FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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A synchronized plunge

It is high time for the world's bourses to stop and take note that the upswing in economic activity in the principal centres of economic activity has come to an end.

In the US, corporate profits fell again in the first quarter, the fifth drop in a row, now by 2%. And the impact of declining oil prices has as yet not been properly recognized (when it does, as per new SEC rules it could mean additional writeoffs of as much as $2 billion). Inventory/sales ratios move up to 1.4, the highest such reading in a number of years. Consumer installment debt, already at an unsustainably high 19% plus of disposable income, has begun to contract, a classic sign that the consumer boom has been deflated.

The F. W. Dodge construction contract index declined 17.2% between the fourth quarter of 1985 and the first quarter of 1986 and was below the quarterly average in March. In fact, F. W. Dodge reported that "March contracting for new offices was the lowest in well over 3 years."

Leading indicators continue to rise, primarily because of the financial components such as money supply and stock prices. The real economy, however, represented by declining industrial production, falling capacity utilization, falling profits, and sluggish and falling real retail sales (particularly after adjusting for debt contracted) is either tilting or falling. Easy monetary policy has created enough debt over the past 18 months to keep alive a consumption boom. But even this effect is beginning to fade: Domestic car sales, despite a third cheap financing scheme have fallen from a 8.7 million cars/year to a 7.7 million cars/year rate. If 5.9% per year can't do it, can consumer saturation be far behind?

Economic weakness in the UK (manufacturing output down for the first time in three years, unemployment continues to rise), West Germany (industrial production down 1% year over year), and Japan (industrial shipment index in the first quarter down, for the largest drop in six years, real consumption spending of salaried workers' households in February down for the third month) indicate that monetary policy has reached its limits. In fact, where it has really been effective is in causing a speculative orgy in financial instruments, particularly stocks. Recognizing belatedly this phenomenon, the bank of Japan has again refused to lower the discount rate despite repeated American pleadings.

The world economies are saturated with inflation, not price inflation *yet*, but inflation nonetheless — credit (=debt) inflation, speculation.... The new Fed nominee, Robert Heller, doesn't see it this way when he declares that "we don't have to worry much about inflation in this country." And though he "respects" Mr. Volcker, he, in no way, shares his views.

The Fed may yet attempt to save the day by *accelerating* the rate of growth of money. Baker wants it, most of the Fed's Board want it (Volcker may quit over this issue), and the bond market feels it: Accelerating money growth, by being *unexpected*, may yet fire up a short-lived reacceleration of economic activity.

The Fed is at a crossroad: It must choose between pain now and more-pain-later. The bond market cannot reconcile a credit inflation of 12%-15% with yields of 7½%. It therefore must readjust its level. The stock markets are finally doing the least expected thing: plunging at a terrifying pace, in an unexplainable fashion. London (see Chart 1), NY (Chart 2), Frankfurt and Tokyo are in a synchronized fall. If it is pain now, then watch out for a 25%-40% plunge. If it is more-pain-later, then a 15%-20% reaction will do for now (mostly on technical grounds and some economic bad news before reacceleration) and there is more madness to come.

A quick and superficial look at the charts of secondary stocks (mostly "small caps") reveal gathering strength, an unusual occurrence if this were a situation of pain now, i.e., a full-fledged bear market. Could the coming shakeout lead to a market revival of secondary stocks, a result of course of massive Fed pump-priming?

An interesting indicator and a very useful trading tool as well, is the Value Line/S&P 500 spread. The Value Line index measures over 1,700 stocks (more than triple the S&P 500 blue chip index) and does not weigh them by capitalization.

In this issue

A promising turnaround in New Zealand could mean a boom in financial assets. We're still bearish on energy futures, but we're exercising a little patience before reentering the short side. Also, interest rates, precious metals, copper, sugar, and handsome profits in our spread corner. Contributions by Albert D. Friedberg, Steve H. Hanke, and Daniel A. Gordon.

As a result, it is a far better guide to secondary stocks than the S&P 500 index. The spread peaked in July 1983 at over *1.30* and has declined relentlessly until very recently, indicating that institutionally-oriented blue chip stocks led the bull market to the detriment of the secondary, small cap stocks. In recent months, the decline in the ratio has slowed down, near par, indicating that the downside momentum may be ending (see Chart 3). In fact, almost by default, the ratio has broken out of the long three-year downtrend line. It now remains to be seen whether *it can turn up in a meaningful way.*

STRATEGY: *The long Value Line/short S&P 500 spread may turn out to be one of the most dynamic and profitable spreads of the year. It will signal that the Fed is going for broke on the inflation front. Since this event is in the realm of possibilities, we urge you rather strongly to pay attention to the spread. We'll keep you posted.*

Retain June '86 S&P 500 puts.

