

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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A crude waiting game

Suppose you are an oil refiner with 75 days' crude supplies. Suppose further that you are being offered crude supplies for delivery in 60 days at discounts of as much as \$1.50/barrel, equal to 5% off spot prices. Would you continue buying spot supplies, replacing current usage, or would you rather sell your stock to the marketplace at prevailing spot prices (i.e., consume your stock, a process known as destocking) and cover your futures needs at a discount? Rational businessmen could not entertain any doubts. As long as bargain-basement deferred deliveries are assured, crude users would "economize" not-immediately-required stocks at a substantial profit with a view to replacing them in the near future.

In the parlance of the futures business, this rather simple operation is dubbed "lending" supplies to the market. In its infinite wisdom, the market will move from contango to backwardation — from a forward premium to a forward discount — to help along the required mobilization of currently tight supplies. This infinite wisdom, of course, is neither less nor more than a reflection of traders' consensus: While a shortage, or tight market, exists today, thus justifying high spot prices, lower prices are likely to prevail in the near future as a result of a drop in demand or an increase in supplies, or both.

The following statements, then, are true of backwardation markets: (1) Supplies are relatively tight. (2) Prices are expected to be lower in the relatively near future. (3) The perception of what constitutes safe and comfortable inventories changes in direct proportion to the widening of the backwardation. (4) As a result, inventories are economized with the overall economic benefit of mobilizing all available resources. (5) Backwardation cannot produce *new* supplies; it can only stretch the availability of existing supplies — a sort of market-induced goods rationing. (6) Backwardation normally complements high and rising prices, the true solution to supply/demand imbalances.

The 1973-74 copper market illustrates quite well this crucial concept. In the midst of a virulent burst of inflation, the US imposed draconian price and wage controls across a very wide range of goods. Price controls prohibited any price increases by domestic copper producers between early June 1973 and December 6, after which most quotes were increased by approximately 8¢/lb. to a range of 68.15¢-69.25¢/lb. In the free market, copper prices soared and reached an all-time

high of 1.40/lb. by April 1974. Price controls exacerbated supply shortages, and as a result, stock levels were progressively reduced both inside and outside the US until they reached historically low levels in March 1974, hardly covering industry needs.

During this time, a relatively modest 1¢/lb. backwardation (spot to three months) widened to a spectacular 19¢/lb. backwardation (Chart 1), a result of bearish *futures* expectations conditioned by the near certainty that price controls on domestic US producers would be lifted in the not-too-distant future and therefore supplies would expand. The lifting of price controls came in April 1974, and, not surprisingly, copper peaked that month, as we already mentioned, at \$1.40/lb. Visible stocks increased from 305,000 tonnes to 568,000 tonnes by the end of 1974 and to a staggering 800,000 tonnes one year later, under the impact of freely available supplies and a collapse in demand associated with the gathering recession. By the end of 1974, prices had dropped to slightly above 50¢/lb., basis Comex, a dramatic 60% fall in prices.

What does the copper episode reveal? Clearly, real or artificial supply restrictions (copper's was artificial in that domestic producers opted to withhold supplies rather than sell them below the market) will call on the free market to find a mechanism to mobilize all available supplies. That mechanism is called a backwardation: sharp premiums for nearby deliveries or, what is the same, sharp discounts for deferred deliveries.

Let us now turn to the crude oil market. *Artificial* supply restrictions (Opec, and more particularly Saudi Arabia) were met by supply rationalization moves in the form of a continuous destocking process that has been a powerful source of frustration to the Opec price/volume manipulators. IEA figures that stocks in the OECD region were drawn down by 500,000

In this issue

Monitoring protectionism on Capitol Hill: Much ado about nothing? Stock indices: The bear market has begun, and we stay short. The US dollar could stage a rally, so we stay sidelined. We review three spreads. The Greek drachma: a big winner. Contributions by Albert D. Friedberg, Steve H. Hanke, and Daniel A. Gordon.

barrels per day (b/d) in the year to October 1, made up of a 700,000 b/d drawdown of company stocks and a rise of 200,000 b/d in government stocks. As a result, Opec has been forced if it were to successfully hold the line, to cut back output to 14.9 mb/d in the third quarter of 1985 from 15.0 mb/d in the second quarter.

Lending to the market, as we have seen, can only stretch available supplies — it cannot produce new supplies. As stocks continue to be drawn down, the bears hope that sooner or later new supplies will appear or possibly that demand will falter enough to make living with the artificial supply restrictions possible. A look at Chart 2 indicates that the drawdown process has reduced private stocks to 73 days of forward consumption, the lowest such pre-winter level since early 1980. Since, however, minimum operating stock requirements are estimated at around 45 days, *it would appear that the destocking process can continue for some time yet. This is a natural result of the widening backwardation:* As stocks are drawn down further and further, the market is willing to pay lenders an ever increasing premium. Chart 3 shows how the backwardation has been widening in recent months by measuring a constant six-month spread. Chart 4 takes a close look at the November '85-May '86 spread in particular.

clude that destocking will continue well through the winter season and will reduce demand for Opec crude by anywhere between 500,000 and 1,000,000 b/d from forecast levels. Led by a powerful and invisible hand, crude users in months ahead will test Opec's resolve to the breaking point as they make do with the barest minimum level of stocks. In the end, new and abundant supplies will come forth and stocks will be rebuilt at substantially lower prices.

In sum, a proper understanding of the structure of the futures market, in particular the formation known as backwardation, helps elucidate the puzzling and little-understood phenomenon of destocking, the likelihood of its continuation, and the limits of the process.

