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Varieties of Monetarist Experiments

The proliferation of monetarist credo has inevitably been accompanied by popular simplifications, gross inaccuracies, and what is worse, patently absurd conclusions. We are not about to give a course on Monetary Theory. In setting the record straight, however, we purport to establish a *working* basis for understanding the dynamics of inflation, interest rates and currency movements.

There are three possible ways to conduct a 'monetarist' monetary policy (excluding, of course, free banking, 100% reserves requirement banking and a pure bullion and gold coin standard): the Friedmanite variety, the recent Bank of England approach and a Fixed Exchange Rate or Fixed Commodity Standard type.

The Friedmanite Variety

The supply of money is to be kept growing at a *steady* 3-4% pace. Friedman ignores the *demand for money* because he claims that, in the long run, it is rather steady and predictable being merely a function of real variables such as economic and population growth, technology, etc. He notes, quite correctly, that monetary policy can only influence real variables when it is unanticipated and, then, for only a brief span of time.

Given the cyclical oscillation of the demand for money around a long term growth factor of 3% p.a. and the steady 3-4% growth of the supply of money, Friedman

predicts a *long term* zero rate of inflation. Correct.

The first problem is, however, in identifying this mystical supply of money. Is it M_1 or the more recent varieties called M_1A and M_1B ? How about M_2 , M_3 ... M_5 ... M_{13} ? Or perhaps we are better off targetting Bank Credit? All of these Aggregates have fluctuated at a widely different rate of growth over the past fifty years, and, particularly, over the past five years. Technological innovations in the banking industry, inflation and the level of interest rates are only some of the factors responsible for the bewildering confusion in identifying *MONEY*.

The second problem lies in *controlling* any one of these definitions of money. The Friedmanite school claims to have found the answer: Control the Monetary Base, the liability side of the Federal Reserve Bank's balance sheet, and you will succeed in controlling currency and deposits of all commercial banks. This is so because there exists a reliable and well-known link between Monetary Base and Money Supply called the *Monetary Base Multiplier*. This Multiplier, however, is just as slippery as the Aggregate. First of all, the Fed, as the Lender of Last Resort, will always come to the rescue of commercial banks through the Discount Window. Causation *seems* to run exactly the opposite of theory under a lagged-reserve requirement accounting system: Banks increase deposits and, two

In this issue

- Continued upside pressure on rates.
- Dollar strength seen continuing.
- Bargain opportunities in corn and sugar.
- A look back to the year that was.

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weeks later, require reserves to support them, at which point the Fed obligingly provides them. Provide them they must because the banking system *as a whole* keeps only a very small balance of excess reserves and has no way of making good this deficiency. This is, of course, not true for *individual* banks who can resort to purchasing Fed Funds from other banks that are flush with balances. The solution would imply a Penal Discount Rate, say 2% above market rates of interest, forcing banks to keep ample excess reserves. The implementation of such a policy is nowhere in sight. A look at the accompanying table shows that commercial banks have hardly been *panicked* into holding larger excess reserves despite the Fed's tough (and momentous) monetarist switch on October 6/1979.

Table I millions of dollars

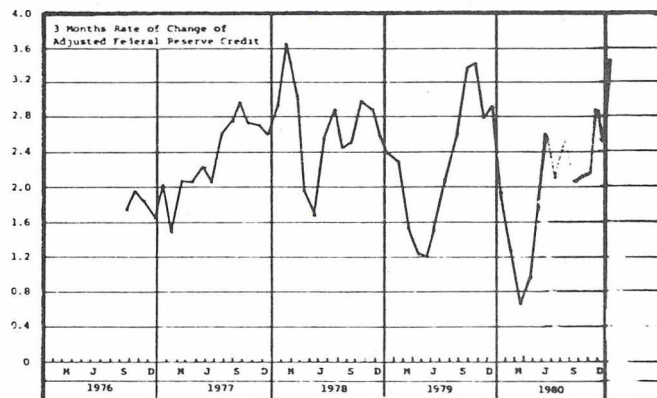
	Required Reserves (1)	Excess Reserves (2)	Quarterly Variation of (1) (3)	(2)/(3) %
<u>1978</u>				
1st Qtr.	36,803	248	1,955	12.69
2nd Qtr.	36,936	151	1,309	11.54
3rd Qtr.	37,687	159	644	24.69
4th Qtr.	39,697	214	3,225	6.64
<u>1979</u>				
1st Qtr.	41,139	256	2,806	9.12
2nd Qtr.	40,172	187	675	27.70
3rd Qtr.	40,698	129	369	34.96
4th Qtr.	42,779	274	1,571	17.44
<u>1980</u>				
1st Qtr.	43,600	292	2,021	14.45
2nd Qtr.	43,917	161	1,393	11.52
3rd Qtr.	41,168	302	2,432	12.42
4th Qtr.		492		

The steady-Multiplier concept suffers from still a third flaw, namely, a given level of reserves could support a growing level of credit, and thus deposits, by the mere expedient of inducing the non-bank public to shift demand deposits to time deposits. This is so, given the differential reserve requirements on these two types of deposits. From October '79 to October '80, demand deposits grew by 4% p.a. and by \$9.4 billion in absolute quantities, while total small time deposits grew by 15.8% p.a. and by \$80 billion. This extraordinary increase in loanable funds and thus *MONEY*, took place in spite of the meager 8.3% growth of the Monetary Base, and the even more encouraging 6.4% crawl of Bank Reserves. The upshot is that the Fed can actually be conducting a *tight* monetary policy, keeping its own balance sheet unchanged while the Monetary Aggregates could be running out of control. Clearly, uniform reserve requirement is a first (and not the only) step in fine-tuning the Multiplier.

The above discussion indicates that even if the Fed is successful in identifying the Monetary Aggregate (Step II), it is far from certain that it can carry out a Friedmanite type of monetarism simply because it lacks the proper tools for controlling the link between its own balance sheet (Step I) and that of the commercial banking system (Step III). But what is even worse, the

Fed did not even succeed in passing Step I. Chart I depicts a pathetic story: The rate of growth of Federal Reserve Credit, (the asset side and counterpart of the Monetary Base) on a 3-month moving average basis, roller-coasts down from an inflationary 3.4% rate of growth per quarter in late 1979 to a deflationary pace of .8%, and up to a mind-boggling 3.5% rate of increase in late 1980-early 1981.

CHART I



The Bank of England or Interest Rate Approach

The Bank of England's Friedmanite monetarism failed even more spectacularly: Instead of a 7-11% rate of growth for Sterling M₃, it produced an astounding increase of well over 20% p.a. Third quarter growth rates reached 39.1% while the October — November, 1980 period averaged out 22% p.a.

