

FRIEDBERG'S

COMMODITY & CURRENCY COMMENTS

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The short side of the cross

Remarkable, you might say. It has been two and a half years since we wrote the piece entitled "Maggie's luck is running out" (Nov. 20, 1983). At the time, we observed that "favorable terms of trade — not sensible policies — were responsible for the enlightened interlude; in short, luck rather than brains and willpower." We surmised that the day of reckoning had come. In our concluding remarks, we said that "the UK's economic recovery is entering its final phase," and as is typical in this phase, "the UK's balance of trade turns deeply negative, primarily a function of soaring imports. In the present cycle, we expect the external sector to deteriorate even further as a result of our forecast of much lower oil prices and their impact on exports." We recommended short sales with Sterling then at 1.47, looking for a first target of £/\$1.25 and eventually (as expanded in subsequent issues) £/\$1.00.

What is remarkable is that their luck ran this long, weathering, at least for now, the surprising knock-out of slumping oil prices. True, 15 months following our bearish forecast, Sterling came within a hairbreadth of reaching a buck. Still, it managed to recover and is now once again straddling the \$1.50 level, with oil at less than \$15/barrel, two consecutive yearly trade deficits amounting to over \$8 billion, and prospects for a third yearly deficit rivalling the record outflow recorded in 1979. What is more, its economic recovery has been extended to mid-1986, a notable fact for what was once called a stop-go economy.

What happened? Maggie's spectacular privatizations kept intact her image of a true conservative, aiding capital flows (and more directly, some flotations attracted foreign capital) while reducing the government's public sector borrowing requirements. The oil bonanza of 1979-85 swelled the country's external assets: In 1984-85 *net interest, profits, and dividends* from those assets nearly equalled the deficit on trade.

The economy was being bootstrapped by an incredible expansion of liquidity and credit. From late 1983 to the third quarter of 1985 (see Chart 1) M1 rose at an annual rate of 17.5%, an acceleration from the 15.5% rate recorded for the period IIQ1982-IIIQ1985. For the fourth quarter of 1985, M1 rose 25% per annum before decelerating somewhat to an an-

nual rate of 9% in the first quarter of 1986. The much broader M3 measure expanded at an annual rate of 12% from the fourth quarter of 1983 to the third quarter of 1985, then recorded a 17.8% rate of growth in the fourth quarter of 1985 and a 10.6% rate in the first quarter of 1986. Recent figures indicate that M3 increased by 3% in May, bringing the year on year annual rate of increase to 19½%; over the past three months, M3 has risen at a staggering 39% annual rate. Target ranges for M3 in 1986 were 11%-15%.

With some lag, Britain is heading for a raging inflation. Signs of what is to come have already surfaced in soaring stock and house prices, especially in the south of England. Wages and salaries per unit of output in manufacturing industry stand between 7% and 8% higher than a year ago, a strong indication of inflation in the non-tradeable sector (so is real estate). The credit boom and its impact on wages are causing an alarming rise in unemployment, now at 13.3%, its highest level in decades.

Maggie's run of luck has been remarkable, but there is little doubt as to the outcome. The drop in oil prices will cost the UK *at least* £3 billion in foreign export earnings; non-oil trade should begin to feel the effects of Britain's lack of labor competitiveness. In all, we expect the current account to re-

In this issue

The best major currency play of 1986-87? How monetary protectionism equals inflation. We're short energy futures. We're monitoring stock indices. And we're long gold and platinum. Contributions by Albert D. Friedberg, Steve H. Hanke, and Daniel A. Gordon.

As always, with your best interests at heart we've decided to give you a vacation. *Friedberg's Commodity & Currency Comments* will not be published in July, as we all take a rest. Next issue will be published in August, and your subscription will be extended one month. The Hotline will continue throughout.

vert back to a deficit in 1986, which will widen in 1987. Wage inflation will make it impossible for the UK to lower unemployment — creating for the government an intolerable dilemma. With elections to be held on or before the Spring of 1988, and facing an increasingly popular and rejuvenated Labor party, Maggie may have to abandon whatever restraint is still being used in economic policy in the pursuit of lower unemployment. It will risk both a resurgence of double-digit inflation and a collapse of Sterling.

The correct *medium- to long-term policy* would be fiscal ease (through lower taxes) and a severe monetary clampdown so as to squeeze the latent and not-so-latent inflation out of the system. But Maggie does not have enough time for this policy to work. If put into practice, it will be perceived as a return to dogmatic monetarism and play right into the hands of Labor. Rather than stand helplessly by over the next 20 months, Maggie may resort to a dramatically opposed strategy: Plug the fiscal drain represented by falling North Sea revenues (a negative fiscal thrust) to look respectably conservative; prime further the monetary pump, lowering interest rates, and point to the extremely low level of consumer price inflation. In this damn-the-torpedoes strategy, Britain's competitiveness will continue to erode, this time without the help of oil. Massive trade deficits will weaken Sterling, which in turn will force the currently repressed inflation (because of worldwide downward pressure on tradeables) to resurface.

The Margaret Thatcher nine-year interlude will be seen just as that: a rally in a long bear market. With Labor in control and a Sterling crisis at hand, there will be little left over of the edifice the Tories built. For, in truth, government expenditures continued to take around 46% of GDP, not much less than the 47.8% share taken in 1982-83 (see Chart 2) and two

percentage points above the level inherited by the Tories in 1978-79. And the reduction in the fiscal deficit and public sector borrowing requirements was but a mirage caused by soaring North Sea oil taxes and privatization. And some of the privatizations were but a transfer from a public monopoly to a private monopoly.

US dollar weakness and *prospective* weakness impedes us from shorting Sterling outright (i.e., against the US unit). Instead, we have focused on the cross rate: Sterling/DM or Sterling/Swiss franc. We thus eliminate the "dollar" risk and obtain a pure play on Sterling. Incidentally, as Chart 3 shows, when measured against the DM, Sterling *never did* recover to the levels of late 1983 and, in fact, has been in a downtrend ever since late 1981.

How overvalued is Sterling at *this* time? It is extremely difficult to estimate unless one is willing to make a number of heroic assumptions. First, we must assume that wages (and not consumer prices) are the best gauge of domestic inflation. Secondly, we must assume that figures published by the IFS on average wages reflect, in fact, a measurable quantity. Finally, we assume that the UK must achieve the level of competitiveness prevailing in the 1976-77 period, before the oil bonanza. Adjusting wages in the UK and Germany by their nominal exchange rates should give us a very *rough* indication of Sterling's over-valuation. Chart 4 tells us that despite Sterling's nominal depreciation vis à vis the DM, its real rate of exchange (as measured by labor costs) has risen by anywhere between 28% and 35%. This grotesque result, if indeed it is, should help validate our intuitive target of a 10%-15% depreciation.

