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A Compelling Case for Rising Interest Rates

In early March, the Shadow Open Market Committee issued a disturbing statement on the present economic situation. Composed of eight monetarist-oriented economists and cochaired by Allen Meltzer, a professor at Carnegie-Mellon University and Karl Brunner, a professor at the University of Rochester, the Committee stated, "... Rapid monetary growth threatens to squander the gains achieved at the cost of the two recent recessions and prolonged stagnation from 1979 through 1982. The original monetary policy of the Administration — to cut money growth in half by 1986 — has been abandoned. The debate about measures of money is a smoke screen to hide a resumption of inflationary policies. Such policies will produce higher interest rates and sustain high risk-premiums in current interest rates. The Administration and the Federal Reserve have no policy to reduce these risk premiums and sustain a low rate of inflation. . . . "

The concept of a smoke screen was further reinforced by Fed Chairman Paul Volcker who, under close congressional scrutiny, conceded that monetary targetting would resume in the very near future based on the *average level of money supply attained in the February-March* period. In other words, Volcker was allowing himself free rein to reflate in a manner totally out of the ordinary in the first quarter of 1983 — an unusual departure from the policies he initiated in October 1979.

Why? In the first place, Volcker, better than anyone else in the Administration, understood how close the banking system came to the brink last August, and he was intent in seeing through a successful renegotiation of the very pressing Mexican, Brazilian, and Argentinian loans. These could not have been closed in an environment of rising rates: The sheer prospect of 11 per cent or 12 per cent LIBOR rates, when added to the 2-2½ per cent margin, would have made hopeless any attempt at rescheduling. As it was, creditors and debtors settled at an interest rate level that makes debt service barely achievable in coming months — and only by sophisticated manipulation of trade data.

Secondly, an unnaturally easy monetary policy would prove highly beneficial to the economy *if producers and consumers could be "conned" into not marking up prices*, thus spilling increased money balances into real increases in demand. This tactic has worked relatively well in recent months where housing sales have made impressive gains. The same can be said for retail sales, demand for nonferrous metals, etc.

The Federal Reserve may have felt a strong compulsion to allow monetary growth rates approaching 18 per cent per annum. Clearly, in the short-term the above two arguments justified this policy. In the long run, however, they would become highly contraproductive. Here's why: Unusually high rates of monetary growth would increase the apparent "real interest rate" premium, which is not so much a "real" premium as it is a far greater level of expected inflation than the current rate of 2-4 per cent per annum. In effect, high rates of monetary expansion (and high and rising budget deficits) have conspired to make the inflation premium component in interest rates as high as 8 per cent for the near term and possibly 10 per cent for the longer term. The result is that interest rates are showing a crushing and stubborn premium

In This Issue

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over current inflation rates that in due course will once again choke the recovery.

Paradoxically, the only way to bring real interest rates down would seem to be to allow inflation to run close to long-term expectations and then to slam on the monetary brakes to induce a belief of falling future inflation rates. Low and/or negative real interest rates (see Chart 1) prevailed during the late '60s and a good portion of the '70s when *price inflation* ran close to built-in expectations *and* the Authorities intervened almost continuously to convince the public that inflation would be brought under control. The favorite tools for accomplishing these expectational changes in outlook were fiscal tinkerings (raising taxes), price controls, short bouts of tight monetary policy, and some populist expressions of supply-side policies.

A long history of persistent inflation cannot be altered by a sudden and sharp disinflationary experiment: Expectations remain high because of well justified cynicism and disbelief. Real interest rates *rise* almost anywhere that a dramatic disinflationary trend has been in evidence after a prolonged period of persistent inflation. Real live experiments recently conducted in Argentina, Uruguay, and Chile, and now in North America and Western Europe support this hypothesis. High real interest rates deepen the depression, widen budget deficits (a result of rising unemployment compensation and other social programs as well as rising service of the debt), which, in turn, prolong the perverse behaviour of expectations.

The deadlock on this vicious circle can only be broken by a *sustained* and steady disinflationary effort on both the fiscal and monetary fronts. As expectations change — and they change slowly — real interest rate premiums will fall. The Fed, and particularly Mr. Volcker, understand this phenomenon quite well and as a result have said that they are about to resume some moderation in the conduct of monetary policy. The successful completion of the rescheduling agreement with the three largest LDC borrowers provides a formula for future deals, the most pressing of which (given their size) are Venezuela, Yugoslavia, and Chile. Never mind that none of the LDCs will be able to service their newly renegotiated loans. That is a separate problem and may still be a few months (?) away.

In the meantime, the banks have been coaxed to roll over existing credits and to extend new credits, the IMF has been given extra resources, and the borrowers have been convinced (temporarily, at least) not to default or repudiate their present loans. It surely could not have been accomplished in a rising interest rate environment.

At this juncture it is worthwhile to draw a distinction between financing speculative activities and financing long-term productive investments. Speculators in buoyant markets hardly stop to think about financing cost. A prime example is the speculation against the French franc: Hoping for a weekend devaluation, speculators think nothing of paying 20 per cent per annum for two days or 40 per cent per annum for three months. Similarly, in an environment where commodity prices are likely to rise 30 per cent over a few weeks, short-term financing costs, regardless of how high they are, can be negligible. On the other hand, a corporation engaged in a serious capital spending program must be extremely diligent with its financing costs. A one per cent per annum difference may mean the difference between a viable and a nonviable project.

This distinction should help us understand the present predicament. On the one hand, interest rates, especially the real component, are too high to undertake productive investments. On the other hand, short-term interest rates are too low to discourage speculative activities such as buying commodities, real estate, and stocks.

In an effort to stabilize at an artificially low level the crucial prime and LIBOR rates, the Fed was forced to expand Federal Reserve Credit, and thus money supply, at rates totally incompatible with long-term goals. Whenever short-term rates (particularly Fed funds) threatened to break on the upside the 8½ per cent level, the Fed entered the market to do "system repos" and, by injecting huge amounts of reserves, managed to abort the rise. In effect, the Fed monetized the Federal debt as an adjunct to maintaining a reasonably low interest rate policy. Speculators, attracted by the massive reflationary policy, began to borrow (or to "dissave") ever-increasing amounts of money, leading to an acceleration in the growth of money supply as the Fed was forced to accommodate this surge in borrowing/dissaving at *a fixed, artificially low interest rate*.

