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Acrophobiacs have been sighted

By Sholom Sanik

Let's face it: We've been here before. The market gets spooked over inflation, interest rates, countries that are falling apart, etc. The Dow Jones Industrial Average drops a few hundred points, and long-suffering bears think it's finally over. The script, however, has varied little over the years. Even large, deep selloffs accompanied by bad breadth and supportive bearish economic fundamentals have turned out to be nothing more than glorified corrections. In defiance of what the bearish community have considered unjustified circumstances, small caps, large caps, mid caps, all caps – for 16 years now – have roared back and made new highs.

Once again, the market has embarked on just such a correction. What will it be this time? More of the same, or is there something unique here? The problems that will ultimately bring an end to the long-running bull market have been with us for a long time. Perhaps this drop will be no different from the others. Perhaps it will. True bears will probe the downside whenever there is some weakness to be sure not to miss the day that sanity finally rules.

But make no mistake. This is no faint-hearted attempt to ride the latest short-term trend. As well-documented in *Friedberg's Commodity & Currency Comments* and previous issues of this letter, readers know how we feel about the Fed's accommodative monetary policy. The bond market, for the most part, has agreed with us. Despite CPI readings that indicate a very tame inflation rate of 2%, bond traders are worried enough to maintain 6% yields on the long bond. After the Fed raised the Fed Funds rate by a quarter of a point on June 29, a short-lived euphoria set in that saw bond yields back off to 5.85% and the Dow Jones rally over 6% to yet another new peak.

Some celebrated the fact that the Fed was not planning to choke the economy with an aggressive 50-basis-point hike in rates, while others were pleased that the Fed took some action to quell inflation fears. Then there were others – you can never make everybody happy – who were downright disappointed that the Fed was not more aggressive while the economy was still strong and credit conditions were stable enough to include another quarter-point rate hike into the move. The influence of this last group could push yields beyond the high mark of

6.19% to "punish" the Fed.

The most recent string of labor data shows that there is indeed a tight labor market. Hawks fear that there are price pressures lurking in the shadows that have not shown up yet in the CPI. Second-quarter ECI grew by 1.1% – the street was expecting growth of .9%. Today's non-farm payrolls came in at 110,000 jobs above analysts' estimates. Average hourly earnings rose .045% against an expectation of .03%.

The market is down about 8% from the recent high. The money that fueled the bull market for so long may be looking elsewhere. Net cash flows into equity mutual funds in the first half of 1999 were 27% below the same period in 1998. The beneficiaries have been money-market and bond funds. Competition from a 6% bond yield may finally be catching up with this market.

There is a point where Treasuries will pay enough to lure investors away from stocks. The opportunities of capital appreciation will be overshadowed by the security of guaranteed returns. The position we are in right now is not that different from where we were shortly before the crash in October 1987. Then, the yield on 30-year Treasuries was about 9%, and CPI was running at 4.5% per annum. Today the yield on Treasuries is over 6%, and the CPI is 2%. Dividend yields on the S&P

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Unless otherwise indicated, all articles have been written by Sholom Sanik (E-mail: ssanik@friedberg.com).

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were 2.8% compared with today's dividend yield of 1.25%.

Although the PE ratio on the S&P has come down from a high of 35 to 31, it still is way above historical norms. To continue our comparison with 1987, consider that the PE ratio on the S&P at the top of the market back in August of that year was 21. It would be clear, then, that the prices we are witnessing today indicate that investors are expecting performances from corporations that are highly optimistic, perhaps even unrealistic.

The breadth of the market has deteriorated drastically. The

broad participation of this decline can be seen in the cumulative advance/decline line (Chart 1) and the 20-day moving average of the ratio of new highs to new lows (Chart 2). It seems that what started as just another ho-hum, glorified correction may be turning into a full fledged bear market.

[July 26, 1999]

CURRENT STRATEGY: Stopped out of our short S&P as per Flash Update of Tuesday, Aug. 17. Liquidated long S&P/short Russell 2000 spreads as per Flash Update of Aug. 23.

