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The US dollar and the coming economic adjustment

The chickens are coming home to roost. Aided by relatively low interest rates and a formidably expansive fiscal thrust, the US economy surged ahead in the '82-'84 period. In the process, it spent a great deal more than it earned, financing its appetite through the willingness of nonresidents to hold — i.e., “save” — dollar balances.

We argued in past issues that the causality of the external accounts ran from capital “inflows” (not absolutely a proper term in a world of floating currencies) to current “outflows.” To nonresidents, the investment opportunities afforded by the US markets kept domestic interest rates relatively subdued, especially when account is taken of the differential tax treatments, an observation we first made in the February 12, 1984 issue. The reasoning runs as follows: domestic users and providers of funds contend with after-tax yields that could be anywhere between 30% and 50% lower than the pre-tax yield enjoyed by offshore investors and nonresidents, on the average. Thus, what might be an attractive yield to an *offshore lender*, would still be an attractive rate to a *domestic borrower*. In fact, the extraordinary rates of growth of *debt*, both public and private, and the historic low level of household savings in recent quarters demonstrate conclusively that interest rates stayed below their “natural” rate and were both unable to ration out borrowers and unable to dissuade consumers and corporate entities from postponing consumption and investments.

For a time, this excessive spending did not represent a major threat. Early in 1984, Federal Reserve Board Chairman Paul Volcker sounded an alarm when he suggested that “we, as a nation will have to borrow abroad (net) about 2% or more of our GNP this year to meet projected needs.” We dismissed the warning by pointing out that industrialized nations, historically, did not seem to reach critical levels of ongoing indebtedness until they reached approximately 4% of GNP.

We adduced proof from the experience of the UK (1973-76) and Canada (1973-76). The charts are reproduced and updated in this issue (see Chart 1). In early February 1984, we concluded that the “budding US current account deficits are

a function of a strong economy where spending is exceeding income thanks to cheap foreign savings, drawn in turn by a relatively attractive economic environment and high (to nonresidents) interest rates. Concern over a US buildup in net international indebtedness is exaggerated and premature....”

At this writing, the US has probably reached and passed the 4% threshold, as the current account is likely to be running in excess of \$160 billion in a \$3.8 trillion GNP. Prior to discussing the implications of this grave imbalance, we should examine the underlying market mechanism in the capital inflow/current account deficit phenomenon.

Capital inflows in fact produced two distinct effects on the US economy. First, by bringing about lower-than-equilibrium interest rates and other asset yields, it stimulated domestic investments and consumption and “recycled itself” out of the US through more imports and fewer exports; the domestic boom, already fired-up by a spectacular widening of the fiscal deficit, was spilling over the external sector. In the textbook case, as *relative* investment opportunities diminish, capital inflows subside, the domestic boom fizzles out, the excessive rate of spending tapers off, and the current account deficit narrows and even turns into a surplus. This so-called economic adjustment would proceed speedily and smoothly or slowly and not so smoothly depending on various “rigidities.” These could be in the government sector (the size of the deficit to be financed domestically and the crowding-out effect on the private sector), the labor sector (wage rates and layoff policies), monetary policy, and so on. Since the disappear-

In this issue

Gold's on the move and presents a once-in-a-lifetime opportunity. We're still committed bears in energy futures. A bear market in stocks is on the way: How you can profit. And a director of the FDIC has some interesting views on Savings and Loans companies. Contributions by Albert D. Friedberg and Daniel A. Gordon.

ance of the current account deficit implies a reduction of domestic spending versus income, *by necessity, it implies at least initially an economic contraction.*

The second market effect of a sizable inflow of capital is through the exchange rate. In a floating regime, the domestic-currency appreciates as nonresidents seek to convert their holdings into that unit. The appreciating rate of exchange cheapens foreign goods and makes domestic goods dear to foreigners. This classic exchange rate effect helps to swell imports and diminishes exports, turning the trade and current accounts negative in roughly the same proportion as the size of the incoming inflows.

Compensating flows are not always simultaneous, a fact that stands to reason when consideration is given to the relative velocities of capital and trade movements. Trade flows are slow to react and require a certain semi-permanency of exchange rate levels and demand for the product. As a result, in floating regimes, exchange rates tend to overshoot trade equilibrium levels, a process that ex post slows down capital inflows. This explains the ratchety, jerking nature of uptrends and downtrends in exchange rates.

We now arrive at the crux of the situation at hand. If the US current account deficit is finally perceived to be excessive (which now seems to be the case), capital inflows will either slow down or even reverse, anticipating lower exchange rates. Since trade patterns are relatively slow to respond to this reversal in capital flows, *the dollar must overshoot on the downside.*

If domestic fiscal and monetary policies aid the adjustment process and accelerate the domestic contraction, the dollar is likely to regain equilibrium in the very near future and at rates not substantially lower than the present ones.

If, on the other hand, the Fed continues its accommodative posture and Congress is unable to make significant cuts in its deficit, then the US economic adjustment will slow to a crawl (as it has for the past 12 months), the current account deficit will not improve, and *the dollar will crash.*

In our view, the income effect has been and is the most important of the two mechanisms at work, notwithstanding popular theory that the "overvaluation" of the dollar is primarily responsible for the external deficit. While important, the rise of the dollar did little more than compensate for the extraordinary decline of the mid- to late '70s. In addition, anecdotal evidence suggests that US prices are not substantially higher than those prevailing in European or Japanese cities, certainly not by a factor of 50%-80% as is indicated by the "overvaluationists."

Clearly, the US has gone on a spending orgy for the past three years, and it must now adjust quickly to avoid a much dreaded currency collapse.

We pointed out last month that the Fed was aware of the danger posed by a sharply falling exchange rate and that as a result, we were hopeful that it would tighten up monetary

policy. In fact, we said that the dollar "will prove to be the outside constraint on the Fed: Should it fall by 5% or more from these levels (about DM 2.89), the Fed will tighten significantly; conversely, should it rise by more than 10-12% from current levels, the Fed will ease significantly." At 2.7550 DM, we have now reached that 5% drop, and thus far, there are no signs of Fed tightening.

In fact, Henry Kaufman has suggested (and forecasted) that the Fed will ease up, given the extremely sluggish state of the economy well into the third quarter of the year. In view of our foregoing discussion, this policy recommendation makes no sense. While it is true that the US has been slipping into recession for the better part of the past 12 months, the decline has been contained, and the economy has been kept barely afloat by an enormous dose of credit. This policy prolongs the inevitable adjustment as the US continues to spend well in excess of its income.

Faced with the truth of a collapsing dollar and a significant revival of price inflation, the Fed must aid and even accelerate the economy's downward lurch, tighten monetary aggregates, spur domestic savings, and produce an economic contraction of probably the order of 2%-6% in the GNP to eliminate the deficit on current account.

