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Betting Against the Pundits

A successful contrarian must do five things:

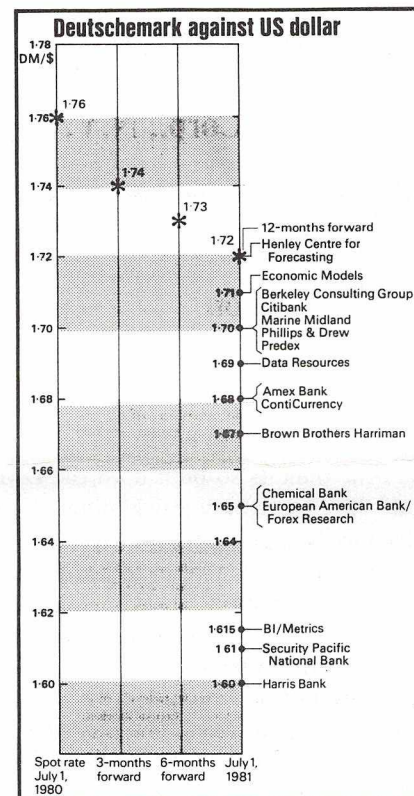
- a) bet against the pundits;
- b) bet against unanimity;
- c) look for a market's puzzling divergence from the pundits' unanimous views;
- d) capitalize on the pundits' misconceptions;
- e) be visionary and, above all, a loner.

Let us study a classic case. On July 1, 1980, the DM was trading at DM1.76 to the U.S. dollar (= .568c U.S.). *Euromoney* magazine polled the world's leading foreign exchange traders for a one-year forecast (Figure 1).

Note that *not one single pundit* expected the DM to fall *vis à vis* the U.S. dollar by July 1, 1981. Thus far, conditions (a) and (b) are fulfilled.

Next, look at the accompanying long term DM chart (Figure 2). On July 1, 1980, the DM was "laboring" under the late 1979 peak of .5975 and the late 1978 peak of .5850, a clear warning that upside momentum had been lost. Why, one may have naively asked, was the DM sluggish if *everyone* expected it to be substantially higher one year later? A "puzzling" divergence, one may call it, and condition (c) is fulfilled.

Figure 1



Reprinted from *Euromoney* magazine.

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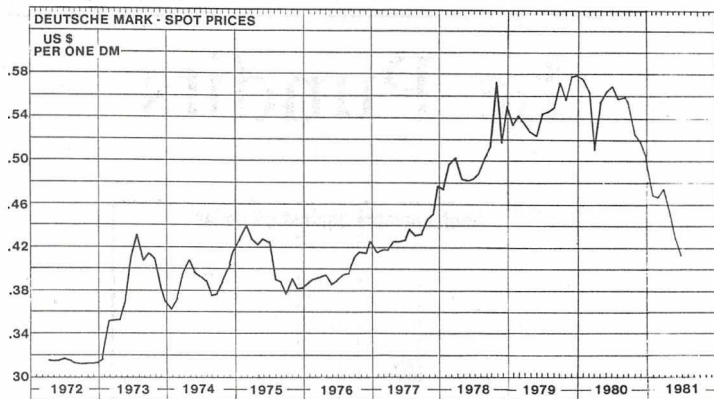
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Figure 2



Why were the pundits so bullish on the DM? Primarily, as the *Euromoney* article pointed out, because the trade balance was going to improve as the U.S. economy gained speed (which, incidentally, it did) and because Germany's inflation rate was still relatively low.

West Germany's trade performance could no longer be influenced by growth differentials given the DM's extraordinary level of *overvaluation*. On Sept. 1, 1980, we compared the rise of West Germany's consumer prices since 1972, *expressed in U.S. dollars*, with the rise in the U.S. CPI for the same period, and concluded that the DM was overvalued by at least 28 per cent. This overvaluation was responsible for turning West Germany's current account surplus of DM16.2 billion in 1978 into a deficit of DM9 billion in 1979 and a deficit of DM12.3 billion for just the first 6 months of 1980. Furthermore, a low rate of *price* inflation does not guarantee a steady value for the currency if *monetary* inflation is excessive, as it clearly was in Germany during 1978, 1979, and the first half of 1980. Hope springs eternal, and the pundits were merely extrapolating yesterday's perceived cause and effect actions. But to the contrarians's delight, these perceptions were incorrect, and consequently their analysis was faulty. Condition (d) comes into place.

As the spot DM ticked .5680, could you have envisioned a diametrically opposed target, say, .4200? Maybe. Would you have been ridiculed? Certainly.

But you would have become a successful contrarian.

The point of this exercise is not to ridicule the superbly-paid foreign exchange prophets, but to draw

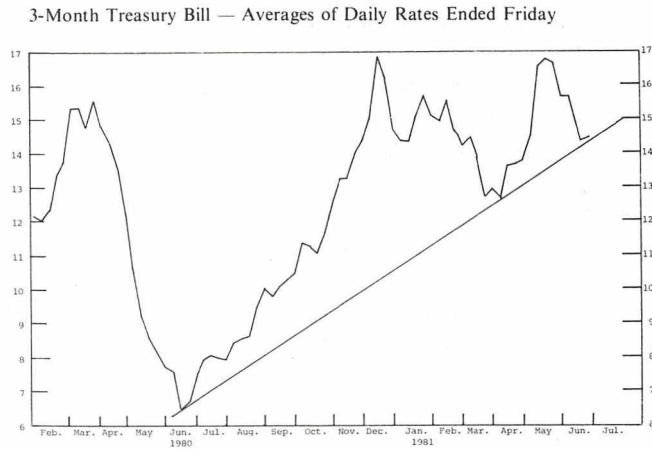
some very worthwhile parallels to the present interest rate scenario.

Consider the following. On June 22, 1981, *The Wall Street Journal* quoted some respectable money market analysts, euphoric that on the previous Friday the Fed had released M₁B figures showing a modest \$500 million rise. "There is *absolutely* no doubt in my mind that rates are coming down," said Cengiz Isradil, a vice-president of Morgan Guaranty Trust Co. of New York (*italics ours*). And "the funds rate will come down to the 15 to 16 per cent range" by July, predicted Wayne Lyski, another vice-president at Morgan Guaranty. "The fundamentals continue to argue for lower rates," agreed Ted Gibson, a senior economist for San Francisco's Crocker National Bank. David Jones, an economist for Aubrey G. Lanston, predicted that as credit demands weaken, the prime rate could fall to "as low as 15 per cent by the end of September."

