

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS

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LA PLUS ÇA CHANGE...

November 5th, 1979

On October 6th, and pressured by 'external' considerations, the Federal Reserve Board announced three major policy actions. The actions taken were all approved unanimously and consisted of the following:

- 1) a 1% increase in the Discount Rate;
- 2) establishment of an 8% marginal reserve requirement on increases in 'managed liabilities' which include large CD's, Eurodollar borrowings, repurchase agreements and Federal Funds borrowing from non-member institutions;
- 3) a change in operating procedures, placing greater emphasis on controlling the supply of bank reserves and less emphasis on confining short term fluctuations in the Federal Funds rate.

The apparently momentous decision was of such significance that the writer was momentarily turned into a 'believer' and jumped at the opportunity of getting aboard a most spectacular secular bull market in bonds. If indeed the Fed was serious in its restraining moves, bank reserves, and consequently, money supply growth would have been curtailed sufficiently to bring inflation down to tolerable levels in a fairly short period of time - perhaps as little as two years. Sadly enough, this was to be only another Act in a continuing Greek Tragedy. Having abandoned our post-October 6th bullish posture, we licked our wounds and retreated to the safety of the galleries.

Following is a list of what we believe has gone wrong.

- 1) Lagged-Reserve Accounting - Since 1968, Commercial banks have had to 'come up' with reserves on the basis of deposit liabilities open in their books two weeks prior to the settlement week. As we already pointed out in our Comments dated November 1st, 1978, this requirement leads to a reverse causation flow: money supply increases (decreases) lead to increases (decreases) in bank reserves (and the Monetary Base) just two weeks later.

Since the banking system, as a whole, cannot create additional settlement funds, the Fed - by way of open market operations or through the Discount Window - accommodates these needs and provides settlement funds. The only imponderable is the cost of such funds. For the statement week ended October 31st, total required reserves jumped by \$1.7 billion but total reserves held jumped by \$1.9 billion. In the four-week period, the cost of Fed Funds rose from 11.91% to 15.61%.

One may conclude, from the behavior of excess reserves, that banks continue to operate comfortably in the knowledge that they will always obtain necessary funding.

2. The 'Discount Window' - The Fed has apparently chosen to supply settlement funds through the Discount Window - at bargain-basement rates of 12%. These borrowings have jumped from just over \$1.0 billion to \$2.9 billion, far surpassing the 'almost' legitimate advances made at the height of the Franklin Bank collapse.

Does the Fed mean to control non-borrowed reserves, rather than total reserves? And more worrisome, are we a step closer to credit controls? We submit that the Fed is intent in avoiding a credit crunch but that it is resorting to a less-than-overt form of credit control. This inference is further supported by the Fed's own release (dated October 6th): "...the board also stressed that banks should avoid loan activity that supports speculative activity in gold, commodity and foreign exchange markets." In other words, if a bank lends 'prudently', i.e. other than for speculative purposes, it will be able to obtain funds at the Discount Window - an extremely profitable arbitrage activity in view of open market interest rates of 15-17%.

The Fed would have to move to a floating Discount Rate (2-3% above, say Fed Funds) to convince us that credit control is not the rationale for such a largesse.

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3. The main impact of raising marginal reserve requirements on CD's, Eurodollar, Fed Funds borrowing from non-members and so on, is merely an increase in the 'spread' between deposit and loan rates - an unnecessary loss of economic efficiency. This increase in the 'spread', of course, applies only to resident U.S. banks and branches, thus putting them at a clear competitive disadvantage vis a vis non-resident financial intermediaries.

The Fed should move towards eliminating differential reserve requirements on demand and time deposits, preferably by lowering them to a uniform level (resulting in a lowering of intermediation costs). Money supply control would then be left to whatever action the Fed takes on the Monetary Base.

Given the above observations, what will happen to money supply and bank credit over the coming months? In the first place, such aggregates as M1 & M2 will begin a pronounced deceleration, similar to the path taken following the November 1st, 1978 package. Once again, the reason will not be found in the Fed's apparent stringency but in the economization process of non-interest (or low-interest rate) bearing money balances. Faced with an opportunity cost of 12-15% p.a., household and corporate units will try to maximize revenues by shifting funds out of currency, demand deposits and savings accounts and into high-yielding CD's and Money Market Certificates. The resultant deceleration will, once again, provide the illusion that "all's well", especially when Monetary Base watchers point to the latter's good behavior. But, as we pointed out earlier on, Monetary Base will shrink along with M1 and M2 and will prove absolutely nothing.

