FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

Hume Publishing March 29th, 1981

Further Musings on Gold

In our Feb. 8 *Commodity & Currency Comments,* we discussed gold's long cycle of undervaluation, a period that lasted from the early 60's right up to early 1980. We demonstrated that during these twenty years, substantially all newly-mined gold entered private markets, a sign of its relative 'cheapness." Throughout 1980, a partial reversal of this trend occured, and as much as 17% of new production was added to reporting (and unreporting) Central Bank coffers. Early 1981 returns indicate that this process is continuing. Figuring prominently is Indonesia's Central Bank which is reputed to have purchased approximately 250,000 ozs. per month. Little is yet known about OPEC countries, but it is likely that Iran and Lybia have been active buyers in the market. It is also believed that Mexico, Peru and Chile have continued their slow diversification out of dollars and into gold, among other international assets. The evidence, then, continues to bear on the view that gold is no longer 'attractively priced' in relation to the private markets' industrial and investment requirements.

There is yet another way to assess gold's relative overvaluation or undervaluation, namely, its feasibility for potential convertibility on an international scale.

The International Reserve position of the U.S. began to deteriorate rather dramatically in 1963 when, for the first time in the twentieth century, its liabilities to Foreign Official Institutions exceeded its gold reserves. Even though the pressure to resume full convertibility was never contemplated seriously by the U.S. Government, partial usage of the gold window, particularly by France, forced the U.S. to adopt, initially, a two-tier market in 1968 and later to close entirely the gold window (August 1971). By then, liabilities to Foreign Official Institutions exceeded gold reserves (at the official price of $35/oz.) by well over $40 billion.

From 1972 onward, the U.S. and the rest of the world operated on an inconvertible paper standard very similar to the one in effect following the U.S. Civil War until specie resumption in 1879. The one crucial difference, of course, was that in the 1863-1879 period, only the U.S. Greenback was inconvertible while the U.K. Pound and other continental currencies remained affixed to gold; in our most recent period, all major currencies floated against each other but were totally divorced from gold.

The hoped-for return to gold convertibility in the 1863-1879 period acted as an effective constraint on money-supply creation. Monetary base, controlled by Treasury currency and note issue, did not register any growth in that 16-year span; at the same time, money supply increased at a mere 1.1% per annum, primarily as a result of a rise in the public's preference for bank deposits over currency. Given extraordinary increases in output and productivity, prices declined almost uninterruptedly from 1867 to 1879, making possible specie resumption at the old Sterling (gold) parity.

Gold: Bear market rally.
Interest Rates: Confusion over monetary aggregates persists.
British Pound: The wrong prescription for a dying patient.
Copper: Keep Kemp-Roth alive, please.

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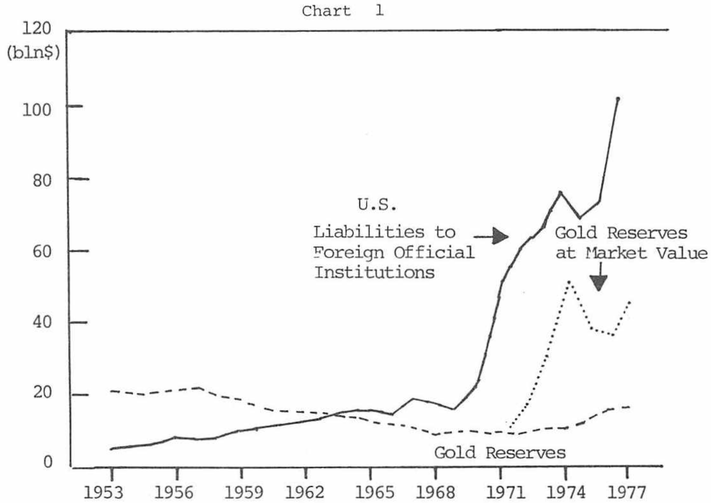
No such luck was in store for the 1970's. The (universal) inconvertible paper standard along with the political rejection of any serious hope for eventual convertibility allowed for money-supply increases well beyond the attainment of even a zero inflation rate.

Well then, reasoned the market place, if prices were not to return to a gold parity equal to \$35/oz., gold would have to 'match' the prevailing price level. In a limited way, convertibility *à la* Bretton Woods would require the U.S. to be able to redeem its outstanding external liabilities with gold. The 19th Century and early 20th Century gold standard did not allow prices in the U.S. to rise *over the long term* and concurrently, kept prices in line in all those countries that operated under the Gold Standard. The more lenient Bretton Woods version would force the rest of the world into line with the U.S. for better or for worse. The U.S. would still be able to export inflation (it did in the 50's & 60's) as long as other nations tied their exchange rate to the U.S. dollar and did not offset the expansionary impulse of a payments surplus.

A *de facto* resumption of convertibility was being imposed by the market place. Inevitably, a more realistic and flexible U.S. Administration would, sometime in the not-too-distant future, adopt a *de jure* convertibility.

Chart 1 depicts the private market's growing pressure to bring gold up to a convertible level. Up to 1974, external liabilities are represented by liabilities to Foreign Official Institutions. In order to present a more realistic picture, we have added the net asset position of the U.S. commercial banks and foreign subsidiaries to liabilities to Foreign Official Institutions in the belief that these claims can find their way rather easily into the hands of Foreign Official Institutions. We have, in fact, computed total short term U.S. external liabilites. It should be noted that, in recent years, U.S. commercial banks have moved rather dramatically to a net asset position, thus diminishing total short-term claims against the U.S. from 1974 onwards; therefore, we have added the net foreign asset position of commercial banks.

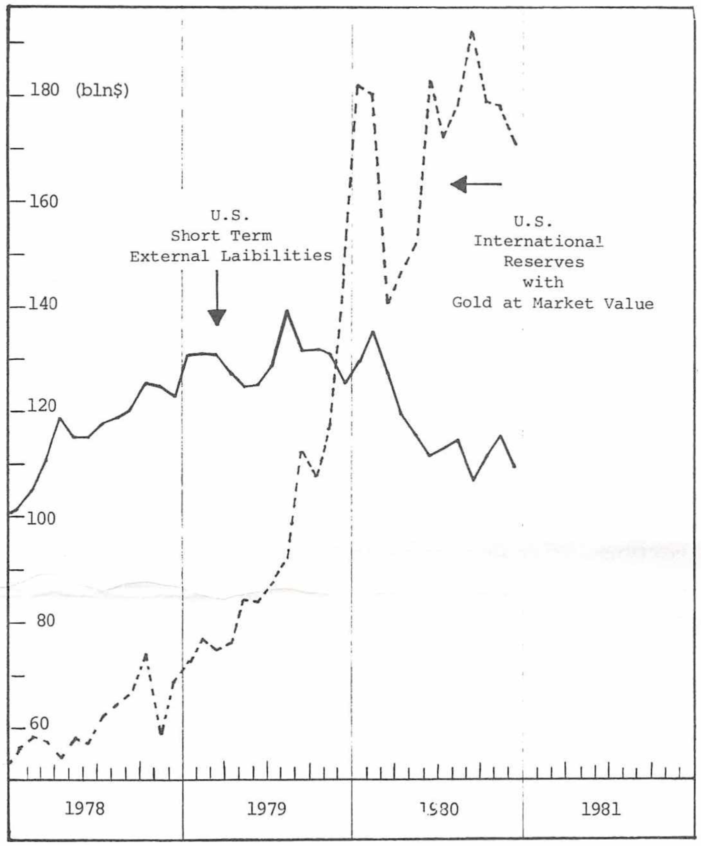
Chart 1



Sources : Board of Governors, Federal Reserve Sysgem
International Monetary Fund

Chart 2 compares the movement of these short-term liabilities in the 1978-1980 period to adjusted U.S. International Reserves. As can be seen, International Reserves adjusted by the market price of gold exceed short-term external liabilities by approximately \$63 billion, putting the U.S. in a comfortable *convertible position.*

Chart 2



Sources : Federal Reserve Bulletin
International Monetary Fund

We can now reverse the question and ask, "What is the lowest price that gold could command, given present U.S. external liabilities, for the U.S. to be in a position to resume full convertibility?" A very simple computation yields a price of \$355/oz. In effect, at \$355/oz., the U.S. would still be in a position to resume convertibility, assuming, of course, that U.S. external liabilities do not increase from these levels.

