FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

FRIED-BERG

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Inflation or deflation? A case of exchange repression

In recent days a number of prominent economists have concluded that we have entered a period of deflation. Commodity prices, they have argued, have dropped rather precipitously, 8.5% in a span of just eight weeks. What is more, gold, that sensitive barometer of inflation, has fallen to new 1983-84 lows and stands barely above the dramatic lows of the summer of '82. Finally, the very strength of the US dollar is *prima facie* evidence that money in the US has been too tight.

In separate and eloquent *Wall Street Journal* editorials, Alan Reynolds and Irving Kristol have urged the Fed to ease or else bear the *mea culpa* of an oncoming deflation. Could they be right?

These gentlemen, we believe, are confusing the *nominal* appreciation of a currency — because of tight money — with the *real* appreciation of the US dollar. The latter is a phenomenon totally unrelated, over a reasonable period of time, to the rate of growth of money. Instead, the real rate of exchange, just like the real wage or the real rate of interest, is a variable that cannot be artificially manipulated. It responds to a multitude of factors, among them these: better profit opportunities; major resource discoveries; political safety; favorable tax considerations; and so on.

In the *long run*, the real rate of exchange will oscillate and return to some mean value *after* it has affected in an important way the country's pattern of trade and production. An outstanding example may be Sterling and its real appreciation in the late '70s in response to highly favorable capital and current flows on account of its North Sea oil, an outcome totally unrelated to the Bank of England's monetary efforts (see our discussion in the Nov. 20, 1983, *Comments*, "Maggie's luck is running out.") The concomitant collapse of manufacturing (and employment) among other things has set the stage for a reversal of capital flows and a return of Sterling from the lofty real levels attained in 1979-1981.

One need not go further to see the neutrality of money in real economic processes (such as the real rate of exchange) than to study the behavior of certain currencies in high-inflation environments and note how, despite lax monetary policies, their inflation-adjusted currencies appreciated.

Choosing an extreme example to establish the point, we note in Chart 1 that Argentina's real rate of exchange appreciated no less than 120% (!) in the five years before June 1981, even as its populist central bank allowed an increase in the broad money supply of as much as 2,549% over the period. Was Argentina's Banco Central too tight?

Of course, one could argue that *relative to the demand for money*, Argentina's Banco Central was too miserly. Since no central bank is in possession of the exact state of the demand for money, it follows that it must target the course of prices. And so, if prices rise "too much," it must tighten; if they fall "too much," it must loosen. The price rule, however, would have been of little use to Argentina's Banco Central. Seeing prices rise "too much," they should have tightened. Interest rates, however, would have skyrocketed past their already incredible 6% *per month* and made foreign inflows even more attractive. If instead, they had focused on the real appreciation of the peso and used a price (foreign exchange) rule to relax their relative tight grip on money, inflation would have turned to hyperinflation.

The obvious truth is that fluctuations in the real rate of exchange are like a "tide in the affairs of men," and policy makers must accept their impotence (and very often, the inconvenience) of forcing early reversals. The best they could do is to try to cushion the impact of the inevitable morning-after hangover, euphemistically called "adjustment" in economic jargon. Efforts should be directed towards encouraging more rather than less capitalization (and a general strengthening) of financial and nonfinancial institutions (perhaps even through tax incentives), a sharp reduction (during the boom) of fiscal deficits, a greater reliance on market disci-

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Chart 1

	Currency Peak (in real terms)	Peak in Economic Activity *	Approx. LEAD TIME: Eco.Activity to Currency Peak	Broad Money Supply % increase**	CPI % inc.**	Broad Money Supply % increase***	CPI % inc.***
United Kingdom	Jan.81(+70.23%)**	IVQ 1979	14 months	+70.2%	+69.6%	+57.4%	+23.6%
Israel	Jul.83(+48.84%)**	IVQ 1982	8	+4869.1	+4366.0	n/a	n/a
Mexico	Jan.82(+51.79%)**	IIIQ 1981	5	+663.8	+205.4	+172.5	+242.9
Brazil	Aug.82(+58.04%)**	IIIQ 1980	24	+326.6	+487.5	+212.8	+240.8
Argentina	Jan.81(+119.6%)**	IVQ 1980	2	+2549.0	+2235.0	+152.5	+3544.0
Chile	Aug.81(+70.78%)**	IIIQ 1981	0	+371.4	+116.9	+32.0	+51.5
Uruguay	Aug.81(+80.5 %)**	IVQ 1980	9	+372.7	+240	+77.77	+93.45
Average	71.40%	Average	8.86				

* GNP (or GDP) in constant terms;otherwise imports and/or industrial Production.

** From prior currency trough to peak period

*** Period subsequent to currency peak

Sources : IFS, Morgan Guaranty Trust Company

pline and competition (especially in the area of financial intermediation), *adopting a freely-floating exchange rate*, and so on.

Since capital flows are far more volatile than current payments and receipts, real exchange rates will rise (or fall) for relatively long periods of time — until equilibrium is restored to the overall balance of payments through offsetting current flows and/or until capital flows find it no longer profitable to move in their former direction (i.e., real estate has become highly overpriced, a socialist has come to power, etc.). In the wake of this cyclical rise (or fall), domestic prices will respond *only partially* to domestic monetary considerations. Internationally-traded goods and services will be "arbitraged" directly with the outside world and thus these prices will rise as little as or less than abroad. Domestically-traded goods and services, depending on their "connection" (through substitution) with the outside world, will vary, again, with the pace of outside goods and services. Some, like labor and real estate, will follow more closely the domestic rate of monetary inflation, as they are not easily "arbitrageable."

A rising real exchange rate acts as an anchor and even as a *repression mechanism* for prices. When in Mexico the broad money supply rose 664% in the five years prior to the peso's peak and prices only rose 205% (see Chart 1), a simple monetarist would have argued that velocity had decreased (or what is the same, that demand for money rose). In fact, the appreciating exchange rate allowed for some useful arbitrage, creating the impression of reasonable price stability. Of course, we know that the Mexican oil boom attracted enormous quantities of foreign capital, which ultimately raised the peso's real rate of exchange (by as much as 52%) and finally caused the collapse of the current account. As the peso rose, *consumer prices seemed to be under control.* Little wonder that Mexico's central bank has missed its inflation target for 1983 and 1984 by a wide mark, despite its good monetarist behavior. As its currency sinks, it no longer enjoys the benefits of price repression.