We are now in a position to estimate fourth quarter supply and demand for Opec crude. Compared with the third quarter average output of 14.9 million b/d, we find the Saudis increasing exports by at least 1.25 million b/d and perhaps as much as 1.8 million b/d; Iraq by 500,000 b/d; Nigeria by 500,000 b/d; Oman (non-Opec), Ecuador, and other smaller producers by probably 150,000 b/d.

Diplomatic sources indicate that the Kharg Island bombings were damaging but have not successfully lowered Iran's 1.4-1.5 million b/d in exports, notwithstanding earlier opinions that Iran's exports had been reduced to 750,000 b/d. Continued Soviet oil production problems have forced them to cut back as much as 500,000 b/d, thus increasing demand for Opec crude. On the negative side, demand for Opec crude will be reduced by 500,000 b/d from recovering of the UK's production level to 2.6 million b/d, 500,000 b/d from increases of various non-Opec producers, and possibly as much as an *additional* 500,000 b/d from further destocking. Allowing for a normal seasonal increase in consumption of 1.5 million b/d, our estimate reveals an ex-ante Opec supply excess of 1.9-2.5 million b/d! *It is impossible for the market to absorb such quantities of crude without suffering a severe price decline.*

An absolute fall in prices will aggravate bearish expectations, widen the backwardation, force more aggressive destocking moves, and threaten to eliminate Opec as a supplier entirely. The cash hungry Opec members will surely resist their displacement: A downward price spiral will have begun.

Opec is trapped. In the crude waiting game, the only thing missing is the knockout punch.

STRATEGY: *As we have repeatedly advised in previous issues, it is imperative to remain short in very deferred months, rolling over continuously, possibly every one or two months.*

In recent weeks, there has been an active market in gasoil out-of-the-money put options. Priced around \$6-\$7 for June and July '86, they are extremely attractive.

Chart 1

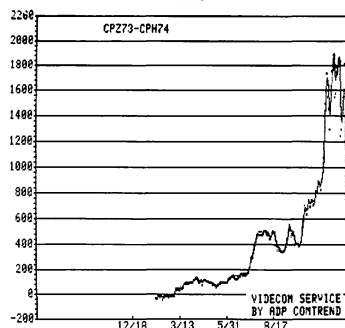


Chart 2

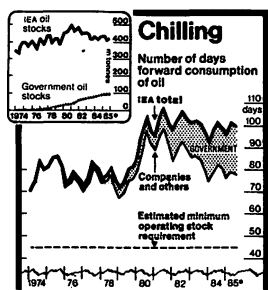


Chart 3

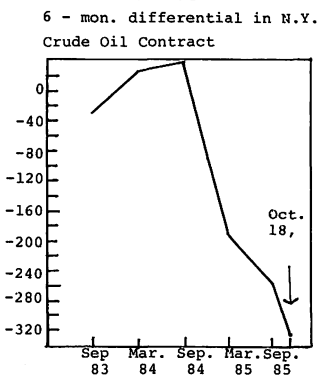


Chart 4

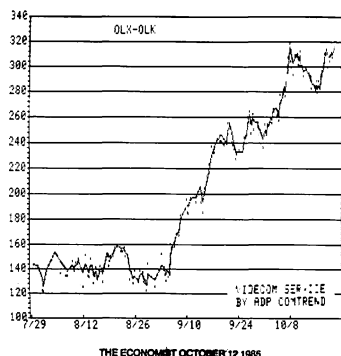
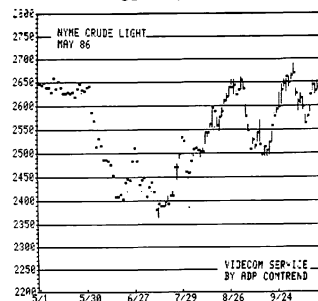


Chart 5



The capitulation of Saudi Arabia (see last month's issue) coupled with a generalized view that spring demand will weaken considerably, putting great pressure on Opec, is causing forward discounts to widen. As they widen, ever stronger incentives are being provided to owners of crude inventories to economize on these inventories. *Our analysis leads us to con-*

Monitoring protectionism

By Steve H. Hanke

In the last issue of *Commodity & Currency Comments*, (September 23, 1985), we identified protectionism as a US policy variable that warrants careful monitoring. In addition to presenting our views concerning the prospects for protectionist sentiment being translated into legislation, we offered an analysis of the linkage between protectionist measures and currency markets. Briefly stated, with the new protectionist measures, the number of dollars that foreigners would earn from exports to the US will be less than without those measures. In consequence, the supply of dollars on foreign exchange markets will be reduced, and the price of the dollar will initially be higher than it would have been without those new measures.

Given the importance of the connection between protectionist measures and the value of the dollar, we offer a status report about protectionist policy activity and the prospects for legislation in this area. During the past month, the Reagan Administration launched a major offensive aimed at choking off protectionist sentiment on Capitol Hill:

- The Administration abandoned its oft-stated policy of not intervening in foreign exchange markets. The US — along with Britain, France, West Germany, and Japan — began to intervene in currency markets in an attempt to drive down the value of the dollar.
- President Reagan took the moral high ground in the trade debate by making a series of hard-hitting speeches in which he contrasted liberal trade policies' benefits with the ruinous consequences of protectionism. It is important to emphasize that he concluded each speech with a threat to veto any trade legislation that would diminish international trade.
- To promote the goal of more liberal trade, the Administration established a trade "strike force" chaired by Commerce Secretary Malcolm Baldrige. Its purpose is to identify unfair barriers imposed by foreign governments on US exports and subsidies obtained by foreigners to promote their exports.
- The White House indicated that President Reagan would vigorously pursue unfair trade practices under Section 301 of the Trade Act of 1974, which authorizes the President to retaliate against countries that engage in unfair trade practices.
- President Reagan dropped his longstanding opposition to the use of US export subsidies. He pledged \$300 million to help US companies match the generous credit terms that foreign exporters, with the assistance of their governments, can offer to their customers.
- The Reagan Administration announced that it will use the dispute-settlement mechanism of the General Agreement on Tariffs and Trade (GATT) to argue cases against

what are claimed to be unfair wheat subsidies by the European community and violations of copyrights and patents by South Korea.