What went wrong? Clearly, the policy tools, which are now being re-considered in the light of such a monumental failure. What went right? The rate of inflation dropped from a torrid pace of 29% p.a. (IVQ 1979 to IQ 1980) to a remarkably calm rate of 4.5% per annum (last 6 months of 1980). Did not this event contradict monetarism? Well, not exactly.

Here is what happened. The Bank of England, unwittingly, set a real rate of interest high enough to *increase* the demand for money in such a way as to offset the very large increase in its supply. Unwittingly, because the Bank intended to control the supply of money. Instead, it ended up controlling the demand for money. This topsy-turvy effect has the advantage of not requiring extremely sophisticated tools. It suffers, however, from two defects. In the first place, the bank has to determine, rather arbitrarily, the *right* rate of interest that will shift upwards the demand for money. Like all government price controls, it can backfire. Furthermore, how high is high enough? Should the Bank aim at a 3% *real* rate of return, 5%, or 10%? And, at which point does it inhibit justifiable long-term investment? The second defect with an interest-rate target rather than a strict-quantity target is that an enormously large pool of money is being created and kept at bay only so long as the non-bank public continues to show a preference for money over goods.

The dikes can potentially be overrun as soon as the Bank makes a (easy) mistake in misjudging the necessary rate of interest. A sudden drop in the demand for money superimposed upon a large prior creation of money can have a devastating impact on the rate of inflation. It is conceivable that, at some future point, money supply will grow at a moderate pace of 10% p.a. and inflation will accelerate, once more, to 30% p.a. or *more simply because the demand for money will have dropped* (i.e. velocity will increase).

Fixed Exchange Rate or Commodity Standard

This approach abandons all pretensions of knowing what *MONEY* is, how it can be controlled or what rate of interest should be set. Instead, it focuses only on one variable, namely, the exchange rate.

In the fixed-exchange rate regime prevailing after Bretton Woods, most Western trading nations went on a Dollar Standard. If this Dollar Standard was pure, i.e. Central Bank did not offset foreign exchange activity via their money market desks, it was possible to achieve a rate of inflation similar to the one experienced by the U.S. If, say, Germany experienced an excessive demand for U.S. dollars, its level of International Reserves would decline and consequently, domestic money supply (a market-determined definition) would shrink until the equilibrium was restored. Conversely, if Germany experienced an accumulation of International Reserves as a result of an excessive inflow of dollars (balance of payments surplus), its money supply was *automatically* expanded as the Bundesbank purchased the excess dollars by crediting sellers with Deutsche Marks. Contractions and expansions were automatic and defining money was unnecessary. Although interest rates at times were used to aid movements in the correct direction, it is also true that, for the most part, they *followed* fluctuation in domestic liquidity. This superb regulator of *MONEY* fell into hard times no sooner than the U.S. began to misbehave. Indeed, the Dollar Standard allowed the U.S. to inflate with impunity as it did not force a meaningful contraction in its International Reserves, nor did it allow the minor losses of International Reserves to contract its money supply. Western Europe resisted the American imposed inflation, not the least because, being the first generator of inflationary impulses, U.S. firms were in a position to absorb deeply un-inflated (as yet) European assets. The weakness of this previously simple system was the corruptibility of the Standard.

Fortunately, we are still able to put monetarism to work by the mere expedient of finding an incorruptible Standard. Gold would be ideal.

Let the Federal Reserves renounce the use of its Open Market operations or any other form of domestic credit creation, except, perhaps, its true function of a Lender of Last Resort by way of a *penal* Discount Rate. Let the Treasury and/or the Federal Reserve state that it will buy

all the offered gold at say \$575/oz and sell all the demanded gold at say, \$625/oz. If gold approaches the lower intervention point, the Fed is compelled to buy gold, thus admitting that the nominal level of the U.S. money supply is inadequate to finance a growing move into money (i.e. the demand for money exceeds its supply). The purchase of gold against crediting the seller's bank account with dollars will tend to restore equilibrium. Conversely, a rise of gold to its upper intervention point will indicate, willy-nilly, that the supply of money is excessive in relation to its demand.

It is clear that all the problems associated with the first two monetarist approaches would disappear. We should no longer need to know what *MONEY* supply we are to control: The price of gold would automatically indicate if there is insufficient supply of or demand for money. This Gold Standard would also do away with sophisticated control mechanisms as well as 'proper' rates of interest.

One problem does remain. If gold is set 'too high,' we would be forcing the Fed to inflate unnecessarily. Conversely, if it is set 'too low,' the Fed would be forcing a deflationary course. What is the 'proper' price?

Consider the following: At \$500/oz the U.S. would be absolutely solvent in meeting its external-dollar liabilities. Gold, being a barren asset, should not attract a greater deal of buying on the part of domestic and/or foreign residents than it does presently. If anything, in view of prospects for price stability, gold should become a better sale than a purchase. Furthermore, the average price of gold during 1980 worked out to \$613/oz with maximum end-of-month to end-of-month variations of only 20% despite war threats, actual wars, apocalyptic oil scares, interest rates fluctuations of at least 100%, Central Banks' buying, Russian selling, etc. It would appear that, barring exceptional changes in monetary policy (a move that we expect, based on the blind adherence to the first two kinds of monetarism), the market has found a stable equilibrium level. How about a buy-sell range, then, of \$575-\$625 oz?

Practical Conclusions:

Federal Reserve Credit is, once again, clearly out of control as indicated by Chart I. With some lag, money-supply growth will explode beyond the permissible limits in the not-too-distant future, necessitating, once again, a sharp jump in the level of interest rates. This action will, most probably, not be effective in its intent because we still do not know which money supply to control, nor how to accomplish this objective, even if we did know, (*given the present setup* of an easily accessible Discount Window, lagged-reserve requirements accounting and defferentiated-reserve requirements). Higher interest rates, however, will operate mainly through the demand for money function, raising it enough to offset outsized increases in 'money supply', thus lowering the rate of inflation.

An overkill may produce a U.K.-style Depression, already comparable to the 1929-1931 slump. Nevertheless, the huge increments in liquidity will come back to haunt us sometime in 1982-1983 when interest-rate levels drop sufficiently to lower the demand for money. Inevitably, we will witness an 'inexplicable' but powerful re-acceleration of inflation.

