FRIEDBERG'S
COMMODITY & CURRENCY COMMENTS
Friedberg Commodity Management Inc. Volume 7, No. 7 August 17, 1986

Worried, but not worried

Yes, we are worried — worried about the US economy. But, we are also not worried — not worried about a lack of trading opportunities.

For some time, we have expressed our concern about the economy. We began the year with a forecast that projected a rather robust first-half for 1986 and a very weak second-half. (See FC&CC Jan. 19, 1986, and April 20, 1986.) What we saw in January (and see more clearly now) was the start of a recession by year's end. What's new is our analysis of the current situation and the derived trading strategies.

Consumer spending. During the first half of 1986, consumer spending was the economy's only bright spot. It provided the major source for what little growth was realized in the first six months. Most believe that consumption expenditures will continue to rescue the economy from recession. We aren't that sanguine about this optimistic outlook.

One factor that has been propelling consumer spending has been the surging stock market. As investors' portfolios increase in value, investors' wealth increases (at least on paper). This encourages investors to consume more. They not only feel more optimistic and are more willing to spend but, more importantly, they also can finance increased spending by selling some of their shares or borrowing against the increased value of their stocks.

The positive wealth effect of the bull stock market is already beginning to fade. As we move closer to a recession and a bear market becomes more clearly defined, the propellant from the stock market on consumption will not only disappear, but be reversed. The falling stock market will actually act as a drag on consumer spending.

Another factor that has supported consumer spending has been the extraordinary willingness of households to incur debt. During the boom period in consumer spending, savings rates have been unusually low, and household indebtedness has risen much more rapidly than disposable income. The rise in the ratio of debt-to-income, which reached a new record in June (19.1%), has put households in a vulnerable position. In consequence, at the onset of the cyclical contraction, consumers will attempt to put their finances on a sounder footing by liquidating some of their debts.

In addition to the cyclical cause for debt liquidation, we should mention the ill-timed, if not ill-conceived, tax reform measure. The pending tax reform will no longer allow individuals to deduct interest on consumer and installment loans. In consequence, when implemented, the tax reform will increase the cost of consumer and installment debt. This will make current levels of consumer and installment indebtedness unattractive. Thus, the tax reform will act to promote the debt liquidation process put in place by the faltering economy.

This debt liquidation process will intensify the economic contraction. The funds used to liquidate debt will come, in part, from disposable incomes. In consequence, the portion of disposable incomes available for consumption will be reduced. This — coupled with the fact that disposable incomes will either be increasing more slowly than they have been or will actually be falling — does not bode well for consumer spending outlook for late this year.

In addition to acting as a drag on consumption and economic growth, the liquidation of debts has yet another aspect, which is of great significance. Consumers who liquidate debts will not only use part of their current disposable incomes to do so but they will also sell some of their assets (for example, stocks and bonds). These sales will have a depressing influence on the price of the assets. This is yet another reason why we believe the stock market is in for some rough sledding.

International trade. Many observers have correctly noted that consumption has been outpacing production in the US. The difference has been made up from imports. As they see it, US production and the economy should pick up soon because the declining value of the dollar has made imports more expensive and exports cheaper. In consequence, they argue that the leakage from US production, which is caused by do-

In this issue

Gold traps the bears and sets the stage for a dramatic rise. We remain long platinum. An update on the short Sterling/long SF and/or DM. Oil: The $2 billion sure thing — and we stay short. Contributions by Albert D. Friedberg, Steve H. Hanke, and Daniel A. Gordon.

Notice to Subscribers

As indicated in the June 1986 issue, we did not publish in July. Instead, all subscriptions will be extended one month.

mestic consumption being partially covered by imports, will soon be plugged. In addition, US production to supply export markets should also pick up. Both of these, it is argued, will close the trade deficit, boost US production and the economy. We don't share this optimism.

For one thing, the dollar has not declined, vis-à-vis our trading partners' currencies, as much as is commonly perceived. Let's look at the Federal Reserve Board's "Trade-Weighted US Dollar Index." According to this index, the dollar has fallen about 33% from its peak in February of 1985. However, the index includes only 10 of our top 20 trading partners, and the dollar has fallen only modestly against the 10 trading partners' currencies that are excluded from the Fed's index. In fact, the dollar has actually soared against Mexico's currency (our third most important trading partner) and Brazil's currency (our twelfth most important trading partner), and both are excluded from this index.

Another distortion in the Fed's index (as well as the other popular indexes) is introduced by the weights attached to the currencies that are included in the index. Currencies are weighted in terms of their financial, rather than their trade, importance. In consequence, from a trade point of view, the index overweights the strong European currencies. The five European Monetary System currencies that are included in the index account for 53% of its value, but only for 19% of US trade. This, of course, means that some of our most important trading partners' currencies are, from a trade point of view, underweighted in the index. For example, Canada is our most important trading partner, with a trade-weight of 20.4%. But the Canadian dollar — which has remained, over the past year, largely unchanged relative to the US dollar — is only given a 9.1% weight in the Fed's dollar index.

By excluding some of our most important trading partners — for example, Mexico, Taiwan, Korea, and Hong Kong — and by weighting currencies in terms of their financial importance, the Fed's dollar index greatly exaggerates, from a trade point of view, the fall in the value of the US dollar. In consequence, we can't expect the trade deficit to close as rapidly as might be implied by the dramatic decline in the dollar's value on the Fed's index.

If this weren't enough, recent theoretical and empirical work throws into doubt the entire notion that a depreciating currency is a "surefire" method to improve a country's trade balance. As a country's currency depreciates, the prices of its imports increase and consequently so does its price level (see FC&CC June 22, 1986). The increase in the price level means that the value of individuals' real money balances falls. In an attempt to bring the value of their real money balances back up, individuals will reduce their expenditures, so that they can increase their money holdings. If the central bank doesn't accommodate this increase in the desire to hold more money by increasing the supply of money, total expenditures by the residents of the country whose currency has depreciated will fall. This reduction in total expenditures will, among other things, result in a reduction in the demand for imports. In consequence, the trade balance will improve.

However, this course is usually not followed. Devaluations are typically followed by expansions in the money supply. These money supply expansions are engineered by central banks to accommodate the devaluation-generated increased desire to hold more money. (Not surprisingly, this is precisely the course that is currently being followed by the Fed.) In consequence, individuals can increase their money holdings without reducing their expenditures, and the demand for imports and the balance of trade are left unaffected in the country whose currency has depreciated.

We conclude that the US balance of trade won't improve as a result of the falling dollar. For those who are watching the trade balance data, improvement can be expected only when the US economy is well into the coming recession and the demand for imports is dampened by a weak economy.

