FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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Two Much or too Little Liquidity?

Quem Jupiter vult perdere, dementat prius. Loosely translated, it means, whom the Gods would destroy they first send mad. Applied to our present economic predicament, it would seem that the proliferation of bank-issued financial instruments and the technical difficulties of classifying these have blurred the US Federal Reserve Board's view enough to confuse both itself and its watchers. Be that as it may, and despite warning voices to the contrary, the Fed has persisted in pushing too much liquidity into the economy in the hopes of pulling a solid recovery. But is it really too much?

First, a look at the monetary aggregates. Although M1 declined in April for the first time since October 1981, the latest figures covering the week ended May 4, leave M1 nearly $9 billion above the level consistent with an 8 per cent growth rate. In the latest six months, M1 has grown at a 13.5 per cent annual rate — far faster than the Fed's 4 to 8 per cent growth objectives of 1983. Adjusted Fed credit, an aggregate directly under the control of the Fed, has shown *annual* growth rates of 12.85, 18, 19, and 15.45 per cent for periods of three months ending in February, March, April, and the first week of May 1983. By any standards, these rates of growths are excessive.

The effects of this reflation have not been slow in coming. Despite continued weakness in oil prices, the Commodity Research Bureau index of spot commodities has advanced almost 12 per cent since the trough made late last year. What is more, key industrial commodities such as copper have advanced 33 per cent in recent months *in spite of mounting surpluses,* an indication that the reflation has been quite powerful.

On the surface it would appear that liquidity is abundant. Or so it seems from the absolute growth rates of money supply *and* their impact on commodity prices. But, is it that simple? After all, liquidity is as much a state of mind as it is bundles of cash. Before the Great Depression of the '30s, loan/deposit ratios were stretched thin at 65 per cent; today, banks are flush with money at an 83 per cent ratio. What is more, the 1975 recovery *began* at a seemingly absurd loan/deposit level of 70 per cent.

It must be clear then, that short of extraneous shocks, liquidity levels are adaptable and can be stretched thinner and thinner, to an almost unimaginable fineness. Furthermore, it's almost a truism that liquidity does not flow evenly like water, but concentrates in pools. In some pools, you'll find extension of credit to securities and commodities markets (short-term and collaterallized) and syndicated loans to high-quality sovereign borrowers. But you'll also discover that credit has been cut off for shipowners, Latin American and Eastern European borrowers, and real estate operators. The compartmentalization of liquidity is so powerful that even steep rate differences are not able to pump the pools. Apart from the necessary fresh credits accompanying reschedulings, no respectable banker would even contemplate extending loans to, say, Brazil, despite the possibility of earning four or five percentage points more than lending to a stockbroker financing securities.

Since banking liquidity levels are *relatively (abysmally!)* low, any extraneous shock to the system will cause liquidity to contract. And herein lies the present dichotomy: On the one hand, liquidity is excessive and lenders are flush with money, thus driving security and commodity prices upward

In This Issue

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in a wild inflationary orgy; on the other hand, *absolute* liquidity levels are inordinately low, and psychological factors can so damage the level of comfort that liquidity vanishes, *precipitating both skyrocketing interest rates, and securities and commodities liquidation.* What is more, the longer the feeling of comfort and flushness prevails, the more surprising becomes the reversal, and the more devastating the impact.

If more proof is needed to confirm the parallel behaviour of (false) comfort (or security) and liquidity, a look at prevailing yield spreads will dispel any doubts: At the end of February, long-dated Treasuries yielded 175 basis points less than double-A-rated utilities and 140 basis points less than double-A-rated industrials. As of last week, the discounts had been compressed to 75-80 points in the case of utilities and 60-70 points in the case of industrials. An even more dramatic example can be seen in the "compression" of the T-bill/Eurospread, which last week traded *below* 90 basis points from a high of nearly 440 points in September 1982.

In anticipation of destroying our banking system, the gods first want to drive the Fed mad. Initially they invite financial deregulation to confuse the monies; they then force the Fed to navigate between the Scylla and Charybdis of liquidity/inflation and illiquidity/deflation. The amount of reliquification of the banking system needed to cushion it from such unexpected adversity as a generalized international debt default would be so large that long before we reached the desired levels, inflation would probably soar into high double-digits.

What are some likely extraneous shocks that could tighten up liquidity to the point of precipitating large-scale liquidation and soaring interest rates? For one thing, a sudden and rapid decline of oil prices *through* the safe \$20-\$25/barrel zone — an event that in our opinion is a certainty before the year is out. The failure of some oil-producing nations and large operators would devastate the largest money center banks and a number of Southwestern banks in the US. Moreover, even assuming a dramatic drop in oil prices, it is clear that a country like Brazil will not be able to continue even the *fictional servicing of its debt* for the simple reason that it will have to withdraw from the International Monetary Fund (IMF) agreement.

In a previous issue we demonstrated that Mexico would fall short of its needs during 1984, despite the \$6.5 billion financing package arranged late last year. Worse yet, its total debt would increase to at least \$114 billion by the end of 1984 — up from nearly \$100 billion in early 1983. After two years of following an *unpopular* and strict austerity program, Mexico would *find itself at least 14 per cent deeper in the hole.*

The Brazilian life-belt is just as ludicrous. Brazil must achieve a record \$6 billion surplus in trade during 1983 *to cover just half its interest payments.* To gain some perspective on what this goal implies, we should note that Brazil has *averaged a \$700 million deficit* in international trade for the past 20 years. In its *best* year, 1981, Brazil achieved a \$1.2 billion surplus, thanks to a colossal 52 per cent jump in exports over the 1979-81 years, a period characterized by favorable terms-of-trade to primary producers and the tail-end of the 1975-81 economic recovery.

Given that exports are not likely to expand vigorously in the face of belt-tightening moves by other Latin American and African countries and that strong protectionist sentiment exists in Brazil's main industrialized markets, imports will bear the brunt of the "squeeze." If imports are to drop to \$17 billion, as officially expected, *real GNP would have to fall an additional 15 per cent from present depressed levels,* setting off a potentially explosive social situation. It should be borne in mind that employment in manufacturing activities has already dropped almost 12 per cent over the past three years.

Militating against the achievement of a \$6 billion *credit* in international trade is the fact that the free market cruzeiro trades at a huge discount from official levels, encouraging overinvoicing of imports and underinvoicing of exports. Also, little attention has been paid (by the lenders) to the enormous misallocation of resources implied in the concept of "saving foreign exchange at any cost." In this connection, major domestic investment programs are being undertaken and/or subsidized, despite the relative advantage enjoyed by imported products (e.g., oil versus synthetic fuel), and entire industries have had to shut down because of a lack of imported parts and machinery.

Nonmarket methods of rationalizing imports are clearly detrimental to the growth of a vigorous export industry. In the medium term (two to five years), it could destroy Brazil's earning power. Here again, lenders are mindlessly deferring the inevitable writeoff into the future. For it is a fact that *even under the best of circumstances, Brazil's total foreign indebtedness rises yearly by at least half of the annual interest bill.* And it is also a fact that "popular" dictatorships (this one is committed to "abertura," or democratization) cannot wield painful austerity programs and still count on popular support for very long. Aggravating the already tense relationship between Brazil and its lenders — meetings in New York this week will attempt a last-ditch effort to restore interbank lines to a minimum of \$7.5 billion — is the recent introduction before the Brazilian Congress of a private bill to nationalize all foreign and locally-owned banks. According to the *Gazeta Mercantil* newspaper, the bill has caused fresh withdrawals of deposits and credit lines from Brazilian banks and branches abroad.

