FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

Hume Publishing October 18, 1981

Temporary Reversal in Rates

(NOTE: On Sept. 28th, with December '81 T-Bills trading at around 85.25, we advised all our trading clients to cover short positions and move to the sidelines. This rare mid-month about-face was prompted by rapidly developing signs of an impending recession, as well as a certain unanimity of views that rates were trending higher. While trading clients, who also receive our *Commodity & Currency Comments,* were advised by phone of this momentous change, regular subscribers, unfortunately, have seen a good deal of their paper profits evaporate by waiting to be stopped at the 87.00 level. The publisher of this letter tells us that some form of "early warning system" will likely be instituted in the future as soon as some technical difficulties can be ironed out.)

Corporate illiquidity can be resolved in either of four ways: a) short-term debt can be funded in the long end of the market, the reverse of what is taking place at this moment; b) corporate earnings and/or cash flow can improve sufficiently to pay down short-term debt, again not a reflection of the present situation; c) a dramatic and unexpected surge in inflation can reduce, in real terms, the burden of debt, including short-term credit — it has not happened nor is it likely to happen for quite some time yet; and d) corporations liquidate inventories and slash proposed capital expenditures, using the proceeds to repay short-term obligations. This latter alternative, by far the most painful form of adjustment, takes place during a recession/depression. It should be noted that a rapid and successful adjustment depends rather importantly on price and cost flexibility — *downward flexibility*. Price rigidities will not allow the market to clear and, instead, will produce a back-up of unsold goods, aggravating the recession and postponing the eventual reliquification process.

Signs abound that the US economy has entered the second recession in as many years. Industrial output declined .8 per cent in September after declining .3 per cent in August. The decline in September took on an ominous turn as it was quite pervasive and has spread beyond the sickly state of affairs of automobile and housing. One of the key declines was in business equipment, which normally tends to hold out the longest as the economy slows down. Other portents include the sharp rise in unemployment, the worrisome climb in the inventory to sales ratio, the dramatic reversal in corporate profits, dropping at a 33.7 per cent annual rate from the first to the second quarter of 1981, and so on. Finally, the extraordinary weakness shown by key industrial materials such as copper, aluminum, rubber, cotton and lumber serves to confirm the rather fragile condition of world economic activity.

In this issue

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We profess not to know how lengthy and how deep the coming recession will be. The most important consideration, however, is to try to gauge how much "reliquification" will take place; if very little dent is made on this problem, the subsequent recovery, when and if it takes place, will pale in relation to the anemic advance registered from the IIQ 1980 to the IIQ 1981 (3.2 per cent in constant 1972 dollars).

The industrialized world has, in effect, sunk into a stagflationary phase, the very product of excessive bank credit. Easy money has fostered illiquidity by stimulating short-term debt at subsidized rates, by financing long-term projects and hard-to-sell assets with roll-over credits, and by encouraging a monstrous mismatching of assets and liabilities. The albatross of illiquidity threatens to choke world economic activity. Rising protectionism (a form of price and output rigidity), and public sector pre-emption of long-term debt markets, may provide the *coup de grâce*.

Figure 1

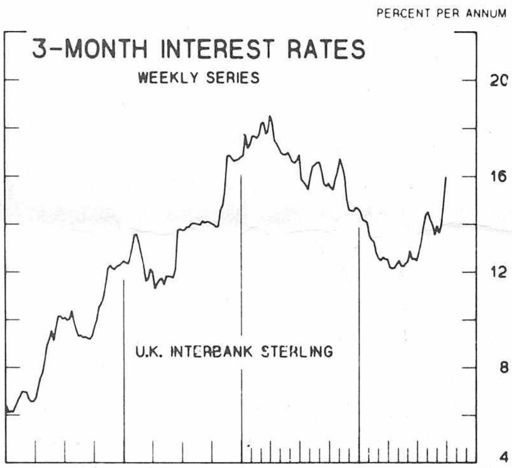
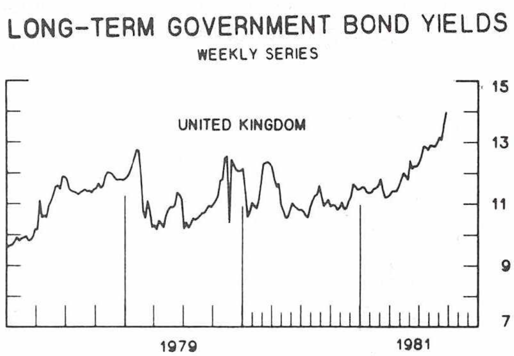


Figure 2



The UK experience is quite telling. From the second quarter of 1979 to August 1981, industrial production dropped an estimated 14 per cent, while unemployment rose for the 24th consecutive month to 11.1 per cent of the labor force. Easily, this is the worst slump in 50 years and, in some respects, comparable to the depression of the 30's. Short- and long-term interest rates, however, bottomed out in the first quarter of 1981 (see Figures 1 and 2), and have since advanced substantially. Bank

Figure 3

current assets and liabilities of large industrial and commercial companies[1]

Amounts outstanding at end of period: £ million

			Seasonally adjusted[2]			Continuous Series,[3] seasonally adjusted
		Number of companies[2]	Total current assets	Total current liabilities	Liquidity ratio per cent[4]	Liquidity ratio per cent[4]
1977	1	210	3,241	3,331	97	97
	2	210	3,207	3,372	95	95
	3	210	3,442	3,462	99	100
	4	210	3,855	3,316	116	116
		226	4,259	3,667	116	116
1978	1	226	4,565	3,509	130	130
	2	226	4,969	3,570	139	139
	3	226	4,717	3,719	127	127
	4	226	4,669	3,754	124	124
		222	4,682	3,759	125	124
1979	1	222	4,451	4,414	101	101
	2	222	4,879	4,626	106	105
	3	222	4,488	4,787	94	94
	4	222	3,716	4,793	78	77
		218	4,135	5,326	78	77
1980	1	218	4,083	6,081	67	66
	2	218	4,480	6,369	70	70
	3	218	4,440	6,597	67	66
	4	218	5,442	6,733	81	81
		212	5,436	6,319	86	81
1981	1	212	4,928	6,781	73	67

[1] Companies in the Department of Industry's survey of company liquidity. Additional details are published quarterly in *British Business*. Unless otherwise stated the survey covers only assets that can be sold or otherwise realised within 12 months and borrowing with initial loan terms of no more than 12 months. [2] Estimates are included until the end of the year for companies that ceased to reply during the year, those companies are then removed from the survey. Some companies were brought into the survey at the end of 1977. Two sets of figures are given for the fourth quarters to show the effects of these and other changes in coverage at year ends. New headings were added at the end of 1979. [3] Figures are adjusted to make the whole series comparable with the second set of figures for 4th quarter 1977. [4] Total current assets as a percentage of total current liabilities.

