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A "Dizzy, Downward Price Spiral"

It's a total failure . . . What do you take me for? I am a man of the desert and nobody is going to laugh at my beard.

(Arabic equivalent to "Nobody is going to take me for a ride").

— Sheik Ahmed Zaki Yamani, walking out of the OPEC Geneva meeting.

I have warned that we may resort to the last medicine . . . this is what I see in front of my eyes . . . We believe the knife has reached the flesh.

— Mana Said Al-Oteiba, UAE oil minister, announcing an increase in output to 1.6 million barrels per day from 1.2 mbd.

I think one strategy is to freeze prices for a prudent period, possibly two or three years.

— Humberto Calderon Berti, Venezuelan energy minister, while admitting that his own country had upped production to 2.1 mbd, or 40 per cent above its total quota.

At long last, the much anticipated slide had begun. The Western media, mesmerized by the glamor of the cartel, wondered aloud, "if only. . ." In their minds, a spirit of cooperation would *have* to prevail, for clearly there would be no winners in a free-for-all.

Demonstrating an uncanny naiveté, Richard Johns in Geneva, writing for the prestigious *Financial Times of London*, headlines OPEC's failure thus: "Price differential issue catches unprepared OPEC off guard." The very next day, Yousef M. Ibrahim, a staff reporter of *The Wall Street Journal*, follows this line of thought and narrates a mystery-filled story of intrigue, plot and counterplot that presumably took place in Geneva and purports to show how Saudi Arabia lured other OPEC members into a trap to assert policy position. More to the point, he claims that "OPEC's oil pact collapsed at the eleventh hour over price discounts." As if OPEC *could have averted* a generalized price war. As if price discounts and quotas are two unrelated issues!

Price discounts and price differentials lie at the heart of

the cartel's prorating of output. Demonstrating this point is relatively easy. You will recall that OPEC agreed in March 1982 to "allocate" 7 mbd to Saudi Arabia out of a grand total of 17.5 mbd. The fact is that Saudi Arabia was never able to sell the allocated quantity even when overall OPEC output did not exceed 17.5-18 mbd. Why? Because African producers undercut the Saudis by offering their low sulfur, high-quality oil at a differential of only \$1-\$1.50/barrel over Saudi light when, in fact, the differential should have been \$3-\$3.50/barrel, or roughly \$37-\$37.50/barrel. By the same token, Iran began *discounting* its oil by as much as \$6/barrel, further undercutting Saudi sales. The result was that the Saudis saw their sales decline to the low 4 mbd level, in effect accommodating a combined rise of almost 3 mbd in the output of Libya, Nigeria, and Iran.

For a cartel to be effective, its members must live by agreed-upon production quotas and must vary their gross prices in such a way as to allow every member the fulfillment of his quota. This would have meant that the African producers would have had to raise their price differentials, while Iran would have had to narrow or eliminate its discount.

It was thus *impossible* for the Saudis to agree on a quota of only 4.5-4.7 mbd if they did not, at the same time, receive assurances from other producers regarding their price discounts and differentials.

It is clear, then, that OPEC's meeting did not fail because of a last minute hitch on an unrelated issue of price differentials. It failed because weak members could not assure the Saudis that they would, in fact, allow Saudi Arabia to produce 4.5-4.7 mbd. Without proper price differentials and the elimination of discounts, the Saudis and Kuwait would have seen their sales slowly disappear *entirely*.

As if the foregoing were not enough to impede a cooper-

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ative agreement, there were other insurmountable problems. Venezuela, for one, in the midst of an election campaign and a grave foreign exchange crisis, could not abide by any production cutback. In fact, it had quietly resumed production at full capacity in direct violation of previous quota arrangements. For another, the BNOC and PEMEX, outside of OPEC's range, were becoming increasingly aggressive sellers, the former burdened by an insane taxation policy on North Sea producers and the latter trying desperately to generate dollars with which to pay interest on their unbearable foreign debt. Neither was about to abide by an OPEC directed price policy. Both were interested in gaining an increasing share of the decreasing oil market.

Emotion, particularly in the Iran-Iraq conflict, has been running high enough to eliminate any commercial points of commonality among Gulf producers. The Iranians were clearly gaining market share at the expense of their arch-enemy, Saudi Arabia. OPEC was being held together by Saudi restraint, but so was Iran. This was unacceptable.

Finally, dissension among the closely-knit group of Gulf producers, Saudi Arabia, Kuwait, Bahrain, UAE, and Oman has been growing daily. UAE has upped production quite considerably in the past few weeks, while Oman has openly resorted to price discounts to generate sales to Japanese buyers. Finally, reliable sources reported that Kuwait sold 5.5 million barrels at \$28.25/barrel, a \$5.75/barrel discount from the official price.

The major OPEC producers, the British and the Mexicans, are locked in a face-saving political game of chicken. The Saudis have prophesied, suggested, and even encouraged the

BNOC to lower its prices by \$2-\$4/barrel, while the latter has merely said that any discounts, if and when they come, will be retroactive to February 1, 1983. Clearly, no one is willing to break the ice in what will surely be a "dizzy, downward price spiral."

At first, product prices (including, of course, heating oil and gas-oil) dropped to the equivalent of approximately \$25½/barrel. As producers have, as yet, not lowered official quotas, some bargain-hunting has developed in the free, or spot, market, tending to narrow somewhat the wide discount, but cutting official sales to below 15 mbd. Pressure is growing for a major producer to cut its official price, at which time the rest will follow.

How far down? We remain as convinced as ever that oil prices will plunge to \$20/barrel by the end of March and to \$8-\$10/barrel by the end of 1983. Our belief is based on these assumptions: (a) OPEC will produce at virtually full capacity, with the exception of Saudi Arabia (6-7 mbd?) and Kuwait (1.8 mbd?), to recover in volume whatever has been lost in price; (b) With OPEC at 23-24 mbd, world oil production will exceed demand by at least 8-9 mbd; (c) Inventory drawdowns will cause a producer panic over the next 60-90 days, as consumers are able to "do without OPEC" for at least 75-90 days; (d) Demand elasticity at the \$20/barrel level will be stifled by consuming nations' imposing stiff tariffs, which in turn will push world prices even lower.