Since, as we have seen, markets are able to impose their own adjustments, it stands to reason that a failure by the authorities, and particularly the Fed, to pull in the belt will produce the self-same results, except at much greater social costs. As the dollar ratchets in a severe downward spiral, US interest rates will rise quite dramatically to create the substitute domestic savings and ration out excessive consumption and investments. Commodity price inflation will once again come to the fore. In the end, the economic adjustment will have taken place but not before wiping out the entire savings and loan industry, decimating the highly-leveraged US corporate sector, and blowing up the major money-center banks loaded with delicate LDC debt, all a result of frightened (at best timid) official policy of resisting as far as possible the inevitable adjustment. A similarly misguided policy in the UK in the mid-'70s caused the final collapse of the fringe banks and the real estate and equity markets before the IMF stepped in to prescribe the obvious.

(Our interest rate forecast elsewhere in this issue is more specific in gauging current policy and should also be consulted.)

STRATEGY: *At this time, the most comfortable place to be is short the US dollar via the Swissie and the Deutschmark. As the weeks of Fed indecision pass, the scope for effective stabilizing action grows, simply because of cumulative changes in sentiment and the slow pace in achieving immediate compensating trade effects, as discussed. We exited profitably long Swiss franc and DM positions on August 6 and re-entered them via the Hotline Update on August 13. Place stops at 42.40 and 34.95, basis September '85 contracts, close only.*

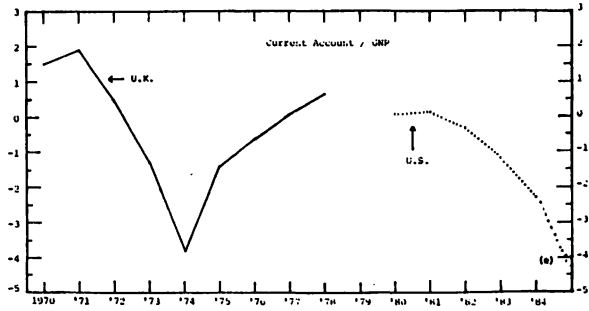


Chart 1

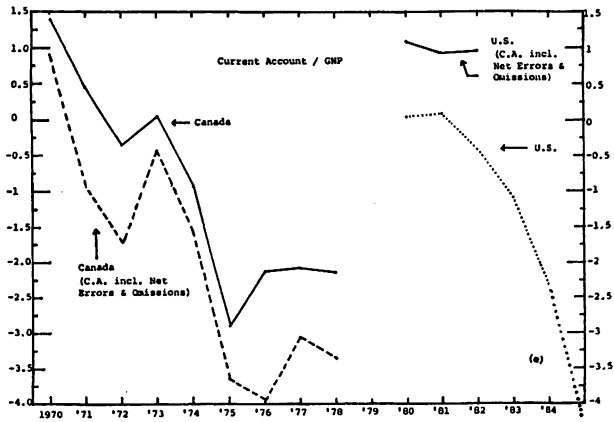


Chart 3

Chart 2

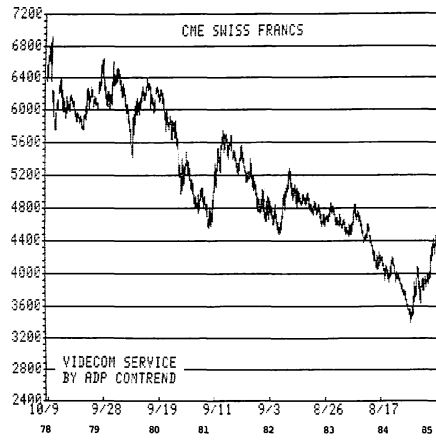


Chart 4

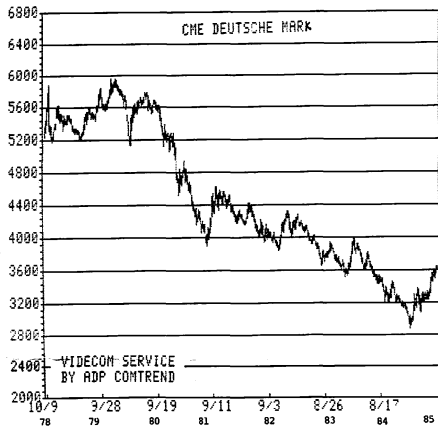


Chart 5

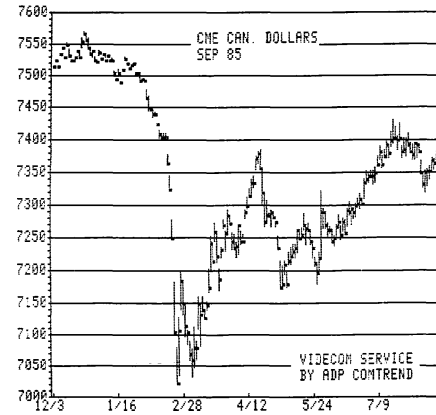
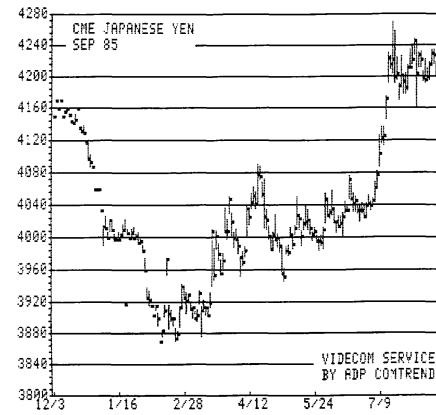
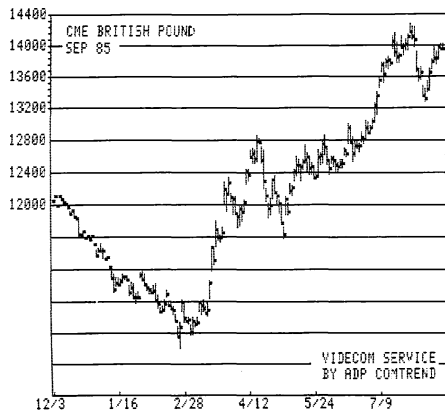


Chart 6



Gold

On the move

After backing and filling in a narrow range for the best part of this past spring and summer, bullion prices have finally gathered enough momentum to break out on the upside, promising to initiate the second leg of a substantial advance.

Significantly, gold prices have firmed in the face of continuing weakness in commodity prices. This temporary divergence points to gold's high sensitivity to the foreign exchange value of the dollar. While continued dollar weakness will, in due course, lift commodity dollar prices, recessionary forces are likely to numb their initial reaction. Not so gold, where industrial demand represents but a minute share of the *total demand* (through a larger share of *yearly production*).

