

September 15, 2010

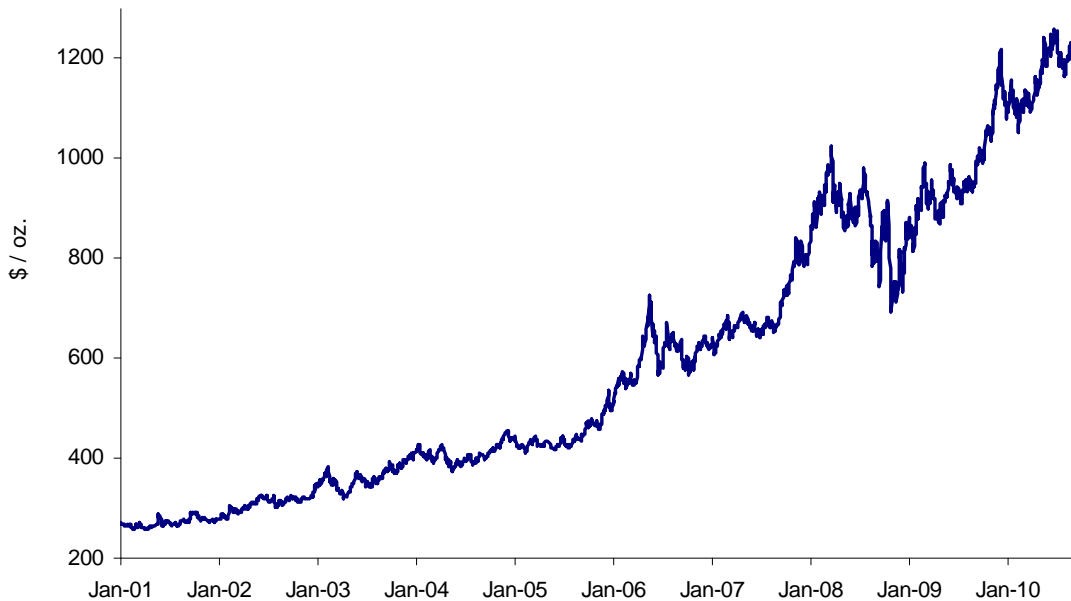
# Greenspan on Gold, Weak Business Investment

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Alan Greenspan spoke today at the Council on Foreign Relations. Asked why gold was hitting new highs, he said he'd thought a lot about gold prices over the years. He'd decided the supply and demand explanations treating gold like other commodities simply don't pan out. He'd concluded that gold is simply different. "Fiat money has no place to go but gold," he said, citing gold's unique value as the "ultimate means of payment" during crises like World War II. "If all currencies are moving up or down together, the question is: relative to what? Gold is the canary in the coal mine. It signals problems with respect to currency markets. Central banks should pay attention to it." We agree and note the huge cost to the world from the wide fluctuations in currency values in recent decades.

## Gold Price (last obs. September 15, 2010)

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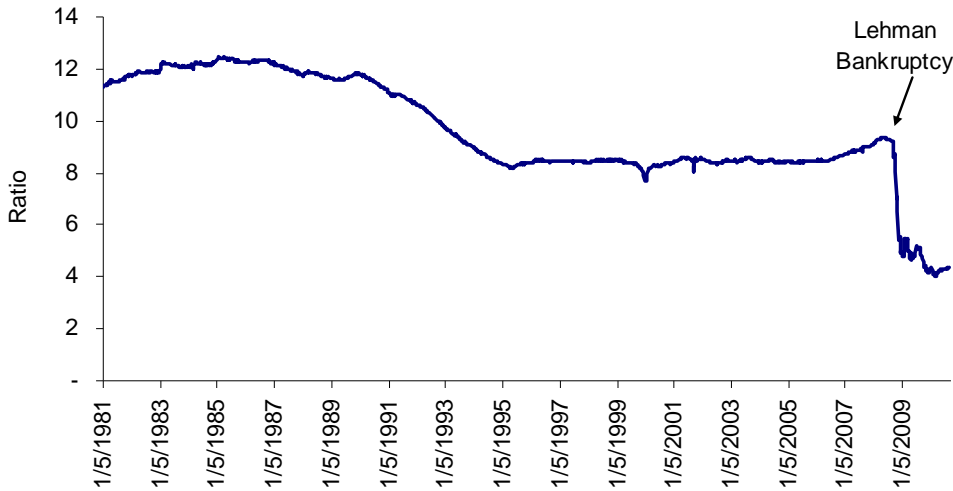


