

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS



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The Eye of the Storm

This past week saw the continuation of de facto and de jure devaluations so reminiscent of the beggar-thy-neighbor policies of the 30s. US monetary policy, *in the face of a rising demand for money*, appears brutally tight to practically every nation of any economic importance. These nations, unwilling to follow suit in deep fear of sinking into a depression, have been "unlinking" themselves from the Fed by allowing their exchange rates to depreciate.

Chart 1 shows the fluctuation *on an annualized basis* of the foreign exchange value of the eighteen largest world exporting nations (excluding the oil-exporting countries) vis à vis the US dollar over the last 12 months, 6 months, and 30 days. At the bottom of the table we have computed the average annualized rate of depreciation on an arithmetic basis for the respective time periods as well as the *appreciation* of the US dollar on a trade-weighted basis. Except for small variations in weights, both sets of figures speak of a frightening upheaval in the world monetary order.

What has happened to cause the magnitude and intensity of these multiple devaluations?

In the majority of cases, had any one of these countries attempted to maintain a fixed relationship to the US dollar, it would have seen its foreign exchange reserves evaporate in a matter of a few weeks or a few months. This has clearly been the case in at least France — which has lost 50 per cent of its reserves since February despite the franc's depreciation *prior* to last Monday — Italy, South Africa, and Brazil.

Domestic monetary growth has been so overwhelming that foreign exchange reserves would have dissipated before the necessary equilibrium was reached. In other cases, i.e., Germany, Switzerland, Canada, and Japan, an attempt

to maintain fixed rates of exchange would not have entailed too large a drop in reserves — but only at the cost of seeing domestic interest rates soar to dangerous levels and thus threaten to aggravate an already depressed economy. In a few other cases, devaluations were accepted so as not to lose a competitive advantage within regional trading blocks, such as Spain, Sweden, the Netherlands, and the UK.

In a classic example of falling dominoes Portugal (not shown) devalued its escudo by 3.75 per cent against the French franc in an attempt to maintain competitiveness vis à vis France, the source of remittances from over one million Portuguese guest workers.

Separately, the Chilean authorities devalued the peso by 15 per cent — hitherto fixed to the US dollar at 39 pesos to the dollar since June 1979 — citing the extraordinary drop in the value of the Japanese yen and the European currencies and their effect on external competitiveness.

More telling than this justifiable argument, was the necessity to achieve a quick adjustment in wages and salaries without having to undergo a further build-up in unemployment. The speculative attack on Chile's international reserves (impregnable reserves, we might add, because every peso in circulation was backed by a dollar, at the prevailing rate of exchange, in reserves) had the sole effect of contracting the monetary base, raising the level of *real* interest rates to over 35 per cent per annum and painfully achieving the only negative five-month reading in the CPI anywhere in the world.

This last case is worth mentioning because it underlines the tight and tightening US monetary posture when viewed against the worldwide rise in the demand for money. The argument runs as follows: Steady money supply growth

In This Issue

The Fed's dilemma: Will the US follow the world into reflation? . . .

Interest Rates: Up, up and away until, that is, disaster strikes . . .

Currencies: The Swiss franc may be better than the mark, suggesting a spread; the pound must continue to drop . . .

Copper: The only consolation is that *this must be* the last leg of the bear market . . .

Precious Metals: As we have said before, the end will be bloody . . .

Heating Oil/Mexican Peso . . . Grains . . . Livestock . . . Cotton

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in a depression may not be sufficient to accommodate the rising demand for money, which, given well-known downward wage rigidities, causes huge layoffs. *At some point*, of course, unemployment exerts downward pressures on real wages, thus helping to achieve recovery. Twentieth-century societies cannot stand the pressure; they submit to reflationary policies sooner or later.

For the most part, devaluations are not a panacea. They tend to provide a quick shot in the arm to the devaluing country's balance of trade. If the relative (to the US) monetary expansion is not checked, however, devaluation causes a corresponding inflation that tends to negate, in short order, the benefits of the devaluation. This is another way of saying that the *real* rate of exchange cannot be lowered unless accompanied by a relatively tight monetary policy. At best, the adjustment can be accelerated with a lower social cost than the one implicit in seeing domestic costs and prices drop.

If we assume for a moment that the major trading nations — in an effort to speed adjustment — accompany their devaluations with a serious effort to check relatively (to the US) expansionary monetary policies, we must wonder who does bear the cost of the overall adjustment. Since in economics "there ain't no free lunch," we must conclude that the appreciating currency's country — in this case the US — bears a great deal of this social cost. In effect, to the extent that the US *real* rate of exchange rises, unemployment and bankruptcies are bound to rise. Interestingly enough, as much as 37 per cent of the decline in the US GNP during the past year was accounted by a drop in net exports. And the effects of a "high" real rate of exchange are, of course, much broader than a mere drop in net exports: tourism, other invisible and long-term investments must also suffer.

What can the US do? In the first place, it must hope that nearly all the depreciating countries continue relatively expansionary monetary policies, thus negating their efforts to achieve a drop in the real rate of exchange. This outcome

is secure in France, Italy, Spain, and Brazil, among the leading world exporters as well as the Comecon countries and Mexico. This outcome however, is far from sure in the UK, Germany, Japan, Switzerland, Canada, Singapore, and Hong Kong.

What, then, can be done? The answer is clear: Abandon monetarism and revert to the gold standard. In years past (as an example, see "Varieties of Monetarist Experiments," January 11, 1981) we argued that the gold standard was superior to monetarism simply because (a) the demand for money is basically unstable, despite much vaunted technical evidence to the contrary, at *turning points* (extreme inflation or deflation) and (b) central banks, not knowing what money is (M₁? M₂? M₃? PSL₂?), cannot possibly be successful in their attempts to control it.

By fixing the price of gold, the Fed will supply reserves to the banking system when deflationary pressures are being felt by way of private and public sales of gold and will absorb reserves when inflationary pressures cause economic participants to demand gold. In other words, the demand for money will dictate the "right" amount of money supply rather than the other way around, as the monetarists preach. Simultaneously, the Federal Reserve must abandon all pretense of managing the money supply via open market operations. It should, however, preserve its role of Lender of Last Resort, using a near-prohibitive discount rate.

The world, and particularly the US, is facing a grave danger of outright deflation. The upward momentum of the US dollar (see the third column in Chart 1) as well as the impending collapse in the money markets, are beginning to take on a climactic character, a sign, perhaps, that a policy reversal is not far off. Some signs that the Fed is changing course are appearing already (see Interest Rates Futures section) although it may be difficult to determine whether in fact it is not merely a short-term technical aberration and if it isn't, whether it is substantial enough to avoid the oncoming panic.