In "Gold: a time to buy" (March 24, 1985), we presented a gold pricing model based on net US short-term external liabilities and arrived at the fortunate conclusion that gold was, finally, fairly priced after having sustained a long five-year decline. We also projected a rather sensational price advance on the basis of a rapid build-up in US external liabilities over the subsequent year or two. We still maintain these views, and in coming issues we will be reviewing this model for fresh valuation guidelines.

In this issue, we toy with the concept of domestic coverage, an integral part of the gold exchange standard that was in use in the US during the greater part of the twentieth century. In essence, currency issued by the US Treasury could not exceed a given multiple of its gold stock; the note issue had a legal gold cover that was lowered to 25% in the '60s, and finally abrogated in 1968.

Of course, this gold cover is a relic of a past monetary standard that is unlikely to be adopted ever again. So why bother with it? Simply to put gold in perspective to the great

"paper inflation" of the past half-century. In conjunction with standard methods of measuring purchasing power (i.e., against CPI or WPI), this calculation serves the useful purpose of telling us whether gold is extremely cheap or extremely dear.

To compute our ratio, we have expanded our denominator: Whereas the strictly legal gold reserve requirement targetted only currency in circulation, we have allowed ourselves to include all federal debt obligations plus commercial bank reserves at the Fed. The rationale for this wider denomination is that there is no distinction between Treasury currency and Treasury debt obligations, where the latter are never to be repaid but merely rolled-over. (Using this rationale Michael Cox, Senior Economist of the Federal Reserve Bank of Dallas in the May 1985 issue arrives at some startling but logical conclusions.)

As Chart 7 shows, gold priced at approximately \$320/oz. represented a mere 4.4% of total Treasury obligations, the lowest ratio in 15 years and only exceeded in the '67-'71 period, just prior to the great bull market of the '70s. (For illustrative purposes, we have also projected the ratio to 1987 under assumption of a widening Federal deficit, the effects of recession.) A return to a more "normal(?) range" would require a rise in gold prices of between 50% and 100% from present levels, *providing* Treasury debt does not skyrocket.

While the above exercise may be somewhat naive (and entertaining), it does provide us added comfort and allows us to state that we are once again facing a once-in-a-lifetime opportunity to purchase gold at reasonable prices.

STRATEGY: Long-term investors should add to previously established long positions.

Chart 7

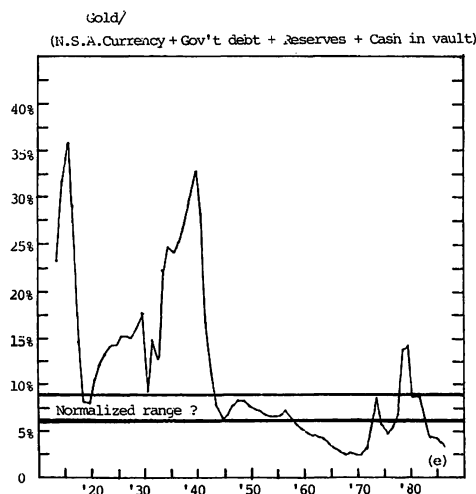
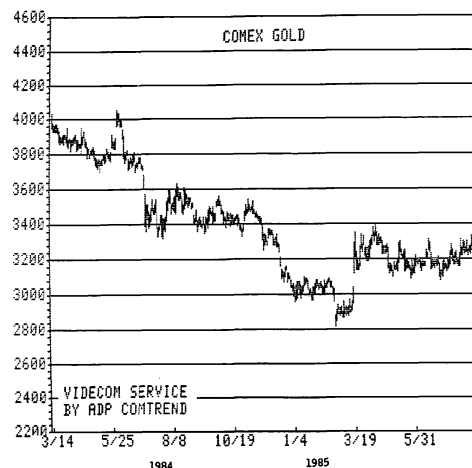


Chart 8



Energy Futures

The only *relevant* news of the past few weeks has been the persistence of Sheikh Yamani's irrational oil policy of cutting oil output to maintain prices. While announcing that the Saudis would no longer consider themselves bound to a swing-producer role and that instead they would move to raise output to their "allotted" 4.3 million barrels per day (mb/d), *in fact* Saudi Arabia produced only 2.6 mb/d in July (of which 350,000 b/d went to storage) and a mere 2.2 mb/d in early August. The Saudis have once again saved Opec from a most embarrassing "downward spiral" — at least for now.

Aside from this all-important supply factor, the New York market was buffeted by a continuous string of unfortunate (for the bear, that is) events. First, the Senate had reportedly reached a bipartisan compromise to cut the Federal deficit by — among other measures — raising a \$5 tax on each barrel of imported oil. This insane idea was quickly rejected by President Reagan, not before causing US crude oil prices to jump over \$1/barrel. As if that shock was not enough, rumors that the Iraqis had destroyed Kharg Island lifted prices again as much as 50¢/barrel. Strangely, the denial brought only slight relief to an already tense market.

Of course, what lies at the foundation of this taut market is the Saudis' heretofore unassailable role as marginal supplier (or swing producer). As world demand shrinks, Saudi supplies shrink, barrel for barrel and almost drop for drop. To maintain this degree of tightness, the Saudis will have to be prepared to see their output vanish entirely over the next 12 months as world demand contracts by a further 5%. Furthermore, consumption decreases will tend to accelerate destocking: every one-day cutback in forward-days' supplies represents approximately 42 million barrels, or *115,000 barrels per day of Saudi output if extended over an entire year but as much as 1.4 mb/d if realized over just one month*. With oil stocks well over 100 days of forward supplies, a sudden run-to-the exits cannot be ruled out.

But, what about continuing a 2.2 mb/d output rate? Can

the Saudis really afford it? After subtracting 800,000 b/d for domestic usage, the Kingdom is left with a mere \$35 million of revenues per day, or just under \$13 billion per year, compared with fiscal expenditures plans of \$55 billion. It won't be very long before even the fabulously wealthy Heshemites lose their shirt and go on welfare.

Meanwhile, oil consumption at the OECD countries continues to erode, falling 3.5% in the second quarter of 1985 with the largest drops registered in Japan 7.8%, Britain 19%, Italy 10%, and France 8%. The US experienced a 1.8% decline. Also in the second quarter, oil stocks were run down a mere 300,000 b/d in contrast to predictions by Opec members of a possible drawdown of 2 mb/d. The IEA further indicated that Opec crude output for the April-June period averaged 15 mb/d, well below the organization's ceiling of 16 mb/d.