Having shown that Central Banks have begun to absorb ever-increasing amounts of newly-mined gold (a sign of 'dearness'), and that full U.S. convertibility can be achieved with as low a price as \$355/oz., we are forced to conclude that gold remains in a bear phase despite sporadic and dramatic rallies.

From a technical point of view, the upside penetration of the Sept. 1980 — Jan. 1981 downtrend line reflects an abatement of selling pressure that carries the potential of a move to \$610/oz. Short of a Soviet invasion of Poland and misinformed hysteria, we doubt that the market will attain this objective.

An invasion of Poland must be considered bearish for the following reasons: a) It would force the Soviet Union to sell bullion in order to finance war-related activities, and b) It may force German banks, faced with the increasing certainty of a write-off of their Polish loans, to sell readily saleable assets such as gold to meet large deposit withdrawals.

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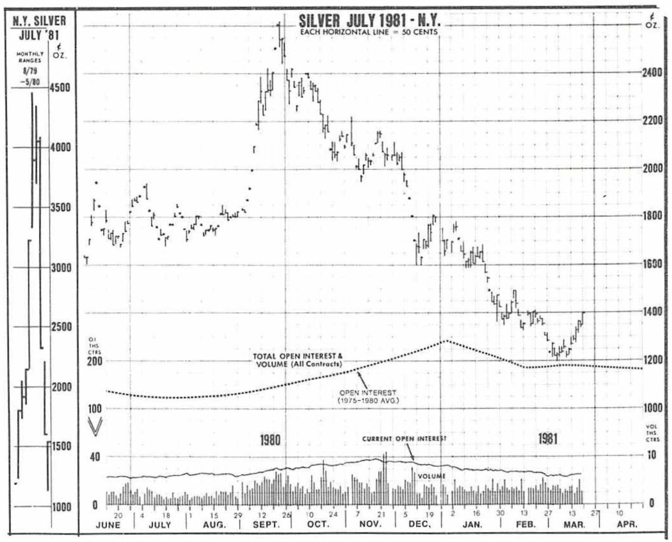

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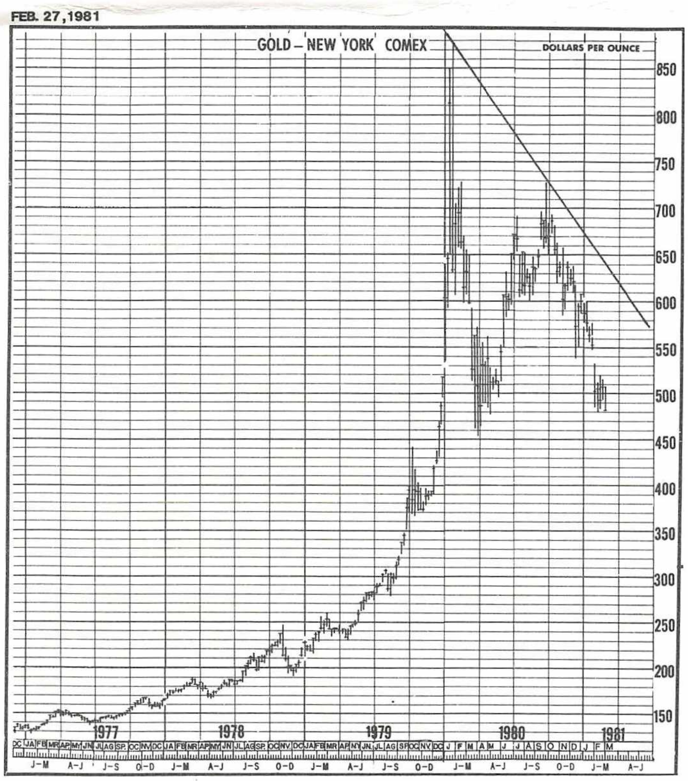

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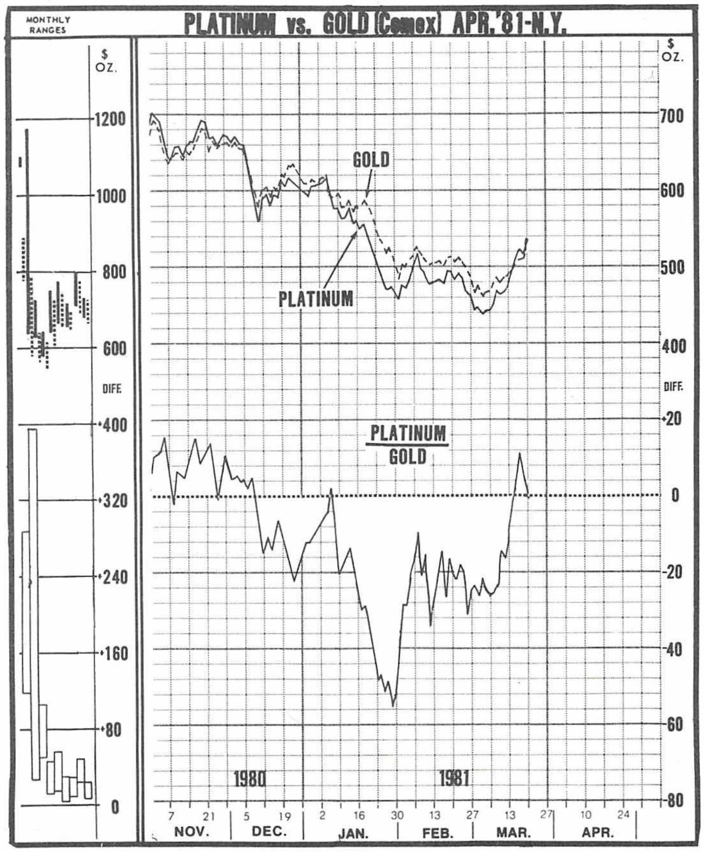
Will the 450 level act as a major support to this gigantic triangle, very much like silver's 1.55 base in 1969-1970-1971?

The 'obvious' 1.55 base is broken before the bull market resumes its advance. Will gold's 450 also be broken?



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STRATEGY: *Should a Soviet invasion occur and fighting develop, gold will initially rise and we would use the opportunity to sell into strength.*

GSA disposal of up to 139 million ounces of silver coupled with the ever-present threat of the Hunt block being sold should continue to act as a powerful depressant in the silver market. We remain sidelined.

