FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

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MARCH 4TH 1980

THAT SINKING FEELING ...

Almost one year ago, under the title "In Praise of Free Credit Markets" we argued that the introduction of Money Market Certificates (MMC's) had changed unalterably the course of American monetary history. This change removed an important bottleneck in the system and permitted the spectacular mushrooming of bank credit that developed over the past year. This liberalization went one step further on January 1, 1980, when commercial banks and thrift institutions were authorized to issue new 2½ year maturity MMC's which, in contrast to the six month MMC,have no minimum deposit requirement and whose maximum rate is tied to the yield on 2½ years Treasury securities. This momentous decision was partially reversed on March 1, 1980, when the Board of Governors announced a temporary ceiling rate of 11.75% and 12% on commercial banks and thrift institutions respectively. It should be remembered that these deposits are able to catapult the effective money supply or, at least, credit supply. This is true if and when small denomination MMC's attract funds away from demand deposits where reserve requirements are as much as 400% higher ! As we pointed out at the time, extraordinary increases in bank credit were possible despite all the talk of a restrictive monetary policy, and so, bank loans and investments expanded by well over 25 per annum in the last half of 1979 while C&I loans grew by slightly over 18% annualized between end of May'79 and the middle of February 1980. The absolute dollar amounts of the increase in bank assets is easily matched by the staggering increase in MMC's plus CD's outstanding.

A credit explosion may continue indefinitely provided the Central Bank sets an artificially low rate of increase, i.e. a negative rate. Reserves are continuously demanded by the commercial banking system which, in turn, is able to catapult these reserves through the fractional reserve requirement system by the simple expedient of moving high fractional reserve deposits to lower ones, such as a MMC's and CD's. Furthermore, loopholes are continuously being found to avoid reserves altogether, such as RP's and overnight Eurodollars. In fact, money supply creation becomes a passive element, entirely dependent on non-bank public portfolio preferences. To top it all, nobody is able to even measure money supply accurately and a childish nightmare descends upon the Federal Governors, money market participants and the public at large.

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What about the redefinitions themselves? The major changes are two new alternatives to M1—M1A and M1B—new M2 and M3 totals and the introduction of an even more all-embracing aggregate called "L." These measures have replaced the existing definitions, and only M1A and M1B will be published weekly.

The M1A measure is essentially the same as the old M1 except that it excludes demand deposits held by foreign banks and official institutions. M1B adds to M1A such checkable deposits as NOW and ATS accounts, credit-union share drafts and demand deposits at mutual savings banks. The new M2 equals M1B plus overnight repurchase agreements, the overnight Eurodollar deposits of U.S. nonbank residents in Caribbean branches of U.S. banks, money market fund shares, all savings deposits, and all time deposits of less than $100,000. Redefined M3 equals the new M2 plus large time accounts at all institutions as well as term repurchase agreements. Finally, "L"—the broad measure of liquid assets—comprises the new M3 plus other liquid assets such as bankers' acceptances, commercial paper, Treasury bills and other short-term U.S. securities.

Economic Week, Citibank

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There is one further twist. No matter how hard the Fed tries to limit its own credit, the non-bank public can respond in such a manner as to <u>increase</u> commercial bank reserves by simply <u>reflowing</u> cash to the system . This phenomenon has taken place in recent months, complicating tremendously the work of the Fed Governors.

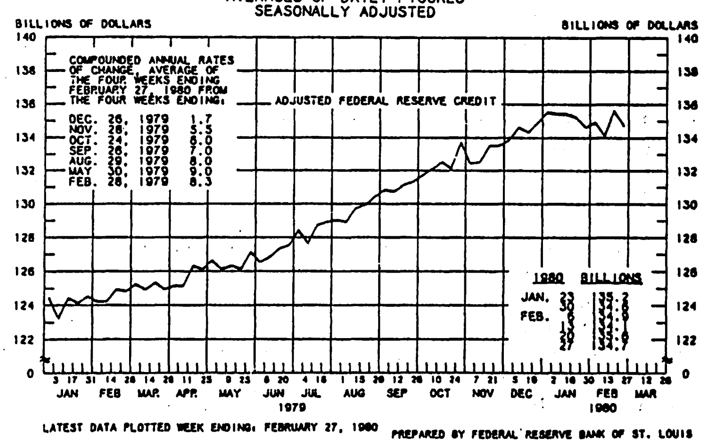
	(1) Monetary Base	(2) Total Reserves	(3) Non-Bank Public Holdings of Currency *	(2) ÷ (1)	(3) ÷ (1)
	(	in Millions of dollars	)	%	%
Aug. 2/79	147,568	41,076	106,492	27.84	72.16
Oct. 4/79	150,019	42,092	107,927	28.06	71.94
Dec. 6/79	154,824	43,640	122,222	28.19	71.81
Feb. 8/80	153,161	43,914	121,078	28.67	71.33

*Estimated.

