FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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The Economic Consequences of the International Banking Crisis

"Today, Mexico and many other countries of the Third World are unable to comply with the period of payment agreed upon under conditions quite different from those that now prevail. . . .

"Payment suspension is to no one's advantage, and no one wants it. But whether or not this will happen is beyond the responsibility of the debtors. Everyone must negotiate seriously, carefully and realistically. . . .

"We cannot paralyze our economies or plunge our people into greater misery in order to pay a debt on which servicing tripled without our participation and with terms that are imposed on us. . . .

"We countries of the south are about to run out of playing chips and if we cannot stay in the game, this will end in defeat for everyone. . . .

"Less time will be required if we can count on the rational support of the international financial community and not on reluctance or punishment for sins we have not committed." . . .

— Jose Lopez Portillo, President of Mexico, at the UN General Assembly

The Problem

Default. As night follows day, default will follow the most extraordinary credit binge witnessed in over 50 years. As in the previous four foreign lending booms, 1817-25, 1860-76, 1900-14, and the 1920s, widespread default will come despite encouraging official pronouncements, talks of international cooperation, and patience, yea, infinite patience on the part of the anxious lenders.

In spite of rumors that Mexico had signed or was about to sign an agreement with the IMF, allowing it to draw on at least $4 billion, the fact remains that IMF officials have not been able to coax Mexican authorities to accept a substantial austerity program. The dispute centers around IMF conditions that Mexico reduce its public sector deficit from 17 per cent of GNP to 6 or 7 per cent by 1983, while Mexican officials are only willing to cut to 10 per cent.

Whatever undertakings are made, they are not worth putting on paper. In the first place, it is quite likely that when Lopez Portillo steps down on December 1, those officials now negotiating with the IMF team will no longer be in power. Even if some key figures remain, one would be hard-pressed to believe that an outgoing president can dictate sharp austerity measures to an incoming president who is already facing a collapsing economy. Finally, an IMF acceptance of a package of measures that *specifically excludes a realistic foreign exchange policy* strains one's imagination. In this connection, it should be recalled that IMF doctors only concern themselves with achieving external equilibrium and regaining the status of a good debtor.

Ceilings on domestic credit creation and public sector deficits are recommended *only* for their effect on the balance of payments. Accompanying these suggestions, the IMF has always recommended a one-time devaluation, or more frequently, a constant adjustment of the real exchange level to be accomplished by either maintaining a freely floating rate or a crawling peg adjusted administratively to reflect inflation differentials on a monthly basis. None of these conditions is present today in Mexico. A veritable state of siege has been in operation in the foreign exchange

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market, where the peso has been grossly overvalued and where dollars are practically unobtainable except in the black market and at rates 50 per cent and higher than officially quoted.

The delay in signing may be attributable to either a total lack of compatibility or to the desire of *both* partners to allow the new Administration to formulate new policy. Either way, as Portillo declared publicly, Mexico will never accept the necessary measures of austerity and realism to be able to repay the $60 billion of debt (out of $80 billion) now owing to the international banking community.

Mexico is not alone. US banks have made over $200 billion of loans to Latin America, the Third World, and Eastern Europe, many of which will never be repaid. To put the problem in perspective, the net equity of the 30 largest US banks as of May 1982 was barely $40 billion. In the last few days, some of the largest US banks reported substantial increases in their nonperforming loans. At Continental Illinois Corporation, these "bad" loans jumped to $2 billion from $1.3 billion last quarter and from $453 million in the third quarter of 1981. It compares with an equity (at market prices) of $800 million and a quarterly operating profit of $32 million. It would take over 15 years, at present levels of profitability, to cover loan losses of $2 billion! At Chase, nonperforming loans rose to $1.2 billion from $698 million. That compares with equity of $1.5 billion (at market prices) and quarterly net operating profits of $124 million. At Chemical, nonperforming loans almost doubled, to $719 million compared with a market capitalization of $875 million and $68.5 million in net operating earnings. And so on.

The devastation is, however, much greater. In the first place, large nonrecurring foreign exchange and bond trading profits inflate quarterly reports. Second, a bank's operating results are being inflated by the mere expedient of "rolling over" debt to the likes of Poland — loans which have as yet not been reclassified as nonperforming. In effect, today's operating profits contain a much higher degree of water and a much higher degree of risk than in past years. Operating profits are no longer comparable, year to year. Furthermore, an ever wider risk premium lies hidden, ready to explode at some future date in the form of a one-time massive write-off.

According to a study by Morgan Guaranty Trust, loans to developing countries last year rose 20 per cent — about twice the rate of increases in bank capital and reserves and also more than twice the rate of increase of overall deposits. Quite clearly, the banking system does not possess the resources to continue carrying on this gigantic bail-out operation.

If banks were to halve their lending rate to 10 per cent, developing nations would lose about 1.5 per cent of GNP, while growth in the industrialized world would be reduced by 0.5 per cent per annum. If instead banks were to stop new lending, developing nations would see their output reduced by 3 per cent and industrialized countries by 1 per cent. These figures are conservative, as they do not take into account the impact of protectionism, a direct result of growing international payments difficulties.

Solutions

At a very recent semi-annual session, the Shadow Open Market Committee, a group of economists headed by Karl Brunner and Allen H. Melzer, considered this problem and concluded in the following manner: "The potential crisis can be averted if governments act correctly. They must recognize that their responsibility is limited to *protection of the integrity of the money supply* . . . the correct procedure for domestic default is to lend to the market, at a penalty rate, to prevent bank runs and to reduce uncertainty about the survival of otherwise solvent firms and institutions." After making a plea to central banks for taking responsibility as lenders of last resort "to banks or bankers of banks operating within the home country, regardless of the nationality of the owners" the group concludes that "a clean statement of responsibility should be made by central banks and governments in major countries." Finally, the group returns to its central theme: ". . . the statement should distinguish clearly between *preventing a decline in the money supply* and protecting the interest of bank investments. The former is a public responsibility, the latter is not."

To prevent a decline in the money supply, the Fed would simply have to offset currency withdrawals with reserve injections via open market operations. Similarly, the Fed could, in a drastic move, declare a moratorium on currency payments and continue its slightly expansive monetary policy. In either case, the public may come to "discount" the value of bank deposits (and currency in the first case), causing velocity to accelerate. Inflation would no longer be restrained by a steady rate of monetary expansion. Furthermore, assuming that a bank can be considered solvent, provided that bad loans are written off over 20 to 40 years — an accounting fiction — and that the same bank can remain liquid, thanks to discount window operations, it would still require three to five years of profits and deposits (via 5-6 per cent increases in money supply) to restore the bank's capital/liabilities and loan/deposit ratios and enable it to resume its normal lending functions.