The Saudi floating stockpile is reportedly in excess of 60 million barrels and growing daily. Have they decided to wait until a critical period or day(?) to see whether demand begins to rise, say September 15? If it does not, could they have possibly decided to unload the entire stock to or through the Aramco partners? Using the pretext that they have merely caught-up with the accumulated quota? If so, it would be hard to believe that prices will not crumble. Of course, the stockpile could be shifted — at a price — from the Saudis to the Aramco partners, but even the latter would have to strain to come up with \$1.5 billion and take the risk of a collapse in prices.

Ultimately, lower, not higher, crude prices are beneficial to the oil companies as they struggle to increase volumes and make their downstream operation profitable.

With their backs to the wall, the Saudis are fighting the last battle... and time is running against them.

STRATEGY: *Remain steadfastly bearish. For the average trader it is prudent to meet margin calls by liquidating part of the position. As for us, we'll go to the wire.*

Chart 9

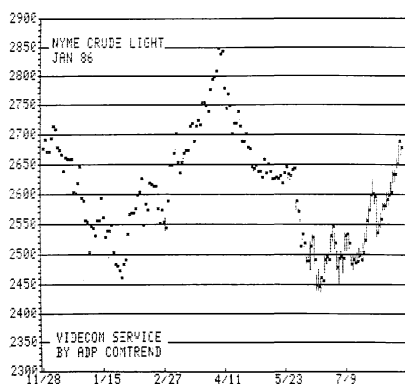
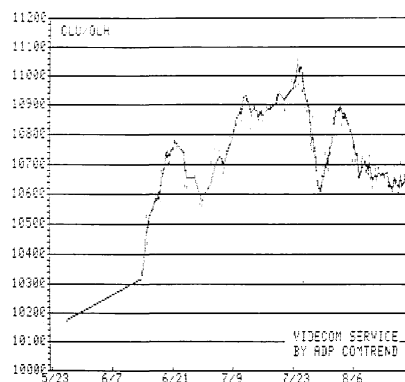


Chart 10



Financial Futures

Short-term US interest rates have begun to firm up in recent weeks, probably a result of the weakening dollar.

The Fed, however, remains unusually timid: adjustment borrowings from the Fed's window remain at the \$400-500 million level, and commercial banks continue to enjoy a respectable level of free reserves. Adjusted Fed Credit, on a 3-month basis, continues to run at a generous 10.6% per annum pace, although there has been a distinct slowing down of the Adjusted Monetary Base, now showing only a 4% annual rate of growth for the past two months. Clearly, there has been a serious lack of restraint and, perhaps, appreciation, of what a collapsing dollar could wreak.

As was already discussed in our lead article, a weakening dollar spells higher interest rates. Either the Fed raises rates to re-attract foreign savings and spur domestic savings or the market imposes its own adjustment process and forces sharply higher US interest rates to compensate for a depreciating cur-

rency after a prolonged loss of confidence. Under the first scenario, rates need not rise nearly as dramatically as under the second alternative, simply because the adverse momentum has not yet become an avalanche.

STRATEGY: We advocate outright short December '85 Eurodollar position and or purchase of December '85 put options, 91.00 striking. We also continue to favor 1 long December '85 T-bonds/2.6 short December '85 Eurodollars (Chart 11) mentioned last month.

Our long T-bond/short S&P 500 spread (Chart 12) is now challenging three-year highs. We continue to favor this trade (see also "Stock Index Futures").

Finally, well-margined accounts should maintain the long TSE 300/short TSE Oil and Gas spread, despite its having moved adversely in recent days. The average investor should not risk more than 33% of the margin on a single trade.

Chart 11

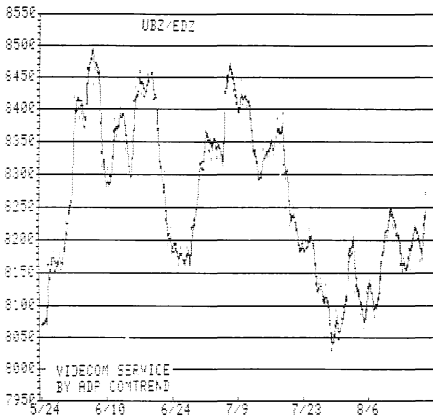


Chart 12

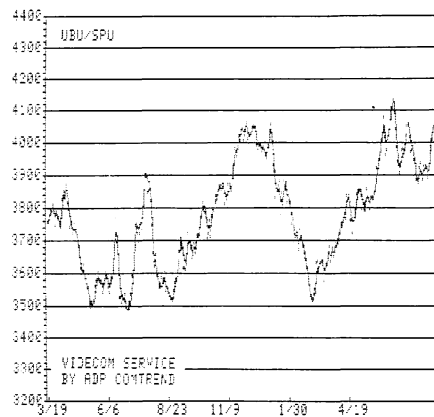
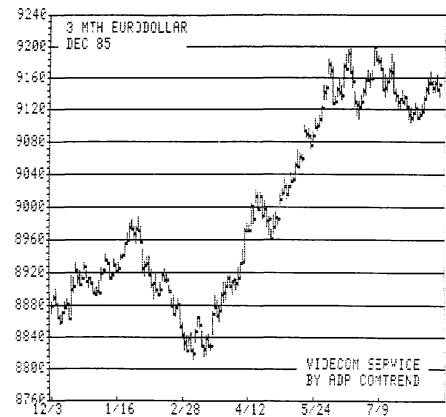


Chart 13



Stock Index Futures

Second quarter US corporate profits are unofficially estimated to be down 2.1% on the first quarter and down 9.3% on a year ago. A *Wall Street Journal* survey of corporate profits shows profits down as much as 14% year over year (see Chart 14.) These figures vindicate forecasts we made as much as eight months ago, predicting a sharp downturn of profits associated with a worsening recession.

Inexplicably, the stock market, not having anticipated the erosion of profits, did not react to the actual event, at least until mid-July. Since then, senior averages have retraced somewhere between 5% and 7% from the all-time highs. Low volume leading to the top and since then may represent the last stage of distribution of the perverse 1982-1985 bull market climax.

Other technical clues, such as the dramatic shrinking of 52-week highs and the parallel weakness in the breadth figures may be signalling the beginnings of a long-overdue bear market. As a final confirmation of the change in trend, we would like to see the Dow Jones Industrial and the S&P 500 penetrate, on a closing basis, their July '84-January '85-May '85 uptrend, which now stand at 1290 and 186.00 respectively (see Chart 15).

STRATEGY: Penetration along the year-long uptrends should signal the beginning of a bear market. S&P 500 put options may then be purchased, preferably those out-of-the-money for the more distant contract months.