Even while money market rates were "stabilizing" at the 13.50 to 14.25 per cent rate for three month Treasury bills and 18.5 to 19 per cent for Fed Funds, euphoria persisted. On June 29, 1981, *The Wall Street Journal's* opening statement on its credit comments was quite reassuring: "Some advice to companies considering major debt offerings soon: wait a while. Interest rates are heading down this summer." Very typical of the consensus opinion, Gordon B. Pye, a senior vice-president of Irving Trust Co. said, "The best strategy would be to defer any long-term borrowing plans . . . inflationary expectations are coming down and the Federal Reserve is getting better control over the money supply . . . the trend in interest rates is definitely down." Morgan B. Stark, a senior vice-president of Chemical Bank, agrees. Companies will be able to borrow long term funds at significantly lower rates if they wait "about 60 to 80 days, and maybe longer . . . Yields in long-term Treasury bonds, currently just over 13 per cent, may fall to about 11.5 per cent and maybe further." Echoing the same theme, Richard B. Hoey, chief economist of Bache Halsey Stuart Shields Inc., said that "the downward revisions in the money supply, combined with emerging signs of weakness in economic activity, imply that the expected decline in interest rates is likely to occur soon."

Once again, conditions (a) and (b) are present. The pundits are (nearly) unanimously voicing their bearish outlook for interest rates. What about condition (c), the market's puzzling divergence from these expectations? Well, it's been two weeks since Fed Funds were supposed to have caved in to 15 to 16 per cent; yet rates persist in the 19 per cent range, with extremes of 23 to 30 per cent on Wednesdays, settlement day. Furthermore, yields on three month T-bills (see Figure 3) have held just above their June '80 to April '81 uptrend, despite the continuous barrage of favorable news, such as moderate M₁B numbers, collapsing commodity prices, and sluggish real economic activity. Condition (c) is therefore also present.

Figure 3



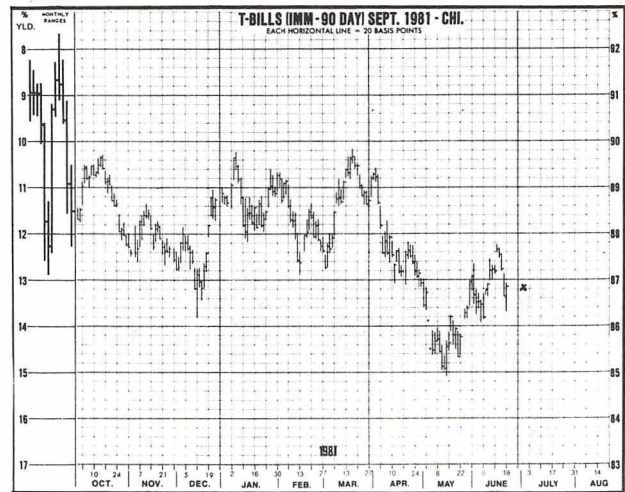
Could it be that these pundits are misreading the signals? We think yes. In the first place, modest growth in M_1B numbers is merely accidental. Given the 7.3 per cent year-over-year growth in Federal Reserve credit, it is only a matter of time before M_1B grows, once again, at a 7 to 8 per cent rate. The "accident," as we have pointed out many times in the past, has to do with shifting portfolio preferences. Transactional balances do not earn interest, and as a result, true rates of monetary expansion can only be captured in the broader aggregates. The Fed has already hinted that it may begin to pay closer attention to M_2 , a measure that will surely show a larger-than-expected rate of growth for June (figures are expected early next week). Furthermore, the extraordinary rate of growth on short-term business credit demands since April (an annual rate of 30 per cent) shows that historically high interest rates are still not sufficiently high to ration out loan demand. On a day when leading indicators were down 1.8% per cent, substantially above the expected 1 to 1.5 per cent number, short-term money market rates turned down.

Modest M_1B numbers do not matter. Collapsing commodity prices do not matter. Attractive real rates of interest (to tax exempt institutions, at least) do not matter. We are in the throes of a liquidity squeeze, one that has been postponed for too long. Why else would banks have to scramble for funds and pay exorbitant rates on settlement day? Why else would there be such an insatiable appetite for credit if business conditions were not favorable? The contrarian is ready to capitalize on the Street's misconceptions.

But he has to be a loner. He must play without stops, ready to be ridiculed by the conventional bankers and theorists. And he must also be a visionary. How about 19.5 per cent for three month T-bills, 15 per cent for long-term Treasuries, 25 per cent for prime . . . by Sept. '81?

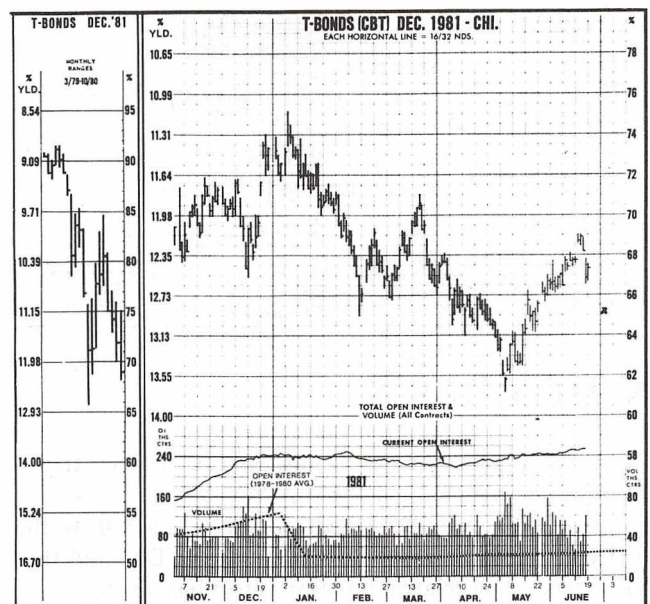
STRATEGY: Remain firmly short Sept '81 T-bills and add on closes below 86.00 and 84.75. Our target is 80.50; risk a close above 87.80, a price it won't reach, in our opinion.

Figure 4



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Figure 5



Reprinted from Commodity Research Bureau, Inc.

