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Canadian dollar: a setback, but long-term trend intact

After taking a stab at the 70¢ level – not seen since May 1998 – the Canadian dollar has retreated into its tight trading range (Chart 1). What pushed this currency to multi-year highs, and what's holding it back now?

On the negative side, the most significant factor affecting the Canadian dollar has been the wide spread between Canadian and US short-term interest rates, currently favoring the US side by 83 basis points. In the days leading up to the last FOMC meeting earlier this month, there was some worry that the Bank of Canada might not match a Fed rate hike, a stance that would push the spread even further apart. This became an even bigger concern when the possibility of a 50-basis-point hike by the Fed was being considered seriously by many economists.

Then, in a January 27 speech, Gordon Thiessen, Governor of the Bank of Canada, laid to rest any fear that his bank was going to assert its independence from events in the US. He spoke of "...a potential buildup of inflation pressures in the United States that could spill over into Canada..." and "...the need for the Bank to be vigilant and ready to act in a timely fashion to safeguard Canada's low trend of inflation."

The market celebrated his comments by driving the currency up to just shy of 70¢. When the euphoria settled down, however, traders realized that the spread between the two countries' rates was still formidable. Nothing had really changed, and in the coming days the currency would reflect this by slipping back below the 69¢ level.

While it is quite true that the Bank of Canada has been completely successful in its efforts to contain inflation within its 1% to 3% target band, Mr. Thiessen was perhaps somewhat inaccurate in his choice of words: "...Canada's low trend of inflation." The core rate of inflation has been in an uptrend since late 1997 when it was .7% per annum. It currently sits at 1.6% (Chart 2). Considering the continued strength in the economies of both Canada and the US, the inflation rate has indeed remained tame. However, if the trend continues, as trends often do, we will soon find the rate of inflation pressing uncomfortably against the

upper end of the band. With commodity prices rising and money supply growing, there are definitely grounds for such worry.

The Bank of Canada uses the core rate in setting official policy. But nothing stops market participants from using the overall rate, which shows that inflation is growing at 2.6% per annum, as their gauge for where monetary policy should be headed, and trade the market accordingly. As such, we expect a stronger Canadian dollar precisely because the Bank of Canada has been vigilant in fighting inflation and will, hopefully, react in a timely fashion as the need arises.

The spread between rates of the two countries must eventually converge. At the moment, lower interest rates remain a drag on the Canadian dollar, but the currency is 10% off the lows, which is a statement of confidence that the Bank of Canada will tighten its monetary policy.

Commodity prices have risen sharply in recent months – the Bridge/Commodity Research Bureau Index of commodity prices is up 17% since last summer. Strong commodity prices alone, however, cannot cause a lasting bull market in a "commodity currency." Consider the New Zealand dollar and the Australian dollar – the other "commodity currencies" – which have tumbled 7% and 6% since the beginning of the

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year. A deteriorating domestic scene has not allowed these currencies to benefit from the improving demand in commodity markets.

Rising prices for Canadian commodities, on the other hand, complements the strength in all sectors of the economy. Where New Zealand is becoming increasingly unstable on the political front, Canada's opposition parties are in disarray, leaving a strong and united – albeit left of center – government.

The merchandise trade surplus has improved dramatically (Chart 3), and the current account has crossed into positive territory for the first time since mid-1996 (Chart 4). Foreigners have not shied away from the strengthening cur-

rency. The Bank of Canada has been intervening quietly to smooth the move, which also helps to explain the recent weakness. The intervention is evident in the \$616 million growth in Bank of Canada US dollar reserves in January, the largest monthly increase in quite some time.

At present, the currency is under some selling pressure. Nonetheless, we view the weakness as temporary – just part of the bumps, grinds, and setbacks that will appear in any long-term trend. *[February 14, 2000]*

CURRENT STRATEGY: Remain long June Canadian dollar. Raise stops to 68.10, close only.