Source: Department of Industry

advances in August were running at a phenomenal 35.5 per cent rate (three months' growth at annual rates), indicating that liquidity was not being restored by any stretch of the imagination. Figure 3 is far more explicit. It can be seen that *liquidity improved right up to the onset of the 1979 peak in industrial production and then, contrary to conventional thinking, liquidity began to deteriorate even as the economy plunged into a slump.* There are a number of reasons for this phenomenon. In the first place, UK industrial and commercial companies are not able (or willing) to raise long-term or permanent financing in the capital markets, relying increasingly on bank advances as a source of funds (see Figure 4). The

Figure 4

Sources of funds[(a)]

£ billions

	Internal funds(b)	Bank borrowing	Other loans and mortgages	UK capital issues(c)	Overseas(d)	Import and other credit received(e)
1963	2.4	0.5	0.1	0.3	0.2	-0.1
1964	2.8	0.8	0.1	0.4	0.1	-0.1
1965	2.7	0.5	0.2	0.4	0.1	-0.1
1966	2.3	0.2	0.1	0.6	0.2	-0.1
1967	2.7	0.3	0.1	0.4	0.3	-0.1
1968	3.0	0.6	0.2	0.5	0.3	—
1969	3.4	0.7	0.2	0.5	0.3	—
1970	3.1	1.1	0.3	0.2	0.5	—
1971	4.2	0.7	0.2	0.4	0.5	0.1
1972	5.0	3.0	0.2	0.6	0.3	0.1
1973	6.2	4.5	0.7	0.2	0.9	—
1974	3.7	4.4	0.1	0.1	1.6	-0.3
1975	5.8	0.5	0.5	1.2	1.2	-0.2
1976	7.5	2.4	0.4	0.8	1.4	-0.6
1977	10.8	3.0	—	0.7	1.5	-0.1
1978	13.1	2.9	0.4	0.8	1.4	-0.7
1979	14.2	4.9	0.6	0.9	—	-0.4
1980	10.2	6.6	0.7	1.3	-0.6	-0.7

(a) All industrial and commercial companies.
(b) Undistributed income (net of stock appreciation), capital transfers (net receipts) and increases in the tax balance.
(c) Issues of ordinary shares, debentures and preference shares.
(d) Overseas capital issues, overseas direct investment in securities, and intra-company investment by overseas companies.
(e) Net of export and other credit given.

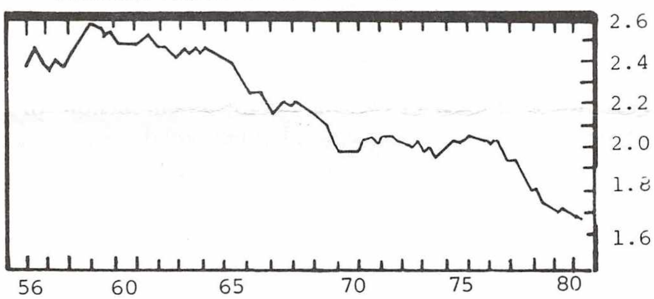
Bank of England 1981

first aggregate pay down of bank loans took place in the first quarter of 1981, hardly making any dent on the total outstanding bank debt of £36.3. Secondly, undistributed profits (retained earnings), as a result of the recession, took a sharp drop for the worse, dropping almost £4 billion during 1980 and continued their drop at an annual rate of 34 per cent in the first quarter of 1981. Finally, the book value of stocks (inventories), rose throughout 1979 and the first two quarters of 1980 despite the recession, indicating abnormal price rigidities, which in turn, aggravated the slump. Only in the last two quarters of 1980 and first quarter of 1981 did we witness a drop in stocks of approximately £2.5 billion (at an annualized rate), a relatively small reversal of the accumulated increases of £9.6 billion registered since the second quarter of 1979, the onset of the recession.

All the bloodletting will have been in vain if corporate liquidity does not improve. At the merest suggestion of an upturn (loudly heralded by the UK press and Treasury), interest rates firm up and threaten to choke any expansionary potential. Well it will, as reliquification has not been accomplished.

Figure 5

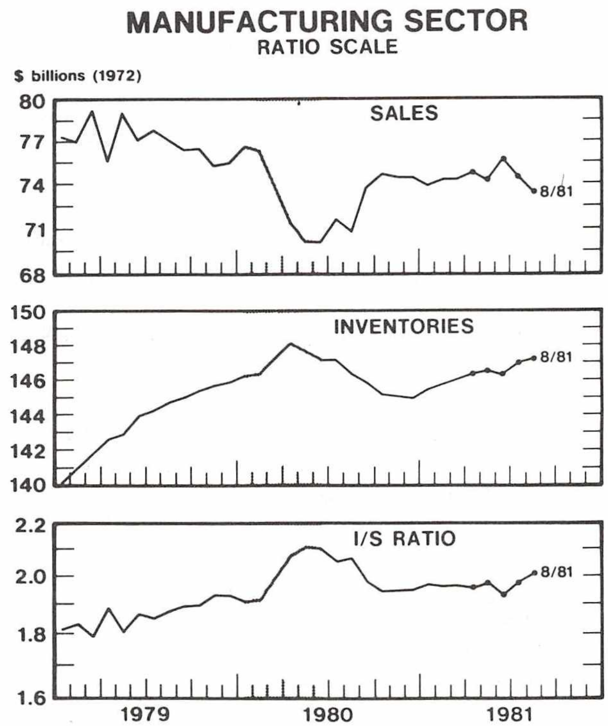
Current Ratio of U.S. Corporations



The British experience augurs poorly for the US, for while the current ratio of US corporations (see Figure 5) is a bit more comfortable than its British counterpart at the second quarter of the 1978 peak, the similarity of background is a great deal more worrisome. In the first place, as we mentioned earlier, US corporate profits are already registering a substantial decline with the consequent impact on internally generated funds. Secondly, inventories have been increasing despite the extremely sluggish pace of sales (see Figure 6). Finally, corporate borrowings at the long end of the market remain uninspiring, at best (see Figure 7).

How do we turn the corner? In the short run, at least, inventories will have to be slashed quickly enough to bring them into line with sales. Depending on price rigidities, this adjustment is slow and painful. Far more important is the willingness of corporations to fund short-term debt with long-term loans, a doubtful proposition given the financial disadvantage of paying off commercial paper and acceptances (bearing 15 per cent) with long-term funds costing as much as 16 per cent and more. As discussed in a past issue of our *Commodity & Currency Comments (August 30, 1981), the slope of the yield curve must become extremely inverted to induce such a funding operation.*

Figure 6



Reprinted from Economic Week

Figure 7

CORPORATE DEBT ISSUANCE
($ millions)

	1979	1980	1981	
January	1,902	3,711	2,442	
February	1,869	1,468	2,751	
March	1,707	2,200	3,652	(3,408)
April	3,078	3,322	5,403	(4,603)
May	2,057	6,682	2,439	(2,233)
June	3,893	7,344	6,198	(5,300)
July	2,055	5,214	3,239	(2,786)
August	2,116	3,757	942	(829)
September	2,772	2,599	2,575	(2,428)
Total	21,450	36,337	29,641	(26,780)

The figures shown in parentheses represent debt totals when original issue discount issues are counted on a net proceeds rather than principal basis.

