

FRIEDBERG'S

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The progressive crumbling of the banking system

It will *probably not* lead to another great depression. Nor even to a severe bout of debt deflation. But it will surely litter the American financial scene with hundreds, maybe thousands, of bankrupt banks and thrifts in the weeks, months, and years to come. And it will, continuously, get in the way of fiscal and monetary policy, tending on the whole, to weaken any impulses of restraint.

Having said *that*, it behooves us to review the evidence in search of clues as to why it is happening, what can be done, and what are some of the potential implications of a crumbling of the banking system.

It is a fact, now acknowledged by every industry participant and observer, that the advent and acceleration of the deregulatory process has increased competition for funds and, for any given rate of interest, reduced relative lending opportunities, forcing banks and thrifts to accept higher degrees of risk in order to improve shareholders' returns. Since, in the short run, funds supplied to lenders are nearly

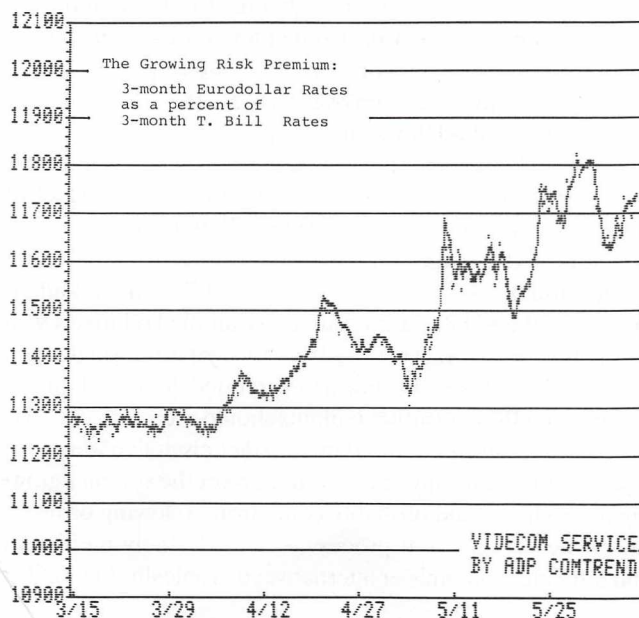
unlimited — a point that we shall return to briefly — profit-maximizing lending officers, concerned with obtaining higher-than-normal returns, put out money in such reckless form as to shrink risk premiums to the absurd. As every good insurance company officer knows, insufficient premiums are a prelude to disaster. This is true for LDC loans as well as domestic real estate, securities, and energy loans.

Strangely enough, deregulation proceeded without an iota of *countervailing discipline*, except perhaps the sporadic visitation of an employee of the Office of the Comptroller of the Currency or the FDIC. Understaffed and unable to uncover fraudulent concealment of problem loans in time, the regulatory agencies began to witness a mounting number of failures — and an alarming drain on their resources.

In fact, *and this should be elementary*, there is only one kind of discipline that could keep a system of 14,000 banks, and savings and loans honest: market discipline. The rapid increase in the threshold of deposit insurance, raised in 1980 to \$100,000 and the awesome presence of the Fed, known and (not merely suspected of) coming to the aid of the superbanks (remember Franklin National?) coincided to remove any kind of desirable market discipline. Banks and thrifts could raise practically unlimited amounts of money by simply bidding up their rates by as little as one eighth of one percentage point. Money market funds and money brokers became extremely efficient in shifting savings to the highest bidder *free of any risk* or, at the very least, with the guarantee of the US government.

It is absurd to blame failures on the mushrooming expansion of financial intermediaries who acted in the best tradition of entrepreneurs by charging competitive fees to

Chart 1



In this issue

We refine our modest proposal for a solution to the banking crisis. Whither the stock market? we ask; it can only go one way, we answer. As for currencies . . . we've run out of places to run. We're still long cocoa for now — but we issue a warning. Soybeans, hogs, and cattle still look bullish to us. Contributions by Albert D. Friedberg and Michael Beech.

channel depositors' funds to the highest bidders. *The indiscriminate sloshing around of funds was and is a direct result of the misconceived system of deposit insurance.* Outlawing money brokers, as the agencies have recommended is akin to breaking the proverbial thermometer to bring down the fever.

Skeptics, of course, will argue that the lack of deposit insurance brought about, or at least aggravated, the Great Depression, as over 5,000 banks suffered terminal runs in the early '30s. To rebut this argument would require a far lengthier answer than is possible in this short space. We might, however, point out that before 1913, the year the Federal Reserve was created by an Act of Congress, and after the establishment of a national currency, banking runs did not have nearly as devastating an effect on depositors as they did during the Great Depression.

As an example, the banking panic of 1907, widely thought to be the proximate cause of the 1913 reform, saw a suspension of specie payment for approximately two months.

In total, however, depositors' losses ran to 2¢-6¢ per \$100 of deposits for the two preceding years and never exceeded more than 18¢ per \$100 of deposits in 1907, a remarkable feat considering the lack of deposit insurance. It does demonstrate, however, that market discipline — the ever-ready danger of a run on an overleveraged and poorly managed bank — kept banks relatively honest. Their problem was merely one of liquidity — no bank could possibly pay off all its depositors simultaneously — rather than solvency. It was this liquidity problem — the famous lack of an "elastic currency" — that the Federal Reserve Act of 1913 came to solve. Instead, its function of Lender of Last Resort lulled depositors into complacency during the '20s and allowed banks to extend risky loans that ultimately forced them into insolvency.

Interestingly enough, during the '40s, '50s, and '60s memories of bank closures kept lending officers within prudent bounds, making for the most part short-term, self-liquidating, and well-collateralized loans. In time, as failures remained isolated, memories faded and a new aggressive style of banking, supported anew by unconcerned depositors, stretched the purview of commercial banking to include merchant banking and even gambling.

Which brings us to the psychedelic world of banking in the '80s. State-chartered S & L's in California can invest as much as 5% of their *assets* in common stocks and other corporate securities plus an additional 7.5% through service-company subsidiaries. Florida lets its chartered S & L's put as much as 10% of their *assets* in corporate securities and an additional 10% in stocks of other thrifts or commercial banks. S & L's in Texas can invest in common stocks, with regulators' approval, without any limits. Rather than facing the music, the Federal Savings & Loans Insurance Corporation (FSLIC) has allowed S & L's to camouflage their insolvency (having chronically lent long and borrowed short) by accounting procedures that artificially raise their earnings and capital. *An incredibly high 89% of the S & L's reported net worth of \$32 billion at the end of 1983 came from accounting gimmicks!*

In the meantime, the FSLIC continues to extend a US government guarantee to existing and new deposits of "walking corpses" in the hope of resurrecting them without having to dip into its own reserves. This insane game is certain to transform every insolvent S & L (the great majority of them) into an outright speculator: If successful, the shareholder and/or manager wins; if not, the taxpayer loses.

Recognizing quite late that deregulation and the complete removal of market discipline would end in tragedy, the FDIC — as opposed to the FSLIC — made a valiant attempt to *reintroduce* some element of discipline. Beginning with the Penn Square failure of July 1982, the FDIC reversed its long-standing practice of merging a failing institution with a solvent one and thus guaranteeing all depositors, including those with deposits in excess of \$100,000. During late 1983 and early 1984, the FDIC moved to make big depositors pay for errors by treating them as general creditors. In a number of cases, these depositors were receiving only 40¢-50¢ on the dollar. It was hoped that the FDIC's new toughened stance would change the no-lose rules of psychedelic banking.

