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GOLD: The long cycle

Last year at this time under the heading "The Price of Gold and Its Economic Consequences," we argued that the long period (1940-1975) of gold's undervaluation had given way to a very substantial overvaluation, making gold a poor investment hedge at the then lofty \$650/oz. The absurdity of the level was proved by comparing the increase in the price of gold to the increase in wholesale prices. We went one step further and showed that even U.S. salaries and wages (which include a higher proportion of productivity than inflation) had lagged behind the spectacular rise in the price of gold. No doubt, other considerations were also at play, the most significant one being the dramatic rise of U.S. external dollar liabilities. On that basis, full convertibility could only be achieved via a \$450/oz price, still a substantial premium over gold's purchasing power. Nevertheless, \$650/oz was clearly not warranted nor sustainable within a world monetary regime that eschewed a gold standard.

An updating of our table, given gold's present level of \$500/oz, indicates a meaningful narrowing of the apparent overvaluation (see Table I). Further evidence of the long cycle may be gleaned from a diagram prepared by Financial Times of London, which has been reproduced overleaf.

In the decade of the 20's and 30's, over 90% of Western gold production accrued to Western Official

Reserves, mostly a result of gold's overvaluation vis a vis private consumption. The percentages began to decline in the decade of the 40's and reached a minimal level in the 60's. By the decade of the 70's, gold was so 'cheap' that 100% of its production went to satisfy the private sector and, to that, Western Official Institutions had to supplement the growing private hunger to the tune of 8% of their own reserves. These findings dovetail rather consistently with our table which depicts a strong statistical undervaluation of gold gathering momentum in the decade of the 60's and 70's. Finally, during 1980 gold began to move back into Western Reserves to the tune of about 200 tonnes or approximately 17% of Western production. Gold has become too expensive for the private sector, which can no longer absorb all newly-mined supplies.

Table I
GOLD'S Purchasing Power

| | 1914 | 1930 | 1940 | 1950 | 1960 | 1970 | 1980* | 1981 (Jan) |
|-------------------------------------|-------|--------|--------|--------|--------|-----------|-------------|------------|
| Gold (\$/Oz.) | 20.67 | 20.67 | 35 | 35 | 35 | 35 | 616.48 | 500 |
| % Inc. from 1914 | | | 169.33 | 169.33 | 169.33 | 169.33 | 2982.49 | 2418% |
| W.P.I. (1975 = 100) | 20.13 | 25.5 | 23.16 | 46.80 | 54.3 | 63.1 | 153.42 | 154.95 e |
| % Inc. from 1914 | | 126.68 | 114.75 | 232.49 | 269.75 | 313.46 | 762.15 | 769.75 |
| ** Earnings of U.S. Employees \$639 | 1368 | 1299 | 2992 | 4743 | 7564 | 16,056.10 | 16,216.66 e | |
| % Inc. from 1914 | | 214.09 | 203.29 | 468.23 | 742.25 | 1183.72 | 2,512.69 | 2,537.82 |

* First 11 months.
** from 1970 hourly wages mfg sector.
Prepared by our staff.

Sources : International Financial Statistics.

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GROUP

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World Gold Production and Share Accruing to Western Official Reserves (the IMF)

| | Production (tonnes) | Share |
|----------|------------------------|-------|
| 1920-'29 | 5,640 | 94 % |
| 1930-'39 | 9,200 | 92 % |
| 1940-'49 | 9,300 | 71 % |
| 1950-'59 | 9,480 | 52 % |
| 1960-'69 | 13,620 | 5 % |
| 1970-'79 | 13,100 | - 8 % |
| 1980 | 1,180 | 17 % |

Sources : Financial Times of London

Will the Western Official Institutions continue to absorb newly mined supplies? And if so, will they do so in an ever-growing way, possibly being forced to buy as much as 800-1000 tonnes per year? We may project an affirmative answer in view of the extraordinarily high percentage of Western Reserves represented by gold. Their interest in gold must be sustained lest a substantial portion of their reserves is devaluated, an unacceptable alternative to any central banker. A rate of absorption of 800-1000 tonnes per year, at present prices, represents approximately \$13-16 billion, a modest sum when compared to either the level of World Reserves (over \$1 trillion) or their rate of growth. At the same time, world inflation of the order of 12% per annum, lowers the real price of gold rather quickly. By this calculation, one obtains an absurdly low real price of \$300/oz by the end of 1984, a level which would, once again, induce heavy private demand.

Last year's analysis was fully vindicated throughout the course of the last twelve months. Gold's net absorption into world reserves at declining prices was symptomatic of a high degree of overvaluation which, towards the early part of 1981, was being modestly corrected. The length of the overvaluation cycle will depend, to a great extent, on the rate of inflation that Western nations, and particularly the U.S., will experience in coming years. For the time being, however, it appears that a large proportion of newly mined gold (set to rise significantly in Canada, U.S. and Brazil) will find its way into the reserves of Official Institutions, who will act, willingly or unwillingly, as Purchasers of Last Resort.

STRATEGY: With gold standing at \$640/oz in early November '80, we advised establishing short positions and risking \$660/oz basis nearby and looking for a test of the May '80 lows of \$450-475/oz. Recent days have seen a loss of downside momentum after good support was uncovered at \$482/oz and the market has formed a trading range, on either side of the \$500 level.

We do not think the bear move is over, as yet, and advise retaining short positions, lowering stops to \$570/oz, basis April '81, close only.



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| | Gold Holdings (mln oz) | Gold Prices (US\$) | Gold Holdings (Market Value) | Total Reserves (mln US\$) | Proportion Gold/ Reserves |
|------------|---------------------------|-----------------------|---------------------------------|------------------------------|------------------------------|
| 1950 | 951.99 | 35.00 | 33,319.65 | 48,324.65 | 68.95% |
| 1960 | 1,083.30 | 35.00 | 37,915.50 | 59,979.50 | 63.21% |
| 1970 | 1,056.83 | 35.94 | 37,982.47 | 94,237.47 | 40.31% |
| 1979 | 929.96 | 512.00 | 476,139.52 | 832,270.40 | 57.21% |
| 1980 (Oct) | 936.33 | 629.00 | 588,951.57 | 991,883.95 | 59.38% |

Source: IFS

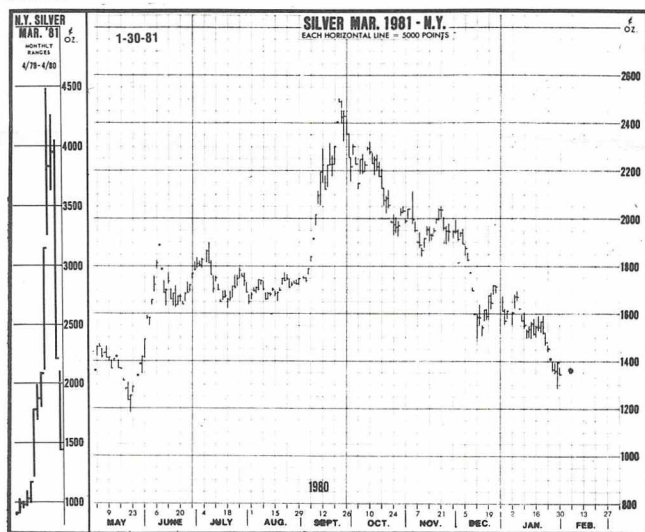
The Silver Saga

This month marks the anniversary of the great bear market in silver; a market that was headed in our January 11, 1980 comments under the title "Tulip Bulb Mania Revisited." Curiously, for the better part of the past twelve months we have had to suffer more inquiries from would-be buyers than would-be short-sellers. "How low can it go?" is the common complaint. This is curious because sensible speculators seldom seem disposed to wonderment over other bear markets such as sugar,

cocoa, coffee, pork bellies or copper. Rather, they accept that what goes up inevitably comes down as price adjusts supply and demand, and thus they eagerly seek profits on the short side. It should be remembered that this marks the second anniversary of the beginning of the great bull market in silver; as early as two years ago silver was trading at \$8.00/oz.