Chart 14

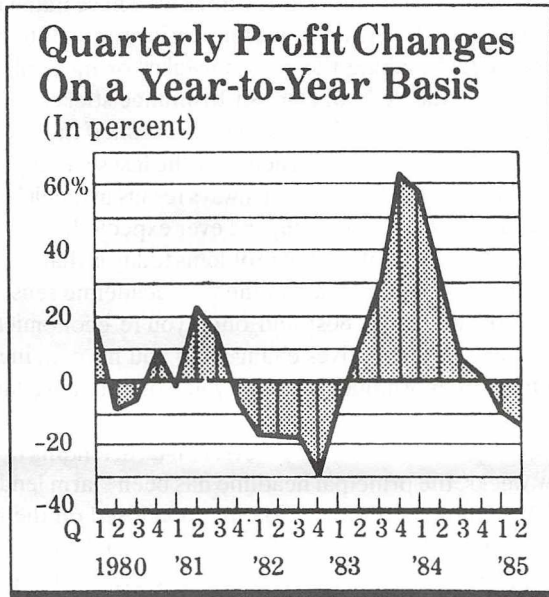


Chart 15



The Banking Mess – Part V

By Eric Hemel

(Excerpted from a transcription of a Conference Copy Incorporated tape recording entitled "WSPG—Financial Safety Nets, I-175A, The Thrifts." Eric Hemel is Director of the FDIC, Washington.)

No conference on financial safety nets would seem appropriate without having a discussion of the savings institution industry in that in the public perception, the thrift industry has become a vulnerable component of our system of financial safety nets.

It's funny in a way that the S&L industry has gotten so much press in the last few months because at least from my economic point of view, things really haven't been better any time in the last five years. Interest rates are down dramatically, probably 300-350 basis points below what they were 12 months ago; the spread between the average return on assets and the average cost of liabilities is probably in the process of reaching all time highs in the third quarter of 1985.

At these rates, the legacy of long-term, fixed-rate mortgages and the stranglehold that they had on the S&L industry may be significantly attenuated. We've done some rough calculations, and my best guess would be that S&L losses of fixed-rate mortgages are probably a third today of what they were a year ago. The fixed-rate mortgage problem at today's rates is dramatically lower than it's been any time really since the fall of 1979. The bad news is that we have a rather substantial legacy leading into 1985 apart from just fixed-rate mortgages.

Amidst considerable controversy and in response to these

very alarming trends, the bank board adopted new capital requirements last January that appear to have had the effect of reducing the amount of leverage the savings institutions can use in growing and acquiring new real estate loans and investments. My own view is that capital requirements that were passed in January were loose, even though I was the technical architect of those. I did not think they would have a terribly significant effect.

The market surprised me. Growth for the first four or five months in 1984 was at a rate of over 20%. In 1985, it's been a rate between 5% and 6%, but at least the people in the field that I talk to say that these capital reins are seriously constraining the growth of the S&L industry. I think to a large extent, we're seeing people pause, simply to reformulate their strategies in an era where capital now counts. And I don't expect 5% or 6% growth to continue. But, it now seems relatively apparent that the long-term growth of the industry will be considerably less than we had feared that it would be.

The shift in S&L problems from interest-rate spread losses to asset-quality losses have a number of implications both for individual institutions and the future of the entire industry. The most visible implication is that the underlying reasons for savings institutions falling into the FSLIC's clutches have shifted. Three years ago, approximately 80% of FSLIC's cases were primarily attributable to spread problems and only 20% to asset quality problems. By 1984, that ratio will completely reverse itself, with almost all the FSLIC's serious problems arising in regard to the disposition of failed thrifts with failed

real estate. And I think it's fair to say at today's rates, we won't see any spread problems, at least not for the next several years.

You might ask, "why agonize over the reason for a failure. Isn't it quite expensive either way?" And the reason is very simple. As a percentum of thrift size, real-estate-related failures have proven two to five times as expensive as interest-rate spread failures have over the last several years. I might sound crazy extolling the virtues of interest-rate spread failures, but in practice, they really are a delight to deal with in comparison to real estate losses. The downside losses on interest-rate spread failures are at least partially limited by the high credit quality of the underlying assets. When a prospective acquirer is looking to buy, he can generally quantify the magnitude of the losses he is taking on. In addition, he can insulate himself from the subsequent interest rate risks, either through the terms of his assistance agreement with the FSLIC or alternatively, by laying off part of the risk through the use of widely-traded financial instruments like futures or options or rate swaps.

In short, disposing of interest-rate spread failures through a system of mergers is usually a practical alternative and one which at least preserves the values of the problem institution as an ongoing concern, thereby diminishing the FSLIC's ultimate cost. In contrast, we've had no such luck in working out real-estate-related failures. I don't even know if we *have* worked out a real-estate-related failure, at least fully yet. And that's because institutions failing due to asset problems had taken on a wide variety of contingent liabilities which are often difficult to identify, let alone to quantify. The assets of the institutions usually consist of raw land or half-completed multi-family or office buildings which were of highly uncertain value. The potential losses to prospective acquirers are unknowable and unhedgeable, and not surprisingly as the shift in the FSLIC's caseload has switched from spread problems to real estate problems, our actual and projected costs have increased quite dramatically.

Commercial vacancy rates nation-wide are 17%, rising with a pipeline of unfinished projects likely to offset even the most favorable scenario for future real estate absorption rates. For those of you who make a living in commercial real estate, I'm not going to repeat the dismal facts and ruin your morning. For those of you who aren't aware of the situation, I suggest you worry about the things you should be worrying about, like nuclear war and reservoirs running dry upstate, and don't get depressed about the commercial real estate situation because it really is, in my mind, unalterably depressing. If you've been trained to believe that demand and supply really matter, we're in for a debacle — it will certainly take a number of savings institutions and commercial banks with them.

Let there be no doubt about it: Though supervisory practices do mean forcing some people out of business. In the months ahead, I'm sure we'll hear many arguments to the effect that it will prove easier and more comfortable to defer our problems by letting problem loans sit on thrift institutions' books at their original values so that cosmetically, everything

can appear neat and clean. But I think as responsible regulators and fiduciaries, we have to reject this argument vociferously. We simply can't allow institutions who have made major mistakes in underwriting loans for new investments to continue to operate making the same mistakes or more all the while enjoying the Federal Deposit Insurance sticker on the door and all the benefits that it provides. I think if there's one lesson that a lot of us have learned over the last several years, it's that deferring problems almost always results in much larger problems much sooner than anyone ever expected.

