

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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The Worst Is Yet to Come

By IRVING KRISTOL

The 1980s have already begun. They began with the takeover of the American embassy in Tehran earlier this month and with the subsequent confrontation between the United States and a virulently anti-Western Iranian regime. This episode is as it were, the shocking prologue to an equally tense drama that stands poised to unfold in the decade ahead. It promises to be an absolutely ghastly period.

These past years have been dominated by problems of domestic economic policy—of maintaining economic growth in the face of inflation, stagflation, high rates of taxation, governmental overregulation of business, etc. Even OPEC has been regarded as primarily a phenomenon within the economists' universe of discourse, and the arguments have centered around the kind of economic policy that would be most appropriately responsive to the new level of energy costs.

On the whole, and from this same economic perspective, we have managed these problems rather badly. The cast of mind shaped in the 1960s—one which perceived the United States as an "affluent society" whose major challenges were achieving a better "quality of life" and a "fairer" (i.e., more equal) distribution of entitlements to wealth, income, and opportunity—was quite unfit to cope with the bleaker realities of the 1970s, and we were very slow getting on a new learning curve.

The Role of Foreign Policy

More recently, however, there have been hopeful signs of progressive adaptation to these realities, an increasing recognition of the need for an economic policy to spur economic growth instead of being indifferent or hostile to it. But one senses it no longer matters quite so much. For it seems clear that in the 1980s it will be foreign policy, not domestic economic policy, that will be decisive for economic growth, and for our destiny in general.

If the 1970s were dominated by considerations of domestic economic policy, the 1980s are going to be dominated by considerations of foreign and military policy. The two are not unrelated, of course—and, indeed, in the case of oil they are most intimately related. But a whole new set of priorities will have to be established, as we come to grips with the fact that the American economy does not exist in isolation from world politics.

Take, for instance, the issue of inflation which President Carter now says is the most important economic problem facing the nation, a proposition that is heartily assented to by conservative economists and Republican politicians. They are almost surely wrong. Two years ago they would have been right, but not now. Today it is military rearmament that is the first priority, economic as well as political. And if there are going to have to be massive increases in military spending, then we shall have to put up with more inflation, for a longer time, than any of us would like. Should the rate of inflation in the 1980s stabilize at, say, 8%, that would represent a not inconsiderable achievement.

The truly important problems of the American economy in the years to come will result from what economists so chastely call "exogenous shocks"—i.e., things that happen elsewhere in the world, things that will profoundly affect us and to which we shall have to respond. None of these things is likely to be pleasant, for the world order—such as it is, which isn't saying much to begin with—is in the process of going through a whole series of convulsions.

The Middle East is the most obvious source of trouble. Even if the Arab-Israeli conflict were not a constant irritant, the chances for stability in that area seem slight. Intra-Moslem religious tensions are on the rise and anti-Western paranoia is endemic. Egypt under Sadat is indeed a remarkable exception, but one can properly doubt whether Egypt after Sadat will remain so. Iran will surely be hostile to American interests, whatever kind of regime is eventually established there. The days—at best, the years—of Saudi Arabia's anachronistic feudal oligarchy are numbered, to be succeeded by Lord only knows what. Iraq is likely to go to war against Iran, or against Syria, or against itself. Syria could easily go the way of Afghanistan and end up as a Russian puppet. Oil at \$50-\$75 a barrel is not too far down the road, and chaos in that region might well result in no oil being available at any price.

All this would seem to suggest the likelihood of some American military involve-

Board of Contributors

The truly important problems of the American economy will result from things that happen elsewhere in the world, things that will profoundly affect us and to which we shall have to respond.

ment in the Middle East to protect our interests, both economic and strategic. Unfortunately, we shall there encounter another presence: the Soviet Union.

The U.S.S.R. is today our superior in effective military power of a kind that is relevant to a situation such as the Middle East's—i.e., conventional military power. Even if we were now to undertake a serious and sustained effort to improve our military capabilities in this respect, it would probably take a good part of the decade to accomplish it. Moreover, a new Soviet leadership is on the verge of coming to office, and all the evidence points to its being very self-confident, highly nationalistic, and likely to be more boldly assertive than its predecessors. And, perhaps most important, the Soviets are going to be needing foreign sources of oil by 1981, and

the Middle East is not only the logical place for them to turn to, it is the only place. So an era of confrontation with the Soviet Union seems to be in the cards.

And as the post-World War II international order falls apart—not only in the Middle East but probably in Latin America as well—all thinking about American foreign policy derived from that era assumes an air of irrelevance. SALT becomes irrelevant. The United Nations becomes irrelevant. Foreign aid becomes irrelevant. Sermons on human rights become irrelevant. NATO itself may soon become irrelevant, as our European allies decide that, in the face of American weakness, *saute qui peut* is the sensible flag to fly. What will be relevant is an American foreign policy in which power, and the readiness to use it boldly, will play a far more central role than has ever before been the case in our history.

Nor will the United States really have any alternative but to use such power to recreate a world order it can live with—a world in which there is relatively free trade and relatively free access to the world's resources. Though there is much we can, should, and in the end probably will do to set our own economic house in order—including the more abundant use of coal and nuclear power, despite any hazards they might create—it is an inescapable fact that the American economy is a vital organ of a larger world economy. The one cannot survive, and certainly cannot prosper, without the other. The wealth of nations today is indivisible. Our economic growth will henceforth be as dependent on our foreign policy as on our economic policy. And if we fail to establish the conditions for such growth, our democracy will itself unravel, as economic pressures give rise to political polarization, at home and abroad.

There is far too much easy and glib talk these days about the need for Americans to tighten their belts, accept a reduction in their living standards, even resign themselves to an economic philosophy of no-growth. It is dangerous and irresponsible talk. Yes, of course, the American democracy can cope with a temporary cessation of economic growth, as it has done in wartime. But only if it is perceived to be temporary. What few seem to realize is that a prospect of economic growth is a crucial precondition for the survival of any modern democracy, the American included.

For over two thousand years, the consensus among political philosophers was that democracy—the rule of the majority—was an inherently unstable and therefore undesirable form of government. The reason they came to this conclusion was not because they were snobs or disliked the common people, or because ordinary people then were inferior to the people of today. It was because they believed, on the basis of experience (in the ancient Greek city-states especially), that in a democracy the majority, being poor, would always use its power to expropriate the wealth of the more affluent minority, and that this would lead (as it always had) to economic chaos, followed by political chaos, followed by the restoration of order by a dictator.

FRIEDBERG
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GROUP

Continued from page 1

What changed the attitude of political philosophers was the emergence of modern capitalism, with its promise of economic growth--of an economic system in which everyone could improve his condition without having to do so at someone else's expense. It is because this promise of economic growth has been kept that democratic politics has survived in the United States, in Western Europe, more recently in Japan. And it is only so long as economic growth remains a credible reality that democracy will remain an actuality. It is the expectation of tomorrow's bigger pie, from which everyone will receive a larger slice, that prevents people from fighting to the bitter end over the division of today's pie.

What the U.S. Should Do

The 1980s will see a disintegrating international order in which economic growth is going to be extraordinarily difficult to achieve, and in which even economic stability will be hard to maintain. It will therefore have to be an overriding goal of American foreign policy to help shape this world so that the growth of the world economy can continue. This will require many sacrifices, but so long as the goal is visibly there, the sacrifices are tolerable. If the goal is not there, our situation will gradually deteriorate until we end up divided among ourselves and destroying our institutions in a frenzy of recriminations.