The US is undergoing a full-fledged boom, led and aided by foreign capital flows. They are attracted to these shores by a number of factors, which we, over the years, have attempted to emphasize. A logical outcome to these gigantic inflows is the phenomenon of a real appreciation of the US dollar, which only *slowly* has been forcing an offsetting — and to date moderate — adjustment in the current account to the tune of approximately a 1.5% deficit of GNP. Very constructive supply considerations in a majority of internationally-traded goods translates into stationary or receding US dollar prices, as the latter continues its inexorable rise. However, domestically-traded goods and services (not easily arbitrageable) tend to follow more closely the accommodating increases in the US money supply with the result that consumer prices are *still* rising, albeit very slowly. Exchange repression is clearly at work.

Here, thus, the explanation for the weakness of prices. To repeat, the dollar is strong, independently of Fed policy and more a consequence of real factors. A strong dollar holds back the prices of internationally-traded goods and services, although it is only partly successful in holding back the prices of, say, New York commercial and residential real estate (a non-tradeable good) or even wages (average hourly earnings are still showing a 3.2% year-to-year increase, unlike lumber, copper, or gold, which are showing negative growth rates).

Contrary to Messrs. Reynolds & Kristol, we believe that the Fed has been highly accommodative. Year-on-year growth in the monetary base has recently hit a new post-1979 high: 8.7%. For the most recent two months' stretch, M1 has grown at a 12.7% annual rate compared with the Fed's avowed target of 4%-6%, while M3,which includes large CDs — the wherewithal of the explosion in bank lending — remains well above target. The chickens will come home to roost when the dollar stops its powerful ascent.

While on the subject of appreciating cycles in real rates of exchange, we thought it would be instructive to study some of the most recent and speculative specimens of this phenomenon. In Chart 1, which we have already alluded to, we note that *peaks in economic activity* tend to occur *well before peaks in inflation-adjusted exchange rates.* Persistent (and even accelerating) inflows of capital — in the latter stages, borrowed funds rather than equity — struggle with diminishing profitable outlets and turn to financing speculative activity. Bloated balance sheets become highly vulnerable and a major process of retrenchment begins. By that time, older and more traditional patterns of trade and production have become severely hit, aggravating the downturn. While the association is clear, the lead characteristics are less so. Nonetheless, they occur in each and every case.

Before we read too much into these observations, there are a number of caveats: The Latin American economies reached, on the average, much greater degrees of vulnerability to foreign capital than the US is ever likely to reach — flows equal to 10%-13% of GNP were the rule rather than the exception. This exception, however, only tells us that the eventual US adjustment will be milder. On the other hand, economic activity in Latin America may have continued a while longer (shortening the lead perhaps) were it not for the approaching world-wide recession.

With these and other caveats in mind, we are still comfortable with forecasting a *much later top to the US dollar* than most bulls are willing to concede and, at any rate, after some *visible* signs of a recession are apparent. It is also sobering to note that the real appreciation of the US dollar in recent years (a little over 40%) is far smaller than the average appreciation by the sample of nations in Chart 1.

STRATEGY: *The US dollar is still going considerably higher. The removal of the 30% withholding tax on US Treasury obligations and the strong probability that the US Treasury will issue bearer bonds outside of the US, should accelerate the advance and inevitably create the conditions for a buying panic that will surely dwarf our imagination. It should be clear that as bullish as we are, we are not able to pinpoint a level for a top for the simple reason that emotion — not logic — will prevail in the end.* Anyone, *including foreign governments and central banks, who owe US dollars will be well advised to switch to a weaker currency, at least until such time as the* blow off *occurs. And, as we have seen, this may not take place for a number of months.*

We continue to favor the short sale of the yen over other currencies, as we feel its cross rate vis a vis the DM is still far too low (i.e., it is still too expensive vis a vis the Deutschemark) A much more reasonable cross rate would appear to be 100 ¥/DM. Lower September '84 stops to 42.25, close only.

A dramatic increase in short Sterling rates (over 200 basis points) returned Sterling to its 3.75 DM level, and although some pressure may now crop up as a result of weakening oil prices, we would discount its extreme impact. A better sale than DM's at 375-380 DM and a poorer sale at 355-365 DM.

In front of the US dollar stampede, it appears to us that the Kuwaiti dinar, the Saudi ryal, the Danish krone and the Hong Kong dollar, in that order, are quite overvalued. We strongly favor the short side of these currencies, particularly the first three.

Canada's net international reserves continue to bleed in a vain attempt to stop the onslaught — the fourth quarter of 1983 saw a loss of US$720 million, the first quarter of 1984 US$546 million, and now, the second quarter shows a staggering drop of US$1,481 million. The deflation proponents would do well to examine Canada's monetary policy: A far tighter rein on money than the US and, yet, a falling Canadian buck. Should the Bank of Canada tighten even further in view of the weakness of its currency? We remain (technically) bearish as we have been for the past many months but begin to feel that the Canadian dollar is becoming "cheap" on a real basis. Advise keeping stops at 75.80, basis September '84, close only.

