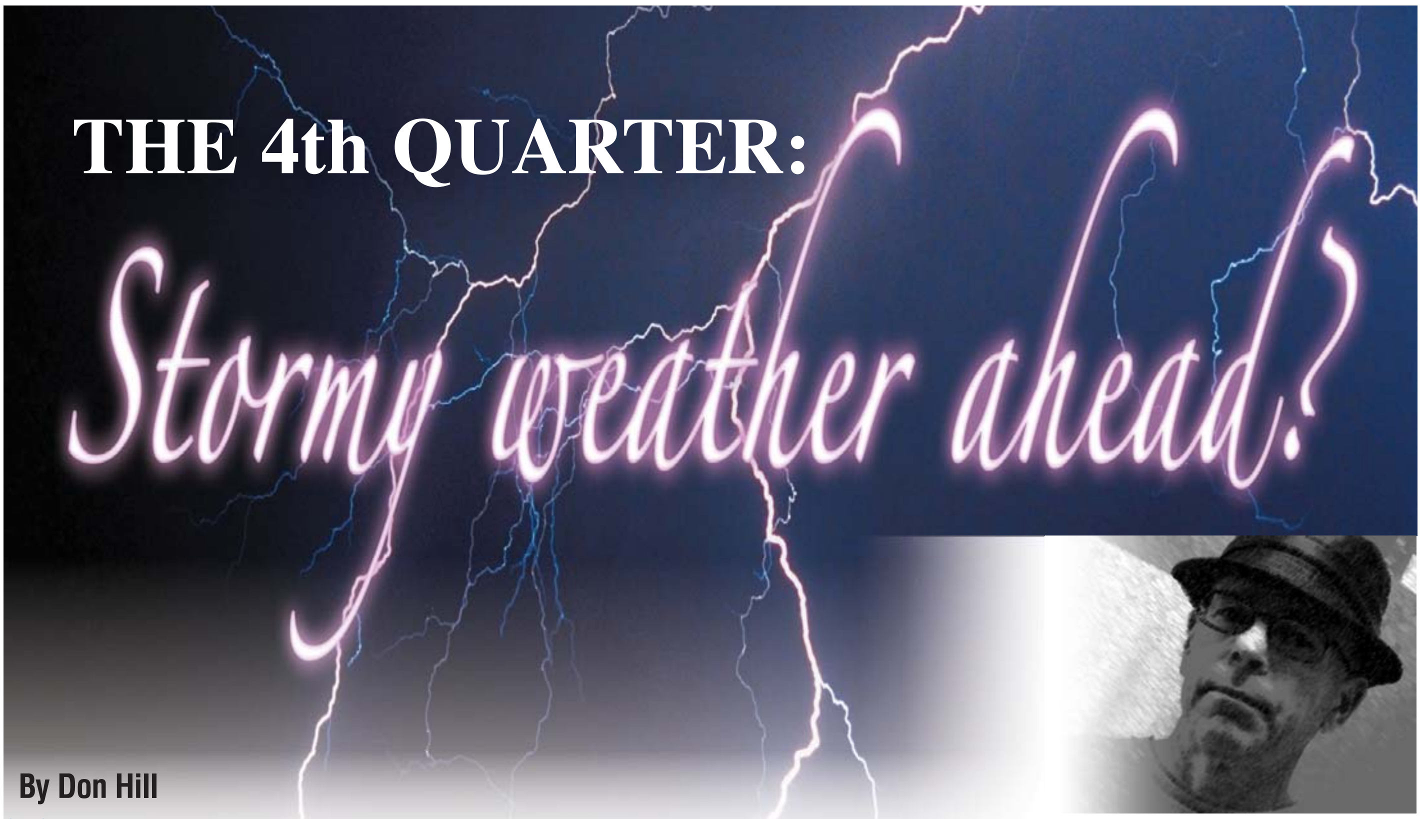
THE 4th QUARTER: Stormy weather ahead?



By Don Hill

I do not want to be right about this.

The turbulence in the financial markets, of late, remains cause for concern. But more troubling is the undermining of confidence, the nagging sense that all is not what it appears to be—that there's something very wrong with the way business is accounted for on the stock exchanges. You have every right to feel this way.