Since we are about to repeat the Nov. 78 - Sep. '79 episode, it is useful to look at the record: while M1 rose at a 5.1% annual rate and the Adjusted Monetary Base at 7.7%, Bank Credit exploded upwards at a better than 14% pace (and total loans at a frightening 16.5% rate). What happened? Negative interest rates made it attractive for corporations and individuals to continue borrowing, and the banking system had no trouble attracting funds, primarily MMC's and Fed Funds repurchases. The October 6th move has finally raised the level of interest rates above the going rate of inflation. When taking into account taxation rates, however, neither depositor nor borrower should be seriously affected. After the initial shock, bank lending should continue to grow and, even, accelerate providing that a) the Fed continues to provide reserves, b) money markets remain free of any controls or ceilings and c) bank liquidity does not reach impossibly low levels.

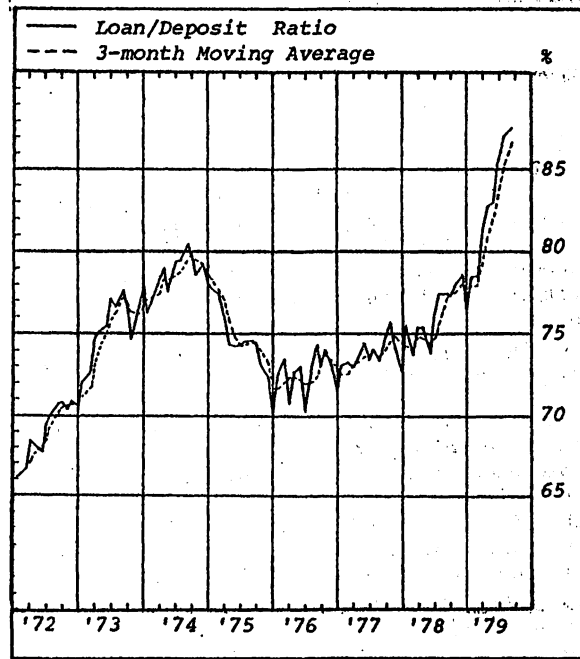
We have now entered the most explosive credit cycle in U.S. history, second to none. It behooves us to answer the following two questions: how high will interest rates go? and, when will it end?

For comparison purposes, we have singled out 1969 as the most effective 'credit crunch' period in the post-war. It brought down gold quotes from \$42/oz. to \$35/oz. (despite the existence of a two-tiered market and the gross undervaluation of the metal), it caused major business bankruptcies (including the famous Penn Central debacle) and was successful in cutting inflation rates by almost half in the subsequent months. Inflation had been running at around 5 1/2% per annum while 90-day Eurodollar deposits reached a high point of 11 1/4% in June 1969 and 11.06% in November 1969 (monthly averages). They were to decline to 4.63% during the second quarter of 1972. Clearly, an interest rate premium of almost 6% above the then current inflation was necessary to quench the red-hot credit boom. Moreover, this 6% premium represented a 100% premium above inflation numbers, enough to ensure positive rates of return even after taxes! The Canadian experience corroborates this picture: an inflation rate of just under 4% p.a. and 90-day finance company paper reaching a 8.4% high.

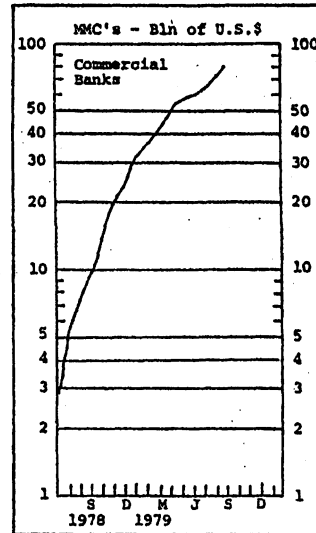
The comparison may not be entirely valid. In the first place, Regulation Q, a ceiling on domestic banks' interest rates, intensified the credit squeeze in 1969 and may have forced the marginal Eurodollar deposits market to unusually high levels. Secondly, the Fed was intent in bringing about a crunch; a politically acceptable risk in 1969 but one totally out of the question in 1979/80, a pre-election year. It is not beyond the realm of imagination, however, to expect interest rates at least short term ones, to exceed the current 14% inflation by 5%, or, even, reach 50-70% premiums above 14%. This brings us to somewhere between 19% and 23%, providing inflation numbers remain stubbornly perched at 1.1% per month.