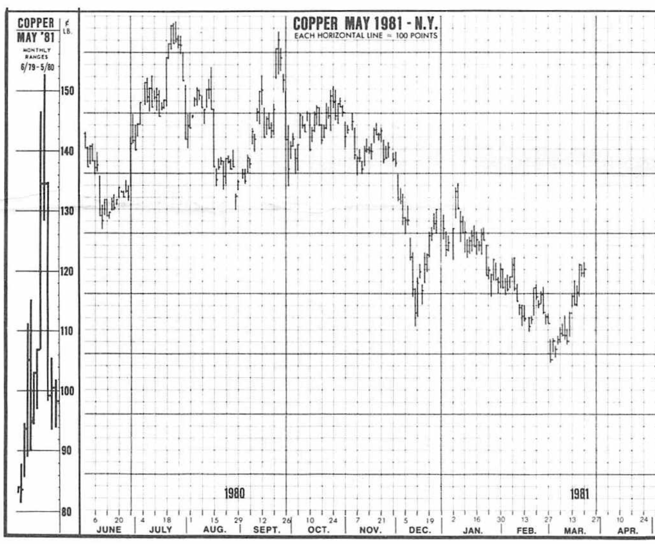
*Platinum's recent recovery **vis à vis** gold is due to hopes for a yet-to-be announced U.S. stockpile acquisition program. Prices, in our view, should resume their downward trend with the possibility of the re-emergence of a small discount to gold.*

Copper

Following our very bullish scenario of last month, we were stung by second thoughts. What if President Reagan's Kemp-Roth tax proposals are not enacted in their entirety? This probability has gained some credence in recent weeks given the House Ways and Means Committee chairman's opposition. Will the resultant fiscal drag on the economy — a direct result of inflation's effect on nominal incomes and their trajectory through unindexed tax brackets — cause it to slow down sufficiently to negate our consumption forecast? We think, yes. As a result, we are predicating our usage assumptions on the successful passage of the Administration's proposals.

Technically, the market's most recent advance has met stubborn selling in the 87¢ area basis May '81, and while open interest has expanded substantially, prices have refused to make any significant headway for at least six or seven trading days. On the other hand, warehouse movement continues to show a gentle decline on a twelve-week basis indicating that usage is already exceeding production levels.

STRATEGY: *Remain long but be prepared for substantial 300-500 point reactions. Only add to long positions if Reagan's tax proposals seem assured of being passed. Should the unthinkable come to pass and meaningful tax reductions are not passed, liquidate positions.*



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Copper Warehouse Stocks

(Combined N.Y.& LME)

	Total (Metric T.)	12-weeks rate of change
Jan.26/81	285,663	-0.45%
Feb. 2	286,165	-0.58
9	283,252	-0.86
16	282,096	+0.58
23	286,495	+3.08
Mar. 2	282,393	+1.07
9	281,867	-0.27
16	282,304	-1.36
23	277,492	-3.04

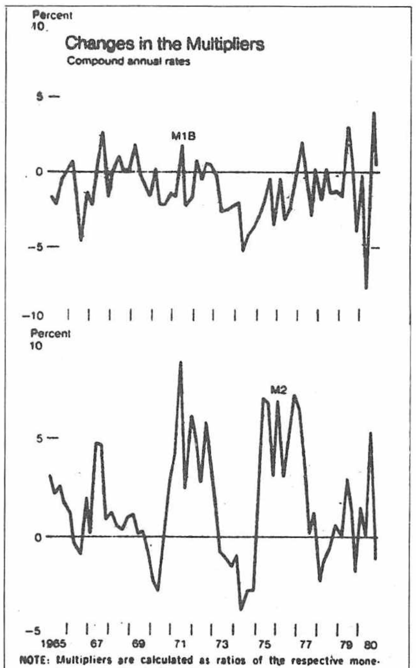
Interest Rates Futures

Lulled into a false sense of optimism regarding money-supply growth, short-term rates tumbled in March, falling from 14¼% to as low as 12¼% for 3 months Treasury Bills before upticking in the most recent week to the 13% level. After adjusting T-Bill rates to a coupon equivalent, 6 months T-Bills traded within 30 basis points of long term Treasuries — a remarkable flattening of the yield curve. The convergence of short- and long-term rates around the 12% level indicates the existence of a 'floor' below which rates are unlikely to drop.

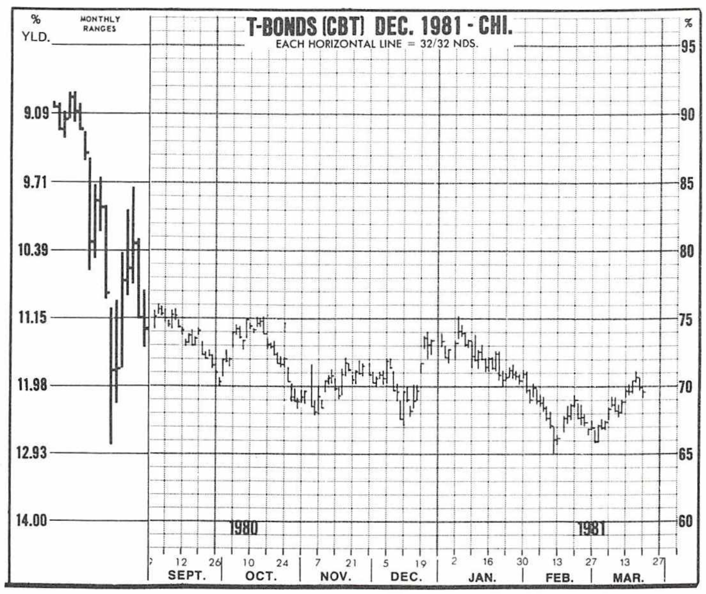
Money supply analysts continue to place heavy reliance on M_1B figures despite the fact that the spectacular growth of Money Market Mutual Funds demonstrates, beyond all probability, that these shares are, to a great extent, interchangeable with 'spendable' moneys such as NOW and ATS accounts. The speed of technological innovation in the banking and financial communities makes obsolete, in a very short time, any definition of money advanced by the Fed staff analysts. It is inconceivable that policy decisions of enormous importance such as the creation of money and the level of interest rates should rest upon such a frail and misleading indicator as M_1, M_A and now M_1B. Furthermore, as repeatedly pointed out in previous Comments, the M_1B and M_2 multipliers (see accompanying chart), the linking nexus to the Monetary Base (the Fed's control variable), are so erratic as to make them practically worthless in the conduct of week-to-week or even month-to-month policy.

Our view remains that differentiated reserve requirements, lagged reserve requirement accounting, an accommodating Discount Window, and the inexorable rise in Federal Reserve Credit *ensure* the System will create the amount of money demanded by the non-bank sector at below equilibrium rates, i.e. at artificially low rates of interest. Money-supply growth will, therefore, always be excessive except to those who have a myopic view of money supply.

STRATEGY: *We were stopped out of Dec. '81 T-Bonds short positions at 69.10 as per last month's suggestion. Our stop, based on chart considerations, underscores the futility of using these entry and exit points given the extraordinary volatility shown by the money markets in recent months. Furthermore, it means that much greater risks must be borne by interest rates futures traders. In line with this caveat, we suggest reinstating the short side of the Dec. '81 T-Bonds, placing stops at 71.20, and looking for a target somewhere between 54 and 60.*



NOTE: Multipliers are calculated as ratios of the respective monetary aggregates to the adjusted monetary base (consisting of currency and adjusted total reserves) as published by the Federal Reserve Bank of St. Louis. Plottings are quarterly.



