



— Friedberg & Co. Ltd. —

347 BAY STREET
TORONTO, ONTARIO, CANADA M5H 2R7
(416) 864-1195
CABLE: FRIEDCO TORONTO
TELEX: 06-23446

Commodity Comments

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Mortgage futures: a new trading vehicle

The Federal Reserve's perseverance in sticking to a modest growth in money numbers, be it M_1 , M_2 or Credit Proxy, has begun to bear fruits.

In the first place, as anticipated here in the August '75 Commodity Comments, slow money growth has reversed a rising bull market in commodities with the result that, with few exceptions, most commodities are well entrenched in bear trends. Secondly, interest rates, in what may seem to be paradoxical, are beginning to edge lower, mostly a result of deflated inflationary expectations.

In recent days, a good deal of talk has been heard about a switch to easy money policy on the part of the Fed. Fed Fund rates, at 5.82 for October 17th, have moved down significantly from the 6.36% peak of late September-early October. This development alone does not represent a return to 'easy money'. Instead, the Central Bank is moving to supply funds aggressively to the banking system as a result of the meager growth in M_1 figures. Indeed, M_1 has grown only .2% on an annual basis since the beginning of August, and it stands at only 4.9% (annualized) higher than the beginning of the year, way below its stated objective of 5-7½% growth. All of the decline in M_1 is due entirely to a drop in the so-called multiplier which is a direct result of the Treasury taking funds out of the commercial banking system. A return to a more normal multiplier of 2.5 should easily add 2.0 billion dollars to the M_1 figures. Monetary base, a better gauge of monetary policy, continues to grow at a steady 6.5-7% rate and it is this area that one should scrutinize for key changes in policy.

What is the outlook for interest rates in the U.S. for 1976? The unequivocal answer is lower. In the first place, commercial loan demand remains slack and although the decline has begun to moderate, no sharp upturn is in sight. The main reason is the high cost of carrying inventories when inflation is lower than the cost of capital. Other reasons include the large rebuilding of liquidity at the corporate level after massive bond borrowings for most of 1975. Also, corporate cash flow is now running ahead of capital expenditures, thus obviating the need for future external financing.

Large Treasury borrowings, the single most important bearish factor in the present market, has been, in our view fully discounted by the market. Commercial banks, in their desire to restore liquidity to their balance sheets, have added enormously to Treasury holdings and will probably continue to do so for at least another 6 months. Also, just as the 1974-1975 fiscal deficits were underestimated by the bond market as a result of the recession's fiscal 'drag', the 1975-76 deficit is being presently over-estimated: the economic recovery should lower the fiscal deficit by at least \$10 billion, a considerable amount to a gun shy money market.

Finally, on the expectational level, the bearish trend of commodity prices should help lop off 1-2 percentage points from present long term rates, bringing long corporates down to 8% and long Treasuries down to 6 ¾ - 7 ¼%.

How to profit from declining interest rates? The CBOT has introduced a new Ginnie Mae mortgage futures contract, extending the futures concept of hedging to interest rates. The G:MA futures contract will be a mortgage-backed certificate guaranteed by the Government-National Mortgage Association. The basic unit of trading are Ginnie Mae certificates with a principal amount of \$100,000 and a stated interest rate of 8%. FHA experience indicates that this pool of mortgages has a life expectancy of 12 years due to normal prepayments; therefore, it can be looked upon as a medium to long term bond.

Trading has begun in contract months of December '75, March '76, June '76 and September '76. Minimum fluctuation of the price of the contract will be 1/32 of 1% of par or \$31.25/contract. The normal daily limit on price fluctuations will be 0.75 of par or \$750.

Margin requirements will be \$2500 and round term commission \$75.

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On the first day of trading GNMA futures traded over 800 contracts indicating a great deal of public and commercial interest. Spreads have been extremely narrow, bettering at times the professional parallel market.

We recommend the purchase of March '76 contracts at present levels which indicate an approximate running yield of 8.50%. A 1/2 percentage point downward move in interest rates will make the futures contract rise to par, bringing a profit of \$6000/contract. Our commodity representatives would be glad to discuss hedging techniques for commercial accounts in further detail. Please call.

Technical Trends

Cocoa	December '75	60.50
	March '76	56.85

News that U.S. consumption of chocolate products in the third quarter of the year broke the string of successively sharply lower readings, aided the ongoing bull sentiment. The actual figure, a minus 3% year-to-year, indicates in reality an increase in consumption when considering the fact that producing nations have greatly expanded their grinding capacity and are now supplying a substantial amount of semi-processed products to consuming nations. Also, manufacturer's grinding activity, in view of their predominately bearish views of the future course of cocoa prices, may not represent an accurate gauge of consumer behavior. Other grinding results continued to show improvement in the Netherlands and West Germany and a further drop in the U.K.