How will it end? Most probably, and in line with our previous observations, the Fed will not end it by refusing to supply reserves to the banking system. In desperation, it might resort to a more generalized form of quantitative credit control, hoping to stave off disaster. This will force corporations to the commercial paper and bond markets, particularly the latter, helping to narrow the inverse yield curve. More of this later.

We are left with the only plausible and effective rein on credit : the exhaustion of bank liquidity. The accompanying chart illustrates this inevitable process. The Loan to Deposit ratio has reached an all-time high of 86.6% (as of end of August). Increasingly, banks have been resorting to highly volatile and costly sources of funds to finance the ever growing appetite for credit. At this pace it will take a little bit more than one year to reach the apparent rock-bottom level of 100%. Even the latter may not represent the practical limit should banks resort to new types of non-deposit liabilities. In this connection, it is noteworthy that Bank Investments have as yet (through 1979) not shown a month-to-month decline. Latest figures indicate a remarkable 14.2% annual growth rate in Bank Investments (August to September 1979). If the entire portfolio were to be liquidated (a totally improbable occurrence), banks could use over \$280 billion to satisfy loan demand. Portfolio losses would deter banks from massive liquidation, putting some stop on the growth of loans. The early stages of the liquidation process, however, would put an unbearable weight on bond prices, literally forcing the Fed to monetize whatever merchandise is offered for sale.

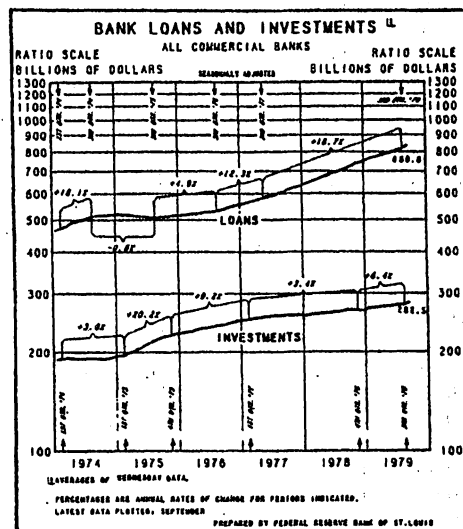
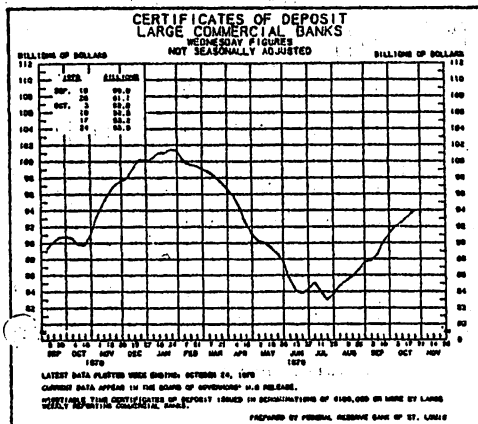


But the banking system is still far from this early portfolio liquidation attempt. It could continue to issue MMC's at the phenomenal rate of \$8-9 billion per month (see accompanying chart). Or it could build-up CP's at a rate in excess of \$3 billion per month (see chart).



Differential reserve requirements will allow it to expand bank credit on the same dollar amount of reserves. This process may easily continue for one or two years, especially if temporarily aborted by quantitative credit controls.

