FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS

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A freefall leading to panic

Energy Futures

The decline in oil prices has begun to accelerate. Before the first phase of the decline is over, an air of panic will surround the market. This is exactly what the Saudis want, and have been warning will happen in recent months.

Sheikh Yamani's new mandate is to force non-Opec producers into a new gigantic cartel that will apportion, fairly, production quotas. In a very recent meeting with Sir Geoffree Howe, the UK's foreign secretary, Yamani impressed upon the Britons the desirability of their flirting with and then marrying the oil cartel. At the same time and with utmost deliberation, the Kingdom raised production levels in early January to almost 8 million barrels per day (mb/d), signed new netback deals and, in short, flooded the crude market, hitting every bid. The price objective: $18/barrel. The political objective: to force the North Sea producers and Mexico to cut back output sufficiently to accommodate an increase in Opec's output to 18 mb/d.

By the spring of 1986, demand for Opec oil may be less than 14 mb/d. "Allowing" Opec to produce 18 mb/d means that the combined North Sea and Mexico output of 6.5 mb/d must be cut *by more than half*. The 30% drop in prices is already causing havoc in Mexico's finances; a further drop in output as envisioned by the Saudis will literally bury the country.

Be that as it may, the Saudis have begun to regain *some* control at the market and are likely to impose new terms on Opec and non-Opec producers. Of course, the gains from further cartelization will be ephemeral as new producers appear on the scene and old producers are tempted to respond to lower prices by increasing production and thus stabilizing revenues. Ultimately, the perverse shape of the supply curve will destroy all hopes of maintaining prices much above marginal costs of production.

In our opinion, a political agreement of sorts is likely to be hammered out in coming weeks, at least in time to prevent the freefall in prices from sliding through $17-$18/barrel. This agreement will mark the end of the first phase of the ongoing bear market and *should* stabilize prices in the $18-$22/barrel range for the spring and possibly summer of 1986. As market forces begin to reassert themselves, the agreements will unravel and a new downleg will occur, which should take prices below $10/barrel and probably as low as $5/barrel.

NYMEX contracts carry an increasingly probable risk: that the US government will impose an import levy on crude. Those proposing a flat import tax of $5-$10/barrel argue that it is an easy way to increase fiscal revenues, that it will protect the domestic oil industry (a strategic consideration), that it will protect energy lenders, and so on. In our opinion, it is an inefficient way of collecting taxes, as some (a substantial portion) of the forced up price is retained by the producers. Moreover, it will put US manufacturers at a significant disadvantage vis à vis foreign manufacturers who can count on cheaper energy input. Finally, it will impact rather severely two important US economic and political allies: Canada and Mexico who, at this time, export in excess of 1.6 mb/d of crude into the US. If, on the other hand, we exempt these two producers, then the tax will be totally ineffectual. (A gasoline tax, on the other hand, would be far more efficient and less politically cumbersome.)

The political process being what it is, we suspect that the crude import tax, although far from ideal, has an excellent chance of passing Congress and overcoming Reagan's initial opposition. We would therefore advise those holding NYMEX short positions to cover positions on the fast move below $20/barrel that we envision taking place in coming weeks. These positions should eventually be replaced with London gasoil contracts.

In this issue

David Rothberg looks back at 1985, and sizes up our track record. Steve H. Hanke looks forward into 1986 and sees storm clouds. Meanwhile, we stay firmly short oil, we enter the short side of the interest rate futures market, we prefer S&P puts, we remain short the Canadian dollar, and we go long gold. Contributions by Albert D. Friedberg, Steve H. Hanke, David Rothberg, and Daniel A. Gordon.

***STRATEGY:** Be prepared to accept profits on the upcoming panic sell-off to $18/barrel. This advice is especially important to those holding NYMEX short positions. Holders of gasoil puts should look to trade against their options beginning at $150/ton, basis the May 1986 contract. Never, however, lose the entire position.*

Chart 1

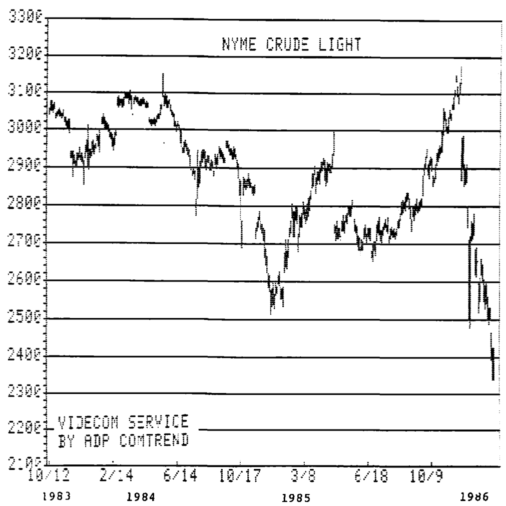


Chart 2

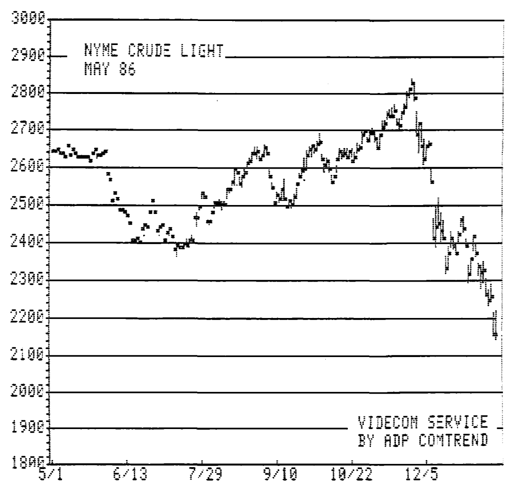
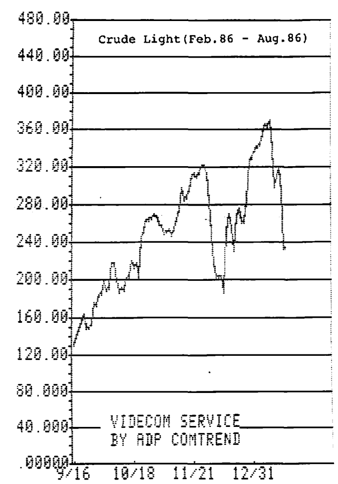


Chart 3



1985: The vintage year that was

Quote of the year: "Stock prices will head south anywhere between 25% and 40% ..." — Jan. 13.

Tie for quote of the year: "In the interest of survival, we resolve to protect ourselves with prudent and reasonable stops." — Jan. 13.