A U.N. conference reached agreement on a new International Cocoa Pact but neither the world's largest consumer, the U.S., nor a substantial African producer, Ivory Coast, will sign the accord. The U.S. had aimed for a new accord which relies mainly on a buffer stock operation to keep prices within agreed levels. This treaty, on the other hand, emphasizes the adjustable export quota system included in the 1972 agreement. The price range which has been settled runs from a floor of 39 cents/lb to a ceiling of 55 cents/lb and is divided into five zones which accommodate both producer and consumer demands. It is our view that this agreement will prove as ineffective, in the next 18 months, as the previous one it replaced, which set out mini-maxi points of 29.5 and 38.5¢ per lb. In fact the 'ceiling' of the 1972 agreement proved to be the floor to the 1974-75 bear market in Cocoa. Given the 'cheapness' of deferred Cocoa options (Dec 76 through March '77 are available at between 43¢-53¢), a good case can be made for buying these positions at little or no risk to the investor.

In previous letters we discussed the possibility of seeing a 1975-76 deficit between production and consumption. The latest ICO estimate indicates that a statistical deficit of slightly less than 5000 tons is in prospect. This potential deficit should be viewed in the light of a total world carryover of under 3 months.

Previously established long positions should be maintained looking for a test of the season highs, at 66-67¢/lb. Keep in close contact.

<u>Copper</u>	December '75	54.60
	March '76	56.50

The continuous pile-up of copper at the LME and Comex warehouses obscures 3 very basic economic factors: a) end-user stocks are at rock-bottom levels; b) exploitation of a new mine, from here on, would necessitate a minimum price of 90¢-\$1.00/lb. (view confirmed by Mr. Inai, president of Mitsubishi Metals Corp. in a recent talk in London) and c) stockpile financing (already being considered by the Japanese Ministry of Trade and Industry), producer cutbacks and a strongly rising curve of economic activity will inevitably absorb excess surplus within the coming year.

The technical picture remains poor, with open interest still hovering around 30,000 contracts in N. Y. and a year-long downtrend still bearing down at about 60-62¢ basis December '75.

Maintain long positions; wait to add on breakout above 62¢ basis nearby.

<u>Cotton</u>	December '75	51.67
	March '76	53.13

A strange thing happened on the way to the USDA's October 10th estimate: December-March '76 spreads widened to an unusual 120 points and open interest began to climb in earnest. The latter development was summarily dismissed last month when we stated that 'our open interest analysis does not reveal any serious deterioration, as yet' but finally a 2000 plus increase in the commitment gave it the kiss of death. Obviously big money was moving to the short side. When coupled with the observation that spreads had widened in the last 6 weeks instead of narrowing as any good bull market should do, it got us to think that either: a) our domestic consumption figures for 1975-76 were overstated (3 MM bales) or b) the USDA export forecast of 3.5-4.0 million bales was way off the mark. In view of the recent export movement and the weakness of economics abroad,

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we lean to the second possibility. The sell off in an already vulnerable market was caused by a disappointing USDA production report showing that 1975-76 outturn will just exceed 9.0 million bales. At any rate, our clients were advised to liquidate their long positions at 55.25-54.80 basis December '75 and so they did. Readers and subscribers have had to wait until the 51.40 sell stop was triggered. On liquidating our long positions, an average profit of roughly 10¢/lb was obtained (approximately \$5000 per contract) on long positions first recommended in early March of this year.

We now prefer to watch this market from the sidelines. Keep in close touch.

<u>Grains</u>	March '76 Wheat	4.10 1/2
	March '76 Corn	2.93 1/2

Now that the uncertainties surrounding Russian grain purchases have been dispelled, we expect prices to work sharply lower. Bumper crops and a technically vulnerable market, as witnessed by the inordinately large increase in the open commitment, should see both Corn and Wheat trade back to their long term support areas, 2.40/bu and 3.25/bu respectively.

Sell March '76 Corn and March '76 Wheat at market with mental stops at \$3.17 (Corn) and \$4.40 (Wheat).

<u>Livestock</u>	June '75 Cattle	40.52
	December '75 Hogs	55.92
	November '75 Broilers	41.37

Sell stops in both Hogs and Broilers were activated last week as they penetrated 59.25 and 42.00 on close. The turn in hog numbers, fuelled by a very favorable hog-corn ratio, will become quite evident by the middle of 1976, at which time a more normal 35-40¢/lb level will be reached. Move to the sidelines.