Chart 1

Leading Foreign Currencies vis à vis U.S.S

	Jun. 82/Jan. 81	Annualized Jun. 82/Dec. 81	Annualized Jun. 82/May 82
	%	%	%
Germany	-2.40	-15.92	-61.90
Japan	-11.42	-27.46	-78.07
France	-15.78	-30.66	-133.26
U.K.	-10.46	-17.66	-45.47
Italy	-13.26	-25.21	-77.12
Netherlands	- 1.21	-16.79	-48.71
Canada	- 6.82	-15.91	-45.08
Belgium	-16.22	-35.85	-79.79
Switzerland	- 4.21	-30.26	-80.43
Sweden	-16.00	-15.93	-46.10
Spain	-13.89	-23.59	-80.41
Hong Kong	- 5.91	+ 0.15	-29.60
Brazil	-46.19	-46.64	-81.99
Korea	- 6.85	- 9.52	-26.00
Singapore	- 0.84	- 9.51	-32.37
Australia	-10.57	-17.95	-35.17
Norway	- 3.70	-13.81	-46.07
S.Africa	-21.08	-29.64	-51.71
Average	-11.49	-21.23	-59.98
Trade Weighted U.S. Dollar	+ 9.70	+23.20	+69.60

Sources: Morgan Guaranty Trust,
International Monetary Fund

Interest Rates Futures

Last month we advanced a number of *technical* observations to buttress our conviction that interest rates were heading higher. We stated that the June '82 T-bond chart offered "the most fascinating example of persistent technical weakness, likely to degenerate into a very severe bear market." After a detailed explanation of why we thought T-bonds were "topping," we concluded: "Can a bear market be far behind?"

Chart 2 shows that our forecasting ability (based on technical interpretation) was uncanny: The market went into a free fall just a few days later, never topping the previous intra-day high of 6507.

We were not as fortunate with the timing on the short-term instruments like the T-bills, CDs, and Eurodollars simply because a totally unforeseen accident, the Drysdale affair, forced the Fed to inject a torrent of reserves into the banking system, causing short-term interest rates to plummet — before firming up once again (see Chart 4).

The technical interpretation remained nevertheless valid. Interest rates were about to confound the experts and once again turn up when least expected. Chart 6, an interest rate forecast published by *The Wall Street Journal* on January 5, 1982, is presented as an amusing record of "expertise" (only Donald Maude of Merrill Lynch came close to the mark).

The argument for higher rates continues to rest on three developments. In the first place, Federal Reserve policy has been quite accommodative in recent weeks. As a result, the monetary base has grown at rates well in excess of those compatible with an upper M_1 target of 5.5 per cent per annum. Base expansion, on an annual basis, is exceeding M_1 growth by at least three percentage points, indicating that M_1 may be "ready" to jump nearly \$15 billion in coming weeks *aside from the expected July bulge*. Such a development would *force* the Fed to tighten *unless a decision to abandon or ignore monetary targets has already been made*.

Nevertheless, even if the Fed decided to bend its monetarist targets so as to provide some stimulus to the economy, it is *not likely* that it would flaunt the guidelines by any substantial margin, say three or four annual percentage points. Therefore, some tightening may still be in store. It should be noted that foreign exchange intervention by the

Fed, with the purpose of stalling the dollar advance, would take it even further afield than it currently is, destroying any semblance of adherence to monetarist targets.

The second argument for rising rates is based on a potential banking crunch. Two measures of banking liquidity, first presented in our August 30, 1981, issue, are reproduced and updated (see Chart 7). It is rather obvious that banking liquidity continues to deteriorate at an alarming rate, perhaps drawing very near the day of a full-fledged banking panic.

The third argument rests on corporate and municipal illiquidity. While we have gone to great lengths to illustrate corporate illiquidity, we have thus far made little mention of municipal woes and their extraordinary need for credit. A recently issued *Chase Manhattan Capital Market Report* notes that "state and local government capital spending has plunged to about a \$37 billion pace in the second quarter from a \$47 billion annual rate in early 1981 . . . in real terms, state and local capital spending is now only half what it was in the early 1970s, and — as a percentage of total state and local revenues — the 11 per cent spent on capital improvements is only one third the proportion back in the late 1950s . . . this dramatic cutback has created a huge deficiency of vitally needed capital investment that may easily total \$200 billion or more. Critical bridges, roadways, and water and sewer systems have been kept in operation for years with quick-fix and "Band-Aid" measures. In many cases, structural decay has reached the point where only total replacement is possible. . . . This suggests an enormous potential backlog of long-term municipal financing."

It is inevitable that the Fed will be forced to reflate, either because of a banking crisis (à la Franklin National) or a corporate failure (à la Penn Central). The \$64,000 question is when.

STRATEGY: *Short of a decisive and well advertised move to reflate — following most probably a major crisis or failure — interest rates will continue to firm and may even "spike" to new highs.*

Remain short interest rates futures; the very nature of the event that will trigger a policy reversal should allow for an obvious stop.