Corporate America. Corporate profits for the second-quarter reflect the fact that the overall economy is sluggish and that some sectors — such as agriculture, oil, mining, and manufacturing — are in recession already. A compilation of second-quarter earnings by *The New York Times* shows that out of 296 major firms 181 reported gains, 74 had declines, 37 realized losses, and four were unchanged. As the economy weakens, corporate earnings will decline further.

In addition to the lower level of profits, their quality will deteriorate. To understand this last point, we must look at the tax laws. In 1981, the Economic Recovery Tax Act (ERTA) was passed. It established the Accelerated Cost Recovery System (ACRS). ACRS allows corporations to expense more depreciation for tax purposes than is consistent with replacement cost accounting. In consequence, the nonfinancial corporate Capital Consumption Adjustment (CCA) has swung to +$67.7 billion in 1985 from -$13.8 billion in 1981. This upturn has dramatically increased corporate cash flows, and hence the quality of corporate earnings. With aging equipment and little investment in new equipment, many companies now face sharp reductions in depreciation allowances. In consequence, it appears that the CCA has peaked, and the quality of earnings will begin to fall. If this weren't enough, the tax reform legislation will increase corporate taxes by $120-$140 billion over the next five years. This will, of course, dramatically reduce after-tax earnings, cash flows, and earnings quality from what they would have been. The timing of the proposed changes in the tax law couldn't have come at a worse time in the business cycle.

The reduced level and quality of corporate earnings promise some profound consequences. Capital spending will contract in 1986. This contraction could, by itself, be enough to pull the economy into a recession by the end of the year. In addition to foregoing new capital spending, more corporations will default on their debt. Led by the steelmaker LTV, defaults are already on the rise. For example, the junk bond default rate for the first half of 1986 was 2.7%, up from 1.68% in 1985. But, perhaps the most subtle and profound consequence of the reduced corporate cash flows will occur in the stock market. In 1984 and 1985 CCA totalled $38.5 and $67.7 billion, respectively. Many corporations have used the increase in cash flow created by CCA to buy back their own stock or some other company's. For example, in 1984 and 1985, the supply of nonfinancial corporate equities declined by a total of $158.6 billion. This puts corporate treasurers in a group by themselves. They have clearly been the most aggressive participants in the bull market. In fact, more than anything else, it has been the corporate use of CCA to purchase stocks that has propelled the big bull. Just think, when a corporation buys back its stock, it not only increases the demand for the stock, but simultaneously reduces the supply. It doesn't require an economics degree to figure out what this double whammy does to share prices. It also doesn't require advanced degrees to reckon what reduced CCA will do to corporate stock purchases and share prices.

STRATEGY: *We remain steadfast bears on the US dollar. As the economy slides into a recession, the Fed will further reduce the discount rate, continue its rapid emission of credit, and inflation, as well as inflation expectations, will rise. In addition, the trade deficit — a datum that traders are watching closely — will fail to close until we are well into the coming recession. All of these factors will continue to put heavy pressure on the dollar, particularly vis-à-vis the Swiss franc and DM.*

Falling corporate profit levels and deteriorating earnings quality will make the "correction" that we have observed in the stock market look like child's play. The bear market will become pronounced as corporate cash flows dry up and corporate treasurers shrink their stock buy-back programs. (See also more comments on Stock Indexes elsewhere in this issue.)

A weak economy, falling dollar and increased inflation expectations all bode well for platinum and gold. Remember that these metals are denominated in US dollars. So, with a decline in the US dollar, the price of platinum and gold, for Europeans and Japanese, falls. The fundamentals, along with problems in South Africa, have ignited the big break-out in these markets. Remain long platinum and gold. (See also more comments on gold and platinum elsewhere in this issue.)

The Fed's discount rate reduction of 50 basis points (to 6%) on July 10, 1986 explains why yields on Treasury securities with maturities of less than three years have fallen by about 40 basis points (see Chart 1). But the yield declines on the short end of the market have not been translated to longer-term securities. The yield on a 30-year bond has actually increased by 11 basis points since July 9, 1986 (see Chart 1). In short, the slope of the yield curve has become steeper, and we anticipate more of the same. As the economy slows, the Fed will continue to reduce the discount rate and increase credit creation. This will increase inflation expectations. It will also accelerate the dollar's fall, which will generate more inflation expectations. These events will make foreign investors shy away from long bonds (and purchase gold or platinum instead). So the demand for long bonds promises to become relatively weak. On the supply side, the federal deficit continues to balloon, causing the Treasury's funding requirements to soar. Tie a weak demand and strong supply with increased inflation expectations, and we conclude that reductions in short rates, which will be engineered by the Fed, will not be carried through to long-term yields.

— By Steve H. Hanke

Chart 1

Yields on Selected Treasury Maturities

Maturity	Yields: July 9, 1986 (Percent)	August 13, 1986 (Percent)	Change (Basis Points)
6 months	6.17%	5.77%	-40
1 year	6.34	5.94	-40
2 year	6.73	6.33	-40
3 year	6.93	6.49	-44
5 year	7.14	6.81	-33
10 year	7.31	7.13	-18
30 year	7.15	7.26	+11

