

# FRIEDBERG'S

## COMMODITY & CURRENCY COMMENTS



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## Why The US Dollar Still Reigns Supreme

Ever since the onset of the second great depression sometime in early 1980, the US dollar has been in a bull market of spectacular proportions. On a trade-weighted basis (see Chart 1), the greenback has soared 40 per cent and has given no sign of topping out.

A variety of explanations have been advanced, none very satisfactory. It has been said that the US dollar has risen in line with a widening of its interest rate differential vis à vis major trading partners. Unfortunately, during the Spring of 1981 and again in recent weeks, sharp absolute and relative drops in US interest rates have not produced the expected decline of the US currency. Refining the data to measure only real rates of interest and their differentials has also not produced expected results.

Would movements on current account be significant? Probably, at least when it comes to the general direction (see Chart 2). At this time, however, the US is running a current account surplus only one third the size of the one achieved in 1975, and yet the dollar stands 10 to 12 per cent higher than at that time.

Could differential rates of inflation be a better explanation for the strength of the US dollar? Charts 3-6 belie this rather sound argument. Moreover, a better overall inflation performance of the US economy would mean that the real rate of exchange, as opposed to the nominal rate of exchange, would not be showing a substantial rise. This clearly is not the case, as shown by our Chart 2. In our view the answer is a combination of two factors: a) a public perception of monetary/fiscal policies; and b) cyclical patterns.

On the monetary front, the Fed has maintained a semblance of discipline as well as, if not better than, Japan, Germany, Canada, or the UK, and far better than the rest of the other industrialized nations. Even more important than this adherence to monetarism has been the perceived trend in fiscal discipline. Western Europe, Japan, and Canada have shown little or no inclination to narrow their rising fiscal deficits. Despite the well-publicized noises about the Reagan deficits, it is still true that as a percentage of GNP, the US budget shortfall is a great deal less serious than that of its European counterparts. As demonstrated by Thomas J. Sargent in "The Ends of Four Big Inflations" (Working Paper #158, Federal Reserve Bank of Minneapolis), a currency can be stabilized if the *fiscal authorities* show a determined drive to stem red ink. Stated in a more general way, monetary policy *gains added credence* if and when the public has come to believe that future deficits do not have to be monetized.

Cyclicity favors the US dollar in two ways. In the first place, US recessions produce a current account surplus, which, as we saw earlier, tend to accompany exchange rate movements. Secondly, foreign nations, deeply mired in a worldwide slump, attempt to recover by stimulating exports. Devaluation vis à vis the US dollar is the preferred method of obtaining such relief (see *Commodity & Currency Comments*, June 20, 1982).

What are the prospects for the US dollar in months ahead? Political pressure in Western Europe and Japan is likely to evoke even stronger anti-cyclical fiscal policies,

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### Contributors

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thus causing a sharp widening of budget deficits. As a percentage of GNP, we may reach an average of 10 per cent for Western Europe and Japan and only 6 per cent in the US (using a \$175 billion estimate). Bullish for the US dollar.

A cyclical approach to the movement of currencies yields basically the same results: a deepening worldwide depression, a desire to reflate by way of an export-led

recovery, and more beggar-thy-neighbor competitive devaluations. Again bullish for the US dollar.

**STRATEGY:** Sell December '82 Swiss francs and December '82 Deutsche marks at market. Retain short positions in Japanese yen and British pound. Look for the US currency to improve about 15 per cent from present levels.