Chart 2

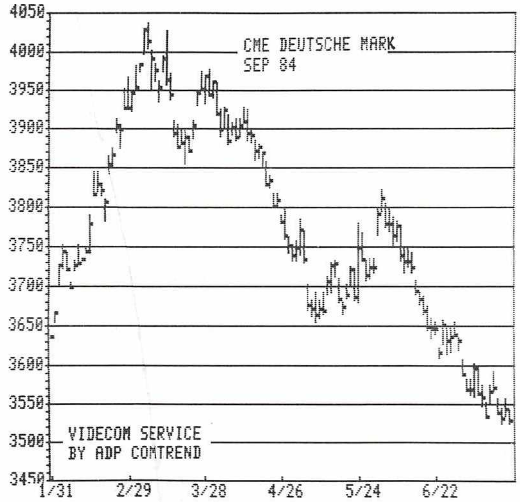


Chart 3

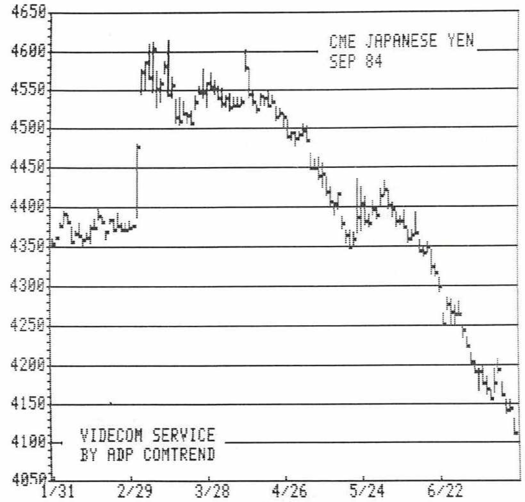


Chart 4

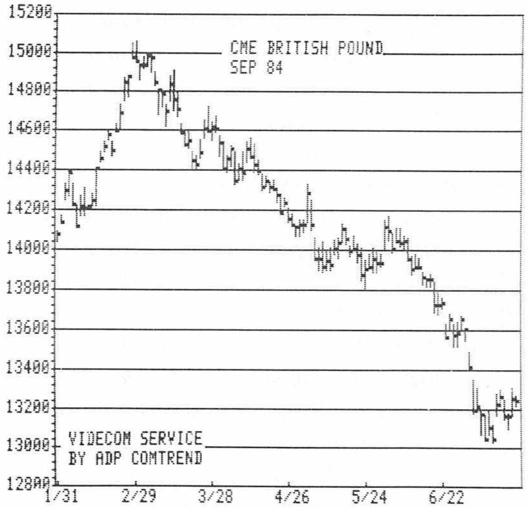


Chart 5

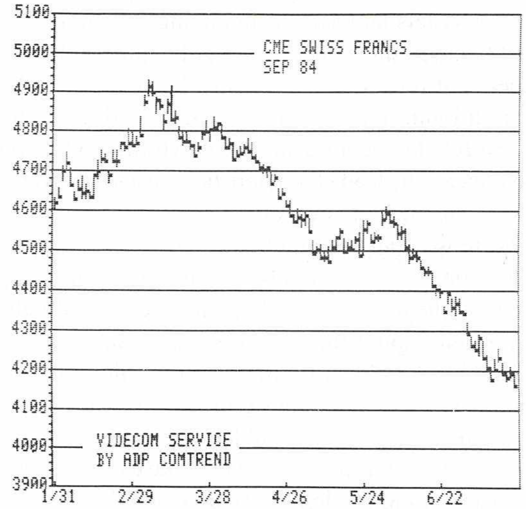


Chart 6

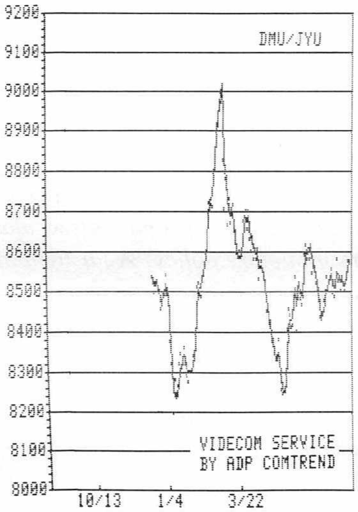
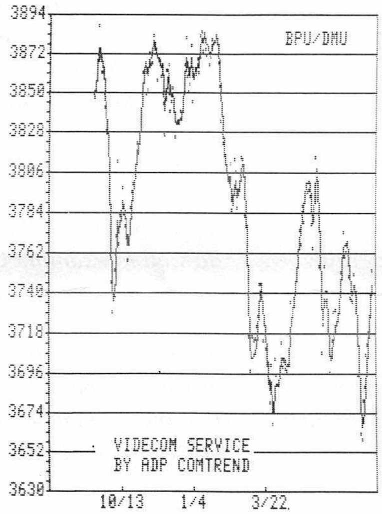


Chart 7



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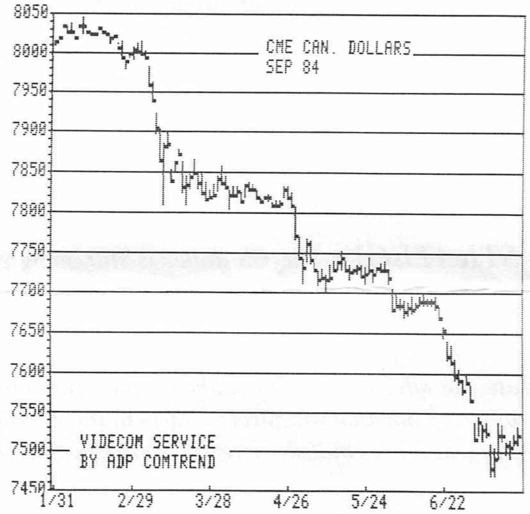


Interest Rate Futures

STRATEGY: *In keeping with our belief that we've entered a long and sustained period of rising interest rates, we suggest taking a more aggressive short position in the September '84 Eurodollar, with stops at 87.65, good anytime (see also Hotline update). Our reasoning is simple: Although futures are trading at a discount from cash levels (i.e., indicating higher rates), the discount is less than 40 basis points. Since we expect rates to climb at least 50 basis points per month, a two-month discount of 40 points is rather attractive.*

Retain long September '84 T-bills/short September '84 Eurodollar spread; it should continue to make new highs in months ahead.

Chart 9

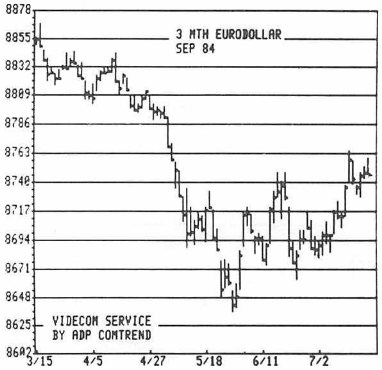
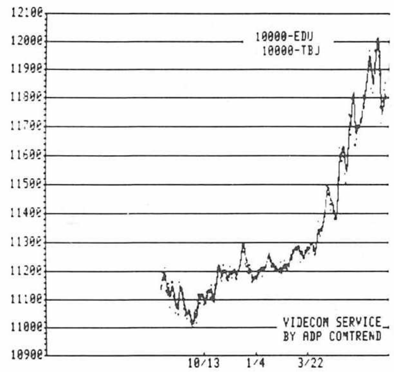


Chart 10



Stock Indices

The big bad bear

Relentlessly, world equity markets tumble to new lows. The pain is as yet silently borne, and here and there one still hears the faithful express a hopeful note. But, in reality, there is little to cheer about. In fact, we are about to witness the most massive stock market shakeout since the '30s.

Last week all junior averages as well as breadth indices made new 1983-84 lows; senior stocks continue to attract institutional funds, shellshocked by air pockets in high-tech, drug stocks, and even the likes of ITT. The latter one-day loss equal to $1.2 billion in market value has as yet not taught the stubborn professional portfolio manager that there are no *serious bids* under these markets. The highly weakened condition of this market can be gauged by the pounding taken by airline stocks last week in spite of sharply improved earnings and prospects for lower oil prices.

