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VOLUME 10
ISSUE 4
FEBRUARY 29, 2008

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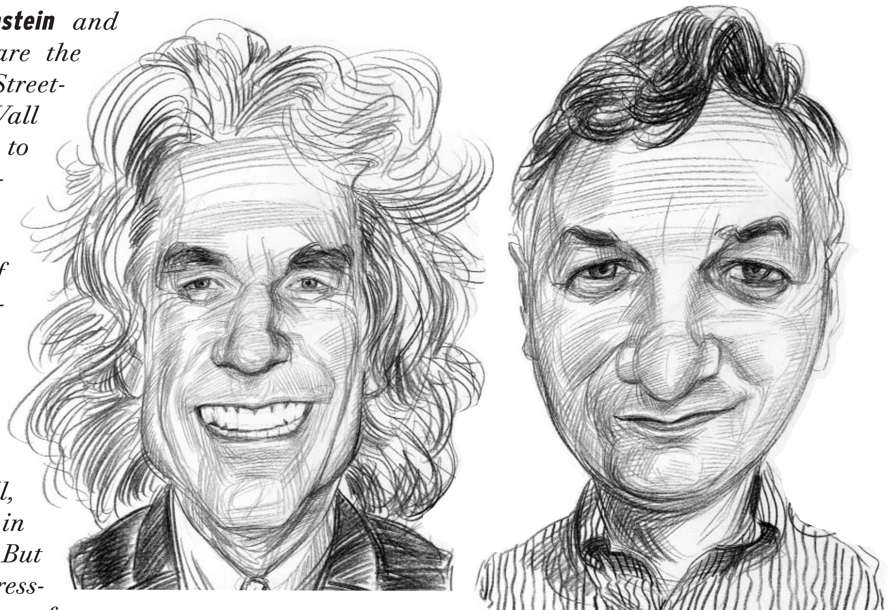
Au Contraire, Maestro

Fleckenstein & Sheehan Truth Squad Shred Greenspan's Image



***William A. Fleckenstein** and **Frederick Sheehan** are the anti-"**Maestro**'s." Streetwise veterans of Wall Street, with the scars to prove it and philosophically contrarian to the core, the two are co-authors of a slim recently published volume with a sensibility about as far from **Bob Woodward's** inside-the-beltway hero worship as, well, Fleck's homebase in Seattle is from D.C. But that's just window dressing, for the real target of **"Greenspan's Bubbles, The Age of Ignorance at the Federal Reserve,"** (McGraw-Hill, 2008) is former Federal Reserve Chairman **Alan Greenspan's** own stab at revisionist history, his autobiographical, **"The Age of Turbulence."** Their aim is deadly.*

*Bill is president of money management firm **Fleckenstein Capital**. He has been sharpening his pen for years, writing daily market commentary on his web site, Fleckensteincapital.com, and a weekly piece for MSN Money, that he calls **Contrarian Chronicles**. Fred's forte is research. A former director of asset allocation services at **John Hancock Financial Services**, whose market analysis has been published in **Marc Faber**'s **Gloom, Boom & Doom Report**, and on the web in **Whiskey & Gunpowder** and the **Prudent Bear**, Fred is years into a manuscript chronicling the full and real story of Greenspan's career.*

I polished off their hot-selling volume in a couple of hours last weekend and got the pair on the phone Monday to discuss the Great Dissembler's legacy as his bubbles pop all around. Listen in.
KMW

Fred, how did an upstanding Boston institutional money man find himself teaming up with — how shall I put it — a flamboyant character like Fleck?

Fred Sheehan: Bill is really the one who was in this thing from the beginning–

Bill: What happened was, believe it or not, **McGraw-Hill** called me and said, "Hey, we think that somebody should do a book about Greenspan." I said, "Nobody would ever read

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Published exclusively for clients of Weeden & Co. LP

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welling@weeden, an exclusive service for clients and prospective clients of Weeden & Co. LP, is published biweekly on Friday mornings, by welling@weeden, a research division of Weeden & Co. LP. Editorial and partnership offices are located at 145 Mason Street Greenwich, CT 06830. Telephone: (203) 861-9814 Fax: (203) 618-1752 Email: welling@weedenco.com jean_galvin@weedenco.com.

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Victor Juhasz
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that book." They said, "No, seriously, we think somebody should write the other side of the story to come out when his book is going to come out." I was going to be back in New York anyway, this was in late August, so I went in to talk to them. They told me what they had in mind and I said, "Okay, let me write you a proposal," and they said, "Great, write this in two months." I said, "No, that's impossible, can't be done." Well, somewhere when that was going on, I was talking to **Jim Grant** and he said, "You should talk to Fred Sheehan; he's got a manuscript. He's got it done." It turns out that Fred also had been talking to them about doing this. Then Fred and I were at the same Grant's conference, so I said, "Hey, Fred, this is what they're telling me. They want to get this done in a couple of months. I don't know that it could be done, but I might be able to do it if we teamed up together," because he'd done a bunch of the research. Otherwise, to research it, write it and fact check it in that amount of time was going to be impossible. So we talked it over and agreed to give it a whirl, and what do you know, it worked. Well, we got done. Whether it worked, let other people decide.

It worked. Though you might have called it, The Maestro is deaf...and dumb."
Bill: McGraw Hill actually came up with the title. They were pretty good about that, I thought, they put some money into art work and into marketing. Contrary to what I've heard about book publishers, I found them to be reasonable. I don't know what Fred thinks –

Fred: Oh, I thought so, too, especially because, despite everything I'd heard, it moved along so quickly.

Yours is definitely not a typical author's experience –
Bill: Well, there's a back story, that I found out when I was in New York last week –

Don't tell me, they're out for blood because they lost the bidding for Greenspan's own book?
Bill: No, the back story is that there's a fellow fairly high up in the McGraw Hill food chain who pretty much sees Greenspan the way Fred and I view him. It was kind of his idea that trickled down to where they found us. So the idea and the book itself have backing from fairly high up in the organization which is why I think that they've been so good about promoting it thus far.