Source: Wall Street Journal; Encima Global

There was a discussion about whether the new Basel III capital standards would cause a credit crunch as banks raise equity capital in advance of far-off deadlines. Greenspan thought not. Banks will be competing for equity capital with each other but are also part of a broader pool spanning non-financial companies, so a phased in capital requirement should be well arbitrated and shouldn't disrupt the flow of credit. More troublesome, banks are currently holding excess reserves that earn only 0.25% per year rather than earn the higher interest

rates available from private borrowers. This is a “clogging of the system caused by the heavy weight of uncertainty.” One measure of this is the low ratio between M2 and M0. The solution is to change the risk assessment. Banks would lend more and the M2/M0 ratio would rise. (This is similar to the velocity of money measure, GDP/M0, which is also very low.)

### M2 / M0 (last obs. August 30, 2010)



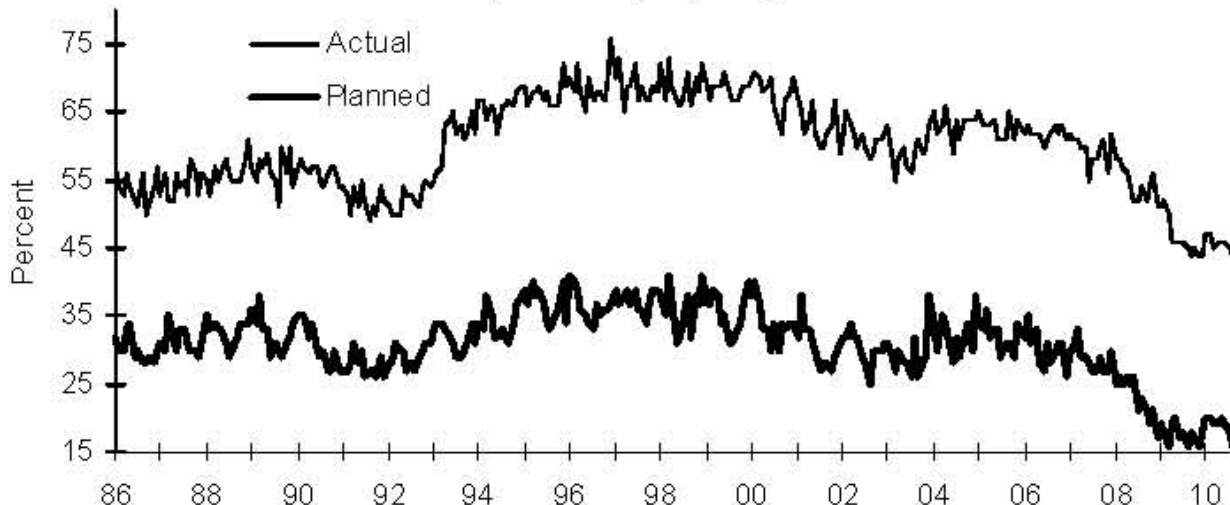
Source: Federal Reserve Board; Encima Global

- Bank aversion to risk is impacting business investment. Greenspan noted that the NFIB August small businesses’ survey of actual and planned capital expenditures have revisited the lows of this cycle that were made in 2009.