The upshot of the foregoing is that, in a fractional reserve requirement system such as ours, the Central Bank is virtually impotent in its efforts to alter or influence in any way the effective money supply. The moment it increases its own assets, however, it may affect the natural rate of interest (Wicksell ?) and thus set in motion a credit explosion similar to the one we are witnessing. Monetary policy should be neutral to the fluctuations of the real economy with perhaps the single exception of its function of Lender of Last Resort. Coming to think of it, that was the only reason the Federal Reserve Bank was established !

The past month has come as close to a 'hands off' Fed policy as we have had in over ten years. The accompanying chart

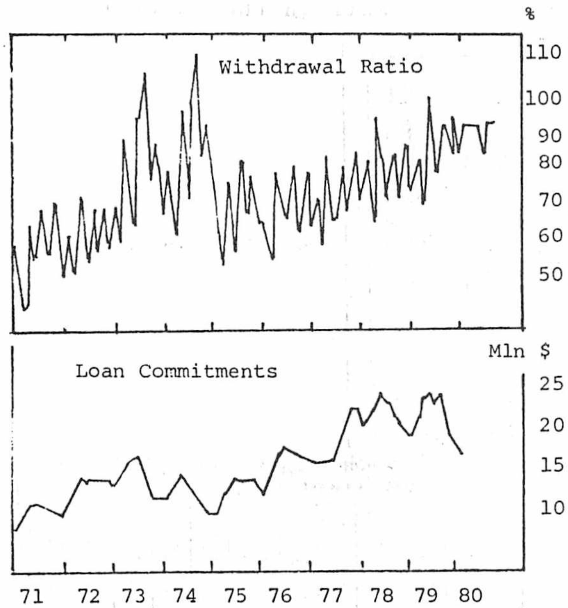
ADJUSTED FEDERAL RESERVE CREDIT
AVERAGES OF DAILY FIGURES
SEASONALLY ADJUSTED

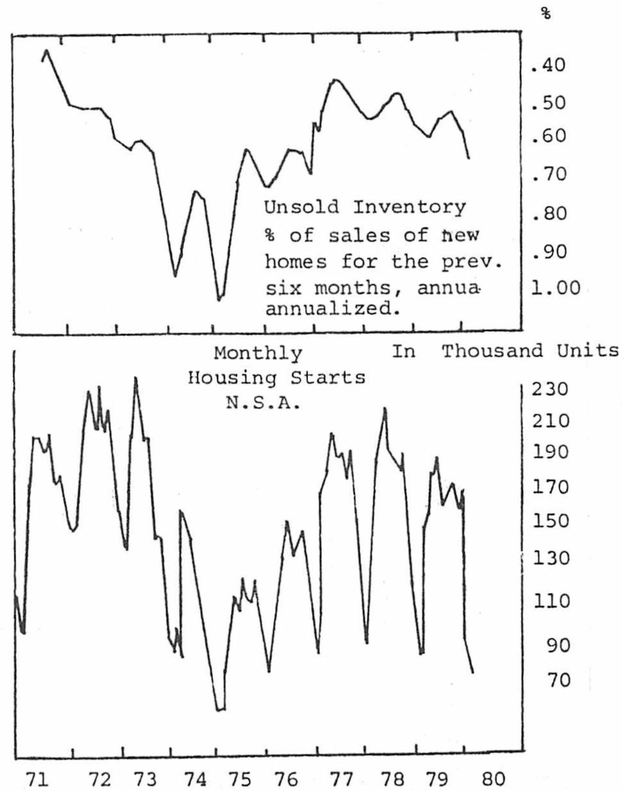


shows a significant flattening in Federal Reserve Credit over the past four weeks. As a direct result, interest rates have shot up to record highs, with Fed Funds trading around 17% and three months T-Bills bettering 15.25%. While in the November 5/1979 issue we indicated that short term rates may well reach 23% per annum, in subsequent issues we backed off this extreme forecast due to our recession scenario. In our view, the real economy was about to soften up significantly enough to reduce credit demands and,thus, interest rates. Two things went wrong: a) the extremely mild winter gave the economy an unexpected lift, particularly at the retail and construction level and b) the generalized fear of credit controls caused heavy anticipatory borrowing.