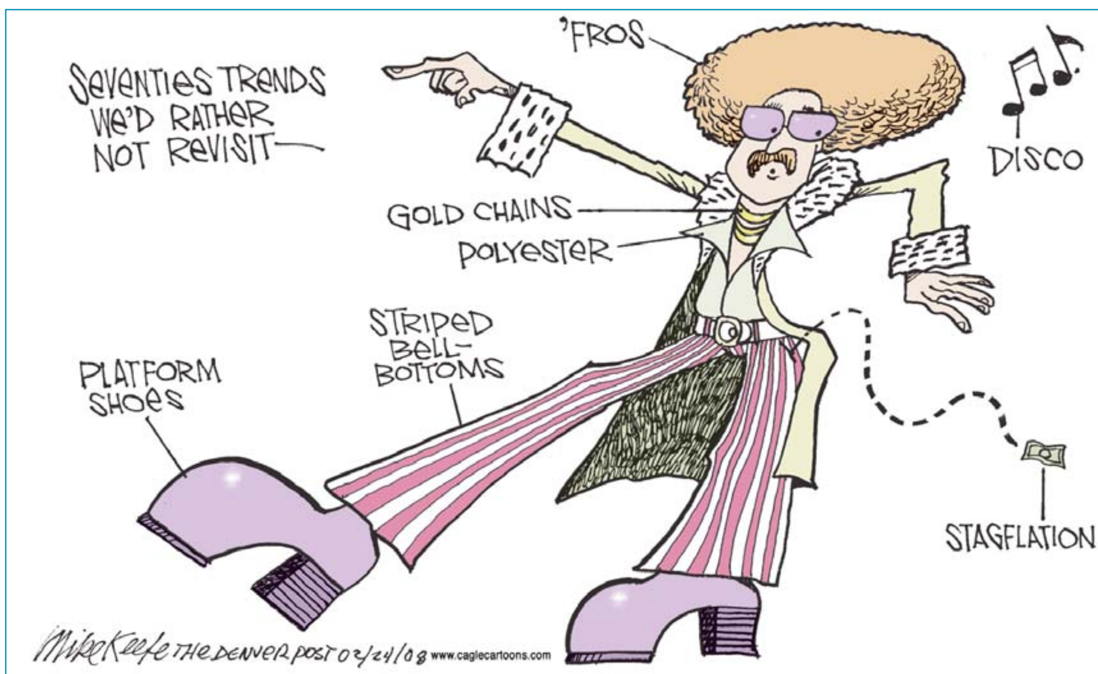
"I'm sure there's somebody else who also could have gotten us into this exact exquisite mess, but I don't think that many could have. So it's not all his fault; but without Greenspan, we probably wouldn't be anywhere close to here."

Too bad that same fellow apparently doesn't hold sway over their rating agency.
Bill: Well, I think that part of their inside viewpoint, at least this one particular fellow's, whom I've actually met, is that had it not been for some of Greenspan's policies and his blanket support for any and all forms of deregulation, perhaps the nuttiness that we saw wouldn't have occurred – and perhaps Standard & Poor's wouldn't have gone drinking before they did their ratings.

So that's the explanation.
Bill: It's all tied up together. When you suppress the business cycle for a couple of decades and you bail out everything that moves, over time, people are going to take too much risk. They're not going to get punished, and those people that grade you on how much risk you're taking are going to assume there isn't any risk, either. So the fact that the credit rating agencies were essentially useless was sort of part of the whole social/economic environment that developed in the wake of Greenspan's policies. That makes sense to me, anyway.

Me, too. Your slim volume makes a great quick read and still manages to lay every ill but the flu epidemic at Greenspan's feet. In fact, you actually did what I had

assumed to be impossible — made me feel a tiny bit sorry for the guy. He had a lot of help in creating the credit morass —



Bill: That's fair, Kate. Once you write a book, it sits there and you think about what you might have done differently. The problem is there were about 10 different books we could've written. Every single problem we have is not solely a function of Greenspan. We don't necessarily mean to imply that – Fred can speak for himself – but what I meant to imply is that, were it not for Greenspan, or for anyone who had the mindset that it appeared that he had (which we tried to show), I don't think we could be in this particular place. I'm sure there's *somebody* else who also could have gotten us into this exact exquisite mess, but I don't think that many could have. So it's not *all* his fault; but without Greenspan, we probably wouldn't be anywhere close to here. You might ask, "What if Bernanke had been on the job?" Maybe we would be; I don't know.

Fred: We do say at least once that Greenspan was not the sole cause, but he was the essential party. We do try to make that point.

There's not much doubt this would be a different world, had Paul Volcker not relinquished the helm.
Fred: To give, I suppose, Greenspan some credit, by the time he became chairman, he did have an FOMC that was much more liberal-thinking about how it should extend credit than it had been for much of Volcker's term. Greenspan also quickly faced a stock market crash and a huge budget deficit. So he stepped into a situation that wouldn't have been easy under any circumstances. I think Volcker had actually become very frustrated by the end of his term. After '82, the appointments made by the Reagan Administration really watered down Volcker's authority and he was winning FOMC votes by one or two votes rather than unanimously, or with only a dissent or two, as he had earlier in his term.

Bill: Also, to take just a tiny bit of pressure off of Greenspan, the real problem is this concept that you can pick the right interest rate to run the economy. Even the Volcker Fed shifted during his term from being monetarist to starting to look at rates to a focus on interest rates. Of course, Greenspan took that to a fine art–and that's why the fact that his judgment was so consistently off helped create all these problems. But almost anybody who thinks that they're going to be able to pick *the right interest rate* for the economy and have it work out okay is delusional.

