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The Impossible Dream
A Canadian-made interest rate policy

Angry MP's and provincial premiers are rallying behind a suicidal idea: lowering *by force* Canadian interest rates regardless of whatever is happening in US money markets. Do these honourable gentlemen understand how this can be accomplished, if at all, without inviting disaster?

The Bank of Canada can peg one of three variables: a) the exchange rate; b) quantity of money in circulation; or c) the rate of interest. If it chose to peg the exchange rate, the Bank would *lose* control of both the quantity of money and the rate of interest. In fact, this operating procedure would in the long run align Canadian inflation rates, money-supply growth and interest rates with those prevailing in the US.

To the rising (and vociferous) choir of Canadian nationalists, this alternative is the most odious form of economic subjugation. But, *why*? Aren't US inflation rates dropping? And isn't that goal the Canadian government's most cherished concern? To answer this question it is imperative to understand the impact of divergent fiscal policies in the US and Canada.

If we assume that Canadian fiscal borrowing requirements are proportionally heavier than their US counterpart, it follows that Canadian interest rates would remain higher than those in the US. This interest rate differential in favor of Canada would attract short-term capital flows and thus create a surplus on capital account. The initial surplus, monetized by the Bank of Canada in an attempt to hold a rigid (nominal) rate of exchange, would swell domestic monetary aggregates, create inflationary pressures, and thus induce an *outflow*, by way of a deficit on current account. And here is the rub: A deficit on current account is potentially unpalatable because it implies a loss of competitiveness and a loss of jobs.

Surely, given enough time, the domestic rise in interest rates would slow the domestic economy, reducing imports of goods and services and increasing their exports (as a result of "slack"). A better balanced current account would reduce the need to attract foreign savings (by way of high interest rates) and domestic interest rates would fall. Playing according to the rules of the game, however, would imply a drastic cutback in domestic economic activity until equilibrium is regained in the current account or until the initial culprit, the high level of government borrowing requirements, is cut back enough to eliminate the a priori reason for the inflow of short-term capital, i.e., high interest rates.

But there is a further complication. The Bank of Canada, for the last few months, has also been trying to simultaneously peg interest rates. This futile exercise blunts the inevitable adjustment, for it is now possible to a) run a deficit on current account and b) run a deficit on short-term capital movements. This process can only proceed as long as the country is willing and able to draw on its foreign assets. A glance at Exhibit 1 makes it quite clear that a policy of domestic credit reflation (a result of pegging or holding down interest rates) *and* exchange rate targetting (in a broad range of 82-84¢) is extremely costly in terms of a loss of international reserves and net foreign assets.

Adopting a third "peg," the rate of growth of money

In This Issue

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supply, introduces a new and most bewildering complication. Admittedly, M_1 targets have remained within a broad but acceptable band of growth, which occasionally, as in recent months, has tended to undershoot even the lower, self-imposed, limits. The Bank of Canada has *appeared* overly restrictive, at least in the eyes of the Ottawa mandarins.

The truth is otherwise. Broad aggregates, such as M_2 and Domestic Credit have grown at super-inflationary rates of 20 per cent-plus per annum (Exhibit 2), hardly a restrictive stance. This veritable explosion of monetary aggregates is a result of *not* being willing to target *solely* the exchange rate. As demonstrated above, an exchange rate policy would have implied, given Canada's heavy fiscal borrowing requirements, a substantially higher level of interest rates — at least over a short period of time — and a more moderate monetary expansion.

What are the results of this confusing and contradictory monetary policy? In the first place, such a policy results in an *unnecessary drain of foreign currency,* which sooner or later will have to be covered at the risk of damaging permanently the country's credit rating.

Secondly, and more importantly, this monetary policy causes *an unnecessary prolongation of a high-interest rate environment* with its suffocating effect on industry. In effect, interest rates are high but not high enough to allow for an automatic adjustment in domestic inflation and competitiveness. It would be far better to endure a *short-lived* depression than a long and drawn out *semi-depression.* Furthermore, the Bank of Canada, by helping absorb government debt at a "reasonable rate" (i.e., below true market rates) is an accomplice to a great cover-up — that is, steep government borrowing requirements are the single most important element in the present monetary disturbances.

The third result is *a substantially higher rate of inflation than the US,* which has nothing to do with structural deficiencies or energy pricing and everything to do with a sliding rate of exchange (with a proper lag) and an expansionary monetary policy.

But let us return for a moment to the "impossible dream." A Canadian-made interest rate policy would imply a loss of control over the exchange rate, *and* a loss of control over the growth of monetary aggregates. The Canadian dollar would float down, while monetary aggregates would continue to explode, ratcheting Canada's seemingly intractable double-digit rate of inflation ever higher.

The Bank of Canada (and the banking system as a whole) would not have to lose foreign currency if it decided not to intervene, i.e., a clean float. Admittedly, a significant devaluation would buy time for Canada in that it would stimulate economic activity. In the longer run, however, and given the framework of a permissive monetary policy, domestic prices would rise sufficiently to offset the gains in competitiveness and the economy would return to stagnation, but with a *substantially higher level of prices.* But the honourable MP's and provincial premiers are already one step ahead of us: they would invoke price, wage, and exchange controls, so that the gains in competitiveness are not whittled away; so that the Canadian dollar does not float too far down.

Wouldn't it be easier for Mr. MacEachen to cut a few billion dollars off his budget (rather than consider adding to it)? And wouldn't it be easier for Bank of Canada Governor Gerald Bouey to stop playing two sides of the fence and concentrate on only one target, the rate of exchange? Are we so sick as to be willing to endure the nightmare of controls and the ensuing loss of liberty?

STRATEGY: *Last month we advised selling the March '82 Canadian dollar, then selling at around 84¢, suggesting that "it remains to be seen what level of exchange rate will prompt the Bank of Canada to raise its bank rate and widen the interest rate differential in its favor."*

To date, the Bank has not taken any defensive action, preferring to wait out the surge in US interest rates in the hope(?) that it will prove short-lived. In keeping with our comments, it behooves us to suggest that perhaps the Bank has abandoned, at least temporarily, its dual monetary operating procedure of exchange rate and interest rate targetting, choosing to lean on the latter given the sentiment in Parliament. If, having made this decision, the Bank chooses to intervene in the foreign exchange market, it should be prepared to lose an extraordinary amount of foreign currency. If, however, it chooses to allow the Canadian dollar to drift in a clean float, it should be prepared to see a drop to 75-77¢.

The choice can give Aspirin a headache . . . .

