



— Friedberg & Co. Ltd. —

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

Commodity Comments

April 28, 1976

Commodity Prices: a re-run of the 1972-1974 Boom?

As an exercise in humility, let us first quote part of our first paragraph of Commodity Comments dated January 20, 1976: "...the first 3 months of 1976 will do well to show a 1-2% annualized increment (in GNP). At worst, it may even show a slight decline..." The actual news, first quarter real GNP up 7.5% over fourth quarter 1975, proved us wrong. The economy was in much better shape than we had been expecting this early in the recovery.

What went wrong? Mainly, we misinterpreted the continuous drop in loan demand to mean that inventory accumulation had not yet began and that, in fact, a certain amount of liquidation was still taking place. Obviously, a sharply expanding positive rate of corporate cash flow coupled with intense economization of money balances (and consequently a sharp rise in velocity) obviated the need for inventory financing. Instead of an inventory liquidation of \$1.6 billion (annual rate) in the 4th quarter, we got a \$9.5 billion rate of accumulation in the first quarter. This shift accounted for almost half the 7.5% gain in GNP.

Since inventory accumulation was running slightly ahead of final demand, which in itself fell behind the average 4.6% gain in the last 3 quarters of 1975, one must assume that a repeat performance is unlikely. Given that monetary velocity has reached its practical limits (in a less than hyper-inflationary environment), further inventory gains will have to be financed by the banking system. While the latter may be 'flush' with liquidity and thus prepared to finance the required expansion, one must not lose sight of the conservatism appearing in banking circles with regards to poor quality loans extensions. In view of this conservatism and the significant lack of adequate capital ratios, the Fed will have to pursue a highly accomodative monetary posture to snap the banks out of a potential liquidity trap. This basic problem is well understood by the Fed which has allowed, of late, a faster rate of growth in monetary aggregates. Nevertheless, even working with the upper established limits for M_1 (7.5%) and M_2 (10%), loan growth should be moderate enough to halt a further speed up in inventory hedging.

We conclude by quoting the last paragraph of the introduction to Commodity Outlook, 1976 (December 16, 1976) "those attempting to make money in the futures markets will be well advised to ignore long range Macro-Economic forecasting and concentrate on the short run (up to 6 months) technical and fundamental picture of each particular commodity". In the same issue and true to this advice, we rated 6 stars (Very bullish):

December '76 Cocoa @ 54.90 (recent high 76.25)
December '76 Copper @ 57.80 (recent high 77.60)
September '76 Orange Juice @ 65.70 (recent high 68.40)
September GNMA @ 93.29 (recent high 96.14), and
October '76 Cattle @ 40.40 (recent high 47.60).

All the above have produced very handsome profits despite a faulty Macro-Economic forecast.

We will continue to adopt a numerical rating system which will be placed alongside the specific commodity heading.

6 (*****)	Very Bullish
5 (****)	Bullish
4 (****)	Neutral-Bullish
3 (***)	Neutral-Bearish
2 (**)	Bearish
1 (*)	Very Bearish

A split rating will indicate our opinion for each particular month as to its expiring value.

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Cocoa **** May 84.25
 **** December '76 71.00 ****London March '77 861.50

Rumours that the Soviet Union was attempting to buy large quantities of Cocoa beans from Brazil, the latter's problems with its Temporoa crop (now estimated at only 91,000 tons down from 108,000 a few weeks ago), a sharp 39.5% jump in U.S. grindings over one year ago and heavy currency hedge buying on the part of U.K. residents combined to set off a spectacular, run away, market for the past 4 weeks.

On Monday, April 26th, the May Contract touched a high of 92.30, surpassing by 200 points our long term target of 90¢/lb set on December 1975, before closing at 90.10 under the weight of informed distribution. Frantic shortcovering, begun 4 days earlier, had been completed and the way was open for a sizeable downside correction.

While the odds favor a resumption of the bull market before the old crop expires, we must exercise an extraordinary amount of discretion before re-entering the long side. Since we may yet have seen the 1976 highs, we urge clients and subscribers to keep in close daily contact.

