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The Consequences of the Federal Reserve's Decisions on the U.S. Economy

An Essay - Part II

Last month we began this series on the Federal Reserve, starting with the purpose and functionality of the system. We discussed the Fiscal Theory, led by John Maynard Keynes (now out of fashion) and the Monetary theory, which is in practice now. We demonstrated the enormous power placed in the hands of the Fed to control the U.S. economy as a whole and we explained how the monetary system works.

Part II, below, addresses the unbridled power of the Fed's 12-member Federal Open Market Committee (FOMC) in shaping the course of the U.S. economy. We explore how the Fed impacts our money supply, our "free market" economy and the lives of all Americans.

Have you ever stopped to consider that you and I are victims of the Fed's attempts to control our economy through what often appears to be trial and error? Having researched the workings of the Fed, I now wonder how the fate of so many can be in the hands of so few. The Federal Reserve's FOMC seriously affects and controls our lives in many ways. This is a committee of seven Federal Reserve Board members and five Federal District Reserve Bank presidents. The members are people like you and me with families and children. Each member has several aides who are likely to possess economic training. Many may play the stock market, and all probably purchase mortgages and consume goods and services. Their collective decisions on various issues determine our economic fate more

than nearly any other type of government action short of declaring war or changing tax rates.



The effect of the FOMC voting may be to make changes in the money supply or

raise or lower the federal discount rate and the federal funds rate. Each decision made by the FOMC alters the course of the economy in one way or another. Naturally, these decisions are taken very seriously and are based on a wide range of economic data, including: the Producer Price Index (PPI), the Consumer Price Index (CPI), Gross National Product (GNP), Gross Domestic Product (GDP), non-farm employment, factory work week and overtime, the rate of growth in the money supply as indicated by M1, M2, and M3, foreign trade imbalances, percentage unemployment trends, production capacity utilization, bank reserve balances, the velocity of money, the stock and bond markets, etc.

Unfortunately, many of the FOMC's

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The Consequences...

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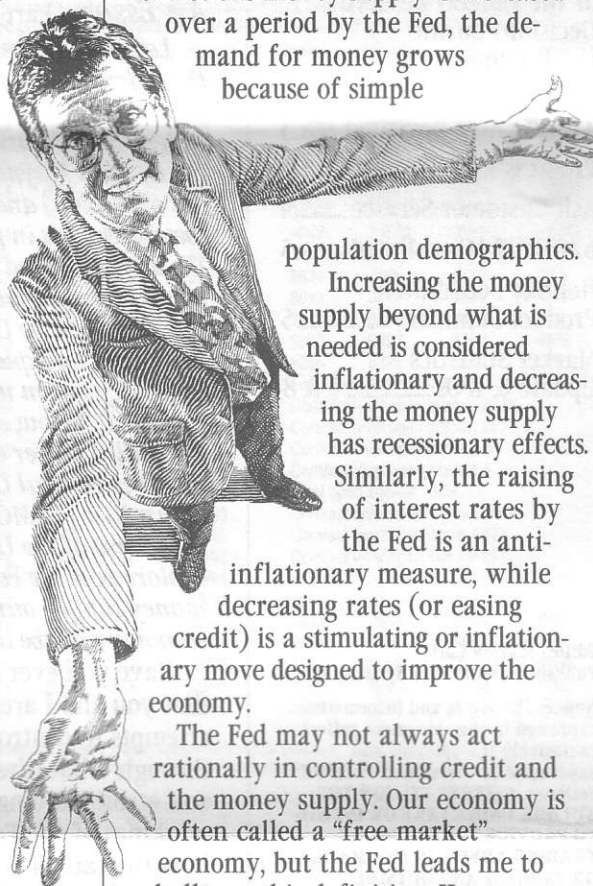
"The Fed decision-makers suffer from a permanent time lag, with limited hope of getting in step with the economy they hope to control."

decisions are based upon survey information that reflects the economy a few weeks before their meetings. Because of the time lag in compiling statistics, the Federal Reserve System is inherently slow to react to changes in the money supply or interest rates. Their resulting delayed decisions could easily impede their own efforts to limit or promote growth. What is achieved may be exactly the opposite of what is desired. Problems the Fed attempts to remedy may have already self-corrected by the time the FOMC acts. The Fed decision-makers suffer from a permanent time lag, with limited hope of getting in step with the economy they hope to control.