Heavy long liquidation in cattle futures (already at a substantial discount from hogs) seems to have been well absorbed in recent sessions and we suspect a significant bottom may be in the offing.

Accumulate June '75 Cattle at between 39.00 and 41.00, if available.

<u>Orange Juice</u>	January '75	62.40
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In spite of a generally better than anticipated USDA production report, orange juice futures were unable to make much headway.

We would retain long positions, placing stops at just below 60.00, basis the close only.

<u>Precious Metals</u>	December '75 Silver	432.20
	January '76 Platinum	146.30
	December '75 Gold	145.10

In a not too unanticipated way, gold prices managed to rally off their one year low and reached slightly over \$146/oz basis spot. In view of the recent fall in interest rates and the strengthening of European currencies, gold prices could continue to consolidate in the \$138-\$147 range for a while longer. The overvaluation we have been talking about for the past few months persists and we fully expect this market to test and penetrate recent lows. Remain short.

As suggested in our previous Comments, the opportunity to buy January '76 Platinum below \$145 arose during mid-October, on the expiry of the October '75 contract. If you are long, place protective stops at 143.00, on close only.

True to form, Silver prices whipsawed about with a clear downward bias, finding good support in the 4.25-4.30 area basis December '75. Retain short positions and lower protective stops to 450 basis December '75, on close only. Add to short positions should December '75 close below \$4.20/oz.

<u>Sugar</u>	March '76	14.00
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An F.O. Licht report indicating that total sugar outturn for 1975-76 will come to 84.3 million tons had surprising little effect on the market. In fact, we suspect that, once again, sugar analysts are overestimating the consumption factor for this coming year. An easy 'feel' for the present state of demand can be had by looking at the USDA's weekly Sugar Deliveries report. The last one, dated October 16, shows that sugar deliveries in the U.S. to refineries and beet processors were 196,345 short tons compared with 207,970 a week earlier and 213,516 tons in the corresponding week a year ago. The 8% drop year to year comes despite the fact that Sugar prices are now down almost 30% from last year!

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We continue to feel that worldwide demand will not exceed 77.00 MM tons, representing the first drop in consumption in over 10 years. Production at 85 MM tons will, therefore, add to existing carryover stocks a substantial 7-8 MM tons, bringing down world prices to the 6-8¢/lb area.

Remain firmly short, adding sales on close below 1340 basis March '76.

<u>Wood Complex</u>	November '75 Plywood	128.00
	March '76 Plywood	130.60

Exactly as anticipated last month, fears of disintermediation are being slowly but surely dispelled. In the first place, a large U.S. Savings and Loan institution has managed to issue a novel bond, collateralized by existing mortgages, at 9 1/8% finding a way around the absurd Regulation Q. Secondly, short term rates have begun to decline on a rather broad front as a result of slack loan demand, better corporate liquidity and an accommodating Fed. policy. We foresee a return to strong deposit inflows into Savings banks and S. & L. institutions for October and a further rise in mortgage loans and commitments, now standing a full 30% above last year's levels. Disposable personal income in constant 1958 dollars has improved rather sharply since late 1973, moving from 575 billion dollars to approximately 615 billion dollars during the first half of 1975, while median prices of new one family homes have declined from a peak of \$41,000.00 to just under \$38,000.00 in the same period. This fact explains rather well the brisk pace of sales of single-family units in recent months. The heretofore weak multi-family sector showed a good 25% gain in permits in the September '75 report just issued. The long awaited turnaround in multi-family starts may have begun. One should note that only 3 of the 30 largest metropolitan areas have a serious oversupply of rental apartments.

Our forecast calls for starts to run at a seasonally adjusted rate of 1,350,000 at end of 1975, 1,550,000 at end of 1 Q 1976, 1,750,000 at mid-1976 and 2,000,000 at end of 1976. This should provide a strong fundamental support to the wood complex in months to come.

Technically, both plywood and lumber prices have begun to recover from what we deemed to have been a vicious intermediate reaction in a long bull market. Plywood prices retraced exactly 2/3 of the entire 1974-1975 advance accompanied by heavy long liquidation. This process came to an end on September 30th when open interest jumped 424 contracts (nearly 9% of the total) reversing the liquidations wave. An additional bullish factor has been the penetration of the 5 1/2 month long downtrend at approximately 130 basis March '76.

Long positions should be maintained and additions should be made on March '76 moving above 138.00 on close.

Albert D. Friedberg
Vice - President
Commodity Futures

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All statements made herein, while not guaranteed, are based on information considered reliable and are believed by us to be accurate.