Resolve of the year: "To protect ourselves with prudent and reasonable stops." — Jan. 13.

Best advice of the year: "To protect ourselves with prudent and reasonable stops." — Jan. 13.

Who got fooled?: "...there is a good chance that the (stock) market will...fool most of the people most of the time." — Jan. 13.

The consistency award: For our prescient views on the US dollar.

We came into the year short the European currencies, the pound and the yen. We had been short for the better part of the past few years often earning the contempt of the crowd, which never seemed capable of coming to terms with the dollar going quite as high as it had and, at the same time, managing to earn great profits on behalf of our customers and subscribers. In February — the crowd for the first time in memory sharing our views — we asked: "Has the dollar peaked?" and went on to answer:

> "At this point our main worry is the near unanimity of views regarding the dollar. The very strong bullish consensus has likely left the dollar in a very vulnerable technical position which would lend success to any kind of technical intervention."

The mark was then trading at 30.10, the Swiss franc at 36.00, the yen at 38.00, and the pound at 110.00 — all basis nearest futures contracts. When we first advised being long the dollar four years previously, they were trading at, respectively: 56.45, 61.94, 43.75 and 226.90. We sounded our herald within two weeks and 2% of their lows, thus adding yet another year to our record of being consistently right on the US dollar. Boring.

The Economic History award: Heeding not at all our admonishments, the economy somehow — we still can't quite seem to understand how — managed to stroll along at a fairly regular clip of about 2.5% throughout 1985. In mid-May, Reuters reported that a group of US business leaders met and expressed some concern over foreign competition. The report read, in effect, that the businessmen felt the trade imbalance would ultimately have a negative impact on the economy, but "they see little chance of a recession." We knew better; after all we make our living forecasting economic trends. Ergo, seeking to set the record straight, we offered the following measured and considered response: "Can anything more ridiculous be said in May of 1985, at least five months into a recession?" (sic)

The most outrageous example of chutzpah in 1985: See the economic history award above.

Friends: The "Good Old Mexican Peso" we called it. We called it that because in the old days of 1982 the peso had been very good to us. It had done exactly what we said it should: devalue massively in two stages from 25 to 150 and earn us a fortune in the process.

When we looked up our old friend in mid February of last year, we found it having to endure some familiar vexations — gross budget deficits, bloated money supply, lots of corruption, etc. It did appear a tad tired looking. We advised it seat itself gently, take a little pressure off its legs. It did. And by June we felt emboldened to request a devaluation of 30%. The peso was then trading at 292 to the dollar. By the time our July letter was composed, our good old friend was 27% lower at 370. The peso fell to as low as 500 before its masters closed the market.

Enemies: The South African rand. We were long in March, out in September at rate 25% less than our entry point. The rand was the largest foreign exchange loss we ever suffered and, in every way, an appalling embarrassment.

Like kissing your sister: In May we constructed a great argument for being short the Greek drachma, concluding a devaluation of 15-20% was likely. Forward discounts were so steep that when the devaluation — of 15.7% — took place in October, we barely made any money.

The proudest example of chutzpah in 1985: In mid-May the stock market made one of the many new all-time highs it was to achieve throughout the year. Our modest response: "The incomprehensible happened."

Crude: Meaning coarse, crass, loud, meretricious, rude, unpolished, odious, objectionable, base, vile, inelegant, ignoble, etc. Also meaning oil.

We came into the year in a relatively bearish frame of mind: "By now having mortgaged your home, you are all firmly entrenched on the short side of crude oil futures" (sic) — Jan. 13. But as the year progressed, we occasionally found ourselves waffling a bit: Jan. 31 — cover one third; Feb. 1 — stopped out of "66% to 83% of short positions; Feb. 12 — reassume all short positions; March 13 — cover all short positions; April 4 — reassume all short positions; May 9 — cover all short positions; June 14 — buy August against half of deferred position; June 28 — liquidate August, add to short positions in deferreds; etc. etc.

In view of the fact that crude oil prices were generally unyielding until the very end of 1985, we understand many who seek our advice were a might perturbed over our crude vascillations. The net effect of all this crudity can be summed up as follows: those who followed the best advice of the year — see above — survived and perhaps even prospered. To those who followed the year's worst advice (see below) we apologize, beg forgiveness, and promise to never be so crude again.

Worst advice of the year: From our hotline update of August 10 as reported in August 18 *Comments* re: crude oil: "...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."

Most ridiculous example of chutzpah in 1985: Oct. 20: "...the Dow Jones Industrial Average recorded new all time highs...For all practical purposes, the bear market has begun."

Little ado about something: In our first epistle of the year we devoted a single paragraph to interest rate futures. The simply stated advice read: "Remain long March T-bonds, raising stops to 69.300." N'er a word was heard of the bonds again in '85 save for some small print in the Hotline section of the epistle of February 17, which reported the sage counsel given to subscribers over the phone on January 31 to liquidate said investment at the market. On January 1, T-bonds (basis nearest futures contract) settled at 70.11. On January 31, T-bonds settled at 73.06. On December 31, the nearest futures contract T-bonds settled at 85.07.

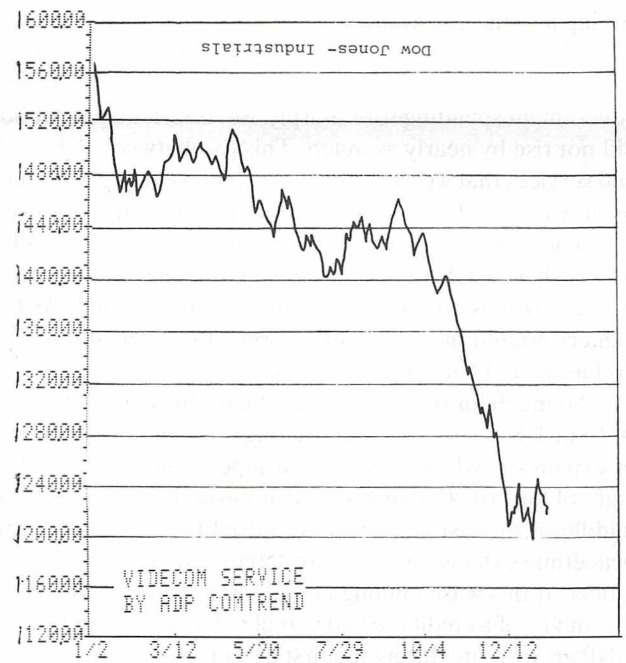
Proviso of the year: "Long term investors, however, should patiently retain their core gold positions."