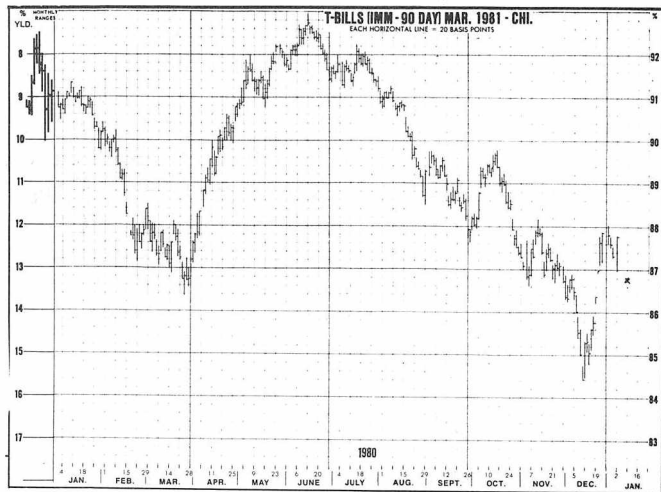
STRATEGY: Interest Rates are heading irregularly higher. Don't believe in a quick 'peaking out' or 'topping out' of rates a la Spring 1980. Once bitten, twice shy.

Short March '81 T-Bills with a generous stop at 89.00 (close only) looking for a move down to 81-82. T-Bonds should also go lower but their risk-reward ratio is far from being as favourable.

Commodity prices should suffer from high carrying charges. Our favorite shorts: Platinum, Copper, Tin, Cocoa, Lumber.

GNMA	Settlement	
	Price	Yield
Mar. 81	70 13	13.055
June	71 04	12.897
Sept.	71 17	12.809
Dec.	71 21	12.782
Mar. 82	71 21	12.782
June	71 20	12.788
Sept.	71 18	12.802
Dec.	71 16	12.815
Mar. 83	71 14	12.829
June	71 12	12.843
Sept.	71 10	12.856
T. Bonds		
Mar. 81	70 11	11.923
June	71 10	11.754
Sept.	71 30	11.648
Dec.	72 07	11.600
Mar. 82	72 11	11.579
June	72 15	11.558
SEpt.	72 18	11.542
Dec.	72 21	11.527
Mar. 83	72 24	11.511
June	72 25	11.506
Sept.	72 30	11.480
T. Bills		
Mar. 81	86.79	13.21
June.	87.69	12.91
Sept.	88.18	11.82
Dec.	88.31	11.69
Mar. 82	88.28	11.72
June	88.32	11.68
Sept.	88.26	11.74
Dec.	88.28	11.72

As of Jan. 9th, 1981



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Precious Metals

The trend here is for unmistakably lower levels.

After peaking at close to \$790/oz, April '81 Comex gold has recorded five consecutive lower highs, with the last one in the area of \$630/oz. The once formidable support at \$600/oz basis Spot has given way rather decisively, leaving behind a massive head — and — shoulders top formation. We remain short looking for a test of the \$500/oz level basis Spot. Stops should be placed at \$640/oz, basis April '81.

Platinum continues to sag below gold and is on its way to vindicating our early November '80 prediction of a \$100/oz discount. Remain short, placing stops at 645 (close only) basis July '81.

The renewed widening of the Gold/Silver ratio leads the way in this vicious Bear Market. In our opinion, a test of the \$10.80/oz lows recorded in early 1980 is not out of the cards. Place stops on short position at \$17.50/oz basis March '81.

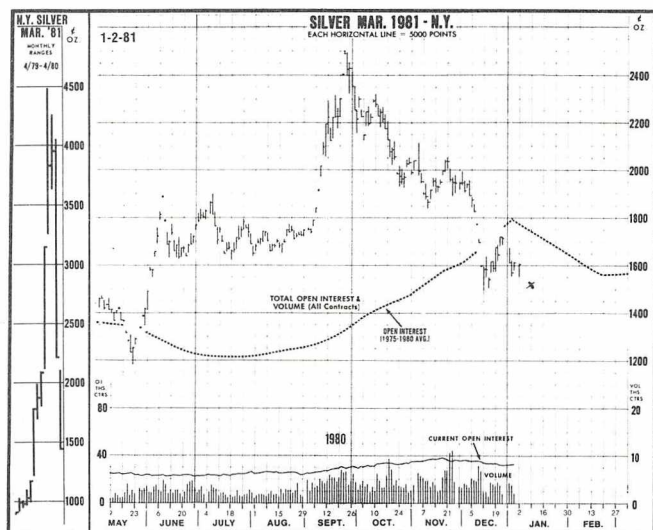
CANADIAN FUTURES CONTRACTS Jan. 9, 1981				
91 DAY TREASURY BILLS (Combined Montreal-Toronto Trades) \$1 million; multiples of \$0.005			GOV. T. OF CANADA BONDS (Combined Montreal-Toronto Trading) — 18 Year 9 per cent \$100,000 principal; price is per cent of par value (Fractions are 32nds of 1 per cent)	
High	Low	Settle	High	Low
97.250	96.049	Mar 81	75.98	68.08
97.290	96.125	Jun 81	73.04	71.24
96.270	96.200	Sep 81	74.15	69.15
Total Sales: Friday 0; Thursday 22			Total Sales: Friday 74; Thursday 30	
Total Open Interest: Thursday 48 - 12			Total Open Interest: Thursday 135 + 4	
Normal Daily Price Limits: 50.150 above or below prior settlement price.			Normal Daily Price Limits: 64.92 above or below prior settlement price.	



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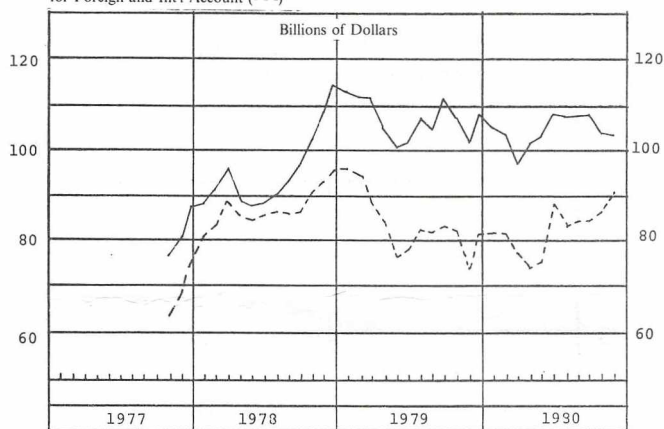


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Currencies

An omen? Total International Reserves owned by Switzerland, W. Germany, Japan and the U.K. track quite closely the level of U.S. Government securities held in custody (by the Federal Reserve Banks) for Foreign and International accounts, as is to be expected, at least for recent years. In the past few months, however, the latter holdings have increased \$16 billion while combined International Reserves, have only increased \$2.7 billion (see Chart II). Who has been buying U.S. Government securities in such a formidable scale? There can only be one source: OPEC surplus. If so, the U.S. dollar strength is broadly based and well sustained.