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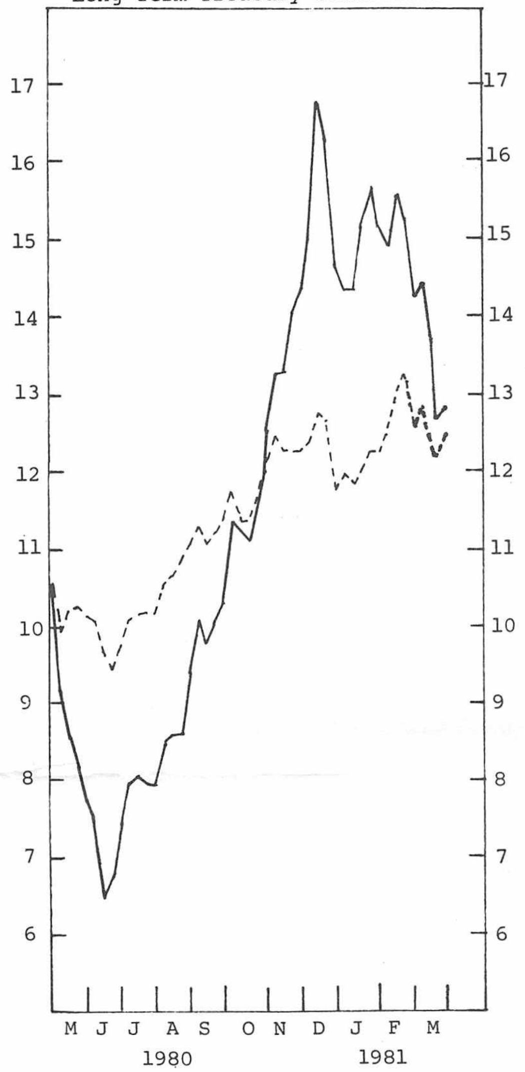
	Settlement Price	Yield
GNMA		
June 81	65 25	14.133
Sept.	66 00	14.080
Dec.	66 04	14.049
Mar. 82	66 07	14.027
June	66 08	14.019
Sept.	66 08	14.019
Dec.	66 07	14.027
Mar. 83	66 05	14.042
June	66 03	14.057
Sept.	66 01	14.072
Dec.	65 31	14.087
T. Bonds		
June 81	65 17	12.821
Sept.	66 02	12.716
Dec.	66 13	12.649
Mar. 82	66 22	12.595
June	66 29	12.553
Sept.	67 01	12.529
Dec.	67 04	12.511
Mar. 83	67 07	12.494
June	67 10	12.476
Sept.	67 13	12.458
Dec.	67 16	12.440
T. Bills		
June 81	88.11	11.89
Sept.	88.72	11.28
Dec.	88.82	11.18
Mar. 82	88.76	11.24
June	88.68	11.32
Sept.	88.59	11.41
Dec.	88.52	11.48
Mar. 83	88.50	11 50

U.S. Interest Rates

3-month Treasury Bill ——

Long-Term Treasury Securities - - -



CANADIAN FUTURES CONTRACTS

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

Season High	Season Low		High	Low	Settle Price	Ch'ge	Open Int.
97.290	96.125	Jun 81	96.430	96.400	96.400	-.065	36
96.675	96.200	Sep 81	--	--	96.525	-.050	3
96.725	96.585	Dec 81	--	--	96.575	-.075	3

Sales: Friday 5; Thursday 5
Total Open Interest: Thursday 42 N-C
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 High	Season Low		High	Low	Settle Price	Ch'ge	Open Int.
86.20	84.17	Jun 81	85.06	85.01	85.01	-.36	,16
86.80	84.97	Sep 81	--	--	85.75	-.20	5
87.78	84.90	Dec 81	--	--	85.95	-.08	4
87.75	85.69	Mar 82	--	--	86.25	-.15	-

Total sales: Thursday: 0

MID-TERM GOVERNMENT OF CANADA BONDS
4-6 Year 9% $50,000 Princ.; Price is % of Par Value
(Fractions are 32nds of 1%)

Season High	Season Low		High	Low	Settle Price	Ch'ge	Open Int.
85-10	82-21	Jun 81	--	--	--	--	-

Sales: Friday 0; Thursday 0
Total Open Interest: Thursday 0 N-C
Normal Daily Price Limits: 64-32 above or below prior settlement price.

GOV'T. OF CANADA BONDS
(Combined Toronto-Montreal trading) — 18 Year
9 per cent $100,000 principal; price is per cent of par value (Fractions are 32nds of 1 per cent)

Season High	Season Low		High	Low	Settle Price	Ch'ge	Open Int.
74-15	67-12	Jun 81	68-16	67-24	68-01	+01	221
71-02	68-04	Sep 81	--	--	68-09	+03	29

Sales: Friday 29: Thursday 110
Total Open Interest: Thursday 250 +10
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 High	Season Low		High	Low	Settle Price	Ch'ge	Open Int.
79-20	73-02	Jun 81	74-20	73-02	74-02	-100	30
79-20	74-14	Sep 81	--	--	74-14	-30	1
79-15	75-15	Dec 81	--	--	76-00	-18	-
79-30	75-28	Mar 82	--	--	76-16	-21	-

Total sales: Thursday: 0

Currencies

British Pound

". . . the burden of income tax and excise duties has to rise, in order to secure lower interest rates and then improve the prospects of industry and employment."

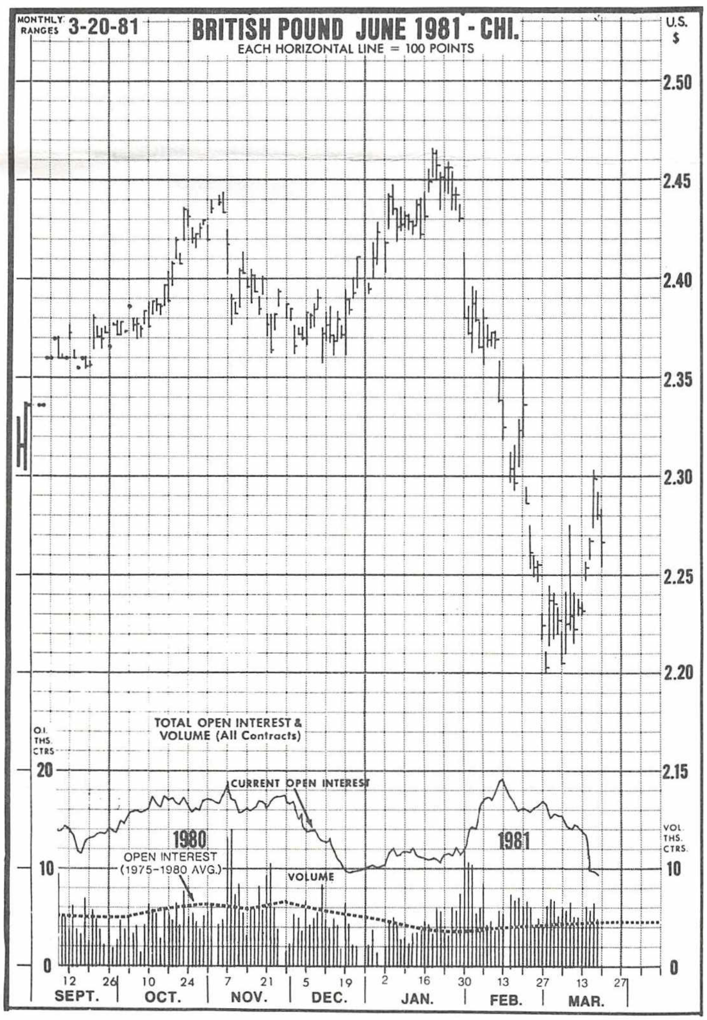
With these historic words, Sir Geoffrey Howe, Chancellor of the Exchequer, set out to reverse permanently what was termed the most exciting economic experiment in the past twenty years to happen anywhere in the industrialized world.