Chart 1 – Cumulative Advance Decline Line (NYSE)

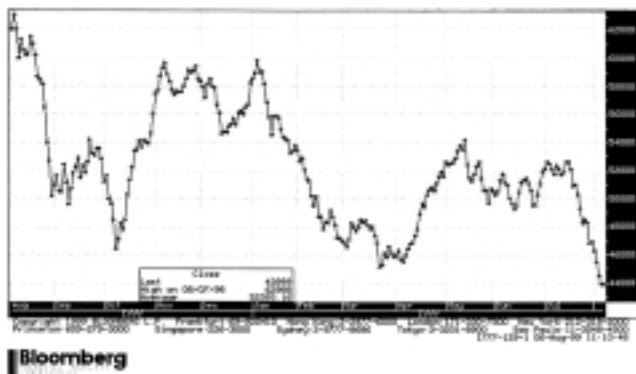
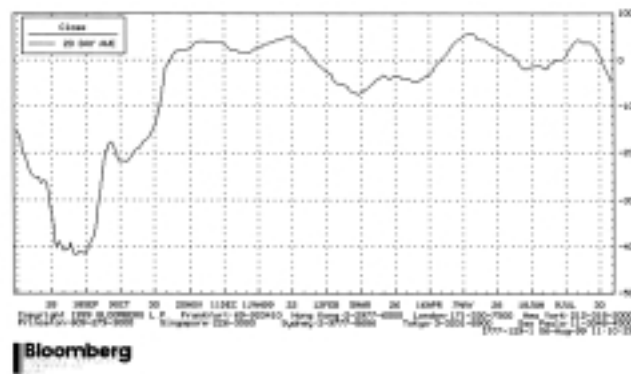


Chart 2 – 20-Day Moving Average of New Highs/New Lows (NYSE)



GOLD/SILVER RATIO

A pause, but the trend is still on track

In February 1991 an ounce of gold bought 98 ounces of silver. Today an ounce of gold will fetch only 48 ounces of silver. While the gold/silver ratio has experienced much volatility throughout the decade, the major trend has been quite clear (Chart 3). Has it been strength of silver or weakness of gold that has caused such a divergence?

Actually, both have contributed generously to the cause. Silver has appreciated 42% since the ratio peaked 8 years ago, while gold has declined by 30% in the same period. Unlike most commodities we trade, silver and gold have both run production/consumption deficits since the beginning of the decade. The big difference between the two is that the deficit in gold is compensated by above-ground supplies, which includes forward and central bank sales. The silver market has no hedging or bank sales to speak of. Scrap has made up some of the deficit since the market began registering deficits in 1990, but a sizeable gap between supply and demand remained (Chart 4). The deficit in the silver market is expected to be about 150 million tonnes in 1999, which represents about 17% of total demand. Are the driving forces between gold's strength and silver's weakness still as prevalent today as they've been most of this decade? Well, the short-term looks a bit shaky, while the long-term is intact.

The bearish effect of central bank sales on the price of gold is twofold. First, as noted, it ensures a well-supplied market. Perhaps of greater importance, though, is the psycho-

logical effect that has been instilled in participants, who must constantly brace themselves for the next onslaught of central bank sales.

Although there is plenty of gold still slated for sale by central banks, the slide in the price of gold has abated for the moment. The last downleg in gold – from \$290 an ounce to \$252 an ounce – was inspired directly by the Bank of England's announcement in May that it would divest itself of 415 of its 715 tonnes of its reserves. The well-publicized sale of the first 25-tonne tranche on July 6 triggered the final (to date) \$10-per-ounce drop of this leg. Prices have since firmed to \$260-per-ounce. Shades of a sell-the-rumor-buy-the-news classic.

The bounce in gold can be attributed to a number of factors. The IMF has discussed selling 300 tonnes of gold to raise cash for loans to impoverished nations. It now seems very unlikely that this sale will ever take place. The proposed sale would have a very difficult time passing through US Congress. This has been known for some time. More recently there has been a campaign by producing nations, which have complained bitterly about central bank gold sales. They argue that the sales, which depress gold prices, are destroying the economies of many of the poor countries that earn a disproportionate share of their export revenues from gold mining and that fit the profile of the very countries the IMF is supposed to be helping. Although the IMF sales would be substantial, they represent but a fraction of the thousands of

tonnes that could be sold by central banks. It is, however, an organization that needs to be politically correct. The news that its sales will likely never happen creates some fresh bullish sentiment.