Chart 2

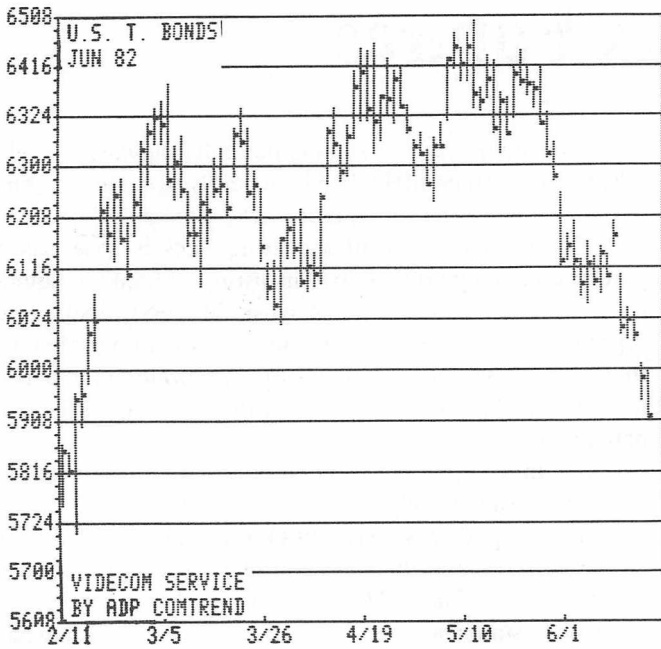


Chart 4

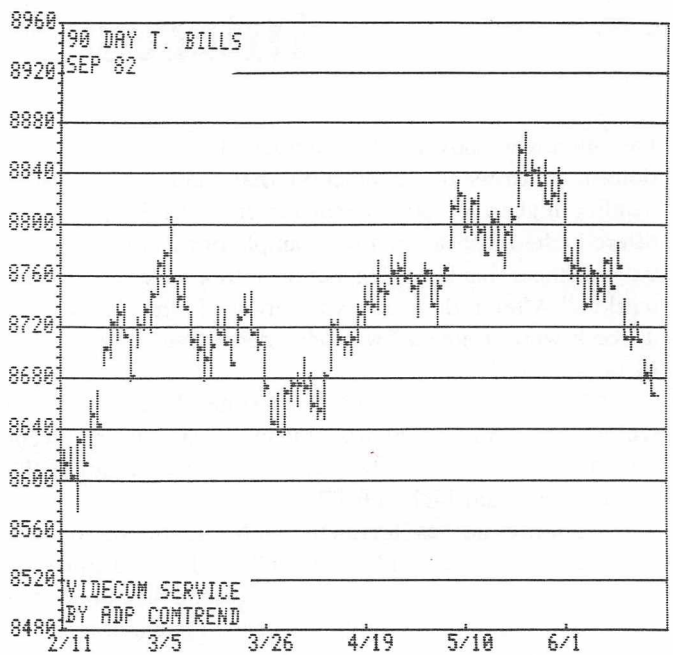


Chart 7

Large Commercial Banks
in New York City

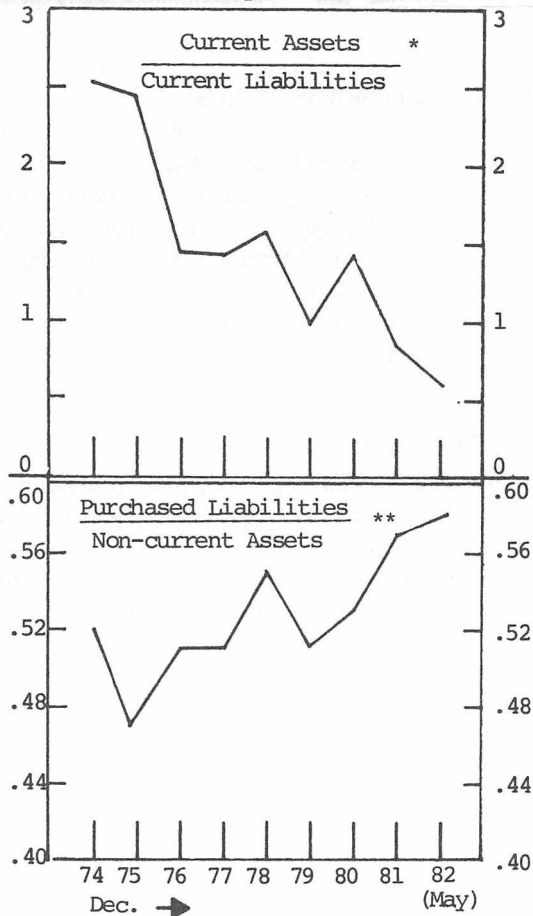


Chart 6

Interest-Rate Forecasts for June 30

	Prime Rate (%)	3-Month Treasury Bills (%)	30-Year Treasury Bond Yield (%)	New Conventional Home Mortgages (%)
Alan Greenspan	11%	8.8	12.9	15%
Townsend-Greenspan				
Timothy Howard	15%	11%	13%	16%
Wells Fargo				
David Jones	14	9%	12½	15
Aubrey G. Lanston				
Irwin Kellner	15	12	13½	16
Manufacturers Hanover				
Alan Lerner	18-20	15-17	16	20
Bankers Trust				
Donald Maude	16	12½	13%	16%
Merrill Lynch				
George McKinney	13	12	13	15
Irving Trust				
Norman Robertson	14	10%	13	15%-16%
Mellon Bank				
Francis Schott	13-14	12	13	14-14½
Equitable Life				
Gary Shilling	13	9	11½	14
Shilling & Co.				
Allen Sinai	12½-13	9%-10	11½-12	14½-15
Data Resources				
John Wilson	13-14	9-10	12-13	15-17
Bank of America				
Dec. 31 closing rates:	15%	11.08	13.62	16%-17%

Jun. 18th, 1982 16.50 12.70 14.21 n.a.

Wall Street Journal, January 4th, 1982

* Current Assets : cash items in process of collection, demand deposits due from banks in the United States, all other cash and due from depository institutions, federal funds sold.

Current Liabilities: Borrowings from Federal Reserve Banks, all other liabilities from borrowed money.

** Purchased Liabilities : Times Deposits, borrowing from Federal Reserve Banks, all other liabilities from borrowed money.

Non-current Assets : Commercial and industrial loans, real estate loans, Securities investments over 1 year, all others minus current assets.

Currencies

Europe and Japan

The EMS (European Monetary System) realignment and a comfortable current account position have given the West German Bundesbank an excuse to ease in the face of slumping new domestic and export orders. Recent statistics indicate that central bank money (the Bundesbank's control variable) exceeded 9 per cent during the first four months of the year, slightly above its own target. Nevertheless, the West German central bank announced last Thursday that it would raise the rediscount quota of the banking sector by DM5 billion, effective next week. Sensitive to reflationary moves, the bond market has suffered a setback, with yields now rising to 9.25 per cent from 8.75 per cent levels reached in late April. Similarly, the deutsche mark has fallen since mid-May from around US 44¢ to a recent US .408¢.

Stagnating output (see Chart 9) and return to a deficit in the public sector should force the Bank of England into a more accommodative posture in coming weeks. Sterling still remains too high in real terms and is likely to suffer additionally from a deterioration in the UK terms of trade resulting from a soft oil market.

Protectionist measures against Japan as well as a wildly inflationary fiscal gap should continue to put downward pressure on the yen. Nevertheless, the Bank of Japan is known to be readying some nonmarket forms of intervention with the purpose of halting the decline at around the 260 yen level. Furthermore, international reserves are more than adequate to maintain desired parity. The reward/risk ratio has become less favorable to our profitable short position.

STRATEGY: *Since the DM/SF ratio has moved up from .79 to .86 (see Chart 12) and since the Swiss National Bank has not been nearly as accommodative, we suggest the purchase of September '82 SF versus the sale of September '82 DM, looking for the ratio to return to .80.*

Remain short the British Pound, risking 182.50 basis September '82. A test of the all-time lows, (\$1.55/£) may come sometime in late 1982, if only as an attempt to revive a moribund economy.

Cover September '82 yen at 38.50; when done, switch to Sterling.

Mexican Peso

A second devaluation, as devastating as the first, is due probably no later than July 5th, one day after the Mexican presidential elections.