As opposed to the 1975 recovery, when total commercial-industrial loans plus commercial paper fell, short-term credit demands have begun to grow very early in the recovery (see Chart 2), a sign that the speculative juices are alive and well . . . and no doubt encouraged by the self-same reflationary effort on the part of the Fed. The vicious circle is complete: The Fed reflates, speculators believe the Fed and are encouraged to borrow and buy "bargains," the Fed feeds more money in an attempt to satisfy borrowers at a low and predetermined rate, speculators receive further encouragement to borrow, and so on.

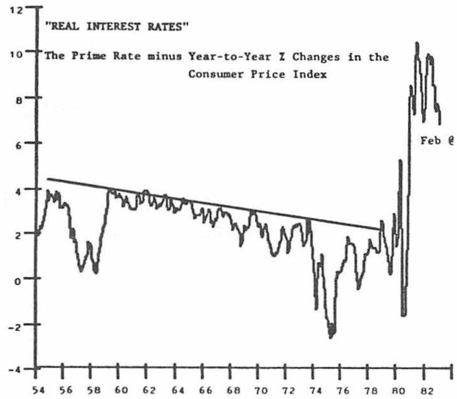
Chart 3 shows that in the past six months, Federal Reserve Credit expanded at an accelerated rate, even while (or rather because) it maintained a fixed and too low rate of interest. How can we tell that interest rates are too low? Simply because they force the Fed to monetize the debt. Higher, equilibrium rates would not necessitate recurrent injections of liquidity. In fact, not only are interest rates too low, but they seem to be *increasingly out of line*. With every passing week, they remain lower and lower in relation to their natural level. It is another way of saying that the true equilibrium rate is rising almost weekly.

By necessity, the Fed will play catch-up ball. Still shell-shocked by the banking crisis and the fragility of the recovery, the Fed is likely to *continue targetting interest rates* rather than reserves, implying at first a relatively subdued and lockstep change in its Fed funds proxy. In most recent memory, two such experiments did not end well: the 1978 episode, which culminated in the October 1979 massacre (and the supposed end to a policy of interest rate targetting) and the mid-1980 recovery, which climaxed six months later in short-term rates of 22 per cent.

What will be the effects of a lagging but nevertheless rising rate of interest? Initially, market participants will be caught off-guard and unprepared and will tend to sell commodities and stocks across the board. As the initial impact wears off, and market participants realize that the Fed will still be forced to provide generous amounts of reserves (even at a higher, but still "too low" rate), the speculative boom will regain momentum, unmindful of higher financing cost. Later and subsequent increases will do little to reverse the speculative splurge, except for sporadic sell-offs. In the meantime, the "real" world economy will crumble under the suffocating pressure of higher debt-servicing costs. In the end, the Fed will slam on the brakes. And then, *sauve qui peut*...

STRATEGY: *Sell September '83 Eurodollars at present levels, which represent a level of 9.90 per cent and a small 50-60 basis points premium to the cash market. Finance this position with an additional $3,500, so as to survive a maximum risk of 91.25. Be patient; our case for higher interest rates is now watertight... and compelling!*

Chart 1



Source: Cyrus J. Lawrence Portfolio Strategy Service

Chart 2

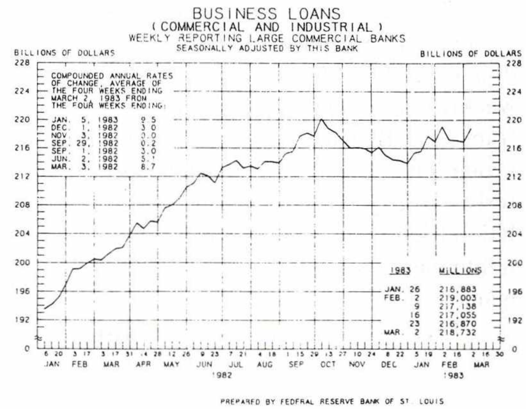
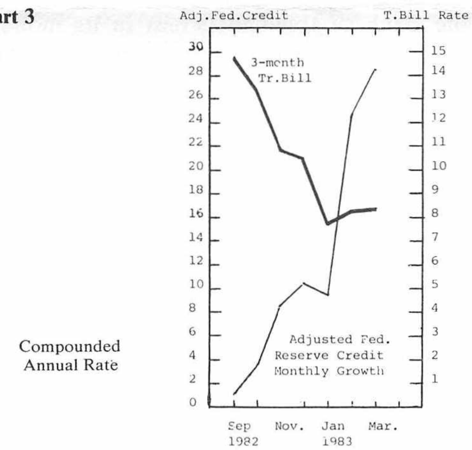


Chart 3



Source: Federal Reserve Bank of St. Louis

Chart 4

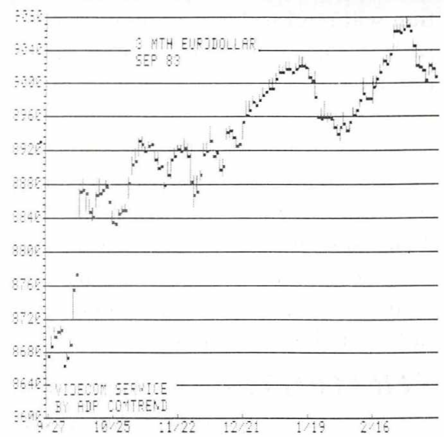
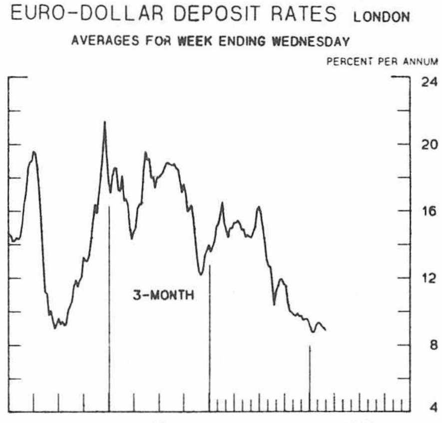
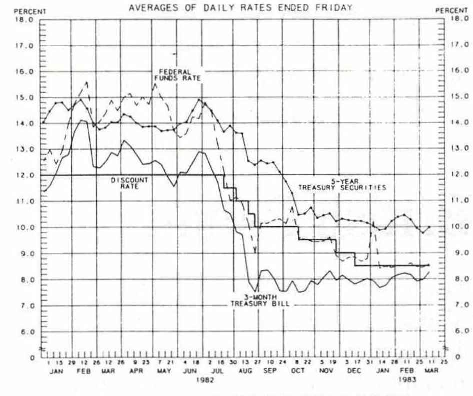


