FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS
Hume Publishing December 20,1981

Discounting the Fed
(or why rates are heading back up)

Once upon a time, farmers brought their produce to market as soon as their harvest was completed and found that, alas, their proceeds were a great deal lower than what they had expected. Merchants watched with glee for their opportunity to cash in on seasonal trends and, sure enough, the early buyers were rewarded as post-harvest blues gave way to firmer markets. Years later, the advent of futures markets made the process a great deal more efficient. Traders *knew* that post-harvest prices represented seasonal lows and very appropriately marked down those prices vis à vis those that would prevail just *prior* to the next harvest. The difference between the low and high points was no greater, however, than the financing and storage costs incurred in carrying produce from the post-harvest period to the end of the season. The merchants' economic (or speculative) gain had disappeared. The futures market had *discounted* the natural evolution of cash prices.

The US Federal Reserve, in its attempt to guide a quantitative monetary policy, does not operate along smooth and invariable rates of growth. Leaving aside the question of whether the demand for money is the *sole* determinant of movements in the supply of money, as some economists would have it, or whether it is merely a very important contributor to the fluctuations in money growth, one would have to concede that the Fed cannot easily produce a steady rate of money growth.

The figures are quite revealing: Starting from the fourth quarter of 1979, a period that saw the Fed commit itself to a purely quantitative policy, the monetary base and adjusted bank reserves showed the rates of growth illustrated in Figure 1.

Figure 1

COMPOUNDED ANNUAL RATES OF CHANGE
OF MONETARY BASE AND RESERVES

	Monetary Base	Variation from prev. quarter annualized	Reserves	Fed Funds From	To
4Q79 — 1Q80	7.1%		0		
1Q80 — 2Q80	6.5%	- 33.8%	+ 2.8%	15.05	— 12.69
2Q80 — 3Q80	9.9%	+ 209%	+ 7.4%	12.69	— 9.83
3Q80 — 4Q80	10.0%	+ 4%	+ 13.0%	9.83	— 15.85
4Q80 — 1Q81	3.8%	- 248%	- 2.6%	15.85	— 16.57
1Q81 — 2Q81	7.8%	+ 421%	+ 8.0%	16.57	— 17.78
2Q81 — 3Q81	4.1%	- 190%	+ 1.7%	17.78	— 17.58
8/12/81 — 11/11/81	1.2%	- 283%	- 0.8%	17.58	— 14.04

As can be seen, quarterly variations in Fed's monetary proxies, or control variables, are extremely large. If market participants were rational, they would expect the Fed to tighten in the current quarter, following a quarter

In this issue

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that shows too much expansion and vice-versa. In practice, these expectations and counter-expectations are played out over weekly figures despite the Fed's warnings that such figures are, at most, preliminary. Here, however, we may disagree: for whereas *money supply* figures such as M_1B and M_2 are subject to a wide margin of error and are likely to be revised significantly in coming months, monetary base and adjusted reserves are almost free of estimations and are a great deal simpler to compile. Therefore, we could be a great deal less circumspect when utilizing these figures. At any rate, for purposes of our analysis, we have used a broad brush and examined only quarterly results.

Returning to our hypothesis of rational expectations, it would follow that the interest rate market would react in a *perverse* way to the Fed's current operating procedures. Thus, a sharp easing would evoke a *rise* in interest rates because market participants expect the Fed to reverse course; a sharp contraction would produce a *fall* in interest rates as the Fed is imminently expected to ease.

Looking at the record we notice that, in fact, the market has reacted in much the same way we had expected with only two exceptions. The first exception to the rule took place between the second and third quarters of 1980 when a very accommodating Fed posture should have found market participants "marking up" interest rates in the natural expectation of a near-term reversal of policy. Instead, Fed funds dropped from 12.69 per cent to 9.83 per cent. This exception can be dismissed for the following reasons: (a) US corporations had just undergone a dramatic reliquification process, having issued a record amount of long-term debt and paid down bank and commercial paper financing; (b) most of the decline in rates had taken place early in the second quarter and, in fact, by the end of the third quarter, rates had already advanced *substantially* above the average 9.83 per cent, standing at 13.19 per cent. It should be noted, however, that the extraordinary jump in rates that occurred over the 3Q1980 to 4Q1980 period more than made up for the apparent "failure" of our model in the earlier quarter.

The second exception to the rule, 4Q80 to 1Q81, showed a relatively minor change in rates and could be attributed to the strong upside momentum already in progress. In all, market participants proved to have *reacted perversely* to the Fed's intentions and well in line with the monetarist credo that expanding money supply figures cause higher, not lower, interest rates, and that contracting money supply figures cause lower, not higher, interest rates.

The most recent period has seen interest rates plummet accompanied by an extremely tight Fed posture. From the middle of August to the middle of October, the monetary base *declined* at an annual rate of 0.8 per cent, while adjusted bank reserves showed nil growth. Furthermore, Federal Reserve credit showed a miniscule annual growth rate of 0.55 per cent for the three months ended in October. The Fed was helped considerably by market expectations in the attainment of this goal.

Recession induced expectations of lower interest rates forced the Fed, repeatedly, to intervene in order to slow down the descent in rates. This maneuver was accomplished by either repurchase agreements or outright sales of securities with the result that reserves growth came to a grinding halt.

In recent weeks, as Fed Funds stabilized in the 12 to 12.5 per cent range, the Fed began to reverse gears and intervened by way of reverse repurchase agreements and/or outright purchases to hold the funds rate from *breaking upper intervention points.* The result was resumed growth of the monetary base and adjusted bank reserves, which are now growing at better than 6 per cent per annum. Further upside pressure on Fed funds will accelerate growth in these two aggregates, *creating the necessary preconditions for a sustained rise in interest rates* over the coming weeks and months.

Why should there be upside pressure developing in Fed funds? For one thing, corporate liquidity is showing no signs of improving, despite the respectable refunding operation achieved in November where almost $7 billion of new long-term debt was placed (deep discount issues are calculated on a net proceeds basis). This is especially true now that corporate cash flow is being eroded by the slump in profits.

More importantly, bank liquidity continues to deteriorate. Figure 2 shows that the critical loan/deposit ratio has just reached a new, all-time high, easily eclipsing the previous peak reached in February 1980. If to this we add the concern about banks' capital generated by the virtual default of Polish loans and possible rescheduling of Rumanian, Yugoslavian, Costa Rican, Bolivian and Sudanese loans, as well as impending trouble in Mexican, Brazilian and Argentinian loans, it becomes apparent that banks' appetite for purchased funds will not abate and may easily exceed last summer's highs.