Chart 1 – Canadian dollar



Chart 2 – Core Inflation Rate

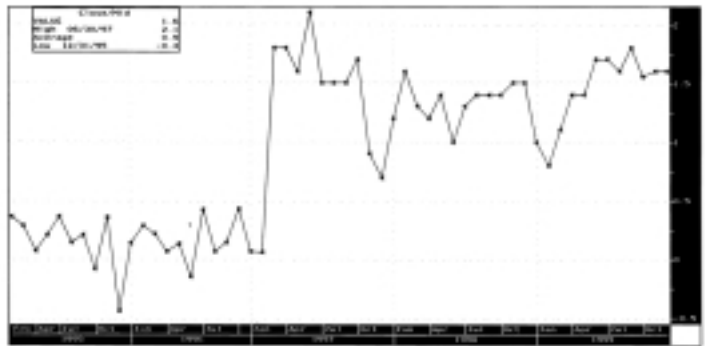


Chart 3 – Merchandise Trade Balance

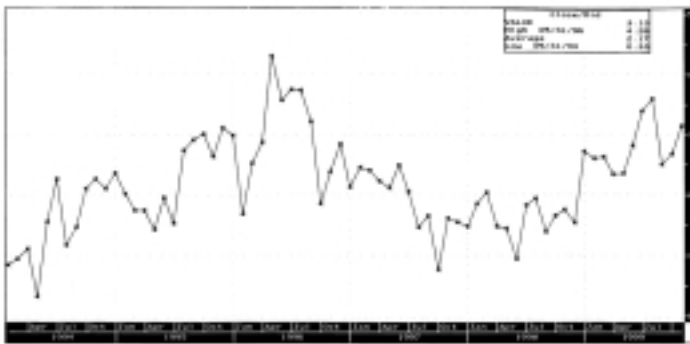


Chart 4 – Current Account Balance



GOLD

Is the gold market smelling inflation?

After spending the months of December and January trading quietly between \$280 and \$290 per ounce, gold prices exploded suddenly on February 4. They burst through the top of the band and ran all the way to \$315 an ounce. Rumor had it that some major producers were not only covering hedges but also overhauling their hedging strategies to reflect newly-found confidence in the future of gold prices. Statements by

gold-producing heavyweights followed in the next few days. Placer Dome Inc., Barrick Gold Corp., and Anglo Gold Ltd. all released statements that verified the rumors. They were either scaling back their hedging programs or suspending them completely.

The gold market had come alive. More rumors were to follow. Word was circulating that the Bank of England was

going to abandon its planned sale of 400 tonnes, but any such notion was quickly quashed by the bank. Then there was the issue of whether creditors were going to allow troubled Ghanaian miner Ashanti Goldfields Co. Inc. to slither out of its troubles. Failure to reach an agreement to restructure its loans would result in a tidal wave of short covering that would be required to unwind its disastrous hedging program.

If we're to assume that producers are serious about cutting back their hedging activities dramatically (i.e., they will not succumb to temptation whenever there's a juicy rally), then these developments are significant indeed. They are especially important in light of the other major event in the gold market back in the fall when 15 European central banks agreed to make their selling programs transparent, which we deemed a bullish factor. While the transparency agreement doesn't actually limit the amount of gold supplied to the market (see comments in the January issue of *Focus on Futures*), the rollback of hedging activities does. When producers sell gold forward, they either have to deliver gold eventually or cover their hedges. Either way, gold is supplied to the market.

Although some producers achieved some spectacular returns from hedging – some earned over \$400 per ounce last year – we can't say that their timing as a whole is impeccable. After net hedging dried up to almost nil in 1998, producers were very active in 1999. In the third quarter alone, they are estimated to have sold forward 386 tonnes, more than the 247 tonnes they sold in the first half of the year. The significance of this is that gold prices spent the entire third quarter below the multi-decade, bargain price of \$265 an ounce. Thus, the wisdom of the gold hedging community as a whole is somewhat suspect. Buybacks in the fourth quarter balanced things out a bit, so that net hedging for the year was 445 tonnes. (All figures courtesy of Gold Fields Mineral Services Ltd. *Gold Survey 1999, Update 2.*) Still, the absence of hedging will

leave a gap in supply that the market counted on to fill part of the annual 1,000-tonne production/consumption deficit.