Much ado about nothing: We warmed to the glow of gold in February and promptly got stopped out. Undaunted we roared bullishly in March — "a time to buy...little downside risk...$500/ounce...$900/ounce." And by May, we were stopped out again. Presumably anticipating that epiphantic moment of August when we could proclaim (in our characteristically quiet, composed way of course), that investors were "facing a once-in-a-lifetime opportunity to purchase gold at reasonable prices," we reinstated our long positions and waited until November to get stopped out for the last time in '85. Gold started the year at 309.70 and ended it at 331.10.

Still waiting for: The Saudi riyal, the Kuwaiti dinar, $5.00 a barrel oil, the inevitable stock market crash.

And finally, what's wrong with this picture?

Chart 4



Storm clouds on the economic horizon

by Steve H. Hanke

Each January, economists display a lemming-like behavior and offer their views on the prospects for the New Year's economy. As a member of this peculiar species, I, of course, am compelled to join the annual migration.

We begin our analysis of the US economy by focusing on productivity. Using the broadest measure of productivity, Gross Domestic Product per employed person, US productivity rose at annual rate of 2.0% between 1950 and 1960 and at 2.1% rate in the 1960s. However, between 1970 and 1980, the annual rate of growth in productivity fell to only 1.4%. This slowdown in output per employed worker is even more dramatic if we use 1973, the year of the first major oil price increase, as a break-point in the productivity series. From 1960 to 1973, the annual rate of growth in productivity was 2.2%. But between 1973 and 1984, it was only 0.6%.

This downward trend in productivity means that domestic output in the US is lower than it would have been if productivity had not deteriorated. For example, the 1985 Gross National Product (GNP) would have been about 21% higher if productivity had continued to grow at the rate that prevailed from 1960 to 1973.

At the same time that domestic US output was lower than it would have been with higher productivity, the US embarked on a new economic policy. In 1981, it began to dramatically increase defense spending. Moreover, it radically altered the Federal tax treatment of investment in order to stimulate investment. It also cut personal income tax rates across the board, so that individuals would retain a higher portion of their income to spend for themselves, instead of paying it to the government.

These changes in policy all had the expected results. In real terms, domestic investment, personal consumption and government spending rose sharply. But domestic production did not rise by nearly as much. This gap between the goods and services that we were using, but not producing, was filled by drawing goods and services from the rest of the world.

The new US economic policy and consequent gap between what the US was using, but not producing, was financed, in part, by massive net capital inflows from abroad. As foreigners poured money into US assets, their demand for US dollars soared and so did the dollar.

So much for the recent past. What's the current prognosis? The US economy is rolling along through the 38th month of expansion, which ranks it as a super-long recovery. Only eight of the last 30 business-cycle upturns, dating back to the middle of the last century, have lasted longer. And, if only peacetime expansions are considered, just three have lasted longer. If this wasn't enough good news, we are currently in the middle of a credit-created boomlet that will generate a real GNP growth rate during the first half of 1986 of about 5%.

But all is not well with the US economy. If the US economy's anemic productivity is to continue to be masked and the recovery stretched beyond the third quarter of 1986, massive wealth transfers from abroad into the US must continue to flow. However, we believe that these prospective flows are in serious doubt because there are policy storm clouds on the horizon that threaten continued wealth transfers into the US.

Let's examine the two major policy storm clouds in order. The first concerns oil. For some time, we have shown that Opec was in the process of unravelling and that, in consequence, crude oil prices must plunge. This fall will provide the US economy with a wealth transfer, relative to what the situation would have been with higher oil prices. In consequence, this transfer will fuel the recovery and help to mask the US economy's weak productivity fundamentals. The bulls on Wall Street finally understood this after crude prices began to fall as a result of Opec's new policy pronouncements, which were emitted from its December meeting in Geneva. A headline in *The Wall Street Journal* of December 13, 1985, "Long Stock-Market Rally Is Seen as Result of Plunging Oil Prices," tells this story.

What the headline does not reveal, however, is the fact that for the US economy, the lower oil prices and consequent wealth transfers will in all probability not be allowed to visit our shores. As soon as world crude prices reach a temporary plateau in the $18 to $20 per barrel range, the US will place a $5 per barrel tax on imported crude and refined products. Such a policy already has the backing of strong politicians, such as Senators Lloyd Bentsen (Texas), David Boren (Oklahoma), Robert Dole (Kansas), and Gary Hart (Colorado). Their case for an oil import tax is straightforward: They want to keep crude prices in the US higher than world prices, so as to prop-up domestic producers and domestic banks that hold large portfolios of domestic oil-related loans. By mid-1986, politicians from oil producing states will pick up additional support for an oil import tax because, by then, the Congress will not have cut enough fat from the Federal budget to meet the requirements of the recently passed Gramm-Rudman budget bill. In consequence, everyone in Washington, D.C. will be scrambling for more government revenues.

As a result of an oil import tax, Americans will not receive the full benefits from falling world oil prices, and the US economy will be deprived of much needed foreign wealth transfers required to keep fueling the recovery.

Perhaps even more troubling than this first storm cloud is the second. It is represented by the so-called tax reform legislation that is, with President Reagan's blessing, making its way through the Congress. At present, this legislation is alleged to be revenue-neutral; that is, it will bring in the same amount of revenue to the US Treasury as the current tax code.

In other words, the reform is designed to shift the burden of taxes from one group to another, while leaving the total tax bill constant. The version of tax reform that has been passed by the House of Representatives will reduce personal income taxes and increase the tax burden borne by corporations. Hence, unless dramatically altered by the Senate, which is an unlikely event, tax reform legislation will cause after-tax rates of return of investment in the US to fall. This will reduce the level of domestic investment. Moreover, the tax reform will reduce the flow of foreign capital into the US economy as after-tax rates of return on US assets are lowered and foreigners deploy their resources toward more attractive alternatives.

If this type of tax reform and its consequences were not damaging enough for the economy, it appears that given the inability of the Congress to substantially reduce Federal spending and the requirements of the Gramm-Rudman budget bill, the tax reform will, in all likelihood, not be revenue-neutral. By the time the reform is passed (probably in 1987), it will actually combine a tax reform tilted against corporate profits with a general tax increase that guarantees the US Treasury increased total tax receipts.

Even though the tax reform/tax increase bill will probably not be passed until 1987, its outlines will be clear to prospective investors by the second half of 1986. In consequence, foreign investors will gear down their investment plans for dollar-denominated assets. This will slow the much needed net capital inflows to the US economy. Moreover, it will have a direct effect on the foreign exchange markets. Lower after-tax returns in the US will reduce the flow of foreign investments to the US, reduce foreigners' demand for dollars, and reduce the value of the dollar from what it would have been. So, the tax reform/tax increase will have results that will be precisely the opposite of those generated by the 1981 tax cut.