Figure 6

GNMA 8% (CBT) - \$100,000 princpl; pts., 32nds of 100%										
	Open		High		Low		Settle		Chg	Open
	Yield	Chg	Yield	Chg	Yield	Chg	Yield	Chg	Interest	
Sept	61-30	62-03	61-22	62-01	- 5	15.093	+.042	13.304		
Dec	62-13	62-18	62-05	62-17	- 4	14.960	+.033	13.408		
Mr82	62-25	62-30	62-19	62-30	- 3	14.853	+.024	10.837		
June	63-00	63-05	62-27	63-05	- 3	14.796	+.024	12.556		
Sept	63-02	63-10	63-00	63-10	- 2	14.756	+.017	12.810		
Dec	63-04	63-13	63-03	63-13	- 2	14.731	+.016	12.453		
Mr83	63-06	63-15	63-06	63-15	- 2	14.715	+.016	11.083		
June	63-06	63-17	63-06	63-17	- 1	14.699	+.008	9.867		
Sept	63-11	63-18	63-07	63-18	- 1	14.691	+.008	11.515		
Dec	63-08	63-19	63-08	63-19	- 1	14.683	+.008	4.865		
Mr84	63-09	63-20	63-09	63-20	- 1	14.675	+.008	6.332		
June	63-10	63-21	63-10	63-21	- 1	14.667	+.008	1.085		
Sept	63-11	63-22	63-11	63-22	- 1	14.659	+.008	863		
Dec	63-23	63-23	63-23	63-23	- 1	14.651	+.008	1		
Mr84	63-24	63-24	63-24	63-24	- 1	14.643	+.008	1		
Est vol 10,000; vol Tue 17,869; open Int 120,980, +2,360.										
TREASURY BONDS (CBT) - \$100,000; pts. 32nds of 100%										
Sept	64-00	64-03	63-11	63-23	- 21	13.188	+.135	54,874		
Dec	64-26	64-27	64-04	64-15	- 20	13.034	+.126	30,717		
Mr82	65-07	65-11	64-23	65-01	- 19	12.920	+.118	27,868		
June	65-17	65-22	65-02	65-12	- 18	12.852	+.111	25,991		
Sept	65-25	65-29	65-13	65-21	- 17	12.796	+.104	27,910		
Dec	66-01	66-03	65-19	65-29	- 16	12.747	+.098	27,609		
Mr83	66-08	66-12	65-24	66-04	- 16	12.704	+.097	22,602		
June	66-10	66-11	66-00	66-10	- 16	12.668	+.097	15,946		
Sept	66-19	66-20	66-07	66-16	- 16	12.631	+.096	24,560		
Dec	66-22	66-23	66-13	66-22	- 15	12.595	+.089	14,506		
Mr84	66-29	67-00	66-19	66-27	- 15	12.565	+.089	12,113		
June	67-00	67-03	66-22	67-00	- 15	12.535	+.089	3,983		
Sept	67-05	67-08	67-00	67-05	- 15	12.506	+.089	2,140		
Dec	67-10	67-10	67-05	67-10	- 15	12.476	+.088	111		
Est vol 54,000; vol Tue 76,225; open Int 290,930, +8,766.										
TREASURY BONDS (NYFE) - \$100,000; pts. 32nds of 100										
Aug	70-06	70-10	69-16	69-27	- 27	13.356	+.163	494		
Nov	70-26	71-00	70-14	70-19	- 26	13.211	+.154	816		
Fb82	70-27	70-27	70-27	71-04	- 26	13.110	+.153	1,592		
May	71-26	71-27	71-14	71-14	- 26	13.051	+.151	1,265		
Aug	71-26	71-27	71-22	71-22	- 26	13.004	+.150	607		
Nov	71-26	71-27	71-28	71-28	- 26	12.969	+.149	469		
Fb83	71-30	71-30	71-30	72-02	- 26	12.934	+.149	169		
May	72-04	72-04	72-04	72-08	- 26	12.900	+.148	100		
Est vol 633; vol Tue 671; open Int 5,512, +221.										
TREASURY BILLS (IMM) - \$1 mil.; pts. of 100%										
Sept	86.56	86.65	86.39	86.41	- 41	13.59	+.41	17,376		
Dec	87.10	87.25	87.00	87.07	- 27	12.93	+.27	9,506		
Mr82	87.58	87.66	87.44	87.50	- 24	12.50	+.24	6,605		
June	87.75	87.84	87.65	87.69	- 23	12.31	+.23	2,502		
Sept	87.87	87.94	87.70	87.76	- 24	12.24	+.24	1,675		
Dec	87.85	87.85	87.76	87.78	- 29	12.22	+.29	857		
Mr83	87.81	87.81	87.81	87.81	- 26	12.19	+.26	412		
June	87.85	87.85	87.85	87.85	- 22	12.15	+.22	5		
Est vol 22,280; vol Tue 24,103; open Int 38,938, -553.										

According to Credit Suisse, the Swiss current account is already running at a surplus after a deficit of approximately SF1.5 billion in 1980. West Germany's current account deficit for May 1981 was barely DM400 million after a substantial deficit of DM2.7 billion in April 1981. West Germany's overall account was in surplus by DM3.68 billion in May, continuing the DM8.14 billion surplus of April. Net foreign assets in both countries seem to have stabilized after the substantial declines that occurred in 1978, 1979, and most of 1980, indicating that excess monetary expansion was being reined in. Admittedly, in the German case, much of this is accounted for by direct government sales of debt instruments to foreign central banks. Japan continues to run a modest current account surplus, although the overall account may be much less favorable because of easy monetary and fiscal policies. The UK's current account figures have been unavailable for some months, although there is still good reason to believe that the UK is still running a good surplus. Here again, however, monetary and fiscal policies are too lax, and further currency deterioration is quite likely.

Should our interest rates forecast prove correct, we anticipate a renewed decline of the above currencies. However, we should caution that the SF appears to be groping for a bottom in the not-too-distant future. Signs of independent strength can be seen in the DM/SF cross rate, now close to 85 pf., and the lowest rate since late 1978 (see Figure 9).

Figure 8

Figure 7

CANADIAN FUTURES CONTRACTS									
91 DAY TREASURY BILLS (Combined Toronto-Montreal trading) \$1 million; multiples of \$0.005					Sales: Tuesday 8; Monday 9 Total Open Interest: Monday 28 M-C Normal Daily Price Limits: 64-22 above or below prior set Hemmett price.				
- Season - - -					- Season - - -				
High	Low	Settle	Chg	Open	High	Low	Settle	Chg	Open
95.875	95.700	95.810	+.015	95	65.08	64.82	64.82	-.02	22
95.725	95.550	95.815	+.015	8	63-16	63-16	63-16	-.02	22
95.870	95.870	95.870	-.02	2	Sales: Tuesday 9; Monday 9 Total Open Interest: Monday 400 -35 Normal Daily Price Limits: 64-22 above or below prior set Hemmett price.				
(Winnipeg trading)					(Winnipeg trading)				
91 day Canada Treasury bills \$200,000; points of 100 per cent					Government of Canada bonds 70 years 10 per cent \$20,000 face value (Fractions are 32nds of 1 per cent)				
- Season - - -					- Season - - -				
High	Low	Settle	Chg	Open	High	Low	Settle	Chg	Open
86.80	81.90	81.90	-.03	3	79.20	84.30	84.30	-.08	5
87.78	82.35	82.35	-.03	3	79.15	84.02	84.02	-.08	16
87.78	82.75	82.75	-.03	5	79.20	84.02	84.02	-.08	16
Total Sales: Monday nil.					Total Sales: Monday nil.				
MID-TERM GOVERNMENT OF CANADA BONDS (Combined Toronto-Montreal trading) 5 Year 9% \$50,000 princpl; Price is % of Par Value (Fractions are 32nds of 1%)					- Season - - -				
- Season - - -					- Season - - -				
High	Low	Settle	Chg	Open	High	Low	Settle	Chg	Open
78.17	77.00	77.00	-.03	20					

Currencies

The U.S. dollar continues to move ahead *vis à vis* the European currencies and the yen, but the fast gains of the past few months are slowly coming to an end. In the first place, the *real* rate of exchange of the DM and the SF (adjusted by relative inflation rates) has already dropped to early 1973 levels, indicating that a current-account turnaround is imminent (see Figure 8).