Chart 1

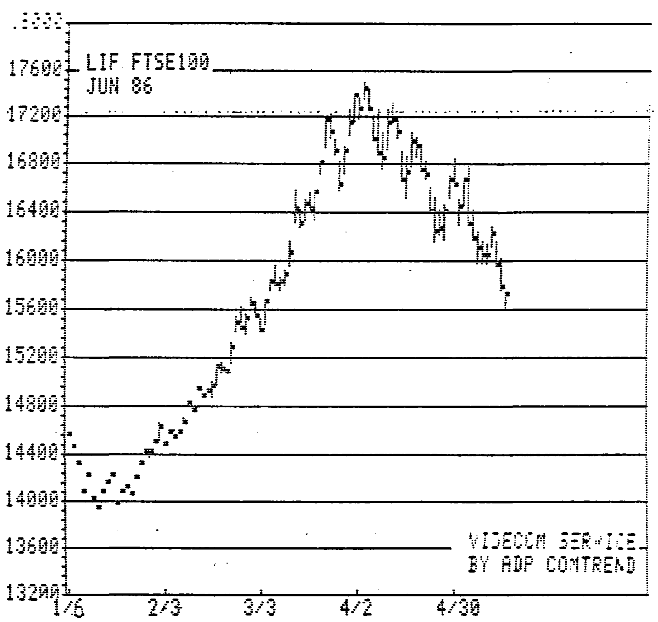


Chart 2

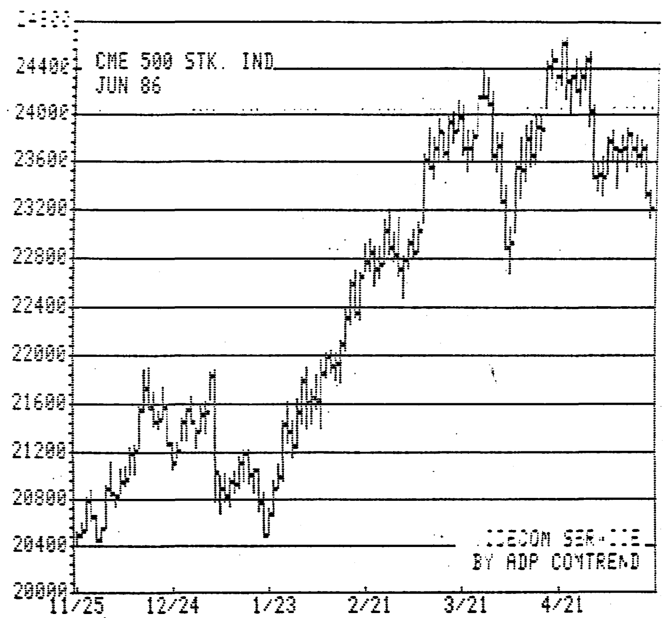
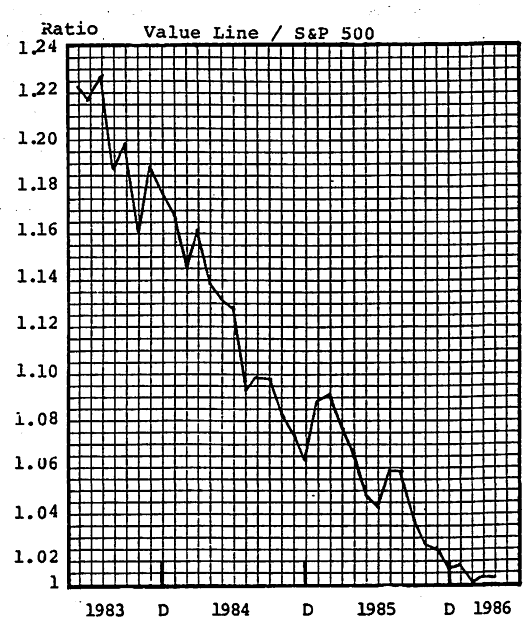


Chart 3



The kiwi turnaround

Made up of three islands that span approximately 286,000 square kilometers (similar in size to the UK or Japan) and located in the South Pacific Ocean, southeast of Australia, New Zealand has been called the sheep and dairy farm to the world. And for good reason. Agricultural exports — mainly meat, wool, and dairy products — account for an average of 70% of export earnings in recent years. Livestock commandeer 75% of New Zealand's cultivated land, while most of its 3.2 million people live in urban areas, including Auckland, Wellington (the capital), and Christchurch.

In the early '50s and by the reckoning of the United Nations, New Zealand was one of the three or four richest countries in the world, behind Switzerland, the US, and Canada. By 1978, its ranking dropped to 22nd spot. In the ever-changing derby of economic fortunes, it is likely that currently, and in relative terms, New Zealand has dropped even further.

It should come as no surprise. Ruled by the National Party, a party conservative by name only, for 29 of the last 36 years, New Zealand has sunk ever deeper into a morass of blissful welfarism. The interventionist bias of the nation's economic policies culminated in the last decade: Between 1975 and 1982 there was virtually no growth while inflation raged at an average of 15% per annum.

The big chill

Then, in June 1982, the government froze wages and prices, froze the exchange rate of the New Zealand dollar, and put a ceiling on interest rates. Price inflation dropped to 3½% by early '84.

According to the *IMF Survey* of July 29, 1985, though, the effect of the freeze had deeper repercussions. The imbalances that had existed in the economy before the freeze were "looked in." The fiscal deficit, for example, increased to 9% of gross domestic product in 1983-84 from 5½% in 1982-83. Dangling the carrot of cuts in personal income taxes to foster acceptance of the wage freeze contributed to the ballooning deficit. The growing deficit, and a reluctance to let interest rates rise resulted in a gradual loss of monetary control.

The current account deficit grew, too — an average of 4½% of gross domestic product in the five years to 1983-84. And like most governments, New Zealand financed the deficit by borrowing abroad. The result: Official external debt rose to about 27% of gross domestic product in 1983-84, from 20% in 1979-80.

The announcement of elections in June 1984 was the wild card in the deck. Private capital flowed out of the country in the expectation of a change in the exchange rate. But the government ruled out such a change, and had to borrow heavily abroad to meet the high demand for foreign exchange.

In the 10 years to 1983-84 real government spending increased at an average annual rate of 5½% — without a corresponding increase in revenue. Because of the three-year election cycle, fiscal policy bounced like a yo-yo. But it was still directed to supporting domestic economic activity. Spending on social services increased; industry and agriculture were given ever more support; and large investments were made in energy projects.

But there were serious problems in collecting revenue to pay for all this largesse. According to the *IMF Survey*, by 1982-83, about 70% of the government's total revenue came from direct taxes. And of that, more and more came from personal taxation. By 1983-84, about 60% of all government revenue was coming from the individual taxpayer. Revenue from corporate tax accounted for about only 6¼%. But even worse, liberal tax concessions narrowed the tax base, which was already narrow enough, owing to an absence of tax on such items as fringe benefits and capital gains.

As you'd expect, the result of the skewed tax system was high average and marginal tax rates. And as we know, high tax rates make taxpayers wonder why they should work and save instead of avoiding and evading. And evading and avoiding is just what they did in New Zealand.

Far-reaching reform

By July 1984, the country was ready for change. The advent of the Labor party in government initiated the most far-reaching economic reform in New Zealand's history. Roger Douglas, the new government's bold finance minister, was the son of an old-time trade union MP and grew up in a traditional labor household. In 1980, while still in opposition, he published a thought-provoking book called *There's Got to Be a Better Way*, a prophetic free-market manifesto that laid the blueprint for a veritable revolution in the second half of the '80s.

Douglas moved to deregulate the economy, lift controls on interest rates, devalue the New Zealand dollar and subsequently float it, and dismantle the complicated, complex, and highly inefficient system of export subsidies and import quotas. At the same time, the finance minister set out to reduce the country's budget deficit, which as we have seen, reached an unsustainable 9% of GDP and became the cause of the country's huge current account deficit, increase in external indebtedness, and high inflation

The 1984-85 budget deficit decreased to NZ$2.7 billion, or 6.9% of GDP; the 1985-86 budget deficit struck even further, to NZ$1.87 billion, or 4.1% of GDP, a 59% reduction in the deficit inherited by the new labor government in July 1984. Being a committed monetarist, Douglas would not resort to monetizing the debt; the entire public sector financing requirement has been raised in the local money market.