Now that the dust has settled on the flutter of new developments in the hedging sector and we think we understand their implications, we move on to this past week's events. On February 17 and 18 the US Labor Department released PPI and CPI for January. The two sets of statistics, for both the headline and core rates, were either in line with or below analysts' expectations, indicating that the effect of a powerful economy, strong money-supply growth, and budding commodity prices have not yet caused much inflation.

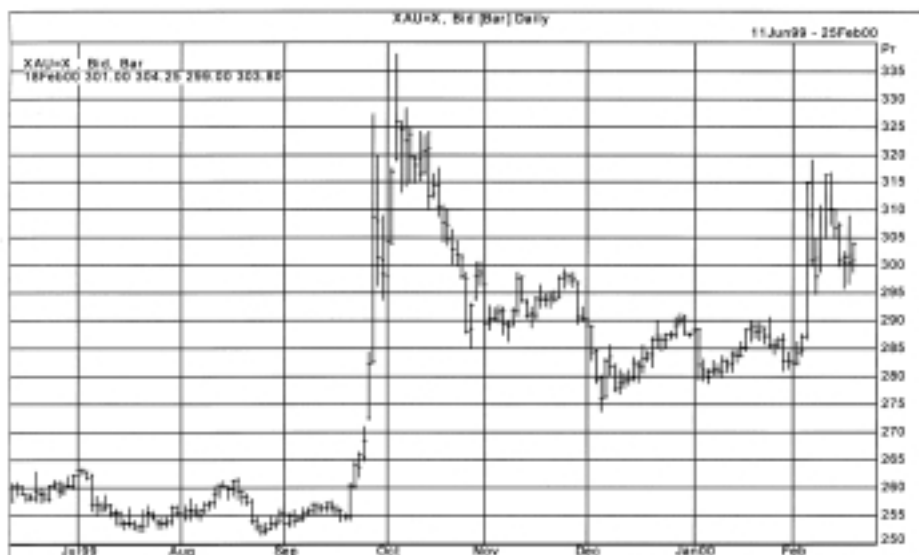
Gold prices were very strong on the morning of the release of the PPI figures. By the end of the session, however, the tame inflation report pushed prices back by about \$8 an ounce from their morning peak. Although this would obviously be disappointing for gold bulls, it is actually great news for gold traders, bulls and bears alike.

The new era has arrived. The market is finally responding to inflation (or disinflation) news. While knowledge of the amount of gold being sold by central bank and producers is crucial, the factors that move gold prices are undergoing a renaissance. We will now see inflation expectations influence prices far more than at any time in recent years.

We, being bulls, find these events very constructive for our case. We are clear of producers' announcements and the fear that Ashanti might have to start covering its hedges. The fact that we are still trading \$15 an ounce above the top of the \$280 to \$290-an-ounce range, is an indication that investors are beginning to take the threat of inflation seriously. With a moderate level of open interest and relatively low sentiment readings, the move has just begun. *[February 18, 2000]*

CURRENT STRATEGY: Liquidate long April gold as per Flash Update of February 25.

Chart 5 – Spot Gold



COPPER**Fading the copper rally**

Commodity prices, as a whole, have found their way out of the basement. The recovery has touched just about all areas: petroleum, base metals, precious metals, grains, and livestock. Although each commodity has rallied for different reasons, the improved outlook, in general terms, can be attributed to the demand that is being generated by continued economic strength in Western countries and the revival of the economies of emerging nations. In some cases, such as the petroleum complex, the turnaround has been complete, because supplies have tightened significantly. In other markets, such as the grain complex, while no real tightness has emerged yet, participants have begun to bid prices higher. They anticipate that the resurgent demand will eventually eat into burdensome stockpiles. Thus, a disaster premium is warranted.