Nominal and real rates of exchange vis à vis U.S. dollar

	D.M.		S.F.		Yen	
	Nominal Rate	Real Rate	Nominal Rate	Real Rate	Nominal Rate	Real Rate
1973						
1st Oct.	.3320	.3750	.2897	.3368	.00352	.003326
2nd	.3650	.4000	.3171	.3612	.003772	.003511
3rd	.4178	.4479	.3410	.3806	.003773	.003554
4th	.3929	.4253	.3197	.3705	.003641	.003696
1974						
1st	.3660	.3944	.3118	.3597	.003421	.003730
2nd	.3995	.4298	.3364	.3909	.003583	.003899
3rd	.3830	.3927	.3355	.3685	.003394	.003552
4th	.3965	.3973	.3628	.3869	.003333	.003404
1975						
1st	.4278	.4339	.4015	.4183	.003409	.003475
2nd	.4247	.4290	.3970	.4018	.00342	.003437
3rd	.3917	.3882	.3752	.3689	.003356	.003316
4th	.3851	.3787	.3773	.3640	.003294	.003255
1976						
1st	.3885	.3866	.3878	.3731	.003307	.003310
2nd	.3910	.3895	.4008	.3899	.003342	.003348
3rd	.3950	.3928	.4035	.3821	.003436	.003459
4th	.4152	.4097	.4088	.3827	.003406	.003432
1977						
1st	.4175	.4079	.3968	.3657	.003502	.003463
2nd	.4237	.4070	.3982	.3596	.003633	.003509
3rd	.4333	.4154	.4170	.3725	.003757	.003609
4th	.4497	.4254	.4578	.3990	.004048	.003811
1978						
1st	.4817	.4475	.5183	.4366	.004208	.003851
2nd	.4886	.4434	.5218	.4248	.004529	.004010
3rd	.4983	.4451	.5958	.4715	.005186	.004443
4th	.5334	.4678	.6143	.4745	.005250	.004370
1979						
1st	.5392	.4638	.5969	.4542	.004964	.004064
2nd	.5278	.4469	.5837	.4397	.004598	.003784
3rd	.5506	.4592	.6105	.4488	.004569	.003824
4th	.5663	.4622	.6157	.4434	.004191	.003533
1980						
1st	.5639	.4523	.6015	.4211	.004106	.003523
2nd	.5523	.4426	.5943	.4115	.004298	.003776
3rd	.5632	.4404	.6129	.4130	.004544	.003903
4th	.5332	.4070	.5806	.3882	.004747	.003966
1981						
1st	.4793	.3711	.5273	.3507	.004865	.003924

All data are average of period. Source: IFS

Figure 9

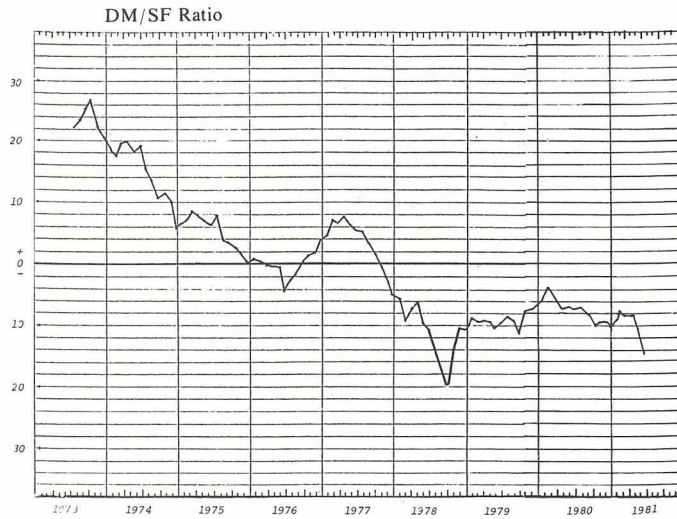
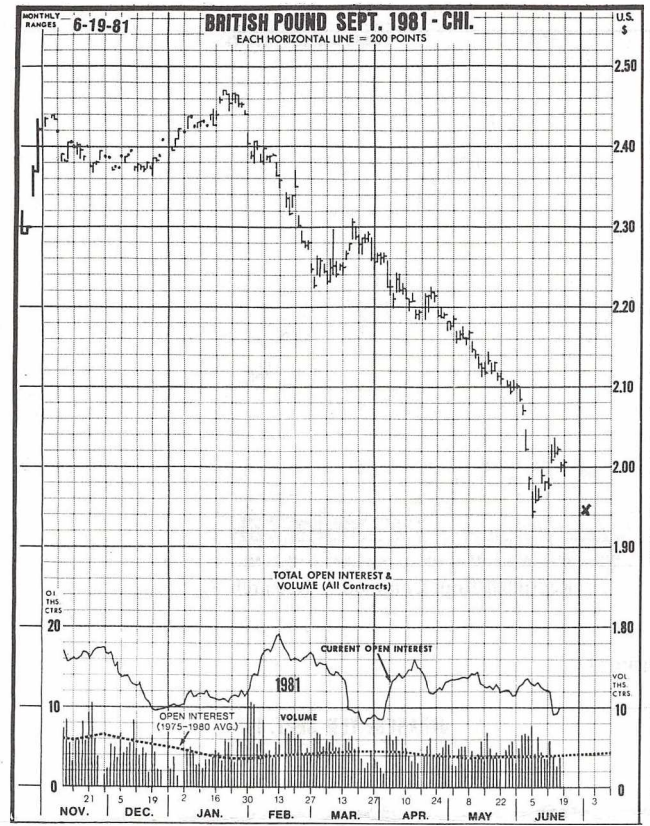