Financial deregulation, public sector crowding out, and still relatively high rates of inflation during 1985 pushed the three-month T-bill rate to a high of nearly 24% and mortgages to 29%. But by mid-May 1986, with inflation down to an annualized 10%, there was light at the end of the tunnel. Responding to the firm control of the public purse exercised by the government and consequently the diminishing impact of the deficit on financial markets, interest rates on short-dated government paper had dropped to the 17½% range.

Prime Minister Lange's government also began a major tax reform, lowering marginal personal tax rates as much as 20 percentage points, while increasing corporate taxes by two to six percentage points, eliminating tax shelters, and pledging the introduction of a 10% value added tax on goods and services by October '86. Late last year, the government introduced a bill to remove all restrictions on the number of local and foreign banks able to operate in the country, a significant move especially when compared with Australia's timid financial liberalization.

In one area the government failed to extend its deregulatory pace: the labor market. Mr. Lange actually restored compulsory unionism, which had earlier been abolished by the National Party. So far, he has proposed no changes in the current system that sets wages on a national basis. In the face of recent 15% pay awards and aware of the ill effects of this policy, Finance Minister Douglas has warned that the labor policy will retard the economy's necessary adjustment, resulting in increased business failures and rising unemployment. It is hoped that increased foreign competition will force an eventual thawing in the labor market.

The adjustment has meant a sharply reduced rate of economic growth. Despite a hoped-for gain of 2%, GDP came to a virtual standstill during the 1985-86 period. The labor rigidities discussed earlier coupled with the continuous downtrend in the country's terms of trade probably will keep growth subdued again in the coming year. Nevertheless, the outward reorientation of the economy, unshackled from repressive and inefficient controls, should begin to show strong positive results in the 1987-90 period.

There are at this time three principal risks to our bullish scenario. In the first place, the upcoming mid-1987 election. New Zealand politics suffers from an extremely short electoral cycle, one that in the past did not allow for long-term, let alone medium-term, planning. The Lange government, to its credit, has proceeded to map out a medium-term strategy involving some significant short-term pain (and thus political risks) in the hope accomplishing a true economic revolution. Clearly, the risks are present.

Secondly, the government is well aware of the deleterious effect of large budget deficits on the country's credit worthiness and currency. The government has been relatively successful in more than halving the fiscal gap in the short two-year span, with the consequent improvement in the country's current account (down to NZ$2.1 billion from NZ$2.6 billion in the previous year). In the 1985-86 fiscal period, the government suffered a substantial drop in tax revenues as a result of slower-than-expected growth. It now remains to be seen whether the solid supply-side fiscal measures announced to take effect for late 1986 will have enough stimulative influence on the economy to produce the desired lift in total tax revenues. In July the government will be bringing down its budget, and a clearer picture of fiscal deficits for the next two years will emerge. Knowing Mr. Douglas' bold and no-nonsense style, we are betting that he will announce further expenditure cuts to bring the 1986-87 fiscal deficit below 3% of GDP.

The third risk relates to the inflexibilities built into the labor market and their effect on retarding economic adjustment. Passed in the hope of buying union cooperation, it may boomerang and create a rising unemployment spiral and a political booby trap in the neo-classical economic model — sufficient, perhaps, to bring down the government, and with it, the entire liberalizing experiment. This risk, however, may be a longer-term consideration, perhaps only to rear its ugly head on a second labor term.

In short, we're witnessing a classic turnaround situation in a highly developed, albeit small, OECD member nation. Good human, capital, and national resources. Excellent management. And, as always, some risks.

***STRATEGY:** Buy deeply-discounted deferred forward positions in New Zealand dollars. Buy financial assets (such as bonds and stocks) denominated in New Zealand dollars and yielding high real rates of return. And keep your fingers crossed, at least past mid-1987....*

Chart 4

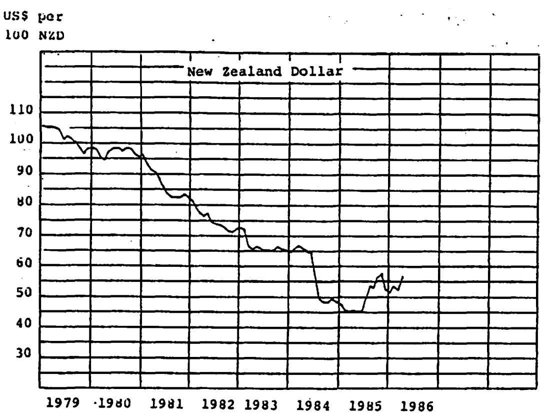


Chart 5

BASKET: U.S. 23%, JAPAN 29%, AUSTRALIA 28%, UK 15%, Germany 5%

YEAR	NEW ZEALAND DOLLAR PER U.S. DOLLAR (PERIOD END)	U.S. 1970 =1.00	U.S. 1978 =1.00	BASKET 1970 =1.00	BASKET 1978 =1.00
1967	1.1227	0.9935	1.3768	1.0148	1.1161
1968	1.1121	1.0034	1.3905	1.0138	1.1150
1969	1.1198	1.0001	1.3859	1.0079	1.1085
1970	1.1161	1.0000	1.3857	1.0000	1.0999
1971	1.1952	0.8793	1.2184	0.9396	1.0334
1972	1.1952	0.8522	1.1810	0.9293	1.0221
1973	1.4284	0.6990	0.9686	0.8300	0.9129
1974	1.3155	0.7575	1.0497	0.8869	0.9754
1975	1.0437	0.9114	1.2630	1.0565	1.1620
1976	0.9500	0.9059	1.2554	1.0006	1.1005
1977	1.0177	0.7851	1.0879	0.9592	1.0550
1978	1.0666	0.7216	1.0000	0.9092	1.0000
1979	0.9862	0.7644	1.0592	0.9768	1.0743
1980	0.9623	0.7584	1.0510	1.0152	1.1166
1981	0.8244	0.8477	1.1747	1.0269	1.1294
1982	0.7325	0.8707	1.2066	0.9720	1.0690
1983	0.6546	0.9374	1.2990	1.0019	1.1020
1984	0.4776	1.2620	1.7488	1.2256	1.3480
1985 (1Q)	0.4615	1.2215	1.6927	1.1532	1.2683
1985 (2Q)	0.4732	1.1482	1.5911	1.0885	1.1972
1985 (3Q)	0.5443	0.9782	1.3556	0.9765	1.0740
1985 (4Q)	0.4985	1.0539	1.4604	1.0539	1.1591