I'm not so sure about that, comrade.
Bill: Exactly. This central planning notion that anyone can pick the right interest rate to run the economy is at the heart of the problem. It's a fallacy and someday it'll probably go out of fashion again. I don't know what a better metric would be, you'd have to figure out some credit or money supply measure – or measures – that have sort of correlation to economic activity, but focusing on picking the right interest rate only is going to get you into trouble over time, for sure.

Wasn't another source of the problems the way that Greenspan cultivated an image of himself as the omniscient lever puller guiding the economy—even as he bubbled around simply trying to follow the markets' lead?
Bill: Well, if the market is willing to follow the

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Fed, it can be led a little bit. I would argue that while he held rates way too low the markets did not seem to mind.

Sure, if you're spiking the punch bowl at a party for teenagers, who's going to complain?
Bill: True. Look, in my almost 30 years in the business, the one concept that I saw carry the day for a long time, which is a complete fraud, is the notion of bond vigilantes. As I can tell, the only thing that bond guys care about is liquidity. The notion that they actually care about inflation is a total farce. You can see that clearly now with the entire curve trading underneath the actual inflation rate. Even even the poorly calculated government CPI numbers are showing almost negative returns out about to 10 years.

Fred: Isn't that a change Bill? Or do you think the notion of bond vigilantes was a fraud back in the '80s, as well?

Bill: Well, I don't know. It could've just been the fact that they couldn't make money on the carry. I'll never forget back in '84 when they backed the bond market up to about 14% even though you could see that the rate of inflation was coming down and that Volcker meant to be vigilant about it. So were they bond vigilantes at that point or not? What might have been going on was just that there wasn't enough liquidity to make the carry trade work. So maybe the liquidity hogs just couldn't play their games and so therefore looked like vigilantes.

You're saying bond traders don't really care about macro issues, just whether they can make a buck on their trades?
Bill: I think that's it. Anyone who was around in the '80s remembers the concept of bond vigilantes. The bond traders were never going to let inflation get out of control again and all that nonsense.

The Fed supposedly didn't dare lower rates too quickly or the market would take them right back up.
Bill: Right, the bond market was going to be eternally vigilant; therefore, we could never have inflation again. That was the story. When in fact, what it looks like is that, in the whole time of easy money in Greenspan's era, no one ever really cared about the rate of inflation, and perhaps they didn't care about it even in the early '80s. Maybe what looked like vigilantes at worked was merely caused by traders' inability to turn a buck in the carry trade because money was snugged up.

Does it make any difference, if the outcome is the same?
Bill: It just means that there really wasn't any check and balance operating in the system.

No adult supervision, in other words?
Bill: And you'd think some would help, because in the absence of that, the excesses can just build up and get bigger and bigger. I mean, for the life of me, I can't find anyone that can give a rational explanation for why the fixed-income market trades where it does, given what the Fed's going to do, which is to print money—because Bernanke's going to drop money from helicopters. He's not going to care where the dollar trades. He doesn't care about the inflation rate. They talk about it, but they don't care.

They have to give lip service to fighting inflation; it's part of their charter.
Bill: Right. But even the Fed plays this make-believe game of inflation "ex-food and energy." I've been complaining about that for 20 years. How can you call ex-food and energy the "core" rate? What's more core than food and energy?

It does amount to forcing the economy on one heck of a diet.
Bill: That just shows the mindset. The rationalization was such that people could pretend. Only in an environment of perceived low inflation can you keep the monetary spigots open long enough to make the kind of bubbles we got. Of course, as Fred and I point out in the book, part of keeping the inflation rate low so that you could keep those spigots open was jiggering the way it's calculated such that there wasn't going to be any until it really got crazy.

"As Fred and I point out in the book, part of keeping the inflation rate low so that you could keep those spigots open was jiggering the way it's calculated such that there wasn't going to be any until it really got crazy."

Well, if you don't count it, it doesn't exist, right?
Bill: So they'd have us believe.

Fred: But let's not forget that mismanaging interest rates is scarcely the only thing that the Fed did wrong during Greenspan's term. Another was lowering and even eliminating some of the reserve requirements of banks so they could lend a lot higher multiples of their capital and then there was also letting the whole derivatives world go nuts, adding to liquidity and making everything impossible to

really understand, which was a big help in creating excesses towards the end of the bubble.

With help like that...
Fred: To just say derivatives were obfuscating what was really going on.

Yet the Chairman used to very publicly sing the praises of derivatives.
Fred: From very early in his term, he sang the praises of derivatives. Whether he was doing it because he really believed it or whether he had some designs that, "Gee, this will really help offload liabilities from bank balance sheets and get them into securities, and I'm now responsible for the banking system," I don't know. But from the early '90s, he sang their praises.

Who knows what he believed? Are you still going forward with your more in-depth study of the Greenspan era, Fred?
Fred: I am. We couldn't in this short book, written in such a short time, go into a lot of things, some of which we alluded to a little bit earlier in this conversation. One of them has to do with Congress and its relationship with the Fed. I go back to the 1950s, when **William McChesney Martin** was getting butchered by Congress for not loosening Fed policy back then. It's been a constant theme ever since the 1950s.

Isn't there some story about LBJ calling Martin in and physically abusing him?
Fred: Yes, **Lyndon Johnson** and **Robert McNamara**, and it sounds as though LBJ and McNamara were kicking trash cans around the Oval Office trying to get Martin to help with their guns and butter policy, but he stood firm – stood firm as he could.

Must have been some scene. Martin was not a big guy, was he?
Bill: He wasn't large in stature, as I recall from pictures.

Fred: No, I don't think he was. He was a great tennis player, but I don't think he was a big guy.

Bill: I like him even better now that I know he was a good tennis player.

Fred: After he retired, he founded the Tennis Hall of Fame. His father-in-law was Mr. Davis, as in the Davis Cup.

Bill: Wow, that's an interesting factoid.

But it wouldn't have endeared him to LBJ.
Fred: No. And Martin probably wasn't much of a barbecue guy.