The Shadow Open Market Committee provides a reasonable solution in view of the enormity of the problem; it would avoid the debacle of a *deflationary* depression.

Felix J. Rohatyn, Senior Partner at Lazard Freres & Co., and architect of New York City's famed bail-out in the mid 70s, takes a more aggressive approach. In a recent article in the *New York Review of Books* he argues for the creation of a modern Reconstruction Finance Corporation of the 1930s, which would inject capital by way of acquiring preferred stock. In his words, "the RFC (or a similar institution) would thus both supply capital and relieve the danger to a bank caused by a sudden, major default. It would permit an orderly settlement of the bank's obligations. It would give our banks protection against a sudden political decision in foreign countries to renege on payments or even to practice financial blackmail . . . the mere existence of such an arrangement under the RFC would help remove the present widespread concern about the soundness of our banks, which is clearly detrimental to an economic recovery . . . Standby loans would be provided by the Fed and more permanent capital by the RFC." Alternatively, the defaulted loans could be assumed by the Fed at its discount window after making some legal changes to the way the "window" operates.

In view of the massive amounts of potential defaults, an RFC-type bail-out would mean (1) the nationalization of most of the banking industry and (2) an enormous increase in the federal deficit, with highly detrimental effects on inflationary expectations. To avoid the permanency of the former and the negative effects of the latter, one would have to *force redemption* of these preferred stock issues over an intermediate period of time and out of profits.

The assumption (i.e., purchase) by the Fed of the defaulted loan, on the other hand, would clearly be inflationary unless, again, the banks entered into a long-term repurchase agreement. Alternatively, the Fed would not advance credit or funds on assumption but would merely record nontransferable IOUs.

Either of Mr. Rohatyn's suggestions do a great deal to improve banks' capital ratios but *very little to improve their ability to make new loans*. In effect, loan/deposit ratios (see Chart 1) continue to hover around the record highs first recorded in February 1982 and then again in June 1982. In contrast to the Shadow Open Market Committee proposal, an increase in money supply is not specifically provided for and, therefore, threatens to atrophy loanable resources. It is clear that to reliquify the banking system, bad assets (i.e., bad loans) must be liquidated (settled or written-off over long periods of time) while deposits (part of money supply) must be allowed to increase.

The 30s were deflationary because *bad and good loans were liquidated to match and surpass the decline in deposits*; the 80s, by necessity, will be inflationary because, in need of loanable resources, bad loans, and only bad loans, will be liquidated and amortized, while deposits will be increased. In the time that it takes for banks to reliquify, strong contractionary forces will continue to prevail, accompanied, of course, by gently rising inflation. At the same time, interest rates, a function of the availability of loanable funds, will remain high in real terms and will be subject to violent fluctuations, a result of sporadic spurts in loan demand.

What If?

"If the concern (of those advocating reflation) is unemployment, reflation will not help anyway. The kind of reflation which they seem to advocate will have no tangible effect. But it will be devastating on the inflation front. Inflationary expectations, which are now beginning to be subdued, would soar, and inflationary habits would be resumed. Interest rates are then more likely to rise, the exchange rate reflecting inflation could fall, wage demands will increase, hopes for productivity may suffer. It is very difficult indeed to believe that they don't understand these implications. What are the motives of these reflationists, who urge what will be distinctly inflationary consequences? If it is wrongly conceived compassion, reflation now will not help the disadvantaged."

— Friedrich von Hayek, in an interview with Edmund Goldberger, published in *The Director*, London

It should be well understood that our earlier discussion is not a scheme to reflate out of a depression. *It is merely a method of containing the ill-effects of poor credits on banking balance sheets, which threaten to aggravate the ongoing depression.*

The world contraction will continue for a variety of other reasons: the enormity of the unproductive public sector in the economies of the industrialized world; the crowding out effect of public sector deficits; the stultifying effects of our tax structure; the illiquidity of individuals and *corporations*; the belt-tightening efforts of the less-developed nations; rising protectionism; and the extremely high cost of labor in real terms.

Reflation would not work to extricate us from these difficulties. The world has become much too sophisticated to ignore real-term comparisons. As von Hayek so succinctly put it, a sort of universal indexation will surely offset any efforts made to reflate our way out of depression. Only a *protracted* period of labor-shedding (and productivity gains), transition from old and declining industries to new and modern technology helped by the *removal* of trade barriers, and a freeze in government spending can produce a lasting recovery.

Will the world be that patient? We doubt it. Some countries will begin reflation almost immediately. Others will succumb only when elections become an immediate issue. In the tragic but inexorable race to reflate, the US will no doubt be one of the last; France and Italy, two of the first.

Long-Term Conclusions

(a) A resolution of the *banking* crisis will not be bullish for gold or any other group of commodities; it will, however, cushion the decline in commodity prices. It will be bullish for stock prices (as it removes the threat of a full-fledged deflationary depression) and slightly bullish for bonds. It will continue to be *quite* bearish for overvalued assets such as crude oil, tin, commercial and single residential real estate in the US and Canada.

(b) The US dollar will continue to strengthen vis à vis most foreign currencies past the resolution of the banking crisis and before the next wave of reflation in the US.

(c) A concerted move to reflate will be bullish for gold and generally all commodities, although the latter as a group and in real terms will not show substantial gains (the depression will still be with us).

FOR NOW: **T-bill short at 91.50**, *basis December '82 (as per Commodity & Currency Comments of August 22). Place stops at 93.00, close only. Look to cover around 90.50.*

US T-bonds. *Last month we suggested that "the unusu-*

ally sharp 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 setback only." Since then, yields in long-term US bonds have dropped from 12.5 per cent to 10.5 per cent in one of the most spectacular and dramatic declines in fixed-income rates. The market has become overbought. Dealers' inventories have become top-heavy, corporate offerings have begun to swell the calendar, and loan demand has recently begun to show signs of recovery, firming up the short end of the market. We believe that a minimum decline of 192/32nds is in store and advise selling at current levels, placing stops above recent highs.