Exhibit I

Canada

		Net Foreign Assets Mln of CD$	Change in Net Official Monetary Assets Mln of US$	
1976	1st Qtr.	- 457	+ 502	
	2nd	- 768	+ 176	+ 521
	3rd	- 962	- 177	
	4th	- 880	+ 20	
1977	1st Qtr.	- 649	- 749	
	2nd	- 907	+ 3	-1,236
	3rd	-1,376	- 321	
	4th	-1,470	- 169	
1978	1st Qtr.	-1,411	-1,387	
	2nd	-2,044	+ 520	-2,741
	3rd	-2,439	-2,176	
	4th	-2,001	+ 302	
1979	1st Qtr.	-2,456	+1,156	
	2nd	-3,803	+ 657	+1,721
	3rd	-4,223	+ 332	
	4th	-3,881	- 424	
1980	1st Qtr.	-3,462	- 218	
	2nd	-3,773	+ 938	- 457
	3rd	-3,158	- 357	
	4th	-2,948	- 820	
1981	Jan.	-3,875	- 125.4	
	Feb.	-3,287	- 60.6	
	Mar.	-2,993	- 343.7	
	Apr.	-4,541	- 202.6	
	May	-4,508	- 240.9	
	Jun.	-5,066	- 93.6	
	Jul.	-4,803	-1,420.5	-251.3
	Aug.	-4,185	+ 452.9	
	Sep.	-5,009	+ 351.9	
	Oct.	-5,831	- 3.1	
	Nov.	-6,382	+1,668.5	
	Dec.	-6,362	- 234.2	
1982	Jan.	-6,220	- 59	

Sources: Bank of Canada Review,
Quarterly estimates of the Canadian Balance of international payments,
Release from the Office of House of Commons

Exhibit 2

Canada

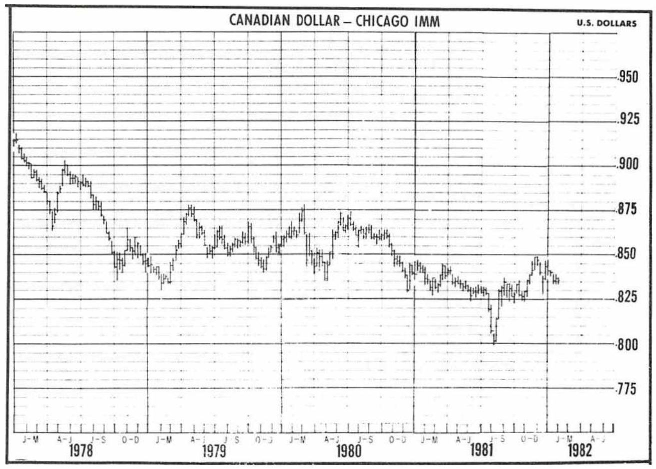
	M1	M2	DCE
1976	8.0	12.6	18.93
1977	8.4	14.0	17.18
1978	10.2	10.7	20.88
1979	7.0	15.8	22.86
1980	6.4	18.1	11.48
1981 *			
1st Qtr.	6.8	13.5	14.92
2nd	9.0	13.8	20.41
3rd	3.6	14.4	

Year-over-year % change

*this quarter over previous year same quarter % change.

Sources: Bank of Canada Review
International Financial Statistics

Exhibit 3



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— Interest Rate Futures —

The perverse effects of rising money supply numbers (alluded to in previous issues, see "Discounting the Fed," Dec. 20, 1981) are continuing to keep this market on the defensive. Bank borrowings from the Fed via the discount window have surged, indicating to Fed-watchers that, in fact, the Fed has tightened by not supplying sufficient reserves to the system, forcing a contraction in non-borrowed reserves.

The explanation may be a great deal simpler: The gap of 300 to 350 basis points that has been opened between Fed funds and the discount rate is too tempting for commercial banks to pass up. The Fed must either close the gap by raising the discount rate 200 to 300 basis points as well as increasing the surcharge to frequent users or it must stop window borrowing by administrative fiat.

The system of restricting asset expansion by making commercial banks "uncomfortable" with their level of window borrowing may ultimately be successful, but it carries a long lead and is impracticable when dealing with overextended financial institutions.

Business loans continue to expand at a rate well in excess of 20 per cent per annum in spite of the fact that the end of 1981 saw the beginnings of a process of inventory liquidation. Clearly, a high degree of illiquidity fosters a persistent demand for credit. As attested by corporate debt issuance in January 1982 of $742 million, the lowest monthly total in three years, this condition of illiquidity is not likely to disappear overnight.

We'll restate our case for a continuing rise in interest rates: the monetary base and federal reserve credit have, since late November, resumed a vigorous uptrend, indicating that the Fed is unable or unwilling to tighten credit. Fortuitously, and unfortunately for the Fed, the M_1 multiplier has been behaving quite erratically but, nonetheless, with a strong upward bias. Not so fortuitously, M_2 is growing at a much faster clip than desired.

In all, market participants expecting the Fed to adhere to oft-stated monetarist targets, are betting on an eventual tightening, leading free market rates on an upward path. The Fed has, thus far, *passively* acquiesced in this surge of rates. A reversal of market expectations can only be brought about by an active signal on the part of the Fed: either a very substantial rise in the discount rate or, better yet, a very substantial drop in the monetary base and Federal reserve credit — a result of aggressive open market (selling) operations.

STRATEGY:*Remain short interest rate futures. Stops on March '82 T-bills, March '82 Certificates of Deposit and March '82 Eurodollars should now be lowered to 87.25 (from 88.00), 85.30 (from 86.25), and 84.60 (from 85.50) respectively. Stops on March '82 T-bonds should be lowered to 59.20 (from 61.00), all basis close only.*

In keeping with our comments, one should look to cover these positions if either the Fed raises the discount rate (plus its surcharge, if any) above market rates of interest — that is, at or above Fed Funds — or it causes a pronounced drop in adjusted fed credit or the adjusted monetary base (as computed by the Federal Reserve Bank of St. Louis) — a minimum of $1.5 billion.