Chart 1

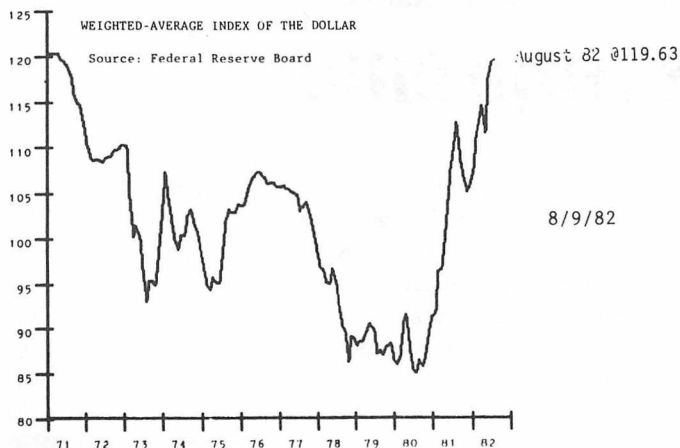


Chart 2

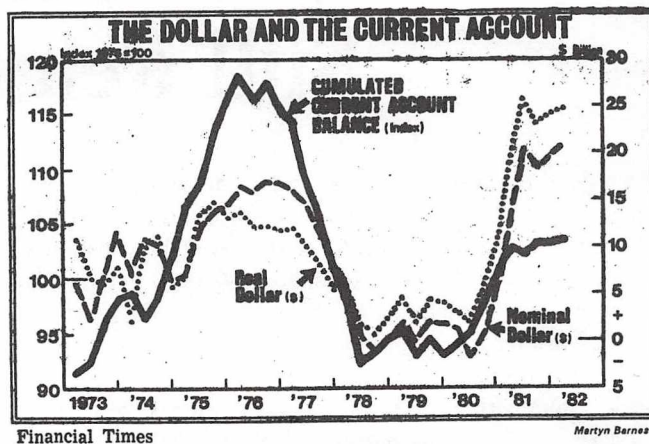


Chart 3

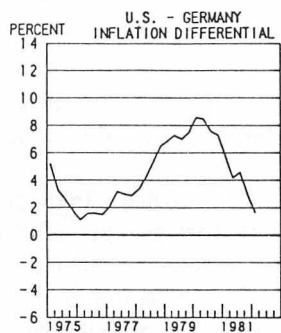


Chart 4

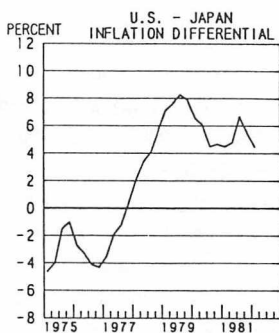


Chart 5

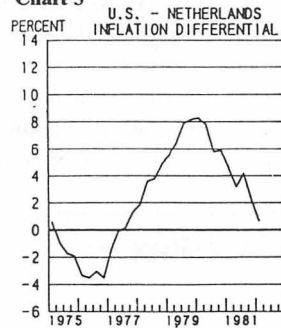
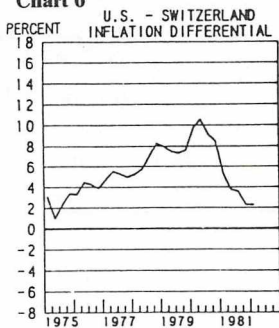


Chart 6



PREPARED BY FEDERAL RESERVE BANK OF ST. LOUIS

Chart 8

Aggregate fiscal deficit (million of U.S.\$)

	EMS*	US
1970	8,053	12,800
1971	17,478	26,100
1972	11,894	14,300
1973	27,011	7,800
1974	28,956	12,100
1975	71,490	85,800
1976	52,536	69,200
1977	65,755	57,300
1978	89,661	54,400
1979	96,200	39,800
1980	116,484	79,700
1981	117,115	87,700

\*Countries of EMS: Germany, France, Belgium, Netherlands, Britain, Italy, Ireland, excluding Denmark for which data are not available.

Chart 7

**Major Industrial Countries: Changes in Relationship of Public Expenditure to Nominal GDP, 1965-79**

(Ratios of percentage changes in public expenditure to corresponding percentage changes in nominal GDP)

	1965-69	1969-73	1973-79
<b>Individual countries</b>			
Canada	1.49	1.19	1.16
United States	1.40	1.06	1.11
Japan	0.92	1.42	1.88
France	1.10	0.93	1.33
Germany, Fed. Rep. of	1.15	1.22	1.41
Italy	1.00	1.29	1.22
United Kingdom	1.34	1.12	1.15

Source: Organization for Economic Cooperation and Development, *National Accounts of OECD Countries, Vol. 2, Detailed Tables, 1962-1979* (Paris, July 1981).

The data for Japan exclude some transfers for which data are not available for years prior to 1970. The combined value of these omitted transfers was equivalent to about 3/4 of 1 per cent of GDP in 1970 and to 1 1/4 per cent in 1979.

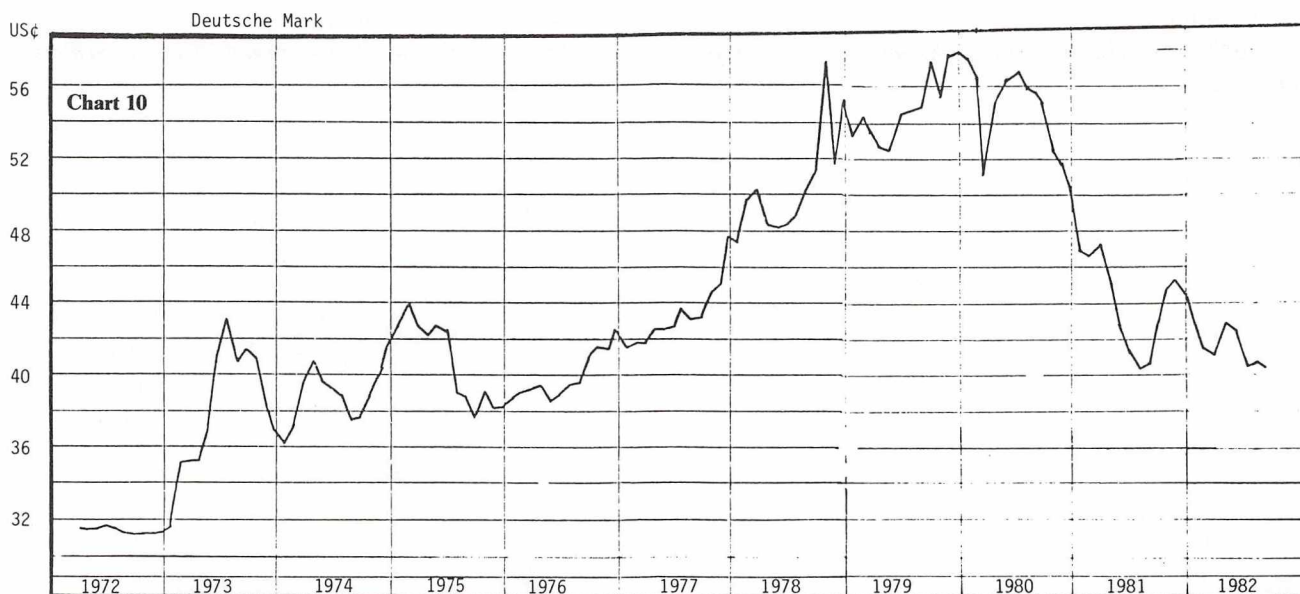
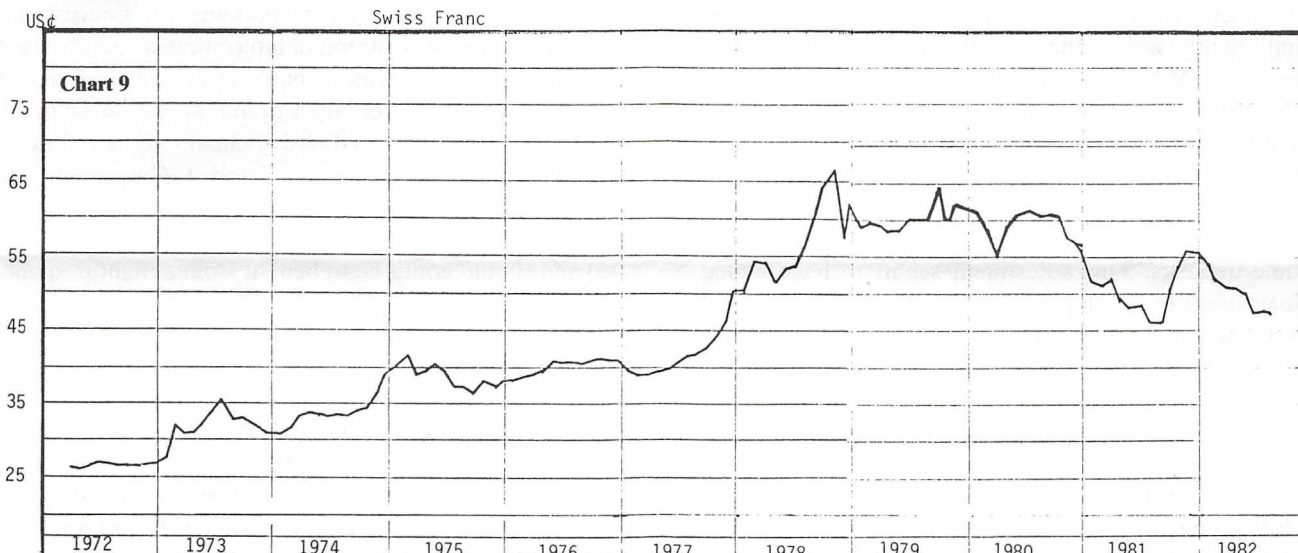