Applying the foregoing observations, we should expect a relatively orderly decline in US short- and long-term interest rates over the coming weeks, *primarily a result of expectations* on the part of conventional thinkers that recessions are beneficial to the money markets. More definitive data on the economy's developing weakness should aid the trend towards lower rates as well as provide the Fed with elbow room to inject reserves at a more generous pace. On that score, year-over-year comparisons of the Feds Reserve Credit have shown a slight drop in the rate of growth. This deceleration, however, has not taken into account the fact that commercial banks' reserves tend to carry an ever-increasing multiplier as a result of shifts into low-reserve requirement deposits. As an example, if only part of the recent funds flowing into all-savers certificates comes from demand deposits and gets reinvested in certificates of deposit issued by commercial banks (such an operation is permissible until March 31, 1982), effective reserve requirements drop, or, what is more meaningful, bankers are able to expand assets on an unchanged level of reserves.

Furthermore, the meaninglessness of targeting narrow monetary aggregates comes to the fore when one observes the astronomical rate of growth in velocity. In the accompanying illustration (Figure 8), we have updated a recent table first published in our *Commodity & Currency Comments, May 31, 1981.*

Figure 8

	Debits to Demand Deposits (billions of US$)	Annual Change %	Demand Deposit Turnover	Annual Change %
1971	12,383	13.57	83.7	8.70
1972	16,438	32.75	76.7	-8.36
1973	20,904	27.16	91.3	19.04
1974	22,938	9.73	99.0	8.43
1975	25,028	9.12.	105.3	6.36
1976	29,180	16.59	116.8	10.92
1977	34,322	17.62	129.2	10.62
1978	40,298	17.41	139.4	7.89
1979	49,775	23.52	163.5	17.29
1980	62,925	26.42	201.6	23.30
1981:				
Feb.	73,175	22.1	253.6	32.15
Mar.	75,487	27.39	262.9	38.08
Apr.	73,622	27.21	257.2	31.09
May	74,801	21.92	260.9	28.59
Jun.	78,745	27.89	281.3	39.60
Jul.	83,745	32.74	296.1	45.36

Souces: Federal Reserve Bulletin

As can be seen, demand-deposit turnover, a proxy for velocity, continues to rise exponentially and shows a remarkable rate of growth of 45 per cent per annum, i.e. one dollar today in a demand deposit does the work of what one dollar and forty-five cents did one year ago. There is hardly any necessity for expanding the amount of demand deposits — the principal component of M_1B — to accommodate the economy's need for increased transactional balances.

Regardless of the foregoing observations, the Fed is likely to become more accommodative in coming weeks with the intention of bringing M_1B more into line with its stated objectives. Even after Friday's reported increase of 5.6 billion, M_1B is well below the $438.2 billion level that would be consistent with a 6 per cent annual growth rate.

In conclusion, the US has entered a recession of indeterminate length and magnitude. Liquidity constraints are likely to become more severe in the months ahead. Interest rates are likely to ease further in the coming weeks, albeit at a subdued pace and *possibly* not easing a great deal further than perhaps 100-150 basis points. Lurking around the corner is a renewed surge in interest rates that will be the result of a liquidity crunch, *à la* the UK. But let us not get too far ahead of ourselves. . . .

***STRATEGY:** Having covered short positions in T-Bills and T-Bonds, we move into hibernation.*

Figure 9

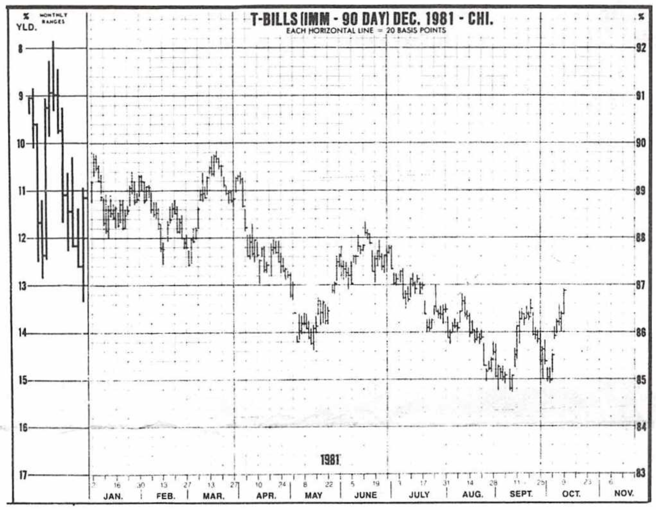


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Figure 10

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

	Open	High	Low	Settle	Chg	Discount Settle	Chg	Open Interest
Dec	86.65	86.68	86.38	86.46	− .16	13.54	+ .16	16,788
Mr82	86.86	86.86	86.59	86.67	− .14	13.33	+ .14	8,027
June	86.97	86.97	86.74	86.87	− .03	13.13	+ .03	4,55[illegible]
Sept	86.97	86.99	86.83	86.94	....	13.06	....	1,677
Dec	87.00	87.01	86.88	86.99	+ .01	13.01	− .01	1,438
Mr83	87.00	87.02	86.95	87.00	....	13.00	....	1,263
June	86.96	87.02	86.94	87.02	....	12.98	....	553
Sept	....	....	....	87.02	....	12.98	....	1

Est vol 22,541; vol Thu 20,783; open int 34,298, +164.

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

Dec	59-08	59-08	58-05	58-11	− 19	14.392	+ .142	56,028
Mar82	59-17	59-20	58-20	58-26	− 19	14.279	+ .140	33,764
June	59-25	60-01	59-03	59-07	− 19	14.183	+ .139	24,364
Sept	60-04	60-10	59-14	59-19	− 18	14.095	+ .130	19,143
Dec	60-17	60-17	59-27	59-30	− 17	14.016	+ .122	19,281
Mar83	60-26	60-26	60-08	60-08	− 17	13.944	+ .121	16,686
June	60-24	60-25	60-17	60-17	− 17	13.880	+ .120	11,877
Sept	61-07	61-07	60-26	60-26	− 16	13.816	+ .111	16,426
Dec	61-08	61-09	61-02	61-02	− 16	13.760	+ .111	13,387
Mar84	61-23	61-23	61-10	61-10	− 15	13.705	+ .104	13,629
June	61-22	61-22	61-12	61-17	− 15	13.656	+ .102	8,168
Sept	61-29	61-29	61-24	61-24	− 15	13.608	+ .102	2,009
Dec	62-04	62-04	61-31	61-31	− 15	13.560	+ .101	617

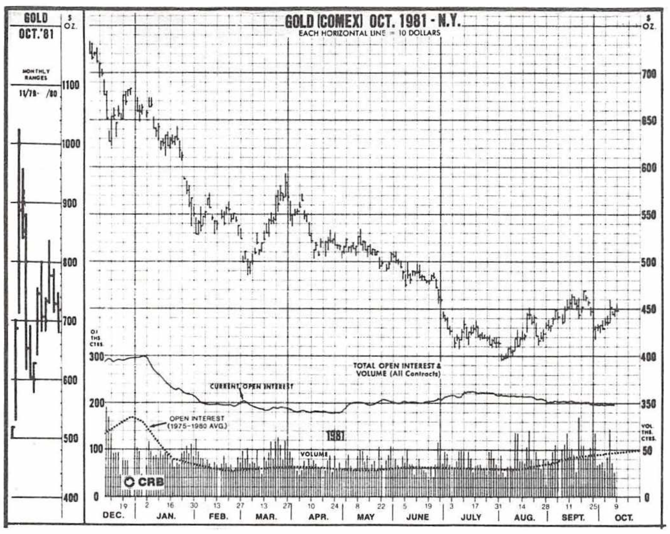
Est vol 59,000; vol Thu 51,030; open int 235,379, −1,290.