Even if the present Brazilian crisis is temporarily papered over, the international debt problem will not go away. In fact, payment difficulties will become increasingly more frequent and increasingly more likely to degenerate into the unthinkable default. When default begins — and in our opinion, it is only a question of time — the pools of liquidity will freeze; what was considered excessive will become insufficient.

Commodity and security prices will bear the brunt of liquidation as *overnight* deposit rates soar into the many hundreds percent per annum. Will the lenders of last resort *be agile enough* to move inside of a few hours? Consider the damage done to the markets by the Hunt affair in late March of 1980 — and that was small potatoes compared with an outright default of, say, Brazil, which constitutes 4 per cent of the total loans of the top of the US banks and perhaps as much as 100 per cent of their combined capital. And, of course, the default of one nation the size of Brazil would encourage a great number of other debtors to default *almost at once.* Will the lenders of last resort *be willing* to back unconditionally the failing institutions at the expense of the public at large (i.e., taxpayers)?

We have examined the relative meaning of liquidity. When the Fed prints too much and there are no financial accidents, liquidity is excessive. Aided by growing optimism and confidence, commodity and security prices rise, and the advance becomes ever more speculative. Banks are said to be flush with money, and money is said to be burning a hole in everyone's pocket. Volume of activity rises to feverish levels (as it has since August of last year). Value considerations are thrown overboard; high tech ventures command ridiculous multiples regardless of their chances of success. Speculative money "shoulders" ever-increasing amounts of hedge selling as witnessed on the copper and sugar markets. Markets become a giant casino. Because of compartmentalization, liquidity does not filter down everywhere; pockets of "dryness" intensify the crisis of the cash-starved sectors. Eventually, the drought spreads, and the whole house of cards comes tumbling down.

Can the world's central banks (including, of course, the IMF) do anything else *but* reflate? Yes, they can try to come to terms with the debtors of the less-developed countries in a more realistic fashion and thus avoid certain default. They must force lenders into *lowers,* not *higher,* interest charges. They must force lenders to sell parts of their portfolio to spread the risk, even if the sales are done at a discount. They must force lenders to begin a serious writeoff program.

It must be recognized that today's problems are not of a flow nature (such as money supply increases), but rather of a stock nature (balance sheet problems, such as heavy indebtedness). Increased flows cannot compensate for deficient structures in a fully-indexed financial market. The world balance sheet must first be cleansed before a meaningful attempt at recovery is made. Otherwise, all attempts to bring the world economy out of its worst rut in 50 years will be to no avail.

STRATEGY: *The long side of commodities and securities is being greased by enormous increases in liquidity. One could hardly be too careful, as it is impossible to pinpoint with accuracy the exact date of an extraneous shock. When it comes, long positions will be devastated. Stops will be of no use.*

Keep a strong short position in oil as an overall hedge (see "Energy Futures") to a liquidation crisis. Same for long T-bills/short Eurodollar spreads.

Currencies

The single most interesting comment we can offer at this time is this: Stop wasting time studying trends in current accounts as an aid to forecasting currency prices. The pundits have posited a bearish view of the US dollar for more than a year on the basis of a deteriorating US current account. In 1982, they claim, the US recorded an $8.1 billion deficit representing a swing of nearly $13 billion from the $4.5 billion surplus in 1981, and its first red ink since 1979. In 1983, the deficit is likely to exceed $20 billion; ergo the US dollar must fall.

Incredibly enough, a little-noticed and hardly talked about item in the balance of payments recorded a net capital inflow of nearly $42 billion! This item, called "net errors and omissions," is a balancing number and arises from unrecorded transactions from numerous sources: drug trade; private purchases of US real estate and securities; recycling of tax-evaded funds; etc. Since an elephant can be driven through this nondescriptive and nonanalytic hole, we might as well turn to analyzing animal entrails or (more sensibly) monetary considerations.

STRATEGY: *The US dollar is likely to remain strong for yet some time. We prefer to remain sidelined in the Deutschemark, Swiss franc, and Japanese yen. We're neutral on the British pound (although it is likely to fall with oil prices),* very bearish on the French franc, *and neutral-positive on the Canadian dollar.*