The Public Sector Borrowing Requirement was forecast to emerge at £13.5 billion (6% of Gross Domestic Product), £5.0 billion higher than anticipated in the 1980 budget. Although much of the excess was accounted for by the higher unemployment benefits, there was also a net shortfall of tax revenues of about £1 billion with receipts from indirect taxes and North Sea oil falling below expectations. The latter was predicted by us simply on the basis of the burdensome increase in taxes outlined in November 1980. The Government's response was, once again, insane: If revenues fall, why not put through a more effective increase in taxes? And so, the new Supplementary Petroleum Duty was put in place — a ta: that would raise an extra £1 billion in 1981-82. The Chancellor tinkered with reliefs to raise additional revenues and to make PRT conditions more onerous on the industry. Little wonder that oil production was kept down to about 1.6 mbd. in 1980 as against the 2.0 mbd. expected a few years ago! Shell UK, one of the leading North Seas oil operators,said that this year it was facing a cash deficit on its total operations and that the additional tax would have to be met by a reduction in capital expenditure and by increased borrowings.

United Kingdom: Budget
(billion pounds)

General Government Expenditure	1979/80	1980/81	1981/82	1982/83	1983/84
General government expenditure at 1980 survey prices	77.9	79.0	79.5	78.0	76.5
			(at 1979/80 prices)		
General government expenditure in cost terms	77.3	79.5	79.5	78.0	76.0
Special sale of assets	−1.0	−0.5	—	—	—
Shortfall, etc.	—	—	−0.25	−0.25	−0.5
National accounts adjustment	2.9	2.5	2.0	2.0	2.0
Interest payments	9.6	10.0	10.0	10.0	10.0
Total expenditure in national accounts terms	**88.8**	**91.5**	**91.5**	**90.0**	**87.5**
General Government Receipts[1]	1979/80	1980/81	1981/82	1982/83	1983/84
			(at 1979/80 prices)		
Taxes on income, expenditure, and capital	60.9	61.0	64.0	65.0	66.0
National insurance, etc.	12.0	12.5	12.5	13.0	13.0
Interest and other receipts	5.5	6.0	6.0	6.0	6.0
Total receipts	**78.4**	**79.5**	**82.5**	**84.0**	**85.0**
North Sea tax revenues[2]	2.3	3.25	4.5	4.75	5.25
Public Sector Borrowing	1979/80	1980/81	1981/82	1982/83	1983/84
			(at 1979/80 prices)		
Total general government expenditure	88.8	91.5	91.5	90.0	87.5
Total general government receipts	−78.4	−79.5	−82.5	−84.0	−85.0
Implied fiscal adjustment	—	—	—	1.0	2.0
General government borrowing requirement	**10.4**	**12.0**	**9.0**	**7.0**	**4.5**
Public sector borrowing requirement	**9.9**	**11.5**	**8.0**	**6.5**	**4.0**
			(percentage)		
PSBR as percentage of GDP at market prices	5.0	6.0	4.25	3.25	2.0

[1] Converted to 1979/80 prices using the deflator for GDP at market prices.
[2] Royalties; supplementary petroleum duty (from 1981/82); petroleum revenue tax; and corporation tax from North Sea oil and gas production (before advance corporation tax set-off).
Data: U.K. Financial Statement and Budget Report, 1981/82



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It should be noted that the UK Government greatly benefited from the sharp increase in oil prices which acted to offset the slowdown in real outturn. As an example, at the end of 1979, the "Forties Field" reference crude was being sold for $26.02/barrel compared to the present $39.25/barrel. If we assume that oil prices will remain at present levels for the next 18 months, and that output, as a result of the new taxes, will stagnate at 1.6 mbd., Government revenue estimates of £5.88 billion for 1981-82 may be off by as much as £1.5 billion.

Sharp increases on alcoholic beverages, tobacco, gasoline and vehicle excise taxes may create a substantial black market in these items, negating part or all of the Government expectations of a £2.4 billion increase in revenue.

On the expenditure side, the Chancellor seems to have engaged in wishful thinking when he outlined a 4% reduction in Government spending for the 1982-1984 period. Large numbers of policy areas are bracketed together as targets for yet-to-be announced specific cuts.

The *coup de grace* came last week when the Industry Secretary, Sir Keith Joseph, announced that the Government was throwing its financial support, to the tune of £200 million, behind privately controlled ICL just because there are a lot of ICL computers in Whitehall. British Steel and BL may have been unavoidable, but ICL . . .?

It is clear that the Government's fiscal drag will become so intolerable that private markets will only be revived via a super-expansionary monetary policy, which, in turn, will collapse Sterling.

STRATEGY: We have confirmed our worst suspicions: The UK is on the way to runaway inflation and stagnating output. Interest rates and Sterling will become the focal point of salvation in a futile attempt to recover lost ground.

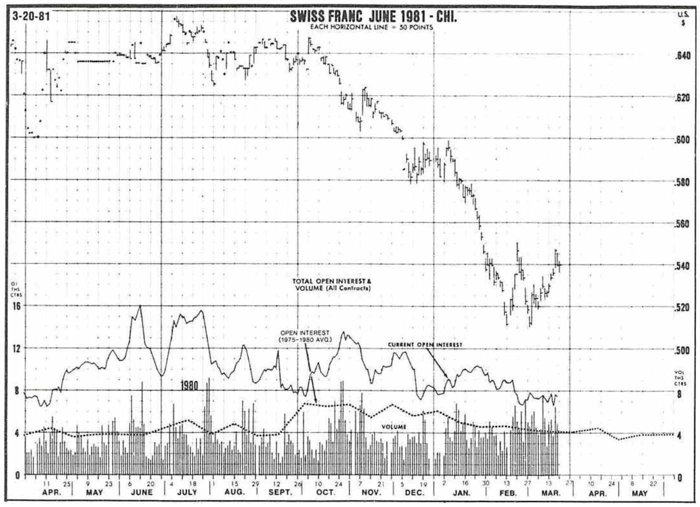
Add to previously established short positions.

DM/SF

A renewed decline to new lows has become a distinct possibility as the political tension in Poland induces unfavorable short term capital flows.

STRATEGY: Light short positions are indicated at this time, placing protective stops at 54.75 basis June '81 SF and 49.25 basis June '81 DM, close only.

A more aggressive short position can be taken should June '81 SF and June '81 DM break early-February lows.