Might there be still other markets that have been influenced by the euphoria and that have run up without sufficient cause? We think that copper may be just such a market.

There is little doubt that the fundamentals have changed enough in the past year or so to present a very reasonable bullish case. Demand has clearly improved, primarily in Asia. It is estimated that Asian consumption grew by about 10% in 1999 and that it will grow a like amount in 2000. On the surface those numbers seem exciting. They should be tempered, however, by the fact that the market was playing catch-up. Consumption in 1998 – during the Asian crisis – was actually down from the previous year by just over 2% in this region. This dragged global consumption down to a 2.7% growth rate in a period when global production was growing at close to 6%.

Still, the growth in demand in has, at the very least, shrunk the production/consumption surplus. A mining analyst at Merrill Lynch & Co. recently pegged the surplus for 2000 at 239,000 tonnes, down from a surplus of 411,000 tonnes in 1999. The most current data come from the International Copper Study Group (ICSG), which puts the surplus as of the end of November at 205,000 tonnes.

Even more bullish is a footnote that appears at the end of the ICSG report that says that the trend in stock changes seen in the period between August and November "...pointed to an overall balanced market."

So why do we think the market is overpriced? First, the outlook for consumption in Asia is probably a bit optimistic. As pointed out, the market was depressed and had pent-up demand that was unleashed suddenly. There is little evidence to suggest that Asian demand can continue at such a rapid pace. Japan, a key importer of copper, is a good example because its economy continues to struggle. Another year of 10% consumption-growth is a lot to ask for.

Then, despite the cutback of some production – North American mines alone shutdown

750,000 tonnes of output – production continues to grow. ICSG estimates that global mine production from January through November last year totaled 11.5 million tonnes, up 3.8% from the same period last year. Consumption in this period grew by 3.6%. In order to achieve the balanced markets analysts are talking about, the demand story had better be awfully accurate.

Taking a look at the latest numbers out of the world's largest producer, Chile, we find that copper continues to flow. December output was up 4.9% over December 1998. For all of 1999, production was up 18% over 1998. No sign of a letup in output there.

Headlines would have us believe that there has been an appreciable drop in LME warehouse stocks. Stocks have come off their most extreme levels – by about 3% – but remain very high compared with historical norms, as Chart 6 clearly illustrates. The contango for cash to 3-month copper is close to its widest levels at \$33 per tonne, which is amazing considering prices have rallied as much as 42% off the lows without any tightness appearing.

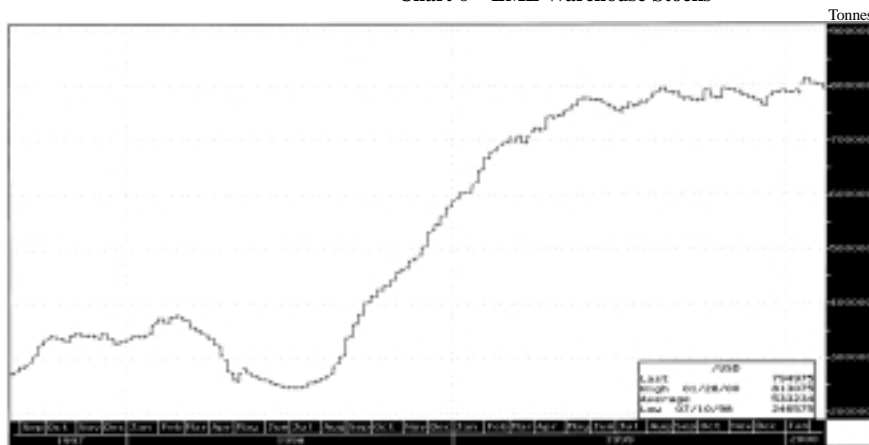
The sharp increase in open interest to about 90,000 contracts is an indication that a speculative bubble was as much responsible for the rally as were the fundamentals. Much of that excess open interest has been shed, while prices were consolidating over the past four weeks, but the most recent Commitment of Trader's data reveal that the long position still contains a strong speculative element.