The opening comments brought into relief the rationality of market participants and the well-known predisposition of markets to discount time-tested economic events. On that score, recent Fed easing will inevitably be followed, as night follows day, by Fed tightening. Rates will have to begin rising. On a more fundamental note, eroding industrial and banking liquidity augurs for a very disturbing and frenzied search for cash in months ahead.

STRATEGY: *Last month we foresaw the possibility that rates would begin turning up during December and provided a timing device to initiate a short position in T-Bills.*

Let us review what happened. Nearby Dec. '81 T-Bills did not show a weekly reversal but did penetrate on the downside the steep and short October-November uptrend. (Figure 4 marked a-b). Subsequently, the market recovered to a new high, forcing a buy stop. Two weeks later, a more gentle uptrend was broken on the downside *(marked c-d), confirming the validity of the bear signal. Basis March '82 T-Bills, the new short position, if taken at 88.75, would now be showing a small profit, approximately 40 points. We also stated last month that "... a more conservative and more reliable approach ... would involve the use of a cash T-Bill weekly average chart and the penetration of its a-b downtrend (yields up, bills down)." This past week's average, 10.98 per cent, meets the downtrend exactly on target. Even an unchanged close for the coming week would give us the* final *technical confirmation. We believe this to be a foregone conclusion.*

Given the severity of the recession and the bulging corporate (and municipal) bond calendar, the yield curve may continue to remain positively sloped. If so, T-Bonds, rather than T-Bills, represent a better sale at these levels, as the latter are already deeply discounted.

Add and/or begin short positions emphasizing first T-Bonds and later Eurodollars, CDs and T-Bills. Place stops approximately 100 yield points higher.

Figure 2 LOAN — DEPOSIT RATIO

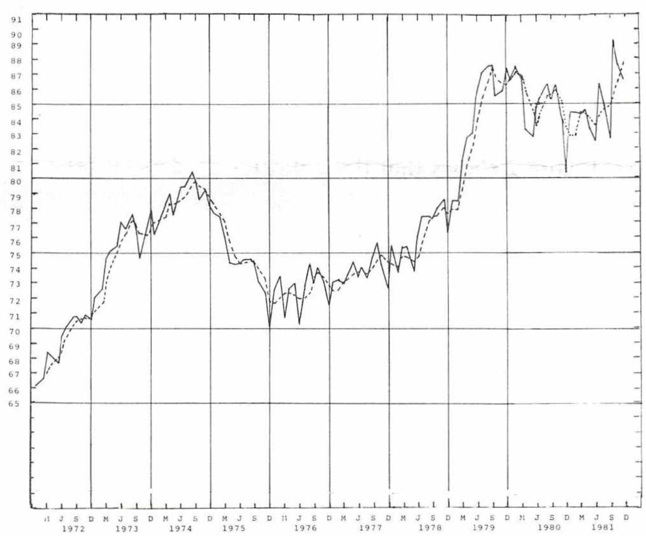

Figure 4

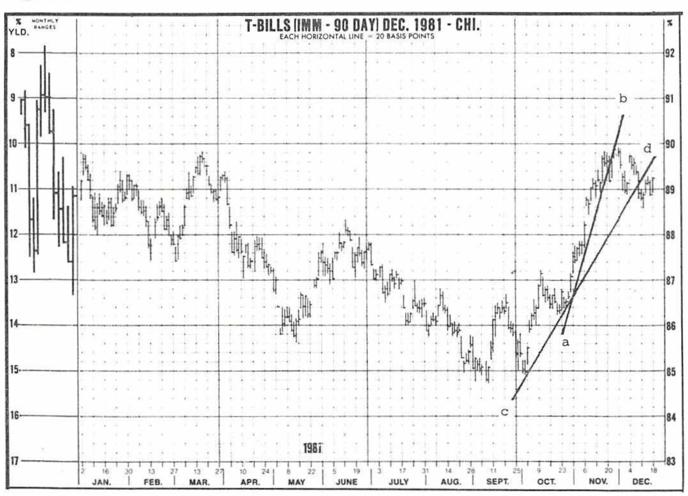

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Figure 3

Polish Loans Not Guaranteed By Third Parties

Bank of America	$125 million - 150 million
Citicorp	75 million - 100 million
Chase Manhattan	75 million - 100 million
Manufacturers Hanover	75 million - 100 million
Morgan Guaranty	75 million - 100 million
Chemical Bank	60 million - 80 million
First Chicago	50 million - 75 million
Continental Illinois	25 million - 50 million
Bankers Trust	25 million - 50 million
Security Pacific	10 million - 20 million
First Interstate	5 million - 15 million
Wells Fargo	.5 million - 10 million

Estimates by Bache Halsey Stuart Shields Inc.