- President Reagan announced that he had obtained what had eluded him at this summer's summit meeting in Bonn: He won unanimous agreement from the 90 member-countries of GATT to begin a new formal round of negotiations to liberalize world trade.

The Reagan Administration's offensive on trade policy has clearly taken some wind out of the protectionist's sails, but although it has slowed the Congressional movement towards protectionism, it hasn't stopped it. Between its huffing and puffing about raising the national debt-ceiling and legislation that would require the federal government to balance its budget by 1991, Congress found time to address trade issues.

Despite the threat of a Presidential veto, the House of Representatives approved legislation that would reduce textile and apparel imports from Brazil, China, Hong Kong, India, Indonesia, Japan, Pakistan, Phillipines, Singapore, North Korea, Taiwan, and Thailand by between 25% and 40% of current levels. The three largest exporters — Hong Kong, South Korea, and Taiwan — would be subject to the stiffest quotas.

This so-called textile bill is the first trade legislation to pass either chamber since Congress returned to Capitol Hill from its August recess. The Senate is currently debating a milder form of the bill.

What is significant about the House vote on their version of the bill is that 262 favored and 159 opposed. This tally falls 19 votes shy of a two-thirds majority, which is the number required to override a Presidential veto. Congressional enthusiasm for the textile bill in the House was dampened by the Reagan Administration's vigorous opposition to it and White House assurances of a Presidential veto. The Administration's position was so strong that 30 lawmakers who had originally cosponsored the legislation, actually voted against their own bill when it came to a floor vote.

It now appears that the Senate will pass a textile bill and that Congress will send a watered-down version of the present textile bill to President Reagan by year's end. The President will veto this milder piece of legislation and Congress will sustain his veto.

The second major piece of trade legislation that continues to show Congressional life is the Trade and Telecommunications Act of 1985. This proposed bill, drafted by Senator John Danforth, would require the President to undertake negotiations with countries that have substantial, but partially closed, markets for telecommunications equipment. The purpose of these negotiations would be to open foreign telecommunications markets and achieve a rough parity of "openness" be-

tween the US market and the foreign markets in dispute. If such a parity were not achieved, the bill would require the President to retaliate against the "closed" foreign telecommunications markets so that the US market would be "closed" to the foreign suppliers to the same degree that the foreign suppliers' domestic markets were "closed" to US exporters. This bill is primarily aimed at Japan.

In its present form, this bill would receive a veto from President Reagan because he objects to the language that would require him to retaliate if negotiations fail to bring parity between US and foreign markets. Congress would sustain such a veto.

Perhaps the most sweeping protectionist measure, which was receiving a great deal of public attention only a month ago, is the Trade Emergency and Export Promotion Act of 1985. This proposed piece of legislation is cosponsored by Senator Lloyd Bentsen and Congressmen Dan Rostenkowski and Richard Gephardt. It contains a complex set of mechanisms that would impose a 25% tariff on goods the US imports from countries that export too much to the US in relation to American products that they import. Under present conditions, Brazil, Japan, South Korea, and Taiwan would be hit with this tariff.

This proposed bill has received little attention since President Reagan began his trade liberalization offensive. To the extent that there has been discussion of this bill, it has been limited to how the bill might be modified to water it down.

The most recent development on the trade policy front concerns talk about moving away from protectionist measures aimed at specific products or countries. Many in Congress are now discussing the possibility of writing a generic piece of

trade legislation. Most proposed provisions of such an omnibus trade bill are either innocuous or even mildly trade-liberalizing in nature. However, one substantive item being discussed addresses natural resource subsidies. Such a provision would require the President to slap a countervailing duty on exports to America if they were derived from state-owned natural resources that had been sold to foreign manufacturers at less than market prices. It is asserted that Canadian lumber exported to the US, for example, would be a candidate for this type of countervailing duty.

At this point, it is premature to make a judgment about such an omnibus trade bill, since one hasn't yet been drafted. However, we bring this new protectionist twist to your attention and will continue to monitor its progress.

Since we first addressed the linkage between protectionist measures and the value of the dollar, President Reagan's trade liberalization hand has become even stronger. This, in part, has been the result of his own initiatives. But it has also stemmed from the growing realization on the part of some members of Congress that increased protectionism would make it increasingly difficult for debtor nations to earn dollars, which are required to service their loans. Not wishing to further aggravate the politically explosive international debt problem, these members of Congress have begun to unilaterally back away from protectionism.

We continue to monitor trade policy developments, since the political winds in Washington, DC, have been known to shift quickly. And if their prevailing direction should move toward protectionism, the dollar's fundamentals will change, and (all other things equal) the dollar will strengthen.

Stock Indices

We are seeing ongoing pressure in foreign, shipping, commercial real estate and agricultural sectors of the economy.

Samuel Armacost, President and CEO,
BankAmerica

Buoyed by the continued rash of leveraged buyouts and acquisitions, particularly in the large capitalization stocks, the Dow Jones Industrial Average recorded new all time highs in what is increasingly being called a "solitary walk." Other averages, such as the S&P 500, NY Stock Exchange Composite Index, and more particularly, the Value Line Index, have lagged significantly and still stand today as much as 6% below recent peaks. Breadth figures and the extreme paucity of net new highs confirm the obvious: For all practical purpose, the bear market has begun.