### Capital Expenditures (last obs. August 2010)

#### Actual Last Six Months and Planned Next Three Months

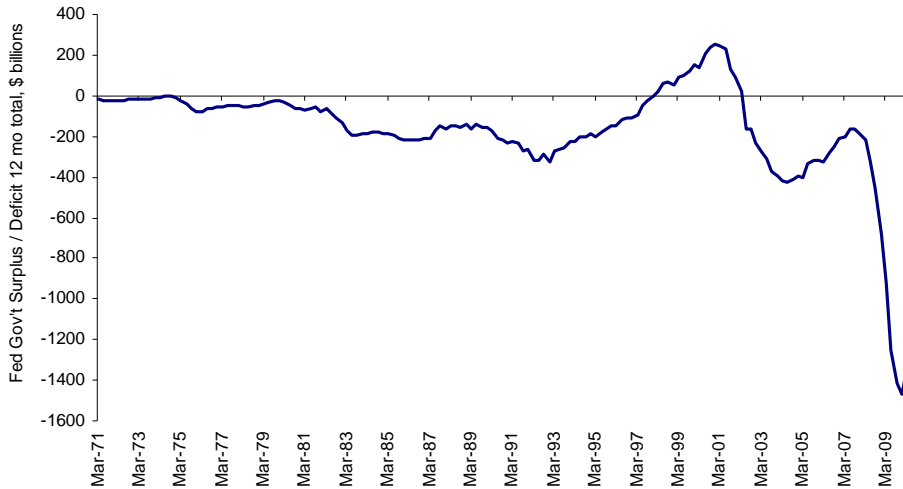
*January 1986 to August 2010  
(Seasonally Adjusted)*



Source: National Federation of Independent Business

To explain the weakness in investment spending by businesses, Greenspan noted what he called a robust correlation between the fiscal deficit and fixed investments nine months later.

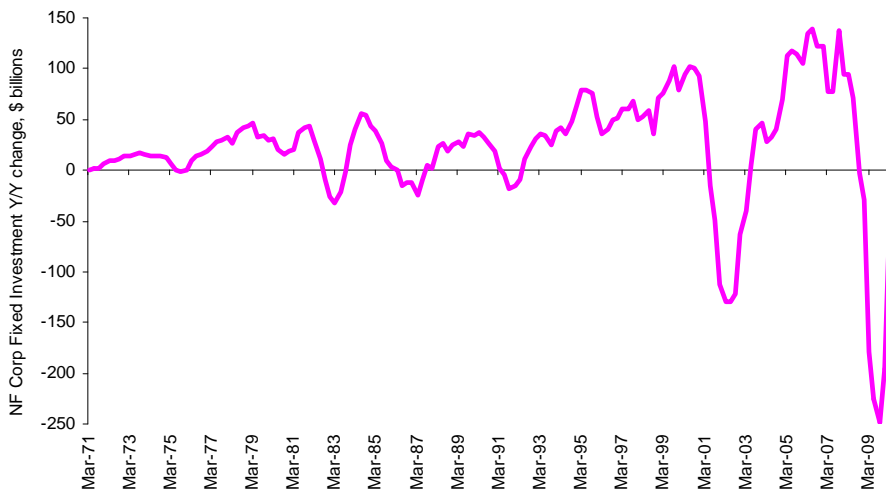
### Federal Gov't Surplus / Deficit (last obs. Q2 2010)



Source: Federal Reserve Board; Encima Global

This “crowding out” leads him to advocate allowing the Bush tax cuts to expire at year end on the view that it would reduce the fiscal deficit and allow an increase in fixed investment. We don’t agree with the correlation or the prescription. In our view, several factors are causing risk aversion and a shortage of animal spirits, including: the lack of federal control over spending; the risk of higher tax rates, the instability of the dollar causing simultaneous worries about inflation and deflation; and micro-economic drags on business. A tax increase now would hurt investment.