Figure 5

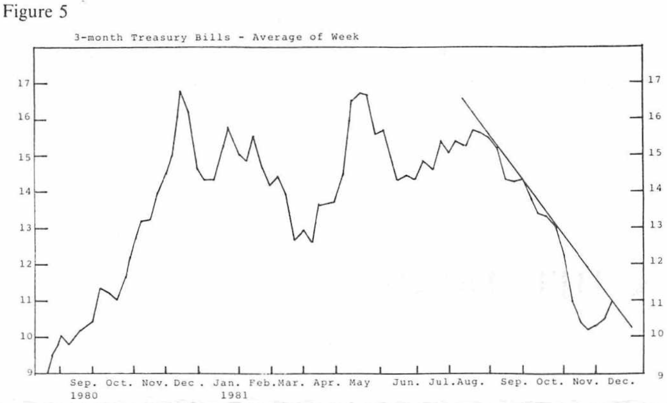

Figure 6

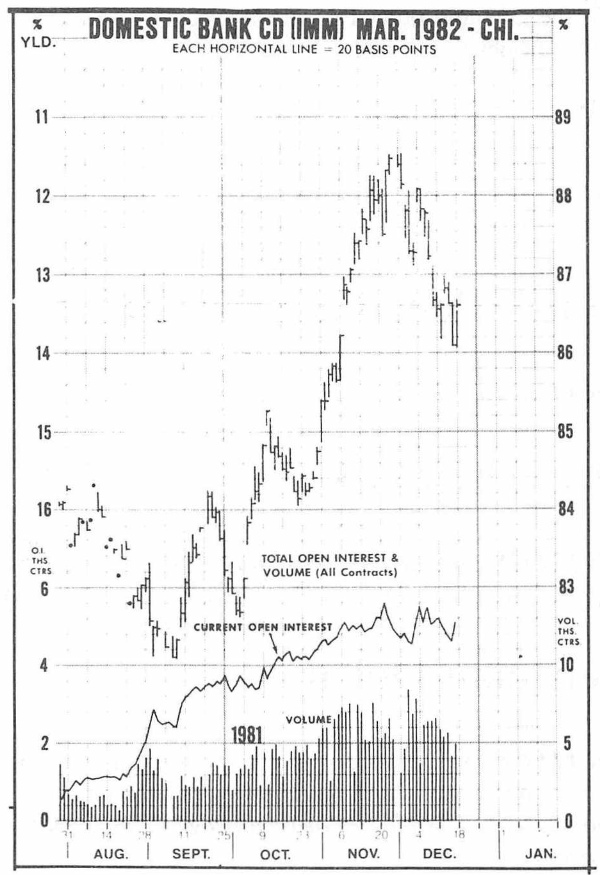

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Figure 7

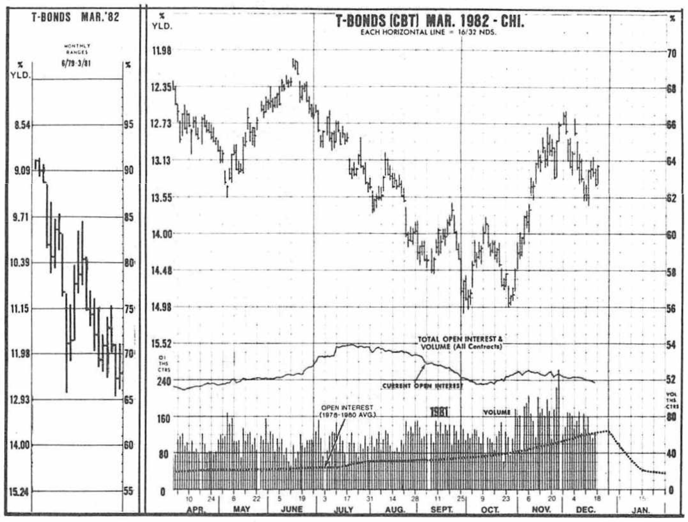

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Figure 10

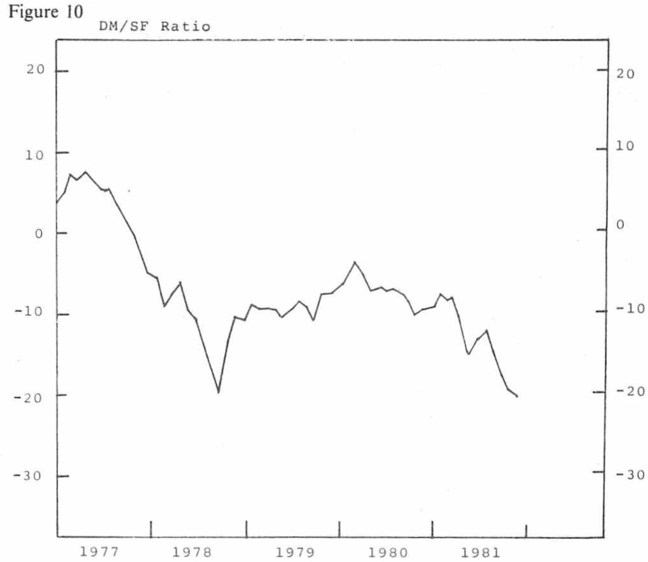

Figure 11

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Currencies

The coming rise in US interest rates should help the US currency resume its stalled advance. Whereas, both the Swissie and Sterling have gained considerable ground vis à vis the DM and other European currencies, they do not merit outright positions.

Swiss Franc

STRATEGY: *Liquidate positions, accepting profits of $2,900.00 per contract.*

British Pound and Yen

STRATEGY: *Remain sidelined.*

Deutsche Mark

STRATEGY: *Initiate short positions at these levels, risking closes above 45.20 basis March '82.*

Canadian Dollar

STRATEGY: *Steep forward discounts preclude us from initiating aggressive short positions. Speculators should remain sidelined, while commercial hedgers may want to sell nearby months.*

Figure 12

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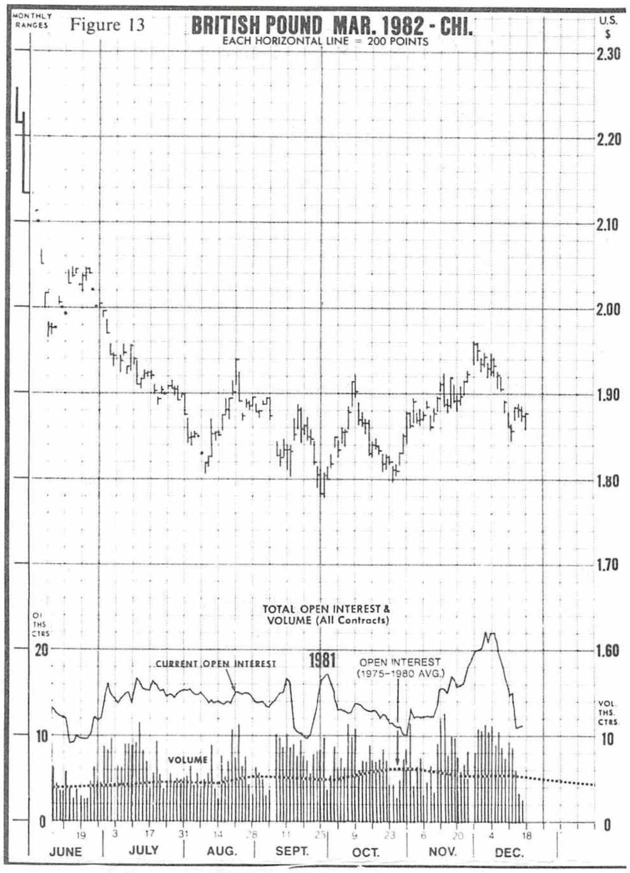