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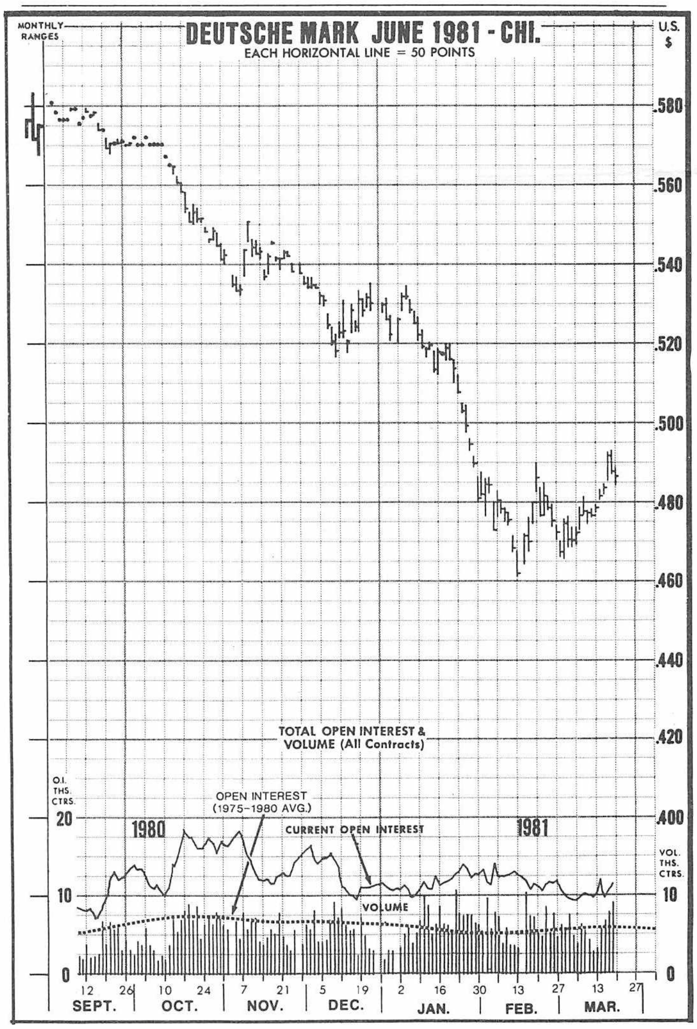

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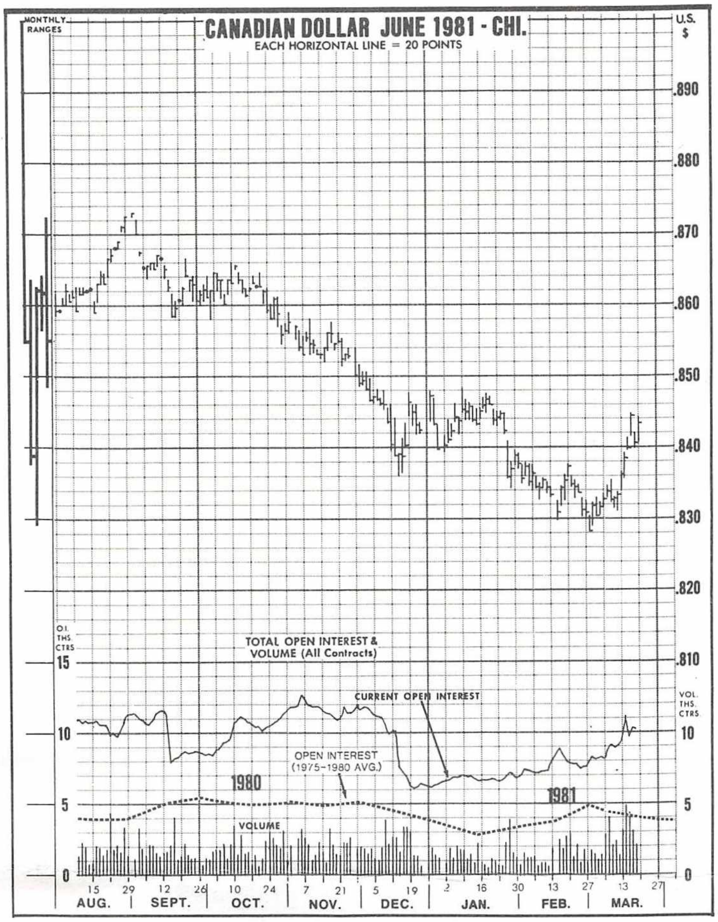
CD$

Short-term negatives remain: the energy impasse between Alberta and the Federal Government and the potential Quebec expropriation of Asbestos Corp., majority-owned by General Dynamics. On the plus side, short-term rates remain widely in favor of Canada with 3 months T-Bills differentials at better than 300 basis points.

STRATEGY: We remain neutral on the CD$. Nevertheless, given the necessity to maintain favorable interest rates differentials, ***vis à vis*** *the U.S., we continue to like the short side of the June '81 Canadian Treasury Bills now trading at a yield of 14.98% versus the current yield of 16.34%.*



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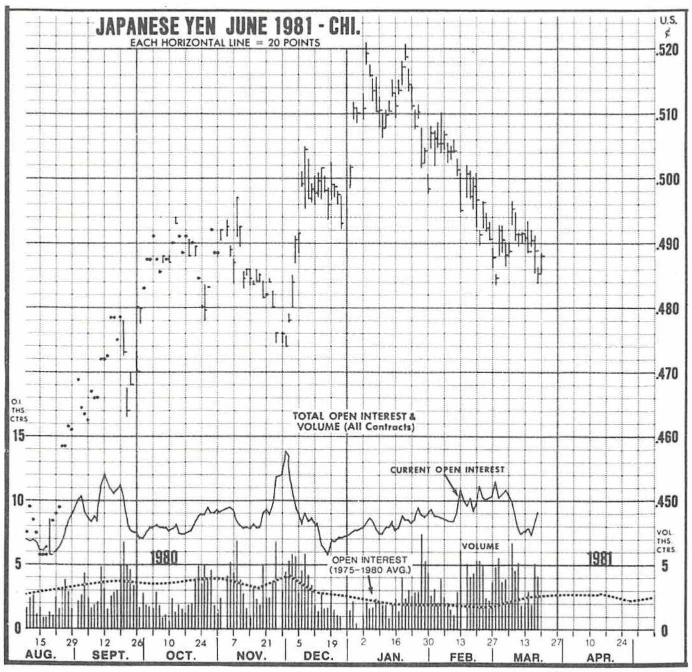