Chart 11

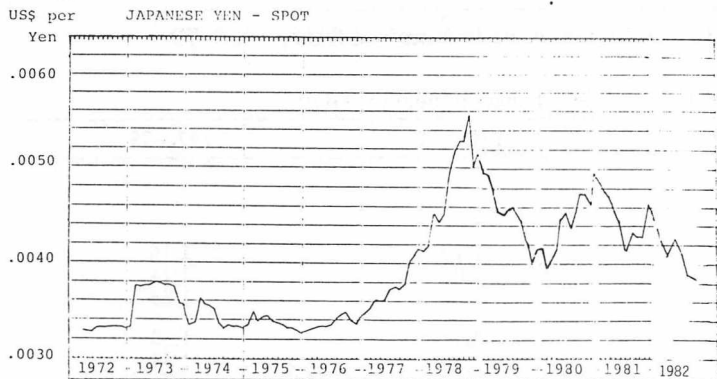


Chart 12



# Interest Rate Futures

Sharp increases in nonborrowed reserves and in the monetary base during May and June have begun to have an expansionary effect on M1, which as of last week was running slightly above the top of its permissible range. Furthermore, M2 has been ahead 10.4 per cent on an annual basis over the fourth quarter of 1981, well above its targeted 9 per cent per annum ceiling.

It should be noted that until now the rate of growth of M1 has been slowed considerably by the drop in the multiplier, probably in response to shifts into both currency and time deposits. This adjustment seems to have ended and may become an element of concern to the Fed and Fed-watchers as M1 picks up an additional and excessive one or two annual percentage points. Interest rates, in their usually perverse fashion, should rise until such time as either the Fed undertakes an aggressive tightening posture or the previous increases in the monetary base and nonborrowed reserves are fully absorbed by corresponding increases in M1. In recent weeks the rate of growth of the adjusted monetary base has become negative, thus bringing down the long-term annual growth rate to 6 per cent, a level compatible with present monetary targets.

The Fed has been hanging tough. As yet there is no indication that a process of deflation has begun, although admit-

tedly, confidence in the Fed's continuing resolve is low, as evidenced by the skyrocketing prices of gold and the unusually high spread between short- and long-term interest rates.

Regardless of the trend of interest rates, quality spreads continue to reflect present banking problems. Eurodollar deposits require an ever larger premium (measured in terms of percentage rather than basis points) over T-bill rates to attract and maintain customer interest. Our spread, short four December '82 Eurodollar and long 5 December '82 T-bills has proven to be an outstanding success (see Chart 15) and should continue to benefit from a flight to quality.

**STRATEGY:** Short-term interest rates are likely to move higher, well within the a-b downward channel traced in Chart 13. Deep discounts in the deferred positions do not allow us to put on an outright short position in T-bills, CDs, Eurodollars. Remain sidelined.

The unusually steep yield curve provides strong underlying support for long-term T-bonds; they are unlikely to fall significantly from these levels. We would therefore abandon recently established short positions and look to be long on sharp setbacks only.

Retain T-bill/Eurodollar spread; it could easily widen to at least a 50 per cent premium.