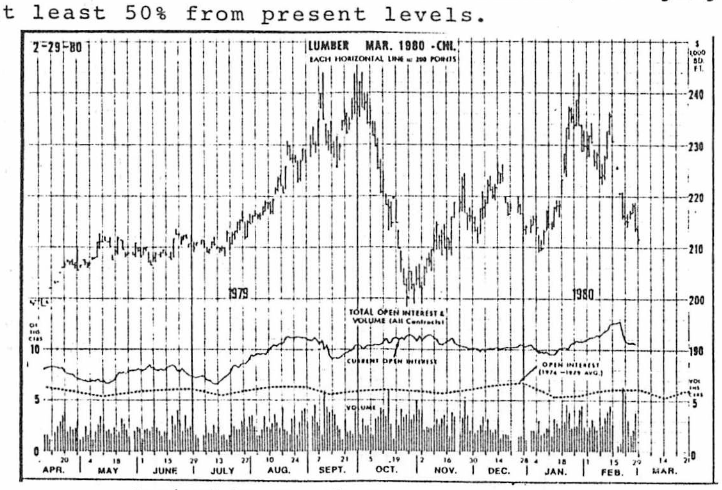
Let it be clear. The economy <u>is on the verge of a serious economic contraction</u>. As we stated last month, unanticipated inflation is no longer a powerful economic stimulus. By now, everyone is living with and factoring a 13-15% inflation rate. Unless inflation jumps to a new and unexpected plateau of, say 15-20%, <u>all</u> factors of production would be running but they would all be standing still. The economy is about to relapse into a sickening state of stagnation, a reflection of pricing frictions and rigidities (see Commodities & Currency Comments, Jan.1,1980 page 2).

A fascinating home-made indicator of impending weakness is our set of housing charts. The ripple effects of a decline in private residential construction are serious enough to weigh down the economy and 'crumble' it into a recession. How serious is the housing picture ? Very.





The withdrawal ratio in the thrift industry measures the degree of their liquidity pressure. The slow uptrend from the 1975 lows, when it stood at just over 50%, has been moderated by the credit liberalization moves adopted by the Fed , i.e. MMC's . In contrast to the huge disintermediation problem of 1973 and 1974, when market rates shot up well above deposit rates, thrift institutions have been able to retain a substantial portion of their deposits, albeit at an ever increasing cost and damage to their profit and loss statements. None-theless, and despite further liberalizing moves, such as issuance of Eurodollar notes, thrifts's liquidity has been eroding almost to the vanishing point requiring ever larger loans from the Federal Home Loan Bank. The result of this erosion can be gauged by looking at Chart II where loan commitments are plotted. When adjusted for inflation, we can easily see the magnitude of the upcoming crash. Granted the supply side of the equation (i.e. financing) is weak, might the Government not come to the rescue of the industry and offer cheap financing ? It would work but for signs that the housing market is saturated beyond repair. A look at Chart III reveals a growing inventory buildup. The graph has been plotted inversely so as to correspond to the movement of housing starts . What is immediately obvious is that inventories of new houses as a percent of recent sales (last six months annualized) have been growing alarmingly. If the past is any guide, the burden of this inventory should make itself felt in the next few months, bringing housing starts down by at least 50% from present levels.



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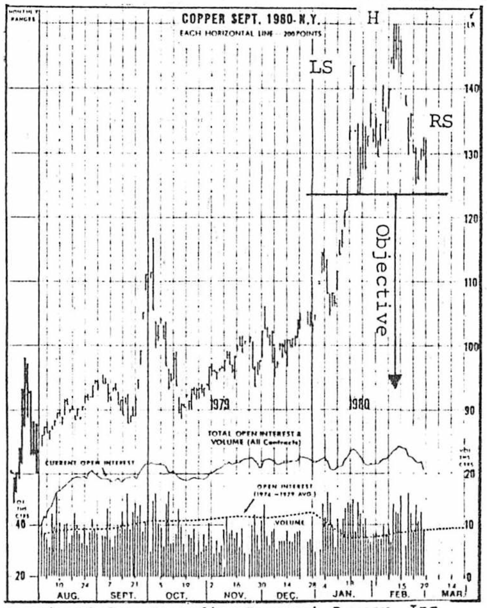
Another good indicator, although this one is coincident with business activity, is the movement of commodity prices. The accompanying chart shows the course of the Dow Jones Commodity Index, a fair proxy for other indices (including our own FCI). We have chosen the Dow Jones, as published by the Wall Street Journal, for its weekly detail. The steep February climb and descent has all the earmarks of a blow off top. The health of the commodity bull market is now suspect, although the correction has been halted at the 'breakout' level and may require a close below 415 on the Dow Jones Spot Index to put the'nail in the coffin'.