Until the run on the Continental Illinois, that is. The FDIC, possibly forced by the Fed, could not countenance the closure of the ninth largest bank in the US. A week-long run, causing deposit withdrawals of around \$6 billion, prompted a lifeboat operation that saw the FDIC and an undisclosed number of banks inject a \$2 billion capital note subordinated to all creditors (with the FDIC's portion at \$1.5 billion), a 30-day \$5.5 billion stand-by facility provided by 24 banks (and with possible (?) Federal Reserve guarantees), and the use of the Fed Discount Window to the tune of \$4 billion daily, later reduced to \$2 billion with the proceeds of the above-listed facilities. But there was more. The FDIC issued a statement assuring that "in any arrangements that may be necessary to achieve a permanent solution, *all depositors and other general creditors of the bank will be fully protected* and service to the bank's customers will not be interrupted."

Six things became immediately clear in the aftermath of the Continental Illinois affair: 1) that the Continental Illinois is the safest bank in the world as it enjoys the *explicit* guarantee of the US government on *all its obligations* (paradoxically, its CDs still yield a premium over CDs of other "blue-ribbon" banks); 2) that the US was not prepared to allow any large, well-known bank go to the wall, *at least insofar as depositors were concerned*, and thus break the already frail level of confidence in the banking system; 3) that shareholders, directors, and managers would probably bear the initial brunt of the attack; 4) that the risk of an inflationary bailout implicit in the \$4 billion extension was handled relatively well by the Fed, removing reserves from the system through open market sales at the same time as it extended discount loans to Continental Illinois (future bailouts should therefore not raise the fear of hyperinflation); 5) that market discipline was, once again, muffled and any attempts to correct the system's growing instability would probably come from a slowing or reversal of the deregulation process — an extremely inefficient and difficult to administer alternative; 6) ironically, the FDIC's

toughened stance of early 1984, in allowing large depositors to lose money, may have accelerated Continental's demise by injecting an element of doubt in the minds of the mega-depositors; interestingly enough, the need to obtain explicit guarantees may well cause the run to spread to the country's largest banks. This may yet occur in the coming weeks as Latin-American debtors intensify their protest over imposed austerity programs and high interest rates.

It is too late for accounting gimmicks to hide the hopeless insolvency of the Citicorps, Chase Manhattans, and Manufacturers-Hanovers. Depositors must obtain either explicit guarantees or substantially higher returns (which are sure, in due course, to wipe out shareholders) than those prevailing at "safe" banks.

We have identified the culprit: deregulation accompanied by a practical removal of market discipline. We have allowed that, nonetheless, enough fear has been put into large depositors' minds that they will either withdraw funds from obviously insolvent banks (including breaking up their deposits into smaller, under-\$100,000 deposits) or demand substantially higher returns.

Explicit guarantees will become commonplace as there is no reason for leaving one's money in a less secure bank; eventually, even the best and most solvent of banks will lose deposits to the likes of Continental Illinois with its incomparable US government guarantee. But as explicit guarantees became commonplace, *all traces of market discipline will have evaporated*. Possibly too, the US government, through the FDIC and the Comptroller of the Currency, *will end up running a very large number of banks, in effect nationalizing the banking industry*.

This nightmare need not occur. Since the most intractable, most painful, and most serious debt problem is concentrated in the less-developed country (LDC) sector, the US must address this issue with quick resolve in the hope of avoiding a banking run cum widely explicit guarantees cum nationalization process. It should, after identifying the exact LDC exposure in each of the largest 20 or 30 largest banking institutions, inject an equal amount of capital — *by way of a non-voting preferred stock bearing a dividend equal to the yield on a 3-month Treasury bill plus 1%*. This preferred stock would cushion these banks against the almost certain danger of default. *The preferred stock will have to be amortized out of profits*, with a provision, of course, that no dividends could be paid until the issue has been retired.

This procedure has some clear advantages: 1) It does not involve a taxpayers' subsidy; 2) it does not discriminate in favor of the larger banks, as they would be paying market rate

of interest; 3) it does not write off or amortize LDC debt with the perverse effects it may have on debtors' attitudes; 4) it concedes to these banks' claims that LDC loans are serviceable and will someday be fully repaid; 5) it shifts the potential losses to the shareholder, an eminently equitable position. In effect, what this procedure will do is capitalize insolvent banks in a very short period of time, thus removing any fears of a collapse. Furthermore the preferred stock injection will provide the banks with a new source of funds capable of generating additional profits and an accelerated redemption of the preferred issue.

Simultaneously, the FDIC should introduce *gradually* a system of deposit *co-insurance*, which should shift at least a small portion of the risk to the depositors but large enough to make them discriminate between failing and solvent financial institutions.

As for the Fed, it should restrict itself to "lend, continue to lend and lend boldly," as Mr. Preston Martin so aptly paraphrased Walter Bagehot, the father of central banking. It should only provide liquidity against good collateral, overcoming the only defect of the pre-1913 banking system. Finally, a much more realistic approach should be taken with regard to the compounding growth of LDC debt, a discussion that lies outside the scope of this article but which has been covered a number of times in past issues (see especially "Deflate the debt, please," December 18, 1983).

Human affairs and political considerations being what they are, it is very likely that recurrent banking crises will be handled on an ad hoc basis, piecemeal and lacking any coherent formulation or, at least, a vision of the ultimate consequences. We must, however, reject out of hand the deflationary scenario painted by some well-respected financial observers: The Fed is committed to a controlled form of bailouts and to a *more or less* gradual increase in the money supply. By the same token, there is little or no incentive to pump up the money supply in order to liquify debts, as much of it is indexed to highly sensitive market rates of interest. Nor are bailouts, as we have seen, necessarily a source of high money growth. Therefore, hyperinflation is not a likely probability.

STRATEGY: *The major impact of this crumbling effect on the (world) banking system should fall on the stock markets, particularly shares of LDC "contaminated" banks. Also, risk premiums should continue to widen, helping our long-time favorite Ted Spread, i.e., short Eurodollars versus long T-bills (see Chart 1).*

Stock Markets

The lateral consolidation initiated in February of this year came to an end in early May as the S & P 500 Index reached barely over 162 to meet the declining 30 weeks' moving

average. From that point on, it declined approximately 8.5%, achieving new lows for the ongoing bear market. All major indices, including the breadth figures, confirmed the new leg

down. Net new lows for the week ended June 4 exceeded 400 issues, handily surpassing the previous level of 247 issues recorded for the week ended February 24.

Although sentiment indicators continue to show a consensus prevalence of bears, it should be noted that present readings are by no means extreme and are only favorable when compared with the June-August 1982 lows, commonly thought to represent the lows of the 1981-82 bear market.

As we have repeatedly pointed out in previous issues, the 1981-1982 episode represented merely a *correction*, indeed the last one, to the bull market in stocks that began in late 1974. The 1984 top is but the beginning of a long and painful bear market (see "The day of the bear," September 18, 1983) that should wash out the excesses of nine long speculative years. As such, any comparison to the 1982 bottom is superficial and likely to prove expensive.