A large \$2.5 billion syndicated loan has fallen apart for lack of interest despite the fact that Mexico has already drawn \$1.0 billion of it in a desperate attempt to shore up

the peso. The bridge financing is putting the underwriting managers in a difficult position, and it is unlikely that they will undertake a new and similar syndication. To put the problem in perspective, Mexico must borrow \$2.0-\$2.5 billion per month to roll over \$10.3 billion of short-term debt (over 20 per cent of the total public sector's debt at end of 1981 and compared with just 5 per cent at the end of 1980), interest on \$51.7 billion of public sector debt (revised upwards by \$3 billion just last month; does anyone know what is going on?) and the foreign exchange portion of the 1982-1983 public sector deficit.

Mexico has finally come to the end of the line. Their creditworthiness problems are now being compounded by the failure of the Grupo Alfa, which has defaulted on over \$2 billion of debt to no less than 134 foreign banks. At this point, there is no "spread" or "margin" over LIBOR (London Inter-Bank Offering Rate) that will entice the foolish banking community into throwing some more good money after bad money. While it is too late for the banks, it is also too late for Mexico. Soon after the election, a full default and moratorium will be put in place and the IMF (International Monetary Fund) will be called to implement an austerity plan, which, of course, will be preceded by a massive devaluation and a continuing monthly "crawling peg." Hyperinflation and revolution (especially if the elections do not come up with the widely expected results) may yet destroy whatever hopes the lending banks ever had of recouping their principal — let alone the interest — over the next 20 years.

STRATEGY: *Sell any and all MP contracts with impunity. Large profits are, once again, nearly certain.*

Canadian Dollar

The central bank has been unwilling to "peg" the Canadian dollar by aggressively hoisting its domestic interest rates. Instead, it has accepted the fact that on a trade-weighted basis, the dollar has behaved rather well and that further tightening may lead to too serious a slump.

Looking from a purely domestic point of view, monetary aggregates are depicting a severe squeeze: M₁ at 24.789 billion on June 2, 1982, is actually lower than the average M₁ for the month of January 1982, while M₂ has grown at an annual rate of only 13 per cent for the past six months, a far cry from the heady 18 to 20 per cent rate of growth achieved in the second half of 1981. More significantly, the monetary base, adjusted for shifts in deposit, is actually showing a minor year-over-year drop. Obviously, pegging the Canadian dollar would entail an even more severe

monetary squeeze, which, in our opinion, may not be fully justifiable.

STRATEGY: Speculators looking to profit from the strength of the US dollar are advised to avoid shorting the Canadian dollar. In the first place the Canadian dollar, in

real terms, is substantially undervalued. Secondly, it is strong on a relative basis (see Chart 1). Finally, if the Bank of Canada persists in its monetary squeeze, the currency is likely to bounce back to the 80¢ mark as soon as the Fed relents — as it must, sooner or later.