STRATEGY: *The most profitable trade of the year is in full swing. Be sure not to miss it. Add with impunity to currently-held put options and short positions in gas-oil, at the market.*

Chart 1

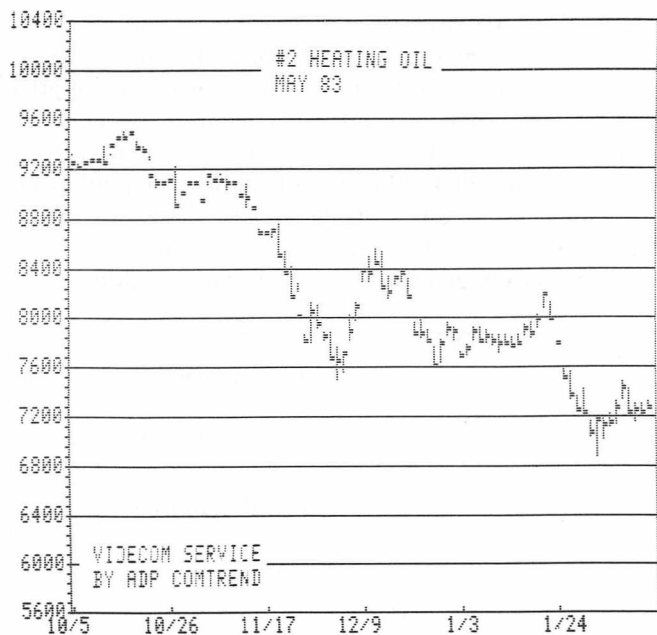
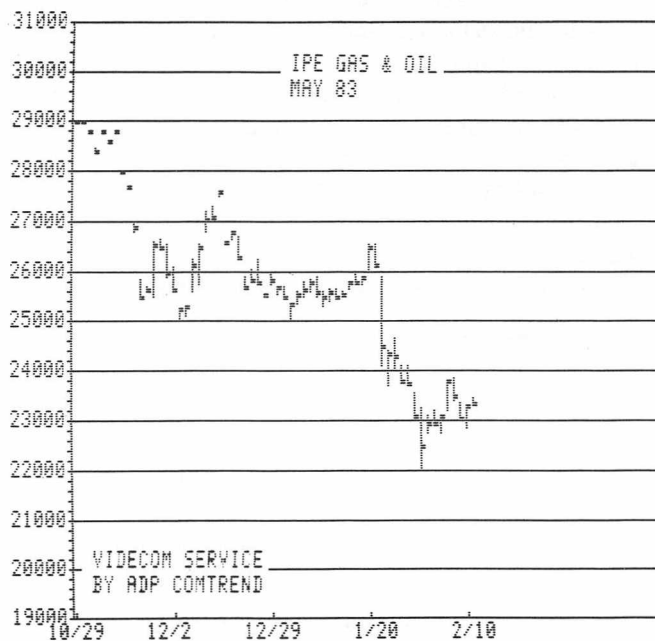


Chart 2

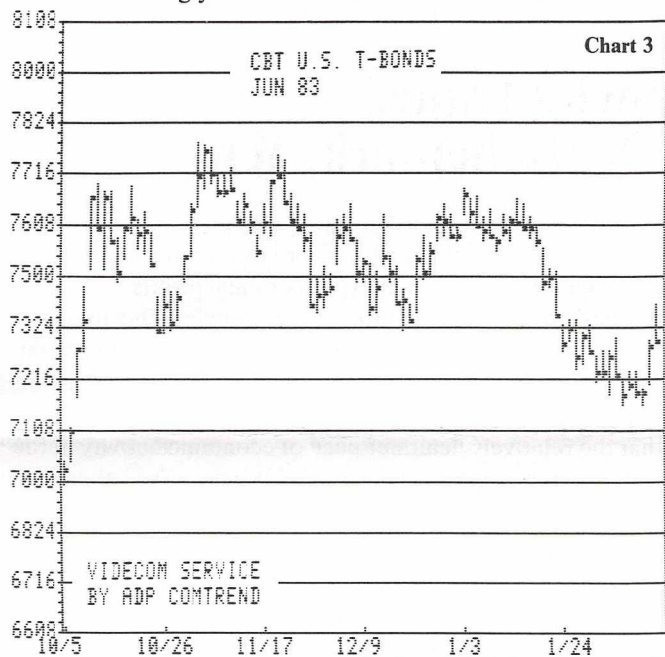


Interest Rate Futures

As far back as December 19 (*Commodity & Currency Comments*, "On Borrowed Dollars, On Borrowed Time"), we commented that US long-term bonds would begin a long descent and that "the time has come to initiate short positions in T-bonds in a serious way."

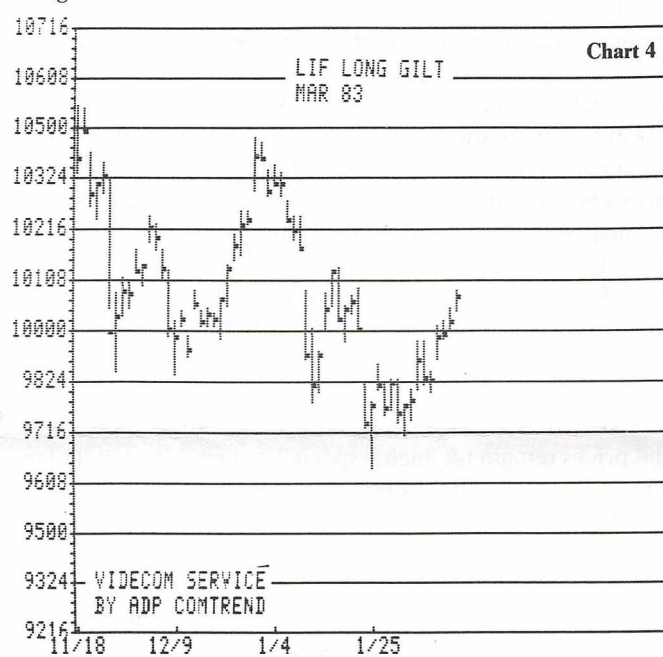
Our timing was rather unfortunate, as we were stopped out just a few days later at 76.20. We chalked it up to our uncanny ability to be wrong in 1982 on anything remotely related to interest rates.

Our rationale, however, was not faulty. The Fed has become increasingly accommodative: Free reserves continue



to hover around \$200-\$300 million, adjusted Federal Reserve Credit has picked up to an annual rate of growth of 9 per cent, budget deficits are getting larger, and the recession has at long last ended. Inflationary expectations *should justifiably* remain high in coming months despite the relatively good CPI performance (see our comments on "Sterling" this issue).

STRATEGY: *Institute short positions at present levels; place stops at 75.00 basis June '83. Retain short positions in long-term Gilts on the LIFFE.*



Currencies

Canadian Dollar

Last month we commented that we were at a loss to understand the relative strength of the Canadian dollar and satisfied ourselves with the comment that it was rather the result of a weak US dollar. Subsequently, as the US dollar strengthened, this hypothesis proved to be invalid.