As early as October of 1979, when the bull market had yet to run one third of its course, we predicted the effect high prices would have: Industrial usage would decline substantially, new refining would add to supplies as would re-melted silver, and warehouse stocks would show a substantial increase. Given that the value of warehouse stocks (121,000,000 ounces) had appreciated in dollar terms to \$2 billion from between \$750-\$800 million nine months earlier, we recognized that a squeeze play was impossible and advised our first bearish position. We sold May '80 silver and bought May '81, which was then trading at a 65¢/oz premium.

By the time we published our November 5th 1979 comments, warehouse stocks had increased to 123,300,000 ounces and the May '80-May '81 spread had widened to \$1.40.



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On November 27, 1979, we conceded that the market, having broken out of an eight-week triangle, was headed for another big rise. By the time our January 11th comments were published ("Tulip Bulb Mania..."), Silver was jumping by as much as \$5/oz in a single trading session. We wrote,

'In coming months newly-priced sterlingware, jewelry and photographic film will begin facing steep consumer resistance, causing a huge backup in traditional pipelines. Pure silver mining and increased Indian smuggling should add considerably to the supply side, while, given present prices, byproduct extraction of silver may turn out to be a primary consideration for many copper-zinc-lead mines.'

We further estimated that 60 million ounces, which at the then prevailing price of \$35.00/oz represented \$2.1 billion, had been privately hoarded and would be disgorged. We conclude that a top was imminent and that it would be formed by a weekly downside reversal.

By the time of our next comments dated Feb. 4, 1980, the weekly reversal had taken place and we added, to our bear spread, a net short position and a spread of long 13 golds to short five silvers assuming that the gold/silver ratio which was then at 20:1 would increase to at least 30:1. On March 4, 1980, we recommended taking off half the May '80-May '81 spreads which had widened to 360 points. The profit was \$15,000 per position. By March 26, 1980, the gold/silver ratio had widened to 31.4:1 and those who were sufficiently capitalized to have assumed that position recommended three months earlier recognized a profit of \$495,000. We held the net short position through June; the majority of positions were covered at profits of between \$15,000 and \$20,000 per contract.

We were right. If the bottom line is money made or lost, we were right. But being analysts as well as brokers it is a source of pride to note that we were right in the face of an overwhelming consensus of bullish opinion and for all the right reasons. The accompanying statistical table vindicates views we projected twelve months ago. At the same time it occasions a projection of events yet-to-come.

Silver in The United States
(Thousand troy ounces)

| Stocks, beginning of period | 1979 | | | | 1980 | | |
|--------------------------------------|----------|----------|----------|----------|----------|----------|----------|
| | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. | 1st Qtr. | 2nd Qtr. | 3rd Qtr. |
| Industry stocks | 26,700 | 33,482 | 27,747 | 21,500 | 16,102 | 30,607 | 35,607 |
| Defense Dept. | 6,400 | 9,860 | 5,810 | 3,100 | 5,870 | 5,400 | 6,000 |
| Treasury Bullion | 39,127 | 39,129 | 39,129 | 39,064 | 39,990 | 39,998 | 39,998 |
| Commodity Exchange | 39,217 | 49,252 | 54,114 | 52,405 | 74,809 | 83,645 | 81,992 |
| Chicago Board of Trade | 39,405 | 56,325 | 56,845 | 65,290 | 58,320 | 57,555 | 45,750 |
| Total | 192,509 | 183,488 | 183,645 | 182,559 | 193,891 | 215,540 | 202,157 |
| Flows, end of period | | | | | | | |
| Mine | 3,415 | 3,604 | 9,385 | 8,688 | 9,145 | 8,762 | 5,288 |
| Refinery | 2,992 | 22,882 | 29,041 | 29,715 | 32,993 | 26,796 | 19,874 |
| Imports | 24,756 | 18,071 | 18,570 | 30,981 | 21,971 | 17,481 | 18,814 |
| Total | 56,123 | 50,497 | 48,576 | 69,384 | 63,104 | 54,987 | 42,776 |
| Net Industrial | 51,779 | 43,040 | 30,914 | 31,515 | 31,450 | 31,462 | 25,277 |
| Chicago | 13 | 13 | 74 | 74 | 0 | 0 | 27 |
| Exports | 5,197 | 4,208 | 5,239 | 20,919 | 24,580 | 38,744 | 9,179 |
| Total | 56,981 | 47,261 | 36,231 | 52,508 | 56,034 | 70,206 | 34,483 |
| Stocks, end of period | | | | | | | |
| Industry | 33,482 | 27,747 | 21,500 | 16,102 | 30,607 | 30,607 | 31,561 |
| Defense Dept. | 9,860 | 5,810 | 5,400 | 5,470 | 5,400 | 4,400 | 3,200 |
| Treasury Bullion | 39,129 | 39,064 | 39,064 | 39,990 | 39,998 | 39,998 | 39,977 |
| Commodity Exchange | 49,252 | 54,114 | 51,485 | 74,809 | 83,615 | 81,982 | 82,114 |
| Chicago Board of Trade | 56,325 | 56,845 | 65,290 | 58,320 | 57,555 | 45,750 | 40,445 |
| Total | 183,488 | 183,645 | 182,559 | 183,891 | 215,540 | 202,157 | 202,167 |
| Apparent increased in Private Vaults | 8,163 | 3,079 | 13,431 | 1,544 | -14,579 | -1,436 | -7,883 |

In the U.S., supplies (comprising mine and refinery production plus imports) increased during the fourth quarter of 1979 and first quarter of 1980 and only began returning to normal (i.e. mid 1979) levels by the third quarter of 1980, at 43,000,000 ounces. Net industrial consumption remained relatively stationary throughout the market's boom, averaging about 31 mln. ounces quarterly. It wasn't until the third quarter of 1980 that net industrial usage dipped to 25.3 mln. ounces, a decline of 20%.

Since the economy was actually weaker in the second quarter than in the subsequent third quarter, we conclude that the decline in usage registered in the third quarter reflects a lagged substitution factor; it took until the third quarter of 1980 for industry to economically replace silver with other materials. It should be noted that net industrial consumption in the third quarter of 1980 was

running as much as 50% lower than in the first quarter of 1979. In other words, the demand curve for silver continued its long downward shift that began in first quarter of 1979.