Figure 10

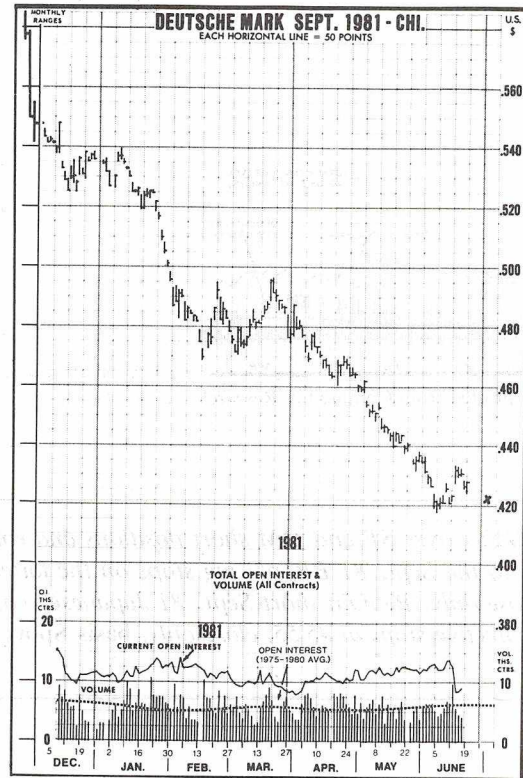
	May 81	Apr. 81	Mar. 81	Feb. 81	Jan. 81
Balance of Trade					
U.K. (bln Stg)				+314	+742
C.D. (bln CD\$)				+461	+793
D.M. (bln Marks)				+864	-923
J.Y. (bln US\$)	+856	+1.52	+2.15	+1.38	-1.47
SFr. (bln Francs)	-482	-703	-798	-784	-388
Current Account					
D.M. (bln Marks)				-1.6	-5.1
J.Y. (bln US\$)	+277	+474	+763	-207	-2.83
Overall Account					
D.M. (bln Marks)				-6.09	+085
J.Y. (bln US\$)	-1.17	+2.44	+1.82	+656	-048
Reserves					
U.K. (bln US\$)	26.49	28.07	28.21	28.43	28.39
C.D. (bln US\$)	3.18	3.165	3.715	3.341	3.436
D.M. (bln Marks)	75.6	72.8	69.1	61.0	67.1
J.Y. (bln US\$)	27.73	27.34	27.02	26.68	26.50
SFr. (bln Francs)	19.3	20.37	23.38	20.96	21.72
Cost of Living/ CPI					
U.K. (1974 base)	294.1	292.2	284.0	279.8	277.3
C.D. (1971 base)	233.2	231.1	229.4	226.4	224.1
D.M. (1976 base)	123.3	122.8	122.0	121.3	120.5
J.Y. (1975 base)	144.8	143.3	142.2	141.4	141.3
SFr. (1977 base)	114.6	113.5	113.8	113.1	112.0
W.P.I.					
U.K. (1975 base)	219.0	217.8	214.5	211.8	209.6
C.D. (1971 base)	267.0	267.0	264.6	262.6	261.1
D.M. (1976 base)	124.9	124.8	124.0	121.9	120.3
J.Y. (1975 base)	133.8	132.7	132.1	132.1	132.3
SFr. (1963 base)	164.4	163.6	163.1	161.8	160.6
Unemployment rate					
U.K. (Jun. 81:10.6)	10.4	10.1	9.9	9.6	9.3
C.D.	7.1	7.1	7.4	7.2	7.3
D.M.	4.8	4.9	5.2	5.6	5.6
J.Y.	2.3	2.4	2.5	2.2	2.2
SFr.	0.2	0.2	0.2	0.2	0.3

Figure 11



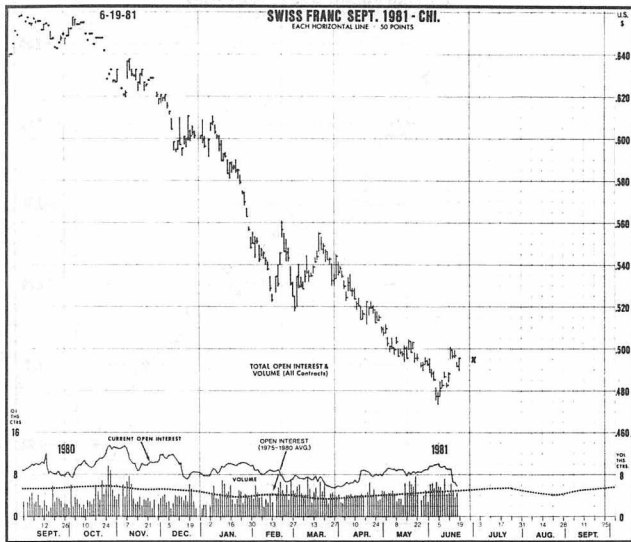
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Figure 12



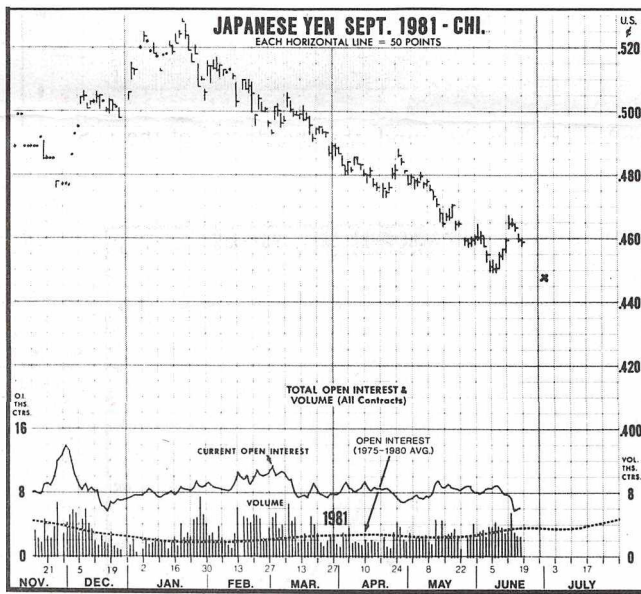
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Figure 13



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Figure 14



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STRATEGY: Cover SF and DM short positions and roll them over to the Sept. '81 BP, placing stops on the latter at 2.03, close only. Remain short Sept. '81 Japanese yen, placing protective stops at 45.55, close only, basis Spot yen.

Figure 15

- FINANCIAL -											
BRITISH POUND (IMM) - 25,000 pounds; \$ per pound											
Sept	1.9320	1.9335	1.9105	1.9155	-.0300	2.4715	1.9105	13,383			
Dec	1.9500	1.9515	1.9300	1.9355	-.0260	2.4020	1.9300	1,111			
Mar	1.9570	1.9570	1.9440	1.9450	-.0250	2.2570	1.9440	70			
Est vol 6,450; vol Tue 8,835; open Int 14,564, +2,469.											
CANADIAN DOLLAR (IMM) - 100,000 dtrs.; \$ per Can\$											
Sept	.8287	.8293	.8284	.8291	-.0012	.8730	.8231	4,843			
Dec	.8272	.8274	.8267	.8274	-.0009	.8570	.8222	822			
Mar82	.8250	.8250	.8250	.8250	-.0020	.8500	.8222	399			
June8250	-.0010	.8280	.8230	182			
Est vol 508; vol Tue 396; open Int 6,264, -122.											
JAPANESE YEN (IMM) 12.5 million yen; cents per yen											
Sept	.4480	.4493	.4471	.4491	+.0008	.5445	.4482	7,694			
Dec	.4574	.4586	.4561	.4581	+.0008	.5319	.4561	822			
Mar82	.4638	.4665	.4635	.4665	+.0025	.4820	.4635	10			
Est vol 3,667; vol Tue 5,597; open Int 8,526, +1,352.											
SWISS FRANC (IMM) - 125,000 francs-\$ per franc											
Sept	.4927	.4929	.4886	.4913	-.0037	.6580	.4735	7,719			
Dec	.5005	.5010	.4967	.4991	-.0037	.6350	.4812	689			
Mar82	.5090	.5090	.5040	.5060	-.0050	.6680	.4892	99			
June	.5155	.5155	.5100	.5115	-.0085	.5240	.4984	9			
Est vol 6,608; vol Tue 7,765; open Int 8,516, -678.											
W.GERMAN MARK (IMM) - 125,000 marks-\$ per mark											
Sept	.4200	.4201	.4180	.4193	-.0030	.5790	.4178	8,933			
Dec	.4243	.4245	.4226	.4236	-.0028	.5480	.4218	764			
Mar82	.4263	.4263	.4255	.4260	-.0030	.4735	.4255	89			
June	.4285	.4285	.4285	.4285	-.0052	.4360	.4285	2			
Est vol 6,677; vol Tue 4,312; open Int 9,788, -588.											