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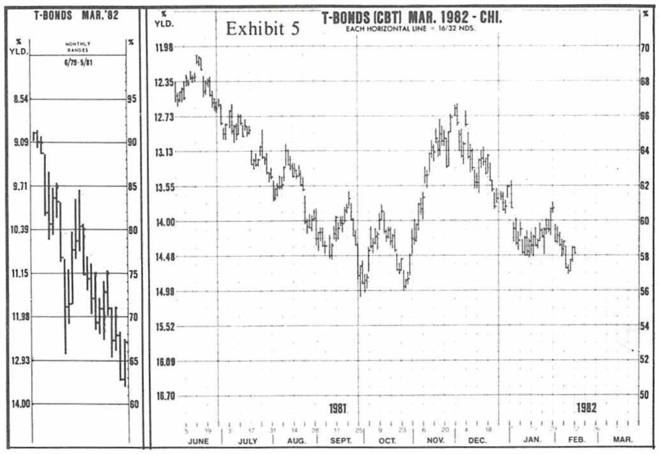

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Currencies

Protectionist noises are growing louder. The US Department of Commerce has decided that 109 of the 132 unfair trading complaints made by US steel producers against suppliers from the EEC, Brazil, Spain, Romania and South Africa merit formal investigations. The petitions for the imposition of anti-dumping and countervailing duties will go to the International Trade Commission.

In clear retaliation, the EEC synthetic fibre industry's Paris-based CEFIC organization has lodged dumping complaints against US producers of textured polyester yarns, including Unitex, Uriti and Macfield. It alleges dumping margins calculated at between 12 and 25 per cent during November and December 1981, claiming that these exporters increased their share of the Italian market from negligible quantities to 25 to 33 per cent.

In counter-claims, the US has accused the EEC of carrying the concept of export restitution for agricultural products (permitted under the Tokyo agreement) too far, using subsidies to take exports away from American farmers. The EEC produced figures showing that its share of the total world food market has risen from 9 to 11 per cent but that it had not been accomplished at the expense of the US(!), which had maintained a stable 17 per cent share. (Following this argument, it is clear that predatory practices against defenseless, less-developed countries are permissible.) Furthermore, the EEC accused the US of moving rapidly into the Middle East poultry market, an important market for European producers ("moving in" — please note the mafiosi overtones!).

On another front, and underlying the increasingly protectionist stance taken by the US administration, word has leaked out of Washington that the US is considering new measures that would thwart Japanese penetration of the US market for high-technology computer chips.

Imports of the so-called 64K RAM chip are allegedly "jeopardizing national security," and would be restricted under a rarely used section of US trade law.

The sorry trend to autarky, as we pointed out last month, is in full swing.

British Pound

Public sector borrowing by the Exchequer is likely to come "comfortably" short of the Chancellor's £10.5 billion target, mostly a result of higher inflation, which has bumped up tax revenues and better-than-anticipated tax yields from the corporate sector. Both of these factors have had, however, a depressing effect on the private sector. The March 9 budget, therefore, is expected to be slightly reflationary as the Chancellor will propose some tax cutting measures. On a more negative note, declining North Sea oil prices and volumes may begin to take a significant bite off the 1982-83 revenues. This is likely to upset rather dramatically the Chancellor's medium-term policy of reducing the public sector borrowing requirements.

We continue to believe that the UK economic recovery will not materialize. In the first place, corporate liquidity, although improved from the abysmally low levels reached in the third quarter of 1980, has as yet not recovered to the pre-recession levels (third quarter of 1979). Illiquidity, in the context of a fairly rigid monetary policy, will act as a straightjacket on corporate expansion.

Secondly, supply-siders will rightfully argue that since personal tax rates are higher today than at the start of the Thatcher reign, strong disincentives to gains in income are still operative.

Finally, the UK's stellar current account performance — in view of Sterling's high *real* rate of exchange — is due only to the extremely low level of domestic activity. Should economic activity pick up even slightly, the UK's balance of trade will be thrown into a severe deficit. Also, the UK's terms of trade have begun to move adversely, and will, by necessity impact negatively its balance of trade. For the above two reasons, we cannot imagine that the UK can afford "prosperity."

Reflationary moves will have to take the route of a depreciating pound sterling.

STRATEGY: *Look for Sterling to weaken in the weeks ahead vis à vis the US dollar and the EMS currencies.*

Add to previously established short positions, looking for an initial target of 1.7750 basis Spot and, later, a challenge of the 1.70 level. It is quite possible that sometime during 1982, Sterling will test its all-time low of US$1.56.

Deutsche Mark, Swiss Franc

STRATEGY: *Remain short. Lower stops to 43.50 (from 45.25) basis March '82 DM, close only. Lower stops to 54.00 (from 55.10) basis March '82 SF, close only.*

Japanese Yen

STRATEGY: *Remain sidelined.*

Mexican Peso

To February 12th, the Spot Mexican peso has dropped 1.25 per cent from the end of January, indicating that the Bank of Mexico may be accelerating its managed currency "crawl."

Mexico's failure to sign the GATT is coming back to haunt her. Manufactured exports, heavily subsidized by the Mexican government, are coming up against protectionist complaints in the US. Since Mexico is not a signatory to GATT, the US producers do not need to prove damage to their interest before duties are imposed on these subsidized exports. Suits have already been filed against toy-balloons and ceramic tiles, and countervailing duties are to be imposed. Mexico fears that it will be hit by duties on many more products, thus tightening the screws on an already serious trade deficit.

While the foreign trade cabinet last month asked Washington to consider making Mexico a special case and accord it the "injury test" normally granted to GATT signatories, it is doubtful that the US administration will comply — especially now that it is complaining about the lack of reciprocity among its major trading partners.

A further complication in US-Mexico relations was introduced several months ago when Mexico stipulated that subsidiaries of US companies like Ford, Chrysler, and General Motors have to match every dollar of imports with a dollar of exports. US trade officials say the Mexican move is going to create serious problems with auto-worker unions.

Politically, the Institutional Revolutionary Party (PRI) faces a renewed battle with the influential trade unions over major economic and social reforms. The *Financial Times* reports that "the union sector of the party, representing 91 of its 300 deputies, is trying to persuade Congress to legislate on a series of key reforms in an attempt to make their image more radical before the elections.

"The reforms sought are:

- 40-hour week to replace the present 48-hour week
- unemployment benefits
- a price-index wages system
- cheaper housing to be provided by employers
- union rights for bank employees
- an end to government intervention in strikes at state-run companies.

"Even though many of these reforms, like the 40-hour week, were introduced into Congress seven years ago by the PRI, they have been constantly resisted. If they were passed, they would transform the structure of labor relations and greatly enhance the union movement's position in the PRI."

Furthermore, Mr. Velasquez, the union leader, is known to be unhappy with the PRI's presidential nominee, Sr. Miguel de la Madrid.

Finally, the Mexican Left, which will take part in the 1982 election for the first time, is becoming increasingly outspoken. The 1982 election may force the PRI even further to the left, culminating 30 years of statism and corruption.