Despite the recent euphoria about the current US economic boomlet, we believe that an oil import tax and a tax reform/tax increase pose imminent threats to the foreign wealth transfers required to mask the US economy's weak productivity fundamentals and to stretch out the economy's super-long recovery. If these threats come to pass as we foresee, the recovery will come to an end by the last quarter of 1986 or the first quarter of 1987.

In consequence of a US economic boom-bust within the year, markets will be volatile, risks high, and opportunities for the informed speculator great. Indeed, 1986 promises to be the year of the speculator, with record-setting volume in financial and currency futures markets. And, yes, even the commodity pits' progressive somnolence of the past three years will be reversed.

STRATEGY:

- *The boomlet during the first three quarters of 1986 will increase credit demand and nominal interest rates by 200 basis points in the first half of the year. As the recession sets in, late in 1986 or early 1987, this process will be reversed and nominal rates will fall. Begin to establish short positions in T-bonds sometime in the first quarter.*
- *The boomlet and consequent interest rate increases in the 2nd and 3rd quarter will provide the US dollar with modest strength through mid-year. But with the onset of recession, falling interest rates, and the anticipation of a tax reform — tax increase, the dollar will turn decidedly downward. Begin the year by retaining any current long positions and adding modestly to them; then, as the economy slows and the tax reform/tax increase appear eminent, go short.*

  In anticipation of a downturn in the economy by the last quarter of 1986 or first quarter of 1987, begin to progressively reduce equity *holdings. Sell on strength in the first quarter.*
- *A US oil import tax will put added downward pressure on world crude prices. Remain short and tilt towards the sale of gasoil contracts on the London market.*
- *By the end of the year, the "inflation is dead" thesis will no longer be echoed. With a progressive pick-up in inflation over the year and in anticipation of more to come, gold will, indeed, be golden. Remain long.*

Interest Rate Futures

In the December 1985 *Recession-Recovery Watch* report, Dr. Geoffrey H. Moore, director of the Centre for International Business Cycle Research, states that each of the three leading indexes tracked by the Center (Charts 5, 6, and 7) signal an end to the *growth recession* that characterized 1985 and point to a reacceleration of real GNP growth for 1986. In fact the growth rate of these indexes on a six-month smoothed basis are well above where they were a year ago:

	Most Recent	%	Year Ago	%
Business Week leading index	Dec. 14, 1985	8.8	Dec. 15, 1984	4.8
BCD leading index	Nov. 1985	4.1	Nov. 1984	-0.3
Leading employment index	Nov. 1985	4.8	Nov. 1984	3.8

The BCD growth rate is projecting a 3.2% annual gain in real GNP for 1986. The *Business Week* index is somewhat more optimistic and projects 4.4% growth in real GNP. In the previous article, "Storm clouds on the economic horizon," Dr. Steve Hanke projects a fairly robust first half of 1986 (+4.5% in IQ and 6% in IIQ) and a much weaker second half (+2% IIIQ, -2.5% IVQ).

Be that as it may, the stronger economic environment is likely to have a negative impact on bonds. Credit demands have already been stepped up (see Chart 8). As we move to a build-up in inventories, we are likely to see an acceleration in borrowing and continued *upward pressure on interest rates.* Should the Fed react by targetting interest rates (in a vain attempt to hold them down), it will surely lose control of money supply. The inflationary fears, in turn, will put strong upward pressure on long-term interest rates.

There are two additional reasons for believing that interest rates will rise in 1986 — and perhaps quite sharply. In the first place, sensitive commodity prices have begun to recover from the long 1984-85 bear market. From the September lows, the CRB index has already advanced 6%, a rise that has been muted somewhat by the spectacular fall in oil price. Strength in gold prices is a particularly worrisome development and leads us to believe that the disinflation "era" is over. Secondly, strong capital inflows predicated very often on capitalizing on the ever-rising US dollar (the "virtuous cycle") are likely to abate as the currency displays continued signs of weakness and threatens to fall even further in the not-too-distant future. Still, the current account deficit, projected to rise to $150 billion in 1986, must be financed by capital inflows in order to square the accounts. It can only be done via higher interest rates, high enough to compensate dollar-holders for any perceived future currency risk. In short, the virtuous cycle of capital inflows, rising dollar, widening current account deficit, low or nil inflation, low interest rates is in the process of being reversed: The current account deficit disappears only over time but at the cost of sharply higher interest rates and more inflation.

STRATEGY: *Higher interest rates for 1986 seem inevitable, especially long-term rates. We are inclined to enter the short side of the market at these levels (see Chart 9), risking recent highs, 86.13, basis March '86. The $2,500 risk per contract is well justified in view of the potential reward: a minimum expectation of 150-200 basis point rise, or a potential profit of $12,000 per contract.*

Chart 5

BUSINESS WEEK LEADING INDEX (CIBCR)

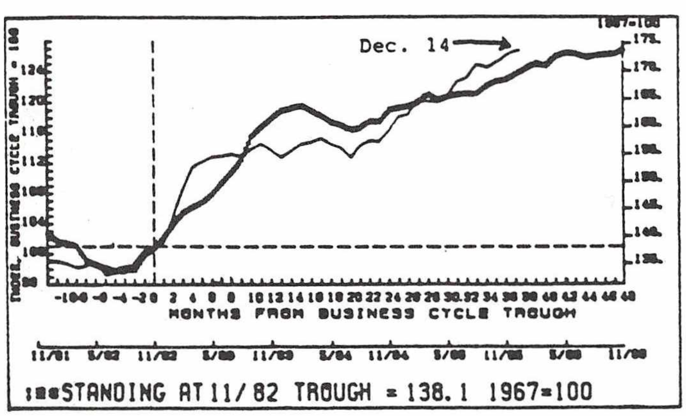
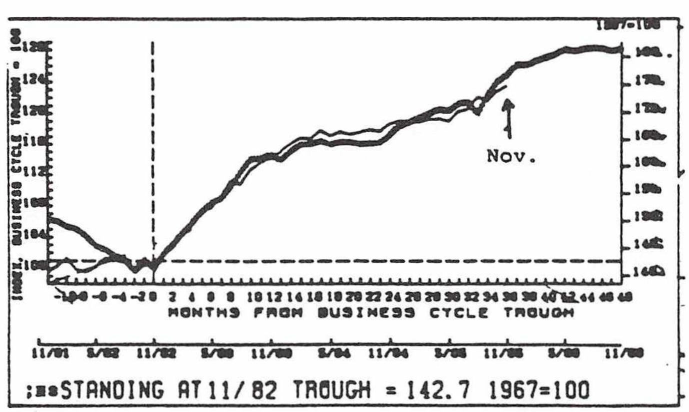