That the supply of silver in the third quarter of 1980 returned to mid-1979 levels suggests to us that the supply curve has also changed, this one in an upward direction. It now takes higher prices to insure the same supplies. The average price of silver during the middle six months of 1979 was approximately \$10.00/oz, while the average price during the third quarter of 1980 was \$17.40/oz.

We would then argue, rather simplistically, that it requires a price of around \$17.40/oz to obtain the same supplies of around 48 mln. ozs. as did the price of \$10.00/oz twenty months ago. If 48 mln. ozs. represents a normal and adequate supply of silver and industrial consumption has decreased by 20% then a surplus of production over consumption still exists.

The Bureau of Mines, in its Annual 1980 review, notes that it continued to investigate new flotation techniques for higher recovery of silver from ore: heap-leach cyanidation and associated carbon absorption, and the development of economic methods for recovering silver from low grade or refractory ores.

STRATEGY: In our opinion, Silver's bear market is not over yet. Overwhelming supplies should be forthcoming at about the \$17-18/oz level, in current dollars, while a substantial drying up of supplies should occur under \$10/oz, disregarding the potential impact of the thinly margined Hunt hoard. At this time, the downward shift in the demand curve for silver should pressure prices towards the lower end of the range.

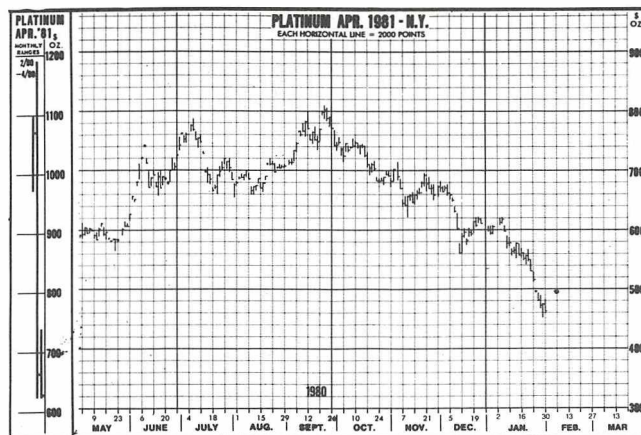
Risk-reward ratios at present levels are unattractive for either the Bears or the Bulls.

Platinum

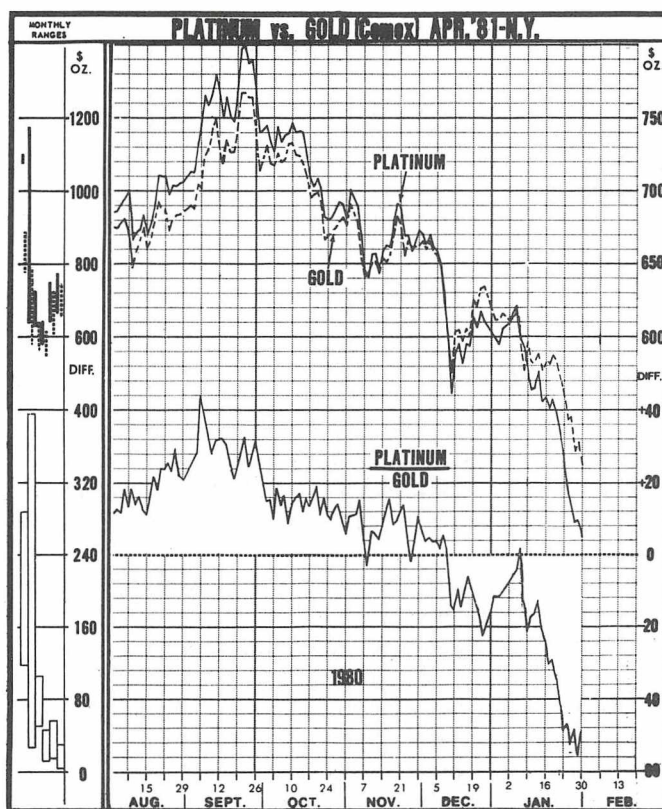
Recent talk of implementing revised U.S. stockpile goals for a variety of strategic metals headed by platinum and chromium, has lent this collapsing market some support. Its discount to gold, foreseen by us as far back as last September, 1980, first widened to almost \$60/oz and has now recovered to about \$18/oz.

In view of President Reagan's budget-cutting efforts, it seems implausible that the GSA should undertake to implement in the very near future its stockpile goal of 1.3 million ounces of platinum, an increase of 860,000 ounces over present levels representing no less than 430 million dollars at current prices.

STRATEGY: We look for platinum prices to ease further in the months ahead, possibly trading under \$400/oz.



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Currencies

DM/SFR

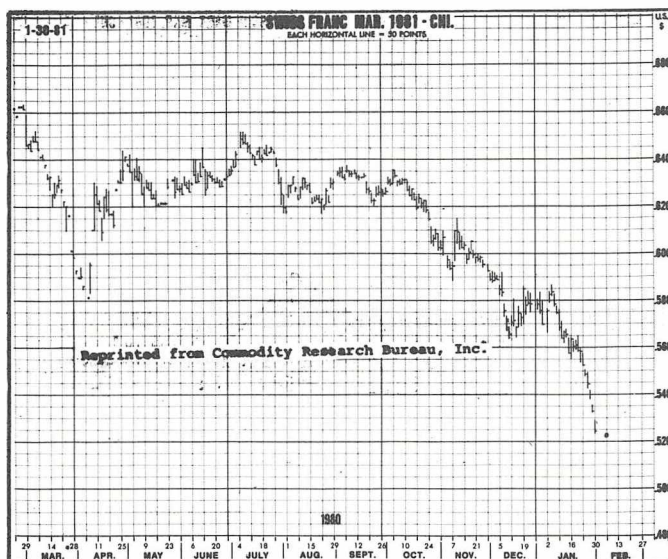
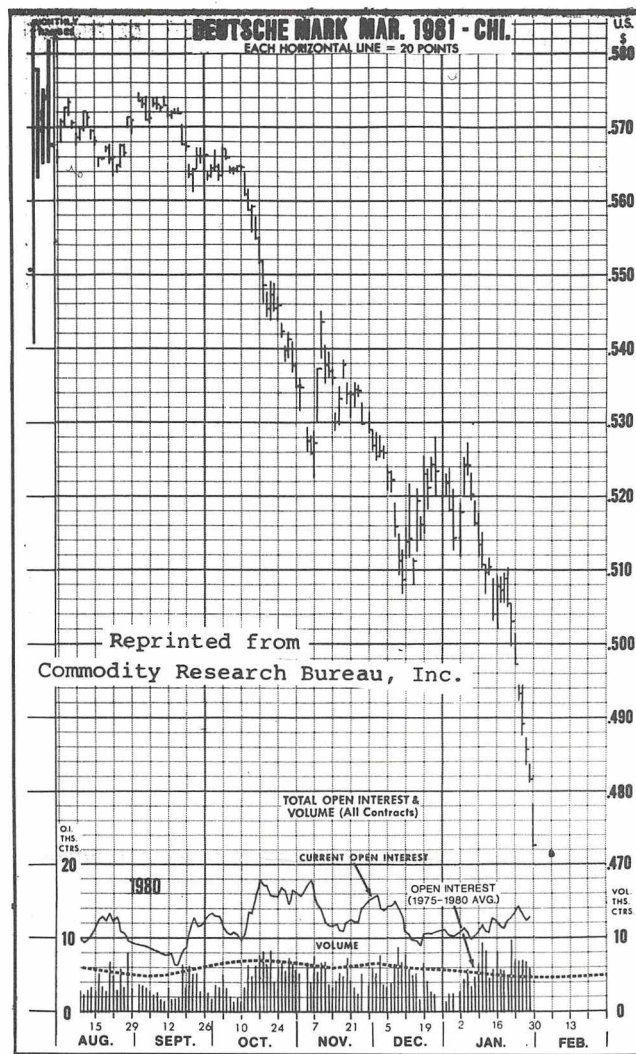
Our oft-stated bearish case for the DM and SF has finally received universal recognition. The rapidity of the decline has begun to take its toll on German public opinion and West Germany's EMS partners. Forceful intervention, estimated at over U.S. \$2 billion, stopped the further erosion of the DM, at least temporarily.