Latent bullishness is still indicated by the fact that May saw \$374 million of initial public offerings, double the April pace of \$184 million, and a very respectable pace, at least compared to 1981-1982. Furthermore, aftermarket prices of those new issues have performed relatively well. Leveraged offers and buyouts have accelerated in recent months, while everyone involved turns his head to the next financier and warns of impending doom.

The progression is beyond rational comprehension: \$2 billion in 1982; \$4 billion in 1983; and over \$10 billion so far

this year! The wherewithal to do these deals is slowly being pulled: Securities portfolios at commercial banks, their second tranche of liquidity, have not only stopped growing but have already declined for four months or more, a prelude to a scramble for liquidity in the not-too-distant future.

Worldwide, other markets have topped out and confirmed the severity of the oncoming decline. In the brief period of four weeks, Tokyo dropped 11.5% as measured by the Nikkei-Dow Average. Despite the severity of the decline, margin debt, as at the end of May (and a few days before the recent bottom) had risen ¥41.5 billion to a record ¥2,784.2 billion (US \$12 billion), a testimony to the madness of crowds. In London, the FT index plunged 13% from its recent record high, breaking in the process the very crucial uptrend from the October 1983 lows. As a matter of more than passing interest, we note that the advances in London and Tokyo in recent years equal approximately the parabolic curve that began in 1926 and led to the 1929 Wall Street crash!

STRATEGY: Our Hotline update (see page 12) advised reinstating short positions in June '84 S & P 500 at approximately 154.50. After a rapid dip to 149.00, the market has recovered and now stands at 155.20. We now advise rolling June '84 into September '84 and placing stops at 156.50, basis the Cash Index, close only.

Chart 2

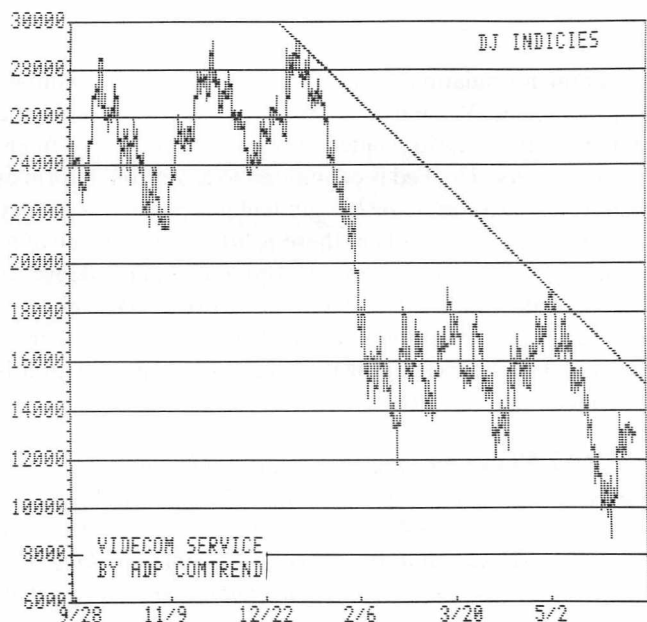
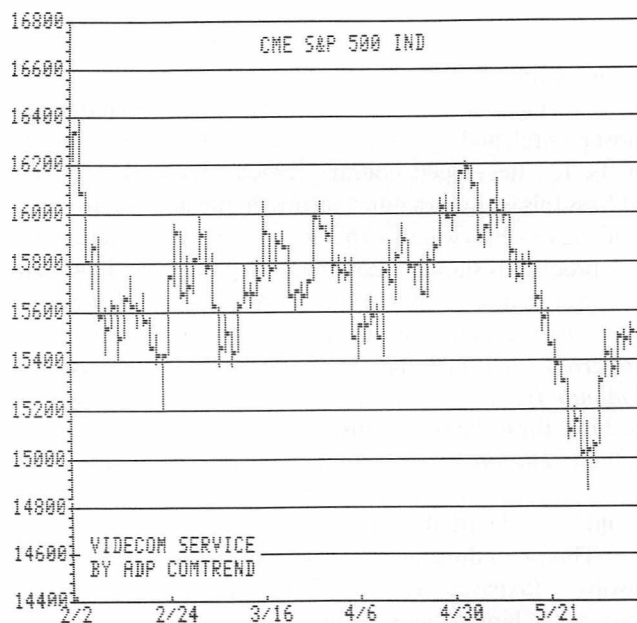


Chart 3



Currencies

Banking fears played havoc with the US dollar, at least for a number of days. On one hand, perceptions that the Fed would be unable to continue its much desired restraint; on the other, large deposit shifts, out of Continental Illinois (and

perhaps Manufacturers-Hanover) and into some foreign banks, causing a sudden and violent wave of dollar selling.

The Fed, in fact, is not likely to be excessively accommodative in an overall sense, allowing itself to fund on a case by

case basis. Moreover, a neutral Fed stance would still collide with rising credit demands and produce eventual tightness. Deposit shifts into European and/or Japanese banks should very soon be back, enjoying the comforts of a US government guarantee. There is, literally, nowhere to run . . .

STRATEGY: In a number of transactions, we covered the highly profitable DM position and advised concentrating short positions in the Japanese yen (see Hotline Update, page 12). We continue to believe that the US dollar will scale to new highs and feel that the highly overvalued yen may be the safest and most profitable short trade. Place stops on September '84 yen at 44.40, close only. DM lovers could re-enter the short side of this currency if September '84 closes below 37.25.

Canadian dollar

Remain short; keep stops at 77.75, basis September '84, close only. In what may be a first ever in the history of rival futures contracts, the Toronto Futures Exchange has launched rather successfully a US \$100,000 contract, denominated of course in Canadian dollars. First-day trading exceeded 1,000 contracts, while Friday, the volume was still recording a respectable 700 contracts. It counts with the enthusiastic support of the Toronto banking and brokerage community and may some day replace the IMM's hegemony in this currency.