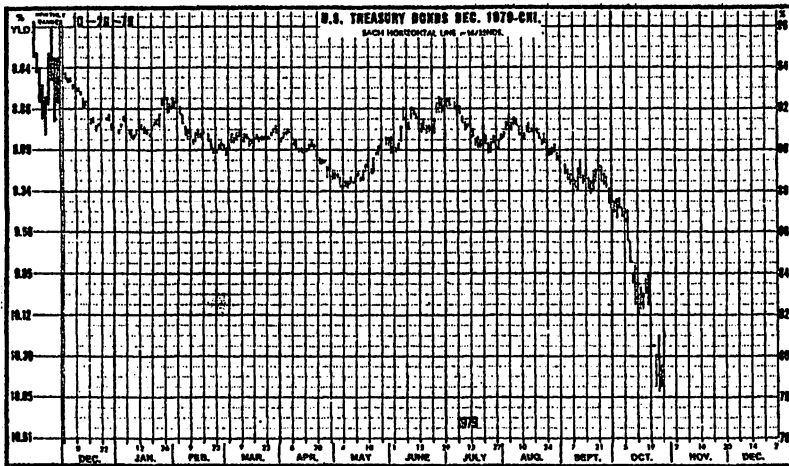
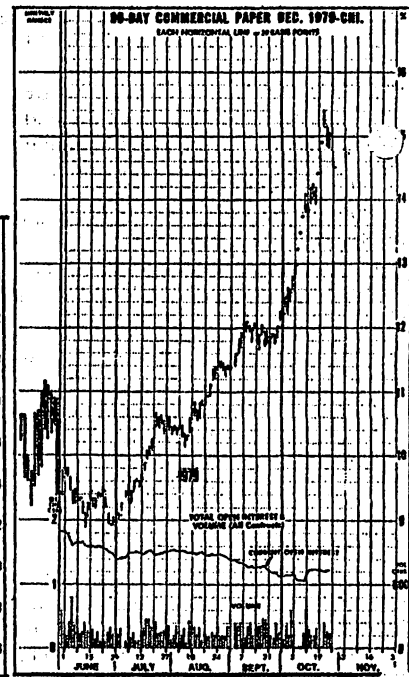
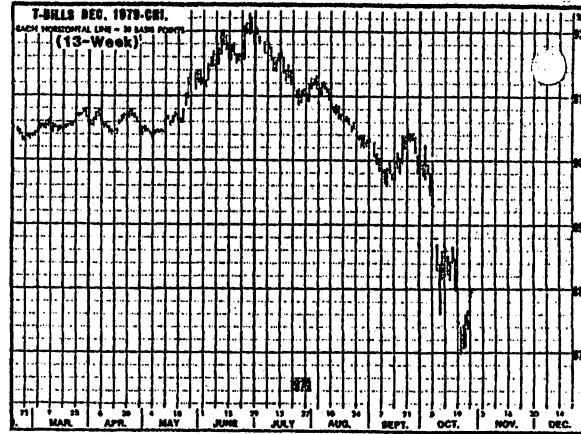
The non-existent recession (repeatedly forecast in our previous Comments) will remain just that : a hope and a mirage to the dying traveller. When he finally drinks the water, he will die - he has drunk too much of it.



**Strategy :**

Interest rates will continue to rise, perhaps a good deal more than generally anticipated. The steeply negative yield curve should narrow in anticipation of quantitative credit controls, now a strong probability. Disregard inter-market spreads but sell outright GNMA's and Treasury Bonds at present levels.

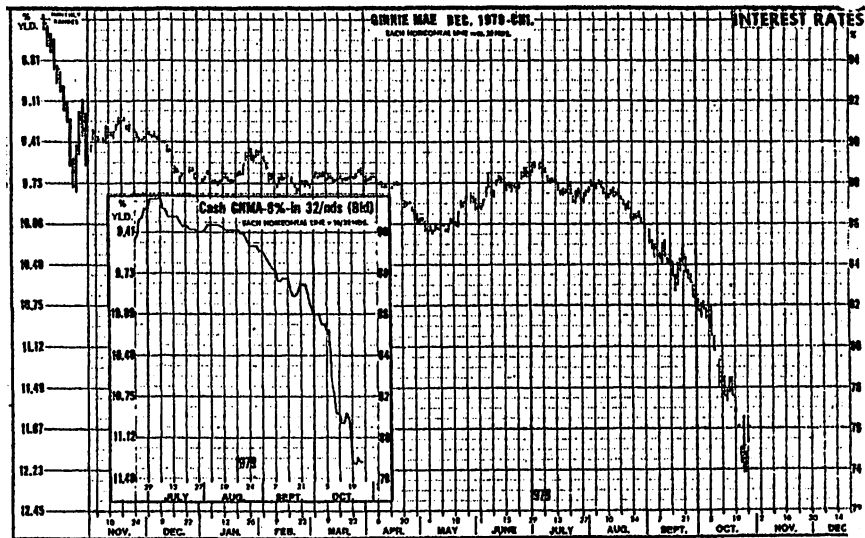
Since foreign economies are playing almost the same monetary game (with perhaps the sole exception of the UK, more later), the 'winner' will be that currency showing the highest nominal return, in this case the U.S. dollar. Sell SF,DM (longs were already stopped out at 64.00 and 56.00 basis December '79, respectively) and Japanese Yen. Retain long BP/Short JY spread, still trading at 490. Place stops approximately 2% above present levels.