Long 5 March '83 T-bills/short 4 March '83 Eurodollars. *Maintain this position until the next major default. Unwind on the news.*

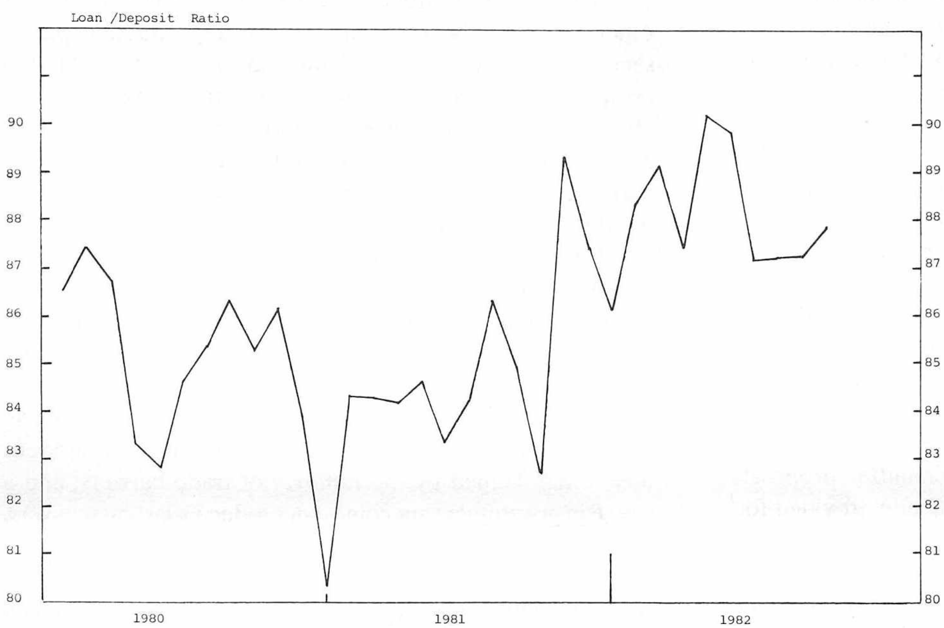


Chart 1

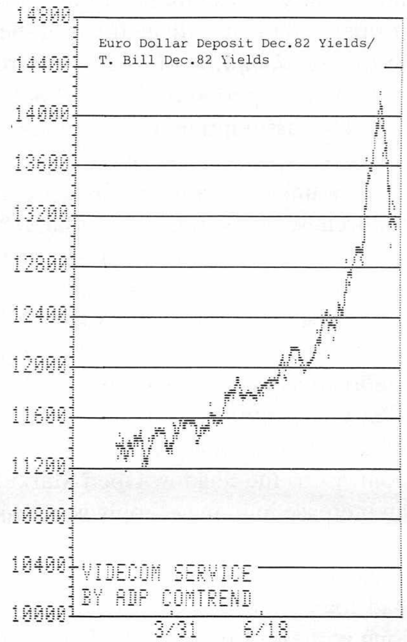


Chart 4

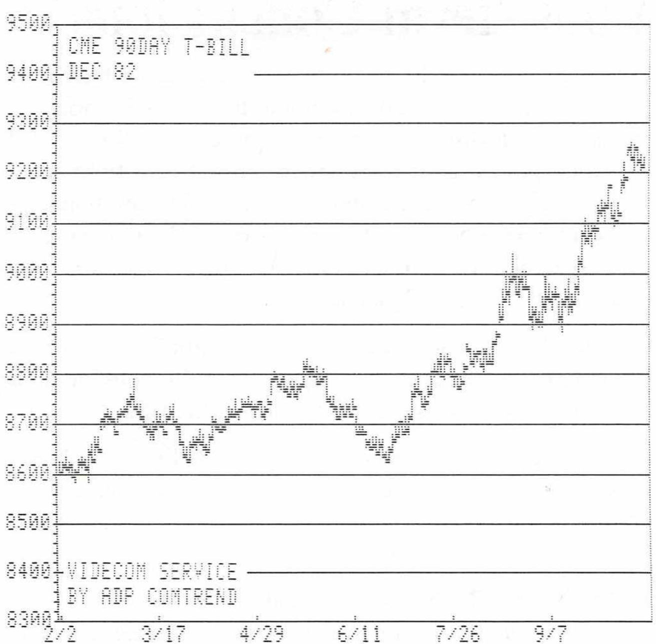


Chart 2

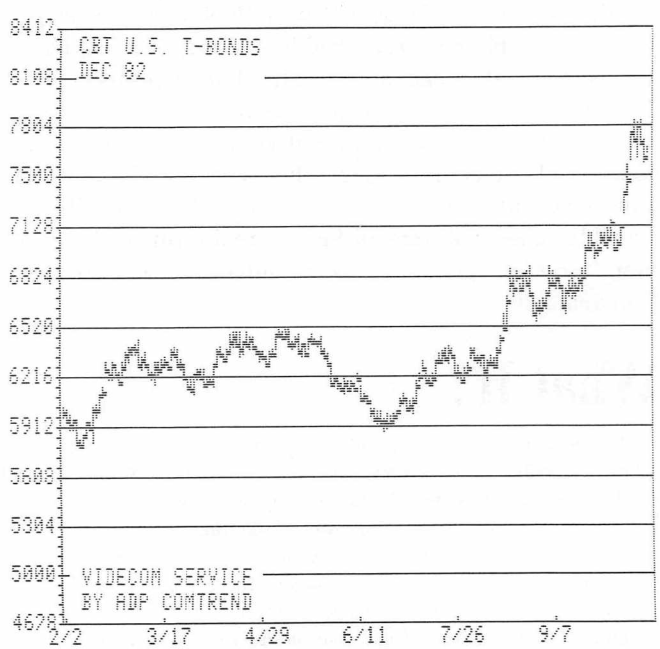


Chart 3

Currencies

DM, SF, Yen, BP

Having recorded multiyear lows as recently as two weeks ago, foreign currencies firmed as US interest rates plummeted. Nevertheless, by the end of the week, the US dollar was, once again, on the advance and within a hairbreadth of recording new all-time highs. Remain short the foreign currencies, placing stops *above* recently recorded highs, i.e., 40.54 basis December '82 DM, 48.31 basis December '82 SF, 38.43 basis December '82 Yen, and 173.05 basis December '82 BP.

Canadian Dollar

The most noteworthy economic development in recent days was the report that the fiscal deficit for the 1982/83 year will exceed $26 billion, up from a recently revised estimate of $20.5 billion and more than double the original estimate of only $10 billion. A public sector deficit of 7.5 per cent of GNP is a disgrace but, even worse, it narrows sharply the government's room to provide stimulus to a collapsing economy.

The second most noteworthy development was the financial bail-out of the Canadian chartered banks engineered by the Canadian Government when it helped provide permanent financing to the dying Dome Petroleum. Given our outlook for crude oil prices, it is unlikely that Dome will ever repay the mountain of debt that threatens to wipe out the capital of the big five chartered banks. *In our opinion, it is only a matter of time before one or more chartered banks are nationalized.*

On the monetary front, restraint is still the watchword. The adjusted monetary base continues to hover around C$16.5 billion, unchanged to slightly lower from January 1982. Monetary stringency has continued to provide good support for the Canadian dollar, which has of late moved up to 81.50. In the process, international reserves have been replenished. As shown in Chart 10, reserves fell $4.3 billion in the first half of 1982 and since the end of June have recovered nearly 2/3 of the total loss.