For the very survival of this nation, our foreign policy is going to have to be oriented quite explicitly toward such a goal. Where will such a foreign policy come from? Who will articulate it? Who will be able to sustain it? Those are the questions that ought to be dominating the 1980 elections. But no one, so far as I can see, is asking them.

Mr. Kristol is Professor of Social Thought at the NYU Graduate School of Business, a Senior Fellow of the American Enterprise Institute and a member of the Journal's Board of Contributors.

THE WALL STREET JOURNAL,

MONDAY, NOVEMBER 26, 1979

As our veteran readers know, we have the highest admiration and respect for Irving Kristol. The above piece is a superb demonstration of the breadth, lucidity and depth of his thinking. The Zenith of Pax Americana was reached in the mid-50's, specifically when John Foster Dulles ordered the retreat of our allies, the U.K. and France, out of the Suez Canal area in the 1956 war despite the flagrant Egyptian violation of international law and property rights. The subsequent 23 year history has been a chronicle of defeat and retreat: Bay of Pigs, Vietnam-Cambodia, SALT II, Nicaragua and, most recently, Iran.

We take issue, however, with two particular propositions. Mr. Kristol states that more recently there has been an "increasing recognition of the need for an economic policy to spur economic growth instead of being indifferent or hostile to it." Furthermore, he goes on to say that inflation is no longer our most important economic problem, "... two years ago they would have been right, but not now." Is the monstrous and confiscatory windfall tax on oil a sign of that economic policy has shifted from being outright hostile to even barely indifferent? Can economic growth be spurred when taxes impose a disastrous burden on incomes, capital and wealth on inflationary and non-existent gains? While we agree that stabilizing the rate of inflation at say, 8%, would represent a not inconsiderable achievement, we can not see how that can be achieved, even remotely. The Federal budget is out of control, the Federal Reserve continues to emphasize phantom money statistics, the American public continues to reduce its demand for money balances, and now ... the Treasury freezes a foreign government's dollar balances, thus effectively eliminating the dollar's role as a reserve currency and a store of value.

Yes, Mr. Kristol, the middle East situation is one more manifestation of the decline and fall of American power. No, Mr. Kristol, inflation is alive and well and ranks alongside with foreign & military policy as the main issues of the 80's, mostly as a result of its corrosive effect on economic growth. Yes, Mr. Kristol, "it is only, so long as economic growth remains a credible reality that democracy will remain an actuality."

Our fundamental views expressed in last month's Commodity and Currency Comments remain unchanged. We will devote the present issue to some brief technical comments that should complement our overall strategy.

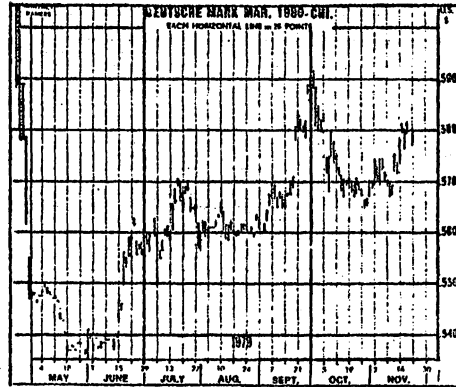
CURRENCIES

- There have been a number of significant developments in the currency area:
- 1) The DM has, once again, re-taken its leading role almost co-incidentally with the U.S. Treasury's move to freeze Iranian dollar balances.. The DM/US\$&DM/SF ratios (both shown) indicate that a powerful bull market in DM is underway. Short positions taken at 56.16 basis December '79 have been liquidated in line with our suggestion of placing stops 2% above that level. Commercial hedgers and long term investors should now move once again to the long side as we foresee a significant rise.
 - 2) The BP/YEN spread (shown) performed exceedingly well in our favor, moving from 495 (when first put on) to just above 538; the long term ratio is seen to have moved to a new recovery high.

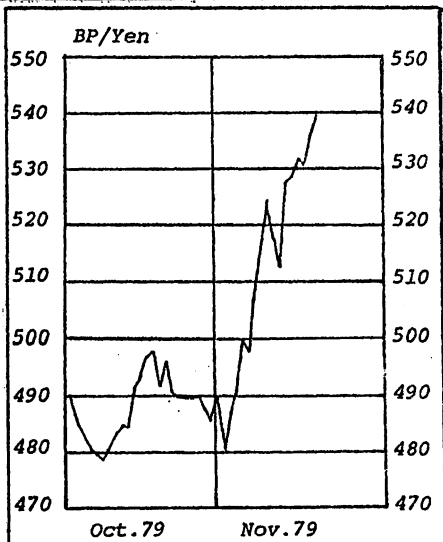
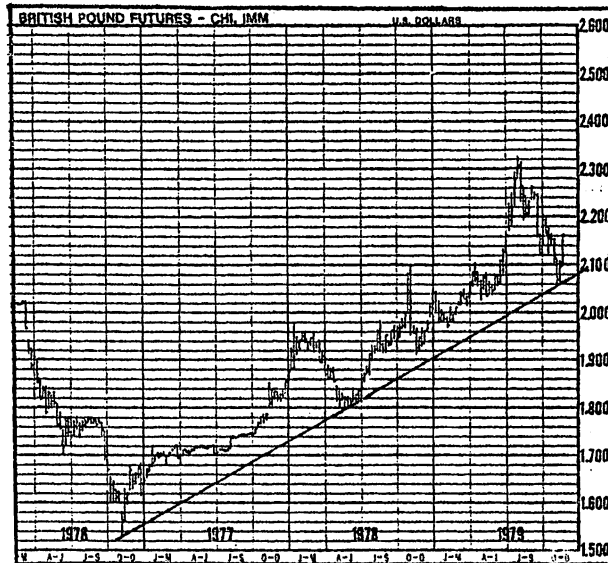
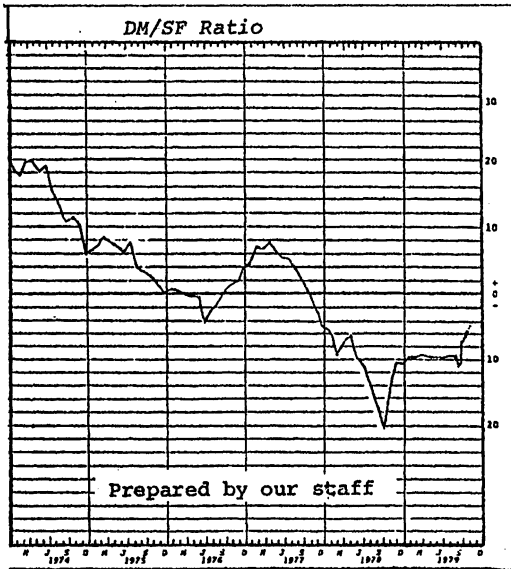
As posited last month, the BP held above the 2.05-2.07 level, which represented its main long term uptrend (see chart).

Three factors should help propel the BP to the 2.40-2.75 area: 1) its status as a petro-currency; 2) adroit monetary management (the 17% MLR jump was higher than the 16% rate we envisioned two months ago, but, of course, it came later so that it had to be higher); 3) liberalization of exchange controls, making the BP one of the few safe havens for holding large international balances.