The potential for a bloody decline is reinforced by the fact that margin debt reached new highs (!) in June in both New York and Tokyo. An interesting perspective on margin debt in New York is gained from the fact that the year-on-year increase (around $6 billion) is almost as large as the *total* margin debt prior to the last serious bear market (1973). In addition, of course, one would have to add leveraged buyouts, options on stocks and indices, and index futures to the inverted credit pyramid supporting equity prices, to understand the magnitude of the approaching decline.

STRATEGY: *Being short the September '84 S&P 500 is not merely an excellent trade (as we have been advocating for the past few months) but it may also be essential to financial survival in the months ahead. This is so because the oncoming destruction of savings and capital will be pervasive; it will be very difficult to find cover from all its effects. A hedge will be badly needed, and none better than a short position in stock futures. Retain buy stops at 15650, basis the Cash Index.*

Chart 11

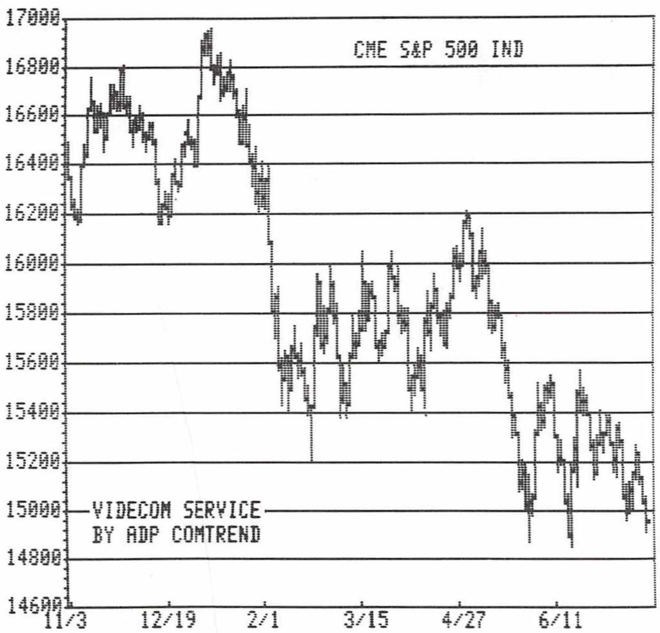
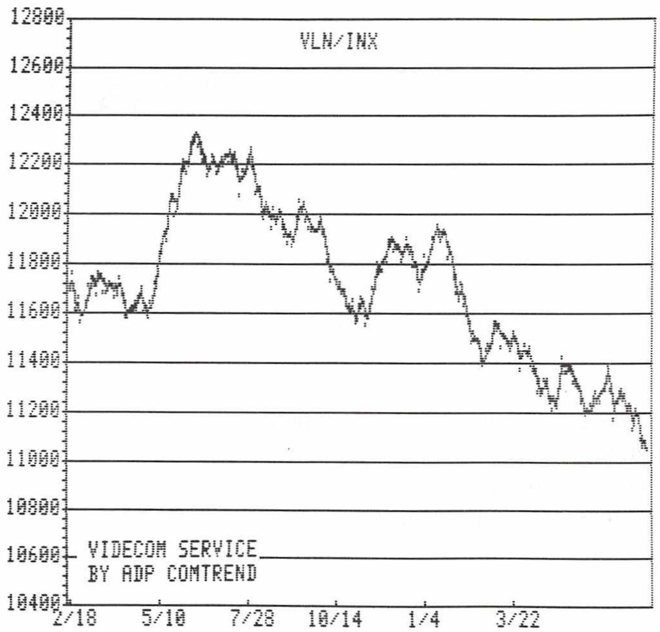


Chart 12



Energy Futures

A sustained and sharp decline in crude oil prices since early June has brought spot quotes as much as $2/barrel below official prices. Late Friday, North Sea Brent was being traded at $28.20/barrel (against its $30/barrel official price) and Saudi Light at $27.30/barrel (against the official $29/barrel).

There are several reasons for the decline: first and foremost, oil is in a long bear market that will not end until prices return to their long-term equilibrium, probably around $8-$10/barrel in 1984 dollars. More recently, contrary to our fears that Iraqi/Iranian attacks on Gulf shipping would succeed in drying up traffic (as insurance rates became prohibitive), traffic continues to load at most points including Kharg Island. Missiles have only a limited impact on oil-carrying tankers as their effect has been compared to a missile's hitting mud. Moreover, Iranian discounts of as much as $3/barrel have overcome any increase in insurance rates and, in fact, have lured many tanker operators with the prospects of making as much as $2 million per cargo. Enormous quantities of this merchant oil have found their way to places such as Singapore, overwhelming buyers and allowing Japanese trading companies to fill their needs at the expense of long-term contracts. Finally, the Saudis have taken advantage of the political/military uncertainty in the region and stepped up production to 5.6-5.7 mb/d, although there are now indications that they have reined-in production enough to allow for Nigeria's 150,000 b/d quota increase and then some.

Since *world* demand is unlikely to have grown much, if at all, over the past few months, one must conclude that the excess supplies of May, June, and July are beginning to pose a serious storage problem. Once again, the British National Oil Corporation may find itself agonizing over the downmove effect of a cut in prices, as Texaco is cutting by about a third purchases from it.

The world glut is finding expression in a carrying-charge structure at the NYMEX with distant months gaining consistently over nearbys (see Chart 14). Unless the Saudis can cut their output to 3 mb/d in front of the restocking period (which should provide some seasonal strength), spot quotes are likely to fall even further, putting unbearable strain on official prices.

STRATEGY: *Having missed this most recent decline, we do not consider it prudent to initiate short positions at these oversold levels, especially in the product market where negative margins are enormous. Any worthwhile rally (100 points in the crude), however, should be used to reinstate new short positions.*

Chart 13

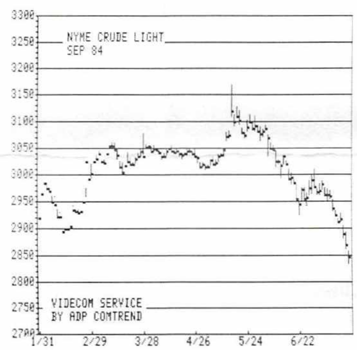
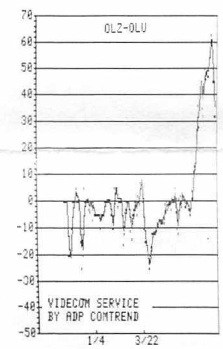


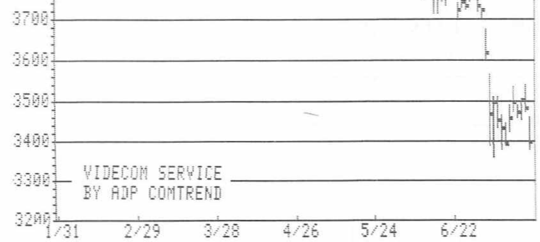
Chart 14



Precious Metals

Paralleling the weakness of all currencies vis a vis the US dollar, precious metals have resumed their bear market. The kindest remark we can make of gold at this time is that it has finally entered the very top of our value range discussed in detail last May '83 in "Gold: not fairly valued." Counter-trend longs were stopped out at 402, basis December '84 as per last month's advice. Remain sidelined.