Back to Greenspan—
Bill: Fred brings up a good point, there were a lot of different directions that we could have gone in. *Greenspan's Bubbles* is just the *Cliff Notes* version. We just tried to sketch out the big picture so folks could figure out: "Geez, how are we in this place now where inflation is soaring and my house price is collapsing and all these bad things are happening? Especially when everything was "just right," when Wall Street was discussing Goldilocks just about 15 minutes ago. How did this happen?" Our book tries to answer that and give credit, so to speak, where credit is due for creating the mess. But there is obviously lots of additional information that we just couldn't get into.

Sure. Greenspan presided over the Fed for, what was it, 19 years? It seemed like an eternity. And all this is basically his fault, you say.
Fred: Yes, he was chairman from '87 to 2006.

Bill: It did seem like an eternity.

Fred: In a sense, he's still hanging on; he's talking more in public today than he was then.

Bill: He just won't stop talking, either.

It must drive Bernanke up the wall.
Fred: I have a quote, from the New York Times in early 2000, when they were interviewing Volcker. It goes something along these lines. "Like all former Federal Reserve Chairmen and former Presidents, Paul Volcker has never spoken publicly about policy since retiring from the Fed in 1987. But this guy (Greenspan), three days later, he was second-guessing Bernanke's policy, and he doesn't stop."

Bill: The most damning quote comes from Volcker, but unfortunately didn't surface until subsequent to us finishing the book. In **Roger Lowenstein**'s article in *The New York Times* – in the Sunday magazine about a month ago, he quoted Volcker as saying "Too many bubbles have been going on for far too long. The Fed is not really in control of the situation." That is the strongest criticism Volcker has leveled to date. I mean, Paul Volcker is a class act. He went out of his way not to be any sort of troublemaker, rabble-rouser, but things just got to the

point in a couple instances where he couldn't *not* say something. Like back in '99, when he said something about the world economy being dependent on the market caps of 25 stocks. So when I read that Lowenstein quote, I about fell out of my chair. I thought for sure that would get a lot of play; but near as I could tell, nobody paid attention to it. It's incredible, isn't it? Considering the way everybody in Wall Street is such a big fan of bedtime stories – we were always hearing, under Greenspan, about the Goldilocks economy; everybody believed that the Fed had magical powers like Santa Claus and the Easter Bunny. Greenspan could wave a magic wand and make anything bad go away, right? So here's Volcker saying, "The Fed's not in control," and everyone snoozes. I guess everyone wants to hang onto the dream.

There's just too much cognitive dissonance in unmasking Greenspan and the Fed as the Wizard of Oz. It also runs counter to the interests of the "regulators" and others trying to unscramble the mess he left.
Bill: Right, we don't want to acknowledge they aren't all-powerful because that doesn't fit the fairy tale we still want to believe. But isn't the media, at least, supposed to be a little bit more interested in probing these things?

Come on, if it isn't hand-fed —
Bill: Okay, you win. But it does seem that all of sudden in the last three months or four months more folks are willing to take a critical look at Greenspan. If this book would've come out before then, I'm not sure if anyone would've cared. So it's our good fortune –

Timing is everything.
Bill: At least people are willing to hear your argument now. At least it feels that way to me. I can tell you, both Fred and I have been writing a lot of this same stuff for a long time and while we did have a few people who agreed with us, I don't think many cared much until very recently.

Yes, but now the subprime mortgage mess is clearly contagious, rather than contained, foreclosures have started and large swathes of the real estate and credit markets have stopped cold. Meanwhile, commodities and inflation are bubbling and the greenback is trash.
Bill: And here's our boy on the tape right now. Greenspan's been giving a speech somewhere – in Abu Dhabi, I guess.

Anyplace that can afford his fee.
Bill: This is important, you want to write this down: "Banks won't know full losses until housing bottoms."

Oh, that's a revelation.
Bill: Except for the fact that he already told us long ago that housing was about to bottom. But we shouldn't go there. It's too easy to reprise his quotes to show how wrong he's been.

Fred: We've been there and done that.

Quite handily in your book.
Fred: But at this point, I can't help throwing in his quote from October of 2006, "Housing has probably bottomed at this point."

Bill: We're being sort of glib here, but you touched on a really important point. The whole concept when subprime started to blow was that the problem was going to be contained. But as a lot of folks you've interviewed laid it out, this was one epic credit bubble. One of the few groups that still seems not to know that there was a credit bubble is the Fed. They seem not to understand that they're dealing with an unwinding of a credit bubble and what that might mean.

There are none so blind as those who will not see...
Fred: I haven't read what Bernanke wrote on the Depression, my understanding, though, is that he thinks that if the Fed had been looser in 1930, right after the stock market crash –

Looser, faster is his prescription, I gather.
Fred: Which is troubling, because it doesn't seem, at least from the little I have read, that he's looked much at how big the different bubbles had gotten by 1929. It wasn't just the stock market. Housing, commercial mortgages had grown to a tremendous level by then and there were all sorts of easy financing methods in the late '20s that hadn't been available before – and weren't going to come back quickly. For instance, mortgage insurance on houses was big then and it disappeared overnight; all 15 insurers went out of business, in '31 or '32. All those things are characteristic of a bubble; they make liquidity easier and make lenders more confident. Then it's all gone. The Fed just pumping more credit into the financial system wasn't going to bring the economy right back in 1930 or '31.