Precious Metals

The very sharp shakeout, occurring one week after our suggested scale-down purchase program, allowed us to acquire bullion at very favorable prices.

There are, however, new clouds on the horizon. The US recession bodes ill for precious metals, particularly silver and platinum whose consumption is primarily of an industrial nature. Furthermore, the GSA silver auction did not go as well as projected *because the US Government was intent on protecting the price.* In effect the GSA opted to sell only 160,000 ounces at the cut-off price of \$9.33/oz (bowing to domestic political pressure as well as to pressure from Peru and Mexico). This means that the official silver overhang will be with us for a much longer period of time than originally anticipated. The auctions may turn out to be more bearish than bullish, at least for the coming months. Finally, the weakness of the US dollar has had a disappointing impact on gold prices, indicating that perhaps the market is a great deal "heavier" than we anticipated. The same can be said about gold's reaction to Sadat's assassination.

Figure 11



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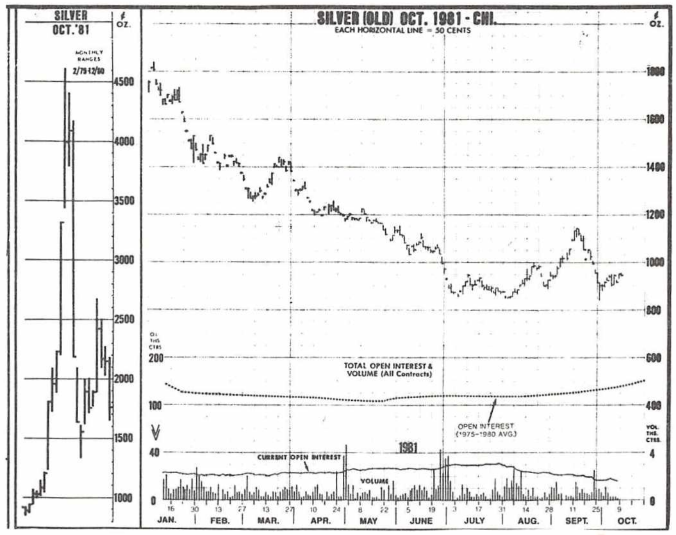
***STRATEGY:** We are making an about-face in our outlook for precious metals and recommend liquidating recently taken long positions.*

Figure 12



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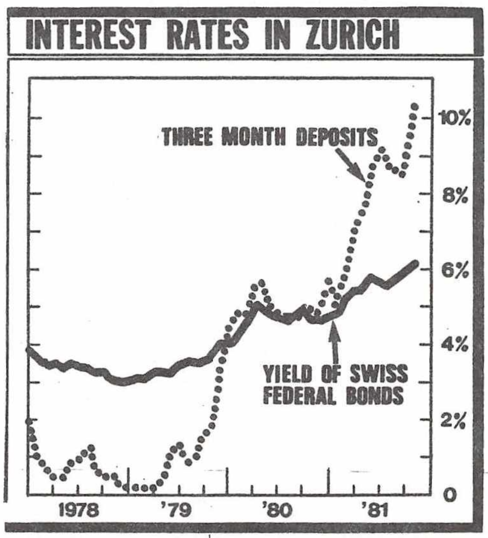
Currencies

Tight domestic monetary conditions (witness the extra-ordinary inverse yield gap Figure 13), in Switzerland are

Figure 13



Financial Times

helping to propel the Swiss unit into new recovery highground, particularly against the BP, the DM, and the rest of the realigned E.M.S. currencies (see Figures 14-17).