I think the cause of a lot of problems today is that a lot of institutions went under water, in the true academic sense, in the late '70s and early '80s; and once you're economically under water, your incentives change and you have an incentive to take on enormous risks that you wouldn't have taken on otherwise. What I see in commercial banking is very much the same way. If you've seen the stories on farm lending in the last few weeks, the principal headline has been "farm lending is up." You know, people aren't being foreclosed on the way most economists have predicted. I suppose if you're a farmer, that's good news and if you're a small town banker, that's probably understandable in human terms. But you're looking at the whole system: What they're saying is, "farm banks that are economically under water are doubling or tripling their ante. They're not biting the bullet. They are continuing to operate for all practical purposes as federal agencies, and they have, at this point, very little incentive to reduce their risks.

I haven't seen the writeoffs on commercial real estate among commercial banks I would have expected, given the huge exposure of commercial banks to office markets — in Texas especially, and generally the sunbelt. What that tells me is that there are some banks whose capital is significantly impaired, who may be, in a true economic sense, under water, who are still doing business, and who I know have to be changing their risk profiles as a consequence.

The fact of the matter is, if your books look good but your underlying economics aren't, you as an institution have different incentives than you did before. I'm terribly concerned that between deferral of losses from farm loans, energy loans, real estate loans, Latin American loans — you name it — a lot of respectable financial institutions are truly close to or actually are under water. Their incentives are changed and they could be consciously — well, presumably unconsciously — doing both the FDIC, and ultimately, the Federal Treasury a very serious amount of harm.

I think a lot of us academic and quasicademic types have really wasted a lot of time in the last few years bantering around, one debate after another on the merits of risk-related deposit insurance. Theoretically, risk-related deposit insurance is the answer to all our problems. There's no doubt about that. But in the real world, where we have to implement the systems we devise and we have to be able to defend the systems we've implemented, across the board, risk-related deposit insurance is just not a serious proposition. We can't measure risk.

The Exotics

Spanish peseta

The courageous austerity program put in place by the socialists has achieved a number of worthwhile goals. The inflation rate has been cut to 9% in 1984 from 14% in 1982 and is likely to be around 7.5% in 1985. The 1984 trade deficit at \$4.7 billion was a substantial improvement over the 1984 deficit of \$8.5 billion. While government sources forecast a \$2-\$2.3 billion current surplus for 1985 after a \$1.06 billion surplus in 1984, the state budget deficit has been cut to 5% of GDP in 1985 and is likely to be cut another half a point in 1986.

The country's Achilles heel has been the unemployment rate, which now hovers around 22% of the working population, and is the highest in Europe. The government has understood that the reason for this high rate of unemployment is the still high level of real wages, and as a result it has moved to maintain wage restraint policies that call for wage rises up to six percentage points lower than the rate of inflation. Also, the

government has introduced tax relief on new employment and has been trying to deregulate the labor market's rigid system of fixed contracts, policies that have come under increasing criticism of the unions and the left wing of the socialist party.

With general elections due next year it is difficult to see how the socialist government can avoid taking *some* expansionary policies. Perhaps the most suitable alternative in view of the recent stagnation of exports and the high level of real wages is to devalue the peseta by anywhere between 10% and 15% while maintaining a firm grip over monetary fiscal policies.

STRATEGY: *As a result, we think the benefits of maintaining a long position in forward pesetas (at an attractive 6%-7% discount) are outweighed by the risks of a devaluation that could be undertaken to solve the alarming unemployment problem. We are neutral against both the DM and US dollar.*

Chart 16

| YEAR | SPANISH PESETAS PER U.S. DOLLAR (PERIOD END) | BASKET | | | |
|-----------|---|-------------------|-------------------|-----------------------|--------------------------------------|
| | | U.S. 1970=1.00 | U.S. 1978=1.00 | U.S. 26% 1970=1.00 | FRANCE 30% U.K. 18% 1978 =1.00 |
| 1967 | 69.70 | 0.9740 | 1.7443 | 0.9788 | 1.3581 |
| 1968 | 69.82 | 0.9678 | 1.7332 | 0.9672 | 1.3419 |
| 1969 | 70.06 | 1.0022 | 1.7948 | 1.0032 | 1.3919 |
| 1970 | 69.72 | 1.000 | 1.7909 | 1.0000 | 1.3875 |
| 1971 | 66.02 | 0.9132 | 1.6355 | 0.9761 | 1.3543 |
| 1972 | 63.57 | 0.8376 | 1.5001 | 0.8870 | 1.2306 |
| 1973 | 56.95 | 0.7148 | 1.2802 | 0.7912 | 1.0978 |
| 1974 | 56.11 | 0.6766 | 1.2118 | 0.7805 | 1.0829 |
| 1975 | 59.77 | 0.6733 | 1.2059 | 0.7562 | 1.0492 |
| 1976 | 68.29 | 0.7070 | 1.2663 | 0.7801 | 1.0824 |
| 1977 | 80.91 | 0.7167 | 1.2835 | 0.8729 | 1.2112 |
| 1978 | 70.11 | 0.5584 | 1.0000 | 0.7207 | 1.0000 |
| 1979 | 66.15 | 0.5068 | 0.9076 | 0.6857 | 0.9514 |
| 1980 | 79.25 | 0.5961 | 1.0676 | 0.8129 | 1.1279 |
| 1981 | 97.45 | 0.7061 | 1.2646 | 0.8319 | 1.1542 |
| 1982 | 125.60 | 0.8439 | 1.5113 | 0.9253 | 1.2838 |
| 1983 | 156.70 | 0.9694 | 1.7361 | 0.9926 | 1.3772 |
| 1984 | 173.40 | 1.0053 | 1.8004 | 0.9178 | 1.2734 |
| 1985 (1Q) | 172.10 | 0.9584 | 1.7164 | 0.9068 | 1.2582 |
| 1985 (2Q) | 174.70 | 0.9569 | 1.7137 | 0.9297 | 1.2899 |

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 17

| Year | Foreign Assets (Min US\$) | CURRENT ACCOUNT | CUMULATIVE 12 QTR. |
|----------|------------------------------|-----------------|-------------------------------|
| | | As % of GNP | Current Account (Min US\$) |
| 1970 | 1520 | 0.2 | -510 |
| 1971 | 2969 | 2.0 | +543 |
| 1972 | 4436 | 1.1 | +1516 |
| 1973 | 6110 | 0.8 | 2022 |
| 1974 | 4402 | -3.6 | -2067 |
| 1975 | 2509 | -3.3 | -6126 |
| 1976 | -146 | -4.0 | -11039 |
| 1977 | -395 | -1.7 | -9939 |
| 1978 | 3551 | 1.1 | -4791 |
| 1979 | 5275 | 0.6 | 629 |
| 1980 | 1097 | -2.4 | -2411 |
| 1981 | 595 | -2.7 | -9034 |
| 1982 | -4347 | -2.3 | -14402 |
| 1983 | 4275 | -1.6 | -11709 |
| 1984 | 8350 | 1.2 | -4720 |
| 1985 (1) | 8884 | | |