GNMA	Settle	Yield
Dec	75-27	11.912
Mar '80	75-12	11.987
Jun	75-25	11.925
Sept	76-01	11.875
Dec	76-06	11.844
Mar '81	76-04	11.857
Jun	75-29	11.900
Sep	75-23	11.944
Dec	76-16	11.984
Mar/82	75-10	12.019
Jun	75-04	12.057

**U.S. Treasury Bonds**

Dec	79-00	10.539
Mar '80	79-12	10.484
Jun	79-28	10.412
Sept	80-03	10.381
Dec	80-04	10.359
Mar '81	90.11	10.345
Jun	80-10	10.340
Sept	80-08	10.349
Dec	80-07	10.363
Mar '82	10-05	10.368
Jun	80-05	10.372



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**GOLD**

Gresham's Law (bad money drives good money out of circulation) continues to operate as efficiently as 5000 years ago. Apart from the U.S. ( & , naturally the two largest producers, South Africa and the USSR ), no new supplies of gold have been coming to the market. Foreign Central Banks either withhold their gold or make modest purchases in the realization that sooner or later gold will once again form the cornerstone of the next international monetary system (see Commodity and Currency Comments, October 1979).

Our estimate that U.S. gold sales will increase to 2-3 million ounces per month and cause an \$80/oz break did not materialize. A timid and Bluffing U.S. Treasury offered 1,250,000 ounces and, of course, they were snapped up. The \$80/oz break came and went and gold looks poised now for another major upside move.

The next upleg will be called the 'Kennedy bull move'. Very appropriately, it began with a violent shakeout below a very bullish looking triangle. It promises to cross \$440 ( z on the way to \$500/oz. Buy April COMEX Gold at market (or add to previously established long positions ) placing protective stops below recent lows (\$372/oz basis London Fix).

**SILVER**

Some bullion has been moving from London to Chicago to satisfy a still (potentially) tight U.S. warehouse level, which now stands at 123,300,000 ounces.

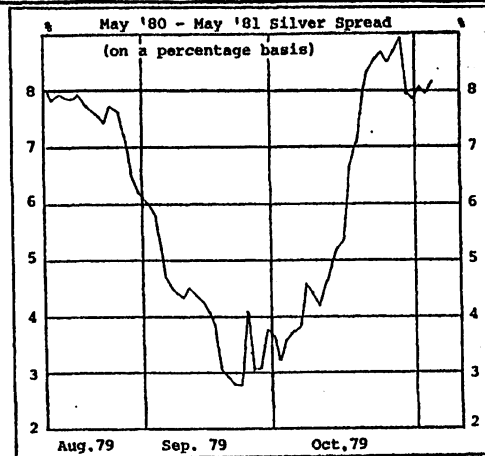
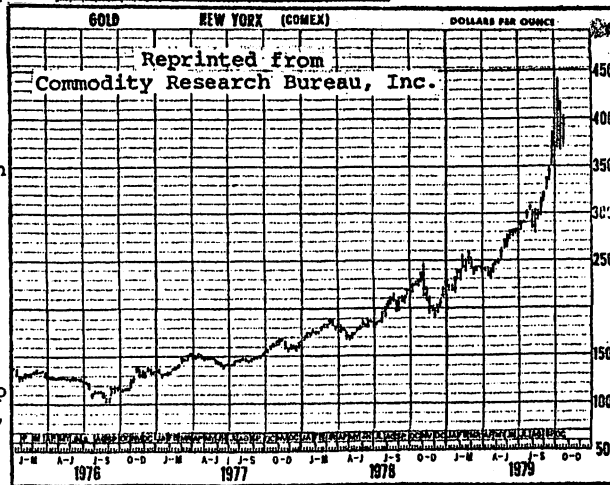
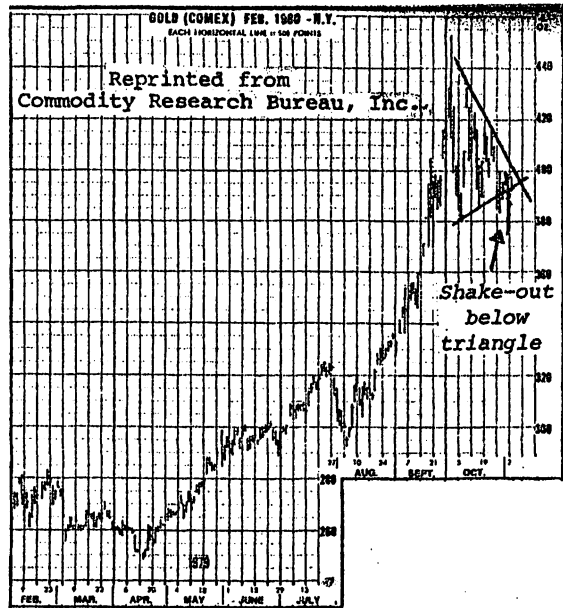
The rise in short term interest rates has caused the one-year convenience yield to drop to a negative 6.04% from -5.52% at mid-month, a small tightening, although well ahead of the critical -7.6% recorded in early Sept. While we are not out of the woods yet, our short May 80 long May 81 spread first recommended last month at 65¢ has successfully widened to 140¢, having touched a high of 190¢.