No doubt, Canadian monetary authorities are supplying the system with less money than is demanded, even at this low level of economic activity. The proof is that international reserves grew in January by as much as US \$316.3 million. Furthermore, the adjusted monetary base fell in January from December, leaving it *below* the level recorded in January 1982.

Is the Bank of Canada making up for fiscal irresponsibility? As pointed out in "Precious Metals" this issue, this state of affairs, i.e., expansive fiscal policy and tight monetary policy, cannot continue indefinitely. The limits of toler-

ance are set by the domestic nonbank public when it begins to reject any further acquisition of government paper. The most recent Canada issue has been poorly received and is reportedly only 65 to 75 per cent sold. Have we reached the saturation point?

It should be borne in mind that even if the above question is answered in the affirmative, Canada can still resort to foreign borrowing. The present limits of the international lending community's tolerance, however, are well known.

In all, it is fair to conclude that monetary policy in Canada can still be effective enough to maintain (and even improve) its rate of exchange. Recent events demonstrate that reports of its demise may, indeed, be premature.

STRATEGY: *Cover short positions at market and move to the sidelines.*

Sterling

Seasonally adjusted unemployment rose another 35,000 in January to reach 2.95 million, or 12.3 per cent of the work force, a new post-war record. There has been no let-up in the underlying increases of redundancies — 30,000-35,000 per month for the past nine months.

Real retail sales have been supported by a generous system of transfer payments. Benefitting from this surge in demand, possibly reinforced by a relaxation of hire-purchases, are manufactured imports, which have grown at 10 per cent since mid-1981, while domestic output sagged 16 per cent.

Retail price inflation has slowed down to 5 per cent per annum. Inflationary *expectations* (measured by subtracting yields on index-linked securities — 2.25 to 2.50 per cent — from yields obtained in long-term Gilts — 11.7 per cent), however, remain stubbornly high at around 9 to 9.50 per cent per annum. This fact may be discomfiting to the many economists who argue that real rates are inordinately high and should be “helped” lower by a more expansive monetary policy. It is clear that inflationary expectations are *definitely* not a function of the most recent CPI figures and that the public has either a long memory or a good “feel” for future inflation (based on fiscal policy etc.). A more accommodative monetary policy will no doubt increase the inflationary premium.

The UK depression gives no sign of abating. Wage costs and prices remain too high, especially when denominated in foreign currency. The UK economy has become “fossilized”: an inflexible labor situation (requiring a *drop* in wages and easy transferability between industries); an illiquid private sector (requiring continuous bank credit); and an oversized government (which absorbs as much as 44 per cent of GDP). As such, the UK economy lived on potent dosages of inflation.

It cannot survive the present attempt of monetary stability unless these rigidities are removed.

STRATEGY: *In the final crunch, monetary stability will give way to deflation. At first, it will be in small dosages (like at the present time), and it won't work. Eventually, the dosage will be increased. By then, Sterling will have crossed the southern border of the \$1 mark.*

Remain short. Those wishing to factor out the US dollar risk, will be well advised to maintain long DM or long SF positions against the short Sterling. This strategy continues to be effective (see charts).

Swiss Franc, Deutschemark, Yen

We were stopped out of March '83 DM and March '83 SF at 42.00 and 50.00 respectively, as per last month's suggestion.

Tight stops were used to protect small profits because of our basic aversion to Continental currencies. Our first concern is political (see “The High Stakes in the European Elections” this issue). In the second place, we do not, as yet, consider the US dollar overvalued, although we do believe that the relatively healthier pace of economic activity in the US vis à vis Europe should give the US a negative balance on current account.

STRATEGY: *For those wishing to speculate on a weak US dollar, we recommend the purchase of gold. In the final analysis, gold will outperform the DM, the SF, the Japanese yen and the US dollar.*

