

Commodity Comments

LETTING THE CAT OUT OF THE BAG . September 30, 1977

A cat called M1 has just jumped out of the bag. It has caused a furor because a) no one knows how to stop him, and b) not everyone is sure that this cat, is going to do all the damage that is feared. Well you see there is another cat in the bag called M2 and a few other ones called M3, M4, M5, even up to M13. And we really don't know which one is going to turn the house upside down. Our little kitty is running pretty fast, somewhere between 10 and 11% per annum, and there are those who say that this means runaway inflation sometime in 1978.

What is M1? M1 is the summation of all currency in the hands of the public, (in the hands of the non-bank public) and all demand deposits, (commonly called chequing accounts) held by the non-bank public at all commercial banks in the United States. As to demand deposits owned by the government and non-resident demand deposits, we'll leave those aside...The grand total of M1 is approximately \$331 billion dollars. This sum equals the "spendable" funds in the hands of purchasers in the U.S. economy and theoretically should provide a good indication of real inflationary pressures in the economy. Monetary economists will equate a 10% rise in M1 with some sort of combination showing real growth and price inflation, i.e. 5% growth + 5% inflation or 6% growth + 4% inflation. In addition to the quantitative increase in M1 economists speak about M1 velocity, that is the rate of turnover of these balances. Presumably, the faster they turn over the greater the effects of these balances on production and prices. There are those who counter that the percentage changes in M1 are ridiculously low when compared to the trillion dollar economy that we have and therefore M1 changes could not possibly have the impact on the economy that they are believed to have. There is another problem though and this one more serious; M1 type money can rapidly disappear into savings type deposits when interest rates provide an attractive return and may later re-emerge out of savings accounts and back into M1 type money as bank savings deposits lose their attractiveness. And we are back to the cat; for now the cat has changed colors and has gone from an M1 color to an M2 color, but bear in mind that all along it is still a cat. The cat incidentally can take on many different colors: some of them such as M3 include certificates of deposit, some even include savings bank deposits, etc.

In our view, and you will no doubt agree, a cat is a cat and money is money regardless of the different shapes they take. Since all financial intermediaries must ultimately keep reserves with the banking system, money can be defined as all deposit obligations created by the commercial banking system. The entire stock of money, very roughly speaking in excess of \$900 billion dollars, can be said to turn over a couple of times a year in order to "generate" total national income, more commonly known as GNP. The turnover rate is a gross oversimplification and an economists' fiction; it is called Velocity.

Because M1 is the most readily used type of money for transactional purposes (people cannot spend directly out of savings accounts) M1 has been chosen as the most important proxy for real inflationary pressures. But borrowing an example from the commodities market, we can show that money does not have to necessarily be spent in order to have an impact on production or prices. Take the case on a crop commodity such as corn with a carry-over (stock) of 1 billion bushels and a prospective increase in supplies of 100 million bushels over and above what is required for consumption. While the corn has not as yet left the elevators, or even the fields, corn prices begin to recede. The market is depreciating corn vis a vis money even though the corn has not been sold yet. Market participants will adjust their own positions in view of the anticipated supply; once the corn has reached the market, the downward depreciation of corn has, ideally, already occurred and no further drop in prices is necessary. By the same token as prospective money supply is increased, market participants mark up their goods (money in this case is like corn in our example) and once money is actually spent prices have already reflected the depreciation. M1 or READILY SPENDABLE MONEY is merely that portion of money that is hitting the market.

However, as we said before, prices have already adjusted to the prospective increase in supplies. It is for this reason that we prefer to look at the more comprehensive M which includes all commercial bank deposit liabilities.

On a more practical level the recent growth of M has easily exceed 10% on a year to year basis. This large growth practically guarantees a high rate of inflation in 1978 and, depending on the productivity of the private and very important public sectors, inflation may range anywhere between 6% and 8% per annum.

The following is an explanation of our ranking system:

- ***** Very Bullish
- ***** Bullish
- **** Bullish Neutral
- *** Neutral Bearish
- ** Bearish
- * Very Bearish

Cocoa

	September 1977 (expired):	209.00
	September 1977 London:	£3395/ton
***	December 1977:	176.00
****	March 1978:	158.05

The see-saw action continues with attention concentrated in the expiring September position in London. At the close of today nearby September traded at a £907/ton premium to December 1977, the highest backwardation in history for these particular months. As of yet only two tenders have been made. In New York, September 1977 went out at a 25¢ premium over December, an indication of extreme tightness.