Finally, we must not forget that the cost of producing copper has been falling steadily, as it has for other metals. Producers will not cut back production in a meaningful way as long as they can sell their copper at current prices while producing the stuff for as low as 40¢ per pound.

[February 25, 2000]

CURRENT STRATEGY: Remain short May copper as per Flash Update of February 15. Lower stops to 87.20, close only.

Chart 6 – LME Warehouse Stocks



GRAINS**Updating corn and wheat**

The corn and wheat markets have run into overhead resistance. They've both dipped roughly 6% from their respective highs. Has there been a material change in the issues that drove these markets from deep depression to the hope of recovery?

Corn

The US grows 40% of the world's corn. Its exports account for 62% of world trade. Any discussion of corn supply, therefore, could focus almost exclusively on the US situation. This is important because the last crop was harvested in the fall, and the next crop won't be planted for a few months yet. Typically, any talk of corn supply in the months in between, other than minor adjustments, is completely irrelevant. Not until March 31, when the USDA releases its first estimate of corn plantings, is there any meaningful data to offer direction. This year was different, however, because in January the USDA lowered ending stocks by 280 million bushels (3% of consumption). Production in 1999 had been overstated and domestic consumption underestimated, both by wide margins. The adjustment for this year's lean data months were hardly minor. The market began its ascent at the time of the January report and put in a handsome rally with good reason.

The February report held true to the spirit of the season, as there was little change from the previous month's data. The only important variable would be export demand, and this, in fact, was the item that was slightly negative. Annual exports were lowered by 25 million bushels, which accounted for all of the hike in ending stocks to 1.739 billion bushels, or 18% of consumption, up only fractionally from the previous month. Export commitments in the past 4 weeks have averaged 815,000 tonnes compared with 759,000 tonnes for the average of the previous 4-week (holiday) period. After the slow holiday period, we thought business would be somewhat stronger than it's been. It does provide, however, a very significant point of reference for us to watch. To get back to the pace where we were in exports earlier this season, we need to see a steady stream of commitments at 1 million tonnes per week or thereabouts. Again, the corrective downleg was not without merit.

In summary: Look for dips in price that are accompanied by an improving export market and shedding open interest for comfortable entry to the long side of this market. The March 31 plantings report, which is expected – like wheat – to show smaller acreage, will provide much guidance.

STRATEGY: *Remain sidelined but closely tuned.*

Wheat

The February USDA report did not hold many significant changes for the wheat market. The world supply/demand balance shifted slightly to the tighter side. Production was raised by 350,000 tonnes reflecting a better outlook for the Australian and European Union crops. Despite a softening of world trade, estimates for domestic feed usage increased enough in Russia, the FSU, and Eastern Europe for the USDA to raise total demand by 1.8 million tonnes. This dropped global ending stocks by 2.15 million tonnes, or 21.5% of consumption, to 127.23 million tonnes. Ending stocks have been trickling down steadily for the past few months. Although there has not been a dramatic shift, the trend does show a tightening world balance.

The USDA lowered US exports by 50 million bushels. This part of the report was no doubt influenced by the poor exports we saw during the holiday season. Wheat exports for most of January just about ground to a halt. The past few reporting periods, however, have shown a dramatic improvement. Average commitments for the past 4 weeks have been 576,000 tonnes, compared with only 209,000 tonnes in the previous 4-week period. Commitments are still behind last year's pace, but the gap is closing.

The progress of the US winter wheat crop has been the primary focus of the news wires. Although knowledge of moisture levels in the key growing regions is vital information, the media use rain, snow, or lack thereof to explain every gyrations in the market. What we do know is that the crop will be smaller than last year because farmers planted less (see last month's *Focus on Futures* for details).