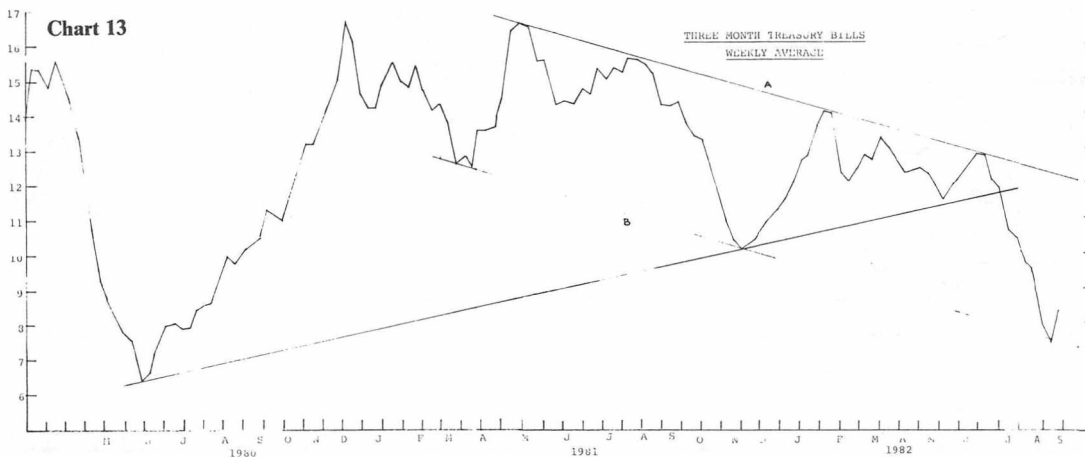
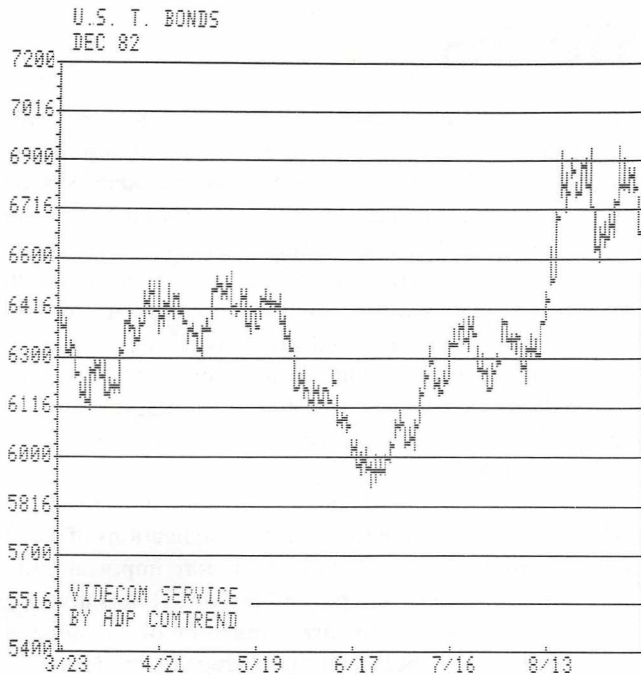
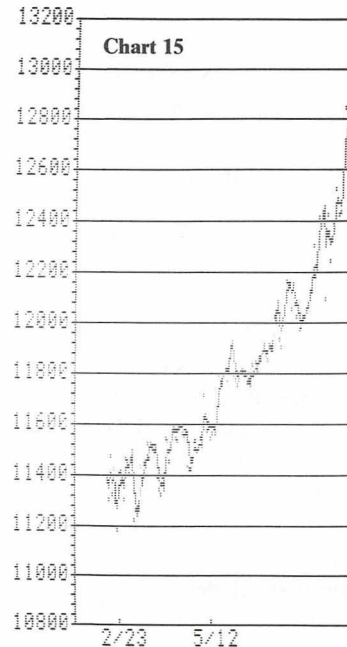


Chart 14



Euro Dollar Deposit Dec. 82 Yield/  
Tr. Bill Dec. 82 Discount to Yield



# Currencies

## Mexican Peso

Foreign exchange controls will be a mess to administer... Mexico is hunkering down into a "siege economy". The US government will be subject to severe criticism for helping the Mexican government and the US banks, while ignoring the plight of US citizens where capital is being "seized" by Mexico.

— John Gavin

US Ambassador to Mexico

In one fell swoop, Carlos Tello Macias, the new Governor of the Central Bank of Mexico, nationalized the Mexican private banks and made official what had been rumored for many weeks: the imposition of exchange controls set in a context of artificial exchange rates.

The following reasons are being advanced for the nationalization of the banking industry: a) it will raise the level of machismo of Mr. Lopez Portillo and his party, evoking parallels to the Mexican nationalization of US oil interests in 1938 — an extraordinarily popular move at the time; b) it gives the government access to confidential banking records, thus tightening the noose around the private sector — individual liberty has been destroyed; c) it allows the government to take possession of roughly \$12 billion of US deposits, the property of *residents* and *nonresidents* (without nationalization, the banks may have refused to hand over the booty); and d) it throws into the moratorium the foreign interbank debt of Mexico's banks, thought to amount to roughly \$10 billion, as part of the consolidation of the public debt.

All of the reasons above are valid and paint an extremely gloomy picture of Mexico. But the Bank of International Settlement and the International Monetary Fund have begun to understand the situation; the former has only allowed the drawdown of a one-third tranche of its \$1.85 billion credit facility. The latter has expressed enough dissatisfaction with the progress of its negotiations to leave in doubt the eventual outcome of a \$4 billion rescue package. Commercial banks are being forced to roll over maturing debt lest they demand payment and come back empty-handed.

The long process of writing off the debt has begun. Sooner or later, all commercial banks will begin to reflect in their balance sheets the nonperforming nature of these loans. In due course, their noncollectibility will also be recognized.

**STRATEGY:** *The making and taking delivery of Pesos on the International Monetary Market will become ever more difficult given the tightening of exchange controls. One should not rule out the reappearance of a two-tier system, at which time futures will, once again, trade freely and reflect true market forces. This is unlikely to occur; however, at least until the new president is sworn in (late December).*

*As advised last month, nearby September '82 was covered with profits in excess of \$22,000 per contract; the same should be done with December '82. Short position in March '83 and June '83 may be retained for the moment in the hope of seeing the reopening of a freely traded market sometime in early 1983.*

# Precious Metals

After flirting briefly with the US \$500/oz. level, gold prices retreated to complete a massive weekly downside reversal, closing a shade above US \$440/oz.