Chart 4

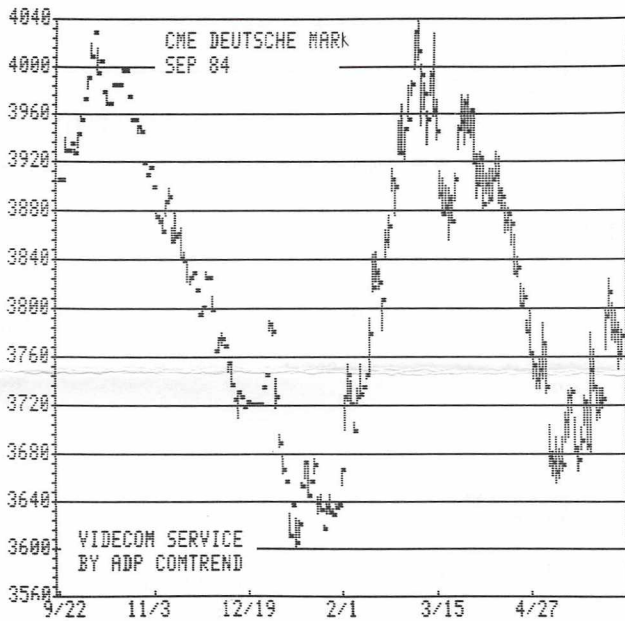


Chart 6

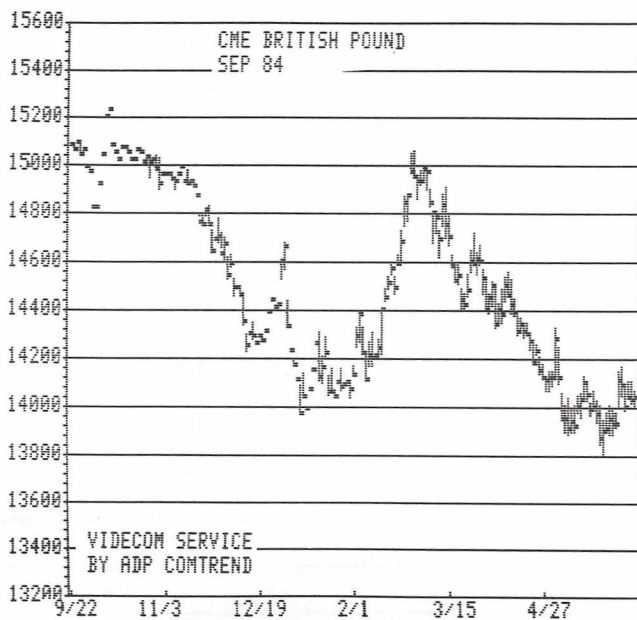


Chart 5

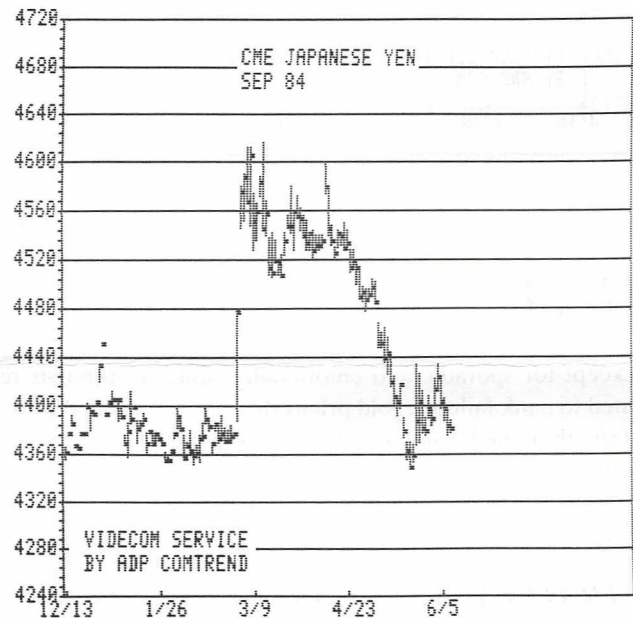


Chart 7

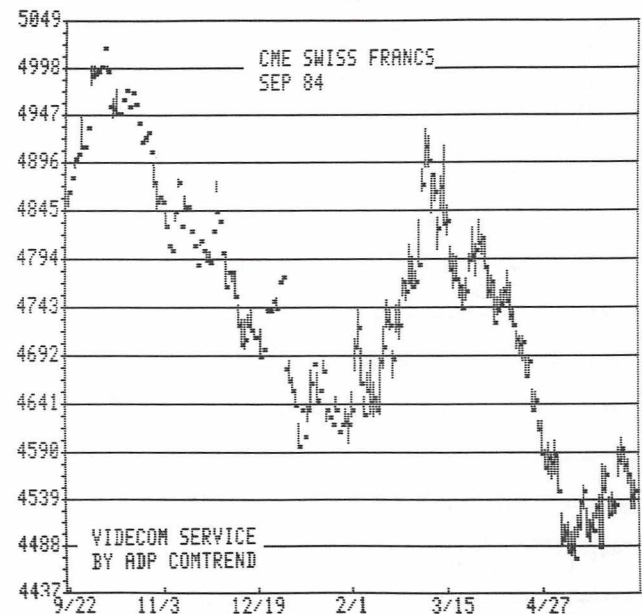


Chart 8

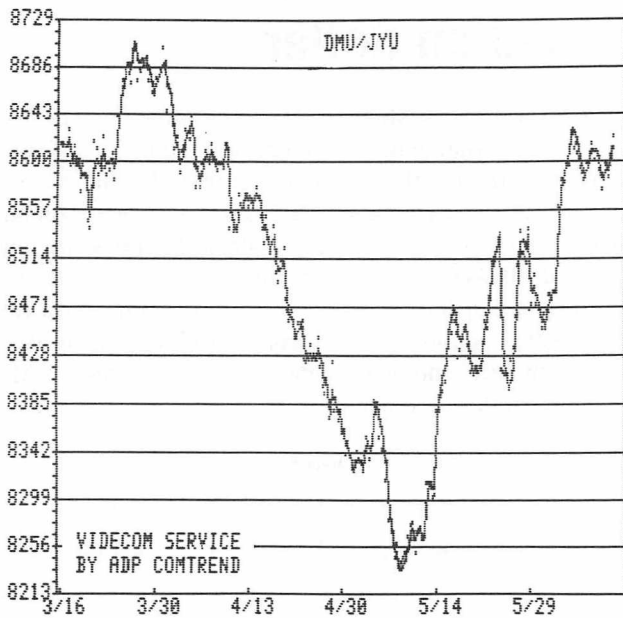
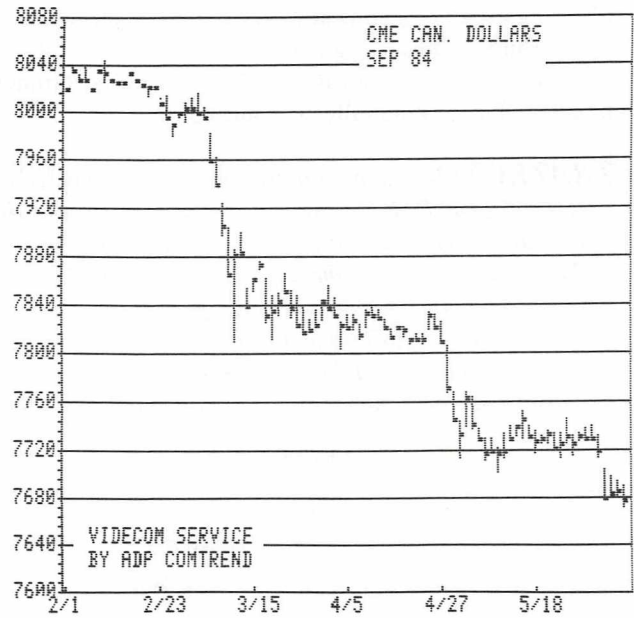


Chart 9



Metals

Gold

Except for sporadic and emotionally-induced outbursts related to bank failures, gold prices should be restrained by the strength of the US dollar in foreign exchange markets as well as by the relative success that the Fed may have in handling, in a non-inflationary way, the bailout of faltering financial interests.

STRATEGY: Our short position was stopped out profitably at around 402, basis December '84, and new long position

opened at approximately 410, basis December '84 (see Hotline Update, page 12). Keep stops at 402, basis December '84, close only.