STRATEGY: Sell British pound, buy Deutschemarks or Swiss francs in equal dollar amounts. It should turn out to be the best major currency play of 1986-87.

Chart 1

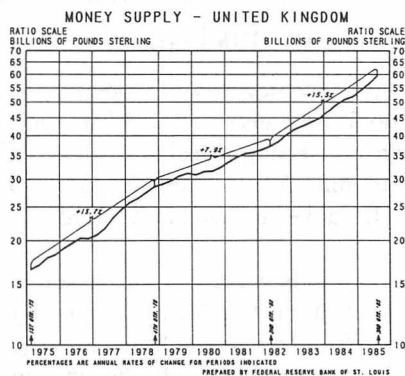


Chart 2

U.K. : General Government

	Total Gov't Expenditure Excl. Special Sales of Assets (£ billion)	GNP (£ billion)	(1) / (2) %
1976	59.476	128.15	46.41
1977	64.201	145.95	43.99
1978	74.365	168.59	44.11
1979	90.153	197.43	45.66
1980	108.647	229.85	47.27
1981	119.975	254.82	47.08
1982	132.949	278.14	47.80
1983	141.302	302.52	46.71
1984	152.302	320.71	47.49
1985	160.5	350.42	45.80

Sources : CSO Financial Statistics, IFS

Chart 3

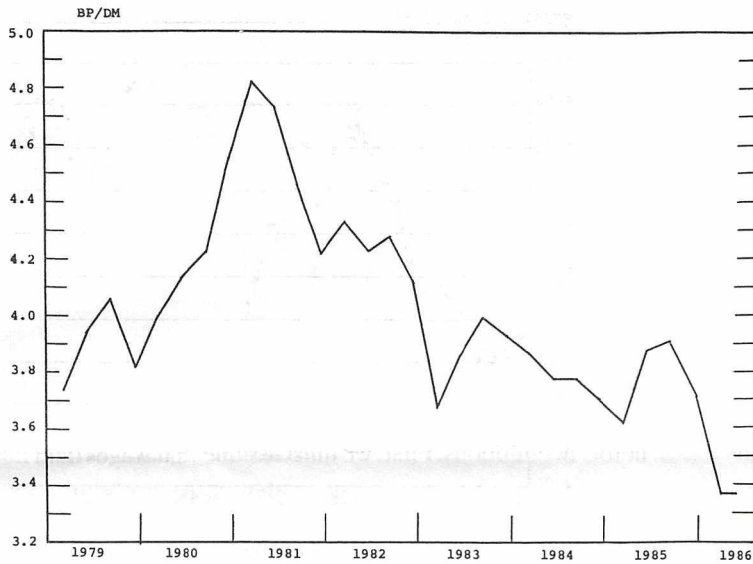


Chart 4

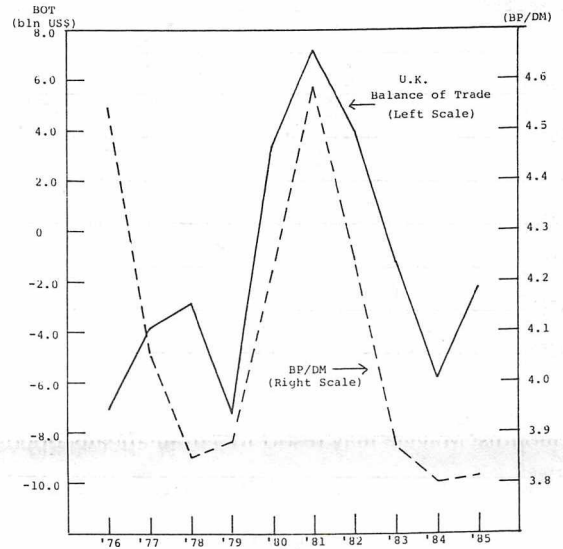


Chart 5

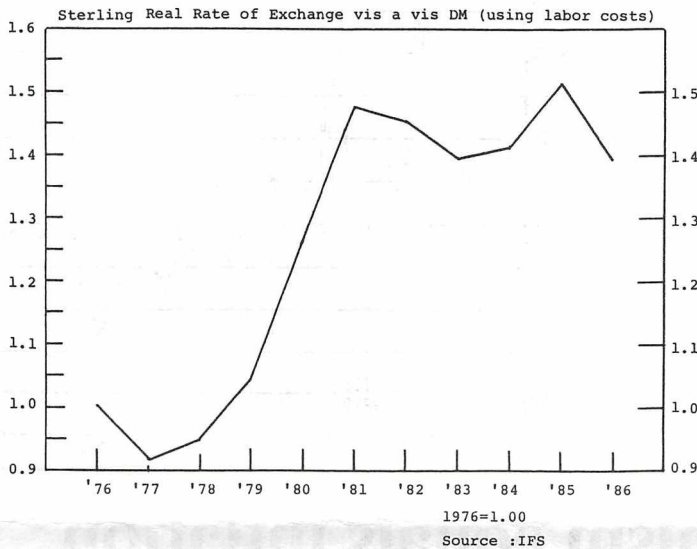
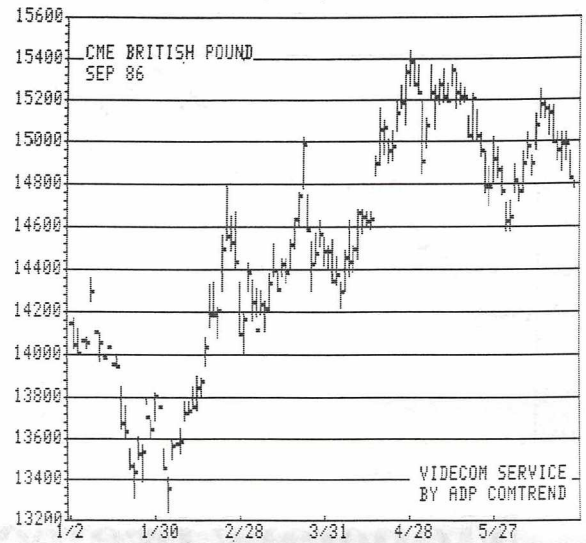


Chart 6



Currencies

Extremely slow progress, if any, is expected in US trade figures, primarily due to two factors:

A) US trade balance responds a great deal more to changes in income and spending of the US economy than to exchange rate levels. The US will have to move into a relatively protracted and deep recession before the trade figures improve enough to calm an increasingly protectionist Congress and the jittery crowd of forex traders who are beginning to extrapolate ad infinitum a buildup of US foreign indebtedness. This recession may not take hold, at least in sufficient magnitude, until late 1986, and therefore trade figures will not show any major improvement at least until early 1987. Thus it is

likely that the US dollar will continue to depreciate until a visible trade turn appears.