Data Source: Federal Reserve Bank of New York

Chart 2

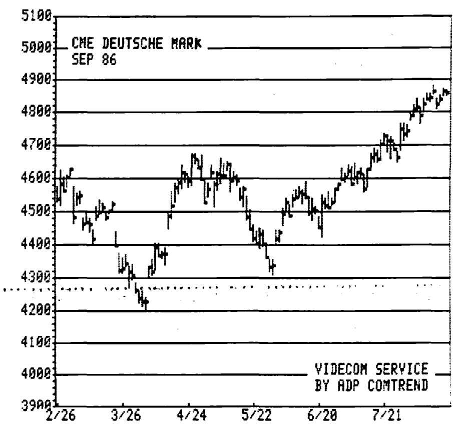


Chart 3

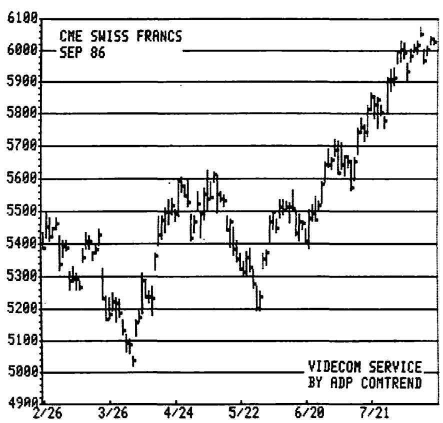


Chart 4

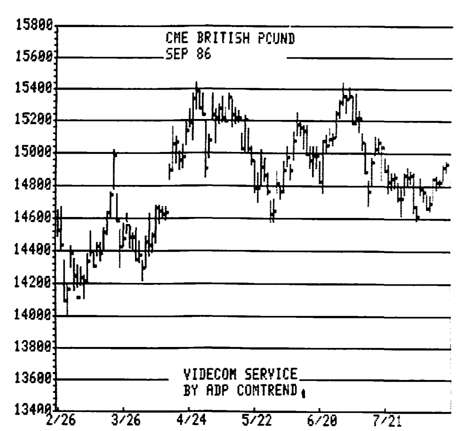
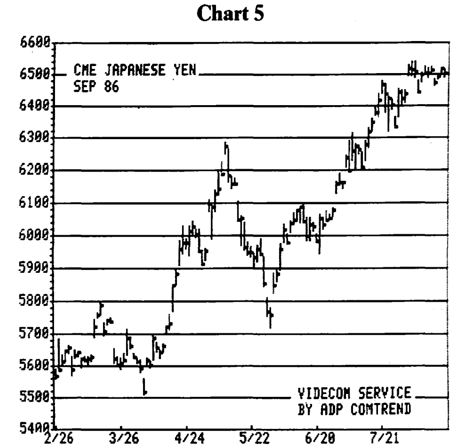


Chart 5



Gold

Gold is *still* (dirt) cheap — cheap being a relative word. One may want to ask, "Relative to what?" Relative to money. And since money today is only a government promissory note to pay money, then money is debt — government debt.

It matters little whether this government debt is interest-free (that is, banknotes and coinage) or bears interest (Treasury bills, notes, and bonds). All these forms of debt, ultimately, have two common characteristics: They help government spend more than its income, and they promise to be redeemed in more debt.

Once upon a time, government money bore a certain connection to gold. It was the days of the gold standard, and it was called the gold-cover ratio. The demise of the gold standard and financial innovation with respect to the diminishing proportion of government money in the total payments system made the gold-cover ratio a highly ineffective anchor in the turbulent sea of inflation.

By the late '60s, the minimum 25% statutory gold cover to paper currency — a vestige of the old gold standard — was smothered by the explosion of currency that was to accompany the post-Vietnam war inflation. Furthermore, earlier monetary authorities, in drafting the gold-cover ratio, never dreamed of the possibility of unbalanced budgets in peace time and the consequent possibility of circumventing the currency limit by the simple expedient of printing interest-bearing notes. And for the 15 years following World War II, they were right. Total government debt grew by less than 5% from 1945 to 1960.

During the 1960s, however, fiscal virtue came to an end, and total debt increased nearly 40%. In 1968 the last remaining restraint on money expansion was removed with the abolition of the minimum 25% gold cover. Admittedly, the growth of private money supply and interest-bearing government debt made the "collar" rather ineffective. On the other hand, since currency was bound to retain a certain relationship to these new forms of money, an explosion of the latter was likely to be accompanied by a large rise of currency — an intolerable situation under the minimum gold-cover ratio statute. As an example, currency grew approximately 10% from 1945 to 1960 and then doubled by 1972 and doubled again by 1980. A weak constraint on total money creation, but a constraint nonetheless.

Backing a currency with gold has not been fashionable for more years than we care to remember. It is not a sign of adherence to the rules of the game. There are no rules, and there is no game. It is not a sign of prestige. Nor is it a sign of "hardness." It is not even *relevant*. So what is the fuss? Simply this: that deep in the human psyche (and even deeper in the vaults of every central bank in the world) gold is the ultimate form of money. And if gold is expressed in "paper" money or "debt" money terms, it must bear a relationship to these financial creations. In an imaginary "money" portfolio, gold must have its place.

Chart 6 illustrates the relative "cheapness" of gold. As a ratio to total US government debt, it has reached the lowest readings since the late '60s, a period marked by the artificially suppressed price of $35/oz. Undoubtedly, there will be economists who will point to a permanent shift in preference for "paper/debt" money over "gold" money with the former bearing a real return and the latter remaining a barren asset. If true, gold's cheapness may be no bargain.

There are, however, a number of problems with this view. In the first place, a saturation point of "debt" money in portfolios cannot be far away if "debt" money continues to grow 8%-10% annually above real wealth. And that is precisely what is happening as US budget deficits reach new records and extend into the future as far as the eye can see.

Secondly, it has been shown that the rising curve of debt/GNP will continue to grow, generating expectations of monetization and rapid inflation, as long as the real cost of the debt exceeds the GNP's real rate of growth, a condition that exists at this time.

Thirdly, to the extent that inflation is measured by the latest 12-month increase in the Consumer Price Index, returns on "debt" money are considered positive. Therefore, US government obligations are yielding anywhere between 1%-3% real returns and the preference over a barren asset such as gold is understandable. But to the extent that *full nominal yields* on government obligations fully reflect future expectations of inflation — standing in sharp contrast with actual experience — there are no longer any positive returns. In effect, government obligations can be said to reflect real yields only to the extent that future inflation rates (out to 30 years) prove as low as present inflation rates. If not, "debt" money holds no advantage over "gold" money. Under conditions of uncertainty and over the medium term gold's role in the money portfolio should remain relatively constant. Therefore, low gold ratios are bargains.

In March 1985 we suggested that gold had entered a bull cycle and titled that month's publication "Gold: a time to buy." Ever since then, spot bullion prices have firmed up and now stand approximately 20% higher than in the spring of 1985. Admittedly, this has not been a great performance, especially in view of the dramatic gain made by the so-called financial assets. Admittedly, too, our very bullish expectations then ('Gold is... a currency play with a long term shot at the moon') have as yet not been realized. What is remarkable, however, is that gold's rise has taken place during the most ferocious commodity bear market in a decade. This supports our view that gold is no ordinary commodity.

In recent weeks the market has begun to strengthen even in Swiss franc, Deutschemark, or Japanese yen terms (see Chart 7), providing the first indication that the next bear phase in the dollar will be more profitably played via gold then via those three hard currencies.

One last comment. As is very typical in the early stages of a bull market, the initial phase is characterized by a great deal of pessimism and by a surprisingly rapid upmove. The low CPI reading of the past few months as well as the ongoing deflation in the commodity markets have made the gold bears very complacent. But this bull move is focussing on 1987 CPI figures (5%-8%) and much higher inflation rates in the 1988-1990 period, as the Fed fights to stave off a massive recession.

The bears are trapped. The stage is set for a dramatic rise.