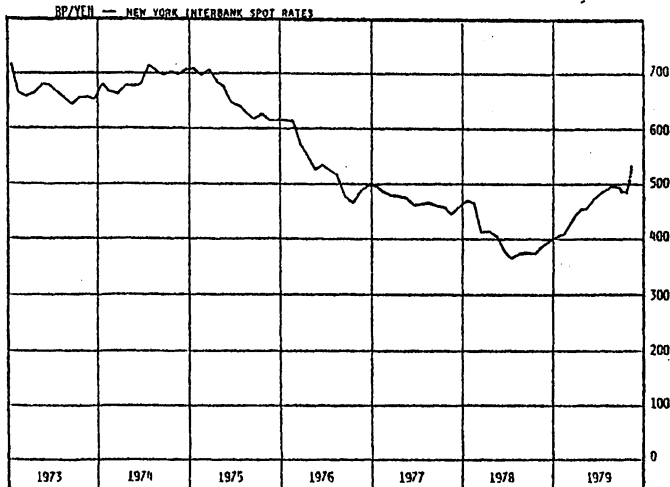
Remain long the BP, short the Yen.



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Prepared by our staff



Prepared by our staff

3) The CD\$ has rallied from a low of 84 to an intra-day high of 85.53, before closing at 85.34 today, failing to trigger our 85.50 stop on close. Remain short, raising stops to 85.60, on close only. Additional short positions may be taken on the 'news' that the National Energy Board will authorize increased gas exports to the U.S. enhancing the trade surplus by \$2.0 billion yearly.

CD\$	Balance of Trade (Min \$)	General Bank Loans**	Money Supply**				Total Liabilities**	Int'l Reserves (Bln US\$)	C.P.I.**	Food Index**	Unemployment	
			M1	M1b	M2	M3					S.A.	N.S.A.
1979 ---												
Apr.	+64	16.55	7.96	5.31	14.38	17.58	16.4	5.14	9.75	16.52	7.9	8.6
May	203	18.32	8.51	6.26	15.22	20.03	16.98	4.08	9.27	13.38	7.7	7.5
Jun.	183	20.34	9.32	6.35	15.75	20.22	17.91	4.18	8.85	11.70	7.5	7.0
Jul.	-13	20.84	8.47	6.49	16.02	20.72	18.10	4.28	7.26	13.64	7.2	6.8
Aug.	-16r	21.44	8.61	6.81	16.98	20.63	18.66	4.27	8.44	10.01	7.2	6.6
Sep.	641	21.81	7.44	5.57	17.00	19.07	17.45	4.51	9.58	12.85	7.1	6.4
Oct.		22.28	6.01	4.08	17.49	19.44		3.92	9.26	12.28	7.4	6.6
1978 ---												
Oct.	153	11.66	12.12	9.67	11.26	13.85	14.71	5.10	8.67	14.55	8.2	7.2

** Year-over-year % change.

UK Economic Indicators

	Visible Balance (Ebn)	Current Balance (Ebn)	Oil Balance (Ebn)	M1*	M3*	DCE (Ebn)	Reserves US\$bn	MLR %	Food Index	FT Comdty.
1978 ---										
3rd Qtr.	-0.367	+0.299	-501	17.2	8.1	+ 572	16.55	10	206.2	253.74
4th Qtr.	-0.039	+0.614	-480	14.9	11.9	+1,774	15.77	12 1/2	208.0	257.69
1979 ---										
1st Qtr.	-1.579	-1.140	-234	7.6	9.3	+1,524	16.78	13	218.8	268.83
2nd Qtr.	-0.714	-0.714	-227	9.7	17.2	+2,705	21.69	14	225.2	293.55
3rd Qtr.	-0.311	-0.311	-166	11.5	9.9	+2,414	23.18	14	231.9	301.66
Apr.	-0.159	-0.159	-123	16.8	6.4	+ 825	21.47	12	221.6	277.11
May	-0.310	-0.310	- 54	13.9	8.1	+ 997	21.53	12	224.0	279.20
Jun.	-0.245	-0.245	- 50	9.7	17.2	+ 885	22.07	14	230.0	293.55
Jul.	-0.046	-0.046	- 44	7.1	14.3	+ 439	23.49	14	231.7	278.92
Aug.	-0.147	-0.147	-130	6.1	12.4	+1,052	23.30	14	231.8	290.04
Sep.	-0.118	-0.118	+ 8	11.5	9.9	+ 923	22.75	14	232.6	301.66
Oct.	-0.339	-0.339	- 85	15.7	15.1	+1,566	22.49	14	234.8	291.34

* Three month's growth at annual rate.

YEN	Balance of Trade	Balance of Payments Overall Account		Current Account (M)	Money Supply**	Reserves (Mln US\$)	W.P.I.**	Unem- ployment	SF	Balance of Trade (Mln SF)	W.P.I.**	Unem- ployment
		Min US\$										
1979 ---												
May	+ 53	- 754	- 828	17.22	24,190	3.50	2.01		1979 ---	-219	3.13	0.4
Jun.	+1,110	- 380	+ 120	9.92	24,980	5.23	2.01		May	- 78	3.83	0.3
Jul.	+ 197	-1,000	+ 878	9.44	25,120	8.26	2.26		Jun.	-586	4.2	0.3
Aug.	- 669	- 387	-1,530	8.75	25,170	10.94	2.23		Jul.	-667	4.9	0.3
Sep.	+ 147	-2,330	- 792		25,330	12.61	2.03		Aug.	-445	6.9	0.3
Oct.	- 350	-3,470	-1,120		23,270	14.54	n/a		Sep.	-593	6.75	0.3
1978 ---									1978 ---			
Oct.	+1,404	- 971	+ 364	11.55	29,390	-4.14	2.27		Oct.	13	-3.96	0.3

** Year-over-year % change.

London Euro Deposits:

	Nov. 2	Nov. 9	Nov. 16	Nov. 23
U.K.				
1 Mo.	14 1/8	14 1/8	17.	16 3/4
3 Mo.	14 1/8	14 3/4	17.	16 5/8
6 Mo.	14 1/8	15	16 3/8	16 1/2
12 Mo.	14 1/2	14 7/8	16.	16.
C.D.				
1 Mo.	14.	13 5/8	13 7/8	12 7/8
3 Mo.	14 1/2	14 1/2	14 3/8	13 3/4
6 Mo.	14 3/8	14 1/4	14 1/8	13 3/4
12 Mo.	13 1/2	13 5/8	13 3/8	13.
D.H.				
1 Mo.	8 1/4	8 3/8	8 3/16	8 9/16
3 Mo.	9 1/16	9.	8 7/8	9 1/8
6 Mo.	9 1/16	8 7/8	8 7/8	8 15/16
12 Mo.	8 11/16	8 9/16	8 1/2	8 3/8
S.F.				
1 Mo.	2 13/16	2 1/2	2 13/16	2 11/16
3 Mo.	4.	3 15/16	4 1/8	4 1/16
6 Mo.	4 1/2	4 5/8	4 9/16	4 3/4
12 Mo.	4 1/4	4 3/8	4 1/2	4 5/8