The market is heavily short, and little would be required to violate resistance levels on the charts to set off a bout of short-covering. Adding to the near-term bullish sentiment is a looming strike by South Africa's National Union of Mineworkers, which would bring the country's output almost to a halt.

The short-term outlook for the bullish case in silver is a bit cloudy. A substantial buildup in the open interest has accompanied the recent 70¢-per-ounce rally. The open interest continues to rise, even though the market has slipped 25¢ off its high. Our interpretation of such a formation typically indicates that the additional buying that is coming through is weak, because it could not sustain the rally.

There's been some interesting bullish news on silver's fundamental front. Despite the fear overhanging the long-term bullish case for silver that rapidly advancing commercial viability of digital imaging would cut into silver demand, some recently published data indicate that this problem is at

the very least on hold. Kodak has been cutting prices on film since spring. Sales of film by Kodak increased in July by 23% over last July. Even more intriguing is the fact that sales at Fuji, which hiked the price of film by 4% during the same period, piggybacked on the demand created by Kodak. Their sales rose by 35% in July.

The gold/silver ratio is very volatile. It is in a very long-term trend probably outperformed in duration only by the stock market. It is clear to us, as illustrated, that the major trend in silver is up and the major trend in gold is down. Still, as illustrated, each market becomes overcooked from time to time and counter-trend moves occur in the spread, but that leaves the major trend intact. This trade is not for the faint of heart and cannot be treated with the same trading disciplinary rules that one would apply to most other trades. At best, one could "lighten up" on the size of the position if it seems that a correction in the spread is imminent, and then use the counter-trend move to re-establish a full-size position.

[August 13, 1999]

STRATEGY: Maintain long silver/short gold spreads.

Chart 3 – Gold/Silver Ratio

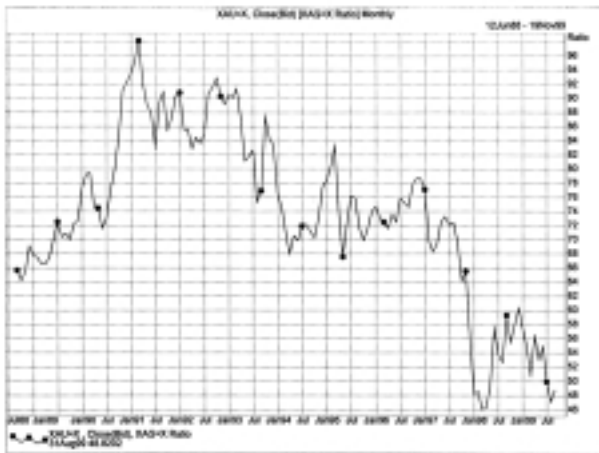
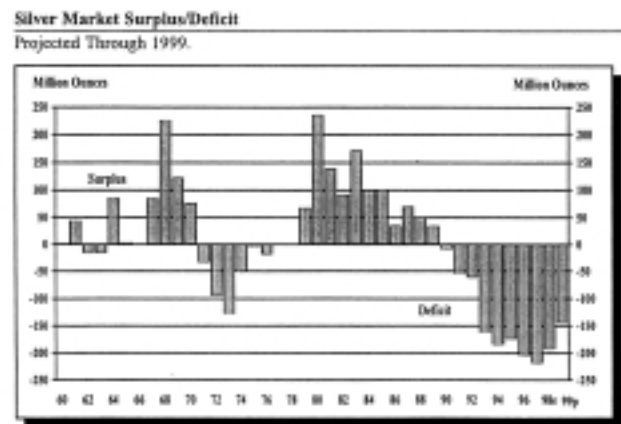


Chart 4



Courtesy of CPM Group's Silver Survey 1999 (February 1999)

THE FED

Doing its job

As the August 17 release of the previous month's CPI data approached, financial-market participants, once again, were found holding their breath in anticipation of what might be dramatic news. Analysts' estimates called for a .3% rise in the CPI for July. The number came in as forecasted. Despite an implied annual inflation rate of 3.6%, traders exhaled and celebrated with rallies in both stocks and bonds. Even before the release of the CPI, the Dow Jones Industrial Average (DJIA) had recovered over half of the losses suffered in the stock market's steep summer slide, indicating that an unexpectedly bad number and any subsequent tightening action by the Fed was already factored into the market. By August 23, the eve of the FOMC meeting, the DJIA completed its recovery, closing at a

new record high. The Fed raised both the Fed Funds rate and the discount rate by 25 basis points (bps). Stocks swayed a bit but maintained their upward course.