On the economic front, PEMEX has requested a consortium of banks to raise $2 billion in Eurocredits. Six major banks have already agreed to underwrite $100 million each, at a margin of 7/8 per cent over LIBOR, or 3/4 per cent over US prime. These banks will be seeking 20 lead managers to underwrite US$100 million each. We have strong doubts that the proposed deal will "fly." At any rate, this loan will test lenders' new perception of credit risks in the particular case of Mexico.

Exhibit 14, prepared by our staff, shows the explosive leakage in Mexico's external account. Over the past five years, international reserves and net foreign assets have managed to maintain a stable relationship to broad money supply. This unusual feat, however, has been accomplished by assuming an ever growing level of international indebtedness, which does not show up in the banking system's *current position.* In effect, Mexico has borrowed foreign currency with maturities of one year or more, retained a *portion* of these borrowings, and added them to short-term assets.

The "leakage," however, is growing by leaps and bounds and indicates that if, for any reason, Mexico is unable to roll over credits for even a few months, its net foreign assets would dissipate almost instantly, making a major devaluation inevitable. That is why Pemex's mandate to borrow $2 billion from the international lending community may represent a watershed mark in its struggle to maintain currency stability.

STRATEGY: *Add to previously established short positions, particularly Sept. '82 and Dec. '82. The pressure for a maxi-devaluation will become irresistible.*

Mexico Exhibit 7

Foreign Assets Leakage *

		bln of Pesos	bln of US$	
1978	1st Qtr.	+11.9	+ .523	-.498
	2nd	-3.6	- .158	
	3rd	-6	- .264	
	4th	-13.6	- .599	
1979	1st Qtr.	+3.8	+ .167	-1,619
	2nd	-9.2	- .403	
	3rd	-22.3	- .979	
	4th	-9.2	- .404	
1980	1st Qtr.	-15	- .656	-4,791
	2nd	-37.1	-1.618	
	3rd	-19.1	- .828	
	4th	-39.3	-1.689	
1981	1st Qtr.	-7.7	- .324	-6,657
	2nd	-56.4	-2.308	
	3rd	** -100.3	-4.025	

* Change in net foreign assets minus change in official and semi-official long-term foreign borrowing.

** Data thru August 1981 only.

Source: International Financial Statistics

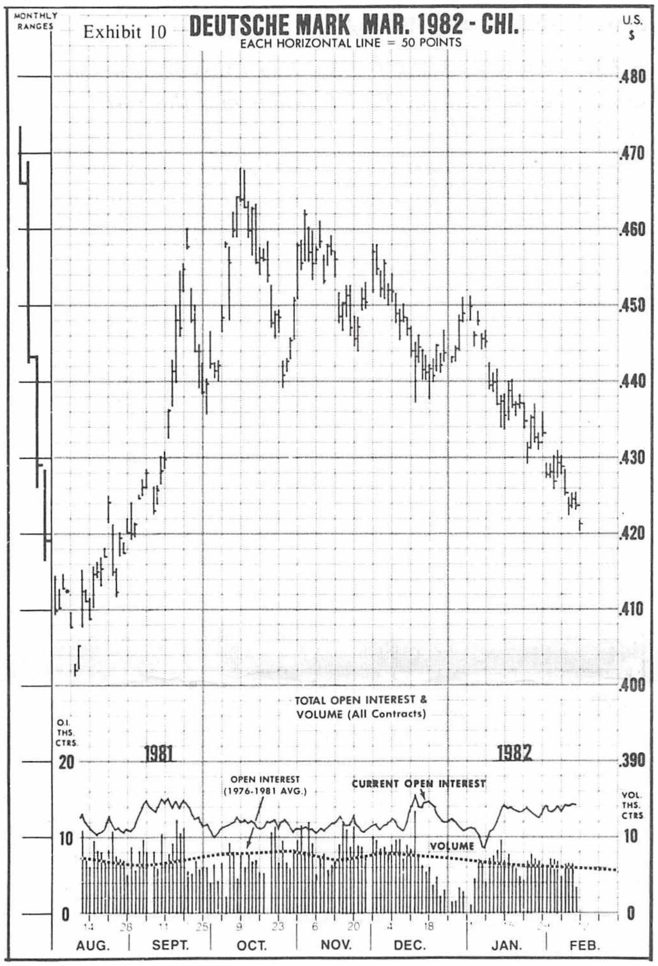

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Exhibit 9

BP/DM Spot Ratio

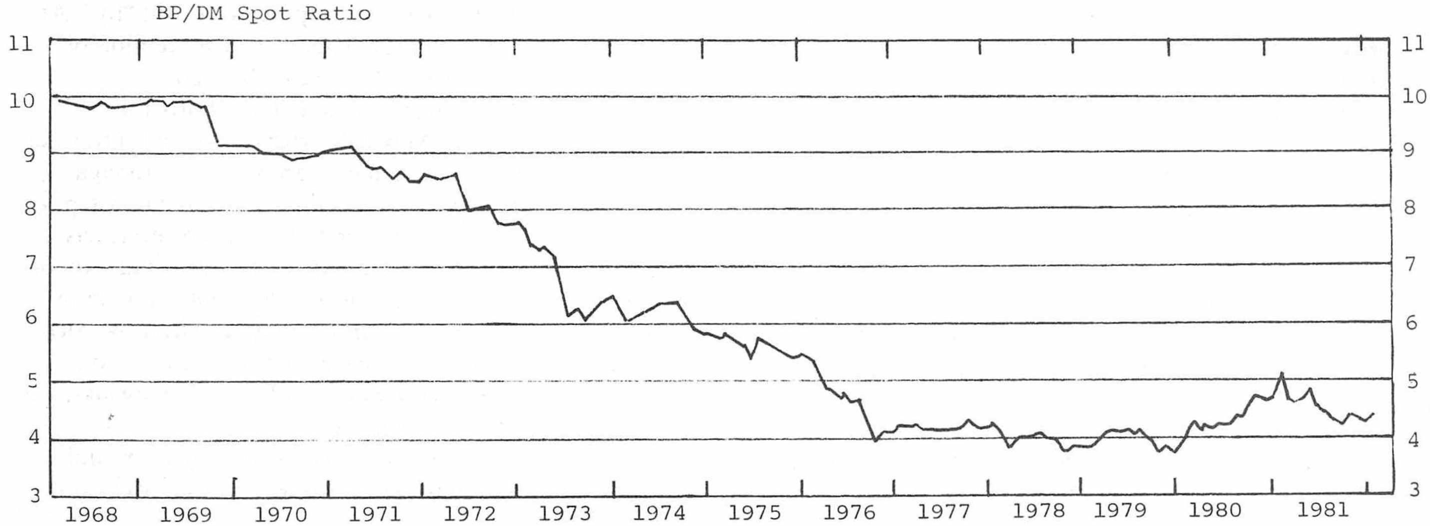

Exhibit 8

UK Public Sector Borrowing
£bn (seasonally adjusted)