The bear case for cocoa was just too pat to have yielded benefits. A fairly large short position, built up during August in expectation of better West African crops and sharply lower consumption, was demolished in the first two weeks of September as nearby September advanced nearly 35¢ a pound and nearby December slightly over 2,000 points. The market can now be said to be on a much poorer technical footing and the long expected decline to the critical \$1.40 to \$1.50 a pound level is now in full view.

Third quarter grindings are due out in October with the U.S. figures to be released around October 7th. The table below shows the lethargic pace at which cocoa beans and products have been moving into the U.S.

U.S. AUGUST COCOA-CHOCOLATE PRODUCT IMPORTS (IN LBS.)

	COCOA BEANS	COCOA BUTTER
Aug. 77	24,187,388	3,290,571
July 77	24,304,901	3,714,766
Aug. 76	46,715,653	2,577,181
Jan.-Aug. 77	330,630,815	28,198,006
Jan.-Aug. 76	402,014,624	36,569,106
	UNSWEETENED CHOCOLATE	UNSWEETENED COCOA
Aug. 77	7,722,163	8,663,661
July 77	4,661,719	13,144,475
Aug. 76	4,856,351	11,888,816
Jan.-Aug. 77	43,555,686	110,139,313
Jan.-Aug. 76	28,038,670	108,806,610

Grindings in the U.S. are expected to be down between 10 and 20 percent; in the U.K. between 10 and 15 percent. Thus far very little is known about the West African crops except that, surprisingly, Ghana will begin the Main Crop in the first week of October, sooner than anyone had anticipated. Having been stopped out of our very modest short positions, we now prefer the sidelines.

Coffee

* November 1977 London: £2158/ton
* March 1978 New York: 151.25

Our special recommendation to cover short positions and resell on a fall below £2,500 basis November in London, though embarrassingly ill-timed, is not regretted. Our suspicions that the market was strictly in the strong hands of physical dealers were confirmed when we noted the sudden buildup in tenderable contracts--27 on September 21st, 586 on September 23rd--immediately following the collapse. The IBC which announced it intended to purchase 330,000 bags over an extended period last week, admitted today it purchased 450,000 bags during last week, thereby admitting at the same time that the squeeze was definitely on.

Clearly the Brazilians were sabotaged. But who was it who knew supplies were available and shorted against them before they appeared? Perhaps nimble arbitrageurs managed to negotiate transfer of mild coffee from New York which was then selling at an 'unnatural' discount to the bitter Robustas. More likely the 'culprits' are the Colombians, rarely allies of the IBC, who, it is rumoured, lowered their registration price by 5¢/lb. to 1.92 for September shipment and \$1.88 for shipment for October through December, the very day after the IBC made known its intentions. Emiliano Calazans, Chairman of the IBC, explains last weeks exercise as "speculative manipulations prejudicial to the interest of producers." A little levity, we believe, is always warranted.

U.S. AUGUST COFFEE IMPORTS, IN LBS.

	CRUDE	ROASTED
Aug. 77	91,935,673	3,821,192
July 77	99,976,991	1,275,842.
Aug. 76	216,487,460	4,206,110
Jan.-Aug. 77	1,478,228,199	37,186,135
Jan.-Aug. 76	1,893,088,286	27,761,497

SOLUBLE COFFEE IMPORTS, IN LBS.

	U.S. TOTAL	FROM BRAZIL
Aug. 77	2,767,190	1,756,745
July 77	5,275,890	3,695,791
Aug. 76	3,854,436	3,399,304
Jan.-Aug. 77	49,759,167	33,167,549
Jan.-Aug. 76	47,365,769	35,289,073

On a more practical note, roastings in the U.S. have levelled off at roughly 70% of last years pace. Imports, as noted above, are trailing last year by roughly the same amount. In the face of all this the IBC claims there are no coffee stocks in Santos, that Brazil can afford to sell only 800,000 bags a month in order to ration supplies; and so the minimum export price stays at \$3.20/lb. Maybe the IBC feels the U.S. Longshoreman's Association will save it. We don't. Nor do we believe there's no coffee in Santos.

Add to re-established short positions on £200 rallies above recent lows. In New York market, prefer sale of March contract.

Copper

**** December 1977:
**** March 1978

For the second time in recent weeks, the advance was stalled at or just below the long-term March, May, June downtrend. At this stage it becomes too difficult to distinguish between accumulation and distribution. It should be noted that the 55¢ level has never been breached on the downside on a closing basis and therefore remains our main support area.

Add to previously established long positions on closes above 58.00 basis December '77; liquidate long positions on closes below 55.00.