Chart 5



Source: U.S. Federal Reserve System

Chart 6



Currencies

Deutschemark, Swiss Franc, Japanese Yen, French Franc

The Deutschemark is surprisingly strong, and the EMS is in chaos. This sums up the two most notable events in recent weeks in the European FOREX markets.

The Deutschemark has shown extraordinary strength vis à vis its EMS partners, the Swiss franc, and even the US dollar. In the EMS wave after wave of speculation mount weekly (especially before the weekend) against the French franc, the Belgian franc, the Italian lire, and the Danish krona. The concerned Central Banks have so far successfully resisted the speculative onslaught either by making the speculation frighteningly costly (and the defeat devastating) or by tightening existing foreign exchange controls (as in the Belgian case).

There is little doubt that the Christian Democratic victory in West Germany is causing some unusually heavy capital inflows, away from the left-leaning governments of France and Italy. Continued membership in the EMS by West Germany could endanger its moderate monetary policy, as intervention will tend to bloat money supply. This may not sit well with the present administration, thus leading to the view, prevalent in recent days, that the EMS is about to lose West Germany as well as France and Belgium.

The strength of the Deutschemark/Swiss franc cross rate is puzzling us, although it may be proof of the increasing status achieved by the Germans. More likely, Germany's depression is so severe as to assure extremely favorable current account readings for many months to come. This, of course, is not the case with Switzerland, still undergoing a rather modest recession.

STRATEGY: *Rising US interest rates will no doubt exert downward pressure on the European currencies as well as the Japanese yen. Looking over the valley (or bump) however, and in line with our opening comments, currencies are likely to firm once the market adjusts to the new phenomenon and so long as the Fed moves to catch up on rates.*

Closes above 43.00 and 43.60, basis June '83 yen and June '83 Deutschemark respectively will indicate a resumption of their advances, which were stalled from early January 1983, at which point we would recommend new purchases.

British Pound

Latest statistics indicate that the economy remains prostrated at a very low level of activity. Retail volume has eased off significantly since December of last year, seasonally adjusted unemployment continues to rise and stands now at 12.4 per cent. As we've pointed out in recent issues, corporate liquidity continues to deteriorate despite the abysmally low level of inventories and activity. Figures for the third quarter of 1982 show that the current ratio stands at a mere 75 per cent, very close to the 72 per cent nadir reached in the third quarter of 1980. This may present a long term stumbling block to continued monetary restraint.

To Mrs. Thatcher's credit, it must be said that a) she has persisted much longer than anyone thought possible, and she gives no sign of reversing course despite an horrendous unemployment problem; b) she has brought down the government's deficit to less than 3 per cent of GDP, the lowest ratio in the industrialized world; c) she has reduced the PSBR to $12 billion, a dramatic reduction from the $27 billion of 1979; d) she has managed to privatize parts of the public sector; and e) she has not panicked to try to stem the decline in Sterling. In fact, Sterling has declined in a rather orderly and gradual manner without causing significant losses in reserves and without greatly upsetting the battle against inflation. The semi-clear float of the Bank of England is a superb example of single-minded determination in the pursuit of an independent monetary policy.

Should the Bank of England persist in its monetary policy (it has just announced a reduction in the target range for the growth of money supply to 7-11 per cent from 8-12 per cent), it is likely that the reversal in the terms of trade will not exact a great deal more from Sterling's effective exchange rate. *This position represents a significant departure from our formerly unabashed bearish outlook.*

STRATEGY: *Weakness in crude oil should, at least for the next while, continue to put down pressure on Sterling. This terms-of-trade play may not, however, last forever and may even be the last bearish argument in the Sterling bear market.*

Cover half present positions at market and place stops on balance at 156.00, basis spot.

Canadian Dollar

Last month we advised covering short positions and moving to the sidelines. We now continue to shift gears forward and advise a long position.

Our bullish case is monetary: International reserves continue to swell (see Chart 15), no doubt indicating a domestic shortage of liquidity. This point can be further underscored by looking at the movement of the adjusted monetary base (see Chart 16). At C$16.6 billion, the adjusted monetary base in Canada stands 5½ per cent lower than in January 1983 and a mere 3 per cent higher than in March 1982. Remarkable for a Bank that supposedly abandoned monetary targets.

The enormous budget deficit yet to be financed for the balance of the fiscal year should attract short-term capital inflows and conversions, thus firming the Canadian dollar in foreign exchange markets.