The Treasury and the Fed are desperately trying to hold the recovery together: Artificially lowering the dollar; allowing the fiscal deficit to widen; and pursuing an easy-money

and easy-credit policy. The combined stimulus has, so far, been pitifully weak. The enormously overextended consumer is being counted upon to carry the ball. It is hard to imagine a lower savings rate than 1.9%, and yet, fourth-quarter projections still call for a 4%-5% annualized rate of growth. As capacity utilization notches lower month by month and as the burden of corporate debt compounds the problem of grappling with outright deflation, one must surmise that little has been learned from previous credit orgies.

Some supply-siders, who (correctly) believe that disinflation is turning into deflation, recommend that the Fed cushion the transaction and even negate ultimate asset liquidation by becoming even more aggressive in providing money. What eludes these theorists is that the more aggressive the Fed becomes, the more private debt is created; the more private debt is created, the more debt-servicing problems are created, especially in view of the *sluggishness* in real activity.

The Fed is well aware of this ominous development but is totally unable to cope with it in a rational nonpolitical way.

Chart 6

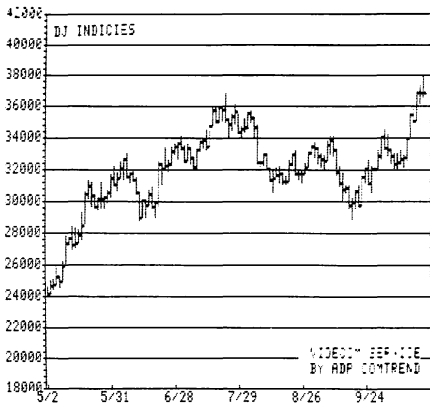


Chart 7

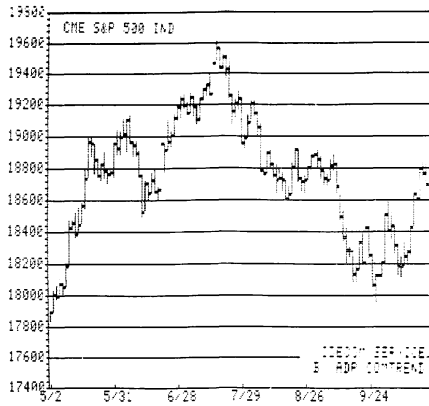


Chart 8

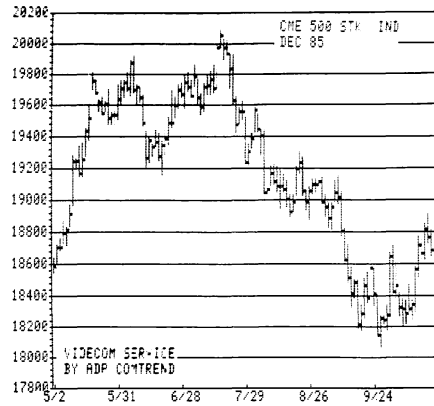
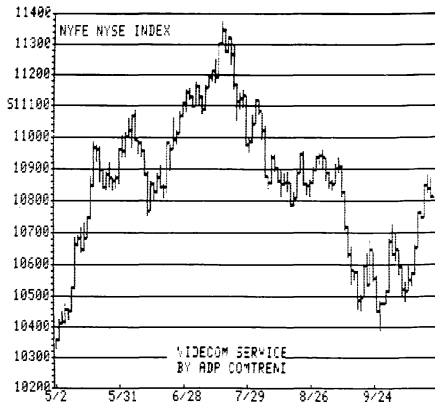
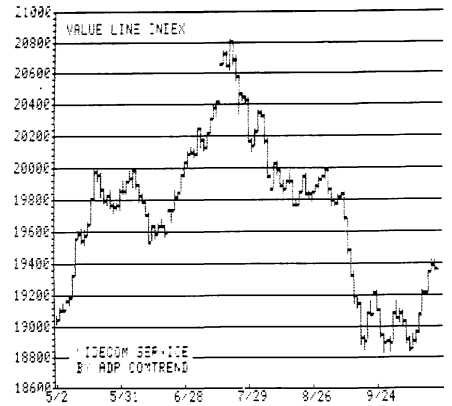


Chart 9

Chart 10

Following, we quote at length from a speech by E. Gerald Corrigan, president of the Federal Reserve Bank of New York, given on September 18, 1985, and extracted from the *FRBNY Quarterly Review*.

"In each of the past several years, total debt in the economy has risen markedly further than GNP...over the 1981-85 period, the ratio of debt to GNP will have risen by about 20 basis points to over 1.60 — a very large change in a ratio of this nature...

"To some extent, private sector debt accumulation has been overshadowed by events in the public sector. And, to some extent they have been muted by what, in my judgment, may be a false sense of security growing out of some statistics which, for example, suggest that consumer liquidity is relatively high and rising or that certain debt ratios for nonfinancial business have stopped rising, or are falling slightly. Taking those and other statistical indicators at face value, one could, perhaps, conclude that outside of the Federal Government, all is reasonably well. Perhaps that is so, but I would suggest that a closer look at trends in the private sector may not justify that complacency.

"I say that for several reasons including the following:

- For the private sector as a whole, the ratio of debt to GNP is at an unprecedented level and is still rising. To be sure, the increase is not as pronounced as for the Federal Government, but there is at least a question as to whether it is reasonable to assume there is that much more good

quality debt relative to GNP today than there was a decade or two ago.