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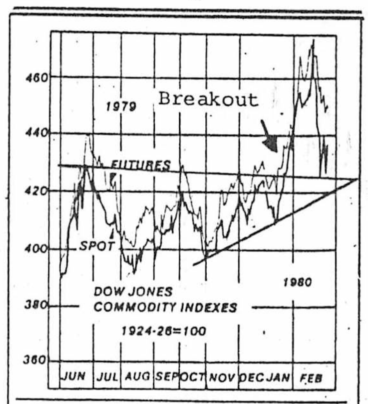
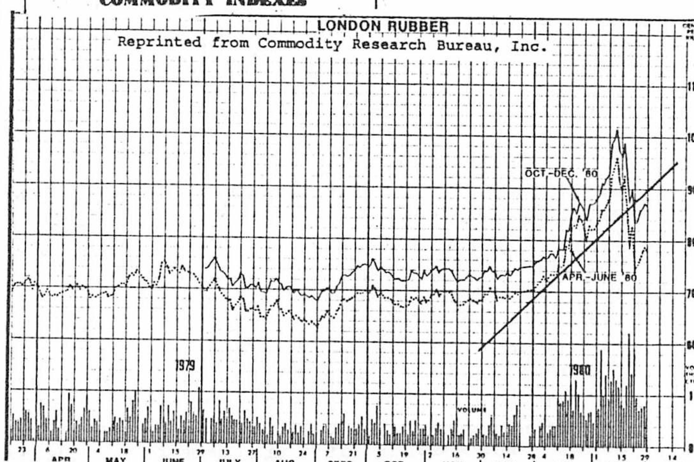
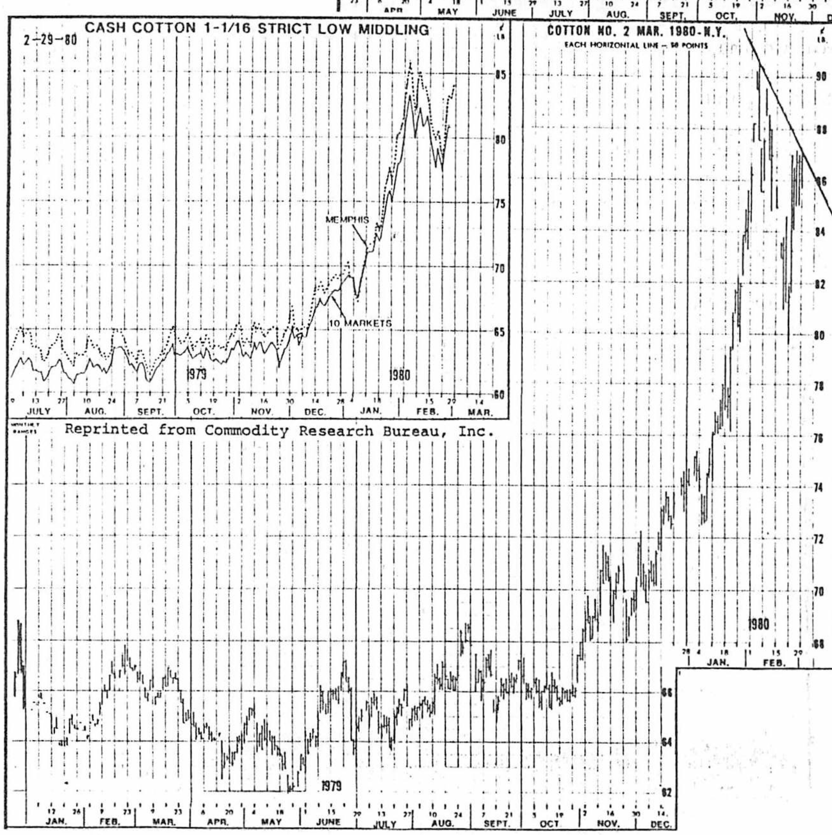


COMMODITY INDEXES

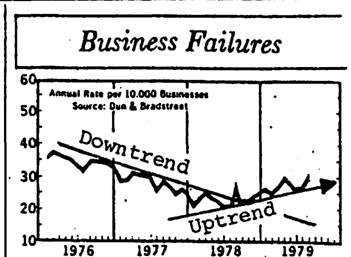
The Wall Street Journal

A close look at some sensitive industrial commodities provide additional confirmation of an imminent economic turn for the worse.





Using technical tools we may interpret bearishly the "Business Failures" chart presented alongside.