Cotton

*** December 1977: 53.61
*** March 1978: 54.45

As opined last month, The USDA's September estimate of U.S. production was revised downward--to 13.2 mln. bales vs. 13.5 mln. bales in August. Mill demand was estimated 100,000 bales lower at 6.7 mln. and exports were pegged at a surprisingly high--given the reported increases in world supplies--4.8 mln. bales with 3.7 mln. bales already booked. Carry-out is now forecast at 5.0 mln. bales versus 2.9 mln. for 1976/77.

We believe September's estimate of the current crop may still be overly optimistic and would therefore not be surprised to see October's revised downward once again. We find no reason to disagree, at this point, with the USDA's estimate of mill use and note that August's consumption data--494,252 bales used at a daily rate of 24,590 bales--falls short of that estimate when averaged out over the course of the year by roughly 5%, thereby leaving us to suggest that a spurt in demand is in the offing.

Place stop buys at 56.00 basis March.

Interest Rate Futures

**** December 1977 GNMA: 98.05
**** March 1978 GNMA: 97.24
*** December 1977 Treasury Bills 93.79
** June 1978 Treasury Bills 93.34

Our special bulletin mailed out on September 19th outlined reasons why we prefer to close out long positions.

In the interim more evidence has surfaced that the Fed has not recouped full control of the monetary aggregates. It would appear that a Fed Funds rate significantly in excess of 6 1/4% is necessary to rein money supply growth. Surely the recent bulge in M1 will be very difficult to erase at present interest rate levels.

Total loans of all commercial banks have begun to pick up quite strongly. Recent figures indicate that August saw an increase of 17.4% on an annualized basis over July which, in turn, was 15.7%, annualized, higher than June. These rates of increase are the highest yet recorded since the beginning of the economic recovery in the first quarter of 1975 and now constitute the most dynamic sector of the growth in bank credit. In fact, July and August showed the first net liquidation of investments on the part of the banking system, presumably to accommodate rising loan demand. Liability management is being revived as Certificates of Deposit issued by large commercial banks continue their recent four month up trend. It should also be noted that member bank borrowings at the Discount window are climbing back to the \$ one billion level as the recently raised Discount Rate continues to lag behind Fed Funds. In the not too distant future the Federal Reserve may have to raise, once again, its lending rate.

The recent shift in portfolio mix by commercial banks belies any weakening in the economy. The ball game seems to be changing: from an orderly, slow, and cautious recovery into a more mature stage which will eventually absorb as much as 90% of industrial capacity.

Sell June 1978 treasury bills at present levels placing stops at 93.55.

Orange Juice

***** November '77: 130.90
***** January '78: 117.40

A magnificent bull market.

Today's movement figures announced at 3,489 thousand gallons exceeded expectations by 300 to 600 thousand gallons. Cumulative demand thus far is still running 6 mln. gallons ahead of last year's pace. A carry-out of less than 30 mln. gallons now seems likely. Cold storage stocks as of mid September stood only at 679 mln. gallons down 37% from last year's inventory. An indication of just how bullish the fundamentals are can be ascertained by the table on the following page.

	<u>76/77</u>	<u>75/76</u>	<u>74/75</u>	<u>73/74</u>	<u>72/73</u>
<u>Rate of Usage Aug. 13 to Sept. 24</u>	3,409	3,943	3,030	3,286	3,139
<u>Stocks as of Sept. 15</u>	679	1,076	1,032	999	647
<u>Ratio of stocks to consumption</u>	5.14	3.66	2.94	3.29	4.85

This far there is no indication of consumer resistance or stockpiling. Rumours that card prices would be increased have been denied pending the October 12th report on orange production, preliminary guesstimates of which grow progressively more bullish sounding. The technical picture remains rosey.

Remain firmly long. Place stops at 1.15 basis November on close only. One must allow room to participate fully in so dynamic a market.

Precious Metals

***** December 1977 COMEX gold: 156.00
 **** December 1977 Silver: 469.00
 ***** January 1978 Platinum: 156.60
 ***** March 1978 Palladium: 43.50

Gold continued its heady advance with spot prices reaching new six month recovery highs. Fueling the recent advance have been reports of sizeable mid-eastern purchases, and speculative buying influenced by staggering U.S. trade deficits. At this stage gold is moving independently of the overall commodity price level. No doubt fear and uncertainty about potential LDC defaults and currency realignments are the prime movers. A growing crescendo of bullish enthusiasm expects prices to reach 165-170 an ounce before too long, a view fully subscribed by us in our last Comments. In view of the unanimity of opinion taking place, we advise caution. Long positions should be closed out on either a) prices breaking below 152 basis December 1977 or b) a fast and sharp rally into the vicinity of the 160 an ounce area basis spot. Long term positions, however, should be maintained by all means as we are truly moving into a frightening period in months and years ahead.