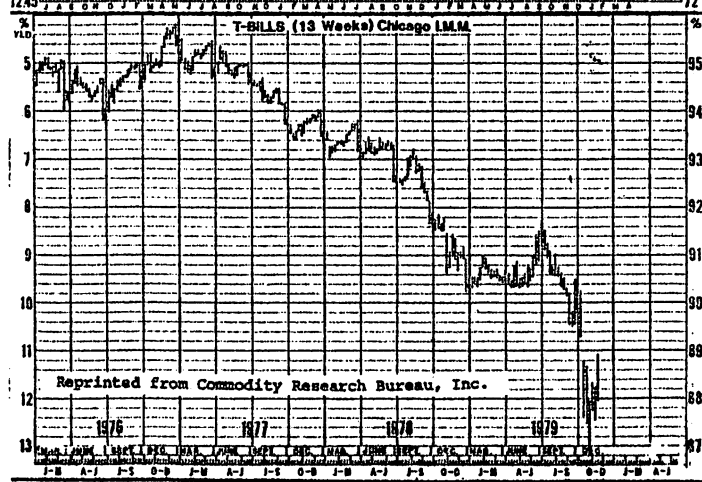
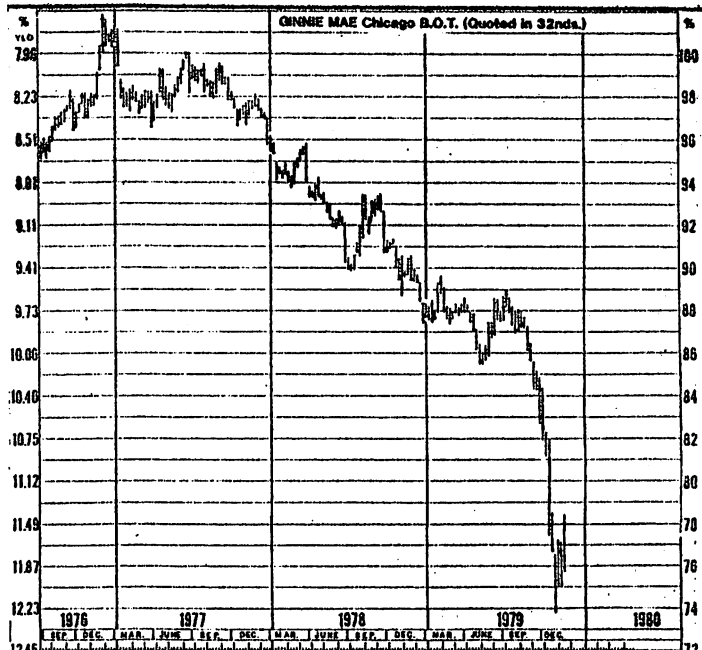
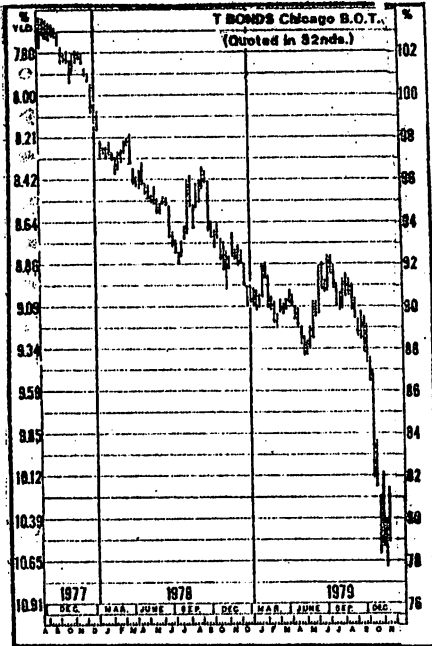
DM	Balance of Trade (Mln Marks)	Balance of Payments	Money Supply**	cost of Living**	Unem- ployment Rate
1979 ---					
May	+2,000	- 300		3.65	3.4
Jun.	1,730	-3,200	11.08	3.91	3.3
Jul.	607	-2,080	9.46	4.58	3.5
Aug.	976	-2,900		4.92	3.5
Sep.	1,900	-2,400		5.33	3.2
Oct.	1,800	-1,000			3.3
1978 ---					
Oct.	4,810	3,450	11.27	2.18	3.9
Net Monetary Reserves (Bln Marks):					
	Oct. 19: 101.9	Oct. 26: 99.4	Nov. 2: 95.8		

** Year-over-year % change.

Quotes:	Dec. 79	Mar. 80	Jun. 80	Sep. 80
BP:	215.55	214.45	213.30	212.50
CD\$:	85.34	85.50	85.65	85.70
Yen:	40.22	40.75	41.30	41.30
SF:	61.03	62.41	63.55	64.75
DM:	57.39	58.03	58.66	59.30

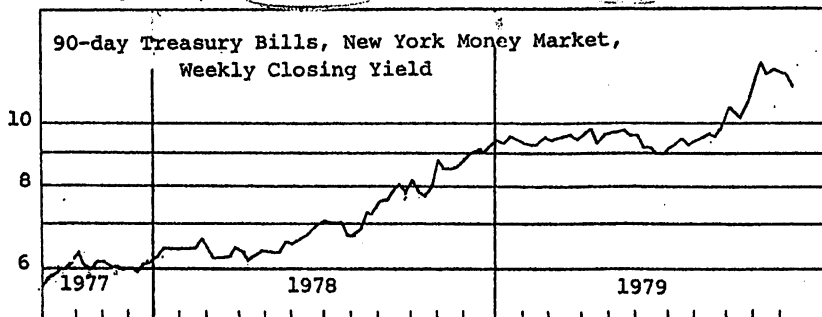
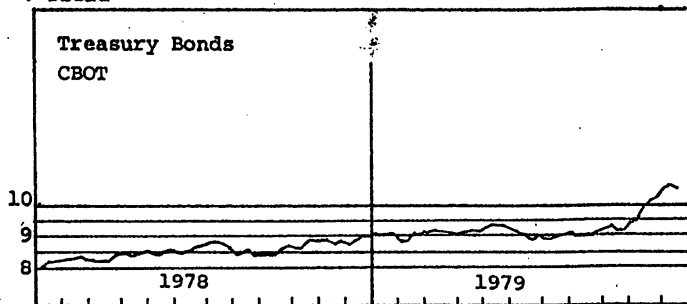
Interest Rates Futures

The accompanying charts have all the earmarks of a selling climax and a culmination of the long bear market in bonds that began three years ago.



The climactic-type action is not as apparent, however, if one were to use a semi-log paper to chart the corresponding yield movement. We reproduce, below, two such charts.

Yield



Prepared by our staff

As of Nov. 26, 79

GNMA	Settle	Yield
Dec	79-15	11.214
Mar '80	79-21	11.179
Jun	80-10	11.058
Sep	80-29	10.949
Dec	80-31	10.938
Mar '81	80-01	10.926
Jun	80-29	10.917
Sep	80-24	10.977
Dec	80-19	11.006
Mar '82	80-15	11.029
Jun	80-12	11.046

Treasury Bonds

Dec	82-04	10.000
Mar '80	82-26	10.004
Jun	83-15	9.916
Sep	83-27	9.866
Dec	84-03	9.833
Mar '81	84-07	9.816
Jun	84-07	9.816
Sep	84-05	9.825
Dec	84-04	9.830
Mar '82	84-03	9.833
Jun	84-02	9.833

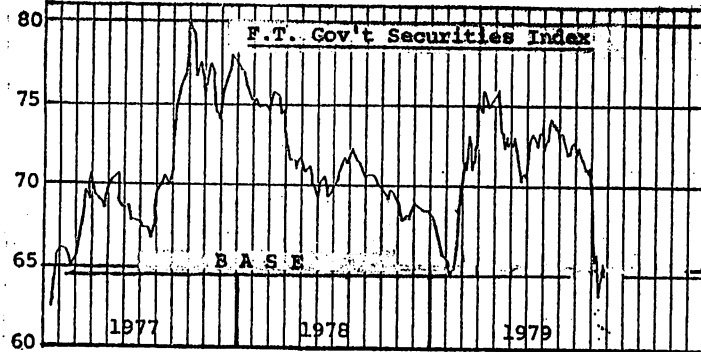
In the case of T.Bills, the semi-logarithmic chart shows a relatively gentle rise over the 1977-1979 period. The "October massacre" and subsequent November recovery represent merely a ripple in the overall picture equalling the violence of, say, the early 1977 and late 1978 moves. One can hardly conclude that a credit crunch has taken place. In view of this orderly uptrend in the 'liquidity sensitive' Treasury Bills rate, one is impressed by the upside breakout recorded by long rates. The steepness of the ascent far eclipses anything seem to date and implies a fundamental re-appraisal of inflationary expectations.