STRATEGY: *We are maintaining our friendly attitude to the Canadian dollar and expect it to climb just a while longer. Intuitively, we feel that some easing is in store as soon as the entire loss in reserves is made up.*

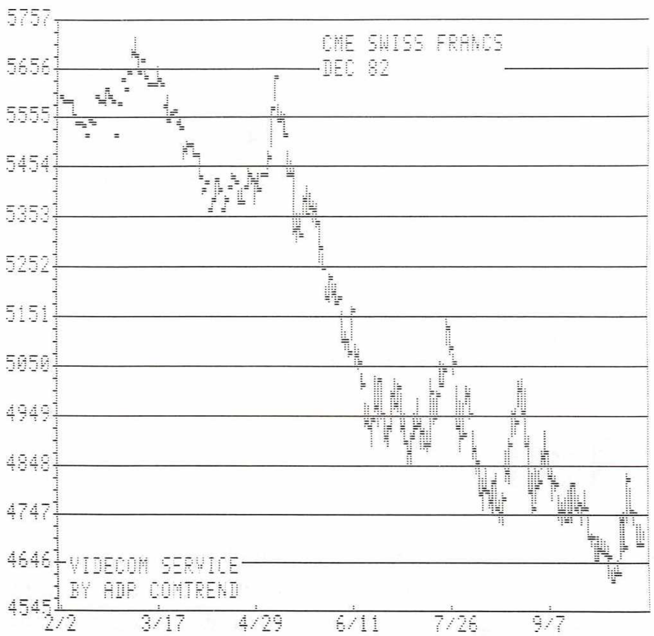


Chart 5

Chart 6

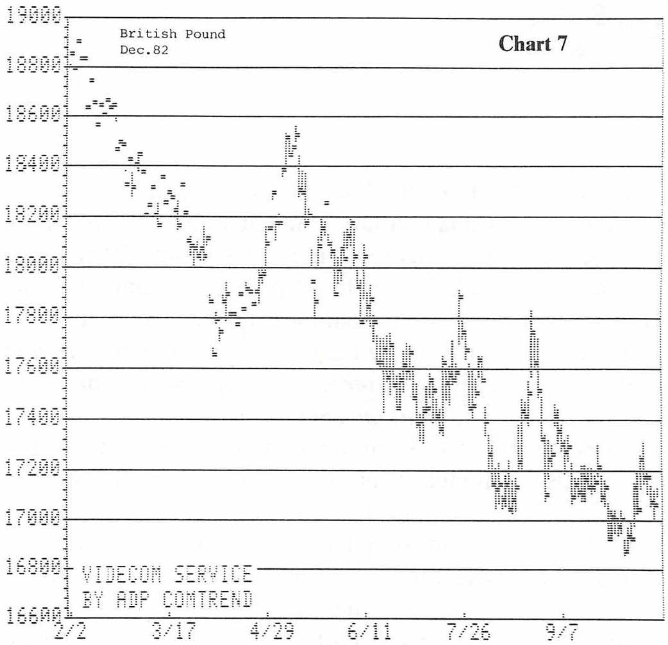


Chart 7

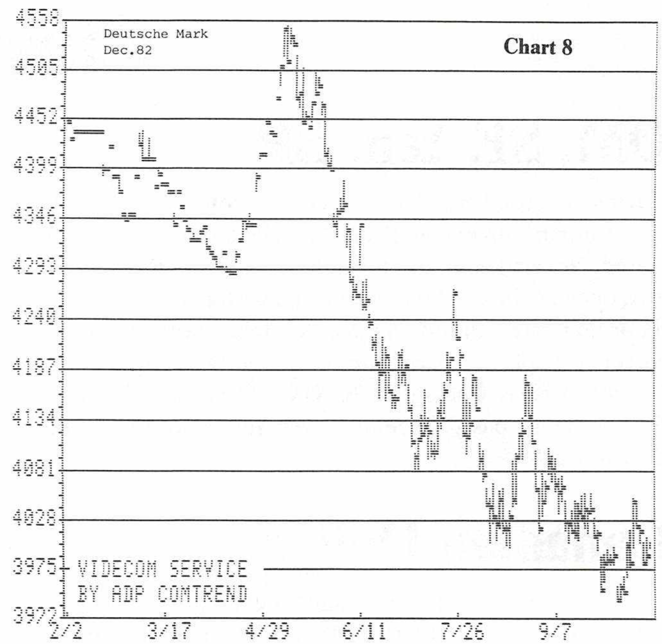


Chart 8

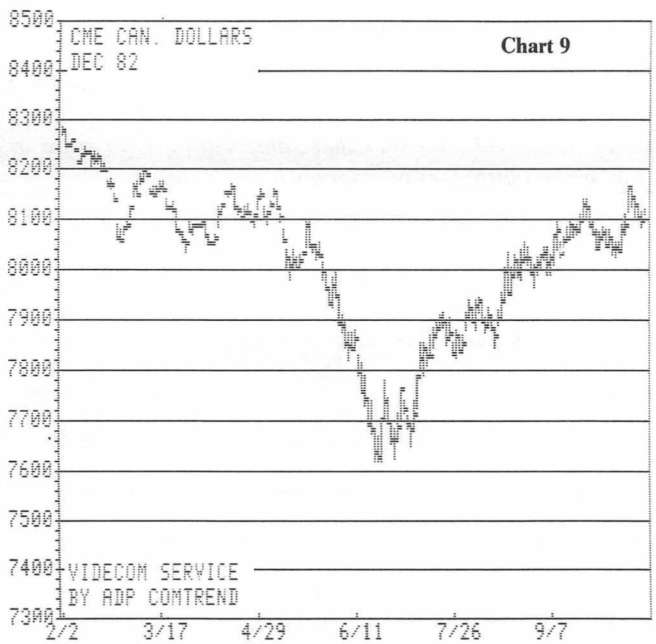


Chart 9

Canada's Official International Reserves
(Millions of U.S. Dollars)

1982	Change in Reserves	Net Official Monetary Movements *	
Jan.	- 73.4	- 59	
Feb.	-797.2	- 788.10	
Mar.	-531.7	- 372	
Apr.	+552.5	+ 117.2	-4,305.20
May	-651.0	- 944.9	
Jun.	+ 56	-2258.4	
Jul.	+343.7	+1093.9	
Aug.	+593.3	+1203.4	+2,275.6
Sep.	- 73.2	+ 478.3	

* True underlying movement of reserves.