Financial years	
1978-79	9.23
1979-80	9.91
1980-81	13.19
1981	
2nd qtr.	6.36
3rd qtr.	3.15
4th qtr.	0.21

Source: Financial Times of London

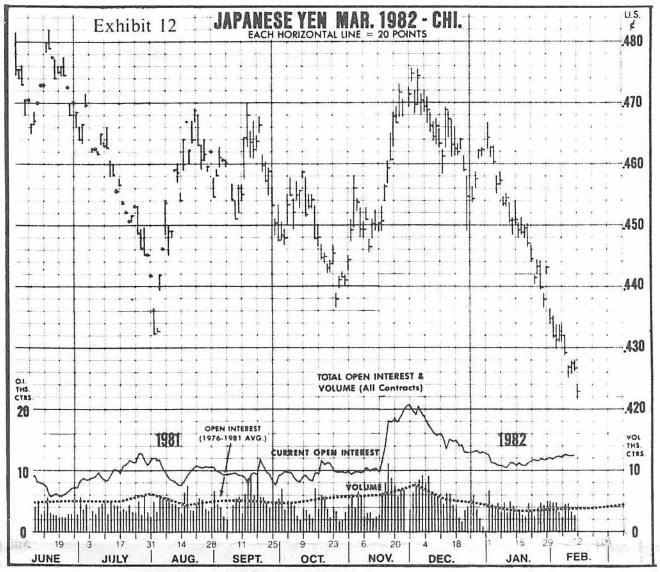

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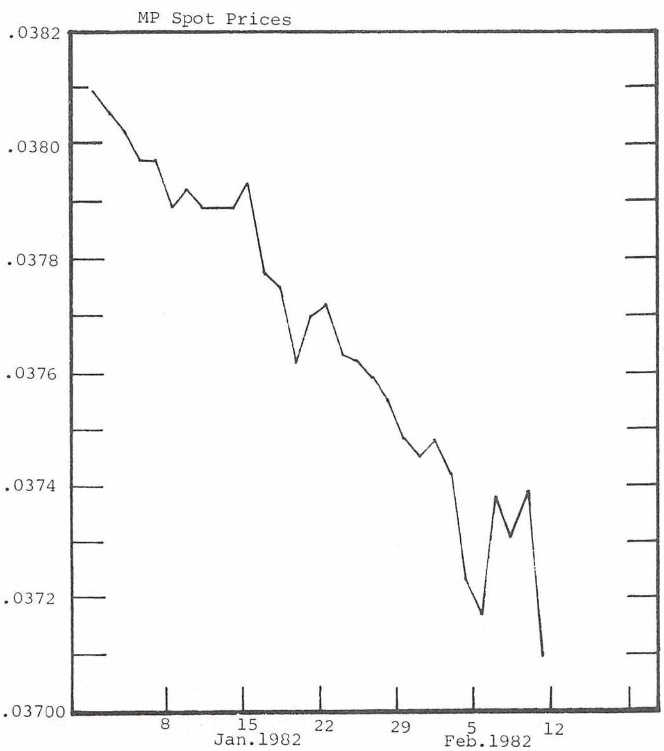
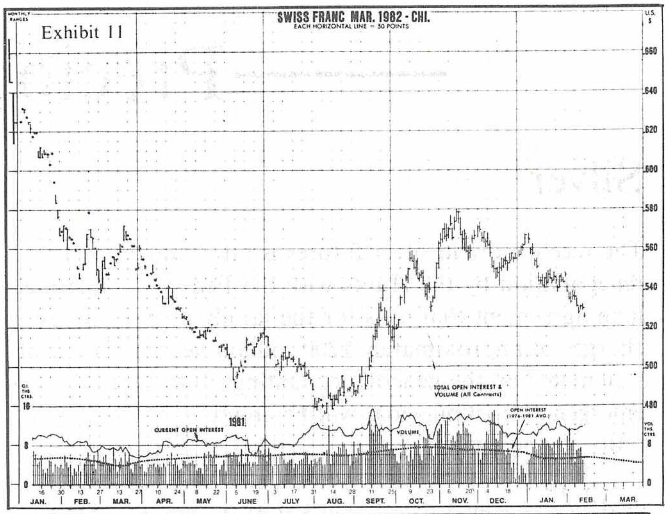
Exhibit 13