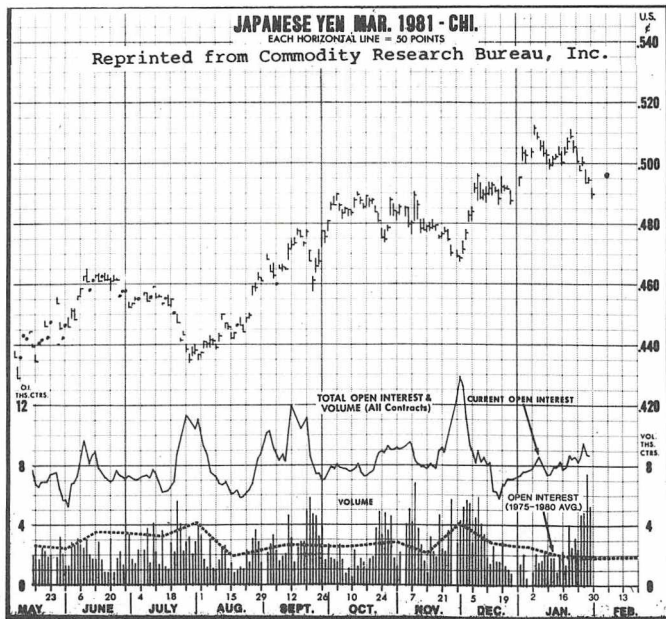
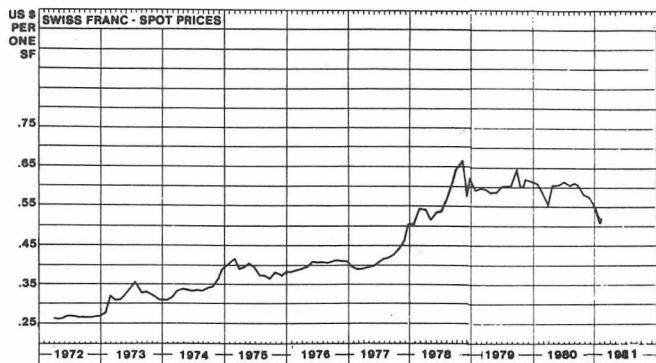
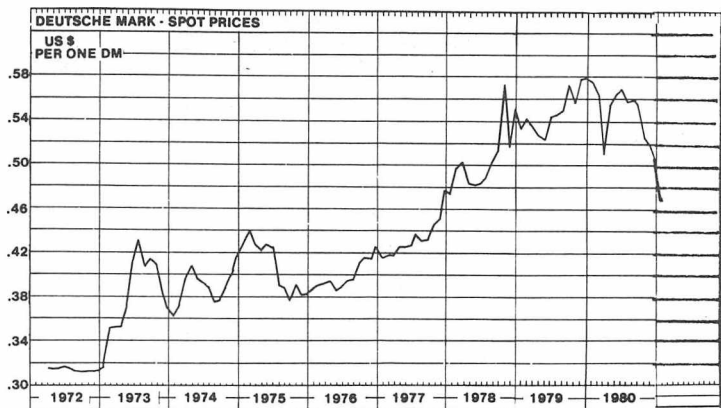
Curiously, just a few days earlier, the Bundesbank had injected over DM 6.0 billion of extra liquidity in the banking system aggravating the supply imbalance that has taken place in the foreign exchange markets. The Bundesbank is trying to play two contradictory themes at the same time: Ease domestic money market conditions while at the same time 'intervene' in the currency markets by mopping up unwanted DM supplies. Impossible. And ridiculous.

Nevertheless, the recent collapse has awakened Germany's consciousness (and that of its other European partners) to the dangers of a devaluating currency and a 'rescue package' is not too distant.

STRATEGY: We would now prefer to cash in on our sensational profits: cover shorts March '81 DM put out at 57.00 and March '81 Sf put out at 63.00 (as per September, 1980 Commodity & Currency Comments) at present levels (i.e. March '81 DM 47.19 and March '81 Sf 52.21) for a profit of about \$12,500 per contract.

Continue to stand aside on the Japanese Yen.





| | Jan. 81 | Dec. 80 | Nov. 80 | Total | | | |
|---------------------------|---------|---------|---------|---------|----------|--------|--------|
| | | | | 1980 | 1979 | 1978 | 1977 |
| Trade Balance | | | | | | | |
| U.K. (bln Stg.) | | .246 | .455 | | | | |
| C.D. (bln CDS) | | .497 | 1.49 r | | | | |
| D.M. (bln Marks) | | 1.01 | 1.377 | 8.72 | 22.46 | 40.95 | 38.41 |
| J.Y. (bln US\$) | | 2.39 | .560 | 2.364 | 2.305 | 24.83 | 17.595 |
| SFr. (bln Francs) | | -.880 | -.510 | -11.24 | -4.718 | -0.526 | -1.089 |
| Current Account | | | | | | | |
| U.K. (bln Stg.) | | .346 | .555 | | | | |
| D.M. (bln Marks) | | -.7 | -1.1 | | | | |
| J.Y. (bln US\$) | | 1.18 | -.610 | | | | |
| Reserves | | | | | | | |
| | | | | Oct. 80 | Sep. 80. | | |
| U.K. (bln US\$) | 28.39 | 27.48 | 28.19 | 28.03 | 27.64 | | |
| C.D. (bln US\$) | | 4.03 | 3.47 | 3.68 | 3.95 | | |
| D.M. (bln Marks) | | 67.4 | 69.4 | 71.9 | 73.9 | | |
| J.Y. (bln US\$) | 26.5 | 25.23 | 24.94 | 24.74 | 23.77 | | |
| SFr. (bln Francs) | 21.72 | 27.36 | 20.82 | 19.2 | 23.16 | | |
| Cost of Living/CPI | | | | | | | |
| U.K. (1974 base) | | 275.6 | 274.1 | 271.9 | 270.2 | | |
| C.D. (1971 base) | | 221.3 | 220.0 | 217.3 | 215.4 | | |
| D.M. (1976 base) | 120.5 | 119.3 | 118.6 | 118.1 | 117.7 | | |
| J.Y. (1975 base) | | 139.6 | 140.5 | 140.2 | 140.0 | | |
| SFr. (1977 base) | | 110.9 | 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) | | 256.9 | 254.9 | 251.5 | 251.5 | | |
| D.M. (1976 base) | | 119.2 | 117.5 | 115.9 | 115.6 | | |
| J.Y. (1975 base) | | 133.0 | 133.2 | 133.1 | 134.1 | | |
| SFr. (1963 base) | | 158.9 | 158.3 | 157 | 155.8 | | |
| Unemployment Rate | | | | | | | |
| U.K. | 9.3 | 9.3 | 8.9 | 7.8 | 7.4 | | |
| C.D. | | 7.4 | 7.3 | 7.6 | 7.5 | | |
| D.M. | 5.6 | 4.8 | 4.2 | 3.8 | 3.5 | | |
| J.Y. | | 2.1 | 2.1 | 2.0 | 2.02 | | |
| SFr. | | 0.2 | 0.2 | 0.2 | 0.2 | | |