STRATEGY: *We have added to our long positions on the close above 371, basis Comex nearest contract. Remain long, and hold on tight.*

Chart 6

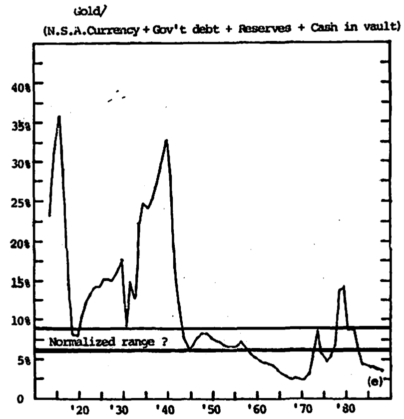


Chart 7

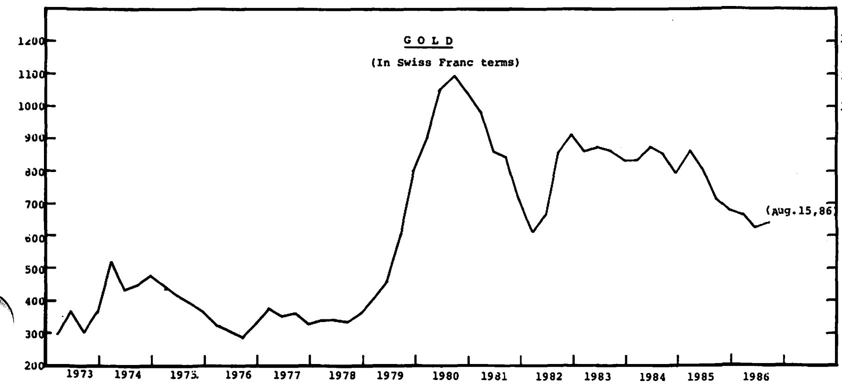
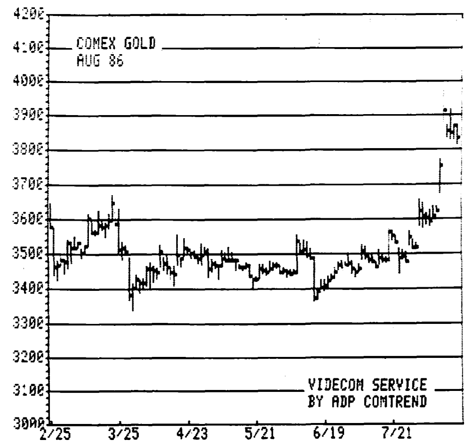


Chart 8



Platinum

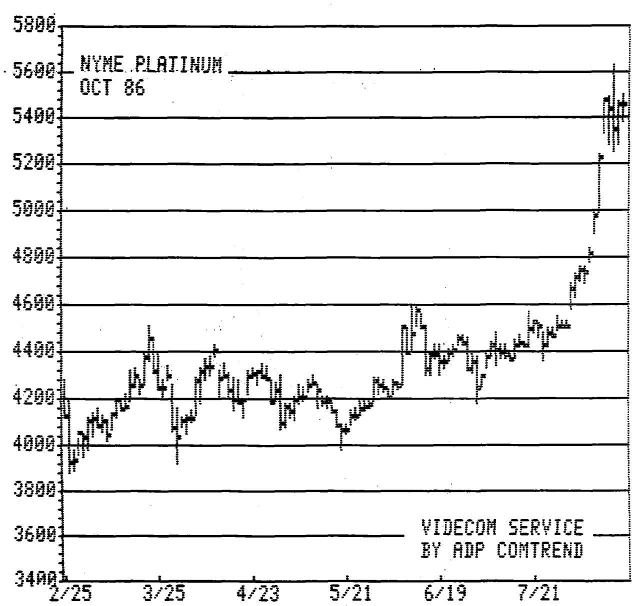
Gripped by "sanctionitis," platinum prices skyrocketed in recent days, trading a full $140/oz. higher than in late June. Its premium to gold has continued to widen and now stands at $160/oz. (after having trade at a $50 *discount* to gold in the summer of 1985). The rising tempo of speculation has not yet reached climactic proportions, as open interest hovers at barely 20,000-21,000 contracts, well down from the highs seen earlier this year and only 5,000-6,000 contracts above a more normal position.

It would appear that the bulk of speculative activity is taking place in the spot market, where purchases are made primarily for cash (no leverage). As a result, the advance is less vulnerable to profit-taking or an early termination of the bull market.

If history is any guide, platinum prices will move into backwardation (that is, near contracts will trade above back months) before we can expect a real threat to this spectacular rise.

STRATEGY: *Remain long; raise stops to 455, basis October '86, close only.*

Chart 9



Currencies

The short side of the cross: an update

To paraphrase the immortal bard: "Methinks the gentleman doth protest too much." Recently, Kenneth Clarke, employment secretary for Mrs. Margaret Thatcher's government in the UK, was heard to resoundingly denounce pay bargaining, that venerable British tradition, as the source of the peculiar phenomenon of high unemployment in an expanding economy.

Though the goings on in Mrs. Thatcher's beleaguered government are every bit as murky as Shakespeare's *Hamlet*, there's no doubt at all about one of the biggest causes of consternation in that green and pleasant land: Unemployment it is — and it continues to balloon, rising in July to a provisional seasonally adjusted total of 3.22 million. The astounding average rise of 12,000 per month over the last six months compares, not very well, with average rises of 5,000 per month in the previous six-month period to January 1986.

Now that we've set the scene, back to Mr. Clarke, the man in the unemployment hotseat. Hoping to add some icing to his remarks about pay bargaining, Mr. Clarke opined that there could be no justification for increases of 7.5% in average earnings when the rate of inflation, at 2.5%, was the lowest in the UK for almost 20 years.

The gentleman doth really protest too much. The UK's true inflation rate is a lot closer to 7.5% than 2.5%. In fact, non-tradable prices and costs (which include labor, services, and real estate) are soaring. A recent example was the 27.3% rise shown by prices of housebuilding sites in South East England in the 12 months to April 1, 1986. Even more spectacular was the 42.3% increase in the price of residential land in inner London.

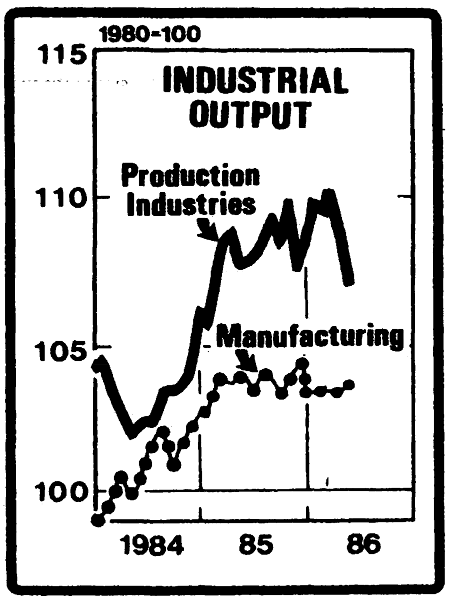
Clearly, as we discussed in our last issue, the extraordinary and persistent increase in narrow and broad money supply, have created enormous distortions in the ratio of non-tradable to tradable goods, increasing the former at the expense of the latter. It has dramatically reduced the UK's external competitiveness, increased unemployment, precipitated the country into an early recession (see Chart 10), and set the stage for a vicious devaluation.