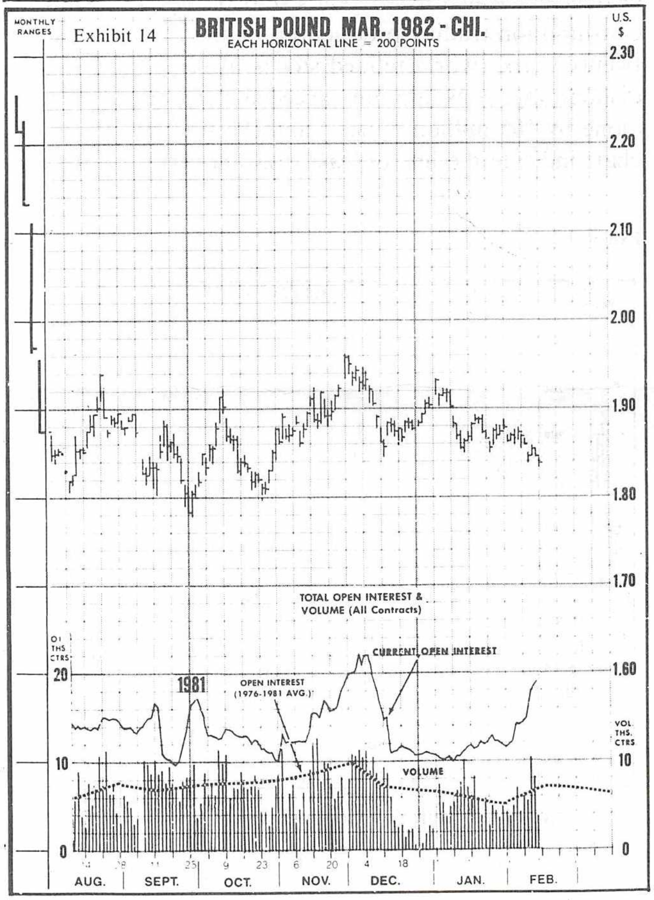


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Exhibit 15

Balance of Trade	Dec.81	Nov.81	Total 1981	Total 1980
B.P. (bln Stg)	+.331	+.051	---	---
C.D. (bln CD$)	+.753	+1.1	+6.51	+7.81
D.M (bln Marks)	+5.14	+3.95	+27.88	+8.95
J.Y. (bln US$)	+2.22	+.613	+20.03	+2.13
SFR. (bln Francs)	-.240	-.256	-3.12	-7.27
U.S. (bln US$)	-1.59	-4.41	-39.68	-36.40
FFR. (bln Francs)	-7.89	-6.68	-59.39	-60.42
Current Account				
B.P. (bln Stg)	+.498	+.218	---	---
D.M. (bln Marks)	+4.9	+1.2	-17.5	-29.8
J.Y. (bln US$)	+1.1	-1.06	+4.73	-10.75
FFR. (bln Francs)			-42.63	-33.1
Overall Payments Balance				
D.M. (bln Marks)	-.895	-.425	-2.28	-27.89
J.Y. (bln US$)	-.298	+.376	-2.14	-8.40

Precious Metals

Silver

The recent rally in silver futures is attributable to (1) renegotiation by the Hunts with the Fed of the onerous loan agreement that calls for the family to pay interest charges of approximately $200 million yearly, (2) recent statements by the general accounting office that a higher emergency stockpile goal will be announced shortly, (3) ratio buying against gold.

We believe the negative fundamentals, the best evidence of which is last year's statistical picture showing consumption trailing production for the first time in twenty years, (world refined stocks increased due to dishoarding; consumption exceeded mine production alone by 105 million ounces) and the still-soft-looking chart indicate the line of least resistance still is down.

STRATEGY: *Remain short silver, risking a close above $10.00 per ounce basis July.*

Gold

Some buying by investors seeking liquid protection against uncertainty — gold has outperformed the overall commodity index in times of depression — has been countervailed by the sluggish economy and Russian sales.

STRATEGY: *We believe the bear market is still in effect and would advise staying short. A close above $430 basis June would be enough evidence of a reversal to move us to the sidelines.*

Exhibit 16

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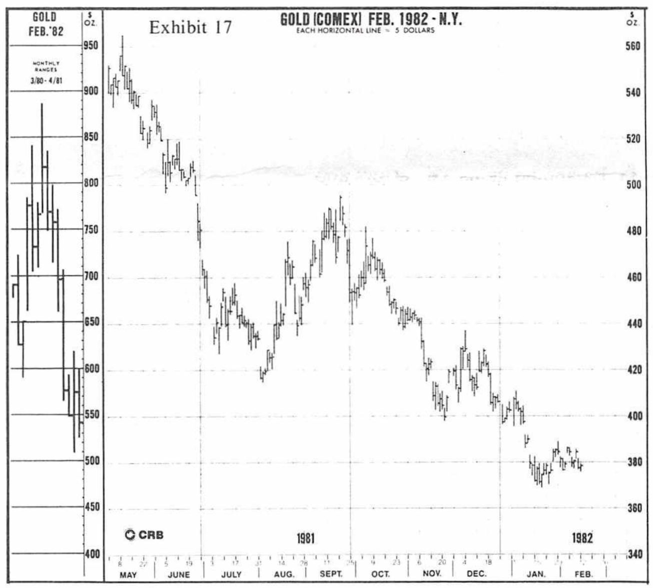
Exhibit 17



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Tin

A gentlemen's agreement of sorts was reached on the London Metals Exchange (LME) that will allow "shorts" unable to deliver prompt material, to pay a £120/tonne penalty over cash for every day they remain in default. While this agreement has alleviated the possibility of a major squeeze come February 25 and 26 (two dates that show very large open positions), it will nevertheless do little to relieve those who have sold forward positions over the past few weeks and months at ever growing discounts to cash.

STRATEGY: *We believe that the mystery buyer has in fact been able to "corner" this market, at least temporarily, and expect prices to maintain a very firm tone in weeks ahead. Buyers of three-month call options, as suggested last month, should relax and enjoy the ride.*

Exhibit 18

Major Tin Producers: Production and Export Earnings

P: Production[1] (thousand metric tons)
E: Export earnings (million SDRs)

	1979		1980		1981[2]	
	P	E	P	E	P	E
Total	172.8	**1,912**	172.2	**2,065**	172.0	**1,700**
Australia	12.6	**87**	11.6	**80**	12.2	...
Bolivia	27.8	**306**	27.3	**291**	28.6	...
Indonesia	29.4	**313**	32.5	**346**	34.9	...
Malaysia	63.0	**819**	61.4	**885**	59.2	...
Nigeria	2.7	**16**	2.5	**15**	2.4	...
Thailand	34.0	**351**	33.7	**426**	31.6	...
Zaïre	3.3	**20**	3.2	**22**	3.2	...

[1] Production of tin-in-concentrates.
[2] Estimated.

Data: International Tin Council; IMF, *International Financial Statistics;* national statistics; and Fund staff estimates

Exhibit 19

Summary of World Tin Position

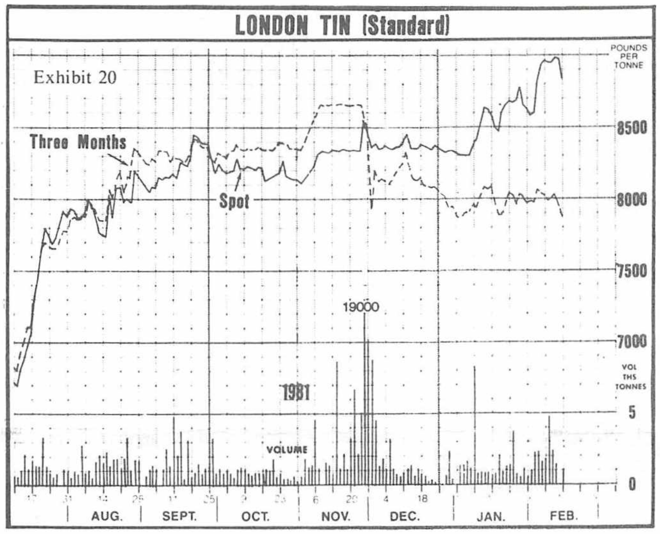
(thousand metric tons)

	1979	1980	1981[1]
1 Production of tin-in-concentrates[2]	200.7	200.5	202.1
Primary metal			
2 Production[2]	201.3	199.5	194.7
3 Consumption[2]	186.3	175.1	173.1
4 Imports from People's Republic of China	2.0	2.6	5.0
5 Exports to Council for Mutual Economic Assistance (CMEA) countries	14.3	15.3	17.4
6 Current supply [2 + 4]	203.3	202.1	199.7
7 Current demand [3 + 5]	200.6	190.4	190.5
8 Excess (+) or deficit (−) [6 − 7]	2.7	11.7	9.2
9 U.S. Government disposals	—	—[3]	5.9
10 ITC buffer stock, net sales (+) or purchases (−)	—	—	3.8[4,5]
11 Balancing items, i.e., errors and variations in private stocks	−2.7	−11.7	...