B) A trade-weighted exchange level of the US dollar that takes into account newly industrialized countries such as Brazil, Korea, Taiwan, and Hong Kong shows a relatively paltry depreciation. Since these countries are not likely to allow their currencies to revalue in real terms, upward pressure on the major continental currencies and yen is likely to persist so as to push the adjustment on to their shoulders.

STRATEGY: Remain long Swiss franc, DM, and yen.

Chart 7

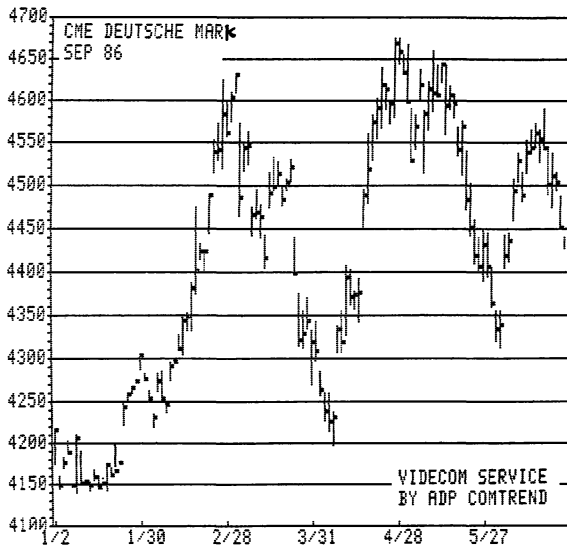


Chart 8

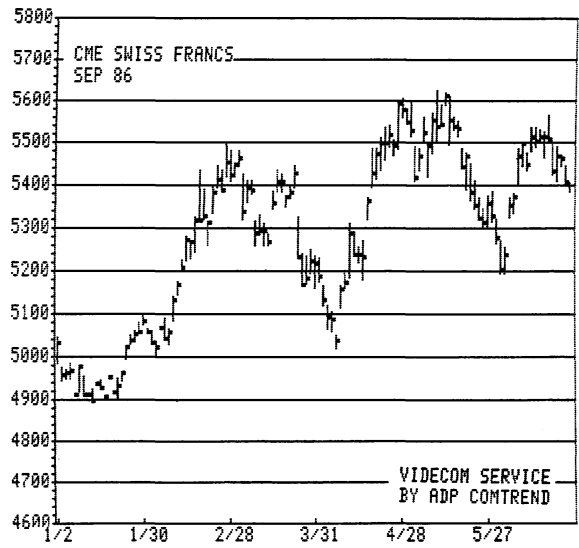


Chart 9

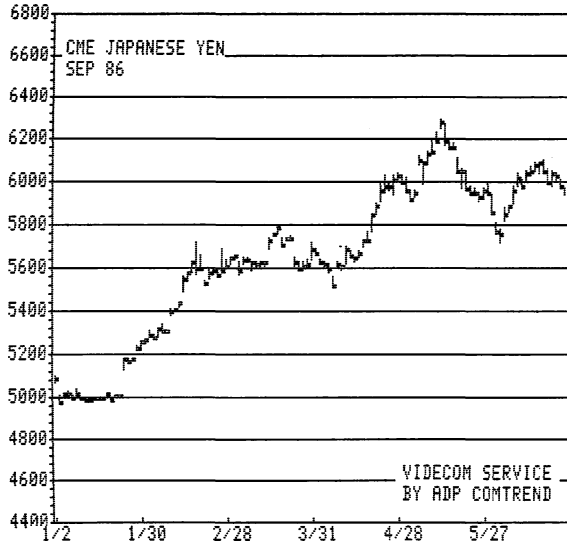
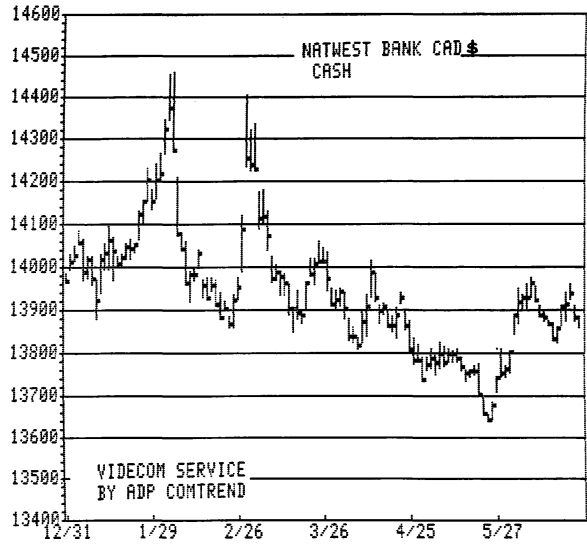


Chart 10



Monetary protectionism equals inflation

Protectionist policies come in two forms: the standard garden variety and the monetary variety. The standard variety — which includes the imposition of tariffs, quotas, and so-called non-tariff barriers — is applied directly to protect home markets. We addressed the economic and policy issues that surround standard protectionist policies in the October 20, 1985, issue of *Friedberg's Commodity & Currency Comments*. We will update our earlier analysis below. In addition, we will introduce and analyze monetary protectionism. This variety involves a set of policies designed to push the exchange value of a home market's currency down, so that imports become more expensive for home country residents to purchase.

Since early in his first term, President Reagan has been, in principle, committed to trade liberalization and opposed to the use of standard protectionist measures. For pragmatic

political reasons, however, the Reagan Administration has done some backsliding with regard to standard protectionist policies. Most recently, for example, the President raised the Canadian ire by imposing a 35% tariff on cedar shakes and shingles imported from Canada. This action was calculated to silence Congressional calls for large-scale, standard protectionism.

That Congress plans to do more than saber rattle about protectionism was made clear last month, when the House of Representatives passed a severe protectionist trade bill. This bill, which was quickly labeled "kamikaze legislation" by President Reagan, would, if ever put into law, be the most wide-ranging piece of standard protectionist legislation since the Smoot-Hawley Act of 1930.