Chart 6

LEADING EMPLOYMENT INDEX (CIBCR)



Current recovery to date (business cycle trough: November 1982 or IV Q 1982)

Average of three long recoveries (1949-53, 1961-69, 1975-80)

Chart 7

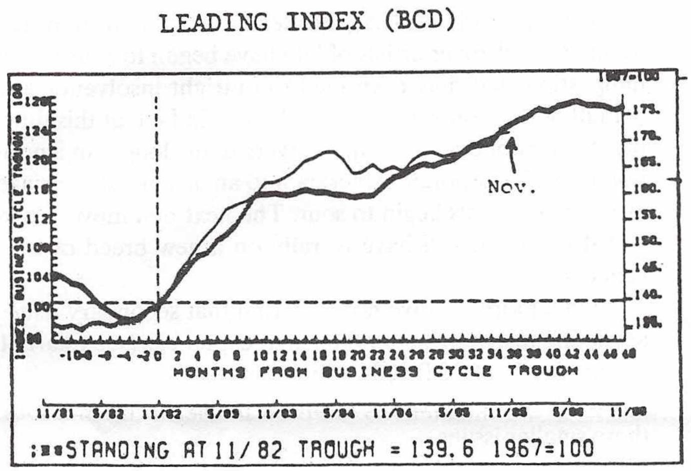


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Chart 8

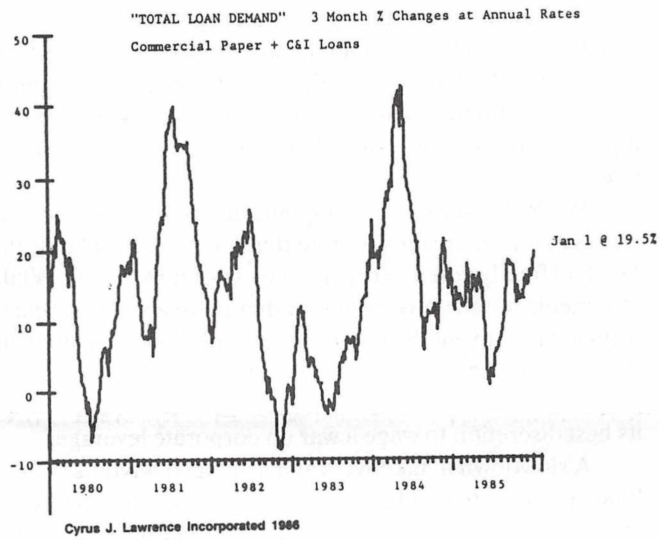
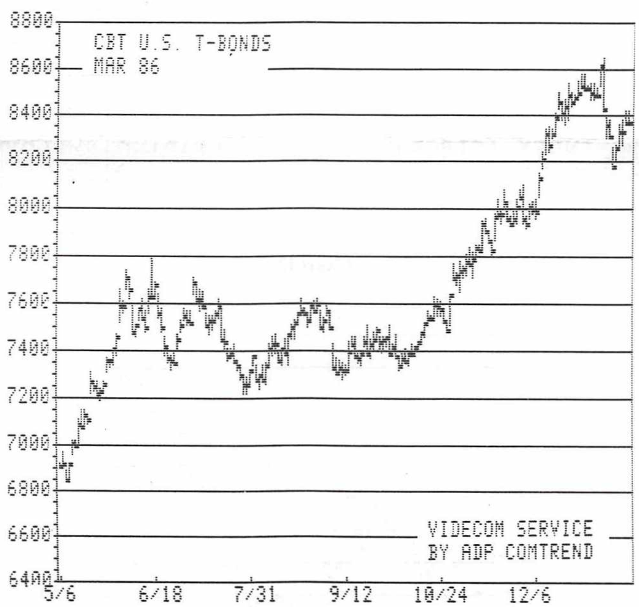


Chart 9



Stock Index Futures

The spectacular September 1985/January 1986 advance came to a dramatic and abrupt end the week before last as the Dow plunged nearly 40 points and the S&P 500 dropped 700 points from new all-time highs. The downside weekly reversal on high volume was our clue that a turning point had been reached.

While it is difficult to pinpoint the exact reason for the reversal, it is interesting to note that on the reversal day, the Fed had finally voted to restrict the use of junk bonds. While opponents of the move point out that there are a great many ways to circumvent the new margin regulations, it is also true that the Fed has unequivocally stated that it is concerned with the use of debt to finance acquisitions and that it will use its best discretion to wage a war on corporate leverage.

A slowdown in takeovers and leveraged buyouts (LBOs) (and as long as the Fed practices a liberal monetary policy, it can be only a *slowdown*) could have a sobering impact on a market that was continually buoyed by this activity.

There is also the matter of increased lender caution. In recent weeks, a number of proposed acquisitions and LBOs have had to undergo significant changes as lenders balked at the fancy levels of buyout prices. This has been true in the TWA, Macy's, MGM/UA, and Beatrice cases. Moreover, a number of takeover artists of late have begun to suffer from indigestion that may even lead to outright insolvency and default of their outstanding junk bonds. In fact, at this time, practically none of the major players is any longer in a position to bluff Corporate America into an unwanted marriage as their own deals begin to sour. The next bull move, when and if it comes, will have to rally on a new breed of buccaneers.

On a more positive note, we find that secondary issues are acting relatively better than high-cap stocks (see Chart 11 Value Line % of S&P 500), which suggests that another bull move is not too far off (3-15 months) and it may be led by these smaller issues.