Copper

STRATEGY: Reentered long side at approximately 66.50, basis September '84 (see Hotline Update, page 12). Place stops at 63.90 (note change), close only.

Chart 10

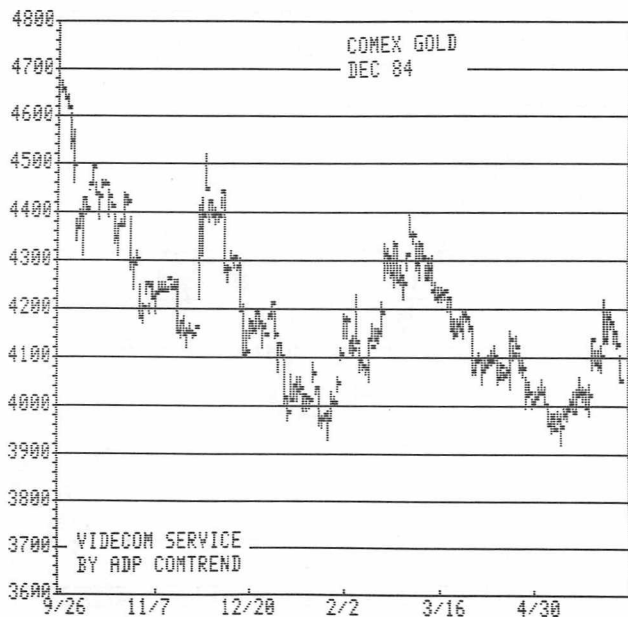
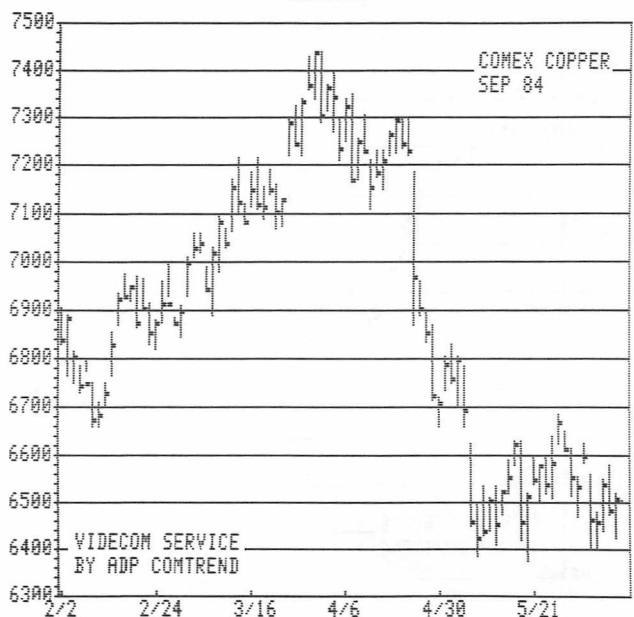


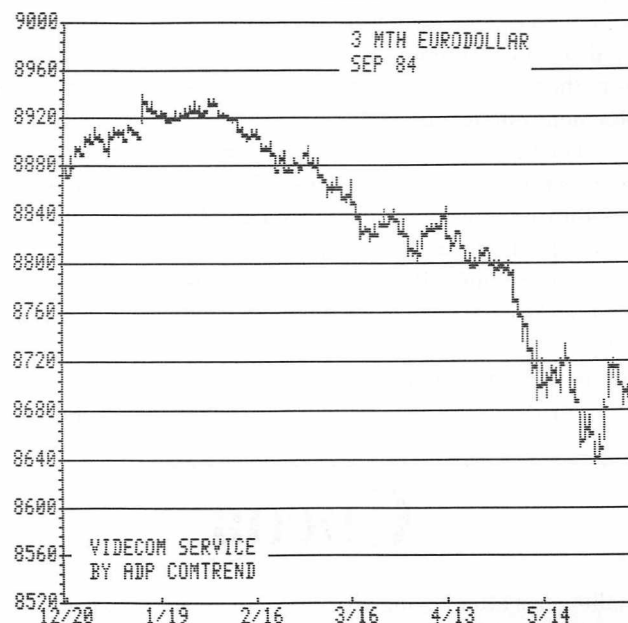
Chart 11



Interest Rates

STRATEGY: Remain short half of the original Eurodollar position, having taken profits below 88.10, basis June '84 (see Hotline Update, page 12). Roll balance over to September '84 if not already short that month as per last issue's comments.

Chart 12



Lombard

Transferring the Hong Kong magic

By Anatole Kaletsky in Hong Kong

(From time to time we'll publish articles and opinion from other journals that we think will interest and enlighten you. Here's a brilliant piece from the Financial Times of London.)

There is only one convincing argument against the many people in Hong Kong who condemn as "betrayal" the British Government's totally unsuccessful efforts to negotiate a satisfactory agreement with Peking over the colony's future. It is that betrayal usually implies some gain for the betrayer. But the Government has failed to extract an iota of national advantage for Britain in the process of paving the way for what could become one of the century's great human and commercial tragedies.

Yet the Government could have helped Hong Kong and simultaneously brought substantial economic benefits to Britain. It could simply make all of Hong Kong's 5.4m residents into full citizens of the UK, with an absolute right of abode in this country. The second best — and morally minimal — solution would be to give this right to the 2.6m people in the colony holding British Territorial Dependency passports. This would still leave the other 2.8m effectively stateless (as all 5.4m are today) and would compare unfavourably with the treatment of the Falkland Islanders.

But it would be good enough to achieve one of the central aims of the exercise: to force the Chinese to offer the sort of guarantees which would prevent much of Hong Kong's

population and all of its wealth-creating talent voting with their feet between now and 1997.

Suppose the Chinese were foolish enough to ignore this possibility or, more likely were simply indifferent about whether they regained possession of a prosperous Hong Kong as opposed to the barren rock which they ceded to Palmerston. Britain would then be "flooded" with Hong Kong refugees. This flood could help to reduce unemployment, strengthen the financial viability of the state social security system and, in general, provide the country with an economic windfall comparable to the discovery of North Sea oil (and a much needed one, since oil, will be rapidly running out by 1997). If all this seems insane, it is only because of the lack of political leadership and economic insight displayed on the immigration issue by one British government after another.

The widespread prejudice that immigration causes unemployment is merely the most pernicious form of a fallacy known as the "lump of labour theory" — the idea that there is a given amount of work to be done and output to be produced in the country, so that any increase in the labour force — or in the number of hours worked — results in unemployment.

But without rehearsing the theoretical arguments against this ludicrous notion — which ignores the fact that every new worker is also a new consumer — it should be sufficient to note that in the past 10 years unemployment has climbed to record levels throughout Europe, while immigration has been

stopped or even reversed through the deportation of "gastarbeiters." The U.S., which continues to benefit from about 1m legal and illegal immigrants a year, has meanwhile descended from the top to nearly the bottom of the international unemployment rate league table.