Our over-all conclusion follows : money rates have merely reflected the stepped up pace of inflation, albeit rather belatedly, and have, as yet, not shown any sign of credit stress so typical of terminal moves. The more determined move at the long end of the market indicates that the Worst Is Yet to Come.

Remain firmly short GNMA's and U.S. Treasury Bonds.

U.K. INTEREST RATES

Unlike their U.S. counterpart, long dated U.K. gilts did not penetrate convincingly the 1978 lows (see chart) indicating quite clearly that inflationary expectations in the U.K. are receding, a rather remarkable phenomenon in view of the record high MLR (maybe, because?) and the much touted 17.2% inflation. The market seems to support our view that U.K. inflation figures will begin decelerating in a significant way. By early 1980, 6-8% per annum is in the cards.

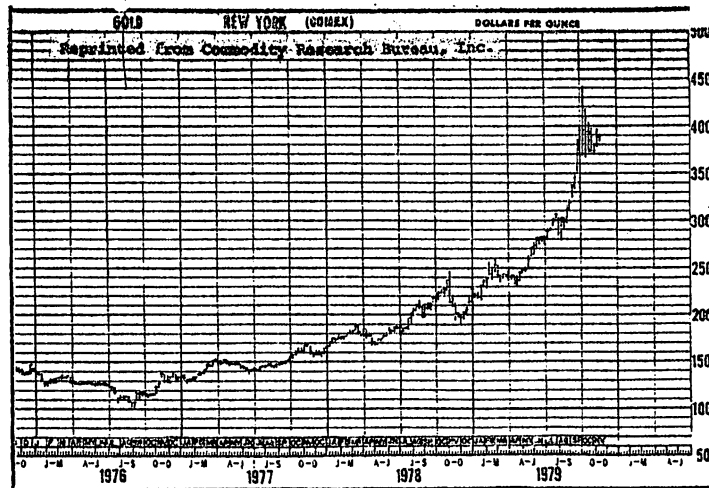


Prepared by our staff

Buy long-dated GILTS at present levels.

PRECIOUS METALS

GOLD - Gold prices have been marking time for the past four weeks moving in a relatively narrow \$15/oz range. The big move is about to begin. Add to long positions when Spot betters \$403, on close only.



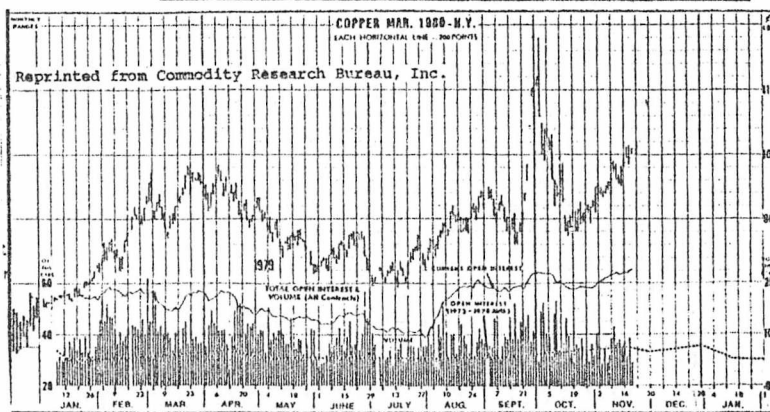
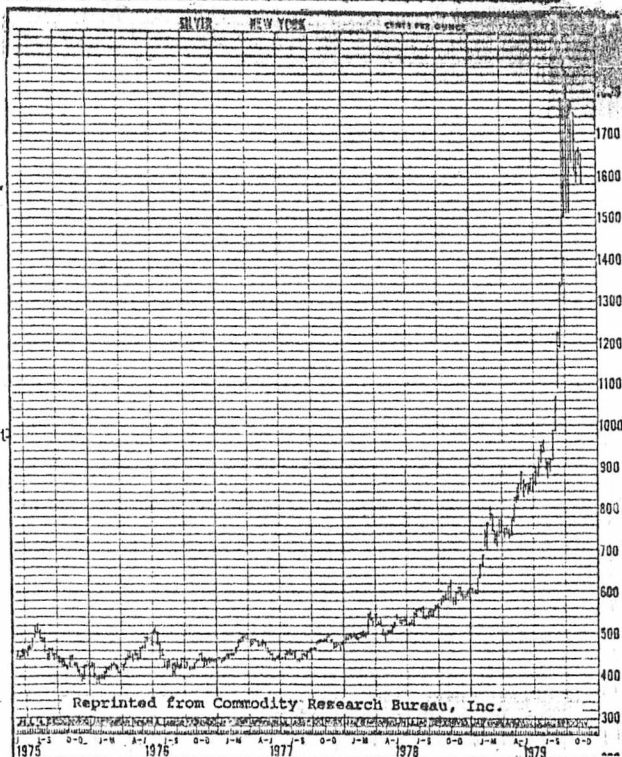
SILVER

Today's limit-up move catapults silver out of its eight-week triangle. A near-term target of \$20-21/oz is indicated, with a potential for an eventual move to \$27/oz. Buy March '80 at market and place stops at 16.20, close only.

COPPER

A promising uptrend seems to have been derailed by the market's realization that a squeeze play in the December positions was no longer a credible threat. We are not so sure, particularly in view of the continuing December '79 premium and the rather tight spread formation in the deferred positions.

We are friendly to the market after this shake-out and suggest entering the long side via March '80. Stops should be placed at 90.00, close only.

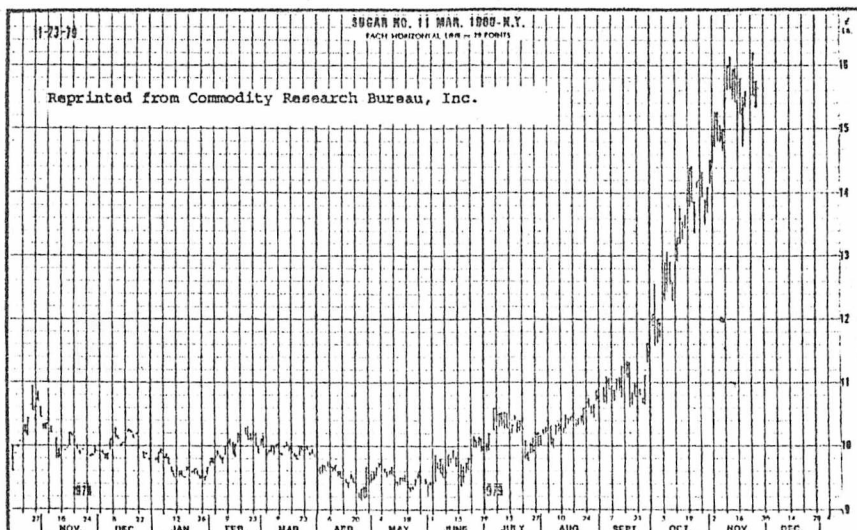


OTHER COMMODITIES ...