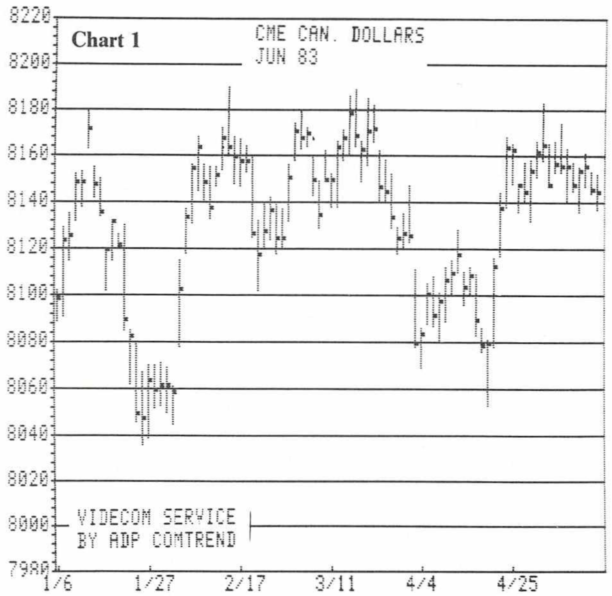


Chart 1

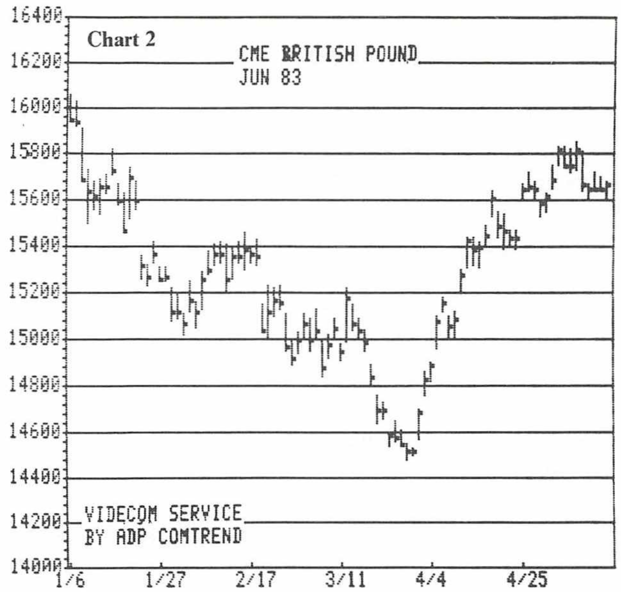


Chart 2

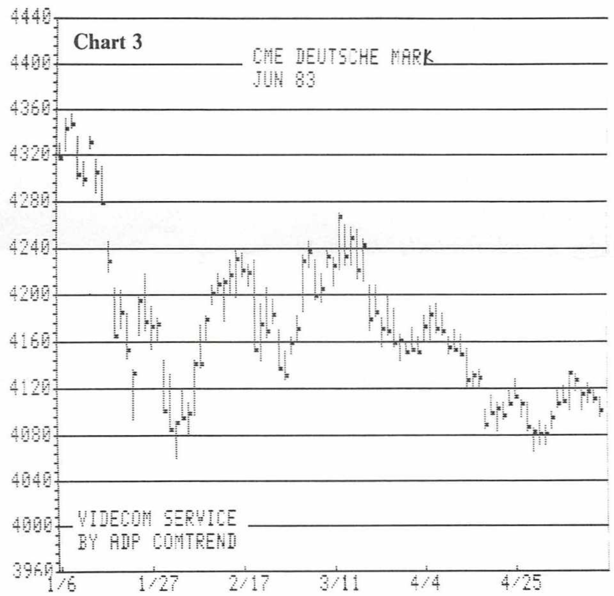


Chart 3

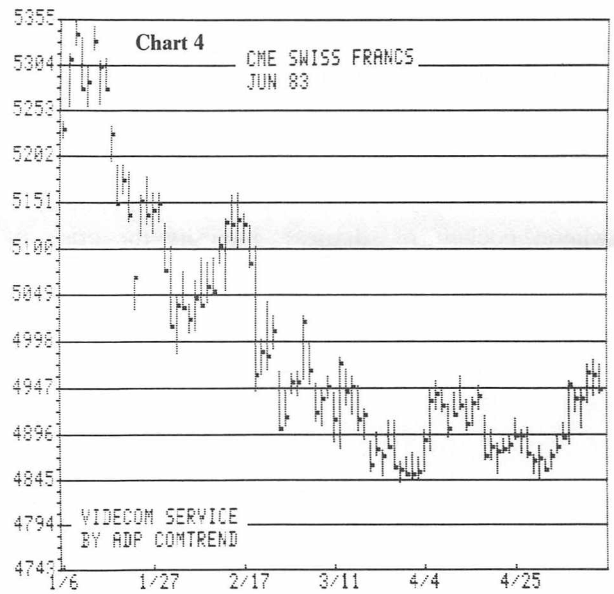


Chart 4

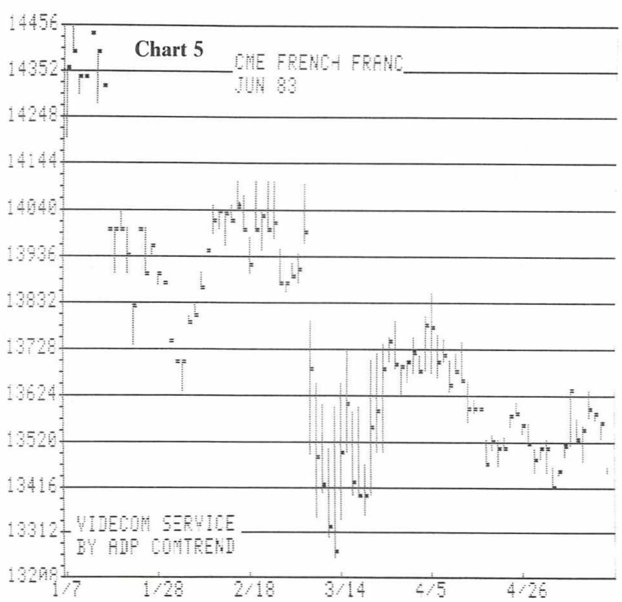


Chart 5

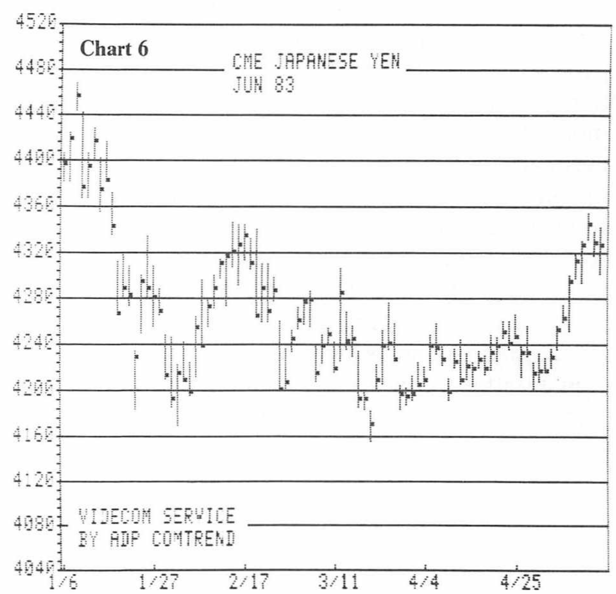


Chart 6

Interest Rate Futures

STRATEGY: *Remain short September '83 Eurodollars, with stops at 91.25. Long September '83 T-bills/short September '83 Eurodollars should be maintained in line with our opening comments. Maintain short positions in LIFFE September '83 Gilts, placing stops at 106.00, close only.*

Chart 7

Chart 8

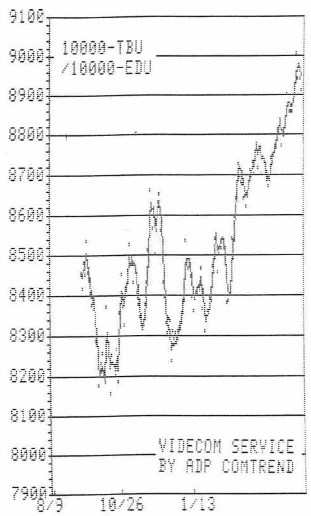
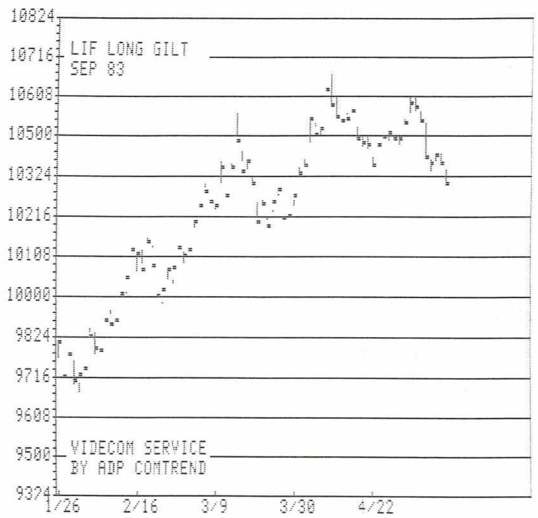


Chart 9



Musings on the Value of Gold

Is there a method of determining whether gold has entered a new bull market? We seriously doubt it. Is there, on the other hand, a method for determining whether gold is fairly priced at, say, $435/oz.? A bit more likely.

Let us start by examining gold's purchasing power. The difficulty, of course, is finding a suitable base year. As in past issues (*Commodity & Currency Comments,* February 8, 1981) we settled for 1914, the year before the great inflation associated with World War One and a year that saw central banks absorb all newly-mined gold — an indication that gold at $20.67/oz. was too expensive for nonmonetary uses.

Parting from that year, we find (Chart 11) that wholesale prices at February 1983 were 8.42 times their 1914 levels, thus indicating that gold's purchasing power equals its 1914 level at a mere $174/oz. Since gold was slightly "overvalued" in 1914 — it was thus possible to run an effective international gold standard — it follows that gold trading at $435/oz. is *grossly overvalued.*

Next we turn our attention to the issue of external convertibility. Under Bretton Woods, the world was on an effective dollar standard because the dollar was easily convertible into gold at $35/oz. This was the case right up to 1971 when the US closed the gold window in an attempt to stem its large gold losses. The losses were occurring because US external liabilities — themselves a product of cumulative payments deficits through the '60s and a sign of excessive monetary ease — were growing at an alarming pace.

Recall that in the mid-'60s, President Charles de Gaulle of France threatened to convert every reserve dollar at the Banque du France into US Treasury bullion so as to cajole the US back into fiscal and monetary discipline. Chart 12 shows that the French were doing their statistical homework. In fact, by 1962 US external liabilities began to exceed the value of the US bullion in Fort Knox *when priced at $35/oz.* By 1970 the convertibility price (the price of gold that could make possible the redemption of all US net external liabilities) exceeded $100/oz.; by 1971, the year of the fateful decision to end gold convertibility, gold should have been "worth" $176/oz. By the end of 1979, gold necessitated a price in excess of $474/oz. to cover the US net international obligations. The free-market price of gold rose to the occasion, and more, hitting a frenzied $875/oz. — clearly a sign that the rise had been overdone (so we commented in January 1980).