Total Reserves minus Gold (—)
 United Kingdom, West German,
 Japan, Switzerland
 U.S. Gov't Securities held in custody
 for Foreign and Int'l Account (- - -)



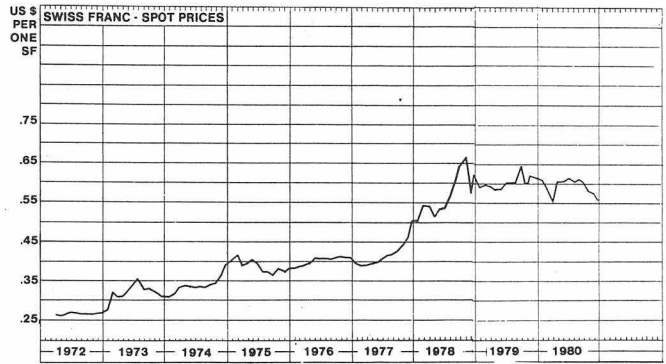
Sources: IFS,
 Federal Reserve
 Bulletin

	Dec. 80	Nov. 80	Oct. 80	Sep. 80	1980 (Jan.-Nov.)	1979	1978	1977
Trade Balance								
U.K. (bln Stg)		.455	.459	.369				
C.D. (bln CDS)		1.56	.658	.553*				
D.M. (bln Marks)		.377	1.68	-1.00	7.71	21.68	37.12	34.17
J.Y. (bln U.S.\$)		.560	.780	1.95	-0.26	1.571	22.21	14.92
SFR. (bln Francs)		-509.8	-7.95	-1.1	-10.36	-4.301	-0.91	-1.58
Current Account								
U.K. (bln Stg)		.555	.534	.444				
D.M. (bln Marks)		-1.1	-1.4	-2.7	-14.49	-8.645	16.71	5.36
J.Y. (bln US\$)		-6.10	-0.73	.930	-11.16	-5.17	16.36	
SFR. (bln Francs)					n/a	3.9	7.9	8.27
Overall Account								
D.M. (bln Marks)		-2.52	-3.45	-3.03				
J.Y. (bln US\$)		+1.35	-1.08	.946				
Reserves								
U.K. (bln US\$)	27.48	28.19	28.03	27.64				
C.D. (bln US\$)	4.03	3.47	3.68	3.95				
D.M. (bln marks)		69.4	71.9	73.9				
J.Y. (bln US\$)		24.94	24.74	23.77				
SFR. (bln francs)	24.02	22.29	19.2	19.27				
Money Supply								
U.K.* (M1)		8.0	6.2	20.5				
C.D.** (M1)		8.69	8.34	5.27				
D.M.** (M3)		5.67	4.80	4.64				
J.Y.** (M1)			0.82	-4.32				
SFR.** (M1)				-6.72				
Cost of Living/CPI								
U.K. (1974 base)		274.1	271.9	270.2				
C.D. (1971 base)		220.0	217.3	215.4				
D.M. (1976 base)	119.3	118.6	118.1	117.7				
J.Y. (1975 base)		140.5	140.2	140.0				
SFR. (1977 base)		110.5	109.5	109.7				
W.P.I.								
U.K. (1975 base)	206.6	206.1	205.3	204.5				
C.D. (1971 base)		254.9	251.5					
D.M. (1976 base)		117.5	115.9	115.6				
J.Y. (1975 base)		133.2	133.1	134.1				
SFR. (1963 base)		158.3	157	155.8				
Unemployment rate								
U.K.	9.3	8.9	7.8	7.4				
C.D.		7.3	7.6	7.5				
D.M.		4.2	3.9	3.5				
J.Y.		2.1	2.0	2.02				
SFR.		0.2	0.2	0.2				

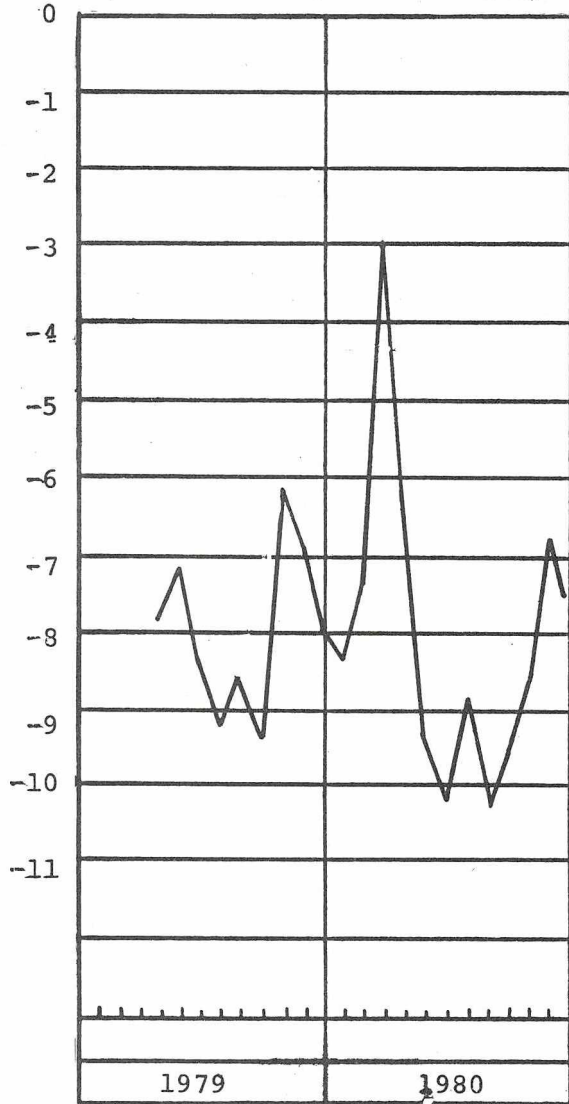
* three months' growth at annual rate
 ** year-over-year % change.

The U.S. current account surplus, likely to reach over \$10 billion during 1981, contrasts vividly with the mounting deficits being registered by W. Germany, Switzerland, and Japan. Further buttressing this surplus on current account is the strong inflow of short-term funds seeking high U.S. yields, a phenomenon likely to stay with us for a prolonged period of time (see opening remarks). Finally, we expect a massive inflow of long-term funds as soon as the new Reagan Administration moves to encourage multinational energy firms to explore for oil and gas in U.S. soil.