SUGAR - A new intra-day high of 16.19 lacked the necessary follow through and the market slumped to limit down, giving the first indication that sugar may have topped out.

The incredible build-up in the open commitment, now equivalent to 4.2 million tons (!), coupled with the relatively high degree of public bullishness make this market a near-perfect short.

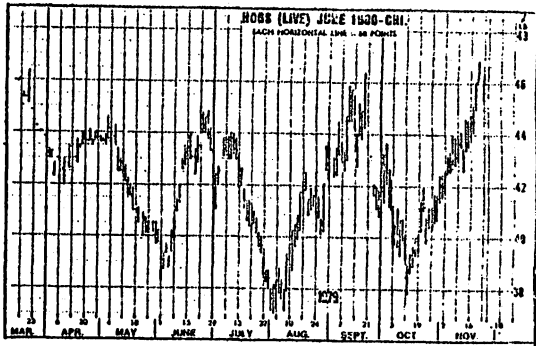
Sell March '80 at present levels, placing stops at 16.20, close only.



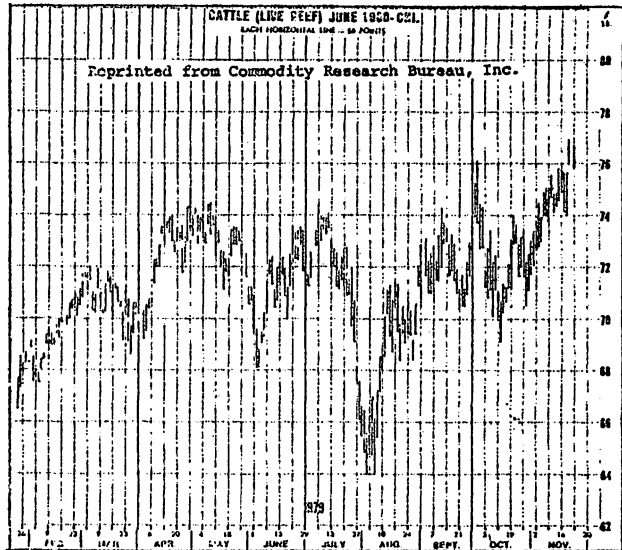
LIVESTOCK FUTURES

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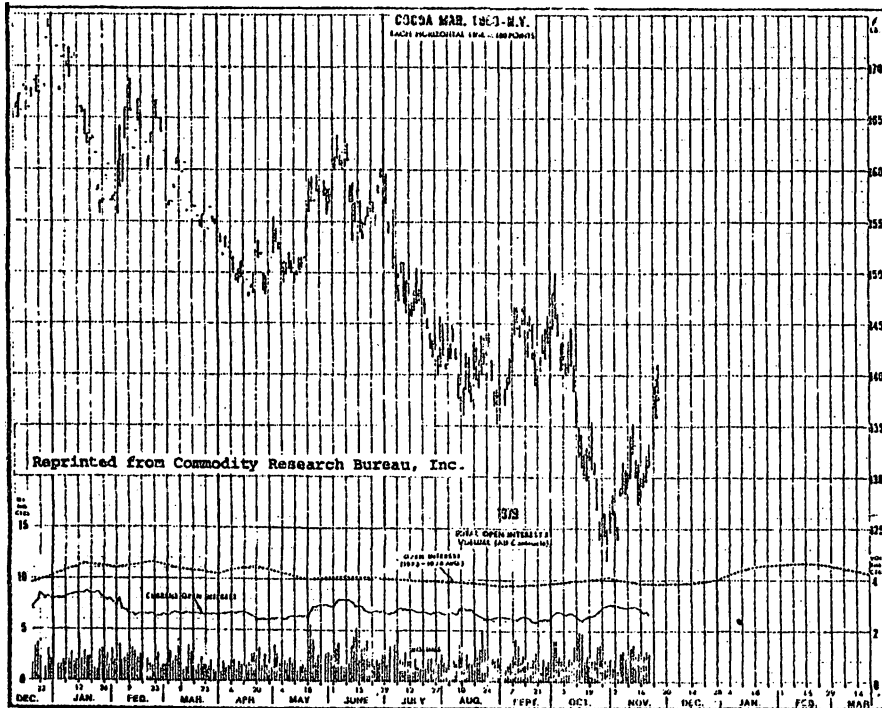


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COCOA - We'd prefer taking advantage of the recent 1300 point run-up and liquidate long positions.



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Exposed Position Bond Market's Plunge Caught Most Investors With Hedges Down

They Couldn't or Didn't Use
Futures in Interest Rates;
But One Saved \$150,000

'I Wish I Had Done More'

By LAWRENCE ROUT
Staff Reporter of THE WALL STREET JOURNAL

Most people in the bond market probably want to kick themselves.

During the recent plunge in bond prices, they could have saved a lot of money by using a four-year-old hedging mechanism that was available for the first time in a sharply declining market. But all except a relative handful weren't able or simply failed to do so.

What most bond-portfolio managers—to cite one group—didn't do was to hedge their bondholdings in the interest-rate futures market. To hedge bondholdings, a portfolio manager could have sold futures in Treasury securities. The reasoning: The futures, which are agreements to deliver government securities at a specified price and future time, would respond much like bonds to an increase in interest rates—that is, their prices would fall.

And after Oct. 6, when the Federal Reserve moved to curb inflation by driving up interest rates, prices of both bonds and interest-rate futures did decline steeply. A well-hedged portfolio manager could have offset much of the loss in the value of his bonds by buying back his futures for less than his earlier selling price. Because the hedging transaction began with the sale of futures, the manager's repurchase of identical futures liquidates his position in the futures market. For the first time, bondholders had an opportunity to do something besides passively riding out a plunge in prices or just selling bonds at a big loss.

Most Steered Clear

Yet, says Robert Zellner, president of Dunavant Financial Inc., a Chicago-based interest-rate-futures brokerage firm for financial institutions, "there were certainly more people who didn't use futures than who did."

The relatively small amount of hedging is particularly striking because of the huge amounts of money at stake in the bond market. The totals for just three major types of bonds: Publicly offered corporates outstanding amount to about \$260 billion, municipal bonds (issued by both states and local governments) about \$315 billion, and marketable Treasury debt about \$495 billion.

And in the bond market last month, the loss of principal was staggering. According to Salomon Brothers, a big New York bond house, prices of high-quality corporates fell nearly 10%. This estimate indicates that a \$1 billion portfolio of corporates—not unusually large these days—may have sustained a paper loss of almost \$100 million; the exact amount would have depended on the particular issues and maturities involved.

So, because of the record declines in bond prices, institutional investors and bond dealers alike are holding seriously depreciated portfolios and are taking substantial losses on securities that they do sell. In addition, corporations planning to issue new bonds are being stuck with sharply higher interest rates.

Big Opportunity

These troubles could present the interest-rate futures market with the biggest opportunity ever before it, proponents of such futures say. "If ever you wanted an advertisement for the interest-rate futures market, this is it," says Morton Lane, president of Discount Corp. of New York Futures. "It's a classic example."

Here's how hedging with futures works. Let's say a bank held a \$1 billion portfolio of bonds at the beginning of October. By the end of the month, those bonds were worth about \$900 million, representing a portfolio loss of about \$100 million.

To protect itself, the bank could have sold \$1 billion of Treasury-bond futures, thus taking a short position in the futures market. During the month, prices of these futures dropped about 8%; so on Oct. 31 the same futures were worth about \$320 million.