Above 1.00 = undervalued
Under 1.00 = overvalued

Chart 6

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Mln US$)
1970	317	-3.76	-283
1971	547	-0.25	-228
1972	888	+1.74	-88
1973	1139	-0.97	+22
1974	568	-12.82	-1761
1975	55	- 8.46	-3092
1976	- 98	- 5.81	-3772
1977	-231	- 4.72	-2664
1978	-234	- 2.73	-1980
1979	425	- 3.90	-2002
1980	317	- 3.46	-2117
1981	729	- 5.41	-2984
1982	797	- 6.23	-3636
1983	850	- 4.68	-3889
1984	1849	- 6.23	-3961
1985	1656	- 5.32	-3550

Chart 7

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

Reserves * + Previous 12-months current Account *** = 1178

(Reserves + 12-months C/A)/MI ** = 1178/2045 = 57.6%

Reserves + 12-months C/A)/Broad Money ** = 1178/7164 = 16.4%

* As at Feb.'86 ** Dec. '85 *** 1985 (1)= 1985 (4)

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1975	1826	3031
1985	2045	7164
% Increase (decrease)	12%	136%
Corresponding % increase in the United States	114%	143%

(a) 1985 Imports as percentage of GNP 27.34%

(b) 1976 - 1985 Imports as percentage of GNP 22.77

1985/(1976 - 1985 average)= (a)/(b) = 120.07%

Source: IFS

Chart 8

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	.5500- .5530	.5450- .5490	.5360- .5405	.5220- .5280	.5000- .5130

Energy Futures

Troubles for the bear began no sooner than the market had begun its inversion. Moving from a full carry to a more normal carry in the early March to mid-April period, the market inverted by late April (see Chart 9) and has since continued to widen the backwardation. The inversion was a sign that spot crude supplies were becoming inadequate. A quick glance at the "crack" spread (Chart 10) indicates that by the time crude bottomed (late March), product prices were already firming, allowing the unhedged refiner (as well as the refiner who was *not* taking down netback crude) to cash in on substantial refining margins.

What was going on? The sharp fall in crude and product prices caused holders to draw down inventories, accelerating the fall and creating, in its wake, a substantial *near term* short position. At the same time, products, at least in the US, showed significant upticks in consumption. The dearth of product supplies widened the crack, the market's mechanism to induce increased refining runs. In short, products have been leading up the supply-starved US market, which, as yet, *had not had enough time* to restock itself. At the same time, producers, shellshocked by the rapidity of the decline, have been reluctant sellers, hoping that OPEC puts its act back together. These hopes were reinforced by the Norwegian strike, which for a few weeks removed 900,000 barrels per day (b/d) from the market, by talk that the US was interested in stabilizing prices, and by rumors that a June OPEC quota agreement was in the making.

OPEC's production should, by now, be rising steadily with the Saudis being extremely careful in meeting their 4.3 million b/d quota (even at the cost of offering discounts of up to $1.15/barrel below netback deals). As the market consolidates its range around the $14-$16/barrel mark, OPEC members' budgets will in due course begin to feel the pinch. Independent decisions to raise output and exports will then bring OPEC production up to new recent highs.

That this is so is already being demonstrated by Kuwait and Abu Dhabi whose combined output is reaching almost 3 million b/d, up from a normal range of 1.5-1.7 million b/d.

Buoyed by renewed hopes of an OPEC accord in June, the market is likely to remain firm, at least through the next four to six weeks. At the same time we are keeping a very close eye on the crack (see Chart 10) on the assumption that a falling spread (= falling refining margins) will signal the end of the upward correction. It should also be remembered that a widening backwardation is the market's mechanism for increasing the spot allocation of supplies (see FC&CC, "A crude waiting game," Oct. 20/85). In due course and probably in short order, US inventories will be replenished, and the market will, once again, become technically vulnerable.

STRATEGY: *For essentially the reasons outlined above, we advised (on our Hotline service) on May 2 and May 8 to cover first one half and then the balance of the short crude position, showing us outstanding profits.*

We are anxious to reenter the short side but believe that a little bit of patience will be helpful. The next leg down promises to be almost as spectacular and as profitable as the first one. We'll keep you posted.

Chart 9

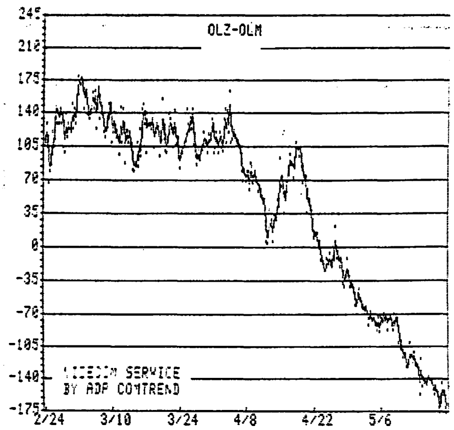


Chart 10

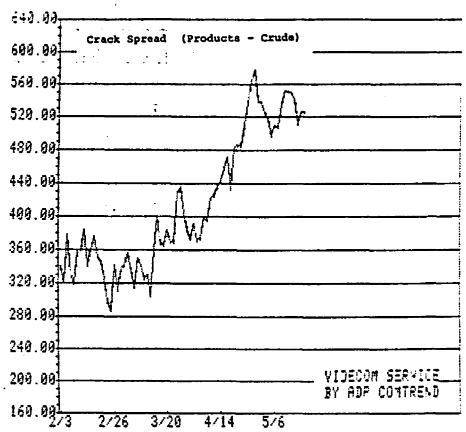
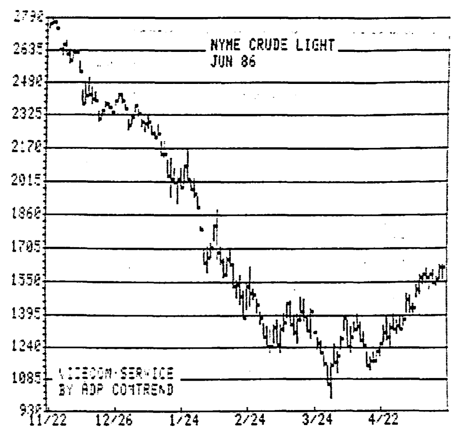


Chart 11



Crude's long-term outlook

Oversupply [of oil] is permanent, and severe downward pressure on prices will last as long as we can foresee.
—Professor M.A. Adelman
November 1985

For the past year, we have analyzed the forces that have been working to unravel the OPEC cartel. Our analyses were short-run, with time spans of no longer than 18 months. These analyses pointed to the fact that — barring a war or revolution that might shut down large producing areas — OPEC was bound to come unglued, and that a crude oil price of $5 per barrel was in the cards. We continue to stand by these views.