STRATEGY: *The developing correction (?)/bear market (?) can be particularly severe. Given the extraordinary volatility of a stock market "run" by megabuck institutions, we hesitate to put out outright short positions in S&P 500 contracts, preferring put options, despite their steep premiums. Maintain previously purchased March '86 puts and add by buying March '86 S&P 500 puts with a 195 strike.*

Chart 10

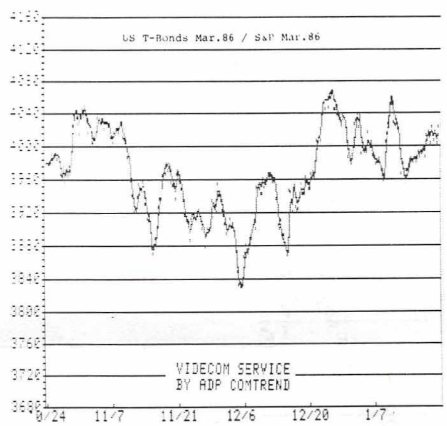
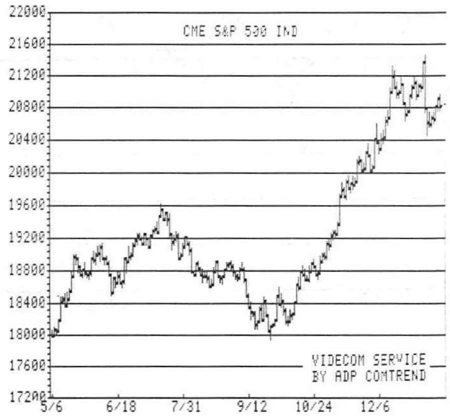


Chart 11

Chart 12



Currencies

We are satisfied with the views we expressed last month and do not think there is anything to add to those comments. We remain *slightly* bullish on the US dollar as we still believe that, near term, the $/DM will trade in a 2.42-2.65 range. Retain long yen/short BP spread.

Canadian Dollar

The rout continues. For the fourth quarter of 1985, Canada suffered a underlying loss of $1.5 billion in reserves, the largest such loss since 1978. Net official monetary movements for 1985 as a whole have been initially estimated at minus $2 billion, also the largest loss since 1978. In the interim, the current account balance has swung to the red for the first time since 1982, a result of surging imports and stagnating exports (see Chart 13).

Final domestic demand and domestic credit are running at an excessive pace, a situation that can be brought back under control by a tight and determined Bank of Canada. In recent weeks, the Bank has widened interest rate differentials vis à vis the US while leaning on excess reserves and it has forced a substantial reduction in chartered banks' free secondary reserves.

The Bank of Canada is facing a difficult choice: allow the Canadian dollar to float lower, perhaps substantially so, or defend it by allowing interest rates to rise and induce short-term capital inflows to offset a deteriorating current account. In view of the rather precarious state of finances of a number of lending institutions (witness the extraordinarily high and growing amount of central bank advances to chartered banks suffering from deposit withdrawals) and the still high unemployment level, we believe that the bank will finally opt for allowing a lower forex value for the Canadian dollar.

STRATEGY: *Remain short, place stops at 71.85, basis March '85, good anytime.*

Chart 13

Canadian balance of international payments
Current account

Seasonally adjusted at annual rates

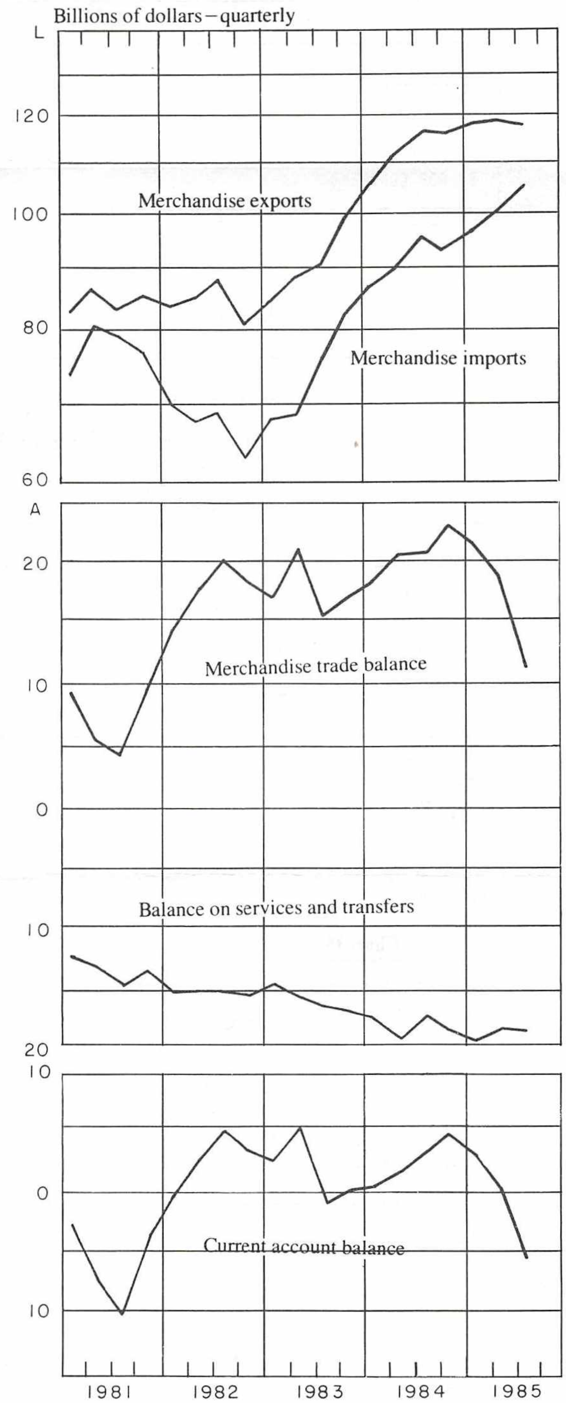


Chart 14

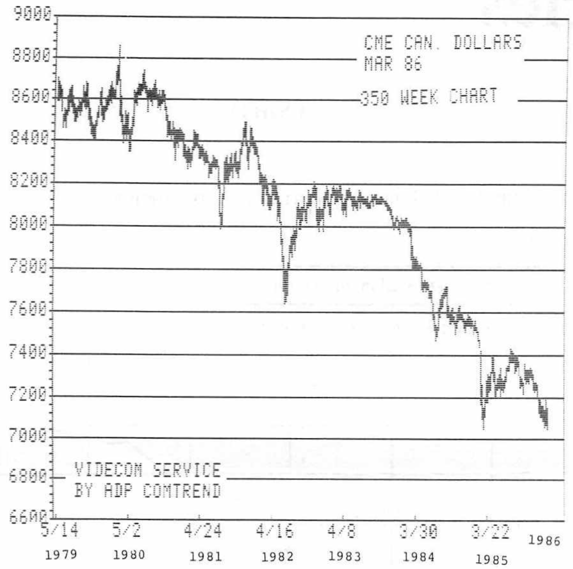
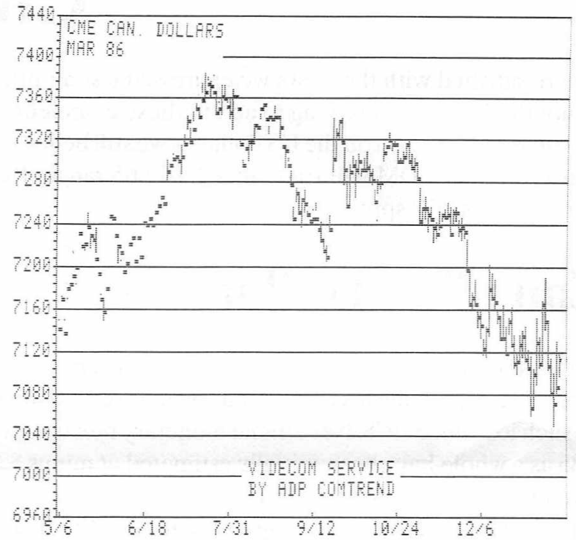