Chart 19

| Rates | | | | |
|---------|---------|---------|---------|----------|
| SPOT | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
| 162.65- | 163.30- | 165.15- | 168.15- | 172.65- |
| 162.85 | 165.10 | 168.35 | 171.35 | 176.85 |

Chart 18

HARD CURRENCY COVER (In millions of U.S. Dollars)

Reserves * + Previous 12-months current Account *** = 18120
 (Reserves + 12-months C/A)/M1 ** = 18120 / 29,766 = 60.8%
 Reserves + 12-months C/A/Broad Money ** = 18120 / 117,000 = 15.5%
 * As at May 1985 ** April 1985 *** 1985 (1) - 1985 (4)

 Figures in millions of U.S. Dollars

| | M1 (Converted to U.S. Dollars) | Broad Money (Converted to U.S. Dollars) |
|-----------------------|-----------------------------------|---|
| 1974 | 29,477 | 78,756 |
| 1985 | 29,766 | 117,700 |
| % Increase (decrease) | 1% | 49.4% |

Corresponding % increase in the United States: 113% (M1), 159% (Broad Money)

 (a) 1984 Imports as percentage of GNP 16.98
 (b) 1975 - 1984 Imports as percentage of GNP 15.31
 1984/(1975 - 1988 average) = (a)/(b) = 16.98 / 15.31 = 110.9%

Source: IFS

Italian lira

On July 22 finance ministers and central bank governors of the EEC agreed to a realignment of exchange rates within the EMS with the Italian lira devalued by 6% and other currencies being revalued by 2%. This realignment was prompted by the weakening of the Italian lira in foreign exchange markets, which culminated in the hectic trading session of July 19 where the lira was traded down by as much as 20% without official intervention. The immediate cause for the market's uneasiness can be found in Italy's worsening trade deficit which amounted to the equivalent of US \$7.5 billion in the first five months of 1985. For the entire year, the current account deficit is expected to worsen to US \$4.5 billion from \$2.8 billion in 1984 and a surplus in 1983.

Far more serious than this modest deficit is the scandalous condition of state finances where the deficit is once again expected to exceed 15% of GDP. Italy is being buried under a mountain of debt. It is rather amazing that price inflation has

been contained, and in fact brought down into single digits for the first time in a decade. While the central government continues to be successful at tapping the high rate of domestic savings, there is little doubt that the situation is a delicate one, highly dependant on confidence in the restoration of some semblance of eventual fiscal order.

Should this confidence be undermined — not a difficult thing to accomplish, given the level of the deficit — one would have to expect an outburst of hyperinflation.

STRATEGY: *The effective 8% devaluation of July 22 caught us unprepared, as we have maintained since late March a long position of Italian lira versus the Deutsche-mark. The damage was, however, mitigated by the steep forward discount on the lira at the time. Nevertheless, once bitten twice shy, and we prefer to close out the position and stand aside.*

Chart 20

| YEAR | ITALIAN LIRA PER U.S. DOLLAR (PERIOD END) | U.S. | | BASKET | |
|-----------|--|------------|------------|-------------|----------------|
| | | 1970 =1.00 | 1977 =1.00 | 1970 =1.00 | 1977 =1.00 |
| | | | | U.S. 13% | BELGIUM 6% |
| | | | | U.K. 10% | FRANCE 26% |
| | | | | Germany 31% | NTHR 7% |
| | | | | | SWITZERLAND 7% |
| 1967 | 623 | 0.9400 | 1.0059 | 0.9489 | 0.7554 |
| 1968 | 623 | 0.9635 | 1.0310 | 0.9645 | 0.7678 |
| 1969 | 625 | 0.9958 | 1.0658 | 0.9993 | 0.7955 |
| 1970 | 623 | 1.0000 | 1.0701 | 1.0000 | 0.7961 |
| 1971 | 594 | 0.9456 | 1.0119 | 1.0249 | 0.8159 |
| 1972 | 582 | 0.9089 | 0.9726 | 0.9908 | 0.7887 |
| 1973 | 607 | 0.9079 | 0.9715 | 1.0705 | 0.8522 |
| 1974 | 649 | 0.9043 | 0.9677 | 1.1375 | 0.9055 |
| 1975 | 683 | 0.8888 | 0.9511 | 1.0715 | 0.8530 |
| 1976 | 875 | 1.0303 | 1.1025 | 1.2512 | 0.9961 |
| 1977 | 871 | 0.9345 | 1.0000 | 1.2562 | 1.0000 |
| 1978 | 829 | 0.8535 | 0.9133 | 1.2393 | 0.9865 |
| 1979 | 804 | 0.8017 | 0.8579 | 1.1960 | 0.9521 |
| 1980 | 930 | 0.8689 | 0.9298 | 1.2354 | 0.9834 |
| 1981 | 1200 | 1.0501 | 1.1237 | 1.2749 | 1.0148 |
| 1982 | 1370 | 1.0919 | 1.1684 | 1.2366 | 0.9844 |
| 1983 | 1659 | 1.1910 | 1.2745 | 1.2364 | 0.9843 |
| 1984 | 1935 | 1.3078 | 1.3995 | 1.1905 | 0.9477 |
| 1985 (1Q) | 1979 | 1.2855 | 1.3756 | 1.2088 | 0.9623 |
| 1985 (2Q) | 1950 | 1.2517 | 1.3395 | 1.2043 | 0.9587 |

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 21

| ITALY | | | |
|-------|------------------------------|-------------------------------------|---|
| Year | Foreign Assets (Mln US\$) | CURRENT ACCOUNT As % of GNP % | CUMULATIVE 12 QTR. Current Account (Mln US\$) |
| 1970 | 5,556 | 0.89 | 5996 |
| 1971 | 6,016 | 1.85 | 5347 |
| 1972 | 5,588 | 1.54 | 4934 |
| 1973 | 5,231 | -1.64 | 1494 |
| 1974 | 1,116 | -4.74 | -8608 |
| 1975 | + 964 | -0.30 | -11181 |
| 1976 | 4,228 | -1.54 | -11544 |
| 1977 | 9,016 | 1.13 | -1041 |
| 1978 | 20,400 | 2.38 | 5776 |
| 1979 | 34,359 | 1.66 | 14091 |
| 1980 | 46,289 | -2.47 | 1850 |
| 1981 | 39,340 | -2.45 | -12991 |
| 1982 | 30,884 | -1.64 | -24089 |
| 1983 | 37,517 | 0.16 | -13733 |
| 1984 | 32,746 | -0.83 | - 8000 |