BP

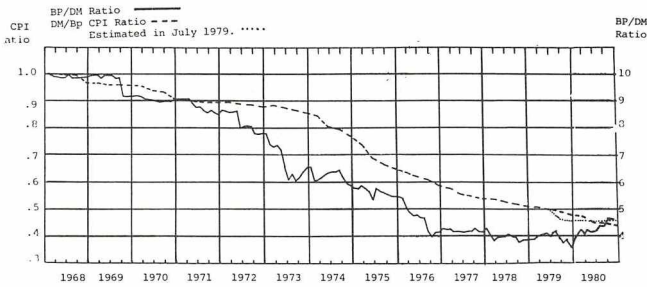
The Battle of Britain II may slowly be drawing to an end.

In the first place, official thinking may be crumbling. Responding to Labor accusations that "the exchange rate was creating mass unemployment," Mrs. Thatcher promised that "the height of the exchange rate (Who told you it was high?) is something we will bear very much in mind when taking other decisions." This is no doubt a veiled reference to an upcoming cut in the MLR on or before Budget day (March 10). This possibility is being reinforced by the continuous drop in the 3-months T-Bill rate, now standing at a fraction above 12%. Furthermore, early relief to industry may be forthcoming atop enormous problems with the deficit-ridden nationalized sector. The UK can't escape a widening Public Sector Borrowing Requirement for 1981-1982, especially when the problem of high inflation has been licked, for the time being.

Has our upside target for Sterling been satisfied? We think yes. Referring to a June '79 forecast in which we drew a Purchasing Power Parity model for the Stg.-DM relationship, we said: "...For a particularly long period of time (1972-1978) Stg. remained widely undervalued on a purchasing power parity concept. Admittedly long-term parities are not particularly good trading parameters. Furthermore, CPI figures may under or overstate true inflation rates as every country utilizes different weights and quality adjustments. Nonetheless, the long term parallelism is remarkable and may be a useful predictive tool. On the present basis, Stg. may have to rise to 5 DM to close the gap, a 19% appreciation vis à vis the DM.

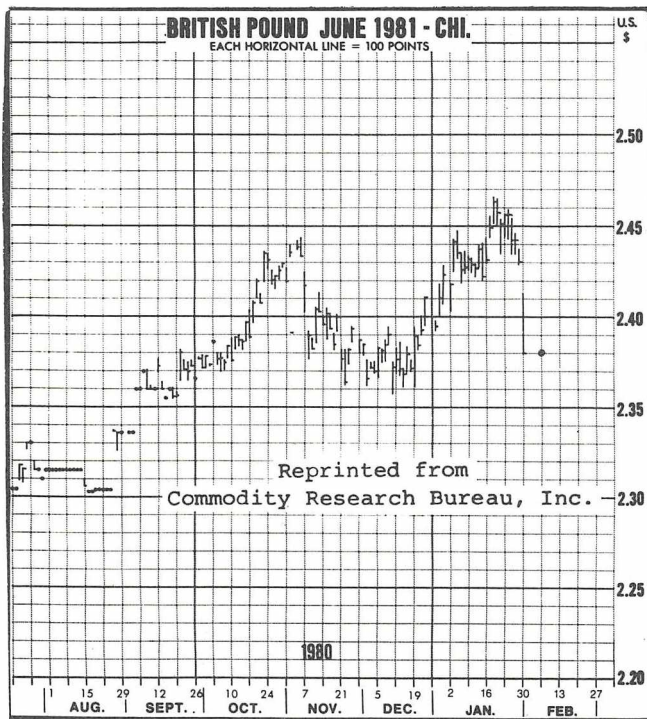
We have also projected CPI figures for the UK and Germany into IVQ 1980 and conclude that a rise to 4.5 DM would not be unreasonable. Moreover, just as Stg. was undervalued for a considerable period of time, Stg. may become overvalued if only due to the present glamorous combination of a truly conservative Government and oil self sufficiency..."

Our update chart shows that Sterling appreciated to just over 5 DM by early 1981, the indicated target date.



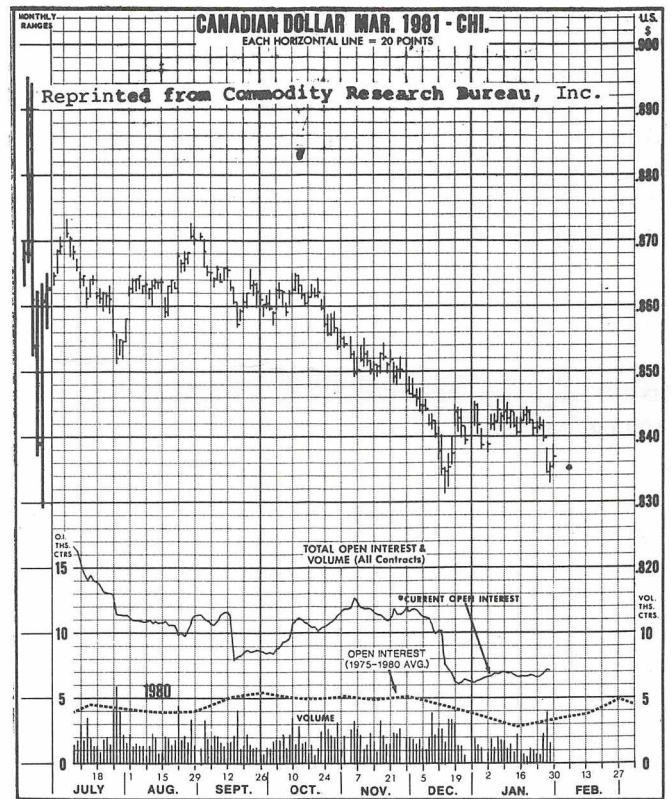
STRATEGY: In line with this reasoning, we now believe that Sterling is due, **at the very least**, for a substantial correction possibly taking it down to the 2.27 area basis nearby. We are reserving judgement on the likelihood of a Sterling bear market, depending on the contents of the Budget to be announced in three weeks.

Sell June BP at present levels, risking 2.4250 basis Spot.