We are a bit disappointed with the slow increase in warehouse stocks although suspect that some bullion is being deliberately held back by confident bears. The Dec.79-Mar.80 switch, now at 66¢, equates approxi to a one-year spread of 225¢. This puzzle is almost too obvious and may be indicating that very powerful forces, beyond our comprehension, are at work. Liquidate half the spreads ( showing a \$3,500 pprofit) and raise stops to 120 on the balance.

U.S. Trade Balance (Billions of Dollars)

	Food, live animals	Food, tobacco	Beverages	Crude inedible materials (except fuels)	Mineral fuels lubricants	Mineral fuels	Oil, fats (animal, vegetable)	Chemicals and related prod.	Metal	Mfg. good and classified by material	Machinery, transport equipment	Misc. mfg. articles	Not classified elsewhere	Total
1975	7.0	-0.1	4.2	-22.0	0.4	5.0	-3.8	22.2	-3.6	0.6	11.0			
1976	5.4	-0.1	3.9	-29.8	0.5	5.2	-6.4	19.7	-6.0	0.2	-5.9			
1977	1.6	0.2	4.9	-40.1	0.8	5.4	-10.1	15.5	-7.5	0.5	-26.7			
78	4.8	0.1	6.3	-38.2	1.0	6.2	-14.8	11.7	-9.0	1	-30.9			
79*	2.64	-0.2	9.36	-43.44	0.98	8.4	-12.92	15.86	-6.5	3.6	-22.2			
1979**	3.44	-0.25	9.11	-44.24	1.14	8.79	-13.25	15.55	-7.16	3.88	-22.9			
1979***	5.77	-0.33	8.35	-49.68	1.16	9.51	-13.71	15.79	-8.46	3.89	-27.7			

\* 1979 data are Jan thru May, annualized.  
 \*\* 1979 data are Jan thru Jun., annualized.  
 \*\*\* 1979 data are Jan thru Sep., annualized.



\*\*\*\*\*  
 A significant trade deterioration is taking place.  
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## BRITISH POUND

Dec. 79: 2.0710    Mar. 80: 2.0720    Jun. 80: 2.07    Sep. 80: 2.0690

Moving one step closer towards ridding the economy of 30 years of mismanagement, the Tory Government eliminated the last remains of its foreign exchange controls. Moving with determination, Thatcher demonstrated her firm commitment to laissez faire economics. London may be due to regain its luster as the world's financial center.

A further monetary tightening is now overdue. Gilts have lost substantial ground in recent weeks despite assertions that the upcoming budget for fiscal 1981 will be just about unchanged from 1980, except for increases due to inflation. In line with conservative thinking, the only increases are slated for defense - up 3% to \$16.7 billion - law enforcement and higher pensions under the British social security system. Hardest hit (by actual cuts) will be education, public housing, transport and lending to Britain's nationalized industries. The plans propose expenditures of about \$ 2.3 billion less than the previous Labor Party 1981 proposals.

Management rationalization and the victorious outcome of the British Leyland's labor confrontation may be a sign that the new policies are beginning to work. The sharp rise in adult unemployment (to 5.3% of the work force) and the fourth consecutive drop in notified vacancies indicate that a turning point in the labor market may be near, blunting potentially dangerous wage demands.

