

The Supply Side Guide of Classical Capital LLC

Vol. 2008, No. 6

April 3, 2008

A. Hamilton



A. Mellon



LEWD, CRUDE FUEL PRICES

By Wayne Jett

©April 3, 2008

The high point of President George W. Bush's economic policy was in May, 2003, when House Committee on Ways and Means chairman Bill Thomas engineered well-designed cuts in marginal rates of income tax. Absent the strong surge in economic growth that followed, the president almost surely would have been denied a second term. Sadly, that resounding economic success was brought to a standstill by bad monetary policy. Democratic presidential candidate Hillary Clinton credibly points to Jimmy Carter-like "economic malaise" during Bush's eighth and final year as president.

The current state of U. S. economic affairs is pitiful:

- The dollar devalued 65% in five years
- Economic growth near zero or worse
- Dysfunctional mortgage and credit markets
- Major financial institutions failing
- Russia proposes international standards for reserve currency
- France asks no further use of dollar as weapon of trade war
- Euro strong vs. dollar even after ECB injects \$500 billion euros

With problems this bad, the president should have trouble-shooters looking for economic problems that are fixable. That means something outside the Federal Reserve's ambit, as the Fed and its hordes of acolytes insist its operations exemplify perfection.

Ask most Americans what the biggest problem in the economy is right now and they will say the high prices of gasoline and diesel fuel. Four decades ago, a poorly considered Supreme Court decision noted that obscenity is difficult to define but easy to recognize when you see it. Gasoline prices are near \$4 per gallon and diesel fuel (used by truckers in swimming-pool quantities to haul food and other essentials) are

even higher. In the past 12 months, crude oil is up about 40%, gasoline is up about 25% and diesel fuel is up nearly 70%. Independent truckers unable to make ends meet are striking April 1-3 to call attention to their plight. Americans struggling to provide for families see these prices as *obscene*.

Bush administration officials respond with platitudes about alternative fuels and lectures on supply and demand. True, these are better responses than proposals from Democratic politicians to pillory “big oil” executives for price-fixing or to take their profits with taxation. There is a better avenue worth exploring.

Setting the World Price of Crude Oil

Neither “big oil” nor OPEC sets the world price for crude oil. The price is determined by trading in oil futures contracts primarily in the U. S. Supply and demand historically determine prices of commodities such as crude oil. Normally, the price of crude oil rises when demand exceeds supply and inventories decline. In the case of crude oil, however, in 2004 its price began departing from norms of supply and demand. Since 2004, crude oil prices have risen even when inventories are high. In the eyes of every fuel consumer, that anomaly is worth examining with a microscope. Why has this been the case, despite all historic experience to the contrary?

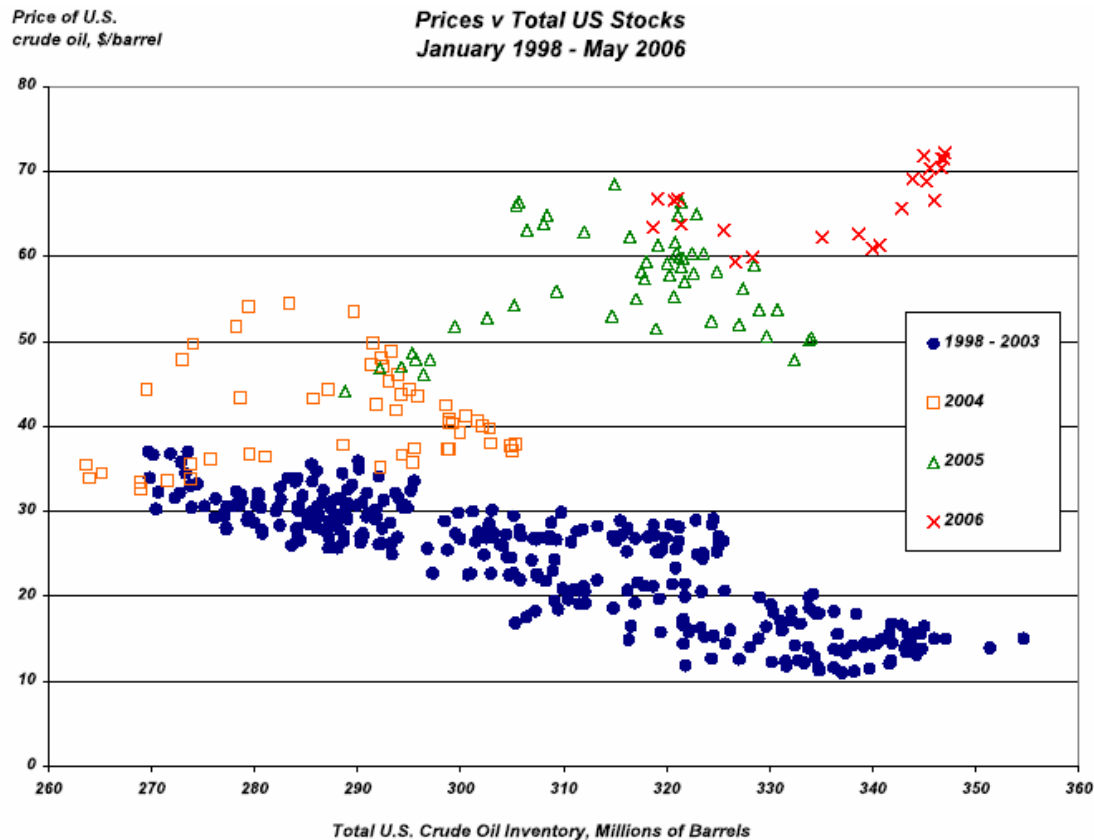
Surprisingly to almost every observer, that question has already been investigated in detail. In 2006, the Permanent Subcommittee on Investigations of the U. S. Senate Committee for Homeland Security finished its inquiry and issued a report.