Mexican Peso

The crawling monthly devaluation of the MP is now accelerating: 1.1 per cent for the month of June. Mexico's troubles are depicted quite vividly by the internal political strife occurring at Pemex. Mr. Serrano Diaz, the architect of Mexico's oil boom, was booted out as a result of his decision to lower Mexico's oil prices by \$4/barrel, a natural reaction in view of falling prices everywhere. His successor, an interventionist and former cabinet member, wants to run against the tide by raising prices \$2/barrel or threatening production cutbacks. If the new price rise is adopted, Mexico's oil exports will dwindle to a trickle. If, on the other hand, Mexican oil prices are lowered again, the current-account deficit will widen totally out of proportion as diminished revenues fail to offset increasingly larger interest payments.

For the first quarter of 1981, Mexico recorded a current-account deficit of \$1.42 billion, 249 per cent greater than the corresponding period in 1980. The increased deficit was mainly due to the following: the continued steep rise in imports, up 60 per cent on the 1980 first quarter; a 3.2 per cent drop in tourism receipts; and a 43.7 per cent fall in the sale of non-monetary gold and silver. Given Mexico's huge foreign debt, estimated at \$55 billion (both public and private), and Eurodollar rates a full 8 percentage points higher than last year at this time, Mexico's interest payments alone will add \$4.4 billion on an annualized basis to the current-account deficit for the second quarter. No wonder Pemex has had to raise its original \$2.5 billion acceptance credit to \$4.0 billion; it is a case of borrowing from Peter to pay Paul!

Figure 16

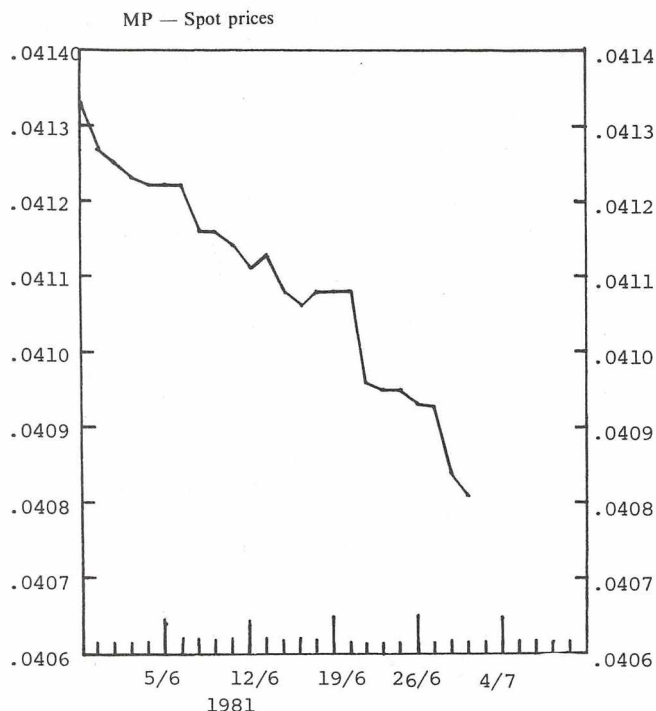
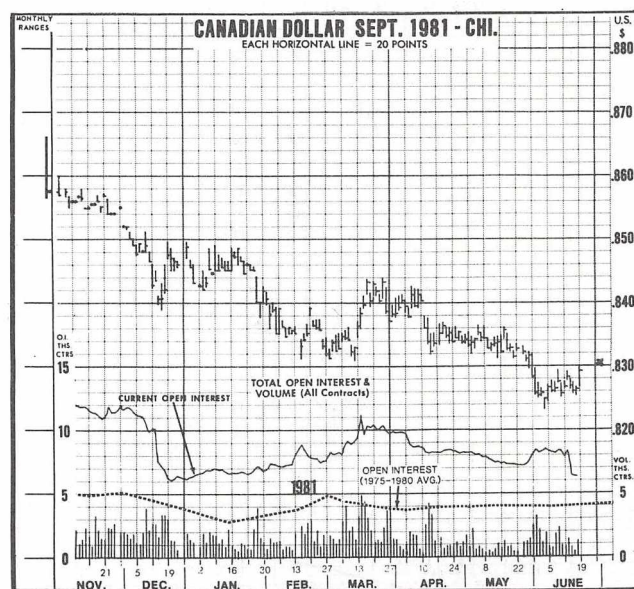


Figure 17



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STRATEGY: *Deferred discounts are beginning to widen, reflecting our much anticipated currency collapse and rising domestic interest rates (caused by hedge borrowing). Nevertheless, the 26 per cent discount of the June '82 against the 40.83 Spot rate is still modest considering our expectations of a minimum 100 per cent devaluation. In fact, based on fundamentals, we think Spot will be allowed to float down to as low as .0013.*

Remain firmly short; add on any 100-150 point rallies in the 1982 position.

Canadian Dollar

Well stabilized but at the cost of maintaining an ever wider interest rate differential vis à vis the U.S. money market rates.

STRATEGY: *Remain short Canadian three month T-bills; treat the currency as a trading affair between 83.40 and 81.50.*

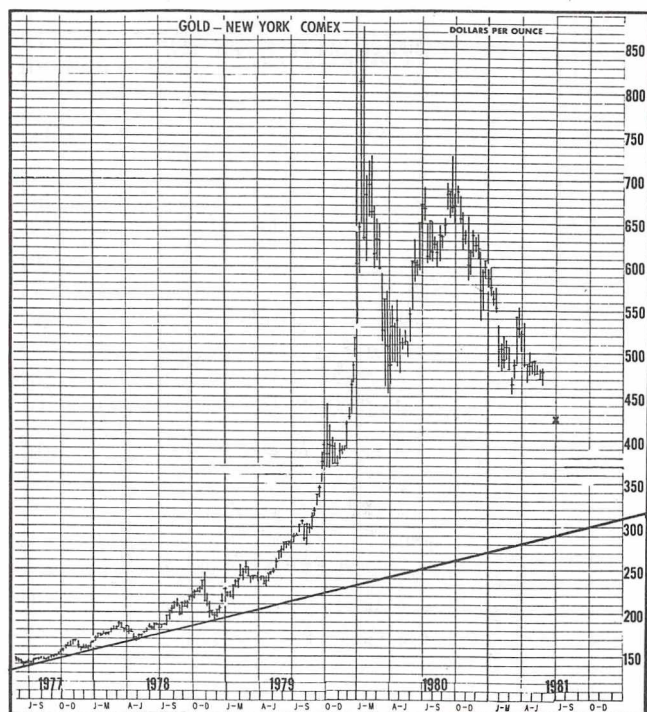
Precious Metals

Our bearish stance has paid off handsomely. In the fundamental background, the "hardness" of the U.S. dollar and now the Swiss Franc makes gold a relatively unattractive store of wealth. Moreover, the collapsing structure of all commodity prices adds further impetus to the bearish sentiment.

