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Commodity Comments

June 17, 1975

*Sterling and the U.S. Dollar: the agonizing decline*

The *de facto* adoption of floating exchange rates sometime after December 1971 has fostered and maintained the ongoing undervaluation of the two key currencies of the Western World: Sterling and the U.S. Dollar. No matter how undervalued these 2 currencies have become vis a vis the European bloc, the decline has persisted. Floating rates were supposed to trade around an equilibrating rate and, as a result, trade surplus and deficits were supposed to be corrected—so said the pundits. Mr. Simon pointed out that, oil apart, the U.S. trade balance swung from a \$2.8 billion deficit in 1972 to an \$18.3 billion surplus in 1974, thanks to the 'benign' devaluations of the past 2 years. But doesn't Mr. Simon realize that the terms of trade swung sharply in favor of the U.S. during this period when agricultural prices and exports went into orbit? Why exclude oil and include wheat and soybeans? And, furthermore, why exclude oil? Must the U.S. not pay for it anyway? Will it get it for free next year? Wasn't the downward float of the U.S. dollar supposed to rationalize the consumption of other imported goods so as to allow the higher valued oil into the country without causing a trade deficit of \$5.9 billion last year? Is Britain also blind to this reality?

The answer is obviously that (a) exchange rates are non-trade-equilibrating (b) the short term devaluation advantages are lost almost as quickly as they are gained with inflation causality running in reverse.

Exchange rates do not align themselves to a rate that will bring the trade of goods and services into balance because they are influenced by capital flows of much greater magnitudes. Short term international capital flows respond to only two factors: interest rates and safety. Since U.S. interest rates have remained relatively low vis a vis European rates (real rates, after adjusting to loss of purchasing power), money flows EAST: to Germany, Switzerland, Netherlands, Belgium and so on. A growing problem, and one that has yet to be perceived by Central Bankers the world over, is the shift of private investment and working capital reserves out of dollars and sterling and into stronger currencies. This phenomenon along with the known leads and lags of international trade easily surpasses trade considerations.

To overcome this modern version of Gresham's Law, the U.S. must make its dollar a scarce, and thus desirable, currency. At this particular juncture of the U.S. business cycle, this alternative is 'not operative'. Worse yet, recent institutional arrangements relating to the recycling of OPEC Eurodollar deposits, threaten to expand the Eurodollar multiplier. If this development is superimposed upon a fairly rapid domestic monetary base growth rate, one will find that the worldwide supply of U.S. dollars could balloon by well over 50% over the next 12-18 months. The imposition of stiff reserve requirements for Euro-currency operations, on the other hand, might imperil the borrowing facilities of vulnerable borrowers, private or public, precipitating a major financial crisis. In short, the present dollar-glut is expected to worsen dramatically over the next year or so and no degree of undervaluation, based on trade considerations, will save it from further deterioration. As with Britain too, the huge sterling balances are slowly moving from larger and ancient holders to small and relatively newer ones. This distribution process is never ending as there is no ultimate redeemer of these balances. Consequently, one set of holders sells to the next one and so on, at ever lower exchange rates and with ever increasing velocity. The only incentive to hold sterling, a positive rate of return, is inconceivable as it would require a 20-35% per annum rate of interest...and bankrupt whatever remains of British industry.

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Our second contention is that inflation-devaluation causality runs in reverse. In fact, that is the way, the only way, a currency undervaluation is corrected when monetary discipline is lacking. Prices domestically begin to rise almost immediately after a devaluation occurs thus confirming, as it were, its external value. It is for this reason that the U.S. experienced such a disastrous inflation during the latter part of 1973 and all of 1974 (this was predicted in our May '73 Commodity Comments) and it is for this reason that Britain, among all industrial nations, suffers from chronic mini-hyper-inflation. A note of interest: various commodity price indexes show that dollar-denominated prices of raw materials rose 240% from late 1971 (the first U.S. devaluation) to early 1974. Since that time, and in spite of the worst industrial depression since the 1930's, the index has dropped only about 25%, thus retracing less than 40% of the entire gain. Undoubtedly, dollar denominated prices have been revalued to reflect the ever decreasing external value of the U.S. dollar. It will not take long before this 'apparent' dollar undervaluation (on a trade of goods and services basis) will become fully valued and then overvalued. From the foregoing it would follow that any low-inflation forecast for the U.S. to 1975 and 1976 will have to contend with a minimum of 8% and possibly as high as 15% rate depending, of course, on the next exchange rate movement.

Technically, both the Deutsche Mark and the Swiss Franc have consolidated over a fairly broad 5% and 10% range respectively over the last 6 months. Very strong underlying support exists for the Deutsche Mark @ around the 42¢ basis spot and for the Swiss Franc at around 39¢ basis spot. Fairly large official resistance is expected to be met at slightly higher levels. It should be noted, however, that the U.S. is already heavily indebted under its swap lines to the Swiss National Bank and the Bundesbank and that maturities on previous commitments are presently coming due thus lessening the chances for a potentially massive intervention. Also, the magnitudes of capital flows previously discussed are huge enough to overcome, in the long run, any artificial propping up operation.