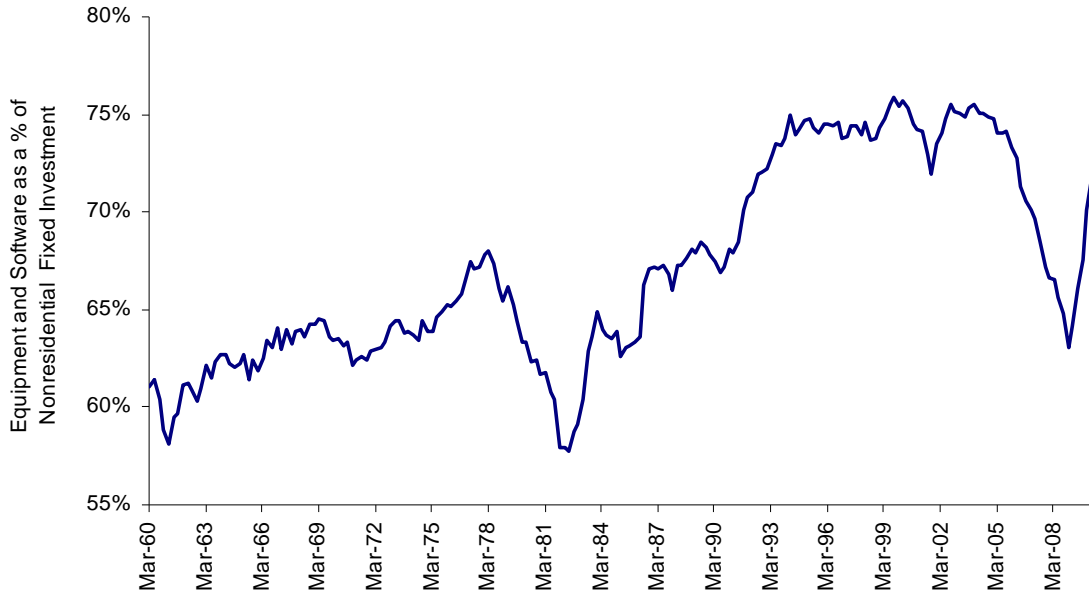
### Nonfinancial Corporate Business Fixed Investment Y/Y (last obs. Q2 2010)



Source: Federal Reserve Board; Encima Global

Greenspan noted another concern in the outlook -- that an increasing portion of the reduced amount of business investment is short term.

### Equipment and Software as a % of Nonresidential Fixed Investment (last obs. Q2 2010)



Source: Bureau of Economic Analysis; Encima Global

Asked about the high and rising debt-to-GDP ratios almost worldwide and the Greek crisis, Greenspan observed the sharp 1979 rise in bond yields as investors focused on U.S. debt.

### 10 Yr US Treasury Bond Yield (last obs. September 15, 2010)



Source: Federal Reserve; Encima Global

Greenspan emphasized that the current fiscal crisis is not just that we “can’t afford it” from a financial standpoint but also that we don’t have the physical resources in the economy to make good on government promises -- the uncontrolled rise in medicare services will cause a resource constraint.

There was also substantial discussion of housing. After a period of excess housing construction, extra housing has to be absorbed through lower construction levels and new household formation related to job growth. For now, however, real estate owned by financial institutions is very high. Furthermore, many conventional mortgages with 20% down payments were written in the housing boom of 2005 and 2006. The value of many of those houses has fallen to the level of the mortgage, with the risk that a downdraft in house prices will cause a wave of non-payments of mortgages (“isn’t it like free rent?”), possibly adding to the housing overhang. In Greenspan’s view, this threat of new underwater mortgages is a bigger risk than a double dip in the broader economy.

Greenspan believes that one factor that would help “lift the pall” over the economy would be higher equity prices, which are particularly stimulative. Our view: equity prices reflect prospects for future after-tax profits. Both respond to changes in the structure of the economy. Rather than Greenspan’s deficit focus and call for a tax increase, we think Washington’s preference for excess spending and more taxes is holding down long-term profit potential for the broad economy, holding back business investment and dampening equity prices.

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