It appears that President Reagan's move against Canadian shakes and shingles will not be enough to appease the

protectionists on Capitol Hill. In consequence, the Congress will probably pass some form of standard protectionist legislation. Even though it will be less drastic than the House trade bill, this legislation, if put into law, would reduce the number of dollars earned by foreigners from exports to the US. In consequence, the supply of dollars on foreign exchange markets would be smaller than without the protectionist legislation, and the exchange value of the dollar would be higher than it would have been without the legislation.

We don't, however, believe that this course will be followed. While the Reagan Administration, in an attempt to hold back the Congressional protectionist tide, has been willing to engage in some pragmatic concessions on standard protectionist legislation, President Reagan has pledged that he will veto any broad-ranging piece of protectionist legislation. Hence, once a large protectionist trade bill is delivered to the White House, it will be vetoed, and the President's veto will be sustained by the Congress.

That the Reagan Administration is strongly opposed to broad scale, standard protectionism and that it ultimately has the votes to beat back such legislation is clear to most observers. What has not been clear is the fact that in an attempt to combat the standard protectionists, the Reagan Administration has been engaging in its own brand of protectionism: monetary protectionism.

Shortly after President Reagan was reelected, Donald T. Regan and James A. Baker III swapped jobs. With Mr. Baker's move to the Treasury, the administration's international economic policies were dramatically altered. Included in the new policy package was monetary protectionism, and its most vociferous advocate has been Mr. Baker.

The rationale behind monetary protectionism is deceptively simple: introduce policies to drive the exchange value of the dollar down; this will make US imports more expensive; the flow of imports will, therefore, be slowed; with less import competition, domestic industries won't push Congress for standard protectionist relief; Congress will back away from introducing tariffs and quotas; and the Reagan Administration will avoid the political costs associated with doing battle with Congress on trade issues.

To implement monetary protectionism, Mr. Baker has successfully used every policy lever available. He has talked the dollar down from his powerful platform as Secretary of the Treasury. He has orchestrated massive central bank interventions against the dollar. And he has successfully leaned on the Federal Reserve to insure that it promoted easy credit. Not surprisingly, the dollar has taken a nose dive.

For those with analytical skills and some historical perspective, Mr. Baker's dollar bashing policies have brought to mind a former Secretary of the Treasury, W. Michael Blumenthal, and the period 1977-78 (see: *FC & CC* April 20, 1986). For one, Paul A. Volcker, Chairman of the Federal Reserve, remembers. Mr. Volcker's remembrance of times past was signaled when, some weeks ago, he simply said that he was concerned about the dollar's fall. Since then, he has repeated this refrain whenever he has had an opportunity. Then, in re-

marks earlier this month, he came clean with just what was bothering him about the dollar's fall. He shocked the financial markets when he said that he was worried about inflation. Yes, Mr. Volcker remembers that inflation was running about 4.5% in late 1977, and that with the dollar's free fall in 1978 and 1979, inflation reached 9.0% in December 1978 and 14.3% one year later.

As we pointed out in the March 23, 1986, issue of *Friedberg's Commodity & Currency Comments* we, too, are worried about inflation. But, many ask, "how can you be worried about inflation, when the major price indices are falling?" The answer is straightforward: The price indices have, in large part, fallen because the price of crude oil, which has a direct and immediate impact on price indices, has fallen. The drop in the exchange value of the dollar, which works indirectly and takes about two years to be fully felt, has only started to increase import prices. What Mr. Volcker knows too well is the fact that a fall in the dollar will directly increase the price of imports; this will reduce the level of foreign competition in the US, which will allow domestic producers to increase their prices; and this will force domestic producers to give in on wage demands, which will increase unit labor costs. In consequence, monetary protectionism and a falling exchange value for the dollar will, among other things, result in more inflation than would be the case without this variety of protectionism.

That this inflationary process has already started can be easily observed by visiting any auto dealer that sells imported cars. For example, the prices for Hondas have been increased four times since September 1985, with a total price increase averaging 14%. Even more revealing are the data on import prices shown in Chart 11. The price changes for the period December 1985-March 1986, calculated on an annualized basis, are truly shocking. Perhaps a review of these data, as well as the selected disaggregated data for several key categories of the consumer price index, was enough to remind Mr. Volcker of the late 1970s experience.

What's clear from viewing Charts 11 and 12 is the fact that recent oil price declines have masked over some disturbing and dramatic signs of strong inflationary forces that have been put in motion by the Reagan Administration's policy of monetary protectionism.

STRATEGY: *The coming wave of inflation will put more downward pressure on the dollar. We remain ferocious bears on the US dollar (see: FC & CC April 20, 1986).*

Don't be tempted by the long side of either the bond or stock markets. As these markets digest Mr. Volcker's warning about inflation and market participants, look more carefully at data on import prices, we are confident that the bears will, in a dramatic move, overwhelm the bulls.

As the inflationary forces, which have been put in place by the falling dollar, are fully felt — precious metals' prices will soar and the patient investors who have built long positions in gold and platinum will be duly rewarded.

— Steve H. Hanke

Chart 11

IMPORT PRICE TRENDS

Commodity Class	Annualized % Change (December 1985-March 1986)
All commodities, except fuels	+14.3%
Crude materials, except fuels	+16.1
Rubber products	+47.5
Lumber	+22.0
Metal ores and scrap	+30.1
Glassware products	+22.0
Manufactured wood products	+48.0
Machinery and transportation equipment	+17.0
Cars and trucks	+23.9
Electrical machinery and motors	+24.4
Textile machinery	+23.4
Metal working machinery	+30.6
Office machinery and data processing	+24.3
Photographic Equipment	+27.2
Optical products	+34.5
Fuels	-76.1

Data Source: U.S. Department of Labor, Bureau of Labor Statistics.

Chart 12

CONSUMER PRICE INDEX

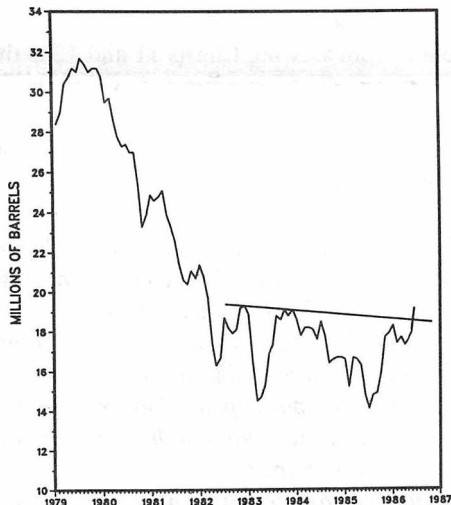
Selected Categories	Annualized % Change (April 1986)
Autos	+5.0%
Shelter and home furnishings	+8.0
Services	+6.5
Medical	+8.7

Data Source: U.S. Department of Labor, Bureau of Labor Statistics.