Using CPI readings that cover recent, short periods of time is not a very useful way of determining what 30-year T-bond yields should be. With 3 months of CPI under our belts after the scary .7% rise in April, many economists now feel increasingly safer in declaring the April number an aberration. In fact the few bad numbers we've seen have been attributable directly to specific – but not necessarily continuously trending – factors. Almost half of the rise in July's CPI, for example, was on account of energy prices. Energy prices have risen dramatically this year. They could continue to rise, but are very volatile

and could just as easily suffer setbacks that would offer up low readings. The actual annualized CPI for the past year is only 2.1%.

In the past, long periods of economic expansion with unchecked growth in money supply have resulted in inflation. That is why the bond market has been so weak, with yields on the long bond rising by 150 bps points since last autumn. The market (including us) has kept bracing itself for that awful bit of inflation news to drop. The fact is that it hasn't and doesn't seem likely to in the near future. Even the wealth effect that should be forthcoming from the unprecedented rise in equity prices does not seem to be translating into higher prices. Every measure of the labor force has been showing tightness for some time now. Falling weekly jobless claims, growth in monthly non-farm payrolls and average hourly earnings, and surprisingly high quarterly employment-cost index figures send some jitters through the market when they are released. Fears quickly abate, though, as the market comes to realize that we may be in a new era with different rules.

Caroline Baum, who authors a regular commentary on credit markets for Bloomberg Business News, summarized the dynamics that move the CPI in an article she wrote on August 17: "The CPI is broken down into commodities (42%) and services (58%). The former are more responsive to global supply and demand; the latter are 'labor intensive' and, by all rights, should reflect the tautness in the labor market. Should, but aren't. While commodities prices have been well behaved all along, the rate of increase in services prices has been drifting lower. In the latest three months, services prices rose at a scant 1.9% annualized rate compared with a 2.5% increase for the last 12 months...The year-over-year increase in core services peaked in February 1991 at 6.5% and has been declining, almost without interruption, to 2.7% as of July..."

If this new assessment is correct, then the Fed is doing its job. The kind of tightening that we and others thought was necessary to keep inflation at bay was not. Already, the Fed's preemptive moves seem to be working because the economy has shown continued growth but with signs of some softness. For that matter, the market is also making a prediction that we've seen the last rate hike this year. March eurodollar futures (Chart 5) were pricing in an additional 25 points of tightening to the Fed's move, but in the last couple of weeks have erased

Chart 5 – March Eurodollars



the premium. The yield on the long bond during this period has retreated by 40 bps from its high to 5.88%.

The yield curve, which can be used as a forecasting tool for the market's perception of the future direction of interest rates has collapsed. The 2-year/30-year yield curve that we've been watching and trading (Chart 6) has dropped to its lowest level in a year and a half. This indicates that bond traders are no longer pressing the Fed to move on short-term rates by pushing up long-term rates. In fact the rapid rate at which the yield curve is narrowing may be an indication that the Fed is ahead of the curve.

For a while, it seemed that commodity prices were stirring and might cause trouble to the very subdued service component of the CPI. The Journal of Commerce Commodity Index, which tracks industrial commodity prices, had been challenging one-year highs recently but has faltered (Chart 7). The Bridge/Commodity Research Bureau's Index has mapped a similar pattern and does not seem to pose any serious threat at the moment.

The sum total of which leads us to believe that the bond market is likely quite oversold. Sentiment readings are still low, because those in the inflation-fear camp – people not unlike ourselves – are just beginning to take note of the reality that the Fed may actually be responding to the market's perception of the issues of the day. [August 27, 1999]

CURRENT STRATEGY: Liquidated long September T-bonds as per flash update of August 31.