Copper ***** May '76 71.20
 ***** December '76 73.90

The Secretariat of the Inter-Governmental Council of Copper Producing Countries (CIPEC) estimated that World Copper production surplus nearly doubled to an average of 69,000 tonnes per month last year against 37,000 tonnes a month in 1974. CIPEC said refined production, excluding socialist countries, averaged 519,000 tonnes per month (579,000) and refined consumption 450,000 (542,000). Total stocks at end of December 1975 had climbed to 1,665,000 tonnes from 1,048,000 a year earlier. Producer stocks rose 165,000 tonnes, all of it in the U.S. and Japan, while consumer stocks in the 5 main countries rose just 29,000 tonnes underscoring our thesis that consumer stocks had been relatively low.

CIPEC was not able to explain recent market action, with cash Wirebars rising to 63¢/lb (!) in mid-March from 55¢/lb in Mid-February and expected only modest increases in Copper prices until the end of this year. Obviously, cartel managers lack a thorough understanding of the terminal markets where, as we have repeatedly pointed out, a 'surplus' can be entirely accommodated through the contango structure.

Having accepted profits at the 65.50 level basis December '76 (mostly as a short term precautionary action) we reinstated longs at 68.30 as per last month's advice.

Market still seems capable of attaining our long term target of 85¢/lb basis spot. At said level copper will have corrected its basic undervaluation vis a vis most other commodities. It is imperative, however, that the next phase of the advance should be accompanied by a reduction in visible stocks. Internally, this will be reflected in a sharp narrowing of the carrying charges on the nearby months which will eventually turn into a backwardation. Should this not occur, however, and should the rate of U.S. inflation continue on a moderate course, the price rise will threaten to abort demand and a subsequent severe sell-off can take place.

Remain long and place protective stops at 70.40 basis December '76, close only.

Cotton *** July '76 63.25
 ***** December '76 62.19

In a surprising report, the USDA announced on April 15th that farmers intended to plant this spring 11,255,000 acres to Cotton, 16.2% above the 9,690,700 planted last year but slightly below the 17% increase indicated in January's survey. The intended average was considerably lower than expected by market sources and prices opened limit up on the next Monday.

Once again, as the market approaches the 63-64¢/lb resistances area basis nearby July, the action of the switches disturb us. The July '76/October '76 spread has been on a steady downtrend ever since early January (when it traded 340 points premium the nearby) and is now down to under even money. Also disturbing, is that trade selling regains strength at these levels finding a very accommodative and bullish public.

We prefer once again accepting profits at these levels and moving to the sidelines until the above 'problems' resolve themselves.

Currencies * June '76 Mexican Peso 77.07
 ** September '77 Mexican Peso 61.90
 ***** December '76 Deutsche Mark 40.01
 ***** December '76 Swiss Franc 40.70

Intense bearish pressure on the Mexican Peso was partially lifted on April 16th subsequent to Berata's statement that a devaluation was not forthcoming. The rally ran

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out of steam shortly thereafter and new pressure has reappeared in the exchange markets. That a devaluation is inevitable is attested by the incredible 22% discount of the September '77 position. What is less certain is the timing. Considering that a run on the meager \$1.5 billion reserves has already begun, it is almost a certainty that a devaluation will come before the end of the Summer of 1976-or within 4 months. The leads and lags of international trade and massive withdrawals of North American residents' term deposits with Financieras (amounting to over \$6 billion!) will accelerate a process that was anticipated no earlier than December 1, 1976, date when the new President Jose Lopez Portillo will take office.

"Even if there was no need to devalue", a prominent banker very aptly put it, "the monetary chaos that is rapidly engulfing us would force it. The wish is always the father to the action:." The June '76/September '77 bear spread has widened considerably in the past 4 weeks but we strongly advise retaining it. A potential profit of as much as \$15,000 per spread is expected.

Last month we suggested long positions in the Deutsche Mark and the Swiss Franc. The U.S. has just reported its widest trade deficit in 18 months as imports exceeded exports in March by a seasonally adjusted \$650.0 million from \$140.8 million in February. Almost at the same time, West Germany announced that its foreign trade surplus had risen to a 15-month high in March, equivalent to \$1.52 billion from \$864.7 million in February and \$1.36 billion a year earlier.