Another factor working against the Fed is the rate at which money turns over in the economy. Known as the velocity of money, this rate is a matter of great concern for the Fed. Velocity tends to amplify money supply considerations and can strongly and more quickly influence recessionary or inflationary effects. The velocity of money is the ratio of the Gross National Product (GNP) to the average money supply. The GNP is the dollar sum of all goods and services that have changed hands in the economy over the past year. This sum divided by the average money supply is the number of times the money supply has turned over. Money velocity has gradually moved upward since World War II from around two to about five or higher. Credit cards and electronic banking are a couple of modern factors which increase the rapid turnover of the money supply.

Whether we like it or not, the money supply must be controlled and it must vary according to the demands of the economy. Population demo-

graphics in the U.S. are such that more goods and services are required every day. The simple fact that new births and increasing human life expectancy increase our population daily creates an ever-increasing demand for money. By doing nothing, the Fed can put a pinch on the money supply. Whether or not the money supply is increased over a period by the Fed, the demand for money grows because of simple



population demographics.

Increasing the money supply beyond what is needed is considered inflationary and decreasing the money supply has recessionary effects. Similarly, the raising of interest rates by the Fed is an anti-

inflationary measure, while decreasing rates (or easing credit) is a stimulating or inflationary move designed to improve the economy.

The Fed may not always act rationally in controlling credit and the money supply. Our economy is often called a "free market" economy, but the Fed leads me to challenge this definition. How can an economy be called "free" when credit is expanded (interest rates are dropped) to expand business activity or credit is contracted (interest rates are raised) to slow down business activity? Such bridled control produces an oscillating economic effect when the reins are held too tight.

The Political Connection

Despite my wish to the contrary, the Fed is a super-political organization. The 12 FOMC members and their

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AUDITRACK Revisited

As reported in the December, 1994 CSI Technical Journal, there is a service for investors and software developers that can take you more than half way to the goal of tracking and certifying the results of your trading system in real time. The new type of pseudo-brokerage service provides audited trading results for paper trades made without investment capital. AUDITRACK, which is a brokerage firm acting in simulation, accepts trading orders in real time, and their independent report results in exactly the same way a full service brokerage firm handles real trades.

AUDITRACK is staffed by professional brokers who take orders by phone or fax, just as any brokerage would. They follow up with confirming phone calls and hard copy reports of fills and executions. They monitor the market liquidity and report accurate would-be fills based on order size and then-current market volume and open interest. For complete authenticity, AUDITRACK supplies a realistic fill price, which is adjusted for market slippage at the time of the order. The reported commission per trade is controlled by the customer, so it reflects the real-world charges associated with individual brokerage firms.

The big difference between AUDITRACK and, say, Merrill Lynch, is the absence of risk. The fills are comparable to a real trading account, but the possible capital erosion is not there. An account can be of any size, and trades can be executed in any quantity. The customer pays a fee of \$1.50 to 2.50 per contract, depending on the service level and size of the account, which can vary from a couple of thousand to more than a million dollars. The service is well worth the cost because it allows the analyst to learn to adjust to unforeseen market conditions, and to do so without risk.

AUDITRACK's value to the user is the real-time treatment received. There

is little difference between the record shown on an AUDITRACK brokerage statement and the result found on any other "real" brokerage statement. Both would prove the general result authenticating the customer's market timing. If you are considering a system you would like to market or purchase, there is no substitute for real-time experience. It makes sense to pass it through AUDITRACK's system for an accurate paper-trade test. Better yet, if you are considering a software purchase, have the software vendor pass it through AUDITRACK and use the account record to certify or reject his methods.