If our economic scenario is correct (see interest rate futures) a capital spending boom is just around the corner. If so platinum is heading much higher. Retain all long positions in platinum and palladium regardless of near term weakness.

Sugar

* October 1977: 7.13
 * March 1978: 8.51

Lack of progress at the ISA meetings in Geneva took a turn for the better late today as an agreement of sorts was arrived at in assigning basic export tonnages. BET (BET'S). A serious impasse concerning Cuba's desire for an export quota 400,000 tons higher than granted, evoked a comical exchange: when the Phillipines remarked the major exporters should not remain deadlocked over only 100,000 tons, Brazil suggested the Phillipines make the donation from it's own BET. The Phillipines responded by saying they would, for once, take Brazilian advice, according to a Cuban ministerial aide. Several points remain yet to be worked out. Among them are the sale of Cuban sugar to non-Comecon socialist countries and a fallback clause for renegotiation of quotas after two years. So far Cuba has only indicated a willingness to limit exports to China outside COMECON countries. The ISA will recommend a BET of 15.905 million tons versus the 15.515 million tons originally proposed. Australia has already shown it's dissatisfaction with an International Sugar Agreement that allows so much sugar into the world market. Our opinion is it is doubtful that member countries will abide by their quotas in view of the enormous glut of supplies. The conference has yet to negotiate price ranges, reserve stocks and details of how such stock should be financed. After the news was carried out on the wires, sugar futures rallied nearly 1/4 a cent a pound but heavy trade selling ultimately proved the truth of the situation.

To reiterate, we doubt a sugar cartel can be made effective in view of the enormous diversity of economic interests as well as the leakages built into the agreement. Psychologically, the market may react upwards by as much as 1¢/lb. Odds, however, favour eventual disappointment and panic liquidation.

Remain firmly short (Having rolled over October '77 into March '78). Look for a 5-6¢/lb. bottom.

Wood Complex

**** Nov. '77 Lumber: 184.10
 **** Nov. '77 Plywood 201.10

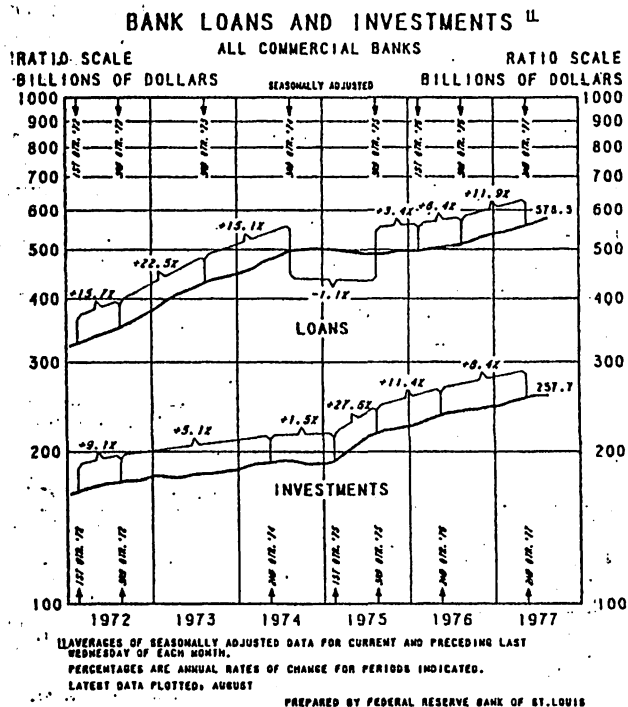
Construction during August continued to perform at a hot clip. Starts totalled 2,022,000, down 2% from July as opposed to the anticipated 4% decline, and are currently running a full 32% above last year's pace. Permits, the indicators of future activity, were up 7% over July.

On the supply side, we understand mills, wholesalers, and retailers are conducting business with inventories on an average thirty to fifty percent less than usual, presumably in anticipation--rather wishful--that the recent softness will continue. The oncoming winter could tighten the situation abruptly.

Maintain long positions. Look for a minimum upside move of \$20.00. Place protective stops at 179.00 basis November lumber on close only.

FRIEDBERG COMMODITY INDEX

AUGUST 1977: 202.35
 SEPTEMBER 1977: 198.20
 NET CHANGE: -2.05%



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

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