Figure 14

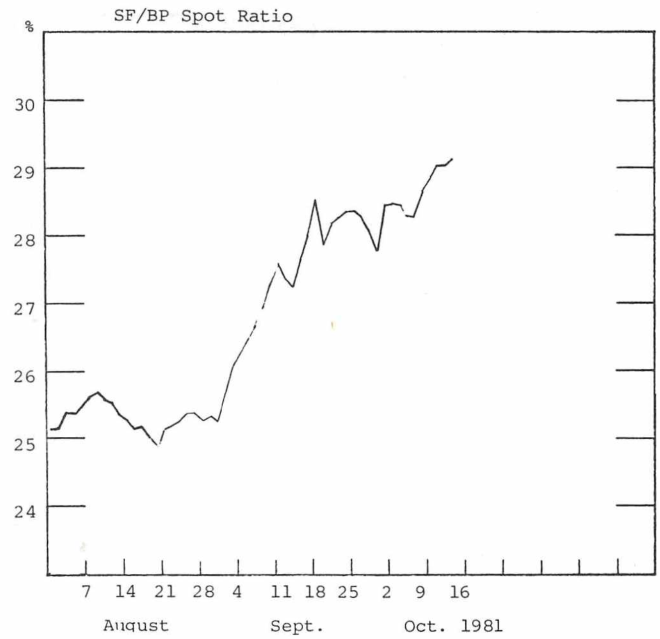


Figure 15

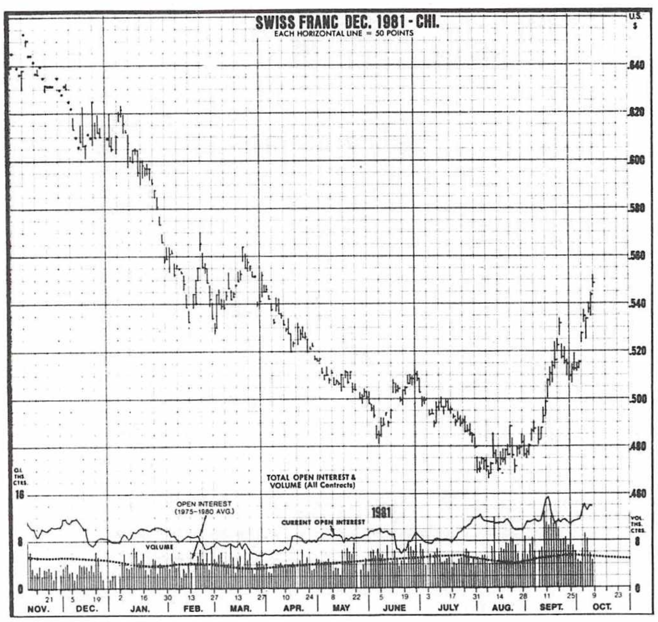


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Figure 16

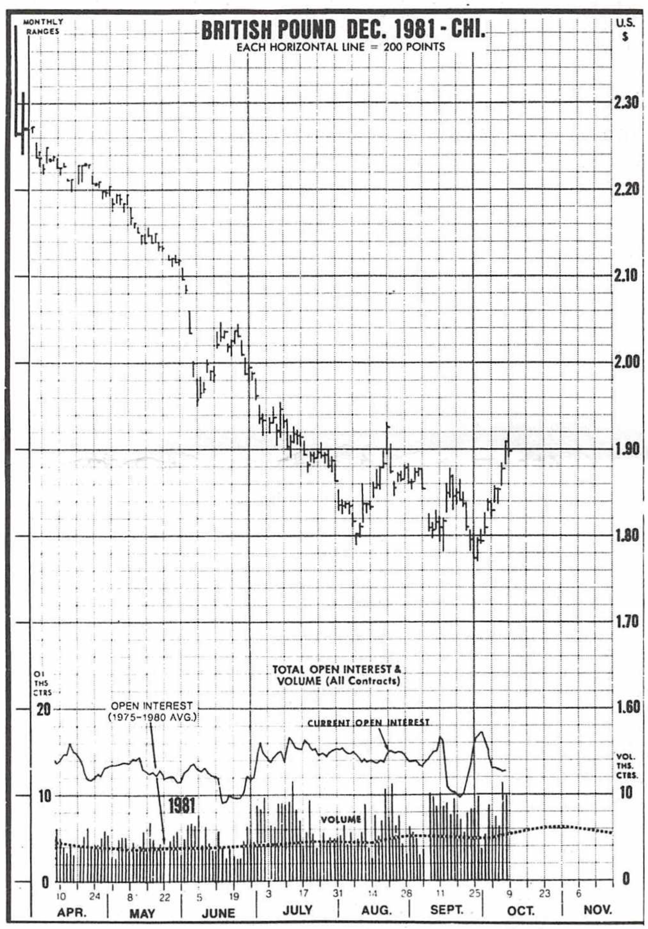

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Figure 17

U.K. Exchange Rate

U.K.		Nominal Rate	Real Rate *
1973			
	1st Qtr.	2.4197	2.1097
	2nd	2.5300	2.1117
	3rd	2.4800	2.0604
	4th	2.3790	2.0366
1974			
	1st Qtr.	2.2793	1.9609
	2nd	2.3973	2.1421
	3rd	2.3500	2.0566
	4th	2.3295	2.0797
1975			
	1st Qtr.	2.3912	2.2788
	2nd	2.3249	2.3201
	3rd	2.1285	2.1601
	4th	2.0426	2.1107
1976			
	1st Qtr.	2.0001	2.1366
	2nd	1.8071	1.9720
	3rd	1.7665	1.9827
	4th	1.6511	1.9260
1977			
	1st Qtr.	1.7135	2.0732
	2nd	1.7190	2.1221
	3rd	1.7351	2.2101
	4th	1.8145	2.3196
1978			
	1st Qtr.	1.9273	2.4918
	2nd	1.8347	2.3423
	3rd	1.9317	2.4754
	4th	1.9843	2.5274
1979			
	1st Qtr.	2.0157	2.5448
	2nd	2.0801	2.6374
	3rd	2.2318	2.8800
	4th	2.1587	2.7735
1980			
	1st Qtr.	2.2536	2.9145
	2nd	2.2849	3.0013
	3rd	2.3811	3.1076
	4th	2.3856	3.0865
1981			
	1st Qtr.	2.3101	2.9922
	2nd	2.0813	2.7197
	3rd (e)	1.8371	2.4040

Source: IFS

* Adjusted by U.S. & U.K. Wholesale Price Index

The West German mark and the Dutch guilder were upvalued by 5.5 per cent and the French franc and Italian lira devalued by 3 per cent Sunday, Oct. 4, in the second major realignment of the European Monetary System (E.M.S.) that was born in March 1979. The Danish krone and the Belgian franc, Luxembourg franc and Irish pound didn't change in their E.M.S. value. The new central rates resulting from this adjustment are the following (in units of national currency per E.C.U.): Belgian franc 40.7572,, Luxembourg franc 40.7572, Deutsche mark 2.40989, Dutch guilder 2.66382, Danish krone 7.91117, French franc 6.17443, Italian lira 1300.67, Irish pound 0.684452.

Recent pronouncements from the Governor of the Bank of England indicate that monetary policy has shifted somewhat from a purely monetarist and quantitative target to one of exchange rate targeting. In effect, the Governor has become alarmed at the impact of a depreciating pound on domestic costs. Sterling's real rate of exchange, however, is still much too high (Figure 17) and continues to put extraordinary pressure on exporters' profit margins. Also, the UK's terms of trade are expected to deteriorate further as the oil glut forces a break in oil prices. Finally, the combination of an overvalued Sterling and excruciatingly high real rates of interest threaten to plunge the UK into a new downward leg in an already serious depression. We remain extremely bearish on Sterling.

***STRATEGY:** Remain long Swissie and short BP. Remain sidelined on the DM and Japanese yen.*

Canadian Dollar and Interest Rate Futures

Monetary policy continues to be extremely expansive. Whereas M_1 growth has shown a decline of 4.4 per cent at annual rates, broader aggregates such as M_2, M_3 and general loans are growing at 14, 16.4 and 27.5 per cent rates (last 3 months, annualized). Canadian dollar major assets, a good proxy for bank credit, has shown on the same basis a 21.3 per cent rate of growth. It should be pointed out that Domestic Credit increased CD$19 billion from November '80 to May '81, or by 12 per cent, while net foreign assets declined almost CD$11.5 billion in the same period, indicating that the Bank of Canada was *impeding* the normal monetary adjustment that follows from an outflow of foreign currency.

Figure 18 shows the continuous downtrend of required reserves as a ratio of total statutory deposits, the result of a shift in public portfolio preferences to deposits that require low reserves (notice deposits). The downtrend in this ratio is likely to accelerate now that the Bank Act has programed a further drop in required reserves. "Beginning March 1, 1981, and for each of the next seven succeeding six month periods, the required rate on Canadian dollar demand deposits will be decreased by $^1/_4$ of one per cent, while that on the amount by which a bank's reservable Canadian dollar notice deposits exceed $500 million will be decreased by $^1/_8$ of one per cent until by September 1984 the required ratios reach 10 per cent and 1 per cent respectively" (Bank of Canada Review).