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Balance of Trade	Feb.81	Jan.81	Dec.80	Feb.80	Jan.80
U.K. (Bln Stg)	+.314	+.742	+ .246	-.226	-.320
C.D. (Bln CD$)		.681	.670	+.782	+.317
D.M. (Bln Marks)	+.864	-.923	1.01	-.46	.342
J.Y. (Bln US$)	+1.48	-1.47	2.39	-.187	-2.38
SFr. (Bln Francs)	-.784	-.388	- .880	-1.11	- .920
Current Account					
U.K. (Bln Stg)	+.614	+1.04	+ .346	-.176	- .296
D.M. (Bln Marks)	-1.6	-5.1	- .7	-2.2	-2.41
J.Y. (Bln US$)	- .060	-2.83	1.18	-1.25	-3.37
Overall Account					
D.M. (Bln Marks)		- .845	-.675	-3.39	-3.88
J.Y. (Bln US$)	+.660	- .048	+.4	-.84	-2.22
Reserves					
U.K. (Bln US$)	28.43	28.39	27.43		
C.D. (Bln US$)	3.341	3.436	4.03		
D.M. (Bln Marks)	61.0	67.1	67.04		
J.Y. (Bln US$)	26.68	26.5	25.23		
SFr. (Bln Francs)	20.96	21.72	27.36		
Cost of Living/C.P.I.				Feb.81/Feb.80	Jan.81/Jan.80
U.K. (1974 base)	279.8	277.3	275.6	12.46	13.05
C.D. (1971 base)	226.4	224.1	221.3	12.19	11.99
D.M. (1976 base)	121.3	120.5	119.3	5.57	5.98
J.Y. (1975 base)	141.4	141.3	139.6	6.48	7.37
SFr. (1977 base)	113.1	112.0	110.9	6.00	5.16
W.P.I.					
U.K. (1975 base)	211.8	209.6	206.6		11.19
C.D. (1971 base)		261.1	257.5		9.71
D.M. (1976 base)	121.9	120.3	119.2	5.81	5.71
J.Y. (1975 base)	132.1	132.3	133.0	3.85	6.69
SFr. (1963 base)	161.8	160.6	158.9	5.34	4.97
Unemployment Rate					
U.K. (Mar.81:9.9)	9.6	9.3	9.3		
C.D.	7.2	7.3	7.4		
D.M.	5.6	5.6	4.0		
J.Y.	2.2	2.2	2.1		
SFr.	0.2	0.3	0.2		

Mexican Peso

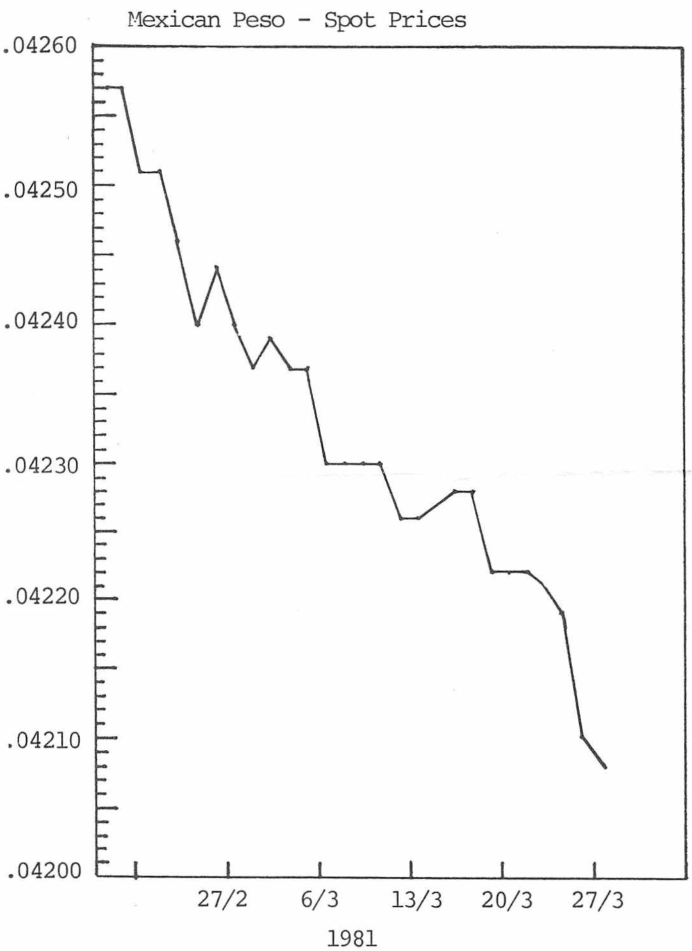
Mexico continues to enjoy triple A credit status in the world money markets as evidenced by the request made by PEMEX to Bank of America to increase its funding facility to $3.5 billion from $2.5 billion. What is noteworthy is that, despite gigantic increases in production, exports and consequently, cash flow, PEMEX still requires net foreign borrowings of over $2 billion to be used for development and to fund imports and exports. Furthermore, gross borrowing requests will amount to *at least* $3.5 billion, an indication that gas and oil earnings are not making any dent in the present debt structure. Where do the $12 billion in oil and gas foreign earnings go? To finance other imports, of course.

While on the subject of other imports, we note that last week the Mexican Government prohibited the further importation of luxury items so as to 'alleviate' the intolerable deficit on current account. This desperate measure will clearly not succeed but may be followed by further protectionist moves that will begin to alarm the complacent private sector.

Finally, the Spot MP has fallen in the month of March (up to and including March 27th) approximately .8%, roughly in line with our guesstimate that the Bank of Mexico has adopted, *for the time being,* a 1% per month crawling devaluation.

STRATEGY: The current account deficit is widening and a foreign-exchange crisis is looming. The game is not up yet because multinational banks are either too naive or are trying to protect their massive prior loans.

Sell deferred MP positions (March and June '82) with impunity; risk, in our view, is $3,000 per contract, reward is at least $15,000 per contract.



Cotton

The market intrigues us once again. Cotton's persistence during the depressing months of December, January and February — months when virtually all markets lost substantial ground and the overall Commodity Research Bureau Index lost 12.0% — has left the market in what appears to be a strong technical position. In contrast to other markets which did describe clear bear phases, cotton has no major downtrends to break; rather, the trading range of the past three months delineates a quite attractive-looking base. This is especially clear in the new crop months which begin with October, though noticeable too in the charts of the May and July '81 deliveries.

Cotton's fundamental picture is as follows: Production for the current crop year which began last October 1st is understood to total around 11.1 mln. bales (there are 480 pounds to a bale). This amount contrasts with 1979/80 production of 14.6 mln. bales and resulted from the severe drought that damaged many crops in the United States last summer. Of the record high 14.5 mln. acres planted, only 13.0 mln. acres were harvested, which means a record high percentage of the crop had to be abandoned. Of much greater significance was the fact that yields were reduced to only 411 pounds per acre. The previous year's yield across the U.S. had averaged 546 pounds per acre; the average yield is about a bale per acre. Since last year's consumption was unexpectedly high, 1980/1981 beginning stocks were down to what is generally considered to be the beginning of the danger level: 3.0 mln. bales. Total supply for the current crop year is thus calculated at 14.1 mln. bales.

Last year, usage buoyed by a surprising-at-the-time increase in exports to a record 9.2 mln. bales. The surprise came about because the People's Republic of China continued to buy relentlessly throughout the year. Mill consumption last year was an average 6.4 mln. bales. This year the PRC has undertaken an austerity program to improve its balance of trade position which is in deficit, as well as to cultivate more cotton than it did last year.

As far as other importing nations are concerned, the world crop outside the U.S. and the high U.S. dollar coupled with the nominally high prices for cotton that prevailed throughout the early part of the current crop year have served to limit exports. Projections for exports are 5.7 mln. bales. Domestic mill use has suffered with the economy and is expected at 5.8 mln. bales. Despite the decline in disappearance, a deficit will be unavoidable and year-end stocks are expected to fall beneath last year's dangerous 3.0 mln. bales to 2.6 mln. bales.