[1] Estimated.
[2] Excluding CMEA countries and the People's Republic of China.
[3] Only 25 tons.
[4] Through September.
[5] Buffer stock holdings are reported by the ITC with a three-month lag; holdings at the end of December 1981 are not yet known.

Data: International Tin Council

IMF Survey



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Heating Oil

The bear market that has been forecast repeatedly and consistently over the past eight months in the *Comments* has become apparent in a fashion so dramatic it surprises even us. Since last writing alone, the price of crude on the spot market in Rotterdam has fallen by $3.75, or 11 per cent. Over the same period, the price of heating oil for May delivery has dropped by as much as $0.10 per gallon.

Clearly long-term factors — i.e., the secular shift toward conservation and increased non-OPEC production — have taken effect. The resultant glut, estimated at between 1.6 and 2.0 million barrels a day, is very much visible, shows no sign of disappearing, and has at last impacted upon the consciousness of buyers and sellers at all levels.

Despite rhetoric to the contrary, it seems virtually inconceivable that official OPEC quotes of $34.00 to $37.00 per barrel can be maintained. As of last week, prices of refined products per barrel of crude had fallen to $30.55 from $34.05 two months ago. This is to say that buyers of crude at official quotes are in effect losing a minimum of $3.45 on every barrel refined.

Of course, official OPEC quotes have become illusory. Just as the prices of non-OPEC, specifically North Sea, oil were recently lowered by $1.50 per barrel (a price dealers already consider unrealistically high), OPEC production is unofficially available at discounts. Libya and Algeria have enforced barter arrangements upon reluctant importers in an attempt to reduce their surpluses, effectively lowering values by seven to eight per cent to approximately $34.00 per barrel from the official quote of $37.00 per barrel.

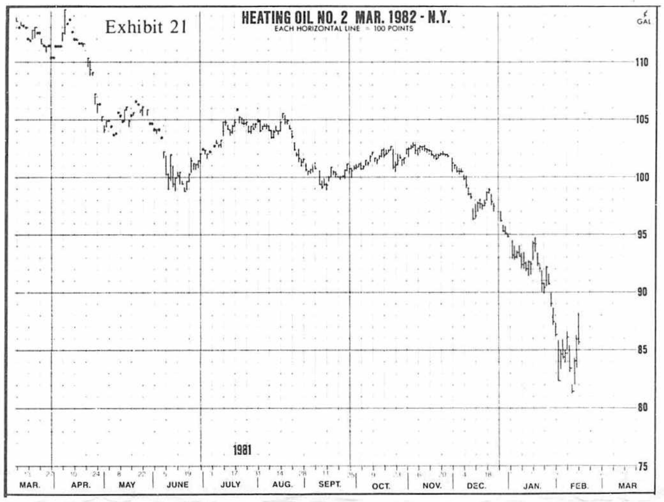
Moreover, these countries, as well as Iran, Iraq and Nigeria have been taking surplus oil to Italy where they refine it themselves and sell it at large discounts. Such tactics, ironically, only serve to swell the world glut and ultimately depress prices further.

Exacerbating the bearish scenario have been large scale selling of fuel oil in Europe by the Soviet Union, apparently as part of an overall effort to earn foreign exchange, and heavy exports of leaded gasoline to the American west coast by China.

STRATEGY: *The bear market is running its course with justifiable vengeance. Product prices, logically enough, have led crude prices lower. The single short-term caveat is that deferred heating oil prices, trading at a 5¢ discount to cash — March 85.73; April 80.36 — suggest that the next leg of the decline in crude may already have been discounted by futures.*

Refined capacity is operating at a low 63.1 per cent. Given that, as previously mentioned, refiners are losing money on a per-barrel basis, it's possible refined production may be curtailed further before *crude quotes fall, thereby making product relatively scarce and inducing a bear market rally.*

*Readers who are still short — we advised taking **partial** profits last month — should remain so and liquidate only in the wake of an upside weekly reversal. We have found liquidity on the NYME is not what it should be, and are therefore somewhat cautious traders. Nonetheless we will look to re-establish our full short line at the downtrend currently 86¢ basis May.*



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Grains

The US recently announced a 10 per cent acreage set-aside program for feed grains in the 1982 production year. Wheat has a 15 per cent set-aside announced about two months ago. While these programs are called voluntary, participation is required to qualify for 1982/83 reserve loans. Set-aside must be at least 10 and 15 per cent respectively for corn and other feed grains, and for wheat.

Corn rallied about 15 cents as projected in our last issue, but lost most of this gain, and is now only 4 cents above mid-January. During this period, corn exports as forecast by the USDA for 1981/82 were reduced from November's expectation of 2,500 million bushels to 2,375 million bushels in December, and to 2,250 million bushels in January's estimate. This was largely anticipated by the market. February saw a further reduction in forecast corn exports to 2,175 million bushels. Reaction to this has been minimal, indicating it was also expected. Corn has dropped less than 10 cents in the past two weeks while wheat has dropped over 15 cents.

Wheat export forecasts were reduced in late January to 1,850 million bushels from 1,900 in December. We outlined in December the reasons for suggesting a downward revision in wheat export and domestic use (particularly for livestock feeding) forecasts. The results of our prophecy have been substantial in the past few weeks' downtrend in wheat futures. Further downward revisions in wheat disappearance figures are not impossible.

Corn feed use in October to December 1981 was up six per cent from 1980 at just over 1,600 million bushels. Higher than expected first quarter feeding resulted in domestic feed and residual use of corn to be forecast 100 million bushels higher than previously at 4,250 million bushels. Carryover stocks were lowered accordingly. Wheat feed use in June to December 1981 totalled about 115 million bushels, more than three times the 1980 level, but below expectations. Feed and residual use was reduced to 135 million from 200 million bushels, and wheat carryover stocks were raised to 1,062 million from 996 million bushels in keeping with these lower-use rate projections.