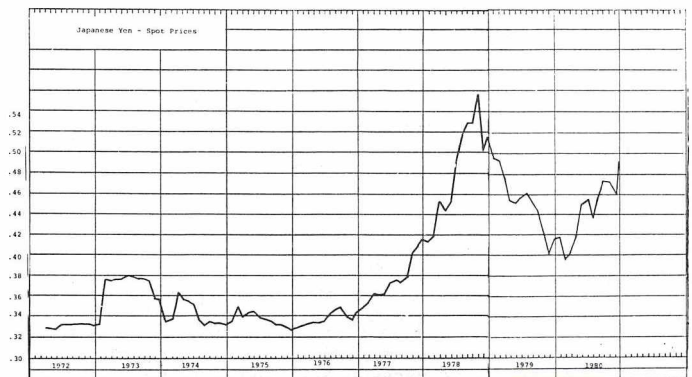
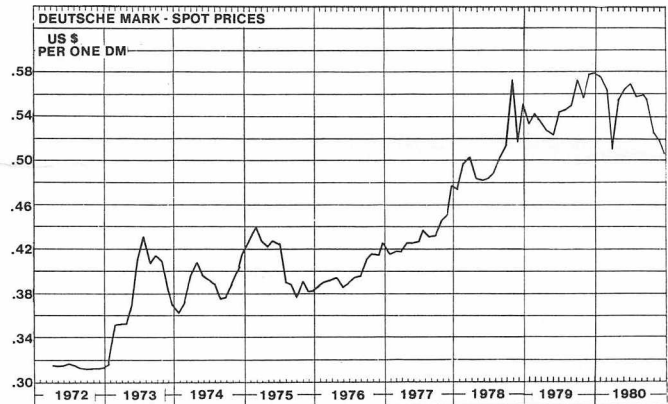
STRATEGY: Remain firmly short March '81 DM & SF lowering stops to 52.80 and 59.00 respectively. Stand aside on the Japanese Yen and British Pound.

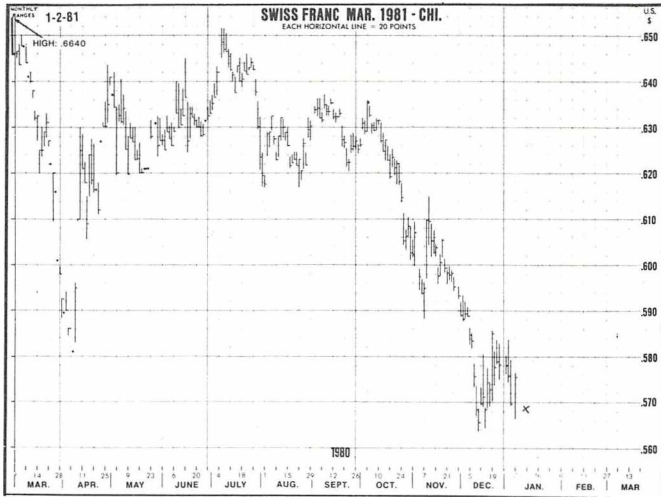


U.S. Trade Weighted Exchange Rate (Smithsonian Central Rates Dec. 1971)

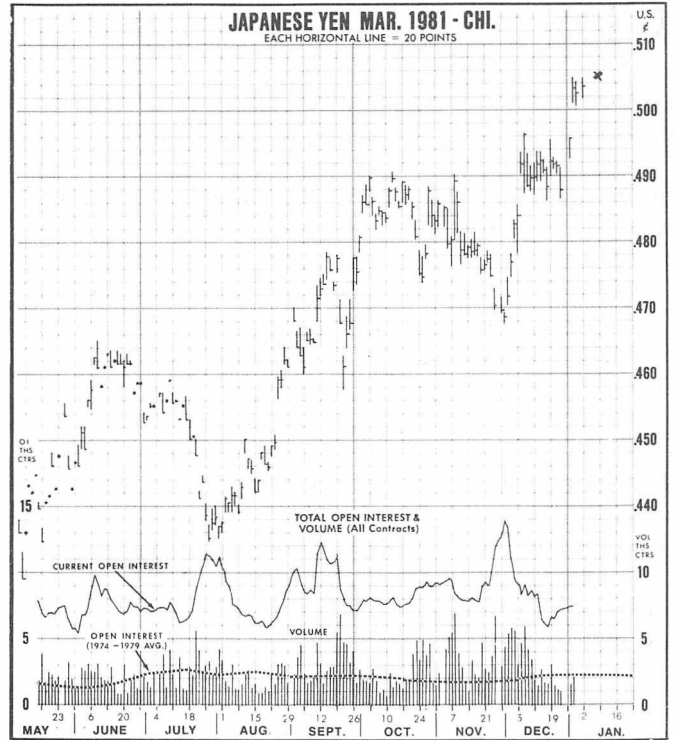


Source: Morgan Guaranty Trust Company

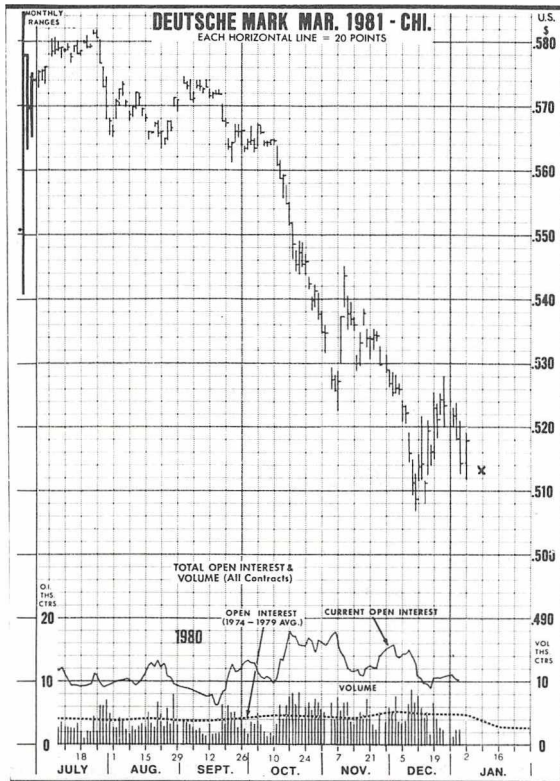




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CDS

As suggested in last month's issue, the CD\$ tested (and broke) the May '80 lows, reaching a low of 82.70. Subsequently, determined action on the part of the Bank of Canada brought the rate back up over the 84¢ level, nullifying our short term gains.