STRATEGY: *The "lid" around 81.75-81.85 on the Canadian dollar is so obvious that it can be characterized as artificial and is a product of intervention by the Bank of Canada. This lid is about to blow off and should lead to a good advance into the 84-84.50 range. Buy June '83 at market; place stops at 81.25.*

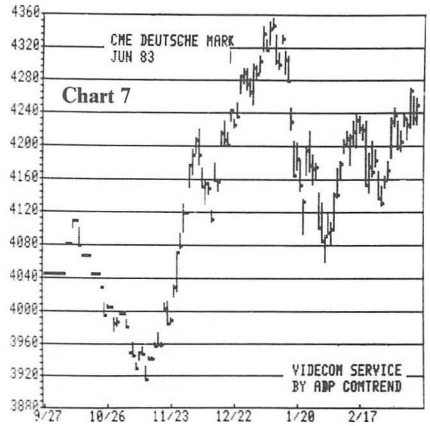


Chart 7

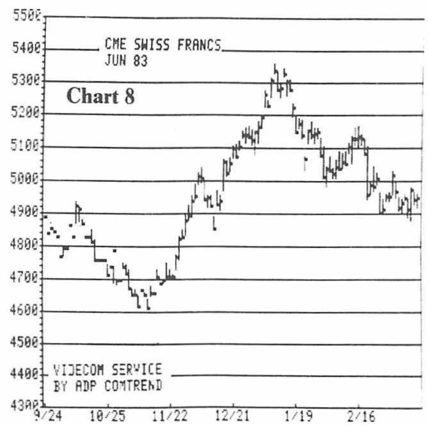


Chart 8

Chart 9

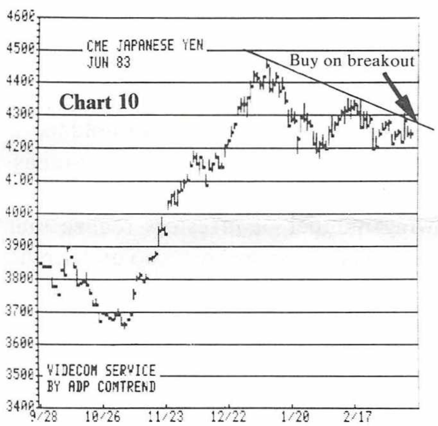


Chart 10

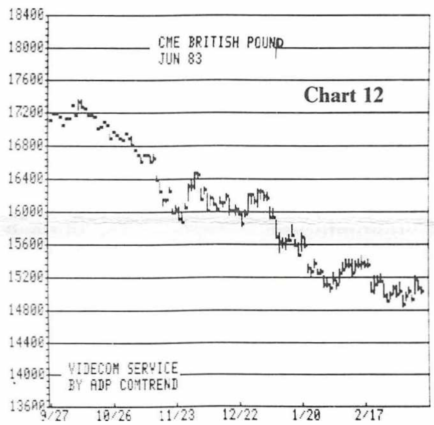


Chart 12

Chart 13

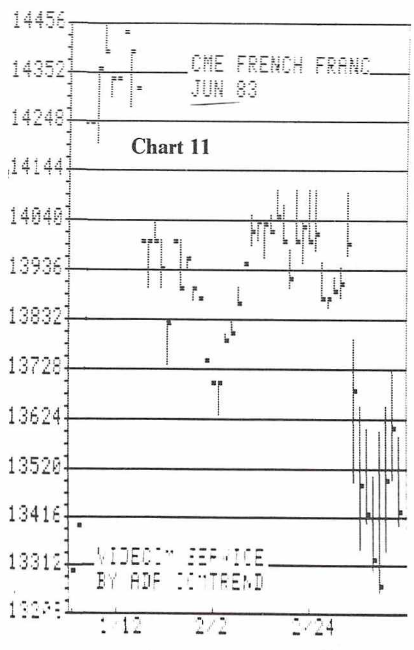


Chart 11

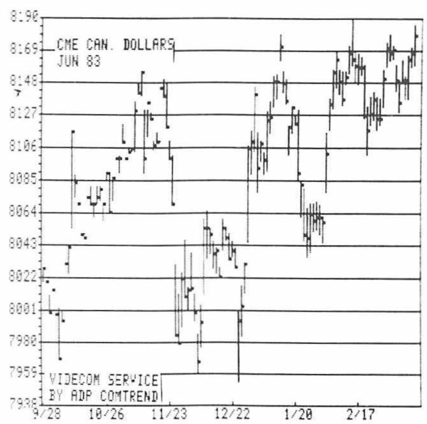


Chart 14

Canada	Net Official Monetary Movements Millions of $
Jan.82	- 59
Feb.	- 788
Mar.	- 372
Apr.	+ 117
May	- 945
Jun.	-2,258
Jul.	+1,093
Aug.	+1,203
Sep.	+ 478
Oct.	+ 318
Nov.	+ 49
Dec.	+ 77
Jan.83	+ 318
Feb.	+ 501

Source:Dept. of Finance, Canada

Chart 15

Canada	Adjusted Monetary Base Millions of Dollars
Jan.82	17,318
Feb.	16,699
Mar.	16,124
Apr.	16,538
May	16,321
Jun.	16,503
Jul.	17,034
Aug.	17 037
Sep.	16,588
Oct.	16,712
Nov.	16,882
Dec.	17,433
Jan.83	17,578
Feb.	16,583
Mar.	16,649

Chart 16

Precious Metals

Whew! What happened to the gold market? A month ago, we advised "adding to present long positions," and did not provide a stop. Many of you probably got caught, and if it's any consolation, so did we.

Gold's collapse was a phenomenon of the market place. The market had become overloaded with long speculators, as witnessed by a bullish consensus over 80 per cent for five consecutive weeks. Many speculators fortunate enough to have profits from earlier purchases pyramided over $500. There was a build-up in open interest, which on COMEX rose between December 17 and February 17 to 130,987 from 117,575. The increases in silver and platinum open interest were much larger — Silver (COMEX) to 51,897 from 33,083, and platinum to 22,819 from 14,352. As of March 15, these figures had fallen to 114,894, 44,562, and 17,593 respectively.

What next? Our principal bearish argument is our expectation of higher interest rates in the near future, which would have a deflationary influence on all commodity prices. Possible further declines in oil prices should not, however, be looked at as a reason to sell. Many traders with short memories seem to forget that after the failure of the previous OPEC meeting on Monday, January 24, 1983, gold rose in the next week by $26 from the close on January 21, and $40/oz, from the intraday low touched that morning. The argument that falling oil prices are destabilizing and bullish for gold will come back into vogue.