CDS

In order to prop up the sagging CD\$ which has been weak due to a combination of long term capital outflows and a negative current account, the Bank of Canada has resorted to maintaining wide short term interest rates differentials. This 3 months T-Bill rate differential reached a peak in late December '80 at about 245 basis points. By early February '81, the differential had narrowed to 145 basis points and the CD\$ was once again under pressure. It is quite clear that differentials well in excess of 200 basis points are needed to support the currency.



STRATEGY: Given the Bank of Canada's commitment to holding the line at the 83¢ level, the following trading strategy seems appropriate: Sell 3-months Canadian Treasury Bills at present levels, i.e. 96.150, which represents a true yield of 16.06% as compared to the cash market of 16.86%. It is quite **unlikely** that the Bank of Canada will manipulate the tender so as to lower the rate; if anything, currency considerations may push it easily above 17%.

Mexican Peso

The spot rate continues to erode and is now trading at 0.04262 forcing downwards the successive expirations of nearby contracts on the IMM (see chart). The crawling devaluation, which began at .04376 around September 1979, only amounts to a 2.6% drop, as yet. Nevertheless, the depreciation has gathered momentum in recent weeks; for the past five months it already shows a 1.8% erosion.

The reason for the recent acceleration may be twofold: a) It has had absolutely no impact on the widening trade deficit, and b) It may represent a gathering avalanche of capital flight.

With regard to Mexico, it is now worthwhile to keep in mind three factors: 1) Growing energy self-sufficiency in the U.S. coupled with a worldwide oil glut should impact unfavourably Mexico's oil and gas exports; 2) The very large devaluation of European currencies vis à vis the U.S. dollar and, consequently, vis à vis the MP; 3) The 86% overvaluation of the MP over the U.S. dollar since 1976 due to the much greater rate of inflation experienced in Mexico during that period.

Heretofore, we favoured selling nearby MP contracts allowing for a one-time 3 months loss of approximately \$1500/contract at contract expiration. This risk appraisal assumed a relatively steady Spot MP and the gradual narrowing of the forward discount as the market approached settlement.

STRATEGY: In view of the more rapid pace of depreciation now taking place in the Spot market, we would be better advised to begin selling deferred contracts. As an example, Dec. '81, trading at 3690 carries an implicit risk of \$5,700 per contract (.04262-.03690) assuming Spot remains at present levels. What is more likely is that the Spot rate will decline gradually to .04000-.04050 if no major devaluation takes place, lowering the implicit risk to about \$3500 per contract. The advantage of selling deferred contracts at the present time is that the forward discount to December '81, approximately 14.5%, is not greater than the prospective inflation differential; thus one is not paying too steep a premium. Should devaluation expectations become more widespread, the forward discount may widen considerably making it expensive to roll-over from the expiring contract to the next position.

Sell Sept. '81 and Dec. '81 MP at present levels.

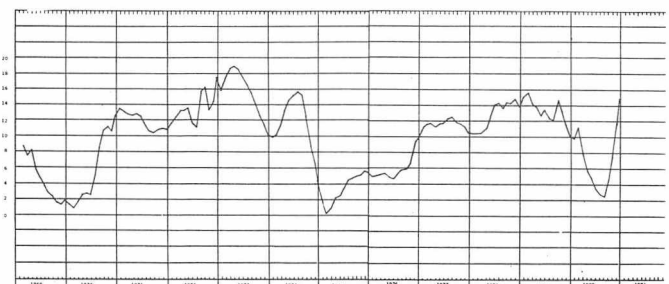
Interest Rates Futures

As suggested last month, recent money-supply readings have become worthless in trying to determine the true monetary temperature. Shifts in deposits included in one series but excluded in another have created an extraordinary amount of confusion among money-supply watchers, and the very Fed has put itself in the position of the blind leading the blind.

Is there, at the present time, a more meaningful way to measure the Fed's performance? Last month we suggested looking at adjusted Federal Reserve Credit, a proxy directly controllable by the Federal Reserve Bank. Continuous monitoring of this variable indicates an annual growth rate of 11.2% p.a., a substantially greater than desired rate of expansion and inconsistent with Fed targets for overall Monetary Aggregates.

Accounting logic directs us to look at the asset side of the banking system's financial statement. Bank Credit, loans plus investments, is the direct counterpart of Bank Liabilities which, in turn, (and apart from a small capital item) includes the broadest measure of money supply. The accompanying chart depicts the month over six months annualized rate of growth of Bank Credit from 1969 to and including December '80. What stands out rather clearly is the very expansive rate of growth of Bank Credit over the past several months, particularly November and December '80.

Bank Loans and Investments (Bank Credit) Source: Monetary Trends
Compounded Annual Rates of Change-month over 6 month Federal Reserve Bank of St. Louis

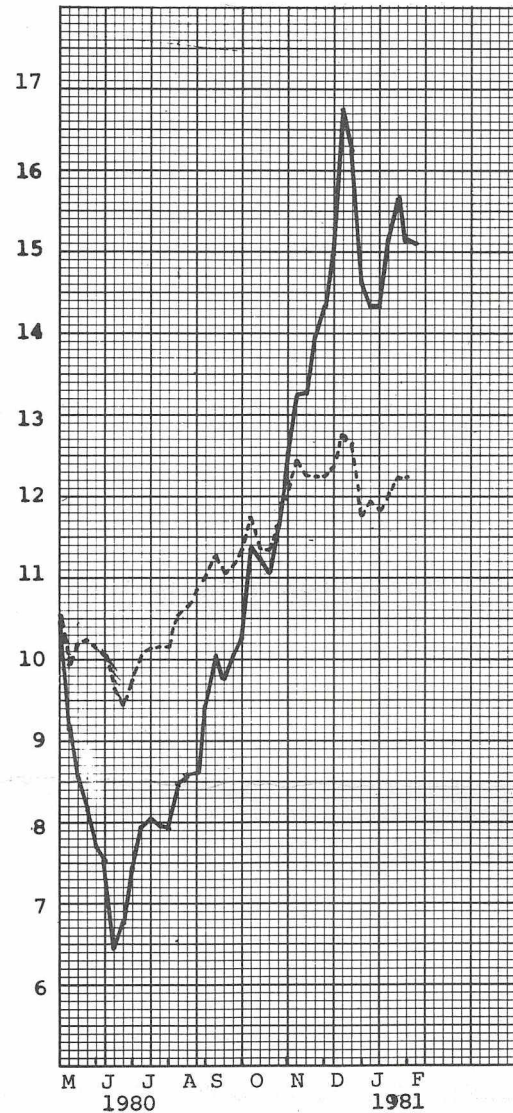


It should be noted that coming out of the 1974/1975 recession, which was accompanied by a very meaningful deceleration of Bank Credit, the latter expanded at a modest pace of around 5% per annum until September, 1976. This modest rate of growth, at least in the initial 18 months of the economic recovery, put a substantial damper on inflationary expectations despite the vigorous rebound in real economic activity. The late 1980 trend is beginning to resemble more closely the ill-fated 1970/71 recovery, when, as a result of the Pen Central bankruptcy, the Fed resorted very early to pump priming at an accelerated rate.