Figure 18

Chartered banks: Cash and secondary reserves

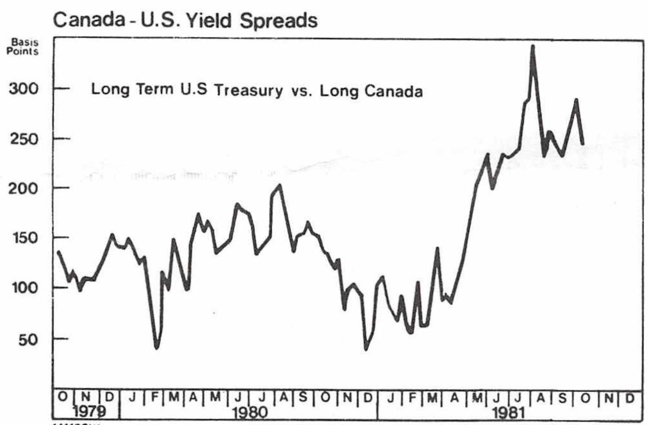
Daily average for period		Statutory deposits: Canadian dollar: Demand	Notice	Foreign currency	Adjustments for previous periods	Cash reserves: Required minimum	Required as a ratio of total statutory deposits (%)
		Millions of dollars unless otherwise indicated					
1979 J	1-15	19,180	88,382			5,837	5.43
	16-31						
A	1-15	19,324	90,463			5,937	5.41
	16-31						
S	1-15	18,848	92,363			5,956	5.36
	16-30						
O	1-15	18,817	93,328			5,991	5.34
	16-31						
N	1-15	18,635	94,059			5,999	5.32
	16-30						
D	1-15	17,580	97,334			6,003	5.22
	16-31						
1980 J	1-15	18,355	98,117			6,127	5.26
	16-31						
F	1-15	18,280	100,116			6,198	5.24
	16-29						
M	1-15	16,954	101,389			6,090	5.15
	16-31						
A	1-15	17,528	102,305			6,196	5.17
	16-30						
M	1-15	17,272	103,784			6,224	5.14
	16-31						
J	1-15	18,221	106,494			6,446	5.17
	16-30						
J	1-15	17,632	107,752			6,426	5.13
	16-31						
A	1-15	17,919	110,289			6,562	5.12
	16-31						
S	1-15	18,507	108,856			6,575	5.16
	16-30						
O	1-15	19,108	108,027			6,614	5.20
	16-31						
N	1-15	21,106	107,665			6,839	5.31
	16-30						
D	1-15	21,180	108,180			6,869	5.31
	16-31						
1981 J	1-15	23,089	106,759			7,041	5.42
	16-31						
F	1-15	22,512	105,069	9,745		7,092	5.17
	16-28						
M	1-15	20,026	114,009	8,737	4,626	7,111	4.83
	16-31						
A	1-15	20,690	113,853	7,971	−30	6,981	4.90
	16-30						
M	1-15	21,754	113,487	6,858	−229	7,100	5.01
	16-31						
J	1-15	20,941	115,080	6,229	−146	7,011	4.93
	16-30						
J	1-15	20,661	117,168	6,093	−32	7,032	4.89
	16-31						
A	1-15	19,845	120,629	6,057	−71	7,081	4.84
	16-31						

Bank of Canada Review

The implication for the growth of bank credit and the continuous deterioration of bank and corporate liquidity is staggering.

The differential in the long end of the market between US and Canadian interest rates should provide traders with a potentially profitable strategy. Given that the CD$ unit has stabilized at the 83¢ level (at any rate it is well above the late summer lows of 80.3), and that the Federal Government is expected to borrow a record sum of money at its yearly CSB campaign, and furthermore, given the likelihood that the Federal Government's borrowing requirements will narrow somewhat from the $11 billion reached last year, long term Canadas should narrow their 225 basis point spread over their US counterpart (see Figure 19).

Figure 19



Fixed Income, Wood Gundy

STRATEGY: *We favor purchase of Dec. '81 Canadian long-term bond futures* vis à vis *the sale of Dec. '81 US T-Bonds on a ratio of 27 to 20 (which weighs the different coupons and exchange rates).*

Remain short the CD$, risking 83.50 basis Dec. '81.

Figure 20

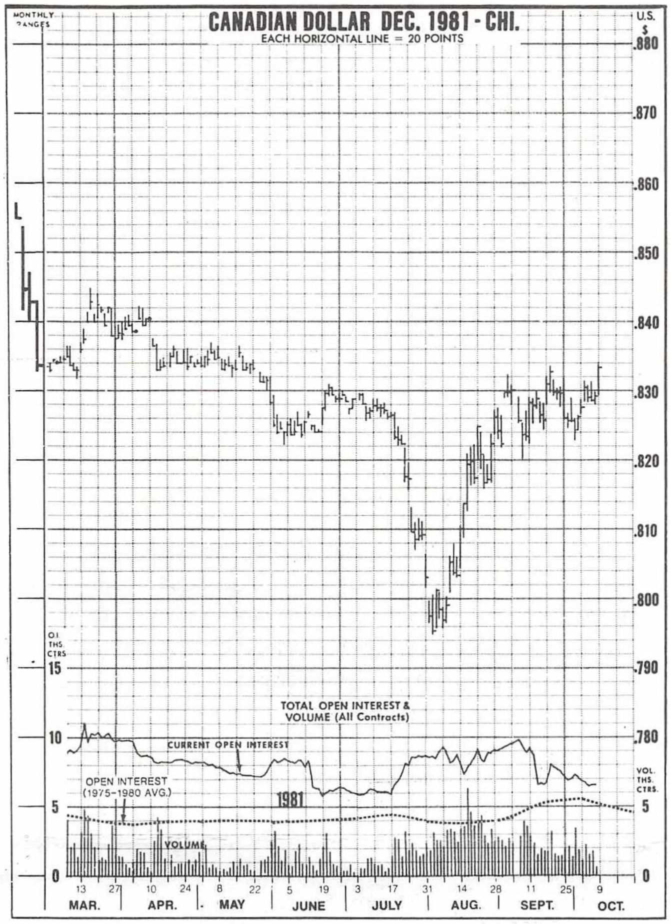


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Figure 21

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	Low		High	Low	Settle Price	Ch'ge	Open Int.
65-08	51-03	Dec 81	56-21	56-02	55-26	- 10	603
63-16	52-12	Mar 82	56-31	56-31	56-06	- 04	4
69-00	54-09	Jun 82	57-09	57-09	56-16	- -	0

Sales: Friday 241; Thursday 70
Total Open Interest: Thursday 607 - 14
Normal Daily Price Limits: 64-32 above or below prior settlement price.

Mexican Peso

Bowing to inevitable market forces, Sr. Angel Gurria, Mexico's Finance Minister, announced that Mexico will launch only 2 or 3 more public-sector Eurocredits totalling $1 billion between now and the end of the year. In the first 9 months of 1981, Mexico's public-sector borrowing totalled about $14 billion, of which no less than $4 billion took the form of short-term bank credit.

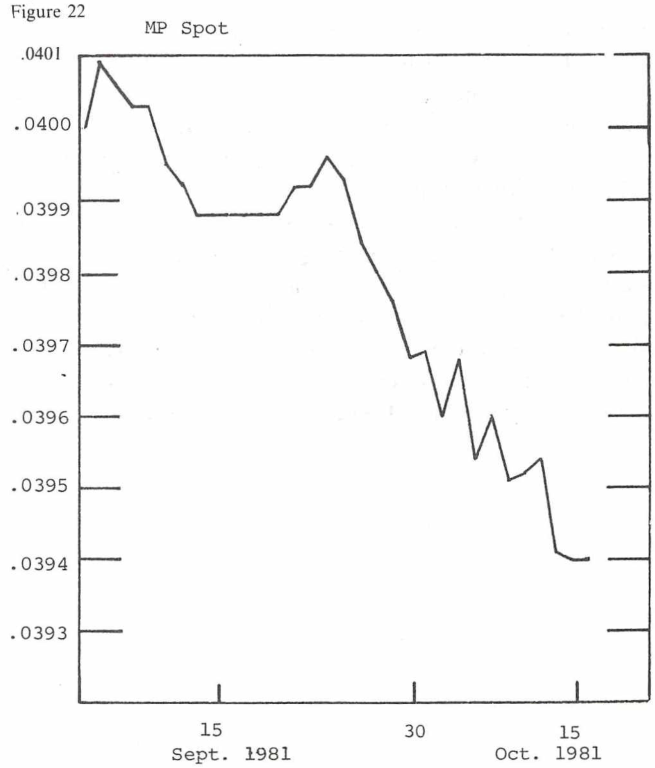
A good example of the highly deteriorated and disorganized state of affairs of Mexico's public finance is the fact that financial information on the country's banking system (including the Central Bank) is only available through December 1980. As a result, it becomes difficult to assess the true outflow of foreign currency, a development that we would like to monitor on a monthly or even quarterly basis.