Interest rate differentials in the 3-months Eurodeposit market, favor the U.S. by 2 percentage points vis a vis West Germany and 4 percentage points vis a vis Switzerland. These differentials just about offset the differing inflation rates in the three countries and are not exerting a strong 'pull' in short term capital flows to the U.S. Fundamentally, then, the outlook remains extremely bright for the two strongest currencies in Europe. Technically, add to long positions if June Deutsche Mark moves above 40.20 and June Swiss Franc above 40.00. Maintain sell stops 60 points below current levels.

A sharp drop in Canadian short term money rates (30 days GMAC notes moved from 10 1/8% to 9 3/8% before stabilizing at the present 9 1/2%) was quickly reflected in the exchange rate of the Canadian Dollar which fell from a 1976 high of 102.20 to 101.15 in the short span of 4 trading days. The Central Bank emphasis on controlling monetary aggregates by observing rates of growth in M_1 has resulted in a slightly more accommodative stance than warranted by the broader measures. Also the recent explosive growth of loan demand at chartered banks has begun to slacken, much in line with an extremely sluggish pace of economic recovery. Should these trends continue, a narrowing of interest rates differential vis a vis the U.S. will occur.

This will, in turn, begin to put downside pressure on the Spot Canadian Dollar, and eventually, on the forward quotes. A narrowing of the 1 year discount to 200 points and/or a drop in the Spot to 101.00 and/or in the December '76 to 98.60 should be taken as a signal to sell our long positions and reverse course. Keep in close contact.

<u>Frozen Concentrated Orange Juice</u>	*****	May '76	59.25
	*****	September '76	62.35

Post-harvest seasonal patterns observed for the past 3 years support the view that the O.J. market will begin to firm up no later than the beginning of May.

Remain long; roll-over Spot May to January '77.

<u>Grains</u>	***	December '76 Corn	2.65
	****	September '76 Wheat	3.49

In keeping with last month's suggestion, we would buy Wheat at current levels risking a close below \$3.20/bu basis the May. We would still keep on the sidelines regarding Corn.

<u>Interest Rates Futures</u>	*****	September '76 Ginnie Mae	95.25
	*****	December '76 Treasury Bills	93.25

Will the Fed tighten? Will double digit inflation return? These are the questions affecting the daily behavior of money market instruments. If the arguments we presented earlier are valid (a more accommodative Fed monetary position in response to strained velocity and an anticipated deceleration in inventory accumulation) then the answer to the above question is no, not significantly.

At this writing, the government's \$6.0 billion refunding operation seems to be doing rather well and the Southern Bell T & T 8 1/2% of 2016 \$450 million offering have stabilized in the after-market at about 8.47%. The long end of the market should not be terribly effected by a Fed fund trading range of 5-5 1/2% or even 5 1/4-5 1/2% as short term rates remained much below long term ones.

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The Ginnie Mae market at the IMM continues to grow. At the end of six months open interest reached a new high of 1,914 contracts while volume amounted to 46,000 contracts, a very creditable performance.

Remain long September '76 GNMA risking 96.10, on close only.

<u>Livestock Complex</u>		April '76 Cattle (expired)	46.02
	*****	October '76 Cattle (new)	45.97
		April '76 Hogs (expired)	49.70
	*****	December '76 Hogs	42.55

We suggested last month that an upside breakout on the livestock complex seemed imminent. The 'breakout' took place with characteristic vigor, taking the new April '76 position to a high of 46.40, fully 800 points higher than 4 weeks earlier. In much the same way, April '76 Hogs rose over 750 points.

Remain long present positions placing protective stops at 45.00 basis New June Cattle, close only, and 49.00 basis June Hogs, close only.

<u>Potatoes</u>		May '76	10.40
	*****	November '76	5.43

Heavy March and April exports from the Maine area have had little effect on the sagging May contract. In the last few days, prices have tended to stabilize around the 10¢ mark and a good-sized rally may be in the offing. Cool weather in the Southeastern potato-growing areas could affect the new crop months, which technically look groomed for a significant advance.

Long May '76 positions should have been stopped out at 12.70 (as per last month's suggestions). Those still long may hold to expiry, risking 9.50.

<u>Precious Metals</u>	***	December '76 IMM Gold	132.10
	****	December '76 Silver	461.60
	****	April '76 Platinum (expired)	148.80
	****	January '77 Platinum	166.00
	*****	December '76 Palladium	44.30

Our precious metals investment strategy for the month of April produced mixed results.

