

Feb 8 '87

REPORT TO THE SECRETARY OF THE TREASURY  
FROM THE U.S. GOVERNMENT AND FEDERAL  
AGENCIES SECURITIES COMMITTEE OF THE  
PUBLIC SECURITIES ASSOCIATION  
January 28, 1987

Dear Mr. Secretary:

Since the Committee last met in Washington in late October, interest rates have moved over a relatively narrow range. Following unusually large year-end demands for short-term bank credit, much of which was inspired by impending tax reform, money market rates have risen on balance by a quarter of a percentage point. Despite rising oil prices and continued weakness of the dollar in foreign exchange markets, long-term interest rates have been essentially trendless over this period, as investors appear to be convinced that the economy will remain in a moderate growth pattern.

The most recent evidence of the economy's performance underscores the view that although an imminent recession is highly unlikely, fully satisfactory growth remains elusive. Preliminary fourth-quarter real Gross National Product (GNP) expanded at a rate of only 1.7%, capping a second straight year of roughly 2.5% growth. Indeed, measured on a fourth-quarter to fourth-quarter basis, real GNP slowed from about 3% in 1985 to 2.2% in the year just ended.

This relative sluggishness and the immediate prospects for more of the same, reflect two key interrelated developments -- persistently large trade deficits that have siphoned off strong domestic demands to foreign producers and a slowing in income gains necessary to support continued spending growth.

Despite the sharp slide in the dollar over the past two years, the trade deficit may experience only limited improvement in the coming year. That depends importantly on a shift in relative growth rates of domestic demand in the U.S. vis-a-vis that overseas. The reluctance of key trading partners to stimulate demand, however, contributes to uncertainty on this score. Moreover, relative prices of tradeable goods have not shifted perceptibly, because of the willingness of foreign exporters to absorb currency losses or, as in some cases because currencies of important trading partners have not strengthened against the dollar. Finally, structural aspects of the trade deficit -- particularly in agricultural products and manufacturing industries, where competitiveness is still lagging - also constrain the chances for improvement in net exports.

Although consumer spending has been maintained at a fairly strong pace in the past year, slowing income gains have crimped savings and discretionary income has actually been declining for several months. Despite continued gains in consumer wealth, aided by a rising stock market, these factors and record debt service requirements relative to income may constrain this largest segment of the economy near-term. Together with slowing investment in nonresidential construction now in train, and a modest move towards fiscal restraint, these developments signal an overall moderation in the pace of final demands.

Against this background of disappointing economic momentum and a falling dollar, monetary policy has remained accommodative, holding short-term rates steady through a period of intense money demands that has revealed itself in part in heading expansion in the monetary aggregates. Gradually, however, bond investors find themselves caught in the middle between opposing concerns: The maintenance of accommodating monetary policy amidst a declining dollar and persistently high trade imbalances, has raised concerns about potentially rising inflation and a reluctance of foreign investors to readily place dollars in our markets. While such prospects could increase pressure on interest rates, offsetting concerns that failed trade improvement may lock us into sluggish economic growth, imply weak private credit demands and further interest rate declines.

Before proceeding with the Committee's recommendations with respect to financing needs for this quarter, let me first earnestly repeat a request made at the last few meetings. Because of the uncertainty of both receipts and expenditures and the possibility that the budget deficit will continue to decline, the Committee deems it essential that a special meeting be called by the Secretary so that the Committee can consider what recommendations it would make as to future financings. The special meeting is needed so that a recommendation can be made when not under the constraints of half a quarter's financing already done as planned and so that the Committee can receive technical assistance from professionals in their firms. It would be most difficult to recommend the elimination of a cycle note in the middle of a quarter or to recommend any other major financing change at that time. We remain ready, willing and able to meet at your request.

To return to the current quarter, the Committee recommends by a vote of 19-1, that the following securities be sold at auction to refund \$14.6 billion of publicly held notes due February 15 and raise \$14.4 billion of new cash:

- \$9-3/4 billion of 3-year notes due 2/15/90;
- 9-3/4 billion of 9-3/4 year notes due 11/15/96;
- 9-1/2 billion of 29-3/4 year bonds due 11/15/2016

This recommendation incorporates the reopening of the 7-1/4% notes due 11/15/96 and the 7-1/2% bonds due 11/15/2016. The vote for reopening was unanimous. The Committee believes that the additional liquidity provided by larger issues is beneficial both to dealers and investors in the market and to the United States Government. We have recently seen considerable buying of corporate securities by investors and the resulting reduction in spreads between Governments and corporates. One of the reasons for this buying is that there are simply not enough long Government securities to satisfy this demand. There is no reason why the Treasury should not be the beneficiary of this buying. In view of the current market prices of the two outstanding issues, we strongly recommend their reopening.