It proves that you have to be nimble when trading the CD\$. It also proves that the Bank will go to any length to maintain an implicit 84¢ dollar. Finally, it proves that the CD\$/US\$ exchange rate is extremely sensitive to short-term interest rate differentials.

The Bank of Canada has justified the continuous sale of gold (82,500 ounces last month) as a method of diversifying Reserves into interest-earning assets and away from barren assets. The delicious irony of this situation is the fact that Canada drew down \$900 million U.S. in its effort to halt the slide of the CD\$, paying interest rates in excess of 20% p.a. Earning interest, anyone?

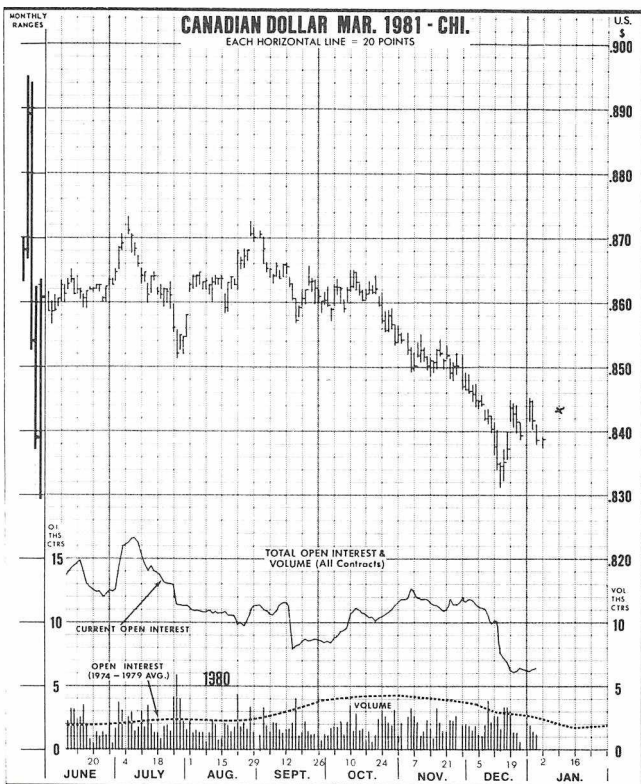
STRATEGY: Cover short positions and remain sidelined.

Mexican Peso

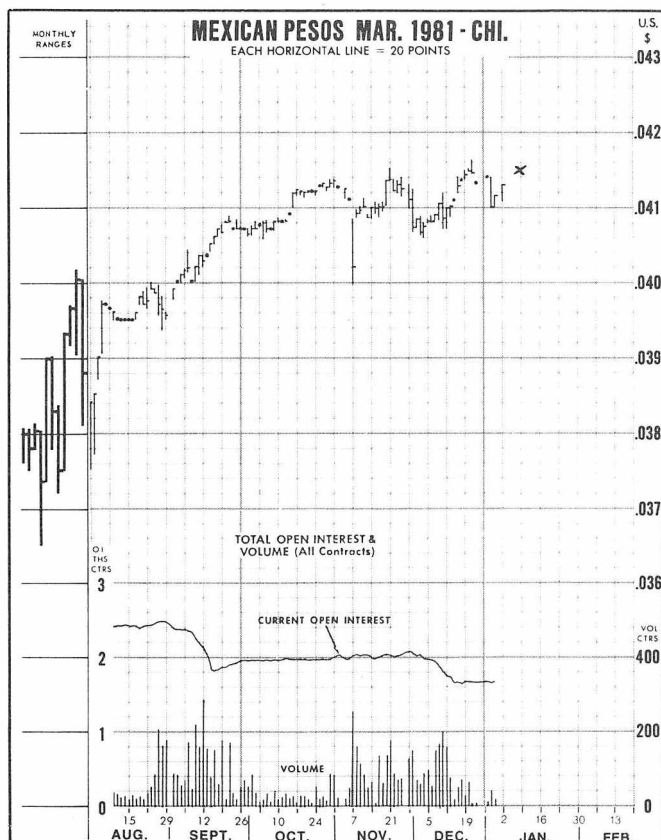
The pace of the mini-devaluation is accelerating. Spot MP is now trading at 42.92, down from a Summer 'parity' of 43.76. The effect has, thus far, been negligible on the trade balance. The same cannot be said about its effect on expectations and its impact on private capital outflows.

Mexico reported record grain and oilseed production this year of almost 23.5 million tons compared with 18.2 million tons in 1979, according to the Government Agricultural Dept. Whereas in 1980, Mexico was forced to import 10.3 million tons worth almost \$2 billion, hopes were being expressed by official sources that a reduction of imports in the order of nearly 40% was attainable this year. Private sources, however, have expressed great reservations about this number and, furthermore, imply that, in dollar terms, little improvement will be seen due to the firmness of grain prices.

A further balance-of-payments complication is seen in the substantially high interest rates applicable to Mexico's staggering foreign debt, now estimated to exceed \$38 billion. A 500 basis point increase in rates would represent a jump in debt repayments of nearly \$2 billion as compared to 1980. This figure is significant when viewed in the perspective of a current account deficit of \$4.2 billion for the year just concluded.



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STRATEGY: Remain short March '81 MP. Maximum risk is seen at 42.90 while potential reward is a devaluation to the 32.00 level.

Potpourri

STRATEGY: Our suggested short position in Heating Oil has gone awry, no doubt affected by the very severe cold weather, cover all positions at the market and look to reinstate same at slightly higher levels (112-114 basis March '81 . . . Remain short Tin and Cocoa . . . Spreaders may enjoy a short March '81 T-Bills versus long June '81 T-Bills; risk 40 points, reward 120 points.

Grains and Oils

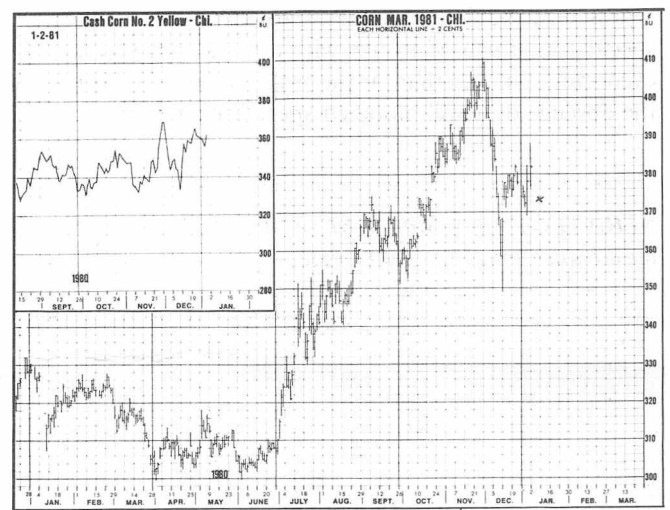
The question is, did December's debacle destroy the bull markets or merely damage and interrupt them? The fundamental scenario of corn and beans, as outlined in our comments of November and December, has not materially altered over the past two months. The strong export performance of corn in recent weeks underscores the tightness we have been expecting will become evermore apparent as we head towards the end of the current 1980/81 crop year. On beans, we still must characterize fundamentals as possibly bullish, "possibly" because of the significant swing factor that can result in export demand depending upon South American production. Weekly soybean exports, unlike corn, are off by comparison to last season.