The violence of the upside move is puzzling. The market "broke out" with a \$10 gap the day Henry Kaufman of Salomon Brothers threw in the towel, admitting that interest rates were in fact heading lower. Curiously enough, during the six weeks *preceding* this breakaway gap, gold prices had dropped roughly \$40/oz., even while interest rates had already begun their spectacular decline. In fact, Fed Funds had already given up better than 450 basis points.

Pausing briefly just above the \$400/oz. level, prices resumed their advance on growing awareness that Mexico was unable to honor its maturing commitments. In a matter of days, gold rose \$100/oz. Why the rush?

Among bulls, opinion is divided as to the cause of this exhilarating ride. There are those who argue that Mexico is just the latest addition to a growing list of defaulting sovereign borrowers and that the banking system (here and abroad) is, as a result, insolvent. Should this be so (and we believe it is), a depositor would be facing the following choices: a) convert uninsured interest-bearing deposits into top-of-the-line paper, i.e., Treasury bills; b) leave *insured* deposits alone as they are as good as T-bills; and c) convert transactional balances into currency to avoid the inconvenience of being unable to pay for groceries while the Federal Deposit Insurance Corporation straightens out the banking mess. *In any case, gold is not likely to be bought* except by those die-hard gold buyers who do not recognize any other form of money but who, unfortunately, lost some faith in the yellow metal as it placidly sank to the \$300/oz. level.

Proof that the public and, better yet, savers did not rush out to convert bank deposits into gold can be found in the fact that Krugerrand sales for August were at the lowest level in two and a half years! Furthermore, open interest on COMEX continued its gentle rolling decline, indicating that the public was not jumping aboard the bull bandwagon. The public did not jump aboard because the public did not understand why it should do so — a clear proof that gold was not acting as a form of substitute for bank deposits (as currency did in the 30s).

The run-on-the-insolvent-banks scenario was more plausible in the Eurodollar arena. There, depositors were not insured and were unlikely to demand currency in large quantities (besides, depositors live thousands of miles away). Furthermore, the purchase of US Treasury bills is inconvenient for two reasons: they attract withholding taxes and they come under US jurisdiction, a distinct disadvantage to Middle-Eastern and Eastern-European holders.

A limping or semi-insolvent banking system is *deflationary*, because bank credit becomes highly restrictive and lending spreads become unusually wide. The threat of a *complete* collapse of the banking system, however, may

force monetary authorities to reflate or, at the very least, make good the losses incurred so as to bail out depositors. Even if a generalized bail out is undertaken concertedly by a number of central banks, it would probably take the form of permitting banks to write off bad loans over lengthy periods of time, much as in the 1929 depression when insurance companies were permitted to carry their investments in securities at artificial prices (well above current market prices). Commercial banks would still have to "cover" their loan losses with future earnings. Cautious lending is hardly the stuff on which inflation is built. Surely not \$550/oz. worth.

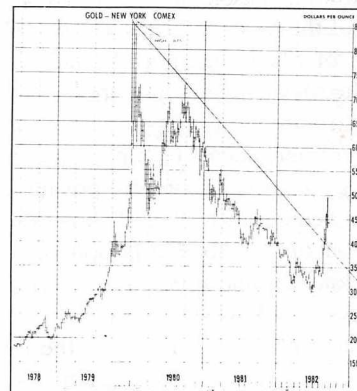
The market has clearly entered a very emotional stage and has not had a chance to digest the implications of some very substantial defaults. What is even more important, the Fed continues to hang tough (see "Interest Rate Futures") and has as yet not given any indication of pursuing a reckless reflationary policy. In our view, this moderate — and possibly even tight — monetary policy will continue well into 1983: Volcker's term will first have to expire and US unemployment will have to cross the "threshold of pain," which, if we can rely on British experience, may not occur before we hit the 15 per cent mark.

A secondary factor may be the potential liquidation of substantial central bank gold holdings (bearish). In this category we find Mexico, Indonesia, Uruguay, Brazil, USSR, South Africa and Canada, all of which are suffering from some kind of international liquidity malaise. Bullish factors may be the possible closure of the Straits of Hormuz (when and if it occurs, see "Heating Oil"), armed subversion in Poland, and tight foreign exchange controls in France.

**STRATEGY:** *The market still has the bit by its teeth and is likely to challenge recent highs once again, perhaps even extending the advance into the \$550/oz. area. Nevertheless, we feel that it has moved well ahead of itself, at least for the time being.*

*We prefer to treat this market as a trading affair: buy reactions to the \$390/oz. area, and sell strength into the \$500-\$550/oz. area.*

Chart 16



Reprinted from Commodity Research Bureau

# Heating Oil

We have been bearish on the prospects for crude oil prices and, by proxy, heating oil prices since November 1980. Readers will recall that it was at about this time last year that our consistently recommended short position began reaping handsome profits. Crude oil prices slumped into the upper \$20/barrel range and heating oil prices fell from 98¢/gallon to 68¢/gallon by mid-February 1982 as the dampening of inflation coupled with the high cost of financing induced massive inventory liquidation and a mini price-war among producers. In response, OPEC imposed a quota system to determine production levels and thus stabilize prices.

We looked upon the OPEC strategy as a unique opportunity to sell what was, in effect, the same bear market a second time. Our argument, which has been extensively described in previous issues, has been and still is that the OPEC strategy is based on a misperception of oil's role as a commodity in the world economy and that not only was it doomed to failure but also it would, ironically, itself serve to inspire that failure.