Chart 5

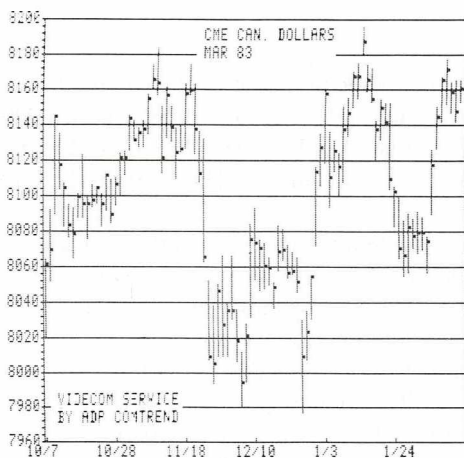


Chart 6

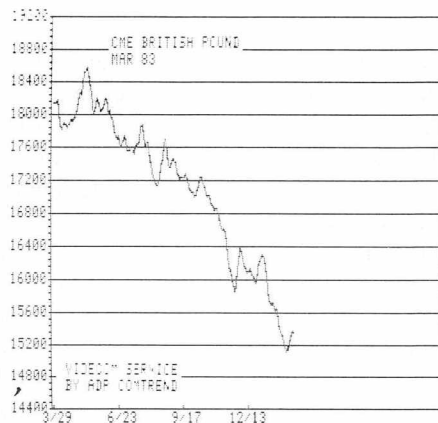
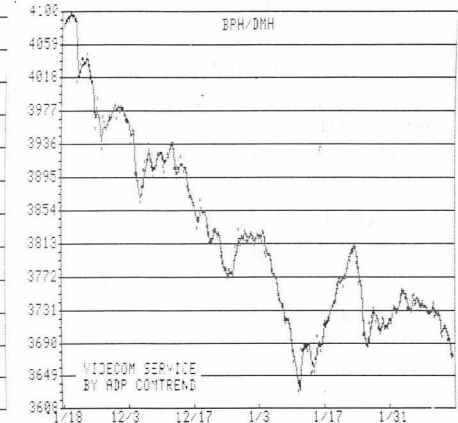
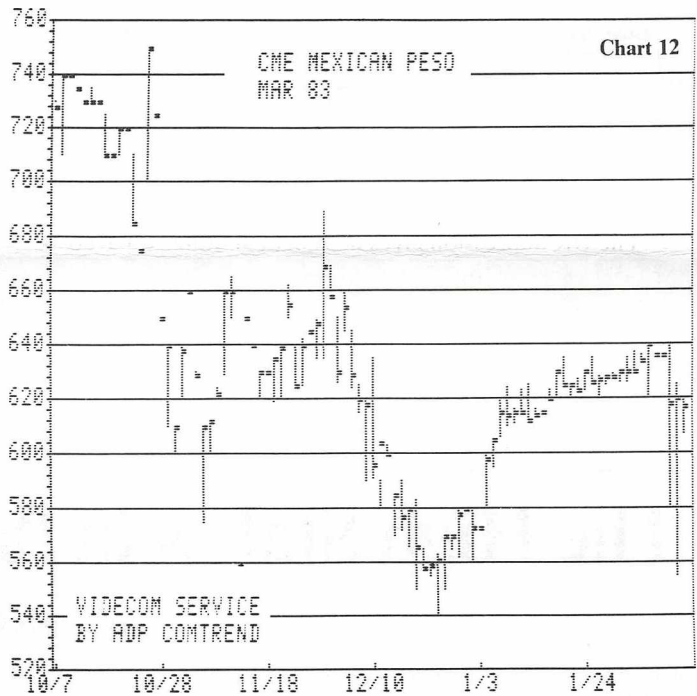
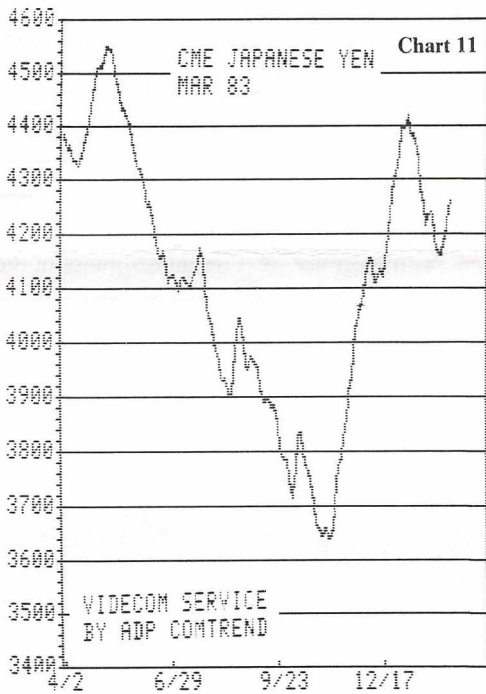
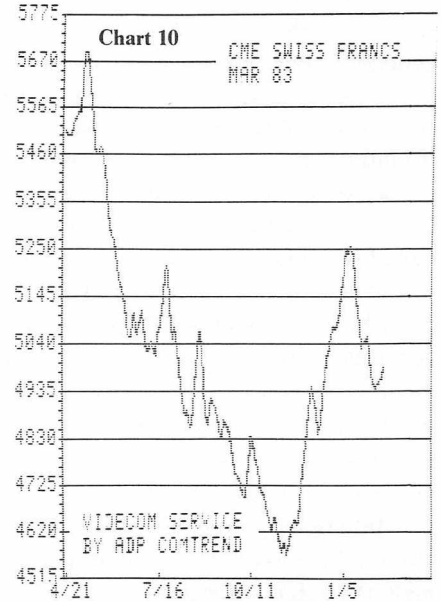
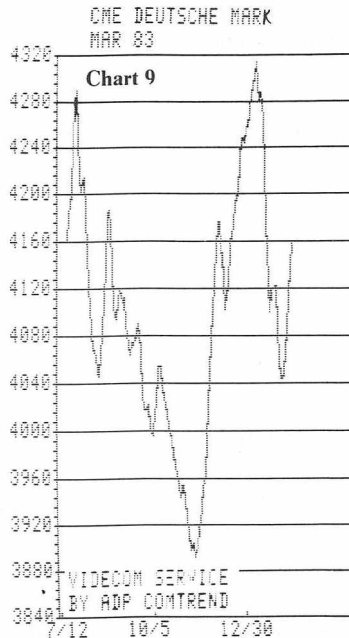
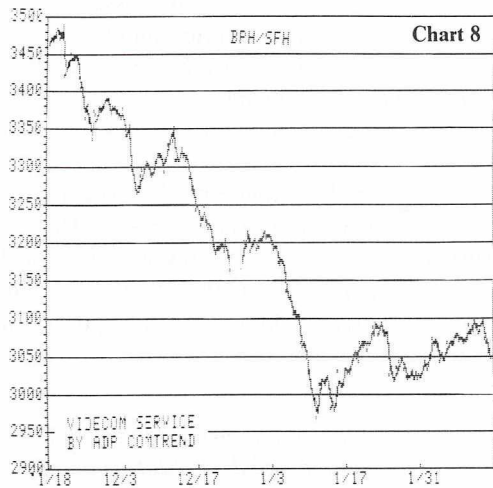


Chart 7





Precious Metals

Having broken out of the \$460/oz. level, gold prices have stalled just under the \$500/oz., giving the impression that the market is once again facing a large overhanging supply of spot metal.

The persistence of free reserves, some Fed backsliding on monetary targets, and the most recent pick-up in the growth of the monetary base have fuelled the advance, despite the fact that gold prices are no bargain at these levels. In effect, a mere \$260/oz. price for gold is sufficient to restore

full external convertibility for the US dollar, a situation that did not exist for the 10-year period leading to 1978.

Of course, one could argue that *full* convertibility, and not just external convertibility, is a more appropriate yardstick, given the extraordinary drop in the quality of (US) money that has developed over the past 18 months. If so, the US, with only 264 million ounces in Fort Knox, would require a price of \$1,850/oz. to redeem its entire supply of currency and demand deposits.

Increasingly, expectations have begun to develop a momentum of their own. While federal deficits do not have to generate inflation if they are not monetized, the public has begun to doubt the resolve of governments, feeling that sooner or later central banks will succumb to the temptation of lowering interest rates by buying government paper. This is another way of saying that in the *short run* a loose fiscal policy necessitates a tight monetary policy but in the *long run* a loose fiscal policy is incompatible with a tight monetary policy.