Chart 15



Grains and Oilseeds

In keeping with the general collapse of commodity prices in the past several weeks, grain prices have tumbled tumultuously. The fundamental situation remains quite bullish, but technically, corn and soybean charts have been devastated by complacent attitudes towards low carryover stocks, owing to assumptions of adequate oncoming new crops. The strength of the US dollar, disinflationary shocks to the economy, and high interest rates have all acted to bring down cash and futures prices for grains. Domestically, however, this will stimulate demand for meat, leading to greater feed use of corn and soybean meal, while soybean oil usage has risen sharply as consumers and processors of food products stock up on soybean and other oil products at recently lower prices. Thus, the decline in prices will set off another round of demand strength for grains, oilseeds, and products for feed and food use, reinducing higher grain and oilseed prices before the end of old crop season.

There has been no lack of grain reports since our June 10 *Comments*. Domestic reports have included a quarterly grain stocks report on June 21 (Chart 17) followed June 22 by a supply and demand report, the first major survey of planted acreage of US crops, on June 28 (Chart 18), and two crop production reports, the first on June 11, and the most recent on July 10 (Chart 16) both of which were followed by supply and demand report.

Based on the June 21 USDA grain stocks report, April to May 1984 usage of corn was down 12.0% from the 1982-83 season, soybean usage was down 16.9% from the year-ago levels, while wheat usage in April and May 1984 was up 3.3% as livestock producers substituted cheaper wheat for scarcer corn. Since the beginning of the season for these crops, corn usage is down 29.4% in the October to May period to 5,187 mbu. from 7,289 mbu. in 1982-83; soybean usage fell 11.6% to 1,484 mbu. in September to May from 1,679; wheat usage rose 5.5% to 2,541 mbu. in June to May from 2,409 mbu. in the 1982-83 season.

Complicating the issue was the fact that the USDA on June 21 revised *downward all* the previously given 1983 figures for grain stocks by considerable amounts. These downward revisions were made based on the June 15 revision of crop production figures for the years 1979 to 1983, which was done apparently to satisfy complaints that the USDA's figures were out of line. Virtually all the 1979 to 1983 crop production figures were revised downward, some significantly.

The changes for 1983 crop production levels are evident in comparing the 1983 levels in Chart 16. As an example of the effect of these revisions, soybean usage in April to May 1984 appeared to be down only 8.8% from last season based on the numbers before revision but was in fact down a much more significant 16.9% from the previous season based on the revised figures. This fact alone helps to explain some of the unusual price weakness in soybeans in recent weeks. Export demand for US grain and oilseeds has recently picked up sharply owing to lower prices, particularly from such places as the USSR and China.

The USSR needs more grain because its domestic crops, while in better shape than in early June, will still yield a 1984 crop of somewhere between 180 mmt (based on a report by Soviet grain trade officials on June 29) and 190 mmt (estimated by the USDA, unchanged from last month). While the USDA has not changed its forecast of the Soviet crop yet, it has changed its forecast of Soviet grain imports in 1984-85 (July-June) to 38.0 mmt from 35.0 estimated in June and 33.0 mmt imported in 1983-84. Soviet wheat imports are now projected at 23.0 mmt in 1983-84, up from 20.0 mmt estimated in June and 20.0 mmt in 1983-84. Soviet coarse grain imports are forecast now at 14.0 mmt, unchanged from last month, but up from 12.5 mmt in 1983-84. Wheat imports are expected higher, even though 1984 production of wheat in the USSR is forecast at 86.0 mmt, up from 78.0 mmt in 1983. On the contrary, coarse grain imports are expected up only marginally in spite of a sharp fall in forecast Soviet coarse grain production to 92.5 mmt from 105.0 mmt in 1983, owing to drought early in the season in coarse grain producing regions of the USSR.

The Soviet Union is apparently expected to take advantage of relatively low wheat prices compared with corn or other coarse grains. Since the end of May, the Soviet Union has contracted to purchase over 2.0 mmt of US wheat, raising its commitments to 6.3 mmt, much of it in recent days. The USSR has also been an active buyer of wheat from Canada and the EEC, and recently has been in the market for US corn for the first time in many weeks.

With regard to soybeans, world oilseed production in 1984-85 is forecast to rise 13% to 185.3 mmt as a result of higher prices in the past year coupled with strong demand worldwide for protein meals and vegetable oils. Many countries are expected to set record oilseed production levels, with record worldwide production of several major oilseeds. Palm oil output reportedly will rise 12% to a record 6.4 mmt in 1984-85. In spite of very large increases in world vegetable oil production in 1984-85, though, the USDA expects only a slight increase in world soybean oil carryover stocks at the end of 1984-85, to 1.15 mmt from 1.08 mmt in 1983-84, and well below the 1.45 mmt carryover at the end of 1982-83.

US soybean oil demand has picked up considerably with recent lower prices. The National Soybean Processors Association reported end of June soyoil stocks at 411.5 million pounds, 97% below 1983 levels, and 181.5 million pound decrease from the end of May. Stocks of soyoil were expected to be between 450 and 500 million pounds. US export of soybean oils were very strong also in May at 208.3 million pounds, up from 163.3 million in April and 63% above May 1983 exports of 127.5 million pounds.

Corn remains stressed in some southern Midwest regions as we encounter the critical pollination period. Continued dryness would reduce crops in these areas by 20% to 50%.