Bill: I'm so glad you made that point, and I

wish we we'd hit it harder in the book. It's the most important point to make about bubbles. Obviously, we've only lived through three bubbles – Japan and the stock bubble and the real estate bubble. I've read as much as I could of the history, and I know Fred has, too. As far as I can tell, the thing that most people today seem not to believe or understand – and the thing the Fed certainly doesn't understand – is the cause and effect. They all believe, more or less, what **Milton Friedman** said, that the Depression was caused by not easing fast enough. They don't seem to understand that *the bubble creates the bust*. It's not that we have a bubble, the Fed does the right thing, and we don't have a bust. Doesn't work that way. It's sort of like there's a direct proportion between how much Tequila you drink and how you're going to feel the next day. That's a lesson they haven't gotten. So think about where we are economically. We had one bubble and, by a miracle, they bailed us out – for the first time – with another bubble. That double play has never happened in the history of the world. But now that second bubble is unwinding and it was a credit-driven bubble that is leaving bad debts in its wake. To think that this is going to be over soon, and painlessly; that they're gong to make up some magic new rules and we're going to be doing well again by the second half of '08 is the height of fantasy. This recession should easily be worse than what we saw in the wake of the 2000 stock bust, and it could be a whole lot worse.

And don't forget, the credit bubble may have "rescued" us from the aftermath of the dot.com bubble, but that bust was hardly painless to anyone invested in the Nasdaq, among other places.

Bill: Clearly, it wasn't painless, but economically, it wasn't as bad as a bubble unwinding can be, especially one that had a lot of bad debt associated with it. People ask, "Why did Japan's bust last so long?" Well, they had a two-in-one bubble that preceded it. They had a huge real estate bubble that really took up their stock market into a bubble. So when they unwound that mess, they had tons of bad debts to deal with, and that's kind of where we find ourselves now.

Not to mention that instead of dealing with their debt problems head-on, they also chose to temporize, to stretch out the recognition of losses as long as they possibly could.

Bill: So we've now taken a page out of the Japanese book.

Seems brilliant, doesn't it?

Bill: Yes. But what Wall Street wants to do at all costs is avoid price discovery. So we're in the price suppression game the same way the Japanese were. Which is sad. One good thing about us here in America has always been that we were supposedly a capitalistic society and would let the chips fall where they fall. Well, we've bastardized that now to the point where nobody wants to permit price discovery anymore. Until we get price discovery and clean out this dead wood, there's no way we're going to have any kind of return to prosperity.

Price discovery is a lovely abstraction – until you discover that the price of your house is falling.

Bill: That's right. It's amazing; people don't seem to appreciate how important the real estate market was to the economy. In the book, we've got a couple of charts that show the economy ex- the growth that was created by mortgage equity withdrawals, and it was pretty punk. Then, when you think that up to 40% of the jobs that were created in the last recovery –

Which was very sub-par in terms of job growth –

Bill: And around 40% of the ones we did get were tied to real estate. Anyway, now we're not only *not* going to be able to take money out of the ATM, our house, we've got people saddled with bad debts and financial institutions saddled with bad debts. That's going to affect psychology and the ability to lend, and we're not going to create those real estate oriented jobs. How can we possibly avoid a serious recession? How is it possible? Everyone who's got this Pollyanna view that things are going to get better in the second half, they don't ever tackle *how* are we going to get past those problems.

Not to worry. Consumers and banks might be pinched, but corporations – with their pristine balance sheets—will bail us out.

Bill: Yes, absolutely!

Fred: There are all sorts of other bubbles that are going to pop, like the student loan bubble, the municipal bubble. And when those kinds of things pop, then it comes more real. Corporations aren't proving immune, either. Look at who is getting stuck with auction rate preferreds and such – funding long-term needs

"The thing that most people today seem not to believe or understand – and the thing the Fed certainly does not understand – is cause and effect. They all believe, more or less, what Milton Friedman said, that the Depression was caused by not easing fast enough. They don't seem to understand that the bubble creates the bust."

with short-term paper.
Bill: Another aspect of the deregulation that Greenspan let run amok is the tremendous amounts of leverage that financial institutions were able to pile up. Amounts that got so immense, and nobody even knew. My favorite example is **Citigroup**. The smartest guy in the room, i.e., **Bob Rubin**, is sitting there as an advisor to the CEO and he seems all of sudden to have gotten a lot less smart. Either he didn't know or couldn't understand, which is sort of hard to believe, what was going on while all this leverage was built up.

"Greenspan sought an Ayn Rand connection more for his own uses rather than because of anything that he ever believed."

There's another possibility: That he was rendered comatose by obscene amounts of compensation.
Bill: It must be that. But that's the problem with what the evolution of deregulation brought us to; with the accounting abuses that were deemed to be okay. Then there's the fantasy of accounting for "Level 2" and "Level 3" assets. I mean, we're talking about these infinitely leveraged animals, the financials, and they can just make believe on when it comes time to "value" what they call their assets. This is my whole point about trying not to see the downside of the business cycle. Again, I come back to the social fabric and how far things have swung, I mean, we've gone out so far. Now that credit is contracting, are these things simply going to come back to someplace where the financial system can function? I don't think it's possible. I don't have any idea how much credit contraction is going to be required, because I don't think anyone can really know how dicey the situation is or how much leverage was created during the bubble.

It's perversely ironic that so much of the faux triple-A paper now gumming up the works was created to game Basel II capital adequacy standards—
Bill: Courtesy of the BIS, another Polit Bureau-like entity. What would be wrong with just going back and saying, "Look, we can all read a balance sheet. I mean why do we need all these regulations?"

Wait, a minute. Have you looked at a balance sheet lately?
Bill: Well you're right. I can't read one anymore. I don't think anyone can. Let's just get rid of all this off balance sheet stuff and this phony baloney mark-to-market. Everything that you learn in the first 90 days of an Accounting 101 course, that's all you really should need to know, right? All these other constructs are just made up to obfuscate things. Maybe we just need to go backwards in time to be able to go forward.

Great thought. But can we go backwards?
Bill: I don't know if we can go backwards *willingly*. But Mr. Market may finally have some other ideas, and force the issue, who knows. Obviously, the politicians have cast their vote. They want to continue to play games.

Fred: Look at the federal budget. The politicians have burdened us with lots of off-balance sheet items that *should* show up on the balance sheet. Why should we be surprised when they let the banking system do the same things?