Gold should be thought of as a form of money popular with emotional speculators and investors. If it is to have a sustainable advance, the reason must be that its utility to the investor will be increasing. We think this will be the case. There is a massive hidden assault on the integrity of paper money going on right now throughout the world. Consider the following:

1. The monetary base has increased at an 18 per cent annual rate for the past two months.

2. When the Third World default comes, as it must, someone has to take the loss. Theoretically it could be the banks and their depositors. (The banks alone cannot afford it.) However, Western governments seem intent on bailing the banks out. This would shift the burden of repaying depositors initially to the government, eventually to the taxpayer. Consequently, the distinction between T-bills and bank deposits is blurring, obviously to the detriment of T-bills.

3. Using the perhaps optimistic figures of the OMB, *The Wall Street Journal* (March 14) calculated that federal debt held by the public will rise between 1982 and 1986 from $929 million to $1,707 trillion, or by 84 per cent. GNP in this period will rise only 37 per cent, so publicly held debt as a percentage of GNP will rise from 30.6 per cent to 41.2 per cent. The burden of this debt is becoming unbearable.

Some form of governmental insolvency is becoming inevitable. But a government is always the preferred domestic borrower; its capacity to print money enables it to crowd out all other borrowers. Thus myriad bankruptcies lie ahead.

With the exception of gold, every financial asset is someone else's debt. The debt stinks. If we face massive debt liquidation, then some holders of financial assets may lose their money. But people with gold won't lose. Alternatively, the government might engineer massively inflationary bailouts, which would at least be democratic — all holders of financial assets (except gold) would lose part of their purchasing power.

We think a growing number of investors realize that uncontrollable deficits and banking problems do undermine the integrity of paper currencies, whatever the CPI actually did last month. This is why gold has risen from $300 to $425 despite a simultaneous deceleration in price inflation. In the *long run*, gold is the only alternative.

STRATEGY: *Our trading recommendation, i.e., remain sidelined, may seem to contradict the above fundamentally bullish view. This neutral position, however, can be attributable to the fact that a great deal of* technical damage *has been inflicted: A breakout of a massive head and shoulder bottom has failed and a promising breakout above a long-term resistance area, namely $460, did not hold. These "failures" presage a great deal more base-building before the climb resumes in earnest.*

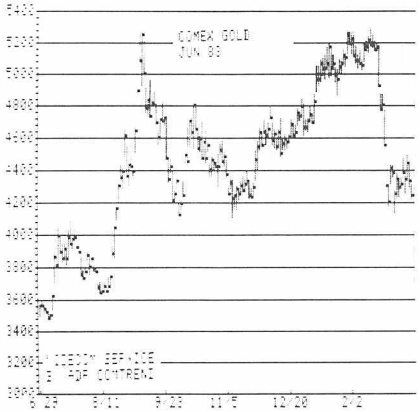


Chart 17

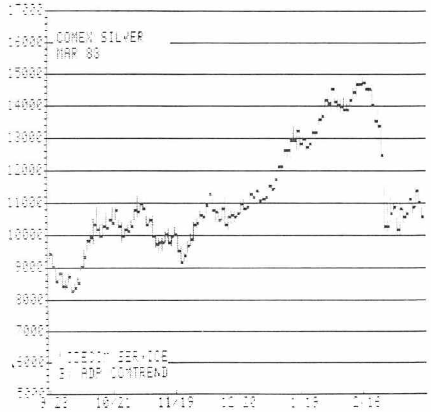


Chart 18

Chart 19

Copper

Since last writing, margin call liquidation in sympathy with crashing previous metals quotes weighed heavily on futures, which lost 10¢, or like gold, 50 per cent of its advance from 1982 lows. The naive sentiment that declining oil prices will serve as a generalized depressant has also served to dampen enthusiasm. As mentioned repeatedly in our comments on other commodities, the decline of the price of a single commodity in the economy does not create disinflation. It only allows for more money to be spent on other goods and services.

Copper prices, above most, should profit by the decline in oil prices inasmuch as business activity will be spurred by reduced energy costs.

A genuine negative influence on copper will be the upturn in interest rates. It will be generally unexpected. And it will impact directly upon a substantial and ever-increasing level of inventories. Currently at 576,469 tonnes, combined LME and COMEX stocks are at the highest levels since mid-1978 and have climbed for 24 consecutive weeks.

The open interest — which has climbed consistently since the lows of end-September of last year were recorded from 65,000 lots to as high as 125,000 lots at the end of February when the highs were achieved — fell by a relatively meagre 12,000 lots during the 10¢ washout. The ongoing high level of open interest when reckoned in terms of the aforementioned warehouse stocks invites the conclusion that the short side of the open commitment is composed of hedgers. It also begs the question of who is long. Were it primarily small speculators, you would rationally assume that the commitment would have shrunk by a lot more than it did during the sharp break in prices — as was the case in gold, silver, and cocoa, for example. That the open commitment did not decline sharply suggests that a good portion of the long position is composed of extremely strong traders. Can there be more than just well-heeled investment buyers?

Is it possible that a manipulation of sorts is being conducted in a market still generally perceived to be cheap? Though unlikely, the possibility does exist.

STRATEGY: *In spite of our view of late that we could defer purchases at present levels, we remain friendly to the copper market, as we predicted copper prices would record lows last September, which would never be seen again. Investors should remain long with stops to protect hefty profits at 70.00, basis May on close.*

Chart 20

Heating Oil — Gas Oil

Now that all the pundits have become experts, there is little that we can add except to say the following:

a) The cartelization of a market has never in history been effective, and this one will prove no exception;

b) Saudi Arabia seems to have committed itself to being a "swing" producer for a period of up to two months, although it is highly unlikely that it will ever accept to go below 2.5 mbd, its arch-enemy's (Iran's) quota;

c) Assuming a "small" amount of cheating, a 2.5 mbd Saudi output, and the additional 1 mbd concentrate allowed to Venezuela, OPEC will produce about 17 mbd, or about 3.1 mbd more than its March production, which saw market prices collapse. Furthermore, we are moving into the slower spring/summer period, making overproduction even more apparent;

d) The IEA estimates that land-based stock held in its 21 member countries at the end of March should total the equivalent of 397 million tonnes, *102 days of forward supplies*, compared with 83 days of forward supply in 1979, 96 days in 1980, and 101 days in 1981. Clearly the major drawdown of stocks is still ahead. As we've pointed out repeatedly in past issues, this (the drawdown) is the single most potent bearish force in the overall scenario, as it will tear apart one producer after another from a common price front;

e) Nigeria's price differential of only $1 is not market-based and threatens an immediate price war with the BNOC. Gulf Oil, which lifts as much as 100,000 b/d from the North Sea, has already indicated that it will shift to the cheaper product, i.e., Nigeria, gearing up to full production of 250,000 b/d. If the BNOC reacts by making its prices more competitive (as is natural, it will), Nigeria will lower its price pulling down Algeria, Libya, and finally the entire OPEC structure;

f) The Soviet Union has increasingly become a (desperate and) competitive seller, with exports running at 1.5 mbd, up from 1.1 mbd last year and 1.0 mbd in 1980. Since crude oil and products represent one of the Soviet Union's most important sources of foreign exchange, you would expect them to continuously undersell the lowest OPEC seller.