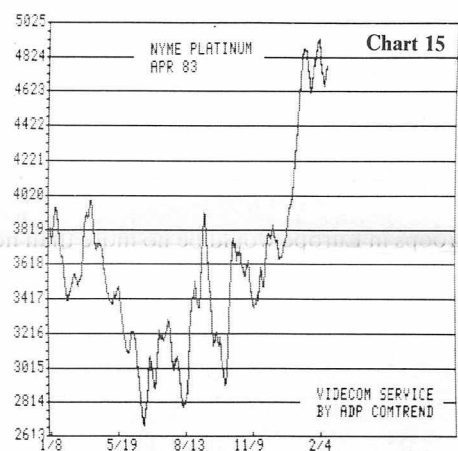
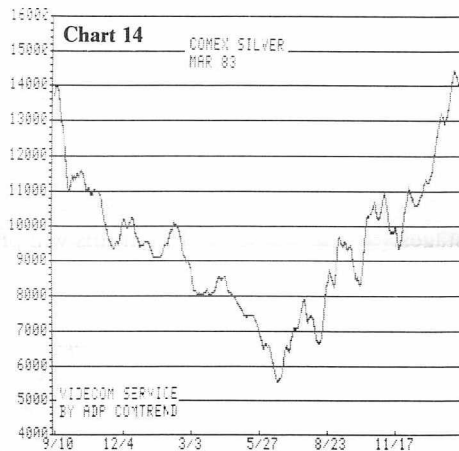
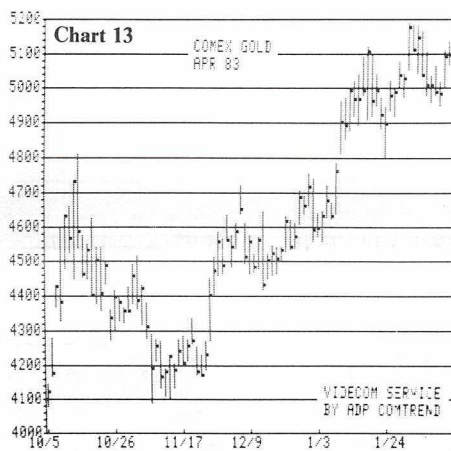
When the interest cost of the federal debt absorbs most of the budget (it is already 25 per cent in Canada) or when the nonbank public is fully saturated with government IOUs, monetary policy must by necessity become subordinated to fiscal policy. *If the public cannot become convinced otherwise, present monetary policy will become ineffective and irrelevant. We may be reaching this stage.*

Inflationary expectations are also operating via another circuit: the resolution of the international debt crisis. Increasingly, the public will (has?) come to suspect that rescheduling

will only prolong the inevitable defaults, and defaults will force monetary authorities to "paper over" the losses. Result: a huge, one time, quantum jump in money supply that will erase many years of laborious target-setting exercises. Again, *if the public cannot become convinced otherwise, present monetary policy will become ineffective and irrelevant. Again, we may be reaching this stage.*

Rightly or wrongly, well-ingrained public expectations will tear apart any stabilization efforts. Unless the US performs drastic surgery on its budget and revises, along with the UK, Germany, Japan, the IMF, and the BIS, the handling of the international debt crisis, gold prices will be pushed up to the fright levels, i.e., well beyond any reasonable estimates of purchasing power.

STRATEGY: *We like the "monetary" play in gold, and we advise adding to present long positions. Silver and platinum may appear more glamorous and may perform relative-ly better than gold in the near term, but in the "crunch" only the yellow metal will substitute for money.*



The High Stakes in the European Elections

by James Goldsmith

March 6 could be a historic day for Europe. Elections will be held in both West Germany and France. In Germany the conservatives could be returned to power with a clear mandate for strengthened policy. In France the result of the municipal elections could be more than a swing back to the conservatives and a rejection of the Socialist government.

But it is salutary to consider the alternative. In Germany the conservative alliance could fail to obtain an absolute majority, the liberal's (Free Democrats) could obtain less than 5 per cent of the vote and be eliminated from national politics and the Social Democrats (SDP) could govern with de facto backing from the Greens. To satisfy the Greens the SDP would have to agree to ban the installation of the new generation of intermediate-range US missiles, by no means an inconceivable concession.

A new Social Democratic government shouldn't be con-

fused with its predecessors. At best it would be of the radical left, with Helmut Schmidt replaced by Hans Vogel and Willy Brandt and the old partnership with the liberals by an alliance with the Greens. Many of the Greens' leaders are sincere and most of their voters well-meaning, but their organization is deeply infiltrated by Communists and their allies. This is no surprise, because the Greens' strategy conforms perfectly with the principal strategy of the Soviets — unilateral nuclear disarmament of Western Europe.

Already, under Chancellor Schmidt, the SDP had wavered on the missiles issue and went so far as to commit itself to a "security partnership with the East" at its party conference last April. This would be a negation of NATO. A new SDP government could be expected to go further, and Mr. Schmidt's successor, Mr. Vogel, has already made the pilgrimage to Moscow.

In France the municipal elections could be no more

than a setback for the Socialist-Communist alliance. This would allow them to pursue their strategy — which so far has been slowed, but remains unaltered. The realists in the government understand that to avoid reaction, changes must be progressive. Citizens can accommodate decline in fundamental freedoms so long as the pace is not too brutal.

But French industry, weakened by nationalizations, Communist union agitation and Socialist demagoguery, would find it more difficult to compete either in its home market or internationally. The drift to protectionism would accelerate at home while industry would look abroad to the softer markets of Eastern Europe. We would be told that France could become the Japan of those markets, so industry would become more dependent on the Eastern bloc.

French foreign policy would continue to be hard to analyze. The words are more or less acceptable, but the deeds are not. France's relationships with Nicaragua, Namibia's SWAPO terrorists and Fidel Castro, along with its involvement in the Siberian gas pipeline, support the Soviet empire, not the Atlantic alliance. No doubt it is difficult for the Socialists to be allied in a government with a firmly pro-Soviet Communist Party.

The dangers of such developments in Germany and France aren't difficult to assess. The US would have to reconsider its policy toward Europe. The Americans couldn't be expected to leave their troops in a Europe in which the balance of power lay so overwhelmingly with the Soviets. US troops in Europe would be no more than hostages.

At the same time the Soviet propaganda machine would redouble its effort to turn American public opinion against Europe. It would continue to orchestrate demonstrations against US institutions and leaders. The media would ensure that every US humiliation was given maximum coverage.

The US public wouldn't be told how, why and by whom such demonstrations are organized. The attraction of isolationism would grow in the US.

Thereafter the position in Europe could be described in stark terms. The US would withdraw its troops. The Soviets would have overwhelming military dominance. Governments that included Communists or groups related closely to them would be in power in France and Germany; such governments would allow local Communist officials to consolidate their grip on key areas of national life such as the unions, media, education and systems of justice. The French economy and to a lesser degree Germany's would be in symbiosis with East Europe. As France and Germany are the heart of the Continent, the rest of Europe would follow their lead. As for Britain, if in these circumstances the Conservatives were re-elected, there would be a withdrawal from Europe and Britain would revert to its traditional offshore role. If the left were to regain power, the next Labor government would find renewed enthusiasm to be a part of socialist Europe.

Conditions would then be ripe for a de facto neo-Yalta. The Soviets would encourage the Americans to revert to the territories covered by the Monroe Doctrine in exchange for reduced Soviet pressure in the Caribbean and Central America. Europe, thoroughly Finlandized, could fall like a rotten fruit without a shot being fired. Europe would progressively become a protectorate of the Soviets.

All this will probably not happen on this occasion. But Europeans would do well to understand the risks.

Sir James Goldsmith is publisher of L'Express, the French magazine. Reprinted by permission of The Wall Street Journal © Dow-Jones & Company Inc., 1983. All rights reserved.