The monetary discipline in evidence since late 1979 reversed the US liability position. Its balance sheet began to improve. By the end of 1982, the external liabilities on the US could be redeemed at a mere $200/oz.; by February 1983, the convertibility level had dropped down to (a coincidental) $170.50/oz.

In the late '60s, a group of US academics maintained that gold was at $35/oz. *because the US was committed to* *buy it at that price;* with this commitment gone, they argued, gold would be reduced to a few dollars per ounce. They were wrong, of course, because, as we saw, the US was going broke — its liabilities easily exceeded its assets when the latter was priced at $35/oz. In theory, however, were the US to become a net short-term creditor to the world (or even a small net debtor, as now), it could remove the last *monetary* prop from under gold prices and allow it to trade at prices that would equate supply and nonmonetary demand for gold. What that price could be, considering the *monetary overhang,* is difficult to say, but it clearly would be substantially less than present levels.

Our fun and games exercise ends with a test of gold's ratio to the US federal government liabilities — currency, debt (bills, notes, bonds), and commercial bank reserves. As is well known, in 1968 the US removed the last vestiges of domestic gold convertibility that required the banknote issue to have at least a 25 per cent gold cover. Chart 13 shows what happened to this ratio. On this basis alone, it would appear that today's gold cover is quite respectable.

We have, however, considered *Federal debt as much an obligation of the Treasury as banknotes* (paper currency). With this premise, we reworked the exercise by adding in Treasury obligations and Federal Reserve obligations (i.e., bank reserves). The results are, of course, much less impressive (Chart 13 column 2). What does stand out, however, is that the gold cover of the late '60s was a great deal more tenuous than it is today (2.49 per cent vs. 7.74 per cent).

One could argue that in a fiat system, no one cares about this silly gold cover. True. We were, however, presenting a perspective on the so-called monstrous growth of federal debt. Deflated by its gold holdings, the enormous size of federal budget deficit becomes a little less awesome and may be telling us that the critical moment for gold may not come for a number of years — unless, of course, the US *adds* to its gold holdings, in which case we gold bulls may have to wait even longer.

STRATEGY: *Gold's bullish case is built on fear: fear of a banking collapse; fear of a war; etc. As discussed in our opening comments, thou, today's excess liquidity could easily turn to illiquidity and bring along a massive liquidation of commodities and securities. Gold would not be spared.*

Our analysis indicates that gold is not fairly priced at these levels *and is not likely to withstand easily a liquidating wave. Traders who heeded our advice last month and bought June '83 under 445 should maintain extremely tight sell stops at $420/oz. Investors should patiently wait for values to reappear. When? Not today. Where? Not at these levels.*

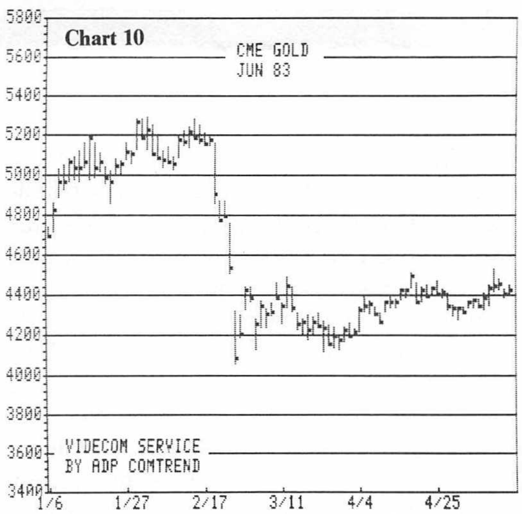


Chart 10

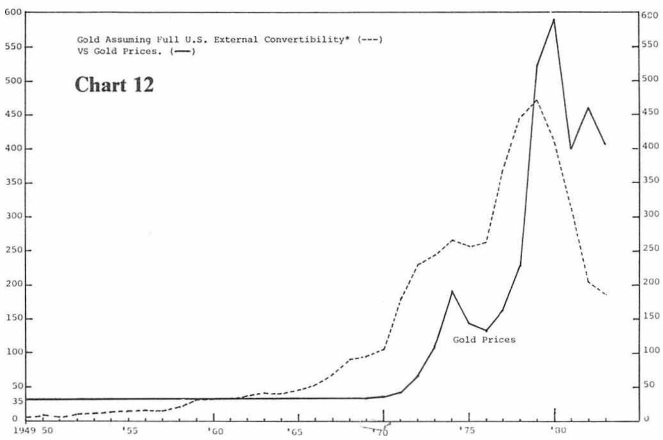


Chart 12

*Net short-term external liabilities of the U.S. divided by gold holdings in ozs.

Chart 11

	1914	1930	1940	1950	1960	1970	1980	1981	1982	1983(Feb.)
Gold($/oz)	20.67	20.67	35.	35.	35.	35.	607.87	459.75	375.80	486.19
% Inc. from 1914			69.30%	69.3%	69.3%	69.3%	2840%	2124%	1718%	2252%
W.P.I.	20.13	25.5	23.16	46.8	54.3	63.1	153.6	167.5	171.1	169.5
% Inc. from 1914		26.67%	15.05%	132.5%	169.7%	213.4%	663%	732.1%	750%	742%

Source : International Financial Statistics

Chart 13

	Gold*/Currency	Gold/Total Federal Debt**
1914	44.12%	23.35%
1915	61.01	31.80
1916	70.05	35.77
1917	70.54	29.00
1918	64.12	14.67
1919	55.52	8.14
1920	48.17	8.10
1921	68.70	10.69
1922	81.60	12.05
1923	82.04	13.20
1924	86.86	14.41
1925	85.40	14.44
1926	86.08	15.20
1927	84.35	15.30
1928	80.36	15.00
1929	84.22	16.03
1930	95.24	17.92
1931	86.56	9.25
1932	74.20	14.86
1933	70.56	12.73
1934	153.69	22.14
1935	181.88	24.88
1936	183.03	24.01
1937	198.39	25.16
1938	225.88	27.34
1939	252.62	29.68
1940	280.89	32,48
1941	236.81	28.09
1942	183.65	16.88
1943	126.17	11.14
1944	91.68	7.68
1945	75.09	6.23
1946	73.31	6.79
1947	80.81	7.57
1948	87.45	8.14
1949	89.35	8.20
1950	84.03	7.60
1951	82.25	7.45
1952	80.10	7.36
1953	78.34	6.82
1954	78.11	6.69
1955	76.59	6.62
1956	76.59	6.77
1957	79.09	7.04
1958	70.49	6.19
1959	66.13	5.76
1960	60.15	5.28
1961	56.12	4.93
1962	51.46	4.56
1963	47.11	4.34
1964	44.20	4.17
1965	37.21	3.67
1966	33.85	3.40
1967	29.28	2.96
1968	24.58	2.55
1969	25.28	2.70
1970	23.66	2.53
1971	23.67	2.49
1972	30.93	3.33
1973	49.41	5.49
1974	74.59	8.61
1975	51.30	5.63
1976	45.05	4.79
1977	50.70	5.43
1978	62.86	6.72
1979	128.14	13.90
1980	131.71	14.25
1981	84.25	8.81
1982	89.19	8.77
1983(Feb.)	80.16	7.74

Source: Federal REserve Bulletin

*Gold, U.S. holdings at year end market prices.
** Total Federal Debt equals currency, Government debt(Bill, Notes, Bonds), Commercial Bank reserves and cash in vault.