Chart 6 – Yield Curve 2-Year/30-Year Treasuries

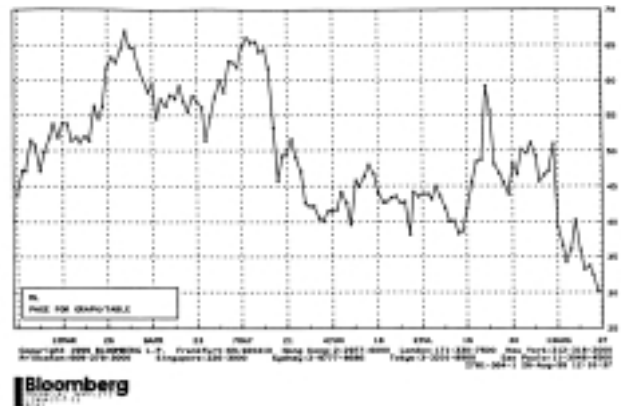


Chart 7 – Journal of Commerce Commodity Index



ROUNDUP

Commodity shorts (and longs): an update on markets we've been watching

Wheat

Wheat prices ended their steep decline exactly a year ago. They have since formed a base, trading between \$2.30 and \$3 per bushel. We've been building a bullish case that was based, mostly, on flat global wheat production in an era during which output of most commodities has been expanding. Demand would pick up, we argued, as the countries that have been the best customers of US wheat see their economies recover from the financial crisis that gripped most of the developing world during 1997 and 1998. While the demand side remains promising, two notable disappointments on the production side have weighed on prices.

Earlier this summer, China's crop was expected to be smaller than the previous year's – 106 million tonnes vs. 110 million tonnes – because of bad weather. The weather situation improved, and crop estimates have risen every month since. In the August USDA supply/demand situation report, China's wheat crop is estimated at 115 million tonnes.

Last week the market was hit with some more bearish production news. Statistics Canada released its estimate of the Canadian 1999-00 wheat crop at 25 million tonnes, which is 1.5 million tonnes above the USDA estimate for the Canadian crop. Analysts at Statistics Canada explain that despite a drop in total acreage from last year, this year's crop is larger than last year's (24.4 million tonnes), because of dramatically improved yields. This likely explains the wide gap between its estimate and that of the USDA. Yields were 20% above the five-year average in some regions.

There have been developments on the demand side to partially offset the increase in production. Despite a record crop of 71.5 million tonnes, India will still import about 1 million tonnes this year. This is a surprise, because it was thought it might even have wheat available for export. Last year it produced 66 million tonnes and imported 2 million tonnes.

Southeast Asian countries like Malaysia have returned to the market and will be purchasing at least as much as last year. Export commitments have been moderate and are just on pace to meet the USDA's estimate of 1.15 billion bushels for 1999-00. In each of the past three weekly reporting periods, export commitments have been higher than the previous week and at around the high end of analysts' estimates. This past week's commitments of 743,000 tonnes was the highest total in 1-1/2 months.

The evolution of dietary patterns in the developing world towards Western-style eating habits was derailed temporarily by the Asian crisis. It was in fact this new demand, of which wheat was certainly part, that caused the powerful bull markets in grains of the mid-1990s. With many troubled countries now recovering, export demand should recover and should be able to absorb the increased production. We continue to monitor exports for the key to the future of wheat prices.

STRATEGY: *Stay tuned.*

Copper

The closing of unprofitable mines has been the guiding force for copper prices these past couple of months. Production cutbacks of roughly 500,000 tonnes of copper would bring production and consumption into balance for the year, possibly ending an era of surpluses that had slashed prices to where many producers were choking. We believe that the market has overreacted to the cutbacks. The very first cutback has been reversed, because the workers at Canada's Highland Valley mine have settled their labor dispute and will be heading back to work, bringing 170,000 tonnes back on line. This development in itself, however, was largely expected and should not impact prices materially.

Unrestored output from mines that will not be reopened will not be very effective in curbing the supply that has depressed prices. The world's largest producer of copper, Chile, is still running at full throttle. Pumping out some 25% of the world's copper, the mining activities in Chile are a window on the world of copper. The most recent figures available show that production in Chile for the month of July totalled 359,701 tonnes, which is 15.8% higher than July of last year. For the first 7 months of the year, output rose by 18.6% to 2.54 million tonnes, compared with the first 7 months of 1998.