The bank could have bought bond futures that day, cancelling its short position and resulting in an \$80 million profit, less commissions, to apply against its \$100 million portfolio loss. Profits from hedging usually don't work out to equal losses exactly, because of differences between futures and portfolio holdings.

Consider the experience of Craig Wardlaw, a bond-portfolio manager at North Carolina National Bank in Charlotte. Expecting trouble, Mr. Wardlaw had sold a lot of bonds as well as hedged in the futures market by the time the Fed acted. "When you've got a \$650 million portfolio, you can get creamed," he explains. "But with interest-rate futures, at least we weren't standing there defenseless." His futures-market profit—about \$150,000—partially offset the decline in his bond portfolio, although his bondholdings, like almost everyone else's, still took a beating. He says he wishes he had used the futures market more extensively.

Even before Oct. 6, a growing number of people had become aware of the potentialities of the futures game. Since its inception at the Chicago Board of Trade nearly four years ago, interest-rate futures have been a phenomenal success, even though until August 1977 only two types of interest-rate futures contracts—in certificates of the Government National Mortgage Association and in 90-day Treasury bills—were traded. (One GNMA contract, for example, covers \$100,000 of securities.)

Now, about a dozen types of contracts are traded on the Board of Trade, Chicago Mercantile Exchange, Amex Commodities Exchange and Commodity Exchange Inc. Trading volume in interest-rate futures rose 198% to 2.3 million contracts last year, and it climbed 206% in 1979's first 10 months.

Moreover, the Fed's moves may give the market a big push. "We're going to have increased volatility in rates," says Laurence Mollner, a vice president at Dean Witter Reynolds Inc. "That points out the need for an awareness of the futures market and how it can be used."

And there's plenty of room for growth. "I would say that less than 1% of the potential users are actually using it," says George Hall, vice president and director of financial futures marketing at Merrill Lynch, Pierce, Fenner & Smith Inc. "Even though it has grown faster than the other commodities, it's still in the embryonic stages."

Its growth has been held down significantly because many people aren't authorized to use it. Many state-chartered banks haven't obtained permission from state banking authorities, and only about 40 national banks have received a go-ahead from the Comptroller of the Currency. The Comptroller's office in Washington says no applications to use interest-rate futures have been rejected, but some bankers contend that the federal authorities have raised numerous objections and, in effect, barred them from the market.

Similarly, many pension-fund managers need to get approval from their boards of directors or state legislatures before using the market. Robert Barman, senior portfolio manager for Minnesota state pension funds, says he "definitely would have used the futures market" if he had had authority to do so. He has asked the legislature for a change in the statute governing his operations.

Also holding down the market's growth is widespread doubt about its effectiveness. Some doubters say that the market isn't liquid enough and that sharp swings in prices make it a dangerous game. They worry that newcomers don't understand it and are getting in over their heads. And they note that because no hedge against interest-rate changes is perfect, it's possible, though unlikely, to get burned both in the underlying securities holdings and in the futures market simultaneously.

Moreover, the small amount of money that investors have to put up can work against them as well as for them. Investors in Treasury-bill futures, for instance, need only about \$1,000 to control about \$1 million of securities. But the leverage works both ways, and if the market moves against them, additional margin money is required immediately. Big losses are possible.

Low Commission Costs

The commission costs of hedging are so low, however, that they aren't likely to retard the market's expansion. To get into and out of a \$1 million hedge in Treasury securities, for example, costs about \$50, and these hedges can be good for as long as two years. Of course, "just how expensive it is depends on whether or not the hedge works," notes Mr. Lane of Discount Corp. of New York Futures.

Despite the risks, most bond-market participants undoubtedly regret not using futures last month. In fact, even the Monday after the Fed's weekend announcement wouldn't have been too late to have saved money.

That's because, while the bond markets were observing the Columbus Day holiday, the futures markets were hopping. If people had come in to work, says Stanley Jonas, manager of the financial-futures division of ACLI Commodities Service Inc. in White Plains, N.Y., "they could have at least mitigated their losses."

One who did was Erwin Williams, a vice president at First Union National Bank in Charlotte. Figuring that bond prices would fall on Tuesday when trading resumed, Mrs. Williams sold futures on Monday. Since futures prices didn't drop sharply until Monday afternoon, she had time in the morning to make up about \$12,000, or about 10% of the decline in her portfolio's value.

Similarly, some Wall Street bond houses say futures helped them cut their losses during the recent bond-market debacle. Observers say more houses are likely to use futures hedging in the wake of the battering that they took in the \$1 billion debt offering of International Business Machines Corp. The underwriting loss, estimated at \$10 million, "is going to become a textbook example for the necessity to hedge" bond inventories, says Frank Mickel, an E. F. Hutton & Co. vice president.

Corporate Users

Industrial corporations also are beginning to use the futures market. Six months ago, Esmark Inc. anticipated rising borrowing costs and, to protect itself, sold about \$15 million of Treasury-bill futures. "The strategy obviously worked," says Jay Proops, treasurer of the diversified company, although he saved less than \$100,000. "I just wish I had done more."

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Speech given by Albert D. Friedberg at

THE CANADIAN COMMODITY AND FINANCIAL FUTURES CONFERENCE

Held: Thursday 1st November 1979 at

Sheraton Centre Toronto

Sponsored by the Oyez Limited

HOW TO HEDGE FINANCIAL ASSETS THROUGH THE COMMODITY MARKETS

A Canadian investor sees a bright future for the UK & would like to invest in the UK's financial market but is not familiar with the variety of instruments or vehicles available to him. - how can he put into effect this concept?

An investor or businessmen requires a high degree of liquidity but is terribly concerned with the deterioration of his liquid capital as a result of inflation - what should he do?

An investor, be it a substantial individual, pension fund or trust company, has a portfolio of high quality bonds and mortgages and feels that interest rates are heading substantially higher over the next few weeks and months; he cannot dispose of this portfolio easily - regardless of the quality of the debt instruments they are not easily marketable but would like protect himself against a potential capital loss - what can he do?

These and many other problems can now be tackled by judiciously using the U.S. futures markets. While everyone here has heard and read about using futures contracts to hedge metal inventories or commitments, grain inventories or grain commitments, wood inventories and wood commitments, and so on, very little has been said regarding financial hedges. Most people in this room have and will have little use during their lifetime for conventional type of hedging operations. But, I submit, everyone here, has and will have a need to, at least look at, if not actually engage in, financial hedging.

What is a financial hedge? In the first place, don't run back to your textbooks to find its definition because you won't find it anywhere - the term has been invented by me and probably does not express properly what I had intended it to mean.

In very simple terms it means:

Have the cake and eat it: keep your assets liquid but protect them as if they were invested in hard alternatives; keep your present portfolio intact, where presumably you know exactly what you're doing, but protect it from capital erosion that arises from rising interest rates, currency depreciation or loss of purchasing power.

Our theoretical investor may hedge against three broad possibilities: foreign exchange losses, inflation losses and capital losses.

Let us first discuss foreign exchange losses and let us first assume that our investor is sitting on a \$100,000 Canadian dollar deposit yielding a competitive rate of return, but he's locked in for 90 days. Four weeks after having made the deposit, he reaches the conclusion that the Cnd.\$ will most probably lose ground vis à vis the US\$ and that, if he had a choice, he would rather convert the Cnd.\$ funds to U.S. and put them into a U.S. term deposit. He has a problem. In the first place, he will have to pay a penalty for moving out of his 90 day deposit (or lose the 'spread' by selling a 90 day paper in a thin secondary market). Secondly, the expected down move of the Cdn.\$, say 2¢, could take place over the next four days, at which point he would once again want to be back in Cnd.\$ - let's say because available rates of interest are more favourable or because the Cnd.\$ will bounce back up, or whatever... How can he put into effect this decision in a flexible and rapid manner?