OPEC has maintained that the oil glut is a function of the world recession and was therefore as temporal as the recession. Our view has been that oil prices, like the prices of any other commodity, are subject to supply and demand elasticities. The high real prices that have prevailed since the first "oil shock" has caused, as Adam Smith would have divined, a reduction in usage of energy generally (and of oil in particular) and an increase in supply of alternate sources of energy (and of oil). (The data is available in previous *Comments*.) Thought of in this way, the well-publicized glut is not temporal but secular. Furthermore, by electing to establish quotas to maintain prices in the belief that the glut is only a temporary phenomenon, i.e., by misperceiving the true reason for the glut, the OPEC producers are augmenting the secular shift, especially regarding the demand component.

The question of course is this: Why have oil prices thus far held and, in recent weeks, risen? The answer is complex. The principal producer in the OPEC cartel, Saudi Arabia, has the financial resources to suffer through what it perceived as a temporarily oversupplied market by reducing their production so that the quota system is manageable. Cheating has been widespread but has not yet mushroomed into a full-blown price-cutting war. A second reason has been that dealers of oil are themselves undecided about the real reason for the glut. A significant percentage of users presumably believe, as does OPEC — and as do several oil analysts — that the glut is temporary and are therefore committing to purchase supply in anticipation of demand that will not materialize.

Markets can often be compared to children's teeter totters. Buyers and sellers sit on either end, preserving a

delicate balance. It takes only a shift of one to the other side to induce a rout. If the factors mentioned above were the only ones to consider, then we should feel quite comfortable to sit and wait for the rout to begin. In past issues we have speculated that one shifting weight would come in the form of Saudi Arabia's giving up its essentially charitable position of defender of the cartel — something that was alluded to by Sheik Yamani yesterday at the final session of a two-week seminar on oil pricing held at Oxford — or in some form of destocking by dealers who ultimately will realize that relative to consumption, inventories are still too large.

But there is another factor to take into account: the conflict between Iran and Iraq. Until recently, the two-year-old war has served to hold prices to a limited extent by providing a fear element to a traditionally nervous industry. But in recent weeks the war has broadened. The Iraqis have bombed Kharg Island, the main depot for Iranian oil, and attacked several vessels seeking onloading. Crude prices have climbed by more than \$1.00 a barrel as Iranian exports have diminished by an amount estimated between 25 and 50 per cent, depending on the reporting source and as insurance premiums have been, as one might expect, raised substantially. Of greater significance is that, in attacking oil facilities, the Iraqis have violated what appeared until two weeks ago to be an unwritten agreement not to disrupt the flow of oil, the lifeblood of all the countries in the gulf area.

In response, the Iranian defense minister stated that Iran might retaliate by acting to interrupt the flow of oil not only from Iraq but also from all countries that are allied with Iraq, which include the conservative nations of Saudi Arabia and Kuwait. This could conceivably mean the closing of the Straits of Hormuz, which are only 25 miles wide at their narrowest point and through which all oil exported by Kuwait and the United Arab Emirates, and most of Saudi Arabian oil — as much as eight million barrels a day — must pass en route to export markets.

We simply cannot assign a probability factor to such a maneuver. We do understand that Iran is suffering extensive losses in the war and that it is being buffeted badly on a second front by the Kurdish liberation movement. Peace could be imminent. We also know that Iran runs the risk of military intervention by the US and sanctions by Europe if it should shut the straits. But we also recognize, as does the world, that the Iranian regime acts on the basis of factors that are beyond reason. And the absence of reason knows no limit.

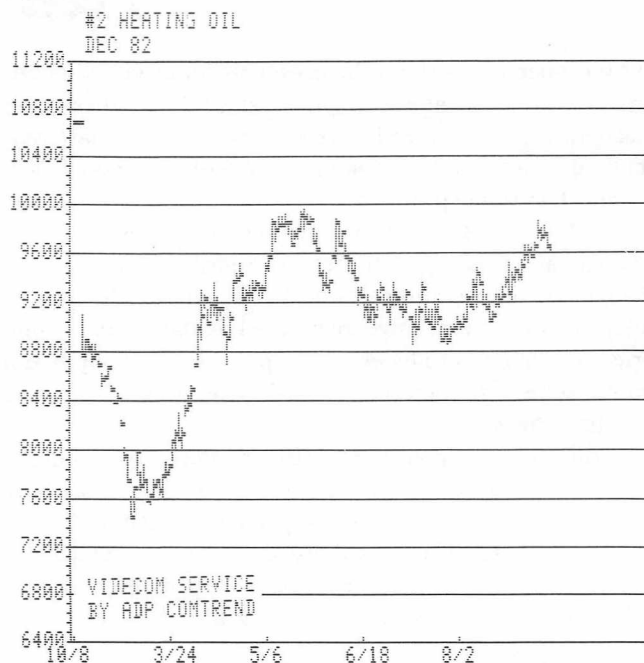
If Iran were to close the straits, oil prices would enjoy a fear-inspired and very temporary but substantial rise. The event would be the final nail in the coffin for oil prices inasmuch as, doubtless, the secular shift in usage and in the supply of alternate energy sources would accelerate. As a

further ramification, a stop on short positions on heating oil futures would be utterly meaningless. We feel crude prices could rise without interruption to as high as \$45 a barrel and heating oil prices to as high as \$1.20 a gallon. Such levels would represent the opportunity of the decade to assume short positions. Obviously, speculators must be particularly astute money managers to remain alive to take advantage of the opportunity.