If our analogy is correct, what can we expect in 1981/1982? In the first place, a continuing high level of price inflation. Secondly, a substantial weakening of the U.S. dollar, culminating perhaps, in a new foreign exchange crisis (if the super-currencies take appropriate tightening moves (see discussion in Currencies) or a renewed move into gold. Thirdly, a counter-move by the Fed, causing rates to skyrocket to new all-time highs (conceivably if the Fed moved early enough, scenarios one and two would not come about).

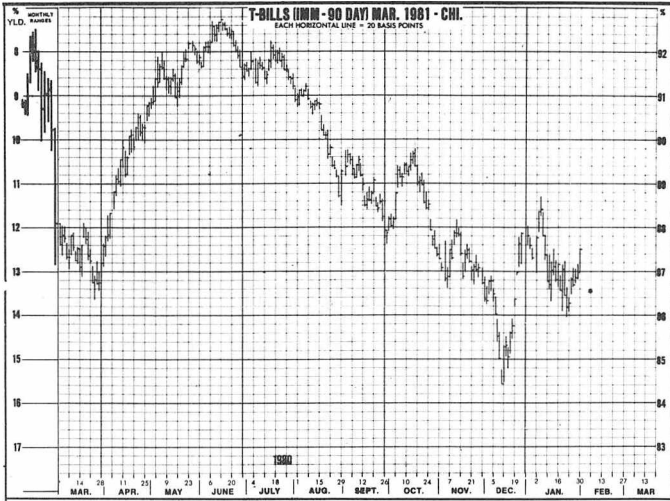
If the Fed misreads the money-supply date (and ignores Bank Credit, for instance), it is likely to relax its posture in coming months making a re-run of the 1970/71 experience an almost certainty. At any rate, long term rates are unlikely to come off from present levels, which merely keep pace with the rate of inflation.

U.S. Interest Rates
 3-month Treasury Bills ———
 Long-term Treasury Securities - - -

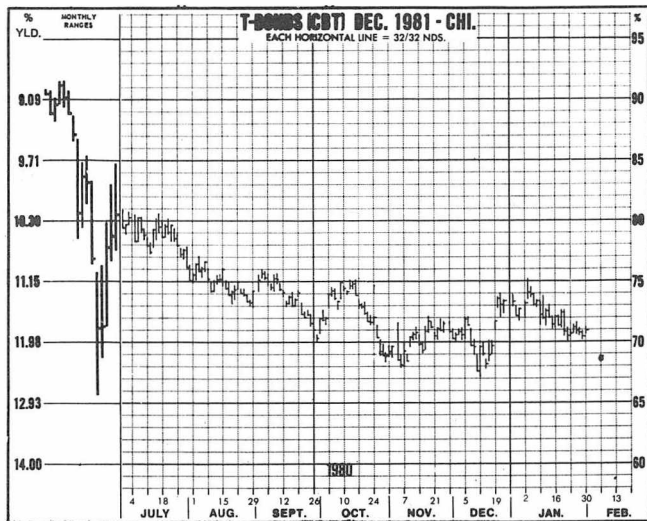


STRATEGY: We repeat last month's advice: Interest rates are heading **irregularly higher**. Remain short March '81 T-Bills, already showing a small profit. Remain short March '81 T-Bill — long June '81 spread until the expiration of March '81; it should widen to 250 points.

Last month we thought that T-Bonds would go lower but that their risk-reward ratio was far from being as favorable. Recent examination of Fed behavior and response to 'good' money supply numbers leads us to reverse this thinking. Namely, **Bond yields** are likely to rise faster than **Bill yields**, at least for the next few months. Sell December '81 T-Bonds at market; place protective stop at 75.00, close only. Look for an eventual move to 55.00.



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Friday, February 6, 1981

GNMA 8% (CBT) - \$100,000 prncpl; pts., 32nds of 100%

| | Open | High | Low | Settle | Chg | Yield | Open |
|-------|-------|-------|-------|--------|-------|--------|----------------|
| Mar | 68-27 | 68-30 | 67-30 | 68-04 | - 15 | 13.574 | + .102 9,816 |
| June | 69-12 | 69-13 | 68-14 | 68-21 | - 11 | 13.451 | + .079 8,915 |
| Sept | 69-15 | 69-15 | 68-28 | 69-02 | - 9 | 13.358 | + .064 8,522 |
| Dec | 69-19 | 69-19 | 69-02 | 69-09 | - 7 | 13.308 | + .050 8,715 |
| Mar82 | 69-20 | 69-20 | 69-06 | 69-11 | - 6 | 13.294 | + .043 13,315 |
| June | 69-13 | 69-13 | 69-07 | 69-11 | - 4 | 13.294 | + .029 16,607 |
| Sept | 69-12 | 69-12 | 69-04 | 69-09 | - 3 | 13.308 | + .021 16,934 |
| Dec | 69-09 | 69-09 | 69-01 | 69-07 | - 2 | 13.322 | + .014 10,105 |
| Mar83 | 69-06 | 69-06 | 69-00 | 69-05 | - 1 | 13.336 | + .007 4,751 |
| June | 69-03 | 69-03 | 68-29 | 69-03 | | 13.350 | 1,667 |
| Sept | 68-27 | 69-01 | 68-27 | 69-01 | + 1 | 13.365 |007 880 |

Est vol 6,000; vol Thu 11,901; open int 100,227, +2,546.

TREASURY BONDS (CBT) - \$100,000; pts., 32nds of 100%

| | Open | High | Low | Settle | Chg | Yield | Open |
|-------|-------|-------|-------|--------|-------|--------|---------------|
| Mar | 67-05 | 67-15 | 66-16 | 66-20 | - 17 | 12.607 | + .101 44,828 |
| June | 68-12 | 68-18 | 67-20 | 67-24 | - 15 | 12.384 | + .088 35,673 |
| Sept | 68-30 | 69-02 | 68-08 | 68-12 | - 11 | 12.277 | + .057 24,446 |
| Dec | 69-09 | 69-09 | 68-18 | 68-24 | - 8 | 12.209 | + .035 22,419 |
| Mar82 | 69-11 | 69-11 | 68-25 | 69-00 | - 6 | 12.163 | + .034 22,855 |
| June | 69-13 | 69-13 | 68-30 | 69-05 | - 5 | 12.135 | + .029 30,106 |
| Sept | 69-10 | 69-14 | 69-06 | 69-08 | - 4 | 12.118 | + .023 23,970 |
| Dec | 69-11 | 69-18 | 69-10 | 69-11 | - 3 | 12.101 | + .017 26,058 |
| Mar83 | 69-13 | 69-20 | 69-10 | 69-14 | - 2 | 12.084 | + .011 12,680 |
| June | 69-15 | 69-21 | 69-14 | 69-17 | - 1 | 12.067 | + .005 5,621 |
| Sept | 69-16 | 69-22 | 69-16 | 69-20 | | 12.050 | 1,365 |

Est vol 45,000; vol Thu 58,220; open int 250,021, +4,376.

