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Commodity Comments
April 30, 1974

...better than Gold?

Commodity futures trading may be undertaken by an individual with three objectives in mind: Gambling. Commercial hedging. Or asset preservation, that is protecting one's capital from the steady and unrelenting loss of purchasing power witnessed in the past 25 years. We address this month's comments to the most difficult of these objectives: asset preservation.

First we must determine if, indeed, there is a need to hedge; is inflation accelerating, decelerating, ending or moving in reverse (deflation)? It is the rate of change that determines profitability in commodity positions, not the overall long term secular movement. And so, by looking at the domestic U.S. scene one concludes that the high prices of last July and August did bring out high supplies and, eventually lowered the boom. What do you know, supply and demand still works!

Grains and livestock prices have decimated their producers who not long ago were chuckling at enormous (paper) gains. Cattle feeders are selling their 52¢/lb animals for less than 41¢/lb, hog producers choke with 38-41¢/lb gilts and barrows when they're brought to the eleven markets and sold for less than 33¢/lb. And if you commiserate the farmer and rationalize his economic naivete, what is there to say about countries such as Canada who continuously raised their selling price for wheat above the market, thus "forcing" the U.S. to be the world's granary--at $6.40/bushel--and now look at the CBOT ticker tape print out a depressing $3.92/bu. for May '74 deliveries. What will the Canadian Marketing Board tell its constituents? Poultry and egg producers are being forced into bankruptcy as the wares sell far below replacement costs. For all practical purposes, inflation in the U.S. markets has not only been arrested but it has moved into reverse. Consider: live cattle reached a high of 60¢/lb. last August--it is now @ 40-43¢/lb. a level already seen in late 1972. Iced broilers traded at a high of 80¢/lb., they have now slumped to 35½¢/lbs. with some Chicago food chains featuring specials at 33¢/lb; these are early 1973 levels. Eggs at 36¢/dozen are "well down" from their 80¢/dozen highs of last August, at late 1972 levels, and well below 1970 prices! Soybean meal, the leader of the 1973 bull parade has collapsed from $450/ton to a paltry $103/ton, a mid-1972 level, and below the 1966 highs!

Can this situation continue for very long? We know that, in the long run, prices travel above their intrinsic production costs; we also know that future supplies are a function of expected cost and economic gain. Finally, we assume that, for example, cattle traders are as prescient as, but not more so, corn traders. We conclude that over a production cycle, prices will tend to move back up over their intrinsic production costs. An illustration is provided in our comment on livestock (see below).

Having established that the last 2 months have swung the pendulum from inflation to deflation, at least in so far as the domestic markets are concerned, we note too that there are powerful forces at work that will swing prices upward once more, albeit not as spectacularly, over the near future.

We like to add one further thought. Our comments in the past have stressed that floating exchange rates have a strong worldwide inflationary bias. In a speech given 2 weeks ago, Chairman Burns of the Federal Reserve has come to the exact same conclusion and therefore rationalized the need for higher domestic interest rates.

We like to quote from our July 24,1973 issue "the flexible exchange rate system is in great part responsible for the general debasement of currencies. We have conclusively proven that exchange rates will not, on their own, find an equilibrium level compatible with trade considerations. In the first place, exchange rates are a function of interest rate arbitrage--and interest rate arbitragers as money market dealers know--do not care in the least about the absolute level of Sterling as D-marks so long as the swap or covered transaction is profitable. This will tend to move huge amounts of short term capital from one country to another regardless of apparent undevaluations or overvaluations...the second reason why floating rates are not self-equilibrating is that they are self-fulfilling. A devaluating currency eventually brings internal purchasing power down to justify that lower externel level." On the basis of the above we went on to predict that American inflation would surpass European before year end. It did, by a wide margin.

The U.S. dollar has been weakening rather sharply in the foreign exchange markets, moving from a recent high of 2.90 DM to the dollar (end of January '74) to today's low point of 2.4365 to the dollar, an actual depreciation of nearly 16%. Similar devaluations have occurred vis à vis the Swiss Franc, the Japanese Yen, the Belgium Franc, the Netherlander Guilder and the Canadian Dollar. As these devaluations work their way through the "system" they will provide an irresistible inflationary push. Without delving too deeply into the mechanics of the inflationary process, we will note that U.S.$ devaluations raise the domestic price level in 4 ways: first and most directly, by raising the U.S. dollar cost of imported goods (such as Sugar, Cocoa, Coffee, etc.); secondly by lowering our international selling prices and thus creating an export boom in exportable commodities such as wheat, corn and soybeans; thirdly, through the "substitution effect", as higher prices for imported goods provide a price-protective umbrella over domestically sold goods and, finally, by encouraging speculative buying waves in such articles as silver and gold--traditional inflation hedges.

With this in mind, our only caveat to an all-out bullish posture are:
a) rising U.S. interest rates making inventorying a costly proposition and
b) dumping of high-cost supplies, a legacy of the "old" high prices.

We have developed an economic model that projects further inflation in U.S. dollars denominated commodities, be it domestic or international. The need exists to hedge one's assets against a renewal of inflationary forces but our timing has been slightly altered by the present structure of high and rising interest rates and liquidation of unwanted and burdensome supplies.

The judicious use of technical trends should provide the necessary timing element.

Trends

Cocoa	May '74	99.75
	July '74	96.00

A most spectacular bull market, having exceeded our first target of 85¢/lb. Cocoa is benefiting from an extremely high supply condition (one of the few commodities in that category); the reduced level of grinding in the U.S., England and Germany is still not low enough to compensate for the extraordinarily low levels of dealers' stocks. Eastern European offtake, particularly the U.S.S.R., continues heavy. Technically, open interest and volume remain subdued and the backwardation is widening--a superb indication that much higher levels are on the offing.