By now, many share our views about the short-run. However, they argue that the current glut won't last too long. As they see it, low prices will produce shortages in the early 1990s because reserves will have been exhausted and not replaced at low prices. For these doomsdayers, the unravelling of OPEC, while beneficial in the short-run, represents a calm before a storm.

We now believe that it is time to evaluate the long-run picture, and address the assertion that oil prices must necessarily rise after the cartel's excess capacity has been digested by the market. For this, we rely heavily on the research that has been produced over the last quarter of a century by Professor M. A. Adelman of the Massachusetts Institute of Technology. In particular, we focus on the results contained in two of Adelman's unpublished research papers: *World Wide Oil and Gas: Permanent Instability* (November 1985) and *The Competitive Floor To World Oil Prices* (April 1986).

At present, the oil industry is going through a transition from a mixed, competitive (non-OPEC), cartelized (OPEC) industry to one that is competitive. In transition, if not restrained by another cartel, producers will increase output to maximize their income. In consequence, they will push output to the point where the additional cost of a barrel of oil is equal to the market price. Under these conditions, world output will be high and prices will be low. High-cost production areas, such as the US and the North Sea, will gradually decline in importance because investments to maintain capacity will not pay.

Contrary to industry claims, production in these areas will not drop suddenly because operating costs, while relatively high, are still low in absolute terms. For example, the operating cost of the British North Sea averages a little more than $2 per barrel, with 60% of production being produced at less than the average and 80% being produced at less than $4 per barrel. For the US, the average operating cost is about $4 per barrel, with about 65% of production being produced at less than average and 95% being produced at less than $8 per barrel. Hence, at a price of $8 per barrel most of the US's current production would continue, and at $4 per barrel 80% of the North Sea's production would remain. At these low prices, however, the incentive to invest in more capacity in the high-cost areas would be gone. Hence, the existing capacity couldn't be maintained, and production would gradually fall.

For OPEC, the transition away from a cartel and towards a competitive environment means full utilization of existing capacity (about 28 million barrels per day) and soaring investments in new capacity. What will this portend for long-run prices (1995-2000)? The answer is given by examining Charts 12 and 13. With competition, rather than a cartel, OPEC will not operate on a backward-bending supply curve (see: FC&CC December 15, 1985, for a discussion of the backward-bending supply curve). OPEC's supply curve will be positively sloped. So, as the price increases, producers will push more high-cost output into the market. For example, at a price of about $2 per barrel, 56.7 million barrels per day (b/d) would be supplied by OPEC alone (the first nine countries in Chart 12).

If the price rose to about $5 per barrel, 62.6 million b/d would be supplied. It should be clear that under strict competitive conditions, the long-run price of oil will not rise from a floor of about $5 per barrel. At this price OPEC production of more than 60 million b/d, plus non-OPEC production, would support any conceivable level of consumption through the end of the century.

For those who may question whether OPEC can physically and economically more than double its capacity by 1995 at a price of $5 per barrel, we must mention only that untapped oil reserves are virtually for the asking in the Persian Gulf region. For example, in Kuwait a 30 billion barrel field was inadvertently discovered in 1983, when a team was drilling for gas to fuel a local power station. In Saudi Arabia, the abundance of undeveloped reserves is truly staggering. For example, of the Saudi's 50 known commercial oil fields, only 15 have been developed.

The bearish long- and short-run outlook should lead to the strong conclusion that competitive economic forces, if allowed to work, will act, through the end of the century, as a heavy weight on oil prices. A $5 per barrel floor for oil prices is solid.

What is not clear is how high the ceiling is and what prospects there are for prices to be lifted from the floor to the ceiling. Given the recent pronouncements from OPEC, it appears that the ceiling might be as high as $28 per barrel. Barring a war or revolution that would knock large chunks of potential OPEC production out, this ceiling, if attained through a new cartel arrangement, couldn't be maintained for an extended period. It would result in too large a gap between price and long-run incremental costs. In consequence, price flights at the ceiling altitudes will be highly unstable because long-run incremental costs, which range from cheap to dirt cheap, will ultimately act as a strong gravitational force, and will cause all high altitude flights to plunge to the floor.

—Steve H. Hanke

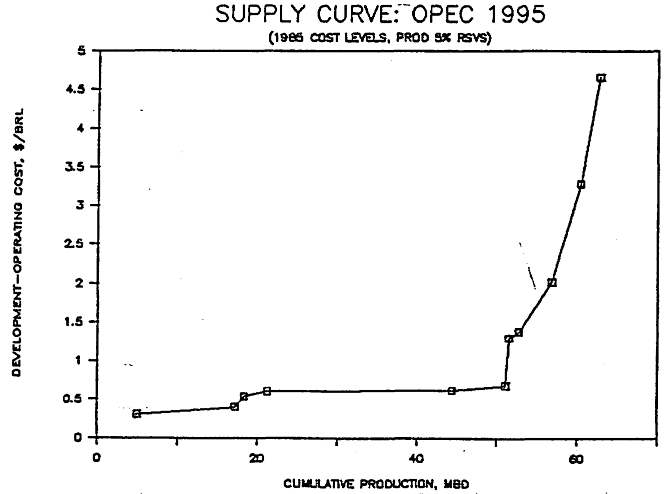
Chart 12

Supply Curve: OPEC 1995
(1985 Cost Levels)

Producer	Cost per Barrel	1995 Potential Capacity (MBD)	1995 Cumulative Potential Supply (MBD)
Iraq	$0.302	5.0	5.0
Kuwait	0.397	12.0	17.0
Indonesia	0.535	1.2	18.2
Libya	0.601	2.9	21.1
Saudi Arabia	0.616	23.0	44.1
Iran	0.677	7.0	51.1
Qatar	1.296	0.4	51.5
Algeria	1.376	1.2	52.7
Abu Dhabi	2.023	4.0	56.7
Venezuela	3.285	3.6	60.3
Nigeria	4.656	2.3	62.6

Data Source: M.A. Adelman, The Competitive Floor To World Oil Prices. M.I.T. Energy Laboratory Working Paper No. MIT-EL 86-011WP, April 1986.

Chart 13



Source: M.A. Adelman, The Competitive Floor to World Oil Prices, M.I.T. Energy Laboratory Working Paper No. MIT-EL 86-011WP, April 1986.