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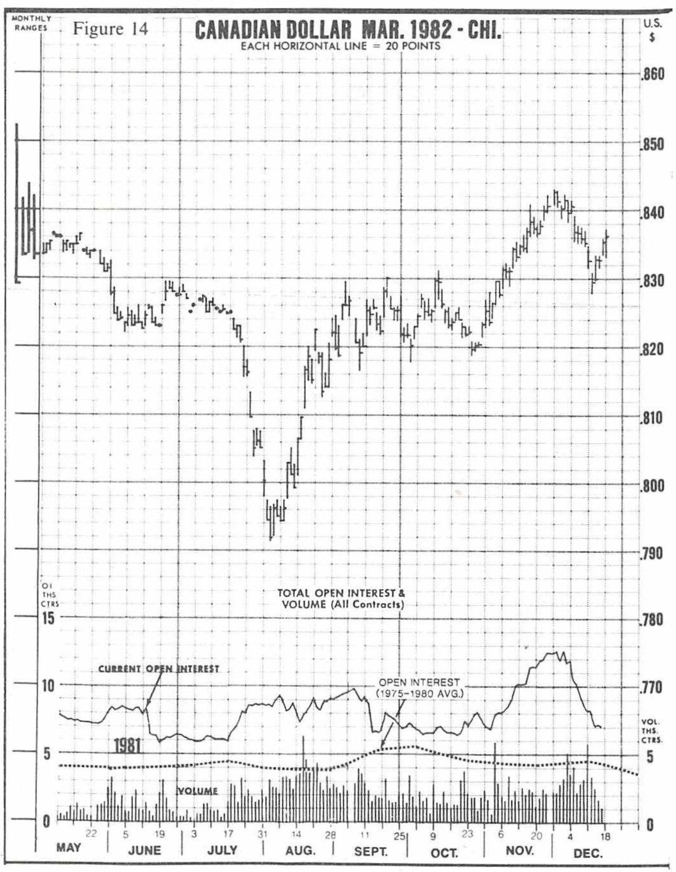

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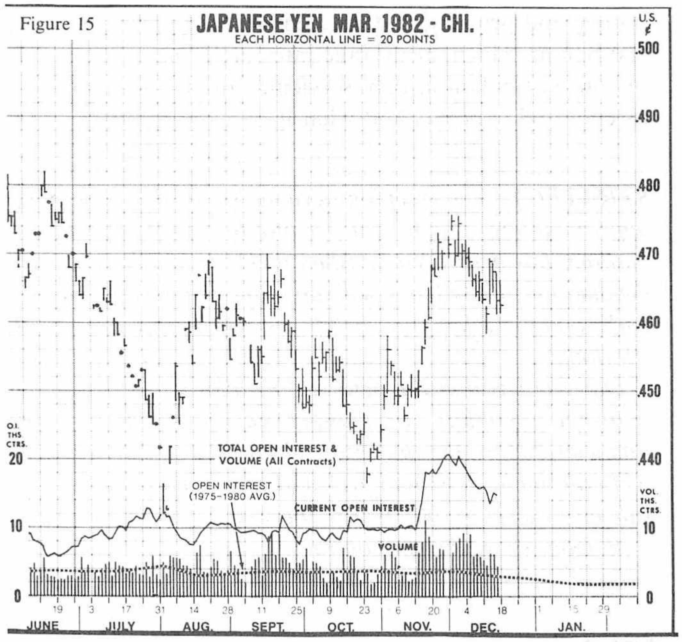

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Mexican Peso

Mexican borrowing woes are beginning to raise eyebrows. First came finance Minister David Ibarra Munoz's revelation that Mexico's total public foreign debt increased by $14.9 billion in 1981 to $48.7 billion because government spending had been higher than anticipated. Combined with at least $15 billion in private foreign debt, Mexico's total foreign debt surpasses Brazil's to take the lead as the world's most indebted nation. Secondly, Mr. Munoz disclosed that the 1982 budget deficit was *estimated* at approximately $27 billion, or roughly 13.4 per cent of GNP, a catastrophic and unsustainable (at least in the context of a semi-fixed rate of exchange) level.

Commercial banks estimated that Mexico would have to raise approximately $20 billion abroad during 1982, broken down as follows: $11 billion towards the public sector's net requirements; $6 to 7 billion of short-term debt; and another $3.3 billion long-term debt coming due this year. These blue-eyed bankers follow Munoz's line in three respects: They accept that the $27 billion deficit will not be exceeded — a totally improbable occurrence given the recent history of government spending profligacy; they accept that $16 billion will be raised locally, although that implies a massive monetization and possible three-digit inflation; and they believe that Mexico's current account deficit will not widen significantly even though the oil market is on the verge of collapse.

Finally, everyone assumes that international lenders will simply raise lending margins and shut their eyes to a sure case of insolvency. By the end of 1982, if Mexico were capable of borrowing an additional $11 to 15 billion (public and private), its total debt would approximate $80 billion, which, at average rates of 15 per cent, would require $12 billion in debt servicing, an amount equal to its entire oil exports. And what if oil exports dry up?

STRATEGY: *The creeping devaluation of the peso, now approximating 1.5 per cent per month, will accelerate. Nothing has been accomplished with the 12 per cent devaluation of 1981 nor will anything be accomplished with something less than a 100 per cent revaluation of the US dollar.*

Our guess is that the peso will be allowed to float (with the possibility of a two-tier market: commercial and financial) before the upcoming election. If so, the peso will crumble to less than .015 and may even reach a ridiculous level of .005 before the year is out.

Remain short distant contracts.

Figure 16

Mexican Peso - Spot price devaluation (end of period)

	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
1980	+2.97%	-0.2%	-0.05%	+0.1%	-0.1%	-0.4%	-0.4%	+0.07%	-0.2%	-0.3%	-0.2%	-0.3%
1981	-0.7 %	-0.6%	-0.9%	-0.8%	-0.9%	-1.2%	-1.1%	-1.04%	-.075%	-1.34%	-1.05%	-1.5%*

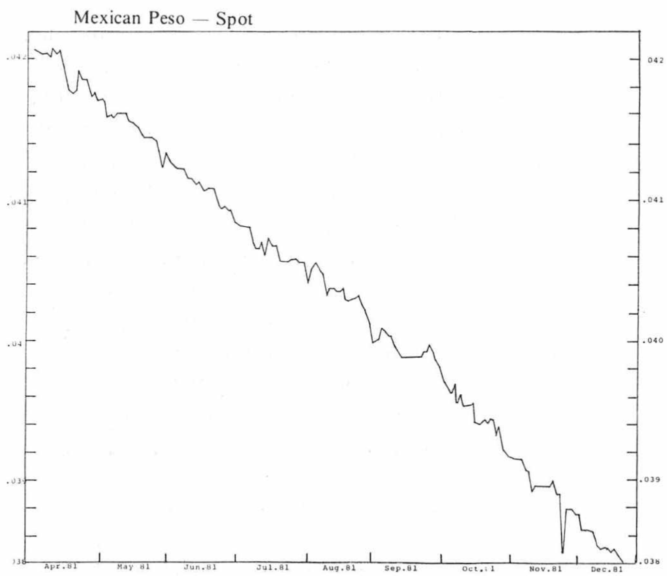
* Dec.18th,1981 closing price against Nov.18,1981 closing price.