The Committee recommended a refunding of the same amount as the last quarter's because of the Treasury's lessened cash demands. We do not believe that the refunding should be reduced because it is the Committee's feeling that emphasis should continue to be placed on quarterly refundings at the expense of other cycle notes, or to a lesser extent Treasury bills. It also believes that some debt extension is still desirable and reminds the Treasury that the elimination of the 20-year bond left a void in the longer dated Treasury market which it is felt should be at least partially filled by reasonably sized 10-year and 30-year issues. We considered the issue of whether there would be buyers for those issues and are confident that the two reopened issues would do well at auction. The Treasury must keep its place in the long bond market with sizeable, viable issues.

For the remainder of the quarter, we recommend the following financings:

- Sell \$10-1/4 billion of 2-year notes at the two remaining auctions, raising \$1.55 new cash;
- Sell \$8-1/2 billion of 5-year notes, raising all new cash;
- Sell \$7-3/4 billion of 4-year notes, raising \$1.55 new cash;
- Sell \$9-3/4 billion of 52-week bills, raising \$1.15 new cash;
- Sell \$14.3 billion at each of the remaining 3- and 6-month Treasury bill auctions, reducing cash borrowing by \$9.7 billion net.

The Committee discussed the advisability of this net reduction in the amount of Treasury bills sold and felt comfortable with its recommendation for two reasons. First, any drift in receipts or change in the budgetary picture can quickly be adapted for by an increase in the amount of weekly bills. Second we repeat the importance we place on continued access and liquidity in the long bond market. If a special meeting were to be called, the Committee might well decide to eliminate one of the non-refunding cycle notes and maintain an increase in the bill auctions, but we would need the time and data this meeting would provide to do so.

Summary of Cash Needed -- \$45 Billion

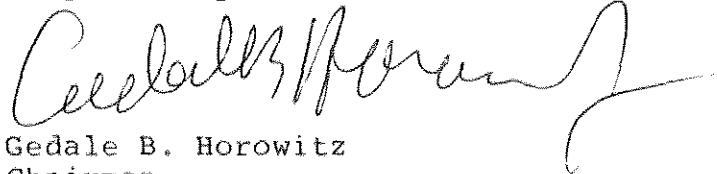
Refunding	\$14.40 Billion
3- & 6-month bills	(9.70)
52-week bills	1.15
2-year notes	1.55
4-year notes	1.55
5-year notes	8.50
	<u>17.45</u>
Already raised	<u>5.25</u>
	22.70
Estimated foreign add-ons	1.30
Net Market Borrowing	24.00
Decrease in Cash Balance	<u>21.00</u>
Cash Needed	\$45.00 Billion

This would produce a projected cash balance on 3/31/87 of \$10 billion which the Committee recommends unanimously. Given the uncertainty with receipts and outlays the Committee by a vote of 17-3 recommends a 6/30/87 cash balance in the \$15 billion to \$20 billion range.

Mr. Secretary, with the hoped for reduction in the budget deficit and unknown effect on receipts of the new tax law, the Treasury is entering into a very important era for debt management. Changes in what has become a regularized financing schedule will surely have to be made, and as noted at the beginning of this report, our group stands ready to assist the Treasury in this task.

Thank you Mr. Secretary.

Respectfully submitted,



Gedale B. Horowitz  
Chairman

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REPORT TO THE SECRETARY OF THE TREASURY  
FROM THE U.S. GOVERNMENT AND FEDERAL  
AGENCIES SECURITIES COMMITTEE OF THE  
PUBLIC SECURITIES ASSOCIATION  
April 29, 1987

Dear Mr. Secretary:

Since the Committee last met in Washington in January, interest rates have risen dramatically, breaking out of a nearly year-long trading range. Intermediate and long-term interest rates have increased between one and one half percentage points in the past several weeks as investors appear to be concerned about a renewed acceleration in inflation. The move higher in short-term interest rates has been relatively modest as monetary policy has remained, for the most part, cautiously accommodating in a period of uncertain economic momentum, worldwide credit fragilities and continuing currency instability.