The one thing you can say for the federal budget process, Fred, is that they make no pretense of following GAAP.
Fred: True enough. And OMB does take a stab at reconciling the budget with GAAP once a year.

So to what do you ascribe Greenspan's obtuseness? Is he still carrying a torch for Ayn Rand, or what?
Bill: I have to confess, I am not a huge Ayn Rand expert, but I have a 21-year-old daughter who has a bookcase full of all of her stuff and she goes ballistic when anyone suggests that Greenspan did anything that Ayn Rand would have approved of. He might, at one time, have been a Rand disciple, but I think his own ego perhaps got the better of him somewhere along the way. But maybe Fred has more cogent thoughts than I on that.

Fred: I haven't read that much Ayn Rand either, but I have looked a lot at Greenspan's earlier life and at his time spent with Ayn Rand. My conclusion about the time he spent with her was that what he was doing – much as he did ever after – was using people within her circle to help himself. For instance, let me see, the way he got introduced into the Nixon campaign was through another of Ayn Rand's acolytes. As I understand it, your long-ago boss at *Barron's*, **Bob Bleiberg,** sort of flirted with Ayn Rand for about a year and then he decided she was a nutcase, but from what I've read, Greenspan used that connection with Bleiberg to get published in *Barron's*.

My understanding is that was no great accomplishment back then, if you'd write

for peanuts. But I do remember Bob practically foaming at the mouth at the mention of Greenspan.
Bill: Did he really?

And that was long before he went to the Fed.
Fred: Anyway, I think that Greenspan sought a Rand connection more for his own uses rather than because of anything that he ever believed. I have a quote somewhere, from what's his name, Nathaniel Branden. He writes – in the autobiography of his love affair with Rand [*My Years with Ayn Rand*]that he published fairly recently [in 1999] – that one of the things about Greenspan that really surprised him was how little he thought Greenspan understood of Rand's beliefs; that whenever he spoke at their meetings his comments were always platitudes. Something like: "That's wonderful Ayn. You've never said anything better," and that would be about it.

Kiss, kiss — ugh!
Fred: That's about the story of his life. So I agree with Bill. Her influence on him philosophically was practically nil.

You're reminding me though, Fred, about an unstated subtext to your book that I couldn't escape as I read it. For all of his bumbling and absolutely abysmal record as an economic forecaster and regulator, he's one hell of a politician.
Fred: Wonderful, the best. Right, from the early '50s, he knew what was important. Sometimes that's evident in quotes I've found and sometimes it's just obvious in what he spent his time doing and not doing. It is only a bit of an overstatement to say that he didn't spend as much time as a practicing economist as he did working relationships with the media, with social connections. And he did that all the way through the mid '80s. He really knew how to use people all the way along.

Bill: He was a superb politician. I'll give him credit for that. As a friend of mine said, he ran the Fed on the applause meter.

And if not objectivist philosophy, he employed all that political talent in the service of what?
Bill: His political skills were utilized to promote Alan Greenspan. That's all it was about. He also used his political skills to persuade people that certain problems weren't problems. Look at what happened after September 11th. Well before the Twin Towers were attacked, we already had serious economic problems and a serious bear market in stocks was underway.

Which, as you pointedly address in your book, everybody now has forgotten.
Bill: Yes, because quick as a bunny, after the attack, he used it as the excuse for virtually all of the economy's ills. Sure, 9/11 exacerbated the problems, but it wasn't the root cause. But he was pretty adroit at explaining things away and people were in a mood to want to believe, so they went with it. His political skills helped him look good and I think that's what was important to him.

Fred: Another thing that really helped him is that most people have such short memories. They never seemed to make the connection between how he had been wrong a few months before, so why would he be right now? That seemed to be a question that was never really raised. It's really the reason I first became infuriated with the guy, although I suppose I was really more infuriated with people who just wouldn't seem to pay attention. He was consistently wrong and yet he was treated like a god. Whenever I brought up inconsistencies, they always seemed to be dismissed. "Oh, that's just Greenspan and his doubletalk," or "that's the way he speaks." But once you actually read and try to make sense of of his statements, which I thought he deserved the courtesy of us attempting to do, he simply makes no sense.

Bill: I think people were willing to "suspend disbelief" about the things Fred's talking about simply because they were voting their wallets. While you're going through a bubble, everything seems pretty darn good. Even many of the folks who got hurt when the stock bubble blew up made it back or felt like they were okay when real estate soared in the credit bubble, so they were voting their wallets.

So you're saying he was a pied piper.
Bill: He *was* a pied piper. In fact, that was my original idea for the book title: "The Pied Piper of the Federal Reserve." That isn't what the title wound up being, obviously, but that's exactly how I saw it.

Fred: If there was one point when something should have clicked with people was when he started talking about stock analysts and using their five-year projections to buttress his argu-

ments.

Bill: Fred, that would have meant that more than five people besides you and me and **Caroline Baum** were reading the FOMC minutes.

Not necessarily. He said that in other venues, including in Congressional testimony. I think I even mocked the absurdity of his reliance on analysts in print.
Fred: Yes, I think he went public with statements like that in May of '99. One thing that I hadn't really done before working on this book with Bill was reading through *all* of the minutes from FOMC Meetings. I read all of them from 1993 through 2001–

Bill: To give credit where it's due, I was speed reading a lot to them, trying to get the manuscript written and I'd say, "Okay now, Fred, would you go back and make sure that this is correct?" The poor guy had to go back through some of those things many times to make sure I was right about what was in fact the first time he'd said something.

Fred: Or there was something like his statements about margin requirements. It was in early 2000 when he talked about how the Fed had a lot of discussions about margin requirements and how they'd done a study and so forth showing that they just didn't work. Well, when I read that, I went back and reread all of the FOMC minutes back through 1997, looking for those discussions. I cut off my effort in '97, when I decided that since they hadn't discussed margin requirements that far back, they simply hadn't discussed it. There were a lot of similar cases where, as I've said before, "He had never said anything like that before, unless he was talking to his wife at home."