On a more positive note, present levels are rapidly approaching a "value" zone. In past *Comments*, we suggested that gold's intrinsic value was vaguely tied into its convertibility against outstanding U.S. short-term external liabilities. At the time (March 29, 1981) we computed an approximate price of \$355/oz. Although on a short-term basis this rationale is meaningless to the market, the longer term picture can find good intellectual support. On Feb. 4, 1980, after gold had completed a dramatic reversal from its all-time high of \$875/oz., we concluded, "technically the \$560-600/oz. level should act as an excellent near-term support . . . Once the lower end of this range is attained, gold will do either of the following: a) form a bullish, but rather boring, high-level base for a considerable period of time, perhaps as much as three years; or b) sink quickly and decisively below \$560/oz. and perhaps retrace 50% to 66% of the entire 1976/1980 advance, taking it to as low as \$360/oz."

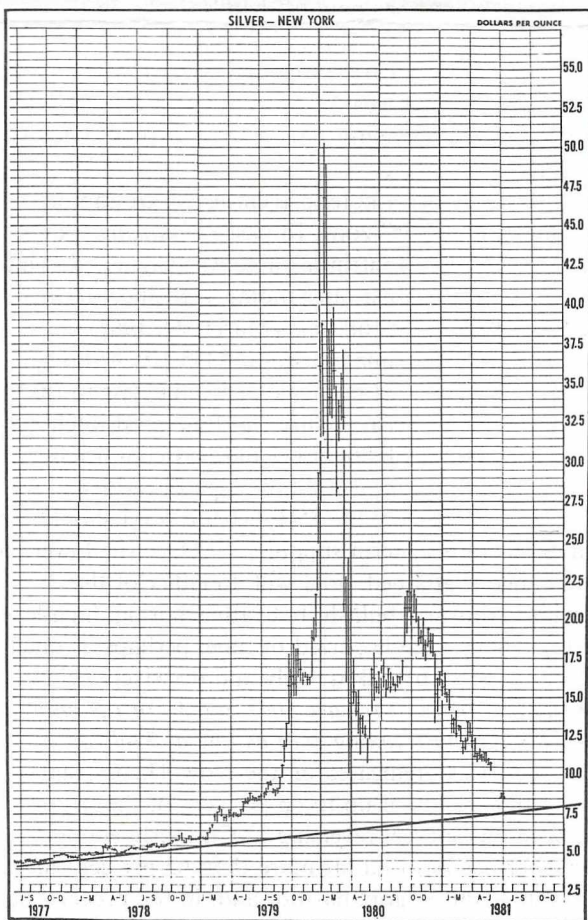
This view was predicated on the Dow Theory that allows retracements of up to 66 per cent of the major trend without actually reversing it. Curiously enough, while silver has retraced far more than 66 per cent of its 1976-1980 advance, gold has not and, in the process, has widened its ratio to an historic high of 50 to 1, thus

Figure 18



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Figure 19



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buttressing our view that gold *may* still be in a major bull market.

Our last technical support occurs at the \$305/oz. level, which is the intersection of the long uptrend begun in 1976.

STRATEGY: Cover present short positions at \$370/oz. basis August '81, but be prepared to re-enter short side on a close below \$360/oz. Long positions should only be established (and, needless to say, short positions covered) on the first upside weekly reversal (i.e., a Friday close higher than the previous one after having made new lows during that week).

Lower protective stops on silver and platinum short positions to \$9.50/oz. and \$420/oz. basis July '81 respectively. The first GSA silver disposal in nearly a decade should presage the bottom of the silver market. At any rate, cover on any upside weekly reversals.

Heating Oil

OPEC's decision, rendered at its June 15 meeting, to cut back production by 10 per cent was sufficient only to temporarily brake this long-term bear market.

Reliable estimates put current OPEC production at 22 million barrels per day (MBD) as compared with 24 MBD in April, the last period for which official figures are available, and 27 MBD through 1980. The reason the market has hardly reacted to the decreased availability is that it recognizes the cutback must be short-lived. Assuming OPEC capacity is in the neighborhood of 35 MBD, which is just slightly higher than the output of the mid-70s, current production represents an unacceptably low 63 per cent utilization of capacity. Both cheating and strains on the cartel's ability to set production quotas are inevitable. All producing nations have come to require ever-increasing revenues in order to continue and complete their massive construction and industrial projects. The whole situation is exacerbated because Saudi Arabia has wisely elected to maintain production at essentially unchanged levels — their announced cutback of 450,000 barrels is miniscule — thus placing the brunt of the burden on their more militant but less sagacious colleagues.

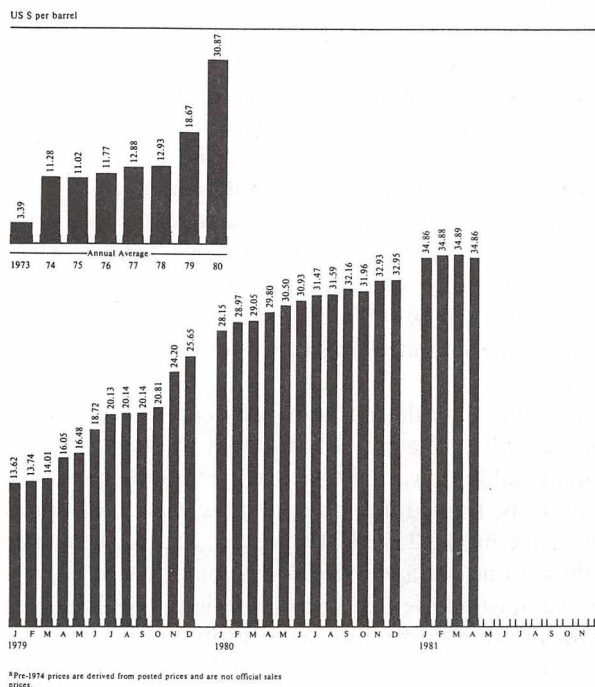
In what has now very evidently developed into a buyers' market, the OPEC strategy of maintaining prices at around \$34 per barrel will prove equally deleterious to its interests. Over the coming 24 months energy demand is expected to increase at about 3 per cent per year. However, the current artificially high level will tend to encourage substitution to non-oil generally, and to non-OPEC oil in particular, production of which continues to increase since deregulation.

Oil prices must decline. How much is the issue. The big price hike from the \$18 per barrel mark to the \$30 – plus per barrel plus level occurred during the latter part of 1979 largely as a result of the Iranian revolution. The cutback in Iranian production drew the entire OPEC output down from 30.9 MBD in 1979 to 26.8 MBD in 1980, or 13 per cent. Imports of crude into the U.S. during the first quarter of 1980 fell to about 4.5 MBD from 5.2 MBD the previous year or, coincidentally, by 13 per cent. The broad point we are trying to make is that the production deficit of 1980 has been offset by demand decreases. Prices should fall to around the \$20 per barrel mark, which is the inflation-adjusted price of 1979.

STRATEGY: Retain existing profitable short positions in Dec. Heating Oil. Our target is 75.00. Place stops at 102.00 on close only. The existence of the gas/oil contract in London and soon-to-be-approved change in contract specifications allowing for delivery in New Orleans, which will attract more hedge business, is creating a professional market that can be traded in volume.