The Cartel continues to crumble. A price of $20 per barrel is a certainty within a very short time; $8-$10 barrel is our end-of-year objective.

STRATEGY: *Remain heavily short gas-oil contracts in London. Stops should be lowered to 260 basis May '83, close only. Puts are bargains at $20/ton for October '83 delivery.*

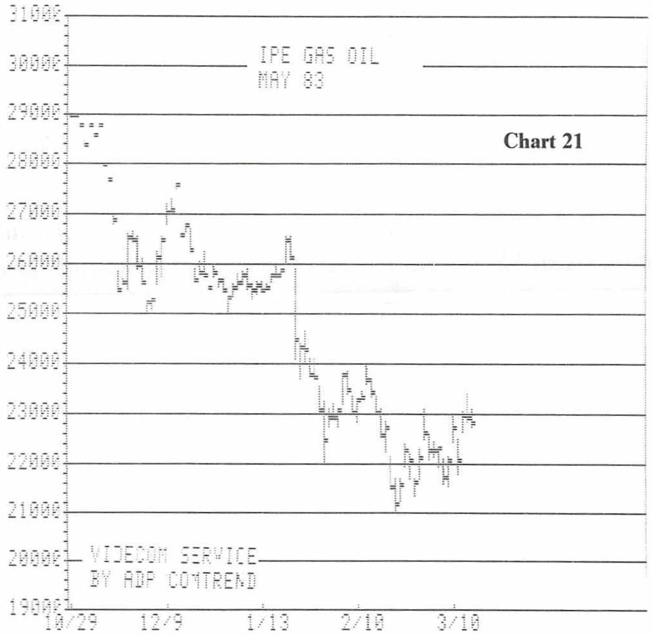


Chart 21

Chart 22

OPEC Quota Allocation

Kuwait (Including Neutral Zone)	1,050,000	Barrels Per Day
United Arab Emirates	1,100,000	
Venezuela (Excluding Condensates)	1,675,000	
Algeria	725,000	
Ecuador	200,000	
Gabon	150,000	
Iraq	1,200,000	
Iran	2,400,000	
Indonesia	1,300,000	
Nigeria	1,300,000	
Libya	1,100,000	
Qatar	300,000	
Saudi Arabia	Flexible	
Total	12,500,000 - 17.5 million BPD	

Cocoa

True to last month's prophecy cocoa prices dropped sharply from a high of 1950, basis May to test the current uptrend (see Chart 23). In the process, the open commitment has shrunk by 4,000 lots and currently stands at 22,534 — the same level it did nine weeks ago when prices were at 1665. The implication is that a goodly percentage of the weak-handed speculative element has been eradicated.

Cocoa, along with virtually every commodity on the board — see Chart 24 of Commodity Research Bureau Index — has suffered first from the distress liquidation that accompanied the sharp decline in precious metals values and more currently, the sentiment that declining oil prices augur for a generalized disinflation. A third factor has been a gathering perception that interest rates are now less likely to trend lower than was earlier assumed.

We believe, as noted at the outset, there is little distress liquidation potential left in the market and that the view that lower oil prices presage lower commodity prices generally is a naive one. It is a dearth of spendable money that causes prices to fall. As noted in our interest rate section the opposite is currently the case. And even without the current lassitude on the part of the Fed, lower oil prices allow for higher money balances to be spent upon other commodities.

The interest rate fear is a real one, especially when taking into account the present high level of inventory. However, we are of the opinion that this interest rate fear is outweighed by the fundamental factors discussed in detail in our previous two issues and by the uptrend that describes the current bull market.

STRATEGY: *We remain long, advising those without positions to take advantage of current levels. Place stops at 1650, basis May on close only.*

Chart 23

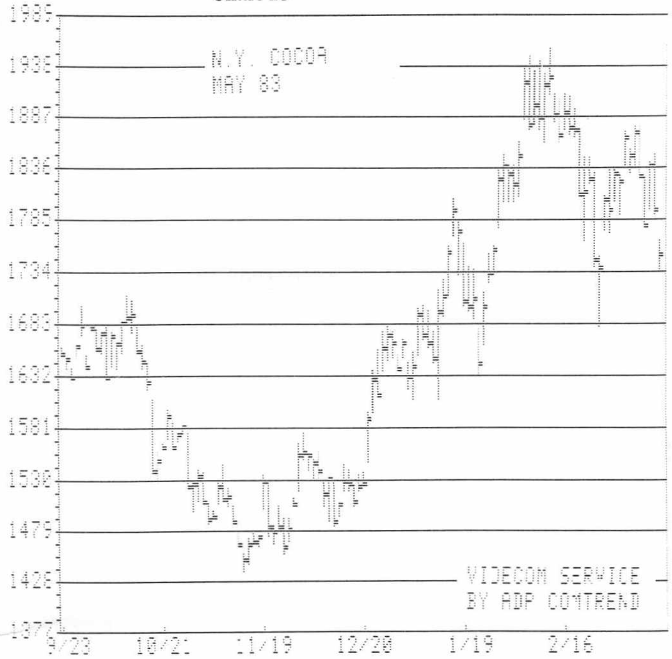
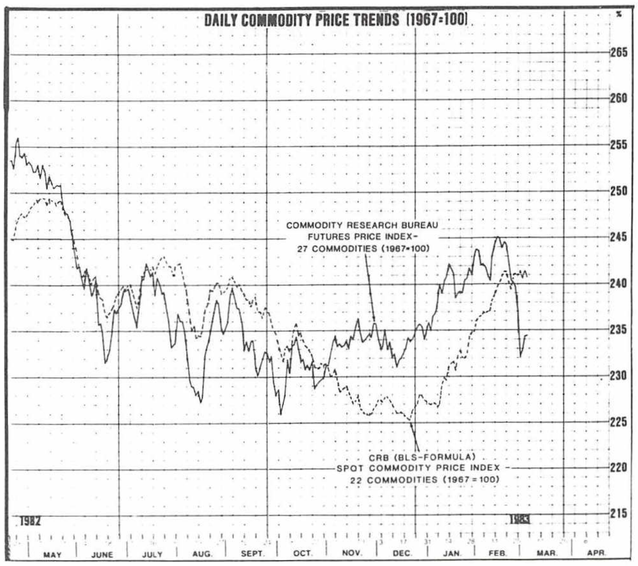