Chart 10

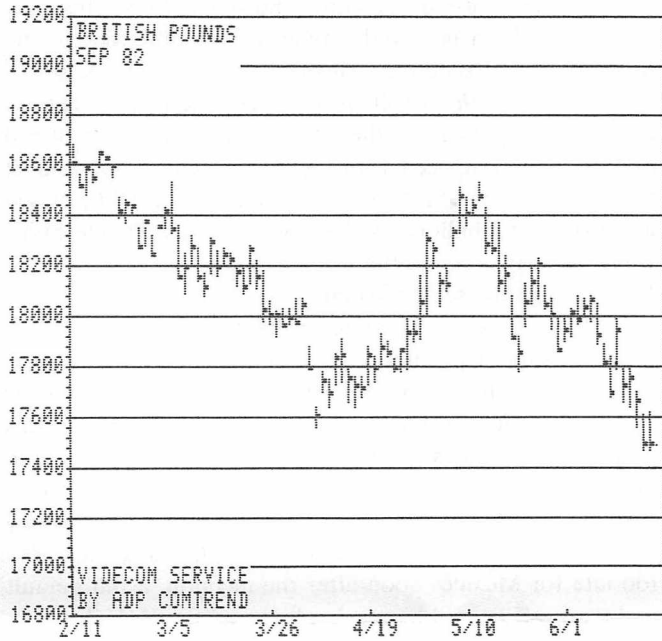


Chart 11

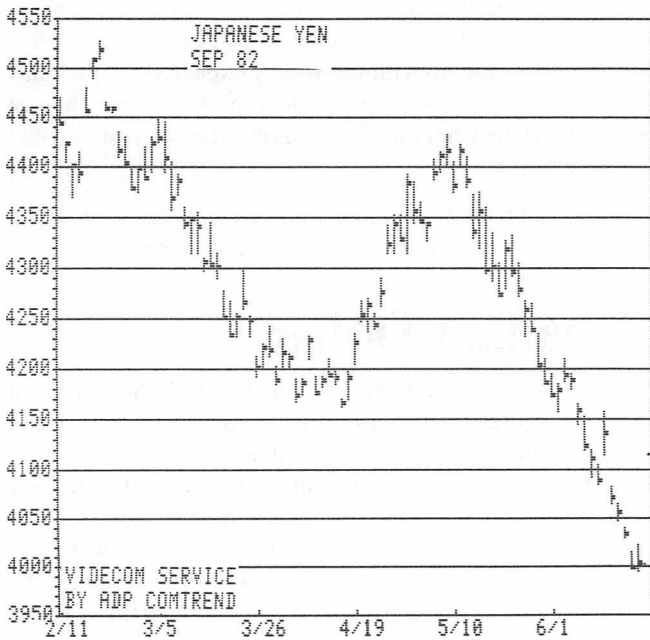


Chart 12

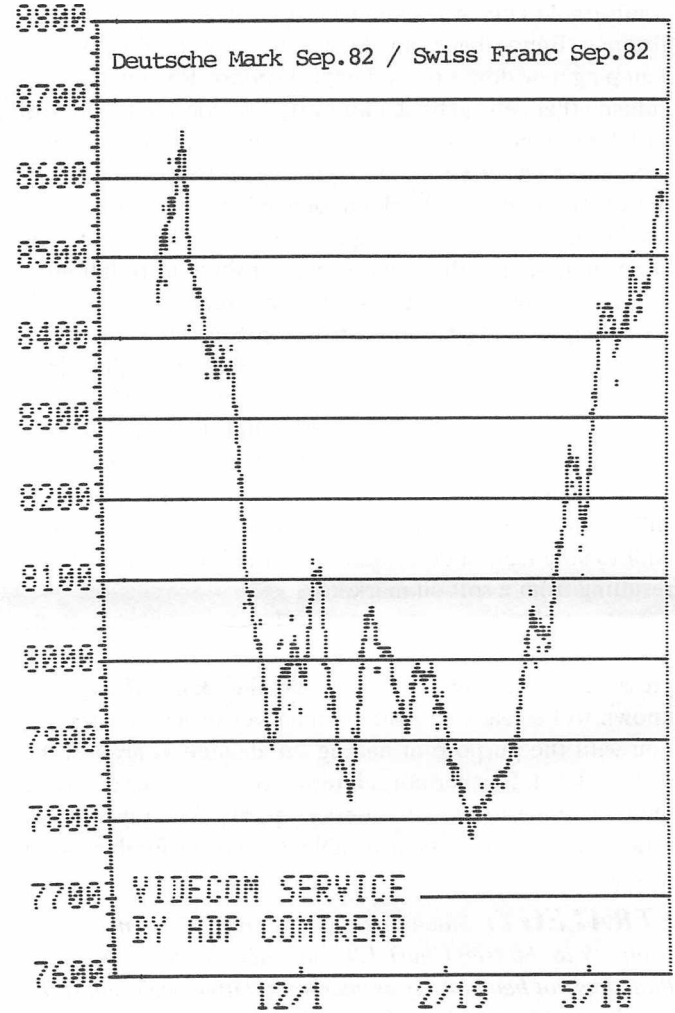
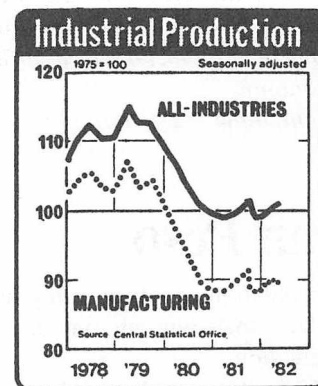


Chart 9



Financial Times

Chart 13

MP IMM Futures

Annualized Forward Discounts %	Sep.82	Dec.82	Mar.83	Jun.83
Cash	56.27	57.04	58.69	60.31
Sep.82		50.67	52.54	54.03
Dec.82			48.29	49.47
Mar.83				45.19

Precious Metals

The unrelenting bear market continues. Only bottom-pickers would dare to stand up to the stampede.

Values are beginning to emerge, i.e., gold is trading at a mere 10 per cent premium (based on latest, delayed, statistics) over its external convertibility value; silver is trading at a meager and near-historic 1/60 of gold.

STRATEGY: A number of months ago, pointing to the fact that gold prices had broken their long-term 1976-1980 uptrend at \$320/oz., we predicted a bloody finish and used

the Falkland Islands crisis to increase our short position. A massive sell-off which, most probably, will see the Hunts lose control over their 60 million ounces, will mark the end of this long decline. It may also mark the day the Fed threw in the towel.

Short positions in August 1982 COMEX gold should be stopped at 350, close only. Short points in silver should be closed out on either (a) an announcement that the Hunts have sold out their position and/or (b) the first upside weekly reversal.

Chart 16



Chart 17



Chart 18



Copper

Last month we advised establishing a long position in July, which was then trading at 73.00, and risking a close below 70.00. Readers may have been fortunate to escape loss inasmuch as the downturn penetrated the stop within three days of writing or presumably, before our *Comments* were received by most subscribers. A rare, albeit a perverse, vote of thanks is owed the post office.

Copper's decline over the past months has been astounding. Its value has declined by 23 per cent from a level already so depressed that it was then, at 70.00, trading at roughly 15 per cent beneath the cost of domestic production. The market has fallen nearly 16¢ per pound or by \$3,000 per contract making new lows 16 of the past 22 trading sessions. And all of this has come about despite some apparently positive news: Car sales have shown signs of bottoming out; housing starts during May registered a 22 per cent rate of increase over April and crossed the one million mark on a seasonally adjusted basis for the first time this year; and AMAX Corp., one of the nation's largest refiners, reduced capacity, complaining that, though offtake

was slow, it couldn't find enough raw sulphate to refine because of the spate of mine closures.

What can explain such a tumble in the value of one of the world's key industrial commodities? Can it be that those who claim the drop heralds an economic depression — an evermore vocal group — are right? We doubt it. First of all the economic news seems to belie such a view. And perhaps more importantly the fact that open interest remains high and volume has actually increased in recent weeks suggests that it is speculators who are taking the most active role on the short side, using the depression argument as justification. That there is ample money available with which to speculate is hardly the sign of hardship one would associate with a collapse. We notice in our own brokerage operation an influx of new customers opening accounts for the express purpose of going short the market.

There is no doubt we are in the midst of an extremely vicious disinflation. This has come about because of the Federal Reserve Board's monetarist policies and need not be elaborated upon here. We feel, however, that in the case

of certain commodities, the disinflation process has entered into the irrational phase. Reasonable values, reasonable fundamental factors are obscured by a mass sell psychology. The current environment reminds us of the buying hysteria that prevailed at the top of the precious metals markets at the beginning of 1980. We must conclude that just as precious metals prices were overvalued at that time, copper prices — and the prices of silver, platinum, and cotton, to name only three more — are undervalued now.

What is the appropriate action for us to take? First we must recognize that any market that is dominated by irrational selling — or buying — represents an opportunity for the astute speculator.

Secondly, we must understand that despite the fact that prices have dropped to well beneath fair value levels, they can continue to drop further yet. In the current phase of the decline fundamental analysis is valueless. The absence of reason knows no limit; therefore, nobody can pick a bottom, saying, in effect, prices should not fall to beneath, say 50¢.

In late 1979 we reasoned gold was worth \$550 per ounce by calculating the dollar's convertibility in terms of US external liabilities. Nonetheless, gold exceeded that level by better than 50 per cent. Likewise copper prices can continue to drop to evermore unreasonable levels, representing in the process an evermore attractive opportunity.

Third, one must believe that once a market has entered into the emotion phase of its trend, that phase is the final phase. In other words, what we are witnessing at present is the final sell-off. The turn from here will not be the beginning of a bear market rally but the end of a bear market. This is not to say that a raging bull market can be expected to begin immediately. It is to suggest, however, that we are approaching a low that barring a horrible and total collapse or a discovery of a cheaper substitute for copper, will not be seen again during our lifetime.

STRATEGY: Since we've concluded fundamental analysis will avail us nothing in our efforts to call the turn, it follows that we must resort to technicals. Once again, we look back to precious metals markets two-and-a-half years ago. Two months before the highs were seen we wrote it was most likely that gold would top out in an outsized weekly reversal. The weekly chart of gold is reprinted here to illustrate (see Chart 20). You'll notice the week's high was higher than the high of the previous week, and the same week's close was lower than the close of the previous week.

We believe the reverse, that is to say a weekly upside reversal, will be the most likely end to the current downturn in copper prices. A second possibility would be an island reversal on either a daily chart or a weekly chart. The accompanying chart of sugar (Chart 21) is the classic illustration of this type of reversal formation. Subscribers who suspect a reversal but are unfamiliar with this somewhat arcane type of commodity chart interpretation should feel comfortable to phone us.