Since our last issue, in which we recommended the short side of the cross, Sterling has depreciated 11% against the Swiss franc and 9% against the Deutschemark. As the election date nears and UK unemployment soars, the authorities may not have many choices open: The most straightforward and least costly in political terms is opting for a real trade-weighted depreciation of 25%-35% from the June 1986 levels. There are indications that, in fact, this route has been chosen.

Unfortunately, monetary policy is not fully conducive to the necessary adjustment, as the Bank of England persists in allowing inordinately large increases in money supply. As Dr. Hanke points out in our introductory comments, this action will tend to negate the beneficial effects of a devaluation and force a vicious spiral of devaluations and inflation.

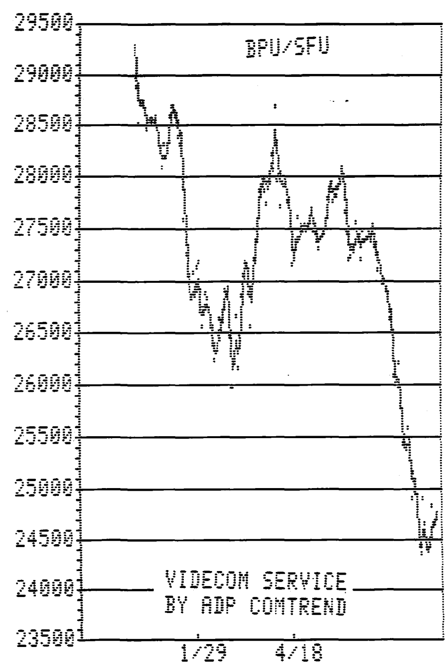
STRATEGY: *We remain comfortably short the British pound versus a long position in Swiss francs and/or DM. Logically, the trade-weighted depreciation still has a way to go. And a permissive Central Bank can push it a great deal further.*

Chart 10



Financial Times

Chart 11



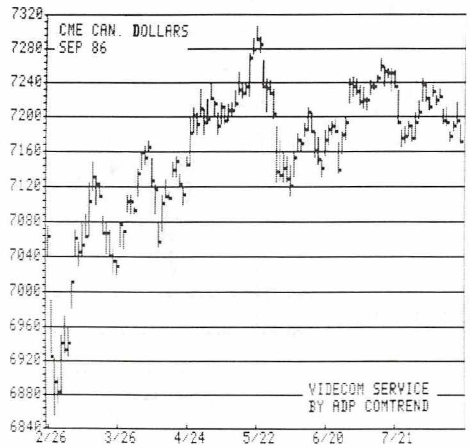
Canadian dollar

Positive reflows in net official monetary movements over the past four months add up to less than $1.2 billion, slightly less than half the loss experienced in the first quarter of 1986. So much for the famous recovery.

Technically, the Canadian dollar is completing a top formation in a very narrow congestion area and looks ready to break down in a significant way. We are resuming our very bearish posture.

STRATEGY: *Sell Sept. 1986 CD at market.*

Chart 12



Oil
The $2 billion sure thing

Netback agreements contain a wonderful incentive for sellers/producers to talk up a market *subsequent to a sale.* In effect, under this agreement, the seller passes to the buyer physical possession of the crude while retaining ownership for price purposes. Saudi Arabia's (and the other practitioners') "netback" crude pricing system linked the price of crude to the price of oil products usually prevailing 30-60 days later (the time it takes to transport and refine). Refiners, only interested in earning a refiner's spread, care little about the direction of the market. Sellers, on the other hand, have found willing buyers but bear the full cost or reap the full rewards of market fluctuations.

Towards the end of June, the Saudis had upped production above 5 million barrels per day (b/d), 700,000 b/d above their self-imposed quota of 4.3 million b/d. These sales were not to be *priced* until the first two weeks of August, at the earliest. In July, the Saudis increased production further, reaching an average of 5.4 million b/d. At the beginning of August, Saudi Arabian oil production was rising close to 8 million b/d and was projected to average as much as 6.4 million b/d for the month.

The Saudis had an immense amount of oil at stake, ready to be priced between early August and late September. Using "back-of-the-envelope" calculations, every $1/barrel rise in the price of crude after August 1st and even if it proved only temporary (that is, 60 days) represents $340 million in additional revenues. A $3/barrel rise, $1 billion. A $5 rise, as it turned out, $1.7 billion. And there is more. The Saudis, no doubt, unloaded a substantial portion, if not all, of the floating storage which could have added an additional $300 million. The grand take: $2 billion.

It is this trading maneuver that lies at the heart of the Saudi's "sudden" change in policy. On the one hand, no doubt they wished to slow the price decline to maximize production and total revenues. On the other hand, their long-term goal of regaining control of the world crude market, stimulating consumption, pricing-out competition, and dealing Iran a fatal financial blow could not be overturned for the mere sake of gaining an insignificant amount of revenue (absent netbacks, a 30% drop in output may or may not increase prices by more than 30%, at least over 60 days). With netbacks in place, the Saudis felt the gamble was well worth it: $2 billion, a show of cooperation (heavily couched in conditional language), and just a 60 day commitment.

Turning to the "critical" September/October period, it should be noted that last year, Opec output averaged 16.6 million b/d, perhaps 200,000 b/d less than what is now being planned (assuming no cheating). The big difference in the four months leading to this period: in 1985, output averaged 14.4 million b/d, while this year it averaged a whopping 5 million b/d more — representing a total increase in unwanted stocks of 600 million barrels!

Refiners' spreads (Chart 13) continue very weak, indicating difficulties in clearing products at these levels. With netbacks disappearing after September 1, it follows that crude purchases should collapse, making Opec production excessive, even at 16.8 million b/d.

Technically the market remains contained inside the trading range recorded in the first half of the year, $10-$17/barrel (see Chart 14). As we approach September 1, we expect the market to weaken and head, once again, to the $10/barrel mark. Short of the fall of Basrah, Iraq's second largest city, to the Iranians (an attack is expected in September), we anticipate the oil prices will move towards their inexorable target of $5/barrel.