Source: Department of Finance,Canada

Chart 10

Precious Metals

As suggested last month, gold had entered a trading range bound by 390 on the downside and 550 on the upside. Short of reflation — not an immediate concern as explained in our introduction — gold's fundamentals are not terribly bright. Heavy USSR selling, as well as the disclosure that Uruguay had sold 100,000 ounces last week, that Canada continued to dispose of gold on strength, and that other countries in balance of payments difficulties were likely to raise much-needed cash by selling bullion, should give the market a pause. We would now *lower* our trading range, advising buying in the 350-375 area and selling in the 450-475 range.

Silver's *relative* strength is rather baffling, although we strongly doubt that the current advance can better the $11.50/oz. highs recorded in the third quarter of 1981. An $8-$11.25/oz. range is suggested for the near term.

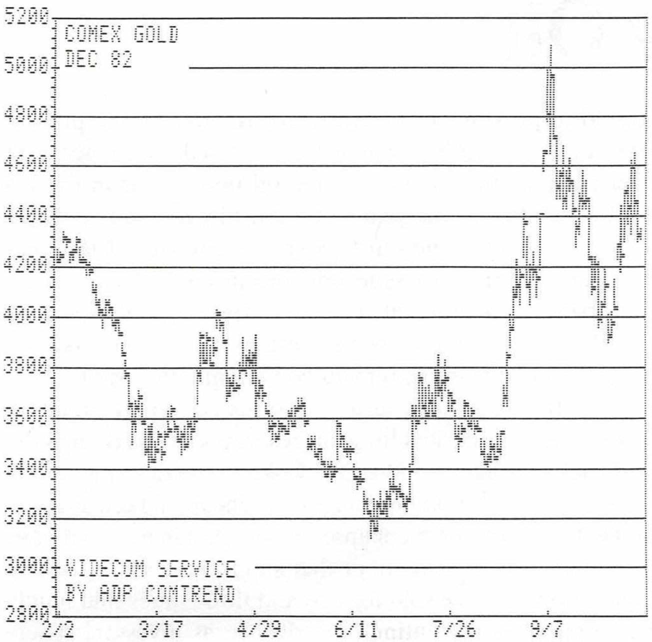
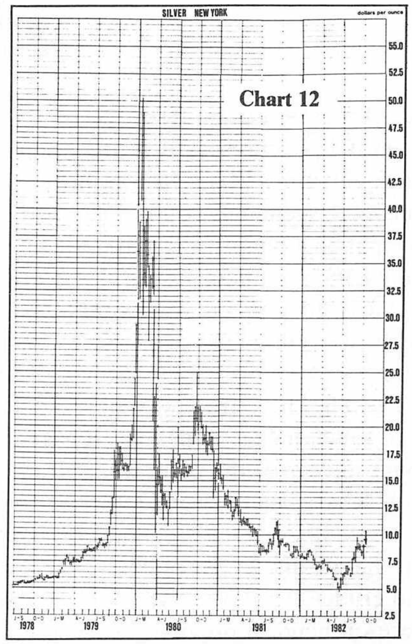


Chart 11



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Copper

Despite the still-sluggish pace of demand from the automobile, construction, and electrical industries, and despite our generally bearish views on the prospects for a general economic recovery, there are *enough* positive aspects to the copper scenario to warrant its being bought on dips of four cents or more from current levels. Inventory levels, which reached their peak of 343,574 metric tons (basis combined Comex and LME stocks), have not reached the unduly burdensome levels of the last bear market of 1976. They are not burdensome when taking into account the reduced availability of supply from new production, the start up of which is likely to be inhibited, owing to the transference of ownership of domestic mines and refineries that has taken place over the past 18 months.

The spate of mine closures was not expected to impact upon stock levels until the second half of 1982 and indeed, since mid August, stocks have fallen to 329,605 tonnes, or by 4 per cent. Copper prices at their lows of June were in real terms the cheapest they have been in decades, at significant resistance levels on long-term charts, and as we have stated repeatedly in past *Comments*, unlikely to be seen again. We still maintain that view.

A host of imponderables can serve to improve the overemphasized, and thus presumably discounted, weak demand component. Improved consumer demand, though isolated in a recessionary environment is a possibility that would serve to improve offtake of electrical manufactures and autos. Federal Reserve policy could have relaxed to the point where cheaper home financing will induce increased construction and may even end up relaxing to the point where inflation once again becomes an issue, thus making copper an investment asset. We don't predict these things but must admit them as possibilities to be taken into consideration.

In sum, the bearish argument is outweighed, and we would look to be long on renewed weakness with stops at 54.00 basis cash.

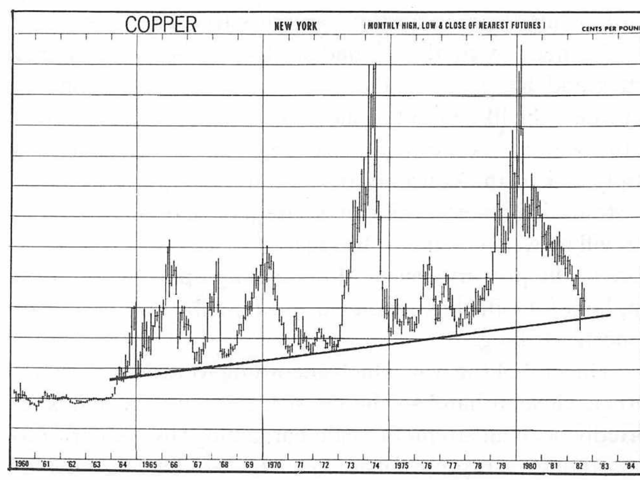

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Chart 13

Heating Oil

Readers will doubtless agree that from our point of view the heating oil market has represented a tragic illustration of the Murphy's Law theme. Many factors have emerged to conspire against our seemingly sound logic and turn what we assumed would be a major bear market into an uptrend that has resulted in inordinate losses. Yet we are of the opinion that those factors are temporary and that the essential bearish case still holds true.

Heating oil prices have gone up because of the following reasons: (1) The Iran/Iraq war has reduced crude output by about 4 million barrels per day. It has furthermore threatened to mushroom to the point where Iran, whose oil installations on Kharg Island were attacked for the first time in early September, would retaliate by inhibiting oil flow through the straits of Hormuz; (2) inventories of heating oil and crude oil are perceived to be low relative to levels that were on hand in previous years; (3) in the past two weeks the stock market has entertained a buying binge in which oil stocks and oil service stocks have participated, inducing spillover buying into futures; (4) there is a consensus amongst weather forecasters that the upcoming winter will be the coldest of the century; (5) there are those who believe that the economy has reached its lows and that an upturn is in the offing, which will serve to inspire an end to the highly-publicized glut.