A more accurate idea of the size of the crop and its yields will not be available until the USDA field agents begin to tour farms early in the spring.

Again, as with the corn market, this recent slide reflected a market that got a bit ahead of itself given the most recent developments on both the supply and demand fronts. Open interest swelled, indicating that the rally had as much to do with speculators jumping in as it did with an outlook for tightening supplies. Open interest has dropped during the slide, easing the weaker hands out of the market. We still believe that prices are cheap and do not accurately reflect a continuously tightening world picture. We sit patiently on the sidelines but with our fingers not far from the trigger.

[February 25, 2000]

STRATEGY: *Remain sidelined but closely tuned.*

HOTLINE UPDATE

Flash Update: Friday, February 4, 2000:

Good morning for Friday February 4, 11:20 am. This is a Flash Update. We have liquidated long July wheat positions at 273.5.

Friday, February 4, 2000:

Good afternoon for Friday, February 4, 4:50 pm. The following is a recap of our current open position recommendations, and our latest stop levels.

- Long March Canadian dollar, with our stop at 68.60.
- Long April platinum, with our stop at 409.
- Long April gold, with our stop revised to 289.
- Long April CRB Index, with our stop at 201.

All stops are close only.

Flash Update: Monday, February 7, 2000:

Good afternoon for February 7, 5:00 pm. This is a flash update. We have sold short the March E-Mini S&P at 1427, placing our initial stop at 1462, close only.

Friday, February 11, 2000:

Good afternoon for Friday, February 11, 5:10 pm. The following is a recap of our current open position recommendations, and our latest stop levels.

- Long March Canadian dollar, with our stop at 68.60.
- Long April platinum, with our stop revised to 459.
- Long April gold, with our stop revised to 295.
- Long April CRB Index, with our stop at 201.
- Short March E-Mini S&P, with our initial stop at 1462.

All stops are close only.

Flash Update: Tuesday, February 15, 2000:

Good morning for Tuesday, February 15, 9:10 am. This is a Flash Update. We have liquidated our long March Canadian dollar position at 68.58.

Flash Update: Tuesday, February 15, 2000:

Good afternoon for Tuesday, February 15, 5:25 pm. This is a Flash Update. We have sold short May copper at 83.75, plac-

ing our initial stop at 87.50, close only. We repeat our Flash Update from earlier today, where we liquidated our long March Canadian dollar positions at 68.58.

Friday, February 18, 2000:

Good afternoon for Friday, February 18, 5:00 pm. The following is a recap of our current open position recommendations, and our latest stop levels.

- Long April platinum, with our stop revised to 485.
- Long April gold, with our stop at 295.
- Long April CRB Index, with our stop at 201.
- Short March E-Mini S&P, with our stop revised to 1405.
- Short May copper, with our initial stop at 87.50.

All stops are close only.

Tuesday, February 22, 2000:

Good morning, for Tuesday February 22, 9:00 am. This is a Flash Update. We have been stopped out of our long April platinum position at 484.

Flash Update: Thursday, February 24, 2000:

Good morning for Thursday, February 24, 9:10 am. This is a Flash Update. We have purchased June Canadian dollars at 68.60, placing our initial stop at 67.60, close only.

Flash Update: Friday, February 25, 2000:

For Friday February, 25, 11 am. This is a Flash Update. We have been stopped out of our long April gold position at 295.

Friday, February 25, 2000:

Good afternoon for Friday, February 25, 4:45 pm. The following is a recap of our current open position recommendations, and our latest stop levels.

- Long April CRB Index, with our stop revised to 205.5.
- Short March E-Mini S&P with our stop revised to 1382.
- Short May copper, with our stop revised to 87.20.
- Long June Canadian dollar, with our stop revised to 68.10.

All stops are close only.

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