While there has been much talk about recovery in Asian countries, whose imports of industrial metals almost disappeared during the Asian crisis, available statistics reveal that the effect on copper consumption has been minimal. The International Copper Study Group reported on August 4 that global refined copper consumption rose .2% for the first five months of 1999, year-over-year. With global refined production rising 2.4% in the same period, it's clear that any recovery in demand will not be able to eat up the overwhelming new supply coming to market.

Throughout the entire bear market in copper prices, LME warehouse stocks have been accumulating unabated (Chart 8). Even during periods of perceived tightness, not unlike the one we're in now where the cutbacks should be starving the market, the inventories continue to build.

With the improved overseas economies providing a mere trickle of fresh demand and the US entering a slowdown, can we expect the current rally to hold? *[August 31, 1999]*

STRATEGY: *Stay tuned.*



Chart 8 –
LME
Copper
Stocks

HOTLINE UPDATE

Tuesday, August 3, 1999:

Good afternoon for Tuesday, August 3, 5:10 pm. There are no changes or new recommendations.

Flash Update: Wednesday, August 4, 1999:

Good morning for Wednesday, August 4, 9:15 am. This is a Flash Update. We have one new recommendation: Cover short September copper positions at the market, presently trading at 76.00.

Friday, August 6, 1999:

Good afternoon for Friday, August 6, 5:00 pm. There are no changes or new recommendations. The following is a recap of this week's recommendations. On Wednesday, August 4, via Flash Update, we advised covering short September copper at the market, then trading at 76.00

Tuesday, August 10, 1999:

Good afternoon for Tuesday, August 10, 5:05 pm. There are no changes or new recommendations.

Friday, August 13, 1999:

Good afternoon for Friday, August 13, 4:50 pm. There are no changes or new recommendations for this week.

Flash Update: Tuesday, August 17, 1999:

Good afternoon for Tuesday, August 17, 4:00 pm. This is a Flash Update. We have one new recommendation: Cover short September S&P at the market, presently trading at 1349.

Tuesday, August 17, 1999:

Good afternoon for Tuesday, August 17, 5:10 pm. There are no changes or new recommendations. We repeat our Flash Update from earlier today to cover short September S&P at the market, then trading at 1349.

Flash Update: Wednesday, August 18, 1999:

Good afternoon for Wednesday, August 18, 1:20 pm. This is a

Flash Update. We have one new recommendation: Buy September T-bonds at the market, presently trading at 115-04.

Friday, August 20, 1999:

Good afternoon for Friday, August 20 4:45 pm. There are no changes or new recommendations. The following is a recap of this week's recommendations.

- On Tuesday, August 17, via Flash Update, we advised covering short September S&P at the market, then trading at 1349.
- On Wednesday, August 18, via Flash Update we advised buying September T-bonds at the market, then trading at 115-04.

Flash Update: Monday, August 23, 1999:

Good afternoon for Monday, August 23. 3:30 pm. This is a Flash Update. We have one new recommendation: Liquidate long Russell/short S&P spread positions, at the market. September Russell is presently trading at 439.60; September S&P is presently trading at 1362.70.

Tuesday, August 24, 1999:

Good afternoon for Tuesday, August 24, 5:10 pm. There are no changes or new recommendations.

Friday, August 27, 1999:

Good afternoon for Friday, August 27, 4:45 pm. There are no changes or recommendations. The following is a recap of this week's recommendations.

- On Monday, August 23, via Flash Update we advised liquidating long Russell/short S&P spread positions, at the market. September contracts were trading at 439.60 and 1362.70 respectively.

Flash Update: Tuesday, August 31, 1999:

Good afternoon for Tuesday, August 31, 12 pm. This is a Flash Update. We have one new recommendation. Liquidate long December T-bonds at the market, presently trading at 114-29.

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Subscription Enquiries for
Friedberg's Focus on Futures
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario, Canada
M5J 2T3
(416) 364-1171

All enquiries concerning trading accounts should be directed to:
In Canada
Friedberg Mercantile Group
P.O. Box 866, Suite 250
BCE Place, 181 Bay Street
Toronto, Ontario M5J 2T3
(416) 350-2903
Attn: Sholom Sanik

In U.S.
Friedberg Mercantile Group Inc.
67 Wall St., Suite 1901
New York, N.Y. 10005
(212) 943-5300

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