For more information contact: Mr. Bob Fitzsimmons, Marketing Coordinator, AUDITRACK, Inc., 309 S.E. Mizner Blvd., Ste. 62, Boca Raton, FL 33432 (407) 393-3876 • (800) 616-2825 • Fax (407) 393-5310. ♦



Progress Report

We are continuing our work on the major hardware and software upgrades underway at CSI and are currently phasing in new systems on our host computer. These are used for short periods of time in the evening to test reliability and accessibility. So far, the test results have been outstanding with much faster portfolio creation speed and improved accessibility.

Most of our tests to date have involved our direct-dial callers. Since that system is virtually stabilized, we are now focusing attention on network access. Tymnet callers can also look forward to faster baud rates in approximately two months. We'll keep you posted on this and provide new phone numbers when necessary. ♦

Ask Customer Service

A couple of times a year, our customer service staff steps aside to let our bookkeeping representatives address issues concerning CSI's billing procedures. Here are a few common questions and answers about our monthly statements from Debbie and Michelle.

Q. *I reduced my portfolio quite a bit at the beginning of this month, so I expected my CSI bill would be lower. I just received my invoice and it shows I owe the same amount for this month as for last. Why isn't there a difference?*

A. Our month-by-month billing procedure for custom portfolios always pre-bills for the current month based on your accessing statistics for the previous month. The current month's charge will always be the same as the previous month's charge, plus or minus any service adjustments. It is these service adjustments that keep the tables balanced and correct for previous over- or under-charges. If you are overcharged for the current month, next month's invoice will show a credit for the difference and your overpayment will apply toward the following month's balance. Likewise, an undercharge for the current month will be followed by a prior-month service adjustment asking you to pay the difference.

Q. *Am I required to pay the amount on my invoice even though I know it will be adjusted next month?*

A. We recommend that you always pay the amount billed and allow our accounting system to work through any over- or under-payments as time goes by. However, if you are sure your adjusted bill will be less than the amount on your invoice and you can't wait for the adjustment, you may submit only that amount which you feel is due. If you know we have substantially undercharged you, please feel free to submit a larger amount for your payment.

Q. *I updated 20 contracts for half the month and 50 contracts for the remainder of the month. How would you calculate my price?*

A. Your monthly rate is based on the average number of contracts and/or stocks retrieved daily over the course of the billing cycle. Our billing cycles actually run from mid month to mid month, as opposed to straight calendar months. Please keep this in mind when changing your portfolio.

Q. *My invoice shows a balance due of -\$39 even though my account has been inactive for over a month. How can I have generated more charges when I haven't been using the service?*

A. Whenever your amount due is a negative number (indicated by a - sign), the invoice becomes a credit memo and no payment is due. The amount shown is the credit in your account which we will apply to your future charges. Credit balances are common on a first invoice and in periods of inactivity because of our prepayment requirement. They may also occur if you overpaid a prior bill or received a credit for a CSI purchase.

Q. *How can I pay my invoices by credit card instead of by check?*

A. If you would like automated monthly billings on your credit card, please request an authorization form from us and return it to the bookkeeping department. Starting the following month, you'll receive a receipt with your invoice. If you prefer to preview your charges each month, you may call or fax authorization at your discretion. We'll need your name, User ID, credit card number with expiration date and the dollar amount of the charge. CSI accepts MasterCard, VISA, Discover and American Express.

Q. *What should I do if there is an error on my bill?*

A. Call or write the Bookkeeping

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6/95 CTJ Mis-collated

Apologies to our regular readers for the misplaced pages in last month's issue. Our printing company mis-sorted the pages and by the time we discovered the mistake, it was too late to re-print. The result may have been confusing to our readers. Fortunately, the pages were numbered correctly so with a little extra effort, most were able to muddle through. Congratulations to those who managed to keep up with the articles and thank you for your patience. ♦

Ask Customer Service...