Energy Futures

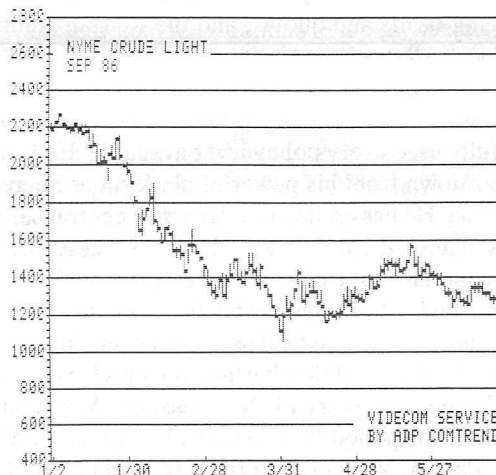
Chart 13

OPEC CRUDE PRODUCTION



Source: Petroleum Intelligence Weekly

Chart 14



Where volume has become more important than price

One picture is worth more than one thousand words. Chart 13 tells it all. From 1979 to mid-1985, the members of Opec, in an attempt to control prices, allowed their production to slide. It was clear that price and output could not be controlled simultaneously, and a conscious choice was made in favor of prices.

The rest is history. The gambit did not pay off as the most powerful member of that cartel, Saudi Arabia, realized it may have to shut down production entirely to achieve continued price firmness. No output at a high price was no consolidation. The strategic retreat called for controlling output (i.e., increasing it) and allowing prices to slide.

Chart 14 can be interpreted, in our opinion, in the same manner as a price chart, as it is, in fact, the reciprocal of a price chart. We submit, therefore, that the June 1986 breakout, to an estimated 19 million barrels per day (b/d) is significant. It supports our view that the price decline will cause a production reappraisal among Opec members, who will become increasingly more concerned with *maximizing revenues*, not prices. Despite all the talk about complying with, or setting, output ceilings of 16.3 million b/d and 17.3 million b/d respectively for the third and fourth quarters, Opec, as a group, has begun, in earnest, a process of revenue maximization. This strategy implies rising production, an obvious "chart" observation.

The imposition of a variety of sales taxes on oil products is slowing down or negating the benefits of price elasticities, to the detriment of producers. The *Wall Street Journal* reports that Italy, the UK, Denmark, Switzerland, Ireland, Australia, Spain, Greece, Portugal, Egypt, and some Asian nations have done so in recent months. Moreover, in some cases, gasoline prices stand above when they stood before oil prices began to fall in January. These taxes, for the most part, serve a fiscal objective, but it cannot be denied that they will obstruct consumption patterns in years to come in much the same way as subsidies in the mid to late '70s slowed the negative consequences on consumption of the rise in oil prices, thus prolonging the "crisis." Producers, thus, can take little comfort from the drop in prices, as it is unlikely to raise consumption levels by anywhere near what is necessary to absorb new supplies.

In view of the "chart" breakout, the Opec meeting of June 25 is irrelevant. Production will rise, and prices will fall. To judge by the chart, production has a long way to rise.

STRATEGY: *Remain short, (see Hotline update); maintain stops at 15.05, basis September '86, close only.*

Canada wastes billions in oil grants

The federal Government has wasted billions of dollars in exploration subsidies to the oil industry since 1980, says a leading Calgary oil analyst.

In his latest monthly newsletter, Ian Doig said two-thirds of the oil discovered in Canada's frontiers in the past 20 years was found before the Government began handing out frontier oil grants in 1980.

And it cost the oil companies \$4.6-billion for that exploration between 1965 and 1980.

But since 1980, \$8.6-billion has been spent on one-third of the frontier oil discoveries, with 70 per cent of that provided by federal Petroleum Incentive Program grants under the National Energy Program. The NEP, which the Conservative Government ended last year, gave funds to Canadian-controlled companies exploring for oil on federal lands and offshore in the Arctic and East Coast. The grants were handed out regardless of whether oil was found.

Mr. Doig said the cost of finding oil in the frontier rose from an average of 75 cents a barrel between 1965 and 1980 to \$2.95 in the past five years.

He said the grants were a waste of money that subsidized high-cost oil found in relatively low volumes.

"A lot of money was rig-driven instead of being geologically driven," he said. "Your mother always told you that you spend your own money more prudently than other peoples' money."

The high costs mean that some of the oil discovered simply isn't competitive with other world sources, he said.

For example, oil discovered in the Hibernia area off Newfoundland could be produced for between \$8.50 and \$9 (U.S.) a barrel. But according to a major U.S. study, 80 per cent of the world's oil can be produced for less than \$8.

This means that Hibernia won't begin production unless the Canadian and Newfoundland governments provide huge tax breaks or other assistance.

"That's the struggle that's going on now between the Mobil group and the government," he said, referring to negotiations between Mobil Oil Canada Ltd. and the two levels of government over the Hibernia fiscal regime.

He said the federal Government is reluctant to give Hibernia any special deals because companies in other frontier areas, such as the Beaufort Sea in the Arctic, would expect similar help.

"It would only take days before the Beaufort boys would be on the plane asking for the same thing."

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Stock Indices

The stock market continues to maintain its lofty levels. Breadth, however, has narrowed significantly. The same can be said about the paucity of new highs, the expansion of new lows, the Dow Jones Transport non-confirmation. New-issue craze is reminiscent of the mid-1983 market top. Still, the large capitalization stocks continue to outperform the rest of the market; for the first time in the bull market, the Value Line index has moved below the S&P 500 index (see the May 18, 1986, issue of *Friedberg's Commodity & Currency Comments* for a more detailed discussion of the spread).

Over the past few weeks, two of the most spectacular bull markets came to an abrupt end. While Paris fell 20%,

Milan literally collapsed, falling 36% in a few trading sessions. Bulls remain as enthusiastic as ever, but we are inclined to believe that these two markets have topped out and are leading the way for a global bear market.