STRATEGY: *Add to short positions, placing stops at 17.25, basis nearby, close only (change from 16.60, as per Hotline update).*

Chart 13

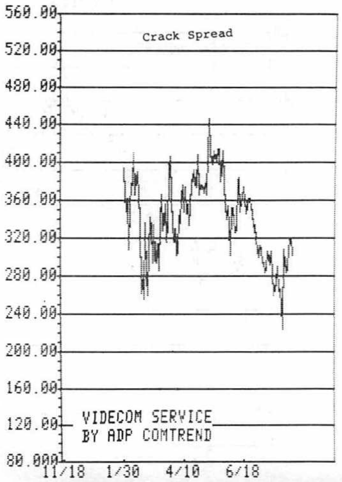
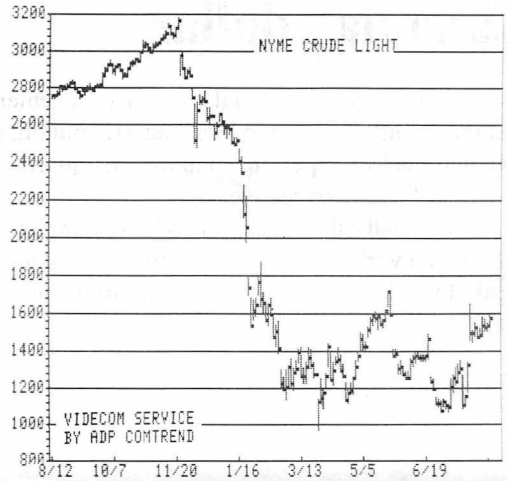


Chart 14



Stock Indexes

Despite the very "tradable" rally that has so far carried the S&P over 1600 points in less than two weeks, we remain unimpressed. Key stocks such as IBM and GM remain in solid downtrends; most importantly, breadth continues to lag. The widely-watched Value Line/S&P spread (which we discussed in the May 18, 1986 issue) remains locked in a downtrend (see Chart 15), which tells us that more and more secondary issues have failed to join the upside.

We are convinced that without a broad-based advance, this market is unlikely to make significant headway. And furthermore, the longer the breadth divergence persists, the more ominous the consequence, especially for the large capitalization stocks.

STRATEGY: *We entered the short side of the S&P on July 14 (as per Hotline message) at around 24200 and covered on August 12 via a 24175 stop. No pain, no joy. Stand by for a new sale recommendation.*

Chart 15

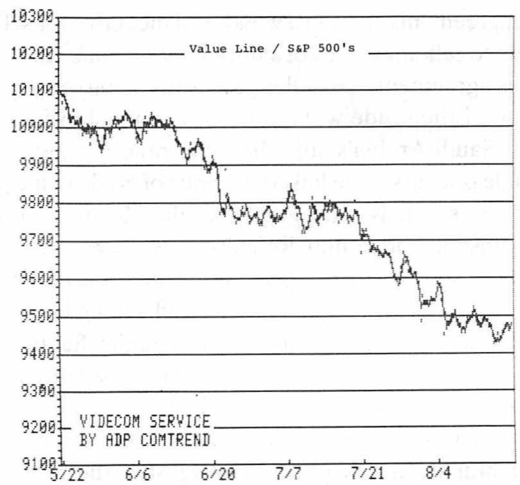


Chart 16

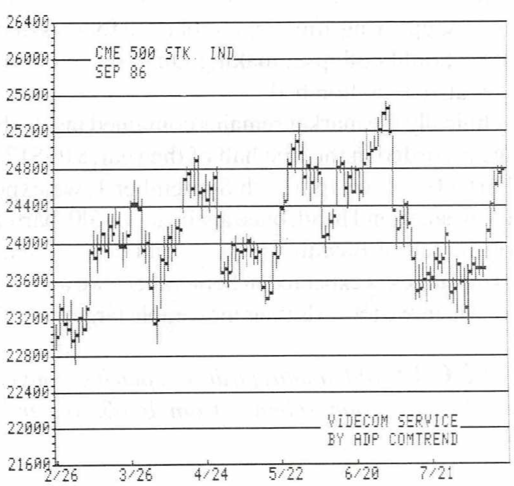
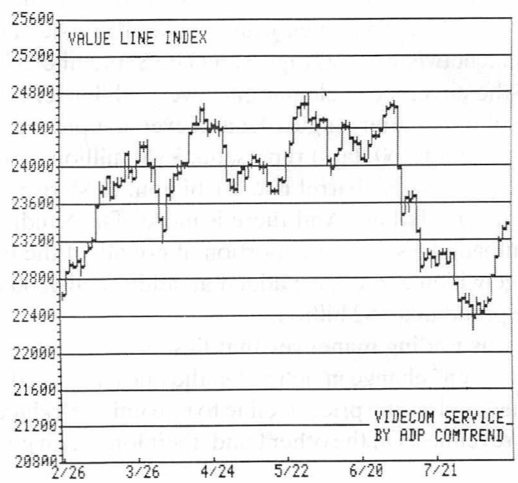


Chart 17



The Exotics

Spanish peseta

A sluggish rate of growth probably running in the neighborhood of 2% per annum has the effect of widening the country's current account surplus, now expected to reach a record $5 billion for 1986, but at the cost of maintaining a tragically high rate of unemployment (19.8%, June 1986). Spain's state budget deficit fell last year to a figure that represented 5% of GDP, against 5.5% in 1984 and 6% in 1982, the year the Socialists took over. Inflation continues to be running at 8% per annum — the same as for 1985 in spite of the introduction of the value added tax when Spain joined the EEC earlier this year.

Our calculations indicate that the peseta is becoming over-valued in real terms. Most probably it can be maintained at these levels only by further repressing economic growth. Domestic measures designed to reactivate the economy should translate very quickly into a deteriorating current account and a falling peseta. Therefore the domestic situation bears close watching for possible signs of reactivation. In the meantime remain neutral.

Chart 18

BASKET: U.S. 21% · FRANCE 25% · Germany 21% · ITALY 11% · NETHERL. 7% · UK 15

YEAR	SPANISH PESETAS PER U.S. DOLLAR (PERIOD AVG)	U.S. 1970=1.00	U.S. 1978 =1.00	BASKET 1970=1.00	BASKET 1978 =1.00
1967	61.08	0.8538	1.3978	0.9040	1.1818
1968	69.68	0.9661	1.5817	0.9670	1.2642
1969	69.85	0.9994	1.6363	0.9957	1.3017
1970	69.70	1.0000	1.6372	1.0000	1.3073
1971	69.24	0.9580	1.5685	0.9942	1.2997
1972	64.27	0.8471	1.3868	0.9257	1.2102
1973	58.26	0.7315	1.1976	0.8395	1.0975
1974	57.69	0.6959	1.1393	0.7943	1.0385
1975	57.41	0.6469	1.0592	0.7747	1.0128
1976	66.90	0.6929	1.1344	0.7856	1.0271
1977	75.96	0.6730	1.1019	0.7871	1.0291
1978	76.67	0.6100	1.0000	0.7649	1.0000
1979	67.13	0.5144	0.8422	0.6826	0.8924
1980	71.70	0.5395	0.8832	0.7483	0.9782
1981	92.31	0.6691	1.0954	0.8183	1.0698
1982	109.86	0.7385	1.2088	0.8415	1.1001
1983	143.43	0.8875	1.4531	0.9433	1.2333
1984	160.67	0.9318	1.5255	0.7162	0.9363
1985	170.04	0.9380	1.3357	0.7079	0.9254
1986 (1Q)	147.40	0.7768	1.2719	0.6829	0.8928