Copper

Last month we postulated that open interest in copper, when examined in terms of warehouse stocks, indicated that hedge pressure was being well-absorbed by investors/ speculators. But open interest now shows a marked tendency to decline, even as warehouse stocks grow — albeit modestly. So we must seek out a new view.

Since last writing, copper stocks in licensed Commodity Exchange (Comex) and London Metals Exchange (LME) warehouses have continued to grow but, as was the case a month ago, at an ever-decelerating rate. Aggregate stocks totaled 586,102 tonnes as of May 9, up from 561,741 tonnes April 11. The four-week aggregate increase of 24,361 tonnes compares with an increase of 22,237 tonnes during the previous review period of mid-March to mid-April. The 12-week rate of change of stocks has slowed to 12.83 per cent — the seventeenth consecutive week of decelerating increases. At the same time, open interest has shrunk and currently stands at 102,437 lots versus 117,000 lots as of last writing and a high of 128,000 lots in late February.

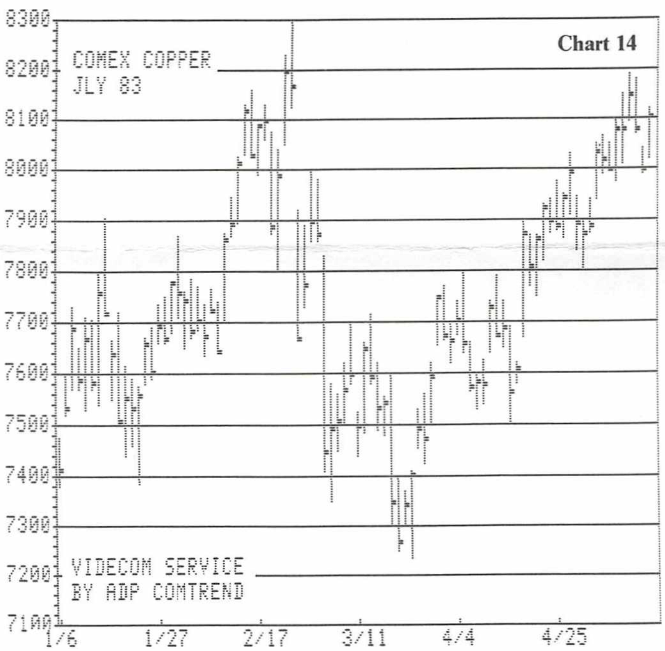
We could argue investors are liquidating previously established positions profitably; at the same time, shorts are accepting losses. Or we could say dealers are leaving nearby warehouse stocks unhedged while at the same time lifting previously-established hedges.

The latter argument would appear most likely in view of the current uptrend in prices coupled with the fairly consistent stream of bullish economic news: The last example came from The US Commerce Department, which announced that retail sales increased 1.6 per cent in April after a revised (from 0.3 per cent) 1.7 per cent increase in March. The durable goods component of sales increased at 4.0 per cent in April and 4.9 per cent in March.

That optimism is rampant in copper is reflected in a bullish consensus of 87 per cent. If our current postulations about the relationship of open interest to warehouse stocks are correct, it means the market is currently in disequilibrium inasmuch as surplus copper is theoretically "unsold." Given the decelerating rate of stock increases, the phenomenon may be temporary. For the time being, though, we must conclude the market is overbought.

Such a conclusion is strengthened by the chart picture which is currently staging its second weekly downside weekly reversal in a month.

STRATEGY: *We have been consistently bullish on copper for nine months, taking the investors' view that the market is a bull market until proven otherwise. While proof is circumstantial at present, we believe profits should be accepted and speculators should be short, risking 5¢, basis nearby deliveries. Our target is the lows of early March.*



Energy Futures

Crude and product prices are in full retreat after having punished rather heavily the mistimed short positions put out in mid-February to early March of this year (see *Commodity & Currency Comments*, April 17). Interestingly, the rally in product prices outdistanced crude prices with the consequent effect of 1) stimulating physical demand for crude and 2) stimulating renewed hedge selling in the product area to lock in the profitable crack spread. Our interpretation is that speculative short-covering in the product market, i.e., gasoil, heating oil, and gasoline futures, pushed prices up beyond their physical equilibrium levels, widening refining margins and prompting an artificial demand for crude, which sustained a 15.3 million barrels per day (mbd) demand from the Organization of Petroleum Exporting Countries (OPEC) during April.

With seasonal demand falling and the disappearance of profitable refining margins (a natural occurrence in a bear market), demand for crude has begun to abate. Unfortunately for OPEC, Nigeria is seen pressing the market at this time, having lifted at a rate of 1.7 mbd for the first 10 days of May after some weeks around 940,000 barrels daily. The conjunction of these factors has put downward pressure on

North Sea crudes, once again threatening to collapse the fragile OPEC price and quote agreement. As the old saying has it, a chain is as strong as its weakest link. This time, Nigeria is not just weak, but downright emaciated.

In a surprising cabinet shuffle, Saudi Arabia's oil minister, Sheikh Yamani, was relieved of his post as oil czar, thus paving the way, in *our opinion,* for a significant change in Saudi policy on oil strategy. It is our belief that the Saudi monarchy has begun to realize what we have been saying in recent months: Withholding supplies in order to maintain the Saudi marker at $34/barrel and later at $29/barrel is clearly not in Saudi Arabia's best long-term interest: It protects the price for other producers who cheat and take advantage of the umbrella; subsidizes the Iranian war efforts (by allowing them to sell oil at $29/barrel); loses reserves for the Saudis, which can be avoided by producing at full capacity and at substantially lower prices; loses *markets* for the Saudis and fosters continued conservation. The Saudis may be ready to accept the view of lower prices/full production. Sheikh Yamani, the personification of OPEC, for obvious reasons does not want to be around when the deal is unraveled.

With every passing day, another nail is put on OPEC's coffin. A free-fall is imminent.

STRATEGY: *Remain heavily short; look for crude to trade down to $8-$10/barrel.*

Chart 15

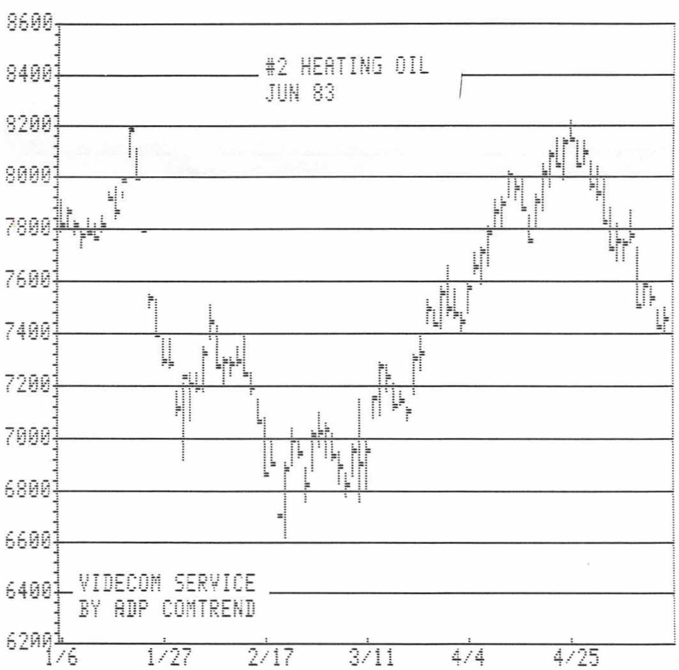
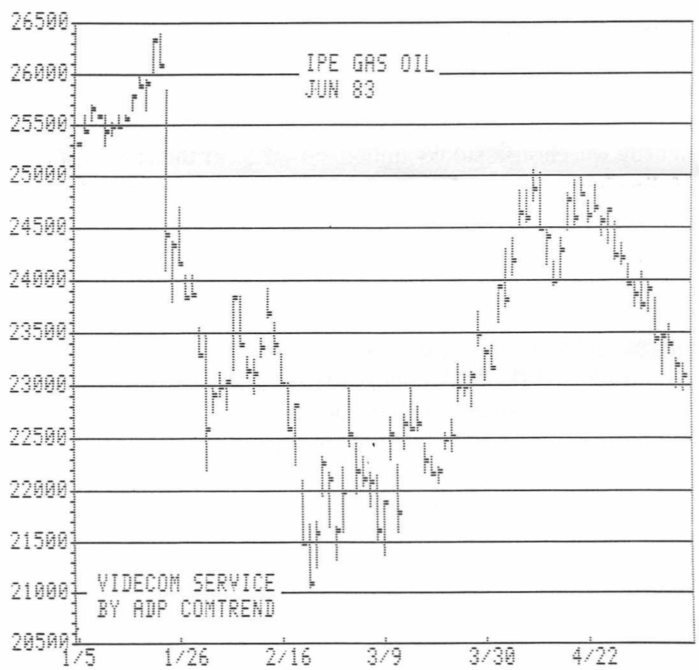