STRATEGY: *Buy December corn at the market, placing stops at 2.80, close only. Also buy November soybeans, placing stops at 6.00, close only. In recent weeks we were stopped out of July soybean oil* profitably, *albeit with reduced profits of 3¢-4¢ per pound. We sold long positions in December corn as recommended on the hotline at 3.13¼ or higher, for profits of about 15¢.*

Chart 16

July 10 USDA Crop Production Report - July 1 Data

(million bushels)	7/10/84	6/11/84	expected	1983	1984/1983 %
Corn	7,810.0	7,925.0		4,166.1	187.5
Soybeans	2,025.0	2,075.0		1,566.7	129.3
All wheat	2,524.0	2,525.0	(2,460-2,601)	2,419.8	104.3
winter wheat	2,021.9	1,972.8	1,989 (1,925-2,078)	1,988.3	101.7
Cotton (mln.bales)*	11.8	11.5		7.771	151.8

June 11 USDA Crop Production Report - June 1 Data

(million bushels)	6/11/84	5/9/84	expected	1983
Corn	7,925.0	7,775.0		4,203.8
Soybeans	2,075.0	2,075.0		1,595.4
All wheat	2,525.0	2,550.0		2,425.4
winter wheat	1,972.8	1,979.4	2,012.3 (1,938-2,075)	1,993.9
Cotton (mln.bales)*	11.5	11.5		7.771

*- 480 lb. bales

Chart 17

June 21 USDA Quarterly Grain Stocks Report - June 1 Data

(million bushels)	June 1/84	expected	Apr.1/84	Apr.-May '84 use	June 1/83	Apr.1/83	Apr.-May '83 use	use Apr.-May 1984/1983 %
Corn	2,137.1	2,097.3 (2000-2200)	3,257.8	1,120.7	5,079.8	6,364.4	1,274.1	88.0
Soybeans	456.5	433.2 (400-452)	753.1	296.6	866.9	1,192.2	357.1	83.1
All wheat	1,394.3	1,394.4 (1370-1450)	1,752.8	358.5	1,541.4	1 877.0	346.9	103.3

Chart 18

June 28 USDA Crop Acreage Report - June 1 Data

(million acres)	1984	expected	1983	based on acreage set-aside report March 23 *	February preliminary plantings Feb.16	1984/1983 %
Planted						
Corn	79.940	81.72 (80.5-82.75)	60.177	(76.979)	81.766	132.8
Soybeans	68.025	67.85 (66.8-69.2)	63.139	NA	65.240	107.7
All wheat	79.526		76.419	(80.0)	82.607	104.1
Cotton	11.343	11.0 (10.8-11.5)	7.946	(12.785)	10.759	142.7
For Harvest						
Corn	71.554		51.443			139.1
Soybeans	66.733		61.815			108.0
All wheat	66.428		61.390			108.2
winter wheat	51.147		47.584			107.5
spring wheat (not including durum)	12.076		11.314			106.7

Chart 19

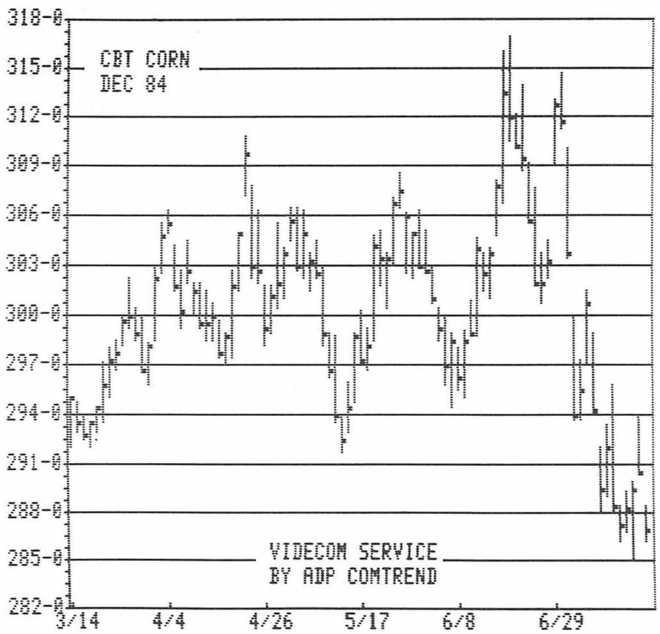
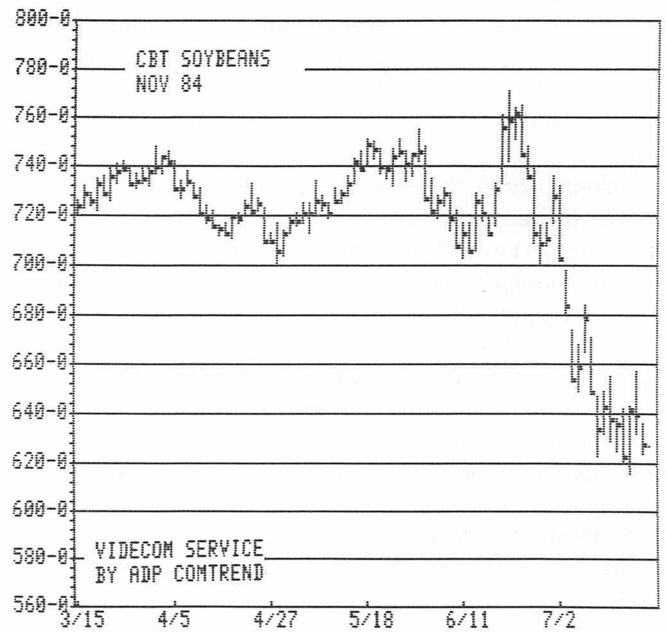


Chart 20



Livestock

Hog prices have broken sharply on both the cash and futures markets. The culprit: burdensome frozen pork belly storage stocks, which have caused August pork bellies to trade at as much as a 1¢ discount to August hogs. This phenomenon has not been seen since the 1979-1981 period. In those three years, pork bellies traded for long periods at discounts to live hogs. Relatively high accumulations of frozen pork bellies in storage during years in which hog slaughter rose to very high levels compared with the mid-1970s insured adequate supplies through the summer period of seasonally-reduced hog slaughter.

However, hog prices during those years remained relatively high given the sizable increases in commercial hog slaughter compared with the previous five-year averages: 1979, +17.6%; 1980, +24.4%; and 1981, +10.7%. The difference in 1984 is that commercial hog slaughter for the year is expected to fall about 5% below 1983 and to only about 2% above very low 1982 levels, placing 1984 slaughter a substantial 7.7% below the past five-year average.

With figures like these, what is keeping hog prices down? The June 21 Quarterly USDA Hog Report (Chart 22) provides few clues, as the two categories of market-weight hogs over 120 pounds are below the respective 1982 numbers; only a few figures differ significantly from 1982. We mentioned pork belly prices as a major suppressing factor for live hog prices, but the sharp drop in 1984 hog slaughter actually reduces total 1984 pork belly supplies to levels roughly equal to 1983 and even 1982 when pork belly prices exceeded $1.00 for the August contract.