We therefore recommend the purchase of September 1975 IMM Swiss Francs and Deutsche Marks contracts at these levels. Fairly safe stops may be initially set at 3990 and 4260 respectively. Present long positions in Japanese Yen should be switched over to Deutsche Mark and Swiss Francs.

Contracts call for 125,000 Swiss Francs and 125,000 Deutsche Mark, present margin required is \$2500. per contract while round turn commission runs to \$60. Liquidity in both markets is excellent.

<u>Cocoa</u>	July '75	45.05
	December '75	41.45

Another upward revision in the Brazilian Temporao crop, this time to 138,000 tons, plus word that only one third to one half the crop had been sold out, jolted the market and reversed a promising rally.

Our long positions were closed out when September '75 broke below 45.00 as suggested last month. The downside potential is much too limited to warrant short sales, even for trading turns, and therefore look to reenter market from the long side in the very near future. Keep posted.

<u>Coffee</u>	September '75	58.54
	London (Robustas) September '75	£ 479

The relatively tight dealer stock position in Angolan coffee spread out to Central American Milds pushing the New York "c" contract to a 6 months' high. Robustas continued their spectacular advance rising almost £ 50 since our late May recommendation.

The recent rate of advance is clearly unsustainable and some kind of a correction is inevitable.

Stops on previously established long positions should be placed at 54.00 (close only) basis N. Y. September '75 and £ 445 basis September '75 Robustas. The September '75-December '75 bull spread put on at 110-100 points should be kept looking for nearby to go over December by 150-200 points.

<u>Copper</u>	July '75	53.30
	September '75	54.20
	3 mos. London Wirebars	£ 542

Buffeted by sharply rising visible copper stocks, prices eroded down to their mid-January lows basis the spot month. Due to the loss of carrying charges this fall back translated itself into new lows for the July '75 forward positions.

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Copper stocks on the London Metal Exchange have risen to a record high 277,000 tons, over 100,000 tons having been added during the past 3 months. This increase in LME copper stocks roughly equals the amount of overproduction for the first quarter of 1975 as calculated by the American Bureau of Metal Statistics. It also coincides rather neatly with the unusual increase of over 10,000 contracts in the New York open interest (125,000 tons). One must assume that the hedging 'load' has been carried by value-conscious investors who are buying metal at a 10-year low (if properly adjusted for the falling U.S. exchange rate vis a vis European currencies). It should be noted that Comex copper stocks have come down from a high of 71,387 on May 18 to less than 68,000 tons today.

There is little doubt that present production cutbacks and improved economic activity will force users to cover their hedges in the near future allowing prices to command a far more reasonable level.

We continue to feel that long term investors should accumulate 6-12 months futures at these levels and, on a scale down, with a first initial target of 80-85¢/lb.

<u>Cotton</u>	July '75	45.77
	October '75	47.22

Strong base-building action at around the 45-46¢ mark for October '75 and a breakout today above this 4-week range nears a challenge to the minor April-May intermediate downtrend line. Market participants have had time, no doubt, to assess crop reports and the likely outturn for the 1975-76 year and will arrive at the only logical conclusion: carryover stocks will be drawn down substantially over the next 12 months, pointing to sharply rising prices. Rising demand is highlighted by the 21% increase in the daily rate of usage from December '74 to April '75 forcing the U.S.D.A. to revise upwards its still-niggardly forecast of domestic mill usage to a 6.2-6.7 million bales range.

Add to previously established long positions when October surpasses decisively the 47.50-48.25 area.

<u>Grains</u>	September '75 Corn	2.67½
	September '75 Soymeal	132.00

Once again the \$2.50/bushel level for Corn and the \$120/ton level for Soymeal proved too powerful for the bears to overcome. Heavy public shortselling in these grains, as well as Wheat and Soybeans, as evidenced by a rising open interest is providing the fuel for what may turn out to be a short-of-spectacular rally.

Buy September '75 Corn and Soymeal at market placing mental stops below the June lows.

<u>Iced Broilers</u>	August '75	45.40
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Since our last buy suggestion, broilers have advanced almost 500 points. The rise has been accompanied by a sharply increasing public commitment and we are thus becoming a bit wary of the long side. Nevertheless, we advise retaining previously established long positions and raising one's stop to 44.00 basis August '75. The rally may yet carry to the high 40's. Keep closely posted.

<u>Orange Juice</u>	July '75	54.25
	January '76	59.25

The bull market continues. A look at the long term Orange Juice chart tracing its movements back to 1968 indicate a terrific long term triangle formation with an upside potential of at least 100% from present levels. This long term formations will be 'activated' if the spot month trades above 58-59¢.

Remain long.

<u>Precious Metals</u>	September '75 Silver	456.40
	October '75 Platinum	149.80
	October '75 Gold	168.10

Our earlier comments regarding the weakening U.S. dollar should give precious metals a strong lift in the coming weeks.

It is our opinion that silver prices may respond rather dramatically to further currency unsettlement and ignore basic fundamental 'softness'. Although we are friendly to the Gold and Platinum markets, we feel that Silver will provide greater upside leverage. As a result, the technically-minded trader should buy September '75 Silver risking 440,00 (close only) looking to sell only part of his position between 490.00 and 520.00, as this move may signal the beginning of a new bull market.