Chart 15



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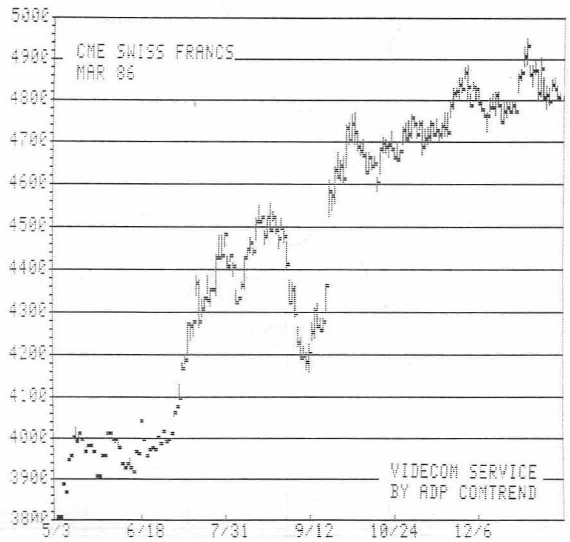


Chart 17

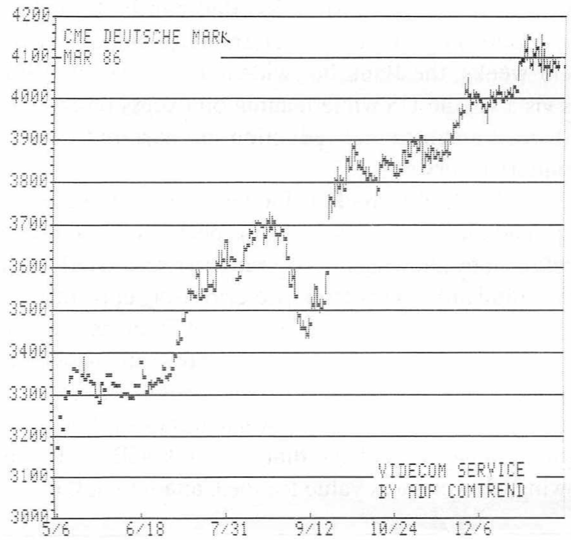


Chart 18

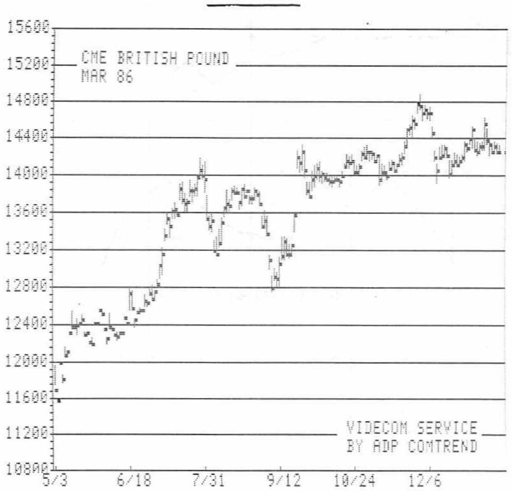


Chart 19

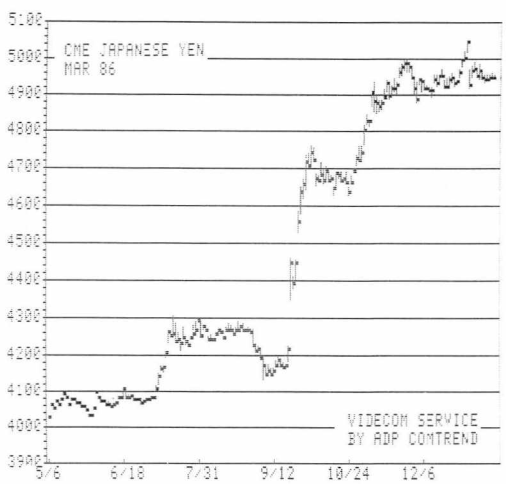
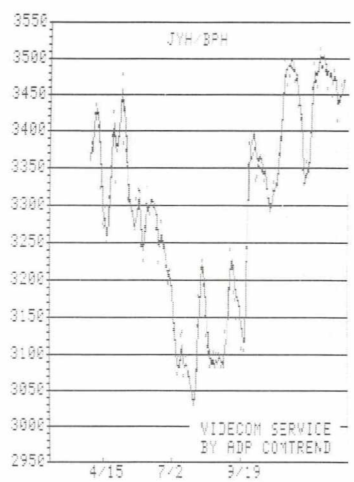


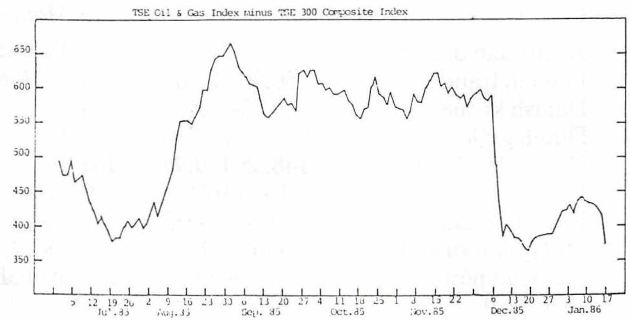
Chart 20



Financial Futures

1. Liquidate the profitable long T-bond/short S&P spread. The forecast rise in long-term rates may affect T-bonds more than stocks.
2. Retain profitable short Toronto Oil & Gas Index/long TSE 300 spread. Accept profits, *on a scale down*, from 200 pts.

Chart 21



Gold

Ever since our March 24 issue ("Gold:" a time to buy"), we have been warning that gold was becoming a bargain and, as a result, an excellent investment for long-term investors.