A number of related developments have been responsible for the tremendous setback in bond prices. Most important among these is the unremitting pressure on the dollar in foreign exchange markets and the fear that a major confrontation is brewing among key trading nations over trade and economic policy. Even heavy reported intervention in foreign exchange markets by the Federal Reserve and other central banks has been unable to arrest the dollar's slide. Although the Federal Reserve appears to be moving in the direction of a modest tightening, efforts to steady the dollar thus far have failed because market participants do not believe that the fundamental policy changes required both here and abroad to stabilize currencies will be forthcoming promptly.

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The dollar's decline has begun to raise inflation fears and concerns about higher interest rates. Investors believe that a falling dollar will lead to a sharp increase in import prices, which will feed through to prices of domestic goods, particularly if U.S. businesses respond to higher import prices by raising their own quotes. In addition, the dollar's continuing weakness has fostered the perception that private foreign investors will no longer be attracted to our markets. Indeed, there is evidence that such inflows, particularly from Japan, have slowed recently. In this context, the painfully slow progress in redressing large budget deficits increases the chances of renewed credit market pressures and weakness in domestic investment.

To underscore the current apprehension in financial markets, reported inflation has been higher in recent months. Consumer prices rose at an annual rate of more than 6% in the first quarter. And even if the substantial rise in energy costs is removed, remaining items have risen by a nearly 5% rate compared with the 3 1/2%-4% increases of the past three years. Strong increases in apparel prices seem to highlight the risks of the impact of higher import prices on inflation. Despite these negative developments, however, other inflation fundamentals remain somewhat favorable as evidenced by continuing low wage growth and rather modest collective bargaining settlements.

The hesitant pattern of economic growth of the past two years has continued into 1987. Although real economic activity appears to have accelerated in the first quarter, the strength was reflected primarily in buildup in nonfarm inventories. Final demands, especially from consumers were weaker, as households continue to retrench after a rapid spending pace last year in the face of slowing real income gains and growing debt burdens. That mix of strong production and slowing demands promises a much reduced pace of activity in the current quarter as demand slowly revives, while businesses attempt to pare unwanted stocks.

Longer economic considerations continue to hinge on progress in reducing the large trade deficit. Apart from the increasing competitiveness of American firms and the beginnings of a shift in the relative prices of tradeable goods, the key to progress in this area lies in the pace of growth among some of our key trading partners. In recent months, however, economic growth projections for the largest surplus nations, West Germany and Japan, have been fading with optimistic estimates bordering near 2% for this year. Rising currency values have hurt export industries in these countries, while the pace of domestic demands remains modest. Although there have been some efforts at

stimulating growth, foreign exchange markets remain doubtful that policies will quickly reduce large internal payments imbalances. Monetary policies in these countries have shown varying degrees of flexibility, while fiscal policies appear largely straight-jacketed.

In an environment of currency instability and nervousness, these developments have placed the Federal Reserve in a particularly difficult situation. Not only would an overt policy move, such a discount rate hike, jeopardize the U.S. economic expansion, it would also temper the prod of a lower dollar on our trading allies to stimulate their own economies. And without policy changes abroad, such a move may only temporarily stabilize the currency. Should the Federal Reserve be forced to act unilaterally, it would heighten the risks of global economic slowdown.

The Committee considered the general state of the economy and the state of the current market for the United States Government and other securities in deciding what recommendations to make in this report. Being market participants we are well aware of the unsettled state the market is in. We also took in to consideration the financing needs of the Treasury in the next two calendar quarters, needs which will not be much affected by whatever resolution occurs in the continuing budget discussion between Congress and the Administration. We also discussed at length possible buyers for the Treasury's offerings and the chance that some recent buyers could not be participants in this quarter.