STRATEGY: *In keeping with last month's comments, we continue to monitor the long Value Line/short S&P 500 spread, looking for a solid breakout before we commit funds to the trade. We'll keep you posted.*

Our June '86 S&P 500 puts expired worthless, a cruel testimony to the difficulties of anticipating the end of this insane bull market.

Chart 15

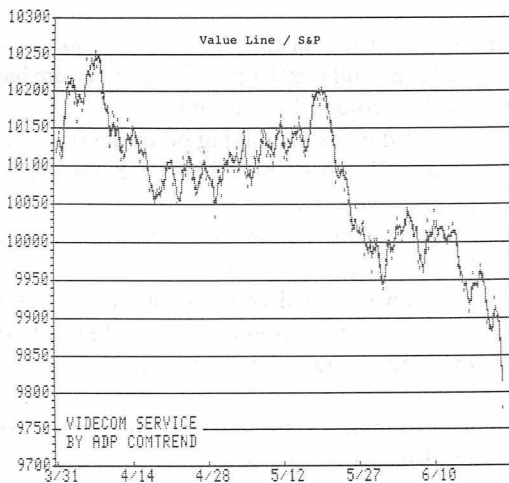
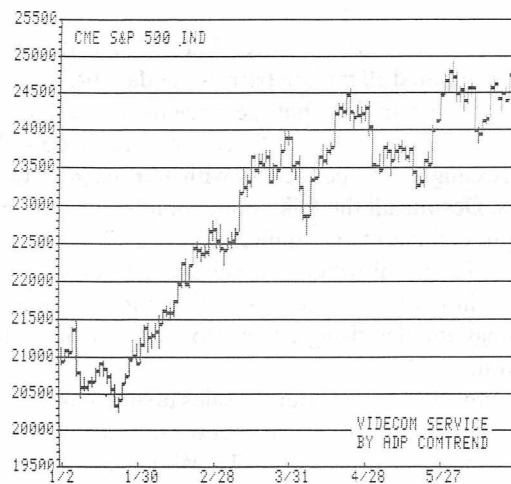


Chart 16

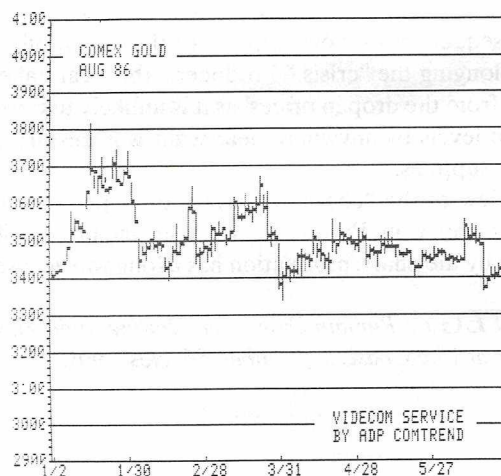


Precious Metals

Gold

Long-term traders gained an opportunity to add to positions on the recent setback to \$337/oz. spot (as per our advice last month of buying on sharp \$15-\$20/oz. dips). Short-term traders should add on crossing 371, basis the nearby Comex contract.

Chart 17

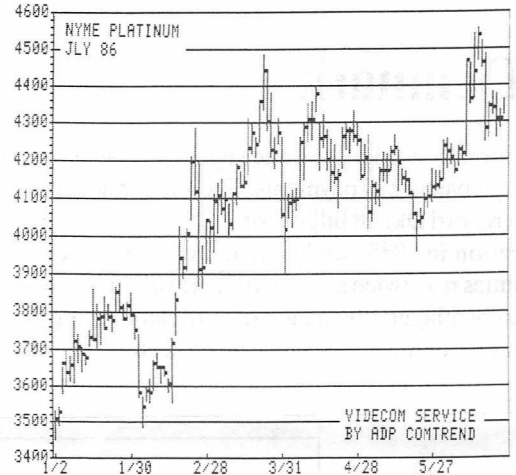


Platinum

Continues to "act" well, last week reaching new recovery highs. News emanating from South Africa continues to be the foremost influence on prices, with the market appearing to be discounting a supply interruption in the near future. The thinness of the metal and the fact that speculators blow hot and cold so very suddenly add volatility and risk.

STRATEGY: *Maintain long positions, protecting them with generous stops. Roll July '86 platinum over to October '86 platinum and place stops at 415, close only.*

Chart 18

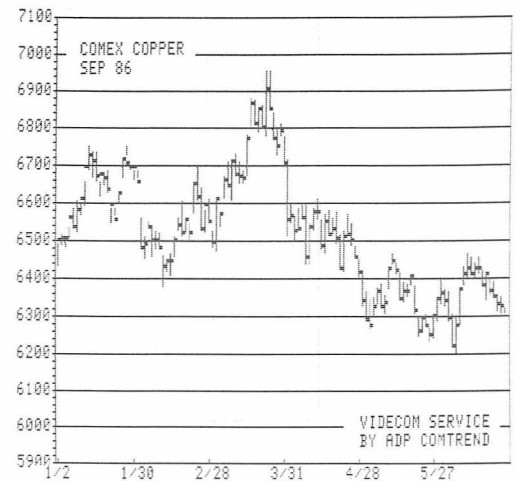


Copper

Nearby contracts appear relatively tight, as evidenced by narrowing spreads: July/Sept '86 and July/Dec. '86 are trading well below carrying costs.

STRATEGY: *The market appears to be devoid of speculative interest; consequently, there is a low risk in holding long positions. Remain long; add on closes above 6950, basis Sept. 86.*

Chart 19

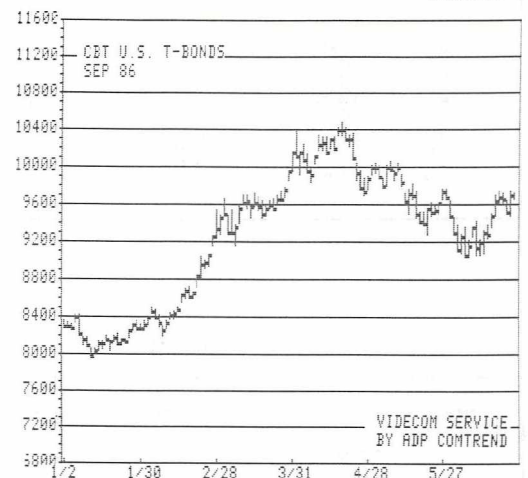


Interest Rate Futures

On June 3 we advised covering short T-bond positions (see Hotline update). We were concerned about the growing signs of economic weakness being displayed by the US economy and the pressure on the Fed to lower rates at the same time. Yields on the nearby June contracts were running in excess of 100 basis points higher than comparable cash instruments, a technical aberration that was bound to be corrected in short order.