Chart 24



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Livestock

Balmy, wet weather has pervaded much of the Northern Hemisphere this winter. The cattle feedlot regions of the Western and Midwestern US were no exception. The seasonal winter strength in cattle futures in February developed into a more-than-nominal move in cattle prices on the upside. Muddy feedlots caused cattle death losses, reduced weight gains, and inability to move cattle to markets. The subsequent cattle slaughter shortages and lower-than-adequate steer slaughter sent cattle futures up more than 3¢ — a result of a large proportion of heifers in marketed animals (arising from exceptionally high placements of heifers late last summer, owing to a reduction in breeding stock replenishment).

The monthly Cattle on Feed report for March was released March 14 and is shown in Chart 25. The placements figures for the month of February were moderately bullish, being below the range of expectations. However, high cattle prices had discounted the expectations of a bullish report and short-run shortages due to muddy feedlots; the market reacted less positively than anticipated. At this juncture, we anticipate a sell-off in the market in keeping with seasonal post-winter weakness.

Feeder cattle prices have been bid up substantially in the past month, conceivably from demand for feeder placements on fall planted winter wheat acreage, which is set aside to comply with PIK grain acreage reduction programs. Such placements allow farmers to profit from both the PIK program and cattle feeding returns. Spring placements may increase as a result of the PIK option and may have a depressing effect on cattle futures from continuing high rates of placement — this has been the case for a year now.

Hog futures have moved in anticipation of an indication of increased breeding stock levels, substantiated by the March 21 quarterly USDA Hogs and Pigs Report. Such increases would bring about increased hog slaughter late in 1983 or in 1984, depending on when the expansion plans began. A survey of pork producers by the National Pork Producers Council shows plans to increase hog production by an average of 4.7 per cent in 1983 over 1982 levels. If this is to be substantiated by the report, hog numbers kept for breeding and farrowing intentions for March to May and June to August should be roughly 104 to 105 per cent of 1982 figures.

Demand for pork bellies for slicing this winter has been disastrously low, as high prices and the poor economy have choked consumption. Pork production is below year-ago levels by 5 to 7 per cent, but belly consumption has been so poor that this production level has been more than adequate. Cold storage stocks, which at one point in the fall were roughly half of 1981's level, are currently approaching year-ago levels. Residual supplies have moved into storage and depressed prices to levels where a demand-based pork-belly price recovery may be in the making.

STRATEGY: *Sell June cattle at current prices with an objective of 63¢ and close only stops at 68¢.*

For those maintaining short positions in April hogs, which reached our near-term target of 51¢, lower stops to 51.5; roll positions into December futures before April. Short positions in December hogs recommended last month above 49¢ should have stops lowered to 48.5. The hog market is entering a temporary bottoming phase at present, and we look to protect profits.

Take long positions in July pork bellies, using buy stops to enter the market at 76¢, close only; place sell stops at 72¢, close only. Our objective is 83¢.

USDA MONTHLY SEVEN-STATE CATTLE AND CALVES ON FEED REPORT

(MARCH 1, data - MARCH 14)

Chart 25

	1983	1982	1983/1982 %	Expected
On feed Feb. 1	8,052	7,055	114.1	
placements-during Feb.	1,179	1,320	89.3	96.5(90-108)
marketing-during Feb.	1,506	1,413	106.6	107.1(104-111)
other disappearance during Feb.*	121	93		
on Feed March 1	7,604	6,869	110.7	112.0(110-114)

* Includes death losses, movement from feedlots to pasture, and shipments to other feedlots for further feeding.

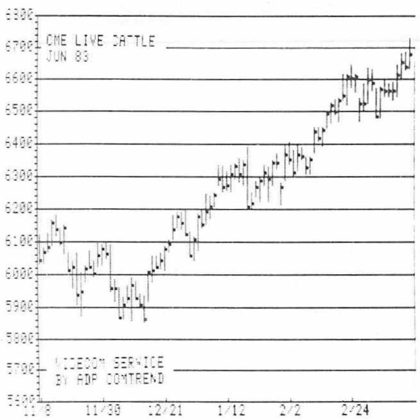

Chart 26

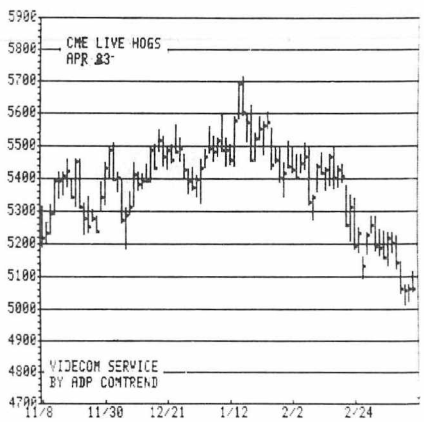

Chart 27

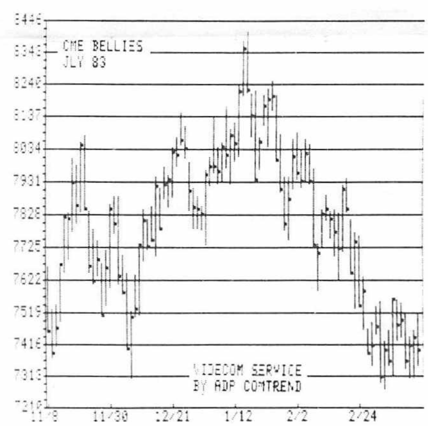

Chart 28

Grains

With dropping fuel costs due to OPEC pricing problems and current interest rates low relative to recent years, costs of production for agricultural commodities are lower than they have been for the past few years. The natural response would be to produce more; this year, however, the payment-in-kind (PIK) program offsets the effect of this response. The net effect of these factors will be shown by participation rates in the PIK program reported on March 22.