The benefits to Britain — and particularly to the poorer areas of the country where they could be encouraged to settle — of a vast infusion of the legendary Hong Kong entrepreneurship (along with the capital to support it) should be apparent enough. But four other points are less obvious. First, as UK citizens, Hong Kong residents would automatically also enjoy the right to live and work in any other EEC country. Second, a large influx of young workers would help to compensate for the ageing of Britain's own population,

which is causing concern about the viability of the social security system in the 21st century. Third, some British manufacturing workers are being displaced anyway by Hong Kong labour, so it might be as well to let the labour come to the jobs instead of vice versa.

Finally, and most important, by 1997 Hong Kong will no longer be a cheap-labour developing country. In fact, if the trends of the past 20 years were to continue, its GNP per capita in 1997 would be 22 per cent higher than Britain's, having started the 1960s 75 per cent lower. A few million people who could achieve that must surely be worth having.

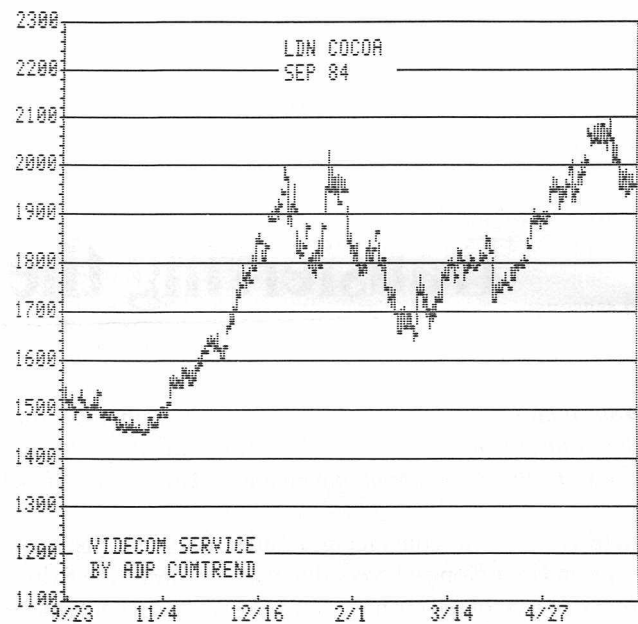
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Cocoa

Stalling just after having broken out of an impressive triangle, the market did not "act" well, particularly in view of the substantial 4,500 contract increase in the open commitment, an indication perhaps of informed Origin selling. It is hard to believe that sufficient distribution has taken place to invalidate many months of prior accumulation. Furthermore, London has been gaining consistently over New York, an indication perhaps that purely speculative selling is bucking improving fundamentals.

STRATEGY: Long positions in London (as recommended last month) have suffered little in the recent stakeout. We advise maintaining long positions in September '84 London cocoa, risking £1,795, close only. Liquidate New York position should September '84 close below 2385.

Chart 13



Grains and Oilseed

Times change! Last month we were faced with relatively weak corn prices and strong soybean prices. This month the reverse is true. Next month? We'll try to explain.

The soybean complex has broken into a headlong downward spin. Why? Largely owing to the successful progression of the Brazilian soybean harvest. And when will it end? We think very shortly, from which point the bull market will continue.

Last month, plantings delays in the Midwest corn-producing states were abruptly reversed in the middle of May as weather patterns improved. The price strength from plantings delays was broken just before our May 13 *Comments*. Before that, corn prices had consolidated from their sharp losses arising from the bearish April 23 stocks report, and the

almost vindictive sharp resurgence of the US dollar during April. Up to that report, corn prices had advanced strongly owing to a long period of exceptional export demand.

Soybean prices, on the other hand, rose sharply in May following the *bullish* interpretation of soybean stocks reported April 23, and calculation of very tight edible oil supplies which caused skyrocketing soybean oil prices (soybean oil makes up about 32% of world edible oil supplies). At this juncture, soybean plantings are progressing very well, with 51% of expected plantings complete by June 3 and no significant plantings delays in sight. Soybean prices now are weakening under the pressure of hedge selling associated with these plantings (as happened with corn in mid-May) and with the Brazilian soybean harvest.

Following the period of weakness in corn prices during sowing, corn prices rebounded to the upper part of a trading range that has developed in December corn between 2.90 and 3.07. We expect a similar rebound in soybean complex prices following completion of the bulk of plantings in the next several days.

The other main factor, though, is the Brazilian soybean harvest. As we have stated, Brazil has, in the past, exported more than her available export surplus of soybeans in her post-harvest season to take advantage of high US prices. Since the Brazilian crop is harvested in April and May, it comes at a time when US suppliers are often running short. By selling at high prices in the summer before the US crop is harvested, Brazil effectively "lends" supplies to the market. Later, following the US harvest in October and November, Brazil re-imports soybeans or products from the US or Argentina to meet domestic requirements at substantially reduced "new crop" prices. This has occurred this year in spite of all the publicized Brazilian restrictions on exports.

Soybean oil, which is tightest in supply among the soybean complex, rose most sharply; now, following the progression of plantings in the US and Brazilian harvesting, it has retreated most sharply. Soyoil, at its recent highs, comprised about 55% of the value of the crush of one bushel of soybeans, against a more normal 35%, owing to forecasts of extremely tight world supplies. At the end of last week (June 8), soybean oil made up a reduced 47% of the crush value for the following reasons:

1. Brazil and Argentina have partially released restrictions on exports of surpluses to the world market in recent days. Brazil currently allows soyoil export registrations of 80% of last season's registrations, until the end of July, when it further eases restrictions. Only 60% of last season's volume may be exported, however, before the end of July, with the balance afterward. Shortly after the May 11 reopening of Brazilian export registrations, it became obvious that export sales were exceeding availability as exporters attempted to take advantage of high international prices and the need for foreign exchange. By late May, 505,000 metric tons (mt) of soyoil had been registered for export to the end of July, having only about 350,000 mt for export in the remainder of the calendar year (exports limited to 80% of last season's 1.07 million mt exports, i.e., 856,000 mt).
Argentina, which for several days had restricted soybean and product exports also, until June 5, is now expected to export 375,000 mt of soyoil in 1983-84 (Oct.-Sept.) compared with 330,000 estimated in April and up a sizeable 36% from the 275,000 mt exported in 1982-83.
2. Talk of increased Malaysian palmoil production and a relaxing of the severely tight world edible oilseed supplies. Peninsular Malaysian crude palmoil output rose to 248,882 mt in April from 205,788 in March and a drought-reduced 216,484 mt in April 1983. However, Malaysian output in the first four months of 1984 was down to 756,838 mt from 816,455 in the same 1983 period; similarly stocks are currently down almost 50% from a year ago. Since palmoil,

comprising about 17% of world edible oil supplies, is the largest volume competition for soybeans among oilseeds in 1983-84, this has considerable importance. In 1983, not only had world soybean production fallen sharply owing to the large reduction in US output but palm oil production was also reduced sharply by drought in the Far East, cottonseed output fell significantly along with world cotton production, and rapeseed output fell in major producing nations, including Canada and the EEC.

3. Export demand for US soybean oil has been rationed sharply by spiraling prices this spring.

However, bearish news aside, with the vicious correction in soybean oil prices, we believe the market is poised for a resumption of the bull market in grains and oilseeds as the evidence of tightness of supplies grows. Given total soybean supplies in 1983-84 at 20.7% below 1982-83, corn supplies at 30.3% below last year, and export commitments (amounts already exported plus contracted sales, *minus* future cancellations) to date of 86.4% of the year ago level for soybeans and 96.3% of last season for corn, prospective exports exceed the availability of US supplies, particularly for corn.