Figure 17

Mexican Peso

	Dec.81	Mar.82	Jun.82	Sep.82
At 1.5% monthly Compounded devaluation from Dec.81 Termination Price	38.47	36.76	35.13	33.58
Closing price as of Dec.18,81		35.29	32.29	29.30
Potential Loss (in points)		147	284	428
(in US$)		1,470	2,840	4,280

Figure 18



Precious Metals

Rising illiquidity and rising interest rates are poisonous to precious metals. Industrial demand for silver fell in the first quarter of 1981 to the lowest level since 1970.

STRATEGY: *Remain short silver.*

Last month we stated, "be prepared to buy Feb. '82 gold if it closed above 440." Despite the recent Soviet "intervention" in Poland, Feb. '82 gold failed to come close to this level. A sign that the market is readying for a sizeable move... on the downside. Maintain the same posture.

Figure 19

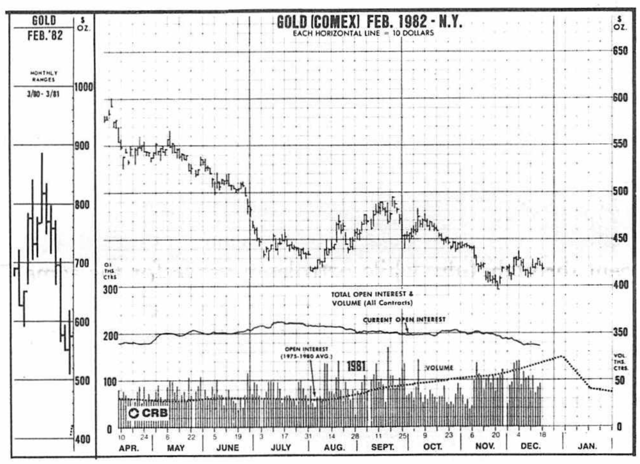


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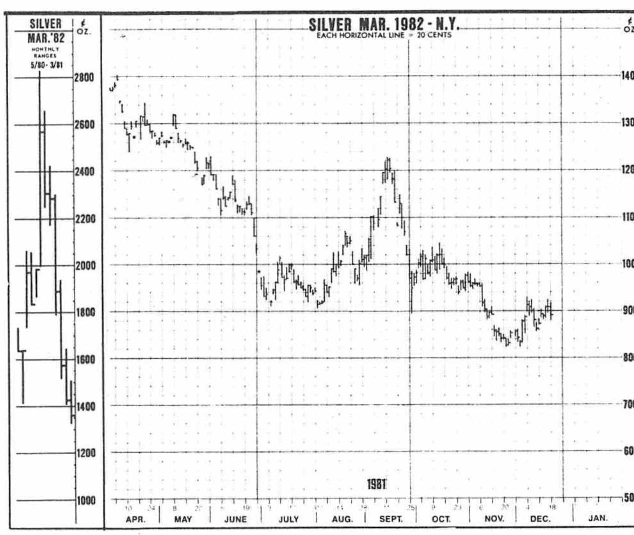
Figure 20



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Heating Oil

We maintain a very negative view toward world oil prices and believe short positions in heating oil futures represent an investment-type position in a bear market that will prove to be of major magnitude.

Our long-term analysis of the crude oil market has been well detailed in our *Comments* of November 1980 and September, October and November 1981. Data made recently available supports previously-made projections.

On the demand side, imports of crude oil and refined products fell 13.1 per cent in November from the previous year, as reported by the American Petroleum Institute (API) in its most recent monthly survey. The drop was to the lowest November level in nine years. Imports of crude fell 12.2 per cent to 3.9 mbd, while product imports fell 15.3 per cent to 1.4 mbd. Actual consumption of oil products including US production is declining at an accelerating rate. During November, usage fell by 6.4 per cent from November 1980, bringing the overall rate of decline through the first 11 months of 1981 up to 5.2 per cent.

Consumer resistance to prices which are, as explained in previous issues much too high in real terms, and conversion to other energy sources (it was recently reported that coal usage in power generation rose 6 per cent through July, while petroleum usage for the same purpose fell 4 per cent) have done serious damage to the fundamental demand base for petroleum products. The effects of the recession on current usage are just beginning to be felt. Barring an extremely cold winter, we expect to see further declines in consumption as the slowdown impacts upon data that will be available in coming months.

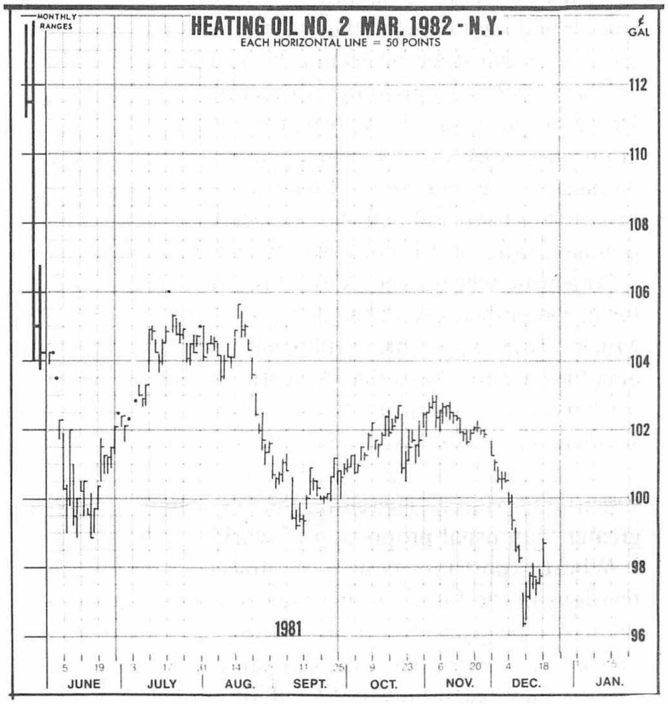
Looking to the supply side, one notes that oil and gas drillings are up 11 per cent over last year. The 69,656 wells drilled to date (end of November) top last year's record of 62,704, which in turn was the highest number of wells drilled since 1956.

While OPEC's decision last week to drop prices by an average of 20¢ a barrel may appear a meager concession, it should be remembered that the concession represents the first since the cartel was founded. The rest of the iceberg will become more apparent as the glut swells: from further reductions in demand; from additional supplies that will be provided both from new wells and from Iraq and Iran (some sources estimate these two embroiled nations can be expected to offer an additional 3mbd to the market); and from other OPEC nations, as balance of payment deficits impact on their economies.