Very simply, he could call his commodity broker and instruct him to sell a December Cdn.\$ contract at present levels, for which he will have to put up a minimal deposit of \$2000. He is now fully hedged - long cash deposit of 100,000 Cdn.\$ and short a futures contract of Cdn.\$ (another way to say it is: long \$100,000 Cdn. equivalent of U.S. dollars) - He will not lose any interest penalty on the deposit and he will be able to cash in on the quick projected drop of the Cdn.\$. He can close out his futures contract at any time

continued.....

prior to the third week of December by merely calling the broker and instructing him to cover. Should the Cdn.\$ in fact drop 2¢, he will offset his cash loss (on the Cdn\$ term deposit) with his profit on the futures position. The so called 'profit', moreover, may be realized in just a few days, allowing him to withdraw his original deposit and profit from the broker at that time. Having covered his 'hedge' - by covering his short position in December Cdn\$, - he's once again long the Cdn\$ - exactly as he intended to be. This procedure is quick and efficient and very well suited to the international-minded investor who may be sitting on unmarketable paper such as very high yielding second mortgages - he continues to enjoy the high returns while he protects the foreign exchange exposure.

Our second theoretical investor, has a portfolio of sound, dividend paying blue chips that he 'knows' will eventually produce a reasonable return when inflation is 'inevitably' throttled back to zero but that, in the interim, will lose a great deal of purchasing power in an environment of double digit inflation. A great number of Canadian institutional investors may be in this position: they produce a steady stream of income for their older clients but are scared to death about the massive deterioration of capital. What can be done?

Very simply, the investor must first zero in on which package of commodities will reflect most faithfully the steady rise of consumer prices. If he is conservative, he will choose those commodities which, in real terms, have dropped over the past 10-15 years. A useful rule of thumb: stick to those commodities which have appreciated less than 250% - the actual rise in the cost of living over the past 12 years. Our firm reviews these situations periodically but all it requires is a couple of hours at the library. Examples today are Cotton, Zinc, Copper, Broilers and Hogs. But before you rush out and buy them, remember, these are conservative, long term investments designed to keep your purchasing power from declining.

After having selected those 'inflation hedges', the theoretical investor will calculate the face value of each one of these contracts, for example: 1 contract of cotton represents 50,000 lbs trading at approximately 65¢/lb for a total face value of approximately \$33,000. He then proceeds to cover, or blanket, the blue chips securities portfolio with an equal face value of those commodities. The investment: approximately 10% of the amount required to be hedged. He should, at all times, consider a back up of at least another 10% in case of sudden drops, amount which may be invested in interest bearing instruments. And voilà, he has a foolproof investment portfolio designed to take care of double and triple digit inflation.

We now come to the third and last type of financial hedge - the one designated to protect the investor from capital losses arising out of adverse interest rate movements. Let us once again suppose that our theoretical investor has a well diversified portfolio of credit instruments: some of it in short term notes, some of it intermediate length maturities, and some in very long term bonds. Clearly the rise in interest rates will create capital losses in each one of these sectors. What can the investor do? After having made the decision that interest rates will move higher, he has to choose the most appropriate hedging vehicle, both in terms of maturity and credit standing. There is a variety of interest rate futures trading on American commodity exchanges, the most popular of which are U.S. Treasury Bonds, 90 day U.S. Treasury Bills, GNMA's and 90 day Commercial Paper. Each one of these instruments has a distinguishing characteristic and while all of them will reflect general movements in interest rates, not all of them will be suited to our theoretical investor's need. As an example, over the past 30 days, long term U.S. Treasury Bonds fell in price from 88 to 78 to reflect an increase in yields of 1.3 percentage points, while GNMA's fell from 82 to 73½ to reflect an increase in yield of 1.6 percentage points, a substantial difference which is due entirely to the difference in credit standing & maturity (GNMA's trade as 12 year bonds compared to the Treasury Bonds' 25-30 year life). Again, in the short end of the market and over the same period of time 90 day U.S. Treasury Bills dropped in price to reflect a 3 percentage point increase in yield, while 90 day Commercial Paper reflected increases in yield of 3.4 percentage points.

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Our theoretical investor, had he hedged properly his portfolio, would have survived unscathed the October bond massacre. Naturally, even while hedging he could have taken an almost infinite combination of positions ranging from mildly bullish to strongly bearish depending on whether he thought that short term rates would rise faster than long term rates or not.

He would consequently change the mix of instruments, based not on the face value of the contract but on their yield equivalences. For example, our theoretical investor may have had a portfolio consisting entirely of 1 million dollars worth of 30 year bonds which he could have neutralized by selling 10 contracts of U.S. Treasury Bonds or GNMA's.

This hedge operation would have given the investor a profit of approximately 100,000 dollars, which would have fully offset the capital loss on his portfolio. Had he, however correctly foreseen that short term rates would have risen twice as fast as long term rates he could have taken an aggressive bearish posture by selling 40, 90 day U.S. Treasury Bills which is the equivalent, on a yield basis, to ten U.S. Treasury Bonds. His profit would then have been nearly 300,000 dollars which, after having offset the 100,000 dollar capital loss, would have netted him a 200,000 dollar real profit.

Understandably our investor may want to 'rainproof' his holdings against any or all of the recently mentioned possibilities so that he may obtain protection against potential foreign exchange losses, inflation losses and capital losses.

Today's brief talk is merely a simple outline of the innumerable-almost infinite possibilities open to today's present investor.

THE WALL STREET JOURNAL

Commodities

Exposed Position: Plunge in Bonds Caught Most Investors Unhedged

Continued from page 9

So does Lawrence Geraghty, a senior vice president at First Pennsylvania Bank in Philadelphia. In the past, Mr. Geraghty has sold futures to hedge against rising costs of the bank's certificates of deposit, at an annual saving of about \$1 million. But recently, he wasn't in the futures market, and he estimates that the bank lost an opportunity to recoup \$250,000 in interest costs. "In retrospect," he concedes, "we should have been more aggressive."

Aggressiveness certainly is the hallmark of people who use the futures market not to hedge but to seek quick profits. These people take advantage of perceived discrepancies in the relationship between the futures market and the underlying debt markets. "When it moves, the futures market reacts with a knee jerk and the cash market is more stable," says Earl Johnson, a securities-trading officer at Seattle-First National Bank. "Both may be going up, but the futures will be more exuberant." So he buys the cash market, sells the futures and tries to profit as the relationship between the markets returns to "normal."

Commodity board members named

Ontario Premier William Davis has announced the appointments to the newly formed Commodity Futures Advisory Board.

The board was created under the Commodity Futures Act, and was established in order to advise the Ontario Securities Commission on developments in the commodities industry and the effect of commodities trading on the provincial economy.

The chairman of the board is C. Warren Goldring, president of AGF Management Ltd. The other members are: Albert Friedberg, president of Friedberg Mercantile Group, John Ground of Osler, Hoskin and Harcourt, William Milliken, vice-president of Maple Leaf Mills Ltd., and Donald Page, executive vice-president of Midland-Doherty Ltd.

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***** Albert D. Friedberg *****

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