The highly-regarded publication *Oil World* said May 22 that world soybean and soybean oil stock-to-use ratios will fall to their lowest levels in 11 years this fall. Soybean stocks of the major exporters (US, Brazil, and Argentina) will be 11.0 mmt (404 mln.bu.) by September 1, 38% below last September 1, and only 12.5% of annual usage. *Oil World* also reported that soybean crushing is currently above the sustainable rate as available supplies in June through August are only 92% of last year's level. With regard to US supplies, US carryover will be equivalent to only 3 weeks usage, the lowest stocks-to-use ratio since the 2.6 weeks reached in 1973. Soybean oil stocks will fall to only 3.9 weeks' usage versus 6.2 weeks last year, and 5.6 weeks at 1976-77 end. World soybean oil ending stocks will fall to below the 4.0 weeks' use experienced in 1973 when prices reached an all-time high of about 45¢.

Oil World says world disappearance of soyoil rose to 3.6 mmt in January to March 1984 from 3.15 mmt in April to June as competing oils run out. *Oil World* calculates world supplies of the five major edible vegetable oils (soybean oil, palm oil, sunflowerseed oil, rapeseed oil, and cottonseed oil, respectively) in April to June 1984 at 11.9 mmt, 4.3% below January to March 1984, 7.4% below October to December 1983, and in July to September 1984 at 11.4 mmt, 4.5% below the current quarter and a very large 8.5% below the comparable 1983 quarter. *Record prices should be in order.*

Of course, the rate of Brazilian and Argentinian exports will be critical, as will the progress of the soybean and corn crops in the US this summer. The USDA 90-day outlook calls for hot, dry weather in the Midwest during the growing season.

Following the cool, wet spring, plant root structures may not be sufficiently developed to prevent a recurrence of last season's weather problems. (The USDA estimates 1984 winter wheat production and gives projections for the corn and

soybean crops based on analysts' judgments and yields trends on June 11.)

STRATEGY: Remain long July soybean oil, rolling

Chart 14

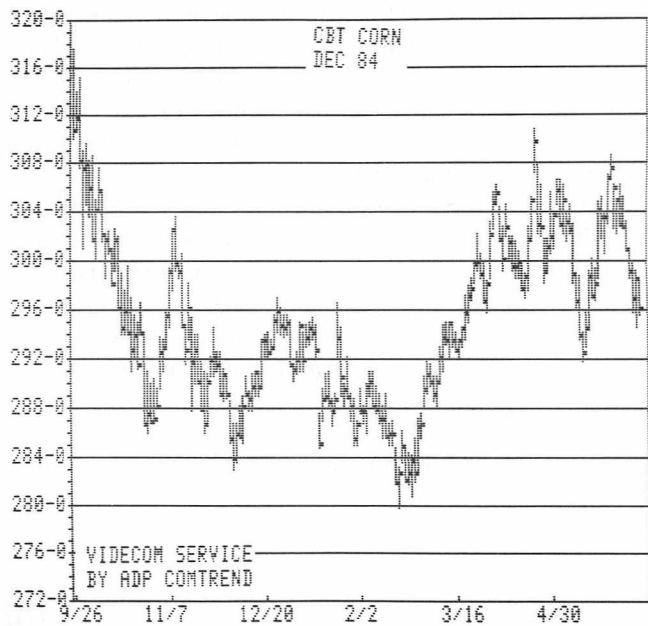
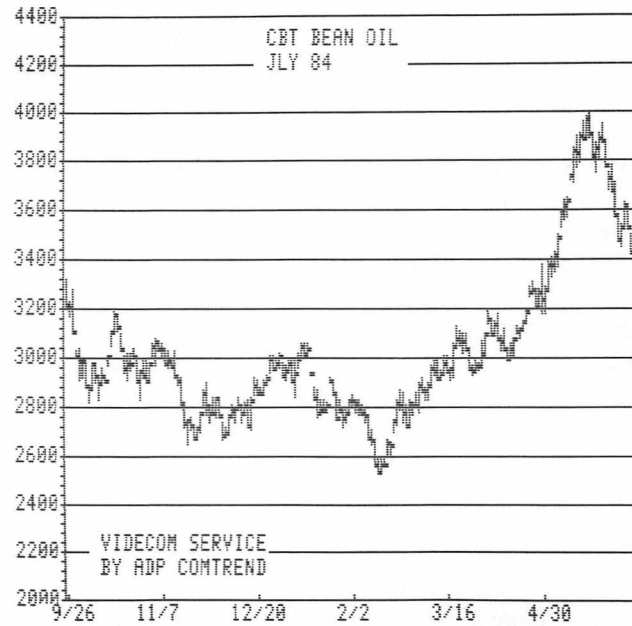


Chart 15



Livestock

We don't want to be stubborn . . . just intransigent! Hog prices have stuck around the mid-to-upper 50's mark as hog slaughter has remained higher than expected. Why?

Two possibilities exist: that hog numbers (partially heavy-weight hogs) were understated in that report; and that sow slaughter has exceeded all reasonable expectations. We think the situation is a combination of these. Either way, higher-than-expected slaughter now should result in lower slaughter in the second half of 1984. The upcoming June 21 hog report will provide proof of actual hog numbers to forecast prices through the summer and fall of 1984.

If the hog report is as bullish as we expect, showing very low sow numbers (kept for breeding) and commensurately lower market hog numbers for fall, the bullish implications of the report should continue until early 1985. Hog production is still not profitable based on the hog-corn ratio at about 14 (100 pounds of live weight hog is worth the same as 14 bushels of corn). A hog-corn ratio of over about 18 would be necessary to induce expansion by hog producers. Sow slaughter as a percentage of total hog slaughter is still quite high at 4.1% to 4.4% in the most recent four weeks, indicating that hog producers are still cutting back to some degree on future hog production plans.

The May 14 monthly seven-state cattle-on-feed report (Chart 16) was interpreted as quite bullish, with placements on feed during April a full 4% below expectations. In addition, marketings during April were a large 3.3% above expectations,

into August when necessary, maintaining stops at 33¢, basis July, good anytime. Also, remain long December corn as an investment-type position with stops at 2.90, close only.

meaning cattle feedlots were left a lot more "current" than earlier expected. However, even if there has not been a "backlog" of ready slaughter-weight cattle, there has been a steady stream of slaughter cattle, which has severely curtailed fat cattle prices. However, as we pointed out last month, the bulk of cattle on feed currently are at heavy weights. Thus, a much larger proportion than normal will be slaughtered in June. In fact, by August, we calculate cattle slaughter will fall to below year-ago levels for the same reasons that hog slaughter this summer will be sharply curtailed; namely, high grain prices since 1983, unprofitable market prices in the past several quarters, and current high interest rates.

The heavy May and June cattle slaughter has sent June cattle futures into a sharp downtrend, but we feel that the bottom in June '84 through April '85 cattle futures may have already been seen. We strongly recommend long positions in December cattle.

Current cold storage stocks of meat (Chart 17) are helping to suppress livestock prices, but as we pointed out last month, these supplies really do not represent many weeks' disappearance.