TREASURY BONDS (NYFE) - \$100,000; pts., 32nds of 100%

| | Open | High | Low | Settle | Chg | Yield | Open |
|-------|-------|-------|-------|--------|------|--------|--------------|
| Feb | 84-08 | 84-08 | 73-07 | 73-08 | - 23 | 12.718 | + .129 2,066 |
| May | 74-24 | 74-24 | 74-10 | 74-08 | - 22 | 12.540 | + .120 567 |
| Aug | 75-05 | 75-05 | 74-28 | 74-24 | - 21 | 12.452 | + .113 314 |
| Nov | 75-11 | 75-11 | 75-03 | 74-31 | - 20 | 12.415 | + .108 364 |
| Feb82 | 75-11 | 75-11 | 75-11 | 75-05 | - 18 | 12.382 | + .096 509 |
| May | 75-12 | 75-13 | 75-12 | 75-06 | - 18 | 12.377 | + .096 882 |
| Aug | 75-13 | 75-13 | 75-13 | 75-07 | - 18 | 12.371 | + .096 574 |
| Nov | 75-14 | 75-14 | 75-14 | 75-08 | - 18 | 12.366 | + .096 266 |

Est vol 1,892; vol Thu 2,503; open int 5,542, +31.

TREASURY BILLS (IMM) - \$1 mil.; pts. of 100%

| | Open | High | Low | Settle | Chg | Discount | Open |
|-------|-------|-------|-------|--------|-------|----------|--------------|
| Mar | 87.00 | 87.00 | 86.48 | 86.48 | - .60 | 13.52 | + .60 20,234 |
| June | 88.61 | 88.61 | 88.11 | 88.12 | - .59 | 11.88 | + .59 13,330 |
| Sept | 89.05 | 89.05 | 88.54 | 88.60 | - .54 | 11.40 | + .54 7,119 |
| Dec | 88.94 | 88.94 | 88.53 | 88.59 | - .47 | 11.41 | + .47 3,142 |
| Mar82 | 88.90 | 88.90 | 88.54 | 88.54 | - .41 | 11.46 | + .41 1,956 |
| June | 88.70 | 88.70 | 88.50 | 88.53 | - .42 | 11.47 | + .42 856 |
| Sept | 88.70 | 88.70 | 88.51 | 88.51 | - .33 | 11.49 | + .33 346 |
| Dec | 88.75 | 88.75 | 88.49 | 88.49 | - .25 | 11.51 | + .25 .74 |

Est vol 18,204; vol Thu 18,147; open int 47,057, +1,560.

THE WALL STREET JOURNAL

CANADIAN FUTURES CONTRACTS

91-DAY TREASURY BILLS
(Combined Montreal-Toronto trading)
\$1 million; multiples of \$0.005

| -- Season -- | | Settle | | Open | |
|--------------|--------|--------|--------|--------|--------|
| High | Low | Price | Chg | Int. | |
| 97.350 | 96.040 | Mar 81 | 96.225 | 96.150 | 96.110 |
| 97.290 | 96.125 | Jun 81 | 96.545 | 96.080 | 96.20 |
| 96.270 | 96.200 | Sep 81 | 96.545 | 96.080 | 96.20 |

Total Sales: Friday 3; Thursday 5
Total Open Interest: Thursday 5
Normal Daily Price Limits: \$0.150 above or below prior settlement price.

(Winnipeg trading)
91-day Canada Treasury bills
\$200,000; points of 100 per cent

| -- Season -- | | Settle | | Open | |
|--------------|-------|--------|-------|-------|-------|
| High | Low | Price | Chg | Int. | |
| 84.20 | 85.00 | Jun 81 | 84.65 | 85.50 | 85.55 |
| 84.25 | 85.30 | Sep 81 | 84.00 | 85.00 | 85.11 |
| 84.30 | 84.90 | Dec 81 | 84.01 | 85.01 | 85.03 |
| 84.23 | 85.75 | Mar 82 | 84.15 | 85.15 | 85.04 |

Total Sales: Thursday 35

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)

| -- Season -- | | Settle | | Open | |
|--------------|-------|--------|-------|-------|-------|
| High | Low | Price | Chg | Int. | |
| 75.08 | 68.08 | Mar 81 | 70.25 | 70.16 | 70.16 |
| 74.15 | 69.15 | Jun 81 | 71.06 | 70.20 | 70.26 |

Total Sales: Friday 25; Thursday 94
Total Open Interest: Thursday 425 + 80
Normal Daily Price Limits: 64-32 above or below prior settlement price.

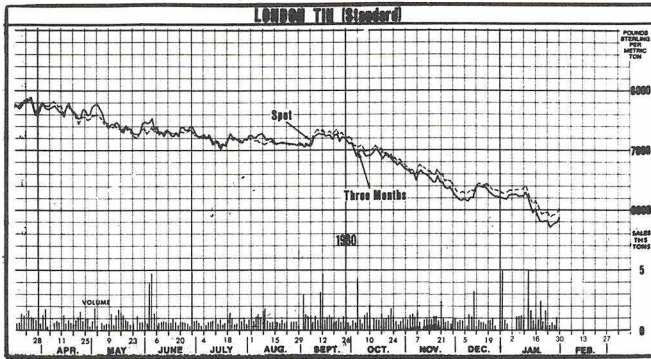
(Winnipeg trading)
Government of Canada bonds
20 years 10 per cent \$20,000 face value
(Fractions are 32nds of 1 per cent)

| -- Season -- | | Settle | | Open | |
|--------------|-------|--------|-------|-------|-------|
| High | Low | Price | Chg | Int. | |
| 79.20 | 78.12 | Jun 81 | 79.04 | 78.26 | 78.26 |
| 79.20 | 78.12 | Jun 81 | 79.04 | 78.26 | 78.26 |
| 79.20 | 78.12 | Jun 81 | 79.04 | 78.26 | 78.26 |

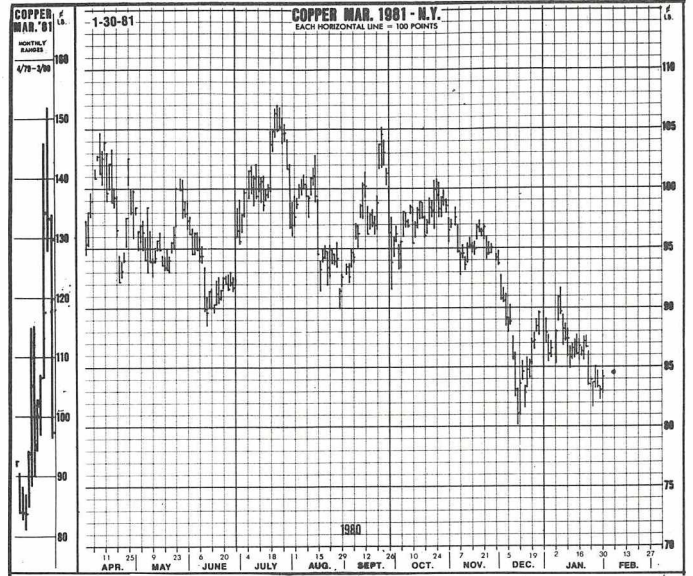
Total Sales: Thursday 12.

Potpourri

STRATEGY: Cover short position in Tin at market (see Commodity and Currency Comments November 26, 1980), with a profit of at least \$400/tonne... Stopped out of long position in Sugar and Corn, both with modest losses... Cover with small profits short position in March '81 Copper...



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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.