The Wall Street Journal

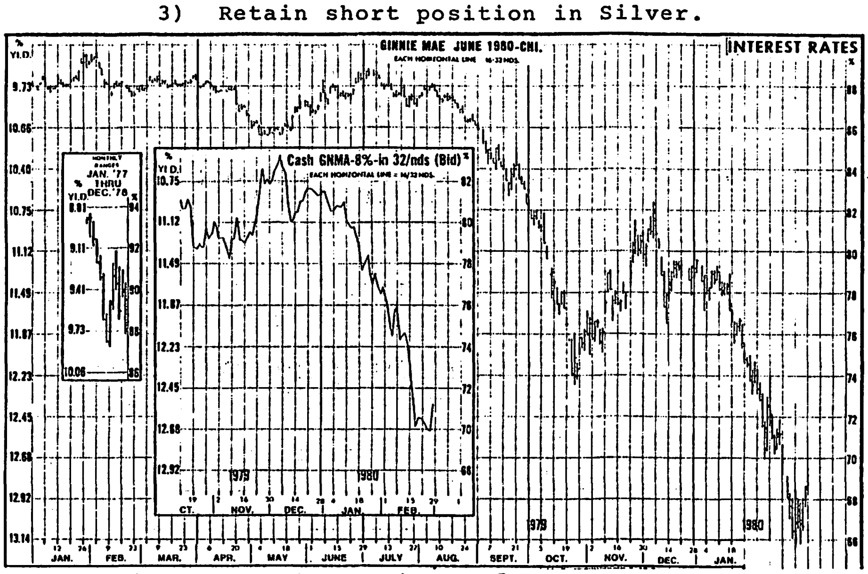
In sum, a credit crunch whose depth and magnitude cannot reliably be judged for it is only now that the Fed has shifted to a relatively 'neutral' position. A real economy that has begun to wilt and which is in the process of commencing a serious contraction. In due course, and barring further anticipatory borrowings, this contraction will reduce credit demands to the point of causing a drop in interest rates.

STRATEGY

1) Be short industrial commodities such as:
May'80 Copper, with stops at 130.00
May'80 Lumber, with stops at 230.00
July'80 Cotton, with stops at 88.00

2) Liquidate September'80 T-Bills, suggested last month to be bought on a scale down basis from 88.50; avoid the bond market until a good technical reversal has taken place; this may occur sooner rather than later.

3) Retain short position in Silver.



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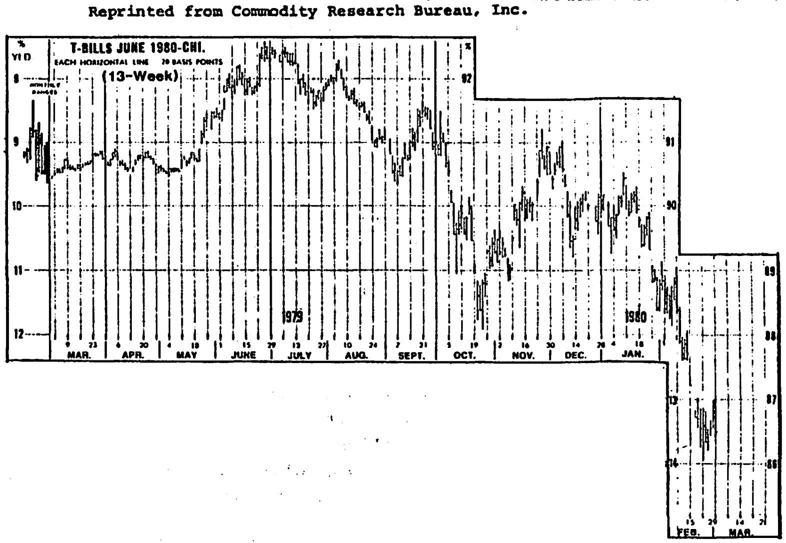


GNMA	Settle	Yield
Mar	68-19	13.465
Jun	68-10	13.530
Sep	68-18	13.472
Dec	68-30	13.386
Mar'81	69-10	13.301
Jun	69-18	13.244
Sep	69-19	13.237
Dec	69-16	13.258
Mar'82	69-13	13.279
Jun	69-09	13.308
Sep	69-05	13.336

Treasury Bonds

Mar	66-29	12.553
Jun	67-27	12.376
Sep	68-19	12.237
Dec	69-11	12.101
Mar81	69-27	12.011
Jun	70-07	11.972
Sep	70-04	11.961
Dec	70-05	11.956
Mar82	70-06	11.950
Jun	70-06	11.950
Sep	70-06	11.950

Treasury Bills

Mar	85.41	14.59
Jun	85.99	14.01
Sep	86.74	13.26
Dec	87.25	12.75
Mar81	87.61	12.39
Jun	87.82	12.18
Sep.	87.90	12.10
Dec	87.92	12.08