Above 1.00 = undervalued
Under 1.00 = overvalued

Chart 19

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Mln US$)
1970	1520	0.2	-510
1971	2969	2.0	543
1972	4436	1.1	1516
1973	6110	0.8	2022
1974	4402	-3.6	-2067
1975	2509	-3.3	-6126
1976	-146	-4.0	-11039
1977	-395	-1.7	- 9939
1978	3551	1.1	- 4791
1979	5275	0.6	629
1980	1097	-2.4	- 2411
1981	595	-2.7	- 9034
1982	-4347	-2.3	-14407
1983	4237	-1.7	-11980
1984	8396	1.4	- 4680
1985	10823	1.5	2365

Chart 20

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

Reserves * + Previous 12-months current Account *** = 22221
(Reserves + 12-months C/A)/MI ** = 22221/38490 = 57.7%
Reserves + 12-months C/A)/Broad Money ** = 22221/115650 = 19.2%
* As at Apr.'86 ** Nov.'85 *** 1986 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dolllars)
1975	32840	87950
1985(Nov.)	38490	115650
% Increase (decrease)	17.20%	31.49%
Corresponding % increase in the United States	108.55%	140.42%

(a) 1984 Imports as percentage of GNP 16.97%
(b) 1975 - 1984 Imports as percentage of GNP 13.90
1984/(1975 - 1984 average)= (a)/(b) = 16.97/13.90 = 122.08%

Source: IFS

Chart 21

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	133.65-133.75	1.3440-1.3470	135.55-136.05	137.05-137.65	139.90-140.75

Italian lira

The 8% devaluation of July 1985 coupled with the sharp reduction in oil prices have helped turn Italy's current account. It is now expected to be in surplus by $4 billion this year. As a percentage of GNP, this surplus represents the best performance Italy has had on its external front since 1978.

The inflation rate is expected to drop to 5.5% this year from 9.5% last year. Although moderate, this inflation rate is a full 5.5% higher than West Germany's thus opening up once again a purchasing power gap between the lira and the DM. In the medium term this gap is not likely to affect the forex value of the lira; however, it will continue to underpin Italy's high interest rate structure.

On a more negative note, the government's borrowing requirements this year will total nearly $63 billion, or 12% of GNP — only a slight improvement from the previous year's 14% of GDP. The public debt outstanding estimated at lira 634,900 billion last year represented 95.9% of GDP, and it seems to be taking a life of its own. Italy must urgently stabilize its debt to GDP ratio lest inflationary expectations arising out of an eventual monetization of the debt throw the country into an uncontrolled hyperinflation.

STRATEGY: *There is no change in our position. We remain long against the US dollar and neutral against the DM.*

Chart 22

BASKET: U.S. 16%, U.K. 11%, Germany 29%, BELGIUM 6%, FRANCE 24%, NETHERL. 7%, SWITZERL. 7%

YEAR	ITALIAN LIRE PER U.S. DOLLAR (PERIOD AVG.)	U.S. 1970 =1.00	U.S. 1977 =1.00	BASKET 1970 =1.00	BASKET 1977 =1.00
1967	624	0.9340	0.9939	1.0548	0.8986
1968	623	0.9569	1.0182	0.9589	0.8169
1969	627	0.9920	1.0556	0.9857	0.8397
1970	627	1.0000	1.0641	1.0000	0.8519
1971	618	0.9779	1.0406	1.0206	0.8695
1972	583	0.9039	0.9619	1.0065	0.8575
1973	583	0.8649	0.9203	1.0462	0.8913
1974	650	0.8995	0.9572	1.0846	0.9240
1975	652	0.8432	0.8972	1.0716	0.9130
1976	832	0.9734	1.0358	1.1773	1.0029
1977	882	0.9397	1.000	1.1738	1.0000
1978	848	0.8671	0.9227	1.1811	1.0062
1979	830	0.8230	0.8758	1.1770	1.0027
1980	856	0.7944	0.8454	1.1551	0.9840
1981	1136	0.9882	1.0515	1.2233	1.0421
1982	1352	1.0707	1.1393	1.2391	1.0556
1983	1518	1.0827	1.1522	1.1720	0.9984
1984	1757	1.1790	1.2546	1.1677	0.9940
1985	1909	1.2145	1.2924	1.3103	1.1163
1986 (1Q)	1598	0.9823	1.0453	1.2096	1.0305

Above 1.00 = undervalued
Under 1.00 = overvalued

Chart 23

Year	Foreign Assets (Mln US$)	CURRENT ACCOUNT As % of GNP %	CUMULATIVE 12 QTR. Current Account (Mln US$)
1970	5,556	0.89	5996
1971	6,616	1.83	5347
1972	5,589	1.54	4934
1973	5,231	-1.64	1494
1974	1,116	-4.74	-8608
1975	+ 964	-0.30	-11181
1976	4,228	-1.54	-11544
1977	9,016	1.13	-1041
1978	20,400	2.38	5776
1979	34,359	1.66	14091
1980	46,289	-2.47	1850
1981	39,340	-2.45	-12991
1982	30,884	-1.64	-24089
1983	37,517	0.16	-13733
1984	32,746	-0.83	- 8000
1985	27,980	0,18	- 1716

Chart 24

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

Reserves * + Previous 12-months current Account *** = 50016

(Reserves + 12-months C/A)/ M1 ** = 50016/156460 = 31.9%

(Reserves + 12-months C/A)/ Broad Money **= 50016/266880 = 18.7%

*As at May 1986 ** October '85 *** 1986 Estimated

Figures in millions of U.S. Dollars

	M1 (Converted to U.S. Dollars)	Broad Money (Converted to U.S. Dollars)
1975	98186	171160
1985(Oct.)	156460	266880
%Increase (decrease)	59.3%	55.4%
Corresponding % increase in the United States	105.3%	138.9%

(a) 1985 Imports as percentage of GNP = 24.25%
(b) 1976-1985 Imports as percentage of GNP 22.66%
1985/(1976-1985 average) = (a)/(b) = 107.01%