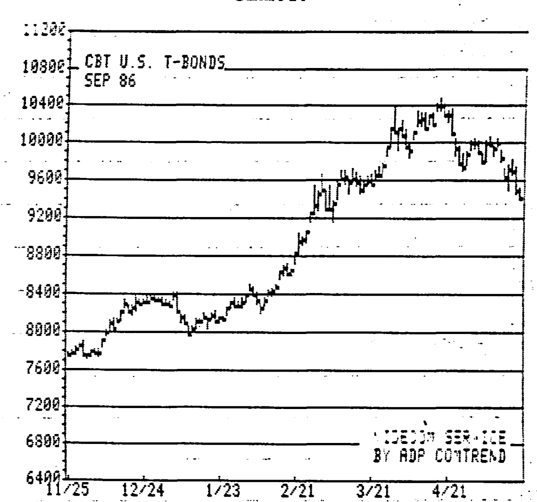
Interest Rate Futures

The money market is reacting as expected. It believes that for the moment the cycle of monetary accommodation may be over, especially given the reluctance of West Germany and Japan to go along with further interest rate cuts. The battle of the dollar (see FC&CC, April 1986) requires the US to maintain *wide and rising interest rate differentials*. Should the US go at it alone and by fiat lower the discount rate once more, it will risk the complete collapse of the dollar, at which point the long end of the market will probably test the 1981-82 lows. In a case of "heads I win, tails you lose," the bond market has cornered the Fed and is demanding higher interest rates.

STRATEGY: *Having finally and successfully entered the short position on May 13 (see Hotline), we remain firmly convinced that we will see 9% yields before 7% and 10% much before 6% yields (if we ever see them).*

Roll over short positions from June '86 to September '86 and lower stops to 99.00, close only.

Chart 14



Currencies

The battle of the dollar has heated up, and the matter of counter-intervention has begun to assume form. As we discussed last month, if US monetary policy remains as highly accommodative as it has been, intervention will be extremely costly and probably futile. Pegging the dollar at these rates will not solve the problem: the US is still spending beyond its means, as attested by the yawning current account deficit. A disadvantage of pegging rates at this time may lie in the fact that it would create a one-sided, low-risk speculation *as dollar rallies would be contained within the specified band* (as different from the present float where risk is indeterminate).

The attractions of a bear dollar position will stand in inverse proportion to the size of the proposed "band": A narrow band will make for an excellent speculation, while a broad range will diminish its attractions. The advocates of pegging (Baker?) would be hard-put to rationalize "bands" so broad that speculators would shun one-sided attacks.

STRATEGY: *Short-term, closes below 53.50, basis June '86 SF, 44.80, basis June '86 DM, and 58.80, basis June '86 yen indicates some further near-term weakness for these currencies. Traders could take advantage of these breakdowns by selling and then entering orders to repurchase around 52.00, 43.25, and 56.25 for the June SF, June DM, and June yen respectively. Long-term traders* should not *disturb long-term long positions on these currencies.*