Looking ahead to next year, the USDA, in its plantings report of two weeks ago, projected acreage given to cotton in the upcoming 1981/82 year to total 14.4 mln. acres or just beneath what was planted this year. Projections of next year's world crop are not as important at this stage as those of the domestic crop because they are subject to such greater variation. Nevertheless the USDA estimates that world acreage could increase by about 3%.

The foregoing are statistics that are known by every conscientious trader in the cotton market and thus will aid us little in forecasting price movement over coming months. It behooves us, then, to search for any clues that may upset the given data.

Since the current year's crop was harvested in the fall, production for 1980/81 is pretty well calculated and unlikely at this point, five months after the harvest, to be revised. Disappearance however is a much less easy number to quantify. The pace of domestic usage and of exports can and will vary throughout the marketing year depending upon a host of variables impossible to know at any fixed point in time. That disappearance is so subject to revision, or so much less quantifiable than supply, is the major reason bull markets more often than not evolve from "demand" markets.

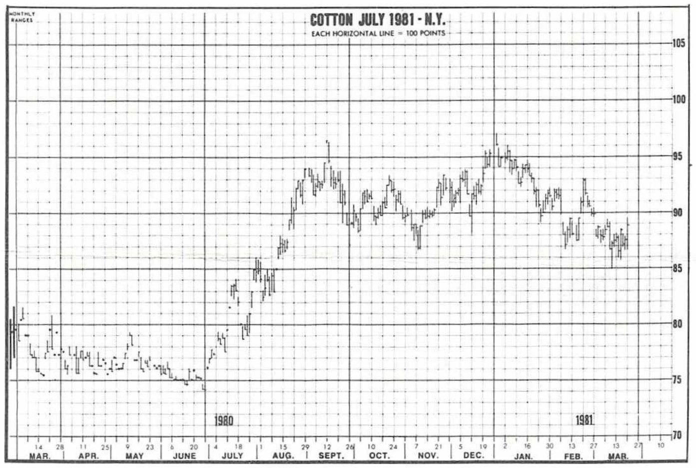
We are of the opinion that the economy is not as weak as is generally perceived. By "generally perceived" we mean by comparison to other newsletters we read. We see a resilient economy growing stronger as the year progresses. The economy impacts upon cotton in the retail sales area primarily and secondarily in housing, as fibre is required in carpeting, drapery, etc. Retail sales have shown strength that is expected to continue. The outlook for housing is, at worst, due for no further deterioration. Although we would prefer not to offer precise numbers, it would not surprise us if domestic mill use were to be 100,000 bales better than projected by the USDA.

On the export side, the most noteworthy data shows that the pace of commitments has already exceeded the USDA projection of total exports by 300,000 bales. This is not as bullish as it might appear to the uninitiated, as commitments to export are easily and often rolled forward into the subsequent marketing year. However, actual exports now total 3.7 mln. bales. This is 64% of the projected total with still seven months in the current marketing year left. The pace of both sales and commitments as a percentage of USDA projections, compared with last year's pace as a percentage of the actual total (9.1 mln. bales), is much higher than at this time last year. On balance, it is safe to conclude that exports are robust and a revision upward would not surprise us. A hidden potential bonus on the export side exists too, in that the PRC, traditionally inscrutable, could return to the market and tip the scales decidedly to the bull side.

Although the above relates more to the old crop than to next years', there is a correlation. The cost of producing cotton this year is estimated at $350 per acre or 95¢ per pound. Assuming a basic inflation of 12%, we assume next year's crop will cost $390 per acre to produce. Making a further assumption that next year's yield will be a normal one — and at this point the market cannot assume otherwise — production costs on a per pound basis would be 81.25¢. Last year at this time, production costs were assumed to be 73¢ per pound. The then new crop October '80 contract opened at around the 69-70¢ mark and never fell beneath it.

In addition, and as alluded to at the outset, there is strong technical support at the 81.00 mark basis December '81. Completing the technical picture, one would be remiss in not noting the large drop in open interest from 37,500 contracts to 26,640 contracts during the past six weeks, a decrease of nearly 30%. This would strongly suggest that the long position is no longer in the hands of weak, small speculators.

CONCLUSION AND STRATEGY: *Long positions are warranted. Greater potential in old crop July. Market can easily retest high of 97.00. Place stops at 84.50, on close. Reward potential remains muted until growing season of new crop gets under way. However, the limited risk makes purchase of deferred positions attractive for the patient and conservative.*



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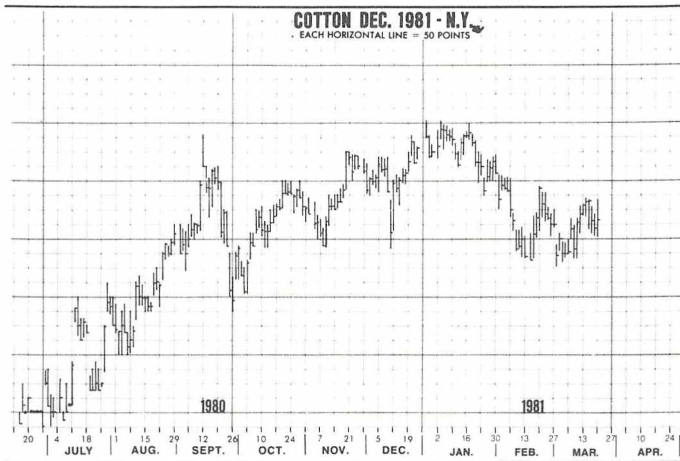

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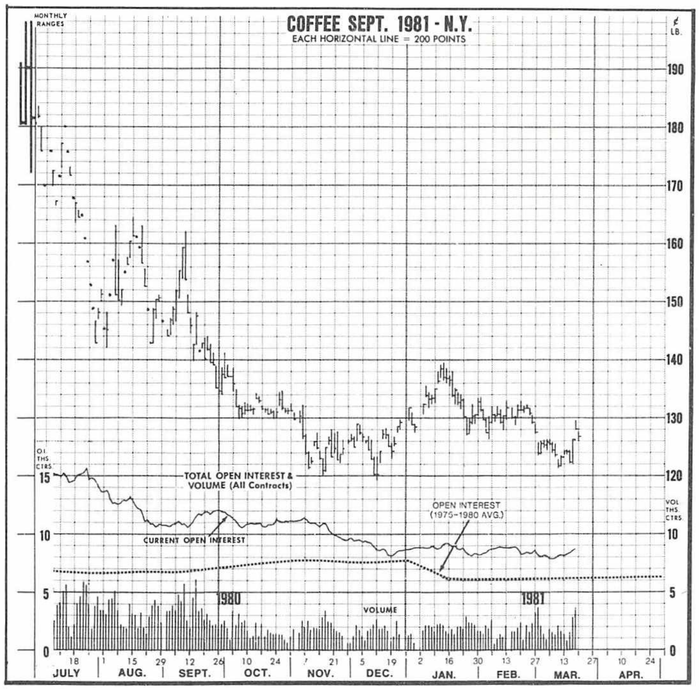
Coffee

There is little of either a fundamental or technical nature that would influence us to alter our strategy outlined in last month's Comments. The market has shown gentle upward bias but has yet to penetrate the upside of prevailing trading ranges. This is especially true of the London Robustas market.

***STRATEGY:** We remain comfortable with our generally bullish outlook and still advise assuming September call options in London.*



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