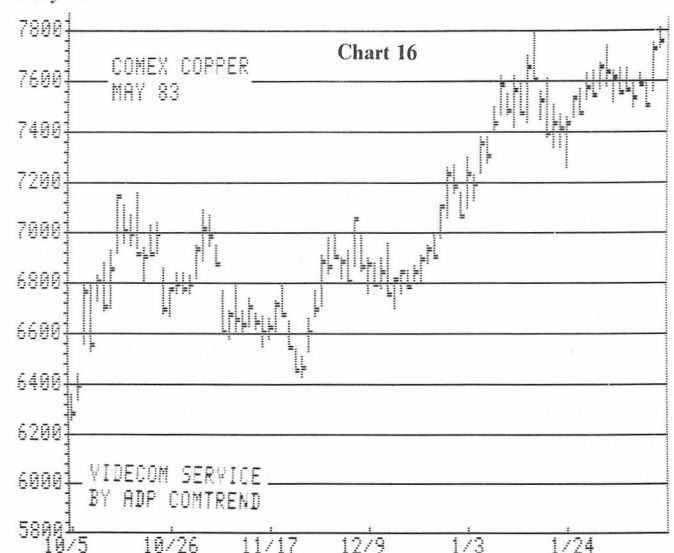
Copper

Copper has benefitted from the rise in precious metals: It is still cheap relative to the cost of domestic production-price. This has induced investment buying on the perception that the economy has turned and that the improvement will be led by the auto and construction sectors — the biggest consumers of the red metal. Hedge buying has also occurred ahead of labor contracts due to expire July 1. In the previous six renegotiations (1964, 1967, 1971, 1974, 1979, 1980), December contracts have appreciated by an average of 43 per cent from their lows to their peaks.

Inhibiting the market is the enormous and ever-increasing level of inventories held by producers — at 1.165 mln at end of 1982 they were the highest since the end of 1978. Moreover, the market is stalled by the fear that a substantial component of demand has been lost permanently due to technological advances and miniaturization and by the fact that 40 per cent capacity currently sits idle.

So far, the struggle between these factors has been resolved (as we predicted over the past six months) by an uptrend in prices. From a trader's point-of-view, that uptrend should be respected.

STRATEGY: Remain long, raising stops to 74.25 basis May '83.



Cocoa

Since last writing, futures have staged a rather marvellous advance of \$300 per tonne, basis May '83. This represents an increase of almost 20 per cent in less than 30 days.

Propellant for this recent bull move has been plentiful. The market has remained concerned over the size of the Brazilian crops, which have, as we mentioned last month, been reduced by drought. Preliminary figures ahead of CEPLAC's first official crop estimate suggest the main crop (October-April) may be 6 per cent less than last year's 1.72 mln bag harvest and that the Temporao crop (May-September) could fall short of 1981-1982 outturn by as much as 20 per cent.

In addition, there has been mounting concern over West African origins. Recent reports of strong Harmattan winds blowing over West Africa are expected to impair flowering of 1983 mid-crops. Bush fires have reportedly ravaged a number of Ghanaian cocoa farms in the central Sunyani district after a recent drought there. There have been indications that Ghana was sold out of current crop, which would mean that the crop would have reached only 190,000 tonnes at best. Transportation difficulties have resulted from the ugly and chaotic repatriation of Ghanians from Nigeria.

Finally, cocoa prices have benefitted from the overall strength of commodity prices generally and of precious metals' prices in particular.

The question now is where we can expect prices to go from here. Current conditions necessitate our offering an immediate and longer-term projection.

We feel that from present levels, prices are most likely to react down, and rather sharply. Our reasons are as follows: We presume the market has discounted the majority of the bullish news noted above in the 20 per cent price advance and that such a plethora of new bullish news is unlikely to be offered to the market immediately or on an ongoing basis; second, the market is technically vulnerable; several deliveries have, just this week, suffered weekly downside reversals; the open interest suggests that the recent advance was fuelled by short covering, which is no longer able to propel the market into new high territory; and finally, the open interest is still relatively large by comparison with deliverable warehouse stocks with first notice day for the March position arriving as we go to press, February 14.

Over the long term we must conclude cocoa has begun a bull market cycle that can be expected to last for some time. A typical cycle, as discussed last month, exists for four years, which is the amount of time it takes for newly planted trees to mature.

There are several factors, other than the length of the previous bear market (which, not coincidentally, lasted four years), that confirm the existence of a new bull market. The now well-publicized supply problems being currently experienced are being blamed for the first production deficit — 100,000 tonnes — in six years.

On analysis, though, we know that cocoa, unlike other

tropical agricultural products — sugar, coffee — is grown on small farms. (This is especially so in West Africa; in Brazil cocoa is grown largely on estates.) Small scale producers who have experienced four years of declining prices are not likely to have devoted the resources necessary to care for extremely sensitive cocoa trees. We suspect that inadequate fertilization and husbandry have rendered cocoa trees vulnerable to the weather, which may not by itself have caused the damage reported had the trees been better looked after. If this is the case, we may expect further crop reductions, ostensibly blamed on the weather, in coming crop years.

This begs the question of the extent to which plantings themselves have been curtailed. The last bull market in cocoa apexed in late 1977 — at nearly \$5,500 per tonne. Prices remained relatively high throughout 1978 before the bear market began in earnest. If plantings reached a peak in 1978, then those trees should have matured this year, which, as noted, will result in a deficit crop. We can conclude that from this year forward, not only will crops suffer from poor husbandry etc. but also that the market will not be overburdened by new trees coming on stream to replenish aging ones. (A cocoa tree has a producing life of 20 years.)