Since we are now of the opinion that the market is dominated by speculators — specifically computer-based trend followers — we believe it likely that the initial upturn from the reversal will be a sharp one. A wave of short covering, which will be seen in a pronounced drop in the open interest, should carry values quickly to the "fair value" range of between 70¢ and 80¢ per pound basis spot. The speculator will have to be astute indeed to take advantage. As we implied earlier, the attractiveness of a long position from the turn will not be so much an investment in the beginning of a great bull market — such would depend upon fundamental factors that at this point are simply unknown — as a quick turn from a low that may never be seen again.

Chart 19

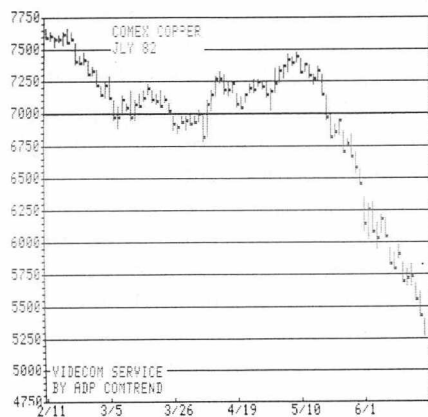
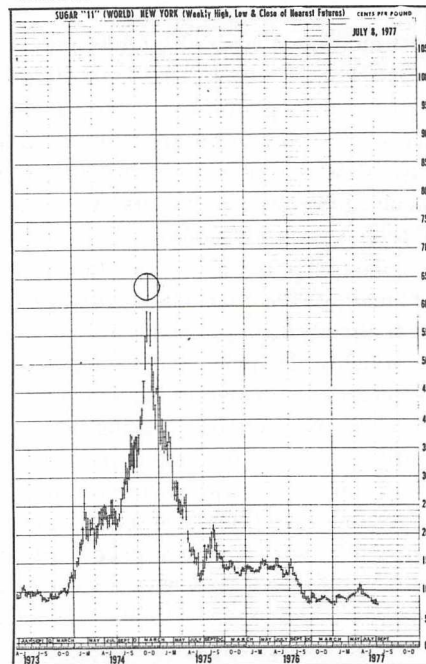


Chart 20



Reprinted from Commodity Research Bureau

Chart 21



Reprinted from Commodity Research Bureau

Heating Oil

Ransom-high prices and repeated threats of embargoes and the like finally caused a secular shift in the demand for and supply of crude oil and related products to occur in 1979. Conservation and substitution of new energy sources have resulted in a reduction in oil demand by 20 per cent over the past three years. Over the same period, decontrol of natural gas prices has resulted in a steady decrease in the amount of oil imported into the US. Last year imports accounted for only 36 per cent of oil demand versus as much as 52 per cent in the late 70s, and during April, the latest month for which data are available, imports declined 1.417 million barrels per day (mbd) to 5.0 mbd, or to the same levels of 1971, the year before the first round of "oil shocks." Moreover, US oil imports have increasingly shifted away from OPEC sources. Chase Manhattan recently calculated that the non-OPEC share of US oil imports has grown from 27 per cent in 1980 to 32 per cent last year.

Though the secular shift in the oil industry began in 1979, it was not until late last year that market forces impacted on prices in any devious way. In the autumn of last year the combination of recession and high interest rates seemed to awaken the market out of complacent perception held by both governments, private industry and speculators that oil prices had nowhere to go but up and up seemingly forever. Concerns that had reaped huge profits simply by being buyers and holders of inventory — not a difficult thing to do in a bull market — were shocked back into economic reality when they came to realize they were sitting on a nonappreciating asset and financing it at debilitatingly high borrowing rates. The holders of oil did the same thing holders of copper, real estate, gold, diamonds, silver, etc. did; they sold and in the process drove prices down in dramatic fashion. Crude prices fell to the mid-\$20 per barrel range and distillate (fuel) oil prices dropped into the mid-60¢ per gallon level by early 1982. Customers of this firm will remember the 25¢ ride we took on the short side of heating oil from last October through January.

The sharp drop in oil prices put a tremendous strain upon OPEC, whose members were obviously as surprised as other participants in the industry. Huge budget and current account surpluses threatened to become, and in many instances did become, deficits. Enormous capital spending programs were abandoned often right in the middle of construction. Extreme financial weaknesses of countries like Nigeria, Ecuador, and Venezuela became visible. The once apparently impregnable cartel — like all cartels only as strong as component parts — seemed vulnerable.

OPEC was caught between a rock and a hard place, as it were. In order to remain intact it had to increase revenues. To do so required making a decision between lowering official prices in accordance with market forces in

the hope that volume would sustain them or to increase prices by reducing production, hoping that such a strategy would have to remain in effect only temporarily. The latter course, which, as we all know was the one adopted, is premised on the view that the much publicized glut was essentially a function of the inventory liquidation that developed in the wake of the recession and high interest rates. OPEC has stated quite clearly they are of the opinion that once rates come down and the economy picks up — and they have made it equally clear they believe both eventualities will come about by the end of this year — demand will broaden, inventories will be replenished, and by and large the industry will return to normal, i.e., to pre-glut levels.

The effect of OPEC's decision to reduce production via the establishment of quota allotments has not been substantial. Users and speculators in the traditionally sensitive oil industry have stooped under the dominion of OPEC for the better part of a decade. The image of OPEC executives' being surrounded by photographers as they strode from Mercedes limousines into meetings at which policy was dictated to the entire globe remain very fresh in the mind.

It should hardly be surprising that prices have risen. Crude prices on the Rotterdam spot market climbed to the \$34.00 benchmark level commanded by OPEC — they currently stand around 50¢ beneath that level — and certain product prices in the US have risen proportionately by an even greater amount. Subscribers and customers are well aware that heating oil prices on the New York Mercantile Exchange at one point advanced to 99¢ per gallon, or to as high as they were before the price break of last fall.

We believe that the assumptions upon which OPEC has based its strategy are faulty and that the market has erred in paying the cartel the respect it has. Current values thus represent a unique opportunity for speculators prescient enough to recognize we have entered into a new era as far as oil is concerned. As we wrote as early as November 1980, oil prices have topped out forever. That they have advanced a second time gives us a second chance to sell a market at its peak. To be short heating oil futures now is similar to having been short precious metals at the beginning of 1980.

The flaw in OPEC's reasoning is not so much that they predict the current recession and high rate environment will end this year, but that they fail to recognize that the secular shift in demand that we spoke of at the outset is established; this means that the old rules of the game will never apply again. A review and slight elaboration upon data discussed in last month's *Comments* supports our thesis: The 20 per cent decline in oil demand experienced over the past three years has been to a level of about 15.8 mbd in the US and to between 42-43 mbd worldwide. In April demand increased

for the first time in that three-year period by the meager amount of less than 0.5 per cent.