- The recent spurt in private sector debt accumulation has, to a large extent, occurred on the upside of the business cycle and the downside of the nominal interest rate cycle and despite what are generally seen as relatively high real interest rates. Since it does not seem at all prudent to assume that the business cycle is a thing of the past, servicing even existing levels of debt in a less favorable economic and interest rate environment could prove very difficult. This is especially true since generalized financial indexation has shifted a sizable fraction of overall interest rate risk from the financial sector to the nonfinancial and household sectors.
- Taking account of where we are in the business cycle, some measures of credit quality problems are disquietingly high. This is especially true, for example, for delinquency rates on home mortgages, and of the overall level of nonperforming loans in the banking system.
- The recent growth in debt has been associated with a very rapid retirement of equity which, in turn, is importantly — but not exclusively — related to leveraged buyouts and the threats of hostile takeovers.

"For example, abstracting from internally generated equity, the 1984-85 period will, if current trends continue, see the net retirement of \$150 billion of equity in the nonfinancial corporate sector — an amount which in nominal dollars ex-

ceeds the net issuance of equity by nonfinancial business over at least the entire post-Korean War period."

Mr. Corrigan states that "it is not easy to capture the underlying reasons for these developments in a few paragraphs." In all modesty, we beg to disagree. In fact, the reason can be stated in one phrase: Easy money begets easy credit; easier money begets even easier credit. Debt accumulation and its tragic ultimate end is a result of using monetary policy to achieve growth. An active and willing Fed can postpone the necessary liquidation of unproductive assets for a considerable period of time. Unfortunately, the very act of postponing the day of reckoning implies a further buildup of debt, where quality diminishes over time as balance sheets continue

to deteriorate. Will we ever reach 100% leverage? In some of the fanciful, theoretical constructs of Modigliani, such a possibility makes good sense. In the real world, we are dead much before then. For proof, ask Sam Armacost of BankAmerica.

The failure of one or two junk bond issuers could end the takeover mania overnight, setting the stage for a waterfall decline. Until then, it is more debt build-up, more bail-outs, and more muddling along.

STRATEGY: Remain short December '85 S&P, with stops at 192.00. Also, remain long December '85 and March '85 S&P 500 puts.

Financial Futures

We review the three spreads first recommended in our July 7 issue:

- 1) Long T-bond/short S&P 500 futures. Chart 11 shows that the spread is consolidating just below its best levels achieved in late September. Maintain positions.
- 2) Long T-bonds/short 2.6 Eurodollars. The continuous improvement (Chart 12) has resulted entirely from a flattening of the yield curve rather than a widening of the Ted spread. Maintain positions.
- 3) Short Toronto Oil & Gas Index/long TSE 300. Spread moving favorably (Chart 13). Maintain positions.

Chart 11

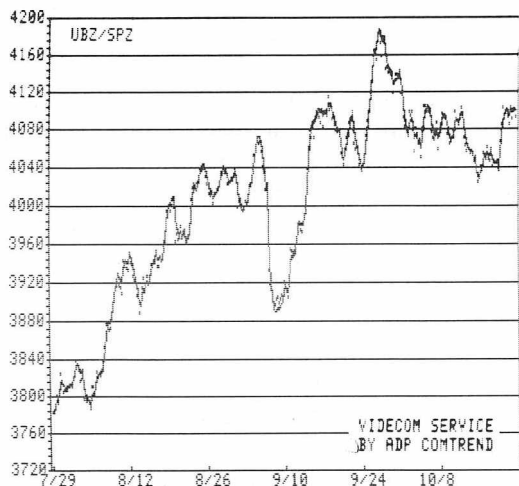


Chart 12

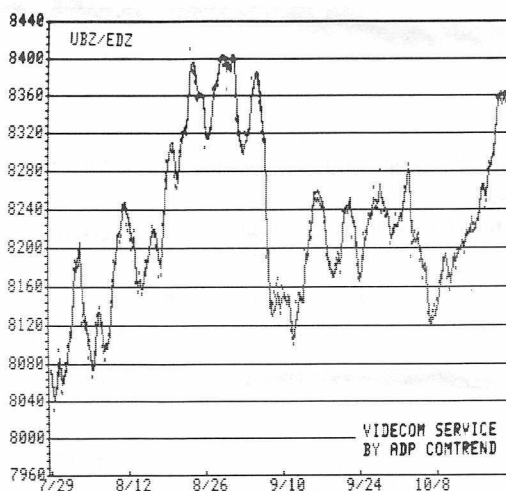
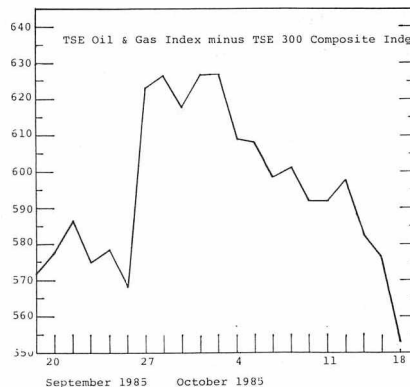


Chart 13



Currencies

US dollar

Heavy central bank intervention cut short a promising dollar rally just as it was about to gather enough momentum to cross the 2.70 DM level. Central banks are displaying a much enhanced and keen sense of market psychology, hitting hard at times of market vulnerability and standing back at other times. With it all, interventions are said to have cost these central banks over \$8 billion to date, *a far greater sum than needed if, in fact, the dollar's path of least resistance is downwards.* It is of course likely that a further concerted effort to intervene could hike the \$/DM to the 2.50 area and the \$/yen to the 2.00 mark. It would appear to us, however, that these levels undervalue the dollar and should prove unsustainable.