Source: IFS

Chart 25

RATES	SPOT	1 MONTH	3 MONTH	6 MONTH	12 MONTH
	1418-1420	1419-1422	1419-1422	1421-1424	1424-1427

Forex Rates & Update

Currency	*Spot*	*3-Month*	*12-Month*	*Comments vis à vis US$*	*Comments vis à vis DM (Spot DM 2.0610)*
*Australian dollar	.6228-.5235	.6073-.6080	.5725-.5742	Stopped out at .6650; rentered long side at .6100. (see Hotline)	Same as Comments vis à vis US
Belgian franc	42.62-42.67	42.72-42.81	42.92-43.12	Remain long	Remain long
Danish krone	7.74-7.75	7.79-7.81	7.96-7.99	Neutral	Remain short
Dutch guilder	2.3205-2.3215	2.3157-2.3172	2.2995-2.3025	Remain long	Remain long
Greek drachma	134.40-135.00	139.15-141.75	152.40-160.00	Neutral	Remain short
Kuwaiti dinar	.29070-.29090	.29140-.29200	.29320-.29510	Neutral	Remain short
*Malaysian ringgit	2.5800-2.6400	2.5900-2.9000	2.5900-3.4000	Covered (see Hotline)	Covered (see Hotline)
New Zealand dollar	.4935-.4950	.4809-.4834	.4500-.4565	Remain long	Remain long
Norwegian krone	7.33-7.34	7.48-7.50	7.90-7.94	Remain long	Neutral
Portugese escudo	146.00-146.30	148.50-150.80	153.50-163.50	Neutral	Neutral
Saudi Arabian riyal	3.7500-3.7520	3.7900-3.7970	3.8500-3.8670	Remain short	Remain short
*Singapore dollar	2.1560-2.1570	2.1480-2.1500	2.1240-2.1370	Covered (see Hotline)	Covered (see Hotline)
Swedish krona	6.92-6.93	6.98-7.00	7.12-7.15	Remain long	Neutral
Venezuelan bolivar	19.50-19.60	19.60-19.90	19.70-20.70	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, June 24: No changes or new recommendations. Next regular update Friday, June 27.

Wednesday, June 25, 2:30 p.m.: This is a flash bulletin. Reinstate short positions in September T-bonds, at the market, using a stop of 9913, good anytime.

Thursday, June 26, 8:30 a.m.: Liquidate profitable short positions in Malaysian ringgit and Singapore dollar, at the market. Also, as of yesterday's update at 2:30 p.m., you are now once again short September T-bonds with a stop at 9913, good anytime.

Friday, June 27: A recap of the week's activities.
1) As of Wednesday's flash update, you shorted the September T-bonds. This position was stopped out this morning at 9913.
2) As of Thursday's flash update, you have covered the short Malaysian ringgit and Singapore dollar positions.

Tuesday, July 1: Liquidate long Australian dollar positions at the market. The market letter was mailed last week. No other changes. Next regular update Thursday, July 3.

Thursday, July 3: A recap of the week's activities.
1) The market letter is in the mail.
2) The Australian dollar long position was liquidated. Next regular update Tuesday, July 8.

Tuesday, July 8: We have several new recommendations.
1) Sell all long positions in September copper at 5825 on stop, good anytime.
2) Lower stops in crude oil to 1385, basis September, good anytime.
3) Aggressive investors can sell September S&P at the market, risking 245.10, good anytime.

Friday, July 11: A recap of the week's activities.
1) Sell all positions in September copper at 58.25 on stop, good anytime.
2) Lower stops in crude oil to 1385, basis September, good anytime.
3) Aggressive investors can sell September S&P at the market, risking 245.10, good anytime.

Tuesday, July 15: One new recommendation; lower stops in September S&P to 241.75, good anytime.

Friday, July 18: A recap of the week's activities. Lower stops in September S&P to 241.75, good anytime.

Tuesday, July 22: No changes or new recommendations.

Friday, July 25: No changes or new recommendations.

Tuesday, July 29: We are reminding you, as stated in our newsletter of June 22, that there will be no market letter in July. As a result, here is a status report of all recommendations that remain valid since our last issue.
1) As per our flash update at 8:30 a.m., Thursday, June 26, we have liquidated our short position of Singapore dollars and Malaysian ringgits.
2) As per our update of Tuesday, July 1, we have liquidated our long Australian dollar position.
3) As per our update of Tuesday, July 8, we have lowered stops in September crude to 1385, good anytime.
4) As per our update of Tuesday, July 8, aggressive investors are now short the September S&P, and as per our update of Tuesday, July 15, our stop is 24.75, good anytime.

Friday, August 1: See: Tuesday, July 29 (repeat)

Tuesday, August 5, 9:10 a.m.: An important flash update. Due to wildly emotional markets and the lack of reliable information on an Opec agreement, we advise that all buy stops in crude oil be temporarily withdrawn as of this morning. Stay posted for a follow up message after 2:00 p.m. today.

Tuesday, August 5: In a flash bulletin released this morning at 9:10 a.m., we advised withdrawing buy stops on crude oil positions in view of the overly emotional reaction of the market to the new Opec agreement and the scant information coming out of Geneva. We are still not able to analyze properly the agreement, principally because we have not been told about quota allocations, that is, who will bear the output cutbacks.

Clearly we are not impressed. First, it will be extremely difficult to reduce output almost 4 million barrels per day; second, Iraq is not participating; third, the agreement begins September 1, allowing Opec members to continue to overproduce and even more so in the coming weeks; fourth, it will only last two months, presumably enough time to allow seasonal demand factors to meet higher output levels toward the end of the year. Underlying demand for Opec output for the September/October period is still considerably lower than 16.8 million barrels per day, especially in view of present *anticipatory demand.* Opec is still working under the illusion that demand will increase. In sum, fundamental factors are still extremely bearish. Technically, today's market action was unconvincing. The market closed well below the middle of the range and almost $2/barrel below the correction highs recorded in May, despite what appeared to be extremely bullish news. Remain short and place stops at 1720, basis nearest contract, good anytime.

Friday, August 8: A recap of the week's activities. In a flash bulletin released Tuesday morning, August 5, we advised withdrawing buy stops in crude oil positions. In our Tuesday regular update, we suggested temporary stops of 1720, basis September. Two new recommendations: 1) Lower buy stops on crude oil positions to 1660, basis September, good anytime; 2) reinstate long positions in Australian dollars.

Tuesday, August 12: On August 11, we were stopped out of the short September S&P position at 241.75, based on our stop recommendation of July 15. No new recommendations.

Friday, August 15: No changes or new recommendations. One note — we were stopped out of our short position in September S&P at 241.75 on August 11. Thank you!

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