A second important cause for a rally in corn is the large entry into the reserve loan program. The USDA's forecasted entry of corn into the farmer-owned reserve was raised to 1,250 million bushels from 900 million.

Weekly loans have slowed somewhat, to 62.5 million bushels in the week ended February 3, compared with 117.6 million bushels the previous week, 226.7 million in the week ended January 20, and 185.6 million to January 13. As of February 3, there were 1,771 million bushels of 1981 crop corn under price support loans; this includes 1,081 million bushels of 1980 and 1981 crops of corn in the farmer-owned grain reserve.

As a result of the described price movements in corn and wheat, our spread in the month of May has moved to 97 cents, wheat over corn. As discussed, future movements should continue to add profits to this; a premium of only 80 cents is conceivable.

The long Kansas City/short Chicago wheat spread in May has also profited. Currently, the KC premium is 27.5 cents. We are looking for this premium to move to 40 to 60 cents. Heavy entries of hard wheat, compared with soft wheat, into the reserve support this expectation.

Dryness in Brazil contributed to some strength in corn and soybean prices late in January with the hope of increased export prospects for the US. However, yields are forecast to have been reduced only about 5 per cent as a result, and strength on this accord has been eroded.

There are indications that soybean production might have been reduced to 13.9 MMT from 14.9 MMT.

European soymeal purchases have fallen sharply as hand-to-mouth buying has recurred in light of perceived high US prices and a high US dollar. A small rally was shortlived in soymeal prices.

A note of interest: The USSR failed to include any crop production statistics in its annual economic report in January. This would lead one to wonder how far below USDA forecasts the actual Soviet crop output was.

STRATEGY: *Maintain long May corn/short May wheat spread on CBT. Also maintain the long KC/short CBT wheat in the same month. Corn may be approached from the long side in nearby months with potential profit of 15 to 20 cents if the short term uptrend over the past couple of weeks is reinstated; place stops 5 to 8 cents from the point of entry. Wheat may be shorted for similar potential profits in nearby contracts with stops 7 to 10 cents from the entrance price. Liquidate long positions in July soybean meal for small losses.*

Exhibit 23

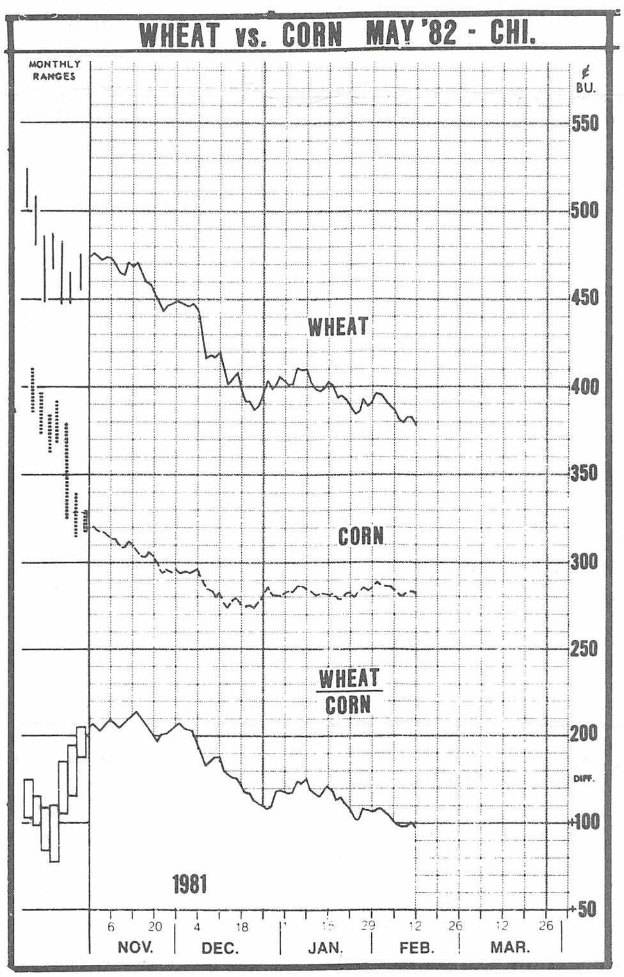

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Exhibit 22	Wheat		Corn	
	1982	1981	1982	1982
Regular loan rate	3.55	3.20	2.55	2.40
Reserve loan rate	4.00	3.50	2.90	2.55
Target price	4.05	3.81	2.70	2.40
Trigger(release) price	4.65	4.48	3.25	3.15

1982 support levels announced Jan.29/82 for wheat and corn, compared to 1981 figures.

Coffee

This year's 1981/82 balance, largely as a result of Brazil's huge 32.0 million bag crop, is expected to show a production surplus of between 15.0 and 20.0 million bags. World production is put at 96.9 million bags by the USDA. Consumption is estimated by the department at 76.2 million bags. Year-end stocks are thus calculated to increase to 41.4 million bags, or a sizeable 54 per cent of the current season's consumption.

Initial projections of next year's crop have focused on Brazil, the world's largest producer. The USDA puts that country's production at 16 to 18 million bags. The 50 per cent reduction is largely due to last July's frost.

Consumption estimates for the 1982/83 crop, which incidentally, begins in July, would be premature. Nonetheless, one notes the consistent reports of increases in weekly roastings figures for the US at plus approximately 4.0 per cent over the past six months and for Holland (which we will use as a proxy for Europe) at plus 10 per cent over the same period. In sum, next year's statistical picture is likely to show improvement.

Given the secular downtrend in consumption that has persisted for 20 years now, and the world recession, one might be accused of grasping at straws were one to try and argue a bullish fundamental case for coffee prices. Yet the market itself is saying it wants to go higher. The nearest delivery, March, has broken its long-term downtrend on a weekly basis.

The persistent premium of cash over forward options is a bullish signal despite the consensus that nearby tightness is the result of producer nations having sold out their quotas (as established by the International Coffee Agreement) and that the phenomenon is strictly temporary. In sum, we are of the opinion the market is in an uptrend and that speculative long positions are warranted.

STRATEGY: *Buy September either outright or via call options in London where the current premium of £145, or $1,300, represents less than the backwardation. If nothing happens to cash prices between now and September, the backwardation guarantees a profit. At the same time, one has the advantage of the uptrend, the projected improvement in next year's balance and the potential bonus of a frost sometime during the May/August period. Place stops in outright position at 115 basis September in New York. We prefer the London market because of the implicit play against Sterling.*

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