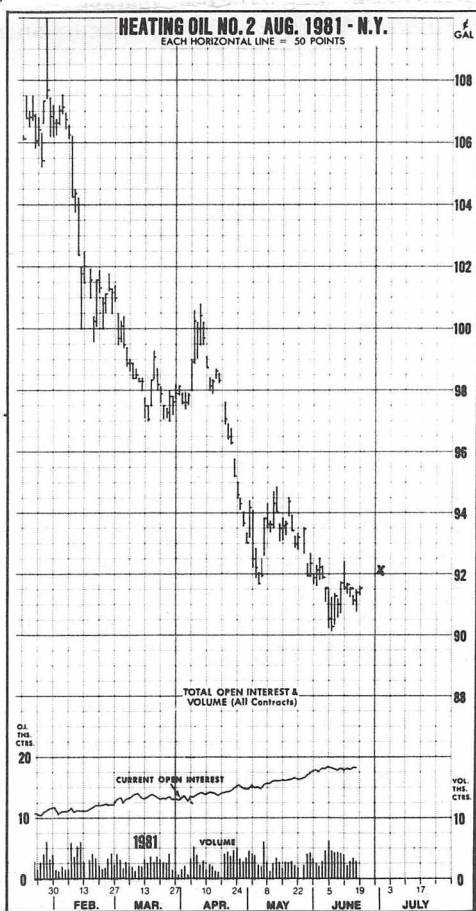
Figure 21

OPEC: Average Crude Oil Official Sales Price*



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Figure 20



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Copper

Must we eat crow? Yes and no. For those unfamiliar with our clairvoyance, we have been predicting a bull market for the red metal since March when we captioned our prophecy under the banner “The Raging Bull.” Since then, the many solid punches we’ve taken below the belt toward the wallet area must have left us a bit dazed. Now, down on the canvas looking up, way up, to the area we originally began buying, we ask ourselves, as every pug must, Wha’ happened?

Well . . . Copper has fallen in keeping with the prevailing bear sentiment that has gushed over all commodities since mid-November. The sensitive CRB index has sunk to 265 from 340. Is it predicting a major recession? It’s very possible. More likely, though, is that the entire market has been undergoing a severe corrective phase to the speculative overbuying of the past eight years. Some markets, like precious metals, still have room for more squeezing. Others, and we number copper amongst them, have already entered “value” levels — copper today, on an inflation-adjusted basis, is cheaper than it has ever been. *Cheaper than it has ever been.* But just as markets can become overbought, they can also be oversold, a concept less manifest to speculators who have enjoyed the raging bull markets — the real ones — of the past decade. This is to say the price can trade lower yet.

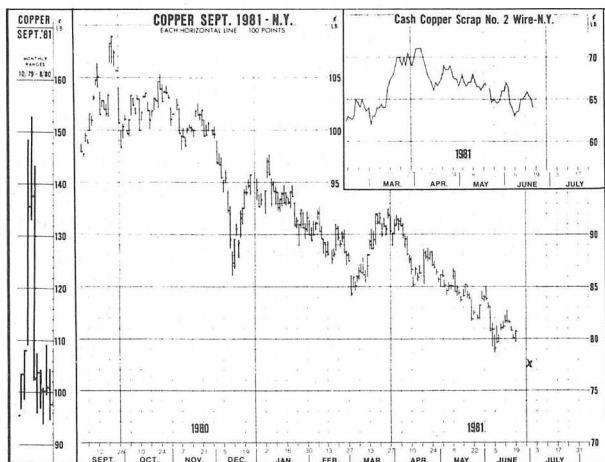
A third factor underlying copper's slide may be the market's recognition of the momentum-gaining protectionist sentiment, the latest example of which is the voluntary restraining order put on Japanese auto exports. Protectionism can only result in lower industrial output and a lower standard of living. Our March forecast was predicated on demand exceeding existing capacity. Since a long lead time was required to develop new capacity, the major part of the price rise would come in the interval stage to ration existing demand. However, if the world economy should grow at only, say, 1 per cent a year, then existing capacity, meagre though it would otherwise be, will be sufficient, so that bottlenecks and the price rationing mechanism will not, perforce, be needed.

The truth is, we do not know why copper has acted as poorly as it has. We do recognize that the trend is unquestionably down. Did we need yet another sparring session to be trained into accepting the maxim of not fighting the market? Evidently we did, and to those who fought with us, we apologize. Given our view of interest rates we must advise that speculative longs be liquidated. We thus retreat to the fans' seats, rooting for copper from the long side. A rally above 86.00 basis Dec. '81 would indicate to us the liquidation was complete and we would re-enter. At current values, copper is cheap enough to be regarded as the best inflation hedge commodity available to those seeking such protection.

Corn

Our short position in September Corn is modestly profitable. Despite recent buying in response to the Soviet drought situation, the trend is still down. Place protective buy stops at 351.

Figure 22

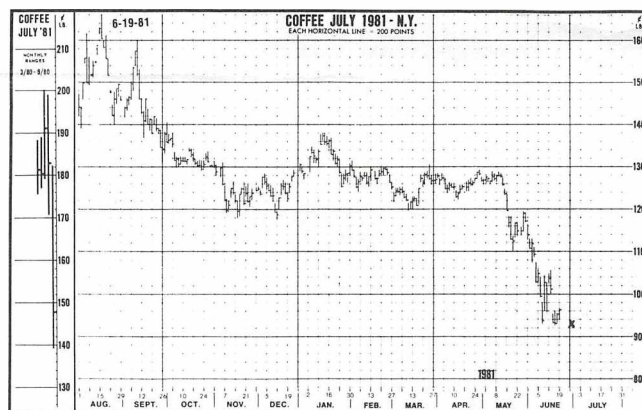


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Coffee

We were buyers today of outright positions in London. With underlying fundamentals known and discounted, the reasons are as follows: 1) The market is in the process of performing a weekly reversal out of a grossly oversold condition; 2) Consensus of bullish sentiment remains unduly low; 3) The international coffee organization (ICO) approved a 1.4 mln. bag reduction in export quotas in the fourth quarter which, though itself discounted, left the market bid limit up for the second day in a row (the implication being that the market expects something more); 4) The "more" is not so much an expectation as a fear of a frost which, according to our weather savant, is predicted to occur within the next week. The frost threat, incidentally, has also been delivered by no less an authority than the Brazilian government, which declared two weeks ago that in addition to a "major risk" in early July, there was also cause for concern in mid August.

Figure 23



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It's worth noting that back in Feb. 1977, we predicted that the then existent bull market, which was speeding en route to 340/lb., would top in April of that year, and that the ensuing bear market would last until beans were offered at 75¢. Beans have traded as low as 83¢, and when you consider that the bear market was interrupted by the mini-frost of 1979, on an inflation-adjusted basis, coffee is within the "value" range.

STRATEGY: Long with stops at £695 basis September in London. Retain call options with esperance.

Albert D. Friedberg
David B. Rothberg

Notes:

Notes:

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