STRATEGY: *Having exacted a handsome profit, we prefer to remain on the sidelines pending a new bout of dollar weakness or an overt easing move on the part of the Fed. Stay posted.*

Chart 20



The Exotics

Denmark

Boom conditions are once again playing havoc with the country's balance of payments. The current account deficit reached a record Dkr 28 billion, or 4.6% of GDP, in 1985. The deterioration in 1985 can be attributed to the fact that import volumes rose twice as fast as export volumes. Denmark continues to be plagued by a lack of sufficient savings to cover investments of the public and private sectors. Another way to put it is to say that the government has not reduced its fiscal deficit

speedily enough to accommodate the fast-growing private sector.

STRATEGY: In spite of substantial progress on the inflation front and government finances, we are nervous about the growing external indebtedness, which already equals more than 40% of GDP. Consequently we advise liquidating the long position vis à vis the US dollar. The forward discounts are reasonable enough to allow us to sell the Danish krone against the purchase of a 1-year forward DM.

Chart 21

YEAR	DANISH KRONER PER U.S. DOLLAR (PERIOD AVG.)	BASKET			
		U.S. 1972 =1.00	U.S. 1979 =1.00	1972 =1.00	1979=1.00
1967	6.9871	1.0777	1.6566	1.0265	1.2578
1968	7.4845	1.1114	1.7084	0.9890	1.2118
1969	7.5192	1.1389	1.7507	1.0079	1.2350
1970	7.4995	1.1285	1.7347	1.0101	1.2378
1971	7.4067	1.0973	1.6868	1.0298	1.2618
1972	6.9493	1.0000	1.5371	1.0000	1.2254
1973	6.0495	0.8433	1.2963	0.8975	1.0998
1974	6.0949	0.8189	1.2587	0.8679	1.0635
1975	5.7462	0.7697	1.1831	0.8590	1.0526
1976	6.0450	0.7859	1.2080	0.8273	1.0137
1977	6.0032	0.7479	1.1496	0.8186	1.0030
1978	5.5146	0.6719	1.0328	0.7922	0.9707
1979	5.2610	0.6506	1.0000	0.8161	1.0000
1980	5.6359	0.7040	1.0822	0.9257	1.1344
1981	7.1234	0.8795	1.3519	0.9980	1.2229
1982	8.3324	0.9910	1.5232	1.0326	1.2653
1983	9.1450	1.0503	1.6145	1.0047	1.2311
1984	10.3570	1.1670	1.7939	1.0195	1.2492
1985	10.5960	1.1799	1.8137	1.0177	1.2459
1986 (1Q)	8.6370	0.9693	1.4899	0.9378	1.1492

U.S. 12% FRANCE 7%
SWEDEN 8% NETHERLANDS 7%
Germany 29% U.K. 17%

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 22

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	446	-3.44	-1170
1971	618	-2.40	-1379
1972	1,180	-0.03	-1032
1973	1,229	-1.67	-964
1974	1,258	-3.10	-1519
1975	994	-1.31	-1946
1976	1,135	-4.64	-3384
1977	2,274	-3.74	-4126
1978	3,428	-2.70	-5138
1979	3,631	-4.58	-6189
1980	3,857	-3.81	-6933
1981	3,159	-3.38	-7306
1982	2,842	-4.21	-6600
1983	3,578	-2.17	-5310
1984	2,509	-3.15	-5072
1985	6,510	-4.53	-5293

Chart 24

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	8.3275-	8.3320-	8.3500-	8.3800-	8.4375-
	8.3375	8.3470	8.3650	8.4025	8.4700

Chart 23

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

Reserves * + Previous 12-months current Account *** = 2747
 (Reserves + 12-months C/A)/ M1 ** = 2747/16995 = 16.1%

(Reserves + 12-months C/A)/ Broad Money *** = 2747/40880 = 6.7%

*As at April 1986 ** Dec. 1985 ***1985 (1) -1985(4)

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1975	8,299	16,995
1985 Dec.)	21,826	40,880
% Increase (decrease)	165.%	140%
Corresponding % increase in the United States	115%	143%

(a) 1985 Imports as percentage of GNP = 30.30
 (b) 1976-1985 Imports as percentage of GNP = 29.14
 1985/(1976-1985 average) = (a)/(b) = 103.98%

Source: IFS

Portugal

Favored by the sharp fall in oil prices, Portugal has been able to extend its improvement in the current account and is now expected to record a surplus of \$800 million in 1986 compared with a surplus of \$420 million in 1985. This improvement comes unexpectedly to a government that has opted to stimulate economic activity via lower interest rates and tax cuts. Economic growth for 1985 was approximately 3%. GNP is expected to grow by 3.5% during 1986.

The new centre-right coalition has moved very slowly in implementing a much promised liberalization. The government continues to be saddled with an inefficient state apparatus and loss-making state enterprises. As an example, in 1985 public sector companies ran up operating losses of approxi-

mately 54 billion escudos (\$338 million), and for the five-year period 1979-84 public sector companies produced net losses of esc. 233 billion. As a result, total consolidated state indebtedness exceeded 1985 GDP; furthermore, the weight of the public debt is entirely responsible for the fiscal deficit, which should equal an alarming 11% of GDP in 1986.

STRATEGY: At this time, the key variables that would affect the currency are relatively favorable. The escudo has appreciated slightly against the US dollar, while it has depreciated against the DM by approximately 9% since the end of 1985. Deep forward discounts, however, have made it difficult to capitalize on these moves. Wide bid/ask spreads deter us from undertaking a position. Remain neutral against DM and US\$.