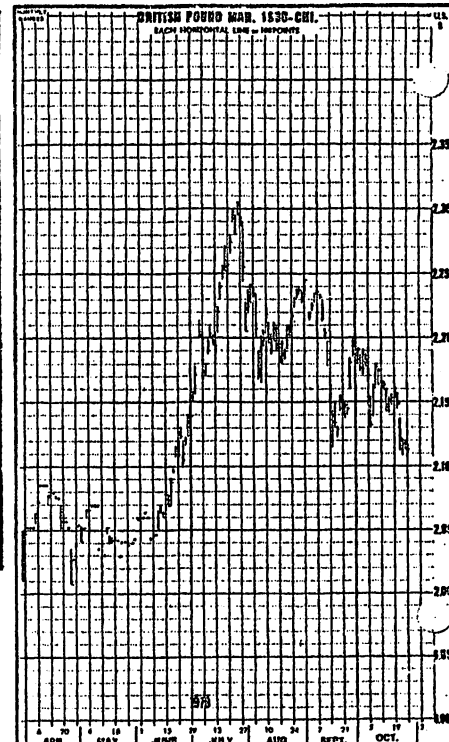
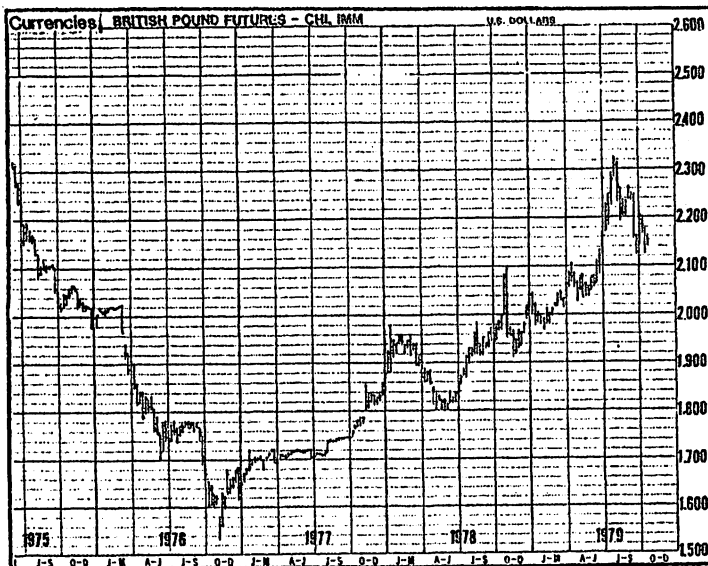
Sterling should firm against the Japanese Yen and other European Currencies while vis a vis the U.S., it should hold above 2.05-2.07 for the foreseeable future. Long term, it should attain a 2.40 - 2.75 range.

U.K. Economic Indicators

	Visible Balance	Current Balance	Oil Balance	M1*	M3*	DCE	Reserves	MLR	Food Index	FT Comdty
	(bbn)	(bbn)	(£M)			(£M)	US\$b/ln	%		
1978 ---										
2nd Qtr.	-0.2	+0.2	-414	10.1	15.0	+2,800	16.75	10.	203.8	242.27
3rd Qtr.	-0.4	+0.2	-501	17.2	8.1	+ 572	16.55	10.	206.2	253.74
4th Qtr.	0.0	+0.4	-480	14.9	12.0	+1,774	15.77	12 1/2	208.0	257.69
1979 ---										
1st Qtr.	-1.6	-1.2	-237	7.6	9.4	+1,521	16.78	13	218.8	268.83
2nd Qtr.	-1.1	-1.1	-210	9.7	17.2	+2,708	21.69	14	225.2	293.55
Feb.	-0.8	-0.6	- 78	17.6	20.0	+1,057	16.62	14	218.7	267.36
Mar.	-0.7	-0.5	- 97	7.6	9.4	- 321	17.45	13	220.2	268.83
Apr.	-0.3	-0.3	-114	16.8	6.4	+ 825	21.47	12	221.6	277.11
May	-0.4	-0.4	- 54	13.8	8.1	+ 996	21.53	12	224.0	279.20
Jun.	-0.3	-0.3	- 42	9.7	17.2	+ 837	22.07	14	230.0	293.55
Jul.	0.0	+0.0	- 41	7.1	14.3	+ 442	23.49	14	231.2	278.92
Aug.	-0.1	-0.1	-123	5.9	12.0	+1,065	23.30	14	231.8	290.04
Sep.	-0.1	-0.1	+ 9			+ 923	22.75	14	232.6	301.66

\*Three months' growth at annual rate.