**STRATEGY:** *Despite the fact that heating oil futures are, from a technical point-of-view, relatively weak (actively-traded December has just completed a downside weekly reversal, heating oil prices have overshot crude prices, open interest has shrunk to a paltry 18,000 lots despite the fact we're moving in the heating oil season), we advise reducing exposure to one contract for every \$40,000 of equity traded. (Gasoil can be held at one for every \$30,000, being approximately 75 per cent the size of the heating oil contract.)*

*This semi-defensive strategy should be maintained until the politics of the gulf region become clearer. Bear in mind that should the conflict between Iran and Iraq not broaden further, there will be ample time to reestablish any short positions liquidated. As we've stated repeatedly, the economics of oil are such that crude prices could fall to less than half of current quotes.*

Chart 17



## Grains

In our opinion, we are about to see the final stab in the bear market that has presided in grains for the past 21 months. Technical support exists in corn at \$2.15 per bushel from October 1979, with much stronger support at \$1.80 from September 1978. In August, a support of about \$5.70 in soybeans was broken, leaving the next major support level at about \$5.05. The next two to four weeks should represent the last heavy pressure on these two markets, as early harvesting begins in the more southern states and 1981 crop corn under loan is revolved out of storage to be replaced by the 1982 crop.

What will be the fundamental, and to date, unrealized factor taking us out of the bear market? Secondly, what is the size of the move we might expect in prices? With regard to the first question, we believe Soviet buying will have to be the variable to cause prices to rise, in view of terribly burdensome stock levels. The USDA forecast Soviet imports at 46.0 million metric tons (mmt) in their August report, the same level as they indicated for 1981-1982 (July-June). In 1981-1982, the USSR imported 13.84 mmt of grain from the US, only about 30 per cent of its total imports.

Owing to lower production of corn in Argentina and South Africa, soybeans in Brazil, and wheat in Australia, the USSR will be forced to import more grains from the US in 1982-1983 in our opinion. The prime competition for the US is Canada in the wheat market, and the EEC in their

highly subsidized grain markets. This leads to our conclusion in answer to the second question; owing to fairly rigorous competition among sellers, and the very burdensome stock level, we cannot at this time expect large increases in grain prices in 1983. However, these levels may provide the opportunity to establish long-term positions in the corn, wheat, and soybean markets with an eye towards a squeeze on the importing nations in the mid-1980s.

First, though, we must assess shorter-term aspects. On September 10, the USDA released its September crop estimates, as shown in Chart 18. The corn estimate was at the low end of expectations, while the soybean estimate was near the middle. The fairly large increase in the 1982 wheat production estimate was probably the most unexpected aspect of the report and may cause a moderate downward shift in wheat prices.

**STRATEGY:** *Our short position in November soybeans from about \$6.10 was stopped out at the lowered stop level of \$5.72. The recommendation to sell corn with stops at \$2.37 is on its way to our target, but the gap was penetrated to a greater degree than we had anticipated. Some traders may have shorted December corn after it failed to fill the gap and should hold these short positions with a target of \$2.00, risking \$2.34.*

*The highly volatile long September/short December*

corn spreads went in our favor the last week of August, September reaching a slight premium to December before falling back. The long September/short December wheat spread broke even or earned a penny or two, but failed to act as projected, owing to exceptionally heavy deliveries on

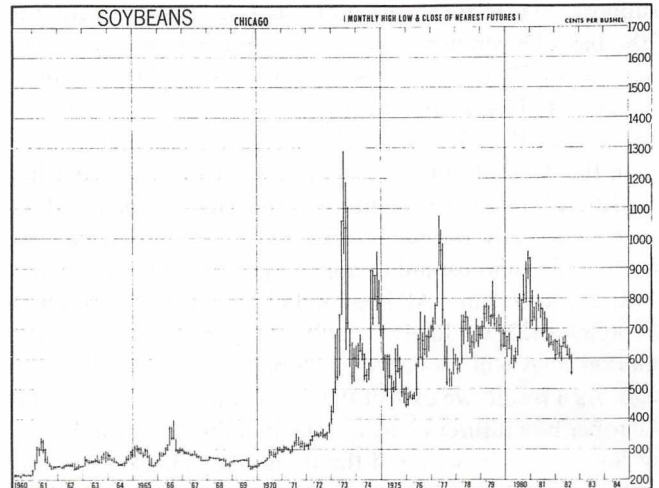
the September contracts. The spread recommended in soybeans, long November/short May, got stopped out and looks technically weak. We have reevaluated the long wheat/short corn spread; it looks topy and we would close out existing positions.

Chart 18

U.S.D.A. CROP PRODUCTION ESTIMATES - Sept. 1 conditions - Sept. 10 report.

	1982	1981	1982 1981 <sup>2</sup>	Leslie-Sept.8	expected
Corn	8318.7	8201.0	101.4	8365.6	8311-8550
Soybeans	2313.9	2030.5	114.0	2332.3	2250-2375
All wheat	2818.5	2793.4	100.9		
Winter wheat	2106.1	2098.7	100.4		

Chart 19



Reprinted from Commodity Research Bureau

## Cotton

Our stops at 65.75¢, basis December, were touched off on August 27. While prices have not dropped significantly in the succeeding time, the September 10 USDA production forecast of 11.03 million bales (versus the August forecast of 11.14 million) was on the high side of many trader's

expectations, the market looks technically weak, and the daily use rate in July was reported on August 25 as 14,100 bales compared with 19,200 in July 1981 and 18,400 in June 1982. We advise standing aside in this market, although in the longer term we expect higher cotton prices.

## Livestock

Our target of hog and cattle prices at par has already been reached, basis October and December futures. In fact, October hog futures traded up to 3¢ or more premium to cattle in a precipitous drop in the traditional premium of cattle prices over hogs, while virtually never looking back. During the same period, cash hogs have traded at premiums to cattle of not much in excess of 3¢ and in most cases significantly less. We would thus take profits presently while hoping to reinstate the spread at three or more cents premium cattle in the December futures.