The small bits of information that can be gathered from Presidential speeches indicate that, as of August 31, 1981, International Reserves increased by $4.9 billion over the year-end 1980. If Mexico's *public sector borrowing* for the first 9 months of 1981 was $14 billion and amortization of the public debt was approximately $2 billion (as per official statements), then the current account deficit and short-term outflows must have been equal to $7.1 billion ($14 bln. - $2 bln. - $4.9 bln. = $7.1 bln.), substantially more than the stated deficit on current account of $3.75 billion for the first 6 months of 1981. Either the deficit on current account almost doubled from June 30 to August 31, or Mexico is being mildly deceitful on its published current account numbers. Furthermore, private sector borrowings have no doubt taken place, thus placing further doubts on Mexico's published current account releases.

Mexico's level of International Reserves and therefore ammunition to defend the currency can be likened to a sink whose drain is open and water pours in from a running tap. As long as the tap runs faster than the water draining out, water accumulates in the sink. The moment water stops coming in at a rapid enough pace, the water level drops. The imminent slowdown in Eurocredits, a result of saturation and prudent (!) debt limits, will begin affecting International Reserves as soon as the last quarter of 1981.

***STRATEGY:** Remain firmly short deferred contracts.*

Figure 22



Wheat

The U.S.S.R. has traditionally imported large quantities of wheat in relation to coarse grains because wheat has dual-purpose value in that it is useful for human or livestock feeding. Wheat is imported for human consumption and poorer quality domestic wheat is freed for livestock feed. However, wheat is not a very efficient livestock feed. A trend towards increased Soviet imports and utilization of coarse grains, primarily US corn, has been evident in the last several years and is expected to accelerate as the Soviet feed compounding industry develops.

World trade levels in wheat and coarse grains are the major factor in the spread differential between wheat and corn. Soviet imports are the most significant proportion of world trade. World trade in wheat and coarse grains are at record levels for 1981-82; major realignments in the spread differential may develop if trade in coarse grains grows while trade in wheat stabilizes.

The current premium for wheat over corn is $1.45 for May '82. High premiums have been evident in periods of apparent year-to-year world food shortages with premiums reaching as much as $1.80 to $2.20 per bushel; wheat is much more important in the human diet on a world scale than as a feed grain to livestock. This was seen in reductions in Soviet livestock inventories in 1975-76. The current depression in corn prices provides a good opportunity to take advantage of the premium price of wheat in relation to corn.

Recent reports indicate that the Soviets may delay shipments of US wheat from Gulf ports. If this materializes, it will be a good indication that Soviet coarse grain imports are to be favored.

Since Argentinian production of corn for harvest in the first quarter of 1982 is reported to be suffering, the Soviets may have to realign their stance of treating the US as a residual supplier. Considering the huge surplus of corn in the US this year due to record output, the US is the obvious source of increased coarse grain imports. Increasing imports of corn at the expense of wheat will undoubtedly narrow the premium for wheat in favor of corn. In view of continuing tightness in world wheat and coarse grain supplies, however, wheat prices should not fall, while corn prices should improve substantially.

Figure 23

GRAIN IMPORTS BY COMMUNIST COUNTRIES AS A PROPORTION OF WORLD STOCKS

Year (July-June Harvest year)	WORLD STOCKS (metric tonnes) (beginning of period)	IMPORTS BY COMMUNIST COUNTRIES (metric tonnes)	RATIO OF IMPORTS TO WORLD STOCKS (%)
WHEAT*			
1978-79	84.2	17.5	20.78
1979-80	100.8	27.0	26.79
1980-81	79.2	36.0	45.45
1981-82	74.7	36.8	49.26
1982-83	79.8	30.1	37.72
COARSE GRAINS**			
1978-79	84.1	21.8	25.92
1979-80	90.7	30.4	33.52
1980-81	89.3	27.9	31.24
1981-82	74.1	37.2	50.20
1982-83	87.6	33.5	38.24

* includes wheat flour

** includes corn, barley, oats, sorghum, millet, rye.

The above data expresses imports by the Communist countries comprising the U.S.S.R., Mainland China, and Eastern Europe as a proportion of world stocks. While a slackening in this proportion is indicated for 1982-83, it is based on a middle scenario projection of production of grains in these countries. Soviet output in particular should improve next year, on a basis of odds alone; they have suffered three disastrous harvests in a row, quite likely due to management incompetence, but also due to inclement weather. Another bad harvest would cause the world grain situation to tighten in spite of significant additions to stocks — shown for the beginning of 1982-83 — (i.e. as of June 30, 1982), due to record world grain output. World stocks are at dangerously low levels. The price of wheat reflects some of this tightness but the price of corn is at unjustifiably low levels; the market is apparently awed by the size of the coming US corn harvest and is ignoring overall world tightness of supplies.

Figure 24

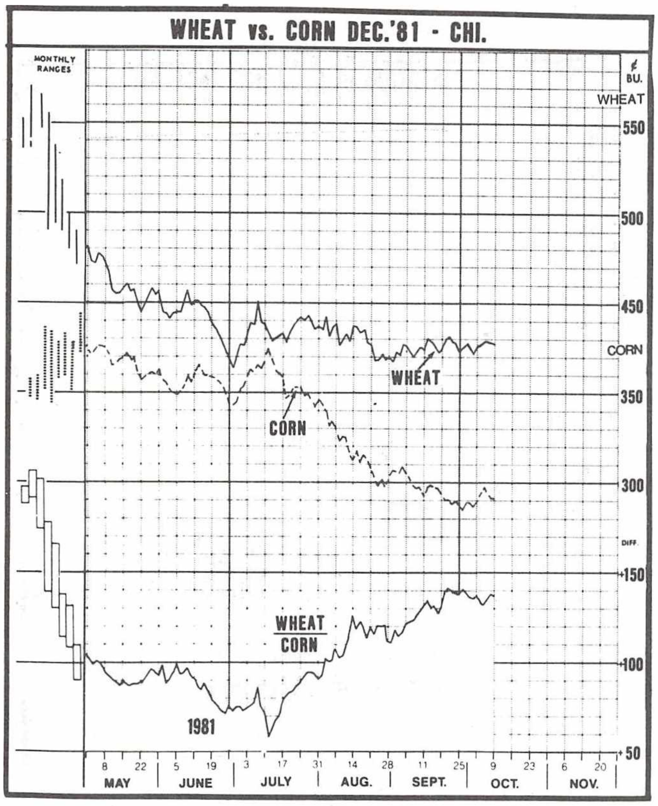
SPREAD DIFFERENTIAL: WHEAT AGAINST CORN
May contract prices on May 1st Chicago (CBT)

	Wheat	Corn	Premium (Wheat Corn)
1978	3.01	2.49	0.52
1979	3.54 3/4	2.61	0.93 3/4
1980	3.85	2.66¼	1.18 3/4
1981	4.37 3/4	3.61½	0.76¼
1982*	4.66	3.21	1.45

*(Current price)

The above table shows the current high premium for wheat against corn for the May '82 contracts, in relationship to the premiums in existence on May 1, 1978-81.