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Department. We can be reached from 9 a.m. to 5 p.m. eastern time Monday through Friday (holidays excluded). Please have your User ID on hand and be prepared to say why you feel the bill is in error. Adjustments may be made up to six months after the initial invoice date. Your billing questions will be handled promptly and courteously. Our phone numbers are (407) 392-8663 and (800) 274-4727. Our fax: (407) 392-7761. ♦

Holiday Schedule

CSI will be closed for voice communication on Tuesday, July 4th for the Independence Day holiday. The CSI host computer will be accessible and data from overseas exchanges will be available as usual. Happy 4th of July! ♦

CSI Software Product Summary

Please check all that apply and complete the information box at right.

Mail or fax to CSI, 200 West Palmetto Park Road, Boca Raton, Florida 33432; Fax: (407) 392-7761

- QuickTrieve®/QuickManager®** for PC - To retrieve, manage & edit data (includes 1995 Alerts Calendar); New daily user \$59. QuickTrieve/QuickManager version 4.06 upgrade (for current QuickTrieve users only): \$39; shareware demo disk \$5
- 1995 Commodity Alerts Calendar** for use with QuickTrieve \$20; Calendar upgrade for current QT 4.06 users \$10
- QuickPlot®/QuickStudy®** for PC - Charting & analysis software (requires QT/QM) \$89
- Trade Data Manager™** - Macintosh downloader & accounting program \$59; upgrade \$49 or *FREE* with \$100 history order
- Trading System Performance Evaluator™ (TSPE)** for PC - Computes your system's capital requirements \$149
- Trader's Money Manager™** for PC - \$399 (includes TSPE); Demo disk: \$15
- TraDesk™** for PC - Traders' complete accounting system - CSI daily user \$149; Unrestricted use \$299; 30-day trial version \$22
- Seasonal Index Value Pack** for PC - Ten years of history for 33 popular commodities \$315
- Daily Updates** for PC - Starting at \$10.80 per month
- CSI Technical Journal Subscription** - \$35/Yr. Reprint - 8/90 to present - \$5/each issue
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The Consequences...

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respective aides do not publish the minutes to their frequent meetings, but they can certainly profit directly or indirectly from the decisions they make. The Fed acts on very short-term issues and they attempt to pacify current administration needs and concerns, including reelection. The longer term view may be better, and the population would be better served if the political element were removed from the equation.

A Computerized Alternative

In my view, the Federal Reserve System could more equitably be managed by a computer. Given the information the Fed has at its disposal, a computer could do an unbiased and fair job of controlling the money supply and the credit markets. Interjecting a politician's opinion is a sure way to achieve a biased and impractical result that will usually benefit one side at the expense of the other.

The computer control model could make published changes in moderation, without resorting to Senate hearings formalizing each and every strategic decision. Subtle changes orchestrated from factual (rather than political) motives would occur in such small deltas as to be largely unnoticed. The economy could be fairly managed and controlled without the usual trauma that may be caused by poorly chosen words of testimony by the Fed Chairman.

This would put an end to the ludicrous practice of acting on espoused feelings and subjective rhetoric from the direction of the Fed. Today, it seems, whatever is said in public or in private about money supply or credit by the Federal Reserve chairman or any key board member has an effect on the economy. These comments, whether planned decrees or misplaced whims, can reverse well entrenched stock market trends, affect mortgage lending practices and change the direction of the bond markets.

A Debt Free Future?

The work done by the Federal Reserve might take a quantum jump in simplicity of management control should the economy ever be free from debt. This, of course, is not within the current responsibilities of the Federal Reserve. Perhaps passage of the proposed balanced budget amendment will soon become a reality. Only then will we be better protected from some form of fiscal disaster. Our current system of money management, although more viable than the former Keynesian policy, does not avoid nor dampen the ever more wildly fluctuating boom to bust oscillations that we regularly experience. At some point there may be little that can be done to control the oscillations that could ultimately become catastrophic for the country and our currency.

What the reader may be left with from this month's Technical Journal is that one should not make trading decisions based on political rhetoric, nor should we expect the government to make rational decisions. On the other hand, markets are very directly affected by the Federal Reserve Board. I urge you to turn to C-SPAN and listen very carefully when the chairman has something to say. Try to capture the substance of his remarks, then prepare as best you can for the economic response. ♦

Bob Pelletier

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