Let us address ourselves briefly to these issues point by point:

(1) While it remains conceivable that Iran, irrational, and therefore unpredictable, will extend the current conflict beyond its already carnage-ridden parameters, it is growing less likely they will close the straits. In order of growing importance the reasons are as follows: retaliation by Western consumer nations would be severe; the conservative gulf states have organized militarily to defend against a closing of the straits; Iran hasn't the capability to close the straits.

A check with the Canadian Department of Energy Mines and Resources indicates that a study was done to determine the likelihood of such an eventuality at the outset of the war two years ago. The conclusion was that Iran simply lacked the considerable resources required to close the straits. The most significant consequence of the Iran/Iraq war will prove to be that it has served to alert the West even more to the precariousness of depending upon Middle East suppliers for oil, thus further inspiring substitution and/or domestic drilling.

The end of the war, which according to various press reports is close at hand — the latest Iranian offensive has reportedly been an attempt to gain bargaining strength prior to a resolution — represents at least 2 million barrels a day of crude. This crude will be dumped onto the market as soon as the two nations attempt to repair their decimated economies.

(2) While it is true that inventories of oil are less than they were in previous years, they are not, as we have demonstrated in previous *Comments*, low relative to the present level of consumption, which has declined by 14 per cent over the past two years. Heating oil inventories in the US are low relative to last year, but it must be remembered that it was dumping of the burdensome inventories of last year that caused prices to slide into the lower 70¢/gal. range. Inventories of heating oil are low relative to gasoline stocks, and this is a technical aberration that will correct itself as refiners' profit margins remain consistently profitable.

(3) Investors have turned to stocks as a play on multiples in the wake of declining interest rates. It's as though the financial community suddenly awoke to the fact that in real terms the stock market is cheap — as cheap, in fact, as it was in the days of the 1975 collapse on an inflation adjusted basis — and elected to remember that stocks now selling at five times earnings once sold for two and three times that much. Share prices may continue to advance as investors speculate in this new perceptual environment upon their "real worth." But commodity prices, which have bounced off their lows in the wake of stocks, need not follow suit any more than they have already. Why? If share prices are rising in a struggle to find value, the rise is expectational. Will they rise to 10 times earnings? Or 15 times earnings? What will those earnings be? Let the market expect what it will. The prices of commodities — especially those commodities that are in ample supply (heating oil, for example) — can only rise so far on expectations. Since commodities are materials used every day, business decisions reflecting real demand and real supply will quickly begin to impact upon prices.

It is our opinion that those speculators who went long heating oil futures — and the 2,000 lot increase in the open interest on the recent breakout from the trading range indicates there were more than a few of them — as they watched Atlantic Richfield and Shlumberger (to name but two stocks) make impressive gains last week, should be regarded as nothing more than a group of soon-to-be-placed sell orders.

(4) The weather forecasters predict a cold winter because of the unusually high level of volcanic activity experienced during the past year or so throughout the planet. While they may be right, we might mention that the profession is probably one of the few that is less reliable in its prophecies than commodity analysis and that, as commodity analysts ourselves, we know all too well the danger of being part of a consensus opinion. In the period October 1-13 in Toronto, degree days have averaged two degrees above normal. Furthermore, since the season has already begun, the effects of an extremely cold winter have already been discounted by trade long hedges.

(5) We simply cannot subscribe to the view that lower rates or a rising stock market augur for the beginning of a recovery of substance. Liquidity constraints will serve to inhibit growth to a maximum of 2 per cent over the next 12

months. No growth or even negative growth would not be a surprise. Such sluggishness will not serve to lift demand for energy in general or oil and related products in particular. Most importantly, it must be borne in mind that the oil glut has not resulted from the slowdown in economic activity as much as it has from the irreversible secular shift toward conservation and substitution. This remains the salient factor of the oil market and the one that ultimately will prevail through all the points discussed above. No number of short-term factors, and no defense strategy by OPEC or by Saudi Arabia can obviate the fact that the demand for oil is, and will continue to remain, less than its availability. We are bearish!

STRATEGY: *Since first recommending being short in March, we have established a stop of 102, basis December. That stop was determined on the basis of the price of crude not exceeding the Saudi benchmark price of $34 per barrel; the high of December '81 contract last year was 102, when crude was $34 per barrel on the spot market. So far this year, spot crude has not traded above $33.90, yet heating oil futures, because of the coincidence of factors discussed above, has gone through our roughly-arrived-at stop. Despite that our "real" top of $34 basis crude has not been violated, and despite our bearish views, prudent speculators should remain sidelined in observance of the dictum of not fighting the market.*

The end of the current uptrend will probably become apparent via a weekly downside reversal of considerable breadth, i.e., a range of two limits or more, accompanied by a sharp drop in open interest. This will unquestionably occur before the expiration of the March contract and perhaps as soon as the next four weeks. Short positions should then be reestablished aggressively in deferred delivery months — March onwards, or February onwards in London — and stops placed at contract highs. We remain of the opinion that the bear market, once it begins, will carry values of crude down to the low $20 per barrel range — our initial objective — and heating oil futures into the 60¢ per gallon range.

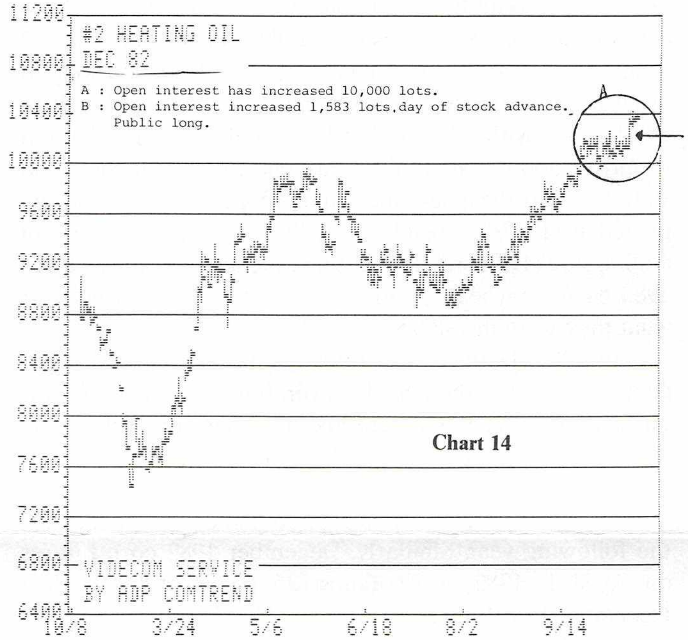

Chart 14

Grains

Cotton

Cotton? Cotton is not a grain! No, but if cotton production in the United States falls by 27 per cent from 1981 to 1982, and if nearby cotton futures prices, nevertheless, continued to drop from about 72¢ at harvest time 1981 to 63¢ at harvest time 1982, then a fall in production of 25 per cent in 1983 to 2100 million bushels of wheat, 6250 million bushels of corn, and 1725 million bushels of soybean still could not cause us to feel very bullish towards grain prices in 1983.