Chart 15

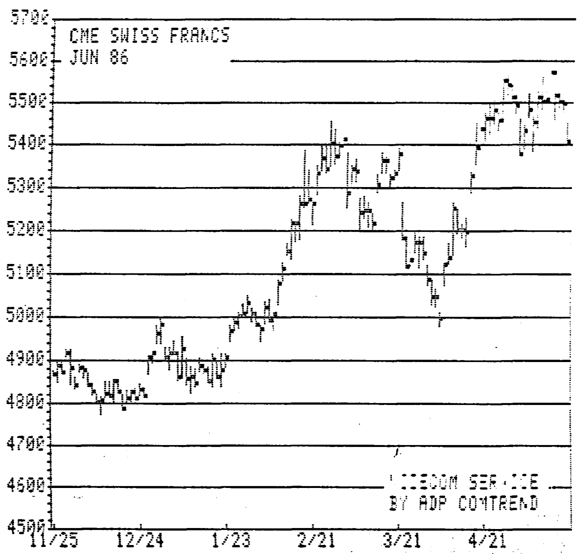


Chart 16

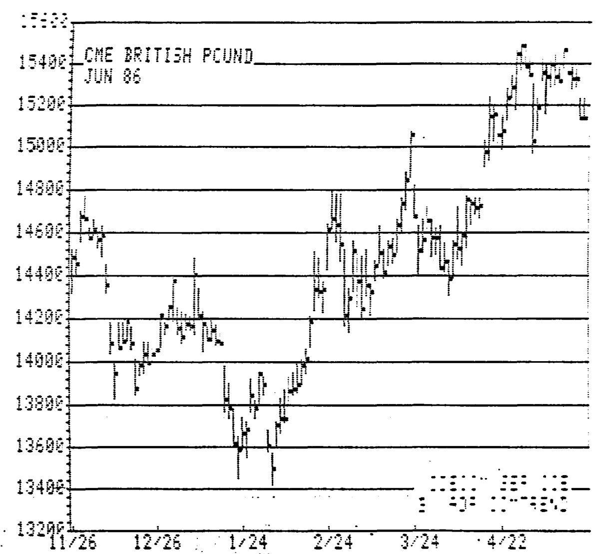


Chart 17

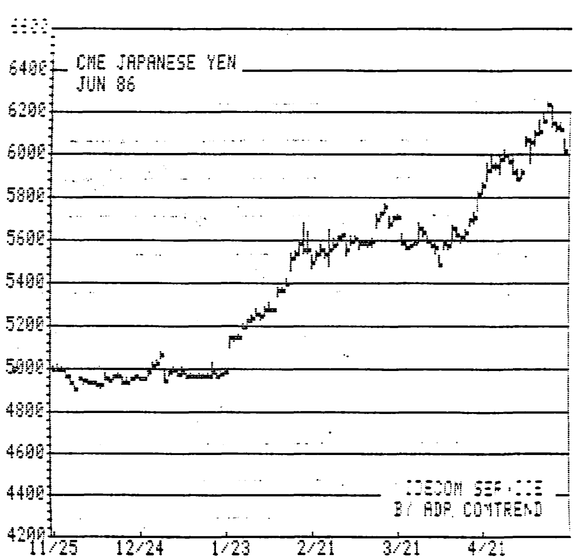
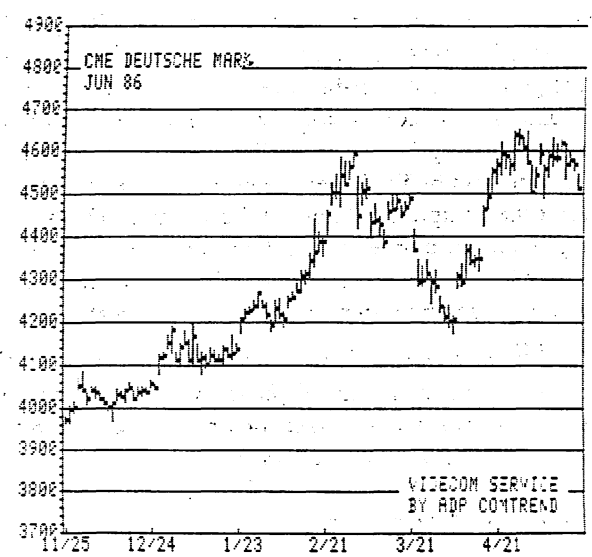
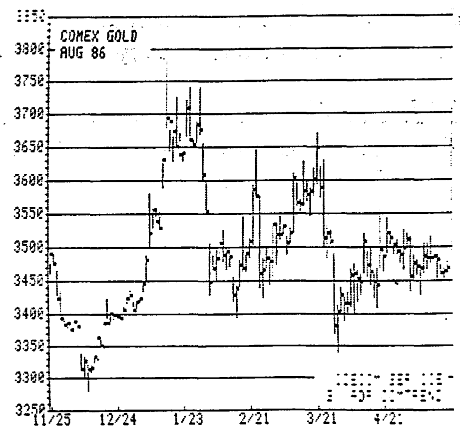


Chart 18



Precious Metals

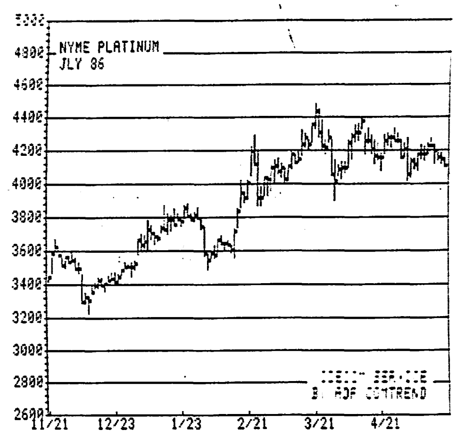
Chart 19



Gold

STRATEGY: *Remain long: long-term, patient investors should add on weakness, i.e., on sharp $15-$20/oz. dips; short-term traders should add on crossing 371, basis the nearby COMEX contract.*

Chart 20

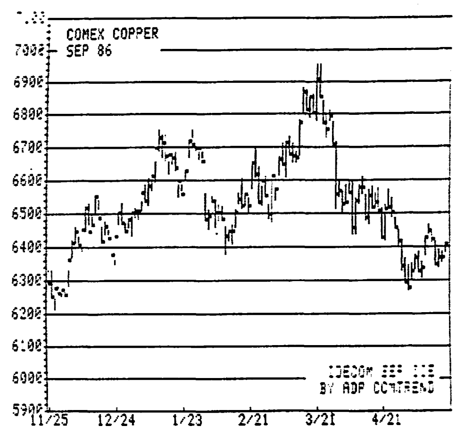


Platinum

STRATEGY: *Remain long. Retain stops at 385, basis July '86, close only.*

Copper

Chart 21



The massive decline in open interest has strengthened considerably this market's technical underpinnings.

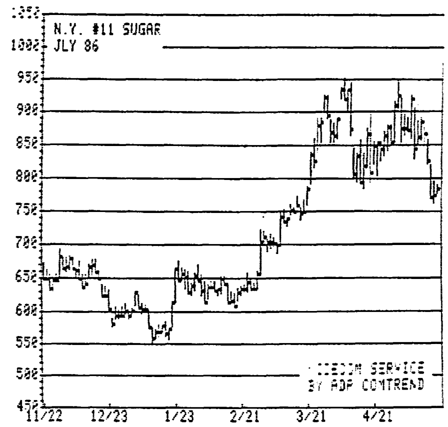
STRATEGY: *Buy September '86 at market; add on close above 65.90.*

Sugar

We have been advocating building up a meaningful long position on large setbacks. Recent action should fit the description, and we now assume a fully-invested position.

STRATEGY: *Place stops at 7.40, basis July '86, close only. The upside looks intriguing as world stocks begin to recede and consumption rises inexorably.*

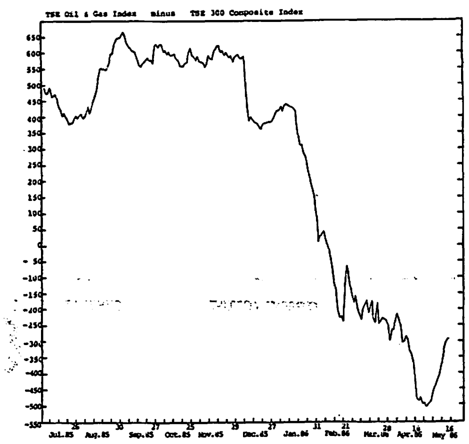
Chart 22



Spread Corner

The long TSE 300/short TSE Oil and Gas traded at our target: 500 points oil and gas under. We have thus closed out the balance of the position with profits of up to 1,200 points, or the equivalent of $12,000 per spread.

Chart 23



The Exotics

Swedish krona

Sweden's current account for 1985 reversed to the negative, due primarily to a first half deficit. In the second half of the year, the country's external accounts bounced and there is now a good possibility that in 1986 we will once again see a surplus in the current account. Another hopeful sign is that the budget deficit as indicated in the government's supplementary budget of late April should fall to 4.8% of GDP in 1986-7 from 5.6% in 1985-6. That in turn compares with a peak of Skr86.6 billion, or 13% of GDP in 1982-3.

Continuing progress on the external and budgetary fronts preclude us from becoming overly negative, despite anemic economic growth (estimated to be 1.6% in 1986 compared with 2.3% in 1985 and 3.4% in 1984) and rising unit labor costs.