Frozen pork belly storage supplies are most notably above last year's level. The movements into storage during April were about 70% above last year's level. But recent daily figures show that the trend towards higher storage stocks is being reversed, with the beginning of seasonally normal out-movements from storage to meet good summer demand in

the face of reduced summer hog slaughter. Movements of frozen and canned hams into storage were far below last year: proof that there is good demand for hams, which should carry prices higher during the summer.

Total poultry stocks in cold storage are 20.8% below last May 1. This should help push prices higher in the second half of 1984. Poultry producers have reacted only in a small way to higher 1984 prices, partly caused by an outbreak of avian influenza in several areas of the US. A small percentage of the national poultry flock was destroyed to contain the spread of this very contagious disease. Total poultry production in the US in 1984 is only expected to be 2% above 1983 levels in spite of higher prices this year.

Frozen beef supplies as indicated in the chart are 17.2% above last May 1, and unlike last April, failed to be drawn

down this April, possibly indicating that beef demand is somewhat lackluster. However, in the face of severely reduced US meat supplies in the second half of 1984, live-stock prices will have to trend substantially higher very soon to ration demand.

STRATEGY: Owing to the higher-than-expected hog slaughter in April, May, and to date in June, we are considering the possible advantages of moving long positions in hogs into more deferred 1984 contracts. Listen to our hotline for details. However, for the meantime, maintain long positions in July hogs.

Remain long December live cattle for the reasons given in this and last month's issues. Maintain stop positions at 62¢, close only.

Chart 16

USDA MAY 14 MONTHLY 7-STATE CATTLE ON FEED REPORT - MAY 1 DATA

('000 Head)	1984		1983		Expected
	1984	1983	1984	1983	
On Feed April 1	7,568	7,268	104.1		
Placements during April	1,515	1,566	96.7	100.7 (97-105)	
Marketings during April	1,523	1,470	103.6	100.3 (97-104)	
Other Disappearance *	184	143	128.7		
On Feed May 1	7,376	7,221	102.1	104.1 (101-106)	

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

Chart 17

USDA May 21 PORK STORAGE REPORT - May 1 DATA

	1984		1983		1984 / 1983 %		Expected
	('000 Pounds)						
	5/1/84	4/1/84	5/1/84	4/1/84	5/1/84	4/1/84	
Frozen Pork bellies	11,862	95,009	54,510	44,304	205.2	112,000	(108-114)
Frozen Hams	38,092	38,341	27,903	12,938	136.5		
Canned Hams	34,933	34,531	32,944	28,398	106.0		
Total Frozen Pork	388,263	350,727	272,717	234,744	142.4		
Total Poultry	263,929	259,684	333,307	325,717	79.2		
Total Frozen Beef	324,989	325,707	277,334	299,075	117.2		

Chart 18

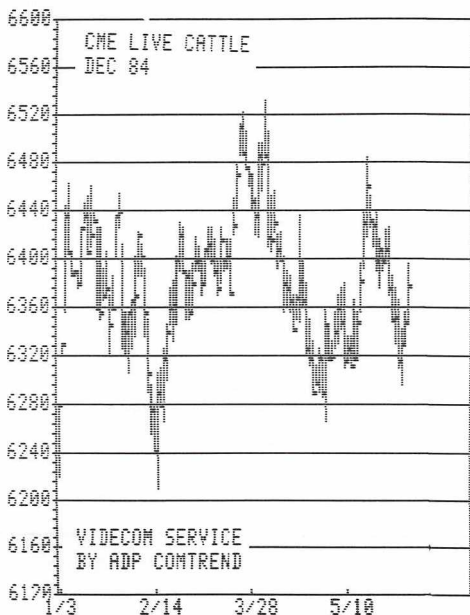
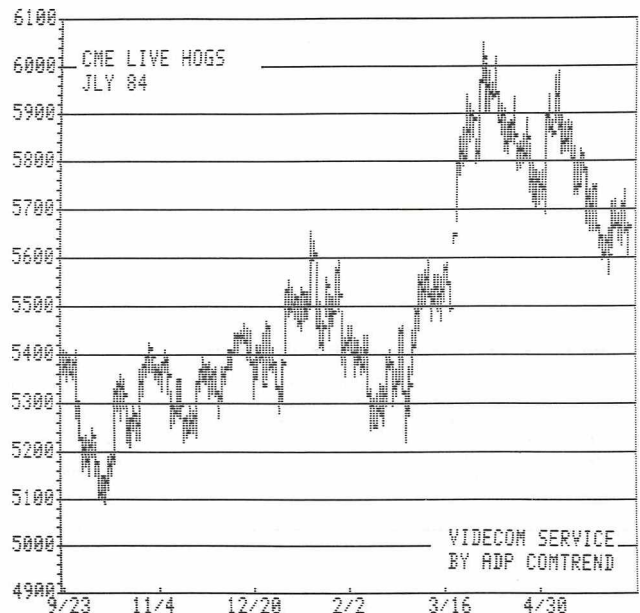


Chart 19



Hotline Updates

Tuesday, May 15. Stops in DM have been lowered to 36.70 on half the position and 36.95 on the balance, all basis the close. Today's close triggered our covering half of this very profitable trade. Therefore, if you have not covered half of your position as of today's close, use today's high of 36.74, basis June, as your stop. Good anytime.

Thursday, May 17. If you covered your short currency position as per the May 15 hotline advice, reinstate these positions, particularly the DM at the market. Maintain 36.95 stop, close only, on June DM, good for the entire position. Also, lower stops in short gold and silver positions to 402.00 and 970.00, basis Dec. gold and silver respectively, good anytime.

Friday, May 18. Take profits on half short Eurodollar position if the market is below 88.10, basis June. You have now reinstated your entire currency short position, particularly the DM, with a stop on close of 36.95, basis June, for the entire position. You are stopped out of short gold and silver positions and are now sidelined.

Wednesday, May 23. Aggressive traders may prefer to switch DM positions to short September Japanese yen, and place initial buy stops at 44.85, basis Sept. close only. Also reenter short side of the June S & P at the market. Place initial stops at 159.00, close only.

Emergency update. Friday, May 25. 1:30 p.m. Buy Dec. gold at the market. Buy Dec. silver at the market. Buy Sept. copper at the market. Stops will be announced later this afternoon.

Friday, May 25. Recap of our positions based on the changes made since our last newsletter.

1. We were stopped out of our Dec. gold and silver positions as per our update of May 17. As of today, we are long Dec. gold and silver with stops at 402.00 and 9.6400 respectively, close only. In the same update, we recommended to go long Sept. copper. Place stops at 6400, close only.
2. We are now short the June S & P as per the May 23 update. At approx. 154.50, basis June. Lower stops to 156.50, basis the close only.
3. We are still short the DM with stops at 36.95, basis June, close only. On the May 23 update, we advised aggressive traders to switch their short positions in DM to Sept. Japanese yen. Lower stops to 44.35, basis close only.
4. We are now short only 50% of our original short Eurodollar position having covered below 88.10, basis June as per our update of May 18. Lower stops on balance to 87.45, basis Sept. close only.

Tuesday, June 6. Repeat of May 25, except first part of No. 3.

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