Chart 16



Cocoa

With current-year production now generally known, attention focuses upon second- and third-quarter grinding figures and, much more importantly, upon production of next year's crop, which for statistical purposes begins October 1.

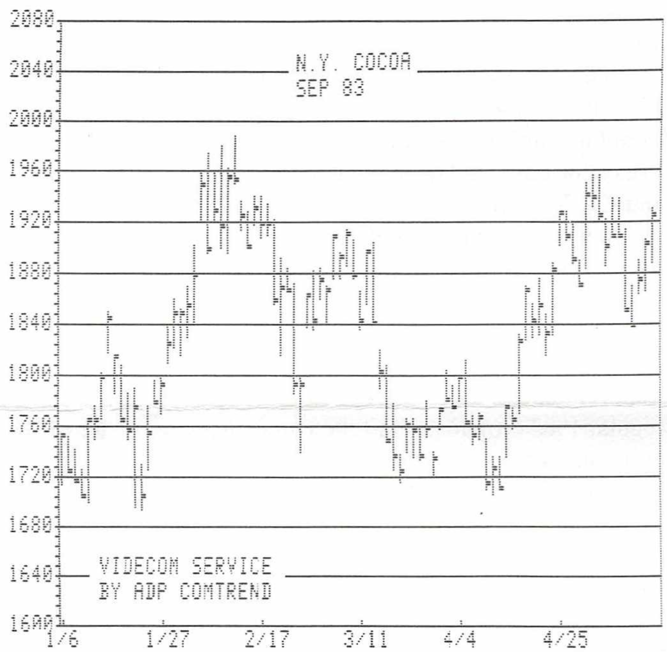
There have been trade reports of pod rot affecting cocoa trees in the Bahia region. The progress of efforts to control this virulent fungus will be closely monitored. Of greater significance will be an emerging understanding of the extent to which growth of cocoa trees in West Africa — principally Ghana — was retarded by the extremely dry weather and consequent brush fires of last month.

With outstanding commitments totalling a high 26,000 contracts, the cocoa market can be expected to be, as ever, volatile in response to news of crop developments, however authoritative. Since originally recommending the long side of cocoa several months ago, we have used as our strongest support the argument that the production-consumption cycle had shifted with the beginning of the current crop year; that consumption would continue to increase in response to relatively cheap prices; and that production would suffer as those same prices induced neglect of existing trees and curtailed the planting of new trees.

As attention now focuses on the 1983-84 crop, the following excerpts from a speech made by Bahia Trade Commission President Angelo Calman De Sa Made on May 12 are especially telling: "Prices will never return to the heights of a few years ago. The answer for Brazilian farms lies in increased productivity, not increased area . . . several years of low world-prices have acted as a brake on the future rise of Bahia cocoa production as many producers became discouraged and neglected their plantations . . ."

STRATEGY: *Remain long with stops at 1675, basis July. New positions should be assumed in London, which has remained relatively depressed in the past month owing to Sterling's strength, which is not expected to continue.*

Chart 17



Grains

The retreat continues. As we pointed out last month, wheat, corn, and soybean prices consolidated, and in fact retreated, on a lack of sufficient additional bullish news.

The most recent news was the May 10 USDA report (see Chart 18). The plantings estimate for corn was 58.812 million acres versus expectations of 56.6 million an average. This prompted the USDA to estimate 1983 corn production at 6,050 million bushels (mbu.) against 5,640 estimated April 22, and 1982 production of 8,397 mbu. Coupled with Payment-in-kind (PIK) entitlement of 1,760 million bu. and 1982-83 carryover of 3,434 mbu. (including PIK entitlement), total 1983-84 supply will be 9,485 million, only 11.2 per cent below 1982-83 in spite of the 28.5 per cent reduction in production.

The plantings estimate for soybeans was 65.810 million acres compared with estimation of 66.4 million. The USDA now estimates 1983 soybean production of 2,075 million bu. compared with 2,100 mbu. estimated April 22, and 1982 production of 2,277 mbu. The 1983-84 supply is expected to be 2,470 million bu., including 1982-83 carryover of 395 million bu. This is a reduction of only 2.9 per cent, regardless of the 8.9 per cent reduction in production.

For winter, the production estimate was 1,893 million bushels versus trade expectation of 1,818 million bu., the Conrad Leslie estimate. This compares with 2,108 million bu. in 1982, for a 10.2 per cent drop. The USDA projection of total 1983 wheat production is 2,353 mbu. as opposed to 2,265 mbu. in the April 22 report and 2,809 mbu. in 1982, a 16.2 per cent fall. This, added to 549 million bushels of PIK entitlement wheat and 1982-83 carryover of 1,550 (including PIK entitlement), means total supplies of 3,906 million bushels — only a negligible 1.9 per cent drop from 3,980 million in 1982-83. The figures were very bearish for winter wheat and corn, and in spite of "friendly" plantings for soybeans and "very bullish" crop prospects for cotton, the trend for prices on May 11 was sharply downward.

Supply and demand projection also indicated a revised USDA forecast of 1982-83 corn exports of 1,950 million bushels from 2,000 mbu., and a revised estimate of 1982-83 soybean exports of 930 million bu. from 950 mbu. Ending stocks for 1982-83 revised upward accordingly. Soybean oil projections were changed to lower production in response to lower 1983 soybean production, while other figures were constant, lowering the ending stock forecast to 1,310 million pounds from 1,365 on April 22 and up from 1982-83 ending stocks of 1,245. Soybean meal production was similarly reduced, while the export forecast was dropped to 7,800 thousand short tons from 7,950, leaving the ending stocks estimate unchanged at 280 compared with 260 for 1982-83.

The USDA acquired 761 million bushels of corn and 223 million of wheat in the program we outlined last month to obtain sufficient grain for PIK entitlement, when added to existing collateral from regular and reserve loan programs, and CCC-owned stocks. The USDA has also offered wheat producers the same type of program to induce them to turn over 1983 crop wheat to the CCC to obtain additional wheat stocks, which apparently fell somewhat short of PIK entitlement needs, even after the 223 million bushels detailed above was acquired. Any shortcoming will be met from requirements that 1983 crop wheat be entered into the regular 1983 crop loans and then *given back* to them as PIK entitlement for some types of bonus.