Planting intentions in 1982-1983 as polled and reported by the USDA are as indicated in Chart 29. Corn acreage was forecast to drop by over 15 per cent; wheat acreage by 8.5 per cent. Roughly two-thirds of these declines could be attributed directly to the PIK program alone, exclusive of the other price support programs, in line with our expectations outlined last month. Soybean plantings were expected to be relatively high versus the grains when compared with last year, as there is no PIK incentive to cut acreage. However, the soybean plantings intentions were interpreted as bullish. Often double-cropped with wheat in southern states, the decline in soybean plantings could cause a similar decline in wheat plantings. Oat plantings are expected up significantly as oat crops are planted as a cover crop (if planted on certified PIK acreage, these oats cannot be harvested for grain).

A survey conducted by the Federal Intermediate Credit Bank of Omaha in early February, however, showed that corn acreage could be down 38 per cent from 1982, and wheat acreage 30 per cent lower. Changing prices and changing minds will cause wide ranges of expectations of participation in the various USDA acreage reduction programs in 1983, with considerable uncertainty over the resulting planted acreages. Thus, the March 22 report will likely result in some abrupt shifts in grain prices in the following days. A recent change in legislation allowing PIK grain not be taxed as income in the year received will be a further inducement to participation in PIK.

US agricultural secretary John Block said in late February that corn PIK participation is expected to be 55 to 65 per cent of the base acreage, resulting in up to a 30 per cent reduction in corn acreage planted.

A Chase Econometrics report done for the National Corn Growers Association and recently released indicates that 1983 harvested corn acreage would have to decline to about 61 million acres from 72.8 in 1982, and to about 48.9 million in 1984 in order to reach a more desirable 15 per cent stocks-to-annual-use ratio by 1985. (The current forecast of 1982/1983 ending stocks-to-annual-use is over 45 percent.) Those levels would probably be impossible to attain, they reported. Under the assumed two-year PIK program, the analysis indicates that US corn exports in 1984-1985 would be 19.5 per cent lower than without the PIK program. The long-term appeal of the program is thus offset substantially by the expectations of the way in which higher prices in the next two years may stifle demand, particularly exports.

The USDA report of participation rates in the acreage abatement programs scheduled for March 22 based on sign-up at the March 11 deadline will be an excellent indication of acreage for harvest, owing to disincentives for failure to comply by those who have signed up.

We await that report in anticipation of our recommendations' being aided by its data.

STRATEGY: *Response to the PIK program has been much more favorable for Kansas City (hard) wheat than Chicago (soft) wheat with a spot price difference of well over 80¢. Similarly, corn price response has been much more positive. However, we would treat the current wheat premium to corn of about 35¢ in the March CBT contracts to be an opportunity to take a longer-term* investment *position at levels near recent historical lows. With the combination of heavy demand for feeder cattle and prospects that many of these could initially be grazed on wheat pastures coupled with low current wheat prices, which will cause greater than earlier expectations of abandonment, wheat prices may in fact have the most to gain. The longer prices stay at these levels, the higher prices will ultimately go in the fall of 1983 and onwards, given the likelihood of acreage abandonment.*

Retain existing wheat-corn spreads, rolling positions into September and add to positions at these levels. Maintain sell stops on Kansas City wheat position at $3.62, basis July and $3.68, basis September, close only. Maintain long outright positions in wheat as recommended last month: Subsidization of and dumping of wheat and wheat flour of the type in US sales of wheat flour to Egypt several weeks ago, and resulting competition through subsidies, are eventually positive for the market.

Look to buy July corn at 2.83, slightly higher than the levels outlined last month. Retain long positions in March '84 corn instituted below 2.95 per last month's recommendations. Place sell stops at 2.70, basis July and 2.83, basis March '84 as protection in advance of the USDA acreage abatement participation report on March 22.

Remain long July soybean meal instituted around 182 to 186, recommended last month with stops at 171, close only. Continue to hold long July Soybean meal/short July soybean oil in a 1:1 ratio.

Chart 29

PLANTING INTENTIONS - USDA Feb 17 report Feb. 1 data

	Indicated 1983	Planted 1982	1983 % 1982	Expected
- all corn	69.569	81.909	84.9	84.0 (79.4-90.0)
- soybeans	68.825	72.162	95.4	98.2 (94.1-101.2)
- all wheat	79.883	87.277	91.5	
dorman wheat	2.940	4.350	67.6	
other spring wheat	13,962	16.576	84.2	
- all cotton	9.281.2	11.499.0	80.7	
sorghum	13.068	16.144	80.9	
oats	14.747	14.211	103.8	
barley	9.675	9.634	100.4	

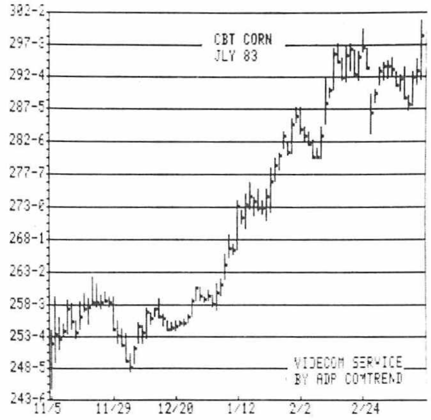

Chart 30

Chart 31

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