PRECIOUS METALS

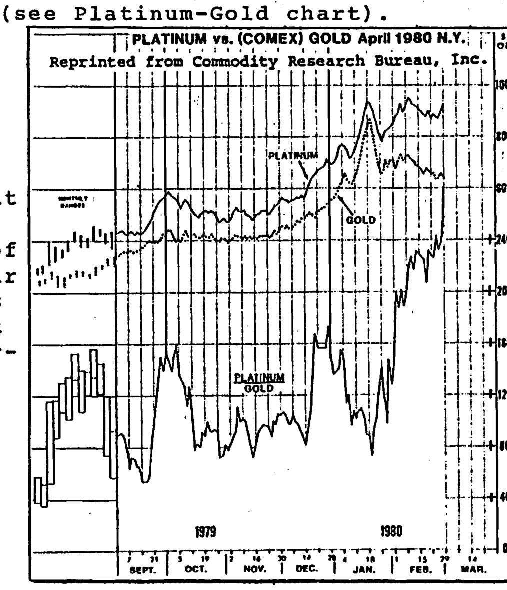
Recent activity may be characterized as rather 'dull' with gold settling in a $100/oz trading range and silver drifting aimlessly in the $33-39/oz territory. In our past few issues we have discussed at length the fundamental outlook for these two metals and have concluded that a fairly prolonged bear market was in progress. Technically, a close below $620 basis April Gold and 33.00 basis Spot March Silver would set in motion a new downward leg with intermediate targets in the low $500's and the low $20's respectively.

A note on recently suggested spreads. The short May'80 long May'81 spread put on at $2.40/oz is currently trading at $3.60/oz and, thus, is yielding an excellent return. A further drop in silver prices will tend to narrow the spread unless interest rates skyrocketed to upwards of 20%. Though this remains a distinct possibility, we should not press our luck. Liquidate one half of the spread at present levels.

The short Silver/long Gold ratio has remained remarkably stable at around the 20-1 level.Continue to hold positions looking for an eventual move to 30-1.

Almost unnoticed, Platinum prices have managed to consolidate their sensational November/January gains, forming in the process a powerful high level consolidation. By the close of today Platinum had set an new all-time high: $1026/oz basis the thinly traded March /80 and $1000.10 basis the April/30 contract.

This exceptional relative strength is significant for two reasons. In the first place, Platinum (as well as the related Palladium) is the only commodity making a new all-time high in recent weeks, a particularly noteworthy development in view of the generally bearish tone of the commodity markets. Furthermore, Platinum has been able to rise despite the weakness displayed by associated precious metals (see Platinum-Gold chart).



Finally, from a technical point of view, the consolidation and recent advance has not attracted a great deal of speculative enthusiasm, much unlike Sugar and Cotton where open commitment figures indicate a heavily overbought market. It can almost be said that the Platinum market did not require 'new buying' to be put up - it was simply the absence of sellers !

What's behind this mistifying rise ? In our January'80 issue we commented on the extraordinary degree of vulnerability on the part of U.S. industry. Private stocks at the end of 1979 were estimated at just over 780,000 ounces representing less than 23% of imports for consumption down from 46% in 1975 and 76% in 1960. This hand to mouth situation was being aggravated by stockpile decisions taken by Congress authorizing the acquisition, as yet not effective, of as much as 861,000 ounces. Much to the credit of the industry, about 300,000 ounces were refined from scrap during 1979,an amount equivalent to 12% of sales to industry. Deliveries against the expired October'79 contract amounted to 18,200 ounces but were easily exceeded in January'80 when 51,800 ounces were required. In response to this development, New York Mercantile warehouse stocks increased from 68,500 ounces at June 29, 1979 to 83,950 ounces at December 20, 1979 to 112,250 ounces at February 29, 1980.

Nonetheless, the latter figure only represents 2245 contracts against a potential delivery requirement at almost 3300 contracts outstanding in the April position. In this era of MEGABUCKS, 2245 contracts represents only $113 million, not a very significant sum of money for those intent on playing the 'squeeze' game.

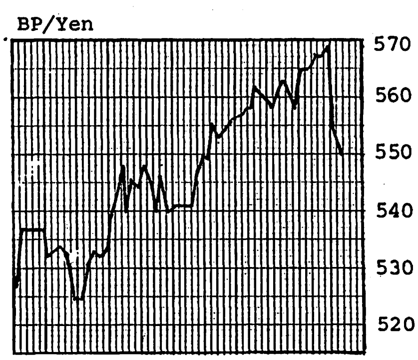
Be that as it may, one can hardly ignore the achievement of a new all time high at this time. Bearing in mind the relative 'thinness' of this contract and the extremly poor 'floor liquidity', long positions may be taken at present levels risking $150/oz. A minimum upside target of $1500/oz can be projected, with an eventual target of as much as $2000/oz.