Chart 25

YEAR	PORTUGUESE ESCUDOS PER U.S. DOLLAR (PERIOD AVG.)		U.S. DOLLAR PER U.S. DOLLAR		BASKET	
	1972 = 1.00	1979 = 1.00	1972 = 1.00	1979 = 1.00	1972 = 1.00	1979 = 1.00
1967	28.8420	1.2986	1.6129	1.2596	1.2834	
1968	28.7280	1.2684	1.5755	1.1559	1.1777	
1969	28.5620	1.2184	1.5135	1.1064	1.1273	
1970	28.6260	1.2194	1.5146	1.1128	1.1339	
1971	28.1920	1.1191	1.3901	1.0628	1.0829	
1972	27.0530	1.0000	1.2421	1.0000	1.0189	
1973	24.5150	0.8529	1.0594	0.8926	0.9095	
1974	25.4080	0.7846	0.9745	0.8178	0.8333	
1975	25.5530	0.7142	0.8871	0.7814	0.7961	
1976	30.2290	0.7514	0.9333	0.7761	0.7907	
1977	38.2770	0.7982	0.9914	0.8523	0.8684	
1978	43.9370	0.8038	0.9984	0.9208	0.9382	
1979	48.9230	0.8051	1.0000	0.9815	1.0000	
1980	50.0620	0.8014	0.9954	1.0276	1.0470	
1981	61.5460	0.9064	1.1258	1.0317	1.0511	
1982	79.4730	1.0114	1.2562	1.0651	1.0832	
1983	110.7800	1.1633	1.4450	1.1357	1.1571	
1984	146.3900	1.2437	1.5448	1.1219	1.1430	
1985	170.3900	1.2525	1.5557	1.1183	1.1395	
1986 (1Q)	152.8900	1.0499	1.3041	1.0296	1.0490	

Above 1.00 = undervalued
Below 1.00 = overvalued

Chart 26

Year	Foreign Assets (Min US\$)	CURRENT ACCOUNT As % of GNP	CUMULATIVE 12 QTR. Current Account (Min US\$)
1970	1,730	-	-
1971	2,119	-	-
1972	2,540	4.13	-
1973	2,937	2.96	-
1974	2,520	-5.13	-135
1975	1,412	-8.36	-1,244
1976	285	-5.93	-2,867
1977	-1,426	-2.65	-2,994
1978	-1,177	-0.27	-2,702
1979	-854	-4.43	-1,474
1980	3,065	-11.35	-3,723
1981	1,772	-14.73	-6,919
1982	1,657	- 5.13	- 6,859
1983	1,411	+ 2.07	-4,768
1984	1,335		-1,098
1985	1,256		

Chart 28

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	151.60-	152.60-	154.35-	157.10-	161.60-
	151.90	153.90	157.90	162.90	171.90

Chart 27

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

Reserves * + Previous 12-months current Account *** = 8935
(Reserves + 12-months C/A)/ M1 ** = 8935/5365 = 166%

(Reserves + 12-months C/A)/ Broad Money *** = 8935 /17090 = 52%

*As at March 1986 ** July 1986 ***1986 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1975	8273	14032
1985 July	5365	17090
%Increase (35.1%) (decrease)		21.84

Corresponding % increase in the 101.1% United States 135.6%

(a) 1984 Imports as percentage of GNP 37.32%
(b) 1975-1984 Imports as percentage of GNP 33.69%
1984/(1975-1984 average) = (a)/(b) = 110.77%

Source: IFS

Forex Rates & Update

<u>Currency</u>	<u>Spot</u>	<u>3-Month</u>	<u>12-Month</u>	<u>Comments vis à vis US\$</u>	<u>Comments vis à vis DM (Spot DM 2.2500)</u>
Australian dollar	.6916-.6923	.6787-.6798	.6491-.6508	Remain long	Remain long
Belgian franc	45.80-45.86	45.81-45.90	45.82-45.98	Remain long	Remain long
Dutch guilder	2.5255-2.5270	2.5189-2.5209	2.4915-2.4950	Remain long	Remain long
*Greek drachma	141.35-141.45	146.70-148.55	163.35-171.45	Cover	Remain short
Italian lira	1539-1541	1541-1543	1545-1549	Remain long	Neutral
Kuwaiti dinar	.29520-.29550	.29540-.29620	.29560-.29760	Neutral	Remain short
Malaysian ringgit	2.6265-2.6275	2.6590-2.6675	2.7165-2.8175	Remain short	Remain short
New Zealand dollar	.5290-.5305	.5180-.5210	.4885-.5000	Remain long	Remain long
Norwegian krone	7.6300-7.6350	7.7410-7.7500	8.1200-8.1375	Remain long	Neutral
Saudi Arabian riyal	3.7500-3.7510	3.7635-3.7685	3.7880-3.7990	Remain short	Remain short
Singapore dollar	2.2670-2.2680	2.2185-2.2215	2.1995-2.2105	Remain short	Remain short
Spanish peseta	143.80-144.00	146.80-148.00	149.80-154.00	Neutral	Neutral
Swedish krona	7.2350-7.2450	7.2930-7.3080	7.3875-7.4100	Remain long	Neutral
Venezuelan bolivar	16.00-16.10	16.00-17.00	16.50-18.50	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

Tuesday, May 19: There are no changes or new recommendations.

Thursday, May 22, Flash Update 10:45 a.m.: Crude oil prices have collapsed in recent days after reaching over \$17 early in the week. The unexplained weakness probably reflects increased Opec production, possibly nearing 18 million barrels a day and a softening trend in gasoline consumption in the US. Refining spreads have begun to narrow and are continuing the renewed bearish outlook. We advise reinstating full short positions at the market, using preferably September and forward New York crude oil contracts. Place initial shorts at 16.10, basis September, close only.

Friday, May 23: A review and recap of the week's activities.

1. You are now once again short the New York crude oil by way of September and forward months as of our flash update of Thursday, May 22, 10:45 a.m. Maintain stops of 16.10, basis September, close only.

2. The market letter, which went out this week, recommended rolling over June T-bond short positions to September. Lower stops even further to 98.10, close only, basis September.

Tuesday, May 27: There are no changes or new recommendations.

Friday, May 30: 1. Lower stops in short September T-bonds to 98 even, good anytime.

2. You are now once again long the Swiss franc and the DM as per our

trading recommendation in our last newsletter. If you were nimble and received the market letter in time, you will have made a reasonable profit of 100-150 points. You are still awaiting reentry into the June Japanese yen at 5625. Early next week, new stops will be announced. Lower stops now to 1550, basis September, close only.

3. We would like to remind you that as of May 22 flash update and repeated on Friday, May 23 recap you are once again short a full position in crude oil.

Tuesday, June 3, Flash Update, 2:50 p.m.: Cover T-bonds short positions at market. If no other new recommendations, this will replace the regular Tuesday update.

Friday, June 6: As of Tuesday, June 3, flash update you have covered your short T-bond position. Also lower stops in crude oil to 15.05, basis September, close only. No other new recommendations.

Tuesday, June 10: No new recommendations. Next regular update, Thursday, June 12.

Thursday, June 12: There are no changes or new recommendations. This recording replaces the regular Friday update.

Tuesday, June 17: No changes or new recommendations.

Friday, June 20: No changes or new recommendations.

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