Short of massive monetary inflation, the US dollar is likely to find good support at these levels and possibly stage a signifi-

cant rally in weeks and months ahead. A more accurate gauge of the rally potential will be available once we can obtain more reliable figures on the size of intervention and the degree to which the US current account deficit has begun to narrow (as a result of both recession and protectionism). It is interesting to note that the average \$/DM rate so far through 1985 is 3.02; should the dollar remain at present levels for the course of the year, the average \$/DM rate for 1985 will be 2.95, still above the 1984 average of 2.845 and the 1983 average of 2.553.

STRATEGY: *We have taken handsome profits. See Hotline Update. Remain sidelined vis à vis the major continental currencies and the Japanese yen.*

Chart 14

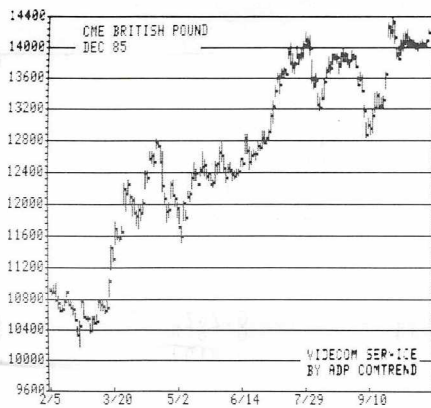


Chart 15

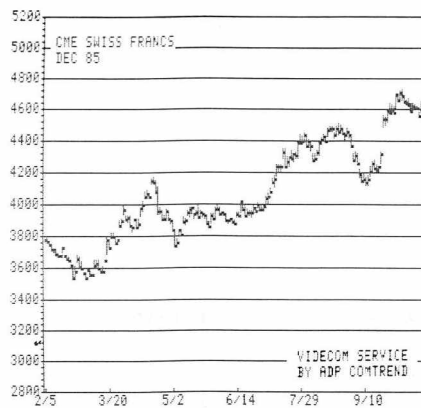


Chart 16

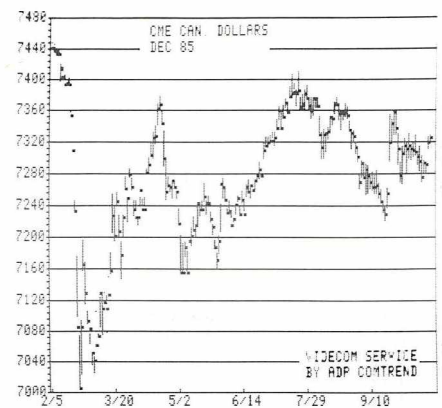


Chart 17

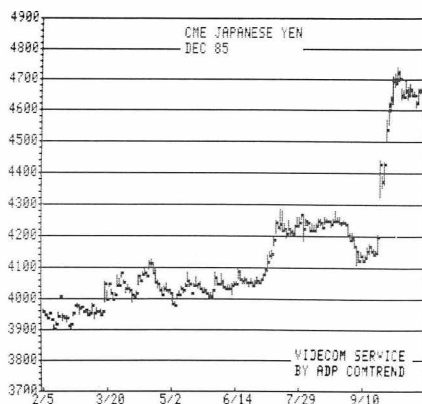
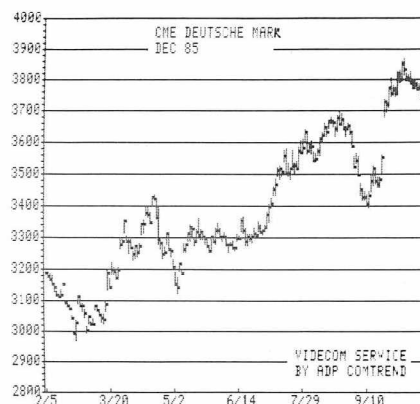


Chart 18



The Exotics

Greek drachma

As expected (May 19, 1985 *Comments*), the Papandreou government finally faced reality and was forced to devalue the drachma by 15.7% as part of a more comprehensive austerity plan. The measures include:

1. A system whereby importers are required to put up to 80% of the value of their imports with the Bank of Greece six months prior to taking the goods.
2. Tightening price controls and lower agricultural prices.
3. Public sector cutbacks in personnel through attrition.
4. Tighter controls on tax evasion.

At the time of implementation of this austerity plan, the Greek economy was showing signs of being seriously out of kilter: a current account deficit of \$2.8 billion compared with a forecast made earlier this year of \$1.9 billion; a fiscal deficit

equal to 19% of GNP, up from 15.5% in 1984; a tottering state and private banking system saddled with bad debts of over 40 enterprises, amounting to over \$1.2 billion; a foreign debt of over \$22 billion; an inflation rate of over 20% per annum — far above the 1985 target of 16%. Clearly Greece has become a basket case. As usual, the austerity package is fraught with contradictions and inanities, the typical result of the muddled thinking of socialists.

STRATEGY: *As long as forward discounts are lower than the expected inflation rates, the drachma remains a candidate for further short selling. Maintain present profitable short positions.*