Right, all of his great thoughts he shared with Andrea while he soaked.
Fred: That bathtub should go into the Smithsonian.

Right next to Archie Bunker's chair.
Bill: One of the more infuriating things about his personal behavior, I find, is this penchant for the revisionism that he's taken on since he has been out promoting his book. I thought I was all done putting pen to paper about this guy after the book. Then, about a month ago he was up in Canada talking at a BMO Conference and he has the nerve to say that, back in May of '04, when he told folks that they were paying a big premium to go with those fixed-rate mortgages and, in essence, told them to take out ARMs and went on to extol the virtues of the financial deregulation that brought us Alt-A and subprime and option ARMs and all that other stuff, that he's been misquoted about that speech. He claimed that in fact he had said that if rates rose it wouldn't work. Well, I went back and checked. That was a throwaway line. Then he also claimed that he had come out a week later in another speech and clarified it all. But that speech was about the trade deficit. And if he said anything to clarify his view on ARMs during the Q&A, we don't have a record of it. But Greenspan gave 22 speeches that year. So *if*, at the time, he really thought he might be getting misquoted, he could have come out and said something. Yet he didn't. What I find staggering is that those sorts of things happen all the time, and I haven't seen anyone, other than a few online guys, stand up and call his bluff about all this stuff. I mean, what he's saying about what he said before is just not true. He keeps trying to muddy the waters and has gotten away with it, and I find that infuriating. He actually summed up by saying he's "not guilty of having promoted those mortgages," when he clearly *is* guilty.

You use quotes from FOMC minutes and other public statements in your book to let Greenspan demonstrate his own fallibility and catch him revising history. But isn't it quite possible that a lot of things discussed and studied at the Fed never make it into FOMC meeting transcripts?
Fred: Yes, it is possible. But when I was doing research into the Greenspan Fed, what I found was that he really only spoke to the other Fed Open Market Committee members, during FOMC meetings. Prior to his reign as Fed Chairman, the Fed staff, all the economists, worked for the various Fed Governors. During Greenspan's term, it became more and more a case that they reported simply to Greenspan. It got to the point where he got upset with one of the FOMC members merely for talking to the staff about how they put their forecast together, for possibly disturbing their research. And it also came to be that the Fed Governors no longer even wrote their own speeches. It might have been **Janet Yellen** who said, "It's a great job if you like to travel a lot and have somebody else write your speeches." There was a fairly long article in *The New Yorker* back in the mid '90s, when **Alan Blinder** stepped down as Vice Chairman. It recounted how, really, it was because he was not paid attention to at all and because he disagreed somewhat with Greenspan. Anyway, Greenspan was able to shunt him aside. When he stepped down, **Felix Rohatyn** thought he wanted to take the position. I guess he was sick of doing deals. But then he talked to Blinder, who said, "Are you crazy?" In any event, it looks as though there was not a lot of conversation on Greenspan's part with the FOMC, other than in the meetings. And he did a superb job of controlling the meetings.

Can you give me an example?
Fred: When there was something raised that he didn't like, he would turn the floor over immediately to somebody else. One time we wrote about this happening was in December of '98. The Fed staff and the other FOMC members were talking about how earnings estimates in the near-term were going down, and this excited Greenspan – because, to his way of thinking, since the analysts still had the same projections for five years out, that lent credence to his pet theory that productivity was improving.

It didn't occur to him that analysts can simply be

lazy, not to mention wrong?
Well, one of the Governors (I forget which) did say to him something to the effect of, "Now, Alan (though they *never* called him Alan), you and I know that these forecasts represent the hockey stick approach of companies. They will *always* tell you that in future years things are going to get much better if things aren't looking well right now." Greenspan replied something like, "I never attempted to make anything more of it than just a side point," and then immediately called on another governor. Just completely ended the discussion. It was the type of the thing he did quite a bit. He also used to call coffee breaks at very convenient times for him.

Bill: Picking up on that, we describe a couple of points in the book where one of the Governors or another would mention the "Greenspan put." I remember one of them making the point that CNBC was talking about the fact that stocks couldn't go down because investors believed the Fed was behind them. But there was no discussion on that. Another time someone brought up the VA Linux IPO and likened it to the South Sea Bubble. There was no discussion of that, either. The only explanation that I think makes any sense as to why these topics were just dropped, is that the committee knew Greenspan didn't want to talk about them, so they wouldn't pursue them. I mean, it seems like if you weren't a proponent of productivity and the fact that it was always understated then you were not talking the approved language.They almost never discussed bubbles at any length, even though he now says they talked about different ways to defeat one.

Why talk about bubbles, if you can't recognize them until after they've burst?
Bill: The other thing that blows me away is that he had the nerve to say in one of his book tour talks that, we didn't ease in late 2000; we waited until we were sure of the story in January 2001, because we wanted to squeeze the last remnants of the bubble out. That, of course, is false. He didn't know a bubble was happening, right? But what's mind boggling is that here's the man who was going to ease at the drop of a hat all through 2001. And he's the same man who, after March 2000, when the markets had started caving in, wouldn't hear of easing. When you read the minutes, you see he was more concerned about his pet productivity theory, He did not want to appear to be casting any sort of prejudice on his productivity theory. The whole drift of the minutes is: We don't want to give the implication that anything's wrong with productivity growth. Finally, in January of '01, he panics. But for almost a whole year he just completely missed the unwinding of the bubble.

He really was Mr. Magoo, as well as a pied piper.
Fred: Pretty much. It's impossible to know what was really running through his mind.

Bill: To be fair, he in all likelihood is a walking encyclopedia of economic trivia. But he's like a lot of folks, they know the price of everything and the value of nothing. So he has all this data but has no idea what they mean. The guy knows a lot, but he has trouble putting the pieces of the puzzle together.