Bearish factors working on the markets at present are, 1) the persistence of relatively high interest rates; 2) a large tie-up at the Gulf end of the Mississippi which is inhibiting export sales and thus weakening the cash basis in Chicago; 3) the possibility that President — elect Reagan may, contrary to his campaign promise not lift the grain embargo and even extend it, should the Soviets invade Poland, which each day appears a less-unlikely event.

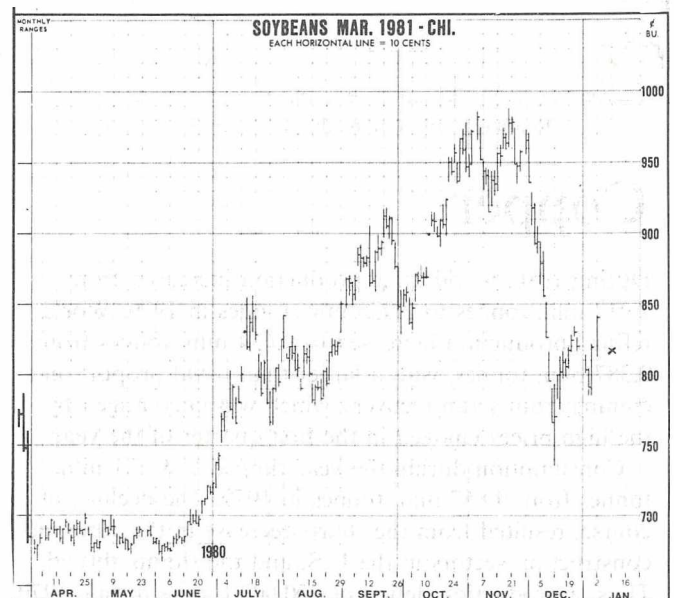
Technically, as can be seen from the accompanying charts, both corn and beans began their December collapses with weekly reversals in nearby positions. The reversal was more dramatic in beans. The sharp one-day reversal on the second last Friday in December did have all the makings of a bottom. Still the ensuing advance

represented only 50% of the decline before it was aborted. Subsequent action has been inconclusive. At present, corn has a better look than beans.

STRATEGY: Taking all things into equal consideration, advise remaining sidelined in beans. The author is long July corn with tight stops of 373 on close. If stopped out, he is convinced that long range fundamentals outweigh all other factors to the extent that he would again probe the long side with protection at December's lows.



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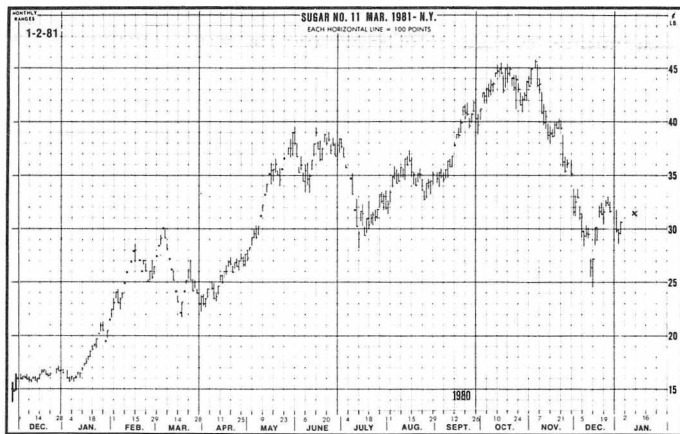


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Sugar

There is a marked similarity between charts of sugar and soybeans over the past three months. Indeed, the biggest distinction between the two is one of degree; Sugar lost 50% of its value while beans lost 25% during last month's collapse. Likewise, despite the precipitous drop, fundamentals are not bearish. The relative flatness of spreads testifies to the expected decline of year-end stocks to as low as 22.5% of usage. Production prospects for next season are not known to be substantial enough to turn this once-great bull market into an equally spectacular bear market. We are forced to conclude that sugar's drop was, as opined last month, the result of speculative panic. The market remains oversold at current levels and thus represents a buying opportunity for strong-stomached speculators prepared to live with a market that may be even more volatile than in the past few months, due to the absence of a still bloodied speculative population.

STRATEGY: Buy March '81 risking 28.10. We anticipate an advance into the 42.00 range.



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Copper

During 1980, world mine production increased from 7.917 mln. tonnes to 7.985 mln. tonnes in 1979. World refined production increased to 9.634 mln. tonnes from 9.387 mln. tonnes, with a larger than usual proportion coming from scrap recovery which was encouraged by the high prices enjoyed in the first quarter of the year.

Consumption during the year slipped to 9.571 mln. tonnes from 9.867 mln. tonnes in 1979. The decline, of course, resulted from the sharp decrease in the auto and construction sectors in the U.S. and the slump abroad. Thus, a production deficit of 500,000 tonnes during 1979 was turned into a 60,000 tonne surplus in one year.

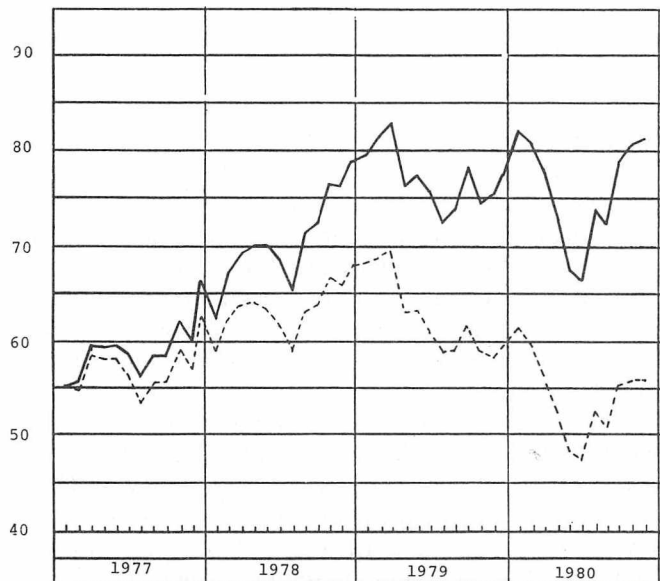
Most of the surplus was used to replenish inventories which had declined precipitously, and virtually without interruption, during 1979. Still, at the end of 1980, (although all relevant data is not yet available), inventory positions were not large. Comex stocks have increased by 90,000 tons to 179,160 tons but LME and refiner stocks in the U.S. are actually lower, albeit modestly, than they were at the end of last year.