Chart 19

YEAR	GREEK DRACHMA PER U.S. DOLLAR (PERIOD END)	U.S. 1973=1.00	U.S. 1978=1.00	----- BASKET -----	
				1973 =1.00	1978 =1.00
				JAPAN 07%	ITALY 18%
				FRANCE 11%	NETHERLANDS 07%
				Germany 28%	SAUDI ARABIA 12%
				U.S. 9%	U.K. 8%
1967	30.00	0.9967	1.1516	0.8325	0.7672
1968	30.00	1.0344	1.1951	0.8549	0.7878
1969	30.00	1.0652	1.2307	0.8893	0.8194
1970	30.00	1.0975	1.2600	0.9100	0.8386
1971	30.00	1.1103	1.2828	1.0034	0.9246
1972	30.00	1.1000	1.2709	1.0002	0.9216
1973	29.70	1.0000	1.1554	1.0000	0.9215
1974	30.00	0.8830	1.0202	0.9379	0.8642
1975	35.65	1.0096	1.1665	1.0381	0.9566
1976	37.03	0.9807	1.1330	1.0477	0.9654
1977	35.50	0.8926	1.0313	1.0481	0.9658
1978	36.00	0.8655	1.0000	1.0852	1.0000
1979	38.28	0.8601	0.9937	1.0962	1.0101
1980	46.53	0.9506	1.0983	1.1462	1.0562
1981	57.63	1.0439	1.2061	1.0653	0.9817
1982	70.57	1.1209	1.2950	1.0743	0.9901
1983	98.67	1.3426	1.5512	1.1772	1.0848
1984	128.48	1.5429	1.7826	1.1864	1.0932
1985 (1Q)	133.85	1.4749	1.7040	1.1652	1.0735
1985 (2Q)	135.77	1.4496	1.6748	1.1671	1.0755

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 20

<u>Year</u>	<u>Foreign Assets</u> (Mln US\$)	<u>CURRENT ACCOUNT</u> <u>As % of GNP</u> %	<u>CUMULATIVE 12 QTR.</u> <u>Current Account</u> (Mln US\$)
1970	917	-7.6	-1,545
1971	554	-7.7	-3,090
1972	1,158	-0.6	-2,816
1973	1,199	-0.3	-1,693
1974	945	-4.1	-1,670
1975	287	-6.6	-4,115
1976	-700	-5.5	-5,898
1977	-655	1.4	-3,907
1978	1,549	3.5	190
1979	4,758	6.3	5,480
1980	7,475	4.6	8,450
1981	2,302	-5.6	2,541
1982	1,034	-4.3	-3,933
1983	911	0.4	-7,121
1984	228	-1.1	-3,551
1985 (1Q)	- 835	-	-
1985 May	- 278	-	-

Chart 21

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

Reserves * + Previous 12-months current Account *** = 4696
 (Reserves + 12-months C/A)/M1 ** = 4696/12520 = 37.5%
 Reserves + 12-months C/A)/Broad Money ** = 4696/22099 = 21.2%
 * As at July 1985 **May 1985 *** 1985 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1974	5816	12985
1985(May)	12520	22099
% Increase (decrease)	115.2%	70.2%
Corresponding % increase in the United States	102.7%	158.2%

(a) 1984 Imports as percentage of GNP 20.95%
 (b) 1975 - 1984 Imports as percentage of GNP 22.77%
 1984/(1975 - 1984 average) = (a)/(b) = 92.0%

Source: IFS

Chart 22

<u>RATES</u>	<u>SPOT</u>	<u>1 MONTH</u>	<u>3 MONTH</u>	<u>6 MONTH</u>	<u>12 MONTH</u>
	154.50- 154.60	156.10- 157.20	157.50- 160.60	160.50- 166.66	168.50- 178.60

South African rand

Any discussion about the future of the South African rand must, of necessity, take into account the adverse international and external political setting. On pure economic grounds, the rand is vastly undervalued. With the subdued level of economic activity, South Africa can comfortably manage to post sizable current account surpluses of the order of US\$ 2-3 billion per year, even allowing for the relatively low bullion prices. This sharp improvement in the current account was projected in our earlier March review and was advanced as a bullish argument for the purchase of deeply discounted forward positions.

The violent political transformation caused by communist elements and picked up by a hypocritical liberal media have left South Africa with nary a friend. A massive threat of capital withdrawal, particularly by the US banks, has dealt the nation an almost irreparable blow in its pursuit of foreign savings and accelerated growth. No doubt, a restructuring of

the present external debt, variously estimated at up to US\$ 20 billion will be reached. In the end, however, it will condemn South Africa to a long period of generating heavy surpluses on the back of the poorest elements of the population. Seen in this light, South Africa will be required to maintain a highly competitive and therefore deeply undervalued rand. Furthermore, exchange controls and exposure limits have removed, for all practical purposes, the possibility of dealing in the forward market.

In all, the currency is unattractive at this time and we will be discontinuing coverage, at least until liquidity is restored in the forward financial rand.

STRATEGY: As previously advised over the Hotline and reiterated in our September issue, long positions have been closed out albeit with losses, even after taking into account the original forward discounts.

Chart 23

YEAR	SOUTH AFRICAN RAND PER U.S. DOLLAR (PERIOD END)	U.S.		BASKET	
		1968 =1.00	1977 =1.00	1968 =1.00	1977 =1.00
				U.S. 28%	U.K. 17%
				JAPAN 25%	SWITZERLAND 10%
				Germany 22%	
1967	1.4018	0.9715	0.9557	0.9768	0.7767
1968	1.3898	1.0000	0.9838	1.0000	0.7951
1969	1.3988	1.0149	0.9984	1.0225	0.8130
1970	1.3943	1.0335	1.0167	1.0388	0.8259
1971	1.3068	1.0899	1.0722	1.1690	0.9295
1972	1.2773	1.0835	1.0660	1.1513	0.9154
1973	1.4900	0.9001	0.8855	0.9990	0.7943
1974	1.4501	0.9180	0.9031	1.0697	0.8505
1975	1.1500	1.1155	1.0974	1.2625	1.0039
1976	1.1500	1.0612	1.0440	1.1874	0.9442
1977	1.1500	1.0165	1.0000	1.2577	1.0000
1978	1.1500	0.9925	0.9764	1.2992	1.0330
1979	1.2094	0.9200	0.9129	1.2631	1.0043
1980	1.3402	0.8355	0.8219	1.1436	0.9093
1981	1.0454	1.0265	1.0098	1.2364	0.9831
1982	0.9314	1.0657	1.0484	1.1973	0.9520
1983	0.8185	1.1145	1.0964	1.1792	0.9376
1984	0.5038	1.6914	1.6640	1.9034	1.5135
1985 (1Q)	0.5250	1.5137	1.4891	1.4772	1.1746
1985 (2Q)	0.5100	1.5077	1.4832	1.5082	1.1992