Having taken all of the factors into account we recommend unanimously that the following securities be sold at yield auction to refund \$12.6 billion of publicly held notes maturing May 15, raising \$16.4 billion new cash:

\$10 billion of 3-year notes due 5/15/90  
9 3/4 billion of 10-year notes due 5/15/97  
9 1/4 billion of 30-year bonds due 5/15/2017

This is exactly the same size and amount of various issues as the January refunding. One important factor in our discussion was the needs of the Treasury in the next two quarters. A refunding of like size will be necessary in the third quarter calendar and a larger one will probably be necessary in the fourth quarter. The market has gotten accustomed to these size refundings and to change now would not be beneficial. There was absolutely no question in any Committee member's mind that the recommended refunding would be underwritten without problem. While some

buyers may disappear we feel that the major change in interest rates will bring in many buyers at a coupon rate ?????? higher than that of three months ago. We believe that, in spite of all pension funds and insurance companies which have held considerable cash in anticipation of higher rates, will commit some of the cash. Finally, we believe that reducing the 10- and 30-year issues by a small amount (up to \$1 billion) would not greatly lower the Treasury's interest cost and would deliver the wrong signal to the market. A nominal reduction would get a great deal of attention and might be interpreted as a sign of weakness. We are convinced that the debt of the United States can be underwritten as it always has been. The only change that could have a substantial effect in interest cost would be a truly substantial reduction in 10- and 30-year issues, but we believe that this short term benefit would be more than offset by the appearance of weakness on the part of the Treasury and the uncertainty it would create as to future financings.

For the remainder of the quarter we recommend the following financings:

- Sell \$10 billion of 2-year notes at the two remaining auctions raising \$250 of new cash;
- Sell \$8 1/4 billion of 5-year notes raising \$1.65 billion new cash;
- Sell \$9 3/6 billion of 52-week bills at two remaining auctions raising \$900 million new cash;
- Sell \$13.2 and 13.6 billion at the remaining 3- and 6-month Treasury bill auctions reducing cash borrowings by \$6.2 billion net.

Summary of Cash Needed -- \$25.5 Billion

Refunding	\$16.400 Billion
3- & 6-month bills	(6.200)
52-week bills	.900
2-year notes	.250
4-year notes	1.650
5-year notes	8.250
	<u>21.250</u>
Already reused (net)	3.250
Estimated Foreign Add-ons	1.000
Net Market Borrowing	<u>25.500</u>



This would produce a projected cash balance of \$20 billion on 6/30/87 which the Committee recommends. The borrowing needs are high in the third calendar quarter and any slippage in asset sales could create a higher cash need.

The Committee also recommends a cash balance of 20 billion for the quarter ended 9/30/87.

The Committee, while realists, encourages a quick decision on the debt ceiling and, if asked, will assist in whatever it can do to obtain passage of the legislation. A temporary extension is helpful, but market uncertainties affecting both supply and interest cost can result from uncertainty and dislocations.

Mr. Secretary, your charge asked the Committee for any comments we wished to make on related matters. With this in mind we spent considerable time discussing non-dollar financing by the U.S. Treasury, particularly a yen denominated financing. As a result of our discussions, we concluded that it was not within the purview of the Committee to make a recommendation on a matter that transcended fiscal policy. There are many areas of policy away from the fiscal arena involved in determining whether or not to do such a financing and we therefore felt that our elected officials were the ones to make such a decision. Let me say, however, that two conclusions did result. If, for policy reasons the U.S. Government determines that a one shot financing in yen should be done, we would ask that the Committee at least be consulted on the method used to effect this financing. In addition, it was the general feeling of the individuals on the Committee that the idea of the United States financing on a regular basis in non-dollar securities was not a good one, because we should repay our deficit in dollars and not have to concern ourselves with the ability to earn foreign currencies to repay the indebtedness.

Mr. Secretary, while we have given only sketchy outline to the foreign denominated debt questions we would be happy, if you desire, to respond orally, as individuals, to any questions in this area.

Thank you Mr. Secretary.

Respectfully submitted,

/s/

Gedale B. Horowitz  
Chairman

REPORT TO THE SECRETARY OF THE TREASURY  
FROM THE U.S. GOVERNMENT AND FEDERAL  
AGENCIES SECURITIES COMMITTEE OF THE  
PUBLIC SECURITIES ASSOCIATION  
October 28, 1987

Dear Mr. Secretary:

During the past several months, financial markets in the United States and elsewhere have witnessed dramatic, and in many cases, unprecedented volatility. The onset of rising interest rates in the spring was fed by concerns about rising inflation, a declining value of the dollar in foreign exchange markets, and evidence of a resurgent economy. In the short span of six months, long-term U.S. interest rates rose by roughly three percentage points to their highest levels in two years. And policy's response to inflation fears prompted significant, though less dramatic, increases in short-term rates, as the Federal Reserve first tightened reserve availability and later raised its discount rate.