We agree with the consensus response to an American Petroleum Institute questionnaire, which indicated that at best, oil demand may have found a level from which it is likely neither to rise nor fall in the mid-term. We further assume — and our assumption is more likely to be conservative than not — that the same is true in the rest of the world, i.e., that demand should hover in the 42-43 mbd range. OPEC's quota allotment allows for production of 17.5 mbd. Non-OPEC production has climbed to 23 mbd. With total supply of 39.5 mbd corresponding to total demand of 42-43 mbd a production deficit of between 2.5 and 3.5 mbd is calculated.

But before drawing any hasty conclusions, there are several other factors to be taken into account. First, non-OPEC production, as we said, has climbed and can be expected to continue to climb. The Soviet Union is in dire need of hard currency. The recent announcement by Petrobras that Mexico had produced and exported a record amount of crude during May typifies the response non-OPEC countries will have to OPEC's cutback. And in the US production is expected to increase to 8.7 mbd from 8.5 mbd last year. That this trend is likely to continue is indicated by data published monthly by the Hughes Tool Corp., showing the drilling count in April took an upturn toward the very substantial 3,970 rigs that were in operation on average during last year.

* Second, OPEC itself cannot maintain its quota system indefinitely. As we pointed out in our April *Comments*, 10 OPEC members are in less than healthy financial shape and four are desperate. Another factor now to be considered is the impending end to the 20-month-old war between Iran and Iraq. The former country has been selling more than its quota at beneath its prescribed price for some time. Is it not likely that Iraq, which has seen its exports virtually dry up altogether because of transportation difficulties associated with the war, will scramble for revenues to repair its debilitated economy in the most expedient manner possible?

The third factor to consider is the level of inventory. We have already calculated that in the unlikely event both OPEC and non-OPEC production remains unchanged from current levels, we will have a production deficit of between 2.5 and 3.5 mbd. That deficit, like any type of shortfall can be compensated for if sufficient reserves are available. Although we cannot be certain, we estimate closing inventories at the end of 1981 stood at 4.6 billion barrels. That amount represented 90 days of supply, which is considered an industry standard. The key point in the OPEC argument is that owing to their cutbacks and the consequent shortfall, buyers will have to return to the market in order to build stocks back to that standard. There are simply too many reasons that argue against this view.

First, the 90-day availability became a standard at a time when inventories were profitable to hold. They are not profitable to hold now and in the current environment may not be profitable for some time. We are in a period when the

oil industry, for the first time in memory, is feeling the same cash flow squeeze everyone else is. And the squeeze is exacerbated by the takeover mania, which incredibly, still prevails. In order to finance its purchase of Cities Service, Gulf is seeking hard-to-find cash where it can.

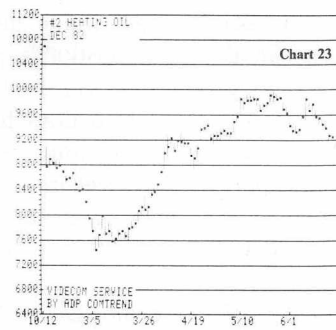
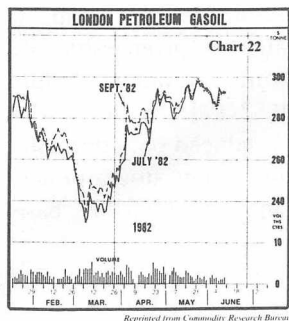
In such an environment we can only conclude that standards are meant to be broken. We remember well the time in 1976 we were long cotton at 80¢ because we calculated year-end stocks would come in at less than the industry standard of 3.0 million bales. Closing inventory worked out to 2.5 million bales and cotton fell to 60¢. The outlook for new crop cotton didn't show any improvement. And neither does the outlook for oil. If the industry standard for oil were dropped to the not unreasonable level of 75 days' supply, then not only would there be no production deficit this year, but even at 17.5 mbd we would have a surplus.

To conclude: We do not believe crude prices can be maintained at the current \$34 per barrel level for any sustainable period of time. We maintain the view that prices will most likely break as an immediate consequence of some revelation of cheating by one or several OPEC members, but this need not be the case. The fundamental case is in place even if OPEC were to elect its suicidal disregard for the market. Oil prices should fall to at least \$20 per barrel although we admit we cannot predict a time frame. The only caveat would be a full blown war in the Middle East, which though not likely, is definitely the speculators' greatest risk.

The heating oil and London gas oil contracts are the most popular oil product vehicles because they attract the largest number of hedgers; small companies as opposed to the large integrated majors represent a more substantial part of the industry than gasoline producers or dealers of crude. As such, these contracts are the most liquid and the ones we have adopted as vehicles to be short, by proxy, the crude market. Looking briefly at heating oil, we notice that capacity utilization has increased in recent months from around 63 per cent to nearly 69 per cent. The reason is that in the semi-panic that followed the OPEC decision to establish quotas, speculators bid up distillate prices to levels that overshot the rise in crude prices, and now refiners are taking advantage of the unexpected bonus of having an improvement in profit margins. A second bearish factor is the increase in distillate stocks witnessed during the past week to 115,705 barrels from 113,596 barrels despite a decrease in production from 2.63 mbd to 2.61 mbd. Domestic inventories are again reaching the too-heavy area.

STRATEGY: *With respect to charts both heating oil and gas oil are in the process of completing classic head and shoulder tops accompanied a weekly reversal at the head. Both markets are, as of this writing, sitting at just above their respective necklines. A break beneath those necklines would induce us to add to our already sizeable short position, concentrating the bulk of the additions in London*

which, though smaller, is a more professional market and not subject to the still-outside risk that a duty will be established on oil imported into the US. (Such has been rumored for some time as part of a compromise on the budget.) Our stops remain at 102 basis December, which was the high last year when crude prices were \$34 per barrel. They will be lowered once the market breaks the technical neckline.



Grains

The grain markets of the past month were marked by slow movement of cash grains from the country to terminal points. This, coupled with declining terminal stocks, caused the cash basis in corn and soybeans in particular, to rise substantially. As a result, nearby futures have been pulled up, leading to very narrow premiums in the new crop months. In fact, July corn is trading at a premium of 1¢ to 2¢ over December.

Besides tightness in cash corn markets, corn will have to come out of loan stocks to satisfy demand before the new crop is harvested. "Free" stocks are forecast at 421 million bushels on September 30. This includes corn under loan. A June 18 USDA (United States Dept. of Agriculture) report indicated balances of 1980 and 1981 crop corn under loan of 599 million bushels, a drop of about 49 million bushels from a month earlier. Thus, at least 178 million bushels of corn must come out from under loan before September 30, and more between then and the new crop season. The rate of loan repayments will thus have to speed up. Farmers are required to repay the \$2.40 loan plus accumulated interest (say, 9 months at 14.5 per cent p.a.) amounting to a total of about \$2.67, whereupon they may sell cash corn. With a farm basis of at least 20¢ under Chicago, futures would have to trade at well over \$2.80 to attract sufficient cash corn to the market.