“Enron Clause” Allows Unmonitored Oil Futures Trading

The Senate PSI found that an obscure federal statute known as the “Enron clause” enacted in 2000 during the last year of the Clinton administration allows trading in crude oil futures contracts *without reporting large transactions to the Commodities Futures Trading Commission*. The “Enron clause” permits such unmonitored trading of oil futures between big investors *so long as the trade is between institutions and does not occur on an exchange that performs a price-seeking function*. The senators found that about three-quarters of all large transactions in crude oil futures contracts during 2006 occurred on such institutional exchanges without reporting to the CFTC. Importantly, the PSI reported that the CFTC actually has jurisdiction to monitor all of this “off-the-record” oil futures trading *because the futures exchanges concede they perform a price-seeking function!*

The Senate PSI found that hedge funds began buying crude oil futures contracts in 2004 on unmonitored institutional exchanges, and the price of crude oil departed from historic norms in relation to inventories. In turn, this departure from historic pricing norms enabled the hedge funds to depict a secular bull market in oil, which attracted additional investments in crude oil futures contracts by large pension funds. This second tier of investors escalated crude prices further. New futures contracts could be bought with terms locking in profits. The price of crude oil reflected in the futures contracts moved ever higher.

Here is the Senate PSI's chart depicting the historically abnormal price action since 2004.



Data source: EIA

Obviously, the price of crude oil has soared far beyond the 2006 peak just above \$70 per barrel to current prices above \$100 per barrel. Since 2004, the price of crude oil has outpaced the sharp drop in the dollar's value, so this is not simply a matter of dollar inflation. The historic oil-to-gold ratio of about 14 barrels per ounce has dropped to a historic low near 7 bbls/oz and oil is presently very expensive at 8.6 bbls/oz after the drop in gold to near \$880/oz.

CFTC Ducks Regulatory Duties

Seeing this suspicious, unmonitored environment for trading futures contracts that are so crucial to the world price of oil, the Senate PSI adamantly urged the CFTC to exert existing authority over exchanges with price-seeking functions so as to require immediate reporting of all large transactions in crude oil futures contracts. Inexplicably, the CFTC did nothing as the 2006 elections handed Senate chairmanships to the new Democratic majority. Then CFTC belatedly reported in October, 2007, that it has no jurisdiction. No action will be taken without new laws from Congress.

President Bush and other Republicans ought to relieve most Americans of their primary reason for thinking the country is on the wrong track. They should leave no stone unturned in learning whether the price of crude oil is being manipulated by hedge funds through unmonitored trading in futures contracts.

A good first step would be for President Bush to pick up the phone and call Norm Coleman, the Republican senator from Minnesota who chaired the subcommittee that wrote the report in 2006. Or, Senator Coleman, call the president. Congress is talking about combining the CFTC with the Securities & Exchange Commission. Before doing anything else, the president and Congress should be sure that trading in crude oil futures contracts does not go another day unmonitored. ~

NO MORE POWER FOR FEDERAL RESERVE

By Wayne Jett
© April 3, 2008

As much as President George W. Bush is committed to the well-being and security of Americans, his economic policy has become perfectly suited to no one except Wall Street (those Franklin Roosevelt pejoratively called “organized money”). With all the talk of emulating Reaganomics, this Republican administration has come closer to the late Nelson Rockefeller’s view of financial matters.