Admittedly, cotton is a much different commodity than grains, 1983 *may* be better economically than 1982 (although we wouldn't guarantee it), and we feel a drop in production to these levels would most certainly cause respective grain prices to rise to more reasonable levels in the producer's perspective. The fact of the matter is, though, that unless there is disastrous weather in 1983, US production is going to be well above these hypothetical levels, which would cause stocks to remain unchanged or drop slightly to more manageable levels. In addition, other exporting nations are reaping much more benefits to costs than the US is from price support programs.

The USDA has announced the 1983 grain price support program: a 10 per cent set-aside and a 10 per cent paid diversion mandatory for wheat in order to participate in 1983/84 regular and reserve loans and to receive deficiency payments (the wheat target price, below which deficiency payments are made to a maximum of the difference between the target price and the reserve loan rate, will be at least $4.30); a 10 per cent acreage set-aside and a 5 per cent paid diversion for corn mandatory to participate in 1983/84 programs (corn target price will be at least $2.86); and a continued $5.02 loan rate for soybean with the target price yet to be decided.

Participation in the 1983/84 programs is likely to be strong. First, the price benefits are substantial; second, advance payments of half the expected deficiency payments at the time of sign-up (starting early in the spring for spring crops, probably before December winter wheat), which would significantly improve cash-flow; third, farmers took a financial bath for not participating heavily in the 1982/83 programs.

Assuming there was 50 per cent participation in the 1983/84 wheat and corn programs, wheat acreage would drop 7.5 per cent and corn acreage would drop 10 per cent from the higher of 1981 and the average of 1980 and 1981 acreage, but the drop would be in the most marginal (i.e., least productive) land. Assuming yields of 32 bushels per harvested acre of wheat and a harvest of 74.5 million acres, production would be about 2384 million bushels, or 92 per cent of the average of expected 1982/83 and final 1981/82 total disappearance, resulting in a very moderate drawdown in currently excessive stocks. Finally, if corn yields fell to 105 bushels with 67.5 million harvested acres, production would be about 7088 million bushels, which is higher than 1981/82 total disappearance, and 95 per cent of that expected in 1982/83, resulting in little or no drawdown in ending stocks of corn. There is no acreage set-aside again in 1983/84 for soybeans, and plantings are likely to be near what they were in 1982/83.

In 1982, fertilizer use rates fell between 5 and 9 per cent from 1981 in the US. However, July 1982 wheat futures on September 1, 1981, were about 12 per cent below July 1981, on September 1, 1980. It is in the late summer and early fall that winter wheat, which comprises three-quarters of total wheat production, is planted and can be hedged for the following year. Similarly, December 1982 corn futures on April 1, 1982, were almost 25 per cent lower than December 1981 futures on April 1, 1981. Fertilizer use rates should fall by a greater percentage than the price of the product in order to be economically optimal, given that fertilizer application rates are very high and marginal product is relatively low. However, this failed to occur in 1982, and will likely continue to be the case in 1983. *Farmers in the US and elsewhere are using too much fertilizer, and as long as their output prices are artificially supported, they will continue to do so.* Yields, as well as acreage, must come down if the equilibrium of supply and demand is to bring about profitable price levels for US farmers. This process will be much more painful if done over the long-term rather than now.

The USDA lowered the Soviet grain import forecast in 1982/83 to 40 MMT (million metric tons) from 44 MMT estimated earlier and 46 MMT in 1981/82. The new forecast includes 16 MMT of wheat (19.6 MMT in 1981/82) and 23 MMT of coarse grains (23.5 MMT in 1981/82). We believe Soviet wheat imports will be higher than now expected, and coarse grain imports lower, owing to respective 1982 Soviet crops, and the trends being seen in the livestock feeding industry in that nation.

STRATEGY: *We cannot visualize significantly higher grain prices between now and the end of 1983. We recommend maintaining short positions in corn. In fact we expect a limited range of trading for grains during that period. Prices have traded in the 2.17 to 2.30 range for several weeks and may appear to some to be forming a long, complex rounded bottom. We feel this will serve to suck in computer operators, among others, and will provide the fuel for a sharp drop in prices in the near future to the $2 level or lower.*

Wheat prices sold off more than moderately in response to the September 10 crop estimate. In fact we believe wheat is oversold relative to corn. Fundamentals support this: our stocks-to-use analysis from the August 22 Comments*; the fact that producers will attempt to store higher value crops (wheat and soybeans) to maximize the amount of value held for future sale; the drought-stricken Australian crop. In addition, wheat for human consumption is a necessity; corn for livestock consumption is not. This fact may be forced upon us by the course of the depression.*

Historically, 80¢ is a low premium for wheat over corn. Some argue that 40 per cent is not. We recommend buying March or May wheat, selling the same month of corn in proportion of 2 wheat: 3 corn. Currently wheat is trading 90¢ over corn. We would risk 80¢ wheat premium and have as our target $1.30 premium wheat.

U.S.D.A. crop production estimates-Oct.1 estimates-Oct.12 report.

	1982-Oct.1	1982-Sept.1	1981	Leslie-Oct.7	expected
corn	8314.9	8318.7	8201.0	8390.1	8352
soybeans	2300.3	2313.9	2000.1*	2310.6	2290
all wheat	2810.5	2815.5	2793.4		

Source: U.S.D.A. *-revised from 2030.5

Chart 16

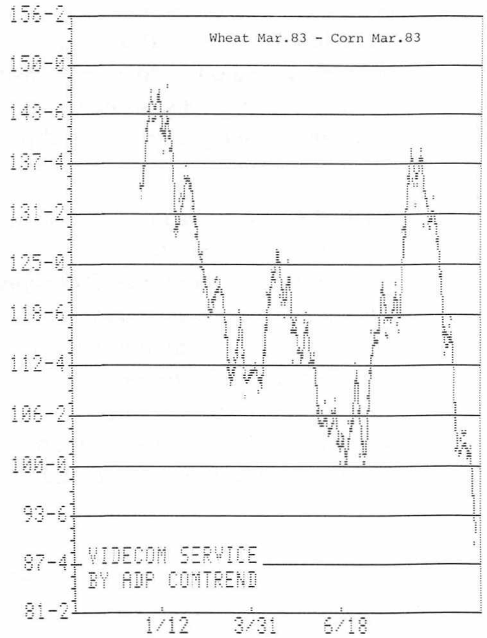

Chart 15

Livestock

Cattle prices certainly were discounted in anticipation of the September 14 USDA cattle and values on feed report, illustrated in Chart 18. The report was not mildly constructive as we had anticipated, but very bearish for deferred contracts as a result of heavy placements and large numbers on feed compared with 1981. The report was so well discounted that the market didn't know what to do next; the day after the report, cattle prices rose sharply in spite of the bearishness. Prices corrected sharply several days afterwards, however. Contrary to many traders' expectations, ourselves included, the cattle inventory has maintained its uptrend, which to some degree is reflected in the heavy placements of cattle on feedlots.