Our recommendation to buy soybean futures last month was stopped out embarrassingly. The market corrected very sharply owing to lack of shifting of Argentine sales to the US, lack of support from a smaller Brazilian crop, and expectation of substantial shifting of corn acreage to soybeans as a result of wet weather. The latter factor is believed by us to have failed to be substantial; this belief will be confirmed or proven wrong by the June 29 acreage estimate of 1982 crop acreages. The June 22 grain stocks report will also confirm or deny whether October to March

soybean use was in fact 1,300 million bushels.

If the 1981 soybean crop was not overestimated, as many believe, following the lower than expected April 1 stocks report, usage will have been 13 per cent higher than 1980/1981. If the June 1 stocks of soybeans are below 650 million bushels the impact could prove bullish for beans. Soybean stocks are currently forecast at 305 million bushels on August 30, 1982, 10 million bushels lower than last month's estimate owing to soybean exports now forecast at 900 million bushels. Our prediction of heightened export figures and lowered stocks has proven correct twice now.

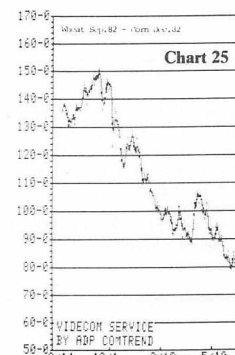
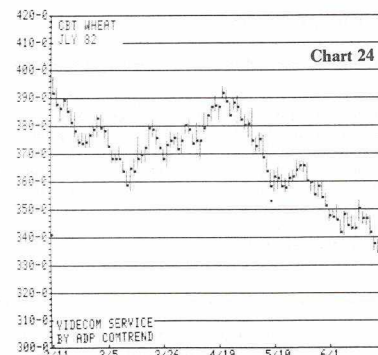
The 1982 US winter wheat crop was forecast by the USDA on June 10 at a record 2,131 million bushels, compared with the previous record of 2,099 million in 1981.

The 1982 Soviet grain crop is now forecast at 185 MMT (million metric tons), compared with 200 MMT last month, and a 1981 crop of less than 175 MMT. Imports are projected at 42 MMT, up 4 MMT from a month ago, and comprised of 25 MMT of coarse grains (21 MMT earlier), 16 MMT of wheat (unchanged), and 1 MMT of miscellaneous grains and oilseeds. Note that 25 MMT of coarse grains represents almost one billion bushels of grain, or roughly 1/8 of 1981, or forecast 1982, US corn crops!

The short July/long November soybean spread should have been closed out at 14¢ to 16¢ premium November (5 1/2 to 7 1/2 cents profit), having reached our target of 15¢. Recently, these spreads have narrowed considerably, reflecting tightness in cash supplies. As a result, the short July/long September spread, which we had forecast to reach 10¢ premium September failed to move past 7¢ and should be closed out.

STRATEGY: Be prepared to take profits from short sales of July wheat, instituted around 3.62, at 3.35 or below, as wheat seasonals indicate that prices tend to bottom just before harvest, which this year will be the third or fourth week of July for SRW (soft red winter) wheat.

Buy September, sell December corn in anticipation of growing tightness in cash markets, which may cause an inversion of corn futures prices. Risk 6¢ premium December because profits may be fairly substantial as corn is forced to come out of loan. As subscribers will not get this issue until after the June 22 grain stocks report, buy September soybeans only if June 1 soybean stocks are below 650 million bushels.



Cotton

Retail sales in May were up 1.5 per cent over April in the US. As cotton is one of the first commodities affected by improving trends in the economy in the short-term, this presents the opportunity to risk recent lows in cotton in anticipation of a turnaround in the economic outlook spurred by US reflation. Such reflation will be precluded by rising foreign currency and gold futures, and falling interest rates futures. Sharp turnarounds in existing trends, particularly in Swiss francs and gold, would be requisite to the purchase of cotton futures as these in turn would reflect US reflation.

End-of-season cotton stocks are forecast to decline from 6.5 million bales on July 31, 1982, to 6.2 million on July 31, 1983 (see Chart 26). Of these ending stocks this July 31, 4.29 million bales are currently under loan. Falling cotton stocks would be largely a result of US cotton production's

falling in 1982/1983 to a forecast 12.5 million bales from 15.6 million in 1981/1982. This drop in production is the result of the 15 per cent acreage set-aside program, poor planting weather, and replanting made necessary as a result in some areas (which also reduced yield prospects somewhat), and unprofitable production, given estimated average production costs of about 75¢/pound. While the most recent projections for 1982/1983 by the USDA raised starting stocks estimates and reduced both domestic and export-use forecasts, thus raising ending stocks projections, cotton may have set a support of 65.75¢ basis December.

STRATEGY: Buy December cotton, risking contract lows at 65.75. If the US economy is reflatated, cotton could rapidly retrace to 75¢.

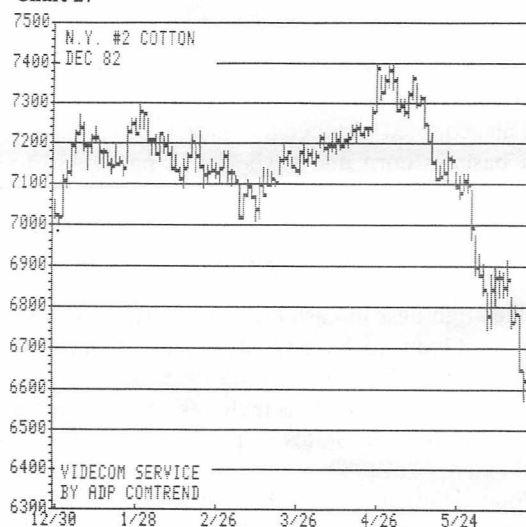
Chart 26

U.S. Cotton supply and demand projections (million bales- 480 lb.)

	1982/83 June 11 forecast	1981/82 June 11 estimates
starting stocks	6.5	2.7
production	12.5	15.6
total supplies	19.0	18.3
domestic use	5.7	5.3
exports	7.3	6.7
total disappearance	13.0	12.0
ending stocks	6.2	6.5
unaccounted difference	0.2	0.2

Source: U.S.D.A.

Chart 27



Potpourri

Buy August hogs, sell August cattle with an objective of prices at par. Risk closes above 9¢, which should not be triggered unless the hog report is not highly bullish as anticipated.

August spreads recommended last month may have been stopped out at the suggested 8¢ level. October spreads are still recommended and those existing should be maintained.

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