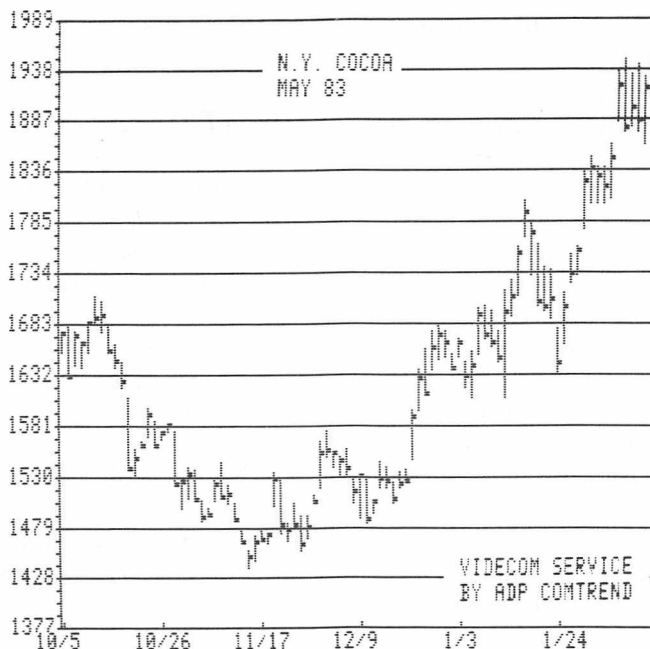
Looking now at demand: Seasonal grindings since the 1977-1978 crop year have been as follows: 1977-1978: 1,399 tonnes; 1978-1979: 1,457 tonnes; 1979-1980: 1,486 tonnes; 1980-1981: 1,585 tonnes; 1981-1982: 1,574 tonnes. Except for the last year, the trend has shown a steady increase. Grinding figures of the major consuming nations — France, West Germany, Holland, Britain, and the US — have recently been released for the fourth quarter and confirm that the trend toward increased consumption is not only continuing but accelerating. For calendar year 1982 as a whole, grindings in the five major consuming nations averaged 16.8 per cent greater than in 1981.

Clearly, cocoa consumption has responded to the free-fall in prices over the past five years. Given the expected deterioration of the value of paper currencies in general and of the dollar in particular (see "Currencies" and note the corresponding rise of commodities in general and of precious metals in particular), we can assume that the trend toward increased usage should persist, or at least not reverse in the foreseeable future.

In summary, we believe it is most likely that cocoa prices will decline in the near term. The decline is to be expected in a market that has advanced as far and as quickly as this one. The decline should be looked upon as an opportunity to assume positions in a long-term bull market, the duration of which, at this point, cannot be quantified.

STRATEGY: *Holders of long positions (advised in last month's Comments) should liquidate half their line, looking to reestablish it as the market approaches its current major uptrend.*

Chart 17



Grains

Market response to the Payment-in-Kind (PIK) program for corn has been extremely buoyant. Some expectations are for as much as a 75 per cent participation rate in the PIK program, in addition to the minimum required set-aside of 20 per cent. From 10 to 30 per cent of base acreage can be used for PIK forecasts of 1983 corn acreage including expectations of a fall to 66 million acres from 81.9 in 1982. Participation at even 50 per cent in the PIK program could result in lower 1983 corn acreage than this.

In addition to the influence of the PIK plan, very large entrances of corn into the grain reserve has served to reduce prospective free stock supplies on September 30, 1983, based on current USDA forecasts, to 409 million bushels from the previous estimates of 589 million bushels. As a result, spreads between old crop months and new crop months of corn have narrowed considerably. Ending stocks in September 30, 1983, are now forecast at reduced 3,384 million bushels from 3,564 million due to an increase in estimates of 1982-1983 and 1981-1982 domestic feeding rates.

The wheat market was battered in late January by the imposition of an embargo on US cotton and soybean imports by China in response to textile trade disputes. It was feared that the embargo might also offset Chinese wheat purchases from the US. China has already surpassed the import obligation of 6 MMT of US grain under the Long-term Trade Agreement, having contracted for 5.2 MMT of wheat (vs. 7.95 at this time in 1981-1982) and 1.8 MMT of US corn. With total Chinese grain imports forecast at 14 MMT by the USDA, a large amount of wheat in particular remains to be

arranged. US soft red winter (SRW) wheat, basis Chicago, may suffer from the Chinese embargo.

In the meantime, our long-awaited hopes for profitability in the wheat/corn spread have been laid to rest by the foregoing damaging effects.

The wheat and corn markets remain vulnerable to sharp moves in either direction both before and after the March 11 USDA report on enrollment in the 1983 acreage reduction programs. Because there is a substantial penalty on farmers who, having signed-up for set-aside programs, change their minds and choose not to comply, the single USDA report on sign-up as of March 11 will be an accurate indication of prospective acreage for harvest for wheat and corn. The penalty is 20 per cent of the target price (\$3.65 for wheat and \$2.86 for corn) multiplied by the number of bushels to have been paid in kind. The rate of repayment in kind as set-aside and over the 20 per cent minimum is a strong incentive to comply, but strong cash and futures prices between now and March 11 will serve to turn opinion away from participation, as farmers are lured by advancing prices.

We would now perceive that participation in the PIK programs would be positive for the corn and wheat markets. At rates of 50 per cent for corn (through which some 20 per cent of each complying farmer's acreage base will be set aside), through the PIK program alone corn acreage will be reduced by 10 per cent of total 1980-1982 "base" acreage; any figure substantially over 30 per cent for wheat (also on an average of 20 per cent of each complying farmer's base) will result in a 6 per cent reduction in total wheat acreage through-

out the PIK program alone. Similarly, figures far below these rough expectations could cause discouraged liquidation of long positions and resultant pressure on the markets.

The markets are sophisticated enough to recognize the long-term beneficial effects of any reduction in farmer-owned reserve stocks due to the PIK program, as would be supported by price advances in the immediate term; the markets had until recently been discounting the possibility that stocks would continue to grow, and low and falling prices reflected the low marginal utility of any addition to stocks if production continued to exceed consumption. However, 1983-1984 appears to have promise for the first year in several in which production roughly equals consumption, and 1984-1985 could be the first in which there is a net drawdown in grain stocks. The long-term price cycle shows signs of having not only bottomed but also readying to turn upwards if 1983 acreage set-aside equals or exceeds our rough expectations.

For at least the early 1983-1984 season, the trigger-release prices of \$4.65 for wheat and \$3.25 for corn from the 1982-1983 crops should serve as effective bids on wheat and corn

prices except in the case of disastrous world weather in the growing season.

STRATEGY: Remain long wheat in a 1:1 ratio of CBT and KC. Abandon short sales of March corn recommended last month above \$2.70. Look to exit the long 1 March KC wheat, long 1 March CBT wheat against short 2 March corn, at \$2.00 premium the combined wheat prices. Buy July corn on any dip to \$2.80, and begin establishing long positions in March 1984 corn on corrections to \$2.95. Long positions in March soybean meal were stopped out at \$176. Reinstigate long positions in July; excellent domestic and export demand, and support from the grains complex serve to benefit the position.

For the long 1 meal, short 1 soybean oil spread, continuing high crush rates and demand for soyoil below the production rate necessitated by meal disappearance have added to soyoil stocks, depressing prices relative to meal. Retain this spread.