That is a shocking turn of events for a president who owes his second term largely to his decision at year-end 2002 to abandon conservative Keynesian advice that designed the demand-padding 2001 tax cut plan. Instead, he turned to the crisp, clear 2003 cuts in marginal tax rates that allowed capital growth and propelled his political success in 2004. Nevertheless, it seems, this was not an economics lesson well learned.

After the 2003 tax cuts, the Federal Reserve allowed a stable dollar and a relatively normal yield curve for a brief period. In June, 2004, the Fed began its ill-advised series of funds rate hikes that continued for two years, slowing growth and reducing demand for dollars, while continuing to inject liquidity by buying Treasury securities. By mid-2005, this two-pronged attack on the dollar produced results. The dollar’s purchasing power in gold dropped from \$350/oz in 2003 to \$735/oz in May, 2006, when Henry M. Paulson Jr. was nominated by President Bush as his third secretary of the treasury.

The Death of Dollar Credibility

Not to be outdone by his predecessor John W. Snow, Paulson continued espousing the “strong dollar” policy mantra around the world as the Fed’s devaluation of the dollar proceeded past \$1,000/oz in 2008. President Bush was drawn into repeating Treasury’s “strong dollar” position even as the ECB injected \$500 billion in

euros trying to stay within sight of the dollar's drop. This is ignominious performance of economic policy and of economic advisers.

Both Snow and Paulson stood aside as the Federal Reserve countermanded faster accumulation of private capital permitted by the 2003 tax cuts, draining capital from production into above-market bank credit costs. As the yield curve inverted two years ago, business customers of banks, not to mention consumers, were denied credit at market rates. Small business necessarily liquidated credit capital, losing capability to maintain existing production, much less to expand and hire.

Small Business Bled, Big Business Fed

That was not the fate of big business, however. While squeezing small business with high bank credit rates, cloaking its actions in inflation-fighting rhetoric, the Federal Reserve continued injecting liquidity through 2006. Since the liquidity could not flow to small business, it flowed to the long end of the yield curve, enabling larger borrowers to finance at low rates through commercial paper and bonds. Fed chairman Greenspan may have been dismayed that long rates did not rise with short rates, as they would when inflation is expected, but his "conundrum" was caused by policy shoving liquidity at big business, Wall Street and Stamford's hedge funds, while small business was denied capital.

Firms awash in credit adjusted accordingly and leveraged to extremes, taking on extraordinary amounts of risk. At September 30, 2007, NYSE member firms had average liabilities-to-capital ratio of 34 to 1. Hedge funds leverage 40 to 1 or higher which, of course, magnifies upside and downside moves. LBO firms had their heyday in taking public firms private. When the Federal Reserve stopped injecting new liquidity in 2007, debtors and investors began to feel the pain of bad credit decisions. Sub-prime home mortgage loans got the lions share of media attention and blame for poor credit quality, but most sub-prime loans were better collateralized and better performing than risks taken on by, say, prime brokers and investment bankers like Bear Stearns.

Bad Policy Must Be Short Term

As the markets detected and punished poor judgment in credit transactions, by August, 2007, fear and suspicion of credit permeated even commercial paper. Until then, FOMC members had heard nothing from golfing companions to arouse concern about denial of credit to small business. Big business' pain, on the other hand, evoked immediate action. FOMC injected additional temporary liquidity, and then began hacking away at the artificially high overnight funds rate in September, 2007. Still, after six months of funds rate cutting, the yield curve remained inverted and bank credit costs to small business unreasonably high. With no small business growth to absorb liquidity and no room for FOMC to drain liquidity without precipitating bankruptcies among financial institutions, the dollar plummeted to historic depths at gold prices above \$1,000/oz.

In March, 2008, the Federal Reserve indemnified J. P. Morgan Chase against loss arising from \$30 billion in debt instruments on Bear Stearns' balance sheet to facilitate

merger of the two entities, but the nature of those financial instruments is unknown in any detail. Since Morgan Chase was Bear Stearns' primary financier of the \$30 billion in investments, Morgan Chase is the primary beneficiary of the Fed's "flexibility" in granting its indemnification. The Fed's aid to Morgan Chase is reminiscent of Franklin Roosevelt's assist to the Rockefellers when they took control of Chase Bank, then the nation's largest, in 1933.