The events of the past week, however, have substantially altered the perceptions and expectations of financial market participants. Indeed, the sharp retreat and subsequent volatile pattern of stock prices have cast a cloud over an otherwise improving pace of economic growth. Important questions have been raised about consumer and business confidence and the potential impact of sudden retrenchment on the overall economy. That shift, in turn, has had a favorable impact on interest rates, erasing nearly half of the previous setback in just a few days.

A sudden jolt to confidence is especially noteworthy at present, because the economy's performance in 1987 has been considerably better than the sluggish pace of the prior two years. An export-led revival in manufacturing activity and capital spending has breathed new life into the current expansion, more than offsetting a slowdown in domestic demand. Indeed, bolstered job and income growth has, until now, been supporting a mild recovery in consumer outlays and the highest levels of consumer confidence in more than a decade. Nonetheless, the improvement in business attitudes and consumer sentiment may now be shaken by the concerns over stock market instability. Even in the event that lost wealth is restored by an interim recovery of share prices, the shock effects of the recent setback may alone be enough to noticeably stall spending decisions for a time.

Any cooling in the pace of economic activity would, of course, not be without its favorable side effects. Against a backdrop of slackening demands, inflation would moderate as business operations slow and pressures on tightening labor markets abate. This is of particular concern in light of recent evidence that the growth in

hourly earnings has picked up to 4 percent from its earlier pace of 2 percent to 2 1/2 percent. And operating rates in key primary processing industries have reached levels not seen since the latter part of the 1970's. Against that background, the volume limitations imposed by import quotas and restrictions have firmed prices of imported goods such as steel and shoes. More rapid import price gains would weaken the discipline of strong foreign competition in curbing domestic price hikes.

The U.S.'s persistently high trade imbalance might also benefit somewhat from a diminished pace of demands as imports slow. A drop in imports would dampen economic growth overseas, most notably in Japan, but also among other trading partners. The plunge in foreign stock markets and an aura of financial uncertainty might also weaken economic prospects abroad, but the effects in the United States may be larger.

Amidst uncertain economic prospects and unprecedented volatility in financial markets, the Federal Reserve faces a difficult task. At this still somewhat early date, the magnitude of the impact of recent events remains unclear at best. Containing the fallout from potential financial dislocations and meeting the heightened demand for liquidity already evident has thrust the Fed into a more accommodating stance. Generous provision of bank reserves has placed renewed downward pressure on the key Federal funds rate. Monetary authorities may be reluctant to take more aggressive measures, such as reducing the discount rate, until sufficient evidence of economic slowing surfaces. Such a posture would serve to buoy financial markets.

Longer term economic considerations remain vitally dependent on the resolution to the twin problems of large budget and external trade and current account deficits. Financial market participants around the world eagerly await news of progress in current budget deliberations in the U.S. Without satisfactory deficit reduction now and a credible promise of future reductions, it will be difficult to meet the financial requirements of a growing economy without the continued reliance on foreign savings or the burden of stubbornly higher real interest rates. With the foregoing in mind, our committee has prepared its recommendations.

We have made a basic assumption as to the amount of open market borrowing to be done by the Treasury. In view of the considerable activity in the State and local series Treasury obligations, we have estimated that Treasury receipts from this activity will be approximately \$10 billion. Our recommendations incorporate this estimate.

For the refunding of \$13.3 billion of privately held notes maturing November 15, we propose that the following securities be sold raising \$10,350 billion of new cash:

- \$9 3/4 billion of 3-year notes due 11/15/90
- 9 1/4 billion of 10-year notes due 11/15/97
- 4 3/4 billion of 30-year bonds due 8/15/2017

The 3- and 10-year issues should be sold at yield auctions as new issues. The 30-year bond incorporates our recommendation that the 8 7/8% bonds of 8/15/2017 be reopened and that the new bonds be sold at yield auction.