Figure 25



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STRATEGY: *The foregoing suggests long outright positions in May '82 wheat may be maintained, but at the same time opens the possibility of a further and less risky play: the purchase of May '82 corn against the sale of May '82 wheat at present spread differentials of $1.45 for wheat over corn.*

Michael Beech

Heating Oil

The confluence of two relatively bullish facts was responsible for the market's recent strength. In the first place, the assassination of President Anwar Sadat of Egypt reminded the world (and oil traders) of the unpredictability of Middle East politics and the instability of the region. The news was good for a $1 rise in Rotterdam's crude prices. Secondly, the perverse logic of a soon-to-be-announced unified OPEC price at the $34/barrel level, *a result of weak oil prices,* was interpreted as being constructive to the market, perhaps for the implications it holds for a reduction in Saudi output. We doubt that the Saudis will cut output to 8.5 mbd; more likely they will make a bit more permanent their first and conditional cut to 9.5 mbd.

Commodities Research Unit Ltd., a London-based firm, estimated mid-year inventories at OECD countries at 3.39 billion barrels or 105 days of consumption, compared to 84 days of consumption at the end of 1979 and 97 days at the end of 1980. Given negative profit margins in refining and expensive storage costs, private oil companies are likely to draw down burdensome inventories and force a break in OPEC prices.

Mexico has recovered its market share despite the continued glut and now boasts contracts totalling some 1.8 mbd compared with 1.5 mbd in June, raising the key question of whether Mexico will have to consider increasing production beyond the current 2.75 mbd "ceiling" in order to meet commitments. This is clearly a bearish development, especially when Mexico in effect has lowered its price to $30.70/barrel for a mix that sells at $31.25/barrel. In other words, volume sales are possible only at discount from OPEC prices. On the other side of the spectrum, Libya has had to lower its price by at least $5/barrel in order to keep its oil output from falling even further. Libya's production stands at about 650,000 barrels/day, down sharply from 1.4 mbd last January.

Symbolically, Libya's negotiation with Occidental Petroleum seems to mask the end of an era, an era that began in May 1970 when the very same protagonists, Libya and Occidental Petroleum, had a *tête à tête* that ended with Colonel Quaddafi extracting an extra 40 cents per barrel and forcing Occidental Petroleum and the rest of the Free World to capitulate.

If one is to heed current rumblings over decontrol of US natural gas pricing, the oil market takes on an even more bearish slant. Oil imports would taper further as natural gas reserves increase due to stimulation of exploration by higher natural gas prices. Groups in the US oppose decontrol as price increases would add to the C.P.I. but they fail to realize that decontrol would lead to much more efficient use of resources and narrow producer margins.

Controls were initiated under the Natural Gas Policy Act of 1978. The prime current concern over this policy is that gas prices are falling behind the value of crude oil on world markets, leading to wasteful consumption of gas. The Act was formulated on the basis that US crude would be selling for $15 a barrel by 1985, less than half its present price, even with current world surplus. The average price of all US gas is $2.13 per million BTUs — the equivalent of selling a barrel of crude for $12.37. The discrepancies in prices from different sources are shocking; prices range from $0.28 (equivalent of $1.62 a barrel) to over $9 per million BTUs due to irregularities in controls.

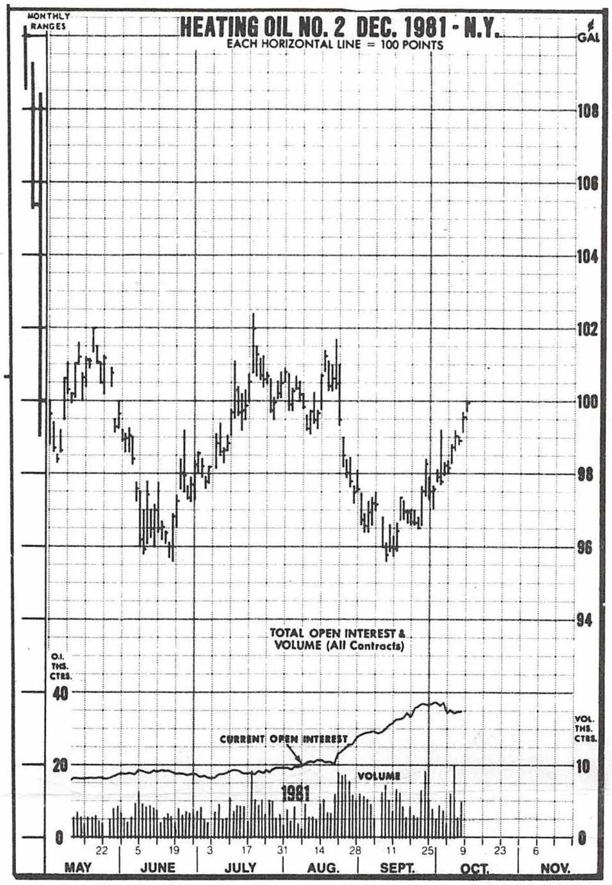
Exploration for crude oil is booming while the search for natural gas has stagnated. Oil exploration increased 39.2 per cent in 1980 from 1979 in terms of wells drilled. The increase in 1981 is expected to be 35 per cent. This rise in crude oil exploration was due to partial decontrol in the oil industry by President Carter and more recently, full decontrol by President Reagan. Gas well drilling increased only 7.2 per cent from 1979 to 1980, and even less than that in the first half of 1981.

If decontrol steps are taken in the natural gas industry, the same rates of increase in gas exploration could result as occurred in the oil industry following price formulation revisions.

In 1984-85, when decontrols are to occur, prices would still be significantly below free-market levels. To correct this President Reagan has several alternatives: 1) decontrol all gas immediately; b) phase in gradual price increases; 3) increase the ceiling price for each category to bring about parity with oil prices by 1985; 4) decontrol all prices for discoveries beginning next year and phase out all controls by 1985. The latter is the method prescribed in a bill presented to Congress by Congressman Phil Gramm of Texas.

STRATEGY: *Short of renewed war in the Middle East, oil prices will follow the path of least resistance, i.e. downwards. Remain firmly short but protect that eventuality by placing stops at a "disaster" level, 105 basis Dec. 81 Heating Oil.*

Figure 26



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Albert D. Friedberg