A lesson from recent history bears repeating—a cautionary tale about 'spin' and statistics. I want to take you back to 1989. It is a pivotal year. The Berlin Wall came down and, shortly thereafter, the Soviet Union failed. This came as a shock to many powerful people who should have known better. **Condoleeza Rice**, for one, who at the time was the White House's counsel on Soviet affairs, failed to see the imminent collapse of the so-called 'evil empire,' although, in hindsight it was readily apparent to anyone who lived in the country that things were not quite up to their billing.

Here's what happened: Soviet central planners in Moscow used statistics supplied to them by bureaucrats and their consultants hither and yon. The bureaucrats told their bosses what they wanted to hear. And those numbers were plugged into Moscow's spreadsheets as facts. So it was not uncommon for Soviet central planners to declare bumper crops in areas of drought.

Expert authorities, such as Ms. Rice and others supposedly in the know, were snowed because they failed to question the veracity of the original numbers used to create Soviet financial reports.

WHY NUMBERS MATTER

You may have missed the story in the financial pages, but a year ago, last March, the Federal Reserve in the United States stopped reporting a key statistic, a measurement called the M3, one of three key indicators of how much money is in circulation.

Before I make my point, you need to know that the M1 reports how much currency is swishing around in pockets, in bank accounts, and in any demand deposit against which cheques can be written. The M2 takes into account all of the M1, savings accounts, balances in mutual funds, and so-called 'time deposits' of less than a hundred thousand dollars.

"But that is all small potatoes," explained **Tim McMahon** in an editorial he wrote for the *Financial Trend Indicator*, because the "M3 includes all of M2 (which includes M1) plus large-denomination ($100,000 or more) time deposits, balances in institutional money funds, repurchase liabilities issued by depository institutions, and Eurodollars held by U.S. residents at foreign branches of U.S. banks and at all banks in the United Kingdom and Canada.

"In other words, M3 tracks what the big boys are doing with the money," he concluded, with the dire warning that since this key indicator, the M3, is no longer reported by the Federal Reserve it enables a whole whack of dollars to be printed without the encumbrance of ever having to immediately account for it. Noting that "inflation and the money supply are very tightly integrated," McMahon, among others I pay close attention to, predicts that a substantial run up of inflation is *to be expected*.

DON'T ASK, DON'T TELL

I hear things, sometimes in confidence, so I must mask the identity of one of my sources, a market analyst who recently left one of the premiere ratings agencies in the United States. He no longer trusts the numbers, he said, which are used to grade investments. Not because his colleagues are involved in anything illegal, but "they are not completely forthright," about what they do not know.

If the stock market hiccup in August has a lesson to teach it is you cannot expect investors to believe in the value of any enterprise—over the long term—without credible numbers. And right now, questions are being asked about the companies and the expertise that determine and report those numbers; a particular sore point is how derivatives are rated (more on that in a moment).

The credit-ratings agency my source worked for (there are two of major consequence in the investment world) "has a stable of economists" over 60, some highly-regarded in financial circles. "Over the last year," he said, his face darkening, "a quarter of these guys have either quit the business or gone elsewhere."

Why? I asked.

"The next few months will tell," he said.

FOLLOW THE MONEY

It now appears to be a shell game at best, and no lesser luminary than **Warren Buffet** said as much, when he declared derivatives the "weapons of financial destruction," the great cloud of unknowing which fogs the financial markets.

The derivatives business, in particular, the value of options, futures and swaps, depends upon an underlying asset, currency, or interest rate, and in practice, should have been a fine investment had the principle ratings agencies assessed the entire money trail (literally, where the buck stops and who pays back that buck) before declaring their worthiness. But they didn't. And it is just a matter of time before we get to pay for these sins of omission—that's right—you and me.

Albertans face the prospect of a double financial whammy. While our economy is hot thanks to the insatiable demand for petroleum, we cannot set the interest rates that determine the price of money we must borrow to build our homes, our businesses, our future. If inflation takes off, as some analysts propose, very soon the purchasing power of a dollar will diminish at the very same time the costs of borrowing escalate—thanks to a liquidity credit squeeze, a consequence of the sub-prime fiasco.

There is a workaround. Albertans, slammed by the financial maelstrom of the 1930s, realized they needed a system of banking and investment sensitive to their particular needs; the provincial government of the day created the Alberta Treasury Branch; it was smart to do so.

Make of this what you will. Our present provincial government is flush with *your* cash. We have the means to soften a financial storm that may well be heading our way. That said, I want to be utterly wrong about the forecast. The next financial quarter will be the one to watch. √

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