As we suggested, the September 22 quarterly USDA hog and pig report was very bullish, particularly for deferred contracts. The report is shown in Chart 17. The market reacted by being locked limit-up for two days and trading off limit-up to close marginally higher the third day.

Because hog prices failed to receive support from the lack of a constructive cattle report, and because the action following the very bullish hog report was poor, and most importantly because time indicates we have come to the end of the price peak as dictated by the hog cycle, we believe hog prices will trend somewhat lower for the next few months, at least. Feed prices are very low, the hog-corn ratio is very high, and regardless of whether interest rates begin a rise from these "low" levels, rates can be locked in for a year or two in the future. Extremely low corn prices on the cash market caused and will continue to cause hog producers to feed corn more intensively. The profitability of hog production will have to cause a response in the form of growing hog numbers. Profitability levels for cattle are much less positive, however, but in light of an increasing trend in placements and lower interest rates at present, cattle producers will likely continue their inventory — building within a one-year time horizon.

Broiler producers have been slow to react but will undoubtedly increase production to take advantage of current fabulous profits. Thus, total meat supplies in the first half of 1983 will be higher than the relevant 1982 period.

We were too early, then, in raising our target for hog prices to 70¢; nor are October or December futures going to rise to the originally-targetted 65¢ level. Just the same, our strategies have proven quite profitable. At this point we foresee hog prices forming a classic head-and-shoulders top. We suspect the right hand shoulder will be fairly drawn out in view of the fact that the September 22 hog report was bullish for the February and April contracts. The discounts to August and October 1983 contracts are prohibitive to short sales; these months are now illiquid in any case. Seasonally, June, and to a lesser degree July, hog futures are strong, and current levels for those months are too low to be shorted.

To participate in dropping hog prices, then, we recommend scale-up selling of April hogs between present levels of 54.5¢ and 56¢, which we may or may not see during the formation of the right shoulder. It is unfortunate to sell futures when the production level is already initially decided (hogs bred for production now will not generate market-weight hogs until at least June 1983) — the variable is feeding rates — but if a bear market develops, it will be fed by the nearby futures (i.e., likely February and April). Producers who made the decision to breed hogs just after the September 1 date of statistics of the hog report could conceivably bring lightweight hogs to market in April 1983. Our argument for greater meat supplies makes us bearish for April hog futures.

Cattle prices trends in the long term are less definitive. We expect cattle futures to trade in a range of 56¢ to 65¢ at least until the first or second quarter of 1983.

Last month we recommended taking profits in the long hog/short cattle spreads, and to reinstitute the spread at 3¢ premium December cattle. Unfortunately, the price differential only went to 2.5¢ premium cattle, before dropping to a discount of as much as 2¢ of December cattle to December hogs. Protective stops in December hogs would have been executed on September 14, just below 58¢; stops at what should have read 55¢ basis February would not have been executed on a close only basis. The long December/short October hogs spread was a tremendous success, reaching price equality within three weeks from the time it was recommended.

STRATEGY: *Sell one contract April hogs every one-half cent upwards from present levels of 54.5¢ up to 56.5¢, for a base position of 5 contracts. If the upper levels are not reached, a partial position is desirable because of the heavy discounts to April hogs and the fact that production levels are already fixed for that time-frame. Stops should be placed at 57.5¢ on a closing basis. The target is initially for 52¢ by sometime in January, 48¢ by April. Aggressive traders could trade February cattle futures in a range of 57¢ to 63¢.*

U.S.D.A. ten-state quarterly hogs and pigs report-Sept.1 data-Sept.22 report

(thousand head)	1982	1981	1982/1981 %	expected	our est.-Sept.12
hogs&pigs on farms	41,620	47,170	88.2	88.4	<90
kept for breeding	5,545	6,357	87.2	92.1	
market hogs	36,075	40,813	88.4	87.8	88
farrowing intentions					
Sept.-Nov.'82	2,165	2,418	89.5	92.7	
Dec.'82-Feb.'83	1,904	1,977	96.3	97.5	

Source: U.S.D.A.

Chart 17

U.S.D.A. seven-state cattle and calves on feed report-Sept.1 data-Sept.14

(thousand head)	1982	1981	1982/1981 %	expected
on feed August 1	6,836	6,451	106.0	
placements-August	1,731	1,419	122.0	112.4
marketings-August	1,689	1,526	110.7	104.9
on feed Sept.1	6,817	6,289	108.4	107.5

Source: U.S.D.A.

Chart 18

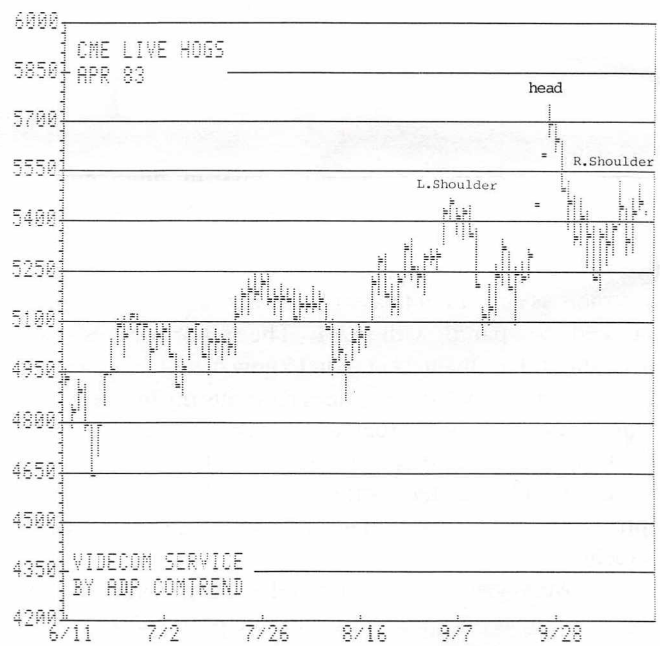

Chart 19

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