As late as September 23, we commented that "long-term investors should not be disturbed by short-term shakeouts." Traders who were stopped out at 316 were told (in the December 15 issue) that "the fundamentals are becoming ever more compellingly bullish."

The recent rise has been attributed to a mystery buyer who has accumulated just under 500,000 ounces in recent weeks. Late in the week, a rumor circulated that the Sultan of Brunei, the world's richest man, was the buyer and that in fact he was interested in purchasing no less than $5 billion worth of gold! Be that as it may, the market has broken out of its nine-month-long base and appears capable of reaching $400/oz. on this first leg of the bull market.

It is interesting to note how gold has continued to gain over silver (Chart 22). As discussed in previous issues, we expect this trend to continue for quite some time yet.

STRATEGY: *Sidelined traders are advised to go long now that the April '86 contract has broken out above its 360 resistance level; protect long positions with initial stops at 330, close only. Long-term investors should ignore short-term shakeouts and should concentrate on accumulating additional long positions on $10-$20/oz. setbacks.*

Chart 22

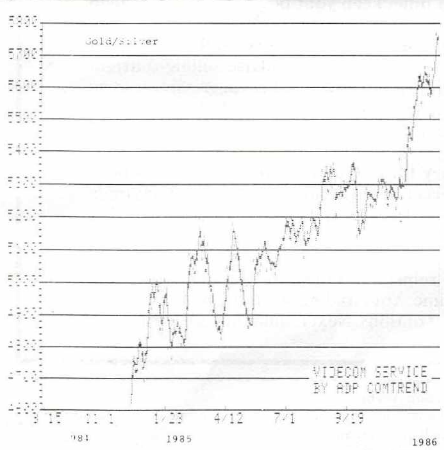
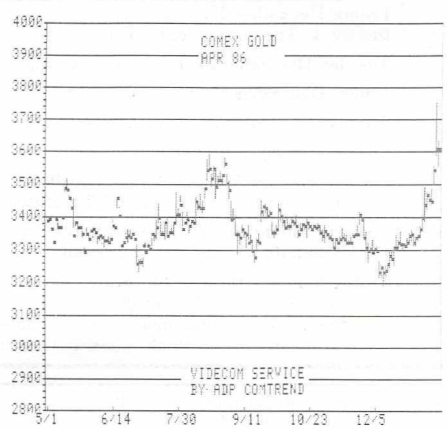


Chart 23

Chart 24



Forex rates & Update

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM Spot DM 2.4600*
*Australian dollar	.7005-.7015	.6833-.6847	.6485-.6505	Buy	Buy
Belgian franc	50.20-50.30	50.45-50.62	50.70-50.95	Neutral	Remain long
Danish krone	9.03-9.04	9.04-9.06	9.05-9.08	Neutral	Neutral
Dutch guilder	2.7710-2.7730	2.7547-2.7572	2.7045-2.7095	Neutral	Remain long
Greek drachma	148.85-149.95	155.85-158.95	173.85-185.95	Remain short	Remain short
Italian lira	1676-1679	1680-1685	1687-1692	Neutral	Neutral
Kuwaiti dinar	.28970-.28985	.28800-.28877	.28605-.28855	Remain short	Remain short
Malaysian ringgit	2.4460-2.4470	2.4540-2.4580	2.4710-2.4790	Remain short	Remain short
Mexican peso	448-454	Not available	Not available	Remain short	Remain short
New Zealand dollar	.5200-.5220	.5005-.5040	.4600-.4720	Sell on rally to .5400	Sell on rally to 1.36
Norwegian krone	7.59-7.60	7.68-7.70	7.94-7.97	Neutral	Neutral
Portugese escudo	158.20-158.70	162.70-168.70	168.20-198.70	Neutral	Neutral
Saudi Arabian riyal	3.6495-3.6500	3.6475-3.6495	3.6475-3.6505	Remain short	Remain short
Singapore dollar	2.1250-2.1260	2.1085-2.1145	2.0750-2.0860	Remain short	Remain short
Spanish peseta	154.00-154.10	156.10-156.80	161.00-163.10	Neutral	Neutral
Swedish krona	7.63-7.64	7.71-7.73	7.84-7.86	Neutral	Neutral
**Venezuelan bolivar	15.75-15.85	16.35-16.95	16.95-18.05	Neutral: due to wide discounts	Neutral: Due to wide discounts

Explanatory Notes

*Indicates change in recommendation from last issue

**Mistakenly printed last month as "remain short."

Indicates change in recommendation from last issue

Currency expected to firm against both currencies.	Buy	Buy
Currency expected to strengthen against US $ and weaken against DM.	Buy	Sell
Currency expected to weaken against both major currencies.	Sell	Sell
Currency expected to weaken against US $, but strengthen against DM.	Sell	Buy
Term used to liquidate short position but does not imply a new buy recommendation	Cover	
Term used to indicate sale advice of previous long position, but does not imply a new short sale recommendation.	Liquidate	

Hotline Update

Thursday, December 15: No new recommendations.

Friday, December 20: There are no changes or new recommendations this week. The market letter is in the mail.

Tuesday, December 24: There are no changes or new recommendations.

Friday, December 27: There are no changes this week.

Tuesday, December 31: There are no changes or new recommendations.

Friday, January 3: No changes or new recommendations this week.

Flash update for Monday, January 6, 1986 — 9:10 a.m.: Sell the March C$ at these levels (7083), risking 7150, close only.

Tuesday, January 7: We are now short C$ as of yesterday morning's update. Maintain stops of 7150, close only.

Friday, January 10: The following change was made this week. You were stopped out of the March C$ at approx. 7165. Stand aside for a new reentry point. One new recommendation: Last month we commented regarding the stock index as follows: "The end is certain to be abrupt and quite dramatic with a good chance of registering a weekly downside reversal. Until such time, keep your powder dry and remain sidelined."

We certainly had an abrupt end to this bull move, and we certainly had a dramatic weekly downside reversal. We advise selling outright March S&P, risking initially 209.0, good anytime. Less aggressive traders may wish to purchase March 195 put options at present levels — now around $750. Next update Jan. 14.

Flash update, Tuesday, January 14, 1:50 p.m.: Reinstate short C$ positions, basis March, at the market, using a stop of 7185, good anytime. This flash will replace the regular Tuesday update unless there are further changes. Next update Jan. 17.

Friday, January 17: We have reinstated the short March C$ position, using a stop of 7185, good anytime. Your trading positions in the S&P have been stopped out. Maintain put options. Next regular update is Tuesday, Jan. 21.

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