On April 21, the USDA estimated April 1 grain stocks, as shown in Chart 19. The figures were quite bullish for corn and somewhat bullish for wheat and soybeans. June 1, 1982, to March 31, 1983, wheat usage was down 5.7 per cent from the 1981-82 period, but January 1 to March 31, 1983, wheat usage was up 5.0 per cent from the 1982 period. October 1, 1982, to March 31, 1983, corn usage was up 2.8 per cent from 1982-82, while January 1 to March 31, 1983, corn disappearance was up 12 per cent from 1982. Soybean usage was up 5 per cent in the September 1, 1982, to March 31, 183, period from 1981-82, with a similarly larger increase in the latter quarter, January to March 1983. The higher rates of use compared with 1981-82 in the most recent quarter, as opposed to the whole season to date, arise from sharply increased feed use for livestock in the first part of 1983. Much of this was above expectations, generating increased feed-use estimates and correspondingly lower ending stocks estimates by the USDA for 1982-83.

The USDA initially estimates 1983-84 Soviet grain production at 200 million metric tons (MMT) versus 180 in 1982-83 and 160 in 1981-82. For coarse grains, production in 1983-84 is forecast at 100 MMT, imports at 15.0 MMT versus 86 MMT and 12.0 MMT respectively in 1982-83. For wheat, 1983-84 production is projected at 90 MMT and imports at 19.0 MMT, compared with 86 MMT and 21.0 MMT respectively in 1982-83.

China's 1983-84 coarse grain production is estimated at 86 MMT compared with a revised 83 MMT in 1982-83, with respective import estimates of 3.0 MMT and 2.5 MMT in two crop years. Wheat production is slated at 71 MMT versus 68.4 (revised upwards by 4.8 MMT for 1982-83 due to a tremendously improved crop). Wheat imports are projected at 12.0 MMT versus 13.0 in 1982-83.

Spring sowings in the USSR to May 9 were at 75.8 million hectares versus 65.7 in 1982-83 owing to a tremendous effort to offset the fall plantings of grain, which were severely reduced by poor fall planting weather and severe dryness in spring soils, delaying spring emergence.

STRATEGY: *Last month, we took profits in March '83 corn on the long side at 3.13. Long positions in September wheat were stopped at 3.62 but have been reinstated at 3.58 with stops maintained at 3.48. Long positions in September Kansas City wheat were stopped profitably at 3.80. July soybean meal was sold at 193 for good profits on the long side. The long meal/short oil spread was liquidated very opportunely, with good profits. The first of two buy orders in July corn was filled at 3.06 and the first of two buy orders in July soybeans was filled at 6.35.*

The bear certainly seems to have gotten back out of the bag *in view of the sharp drop in corn futures and the elimination of much of the reasoning behind the large premium of July corn over December. In soybeans, the breakaway gap was filled, and it's likely that plantings delays will continue to cause shifts from corn to soybean plantings. Our information suggests that wet weather may persist in North America through June. Sell long positions in July soybeans at the market. Sell July soybean oil at the market, risking 20.50¢ on stops, and take profits if and when 18¢ presents itself. Those preferring spreads should again buy 1 July soybean meal/sell 2 July soybean oil, risking only $1,800 per spread.*

We must admit we are in a quandary about long positions in corn. If we liquidate, we may not get back in before further plantings delays and weather problems turn the market back into an uptrend. Such is life! Because we believe 1) the July-December corn spread will go back towards par and 2) hedgers in December corn will likely be presented with an opportunity to cover short hedges at 2.80 before mid-June, then July corn may well be nearing 2.80 before our next report. Sell long positions in July corn at the market, cancelling stops at 2.92 — so much for the quandary! Sell July, buy December corn at present levels near 14¢, July over, with a target of par and risking 20¢ July over.

Chart 18

May 10 USDA Crop Production Report
May 11 USDA Supply and Demand Projections

May 1 data
(million bushels, except acreage figures)

	1983/84 5/11/83	1983/84 4/22/83	1983/84 2/17/83	1982/83	current 1983/84 / 1982/83 %	May 10 crop production expectations
all wheat	2,353	2,265		2,809	83.8	
- mln acres planted	77.369		79.883	87.277	88.6	
winter wheat	1,893			2,108	89.8	1,818
- mln acres planted	62.981		62.981	66.351	94.9	
- mln acres harvested	47.058			58.347	80.7	
corn	6,050	5,640		8,397	72.0	
-mln acres planted	58.812		69.569	81.909	71.8	56.6
soybeans	2,075	2,100		2,277	91.1	
-mln acres planted	65.810		68.825	72.162	91.2	66.4
cotton (mln bales)	8.8	9.2		12.0	73.3	
-mln acres planted	8.125		9.281	11.499	70.7	9.0

Source: U.S.D.A.

Chart 19

April 21 USDA Grain Stocks Report - April 1 data

						USAGE Jan - Mar		USAGE season to Mar	
	EXP.	4/1/83	1/1/83	10/1/82	4/1/82	1983	1982	1982/83	1981/82
corn	6,520	6,362.8	8,423.8	2,285.9	5,131.8	2,060	1,840	4,320	4,204*
all wheat	1,900	1,868.9	2,520.5	2,987.1	1,557.1	652	621	2,104	2,231**
soybeans	1,240	1,196.7	1,826.5	266.2***	1,040.6	630	--	1,350	1,286****

Source: U.S.D.A.

* corn season began October 1, 1982
** wheat season began July 1, 1982
*** September 1, 1982 soybean stocks
****Soybean season began September 1, 1982