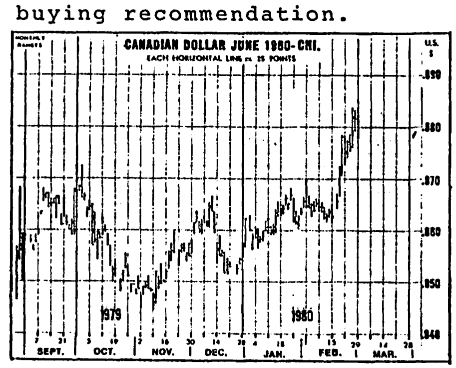
CURRENCIES:

The tightening U.S. money market is having a devastating effect on foreign exchanges. The U.S. dollar is clearly on an impressive upswing and there is little telling as to how high it may rise. The most recent move is conclusive evidence that trade figures are not particularly important as determinants of foreign exchange fluctuations. Rather, a determined monetary policy will influence the all important 'residual' capital flows so as to exchange and balance the demand for goods and services against the supply of financial instruments.

In this context, a review of each individual currency is not necessary. Since we remain friendly to Sterling, we recommend once more, hedging the position via the sale of an equivalent amount of Swiss Francs or Japanese Yen. We are not impressed with the recent Yen 'rescue package' and think that they will continue to lose reserves at a rapid clip unless a much more restrictive monetary policy is put in place.

Energy and a majority government have much more to do with the CD$ at the present time than balance of payments or monetary considerations. In this regard, figures presented here under the CD$ caption show little slackening in the pace of general loans or broad monetary aggregates. While the Government's cash position may be too low and ineffectual to resist the recent advance, it may opt for leaving the present interest rate structure unchanged thus facing adverse flows of capital. We believe this to be likely and therefore suggest taking profits on last month's buying recommendation.





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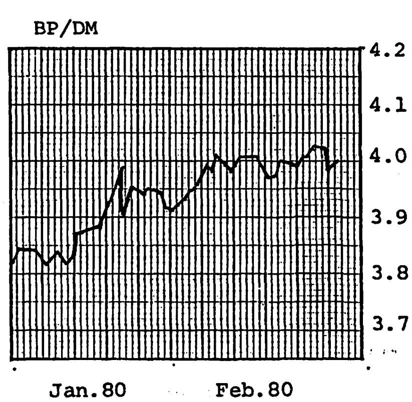
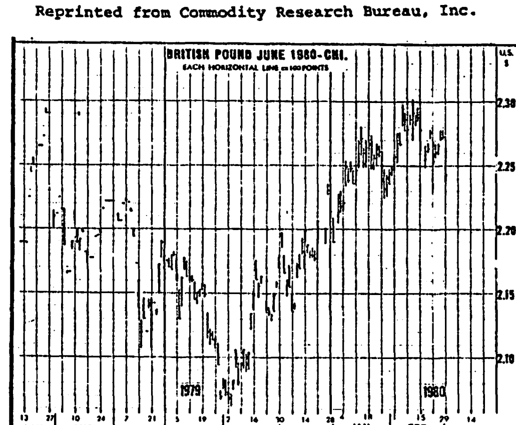


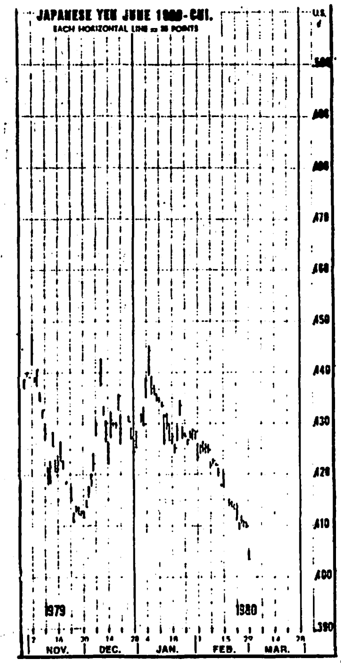


Yen

1979 ---	Balance of Trade	Balance of payments Overall Account	Current Account	Reserves	W.P.I.	Unem-ployment
Aug.	- 669	- 387	-1,530	25,170	10.94	2.23
Sept.	+ 147	-2,330	- 792	25,330	12.61	2.03
Oct.	- 350	-3,470	-1,120	23,270	14.54	2.15
Nov.	-1,220	-1,560	-2,220	20,170	16.07	2.17
Dec.	+ 731	- 512	-2,470	20,330	17.52	2.07
Jan.		-2,220		21,010	20.39	

Open Interest (Feb.29/80) : 5,446 Daily Volume (Feb.29/80) : 2,057
Contract Size : Yen 12,500,000.00 (Approx US$ 51,000)
Minimum Fluctuation : .0000010 ($12.50) Margin Req'd :US$ 3,500.00
Daily Limit (Normal): .0001 ($1,250.00) Commission :US$ 55.00
Trading Hours : 8:25 am - 1:25 pm Chicago Time
Delivery Months : March, June, September, December.