Chart 23

| Rates | | | | |
|--------|---------|---------|---------|----------|
| SPOT | 1 MONTH | 3 MONTH | 6 MONTH | 12 MONTH |
| 1845 - | 1860 - | 1868 - | 1892 - | 1935 - |
| 1849 | 1867 | 1876 | 1902 | 1947 |

Chart 22

| HARD CURRENCY COVER (In millions of U.S. Dollars) | |
|---|---|
| Reserves * + Previous 12-months current Account *** = 37231 | |
| (Reserves + 12-months C/A)/M1 ** = 37,231 / 144,358 = 25.79% | |
| Reserves + 12-months C/A/Broad Money ** = 37,231 / 242,510 = 15.35% | |
| * As at June 1985 ** Dec. 1985 *** 1985 (1) -1985(4) | |
| Figures in millions of U.S. Dollars | |
| M1 (Converted to U.S. Dollars) | Broad Money (Converted to U.S. Dollars) |
| 1974 91,102 | 144,779 |
| 1984 (4) 144,358 | 242,510 |
| % Increase 58.4% | 67.5% |
| (decrease) | |
| Corresponding % increase in the United States 109.4% | 149.7% |
| (a) 1984 Imports as percentage of GNP 21.1% | |
| (b) 1975 - 1984 Imports as percentage of GNP 22.0% | |
| 1984/(1975 - 1984 average) = (a)/(b) = 95.9% | |
| Source: IFS | |

Forex Rates & Update

| <u>Currency</u> | <u>Spot</u> | <u>3-month</u> | <u>12-month</u> | <u>Comments vis-à-vis US\$</u> | <u>Comments vis-à-vis DM spot DM 2.7600</u> |
|---------------------|---------------|----------------|-----------------|--------------------------------|---|
| Australian dollar | .7010-.7020 | .6867-.6882 | .6560-.6585 | Remain long | Remain long |
| Belgian franc | 55.86-56.08 | 56.08-56.28 | 56.51-56.86 | Buy | Remain long |
| Danish krone | 9.99-10.00 | 9.99-10.01 | 9.99-10.02 | Neutral | Neutral |
| Dutch guilder | 3.1060-3.1075 | 3.0878-3.0903 | 3.0205-3.0250 | Buy | Neutral |
| Greek drachma | 130.15-130.25 | 135.15-138.00 | 148.15-160.25 | Short; long Swiss | Remain short |
| Indonesian rupiah | 11.80-11.85 | 12.10-12.50 | N/A | Remain short | Remain short |
| Kuwaiti dinar | .30160-.30180 | .30040-.30120 | .29760-.30025 | Short, long Swiss | Remain short |
| Malaysian ringgit | 2.4560-2.4580 | 2.4610-2.4655 | 2.4635-2.4755 | Neutral | Remain short |
| Mexican peso | 334-337 | 388-395 | 539-607 | Remain short | Remain short |
| New Zealand dollar | .5335-.5355 | .5070-.5110 | .4635-.4780 | Remain long | Neutral |
| Norwegian krone | 8.15-8.16 | 8.24-8.26 | 8.43-8.46 | Buy | Neutral |
| Portugese escudo | 1.6450-1.6550 | 1.6900-1.7750 | 1.8600-2.0800 | Buy | Liquidate |
| Saudi Arabian riyal | 3.6500-3.6510 | 3.6520-3.6545 | 3.6550-3.6600 | Remain short | Remain short |
| Singapore dollar | 2.2045-2.2060 | 2.1837-2.1882 | 2.1450-2.1565 | Neutral | Remain short |
| South African rand | .4050-.4150 | .4025-.4145 | .3880-.4050 | Remain long | Liquidate |
| Swedish krona | 8.24-8.25 | 8.38-8.40 | 8.60-8.63 | Neutral | Liquidate |
| Venezuelan bolivar | 14.30-14.37 | 14.40-14.67 | 14.65-15.70 | Neutral | Neutral |

Explanatory Notes

Currency expected to firm against both currencies.

Currency expected to strengthen against US \$ and weaken against DM.

Currency expected to weaken against both major currencies.

Currency expected to weaken against US \$, but strengthen against DM.

Term used to liquidate short position but does not imply a new buy recommendation.

Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.

Buy

Buy

Sell

Sell

Buy

Sell

Sell

Buy

Cover

Liquidate

Hotline Update

The new market letter is in the mail.

Tuesday, July 23: Already we are revising upwards stops in September SF and September DM positions to 4105 and 3425 respectively, close only.

Friday, July 26: We are revising upwards our stops in September SF and September DM, to 4203 and 3492 respectively, close only.

Tuesday, July 30: Flash update. 8:35 a.m.: Raise stops on long SF and DM speculative and hedge positions to 4301 and 3535 respectively, basis September, close only. This update will replace the Tuesday afternoon broadcast if there are no additional changes.

Friday, August 2: Flash update. 8:35 a.m.: Liquidate long SF and DM positions for speculative and hedge accounts if the September SF and DM closes below 4352 and 3547 respectively.

Friday, August 2: The stop levels advised in the flash update this morning at 8:35 a.m. were only valid for today. You have not been stopped out of these positions. Reinstate our former stop for speculative and hedge accounts of 4301 and 3535, basis September, close only, on the SF and DM respectively.

Tuesday, August 6: As per recommendation of Friday, August 2, both hedge and speculative accounts were stopped out of the September SF and DM at today's close. Remain sidelined.

Friday, August 9: A summary of changes made during this week.

You are now flat the SF and DM positions for both speculative and hedge accounts, having liquidated long positions as of Tuesday, August 6. No further recommendations.

Tuesday, August 13: Flash update. 8:30 a.m.: In view of Fed complacency, we are urging you once again to enter the long side of the SF and DM. Therefore, speculative accounts should purchase September DM and SF at the market with initial stops at 3495 and 4240 respectively, close only. Assuming that you do not care to follow this speculative opportunity, you are advised nonetheless to hedge short KD and Greek drachma short positions by buying SF in an amount equal to 30% of your long US\$ exposure in dinar and drachma. Please note that we do not think that at this time there is a need to hedge the Saudi riyal or Mexican peso or Indonesian rupiah.

Tuesday, August 13: As per our flash update, speculative and hedge are now long once again SF and DM. Maintain stops on close of 4240, basis September SF and 3495, basis September DM.

Friday, August 10: This is a summary of the week's changes. You are once again long the September SF and DM as per our flash update of Thursday 13, 8:50 a.m. We have received many inquiries regarding crude oil. We have not made any changes, although the market has moved adversely in a substantial way. We have not recommended stops and thus far advise you to liquidate positions only if and when it is needed to meet margin calls.

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