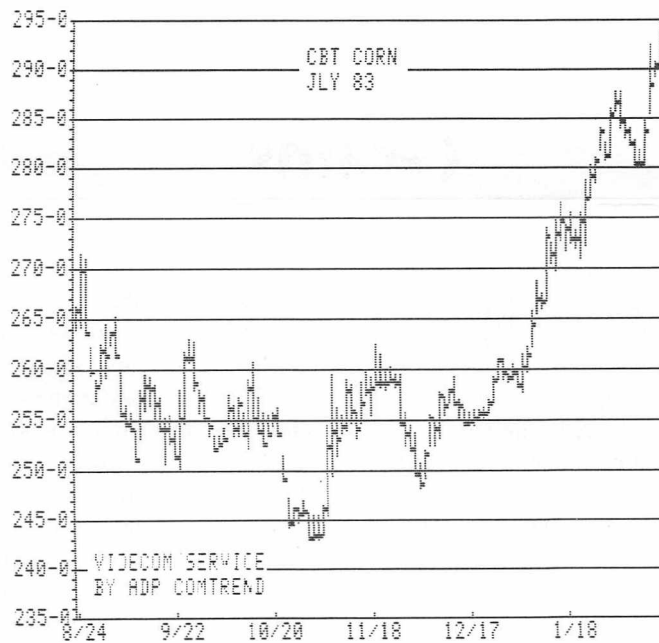


Chart 18

Livestock

A bearish semi-annual cattle and calves on feed-report on January 18 and a bearish semi-annual cattle inventory report on January 27 (see Charts 19 and 20) has failed to result in sharply lower cattle prices to date. However, the effects of the greater numbers of marketable cattle in the next several months than previously expected should affect the live cattle market. We believe cattle futures remain in a trading range and will move to the lower end of this range once more as

seasonal strength during the winter period wears off. Cattle breeding herd inventory has entered a liquidating phase, but positive effects of this liquidation will not be felt until the fall and afterwards.

Hogs have traded at the upper end of a trading range due to seasonal factors, in combination with another foot-and-mouth disease cutback in Denmark and the recently ended truckers' strike in the US. The strong uptrend lines in the

deferred months have broken (we advised covering short positions in October futures last month). However, short positions in April are carrying moderate profits. Seasonally higher slaughter in the next month and weak pork packer profit margins should pressure prices.

STRATEGY: Remain short April cattle with stops at 63.5, close only, and a target of 57. Stay short April hogs with stop protection at 58, close only, and a near-term objective of 51¢.

Sell December 1983 hogs at current levels in expectation of a build-up in breeding inventory, with stops above 50¢, close only.

USDA Cattle and Calves on Feed, Jan. 18
TOTAL THIRTEEN STATES
(in thousands)

	1982	1981	%-X	EXP.
On Feed				
October 1	8,800	8,210	107	
Placed On Feed				
During Oct.-Dec.	7,226	6,248	116	115.1
Marketed During				
October-December	5,384	5,089	106	109.5
Other Disappearance				
During Oct.-Dec.-Y	371	341	109	
	1983	1982	%-Z	
On Feed				
January 1	10,271	9,028	114	111.8

X — 1982 as a percent of 1981.
Y — Other disappearance includes death losses and feedlot movements.
Z — 1983 as a percent of 1982.

KINDS ON FEED JANUARY 1
(in thousands)

	1983	1982	%-Y
Steers and Calves	6,653	6,207	107
Heifers and Heifer Calves	3,555	2,771	128
Cows and Others	63	50	126

Y — 1983 as a percent of 1982.

ON FEED BY WEIGHTS GROUPS JANUARY 1
(in thousands)

	1983	1982	%-Y
Steers and Steer Calves			
Less Than—			
500 pounds	368	298	123
500-699 pounds	1,228	1,079	114
700-899 pounds	2,004	1,868	107
900-1099 pounds	2,330	2,337	100
1100 pounds and over	723	625	106
Heifers and Heifer Calves			
Less Than—			
500 pounds	277	217	128
500-699 pounds	1,013	749	135
700-899 pounds	1,406	1,120	126
900 pounds and over	859	685	125

Y — 1983 as a percent of 1982.

INTENDED MARKETINGS
(in thousands)

	1983	1982-A	%-Y
January-March	6,067	5,443	111

Y — 1983 as a percent of 1982.
A — Actual marketings.

Chart 19

U.S. CATTLE STOCKS

The US Department of Agriculture reported the January 1 cattle stocks, including the following, in thousands:

	1/1/83	1/1/82	Pct-X	Exp.
All cattle and calves	115,201	115,604	100	98.6
Cows and heifers that have calved	49,146	50,331	98	96.6
Beef cows	38,081	39,319	97	96.0
Milk cows	11,066	11,012	100	99.8
Heifers 500 lbs. and over	18,829	18,328	103	101.0
For beef cow replacement	6,343	6,615	96	95.8
For milk cow replacement	4,532	4,532	100	100.3
Other heifers	7,954	7,181	111	106.2
Steers 500 lbs. and over	16,229	15,501	105	100.5
Bulls 500 lbs. and over	2,615	2,618	100	98.8
Heifers, steers, and bulls under 500 lbs.	28,382	28,827	98	98.4

X — 1983 as a percent of 1982.
February 1, 1983

REUTER'S, Chicago, Illinois

Chart 20

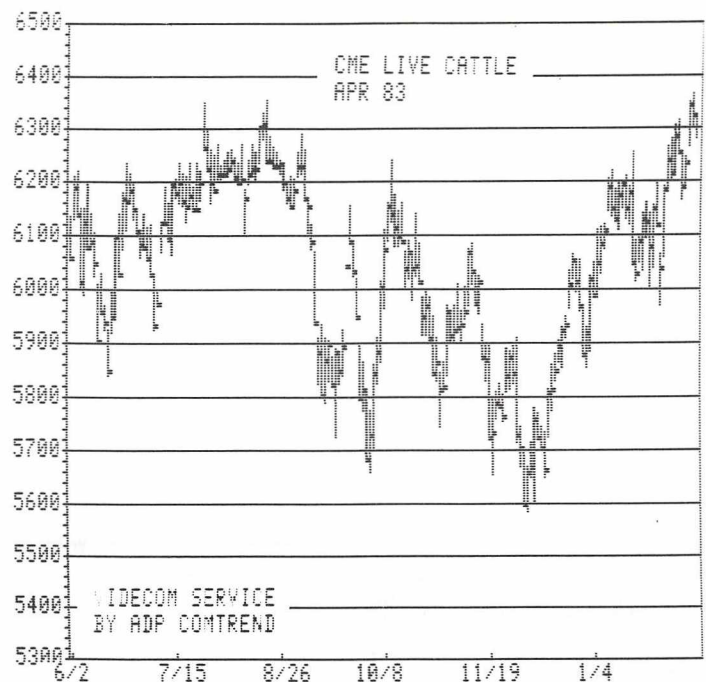


Chart 21

Chart 22



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