The sharp drop in cattle prices in the past three weeks apparently results from the market's discounting heavy

placements of cattle on feedlots in March, April, May, and June. This was one of our bases in recommending the long hogs/short cattle spread that has fared so well. Because cattle producers have apparently halted their expansionary phase and because there are strong technical supports basis December cattle at 59.6¢ and 58.2¢, we feel the market has probably discounted the likely declines in price from heavier marketings of cattle arising from heavy spring placements. A seven-state cattle-on-feed report will be released Tuesday, September 14. Placements in August are expected to be 10 to 20 per cent higher than a year ago. The cattle-on-feed inventory is expected to be about 10 per cent

above a year ago. We expect the report to be at the low end of expectations; we make this projection based on the fact that the premium of feeder cattle (cash and futures) has dropped tremendously in past months, maintaining a trend of over eight months.

If, as we forecast, the cattle-on-feed report is construed bullishly, cattle futures will benefit from a high level of support. This in turn will add tenacity to our new target of 70¢, basis December hogs, revised upwards from 65¢. The September 22 hog report is the prime factor in our recommendation. Hog slaughter in late August and early September has run 10 to 16 per cent below 1981, significantly lower than the drop of only 8 per cent forecast from June 1 hog statistics. While hog slaughter has risen in the past few days, as is seasonally normal, back to over 300,000 a day, we believe the sharpest fall in hog slaughter as a percentage of 1981 is yet to come. All hogs and pigs numbers reported on September 22 will likely be below 90 per cent of 1981, and market hogs will probably be 88 per cent or less of a year ago. As a result, we expect the strong uptrend shown in the October hog futures chart to remain unbroken past the end of September. However, if the trend line is broken, a sharp correction will provide an excellent opportunity to establish new long positions in December and February hog futures before the September 22 USDA report.

**STRATEGY:** Liquidate spread positions in October and December hog-cattle spreads at present very profitable levels. This spread was first recommended May 16 at well over 6¢ premium October cattle. Reinstate the long hogs/short cattle spreads in December futures at premiums of 3¢ or more cattle over hogs, if and when the opportunity arises, with stops at 5¢, and a target of prices at par, which we have consistently recommended. While we feel we cannot recommend establishing new positions at present levels before the September 22 hogs and pigs report if the trendline is broken, a rapid 2¢ or 3¢ correction would provide a perfect stepping stone for entry into long December and February hog positions.

Raise stops on existing and any new positions in December hogs instituted on any corrections before the USDA report, to 58¢ on a closing basis. Place stops at 53¢-50¢ basis February. The current 3¢ discount from October hog futures represents an ideal opportunity to roll existing long October positions into December. Consistent with this recommendation, we advise those interested to institute a spread of long December/short October hogs, the short October hogs position to be liquidated by the end of September. For this short-term trade, we have a target of prices at par, and would risk 3.5¢ premium October hogs.

Chart 20

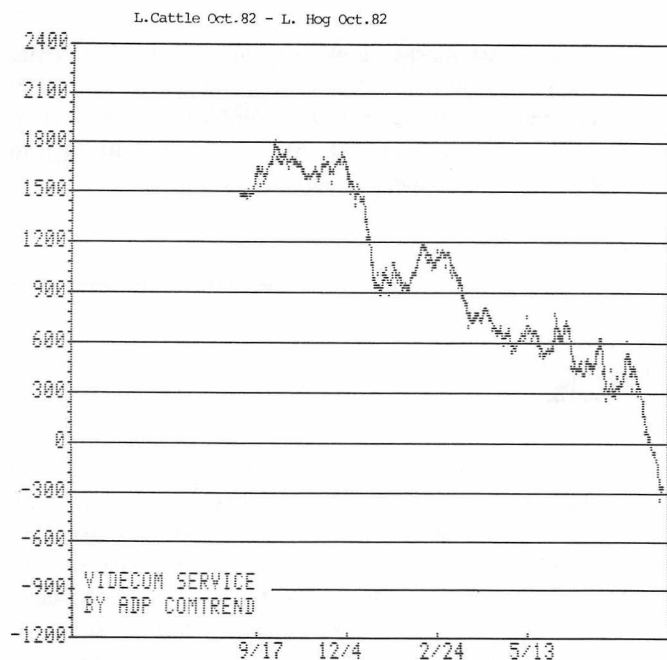
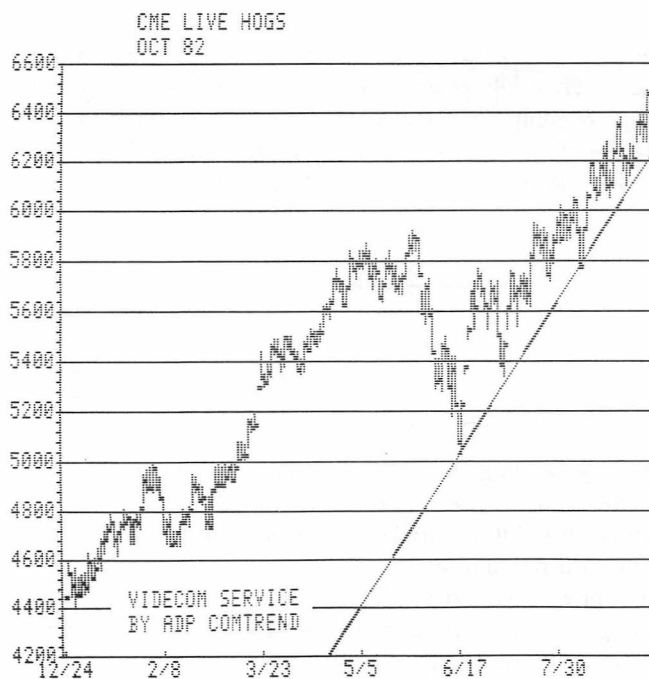


Chart 21



# NOTES

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

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