The five-cent decline in futures prices that has taken place during the past month reflects the market's perceptions of various components of the above scenario. However, while the break is encouraging to the bears, especially inasmuch as it represents a significant deterioration of the chart picture, futures prices do not and will not lead crude prices lower. And it is the price of crude which we are essentially forecasting to fall. This is only to say that while the best is yet to come, the full scenario may take some time to unfold. This is why, at the outset, we referred to our short position as an investment, to be distinguished from a trade.

STRATEGY: *Remain commitedly short, preferably deferred deliveries. Our target and risk level are 75,000 and 100.60 respectively, both basis liquid March.*

Figure 21



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Grains

In our October 18 issue we pointed out fundamentals that predicted rising grain prices, particularly for corn. In spite of declines in grain prices between that time and our November 15 issue, we remained bullish for wheat and corn without the protective value of stop recommendations.

By definition, we had key reversals in the corn and soybean futures on Dec. 1. The nearby wheat contract failed to make a full key reversal. The reversals were technically supportive factors, which corresponded with our fundamentals.

However, all support was blown apart shortly thereafter when grain prices entered a free fall.

This came about on December 7 when it was rumored that Australia sold 1 million metric tonnes (MMT) of wheat to India. Sales of 750,000 MT have so far been confirmed. Traders attributed that day's losses to recessionary factors, but in fact it was expected that India might import US wheat. This, combined with the onslaught of recession, set off the current major decline in grain and oilseed prices.

Bullish fundamentals have been completely discounted as a result of the current "recessionary psychology." As suggested in our last report, there was some improvement in corn export sales, in the week ended November 12, but this has not been sustained. Wheat sales have declined from October levels, consistent with seasonal patterns. We continue to watch for greater corn export sales.

The USDA recently revised its forecast of USSR imports this season. Wheat imports are now forecast at 19 MMT (18 MMT previously); corn imports at 23 MMT (24 MMT previously). Total import projections remain unchanged at 43.0 MMT, including soybeans and meal. The department correspondingly reduced the US export forecast and raised the US ending stock projection by 75 million bushels.

The USSR has apparently increased wheat feed use. However, according to reports, the Soviets will have to shift grain purchases towards coarse grains to avoid further damage to livestock herds. Livestock numbers and meat production have suffered. We expect a more normal purchase ratio of 2:1, corn over wheat, to begin presently.

Argentine wheat exports and sales have fallen sharply so far in December, even though the harvest is in full swing. Much of the exportable surplus has been committed; this is also the case for Australia. Argentina's 1982-83 corn crop for harvest in several months is expected to be significantly smaller than in 1981-82. Brazilian soybean supplies have been severely depleted; the new crop will not be harvested in Brazil until March. Therefore, the US commands an even greater than usual proportion of world stocks.

Wheat export targets may be subject to downward revisions in the future. Using the average export pace for the past nine years, based on first quarter exports in each season, the Leslie Analytical Organization projects that exports may reach only 1,763 million bushels compared with the USDA's target of 1,900 million bushels. Also, given the recession, lower US demand for meats and subsequent drops in livestock placements and numbers on feed, the USDA feed and domestic use projections may be too high.

Domestic use targets have not been reduced downward to account for the recession. Although average use rates for July to October were consistent with domestic use targets of 932 million bushels, the recession's impact did not really begin to be felt until late October. (See figure 22, 23, 24)

The 1981-82 carryout is indicated as lower than the total under reserve and loan programs. This means withdrawals of wheat from the reserve would be in order if the USDA's targets are correct. Prices would likely have to go to the release price of $4.65 to bring this grain to the market.

We have been monitoring the entrance of 1981 crop corn into the reserve and loan program. Significantly higher reserve and loan entries were recorded in the latest report, to December 2. This is shown in Figure 25. Large entries into the reserve should be very supportive for corn prices. At a $2.40 support level, reserve loan producers pay 14.5 per cent interest the first year. This amounts to $0.348 in interest; the cash price farmers would sell at could thus conceivably be as low as $2.05. Given a basis of $0.20 to 0.35, Chicago over farm price, we see the theoretical minimum price of corn on the CBT, given the reserve program, as $2.25 to 2.40. Corn has traded in this range over the past week. Wheat, on the other hand, is far from its price support of $3.20.

It is always possible for grain hedgers to be overwhelmed by total supplies, irrespective of what is held in reserve. Therefore, prices may temporarily trade below support levels. However, bottom pickers should do well to respect the 2.25 to 2.40 level calculated in the preceding paragraph.

Currently, our recommended short May wheat-long May corn spread is at a price differential of $1.28 3/4. For some who placed it at $1.57 1/2, it is making $0.28 3/4 ($1,437.50 per contract). Our present target for the spread is $1.10 in line with our expectations of a return to a more normal Soviet purchase ratio. Hard wheat (basis Kansas City, preferred by the USSR — bread-type wheat) is to be tighter in supply towards the end of the season than soft wheat (basis Chicago, which China imports — pastry-type wheat). See Figure 22.

This would suggest the purchase of May '82 KC wheat against the sale of May '82 CBT wheat at present levels.

World demand for soybean has been rising at a faster rate than supplies, but the aforementioned "recessionary psychology" is preventing a recovery in prices. Estimated supplies of US, Argentine, and Brazilian soybeans for September to December 1981 were up 7.6 per cent from last year, while disappearance is expected to rise 8.3 per cent. US disappearance for the first four months of the 1981-82 season is expected to rise by up to 16.6 per cent versus only 11.4 per cent for supplies. The USDA raised its 1981-82 export estimate by 10 million bushels on December 11, approximately 2 per cent of all projected exports.

STRATEGY: *Retain long May '82 corn-short May '82 wheat spread, looking for 1.10. Institute long KC-short CBT wheat spreads, looking for a 20¢ per bushel profit.*

Await confirming technical signals in grains and soybeans that would run parallel to our fundamental idea before reentering the long side of market.

Figure 22

Projected Wheat Balance by Class, 1981-82
(million bushels)

	Hard Winter	Soft Red	Hard Spring	Durum	White	Total
Supply						
Carryin	540	38	257	60	93	988
Production[2]	1104	658	468	183	339	2752
Total	1164	696	725	243	432	3740
Disappearance						
Domestic	392	241	178	56	65	932
Export	870	425	225	80	300	1900
Total	1262	666	403	136	365	2832
Carryout						
Carryout	382	30	322	107	67	908
Total in Govt. Programs on 10/1/81	431	49	225	31	73	810

Includes imports.