Above 1.00 = undervalued
Below 1.00 = overvalued

FRIEDBERG'S

Chart 24

Year	Foreign Assets (Mln US\$)	CURRENT ACCOUNT	CUMULATIVE 12 QTR.
		As % of GNP %	Current Account (Mln US\$)
1970	356	-4.15	-1048
1971	396	-3.05	-1127
1972	853	-3.09	-1166
1973	771	-7.08	-1933
1974	543	-5.89	-2732
1975	165	-4.06	-3209
1976	-418	-3.99	-2949
1977	-822	-3.98	-2881
1978	-1347	-2.93	-2959
1979	-1615	-4.74	-3916
1980	-1319	-5.32	-5050
1981	-1768	-6.33	-6503
1982	-2386	-4.84	-6509
1983	-2486	-5.34	-6178
1984	-2272	-6.37	-5902
1985 (1)	-2111	-	-

Chart 25

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

Reserves * + Previous 12-months current Account *** = 54
 (Reserves + 12-months C/A)/ M1 ** = 54/4323 = Nil
 (Reserves + 12-months C/A)/ Broad Money ** = 54/17866 = Nil

*As at August 1985 ** April 1985 *** 1985 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1974	3740	9506
198	4323	17866
%Increase (decrease)	15.6%	87.9%
Corresponding % increase in the United States	104.6%	157.7%

(a) 1984 Imports as percentage of GNP = 25.77%
 (b) 1975-1984 Imports as percentage of GNP 22.97%
 1984/(1975-1984 average) = (a)/(b) = 112.90%

Chart 26

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	.3800-	.3775-	.3740-	.3720-	.3670-
	.3830	.3820	.3790	.3780	.3750

Forex Rates & Update

<u>Currency</u>	<u>Spot</u>	<u>3-month</u>	<u>12-month</u>	<u>Comments vis-a-vis US\$</u>	<u>Comments vis-a-vis DM spot DM 2.6400</u>
*Australian dollar	.7050-.7060	.6912-.6932	.6795-.6815	Sell at 7500 Stops at .6700, basis spot	Liquidate as per US\$ stop
*Belgian franc	53.30-53.35	53.34-53.43	53.47-53.68	Liquidate	Remain long
Danish krone	794-795	806-807	829-831	Neutral	Neutral
Dutch guilder	3.0350-3.0450	3.0650-3.0850	3.2050-3.2350	Liquidate	Remain long
Italian lira	1777-1778	1779-1781	1785-1787	Neutral	Neutral
*Kuwaiti dinar	.29475-.29495	.29353-.29450	.29154-.29413	Remain short	Remain short
Malaysian ringgit	2.4535-2.4555	2.4530-2.4590	2.4535-2.4655	Remain short	Remain short
*Mexican peso	395-400	458-478	647-724	Cover another 40%. Remain short balance	Cover another 40%. Remain short balance
*New Zealand dollar	.5800-.5820	.5500-.5595	.4950-.5070	Liquidate	Neutral
*Norwegian krone	792-793	800-802	821-824	Liquidate	Neutral
*Portuguese escudo	163-165	167-177	178-195	Liquidate	Neutral
Saudi Arabian riyal	3.6500-3.6510	3.6540-3.6570	3.6620-3.6680	Remain short	Remain short
Singapore dollar	2.1370-2.1390	2.1260-2.1320	2.1070-2.1390	Remain short	Remain short
Spanish peseta	160.90-161.10	161.75-162.95	166.90-170.10	Neutral	Neutral
Swedish krona	954-955	956-958	957-960	Neutral	Neutral
Venezuelan bolivar	14.65-14.85	14.80-15.30	14.95-15.65	Neutral	Neutral

Explanatory Notes

*Indicates change in recommendation from last issue

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
Buy	Sell
Sell	Sell
Sell	Buy

Cover

Liquidate

Hotline Update

Flash update, Monday, Sept. 23. 8:55 a.m.: We have received an unusual gift this weekend. Liquidate long SF and DM positions at the market and stand aside.

Tuesday, Sept. 24: There are no changes. You have liquidated profitable SF and DM positions and stood aside. Next regular update Friday, Sept. 27.

Friday, Sept. 27: A review of the week's activities: You liquidated long SF and DM positions profitably as of the Flash update Monday morning. No other changes. Next regular update Wednesday, Oct. 2 at 9:00 a.m.

Wednesday, Oct. 2. 9:35 a.m.: There are no changes at this time. Next regular update, Friday, Oct. 4, after market hours.

Friday, Oct. 4: A review of the week's activities. There were no trading suggestions made during this past week, nor do we have any new suggestions at this time. Next regular update, Oct. 9, 9:30 a.m.

Wednesday, Oct. 9. 10:00 a.m.: There are no changes or additions at this time. Next regular update, Oct. 11, after market hours.

Friday, Oct. 11: There are no changes or new recommendations at this time. Next regular update, Tuesday, Oct. 15, after market hours.

Tuesday, October 15: There are no changes or new recommendations. Next regular update Friday, Oct. 18.

Friday, October 18: There are no new trading recommendations this week. Next regular update Tuesday, Oct. 22.

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