In making this recommendation, the committee took a number of factors into consideration. We first decided by a vote of 11-7 to propose the selling of a long bond, even in its reduced size. Those in favor of selling a long bond cited regularity of issuance and the request given in the charge for a refunding to raise \$10-11 billion of new cash as among their reasons. Those opposed felt that a smaller issue proved little, as the market would understand the omission due to the 4 1/4 % limitation, and because of their fear that a small issue might make market manipulation possible. The latter reason, plus the importance of added liquidity provided by larger issues, led to the recommendation being tied to the reopening of the 8 7/8% bonds. An issue of such small size would not mean much without the reopening. It was felt that there was enough room between the current market price and the base 92 3/4 point discount permitted to be certain that the new bond could sell safely. After the motion to sell a long bond carried by the aforementioned 11-7 vote, the committee voted 15-3 to propose the refunding discussed above.

For the remainder of the quarter, we recommend the following financing:

- Sell \$9 1/4 billion of 2-year notes at the two remaining auctions, reducing cash borrowing by \$1.2 billion.
- Sell \$7 1/2 billion of 5-year notes, raising all new cash.
- Sell \$7 1/4 billion of 4-year notes, raising \$1.45 billion of new cash.
- Sell \$13.6 billion of 3- and 6-month bills at the remaining auctions, raising \$2.3 billion.
- Maintain the two remaining 52-week bills at the same amounts as are maturing.

## Summary of Cash Needed -- \$80 1/4 billion

Refunding	\$10.350 billion
2-year notes	(1.200)
4-year notes	1.450
5-year notes	7.500
3- & 6-month bills	<u>2.300</u>
	21.600
Already raised	26.75
Estimated foreign add-ons	<u>4.50</u>
Net Market Borrowing	52.85
SLUGS	10.00
Decrease in cash balance	<u>21.50</u>
Cash raised	\$84.35 billion

This would produce a projected cash balance of \$19 billion. We are recommending a cash balance in excess of \$15 billion for two reasons. First, in case our estimate of \$10 billion of SLGS is too high (which we don't believe), the excess cash balance could be used to make up the difference. Secondly, you have asked our opinion on the scheduling of 7-year notes, and we believe that the increased cash balance would be used to alleviate the problem. We recommend that 7-year notes in the future be dated on the date the outstanding notes mature. This would alleviate a problem for the Federal Reserve by permitting it to roll its 7-year holdings at auction, something it could not do with a different day of dating and day of maturity. Also, it would permit outstanding public holders to roll holdings without any inconvenience. There would also be the added advantage, particularly in this quarter, of removing the 7-year from auction in what is the worst market week of the year, the week between Christmas and New Year. The committee believes that a sale in this week produces higher yields to Treasury than any other time of the year. However, moving the dating of the 7-year to the 15th of the month creates a cash problem for the Treasury in the beginning of the month, a problem that could be solved by use of the larger cash balance or alternatively through the sale of a short-dated cash management bill.

If for any reason our SLG estimate is incorrect, we would recommend adding to the 3- and 6-month bills. As the current state of the equity and Treasury markets has led to very sizeable bill purchases, we feel that Treasury should take advantage of this opportunity. This is the reason that we have recommended an increase in 3- and 6-month bills to \$13.6 billion weekly.

You should also note that we have reduced or held steady the next 2-, 4- and 5-year note auctions. We have done this in preparation for the hopeful decline in Treasury calendar due to a budget deficit

reduction. As you may remember from the report of our special meeting this year, we proposed such a decrease in these issues, leading possibly to the elimination of one of the cycle notes altogether. We trust we are preparing the way.

The committee cannot let this meeting go without commenting on the PSA's letter on SLGS. Though we are a committee of PSA, we reject this letter out of hand. We are not at all sympathetic to the issue raised vis-a-vis state and local governments, as issuers entered into these transactions on an economic basis when they were done. They should not have the opportunity to profit from the issuance of SLGS at above market yields, thereby penalizing all tax payers for the benefit of particular taxpayers of a single state or municipality. We would urge Treasury to move as quickly as possible to daily pricing of SLGS to completely eliminate this abuse.

Finally, as I complete my term as chairman of this committee, let me say thank you to you Mr. Secretary and your staff and the committee for the opportunity to serve you and the Treasury in what I believe is a most important and worthwhile endeavor.

Thank you Mr. Secretary.

Respectfully submitted,



Gedale B. Horowitz  
Chairman