So what now? Greenspan peddles his book and Bernanke battles mission impossible?
Bill: Bernanke has been dealt a bad hand. Having said that, he can't cure this. One of these days, the recession is going to get nastier and folks are going to find out, as Volcker said, that the Fed's not in charge. So the stock market is going to take matters into its own hand and start pricing securities lower. Bernanke is going to feel like he's got to keep pumping and so he's either going to lose the dollar or the bond market. Now inflation has broken out in the open. It's acceptable to pass along price hikes. I don't think that genie is going back in the bottle for a long time. But ultimately the bond market is going to be a disciplinarian. In fact, recently the tanking of the 10-year is taking mortgage rates back up. Folks think the Fed's has eased so mortgage rates have come down, but guess what, they're headed back up. One thing for certain, there's no amount of inflation and there's no level of the currency that's going to stop Bernanke from printing money. As Fred pointed out, he wrote those papers at Princeton and he feels that the Fed is responsible for the Depression in that they didn't cut fast enough. He doesn't blame instead the fact that they blew the bubble up in the first place. What he's going to do is very easy to predict: cut rates and then cut rates some more.

You don't approve?
Bill: Printing money, which got us here, and trying to hold interest rates below the inflation rate is not a really good idea, I don't think, and trying to continue the efforts to suppress price discovery is also not a good idea. The last time I checked, we're supposed to be proponents of capitalism and as we all know, booms and busts

"Inflation has broken out in the open. It's acceptable to pass along price hikes. I don't think that genie is going back in the bottle for a long time. But ultimately the bond market is going to be a disciplinarian."

go together. Busts clear away the dead wood and all the people that took too much risk, then we get set for the next recovery. Trying to fight that tooth and nail; going so far as to hold rates way below the inflation rate, that's not going to go anyone any good. It's just going to make matters worse. Part of me keeps hoping that we'll just let financial gravity take over and have this brutal crack up. Not that I want anyone to take a lot of pain, but I want to clear the air and cleanse the system. If we take the pain, get it over with, we'd have a decent foundation instead of the balsa wood structure we had coming out of the last bubble.

In theory, I'm with you. But if you have banks without capital, how does capitalism work?

Bill: Good point. Maybe we just start changing the rules and start slowly working our way back to some solid foundation. The good thing about crises is sometimes people actually do the right thing, but their first attempt is usually to do the politically expedient thing. If Fred and I are right about where this is headed, and about the ugliness that's going to come out of these things, then we'll be in a good-sized recession next year as the new Administration comes in. If it and Congress are as larded up with Democrats as looks possible, perhaps we wind up with re-regulation.

Fred: That's reasonable but of course the politicians get an awful lot of their contributions from financial institutions. I suspect that things have to get a lot worse in the financial system before we actually do something that's productive rather than a Sarbanes-Oxley-type of thing that looks good but is probably worse than doing nothing.

Bill: Well, if the Fed loses the bond market, it's game over. Then the financial markets are going to go where the financial markets are going to go, the dollar tanks with the Fed definitely not in charge, that is going to lead to a lot slower stock prices in a weaker economy.

What are you two doing with your money?

Bill: I run a short fund, so you'll be shocked to know that I'm actually short. I was really aggressively short coming into the year and then when we had the big nasty break, I took a bunch of stuff off and have been slowly putting it back out. I'm trying to dance around as you have to do on the short side. People think that if we bail out **Ambac,** that's going to solve all our problems, so we'll have to deal with a rally if it comes to that. But in the next month or so I would expect to be maxed out short because I think that when the Q1 numbers are reported, they're going to be bad on the income statement side. And, on the balance sheet side, we will find more people that have cash management holes, like the news from **Bristol-Myers** the other day. In terms of outside markets, I'm friendly to gold. I sold a bunch of my gold recently but I'm very nervous not having my normal full insurance position in that. I'm trying to be a little clever. I'll probably have to buy it back higher. I had a big position in currencies, but I don't now because, other than in the Canadian dollar, I don't have much confidence in many of them. If I knew the Fed had lost the bond market for sure, I'd just max out bond shorts and then get short stocks down the road.

Fred: What I'm long is gold and also commodity stocks, although a lot less than I was earlier. I think that generally the stock market just can't hold up and will get hit. And I am as close as I could ever be to knowing anything that's going to happen in the markets, when I say that the financial stocks are going to keep going lower. So I am short financials. This is probably about the simplest portfolio I've had in a long time. I think Greenspan had it right in 1959 when the said, "Once stock prices have reached the point at which it is hard to value them by any logical methodology, once stocks are bought as they were in the 1920s, not for investment but to be off-loaded at a still- higher price, the ensuing break could be disastrous because panic psychology cannot be summarily altered or reversed by easy money policies." Did he believe that back then and forget it? Or did he still know that while he was talking about the "productivity miracle" and the stock market in the late '90s? I don't know.

But it's good to know someone is finally asking. Thanks, gentlemen.

W@W Interviewee Research Disclosure: William A. Fleckenstein and Frederick Sheehan are the co-authors of the recently published, "Greenspan's Bubbles, The Age of Ignorance at the Federal Reserve," (McGraw-Hill, 2008). Bill is president of Fleckenstein Capital, a money management firm based in Seattle. He also writes a daily contrarian market commentary column for his web site, Fleckensteincapital.com, and a weekly piece for MSN Money, called Contrarian Chronicles. Fred is a former director of asset allocation services at John Hancock Financial Services, whose market analysis has been published in Marc Faber's *Gloom, Boom & Doom Report*, and on the web in Whiskey & Gunpowder and the Prudent Bear. This interview was initiated by Welling@Weeden and contains the current opinions of the interviewee but not necessarily those of Fleckenstein Capital. Such opinions are subject to change without notice. This interview and all information and opinions discussed herein is being distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed. In addition, forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, or as an offer or solicitation for the purchase or sale of any financial instrument. No part of this interview may be reproduced in any form, or referred to in any other publication, without express written permission of Welling@Weeden. Past performance is no guarantee of future results.

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