Now what about cattle? Cattle slaughter rates have recently been high as feedlot operators market animals placed late last year and early this year (feedlot placements rose over 10% from 1982-83). Slaughter rates will decline substantially, however, after heavy-weight steers, reported at 23.7% above 1983 levels (see Chart 23) are worked off in the next couple of weeks. By December, though, steer slaughter may fall to more than 15% below last year's levels, exerting strong upward influence on cattle prices, despite a seasonal tendency for lower cattle prices at that time.

The July 18 USDA Quarterly 13-state Cattle-on-Feed Report (Chart 23) was considered bearish for the August cattle contract but positive for deferred contracts, given placements 5.5% below last year in the second quarter, and 2% below expectations. The Monthly 7-State Report was also judged in the same way, but with an even greater difference in placements during June, showing the trend towards fewer cattle on feed, foreshadowing higher prices in late 1984.

The July 20 Cattle Inventory Report (Chart 21) was mildly negative compared with expectations but should not have a large impact on prices, as almost all categories of cattle numbers are down from last year, particularly steers over 500 pounds, down 2.6% from 1983 levels. In fact, the number of cattle on feed in 1984 in the 13 major states has fallen from well above 1983 and 1982 on April 1, 1984, to well below 1983 and 1982 in only three months.

As we predicted, frozen pork belly storage stocks, while still large (see Chart 26) have recently begun to fall very sharply as low prices stimulate demand.

Cattle marketings were certainly higher in the second quarter of 1984 than 1983, by a margin of about 2% as shown in the July 18 USDA Quarterly Cattle-on-Feed Report (Chart 23). In fact, cattle slaughter to date in July is averaging 6.3% above 1983 and in June was 5.1% above 1983. Still, cattle prices remain high relative to hog prices, with the August price differential well over 10¢. Hog prices remain weak despite a decline of about 10% in current hog slaughter from last year, while cattle prices remain strong in the face of current slaughter 6% higher than 1983. Why? The short-term disinflationary impact of high interest rates may have affected hog prices, but there's more to the story.

In fact, the hog report was not really bearish. It was simply not as bullish as the market had expected. Contrary to the expected 12% decline, hog numbers were down only about 10%. Though in many categories hog numbers are lower than respective 1982 numbers (when prices reached record-highs in August), this 2% difference has resulted in a decline in prices of over 8%.

Basically, we believe that this surprising decline is a short-term effect of a break in the trend of hog prices and the strong negative influence of producer hedges in a declining market. However, we expect a retracement of hog prices to the upper 50 range in short order.

Stocks declined by 12.45 million pounds nationwide in June, compared with a decline of only 1.20 million pounds last year in June. Also, to date in July, stocks in the eight Chicago-area daily reporting warehouses have been declining almost four times last year's rate. If this pace keeps up, frozen pork belly stocks could fall to around 30 million pounds by September 1. Given the prospect for falling hog slaughter and fresh pork belly production well below last year, this could induce substantially higher cash pork belly prices.

STRATEGY: *Remain long August hogs, rolling into October when necessary, with stops at 53¢, basis August, close only. Also, maintain long positions in December cattle, taking profits at 68¢, with stop protection at 64.5¢, close only.*

Chart 21

JULY 20 USDA SEMI-ANNUAL CATTLE INVENTORY REPORT - JULY 1 DATA

('000 head)	1984	1983	1984/1983 %	Expected	Exp.%
Cattle & Calves on Farms	121,950	123,540	98.7	120,900 (119.8-121.7)	97.8 (97-98.5)
Calf Crop	43,400	44,093	98.4	43,300 (42.9- 43.5)	98.2 (97-100)
Cow Inventory	48,950	49,600	98.7	48,350 (47.6- 48.8)	97.5 (96-98.4)
Heifers 500 Lb.	18,600	18,570	100.2	18,350 (18.3- 18.4)	98.8 (98-100)
Steers 500 lb.	16,400	16,840	97.4	16,450 (16.0- 16.6)	97.6 (95- 99)
Heifers, Steers, & Bulls 500 lb.	35,500	35,970	98.7	35,250 (35 - 35.5)	98.0 (97-98.7)

Chart 22

JUNE 21 USDA QUARTERLY HOG REPORT - JUNE 1 DATA

	Actual	1984/1983 % (revised)	Exp.	Exp. %	June 1/83	1984/1982 %	June 1/82
All Hogs	**52,030**	**90.6**	50,901	**88.6(85-90)**	**57,450**	**100.1**	**51,990**
Kept for breeding	7,335	90.8	7,065	87.5(85-90)	8,074	99.3	7,389
Kept for market	44,695	90.5	43,797	88.7(85-90)	49,376	100.2	44,601
< 60 lb.	18,997	86.9	19,189	87.8(85-90)	21,855	100.3	18,941
60-119	11,224	94.2	10,485	88.0(85-90)	11,915	102.5	10,954
120-179	7,981	91.1	7,817	89.2(86-90.8)	8,764	97.3	8,200
> 180 lb	6,493	94.9	6,363	93.0(88-96)	6,842	99.8	6,506
Farrowing intentions							
Mar-May	3,062	88.0	3,071	88.3(86-90)	3,478	101.6	3,014
Jun-Aug.				(87-90.5)			
Jun-Nov.	5,609	88.8	5,656	(87-92)	6,319	96.5	5,815
Sept.-Nov.				(90-93)			
Pig Crop							
Mar.-May	23,206	87.7	23,411	(88-89)	26,453	102.5	22,642
Dec.-May	41,478	88.6	41,330	(88-88.6)	46,806	101.1	41,035
Pigs per Litter							
Mar.-May	7.58	99.6	7.54	(98-100.25)	7.61	100.9	7.51
Dec.-Feb.	7.31	98.4	7.28	98.0	7.43	102.5	7.13
10 -State Report							
All Hogs	41,330	91.3			45,250	100.3	41,190
Kept for breeding	5,735	92.1			6,224	100.8	5,689
Kept for Market	35,595	91.2			39,026	100.3	35,501

Chart 23

July 18 USDA 13-State Quarterly Cattle on Feed Report - July 1 Data.