Figure 23

Wheat And Wheat Flour Exports
From The U.S.
(million bushels)

Year	Total Exports	First Quarter Exports	First Quarter As % of Total
1972-73	1135.0	28.8	25.4
1973-74	1217.0	525.8	43.2
1974-75	1018.5	330.4	32.4
1975-76	1172.9	428.4	36.4
1976-77	949.5	398.8	42.0
1977-78	1123.9	381.7	34.0
1978-79	1194.1	493.3	41.3
1979-80	1375.2	511.0	37.2
1980-81	1510.1	518.4	34.3
1981-82			
Mean	(1763)	638.1[1]	36.2

[1] Wheat exports plus 5 percent to adjust for flour exports.

Figure 24

Domestic Wheat Consumption
(million bushels)

	Total Consumption	First Quarter Consumption	First Quarter As Pct. of Total
1972-73	797.5	369.7	46.4
1973-74	747.9	327.8	43.8
1974-75	686.1	245.3	35.8
1975-76	735.1	258.8	35.2
1976-77	754.4	226.1	30.0
1977-78	859.0	373.4	43.5
1978-79	837.0	326.7	39.0
1979-80	783.1	277.1	35.4
1980-81	773.3	282.1	36.5
Overall mean			38.4
Selected mean[1]			43.1
1981-82	(923)	398	

[1] Mean of years when first quarter feed disappearance was large—1972-73, 1973-74, 1977-78, 1978-79.

Figure 25

ENTRANCE OF 1981 CROP CORN INTO
THE GRAIN RESERVE & LOAN PROGRAM

(Million Bushels) week ended:	WEEKLY LOANS	TOTAL LOANS	GRAIN RES.	OUTSTANDING
Nov. 4	32.2	81.9	24.2	57.3
Nov. 11	35.9	117.8	40.0	77.4
Nov. 18	89.7	207.8	82.7	124.2
Nov. 25	86.0	293.5	125.6	167.1
Dec. 2	125.2	418.7	190.7	227.2

Figure 26

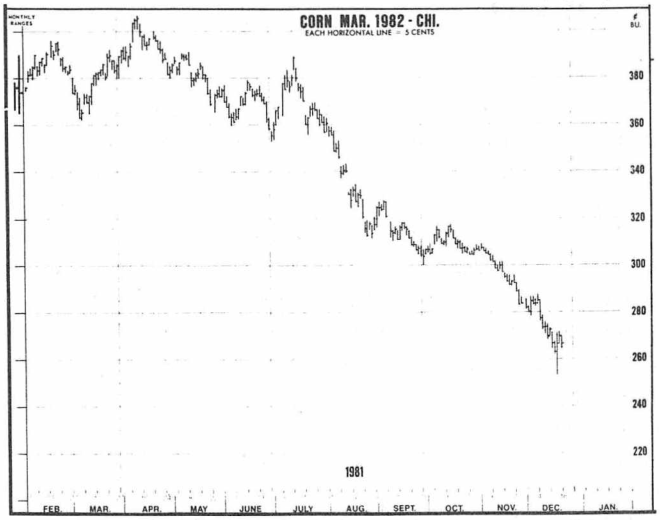

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Figure 27

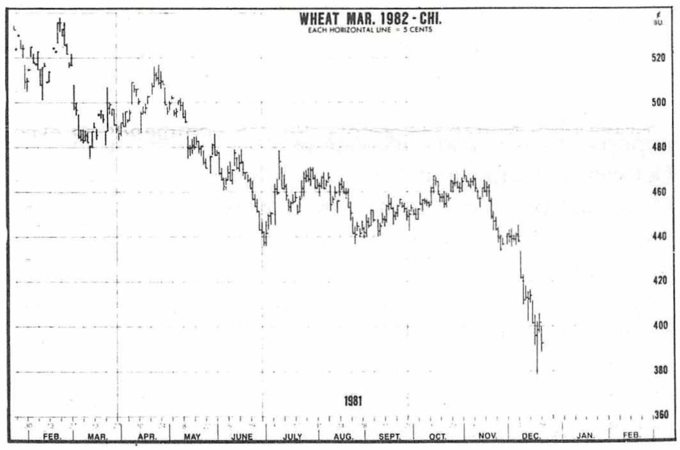

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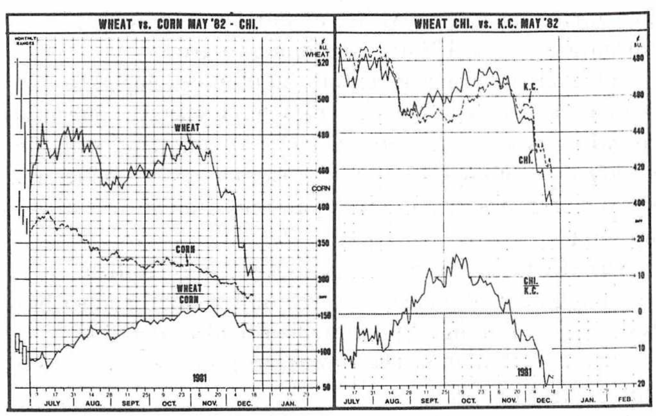
Figure 28



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Cocoa

We are of the opinion the bear market rally in cocoa prices that we forecast in our last *Comments,* dated November 15th, has spent itself. Short positions at current levels are warranted.

Review of last month's *Comments:* Cocoa prices in the midst of major bear market cycle. Current fundamentals are bearish. Fundamentals both long-term and short-term obscured by the ICCO, which has established a buffer stock in a thus far unsuccessful attempt to buttress prices. In the wake of the buffer stock managers' inability to achieve aims consistently, despite having purchased 65,000 tonnes, the ICCO was due to meet and possibly provide additional funds.

Updating current fundamentals we note Gill and Duffus' most recent estimate for the 1981-82 crop year calls for a 97,000 tonne surplus versus 96,000 tonnes forecast last month and 81,000 tonnes actual last year. Production is put at 1.71 mln. tonnes versus 1.68 mln. tonnes estimated last month. Consumption is now estimated 1.61 mln. tonnes versus 1.59 mln. tonnes last month. The 97,000 tonne surplus when added to this year's beginning stocks leaves a carryout to consumption ratio of nearly 50 per cent.

Looking at demand in the US, the trend of higher imports of cocoa and chocolate products continued in October, the latest month for which figures are available. On a total bean equivalent basis, imports totalled 88,897,532 lbs., up 91.6 per cent over October of last year. Through the first ten months of 1981, cumulative imports, again on a total bean equivalent basis, were running 47 per cent ahead of last year's pace. Imports of beans only during October jumped sharply to 53,889,347 lbs., up 151 per cent over October of last year. Cumulative imports of beans through October were running ahead of last year's pace by 91 per cent.