STRATEGY: *Remain long against the US dollar and neutral against the DM.*

Chart 24

BASKET

U.S.	16%	FRANCE	7%
NORWAY	13%	U.K.	19%
Germany	23%	DENMARK	12%
		FINLAND	10%

YEAR	SWEDISH KRONOR PER U.S. DOLLAR U.S. DOLLAR (PERIOD END)	U.S. 1970 = 1.00	U.S. 1978 = 1.00	BASKET 1970 = 1.00	BASKET 1978 = 1.00
1967	5.16	0.9612	1.3627	0.9568	1.0145
1968	5.18	0.9858	1.3976	0.9760	1.0348
1969	5.17	1.0107	1.4329	1.0108	1.0718
1970	5.17	1.0000	1.4177	1.0000	1.0603
1971	4.86	0.9126	1.2938	0.9880	1.0475
1972	4.74	0.8697	1.2330	0.9282	0.9842
1973	4.58	0.8358	1.1049	0.9372	0.9957
1974	4.08	0.7502	1.0636	0.8826	0.9359
1975	4.38	0.8021	1.1372	0.9110	0.9659
1976	4.12	0.7246	1.0273	0.8156	0.8627
1977	4.66	0.7832	1.1104	0.9860	1.0454
1978	4.29	0.7054	1.0000	0.9431	1.0000
1979	4.14	0.7068	1.0017	0.9945	1.0542
1980	4.37	0.7434	1.0540	1.0684	1.1328
1981	5.57	0.9328	1.3224	1.1419	1.2107
1982	7.29	1.1933	1.6918	1.3393	1.4200
1983	8.00	1.2403	1.7583	1.2934	1.3714
1984	8.98	1.3458	1.9080	1.2205	1.2941
1985 (1Q)	8.87	1.2884	1.3266	1.2218	1.2755
1985 (2Q)	8.80	1.2679	1.7975	1.2419	1.3168
1985 (3Q)	8.06	1.1672	1.6548	1.2160	1.2093
1985 (4Q)	7.61	1.0952	1.5527	1.1738	1.2446

Above 1.00 = undervalued
Under 1.00 = overvalued

Chart 25

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Mln US$)
1970	916	-0.8	-578
1971	1286	0.9	-110
1972	1950	1.3	654
1973	3267	2.7	2348
1974	3261	-0.9	1444
1975	4072	-0.4	535
1976	3443	-2.1	-2542
1977	3553	-2.6	-4171
1978	3263	-0.2	-4080
1979	369	-2.2	-4846
1980	-1221	-3.5	-7069
1981	-3119	-2.5	-9665
1982	-3748	-3.4	- 10565
1983	-3717	-1.0	-7090
1984	-4705	0.4	- 3870
1985	-4332	-1.1	- 1597

Chart 26

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

Reserves * + Previous 12-months current Account *** = 5000
(Reserves + 12-months C/A)/MI ** = 5000/7698 = 64.91
Reserves + 12-months C/A)/Broad Money ** = 500/44317 = 11.2%
* As at Feb. 1986 ** March 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)
1975	8195	39078
1985 (March)	7698	44317
% Increase (decrease)	(6.06)	13.4%
Corresponding % increase in the United States	89.5	125.9%

(a) 1985 Imports as percentage of GNP 29.16
(b) 1976 - 1985 Imports as percentage of GNP 25.84
1985/(1976 - 1985 average)= (a)/(b) = 112.84
Source: IFS

Chart 27

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	7.1150 -	7.1420-	7.1810-	7.2200-	7.2950-
	7.1200	7.1500	7.1900	7.2325	7.3125

Forex Rates & Update

Currency	Spot	3-Month	12-Month	Comments vis à vis US$	Comments vis à vis DM (Spot DM 2.22)
Australian dollar	.7190-.7197	.7058-.7069	.6730-.6747	Remain long	Remain long
Belgian franc	45.10-45.15	45.19-45.28	45.21-45.41	Remain long	Remain long
Danish krone	8.1925-8.1975	8.1975-8.2050	8.2125-8.2400	Remain long	Neutral
Dutch guilder	2.4915-2.4925	2.4840-2.4860	2.4555-2.4585	Remain long	Remain long
Greek drachma	139.00-139.10	143.25-145.65	152.00-167.00	Remain short	Remain short
Italian lira	1517-1519	1519-1520	1522-1526	Remain long	Neutral
Kuwaiti dinar	.28980-.29010	.28980-.29057	.28950-.29153	Neutral	Remain short
Malaysian ringgit	2.5940-2.5960	2.6340-2.6460	2.6940-2.7960	Remain short	Remain short
Norwegian krone	7.5325-7.5375	7.6475-7.6575	7.9575-7.9775	Remain long	Neutral
Portugese escudo	148.50-149.00	152.50-158.00	158.50-189.00	Neutral	Neutral
Saudi Arabian riyal	3.6503-3.6508	3.6553-3.6588	3.6825-3.6910	Remain short	Remain short
Singapore dollar	2.2120-2.2130	2.2050-2.2070	2.1870-2.1980	Remain short	Remain short
Spanish peseta	140.50-140.70	142.40-142.90	146.75-147.95	Neutral	Neutral
Venezuelan bolivar	20.00-20.05	20.10-20.50	Not available	Neutral	Neutral

Explanatory Notes

*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

Tuesday, April 22: The market letter will be mailed today. Next regular update: Friday, April 28.

Wednesday, April 23: The market letter is in the mail. There will be no regular Friday update. Instead a broadcast will be made at 9:00 a.m., Monday, April 28.

Monday, April 28, 9:45 a.m.: In line with our latest market letter comments, we now believe that the timing is correct for establishing an initial short position in June T-bonds. Sell at market, placing initial stops at 101.11, good anytime.

Tuesday, April 29: As of yesterday morning's flash update, you are short the June T-bonds with a stop at 101.11, good anytime.

Friday, May 2: We advise to cover immediately up to one half of your short crude oil position by preferably purchasing July. Also you are now short the June T-bonds with a stop of 101.11, good anytime.

Tuesday, May 6: No new recommendations.

Flash update, 2:40 p.m., Thursday, May 8: The crude oil market looks higher. On May 2, we advised covering one half of the short position by way of buying the front months. We now strongly suggest that the balance should be covered. Stand aside for a new selling opportunity.

Friday, May 9: Here is a review of our hotline update. On May 8, Thursday, we advised covering the balance of the short crude oil position at market. You should now be flat. Remain sidelined until further notice. One new recommendation: Having been stopped out of the June T-bonds, we advise reentering the short side of the market at 98.00, stop close only.

Tuesday, May 13: As at Monday, May 12, at the close, you are short the June T-bonds at approximately 97.06, as they violated the 98.00 level recommended for selling. Use a buy stop of 101.11, good anytime.

Friday, May 16: We are now short the June T-bonds. Raise *(Editor's note: This, of course, should have been "lower")* stops to 100 even, close only. No new recommendations. Next update Tuesday, May 20.

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