	1984	1983	1984/1983 %	Expected	1982
On feed April 1	9,340	9,153	102.0		8,818
Placements- April-June	5,572	5,894	94.5	96.6(94-98)	5,781
Marketings- April-June	5.630	5,527	101.9	102.7(100.5-107)	5,209
Other disappearance	582	450	129.3		
On feed July 1	8,700	9,070	95.9	97.5(94-100)	8,981
Weight breakdowns					
Steers and calves	5,640	5,661	99.6		5,643
less than 500 lb.	222	171	129.8		162
500-699 lb.	533	643	82.9		667
700-899 lb.	1,900	2,083	91.2		2,283
900-1099 lb.	2,410	2,299	104.8		2,185
over 1100 lb.	575	465	123.7		346
Heifers and calves	3,028	3,380	89.6		3,306
less than 500 lb.	72	73	98.6		117
500-699 lb.	600	667	90.0		811
700-899 lb.	1,497	1,695	88.3		1,711
over 900 lb.	859	945	90.9		667
Cows and others	32	29	110.3		32
Intended marketings-July-Sept.	5,995	5,891	101.8		

Chart 24

7-State Monthly Cattle on Feed Report - July 1 Data

On feed June 1	7,318	7,331	99.8		7,363
Placements- June	1,445	1,582	92.0	95.2(90-100)	1,420
Marketings- June	1,554	1,560	99.6	101.5(99.5-103.5)	1,515
Other disappearance	94				
On feed July 1	7,125	7,275	97.9	98.3(97-99)	7,181

Chart 25

June 13 USDA 7-State Monthly Cattle on Feed Report - June 1 Data

On feed May 1	7,376	7,221	102.1	
Placements- May	1,798	1,838	97.8	100.8(96.6-104)
Marketings- May	1,637	1,578	103.7	104.7(101-109)
Other disappearance	219	150	146.0	
On feed June 1	7,318	7,331	99.8	101.0(98.8-102)

Chart 26

July 20 USDA Cold Storage Stocks

('000 pounds)	July 1	June 1*	July 1/83	Expected
Frozen pork bellies	115,081	127,527	63,468	118.2(115.0-120.0)
*-revised				(-7.6 → -12.6)

June 22 USDA Cold Storage Stocks

('000 pounds)	June 1	May 1	June 1/83	Expected
Frozen pork bellies	127,646	112,205	64,671	125.5(118.0-129.2)
				(+6.1 → +17.3)

Chart 27

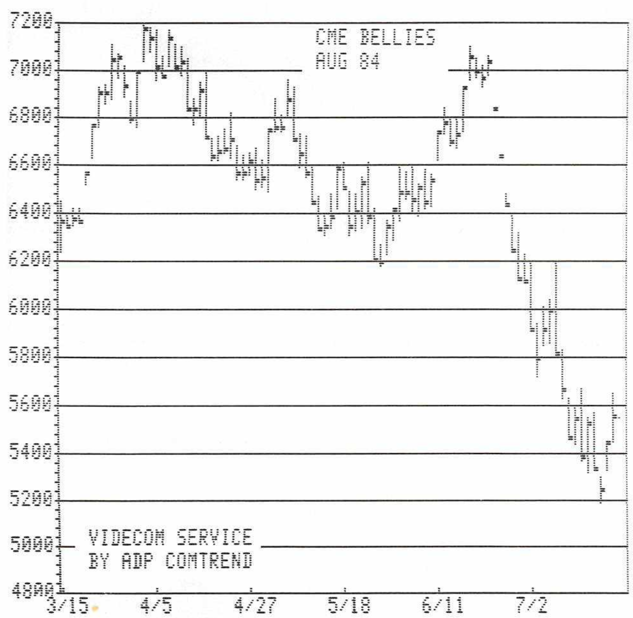


Chart 28

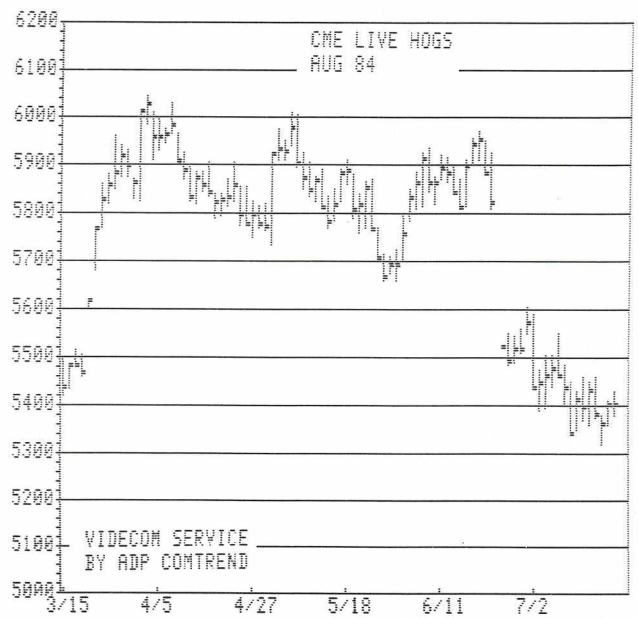
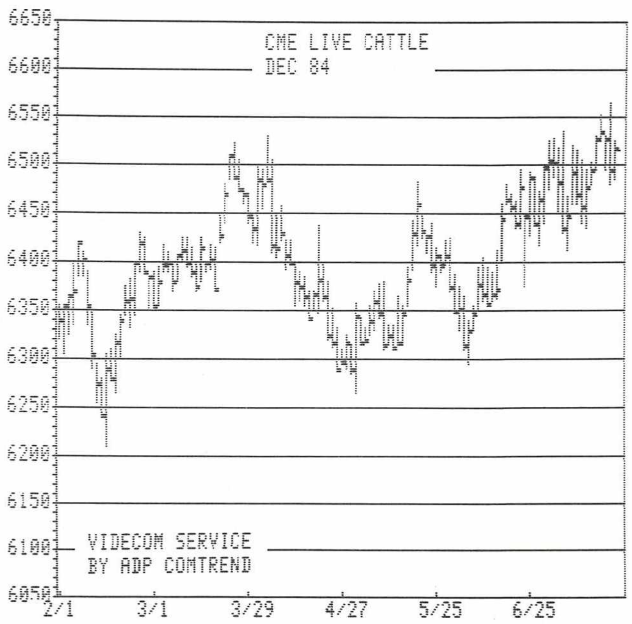


Chart 29



Hotline Updates

Friday, June 29, 10:45 a.m.: Sell long positions in December corn at 3.13¼ or better. (This recommendation was not filled on Friday, as the day's high was 3.13).

Friday, July 29, 4:30 p.m.: We repeat our June 29 recommendation to sell December corn at 3.13¼ or better, good anytime. (Filled Monday, July 2, below the high of 3.14¾).

Monday, July 16: As the balance of your short September Eurodollar position was stopped out Friday above 87.45 on the close, as per May 25 Hotline update, we now recommend reinstating full short positions at present levels, using a top of 87.66, basis September, good anytime.

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