Chart 20

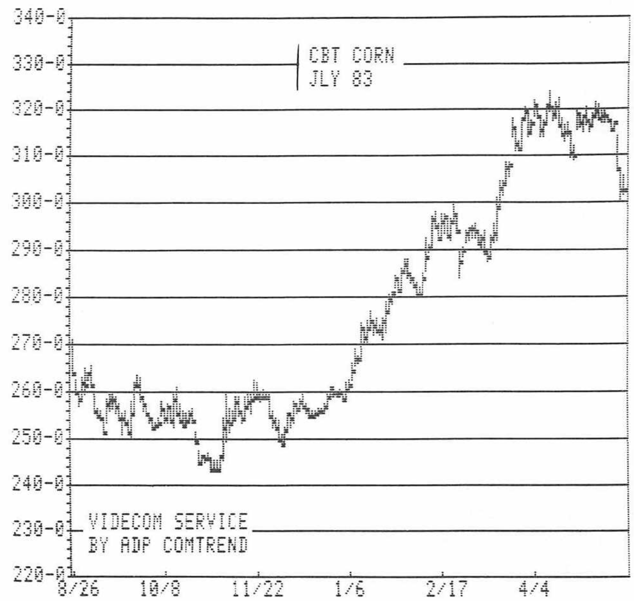


Chart 21

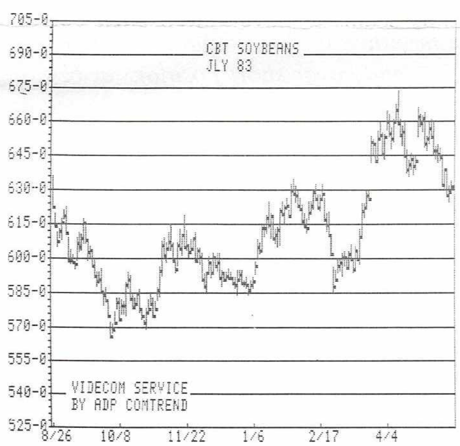


Chart 22

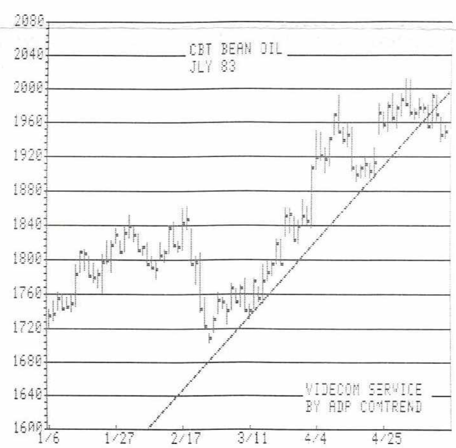
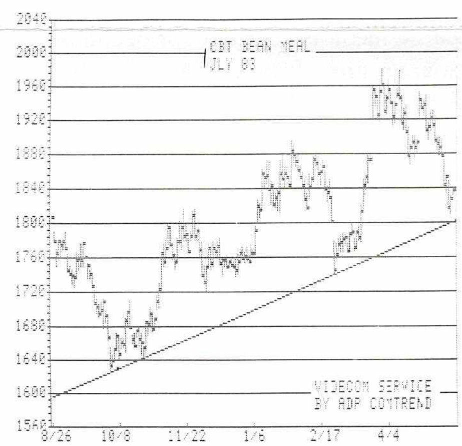


Chart 23



Livestock

At least two controversial issues pervade the livestock market at present. Will the normal seasonal rally in hog prices occur this year? Secondly, are the fed cattle markets at present "current" (i.e., marketable cattle are not in excess of existing demand levels) or are they developing a backlog (a build-up of available marketable feed cattle supplies)?

With regard to the first question pertaining to hogs, we gave reason last month that "some of the traditional summer strength may be eroded, but we would advise being wary of rally." Some analysts expect rallies of up to 10¢ in summer hog futures. A reduction in hog slaughter numbers has taken place since the peak in late April, but several factors are likely to preclude a strong seasonal rally. In our opinion, these are:

1) The expansion in late 1982 and early 1983 in breeding stock will bring market hogs to slaughter during the period of normal seasonal strength (June-August)

2) Slaughter and pork production in the past month have been 2 to 3 per cent above a year ago versus general

expectations of 2 to 3 per cent below a year earlier, indicating the extent of the breeding stock increase and subsequent market hog supply increase

3) Labor problems at the largest US pork processor, Wilson Foods Inc., accounting for almost 15 per cent of total US slaughter, while apparently alleviated for the moment, still represent a threat to live hog futures. A strike would cause a severe backlog of live hogs, depressing futures. At the same time, pork supplies would be curtailed, raising retail and wholesale prices for processed carcasses, including pork bellies

4) Red meat demand is still depressed and declining, particularly as evidence by pork belly price declines in 1983.

As noted, we would be wary of a rally, but these reasons discount the possibility of a large rise in live hog futures in the summer of '83. On the other hand, if market hog prices fall too far, too fast, producers will *open the farm doors and let 'em go!* When the hog-corn ratio falls below 14 to 1, producers tend to reduce their inventory-building. While we are in no current danger of falling below this level from levels of around 16 to 1, the resulting sow slaughter would depress current prices further while increasing price expectations for dates more than nine months in the future. At this point, we continue to believe that hog producers continue to build inventories, possibly at very high rates. That hypothesis will be accepted or rejected based on the June 22 quarterly USDA hogs and pigs report.

Returning to the second of our initial questions, are cattle feedlots "current" or becoming backlogged? Various sources provide no conclusion to this pondering. The April USDA quarterly 13-state and 7-state cattle on feed reports showed figures prompting the USDA to project second-quarter 1983 feed-cattle marketings about 9 per cent above 1982. Marketings and slaughter rates at between 100 and 105 per cent of a year ago in recent weeks might indicate that feedlots are current, when compared with numbers on feed. Developing backlogs are suggested, though, by the quarterly figures indicating heavyweight steer numbers (over 1,100 pounds), up 21 per cent, and heavyweight heifer numbers (over 900 pounds), up 42 per cent over 1982. Until some weeks with cattle slaughters more than 10 per cent over 1982 levels are experienced, we believe that a backlog of marketable cattle is evident somewhere in the US.

The monthly USDA cattle and calves on feed report released this past Friday, May 13, indicated placements in April at 100 per cent of 1982 levels, at the top range of expectations; this is bearish for deferred 1983 live cattle futures. Marketings in April were in excess of expectations, although within the range, leading traders to term the report slightly bullish for June futures. Numbers on feed were roughly as expected at 102.2 per cent of a year ago.

We expect bearish placements figures, and expectations of some backlogs of fed cattle coming to market in the next few weeks will outweigh the slight bullishness of marketings figures, causing an eventual decline in June cattle futures.

STRATEGY: *Maintain short positions in December hogs from above 49¢ with stops at 45.75¢. Resell if the opportunity presents itself at 47 and again at 48. Short positions in June cattle indicated last month at 68.80¢ should be maintained. Lower stops to 68.50¢ and cover short positions at 62¢ or before expiry of the June contract. Add to positions by selling August futures at the market, with stops at 66¢.*

Chart 24

Chart 25

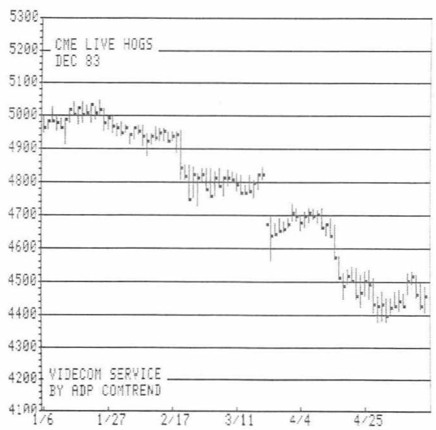


Chart 26

May 13 U.S.D.A. monthly 7-state cattle and calves on feed report -- May 1 data.

(1000 head)	1983	1982	1982/1981	Exp.
on feed April 1	7,268	7,024	103.5	
placements April	1,566	1,565	100.0	95.4 (90-100)
marketings April	1,470	1,414	104.0	101.5 (97-110)
other disappearance	143	109	131.2	
on feed May 1	7,221	7,066	102.2	102.0 (100-104)

April 18 U.S.D.A. quarterly 13-state cattle and calves on feed report -- April 1 data.

(1000 head)				
on feed Jan. 1	10,271	9,028	113.8	
placements Jan - Mar	5,047	5,572	90.6	91.1 (87- 94)
marketings Jan - Mar	5,714	5,443	105.0	106.4 (104-109)
other disappearance	451	339	133.0	
on feed April 1	9,153	8,818	103.8	103.9
steers and calves	5,816	5,668	102.6	100-105
<500 lb.	206	159	130.0	
500-699	1,109	1,100	100.8	
700-899	1,941	2,045	94.9	
900-1099	1,917	1,831	104.7	
>1100 lb.	643	533	120.6	
heifers and calves	3,299	3,111	106.0	103-110
<500 lb	170	143	118.9	
500-699	1,009	1,254	80.5	
700-899	1,404	1,208	116.2	
>900 lb.	716	506	141.5	
cows and others	38	39	97.4	110
intended marketings Apr-Jan	5,673	5,209	108.9	

April 18 USDA monthly 7-state cattle and calves on feed report -- April 1 data

placements - March	1,394	1,787	78.0	83.6 (75- 90)
marketings - March	1,593	1,642	97.0	105.3 (102-108)
other disappearance	137	96	143.0	

Source U.S.D.A.

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