Remain long this market by switching present long May '74 Cocoa (soon expiring) into July '74; less speculative oriented money may move into deferred 1975 positions at substantial discounts.

Coffee	July '74	73.15

A good deal of base-building a taken place in this commodity with prices backing and filling around the 71-75¢ mark basis July '74 after receding from the 85½¢ highs.

Volume and open interest have decreased substantially and we feel that the market is almost completely devoid of speculative interests. Being an international commodity in the hands of a substantial monopolistic force such as Brazil, coffee may yet emerge as one of the early 1974 bull markets.

Grains

July '74 Wheat	3.77
July '74 Beans	5.48
July '74 Meal	116.30
July '74 Oil	26.95
July '74 Corn	2.77 3/4

We have definitely overstayed these bull markets, especially corn. During the past 6 weeks, selling has been advised in the above. If you still long, liquidate all long positions as the near term picture remains unclear.

Soybean Meal has been the target of heavy and indiscriminate selling as a result of the resumption of anchovy fishing off Peru's Coastal waters. The just announced 2,000,000 ton ceiling for this season should yield 400,000 tons of fishmeal and provide stiff competition for the soymeal. Together with actual exports up to April 7, indicated total exports of meal this season are 5,893,100 metric tonnes, well above the 4,968,200 metric tonnes forecast by the USDA. The corn-meal ratio of $100/ton to $450/ton of last Summer has turned into a $98/ton/$104/ton relationship at the present time--cheap enough to up supplemental meal diets to perhaps as much as 17% (in fed cattle) from last summer's 11-12% range. Also the present dollar devaluation will "cheapen" meal even further to European countries and they provide the bulk of American exports. It can readily be seen that a slight improvement in domestic usage and exports will bring back meal prices to a level far more compatible with its true dollar price--a $180-230 range.

Technically, more quiet base building accompanied by liquidation must take place before this market is ready to turn.

Liquidate long positions (if not already done so) and buy crossing the 130-135 area basis July '74.

Livestock Complex

August '74 Cattle	45.05
August '74 Hogs	34.65
February '75 Bellies	48.40
September '74 Broilers	35.80

Assuming $2.75/bu for corn, $105/ton for meal and 41¢/lb. for feeder cattle, replacement costs for choice steers (depending on location) will range from 43¢-45¢/lb, 2-4¢ above present cash markets. Not only are feedlot operators losing money on existing animals, but given present costs of production and present cash prices, their feeding operation becomes a money losing proposition into the foreseeable future.

One cannot logically argue that farmers foresee lower feed prices as deferred corn prices (to the first quarter of 1975) do not reflect a substantial discount from cash. We must conclude therefore, that presently burdensome supplies, by depressing prices, will substantially alter the farmer's profit expectation and therefore reduce placements sharply into the latter part of '74 and early part of 1975. This conclusion is supported by the U.S.D.A.'s recent 23-state Cattle on Feed Report showing total placements at 5.3 million head vs. 6.0 million head placed last year.

Very heavy hogs and cattle arrivals (in some case over 30% above last year) to the 11 major midwestern marketing terminals continues to put pressure on the present futures structure. Bacon slicings in the week ended March 30 totalled 26,584,266 lbs compared with 24,299,913 lb., one of the first year-to-year increases. These consumption increases should very soon begin making a dent in heavy storage stocks.

The livestock complex remains temporarily at least, at the mercy of heavy slaughter prompted by a large build-up in animal numbers and weights. This supply condition may last a few more weeks and perhaps begin to taper off around beginning of June.

We prefer liquidating long positions and moving to the sidelines until a substantial change occurs in marketings or, alternatively, until consumption clears the present overhang.

Precious Metals

July '74 Silver	574.00
July '74 Platinum	238.50
July '74 Gold	175.00

High carrying charges coupled with increased silver coins-melted supplies (over 5 Million ounces in April), should bring silver prices back to the high

400's basis spot. Long position should be closed out and short positions taken risking 595.00 basis July '74. Stubbornly high open figures for platinum and poor volume patterns indicate that some substantial distribution is taking place under the cover of strong silver prices. Sell and move to sidelines.

Gold prices, in our view, have reached an intermediate top of some significance. Our November 29th issue (gold: demonetized or remonetized) fully discounted the present agreement reached by European Central Banks in settling debts among each other at prevailing free market prices; at the time, that was one of the reasons why we became bullish and advised long positions. At the moment, and on a negative note, we feel that a fluctuating asset can play havoc with central banks' concern for dependable reserves and minor drops could at first induce selling instead of buying.

Liquidable long positions taken in the mid-90's if London drops below $166.75/oz. Subsequently, reinstate long positions only if London gold tops $180/oz.

Potpourri

Long positions in the wood complex were closed in early April as interest rates posed posed the threat of aborting the housing recovery; both plywood and lumber look lower, expecially the latter... short positions in European currencies were also closed as the U.S. dollar, retraced more than 50% of its previous advance, indicating a new U.S. dollar bear market; there is still time to move to the long side in DM and Swiss Francs...

Remain long Canadian Dollars...

Deferred Sugar deliveries especially new crop months (ranging from as low as 12.27 for September '75 to 15.88 for March '75) represent ideal inflation hedges, since a very tight supply condition persists. We expect nearby prices to move up from the present 22.50¢ to the old 28¢ highs in short order...

Albert D. Friedberg
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