Since grinding figures are published quarterly, we do not know the extent of current bean usage. As we pointed out last month, through September only, 69 per cent of beans imported during the year were ground, leaving 31 per cent presumably in inventory. We assume at present that inventories in the US are continuing to grow.

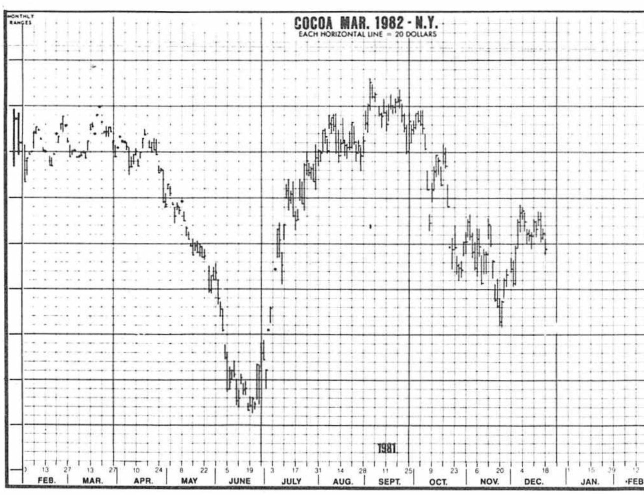
Whether the recent inventory buildup developed in anticipation of ICCO buffer stock buying as we opined last month or whether inventories increased unintentionally in anticipation of consumption that simply has not materialized, the outsized stocks do serve as an impediment to a sustained uptrend.

The ICCO has been conspicuously quiet. No firm announcement of increases to the buffer stock budget have been made, although four Brazilian banks offered to contribute \$85 million via a three- to four- year loan with interest tied to Libor.

Surely the month's price rally must have been in anticipation of something more substantial. One might conclude that the top of the rally (2100 basis May) discounts "the worst." N.B. It is noteworthy from a technical point of view that 2100 does represent virtually a 50 per cent retracement from the bottom of the market to the breakdown area.

STRATEGY: *Last month we called for a bear market rally that could carry values to the 2150 area, basis March, at which point one should begin to sell on a scale up. The rally managed to achieve 2050 only. We feel the evidence, in sum, suggests another leg of this major bear market is beginning. Advise establishing short positions in May with stops at 2125. Our target is 1550.*

Figure 29



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Sugar

Since last writing, the sugar market has advanced some 50 basis points. The rally has been attributed to broad speculative buying: Most prominent has been the dramatic bidding for a reputed 10,000 lots of March by a single individual or group from California. Despite the foregoing, we remain bearish and short.

There has been little change in official projections of long-term fundamentals since our November 15 *Comments.* World production is put at 95.8 mln tonnes by the USDA. The consensus of projections of world consumption is marginally lower, pointing to the 91.2 mln. tonne level from 91.6 mln. tonnes estimated last month. The resultant surplus works out to 4.6 mln. tonnes. N.B. Our own projection of the 1981-82 world surplus, given competition from artificial sweeteners, and the international recession, remains unchanged from last month at 5.0 mln. tonnes.

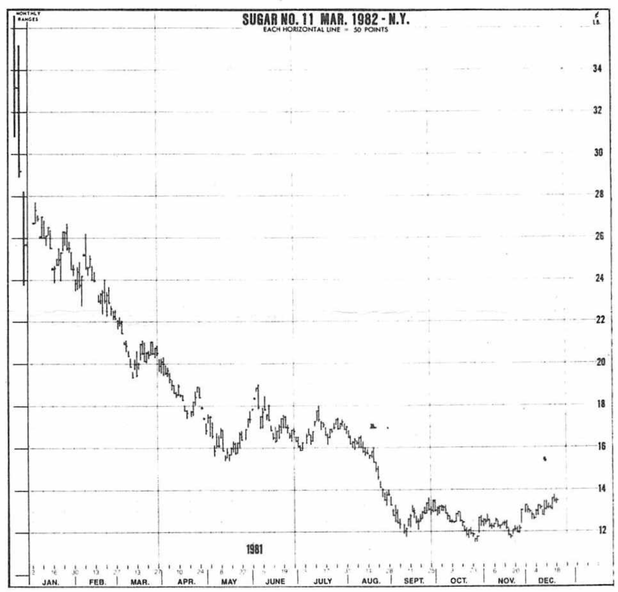
Strong doses of bearish news have accompanied the bearish statistics: On November 25th the USDA estimated that world stocks at the end of 1980-81, at 25.1 mln. tonnes, will represent 27 per cent of annual consumption. On December 3rd F.O. Licht forecast that European production could exceed current estimates, owing to excellent yields and extra areas sown to beets. On December 15, the European statistician raised his estimate of European production by 300,000 tonnes. On December 4th Cuba's sugar minister said this year's production should be "the best since the revolution." Even beleaguered Poland reported a production estimate of 1.7 mln. tonnes versus 1.043 mln. tonnes produced last year.

That Sugar prices have managed to advance in the face of such negative information begs the trader's most basic query: Does the market know something as yet not publicized; or is the market at these levels "wrong"? Inasmuch as we are trend followers — certainly not ones to fight the tape — we would normally take the former view. In this case, however, we uncharacteristically opt for the latter.

As we said at the outset, the majority of the buying has been speculative. We understand this to be so because of the Reuters commentary, which typically describes up days as resulting from "buying based on the recommendation of a large brokerage house." In addition, Market Vane's consensus of bullish opinion has climbed to 65 per cent, the highest of all commodities traded. (The average consensus of all commodities is 35.5 per cent). N.B. The workings of those who have been bidding for the block of 10,000 contracts of March have been heralded in a Wall Street Journal article of December 10th. Presumably such aggressive buying has had the effect of encouraging a substantial number of hangers on. Since last writing, the open interest in New York has increased by 10,994 contracts or a very large 17.2 per cent to 74,873 lots (open interest has increased 20,000 lots since mid-October). Given that prices have managed barely a 50 basis point advance during the period and have yet to break conclusively into new high ground — a sharp advance with follow-through above 14 cents would confirm at the very least an intermediate uptrend — we must conclude that the aforementioned bearish fundamentals have prompted producers to avail themselves of the rally and satisfy the speculative bidders relatively easily. Too easily in our view. Should the current move not confirm an uptrend soon the speculative long position will be eliminated in the all-too-familiar sequence of disappointment liquidation, followed by stop-loss selling, followed by margin call liquidation.

STRATEGY: *Remain short. If stopped out as per last month's advice at 13.50, basis March, reinstate short positions. Place stops at 14.00. Our target is 8.50*

Figure 30



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Notes: