptable level of supplies on hand. It currently implies that demand must be reduced a little, and supply must increase a bit from, say, South America, to supply U.S. market demand. The open question is what bean price will be sufficient to carry out this price rationing. The same sort of situation exists with wheat—and there are other interesting commodities with low inventories, strong demand that will participate in this industrial recovery.

#### **It sounds strange to talk about participating in the industrial recovery with soybeans.**

How else? Yes, we can buy shares. Stock prices look higher from a technical point of view. I'm very impressed by the technicals. But I'm not impressed much by the fundamentals. The valuation problems everybody talks about *are* there and it's hard for me to see large increases of corporate profit going forward, as we said. I think that Buffett was right when he said that equities would see 5-6% a year growth over the next few years, given dividend levels. Commodities should provide more attractive returns.

#### **Are you seeing a surge in demand for your institutional commodities management services, now that they're becoming an "asset class" again?**

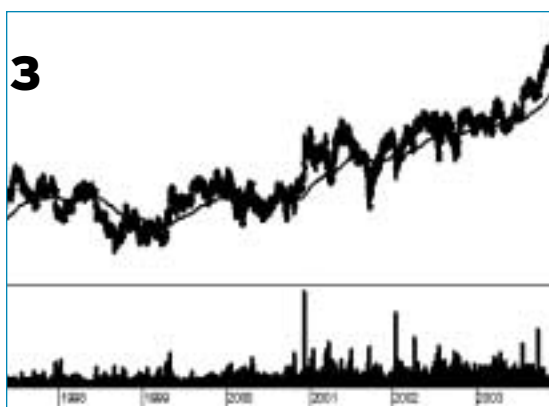
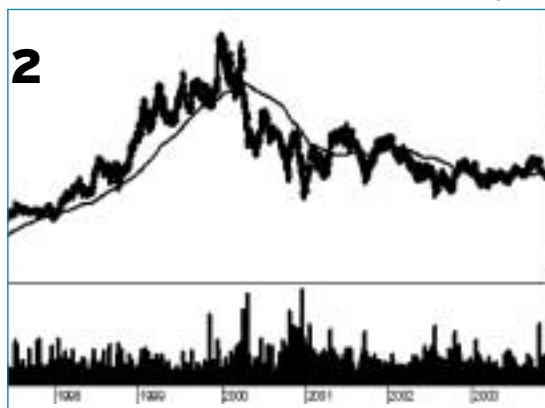
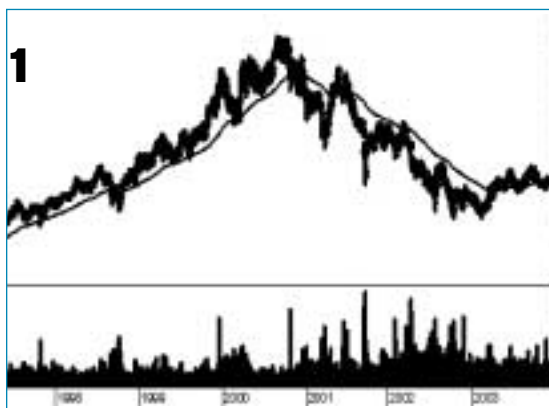
No, it's funny, I haven't seen a lot. There's been a little bit of interest in gold, but the gold bugs have been there forever and they just wake up from time to time. Other than that I don't see a lot of institutional, much less public participation yet in commodities. But they're still not an "asset class" in real terms. You won't hear much about them on CNBC until we cross that distant frontier.

**Thanks, Albert.**

# tradingideas

## What Charts Are These?

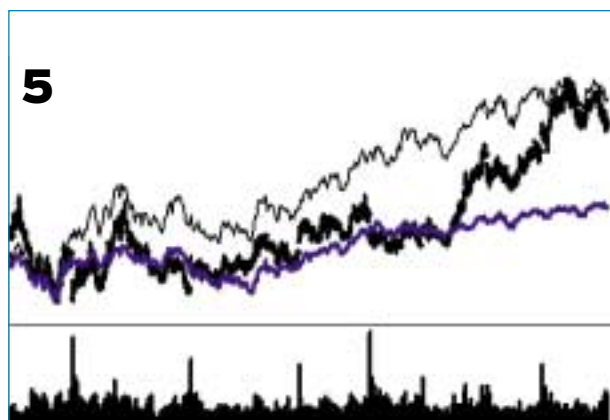
(Answers, page 3)



### Year-End Brain Tease

Here's a little challenge for the office holiday festivities. (You supply the libations.) It's been quite a year for investors, the more venturesome, the better; quite a relief to see positive returns again after those three dreary post-bubble years, so let the partying begin. If things start getting a little out of hand, though, it might do well to pass around this sheet, not so much for the guessing game, but for the potentially sobering implications of the correct answers (see page 7). I pulled the charts together after chatting a bit with one of Wall Street's most widely respected elder statesmen, a strategist who these days shares his insights with but a few.

This year's big B-wave recovery has played out pretty much as my guru expected, with the sharpest percentage gains in the Nasdaq stocks that bore the brunt of the massive A-wave down, and the market's recent strong breadth readings, he adds, probably give the cyclical bull more time to roam higher. But this seasoned observer of the market's ebbs and flows warns that it's a mistake to be transfixed here by moves in the broad averages and ignore what's going on under the surface. There, he sees many of the large-cap bubble market favorites, the stocks that still dominate institutional portfolios, tracing out chart patterns that are just "dead" like (1), which is a large-cap that this year has acted like a lot of Nasdaq's rebounding small fry, or are utterly uninspiring (2). "Which fits, if we're going to have a post-bubble 6% average rate of return for the S&P, over this decade, that means that a lot of big stocks aren't going to do well." The classically positive (3) and (4), by contrast, belong to a couple of old-line prosaics. A host of denizens of the market's broad middle, including (3) even have been notching new highs. Indeed, the S&P mid- and small-cap indices have hit new all-time highs, while the headline averages, despite their healthy '03 bounces, are mere shades of their former selves.



"The thing to watch for right now are signs that the speculative B-wave rallies are faltering. Techs, the QQQs, have been outperforming the S&P and the Dow ever since November 2002. Yet in the last two weeks, the QQQs didn't make new highs with the Dow and the S&P, and actually went down a little more in the reaction during the prior correction/consolidation." In short, the techs [a hint for (5)] may well be signaling the beginning of the end of the B-wave rally. "Like the way that big relative strength change in Nasdaq in March of 2000, was the start of the end."

"But have a great holiday," he concluded. We intend to enjoy it. Hope you do, too.

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