The Federal Reserve's current dilemma – its currency near collapse unless liquidity is drained, and private financial institutions near collapse if liquidity is denied – is emblematic of the Fed's trademark stop-and-go liquidity valve. During 1996 to 2001, FOMC provided no liquidity to accommodate robust growth. The dollar soared to \$252/oz in 1999, destroying profits with reduced prices, and caused U. S. equity markets to crash in 2000-2002. Since 2004, FOMC's deliberate weakening of the dollar above \$1,000/oz represents a devaluation of 75% in the international reserve currency within a span of four years.

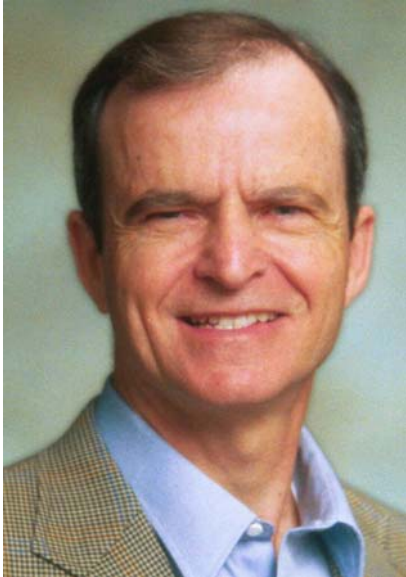
Federal Reserve as "Market Stability Regulator"

In the context of this abysmal performance by the Federal Reserve in its primary function – managing the national currency – it comes to pass that this failed organization is recommended to assume even greater power in U. S. financial markets. Secretary of the treasury Henry Paulson recommends that the Fed be given power as the "market stability regulator" to take "corrective actions when necessary in the interests of overall financial market stability." The Fed would be authorized to collect information from financial institutions and to disclose (or refrain from disclosing) information to the public.

The Federal Reserve is a private entity owned and managed by the bankers of Wall Street. Treasury secretary Paulson is the former CEO of Goldman Sachs, pre-eminent investment bank and power on Wall Street. Paulson and Goldman Sachs are said to have played pivotal roles in promoting the Fed's facilitation of the Bear Stearns takeover. The Fed being so compliant, of course, more power to the Fed is entirely consistent with Wall Street wishes.

The Federal Reserve's devaluation of the dollar must serve Wall Street interests or the central bank would not be in such favor. However, devaluation does not serve main street business or ordinary Americans well. The twin scourges of inflation and deflation have ravaged the country since 1971. The last thing Americans want or need is additional doses of abstract, obtuse cover stories from the Fed for Wall Street's financial escapades. The Federal Reserve should be ordered to stabilize the dollar's value relative to gold, and its authority should be limited strictly to that purpose. ~

WAYNE JETT is managing principal and chief economist of Classical Capital LLC, a San Marino, CA firm engaged in economic analysis, asset management and investment advisory services. He is a member of the CFA



Institute and the CFA Society of Los Angeles, and he speaks to CFA chapters nationally on the subject of monetary policy reform. His 2000 book *A General Theory of Acquisitivity* buttresses classical economics and free markets. In private law practice 1970-1999, he argued cases in the Supreme Court of the United States, the U. S. Court of Appeals, and the federal and state trial and appellate courts. He has led seminars in supply-side economics for CFALA and for Security Analysts of San Francisco, and speaks and writes on constitutional, tax reform and monetary issues.

CLASSICAL CAPITAL LLC

Wayne Jett, Managing Principal and Chief Economist
1470 Cambridge Road, San Marino, CA 91108
Tel/Fax (626) 793-9614 Email wjett@socal.rr.com

The Supply Side Guide is an investment newsletter published by Classical Capital LLC to provide classical economic analysis, is available by subscription to an audience of institutional and individual investors, and is not to be viewed as investment advice to any particular person or firm. Classical Capital LLC or its principal(s) may from time to time own securities mentioned in the Supply Side Guide. No offer of investment advice is made unless and until a written investment advisory agreement is presented by Classical Capital LLC, and no investment advisory relationship shall exist unless and until such a written agreement is signed by Classical Capital LLC and a particular person or firm. Past investment performance is not an assurance of future performance. © 2008 by Classical Capital LLC; all rights reserved.