Gold remained practically unchanged despite recent strengthening in other sectors of the commodity markets. On a more positive note, the market seems to have well discounted the upcoming IMF sales.

An agreement has reportedly been reached with the BIS and other institutions to the effect that bidding at the auctions will not be done on behalf of Central Banks. As we approach 'D' day, it is obvious that the present build-up in open positions representing dealer short selling will provide the necessary buying cushion at the auctions. Indeed, it is quite likely that either the day of the announcement or, more likely, the day of the auction will complete the present extended bottom as shorts bid for metal to cover their positions in the terminal market.

We therefore advise covering all short positions, remaining flat. Go long if December '76 IMM Gold betters 139.00; short if December '76 IMM Gold closes below 128.00.

Silver proved to be the biggest disappointment of the month (despite an early buy signal our clients received on April 2nd). Heavy hedge buying of LME metals on the part of U.K. investors and news that India had once again restricted the exportation of Silver bullion, carried July '76 through an 8-month downtrend. After having reached a 5 month's high at 466.00 prices retreated to the mid 440's, finding good support.

While the trend reversal seems quite significant, upside potential seems to us to be still vague and rather limited. Having covered July at approximately 448.00 (the first close over 440.00 as per last month's instructions), we are tempted to go long at these levels risking a close below 440.00.

Platinum, on the other hand, was a winner. An outright purchase recommendation to buy January '77 Platinum @ 148.00 (Commodity Comments, January 20, 1976) has recently seen a \$24/oz profit. Also, in December 1975, a recommendation to switch gold into platinum at then prevailing prices yielded a total 'profit' of \$34/oz—a saving of \$10/oz in the drop of gold and an actual profit of \$17/oz in the rise of platinum.

Remain long, raising protective stops to 159 basis January '77, close only.

Although thinly traded, Palladium may be the cheapest precious metal available. Having reached a high of \$152/oz, prices dropped to as low as \$36/oz (!) and have since recovered to \$42-43/oz. A far more realistic price given its precious metal and industrial characteristic is \$60-80/oz. A contract calls for 100 ounces, margin required is \$1,200 and round turn commission \$50.

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Sugar

*	May '76	13.80
*	October '76	14.08

The market remains locked in a 250 point range, not quite decided whether to join the ranks of the bullish international commodities or the bearish-tilting American grains.

The only outstanding feature in the market has been the sharp discount that has developed in the Spot May (which expires Friday) v.s. the forward positions. Rumours are circulating to the effect that a large quantity of Philippine sugar will be tendered against the still large Spot position; Philippine sugar tends to sell at a 50 point discount from the Board. Be that as it may, this move from a backwardation to a contango does not augur well for the overall market as it indicates that supplies remain extremely plentiful.

Russia continues to shop around, rather leisurely for an additional few hundred thousand tons. While India was reported willing to sell the Soviets 200,000 tons of Whites, word today has it that this may not be possible, after all.

U. S. deliveries continue lacklustre. Ironically, the recent rise in Coffee and Cocoa prices may begin to affect Sugar consumption just as the opposite was true in 1974.

We remain convinced bears. In our view, Sugar will trade down to the 6-8¢/lb mark before year-end. Maintain protective stops on July shorts @ 15.50.

<u>Wood Complex</u>	*****	May Plywood	150.50
	*****	September Plywood	157.00
	***	May Lumber	154.40
	*****	September Lumber	169.90

The nationwide housing recovery continued in March, albeit at a slightly reduced pace. While all housing starts fell to 1.44 million units from 1.56 in February, it was significant to note that both the 2-4 family and 5-plus family units sector turned in a much reprovved performance in March, at 73,000 and 236,000 seasonally adjusted annual rates, respectively. Furthermore, multifamily permits jumped 20% to a 249,000 rate. As nationwide apartment vacancy moves down to the 5% level, rents will begin firming up and multifamily construction should pick up to the 700,000 mark by early next year.

The \$10/1000 board feet advance in early April was accompanied by too many bulls. Those that kept in close contact were able to take advantage of the bulge. Long term long positions should not be disturbed, however, as we feel a new uptrend will begin in mid-May.

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 accurate.