*** Mar. '80: 40.74 Jun. '80: 41.33 Sep. '80: 41.98 Dec. '80: 42.15 ***

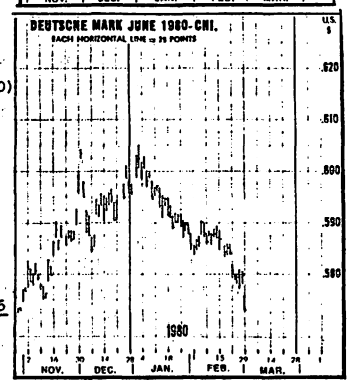


DM

1979 ---	Balance of Trade (Mln	Balance of Payments Marks)	Unem-ployment Rate
Aug.	976	-2,900	3.5
Sept.	1,900	-2,400	3.2
Oct.	1,800	- 800	3.3
Nov.	1,510	- 900	3.5
Dec.	800	- 500	3.8
Jan.	34	-2,200	4.5

Open Interest (Feb.29/80) : 10,644
Daily Volume (Feb.29/80) : 3,493
Contract Size : DM 125,000.00
(Approx. US$ 71,250)
Minimum Fluctuation : .00010($12.50)
Daily Limit (Normal): .010 ($1,250.00)
Margin Required : US$3,500.00
Commission : US$55.00
Tradeing Hours :8.19am - 1:19 pm
(Chicago Time)
Delivery Months:Mar.,Jun.,Sep.,Dec.

*** Mar. 80: 56.01 Jun. 80: 57.18 Sep. 80: 58.17 Dec. 80: 59.08 ***



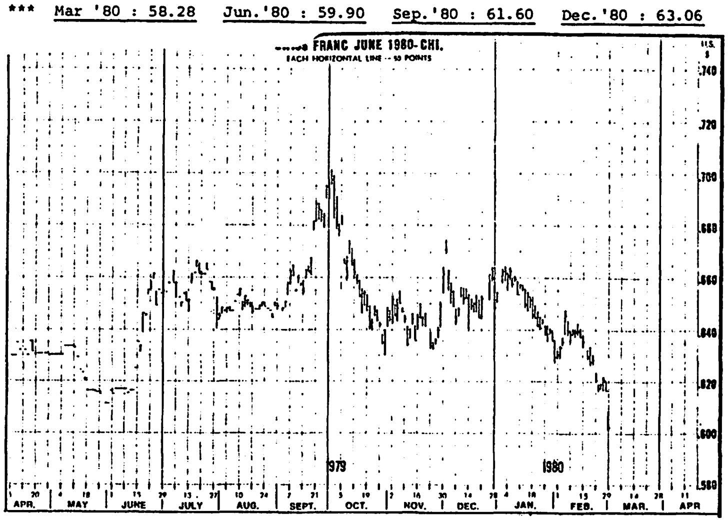
SF

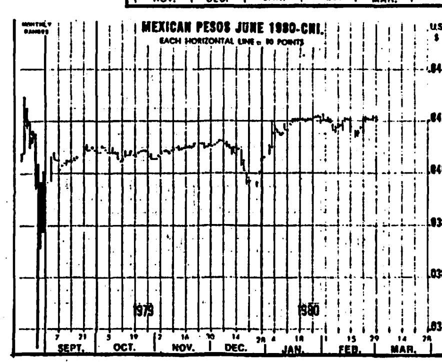
1979 ---	Balance of Trade (Mln SF)	W.P.I.* %	Unem-ployment
Aug.	- 667	4.9	0.3
Sep.	- 445	6.9	0.3
Oct.	- 593	6.75	0.3
Nov.	- 386	6.83	0.3
Dec.	- 417	6.90	0.3
Jan.	-920.2	6.99	0.4

Open Interest (Feb.29/80) : 10,361
Daily Volume (Feb.29/80) : 3,281
Contract Size :SF 125,000.00(Approx.US$ 75,000)
Minimum Fluctuation: .00010($12.50)
Daily Limit (Normal):.0150 ($1,875.00)
Margin Required :US$ 3,500.00
Commission : US$ 55.00
Trading Hours: 8:15 am - 1.15 pm
Delivery Months: Mar.,June.,Sept.,Dec.

******* Switzerland's capital exports totaled 27.7 bln francs in 1979 compared with 21.89 bln a yr ago.

*** Mar '80 : 58.28 Jun.'80 : 59.90 Sep.'80 : 61.60 Dec.'80 : 63.06 Mar.'80: 64.35





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POTPOURRI

Liquidate long Cocoa positions,.. Sell May'80 sugar risking 27.50... Remain long Livestock complex.

F.C.I.

Feb. 80: 291.35
Jan. 80: 297.63
Feb. 79: 259.95

- 2.11% from prev. month
+12.08% from year ago.

FRIEDBERG MERCANTILE GROUP

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

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Albert D. Friedberg