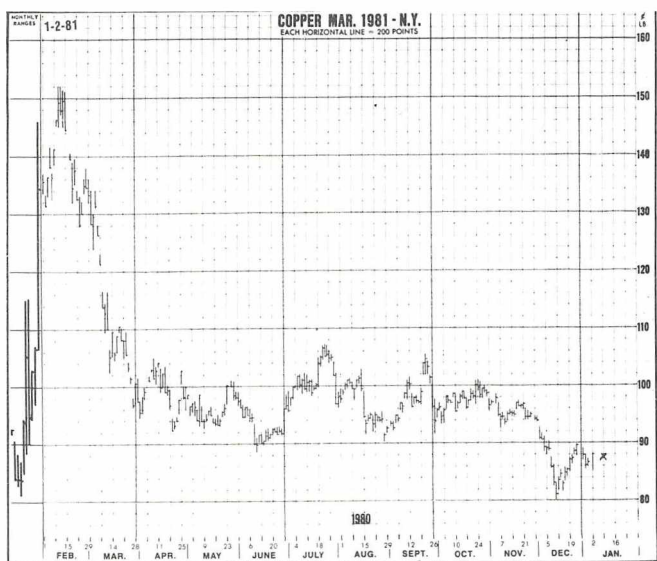
Clearly, copper's price will depend on production and consumption prospects for 1981. Mine production during 1981 is forecast to increase at its secular rate of about 1.5% to 8.035 mln. tonnes; this despite lower prices. Domestic mines have incentive to continue operations because of the precious metal's byproducts. Foreign mines are restrained from cutting back production due to the disproportionate share copper mining has of the economies of LDC's notably Zambia, Peru and Zaire. Refined production during 1981 is forecast at 9.750 mln. tonnes.

On the demand side, it is not expected that the construction and or auto sectors will register much net change over 1980. However, the deepening recession abroad should serve to dampen offtake to 9.4 mln. tonnes. This forecast then yields a production surplus for the second consecutive year, this year to 300,000 tonnes.

CONCLUSION AND STRATEGY: The above fundamental scenario does not argue for much upside potential for the red metal. Downside pressure will be augmented by our expectation of rates which could reach into the 25%-28% range. Our view for the year is that copper will not better \$1.05/lb and is likely to dip to as low as 70¢. We expect an average price of 85¢. At present we are short March, with stops at 91.00.

U.S. Durable Good (—)
Deflated by CPI, Jan. 1977 = 100 (- - -)
Billions of Dollars





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1980 a Retrospective Glance

In our comments of January 1, 1980 we made some long-range forecasts of commodity and currency values—beginning with the disclaimer “. . . we will tell you our views but they will not be as bold nor as brief nor even as precise as last January. Perhaps for that reason you must lend them less credence. Perhaps the gift of simple prophecy has left us to be replaced by earthly sophistry.” How were we as sophists? Well considering that the most volatile commodity of 1980 was money itself, our examination of the entrails of animals and of the stars yielded results which were mixed but not too bad on balance.

What happened to platinum and gold? The former “should become the glamour metal of the 1980’s.” We were “holding out for a long term manifold increase in price.” At the same time, “twenty-five per cent of one’s net worth should be held (in gold) despite the possibility of a swing in gold trade down to the \$300-350/oz mark sometime during 1980. Well platinum did, in the early part of the year, nearly double in price crossing the \$1000 mark early in the year. And the 1980’s are hardly over. Nonetheless, being more an industrial than a monetary metal, platinum succumbed to the debilitating effect high rates had on the cost of financing inventory and on auto sales, platinum’s — who’d a thought it? — at a discount to gold (We saw it coming, Nov. 3rd.) and from Dec. 31st ’79 to Dec. 31st, 1980 shed \$100 an ounce. Based on the closing prices, once again of the spot gold contracts on Dec. 31, 1979 and 1980 respectively, the market advanced by about 11% from \$533 to \$566/oz. He who heeded our advice of maintaining 25% of equity in

bullion was thus implicitly rewarded roughly the same amount as the investor who rolled his cash into T-Bills. Actually, taking into account taxation, the bullion holders did better.

Copper was a market “seen to move substantially higher... as soon as the present economic contraction runs its course.” The jury is still out on this one as the course has proven somewhat longer than expected and the contracted are still running. (Is Chrysler running?? Now there’s an open-ended question?) Still and all we did say “Copper should not trade below 75-78¢ per lb during 1980” — the low was 77.05 — “with an upside potential of \$1.23” — the market achieved \$1.40 — “and a yearly average of 98¢ to \$1.01” — the average monthly closing price of the nearest futures contract was 95.62¢. Now who could do better than that?

Looking at our forecast of currencies reminds us a bit of baseball predictions. Why? Well first of all, this year’s baseball season witnessed the relegation of myth to the realm of foolish old wives’ tales. And so did the currency markets. Who ever said the Phillies couldn’t win in September and that a Republican could never be elected president the same year a national league team won the world series? And who ever said the British pound and the U.S. dollar would be perennially soft currencies? What baseball pundit picked the American league final standings as accurately as we did the world currencies: 1) the British Pound, 2) the Japanese Yen, 3) the U.S. Dollar, 4) the Deutsche Mark? Lets hear it for us.

What of 1981?

As we said at the outset, the salient feature of last year was the volatility of money markets. In the interest rate section of this month’s comments we point out that such a phenomenon is likely to persist and perhaps even increase in magnitude. Given that the cost and availability of money has assumed, to an ever-increasing degree over recent years, a disproportionate influence over commodity and currency values, and facing as we are a new administration which, we hope, will address itself sincerely to much-needed policies of monetary reform, we feel that long-range forecasts, at least at this point, cannot be made. Instead, individual commodities and currencies must be monitored on a month-to-month basis. Stay posted.

*Albert D. Friedberg
David B. Rothberg*

Notes

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