Source: Financial Times

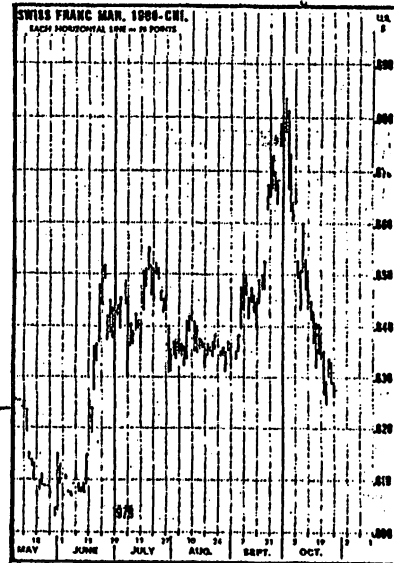


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**DEUTSCHE MARK**

	Dec.79:	56.16	Mar.80:	57.06	Jun.80:	57.84
	Balance of Trade	Balance of Payments	Money Supply**	cost of Living**	Unem- ployment Rate	
	(Mln Marks)	(Mln Marks)	%	%	%	
1979 ---						
May	+2,000	- 300		3.65	3.4	
Jun.	1,730	-3,200	11.08	3.91	3.3	
Jul.	607	-2,080	9.46	4.58	3.5	
Aug.	976	-2,900		4.92	3.5	
Sep.	1,900	-2,400		5.33	3.2	
1978 ---						
Sep.	4,730	+1,100		2.25	3.8	
Net Monetary Reserves (Bln Marks):						
	Oct.5:	101.8	Oct.12:	102.2	Oct.19:	101.9
** Year-over-year % change.						



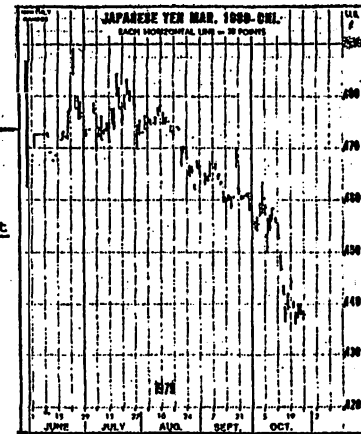
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SWISS FRANC →

JAPANESE YEN



	Dec.79:	61.50	Mar.80:	63.23	Jun.80:	64.52
	Balance of Trade	W.P.I.**	Unem- ployment	(M1) Money Supply		
	(Mln SF)	%	%	%		
1979 ---						
May	-219	3.13	0.4	6.7		
Jun.	- 78	3.83	0.3	7.1		
Jul.	-586	4.2	0.3	8.95		
Aug.	-667	4.9	0.3			
Sep.	-445	6.9	0.3			
1978 ---						
Sep.	+125	-4.67	0.3	18.59		
Weekly Reserves (Bln SFr) :						
	Oct.10:	21.86	Oct.19:	21.42	Oct.29:	22.35



Dec.79: 42.55 Mar.80: 43.26 Jun.80: 43.85

	Balance of Trade	Balance of Overall Account	Payments Current Account	(M1) Money Supply**	Reserves	W.P.I.**	Unem- ployment
	(Mln US\$)	(Mln US\$)	(Mln US\$)	%	(Mln US\$)	%	%
1979 ---							
May	+ 53	- 754	- 828	17.22	24,190	3.50	2.01
Jun.	+1,110	- 380	+ 120	9.92	24,980	5.23	2.01
Jul.	+ 197	-1,000	+ 878	9.44	25,120	8.26	2.26
Aug.	- 669r	- 387r	-1,530	8.75	25,170	10.94	2.23
Sep.	+ 147	-2,330	- 792		25,330	12.61	2.03
					23,270(Oct)		
1978 ---							
Sep.	+2,630	+ 346	+1,910	11.58	29,240	-3.81	2.41

\*\* Year-over-year % change.

**MP FORWARD DISCOUNTS (at annualized rates)**

	Dec/79	Mar/80	Jun/80	Sep/80	Dec/80	Mar/81
Spot	9.23	11.44	11.74	11.52	11.35	11.20
Dec'79		12.55	12.37	11.91	11.61	11.40
Mar'80			12.19	11.59	11.30	11.11
Jun'80				10.99	10.86	10.76
Sep'80					10.73	10.64
Dec'80						10.56

**POTPOURRI**

Livestock futures continue to look attractive; remain firmly long...  
 We've been finally stopped out of short Sugar positions; remain sidelined...  
 close out long wheat, short bean (4-3 ratio) spread; it shows an approx. gain of \$4,000.00 ...

Cocoa was behaving well before the floor was removed from under; roll-over to March'80 and retain long term long positions...

Housing starts are not as yet ready to collapse; short position in deeply discounted lumber futures may be premature...